# Impact of COVID-19 on Real Estate Funds, & Cytonn Weekly #25/2020

## Focus of the Week

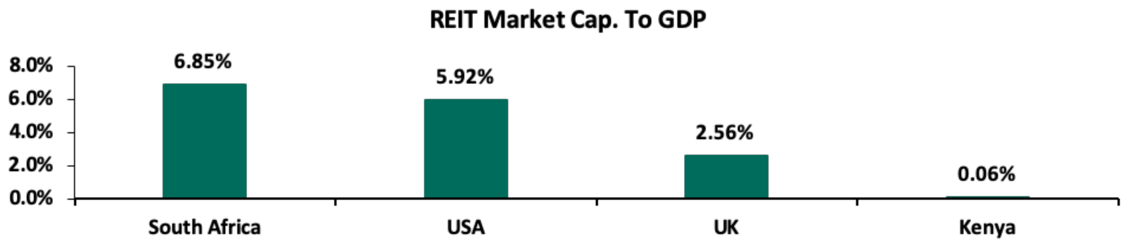
The COVID-19 pandemic started more as a global health crisis and has now triggered severe economic recessions as the impact of the pandemic continues to be significant. The Organization for Economic Co-operation and Development (OECD) in their OECD Economic Outlook, June 2020, expect global growth for 2020 to contract by 7.6% if there is a second wave of infections before end of the year and a 6.0% contraction if a second wave is avoided. There has not been any particular country or region that has been spared due to the lockdowns, which have significantly impacted trade and supply chains leading to declines in investments across the board since the beginning of the pandemic, with the S & P 500 having declined by 4.1% on a Year to Date (YTD) basis. Commodity prices have also been on a decline, with Oil recording consistent price declines resulting from low demand due to the lockdown measure. The Real estate sector, which has been considered a safe haven over time, has also been hit by massive illiquidity affecting the performance of the sector.

Closer home we have seen the Nairobi Stock Market register significant declines with the NASI declining by 13.1% on a YTD basis. The Fahari I-REIT, Kenya's only listed Real Estate fund has also not been spared having declined 41.4% YTD. In Q1'2020 Kenya's Listed Banks recorded a 0.9% points increase in gross Non Performing Loans (NPLs) to 11.3% from 10.4% in Q1'2019. This was high compared to the 5-year average of 8.5% as banks allow their clients to restructure their loan portfolios as a result of the tough operating environment. We have been analysing the impact of the pandemic on various sectors, where we looked at the Potential Effects of COVID-19 on Money Market Funds. We then wrote about the Impact of COVID-19 on Kenya's Real Estate Sector, focussing on the impact of the pandemic in the residential, office, retail, and, hospitality sectors and this week, we focus on the Impact of COVID-19 has had on Real Estate Funds and therefore we shall cover the following;

a. Introduction to Real Estate Funds,
b. Types of Real Estate Funds,
c. How COVID-19 Has Impacted Funds in the Global Market and Measures Being Undertaken to Assist,
d. What Support Mechanisms Can Be Employed to Assist Real Estate Funds
e. Conclusion

a. **What are Real Estate Funds?**

A Real Estate Fund is an investment vehicle that enables investors to pool their funds together and invest largely in Real Estate. The funds can either be privately offered, publicly offered or traded in a listed Stock Exchange. Kenya in comparison to the rest of the world has a less developed formal real estate funds market, but a lot of effort has been going towards developing the sector. Using Real Estate Investment Trusts (REITs) as an example, Kenya has only one listed REIT, Fahari I-REIT, and accounts for less than 0.1% of REIT market cap to GDP, compared to South Africa, USA and UK at 6.9%, 5.9% and 2.6%, respectively as illustrated below;




***Source: JSE, NSE, NAREIT***

The governance structures of real estate funds largely mirror the governance structures of other funds, in that, if it is publicly listed then it should be under a trustee structure, but if not publicly traded the governance structure can be diverse, including the selection of a Board of Directors. At its basic form, even a group of investors who come together to collect funds for investment in real estate can be deemed a real estate fund i.e. the investment groups or the "Chama". Gaining exposure in real estate through real estate funds has various advantages among them being;

i. Lower capital requirements compared to traditional brick and mortar real estate investment,
ii. Access to a diversified portfolio- The fund can invest in real estate across a variety of property sectors and various asset classes, therefore reducing the risk of a drop in the investment value,
iii. Time-saving- Fund managers undertake the day to day activities of managing the investments saving the investors time and headache of doing it themselves,
iv. Access to Professional management. The funds are managed by professionals who can choose the right balance between risks and rewards, therefore eliminating the burden on the investor,
v. High transparency compared to brick and mortar since the prices of the units are observable, and,
vi. Tax benefits, as the government seeks to grow the REITs market there are a couple of tax incentives for investing in the real estate funds as highlighted in our note on Tax Incentives for REITs as an Investment Alternative.

There are however certain risks that come with investment in Real Estate Funds among them;

i. Lack of control as investors delegate the decision making roles to the manager of the fund and therefore they have limited control over where the fund invests,
ii. Illiquidity risk- although the assets are relatively liquid compared to brick and mortar investments, the underlying asset remains real estate, consequently, there are times liquidity is not guaranteed, and,
iii. It is difficult to value real estate funds during periods of extreme economic uncertainty

b. **Types of Real Estate Funds**

Investors can venture into real estate through either Real Estate Funds or directly investing in real estate, which involves the purchase or leasing of property. The following are the main types of Real Estate Funds:

I. **REITs**- These are regulated investment vehicles that enable collective investment in real estate, where investors pool their funds and invest in a trust to earn profits or income from real estate, as beneficiaries of the trust. REITs source funds to build or acquire real estate assets, which they sell or rent to generate income. The income generated is then distributed to the shareholders at the end of a financial year. There exist three types of REITs namely;

- Income REITs (I-REITs) - This is a form of REITs in which investors pool their resources for purposes of acquiring long-term income-generating real estate including residential, commercial and other themes. Investors gain through capital appreciation and rental income. Dividends are usually distributed to unit-holders at the agreed duration, with the appreciation realized upon the sale of the units at a higher value,
- Development REITs (D-REITs) – A D-REIT is a type of REIT in which resources are pooled

together for purposes of running development and construction projects. This may include residential or commercial projects. A D-REIT can be converted to an I-REIT once the development is complete where the investors in a D-REIT can choose to sell, reinvest or lease their shares or convert their shares into an I-REIT, and,

- Islamic REITs - An Islamic REIT is a unique type of REIT that invests primarily in income-producing, sharia-compliant real estate. A fund manager is required to conduct a compliance test before investing in real estate to ensure it is Sharia compliant and that non-permissible activities are not conducted in the estate.

II. **Structured Products**- These are products that are highly customized/tailor-made investment products that are packaged by investment professionals, to enable the investor to access returns that are not accessible in the conventional market. There are publicly placed structured products, however, the majority are privately placed. Examples of privately placed structured solutions include structured notes, which are backed by high yielding assets such as real estate and commercial papers.

c. **How COVID-19 has Impacted Funds in the Global Market and Measures Being Undertaken to Assist**

According to rating agency Fitch, approximately 80 funds were suspended in Europe in March 2020, resulting from the high cash outflow and large drops in asset prices as investors prioritize liquidity and became more selective in the investment opportunities they considered, while those with existing investments looked to cash out to enhance their liquidity. The real estate sector in which real estate funds have significant exposure has seen a reduction of the labour force and a disruption in the supply chain resulting in a slowdown in construction activities hence reducing revenues significantly thus making it difficult for funds to meet the liquidity need of investors. Some of the measure taken by various economies to mitigate the impact of the pandemic on both real estate and real estate funds and to manage liquidity include;

| Country | Response Measure |
|---|---|
| UK | • Authorized fund suspensions- The Financial Conduct Authority (FCA) issued guidelines after the decision by several funds to announce a temporary suspension of trading in their property portfolios. According to the FCA guidelines, property funds should suspend dealings if there is material uncertainty over the value of 20.0% of their assets |
| US | • The government has provided liquidity through a Primary Asset Purchase Program, which has been extended to support corporate debt and purchase of high-yield bonds to support debt from corporates that are struggling given the COVID-19 pandemic, or debt that has been downgraded |
| India | • The Reserve Bank of India launched a USD 6.6 bn liquidity infusion for funds to support them during the COVID-19 period |
| UAE | • The Central Bank revised the limit on bank exposure to the real estate sector. Once exposure reaches 20% of a bank's loan portfolio (measured by risk-weighted assets), it can increase this to 30% but will be required to hold more capital. |
| Abu Dhabi | • No individual or commercial real estate registration fees until the end of 2020 |

**Case Study: United Kingdom (UK) Real Estate Funds**

The UK economy, like the rest of other global economies, has been impacted by the ongoing pandemic making it difficult to value property owned by funds prompting the suspension of various funds. The suspension of funds is in line with the Financial Conduct Authority (FCA) guidelines, which stipulates property funds should suspend dealings if there is material uncertainty over the value of 20.0% of their assets. Previously in the UK, property funds have blocked withdrawals due to liquidity issues resulting from the 2008 financial crisis and the Brexit vote. The Bank of England in its Financial Stability Report 2019, cited that there exists a mismatch between redemption terms and the liquidity of some open-ended funds, particularly in stress conditions and as such, to enhance consistency between liquidity and redemption terms, the bank proposed a combination of;

I. Longer redemption periods, and,
II. A system to force those leaving the fund in times of market stress to accept a discounted price for their units.

Fund managers in the UK have taken various mitigation measures, such as suspension of funds, in light of the current tough operating environment to manage liquidity as few can fulfil redemption requests immediately and others forced to suspend operations. The table below highlights real estate funds that have been suspended in the UK so far;

| No | Name of Fund/ Company | Size |
|---|---|---|
| 1 | St James's Place (SJP) Gates Property Unit Trust | GBP 3.6 bn (Kshs 460.0 bn) |
| 2 | 1. Aberdeen UK Property Fund<br>2. Standard Life Investments UK Real Estate, and,<br>3. ASI Global Real Estate Fund<br>All funds for Standard Life Aberdeen | GBP 3.3 bn (Kshs 422.0 bn) |
| 3 | Legal & General Property Fund | GBP 2.9 bn (Kshs 371.0 bn) |
| 4 | M & G Property Portfolio for M & G Investments | GBP 2.4 bn (Kshs 307.0 bn) |
| 5 | Janus Henderson UK Property Fund | GBP 2.0 bn (Kshs 249.0 bn) |
| 6 | Thread needle UK Property Authorized Investment Fund (PAIF) | GBP 1.4 bn (Kshs 179.0 bn) |
| 7 | Kames Property Income Fund | GBP 0.7 bn (Kshs 92.0 bn) |
| | **Total** | **GBP 16.3 bn ( Kshs 2.1 tn)** |

**Key to note for investors, as long as the investments have been done in quality real estate projects, it is important to ensure the fund managers are preserving value so that once the time of illiquidity passes they can be able to get value for their investments.**

d. **What Support Mechanisms Can Be Employed to Assist Real Estate Funds**

Real Estate funds have been hit by temporal liquidity challenges especially where the funds are open-ended, what the funds can do is borrow from what the other organizations are doing to preserve the value of the funds such as reducing cash payout to investors and seeking capital restructuring from investors. Below are some of the suggestions of what can be done to preserve value;

i. Suspension of withdrawals from funds- In Europe, it is estimated that over 80 funds were suspended to preserve value and liquidity,
ii. Reduced development activity to ensure the cash requirements are lower,
iii. Suspension of fees related to real estate by the government - Some governments like Abu Dhabi have suspended registration fees for real estate as they seek to support the real estate sector,

iv. Asset buying programs- Various governments have set aside cash to help struggling businesses,
v. Direct Investments into Funds- In India the government directly infused cash into the funds to help with liquidity,
vi. Developers can seek different financiers such as Private Equity firms to finance their projects, and,
vii. Disposal of Assets but within the prevailing market rates.

e. **Conclusion**

In conclusion, we believe that real estate funds will remain attractive as on the longer end they provide higher returns well above inflation and are good for diversification away from traditional asset classes such as Equities and Fixed Income. Property prices have avoided a slump and remained relatively stable in the Kenyan markets and therefore it is key for investors to ensure that the underlying assets remain attractive. The managers of real estate funds should ensure that they do everything possible to mitigate the impact of the pandemic and to protect the underlying investments. On the other hand, investors in real estate funds need to appreciate that illiquidity during times of stress, such as the pandemic, is normal in real estate hence work together with managers to navigate the environment.



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