Linkages between capital structure policy and Malaysian real estate investment trusts property portfolio enlargement

Rohaya Abdul Jalil¹, Maimunah Sapri¹, Tiong Chai Ping¹

¹Centre for Real Estate Studies, Faculty of Geo-information & Real Estate, University Technology Malaysia

¹rohaya@utm.my

Abstract. The superiority of real estate investment trusts (REITs)' tax regime which gives tax waived provided REITs distributed 95 percent of earning to unit holders, had limits its potential to expand in term of its property portfolio enlargement (PPE). This study aims to determine the links between capital structure policy of Malaysian REITs (M-REITs) and PPE agenda. Adopting a descriptive analysis and deployed a ten years data of M-REITs, this study reveals that there is an opposite relationships between debt-to-equity ratio (D/E) and the average increase percentage of property total value (AIPPTV). This study indicates that as D/E grows, there will be a resistance in PPE agenda. This explains the poor size of M-REITs properties total value, which 58 percentage of it is less than RM1 billion. This study suggests M-REITs should plan their PPE financing option as the cost of debt (k_d) advantage when lower interest rate imposed. There other factors influence REITs PPE such as the quality and the performance of properties, properties diversification in term of property type, geographical and size, institutional ownership of the property, externally managed managers and issue of cash flow of majority unitholders in REITs.

1. Introduction

The superiority of Malaysian real estate investment trusts (M-REITs)' tax regime rules tax waived for M-REITs companies which distributed 95 percent of earning to unitholders, had limits its potential to expand in term its property portfolio enlargement (PPE). Without further PPE, the distribution for unitholders remain the same or in fact lower for the coming year, indicating no or negative growth. This phenomenon, would depressed the unitholders and lead to exit the REITs and consequently cause REITs unit price diluted. Therefore, REITs need to plan for PPE to remain competitive in the market [1 and 2].

In the point of corporate finance, PPE can be implemented either through (i) new additional issuance of shares ; (ii) debt financing or ; (iii) internal sources of funding from retain earnings [3]. Nevertheless, third financial option above is not rational for REITs since they only left with 5 percent retained earnings to be brought forward for the subsequent financial year. This is the effects of the eligibility of tax waived given for REITs if distributes 95 percent of net profit after interest (NPAI) to the unitholders. Although internal sources of funding had its cost of capital towards the company, but it considered as lower compared to the other financial option.
However, the additional issuance of shares as well as debt financing have its own setback toward REITs. If additional issuance of REITs unit is adopted, it let an increase in number of unit in circulation [1]. Although, it lead an increase of NPAI but the increase of NPAI is not in tangent with the increase of REITs unit. This resulted less dividend per unit (DPU) distributed compare to the prior PPE by REITs. This will depressed REITs unitholders, and may lead them to exit their REITs investment. On the other hand, if debt financing is adopted, REITs will suffered financial commitment of interest payment regardless of profit making or not [4]. REITs will have a lower NPAI compare to the option of additional issuance of units [3], [5], [6] and [7]. Moreover, the tax shelter benefit would not be enjoyed by REITs since they are tax waived [1], [2] [8] and [9].

Therefore, REIT need to wisely decide which financing option to opt to materialize their PPE agenda. If PPE was not undertaken by REITs, and the properties portfolio remain the same, rental net operating income depleted over the year, and soon producing no growth for REITs distribution [2]. The investors will not tolerate with stagnant dividend yield (DY), moreover the effects of inflation will deteriorating the value of the distribution [10]. Distressed investors will exit their REITs investment thus diluted the REITs’ unit price. The balance trade-off between debt or equity as capital structure policy is crucial issue among REITs. The issue of over gearing with REITs companies is crucial since it implicates the REITs’ earnings in long run. Meanwhile, larger number of unit in circulation also resulted low distribution and effects the total return [11]. The Malaysian REITs Guidelines 2010, suggest the gearing level of REITs cannot more than 40 percent. Thus, does the combination of debt and equity proportion in capital structure would assists M-REITs PPE agenda? Thus, this study attempt to examine the M-REITs capital structure policy and to examine its interaction with M-REITs PPE. This study deployed a ten years data of M-REITs from year 2006 until 2015.

2. Property portfolio enlargement
The dividend yield distribution by REIT is superior than the average companies, resulted REITs is perceived as a long term investment by investors. Therefore, in order to remains competitive REITs need to strategize on their operating rental activities, and PPE is one of the initiatives to improve REITs performance. Nevertheless, the REITs disposition, limits their aggressiveness expansion in term of new properties acquisition in the portfolio. Left with 5 percent retained earnings remain brought forward from prior year, it is insufficient to finance new property acquisition. REITs need to consider for external funding such as additional issuance of unit or debt financing.

The property investment acquisition depends on the property size, preferences on property type and criteria for obtaining mortgages [12]. Meanwhile [13], propose a normative model of the property investment decision- making process in REITs, in which comprised of stage of envisioning, planning, dealing and executing. Besides need to emphasised on the objectives, asset identification, portfolio impact assessment and post audit of property acquisition. The REITs shareholder return had a significant relationship with property portfolio acquisition. This excess return were as effect when REITs reconfirm their geographical focus in the property acquisition, private debt financing adopted or private placement with financial institutions to finance the acquisition transactions [14]. However, REITs due to not pay taxes, shown abnormal return in real estate sell-offs by all type of REITs. While, there inverse relationship between the REITs decision to benefit sale proceed to surrender long-term debt and the abnormal return [15]. The credit line availability had a significant relationship with property acquisition of the firm [16]. Besides, there are inverse relationship between REIT size and weighted average cost of capital (WACC) [17]. In fact, for all cost-of-capital measures found significant economies of scale, such as the positive and
significant relationship on firm size. While financing through equity are the mean for PPE compared to
debt financing [18].

A contradict argument of properties restructuring effects of REITs by [19], that highlighted that REITs
sell-off their property was to retire the long term loan as well as a strategy to repurchase new property
cash from the sale proceed of earlier property divestitures. Moreover, the property sell-off by REITs was
mechanism to reduce geographical dispersion and property type diversification, and as a strategy to
increase operating efficiency within REITs property concentration.

3. New additional issuance of REITs unit
Tax shelter is not been enjoyed by REITs resulted no advantages on debt financing. Thus, additional
issuance of unit depends on financial situation sentiment, listing cost and cost of equity. The firm has an
optimal capital structure, and new security issues represent a movement away from or toward this
optimum. Determinants of the optimal capital structure may include taxes (as alluded to in the
introduction), expected bankruptcy costs, and the minimization of agency costs. For a REIT, the optimal
capital structure (based solely on tax considerations) is likely to be one hundred percent equity [20]. The
implied-cash-flow change hypothesis suggests that unexpected offerings of securities, whether they are
debt or equity, are used by investors to infer that operating cash flows are lower than expected [21]. As a
general rule, REIT operating cash flows are difficult to forecast. For example, it is relatively easy to
forecast the depreciation deduction and debt service with a fixed-rate mortgage but much harder to
forecast expected rents, vacancies, or selling prices. Since the tax code by which REITs must abide forces
them to follow a policy of high dividend payout rates, REITs should employ external markets more
extensively than do corporations [22]. It follows that external security issues by REITs may be more
predictable than for corporations. The issue of informational asymmetry has several different implications.
First, firm managers may be viewed as having superior information and may wish to convey that
information to the market. One way to accomplish this is through capital structure changes [23]. The
managers with more information may decide to issue securities whenever the securities are overpriced in
the market. In turn, the market may react negatively to the announcement of the issuance of any new
securities [24]. Thus, the prediction of the informational asymmetry hypothesis is ambiguous.

4. Debt financing
The REITs decided to hold little cash to reduce the agency problem of cash flow and in a long run, it
increased transparency and reduced the future cost of external capital [25]. The REITs dividend policies
were being determined by agency cost, while higher payout ratio were favoured by the investors as they
use it as a device to supervise management investment decision [26]. On average, dividend payout ratio of
REITs was 70 percent higher than what was required by the tax regulation. This was due to the agency
theory that explained the excess dividend phenomenon [27]. The determinants are such as free cash flow,
management type, firm size, real estate investment growth rate, leverage ratio and return on asset(ROA).
Despite the restriction of tax regulation on REITs, the REITs still benefit the use of debt. This is because
REITs had advantages in terms of its tangibility to attract better debt deal compared to non-REIT
companies [1], [28], [29] [30] and [31].

The larger the size of REITs, the more advantages in debt financing choice and difference property
type result in different return which affect lower financial risk [1]. REITs of riskier firm tend to reduce the
overall company uncertainty by adopting a more careful capital structure due to negative relationship
between operating risk and leverage. The REITs’ size was directly influenced by the amount of debt
issued which confirmed the hypothesis that debt was cheaper for bigger firm. While its issue was affected
by economies of scale. The REITs’ size is an important factor in determining their strategic and financing choices, where larger REITs have less constrain when seeking fund in the capital market compared to smaller REITs that need to focus on achieving financial return. The tangibility of REITs asset caused more favourable financing term because the nature of fixed asset was to retain more value in case of liquidation. REITs with more operating risk will choose low financial risks. However, this seems to be the opposite of the finding by [32], on the scale of efficiency on increase cost of debt. The diversified REITs were less levered due to its low collateral value of assets and less attractive [28]. The pecking order theory on cost of capital indicated REITs with more growth opportunities will have higher leverage ratios. The tangibility of asset result in a positive correlation with leverage and riskier operating REITs choose a lower financial risk and low gearing. The following Figure 1, depict the simulation on wealth effect of debt financing over the additional issuance of share. This tax implication on REITs and Non-REITs companies are portrayed, besides that the earning implication financing option. Although the Figure 1, showed that REITs which adopt debt financing enjoyed high dividend per unit (DPU), but this is subject to lower interest rate. Besides, the REITs should benefit the information asymmetry on the equity financing if the issuing cost is lower than the cost of debt financing.

| Non REIT (RM’000) | REIT (RM’000) |
|-------------------|---------------|
| **Adopt Debt Financing** | **Adopt Additional New Issuance of Unit/share** |
| Net Profit Before Interest & Tax (NPBIT) | 130 | 130 | 130 |
| Less: Interest | (30) | (30) | (-) |
| Less: Tax(24%) | 100 | 100 | 130 |
| Net Profit After Interest & Tax (NPAIT) | 76 | 100 | 130 |
| **Dividend Distribution** | | | |
| REIT Tax regulation at REIT 95% | 95 | 123.5 |
| Non REIT company at 60% (assumption) | 45.6 | |
| Retained Earnings | 30.4 | |
| Therefore, dividend per unit(DPU) | 45,600 | 95,000 | 123,500 |
| = 4.6 sen | = 9.5 sen | = 9.0 sen |

**Assumption**

i. Additional capital investment need is RM 375,000.00.
ii. The existing the number of unit/share is 1,000,000 with face value RM1.00 each.
iii. New Issuance of Unit/Share for RM375,000 for capital investment result in additional number of 375,000 unit/share.
iv. Debt financing is at 8% interest yearly.

**Figure 1.** The simulation on wealth effect of debt financing over the additional issuance of share

*Source: Authors compilation*
5. Data analysis and discussion

The following Table 1 is the correlation analysis table of the linkages between capital structure policy and M-REITs PPE. It is showed that $K_d$ had a insignificant relationship with TPV (corr: 0.023), while $K_e$ had a significant relationship with TPV (corr: 0.397). The result indicates that M-REITs PPE is execute through financing option of additional new issuance of REITs unit [24] and [31]. The M-REITs are overpriced and the effect of information asymmetry encouraged additional new issuance unit compared to the debt financing. This resulted an overall influenced of WACC and TPV (corr: 0.204).

|                      | Kd  | Ke  | WACC | Debt/Equity Ratio | Gearing Ratio | Total Value of Property |
|----------------------|-----|-----|------|-------------------|---------------|-------------------------|
| Kd                   |     | 0.103 |     |                   |               |                         |
| Ke                   | 0.414 |     | 0.059 |                   |               |                         |
| WACC                 | 0.281 | 0.083 | 0.181 |                   |               |                         |
| Debt/Equity Ratio    | 0.292 | 0.060 | 0.215 | 0.983             |               |                         |
| Gearing Ratio        | 0.023 | -0.397 | 0.204 | 0.033             | 0.091         |                         |

Meanwhile the capital structure proportion which represented by D/E and gearing ratio showed (corr: 0.033) and (corr: 0.091) respectively. The result indicates that gearing ratio had superior impact on TPV.

Further analysis on D/E ratio and gearing ratio upon the average increase percentage of property total value (AIPPTV) showed in Figure 2 which consist Gering Ratio and D/E ratio. There are 42 percent of M-REITs gearing below than 20 percent and had AIPPTV at 13.2 percent. Another 43 percent of M-REITs gearing between (20 percent < x < 40 percent) show they had AIPPTV at 13.5 percent. There are 17 percent of M-REITs is geared between (40 percent < x < 60 percent) and they had AIPPTV at 10.9 percent. Meanwhile D/E showed that there are 60 percent of M-REITs D/E below than 40 percent and had AIPPTV at 25 percent. Another 34 percent of M-REITs D/E between (40 percent < x < 80 percent) show they had AIPPTV at 34.8 percent. There are 6 percent of M-REITs D/E more than 80 percent and they had AIPPTV at 5.2 percent.

This study reveals that there is an opposite relationships between debt-to-equity ratio (D/E) and the average increase percentage of property total value (AIPPTV). It indicates that as D/E grows, there will be a resistance in PPE agenda. This seem to confirm the prior findings on the significant relationship of $K_e$ and TPV which implied that equity financing would be preferable as mechanism of M-REIT PPE. Figure 3 show the M-REITs property total value hold from year 2006 until 2015. This explains the poor size of M-REITs properties total value, which 58 percentage of it is less than RM1 billion and only 3 percent of M-REITs PTV more than RM5 billion. This study suggests M-REITs should plan their PPE financing option benefiting the information asymmetry on equity financing $K_e$ and took advantage of cost of debt ($K_d$) when lower interest rate imposed.
Figure 2. The relationship of gearing ratio, D/E ratio and average increase percentage of property total value.

Figure 3. M-REITs property total value hold from year 2006 until 2015.
6. Conclusions

The M-REITs PPE is important in order to ensure the REITs remain competitive as a long term investment instrument. The information asymmetry advantages on equity financing should be benefited since M-REITs is positively perceived and overpriced. Besides, debt finance also should be considered when the lower interest rate is offered. The capital structure policy is one factor that had been taken into account upon M-REITs PPE. Moreover, there are other determinants such as the quality and the performance of properties, properties diversification in term of property type, geographical and size, institutional ownership of the property, externally managed managers and issue of cash flow of majority unitholders in REIT that had influences on the M-REITs PPE agenda.

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