*Research Inventy: International Journal of Engineering And Science*
*Vol.12, Issue 3 (March 2022), PP 50-58*
*Issn (e): 2278-4721, Issn (p):2319-6483, www.researchinventy.com*

# The Risk and Uncertainties of International Real Estate Investment in Developing Economies: Nigeria Perspective

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***Abstract***
*Risks and uncertainties associated with international real estate investment especially in developing economies has been an important discourse as it concerns Foreign Direct Investment (FDI). Developing economies need to overcome their own challenges in the development process especially in the areas of capital accumulation and technological development. Again, it has been established that internationalized real estate investments plays a leading role for emerging economies like the Nigerian economy because it increases the capital investments base and offers important profit opportunities not only for the host country but also for the country investing. The aim of this study is to expose the factors that pose imminent risks and uncertainties in international real estate investment in developing economies. The study employed the use of secondary data for a qualitative analysis of the subject matter. The analysis showed that legal regulations and incentives to draw in investments creates an effective and favorable environment in Nigeria. Today, Nigeria does not only attract foreign investment, but also invests in other nations. These shows that having a role in multiple areas of the global economy improves the capital investment growth. The study recommends that government policies should be reviewed to create more viability to the Foreign Direct Investment (FDI). The study also suggested that developing economies can be enhanced if property markets are well coordinated and sustained. It also recommends that building materials should be manufactured locally so that the cost would be minimize.*
***Keywords: Risk, Uncertainties, Real Estate, Developing Economies, FDI, Nigeria.***

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Date of Submission: 15-03-2022 Date of Acceptance: 29-03-2022

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## I. INTRODUCTION

Developing economies need to overcome their own challenges in the development process regarding their insufficient capital accumulation and technological deficiencies likewise low income and low savings to succeed in the capital accumulation they have which takes a very long term. The financial globalization has enabled investors worldwide to diversify assets and therefore to distribute risk and to direct capital to places where productivity and expected returns are high (Quinn, 1997). During the late 80s and early 90s, new technologies facilitated the transfer of funds from country to country and improved the internationalization of assets (Garrett, 2000; Talalay, 2000; Sassen, 2006). An increased investor appetite for global investment in equities and bonds, and later property, has fuelled this global boom in international real estate investment which has helped to push down hurdles to foreign direct investment(FDI).The free movement of capital is known as the most vital component of the economic dimension of globalization taken together the conditions of FDI and it's been determined that real property investment has an increased share throughout the total investment figures in Nigeria.

In 2009, the flow of global FDI capital was 21% of global GDP (Lahiri, 2009), and FDI and loans are the dominant types of investment received by many emerging markets (Daude and Fratzscher 2008). For example, Daude and Fratzscher's 2008 survey of 77 countries found that: "in our sample the average share of FDI in total foreign investment is 46% for developing countries, but only 22% for developed countries".

In the light of international real estate investment, financial globalization helped to create new investment vehicles which accelerates to solve many problems that are characterized by this asset class (Baum, 2008). International or cross-border property investment has boomed, and indirect property investment (investing through securities such as REITs, and through unlisted funds) has become commonplace. International real estate investment through unlisted funds has included 'core' strategies, through which capital has been allocated largely to developed markets, and 'opportunity funds', which have also allocated capital to developing and emerging markets (Baum, 2009).

This development has been a boom in listed real estate markets, especially in the Real Estate Investment Trust (REIT) format, and in the number and value of unlisted property funds. The growth of the listed REIT market is largely a matter of public record, while investing in unlisted real estate vehicles has become an increasingly standard route to attaining international real estate exposure. Importantly, the change has had two main impacts: first, international property investment has boomed; second, indirect property investment (investing through securities and funds) has become the standard. The globalization of business activity was, prior to 2007-8, a continuing process, driven both by the conversion of ownership of successful companies from domestic to multi-national concerns, and by the increasing opportunities offered to corporations and institutional investors and banks to own overseas assets through globally-traded stock markets. The real estate investment (the construction of manufacturing facilities, for example) accounted for more than 40% of all foreign direct investment in the decade to 2001. Both occupier demand and the ownership of corporate real estate facilities have become increasingly driven by the needs of the multi-national enterprise.

The European and global cross-border investment also increased in popularity throughout the 1990s. In the City of London, for example, foreign ownership rose from around 4% in the mid-1980s to 45% at 2006 (Lizieri and Kutsch, 2006). Diversification by institutional investors is a powerful driver of this activity, while other investor groups seek higher returns by playing the global property cycle. If returns going forward in the US property market are perceived to be disappointing, US money will look abroad (Moshirian and Pham, 2000). The rise of international benchmarks and improvements in data provision, coupled with globalization in general and the growth of the international investment house in particular, have added to the appeal of international investment. The world's top investors have gone global.

According to Property Funds Research data, of the top ten global investors seven have global real estate portfolios and the other three have announced plans to invest in global real estate for the first time. It is now unusual among large investors not to have a global property strategy. Currency hedging is, however, expensive and difficult to achieve efficiently (Lizieri, Worzala and Johnson, 1998) and vehicles are rarely fully hedged. This problem leaves investors at the mercy of currency movements. Other perceived difficulties, including the dangers of operating from a distance with no local representation, increases the attraction of investing internationally through liquid securitized vehicles and unlisted funds.

Two dominant styles of international real estate investment vehicle have emerged since the 1990s, driving much of the recent international activity. These are distinguished by the objective being pursued. The key drivers for investing outside the domestic property market and buying global property are the increased opportunities for either or both of (i) diversification and (ii) enhanced return. These potential benefits come at a cost of increased complexity of execution. The diversification drive has been characterized by core and core-plus property funds, and the search for return by value-added and opportunity funds. This latter property fund type has commonly explored emerging markets. While some researchers argue the importance of locality amidst the globalization theories (Leyshon and Thrift, 1997, Daniels, 1996, Talalay, 2000, Sassen, 2006), and others argue that investment in Western Europe, North America and the Pacific Rim still represent the majority in terms of volume of activity (Lizieri, 2009), it is clear from Baum (2008) that property investment in emerging markets had become very common prior to the credit crunch of 2007-8.

The investors and fund managers typically allocate capitals to regions and countries before selecting buildings or funds (Baum, 2009). The main argument for country relevance is that social interaction as provided by spatial proximity helps to build trustworthiness and rapport. These are important factors that help to obtain market information (Leyshon and Thrift, 1997, Agnes, 2000). For this reason, geography still matters for portfolio choice, savings and investment, and can have a great influence on investor's decisions and returns (Stulz, 2005). In this context, some countries attract less capital than others as a result of hurdles, both actual and perceived.

In the literature of international trade, gravity equations are widely used to explain bilateral trade flows in terms of GDP, distance and other factors that can be considered as impediments. These factors include language, technology and available information between countries (Garmaise and Moskowitz, 2004; Portes and Rey 2005, Daude and Fratzscher 2008). However, gravity formulas have their shortfalls, mainly to do with omitted variables in the model (Anderson and Van Wincoop, 2003), and they do not seem to fully explain asymmetries found in cross-border investment particularly regarding developing economies.

Geographers argue the relevance of locality and the existence of hurdles, but this argument is also supported by economics, as markets, costs, competition and government regulation are seen as the four pillars of globalization, and foreign direct investment is usually attracted to large local markets with good local labour (Daniels, 1996, Case et al., 1999, Hoesli et al., 2004) and with low entry costs. Hurdles to international investment create costs, both direct and indirect.

The production of high quality real estate needs to be financed through large scale equity and debt capital. This is especially required in emerging and developing markets which are short of such real estate capital. This requires entrepreneurship represented by equity capital or foreign direct investment (FDI). If actual and perceived hurdles to investment influence investor behaviour, then large and more advanced economies will always dominate in real estate investment, and a levelling-out of economic prosperity may be inhibited.

**Research Objectives**

The aim of this study is to expose the factors that pose imminent risks and uncertainties in international real estate investment in developing economies with reference to Nigeria.

The main objective of this study is to confront qualitative responses from investors in order to have a more accurate picture of the formal and informal hurdles affecting the countries under study.

## II. LITERATURE REVIEW

Nigeria's real estate industry is still grossly underdeveloped, with very limited and in some cases non-existent institutional quality product. However the continued interest of investors in the region , spurred by current real estate fundamentals and a positive macro- economic outlook, point to growth in the market; if not all over the country, in the short to medium term, at least in its major markets of Lagos, Abuja and Port-Harcourt.

The Nigeria's economy is projected to grow by 1.5% in 2021 and 2.9% in 2022, based on an expected recovery in crude oil prices and production. Stimulus measures outlined in the ESP and the Finance Act of 2020 could boost non-oil revenues. Improved revenues can narrow the fiscal deficit to 4.6% and the current account deficit to 2.3% of GDP in 2021 as global economic conditions improve. Reopening borders will increase access to inputs, easing pressure on domestic prices and inflation, projected at 11.4% in 2021. Downside risks include reduced fiscal space, should oil prices remain depressed. In addition, flooding and rising insecurity could hamper agricultural production. Furthermore, depletion in foreign reserves from $35 billion (7.6 months of import cover) could lead to sharp exchange rate depreciation and inflationary pressures. A potential relapse in pandemic cases could exacerbate these risks. High unemployment (27%), poverty (40%) and growing inequality remain a major challenge in Nigeria.

According to Aso; Nebo; Aguome (2020), one of the issues which have been raised in the investment incentive literature as it concerns FDI is the institutional framework of the FDI attracting country. This covers the administrative and legal policies which govern investment and the status of foreigners in a country (Bohn et al, 2000; Obi et al, 2019).

Some countries try to eliminate or lessen the impact of those hurdles that are most likely to segment the local market from the global capital market. These hurdles have been classified into formal and informal or direct and indirect hurdles. The formal or direct are those that affect the ability of foreign investors to invest in emerging markets, for example in the form of taxes and laws; the informal or indirect hurdles are those that affect investor's willingness to invest, and mainly due to reservations regarding cultural or political issues (Nishiotis, 2004).

Previous studies have listed some impediments affecting the trading of goods, the setting up of companies, and the openness of the stock markets or a mix of all. The most important hurdles to global equity-market integration are said to be: poor credit ratings, high and variable inflation, exchange rate controls, the lack of a high-quality regulatory and accounting framework, the lack of sufficient country funds or cross-listed securities, and the limited size of some stock markets (Bekaert, 1995).

According to Lahiri (2009), FDI as "a long-term investment by a non-resident, but with control (a 10% or greater share)". There are different types of FDI, ranging from the development of new buildings, the expansion of existing ones, acquisitions and (in case of multinationals), mergers. It can be deduced from this that the hurdles to investment between the parent and host country will be different depending on the type of investment. For example, tax incentives that a multinational receives for relocating its manufacturing plant to a host country have been known to be more substantial than those received by an insurance company investing in commercial property in the same country (Lahiri, 2009). On the other hand, other costs such as skills levels of the working population may not be considered a barrier to real estate but will be for producers.

The Real estate industry of any country is largely affected by the country's economy. As such the emergence of a real estate market is inextricably linked to the larger economic environment. That said, it is also recognized that real estate, as a sector of the economy and a separate asset class in the capital markets, is very unique and has characteristics and parameters for growth, specific to it. In assessing the risks of real estate investments in international markets, investors take into consideration the general risks of a country in terms of political stability, business environment, currency fluctuations and the likes and then, in addition to these, they consider real estate specific risks such as, entitlement risk, legal risk, market risk, financial risk and execution risk to mention a few.

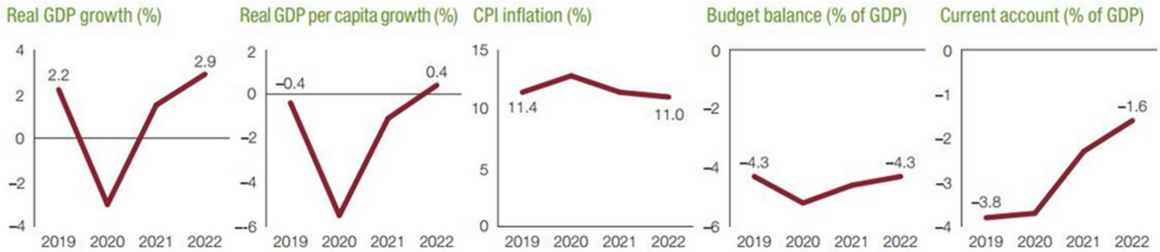
These risks and uncertainties manifest themselves in different capacities in each market. As such, despite its recent sophistication and integration into larger capital markets, Real Estate is still often referred to as a 'local' business. However, Jones Lang LaSalle, a leading advisory firm, produces a Real Estate Transparency Index, first published in 1999, latest version 2008. In classifying market transparency, this survey-based measure uses judgements about the following:

a) The availability of investment performance indexes;

b) Market fundamentals data;
c) Listed vehicle financial disclosure and governance;
d) Regulatory and legal factors; and
e) Professional and ethical standards.

The Middle East and North Africa region had the lowest average transparency when compared to other surveyed regions. Asia Pacific contains high transparency markets such as Australia and New Zealand, but also houses Cambodia, which is classified as having an opaque real estate market. India, China and Vietnam were 2008's most improved markets in the region while Indonesia, Malaysia and South Korea showed little improvement.

Nigeria's public debt is relatively sustainable at 25% of GDP. But debt service payments are high, and the country's ability to attract external private financial flows is hurt by macroeconomic imbalances and policy uncertainty. During the first half of 2020, Nigeria received \$7.1 billion in foreign investment. This was half the amount it received in the corresponding period of 2019. Nigeria's financing requirements require improved domestic revenue collection. Currently, nonoil revenue collections are equivalent to 4% of GDP. The revenue yield in 2020 from an increase in the value-added tax rate to 7.5% from 5% was less than projected because of subdued economic activity. Broadening the tax base could strengthen Nigeria's fiscal buffers, if structural reforms to enhance compliance are supported and illicit financial flows are tackled. Remittances and sharia-compliant sukuk bonds also offer potential financing options. In 2019, remittances totalled \$23.8 billion (5.3% of GDP), but the effect of the COVID– 19 pandemic in key source markets could reduce this figure. The third issuance of sukuk bonds of 150 billion naira (\$395 million) in June 2020 attracted 669.1 billion naira, of which 162.5 billion naira was allotted to finance 44 critical road projects. Use of foreign reserves as a financing option in the medium term is impaired by lower oil receipts, the main source of foreign exchange.




*Source:* Data are as of December 2020 and are from domestic authorities; figures for 2020 are estimates and figures for 2021 and 2022 are projections by the African Economic Outlook team.

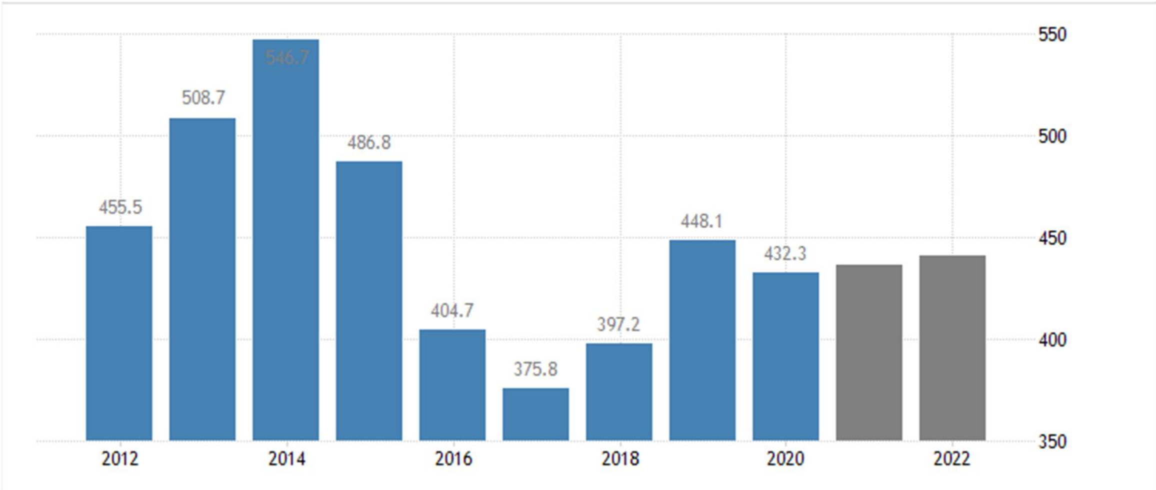
## III. METHODOLOGY

This study was designed to be a qualitative analysis of the subject matter. It involves the gathering and synthesis of data and information on the country's development as an emerging market, and consequently, the indicators of the potential for its real estate markets. Sources includes information and reports by industry's professionals, newspaper articles, government reports and interviews with private sector participants involved in real estate in the region – investors, developers etc.

## IV. THE FORMAL HURDLES

There are different types of formal hurdles, which include restrictions to capital accounts and legal hurdles which relate to taxes and to ownership of foreign assets. This study presented a list of all formal hurdles which are likely to occur in real estate investments, and asked interviewees to rank them according to their importance and how likely they were to deter them from investing in that country.

**'Push and Pull Factors'** are terms used in economics to explain international capital flows. Push factors can be related to the lack of lending in the investors' country, while pull factors are related to the risk-return relationship in the host country (Montiel and Reinhart, 1999).




**Source: World Bank, 2020.**

The Gross Domestic Product (GDP) in Nigeria was worth 432.30 billion US dollars in 2020, according to official data from the World Bank. The GDP value of Nigeria represents 0.38 percent of the world economy. The gross domestic product (GDP) measures of national income and output for a given country's economy. The gross domestic product (GDP) is equal to the total expenditures for all final goods and services produced within the country in a stipulated period of time. Pull factors include some countercyclical policies that some countries like Nigeria apply when faced with a surge in the inflow of capital, for example capital controls.

**Restriction to Capital Accounts**

Capital controls affects the ability of investors to repatriate their investment. If domestic savings are scarce in the host country, it is likely that capital account transactions will be restricted. A common direct restriction could be the imposition of a minimum period of investment (Bekaert, 1995). It follows from this that restrictions on international financial flows are less prevalent in high-income countries with large domestic savings (Eichengreen, 2001). Although recent empirical research has shown that capital controls do not affect the inflow of FDI (Montiel and Reinhart, 1999). However, our preliminary survey shows that real estate investors are likely to consider restriction to capital accounts a high barrier. Preliminary survey revealed that there were no low ranks suggested for this issue and restrictions to capital accounts appears as a medium to high barrier to investment.

**Legal Hurdles**

Legal hurdles arise from the different legal status of foreign and domestic investors. This could be in the form of ownership restrictions and/or the imposition of higher taxes (Bekaert, 1995). For example, governments in both developed and developing countries often impose ownership restrictions as a means of ensuring domestic control of local firms, especially those firms that are regarded as strategically important to national interests (Eun and Janakiramanan, 1986).

**Taxes and Costs**

The residence principle means that incomes from foreign and domestic sources of residents are taxed at equal rates, while incomes of non-residents are tax exempt (Razin et al. 1998). However, this ideal tax structure is often altered, thus affecting capital flows. The countercyclical policies mentioned above in the context of pull factors can also include tax benefits, for example in cases when countries need to increase FDI.

The costs associated with holding foreign securities in a portfolio include transaction costs, information costs and differential taxation. This is the differences in the taxation of capital gains and repatriation of capital (Demirguc-Kunt and Huizinga, 1992).

**4.2 Informal Hurdles**

Informal hurdles to international investment arise because of differences in available information, accounting standards and investor protection. There are also risks that are especially important in emerging markets (Emerging-Market-Specific Risks or EMSRS) such as currency risk, political risk, liquidity risk, economic policy risk and macroeconomic instability (Bekaert and Harvey, 2002, Nishiotis, 2004). Legal and title risk is a real estate issue that we can add to this category.

**i. Political Risk**

Politics can influence economic decisions and the country's degree of openness to foreign investment. Some authors argued that democratic governments are less likely to impose capital controls (Brune et al., 2001, Quinn et al., 2001). This is explained by the fact that democracy comes with increased rights and citizens' ability to press for the removal of restrictions on their investment options (Eichengreen, 2001). It can be inferred that investors will be deterred from investing in non-democracies.

In Nigeria, there are pressure from powerful groups within the countries and the relationship between political groups (for example, the degree of democratization), financial reforms and future economic growth have been one of the challenges in emerging economies.

In addition, it should be pointed out that the most important difference between emerging and developed economies is the much more prominent role of politics in emerging markets and their larger public sectors which can act as pressure groups (Bekaert and Harvey, 2002). The pressure groups are at the heart of political instability and can add substantial risk premiums to returns and therefore deter foreign direct investment.

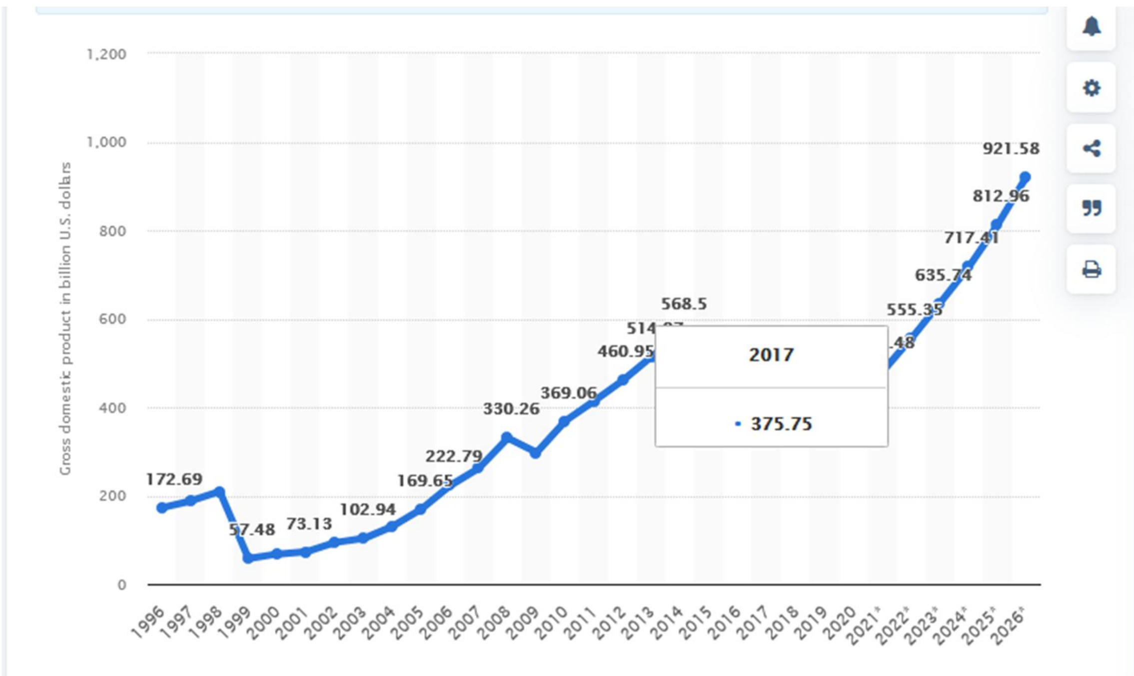
North (1990) distinguished between formal institutions (laws, rules) and informal behaviour. The state is the third party enforcing the laws while at the same time confronting the trade-offs between disorder, control and constitutional liberalism. FDI has been suggested to be less sensitive to corruption.

The share of inward FDI and also foreign loans is highest for countries with weak institutions like Nigeria and poorly developed or badly functioning capital markets. Therefore, although FDI may have beneficial effects on the economy, a composition of foreign investment that is heavily tilted towards FDI is likely to be a signal of some fundamental weaknesses of the host country economy, thus providing support for the argument of Hausmann and Fernandez-Arias (2000) and Albuquerque (2003)" (Daude and Stein 2004).

In capitalist economies, public and private institutions can change or establish new economic rules. In other words, they can shape the characteristics of a country (laws, culture, history, politics, economics, and so on), how the institutions are shaped and how much the state intervenes affects the country's economic performance, risk and investment.

**ii. Currency Risk**

Currency movements can have a dramatic impact on equity returns for foreign investors. A possible irony of international investment is that many developing economies manage to keep exchange rate volatility lower than that which is typical in industrial economies.




**Source: Statista, 2022.**

The statistic shows gross domestic product (GDP) in Nigeria from 1996 to 2020, with projections up until 2026. Gross domestic product (GDP) denotes the aggregate value of all services and goods produced within a country in any given year. GDP is an important indicator of a country's economic power. In 2020, Nigeria's gross domestic product amounted to around 429.42 billion U.S. dollars. This is not surprising as many developing economies try to peg their exchange rates to the U.S. dollar or to a basket of currencies (Bekaert, 1995). (A critical literature review on currency risk and international real estate investment can be found in Sirmans and Worzala, 2003). This is also seen in Nigeria and has a dramatic impact on equity returns for foreign investors.

**iii. Liquidity Risk**

In Nigeria, liquidity also presents a problem for direct investment in private real estate. This type of risk not only captures the time it takes to execute the trade, but other factors such as direct and indirect costs of trading and the risk and uncertainty concerning the timing of selling and the achievement of the expected sale price (IPF, 2004). The high cost of building materials as a result of liquidity rate presents a problem for International real estate investment. Building materials should be manufactured locally so that the cost would be minimize.

Crucial in the issue of liquidity for emerging property markets, especially for opportunity funds which try to buy and sell in a short space of tie to maximise return and performance fees or carried interest payments, is the prospective 'take-out'. Emerging markets are likely to have less well developed local institutions and investment funds, and international owners are less likely to be represented. In addition to potential shortages of equity players ready to buy, there may also be a shortage of bank debt. Local investors may find it hard to raise the cash to buy a property if there is no local debt available, and international buyers will often use local debt to lay off some currency risk (Baum, 2009) - so if debt is unavailable liquidity can disappear. This is a critical problem for a closed ended, limited life unlisted property fund.

**iv. Cultural Hurdles**

Despite the empirical research which attempts to price different type of risks, there is some evidence that investment decisions are also based on sentiment (Lizieri, 2009). As stated before, investors' behavioural attitudes have been the subject of recent research (Bailey, Kumar, and Ng, 2004, Graham, Harvey, and Huang, 2004) but further analysis is needed in order to disentangle economic bias based on GDP and population from the influence of formal and informal hurdles when it comes to making real estate investment decisions at an international level.

**v. Geographical Hurdles**

There are theories that contest the inevitability of financial globalization, claiming that geographical hurdles still exist (Goldberg et al).

The geographical proximity is an important factor mainly because people now do not buy on trust: "today people like to know more, and every piece of real estate is different so you need to go there and people don't rush to buy things without local due diligence, and that slows things down."

**vi. Legal and Title Risk**

A critical real estate issue is the risk of defective or unenforceable title. This is an issue in newly democratized markets such as the Baltic region and central, eastern and south-eastern Europe, where prior claims preceding communist state ownership can complicate acquisitions. This can be insured in many cases, but remains a risk in some. In Buenos Aires, methods of piecemeal or tiered development can lead to multiple ownership and a scarcity of institutionally acceptable single title assets. The issue of state title 'resumption' has been problematic in Zimbabwe, and adds to the conception of title and legal risk associated with political risk. "Why take this risk or pay excessive costs of due diligence or insurance, especially when currency risk is also present, unless prospective returns are huge?"

## V. CONCLUSIONS AND RECOMMENDATION

Formal and informal hurdles to international real estate investment are important in determining cross-border real estate capital flows as seen in Nigeria. The international real estate investment is one of the best investment drive available in any developing economies. Formal hurdles are prevalent in international real estate markets because real estate ownership is easily regulated, real property is easily taxed and capital controls can be applied to real estate assets as easily they can to any asset type. This may act to leave domestic investors in a better relative position and exclude foreign buyers.

Informal hurdles are equally challenging in Nigeria. The large lot sizes involved in real estate means that diversification is less easily achieved (Baum, 2007) and this leaves systematic country risks with investors. Currency and title risks in particular are likely to loom large in investor thinking. In an equity portfolio of an emerging market, currency risk can be diversified for a real estate investor. These may be impossible which implies that hedging is required but this can be very costly or even impossible to achieve.

Major attractions in the emerging markets are obvious; increasing income level of middle class population, few domestic competitors, and availability of cheap labour/ abundant natural resources. Though

China has immense resources, and its population is higher than US or EU, its per capita income is less than one sixth of that of an average US worker. The country also suffers disparity of wealth between city and rural areas. Despite the constraints, opportunities are ample in the emerging markets. Businesses can make money in these countries, provided they enter the market at the right time, utilizing the right opportunities, and possess a right mind-set regarding the risks associated therein.

Diligence is more important, and shortcuts need to be avoided. The merchandise, service, price, and competitors should be considered along with the distribution system. Companies should enter into the niche market through competitive aspects.

This study finally concludes that international real estate investment if explored would create reliable return to the investment owners, the benefits that can be derived from international real estate investment has been revealed by this study. This study recommends that government policies should be reviewed to create more viability to the Foreign Direct Investment (FDI). The study also suggested that developing economies can be enhanced if property markets are well coordinated and sustained. It also recommends that building materials should be manufactured locally so that the cost would be minimize.

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Ndive Paul Chinedu, et. al. "The Risk and Uncertainties of International Real Estate Investment in Developing Economies: Nigeria Perspective." *International Journal of Engineering and Science*, vol. 12, no. 3, 2022, pp. 50-58.