

“THE EMERGING ECONOMY: REAL ESTATE DERIVATIVES.”

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“Derivatives make markets more complete that is, they make it possible to hedge risks that otherwise would be unhedgeable. ... risks are born by those who are in the best position to bear them and firms and individuals can take on riskier but more profitable projects by hedging those risks that can be hedged. As a result, the economy is more productive and welfare is higher.” - René Stulz

In the US Real Estate Market, the securitization revolution of the 1990s helped produce today's robust public real estate investment trust (REIT) and commercial mortgage backed securities (CMBS) markets. It also has facilitated major capital flows into real estate in recent years that have strengthened linkages between private real estate asset markets and wider national and global capital markets. This shift has transformed real estate financial structures, capital sources and investment products. The real estate sector continues to evolve at a rapid pace, with the emerging commercial property derivatives market being the latest innovation. There is significant interest by many real estate market participants in the development of commercial property derivatives.

The development of a market for commercial property derivatives is a natural “next step” in the evolution of real estate investment from an extremely private and local market to a fully the turbulent one years after the real estate collapse of the early 1990s. From that period of distress, the modern REIT and CMBS markets emerged to radically change the way that real estate in the U.S. is held and financed. It is probably no coincidence that the growing interest in property derivatives is today occurring during a period of uncertainty and concern over the future prospects for the economy and property markets.

A property or real estate derivative is a financial derivative whose value is derived from the value of an underlying real estate asset. In practice, because real estate assets fall victim to market inefficiencies and are hard to accurately price, property derivative contracts are typically written based on a real estate property index. In turn, the real estate property index attempts to aggregate real estate market information to provide a more accurate representation of underlying real estate asset performance.

A Real Estate is a property consisting of land and the buildings on it, along with its natural resources such as crops, minerals, or water. It also refers to any immovable property of this nature. Investment in real estate has long been dominated by large investors, such as pension funds, insurance companies and other large financial institutions. However, following the globalization of real estate investing and the evolution of new offshore opportunities, both of which allow for greater diversification and return potential, there is an increasing trend toward finding a permanent place for real estate in institutional portfolio allocations.

Real estate was the last major asset class without a significant derivatives market but this is changing as there is now an emerging market of derivative instruments for property investment trade and those who invested in real estate and in the past had to listen to how investors in equities and commodities could hedge their investments against losses, now have access to a host of other new and powerful strategies. While still embryonic, this market holds the promise of potentially significant benefits for real estate investment practices and markets.

Property derivatives represent a new way for investors to gain or reduce exposure to the real estate asset class, quickly and without directly buying or selling properties, while relying on the performance of a real estate return index. Specifically, a fully formed and functioning derivatives market for commercial property lifts the opaque veil of the private market that has retarded information efficiency and hampered price discovery in this multi-trillion dollar investment market. All real estate investors, regardless of their specific interest in using these instruments, should support the development of this market and the numerous benefits that they will ultimately bring to the asset class. The speed and ease of execution, reduced upfront capital requirement and ability to protect real estate portfolios on the downside provide added flexibility in executing real estate investment and portfolio risk management strategies.

This makes this derivative the logical next step in the evolution of real capital markets, continuing the transition from a private asset class characterized by high transaction costs and the inability to sell short to one with significant public market integration and the associated fast pace of financial innovation.

REAL ESTATE DERIVATIVE PRODUCTS

There are two major real estate derivative products used widely in

| Market Update | | | |
|------------------|----------|----------|----------|
| | 15/01/13 | 15/12/13 | 07/02/14 |
| Naira / US\$ | 154.1 | 155.2 | 155.75 |
| Bonny, US\$/bbl | 109.78 | 107.84 | 109.9 |
| 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) | 07/02/14 Price (N) | %Change in Price |
| OANDO | 24.25 | 22.00 | -9.28 |
| GTBANK | 27.02 | 27.48 | 1.70 |
| OKOMU | 44.00 | 42.45 | -3.52 |
| STANBIC | 21.35 | 20.00 | -6.32 |
| DANGSUGAR | 11.70 | 11.64 | -0.51 |
| FDSON | 2.79 | 3.00 | 7.53 |
| TRANSCORP | 4.35 | 4.11 | -5.52 |
| CCNN | 11.75 | 10.72 | -8.77 |

| | PRICE (N) | | NAV (N) | |
|----------|-----------|----------|----------|----------|
| | 31/01/14 | 07/02/14 | 31/01/14 | 07/02/14 |
| UHOREIT | 50.00 | 55.58 | | |
| UPDCREIT | 10.00 | 10.17 | | |

| INDEX | 31/12/13 | 07/02/14 | % Change |
|-----------|-----------|-----------|----------|
| NSE ASI | 41,329.19 | 40,773.50 | -1.34 |
| GMA Index | 1.50 | 1.48 | -1.80 |

Source: CBN, DMO and NSE

developed and local markets in recent years. They are Real Estate Investment Trusts and Mortgage Backed Securities and we explore them in brief below but throw the spotlight on them in coming articles. Our interest in these products is fueled by the changes taking place in the mortgage and real estate sectors of the Nigerian economy such as the recapitalization of mortgage banks and the introduction of the Nigeria Mortgage Refinance Company (NMRC).

1. Real Estate Investment Trust (REIT): REITs are investment vehicles that invest in a diversified pool of professionally managed real estate assets. They are securities that sell like a stock on major stock exchanges and invest in real estate directly, either through properties or mortgages. The first REIT introduced to the Nigerian capital market was the Union Homes REIT in 2008 opening up investors in the local market to Real Estate Derivatives. REITs have the following characteristics: they are relatively passive investment in a pool of real estate assets; they produce a steady rental stream; they have potential for capital growth; they produce a high tax-effective yield (flow-through taxation); they provide a way for investors to invest in real estate without the large capital outlay; they have diversification benefits; they are typically structured as a unit trust or corporation; they are listed and traded on a stock exchange; and they are either externally or internally managed.

They have three main benefits:

- Flow-through taxation: as long as the REIT meets certain requirements under the various tax laws, investors can benefit from “flow-through” taxation (this is not yet applicable in Nigeria but steps are being taken to incorporate this feature which is standard in other climes), in which the REIT is not taxed on its income and tax is paid

only once in the hands of investors.

- Greater liquidity and capital flexibility: investors are able to get exposure to the capital growth and income stream of the underlying assets without large capital outlay. It also allows investors to benefit from greater liquidity as compared with investing in the real underlying assets.
- High yield: typically, the main attraction of REITs is their yield. REITs usually have high payout ratios that are either mandated in REIT codes or are incentivized by taxation requirements.

REITs receive special tax considerations and typically offer investors high yields, as well as a highly liquid method of investing in real estate. There are three types:

a. Equity REITs: These REITs invest in and own properties (thus responsible for the equity or value of their real estate assets).
 b. Mortgage REITs: Mortgage REITs deal in investment and ownership of property mortgages and purchase existing mortgages or mortgage-backed securities.
 c. Hybrid REITs: Hybrid REITs combine the investment strategies of equity REITs and mortgage REITs by investing in both properties and mortgages.

2. Commercial mortgage-backed security (CMBS): This is a type of fixed-income security that is collateralized by commercial real estate loans. Typically these loans are for commercial properties such as office buildings, hotels, malls, apartment buildings, factories, etc., but not single-family homes. On the CMBS side, traded derivatives include total return swaps and credit default swaps (CDS). As is the case with corporate bonds, commercial mortgage-backed securities are at risk of default if the underlying borrowers fail to make their principal and interest payments. The risk of individual issues can vary based on the strength of the property market in the specific area where the loans were originated, as well as by the date of issuance. For instance, CMBS issued during a market peak or a time in which underwriting standards were more relaxed would be seen as having higher risk. They can also be negatively affected by weakness in the real estate market, which was the case during 2009.

BENEFITS

There are several benefits of, and uses for, real estate derivatives, which are useful tools for hedging and managing risk and managing portfolio returns. The following examples illustrate uses of commercial real estate derivatives.

Risk Management: Derivatives can be used to lock in market risk.

Quick Market Entry: They help gain exposure to a particular market in less time than it takes to acquire property in that market
 Portfolio Optimization: They are useful tools to maximize portfolio returns.

Synthetic Portfolio Re-Balancing: They allow an investor to quickly increase or decrease exposure to commercial real estate without buying or selling the underlying real estate.
 Increased Allocation to Real Estate

CONCLUSION

Going forward, growth of the real estate derivatives market has the potential to greatly benefit the commercial property investment community. Derivatives are useful instruments for managing risk, rebalancing and optimizing investment portfolios, as well as maximizing portfolio returns by facilitating short sales. Derivatives enhance real estate markets and real estate pricing by increasing liquidity and lowering costs. While real estate derivatives are still in a nascent stage in Nigeria, the development and adoption of these instruments seems to be picking up steam. Several new instruments are being created and introduced to the market. Also, the introduction of the Nigeria Mortgage Refinance Company is a step in developing these instruments as the industry gets more standardized and players look for creative ways to refine their assets.

While many are excited about the new investment and risk management possibilities offered by property derivatives, others are skeptical about investors' willingness to embrace these new tools. There is also concern that trading by nontraditional real estate investors with a short-term focus (e.g., hedge funds) will add volatility to and potentially destabilize the private property market. To these market participants, real estate represents tangible, bricks and mortar assets, whereas derivatives are seen as complex financial instruments created by investment bankers.

However, because commercial real estate assets are capital intensive and relatively illiquid, real estate investors have found it hard to hedge their exposure or execute alpha strategies. Real estate characterized by high transaction costs and a market less efficient than stocks and bonds have added to the difficulty in rebalancing portfolios in response to market changes. Real estate derivatives have changed the commercial real estate market by allowing investors to tactically change their exposures to specific risks and opportunities without the need to buy and sell assets. These derivatives allow for exposure to either a different sector of the real estate equity market or by trading a real estate exposure for a variable interest rate plus or minus a premium. The ability to swap exposures allows the real estate investor to become more tactical when investing. They can now move in and out of all four quadrants of the real estate market, which allows for greater risk management and the potential for adding increased return to their existing real estate asset allocation on either a short-term or longer-term investment horizon.

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