Real Estate Investment Trusts, REITS, as an Investment Alternative, & Cytonn Weekly #52

Focus of the Week

Following the licencing of Cytonn Asset Managers as a Real Estate Investment Trust (REIT) Manager by the Capital Markets Authority (CMA) in February 2019, Cytonn Investments Management Plc embarked on the process of structuring a REIT for two of its projects, The Ridge in Ridgeways and RiverRun Estates in Ruiru. This move was aimed at bringing access to high-yielding investments to investors in the regulated markets as well as diversifying funding sources for Cytonn's real estate pipeline.

In this regard, this week we look at REITs both as a funding method for real estate developers, as well as an alternative asset class for investors.

This focus will cover the topic as outlined below:

?. Introduction to REITs, where we cover the definition of REITs, and look at the various types of REITs, as well as a brief overview of the structure of REITs,
i. History of REITs, where we lay out the development of the REIT market since inception, both globally and in Africa,
ii. The Case for REITS for Investors & Developers, where we outline the benefits of REIT structure, both as an asset class and a funding vehicle, and the demerits associated with this,
iii. Challenges Facing REIT Adoption in Kenya,
iv. Case Study of the South African REIT Market,
v. How to Boost the REIT Market in Kenya.

Section I: Introduction to REITs

REITs are regulated investment vehicles that enable collective investment in real estate, where investors pool their funds and invest in a trust with the intention of earning 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.

A typical REIT structure includes 4 key parties, namely;

?. **The Promoter** – The promoter pools all resources to structure a REIT. For instance, in the proposed Cytonn D-REIT, Cytonn Investments Management Plc is the promoter of the REIT,
i. **The REIT Manager** – The REIT Manager is tasked with the role of allocating the funds to the real estate assets that yield a favourable return to investors,
ii. **The Trustee** – The Trustee's role is to act on behalf of beneficiaries, usually the investors in the REIT, by assessing the feasibility of the investment proposal put forward by the REIT Manager and ensuring that the assets of the scheme are invested in accordance with the Trust Deed,

appointing the key parties and consultants in a REIT, and ensuring that distributions from the assets of the REIT are made in accordance with the Offering Memorandum, and,

iii. **Property/Project Manager** – The Project Manager's role is the development management of the ongoing developments in the REIT while the Property Manager's role is the management of the completed real estate developments acquired by the REIT.

There exist three types of REITs namely;

1. **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 realised upon sale of the units at a higher value.
2. **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.
3. **Islamic REITs** - An Islamic REIT is a unique type of REIT that invests primarily in income-producing, Shari'ah-compliant real estate. A fund manager is required to conduct a compliance test before investing in real estate to ensure it is Shari'ah compliant and that non-permissible activities are not conducted in the estate.

Section II: History of REITs

REITs were created in the United States in 1960, to give all investors the opportunity to invest in large-scale, diversified portfolios of income-producing real estate, in the same way they typically invest in other asset classes, through the purchase and sale of liquid securities. At this time, REITs primarily consisted of mortgage companies, and witnessed a significant expansion in the two decades that followed, owing to the increased use of REITs as funding vehicles in land development and construction deals. The US REIT market is the largest in the world. Currently there are in excess of 200 listed REITs existing in the US.

The second market to implement the REIT structure was Australia, with the first property trust being listed in 1971. Canada followed suit by adopting the REIT structure in 1993. The United Kingdom, however, despite being a major powerhouse in the world economy, only introduced REITs into their listed property system in early 2007. This delayed implementation was majorly due to criticism by key market players, alluding to the presence of many mechanisms of property ownership, thus scepticism as to whether another vehicle was required.

In Africa, Ghana was the first to implement the REIT structure, with The Home Finance Company establishing the first REIT in Ghana in August 1994. This was followed by Nigeria, with the Union Homes Hybrid Real Estate Investment Trust being launched in September 2008. South Africa, despite only having been launched in May 2013, has proven to be the most successful REIT market in Africa. In Kenya, the first REIT, Fahari I-REIT by Stanlib, was approved by the Capital Markets Authority in October 2015, and has been the only operational REIT to date.

Section III: The Case for REITS for Investors & Developers

The main benefit that developers stand to benefit from REITs is the easier access to relatively lower cost capital, allowing them to develop institutional grade real estate. By selling stabilised assets to REITs, property developers can unlock capital that can be more effectively deployed in new development projects.

Investors stand to benefit from REITs, given that they have been total return investments where the investor gets both the capital appreciation and yield. They historically have provided high dividends plus the potential for moderate, long-term capital appreciation. Additionally, REITs have offered investors liquidity, portfolio diversification and strong corporate governance. However, it is important to note that past performance may not be indicative of future results for any investments, including REITs.

The benefits of REITs for Investors include;

?. **Diversification** - REITs, fixed income securities and equities have different long-term investment characteristics creating diversification when combined within a single portfolio. This diversification creates the opportunity for blended portfolio to earn higher returns while reducing the potential for negative or low returns.
a. **Low Cost Exposure to Real Estate -** REITs offer access to the property market with professional investment management at a relatively low transaction and management cost. A professional, dedicated management team responsible for the day-to-day operation of the business, provides the investor with expertise beyond his or her knowledge base.
b. **Transparent Investment Vehicle -** Investors are able to understand exactly what they are invested in, from the actual assets, costs and returns.
c. **Accessibility –** A REIT can more easily be bought or sold. Investors do not have to deal with the complexity of selling a physical property. REITs allow an interested real estate investor to buy units (shares) and be a part owner of a real estate asset without having to deploy a lot of capital, compared to buying an entire piece of property.
d. **Tax Exemption –** REITs in Kenya have a number of tax benefits, among them being;
    ?. A listed REIT also allows underlying owners of the real estate assets to enjoy corporate tax exemption, currently at 30% per annum. The only taxation is on distribution of profits to the unit-holders, which would be subject to withholding tax (“WHT”) at the rate of 5% for resident and 10% for non-resident unit-holders,
    i. The amendment of Section 20 of the Income Tax Act as per Finance Bill 2019 also saw REITs’ investee companies being exempted from income tax. This will allow REITs to invest more in companies that develop real estate, rather than going though the process of transferring properties to the REIT,
    ii. Transfer of properties to a REIT also attracts a stamp duty exemption, as per Section 96A (1) (b) of the Stamp Duty Act.
e. **No Shareholder Liability -** As is the case with equity investments in other publicly traded companies, shareholders have no personal liability for the debts of the REITs in which they invest.
f. **Liquidity –** REITs offer a liquidity advantage over direct investment in privately traded underlying real estate assets. This advantage of a listed REIT extends to the owners of real estate as well since they do not have to sell the entire asset if they are looking for a little liquidity.
g. **REITs Deliver Income & Long-term Growth -** REITs offer strong long-term total returns. Excellent long-term performance and strong diversification attributes make REITs a natural component of a well-balanced efficiently performing portfolio. REITs own tangible assets and often sign their tenants to long-term lease contracts. Because of this, REITs tend be some of the most stable companies on the market.

Section IV: Challenges Facing REIT Adoption in Kenya

There are a number of factors that have led to the slow development of the REIT market in Kenya. These include;

?. **Inadequate Investor Knowledge - Being a relatively new market segment, there is inadequate investor awareness or education of REITs hence low investment in the market. Inadequate investor knowledge was one of the main reasons attributed to the low subscription rate (29%) and consequent poor performance of Stanlib Fahari I-REIT,**

as well as the failed issuance of the Fusion D-REIT in 2016,

a. **Negative Investor Sentiments -** Investor sentiments on Kenyan REITs is currently negative mainly due to the general poor performance of the market. For instance, in 2018, the equities market was on a downward trend, with NASI, NSE 25 and NSE 20 declining by 18.0%, 17.1% and 23.7%, respectively, as a result of declines in most large cap stocks, with 8 companies issuing profit warnings as compared to 6 in 2017, while 2 companies, namely Deacons and ARM Cement, were suspended from trading at the Nairobi Securities Exchange,

b. **Need for a Broader Pool of Trustees –** Currently, Kenya has only three institutions certified as REIT trustees. In South Africa a Public Company, an approved company or institution or a bank can be a trustee, thus there is a wider pool of trustees. There is a need to have more corporate trustees apply for REIT trustee licences, and thus there is need to review this minimum share capital requirement, which will include other appropriate players, and in turn make it easier to bring REITs into the market,

c. **High Minimum Amount Investable in all Real Estate Investment Trusts (REIT) -** The current regulations define the minimum subscription amount per investor at Kshs 5.0 mn for a Development REIT (D-REIT), which is too high to attract significant interest from investors,

d. **Opacity of Exact Returns for Underlying Assets -** Despite the best efforts of the regulator to promote transparency in the operation and administration of REITs in Kenya, there exists a gap in the determination of returns from individual assets held by these trusts. This means that investors are not able to tell the exact yields of underlying assets owned by a REIT and this is mainly caused by lack of a clear framework on determination of returns as well as valuation standards especially with regards to investment grade commercial assets,

e. **Capping of Interest Rates -** Capping of interest rates has generally slowed down real estate growth as banks have slowed credit to the sector amidst tightened credit standards as well as uncertainty in the sector and reversal of the interest cap law. Lack of cheap financing in the country has contributed to the slow growth of REITs e.g. Stanlib Fahari I-REIT has faced challenges in raising additional capital through debt financing and noted interest capping as one of the factors that contributed to slow growth of the property market in 2017. It remains to be seen, however, if a repeal of the interest rate cap law will revitalise the real estate industry in Kenya, thus boosting the REIT market,

f. **Shallow Investment-Grade Asset Pipeline -** The pool of available investment grade real estate assets in Kenya that have the ability to generate attractive and sustainable returns is shallow. For instance, Stanlib Fahari I-REIT had to apply for regulatory exemption to extend the deadline for acquiring real estate assets after failing to meet the 75% of real estate income-generating assets threshold within 2 years of the REIT's authorization to operate. Low supply of investment-grade properties for sale in the market was also a key factor that contributed to the acquisition of Stanlib Fahari I–REIT's properties in Nairobi's Industrial Area, a generally low performing zone in the property market, amidst pressure to beat CMA's deadline to invest at least 75% of the REIT's total net asset value in real estate within 2 years of its authorization,

g. **Inconsistent Income -** Rental income may be inconsistent over the investment period, attributable to various factors such as termination of lease agreements and failure to renew the same or secure tenants in good time for income continuity. Efficient management of REITs becomes a key factor in the realization of good returns.

Section V: Case Study of the South African REIT Market

The main markets that have REITs in Africa include South Africa, Kenya, Ghana and Nigeria. South Africa has the most developed REIT market with 23 active REITs with a market cap of ZAR 400.0 bn (USD 26.1 bn).

The South African listed property sector is now one of the largest sectors on the JSE by market capitalisation and continues to grow in liquidity. There are now four REITs among the top 40 companies on the JSE, with some global REIT giants in South Africa, such as GRIT, competing with peers from established economies. The listed property sector has been the best performing asset class over last 14 years on the JSE despite the challenging macroeconomic factors in that country.

In South Africa, most investment properties are owned by financial institutions, pension/provident funds including government and parastatal funds, and by property holding vehicles listed on the JSE. In addition to the listed property sector, there are several substantial unlisted companies, and many small to medium-sized unlisted and private companies in that market. Many private property owning companies build up portfolios of investment-grade properties across the various subsectors like retail, office or industrial, with a small component of mixed-use and residential. In terms of value, retail property comprises the bulk of the investment at 60% of the total, with office/commercial properties coming in second at 25%, according to Investment Property Databank Index (IPD) South Africa Annual Property Index.

Factors Driving the Success of the South African REIT Market

Some of the factors that have led to the rapid development of the REIT Market in the South African industry include;

?. **Presence of Already Developed Capital Markets** – Even before the adoption of the REIT structure, the capital markets in the country were already well established. Not only did this make it easier for investment managers in structuring offerings for investors, given that they had built expertise, but it also boosted the uptake given that investors already had sufficient confidence in the capital markets,

i. **Diverse Property Offerings** – The property sector in South Africa is well diversified, with large institutional developers in all the real estate subsectors, who have built a strong track record in real estate delivery, while at the same time giving attractive returns. This has had a snowball effect, by encouraging lenders and investors to commit capital to this sector, further spurring the growth of this sector,

ii. **A Diverse Pool of Trustees** – In Kenya, REIT trustees have to have a minimum share capital of Kshs 100.0 mn, thus restricting it majorly to banks. Even then, there are only 3 banks that are authorized as Trustees. In South Africa a Public Company, an approved company or institution or a bank can be a trustee, thus there is a wider pool of trustees,

iii. **Minimum Investments** – In South Africa, listed REITs all have to comply by the Johannesburg Stock Exchange (JSE) Rules. According to the JSE, there is no limitation of a minimum amount of capital needed to invest, only a minimum of one share, unlike in Kenya where a minimum capital outlay by an investor in a D-REIT is Kshs 5.0 mn. Taking the median income in Kenya of Kshs 50,000.0, the minimum for a REIT is 100 times their median income. In this regard, these low income investors that need protection by the Regulators, are cut out of the regulated real estate investment bracket, thus end up being exposed to risky real estate investments which do not fall under regulation, but accommodate this lower bracket of income earners, and,

iv. **Good Corporate Governance** – Good regulation practices and corporate governance have acted as an incentive to both local and foreign investors, who have the assurance that their funds are being properly administrated and utilised.

The success in implementation of alternatives in the South African industry did not go without a host of challenges, such as (i) fluctuation in the real estate industry, where the property market in South Africa took a hit following the 2008 global economic crisis, and, (ii) competition with higher returns in Asia and other African markets.

Section VI: How to Boost the REIT Market in Kenya

The REIT Market in Kenya has potential for growth, but this will only be possible if a supportive framework is set up. The following measures can be implemented to revitalise the REIT market;

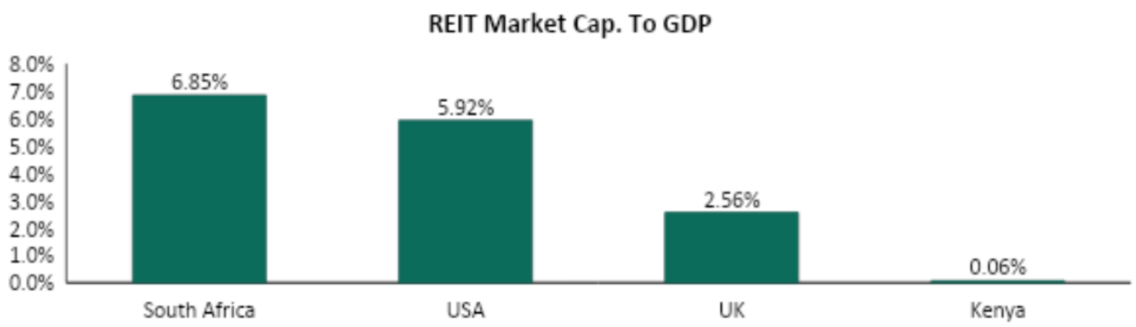
?. Teaming Up of the Market Players and the Regulators to Offer Constant Training to the Investing

Public - This training should include training the real estate developers on how they can harness the capital markets as a source of capital for development,

a. **Broaden the Pool of Trustees - Currently, Kenya has only three institutions certified as REIT trustees. In order to make the REIT market more vibrant, we need to widen our pool of investment fund trustees to include capable professionals or corporates. For example, in the UK a Chartered Accountant can register with the Financial Conduct Authority to be a trustee, and in South Africa, an insurance company can also be a trustee,**
b. Reduce the Minimum Investment to a Reasonable Level - In order to attract capital into capital market vehicles such as Real Estate Investment Trusts (REITs) for real estate development, the minimum investment amount needs to be amended. The current regulations define the minimum subscription amount per investor at Kshs 5.0 mn for a Development REIT (D-REIT), which is too high to attract significant interest from investors. An amount of Kshs 1.0 mn ensures the investor is sophisticated while also allowing a larger pool of investors to participate,
c. Development of Institutional Grade Real Estate Assets – Currently, inadequate urban planning has given rise to a defined gap in the real estate market for real estate that is more than just a provision of housing, and that can give returns to investors. In this regard, development of institutional grade real estate assets would provide strong underlying assets for REITs, which can support the returns to investors,
d. Continuous Improvement on the Regulation and Government Support for REITs e.g. providing regulations that assist in real estate uptake to help increase cash flows into the property market,
e. Collaboration of Key Players in the Real Estate and Investment Sectors will Play a Major Role in Harnessing Broad Support with Regards to Issuance of REITs in the Country . Promotion of club deals at an early stage in the structuring of REIT offerings could go a long way to attract institutional support for successful REIT offerings, and,
f. Industry Players Should Seek Ways of Enhancing Investor Confidence in Kenyan REITs e.g. through;

?. Increasing the amount of principal or other leverage instruments by promoters prior to a REIT offering to give investors some comfort that the promoters believe in the REIT,
i. Providing minimum return guarantees for investors, and,
ii. Promoting clearer and more transparent financial statements of publicly real estate firms, listed properties and REITs in general.

In summary, there is a lot of opportunity in the REIT market in Kenya, as evidenced by the low REIT Market Cap to GDP, at less than 0.1%, compared to more developed markets such as South Africa, at 6.9%. Should the investments in real estate be packaged into securities that enable the public an opportunity to own real estate, this will open REITs up to investors and in turn lead to deepening of our capital markets.



It will however require the collective efforts of developers, investment managers, regulators, government and other key players to create a success story for REITs in Kenya, similar to what has been witnessed in South Africa. We still hold that if measures to increase public awareness and educate the masses on REITs as an asset class are taken, this will boost returns of the underlying asset, which is real estate as an investment instrument.

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