RESIDENTIAL REITS AND THEIR POTENTIAL TO INCREASE INVESTMENT IN AND ACCESS TO AFFORDABLE HOUSING IN AFRICA

REPORT 2: CASE STUDIES OF AFRICAN REITS

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FEBRUARY 2017

Prepared with the support of:
Case Studies of African REITs: Residential Reits in Africa

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ACKNOWLEDGEMENTS
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<th>Abbreviation</th>
<th>Full Form</th>
</tr>
</thead>
<tbody>
<tr>
<td>AFHCO</td>
<td>African Housing Company (formerly Affordable Housing Company)</td>
</tr>
<tr>
<td>CAHF</td>
<td>Centre for Affordable Housing Finance</td>
</tr>
<tr>
<td>CEO</td>
<td>Chief Executive Officer</td>
</tr>
<tr>
<td>CFO</td>
<td>Chief Financial Officer</td>
</tr>
<tr>
<td>CGT</td>
<td>Capital Gains Tax</td>
</tr>
<tr>
<td>CIS</td>
<td>Collective Investment Scheme</td>
</tr>
<tr>
<td>CIT</td>
<td>Companies Income Tax</td>
</tr>
<tr>
<td>CMA</td>
<td>Capital Markets Authority</td>
</tr>
<tr>
<td>CMBS</td>
<td>Commercial mortgage-backed securities</td>
</tr>
<tr>
<td>CMSA</td>
<td>Capital Market and Securities Authority</td>
</tr>
<tr>
<td>DPS</td>
<td>Dividends Per Share</td>
</tr>
<tr>
<td>D-REIT</td>
<td>Development and Construction Real Estate Investment Trust</td>
</tr>
<tr>
<td>DSE</td>
<td>Dar Es Salaam Stock Exchange</td>
</tr>
<tr>
<td>EPRA</td>
<td>The European Public Real Estate Association</td>
</tr>
<tr>
<td>FDI</td>
<td>Foreign Direct Investment</td>
</tr>
<tr>
<td>FSB</td>
<td>Financial Services Board</td>
</tr>
<tr>
<td>GOG</td>
<td>Government of Ghana</td>
</tr>
<tr>
<td>HCA</td>
<td>The Homes and Community Agency</td>
</tr>
<tr>
<td>HFH</td>
<td>Houses4Homes</td>
</tr>
<tr>
<td>HPET</td>
<td>Housing Partnership Equity Trust</td>
</tr>
<tr>
<td>HPN</td>
<td>Housing Partnership Network</td>
</tr>
<tr>
<td>HR</td>
<td>Human Resource</td>
</tr>
<tr>
<td>IAS</td>
<td>Investment and Securities</td>
</tr>
<tr>
<td>IFC</td>
<td>International Finance Corporation</td>
</tr>
<tr>
<td>IHS</td>
<td>International Housing Solutions</td>
</tr>
<tr>
<td>I-REIT</td>
<td>Income Real Estate Investment Trust</td>
</tr>
<tr>
<td>J-REITs</td>
<td>Japanese REITs</td>
</tr>
<tr>
<td>JSE</td>
<td>Johannesburg Stock Exchange</td>
</tr>
<tr>
<td>LIHTC</td>
<td>Low-income housing tax credit</td>
</tr>
<tr>
<td>LLC</td>
<td>Limited Liability Company</td>
</tr>
<tr>
<td>MBS</td>
<td>Mortgage-backed securities</td>
</tr>
<tr>
<td>MD</td>
<td>Managing Director</td>
</tr>
<tr>
<td>MSCI</td>
<td>Morgan Stanley Capital Group International</td>
</tr>
<tr>
<td>NAV</td>
<td>Net Asset Value</td>
</tr>
<tr>
<td>NHC</td>
<td>National Housing Corporation</td>
</tr>
<tr>
<td>NHIF</td>
<td>National Health Insurance Fund</td>
</tr>
<tr>
<td>NSSF</td>
<td>National Social Security Fund</td>
</tr>
<tr>
<td>PLS</td>
<td>Property loan stock company</td>
</tr>
<tr>
<td>PO-PSM</td>
<td>President Office-Public Sector Management</td>
</tr>
<tr>
<td>PSPF</td>
<td>Public Service Pension Fund</td>
</tr>
<tr>
<td>PUT</td>
<td>Property unit trust</td>
</tr>
<tr>
<td>REIT</td>
<td>Real Estate Investment Trusts</td>
</tr>
<tr>
<td>RMBS</td>
<td>Residential mortgage-backed securities</td>
</tr>
<tr>
<td>ROI</td>
<td>Return on Investment</td>
</tr>
<tr>
<td>RRI</td>
<td>Responsible Residential Investment</td>
</tr>
<tr>
<td>RSL</td>
<td>Registered social landlord</td>
</tr>
<tr>
<td>SA</td>
<td>South Africa</td>
</tr>
<tr>
<td>SEC</td>
<td>Securities and Exchange Commission</td>
</tr>
<tr>
<td>UK</td>
<td>United Kingdom</td>
</tr>
<tr>
<td>USA</td>
<td>United States of America</td>
</tr>
<tr>
<td>VAT</td>
<td>Value Added Tax</td>
</tr>
<tr>
<td>WHC</td>
<td>Watumishi Housing Company</td>
</tr>
<tr>
<td>WHT</td>
<td>Withholding taxes</td>
</tr>
</tbody>
</table>

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1. Introduction

Until now, African markets have largely failed to provide investors with targets in the residential real estate space that are sufficiently substantial and/or accessible to warrant their attention. Consequently, the majority of housing investment in most African countries comes from government debt or domestic savings rather than from international capital markets and domestic institutional investment markets, as is the case in developed economies. This contributes to limited financial resources being channelled towards Africa’s housing developers. A key challenge for policy makers is thus to improve housing delivery value chains – specifically, in a way that broadens access to finance for housing developers, and, in doing so, expands access to adequate housing for individuals.

The introduction of Real Estate Investment Trusts (REITs) is one innovative approach that policy makers, property developers and real estate investors in certain African countries are promoting in an attempt to address finance constraints in real estate markets. A REIT is a tax-efficient investment vehicle designed to aggregate diverse sources of funding (from international and institutional investors through to households), and target them into a real estate portfolio that extends beyond the limitations of individual projects. While the REIT structure is found in the context of real estate markets more broadly, it is its potential application in the affordable residential property market which is the focus of this study.

Indeed, residential REITs targeting affordable housing represent an intriguing conduit for channelling investment into an under-served market. This study seeks to understand the REIT structure and to explore its relevance for affordable housing investment in Africa. We build a case for residential REITs as a mechanism in supporting affordable housing finance and increased investment in affordable housing in the continent based on specific, yet varying, contexts.

Partially because of early stages of development of African REIT markets, REITs have been marginally successful within many of the African countries that have established REIT frameworks. However, as explored below, the varying performance of REIT markets across the continent has a lot to do with the various contexts in which these markets are emerging. This suggests that in addition to exploring the potential for affordable housing REITs in Africa, it is essential to understand the contextual factors that support or undermine REITs more generally. Interviews with a variety of real estate and housing finance experts across the various jurisdictions indicated that a number of critical enabling conditions need to be in place before REITs can thrive in any given context.

This report looks at specific case studies (Nigeria, Ghana, South Africa, Tanzania, Kenya, Rwanda and Morocco) to understand the implementation of various residential REIT frameworks throughout Africa. This informs critical enabling conditions for REITs in Africa, the challenges faced by residential REITs in this context, and potential approaches to increasing the financial viability of African affordable housing REITs which are presented below.

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2. The African Context

Since 1994, legislation/regulations governing REITs has been introduced into a number of African countries, including Ghana, Tanzania, Nigeria, South Africa, Kenya, Rwanda, and Morocco. While the institutionalisation of the REIT structure has given rise to around 30 REITs in South Africa since 2013, the emergence of REITs in other African countries has gone at a slower pace.

Table 4 summarizes the current status of the REIT legal frameworks and REIT sectors in Africa, while Figure 12 visually captures the presence of REITs in Africa to date.

<table>
<thead>
<tr>
<th>Country</th>
<th>REIT Legal Framework</th>
<th>Year of Establishment</th>
<th>Regulator</th>
<th>No. of Registered REITs</th>
<th>Size of Industry</th>
<th>Primary Sectors</th>
</tr>
</thead>
<tbody>
<tr>
<td>Ghana</td>
<td>No specific REIT law; Securities Industry Law 1993; Securities Industry Amendment Act of 2000; the Unit Trusts and Mutual Funds Regulations 2001</td>
<td>1994</td>
<td>Securities and Exchange Commission (SEC)</td>
<td>1</td>
<td>US$12.6 million</td>
<td>Residential, Commercial</td>
</tr>
<tr>
<td>Tanzania</td>
<td>CMS Collective Investment Scheme Real Estates Investment Trust Rules of 2011</td>
<td>2011</td>
<td>Capital Markets and Securities Authority</td>
<td>1</td>
<td>US$40 million</td>
<td>Residential</td>
</tr>
<tr>
<td>Rwanda</td>
<td>Regulation No. 14 on Real Estate Investment Trusts</td>
<td>2013</td>
<td>Capital Markets Authority of Rwanda</td>
<td>0</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>Morocco</td>
<td>n/a</td>
<td>2015 / 2016</td>
<td>n/a</td>
<td>1</td>
<td>n/a</td>
<td>Commercial</td>
</tr>
</tbody>
</table>

93 Source: authors own compilation
The varying regulations and legislation governing REITs in different African countries have given rise to significant diversity among emerging REIT frameworks in Africa. Table 5 summarizes the key characteristics of the REIT structures found in various African countries.

Table 5: REIT structure comparison across African countries*5

<table>
<thead>
<tr>
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<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Ghana</td>
<td>Internal</td>
<td>n/a</td>
<td>Allowed</td>
<td>None</td>
<td>None</td>
<td>No</td>
</tr>
</tbody>
</table>

*5 Source: author’s own compilation

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In the sections that follow, the history and characteristics of the REIT structure in various African countries are investigated in further detail. Furthermore, the health of the REIT market in each of these countries is outlined and the experiences of four selected African residential REITs are explored.

### 2.1 Ghana

In Ghana, a REIT is considered a Collective Investment Scheme and is governed by the Securities Industry Law 1993, Securities Industry Amendment Act of 2000, and the Unit Trusts and Mutual Funds Regulations 2001. The operation and regulation of Collective Investment Schemes fall under the supervision of the Securities and Exchange Commission (SEC) Ghana.\(^99\)

It is important to note that in Ghana no REIT-specific regulations exists. Consequently, REITs are not subject to any tax exemptions. Rather, a REIT is governed as a Collective Investment Scheme (CIS),\(^100\) and is thus subject to the following requirements:

- With respect to capital requirements, the manager of the CIS is required to have a minimum issued and paid up capital of GH¢1 billion (US$250 million).
- Furthermore, every custodian of the CIS is required to have a minimum issued and paid up capital of GH¢5 billion (US$1.3 billion). Nevertheless, these capital requirements are subject to review by the Commission.
- The promoters of the CIS are required to set a minimum amount, subject to the approval of the Commission, referred to in these Regulations as the “minimum

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<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Nigeria</td>
<td>Internal</td>
<td>75%(^{96})</td>
<td>Allowed</td>
<td>15%</td>
<td>90%</td>
<td>No(^{97})</td>
</tr>
<tr>
<td>Tanzania</td>
<td>External</td>
<td>50%</td>
<td>Maximum 10% of total assets</td>
<td>None</td>
<td>90%</td>
<td>No</td>
</tr>
<tr>
<td>South Africa</td>
<td>Internal / external</td>
<td>75%</td>
<td>Allowed</td>
<td>60%</td>
<td>75%</td>
<td>Yes</td>
</tr>
<tr>
<td>Kenya</td>
<td>External</td>
<td>IREIT: 75% DREIT: 35%</td>
<td>Allowed</td>
<td>IREIT: 35%</td>
<td>DREIT: 60%</td>
<td>IREIT: 80% DREIT: Optional</td>
</tr>
<tr>
<td>Rwanda</td>
<td>External</td>
<td>100%</td>
<td>Not allowed(^{98})</td>
<td>20%</td>
<td>90%</td>
<td>No</td>
</tr>
<tr>
<td>Morocco</td>
<td>External</td>
<td>70%</td>
<td>n/a</td>
<td>n/a</td>
<td>n/a</td>
<td>Not yet</td>
</tr>
</tbody>
</table>

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\(^{96}\) Includes government securities

\(^{97}\) However, company income derived from investments in government securities and corporate bonds is deducted before arriving at the taxable incomes for CIT purposes. Furthermore, the dividends of publicly traded REITs are exempt from withholding taxes (WHT) in the hands of the investors.

\(^{98}\) However, 20% of total assets can be undergoing refurbishment, retrofitting and renovations


\(^{100}\) Essentially, in Ghana, Collective Investment Schemes functions in place of what would be REITs. The HFC REIT, however, refers to itself as a REIT due to the fact that it invests primarily in real estate.
initial subscription” to be raised by the scheme the minimum initial subscription. The promoters are further required to guarantee the minimum initial subscription.

The board of directors of the CIS have the exclusive right to create and issue interests for the account of the scheme. The issues of interests may be subject to a prospective investor purchasing interests of a minimum number and value. The Fund Manager is responsible for the selection of assets and the management of the portfolio based on objectives stated in the trust deed.

In practise, the absence of REIT-specific legislation and regulations in Ghana has resulted in an unclear REIT framework and a tax regime that does not work well for the REIT sector. Furthermore, the REIT market faces significant challenges such as the general public’s lack of awareness and understanding with respect to REITs. Consequently, only one CIS that invests primarily in real estate and classifies itself as a REIT has been established to date.

Significantly, a REIT Bill is in the pipeline and is expected to provide a better framework for the operations of REITs going forward.

### Case Study 1: HFC REIT – Ghana

#### Background

The HFC Real Estate Investment Trust (HFC REIT) was established by HFC Investment Services Limited in August 1994. It is an internally managed REIT, whose main objective is to provide investors with capital appreciation in a long-term diversified portfolio. Universal Merchant Bank, the trustee of the fund, is responsible for ensuring that the HFC REIT is managed effectively for the benefit of the unit holders.

HFC REIT primarily focuses on investing mobilized funds into securities of real estate companies or equity in companies that engage in real estate investment activities. The fund also holds property for rental income and engages in the development of real estate. It thus serves as an alternative investment vehicle for diversification into residential and commercial real estate activities. A proportion of the fund (39%) is invested in high-yielding short-term securities to provide liquidity.

While HFC REIT is open to the general public, and mobilizes funds from individuals, groups, charities and corporate bodies, it is not listed on the Ghana Stock Exchange. Investments into the REIT and withdrawals out of the REIT are facilitated by HFC Investments or HFC Bank. About 95% of the REIT’s investors are local retail investors, while the remaining 5% are local institutional investors.

The REIT, which does not have any debt financing, does not pay out dividends or provide regular income to its investors. Rather, all income earned by the trust is added to its portfolio, which is valued daily. If investors choose to exit the trust they receive the value of their shares, which is determined during the daily portfolio valuation. In other words, HFC REIT is a long term fund. The CEO of HFC explains that this structure was chosen due to the flexibility that it provides with respect to cash flow: “One does not have to keep servicing debts or be under the pressure to return funds to investors”.

#### Social Impact

HFC REIT was originally established with the purpose of channelling long-term funds into the development of affordable housing. It was set up to compliment the mortgage banking business of Home Finance Company Limited, which was discovering that there were not enough residential properties to finance. The fund was thus established to go into property

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101 Interview with Mr. Peter Larbi Yeboah, HFC Investment Services Limited.
102 See Case Study 8: HFC REIT – Ghana
103 Once a redemption form has been submitted, the manager is obliged to redeem the units and make payments for them within a maximum of five working days at a prevailing price on the actual day of disinvestments as displayed by the manager.
development itself and also to finance real estate companies. More specifically, the aim was to mobilize long-term funds at a lower cost than construction finance, in order to provide developers with the flexibility required in the context of affordable housing developments. The REIT was also perceived to be an investment opportunity for prospective homeowners, who were looking to begin saving towards their down payment.  

However, around 2010 / 2011, housing market dynamics shifted, making low end housing unattractive due to low return margins. Since HFC REIT’s investment decisions are primarily guided by profitability, its focus subsequently shifted to the upper end of the market.

Since its establishment, the REIT has developed various low end and upper end housing projects, including over 80 executive houses and serviced plots in Communities 18, 20 and 25 at Tema. HFC REIT employs the services of HFC Realty to develop and construct their properties. It develops both for outright sale and for rental.

Portfolio and Performance

HFC’s assets currently amount to GHS 50 million (US$12.6 million). At present, 14% of the fund’s assets are in residential property.

The asset mix of the fund is illustrated in the figure below.

Figure 2: Portfolio / asset mix (2015)

![Asset Mix Diagram](source: HFC REIT Annual Report 2015)

Despite challenging economic conditions (characterised by rising inflation, high interest rates, and reduced disposable incomes), HFC REIT managed to return a yield of 24.26% in 2015. This was significantly above the year end inflation rate (17.5%), and slightly above the one year Government of Ghana (GOG) note against which HFC REIT benchmarks itself (22.5%). The REIT has consistently exceeded this benchmark, as illustrated in Table 5 below.

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*The down-payment was 20% of the property value at the time.


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Table 6: HFC REIT yield vs 1 year GOG note yield (2013 - 2015)

<table>
<thead>
<tr>
<th></th>
<th>2013</th>
<th>2014</th>
<th>2015</th>
<th>3 year Average</th>
</tr>
</thead>
<tbody>
<tr>
<td>REIT (%)</td>
<td>23.01</td>
<td>23.61</td>
<td>24.26</td>
<td>23.16</td>
</tr>
<tr>
<td>GOG 1 year Treasury Note (%)</td>
<td>21.19</td>
<td>21.52</td>
<td>22.51</td>
<td>21.74</td>
</tr>
</tbody>
</table>

Challenges and Opportunities

In the near term HFC REIT is pursuing the development of approximately 5,000 square meters of office space and the construction of 1,400 square meters of affordable residential units in Accra. These two accretive projects with estimated valuations totalling USD6.6 million are expected to commence in 2017.

At the same time, the CEO of HFC Investments highlights a number of challenges that the REIT faces. This includes the general public’s lack of awareness and understanding with respect to REITs, which hinders the flow of money into the REIT. A further challenge is that while the developmental focus of the REIT necessitates a long term fund, investors typically want a shorter maturity instrument (e.g. an investment that generates yearly returns). This mismatch between supply and demand further deters potential investors. HFC is thus engaging with a limited pool of interested investors.

Finally, since the REIT is structured as an open ended fund, it is required to keep a portion of the fund as cash or near cash investments in order to allow for enough liquidity for unanticipated redemptions during the year. This in turn limits what the REIT could be doing with the money and dilutes its returns.

Nevertheless, the outlook is positive. HFC’s CEO envisions HFC REIT continuing to grow over the next five years as investors become more comfortable with the REIT structure, and the economy recovers and grows further. Furthermore, the Tier 2 and 3 pension funds are expected to channel further investment into the REIT and expand its portfolio.

2.2 Nigeria

In Nigeria, REITs are defined as Collective Investment Schemes (CISs) that enable investors to pool their resources to form, own and manage portfolios of real estate properties. While Section 154 of the Investment and Securities (IAS), 2007 empowers the Securities and Exchange Commission (SEC) to approve, register and regulate REITs and other CISs, the rules governing the operation of the aforementioned schemes are outlined in the Securities and Exchange Commission Rules and Regulations, 2011.\(^\text{106}\)

Three types of REITs currently exist in Nigeria, namely, equity REITs, mortgage REITs and hybrid REITs.\(^\text{107}\) A REIT typically adheres to the following characteristics:

- the SPV may be a corporation or an Investment Trust;
- it is either publicly traded on the stock exchange or owned by private investors;
- it is managed by a Board of Directors or Trustees;
- it has a minimum of 100 shareholders;\(^\text{108}\)
- it invests at least 75% of its total assets in real estate assets (typically investment properties from which rental income is earned) and in Government Securities;


\(^{108}\) Additionally, not more than 50% of its shares can be held by 5 or fewer individuals.

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it derives at least 75% of gross incomes from rents and mortgages;\textsuperscript{109} it pays dividends on at least 90–95% of taxable income; and it adheres to a maximum gearing ratio of 15%.\textsuperscript{110}

It is important to note that REITs in Nigeria are still required to pay Companies Income Tax (CIT) at a rate of 30%. However, certain other pockets of tax exemptions exist, such as the waiver of taxes on asset and mortgage-backed securities.\textsuperscript{111} Additionally, the dividends of publicly traded REITs are exempt from withholding taxes (WHT) in the hands of the investors. Value Added Tax (VAT) and Capital Gains Tax (CGT) on sales of these units or securities are also not applicable.\textsuperscript{112}

The Skye Shelter Fund REIT, Union Homes REIT, and UPDC REIT were launched in Nigeria 2007, 2008, and 2013 respectively. These were subsequently followed by the establishment of Sun Trust Hybrid. The total capitalisation of REITs in Nigeria is over US$224 million.\textsuperscript{113}

<table>
<thead>
<tr>
<th>Table 7: Established REITs in Nigeria</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Sectoral Focus</strong></td>
</tr>
<tr>
<td>Union Homes REIT</td>
</tr>
<tr>
<td>Skye Shelter Fund REIT</td>
</tr>
<tr>
<td>UPDC REIT</td>
</tr>
<tr>
<td>Sun Trust Hybrid</td>
</tr>
</tbody>
</table>

The prospects for REITs as an investment vehicle going forward is perceived to be strong, due to the high demand for and undersupply of real estate assets in Nigeria, and limited institutional investment exposure to real estate.\textsuperscript{114}

**Case Study 2: Union Homes Hybrid REIT – Nigeria**

**Background**

The Union Homes Real Estate Investment Trust (REIT) is a close ended Unit Trust Scheme whose primary objective is to achieve long term capital appreciation of its assets. It was established on the 19\textsuperscript{th} of August 2008 as a Unit Trust Scheme, and was registered and listed on the floor of the Nigerian Stock Exchange on the 2\textsuperscript{nd} of July 2010. It is actively and externally managed by a fund manager,\textsuperscript{115} which reviews the acquisition, investment and disposal of the REIT’s properties and assets in the context of an investment committee.\textsuperscript{116}

\textsuperscript{109} Furthermore, 90–95% of this gross income must come from rents, interest and capital gains on other securities.


\textsuperscript{111} In 2010, the Debt Management Office approved a waiver of taxes on all categories of bonds, Mortgage-backed Securities, and Asset-backed securities. While these tax arrangements benefit Mortgage and Hybrid REITs, they potentially act as a disincentive to investing in real estate assets directly – and thus undermine the establishment of Equity REITs.


\textsuperscript{114} Interview with Agbaje Omosola, Head Corporate Service & Investor Relations, Union Homes REIT.

\textsuperscript{115} Union Homes Savings & Loan Plc, a subsidiary of Union Bank of Nigeria Plc, was originally the fund manager. However, they subsequently went bankrupt and the majority of their shares were acquired by Aso Savings and Loans.

\textsuperscript{116} The investment committee comprises independent members & representatives of the fund manager and trustees.
Union Homes REIT was established with the purpose of providing retail and pension fund investors with the opportunity to invest in a diversified portfolio of real estate assets. The REIT structure was chosen due to its status as a low risk, tax efficient investment vehicle that maximises returns and exhibits low correlation with other asset classes.

Its investors include pension fund administrators, financial institutions, individuals and corporates organisations. The REIT distributes 90% of its annual returns from all investments, annually.

**Portfolio**

Union Homes REIT is a Hybrid REIT which invests in both properties and mortgages, allowing investors to benefit from a two-pronged asset approach. It seeks to maintain a diversified portfolio by investing in residential and commercial sectors that have attractive investment fundamentals. Also, a small proportion of the fund’s assets (less than 10%) is held in money market instruments to provide liquidity and diversification.

The REIT does not prioritise, or even promote, socio-economic developmental impact. Rather it makes investment decisions based on factors such as the location of the property, and the investment's potential to deliver high, regular returns and high capital growth. Its residential portfolio, which comprises 69% of the total portfolio, predominantly lies in luxury apartments. The REIT owns and manages nine luxury residential apartments and four commercial properties in Lagos and Abuja.

Union Homes REIT focuses on growing income returns through rental escalations, building re-tenanting and more efficient utilization of space. It also occasionally engages in the redevelopment of properties to enhance value and support longer-term income and capital growth. However the extent of the development that it can undertake is limited by investor guidelines.

**Challenges and Opportunities**

In 2014, there was no profit distribution due the REIT’s negative net performance of N1 291 391 474 (US$4.4 million). This was attributed principally to the revaluation loss suffered on the trust’s investment properties during the year. Furthermore, two of the REIT’s key properties were vacant during 2014 due to major repairs on them.

Union Homes REIT’s head of corporate service and investor relations further suggests that the regulatory rules that limit investments in real estate development pose a challenge to the REIT, and hinder its ability to achieve longer-term income and capital growth. He asserts that increased flexibility in the investment guidelines, would give rise to higher returns.

2.3 Tanzania

The REIT structure was implemented by the Capital Market and Securities Authority (CMSA) of Tanzania in 2011. The REIT regulatory framework, known as the CMS Collective Investment Scheme Real Estates Investment Trust Rules of 2011, provides rules relating to eligibility, responsibility, key players, listing procedures, and the operationalization of REITs.

Sections 117 and 118 of the Act prescribe that a REIT must appoint a management company that has been approved by the CMSA. The management company, in turn, is required to appoint a trustee, which must be a bank or financial institution. In addition to the appointment of a trustee, the management company should “establish and maintain...
additional arrangements to provide an oversight over the operation and management of the fund, such as appointing an investment committee for the fund... The initial size of a REIT is required to be at least TZS 10 billion.

According to the Act, at least 50% of a fund’s total asset value ought to be invested in real estate or single-purpose companies at all times. Real Estate acquired by the fund is required to:

- be tenanted;
- have a good track record and good prospects of future net rental income of reasonable levels;
- be competitive and located within good catchment areas, as evidenced by market studies; and
- be free from encumbrances at the time of acquisition.

When it comes to real estate under construction, on the other hand, a REIT may acquire the real estate, provided that:

- income from real estates within the fund’s investment portfolio is sufficient to ensure that there is no substantial dilution to the fund’s earnings per unit during the construction period;
- the prospects for the real estate to be acquired upon its completion is reasonably expected to be favorable, and
- the total value of real estates under construction acquired by the fund does not exceed 10% of the fund’s total asset value (after the acquisition).

Furthermore, REITs are permitted to acquire real estate located outside of Tanzania, provided that the acquisition is in the best interests of the fund and its unit holders.

REITs in Tanzania can be listed or unlisted funds. The prices of listed REITs are determined by the price on the exchange, while the prices of unlisted REITs are determined by the NAV of the fund. Importantly, REITs are required to distribute at least 90% of their annual net income after tax to unit holders as dividends each year.

The commercial REIT market in Tanzania is perceived to have huge potential. This potential is illustrated by the four to five recent initial public offerings (IPOs) done locally which were oversubscribed. Immense interest in REITs is likely due to the fact that, at present, developers are too reliant on debt and their own (often limited) capital.

Despite the fact that the only existing REIT in Tanzania at present is a residential REIT, the future of residential REITs in Tanzania is more uncertain. This is because Tanzania currently has a limited stock of existing housing (and affordable housing in particular) for REITs to acquire. In addition, there is only a handful of private developers in the residential sector. Consequently, there is limited development capacity in the residential sector, and REITs focusing on housing would face challenges building up a significant property portfolio.

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120 REITs may only acquire fully developed real estate that is not fully tenanted provided that, amongst other conditions, there exists a good potential to secure tenants and the acquisition is forecasted to provide a reasonable return within a reasonable period of time.
123 Interview with Heri Bomani, Managing Director of Pangani Group.
124 See Case Study 10: Watumishi Housing Company – Tanzania.
125 All of these developers have traditionally focused on residential stock aimed at the prime segment. Interview with Patrick Mususa, Projects and Business Development Manager at the Dar es Salaam Stock Exchange.
126 Even Development REITs typically need to partner with established developers in order to undertake development activity (unless they already have in-house capacity). A property market lacking a number of developers with experience in residential development would therefore act as a constraint on a Development REIT’s operations.
Nevertheless, the Capital Markets & Securities Authority is prepared for the establishment of new residential REITs, and it is anticipated that a company could move from start to market listing and full capital raising within 6 months.  

In order to attract private investment, such REITs would need to deliver returns that surpass government paper returns (18-19%) and private sector bond returns (such as NMB Bank and Exim Bank trading at 13-14% yields).

Case Study 3: Watumishi Housing Company – Tanzania

Background

Watumishi Housing Company (WHC) was established in 2014 and was licensed by the Capital Market and Security Authority (CMSA) in 2015, thus becoming the first fully-fledged REIT to be established in Tanzania and East Africa. It is managed by Watumishi Housing Company (WHC), which is a public entity property developer and the main implementer of the Tanzania Public Servant Housing Scheme.  

WHC-REIT was established with the purpose of providing the general public with an opportunity to participate and create personal wealth as well as contribute towards overall social and economic development. The REIT structure was also implemented in order to provide institutional investors (such as pension funds), who had reached their cap on real estate portfolio allocation, further opportunity for investment. As a mission, WHC-REIT seeks to work with other national and international fund managers and other stakeholders to develop the REIT market in a manner that is beneficial to all parties.  

The REIT received initial funding of TZS 68 billion (US$ 31 million). Currently, it is unlisted and is fully owned by shareholders of WHC. Unit holders of WHC-REIT include seven public institutions namely; PPF Pensions Funds, National Social Security Fund (NSSF), Public Service Pension Fund (PSPF), LAPF Pensions Fund and GEPF Pension Fund, the National Health Insurance Fund (NHIF) and National Housing Corporation (NHC).

This lock-in period, however, is planned for only three years, of which one year is left. After this, WHC-REIT units will be traded on the Dar Es Salaam Stock Exchange (DSE). Through this channel, the general public will be able to invest in the REIT. It is proposed that listing the REIT on the stock exchange will allow the company to expand its capital base and channel foreign investment in the company.

WHC is governed by the Board of Directors which comprises the CEOs of all the unit holders. The Government of the United Republic of Tanzania is represented in the board through co-opted members from the Ministry of Lands and Urban Development, the Bank of Tanzania and the President Office-Public Sector Management (PO-PSM). The day to day activities of WHC is managed by the Managing Director (CEO) who is assisted by the Chief Operating Officer and the Chief Financial Officer (CFO). Three other senior managers

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127 Interview with Patrick Mususa, Projects and Business Development Manager at the Dar es Salaam Stock Exchange.
128 Interview with Heri Bomani, Managing Director of Pangani Group.
129 NMB is a top bank in the market and thus perceived to be lower risk than government. As a result, lower returns have still appealed to investors. Interview with Patrick Mususa, Projects and Business Development Manager at the Dar es Salaam Stock Exchange.
130 In Tanzania investments in the stock market have relaxed regulations compared to direct investments in property. For example, in the case of the Government Employees Provident Fund the max investment in domestic property is 8% whereas for domestic equity it is 55%.
132 These agencies were encouraged by government to put in capital to fund the REIT.
oversee the autonomous departments of procurement, legal, and marketing WHC seeks to maintain a lean but a dynamic workforce in line with the objectives of the company.\(^\text{134}\)

### Social Impact

Tanzania has a housing shortfall in excess of two million units. The need to accelerate the rollout of houses and specifically affordable homes was a key motivating factor behind the establishment of WHC. The REIT was conceptualised as a platform to fund the development of such affordable homes. More specifically, the WHC-REIT aims to mobilise funding for the development of low-middle income housing, both for sale and for rent. The target house price is between US$ 10 000 and US$ 40 000.\(^\text{135}\)

The first phase of development, launched in December 2015, consists of 1 500 units spread across 11 regions. The houses are to be sold under mortgage arrangements to public servants. According to Tanzania Invest, only 1.5% of public servants are provided accommodation through mortgages or any other type of housing finance. The WHC-REIT has attempted to mitigate this by entering into agreements with various banks so that workers can access mortgages at lower interest rates (11 to 13 percent, as opposed to 22 percent) for longer bond terms (up to 25 years), making the cost of accessing mortgages much lower.\(^\text{136}\)

### Portfolio

WHC-REIT’s property portfolio currently sits at around US$ 40 million, with 100% of this in residential real estate. Its investment decisions are guided by the need to build affordable homes, while simultaneously providing investors with a return of 15%. WHC-REIT has not distributed returns as of yet, due to the fact that it has not reached its first year end. The REIT’s gearing ratio is currently at 60% (with debt being 60% and equity being 40%).

### Challenges and Opportunities

The CEO of WHC-REIT is optimistic about the REIT’s future and expects it to grow gradually to TZS 35.8 billion (US$ 164.7 million) in the next five years. He believes that the REIT is a powerful vehicle for funding the delivery of homes, and asserts that it has been successful in supplying units at cheaper prices than seen previously. According to the CEO, thus far, WHC-REIT has enhanced the supply of affordable homes, contributed towards job creation, and supported market deepening through enhanced choice of unit types.

However, at the same time, WHC-REIT has faced certain challenges such as high construction costs\(^\text{137}\) and unrealistic consumer expectations about house pricing.\(^\text{138}\) Tax uncertainty, resulting from the election of a new government focused on widening the tax base through the introduction of new taxes and the enforcement of existing taxes, has also disrupted the housing market. For example, VAT relief on housing was expected to be introduced in the new financial year but was never been implemented. The government’s implementation of tighter monetary and fiscal policies has also resulted in market liquidity drying up. Consequently, investors have limited capital pools at present to channel into investment vehicles such as WHC-REIT. This in turn calls into question the extent to which there is space for growth for REITs in the Tanzanian market.

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\(^{134}\) http://whctz.org/


\(^{137}\) Despite the fact that both Tanzania and Kenya have ports and therefore should have similar import costs, it is at least 20% more expensive to build a house in Tanzania than in Kenya.

\(^{138}\) The majority of Tanzanian consumers are seeking housing but are finding prices to be out of their reach. The affordable segment is looking for units below US$50k, however the majority of units supplied are at much higher prices. Consumers are thus enticed into schemes but on further enquiry often establish that the prices are beyond what they can afford.

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Furthermore, many investors do not have a good understanding of the REIT platform and are thus hesitant to invest in it. This is exacerbated by the fact that the affordable housing space offers lower returns than other property asset classes and is thus not an obvious investment target.\textsuperscript{139} Furthermore, according to the REIT’s CEO, investors in WHC-REIT need to have patient capital, and be willing to receive more flexible returns on capital. In other words, in the affordable housing context the REIT structure does not give rise to the same quick investment vehicle that it gives rise to in other contexts. According to the CEO, further work needs to be undertaken in order to convince private investors that affordable housing is an attractive investment class.

This calls into question whether the WHC-REIT will be successful in attracting private capital from investors purely targeting financial returns once the REIT is listed on the Dar Es Salaam Stock Exchange (DSE). Indeed, it is important to highlight that the existing institutional investors in the REIT were largely coerced by the Tanzanian government to invest in the REIT.\textsuperscript{140} Put another way, for these institutions investing in WHC-REIT was a social investment decision – as opposed to an investment decision based purely on expected financial returns.

Nevertheless, both the CEO of WHC-REIT and representatives from the DSE are confident that the REIT will be able to attract investors once listed. Indeed, bilateral development partners have already expressed interest in investing in the REIT as a means to stimulating housing delivery in the Tanzanian context. Representatives of the DSE further assert that listing WHC on the stock exchange will subject the REIT to stronger governance process protocols and thus indirectly enhance its performance.

2.4 South Africa

Prior to the introduction of REIT legislation in South Africa in 2013,\textsuperscript{141} two alternative forms of publicly traded property entities were recognized. These were referred to as property unit trusts (PUTs) and property loan stock companies (PLSs). While both PLSs and PUTs were funds that invested directly into property, they were unevenly regulated and subject to different tax treatments.\textsuperscript{142} Both entities had their weaknesses.

PUTs were regulated as Collective Investment Schemes (i.e. mutual funds) and required administration and fund management to be separate. This gave rise to a passive investment vehicle, which deterred many investors. Such investors argued that since real estate is an active business, management should not be separated from the overall fund.\textsuperscript{143} PLSs were regulated under the Financial Services Board (FSB). Although PLSs were internally managed, they were poorly regulated and were generally treated as companies with respect to tax regulations. Indeed, “a degree of uncertainty prevailed over whether PLSs were legitimately entitled to deduct interest on the debenture component of linked units issued to investors”.\textsuperscript{144}

Additionally, both PUTs and PLSs were problematic as they were unfamiliar to foreign investors.\textsuperscript{145} The REIT legislation was thus introduced to establish robust regulation, and to provide clarity to the market with regards to how real estate entities and their shareholders

\textsuperscript{139} Interview with Fred Mswebwa, CEO of Watumishi Housing Corporation.
\textsuperscript{140} Interview with Heri Bomani, Managing Director of Pangani Group.
\textsuperscript{141} 25BB of the Income Tax Act No. 58 of 1962; JSE Listings Requirements for REITs
\textsuperscript{143} Interview with Brian Azizahaloff, MD of Capstone Property
would be taxed. Following the introduction of the REIT legislation all of the existing PLSs (approximately 15) and most of the existing PUTs (approximately 6) converted into REITs. The South African REIT legislation provides for two distinct types of REITs, namely Company REITs and Trust REITs. Existing PLSs converted into Company REITs, which may be internally or externally managed and are regulated in terms of the Companies Act, while existing PUTs converted into Trust REITs, which are externally managed and are regulated in terms of the Collective Investment Schemes Act. Both types of REITs are ultimately listed property investment vehicles that are similar to internationally recognized REIT structures.

According to the SA REIT Association, all JSE-listed REITs must:

- own at least R 300 million of property
- keep debt below 60% of their gross asset value (leverage ratio)
- earn 75% of their income from rental or from property owned or investment income from indirect property ownership
- have a committee to monitor risk
- not enter into derivative instruments that are not in the ordinary course of business
- pay at least 75% of their taxable earnings available for distribution to its investors each year

Section 25BB of the Income Tax Act effectively allows a REIT to achieve tax neutrality. According to this section of the Act, a REIT can deduct for income tax purposes all “qualifying distributions” to shareholders, which include dividends paid or payable, or interest incurred in respect of linked debentures.

At the same time, “qualifying distributions” received by shareholders are not exempt from income tax and consequently, depending on the nature and tax profile of the shareholder concerned, may be taxable in their hands. Dividend tax is imposed on “qualifying distributions” to foreign shareholders subject to a reduction in terms of an applicable double tax treaty.

The REIT legislation has been successful in giving rise to a recognisable and understandable structure that has been able to attract foreign investment. Since its introduction, REITs have grown significantly as an asset class – they now comprise 4% of the Johannesburg Stock Exchange (JSE). The REIT market is liquid and active and has given rise to deal-flow and immense corporate activity. As of January 2017, the South African REIT market comprised of 31 listed REITs with a market capitalisation of R320 billion. These REITs are summarized in Table 7 below.

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146 The establishment of the REIT structure came about as a result of a partnership between the PLS and PUT associations and DTI. DTI was very supportive of the idea savings. DTI thus provided the political backing for the decision to establish a REIT structure.


149 Interview with Keith Engel. Deputy CEO of SAIIT

150 SA REIT Association Website. Available at: http://www.sareit.com/index.php

151 The South African REIT regulations do not allow for REITs that buy and develop to sell. REITs are however allowed to develop to hold.


153 Pension funds are not subject to tax on such distributions.


155 Interview with Laurence Rapp. Chairman of SA REIT Association

Table 8: Established REITs in South Africa

<table>
<thead>
<tr>
<th>REIT</th>
<th>Sectoral Focus</th>
<th>Size of Portfolio</th>
<th>Management Type</th>
</tr>
</thead>
<tbody>
<tr>
<td>Arrowhead Properties Ltd</td>
<td>Diversified - with residential</td>
<td>R7.3bn</td>
<td>Internal</td>
</tr>
<tr>
<td>ACUCAP Properties Ltd</td>
<td>Diversified - without residential</td>
<td>R7.5bn</td>
<td>Internal</td>
</tr>
<tr>
<td>Ascension Properties Ltd</td>
<td>Diversified - without residential</td>
<td>R3.8bn</td>
<td>External</td>
</tr>
<tr>
<td>Capital Property Fund</td>
<td>Diversified - without residential</td>
<td>R16.9bn</td>
<td>Internal</td>
</tr>
<tr>
<td>Delta Property Fund</td>
<td>Diversified - without residential</td>
<td>R10.5bn</td>
<td>External</td>
</tr>
<tr>
<td>Dipula Income Fund</td>
<td>Diversified - without residential</td>
<td>R5bn</td>
<td>External</td>
</tr>
<tr>
<td>Emira Property Fund</td>
<td>Diversified - without residential</td>
<td>R33bn</td>
<td>External</td>
</tr>
<tr>
<td>Fairvest Property Holdings</td>
<td>Diversified - without residential</td>
<td>R1.4bn</td>
<td>Internal</td>
</tr>
<tr>
<td>Fortress Income Fund Ltd</td>
<td>Diversified - without residential</td>
<td>R6.6bn</td>
<td>Internal</td>
</tr>
<tr>
<td>Fountainhead Property Trust</td>
<td>Diversified - without residential</td>
<td>R14bn</td>
<td>External</td>
</tr>
<tr>
<td>Equites Property Fund</td>
<td>Industrial</td>
<td>R4.1bn</td>
<td>External</td>
</tr>
<tr>
<td>Freedom Property Fund Ltd</td>
<td>Diversified - with residential</td>
<td>n/a</td>
<td>Internal</td>
</tr>
<tr>
<td>Growthpoint Property Ltd</td>
<td>Diversified - without residential</td>
<td>R79bn</td>
<td>Internal</td>
</tr>
<tr>
<td>Hospitality Property Fund</td>
<td>Hospitality</td>
<td>R5.1bn</td>
<td>Internal</td>
</tr>
<tr>
<td>Hyprop Investments Ltd</td>
<td>Retail</td>
<td>R18.7bn</td>
<td>Internal</td>
</tr>
<tr>
<td>Indluplace Properties</td>
<td>Residential</td>
<td>R2.35bn</td>
<td>Internal</td>
</tr>
<tr>
<td>Investec Property Fund Ltd</td>
<td>Diversified - without residential</td>
<td>R5.8bn</td>
<td>Internal</td>
</tr>
<tr>
<td>Octodec Investments Ltd</td>
<td>Diversified - with residential</td>
<td>R11.6bn</td>
<td>External</td>
</tr>
<tr>
<td>Oasis Crescent Property Fund</td>
<td>n/a</td>
<td>n/a</td>
<td>Internal</td>
</tr>
<tr>
<td>Premium Properties Ltd</td>
<td>Diversified - with residential</td>
<td>R3.58bn</td>
<td>n/a</td>
</tr>
<tr>
<td>Rebosis Property Fund Ltd</td>
<td>Diversified - without residential</td>
<td>R6.59bn</td>
<td>External</td>
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<tr>
<td>Redefine Properties Ltd</td>
<td>Diversified - without residential</td>
<td>R25bn</td>
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<tr>
<td>Resilient Property Income Fund</td>
<td>Retail</td>
<td>R21.1bn</td>
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<td>SA Corp Real Estate Fund</td>
<td>Diversified - with residential</td>
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<td>Safiri Investments</td>
<td>Retail</td>
<td>R1.75bn</td>
<td>Internal</td>
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<tr>
<td>Sycom Property Fund</td>
<td>Diversified - without residential</td>
<td>R8.4bn</td>
<td>External</td>
</tr>
<tr>
<td>Synergy Income Fund Ltd</td>
<td>Retail</td>
<td>R2.4bn</td>
<td>n/a</td>
</tr>
<tr>
<td>Tower Property Fund</td>
<td>Diversified - without residential</td>
<td>R3.9bn</td>
<td>External</td>
</tr>
<tr>
<td>Transcend</td>
<td>Residential</td>
<td>R942 m</td>
<td>External</td>
</tr>
<tr>
<td>Vukile Property Fund</td>
<td>Diversified - without residential</td>
<td>R13.3bn</td>
<td>Internal</td>
</tr>
<tr>
<td>Vunani Property Inv. Fund</td>
<td>Commercial</td>
<td>R1.4bn</td>
<td>Internal</td>
</tr>
</tbody>
</table>

However, growth opportunities in the larger REIT sector in South Africa have been shrinking. Economic growth has stalled and the cost of capital has gone up. It is also getting
harder to push up rentals in the office, retail and industrial sectors, due to an oversupply of space.157

Many REITs have responded to these challenges by investing offshore – particularly in Australia, Europe, and the US.158 At the same time, certain real estate experts suggest that the residential property market represents a new opportunity in the context of the stagnation of the more traditional property sectors.159 Indeed, increasing rates of urbanisation and the declining availability of home mortgages has resulted in substantial demand for rental housing and growing levels of rental prices.160

Some experts assert that the South African REIT sector is now becoming large enough to specialise, and that the next big opportunity for REITs is in the residential property sector. It is suggested that the structure of the residential property market, which currently consists of large privately owned properties, presents significant opportunities for new players.

The emergence of three or four new residential REITs within the next three years has been predicted.161 Transcend, an off-shoot of the well-established private equity firm International Housing Solutions (IHS), listed on the JSE on December 1 2016, thereby becoming South Africa’s second focused residential REIT. The company’s focus is to acquire yield-accrative rental properties, with a specific focus on the affordable housing market and middle-income households.162 Transcend currently holds a portfolio of 13 properties, comprising 2,472 units, which fetch rentals of between R3 000 to R7 000.163 The REIT is offering an initial forward dividend yield of 8.5%.164

Additionally, the diversification of traditionally commercial REITs into the residential sector is foreseen.165 Such a redirection of strategy has already been demonstrated by SACorp, which acquired AFHCO’s residential portfolio in April 2014.

Real estate players also perceive opportunities for South African REITs to invest in residential property in other African countries such as Zambia and Mozambique.166 Indeed, SACorp recently acquired residential property in Zambia, where there is a desperate shortage of housing.167 Transcend also sees expansion opportunities throughout the African continent.168

However, the residential REIT market is still in the early stages and the market has yet to fully buy into the concept.169 Indeed, Octodec, Redefine Properties, SACorp Real Estate, Transcend, and Induplace are the only South African REITs significantly invested in the

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157 Interview with Keith Engel. Deputy CEO of SAIT.
158 According to Engel, internationally interest rates are historically low, markets are liquid, there are opportunities to build scale quickly and there are niche markets within which South African REITs can play. Although REIT investment in other African countries was popular in 2014 / 2015, many South African REITs have since pulled back out of the rest of Africa.
159 Interviews with Francois Viruly (Professor of Economics at UCT) and Renney Plitt (CEO of AFHCO).
160 Interview with Laurence Rapp. Chairman of the SA REITs Association.
161 Interview with Francois Viruly. Professor of Property Economics at UCT.
162 Makhlaka, R. (2016) Affordable housing heads for the JSE. Available at: http://today.moneyweb.co.za/article?id=628762#.WC26jLJ968G
163 Transcend’s portfolio of residential properties were all completed within the past 6 years and are located within secure estates. These assets differ from conventional inner-city residential rental housing in that they are predominantly 2 and 3 storey walk-up apartments located in desirable and high demand neighbourhoods and are often equipped with lifestyle-enhancing facilities. Transcend Property (2016) Company Profile. Available at: http://transcendproperty.co.za/company-profile/
165 Interview with Renney Plitt. CEO of AFHCO.
166 While a South African REIT doesn’t need REIT legislation to be in place in other countries to acquire property there, they do need to be careful with the country-specific tax legislation.
167 SACorp is considering creating a specialised residential fund once its residential portfolio is large enough.
168 Makhlaka, R. (2016) Affordable housing heads for the JSE. Available at: http://today.moneyweb.co.za/article?id=628762#.WC26jLJ968G
169 Interview with Laurence Rapp. Chairman of the SA REITs Association.
residential sector. Scepticism with respect to the residential sector’s ability to deliver appropriate yields is still prevalent.

The experiences of Indluplace are explored in the case study below.

**Case Study 4: Indluplace Properties – South Africa**

**Background**

Indluplace, South Africa’s first focused residential REIT, was listed on the JSE in June 2015, with a portfolio of ZAR1.6 billion (US$118 million). Since listing it has increased the value of its properties to over ZAR2.3 billion (US$170 million) and currently owns 115 residential properties, consisting of almost 5,400 residential units and about 12,600m² retail area, spread mainly across Gauteng.

Indluplace emerges in the context of a South African listed residential property market that is substantially under-represented relative to developed countries, and which is failing to meet the high demand for affordable, well managed rental housing. Indeed, Arrowhead Properties took the decision to establish Indluplace, as a result of the significant opportunity for growth that it saw in the listed private rental sector.

The REIT’s primary objective is to give investors growing yields and returns. It is Indluplace’s intention to aggressively grow its portfolio by acquiring yield enhancing properties and portfolios that provide income from the day of acquisition, and to pay growing distributions to its shareholders on a quarterly basis. In the process, it also seeks to deliver high quality products and bring a superior level of management into the residential property sector.

Indluplace follows the Arrowhead model. While they have executive directors and a small internal asset management team, their property management and accounting functions are outsourced. They believe that it is better to outsource these functions during the growing phase of a company as it provides flexibility and allows one to bring in a variety of expertise when investing in various geographical locations and markets.

Indluplace’s investors are primarily local. While Arrowhead owns 60% of the REIT and Indluplace’s management owns 7.5% of the REIT, the remaining investors are largely professional fund and investment asset managers. Large institutional investors in Indluplace include Stanlib and Investec.

**Social Impact**

Indluplace invests purely in residential property. Within the context of the residential property market, it invests in a variety of products and building types, and targets a diversity of income groups and markets. While it only invests where the yield works, it is

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370 At the same time, however, other property development companies that generate profit through the development and sale of large-scale residential estates are present in South Africa. Such companies, many of which are listed on the JSE, do not have REIT status due to the fact that the REIT regulatory regime is intended for companies focused on income distribution, rather than returns on capital employed (although this may change in the future). Balwin Properties, for example, did not seek REIT status when it listed on the JSE in October 2015 due to the fact that it does not focus on the distribution of net rental income to shareholders. Rather, Balwin’s business strategy targets investors who are seeking growth through development. Available at http://www.balwin.co.za/jse-investors/shareholder-centre/

371 Interview with Keith Engel. Deputy CEO of SAIT.


373 While South African listed residential property comprises less than 2% the total listed property market, listed residential property makes up 15% of the total listed property market in the USA.

374 http://www.indluplace.co.za/index.php

375 In this context, the tax arrangements of the REIT structure are particularly advantageous to Arrowhead, which receives dividends from Indluplace before tax has been deducted.

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simultaneously conscious of the potential role that rental accommodation could play in solving the shortage of affordable housing accommodation in South Africa.

Currently 38% of Indluplace’s portfolio consists of apartments in the Johannesburg Inner City, which primarily cater for the lower to mid-end of the property market. These units are on average rented out for around ZAR3 900 (US$288) a month, and serve households earning between ZAR10 000 (US$739) and ZAR15 000 (US$1109) a month.\(^{177}\)

While these units serve an important market, Indluplace has not significantly invested in accommodation suitable for households earning less than ZAR10 000 (US$739) a month, despite a desperate need for it.\(^{178}\) Indluplace’s CEO highlights that it is extremely difficult for private investors to play in this sphere of the market as, while the goal of all REITs is to provide their shareholders with high and regular incomes, low-income housing tends to yield low returns.\(^{179}\) Nevertheless, he suggests that the management and renting out of these low-end housing units can work when part of a larger residential portfolio. For example, many of Indluplace’s inner city buildings contain a few small rooms (with shared bathrooms and kitchens), which are rented out for about ZAR 1 300 (US$97) a month and are thus affordable to a household earning between ZAR 4 000 (US$300) and ZAR 10 000 (US$739).\(^{180}\) These rooms, however, are a small portion of Indluplace’s portfolio.

It is important to note that Indluplace has effectively shied away from the actual development of residential property and, instead, has preferred to invest in income producing properties with reliable track records. This is because, while Indluplace is an income fund that promises its shareholders quarterly distributions, development activity has the potential to drain distributions. Indeed, undertaking even a ZAR500 million (US$37 million) development would result in a quarter of the fund being tied up, and this would have the effect of diminishing short-run investor returns. Nevertheless, the REIT is currently considering undertaking small developments and is open to entering into an agreement with a developer in the future.

Although Indluplace has not yet contributed to an increased supply of rental accommodation, it is positively impacting the residential property market in other ways. Importantly, through the acquisition of ready-developed property, Indluplace offers an exit for developers of residential stock or portfolios. This facilitates the release of capital for developers, which can then be channelled into further housing developments. In other words, Indluplace serves to expand the residential funding pool, and thus plays an indirect role in relieving the rental housing shortage.

Additionally, Indluplace’s presence has contributed to an enhanced quality of management within the rental market, and has had a positive impact on the improvement districts. Indeed, since Indluplace is a long-term investor (i.e. it is not in the market of buying and selling), it has an interest in investing in the surrounding environment and buildings.

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\(^{179}\) REITs buy the net income stream of a property (i.e. rental income less management expenses). While rental income is lower for affordable housing units than for higher-end units, management expenses are not lower. Therefore, affordable housing investors will only be able to generate returns equivalent to those generated by higher-end units, if they are able to make significant savings on the initial capital expenditure of the property (i.e. the cost of acquiring / developing the property). To date, very few (if any) property investors / developers have succeeded in developing a financial model for low-end affordable housing that yields returns equivalent to those generated by prime residential property. See section 4.3 for further discussion around this issue.


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Consequently, a large focus of Indluplace’s board is to be involved in improvement districts and social programmes, in the context of their residential properties. 

**Portfolio and Performance**

The tables and figures below capture the size and breakdown of Indluplace’s residential portfolio.

Figure 14 illustrates that the majority of Indluplace’s property portfolio is located in Johannesburg, with 38% being in the inner city.

**Figure 3: Geographical Spread of Portfolio (units)**

![Geographical Spread of Portfolio](image)

Source: Indluplace.co.za

Table 8 demonstrates that out of the 5,447 residential units owned by Indluplace, only 269 (5%) fall into the category of student housing.

**Table 6: Indluplace Portfolio (March 2016)**

<table>
<thead>
<tr>
<th></th>
<th>Number of Units</th>
<th>Proportion of Portfolio</th>
</tr>
</thead>
<tbody>
<tr>
<td>Normal Residential</td>
<td>5,178</td>
<td>95%</td>
</tr>
<tr>
<td>Student Accommodation</td>
<td>269</td>
<td>5%</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>5,447</strong></td>
<td><strong>100%</strong></td>
</tr>
</tbody>
</table>

Source: Indluplace.co.za

Finally, Figure 15 illustrates that the largest proportion of Indluplace’s portfolio comprises of two bed units (44%), followed by bachelor units (20%) and one bed units (16%). Only 6% of Indluplace’s portfolio consists of communal rooms targeted at very low-income earners.

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Indluplace plays a leading role in the Ekhaya Community Involvement District, and has been involved in setting up the Windsor Action Group / Community Policing Forum.
Indluplace pays 100% of its profits as dividends, and is the only REIT besides for Arrowhead that pays quarterly distributions. To date its annual return has averaged at around 9.5%.\(^{182}\)

Currently, almost 100% of Indluplace’s funding is in the form of equity and it has no bank debt. While it would be willing to take on a degree of debt if a good opportunity came along, it would not exceed a LTV of 34%.\(^{183}\)

**Challenges and Opportunities**

Indluplace has been criticised by its competitors for acquiring poor quality, sporadically located properties in order to reach the critical mass required to attract investor attention. The effectiveness of outsourcing property management in the context of residential property has also been questioned.\(^{184}\)

While Indluplace’s CEO is largely happy with the progress that has been made with respect to growing the fund and paying out dividends, he too acknowledges that there is still work to be done. He notes that the REIT faced a number of challenges during its first year, including:

- **Markets conditions** – funding became more expensive towards the end of 2015,\(^{185}\) and it became more challenging for the REIT to purchase stock at the correct price. Additionally, the weakening of the macro-economy impacted tenant affordability levels, which in turn restricted the REIT’s ability to escalate rentals.

- **Misperceptions regarding residential REITs** – Indluplace experienced difficulties with respect to explaining the residential REIT market to investors. Most investors tend to think of risks (specifically, evictions) when they think of residential property,\(^{186}\) and fail to understand that the fundamentals in the residential market are good.\(^{187}\) These misperceptions are exacerbated by the fact that there is very little information available on residential property in the form that property investors are used to. Indluplace is working on changing...

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\(^{182}\) 9.5% exceeds both the 2016 inflation rate, which was 6.5%, and the average return on commercial REITs, which sits at about 9% per annum.

\(^{183}\) Since Indluplace distributes all of its profits, it would be required to go to the market or take-out a loan in order to finance further investments.

\(^{184}\) Interview with Renney Plit, CEO of AFHCO.

\(^{185}\) Towards the end of 2015, the president of South Africa unexpectedly fired the Finance Minister plunging the country’s economy into uncertainty.

\(^{186}\) In reality, Indluplace has evicted only two people in two years.

\(^{187}\) E.g. demand is high and vacancies are low

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perceptions, and has started provided residential information in a format that property investors understand.188

**Management challenges** – Indluplace has found it difficult to change the management culture of newly acquired buildings. Some portfolios that Indluplace acquired were previously poorly run, and it was challenging to re-align management philosophies and reporting structures.

Nevertheless, Indluplace’s CEO remains positive about the REIT’s growth potential due to the strong fundamentals of the residential property market, with respect to vacancies, arrears and growth in rentals. Furthermore, the high demand for well-priced, well-managed, well-located properties, means that if Indluplace’s properties are priced correctly they will have low vacancies, and if they are managed properly they will have low arrears.189

The demand for focused residential REITs such as Indluplace is thus projected to grow as investors become more comfortable with the concept and seek to diversify their portfolios accordingly.190

### 2.5 Kenya

In 2013, Kenya became the third African country to establish a real estate investment trust (REIT) as an investment vehicle. Kenyan REIT regulations (The Capital Markets (Real Estate Investment Trusts) (Collective Investment Schemes) Regulations, 2013) provide for two types of REITs, namely IREITs and DREITs.

An IREIT is an Income Real Estate Investment Trust Scheme, in which investors pool their monies for purposes of acquiring long term income generating real estate including housing and commercial real estate. An IREIT is characterized as follows:191

- It invests at least 75% of the total net asset value in income producing real estate;
- It earns at least 70% of its income from rent, license fees or access or usage rights or other income streams of a similar nature generated by eligible investments in income producing real estate;
- It adheres to the restriction that borrowings cannot exceed 35% of the total asset value;
- It distributes a minimum of 80% of the net after tax income of the fund from sources other than from realized capital gains on the disposal of real estate assets;192 and
- Offers to invest in it can be made either as a restricted offer or an unrestricted offer.193

A DREIT, on the other hand, is a Development and Construction Real Estate Investment Trust Scheme, in which investors pool their monies together for purposes of acquiring real estate, with a view of undertaking development and construction projects and associated

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188 Interview with Carel de Wit and Terry Kaplan, Indluplace. Examples of Indluplace’s approach to annual reports and investor presentations can be found on its website: [http://www.indluplace.co.za/index.php](http://www.indluplace.co.za/index.php)
189 The high indebtedness of South African consumers also means that people struggle to get bonds, which further increases the demand for rental.
190 Paradoxically, more focused REITs actually help investors to diversify; because investors know exactly what segment of the market they are investing in and can build their portfolio accordingly.
192 Any realized capital gains may be retained and invested in income producing real estate.
193 While, a restricted offer is made to professional investors only, an unrestricted offer can be made to any investor.

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activities. In the context of DREITs, returns mainly come from sales proceeds. A DREIT is characterized as follows:

- It invests at least 30% of the total asset value directly in development and construction projects, or income producing real estate which the D-REIT has developed or constructed;
- it adheres to the restriction that borrowings cannot exceed 60% of the total asset value;
- it has the option to either distribute any realized capital gains, or retain and invest any realized capital gains in new acquisitions or developments;
- it has a minimum of seven investors; and
- offers to invest in it may be made only to professional investors.

Both an IREIT and a DREIT are required to have a trustee who is independent of the REIT manager and the promoter. A trustee may be a bank, bank subsidiary or company/corporation that has the experience and the financial, technical and operational resources required to conduct business effectively as a REIT trustee. Additionally, both the REIT trustee and the REIT manager must be licensed by the Capital Markets Authority (CMA). To date, the CMA has approved and licensed five REIT Managers, namely; Stanlib Kenya Limited, Fusion Investment Management Limited, CIC Asset Management Limited, Centum Asset Managers Limited and UAP Investments Limited.

Furthermore, for a company to operate as an authorised REIT, it must apply to the CMA as either a close-ended or open-ended REIT. A close-ended REIT issues a specific number of shares through an initial public offering and does not issue new shares as investor demand grows. Prices, in this context, are driven by investor demand. An open-ended REIT, on the other hand, can issue an unlimited amount of shares. As more investors buy into the fund, more shares are issued; hence purchases and sales of fund shares take place directly between investors and the REIT. This requires a daily valuation process, which adjusts the REIT’s per share price to reflect changes in portfolio (asset) value.\(^{194}\)

Importantly, corporate tax exemption plays a critical role in incentivising investment into the REIT industry in Kenya.\(^{195}\)

In recent years, the REIT market has performed relatively poorly in Kenya. In 2016, Kenya’s only listed I-REIT, Fahari I – REIT, shed 45% of its value.\(^{196}\) Furthermore, Fusion Capital’s attempt to list a D-REIT (FRED – Commercial), failed due to the REIT being undersubscribed.\(^{197}\)

According to Cytonn Investments (2016),\(^{198}\) the Kenyan REIT market’s poor performance during 2016 can be attributed to (i) poor returns from the underlying assets (ii) opacity of the exact returns from the underlying assets, (iii) inadequate investor knowledge and lack of institutional support for REITs, and (iv) the negative sentiment currently engulfing the sector given the poor performance of Fahari and failure of FRED.

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\(^{194}\) Ebrahim, M. (2014). An Introduction to REIT’s in Kenya. Available at: https://www.linkedin.com/pulse/2014090916345924063084
\(^{196}\) The D-REIT succeeded in raising only 37.8% from four investors out of the minimum requisite of 50% from at least seven investors. Cytonn Investments (2016). Cytonn Annual Markets Review. Available at: https://cytonn.com/download/Cytonn_Annual_Markets_Review_2016.pdf

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2.6 Rwanda

Rwanda’s REIT guidelines (Regulation No. 14 on Real Estate Investment Trusts) were established in 2013, with the objective of providing “better access to stable, global and more competitively priced capital, as well as stronger and more professional property businesses.”

According to the guidelines, every REIT is required to be managed by a real estate investment management company that has obtained a certificate of registration from the Capital Markets Authority of Rwanda. The REIT and its management company are required to be independent of each other, and both must have a net worth of at least 25 million. Trustees of a REIT are to be appointed by the establishers of the REIT, and must be either a scheduled bank, a trust company that is a subsidiary of a bank, a public financial institution, an insurance company, or a corporate body.

In Rwanda, REITs are required to hold 100% of their assets in real estate. Generally, this real estate is required to be income generating. Nevertheless, a REIT may acquire uncompleted units in a building which is unoccupied and non-income producing, or in the course of substantial development, redevelopment or refurbishment, provided that the aggregate contract value of such real estate does not exceed 20% of the total net asset value of the scheme. At the same time, however, a REIT is prohibited from investing in vacant land or participating in property development activities. Aggregate borrowings of a REIT may not exceed one fifth of the value of total gross assets of the scheme.

Unit certificates issued under a REIT scheme are required to be listed immediately after the date of allotment in recognized stock exchanges, and are freely transferable. REITs are required to distribute at least 90% of their annual net income after tax to unit holders as dividends each year.

To date, no REITs have been established in Rwanda.

2.7 Morocco

In 2015, Morocco passed legislation allowing for the creation of REITs. Under this law, REITs are required to invest at least 70% of their assets in real estate, while the remainder can be invested in other assets to help diversify their investment portfolio. Moroccan REIT legislation further requires an external asset manager to undertake the management of any REIT operating in the country.

However, the legislation does not include changes to the fiscal framework. Consequently, at present, companies acting as REITs are taxed in line with limited liability companies. An upcoming financial bill is expected to include a tax package which would complete the REIT legislation.

Real estate has traditionally been an attractive asset class in Morocco, particularly in recent years. The sector accounts for the largest share of foreign direct investment (FDI) inflows, at 38.6% of the total. While return on investment (ROI) on real estate averages around 9% in Casablanca – double the 4.5% average in Paris – investors have been slow to invest in Morocco’s commercial capital, as the high level of taxation on investment effectively eliminates the difference in ROI.

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199 Regulation No. 14 on Real Estate Investment Trusts (2013) Official Gazette n° 34
200 For the purpose of the regulation, property development activities do not include refurbishment, retrofitting and renovations.
Consequently, once the REIT fiscal framework is in place, international investors are expected to start entering the sector. This in turn is expected to launch REITs in Morocco, with as many as five or six new REITs expected in the coming years.

In early 2016, the government restructured Vecteur LV (VLV), a subsidiary of Moroccan retail distributor Label Vie Group, into the country’s inaugural REIT. Going forward, MARA Delta is also set to convert its Moroccan subsidiary into a REIT, in order to gain from tax savings created by the dispensation. To address the REIT legislation’s requirement for an external asset manager, Mara Delta has formed an asset manager, Morocco REIT Management SA, as part of its conversion of the Moroccan Fund into a Moroccan REIT. Mara Delta will hold a 20% stake in the asset manager.  

3. REITs in Africa

To date, REITs have been only marginally successful within many of the African countries that have established REIT frameworks. In part, this can be attributed to the early stages of development of African REIT markets. However, as explored below, the varying performance of REIT markets across the continent has a lot to do with the various contexts in which these markets are emerging. This suggests that in addition to exploring the potential for affordable housing REITs in Africa, it is essential to understand the contextual factors that support or undermine REITs more generally. Interviews with a variety of real estate and housing finance experts across the various jurisdictions indicated that a number of critical enabling conditions need to be in place before REITs can thrive in any given context.

Many of these conditions relate to the institutional strength of the country and property markets in question. For example, robust property rights and accurate records of title deeds were highlighted as key elements underlying the type of institutional structure required for REITs to emerge.204 Furthermore accurate and reliable property valuations as well as property market transparency were identified as essential.205 In other words, a certain level of market development and maturity is required for the REIT structure to work.

The legislative and regulatory context was also highlighted as being key. For example, appropriate rental market legislation (i.e. legislation that appropriately protects both tenants and landlords) was presented as a pre-condition.206 Such legislation is particularly relevant in the context of residential REITs. All interviewees emphasized that the tax legislation and financial regulations that define the REIT framework need to be drafted appropriately.207

Economic conditions were also identified as significant. This is because REITs need economic growth and income to maintain demand. In this context, buyers and a vibrant market (preferably with mortgages in play) are essential.208 Interest rates constitute another economic factor at play. A high interest rate environment discourages investments in REITs because the opportunity costs increase substantially – especially if investors can invest in high yielding government securities.209

In addition, the important role that institutional investors play in the context of REIT markets cannot be ignored. Investment in the REIT asset class is typically well-suited for institutional investors looking for stable growing income returns over the long term – such as pension and retirement funds, mutual funds, unit trusts and other collective investment schemes. 210 For such investors, REITs provide an attractive opportunity to achieve portfolio diversification through investment in real estate.211

REIT markets, in turn, benefit from robust institutional investor participation. Indeed, from a REIT’s perspective, the vast amounts of money with which institutional investors are endowed represent increased market liquidity and the potential for large-scale real estate

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204 Interview with Francois Viruly, Professor of Economics at UCT and Interview with Keith Engel. Deputy CEO of SAIT.
205 Interview with Francois Viruly, Professor of Economics at UCT.
206 Interview with Francois Viruly, Professor of Economics at UCT.
207 What constitutes an appropriate REIT framework in the African context will be further explored in the sections that follow.
208 Interview with Carel de Wit and Terry Kaplan. CEO and Financial Director of Indluplace and Interview with Heri Bomani. Managing Director of Pangani Group.
209 Interview with Evans Osano, FSD Africa.
211 In the US, most large institutional investors generally maintain permanent real estate allocations of 8 percent to 10 percent of their portfolios. Due to the historically attractive returns offered by REITS and their inflation hedging characteristics, institutions are increasingly looking at the REIT market as representing a meaningful portion of that 8 percent to 10 percent allocation to real estate overall. Kennedy, A. (2016). More Institutions Investing in REITs. Available at: https://www.reit.com/news/podcasts/more-institutions-investing-reits

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investment. Furthermore, the engagement of prominent institutional investors in REIT markets tends to improve the monitoring aspects of such markets, as institutional investors normally have the expertise and motivation to spend resources to monitor the companies in which they invest.

Therefore, the viability and potential dynamism of an emerging REIT market is significantly impacted by the number of institutional investors already present in the market, and the regulatory frameworks that determine the extent to which institutional investors are allowed to invest in REITs.

Finally, interviewees agreed that REITs require critical mass to attract investor interest, and therefore the emergence of REITs in Africa, first requires the existing property markets to reach a certain scale and maturity.

Critical mass is important because a REIT needs to be liquid and tradable in order to be attractive to investors. In other words, shareholders need to be able to buy and sell their shares in the REIT relatively quickly and easily. This in turn is only possible in a context in which many different shareholders each hold relatively small percentages of the total shareholdings of a given REIT. Since shareholders – and institutional shareholders in particular – also often seek to make large investments, liquidity and tradability are only achievable in the context of a REIT with a large asset portfolio.

This concept can be illustrated with an example. Assume that a REIT holds property to the value of US$100 million, 40% of which is financed through debt and 60% of which is financed through equity (i.e. shares). In this case, only US$60 million of shares would be in trading. Institutional investors, however, would be looking to invest US$10 million plus. This would mean that a given institutional investor could come to own one sixth of the total shares in trading. This would significantly limit the liquidity and tradability of the REIT’s shares.

The implication is that REITs need to amass substantial portfolios before listing. Furthermore, in order to grow investor returns, REITs need to continue purchasing / developing properties once they are listed. This, in turn, can only take place in the context of a property market with substantial existing housing stock and the existence of capable, well-governed developers.

3.1 Residential REITs in Africa

The concept of critical mass is particularly pertinent in the context of focused REITs, such as residential REITs. Since residential REITs invest only in residential property, the property market needs to be large enough to provide a potential REIT with the opportunity to build up its portfolio through the acquisition of existing residential properties.

As demonstrated by the case studies in the previous section, REITs in countries with limited residential property markets have tried to get around this restriction by developing their own residential portfolios from scratch. However, the experiences of these REITs demonstrate that such REITs are not able to generate high and regular returns in the short-term – a key incentive for the REIT model in the first place. The advantages and

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212 In South Africa, for example, institutional investors are entrusted with approximately ZAR 30 trillion (US$ 748 billion) of savings. Interview with Heather Jackson, Head of Specialist Credit, Ashburton Investments.


214 Interview with Brian Azizahaloff, CEO of Capstone Properties.

215 In the South African context, for example, it is estimated that REITs need a market capitalisation rate of above R5 billion to be successful. Assuming 35% gearing, this means that REITs need to have property portfolios of above R7.69 billion.

216 Interview with Heri Bomani, Managing Director of Pangani Group.

217 Interviews with Renney Plit, CEO of AFHCO and Laurence Rapp, Chairman of the SA REIT Association.

218 This is because properties under development are not income-producing (i.e. they are not yet occupied by rent-paying tenants). Therefore, portfolios consisting primarily of such properties cannot immediately provide returns to shareholders in the form of dividends.
disadvantages of REIT engagement in development will be further explored in the sections below.

Another contextual factor impinging upon the feasibility of residential REITs in Africa include the urban form of African cities. Interviewees indicated that residential REITs rely upon economies of scale and thus seek to invest in high-density housing, single-ownership apartment buildings and large mixed-use developments. Cities that lack such property assets and have limited land availability for this sort of development do not provide ideal environments for the emergence of residential REITs.

Other elements impacting the financial viability of residential REITs include:

- **The issue of VAT**: in certain jurisdictions, property owners can claim VAT on the price paid on the purchase of a commercial property, but cannot claim VAT on the purchase of a residential property.

- **Land regularization and residential re-zoning**: in many African countries, the procedures required to prepare land for residential development, such as getting properties rezoned for residential use and securing title deeds, are slow and challenging. The inefficiency of such procedures negatively impacts the cash-flow of residential developments. A key consideration therefore, is where in the housing delivery value chain REITs can play the most effective role.

- **Higher management costs**: The management time and effort required in residential property is more significant than in other markets, due to the fact that the contracts are shorter and there are more tenants. Although risk is diversified (across tenants), there is more focus on systems and collection methodology than in the traditional market.

The aforementioned issues differentiate the financial business case of a residential REIT from that of a commercial REIT, and have led investors to question whether or not residential REITs can give rise to high enough yields.

Evidence from the African residential REIT case studies is mixed. On the one hand, in Nigeria, the Union Homes Hybrid REIT failed to distribute dividends in 2014 due to the REIT’s negative performance. On the other hand, HFC REIT managed to return a yield of 24.26% in 2015, which was significantly above the year end inflation rate (17.5%), and slightly above the one year Government of Ghana (GOG) note against which HFC REIT benchmarks itself (22.5%). However, none of HFC’s yield was distributed to investors, due to fact that HFC REIT is a long-term investment vehicle that focuses on capital growth.

In South Africa, Indluplace has on average distributed annual returns of 9.5% to investors. While this is substantially higher than South Africa’s average rate of inflation and slightly higher than the average annual dividends delivered by commercial REITs (around 9%), it remains uncertain whether these returns are high enough to attract and maintain interest in the residential real estate sector in South Africa.

This issue, which takes on particular significance in the context of REITs investing in affordable housing, is further explored in the section that follows.

### 3.2 Affordable Housing REITs in Africa

In the context of this paper, affordable housing REITs simply refer to REITs that invest in residential property that is affordable for the majority of the population in African
countries. Assuming that the conditions outlined above are in place, the feasibility of such a REIT should purely be determined by the extent to which the fund is able to offer investors returns that are appropriate given the level of risk associated with the investment portfolio.224 As one interviewee stated: “Investors look only at risks and returns. If the returns outweigh the risks, they will be willing to invest”.225

In order to attract private investment, affordable housing REITs would thus have to deliver yields comparable to those offered by other investment assets, such as commercial REITs. These yields would further have to be adjusted in order to take into account the relative level of risk associated with affordable housing as a property asset.

All of the interviewees indicated that affordable housing as an asset class is perceived by the market to be substantially riskier than the more traditional asset classes. This is primarily due to the management risks associated with affordable housing, which include:

- **Uncertain effective demand:**226 Effective demand is perceived as uncertain in the context of affordable housing due to the fact that tenants often have low, and potentially unreliable, incomes. This perception is based on the assumption that lower income households tend to engage in more precarious employment and suffer more with economic downturns.

- **The inability to evict non-paying tenants** due to legal or reputational considerations: Reputational risks, in particular, become a factor for rental providers in affordable housing, due to the fact that society often perceives it as cruel or unjust to evict lower-income tenants who are unable to pay their rent.

- **Urban decay:** The lack of effective urban management and general urban decay negatively affect investment values as well as tenant perceptions and willingness to pay.

Affordable housing REITs would thus have to compensate for this risk by offering yields higher than those provided by the more traditional investment assets. In the South African context, for example, it is estimated that an affordable housing REIT would need to deliver returns at least two to three percentage points higher than those typically delivered by commercial REITs in order to attract investment from the market.227

Whether or not this is possible in practice is a matter of debate, and very much dependent on the particular context. As highlighted in the previous section, residential REITs are already faced with challenges that impinge on their ability to deliver high returns. The sections that follow therefore explore various factors that influence the risk – return profile of affordable housing REITs, with the view of understanding the conditions under which this asset class could constitute a feasible form of market investment in the context of the REIT structure.

**Affordable Housing Market Segment**

A key determinant of the risk-reward profile of a given affordable housing REIT is the precise segment of the affordable housing market being targeted. Interviewees indicated that there is a floor to the income levels of tenants below which a REIT cannot feasibly go.

This is because, on the one hand, the risks associated with affordable housing (outlined above) are perceived to become more pronounced the further down the affordable housing market that rental providers go. Households with a monthly income of US$1100 are generally assumed to have a more stable and reliable source of income (i.e. form of

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224 Interviews with Michael Bookstaber, Renney Plit, Brian Azizahaloff, Keith Engel, Carel de Wit and Terry Kaplan.
225 Interview with Renney Plit. CEO of AFHCO.
226 Effective demand refers to the level of demand that represents a real intention to purchase by people with the means to pay.
227 Given that commercial REITs are on average delivering around nine percent annual returns, an affordable housing REIT would need to deliver around 12% annual returns in South Africa.
employment) than households with a monthly income of US$330 per month. Similarly, the reputational damage to a rental provider forced to evict a household with a monthly income of US$330 is likely to be worse than the reputational damage that would be suffered if the evicted household had a monthly income US$1 100.

At the same time, **returns on affordable housing investment tend to decrease** as the income levels of the target market decreases. This is because rental affordability, and therefore household income, determines the levels of rent that a housing provider can charge. For example, assuming that households can put 25% of their income towards rent, a rental provider can charge an average monthly rent of US$275 if its target market is households with an average monthly income of US$1 100. However, the same rental provider can only charge an average monthly rent of US$82 if its target market is households with an average monthly income of US$330. Consequently, REITs targeting the lower end of the rental market (i.e. households with lower levels of income) need to accept **lower levels of rental revenue**, relative to REITs targeting middle-income households.

Operating expenses, however, **are more or less fixed**, irrespective of the income levels of the target tenants. Certainly, there is a floor operating cost that rental providers cannot go below. For example, the **operating profit** (i.e. rental revenue less operating expenses) earned by housing providers targeting lower-income households is **thus necessarily lower** than the operating profit earned by housing providers targeting relatively higher-income households. (Indeed, operating profit becomes negative if the level of rent that the target market can afford is lower than the floor operating costs.)

Operating profit in turn directly influences the net profit that a housing provider makes. Net profit is what remains of the operating profit once the REIT’s financing costs have been paid. Consequently, **given financing costs, lower operating profit results in lower net profits**.

It follows that the **only way for a low-income residential REIT to generate profits equivalent to those generated by higher income residential REITs is to reduce its financing costs**. In theory this should be possible, as the cost of acquiring / developing a building consisting of housing units appropriate for low-income earners is expected to be lower than the cost of acquiring / developing a building consisting of housing units attractive to middle-income earners. However, in practise, **rental providers have struggled** (or have been reluctant to try) to get the financial model for lower-income housing to work.

Indeed, to date, very few property investors / developers have succeeded in developing a financial model for low- end affordable housing that yields returns equivalent to those generated by middle-income residential property and commercial property. In the South African context, for example, property investors are generating relatively high returns through the provision of rental housing targeting households that earn between R2 000 (US$1 500) and R15 000 (US$1 124) per month. However, these same property investors have largely not been able to arrive at a model that allows for the same returns to be generated in the context of households earning below R10 000 (US$750) per month.

Nevertheless, more interest is being shown in trying innovative approaches to making the financial model work for lower-income rental housing. For example, with the assistance of

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228 For example, the floor operating cost is estimated at around R1000 (US$73) per month in the Johannesburg inner-city.

229 The implications of developing as opposed to acquiring property in this context are explored in the section below.


concessional financing from the French Development Agency (AFD), AFHCO (African Housing Company, formerly Affordable Housing Company) recently re-developed two buildings in the Johannesburg inner-city in an attempt to cater for households earning between R4,500 (US$334) and R6,000 (US$445) per month. A communal ablutions model was implemented in order to reduce capital expenditure. The project demonstrated that, in certain circumstances and with the assistance of certain financial instruments, affordable rental housing can be provided for low-income earners at reasonable rates of return.

Innovative approaches, such as the one taken by AFHCO and AFD, are key to increasing returns in the context of investing in lower-income housing. Further work in this area could contribute towards making low-income housing REITs feasible from a risk-reward perspective. Another approach certain REITs are taking, in an attempt to deliver low-income housing without negatively impacting their risk-return profiles, involves nesting housing assets catering towards the bottom end of the market within a larger residential or diversified portfolio.

For example, as outlined in the South African case study, Indluplace rents out a number of small rooms with shared bathrooms and kitchens for R1,300 (US$97) a month. Since these rooms are a small portion of Indluplace’s portfolio, they do not significantly influence Indluplace’s overall risk-return profile. Similarly, the communal housing units developed by AFHCO (described above) are nested within SACorp’s larger property portfolio. Large residential and diversified REITs thus potentially have an important role to play in the delivery and management of affordable housing catering for lower-income earners.

Development versus Acquisition of Property

The potential role of REITs in property development takes on renewed significance in the context of affordable housing in Africa.

In addition to contributing towards the fulfilment of a social need (i.e. the provision of additional stock of much-needed affordable housing) and addressing the issue of critical mass (discussed above), it has been suggested that new development has the potential to enable REITs to achieve higher returns in the context of affordable housing, thus making the model financially viable. When evaluating the potential role of development in the context of residential REITs, it is necessary to differentiate between property investors that develop to rent and those that develop to sell.

Developing to Rent

According to various REIT experts, the development of residential property for the purpose of ultimately renting it out can be made to work in the context of the REIT structure. The primary source of the REIT’s revenue in such a context would be rental income, which would eventually flow into the REIT in a predictable and relatively regular

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235 Section 5 further considers the need for innovative approaches to the financing and delivery of low-income housing.
236 Carol de Wit and Terry Kaplan. CEO and Financial Director of Indluplace.
237 In April 2014, SA Corporate Real Estate Limited (SA Corp) concluded a R953 million transaction to acquire the entire issued share capital of AFHCO and its portfolio of 27 Johannesburg inner city properties. According to the CEO of SA Corp, in the context of a scarcity of assets in the traditional spaces, the company was seeking to gain exposure to non-traditional areas with robust investment cases. SA Corp had decided to gain exposure to the affordable housing component of the residential property sector due to the strong fundamentals underlying the sector, and the manner in which it allows property developers to diversify over thousands of leases and to buy into an economic environment.
238 Interview with Renney Plit. CEO of AFHCO.

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manner. Consequently, after an initial period of development, the REIT would come to be in a position to distribute regular profits to its shareholders (generated from the inflow of rental income) – dividends that would be relatively high, due to the fact that the REIT’s net profit would not be taxed at the corporate level. In this context, the REIT structure (i.e. the REIT tax arrangements and the associated regulations) would work effectively to incentivise investment in the residential property sector.

Engaging in this sort of development activity in the context of residential property – and affordable housing in particular – can result in higher returns than simply acquiring property for rental purposes. This is because new developments allow for the intended affordable nature of the property to be factored into account during the construction process. Thus, like in the AFHCO example above, a residential property could be constructed with relatively small rooms and communal bathrooms – thereby lowering capital expenses (as less bathrooms need to be constructed) and increasing rental revenue (as more tenants can be housed). Higher revenue streams and lower capital expenses (and therefore lower financing costs) ultimately translate into higher returns.

However, it is important to highlight that a REIT of this design would only be able to distribute regular, high dividends once its portfolio of developed properties reaches a certain size. The process of building its property portfolio to a scale at which the portfolio would effectively and consistently generate returns would require significant incubation and investment of capital upfront. This introduces a higher level of risk into a REIT that is seeking to develop, as opposed to acquire, its portfolio – and has the potential to result in the dilution of investor returns in the short-term.

The question thus becomes whether the increased returns resulting from development activity in this context outweigh the higher risks. Interviewees indicated that this approach to property investment does have the potential to positively impact the risk-return profile of a REIT investing in affordable housing. However, most interviewees qualified this assertion by stating that such development should only be undertaken in the context of a larger income-producing portfolio. It was suggested that having between 10% and 30% of a REIT’s portfolio in affordable housing development could increase the overall returns of the REIT, without noticeably diluting short-run returns or significantly raising the REIT’s risk-profile.

One interviewee nevertheless suggested that, in the context of affordable housing, having a larger proportion of a REIT’s portfolio in development could be beneficial. According to this argument, although the development stage would slow down the dividend stream initially, the REIT would make up for it from future growth. This approach, however, would only be viable in the context of rental apartments (i.e. not in the context of houses to rent).

Developing to Sell

In the context of the REIT framework, the concept of developing residential property for the purpose of subsequently selling it is significantly more controversial.

The primary source of a REIT’s revenue, in this context, would be proceeds from the sale of properties, which would likely flow into the REIT at irregular, non-frequent intervals. Such a REIT would thus not be in a position to distribute regular, consistent profits to its shareholders. Rather, its purpose would be to generate long term capital growth.

[239] Interviews with Michael Bookstaber, Renney Plit, Laurence Rapp, Brian Azizahaloff, Keith Engel, Carel de Wit and Terry Kaplan.
[240] SACorp, for example, has been successfully engaging in residential development in the context of their larger property portfolio and a strong balance sheet. Presently, they are seeking to roll-out about 60 residential units per month.
[241] Interview with Keith Engel, Deputy CEO of the SAIT.
Such an investment vehicle would therefore not exhibit many of the distinguishing characteristics of the traditional REIT structure, and would carry a lot more risk. Critics argue that the “patient capital” required in the context of this sort of REIT is an internal contradiction in the context of REITs, which are synonymous with safe, consistent and predictable cash-flows. According to this argument, classifying such an investment vehicle as a REIT introduces “hidden” risk into a traditionally safe investment asset and therefore has the potential to damage the reputation of the entire REIT industry in emerging markets. It is for this reason that the concept of Development REITs (D-REITs) has come under fire from many housing finance experts, who argue that D-REITs ultimately require a different type of investor from that associated with traditional REITs.

At the same time, however, it has been argued that a REIT developing and selling multiple, small units – such as those developed in the affordable housing sector – would be less exposed to risk than a REIT developing and selling a few, large developments (which are typical of the commercial and high-end residential sectors). According, to this line of thinking, the sale of multiple affordable housing units on the market could be viable from a risk perspective. Nevertheless, even in this context, development would need to be kept at below 30% of the REIT’s total portfolio, in order to ensure the REIT’s ability to pay regular dividends to its investors.

The REIT structure, therefore, is not ideally suited for directly facilitating the development and sale of affordable housing units at scale. Nevertheless, affordable housing REITs have the potential to play an important role in ensuring demand for affordable housing, thereby freeing up capital for developers active in the sector. Indeed, a thriving affordable housing REIT sector would enable developers to develop a pipeline of residential units targeting the affordable housing market segment, with the knowledge and security that they would be able to off-load the units to various REITs once the development stage was complete.

A key question that arises from this discussion, is whether a modified, more appropriate version of the REIT structure could be developed to incentivise the development and subsequent sale of affordable housing. In other words, although the REIT structure may not be appropriate for the direct channelling of “patient capital” into affordable housing development, perhaps there is a need for another mechanism that could serve this goal.

One approach could be to create an incentive mechanism, applicable in the context of affordable housing development, which reduces the financial costs associated with the sale and transfer of property. In contrast to the REIT structure, which focuses on the reduction / exemption of corporate tax on the condition that the majority of the REIT’s profits are distributed, such a mechanism could exempt developers from capital gains tax, stamp duty and transaction tax on the transfer of property.

Such a mechanism would result in significant financial savings for developers selling newly developed property. Large property developers employing this mechanism could potentially attract large institutional investors (such as pension funds) seeking long-term capital growth. When applied in the context of affordable housing, it could thus incentivise the development and delivery of an under-supplied asset at scale.

Although REIT regulations in certain jurisdictions allow for exemptions on capital gains tax, stamp duty and transaction tax, it is proposed that a separate and distinct mechanism be applied in the context of affordable housing development and sales. This is because certain other features of the REIT framework, such as the requirement to distribute the majority of profits to shareholders each year, simply do not make sense in the context of an

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242 Property investors that make money on sales, as opposed to rental, carry additional risk because there is no smoothing when the economy takes a hit. Interview with Keith Engel, Deputy CEO of the SAIT.

243 Interviews with Keith Engel, Deputy CEO of SAIT and Michael Bookstaber, Global Housing Strategies.

244 Interview with Keith Engel, Deputy CEO of the SAIT

245 Interview with Keith Engel, Deputy CEO of the SAIT

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investment vehicle seeking to attain long-term capital growth. In addition, and perhaps even more importantly, creating a mechanism distinct from the REIT framework would avoid the problem of conferring the REIT “brand” on an investment vehicle that has significantly different risk-return characteristics from a REIT – thereby potentially misleading investors looking for safe and regular returns.

4. Conclusion
The application of the REIT structure in the context of residential property in Africa, and affordable housing in particular, introduces unique challenges. The fundamental question becomes whether or not REITs investing in affordable housing are able to generate competitive returns, given the specific costs and risks that exist in the affordable housing sector.

Addressing this question requires private sector experimentation as well as government and NGO support. The private sector needs to be incentivised and supported in experimenting with various segments of the affordable housing market, as well as with the appropriate role for property development in the context of affordable housing REITs. It is proposed that if, in addition, government and NGOs intervene to minimize the risks and costs associated with affordable housing, a viable affordable housing financial model can be developed. Such a financial model would have the impact of making the affordable housing segment an attractive target market for REITs, which in turn could potentially stimulate much-needed retail and institutional investment in affordable housing markets across Africa.
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