Securitizing Real Estate - A Primer on the New Financial Instrument

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Real estate has been traditionally regarded as a lumpy and illiquid investment. The acquisition of a real estate asset involves large capital outlays, which is, in most cases, beyond the reach of small investors. Therefore, the indirect avenue by which the small investors could ride on the upward property cycle and reap the economic benefits is to invest in the shares of listed real estate companies. Studies have shown that there are strong relationships between the performance in real estate market and the prices of the real estate stocks listed on the Singapore Stock Exchange (SES). The investors, in this case, are nonetheless still one step short of being able to directly participate in the sharing of the revenue generated from a specific property.

In the UK, unitization vehicles such as Single Asset Property Company (SAPCO), Single Property Ownership Trusts (SPOT) and Property Income Certificates (PINC)s have been introduced to facilitate investors to take up the equity interests and directly participate in the rental and capital value performance of a property. In the US, the comparable vehicles like mortgage-backed securities and real estate investment trusts are also created for securitizing illiquid real estate assets. Listed and unlisted property trusts are the answer to the real estate securitization in Australia. The secondary market instruments are also promoted by the government of Singapore to offer more options for investors to take part in the real estate market activities. The following statement was made by the Monetary Authority of Singapore (MAS) in response to a question by the Business Times on 20 July 1998:

“MAS recognises the potential benefits of asset securitisation. We plan to develop the securitisation market here. We encourage market players to provide regular inputs on the concept, and will work closely with them to promote the growth of a vibrant and well-regulated asset securitisation industry.”

Property-related securitisation surfaced in Singapore in 1986 with the first mortgage-backed bond (MBB) issued with pledges on the first legal mortgage of the Hong Leong Building, the flagship office building of the Hong Leong Holdings Ltd. The MBB has picked up steam since the 1986’s issuance and accumulated a total of S$2.53 billion in 1998. Following the MBB, guidelines for setting up property funds in Singapore was

1 Business Times, “Asset Securitisation set to take off in Singapore,” 20 July 1999
announced by the Monetary Authority of Singapore (MAS) on 14 May 1999. The market response, however, has so far been rather lukewarm due to the low rental yields of commercial properties and the absence of tax exemption incentives, as claimed by some researchers.

The third class of securitized real estate instrument is created via the sale of the 26-storey flagship building of the national shipping company, Neptune Orient Lines (NOL) to Chenab Investment Limited (CIL), a special purpose vehicle (SPV) set up to facilitate the financing of the transaction by issuing $185 million worth of 10-year fixed rate bonds. Commonly known as asset backed securitization (ABS), this form of securitization offers a new way for developers or property owners to raise fund and it quickly gains favor among property developers, which saw in 1999 alone, a total $1.82 billion worth of prime commercial properties being securitized (Table 1). The ABS will be the focus of discussion in this article.

### Table 1: Recent Asset Backed Securitization Deals in Singapore

<table>
<thead>
<tr>
<th>Issue Date</th>
<th>Property</th>
<th>Owner/ Originator</th>
<th>Market Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Mar 1999</td>
<td>NOL Building</td>
<td>Neptune Orient Line</td>
<td>$185 million</td>
</tr>
<tr>
<td>Jun 1999</td>
<td>Century Square Shopping Mall</td>
<td>First Capital Corp</td>
<td>$200 million</td>
</tr>
<tr>
<td>Jul 1999</td>
<td>Robinson Point</td>
<td>DBS Land</td>
<td>$193 million</td>
</tr>
<tr>
<td>Sep 1999</td>
<td>268 Orchard Road</td>
<td>DBS Land</td>
<td>$184 million</td>
</tr>
<tr>
<td>Dec 1999</td>
<td>Tampines Centre</td>
<td>DBS Bank</td>
<td>$180 million</td>
</tr>
<tr>
<td>Dec 1999</td>
<td>6 Battery Road</td>
<td>DBS Land</td>
<td>$878 million</td>
</tr>
</tbody>
</table>

*Source: Author*

**Securitization Process and Structure**

Securitizing real estate is a process of turning equity interest in real estate, which is illiquid and lumpy, into tradable securities such as bonds or shares. One key feature that distinguishes the ABS from the traditional mortgage-backed or collateralized loan arrangement is the separation or *off-the-balance-sheet* transfer of ownership of the real estate asset to a SPV. SPV is a trustee created to facilitate the “pay-through” of the receivable from the securitized real estate to the investors and also to isolate the investors from the bankruptcy risks of the originator. The setting up of a SPV helps to improve the transparency and also enhance the credit rating of the issues. For all the ABSs in Singapore thus far, fixed rate bonds are issued and sold by the SPV to private and institutional investors, which entitle them to directly claim on the rental flows and also partially share the price appreciation of the securitized building.

The structure of a typical real estate securitisation transaction is illustrated by the flowchart in Figure 1. Basically, the originator who is also the owner of a property will legally transfer *off-the-balance-sheet* the ownership right of the securitized property to a SPV in return for sale proceeds, which are determined on the basis of an open market valuation. The transaction is not dissimilar from other enbloc sales in the real estate

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3 *Business Times,* “NOL sells Alexandra HQ in $185m asset securitisation deal,” 31 December 1998.
market. However, there are two unique conditions/options attached with the sale and purchase agreements. The first condition allows the originator to lease back the property for a period no longer than the bond maturity, and the second condition gives the originator the right to buy-back the property, anytime after three years of the origination of the security, at a price that is between 65% and 75% off the prevailing market value. The SPV will finance the purchase of the securitized property by issuing and selling secondary market instrument in the form of bonds and redeemable preference shares to investors. The investors will then receive via the SPV a periodic fixed coupon payment, which is generated from the rental and other revenue from the property. In addition, the investors will also be entitled to a percentage share of any capital appreciation of the property when the originator exercises the options to buy-back the property.

**Figure 1: Structure of a Typical Asset Backed Securitization Deal**

*Source: Author & Cynthia Ng*

**Benefits of Securitization**

Securitization, or ABS in specific, creates a new way for property owners/developers to directly access to the source of funds from the investors/borrowers via a secondary market for real estate. In the ABS arrangement, the SPV takes over the roles of the traditional deposit-oriented financial intermediary, like banks and finance companies, to facilitate the matching and the exchange of cash flows between investors and property
owners/developers. From the investors’ perspective, ABS opens up an array of opportunity for them to directly own securitized interests on prime commercial properties. Investors, in particular the institutional investors, have shown overwhelming interests in the recent asset backed bonds. For example in the securitization of the Robinson Point, the market sentiments and responses to the bond issues are reflected in the articles of two main local newspapers,

“When DBS Land launched a property securitised bond last week for Robinson Point, an office building, retail investors snapped up a $20 million tranche reserved for them in just four hours.”
Business Times, 20 July 1999

“The response was overwhelming … the issue was oversubscribed by institutional investors alone.”
Straits Times, 17 July 1999

There are a string of reasons such as high interest rate, rising cost of originating loan and also tight liquidity in the debt market that have motivated the growth of securitization in the US. In Singapore, there may be different motivations that drive the securitization market. The current low and stable interest rate regime and the excess liquidity in the financial system give little incentive for developers to find alternative source of funds. However, the low interest and excess fund financial environment may not persist and the traditional deposit-loan structure may change with the impending liberalization of the financial and banking market. The time is, therefore, ripe for the banks to take a serious view on the impacts that the securitization would bring about on the conventional financial intermediation arrangement. A senior local banker made the following comments on the Business Time two years ago at the Business Times,

“We are looking at securitisation for our customers. We have potential deals that may come through. Credit lines are drying up and that is one reason why customers are prepared to listen.”
Business Times, 20 July 1998

For property developers / owners, securitization offers an alternative and viable way of securing long term productive capital at attractive terms. By transferring the property off-the-balance-sheet, it injects liquidity back to the company and also indirectly reduces the gearing of a company with heavy borrowing liability. This is also an effective way by which property developers/owners can diversify their financing risks. They are “insulated” against the floating interest rate risks by diverting from the traditional source of funds in the financial market. Another important motivation for property developers / owners to consider securitizing their real estate is the advantage where they can free up the capital “locked-in” in the holding of low yield properties. They can reinvest the capital to improve the yields and efficiency of the capital. A buy-back option that is

structured into the securitization deal, a feature that is unique to the Singapore market, allows the owners to retain the upside potential of the price appreciation of the property. This feature further enhances the attractiveness of the securitization deal.

The ABS bond yields that range from 5.50% to 6.75% are more attractive than the bonds issued by the government agencies like the Jurong Town Corporation (JTC) and the Housing Development Board (HDB), which give fixed coupon yields of between 3.875% and 5.0%. Therefore, it was not surprising to see the over-subscription in the Robinson Point’s ABS issues. Compared to the investment in listed property companies stocks, the ABS investors are protected from the credit and financial liability of the originator. In the case of the financial distress of the listed property company, the shareholders’ interests would be subordinated to those of the debtors and preference shareholders, and their equity interests may be eroded if the net assets of the company are insufficient to cover the accrued liability. Whereas, the ABS investors, on the other hand, are “immune” from the financial difficulty of the originator because their interests are backed by the securitized property that has been transferred off-the-balance-sheet of the originator. Therefore, ABS is a lower risk secondary market instrument vis-à-vis the listed real estate stocks. The tradability of the asset-backed bonds on the stock exchange at a marginal brokerage fee is another benefit, which is not available to the direct investment in physical assets.

**Impacts on Real Estate Market**

Asset securitization is certainly making its inroad to the secondary market in Singapore. Property developers with skills and experience in property development should better utilize their capital and efforts in the development activities rather than locking-in their productive capital on low-yield prime properties. In other words, more productive capital could be re-injected into the real estate market via securitization of the prime commercial properties. Investors are also open to more avenues in which they could diversify their investment portfolio into the property markets without having to assume the risks associated with the management and leasing of the physical properties.

For an active securitization market, there are still many practical and institutional issues that are yet to be resolved. The pricing of the ABS instruments and the premiums associated with the embedded buy-back and lease-back options, the rating of the instruments, the tax implications on the off-the-balance-sheet transfer of the property and the effectiveness of the pay-through structure for the SPV are some important questions that need rigorous research. Another critical issue is related to the information asymmetric of investors, i.e. a scenario where the originator has more knowledge of the properties selected for securitization than the investors. If the originators chooses to securitize only the less desirable assets, the investors may end up with “lemon,” a term that is used in economics to describe a product that is inferior in quality given the price.

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