

**THE EXISTENCE OF REAL ESTATE INVESTMENT TRUSTS (REITS) NEEDS  
BY INSTITUTIONAL INVESTORS AT THE NAIROBI STOCK EXCHANGE**

**BY:**


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A management research project submitted in partial fulfilment of the requirements for the degree of Master of Business Administration University of Nairobi

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## Declaration

This management research project is my original work and has not been submitted for a degree in any other University.

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## **Abstract**

Real estate is an important investment asset class but it poses considerable problems for portfolio managers in valuing direct real estate investment. Real estate illiquid nature increases transaction costs yet it is assumed to be a safer asset for long term investment. Real estate can be purchased (direct investment) or the investment can take place through land held by listed or unlisted companies (indirect investment).

REITs are the only truly liquid assets related to real estate investment. Indirect investment in real estate investment trusts (listed REITs) transforms the illiquid nature of direct real estate and offer more liquid investment vehicles thus forms part of a well diversified investment portfolio. Public REITs do not exist in Kenya.

This study sought to investigate whether there exists REITs needs among institutional investors trading at Nairobi Stock Exchange. A sample of 30 institutional investors consisting of pension fund managers and unit trusts was used. The findings show that investors would invest in REITs if they were to be introduced at the exchange and therefore confirming that REITs needs do exist among institutional investors at the NSIE.

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Special thanks go to those who took their time to respond to my questionnaire and those who provided insights about REITs and therefore enabled me to complete the study.

## **Dedication**

To my best friend and loving husband David and the greatest gifts and sources of our happiness. Michael and Victoria.

To my loving mother and uncle for your unending support, prayers and love for me. You built a firm foundation for my education life.

## List of Acronymns

CPI:	Consumer Price Index
CMA:	Capital Markets Authority.
NSE:	Nairobi Stock Exchange
RBA:	Retirement Benefits Authority
REITs:	Real Estate Investment Trusts
S&P:	Standard & Poor
T- Bill:	Treasury Bills
UK:	United Kingdom
USA:	United States of America

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## 1.0 Background

### 1.1 Introduction

An investment is the current commitment of money or other resources in the expectation of reaping future benefits, Bodie et al., (2008). An investor will evaluate the risk associated with the investment, the duration, the returns and the liquidity of the investment before making an investment decision. Reilley and Brown (2006) state that investment involves current commitment of funds for a period of time in order to derive future payments that will compensate the investor for time the funds are committed, the expected rate of inflation and the uncertainty of future payments.

Investments are classified into financial assets and real assets. Financial assets are claims to the company's wealth and determine how the ownership of real assets is distributed among investors. Real assets comprises of land, buildings, machine and knowledge that can be used to produce goods and services. They help in creating wealth and appeal due to rental income, tax write- offs and capital gains, Bodie et al., (2008).

Charles and Nearchs (1997) defines real estate as land and buildings. He further argues that technically, real estate consists of the physical land and structures while real property consists of the legal interests associated with ownership of the physical real estate. Investors put their funds in real estate for regular income (rent) and or the capital appreciation it affords, Wurtzebach et al., (1995).

Chiang et al. (2009) notes that the relationship between real estate returns and that of other asset classes is important to investors, since it provides information to guide portfolio management. Levy and Post (2009) posit that investments in financial asset differs from investments in physical assets due to their unique characteristics of divisibility, marketability (liquidity), the holding period and information availability. Owning property nevertheless is known to be a safe and profitable investment since investors not only receive periodic income in form of rent, but also the property appreciates in the value over time.

According to Brueggeman and Fisher (2008), REITs have their origin in the USA. They state that the Congress passed the Real Estate Investment Trust Act in 1960 which exempted these special-purpose companies from corporate income tax if certain criterion was met.

A Real Estate Investment Trust (REIT) is set up as a company that owns, manages and develops real properties with which the company and its management have developed successful experience. If listed, its security sells like a stock on the major exchanges and invests in real estate directly, either through properties or mortgages. Real Estate Investment Trusts (REITs), is an indirect way of investing in real estate. It is an option that gives an investor many advantages of property ownership without having to find the property and perform managerial roles, [www.co-opbank.co.ke](http://www.co-opbank.co.ke).

Brueggeman and Fisher (2008) define a REIT as a closed end investment company which offers investors the opportunity to invest in real estate assets. They document three types of REITs; Equity REIT where a corporate entity is engaged in the acquisition, management, building, renovation, and sale of real estate, mortgage REIT where a company specializes in underwriting, acquiring and holding debt obligations guaranteed by real estate properties and hybrid REITs which combine the investment strategies of equity REITs and mortgage REITs by investing in both properties and mortgages.

There is a property boom in Kenya mainly due to severe shortage of residential and commercial buildings, Daily Nation (23<sup>rd</sup> Sept 2010). This has resulted in growth in the construction industry in the recent past. A walk around the city confirms that there is vast development in commercial buildings such as exhibitions, hotel buildings, office blocks in Upper Hill area, Hospitals, parking lots, industrial parks like the Sameer business park, shopping malls like the Westgate, the Westland Mall, Village Market, Capital Center, Yaya Centre, the Nyali Cinemax and Longonot place among other spaces in Kenya.

Financing the housing sector (residential property) is a priority to the government and the role of financial institutions cannot be underestimated in the growth of construction industry, Business Daily (8<sup>th</sup> Sept 2010). Attempts by National Housing Corporation to raise Kshs 5 billion through a corporate bond was declined by the CMA due to poor

credit rating. There exists a gap between the providers of space and the way they finance the construction of the space both residential and commercial. Introducing a Real Estate Investment Trust (REIT), would enable the developer raise funds from many investors. According to government statistics, Kenya requires 150,000 houses every year but only an average of 50,000 is achieved. The Kenya Sectional Properties Act 1987 was enacted to enable subdivision and regulation of a building both horizontally and vertically for each defined area of cubic airspace. Daily Nation (7<sup>th</sup> Sept 2010). The government has raised the core capital that banks can lend to the housing sector from 25 per cent to 40 per cent in 2010/2011 budget coupled with improving infrastructure to stimulate the growth of real estate. Daily Nation (7<sup>th</sup> Sept 2010)

The Nairobi Stock Exchange (NSE) was constituted in 1954 as a voluntary association of stockbrokers registered under the Societies Act. In 1988 there was the first privatization through the NSE with a successful sale of a 20% government stake in Kenya Commercial Bank. In 1994 the NSE was rated by the International Finance Corporation (IFC) as the best performing market in the world with a return of 179% in dollar terms. As at 30<sup>th</sup> September 2010, there were 47 quoted companies at the exchange, and the market capitalization was 1,173.7 Billion Kenya shillings. The market also deals in corporate and infrastructure bonds, treasury bonds and unit trusts. There are no REITs at the NSE. ([www.nse.co.ke](http://www.nse.co.ke))

Kenyan pension Schemes put 50.2% of their funds in real estate (RBA annual report, 2000) compared to only 7% in Europe and 1.9% in America (RBA, Financial Times, 2000).

## **1.2 Problem Statement**

In developed markets like United States and Australia, many investors looking for higher returns turn to REITs as an alternative to bonds. Cotter and Roll (2009) conclude that Real Estate Investment Trusts (REITs) are the only truly liquid assets related to real estate investments. Benveniste et al (2001) find that creating liquid claims on relatively illiquid property assets increases the value by 12 – 22%. This illustrates that REITs make it easy to invest in real estate.

In Kenya majority of real estate investments are by institutions like insurance companies and pension schemes. Kenya's Retirement Benefits Authority investment guidelines restrict investments in immovable property to 30%, while the Capital Markets Authority Collective Investment Schemes Regulations, (2001) limit investment in immovable property to twenty five (25) percent of the book value of the investments of the collective investment scheme. These guidelines are aimed at ensuring that the schemes portfolios are adequately diversified.

Investment in real estate requires huge financial resources. The growth of real estate is hindered by lack of funding as the key players are private developers and few institutions who can afford the huge investment outlays. Wurtzebach et al. (1995) observes that the growing role of institutional investors is one of the most significant trends in the American and European real estate market place during the 1980s and early 1990s. Njiru(2003) notes that active lenders as well as equity investors, banks, pension funds and life insurance companies have greatly expanded their impact in real estate.

There are few studies done on real estate in Kenya. Njoroge et al. (2006) studied the property sector in Kenya and observed that the number and types of instruments that are available at the Nairobi Stock Exchange are not enough for the market and this shows the need for financial innovation. Njiru (2003) examined the performance of real estate markets within the Central Business District and found out that CBD real estate achieved an average return of 10% in 5 years whereas quoted ordinary shares achieved negative returns in three of the five years of study and that the NSE index declined by over 65%.

Plans to list real estate firms to trade at the stock market have not yielded fruits at the NSE. Kariuki (2006) observed that a company known as Anglo African properties attempted to list in 2001 at Nairobi Stock Exchange but the attempt failed.

Since the main drivers of financial markets are the institutional investors, this study sought to find out if the institutional investors at the Nairobi Stock Exchange need Real Estate Investment Trusts (REITs).

### **1.3 Objective of the Study**

The study sought to investigate the existence of REITs needs among institutional investors at the Nairobi Stock Exchange.

## **1.4 Importance of the study**

The study will be of importance to investors as REITs will provide an avenue to diversify portfolios, thereby possibly earn higher returns than investments in portfolios without real estate shares.

The study will invoke the government desire to prevent further flow of investment offshore, where investors are investing in existing REITs thereby consolidate funds within the economy.

There being very few studies in REITs, this study will invoke further research on other aspects on REITs at the Nairobi Stock Exchange.

## CHAPTER TWO

### 2.0 Literature Review

#### 2.1 Introduction

This chapter presents a review of literature on investments in real estate and REITs. It reviews the concept of REITs, documents the history of REITs, reviews past empirical studies on REITs and concludes.

#### 2.2 Real Estate and REITs

Sharpe et al define real estate investment trust (REIT) as an investment fund, similar to an investment company whose investment objective is to hold primarily real estate related assets, either through mortgages, construction and development loans, or equity interests.. They add that in return, REITs are required to distribute 90% of their income which may be taxable, into the hands of the investors. They note that REIT structure was designed to provide a similar structure for investment in real estate as mutual funds provide for investment in stocks. They note that REITs can be privately held publicly listed on stock exchanges like shares of common stock.

Bruno (1999) observes that real estate possesses four types of risks that are not found in most other investments. He notes that real estate is illiquid in nature than financial instruments, it is difficult to find a buyer and a seller and this raises transaction costs. He adds that there is no continuous auction trading market that exists for real estate and hence quoted prices may not represent properties intrinsic value. Further, he observes that real estate markets are likely to be segmented and therefore not as efficient as the markets for other assets thus the cost of acquiring information is greater. He concludes that REITs emerge to offer the benefit of fast and easy liquidation of investments in the real estate market unlike the traditional way of disposing real estate.

Cotter and Roll (2009) observe that REITs are of three broad categories, equity, mortgage, and hybrid. Equity REITs are devoted to direct purchases of real estate requiring at least 75% of their total assets in income producing real estate properties.

Mortgage REITs hold portfolios of loans backed by real estate collateral with at least 75% of their assets in residential mortgages, short and long term construction loans and mortgages in commercial properties. Hybrid REITs are a combination of the two, investing in both properties and real-estate related loans. Within these categories, the REITs are further categorized by the main property types held or financed such as residential property and commercial property.

### **2.3 History of REITs**

Brueggeman and Fisher (2008) document that Real estate investment trusts (REIT) system was born in the US in 1960. Prior to 1960, only wealthy individuals and corporations had the financial resources necessary to invest in significant real estate projects such as shopping malls, corporate parks and health care facilities in US. In response, Congress passed the Real Estate Investment Trust Act of 1960. The legislation exempted these special-purpose companies from corporate income tax if certain criterion was met. It was hoped that the financial incentive would cause investors to pool their resources together to form companies with significant real estate assets, providing the same opportunities to the average American as were available to the elite. Three years later, the first REIT was formed. The original legislation had some significant drawbacks since it required the executives in charge of the business to hire third parties to provide management and property leasing services. These restrictions were lifted in the Tax Reform Act of 1986. In 1999, the REIT Modernization Act was passed. The law allows REITs to form taxable subsidiaries in order to provide specialized services to tenants that normally fall outside the purview of real estate investing. Although the law still has some limitations as to the types of services that can be offered, it is expected that the quality of service at REIT- managed properties will improve significantly as a result of its passage.

The UK bulletin (May 2010) posits that it is noteworthy that every country has different regulation about REITs. It notes that Italian real estate investment funds enjoy a favorable tax status without being subject to mandatory payouts and that the preferred taxation is provided in order to off-set the severe prudential regulatory burden. Further, REITs are considered pass-through vehicles at entity level in the sense that income both from current operations and from asset dispositions is tax-exempt. At the investor level, distributed dividends and capital gains on REITs' shares are subject to a 12.5%

withholding tax for individual shareholders, and are considered corporate income and therefore subject to regular tax rates for non-individual shareholders. The withholding tax for individual investors is the same as for long-term debt and equity investments.

According to UK bulletin (May 2010), domestic REIT legislation is fairly a new concept in the world. German and UK were the only G8 countries without legislation by the end of 2006. It notes that countries that have introduced REITs include Singapore in 1999, Australia in 1971 and UK in 2007. In Italy, it notes, REITs have developed gradually from 1992 into a relatively more efficient real estate instrument. This is has been attributed to stable dividends and are less sensitive to the state of the general economy.

Schulte (2000) observes that the German tax system has traditionally favored a private real estate investment over a corporate investment. He states that this is because losses from private real estate investments were fully deductible from personal income tax. A special tax law allowed investors to depreciate their investments in the former East Germany at the rate of 50% in the first year. Additionally, there was no capital gains tax for more than two years while corporate entities had to pay a capital gains tax. However, tax reforms of 1999 changed the bias for private real estate by disallowing deductibility of tax losses from any other class of income.

As of January 2010, India was formulating legislation for REITs in the Indian real estate market. Once introduced these Indian REITs will help individual investors enjoy the benefits of owning an interest in the securitized real estate market. The best benefit being that of fast and easy liquidation of investments in the real estate market unlike the traditional way of disposing real estate. The government and Securities and Exchange Board of India (SEBI) through various notifications is in the process of easing the norms of investing in real estate in India directly and indirectly through foreign direct investment, through listed real estate companies, mutual funds among others. With the current real estate boom and the market being flooded with Initial Public Offer of various listed real estate companies in India it will be the best time for investors to own a share of the profiting market economy. Legislative framework, revised investment norms, a favorable investment opportunity, and a clear taxation policy will provide the right kind of investing opportunity in India in the time to come. Wikipedia.



In Africa, REITs are also gaining popularity in some nations where financial markets are well developed. South Africa was the top performer in the world in terms of total return over three year period giving a hefty 34 per cent. The number of public REITs in South Africa was seven by the end of 2006. Business Daily (10th August 2009). REITs recently took centre stage in Nigeria when the N50billion Union Homes Hybrid Real Estate Investment Trust was launched in September 2008. Wikipedia.

In Kenya, there exist private equity funds which are not regulated. The Business Journal, (August 2010). The REITs concept is currently practiced privately by Africa REIT ltd, a private REIT company in Kenya with a Share Capital of Shs1.2B with 40,000 number of share of ksh.30,000 per share.

## **2.4 Portfolio Theory and Real Estate**

Brueggeman and Fisher (2008) note that every investor will consider adding real estate investment vehicles to an existing portfolio if it will result to increase in expected portfolio returns while maintaining or lowering portfolio risk. They demonstrate that real estate returns in relation to other investments has a potential benefit for portfolio diversification. In a correlation matrix for selected Assets (appendix ii), they show that the returns on equity REITs tends to be positively correlated with common stocks (0.5338) and corporate bonds (0.2922) and a negatively correlated with T-Bills at -0.0405. Their relationship suggests that equity REITs have less than perfect correlation with the S&P 500 and corporate bonds. They observe that the correlation coefficient between both equity REITs and treasury bills is very low and conclude that there is a good chance that if this real estate investment are combined in a portfolio containing common stock, bonds and T-Bills, diversification benefits could be achieved.

Lee and Stevenson (2005) document that REITs provide diversification benefits to mixed-asset portfolios, benefits that appear to come from both the enhanced returns on REITs and their reduced risk. Levy and Post (2009) note that REITs offer investors an efficient way to invest in real estate and diversify their portfolio without committing large amounts of money.

## **2.5 Liquidity and Real Estate**

Bodie et al (2008) defines liquidity as the speed and ease with which an asset can be converted to cash based on information. Liquidity is the relationship between the time dimension, how long it will take to sell and price dimension, the discount from fair market price of an investment asset. Cash and money market instruments, the treasury bills and commercial papers where the bid-ask spread is a fraction of 1% are the most liquid assets and real estate is among the least liquid. Both individuals and institutional investors must consider how likely they are to require cash at short notice and therefore they establish the minimum level of liquid assets they need in the investment portfolio. Bodie et al (2008).

Benveniste et al (2001) find that creating liquid claims on relatively illiquid property assets increases the value by 12 – 22%. This illustrates that REITs make it easy to invest in real estate.

Reilley and Brown (2006) define liquidity risk as the uncertainty due to the ability to buy and sell an investment in the secondary markets. They note that even with identical attitudes towards risk, different households and institutions might choose different investment portfolios because of differing circumstances which include tax status requirement for liquidity, or flow of income from portfolio or regulatory restrictions.

## **2.6 Behavioral Theory and Real Estate**

Ritter (2003) notes that modern finance is based the Efficient Markets Hypothesis (EMH) which argues that competition between investors seeking abnormal profits drives prices to their correct value. He notes that the EMH does not assume that all investors are rational, but assumes that markets are rational. In contrast, he observes that behavioral finance assumes that, in some circumstances, financial markets lack information efficiency.

Lay et al. (2006) in their study on the Perception of Real Estate Investment Opportunities in Central/South America and Africa using 1,068 institutional investors found out that these investors are sensitive to higher returns and political stability and that exposure to

real estate in Central/South America and Africa was extremely limited, although there are some interested investors. They state that it is surprising how little attention has been given to real estate in these areas, despite the relatively high levels of funds flowing into real estate around the world.

Real estate investors have become increasingly international in their outlook over the last decade altering the breadth of investment opportunities. Lay et al (2006). Njiru (2003) observes that investors in real estate are individuals and institutions that provide the capital necessary for the purchase or development of a particular real estate asset. He notes that active lenders as well as equity investors, banks, pension funds and life insurance companies have greatly expanded their impact in real estate. Syagga. (1994) observes that in Kenya most individuals who can afford have invested in real estate for their own occupation or for the return it affords. Wurtzebach et al. (1995) observes that the growing role of institutional investors was one of the most significant trends in the American and European real estate market place during the 1980s and early 1990s.

Miles et al. (1994) notes that investors must remember that diversification characteristic of real estate as compared to stocks and bonds makes an impressive argument for including 5-15% real estate in a mixed portfolio. Njiru (2003) asserts that the reason for Miles et al. (1994) recommendation comes from real estate returns low correlation with other financial assets. Maggin et al. (1998) agrees that real estate has been shown to provide an excellent hedge against inflation particularly in the long run.

Kariuki (2006) in his study on real estate securitization in Kenya finds that investors would be ready to buy shares in a property company upon listing but the willingness to invest in shares reduces as the amount went up. He also finds that most property owners pay little or no taxes on their earnings and no advantage would be gained by listing than the savings due to unpaid taxes and thus their unwillingness to have their property companies listed.

Feifei et al (2010) observes that commercial real estate value generally exhibits a low correlation with other popular asset classes. Feldman (2003) confirms that investments in real estate companies help reduce a portfolio's total risk and improve overall asset allocation efficiency, and further observes that real estate value is sensitive to changes in

interest rates and inflation. They conclude that real estate investments offer hedges against interest rate rises and inflation.

Feifei et al.(2010) also report that residential real estate investment is an effective hedge against both expected and unexpected inflation. They state that REITs serve as an effective hedge against inflation because the growth in the rental income they collect and distribute to investors is correlated with inflation in the consumer price index. Titman et al (2009) show that REITs returns have stronger predictive power for future changes in interest rates and inflation than does a broad equity market index.

## **2.7 Requirements for REIT status**

Quaranta and Biasin (2009) observes that every REIT must pass four tests annually in order to retain its special tax status in US. This includes, the REIT must distribute at least 90 percent of its annual taxable income, excluding capital gains and dividend to its shareholders.

The REIT must have at least 75 percent of its assets invested in real estate, mortgage loans, shares in other REITs, cash, or government securities. The REIT must derive at least 75 percent of its gross income from rents, mortgage interest, or gains from the sale of real property. At least 95 percent must come from these sources, together with dividends, interest and gains from securities sales. The REIT must have at least 100 shareholders and must have less than 50 percent of the outstanding shares concentrated in the hands of five or fewer shareholders.

## **2.8 Dividend Payout**

Chiang et al (2009) notes that in recent years in USA, REITs have developed into a relatively more efficient real estate instrument. Starting in 1992, REITs have grown significantly in both size and number. This is due to the fact that REITs pay stable dividends and are less sensitive to the state of the general economy.

The UK REITs have to distribute 90% of their income. In USA a REIT company must distribute at least 90 percent of its taxable income to shareholders annually in the form of

dividends. In Kenya, Capital Markets Authority stipulates that a REIT scheme shall distribute to unit-holders as dividend each year an amount not less than 90% of its annual net income after tax. The high dividend payout (90% of profits) to shareholders is designed to provide for a level of regulation and investor protection.

## **2.9 Advantages of Real Estate Investing through REITs**

The UK bulletin (May 2010) observed that there are benefits of REITS in any economy. It demonstrates that the UK property industry welcomed REITS in 2007 upon a REIT's legislation that was enacted in the Finance Act 2006. There was general agreement that creating a new tax efficient investment entity for investors in real estate would bring a wide range of benefits to the UK property market. The objective was to create a tax-transparent vehicle for indirect real estate holdings that would enable investors to pool their money and therefore provide them with benefits and tax advantages that are generally available only to large scale investors who have the fund to invest in real estate directly. A well regulated vehicle that provides greater access to both the residential and commercial property investment markets would appeal to both retail and institutional investors.

The UK legislators decided to introduce REITS as a way to spur the development of its commercial and residential property industry which was very fragmented with a considerable amount of residential and commercial property being held by small scale landlords.

The result was that few smaller investors could gain access to the property investment market and institutional investors struggled to assemble property portfolios. The indirect property investment was a chance to enhance investment in the commercial and residential property. It would increase supply and promote structural change in the property market. REITS would improve the affordability and professionalism of the private rented sector, UK bulletin (May 2010).

Double taxation avoided, allowing more of the investor's capital to compound, a professional, dedicated management team is responsible for the day-to-day operation of

the business, providing the investor with expertise beyond his or her own knowledge base. Unlike real estate directly held by the investor, REITs are a liquid asset that can be sold fairly quickly to raise cash or take advantage of other investment opportunities. UK bulletin (May 2010)

Using REITs, investors with little funds available can diversify their holdings between various geographic areas and property specializations. In the case of direct property ownership, this would not be financial feasible unless the investor took on excessive leverage or business partners. REITs can tap the debt and equity markets and raise funds to take advantage of opportunities when they arise. UK bulletin (May 2010).

REITs have a lower correlation to equities than many other asset classes, providing portfolio stability for those with an active asset allocation strategy. They pay high cash dividend relative to the market. UK bulletin (May 2010).

Newell (1995) asserts that REITs improve tradability, liquidity and ability to invest in high quality assets of a value that would otherwise be beyond normal prudent investment criteria. He notes that investors in REITS can achieve better investment mix by diversifying risk in terms of geographic spread, property type, greater investment flexibility, with the ability to react more quickly to changes in market conditions and partial disposal of assets while retaining significant management benefits.

## **2.10 Taxation of Real Estate in Kenya**

The Kenya Income Tax Act (2004) exempts income earned from unit trusts from taxation. This could be used to set up REITs as open ended REITs. Currently, REITs can only operate in Kenya as real estate investment scheme and the legislation only permits the schemes to hold 25% of their assets as real estate. This locks out Property firms that want to convert to REITs.

Capital gains are not currently taxed in Kenya upon suspension and this can encourage buying and selling of property. Real property tax (land rates) is assessed by local authorities. Stamp duty is levied at a rate of 4% on immovable property and 2% if levied outside the municipalities. Stamp duty is levied at 1% on transfer of shares and other

securities. There is an exemption if the shares/securities are listed on the Nairobi stock exchange. Kenya Income tax Act (2004).

## **2.11 Valuation of REITS**

Shares of a REIT are valued using net asset value or financial approach. Quaranta and Biasin (2009) argue that an asset-based (NAV) valuation approach incentivise REIT managers to maximize leverage because of the positive effect of debt on share value under the NAV criterion. This positive effect occurs even though financial theory would indicate that from a market perspective; too much debt could have a negative impact on market value of shares consistent with the perception of financial risk.

The financial approach is based on market prices. Syagga. (1994) outlines that market valuation is a process of comparison, where one assesses the price at which the property would sell if offered for sale on the open market. He adds that this is based on investment appraisal which assesses the inherent value of a property for the purpose of making investment decisions. He further suggests that in property investment appraisal, the valuer should make explicit allowance for risk and the principal variables affecting future return, particularly the prospects of rental growth and obsolescence.

## **2.12 Conclusion**

Sharpe et al. (1999) observe that although REITs offer institutional investors many advantages, the key question is whether the REIT market will offer sufficient trading volume to attract large investors. They note that trading in REITs has historically not been large enough to accommodate a substantial influx of institutional investors. They conclude that if demand increases, more REITs offerings will occur and property development firms will package more properties into REITs to finance growth.

## CHAPTER THREE

### 3.0 RESEARCH METHODOLOGY

#### 3.1 Introduction

This Chapter sets to explain the research design, population of interest, sampling method used and how the data collected was analyzed.

#### 3.2 Research Design

The study is an exploratory research. This is conducted into an issue or problem where there are few or no earlier studies to refer to. The focus is on gaining insights and familiarity for later investigations. The concept of REITs as an investment opportunity is new. The design will help in investigating the existence of Real Estate Investment Trusts needs by institutional investors.

#### 3.3 Population

The target population for the study was all institutional investors who are currently trading at the NSF. There are several institutional investors that trade at NSE however, due to limitation of time and the fact that REITs are proposed as an alternative investment for pension funds, the study concentrated on insurance companies, collective investment schemes, pension fund managers, investment advisors and stock brokers.

#### 3.4 Sampling

The sample frame constituted of the pension fund managers and unit trusts. The quota sampling technique was used which involved the use of both stratified sampling and convenience sampling. The strata included pension fund managers, investment advisors and unit trusts. Convenience sampling was used to select a sample of 30 among the registered pension fund managers, insurance companies and unit trusts within Nairobi. This sample size is considered to be large and therefore representative.

#### 3.5 Data Collection and analysis

The approved names of pension fund managers were obtained from RBA website (appendix iv). The registered insurance companies and unit trusts were obtained from the NSE website. Data was collected from primary sources using a structured questionnaire which was distributed to the fund administrators, investment advisors and the heads of



research and product development. Follow up was done through a research assistant who assisted in dropping and picking the filled up questionnaires. The data collected was qualitative in nature and hence content analysis and descriptive statistics were used to analyse the data using percentages.

### **3.6 Data Reliability and Validity**

To ensure data reliability and validity, data was collected through structured questionnaires. The questionnaires were dropped and picked. Follow up telephone interviews were conducted to enable the researcher to clarify the reasons for the answers and also to seek further insight. Data collected was then edited in order to impose minimum quality standards.

## CHAPTER FOUR

### 4.0 DATA ANALYSIS AND FINDINGS

#### 4.1 Introduction

This chapter describes and discusses the findings and analyses the results of the research. The results by all respondents are shown according to how they responded to the question. Percentages are calculated and shown in both tables. In each category, there is a discussion and interpretation of the results. A total of 30 fund administrators trading at the Nairobi Stock Exchange were sampled. Every institution was given a questionnaire out of which 17 institutions responded by completing and returning the questionnaire. Follow up interview questions were done to validate the responses and to gain further insight to the responses. This gave a response rate of 56.67%.

#### 4.2 Findings

The responses on how long the respondent has traded at the NSE were as table 1 below.

**Table 1 : Response to duration of trading at the NSE**

Trading duration at NSE	No. of respondent	Percentage
Less than 5 years	1	6%
5 – 10 years	2	12%
Over 10 years	14	82%
<b>Total</b>	<b>17</b>	<b>100%</b>

*Source: Research data*

82% of the respondents have traded at the NSE for over 10years, 12% for five years and 6% for less than 5 years.

100% of the respondents indicated that they invest 30% in real estate whilst investment in shares, bonds, treasury bills and foreign properties were not disclosed to protect the respondents' internal investment strategies.

On the factors that influence investment ratio, all the respondents indicated that they are limited by the limit set by Retirement Benefit. The responses on whether they consider investments in real assets and real estate investments trusts (REITs) in developed markets in portfolio diversification were as follows:

**Table 2: Offshore investments in real estate and REITs**

Offshore investments	No. of respondent	Percentage
Yes	11	65%
No	6	35%
<b>Total</b>	<b>17</b>	<b>100%</b>

*Source: Research data*

65% of the respondents have offshore investments in real estate and REITs offshore while 35% do not have. 100% of the respondents indicated that they are willing to invest in real estate investment trusts if they were to be introduced at the NSE. This was a 100% positive answer indicating that there is an appetite for public REITs at the NSE.

The responses on the main motivator were coded by assigning numerical values on a likert scale (1 – 5). 5 indicate very important and 1 the least important. The responses to the main motivator to invest in real estate investment trusts were as per the follows:

Motivation for REITs	5	4	3	2	1	%age
Liquidity benefit	17	0	0	0	0	100%
Search for higher return	17	0	0	0	0	100%
Risk reduction in portfolio	15	2	0	0	0	88%:12%
Dividend payout (steady income stream)	17	0	0	0	0	100%

Potential capital appreciation	17	0	0	0	0	100%
Tax incentives(stamp duty/corporation tax	17	0	0	0	0	100%
Risk reduction of directly investing in real estate	14	3	0	0	0	82%:18%
Professional management of assets	17	0	0	0	0	100%
Benefit from market determined valuation	17	0	0	0	0	100%
Hedging against inflation	17	0	0	0	0	100%
Unlocking real estate value	17	0	0	0	0	100%

*Source: Research data*

100% indicated liquidity benefit, search for higher returns, dividend payout, capital appreciation, tax incentives, professional management, market valuation hedging against inflation and unlocking real estate value as very important motivators of investing in REITs. 88% rated risk reduction in portfolio very important and 12% as important. 82% rated risk reduction of directly investing in real estate very important and 18% as important due to the risk of the underlying assets.

In regard to the constraints to increasing investment in real estate, the responses were:

Constraints to investment in real estate	No. of respondent	Percentage
Regulation	17	100%
Huge initial outlay	0	0%
Lack of market determined prices / Real estate index	3	18%
High cost of obtaining information	0	0%

*Source: Research data*

100% pointed out that regulation is the key hindrance as there lack a platform to the way REITs can operate. 18% added that lack of a real estate index constraints the process of benchmarking in appraisals.

About why there are no property securities at the NSE, the responses were:

<b>Reasons for non existence of property securities</b>	<b>No. of respondent</b>	<b>Percentage</b>
Lack of knowledge of REITs requirements	17	100%
Unwillingness by developers to share information	4	24%
Fears that market prices will not reflect correct asset value	15	88%
Lack of awareness of public listing advantage	0	0%

*Source: Research data*

100% indicated lack knowledge, 24% unwillingness by developers to share information for listing purposes, 88% fear that market prices will not reflect the correct asset values and none responded on lack of awareness.

## **CHAPTER FIVE**

### **5.0 CONCLUSIONS, SUMMARY AND RECOMMENDATIONS**

#### **5.1 Introduction**

This chapter provides the summary of the findings, the limitations and the recommendation for further studies on REITs.

#### **5.2 Summary of findings and conclusions**

The objective of the study was to investigate the existence of Real Estate Investment Trusts (REITs) needs among institutional investors at the NSE. It was found out that 100% of the fund managers would embrace the concept of REITs if they were to be introduced at the NSE. The study found out that interest in REITs was due to the diversification benefits. REITs are seen to provide comparatively lower risk in the long term, they have liquidity and tradability benefits as compared to the underlying assets. The study also found out that private REITs are in practice and therefore the need for public REITs which can operate within a regulated framework is essential.

It emerged from the study that most of the fund managers and heads of research and product development have done proposals on introduction of REITs. This indicates that there is an appetite for long term investment opportunities in REITs. The questionnaires data validation process through telephone interviews confirmed that there is a future for REITs at the NSE as they are necessary even for small organization and the market needs them due to the returns and capital appreciation of real estate among other benefits.

### **5.3 Limitations of the study**

This study was limited to institutional investors trading at NSE who are within Nairobi due to logistic convenience. The study limited itself to five major institutional investor subgroups namely the pension fund managers, insurance companies, unit trusts, stock brokers and investment advisors who have offices in Nairobi. The logistics, cost and time would not allow the researcher to cover institutional investors in other major cities. There are other investors who invest at NSE in large volumes for instance large retail investors who were also left out in this study.

Unwillingness by respondents to disclose the percentage of funds invested in other options means that an analysis could not be done on how the options are rated against real estate. Whereas the majority of real estate investors are not pension funds, the study limited itself to the NSE and as such it was difficult to test the awareness of other investors.

### **5.4 Recommendations for further research**

A follow up study should be done to identify the policy changes that need to be put in place to favour or hinder the introduction of REITs at the NSE despite the proposals that have been forwarded to introduce them.

A feasibility study on the introduction of real estate investment trusts needs may be carried out by the Capital Markets Authority. A further study can also be done to analyse the problems encountered in introducing REITs in developing markets, so that Kenya can learn from its predecessors.

### **5.5 Recommendation for Policy changes**

CMA can propose policy, institutional and regulatory changes and reorganization that would be necessary to introduce and achieve a vibrant REIT market at the NSE.

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# Appendix i

## Questionnaire

Name of the Institutional investor.....

1. How long have you traded at the Nairobi Stock Exchange?

- Less than 5 years [    ]  
5- 10 years [    ]  
Over 10 years [    ]

2. Please indicate percentage (%age) of your investment in the following options:

- a) Real estate [    ]  
b) Shares [    ]  
c) Bonds [    ]  
d) Treasury Bills [    ]  
e) Foreign property [    ]  
f) Others (please specify).....

3. What are the factors that influence your investment ratio in real estate? *Please tick where appropriate.*

- a) Limit set by CMA regulations [    ]  
b) Limit set by RBA regulations [    ]  
c) Expected return and risk [    ]  
d) Duration of holding the investment [    ]  
e) Liquidity preference [    ]

Others (please specify) \_\_\_\_\_

4. Do you consider offshore investments in real assets and real estate investment trusts (REITs) in developed markets in portfolio diversification?

- Yes [    ] No [    ]

5. Would you invest in Real Estate Investment Trusts (REITs) if they were to be introduced at the NSE?

- Yes [    ] No [    ]

6. What would be your motivation to invest in real estate investment trusts?  
where (5) is Very important and (1) least important

- |  |     |     |     |     |     |
|--|-----|-----|-----|-----|-----|
| a) Liquidity benefit                                   | (5) | (4) | (3) | (2) | (1) |
| b) Search for higher returns                           | (5) | (4) | (3) | (2) | (1) |
| c) Risk reduction in a portfolio                       | (5) | (4) | (3) | (2) | (1) |
| d) Dividend payout (steady income stream)              | (5) | (4) | (3) | (2) | (1) |
| e) Potential capital appreciation                      | (5) | (4) | (3) | (2) | (1) |
| f) Tax incentives (stamp duty/corporation tax)         | (5) | (4) | (3) | (2) | (1) |
| g) Risk reduction of directly investing in real estate | (5) | (4) | (3) | (2) | (1) |
| h) Professional management of assets                   | (5) | (4) | (3) | (2) | (1) |
| i) Benefit from market determined valuation            | (5) | (4) | (3) | (2) | (1) |
| j) Hedging against inflation                           | (5) | (4) | (3) | (2) | (1) |
| k) Unlocking real estate value                         | (5) | (4) | (3) | (2) | (1) |

7. What are the constraints to increasing investment in real estates in Kenya?

- Regulation
- Huge initial outlay
- Lack of market determined prices/Real estate index
- High cost of obtaining information

8. Why are there no property securities in Kenya

- Lack of knowledge of REIT's requirements
- Unwillingness by developers to share information
- Fears that market prices will not reflect correct asset value
- Lack of awareness of public listing advantage

*Many thanks for filling this questionnaire*

## Appendix ii

*Correlation Matrix for selected Assets: Quarterly Returns, 1978 – 2006*

	CPI	Bonds	S&P 500	T - Bills	NCREIF	REITs
CPI	1					
Bonds	-0.2123	1				
S&P 500	-0.1288	0.1767	1			
T - Bills	0.5364	0.1570	0.0251	1		
NCREIF	0.2619	-0.1616	-0.0302	0.2974	1	
REITs	-0.0752	0.2922	0.5338	-0.0405	0.0299	1

(Source: Brueggeman and Fisher 2008,pg 661)

## Letter of Introduction

10<sup>th</sup> October 2010

**Dear Respondent.**

I am a post graduate student at the University of Nairobi, School of Business. In partial fulfilment of the requirement for the award of the degree of Masters of Business administration (MBA), I am conducting a research study on “The existence of Real Estate Investment Trusts ( REITs) needs by investors at the Nairobi Stock Exchange.”

In order to undertake the research, your company has been selected to form part of this study. This letter is to request your assistance in collecting information through the attached questionnaire.

The information and data collected will be used for academic purpose only and will be treated with strict confidentiality.

A copy of the final report will be available to you upon request. Your assistance and cooperation will be highly appreciated.

Thanking you in advance.

Yours sincerely,

Diana Michuki  
MBA student  
School of Business  
University of Nairobi

## **Appendix iv**

### **Registered Fund Managers as at 30<sup>th</sup> September 2010**

African Alliance Kenya Management Company Limited

PineBridge Asset Management Ltd.

Amana Capital Limited

Apollo Asset Management Limited

British-American Asset Managers Limited

Co-op Trust Investment Services Limited

Dry Associates Limited

Genesis Kenya Investment Management Ltd.

ICEA Asset Management Ltd

InvesteQ Capital Limited

Jubilee Financial Services Ltd.

Kenindia Asset Management Company Limited

Madison Asset Management Services Limited

Old Mutual Asset Managers (Kenya) Ltd.

Sanlam Investment Management Kenya Limited

Stanbic Investment Services (EA) Ltd.

Zimele Asset Management Company Limited