A LITERATURE REVIEW ON DIVERSIFICATION STRATEGY OF MALAYSIAN REAL ESTATE INVESTMENT TRUST (M-REIT) AND IT’S PERFORMANCE

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Abstract

The aim of this paper is to review the performance of Malaysia REITs based on property type. Previous study has found that Malaysian REITs received poor response from investors both local and international. The study had shown that the underperformance of Malaysian REITs was linked to the unique characteristics of REITs’ property allocation. Some studies on REITs or real estate portfolio, however, have used property type as the determinant to examine their risk and return performance. This may show that the property type is the important determinant which can influence the performance of REITs. The lack of local study on this determinant of influence on performance of Malaysian REITs is a research gap, which needs to be explored that can provide more insight of it.

Keywords: Diversification, Economic location, Property Types, REITs

1.0 INTRODUCTION

Real Estate Investment Trust (REIT) is one type of indirect real estate investment. REIT is owned by listed companies that owns and actively manage the portfolio of high quality income of real estate such as commercial office, hotel, retail mall etc. In general, REIT must invest at least 50% of its total assets in real estate and the principal assets of the companies governing the REIT must be real estate (REITs Guidelines, 2012). Although REIT is being listed in the stock market but the rental income secures the income stream. REIT is required to distribute its 90% of taxable income to shareholders annually in the form of dividends. So, these characteristics of REIT makes it as a hybrid investment, offering liquidity as stock and the income stream, secured by a long lease in quality commercial real estate (Newell, 2012). Furthermore, REITs are investment vehicles, which are able to provide wider diversification opportunities, greater liquidity of funds, ease of operations, and the ability to diversify at any level of investments (Chan et al., 2002 and Zietz et al., 2003).

In year 1989, Malaysia introduced Property Trust Fund (PTF) market but received limited support from the investors due to structural factor (Newell and Osmadi, 2010). This led to the establishment of first Malaysian REITs in August 2005 after Securities Commission of Malaysia issued new guidelines for M-REITs. Besides, the successful introduction of REITs in other Asian countries such as Japan, Hong Kong and Singapore encouraged Malaysia to developed REITs. However, Malaysian REITs received inadequate response from institutional investors (Jalil and Hishamuddin, 2015).

Jalil and Hishamuddin (2015) stated that one of the reasons of unattractiveness of Malaysian REITs was the difference of property location as the financial performance of REITs is influenced by location. In addition, the study of Newell and
Osmadi (2010) pointed out that strategic property locations is one of the key factors influencing the performance of M-REITs after conducting a survey with property and REITs fund managers. Difference in property type of REIT may result in different performance. Jalil and Hishamuddin (2015) found that the type of underlying property of REITs is one of the determinants, which influences the performance of M-REITs. For example, REITs, which focus on only single type of property in their property portfolio, will enjoy large liquidity than REITs with several types of property in its portfolio (Danielsen and Harrison, 2007). Besides, Gyourko and Neilling (1996) stated that the property type of REITs invested in influence the systematic risk of REITs. Then, Hartzell et al. (1986) noted that there is low correlation between different types of properties while they were analyzing the returns on an institutional real estate portfolio. They suggest that diversification across property types might have benefits.

Basically, property location and property types are two common factors which used to explain the performance of real estate portfolio (Eichholtz et al., 1995). In term of property location, some past researchers such as Hartzell et al. (1986), Shulman and Hopkins (1988), Muller and Ziering (1992), Muller (1993) and Anderson et al. (2001) have pointed out that compared to geographical locations; economic location is the alternative effective approach in order to construct the property portfolio. This will be discussed further in the section below.

Extensive research to examine the performance of REITs by employed property type and property locations have been conducted in U.S and U.K. However, little is studied in Malaysia about the performance of REITs in terms of analysis of both the property type and property locations of REITs. This is relevant specifically to equity investors, whether local or international who are interested to enter the Malaysian REITs market especially in term of property type and location of REITs. Both are discussed below. Section 2 discusses the relevant literature on REITs property type, while section 3 is on the relevant literature of REITs property type followed by discussion of the review.

2.0 RELEVANT REVIEW ON PROPERTY TYPE OF REITS

Typically, the portfolios of REITs are classified as specialized if the REITs portfolio held is 75% or more in one type of property. Whereas, if a REIT has held less than 75% of its portfolio invested in any one-property type, then it is classified as diversified (Ambrose and Linneman, 2001; Benefield et al., 2008). Generally, REITs are invested in high value and high profile real estate such as hotel, shopping mall or office tower in Malaysia (Wong, 2015). Besides, some REITs markets are invested not only in commercial building but also residential and industrial (Pham, 2012).

According to Newell (2012), the quality of underlying asset of REITs is one of the attractive investment features for investors to invest in REITs. Generally, the main revenue of the REITs stock is from the rental income. Thus, the property type will influence the market share price of REITs, as different types of property are subjected to charge for different rental rate based on local property market.

There have been some previous study reviews on the performance of REITs based on property types. According to study of Capozza and Lee (1995), the stock market will place higher values in retail REITs and lower value on warehouse REITs based on the local property market. Hartzell et al. (1986) noted that the correlation between different property types was low and suggests that the diversification across property types in REITs might have benefits. In addition, the research of Khoo, Hartzell and Hoesli (1993) show that the levels of information increasing along with more analyses done based on the property types of equity REITs. Benefield, Anderson and Zumpano (2009) mentioned that when a particular REIT is exposed to various property types then the return of the REITs is not subject much to the return of any particular property category. This shows that the return of REITs can be diversified across different
property types. For example, when residential properties performed poorly, retail properties might be performing particularly well.

Gyourko and Nelling (1996) mentioned that the property types of REITs portfolio are influenced by the systematic risk of the REIT. They conducted a study by employed asset and equity betas as dependent variable and descriptive of REIT’s property type composition and size as independent variable to run a regression analysis. Results of the study showed that the systematic risk of REITs are different and depends on the property type of that particular REIT owns. The results show that REIT which focus on retail property consist of higher beta compare to REIT focus on industrial or warehouse property in US REITs. Moreover, the other important findings from the study of Gyourko and Nelling (1996) also pointed out that REIT which holds only retail property tend to have 50% beta higher than the REIT holding industrial properties only. Hence, the retail-oriented REITs have significantly higher beta than industrial-oriented REITs. This shows that although retail-oriented REITs will give high return as compensation for high systematic risk. This results support by the later study of Han and Ziobrowski (2011) who examine the abnormal return of specialized REITs and diversified REITs by employ Capital Asset Pricing Model (CAPM) to measure and show that the specialized REITs have higher market risk than diversified REITs. Intuitively, these studies reveal the benefit of diversified REIT in different property types.

Chen and Peiser (1999) note that the property type diversified REITs performed poorly compared to most of the specialized REITs categories. This finding was supported by the study of Morri et al. (2008), which stated that the diversified are more risky and less levered because of its low collateral value of assets. In contrast, there are some findings from the mainstream corporate finance literature indicating that the REITs which focus on one property type will perform well compare to REITs with diversified property type and the survey reported by Johnson (1999) mentioned that when a REIT company focuses on one property type, it will avoids increased management cost.

Majority of empirical research, mainly done in United State REITs market, show that the property type will have effect on the performance of REITs and it is one of the common factors to explain the performance of REITs too. Malaysian REITs are invested in different types of property and offer opportunity to investors for numerous property types to invest such as commercial offices, retail malls, hotels, healthcare and warehouses. In consideration of a different opinion and the lack of local study on the influence of property type on REITs’ performance, it is perhaps imperative to explore the matter in Malaysian REITs.

3.0 RELEVANT REVIEW ON ECONOMIC LOCATION

As mentioned above, property location is one of the common factors to explain the performance of real estate or indirect real estate investment vehicle like REITs. Based on the findings of the previous research, the portfolio diversification across property location of REITs would minimize the risk and improve the REITs performance and it can be considered as effective portfolio investment strategy (Florida and Roulac, 2007; Worzala and Bajtelsmit, 1997). Generally, the quality of location is dependent on the economic activities, which occur on these locations (Mahoney et al., 2000). In short, location is important to all immovable properties and this seems to be reasonable because location determines the rent level of the properties. Therefore, this signifies that the financial performance of REITs is correlated to the location of properties.

In Malaysia, location is an important factor to REITs (Newell and Osmadi, 2010; Jalil and Hishamuddin, 2015). Jalil and Hishamuddin (2015) stated that the unique difference of location of Malaysian REITs make it difficult for investors to evaluate the REITs investment. This indirectly will cause Malaysian REITs become unattractive to investors. For instance, Sunway REIT properties are mainly located at the Central Business District (CBD) such as
Kuala Lumpur, as Sunway REITs focus on retail and hotel business. Meanwhile, Axis REITs are located on their industrial properties at industrial areas, which have different economic location values compared to Sunway REITs properties. So, it obviously shows that the REITs companies will locate their properties in the location, which is essential to the business.

This study focuses on economic location of the property rather than geographical location. It is common to use the traditional geographical location, whereby the performance of REIT can be reflected through diversification of location. However, Hartzell et al. (1986), Shulman and Hopkins (1988), Muller and Ziering (1992, Muller (1993) and Anderson et al. (2001) have studied real estate portfolio construction by grouping the property locations in term of economic base. Hartzell, Shulman and Wurtzebach (1987) point out the issues in previous study, which looked at the diversification on regional base in real estate portfolio. They have segmented the United States into four regions without considering the underlying economic activity in those regions. Thus, their study was segmenting United States into eight regions, which are based on the similar economic characteristics. They employed quarterly data from a large institutional real estate database from year 1973 through 1987 to compare diversification by geographical location with diversification by economic location in United States. Their results show that the correlation coefficient among the eight economic locations were lower than the traditional four geographic location, hence, showing that the economic location diversification is more effective than the traditional geographical location diversification

Later, those results were supported by the study of Anderson et al. (2001). In their study, they pointed out whether the REITs of these locations have a similar economic structure and responded to same economic events? Hence, in order to solve this issue, Randy and John derived the economic location by employing multivariate regression technique known as cluster analysis on the top 100 MSAs (Metropolitan Statistical Area), six clusters of MSAs were then identified which are manufacturing centre, financial centre, government/education, regional distribution, retirement and small MSAs in the United States. They grouped the property in the set of fundamental economic factors which could have a meaningful impact on the markets over time such as employment structure, economic growth pattern, demographic and space distribution by property type of markets. By using this methodology for imputing REITs return into each of the economic locations, their results revealed the return correlation coefficients are low between the economic locations. They suggested that diversification across economic location of REITs is significant and can reflect the performance of REITs.

The review of the relevant literature of economic locations indicates that the performance of REITs could be driven by different economic factors in a particular geographical location. However, many of the studies were done in United States. There is lack of Malaysian REITs’ study employing economic location approach to examine the performance of REITs. Hence, there is a research gap, which can be explored in Malaysian REITs.

4.0 DISCUSSION

The relevant literature review for property types and property location of REITs was essential in order to identify the determinant that are significant in assessing the performance of Malaysian REITs and designing the portfolio diversification strategy for Malaysian REITs. Basically, diversification strategy is about the portfolio allocation in a particular investment. For real estate portfolio, property type and property location are two common determinants to construct a diversification strategy (Eichholtz et al., 1995) and of course this is applicable for REITs portfolio too.

These two determinants seem to support and influence each other based on the relevant literature. The correlation between real estate return aggregate by property type and property locations was found by Eichholtz et al. (1995), highlighting the usefulness of diversification in
real estate portfolio. Similar view was expressed by Anderson et al. (2001), indicating influence of both property location and property type data on REITs return performance. This is consistent with previous studies on benefit of REITs’ risk minimization and the function of diversification through property type and location for effective portfolio investment strategy (Florida and Roulac, 2007; Worzala and Bajtelsmit, 1997). Thus, it can be concluded that there is relationship between these two determinants that influenced each other in examining the REITs financial performance. Figure 1 below indicates the relationship of both this determinants influenced by each other.

![Diagram showing the relationship between Economic Location, Property Type, and M-REITs Financial Performance](image)

Figure 1: Relationship of property type and economic location to influence REITs financial performance

The previous study mainly employed REITs return index from databases sources such as New York Stock Exchange, American Stock Exchange etc. This type of data series may not be a good proxy for future references as they are secondary data which being extracted by some econometric tools or software. Thus, in our study, we are going to get the REITs data from REITs company annual report in order to have a good and precise interpretation on REITs performance. In addition, the previous study on economic location of REITs (Anderson et al., 2001) do not consider the rental yield, occupancy rate and the accessibility of underlying buildings of REITs; they only examine monthly total return data for REITs share for their performance. In this study, the use of rental yield, occupancy rate and the accessibility of underlying buildings of REITs will provide more insights to the performance of REITs and construct more robust portfolio diversification strategy for REITs based on property type and economic location of underlying asset of M-REITs.

5.0 CONCLUSION

The discussion above focused on the two important determinants, i.e. property type and economic location for examining the performance of REITs. Basically, property type and location are two common determinants used to develop a REIT portfolio diversification strategy. The risk and return of different property type of REITs, either diversified or specialized, is believed to be different and in the same time the performance of REITs should be different across location or region within each property type.

REITs have been established in Malaysia since year 2005 and it is an important property investment vehicle in Malaysia, which can provide better diversification benefit. However, Malaysian REITs still receive poor response from investors especially institutional; compare to others Asian REITs such as Singapore, Hong Kong and Japan. The reason for such lack of interest is not clear, mainly due to the lack of study and insight of the Malaysian REITs performance. It is therefore suggested that fresh study is needed for exploring the performance of Malaysia REITs according to above two aspects of them.

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