Valuation

- We are of the view that the Fahari REIT is a "Buy" with a target price of Kshs 16.7, representing an upside of 50.3%, from the current price of Kshs 11.6, as at 29th March 2018, inclusive of a dividend yield of 6.5% using relative valuation
- Fahari REIT is currently trading at a P/B of 0.6x and a P/E of 12.3x, versus an emerging markets average of 0.9x and 14.9x, respectively

Highlights:

- The REIT currently holds 3 properties: Greenspan Mall, a shopping centre in Donholm with a Gross Lettable Area (GLA) of 16,122 SQM that is approximately 90.0% let, Signature International Limited, a semi-office and light industrial building in Industrial Area with a GLA of 710 SQM that is 100.0% let with a single tenant and Bay Holdings Ltd, an office property also in Industrial Area with a GLA of 3,092 SQM and that is also 100.0% let with 3 tenants
- Out of a total asset value of Kshs 3.8 bn, 65.5% is invested in the aforementioned properties worth Kshs 2.5 bn, with 34.5% in cash and cash equivalents. The REIT, that has been in operation for 28 months now, is allowed to invest no more than 25% of its total asset value in cash and cash equivalents after the first 24 months. The company was, in October 2017, granted an extension until 31st March 2018 by the Capital Markets Authority to comply with the regulations
- The REIT managers have since announced plans to acquire the 330-Gitanga Road, a low-rise grade A office space in Lavington at Kshs 850.0 mn subject to regulatory and unitholder approvals
- The REIT registered a 61.0% growth in earnings per unit to Kshs 0.95 per unit from Kshs 0.59 per unit in FY'2016 attributed to a significant reduction in fund-management costs and increased rental income
- The REIT realised a net profit of Kshs 171.1 mn and declared a first and final distribution of Kshs 135.8 mn to unitholders at Kshs 0.95 per unit, subject to unitholders approval. Investors will realise a 6.5% dividend yield at market price as at 29th March 2018, 2.2% points higher than the yield realised in FY'2016 of 4.3%. Despite the growth, the yield is relatively low compared to government securities whose yields currently stand at 8.0% and 11.1%, for the 91-day and the 364-day Tbills, respectively but higher than the NASI dividend yield which currently stands at 3.4%
- With a net profit of Kshs 171.1 mn, the properties under management (worth Kshs 2.5 bn) realised a 7.0% rental yield which, in our view, is relatively low compared to the market average of 9.4% rental yield for retail space and 9.2% yield for office space.

Income Statement

- Earnings per unit rose by 61.4% to Kshs 0.95 per from Kshs 0.43 per unit in FY'2016 mainly due to a 24.8% decline in fund-management expenses to Kshs 135.6 mn from Kshs 180.4 mn in FY'2016 and a 12.4% growth in rental revenues to Kshs 279.4 mn from 248.6 mn in FY'2016. The decline in expenses is because of the one-off set up and listing costs such as promotional and marketing expenses incurred in H1'2016 equal to Kshs 118.3 mn and the fact that the REIT currently has no debt, thus no financing costs compared to the previous period, which had Kshs 23.0 mn, paid off in H1'2016. Property operating costs during the period increased by 13.8% to Kshs 96.3 mn from Kshs 84.6 mn, which we attribute to additional operating costs from the 2 properties acquired mid-2016
- Rental income grew by 12.4% to Kshs 279.4 mn from Kshs 248.6 mn as a result of rental income generated by the two properties that were acquired towards the end of June 2016 as well as an increase in rental income in line with lease escalations. The company, however, noted that rent only grew marginally as tenants bargained for discounts on lease renewals due to the unfavorable economic climate in 2017
- Total Operating expenses stood at Kshs 231.9 mn, 12.5% lower than Kshs 265.1 mn in FY'2016, out of which 58.5% 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 41.5% of the total operating expenses. A large portion of revenues, at approximately 48.5%, are going into professional fees, hence the low returns to the investor. The REIT may, however, rely on economies of scale to increase profits from the additional properties hence lowering this percentage

- Net Profit grew by 61.4% to Kshs 171.1 mn, from Kshs 106.0 mn in FY’2016. This is on account of the 12.4% increase in rental income and the 24.8% decline in fund-management expenses. At a 91.0 % pay-out ratio from distributable earnings, the REIT recommended a Kshs 135.7 mn dividend to its unitholders at Kshs 0.75 per unit, realising a 6.5% yield as at market price on 29th March 2018

Balance Sheet

- Total assets increased by only 1.3% to Kshs 3.8 bn from Kshs 3.7 bn in FY’2016 driven by a 1.0% increase in investment property fair value gains
- Total liabilities declined by 26.3% to Kshs 95.4 mn from Kshs 129.5 mn in FY’2016, driven by a decrease in payables as the REIT incurred no financing costs in FY’2017
- Shareholders’ funds grew by 2.3% to Kshs 3.7 bn from Kshs 3.6 bn in FY’2016 and thus the REIT closed the year with a Net Asset Value of Kshs 20.3, slightly higher than its listing price of Kshs 20.0
- The REIT currently has a return on assets of 4.5% and a return on equity of 4.7%, compared to 2.9% and 3.0%, respectively, in FY’2016.

Ratios Summary	FY’ 2016	FY’ 2017	y/y change in percentage points
ROA	2.9%	4.5%	**1.7%**
ROE	3.0%	4.7%	**1.7%**
Debt Ratio	3.5%	2.5%	**(0.9)%**
PBT Margin	22.3%	46.0%	**23.7%**

Performance

- On the bourse, the REIT’s performance has been on a decline since its listing at Kshs 20.0 per unit. In 2016, the REIT traded at an average of Kshs 17.4 per unit, in 2017 it traded at an average of Kshs 11.3 per unit, while in Q1’17 it has been trading at an average of Kshs 10.5 per unit, losing 47.5% of its value
- The above is so because, in principle, the REIT has not been capitalising on the key advantages of REITs which include:
    i. High Yields – The REIT realised a 6.5% dividend yield in FY’2017, which is lower than government securities while the properties’ rental yield of 7.0% is lower than the market average yields for retail space in Nairobi at 9.4% while that of office space is 9.2% on average
    ii. Diversification – The Fahari REIT has not well diversified in property as well as location as 2 of its properties are in the lower performing zones of Nairobi. That is Mombasa Road and Industrial area.

The REIT has also continued to underperform due to poor investor sentiments on the returns of listed property in Kenya.

The fund-managers recently announced plans to acquire 330-Gitanga Road, a low-rise Grade A office in Lavington at Kshs 850.0 mn in line with the regulatory requirements to invest at least 75.0% of assets in real estate properties. The property is expected to generate approximately Kshs 73.8 mn income during its first year, realising an 8.7% rental yield which is higher than the current rental yield of 7.0% from the existing assets. In our view, this is a commendable move given the relatively low supply of grade A offices, but with high demand from multi-national firms, and with potential yields of up to 9.8% compared to the overall market office yields of 9.2%. The REIT is likely to benefit from increased revenues, diversified sectoral exposure, and improved economies of scale. If well-implemented, this, as well as the improved performance in 2017 is likely to boost investor appetite for the REIT product in the long-term. We expect the REIT to continue trading at low prices in the short-term but improve in the long-term as investors gauge and appreciate the performance of the product.

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

Figures in Kshs bn unless otherwise stated

Balance Sheet	FY’2016	FY'2017	y/y change
Total Assets	3.72	3.76	**1.3%**
Total Equity	3.59	3.67	**2.2%**

Total Liabilities	0.13	0.10	**(26.3%)**

Income Statement	FY'2016	FY'2017	y/y change
Rental Income	0.25	0.28	**12.4%**
Income from Other Sources	0.14	0.10	**(26.3)%**
Operating Expenses	0.27	0.23	**(12.5)%**
Profit Before Tax	0.11	0.17	**61.4%**
Basic EPS	0.59	0.95	**61.4%**