CAPITAL MARKETS AUTHORITY

Promoting the Integrity and Growth of the Capital Markets

REAL ESTATE INVESTMENT TRUSTS (REITs)

INTRODUCTION

In the last decade, the Kenyan economy has experienced significant growth in most financial sectors. This growth has been attributed to a vibrant private sector and the ever-increasing appetite for foreign investments in Africa. Kenya has been regarded as the preferred hub for multinationals and other international organizations with operations in East and Central Africa.

In the past, Kenya did not have a formal framework that allows for efficient financing of large real estate developments, other than traditional mortgage financing. As a result, real estate developers have historically resulted to entering into joint ventures of various forms, in order to finance their development projects.

However, as these joint ventures are not specifically designed for real estate projects, they create significant limitations for developers and other potential investors. These limitations include tax inefficiencies and increased costs of capital for development. In addition, it is not uncommon to have disputes between joint venture partners. These disputes lead to delays in delivery of the real estate products.

In recognition of the significant growth in real estate sector of the economy and the need to provide a framework for financing real estate investment projects in Kenya as one of the Big 4 Agenda initiatives, the Capital Markets Authority has developed this brochure to demystify Real Estate Investment Trusts (REITS) in the Kenyan context.

COMMON TERMINOLOGIES

REIT MANAGER:
A company incorporated in Kenya and licensed by the Capital Markets Authority to provide real estate management and fund management services for a REIT scheme on behalf of investors.

TRUSTEE:
A company or corporation appointed under a trust deed and licenced by the Capital Markets Authority to hold the real estate assets on behalf of all the investors.

TRUST DEED:
A document which establishes or sets out the terms of the trust creating the REIT and includes any document that varies the terms of the trust, the rights of the beneficiary and the powers of the trustee or manager.

PROMOTER:
A person or a company involved in the setting up of a real estate investment trust scheme. A promoter is deemed the initial offeror or issuer of REIT securities and is involved in making and submission to the Capital Markets Authority for approval, of a draft trust deed, draft prospectus or an offering memorandum.

Visit the CMA Website at www.cma.or.ke to access the Capital Markets (Real Estate Investment Trust) (Collective Investment Schemes) Regulations Legal Notice No. 116 of 2013 as well as the Key Terminologies.

1. What are REITS?

REITs are a collective investment scheme in real estate that is structured as a trust where an investor owns rights or interest in the form of units and earns returns from income or capital gains. The property is held by a trustee on behalf of unit holders and professionally managed by a REIT manager.

2. What types of Real Estate Investment Trusts are Provided for in Kenya?

a. **Income Real Estate Investment Trust or "I-REIT": This is a form of REIT in which investors pool their resources for purposes of acquiring long-term income-generating real estate including housing, commercial and other real estate. Investors gain through capital appreciation and rental income. The appreciation is usually distributed to unitholders at the agreed duration.**

b. **Development Real Estate Investment Trust or "D-REIT": D-REITs is a type of REIT in which resources are pooled together for purposes of acquiring eligible real estate for development and construction projects. This may include housing or commercial projects. D-REIT can be converted to an I-REIT once the development is complete where the investors in a D-REIT can choose to sell, reinvest or lease their shares or convert their shares into an I-REIT**

3. What are the key benefits of REITS?

1

LIQUIDITY:

Investments in real estate are perceived to be the ultimate immovable, illiquid assets. However, REITs listed on securities exchange can make real estate investing easy and efficient, thanks to market liquidity. As a result of their liquidity, REIT and listed real estate equities have become the most efficient way for investors and investment managers across the globe. Unlike direct investments in property which are generally illiquid, investments in I-REITs may easily be converted into liquid cash by selling the units in the market.

2

TRANSPARENCY:

REITs are registered and regulated by the securities exchanges across different jurisdictions. This means that they are listed and traded in the public domain, making them sufficiently transparent. Being regulated products, REITs must disclose financial information to the respective investors on material risks and any developments in timely fashion.

3

PORTFOLIO DIVERSIFICATION:

REITs, fixed income securities and equities have different long-term investment characteristics creating diversification when combined within a single portfolio. This diversification creates the opportunity for blended portfolio to earn higher returns while reducing the potential for negative or low returns. Additionally, REITs offer flexibility where investors can build portfolios of custom REIT portfolio based on cap size, sector and geographic exposures. For instance, shopping malls, residential projects and industrial real estate projects are all very different, yet within the same sector, thereby aiding portfolio diversification.

4

CONSISTENT INCOME:

I-REITs are by law required to pay out at least 80% of its taxable income to their unitholders in the form of dividends. Consequently, REITs tend to generate a stable and consistent income stream for investors. This attribute of REITs investment performance takes on special significance for income-oriented investors, such as retirees.

5

ACCESS TO NEW CAPITAL:

REITs provide a mechanism to pool capital for investment into capital intensive long-term income producing real estate projects, which supplements other capital raising avenues which include debt and equity markets and raise funds to take advantage of opportunities when they arise. This offers investors easier access and ownership in the growing real estate sector in a manner which is not as capital intensive as a direct purchase of property.

6

LOW COST EXPOSURE TO REAL ESTATE:

REITs offer access to the property market with professionals such as property managers and fund managers at a relatively low transaction and management cost. Professional, dedicated management team responsible for the day-to-day operation of the business, provides the investor with expertise beyond his or her own knowledge base.

7

INCOME DISTRIBUTION:

All distributions of income and all payments for the redemption of units or sale of shares received by unit holders will be deemed to have been already paid.

8

HIGHER YIELDS AND RETURN:

REITs offer strong long-term total returns. Excellent long-term performance and strong diversification attributes make REITs a natural component of a well-balanced efficiently performing portfolio. Adding REITs to the typical investment portfolio can have a dramatic impact on its long-term stability and returns. REITs own hard, tangible assets such as land and buildings, and often sign their tenants to long-term lease contracts. Because of this, REITs tend to be some of the most stable companies on the market.

4. What are the risks associated with investing in REITs?

i. Despite the surge in property prices, people's personal incomes have not grown in tandem, therefore there is a strong possibility of a downward correction in property prices in Kenya as potential investors find it hard to participate in the market.

ii. Potential investors must scrutinize the amount of debt on a REIT's books as this can result in low distributions pay outs in case of a high interest environment. REITs have a limit on the maximum borrowing power, therefore the debt a REIT can have is controlled and can't be exceeded without default.

iii. Rental defaults and low occupancy rates may yield low income.

iv. The decrease in rental income as a result of the termination of lease agreements or non-renewal of lease agreements and failure to secure replacement tenants in good time.

v. For close-ended REITs, the investor is not able to access their investment before the end of the investment period. The investor cannot seek to redeem his investment before expiry of the investment period unless there is an arrangement with the Trustee's consent for the sale of the Investor's units.

vi. Economic and political situations that could lead to depreciation in the value of the property.

vii. Change in taxes – while REITs are currently exempt from VAT and stamp duty taxes, these benefits may change depending on the regime in place.

viii. Limited pool of investors especially institutional investors, like pension schemes, who are only allowed investment to a tune of 30 percent of asset of trustees.

5. What are the Features of REITs?

REITs trade like stocks but in some ways are more like unit trusts. REITs have the following characteristics:

1. Trade publicly on a securities exchange.

2. Listed REITS may be sold in an Initial Public Offer (IPO).

3. Are made up of a pool of money accumulated from many investors looking for a diversified real estate (like unit trusts) portfolio.

4. Restricted I-REIT - An offer that is made to specific group meeting certain thresholds such as being a professional investor. The intent of the restrictions is to protect the public in ensuring that only a certain criterion participate first-hand. An example is an I-REIT offered in minimum subscription or offer parcels of five million shillings and may, subject to these Regulations, only be transferred to a party to whom they could have been issued or offered.

6. What are the Minimum Sizes of Initial Assets for both REITs in Kenya?

a. The minimum size of initial assets for income REITs is Ksh.300 Million.

b. The minimum size of initial assets for Development and Construction REITs is Ksh.100 Million.

7. What are the Eligibility Requirements to Offer Real Estate Investment Trust for Income (I-REITs) in Kenya?

a. Property must be held in trust and professionally managed by a REIT manager.

b. The Trustee must be independent of the Promoter.

c. Only persons qualifying as professional investors in D-REITs qualify to invest in restricted I-REITs.

d. If unrestricted, offer must be listed on an approved exchange, for instance Nairobi Securities Exchange (NSE).

e. If restricted, offer may be listed but only on restricted exchange as per D-REIT, made to professional investors.

f. An I-REIT should invest, within two years of the date of its authorization as a real estate investment trust scheme, at least 75% of the total net asset value in income producing real estate.

g. The investment must be an income generating real estate property.

h. At least 1 (one) investment within 180 days of close of the offer or cash will be returned in full to the investors. During this period, funds to be held in trust account controlled by the trustee until registration.

i. Must be wholly owned and controlled company/ corporation conducting real estate business.

j. May borrow up to 35% of the total asset value and up to 40% of the total asset value with approval of the unit holders by way of an ordinary resolution for a temporary period of up to 6 months. No extension is permitted.

k. After the second year of authorization, at least 70% of the income must come from eligible investments in income producing real estate.

8. What are the Eligibility Requirements to Offer a Real Estate Investment Trust for Development (D-REITs) in Kenya?

a. Property must be held in trust and professionally managed by a REIT manager.
b. The Trustee must be independent of the Promoter.
c. May only be listed on an approved market segment of approved licensed securities exchange which limits trades to minimum of Ksh.5 million and the investors to professional investors.
d. Should only be offered to professional investors and does not need to be listed on a securities exchange.
e. Direct investments in real estate with at least 1 (one) investment within 180 days of close of the offer or else 25% of the unit holders may request the return of cash.
f. A minimum 30% to be invested in development and construction projects or income producing real estate within a year of authorization which the D-REIT has constructed or developed.
g. May borrow up to 60% of the asset value or up to 75% of total asset value with approval of unit holders, by way of an ordinary resolution, for temporary period of up to 6 months.

9. What is the Minimum Number of Investors to Participate in an I-REIT or D-REIT?

A minimum of 7 investors in both D-REIT and I-REIT.

10. Can a Development REIT convert to an income REIT?

Yes, it may convert to an I-REIT after the property has been developed.

11. Who is Eligible to Invest in REITs?

There is no regulatory minimum amount of investments for investors investing in unrestricted I-REITs. However, a minimum investment of Kshs.5 million required for an investor to qualify to be categorized as a professional investor for purposes of investment in a D-REIT or restricted I-REIT.

12. Who is Considered a Professional Investor in Kenya for the purpose of REITS?

A professional investor includes; any person licensed under the Capital Markets Act; or an authorized collective investment scheme; or a bank or subsidiary of a bank, insurance company, cooperative, statutory fund, pension or retirement fund or a person including a company, partnership, association or a trustee on behalf of a trust which, either alone, or with any associates on a joint account subscribes for REIT securities with an issue price equal to at least five million shillings.

13. What is the Initial Minimum Funds Retention for a Promoter?

a. For D-REITS, a promoter must maintain an investment of at least 10% of the value of the fund as at the date of the issue of units for 2 years. Thereafter, the promoter may reduce its investment to 0%.
b. For I-REITS, a promoter must maintain investment of the value of the fund as at date of the initial issue of units of 20% Net Asset Value for the first year and 10% for the second. Thereafter, the promoter may reduce its investment to 0%.

14. What are some of the Tax Treatments for REITS?

Below are some of the tax treatments with regards to REITs:

a. REITS registered by the Commissioner of Income Tax are exempt from Income Tax except for the payment of withholding tax on interest income and dividends.
b. Income of exempt investors remains exempt.
c. Withholding tax constitutes final tax on that income.

For further information, please contact:

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