

**AN INVESTIGATION INTO THE STRATEGIES FOR COMMERCIAL REAL  
ESTATE DEVELOPMENT FINANCING IN KENYA**

**BY**

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**MA VALUATION AND PROPERTY MANAGEMENT**

**B50/7383/04**

**NOVEMBER, 2010**

**PROJECT WORK SUBMITTED IN PARTIAL FULFILMENT FOR THE DEGREE  
OF MASTER OF ARTS IN VALUATION AND PROPERTY MANAGEMENT IN  
THE DEPARTMENT OF REAL ESTATE AND CONSTRUCTION MANAGEMENT,  
SCHOOL OF BUILT ENVIRONMENT, UNIVERSITY OF NAIROBI.**


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## DECLARATION

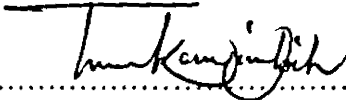
I, **Ruth Achieng' Okal**, hereby declare that this project is my original work and has not been presented for a Diploma or Degree in this or any other University.

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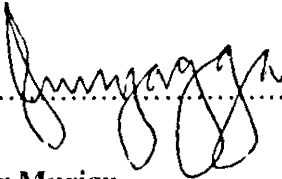
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## DECLARATION BY THE SUPERVISORS

This project has been submitted for examination with our approval as the University Supervisors.

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## **DEDICATION**

This project is dedicated to my husband Mr. Ng'ielu and to my two children Katelyn and Brian for their prayers, love, encouragement and support.

## **ACKNOWLEDMENT**

I am so grateful to many people who have enabled me to write this research project. First and foremost, my deepest gratitude is to the Almighty God for guiding me, giving me good health throughout my study.

Special thanks go to my Supervisors, Dr. Tom Konyimbih and Dr. Jennifer Murigu for advice on how to conduct the research, on where to get information, and their availability throughout my research period.

I would also like to thank my beloved Silas for his love and for giving me a study atmosphere throughout my research period and great encouragement.

I must also recognize my boss, Ben Woodhams and work-mates, for their inspiration and support in terms of research information.

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## ACCRONYMS

BOT	Build Operate and Transfer
CBD	Central Business District
HP	Hire Purchase
HSBC	Hongkong and Shanghai Banking Corporation
ICDC	Industrial and Commercial Development Corporation
IFC	International Finance Corporation
LIBOR	London Interbank Offered Rate
NAV	Net Asset Value
NPV	Net Present Value
PINCS	Property Income Certificates
REITs	Real Estate Investment Trusts
SMEs	Small and Medium Enterprises
SPA	Sectional Properties Act
SPM	Special Purpose Mudaraba
SPOTS	Single Property Ownership Trusts
SPV	Special Purpose vehicle

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## ABSTRACT

Real estate is the largest asset class in the world. For example Johnstone (2004) observed that the value of housing in the United States of America alone was Sixteen Trillion United States Dollars. Other authors have claimed that real estate is the greatest source of wealth for most families and makes up to 50% of the world's wealth. Njiru (2003) as cited by Muchiri (2006) indicates that in Nairobi, Kenya, land was estimated to have a value of Kenya Shillings One Hundred and Forty Billion as at the year 2003.

The purpose of this study is to investigate the strategies adopted in financing commercial real estate development or investment in Kenya and specifically to examine their accessibility and affordability. Investments in commercial real estate require huge financial outlays and once the funds are invested, the resources are sunk. Liquidating the full investment will usually take months or in some cases years. Based on the foregoing, an investor in real estate usually takes in addition to the normal business risk, a liquidity risk. In seeking a return on his investment, usually as rent and capital gains, an investor will then seek to be compensated for this additional risk. Hence the financing strategy must be comprehensively considered for the investment to be economically viable.

The study adopted the deductive approach as it defined the overall scope of the project. Both primary and secondary data were collected through review of existing literature, questionnaires, interviews and site visits. The results were analysed and presented using statistical package for social studies (SPSS) version 12.

The study found out that factors such as minimal economic performance and the Retirements Benefits Regulations of (2000) have considerably reduced the amounts that the government and pension funds can invest in real estate. This model has left the role of real estate provision in the hands of private sector with limited sources of equity funding. Most aspiring real estate investors were also not well versed with the financing options available to them. This led some entrepreneurs to opt for some financing options which have proven to be very costly in terms of financial costs. This led in turn to delayed completion dates, occupancy dates for prospective tenants or purchasers hence the investors incurred huge financial losses and penalties including auction of the property used as security.

The problem of real estate financing in Kenya is aggravated by scarcity of money which is brought about by lack of security for borrowing, the high and fluctuating interest rates and the problems of maturity profile brought about by deposits and loan mismatch. Financing institutions in Kenya overwhelmingly relied on public deposits which were mostly short term in nature while lending for real estate investments are long term in nature. There is therefore a mismatch between borrowing short and lending long, which eventually pushed up interest rates and tended to lower the loan periods. Because of the limited financing options, the real estate industry has been characterised by rigid financing conditions and relatively high interest rates.

On the other hand, the research also revealed that most investors in Kenya considered real estate a good investment class and were striving to make whatever equity resources that they have go as far as possible in acquiring real estate investments. Thus, relatively small non-institutional investors mostly had limited equity and relied more on debt financing to acquire real estate, since it was difficult for them to acquire additional equity funds in any organised and liquid market.

Kenya lacks the secondary mortgage market and other modern forms of property financing like Real Estate Investment Trusts (REITS) which could go a long way to increase investment in real estate sector. This would alleviate the illiquidity and indivisibility risks. Other solutions were found to be through innovative financing strategies which should be aimed at the small and medium enterprises and the specialised groups like Muslims and women who have been left out in the financing sector for long. This would increase the accessibility and affordability of real estate financing and increasing the supply of commercial real estate.

# CHAPTER ONE

## 1.0 INTRODUCTION

Real estate whether commercial, residential or industrial plays a major role in the socio-economic development of any country. It provides facilities and space for peoples' daily activities, income for the investors and is also a source of pride for the community. Murigu (2002) reiterated that the well to do nations and communities are often associated with the concentration of large numbers of commercial buildings in their capital cities and good residential suburbs. Even the status of a business organisation is reflected in the location of its offices and the condition of the building from which it operates.

Generally developing real estate is a high risk activity requiring large sums of funds to be tied up in the production process and providing a product that is generally indivisible. The process and the returns thereof are also affected directly by the economic performance at both local and national levels. Unfortunately, most investors and developers do not have such large sums of money at hand to put in real estate and as such have to resort to borrowing or a combination of equity and debt to finance their real estate investments. Even if they had equity, many investors are ardent believers in leverage and would prefer to use as little equity as possible and more debt financing to acquire real estate investment.

In Kenya like many other countries, real estate is a substantial investment asset class. Murigu, (2002), observed that with the concept of ownership deeply ingrained in the minds of many Kenyans, a disproportionate amount of the country's wealth is tied up in real estate. Whether it is the purchase of a modest family's first house or developing a multibillion dollar commercial project, accessibility and affordability to financing is the key to a successful real estate investment. Anecdotal stories abound of aspiring Kenyan entrepreneurs whose investment in real estate for sale or rentals are always in limbo. This has been evidenced by the Kenyan landscape which has been riddled with projects which have stalled or substantially delayed due to non-viable financial solutions, *The Standard* (13/11/08).

It is therefore imperative that the economy offers viable sources and strategies of financing to boost real estate investments. The access to and provision of a reasonably priced credit to any business organisation or individual to a large extent contributes to its growth, (Waiganjo, 2003). In Kenya, Talukhaba (1996) noted that, there is difficulty in completing projects within

the specified cost and time. He further noted that project delays are the norm rather than the exemption in the building industry. These delays usually result in increased project costs in terms of revenue losses due to the inability to utilise the premises productively, material price escalations, contractual claims and increased cost of finance.

The concept of commercial property financing in an emerging economy is a crucial one especially given the fact that the economy is characterised by semi-developed capital markets, low liquidity, limited foreign resources and deficient available expertise. The viability of the project must therefore be evaluated in the context of various risks that hinge on legal, operational management, market and financial risks. Since the finance industry is crucial to the successful provision of commercial real estate and the growth of the economy as a whole, this study aimed at analysing the strategies of financing the commercial real estate in Kenya on order to benefit all industry players.

## 1.1 PROBLEM STATEMENT

Kenya has a fairly well developed construction and building industry with readily available quality engineering, building and architectural design services. The industry is currently in an upward trend due to the implementation Infrastructure Development Programme through gradual and sustained investment in the road sector by the government. For example disbursements from Kenya Roads Board to the various roads agencies increased by 23.4% to Kshs 19.0 Billion in the year 2008/2009 from 15.4 Billion in 2007/2008, (Economic Survey 2009). The government has also formulated strategies like the Vision 2030, Nairobi Metro 2030, The new Constitution and the National Land Policy which are geared towards forming Nairobi Metropolis into a **World Class African Metropolis** that is **safe, secure, and prosperous** that is globally competitive both in Africa and beyond (Nairobi Metro 2030, p. iii). It therefore follows that huge financial input will be required to achieve this.

The increase in population and rural to urban migration has also presented numerous opportunities for investors both in the housing and commercial sector. It is projected that Kenya will have a population of over 60 Million people by the year 2030 and more than 50% of these will be living in urban areas creating a huge demand for housing units, commercial and industrial facilities for location of offices and various manufacturing units.

However these numerous investments opportunities may not be adequately tapped due to the following challenges causing insufficiency in financing commercial real estate.

### **1.1.1 Inadequate financing Options**

There are various challenges facing real estate developers and investors such as scarcity of good development land, lack of funds, lack of skilled labour and legal provisions including outdated buildings codes and regulations. The Kenya Government has attempted to solve the scarcity of land issue by opening up other suburban areas especially within the Nairobi Metropolis for large scale property development by implementing infrastructural improvements including construction of super highways, bypasses and overpasses. As mentioned above the Government has also developed various policies for example Vision 2030, The National Land policy and the Constitution which aim to guide physical growth and investment by facilitating the delivery of efficient, cost effective and equitable land related services. These efforts among others have already opened up areas like Thika, Kiambu, Machakos and Kajiado Districts for large scale real estate developments.

Financing, which is the most important resource in real estate investment, is a challenge in Kenya both at the development stage and at the end user level. Kenya has only two major financial institutions specialising in real estate funding. These are Savings and Loans, (S&L) Limited and Housing Finance, (HIF). The former merged with the parent company, Kenya Commercial Bank on 1<sup>st</sup> January 2010, which now only leaves the latter as the only stand alone specialised real estate financing company.

The other sources of real estate development finance are commercial banks, venture capitalists, investments groups and pension funds. For these financial institutions, real estate is just but one of the many sectors that they invest in and depending on their investments goals and legal provisions; they can only invest a portion of their investible funds in real estate. Real estate investment is also marred with issues of illiquidity, indivisibility and requirement of huge initial capital outlays, hence lowering the financiers' motivation to put their money in it. For example, due to the above reasons, all the fund managers in Kenya only have 6% of their investible funds invested in real estate (Knight Frank, 2009).

The problem of inadequacy of real estate financing is double faced. On one hand there is limited supply of funds for lending due to low deposits held by financing institutions and on

the other hand there is a mismatch between the short term deposits and long term lending. Funds must be available first before they are lent to borrowers. Financing institutions in Kenya have for a long time overwhelmingly relied on public deposits which are mostly short term in nature. Mensah (1997) as cited in Waiganjo (2003) concluded that there is therefore a mismatch between borrowing short and lending long. As shown in table 1.1 below, no deposit had a maturity period of over five years while loans maturing in over five years accounted for over 90% of the total portfolio.

**Table 1 Maturity Profile of Deposits and Loans from Mortgage Providers**

Maturity in Years	1996		1997	
	Kshs (Billions)	%	Kshs(Billions)	%
<b>Deposits</b>				
Up to 2 Years	7.7	74	8.3	72.3
2 -5 Years	2.7	26	3.2	27.7
Over 5 Years	0	0	0	0
Total Deposits	10.4	100	11.5	100
<b>Loans &amp; Advances</b>				
Up to 2 Years	0.1	1	0.1	1.2
2 -5 Years	0.8	7.5	0.8	7.8
Over 5 Years	7.3	91.5	9	91
Total Deposits	8.2	100	9.9	100

Source: Kippra Survey Results 2001: (adopted from Waiganjo, 2003)

The deposit to loan mismatch eventually pushes up interest rates and further manifests into rigid financing conditions.

### 1.1.2 Inequitable financing Strategies

Generally real estate investors do so with a hope of making profit or gain in their investments through cash flows or capital appreciation. Traditional financing strategies as represented by financial institutions in Kenya do not offer favourable financial leverage to the borrowers. They have been heavily tilted towards benefiting the lender at the expense of the borrower (Ndungu, 2001). Most financial institutions in Kenya apply Adjustable Rate Mortgages (ARM), which leads to variations (often increases) in the monthly instalments payable for loans. Waiganjo (2003) also noted that increases in monthly instalments with static or

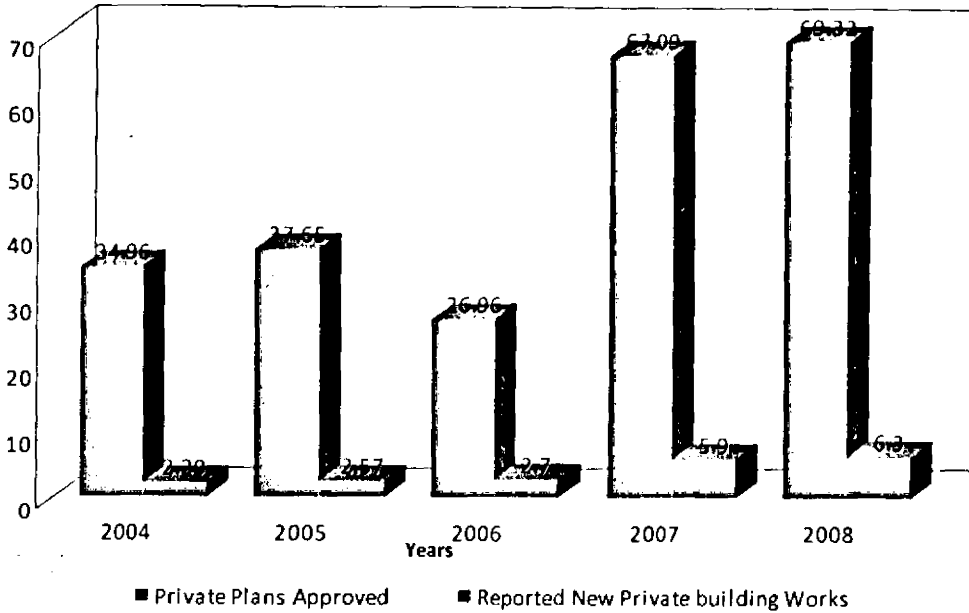
declining incomes coupled with rising costs of living leads to defaults and consequently to non-performing loans.

Kindleberger's (1998) study as cited in Waiganjo (2003) shows that high interest rates lead to decline in asset prices, increased bankruptcy, and insolvency leading further to substantial drop in the stock of money in circulation, a breakdown in allocation mechanism of financial capital leading to financial crisis. Whereas banks price their levels of interest rates by considering various factors including risk levels, the high rates are counterproductive in that they perpetuate economic recession in vicious circles. They lead to contraction of credit availability, particularly in the private sector, and thereby reducing their net worth. High rates also provoke bankruptcies in companies leading to unemployment and loss of incomes and disrupt court systems even where bankruptcy laws are in place (IPAR, 2000).

In the real estate sector, these has led to several projects being approved but fail to take off as there is lack of viable financing whether through the financier or equity partners. The ratio of reported new private buildings completed to the approved plans remains very low (Economic Survey, 2009). Although the low ratio could be attributed to a combination of factors including increased approvals due to enhanced enforcement, rising costs of building and non-reporting of completions on the one hand, it is very probable that the delays or inability to complete projects within timeline is due to inequitable financing strategies.

It is also noteworthy that the loans and advances to the construction sector in the country declined by 7.4% in 2008 compared to the previous period in 2007 (Economic Survey 2009, p 21). A good example of a project which was delayed due to inadequacies in financing from the author's own experience is the Karen office Park on Langata Road. The project is was delayed for three years due to the inability of the developer to get equitable financing through the financial system despite the project being in a prime location, well designed with a reputable project team and even achieving pre-lets off-plan. This led to great inconveniences to the tenants who had committed themselves by executing letters of offer for their proposed occupation of the building.

**Figure 1 Comparison of Value of Approved and Reported New Private Building Works in Main Urban Areas in Kenya, 2004 - 2008.**



Source: Economic Survey, 2009

### 1.1.3 Difficulties in Meeting Debt Service Obligations

This arises when there is disparity between rental incomes and the mortgage repayment rates exposing the safety of the investors' capital and the legal ownership of the property to risk (Murigu, 2002). This challenge faces both the investor and the end user. For the investor / developer, in Kenya due to the problem of borrowing short and lending long, the commercial loans are offered for short periods usually five to a maximum of ten years while the interest rates remain relatively high. These then pose a challenge of inability to service the loan since in the first 2 -3 years of development, the property is usually not 100% let or sold so the income from it is insufficient to repay the loan.

According to Syagga (1998), it is rare to break even with borrowed funds in the first five (5) years. The scenario becomes worse when effects of inflation reduce the effective income available to pay loans. This is because rental leases normally have escalation clauses for rental increase of about 7.5% to a maximum of 10% per annum for office and retail respectively



against an average annual inflation rate of 10% which soared to 26% in the year 2009 as depicted in the graph below.

The problem is aggravated by high incidence of voids either by properties taking too long to rent out or clients moving out to more efficient buildings or reducing their space requirements as a cost cutting measure. Due to disparity between the rents and the mortgage repayment rates, the investors of real estate have continued to default in loan repayments. Non-performing loans is still a big problem despite the fact that it has shown a great decline from the levels some eight years ago, whereby non-performing loans comprised 39.3% of the total loan portfolio Economic Survey (2001:20) as cited in Murigu (2002), Economic Survey, 2009:100) . In fact Yazici (1963) as cited in Kituuka (2001) rightfully summarised the situation when he contended that “to finance a fixed asset with short term loans usually ends up in a financial crisis” In this regard, investors are forced to look for other alternative means of servicing their loans.

For the end user, the problem is even worse. For example in Kenya, only a small proportion of the urban households estimated to be less than 10% have traditionally qualified for mortgage loans in Housing Finance Institutions (HFIs) with the majority ruled out by their low incomes (Alder and Mutero, 2007). Borrowers generally consist of high net worth individuals. Even with the fall of interest rates since the 1990s and the recent extension of residential lending terms to twenty five (25) years, the impact of mortgage lending is very minimal. ([www.finmarktrust.org.za/documents/19\\_Rust\\_HFA.pdf](http://www.finmarktrust.org.za/documents/19_Rust_HFA.pdf), accessed on 17<sup>th</sup> September 2010). It is estimated that less than 30% of the households can afford mortgage to purchase the least expensive built unit due to high house prices, high interest rates and instability of household incomes.

A national survey on financial accessibility by Central Bank of Kenya in June 2009 revealed that only 41% of adult Kenyans had access to financial services. This then leads the author to suggest that there is great need for long term real estate financing but the accessibility and affordability rate amongst the population is low.

#### **1.1.4 Stringent Lending Terms**

In Kenyan Financial sector, any real estate lending requires that the borrower issues collateral in terms of title deed to be charged to the lending institutions, whose value as at the time of

issuing the facility should be greater than that of the loan advanced at that time, without regard to the value appreciation over time (Ndungu, 2001). Furthermore, Kenyan financing institutions are regarded as extremely conservative in their appraisal of loan applications and sometimes the use of credit guarantee by directors is called to question. (Kituuka, 2001). Procedural aspects also pose problems as loan appraisal procedures often take an inordinate amount of time often measured in months rather than weeks; and SME applicants are kept at bay with continuous requests for additional documents. Moreover, the intimate relationship between large financial institutions and a relatively a small number of key players in the economy generates impressions that money usually goes to the same people” thereby depriving SME’s of the necessary support.

The lenders have basically been basing their lending decisions to lend on credit rating and assessment of the borrower. This however has been based on historical data which to a large extent does not predict the future situations with accuracy. The requirement for another security to be charged is also outrageous as few are the times that borrowers have many parcels or developments to charge to the lending institutions. This has led to low demands for mortgage/loan facilities for commercial projects and a low ratio between the approved plans and the reported completions (Economic Survey; 2009).

There is however a catch twenty two situation. On the other hand, these stringent rules are understandable if you consider that commercial property financiers face unique challenges and risks such as payment delinquency, default, discrepancies in appraisal and valuation, foreclosures, redemption, auction and forced sale. The list of pitfalls is long and the financier has to safeguard the safety of the shareholders money. Concerns are more attenuated when anticipated income and or value associated with the property are pledged as collateral. Should that anticipated income fail to materialise and many times it does, in the short run or if the value of property drops unexpectedly, lenders can reluctantly even inadvertently become direct owners.

Such was the situation in Nairobi’s real estate sector when the 2003 – 2005 housing boom had created its first casualties. Prices of the newly built apartments for sale had dropped by 20% in a span of two years due to mainly selective oversupply in areas known as zone 4 – Kileleshwa, Kilimani and Lavington. Investors were unable to sell their properties at a profit which led to increase in incomplete projects and the developers faced with financial difficulty opting to sell at cost (Musumba, 2008).

### 1.1.5 Inadequate Alternatives for Special Groups

The other problem is that over the years there have emerged special categories of investors who require customised financial strategies. These include religious groupings, women or persons with irregular income patterns. For example, the Muslims are governed by the provisions of the Holy Quran which prohibits borrowing or lending at a rate of interest. This has put Muslims around the world in a difficult position when it comes to buying or developing a property. All conventional mortgages or loans in Kenya consists of borrowing or buying at a rate of interest and therefore most Muslims find themselves in a difficult situation whether to abide by the Shariah and their moral beliefs or to coincide with the traditional western approach to investing in real estate.

Dr. Usmani in his book of 2002 reiterated as follows; “It is very important to know the definition and the forbiddance of Riba (interest) and the injunctions relating to its unlawfulness from different angles. On the one hand, there are severe warning of the Qur’an and Sunnah and on the other, it has been taken today as an integral part of the world economy. The desired liberation from it seems to be infested with difficulties. The problem is very detail orientated and has to be taken up on all possible aspects”.

The economic philosophy of Islam has no concept of interest because according to Islam, interest is the curse in society which accumulates money around a handful of people. In addition, it results in inevitably creating monopolies, opening doors for selfishness, greed, injustice and oppression. On the other hand Islam encourages highest moral ethics such as universal brotherhood, collective welfare and prosperity, social fairness and justice. Due to this reason, Islam renders interest (riba) as absolutely forbidden (haram) and strictly prohibits all types of interest-based transactions (Dr. M Usmani, 2002). It is therefore worth exploring the various ways of making financing possible for this group of people within the confines of their belief.

Other special groups like women, and self employed persons (seasonal earners) have also been yearning for customised financing strategies to coincide with their needs, timing of income and affordability. Traditionally women rarely hold titles in their names. Most of the times, the male child are the ones who inherit land parcels from their fathers. It therefore becomes quite challenging for women to access financing as the collateral is a title deed which they rarely hold. This gives the men an advantage over the women when it comes to

investing in real estate. Also, the conventional methods are based on calendar periods and fixed repayment schedules which pose a challenge for self employed persons who do not have regular income.

## **1.2 PURPOSE OF THE STUDY AND RESEARCH QUESTIONS**

The purpose of this research is therefore to highlight the problems facing commercial property financing in Kenya with a view to suggesting the remedial measures to assist the government, financiers and real estate developers and investors to ensure that more investment is channelled towards commercial real estate development. The researcher will seek to illustrate the weaknesses of the traditional strategies and recommend equitable and sustainable financing strategies for financiers, developers and investors. Other questions the study will seek to answer are:

- What is the impact of interest rates and loan periods on the accessibility and affordability of commercial real estate?
- Have the commercial real estate lending as contrived by the financial institutions had any substantial impacts in commercial real estate development in absolute terms as envisaged by the Government in declared policies?
- Are there adequate sources of public equity capital for commercial property development in Kenya?
- Is there enough capital available from the financiers to finance private real estate developments?
- In their endeavours to promote foreign sources of development capital, have financial institutions in Kenya exercised due interest in the development of local sources of capital?
- Is the Kenyan market ready to embrace newer forms of financing like securitisation and unitisation?
- How is the financial sector in Kenya dealing with Islamic and other specialised financing needs for commercial real estate in the society?

### **1.3 OBJECTIVES OF THE STUDY**

The main objective of the study is to highlight the challenges facing commercial property financing in Kenya and their impact on accessibility and affordability of debt financing.

Other specific objectives were as follows:

- A. To evaluate the traditional and emerging commercial property financing strategies in Kenya
- B. To determine the impacts of the traditional and the emerging financing strategies in accessibility and affordability of commercial property financing
- C. To evaluate challenges facing both financiers and investors in financing commercial real estate in Kenya
- D. To recommend and draw conclusions on the equitable and most appropriate financing strategies in the Kenyan market

### **1.4 PROPOSITION**

Insufficiency in financing of commercial real estate is the major cause of large disparities between the approved projects and the reported completions of projects leading to stalled or delayed projects in Kenya.

### **1.5 STUDY ASSUMPTIONS**

When we consider Kenya as an example of other developing countries, and as has been discussed above, the list of problems associated with real estate finance institutions endeavouring to direct funds in real estate development is inexhaustible. The Kenyan experience includes a semi-developed stock market, limited foreign resources and deficient available expertise (Kituuka, 1981). This then brings the researcher to interrogate the question “what is the nature of commercial real estate financing? This study envisage an investment capital to meet the requirements for the funds to be invested in fixed assets like the purchase of the land and construction of buildings. Other aspects for financing include procurement of plant and machinery including electrical and mechanical installations like the lifts and backup generators. These are loans which should normally be amortized out of the earnings of the project for periods between five to thirty years. This study therefore dwells on the medium to long term financing.

The study assumes and in agreement with Kituuka (1981), that there are two distinct groups of lenders in the Kenyan market namely the mortgage lender and the equity investor. The study addresses itself majorly towards the mortgage lender aspect but also discusses certain aspects of equity investors as it has been found that in Kenya, the main commercial development financing institutions combine in varying proportions the two aspects of commercial financing. The equity investor buys shares in a proposed or existing project with a view of maximising capital gain on his investment or conversely minimising his net losses (Kituuka, 1981:p7).

These investors could be individuals, partnerships, corporations, trusts or pension schemes or funds. Mortgage lenders usually accept a relatively low return on their capital than they could obtain in equity investment in return for lower risks involved with the investment. On the other hand the mortgage lender will tend to recover his capital whether or not a project is profitable whereas an equity investor would mostly benefit when the project has declared dividends. It is against this background that the researcher made the following assumptions.

1. Debt financing should be aimed at being equitable, sustainable and beneficial to both lender and borrower.
2. Borrowers in the commercial real estate sector usually secure the financing with the sole intention of managing their developments well and to secure adequate cash flows to cover the repayment of the principal and interest in full and promptly. They also hope to make some profit in the form of surplus and capital growth as their reward for having taken the risks of investing in real estate.
3. The lenders on the other hand lend out their money in order to make profits from the interest or sale proceeds from foreclosed property and to increase their shareholders wealth.

## **1.6 SIGNIFICANCE OF THE STUDY**

This study is expected to be of significance to the financiers, researchers and real estate professionals. Limited research work has so far been done on commercial real estate financing parse in the country despite the fact that real estate is one of the major sectors in the country. For example the real estate and construction sectors contributed 5.5% and 3.8% on average to the economy in the period between the years 2003 to 2008 respectively as tabulated below.

**Figure 2 Sectoral Contribution to Economy between the year 2003 and 2008**

<b>Industry</b>	<b>2003</b>	<b>2004</b>	<b>2005</b>	<b>2006</b>	<b>2007</b>	<b>2008</b>
<b>Agriculture, fishing and forestry</b>	<b>25.8</b>	<b>24.9</b>	<b>24.2</b>	<b>23.8</b>	<b>22.0</b>	<b>23.8</b>
<b>Industry</b>	<b>15.6</b>	<b>16.2</b>	<b>17.0</b>	<b>16.5</b>	<b>16.4</b>	<b>16.6</b>
<i>of which.</i> Manufacturing	9.7	10.0	10.5	10.3	10.4	10.6
Construction	3.3	3.8	4.0	3.9	3.8	3.8
Electricity & water	2.1	1.9	2.0	1.8	1.5	1.5
Other	0.5	0.5	0.5	0.5	0.7	0.7
<b>Services</b>	<b>58.6</b>	<b>58.9</b>	<b>58.8</b>	<b>59.7</b>	<b>61.6</b>	<b>59.6</b>
<i>of which.</i> Wholesale and retail trade	8.7	9.2	9.2	9.3	9.7	10.0
Transport & Communication	9.2	9.9	10.3	10.6	10.6	10.2
Financial activities	4.3	3.5	3.5	4.0	4.7	4.7
Education and health	10.7	10.5	10.0	9.5	9.3	8.7
Real estate, rent and buss. Services	5.9	5.7	5.6	5.4	5.3	5.1
Other services	19.7	20.1	20.2	20.9	22.0	20.8
<b>TOTAL</b>	<b>100</b>	<b>100</b>	<b>100</b>	<b>100</b>	<b>100</b>	<b>100</b>

Source: Economic Survey 2009

Waiganjo (2003) in his study of causes of non-performing loans in Kenya's residential property market noted that few studies had been undertaken in the whole subject in property finance in Kenya. Muchiri (2006) reaffirmed these sentiments. Furthermore most of the literature available in the various books and internet usually address the developed world, which tend to have a more vibrant property market as compared to a developing country like Kenya. Other notable studies that have been done in this field are Njiru (2003) which attempted to determine commercial returns in the Nairobi Central Business District (CBD) and Njoroge (2001) on the position of the Nairobi Stock Exchange (NSE) with regard to property. This study is therefore expected to stimulate more interest in the field of commercial real estate financing.

Another study by Kaberere, (2001), Investigating Mortgage Financing Strategies applied in the various institutions in Kenya concluded that financiers in residential investment needed to be more innovative and develop appropriate financing strategies and means for financing residential property buyers in Kenya. It is evident that these studies have concentrated mainly

in the residential sector and how to improve credit availability to home buyers or the end user financing leaving out the commercial sector which is the intermediary to the real estate production.

Not much empirical studies have been conducted in financing options available for the commercial properties. Many are the times when real estate investors especially beginners get frustrated when they keep being sent back for more details or documents by the financier simply because they were not properly informed of the procedures and requirements to be followed in the first instance or because the financiers are uncomfortable advancing credit to 'unknown firms' or sectors of real estate. This sentiment was also raised by Kituuka (1981), as he pointed out that a "small or growing firm without high credit rating and a strong background of earning often finds it extremely difficult if not impossible to obtain loan funds on a competitive basis.

It is therefore common to find these firms occupying space as a tenant in other multi-user buildings owned by large firms" This research aims at reviewing the commercial property market and specifically investigate the various financing strategies both traditional and emerging trends that have been employed in this sub sector and to suggest recommendations for improvement. The study will be useful to investors and portfolio managers in bridging the gap in knowledge of existing and emerging trends and to deepen their understanding of the requirements to improve the accessibility and affordability of commercial real estate financing in Kenya.

It will be most useful to borrowers and lenders who would have a better understanding of the operations of the property market and the various financing options on offer including their advantages and disadvantages. This will assist both the investors and the financiers to choose the appropriate financing strategy for their projects. The study will also be informative to property professionals who are always approached by lenders, developers and investors for advice in the field of real estate investment viability and financing.

Furthermore, lenders will also find this study useful as it explores the various options and urges them to be innovative and come up with customised strategies to satisfy the specific needs of their clients and the local demand for financing. The financial institutions will need to reassess the strategies available for property financing and to develop innovative means that appeal to and are relevant to the Kenyan market. Lastly, the study is expected to be of



interest to policy makers as they play a role to influence the property and finance sector through use of macroeconomic policies. It is expected that it will bring forward a new view of property investments.

## **1.7 SCOPE AND AREA OF STUDY**

Commercial property was defined by Clauretie & Sirmans (2006), Fabozzi (2007), Brueggerman et al (2008) to mean properties including, but not limited to the following categories of real estate:

- Multifamily properties like apartments, condominiums, maisonettes, flats and gated community housing.
- Office buildings and / or office parks
- Industrial Properties and warehousing
- Shopping / retail Centres
- Hospitality / Hotels and motels
- Healthcare facilities

In this regard, this study adopted the above definition but with a few exceptions whereby a commercial building was taken to be a structure other than single residential buildings which is developed or acquired for investment purposes only in the expectation of profit. Financing of industrial properties parse was elaborately studied by Kituuka (1981) and as such these were excluded from this study. End financing of individual residential real estate has also been studied by various authors like Kaberere (2001), Waiganjo (2003) and Musumba (2008). In this regard, the study addressed itself towards the development financing and not end user financing. The study further narrowed down to office and retail projects with a belief that the financing strategies adopted for these two types of commercial real estate would apply to all the other forms of commercial real estate.

The choice of Nairobi is based on the fact that it is the capital city of Kenya and compared to the other urban centers in the country, it has the highest concentration of commercial buildings and the headquarters and branches of all the financial institutions. As such, it forms a good representative of the other urban areas of the country.

The following challenges were experienced during the study: Limited financial resources, time limitation, and lack of timely and reliable information/data and unwillingness of respondents like banks to discuss legal and personal matters of their clients.

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## 1.8 ORGANIZATION OF THE STUDY

The study is organized in five chapters. Chapter one gives a general introduction to the area of study. These include introduction, the statement of the problem statement, the study objectives, the scope, choice of the study area, significance of the study and its organization.

Chapter two consists of review of literature related to commercial real estate development financing. This chapter has a detailed analysis on the real estate development process, sources and methods of real estate finance, their advantages and disadvantages. The information contained in this chapter forms the theoretical framework in which efforts to propose the appropriate financing strategies for commercial real estate financing are founded.

Chapter three details the research methodology. It highlights the types of data and their sources, target population, the sample and sampling techniques that were adopted in the study.

Chapter four gives data analysis and presentation. Specifically it determines the sources and strategies of commercial real estate financing, the challenges facing the conventional commercial real estate financing and their proposed solutions.

Chapter five evaluates the findings and derives conclusions and recommendations of the study.

## CHAPTER TWO

### LITERATURE REVIEW

#### 2.0 INTRODUCTION

The previous chapter discussed the commercial real estate financing problem in Kenya. In this chapter the researcher discusses the real estate development process in general and then elucidates the importance of financing in the development process. The author also discusses various sources and strategies of financing commercial property investments together with their advantages and disadvantages. This chapter provides a theoretical framework upon which recommendations on the financing strategies that investors can adopt when investing in commercial real estate as part of their portfolio are suggested.

#### 2.1 PROPERTY DEVELOPMENT

Property development has been defined as a process that involves changing or intensifying the use of land (Cadman & Topping, 2001). According to Greer (1993) Property Development involves placing improvements usually buildings on land while rehabilitation is the renovation and in some cases remodeling of existing structures. McKenzie and Betts (1976) goes further to separate property development into two aspects as Land Development – which refers to subdividing and preparing land for building and; Construction – which refers to the actual erection of buildings and improvements on the land. For the purpose of this research, the first definition that involves the process of changing or intensifying the use of Land was adopted.

Property development is an industry in itself that produces building for occupation by bringing together various inputs which include land, building materials, labor, finances and professional skills and expertise. It employs substantial resources of capital and labor to produce product, which is relatively immobile and indivisible. Ventures usually originate with a concept for finished urban space and perception of unmet demand otherwise referred to as “ideas in search of site” whereby a developer who identifies an entrepreneurial opportunity seeks out a site upon which the demand can be satisfied. Alternatively it would be a developer or investor seeking an appropriate use for previously acquired site also known as a “site in search of an idea”.

Whether a development originates with site to be exploited or a vision to be fulfilled, the common denominator is the need for particular blending of talent and organizational skills that characterizes successful real estate development. The creation of new real estate project needs managerial talent to plan, coordinate and control the factors of production i.e. Land, Labor and capital so that the end product is not just a towering asset but a profitable one. These skills are provided by the developer, investor, contractor and architects all of whom are instrumental in the creation of successful real estate development being completed and occupied by the owner or the tenants.

Commercial property development in Kenya is usually carried out by individuals, corporate organizations, Government departments, banks, other financial institutions, Pension funds, insurance and re – insurance companies, local authorities, or by specialist development companies for rental or outright sale. Irrespective of who is carrying out the development, in a very broad perspective, the same procedures, calculations and discussions usually apply to the development process. The strategies and methods of securing finance will however differ depending on the nature of the borrower, developer or investor.

## **2.2 STAGES IN REAL ESTATE DEVELOPMENT IN KENYA**

Property development involves both the acquisition of land and the subsequent subdivision and construction on it. In Kenya property development broadly involves the following phases:

### **2.2.1 Phase 1 - Market Survey and Feasibility Study**

This phase involves four stages depending on whether the investor already has land under his ownership or is yet to acquire a parcel for development.

#### **Stage 1 - Sourcing for Properties**

This stage is for those who wish to purchase land as mentioned above in an idea in search for a site. Here the prospective developer looks for a parcel of land with potential for development. This has been the case for most recently developed office and retail projects within the decentralized locations due to increased demand for such outside the Central Business District.

## **Stage 2 – Initial opportunity Assessment**

For those investors who already have land or once a parcel has been identified, the developer carries out market research to be able to know with clarity the market trends and determine the highest and best use for the particular parcel. This stage also preliminaries to source for available finance options to determine investors' limits and projects' viability. The consultants include a development manager to coordinate the whole process or individually, an advocate, an architect, a surveyor a town planner and estate agent to advise honestly on end values and marketability.

## **Stage 3 – Detailed Assessment, Concept Development and Valuation**

Once a developer finds a potential site, now he must come up with a concept for it. What can he put on it? How many units? How big? What restrictions are there? Are there encumbrances or covenants on the title? This is usually achieved via a detailed market survey and an initial feasibility study. Prior to undertaking any development the developer should undertake an independent market analysis to determine whether a users market exist for the proposed projects. Regardless of the nature of the development, a supply, demand and marketability analysis must be carried out before a development can take off. It is important to design and build a project that is marketable. These form the heart of a market analysis and must be determined before any firm commitments are made. McKenzie and Betts, (1976) warned that “the time to be concerned about sale potential is before not after the project begins!”

Real estate developments are also subject to legislative controls like land use regulations, lease covenants and building codes which limit the investor's freedom to use his land as he wishes. In Kenya developments are controlled through zoning regulations, Building codes and bye laws, various acts of parliament including; The Physical Planning Act, Environmental Management Coordination Act, National Environmental Management Authority and various conditions which are imposed on the title among others. The developer must also undertake a detailed analysis of the neighborhood as an important consideration of town planning is keeping the neighborhood character Neighborhood Associations also control property developments within their neighborhoods.

After the concept development, then comes a feasibility analysis usually done by estate agency firms, valuers or even financial consultants. The parameters to be analyzed include

time scales, all costs including consultants and construction costs as well include likely end sale values and the profit margin that the investor wants. If the profit is reasonable, the proposal is taken to the next stage where the developer works out what the land is worth to him.

### **2.2.2 Phase 2 - Acquisition**

This phase includes the actual negotiation, funding and purchase of the parcel of land. If he has money at hand, then pays for the land and have the title transferred to his name. If not, then he has to approach a financier and have a residual valuation of the parcel done to be able to process financing for the same. He decides in which entity he will get the best asset protection and the best tax advantages. Funds for land purchase could come from various sources i.e. from a syndicate, sale of ownership shares, loan from financial institutions or private party, own savings or from other semi formal sources like SACCOS.

### **2.2.3 Phase 3 – Development of the Project**

This phase involves the local authority planning approvals, detailed designs, and award of tenders and actual construction of the project.

#### **Stage 1 – Securing Planning and building Approvals**

A real estate development is not possible unless proper Local Authority permits are obtained. Government regulations like zoning, building codes, plot ratios, plot coverage, environmental audit reports, and utility requirements are essential part of real estate development and a developer or his project team must be familiar with and assess the likelihood of obtaining the same. The project architect draws up plans that fit in with the planning regulations and accords with the local council's development guidelines. Due to the increasing complexity of the development process, a surveyor and town planner are often involved at this stage.

This stage may take up to 8 months before he gets a planning and development approval. For example, the technical committee at the Nairobi City council meets only once a fortnight. The key factor here is the time taken to obtain the approvals. Long delays due to Government red tape can cause a project to fail due to missed sales or increased cost for land, labor, materials and capital. It is therefore mandatory to carefully review the time needed for this stage and the penalties for delays. A good example in the Kenyan Coast is Medina Palms, a proposed

luxury beach front development whose approval was delayed for over three years due to environmental concerns raised by the neighbors. It finally broke ground in October 2010 but some of the purchasers who had put in deposits had to pull out as they could not wait any longer. Once the Development Approval has been achieved, the architect and engineer document the working drawings to allow him to get a building permit.

## **Stage 2 – Pre-Construction and Tendering**

At this stage the project manager obtains quotes from builders, awards the tenders and obtains bank approval for the development loan. Real estate developers and investors rarely pay for their projects as they are strong believers of the principle of leverage; using minimum amount of equity funds and maximum amount of borrowed funds to control a large investment. After land acquisition, funds for construction usually come from traditional lenders like banks, savings and loans schemes, insurance companies and mortgage companies. Other sources could include pension schemes, and sources from the diaspora. The role of financing cannot be over emphasized, as without adequate funds, a real estate project as developers put it cannot “fly” (McKenzie and Betts, 1976).

Adequate financing depends on two main variables namely: the market potential of the project and the condition of the money market. If a developer can prove to the lenders that a strong market exists for the proposed project and if lenders have funds available at reasonable interest rates, chances are that the project will be funded. On the other hand if the money market is tight and supply of funds is limited, a developer may find it impossible to borrow funds needed regardless of market potential of the project which will have to be shelved due to lack of funds. The latter seemed to have been the situation in Kenya where the financial institutions relied too much on internal borrowing by the Government. This reduced the amount of finance available for lending to the real estate sector.

## **Stage 3 – Actual Construction**

The first thing to do here is land preparation which involves clearing of the land, installation of offsite improvements i.e. utilities, streets to make way for onsite construction. Construction begins as soon as land preparation permits and timing is critical. Building is done in phases, frequently by different subcontractors. Blending each phase to eliminate delays is one of the most difficult tasks in this phase. This is where a project manager is required to handle the

issues. Delays between construction phases may occur because of adverse weather, labor strikes, material shortages, post election violence or wars and improperly estimated time requirements for various construction activities.

Delays cost money as interest accrues on construction loans and labor is paid for standby time. The builders are usually paid progressively at the completion of each stage using draw downs from bank loan. This stage can last 12 – 24 months depending on the size of the project. The main aim is completing the project within set budget, time and specification. Again as had been noted in the problem statement, this stage is one of the most challenging in the Kenyan case where project delays is the norm rather than the exception (Talukhaba, 1996).

#### **2.2.4 Phase 4 - Disposal or retention**

This phase is determined by the investors initial intention, whether he intended to hold the property or to dispose of it on completion. The following stages are therefore involved in this phase.

##### **Stage 1 - Market distribution**

This phase is concerned with selling and transfer of the project. Frequently the sale takes place before construction begins or if built on speculation, the property may be sold before the construction is completed. In other cases, the project is not sold until construction is completed. However the actual transfer of legal title usually does not occur until the property is completed and ready for occupation. Today most financiers and developers are pushing for pre-sales and pre-lets before they break ground in order to reduce the cost of construction. The development success depends on the ability to secure willing occupiers or purchasers at the expected rent or price within the period originally forecast in the evaluation.

##### **Stage 2 - Property Management**

This stage refers to maintenance and servicing of the project after construction. This involves two major activities i.e. physical upkeep and administration and record keeping. Physical upkeep refers to maintenance and repairs while repairs and record keeping involves lease administration, legal requirement implementation, rent collection, ledger accounts, and

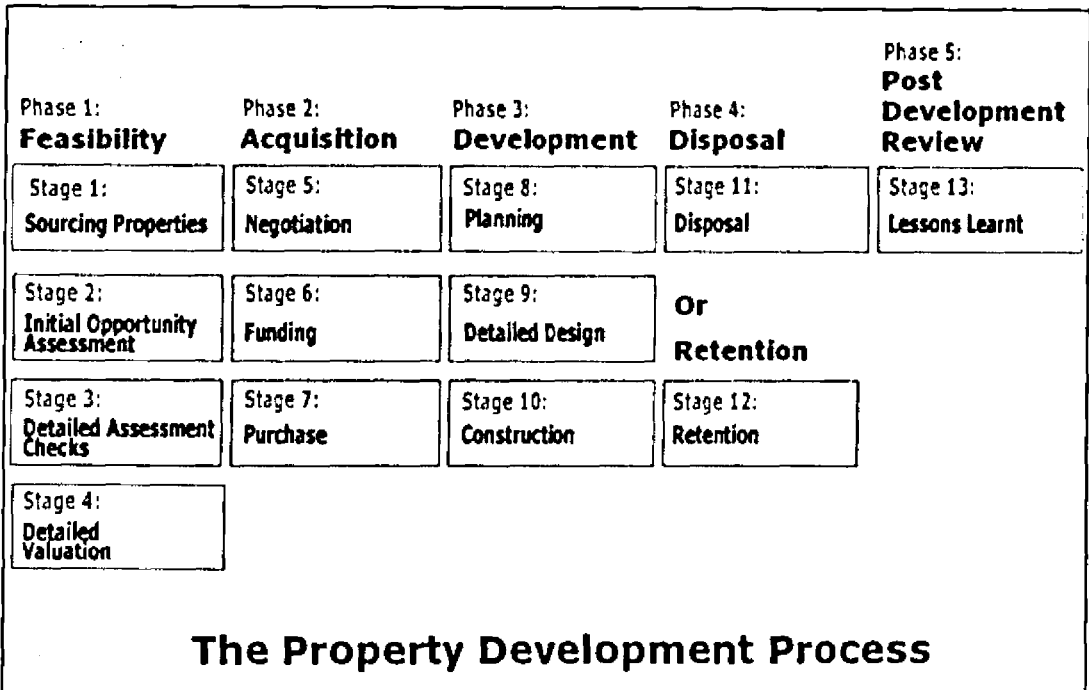


preparation of income and expenditure sheets for tax purposes. This stage continues until such a time that the project is sold to another investor or redeveloped.

### 2.2.5 Phase 5 – Post Development review

This is a monitoring and evaluation state. The developer reviews the above phases and learns for the past mistakes or success in a bid to better the next undertaking. These lessons also help the other developers who intend to venture into real estate development.

**Figure 3 Diagrammatic Representation of the Property development Process**



Source: Authors own construct, September 2010

In summary, the above stages are not mutually exclusive and usually overlap many times in real life. It is also worth noting that real estate transactions are require large sums of money and are usually protracted and costly mainly because they deal with people’s rights and interests. These transactions can sometimes be complex and cumbersome even for the purchase of a simple house. The developer should therefore be keen to ensure that projects are delivered on time and within budget and specifications. To achieve these objectives and make a profit, he requires sound financing options.

### 2.3 RISKS ASSOCIATED WITH REAL ESTATE INVESTMENT

Risk has been defined by Byrne & Cadman (1996) as the measurement of a loss identified as possible outcome of a decision. It gives an investor a preview of the likely outcome, which in turn assists him in making a choice on whether or not to commit his capital and if so, how much and for how long. Murigu (2002) states that, risk may however be a bit difficult to determine at the inception of any undertaking, but in spite of this fact, the promoter of a project should be in a position to estimate the magnitude of loss that is likely to occur.

As Lord Kelvin (1989) as cited in Swazuri, (1996; 8) once rightfully remarked;

“When you can measure what you are talking about and express it in numbers, you know something about it, but when you cannot measure it in numbers, your knowledge is of a meager and unsatisfactory kind’.

Dubben et al (1991; 129), defines risk from a property investment point of view as the level of probability that a required return, measured in terms of capital value and income will not be achieved. He goes on to state that risk is about the interaction of future returns which can have a number of possible results and the chances that a particular outcome will result. For example the actual return on investment could be significantly different from the return one had expected. The degree to which actual performance may exceed the expected performance is referred to as “upside potential”, while the amount by which it falls below the expectation is referred to as the “downside risk”.

The latter is of utmost concern to the commercial real estate investors and financiers especially in situations where the investment is funded through borrowed funds as one could lose everything including the principal. In fact risk analysis is an integral part of real estate financing. This is because real estate investment by its very own nature involves all kinds of risks. There are some characteristics that are peculiar to real estate that make it riskier than other alternative investments like government securities. Hertz et al (1983), Cooper et al (1987), MacLeary et al (1988), Wurtzback et al (1994) and Brueggerman et al (2008), discussed these characteristics and risks inherent in real estate investments as follows:

## **i) Business Risks**

Real estate investors are in the business of renting space. They incur business risk of loss due to fluctuations in economic activities that affect the variability of income produced by the property. Changes in economic conditions often affect some properties more than others depending on the property type, its location and any existing leases. Many regions in the country and location within cities experience differences in rate of growth due to changes in demand and population size and structure.

Those properties that are affected to a greater degree than the others would be riskier while another property with a well diversified tenant mix is likely to be less subject to business risk. Tenants may also fail to perform their obligations under the lease like repairs, vacate the premises before expiry of the lease or even fail to renew their leases. Similarly a property with leases that provide the owner with protection against unexpected changes in expenses would have less business risk. Such are the commercial leases in Kenya where rent escalations are predetermined and inbuilt in the lease so the owner knows exactly how much rental income to expect over the lease period.

## **ii) Financial risk**

This is the uncertainty introduced by the method of financing the investment and of realizing the projected rental growth and appreciation of capital value. The use of debt financing also referred to as financial leverage magnifies the business risk. Commercial real estate employs substantial amounts of borrowed capital and the potential inability of the property income to cover the debt service constitutes financial risk, which increases as the amount of debt and real estate size is increased.

The degree of financial risks also depends on the costs and structure of debt for example a loan that gives the lender participation on appreciation of the value of the property in exchange for lower monthly payment may have less financial risk. On the other hand the fact that lenders offer varieties of variable rate mortgages can also expose the investment to financial risks. Variable rate mortgages, leads to variations (often increases) in the monthly installments payable for the loans. Increase in repayment amounts with static or declining incomes coupled with rising cost of construction leads to defaults and consequently non-performing loans.

### **iii) Liquidity Risk**

Real estate investments are relatively illiquid with the ability to promptly divest the project in response to changing economic, financial and investment conditions lengthy and limited, unless such property is securitized. This risk occurs when a continuous market with many buyers and sellers and frequent transactions are not available. The more difficult an investment is to liquidate, the greater the risk that a price concession may have to be given to a buyer should the seller have to dispose the investment quickly. It can take from six months to a year or more to sell real estate especially during periods of weak demand in investment real estate. Special purpose properties would tend to have much more liquidity risk than properties that can easily be adapted to alternative uses.

Apart from the high degree of liquidity risk, Muchiri (2006) reiterates that one of the other major problems of owning real estate is its indivisibility. In Kenya; it is extremely difficult to liquidate part of the investment if the investor was to find another investment opportunity that afforded him a higher Net Present Value (NPV). The Kenya Sectional Properties Act of 1987 which provides a framework for ownership of part of a property was designed specifically for resale of self contained units and cannot be said to enhance divisibility.

### **iv) Inflationary Risks**

Unexpected inflation can reduce an investor's rate of return if the income from investments does not increase sufficiently to offset the impact of inflation thereby reducing the real value of the investment. Some investments are more favorable or adversely affected by inflation than others. Despite inflation risk, real estate has historically done well during periods of inflation. This might be attributed to the use of leases that allow the net operating income to adjust with unexpected changes in inflation.

Furthermore the replacement cost of real estate tends to increase with inflation. During periods of high vacancy rates, however, when the demand for space is weak, and new construction is not feasible, the income from real estate does not tend to increase with unexpected inflation.

#### **v) Management Risk**

Most real estate investments require management to keep the space leased and maintained to preserve the value of investments. The rental and overall rate of return that an investor earns can depend on the competency of the management, known as the management risk. This risk is based on the capability of the management and its ability to innovate, respond to competitive conditions, and operate a business activity efficiently. Some property require high level of management expertise than others for example regional malls require continuous marketing of the mall and leasing of space to keep a viable tenant mix that draws customers to the mall.

Therefore, identification of the anchor tenant in a retail centre is key to attracting tenants to the centre and should be carefully done. The anchor also is responsible for most of the traffic to the centre and its market appeal influences the performance of the centre against competing centers. On the other hand, the type of tenants selected to operate in the shopping complex determine the pull factor of the centre. The tenant mix should be carefully done to ensure the centre provides a diverse range of goods and services to attract and retain customers.

#### **vi) Interest Rate Risk**

Changes in interest rates will affect the price of all securities and investments. Depending on the relative maturity ( short term versus long term) of the investments, however, some investments prices will respond more than others , thereby increasing the potential for loss or gain , that is the interest rate risk. Real estate tends to be highly leveraged, and thus the rate of return earned by equity investors can be affected by changes in interest rates. Even if an existing investors has a fixed rate mortgage or no mortgage, an increase in the level of interest rate may lower the price that a subsequent buyer is willing to pay. Furthermore yield rates that an investor requires for real estate tend to move with overall level of interest.

#### **vii) Legislative Risk**

Real estate is subject to numerous regulations i.e. tax laws and monetary policy, rent controls, zoning and other restrictions imposed by Government. Legislative risks result from the fact that changes in regulation can adversely affect the profitability of the investment. Some local Governments have more restrictive legislation than others especially for new developments.

For example North (1976), noted that a change in the nation's monetary policy naturally influences the lending institutions, the degree of which depends on the extent of their involvement in the various capital markets.

In Kenya, any changes that occur to regulations like Public Health Act, Stamp Duty Act, Landlord and Tenant Act (Shops, Hotels and Catering establishments) may impose restrictions on the property or open up new opportunities all together. For example the provisions of the New Constitution and The National Land Policy have reduced interest on all land owned by foreigners to 99 years leasehold regardless of whether they were formerly freehold or 999 years leases without compensation for any loss of value arising thereof.

#### **viii) Environmental risk**

The value of real estate is often affected by changes in the environment or sudden awareness that the existing environment is potentially hazardous. For example while it was common to use asbestos to insulate buildings, asbestos in buildings is now perceived to be a potential health hazard. A property may also become contaminated by toxic waste that is spilled or was buried at the site or adjacent site. Environmental Risk can cause more loss than other risks because the investor can be subject to clean up costs which far exceed the value of the property.

#### **ix) Sector Risks**

This risk is closely associated with environmental risk. The property market is heterogeneous with very many sub sectors. The sector risk is double faced. The first dimension distinguishes the property by type like industrial, commercial, residential, agricultural or special properties. The second dimension has to do with the location of each property. Because of the fixed location, the type of use suited for the site, the returns are quite sensitive to the changes in immediate environment and hence changes in the location. Sector risks are therefore the chance that inter-sector price movements or performance differences between sectors will affect the subject investment.

#### **x) Structural Risks**

These are risks resulting from physical, economic and functional obsolescence. They could result due to poor structural design, poor construction, rapidly changing consumer tastes and

preferences and design parameters. To remedy these defects require huge finances which many at times is not recoverable from the tenant through service charge but must be borne directly by the investor. This then increases the cost of the project and reduces its earnings.

#### **xi) Development Risks**

Property developments typically require substantial capital outlays during the construction periods, and it may take months or years before positive cash flows, if any, can be generated through sale or lease of completed properties. The time and costs required to complete a property development may increase substantially due to many factors beyond the investor's control, including the shortage, or increased cost of material, equipment, technical skills and labour, adverse weather conditions, natural disasters, labour disputes, disputes with contractors, accidents, changes in government priorities and policies, changes in market conditions, delays in obtaining the requisite licenses, permits and approvals from the relevant authorities and other unforeseeable problems and circumstances.

Some of these risks may be due to manmade or natural perils which result into the damage to property, indirect or consequential loss because of damage to the property. Events responsible for these include storm, floods, earthquakes, explosions, political violence and fire. Some authors call these pure risks, which form the basis of commercial property insurance.

#### **xii) Currency risk**

Where the developer finances the project on a different currency, for instance the United States dollar and the rents are received in the local currency; movement in the exchange rates may impact negatively on the project returns in case the rates do not favour the developer. With Kenyan Shilling based market and constant swings in the exchange rates, it is advisable for the developer to take the same currency in borrowing as the lease contracts entered into with the tenants. Maisel (1966; p 128 – 132) noted that in his experience, most medium and small scale firms do not want to undertake the foreign exchange risk involved in the borrowing directly from international institutions or even national development banks that pass on the foreign exchange risk to the borrower.

Kituuka (1981) however noted a very peculiar characteristic in the Kenyan market. He reiterated that this is not the case in Kenya. Borrowers would just be too happy to obtain the

financial assistance from a development institution and that the foreign exchange risk would be a secondary consideration. He continued to note that obtaining a loan from a development institution like Industrial and Commercial Development Corporation (ICDC) implies prima facie viability of the project and assists the borrower to solicit other loans like short term loans for working capital from the banks and other financial institutions. This led the author to suggest that in developing countries like Kenya, a situation arises whereby demand outstrips supply of loans such that the foreign exchange risk in financing becomes a factor of less significance to the borrower.

It is no doubt that property development or investments involves many kinds of risk. Only in exceptional cases has the developer all the finance he needs to undertake the development and the willingness to bear the risks involved. Even if he had all the money, investors are risk averse and would prefer to leverage. Leveraging allows the investor to increase the portfolio size by spreading their equity across a number of properties. It is therefore necessary to spread the risk and the financial burden to those parties who are able and willing to share them like the financiers or joint partners

Any of the above factors, singly or in aggregate, may lead to a delay in, or the failure of, the completion of a property development and result in costs substantially exceeding those originally budgeted. Failure to complete a property development according to its original plan, if at all, may have an adverse effect on the project's reputation and success. As a result, returns on investments, if any, might not be timely recognized or might be lower than originally projected. In this regards, the availability of capital and the associated costs (interest rates and processing fees) are key factors to consider in commercial real estate investment. Finance once secured must be certain as any break in the flow of capital, during the development can result in additional expenses if not complete disruption of the project (Murigu, 2002).

Brueggerman et al (2008) in analyzing the risks associated with real estate investment concluded that in doing final analysis, a prospective investor in a specific real estate project must estimate and compute an expected return on the project and compare that return with expected returns on other specific real estate investments as well other investments. Any risk differentials must then be carefully considered relative to any risk premium or difference in expected returns. In all such comparison, Investors must then make fine judgment as to whether the investment is justified. While there are wide differences of risk acceptability



among estate developers and investors, where the prospect of failure is at all real, the project is unlikely to be undertaken. However as a general rule of investments, the higher the risk the higher the expected return.

## **2.4 PROPERTY DEVELOPMENT FINANCE**

Financing is an integral part of real estate development. Without it, a project cannot fly. Two types of finance are required for property development i.e. short term finance to pay for the costs of production like land purchase, building costs, professional fees, promotion costs and long term finance to enable developers to repay their short term borrowing and either retain the property as an investment or realize their profit. Whether the developer retains the property as an investment or sells it to realize its profits depends largely on their motivation and prevailing market conditions.

In Kenya today the trend is for immediate disposal especially in the residential sector. Offices are largely for rental however there has emerged a trend in the last two years where office suites are being developed for outright sale especially in the decentralized office nodes outside the Central Business District (CBD). Some developers have also developed build to suit schemes like the three buildings occupied by Safaricom Limited on Waiyaki Way, in Westlands, Nairobi. In the industrial sector, most projects are built for owner occupation and therefore being held for a long time.

## **2.5 SOURCES OF PROPERTY DEVELOPMENT FINANCE**

There are various sources of development finance. According to North (1976), Kituuka (1981) and Cadman et al (1995) these sources include financial institutions, banks and building societies, property companies and stock markets, overseas investors, private individual (equity), joint ventures, partners and government assistance through grants or through partnership with local authorities.

In most real estate developments, the most common source of funds is owners equity combined with medium to long term loans in form of corporate or project loans, joint ventures and mortgages. The main sources are commercial banks. These banks accept deposit from the public and also borrow from other sources. Together these funds are advanced to individuals, business and Governments. Clauretie and Sirmans (2006) affirmed that the commercial banks

are an important source of commercial real estate loans especially loans for acquisition, development and construction of real estate projects.

The use of equity alone is hardly enough due to heavy capital outlay required for purchase or development of commercial property. Cooperative loans can be used in smaller projects where the developers can build incrementally and take another loan once the initial one has been repaid (Waiganjo, 2003). This is however not adequate for commercial real estate projects which usually require large capital outlays. These require a more formal financing arrangement where a financial institution provides the finance required to pay off property owner or pay for construction costs and creates a debt, which is paid by the purchaser or developer over agreed time with interest. In addition the financier creates a legal interest in the property that secures the money loaned in the event of default in repayments.

The role of various financiers within the property development process has varied depending on the position of both the business and the development cycles at any particular time in relation to the credit cycle. This is because financiers are in the business of making money and property is only one of a number of the assets that they can invest in and lend money against. Clauretje and Sirmans (2006) further noted that each financier has different motivations and liabilities influencing their policies towards property as either investment or as a security against a loan. Whichever the motivation, the lenders primary objective is that the property being offered as collateral security for the loan should form sufficient security in the event of the borrower being unable to meet his financial obligation.

Maisel (1965; p. 125 – 126) singled out safety of capital and liquidity of capital as being the most important factors influencing a firm's willingness to lend followed by relative profitability. He continued to note that there is inherent risk, the probability that the stated rate of return on a loan or a portfolio of loans will not be received because may be the borrower cannot meet his commitment on time, the borrower is insolvent, national catastrophes have made calculated yields meaningless and generally there is a possibility of risking the loss of the property during foreclosure because of non liquidity nature of real estate.

Chen, (2004), and Bohn, (2009) assert that modern trends in real estate investments decision indicate that investors and lenders are not after recovery of capital invested in the project through sale of the project or by foreclosure. This is because recovery of capital through foreclosure is costly and involves lengthy procedures and litigation. Furthermore, the process

of sale may not cover the outstanding debt and this may call for deficiency judgment for the difference. In this regard and as will be discussed in the following chapters, financiers would only regard foreclosure as a last resort. The modern types of real estate development financing are such that the conventional means of recovery would be to try and improve the project rather than foreclose the collateral security. This is achieved by planning a work out strategy.

The goals of a successful financing workout should be maximum recovery, strengthening the lender's collateral position and rights, reduction of loss and other risks, and avoidance of the expense of protracted litigation (even if litigation is initiated to bring the borrower to the table). In exchange for this additional certainty and strength, time and/or other concessions may be granted to the borrower which makes practical sense for the lender after careful analysis of the factors surrounding each particular situation. Additionally, the successful workout should better position the lender to enforce its rights and remedies in court without a long battle should the borrower default after the restructure. In the other hand, it gives the borrower another chance to make good his obligations. This is deemed to be the equitable way of financing real estate investments.

## **2.6 HISTORY OF COMMERCIAL REAL ESTATE FINANCING IN KENYA**

In Kenya, majority of commercial real estate is owned by private individuals and companies. According to a study by Murigu (2002: p. 185), out of a total sample of 189 commercial buildings in Nairobi, 89.4% were privately owned with 56.7% belonging to individuals and 32.7% belonging to private companies. Public and parastatal owned buildings constituted only 9.3%. She further noted that these buildings were held for long term investments as part of a portfolio. It is therefore imperative that for these investors, returns is top in their motivation to own real estate. Before an investor undertakes a real estate investment, he will consider his financial position as well as availability and cost of finance.

Since large sums of money are required in real estate investments, very few investors are able to supply all the required funds and hence the need to borrow. However, even if the investor has enough money for the project, he may choose to borrow anyway and use the excess equity to buy other properties. Because equity fund can be spread over several properties, the investor could reduce the overall risk of the portfolio. In this regard, availability and cost of financing is of great importance for any healthy real estate investment climate. This is the basis of real estate investment financing.

In Kenya before the 1980s, short term finance was generally provided by banks in the form of secured loans against the site and sometimes other buildings. Long Term financing was pre-arranged and provided by insurance companies, international bodies like International Finance Corporation and Industrial and Commercial Development Corporation (ICDC) in the form of fixed interest mortgages (Kituuka, 1981). He further noted that property loans had been very popular but its funding had been extremely inadequate to cope with demand. The tendency had been therefore to confine the loan scheme to new construction rather than existing premises.

At that time, ICDC offered loans up to 80% of the cost of construction with maximum loan by the year 1979 being Kenya Shillings Four Hundred Thousand Only (Kshs 400,000) repayable over fifteen years at an annual rate of interest of 12%. He further noted that this scheme was workable for properties within urban centres and had been inadequate to serve the interest of the small rural properties with lower rental values and relatively high construction costs. The terms of repayments were based partly on the amount of rent that a property generated and partly on the amount of loan. These repayments could only be met by the urban projects with higher rental figures and generally low construction costs due to existence of basic infrastructure.

This situation still manifests itself with loans for rural development still difficult to qualify for. Also urban property owners find it quite challenging to meet the repayment obligations within the first five years of the property development before it is fully let (Syagga, 1998). Occasionally the development would not be retained by the developer but sold as an investment to the insurance company or directly to an occupier. This was in the case where a developer could not arrange suitable long term financing. For example, Syagga (1998; 85) noted that in Kenya, approximately 52 financial institutions (both banking and non-banking) provided either bridging finance on short term basis (3 -5) years and / or end finance on long term basis (10 -20) years.

The period of three to five years was quite short hence most investors were unable to arrange suitable financing. It was rare for the financier with exception of some banks to participate in the profit or risk of development. With time, this changed and today some financial institutions like Housing Finance Company of Kenya (HFCK) and Savings and Loans Limited are actually involved in every stage of the development of properties that they are financing both residential and commercial properties for rental or sale.

As inflation became a permanent feature in our economy, the financiers saw the disadvantages of granting fixed interest mortgages and wanted to participate in the rental growth. At the same time, long term interest rates rose and the developers were faced with an initial shortfall of income mortgage interest and capital repayments often referred to as “reverse yield gap”(Kaberere ,2002), which has remained almost a permanent feature in property financing. Thus insurance companies became less inclined to grant mortgages and developers were forced to give away some share of the future rental growth in order to close the gap. This led to lender participation in the investment.

Kituuka (1981) noted that in Kenya ,this took the form of mortgage participation loans whereby the lender contracts to receive in addition to the conventional debt services payments, a share of the annual income produced by the project being financed and or right to participate in some or all the proceeds which accrue to the equity in the property. An active property market emerged and the traditional division of roles of short term and long term property financiers began to blur. At first in order to attract best investments, long term investors began to compete with and take on the traditional role of short term financiers. At the same time some traditional short term financiers, banks began to seek a share in equity of development itself.

As competition for the best (prime) investments increased, some of the insurance companies and pension funds either on project basis or by acquisition began to take on the role of developers accepting additional element of risk, in return for a marginally better long term yield. The funding of developments on long term became dependent on the property satisfying the criteria of investors. Developers therefore had a much wider choice of financial sources. The insurance companies became more involved with the direct ownership of property and they were gradually joined by other financial institutions in 1993. They encouraged by low property values and expectation of rental growth, relative increased buying and selling and poor performance of other forms of investment (Waiganjo, 2003).

This was evident in firms like Insurance Company of East Africa, Lion of Kenya, Old Mutual, Kenya Re, Blueshield Insurance, and Geminia insurance, Commercial Bank of Africa, CFC-Stanbic Bank Limited, Standard Chartered Bank, Kenya Commercial Bank, and Barelays Bank which became direct owners of substantial sizes of real properties. The banks became the dominant source of finance during the mid 2000s, during the development boom encouraged by rapid increases in rents and capital values caused by occupier demands. They

replaced the other institutions that had reduced their property investments in the 1980s and early 1990s largely due to better performance of the other forms of investments such as equities (stocks and shares), compared with the poor performance of the property during that time and due to government regulations dictating how much pension schemes could invest in real estate.

To date the sources of commercial real estate financing largely remain the commercial banks, venture capitalists and international bodies like International Finance Corporation (IFC). One of the biggest challenges however remains the problem of deposit to loan duration mismatch.

## **2.7 STRATEGIES OF PROPERTY DEVELOPMENT FINANCING**

There are many methods of obtaining development finance in the world over. The history of various sources has been discussed above. The last decade has seen an increase in demand for real estate finance vehicles. It has also witnessed some innovations in this sector for example the emergence of unit trusts from old mutual insurance company. The researcher now focuses on the various conventional and emerging strategies of financing that have emerged in Kenya, their successes and shortcomings.

### **2.7.1 CONVENTIONAL STRATEGIES OF FINANCING COMMERCIAL REAL ESTATE INVESTMENTS IN KENYA**

The choice of both source and method of finance will depend on how much equity (owner's capital) that a developer is able and willing to commit to a scheme and the type of ownership. For example is it a partnership or limited liability company. If the developer has insufficient capital, then the aim is to arrange as much external finance as possible, whilst retaining as much as of the equity as possible without giving away bank or personal guarantees (Cadman & Topping, 2001). A decision has to be made as to how much risk the developer wishes to pass on to the financier in return for a share in the financial success of the scheme. The availability and choice of finance will depend largely on:

- The company's size and structure
- Financial strength of the company
- Track record of the company
- The characteristics of the development scheme to be funded

- The duration of the scheme.

These factors are discussed below under the various methods of financing. The developer also needs to be aware of tax consequences associated with the method he/she chooses. The various conventional financing methods are discussed below:

### **2.7.1.1 Short Term Finance**

According to North (1976) nearly all real estate developments require interim financing to provide the developer with working capital between the dates of the project commencement and completion. This requirement stems from the fact that the funding of the project with long term financing is normally withheld until the property has been completed and occupied by the owner or by the tenant (Brueggeman & Fisher 2008). Even though progress advances on the permanent financing are occasionally available to the builder, further funds are required by the builder to cover capital outlays during the early stages of construction cycles as well as his expenditure in excess of the periodic progress draws.

Short term financing may even be used to purchase and service land prior to the commencement of construction. Additionally, developers also have front end and indirect costs of planning, architectural work, accrued property taxes, professional and other disbursements which have to be met during the development period. The following are the forms of short term financing that are available in the Kenyan market.

#### **a) Bank Loans**

Banks usually provide short term development finance either on a rolling or project basis. This can be by means of overdraft facilities or short term corporate loans secured against assets of the development company or project loans secured against a particular development. For many developers especially smaller ones, forward funding is difficult to obtain as they are unable to provide the required guarantees. Also prime properties acceptable to funding institutions represent only a small part of the market and to some extent and has been discussed above, tend to be geographically restricted to major towns.

From the developer's point of view, borrowing from the bank allows greater flexibility and enables him to benefit from all the growth, unless some of the equity is given away. He can repay or refinance the debt when the time is right and sell the completed project at a higher

price (Brueggeman & Fisher, 2008). In addition he will not be subject of degree of supervision through the development process. If the market conditions are good where rents and capital values rise rapidly, it is more profitable for developers to arrange debt finance as opposed to equity finance for the above reasons. This method of financing has been employed by some developers in Nairobi like Eden Square in Chiromo road whose construction was initially financed by Barclays Bank of Kenya and then refinanced by Commercial Bank of Africa. The different types of bank loans available in the Kenyan market today include:

**(i) Development and Construction Loans**

The terms development and construction loans are always used interchangeably although they mean different things to lenders. North (1976) defines them as follows:

Development Loans – is a short term loan of up to three years for the purpose of acquiring and servicing land. Once the land is sold by the developer, then the proceeds go towards the repayment of the loan.

Construction loans – this is a type of interim financing designated for the actual construction of the project. Funds are disbursed to the builders as need for working capital arises. The developer will repay the construction loan out of the proceeds from progress draws from the long term financing. Commercial banks usually provide the bulk of interim financing. However North (1976) warns that “banks lack experience and expertise in commercial real estate and this is reflected in their conservative approach to non- residential construction financing”.

This is evidenced in the Kenyan case whereby the two real estate specialized lenders Housing Finance Company Limited and The Savings and Loans Limited have tended to concentrate in residential property development. For commercial property financing, the credit approval is slow, the availability of funds limited, and a line of credit may only be permitted on one project at a time. These sentiments were also echoed by Kituuka (1981) when he noted that in general, Kenyan banks are considered to be extremely conservative in their appraisal of loan applications with stringent collateral requirements including credit guarantees by directors.

Procedural aspects also posed problems; loan appraisal procedures often took an inordinate amount of time often measured in months rather than weeks and Small and Medium



Enterprises (SMEs) are kept at bay with continuous requests for additional documents. Moreover, the intimate relationship between large financial institutions and relatively a small number of key players in the economy generates the impression that money usually goes to the same people thereby depriving SMEs of the necessary support.

This is a sad state of affairs that reflects the situation in Kenya. There are numerous complaints from the upcoming developers who are unable to raise financing because they do not have existing track record or are not known to bank officials. This was witnessed when the author was involved in sourcing for financing for an upcoming office development in Karen, which got delayed for three years. This was because the prospective financiers kept demanding for unachievable requirements like pre-letting off plan which is a difficult to achieve in a market like Kenyan one.

As was indicated by Murigu (2002) most occupiers in Kenya will usually only commit themselves to a building as it nears practical completion or when it is finished. The purpose built market in Kenya is also very limited, making majority of construction speculative. Tenants tend to be cynical about developers time and quality statements and calculate that the threat of unoccupancy provides bargaining lever as a scheme nears completion. For example in Karen Office Park, even when a financier eventually came along, they took a record six months carrying out due diligence on the developer before they could commit their money on the project. This caused substantial delay in the project delivery and hence claims from the few tenants who had already committed themselves.

## **ii) Corporate Loans**

The development company may arrange for overdraft or loan facilities with their banks. Here the bank is concerned with the strength of company, its assets, profits and cash flows. This type of finance is more appropriate for investor developer or large developers rather than trader developer or small developers as they have large asset bases which can provide the necessary security for bank borrowings. Corporate loans can be obtained at lower rates than project loans. Again, the problems of small scale investor are attenuated here. This leads the author to suggest that a small or growing firm without a high credit rating and strong background of earning often finds it extremely difficult if not impossible to obtain loan funds on competitive basis.

### iii) **Project Loans**

These are loans which are secured against a specific development project. Banks will usually provide 65 – 70% of the development value or 70 – 80% of the development costs while the developer provides the balance of the money required for the development from their own sources (Cadman & Topping, 2001). The bank limits their total loan to guard against reduction in the value of the scheme during the loan period. In addition, they insist on equity injection by the developer to commit him and also to encourage him to complete the project. He is also responsible for any cost overruns. In Kenya, most banks prefer pre-let or pre-sold developments as they represent lesser risk to the bank than a totally speculative one. Lending conditions vary according to perception and confidence in property market.

Project loans are attractive to smaller trading companies as they are not worth enough to fund their full development programs through corporate loans. For larger companies these loans can be carried off the parent company balance sheet by forming a joint venture with the bank and the subsidiary company. In Kenya currently there are a rising number of developments whereby the banks and the developers have partnered to develop projects and at the same time the bank gives end financing to the buyers. Good examples are Housing Finance (HF), Kenya Commercial Bank (KCB) and National Bank of Kenya (NBK).

When the bank lends against a particular development, it will form part of the security for the loan. The developer will need to forward the project details, market study, feasibility study and valuation to the financier. At the least, the bank will need to ensure that the property is well located, the developer has the ability to complete the project and that the scheme is viable. However, here the banks views the scheme as a form of security and not an investment, hence is more concerned with the underlying values of the scheme rather than details and specification (Brueggerman & Fisher, 2008). The valuation forms the most important part of the presentation together with supporting information and market analysis and feasibility study.

Also interest rates on investment loans will be lower than that of speculative development loan. It is against this background that most developers in Kenya are striving to pre-let or pre-sell their schemes albeit with much difficulty in a market where occupiers believe in first seeing the finished product before committing themselves. The developers are employing wooing techniques by even offering discounts to early buyers and rent free periods to early

renters. A case in point is 14Riverside where tenants are getting up to six months' rent free period if they sign lease agreements prior to completion of the construction which is slated for December 2010.

Interest rates on short term loans are likely to be floating. The bank also considers the affordability of the loan either by sale of completed project or refinancing from another bank. This is because the rental income on completion of a project is usually not enough to cover interest costs on the loan due to reverse yield gap problem. The bank will also protect its security by obtaining a first charge on the site and the development. In the event of default, the bank will be able to obtain ownership and step into the developer's shoes which may require an assignment of building contract and any pre-sale or pre-letting agreement. These charges are registered against the title as encumbrances and can only be discharged once the borrower completes the obligations.

Like a forward funding institution, the bank will also require collateral warranties from professional team. Guaranties may be required from parent company or third party if financial strength of Development Company is considered inadequate. A full recourse loan will involve a parent company providing a full guarantee on the developer's capital and interest payments together with a guarantee that the project will be completed.

In the developed world like the United Kingdom (UK), during the 1980s, limited or non-recourse loans became attractive proposition to developers wishing to finance their projects whilst providing limited or no guarantees. With limited recourse loans, the parent company may only have to guarantee costs and interest overruns. A non – recourse loan involves no guarantee with the only security for the bank being the development itself. However the parent company is still responsible and it would be difficult for the developer to walk away from the scheme without damaging their reputation.

The financier usually imposes several costs and fees which are payable upfront by the developer. These include appraisal fees, presentation costs, and arrangement fees, management fees, and commitment fee on the part of the loan not drawn down initially. According to an interview with loan officials of Housing Finance Company of Kenya Limited, these costs would be anything between 5 – 7% of the value of the loan.

#### **iv) Investment Loans**

Development companies wishing to retain the development can secure an option to convert the project loan into an investment loan on completion of the project once it is let, usually up until the first rent review or escalation, (Cadman & Topping, 2001).

Alternatively, the developer can agree a combined project and investment loan from the outset. Also the developer may be able to refinance the loan on completion on better terms. This is a motivating factor for some developers and hence they usually choose to refinance on project completion. For example Eden square on Chiromo Road, Westlands was refinanced by Commercial Bank of Africa at lower rates of interest (4%) after completion after having been financed by Barclays Bank of Kenya during construction. On investment loans, banks usually lend up to 75% of the value, but there is also the problem of the rent not covering the interest payment.

Banks wish to see the interest covered by the rent income, and therefore can limit the loan. This may be relaxed where the property is reversionary (let below market rent) or the parent company guarantees the short fall interest. Otherwise the developer may be required by the bank to cap interest rate or to rearrange payments on the loan. Interest rates on investment loans are usually lower than far riskier speculative projects loans and the risk to the bank will depend on the financial standing of the tenants. In this regard, banks will insist on approving any leases or sale agreements and endorse the same before they are registered against the title.

#### **v) Mezzanine Finance**

Cadman & Topping, (2001) indicates that a project loan may be split into different layers known as senior debt and mezzanine debt. If the developer is unable to provide normal equity requirement or wishes to increase the amount of the loan to cost ratios, senior debt may represent the first 70 – 85% of the development depending on whether the development is pre-let or pre-sold. The developer may then raise additional money by way of mezzanine finance which may involve him losing some of the equity or taking out insurance policy. As this level of mezzanine finance is quite risky, the bank will usually charge a higher interest rate than that of a senior debt or require a share of the profits of the development.

They will also require full guarantees from the parent company. If mortgage indemnity is taken out on the entire loan or the mezzanine layer, it will reimburse the lender if the loan is not paid in full and will involve the developer paying a substantial amount of premium to specialist insurance company. Equity sharing with the bank may involve profit share or an option on legal interest in the scheme. Sometimes due to tax implications, the profit share is expressed as a fee in which case a bank will become part of the development team and become involved in the decision making process.

Kituuka (1981) observed that in Kenya, quite often equity investment has gone hand in hand with lender participation in decision making in a project. He further noted that lender participation can take the form of mortgage participation loan, whereby the lender contracts to receive in addition to the conventional debt repayment, a share of the annual income produced by the project being financed and / or rights to participate in some or all of the proceeds which accrue to the equity in the property. The distinctive feature of income participation is that the participation arrangement is extinguished with the maturity of the loan whereas; equity participation has been associated with indefinite terms that may persist beyond the loan maturity. It is therefore in the interest of the investor to strive to get as much financing from the lender as possible without giving away his equity rights.

#### vi) **Syndicated Loans**

When the necessary development finance needed is too large, then it can be borrowed from more than one bank. For example, in the late 1980s many large office projects in the city of London were financed this way (Cadman & Topping, 2001). The lead bank is usually an established property lending bank with necessary expertise employed in-house, will arrange the syndication of banks. The lead bank may underwrite the entire facility or agree to use its best endeavors to secure the syndication. The lead bank usually has the final responsibility for making decisions on behalf the syndicate during the period of the loan.

In Kenya, such a bank would be Housing Finance or Kenya Commercial Bank through its Savings and Loans arm. There are also some private institutions like Renaissance Capital (K) limited that have arranged a syndicate to finance large development projects like satellite city development or infrastructure construction like the proposed Tatu City in Kiambu County which is expected to house some sixty two thousand (62,000) residents and twenty three thousand (23,000) daily visitors upon completion in ten years time.

## vii) **Interest Rate Options**

The developer may wish to protect themselves from the risk of changes in the base rate or LIBOR over the period of the development project especially when the market is uncertain. In this regard, he may seek a fixed interest loan. However; this may lead to the company being tied for a long time to a high interest rate and not being able to benefit from the subsequent reductions. Such was the case in the 1990s where the prior borrowers who had fixed rate mortgages were unable to benefit from the prevailing low interest rates that had occurred over time. Therefore developers may compromise and try to hedge the risk that interest rates will raise during constructions, but this is always at a cost.

The usual form of interest hedging is 'capping' which limits the amount of interest the developer will have to pay and is similar to insurance policy. For example a loan that is linked to LIBOR the bank will reimburse the developer the cost of interest over and above cap rate. Cadman and Topping (2001) however warns that hedging is more difficult on a speculative development loan than on loans for income producing investment properties due to uncertainty of the amount of loan outstanding at any one time.

### a) **Sale and Leaseback**

This is alternative to forward funding whereby the developer retains an interest in the investment created by the development. This form of arrangement was dominant in the 1970s and 1980s however today; most institutions prefer to retain total control. A sale and Leaseback involves the freehold of the scheme passing to the fund on completion, with the fund simultaneously granting a long lease to the developer, who in turn grants a sublease to occupational tenants. There are many variations to this method with two common ones being top sliced or vertical sliced.

a) **Top Sliced** – The fund receives rent form the developer in accordance with the required yield. He then retains any profits from letting at a higher rent, than payable to the fund. However if the developer's lease with the fund has an upward only escalation, then his profit may be rapidly eroded over time. Hence meaning that the developer's profit may only be scalable to the fund.

b) **Vertical Sliced** – This is a better option for the developer as him and the fund share rental income from the property in relation to an initial agreed percentage throughout the

length of the lease. Institutions prefer to enter into a sale and leaseback directly with occupiers to create attractive property investments with tenants of good financial standing.

Sale and lease back are not common in Kenya. One recent example is of the recent sale of Stanbank House on Moi Avenue, Nairobi by Standard Chartered Bank to a private investor while the bank retained the occupation of the ground floor under a lease from the new owner. This was a precondition for the sale and was made part of the sale agreement. (Knight Frank: September 2010).

### **2.7.1.2 Long Term Financing**

This is sometimes referred to as permanent financing and it refers to long term debt capital which is acquired by a real estate investor, either to conserve or to extend the amount of cash equity in the property or to enhance equity holders rate of return through leverage. In the development process, long term financing is often required to extinguish the short term or interim financing once the project is completed (Brueggerman et al, 2008).

The following are the various forms of long term real estate financing:

#### **a) Commercial Mortgages**

Mortgage has been described as a conveyance of land or an assignment of chattels as security for the payment of a debt or the discharge of same mortgage transaction; consist of transfer of the legal or equitable title to the property from the borrower to the lender to be held by the lender until his claims under the mortgage are satisfied. The borrower's right is to have the title restored to him on fulfillment of his obligations to the lender even if he does not do so until after the contractual date of that fulfillment Cousins (1989) as cited in Waiganjo (2003).

Fisher and Lockwoods (1989) as cited in Waiganjo (2003) while writing on the law of mortgaging defines a mortgage as security created by contract conferring interest in property, defensible upon performing the condition of paying a given sum of money with or without interest or of perform some other condition. In simple terms, we can therefore say that a mortgage is a loan secured on a property whereby the borrower has to repay the capital loan plus interest by a certain date.

Real estate has various advantages that enable it to be preferred security for debt. Its immovable, has capacity to appreciate in value over time and often earns financial returns by

way of rent or outright sale. Because of this, many lenders are willing to provide debt capital for real estate purchases or developments as long as their assets seem adequate collateral for the loan. Waiganjo (2003) noted that a legal framework for real estate financing in Kenya as security does exist and if the borrower should default as the loan, the value of the property can be used to satisfy the debt.

North (1976) and Clauretie (2006) noted that mortgages are a relatively attractive investment, however, in that they offer comparatively high yields, and afford a considerable degree of security of capital and income. On the downside, the mortgages are illiquid and are an investment which is relatively expensive to administer. Cadman & Topping (1995) disagreed with North's and Clauretie's position as they observed that "today, not many lenders are interested in long term non – equity participating loans such as mortgages especially in commercial property segment. From their perspective, a mortgage is a fixed income investment which is very illiquid.

Indeed the specific characteristics of real estate such as its illiquidity, indivisibility and difficulty in transacting and managing make it unattractive owning. This is the reason why fund managers collectively in Kenya own only 6% of their portfolio in real estate. Hence, commercial real estate backed mortgages are extremely difficult to liquidate if the financier was to find another investment opportunity with a higher Net Present Value (NPV), especially in a country which lacks secondary mortgage market like Kenya.

Mortgages are also perceived by a section of investors as quite complex. When discussing the problems of mortgage participation in terms of industrial building, Kinrad and Messner (1976) as cited in Kituuka, (1981) have felt that perhaps the most distinctive characteristics of this new form of mortgage loan contract are the virtual uniqueness of each contract and the related complexity which is introduced to the financing of the industrial space. Complicating the situation further is the fact that typical international lending agencies capable of funding large developments make loans in foreign currencies to cover foreign exchange components of the project in developing countries. However a large part of the demand for funds in the industry by private sector is for local currency.

This has led some real estate developers to charge rent and service charge in different currencies. For example in Nairobi, Eden Square in Chiromo Road , Westlands and Landmark Plaza on Argwings kodhek road charge rents in US Dollars to go towards repaying



the US Dollar mortgages and service charge is in Kenya Shillings to go towards paying for operating expenses all of which are chargeable and paid for in the local currency. The reason for charging US Dollar rent is to cushion the developer from costs of currency fluctuations which occur as the Kenya Shillings gains or losses strength against the US Dollar. This concurs with Mikesell (1966) observation that in his experience most medium and small scale firms do not want to undertake foreign exchange risk involved in borrowing directly from international institutions or even from national development banks that pass on the foreign exchange risk.

Some banks, building societies and life insurance companies provide mortgages on commercial properties. Mortgages may normally be granted on a loan to value ratio of between 60 – 80 % depending on the security being offered by the borrower in relation to the quality of the property, the financial standing of the tenant and the borrower. It is rare to get fixed rate mortgages in Kenya (Kaberere, 2002). Demand for mortgages is further limited due to the reverse yield gap. Various methods have been developed to overcome this initial deficit problem caused by difference between the rental income and the loan repayment over the first 5 – 10 years. Interest repayment might be fixed at a certain period and then converted into a variable rate. Some borrowers do not want to be exposed to variable interest rates and may negotiate what is termed as a drop lock loans which allow the borrower to switch from variable rate interest once the rate reaches a certain level. In Kenya mortgages run for between five to fifteen years depending on the financier and terms of the mortgage (Waiganjo, 2003). They are however popular with end user residential purchases than commercial property financing.

## **b) Corporate Finance**

There are various ways of raising equity and debt finance from institutional investors via the stock exchange. Some of the most commonly used methods include the following:

### **1) Equity finance**

**i) New Shares** – companies may raise money by selling shares to investors in a floatation of the stock market. These could be ordinary shares (share in the equity of the company). These shareholders have voting rights and share in the risks and profits of the company. Profits after tax are distributed to them via dividend usually half yearly. The other

is preference shareholders who rank above the ordinary shareholders in the entitlement to dividend payments. However they do not have voting rights and do not participate in any growth in company profits. Recently we have experienced various Initial Public Offers (IPO's) as a means of raising finance to name but a few like KenGen, Safaricom Limited and Cooperative Bank.

ii) **Rights Issues-** A company can raise additional capital by offering existing shareholders the right to purchase a number of additional shares in proportion to their existing shareholding at a lower price. The ability of a company to raise capital through a rights issue will depend on the stock market conditions, the state of property market as measured by property share performance and the Net Asset value (NAV) per share.

In the UK, during 1993 and 1994, several companies successfully raised capital in the stock market via rights issue as the property share prices performed well, while only marginally diluting the Net Asset Value (NAV) of their shares (Cadman & Topping, 2001). Here in Kenya we witnessed Kenya Commercial Bank rights Issue in the year 2009.

iii) **Retained earnings-**This is a source of finance from the company's own resources generated by profits. Some profits will have to be distributed to shareholders as dividends.

## II) Debt Financing

Debt finance instrument may be secured on specific property assets or the property assets of the company as a whole. Alternatively, they may be unsecured where investors have to rely on the financial strength and track record of the company. The following are some of the debt financing strategies employed by corporate in real estate investments.

a) **Bond Financing** – This is an 'I Owe You' secured on specific investment property or completed and let development owned the company. The bond route is a traditional alternative way for a corporation to raise debt capital without issuing shares or applying for a mortgage loan. When a corporate elects to follow a bond route in real estate financing, the terms and conditions of issue (prospectus) are prepared by an agent appointed by corporate borrower and issue to the market for subscriptions. For example, the government of Kenya plans to issue the 31 billion shillings infrastructure bond with a coupon of 6 percent redeemable over six, seven and nine years. The central bank has been in the driving seat of

lowering rates so they couldn't issue a bond with a higher yield than that of similar bonds in the secondary market," said Duncan Kimani, head of fixed income at Bank of Africa at a press conference by (Reuters, 3.08.2010).

Infrastructure bonds have been popular in the East African nation's debt market, ever since their introduction in 2009, mainly because earnings on the bonds are tax exempt to encourage investors. This will be Kenya's fourth infrastructure bond. The last issue in February 2010 was worth 14.5 billion and the inaugural one in early 2009 was worth 18.5 billion shillings. Jackson Kitili, central bank's director of monetary operations and debt management, said "We want 31.6 billion shillings and we are going to have it amortized at sixth, seventh and ninth year. Most of it will be at the sixth year," (adopted from a Reuters Article by Duncan Miriri and George Obulutsa in Nairobi, on August 3, 2010, 3:40 pm

North (1976) notes that the principal advantage of using bond route is that the borrower can occasionally raise debt capital in the amount up to 100% of the cost of the real estate project as long as the cost of the venture does not exceed its market value. The investors in bond receive interest annually, and their initial investment is repaid at a specific future date. Bonds are securities that can be traded in the stock market, the interest rate (known as coupon) can be structured to avoid the usual problems of rental income shortfall. For example, with a stepped interest bond, the investor receives low interest rates initially which rises at each rent review.

An alternative is the zero coupon bond where an annual interest is repaid but the investors are repaid on the redemption date at a premium. However both these types of the bonds rely on rising property values and many such bonds have to be restructured through negotiation with investors.

ii) **Debentures** – These are issued by company to institutional investors whereby the institution effectively lends money at a rate of interest below the market levels in return for a share of the company's growth. The money is typically lent long term usually up to 30 years at a fixed rate of interest and is secured upon the company's property assets. Normally security is specifically related to the named property but sometimes provision is made to allow the company to substitute one property for another subject to agreement on valuation.

iii) **Unsecured Loan Stock** – Property companies may issue to institutions unsecured loan stock (not secured on the assets of the company) at a fixed rates of interest which within a specific period, can be converted at the option of the institution into ordinary shares of the company.

## 2.8 EMERGING FINANCING STRATEGIES FOR COMMERCIAL REAL ESTATE INVESTMENT

As has been discussed above, the property and financial markets are continually trying to develop financing techniques to reduce the problems of illiquidity of property investment in an attempt to make property investment more comparable to other forms of investments. Below are some of the emerging financing strategies aimed at reducing the effects of illiquidity and indivisibility of real estate.

### a) **Unitization and securitization**

Many large projects are difficult to finance by one institution hence the need to split up the costs amongst several investors of like minds.

*Unitisation* means splitting up of ownership of property or portfolio of properties amongst several investors.

*Securitisation* is a term used to describe the creation of securities which can be traded in the stock market i.e. shares, bonds, debentures and unit trusts. Muchiri (2006) describes the concept of securitisation to involve the “investment of a modern well run corporate entity, financed by a large number of individuals who hold their claims to the asset in the form of marketable securities” Therefore the creation of securities is one way of achieving unitisation and securitisation. There have been various attempts at unitisation of large properties i.e. splitting the ownership of property into small manageable chunks allowing several investors to invest in the property.

In Kenya, it has proved difficult in practice to divide ownership of an individual property in law. For example the Sectional Properties Act of 1987 which was enacted to provide a framework for ownership of a part of a property was designed specifically for resale of self contained units and cannot adequately enhance divisibility. In fact, even the multi-dwelling

units that are being sold to individuals mostly do not apply this act. Instead they apply the Registration of Titles Act and the Companies Act. Some attempts at unitisation include:

i) **SPOTS (Single Property Ownership Trusts)** – This involves a trust owning a property and spreading the ownership among investors in the form similar to unit trusts. In the UK, this has faltered due to tax problems as the taxman could not allow the income to pass to unit trusts holders before deduction of tax. In Kenya, this is now emerging form of property investments amongst many people through the insurance companies like Old Mutual.

ii) **PINCS (Property Income Certificates)** Involves complex structure of companies and leases. A PINC is a security consisting of an income certificate, a contract to receive a share of income of the property after management costs and taxes and an ordinary share in the management company, which manages the property. As a security it is capable of being traded at the stock exchange. The investors receive the benefit of ownership, in the form of share in the income and capital growth, without directly owning the property.

In Kenya, there was an attempt for this exciting property investment opportunities was expected to take off once a new investment vehicle Rutley East African Property limited (REAP) set up shop in 2008. Sadly this plan was shelved at its infancy. It was to purchase existing (completed) properties from building owners and generate income from rental of the property. The fund could either buy the whole property or part of it. A fund can also invest within its limits, its equity in developments projects. The fund manages the property assets to maximize its returns. The fund can sell shares in itself either by way of private placement or a listing at the stock exchange which provides alternative opportunities for investors' to participate in the property market.

The fund selects suitable properties; manages them to produce attractive returns to investors. The other examples as has been mentioned above include Old Mutual Unit Trusts.

#### **b) Joint Venture (JV)**

This is where the developer seeks other equity partner(s) to finance a project. The property owner may contribute the vacant site upon valuation while the equity partner contributes the development finance. This trend is now increasing as opposed to the past when investors used low – trust model; where they would invest all alone even if this limited their potential of their

enterprise to grow. Nowadays more investors are pooling resources to share both risk and reward. Joint investments also allow participants to diversify while taking advantages of economies of scale. As they produce larger projects than they could on their own.

A recent local example is the joint venture between Lion of Kenya Insurance Company and Karen office Park Limited, whereby the latter provided the land that they own and the former provided construction financing to develop Karen Office Park , on Langata Road , Karen. At a more local level, workers have a head start in this model with their “chamas” and “merry go round”. However they need to convert those “chamas” into investment clubs and focus on the returns so that it is clear when professionally it can add value.

In Europe and the US, investors are widely exposed to both pooled investment through secondary mortgage mutual funds and real estate investment trusts. By relying on these concepts investors can participate in the high returns offered by real estate, make contributions in their country's' progress. This method may also be combined with loan financing in order to produce large scale commercial real estate.

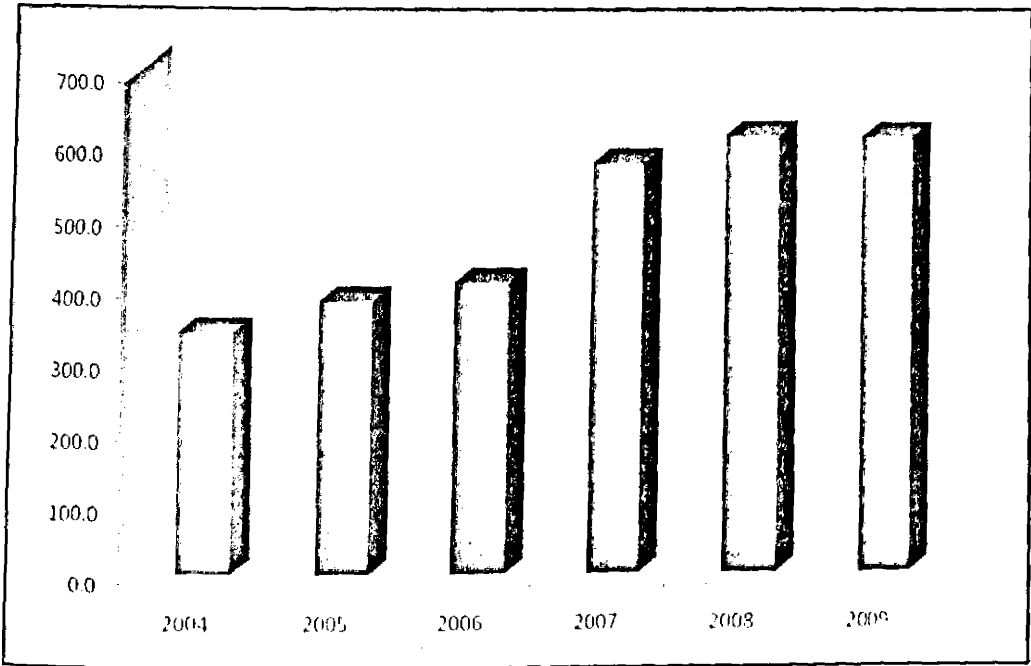
### **c) Presales**

This method has been used in Kenya to finance projects in the past and is by far the most ideal (but not necessarily the easiest to achieve) as risks are minimal and one avoids paying interest to the financiers, which has an effect of reducing returns on investment. It is common to find many projects in Nairobi both residential and commercial being sold off plan and the developers are not willing to break ground until they reach a particular percentage of sales. Banks also nowadays put presales as a pre-condition before they can finance a project. This method is also advantageous to the end purchaser as they are able to pay in installments over the construction period thereby lessening the financial burden they would have to carry if they were to make payment at one go. Those who purchase off plan also get discounts thereby standing a chance of getting higher returns from the invested amounts. It is however worth noting that presales or pre-lets is not easy to achieve in an immature market like Kenya where buyers believe in first seeing the finished products before they can commit their money to the proposed project

d) **Diaspora Participation**

The flow of foreign remittances into Kenya has been increasing remarkably over time as shown in the graph below. Total remittances in 2009 stood at US \$ 609 million (equivalent to Kshs 47.1 billion) which was slightly lower than 2008 remittances of US\$ 611 million (but higher in shillings terms equivalent to Kshs 42.3 billion due to exchange rate movements).

**Figure 4 Annual Remittances inflow to Kenya , 2005 - 2009**



Source: Central bank of Kenya website accessed on 24<sup>th</sup> September 2010

Analysis of this data shows that annual remittances have been rising steadily since the year 2004. The year 2009 was a much better year for remittances than 2008 since there were no major events like the Safaricom IPO in 2008 and the onset of the global financial crisis. But Kenyan emigrants enhanced remittances inflow in 2009 mostly for consumption smoothing due to adverse effects of domestic shocks including the prolonged drought and the post election violence in early 2008. However the return of global economic growth in the second half of 2009 has signaled a rebound in confidence both in the financial markets and production of goods and services. This rebound in economic activity, which is stronger in developing economies and emerging markets, will sustain the pick-up of remittances inflow in 2010.

**Table 2 Monthly Remittances Inflow 2005 - 2009 in US\$ '000's**

<b>Year</b>	<b>2005</b>	<b>2006</b>	<b>2007</b>	<b>2008</b>	<b>2009</b>
January	28,564	31,506	40,930	53,925	39,535
February	26,056	30,283	39,533	50,382	53,353
March	31,219	36,354	48,562	59,344	55,361
April	29,216	35,369	38,251	67,872	48,117
May	32,358	42,427	41,163	48,538	49,180
June	34,360	35,667	48,643	49,490	46,347
July	29,133	41,065	53,350	44,137	50,372
August	31,759	30,587	58,803	43,388	55,947
September	31,616	28,841	60,575	48,953	53,347
October	33,037	29,633	46,848	61,113	53,037
November	34,282	31,403	55,564	43,970	48,231
December	40,557	34,459	41,421	40,129	56,329
<b>Annual Total</b>	<b>382,153</b>	<b>407,593</b>	<b>573,643</b>	<b>611,241</b>	<b>609,156</b>

Source: Central bank of Kenya website 24<sup>th</sup> September 2010

In general, the remittances data could signal the fact that economic activities in the source markets are recovering and as such they will be significant sources of future remittances. According to Central Bank, most of these Diaspora remittances are used to support investment especially in real estate (construction) and investment in equities in the stock market.

**e) Build Operate & Transfer (BOT)**

This is a situation where a landowner leases the land to a developer for a fixed term on agreement that the lessee will develop the land, operate the improvements for the fixed term of say 20 years and transfer the same back to the lessor at the end of the term. Though the land owner will benefit marginally from the ground rent, main benefits accrue at the end of the lease when the property and developments are transferred back to the lessor. This works well where a lessor owns prime land that he is unable to raise enough funds to develop.

This type of financing is rare in Kenya, though would work well in the hotel industry. For example, the new crop of developers who are buying large coffee farms in Central Kenya,



master planning them into integrated community developments and leasing out to private developers in the specialized sector like the hotel operators to build operate and transfer after say 30 years. An example of such a scheme that is currently selling is Thika Greens Golf Estate along Thika-Muranga Road.

#### **f) Islamic Financing**

This is a relatively new phenomenon in the international financial markets which has been on the rise (Pike and Naele, 2009). Islamic banks offer shariah compliant financial products that conform to the teaching and interpretation of the Koran and Islamic scholars. The key principles in Islamic finance are the strict explicit prohibition of Riba or the earning of interest, which is off course at the core of traditional banking and finance. The other principle is the exclusion of transactions involving gambling, alcohol, porcine products and pornography. This has put Muslims around the world in difficult position when it comes to buying or developing a property.

All traditional conventional loans or mortgages consists of borrowing or buying at a rate of interest and therefore most Muslims find themselves in a difficult situation as to whether to abide by the Shariah and their moral beliefs or to coincide with the traditional western approach to buying properties. Dr. M Usmani (2002) reiterated that; "It is very important to know the definition and the forbiddance of Riba (interest) and the injunctions relating to its unlawfulness from different angles. On the one hand, there are severe warning of the Qur'an and Sunnah and on the other, it has been taken today as an integral part of the world economy. The desired liberation from it seems to be infested with difficulties. The problem is a very detail orientated and has to be taken up on all possible aspects".

In recent years, Islamic Finance is reckoned to have grown at 10 – 15 percent per annum and to be now worth £ 250 Billion globally, with some 300 financial institutions offering Islamic products (Pike and Naele, 2009). Its growth has been attributed to the various factors, principally heightened awareness and observance of Islamic principles among Muslims, the increase in liquidity in the Middle Eastern nations following increase on oil prices in the 1970s and more recently in the 2000s, the presence of certain Western Banks such as Hong Kong and Shanghai Banking Corporation (HSBC), in the middle East who are anxious to develop new products utilizing their resources and expertise and including close knowledge and experience of the local markets.

The economic philosophy of Islam has no concept of interest because according to Islam, interest is the curse in society which accumulates money around a handful of people; in addition, it results in inevitably creating monopolies, opening doors for selfishness, greed, injustice and oppression. On the other hand Islam encourages highest moral ethics such as universal brotherhood, collective welfare and prosperity, social fairness and justice. Due to this reason, Islam renders interest (riba) as absolutely forbidden (haram) and strictly prohibits all types of interest-based transactions (Usmani, 2002).

Under Shariah, interest is reckoned to unfairly reward the provider of capital or loan for little or no effort or risk undertaken. The Islamic economic model is based on a risk and profit or loss sharing contract. Islamic financial products allow interest income to be replaced with sharing the cash-flows earned from the profit making activities, in effect, converting lending and borrowing into equity based transactions. Because of this, most conventional equity products are judged to be acceptable under shariah (convertibles and warrants would be exemptions), although the distribution of the profit is based more on reward for effort rather than for mere ownership of capital. (Financial Times, 2008).

Islamic financing is however faced with many issues and controversy over Islamic financial products. Questions as to what are and what are not shariah compliant continues to be open to various interpretations among Islamic scholars. Khalaf (2008) when writing in the Financial Times magazine noted that the fast growing Islamic bond market has been seized by a fit of religious doubt. The Islamic bonds called Sukuk have been faced with growing questioning in recent months sending the financial engineers to the drawing board. There are many variants of the models of shariah complaint bonds (Sukuk). However Pike and Naele (2009) noted that they all share common feature that returns to the investor are linked to the performance of a real asset for example what is bought with the money raised. The debate over purity of sukuks underlines the wider problem of a lack of standardization in Islamic finance. Each financial Institution relies on its own shariah board to sign off products. Hence different scholars often disagree on what is Islamic even within one country.

The word sukuk itself means certificate namely the documents issued when such a deal is set up. The design of the security however resembles more conventional securitization process that sets up a Special Purpose vehicle (SPV) to acquire assets, issue financial claims on the asset and arrange for payment of returns. Sukuks come in a different structures but the most popular one involves the repurchase undertaking where the issuer promises to pay back the

face value of the bond when it matures or in the event of a default (Khalaf, 2008). When viewed from this perspective, the structure looks to like a guaranteed return, which goes against the spirit of Islamic finance where interest is banned and buyers should share the risk and profit alike.

The certificates that encapsulate these financial claims represent a proportionate beneficial ownership for a stated period. The risks and the returns that are connected with the cash-flows of the underlying assets are passed to the investor in the sukuk. The equivalent agency to the SPV is called a Special purpose Mudaraba (SPM). A Mudaraba Sukuk essentially records agreement between two parties whereby one party provides the capital required to finance the venture for the other party (the mudarib) to work with on the condition that the profit will be shared in accordance with a pre-agreed ratio, and that capital will be returned when the sukuku are surrendered. They represent units of equal value in the equity of the business venture and all investors receive returns in ration to their proportional ownership.

Mudaraba sukuku are used to enhance public participation in large investment projects such as oil field development. Sukuku that provide medium term asset finance require a further device based on leasing principles (Ijara). The cash-flows paid over to Special Purpose Mudaraba (SPM) that manages the lease contract are passed over to the investors as payments that include elements of rental and principal. While this could be thought to come close to a conventional lease or perhaps a hire purchase (HIP) contract, it should be remembered that the sukuk gives the investor beneficial ownership of the underlying asset(s) and thus participation in the earnings or fruits (usufructs) of the assets and also any losses (Iqbal, 1999) and (Hassa & Lewis, 2005).

In Kenya, the first ever fully fledged Islamic bank Gulf African Bank, started operations only two years ago in March 2008 targeting mainly the estimated nine million Muslim population. The Islamic bank boasts of a capital base of Sh1.7 billion with private equity firm Istithmar World, Bank Muscat International, PTA Bank, United Arab Emirates investment firm Gulf Cap as well as leading local and international investors forming the firm's main shareholders.

The second fully fledged Islamic bank, First Community Bank started operations in April 2008 with a capital base of \$16 million and has ten branches already. First Community Bank aims to expand abroad after a launch in its home market, Kenya, exceeded its expectations. "Within the next year to one-and-half years we should be seeing our first branch outside

Kenya," Nathif Adam told Reuters during an Islamic banking conference in Manama in April 2009. He said the bank is targeting neighbouring countries Uganda and Tanzania and has already held talks with regulators.

These two Banks offer corporate banking, housing finance, car finance, retail banking products as well as other services that conform with tenets of Islam, which are available to any individual or outfit seeking an "alternative" banking solution. Interest in Islamic banking followed the amendment in 2007 of section 53 of the Banking Act, removing prohibitions on trading in and holding of fixed assets. The amendment was intended to promote the introduction of innovative products in the banking sector, including Islamic Banking products that may require an institution to hold a fixed asset, such as in the case of mortgage financing, or goods or commodities in the case of consumer lending.

## **2.9 GOOD PRACTICE IN FINANCING OF COMERCIAL REAL ESTATE**

Financing has been identified as an integral part of real estate development without which a project cannot take off. There are a variety of the sources and methods of financing commercial property developments especially in short term. The choice, availability and affordability of funding will depend on the nature of the project, ownership structure of the investing firm, the financial strength of the developer, the value of the collateral, how much risk the developer wishes to share, loan period, the level and nature of interest rates, the religion and the confidence of both the financial institution and the investor in relation to the underlying economic conditions at a particular time. For example, a pre-let scheme being carried out by a financially strong investor presents the best proposition from a financier's point of view.

The developer therefore needs to strike a balance that will optimise returns on investment and at the same time mitigate risks associated with each financing method like interest rate, financial, currency and liquidity risks. For example, if the developer wishes to retain flexibility either wishing to retain the investment or sell it when market conditions are favourable, then debt financing is favourable only in the short run. The developer also needs to carefully evaluate risks specifically associated with real estate such as liquidity, legislative, management, financial, inflationary, sector, business and development risks through the use of market analysis and feasibility studies. The greater the risk, the less likely the developer will

be able to obtain debt financing, on favourable terms unless the developer either contributes its own capital or shares the eventual profits and capital growth.

Property has to compete with other forms of investments which offer more liquidity to the investors so funding and valuation techniques have to be developed to improve the attractiveness of the property as an investment. It is important to note that both the lender and the borrower become partners in a financed real estate venture for at least the term of the facility regardless of the terms and conditions of the loan. Both parties are in reality investors in the property and both have mutual investments objectives to maximize respective returns on investments and to minimize risk and exposure.

The lenders primary objective is that the property that is being offered as collateral security for the loan should form sufficient security in the event of the borrower being unable to meet his obligation. It therefore follows that and in line with observations of Maisel (1965) that safety and liquidity of capital should be the most important factors influencing a firm's willingness to lend, followed by relative profitability. There is inherent risk, the probability that the stated rate of return on loan or a portfolio of loans will not be received because may be a borrower cannot meet his obligation on time, the borrower is insolvent, national catastrophes have made calculated yields meaningless, and generally there is a possibility of risking the loss of the property during foreclosure because of the non-liquidity nature of real estate.

The overall objective for the investors and lenders should be to reach an equitable financing strategy. Modern trends in real estate investment decision in the first world indicate that investors and lenders are not after recovery of capital invested into buildings and plant and equipment through sale of projects or foreclosure for that matter. This is because recovery of capital through foreclosure is costly and involves lengthy procedures and litigation. The process of sale may also not cover the outstanding debt and this may call for deficiency judgment for the difference (Maisel, 1965). This may further involve equity of redemption, unless there is a trust deed or a mortgage with power of sale. The process may in the end not be beneficial to either of the parties.

In this regard, a good practice is to structure financing that is both accessible and affordable to the borrower and secure and profitable to the financier. Financiers should only regard foreclosure as a last resort. The terms of financing in cases of default should be such that the

means of recovery would be to try and improve the enterprise rather than foreclose on collateral. It should have loan workout strategies. It is against this background that both the investors and the lenders must strive to strike a workable solution that is equitable to both parties.

Whereas reduced interest rates might reduce default rates due to lesser repayment instalments, it is the proposition of this study that the most important consideration should be the availability of creative lending strategies that structure debt and equity in a manner responsive to the prevailing conditions. If debt finance is used then both the developer and the financier must have regard to the availability of long term financing and other unique requirements of both parties. The risk and return should be objectively analysed through the use of market study and appraisal which includes an analysis of the economic base of the region and the submarket. The specific data should show the vacancy rates, rents of current and future competing schemes, values of the project and the expected demand by renters. In short the lender and the borrowers must be satisfied that the occupancy and the income will be adequate to support the mortgage repayments.

The study further proposes introduction of Secondary Mortgage Market (SMM) which will introduce more players in the mortgage industry thereby increase availability of long term funding and mitigate against the illiquidity risks for commercial real estate. In order to mitigate against indivisibility risk of real estate, good practice indicates that innovative ways like real estate investment trusts should be applied.

## CHAPTER THREE

### RESEARCH METHODOLOGY

#### 3.0 INTRODUCTION

This chapter involves the ways in which the research was carried out and the research methods that were implemented for this project. The nature of this research was 'exploratory' and the technique applied was mainly qualitative in nature. An exploratory research is one that aims to seek new insights into a phenomenon, to ask questions and assess a phenomenon in new light (Saunders et al, 2003). This design was chosen in order to gather in depth information that will help define the shortcomings in the commercial real estate financing and enable the researcher to suggest the actions, which can be taken to overcome them.

#### 3.1 SOURCES OF DATA

The sources of data for this study were:

1. Data regarding the various strategies of commercial property finance available from various financial books, journals, websites and the major financial institutions including banks, building societies (if any), unit trust funds.
2. Data related to specialized property finance strategies like shariah compliant financing methods was sought from Islamic Banks, religious websites and books.
3. Data regarding the various finance options that have been adopted in the past was gathered from selected developers within the Nairobi with special focus to commercial property zones of Westlands, Riverside, Upperhill and Mombasa Road.
4. Data regarding the various methods of finance employed in other countries like the UK and US was sourced from books, journals, magazines and internet. Majorly to deepen the authors understanding of the field of real estate financing and for comparison purposes.
5. Data regarding the Government methods of raising development finance like infrastructure bonds was sourced from the Capital Markets Authority based at Nation House, Central Bank of Kenya website and the media.

### 3.2 POPULATION, SAMPLING AND SAMPLE SIZE

Population has been defined by Mugenda and Mugenda (2003) as a complete set of individual cases and objects with some common observable characteristics. The target population for this study comprises all the developers, investors and financiers of all commercial buildings in the city of Nairobi that have:

- Either invested in or financed commercial property that are income producing.
- Property that is not owner occupied. The subject property must have been acquired or developed by the current owner purely as an investment.
- Property not of temporary construction
- Property that are of sizes of 40,000 Square Feet and above

According to the reviewed literature, commercial property was defined by Clauretic & Sirmans (2006), Fabozzi (2007), Brueggerman et al (2008) to mean properties including, but not limited to the following categories of real estate:

- Multifamily properties like apartments, condominiums, maisonettes, flats and gated community housing.
- Office buildings and / or office parks
- Industrial Properties and warehousing
- Shopping / retail Centres
- Hospitality / Hotels and motels
- Healthcare facilities

This study adopted the above definitions but with a few exceptions whereby a commercial building was taken to be a structure other than single residential buildings which is developed or acquired for investment purposes only in the expectation of profit. Financing of industrial properties parse was elaborately studied by Kituuka (1981) and as such these were excluded from this study. End financing of individual residential real estate has also been studied by various authors like Kaberere (2001), Waiganjo (2003) and Musumba (2008). In this regard, the study addressed itself towards the development financing and not end user financing. The study further narrowed down to office and retail projects with a belief that the financing strategies adopted for these two types of commercial real estate would apply to all the other forms of commercial real estate.



The choice of Nairobi is based on the fact that it is the capital city of Kenya and compared to the other urban centers in the country, it has the highest concentration of commercial buildings and the headquarters and branches of all the financial institutions. As such, it forms a good representative of the other urban areas of the country.

As at December 2008, the Kenyan banking system comprised of 43 commercial banks and 2 mortgage finance companies (Economic Survey; 2009: p. 100). Before administering the questionnaires, the researcher identified an accessible population of 47 controlled banks and 13 non controlled banks in Nairobi sourced from the Central Bank of Kenya website as at 17<sup>th</sup> March 2009. These were the two existing sampling frames that the researcher relied on to come up with a representative sample as they were from Government official records. The researcher carried out a preliminary survey in the top ten real estate firms in Nairobi to find out which of the financial institutions were actively involved in real estate financing.

This was based on the number of valuation instructions that each financial institution had given each real estate firm during the property boom period between the years 2003 to 2008, (Knight Frank, 2008). The financial institutions were then ranked according to the number of valuation instructions that they had given to the real estate firms in a descending order. Since the financial institutions which were involved in commercial property finance were few and due to time and financial constraints, the researcher applied the non –probability purposive sampling method and selected the top eleven institutions to study.

The first ten offered real estate financing services while the eleventh institution, cooperative bank was in the process of launching real estate finance services. Out of the sample size of 11 major institutions that were selected, six were listed with Nairobi Stock exchange, three were controlled but not listed in Nairobi Stock Exchange while the last two were in the specialized category offering Islamic financial services only.

The institutions that had given most instructions for valuation for financing purposes and that were sampled for the study included Barclays Bank of Kenya, CFC – Stanbic Bank Limited, Housing Finance Co. Limited, Kenya Commercial Bank Limited, Commercial Bank of Africa, National Credit Industrial Bank Limited, Standard Chartered Bank Limited, Investments and Mortgages Bank Limited, and Ecobank Limited. Cooperative Bank of Kenya Limited was in the process of launching its property finance department. There were only two

Islamic financial services providers namely Gulf African Bank Limited and First Community Bank Limited which were both interviewed.

It was not easy to obtain adequate data regarding the property developers and investors in Kenya. This was due to two reasons, one, the researcher was unable to find a centralized source of this information or a database as most developers operated privately and even secretly. Attempts to get this information from Kenya Property Developers Association were not fruitful as the organization does not divulge such information to non members. Secondly, there was an observed reluctance of some respondents of the financial institutions to subscribe information about their clients as they regarded this as bank restricted matters and that they had to preserve financial secrets of their clients.

Furthermore, the financial institutions could not give this information as they feared that it could land in their competitors' hands. In this regard, the researcher relied heavily on the real estate marketing material like advertising magazines, media and property websites and then identified developers by visiting ongoing and recent developments within the commercial zones in the City of Nairobi. The zones that were sampled included:

**Table 3 Selected Commercial Zones of the City of Nairobi**

Zone	Areas Covered
1A	The city centre and parts of Nairobi Hill
1E	Upperhill
3	Westlands and Parklands
4	Kilimani and Riverside

Source: Adopted from City Council of Nairobi Zoning Regulations

The researcher identified 16 developers, owning 11 office blocks and 5 retail developments geographically spread out as follows; four in Westlands, one in Riverside, three in Upperhill, four in Ngong and Langata Roads and four in Mombasa road. Each developer that was interviewed had developed or invested in a project above 40,000 Square feet in size. This guideline was used as the author had further stratified the commercial real estate into the following groups.

**Table 4 Types of Commercial Developments**

<b>Group</b>	<b>Size (Square Feet)</b>
Small	0 – 40,000 Square Feet
Medium	40,001 – 100,000 Square Feet
Large	Above 100,001 Square Feet

Source: Author's own construct

For the purpose of this study, the researcher concentrated on medium and large projects. These are the properties that would normally cost approximately Kenya shillings 200 Million and above to develop as per the construction rates in Kenya recorded in 2009 which was Kshs 45,000 per Square Metre for high rise buildings with lifts (The Quantity Surveyor, October, 2009). The researcher considered these to be the class of properties that would normally require a combination of debt and equity financing.

### **3.3 TYPES OF DATA**

Two types of data were collected as follows:

- Qualitative data regarding traditional sources and methods of commercial property finance from financial institutions and other private sources of finance.
- Both qualitative and quantitative data to determine the impacts of the traditional and the emerging financing strategies in accessibility and affordability of commercial property financing. These include data on interest rates, loan periods and amounts.
- Both qualitative and quantitative data on the introduction, use of and success of emerging commercial property financing strategies.

### **3.4 DATA COLLECTION**

The researcher carried out a deductive approach which helped in developing a theory and proposition and further design a research strategy to prove or disprove the proposition as opposed to an inductive approach which would involve collecting data and then developing a theory after data analysis. Therefore a deductive approach was used as it defined the overall scope of this research project.

According to (Saunders, 2003), most research projects require some combination of secondary and primary data to answer your research question(s) and meet your objectives'. Both primary and secondary data were collected in order to complete the research in this project.

Secondary data is data used for a research project that were originally collected for some other purpose, the secondary data provides a starting point in research and has the advantages of being readily available and cost effective' (Saunders , 2003). This was achieved through reviewing of books, journals, website postings, annual reports of lending institutions, publicity materials, newspapers and magazines among others. Secondary data may be defined as modified primary data and could therefore possess some level of attendant distortions arising from various channels of communication through which they have passed. This therefore called for collection of primary data to help reinforce the findings of the secondary data.

Primary data is data collected specifically for the research project being undertaken. It is useful and can counterbalance the disadvantages of secondary data which may be, outdated, incomplete and inaccurate (Saunders, 2003). It provides information that is very close to reality. Extraneous and circumstantial influences in this type of data are usually available and can be factored into the analysis unlike the case of secondary data. Hence, the benefit of combining the two was complimentary to this research project.

On the other hand and as has been stated above, secondary sources of information did not fully enable the author to gather inside information from the perspective of the financial institutions thus this is where the author implemented primary research. This consisted of interviews with members of the financial institutions who provided the service of commercial property financing. Banks sampled were interviewed in Nairobi in order to establish their views on traditional financing strategies their challenges and other solutions and emerging trends in financial products. Since the study aimed to investigate the traditional and emerging trends in commercial property financing, it was of great importance to collect primary data from banks, insurance companies and developers. In addition to this, Shariah Compliant financial institutions were interviewed. This was carried out to obtain relevant and precise information required for the project.

The researcher developed the questionnaire design for financial institutions (both conventional financial institutions, and Shariah compliant banks) and developers annexed as appendices I & II). The questions in the questionnaires were short and simple including open-ended, closed-ended, Likert-scale and possibility questions. However the researcher intentionally tried using more open-ended questions to gain more of an in-depth analysis from the providers of commercial property financing in the Kenya. All the interviews were conducted in person. Institutional representatives that were not available for oral interviews were approached through telephone interviews or email and later interviewed in person as necessary.

Although the email approach was used as a secondary measure if the respondents not available, it was found to be a suitable data collection technique due to the fact that the respondents were able to answer the research questions in their own time resulting in effective and reliable results. On the other hand, the researcher did not carry out any focus groups discussions as a data collection technique because it was not possible for the researcher to bring together members from different financial institutions due to their own time constraints and the nature of this project.

### **3.5 DATA ANALYSIS AND PRESENTATION**

Data obtained from the field in raw form is difficult to interpret. Such data must be cleaned, coded, keyed into a computer and analyzed (Mugenda & Mugenda, 2003). Data presentation and analysis refers to ways and means through which raw data from the field is cleaned, coded and analyzed in order to make interpretation possible. To answer the first three objectives of the study the researcher reviewed existing related literature and administered questionnaires. The study was intended to evaluate on the implications of traditional and emerging financing strategies in commercial property development in Kenya. In order to gain in-depth information and complete the research objectives, both quantitative and qualitative analysis was carried out.

The data obtained was analyzed by the use of the statistical package for social studies (SPSS) version 12. To determine the impacts of traditional strategies on accessibility and affordability of commercial real estate financing, further analysis was carried out using sensitivity analysis relating loan amounts, loan periods, interest rates and the repayment schedules. The results obtained were presented in tables, pie charts and graphs.

The fourth objective regarding recommendations and conclusions was achieved through harmonization of findings on the above three objectives. The efficient means proposed is one capable of overcoming the shortcomings of the conventional methods of commercial property financing.

## CHAPTER FOUR

### DATA ANALYSIS AND PRESENTATION

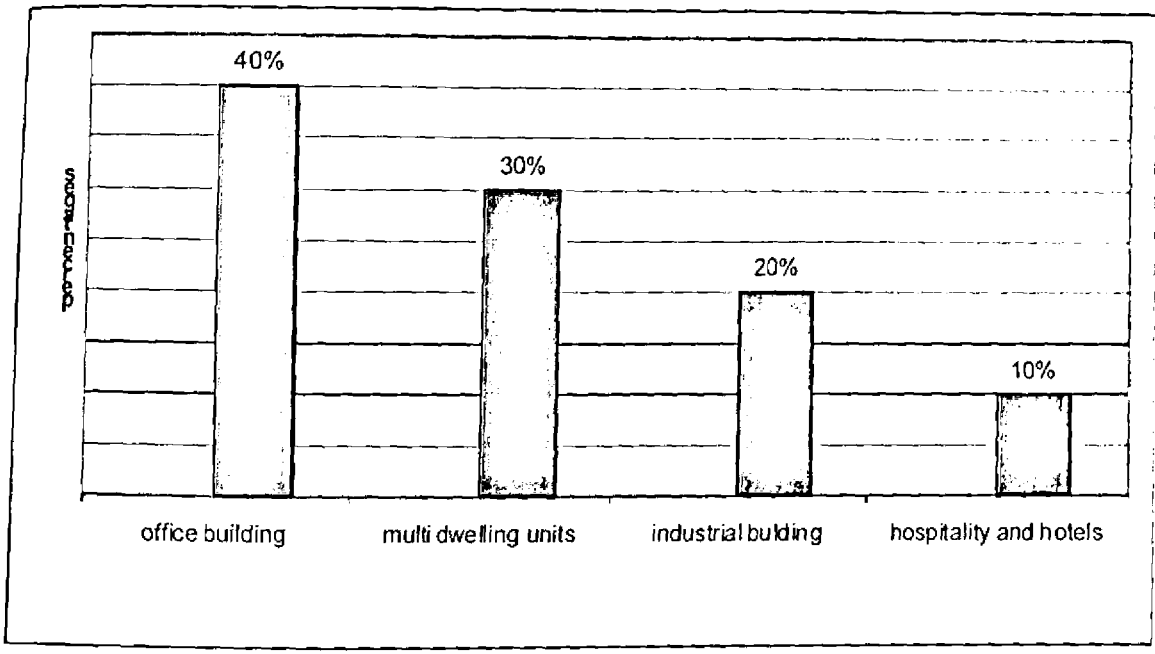
#### 4.1 INTRODUCTION

This chapter presents an analysis of primary data which was collected from the various correspondents. The findings were then related to the gaps identified in the literature review. As has been mentioned above, the data obtained from the field was analyzed by the use of the statistical package for social studies (SPSS) version 12 and Microsoft excel 2007. The results obtained were presented in tables, pie charts, percentages and graphs following the objectives listed below.

#### **Portfolio Mix of Commercial Real estate Developers**

On commercial property projects carried out by developers, of all were limited liability property development companies, 4(25%) had developed more than seven units in the year 2008, 8(50%) developed 1-3 units between the year 2006 and the year 2009 and 8(50%) developed 4-6 units within the same period. These units were situated in Lavington, Kileleshwa, Westlands, Industrial area, along Mombasa road and Chiromo road. A unit as used in this project represents a commercial office block, industrial complex, retail centre of 40,000 Sq ft and above or apartment block of at least 4 storeys and has more than four dwelling units. The portfolio mix by the organizations was as represented in the Figure 5 below.

Figure 5 Portfolio Mix of Commercial Real Estate Investors



Source: Field Survey, 2009

### Reasons for Investing in Commercial Real Estate

Even though, the literature review revealed that real estate investment is marred with a series of risks, which are either sector specific or general, the data revealed that many investors preferred to invest in it. The reasons given for investing in real estate projects differed from one organization to the other. These reasons augmented the fact that real estate is considered a good investment asset class. From the literature review, it was found out that investors invest in real estate with the anticipation that market demand for space in the property will be sufficient to produce net income after collecting rent and paying out operating expenses. This income constitutes part of the investors return before taxes and cost of capital. Other investors also anticipate selling the properties after holding them for sometime at a higher price. Yet others invest in real estate to achieve portfolio diversification together with different other investments like stock, bonds and money market funds (Brueggerman et al, 2008). The reasons adduced by the interviewees (developers and investors in real estate) included:



**Table 5 Reasons for Investing in Real Estate**

Reason Adduced	Number of Respondents	Percentage
Capital appreciation of real estate	15	94%
Stable returns	12	75%
Speculative development due to demand for premises from the locals, Kenyans in Diaspora and multinationals	10	69%
High growth rate of the development sites with high demand	10	69%
Passion for high returns	10	69%
Prestige and status symbol	5	31%
Demand for the hotels by business travellers	4	25%
High foreign investments	3	19%
Owner occupation	3	19%

Source: Field Survey 2009.

From the above analysis, the author found out that commercial property investors regarded capital appreciation as the highest motivation to invest in this sector which stood at 94% of the respondents. Investors anticipated selling or divesting from the property after holding them for some time. They expected prices to rise over the holding period particularly in an inflationary environment. Thus any increase in price contributed to an investor's return.

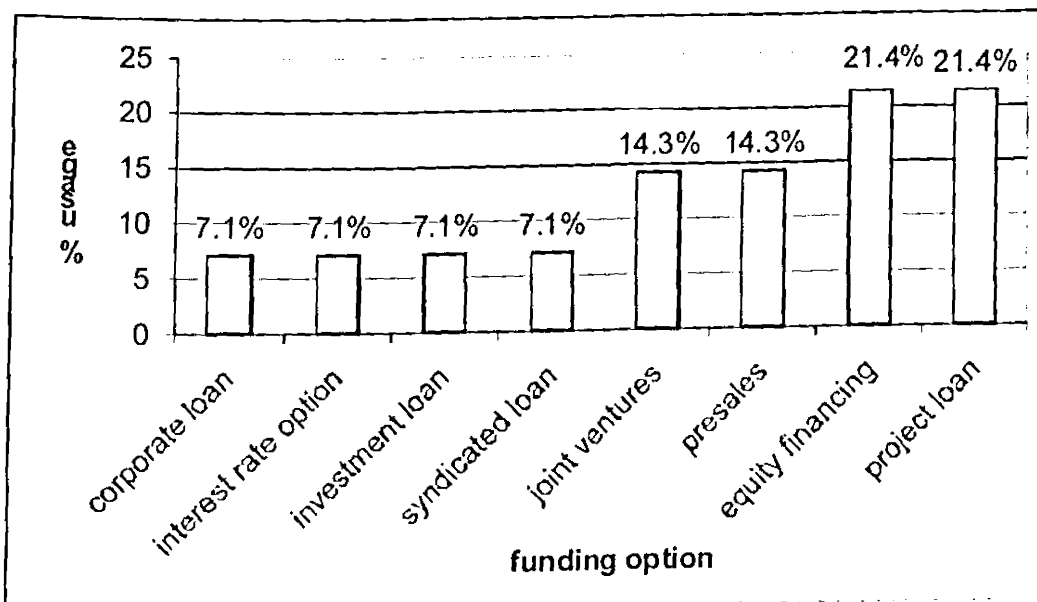
This was followed by stable returns that real estate had been enjoying as at the time of carrying out the study during the property boom which stood at 75% of the respondents. Investors anticipated that the market demand (both from locals and Kenyans in Diaspora) for space in property would be sufficient to produce positive net income after collecting rents and paying operating expenses. This income constitutes part of an investor's return before taxes and costs of finance. The other reasons that were regarded highly by the investors included, diversification of their portfolio, high price / value growth rates of development sites and passion for high returns which all tied at 69%. The least motivation for the investors was owner occupation which was only identified by 19% of the respondents.

It was the conclusion of the author that the above motivations indicate that real estate is considered a substantial investment asset class. Compared with other investments, real estate offers usually a low price risk, steady income, and a relatively high dividend yield. It therefore offers a diversification model either geographically or by type of property. With some form of innovations, it should be able to compete fairly with the other investment classes and mitigate the illiquidity and indivisibility risks. By buying shares in a Real Estate Investment Trusts (REITs), investors can add an asset to their portfolio which has a risk and earnings profile that lies between that of shares in listed non-real estate related companies and government bonds. Additionally, the low correlation of a REIT's performance with those of other asset classes can add to portfolio diversification.

### TRADITIONAL STRATEGIES OF FUNDING COMMERCIAL REAL ESTATE INVESTMENTS IN KENYA

In line with the first objective, it was discovered that there are several traditional commercial real estate financing strategies that are adopted by developers and financiers in Kenya. However, the preference of each strategy varied between the developers and investors as discussed below. Property development companies funded their projects differently as shown below in Figure 6.

Figure 6 Funding Options Used for Development Projects by Investors



Source: Field Survey, 2009

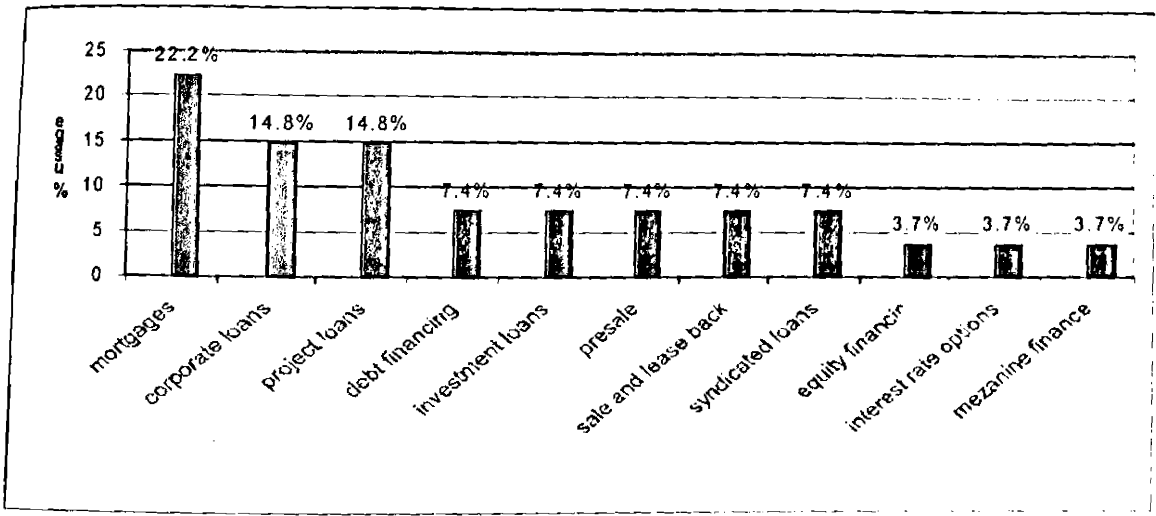
From the developers' point of view, the most popular form of commercial development financing was project loan and equity financing which stood at 21.4% each. This is in line with the literature review finding that project loans are secured on the specific project and allows the developer the flexibility to utilise other properties to secure additional funding. Equity financing was preferred by developers in order to benefit from shared risks and income. This was followed by joint ventures and presales which have come up as preferred alternatives to other types of loans like investment loans, project loans and syndicated loans. Joint ventures allow the investor to benefit from economies of scale achieved through pooling of resources.

Corporate loan financing was only preferred by large developers rather than small developers as they have large asset bases which could provide the necessary security for bank borrowings. Large developers were able to negotiate for corporate loans at lower rates than project loans.

Other financing option that was mentioned included shareholder loans. As opposed to the stringent regulations adopted by the financing institutions, the developers preferred these non-conventional sources as they were easier and faster to access and process. They could also be arranged on more flexible terms than bank loans. Unfortunately, this strategy may not raise the large capital outlay that is required for real commercial real estate investments. It was however utilised in cases where there were cost overruns and the investor was unable to negotiate for additional short term funding from the formal financing institutions.

On the other hand, 10(90%) of the financiers offered commercial property funding while the 1(10%), Cooperative Bank of Kenya did not. At the time of data collection, this particular financier was in the process of preparing a home mortgage package which was to be launched within the following year. This is a clear indication that there is still demand for real estate development finance. The forms of property financing offered by the financiers are as shown in Figure 7 below.

Figure 7 Preference of Strategies of Property Financing by Financiers



Source: Field Survey, 2009

From the financiers' point of view, they preferred mortgages as a form of long term financing standing at 22.2% of all the financiers interviewed. This is due to the fact that and as had been identified in the literature review that mortgages are a relatively attractive investment as they offer comparatively high yields, afford a considerable degree of security of capital and income. On the other hand, those financiers who did not offer commercial mortgages argued on their downside. In a market like Kenya with no secondary mortgage market, mortgages are illiquid investments which can be quite expensive to administer.

Project loans and corporate loans followed as the preferred choices of short term financing each preferred by 14.8% of the financiers. The financiers indicated that corporate loans were popular with large developers while project loans were mostly preferred by the small investors. In most cases, the bank was concerned with the strength of company, its assets, profits and cash flows. The financiers were however hesitant to give equity financing which was identified by only 3.7% of the financiers. This is due to the fact that the financiers would not like to take in the additional risks of associated with directly owning real estate like illiquidity and indivisibility risks.

# EMERGING STRATEGIES OF FUNDING COMMERCIAL REAL ESTATE INVESTMENTS IN KENYA

## Islamic Financing

Islamic financial institutions are relatively recent creations: Although the origin of modern Islamic banking was in Egypt in the year 1963, it probably would not have developed as an important financial force without the strong support of Saudi investors. The Islamic Development Bank

(IDB) was established in 1975 and gave momentum to the Islamic banking movement. Since the creation of the IDB, a number of Islamic banking institutions have been established all over the world and some countries have taken the necessary steps to organize their banking systems along Islamic lines. The first private Islamic commercial bank, the Dubai Islamic Bank, was founded in 1975. In Kenya, major banks like Barclays Bank and Kenya Commercial Bank offer some Islamic banking services within their portfolio. There are also a few fully compliant Islamic banking and insurance institutions as discussed below.

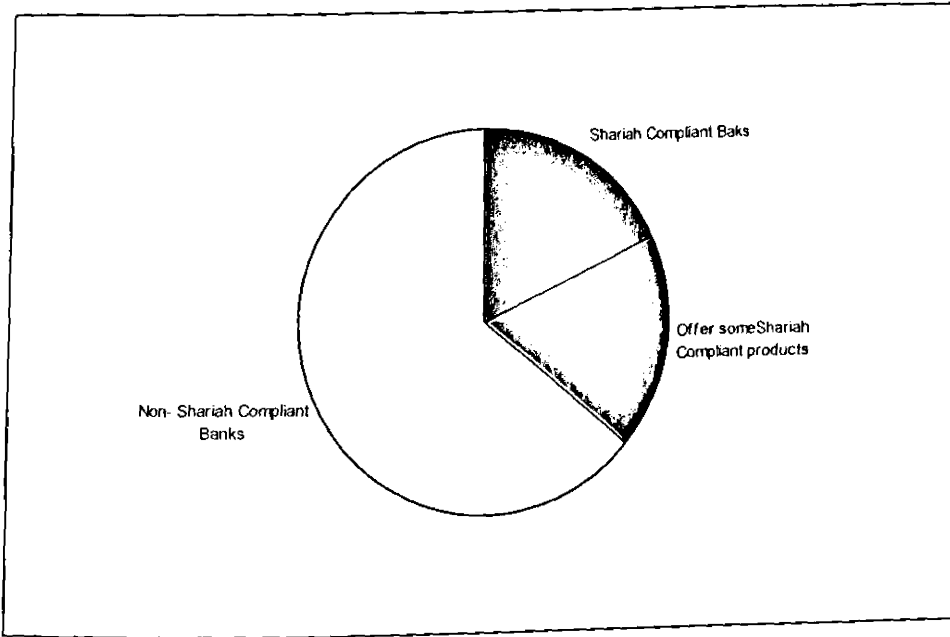
As had been identified in the available literature, the main principles of Islamic finance include:

- The prohibition of taking or receiving interest;
- Capital must have a social and ethical purpose beyond pure, unfettered return;
- Investments in businesses dealing with alcohol, gambling, drugs or anything else that the *Shari'ah* considers unlawful are deemed undesirable and prohibited;
- A prohibition on transactions involving *masir* (speculation or gambling); and
- A prohibition on *gharar*, or uncertainty about the subject-matter and terms of contracts -- this includes a prohibition on selling something that one does not own.

Out of the eleven financing institutions that were interviewed, only two (18%) had introduced Islamic banking amongst their financial portfolio. These were Barclays Bank of Kenya and

Kenya Commercial Bank. These were still at the trial stage and were mainly concentrated to the savings account. There were two (18%) fully fledged Islamic Banks namely First Community Bank and Gulf African Bank. These are represented in figure 8 below.

**Figure 8 Islamic Financing Services in Kenya**



Source: Field Survey, 2009

About the introduction of the Islamic banking and its impact on the access to real estate financing, 40% of the developers that were interviewed did not have an experience with dealings with such institutions. The other 50% thought that it is likely to impact big in the long term since it has a catchment of the 10 Million Muslims. If they embrace this kind of financing, the end result will be improved access to shariah compliant financing. The other 10% of the developers still felt that this was a new phenomenon and there is a need to still weigh on their services and their charges before jumping into conclusion regarding their impact.

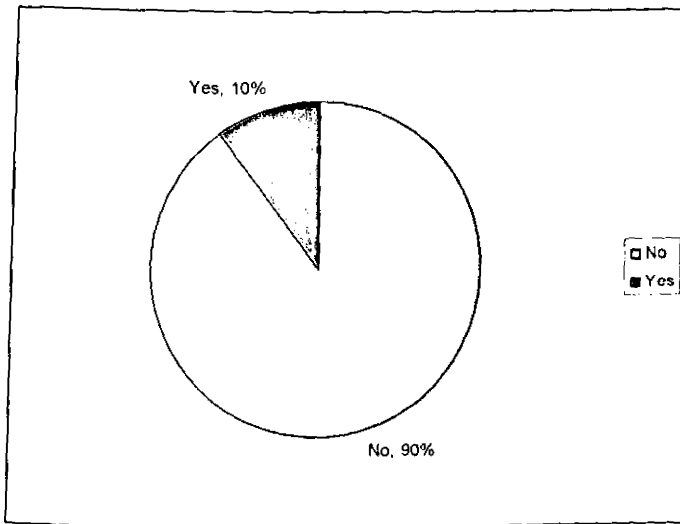
It therefore follows that this financing strategy is still relatively new in the Kenyan Market and a lot of marketing and promotion still needs be carried out to ensure that its existence and benefits is communicated to the target market. Hopefully, it will add to the variety of financing strategies available to investors and help reduce the lower the interest rates charged by conventional financiers due to competition.

## Other non-conventional financing Strategies

Only 1(10%) of the organization had introduced non conventional commercial property financing while 10(90%) had not as shown in Figure 9. for the organization that introduced, the reasons given were: that some individuals and or companies who are specifically in real estate investment might not be attracted to the conventional property financing and maybe looking at using different options to enable them access affordable and flexible financing designed around their income arrangements. This included strategies like:

- Releasing value on already existing properties.
- Attaching two or more properties.
- Using cash flow from other business to secure property financing arrangement.

**Figure 9 Other Non-conventional Financing Strategies in Kenya**



Source: Field Survey, 2009

Only three, (25%), of the financiers had special funding facilities for the clients while 8 (75%) did not. One organization had special arrangement for the Kenyans in the Diaspora who use the brokers to realize this and most financial institutions staff members enjoyed lower interest rates and higher funding levels than the market levels.

From the above analysis, it is evident that commercial real estate financing in Kenya is still lacking in innovative strategies that are equitable to both financiers and borrowers. In this regard, both parties should work together to come up with effective strategies.

## **IMPACTS OF THE TRADITIONAL AND THE EMERGING FINANCING STRATEGIES IN ACCESSIBILITY AND AFFORDABILITY OF COMMERCIAL PROPERTY FINANCING**

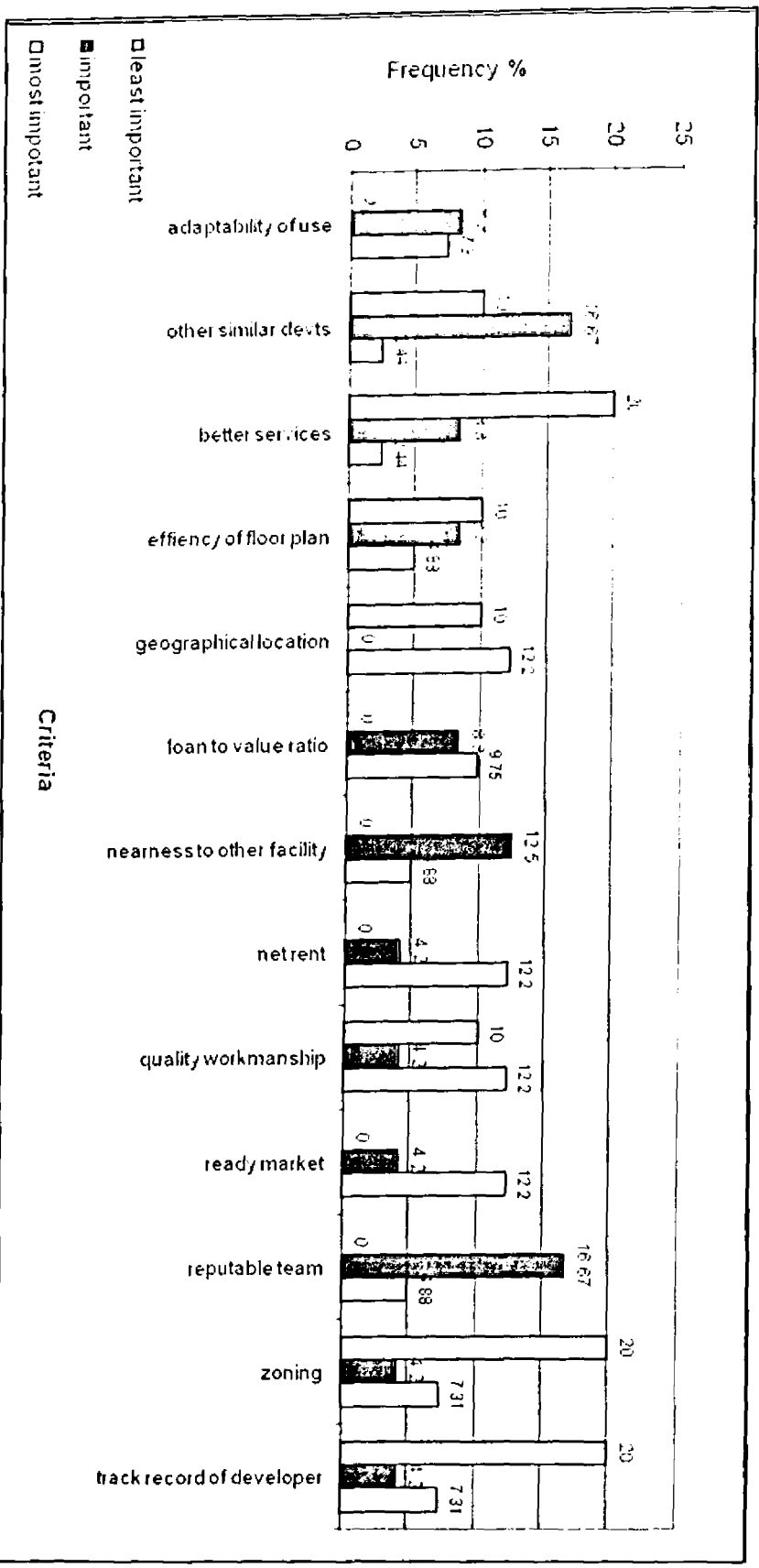
In order to answer objective number two regarding the impacts of both traditional and emerging financing strategies, the author sought to understand the criteria adopted by the financiers in choosing the properties to finance and their likely impacts on prospective investments.

### **Criteria of choosing properties to finance**

10(90%) of the financiers had a clear criteria of choosing which properties to finance while 1(10%) did not. This specific organization had not yet introduced commercial real estate financing. The developers and investors had to fulfil these requirements before qualifying to be awarded loans. This was graphically represented as shown in figure 10 below from the most important to the least



Figure 10 Criteria for Choosing Properties to Finance



Source: Field Survey, 2009

From the above, it is evident that the criteria is long and may discourage prospective investors from approaching the financing institutions. Financiers are however concerned with any factor that affects the land and marketability of the properties being used as collateral for loans. In particular, financiers are more concerned with whether properties that they are financing will generate enough cash flows to cover the loan repayments and that it forms sufficient security in the event that the borrower being unable to meet his obligation. It is this finding that leads the author to conclude that safety of capital and liquidity of capital being the most important factors that influences a financier's willingness to lend followed by the expected profitability.

All the financial institutions (100%) that were interviewed would not consider any financing transaction unless the market study and feasibility analysis confirmed that the project was financially, legally and physically viable. This was then followed by 76% of the financing institutions putting importance on the project specific information which included securing all the relevant approvals from the planning authorities, National Environmental Management Authority, clean and unencumbered title, bills of quantities and change of user if necessary. The third most important consideration was track record of the borrower which was identified by an average of 73% of the financiers. This included the business performance indications, audited reports for a period of time, guarantees from the parent company and Curriculum Vitae of the key personnel like the directors or partners.

The above findings are in line with the observations of Maisel, (1965) when he stated that lenders need to be careful because there is inherent risk, the probability that the stated rate of return on a loan or portfolio of loans will not be received because may be a borrower cannot meet his commitment on time, the borrower is insolvent, national catastrophes have made the calculated yields meaningless and generally there is a possibility of risking the loss of the property during foreclosure because of the non-liquidity nature of real estate.

It is however the proposition of this study that adequate credit assessment is necessary to ensure that only those borrowers who are able and willing to pay debts are availed credit. It will also ensure that funding goes to the deserving projects not just who has a good relationship with the financial institutions top management. This together with well laid out loan administration will reduce the financial, business and interest rate risks.

## IMPACTS OF FINANCING STRATEGIES IN COMMERCIAL PROPERTY FINANCING IN KENYA

(8)50% of the developers felt that the level of effectiveness in the Kenyan financial market in meeting the demands of the local investor was average while 8(50%) felt that it was good. The reasons given for these investors and developers were: that some institutions have been in existence for many decades like Housing Finance and thus have wealth of experience in the local market. This is the largest mortgage finance institution which has been in operation since 1965; however it is worth noting that it has been concentrating a lot in residential sector and financing by providing mortgage and saving opportunities for home buyers. As per the Banking Act Cap 488 of the Laws of Kenya, a mortgage institution must place at least 75% of its loan portfolio in residential property. It only started aggressively getting involved in the commercial real estate financing in 2008.

Other respondents indicated that banks have a lot of money to lend after making billions of profits and are very aggressive in marketing their loans and expanding by opening offices in other regions. A good example at hand is Kenya Commercial Bank which has opened branches in Uganda and Rwanda. This could be explained by the fact that shortly after it came into power in December of 2002, the National Rainbow Coalition Government reduced public sector borrowing substantially, a policy which saw the yield on treasury bills fall to less than 3% in 2004 from over 22% in 1996 (Economic Survey; 2005). This sharp drop in yield provided the impetus for banks to turn to mortgage lending, a more profitable investment avenue.

Interest rates on mortgage loans have also fallen substantially, from 31% in 1996 to 13-15 % in 2009 depending on the specific financing institution (Economic Survey, 2009). Despite this rosy picture, the borrowers still face problems of meeting their financial obligation especially in the first five years after construction due to reverse yield gap as will be shown in figure 12 below. Financial institutions also face the problem of deposit and lending period mismatch also known as borrowing short and lending long.

Only two organizations gave the credit value that they have advanced to their clients in the year 2008(average of Kshs 3.541 billion) while only one gave the value for the year 2007(Kshs 1.097 billions). Others did not give the values for reasons like: data was not available as real estate financing is done as normal corporate borrowing and not commercial

... financing as a product while others needed to be given more time to give the details ... felt that this was confidential company information that could not be divulged to the general public.

... of the financiers did not give the duration that they had carried out commercial property financing while 5(45%) gave. However the author reviewed literature relating to the ... of the various financial institutions to gather this data. The mean of the number of ... was 33.75 years, the minimum number of years was one (1) year while the maximum ... of years fifty (50). This means that Kenya has a fairly mature financial sector. The ... of developments that they have financed included: commercial and multi-dwelling ... units, office buildings, retail centers, hotels, others included expansion of special ... properties like schools while others felt that they can support any venture as so long ... applicant can demonstrate that he can repay from other business income.

The following were identified as major providers of real estate financing in Kenya as at the time of data collection:

- Housing Finance (previously Housing Finance Company of Kenya)
- Savings and Loans (S&L) under the parent company Kenya Commercial Bank
- Standard Chartered Bank
- Barclays Bank
- CIC-Stanbic Bank
- Gulf African Bank
- First Community Bank

Unfortunately, and as has been indicated above, data regarding lenders' total and annual book ... including the number of loans and their value, is not published. It is therefore not easy ... the author to accurately determine the impacts of commercial property financing.

The new entrants have introduced stiff competition and innovation in a market formerly ... by a few players and with little creativity in the design of financing products. ... of these innovations include the choice of fixed-rate mortgages, for the first time in the ... the introduction of 100% financing by one of the banks for loans exceeding Kshs 7 ... (USD 104,000) as at the year 2007; and the growth of home equity loans secured by ... properties. Debate on the introduction of a secondary mortgage market, long in the

pipeline, has also re-started, led by the Ministry of Housing and the private sector, including the chair of the Nairobi Stock Exchange.

### **Status of Commercial real estate market**

The developers had varied view on the fact that some industry players have been urging banks to freeze any lending to office developers until demand caught up with supply. Some felt that the construction of office space should slow down. Instead more residential units should be developed and financial institutions should only finance key projects. Others especially in the multi dwelling units sector felt that the demand still out strips supply and that the government has not managed to build the 150,000 residential units per annum as required in the urban centers hence the development momentum should continue. Others felt that the office rental market had an oversupply, but if the developments started now are controlled then this oversupply would reduce in two to three years time. It was generally agreed that demand for office suites for sale was still high and this should be encouraged.

The financiers explained the trend of the demand for the commercial property finance over the last decade (year 2000 -2009) that the demand had been on the rise on residential and other commercial developments especially where more profits could be reaped and this was attributed to be as a result of improved economic growth. The demand for commercial property finance had been supported by the improved availability and accessibility to credit facilities, stable interest rates, demand for commercial space and favorable government policies. This demand could even be higher if the challenges facing the financiers and investors are mitigated in an equitable manner.

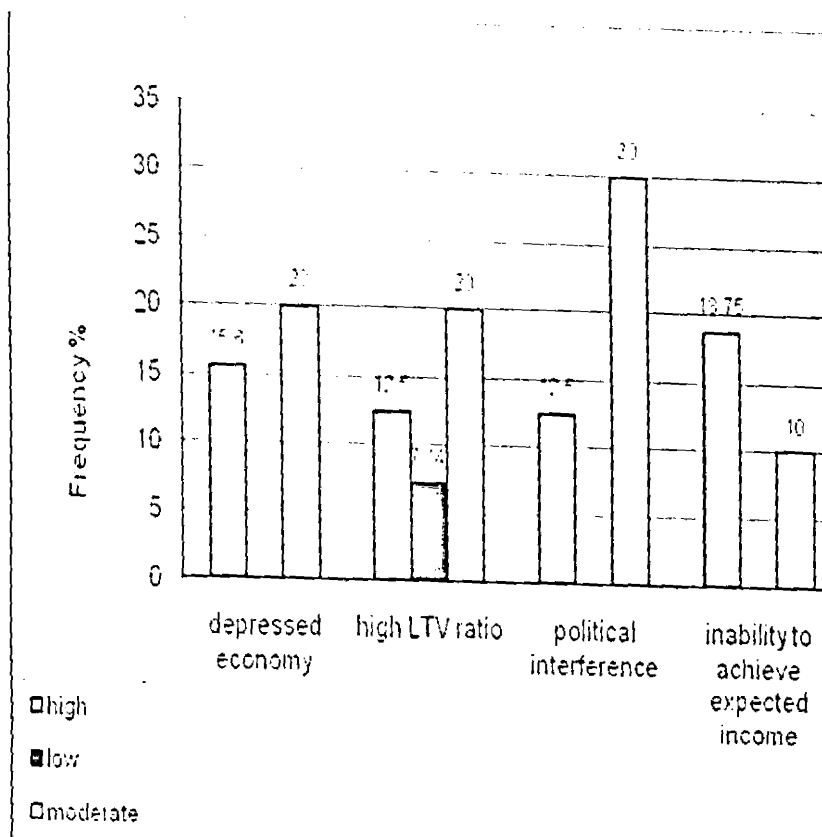
## **CHALLENGES FACING BOTH FINANCIERS AND BORROWERS IN COMMERCIAL REAL ESTATE FINANCING**

### **Unviable Financing Strategies**

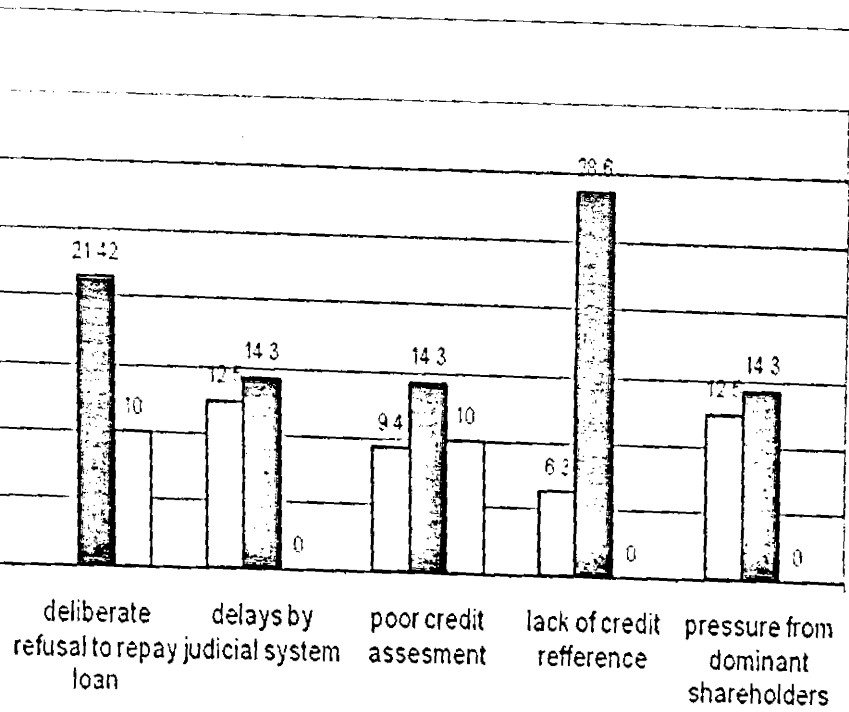
This is a situation whereby the financing option sold to the investor does not match with their income situations hence leading to difficulties in meeting the debt obligations. The financiers suggested the following reasons contributing to unviable financing strategies in Kenya.

These were represented graphically as shown in Figure 11 below.

**Figure 11**      **Reasons for Unviable Financing Strategies**



Source: Field Survey, 2009



Variables

From the above the greatest risk was inability to achieve the expected income, followed by depressed economy, political interference, delays in judicial system, pressure from dominant shareholders and poor credit assessment. Factors such as depressed economy, political interference, delays in judicial system, lack of credit reference bureau and pressure from shareholders are not within the control of either the borrower or the financiers. These therefore need to be addressed by the government through sound macroeconomic parameters, efficient judicial system and establishment of a national credit reference bureau. Other factors like inability to achieve expected income, poor credit assessment, high loan to value ratio and refusal to pay are within the control of borrower and financier and can be mitigated through objective market analysis, feasibility study and risk analysis. The financiers can therefore carry out further training for their loan officers to ensure that they are well equipped to carry out risk analysis. The market analysis and feasibility studies should be able to evaluate the marketability of the project and predict the expected income and returns based on data from existing comparable projects.

One or a combination of the above factors led to some investors settling for unviable financing strategies which eventually ended up being too expensive in the long run and hence defaults in repayments. Some of these factors are discussed below.

### **High Interest Rates versus short loan periods**

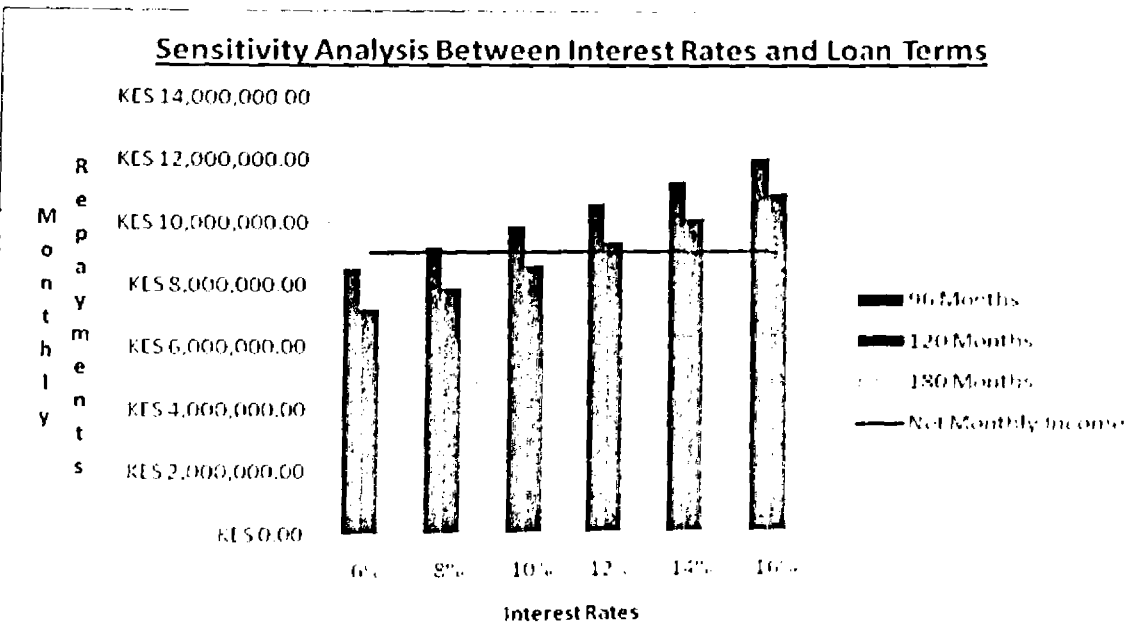
The developers and investors had different experiences in arrangement for, during draw downs and repayment of the loans. As had been discovered in the literature review, there existed a cordial relationship between some high net worth developers and financing institutions. One organization which had been in the real estate sector since the year 2000 had good relationship with the financiers thus had good response time. However, following the global economic crisis in the year 2008, the whole financing process had slowed down as financiers were being extra careful with which collateral they would finance.

Further due to the global financial crisis and erratic inflation, other developers had experienced decrease in returns from 14% to 8% against prevailing interest rates of between 14% - 16%. On the other hand, financiers were not willing to give funds for more than five years thus giving a challenge in the repayment of the loans as depicted in the graph below.



The analysis below is for a 100,000 Square Feet commercial building in Westlands with 200 lettable parking bays. The net rent is Kshs 80 per square foot per month while the parking fee is Kshs 7,500 per bay per month. The loan amount is Kshs 650 million. From the analysis, it is evident that as the interest rate and the loan repayment amount have a direct relationship increases; hence the monthly repayment increases with increase in interest rates. The loan period however has an indirect relationship with the loan repayment amount, hence increases in loan period results in decrease in the monthly repayments

**Figure 12      Sensitivity Analysis between Interest Rates and Loan Periods**



Source: Field survey, 2009

The graph has assumed a constant net monthly income. In as much as the commercial leases have escalation clauses entrenched in them, the annual percentage increases of between 7.5% - 10% are usually not sufficient to cover the effects of inflation which averaged at about 10% annually and sometimes rose as high as 26% like in the year 2009 according to the literature review. Hence the analysis assumes an expected income equivalent to the first year's net income. The investor can only afford to repay loans between interest rates between 6% - 14% if the period is 15 years (180 months) and above. If the period is reduced to 10 years (120 months), then the borrower can only afford repayment to a maximum interest rate of 10%. If the period is reduced to 8 years (96 months), which is the typical commercial lending period

in Kenya today, then the repayment obligation can only be met if the interest rate is below 8%.

The situation in Kenya is such that the financiers are offering between 14% and 16% and loan for periods of between 5 and 8 years. As can be depicted from the above analysis, this situation is not sustainable and the borrower will either have to find other means of meeting the debt obligations. Furthermore, financial institutions including mortgage institutions adopt Adjustable Rate Mortgages (ARMs) or floating interest rates based on bank base rates which can fluctuate over time often leading to increases in monthly repayments. Increases in loan installments with static or declining incomes coupled with rising costs of living leads to defaults. Also the short lending periods for commercial property means that the repayments are high often over stripping the monthly income hence causing reverse yield gap or negative cash-flows for the initial years of holding the investment. The solution would be to reduce the interest rates and lengthen the loan periods in order to come up with equitable financing solutions. The study proposes an interest rate of 10% for periods between 10 – 15 years.

Another problem identified is the high cost of production of commercial real estate. The different cost components include land, actual construction and professional fees. The cost of commercial land in Kenya is quite high ranging between 20 – 25 % of the total project costs. In the above analysis, cost of land was Kshs 150 million which is approximately 23% of the total cost of the project. Construction costs usually fluctuate over the construction period depending on the foreign exchange rates, labour costs and fuel costs. Many at times costs tend to escalate over time.

### **Stringent Requirements for borrowers**

Developers experienced difficulty with the funding of the initial projects while for the subsequent projects; it became easier to get funding since the financiers had developed confidence in the developers. In fact track record of the developer or investor was registered as one of the top three criteria amongst the financial institutions when deciding on the projects to finance. This meant that investors who were new in the market found it very difficult to access financing on competitive basis even if they had a good project. These sentiments were in line with observations by Kituuka (1981) when he noted that “a small or a growing firm without a high credit rating and strong background of earning often finds it extremely difficult if not impossible to obtain loan funds on competitive basis.

A case in point is the development of Karen Office Park on Langata Road which was delayed for over three years due to inability of the developer to get reasonable financing terms. This was despite the fact that the proposed project was a grade A office units located in the most sought after areas of Karen. The major problem was that this being the first development that this developer was undertaking, they did not have the track record that the financiers were looking for. Even when Lion of Kenya Insurance Company finally agreed to finance part of the project, it took more than six months carrying out due diligence before they could commit to the project. This caused huge delays in the project schedule which resulted in loss of revenue.

Small and Medium Enterprises (SMEs) are kept at bay with continuous requests for additional documents. Moreover, from the field survey, some investors seemed to own several projects leading the researcher to suggest that there seemed to be an intimate relationship between large financial institutions and a relatively small number of key players in the economy generating the impression that money usually went to the same people, thereby depriving SMEs of the much needed support.

Other challenges that were identified by the developers during the study included:

- **Bureaucracy in government departments** for example long procedures incurred during change of user or extension of leases and getting development permission is very slow sometimes up to one year.
- **Poor record keeping** leading to loss of titles / documents and the Ministry of Lands offices.
- **Reduction in Diaspora demand** due to global economic crisis in the year 2007/2008.
- **Disparity between actual and expected income** leading to deficiency in income for repaying loan especially in the first two to three years of development.
- **Job losses** and major multinationals downsizing or closing down thus reducing demand for commercial space
- **Lower foreign investment** due to low investor and consumer confidence following the 2008 post election skirmishes and the global financial crisis.
- **Low quality of workmanship** and shoddy contractors
- **Lack of proper and relevant by-laws and building codes**

- **Poor infrastructure** for example poor road development and maintenance, inadequate water and power supply and lack of trunk sewer in various locations with real estate development potential,
- **Lateness in completion** of projects within design and budget
- **Low availability of financing** while most banks do not have relevant expertise and experience in commercial real estate finance. This was coupled by high cost of finance.

The above challenges have led to the inability to complete the real estate projects promptly within design and budget.

### **Challenges facing Financiers of Commercial Real Estate**

Of all the financiers, 7(64%), had experienced challenges in administering the commercial property financing while 4(36%) had not. The challenges experienced were highlighted as follows:

- **Delays in completion** of developments plus cost overruns continued to be a challenge and needed to be assessed.
- **High Costs** - High cost of real estate investment including high pricing of materials, land, labor and cost of finance. Infrastructural costs and land values had also increased thus impacting negatively on the selling price of the space. This coupled with deteriorating conditions of existing infrastructure or lag in infrastructure development and maintenance to keep pace with the boom in construction led to increased development costs as developers strived to provide infrastructure like roads, water, sewer and Internet to their properties. This service should ordinarily be provided by the government and local authorities.
- **Depressed economy and instability of jobs** following the global economic crisis which forced major multinationals to reduce their commercial space (both office and industrial) needs substantially as part of their restructuring. Furthermore, the rise in price meant that the demand was available though uptake rate slowed down due to lack of good reliable buyers. This was attributed to the depressed economy especially in the 1990s and year 2008 and 2009 as a result of poor economic growth, post election skirmishes and the global economic crisis.

- **Unregulated Market** - The commercial property market was not well regulated with only a few players controlling the market and therefore potential investors were not able to access the required financing on competitive basis.
- **Payment Delinquency** - Poor repayment especially during the first three years of completion before full letting or 100% sold status is achieved when loan repayment amounts far outstrip income due to reverse yield gap.
- **Shortage of property-related financing products** -The other reason was that there has never been sufficient funds to venture into long term commercial property financing which is quite capital intensive at the beginning and requires long time to repay the debt. This was due to the problem of deposit-to-loan mismatch. Financing institutions in Kenya overwhelmingly rely on public deposits which are predominantly short term in nature. This leads to the problem of borrowing short and lending long for the financing institutions which eventually lead to high interest rates.

Also Kenya lacks a secondary mortgage market hence it is difficult for the financiers to divest from the long term illiquid mortgage that they have committed to. This meant that there was less money in circulation to finance further projects.

- **Some developers** would collect money from investors and not deposit the same to the bank to reduce the loan hence the problem of high rates of non-performing loans. Other developers were greedy to make abnormal returns thus inflated property prices.
- **Competition from other investment opportunities** - Existence of other forms of fast rewarding investment opportunities like shares and Treasury-bills which compete for the same investment funds as real estate.
- **Inappropriate government policies** including lack of a comprehensive land policy to govern access to and development of land, lack of proper and coordinated town planning, lack of public land banks for major real estate developments and low key involvement by the government in form of providing required financing and public goods provision like infrastructure.
- **Nonperforming loans** – There has been high incidence of non-performing loans in the 1990s and 2000s due to poor economic performance and global economic crisis where a lot of loans had been collateralized on real estate whose value was not sufficient to recover the outstanding amounts almost leading to a collapse of the financial sector in

some countries like the United States and creating ripples which were felt as far as Kenya and Africa in general.

- **Discrepancies in appraisal** – This is closely related to the above challenge especially in situations where some valuers gave different figures for the same projects. This would lead to situations where loans are collateralized with inadequate security. This posed the risk of financiers being unable to recover their money in the event that the borrowers defaulted.
- **Delays in judicial system** – The financiers like Housing Finance and Savings and Loans indicated that the litigation in Kenya was so slow and open to abuse by crafty borrowers who wished to cause delays through court injunctions and other tactics. A report from central bank of Kenya in 2001 noted that it takes not less than five years to realize securities even when they were properly charged.

## **PROPOSED SOLUTIONS TO THE CHALLENGES FACING REAL ESTATE FINANCING**

The solution to the above challenges needs to come from the parties that are involved in commercial real estate financing. The financiers had proposed two ways of dealing with the challenges facing commercial real estate investments. The first way was through the actions by the financiers themselves to curb cases of default and to accurately match the best type of financing to each project. The given strategies included the following in order of importance:

- Elaborate credit appraisal procedures and prudent risk assessment
- Ensure uptake (demand) exists at the outset of the project
- Fixed contract structures
- Project monitoring and relationship management
- Establishment of management information system
- Portfolio risk analysis
- Maintaining professionalism and ethical standards by the staff
- Insistence on good and marketable collateral
- Good lending policies
- Good credit monitoring policies and robust collection strategy
- Clearly interrogate history of the developer, sale by auction in extreme cases
- Loan restructuring or rescheduling, or workout strategies

According to the financiers, all these strategies were found to be effective in reducing the default rates.

Secondly, the financiers proposed that the challenges facing the real estate investors can also be addressed by the government. The strategies identified included:

- Improvement of the judicial systems to speedily and effectively determine the cases commercial disputes. This is to be done through appointments of more judges and magistrates and provision of more physical facilities. The various laws governing real estate should also be amended and harmonized to assist in judicial system.
- Clear and harmonized government guidelines on building and zoning regulations
- Increase in government contribution on infrastructure development and maintenance
- Government subsidies to assist mortgage takers thus reducing cost of financing commercial property investments
- Effective governance from relevant authorities
- A strong enforcement regime in case of handling defaults cases
- Government to provide land which is serviced and then the cost of putting up developments will then come down
- The sector requires more involvement by the government to ensure availability of cheaper credit
- Well laid policies that give incentives to investors.

The developers gave the several recommendations in solving the challenges facing the real estate investment in Kenya and increasing accessibility to real estate financing. These were broadly divided into two points of action, on one hand by the government and on the other by the financial institutions.

As for the Government, the investors recommended that it should:

- Increase the investor confidence by reducing bureaucracy and taming corruption.
- Attract more foreign development investment and reduce and cap interest rates
- Increase investment in sewerage, roads and other infrastructural facilities like power, internet, and communication.
- Improve timeliness for approvals of projects, improve on title deed processing and problems like double allocation, illegal allocations

- Implement proper record keeping and Land Information and Management Systems to enable efficient and fast access to land information and to respect the sanctity of the land.
- Abolish Value Added Tax (VAT) on commercial rent and/or allow investors to claim Value Added Tax (VAT) on second or subsequent projects.
- Allow high plot ratios in some rezoned commercial areas like Westlands and Upper Hill as land prices are quite high and the current ratios do not allow developments which make economic sense.
- Provide clear and up to date guidelines on development controls and approvals, reduce the time required for development approvals.
- Come up with clear, proper and appropriate building standards.

In terms of the actions required of the financing institutions, the investors recommended that

- Banks to reduce the interest rates to manageable levels. The current 13-15% was felt to be on the high side.
- Central banks to regulate and fix interest rates over the period of the loan to help in predictability in the future repayments.
- Banks to reduce the tendency to over secure loans. The banks should shift from collateral lending to character lending by putting more emphasis on the borrower's ability and willingness to pay before considering the security offered as collateral.
- Longer term financing for periods in excess of ten years would be ideal for commercial property financing.
- Assess projects independent of the promoter so that all good projects stand a chance to benefit from available financing. The feeling that money always goes to the same people should be eradicated.
- Reduce time lag in loan approvals.
- International banks should reduce red tape and be willing to lend in local currency thereby not exposing the borrowers to currency risks.

Due to the above challenges, 12(75%) of the commercial real estate investors faced problems in meeting their obligations and chose to reschedule their loans. They were however unable to give the data on the number of years and the amount as this was considered confidential information which they feared could land into their competitor's hands and could be used to discredit them. The reasons given for the rearrangement of loan repayment included



- Difficulties in repayment, 8(50%),
- To increase the repayment period, 8(50%),
- To reduce the repayment amount, 4(25%) to manageable level
- The other reason given was due to inability to sell or rent out the property in time and within budget and to the intended user thereby necessitating rescheduling.

The above scenario was also confirmed by the financiers who indicated that whenever a borrower had difficulties in meeting their obligation, the financial institutions would take the following measures: discussion with the borrower, getting their proposal and then weighing options of restructuring the facilities to assist the borrower meet their obligations. The financiers would take up early engagements to pursue other options like foreclosure to secure the institution interest, refinance the debt, restructure the debt, sell off the collateral by private treaty or auction the property in a worst case scenario.

This therefore led the author to conclude that loan workouts, restructuring or rescheduling is a common phenomenon in real estate financing in Kenya and perhaps this could be a sign that most of the available financing strategies are not appropriate for the local market.

## **Conclusion**

Generally, Kenyan banks have improved in the terms of providing mortgages and project finance compared to a few years ago but a lot still has to be done to bring it to affordable level. The cost of borrowing at an average of 14% per annum is still very high hence low yield thus not justifying the borrowing. The other issue to be addressed is difficulty in borrowing long term finance for commercial real estate development. Interest rates should also be fixed even if for a predetermined period of time to enhance predictability of future installments. The government through central bank should put in measures to enable the lenders to give funds on equitable basis.

On the other hand, the study found out through review of literature and analysis of primary data that the market REITs are viable in the market with huge expectation from the institutional investors due to the anticipated benefits. The opportunities that exist in the market that would lead to growth of the sector are the robust economic conditions, growing real estate sector, rising population numbers, high interest rates, limited property financing alternatives in the market and huge developer interest.

## CHAPTER FIVE

### SUMMARY, CONCLUSIONS, RECOMMENDATIONS AND AREAS OF FURTHER STUDY

#### 5.0 SUMMARY OF THE STUDY AND CONCLUSIONS

The study was set out to establish the challenges associated with commercial real estate financing and recommend the proposed solutions. The specific objectives were as follows:

- To evaluate the traditional and emerging commercial property financing strategies in Kenya
- To determine the impacts of the traditional and the emerging financing strategies in accessibility and affordability of commercial property financing
- To evaluate challenges facing both financiers and investors in commercial real estate in Kenya
- To recommend and draw conclusions on the equitable and most appropriate financing strategies in the Kenyan market

From the field study it has been established that:-

Most new commercial developments were taking place outside the Central Business District in areas like Lavington, Kileleshwa, Westlands. Industrial area, along Mombasa road and Chiromo road. The portfolio mix of commercial real estate development in Kenya included office blocks, Multi dwelling apartment blocks, industrial premises/ parks, hospitals, schools, and hotels with office sector dominating the portfolio mix at 40% as shown in figure 5. Office development has gained popularity in the decentralized locations of the city that were originally zoned for low density residential dwellings like zone 4 which includes Westlands, Lavington, Kilimani and Kileleshwa.

Most of the developments are to be found along the major roads like Chiromo / Waiyaki Way, Riverside Drive and Lenana Roads. More office and industrial premises are to be found along Mombasa Road. This can be said to be due to the ease in accessibility by both public and private transport, close proximity international airports, vast residential neighborhoods and

also due to improved infrastructural services like road expansions and upgrades and fiber optic cable.

In terms of availability of financing, 87.5% of the financiers offered different forms of commercial real estate financing while 12.5% did not as shown in figure 7. With a mean of number of years the financiers in Kenya have been offering Commercial Property financing being 33.75 years, it is surprising to note that some financial institution had not started to offer such facilities as at the time of data collection. Perhaps this could be explained by the complexity, large initial capital outlay, several risks, vast knowledge and experience needed in order to set up such facilities. The following were the traditional forms of financing in the market: corporate, project, syndicated and investment loans, mortgages, joint ventures, presales, mezzanine finance and equity financing.

The investors and developers prefer equity financing and project loans to all the other forms of financing. Equity financing and project loans stood at 21.4% each while corporate loans and the other forms of loans stood at a distant 7.1% as shown in figure 6. Since real estate is a long term capital intensive investment, most investors strived to ensure that whatever equity resources they had, went as far as possible in acquisition of real estate investments. On the other hand, equity financing and project loans were not popular with financiers as only 3.7% and 14.8% of the financiers issued equity finance and project loans respectively as indicated in figure 7. This confirms that fact that financiers who provide financing for acquisition of real estate are risk averse, therefore they limit their equity investment in the project and require larger equity for the purchase of real estate property from the investor especially by small corporate that they perceive to be risky

Based on the above, it therefore follows that relatively small non – institutional investors with limited equity will have to rely heavily on debt financing to acquire real estate since it is difficult to get additional equity funds in any organized liquid market as currently presented in the Kenyan market. In this regard, one would expect that such a small non – institutional investor would use larger portion of debt to acquire larger or more expensive properties. This puts the small real estate investors into a non-level playground with the large corporate who are able to negotiate favorable terms with the financier.

The financiers offered a higher percentage of mortgages at 22.2% as per figure 7 while uptake with investors in commercial real estate low as evidenced by the figures 6 and 7 above.

Mortgages are usually preferred by single dwelling residential house or home buyers as opposed to financing commercial real estate development or investment. Based on the discussions above, the author asserts that financing commercial real estate development is financing a completely new project and mortgage financing is not the correct tool for it. With a mortgage one is essentially buying a property; be it land or a residential house on land, or an apartment; and buys it to own for the long term; that is 15 to 30 years or more.

When financing commercial real estate development, a developer must look at financing an entire project, of which the land is one tangible part and the other part comprise building plans or the actual building. The investor is not just buying land when financing commercial real estate development; he is asking the financial institution to approve the purchase of the land, as well as the construction of the whole project. At completion of the project, he plans to sell or lease out all or part of what he has created and repay the financial institution what he borrowed for financing the real estate development less any profits that he made which are his earnings.

There was evidence of existence of intimate relationship between large financial institutions and a relatively a small number of key players in the economy which generated the impression that money usually goes to the same people" thereby depriving SME's of the necessary support. Experienced developers confirmed that they kept good relationship with the financiers in order to achieve prompt response time, however following the global economic crunch; the whole process has slowed down. The developers have experienced decrease in returns from 14% to 8% hence the financiers were only willing to fund key projects. As a result financiers strengthened their vetting criteria and were only willing to fund key projects for periods not longer than five years causing challenges to the investors in meeting their loan repayment obligations.

Novice developers experienced difficulty in getting financing for their first projects, however the good news is that it got easier as they required financing for subsequent projects after successful delivery of the first one and the financiers developed confidence in them. This has been so since the financiers are now starting to focus more on character lending putting a lot of emphasis on track record of the developer, the technical team behind the project and the financial strength of the company. In as much as the developers found this as a challenge, it is the opinion of the author that this is a good advance in commercial real estate financing that would ensure that money goes to the right projects and to those with demonstrated willingness

and ability to repay the loan. It is high time the financiers shifted from "collateral" lending to "character" lending by putting more emphasis on the potential borrowers willingness and ability to pay before considering the security being offered as collateral. This however does not mean in any way that the collateral is of minor importance.

It was evident that despite the remarkable improvement experienced in the Kenya real estate investment sector, there are still a lot of challenges facing real estate financing: bureaucracy in Government processes, like long procedures incurred during change of user or extension of leases, double allocation or illegal title deeds, getting development permission is very slow up to one year, short period of financing mostly 5 years for commercial property, most banks do not have experience in project finance hence sometimes an investor is sold to a wrong financial product, high interest rates which are mostly floating based on bank base rates, low availability of financing due to competition from other fast rewarding investment options, deficiency of income from the project to meet loan repayment, shoddy contractors, lateness in completion of project, lack of proper by laws and codes. This has led to challenges when trying to meet their financial obligations and developers often have to look for other sources of income to repay the loans. All these have led to inability to finish the projects within budget, design and time.

It was also established that commercial real estate financing sector lacks innovations to cater for the emerging needs of the investors. Only 12.5% financiers had introduced non-conventional commercial property financing as shown in figures 8 and 9. Investors are nowadays versatile and are looking at different options other than the traditional methods of financing. These included releasing value in an already existing property, attaching two properties at ago, or utilizing cash flows from other businesses to secure property financing arrangement. 25% of the financiers had introduced the special financing arrangement for Kenyans in the Diaspora. It is therefore the authors' conclusion that this is still a green field that is ripe for exploration. The Government should therefore partner with the financial institutions and the real estate investors to come up with modern financing strategies that are equitable to both parties. This will improve on both the quality and quantity of commercial real estate investment in the country.

It was established that there were cases of unviable financing strategies due to several factors that are either within or without the control of both the financiers and the developers. These included inability to achieve expected income topping the list, followed by depressed

economy, High Loan to value (LTV) ration, delays by judicial system, pressure from dominant shareholders, political interference, poor credit assessment, lack of credit reference and deliberate refusal to pay by the borrower. Some of these were in the process of being solved at the time of the study for example: a credit reference bureau was at advanced stages of being set up, the financiers had introduced more stringent lending criteria and the government was putting in measures to improve the judicial system and change the constitution and other land related laws. There was therefore hope for a better financing environment in future.

The study has shown that the financial institutions rely heavily on deposits from the public as a source of their funds for lending to the investors. In this regard, they are faced with the threat of deposit to loan mismatch as a result of the problem of borrowing short and lending long for the real estate financing companies, which eventually push up interest rates. Also because of the limited financing options, the real estate industry has been characterised by rigid financing conditions and relatively high interest rates. Some institutions especially those headquartered in the first world have resorted to promoting private capital in foreign currency and yet most firms in the private sector of the economy require equity and debt financing in local currency. This is due to the fact that private sector wish to avoid the currency risks that financial institutions usually wholly pass on to the investors.

The contribution foreign sources of capital have been commendable. However it is the conclusion of this study that heavy dependence of the Kenyan investors on these sources of foreign capital is a matter of great concern. It is therefore the recommendation of this study that Kenya has to address itself to the need to raise more commercial real estate development capital from local sources. The Government and the financial institutions should explore the strategies of getting more commercial banks and some semi –formal institutions like SACCOS to be more involved in commercial real estate financing, to enable developers to borrow long term and on flexible terms. Increased competition amongst financiers will reduce the interest rate to manageable levels and increase the amount of funds directed at commercial real estate investments.

Local Authorities should also play a more positive and active role in commercial real estate development by carrying out their duty of infrastructural development and maintenance beforehand. They should also harmonize and modernize all the building codes, zoning

regulations and be able to guide the real estate developments in line with government strategies namely the constitution, vision 2030 and land policy.

From the above, it is evident that commercial real estate financing in Kenya is faced by several challenges which need the joint effort of all the industry players to address. The prospect of harnessing sufficient capital or development of reasonable and sizeable commercial real estate sector is a crucial problem to all developing countries. Lack of capital has been described as the essence of underdevelopment. The problem of large sums required for real estate developments and poverty in developing countries are compounded by the fact that a lot of the required capital input is in the form of foreign funds which often cannot be realized from domestic sources mainly earned from agriculture. The concerned parties must therefore interrogate domestic solutions.

## 5.1 RECOMMENDATIONS

Real estate investments in emerging economies are characterized by low liquidity; slow pay back and high sunk costs, enduring uncertainties about effective demand, price per unit and land and infrastructural costs. A lot of investors in Kenya often wonder if real estate investing will work for them. The truth is real estate works in almost every market as long as the investor learns their market and adapts the techniques that it requires. For example, in Kenya in the last 10 years, real estate sector has become one of the most lucrative ones. Getting development financing is not easy to do, especially large amounts as required in commercial real estate, but the real hard part is to get started as at the beginning, an investor does not have track record. The following are the recommendations that the author has suggested in order to improve the real estate financing in Kenya.

**Lending Period** – Instability of incomes especially in the first five years of a project life makes long term debt risky to lenders and unattractive to borrowers. The lending period especially for properties developed for letting should be increased to be at least ten years to allow the project to reach full occupancy and stable rental income. This will ensure that the loan repayment installment is lower and that the income collected is enough to repay the loan. This will curb the problem of inability to meet the financial obligation due to reverse yield gap. This will further reduce the cases of defaults and non performing loans.

**Interest rates** – High real interest rates between 14% and 16% which are then amortized over few years creates high monthly repayment that most developers cannot afford. The interest rates should be reduced to 10% or below and fixed at least for the first five years post construction to improve predictability of the future repayments that the borrower needs to make. This helps the borrower to plan for the repayment with a high level of certainty and make prompt arrangements for any expected shortfalls. This gives the borrowers peace of mind and ability to set the rental or sale incomes that are reasonable due to reduced interest rate risk. The lender on the other hand incurs less loan administration costs as they do not need to go through continuous recalculations and accounting for the repayments. They are also able to predict their income with certainty and budget for other sectors they wish to invest in. This recommendation will however require government intervention in order to lower and stabilize base lending rates. As the final lending rates are subject to a margin over and above the base lending rates.

**Shortage of property-related financing products and entities:** This relates to the availability and affordability of long-term debt financing for commercial property development, as well as access to mortgage finance and buyer protection to expand the commercial property market. It also concerns the development of liquid secondary property markets through the emergence of different types of property businesses, including domestic and international institutional investors and equity funds. It also comprises – principally for all real estate developments – a strengthening of the use of local currency in real estate financing where significant risk from un-hedged currency exposure emerges. Kenya has been characterized by unavailability of long term funding which creates interest rate risk and limits supply of credit. The study recommends that the financial sector should expand the sources of long term financing by including other semi –formal players like SACCOS to participate in commercial real estate financing.

Secondary markets are essential to the efficiency of the real estate market as a whole. But their development remains a principal transition challenge in the real estate financing sector for the entire country. Kenya lacks a secondary real estate market and is impaired by a lack of liquidity, risks of indivisibility and a scarcity of market players capable of providing depth, such as large-scale institutional investors or sector-specific real estate funds. This is not only the case for commercial property but also for residential property. The Government bodies like Central Bank, Ministry of Finance and Local Authorities should also put in place



regulations that ensure that money is available for investing in real estate through both secondary and primary market. The major challenge currently refers to creating the first ever secondary market activity. Secondary mortgage market will ensure that there will be adequate amounts of money in circulation for further lending by the primary financiers like Housing Finance and Savings and Loans.

To further mitigate the risks associated with real estate investments for example illiquidity and indivisibility, the study recommends the introduction of Real Estate Investment Trusts (REITs). Challenges remain to the introduction and growth of the REIT sector and the study found that limited number of investment grade properties, high interest rates in case of refinancing, low rental yields due to effects of inflation, high concentration risk in real estate investment, fast rising property values, lack of legal and enabling framework, inefficient property market and limited REIT expertise in the country would have to be overcome.

Property developers, Insurance Companies and Fund Managers are optimistic that the establishment of REITs will spur the growth of the real estate sector in the country. The developers can expect that raise fresh capital through REITs by tapping into the capital markets which have mainly been the preserve of blue chip companies that can pass the listing requirements of Capital Markets Authority and Nairobi Stock Exchange (NSE).

Many Kenyan enterprises have traditionally owned real property outright and used it for their own business purposes. The local market can therefore anticipate a significant influx of commercial real property from this source in the coming years. The mobilization of the capital previously tied up in real estate will result in increased real estate market liquidity. The latter is an observation from other mature REIT markets, which might have relevance for Kenya as well.

Some of the developers and insurance companies viewed the REITs as an avenue to offload their real property holding to take advantage of its tax benefits while at the same time having exposure to the real estate sector, albeit now indirectly. Because it is required to distribute most of its earnings, a REIT has only limited internal financing capability and thus lacks an important source of financing for organic growth. This would limit the growth of the KN-REIT but through IPOs, the trust can raise funds to acquire property

**Embracing Innovations** – From the study, it was evident that there is a growing consensus that alternatives must be found to the traditional mortgage lending in Kenya. Financial institutions need to offer real estate developers new avenues that will unlock funding which has been identified as a major stumbling block to increasing supply of real estate. The financial institutions should embrace innovations in their products to ensure that they reach as many clients as possible. Some of these innovations that can be explored include public – private partnerships, the choice of fixed-rate mortgages, the introduction of 100% financing for some key projects, the growth of home equity loans secured by mortgaged properties and expansion of shariah compliant products and introduction of a secondary mortgage market.

**Availability of accurate and prompt information** – Both parties need to have adequate information to enable them make relevant applications, enquiries and analysis. In order to make the whole financing process simpler for the borrower, the study recommends the rules below to help real estate investors and other industry players understand the way the financier will view their request for financing and how it will be evaluated before they qualify for financing.

**i. Knowledge of the specific market:**

The investor must do his homework on the market that he is going to build on. A decent real estate lender knows his market and will not be sold on a project that does not seem viable. A developer must be able to back up their projections of how long it will take him to sell or rent out the units that he is going to build. These projections will be dissected not only by the bank, but also by the appraiser that will give an estimate of value for the project “as completed”. In this regard, it is prudent to ensure that he has a conclusive and up to date market and feasibility study from a reputable team of consultants.

On the other hand, real estate development financing is carried out by a wide range of financial institutions, (lenders) who have a wide range of finance products to sell. They are like “supermarkets for money”, only each product or range of money products has a different sales person, with sales and profit targets. So if a developer walks in to a lender’s office and starts talking about buying land and as he is new to the development business, he does not emphasize the development aspect of his plans, he will be sold the wrong finance product which can be very costly in both time and money.

## **ii. Familiarization with the industry:**

Every investor needs to understand how it is that they are going to make money as a developer, and how they are going to finance their operations. There are laid down planning controls and procedures to determine how many units/apartment or size one can develop on a parcel of land, and that process finally allows the developer to determine if they have a financially viable development.

Trained developers or those with relevant in-house professionals can do all this investigation work with minimal cost and time and then proceed to lodging a Development Application. The study recommends that this process be carried out and lodged with the relevant Local Authority so that the developer knows before committing to buying the land, if their development will be allowed to be constructed by the local authority or not.

In addition trained developers know about how real estate development financing works and how they should go about getting it, again before committing to buying the land or any contracts and subcontracts. A novice developer must contract and maintain good working relationship with the real estate consultants like agents, architects, planners and engineers in order to be guided through the development appraisal process and to make the right decisions.

## **iii. Careful consideration of the Project Size:**

The biggest mistake that novice developers usually do when it comes to getting a development loan from a lender is to start with a really big project. The borrower should take into consideration that if they have never done anything bigger than a single-family home, they might find the lenders unreceptive when they approach them with plans to build a big project like 4-storey apartment block with 30 units. It comes down to experience and the financial strength to be able to meet the lenders equity requirements. An investor must therefore ensure that whatever commitments he makes today, he is in a position to fulfill them in the future because, the financiers will surely exercise the options of foreclosure and auction should he default in loan repayments.

## **iv. Source of repayment must be well supported:**

This is always at the core of the loan. An investor's experience and knowledge will get him in the door, the source and adequacy of repayment will get the loan approved and on its way to

closing. The financiers regard the net rent achievable, effective demand and liquidity of the project as very important when deciding on which properties to finance. Once and above these, they will also require other forms of guarantees like having a first charge on the property, director's personal guarantees and bank guarantees.

**v. Experience and track record of the borrower:**

This has to do with the above "Do not bite more than you can chew" line, which is worth repeating. As has been discussed elsewhere in this study, if a developer has shown that he is able to pull a development off in the past, his future financing requests will be easier to get. This came out clearly from the respondents who got it much easier to get finances for the subsequent projects than it was at the beginning. The more experienced a developer is, the more they are able to put together a reliable team which ensures that the project is delivered within time, budget and design.

**vi. Maintenance of relationship with the lender:**

The modern loan officer has become a sort of mercenary. The number of lenders that remain with a single bank for all of their careers is much smaller than it used to be. Many are head hunted into other companies or new sectors. It pays a lot for the developer to maintain a good relationship with a real estate lender. Actually, it is advisable for a developer to maintain a good working relationship with several loan officers and several financiers. The fact is that a good loan officer will make the ease for an investor when the time comes to get his loan approved. Keeping good relationship with several officers and financiers also helps a developer to have access to several proposals that he can choose from, make informed decisions and get a better deal as at that particular time.

**vii. Understanding the point of view of the lender:**

The commercial real estate lender will be more than happy if an investor makes a million shillings or five million from developing a commercial project. But as has been indicated elsewhere in this study, the lender will not be interested in lending their money unless he has a strong source of repayment. It is therefore advisable for the investor not to try to approach the lender with a sales pitch such as "We have the potential to make millions", that is best saved for the equity investors. The lender wants to make sure that his loan is going to get repaid and

in case of nonpayment, the collateral is enough to recover the debt, so the investor must be able to demonstrate the figures.

The next thing to realize is that in the well established financing industry, "do you know somebody line does not usually work". The "worst" mistake some investors make is to think that because they know someone who works in the lender's office including the Bank Manager that they will be looked after in some special way. This is not the case in a decent financing institution. When it comes to 'lending money' all employees for a lender are functionaries and information gatherers so there will be no "special relationships". To a lender a borrower is a Credit Risk Assessment (CRA). All decisions on lending are made by a centralized Credit Department, so a friend at the bank, no matter how willing they are to help you, is powerless to influence a lending decision. Gone are the days when powerful shareholders at the bank or politicians would send letters or make phone calls to the bank manager with directives on how to assist their friends. This led to the collapse of many financial institutions due to bad debts.

In conclusion, it is worth noting that an approach to a financial institution for real estate development financing is a planned, organized event, with the developer in charge of the agenda. He must not only know the correct department to deal with, know their lending policies in detail, know the person who will handle his application and ensure that his application is professionally prepared by his officers and authorized consultants so that real estate development financing is prepared based on the lenders' current policies. The borrower must ensure that he gives the lender the exact amount of information they require to make a prompt and accurate decision and nothing more or less. The application must therefore be; clear and concise, no questions raised by the lender due to lack of, or incorrect information, and no delays in taking decisions. This will ensure that the project is not delayed due to lack of or inability to raise financing on time. It will also ensure that the correct financing strategy is sold to the right project.

## 5.2 AREAS OF FURTHER STUDY

This study was a first step to document the commercial real estate financing strategies applied in Kenya. Further research is recommended in the following fields:

- Lending Assessment Criteria for commercial real estate financing
- Strategies of reducing Liquidity Risk in real estate ownership
- Ways of enhancing access to capital and affordability of financing in a developing country

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PENDING

Statement of Assets, Liabilities

with Old

Assets

Liabilities

Surplus

Completed

Uncompleted

On 1

Commercial Projects Pending Development

Name

What

able to

limited

how many

What

units

3

6

more than

at least

Office

... of ... Management ...

...

...

...

Year Development      Location

...

- Multi-dwelling units i.e. flats, gated communities
- Industrial building(s)
- Shopping / retail centers
- Hospitality and Hotels
- Healthcare facilities
- Other – specify

5) What reasons led you to put up these developments?

- i. To satisfy an economic / social need
- ii. To generate Profit or avoid losses
- iii. To safeguard continuity of company / family owned estates.
- iv. Independence – Freedom and security in real estate ownership
- v. Social Benefit i.e. creating employment, protecting environment
- vi. Prestige and political Power/ corporate image

6) How did you fund these developments?

- a. Equity Financing
- b. Loan
- c. Mortgages
- d. Joint Ventures
- e. Presales
- f. Bonds and debentures
- g. Unitization and Securitization
- h. Sale and Lease back
- i. Diaspora Participation
- j. Build , operate and Transfer (BOT)
- k. Forward Funding
- l. Other –Please specify

.....  
.....  
**Section II – Impacts of conventional and emerging commercial real estate financing strategies in Kenya.**

7) a) If your answer to the above was debt financing like loan, mortgages, what was your experience in :-

i) Arranging for the loan?

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ii) During disbursement of the loan?

.....  
.....

iii) Repayment

of the loan?

.....  
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9. b) What requirements did you have to fulfill before you were awarded the loan?

Provide:

- A profit-and-loss forecast for the next twelve months
- Business bank statements for the previous six months
- Current business performance indications
- Audited accounts for the last two years
- Asset and liability statements for each applicant
- CVs and/or profiles of each partner or director of your business
- A full business plan that reveals how the property will contribute to your cash flow and how you intend to repay the loan
- Brochure indicating property location and specifications
- Approved Architectural drawings and planning consents

- Site investigation Reports
- Feasibility studies and Market Surveys
- Bills of Quantities
- Construction Schedules
- Bank Guarantee / Parent company Guarantee

8) Have you rescheduled your loan repayment?

Yes  No

If yes, by how many years .....

9. Why was rescheduling of your loan / mortgage necessary?

- a. Difficulties in repayment
- b. To increase repayment period
- c. To decrease repayment amount
- d. Any other

**Section III – Challenges facing Commercial Property Investors in Kenya**

10. What challenges did you face when sourcing for finance for your developments?

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11. What challenges have you faced during your loan repayment?

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12. In your opinion what are the challenges facing real estate investment in Kenya

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13. In your opinion, what would you say is the level of effectiveness in the Kenyan Financial market in meeting the demands of the local Investor? Bad  average  Good  Excellent

Please Explain.....  
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**Section IV – Recommendations and conclusions**

14. What in your opinion do your opinion would solve the above challenges?

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15. What in your opinion should the financial institutions do to increase accessibility to commercial property funding?

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16. What do you think should be done by Government to increase investment to good quality and affordable commercial properties?

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17. Recently, there has been an introduction of Islamic banking in Kenya, how in your opinion do you think this is likely to impact in access to real estate financing?

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18. There has been a lot going in especially in the media regarding a possible glut in the office market in Kenya and that some industry players are now urging banks to freeze any lending to office developers until demand catches up with supply. What is your take on this?

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**Thank you very much for taking time to fill in this questionnaire.**

## APPENDIX II

### Questionnaire for Property Financiers

I, **Ruth Okal** am undertaking a Research Project Paper in Partial Fulfillment for the Award of a Masters Degree in Valuation and Property Management in The School of Built Environment, Department Of Real Estate and Construction Management in the University of Nairobi.

This study is for academic purpose only and any data or information shall be treated with great confidence. Kindly take sometime to answer the following questions to assist me complete my study.

#### Section I – Property financing Strategies in Kenya

1. Name of Organization (Optional)

\_\_\_\_\_

2. Does your organization offer commercial property funding?

Yes

No

3. If yes, which of the following methods or forms of property financing does your organization provide? Please tick as appropriate.

a. Forward Funding

b. Sale and Lease Back

c. Bank Loans – Please specify:- Corporate loans  Project Loans  Investment  
Loans  Mezzanine Finance  Syndicated Loans

Interest Rate options

d. Mortgages

e. Equity Financing

f. Debt financing i.e. Bonds and debentures

g. Unitization and Securitization

h. Joint Ventures

i. Diaspora Participation

j. Presales

- k. Build , operate and Transfer (BOT)
- l. Other –Please specify

How long have you been in business commercial property financing?.....years

4. What types of development have you or do you finance?

Office Buildings

Retail Centres

Industrial Buildings

Hospitality like Hotels

Multi-dwelling residential Units

Special Purpose properties like hospitals, stadia

Other -  Specify

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ADD LIBRARY

5. Have you ever introduced any non conventional commercial property financing methods? Yes  No

6. If yes, please enumerate and explain why this was necessary.

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7. Do you have any special funding facilities for special categories of clientele like Muslims, Women, Kenyans in Diaspora, staff members Yes   
No

8. If yes, which ones and what would be the special features of each category?

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**Section II – Impacts of Conventional and Emerging Commercial Property Financing Strategies in Kenya**

9. Please indicate in the table below how much credit you have advanced in the Commercial property financing in the last decade in Kshs (, 000,000,000's).

Year	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008
Amount										
1 - 4.9										
5 - 10										

10. What has the demand for Commercial property finance been like over the last decade?

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**Section III – Challenges facing Commercial Property financiers and investors in Kenya**

11. Have you ever experienced any challenges in administering any of the above mentioned commercial Property financing Methods?

Yes  No

If yes, which ones? Please explain in details

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12. Do you have criteria of choosing which properties to finance?

Yes  No

If yes, please rank them in order of importance with 1 indicating least important, 2 indicating important and 3 indicating most important. If no, please explain how you advance finance for commercial property development.

	1	2	3
i. Net rent achievable	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
ii. Loan to value ratio	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
iii. Track record of the developer	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
iv. Geographical location	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
v. Reputable project team	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
vi. Quality of workmanship	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
vii. Efficiency of the floor plans	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
viii. Adaptability of the user	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
ix. Availability of other similar developments	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
x. Ready Market i.e. lots of clients	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
xi. Nearness to other facilities e.g. shopping malls	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
xii. Better services	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
xiii. Zoning matters	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
xiv. Age of Developer	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
xv. Other	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>

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13. What measures does your organization take when borrowers require or are facing difficulties in meeting their obligations?

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The following have been suggested to be some of the factors contributing to unviable strategies being chosen by investors? Please rank them

High ( ) Low ( ) Most rated ( )

Depressed Economy

High LTV Ratio

Political Interferences

Inability to achieve expected income

Deliberate refusal to repay loan

Delays through judicial system

Poor credit Risk assessment system

Lack of credit refence systems

Pressure form dominant shareholders

Other - Specify

What strategies have you applied to curb cases of default and how effective have they been?

Q7

Strategy:

Effectiveness

.....

.....



- 3.....
- 4.....
- 5.....
- 6.....
- 7.....
- 8.....
- 9.....
- 10.....

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**Section IV – recommendations and Conclusions**

16. In your opinion, what are the challenges facing real estate investment in Kenya?

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17. What do you think would reduce these challenges and avail more affordable credit to the commercial property investor?

Explain

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18. What do you think the Government should do to improve commercial property development especially in urban areas?

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19. Recently, there has been an introduction of Islamic banking in Kenya, how in your opinion do you think this is likely to impact in access to real estate financing?

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20. There has been a lot going in especially in the media regarding a possible glut in the office market in Kenya and that some industry players are now urging banks to freeze any lending to office developers until demand catches up with supply. What is your take on this?

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**Thank you very much for taking time to fill in this questionnaire.**