

Legal impact on REITs: Lessons for Mexico

By

Juan Carlos Testa

THESIS

Submitted to
KDI School of Public Policy and Management
in partial fulfillment of the requirements
for the degree of

Master of Business Administration

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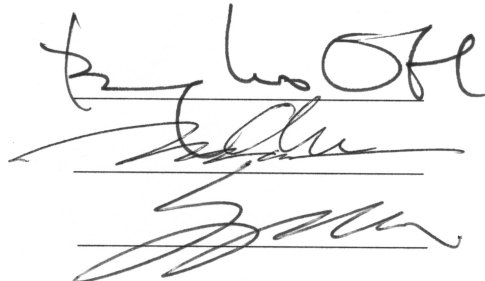
Master of Business Administration

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Three handwritten signatures in black ink, each written over a horizontal line. The top signature is the most legible, appearing to be 'Byungho OH'. The middle and bottom signatures are more stylized and difficult to read.

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ABSTRACT

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By

Juan Carlos Testa

Real Estate Investment Trusts (REITs) have already been operating for some years in different countries around the world. Though the REIT structure presents many similarities or “standard structures” its success and growth have not been the same. While some countries such as the United States, Australia and Singapore have a relative successful REITs’ market other countries like South Korea and Hong Kong struggled at least during the first years of implementation to make REITs successful. Yet on the margin, other countries that have followed the trend and implemented “copy and paste” regulations on REITs have an insignificant REITs’ market despite the good will of their policy makers to establish REITs as an attractive financial option. In this case, Mexico, that nonetheless has implemented several regulations and improvements on the existing policies to make REITs more attractive to the investors, has failed to achieve an increase in the participation of REITs in the financial markets. The reason can be blamed on a not yet well diversified financial market and the tax system itself. It turns out that the specific regulation on REITs on the Tax Law is not the problem but the tax system as a whole, which is perceived as low transparent and complex, which has discourage investors that otherwise may have opted for REITs choose other options despite the specific advantages to invest using REITs models in Mexico.

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Introduction

Law is one of the main tools of social and economy change. While the relationship between law and economy, and subsequently its influence on business, is recognized, there is still much debate towards its real impact. The recent years have seen the flourish of diverse theories that have as a common bond the importance of understanding the interaction that the legal reforms have in the business development of the countries where these reforms are applied. It is not only important for theorists but also for policy makers aiming to attract investment into their economies.

Finding clear evidence between the legal framework and its impact in the object purpose of that regulation has never been simple. Several authors have conducted research on different legal topics and their impact. Among those authors, Benjamin C. Esty and William L. Megginson in their work "Creditor Rights, Enforcement, and Debt Ownership Structure: Evidence from the Global Syndicated Loan Market", showed that enforcement of loan terms depends on the legal system in the country where project is located. As a result, they concluded that creditors must understand not only their legal rights in the countries in which they lend, but also the effectiveness of enforcement mechanisms in those countries.

The before mentioned work, provides a vision where the Law has to be analyzed not in its particular regulation (understood as that contained in a particular Code or Act) but how does the body of laws interacts with the whole system, including Financial and Economic one.

Following these ideas, we intend to provide a research that considers the correlation between law system, legal concept and development (understood as how the legal concept is received

in the public where it is purposed to be applied).

REITs provide several interesting characteristics for the analysis of the “law-impact” development research. REITs depend, as most projects, on several variables given in a Real Estate market; however we perceive that REITs are very reactive to “favorable tax treatment”. Besides, REITs regulations around the world are more or less standardized which makes it more feasible doing a comparative law study.

REITs given its relative novelty are a great study case for several reasons. The concept of trust was born in the Common Law, and then given its success was adopted in several Civil Law countries. Moreover, Trusts are legally one of the most flexible instruments that law can take use.

In Mexico trusts were adopted from the Common Law models and therefore REITs were not the exception. The Mexican Law that calls Trusts “*Fideicomisos*”, and for the case of Mexican REITs adopted similar structure of other models, where are two basic components identified, being one law that describes the corporate design a REIT is requested, and the other that gives the rules for those REITs in order to apply for the tax incentives.

During the research we studied several REITs in various countries; however we decided to focus on three besides Mexico, for considering them as representative. US REITs for being the first ones and set the structure of other REITs; Hong Kong, for the challenges that faced on implementing its REITs model given its extra financial and legal implications; and South Korea, that established REITs with specific investment goals (rather than simple attracting investment in general) and its particularities of its Real Estate market.

The comparative analysis provided as helpful tool, however, it would be hard to reach conclusions from the deeper analysis on the specific REIT law structure in Mexico. As we will analyze further in this thesis, Mexico has not seen too much increase in its REITs' market despite the fact that its REIT structure is basically the same as it is in other countries that have experienced much better results. Therefore it has been necessary to try to find out other ways to identify where the problem is.

In this thesis we pointed out two basic hypotheses:

- 1) The regulations implemented are not adequate. This can be due to some possible missed points that are present in other countries' regulations, or that the Mexican REITs need a totally different approach towards REITs to make it successful.
- 2) The regulations are adequate but there are other circumstances that have deterred the adoption of REITs in Mexico. In this case the problem may be in other factors that affect the growth of REITs in Mexico. The problem can be in a myriad of factors: financial, economical and/or social. However the present thesis will just focus on those aspects that generally tend to affect other financial instruments.

It is considered that the tax treatment is possibly the single most important aspect for investors when considering investing in REITs, but as we will see later is not the only who can decide the success or failure of REITs' implementation. We will determine if REIT's legal structure, including tax treatment, is, per se, the most significant variable to determine REITs success despite law enforcement or other significant variables from the legal point of view, such as enforceability of contracts, foreign investment regulation, business law or socio-economic variables.

Evidence indicating that REIT's success is directly correlated to the law system could suggest an advantage for following and replicating those REITs models. On the other hand, if in spite of similar legal structures in the world regarding REITs we obtain different results, we may suggest other factors that could have a bigger influence on the development of REITs.

This thesis is intended to provide an overview of the influence of law making on the development and construction of different legal concepts and its actual application and at the same time provide realistic perspectives of success when other conditions are not meet. We will talk about what in this thesis we will call the REITs infrastructure (in difference to REITs structure, which is its legal regulation). This infrastructure is described here as those economical and financial institutions that are needed in a given market for REITs to succeed.

Chapter 1

1. Real Estate Investment Trusts

1.1 Real Property Concept

In democratic societies, the importance of the concept of property is second only to that of the idea of liberty. Property is a legally protected interest or group of interests. It is valuable because only law provides that certain consequences follow from the ownership of it. The right to use property, to sell it, and to control to whom it shall pass on the death of the owner are all included within the term “property”. Property may be classified as tangible or intangible and real or personal, but these classifications are not mutually exclusive. Real Estate or Real Property is defined as the land and anything growing on, attached to, or erected on it, excluding anything that may be severed without injury to the land.¹

The simplest way to distinguish between personal and real property is saying that land and all interest in it are real property, and everything else is personal property.

Kinds of Property

	Personal	Real
Tangible	Goods	Lands Buildings Fixtures
Intangible	Negotiable Instruments Stock Certificates Contract Rights Copy Rights Patents	Leases Easements Mortgages

Source: Mann, Richard A & Robert, Barry S., p. 1005

¹ Garner, Bryan A. (ed.), *Black's Law Dictionary*, West Group, United States, 1999, p. 1234

1.2 REITs Definition

A REIT description can change in some aspects depending on which part of the world you are in. Nevertheless, the basic points that define REITs are common in most regulations around the world.

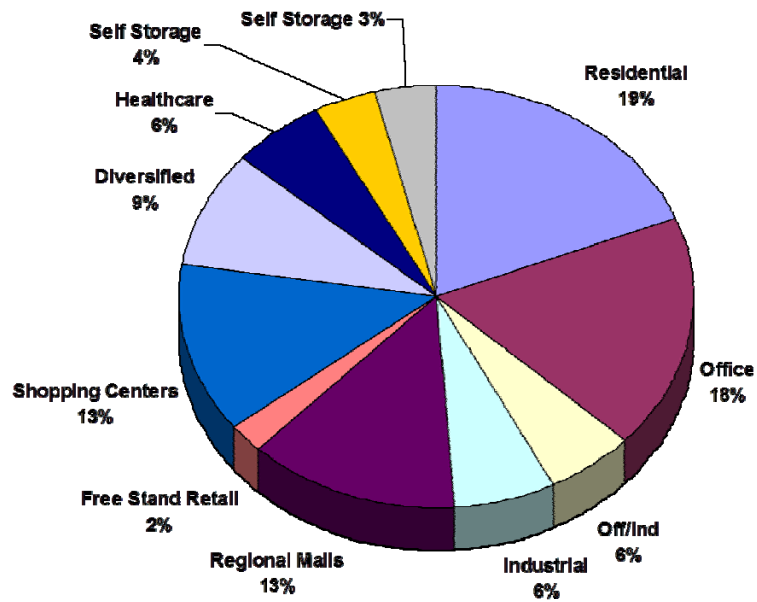
A first definition can be taken from the Black's Law Dictionary which defines REITS as those companies that invest in and manage a portfolio of real estate, with the majority of the trust's income distributed to its shareholders.²

The features that a REIT needs to have, as previously mentioned, may vary from one country to another, but basically the essential characteristics to qualify as a REIT are:

- REITs are formed into the legal figure of "trust".
- The REIT needs to have most of its assets coming from real estate investment.
- It must distribute most of its taxable income to its shareholders.
- In most countries income distributed to its shareholders in form of dividends does not pay corporate tax.
- There are a minimum number of shareholders and maximum amount of shares that can be held by a single shareholder.
- Some REITs' shares are traded in stock exchanges but this is not necessary for all the REITs.
- Has professional management

² Ibid, p. 1271

- There can be different types of REITs in the same legislation, like in the USA, where there are Equity, Mortgage and Hybrid REITs.
- REITs generally can invest in all property types.



Source: NAREIT

Chapter 2

2. Global REITs

2.1 United States

REITs originated in the USA when the American Congress created the REIT as a tax vehicle in 1960, aiming to encourage the participation of small investors by giving them tools and advantages that were normally just available to those with strong resources.

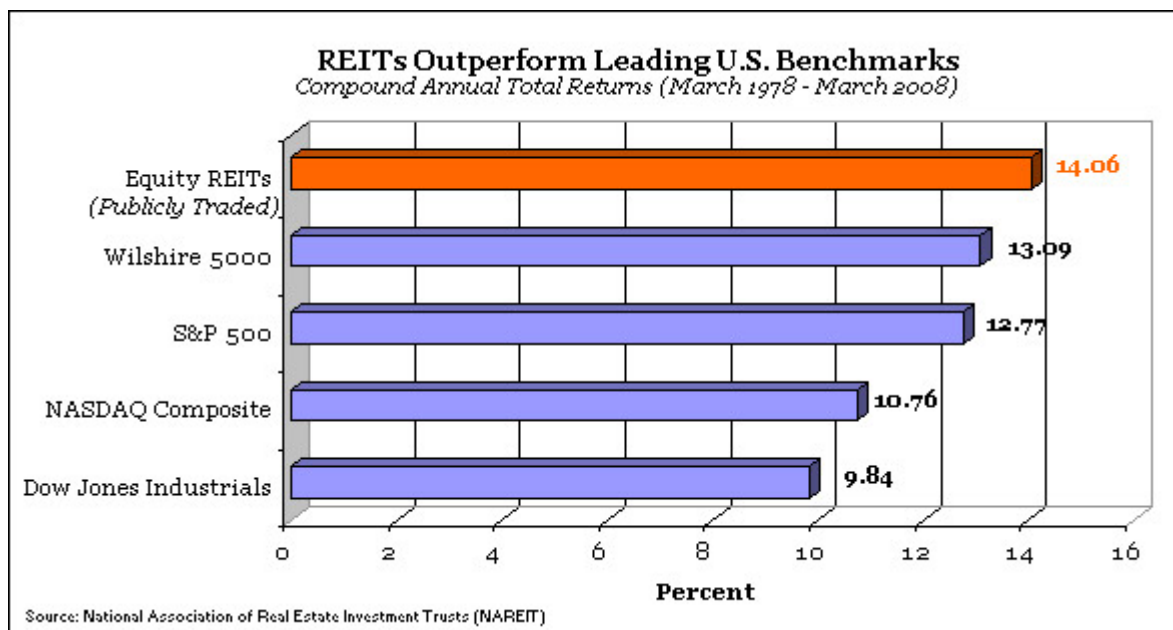
Another advantage pointed out by the Congress was the possibility to divide the risk of the investor by just purchasing a small part of real estate property and by diversifying into different projects.

In order for a company to qualify as a REIT in the U.S., it must comply with the rules specified under the Code relate to the organization and governance of the entity seeking REIT status:

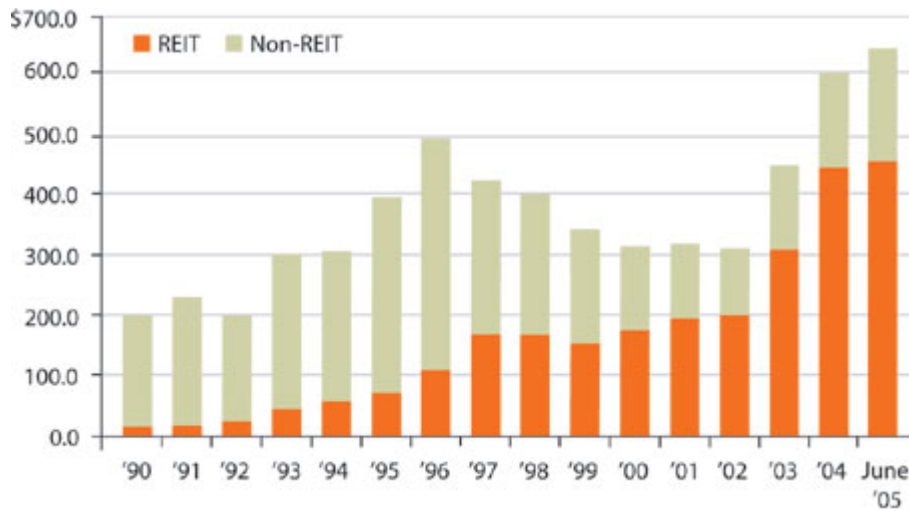
- Managed by one or more trustees directors
- The beneficial ownership of which is evidenced by transferable shares or y transferable certificates of beneficial interest.
- Neither a financial institution or an insurance company
- Shareholders 100 or more persons
- A REIT may not own more than 10% of the voting securities of any single issuer, and no more than 5% of its total assets may be represented by securities of any one issuer.
- Invest at least 75 percent of total assets in real estate

- At least 75 percent of gross income must come from rent or interest from mortgages on real property
- Distribute annually at least 90 percent of taxable income to shareholders in the form of dividends.

The REITs in USA have been successful when compared to other securities. During the 20-year period between 1975 and 1995, equity REITs consistently outperformed the S&P 500, the Dow Jones Industrials, utilities, bonds, and direct real estate owned by U.S. institutions as measured by the Frank Russell index.

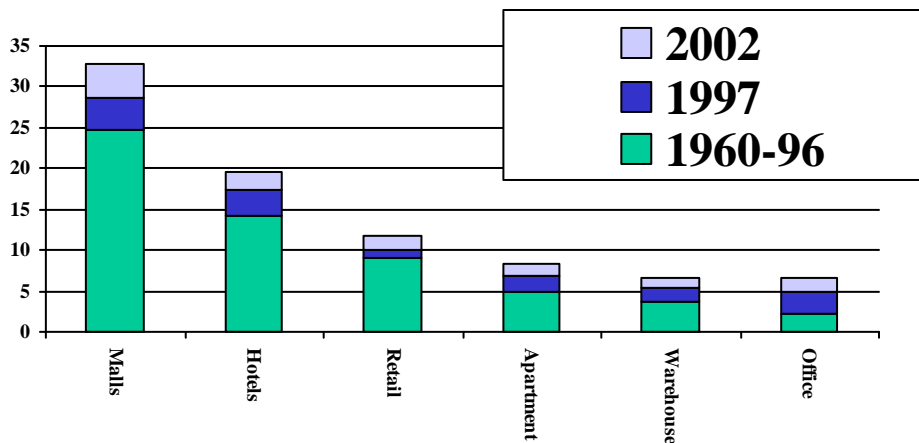


Most of the growth in securitization of real estate assets has been done using REITs as investment vehicles



Source: UBS, Thomson Financial Datastream

Percentage of Real Estate held by REITs as of December of 2002



Sources: F.W. Dodge, SNL REIT Securities Database, Wilshire Associates R.E. Securities Index, Bloomberg REOC Index, CB Commercial - Torto Wheaton Research, Smith Travel, U.S. Census Bureau, U.S. Dept. of Commerce, National Research Bureau and Prudential Real Estate Investors Research

The increasing participation of REITS is not a fluke; the REIT industry reformed itself through self-regulation and some painful lessons on the early 1970s.³ Unfortunately for the REIT industry, real estate tax shelter partnerships came along in the early 1990s. In 1981

³ Garrigan, Richard T. and Parsons John F.C. (Eds.), Real Estate Investment Trusts, Mc Graw-Hill, United States, 1998, p. 4

with the congressional blessing of real estate tax shelters⁴, the real estate marketplace was converted from an industry largely disciplined by basic supply and demand, to a real estate market place where tax shelters drove the investment and overdevelopment of commercial real estate.

After several tax reforms, some more successful than others, the investors began seeking current income and long-term growth as real estate investment performance characteristics. Investors subsequently turned to the REIT industry for this income and growth. Public REITs will also attract more institutional capital. As the REIT industry grows in size, depth, and quality as the infrastructure matures through more experienced buy and sell independent analysis. And as REITs become more accessible to investors through market acceptance and growth of actively managed real estate securities funds, large flows of capital seeking stable, attractive currently yields and long-term growth in cash flow from real estate investments will become commonplace.

The real estate market is cyclical; the stock market is cyclical; the economy is cyclical. Whatever the environment, REITs have historically proven their ability to perform.⁵

In summary:

- US REITs took time to settle. But once established, they gained awareness from the investors, and experienced a fast growth. Now, they are predicted to have a healthy future.

⁴ A legal method of minimizing or decreasing an investor's taxable income. Tax shelters can range from investments or investment accounts that provide favorable tax treatment, to activities or transactions that lower taxable income.

⁵ Ibid., p. 8.

- In the last decade the US REIT industry has grown dramatically in size and importance.
- There are currently around 200 REITs, worth \$355.1 billion, or 2.2% share of US stock-market capitalization.



Source: Stockcharts.com

2.2 Hong Kong

Hong Kong introduced a REIT code in July 2003, allowing property trusts to be created and listed on the stock Exchange. However many factors prevented that market from blossoming.

At first, many landlords said they were reluctant to sell buildings in a city where land was so scarce.⁶ For many, their buildings had a strong psychological grip. Hong Kong also did not give special tax benefits to REITs that other countries offered, so listed companies holding property assets lacked the extra incentive to spin them off into property trusts. However,

⁶ Whiting, Dominic, *Playing the REITs Game: Asia's New Real Estate Investment Trusts*, John Wiley & Sons, Singapore, 2007, p. 22

many analysts and bankers believed it just needed someone to launch a trust to show there was enough investor enthusiasm to allow other property firms to follow suit. If the REIT were large enough it would also be useful in setting a price benchmark for the rest of the market, giving an indication of how much an investor would be willing to pay for a certain type of building. That's when the Hong Kong Housing Authority stepped in. It employed investment banks UBS, HSBC and Goldman Sachs as underwriters and JP Morgan as an adviser, and announced publicly that it would spin off building into Link REIT.

The Link REIT was the first REIT listed on the Hong Kong Stock Exchange. The initial public offering was set at the end of 2004 and the investor anticipation of what would be Hong Kong's first REIT made a lot of money flowing into Hong Kong. Its property portfolio now comprises 180 retail and parking facilities across Hong Kong. Hong Kong property trusts were like the proverbial London buses, a long wait, in this case almost two years since REIT legislation was passed, and then suddenly three came at once.⁷ Two weeks after the Link's market debut, another REIT, the Prosperity REIT listed, and that was followed a week later by the first trust completely comprising mainland Chinese buildings. The strong demand from investors looking for a solid yield and the potential to tap into Hong Kong's rising property market obscured any worry in case the predicted rent rises failed to materialize. "The strong debut clearly shows a good market appetite for REITs" said Anthony Ryan, head of real estate investment banking at JP Morgan Chase & Co., which sponsored the IPO. Much of the skepticism Hong Kong landlords about REITs were evaporated.

Crowded Hong Kong, where land for new development is scarce, has been a favorite for property investors as a capital gain play. But the market is notoriously volatile because

⁷ Ibid., p. 25

speculations are often rife. Bubbles can grow in a year and be pricked in an even shorter time. But the Hong Kong REIT market soon began to stumble. Investors were getting nervous about rising interest rates, so REITs seemed less attractive as pure yield investments. In addition, global stock markets began to slide, with investors specifically trying to avoid Asia, since the prospect of raising US interest rates could damp demand for the region's exports. Hong Kong's notoriously faddish individual investors were also becoming aware that REITs were steady, long-term investments, not stocks you could buy in the morning and sell in the evening for a short-term bet.⁸ Individual investors were getting suspicious about property trusts, and wondering why a landlord would sell a building if it was such a good investment.

Some REITs in Hong Kong faced unique circumstances. By May 2006, average property values in the city had shot up 70% since a slump during the 2003 SARS outbreak, but rents were only starting to catch up because most leases lasted for three years.

George Pavey, head of equity capital markets at HSBC in Hong Kong, argued that Hong Kong's REIT market would revive fairly quickly though, with property companies deciding to lower their price expectations helping Hong Kong's REIT market to show signs of life by the end of 2006.⁹

The key requirements for REITs in Hong Kong include:

- The REIT must be in the form of a trust
- The management company has to have a license to manage collective schemes and have a five-year track record in managing public funds.

⁸ Ibid., p. 27

⁹ Ibid., p. 29

- The REIT must allocate 100 percent of its income after-tax as dividend
- Hong Kong REITs' are required to invest only in Hong Kong real estate.
- The REIT directly must hold the real estate.
- Requirement to hold its real estate for a minimum period of years unless otherwise approved by its unit holders.
- A limit on the extent to which a REIT can borrow and leverage its assets.

The geographical restriction to only permit investments in Hong Kong real estate has attracted the most comment as Michael Chin from Jones Day has pointed to, “Many industry observers see this as an unnecessary restriction which will lessen the attractiveness of REITs to Hong Kong investors, particularly as it will exclude access to the potentially lucrative market in China”.¹⁰

Hong Kong’s regulation can in one hand be considered restrictive and not advantageous in comparison to other regulations but in the other hand there are several factors that make us believe that there would be an increasing appetite from investors for REITs and just the regulation will accommodate these necessities later on.

2.3 South Korea

The South Korean government introduced REITs primarily to help corporate restructuring efforts. In other words, to allow struggling companies to sell their property to the public at a good price. But unlike other countries, it created two types of REITs: Corporate restructuring REITs, or CR-REITs, and the ordinary trust structure, called K-REITs.

¹⁰ Chin, Michael, *The Progress of REITs in Hong Kong*, www.jonesday.com, 2003

CR-REITs were unique in that they needed to source at least 70% of their assets from companies undergoing restructuring due to insolvency or companies that intended to use the proceeds to pay off a debt. Because the incentives were more generous for CR-REITs, all early trusts created in Korea chose that structure. CR-REITs received a waiver on acquisition tax if the pay-out was more than 90% of profit. In comparison, K-REITs were given a 50% exemption from acquisitions tax and registration tax, but received no corporate tax benefits. Neither type of trust could borrow in order to fund a new investment. Another problem with the original rules was that they only allowed CR-REITs to exist for five years, raising concerns among investors about what would happen to the trusts once the period was over. Would they sell their buildings and dissolve themselves or would they convert to K-REITs? What would their tax treatment be?

The whole landscape shifted in 2004, when the government introduced a new structure for indirect property investment, the Real Estate Trust Fund (RETF), which had many advantages over the CR-REITs and K-REITs. For example, there was much less regulatory red tape for creating a RETF; the funds could borrow more and could start up with less capital; and there was no limit to their lifespan. Many expected RETFs to become the dominant form of listed property investment. But with REIT markets flourishing in Singapore and Japan, South Korea finally changed its rules in April 2005 to extend the tax benefits to CR-REITs and K-REITs. Authorities also allowed two types of general property trusts to be formed: a self-managed REIT and a paper company REIT, for which the management functions are delegated to a third party asset manager.

Analysts said the fore mentioned changes and others that allowed CR-REITs to continue indefinitely by converting into general REITs were needed to keep foreign investment

flowing into Korean property. Several pension funds and insurance companies, especially from Europe, bought Seoul office blocks cheaply in the wake of the Asian economic crisis, and flourishing REIT market would offer them a good way of cashing in. The REIT market was also tipped to become popular with a domestic population that was wary of an often volatile stock market.

“I think they will take off. It’s a natural progression, by history and tradition; Koreans are not keen on the share market, where there are transparency issues. The government wants to get liquidity into the market because money is in bank deposits or under beds, so it is trying to attract capital by offering more investment vehicles” said Scott Girard, head of research at consultants Jones Lang Lasalle.¹¹

Particularities about Korea

Korea has a unique rental system called *chonsei*, where a tenant pays a big down payment instead of regular rent payments, which the landlord invests, gambles, or leaves in a bank savings account. The *chonsei* is returned at the end of the contract, so the tenant only pays the opportunity cost of not having the money to spend for a period of time.

The system is popular with landlords who dabble in other business and with small-scale developers, who use *chonsei* payments to finance new projects. Those who can afford to pay it are happy because *chonsei* appears to be a rent free deal. But at \$1 million for a 400 square meter office in central Seoul, a growing number of corporate tenants prefer landlords who ask for rent.¹² Traditionally, South Koreans would take turns pooling funds among family and community members to stump up for *chonsei*. That system is breaking down as low interests rates make bank loans more attractive and extended family units fragments. *Chonsei* is also

¹¹ Ibid., p. 57

¹²Ibid., p. 58

going out of fashion with landlords, partly because they find it hard to make money while interest rates are low. So, both sides are edging towards *wolsei*, a mix of rent and *chonsei*.

In the commercial sector, investors were snatching up Seoul office buildings in the early 2000s for rental yields of as high as 8% and discarding the traditional system. The proliferation of REITs in Korea will also undermine the traditional system, because investors in trusts want a stable, long-term rental income.

Chapter 3

3. Mexican REITs

3.1 Mexican REITs: Broke down into pieces

Mexican REITs, or *Fideicomisos de Infraestructura y Bienes Raíces* (FIBRAs), were first introduced in 2003 by modifications in the Mexican tax laws (mostly in the Income Tax Law), and by 2006, new rules were included.

Mexican REITs or FIBRAs' concept doesn't vary drastically with the other REITs around the world as we will analyze later. The FIBRA has to be created under the form of a bank trust wherein the bank (trustee) holds the trust deed for the purchaser (beneficiary). While the trustee is the legal owner of the real estate, the beneficiary retains all ownership rights and responsibilities and may sell, lease, mortgage, and pass the property on to heirs.

The *Fideicomiso* (Trust)

Trusts (or *fideicomisos*) are written contracts regulated under the General Law of Negotiable Instruments and Credit Transactions (*Ley General de Títulos y Operaciones de Crédito*) pursuant to which one or more settlors (entities or individuals) (each a *fideicomitente*), contribute assets (i.e., real estate, money, rights, securities, movable assets, etc.), to the performance of a valid and legal purpose, for the benefit of one or more specified beneficiaries (*fideicomisarios*).

The requirements to form a trust are established in the General Law of Negotiable Instruments and Credit Operations¹³ as follows:

ARTICLE 381. By means of a trust the maker thereof assigns certain property for a definite legal purpose, entrusting its execution to a fiduciary institution.

ARTICLE 382. A trust shall be valid even though constituted without a beneficiary being designated, provided the purpose is both legal and definite.

ARTICLE 383. Both individuals and juridical persons, who have the necessary capacity to receive the benefits which the trust implies, must be trustees...

ARTICLE 384. Only individuals or juridical persons duly capacitated to dispose of the property covered by the trust may be makers of trusts. The competent judicial or administrative authorities, when it is a matter of property, the care, conservation, administration, liquidation, distribution, or alienation of which corresponds to said authorities or the persons they designate, may become trustees.

ARTICLE 385. Only the institutions duly authorized as fiduciaries by the General Law of Banking Institutions may act in such capacity.

In case, at the time a trust is constituted, a fiduciary institution is not designated by name, the institution selected by the trustee or in default thereof, by the Judge of First Instance of the place where the property is located, from among the institutions expressly authorized in conformance with the law, shall be deemed as designated.

The maker of the trust may designate several fiduciary institutions to jointly or successively execute the trust, establishing the order and conditions of substitution.

Except as provided for in the deed establishing the trust, when the fiduciary institution does not accept it, or if by resignation or removal, it ceases to discharge its duties, another such institution must be named as its substitute.

The trust shall cease if no substitution is possible.

ARTICLE 386. Property and rights of all kinds may be placed in trust, except those which, according to law, are strictly personal ones of the holder.

Property placed in trust shall be considered as subject to the end for which it is destined, and in consequence, only the rights and actions relating to such end may be exercised with respect thereto, with the exception of those expressly reserved by the maker of the trust, those which are derived for him from the trust itself, or those legally acquired with respect of such property prior to the constitution of the trust by the trustee or by the trustee or by third parties.

The trust constituted in fraud of third parties may at all times be attacked on a basis of nullity by the interested parties.

¹³ Mexico, *Ley General de Títulos y Operaciones de Crédito*, 2010

ARTICLE 387. The trust may be constituted by a deed executed by living persons or by will. The creation of a trust must in all cases be made in writing, and conform to the terms of ordinary legislation governing the transfer of rights or the transfer of ownership of the things given in trust.

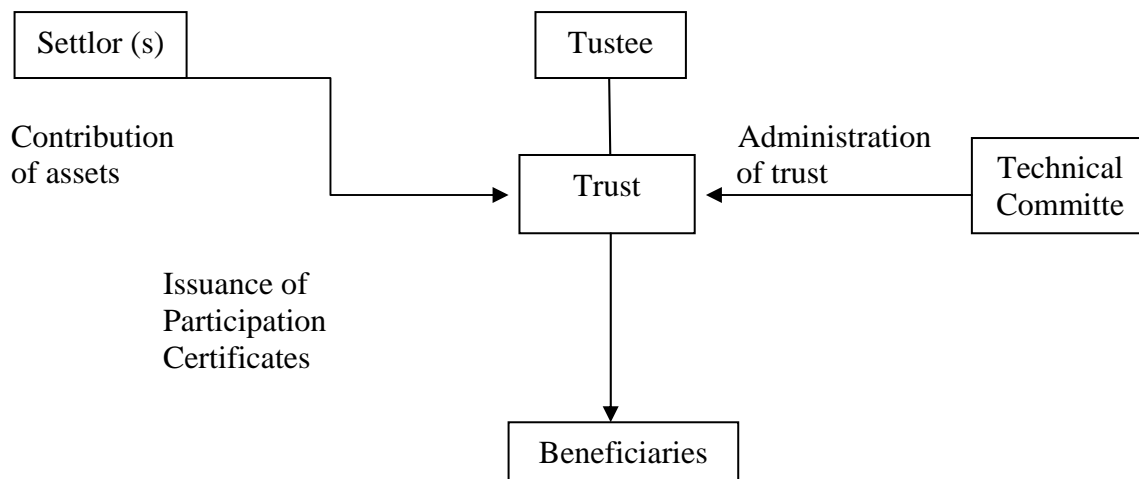
ARTICLE 388. The trust which involves immovable property must be registered in the section of the Public Property Registry corresponding to the place in which the property is located.

The trust shall take effect against a third party, in the case of this article, from the date of its inscription in the Registry.

ARTICLE 390. The trustee shall have, in addition to the rights granted by the trust indenture, the right to require the fiduciary institution to comply therewith; to attack the validity of the acts committed by the latter to his detriment, in bad faith, or exceeding its power which, under the trust indenture or the law, corresponds thereto, and where applicable, to recover the property which in consequence of such acts, has passed out from the patrimony which is the object of the trust...

ARTICLE 391. The fiduciary institution shall have all the rights and actions required for the carrying out of the trust, with the exception of the rules and limitations in this respect established at the time of drawing up the trust indenture; it shall be obligated to carry out said trust in accordance with the trust indenture; it cannot excuse itself or resign except for grave causes approved by the Judge of First Instance of the place of its domicile, and must act at all times with due care, being responsible for the losses or of damages to the property which are due to its negligence.

Mexican Trust structure



As part of the trust agreement, the settlor entrusts the carrying out of, and compliance with, the purpose of the trust to a trustee who, in general terms, will act for the benefit of the beneficiaries.

- Trustees may only be fiduciary institutions specifically authorized pursuant to the law (in general, banking institutions).
- As long the purpose of the trust is legal and valid, a trust may be initially formed without the designation of a beneficiary. Any individual or entity with sufficient capacity to receive the benefits or proceeds of the trust may be a beneficiary thereof.
- When the corpus of the trust comprises real estate, the trust agreement must be evidenced in a public instrument, issued before a notary public and registered with the Public Registry of Property in the jurisdiction where the property is located.
- The assets and rights comprising the corpus of the trust represent an autonomous patrimony or estate which is separate and independent from the estate or patrimony of the settlor, the trustee (*fiduciario*) and/or the beneficiaries of the trust.

The participation of the beneficiaries in a trust is normally evidenced through negotiable instruments known as participation certificates, which grant to their holders:

- A proportionate share of the assets, securities or rights held in trust;
- A proportionate share of the proceeds deriving from such assets, rights or securities; and
- The right to receive a proportionate share of the net product resulting from the sale and/or leasing of said assets, rights or securities.

- Depending on whether the corpus of the trust is composed of movable assets or real estate, trust participation certificates may be:

- Ordinary Participation Certificates (*Certificados de Participación Ordinaria* or “CPO”, in Spanish); or

– Real Estate Participation Certificates (*Certificados de Participación Inmobiliaria* or “CPI”, in Spanish).

- Participation certificates may be placed in the Mexican Stock Market through a public offering, or placed through private offerings. Currently there are no specific rules for the issuance in a private or public offering of participation certificates specifically related to REITS; therefore, any issuance of such instruments would have to be made following the general rules.¹⁴

- Since a Mexican trust is a contractual agreement, it does not have an independent legal personality and, regardless of the fact that it has an autonomous patrimony, it must always act through its trustee or through attorneys-in-fact appointed for such purpose.

- Upon the formation of a trust, the settlor transfers to the trustee legal title to the assets, securities or rights comprising the corpus of the trust, and the trustee will hold “fiduciary ownership” and limited title to such patrimony, since the trustee may only dispose of same in accordance with, and exclusively to comply with the purpose of the trust.

- Contrary to civil ownership, fiduciary ownership does not entitle the trustee to use and enjoy the assets comprising the corpus of the trust, nor is the trustee entitled to dispose in its favor of the possession and benefits thereof. Such rights are granted only to the beneficiaries (or to the settlor itself) of the trust. In addition, fiduciary ownership may only be exercised within the scope and limits of the relevant trust agreement.¹⁵

¹⁴ SLC Attorneys, *Investment Trusts – Mexican Legal Issues*, United States, Powerpoint, 2005

¹⁵ *Idem*.

- Except in respect of a trust formed to secure a payment obligation, the trustee may not be the beneficiary of a trust for which it serves as trustee. Ultimate ownership of the assets comprising the corpus of the trust is vested in the beneficiaries thereof or, in the settlor, if the settlor reserved the right to revert ownership of some or all of the assets comprising the corpus of the trust.

Besides the requirements above mentioned to form a trust Mexican REITs must observe the following requisites stated in the Mexican Income Tax Law¹⁶ in order to obtain the tax incentives:

Article 224. The following shall be observed by trusts complying with the requisites established in Article 223 hereof:

I. The taxable results for the fiscal year of the revenues generated by the assets, rights, credits or securities comprising the trust fund shall be determined as provided in Title II hereof by the trustee.

II. To determine the amount of taxable results applicable individually to each such certificate of participation, the taxable results for the fiscal year shall be divided by the number of such certificates issued by the trustee of the trust.

III. There shall be no obligation to make the provisional Income Tax payments referred to in Article 14 hereof.

IV. The Income Tax on the results distributed by the trustee shall be withheld to the holders of certificates of participation by the latter, who shall apply a rate of 28% on the amount so distributed, unless the holders of such certificates are exempt from payment of Income Tax on such revenue.

When the certificates of participation have been placed with the investing public, the Income Tax referred to in the next preceding paragraph shall be withheld by the financial intermediary with whom said certificates have been deposited, and the trustee shall be released from the obligation so to withhold.

V. Holders of certificates of participation who reside in Mexico or reside abroad but have a permanent establishment in this country shall accrue as taxable the results so distributed to them by the trustee or financial intermediary as proceeding from the assets, rights, credits or securities comprising the fund of the trusts having issued said certificates and shall also accrue as taxable the profit from alienation of such certificates (unless such holders are exempt from payment of Income Tax thereon) and may apply as credit the tax withheld from said result and said profit, to the Income Tax due by them in the fiscal year of distribution or alienation.

¹⁶ Mexico, Ley del Impuesto Sobre la Renta, 2010

Individuals residing in Mexico shall consider that the taxable results so distributed corresponds to the revenues referred to in Section II del Article 141 hereof.

Amounts withheld from holders of certificates of participation who are foreign residents shall be deemed final tax payment.

VI. [Revoked]

VII. When the pension and retirement funds referred to in Article 179 hereof acquire certificates of participation, they may apply the exemption granted in said Article to their revenues from the assets, rights, credits or securities comprising the fund of the trust having issued said certificates and to the capital gain obtained for the alienation thereof.

VIII. The pension and retirement funds referred to in Article 33 hereof may invest up to 10% of their reserves in certificates of participation issued by the trusts referred to in this and the next preceding Article.

IX. Upon alienation of an entrusted property prior to lapse of the minimum period referred to in Section IV of Article 223 hereof, tax at a rate determined by applying a rate of 28% to the profit obtained from such alienation, determined as provided, in Chapter IV del Title IV hereof, shall be paid by the trustee for the account of the holders of certificates of participation (without identifying said holders) in the term of 15 days next following such alienation. Said tax may be applied as credit by the holders of such certificates to which the trustee distributes said profits (provided, that said profit is taxable for them) and no tax shall be withheld on the profit so distributed.

X. When the taxable results for the fiscal year on the revenues generated by entrusted assets exceed the amount thereof distributed on or before March 15 of the next preceding year to the holders of certificates of participation, the trustee shall pay tax at a rate of 28% on the excess for the account of such holders (without identifying them) in the term of the next following 15 days. Said tax may be applied as credit by holders of such certificates receiving subsequently the revenues proceeding from said excess (if such revenues are taxable for them) and no tax shall be withheld on the profit so distributed.

XI. Holders of certificates of participation shall pay Income Tax on the profit from alienation thereof, determined by subtracting the average cost of each certificate so alienated from the revenue from such alienation.

The average cost per certificate of participation shall be determined by including in the computation thereof all certificates of the same issuing trust had by the alienator as of the date of alienation, notwithstanding that all such certificates are not alienated.

The average cost of certificates of participation shall be computed by dividing the proven acquisition cost of all certificates of the same issuing trust had by the alienator as of the date of alienation, updated from the month of acquisition to that of alienation, by the total number of such certificates held by the alienator.

When an alienator does not alienate all certificates of participation of an issuing trust had as of the date of an alienation, the proven acquisition cost of the certificates not alienated in computations of such cost for subsequent alienations in terms of this Section shall be that which was determined in the computation thereof for the next preceding alienation, and the acquisition date shall be the date of the latter.

Acquirers of certificates of participation shall withhold as Income Tax from alienators thereof, 10% of the gross revenues obtained by the latter, with no deduction, unless the alienator is an entity residing in Mexico or be exempt from payment of revenues from assets, rights, credits or securities comprising the patrimony of the trust having issued such certificates.

When a trustee delivers to a holder of a certificate of participation an amount exceeding the taxable results for the fiscal year generated by the entrusted assets, said amount (updated from the month of delivery to that of alienation of a part or all such certificates on the occasion next subsequent to said delivery) shall be deemed capital refund and shall decrease the proven acquisition cost of said certificates.

For purposes of the next preceding paragraph, trustees shall keep an account on which they register such capital refunds, and shall give holders of certificates of participation (except those placed with the investing public) evidence of all refunds so received.

XII. When certificates of participation placed with the investing public through the acknowledged markets referred to in Sections I and II of Article 16-C of the Federal Tax Code are alienated through said markets, Income Tax shall not be due on the profit obtained from such alienation by foreign residents with no permanent establishment in this country or by individuals residing in Mexico.

XIII. Persons who contribute properties to a trust in the status of trustors and receive certificates of participation for the full or partial value thereof may defer the payment of Income Tax on the profit on alienation of each such certificate through such contribution (the amount of which is to be updated for the period from the month of such contribution to that of such alienation) until the occasion of such alienation.

For purposes of the next preceding paragraph, the tax shall be computed by applying a rate of 28% to the profit on alienation of such properties and shall be paid in the term of 15 days next following alienation of such certificates.

The profit obtained from alienation of property through contribution thereof to a trust in the status of trustor, represented by each certificate of participation received in exchange for such assets, shall be determined as provided herein, with the value given to such properties in the instrument of issuance of such certificates being deemed the alienation price thereof and the resulting profit being divided by the number of such certificates (determined by dividing said value by the par value of each certificate).

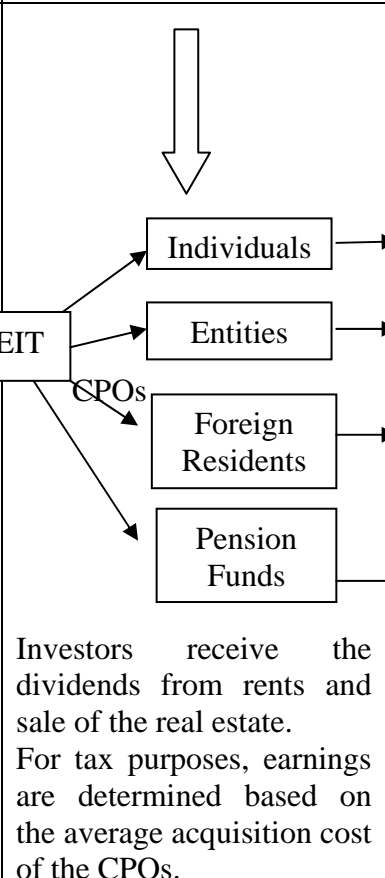
The deferment of tax payment referred to in this Section shall terminate on alienation of the properties by the trustee, and the tax shall be paid in the term of fifteen days next following such alienation thereof, by the trustor having contributed such properties.

For persons paying tax under Title II hereof, the tax on the profit shall be due in the fiscal year of alienation of said certificates, or of the entrusted assets by the trustee, the amount thereof shall be updated for the period from the month of contribution of the assets to that of alienation of said certificates or the properties, and the tax paid in the terms of this Section shall be deemed provisional payment of Income Tax for the fiscal year.

Trustors who receive certificates of participation for contribution of property to a trust shall consider that the quotient of division of the value assigned to such properties in the instrument of issuance of such certificates, by the number thereof (as determined by dividing said value by the par value of each certificate) is the proven acquisition cost of each such certificate, and the acquisition date is that of their receipt as such contribution. The profit on alienation of the certificates referred to in this paragraph shall be determined as provided in Section XI of this Article.

XIV. When trustors contribute properties to a trust and said properties are thereupon leased by the trustee to the beneficiaries, Income Tax due on the profit on alienation of such assets may be deferred until the first to occur: the date of end of the lease agreement (provided, that the term thereof does not exceed 10 years) or that of the trustee's alienation of the properties so contributed, on which date the tax on the profit resulting from application of a rate of 28% to the amount of said profit, updated for the period from the month of such contribution to that of the end of such lease agreement or of the trustee's alienation of the properties, shall be due and payable.

Mexican REIT structure

REIT	Investors	Tax Treatment
<p>At the time of contribution of the real estate, the trust does not pay taxes, nor makes any withholdings</p> <p>REAL PROPERTY</p> <p>Cash or CPO</p> <p>Income taxes shall be paid by settlor (owner) upon the sale of the real property or of the CPOs</p>	 <p>Investors receive the dividends from rents and sale of the real estate. For tax purposes, earnings are determined based on the average acquisition cost of the CPOs.</p>	<p>The beneficiaries of the trust are exempted from making provisional payments They only file an income tax return at the end of the year.</p> <p>Net income will be accumulated.</p> <p>Income will be accumulated.</p> <p>Payment of any withholding is made and compensated pursuant to International treaties.</p> <p>Domestic: Do not pay taxes</p> <p>Foreign: Pay taxes according to their local tax regime</p>

We can summarize the previous table as follows:

Organization

The trusts must be organized under Mexican law and the trustee must be a credit institution residing in Mexico and duly authorized to act as such in this country.

Purpose

The primary purpose of the trust is acquisition or construction of properties intended for lease or for acquisition of the right to obtain revenues proceeding from lease of such assets, and also for the grant of financing for said purpose with the assets so leased serving as guarantee.

Investment of patrimony

At least 70% of the trust fund be invested in real properties or in the rights or credits referred to in the next preceding Section and the remainder be invested in Federal Government securities registered in the National Securities Registry or in shares of debt-instrument investment corporations.

Destination of buildings

The real property built or acquired is intended for lease and not to be alienated prior to the lapse of at least four years from the end of construction or the date of acquisition, respectively. Real properties alienated prior to the lapse of the established term shall not warrant the preferential tax treatment established in Article 224 before mentioned.

Certificates of participation

The trustee issue certificates of participation covering the assets comprising the trust fund and said certificates be placed with the investing public of this country or be acquired by a group of investors comprising not less than ten persons of which none is a party in a relationship with any of the others nor owner of more than 20% of all the certificates of participation issued.

Distribution of taxable results

The trustee must distribute at least annually and no later than March 15, among all holders of certificates of participation, 95% of the taxable results generated in the next preceding fiscal year by the assets comprising the trust fund.

3.2 Other laws affecting REITs

If a foreigner owns property in the restricted zone, the property may be held in trust by a bank, with him/herself listed as the main beneficiary. The restricted zone is 60 miles from any Mexican border and 30 miles from the coast.

Foreign Investment Law¹⁷

Real estate outside the restricted zone Exploitation of mines and waters

Article 10-A. Aliens intending to acquire real estate outside the restricted zone or to obtain concessions for exploration and exploitation of mines and waters in national territory shall require previously to file with the Ministry of Foreign Relations a written instrument setting forth their agreement with the provisions of Section I of Article 27 of the Political Constitution of the United Mexican States and to obtain the corresponding permit from said Agency.

When the intention is to acquire real property in a municipality located entirely outside the restricted zone, or to obtain a permit to exploit mines and waters in national territory, said permit shall be deemed granted unless a negative issued by the Ministry of Foreign Relations is published in the term of five business days next following the filing of the application.

When the intention is to acquire real property in a municipality part of which is located in the restricted zone, the Ministry of Foreign Relations shall resolve thereupon in the term of five business days next following the date of filing thereof...

Authorization required by trustees

Article 11. Authorization of the Ministry of Foreign Relation shall be required for credit institutions to acquire rights, in the standing of trustees, to properties located in the restricted zone, when the purpose of the trust is to permit use and advantage of such assets but without constituting rights in rem in respect thereof, and the trust beneficiaries are:

I. Mexican corporations the charter of which does not contain clause of exclusion of aliens, in the cases provided for in Section II of Article 10 hereof; or

II. Alien individuals or entities.

¹⁷Mexico, Ley de Inversion Extranjera, 2010

Meaning of "use and advantage of real property located in a restricted zone"

Article 12. The term "use and advantage of real property located in a restricted zone" shall be deemed to mean the rights to have use or advantage of such property, including, as applicable, obtention of civil fruits and products and generally of any yields resulting from operation and exploitation for purpose of profit, whether through third parties or through the trust institution

Maximum duration of trusts

Article 13. The maximum duration of the trusts referred to in this Chapter shall be fifty years and may be extended upon request of an interested party.

The Ministry of Foreign Relations may at any time verify compliance of the conditions under which the permits referred to in this Article were issued, and also the due filing and the veracity of contents of the notices provided for therein.

Chapter 4

4. REITs. A Framework of Analysis

In order to analyze to what extent a legal reform or new regulation has impacted REITs performance we might consider other variables that may correlate negatively or positively to its success. There are different variables, that in theory, affect the extent of a REIT market and for the purposes of the present thesis we will divide these variables in two, and name them arbitrarily¹⁸ as legal and socio-economic variables.

1. Legal:

- Tax incentives for REITs
- Tax incentives for shareholders
- Structure of REIT companies including shareholder diversification, management, etc.
- Borrowing capacity

2. Socio-economic:

- Economy in the selected market
- Availability of real estate properties in the area
- Interest rate
- Preference of individual investors
- Risk, return and other characteristics of alternative investments such as real estate, common stock, bonds, etc.¹⁹

¹⁸ There is a thin line between those variables that were born from the legislation (reforms) and those that are consequence of the economical, political and social conditions. Some analysts would find more convenient to divide the variables into those affecting REITs directly (legislation enacted with the purpose to affect on REITs) and indirect (variables that were born or not from enacted laws but without the purpose to affect on REITs)

¹⁹ Lim, Gill-Chin, *A Comparison of REITs In Three Countries: What Can Japan and Korea Learn from USA?*, Michigan State University, Powerpoint

4.2 Legal Variables

Tax and other incentives

REITs owe their very existence to the authorities creating new guidelines and granting special privileges. The taxation regimes for investors and the trusts, and the rules governing trusts, are therefore central to the scope and nature of a REIT's activities and ultimately to its performance. Regulatory changes introduced after a market has been created can have a massive and immediate effect on share prices.

The major motive is to offer a much needed alternative vehicle to investors whose choices have mostly been limited to stocks and bonds. A vibrant REIT market also improves the transparency of property markets because trusts are obliged to supply flow of information about rents and capital values to their investors. REITs also tend to be active purchasers of buildings, so they can help revive property markets.

Landlords are often keen to selling their buildings in order to raise funds for new projects, and REIT markets can give them a good price. But in most cases, for a REIT market to take off, a government needs to provide special corporate tax incentives to persuade owners of buildings that it is more advantageous for them to hold a stake in a publicly traded trust than own the whole building privately. Typically, governments will waive corporate income tax on REITs. A fundamental result of the corporate income tax waiver, together with tax breaks for investors, is that property trusts are usually valued higher than other types of property companies.

REITs in general tend to trade at much more than their buildings are worth on the open market (a premium to their net asset value) whereas other property companies listed on stock markets tend to trade at discount. But in majority of cases, the premium is also largely due to the tax breaks for REITs. Because more of the rental income flows to the owners of the buildings, the buildings are more highly valued. This difference in valuing property held by trusts exists for almost all REITS in Asia, and over a much longer period, has been the case for the established REIT markets in the US and Australia. Trusts in Japan have traded at as much as 80% premiums to net asset value, whereas 30 – 50% premiums are common in Australia.²⁰

Experience has already shown that regulatory changes after a REIT market has been introduced can have a major bearing on the way REITs operate and the returns they can give investors. Any reduction on tax, either at the corporate or REIT level or on investors will immediately improve returns.²¹

In Asia, Singapore has been the most generous with its tax incentives for REITs, and has gone further in easing rules on the activities of trusts. Some analysts say there is no better way of owning property. For example, when the Singapore government waived withholding tax for local individuals and cut it for foreigners, REIT share prices jumped.

On the other hand, Hong Kong decided that its tax breaks for investors in any kind of stock were already good enough, and it offered nothing special for property trusts. The REIT market there took a long time to start up, because there was no big tax incentive to persuade

²⁰ Garrigan, Op. Cit., p 79

²¹ Idem., p 81

cash-rich property companies to sell their buildings unless the property market was approaching its peak.

Another tool regulators can wield to make REITs more attractive is raising the amount a trust can borrow, which makes it easier for trusts to expand by buying new buildings. Higher debt can give a REIT the opportunity to improve returns for investors from buildings that have relatively low yields on the open property market.

Regulators in Asia have limited the amount of debt REITs can take on in order to protect investors from excessive risk. Obviously, when interest rates rise, trusts can get into trouble if their debt is high, although managers usually try to fix their interest rates by issuing long-term mortgage-backed securities or through interest rate swaps. Australia has no limit on borrowing but listed property trusts there have tended to keep around a 40% gearing rate.

Singapore and Hong Kong have both raised their limits on borrowing since they introduced their original REIT codes. Singapore has gone to the farthest with trusts allowed to borrow as much as 60% of their asset value as long as they obtain a debt rating from a credit ratings agency. Hong Kong lifted its gearing limit to 45% in 2005 from 35%.

Law and Governance

Mexico	USA	Korea
Since 2003 General Law of Negotiable Instruments and Credit Operations, Income Tax Law, Foreign Investment Law Minimum 10 shareholders One shareholder no more than 20% Weak protection	Since 1960s Four major acts Minimum 100 shareholders Five or fewer shareholders no more than 50% Protection by SA and SEA	Since 2001 One law & Imp. R. Founder more than 10% and less than 30% At least 30% by public An individual less than 10% Weaker protection than USA

Operation and Management

Mexico	USA	Korea
At least 70% invest in RE At least 95% of income as dividend distribution Own operate & manage develop M&A possible	At least 75% invest in RE At least 90% of income as dividend distribution Own operate & manage develop M&A possible Professional service internalized	At least 75% invest in RE At least 90% of income as dividend distribution Development included M&A difficult Internal and External

Current situation of Mexican REITs

REITs in Mexico have been ruled since 2003. Yet, since then only one REIT has gone public, the Casablanca Trust, introduced in 2006 with 27.6 US million dollars in secured securities. Given Mexico's size of economy and potential for real estate, the existence of only one public REIT might seem much less than expected.

Some analysts state that the slow reception of Mexican REITs is because the legal structure still is not clear, especially when talking about what tax incentives will reach the REITs and the request for more revision on the current legislation.

In our opinion this argument was truth under the previous legislation. The previous legislation considered the real estate transfer tax (*impuesto sobre adquisicion de bienes inmuebles*). The real estate transfer tax is a local tax that taxed the contribution the real estate to the trust, the sale of real estate by the trustee or the sale by beneficiaries of participation certificates. As it can be easily perceived under that regime, it was not attractive for investors to purchase certificates from REITs due to the tax imposition.

The reforms changed that scenario allowing investors that purchased certificates of participation being waived from the tax, and just the initial transfer of the real property to the trust being taxed.

The following chart shows the Mexican Estates that initially agreed to participate in the tax exemption from real estate transfer:

- 👍 Distrito Federal
- 👍 Estado de México
- 👍 Baja California
- 👍 Sonora
- 👍 Sinaloa
- 👍 Nayarit
- 👍 Michoacán
- 👍 San Luis Potosí
- 👍 Puebla
- 👍 Tabasco
- 👍 Campeche
- 👍 Hidalgo
- 👍 Guanajuato



Source: Bolsa Mexicana de Valores

Another issue that may deter the success of Mexican REITs is the requirement for non public REITs. It is necessary to be formed by at least more than 10 shareholders and that none of them hold more than 20% of the investment value.

Nonetheless, this requirement's intention is to prevent REITs' work as a structure exclusive for private investment. Looking to avoid taxation, some analysts have considered that it can have a negative effect to not allow investors to have control over the REIT, as it occurs in

other shares where there is usually a strong group that controls and makes the important decisions.

Here we again disagree, in other countries where REITs have been established successfully, imposed even higher number of minimum shareholders (i.e. USA), and though it is not the purpose of the present thesis to enter into debate of an issue related to corporate governance, we consider that having a structure that allows strong control groups on REITs would undermine the original purpose of REITs.

For other analyst, REITs have found problems on settling due to the fact that property in Mexico is held by families rather than corporations. Phillip Kibel VP Senior Creditor Officer from Moody's Corporation says. "In the United States, companies were mostly run as partnerships before REITs came along, while in Mexico they are still familial organizations,"²²

As we commented previously on the Hong Kong experience this was an initial problem for the REITs to take off and there is optimism that as happened in Hong Kong as soon as REITs become successful more family properties will go public.

"There are lots of good properties that could be converted to REITs, but most are owned by families. There aren't as many private companies or entrepreneurs in Mexico, and that's what you need to start a REIT. We do anticipate generational changes that will lead some of these families to convert their properties to REITs, and there are some lawyers and investment bankers looking into REITs."²³

²² Kibel, Phillip, www.nareit.com

²³ Ibid.

Still, we also have to keep in mind that maybe it is too soon to judge Mexican REITs. For example, the US REIT has not always been successful. It took more than forty years of various revisions to increase the size of the REIT industry.

Moreover, in terms of governance system, the USA is much more diversified than Mexico. Ownership concentration is possible in Mexico. USA has a wider range of protection by law.

Some other things we have to consider if we want to make more objective comparisons between both countries (Mexico and USA) are:

- Investment in real estate and dividend distribution requirements are almost the same.
- Mexico's REIT structure differences are not that different from those of US REITs.
- US REITs have grown in size substantially over the last thirty years, but they are still a small portion of the whole commercial real estate.
- In view of the policy goal, there are fundamental issues of income distribution and distributive implications of REIT in the United States and yet to have a clear understanding for Mexico's policy makers.
- US REITs have passed under several revisions and tough mechanisms of improvement. Mexico still needs to prove the efficiency of the latest reforms and probably go thru more revisions on REIT rules if they want the REIT to be an effective public policy instrument.
- Mexico's regulation on REITs has been for a relative short time. This is important in an economy that usually takes time to catch up with the economic reforms.

- REITs first years' regulation in Mexico has coincided with a period during which Mexican economic conditions have been far from ideal.

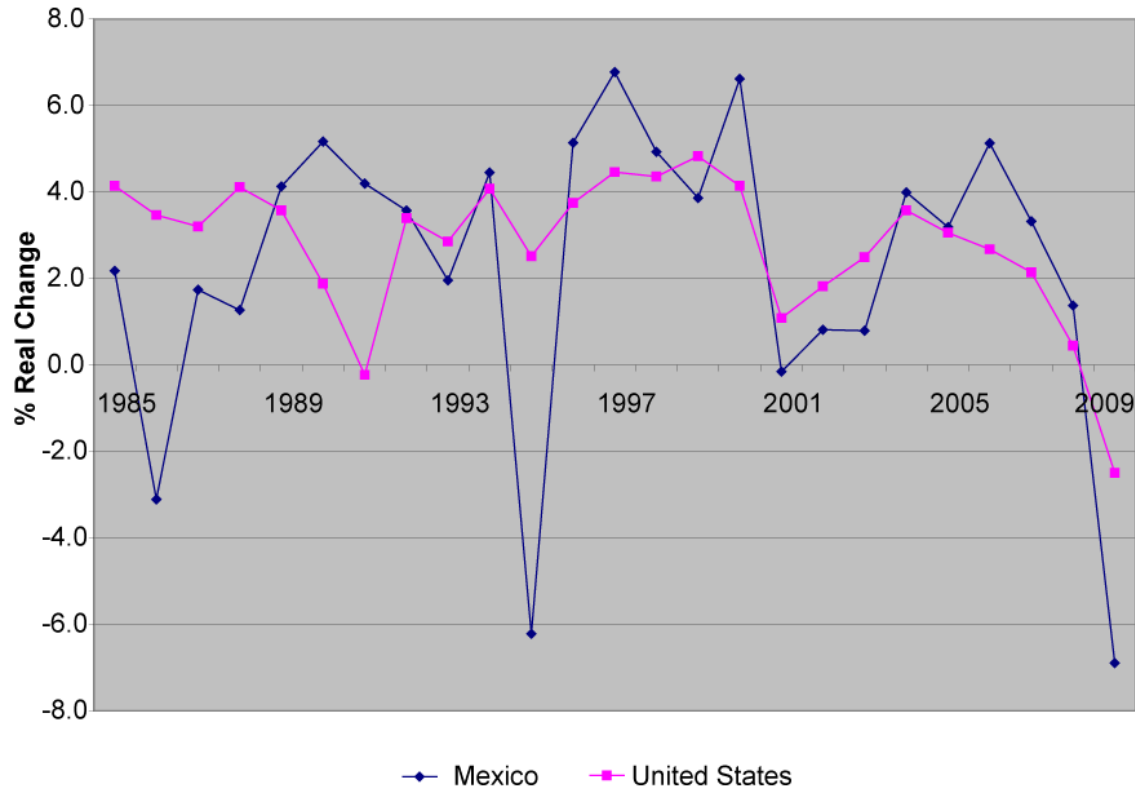
Still, we also have to keep in mind that maybe it is too soon to judge Mexican REITs. For example, the US REITs have not always been successful. It took more than forty years of various revisions to increase the size of the REIT industry. Korean REITs are also relatively new, however in just 10 years of life, Korean REITs have gone through several reforms as we saw in Chapter 2. Korean REITs have undergone the creation of different structures, CR-REITs, K-REITs and finally RETFs, which was the one that proved to be more successful given its advantages. However the process that brought Korea to reach conclusions was not a flat line, and an active approach from the authorities to fix the REITs structures was necessary in order to achieve the desired results. Similar to Korea, REITs in Mexico have been for a short period but different to Korea, Mexico has had little opportunity to test its structure.

4.3 Socio-economic variables

Mexico's Economy

In recent years Mexico has experienced the deepest recession in the Latin America region following the most recent crisis. Other Latin American countries have experienced negative economic consequences from the global financial crisis, but to a lesser extent mostly because of the high dependence to the USA market.

GDP Growth Rates for the United States and Mexico



Source: Economist Intelligence Unit

We consider that REITs regulation in Mexico has coincided with a bad performance of the Mexican economy, making investors more reluctant to try new investment vehicles, though some experiences have shown that REITs can be a good part of an investment portfolio during economic crisis.

Financial Markets in Mexico

Two prominent characteristics of Mexico's financial system are that financial assets have short maturities (contrary to the nature of REITs) and that the funds that flow through this system are highly volatile.²⁴

The investors' reluctance to make long-term commitments to Mexico's financial markets results from experience: in the 1980s, while ex ante real interest rates on Latin American financial assets were usually high; ex post real interest rates were often highly negative. In the 1990s, policymakers, realizing that reforms designed to reduce the vulnerability of Latin American financial markets cannot succeed until investors gain confidence that the real value of their long-term investments is protected, instituted stabilization programs and structural reforms that have improved the environment in which financial markets operate²⁵.

On the other hand, Mexican debt market is still largely dominated by government bonds, certainly affecting the issuance of corporate bonds. This effect in economics can be due to the "crowding out" of the private sector through government borrowing in domestic currency or to imperfect corporate governance and unreliable contract enforcement mechanisms.²⁶ Moreover Tovar and Quisepe-Agnoli²⁷ have pointed out that corporate bonds are not as attractive as government bonds since the later are free of taxes

²⁴ Rojas-Suarez, Liliana, *Building Stability in Latin American Financial Markets*, Institute for International Economics - Center for Global Development, United States, 1998, p. 3

²⁵ Ibid p. 3

²⁶ Habermann, Harald, *Financial Development in Mexico between 1975 and 2009*, Case study in financial research, University of Glasgow, Department of Economics, p. 68

²⁷ Tovar, Camilo E., and Quisepe-Agnoli, Myriam, *New financing trends in Latin America : an overview of selected issues and policy challenges*, Federal Reserve Bank of Atlanta, Economic Review, 2007

Despite the recent gains, investors remain wary of making placements in second-tier initial public offerings (IPOs). Purchasers of new issues were disappointed after prices fell in numerous medium-sized companies that made offerings in 1996 and 1997. IPO activity in Mexico remains tepid and the market for second-tier IPOs is barely visible. There were only three IPOs in 2005.²⁸

Interest rates

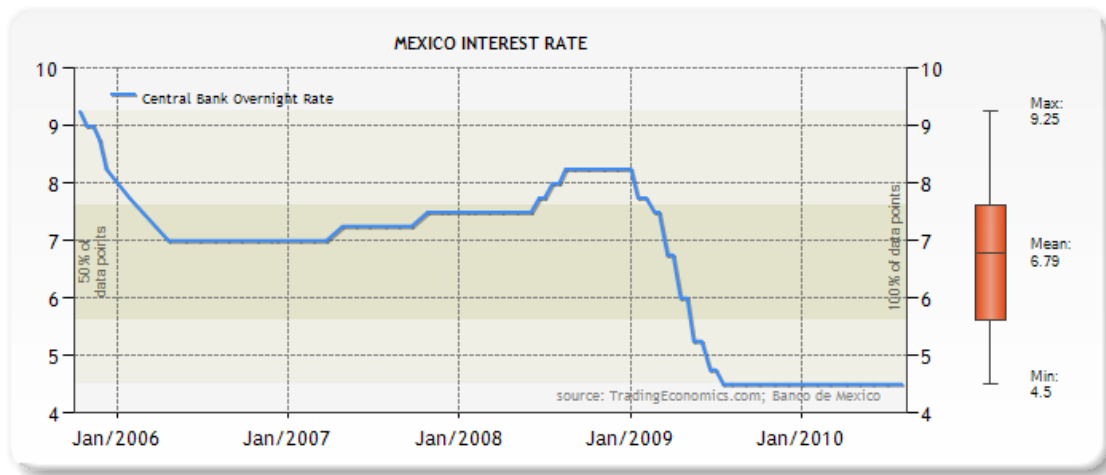
REITs are relatively high-yield instruments. And as a high-yield investment, a REIT can be expected to exhibit sensitivity to interest rate changes. At the same time, although there is some disagreement in this issue, the conventional wisdom says that higher rates are generally bad for REITs.²⁹

Mexico kept in the previous years relatively high interests rates and we can presume those competed with other investments as well as those that may have transformed into REITs investments.

Nonetheless, Mexico's central bank starting from 2009 has held interest rates low this year to support the weak economy, and we could expect that REITs will become more attractive for investors once interest rates are kept low and investors look for more profitable investment vehicles.

²⁸ www.countryanalysis.eiu.com/country_reports.html, Country Finance Main Report: April 26th 2006 (Mexico) Securities Market Overview

²⁹ Harper, David, The Impact Of Interest Rates On Real Estate Investment Trusts, article from www.investopedia.com



Source: <http://www.tradingeconomics.com>

Difficulties on doing real estate business in Mexico

Mexico shows a middle balance when compared with other economies in terms of ease of doing business; but, when compared with those that have a going REIT market, it is clear that Mexico is falling behind. There is a lot of room for improvement from Mexican authorities regarding key concepts which are important for real estate investment, such as dealing with construction permits, registering property, getting credit, paying taxes, protection for investors, and enforcing contracts.

One of the most common claims for investors is that regardless that Mexico has created tax incentives similar to those of USA for REITs; the tax system is still very complicated and not transparent. In terms of paying taxes (the only concept where Mexico has revealed a real improvement, changing in rank from 149 to 106), an important factor when it comes to REITs as we have exposed in the present work, Mexico shows an evident lack of competitiveness. Though this reflects in other industries, REITs are more sensitive due to its sensitive on tax changes where additionally there are no more incentives.

The tables below shows Mexico's performance on key factors compared with two other economies (South Korea and USA) that, as well as Mexico, have regulations on REITs.

United States

Ease of...	Doing Business 2010 rank	Doing Business 2009 rank	Change in rank
Doing Business	4	4	0
Starting a Business	8	6	-2
Dealing with Construction Permits	25	26	+1
Employing Workers	1	1	0
Registering Property	12	11	-1
Getting Credit	4	4	0
Protecting Investors	5	5	0
Paying Taxes	61	54	-7
Trading Across Borders	18	16	-2
Enforcing Contracts	8	9	+1
Closing a Business	15	15	0

South Korea

Ease of...	Doing Business 2010 rank	Doing Business 2009 rank	Change in rank
Doing Business	19	23	+4
Starting a Business	53	133	+80
Dealing with Construction Permits	23	23	0
Employing Workers	150	149	-1
Registering Property	71	65	-6
Getting Credit	15	12	-3
Protecting Investors	73	70	-3
Paying Taxes	49	45	-4
Trading Across Borders	8	12	+4
Enforcing Contracts	5	7	+2
Closing a Business	12	12	0

Mexico

Ease of...	Doing Business 2010 rank	Doing Business 2009 rank	Change in rank
Doing Business	51	55	+4
Starting a Business	90	114	+24
Dealing with Construction Permits	37	33	-4
Employing Workers	136	136	0
Registering Property	99	90	-9
Getting Credit	61	59	-2
Protecting Investors	41	38	-3
Paying Taxes	106	149	+43
Trading Across Borders	74	69	-5
Enforcing Contracts	81	76	-5
Closing a Business	24	24	0

Dealing with Construction PermitsDB10 rank: **37** DB09 rank: **33** Change in rank: **-4**

Shown below are the procedures, time, and costs to build a warehouse, including obtaining necessary licenses and permits, completing required notifications and inspections, and obtaining utility connections.

Indicator	Mexico	Latin America & Caribbean	OECD Average
Procedures (number)	12	16.7	15.1
Time (days)	138	225.0	157.0
Cost (% of income per capita)	113.1	210.8	56.1

Registering PropertyDB10 rank: **99** DB09 rank: **90** Change in rank: **-9**

The ease with which businesses can secure rights to property is shown below. Included are the number of steps, time, and cost involved in registering property.

Indicator	Mexico	Latin America & Caribbean	OECD Average
Procedures (number)	5	6.8	4.7
Time (days)	74	70.4	25.0
Cost (% of property value)	5.2	5.9	4.6

Getting CreditDB10 rank: **61** DB09 rank: **59** Change in rank: **-2**

Measures on credit information sharing and the legal rights of borrowers and lenders are shown below. The Legal Rights Index ranges from 0-10, with higher scores indicating that those laws are better designed to expand access to credit. The Credit Information Index measures the scope, access and quality of credit information available through public registries or private bureaus. It ranges from 0-6, with higher values indicating that more credit information is available from a public registry or private bureau.

Indicator	Mexico	Latin America & Caribbean	OECD Average
Strength of legal rights index (0-10)	4	5.5	6.8
Depth of credit information index (0-6)	6	3.3	4.9
Public registry coverage (% of adults)	0.0	10.0	8.8
Private bureau coverage (% of adults)	77.5	33.2	59.6

Protecting InvestorsDB10 rank: **41** DB09 rank: **38** Change in rank: **-3**

The indicators below describe three dimensions of investor protection: transparency of transactions (Extent of Disclosure Index), liability for self-dealing (Extent of Director Liability Index), shareholders' ability to sue officers and directors for misconduct (Ease of Shareholder Suits Index) and Strength of Investor Protection Index. The indexes vary between 0 and 10, with higher values indicating greater disclosure, greater liability of directors, greater powers of shareholders to challenge the transaction, and better investor protection.

Indicator	Mexico	Latin America & Caribbean	OECD Average
Extent of disclosure index (0-10)	8	4.0	5.9
Extent of director liability index (0-10)	5	5.3	5.0
Ease of shareholder suits index (0-10)	5	6.0	6.6
Strength of investor protection index (0-10)	6.0	5.1	5.8

Paying TaxesDB10 rank: **106** DB09 rank: **149** Change in rank: **+43**

The data below shows the tax that a medium-size company must pay or withhold in a given year, as well as measures of the administrative burden in paying taxes. These measures include the number of payments an entrepreneur must make, the number of hours spent preparing, filing, and paying, and the percentage of their profits they must pay in taxes.

Indicator	Mexico	Latin America & Caribbean	OECD Average
Payments (number per year)	6	33.2	12.8
Time (hours per year)	517	385.2	194.1
Profit tax (%)	22.9	20.4	16.8
Labor tax and contributions (%)	26.7	14.7	24.4
Other taxes (%)	1.3	13.2	3.3
Total tax rate (% profit)	51.0	48.3	44.5

Enforcing Contracts		DB10 rank: 81 DB09 rank: 76 Change in rank: -5	
The ease or difficulty of enforcing commercial contracts is measured below. This is determined by following the evolution of a payment dispute and tracking the time, cost, and number of procedures involved from the moment a plaintiff files the lawsuit until actual payment.			
Indicator	Mexico	Latin America & Caribbean	OECD Average
Procedures (number)	38	39.7	30.6
Time (days)	415	707.0	462.4
Cost (% of claim)	32.0	31.3	19.2

Source: <http://www.doingbusiness.org>

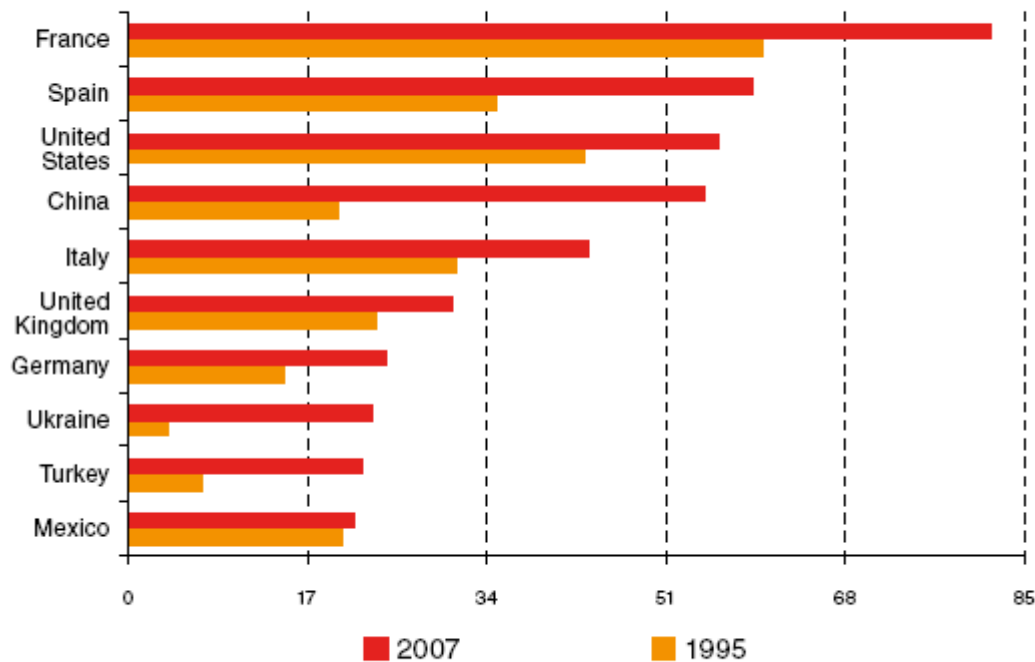
4.4 Opportunities for REITs in Mexico

We have analyzed some of the reasons why REITs in Mexico have not taken off yet. However, this study will not be complete if we do not include one specific chapter to examine the enormous potential for Mexican REITs once the issues exposed in the previous chapter have been tackled off.

Mexico is one of the top 10 tourist destinations in the world and the largest market in Latin America and the Caribbean³⁰. We consider that the big potential of the tourist market will be the main attractions for investors and REITs the perfect vehicle to make investments in this sector.

³⁰ CEPAL, Foreign direct Investment in Latin America and the Caribbean, United States, 2009, p. 17

**MAIN TOURISM DESTINATIONS, BY INTERNATIONAL ARRIVALS,
1995-2007**
(Millions of visitors)



Source: Economic Commission for Latin America and the Caribbean (ECLAC), on the basis of information from the World Tourism Organization (UNWTO).

The Mexican tourism sector is shifting from the “traditional hotel property” to a greater diversification in tourism-related real estate developments:

To the traditional vacation hotels, many of which operate as all-inclusive schemes, have been added integrated multipurpose hotel and real estate mega-projects, which may include luxury hotels, condominiums, timeshare complexes, vacation homes, marinas, golf courses, wellness centers and shopping centers, ideal for being projected through REIT investment.³¹

The big number of beautiful natural attractions and cultural attractions combined with the proximity to the United States, lower land prices and cost of living, and better guaranties for purchasing property have been in the last years a magnet for real estate developers wanting to attract investors, especially from the United States.

Travel & Tourism Competitiveness Index: Human, cultural, and natural resources

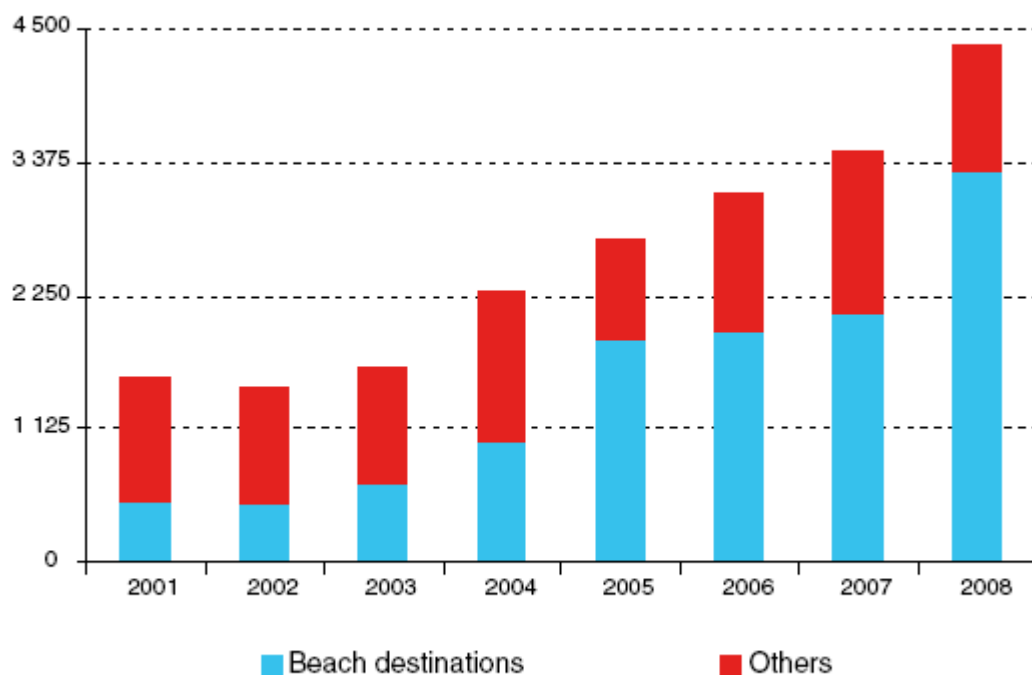
³¹ Ibid., p. 19

Natural Resources		Cultural Resources	
Rank	Score	Rank	Score
25	4.44	25	4.43

Source: World Economic Forum

Baby boomers from the United States, are acting as key drivers of demand for these high-end tourism destinations and thanks to the land reforms of 1994 that allowed foreigners to own real estate within particular areas and under certain circumstances (under a bank trust) real estate developments are on the high wave.

MEXICO: PRIVATE INVESTMENT IN TOURISM, BY SEGMENT, 2001-2008
(Millions of dollars)



Source: Economic Commission for Latin America and the Caribbean (ECLAC), on the basis of information from the Secretariat of Tourism of Mexico (SECTUR).

Conclusions

Mexico has followed the REIT trend around the world in terms of regulations. However, REITs in Mexico are far from being successful. Nevertheless, we should not forget that even in much more dynamic and competitive economies such as Hong Kong and Korea, REITs' development has faced many challenges and most countries have gone through different reforms (i.e. Japan, Korea). Mexico itself has implemented two main reforms in terms of REITs and it is expected to implement another at the beginning of the coming year.

Although at first sight we may conclude that Mexican REITs' conditions do not differ greatly from other countries, and due to the great potential that REITs in Mexico apparently has for many investors, it's interesting to ask why REITs in Mexico are yet to take off.

We have seen that the regulation on REITs in Mexico is very similar to that of United States and other countries. And though in the first legislation on Mexican REITs has several flaws, the reforms have fixed in great extent those inconveniences.

Importing regulations from one country to another doesn't necessarily imply that because they were successful in the country of origin that it will be in the reception country. However, we consider that the law-makers have kept the nature of international trust regulation and have taken advantage of the flexibility of this legal figure when applying to the Mexican legal framework. That does not mean that in legally Mexican REITs are not subject to perfectionism, but that it has started in good way our path to find a better set of regulations around REITs.

However, no matter how good are the intentions in order to make REITs, if other factors limit the growth of Mexican REITs we can expect to see sporadic public REITs and mainly those interested in the tourism sector, regardless of the fact that Mexico's real estate market is valued in \$15,460,744,980 USD³².

It is not likely at this point that investors interested in industrial and office real property will go for REITs, since it is not yet well perceived how tax incentives will be enough to shadow other inconveniences that limit the REITs' expansion.

Structural issues are the main problem not only for Mexican REITs but also for other types of investments, though due to their nature, REITs are highly sensitive to these variables especially when there is still a lot of skepticism of investors around long-term investments.

In the United States and other countries it has been easier to appreciate the negative or positive impact on the different reforms. In Mexico, the result has been neutral without creating the expected growth on REITs. Though regulations are fundamental for the development and success of REITs, and good first steps have been taken, policy makers need to understand that isolated regulations without considering the entire framework around, regardless of certain tax incentives, will not be enough to reach the goal of creating new options for investment in the Mexican real estate market.

³² Just for the office and industrial sector of the cities of Mexico, Monterrey and Guadalajara. Source: Colliers International

RECOMMENDATIONS

While we believe the main problem for REITs to make roots in Mexico is the little diversified financial market and its tax system, it would be irresponsible and simplistic to just mention that it is necessary to perform a series of reforms in that sense. Not only has it not been the purpose of this thesis to reach deep conclusions and analysis of those topics but it will be unrealistic to consider that major reforms can be done in the next few years.

On the other hand, as we have been analyzing it is possible to make other changes that can make an impact on REITs acceptance in Mexico that do not consider a whole reform but a series of minor adjustments. No country, as has been exposed, found the immediate key to success on REITs, but there is evidence that some minor improvements can contribute a lot.

Though trusts have been incorporated in Mexico for some years already, there is still little knowledge about them even from the professionals in the Financial and legal field. It is not difficult to understand why the general investors see with reticence REITs when even most lawyers do not know how the REITs operate. The Mexican tax code is not easy and requires considerable study to be considered a reasonable tax lawyer, that summed with the fact that trust are not yet well understood, has contributed that few specialist recommend to their clients investments made on REITs.

During the research for this thesis I could perceive that the financial institutions have had the will to increase the awareness among investors of the advantages of using REITs. Specifically, the Bank of Mexico and the Mexican Stock Exchange have performed a series of conferences in order to inform to the public about REITs and periodically have

information regarding the topic. However the Tax Ministry and its dependencies have done little or nothing to provide more information to the accountants and lawyers who finally are the ones that can capture the incentives on the law on benefits to their clients.

We will not suggest that the tax policy makers grant more incentives, since the tax incentives are in accordance with other countries' regulations but we would like to suggest changing some simple requirements and reducing some costs to make REITs more accessible to the general public.

In Mexico one big problem for trusts is that only a Bank can be a trustee. While some countries have similar limitations, we have to consider that historically in Mexico Banks there is little offer to constitute Trusts, and therefore usually the cost of their services in any trust is very high compared to that with other countries. In the same line trusts have to be constituted before a Public Notary. Generally Notary services in Mexico are expensive but when the price comes to constituting trusts usually is even higher.

The initial costs may not represent a deterrent for big companies that are able to analyze efficiently cost and benefits, but as we discussed in chapter 2, in Hong Kong one of the initial problems for REITs to take off was that the families that held properties was that they were reluctant to invest on REITs. In the case of Mexico where also most of the real estate is hold by families rather than companies as it is the case in the USA, it makes it easier to understand why the initial high expenses can back owners to go for REITs. There are tax incentives but these are overlooked because it is not easy and definitely not cheap to constitute a REIT in Mexico.

In recent years Mexico implemented a program called "tuempresa" to start new companies. This program allows reducing time and procedure in an 80% that for example gives the possibility to use standardized formats available online in order to promote that more public has the understanding and access to constitute legally a new company.

In a similar way and it could be possible to reduce costs and at the same time not to compromise the legal certainty. This can be achieved by creating a national registry where all the trusts could be listed and the public can have access to the conditions of the property. Not only REITs and other trusts could benefit from the creation of a National Public Registry available online but other types of commercial and legal transactions. This public registry would be in charge to point all the liens and obligations on different properties and can be supported by the Government. By having this legal back from the government it would make unnecessary a Bank in the constitution of a Trust.

We are not suggesting that making it cheap to constitute REITs is the solution as it does not mean that just because improving the process and cost to start a company will make automatically profitable companies; however, is a good start to allow more public into the game.

One of the reasons I feel so attracted about the REITs was its "democracy", it allowed the general public to participate in the Real Estate market. Especially when the current economical situation in the world has made the Real Estate prices inaccessible for the most part of the population, REITs allowed not only to diversify the risk but to facilitate more players in the real estate market that otherwise would never do.

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