

Identifying the Major Constraints to Investment in Residential
Rental Property in South Africa

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Abstract

Purpose – This research investigated the constraints to investment in residential rental property in South Africa. This research does not attempt to value or place these constraints in any hierarchical order; rather, it identifies the constraints in the South African context for research in the future.

Design – A literature review was conducted, and constraints to residential rental property were identified. A semi-structured interview was then designed, and a field study was launched, interviewing key residential investment property market stakeholders regarding their views on the constraints to investment in residential rental property in South Africa. Quantitative data was used to corroborate the findings of the interviews, and pattern analysis was the technique drawn on to explain the findings.

Findings – Participants identified six major constraints to investment in residential rental property in South Africa. These include financial liquidity or funding; property liquidity; management skills; management costs; the lack of investment market information; and legal constraints.

Practical Implications – The results of this research will enable further research into the specific constraints mentioned above, in order to assess if there are ways to minimise those constraints going forward.

Table of Contents

Declaration.....	i
Abstract.....	ii
List of Tables	vi
List of Figures.....	vi
List of Abbreviations	vii
Chapter 1: Introduction	1
1.1 Introduction	1
1.2 Background to the Study	1
1.3 Problem Statement	3
1.4 Research Question	3
1.5 Research Proposition.....	3
1.6 Research Aim	3
1.7 Research Objectives	3
1.8 Research Methodology	4
1.8.1 Research Approach and Research Design.....	4
1.8.2 Data Collection.....	4
1.8.3 Data Analysis.....	4
1.9 Limitations and Delimitations	4
1.10 Report Framework.....	5
Chapter 2: Literature Review.....	6
2.1 Introduction	6
2.2 Review of the South African Residential Property Market.....	7
2.2.1 A history of residential rental property in South Africa.....	7
2.3 Supply of housing	8
2.3.1 Public sector delivery	8
2.3.2 Private sector delivery	8
2.3.3 Existing rental stock	9
2.3.4 Gaps in the supply of rental housing	10
2.4 Housing Affordability	11
2.5 Extent of demand for rental housing	13
2.5.1 Overview	13
2.5.2 General housing demand	14

2.5.3 Summary of housing supply and demand	17
2.6 Residential rental property portfolio in an investment context	18
2.6.1 Investment company structure.....	19
2.6.2 Modern Portfolio Theory (MPT) and residential rental property.....	20
2.7 Constructing a residential rental portfolio.....	21
2.7.1 Residential rental portfolio: An overview	22
2.7.2 Key characteristics of the private residential rented sector	23
2.7.3 Constraints or disadvantages to holding a residential rental portfolio:	24
2.7.4 Asset allocation	26
2.7.5 Managers’ skill-set and financial models	27
2.7.6 Portfolio performance and benchmark indices.....	28
2.7.7 Transaction Costs	29
2.8 Summary	30
Chapter 3: Research Methodology.....	32
3.1. Introduction to Research Methodology.....	32
3.2 Data Collection.....	32
3.2.1 Semi-structured interviews.....	32
3.2.1.1 Interview sample	34
3.2.2 Interview questions.....	35
3.2.3 Secondary data analysis.....	35
3.3. Data Analysis	35
3.4 Limitations and Delimitations	36
3.5 Summary	38
Chapter 4: Research Findings and Data Analysis	40
4.1 Qualitative Findings and Analysis	40
4.1.1 Survey participant demographics	40
4.1.2 Research Results – Pattern-matching	41
4.1.2.1 Financial Liquidity (Funding)	42
4.1.2.1.1 Summary of findings	43
4.1.2.2 Property Liquidity (Stock).....	43
4.1.2.2.1 Summary of findings	44
4.1.2.3 Rental Return.....	45
4.1.2.3.1 Summary of findings	46
4.1.2.4 Management Skills	46
4.1.2.4.1 Summary of findings	48
4.1.2.5 Management Costs	48
4.1.2.5.1 Summary of findings	50

4.1.2.6 Investment market information	50
4.1.2.6.1 Summary of findings	51
4.1.2.7 Residential risk profile	51
4.1.2.7.1 Summary of findings	53
4.1.2.8 Legal constraints	53
4.1.2.8.1 Summary of findings	54
4.1.3 Additional findings	54
4.2 Economic Data Findings and Analysis	55
4.2.1 National yield comparisons	55
4.2.2 Regional yield comparisons	58
4.2.3 Segment yield comparison	59
4.2.4 Yield by tenure number of rooms.....	60
4.2.5 Conclusion to quantitative findings.....	61
Chapter 5: Conclusion and Recommendations.....	62
5.1 Findings regarding the research question.....	62
Other notable findings	67
5.2 Recommendations and further areas of study.....	69
References.....	70
Appendices.....	74
Appendix A – Field Study Interview Structure.....	74
Appendix B – Confidentiality and Consent.....	76
Appendix C – Ethics Clearance.....	77

List of Tables

Table 1 Home typology, 2002-2010 (Lachman, 2012 p 47).....	10
Table 2 Housing product availability by housing sub-market type (Rust, 2006 p31) ..	11
Table 3 Mortgages granted - gross monthly income of individual (Rust, 2012 p13)..	12
Table 4 Maximum rent affordability derived from monthly household income and average expenditure on housing (Stats SA, 2011). *	14
Table 5 Change in Average Rents, 2006-2011 (Lachman, 2012 p50).....	117
Table 6 Interview respondent heat map.....	37
Table 7 Participant coded to entity and role.....	37

List of Figures

Figure 1 NHBRC enrolments 2007-2014	9
Figure 2 Total mortgages added per year (Rust, 2012 p13)	12
Figure 3 Credit granted as a percentage of distribution (Rust, 2012 p12).....	13
Figure 4 Rented Dwellings by Province (Social Housing Foundation, 2008 p12).....	16
Figure 5 National gross average yield (TPN-FNB, 2015 p1)	56
Figure 6 Proportion of buyers buying to let (TPN-FNB, 2015 p2)	57
Figure 7 Percentage of residential rental tenants in good standing (TPN-FNB, 2015 p2)	57
Figure 8 Gross yield by major metropolitan region (TPN-FNB, 2015 p3)	58
Figure 9 TPN percentages of residential rental tenants in good standing by major province (TPN-FNB, 2015 p3)	58
Figure 10 Gross residential property yields - by area value band (TPN-FNB, 2015 p3)	59
Figure 11 Percentage of residential rental tenants in good standing by rental price band (TPN-FNB, 2015 p4)	60
Figure 12 Average gross yields by tenure and room number (TPN-FNB, 2015 p5)...	61
Figure 13 Major Constraints to Investing in Residential Rental Property in SA.....	67

List of Abbreviations

AVMs	Automated Valuation Models
BFP	British Property Federation
CAPM	Capital Asset Pricing Models
CPA	Consumer Protection Act
FNB	First National Bank
GDP	Gross Domestic Product
IPD	Investment Property Databank
JSE	Johannesburg Stock Exchange
KZN	Kwa-Zulu Natal
MPT	Modern Portfolio Theory
PUT	Property Unit Trust
PIE Act	Prevention of Illegal Eviction Act
REIT	Real Estate Investment Trust
SAPY	South African Listed Property Index
SHF	Social Housing Foundation
TPN	TPN Rental Bureau
VAT	Value Added Tax

Chapter 1: Introduction

1.1 Introduction

In recent years, there has been a shift in the focus of listed property funds from purely commercial, industrial or retail property assets to an acknowledgement of the value of building a residential property portfolio as a means of diversification from the other property types. It has also been acknowledged as a property type with its own strong investment characteristics and returns (Indlu Place Properties, 2015).

There is also a severe shortage of housing in Africa, and many of its citizens either live in informal accommodation, or have no shelter at all (Leissner, 2015). Given the need for yield-enhancing property assets from the private investment sector (Indlu Place Properties, 2015), and the need for rental accommodation from the consumer, this research seeks to investigate the constraints to investing in residential rental property in South Africa. This is undertaken in order to clarify if it would be economically viable for more investment into residential rental properties to occur from private and institutional investors.

In this chapter, the background to the study is described, and then the problem statement, research question, proposition, aim and objectives follow. A brief outline of the research methodology used in the study is presented, followed by the limitations and delimitations of the study and a framework for this report.

1.2 Background to the Study

South Africa hails from a past in which provision of formal public rental housing was closely tied to the politically and economically motivated control of the African labour force (Wilkinson, 1984). During Apartheid, from 1948 onwards, formal urban townships were constructed *en masse* in order to facilitate the removal of freehold rights of Africans in designated “white” urban areas and to control the movement of Africans from the “homelands”; and the occupancy of the rented units was consequently closely monitored (Watson & McCarthy, 1997).

It is reasonable to expect that property investment companies could play an important role in the transformation of South Africa's residential housing market and the supply of stock into this market. These entities may take the form of private individuals, private limited companies specialising in residential investment property, institutional private property investment vehicles, or listed property companies in the form of a Real Estate Investment Trust (REIT).

There is strong evidence in other countries such as Canada, that as much as 30% of all residential accommodation is rented in the private sector (Miron, 1994). Other countries have a much larger residential weighting in their REIT structures, while South African REIT's hold less than 2% of their assets in residential property as of January 2015 (Indlu Place Properties, 2015). There seems to be a strong demand for residential rental stock, and the issue lies with finding ways to enable supply through breaking down the constraints, if any, to residential property investment.

Between 2006 and 2015, gross national residential rental yields varied from between 7.54% to 9.65% excluding possible capital gains (Loos, 2015). This seems to show that there is a strong investment case for residential property investment with other asset classes, such as two-year government retail bonds on the market at a yield of 7.25% (RSA, 2015), and historical dividend yields varying between 2-6%.

Despite the possible incentives for private property investors to participate in the market, there are many practical difficulties associated with constructing a residential property portfolio. Some of the management issues that have been identified include small transaction sizes as opposed to larger commercial investments, and the numerous properties to manage in a sizable portfolio. There is evidence to suggest that this hinders entry into this market by larger institutions (Mansfield, 1999). The proportion of buyers purchasing to rent in the South African market is at its lowest proportion since 2004, when 26% of residential property purchases were for rental as opposed to 2015 where only 9% of residential property purchased is for rental (Loos, 2015). In the context of the strong need in South Africa for residential rental property, and the possible financial gains to be made for a prospective investor, the following problem statement can be formulated:

1.3 Problem Statement

Despite an appetite by the private sector for yield enhancing and portfolio diversifying property assets in South Africa, there is limited private sector investment in residential rental property in South Africa.

1.4 Research Question

What are the main reasons for limited private sector investment in residential rental property in South Africa?

1.5 Research Proposition

There are management, financial and political constraints that inhibit significant private sector investment in residential rental property in South Africa.

1.6 Research Aim

To identify the factors that constrain private sector investment in the South African residential rental property market.

1.7 Research Objectives

- Review the literature to firstly, understand the South African residential market and establish the size of potential and current demand for rental within the market. Secondly, to ascertain what factors have been identified that restrict investment in international residential rental markets.
- Through a field survey design, undertake a series of qualitative, semi-structured interviews of property investors, developers and managers to establish if these same factors restrict investment in residential rental property in South Africa.
- Process and analyse the interview responses using pattern-matching techniques.
- Apply descriptive statistical techniques to investment returns secondary data to corroborate the findings of the field survey.
- Use the analysis to conclude what factors inhibit significant investment residential rental property in South Africa.

1.8 Research Methodology

1.8.1 Research Approach and Research Design

A mixed-methods approach was used and the process applied primarily a qualitative field survey design to answer the question. A quantitative secondary data design was then used to statistically describe and analyse rental returns and these findings were used to corroborate the information gathered by the field survey (Hammersley, 1996; Bhattacharjee, 2012).

1.8.2 Data Collection

In terms of the field survey design, semi-structured interviews were used to collect the data for the research. This is because interviews offer richer and more extensive material than data from surveys or even the open-ended portions of survey instruments (Yin, 2009).

Secondary data of property rental returns were then attained from the TPN-FNB Residential yield database (Loos, 2015) which combines the TPN rental data with FNB's house price data. Gross yields were derived for certain categories of residential rental property from the data and used to corroborate the findings for the qualitative research.

1.8.3 Data Analysis

A combination of quantitative and qualitative analysis was used to analyse the data collected. Pattern-matching was used as the analytical strategy, where empirical patterns were matched with patterns identified in the literature (Yin, 1994). Descriptive statistics were used to analyse the secondary data regarding the average rental returns.

1.9 Limitations and Delimitations

This study is subject to the following limitations:

- a) This study is limited to South African residential investment property, in line with the research questions to be addressed.
- b) Due to the limited timeframe of this research, it was not possible to interview an exhaustive list of property experts in South Africa, this research therefore focused on a select number of experts in the residential investment field.

1.10 Report Framework

The research report contains the following structure:

Chapter 1 provided the introduction and a background to the study, followed by the problem statement, research questions, research propositions and aims and objectives of the study. The research methodology, limitations and delimitations of this study were also outlined above.

Chapter 2 reviewed the literature on the demand for residential rental property in South Africa and the factors that have inhibited investment in residential rental property across international markets.

Chapter 3 discussed the research methodology constructed for the purposes of this research. It explores the requirements and limitations of the method used.

Chapter 4 presented and analysed the findings of the research.

Chapter 5 concluded the research by providing a summary of the research and the limitations faced. Recommendations for future research were also outlined in this section.

Chapter 2: Literature Review

2.1 Introduction

This chapter reviews the literature of the South African residential property market from a historical macro level, and further investigates the supply and demand for housing in South Africa. The literature review then examines the demand for rental housing in South Africa and addresses the findings from a practical point of view, investigating the financial feasibility and practical implications of constructing a residential rental portfolio. Patterns identified through the literature, and later assessed in line with the data collected for this research, include:

- Financial Liquidity (Funding)
- Property Liquidity (Stock
- Rental Return
- Management Skill
- Management Costs
- Investment Market Information
- Residential Risk Profile
- Legal Constraints

These patterns run through various sections of the literature, and as such, the discussion enclosed below identifies the considerations that are pertinent to understanding the constraints to property investment in South Africa.

The literature review is presented as follows:

Section 2.2 presents a general review of the South African residential property market, and provides a brief history of it in order to lay the context for the following sections.

Section 2.3 deals with the supply of rental housing, both from a private and public viewpoint.

Section 2.4 discusses housing affordability.

Section 2.5 deals with the demand for rental housing in South Africa and explores the current market situation. This section also investigated the need for rental housing and investigated the existing rental stock position in the country.

Section 2.6 investigates the inclusion of residential rental property in the context of an investment portfolio context, and deals with the suitability of residential property for investment in relation to Modern Portfolio Theory (MPT), as well as suitable company structures for the residential rental investment company.

Section 2.7 of the literature review addresses issues relating to constructing a residential rental portfolio. Finally, section 2.8 summarises the literature review.

2.2 Review of the South African Residential Property Market

2.2.1 A history of residential rental property in South Africa

In the last century, extensive programmes were enacted in some Southern African countries where the provision of formal public rental housing was closely tied to the politically and economically motivated control of the African labour force (Wilkinson, 1984). During the era of Grand Apartheid, from 1948, formal urban townships were constructed *en masse* in order to facilitate the removal of freehold rights of Africans in “white” urban areas, and to control the movement of Africans from the “homelands”. To this end, the occupancy of the rented units was consequently closely monitored (Watson & McCarthy, 1997).

With the advent of democracy in 1994, housing policy was subject to extensive debate through the National Housing Forum, however, the most important features of the new housing policy framework (published in a government White Paper in 1994) are a result of earlier policy-making efforts and strongly reflect the interests of the private sector (Lupton & Murphy, 1995). Central to the policy was the concept of a public-private partnership and a commitment to the “incremental approach” to housing, which involved a one-off capital subsidy to provide serviced sites with some superstructure on freehold title. The onus is on the beneficiary thereafter to manage the property with their own resources (Watson & McCarthy, 1997). Some provision was made for formal rental accommodation through housing cooperatives and non-

profit “social housing” agencies, but the role that these provisions would play in the solution were viewed sceptically at the time of enactment (Wilkinson, 1984).

To understand what pressures there are in the housing sector in South Africa currently, and to analyse how rental housing could alleviate these pressures, it is important to gain an understanding of the demand throughout the income spectrum, and inspect what kind of housing is needed to assist in relieving the lack of housing. The following section will address the demand for housing in South Africa.

2.3 Supply of housing

2.3.1 Public sector delivery

The government is the biggest single provider of housing in South Africa (Lachman, 2012). The government reported that 2.5 – 2.8 million new units were completed between 1995 and March 2011 (Lachman, 2012).

Despite the increasing supply of subsidised units into the market, the public sector cannot keep up with the demand. In the fiscal year 2010-11, only 121 879 units were delivered (Lachman, 2012). The government has therefore fallen short of its goal of producing 160 000 units annually for low-income households. The government does not contribute to the supply of any housing above this threshold. The lack of delivery in the public sector points to a need for the private sector to play a role to alleviate the housing shortage (Leissner, 2015). This contributes to the constraints faced by investors when considering whether to invest in the South African property market, and reflects the pattern of *Property Liquidity*, as there is a shortage of stock available.

2.3.2 Private sector delivery

According to NHBRC data of housing enrolments between 2007 and 2014, the private sector delivered over 1 million homes (NHBRC, 2014), this is a five-fold increase from the period between 2000 and 2004, where 200 000 new units were delivered (Rust 2006a). Of the 1 million units delivered in the period from 2007 to 2014, 704 632 (70%) units were housing subsidy enrolments or alternatively “affordable housing”. The proportion seems to be rising from 30% of all annual enrolments being subsidy housing in 2004, (Rust 2006a) to 70% in 2013 and 2014 as shown in Figure 1.



Figure 1 NHBRC enrolments 2007-2014 (Lachman, 2012 p 45)

2.3.3 Existing rental stock

South Africa’s housing stock predominantly consists of single-family detached homes (Lachman, 2012). According to recent data, nearly 70% of South African households own their own homes, either entirely or in part (Lachman, 2012). Renters constitute 21% of households, and while 10% of people live rent-free, either through a formal arrangement or as squatters (Lachman, 2012).

More than three out of every four South African dwellings are considered to be “formal” which means that it is owner-occupied (protected by deed) or subject to a lease. From Table 1, one can see that although formal stock has increased since the end of Apartheid, the share of homes that are owner-occupied or protected by a lease has not changed substantially. This suggests that the rate at which formal housing is being constructed is not sufficient to lessen the demand for informal units, a clear pattern within the literature that links to property liquidity constraints in terms of the contextual issues faced in rental property investment in South Africa.

Table 1 Home typology, 2002-2010 (Lachman, 2012 p 47)

	<u>Number of Units (000s)</u>					<u>Formal</u>
	<u>Formal</u>	<u>Informal</u>	<u>Traditional</u>	<u>Other</u>	<u>Total</u>	<u>Share (%)</u>
2002	8,104	1,434	1,170	306	10,708	75.7%
2003	8,439	1,452	1,210	261	11,101	76.0%
2004	8,699	1,392	1,358	262	11,449	76.0%
2005	8,553	1,895	1,320	306	11,768	72.7%
2006	9,163	1,806	1,221	286	12,190	75.2%
2007	9,389	1,918	1,244	350	12,551	74.8%
2008	9,930	1,882	1,385	153	13,197	75.2%
2009	10,430	1,845	1,417	120	13,692	76.2%
2010	10,999	1,859	1,385	61	14,243	77.2%
% Increase, 2002-2010	35.7%	29.6%	18.4%	-80.1%	33.0%	

2.3.4 Gaps in the supply of rental housing

It is clear that housing supply and housing affordability is severely constrained in South Africa. This creates increasingly limited residential opportunities across South Africa, and infers that the housing backlog is not limited to the subsidised market. Large portions of South Africa's housing market are struggling to meet demand, driving even the more affluent markets to reach the limits of household affordability as households are forced to compete for limited supply.

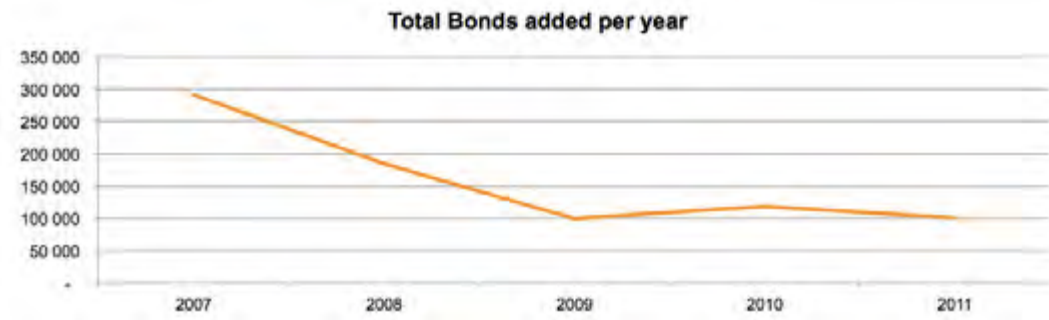


Figure 2 Total mortgages added per year (Rust, 2012 p13)

Rust (2012) also highlighted the slight decrease in the ability of lower income households to qualify for traditional bank finance. For earners of below R10 000 per month, the share of credit granted fell from 5.81% in 2010 to 5.64% in 2011 (Rust, 2012) as illustrated in Table 3.

Table 3 Mortgages granted - gross monthly income of individual (Rust, 2012 p13)

Level of income	2010-Q3	2010-Q4	2011-Q1	2011-Q2	2011-Q3
<=R10k	2 430	2 530	2 147	2 090	2 568
% share of credit granted	5,81%	5,96%	5,61%	5,47%	5,64%
R10.1K-R15K	4 972	5 288	4 577	4 523	5 708
% share of credit granted	11,88%	12,46%	11,96%	11,84%	12,53%
>R15K	34 433	34 620	31 539	31 574	37 270
% share of credit granted	82,31%	81,58%	82,43%	82,68%	81,83%
Total number of mortgages	41 835	42 438	38 263	38 187	45 546

As shown in Figure 3, it was also noted that credit in the form of mortgages granted has fallen from highs of 45% in 2008 to around 30% of total credit granted in 2011. Unsecured lending has more than doubled its share of total credit granted in the same period (Rust, 2012).

In addition, The Social Housing Forum (2008) stated that changes in South Africa's credit law, the global credit crisis, and increasing interest rates have reduced the ability of many households to finance home ownership (SHF, 2008). With the reduced ability for home ownership in South Africa, there is an increase in the need for rental accommodation to supply the housing market.

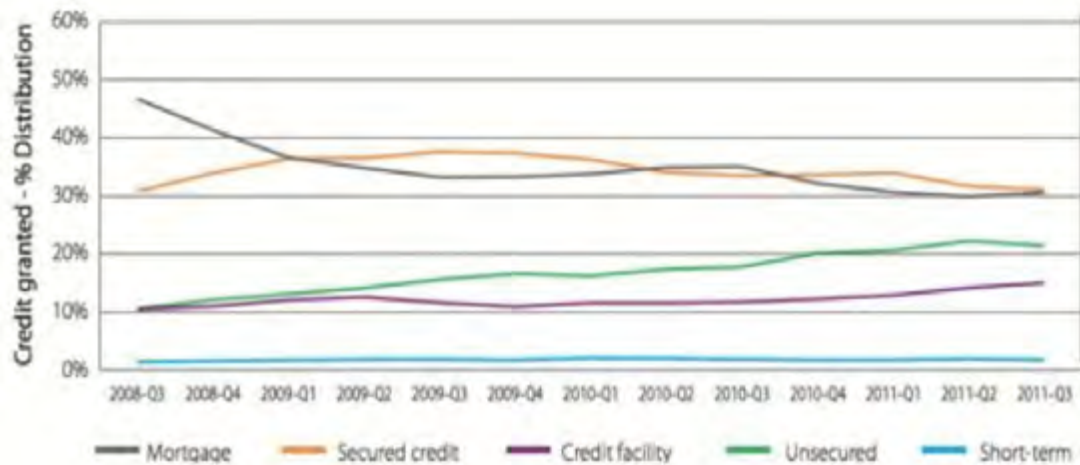


Figure 3 Credit granted as a percentage of distribution (Rust, 2012 p12)

2.5 Extent of demand for rental housing

2.5.1 Overview

Statistics South Africa (2010) indicated that the country had 14.3 million households in 2010, and that nearly 3.3 million new households were formed between 2002 and 2010. Current projections estimate that there will be a demand for a minimum of 1.24 million new housing units over the next 20 years in order to meet minimum population growth (Lachman, 2012).

An estimated 62% of South Africans now live in urban areas (Lachman, 2012). By 2030, this share is expected to exceed 71% (Lachman, 2012), which means that housing will be needed for another 7.9 million people in South Africa's cities and suburbs over the next 20 years. which indicates that although there will need to be a total increase of only 1.24 million units of housing in the cities, the true demand may be closer to 7.9 million over the next 20 years (Lachman, 2012). This discussion by Lachman (2012) fits in with the broader pattern in the literature of the property liquidity constraints facing the South African housing market. The pattern indicates the fact that a shortage in supply results in an over-demand for limited housing stocks, which can act as a barrier to willingness to invest in the property market.

However, the effective demand for housing is severely constrained by low levels of affordability in terms of housing ownership, and this is a reflection of the pattern of

Financial Liquidity as a shortage of funding renders investment in property an unaffordable prospect.

2.5.2 General housing demand

In South Africa, rental supply is so informal that it is difficult to gauge rental demand accurately (Steedley, 2016). Due to the difficulties associated with estimating demand, the researcher has drawn from established methodologies in past research (Eighty20, 2008). In order to measure the demand for rental property, this research identified the discrete income bands as per the SA Income and Expenditure Survey (2011), and calculated affordability by multiplying the average household expenditure on housing by the average incomes to find out the affordability bands of South Africans.

Table 4 illustrates the availability of stock given the affordability parameters of the various housing sub-markets. Overall, there is very little stock available for households earning less than R10 000. This supports the findings in Table 2, that illustrate that about 51% of South African households require accommodation that costs R 8 000 or below.

According to the Stats SA Income and Expenditure Survey (2011), an average of 32% of household expenditure was allocated to housing in 2010/2011, seen in Table 4.

Table 4 Maximum rent affordability derived from monthly household income and average expenditure on housing (Adapted from Stats SA, 2011). *

Monthly household income	Maximum Rent Affordability at 32%	Total	
		Number of Households (Thousands)	%
No income		778	8,6%
R1 - R1600	R512	225	2,5%
R1 601 - R3 200	R1 024	371	4,1%
R3 201 - R6 400	R2 048	633	7,0%
R6 401 - R12 800	R4 096	1 334	14,7%
R12 801 - R25 600	R8 192	2 070	22,8%
R25 601 - R51 200	R16 384	2 062	22,7%
R51 201 - R102 400	R32 768	1 221	13,4%
R102 401 or more		388	4,3%
Total		9 082	100,0%

From the evidence presented in Table 4, it would appear that the majority of households (60%) fall into a rental affordability band of between R4 000 and R16 000 per month. A significant portion (22%) can only afford R4 000 or less per month on rent, while the bottom 9% has no income to support living in rental accommodation.

Although the information presented above is not conclusive evidence of the size of rental demand in South Africa, it illustrates that there is a strong demand for rental accommodation, and that a significant proportion of the population can afford to rent some form of residential property.

Due to the lack of data around demand for rental housing in South Africa (Steedley, 2016), the number of informal dwellings inhabited at the 2011 census was used as a proxy for the unsatisfied demand for rental housing in South Africa. The 2011 census showed that the number of shacks and informal dwellings had increased to about 1.9-million dwellings in total (Wilkinson, 2015).

Supplementary evidence of the size of the rental market is the number of rented dwellings in South Africa. Figure 4 illustrates that a large proportion of South Africans rent their dwellings, especially in metropolitan areas. In Gauteng for instance, 31% of people rent their accommodation, which equates to roughly between 839 000 and 935 000 people. This section refers to the pattern of *Investment Market Information* that has been established in the literature. A strong demand for rental accommodation has been shown, though affordability persists as a consideration of who is able to engage in this market, and how they are able to do so.

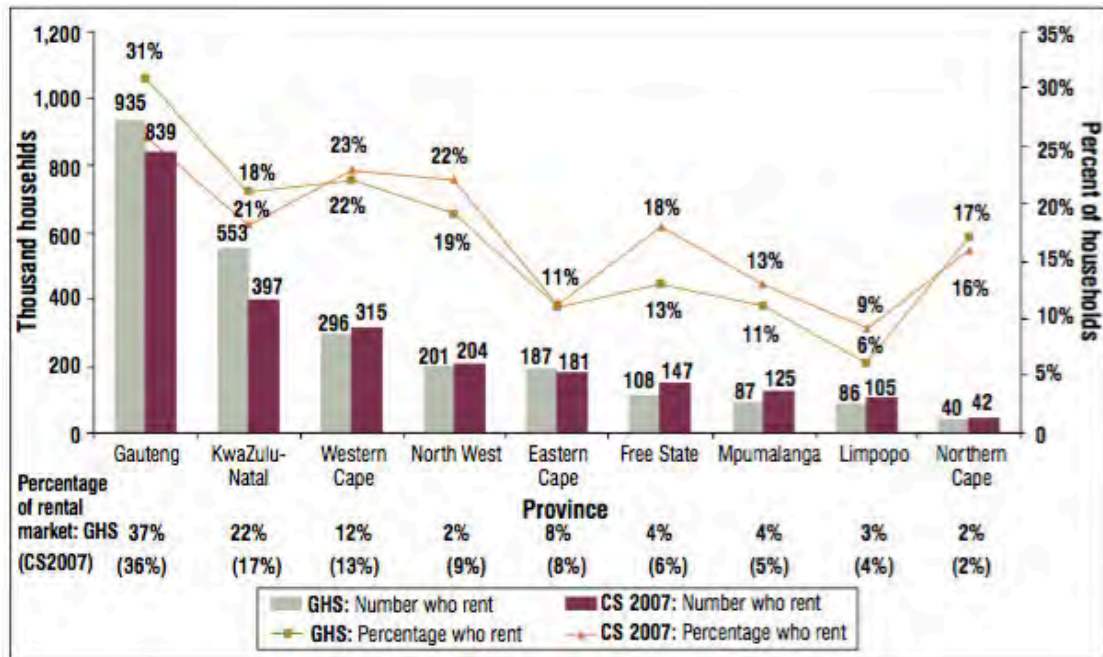


Figure 4 Rented Dwellings by Province (Social Housing Foundation, 2008 p12)

The provision of sound, affordable rental stock is important to sustaining economic growth in South Africa (Lachman, 2012). The Social Housing Foundation shows that the majority of renters in South Africa are poor, with 55% having monthly incomes of less than R 3, 500. Another 22% have moderate incomes of R 3, 500 – R 5, 000 (SHF, 2008). Although individual incomes are low, household incomes typically can be pooled together to rent sufficient accommodation as shown in Table 4.

Rentals rose dramatically during the recession, and Table 5 shows that rentals for 1-bedroom accommodation have seen an average percentage increase of between 34.9% and 69.9% from 2006-2011, depending on the location within South Africa. With the sharp rise in rentals, there is a clear indication that an undersupply exists in residential rental property and that there is room for more supply in the market. This is evidence of the patterns of financial liquidity, property liquidity and investment market information that were identified as clear patterns in the wider literature. These patterns illustrate the fact that demand for rental accommodation has recently risen, however the provision of financial resources and housing stock to meet this demand remain mismatched in terms of supply. This in turn creates constraints that shape the decisions of investors in engaging with the South African property market.

Table 5 Change in Average Rents, 2006-2011 (Lachman, 2012 p50)

	1 BR 4Q 2006 3Q 2011	% Increase	2 BR 4Q 2006 3Q 2011	% Increase
Johannesburg	R 2 269 R 3 062	34,9%	R 3 114 R 3 985	28,0%
Pretoria	R 1 652 R 2 807	69,9%	R 2 285 R 3 504	53,3%
Durban	R 2 185 R 3 180	45,5%	R 2 751 R 3 955	43,8%
Cape Town	R 2 098 R 3 234	54,1%	R 2 785 R 4 133	48,4%
Port Elizabeth	R 1 654 R2 605	57,5%	R 2 162 R3 008	39,1%

Overall, there is no direct way to measure the demand for rental housing in South Africa. However, from the findings presented above, it is reasonable to conclude that there is substantial rental demand for housing in some form or another. The number of informal dwellings in South Africa indicates the need for formal housing solutions.

There is also a large rental market, especially in metropolitan areas. This is illustrated by the fact that in Gauteng, for instance, there are currently around 900, 000 households in the rental market. Finally, there is clear affordability for rental housing, as supported by Table 4, which demonstrates that 60% of households in South Africa can afford an average of R 8, 000 per month for rental accommodation.

2.5.3 Summary of housing supply and demand

Overall, it is clear that there is a substantial lack of housing stock in South Africa. The issue is matching that demand with a supply of adequate rental housing at a price that the market can afford.

There has been increasing pressure on households from a home ownership perspective, because incomes have stayed stagnant as real house prices rise. It is

evident that there is a clear gap in the supply of housing in the sub-R 10, 000 income sector of the market.

The public sector is struggling to keep up with demand for the nation's need for adequate accommodation, and this leaves room for the private sector to address this in the market. Although the private sector is doing more to meet this need, there seems still to be a gap at the lower end of the market for housing stock that cannot be satisfied with current market conditions, and especially does not fit the traditional South African model of home ownership.

For the above-mentioned reasons, there is a need for a suitable economic residential rental model to be formulated in order to plug the gap in the lower end of the market, and provide housing for South Africa's under-supplied market. In this section, *financial liquidity, property liquidity, and investment market information* were identified as clear patterns in the literature that explain the nature of the South African housing market, as well as the potential constraints faced by investors in considering this market. The following section of the literature review provides a framework for assessing the economic viability of such a model.

2.6 Residential rental property portfolio in an investment context

The literature has, so far, provided a contextual overview of the South African residential property market. It also identified a need for private sector involvement, with strong inferences that, for a certain sector in being the residential market catering for individuals who earn R 10 000 or less per month, a residential rental model will most likely be the best solution to alleviate the housing supply issues.

In the following section of the literature review, this research identifies suitable investment company structures for rental of residential property, and assesses their suitability for creating a residential rental portfolio. This research then investigates how the ownership of residential rental property applies in the context of Modern Portfolio Theory (MPT).

2.6.1 Investment company structure

In South Africa, the establishment of listed property vehicles dates back to 1969 when two property unit trusts (PUTs) were established and listed on the JSE (Silva, 2014). PUTs issue units - which consist of a share and a debenture – and the profit is distributed as interest repayment on the debenture. In order to conform to international standards, South Africa began the process of converting its listed property companies into REITs in 2006, (Silva, 2014).

In 2009, the National Treasury tabled a White Paper on REITs, and in 2011, the National Treasury released a Taxation Legislation Amendment Bill, which contained the proposed Section 8G, which dealt with perpetual debentures and their deferred tax liability (Silva, 2014). The new Taxation Legislation Amendment Bill, which was released in February 2013, contained the 25BB REIT tax dispensation, clearing the way for REITs in South Africa.

Finally, in March 2013, the JSE released the amendment Section 13 of their listings requirements enabling REITs to list from the 1st May 2013 (Silva, 2014). In terms of the listing requirements of Section 13, in order to qualify as a REIT, a property company must conform to six requirements (Silva, 2014):

1. The company must have at least R 300 million property assets.
2. Pay 75% of distributable income annually.
3. Maintain a loan to value of less than 60%.
4. A committee must be appointed to ensure risk management procedures are adhered to and disclose risks annually.
5. The company must only enter into derivatives during the ordinary course of business.
6. Rental income should constitute 75% of company revenue.

It is clear that South Africa has the financial and legal framework in order to build a private or listed property fund that is both strong and profitable. The incentive to do so would be driven by achieving a risk-related return and achieving the benefits of diversification as proposed by modern portfolio theory. This evidence additionally reflects the patterns of *Rental return, residential risk profiles, legal constraints and*

investment market information that have been identified in the broader literature. These are discussed in further detail below, as well as in the findings of this research.

2.6.2 Modern Portfolio Theory (MPT) and residential rental property

MPT states that assets cannot just be selected on a “risk and return” basis for the individual asset, but in consideration with the returns for each pair of assets (Montezuma, 2004). This research shows the importance of understanding the constraints of residential property investing in South Africa, and it sets out why investment in residential property is important. Investment in residential property promotes diversification of an investment portfolio as a whole, and therefore enhances the efficiency frontier of an optimal portfolio, according to MPT. Over the past 25 years, several empirical studies have been devoted to understanding the risk-return characteristics of property and its contribution to risk diversification within a mixed-asset portfolio (Markowitz, 1952, 1959, 1987). Furthermore, there are diversification benefits from holding a geographically diverse portfolio, with specific reference to the United States market (Montezuma 2004). There is also substantial literature suggesting that residential property is a more effective hedge against inflation than shares and bonds (Montezuma, 2004).

Existing empirical studies also suggest that direct residential property investment often generates risk-adjusted returns comparable to bonds and shares, but also provides low correlations with those asset classes (Montezuma, 2004). This reflects the pattern of *investment market information* identified as a key consideration for investment in the market. Research has shown that real estate income and value cycles differ across different property types and across different markets (Edelstein & Tsang, 2007). Wheaton (1999) further demonstrates that different types of real estate in the US exhibit different cyclical patterns over time, and their cycles have differing correlations with the economic cycles.

Further, a similar study by the United Bank of Switzerland (1996) found that residential property is unrelated to equity, bond or direct commercial property markets, but it is linked to the income profile of the occupants and investors. This is a feature of the *residential risk profile pattern* identified in the broader literature. The study also indicated that the parallel market with owner-occupiers encouraged

substitution between markets for occupiers and investors (United Bank of Switzerland Research, 1996). Furthermore, the residential sector generally provides an effective hedge against inflation (United Bank of Switzerland Research, 1996).

When composing an investment portfolio, diversification is of key strategic importance, especially to institutional investors (Venmore-Rowland, 1990). A minimum of 20 to 30 properties is required, and even then, there is likely to be residual risk with up to 100 properties (Venmore-Rowland, 1990). With residential property, the diversification effect may be easier to achieve due to the smaller transaction sizes per property relative to other property assets (Venmore-Rowland, 1990).

It is also interesting to note that there is evidence to suggest that there are different effects between GDP and residential property, versus GDP and commercial property types. In a study, applying Granger causality tests, Green (1997) shows that residential investment “causes”, but is not caused by GDP, and non-residential investment does not “cause” but is caused by GDP. From the findings, it is reasonable to deduce that residential and non-residential investment will take place in different phases in the economic cycle, as one leads (residential) and one lags (non-residential) GDP.

From the literature reviewed, it is evident that residential property provides an alternative allocation to investors from an investment portfolio point of view, which would specifically include fund managers and institutional investors. Since the correlation between housing and commercial property is low (Montezuma, 2004), housing may also provide diversification opportunities within the listed property sector. These are characteristic of the pattern of *investment market information and residential risk profile* discussed more thoroughly in the literature and explored in the research undertaken here.

2.7 Constructing a residential rental portfolio

It has been established that there is a clear place for residential rental property in a broader investment portfolio context. The following section of the literature review

discusses the issues directly relating to establishing and operating a residential rental property portfolio. This section highlights all the factors that should be taken into consideration when constructing a residential rental portfolio, so that there is a context in which the constraints can be drawn from. This also ensures that there is an exhaustive review of all related factors. These factors also reflect the pattern of *residential risk portfolio* discussed elsewhere in the literature.

2.7.1 Residential rental portfolio: An overview

The residential private rented sector represents a major investment opportunity for individuals, corporate entities, and institutions (Mansfield, 1999). According to Alan and Collet (2000), there is evidence that private investors are entering the residential rental market in a strong manner, where professional fund managers struggle to enter. According to one survey, the great majority of investors are small scale with one survey indicating that:

- 53% of borrowers have only one investment property;
- 40% of borrowers have 2-9 properties; and
- 7% have 10 or more properties

According to two major practitioner reports in the United Kingdom, British Property Federation (BFP) (1998) and FPDSavills (1998a), the following common findings were reported for residential property in that market:

- In 1998, the sector was broadly seen as immature, imperfect and poorly researched;
- The sector displayed high risk/low return profiles compared with other asset classes;
- It is management intensive in day-to-day and portfolio aspects; and
- Historic net asset value to vacant possession problems.

Despite the challenges faced with constructing a residential portfolio mentioned above, there is evidence that there is a gap for certain types of investors to profit in the market. For instance, almost 30% of all residential accommodation in Canada is rented out by private individuals (Miron, 1994). This is anecdotal evidence that shows that in markets outside of South Africa, residential property investment appears to be a financially profitable investment, and the research undertaken in this study aimed to assess whether this is the case in South Africa.

While the roles of larger property owners are clearly defined and segmented, the economic roles of the private residential landlord can be divided into two broad categories: property financier and property manager (Miron, 1994). The landlord will need to ascertain what an acceptable value of the investment property will be, given the challenges stated above, and come to a conclusion on how to finance the purchase of the property. The landlord will also need to decide what level of maintenance should be upheld on the building, and what segment of the rental housing market to target, as well as the timing of the disposal of the rental asset. This fits in with the pattern of *rental returns and management costs* discussed elsewhere in the literature, and investigated more deeply in the interviews conducted for this research.

However, there are many practical difficulties associated with assembling a residential portfolio, some of which are unique to residential property, and others that challenge the assembly of a portfolio of any property asset class. These issues are covered in the following section.

2.7.2 Key characteristics of the private residential rented sector

In comparison to the direct and indirect commercial property investment markets, the privately rented sector displays a broad range of structural and ownership characteristics that have potential to provide further diversification benefits within investment portfolios (Mansfield, 2006). Mansfield identifies the following benefits:

- Residential units are widely segmented by unit type – apartments, studios, lofts, flats, detached houses and townhouses.
- Residential units are not geographically constrained, despite being location-sensitive.
- Residential units have a broad and diversified demand base – students, people with insufficient capital to enter the housing market, corporate leases, elderly, and single people and people with a short-term view on residence in general.
- Furnished and unfurnished rental accommodation can also be offered.

Many of these benefits may well contribute to weak market efficiency in the residential market. Due to the small transaction sizes and the broad base of unit types and users, sometimes information is less readily available than it is in other property

asset classes, such as listed property and listed equities in general (Mansfield, 2006). This reflects the pattern of *investment market information* that is investigated more thoroughly in the interviews undertaken for the present study. The following section investigates the efficiencies further.

2.7.3 Constraints or disadvantages to holding a residential rental portfolio:

2.7.3.1 Efficiency of the residential real estate market

Guntermann and Smith (1987) confirm that the real property market has many possible sources of inefficiency; for instance, it is not centralised or standardised like the commodities market. Properties also trade a lot less frequently, which complicates the calculation of holding period returns. The problem is further compounded by the unique characteristics that individual properties possess and the huge emphasis on the locality of the specific property. The scarcity and quality of information also adds to the inefficiency of real estate markets.

Residential real estate is purported to be only efficient in the weak form of the market (Guntermann & Smith, 1987). The weak form of the market efficiency hypothesis implies *rational* rather than *adaptive* expectations on the part of the investors. Market inefficiency means that prices only gradually adapt to underlying changes in supply and demand. The adaptive expectations view is widely held to produce one of two outcomes. The market will either under-react so that prices move to the new “correct” level too slowly, or it will overshoot, resulting in an “affordability” problem so that a subsequent reversal is needed in order to reach the “correct” price level (Guntermann & Smith, 1987). This is reflective of the pattern of *residential risk profiles* found in the broader literature. This study aimed to explore the characteristics of the South African property market, in line with the expectations described above.

It is interesting to note that previous research has indicated that a low rate of appreciation in real estate values in one year implies a high rate of appreciation in subsequent years (Guntermann & Smith, 1987). Guntermann & Smith (1987) confirmed in their research that a portfolio of residential properties, whose appreciation was in the highest deciles the previous period, underperformed a “buy-the-market” strategy excluding transaction costs. On the other hand, their findings were that a portfolio of real estate whose return was in the lowest deciles in one

period produced an average rate of return, which exceeded the “buy-the-market” strategy (Guntermann & Smith, 1987).

2.7.3.2 Financial and liquidity issues

By its nature, property is a long-term investment opportunity, which cannot compete on similar terms with other asset classes that produce returns in a much shorter timeframe (Mansfield, 1999). Illiquidity is thought to be the key issue when investing in commercial property (Hargitay & Yu, 1991; Ball et al., 1998). With this in mind, at an investment level, residential property is due to suffer from the same liquidity issues as commercial property. This study assessed whether these issues were present in the South African context.

Another factor that is unfavourable when comparing residential property to most other asset classes is the predictability of cash flows arising from the short-term nature of residential leases. Cash flows may be relatively easy to predict in the first year or two with an adequate amount of market research, however they become more difficult to predict beyond that as the market is less and less predictable in the end. Other assumptions must also be factored in to the cash flows and these are harder to estimate, for instance renovation and maintenance provisions, and changes in tax regimes (Mansfield, 2006).

In historic market reports such as British Property Federation (1998) and Investment Management Group (1997), liquidity was identified as a major constraint on the investment of property as an asset class due to the small unit sizes of single residential properties. The residential portfolio will need to be diversified by size, location and condition to secure broader return benefits. It will not be easy to dispose of an entire portfolio, especially of residential investment property in any given market due to the lack of large-scale investors, and disposal of individual properties to smaller investors or owner-occupiers, will be an extremely lengthy process (Mansfield, 2006).

One of the major risks is the mismatch between borrowing and lending. The investor will typically borrow long-term (through a mortgage) and lend short-term (through residential lease) (Miron, 1994). Although this is a bank risk, one must consider how such a risk of liquidity will affect the ability of property investors to qualify for

financing in a market where residential leases are relatively short-term, as in the South African market. These issues reflect the broader pattern of *financial liquidity and rental return* considerations in the literature identified through this research.

Other problematic issues ranged from composing of a residential portfolio to financial modelling, as well as the unfavourable comparison to the conventional lease framework including shorter-term lease structures and leases that are not fully repairing and insuring (FDP Savilles, 1998).

2.7.4 Asset allocation

Given the broad diversity of possible residential rental investments to be made, careful thought must be given to the asset allocation of the residential rental portfolio, and what the disadvantages and advantages may emerge from specific allocations. There are many opportunities for residential property owners to differentiate themselves in the property market (Mansfield, 1999). For instance, investors could opt to construct a portfolio of new-build, second-hand units, or a mixture of both. As noted by Mansfield (1999), the initial inclusion of poorer quality units in a portfolio may be a false economy, because there might be increased maintenance expenditure, as well as problems of compositional churn, if considered appropriate. Mansfield (1999) states that portfolio composition is possible via:

- Direct development;
- Rehabilitation programs;
- Predatory bulk-buying from contractors or developers in financial difficulty or who would be happy to sell at a discount for bulk;
- Purchase of mortgage repossessions prior to auction and;
- Piecemeal and highly selective acquisition.

The easiest way of acquiring a portfolio would be to buy one in the market; however, there is fierce competition for these scarce portfolios (Allan & Collet, 2000). This matches with the pattern in the literature that focuses on *residential risk profiles*.

Hendorshott & Shilling (1982) espouse that the tenant's decision to buy or rent boils down to the present value of expected future cash flows and the value of the initial equity investment. Wang et al. (1991) hypothesised that rental properties have a negative impact on both the quality of the maintenance for the rental units and the

neighbourhood living environment, and therefore property value of single-family residences in that neighbourhood. Wang et al. (1991) study demonstrated that there might indeed be an inverse relationship between the value of a house and the presence of rental properties, as this was the case in the area of their study in America.

Wang et al. (1991) noted that the accumulation of single-family rental properties in a residential neighbourhood seems to have the same negative impact as the intrusion of apartments or other types of undesired properties. When making an investment decision, this is something that one should keep in mind; however, it may not affect the final decision. This is particularly because one of the biggest factors contributing to the reduction in property value was the fact that it was found that less than adequate maintenance was carried out on rental properties. This should have been addressed by the property and asset managers, and is therefore avoided with an investment property.

2.7.5 Managers' skill-set and financial models

Residential property's heterogeneous nature adds to the complexity of the decision making process as managers may require greater skills and more detailed submarket knowledge in order to find the optimal investment properties (Mansfield, 1999). For many years, residential management was considerably neglected in the property market, and large-scale investors researching the private residential rental market have been disappointed by the level of skill and service available to them (Allan & Collet, 2000). Mansfield (1999) further points out that some residential-specific life-cycle characteristics of residential property increase the risks in unit selection and include:

- Age;
- Type of construction and original specification;
- Additions, alterations and extensions
- Pattern of use and abuse of the property and;
- The extent of maintenance and repair programs.

All fund managers must have a level of financial literacy. In the broader investment community, MPT and capital asset pricing models (CAPM) are utilised in order to create efficient portfolios. However, the mainstream principles, although theoretically useful, cannot be directly applied to the property sector because of the fundamental

characteristics of property, such as its heterogeneity (Mansfield, 1999). Brown (1987) and Evans and Archer (1968) have proposed refinements to the CAPM and MPT models to make them more appropriate in the application to property. Mansfield (1999) however, is of the view that their use is likely to be limited further in a residential context because of the complexities of the sub-sector. These issues are discussed within the interviews conducted for the present study, and contribute to the pattern of *management skill* and *residential risk profiles* identified through the broader literature.

Once a suitable framework has been formulated for investment appraisal and property selection, it is then necessary to have a framework in order to benchmark and assess the performance of the constructed portfolio effectively. Section 2.7.6 outlines portfolio performance and benchmark indices.

2.7.6 Portfolio performance and benchmark indices

Performance appraisal is a holistic process with the primary objective of identifying ways of improving overall portfolio performance (Mansfield, 1999). Appraisal involves performance measurement, analysis and adjustment if not accurate. It should be noted that performance measurement relates to both the performance of the investment itself and the performance of the management, which helps to provide the investment returns (Allan & Collet, 2000).

For bonds and equities, performance measurement is quite straightforward as obtaining exact comparable transaction prices (from the stock exchange, for example) are relatively easy. In the property sector, however, comparative benchmarking is made difficult by the lack of a single, definitive market index, for example, IPD, or an index that tracks listed residential property performance. Furthermore, it is not possible for a single index to be truly representative of the whole market, due to the heterogeneous characteristics of property, its localised nature, and the problem of valuation as a proxy for transactions (Brown, 1992; Lizieri & Venmore-Rowland, 1993; McAllister, 1995).

In the South African market, there is very scarce benchmarking data available, with the existence of a sole residential-only fund listed in 2015 (Indlu Place Properties,

2015) and other imperfect data that can be synthesised through the rentals gathered through TPN data and indications of value provided by financial institutions.

The foremost listed index in South Africa is the SAPY index, which comprises the top 20 liquid companies, by full market cap, in the Real Estate Investment & Services Sector and Real Estate Investment Trusts Sector, with a primary listing on the JSE (JSE, 2016). This is broadly useful, however does not allow for accurate comparisons with specialist funds that do not wish to track the broader listed investment market.

2.7.7 Transaction Costs

Transaction costs tend to be high when dealing with residential properties and this is due to the large volume of stock and lack of effective systems. There is a comparative lack of large-scale disciplined residential management, and this can result in an “informal” sector in which “amateur” landlords undertake all management responsibilities themselves (United Bank of Switzerland Research, 1996).

There are a number of costs associated with the acquisition of a single or portfolio of residential properties that the purchaser must be aware of. In adapting these costs for the SA context and drawing on Mansfield (1999), these include:

- Establishing the initial selection criteria for the portfolio – location, type of unit, monetary size, condition – possibly by consultants;
- Initial inspection of the properties, possibly by consultants;
- Surveys of the property for valuation and/or mortgage purposes;
- Scheme design, costing and building contract costs for units in need of rehabilitation;
- Standard title search costs;
- Conveyance fees;
- Title registration fees;
- VAT on professional fees and on construction work;
- Transfer duty on a rising scale related to capital value of the unit at time of purchase, if bought from a non-VAT vendor and VAT if purchased from a VAT vendor.

Many of the direct acquisition costs cannot be avoided, such as VAT, because of their statutory nature. It is possible, however to manage many of the other fees down such

as conveyance and valuation costs through economies of scale and building relationships (Mansfield, 1999). Changes in taxation can also seriously affect the rental returns earned by the investor. For example, in Canada, there was a change in the allowable depreciation expense slipping from 10% to 5% in 1978, and 4% in 1987 (Miron, 1994). The study undertaken here examined whether this pattern of *management costs* had an impact on the willingness of investors to engage with the South African market. Furthermore, the research assessed whether these issues constituted a form of constraint or facilitation to investment in this market.

2.8 Summary

From the literature reviewed, it is evident that there is an under-supply of housing in South Africa. There is a financial and legal framework in place to support the provision of this housing. This is a display of the patterns associated with *financial liquidity and legal constraints* identified in the broader literature. Although the majority of South African households are owner-occupiers, there will be an increasing demand for rented residential stock due to lack of affordability to own and the increasing population of potential homeowners.

Furthermore, rental trends appear to be in favour of investors, since the demand for rental accommodation appears to be increasing rapidly. Furthermore, there is a shortfall between combined private and public sector housing delivery, and this presents an opportunity for an investor to invest in residential property for rental in the current South African market. This pattern is assessed in the interviews conducted for this study under the theme of *rental return*.

However, residential property investment for rental is generally left in the domain of the individual in South Africa as noted, only 2% of the listed property sector is residential focused (Properties, 2015), although, some countries such as the United States have a significant institutional residential investment holding. Notwithstanding the fact that there is not a large holding of residential investment stock in larger institutional hands, there is certainly a strong case for residential property investment in a portfolio context as a hedge against inflation and as a diversifying asset class,

even when compared to commercial property. This relates to the pattern of *property liquidity* discussed in the broader literature, and is assessed here for its applicability to the South African context.

The literature suggests that the low representation of rental residential property in a portfolio may be due to market efficiency in the residential property market; liquidity of individual residential property units; managers' skill set and financial models; portfolio performance and benchmarking issues; and management and transaction costs. From reviewing the context of the South African residential market, it is evident that regulation and government policy are also factors that need to be investigated in the research.

Chapter 3: Research Methodology

This chapter details the research methodology, research design, data collection techniques and the data analysis techniques used to undertake the research.

3.1. Introduction to Research Methodology

A mixed-methods approach was used and the process applied primarily a qualitative field survey design to answer the question. A quantitative secondary data design was then used to statistically describe and analyse rental returns and these findings were used to corroborate the information gathered by the field survey (Hammersley, 1996; Bhattacharjee, 2012). The aim of this research was to investigate the constraints faced by investors of residential property in the South African market. Qualitative research allows for a more nuanced and particular approach to be adopted, and for a more in-depth analysis and comparison of viewpoints to be examined (Punch, 2006).

3.2 Data Collection

3.2.1 Semi-structured interviews

Surveying people in interviews can be used for descriptive, exploratory or explanatory research and is best suited for studies that have individual people as the unit of analysis (Bhattacharjee, 2012). For the study undertaken here, interviewing as an exploratory method was the most appropriate. The method selected allowed for the asking of exploratory questions to the participants in order to assess their opinions on the specific constraints to residential property investment in the South African context. These constraints were assessed in terms of the patterns identified in the literature, including: *financial liquidity (funding), property liquidity (stock), rental returns, management skill, management costs, investment market information, residential risk profiles, and legal constraints*. These patterns are also reflected in the schedule of questions asked in the interviews. The extent to which these patterns were confirmed or contradicted in the interview data was analysed in this research. Secondary data analysis facilitated the process of drawing of conclusions by providing further data and evidence that bolstered the findings of this research (Bowen, 2009).

Semi-structured interviews were used to collect the data for the research. Interviews can offer richer and more extensive material than data from surveys or even the open-

ended portions of survey instruments (Yin, 2009). An interview is a data collection technique that involves one person (the interviewer) asking questions of another person (the interviewee). The questions may be open-ended, closed-ended, or both (Teddlie & Tashakkori, 2009).

The flexible format of the interview method can reveal how field study participants construct reality and think about situations (Yin, 2009). This was particularly useful when investigating the constraints in residential property investment as it provided insight into how the constraints might be addressed in the future, as well as how different practitioners defined and viewed constraints. Interviews were also useful for the ability to identify or confirm patterns of discussion across the participant group that matched the trends identified in the literature review. This facilitated assessment of the applicability of this literature to the specific context of the South African property market, and the extent to which these patterns were confirmed or contradicted by the interviewees. Face-to-face interviews were conducted where possible; however, some interviews were conducted telephonically due to the geographical and time constraints. Seven interviews were conducted in total and of those, three were conducted in person and four were conducted telephonically.

The qualitative nature of this research allowed for more data to be gathered in the interviewing process than from questionnaires. Furthermore, interviews are generally more flexible, and this allowed information to be gathered about an area of the topic that may not have been previously considered (Strauss & Corbin, 1998).

In accordance with the recommendations from Bhattacharjee (2012), the interviewer sought to be well versed in the subject matter, reflexive and aware of any biases they held, and took into consideration how responses were stored and used. Further, the questions used for the interviews and the schedule thereof were piloted prior to collecting data with participants. All efforts were made to ensure that interviews took place with consideration shown towards the comfort and convenience of the participants.

3.2.1.1 Interview sample

For this research, an expert sample was compiled. The advantage of this approach is that since experts tend to be more familiar with the subject matter than non-experts, opinions from a sample of experts are more credible than a sample that includes both experts and non-experts (Bhattacharjee, 2012).

Snowball sampling was also used in order to access hard to reach sample units (such as chief executives) and conduct more in-depth research. Snowball sampling refers to a process of referrals, whereby respondents are asked if they know and can recommend other expert participants in their networks, who would make a valuable contribution to the research (Bhattacharjee, 2012). Through the snowball sampling method, three out of the seven interviewees were sourced.

The following stakeholders were targeted for interview:

- Private property asset managers
- Listed property asset managers
- Institutional property asset managers
- Residential property developers
- Residential property managers
- Commercial property managers

The above stakeholders were identified as the individuals with the most knowledge around residential property investment, both from a residential investment and other property investment point of view. Having assessed the pertinent patterns related to this set of issues in the literature, these stakeholders also represent the diversity of factors that contribute to the willingness for investment in the South African property market. Selecting a broad range of stakeholders enabled the researcher to identify why some entities choose to invest in residential property, as well as why other investors have chosen other property asset classes, and allowed a balanced view of the constraint to residential property investment.

This research investigated the opinions and attitudes of industry experts on residential property, and in doing so; it drew on individuals as the unit of analysis. The individuals chosen were industry professionals who deal with various stages of the

property investment process, from asset managers, to private investors, as well as the opinions of the property managers who are charged with the management of property asset classes on a daily basis.

3.2.2 Interview questions

During the review of the literature, many patterns in the creating of a residential investment portfolio were identified. The areas were *financial, management and information* constraints, which were the broad groupings of the patterns discussed earlier in this thesis. The questions asked by the interviewer aimed to cover the existing identified issues, but also gave the interviewee opportunities to assist in unearthing new patterns that are specific to the South African context, or have not been identified in the literature, and can be seen in Appendix A.

3.2.3 Secondary data analysis

Data collected from documents relating to residential property values and market rents were also used in order to identify residential property rental yields in South Africa. Data was primarily gathered through TPN rental bureaux and the FNB house price index. These sources were selected due to their wide use in the industry as a result of being the largest repositories for their respective information (Rentals for TPN and valuations for FNB house price index).

Secondary data of property rental returns was attained from the TPN-FNB Residential yield database (Loos, 2015) which combines the TPN rental data with FNB's house price data. Gross yields were derived for certain categories of residential rental property from the data and used to corroborate the findings for the qualitative research. This data was numerical and economic information that was statistically descriptive in nature detailed average rental and return data for given residential property markets. The secondary data was used to a lesser degree than the interview data and was intended to corroborate the findings that emerged through the interviews.

3.3. Data Analysis

This study used the pattern-matching technique to analyse the qualitative data by

matching the empirical patterns that emerged from the interviews with the patterns identified in the literature. According to Yin (1994), the analysis of qualitative data using pattern-matching moves through five phases, namely: First, compiling the data into a formal database, which requires the careful and methodical organisation of the original data. This step was conducted with the assistance of the Nvivo software program, which was used to archive all data collected. Second, the data must be disassembled in the database, which can involve a formal coding procedure. The formal coding process was carried out in Nvivo. The researcher analysed the interview transcripts, identifying broad patterns that were also reflected in the literature. This study used a coding process to centre the findings on key nodes also identified in line with the questions asked during the interviews conducted for this study. The details of these patterns can be found directly below. The third phase (reassembling) was conducted to elucidate the emerging concepts and constructs that could be used to address the research question posed herein. Fourthly, the data had to be interpreted and finally, a conclusion was reached for the data presented.

Nvivo was used to process the data. This was done to ensure that maximum insight was extracted from the data with care and careful analysis by the researcher. Due to the small sample size, the researcher was able to conduct an in-depth analysis of each interview and draw richer conclusions with a pattern-matched approach. Guided by the literature and developing upon the discussion established there, the following patterns were drawn out and then investigated in the interview process:

1. Financial Liquidity (Funding)
2. Property Liquidity (Stock)
3. Rental Return
4. Management Skills
5. Management Costs
6. Investment Market Information
7. Residential Risk Profile
8. Legal Constraints

3.4 Limitations and Delimitations

In Chapter 2, the researcher identified what the general issues were surrounding residential rental property investment, namely, supply and demand factors, and the driving and restricting factors around investment in residential property (Allan &

Collet, 2000; Ball, et al., 1998; British Property Federation, 1998; Investment Management Group, 1997). This produced a foundation from which a general idea of the constraints facing the market could be formulated, and therefore internal validity for this study was generated (Bhattacharjee, 2012). However, the findings are still not generalisable to the overall population at large (Bhattacharjee, 2012). This is due to the snapshot view of the phenomenon that qualitative interviews provide, and the limited applicability of the findings to the broader population that is inherent in this research method (Bhattacharjee, 2012).

To ensure external validity, the research needed to identify and refine what the major constraints on the residential property market were, as well as their relative impact. In order to ensure reliability and validity firstly, the correct research approach, design and method of data collection had to be identified based on the phenomenon being researched, the philosophical position taken towards understanding and gathering the data about this phenomenon and the data available. Secondly, the correct protocols and procedures associated with the collection and analysis of the data had to be followed (Bhattacharjee, 2012). All efforts to achieve this were made in conducting this research.

Interview research has several inherent strengths compared to other research methods the most relevant strength to this research method is that interviews are an excellent vehicle for measuring a wide variety of unobservable data, such as people's preferences, attitudes or information (Bhattacharjee, 2012). Therefore, a well-designed interview tool that aims to extract pertinent information is critical. This research addressed the attitudes and opinions of experts about the constraints to investing in residential investment property for rental. Another strength is that interview research can be conducted from a distance, for instance over telephone (Bhattacharjee, 2012). This is particularly useful to this research sample, as the experts involved in the research were under time constraints or located far away geographically. Because the research is not limited geographically, the validity of the research is greatly enhanced due to the fact that research can be gathered by participants that are too busy to meet physically (i.e. over the phone) or people that are in different locations across South Africa and abroad.

However, because of the non-temporal nature of interview research, internal validity is difficult to infer, and surveys may be subject to respondent biases. This bias may lead to subjects providing a “socially desirable” response rather than their true beliefs or feelings, for example, which is problematic in terms of ensuring internal validity (Bhattacharjee, 2012). This research maintained the confidentiality of all participants and in this way, attempted to overcome any respondent biases that may have appeared.

Secondary data analysis was used in the research, which involves analysis of data that has already been collected and tabulated by other sources (Bhattacharjee, 2012). This data may include data by government agencies such as employment statistics from Statistics South Africa, by other researchers, or publicly available third party data, such as financial data. Secondary data analysis is an effective means of research where primary data collection was too costly or infeasible, and secondary data was already available at a level of analysis suitable for answering the researcher’s questions (Bhattacharjee, 2012).

Secondary data collected for this research focused on rental yields in South Africa, as well as operating costs. Secondary data was also collected around the risk profile of different types of residential rental properties in South Africa. The data collected was used to ascertain the financial feasibility of residential property as an investment compared to other asset classes based on its risk and return profile. This analysis further developed the pattern-matching assessment conducted during the interviews (Yin, 1994).

The limitations of making use of the secondary research design are that the data might not have been collected in a systematic or scientific manner and hence may be unsuitable for scientific research. Furthermore, as the data was collected for a presumably different purpose, they may not adequately address the research questions of interest to the researcher (Bhattacharjee, 2012). For this reason, it is important to use only reputable sources of secondary data, and through the use of triangulation, ensure that it is relevant and reliable (Hammersley, 1996).

3.5 Summary

This chapter outlined the process followed in order to undertake the required research.

This chapter explained the research approach chosen to conduct the research, and why it was appropriate for the specific research that was conducted. The research design used followed, with the inclusion of an explanation of the research methods selected and how it was carried out in order to accomplish the research objectives. An outline of the data collection techniques used and the analysis techniques employed, as well as issues related to validity and reliability of the research concluded this chapter.

Chapter 4: Research Findings and Data Analysis

The literature review was used as a point of departure to identify the patterns of general constraints to investing in residential rental property. The broad perspectives that were identified in the literature review were then used as guidance for developing the interview schedule, and coding of interviews during subsequent analysis. The interviews were transcribed, and the researcher analysed each sentence, either matching a sentence to an already identified pattern, or using the transcripts to draw additional patterns that had emerged in the data collection process. This chapter presents the results of this research process by first discussing the qualitative findings that emerged and the analysis thereof. Each of the patterns used to frame these findings are discussed in turn, and an assessment of whether the data from this study matches or diverges from these patterns is made.

The quantitative findings and the extent to which this data corroborates or contradicts what was discovered in the qualitative interviews are then discussed.

4.1 Qualitative Findings and Analysis

This section of the report presents the results obtained from the semi-structured interviews in line with the methodology laid out in Chapter 3. The full interview transcripts can be found in Appendix B.

Section 4.1.1 provides an overview of the respondent demographics, including their industry, and position in the company. Section 4.1.2 presents the research results, and additional findings are presented in Section 4.1.3.

4.1.1 Survey participant demographics

Seven respondents were successfully interviewed as part of this research. The respondents were chosen for their expert knowledge on residential property from different perspectives. All respondents were either in high management or at directorship level. The respondents represented five different types of entities, namely: listed funds, property managers of listed assets, institutional investors, private residential property funds and private residential developers. All respondents were on either the operational, asset management or finance side of the entities investigated. Table 6 illustrates the respondents' backgrounds.

Table 6 Interview respondent heat map

	Director	Asset Management	Finance
listed Fund	1	1	
Prop Manager	1		
Institutional Fund			1
Private Fund	1	1	
Private Developer	1		

4.1.2 Research Results – Pattern-matching

In order to present the data collected from the semi-structured interviews effectively, conceptually ordered displays are used. As opposed to relying on time or role as the organising principle, it orders the display by concepts and variables (Miles & Huberman, 1994). Nvivo coding software was used to group the content of the interview around “nodes” of patterns. Table 7 identifies a participant to a certain entity type and their role within the entity. All text in italics is direct quotations from the interviews.

Table 7 Participant Coded to Entity and Role

Participant Code	Entity Type	Role Within Entity
A	Residential REIT	CEO
B	Diversified REIT	Asset Manager
C	Residential Property Manager	CEO
D	Institutional Private Equity Fund	Deal Maker
E	Large Private Property Fund	Asset Manager
F	Private Residential Developer	Director
G	Large Private Property Fund	CEO

The following patterns were identified in the literature and then embedded in the interview schedule. They also constitute the analysis frame used for this research and are presented as follows:

1. Financial Liquidity (Funding)
2. Property Liquidity (Stock)
3. Rental Return
4. Management Skills
5. Management Costs
6. Investment Market Information

7. Residential Risk Profile

8. Legal Constraints

4.1.2.1 Financial Liquidity (Funding)

Participant “A” found that there was funding available at a price with regard to the listed property space, however, it was noted that for individuals, equity funding could be an obstacle.

Participant “A” noted that almost all borrowings in a REIT structure are interest-only borrowings, with the option to roll over that interest every 5 years. This is an advantage for the investor, since they are not paying additional capital towards the instalment, which has two cash effects according to the participant. Firstly, it reduces the cash out component, but secondly it also reduced immediate tax out, because there is a larger interest (expense) component to the income statement of the portfolio.

Participant “B” found that there was very little to no financial constraint to raising capital; in fact, it was *“quite the opposite,”* with an over-subscription and yield compression of recently listed residential and other REITs on the JSE.

Participant “C” noted that it is important to consider the cost of debt when making an investment decision, and currently, a lot of property is being bought on negative gearing *“where the cost of finance is higher than the rental return”*. The participant pointed out that this is a dangerous strategy as cash outflows persist for the first few years, and that access to the right funding remains a constraint.

Participant “D” stated that due to the success of their first fund, it has been relatively easy to get funding for their second. The terms are generally interest only loans and up to 80% of the loan to value of his investments. Participant “D” also notes, however, that the environment has become a lot stricter than it used to be in the early 2000s when lenders were granting 100% loan to value on residential assets, especially at the top end of the market, such as golf estates.

Participant “E” found that the banks were much more cautious when lending with regard to residential investments as opposed to office or industrial. The participant

thought that it was partially due to the nature of the leases being shorter term and without surety in general.

Participant “F” found that the banks currently have “*a much more constrained view in recognition of debt for residential properties*”. It was further pointed out by the participant that banks had a different perspective on residential as opposed to commercial property from “*a psychological point of view*”. Participant “F” was of the opinion that this hesitancy to grant finance was due to a history of large developers or developments failing in South Africa.

Participant “G” made the distinction that funding constraints differ from the point of view of an institutional investor or even a large private investor, to that of your average residential rental property investor. The constraints were tougher on an individual, in Participant "G"'s opinion. If financing through a company, Participant “G” did not think that funding was a material constraint.

4.1.2.1.1 Summary of findings

Overall, it seems that there is a clear distinction that is drawn between what type of institution is asking for funding and how easy it is to obtain the funding. From the interviews, it is clear that for an individual or a small company, obtaining funding at a decent rate and on favourable terms is not easy. In all likelihood, the lender will demand an amortising loan with a rate of around prime. For the larger listed and institutional investors, however, it would appear that there is funding available at more competitive rates, through either debt or equity, and these investors are able to access more structured products, such as interest-only loans that have cash flow and tax advantages.

4.1.2.2 Property Liquidity (Stock)

Participant “A” noted that enough stock could not be found, or that the stock was too expensive at the time of proposed listing of his residential vehicle. Despite having around R 400 million worth of stock, Participant "A" could not invest, as the institutional investors were only interested in investing in investments of R 1.5 billion and above. When asked if it was a constraint that transactions in the residential market were much smaller in value than in the commercial market, the participant replied,

“there’s a huge problem with that”. Participant “A” stated that the minimum transaction size must be at least R 20 million to gain interest.

Participant “B” Noted that there was a shortage of *“chunky supply”* and that the ownership of residential property in South Africa was fragmented, and there were not many large institutional investor holdings any more in the asset class. Due to the fragmented nature of the market, Participant “B” noted that it is a challenge for large funds to find sizable investments and that these would constrain the growth of large residential investment opportunities.

Participant “C” stated that stock availability is an issue because it is hard to acquire ready assembled portfolios, since residential property tends to be owned by many smaller investors.

Participant “D” stated that transaction size was a constraint, and that the participant needed to source at least 300 units for an individual transaction.

Participant “E” agreed that it was definitely a constraint when making a decision to purchase units while looking to acquire blocks. However, the smaller transactions were viewed as favourable when disposing of the properties because of the larger pool of buyers.

Participant “F” was sceptical that there was room for a listed market of purely residential. According to Participant "F", there is not a big enough population in South Africa, stating, *“It's just not big enough, if you were going to go to America; you’re going to get the numbers”*.

Participant “G” Stated that sourcing big enough transactions in residential rental property was *“not that easy”* contrasted to commercial property where the transactions for individual properties can be substantially larger and less fragmented.

4.1.2.2.1 Summary of findings

Overall, it would appear that there is a lack of suitably sized residential property transactions in the current environment due to fractionalisation of holdings in

preceding property cycles. There also might be a constraint inherent in the size of the South African residential property market. It is noteworthy to identify that when exiting a residential property holding, the small transaction sizes may be an advantage due to their divisibility and ability to be sold to a non-investor, owner-occupier market in smaller tranches.

4.1.2.3 Rental Return

Participant “A” noted that the average return that investors were looking for on residential property was lower than on commercial. He stated, “*Obviously that’s one of the challenges we have*”. Participant "A" noted that despite this, however, they had been able to find properties with yields of 10-11%. Participant "A" noted that those yields were achievable, as they had found private investors facing cash flow problems, as discussed above in the “funding” findings.

Participant “B” found that recent yields on listed residential funds were very competitive at around 9%. However, this participant cautioned that tenants’ disposable income is not growing due to the lack of economic growth in South Africa, and therefore yield escalations in the future may be very constrained.

Participant “C” noted that yields tend to be lower in residential rather than in commercial property. Commercial property generally trades at 9-10% and residential at 7%. However, recently, due to the competition in the listed space, good quality commercial yields are trading at around residential yields. According to Participant “C”, the yield is very dependent on the residential property asset, and purchasing residential in, for instance, Cape Town will not be able to give you a comparable yield to residential inner city property.

Participant “D” noted that there are definitely rental ceilings in particular nodes, so one cannot rely on a 10% annual escalation. Participant "D" additionally discussed the fact that yield escalations in residential property were constrained by factors such as earnings and consumer price inflation. This participant stated that, “*salaries grow at 6% whatever the number is, and fuel is that. So there is an obvious rental ceiling in every market*”.

Participant “E” commented that rental yields in residential property were comparatively low and that “*you’ve got to bank more on capital return which you can either get completely right or completely wrong*”.

Participant “F” noted that residential yields are trading at around 7% currently, and good commercial assets at around the same rate. The participant noted that the capital gain in a bull market would greatly enhance overall return if assets were retained over the long run.

Participant “G” stated, “*If you’re buying an apartment block now, and you are getting returns in excess of 7 or 8%, I think you are doing bloody well. And that to me doesn’t seem like a great return*”. Furthermore, when comparing the returns of residential property to commercial, the yields were poor in relation to perceived risk.

4.1.2.3.1 Summary of findings

There is evidence that residential rental yields have historically traded at a lower yield than commercial assets. In the current environment, however, that seems to have shifted, and most residential and commercial assets are traded at around 7%. There seems to be more upside potential for capital gain in residential over the longer term, however this is not guaranteed. Rental growth in residential may, however be constrained more than commercial due to economic conditions.

4.1.2.4 Management Skills

Participant “A” commented, “*the real challenge [in property investment] is management*”. Further, it was pointed out that rental collection and minimising vacancies are the two major challenges. This participant chose to outsource most of their management, and noted that although it is hard to find managers with the required skill, they do exist. Participant "A" continued and said these managers are very area specific, and therefore, there are different managers managing assets in different geographical locations.

Participant “A” confirmed that for the different types of residential rentals, different skills, and therefore different managing agents, are required. This applies in the examples given of the difference between managing student accommodation versus inner-city residential rentals. Further risks of bad management were highlighted by

this participant, such as the risk of inner-city buildings becoming vulnerable to hi-jacking if proper management was not adhered to. Access control and systems were noted to be extremely important for good residential property management.

Participant “B” noted that there were competent managers in the field of residential property rentals, and that good management was “*critical*”. Once again, the importance of systems and access control were highlighted. The participant also made note of the need to invest in a much bigger team for management, as opposed to commercial property. At an estimate, for 100 000 square metres of commercial property, one may need a team of 50, whereas for residential property, one would need closer to 200 staff members to manage the property.

Participant “C” noted that residential management was very management intensive and that systems (in particular, maintenance and billing systems) were essential. Participant “C” was of the view that the same skills were required in order to manage commercial and residential property; however, the scale for the same investment was much larger with the latter.

Participant “D” manages their company’s portfolio in-house. This is due to the experience gained while launching their previous fund, when competent residential property managers could not be found. Issues relating to the management of residential property were shorter lease terms, high turnover of tenants, and the need to be “*on the ground*” to lease out and manage the properties.

Participant “E” noted that residential managers might even have to be “*callous*” in their dealings with non-paying tenants, and that it was a much tougher job than commercial management. However, it was possible to find competent managers for residential rental property, in Participant "E"'s experience.

Participant “F” noted that there is a lot more administration involved on residential leases due to their shorter-term nature, however this participant noted that shopping centres were similarly admin intensive. No specialist skills were required in order to be an effective property manager in the view of Participant “F”, and this respondent has managed to find suitably skilled managers for these residential assets.

Participant “G” noted that management becomes a lot easier if you purchase large blocks of units, as opposed to fragmented units due, to the management-intensive nature of the asset. With regard to the availability of skills, the participant cautioned that “*every Tom, Dick and Harry [was] trying their hand in residential management*” and that it was not easy to find competent external managers.

4.1.2.4.1 Summary of findings

Overall, it appears that management can be done either internally or externally. The interview data shows that effective systems and a “hands-on approach” are essential to good residential property management; however, limited skills are required. Having said that, it is evident that competent external management is hard to find, and that investors who become large enough to incorporate the function in-house view that as a more efficient option.

4.1.2.5 Management Costs

Participant “A” noted that the lowest his fund was paying on management costs was 6% of the gross rental collections, but that it was excluding VAT due to the fact that residential rental is VAT exempt. The participant found contrasts in their experience of residential property rentals, where one could expect to pay 2.5-3% and conceded that the costs were much higher. Participant “A” viewed this as a constraint when calculating the yield on the property because these costs have a negative impact on the yield calculation.

Participant “B” noted that commercial management fees were between 1.5-2% of gross collectables, and that residential management fees can be anywhere between 3-7%. In terms of operating costs, Participant “B” noted that commercial leases often have operating cost escalations separate to net rental, which softened the negative impact of increases in operating costs. In this case, on some buildings under their control, they were achieving up to 12% on operating cost escalations. In residential property rentals, these costs have to be absorbed by the landlord until renegotiation of the lease.

Participant “C” noted that residential management generally cost between 5-8% of gross rentals collected. However, Participant "C" cautioned about using price as a main criterion for a property manager. Participant “C” stated that, “*residential would tend to be higher than the equivalent commercial portfolio*”.

Participant “D” noted that many costs are fixed, so scale is important when calculating costs. Participant "D" noted the different scenarios where management costs were a constraint, particularly in the case of properties with less than 20 tenants. Participant "D" explained that in larger properties with many tenants, “*your expenses to operate that [residential asset], a security guard gets paid X*”. This in turn limited the constraint felt with larger rental properties.

Participant “E” found management costs in residential property to be similar to commercial property. Participant "E" cited the tendency for operating costs to be absorbed by the landlord until renegotiation of the lease to be a constraint. Additionally, it was pointed out that it was not possible to add operating costs on top of the base rental, because “*it comes back to what market-related rentals are*” meaning that it is not possible to charge a premium on what the market is willing to pay for the residential unit. Participant “E” did not think that management costs were a constraint for residential rental property, and stated that these are just a factor when calculating the yield.

Participant “F” noted that residential property management costs are substantially higher compared to commercial property management. From this participant's perspective, a small investor could not afford to pay for management, and had to effectively manage this internally, or by the investors themselves. Larger investors could reduce the costs by absorbing management function. Overall, management costs were a constraint, up to a certain size portfolio.

Overall, management costs for residential assets seem to be substantially higher for competent managers in residential property as opposed to commercial property. For the larger investor, it is apparent that internalising these functions can reduce costs, but this is only viable at a certain threshold, so smaller investors are left to manage the properties themselves or sacrifice yield.

4.1.2.5.1 Summary of findings

Another management cost factor is the operating costs for residential properties, which have to be absorbed by the investor, but can be passed on to the tenant in commercial property. The shorter-term leases in residential properties make it easier to revise rentals in changing cost conditions, however, it has been noted in the interviews conducted, that there is a definite ceiling imposed due to economic conditions and market rents, so the effectiveness of this is questionable.

4.1.2.6 Investment market information

Participant “A” said that there was a mismatch with the information expected from investors, and what was required to make an informed investment decision for residential property. It was indicated that metrics such as 'square metres' become meaningless in the residential investment market, but 'number of rooms' in each unit remain important. According to Participant “A”, contractual income is also irrelevant in residential leases because leases are month to month, and people can just move out, so a lease profile also becomes meaningless.

Participant “A” believes that this lack of information has been a contributing factor to the credibility of residential investment in the past, but over time, this will become less of an issue as the institutional investment market begins to understand the qualities of a residential portfolio better.

Participant “B” stated that *“To invest in any investment vehicle where there’s little information available, I think will be very difficult, [an] almost impossible investment decision”*, however, the participant felt that institutional investors were *“putting their toes in the water”* with smaller listings, such as the newly floated residential REITs. Investment in larger funds, however, would take some time before the market was willing to accept the lack of information, or a suitable record of accomplishment was built.

Participant “C” noted that internationally, the residential listed sector is far bigger than in South Africa, comprising up to 15% of some portfolio holdings whereas in South Africa, it was relatively immature with around 1% of total listed holdings. For

institutions, or “armchair investors”, Participant “C” saw the lack of information available as a constraint, but conversely, for the smaller active investor, it was as an opportunity to exploit the market with the lack of information.

Participant “D” noted that the information that needed to make investment decisions was readily available, in their experience. The participant used selling prices gathered from title deed information and rentals from credit bureaus such as TPN credit network. Information was not a constraint for their investment decisions.

Participant “E” did not view the lack of information as a constraint. As a smaller investor, all investments were evaluated on an individual performance basis, and indices and comparative information had no bearing on her investment decisions.

Participant “F” noted that the lack of investment information for an institutional investor is a constraint. Without the existence of benchmarks and sufficient relevant data, Participant “F” was of the view that institutional, investors would not be able to fully evaluate residential as an investment option.

Participant “G” evaluates deals on a deal by deal information, and lack of property information was not noted as a constraint to their investment strategy.

4.1.2.6.1 Summary of findings

Overall, it is apparent that for institutional investors the lack of performance related and benchmarking information is a constraint to investment in residential property. For private and smaller investors, it would appear that the lack of information is viewed either as neutral or not applicable, or an advantage because the smaller players had specific market knowledge unavailable to external parties and could leverage off it.

4.1.2.7 Residential risk profile

Participant “A” believed that the risk profile in residential rental investment was overall better than that of commercial. Participant "A" cited that one has many individual leases, and that they would not all expire at the same time, or that people were not going to all leave at the same time.

Participant “B” highlighted risks for certain types of residential property, for instance accommodation in mining towns. The participant was wary of the quality of the underlying properties that might be a candidate for the large-scale purchase of funds in the future. This concern speaks more to the quality of the underlying property and area rather than inherent risks in residential property.

Participant B also noted that the tenant risk of damage to property was far higher in residential rentals than in commercial, where only a small deposit is held, and there is not much recourse to claim damages.

Participant “C” noted that residential property, if held in a large enough number, is risk averse, due to the nature of having many smaller leases and these leases being able to “carry” defaulting tenants. The participant stated that residential rental property was in fact, “*a very defensive asset class*” because, although, you might have to adjust your rentals downwards from time to time, there will always be a market for your investment.

Participant “D” stated that “*residential is a more fluid market*” and that, along with the large scale of smaller leases, the risk profile of residential rental property is lower than commercial.

Participant “E” noted that it was easier to forecast the long-term attractiveness of commercial properties with regard to changing demographics of an area. The participant stated, “*The likelihood of the status of an industrial area drastically reducing is not high. The risk is far lower than in residential*” The participant was also of the view that the sureties provided for commercial property made a materially positive difference to the risk profile.

Participant “F” did not comment on the risk profile of residential rental property.

Participant “G” noted that due to the diversified nature and spread of tenants over a larger portfolio, the risk was greatly reduced from his point of view when contrasted with commercial property. The participant noted further however, that in a small portfolio this does not hold true, as there is high risk of individual tenants defaulting.

4.1.2.7.1 Summary of findings

Overall, there is a consensus that the risk profile in residential may be relatively better than in different property sectors when taken in the context of a large multi-property portfolio, however, the risk for smaller investors is multiplied.

4.1.2.8 Legal constraints

Participant “A” noted that due to legislation such as the Consumer Protection Act (CPA), it is no longer possible to legally hold a tenant to the tenure of a lease once one month’s notice has been issued. This is not viewed as a constraint by the participant due to the fluidity of tenants and the ability to replace them in a large portfolio. The participant stated that *“when a tenant can’t pay, the tenant moves out”* and that in their experience as a former external director of the Johannesburg Housing Company for 12 years, they were aware of only 5 cases of legal issues with tenants who were evicted.

Participant “B” acknowledged that legislation protected residential tenants, but emphasised that there were legal issues in commercial property ownership as well. For them, all these issues needed to be managed effectively; however, they no true legal constraints were evident.

Participant “C” had no view on the legal framework as being a constraint.

Participant “D” noted the legislative landscape around residential property, citing the CPA and Prevention of Illegal Eviction (PIE) Act. However, it was noted that there is a legal framework in every industry, and that the legislation was not a constraint to investment in residential rental property.

Participant “E” noted that in the past, they had had non-paying tenants that did not leave when evicted on reasonable grounds, and who took 6 months to evict. The loss of income on the property over the period negatively affected the investment and the participant was therefore of the view that the legal framework for residential rental property is a constraint.

Participant “F” was of the view that there were no legal constraints to investment in residential rental property, and had no further comments.

Participant “G” cited legislation such as the PIE Act and CPA as constraints to residential investment, and noted that these risks had to be managed effectively.

4.1.2.8.1 Summary of findings

Overall, it is evident that there are certain legal protections afforded to tenants that may prejudice the landlord of residential rental property. That being said, some felt it was a constraint, and others felt it was an acceptable legal framework. The distinction seems to be between the larger/ institutional investor, and the smaller investor.

Larger investors have a larger pool of tenants, and therefore, these non-paying tenants have a diminished effect on the overall investment vehicle return, and can be absorbed. However, in the case of investors with 10 units, for instance, they could suffer a 10% reduction in gross rental, while still bearing all of the costs. In this instance, these investors could be extremely negatively affected by the legal framework, which favours tenants over landlords excessively.

4.1.3 Additional findings

The participants were requested to identify any other constraints that were not directly asked about during the interview. The following constraints were identified:

Participant “A” noted that generally property transfer duty was payable on transactions, unless the residential property was held in a company. This creates a mismatch between the purchaser’s yield and the seller’s yield, given that the purchaser needs to take the transfer duty cost into account when purchasing the property. Commercial property on the other hand, is generally bought and sold in a company structure and is zero-rated for VAT.

Participant “F” noted that, for them, the South African social environment as a constraint, in the sense that there is a gaping disparity between the haves and have-nots. Participant “F” was of the view that this poses a problem because although supply of housing can be made available, the vast majority of people do not have the

resources to either purchase or rent. Participant “F” further noted that economic confidence is a constraint to investment in residential property currently, and that the meagre economic outlook for South Africa did not bode well for the investment market.

Participant “G” noted government administration as a constraint, citing that it often took him well over the expected time to effect transfer, which put pressure on cash flow, and according to this participant, could put smaller investors out of business.

It is clear that there is a distinction drawn between smaller private investors and large companies and institutions. Many constraints for one are an advantage for the other. For instance, funding is a constraint for the smaller investors, but for the larger investors, there seems to be an abundance of funding.

4.2 Economic Data Findings and Analysis

This section analysed the yields available to residential property investors and is used to corroborate yield data gathered during the semi-structured interview process.

Residential property yields have historically been hard to attain on a large-scale basis. This is partially because there is little institutional or public company investment in residential property and therefore, the data that is available is held by private individuals. The most extensive historical source of information can be found from rental data collected by the TPN Credit Bureaux. Residential values are also recorded at banks with residential lending books, where mortgages are lent against properties.

4.2.1 National yield comparisons

The TPN-FNB Residential Yield dataset combines the results of TPN rental data along with FNB’s house price data and it is Automated Valuation Models (AVMs). This is done in order to calculate the Gross Initial Yield on a range of properties on a national level. According to the TPN-FNB data compiled in Figure 5, the national average gross rental yield on residential property, as at the 4th quarter of 2007, was estimated at 7.54%. This coincided with a multi-decade real house price peak, following a lengthy house price boom during prior years (Loos, 2015). By the final

quarter of 2011, the yield had moved upward to 9.65% as house prices fell from their peak.

As illustrated in Figure 5, from early 2012, a slow decline in gross yield set in, as the home buying market strengthened again. As at the 1st quarter of 2013, the TPN-FNB report estimated that national average gross yields had declined to 8.58%. Since 1st quarter 2013, rental yields have been on a steady but mild decline, suggesting that, all things being equal, there has been a slow and steady strengthening of capital prices.

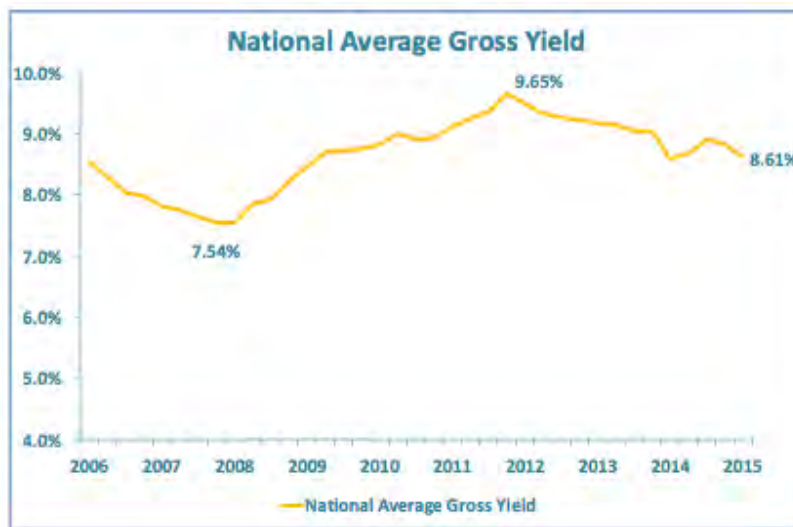


Figure 5 National gross average yield (TPN-FNB, 2015 p1)

As a broad estimate, Loos (2015) suggests that one can take 1.5% off the gross yield to estimate a net yield. If one were to apply this estimate to the national gross yield today, the average net yield would be around 7.1%. Since the cost of financing at the time of writing this research was around 9.25%, the average homeowner would not be able to achieve a net rental at a higher rate than their financing costs.

The spread in finance costs and yields may explain the low rate of buy-to-let investors in the market currently (9%) as opposed to above 25% in 2004 as illustrated in Figure 6:

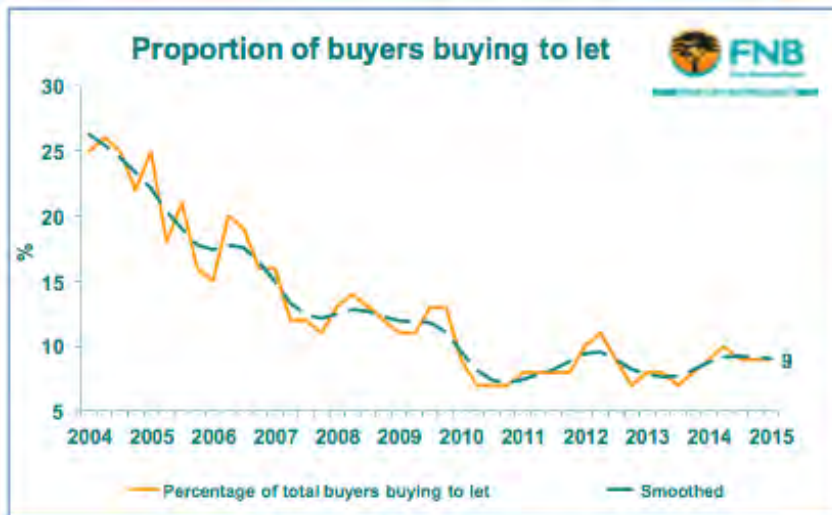


Figure 6 Proportion of buyers buying to let (TPN-FNB, 2015 p2)

Other variables should also be taken into account when investing in residential property however. It is also perhaps equally important to evaluate the yield compared to the investment risk. In Figure 7, we can see that residential tenants in good standing have gone from a low of around 71% during the 2009 recession to 86% on the first quarter of 2014.

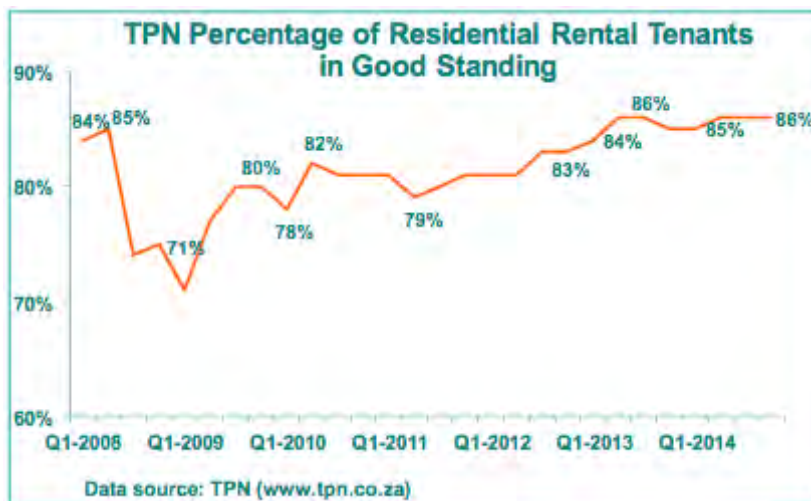


Figure 7 Percentage of residential rental tenants in good standing (TPN-FNB, 2015 p2)

It is notable that the percentage was relatively high immediately before the recession, and after 2009, it has steadily climbed to historical levels. This may well indicate the effect that a recession has on tenant credit and accounted for when considering the property cycle and which stage one is currently in.

4.2.2 Regional yield comparisons

The TPN-FNB report further breaks down yields by region in South Africa. By the data presented in Figures 8 and 9, as at the 1st quarter of 2015, the three Gauteng metros had the highest yields, being City of Joburg (9.74%), Tshwane (9.18%) and Ekurhuleni (9.03%). Gauteng also recorded the second poorest payment performance with 86% of tenants in good standing, after KZN (82%). The Western and Eastern Capes had the lowest gross yields, but the highest proportion of tenants in good standing, suggesting that the financial notion of high-risk investment will equate to high return holds true, at least in the residential rental sector in South Africa.

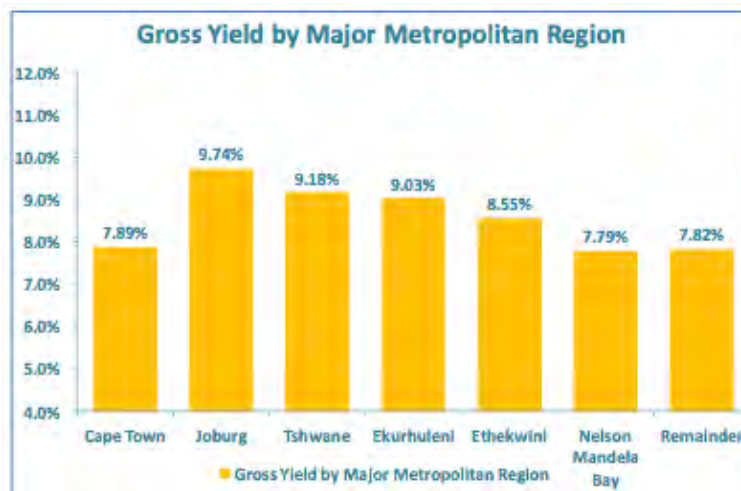


Figure 8 Gross yield by major metropolitan region (TPN-FNB, 2015 p3)

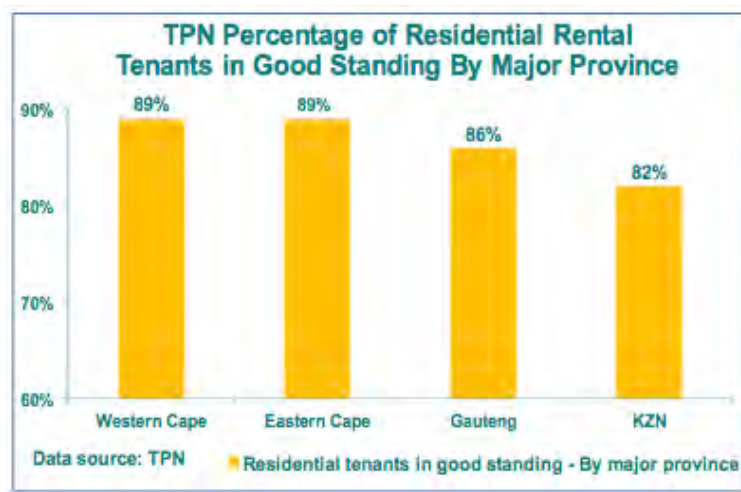


Figure 9 TPN percentages of residential rental tenants in good standing by major province (TPN-FNB, 2015 p3)

4.2.3 Segment yield comparison

In order to gauge comparative yields by price segment, the TPN-FNB rental review segmented the average value of homes into five price ranges as set out in Figure 10.

The following categorisations were made:

1. Lower Income – below R 600 000
2. Lower Middle Income – R 600 000 – R 900 000
3. Middle Income – R 900 000 – R 1 200 000
4. Upper Middle Income – R 1 200 000 – R 1 500 000
5. Upper Income – R 1 500 000 and above

It is notable that in the 1st quarter of 2015, in the lower income areas, the median yield was estimated at 9.4%. In the lower middle-income areas, the yield was slightly lower at 8.89%. The yield dropped further in the middle-income areas to 8.47% and further yet to 8.16% for upper-middle-income areas. Finally, a more significant drop to 7.44% was seen in the upper-income areas.

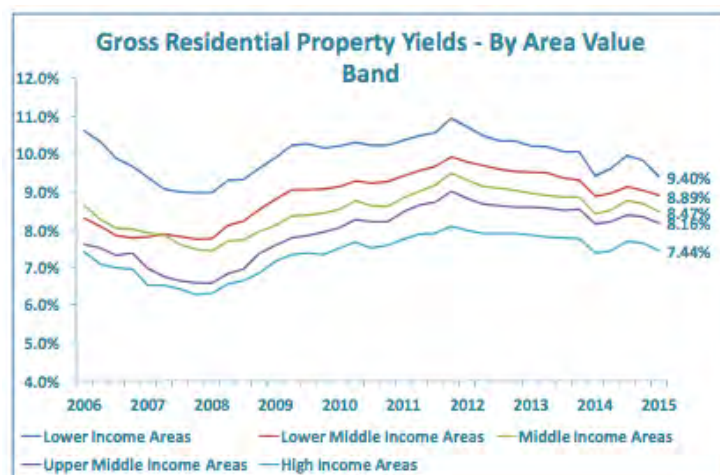


Figure 10 Gross residential property yields - by area value band (TPN-FNB, 2015 p3)

From the information, it appears that cheaper properties, on average, produce higher gross yields for investors. Total return, however, does not only depend on gross yield achievable, but also on other factors such as vacancy and good standing of existing tenants. These factors can be classified as risk factors.

Using TPN data regarding the percentage of tenants in “good standing” regarding their rental payments, presented in Figure 11, we can see that in the lowest price range, only 80% of tenants are in good standing. Many of the homes in this segment

most likely fall into the “affordable” or “low income” areas. The next two price ranges have the best tenant record, with homes with a rental of R7 000 – R12 000 (or price range of between R9 00 000 – R1 200 000) having the highest at 89%.

It is notable that, once we move past the middle-income price range, the percentage of tenants in good standing declines in the higher price bands.

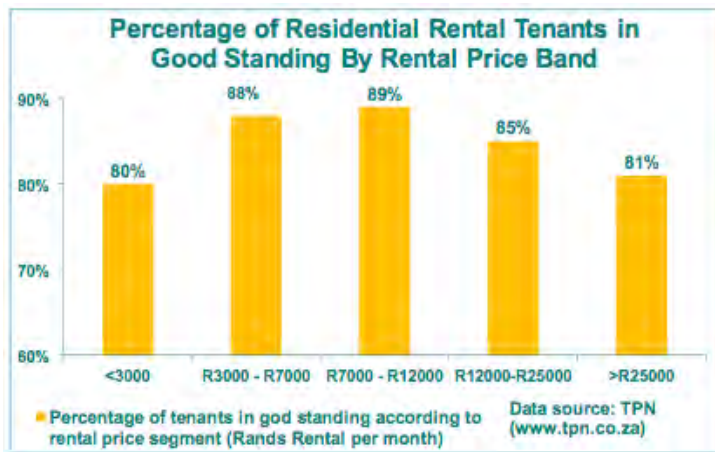


Figure 11 Percentage of residential rental tenants in good standing by rental price band (TPN-FNB, 2015 p4)

From the evidence presented, it would appear that the most attractive position from the point of view of a landlord, given the risk and reward profile of each price range, would be the lower middle income and middle income price ranges or stated alternatively, homes from between R 600 000 – R 1 200 000.

4.2.4 Yield by tenure number of rooms

Figure 12 segments average gross yield by free hold and sectional title as well as the number of rooms in each dwelling in those categories.

From the data presented, it appears that sectional title properties produce the highest gross rental yields with a one-bed at 9.53%, a two-bed at 9.28% and a three-bed at 8.92%. Freehold homes generate a yield of 7.99% for dwellings with fewer than three bedrooms.

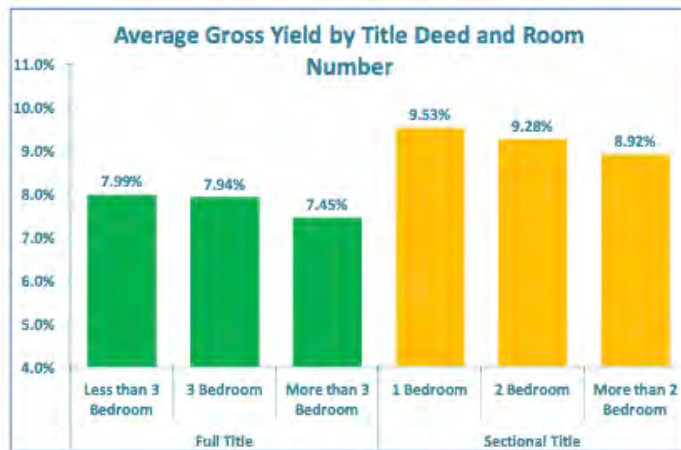


Figure 12 Average gross yields by tenure and room number (TPN-FNB, 2015 p5)

4.2.5 Conclusion to quantitative findings

National rental yields are on a steady, slow, and declining trajectory, suggesting that property prices are increasing. The buy-to-let market currently contributes the least to the residential investment market than it has in over a decade, from 25% in 2004 to 9% currently. Coupled with the cost of finance being above rental yields for most, and interest rates forecast to rise, this may still be the case.

From commercial investor’s point of view, this means that there is less competition and more opportunity. With access to cheaper finance than the individual consumer, the residential market should be considered as an investment avenue.

Regionally, it is evident that the highest yields are produced in Gauteng. On a property level analysis, the evidence suggests that the most profitable properties adjusted for risk, are properties valued at between R600 000 – R1 200 000. Properties in this price range seem to be further enhanced if they are sectional title units with three bedrooms or less.

The quantitative data clearly supports the qualitative data extracted from the interview responses, in which many respondents indicated financial constraints to investing in residential rental property in South Africa.

Chapter 5: Conclusion and Recommendations

In this chapter, the report presents an evaluation of the research against the research objectives, question, aims and proposition stated in Chapter 1. A conclusion on the research is then presented and finally, recommendations for further areas of study are stated.

5.1 Findings regarding the research question.

The research question was, *“What are the major constraints that the private property investor faces when investing in residential property for rental in South Africa?”*

This question was answered by:

- Reviewing the literature to firstly, understand the South African residential market and establish the size of potential and current demand for rental within it. Secondly, to ascertain what factors have been identified that restrict investment in international residential rental markets. This process allowed patterns to be identified, which could then be assessed in terms of the South African context.
- Through a field survey design, undertaking a series of qualitative, semi-structured interviews of property investors, developers and managers to establish if these same factors restrict investment in residential rental property in South Africa.
- Processing and analyse the interview responses using pattern-matching techniques.
- Applying descriptive statistical techniques to investment returns secondary data to corroborate the findings of the field survey.
- Using the analysis to conclude on what factors inhibit significant investment residential rental property in South Africa.

By answering this question, the research aim of *identifying the factors that constrain or create barriers to residential rental property investment for private property players in the South African market* was achieved.

The research showed that the key factors inhibiting investment in residential rental property in South Africa were as follows:

Financial Liquidity

Financial liquidity is a constraint to smaller investors, who are not able to access cheap finance and interest-only loans. For larger and institutional investors, this is not currently a constraint. From evidence obtained through interviews, it is clear that for an individual or small company, obtaining funding at a decent rate and on favourable terms is not easy. In all likelihood, the lender will demand an amortising loan with a rate of around prime. For the larger listed and institutional investors, however, it would appear that there is funding available at more competitive rates, through either debt or equity, and these investors are able to access more structured products, such as interest only loans, which have cash flow and tax advantages.

From evidence gained through the assessment of financial and economic data, it was shown that national rental yields are on a steady, slow, and declining trajectory which suggesting that property prices are increasing. Coupled with the cost of finance being above rental yields for most, and interest rates forecast to rise, this may still be the case. Therefore, financial liquidity has been identified as a key constraint for particular investors in the South African rental property market, namely those individuals and smaller companies who are unable to work with the rise of property prices in recent years. The assessment of economic information conducted for this study provided evidence that residential rental yields have historically traded at a lower yield than commercial assets. In the current environment, however, that seems to have shifted, and most residential and commercial assets are traded at around 7%. There seems to be more upside potential for capital gain in residential over the longer term, however this is not guaranteed. Rental growth in residential may, however be constrained more than commercial due to economic conditions.

The patterns identified in the qualitative data closely matched the financial patterns identified in the literature.

Property Liquidity

For larger and institutional investors, finding sizable residential property transactions is a major constrain. There is a scarcity of large assembled residential assets in the South African market. This is due to fractionalisation of holdings in preceding property cycles. There also might be a constraint inherent in the size of the South African residential property market. It is noteworthy to identify that when exiting a residential property holding, the small transaction sizes may be an advantage due to their divisibility and ability to be sold to a non-investor, owner-occupier market in smaller tranches. Identifying this constraint contributes to the issues noted by Lachman (2012) regarding the availability of property in South Africa that is available for rental use.

Property liquidity was identified as a pattern in the literature, and the pattern was again identified in the interviews conducted. The research concludes that this pattern was matched in the interviews.

Management Skills

Access to competent property managers is a constraint to residential rental property investment. There is evidence to suggest that installing the correct systems and processes will help counter this constraint.

The pattern of management skills being a constraint to investment in residential property for rental was clearly supported by the respondents in the research, and therefore matches closely to the literature.

Management Costs

This research showed that management costs are higher in residential property compared to the management of other types of property. This could be evidence of the more labour intensive nature of residential property. Due to the high management costs, returns on investment are reduced. From the discussions arising in the interviews, it appears that management can either be done internally or externally.

The data shows that systems and “a hands-on approach” are essential to good residential property management, however not much skill is needed. However, having said that, it is evident that competent external managers are hard to find, and that investors who become large enough to incorporate the function in house, see that as a more efficient option.

Another management cost factor is the operating costs for residential properties that have to be absorbed by the investor but can be passed on to the tenant in commercial property. The shorter-term leases in residential make it easier to revise rentals in changing cost conditions, however, it has been noted in the interviews and economic data collected in the course of this study that there is a definite ceiling imposed due to economic conditions and market rents, so the effectiveness of this is questionable.

Management costs were a constraint to the respondents interviewed, but some respondents identified ways to overcome the constraints of management costs. This pattern therefore loosely matched the literature.

Investment Market Information

The lack of investment market information makes it harder for property investment companies to raise funds on a larger scale. The lack of information is becoming less and less of a constraint as investors become familiar with the new metrics and accumulation of market information, thanks to pioneers in the residential rental industry such as Indlu Place Properties. Overall, there was consensus in that the risk profile in residential rental property may be relatively better than in different property sectors when taken in the context of a large multi-property portfolio, however, the risk for smaller investors is multiplied.

There was a clear match between the literature and the qualitative research performed relating the lack of investment market information relating to residential rental property.

Legal constraints

For smaller investors, legal protection of tenants can become a major constraint to investing in residential rental property due to the amount of time it can take to evict

an unlawful occupier of your property. For larger investors, this does not pose as much a constraint due to the size of their portfolio, and their ability to absorb losses from a defaulting tenant.

There was a loose association with legal constraints being an issue for investors in residential rental property in south Africa. Although it was clearly a concern for some respondents, others had not identified it as a major constraint. Legal constraints as a pattern matched weakly but still significantly to the pattern identified in the literature.

The following patterns were identified in the literature, and it is indicated whether the patterns were matched in the research:

- Financial Liquidity (Funding) – Strong Match
- Property Liquidity (Stock) – Strong Match
- Rental Return – Strong Match
- Management Skill – Strong Match
- Management Costs – Loose Match
- Investment Market Information – Strong Match
- Residential Risk Profile – No Match
- Legal Constraints – Loose Match

Figure 13 has been compiled to assist with the visualisation of the severity of constraints in relation to each other:

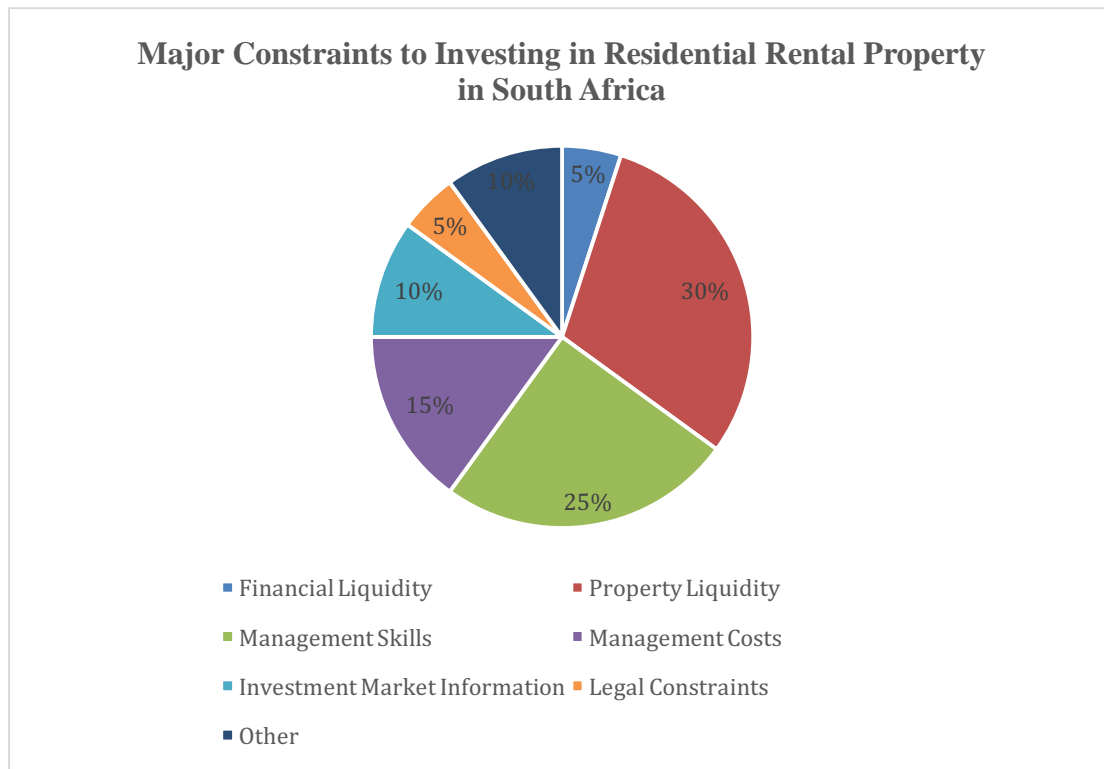


Figure 13 Major Constraints to Investing in Residential Rental Property in SA

Figure 13 is a visual representation of the proportion that each pattern identified in the research contributes to the overall constraints to investing in residential rental property in South Africa. The figure is intended to provide a quantifiable visual representation of the predominantly qualitative research conducted. There is an element of subjectivity from the author in calculating the weightings of the figure; however, the proportions have been prudently measured according to the contribution of each factor ascribed by the research participants.

Other notable findings

Both secondary rental property data (TPN-FNB, 2015) and the interview data from this study show that residential property yields are attractively high compared to other property asset classes, and based on this, there is a strong case for good rental growth in the future.

The research found that, in many ways, residential property has a better risk profile than commercial property. This is because there is diversity and a broad mix of leases,

and there is always a market for accommodation at the right price in South Africa. Other notable findings are that there is a difference between being a large investor, typically listed or institutional, and a smaller, private investor. Many constraints for smaller investors become less of a consideration for larger investors.

Finally, the research made it evident that it is fundamental to implement the correct systems and processes when building a residential property portfolio of any size, and that great care and planning must go into the implementation of these systems.

Overall, there is a sound legal framework to build a large residential rental portfolio; however, it is a challenge to find enough residential units in single transaction sizes. The investor must also pay close attention to the implementation of systems for management of the property, as well as ensuring that management costs are minimised as far as possible.

As investors become more and more comfortable with investing in residential property with the accumulation of new market information and adoption of new paradigms, there is a positive outlook and scope for further large-scale investment in residential property for rental in South Africa.

The research findings show that there was a shortage of skills in the residential property management field, as well as high operating and general management costs of residential rental property. However, despite the fact that financial costs were found to be a hindrance for smaller investors, larger investors found that these constraints were negligible, especially compared with other asset classes. The research also found that there is an enabling political environment around residential rental property, with supportive legal structures in place.

As a result, the research conducted supports the research proposition insofar as there are management constraints that restrict large-scale investment in residential property. However, the evidence does not support the proposition regarding political and financial constraints to the South African residential rental market and therefore the proposition proposed can only be partially supported.

5.2 Recommendations and further areas of study

Future areas of study should focus more on a specific type of investment vehicle. For instance, a focus on residential REITs in order to ascertain the constraints specific to that type of investment structure would be a useful area of further study. This is because there are evidently specific constraints and benefits that affect different investment structures, and so careful analysis needs to be carried out regarding each type.

Further research should also be conducted around the management of residential rental investments, specifically focusing on analysis of the systems and processes used in order to improve efficiency and reduce costs.

One other area that should be investigated is the extensive research into financial returns of each market segment, which should also include comparison between newly constructed units, based on cost and purchased second hand stock.

Overall, there is a large body of knowledge to be investigated around the residential real estate investment market. Further research should focus on either one area of concern, for instance, financial, management, legal or political. Alternatively, focus on a particular market segment based on affordability or value.

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Appendices

Appendix A – Field Study Interview Structure

Interview Structure

Greeting and Introduction:

Good morning/ afternoon. Thank you for taking the time to attend this interview.

Explanation of research topic:

What are the constraints for property investors investing in residential property for rental in South Africa?

Non-disclosure and confidentiality:

The participants in this interview will be kept anonymous at your request and only the researcher will have knowledge of their identity.

Questions:

Please would you give a brief explanation of what your organisation does and your role within it?

From the literature reviewed, a few broad patterns were identified as constraints to residential property investment; they included financial, management, and information constraints I would like to discuss them with you through a series of structured questions.

Financial Issues:

1. Is liquidity a constraint in residential property investment? Relative to other property and asset classes?
2. To what extent does liquidity influence your decisions to invest?
3. Compare the financial return between residential and other property asset classes.
4. Is this return sufficient to attract investment?

5. How volatile are these returns?
6. Are there any financial or tax constraints specific to residential property investment?

Management Issues (asset managers and property managers):

7. What specific skills are required to be a competent residential property manager?
8. Are there competent managers in the field?
9. Is “managers’ skill-set” a constraint in residential property investment?
10. Are management costs a constraint for residential property investment?
11. What are the differences between management costs of residential property as opposed to other property asset classes?

Investment and Property Market Information

12. Is the lack of portfolio performance and benchmarking indices for residential property a constraint for residential property investment?
13. Does insufficient property investment information such as portfolio performance, benchmarking, rental etc. reduces investment credibility or possibly create unexploited opportunities?

Other Issues

14. What social, legal or political constraints are there to residential property investment?
15. Are there any other constraints that the residential property investor faces in the South African context?

Thank you for participating in the interview process!

Appendix B – Confidentiality and Consent

Consent Form:

Identifying the Major Constraints to Investment in Residential Property in South Africa

Dear,

My name is Marc Frew and I am conducting research towards a master's degree at the University of Cape Town. I am researching the major constraints to investment in residential property in South Africa and would like to invite you to participate in the research project.

Please understand that your participation is voluntary and the choice to participate is yours alone. If you choose not to participate, there will be no negative consequence. If you choose to participate, but wish to withdraw at any time, you will be free to do so without negative consequence. However, I would be grateful if you would assist me by allowing me to interview you.

This interview will be recorded in order to be transcribed for analysis at a later date.

The research will be used for academic purposes only in terms of completing the masters thesis and it may be published in an academic journal. As a result, please indicate if you wish your input to be anonymous by marking as appropriately below.

Your assistance in this research is greatly appreciated.

Yours faithfully,

Interviewee Name:

Interviewee Organisation:

I hereby **provide / do not provide** my consent to be named within the research report.
(Please cross out what is not applicable)

Signature: _____

Date: _____

Appendix C – Ethics Clearance

Application for Approval of Ethics in Research (EIR) Projects
Faculty of Engineering and the Built Environment, University of Cape Town

APPLICATION FORM

Please Note:


Any person planning to undertake research in the Faculty of Engineering and the Built Environment (EBE) at the University of Cape Town is required to complete this form **before** collecting or analysing data. The objective of submitting this application prior to embarking on research is to ensure that the highest ethical standards in research, conducted under the auspices of the EBE Faculty, are met. Please ensure that you have read, and understood the **EBE Ethics in Research Handbook** (available from the UCT EBE, Research Ethics website) prior to completing this application form: <http://www.ebe.uct.ac.za/usr/ebe/research/ethics.pdf>

APPLICANT'S DETAILS		
Name of principal researcher, student or external applicant	Marc Alexander Frew	
Department	EBE	
Preferred email address of applicant:	Marc.frew@gmail.com	
If a Student	Your Degree: e.g., MSc, PhD, etc.,	MSc Property Studies
	Name of Supervisor (if supervised):	Robert Mc Gaffin
If this is a research contract, indicate the source of funding/sponsorship	Click here to enter text.	
Project Title	Identifying the Major Constraints to Investment in Residential Property in South Africa	

I hereby undertake to carry out my research in such a way that:

- there is no apparent legal objection to the nature or the method of research; and
- the research will not compromise staff or students or the other responsibilities of the University;
- the stated objective will be achieved, and the findings will have a high degree of validity;
- limitations and alternative interpretations will be considered;
- the findings could be subject to peer review and publicly available; and
- I will comply with the conventions of copyright and avoid any practice that would constitute plagiarism.

SIGNED BY	Full name	Signature	Date
Principal Researcher/ Student/External applicant	Marc Alexander Frew		14 Aug 21015

APPLICATION APPROVED BY	Full name	Signature	Date
Supervisor (where applicable)	ROBERT MCGAFFIN Click here to enter text.		 Click here to enter a date.
HOD (or delegated nominee) Final authority for all applicants who have answered NO to all questions in Section 1; and for all Undergraduate research (Including Honours).	Click here to enter text.		Click here to enter a date.
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Appendix D – Survey Transcripts

Participant “A”

INTERVIEWER: Okay, perfect. Initially I would just like to find out on the record what your position is here at Indluplace Properties and how and a bit of a background about the business.

INTERVIEWEE: I'll just give you a bit of background. In 2009 I had just retired from Apex Hi. I wanted to start a Residential Fund. Now, when I talk about real estate from my point of view it's much more of a financial exercise. I know how to raise money, I know how to structure listed vehicles, and normally find stock and those are the things put together. It's not complicated actually a very easy business but I'll talk about this. And I found that there was certainly funding available at a price but I couldn't find the stock, I couldn't find enough stock. Stock was too expensive at that stage, so I actually ended up with about 400 million Rands worth of stock and the institution investors who I'd spoken to said unless the fund has got 1.5 billion Rands worth of stock, we're not interested so it fell apart, didn't work. I'm the Chief Executive of Arrowhead Properties, which is a straight forward REIT today and it's a diversified REIT, it's got offices et cetera, offices retail and industrial, normal thing. Somebody came to see me and said they wanted to start a residential REIT, what did I think. I said look, I think you're going to have difficulty. You'll find the money, the money is there, it can be structured you'll find borrowings and you'll find equity. You're not going to find stock, not enough. [inaudible 0:01:52] the lady, anyway, then she went to work for somebody else but she introduced me to somebody who had a portfolio who was willing to sell about two hundred million Rands of stock and I thought to myself why not do it in Arrowhead. It ticks all the boxes of the things we want to do, we look for revenue enhancing assets, and we can find the money as much as we want to. What's the difference between buying residential or industrial? Obviously, the structure is different, the leasing etcetera but okay, so we formed a subsidiary and we bought two hundred million Rands of stock. And that's the way it started and then we bought more stuff and eventually we got up to R1.6 billion and all that we've done is we have now put that subsidiary, which bought the residential stuff we put that into, we listed it.

INTERVIEWER: Okay.

INTERVIEWEE: We had some borrowings, which we paid off so we've reduced our stake, instead of having a 100 percent in the thing we needed to have the stock exchange listing; we needed to at least sell 20 percent off. There are four of us that have a stake in the business, so at present Arrowhead is at 70 percent stake and over time that stake will reduce. But it's very simple, Indluplace has got at present R1.6 billion worth of residential stock and it's a mixture. Its bottom end of the market, units, flats and then some slightly better stuff. Our average rental is about R5, 000.00 a month in our portfolio. Most of it is in and around Johannesburg and Pretoria but we've got some stuff in Witbank. We've got some student accommodation but it's very little, mainly accommodation for families. Indluplace sees itself as being an exit for developers who want to sell and for people who have got portfolios that want to take money off the table and they want to sell their portfolio. So, that's what we sell. We can raise as much money as we need to at present and actually our [inaudible 0:04:3] is quite good on the market so our cost of capital is probably 8.5 percent, it's not bad and Indluplace is totally equity financed, it has no borrowings. It has got no loans from the banks. It's all in equity finance. And the intention is to grow it on that basis, to find more stock and to grow the fund. I believe that the risk profile in residential is much better than in commercial because you've got lots of little leases and they're not all going to expire at the same time or people are not going to leave at the same time. The real challenge is management. Now, we outsource all our stuff, so we got to know that we've got good managers and they're on top of it. It's the question of collecting rentals and seeing that your vacancies don't go out of kilter, you know, in terms of dealing with the accounts and maintenance repairs, that's the same as any other business. But it's really the question of seeing that your revenue stream remains as you budgeted for it and that you can grow the rentals. And there are certain things that we've learned about residential that we didn't know from commercial you know. Question of leases of being, you know what, with the, today a tenant can give you two months' notice, can move out whenever they want to so why [inaudible 0:05:19] to leases or former leases. You know when we listed on the stock exchange it was the first time they had a residential company

listing. All the information that they were given before all dealt with square metres you know; how long leases were. You know when we came to them and said look, square metres doesn't mean anything. It's more important to tell people that it's a one bedroom, two bedroom, bachelors and we don't have contractual income because all the leases are monthly or people can move out. We don't have a lease profile. You know that shook them for a while, you know, so it's a different kind of business. But I think that, and more and more people are going to go into it. I think, we were the first but I think there are going to be a lot more.

INTERVIEWER: Do you think there's space for each different residential sub sector or.

INTERVIEWEE: I think people are, I think that what we've done, we've become a focussed residential REIT. If you're saying will there be, will the focus become even narrower? I think for instance you may well find a student accommodation REIT. I think so, I think that's possible. For the rest I think it will probably diversify because you've got most of the same elements. You know I'm not sure that you're going to have something that's only going to be upmarket or that it's only going to be in the major apartment block business. So, I don't think that's it's going to be narrower than other than student accommodation. I think there's room to have student accommodation REIT maybe, but I think that's a very different business.

INTERVIEWER: And what about the, is there a difference as far as you can see on the yields in those different types of property, residential property. How does it compare to other more traditional South African listed asset property classes?

INTERVIEWEE: I think most people will tell you that residential people are looking for much lower yields than on commercial. And obviously that's one of the challenges we have. I would think that most people who have individual units are getting very low returns. They're paying an ex price and then they're paying the levies and they paying whatever else and they're getting the rental in. I would think, and certainly the top end of the market returns, the must be very low. But look we've been able to buy stuff at 10 percent and 10.5 percent and 11 percent, because as I said, we're looking at major parcels where people want to exit and probably held it for a long time. I think the constraint with most people who are building portfolios who ask for constraints is that, most people find it difficult to raise equity.

INTERVIEWER: Okay.

INTERVIEWEE: So, first of all you tried [inaudible 0:08:17] so then you try to bond as high as you can. Not so easy and that's also becoming more expensive but in most cases people are having to pay interest and capital. In the REIT structure almost all the borrowings, if there are borrowings, are interest only loans, which you repay after five years, in fact you roll them over at 99.9 percent [inaudible 0:08:39] and as I said the equity can cost you, if you look at any of the funds, the equity ranges from the best funds are at 4.5 percent return and right on the other end are about 12 percent. So, you know. So, for many people the holding of residential stock in paper, they might be doing better and their assets are becoming worth more and they're paying down their loans but they're not seeing any cash coming out. They're paying capital back. If they're paying capital back they're probably paying tax somewhere as well because of the structure. So, we have found that we have been able to do deals with people that, you know, they built up nice portfolios at three, four or five hundred million or maybe a billion but for the last five years they've run like crazy and they're not taking money out. So, that is the opportunity that we have. But we have to buy; we can only buy assets that give us a yield that is greater than our cost of capital.

INTERVIEWER: So what's your hurdle rate at the moment?

INTERVIEWEE: Well as I say we can borrow money at eight and a half. We're looking at buying stuff at 10 percent. Now, that's straight forward, I mean that's Nett income and as I say we can raise the equity on that basis. Not talking about borrowing, we've got no loans from the bank at present. We can borrow up to 30 or 40 percent and the bank will be very happy to lend us the money. But that cost of money stays just under 10 percent for us.

INTERVIEWER: And what about, I mean, liquidity in the residential market and you know the size of transactions are comparably smaller to your, you know, your other property asset classes.

INTERVIEWEE: There's a huge problem with that.

INTERVIEWER: Is it?

INTERVIEWEE: It's a question of money. It's a question of return. And there are some very big developers. You take Calgro, you take, ag, we bought a big townhouse complex, can't remember the name of the fund, the developer. But you know there are people that are developing, five, six hundred units a year. You know they're going to sell them. This is an

opportunity to sell them in one shot.

INTERVIEWER: And what's, just what, like what is the minimum charge of units Indluplace would look at. Just as a kind of...

INTERVIEWEE: I would look at 20, 30 million.

INTERVIEWER: Twenty, thirty million Rands. Okay. So, do you look at the overall...?

INTERVIEWEE: But we'll also do four hundred million or we'll do a billion.

INTERVIEWER: Okay.

INTERVIEWEE: But it's yields. For us the first thing we look at is yield, then we'll look at all the other things. Location, type of tenants, the quality of the building. We do due diligence on everything but if the yield is right we look very carefully and we make up our minds very quickly.

INTERVIEWER: Really. I mean how much, what is the weighting on a kind of, what kind of risk return model do you use and is it different in the residential space, you say, you know, you just can't lease terms.

INTERVIEWEE: I have no borrowings, you know, no risk, no borrowings so it's a cash in; it's a money in, money out. You know, our risk is that we're going to do a deal now and by the time we get transfer because of, first of all if it's, if the transaction is over eighty-five million Rand we've got to go to Competitions Commission, it takes two to two and a half months, we've got to do due diligence, we've got to raise the money. So that period, there's risk in terms of our cost of money. That's our challenge and up to now interest rates have been falling over many years but now interest rates are relatively on track but starting to go up. I mean they have gone up a bit. So I would say that's our risk but other than that we don't have major risk. You know the property might generate less than we budgeted for, then the return to our shareholders is going to be less. We're a strictly, a money in, money out business.

INTERVIEWER: Okay. Okay. And what about management issues. There's quite a bit of talk in the literature around quality of management being slightly less than in the residential space and I mean, are there professionals in that space, what skills do you need to manage a property, residential portfolio?

INTERVIEWEE: Look, in our business, generally, in Arrowhead and most of the businesses I've run before, I've been more comfortable with an outsourcing model. I mean, when, I was involved with Anglo American for 25 years, I ran their Real Estate business and at one stage we employed two and a half thousand people, you know, and eventually we sold all of that management business. So we have got assets, what we would call, and obviously there are people here that are involved in acquisitions and I think those people are very talented and work hard at that and then we've got two asset managers who and what is their, their main function is overseeing the property management, so what we've tried to do in residential and on the commercial side as well. On the commercial side we've got JHI and they run our portfolio in the whole country. They've got the ability, and they've actually been very good for us. I think they've been excellent. Our sense was that there isn't an individual collecting agency, or if you want to call it, or property manager country wide and even in Johannesburg, if you want to look only in Johannesburg there are specialists in certain areas. So, what we've said to ourselves is that we're going to look at the right managers for the properties that we're buying and we've been able to find them. For instance, if you're in the student accommodation business I think it requires a different skill. If you're in the, if you've got stuff in Soweto it's different to having stuff in Witbank. So, and our asset managers have to be very careful, so you know, it's a question of every month going through line by line, income and expenditure, seeing what the vacancies are, seeing what the arrears are, why the vacancies have gone up, you know all of those sort of things. And I think if you manage tightly then really, the risk is low. If you don't manage it well, you've got buildings in the CBD that will be hi-jacked.

INTERVIEWER: Ja, sure. And especially...

INTERVIEWEE: If you manage it well, you know, if you see that the buildings are not, you know, that the occupants are what you think they are, you have access control, there are all those sort of things that you need to know about residential. But from our limited experience over the last two years we think we've been able to find people who do it and we've been getting the returns that we expected.

INTERVIEWER: I mean, what about, are there other, I mean the cost, really what I'm trying to ask you about the management cost, you know, to income ratio.

INTERVIEWEE: Higher, higher

INTERVIEWER: Are they higher or relatively higher?

INTERVIEWEE: I mean, we're paying, I think the lowest we're paying on rent collections is 6 percent of the rental collections.

INTERVIEWER: On gross rental.

INTERVIEWEE: On gross rentals as the rental, well there's no VAT but it's not only rentals, it's also on whatever else you're collecting, whether it's electricity or whatever although in most cases the electricity is pre-paid but on other costs that you add on. But in the commercial side it's anywhere between 2.5 and 3 percent. No, it's much more. But that's part of it. When you buy a property that becomes part of it.

INTERVIEWER: Okay, ja sure. All right. Sorry just to recap, just confirming you can find the management skills sets required...

INTERVIEWEE: We think so.

INTERVIEWER: Professional management.

INTERVIEWEE: As I said you know, we, when we were looking at residential, we did see that most of the successful owners of residential stock managed it themselves.

INTERVIEWER: Okay.

INTERVIEWEE: We have decided not to do that and I suppose the, you know, we're going to have to see. We may well find that in two or three years' time that it will pay us to do it ourselves. As I said, it's just a question of the management of our entire business. We only have eleven people running two listed companies. We'd like to keep it that way. It may be twelve or thirteen people but that's enough. So, but there are issues with it. But I've become confident at present we're doing it okay. The other thing that we've done is that with the bigger portfolios we've purchased, we have purchased from people who ran the stock, okay. We entered into arrangements with them where they gave us a two year guarantee, a Nett rental guarantee and they carry on managing it.

INTERVIEWER: Okay.

INTERVIEWEE: They've got a great incentive. We held back money. If they don't meet the guarantee, we take the money out of the account that's there.

INTERVIEWER: Okay.

INTERVIEWEE: So, there's a great incentive for people to run it properly but we still oversee it very carefully.

INTERVIEWER: Okay. One of the other, like, broader themes that came up in the literature...

INTERVIEWEE: The first thing that's very important is that if you buy commercial assets you can zero rate them and you pay no VAT or transfer duty on the acquisition of the asset. In residential there is transfer duty. So, you've got 8 percent disconnect, disconnect between the purchaser and the seller.

INTERVIEWER: Even though you not charging VAT on the rental can you claim that, the VAT back.

INTERVIEWEE: There's no VAT, its transfer duty.

INTERVIEWER: Or the transfer duty back? Can you not?

INTERVIEWEE: There might be an input when you resell it but I don't think it is either. That would be on VAT. So it, that is a major challenge and it is [inaudible 0:18:28] when I'm saying that we're buying a portfolio on a 10 percent yield, the seller is selling it to us at 8 percent higher, the yield. That is a constraint and look, you might find assets in companies, you might buy the companies in which case you'll only pay share transfer duty, which is very, very low so there are ways of avoiding that extra cost but at the end of the day it has got to be paid somewhere. That is a major constraint and the reason for it is because there's no VAT on the income that is produced.

INTERVIEWER: So, they actually just, they, even though you buying it at a ten they most likely buying it at or selling it at an eleven and a half...

INTERVIEWEE: Ten and a half percent, just under eleven percent.

INTERVIEWER: Okay. And what about, you know it seems like there's a lack of proper kind of benchmarking, benchmarking industries, rental, general rental information available. You know, transaction prices, especially for bigger types of residential portfolios that you deal with. Is that a constraint, is that maybe an advantage because of the lack of information in an imperfect market and what's. How do you view that?

INTERVIEWEE: I think that that's the kind of information that analysts look for and asset managers, maybe. For better or for worse, I mean when I tried to start this thing in 2009, the analysts and everyone knew nothing about residential. They thought that the risk was

ridiculous, that you wouldn't collect the rentals, you'd have huge vacancies. When we go and see the people today, they telling us that it's a great investment and that it's wonderful and that the, you know, the vacancies are low et cetera, et cetera. I think that will build itself up. As I said we're the first people to be public. So, I think over time there will be more information, there will be more information available but I don't think it's a constraint to buying and selling.

INTERVIEWER: Okay. Those are the broader themes that I had for you, I'd just like to. First of all, I'd like to ask if there's any other constraints that you can think of, anything that is particularly peculiar or particular to the residential market, something that, maybe not, if you can't think of any constraints, anything that effects it differently from other property market.

INTERVIEWEE: Not really. It's, that's why I say, it fitted so well into Arrowhead you know, and now as a separate asset class. There are other people that have done it, I mean [Otrodec? 0:21:08] have been involved for years and years. They've built up a big portfolio both in the listed vehicle and outside the listed vehicle. And there are other people that have tried. I think, I think student accommodation is just a very different business, you know. Other than that I think I can't see that there is going to be much in terms of the high end business. I suppose sectional title does become a constraint. You know we, it's difficult buying a residential scheme where you don't own it 100 percent, you know. Even though you might control the corporate body, so you know, we're trying to see that we're buying stuff where we own 100 percent but people are bringing us stock where they're saying look, you know we, 30 percent have been sold, you know, so there is a corporate body, obviously control the corporate body and it is all rental and et cetera et cetera. That's second prize for us but we will look at it if the yield is right. But I think that is also a constraint in buying large chunks. Other than that it's the raising of equity, you know, property in its nature is an expensive business. You buy your own home; it's probably the most expensive thing you're going to do. You know, so, you need to find equity and the listed sector, certainly over the last number of years has been a wonderful supply at the right price. As much as you want.

INTERVIEWER: Do you think it's going to continue into the future?

INTERVIEWEE: Things will change. As interest rates are becoming difficult and if you don't have inflows into these funds there's not going to be outflows for investments, so I think that could change. But again it has become quite sophisticated, there are indexes today and it depends where you are on the index, what the asset managers are going to put into your fund, how much they're going to have. It's become quite a sophisticated sector.

INTERVIEWER: I'm sure you've got a wealth of information, well I know you've just given me a wealth of information but just to recap and clarify a hundred percent because you've given me the top 3 to 5 constraints that you see in the residential, specifically residential property.

INTERVIEWEE: Its yield, because we need to buy at a yield that is greater than our cost to capital, so I think it is yield. It's obviously being able to find equity, it is management and a smaller thing is, well it comes into the yield and the price is the transfer duty, so there's really a disconnect, there's a leakage because of the tax or because of the transfer duty.

INTERVIEWER: What about the legal constraints? I mean we've got quite a sophisticated or very protected residential you know legal system.

INTERVIEWEE: Our experience has been when the tenant can't pay the tenant moves out. You can get into trouble at the lower end of the market, there's a thing called [inaudible 0:24:26] and all that sort of thing. It becomes very difficult and can take months, there's a Housing Tribunal and all of that. Our experience and I was involved with the Johannesburg Housing Company for twelve years as an external director. I don't think they had, maybe five cases in twelve years of tenants that took them on. I think if you're running the right kind of business, you're honest with your tenants, you're running a proper ethical business, you don't have legal problems.

Participant "B"

INTERVIEWEE: [inaudible 00:00] if I don't have the answers I may have to come back to you.

INTERVIEWER: Okay perfect. First of all, do you mind if I record this interview so I can transcribe it later?

INTERVIEWEE: No its fine, not a problem.

INTERVIEWER: Okay perfect and I will send you copies of the transcript and you can read

over it and we can have a, you know, if there is anything that you prefer to omit or add in due course that's also fine.

INTERVIEWEE: Okay.

INTERVIEWER: Okay. So my research for my Master's Thesis is around the constraints to residential property investment in a South African context and you know, those are constraints for either the private investor or listed companies or institutional investors, so it's quite broad from that point of view but of course you know, a challenge to you, it will probably be more focused around the listed space and in the literature there are three broad topics that are you know, are consistently highlighted and those are certain financial constraints, other management constraints, and constraints around the availability of information and benchmarking indices. So first of all, this is quite a structured interview. I got quite a few questions but of course if you got anything to add I would absolutely love to hear it. So just with regards to the financial constraints, I would like to know from your point of view, if access to liquidity is a restraint for residential property and also liquidity in the sense of finding the right transaction sizes you know, the smaller size of residential property in nature?

INTERVIEWEE: Okay. If we look at the statement or the literature that says it, there is a financial constraint, I am not clear what is meant by that and I, we've actually seen quite the opposite with the listing of [Inclue? 01:46]. [Inclue? 01:47] has been over-subscribed several times and also there, the yield compression that took place shortly after listing is a clear indication that there's appetite in the institutional market for a different type of product which is [Inclue? 02:08].

INTERVIEWER: Okay.

INTERVIEWEE: It's a different sector and there will undoubtedly be, or there is, money available for that sort of investment at the right yield, and the yield was obviously very attractive and it was over-subscribed. Now, the institutional investors will only invest if the investment can be sizeable. So there is a caveat to what I am saying that there is appetite for it, it's appetite at the right yield and above a certain minimum size. The larger investors will not invest in the individual houses and complexes and so forth, they will only invest if it's large chunky, monetised investment opportunities.

INTERVIEWER: So from your point of view, do you think that might be a constraint going forward? Do you think there is enough of a market of those bigger residential size chunks or...?

INTERVIEWEE: There is a shortage of chunky supply. The ownership of residential units in South Africa is, in the main, according to my knowledge, and I am not the expert in the industrial market, so it's an antidotal view. It is very segmented and the larger institutions sold out of their residential investments many years ago, so it's quite a challenge for any promoter of a listed residential fund to find sizeable investments that they can buy from individual owners and, or consortiums and that would, in my view, put a dampening effect on the growth in residential investment opportunities.

INTERVIEWER: Okay.

INTERVIEWEE: It's just that you don't find individual large owners of residential units. Many of those investors have already sectionalised those units.

INTERVIEWER: Ja.

INTERVIEWEE: And sold it off. Not many are actually keeping it for rental purposes, not many. I am not saying there is nothing, but there are not many such opportunities to my knowledge.

INTERVIEWER: Do you have a view on where those opportunities, I mean where might the opportunities be in the future in the market? I mean is there [inaudible 04:38].

INTERVIEWEE: The opportunities very clearly would be where there is a mass demand for residential units and those would be your educational institutions, your cottages, your universities, your schools that may have residential components to it and even your large employers in outlying areas.

INTERVIEWER: Yes.

INTERVIEWEE: If there's mines or new power stations where the pool of labour has to be provided for.

INTERVIEWER: Ja.

INTERVIEWEE: That could be an opportunity where the employer develops and, then do a sale and lease back with the listed company.

INTERVIEWER: Okay. And you mentioned the returns earlier. Do you, is there, do you see

a difference between the residential returns and returns in the other property asset classes and how do you, how does that compare with the risk profiles?

INTERVIEWEE: Well if you look at the history of [Inclue? 05:34] which is the best proxy that you can use, I can't recall exactly what the listing yield was, from memory it was something like 9% and I think its trading at the moment just above 7%.

INTERVIEWER: Okay.

INTERVIEWEE: So it is on par with some of the mid-capped listed diversified companies.

INTERVIEWER: Yes.

INTERVIEWEE: You know the rich. Whether it's justified I don't think so, because there is a, there's not the embedded growth that you have in the rest of the lease sector with the contractual escalations because typically, your leases in the residential units are shorter and they don't necessarily have built in escalations. They may be for two years or so, whilst in the listed non-residential sectors there while of the sector is probably closer to 3½ years to 4½ years.

INTERVIEWER: Yes.

INTERVIEWEE: So that is in my mind, an impediment for investing in the residential market, is that you don't have those built-in escalations unless you've got a long term sale and lease back situation where the employer actually takes the risk but then, you actually investing in a corporate bond you actually not investing in a real estate.

INTERVIEWER: Ja. Do you think maybe, I mean because of the individual leases does it also not give you an opportunity to revise your leases upwards you know, in line with inflationary costs, or do you think there's a ceiling, you know there's pressure downward, pressure on the rentals as well, so it's not.

INTERVIEWEE: Definitely it all depends on disposable income, growth and disposable income and your individuals that is looking to rent space are all under pressure at the moment.

INTERVIEWEE: Ja.

INTERVIEWEE: They are over indebted and their disposal income is not growing and jobs are not, there's not you know, job numbers is not on the increase in South Africa, so you will have a lid on what the individual can pay and if you do achieve escalations at inflation, I think you actually doing very well.

INTERVIEWER: Ja okay...

INTERVIEWEE: If you can do it on an ongoing basis.

INTERVIEWER: Yes. And do you think that, I mean and what's your view on residential as, you know maybe not on behalf of Investec but as an asset manager would you, you know in your kind of private capacity would you, what is your view on investing in residential, you know in terms of you know, are the returns sufficient? You know what, given the risk profile, what is your personal view on it?

INTERVIEWEE: My personal view on it is that unless it's a corporate lease in an area where, over the longer term is that lease is cancelled, or comes to an end, that you can actually do something with the underlying real estate, like sectionalising and then sell it.

INTERVIEWER: Okay.

INTERVIEWEE: Because at the end of the day our view and that is my view as well, you have to look at the underlying real estate. The fact that you have at the top a lease that's introduced and that could be for a, not the short term, but a medium term period, is not going to make the investment stack up

INTERVIEWER: Ja.

INTERVIEWEE: If, and let me give you an example. If you for example now invest in a residential complex that is situated at the Mine in the outlying areas far from any metropolitan mode and that particular Mine signs a lease with you and that lease comes to an end and the Mine is reducing staff because of the prospects of that particular mineral that's mined there or negative prospects of that particular Mine, what are you going to do with the underlying real estate?

INTERVIEWER: Ja.

INTERVIEWEE: You can't. There is no demand for it so one has to look very carefully at what you are investing in and that is again, where is it positioned, is there long term alternatives for it, for the asset and, ja whether you will get the upside in the escalations. It's a quite a tricky market. South Africa is not, doesn't have the letting culture that you find in Europe in particular. You know in Europe you can find professional people that will rent their accommodation, their unit for their entire life, but they will take care of that asset as if

it's their own, so the Landlord does get the upside in rental escalations and also any refurbishment costs and upgrade costs are minimal because your tenants are actually looking after the building.

INTERVIEWER: Ja.

INTERVIEWEE: In South Africa, tenants are not known for taking care of properties and there's very often a capital cost that the landlord has to incur in order to make the unit good once a default tenant has moved out.

INTERVIEWER: And do you think that's more...

INTERVIEWEE: And...

INTERVIEWER: Do you think that's more applicable to residential than say industrial or commercial or is it just a constant...

INTERVIEWEE: Oh very much so, very much so....

INTERVIEWER: Okay.

INTERVIEWEE: Definitely. Your individual actually in the main, does not care about the unit that they live in and they will spend the absolute minimum on the maintenance and, if at all, and they look at it as a short term alternative. If this Landlord doesn't want me, I will go to another Landlord. Whilst in an industrial market you have companies that's usually of more substance than an individual so although you got a lot more lessees that in a residential environment, that supposedly spreads your risk, it is in my view, as pro proportionate of total risk, it is higher than your non-residential market.

INTERVIEWER: Yes. Okay.

INTERVIEWEE: Cause in an industrial park you at least will have a large number of quality tenants and that's in financial good standing. You may have perhaps a turnover and, let's use an example of say 4%, 5% of tenants that over a period of three years that may either vacate or fall over.

INTERVIEWER: Yes.

INTERVIEWEE: And I think you will find that, that ratio in the residential market is probably higher, closer to 10%.

INTERVIEWER: Ja. Sure okay and then what about...

INTERVIEWEE: And...

INTERVIEWER: Yes

INTERVIEWEE: And then obviously the management is, that's a different kettle of fish

INTERVIEWER: That was actually my next question.

INTERVIEWEE: Ja.

INTERVIEWER: Ja so onto the management what, are there specific skills required to be a competent residential property manager as opposed to a commercial one and do you think that there actually those, can you find those skills in the market are they competent residential managers?

INTERVIEWEE: There are competent residential managers, but the critical thing there is that first of all you need very good systems in vetting your tenants, installing them, and then when they vacate, to do your take back inspections and recover the monies, any make good monies from them. So you need quite a big, or you need to invest in systems and you also need to invest in a big team.

INTERVIEWER: Yes.

INTERVIEWEE: That can handle the process. It's a very management intensive process. If you have a portfolio for argument sake of, hundred thousand square metres of non-residential you may only need a team, and these are just rough ratios, you may need a team of only say fifty people to do it.

INTERVIEWER: Ja.

INTERVIEWEE: If you got hundred thousand of residential you probably need two hundred people.

INTERVIEWER: Yes.

INTERVIEWEE: To take care of the portfolio and to ensure that you actually get your money and that you try and grow your income.

INTERVIEWER: Ja.

INTERVIEWEE: So it's not impossible, not at all because there are players in the market that do it and they do it very well but you have to have those two legs in place and aspects like access control and pre-payment of meters etcetera, etcetera, is just the you know, it's another quirk of what's required in that market to be successful.

INTERVIEWER: Ja. And what about the management cost do you think those, are those....

INTERVIEWEE: Management costs will be higher but it's because you need a bigger team to do it, you know.

INTERVIEWER: Ja sure.

INTERVIEWEE: The management companies have to pay a bigger team and for that they need a higher ratio. On average in the non-residential market, your management fees probably around 1½% to 2% of gross collectables. You will find that in the residential market it could go anything from 3% minimum up to 7%.

INTERVIEWER: Yes. So, and is that like, would you say that's a very important consideration or would you just, I mean would that just be part of your yield calculation?

INTERVIEWEE: No that's just part of your yield calculation.

INTERVIEWER: Okay so

INTERVIEWEE: Ja that would just come into the calc.

INTERVIEWER: Ja. And do you think that differentiates people in the market? For instance, I mean, does that make it, does it give larger players an advantage who can you know, who maybe can minimise those costs. You got an in-house team and operating at around...

INTERVIEWEE: Yes.

INTERVIEWER: 3% of collections.

INTERVIEWEE: Ja. Obviously you get a Conway of stuff if you larger.

INTERVIEWER: Ja.

INTERVIEWEE: And also if your investments are concentrated. In other words, say, let say in the CBD of Johannesburg you own ten offices [inaudible 16:15] buildings that spread only over five street blocks.

INTERVIEWER: Yes.

INTERVIEWEE: So your team can be there and they can you know, do visual inspections and if plumbing is required it can quickly be sorted, if electricians are required it can quickly be sorted. And that's quite important to have a quick response time in the residential market whilst your, in the non-residential market, Yes, your response time must be equally quick, but you will find that your tenant is more sophisticated and will probably handle many of the small nitty gritty items themselves.

INTERVIEWER: Okay. And then...

INTERVIEWEE: You know. Okay.

INTERVIEWER: And what about the operating costs, we were talking earlier about you know, maybe you know, the difference in lease terms and not affecting you know, adjusting for operating costs that the Landlord's got to absorb. What is your view on the you know, on the about the nature let's just have a chat about the nature of the operating costs of residential property as opposed to commercial and then you know, the different you know, in residential it seems to me that you, the landlord is responsible or bears the burden of more of the majority of the operating costs whereas in commercial, you know it can tend, it tends to swing the other way with the lessee bears the burden and, you know how do inflationary pressures affect that. Is it negative for leases? is it positive for leases? what is your view on the operating costs compared between residential and commercial?

INTERVIEWEE: Well you asking me as if I know what's going on in the, these questions as if I know what's going on in the residential market. I am not in the residential market so I can only give you a view.

INTERVIEWER: Perfect.

INTERVIEWEE: The. If you look at the lease structure of residential leases versus the lease structure of typical non-residential leases, you will find that the residential lease will be on a gross basis, in other words it will be a number, say for argument sake, R5000.00 a month and that's it that the tenant pays, except for electricity consumption, which is then metered. So there is only two components, cost components, or rent components. Not rent components, cost of occupation components. For a residential tenant its rent and electricity.

INTERVIEWER: Ja.

INTERVIEWEE: And. Because they need that certainty. An individual cannot have uncertainty as to what their costs would be 'cause they don't have unlimited budgets and in that, or having said that, what it means is that the Landlord picks up unanticipated escalations in the underlying operating costs, for example, your rates or your common area electricity or maintenance of the building that is unforeseen. The landlord must just pick it up because he has to keep his building running.

INTERVIEWER: Ja.

INTERVIEWEE: Or, and if you now contrast that against your non-residential lease which is typically

on a basis that the tenant pays a net rent, they pay operating costs contribution, and they pay pro-rata rates and taxes, so immediately your Landlord has no risk on the rates and taxes increases, the tenant picks that up. On operating costs, what we try and do is negotiate a higher escalation on the operating costs versus the rental.

INTERVIEWER: Okay.

INTERVIEWEE: So for example, your net rental will escalate at say 8% or 7½% or 8%, whilst your op-costs component will escalate at 9% or higher. We are achieving in certain industrial properties we are actually achieving up to 11% and 12% on the operating costs component.

INTERVIEWER: Okay.

INTERVIEWEE: Now you will never be able to do that with a residential tenant.

INTERVIEWER: Yes.

INTERVIEWEE: The residential tenant wants certainty about occupation costs.

INTERVIEWER: Ja.

INTERVIEWEE: A tenant in a non-residential market looks at it as part of their cost of occupation which is more variable and there's a bigger margin that the tenant can absorb in changes in those costs. We're also doing, in many of our higher quality buildings we actually do what we call a variable op-costs lease which means that the tenant pays a net rent that escalates at a certain percentage.

INTERVIEWEE: Yes.

INTERVIEWEE: It does pay a contribution to op-costs and it picks a pro-rata rates but the op-costs are reconciled on a quarterly basis and then the tenant has to top up if the payment was less than what the actuals were or there's a credit to the tenant.

INTERVIEWER: Okay.

INTERVIEWEE: So by structuring in that way the landlord has basically distanced itself from any unanticipated costs increase the tenant picks up everything.

INTERVIEWER: Okay.

INTERVIEWEE: And that's very typical in your pre-grade office buildings.

INTERVIEWER: Ok. Is that being the case for, you know, is that kind of established?

INTERVIEWEE: Yes it is.

INTERVIEWER: Okay.

INTERVIEWEE: Yes it is. We've got several buildings in our portfolio that works on that basis and we've just bought quite a few, well almost R8 billion worth of properties in the last four months and some of those Landlords do exactly the same.

INTERVIEWER: Okay.

INTERVIEWEE: So yes, it is a very common way of structuring leases and particular on a, pre-grade buildings.

INTERVIEWER: Ok. Perfect and then is there anything else that comes to mind around the management issues, you know either from a property management or a kind of asset management perspective on residential?

INTERVIEWEE: Well that I can say is that as far as the residential management is concerned, what's quiet critical is that the landlord ensures that his building is in such a, that it has such systems that invade, let's call it invaders or non-tenants can't come into the building in other words very strict access control, and also what in my view, what's necessary is to ensure that utility payments are done on a prepaid basis.

INTERVIEWER: Okay.

INTERVIEWEE: So that your landlord is never exposed to if a tenant defaults, to have to settle the arrears on the electricity account.

INTERVIEWER: Ja.

INTERVIEWEE: But if it's on a pre-paid basis he protects himself against that.

INTERVIEWER: Ja sure. Okay perfect.

INTERVIEWEE: Okay.

INTERVIEWER: The final kind of broad area which you also mentioned, touched on earlier, you know institutional perspective really but I suppose also from an internal kind of monitoring and management perspective is, there seems to be a lack of, first of all you know, benchmarking performance, benchmarking indices in residential property and then there is also a whole host of kind of other benchmarking information that's not hundred percent full or accurate in terms of operating costs, you know rentals in certain areas, full overviews of escalations, historic escalations all that kind of market information that's more available in commercial. Do you see that as a.

INTERVIEWEE: If that information is not available I can't take a view on whether that information is available or not available because we are not looking at that. But if that information is not available it will just be an impediment to large investments.

INTERVIEWER: Yes.

INTERVIEWEE: Sizeable investments because your big investors would require benchmarking to understand which of the residential alternatives, alternatives available to them, or residential investment alternative is available to them

INTERVIEWER: So for instance...

INTERVIEWEE: Are better or worse.

INTERVIEWER: For instance how would that affect to, I mean from your point of view how would that affect an institutional investor that is looking at a company like [Inclu? 24:03] who doesn't have a long track record there is no comparative information within residential they can compare it to the broader property market, but there is no real kind of performance benchmarking information for the residential property sectors, does it make a difference or will they just take it on a purely yield basis and say, compare this to, you know other investments at a different yield or...

INTERVIEWEE: You should actually talk to the investors that invested in [Inclu? 25:32] to give you a view. I don't know, but I would think that if they don't have a benchmark how would they know for example that the rentals are above or below market. If you would like, ideally like to invest in any investment vehicle where there's actually some upside potential in the rental levels, to ensure that you not only getting the growth from the, on the contractual escalation but you also that there is potential to get growth from the, on a [inaudible 26:02] and if that information is not available I think it will be a very difficult, almost impossible investment decision unless, what the investors have done with [Inclu? 26:17] is that they saw it as a milk tin so it is an interesting alternative and they've basically just put their toe in the water to try and understand the market because it's also a very small listing if you compare it to the rest of the listed sectors so you would probably find that the guy said okay in my total portfolio of how many billion I just want to put my toe in the water to also test the residential market.

INTERVIEWER: Ja.

INTERVIEWEE: And I would speculate that some of them may have taken that sort of approach because you also find that same approach with some of the new listings that come in.

INTERVIEWER: Ja.

INTERVIEWEE: The smaller listings that came to the market over the past sort of two years is, that they will get investor support because there is always a story that the investors buy and they just, you know for a bit of a different flavour they will invest in something that offers a different story and a different product range.

INTERVIEWER: Ja. And what, I mean what is your. It's not the first time that we've seen kind of a large residential portfolios being formed in South Africa but it seems to have been quiet, it didn't, those portfolios as you say have, you know were dissolved over the years and it seems, I mean what's your view on the kind of sustainability of a public, a residential portfolio in the public space either listed or institution...

INTERVIEWEE: You know, well I think it will definitely grow as far as the investment alternative is concerned, but it won't grow at the same rate as the non-residential sector.

INTERVIEWER: Okay do you think there's still...

INTERVIEWEE: Because of the fragmented ownership.

INTERVIEWER: Yes.

INTERVIEWEE: Ja and perhaps not enough available.

INTERVIEWER: Is there still scope for growth in the non-listed, in the non-residential listed sector?

INTERVIEWEE: Absolutely if you think of how many unlisted big non-residential funds are still around then the answer must be yes.

INTERVIEWER: Ja.

INTERVIEWEE: If there's I don't know what, exactly what the ratio is and I don't think even ITD knows but I, the listed sector represents an important part of the total non-residential real estate market in South Africa but by no means is it close to being the dominant, you will probably find that its, I don't know 70%, 60%, 70% of total cause your big owners are not listed the Eskom Pension Funds, the PIC's, the Mutual's they are not listed.

INTERVIEWER: Yes ja.

INTERVIEWEE: Liberty, they are not listed and you don't have access to that information, but they do have very, very large assets.

INTERVIEWER: Do you think they that there's still gonna be a drive towards those larger investors into listing?

INTERVIEWEE: No. not necessarily, not necessarily because there is no immediate benefit for them in doing that. They've got patient money and there is no reason why they should go the listed route. They can row their own boat and there's no benefit for them in having to expose their performance to the outside market.

INTERVIEWER: Ja. And will, I mean do you see any other constraints, do any other constraints pop to mind, come to mind that are specific to residential? What about for instance do you think that the legal protection that tenants have, is it constraint? Some people you know some people argue...

INTERVIEWEE: Yes of course a constraint but you have you also have in your non-residential markets you do have constraints with the CPA leases etcetera, etcetera, so you just have to work around it and your business market has to take cognisance of it.

INTERVIEWER: Ja and in terms of the economic environment and you know we're talking about the management costs on a broader economic level, do you think there more, the fundamentals are more conducive to one type of property you know, over the medium to long term than another or do you think they are on an equal footing?

INTERVIEWEE: No I, you now talking non-residential?

INTERVIEWER: Both, comparing the two what, you know is there a difference? First of all is there a difference and if there is what is the difference?

INTERVIEWEE: Well I, if my view is I won't touch residential it's just not an asset class that I feel comfortable with, but that's my personal view. I would if, I believe that the real growth lies in the non-residential market in certain areas in the non-residential market that's where the growth.

INTERVIEWER: Okay.

INTERVIEWEE: That's where the growth lies, but in particular on the total [inaudible 31:12] basis.

INTERVIEWER: Okay.

INTERVIEWEE: You know on; in the residential market you may get [inaudible 31:16] but I am not clear as to what your capital return component will be.

INTERVIEWER: Okay sure, Ja. I suppose it's also very, you also, it's in that grey area where you can like as you mentioned earlier, you can sectionalise it and then you've almost got two different capital, you got to track two different capital growth rates, you got your kind of your yield based one but you've also growth market...

INTERVIEWEE: Yes

INTERVIEWER: Like a market growth rate in there somewhere as well.

INTERVIEWEE: Ja.

INTERVIEWER: It might be advantageous or disadvantageous I suppose.

INTERVIEWEE: Ja. Mark I have to run.

INTERVIEWER: Okay.

INTERVIEWEE: If you need to discuss any further points, I am happy to do that but we'll have to set up another time.

INTERVIEWER: Thank you that's actually those are all the questions I have. Thank you very much for your time.

INTERVIEWEE: Not at all.

INTERVIEWER: If you don't mind I am going to send you a consent form that you can fill out any time, you know in the next couple of weeks, just a signature to consent to the interview if you don't mind?

INTERVIEWEE: Perfect no problem.

INTERVIEWER: Thank you...

INTERVIEWEE: Will do that...

INTERVIEWER: Okay great thanks a lot again.

INTERVIEWEE: Okay take care.

INTERVIEWER: Bye then you too Bye.

INTERVIEWEE: Bye.

Participant “C”

INTERVIEWER: That I miss out but it's generally around the topic of barriers or constraints to residential property investment in South Africa from a certain points of view, so first of all I'd like to just ask for your consent to record this interview, so I can transcribe it at a later stage.

INTERVIEWEE: Sure.

INTERVIEWER: And secondly could you just, shall we start then?

INTERVIEWEE: Yes, absolutely kick off.

INTERVIEWER: Okay perfect, thanks. First of all, Paul, would you mind just confirming what your organisation does and your role within that organisation.

INTERVIEWEE: The organisation's name is [inaudible 0:00:48.1] PTY Limited, we're a residential investment company also doing the occasional development and I'm the CEO of the company.

INTERVIEWER: Okay good, thanks. Paul, as part of the research we do quite Literacy Review, it's about covering all the academic literature around topic and we're investigating what the gaps are and during the course of that review 3 main major themes came up around the constraints of residential property investment and those were financial constraints, management constraints and lack of information really, constraints around the availability of information in the residential investment sector, so I've kind of categorised my questions as that and do you mind if we start with the financial issues [inaudible 0:01:46.1] some questions around that?

INTERVIEWEE: Sure.

INTERVIEWER: One of the issues, something that came up was the issue of liquidity in the residential property investment sector and the fact that transaction sizes are smaller than usual or smaller than usual property other types of property assets and sometimes that poses a kind of issue in terms of building up a big portfolio and trading it. Would you think that liquidity is an issue in property investment, residential property investment in particular?

INTERVIEWEE: I think it's an issue to the extent that it's hard to acquire a ready assembled portfolio, so residential property tends to be owned by lots of smaller investors in investment groups right from one person who owns his own investment house all the way through to a family that might own a block of flats or a couple of blocks of flats, but you know in terms of sort of ready assembled portfolios, not many that exist, not many groups that have created their own larger portfolios, which make it harder for somebody wanting to get into the space [inaudible 0:03:02.4] really need to accumulate a portfolio themselves.

INTERVIEWER: All right, okay and do you think, I mean would it affect one's investment decision, is it substantial issue or do you think it's something that you can get around and what extent does it affect the investment decision?

INTERVIEWEE: I think [inaudible 0:03:25.4] the classic investment is a personal – what do you call it, investment house. You buy a property to rent out to get rental income for yourself but that kind of direct investment is readily accessible to everybody and I think everyone understands exactly what's involved in it. You go find the property, you get a bond, you find a tenant et cetera so very easy to get exposed to that kind of investment. If you're talking about more in sort of a public domain where you're talking about listed companies where you can buy into and have an exposure to the residential sector, then it's obviously quite a big sector internationally residential making up quite a fair share of the listed property sector. It's quite a new sector here in South Africa, so people like City Properties and [Arrow Head? 0:04:13.5] do have residential exposure and its corporate backed but it's relatively new and as a standalone asset class it's relatively new.

INTERVIEWER: Okay, and in your experience what's the return profile like in residential property, is it attractive compared to other different property asset classes and how does that – just the risk return profile really and also do you have any kind of opinion about the volatility of the returns?

INTERVIEWEE: Sorry [inaudible 0:04:51.3] my son, he's fallen over.

INTERVIEWER: Sure.

INTERVIEWEE: [inaudible 0:04:55.0] are you okay, let's have a look. There we go. Mark, can I call you back in 2 minutes?

INTERVIEWER: Yes sure.

INTERVIEWEE: Apologies.

INTERVIEWER: No of course not. Cheers, thank you, bye.

[Audio break 0:05:15.3]

INTERVIEWEE: So, you asked me about the return profile.

INTERVIEWER: Yes.

INTERVIEWEE: [inaudible 0:05:19.2] okay, lets open the door here. Okay so, I guess one of the great trends of residential property is its lots of individual units, so there's traditionally always a demand for housing, could argue that maybe if your rent is wrong you can't rent something out but if you're prepared to drop your rent on certain units from time to time then pretty much all accommodation is normally rentable, so it's a very solid income stream. I guess it's a very [inaudible 0:05:50.6] income stream because irrespective of the economic cycle people need somewhere to stay.

INTERVIEWER: Yes.

INTERVIEWEE: So, if those were key characteristics of it I would also say that traditionally it's been quite hard to – you know your return in residential can be lower than what people would see in commercial, as a starting yield that was certainly true historically where in the commercial space you were looking at 9 or 10 per cent returns whereas in a residential space maybe 6 or 7 per cent returns or yields. I think that's changed a lot over the last few years with the big commercial deals taking place in 6 or 7 per cent yields and it is possible to buy residential property at 9 and 10 per cent yield, so you've seen a whole change-around in the relative yields that can be achieved between a traditional commercial portfolio and what you can achieve in a residential portfolio and I think that's basically in the search for yield that makes residential property or the right kind of residential property a lot more attractive.

INTERVIEWER: Okay and in terms of residential property and sub property sectors, what is the right kind of residential property? Is there a difference between different types of residential income wise, different accommodation types, you know, student accommodation versus normal residential accommodation? How would you kind of differentiate between the different sub residential asset classes, is there a distinction or not really?

INTERVIEWEE: I think just a personal view on it. I mean if you had to look at a house in Cape Town or on the coast, let's take Cape Town as an example. Your rental yields on a property like that could be significant low, probably 4 or 5 per cent and I think that partly reflects the fact that many people buy – not holiday homes but retirement homes or holiday homes and then put them on the market to rent and they're not staying there so you have this, if you like, oversupply relative to demand and that affects yields, so those kind of property that's hard to get a solid income return but as soon as you look at that, call it entry-level type accommodation, townhouses, inner-city blocks et cetera then the yields are very much not affected by external factors like holiday homes and so on and then you're looking at close to 9 or 10 per cent yield and that would be the yield the professional investor would demand in order to invest in that kind of property.

INTERVIEWER: Okay.

INTERVIEWEE: So, I guess there is a range of properties, I'd say luxury homes is probably the worst place to invest if you're chasing yield but you might do so for a whole bunch of other reasons that have nothing to do with yield and then if you move along the spectrum of residential properties the sort of high-density entry-level accommodation is probably the place where you can get the best cash yields. Not so much on the capital growth side of it but certainly in terms of starting cash yield and ready demand and lots of people looking for that accommodation, it's probably the best place to invest.

INTERVIEWER: And do you think it's quite a strong correlation between the risks to investing in that type of property and the relative returns? What I'm trying to say is you think you can earn a high yield, is there more kind of payment risk and tenant risk and all the associated.

INTERVIEWEE: So, I think that is where the property market is a little bit different to an average investment class because people are prepared to pay prices for property that often have nothing to do with its inherent characteristics of an investment asset. If I wanted to buy a house for myself I might always have wanted a swimming pool and I am willing to pay a 20 per cent premium because a particular house has a swimming pool but that's a personal choice more for what I'm willing to pay for and if you had to ask me what the extra return is for my swimming pool, I'd have to say it's very negative compared to

INTERVIEWER: [inaudible 0:10:03.7].

INTERVIEWEE: The cost of running it et cetera, so that's where I think in the normal space where individuals buy homes for themselves there's probably a very different kind of dynamic at play because people are interested in a place where they want to live. As soon as

you talk about investment properties, which is where people are buying something to get a return as opposed to their own place, I think then it starts to mirror what the more conventional types of property, so and that tends to be the rental market I'm talking about because you're looking for a tenant who's willing to pay rent and he's very price sensitive, so he's looking for the best value for money within his affordability bracket and they tend to people looking for accommodation and when I say that it's not a general rule, I can't say that there's always somebody who's willing to rent. If you take cities like Detroit for example in the USA there's a massive oversupply of accommodation, the economy there has shrunk over a number of decades but if you're in a growing city that's attracting people to come into it like Johannesburg then there's always people looking for accommodation, new first time, not home owners but first time home renters.

INTERVIEWER: Do you look at the macro factors when – are those important to – in terms of looking at city growth, what the economy is doing, what factors are important when – what macro factors are important when making a financial decision like that? Investment decision.

INTERVIEWEE: Yes, if I go back to what I said earlier on about residential property I think it's an extremely defensive investment class. People are always looking for somewhere to rent and the affordability of the accommodation is obviously affected by outside factors like cost of electricity and so on just means that a tenant has less disposable income but at the same time a person's home is often a priority purchase, so they'll pay their rent before they'll pay a number of other expenses, so from a macro point of view I guess the rule we've always followed is if we can sign property that provides a solid upfront yield and you're getting that yield without any obvious, let's call it risk characteristics to the property, then it makes sense to invest in it. Yes, probably covers it adequately.

INTERVIEWER: Okay, and then what about – I mean are there any kind of – especially within a – you know, within the South African context it seems to be – there's a little bit of a disjoint or disconnect between – well there's a bit of a tax issue around the Vat ability of residential rent and the input is you can claim on the purchase of residential property, do you find – is that an issue for you?

INTERVIEWEE: Well, I mean residential rent is an exempt supply typically so there's no VAT that's raised on the residential rent itself, a private dwelling in terms of the VAT Act and that also means that a lot of your expenses you can't claim, Input VAT on those expenses, so the cost of electricity et cetera but having said all of that a lot of those costs typically gets passed onto the tenant, so you as a tenant would be paying your own electricity for accommodation and it could be charged by the council with electricity included and the tenants would need to pay that all-inclusive cost including VAT so it doesn't, I don't know if it has a major impact on the landlord. It's the whole issue about deductibility of VAT included in expenses, it's clearly a relevant consideration but I wouldn't call it a major consideration.

INTERVIEWER: Okay, and are there any other financial considerations that may be particularly relevant to residential property investment or property investment as a whole in South Africa?

INTERVIEWEE: So, I guess the whole scenario of investing in residential property depending on whether or not you're in the very lucky division of being able to buy a property without borrowing any money or if you are in the position of buying a property and borrowing money in order to pay for it. One of the main driving factors is the difference between the cost of debt and the cash return that you'll generate from your property, so that's always a very important consideration just to take into consider, take into account. It doesn't make sense from an investment point of view to buy properties if you are running at a loss for the first 2 or 3 years of relying on renting pieces to gradually pull you right, very risky strategy, you need to find someone to fund those losses for you but if you can find property which generates yield that are more than the cost of debt to you but a positive return from day 1 and then property inflation is always your friend. Rents keep going up every year, typically by inflation, in fact normally the correlation is linked to CPI and Gross National Product and your cost of debt typically stays constant, so I think it's a very important consideration just look at what yield you're earning versus what the cost of debt is and clearly if you're able to borrow money more cheaply than other people then you're in a very different situation as to which properties makes sense for you to invest in.

INTERVIEWER: Sure, do you think – should you look at those 2 issues separately, should you have pure properties per – pure hurdle rate based on the property and then factor in your debt or do you think it does make it a bit more flexible for instance – do you think that you've

got a lot more leeway if you don't have capital instalments as well as interest instalments to make on a monthly basis.

INTERVIEWER: So, the way I would look at this is to say that your hurdle rate, the rate that we would select as a rate at which we're willing to buy property at would be strongly influenced by the cost of debt, so in periods of high interest rate we might pass on certain properties that give a certain yield but in periods of lower interest rates we might buy them, so I certainly wouldn't separate the two, I'd say that the hurdle rate that you select should just be appropriate for both whether or not you need to borrow money or even if you don't need to borrow money, then the cost of debt is certainly reflective of the opportunity cost of what you should be earning, so it comes in both ways. It comes into your investment decision one way or another and ultimately into what you use as a hurdle rate.

INTERVIEWER: Okay, great thanks, those are financial kind of questions I've got at the moment and then the next general theme is around management, both asset management and property management. I suppose both apply to you, so just – are there any specific skills that are particularly relevant to being a competent Residential Property Manager as opposed to a manager of other property asset classes?

INTERVIEWEE: Yes, I would guess the things to remember about residential property is its lots of units, so it's very management intensive, so you need good systems, good billing systems, good maintenance systems to keep track of what needs to be fixed and what you're spending on fixing it and its quite people intensive, so relative to let's call it a billion Rand fund invested in commercial property, which might consist of 3 or 4 shopping centres and maybe 50 or 60 tenants, residential might consist of an equivalent size portfolio might consist of 60 or 70 buildings and maybe 2000 tenants, which is much more intensive and then it just means you need good systems and good processes.

INTERVIEWER: Okay, and - I suppose – and then do you think is there a need for – where does the difference come in there – can you – is there issue with – is there like a lack of skills or a lack of skill set or is it all about the systems and can you really get away – is it more about just employing the right systems and the skill sets will follow – is not really as relevant from a professional manager's point of view.

INTERVIEWEE: No, I think the professional manager whether it's in commercial, residential has many of the same issues. You need to deal with municipality in terms of municipal accounts, you need to deal with billing, all the skills are pretty much the same. I just think the difference is really in scale, that in the residential side you tend to deal with a lot more units at any point in time, so it's not different skills, I would just say it's just the fact that there are lots of different units.

INTERVIEWER: Okay and what about...

INTERVIEWEE: And that. Yes?

INTERVIEWER: I was just going to ask also about the management costs associated because if it is more management intensive it would seem – are the management costs higher and does it affect – is that quite a big consideration to take into account and how you control that.

INTERVIEWEE: So, I think in residential you can typically get property management done for you for somewhere between I guess five percent of rental collected to eight percent of rental collected would be the range. I would guess that the trick is that the sort of area if you're an investor and you want to pick a property manager I wouldn't say that price should be the main criteria. You're looking for someone who's competent, got experience in this field, knows what they're doing, so it's more about the skills set you're getting, so it is very intensive but if I had to compare it to – I'm just thinking about the cost of looking after commercial portfolio, I guess the costs are relatively comparable in terms of what managing agents would typically charge, so it's not that there is a major cost difference between the two and back to what I was saying earlier to a large extent it's the same skill but your system and processes tend to be a lot more efficient for residential property management than in an equivalent commercial portfolio.

INTERVIEWER: Okay, and then just another question around cost, I suppose more a financial issue but do you find that – is there a difference in operating costs as opposed to management costs – the operating costs – is there a difference – so is there a difference between other types of property asset classes and residential and what is the difference?

INTERVIEWEE: So, I guess fundamentally most commercial leases tenants are liable for rent plus a share of operating costs, so many of the costs of running the building would certainly be passed onto the tenant as a charge and that is in commercial. In residential the tenants typically would pay rent and included in the rent are a number of other services,

which might include security, various other things that you provide in the building, so I would guess the operating costs of residential would tend to be – or let's call it the unrecovered operating costs would tend to be slightly higher than an equivalent commercial portfolio.

INTERVIEWER: Okay and do you think that's – have you found that to be an issue, is that a bit of a caveat, it is hard to?

INTERVIEWEE: Well, I think, you know...

INTERVIEWER: Control those costs.

INTERVIEWEE: When you look at a yield analysis and you decide which properties to buy you look at the yield Net of costs, so you would factor that into account right in the beginning and if the asset doesn't stack up and give you the right yield, it's probably not an asset that you'd want to buy.

INTERVIEWER: Sure and just in a South African context we've got quite a high inflation environment with all costs, so is it harder to predict – because more cost is being passed onto you is it harder to predict the medium to longer term yield in residential property perhaps?

INTERVIEWEE: It's a long-term question; I need a 2 years to be able to answer that. Look, a lot of the costs you do pass through to [inaudible 0:23:25.1] the tenant would typically pay for electricity consumed in his apartment and water consumed and so on, so those costs are ultimately passed onto the tenant but cost of providing security in a building, management fees that you need to pay, rates on the property and so on, those will be borne by the landlord, so if you just take those costs and say: Over time what are they likely to do, well municipal costs like rates are always under pressure to go up, staff costs always under pressure to go up as well, so that will affect your return as a landlord but at the same time you're also getting higher rent over time, so I would really expect those 2 to a large extent to offset.

INTERVIEWER: Okay and what about – there's also quite a bit of research and talk in the literature around – I suppose benchmarking information, property market information and the residential industry property sector as opposed to the general – more established property investment asset classes and the lack of benchmarking industries specifically for the residential and the lack of reliable gross rental information and operating cost information, is that – do you agree with that or is there sufficient information and if there isn't how does it affect you, do you think it actually opens up opportunities for you or...

INTERVIEWEE: Yes, I guess there's a lot less published information so because residential class in South Africa is relatively new, it's not analysed as a separate asset class or hasn't been historically, so that does make it harder for someone who's sitting there and saying: What should I be doing in a particular space but if I give you the analogy, it's just like buying a house. Before you've gone looking in a particular suburb and seen what other houses are selling for and so on; you don't really have much ideas to what a house should be selling for and you learn from what you see and then you go: This is a good deal or good value for money in this particular area relative to what else is available, so I don't think it really hinders you if you're a professional property investor and you're prepared to spend the time looking at lots of properties to get a sense of where value is but I think if you're trying to do an analysis from your chair then I think there is a definite shortage of information.

INTERVIEWER: Okay and what about from an investor's point of view, do you have any – from an institutional investor's point of view or from a public investor's point of view does that make it hard as a sell in your view to sell residential property as a kind of institutional investment class?

INTERVIEWEE: I guess it does in the sense that people haven't yet seen the characteristics of the property then they're not quite sure what they're getting but we're not in that space of selling the institutional market, I don't really have much experience of it but I'm just guessing that on the one hand people might say: We're not sure how this asset class will perform, on the other hand I think there's generally a lot of support from the institutional industry to say we would like to invest in housing and making housing available in this country, so it's probably a bit of a trade-off between the two.

INTERVIEWER: Okay and then what about – are there any kind of social level or political constraints that you see that are specific to the South African context. We're quite heavily legislated in terms of residential tenant protection, is that an issue, what are the issues that you see?

INTERVIEWEE: Mark, sorry would you excuse me? Actually I'm being called away by my wife for something.

Participant "D"

INTERVIEWER: ... and you can have a look at it and tell me if you want to add anything or if there is anything that ...

INTERVIEWEE: That is fine.

INTERVIEWER: Okay, perfect. So would you mind if we start?

INTERVIEWEE: Sure, okay.

INTERVIEWER: Okay. Just for the purposes of the recording, would you mind just telling me a little bit about your position at the organisation and what your organisation does?

INTERVIEWEE: Okay. I will start at the organisation, Private Equity in vehicle. We basically manage funds, investor funds, local and foreign investors ranging from pension funds to the likes of Eskom. Well, their pension fund, so I think it is similar. You have got the likes of OPEC, you have got the likes, in our first vehicle, I think, you know, Citibank, you have got Canadian based investors as well.

Like I mentioned earlier some of them would like to or prefer to remain anonymous, some, once our investment process is closed will actually make an announcement because it is part of their, I think they prefer to make the noise around, I will give you an example, the NHFC. They have got a certain mandate to invest in a certain cluster there of residential community and us being one of the vehicles that they can do direct investments with, it is a good relationship.

We have three investment vehicles. Our first investment vehicle is; I think we raised about 1.8 billion in Rands. That was invested across, and a lot of that equity is obviously recycled into future phases. If you are looking at a scheme of, what, a thousand to ten thousand units, we have got schemes such as Fleurhof, which was nine thousand five hundred or ten thousand opportunities that, there is actually a picture there in the other Boardroom. You know Fleurhof?

INTERVIEWER: I am not familiar with Fleurhof.

INTERVIEWEE: It is between Roodepoort and Soweto.

INTERVIEWER: Okay.

INTERVIEWEE: Then you have the likes of Jabulani, which is about, between 4,500 and 5,000 opportunities.

INTERVIEWER: Yes.

INTERVIEWEE: There, look, those schemes, Fleurhof is a mixture of, there are some RDP housing or BNG housing, there is FLISP type housing, targeting that market. There is social housing which was bought by social housing operators on an ongoing basis.

There is rental stock that we hold. I think we hold 223, if my numbers are not incorrect. There is open market sales. That was a good structure and working with government or Council to actually, like the land, bring in the land services to enable us to actually build top structure and so on at prices that accommodate that market.

Me. Phil, I am a dealmaker here which is not a very common, when I meet clients they find that very interesting. Basically what my role entails is, it is your origination, sourcing the deal, structuring it, negotiating, and there is a lot of negotiating that we go through. Price, unit mix, amenities, looking at that kind of detail and putting the actual scheme together. And then once that is in place, and also, I mean, determining if you are dealing with the right person, which is, do they own the land, or do they have rights or access to the land.

One of the things that I think, I will call it lessons from our first fund is, when you are dealing with a person who does not own the land, you negotiate, you conclude, then the actual owner says, but I never agreed to that. Or they come, they present a scheme to you, the rights are not in place then you are going to go through a two year, three-year process. Or electricity is available, it is not available. So we prefer to have all of those things up front.

Once that is structured and packaged I then take that through our investment process which starts at, we have got an internal deal forum where we will discuss an opportunity which is, bring in our legal, bring in the rest of our deal team, we bring in our asset managers, rental and development asset managers, just to get aspects before I take that into our formal process which starts at our Review Committee.

The Review Committee basically says, whatever assumptions that have gone in, whatever approaches, are we buying on a turnkey basis? Are we jiving with the developer and selling to market? Are we doing a hybrid of the two? What are the assumptions? Capital growth, the basis of that? Rental growth, basis of that?

We do have projects where we just buy turnkey, hold an average period of say four years and then trickle sell into market. Or say, put that, package it, sell it to a listed fund or something along those lines. Obviously that market has now started to become a bit more active than a few years back.

INTERVIEWER: Yes.

INTERVIEWEE: And then post that, I will take that, bring in an external market analyst. That is important because one, the person needs to be independent, not us, not the developer's person, to give you insights as to what that market, what is common in that market. You can obviously do a site visit, we do a site visit, you see that. There is a raise one market, it is a combination of raise one, raise three or it is just raise threes.

INTERVIEWER: So what is this site analyst? So like what kind of ...

INTERVIEWEE: So you're understanding ...

INTERVIEWER: ... what about the site analyst?

INTERVIEWEE: It is people that we have fortunately come across who have been doing work, I think some of them have worked with the likes of [Demo Con? 00:06:34.6] in think. But now I have gone independent, some have worked as research analysts previously, who understand the process of putting together a report of that nature. You are looking at demand; you are looking at supply. When you talk demand, what product is demanded at what price? From a rental and sales perspective.

INTERVIEWER: Yes.

INTERVIEWEE: Because the one thing that enables us to get to the returns that we promise our investors is an up-front discount, because we are buying in bulk. Thereafter an assumption around capital growth annually. I understand the residential market will have its ups and downs but there is obviously a call than an average. So we then build that in. And assumptions around rental growth and over the holding period, so if you are assuming we are holding for four years, we are going to make that assumption and then there is a trickle sale period of two years thereafter.

We do best to be conservative and that is part of lessons learned and the first fund where you go aggressive in your capital growth assumptions. A valuer comes end of the year and says, no. And obviously you need to adjust. And you need that independent valuer as a checkpoint. Or, I mean, things such as rental ceilings in a particular node. It is all fine to say, rental today is R5,000. But if I assume ten percent rental growth for the next five years, it does not mean I will get to R8,000 or R9,000, whatever the number is.

INTERVIEWER: No, true.

INTERVIEWEE: My maths is not accurate. But it does not mean that I will get to that and the market will still be the same because if you are growing at six or seven percent, inflation at some point was at 4.4, I think now it is at five percent, people's salaries go at six percent, five percent, whatever the number is. And other goods that people consume grow at that or more.

INTERVIEWER: Yes.

INTERVIEWEE: Fuel is that. So, yes, there is obvious rental ceilings in every market that is why it is quite important to come in conservative and also be conservative in your assumptions. And if we get wrong our starting point so if you assume, you assume the market is here and we are here, this is our purchase price that is market value. Let us assume you are buying at a ten percent discount.

INTERVIEWER: Okay.

INTERVIEWEE: Market, you then assume market is going to grow and then we then, this is where we are buying at.

INTERVIEWER: Yes.

INTERVIEWEE: But we paid our market value here and we would like to grow with market.

INTERVIEWER: Sure.

INTERVIEWEE: If we buy here, assuming the market value is here, and then we are growing, at any point in time we are over-valued.

INTERVIEWER: Yes.

INTERVIEWEE: And that is when our valuer comes and pulls us down. It has happened. And I think that is where the lessons come from. And this is also the same principle with rental. So then, yes. Package that, present it, get the market study done, evaluation of the land, if that is one of the, if we are going into a JV structure with the developers coming in with land and then we will put in equity.

And then the final leg to our investment process is our Investment Committee, which then says, the assumptions you made originally have been proven or disproven by the market study. If disproven, what changes have you made? Are we still at our targeted returns? If the answer is yes and everything else ticks, we get approval, there is a voting process. Most of our voting members, I mean, Rob is our MD, he sits here. Our other voting member is in Cape Town. And then some are US based, Scotland ... based in Switzerland.

So you get all of that happening and you get your CPs to say, these are the CPs that should happen prior to the agreement being effective and these are CPs for transfer. So, for example, CPs to transfer, an obvious one would be occupancy certificates. And, but those are fairly standard.

INTERVIEWER: Okay.

INTERVIEWEE: But then you may find CPs to closing of the deal, the agreement being effective, such as, we need confirmation that bulk services are available from Council, not from a professional. And that is stuff that you can get prior and if there are certain scenarios where that is not available immediately, put that to Investment Committee and say, are we comfortable with this coming 30 days' past signature or prior to transfer, are we comfortable with those assumptions? And once everything is in, oh, yes, and then I have to go source debt.

INTERVIEWER: I got it.

INTERVIEWEE: From banks. And your likes of your Standard Bank, Nedbank.

INTERVIEWER: How is your debt structure? Is it normal, kind of like, amortising type of loan or is it all ...

INTERVIEWEE: We are fortunate in that, given the performance in our first fund, getting into our second fund and our third investment vehicle, which is a (Pty) entity, not a fund, as per se, we get terms such as an interest-only facility for a five-year period with a bullet, which we will either refinance or start repaying as we start selling units.

INTERVIEWER: Yes.

INTERVIEWEE: So that assists from a cash flow perspective but then you obviously have ICR governance that are built in place. You need a stabilisation period for your lease out. This is what we effectively take as market risk ...

INTERVIEWER: Yes.

INTERVIEWEE: ... on a turnkey basis, where a developer does what they need to do on their own, independently with their own debt and equity, but then when it kicks in, when you take transfer of the first phase or the entire development, we need to lease that out.

INTERVIEWER: Yes.

INTERVIEWEE: Preferably transfer should be on a phase basis, the rationale being, if you are buying 300 units you do not want 300 empty blocks.

INTERVIEWER: Yes, sure.

INTERVIEWEE: Or 300 empty units. You want at least the first 50 or 100, then the next 100, then the next hundred. It assists with your lease up, also with your, when meeting your governance for debt.

INTERVIEWER: Yes.

INTERVIEWEE: Because then, I mean, 300, your lease up period, if you assume ten units a month, that is 30 months to lease up.

INTERVIEWER: Yes.

INTERVIEWEE: I do not know of a bank that is going to wait 30 months to get, to be able to measure a covenant.

INTERVIEWER: Because it was only needed, they release the funds on transfer, which pays as well.

INTERVIEWEE: Yes. So if they release funds on first phase, at least that will have a period to lease up, that is ten months, less than a year.

INTERVIEWER: Yes.

INTERVIEWEE: Following financial year end, they can measure.

INTERVIEWER: Yes.

INTERVIEWEE: Then you just post the next one. At least that you can manage and they can tell their credit that we will have sight of how it is performing as we go along.

INTERVIEWER: Yes.

INTERVIEWEE: Once debt is also in place, guarantees are issued, then my role comes to an end. Obviously there is a relationship element to it which is ongoing. Then that becomes, I hand over to our asset management, if it is one of the CPs, for example, we would, we may want one of our development asset managers to be involved as a watching brief person to say, monthly Steering Committee meetings, just to see what is happening on site.

INTERVIEWER: Oh, yes.

INTERVIEWEE: Obvious reason, you do not want to wait until the very end when you are snagging to say, but we are not happy with that, you are not happy with that, that, that.

INTERVIEWER: Yes.

INTERVIEWEE: If we can pick those things up earlier on, even on a turnkey, I mean, especially on a turnkey basis because there, truthfully speaking, we are not involved until that point in time but we do not enter into agreements to walk away from them.

INTERVIEWER: Yes, sure.

INTERVIEWEE: Once a commitment is made, I mean, that is part of our reporting to investors and it is their money and I support a man. So once we say we are going to draw June to 2017, because you started developing, that timeline they monitor because then they go back to their Investment Committees and say, capital to be drawn for investment in SA via this vehicle is X in 2017, it is X in 2016, X in 2018. So that becomes very important.

Where we are JV-ing with the developer and building and selling to market, that then becomes an obvious, we are involved. We are taking risks jointly with the developer.

INTERVIEWER: So who does your management of the units that you hold? Is that done in house or ...?

INTERVIEWEE: No, it is done in house. We have set up a property management company that reports to our asset management function. Previously Fund 1, per se, as an example, we had our asset managers, we had our property managers being external parties. Renprop, CSI, Zenprop is it Zenprop Zari.

INTERVIEWER: Those are on the commercial side?

INTERVIEWEE: No, no. Zari.

INTERVIEWER: Okay.

INTERVIEWEE: I was just remembering the "Z" at the beginning. Your Zari Properties, whoever is in the Western Cape, whoever is in KZN, and then they would report, there is a central system that our asset managers have live access to, and our property managers had to feed information into, so if a unit has been vacant for a month or a week, they would be able to pick it up as soon as possible.

INTERVIEWER: Okay.

INTERVIEWEE: And then, yes, the property managers, and a fee for that function, whatever the percentage is, and life goes on. So now that structure, we have tried to bring it in house because obviously, I mean, there is an amount that you pay for it.

INTERVIEWER: Yes, sure.

INTERVIEWEE: So if you can negotiate, if you can offer those services in house it means that one, I mean, the property management team sits here.

INTERVIEWER: Yes.

INTERVIEWEE: It is easier to communicate things, it is easier to control that function now, now that it is in house. Yes.

INTERVIEWER: Okay.

INTERVIEWEE: And then asset management will obviously be responsible, the development side will, until completion be responsible and then there will be a handover to our rental asset managers who basically work with property managers to make sure that occupancy is at the right levels, our lease ups are going accordingly, our cash flow position is where it is supposed to be.

INTERVIEWER: Yes.

INTERVIEWEE: That we are meeting all our debt requirements, that we are paying our debts.

INTERVIEWER: Yes.

INTERVIEWEE: Interest payments. And ongoing management of that.

INTERVIEWER: Okay, so I mean, you get quite a bit of exposure around different, I

suppose, different, like a broad category of different kind of deal types in terms of, you know, selling outright to renting ...

INTERVIEWEE: Yes.

INTERVIEWER: ... and specifically in the residential field, which is great, because this is what my research is generally based around. Yes. Just reading through the literature, three broad kind of categories stick out in terms of constraints that have been particularly kind of relevant to residential and those are like broad financial constraints, there are some management issues, and then availability of financial information.

So I really want to ask some questions around the financial issues if you don't mind. From your point of view, and with your experiences, do you think liquidity is an issue in residential property investment and assembling a portfolio, you know, specifically in terms of the transaction sizes and assembling of the large enough transaction ...

INTERVIEWEE: From an equity perspective? I mean, a fund raising period is quite long, sort of a six-month period. It is, I think, what, two years to actually get to a first close. From a debt perspective, liquidity together with cost of capital go together, and bank appetite.

So I mean, I fully understand, I was at a bank previously, an investment bank. I looked after debt, financing for residential properties. But one of the things, there is your Basle 3 that is in place now, which has higher capital holding requirements. As liquidity issues, there is the market itself, you are moving from a market where you could get gearing of, I think there were deals that were done at a hundred percent. Other banks which did deals and more than that.

Markets that were highly sought after, golf estates, the residential on it, and certain banks took significant positions on those. Look at the write offs that they experienced. But then you are looking now where banks have taken a more conservative approach and say, what is cash liquidity, well, our best tier clients, and that is track record, they have survived the crisis.

INTERVIEWER: Yes.

INTERVIEWEE: We are fortunate to fall into that space but not every developer falls in that space.

INTERVIEWER: Yes, sure.

INTERVIEWEE: But now then, even from that perspective, maximum gearing that you are getting is what, eighty percent on a development loan.

INTERVIEWER: Okay.

INTERVIEWEE: About 65 percent on an MTL. Now you look at that gap of twenty percent requirement, your land is probably not going to be the only thing you put in on a development loan, so you need to put in some liquidity of your own. A normal developer on the street may not have that, most likely does not have that. On an MTL, if you are trying to build a rental portfolio which in today's economy is what is most sought after, people cannot afford to buy. Ninety percent geared, ninety percent gearing from a home loan perspective means I need to put down ten percent. On a unit of 500,000 that is 50K.

INTERVIEWER: Yes.

INTERVIEWEE: Not everyone has that.

INTERVIEWER: Yes.

INTERVIEWEE: Especially in affordable housing space. But then the guy who has to develop and hold this thing has to, or the one who is buying and holding it, gets debt of 65 percent. Whoever that person is needs to put down, what, 35 percent equity. Quite significant. To do a ten, twenty-unit scheme is not really the most ideal because to give you a basic example, your expenses to operate that, a security guard gets paid X.

INTERVIEWER: Yes, sure.

INTERVIEWEE: Spreading that over 50 units or you are spreading it over 300 units.

INTERVIEWER: So what is the minimum type, the minimum threshold that you look for?

INTERVIEWEE: For us, we look at schemes of at least 200 units.

INTERVIEWER: At least 200 units.

INTERVIEWEE: Yes. 200 to about 350.

INTERVIEWER: Okay.

INTERVIEWEE: You are getting your operation efficiency. You are also, from an equity investment perspective, I mean, our objective in [inaudible 00:23:21.2] is to invest in about 20,000 units.

INTERVIEWER: Yes.

INTERVIEWEE: If we look at 50 unit schemes that is a long period.

INTERVIEWER: So have you got quite a big focus on selling, I mean, with the kind of big push into residential, specialised [inaudible 00:23:36.2]? Have you got a big focus [inaudible 00:23:38.8] in the future? Or ...

INTERVIEWEE: We are looking at a few transactions of selling into, ambitions, there are ambitions and there is also what ...

[Talking simultaneously]

INTERVIEWEE: ... no, no, no, I mean, if I am taking off 300 units in your scheme, how long does it take, I mean, you guys are in the business of developing and selling, how long does it take you to sell? I mean, you guys do fairly well so your CEDA scheme, but not every developer will sell that out.

INTERVIEWER: Yes, sure.

INTERVIEWEE: Like hot cakes. So you are getting savings on that. You are getting your pre-sales met from the get-go because we are taking everything. Obviously there is equity that you will need to put in but that is between you and your financier. But your debt can kick in as soon as your equity level has been met and whatever other CPs that the bank may have.

It is not an easy space to get in, it is an expensive space to get in. You need to secure land. Land availability agreements, from my experience, are not a top favourite for banks. Can you register a bond over the property? You need permission from whoever the owner is. Is there an existing bond over the property? There are such discussions. So it is difficult to minimise your up-front capital outlay because of obvious constraints. But yes, that is where the market is.

INTERVIEWER: Yes. And what about, can you compare the financial returns between residential as opposed to other kind of property asset classes in particular? And what about, and also, I mean, do you see a big difference in your returns from rental as opposed to development?

INTERVIEWEE: I will maybe talk, I mean, an obvious one is, commercial space you can get a five-year lease.

INTERVIEWER: Yes.

INTERVIEWEE: Here we, in residential it is a six or twelve-month lease. If you find a 24-month tenant, I do not know. So you are taking that risk. You are obviously going to turn through leases in a period of four years on a unit. Commercial space you are getting that comfort, yes, but then commercial and office space, I am not in that space but what I see, take Randburg as an example. There are a lot of refurbishments that have happened there.

Randburg used to have a lot more offices than it has now. Now there are refurbishments into residential because Randburg is actually good rental residential space. And there is obviously vacancies that are coming about, a lot more people moving into Sandton, a lot of the corporates that used to sustain a lot of the nodes that are in and around Sandton are now building their own which means that someone is actually being left at the significant vacancy, wherever they are.

You see a lot more, there are office spaces still coming up. I have my views as to whether those should happen or not. There is a lot of shopping centres that are popping up. It makes me wonder, what is your, is it cannibalising the market? Because market, disposable income is the same. So now if you are building Mall of Africa you have got Sandton, you have got Rosebank, one of them will suffer.

If you look at the Rosebank Mall two years ago, it was the site by the Hyatt Hotel, which had vacancies, significant vacancies. There was, I think it was a combination of issues. One, I think you needed a key anchor on the site, not just have all your anchor stores on the Zone side. So there are a lot of vacancies. I mean, I used to be in that area.

I remember a guy opened a store, clothing. A few months later, and I used to go and just have a chat with him, he took his pension, believed in his plan, opened. A few months' later doors are not open. Stock and everything is inside, you can see letters going under the door, and the business had gone under.

So residential, you take similar risks but our vacancies are manageable because you can get a tenant, it is maybe a function of, I am not, maybe my average, my rental ceiling, maybe I am too expensive. What are my competitors charging, has the rest of market adjusted down, then I need to do the same? Have I answered you?

INTERVIEWER: Yes. Well, it seems like there is a little, if I can reiterate what you said, [simultaneous talking].

INTERVIEWEE: From a returns perspective?

INTERVIEWER: Well, definitely from a risk perspective I think what you, if I understand you, it is almost less risky because of the volume and the kind of replace-ability of tenants, you know, it is not as specialised.

INTERVIEWEE: Yes. There is the yes and no because, I mean, the residential is a more fluid market.

INTERVIEWER: Yes.

INTERVIEWEE: I will call it that. But if you get it wrong either during development, that is why you need to deal with the right jockey, or post in your management, and not every commercial operator is a good residential operator.

INTERVIEWER: Yes.

INTERVIEWEE: From a property management perspective. So that is also very, that is a very key function. I mean, I will give you an example. We have got a development, and not every residential development is a rental.

INTERVIEWER: Yes, that was one of the key issues ...

INTERVIEWEE: Is a rental development. I will give you an example. We had an experience where we bought a portfolio from a developer, one of Gauteng or South Africa's prominent developers. Five schemes, about 1,200 or 1,500 units. It was a mixture of Res 1 units and Res 3 units in different nodes.

INTERVIEWER: Yes.

INTERVIEWEE: Ranging from your Midrand to Naturena. The freestanding stuff, those were buying into all this rental stock. Your rental escalations, you are not getting them. And the rationale behind it is, freestanding stock is most likely at a lower yield than a normal 500,000 or 600,000 unit that is the south or that is in Midrand. So a lot of people, if I am asking for R8,000 in rental or R7,000 in rental, why do I not just buy? This is R4, 000 or R5, 000, or 5,000 to R6, 000 rentals, which is palatable.

So you get to a point where that ceiling is reached and I think with Res 1 units, those are more fitted to a develop-sell-to market. If you are in the right node, you have got the right product, specifications; you most likely do well on selling Res 1 type units. Res 3 units, good for rental, I think, in most areas where there is Res 3s already because we do not go into an area, strategically we do not go and develop an area. So we would not go and develop Dainfern onward.

INTERVIEWER: Yes.

INTERVIEWEE: But we would look for a scheme in Dainfern, an infill site.

INTERVIEWER: Okay.

INTERVIEWEE: Do some infill that fits our fund parameters. Yes.

INTERVIEWER: Okay. And, I mean, did you have any other financial kind of tax constraints in mind that are specific to the residential market?

INTERVIEWEE: Well, there was, I think they have extended it. There was that VAT concession where, if you are holding as rental stock you are not deemed to have sold, blah, blah, blah, and you are not required to pay, because I think you previously would have been deemed to have sold, changed your intention when you hold as rental stock and be liable for VAT. So they gave, it was initially I think a 36 month, just check the concession for me.

INTERVIEWER: Okay.

INTERVIEWEE: 36 months, whereby you are not, they defer the payment of that VAT which for us was actually quite a good benefit because when we buy the stock we are obviously buying VAT inclusive.

INTERVIEWER: Yes.

INTERVIEWEE: And that cost is set until, it sits with us until we start selling the units. You do not want to pay, you obviously want to ...

INTERVIEWER: Or reduce your yield by a bit of [inaudible 00:32:48.3] ...

INTERVIEWEE: Yes. It sits on your yield.

INTERVIEWER: Yes.

INTERVIEWEE: Basically. So now I think they have extended that, so now, which means you need to separate your investment vehicles. What you are buying with a short term, medium term intention of selling, put in a separate entity and what you most likely are to sell on a yield basis, which is basically selling the cash flow and not the capital growth of that, put in a separate vehicle. And you need to understand that intention up front, to put yourself in a better tax position.

INTERVIEWER: Okay. Perfect. And then you briefly touched on some management issues. That was also something that came up quite a lot in the literature, around, you know, managers' skill sets, differing in residential as opposed to commercial, that they are not necessarily the same or similar and also there is quite a lot of talk, you know, quite a lot of literature around residential management not being possibly as professional as commercial management and there being a bit of a, like a lack of skills in the space. You know, what kind of, what do you think are the specific skills that are required to be a competent residential manager? And can you find those skills in South Africa? Especially ...

INTERVIEWEE: Yes, you can. There are not as many players in that space, well, I think that has changed now but initially there were not as many. There was your common names and the guy on the street who started a property management company, it was either an understanding of the residential market. It is a very, what is the word, it is legs game so you need to be on site regularly, you need to understand why people are moving out.

And given that your leases are more short term than they are medium you need to understand, you need to have a system, a solid system in place that you can track everything. Track your leases, track your expiries, and track your reasons for moving. Track your reasons for people moving in. Understand your escalations. What escalations can you reasonably chuck into a development? And what escalations can people take?

Skill set of actually managing tenants' issues. Things like the PAIA Act that are in place. If a tenant is not paying what is your recourse? You need a strong property manager who can actually take care of that process to say, as much as you need to find them alternative accommodation, you need a tenant, a paying tenant in the unit as soon as possible.

INTERVIEWER: Yes.

INTERVIEWEE: So that skill set. And we are not talking about a guy coming with a *knobkerrie* and scaring the tenants out, it is obviously illegal, but you need a person who is competent enough to actually manage that process to say, you are not paying, you have not been paying for two or three months, and it is not a, you have missed a payment, move out.

There is obviously discussions and what you will find, I mean, I think one of our property managers, I overhear him with tenants almost every day. You have conversations with them, you follow up because the agreement was, you are going to pay on the 20th, that is your salary date, but it is now the 25th or 26th or 28th and you still have not paid, what is happening? And you know that from the beginning of September you would ideally want a tenant who is going to pay you and if this one still holds you two months prior ...

INTERVIEWER: Yes. Sure.

INTERVIEWEE: you need to come to a point in time where you make a call.

INTERVIEWER: And what about the management costs? I mean, do you have much, what is your view on; is there a higher cost in managing residential properties as opposed to commercial? I know it is not really where you specialise.

INTERVIEWEE: I do not have a view. I can tell you, I mean, your property management costs in residential will, what, range from five to seven percent ...

INTERVIEWER: Of the gross [inaudible 00:37:04.1]?

INTERVIEWEE: of your gross income. Ex VAT.

INTERVIEWER: Okay.

INTERVIEWEE: Where that compares, how that compares to commercial, I am not sure, I would suspect it is higher than in residential, given the volume.

INTERVIEWER: Yes.

INTERVIEWEE: Because, I mean, volume of income that you are getting from residential versus a shopping centre. So a 200-unit scheme, I do not know. You would need to compare that to what property managers in the commercial space charge but I think we get, our property management fees are, what, that we get charged by external parties' average at about six percent.

INTERVIEWER: Okay.

INTERVIEWEE: We obviously negotiate that.

INTERVIEWER: Oh, okay.

INTERVIEWEE: Yes.

INTERVIEWER: So do you think that is why, does that possibly put a bit of pressure on your yield as well?

INTERVIEWEE: No, no, it does. It does, but you need the function. You need a competent person. When I say person, whatever the entity is, whoever the entity is. But you need competency, you need systems in place, you need them to have a strong team in place because I may deal with you and you represent Renprop but I need to understand that you have actually got the capacity, a strong team of people who will be on site.

If we are in lease up you need someone who is going to be on site actively because it is not every person who is going to phone in and make an appointment, someone may be driving past and be like, oh, I see you are advertising for rentals.

INTERVIEWER: Yes, sure.

INTERVIEWEE: I am driving past an area that I may want to move in but I am actually going to do something in Pretoria for the day so now, am I going to go there and come back here, or can I just see you quickly and go, and then I will call?

INTERVIEWER: Yes.

INTERVIEWEE: So it is those dynamics.

INTERVIEWER: And then what about, I mean, what about, that is, so as I mentioned earlier, there are three kinds of major issues and major themes around residential property investment.

INTERVIEWEE: Yes.

INTERVIEWER: The first one is financial, which you have covered. The second one is management ...

INTERVIEWEE: And your management is actually quite key for your financiers because the banks, I mean, you can go through any of our purchase agreements, or our debt agreements. They want to sign off on the property manager.

INTERVIEWER: Really? So it does actually take an active interest in the ...

INTERVIEWEE: They want to understand, because remember, we are, we play a fund manager role.

INTERVIEWER: Yes.

INTERVIEWEE: There is, we have got an asset management team, we have got all of that. We have got the funds. Then there is the property.

INTERVIEWER: Okay.

INTERVIEWEE: Collection of income which is how they get paid.

INTERVIEWER: Yes.

INTERVIEWEE: So they need sight as to who is responsible for that function. If you are doing it in house, do you have the capacity over and above your fund management role?

INTERVIEWER: Okay.

INTERVIEWEE: Which is part of the rationale on setting up a separate property management company.

INTERVIEWER: Okay. Yes. Okay, fine, thanks. And then the third one is the residential property market information in terms of benchmarking indices, in terms of, you know, actual management cost information, rental information, general market information. You know, from your point of view does that make it harder to build a residential fund or less hard? I mean, are there gaps in the market? Are there inefficiencies, because there is less market efficiency? How do you view the issues around that?

INTERVIEWEE: Data, for example, key data that you need is, 2014 what was the average selling price on a [inaudible 00:40:40.7]. Selling prices for a node. That is fortunately available because you have got your Deeds Office which is quite a competent structure in South Africa. So I can tell you, and SEDA, average Sectional Title prices for a scheme of whatever size is X, 2014. Whatever transfers that have happened in 2015. There is obviously delays but I think your margin of error is quite, is low or acceptable.

INTERVIEWER: Okay.

INTERVIEWEE: So you have got that information and you have got the likes of Lightstone who collect that information and pull reports together ranging from which financiers are the most active from a home loans perspective in a particular node. Capital growth, take last

year's Sectional Title average price, compare it to this year. So you understand that, okay, if I look at the past three years I have been achieving six percent.

INTERVIEWER: Yes.

INTERVIEWEE: What is happening now that I think will capitalise growth going forward? And that is part of the work that we do. Rental data, you have got, the rental data is quite tricky because rents do not do this perpetually. So you have got the likes of TPN, Tenant Profile Network, I think, who, we use a lot of their reports so I will go and I will look at an area and say, two bed one bath units in the area, how have they been renting out? How has that rental been going? What escalations historically have been achieved? Is it above the national average, what is the national average? Because they put that data in.

INTERVIEWER: Okay.

INTERVIEWEE: And what are the dynamics? What is the age groups of people buying, people renting in the area? So that data, I heavily rely on your Lightstone and your TPN because I understand the demographics of people buying there. Household incomes in an area, very important information. If you use a principle, I think it is home loans principle that says, max 30 percent of your income is your housing provision. So now if I understand what the household income bracket is for a particular node, I have an indication of what rentals I can charge.

INTERVIEWER: Yes. Okay.

INTERVIEWEE: Then I take that and I test it against what has actually been charged in the area previously. If it is higher than my range I am fine, I do not need to increase but if it is lower I definitely need to adjust down.

INTERVIEWER: Yes.

INTERVIEWEE: That is that conservative approach kicking in. So that, I mean, things like vacancies, vacancy information is quite difficult to pick up. I cannot tell you vacancies in Fourways.

INTERVIEWER: Yes.

INTERVIEWEE: I cannot. I can build structures to minimise vacancies in a particular development but the data is not sitting anywhere. I probably understand why it will not sit anywhere because it is quite sensitive data and no one wants to show that I have got ten percent vacancies, or fifty percent vacancy. They will tell you that vacancies are at a certain point but this was because of whatever issues in the past.

INTERVIEWER: Yes.

INTERVIEWEE: So yes.

INTERVIEWER: Okay. And what about the more kind of ...

INTERVIEWEE: Oh, and another source is your Property 24, Private Property websites that, it is what is available ...

INTERVIEWER: Do you use those as well?

INTERVIEWEE: No, no, we use, we look at it.

INTERVIEWER: As a just rule of thumb?

INTERVIEWEE: Yes, just look at what people are asking for from a sales perspective, what people are asking for from a rental perspective. Obviously that does not say, the sale was closed ...

INTERVIEWER: Yes, yes, sure.

INTERVIEWEE: ... at the asking price or they actually had to take a R50,000 knock, or the rental was, the unit was leased out at the asking rental.

INTERVIEWER: Yes. I suppose it is quite a good indicator though, of the market.

INTERVIEWEE: No, it is, it is. So, I mean, you take a combination of what current asking prices are and you look at historic rentals.

INTERVIEWER: Yes.

INTERVIEWEE: You get a feel of where the market, that particular node as a market is.

INTERVIEWER: Yes.

INTERVIEWEE: We have also done an internal, I mean, it is an ongoing process, the report is not finalised, a report that says, nationally what are the hot spots? Given whatever assumptions that you want to, so you want a certain income bracket, you want certain capital growth, you want certain economic activity happening in that area.

INTERVIEWER: So you guys also build a, compiling your own ...

INTERVIEWEE: We have to.

INTERVIEWER: ... information.

INTERVIEWEE: We have to. As we go along, as we learn, as we invest in a Randburg, as an

example, and not achieve or achieve the rental growth or the capital growth that we projected. You then come to understand that it is actually more rental than a sales market, or it is more a sales market than a rental market. And that data you use going, when you look at other schemes because

INTERVIEWER: Okay.

INTERVIEWEE: ... as you move into other funds you are obviously going to end up investing in areas or nodes that you have been in before.

INTERVIEWER: Yes. Yes, okay. Well, well. And from a benchmarking point of view, I mean, how do your investors meet? Do they just, how do they, do they have a [inaudible 00:46:10.7] rate? Does it help or is it like a bad thing that it is possibly not as much benchmarking information available from a residential point of view? How does it affect you?

INTERVIEWEE: We are returns driven so another calculation that is based on a fancy model that was developed some time ago, which is mainly achieved by the discount that you get up front, your capital growth and your rental growth. And obviously how you lease up or you sell, your lease up rate and your sales rate. Those are the keys to your achieving that.

From a develop, JV developed sell-to-market perspective where we get to a 25 percent IRAR, it is a comfortable space. 25 plus, pre-tax. From a, and that is where you are development risk so when you, it is a turnkey transaction a 23 percent IRAR is acceptable.

INTERVIEWER: Is that pre-tax?

INTERVIEWEE: Pre-tax.

INTERVIEWER: Okay.

INTERVIEWEE: So those are, the capital is expensive but the capital is meeting a certain, quality need. There is a shortage of capital in this space. Not every developer has liquid cash. Go to any developer's financials.

INTERVIEWER: Yes, sure.

INTERVIEWEE: Depends on where you are. You have got quite significant inventory, work in progress because you are developing ...

INTERVIEWER: It is a hugely capital intensive industry, I mean, the cash flows are, yes.

INTERVIEWEE: Yes, it is the nature of the game. So at a point in time you are asking for 20 percent equity or 30 percent equity or 35 percent equity to go into a development, not every developer can do that. But they do have the land that they bought years ago that they are sitting on, or that they have been rezoning over a period. So that is one other function. I think they are calling me now. Is it done?

UNIDENTIFIED SPEAKER: Sorry.

INTERVIEWEE: Okay, I am coming now. Sorry, man. So yes, that is ...

INTERVIEWER: Okay.

INTERVIEWEE: That is it.

INTERVIEWER: I mean, just, are there any other, you mentioned, you know the PAIA Act. Are there any other legal constraints? From what I have, from my conversations with people it seems that, or is it a constraint? You know, does that legal kind of protection and framework, is it a big threat or is it, you know, something that you can overcome? Is it ...

INTERVIEWEE: In our space, what makes maybe, if you compare us to a commercial or an office operator, is things like the CPA.

INTERVIEWER: Yes.

INTERVIEWEE: Because we are not, you will have that odd corporate signing a lease for units in a development, but we mainly deal with end users ...

INTERVIEWER: Yes.

INTERVIEWEE: ... who are protected by the CPA so you need to be cognisant of that, you know, at least, I mean, when the Act came in we had to amend our lease agreements to reflect and align with it. Sale agreements as well. So that as a threat poses things like, blatantly put, you can sell a unit, the person can pay a deposit, but they can actually be cancelled.

INTERVIEWER: Yes. Okay.

INTERVIEWEE: You can sign a twelve-month lease, they give you, I think, twenty working days' notice, they will blame it on affordability, twenty days you are out of a tenant.

INTERVIEWER: Yes.

INTERVIEWEE: That guarantee of twelve months falls away.

INTERVIEWER: Yes.

INTERVIEWEE: Or the notice period of two months that people used to ask for falls away. So those dynamics, you are dealing with end users, you are not dealing with corporates. Very

important to actually, and you are not dealing with sophisticated developers because our agreements with our developer partners are very intense. We, [inaudible 00:50:15.9] fund so we need to protect ourselves as a fund manager and we need to protect our investors. Most of them who are LPs, who want to remain silent, they do not want to be actively involved in the business. Thus not want to be publicly known so you need to protect that info and you need to protect yourself, especially, I mean, on turnkey transactions where we are taking transfer. How involved do you want to be in the development, given that you are not actually taking the risk?

INTERVIEWER: Yes.

INTERVIEWEE: But you also want to protect your interests because you want to take transfer of this asset that you have already said, it is approved, we have committed equity ...

INTERVIEWER: Yes. Okay.

INTERVIEWEE: Yes.

INTERVIEWER: And what about, I mean, can you think of anything else that comes to mind? Any constraints, what are, like, what are the biggest constraints? I mean, for you in your role and then generally in, you know, what are the biggest constraints in putting together a deal and what are the biggest constraints in property and residential property investment? In your view?

INTERVIEWEE: The economy is what it is and you need to, you cannot change that. You need to align with that, especially where we are now. The cycles that we have gone through coming out of a recessionary period where banks took a bit of, a few lessons. That now, I mean, for sale projects you always need a market to update that.

High demand for rental but you need to be able to enable that from how your financing structures are put together, from how you invest, from the assumptions that you make up front, because you are not taking a twelve-month view when you are buying on a turnkey basis, you take a long term view. You would not really make, you would not make money, which is the reason why we are in business, by taking short term six or twelve-month investment positions. You are taking a five, ten-year position.

Our funds are ten year funds, that includes origination, that includes asset managing through, I mean, that includes origination, development of the actual asset, management of the asset as rental stock and sales into market. So that is how you end up having an average of four or five years holding as rental stock.

INTERVIEWER: Okay.

INTERVIEWEE: Because currently, I mean, our second fund started last year July. We have been buying assets, entering into agreements, developers are now building.

INTERVIEWER: Yes.

INTERVIEWEE: We are taking transfer of our first batch of 60 units in a scheme of 480 units now, September.

INTERVIEWER: Yes.

INTERVIEWEE: That is like, I mean, this is September now, and the fund has been running since last year Feb.

INTERVIEWER: Yes.

INTERVIEWEE: So we probably going to start getting most of the assets that have been loaded up front, 2016 late, 2017.

INTERVIEWER: So what about, I mean, going back to, do you think that is maybe an issue to do with the property liquidity and, you know, financial [inaudible 00:53:24.4]?

INTERVIEWEE: No, developers are not going to just roll out and go develop and we come and say, oh, we like that, we will take it.

INTERVIEWER: Yes. So do you think, is that like a ...

INTERVIEWEE: It is highly linked; it is highly linked. You are not going to, you may buy the land if you are getting it at a good price or you are finding a distressed owner, you buy the land. You take it through the process but you are not going to invest any more capital as a developer. So now when an Aegis or similar comes along and says, I am interested in buying, you still have to develop.

INTERVIEWER: Yes.

INTERVIEWEE: And in developing you still need to bed down your capital structures, equity, are you in a position to throw in equity? Because if we are buying on a turnkey basis you are sorting that out on your own, you are sorting out your debt on your own. If we are JV-

ing, are you comfortable with the return structure?

Because if we are putting in most of the equity capital there is a waterfall structure. We rank first, you rank second from both the return of the upfront capital and returns, so our returns need to be received. This is all post repayment of debt. So you get our equity invested, you get yours. You get our return, you get yours. Then whatever is left is split according to shareholding.

INTERVIEWER: Yes.

INTERVIEWEE: So that is highly linked. I do not know soon your submission is due but a place where we have our Affordable Housing Conference, it is in September, on the 3rd, I think ...

INTERVIEWER: Okay.

INTERVIEWEE: ... where we call most of the developers in and you hear the issues that they come about. Some of the constraints are not finance related, they are actually taking properties through those rezoning process, Council constraints, that is, yes, that is very important. Availability of bulk, electricity, bulk contributions that have to be made.

INTERVIEWER: Yes.

INTERVIEWEE: Those inherent that on its own delays a project significantly. I will give you an example. We have got a project, Jabulani. When we started we believed we have got, we had electricity for 5,000 units. I think 1,000 or 2,000 in, but that was not the case. We literally had to stop construction on site because we were selling and renting and I was actually doing well. But you cannot plough more capital without sight of where your electricity will come in.

INTERVIEWER: Yes, sure.

INTERVIEWEE: And where to find alternative means of getting electricity at our cost to the site because that was, there was a shorter line of sight of that happening if we do it, versus waiting for our favourite provider.

INTERVIEWER: Yes, sure.

INTERVIEWEE: And, I mean, your Council turnaround, I know the Mayor, the City of Johannesburg Mayor believes in changing that. I mean, things like your EIAs, it is a constraint for government owned properties that they are trying to deliver, what do you call it, RDP housing or social housing.

INTERVIEWER: I mean, we know, we took a, you are talking about lopsided? EIA and the process of the environmental people took seven years. We have had it for ten; it has been a zoning process of ten years.

INTERVIEWEE: I used to work at Eskom at some point. I used to drive past the sign and I was like, why is no one developing on this site? This is years ago.

INTERVIEWER: Yes.

INTERVIEWEE: And I was like, this could sell. This could sell. And when it finally happened I was like, and I had just bought a unit in Randpark Ridge and I was like, I would have bought here. But those are constraints that, even before we get involved in a project, to get involved in a project that is on land that is currently farm land, I know it is the cheapest land you will find but ...

INTERVIEWER: Yes, well, that is what we deal with mainly, but I mean, that is a two or three-year process till you break ground, and then [inaudible 00:57:36.2] ...

INTERVIEWEE: Till you get to a point where you [inaudible 00:57:37.4] ...

INTERVIEWER: that is a five, six-year process, yes.

INTERVIEWEE: period before you put a unit on the site.

INTERVIEWER: Yes.

INTERVIEWEE: And that is not because you are developing slowly.

INTERVIEWER: Yes, that is a very, quite a constraint. Okay, perfect. So, anything else you think, in terms of the constraints?

INTERVIEWEE: No, no, nothing else. Nothing else. Your capital is important, I mean, you have listed the items that are, on the management side you also, I mean, I assume that covers your sales team because your sales team, if you are selling into market needs to be very strong. Need to understand the fact that, depending on which market you are in, I will give you an example. In the affordable housing space, we have to sell a unit an average of three times.

INTERVIEWER: Okay.

INTERVIEWEE: Because I come, I sign an offer to purchase, get my bank approval, two

months later I go buy a TV on credit, bank reassesses my, I do not remember what the period is, my affordability.

INTERVIEWER: Yes.

INTERVIEWEE: That has not changed. Now the bank says, you have to put in whatever equity because your net available monthly is lower. Guess what, the guys says. I do not have the deposit. I have to cancel.

INTERVIEWER: Yes.

INTERVIEWEE: We [inaudible 00:58:54.6]. So that average rate of selling a unit three times, imagine doing that on 300 units.

INTERVIEWER: Yes, sure.

INTERVIEWEE: So it becomes a painful exercise but you need to be active on site and compared to years ago, and I actually know two houses down there is a development that is happening from where I stay. They are using the whole model of selling off plan. You come, you park your tent, you park your car, you have got these nice papers, and the site is open. There is not an ounce of soil being lifted. No activity. And you expect people to come buy. This has been happening, I moved in last year October. They are still signing now and it is twelve units. So you need that activity on site to actually convince people that, okay, I am buying now, you are saying delivery date is March 2016. I see you will be done by then.

INTERVIEWER: Yes.

INTERVIEWEE: If I go by and that site next door from me, they are then telling me they are going to be delivered in June next year, I cannot buy. I do not believe it because it is twelve units. Had I bought last year October I would still be waiting ...

INTERVIEWER: Sure, yes.

INTERVIEWEE: ... for one unit in this scheme of twelve. This is ridiculous.

INTERVIEWER: Yes.

INTERVIEWEE: So that maybe is linked to your capital constraint because you need that activity on site, you need that up front capital, you need that liquidity, as you put it, to go into a project because a bank is not going to give 100 percent.

INTERVIEWER: Yes.

INTERVIEWEE: So you can get going immediately.

INTERVIEWER: Yes, sure. Perfect, thank you very much, I really appreciate your time, I really do.

INTERVIEWEE: Rushed a bit at the end. I was running ...

Participant “E”

INTERVIEWER: Okay cool. Well, thanks for agreeing to help me with my interviews.

FEMALE SPEAKER 1: No problem.

FEMALE SPEAKER 2: Well, as long as our names are there hey.

INTERVIEWER: Of course, they will be. I've sent you a form, if you guys don't mind filling that out. I sent you a consent form actually so you've got to put your names down there and they'll definitely be in my research when it gets published in the academic journals you'll...

FEMALE SPEAKER 1: [inaudible 0:00:30.4].

INTERVIEWER: Okay, well perfect. Can we start?

FEMALE SPEAKER 1: Yes, go for it.

INTERVIEWER: Okay, so first of all I'd just like to also confirm what your roles are at [Masalini? 0:00:47.3] and what exactly does [Masalini?] Capital do?

FEMALE SPEAKER 1: Okay [Masalini? 0:00:58.7] Capital is [inaudible 0:00:59.4] they basically has various investments and property is one of them, then listed stock and also private equity in various cyber companies.

INTERVIEWER: Okay perfect. So, I understand that you guys have read the questions I sent you a list of the questions and you read through them, so let's start at – so just as I explained in the – just before the questions a few broad areas have come up in the literature around constraints particularly to do with residential property investment and those are some financial constraints, management constraints and also some information constraints just regarding the availability of information, so in terms of financial issues have you found that liquidity is a constraint in residential property investments relative to other property asset classes or not? And...

FEMALE SPEAKER 1: Yes I don't, I think that overall if we look at a high level I think for us residential has not been our preferred investment. I'm talking from a property point of view, not from the rest and all the others what it did and [inaudible 0:02:30.8].

INTERVIEWER: Okay.

FEMALE SPEAKER 1: I think it's for various reasons which obviously [inaudible 0:02:35.3] here but I think that kind of generally the overview and I think the one thing with regards to funding and financing, the one thing we have found is that - and I don't know if I'm jumping all over here, Mark but...

INTERVIEWER: Do it, that's perfect. I'm going to...

FEMALE SPEAKER 1: You can just slot us into whichever question.

INTERVIEWER: Exactly.

FEMALE SPEAKER 1: But the one thing is from a financing point of view with bank financing we kind of fell and we have various investments, we have one which has been quite a few units that has been rented out to individuals, so a whole lot of individuals, then we also had about 12 units which we have a lease by a corporate, so we've had quite a few different types of tenants and contracts with but we find that it hasn't been as easy with funding [inaudible 0:03:41.7] yes.

INTERVIEWER: Okay [inaudible 0:03:43.7].

FEMALE SPEAKER 1: I think for a few reasons I think the one being that you don't have a single tenant, so they don't get as much security and they find it a far higher risk doing funding for residential.

FEMALE SPEAKER 2: Yes, and I think [inaudible 0:04:03.3] point is that you seem to – if you're a private person, if I go and buy one of those units, say I buy number 4 whatever, Morningside Village in my own capacity the bank is more willing to give me a higher amount of funding than if I come as a company, so and it seems like banks favour individuals owning residential property compared - than companies owning more commercial properties, it seems like that's the standard. So, if a company wants to apply for finance like I wanted to apply for finance for 12 units the amount of funding they were prepared to give me as a company was maybe 70 per cent Loan to Value where as an individual you can go to 90 per cent Loan to Value, so there seems to be some difference when the banks don't quite [inaudible 0:05:14.5] how to view it and I can't say why. Look on commercial properties you can maybe push to 80.

INTERVIEWER: Okay.

FEMALE SPEAKER 2: But it seems like if you're a business owning a group of residential properties for investment and return they don't give you the best rate they could give you over

that property if you were an individual. Do you understand what I'm trying to say?

INTERVIEWER: Yes sure, I do and then do...

FEMALE SPEAKER 2: So are you're talking about somebody having all that cash on hand to be able to buy.

INTERVIEWER: Yes well, in terms of – because its smaller units do you find – is it just finding stock to buy for instance is it harder because you have to buy in smaller transaction sizes and find it or is it not a big difference because you still buy like say blocks of units if you do buy.

FEMALE SPEAKER 2: Yes I think if you're a company you're going to buy in chunks.

INTERVIEWER: Like for instance what happens when you sell the units, is it harder to sell them because now you've got to find 20 – you've got to deal with 20 buyers as opposed to 1 new investment buyer?

FEMALE SPEAKER 1: No, we actually, you see at one stage we sold about 50 whereas and - we had – you had a few problems. I think like Lisa said its far more – it was easier to almost sell off because you've got a total different market buying - buyers because obviously for people everybody needs a home, so whereas if you're selling one big property and you were just comparing it to the property we have with Bell Equipment, it is being specifically designed and built for their specification, so if we had our 15 Morningside Village units, it was a lot quicker and easier to sell them than it is to sell a big industrial commercial property. You're limiting obviously your buyers, you really are narrowing it down but the one thing we did struggle with when we were selling was there was quite a lot of – the funding was quite a big issue, there was quite a few more constraints and suspensive conditions in order for the sale to go through, so where we had to sell Bell Equipment to whoever for them to get funding is not really a big issue because the people that are looking at that asset have got the money, whereas selling to Mr Smith who's now got to either sell his house and then raise more financing and, and, and so we found it far, although it was probably a more simple processes it wasn't as quick.

INTERVIEWER: Okay. So and what about the returns that you're seeing from residential as opposed to other industrial properties that you guys have bought and other properties...

FEMALE SPEAKER 2: No [inaudible 0:08:30.0] and I debated that, so you've got your monthly return from renting to individuals which comes with a host of all other problems which I'm sure we'll address under the management but what we find with some of the properties is selling a commercial property it is easy to get a valuation, this is your rental blah, blah, blah, this is your cap rate and it's not [inaudible 0:08:59.2] what an average market cost is per square meter for land or whatever, so that is easy to calculate and usually when you buy property your full cost going forward every year and year because you [inaudible 0:09:13.1] is quite as easy to determine when [inaudible 0:09:16.7] going to be where the residential unit you're actually more driven by the market conditions of where those townhouses or places are and what the market's like, so the yields; the increase really only happens over the last 24 months where the last 5 years preceding that they've kind of remained at cost because development hasn't completed so people would then rather prefer to buy a new unit at a similar price.

FEMALE SPEAKER 1: So Mark, when you're talking about return and you're talking about an income monthly kind of return

INTERVIEWER: Well both, I mean what ...

FEMALE SPEAKER 1: What return were you [inaudible 0:09:57.3].

INTERVIEWER: Because obviously the capital return is maybe more volatile because it's based on...

FEMALE SPEAKER 1: Yes.

INTERVIEWER: So but what ... Both returns really, just the overall return including the income return, what kind of rental yield can you expect – have you seen a difference in rental yield is that a constraint, can you only get a lower rental yield, do you have to bank more on capital appreciation like what's the story about it?

FEMALE SPEAKER 2: Yes, I think you've got to bank [inaudible 0:10:23.7] more on capital return which is – because you can either get it completely right or get it completely wrong.

FEMALE SPEAKER 1: So there's not really a set formula as Lisa said. I think it is easier, more easier to determine or you have a very good idea when you're buying the property as to where you're going to be 5 years down the line with your value unless you know obviously the area changes but the likelihood of an industrial area drastically reducing is not, the risk is

far lower than in a residential.

INTERVIEWER: Okay, so you think residential is more volatile in terms of the capital...

FEMALE SPEAKER: Totally, yes absolutely.

INTERVIEWER: Capital appreciation.

FEMALE SPEAKER 2: Ja, look with interest rates going up they negatively affect what you're going to sell it at whereas [inaudible 0:11:13.6] I know but still it's from [inaudible 0:11:18.0] that impact the price [inaudible 0:11:20.4] compared to commercial, yes so interest rate change doesn't really affect the purchase price.

INTERVIEWER: Yes and what about VAT considerations, how does VAT affect your residential property investments?

FEMALE SPEAKER 2: It doesn't you can't claim VAT.

INTERVIEWER: So, does that, yes so does that make – because I mean you've got to buy it – you've probably going to buy it with VAT or transfer duties at least but you can't recover that on your rental so does that make ...

FEMALE SPEAKER 2: Not at all.

INTERVIEWER: Does that...

FEMALE SPEAKER 1: Yes [inaudible 0:11:55.8] but I mean for residential for commercial property it's also [inaudible 0:12:02.2].

FEMALE SPEAKER 2: When I'm doing if I had to compare like and like, the one is [inaudible 0:12:09.5] the whole thing because you can't claim back the VAT but when you sell it obviously you're not adding VAT to it so at the end of the investment.

FEMALE SPEAKER 1: I think whenever you do look at the numbers though is that the tax, the VAT and transfer duty just kind of all included.

INTERVIEWER: So, you just go take it into account when you doing it.

FEMALE SPEAKER 2: Yes absolutely.

FEMALE SPEAKER 1: No, but the one thing we did chat about is that there is a better recoupment or allowance if you own so many more townhouses [inaudible 0:12:45.6] which helps with your cash flow in the beginning because its accelerates, because the building allowance is 12% which really helps with your cash flow.

INTERVIEWER: Yes, what's the allowance on a residential...?

FEMALE SPEAKER 2: There's a rule, Mark that says if you've got, I think it's more than 5 – or more than 5 residential properties you can claim 5 per cent building allowance.

INTERVIEWER: Okay, is that – what into the – all the way down to – is it reducing down to 0?

FEMALE SPEAKER 2: Yes, obviously when you sell it [inaudible 0:13:22.5] recoupment but then at least you have the cash.

INTERVIEWER: Okay.

FEMALE SPEAKER 2: So, from a company point of view like if I think of those 12 townhouses we had, well we still have its just in another company I never – I was profitable but I didn't actually pay tax because I had that 5 per cent building allowance, so I never paid tax on the rental even though I was profitable for the first five or six years.

INTERVIEWER: Okay.

FEMALE SPEAKER 2: So, that definitely is one positive because you don't get that on a commercial building unless you're one of those [inaudible 0:14:05.0 which is few and far between].

INTERVIEWER: Okay cool, so are there any other financial constraints that you can think of or financial issues?

FEMALE SPEAKER 2: No, just getting the rent in from the tenant.

INTERVIEWER: Oh yes.

FEMALE SPEAKER 1: Yes, which I don't know if you want to address under management.

INTERVIEWER: Yes, I suppose that's more management, maybe collecting the rent is more management, so let's move on to the management issues. Do you guys have stuff that you prepared or should I just run through the questions and you can give me or let me know?

FEMALE SPEAKER 2: Yes, run through the questions then you can ask them more specifically.

INTERVIEWER: Okay, so the first one is what specific skills are required to be competent residential manager contrasted or compared to a commercial manager, do you think the skills are the same, what special skills do you need?

FEMALE SPEAKER 1: No, I think very different and the one thing we both agreed on is that they have to be very firm and almost quite callous.

INTERVIEWER: Okay.

FEMALE SPEAKER 1: I think you've got take the emotion out, I think it's much easier if you are dealing with a big corporate to kind of say: Listen chap, if you don't pay 7 days I'm chucking you out, versus the emotional family with 5 kids and saying I'm going to chuck you out, so you've got to be very clinical and keep up to date on it because if you don't and I mean yes. You've got to have a knowledge of the law to protect.

INTERVIEWER: Yes, okay.

FEMALE SPEAKER 1: That's the big thing is that there is that protection.

FEMALE SPEAKER 1: That Legal Tribunal thing.

INTERVIEWER: So is that protection law – do you think it's a bit of a constraint.

FEMALE SPEAKER 2: Yes [inaudible 0:15:51.0] absolutely We had a tenant, we actually bought a property that had a lease and actually came with and then they never paid their rent and then we sent them an eviction notice and they took it to the Housing Tribunal and [inaudible 0:16:06.2] the sheriff of the court or whatever, so it was just a nightmare.

INTERVIEWER: Really, okay. And what about the manager skill set – do you deal – do you guys - have you been managing those properties yourself or do subcontract it to management companies and is there a difference in the management competencies of commercial managers as opposed to residential managers, do you think some are more professional than others?

FEMALE SPEAKER 1: I think we've only dealt with one property manager from the residential, it's a company and she's been fantastic and she's very hands-on so yes, she [inaudible 0:16:44.4] plumbers and electricians and cleaners and that kind of thing. It's not – I don't think you have to have a huge skill like you need a B. Com in property management. I think you've got to be practical and you've got to be willing to give, coordinate and do a varied range [inaudible 0:17:03.8] range of things from plumbing and electrical and dealing with cleaners and so yes.

INTERVIEWER: Okay and what about the management costs, do you think the management costs are higher?

FEMALE SPEAKER 2: No, I think they're about the same.

INTERVIEWER: Are they?

FEMALE SPEAKER 2: Yes, in fact I just – when I got your list I made 1 or 2 phone calls and at the moment it's for residential is it is 3, well, okay, that's what we pay, so I don't know, I think up to 5.

INTERVIEWER: Okay.

FEMALE SPEAKER 1: Yes and to get a – for commercial it's also about 3 and a half.

INTERVIEWER: For management on the gross rental?

FEMALE SPEAKER 2: Yes.

INTERVIEWER: Okay and what...

FEMALE SPEAKER 1: So I would say they're the same.

INTERVIEWER: And what about the operating costs of the properties, is there a difference between the operating costs of [inaudible 0:18:01.4] industrial is like a triple net lease whereas perhaps residential you've got to take the rates and levies into account which does that make a big difference [inaudible 0:18:15.1].

FEMALE SPEAKER 1: No, I think [inaudible 0:18:15.1].

INTERVIEWER: Because there's more variables involved, cost variables or how does that affect you?

FEMALE SPEAKER 1: You know the cost for your commercial – your triple – look you obviously have various types, so where we've got mini units with smaller tenants we often pick up base costs and then they pay increases but and then obviously our triple net leases we don't pay a thing, well most of them anyway, so those are great. When it comes to residential all of ours anyway in our situation we pay all the rates, we pay insurance, we pay levies, we pay everything except they pay for electricity and cleaning.

INTERVIEWER: Yes.

FEMALE SPEAKER 1: So, it's everything else we'd have to pick up the cost and you almost want to, Mark, because you don't want them to fall into arrears because then ultimately you're responsible for that so.

INTERVIEWER: Yes sure but you get...

FEMALE SPEAKER 1: [inaudible 0:19:15.3].

INTERVIEWER: Do you think that makes it a little bit more tricky or is it like a little bit of a – a bit more tricky with residential because there is that issue of more variable expenses or more variable costs?

FEMALE SPEAKER 2: I don't think there is because on a commercial property you don't have to pay rates [inaudible 0:19:34.9] you're going to pay levies so can't say then more costs, no I think there would be [inaudible 0:19:46.5]

FEMALE SPEAKER 2: Because you would pay in most of your [inaudible 0:19:51.5] you would just pay the bank.

FEMALE SPEAKER 2: No, I know but you built that extra saying my rent is 10 but I'm actually going to charge you 11 because I'm paying rates and that, so I think you build those costs in but then it comes back to what is a market related rent so you [inaudible 0:20:09.9] include this in charging your rentals but it's no use saying: I have to charge 10 000 when you can only get 8 000 in that area for those units because that is what the, the market determines

FEMALE SPEAKER 1: And the other things is if in residential if you're picking up that full cost, I mean say that they decide to drastically increase as they did in Durban about 2 years ago they drastically increased their rates. Now, if the tenant is picking up the increases they have to absorb that cost whereas with residential you've got to pick up all those costs.

INTERVIEWER: Yes and what about the leases, the lease terms, do you think that's a – do you see it as a constraint that the leases are shorter in residential or does it not really matter or what implications does a difference in lease terms have in your [inaudible 0:21:00.5]?

FEMALE SPEAKER 2: Well, I think if you have a longer term lease obviously that would be favourable because I think that helps you going back to funding because the banks and the security and the whole thing, you know its guaranteed income coming in. I know with most of our commercial as well, I'm talking about our smaller ones anyway, we have sureties and deposits and everything from those tenants whereas residential I think if you have a deposit but you're not going to sign surety and as a business you [inaudible 0:21:37.7] have some assets that you can take if need be, your lease hold, improvements and, and, and whereas if the guys in your residential home I mean the [inaudible 0:21:51.4] so

FEMALE SPEAKER 2: I think yes the leases in a commercial property are a little bit more supported by law like contracts and all that kind of stuff when leases for an individual on a private property they're going to – residential property it's kind of not as enforceable and a whole lot [inaudible 0:22:15.7] I think [inaudible 0:22:17.0] with the legislation [inaudible 0:22:21.1] the only amount you have an individual sign up for 2 years' maximum.

INTERVIEWER: Okay and I suppose they can also leave whenever they want, really, it's like a month notice.

FEMALE SPEAKER 2: Yes [inaudible 0:22:32.3] the remaining balance [inaudible 0:22:35.3] you actually don't do it so there seems to be more protection and rules and regulations in a commercial than a residential let.

INTERVIEWER: Yes, okay and what about the investment market information available out there, is it – because you know in the commercial space its quite – is established – for instance if you're in listed property maybe it applies less to you guys but there are benchmarking indices and you can say: Well, whatever, listed property is earning this and you can benchmark and you can – or commercial – the [inaudible 0:23:12.0] that and say industrial in this area is achieving this on average and retail is achieving that so you can benchmark your investment against that whereas residential really doesn't have and of that type of benchmarking and also benchmarking of the gross rentals for an area, all of those records are much more kind of established for commercial, does that affect your – is that a constraint in residential property maybe or is it a I mean ...

FEMALE SPEAKER 1: No [inaudible 0:23:40.4] it has an impact but I think the way we are here it comes down to the numbers and that is how it works for us, so we know that's the kind of return we will want and so that's what we – so whether I suppose its low or not for somebody else we just say that's what we prepared and that's what we want to achieve and so if it [inaudible 0:24:05.2] well that's it, we're obviously not like a listed fund where you've got to have this and that and so yes, or us that – but I mean obviously the reality is there isn't much information out there, so for us it's not really a big thing because we do our own things and benchmark whatever, so whether its actual shares versus a property that's residential commercial doesn't actually make a difference for us.

INTERVIEWER: So, what do you guys look for now, what's your hurdle rate?

FEMALE SPEAKER 2: Well, 20 per cent.

INTERVIEWER: Yes, 20 per cent are IRR?

FEMALE SPEAKER 1: Yes, you know [inaudible 0:24:49.0].

INTERVIEWER: And is that with what kind of gearing or is that 20 per cent on the property and then excluding [inaudible 0:24:55.4].

FEMALE SPEAKER: No, we normally, no it's normally, it would be before gearing. Mark I think it is, it's before.

INTERVIEWER: Okay, all right and then so and what else – are there any other constraints that you guys see in residential property in particular and you know social or legal, political constraints or is there anything kind of – are there any other residential property constraints that an investor in South Africa would face do you think?

FEMALE SPEAKER 2: The biggest thing for us would be just the whole legal protection probably for the individual [inaudible 0:25:50.1] for almost 6 months and not pay rent and then you still got to pay all the legal costs in going and you've got to submit something to the magistrate and its hugely onerous and costly.

INTERVIEWER: Yes sure.

FEMALE SPEAKER 2: And I think also because as a country we are now with people being retrenched and, and, and its kind of on the down, the economical situation is that you are going to find more people that are going to struggle and are not going to be able to meet their commitments.

INTERVIEWER: Yes I suppose so, okay.

FEMALE SPEAKER 2: And then to me the other thing is how they look after your property some are very good but it seems like the majority will – we had a situation where we've had Chinese people move in and they have about 10 people in the property and you can't get all the grime off the stove and you've got to chuck away this and chuck away that was the one thing when we did sell we would often have to reduce our price because the carpets were dirty and like really bad, that they then literally be ripped up or there was [inaudible 0:27:08.4] so even though we've got value for the property almost all of them we had to at least reduce price, 5 per cent I'd say.

INTERVIEWER: Really?

FEMALE SPEAKER 2: Yes but then there were some people who really looked after them well but that's been a smaller percentage.

INTERVIEWER: Yes sure and what...

FEMALE SPEAKER 2: And commercial property there's less for people to really stuff up.

INTERVIEWER: Yes, I suppose so and you yes.

FEMALE SPEAKER: So the carpets really in a residential and because you kind of get somebody [inaudible 0:27:44.0] they almost felt responsible for that and they take that all out [inaudible 0:27:49.0] so you can't do as much damage, you know?

INTERVIEWER: Yes sure.

FEMALE SPEAKER 2: Yes, so we don't find it very positive [inaudible 0:28:01.5].

INTERVIEWER: But why not, is it just because it's more management intensive or why don't you?

FEMALE SPEAKER 2: I think that's probably the biggest thing. I think you can overcome funding and we'd had to negotiate but we've been able to get to reasonably good funding that's been very much marketable but I think our biggest experience and probably negative as being the – when we say management not – we've got a very good property manager so it hasn't been really a problem but the risk when people don't pay [inaudible 0:28:44.9] or then the treatment of your property and those have probably been the 2 biggest negatives for us.

INTERVIEWER: Really, okay. Cool guys, thanks.

FEMALE SPEAKER 2: But the flipside is that if you're running on a limited amount to invest and it's a great way to start to build up [inaudible 0:29:05.9] don't have to outlay R10 million on a [inaudible 0:29:11.0].

INTERVIEWER: Yes, definitely.

FEMALE SPEAKER: On a sort of like a couple of factory units, you can start off maybe at an 800 [inaudible 0:29:18.8] bachelor flat and rent that out so but for a company, I don't know if that's what funding – that's not always an issue that you want to start small.

INTERVIEWER: Yes, okay cool. Perfect, well that's the end of the questions unless you guys have anything else to offer or add...

FEMALE SPEAKER 1: No, [inaudible 0:29:40.2] is just to say I know with – okay but it's obviously an individual which is different, which is not what you're asking but if an individual buys a property and they want to get a bond the bank will not look at that lease that you've got there, they will only look at whether you as the owner can support it, they don't take lease into consideration at all.

INTERVIEWER: Yes I suppose – that's true but it's also – I think that's changing though, just depends on the market how the banks are actually looking at leases again. I know that

some of the banks will look at your rental income if on other properties if it comes into – if you bank with them and it goes into their account for instance and Absa's launched a new product now which is like an investment property bond, which also takes into the account the lease as well as your income I think, so.

FEMALE SPEAKER 1: Oh.

INTERVIEWER: It does depend but I think definitely they don't just look at the lease like commercial where that is [inaudible 0:30:47.2] its more to do with your personal income than what the lease says but that's also a constraint because you guys were talking about the banks being willing to lend at 90 per cent and sure they'll lend at 90 per cent but that's only for your first or second property and then it's all the way back down to 50 or whatever you can't perpetually borrow at 90 per cent either, which sucks.

FEMALE SPEAKER 2: No, but I think, Mark, there are such loans like if you can rent as a company to invest you have that allowance – if you can find – to me it's – I have the money but [inaudible 0:31:22.5] you get a well-known company but say Pick n Pay you want to have ten of their managers that they've brought down from Zimbabwe and they put them in there and they going to rent those 2 units from you for the next 3 years and they're going to have varying people in it but they of an professional standing there will only be maybe maximum 2 of them because it's a work thing, that to me is a very attractive kind of investment in a residential property where the residential property almost becomes a commercial thing, if you understand what I'm saying.

INTERVIEWER: Yes sure.

FEMALE SPEAKER 2: And you can [inaudible 0:32:04.5] the leases with a reputable company [inaudible 0:32:08.6].

INTERVIEWER: Yes so would you guys look at residential again or not?

FEMALE SPEAKER: Sorry?

INTERVIEWER: Are you guys looking at residential again or not really at the moment?

FEMALE SPEAKER 2: No, [inaudible 0:32:16.1] but the one residential unit where we have got a good lease for the company actually does work.

INTERVIEWER: Oh does it? Where is that, is that.

Participant “F”

INTERVIEWEE: One. Financial Issues: Is liquidity a constraint in residential property investment relative to other property and asset classes? Yes, I think it's a major constraint. I think that the banks have a much more constrained view in recognising debt for residential properties. Particularly, the bigger developments and I think probably a part of that is that you're not really dealing in the listed vehicle market so you have different balance sheets or they're looking at a different balance sheet, from a developer point of view. And I think that banks are, even from a psychology point of view, have a different approach towards commercial-industrial on the one hand and residential on the other. I think there's been a history in South Africa, maybe more widely as well but certainly in South Africa, of big residential developments failing and I'm talking about over the last thirty, forty years but there've been a number of them. So, I think those scars are still there and I think banks are more cautious about residential.

So to what extent does liquidity influence our decision to invest? At Summercon, fortunately not hugely. Obviously, liquidity is always important but we're not looking for bank loans in order to develop. If we were, I think it would make our business a lot more difficult because of the constraints banks usually impose on residential developers that they sell out a certain portion of the development before they can do drawdown of capital.

Compare the financial return between residential and other property asset classes. I'm a little bit out of touch in this regard now, Mark. But, I would say that decent commercial industrial assets at the moment, are probably selling at around about six percent yield, maybe five or even four if you go into the really good categories. Whereas good residential property, you're getting a return of around about six so, it's comparable. There's more admin in a way because your leases are generally a short-term lease – maybe one year, occasionally two or three, but generally one year. Whereas your other type of tenancy in industrial-commercial will vary between three and ten. So, it's a sort of an easier administrative situation. But not necessarily so, your big shopping centres have a lot of administration involved in them and you need to be at the head of your game all the time, from a marketing point of view, redevelopment point of view, and with residential you don't really redevelop. So, each of the sectors come with their own baggage. Probably, the easiest is industrial.

Is this return sufficient to attract investment?

Yes, it is but it's a certain type of investor. Again, it's more your man on the street type of investor. There is a trend at the moment which seems to be emerging for a larger investment company to start considering residential. We are seeing it coming into the market. It's still early days and whether that will mature is yet to be seen. We've seen this before also, that institutional investors coming in, very often they exit within a ten-year period, not to be seen again for another cycle or two and then it's repeated again. The real, steady investor is your man on the street that buys between one and ten, over a period of time. How volatile are these returns? They're not very volatile. They're pretty stable and if they are volatile they generally will be volatile upwards in a bull-market where they will then go to eight or ten percent yield, and this is excluding capital gains, this is, the six percent yield is excluding capital. But, in certain bull-markets, that yield can go up from six to eight, maybe even nine or ten and then obviously capital gain in a bull-market also can be considerably more than on average. But, your average capital growth is probably around about 4 percent per annum.

Are there financial or tax constraints specific to residential property investments? Well, financial we've discussed. Tax constraints – there aren't any. You're taxed on your net income but you also are entitled to recover your losses. So, the typical investor would probably look to maintain his investment with a reduced bond amount outstanding so that by and large, the income that is received is enough to cover the expenses so he would be in a net non-taxable position, at least for a period of time and that's relatively efficient. What specific skills are required to be a competent residential manager? It is definitely a specialist position and it's not very difficult. They don't need to be highly educated or intelligent people. It really requires people that will repeat a set of set procedures, of which are not very difficult. You will have to add to that a bit. Are there competent managers in this field? Yes, I think there are. I don't think there are lots of them but I think there are. I think we've managed to secure the services of two different companies that we give repetitive work to and we manage their skill competencies as best we can. But, they're not bad at all. Is management's skill-set a constraint in the residential property investment market? I think it is a challenge but it's a moderate challenge. And I think that it's not so much in the management of the

developments per se, it's more in the letting agent field, that probably, their skills could be improved where the industry is large enough to attract a brighter quality of letting agent. Are management costs a constraint for residential property investment? No. What are the differences between management costs of residential property as opposed to other property class assets?

I would say that probably the percentages are quite similar where, other property class assets, the real efficiency is particularly in industrial, is that there's not a lot of management that they have to do. Leases might be renewable every five to ten years. The nature of the buildings themselves doesn't require that much maintenance or management. Obviously, there's some... Shopping centres are different, office blocks I would say are probably somewhere between shopping centres and industrial from a man hour point of view. Residential property would be quite intensive, at least on the level of shopping centres. But, I don't think that the costs are disproportionate in residential. Investment and property market information: Is the lack of portfolio performance and the benchmarking indices for residential property a constraint for residential property investment? I would say that the answer to that is yes, if you're a listed vehicle or you're an institutional type of vehicle – pension funds and so on, because I don't think there is that sort of information out there, readily available. And, I think it's necessary for that sphere of the market to show some quite considerable improvement before these types of investors more generally come into the market. I would imagine that's one of the major reasons that they're not in the market but it's a catch 22 - in order to get that information, more of them need to come into the market; otherwise no one's going to bother to capture it. Does insufficient property investment information such as portfolio performance et cetera, create unexploited opportunities? Yes, it definitely does. Because I think if there was more information and it showed decent returns that were sustainable, I think more institutions would come into the market. In a market like South Africa's is there really room for a big market like this, residential wise, for those investors? I'm not sure, I don't think so. I don't think that there's a big enough population of buyers for this sort of property, to make a portfolio big enough for ten or fifteen players, proper players, to really get interested. I just don't think there's enough of that population. Probably, if South Africa's population was fifty million, the people investing in this market may be five million. So, it's just not big enough. If you were to go to America, you're going to get the numbers, I would imagine, and possibly in other parts of the world as well, but I'm not sure, in South Africa. I think it's going to remain a sort of peripheral business for institutions. There'll be a few but I don't think we're going to see a residential property board on the JSE.

INTERVIEWER: And what about the size of the transactions? Do you think that's also a hindrance or constraint to - in terms of building a portfolio and finding a sizeable and a big enough transaction size to invest in?

INTERVIEWEE: Well, if we look at Sandton, generally now, Sandton Central. If a fund or two decided now that, they were going to go into that market and buy those types of investments, then that is a really good investment for a listed vehicle. For instance, there's a new launch which is going to be called The Beacon – its two hundred and forty units in Illovo and they're coming in at around about two million Rands a piece – that, I would imagine, for an investment vehicle is a fantastic buy. All of it. And if you've got a couple of vehicles that specialise in buying that type of investment in Sandton, Joburg or at the Waterfront in Cape Town and possibly now next to the harbour in Durban, with the massive new investment that they're talking about there, then those types of investments, I think would be good investments for those types of vehicles. Whether they would be interested in the long-term in buying one-beds and two-beds, sectional title, that are not in the big blocks but are more a la Summercon or other similar developers. I'm not sure that that would be as interesting for them, generally. Although, there are one or two that are making those investments now. Other issues: What social, legal or political constraints are there to residential property investment? Obviously, the social constraint at the moment is the mismatch in South Africa, between the haves and the have-nots. There are far too many have-nots and socially, we don't see a big enough growth coming into this market out of the South African population. It's been very disappointing, the transfer of wealth into the black middle-class, who might want to buy a type of investment, residential investment that we offer, there simply don't seem to be a substantial number of those coming through. And we've seen very slow growth, if any growth at all, in the acquisition of our model by what were called, the previously disadvantaged people of South Africa. So, they remain, it seems to us, disadvantaged. If they aren't, they not buying our products. So, legal? No. There are no legal constraints. Anyone

can buy. Political constraints? There are no political constraints. So, the constraints for social are economic. Are there any other constraints that the residential property investor faces in the South African context? Yes. Our confidence is a constraint, lack of confidence. So, that's a political lack of confidence and an economic lack of confidence. People feel either at times, insecure about their own jobs or position...

INTERVIEWER: So, would you say that maybe then there is a political constraint in the sense that the maladministration and kind of bad market sense might limit...

INTERVIEWEE: When I said there's no political constraint, what I meant was there's no legislation...

INTERVIEWER: no direct...

INTERVIEWEE: there's no direct legislation that prohibits a class of people from buying. But what the politics, the current political climate in South Africa; the consequence of the maladministration and general lack of confidence in the ANC, leads people to reconsider whether they should make a long-term debt. It's not about owning the property for a long period of time, it's more about taking on long-term debt, and they don't feel comfortable about certain issues – including their own jobs and so on, but also the political future of the country and so on, that they're less likely to make the investment in property.

INTERVIEWER: Also, I suppose it becomes less attractive if the country's growth rate is close to zero, so what is your capital growth going to be like? Which is a huge contributing factor...

INTERVIEWEE: There's no question about the truth in that. So, if we continue with the one percent growth rate, or something along those lines, even though inflation is around about five, the constraint on capital growths will, in due course, become evident. Breaking of constraints identified? I think the major constraint is confidence. I think that in a market where the consumer is confident about his or her future and the future of the country, we generally have seen over the years, a much larger appetite for the kinds of residential investment that we offer. Where the confidence level is low, then other things follow. Very often, together with low confidence, is low economic growth. Low economic growth spooks the banks and makes them more cautious, so you get yourself down towards a perfect storm and then all those things work against sales, and then our product market slows down just like everyone else's.

Participant “G”

INTERVIEWER: Okay, thanks. Well there are three main themes that kind of appear. Those are around financial constraints, management constraints and the availability of information in the market. So, with regards to the financial constraints, do you think that liquidity is a constraint in residential property investment? From both the availability of finance and also the size of the transactions. Transaction sizes and the ability to find big enough transaction sizes and chunks to make it viable.

INTERVIEWEE: Are you talking about for a fund type investor or an individual?

INTERVIEWER: Well, it's quite open. So, I mean the three kind of broad types that I'm looking at are listed vehicles, individuals, and then institutions, you know. From your perspective, really?

INTERVIEWEE: Well Mark, if you talking financial, the financial constraint and it's an institutional investor or a fund or even a large private investor. I don't think the financial constraints are as tough as they are as an individual. I mean, as you know, if you going to get finance for a block of residential properties. If you doing it through a company, it's not that much of an issue. I think you've still got to go through the hoops, probably more so than you did five or ten years ago. But, as an individual it's a different story. There the credit criteria are different. They look at income very much more so than they do as a company. So, there are differences in terms of financial constraints there. But you know, quite honestly I don't think that's a big constraint for a big investor. Not in residential. I mean if I were to buy a block of 20 units for example, I think I could get interest only type of finance. I wouldn't get it for a 10-year period, but I would get it for a reasonable period of time, relatively easily. I think. Given there is a balance sheet. I'm not so sure that there is a financial constraint.

INTERVIEWER: And what kind of rates are you looking at, just out of, of interest?

INTERVIEWEE: In the old days you certainly were able to get prime less quite a lot. I think today, you probably going to pay prime plus something. So the interest rate environment has changed a bit. So ja, definitely the finance costs are more. But I'm not convinced that it's a real constraint...

INTERVIEWER: And what about liquidity in the sense of the size of the transactions. Is it a bit of a barrier or a bit of a constraint finding transactions that make it worthwhile for a larger investor to participate in the market?

INTERVIEWEE: Ja, that's the problem. If I look at the way that these residential funds are cobbling themselves together. To me it looks like they are either developing blocks themselves, like it might be an apartment block. Or if it's a mixed-use development then they taking the residential as a block and then doing the rentals out of that. So, that to me is [taking 06:51] far more a constraint. How do you actually build a decent, a chunk of revenue in one go? So that's not so easy. You know if you're in commercial, you go and buy an industrial property or an office block or something. You know, you can get a nice chunky size with one transaction. Residential, that's more difficult and you know you also don't want them spread. One apartment in this block, one apartment in that block, one apartment in that block. You looking for a manageable block so that your management costs can come down quite substantially. So that is more of a restraint. There I'd agree with you.

INTERVIEWER: And what about, is there a difference in returns that you have experienced in residential versus commercial and can you compare the risk and return profile of residential property as opposed to other property asset classes.

INTERVIEWEE: Well I mean, you going to be more qualified than me to answer that, but I suppose risk and return. I suppose the advantage of residential is that you far more diversified over a bigger base of clients. So that your risk of bad debt and all of those risks are probably spread out. In terms of returns, you know the only residential property that I've got at the moment are ones that I've had for a while. So the returns are actually pretty good, because, but I've built them up over time. But, if you buying an apartment block now, and you are getting returns in excess of 7 or 8 percent. I think you're doing bloody well. And that to me doesn't seem like a great return. I don't know what you're finding.

INTERVIEWER: Well if you buy something from us, you will get a 7 percent net return...

INTERVIEWEE: Do you get 7 percent?

INTERVIEWER: Unfurnished, you'll definitely get 7 percent with us. I don't know I think maybe, I chatted to a recently listed purely residential fund and they only acquire properties 9.5 and above. But I mean that's kind of inner city stuff. You know we have those kind of matrix deals that come our way once in a while. Huawei or corporate type of deals and those

offer around 9 percent, with no real kind of research or background. But I mean, if you looking to build a portfolio either you make sure that you come across those types of things consistently. You actually going to have to go out... I think 8 percent is quite reasonable, but it's not high.

INTERVIEWEE: Ja, if you developing now in the commercial space. You've got to be quite gutsy to accept a return of less than 10 percent...

INTERVIEWER: What do you find? Do you find that you can reasonably expect a return of around 10 or more in commercial property?

INTERVIEWEE: Ja, in the smaller stuff. I mean if you going for the very big retail centres and that kind of thing, it's probably more of a challenge. But in the smaller stuff, if you're developing. You're definitely looking at that. You need that safety margin. But then the risk profile is different. You know, you are looking at a bigger investment in one building as it were, as opposed to spreading your risk. Tell me, why are these residential funds, why are they setting up? What is the logic behind it? Because it's never been a great investment from that point of view. You can understand individuals doing it, because they can afford to do one apartment here, one apartment there. But, what is the logic of doing 8 or 9 percent initial yields on residential. I mean, are the escalations that much better?

INTERVIEWER: Are you asking me or is this a rhetorical question?

INTERVIEWEE: No, no, no, I am asking...

INTERVIEWER: From what I have heard from those guys is that now comparably, the residential yields are actually very competitive because they looking at 9.5 or 10, maybe up to 12 percent on commercial property. Because when I saw who bought over the last couple of years, you looking anywhere between maybe 4 for a top, top class asset to 7 or 8 percent for you know a good listed fund type of asset purchase. So, comparatively the returns are better, they also point out that although it is actually slightly less risky because you do have so many leases and so many tenants and although they're short term. You know it's very easy to massage, smooth that out into more predictable returns. I think there's an appetite for more properties. I mean properties outperform historically. So there is a huge appetite. It probably isn't at the top of the cycle. There is a huge appetite for listed property assets, so I think they've just run out of other assets in the country to buy.

INTERVIEWEE: No, I don't think that's the case. I mean you can buy into the bigger list of funds now and your yields are, I mean your growth points are operating on a full 13:01 yield of probably what, 6.5. I don't know what they are at the moment, but...

INTERVIEWER: Really? I thought it was lower than that.

INTERVIEWEE: The smaller funds are over 7.

INTERVIEWER: Ja, but I mean you buying [truck? 13:11] property in a lot of those as well. And I don't know if they are over 7 at the moment. I haven't had a look for a while, but I mean...

INTERVIEWEE: Ja, and then you can get some of the offshore stuff, like there is a company called Sirius that is listed here. All the investment is German industrial property. You getting a yield of over 4 percent in dollar chips. So, and there you've got a diversification of assets in the fund etcetera. Why would you develop a property at 4 percent yield in this country? I haven't heard of anyone doing that.

INTERVIEWER: Ja, What's Hi-prop's yield at the moment? I think it's around 4 percent?

INTERVIEWEE: Ja, I don't know actually.

INTERVIEWER: Definitely, there is a lot of options and maybe possibly safer places to put your money at a better yield. But, if you looking now at Indulu Place, that's kind of Arrow Head Subsidy that's just listed and you looking at a 9.5 or 10 percent forward yield. You're doubling the yield on Sirius, if you put the currency risk aside and put currency fluctuations aside, you know you buying into a vehicle that's returning twice a yield on an annual basis. So I suppose that's quite attractive for certain people.

INTERVIEWEE: Well you've got to look past the yield that the shareholders are getting and bear in mind that with Sirius their funding costs at 4 percent, their yields at 8 percent. You know, if you look at Arrow Head, their funding costs are nowhere near 4 percent.

INTERVIEWER: Ja, they probably around 8.5 or 9.

INTERVIEWEE: So you know you've got to look at the fundamentals and say what's going to happen 2 or 3 years' time with those kind of businesses. That's the appeal to me of that Sirius model. And we not there yet in South Africa, our funding costs are still too high. And we haven't got that scenario where the yield is double the funding cost, which is obviously a very attractive place to be. Ja, I don't know. Are those the kind of restraints that you're

actually after? I mean, are there not bigger restraints? I mean, take a developer, take Summercon for example. I mean if you look at the restraints that you guys operate in terms of bloody well getting land zoned, going through the inefficiencies of the development process, dealing with government...

INTERVIEWER: Is that different though? I mean how would you say that differs from commercial property that still has to go through the same zoning processes that...

INTERVIEWEE: No, no, no I agree with that. But you're asking in terms of residential. I agree with that. I mean to develop in Joburg now is not an easy task. I mean there are hoops that you need to go through. You know just electricity alone, or access to services, the amount of time you have to wait. In a smaller kind of example that property we've got in East London, to try and get services in there has been a nightmare. Okay East London is quite... is something else. But you know that kind of thing is not easy. And in Cape Town it's more efficient, but the authorities are getting tighter and tighter in terms of the regulatory side. I mean the nightmare we went through with the Old Bakery to get fire approvals; it took us almost a year. Those to me, from a developer's perspective are real restraints and that's why for me, I'm so hesitant on development. That just adds huge risk because then you're playing with your initial yields. You need a real margin of safety to make these bloody things work. But I don't know what your angle is? Whether it's from a developer's point of view, or whether it's from an investor's point of view?

INTERVIEWER: Look strictly speaking I am looking at it from an investor's point of view, and then either as a private, you know, individual or a bigger private entity like you know, some type of fund or a listed fund. But it's all interlinked.

INTERVIEWEE: And so what is the basis of your thesis then? What are you trying to prove or disprove?

INTERVIEWER: Well I am trying to identify the major constraints to investment in residential property in South Africa, and by that I suppose you can further define it to the constraints in residential property as opposed to investment in other property asset classes. So, what makes residential property more difficult, if anything, to invest in or what are the pitfalls, what makes it more tricky than buying an industrial, you know, buying some logistic... some warehousing space in Midrand or buying a small shopping centre. What are the differences and what makes it more, if there are any constraints what should people be aware of when they choose to invest in residential as opposed to something else, within property investment.

INTERVIEWEE: Ja, things like tenant risk, leases are far shorter term, your tenant risk increases with an economy that, I think probably ratio wise increases substantially with a negative economy to some of the longer term commercial leases that you'd have in place.

INTERVIEWER: What are your views on that? Does it make a difference if you take an individual residential lease then it certainly doesn't stack up against a stronger commercial lease, in terms of the legal protection that the lessee has. You know, the ease that they can get out of the lease, the lack of recourse the landlord has. But do you think it also differs, is there like economies of scale almost in residential leases because if you get to certain stage and those things almost become irrelevant. As you pointed out earlier, because now you've got so many leases and you can almost easier to smooth out the effect of those defaulting tenants and vacancies because it's so easy to replace them. It's very easy to replace them, and it's a lot easier to maybe manage multiple residential leases...

INTERVIEWEE: Ja, I would agree with you, if you were a big investor. So, if you've got 100 or 200 units or whatever your number is. That is a different thing. But, if you're an individual. That's why I'm not quite sure which angle you're coming from, because if you're an individual, that's a substantially different picture. You might be sitting with 5 units and 2 go bad, you know that's a big number. That's 40 percent of your base, and then the other thing is, as an individual if you are say trying to buy 20 units. Your financing definitely becomes a lot more difficult than if you were buying similar size industrial property as a single thing. The banks are not going to finance you, they see it very differently. And there are not many banks that will give you kind of 10-year finance like that, they wouldn't treat it as commercial. So that, going back to your initial point about financing, then I'd say that would be a restraint in that particular instance.

INTERVIEWER: Okay

INTERVIEWEE: But, I mean the more fundamental restraints. Ja, I mean you're not going to look a country risk or anything, I don't know if you're going to do that?

INTERVIEWER: Well I mean, that is a part of it. You know, I'd say I've isolated it to...

I've put it in a South African context. Because obviously there are different risks across borders, so maybe looking... I wouldn't necessarily compare it to different countries, but it's definitely looking at it in a South African context. So, for instance you know our social, legal and political background. You've got kind of a multitude of legal protections for tenants. You've got PI Acts; you know all that kind of stuff that really makes it... You know, well it protects tenants, so is that a risk? Some people say it's not really, so also from a larger investor point of view. They just manage those tenants correctly and there aren't many legal kind of constraints. But, I suppose again if you are a smaller investor and you've got one tenant that doesn't move out. Never mind having 20 percent of your portfolio vacant, there's an illegal squatter, actually a legal squatter for up to 2 or 3 years occupying your premises, that's maybe utilising your utilities and costing you a lot more than a vacant premise.

INTERVIEWEE: Ja, absolutely. Also, I do think there's a differential risk between Cape Town and Joburg for example. And there's a reason why the property prices are different. Because first of all, in Johannesburg I think there's more land available, it's easier to buy property there. But, by the same token, you have the uncertainty as to service delivery. And I think that for me personally, that's a restraint. I'm locally, very nervous. We tried to, when was it, about a year ago we tried to move some property, well we did move it, but it took bloody ages to get this transfer to take place. And I sit back and I say that's an impediment. Why do I have to go through this and that thing? And now I've got to liquidity issue when I try to get out of the investment. So liquidity now becomes a big issue for me at a personal level. If you've taken gearing and you've maxed your gearing and you now want to try and offload and get a bit of liquidity, it's not easy. It really is not easy. And I say to myself, what price am I prepared to pay for liquidity? And that's quite high at the moment, quite honestly.

INTERVIEWER: So do you think that the processes are easier in Cape Town or better administered?

INTERVIEWEE: Administered better and service delivery is a little bit better. It's not a major amount better, but it's easier. But the problem is, the prices are higher and I'm not so sure that your yield opportunities are there. The rentals are much higher here. I mean you can get a bloody rental for an unfurnished 2-bedroom apartment for R30 000 in Newlands, but you paying a big price for that. But, the liquidity risk here in Cape Town I think is a little bit less. So I don't know if that does come into it. But certainly for me, I have turned right back on residential investing.

INTERVIEWER: You have?

INTERVIEWEE: Ja.

INTERVIEWER: Why is that? I mean what are your motivations or reasons for it?

INTERVIEWEE: My main one is liquidity. I can't take the risk of taking a year to do a transfer of a property.

INTERVIEWER: Oh you say you've turned right off it?

INTERVIEWEE: Turned right off it.

INTERVIEWER: Oh okay.

INTERVIEWEE: I'd much rather get a lesser yield and invest in a property fund or in a bigger commercial property, where I've got more gearing flexibility and that kind of thing. And I don't think the residential yields compensate for that sufficiently and that's at a personal level. Having said that, if my kids were keen to get into property, I would suggest the first thing they do is start with apartments and then they learn the tricks of the trade etcetera and it is nice and easy to get into. But, if I were to look to invest in 100 units of residential, I would be very, very hesitant.

INTERVIEWER: And what about, there are some management issues that keep on popping up in the literature and in conversations, and those are asset management and property management issues combined. Do you want to answer that?

INTERVIEWEE: I would imagine that these big funds buy blocks of property. They are not going to buy one apartment in a block. I would imagine. So, your management issues become a hell of a lot easier. I mean when I was buying groups of townhouses from Summercon, it would always be in one particular development and that just made the management a hell of a lot easier. So, I think there are ways around making the management easy. It's obviously a lot more intensive in terms of, if you're dealing with thousands of different people. I would imagine the management costs are substantially higher. But I think that's just a case of getting organised. If you're a small investor, you can't really employ a management company because your returns get hammered. But, the bigger you get, the more you can spread your management costs across more units. And that for me becomes less of

an issue. I haven't got an opinion on asset management.

INTERVIEWER: And what about the skill set of the managers in residential property, are they comparable to the expertise and skills that you can find in commercial property management?

INTERVIEWEE: No, that's a very good point. No, it's such an easy game to get into. I think you'll find every Tom, Dick and Harry trying their hand in residential management and finding that they get bombed out by volume. So, I think that's quite a good point.

INTERVIEWER: Okay, so would you say the cost to employ the managers are relatively high compared to the commercial property management?

INTERVIEWEE: I think they are quite high. Summercon deal with a crowd... I can't remember their names anymore. Angle I think. They were charging, they charge a flat fee, I don't know what it is now. I must admit, I don't use them. But, you know it was kind of a linear thing. To me it looked, if you had 100 properties you weren't getting a hell of a big discount percentage wise than if you had 10 properties and you know those costs seem to be high. I eventually ended up employing someone and I found that that worked for me. But you know, that's a big risk in itself. But, I would imagine that the bigger guys are employing their own staff and bringing it in-house...

INTERVIEWER: Well, the guys I've spoken to actually aren't. The gross yields on residential are almost astronomical actually. I mean, they're willing to sacrifice you know 5 to 7 percent gross rental yield to management, because it is so management intensive. So they taking a 5 percent on their gross income at least, knock. They are buying properties on a gross yield of close to 15 percent and on a net basis it comes closer to 9 or 10 percent. So the costs are high. But, a few people have mentioned that although they are high, it's always a consideration...

INTERVIEWEE: It's a huge consideration. That is hell of a high. If that's what it is, that's a huge constraint.

INTERVIEWER: What about the actual property costs and the different structures of the leases? For instance, you've got to absorb possibly quite a few more costs in a residential lease, than you do as opposed to, certainly in an industrial lease, it goes on a sliding scale. But, is that a risk that you know electricity is passed on, but rates and levies are, if you buying a sectional title, levies. And if you not buying sectional title than all the associated property management costs, insurance. Those are all absorbed by the landlord. Do you think that there's a risk in, kind of South African...? We tend to be; we are in quite an inflationary environment for all taxes as well as just inflation in general.

INTERVIEWEE: There's definitely an advantage for the residential because you have got a shorter lease period. So once a lease is over you can change the lease to reflect the increases. Let's say you sitting with an industrial 10-year triple net lease. A lot of the time you don't have an opportunity to adjust unless you set your lease up that way. So I don't know if that's a disadvantage. I think a shorter lease period actually makes it easier to change it in time, whether the market can or not. I don't know. The other thing is, just going back to that management fee scenario. Let's say you're an investor and you have 100 units and you say you prepared to pay 5 percent. I mean that is a huge base. You're now competing with Joe Soap who's buying 1 or 2 units and managing it himself, so he's not prepared to pay that 5 percent because he's going to do it himself. So he's prepared to buy a unit at 9 percent initial yield, whereas you've got to buy that same unit at 14 percent to get the same return. So, you're competing with a guy who's prepared to pay a lot more for the property - that makes it quite tricky.

INTERVIEWER: Definitely, I suppose it depends on where you position yourself. If you're buying in the Northern Suburbs of Joburg or whatever you probably will be out priced on the market. But you know, if you are competing with, if you are buying inner city properties that take maybe a little bit more technical skill to maintain and manage and is a huge transaction. You can't just buy one R400 000 unit in Hillbrow, because you'll probably get shot collecting the rent. So, you really need to buy a whole block and employ the right security measures and maybe there are bigger barriers to entry where residential property can become profitable for funds and bigger investors, where there are all those kind of barriers as opposed to just the price barrier. Rob, what about... there's also... more from a financial investor's point of view as opposed to a real property investor's point of view, there's quite a lot of literature around the lack of portfolio performance and benchmarking indices for residential property and also general residential benchmarking information in terms of gross rentals in certain areas, accurate operating costs and comparable information. Do you think that's an advantage or

kind of a hindrance in residential property investment? If you were to buy into a fund now, is the lack of portfolio performance in benchmarking kind of a constraint, or do you think it's irrelevant?

INTERVIEWEE: It's an interesting question. If you're an institutional financial investor, it has to be a restraint, because we just don't have enough of those funds with enough of a history to actually look at what the performance is. I would agree with that 100 percent. That's as a financial institutional investor, I would agree with that. As an individual investor, I think it's less of a constraint because if you've got a little bit of knowledge of the market you can make that. But if you looking for portfolio performance, I mean I don't know. Three years ago there wasn't any residential funds on the market, so there's nothing to compare it to. I would agree with that. But I don't know how much of a restraint... I don't know what the investor profile is of some of these residential funds, but I'm sure it's priced in and there is some sort of a premium that you getting out of these funds.

INTERVIEWER: I think so. I mean that definitely seems the case, looking at what returns you can expect. It seems that institutions, big players firms come into the residential market every 20 years, and then disappear again after a while.

INTERVIEWEE: Ja, I must admit I can't really give an informed comment on that. I don't view it from that point of view and I don't have any interaction with any institutional investors on this. I can only give an opinion, but I can't give an informed answer.

INTERVIEWER: Are there any other constraints that you can think of, you know, what's particularly cumbersome for investing in residential property or what would you say people should be wary of?

INTERVIEWEE: Those would be the major. For me regional is a constraint, you've got to take a view on what you think is going to happen in our markets going forward. Our economic policies are going to affect the property market, whether we like it or not. We are sitting in a high inflation scenario, with a low growth rate and pressure on interest rates. That's a big constraint.

INTERVIEWER: But that seems like it's a perfect storm for rentals though, almost. People are going to be forced into the rental market if they can't, so maybe it's a good time to get in?

INTERVIEWEE: Well you need a bit of a growth rate for that to happen. If an economy is not growing, where are the increases? Where are your inflation related increases going to come from? I mean you know yourself. I mean let's say our inflation is running at 7 percent, you come to renegotiate your lease at an individual level with your tenant, they fight hard against any bloody increases. It's not a slam dunk. That would worry me. But having said that, the beauty about residential and it's the same with any property is, that as you reducing that debt. Some of the properties that I've held for 6 or 7 years, the yields are fantastic. So long term, it makes a hell of a lot of sense. I just worry that our economy and this kind of stagflation scenario, stayed for a lot longer than expected. I'm not so sure property becomes that interesting.