ISSUE BRIEF

AFRICAN UNION FOR HOUSING FINANCE

Promoting Residential REITs for Affordable Housing

September 2017

Internationally, the REIT structure has proved to be an effective mechanism for attracting retail and institutional investment capital into global real estate markets. The nascent REIT market in Africa has further confirmed the huge potential that such a mechanism has for channelling investment into African real estate markets. In this context, residential REITs constitute an innovative vehicle for increasing the quality, supply and affordability of residential properties across the continent.

This document summarizes the findings of a study commissioned and launched by CAHF in early 2017, which explores the relevance of REITs for affordable housing in Africa[1]. It outlines the enabling conditions that need to be in place in order to facilitate the emergence of REITs in Africa, as well as the risks and costs that would need to be addressed and minimised if the REIT structure is to successfully channel capital towards Africa's affordable housing developers.

A key finding of the study is that African governments, through their policies and regulatory interventions, have an important role to play in creating an environment conducive to the emergence of affordable housing REITs. The members of the AUHF urge their governments to prioritise the recommendations listed in this report. We are available to discuss these and other issues with policy makers and regulators as required.

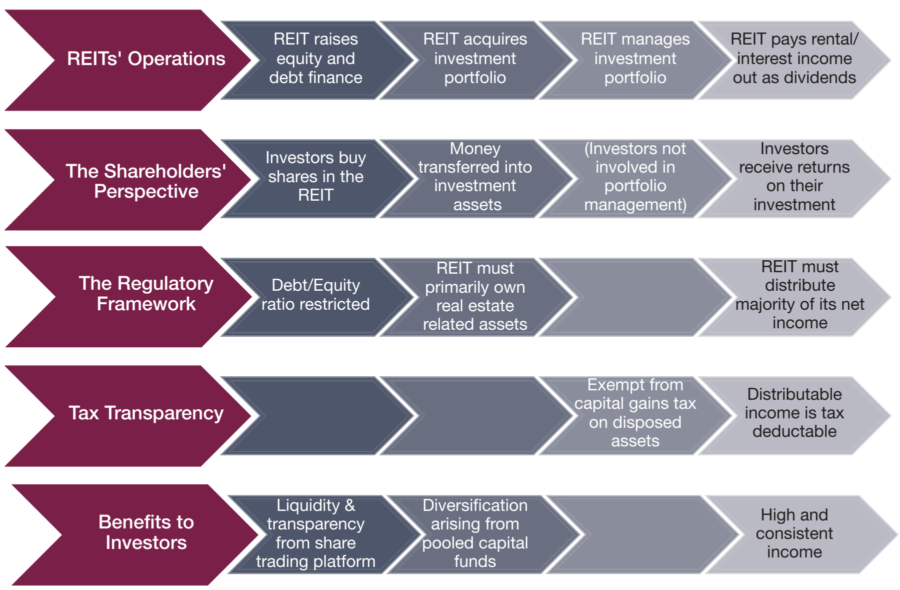
Understanding Real Estate Investment Trusts

Real Estate Investment Trusts (REITs) are essentially companies or trusts that own and often manage a portfolio of mortgages and/or real estate properties, and operate in accordance with certain rules and regulations. REITs allow investors - both institutional and retail (i.e. individuals) - to invest in portfolios of mortgages or large-scale properties through the purchase of shares. The shareholders of a REIT, in turn, earn a share of the income stream produced by the investment portfolio.

A key distinguishing factor of REITs is the manner in which they aggregate diverse sources of funding and target them into real estate portfolios that extend beyond the limitations of individual projects. REIT regulations and legislation providing for preferential tax treatment and requiring high rates of profit distribution constitute additional factors that differentiate REITs from other property investment and financing vehicles. Together, these unique factors enable REITs to raise finance from investors who otherwise might lack access to – or be reticent to engage in – real estate markets.

Although the specifics of REIT structures vary internationally, the defining characteristics of a REIT are largely consistent across most jurisdictions. The REIT regulatory and tax frameworks, the associated benefits to investors, and the way in which these relate to the REIT's operations are captured in the figure below.

Defining characteristics of a REIT



The African Union for Housing Finance (AUHF) was established as a member-based body of housing lenders in 1984. Today, the AUHF comprises of members from countries across the continent. Members include commercial and mortgage banks, building societies, microfinance banks/institutions, housing development corporations, developers, government departments/ministries, and other institutions involved in the mobilisation of funds and development of shelter. As an industry body, the AUHF promotes the development of effective housing finance markets, and delivery of affordable housing across the African continent, working in the interests of both the members and the industry as a whole. In serving its members and realising its vision, the AUHF pursues four main activities:

- Networking and deal facilitation
- Capacity building and training
- Lobbying and advocacy
- Information collection and dissemination

For more information contact auhf@housingfinanceafrica.org

Centre for Affordable Housing Finance in Africa

This document is based on research undertaken by the Centre for Affordable Housing Finance in Africa.

[1] A detailed report, as well as supplementary documentation, is available on CAHF's website. See http://housingfinanceafrica.org/projects/residential-real-estate-investment-trusts-africa/applications.

REITs are classified according to the type of property that they invest in. A residential REIT invests exclusively in residential properties (usually rental apartment buildings), and traditionally owns and often manages these properties. Some residential REITs specialize in different geographic markets or classes of properties, such as luxury housing, senior housing, student housing and affordable housing.

REITs that invest in affordable housing are of particular interest from a developmental perspective. This is because such REITs represent an alternative mechanism for attracting capital and channelling investment into affordable housing markets, thereby increasing the quality and supply of affordable housing.

REITs in Africa

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. The size and nature of various REIT markets across Africa is illustrated in the table below.

The African REIT industry

Country	Introduction of REIT Regulations (year)	Number of Registered REITs	Size of Industry	Primary Sectors
Ghana	1994	1	US$12.6 million	Residential; Commercial
Nigeria	2007	4	US$224 million	Residential; Commercial
Tanzania	2011	1	US$40 million	Residential
South Africa	2013	30	US$16.1 billion	Residential; Commercial
Kenya	2013	1	US$35.5 million	Commercial
Rwanda	2013	0	n/a	n/a
Morocco	2015 / 2016	1	n/a	Commercial

For the purpose of the study, four case studies of REITs engaged in residential property markets across Africa were conducted. These case studies explored HFC REIT in Ghana; Union Homes Hybrid REIT in Nigeria; Watumishi Housing Company in Tanzania; and Indluplace Properties in South Africa[3]. The key findings from these case studies are presented in the section below.

Findings

REITs are a new feature in the investment landscape in Africa. To date, they 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.

Indeed, a number of critical enabling conditions need to be in place before REITs can thrive in any given context. These conditions include the existence of robust property rights, accurate records of title deeds, and reliable property valuations. Furthermore, appropriate rental market legislation, a comprehensive REIT framework, stable economic conditions, and the presence of engaged institutional investors are important. Finally, REITs require critical mass to attract investor interest, which can only take place in the context of a property market with substantial existing housing stock and / or the existence of capable, well-governed developers[4].

Residential REITs – and affordable housing REITs in particular – face additional challenges in the African context. These include limited existing residential property markets; challenges around land regularization and residential re-zoning; higher management costs; uncertain effective demand; and risks surrounding evictions. Such factors have contributed to the perception that affordable housing REITs are incapable of generating high enough returns to be market competitive, given the specific risks that exist in the affordable housing sector.

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. 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. At the same time, returns on affordable housing investment tend to decrease as the income levels of the target market decreases.

[2] Source: authors own compilation
[3] These case studies can be found in the full version of the report. See http://housingfinanceafrica.org/documents/residential-real-estate-investment-trusts-case-studies-african-reits/
[4] Interview with Heri Bomani. Managing Director of Pangani Group.

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. Nevertheless, more interest is being shown in trying innovative approaches to making the financial model work for lower-income rental housing. An example of an affordable rental housing project that succeeded in providing accommodation for low-income earners at reasonable rates of return is providing in the text box below.

AFHCO's Communal Housing Model

In South Africa, 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[5]. With the assistance of concessional financing from the French Development Agency (AFD), a communal ablutions model was implemented in order to reduce capital expenditure. The project successfully demonstrated that, in certain circumstances and with the assistance of certain financial instruments, viable financial models can be developed in the context of affordable housing investments.

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, the communal housing units developed by AFHCO (described in the text box) are nested within SACorp's larger property portfolio6. 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.

A third approach being pursued by certain property investors, involves engaging in the actual development (as opposed to the subsequent acquisition) of affordable housing projects. Indeed, 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.

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.

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. However, the concept of developing residential property for the purpose of subsequently selling it is significantly more controversial, as such an investment vehicle would not exhibit many of the distinguishing characteristics of the traditional REIT structure, and would carry a lot more risk.

Recommendations

While the AUHF supports the development of the REIT model to facilitate investment in affordable housing across Africa, the success of such a concept will ultimately depend on two overarching factors:

- The presence of the **critical enabling conditions** that need to be in place for *REITs in general* to emerge and thrive; and
- The ability to **increase the returns and decrease the risks** associated with *affordable housing* as a unique property type.

While interventions in less mature markets will typically begin by focusing on addressing the former, interventions in more mature markets will increasingly focus on engaging with the latter.

Government is the entity best placed to undertake the institutional work required for the property market itself to function effectively, and thus become a suitable context for the large-scale establishment of REITs within the African context. Governments seeking to support the emergence of REITs within their countries should focus on entrenching the following enabling conditions:

- a strong, well-enforced system of **property rights;**
- **property market transparency** (e.g. quality property valuation and risk assessment systems);
- appropriate **rental market legislation** (which affords sufficient protection to landlords); and
- economic stability and growth.

[5] Approximately 24% of the South African population falls within this income band. Melzer, I. (2015). Housing Sector Performance: Overview of demand. Available at: http://www.housingfinanceafrica.org/wp-content/uploads/2015/10/10_Melzer_Housing-Sector-Demand-Slides-Final.pdf

[6] Similarly, 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.

Importantly, comprehensive and unambiguous **REIT legislation and regulations** should form the foundation of any REIT framework. Each of these factors need to be addressed in order to support the emergence of residential REITs across the continent. It is proposed that the establishment of residential REIT sectors should not be attempted in countries where the majority of these conditions are not being met. Attempting to do so, may harm the reputation of the REIT structure in the long-term.

Other potential government interventions, outlined below, are based on the idea that government can play a role in **decreasing the costs and minimizing the risks associated with the development, acquisition and management of affordable housing** as an asset class. The purpose of such interventions would be to incentivise individuals and / or institutions considering various investment options to invest in affordable housing.

At the municipal level, interventions aimed at reducing costs could include: **increasing the pace of land regularization** and preparation and residential re-zoning; **lowering municipal levies and services charges** on affordable housing; and **enforcing effective urban management.** If implemented effectively, such interventions would positively influence the returns that could be generated on a REIT's investment in affordable housing.

At the same time, the **perceived effective demand risk** faced by affordable housing REITs could potentially be **mitigated through government intervention.** For example, government could engage an affordable housing REIT in the process of housing government officials. In this context, government could deduct rent directly from officials' salaries, thereby providing a measure of insurance to the REIT that rentals will be paid. This could – more controversially – be extended to a subject-based rental subsidy or voucher system which would underpin lower-income household affordability and mitigate some of the risks rental providers face.

Taking this concept one step further, government could enter into head leases with REITs investing in affordable housing and targeting low-income earners. This would essentially amount to government underwriting the rentals paid by the affordable housing tenants, thereby eliminating the non-payment risk faced by affordable housing REITs. These approaches to minimizing the risk associated with investment in affordable housing could significantly contribute towards the stimulation of investor appetite for affordable housing REITs.

Additionally, government could experiment with approaches to incentivising market investment in affordable housing through the **application of innovative financial instruments** that serve to increase returns on private investment in the sector. For example, government could facilitate the replication of projects similar to the AFD / AFHCO communal housing project through the provision of grants in the form of concessionary financing to REITs, on the condition that a set proportion of the housing units acquired and / or developed are allocated to beneficiaries that fall within a specific income target group.

While such an approach would serve to stimulate investment by property developers and investors in affordable housing more generally, it would be particularly impactful in the context of the REIT market – due to the large amounts of capital it could potentially attract from existing REITs seeking to diversify into new, yield-producing sectors.

Finally, turning to the role of the private sector, investors and developers are encouraged to continue **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. Such experimentation – together with the type of government support outlined above– would likely result in the emergence of a financial model competitive enough to attract significant private investment into affordable housing markets.

It is further proposed that the **dissemination of data and case studies** capturing the experiences of REITs in affordable housing will work towards familiarising retail and institutional investors with the workings and potential benefits of REITs in this sector. This is in turn would encourage investors to utilise the REIT structure in the channelling of resources towards the affordable housing market segment.

CONNECT ON SOCIAL MEDIA:

Twitter: @AUHF_Housing | Facebook: @auhfhousing | LinkedIN

CONTACT US:

Noluthando Ntshanga, AUHF Coordinator
www.auhf.co.za | auhf@housingfinanceafrica.org | (T) +27 11 447 9581 | (C) +27 82 834 3556