Bifm
Dynamic
Wealth Management

Real Estate Funds- What Investors should know.

Over the years we have seen a surge in property development in Gaborone and surrounding areas. The new CBD has transformed the skyline of the city with new high-rise buildings, and the emergence of new modern one-stop shopping centres has been on an upward trajectory. In surrounding areas like Tlokweng and Mogoditshane, the development of multi-residential units has been on the rise as the population migrates more into urban areas. The common factor for these commercial establishments is the chase for rental and capital returns. But the question we want to look at closely is how pension funds can participate in the property market? To that end, we explore, in detail, the various investment vehicles available namely listed (public) property funds and non-listed (private) property investments.

Listed (Public) Funds

In general, the fact that an instrument is listed means it can be traded on a formalised exchange such as the Botswana Stock Exchange (BSE). The most common listed real estate securities are property sector stocks, listed Funds (ETFs and Mutual Funds), and Real Estate Investment Trusts (REITs).

Listed Funds pool funds from several investors and invest directly in the different sectors of the property market, generating both rental and capital returns and distributing excess income to investors. To gain access to listed Funds, investors can buy shares directly in the open exchange. A REIT, on the other hand, is an investment company that owns and operates income producing real estate. There are specific requirements that must be met for an undertaking to qualify as a REIT. Two distinguishing features of a REIT are at least 75% of the total assets must be invested in real estate, and the share of gross income must come from property rentals; moreover at least 90% of the portfolio's taxable income must be paid as dividends to shareholders (or unitholders). To gain access to REITs, investors can purchase shares (or units) directly on the open exchange or invest in a pooled Fund, typically referred to as a Mutual Fund.

In Botswana, listed property companies are structured as variable rate loan stock (VRLS) companies in terms of the Companies Act. and These issue shares and debentures, which together comprise linked units. The ownership of linked units in a VRLS company is tax efficient as profits are distributed by means of both dividends and debenture interest, with the debenture interest typically being larger than the dividend and the total amount of interest is tax deductible from the income of VRLS company as an expense. However, dividends and interest are subject to withholding tax unless the unitholder is tax exempt, as in the case of pension funds.

Unlisted (Private) Funds

In contrast, a non-listed real estate exposure involves buying an interest in one or more real estate properties where the investor receives cash flow payments from rental and capital appreciation of the property. Investors can gain access to non-listed real estate through direct purchase of properties or participating in a Mutual Fund to pool their capital with other investors and participate in larger properties that may otherwise be too expensive for them individually. The Bifm Local Property fund (Bifm LPF) is the only unlisted investment vehicle available to small to medium institutional investors and enjoys tax efficiency as it is structured as a VRLS. Other large institutional investors invest directly through their own Funds through a similar structure.

Common features and key differences

Research shows that both listed and non-listed real estate exposures are exposed to the same real estate factors, but the short-term dynamics of the two tend to differ. In the long run, however, after correcting for leverage, smoothing effects, and sector differences, both types of investments behave similarly. The table below shows some of the key differences between listed and non-listed real estate investments.

Figure 1: Comparison of Listed and Non-Listed Real Estate

	Listed Real Estate	**Non-listed Real Estate**
Returns	Correlation to underlying real estate in the medium to long term but to equities in the short term	Returns are expected to be higher than listed due to the high correlation with direct real estate markets.
Volatility	High	Low
Liquidity	High, daily	Low
Transparency	High (Public disclosure requirements mandatory)	Low (information not widely available)
Governance	Strong by law, the board of directors directly responsible	Weak, mostly as a result of fund structure.

Investor Influence	Limited impact on management and strategy	High impact on management and strategy
Leverage	High	Low
Initial Investment Requirement	Easy to achieve from pooled investors	Difficult to achieve due to the high investment needed to construct a well-diversified portfolio

Source: KCM

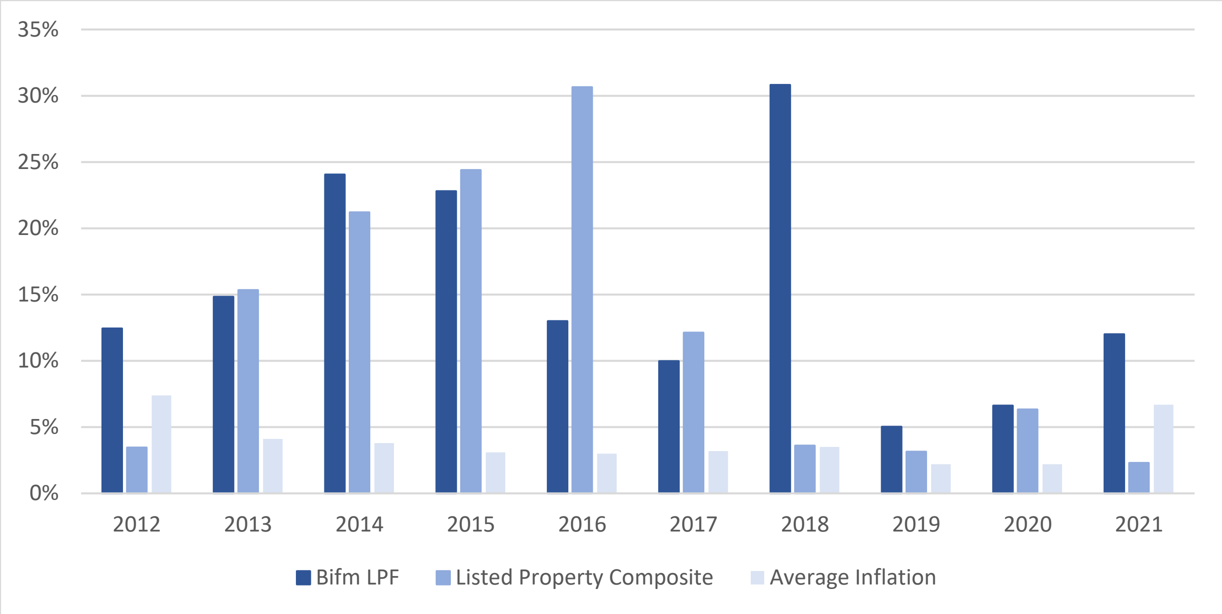
A key difference between listed and unlisted real estate is that the former trade on more centralised exchanges and offers immediate liquidity with transparent pricing. Whilst this may be true for developed markets exchanges, it is not necessarily true in the case of BSE, which is characterised by liquidity constraints. The non-listed real estate is a more illiquid asset, and transactions can take several months to conclude. The liquidity assumption has consequences for both pricing and reported returns of the listed and non-listed real estate.

Whilst listed and non-listed real estate are exposed to the same real estate factors, listed real estate tends to have a higher short-term correlation to equity markets. This is so because listed real estate companies are traded on stock exchanges where other equities trade. Investors will typically buy and sell real estate securities relative to how they fair against other listed stocks as they form part of the same index. However, in the longer term, the expectation is that listed real estate returns to be more correlated to the underlying property markets returns whilst non-listed real estate, in the long run, are expected to generate higher relative returns due to the liquidity premium.

Real Estate Market Opportunities in Botswana

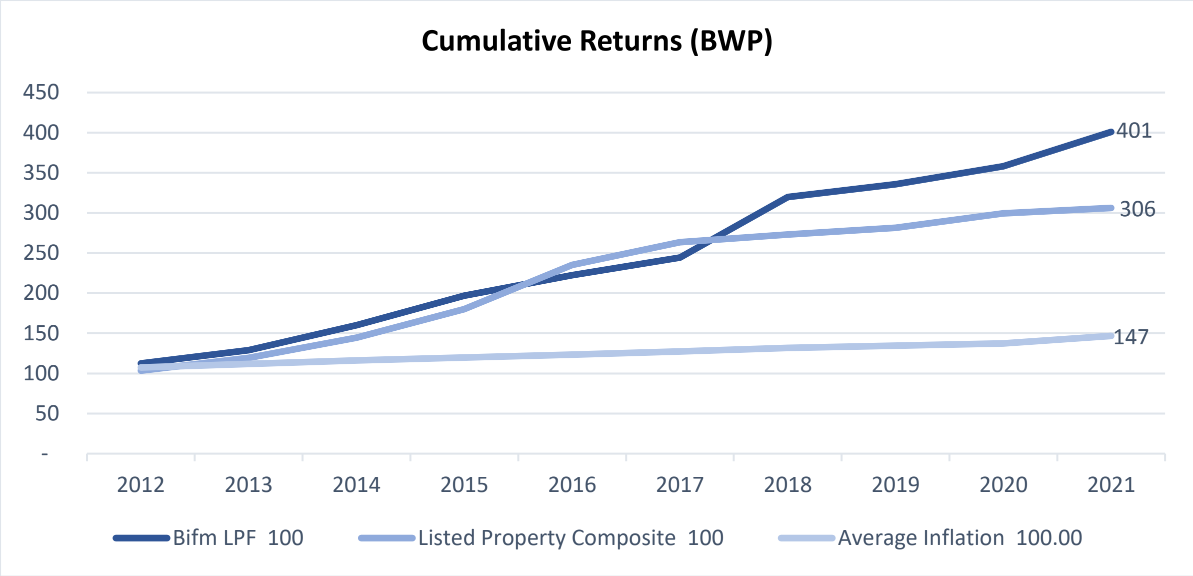
The chart below shows the average returns of the available real estate investment opportunities in Botswana. The listed market is represented by a composite of property companies (known as Variable Rate Loan Stocks) listed on the BSE. The unlisted property market returns are represented by the Bifm Local Property Fund, the only unlisted real estate investment vehicle for small to medium institutional investors. Unfortunately, there is no publicly available benchmarks (performance yardsticks) for unlisted real-estate investments in Botswana.

Figure 2: Comparison of Listed and Unlisted Property Returns Against Inflation



The above chart generally confirms that a weak but positive correlation exists between listed and un-listed property returns in the short term; the listed property returns are more correlated with the performance of the BSE Domestic Company Index (DCI). Unlisted real estate returns, on the other hand, are more correlated with the performance of the general property market. Against inflation, the unlisted property returns have outperformed inflation from 2012 until 2020, which supports the notion that real estate acts as an inflation hedge in the long run. Listed property returns have outperformed inflation in calendar years save for 2012 and 2021.

Figure 3: Cumulative Property Returns Chart



The above chart shows that P100 invested at the beginning of 2012 in a diversified unlisted property fund (the Bifm Local Property Fund is used as proxy) would have generated a gross return of P301 by the end of 2021 and a real return of P264. In contrast, P100 invested in a listed property fund at the beginning of 2012 would have generated a gross return of P206 by the end of 2021 and a real return of P169. The average inflation shows that a good/service that cost P100 at the beginning of 2012 cost P147 at the end of 2021. Two important observations can be drawn from the above. The first observation is that unlisted property Funds have generated higher returns than listed property Funds in the long run due to the liquidity premium. In the above graph, the unlisted property Funds generated a P95 real return in excess of listed Funds' returns. Lastly, both the listed and unlisted property Funds real returns were in excess of inflation, this supports the notion that real estate returns act as an inflation hedge in the long run.

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