GLOBAL HOUSING STRATEGIES
consulting & investment services

An Alternative Off-Take to Home Sales: The Rental Housing Solution

THE PROBLEM & THE CHALLENGE

Residential housing developers are always concerned with sales. They are generally wary of building many homes and ending up stuck with inventory. In fact, most successful housing developers avoid building houses on "spec", meaning they avoid speculative building in anticipation or reliance that sales will ultimately occur. The reason: it is very expensive to sit on an inventory of unsold homes. Such inventory becomes a "deal asset", meaning it generates no cash flow while being held.

In many emerging markets where housing deficits are large and continuing to grow, one may be tempted to think that it is far-fetched for a good developer to have difficulty selling homes. In other words, you might argue that this risk is minimal in emerging markets. However, this is not necessarily the case for two reasons: (i) sales must be made at price points that are affordable to the homeowner, and (ii) monthly payments on the mortgage loan needed to finance the purchase must be affordable to the homeowner. Both the home and the borrower must be bankable. If either of these two conditions are not met, sales in sufficient quantity cannot be achieved.

OUR ANSWER TO THE CHALLENGE

The solution involves converting the "dead asset" to an income-producing asset and thereby achieving complete sell-out of homes offered for sale. We can do this by marketing to a portion of the home-buying public that can afford to rent, but either don't want to buy a home (they prize their mobility/flexibility) or can't afford to buy a home (perhaps because interest rates are too high or the required down-payment is too large). People must have someplace to live, so let us design housing projects – focused on middle-class affordable housing - where rental rates are affordable to a wide group of households while concurrently satisfying the investment requirements of investors. The challenge is now to design the investment vehicle and find the investor group who would find such a vehicle attractive.

One kind of investment vehicle is a simple real estate operating company (a REIV) which acquires, holds, and trades residential housing portfolio for rental. They can be a suitable investment vehicle for provision of rental housing on a commercialized basis. A special kind of investment vehicle is Real Estate Investment Trusts (REITs). REITs are companies with tax-passthrough characteristics enabled by law. This means that they are not taxed on the earnings from their assets , but rather only the investor in the vehicle is taxed. The avoidance of double taxation goes a long way to making this kind of investment vehicle more financially attractive . The vehicle will have shareholders who may be a combination of professionally run investment institutions like pension funds, and private individuals. The REIV is ultimately listed on a local stock exchange and traded. Thus, the investor obtains market-discipline, transparency, and liquidity - in addition to a respectable "total return."

WHAT IS "TOTAL RETURN" AND HOW WOULD THIS WORK?

Total return is a combination of cash flow yield and capital appreciation. Cash flow yield stems from net rental income (net of property management expenses). Capital appreciation comes when the homes are sold to homeowners or other investors, likely after a holding period of five years or so.

[1] If they payout 90 to 95 percent of net earnings each year. This threshold percentage of payout is typically embodied in the enabling law.

[2] The tax passthrough feature is important to avoid double taxation. Because of the passthrough feature, there is more "juice" meaning higher yields for investors. It makes the proposition much more attractive. If you employ an ordinary corporate structure, you get more flexibility but less profit. REITs are passthrough vehicles and that is the way they would operate in Rwanda, as elsewhere. It is "securitized" real estate. Any investor, even ordinary everyday people, get to invest and benefit from holdings in commercial (income producing) real estate. You do not need sophistication or special knowledge. You do not need large sums of money to participate. The investment is relatively safe with respectable total return. In fact, our perspective is that retail investors see the investment opportunity in rental housing, but few can afford to develop or buy. The REIV or REIT offers participation in relatively small increments. It is often called "democratization" of real estate investing.

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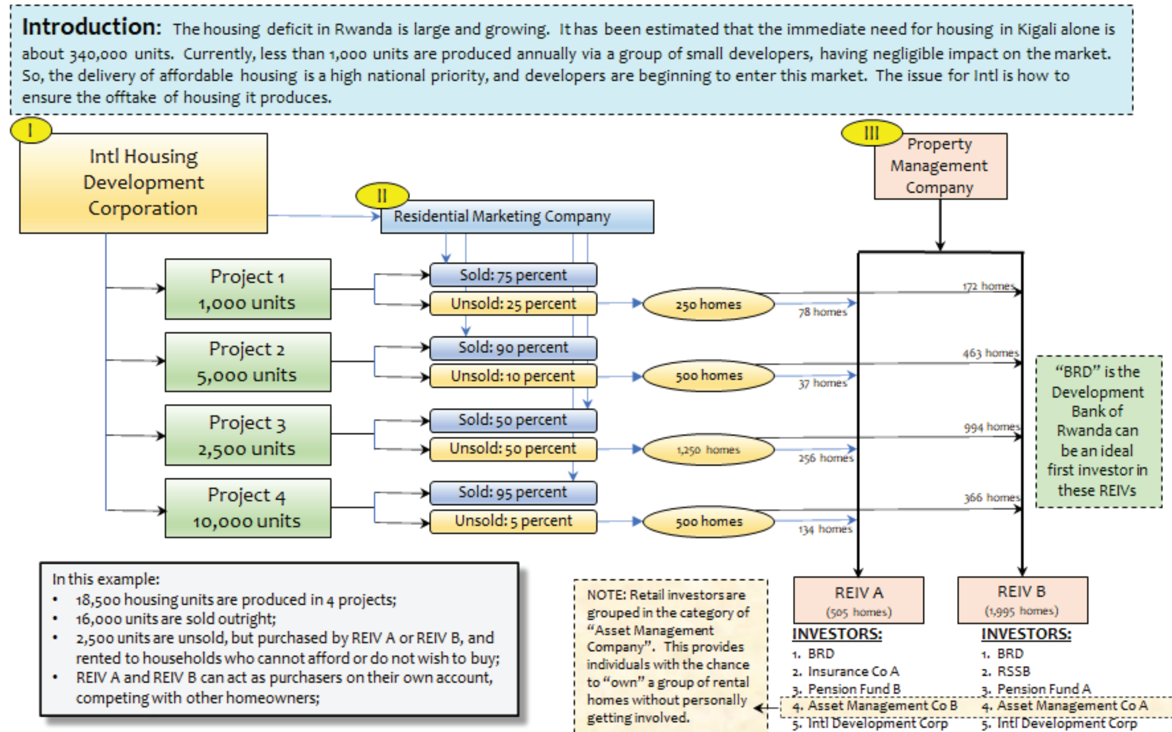
The process: we initiate the creation of a housing REIV (or two) and bring in other investors, even the local investing public, perhaps in the form of a pooled investment vehicle. This REIV bids for some of the housing production, in accordance with its financial resources. The developer obtains sales of homes – to the REIV, the public obtains a stock of housing for rental, and the investment community obtains a new high-quality asset class. This asset class has a regular bond-like yield with a periodic "sweetener" in the form of price appreciation. More jobs are created, and the higher level of economic activity serves the national economy well in many other ways. Win-win-win-win.

A PRACTICAL EXAMPLE

The following graphic helps illustrate how all this might work in practice:



LISTING THE REIVS AND EXIT STRATEGY

It is important to be realistic about immediate listing and liquidity. In an emerging market, even in Rwanda where the Capital Markets Authority and the Stock Exchange Authority are looking for new listings to strengthen the stock exchange, listing any new and unproven venture is difficult. To successfully list, the enterprise must evidence some track record of performance (meaning profitability) and demonstrate that it is staffed and run by people who know what they are doing. Therefore, it is common for a new REIV to be organized and operate as a private company for 2 to 3 years, and then go for a listing. All the while, it needs to get audited regularly by a major accounting firm. The exit for founding shareholders (who would be expected to take a significant shareholding at the inception) might come from listing. This does not mean that a lead investor must go it alone at the beginning. A REIV organized as a non-public company can certainly have in-country and international partners, and this might be manageable with only 20-30 percent lead investor-related shareholding. But it would have to be "first money in" as founding shareholders. Once a track record is established, it would be relatively easy to list the REIV and begin to seek a complete or partial exit, if that is what the principals wanted to do. On the other hand, the peak in the growth of the hard asset valuation would probably come in the 4 to 6-year range. Thus, it might make financial sense to have a seven-year investment horizon in mind.

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