

REITs: WHEN SAFETY OF INVESTMENT IS A PRIME FACTOR

Real Estate Investment Trusts (REITs) is an asset class that will witness significant growth in the Nigerian financial market in the very near future. Key factors will drive this growth. Of utmost importance is the safety of the REITs instrument which derives from the way it is designed and structured. Also incomes from REITs are based on increasing demand for real estate properties, both commercial and residential. The steady growth in Nigerian population and economic activities therefore translates to higher demand for these classes of properties with its attendant higher revenue earning capacity. Another point is the revised pension fund act 2014 has expanded the investment horizon of the Pension Fund Administrators (PFAs) – with wider space for products like REITs.

Recently, several bullish signals have manifested themselves within the sector, indicating that the tide is turning. Demand for office complexes, retail space and residential housing justifies the emergence and growth of the REITs market and, as occupancy rates continue to stabilize or even rise, this will help tremendously with REITs' cash flow.

The inherent feature of safety makes a REITs instrument a good asset class for the institutional investors, particularly the Pension Fund Administrators (PFAs) and Insurance Companies, asset management companies. Safety and recoupment of investment is accorded the highest priority in the management of pension assets. This is essentially why REITs will soon become a major composition of their portfolio.

SAFETY EDGE OF REITs

Unlike other real estate derivatives, REITs has high advantage of safety. This is ostensibly due to the basic underlying consideration involved in the design, structure, and packaging of the instrument. REITs are financial instruments that pool funds together for investment in real estate assets either directly in equity ownership of properties or through mortgages. They can be issued in a number of variants major among which are Equity REITs, Mortgage REITs, and Hybrid REITs. Most REITs are listed and traded on the Stock Exchanges thereby offer high level of liquidity which is otherwise not attainable in direct property deals in the real estate sector. The safety of the instrument derives from its structure and the basic elements of enhancement that are built in to support it.

ENHANCEMENT OF THE INSTRUMENT

In the enhancement of a financial instrument, the objective is to put it in a form that will approximate or

MARKET UPDATE

| | 15/01/13 | 15/12/13 | 01/08/14 |
|------------------|----------|----------|----------|
| Naira/US\$ | 157.65 | 159.94 | 161.74 |
| Brent, US\$/BBL | 109.78 | 107.84 | 113.19 |
| COCOA, US\$ | 1487.82 | 2685.47 | 2760.56 |
| MPR% | 12.00 | 12.00 | 12.00 |
| INFLATION RATE % | 10.3 | 7.9 | 8.0 |
| MORTGAGE RATE % | 22.0 | 23.0 | 23.0 |

STOCKS CONSTITUTING GMA INDEX

| STOCKS | 31/12/13 Price (N) | 01/08/14 Price (N) | %Change in Price |
|-----------|--------------------|--------------------|------------------|
| OANDO | 24.25 | 27.00 | 41.34 |
| GTBANK | 27.02 | 28.00 | 6.59 |
| OKOMU | 44.00 | 33.22 | -24.50 |
| STANBIC | 21.35 | 31.00 | 45.20 |
| DANGSUGAR | 11.70 | 9.00 | -23.08 |
| FIDSON | 2.79 | 3.00 | 7.53 |
| TRANSCORP | 4.35 | 5.51 | 26.67 |
| CCNN | 11.75 | 14.00 | 19.17 |

| | PRICE(N) 31/01/14 | NAV (N) 01/08/14 |
|----------|----------------------|---------------------|
| UHOREIT | 50.00 | 50.00 |
| UPDCREIT | 10.00 | 10.00 |

| Index | 31/12/13 | 01/08/14 | % Change |
|-----------|-----------|-----------|----------|
| NSE ASI | 41,329.19 | 41,934.43 | 1.46 |
| GMA Index | 1.50 | 1.67 | 11.21 |

Source: CBN, SEC and NSE

fully guarantee its capacity to deliver the expected returns. The enhancement anticipates all possible risks and then builds in structures that address the risks and ensures that the safety and returns on the investment are not jeopardized. In the packaging of REITs, the appropriate enhancement mechanisms are built in to strengthen its integrity. These mechanisms include insurance guarantee, cash flow integrity, rating, and strong management.

GUARANTEE ON RENTAL INCOME

Guarantee on rental income is quite often used to enhance the performance of REITs as well as obtain good rating. Usually it is an agreement to mitigate a shortfall in rental income flow. The essence is that investors in REITs are assured of full rental income and steady dividend payment.

The guarantee allows for the transfer of rental income risk without the transfer of an underlying asset.

CREDIT RATING

The safety of REITs as a financial instrument is reinforced by the credit rating it attracts. A credit rating measures a financial obligation against the capacity for repayment. The ratings for securities such as bonds and similar instruments are based on substantial due diligence conducted by approved rating agencies. While the issuer will strive to have the highest possible credit rating since it has a major impact on pricing of the instrument, the rating agencies must take a balanced and objective view of the security or debt instrument.

CASH FLOW INTEGRITY

A strong point for REITs is the strength of their cash flows. REITs, particularly equity REITs are issued based on tenanted properties with confirmed and known income flows through rents. The indication is that the strength and reality of their cash flows can be tested even ahead or from the point of issue of the instrument. In other words an investor can determine the safety of the investment even before the money is put down.

DUAL MANAGEMENT ADVANTAGE

REITs have the peculiar advantage of being run by dual but independent managements. Each of these managements come in with their expertise and interests which when combined significantly boosts the performance of the investment. The fund manager takes a veiled ownership of the REITs. In addition, there is the property manager that has a responsibility for scanning, picking and recommending for acquisition as well as managing the properties held by REITs.

CONCLUSION

Perhaps the resilience of REITs can be said to be its strongest point when considering the safety of the instrument in comparative terms. For example In the US, REITs bounced back much more easily from the financial crisis and recession than any other investment option. In the first 12 months after the meltdown, REITs outperformed the general market. The industry also reestablished its access to the capital markets for both equity and debt.

A recent report from the National Association of REITs (NAREIT) reported that a U.S.-based REITs reported that the FTSE/NAREIT index had a 10.23% compound annual total return for the 12 month period ending June 30 of same year. The index is composed of 148 U.S.-based REITs. This compares favourably over the Standard & Poor's 500 Index which had a compound annual total return of -1.59% over the same time frame. This clearly sounds a good note for investors who are inclined to safety of their investments over riskier instruments that offer higher returns; although most REITs offer both safety and high returns on investment.

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