# INTRODUCTION OF REAL ESTATE INVESTMENT COMPANY(REIC) AND ITS EFFECTS

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## Definition and brief of REIC

The Ministry of Construction and Transportation announced the main contents of a "Law on Real Estate Investment Companies" that will be submitted to the National Assembly in September.

REICs (Real Estate Investment Companies) are Korean real estate indirect investment institutions that finance funds through stocks and bonds in the capital market and distribute dividends after investing funds in real estate and securities related to real estate.

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According to the announcement, REICs have stricter conditions than US Real Estate Investment Trusts (REITs) regarding issues such as start-up and asset management conditions. REITs have no restrictions on their set-up conditions, investment objects, or financing methods, and the only condition is that 75% of their assets have to be composed of real estate and securities related to real estate. In addition, 75% of their yearly revenue has to come from real estate and securities related to real estate. Also 5 persons or below cannot own 50% of the stock.

## The background of REIC introduction

There were three important factors in the background of REIC introduction. First, after the IMF crisis in 1997-98, nearly bankrupt corporations needed to sell bad bonds and real estate in order to improve their financial structures. But, their effort didn't work in the private sector due to the frozen real estate and capital market.

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Second, the government injected public funds of 64 trillion won into ailing firms in order to help their revival (or rearrangement) and economic recovery. However, the government has had difficulty getting back its funds.

*ABS and MBS transactions have been rare due to the immature secondary market.*

Third, there are limits to the institutions introduced in order to liquidate assets such as real estate. In 1998, the Korean government made Asset Backed Securities (ABS) and Mortgage Backed Securities (MBS) by enacting a “Law on MBS” and a “Law on Asset Liquidity”, but transactions have been rare due to the immature secondary market. Also, established real estate trusts cannot get financial trusts and have had difficulty liquidating invested funds because they have only limited listing rights in the stock market.

### Table 1. Requirement of REIC and its Expected Effects

| | Requirement | Expected Effect |
|---|---|---|
| **Set-up Conditions** | · joint-stock corporation by commercial law<br>· minimum capital 100 billion won | · enlarging REICs |
| **Governance structure** | · equity per shareholder: 10% or below<br>· shareholders: 300 or more<br>· internal organization : a general meeting of shareholder, board, audit | · strengthening internal organization by restricting equity per capital<br>· prohibiting personal holding companies<br>· minimizing moral hazard in operating fund |
| **Organization Structure** | · Inclusion of asset management in REIC<br>· external organization: real estate deposit companies, etc | · reducing transaction cost by internalizing asset management companies<br>· strengthening external monitoring by trusting REIC assets to Real Estate deposit companies |
| **Investment Object** | · trading real estate and securities related to real estate<br>· prohibiting backed loans (mortgage REITs) | · inducing secure investment<br>· expanding long-term bond circulation market (such as ABS, MBS)<br>· restricting development investment by backed loan |
| **Asset Management** | · holding 90% of total assets as real estate or securities related to real estate<br>· restricting disposal of owned real estate within 5 years | · prohibiting diversification into other industries<br>· restricting short-term speculation for getting capital gain |
| **Financing** | · direct finance: listing within 2 years after set-up<br>· indirect finance: loan-to-asset ratio of 30% | · magnifing the liquidity of invested funds<br>· enlarging business transparency of REICs<br>· prohibiting weakness by business on loan |

## Requirements for establishing REIC

REICs were designed to maximize business stability and investor security. The main requirements are that the minimum startup capital is 100 billion won, while equity per capita is restricted to 10% and the number of shareholders must exceed 300. These items will have the effect of enlarging REICs, prohibiting them from becoming personal holding companies and minimizing moral hazard in real estate investment. In addition, REICs are prohibited from making backed loans (mortgage REITS) in order to restrict development investment by backed loans. Also, REICs are required to list on the stock market within two years after set-up to increase the liquidity of invested funds and improve business transparency.

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## The expected effect of REIC on the markets

The introduction of REICs is expected to bring lots of change to markets including the real estate and capital markets. Investment risk will decrease because of greater asset portfolio opportunities. And a 5-6% increase in the size of the capital market will mean an increase of 17.5-21 trillion won. Furthermore, REICs will improve the efficiency of the real estate market by linking it to the capital market. But after REICs have been established, the government needs to prepare clear standards to permit housing and SOC construction with guaranteed profitability and stability. Also, the government needs to induce the specialized investment object by developing institutional incentives instead of preventing REICs from making backed loans (Mortgage REITs) legally.[1)]

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## Construction Firms' response

In 1999, the rate of housing diffusion in Korea reached 93.3%. The demand for new housing construction is expected to fall in four or five years. So, in the very time

1) In an analysis of the correlation between equity and mortgage REITs' profit rate in the US, the correlation coefficient had a positive sign (full period: 0.78). This indicates that the mixing of investment objects, equity and mortgage REIC, is unfavorable to REICs in reducing business risk.

**< Profit Rate Correlation Analysis (1972-97) >**

| | Full period | 1972-79 | 1980-89 | 1990-97 |
|---|---|---|---|---|
| Correlation Coefficient | 0.78 | 0.9 | 0.62 | 0.68 |

when REICs are introduced and low growth in the construction industry is expected, construction firms have to cope with REICs in order to maintain proper financial structures and maximize profits instead of sales.

*Construction firms should maintain stable capital structures by replacing their financing sources from bank loans to direct finance from the capital market.*

There are three ways that Korean construction companies can respond to REICs. First, construction firms should maintain stable capital structures by replacing their financing sources from bank loans to direct finance from the capital market when financing development investment such as apartments, SOC construction and reconstruction.

Second, construction firms can participate in the creation of REICs as shareholders, vertically affiliate with REICs and build organizational, internal infrastructure for real estate management including development investment. This would help REICs diversify their profit sources and promote synergy between REICs and construction firms. However, because the government is going to stipulate an equity limit of 10% per shareholder in order to restrict individual control over REICs, it is impossible for construction firms to completely integrate with REICs in the nature of a conglomerate relationship to its affiliates.

*Construction companies can reduce cutthroat competition within the industry by maintaining long-run contract relations as independent corporations.*

Third, construction companies can reduce cutthroat competition within the industry by maintaining long-run contract relations as independent corporations. Also, they can enlarge their business opportunities and settle the problem of surplus production capacity by forming long-run networks with more than one REIC. VIP

**Figure 1. Response to REICs by Market Participants**