Wealth Management Training

Introduction to Real Estate Investments

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I: Introduction to Investments

Macro Economic Variables Determine investments

Knowing what investments will do well under each scenario is important

- **Investments:** This is the purchase of an Asset with the hope of generating some income in future or the asset appreciating hence being able to sell it at a profit
- The investment outlook of an economy is determined by :
  - Expected GDP or economic growth globally and locally
  - Level of inflation and interest rates
  - The currency prospects
  - Performance of other trading countries
  - Political stability
  - Social stability

The performance of the investments is largely determined by peoples views on all the above

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Introduction to Investments – Broad Classifications

There are two main broad classifications of investments based on the ease of accessibility

	Description	Characteristics
Traditional Investments	i. Equities	• Liquid • Price visible on stock exchange
	ii. Fixed Income	• Liquid • Highly sensitive to interest rates • Returns made of both coupon and principal
Alternative Investments	i. Private Equity	• Illiquid • Difficult to price • Lack of availability of transaction data
	ii. Real Estate	• Illiquid • Provides inflation hedge (have their own value) • Low correlation with traditional investments • Lack of availability of transaction data

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II: Real Estate Investment Opportunities

Introduction to Real Estate

Private and public real estate have distinct characteristics

Forms of Real Estate

- Investments into real estate can be categorized into public and private market investments:

Private

- Ownership usually involves direct investments like purchasing property or lending money to a purchaser
- Direct investments can be solely owned or indirectly owned through partnerships or commingled real estate funds

Public

- Ownership involves securities that serve as claims on the underlying asset
- Includes ownership in a real estate investment trust (REIT), a real estate operating company (REOP)

Source: Alexander Forbes

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Classification of Real Estate

A simplified classification of real estate assets; the examples listed are not exhaustive

Real Estate

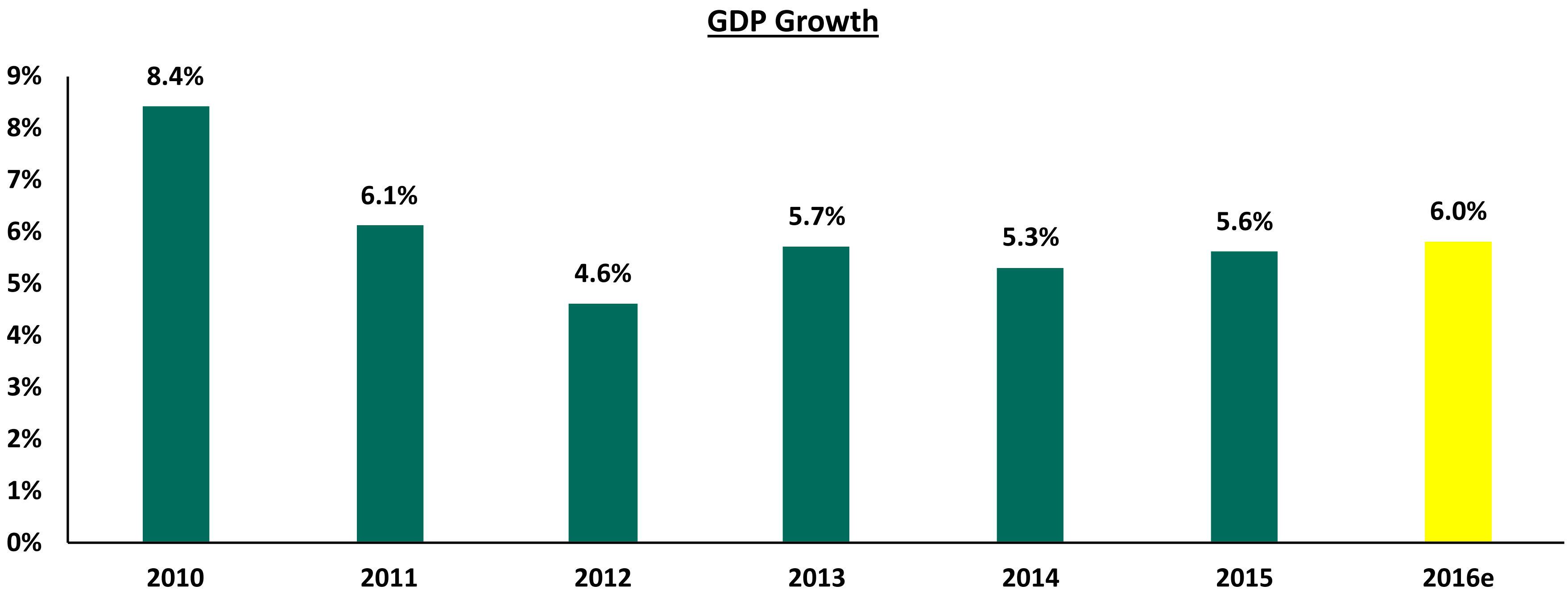
Residential

- Single-family homes
- Multi-family properties

Non-residential

- Offices
- Industrial/warehouse developments
- Retail
- Hospitality
- Mixed-use developments

Kenya's GDP Growth Avg. 6% since 2010, needs financing



- 2016 GDP is expected to come in at 6.0% underpinned by (i) high government expenditure on infrastructure, (ii) the energy sector growing at 6.8%, **(iii) Real Estate estimated to grow at 6.9%**, (iv) Agriculture growing at 3.4% and (iv) the recovery of tourism growing at 9.5%

Source – Cytonn Research

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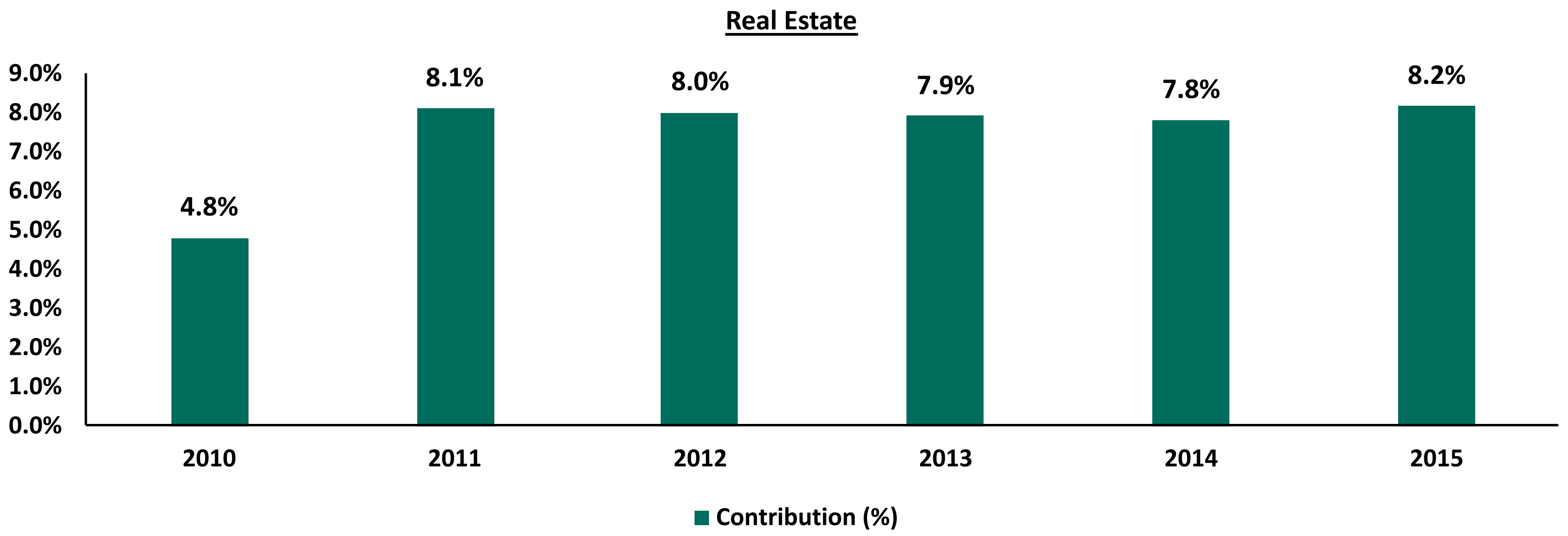
Real Estate Contribution to GDP Has Been Increasing

Real Estate is among the fastest growing sectors in the economy, contributing to 8.2% of GDP, from 4.8% in 2010

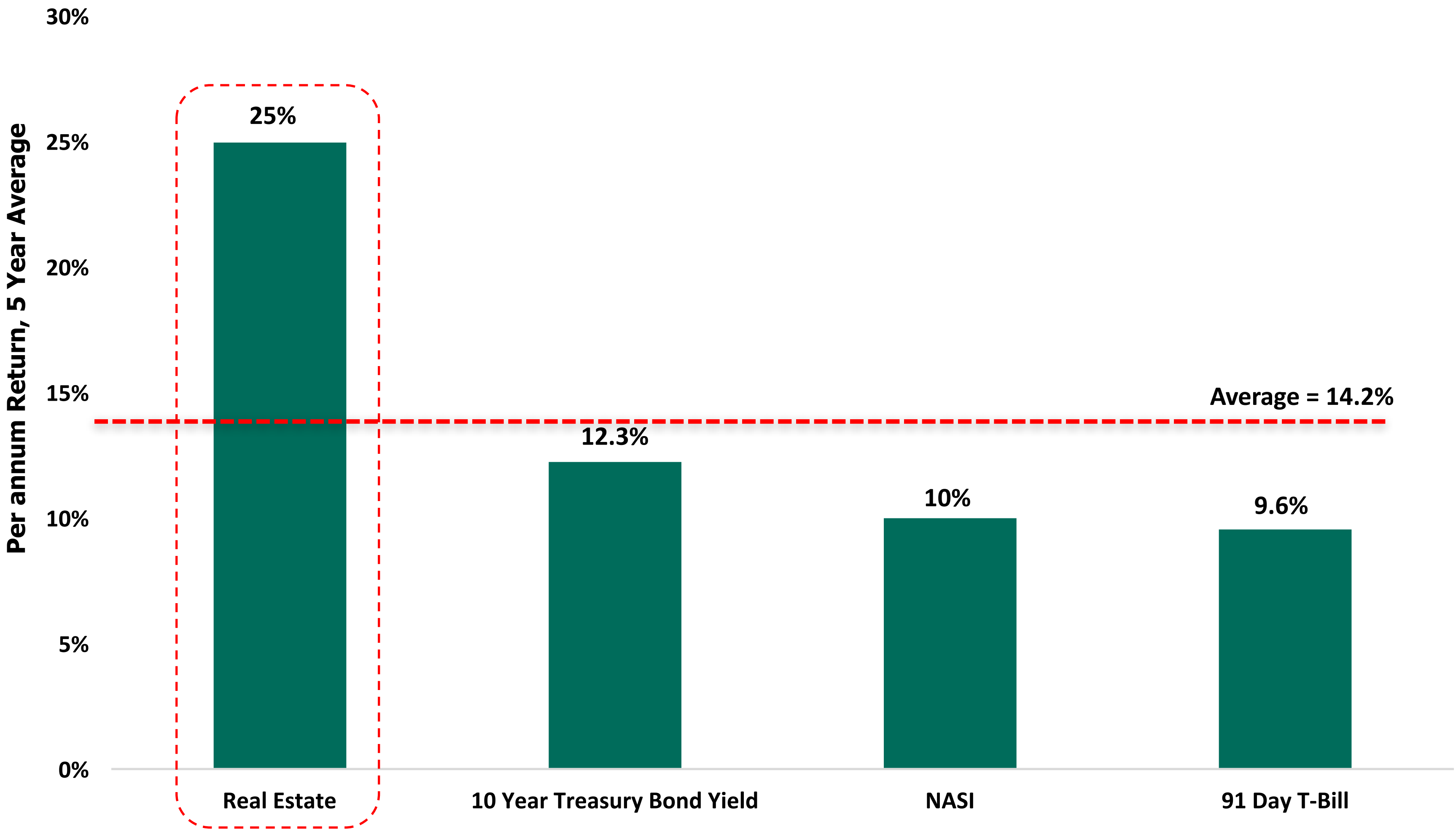


- The Real Estate sector is among the fastest growing sectors in the economy driven by a fast growing middle class and improved infrastructural developments by the government
- Despite Agriculture being the main driver of the economy, the tide is shifting and sectors such as Real Estate are emerging as the fastest growing sectors and are positioned well enough to drive the economy in the years to come. Real Estate is now the 5th highest contributor to Kenya's GDP, having a 5 yr. growth rate of 5.0%
- In order for this growth to be sustainable, access to credit is vital and PE investments are a major source in providing an alternative solution other than the traditional sources

Source – KNBS

Returns: Real Estate Offers the Highest Returns – Creating Wealth

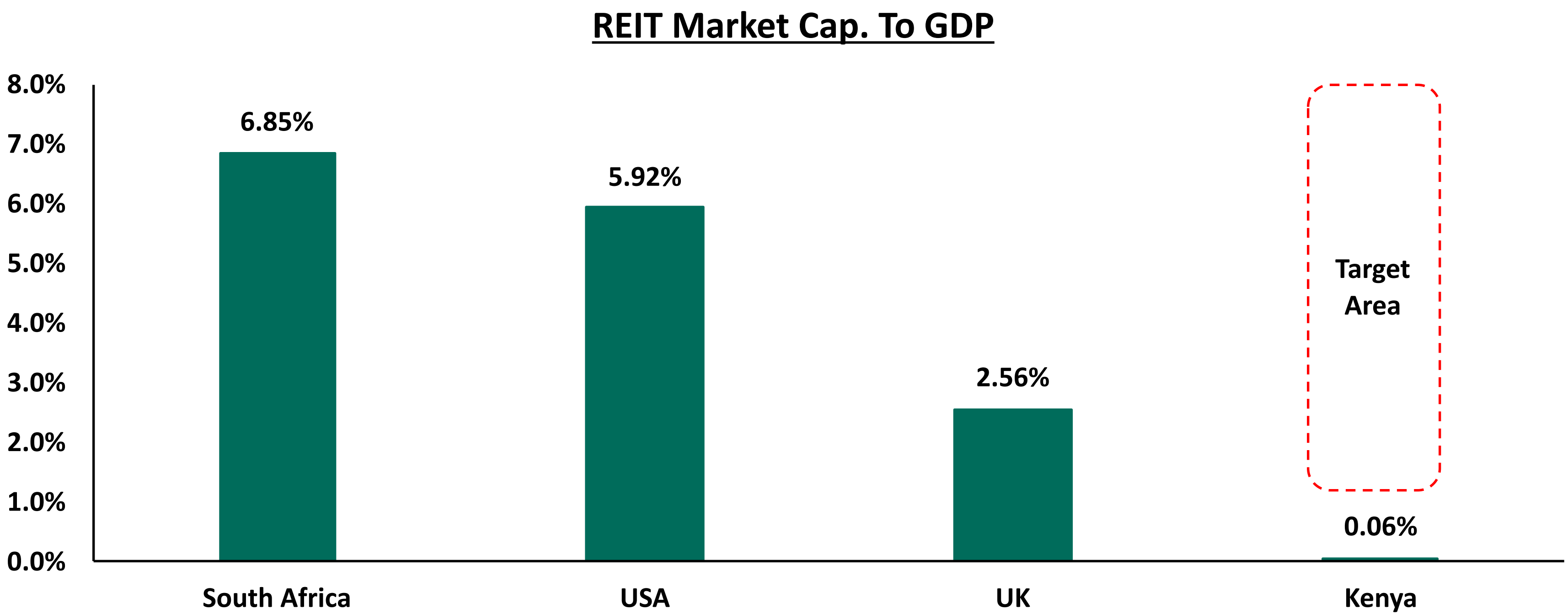
Traditional investments returning 10% compared to 25% for real estate, & projected to continue



And the Best Returns are Not in the Listed Markets …Yet..

The opportunity to securitize real estate will increase deepening of the capital markets in Kenya

- The investments in alternative markets can be packaged into securities that enable the public (those who are unable to invest in such asset classes) an opportunity to own real estate, and lead to deepening of our capital markets
- REIT's such as FRED and Fahari I-Reit are examples of such securities and have increased the market cap of the securities exchange and capital markets deepening



Portfolio Allocation and Returns – Case of 2015

Portfolios with allocation to alternatives outperformed those without alternative investment exposure

- We consider a typical conservative moderate portfolio with 65:35 allocation in fixed income and equities, (all traditional investment portfolio) and another with 50:30:20 allocation in fixed income, equities and Real estate (alternative investment)
- As indicated below, taking 2015 as a case, a portfolio with purely traditional investments recorded a negative return of 6.0% compared to a positive return of 0.7% in a portfolio with exposure in alternatives

		Portfolio	
Asset Classes	**2015 Asset Class Return**	**Without Alternatives**	**With Alternatives**
Fixed Income	(3.5%)	65.0%	50.0%
Listed Equities	(10.6%)	35.0%	30.0%
Real Estate	25.0%	0.0%	20.0%
Weighted Return		**(6.0%)**	**0.7%**

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III. Cytonn’s Strategy

Cytonn's strategy

Cytonn looks to bridge the Supply and Demand gap in the Real Estate market

- For many years, the supply and demand have been largely disconnected in the Kenyan Real Estate market, characterized by adhoc forays by players on both sides

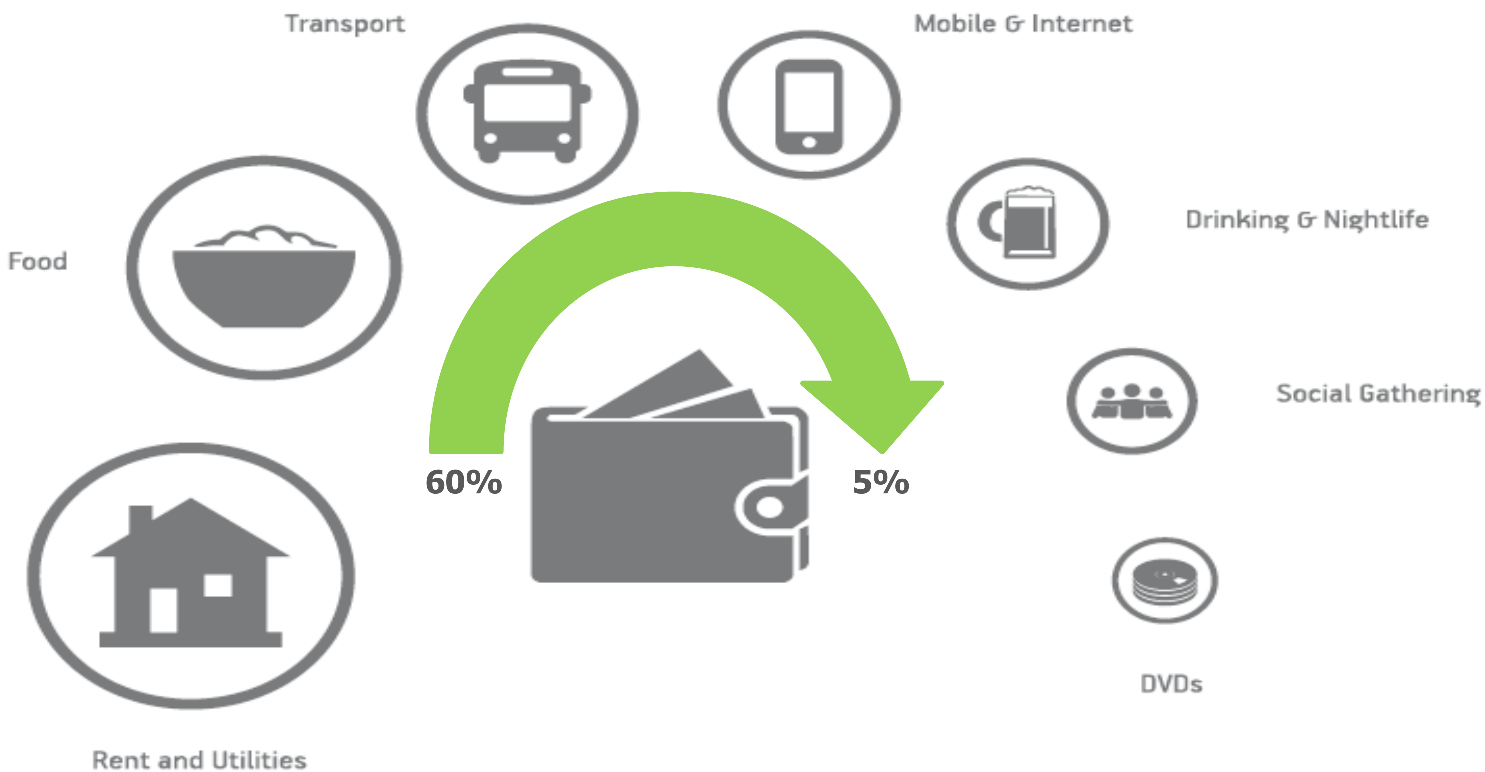
Supply Side / Developers	PE Players to Couple Supply & Demand	Demand Side
DEVELOPERS	**Cytonn & PE Players**	**INSTITUTIONAL & HIGH-NET WORTH**

By matching demand in the economy, which is 200,000 units per annum, to supply from institutional grade real estate developers in the region, private equity players provide expertise and execution capability to reduce the housing deficit in Kenya

Demographic Trends: Share of the Wallet

Citizens spending more on Rent & Utilities

- Individuals are willing to spend up to 60% of their Income on Rent & Utilities
- This growing wallet share, combined with rapid urbanization bodes well for Real Estate



Source: Research by Ark Africa, 2014

The Opportunity in Residential Housing

Real Estate has the opportunity to create Kshs 240 Bn of AUM

35% of the 40 Million Kenyans are employed

- 14 Million Kenyans are employed

Of the 14 Million employed, 20% earn on Average KES 100K

- 3.5 Million Kenyans earn KES 100,000 per month
- 75% of those reside in the Nairobi area & Metropolis
- 67% of residents within Nairobi Metropolis are renters

The 1.4 Million people are able to spend KES 20,000 per Month on rent

- 1.4 Mn X 20,000 = Cash Flows of KES 28.1 Billion per month
- This equates to KES 337 Billion per Annum
- Assuming we Target only 5%, it equates to roughly KES 16.9 Billion per annum

These Cash-flows can create an AUM of KES 241 Billion

- Capitalization for the KES 16.9 Billion is at 7%
- This equals to KES 241 Billion of AUM

The opportunity in Real Estate is similar to that which Equity had in Banking, and Safaricom in Telecommunications 10 Years ago

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Key Themes Driving our Property Development

The below are just a few of the factors driving our thematic investments in Real Estate

KEY THEME	REAL ESTATE SECTOR PROVIDING EXPOSURE TO KEY THEME				
	Master Planned Communities	**Commercial Office Parks**	**Commercial Mixed-Use**	**Suburban Malls**	**Hospitality Sector**
1. Large Housing Deficit	✓		✓		
2. Growth of Middle Class	✓	✓	✓	✓	✓
3. Demographic Trends	✓	✓	✓	✓	✓
4. Improved Infrastructure	✓	✓	✓	✓	✓
5. Political Decentralization	✓	✓	✓	✓	✓
6. Kenya as a Regional Hub	✓	✓	✓	✓	✓

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VI. Overview of Real Estate Market in Kenya

Real Estate in Kenya

Real estate sector expected to continue growing on the back of developments such as REIT's, and the entry of institutional developers and financiers to the market

Macro-economic Contribution

- The real estate sector contributed to 8.2% of Kenya's GDP in Q1 2016
- In Q3/2015, the construction and real estate industry recorded the highest growth at 14.1%, compared to 10.1% in financial services and 7.1% growth in agriculture
- A stable political environment, as well as favourable macroeconomic conditions such as a relatively stable interest rate environment have led to positive development in the sector

High Returns

- Real estate has consistently out performed other asset classes in the last 5 years, generating returns of 25% p.a., compared to an average of 10% p,a. in the traditional asset classes
- Residential units in Kenya generate an average rental yield of 5.0%, while commercial space generates an average yield of over 9.0%

Recent Developments

- The real estate sector which was previously dominated by individual developers has seen entry of more institutional developers such as Saccos, private equity firms and foreign institutions
- Development of REITS in the capital markets, as a way to raise funding and exit real estate developments, is likely to attract more institutional investors
- The real estate market has also seen an increased interest in the structured products aimed at easing the financing of the developments in the market

Market Outlook

- We expect continued growth on the back of improved macroeconomic conditions, sustainable high returns, and a changing operational landscape as developers strive to satisfy the high housing deficit
- The industry however continues face challenges such as the unfavourable interest rate environment

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Factors to Consider when Investing in Real Estate

Market performance is the key factor to consider while investing in real estate as it helps determine expected returns

- Real estate investment involves a relatively favourable risk/reward profile, but with relatively low liquidity as compared to other types of investments
- When considering investing into real estate, one should put into consideration the following factors;
- **Market performance** – One should analyse on the real estate trends over a given period, e.g. five years to measure the expected future returns on the investment based on the following factors:
  - **Uptake –** Find the historical and current records of the market uptakes, as this is directly related to the future expected gains in terms of price appreciation and demand hence a better cash conversion period for the projects
  - **Occupancy –** This informs on the market performance, in terms of expected rental yields and rental escalations
  - **Rental yields –** Rental yield is a key factor to long term project profitability as its related to the time needed to recover your initial investment. Thus a market or real estate theme with a higher rental yield is more attractive. For example its more profitable to invest in commercial office at 10% rental yields as compared to residential at 6% rental yield in Nairobi market, all other factors held constant
  - **Capital Appreciation –** This informs mainly on land investment. It helps investors make a decision based on whether to buy land for speculations and developers too can consider land banking for future gains

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Factors to Consider when Investing in Real Estate, continued…

Location is a key factor to profitability in real estate as it is directly related to property valuations

- **Location –** This is the key factor to profitability in real estate as it is directly related to property valuations. Proximity to amenities, neighbourhood status and scenic views are major factors for residential property valuations; while proximity to markets, warehouses, transport hubs, freeways, tax-exempt areas, play an important role for commercial property valuations
- **Infrastructure –** Investors should consider factors such as road network, sewer line , electricity and water connections among others in the area to enable accessibility and for convenience as they directly increases the value of the project as well as demand
- **Security –** Security in the area is directly affects the uptake of the projects as clients have more confidence for areas associated with safety
- **Supply and Competition –** This are key factors to consider whether the type of investment you want to venture into has been exhausted by other developers and the type of the competitors you expect into the industry. This will help prevent you from being locked in a project

Real Estate Exposure

Despite being capital intensive, there are several ways how one can get exposure in real estate

- Real Estate is capital intensive and therefore, not everyone can get into this kind of investment. However, there are several ways through which one can invest in Real Estate namely
  - **Real Estate Investment Trusts (REIT's)** - A REIT is a company that mainly owns and operates income producing real estate such as apartments, shopping centers, offices, hotels and warehouses. REITs were created in order to make investments in large scale income producing real estate available to average investors. There are 2 kinds of REITS,
    - **Investment REIT (I-REIT)** – This is an investment in an income generating Real Estate such as residential or retail developments where 90% of the income is distributed among the REIT holders as dividends. In Kenya, The Fahari I- REIT is the first of its kind having achieved only 29% subscription at issue
    - **Development REIT (D-REIT)** – This is an investment in an development company where the REIT Holders will receive their returns once the company exits the development. In Kenya Fusion D-Reit would have been the first of its kind but however failed to get the minimum requirements in terms of subscriptions and number of individual investor
  - **Project Notes** – This is a structured debt instrument backed by a Real Estate project where investors buy into the note which guarantees them a return. The notes can be structured in a way that the minimum amount investable is favorable for people with fewer funds at their disposal
  - **Shares in a Real Estate company** – A Real Estate company, either a developer or an investing company, can list on the main bourse allowing common investors to have a chance to tap into the high returns from Real Estate. As the company derives value for Real Estate, so will the investors realize value through share price appreciation and dividend payments

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Real Estate Investments – Traditional Way

Traditionally Kenyans have been investing in real estate via Brick and Mortar

- There are two ways to access real estate in any market,
  - **Brick and mortar:** this is the development of a building or the purchase of a parcel of land, aiming to benefit from future capital appreciation and rental income
  - **Real estate investments:** this is the conversion of the physical real estate asset into a liquid investable product. This can either be public markets tradable like REITs or privately placed
- Traditionally, Kenyan's have been investing through the brick and mortar way. However they have been facing the following challenges:

How We Have Traditionally Invested in Real Estate

Summary

- Traditionally, Kenyans used to invest in real estate through brick and Mortar. They would purchase a piece of land and then embark on developing a building
- Financing for these investments is typically personal savings and expensive bank debt

Challenges

- The traditional way of investing in Real Estate had the following challenges;
  1. Illiquidity – Exiting brick and mortar Real Estate is hard as there lacks an official platform for transactions and pricing is opaque
  2. Delays in land titling process
  3. Brick and mortar Real Estate is expensive hence people resort to expensive bank debt

Source: Cytonn Research

Real Estate Investments – The "Sharp" Way

There are three broad ways through which one can invest in real estate

- Apart from the traditional 'smart' way of investing in Real Estate which was through brick and mortar, investors can opt for the following 'sharp' investment options, depending on the investors' investment needs, risk/return profile, time horizon and liquidity needs;

Investment Type	Description	Investment Horizon	Risk Appetite/Return Profile
Equity	Purchasing partial ownership of a vehicle owning real estate developments and using a professional developer to manage the development activities	3-7 Yrs	Risk appetite is high hence they demand returns in excess of 25.0%
Mezzanine	Providing subordinated financing to a real estate development. The financing is junior to bank debt, hence gets paid only after the bank but senior to equity, hence gets paid before equity investors	1-3 Yrs	Risk appetite is moderate hence demand returns of between 14-15%
Project Notes	This involves financing for construction by investing in a fixed income note backed by real estate	1 Yr (Depends on set milestones)	Risk appetite is low, however they demand returns on average of 18.0% due to the leverage they hold. They usually finance 60.0% of the project

Source: Cytonn Research

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Investment Planning Process for Private Real Estate Projects

For private players, planning for an investment in a real estate project requires many steps; spanning from market research and feasibility tests/modelling, budgeting and project finance/fundraising, project management and eventually exit;

I. Market Research – Involved in proactive and reactive research activities mainly aimed at informing the strategy for deal origination or project feasibility;

II. Project Finance – Involved in raising of capital to run the project and financial modelling for the project to test financial viability and budget formulation;

III. Project management – Involved in running of the project, ensuring budgets and timelines are adhered to;

IV. Exit – Involves the realization of the investment return.

Market Research needs to be both proactive and reactive

Research Idea

- Proactive and reactive research
- Hypothesis to be guided by leads under evaluation and focus of the week

Research Design

- Specifying type of data to be collected (qualitative, quantitative or both)
- Construction of questionnaire
- Preparation of data entry, analysis and presentation template
- Determination of sampling process and sample size

Data Collection

- Desktop research and field survey
- Data cleaning and record

Data Analysis And Publication

- Statistical evaluations
- Hypothesis testing

Presentation

- Comments and recommendations are made
- Verdict to be given on whether to proceed

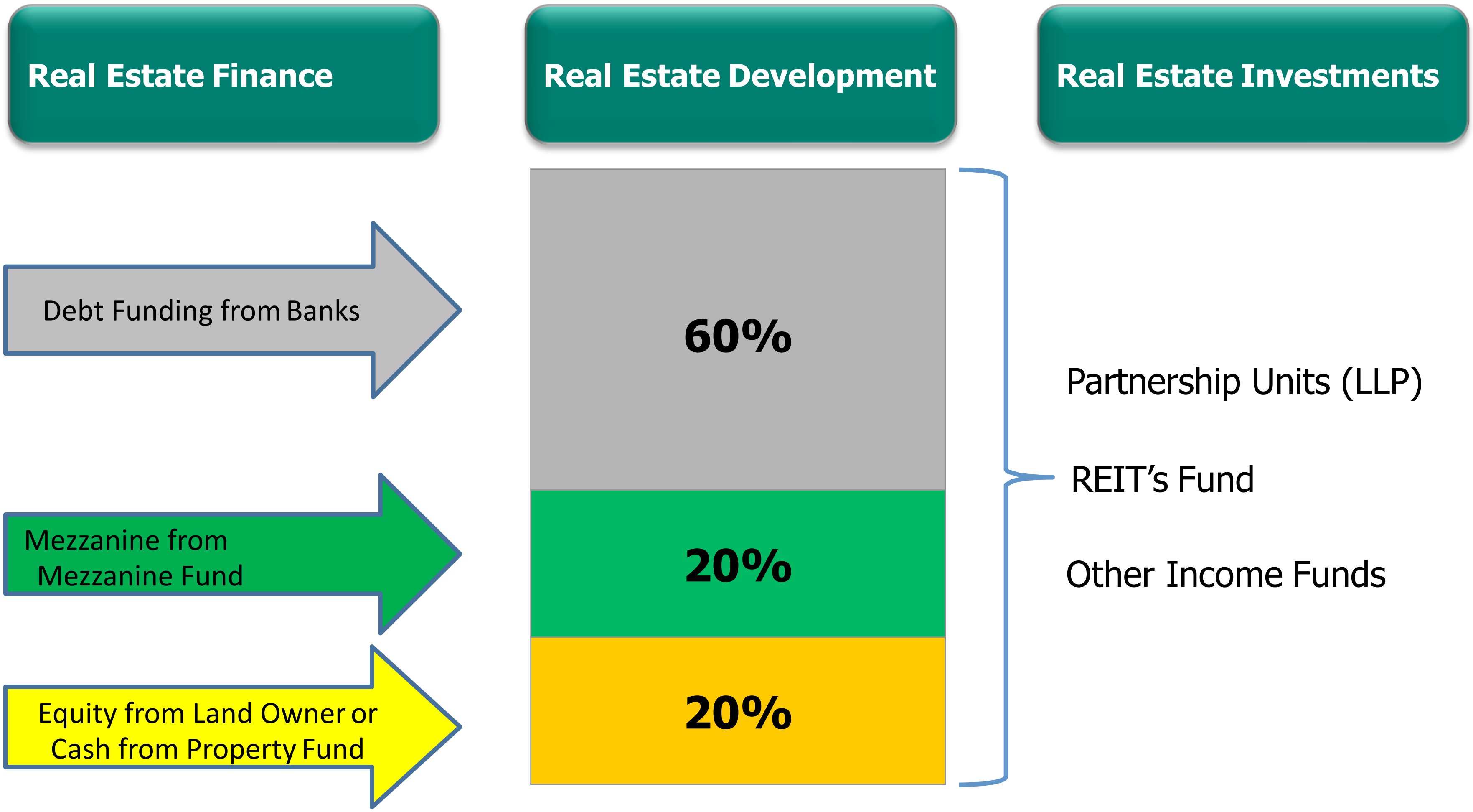
After Market Research, Budgeting and Project Financing begins

Fundraising for real estate is key considering the capital intensive nature of projects

- The capital intensive nature of real estate projects is quite daunting for anyone looking to develop or invest in real estate. It is therefore imperative for one to have a strategy for accumulating the funds to embark on a project of this nature
- For this reason, fundraising for real estate is one of the most important aspects in the development process
- There is an abundance of capital in the market. However, what is lacking is knowledge of how to tap into these sources of capital and to channel these funds into real estate developments. Strategic ways that any company can tap into this include:
  - **Institutionalize development:** Have proper corporate governance structures to build investors confidence in your company and products
  - **Structuring real estate into investment instruments that are focused on target returns:** Investors are more interested in returns rather than the brick and mortar aspect. Packaging your product into an investment is thus important
  - **Coupling fundraising and development:** Given the very risky nature of development, investors tend to want the fundraising function working alongside the development function in order to ensure that the development process is very sensitive and responsive to return expectations
  - **Professionalized development:** Employing professional development and project management experts, and having strong investment committees approve development prior to commencement

Typical Capital Structure & Value Chain

Highlighted is our typical Real Estate capital structure consisting of 60% debt and 40% equity



V. Legal Factors to Consider in Real Estate Investments

Legal Factors to Consider in Real Estate

I have made a decision to invest in Real Estate so what next…

- Investment in Real Estate involves dealing in land and as we all know, in Kenya and generally the whole of Africa, the most emotional and complex issues legal issues revolve around land with some land matters stuck in court for 20 years or more, something that warranted a specialised Court for Land matters at the level of the High Court, the Land and Environmental Division;

- Real Estate Companies such as Cytonn Real Estate, LLP through its structured projects or real estate units provide an easy and convenient way to invest in real estate as they put into consideration the key legal matters that need to be considered in a Real Estate investment, throughout the project life cycle, which include:-

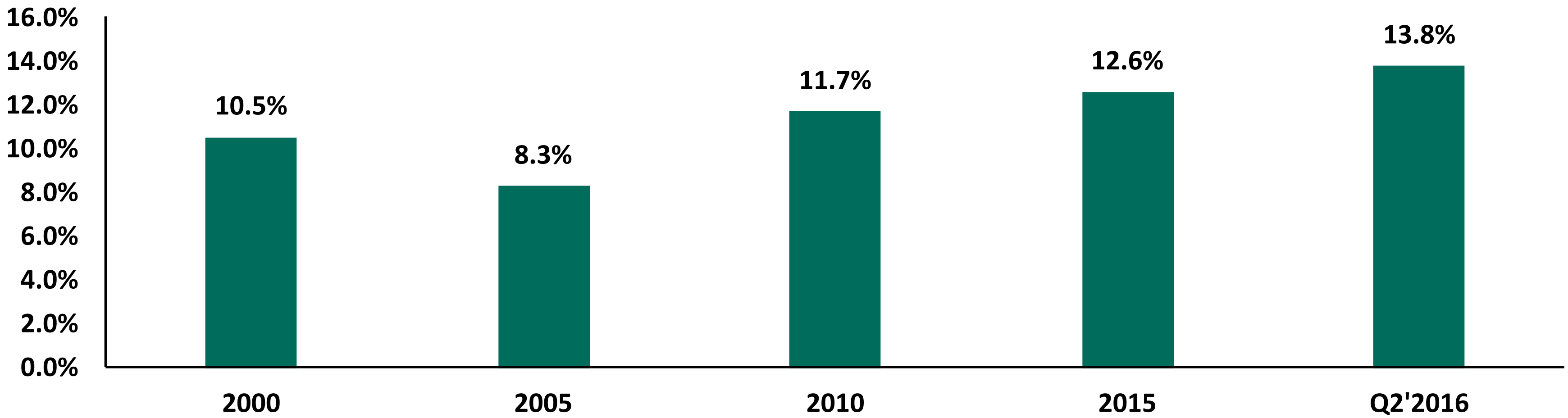
  - Undertaking Due Diligence prior to acquisition;
  - Tax Structuring and choosing the right legal entity;
  - Ensuring the relevant statutory approvals are obtained to facilitate the construction and the contract documents with the various contractors and professionals are legally sound;
  - Preparing the right legal documentation to facilitate the sales process such as Sale Agreements and Leases; and
  - Determining the right structure and preparing the relevant legal documentation for Management of the Property after completion of the Project.

VI. Conclusion

Conclusion

Real Estate has delivered the best returns over the past years with a 5-year average of 25.0%

Real Estate and Construction Contribution to GDP



- Real Estate and Construction industry’s contribution to GDP has bee on the rise since 2000 from 10.5% to 13.8% in Q2’2016. It has also been the consistent asset class in terms of performance delivering a 5-year average return of 25.0%
- With continued government expenditure in improving infrastructure and energy provision, the sector is expected to continue to grow. With this positive outlook, it is imperative that fund managers should have an exposure to Real Estate to achieve high and stable returns in future

Q&A