Stanlib Fahari I- REIT Earnings Update – FY' 2018

Valuation:

- We are of the view that the Stanlib Fahari REIT (I-REIT) is an "**ACCUMULATE**" with a target price of Kshs 9.8, representing an upside of 6.5% from the current price of Kshs 9.2 as at 29th March 2019, using relative valuation and discounted dividend valuation method, and an FY'2018 dividend yield of 8.1%,
- The I–REIT's performance in terms of dividend yield at 8.1% is in line with the commercial real estate market average of 8.3%, with 8.5% rental yield for retail space and 8.0% yield for office space in Q1'2019. However, the yield is attributable to its declining stock price closing at Kshs 9.2 per unit as at 29th March 2019 in comparison to Kshs 11.6 as at 29th March 2018, representing a 20.3% loss of value,
- The Fahari I-REIT is currently trading at a P/B of 0.4x and P/E of 8.6x, versus an emerging markets average of 0.9x and 14.9x, respectively,

Key Highlights in FY'2018:

- The REIT, in May 2018, acquired a Kshs 850.0 mn property, 67 Gitanga Place, in Lavington, Nairobi in order to diversify its portfolio and meet the Capital Markets Authority (CMA) requirement of investing at least 75.0% in real estate within 2-years. This brings the total properties owned by the REIT to 4, all located in Nairobi, the others being; (i) Greenspan Mall in Donholm, (ii) Highway House in Industrial Area, and (iii) Bay Holdings Limited in Industrial Area. The 4 properties have a total Gross Lettable Area (GLA) of 23,161 SQM,
- The REIT has 87.5% of its total asset value invested in real estate, 22.0% points higher than 65.5% in FY'2017 in line with the CMA's regulations that require it to invest at least 75.0% of its assets in real estate,
- Construction of a 3-screen cinema with 100 seats each at the Greenspan Mall is nearing completion and the tenant is expected to begin operating in Q2'2019 under a 10-year lease. This is meant to increase foot traffic, benefiting existing and future tenants and increase rental income for the REIT. The REIT has also recorded successful renewal of key tenant leases at the mall, countering the challenges on vacancies hence boosting the mall's future cashflows. These efforts are expected to boost the REIT's rental revenues, translating to an increase in rental yield going forward,
- The REIT realized a net profit of Kshs 193.5 mn and declared a first and final distribution of Kshs 135.8 mn to unitholders at Kshs 0.75 per unit equal to the final distribution in FY'2017 of Kshs 135.8mn. Investors will realize 8.1% dividend yield at the market price of Kshs 9.2 as at 29th March 2019.

Income Statement:

- Earnings per unit rose by 13.1% to Kshs 1.07 per unit from Kshs 0.95 per unit in FY'2017, driven by a 4.6% increase in operating income that outpaced the 3.1% increase in operating expenses,
- Operating income rose by 4.6% to Kshs 389.4 mn from Kshs 372.3 mn in FY'2017. Performance was driven by a 10.9% growth in rental income to Kshs 309.8 mn from 279.4 mn in FY'2017, as a result of the rental income contribution from the Grade A office - 67 Gitanga Place that was acquired in May 2018, and a 40.2% increase in fair value gains on revaluation of investment property to Kshs 43.1 mn from Kshs 30.8mn in 2017,
- Interest income decreased by 43.5% y/y to Kshs 56.4 mn from Kshs 99.9 mn recorded in FY'2017, attributable to the use of interest earning cash deposits to fund the acquisition of the 67 Gitanga Place Office,
- Distributable earnings declined by 14.2% to Kshs 127.9 mn from Kshs 149.1 mn in 2017 as a result of an increase in vacancies in 2018, e.g Highway House, was vacant for the first 9 months of 2018

following the exit of the tenant at expiry of the lease, as well as tax leakages in the form of irrecoverable withholding tax at property subsidiary company level. The renewal of the key tenants' leases will, however, curb the issue of vacancies and increase the rental income in future,

- Total operating expenses stood at Kshs 239.1 mn, 3.1% higher than Kshs 231.9 mn in FY'2017, out of which 54.5% was attributed to fund-operating expenses such as audit, trustee fees, and license fees, while property expenses which include maintenance of tenants and properties, filling vacancies, marketing, and public relations accounted for 45.5% of the total operating expenses. A large portion of revenues, at approximately 49.7%, are going into professional fees. However, we note that fund management expenses decreased by 4.0% to Kshs 130.2 mn attributed to the downward review of the REIT Manager's fee which took effect from 1st July 2017, and recoupment of VAT input expense that had previously been capitalized to the fund,
- Net profit grew by 13.1% to Kshs 193.5 mn, from Kshs 171.1 mn in FY'2017. This is on account of the 10.9% increase in rental income and the 40.2% increase in fair value gains on revaluation of investment property bolstered by the construction of a modern 3-screen Cinema at Greenspan Mall,
- The REIT recommended a Kshs 135.7 mn dividend to its unitholders at Kshs 0.75 per unit, realizing an 8.1% yield on its market price as at 29th March 2019, translating to a 70.1% pay-out ratio. However, we note that the final distributable earnings declared by REIT manager is 6.1% above the FY' 2018 distributable earnings of Kshs 127.9mn and thus will be funded from Equity.

Balance Sheet:

- Total assets increased by 2.4% y/y to Kshs 3.9 bn from Kshs 3.8 bn in FY' 2017, attributable to a 36.8% y/y increase in investment property to Kshs 3.4 bn from Kshs 2.5 bn in FY'2017, with the purchasing of the 67 Gitanga Place office building in Lavington at Kshs 895.5 mn. The acquisition has contributed to the sectoral diversification of the portfolio, increasing exposure to the office sector and semi-industrial to 30.5% from 16.9% in FY'2017,
- Total liabilities increased by 2.4% to Kshs 128.7 mn from Kshs 95.4 mn in FY' 2017, driven by an increase in payables. The REIT incurred no financing costs in FY'2018,
- Shareholders' funds grew by 1.6% to Kshs 3.72 bn from Kshs 3.66 bn in FY'2017 and thus the REIT closed the year with a Net Asset Value of Kshs 20.6 per share, 2.9% higher than its listing price of Kshs 20.0,
- The REIT currently has a return on assets of 5.0% and a return on equity of 5.2%, compared to 4.5% and 4.7%, respectively, in FY'2017.

Key Take-outs:

- On the bourse, the REIT's performance has been on a decline since its listing at Kshs 20.0 in November 2015. The REIT traded at an average of Kshs 10.6 per unit in FY' 2018, compared to Kshs 11.3 in FY 2017, thus losing 6.2% of its value y/y and 47.0% from its listing, an indication of the continued lack of investor appetite for the instrument,
- We expect the REITs rental revenues to increase driven by; (i) increased diversification of the portfolio, with the purchase of 67 Gitanga Road building, (ii) construction and operation of a 3-screen cinema with 100 seats each, at Greenspan Mall, which is intended to increase foot traffic and boost existing tenant customers, and (iii) the expected legislation to exempt REIT owned subsidiaries from withholding tax. Investors and developers will venture into the REITs market to diversify their Real Estate holdings due to the decreased occupancies in the Nairobi retail and office market, driven by the space surplus in the market.

Below is a summary of the key line items in the balance sheet and income statement;

Figures in Kshs bn unless stated otherwise

Balance Sheet	FY 2016	FY 2017	FY 2018	Δ Y/Y (FY' 2017/ FY' 2018)
Total Assets	3.72	3.76	3.85	2.4%
Total Equity	3.59	3.67	3.72	1.6%
Total Liabilities	0.13	0.10	0.13	34.8%

Figures in Kshs bn unless stated otherwise

Income Statement	FY 2016	2017 FY	FY 2018	Δ Y/Y (FY' 2017/ FY' 2018)
Rental Income	0.25	0.28	0.31	10.9%
Income from Other Sources	0.14	0.10	0.06	(43.7%)
Operating Expenses	0.27	0.23	0.24	3.1%
Profit Before Tax	0.11	0.17	0.19	13.1%
Basic EPS	0.59	0.95	1.07	13.1%

Ratios Summary	FY 2016	2017 FY	FY 2018	Δ Y/Y (FY' 2017/ FY' 2018) % points
ROA	2.9%	4.5%	5.0%	0.5%
ROE	3.0%	4.7%	5.2%	0.5%
Debt Ratio	3.5%	2.5%	3.3%	0.8%
PBT Margin	22.3%	46.0%	49.7%	3.7%
Rental Yield	4.4%	7.0%	5.7%	(1.2%)