Overview on KSA REITs

December 2019

The recently introduced REITs in the Saudi stock market provide the risk averse investor with a stable income-generating investment, in an economy that has been facing multiple challenges since 2017. While the REIT sector has been under-performing since inception, the outlook for the sector is positive on the long-term, as the economy is expected to regain momentum.

Key Points

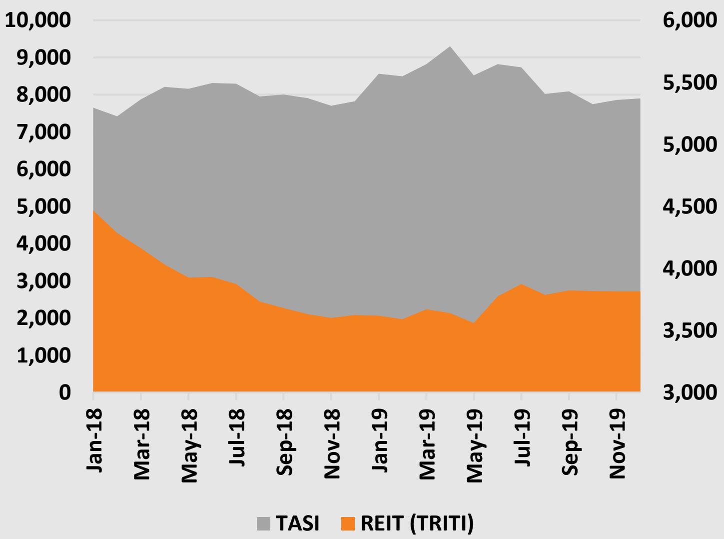
- **As of November 2019, the total number of listed REITs reached a total of 17 REITs**. Since 2016, when REITs were first introduced in the Kingdom, it was expected that this type of investment would appeal to investors during an economic downtrend. However, the capital market performance of REITs hasn't been encouraging since inception, as all REITs are being traded below their listing price.

- **The relationship between the real estate market and REITs market is not to be ignored**, as the subdued performance of the real estate market during 2019 pressured rental rates, which ultimately affected the REIT sector. Moreover, the clear lack of liquidity in the capital market coupled with the recent ARAMCO IPO, had a negative impact on REITs in a more technical sense.

- **Due to the transformational phase that the Saudi economy is currently undergoing, we expect that on the short and medium term the REIT market will continue to under-perform.** However, as the government reforms, the National Transformation Plan (NTP), and Vision 2030 come to effect, the outlook for the REIT sector is nothing short than promising, provided the inclusion of Riyad REIT and SEDCO Capital REIT in FTSE EPRA Nareit Global Emerging Index and the plan to add AlAhli REIT (1) and Musharaka REIT as per their recent announcement on the 18th of December.

KSA REIT Sector, TTM (17 listed REITs)	SARmn
Total Net Income	522
Total FFO	910
Total Dividends (H1 2019)	852
Total Market Cap (26/12/2019)	14,843
Total Book value of Investment Property	17,617
Average Dividend Yield semi annually	5.7%
Total Debt	SAR5,005

REITs Vs TASI



1 Economic Overview

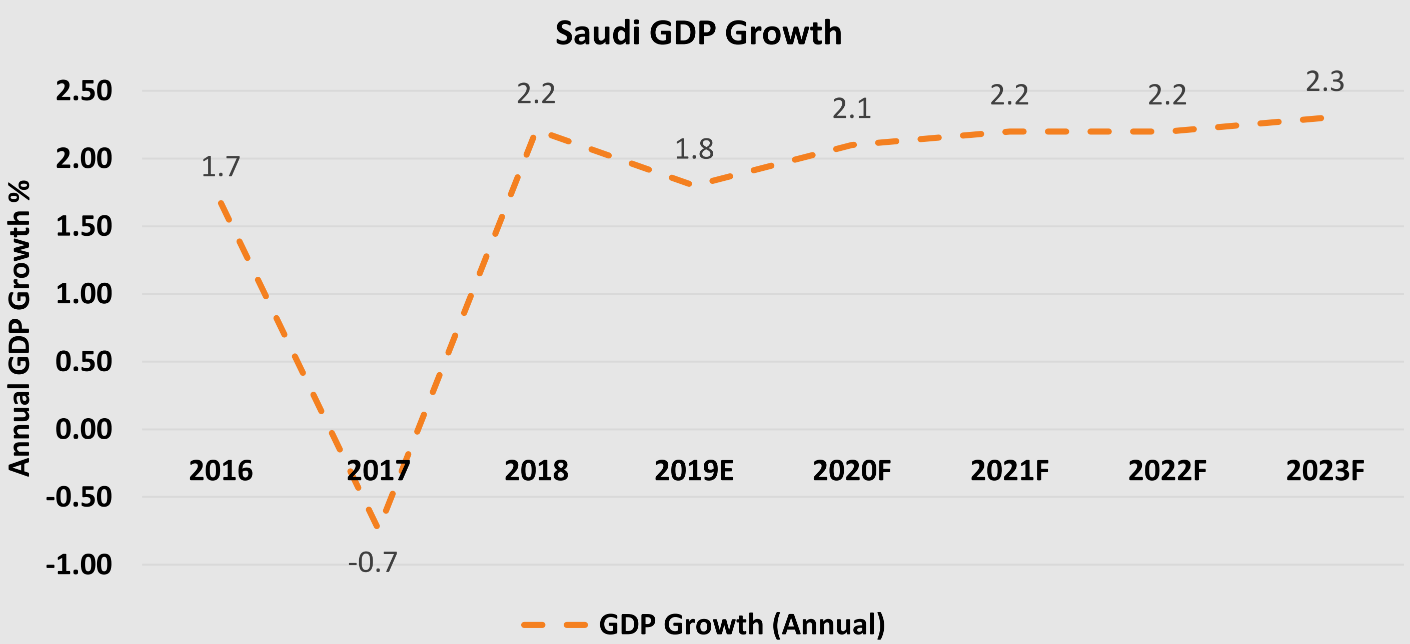
- **The REIT performance has been affected by a number of factors**, while it could be easily attributed to the fact that it's a fairly new market for the Saudi investor and all the companies are in their growth stage, the subdued performance of the real estate market during the year had a negative impact on the REITs performance.

- **A general slowdown in the economy hit the real estate market in 2019.** Despite the improvement in most sectors across the kingdom**,** the real estate sector has been enduring a prolonged slump for the last few years and doesn't show much signs of recovery towards the end of 2019. During the year, major infrastructure projects were put on hold in an attempt to apply corrective measures for the long term well being of the economy. The latter significantly impacted the real estate market, as it pressured real estate selling prices, rental rates and occupancy rates during the year.

- **Moreover, the immaturity of the Saudi REIT market** is especially prevalent in the buying pattern of investment properties of the listed REITs, which was highlighted in the lack of strategy of highly diversified REITs. As of H1 2019, the market included a total of 138 buildings varying between different asset classes across all market sectors.

- **A strong and evolving regulatory framework has proven to be favorable in more mature markets**, therefore, we expect that this will remain a key objective in the development of the REIT market in Saudi Arabia. The Saudi Arabian Capital Market Authority (CMA) has recently approved a number of amendments to initial regulations governing REITs, including the increase in the minimum capital requirement for new funds from SAR100mn to SAR500mn.

- **Going forward, the implementation of the National Transformation Plan (NTP) and 2030 vision** is expected to decrease the Kingdom's reliance on the hydrocarbon sector and support stronger non-oil growth. is set to remain a central element of economic policy over the coming years, yet it is likely to be a gradual process, which requires some time to come into effect.



Source: International Monetary Fund (IMF), World Development Indicators

2 REITs Capital Market Overview

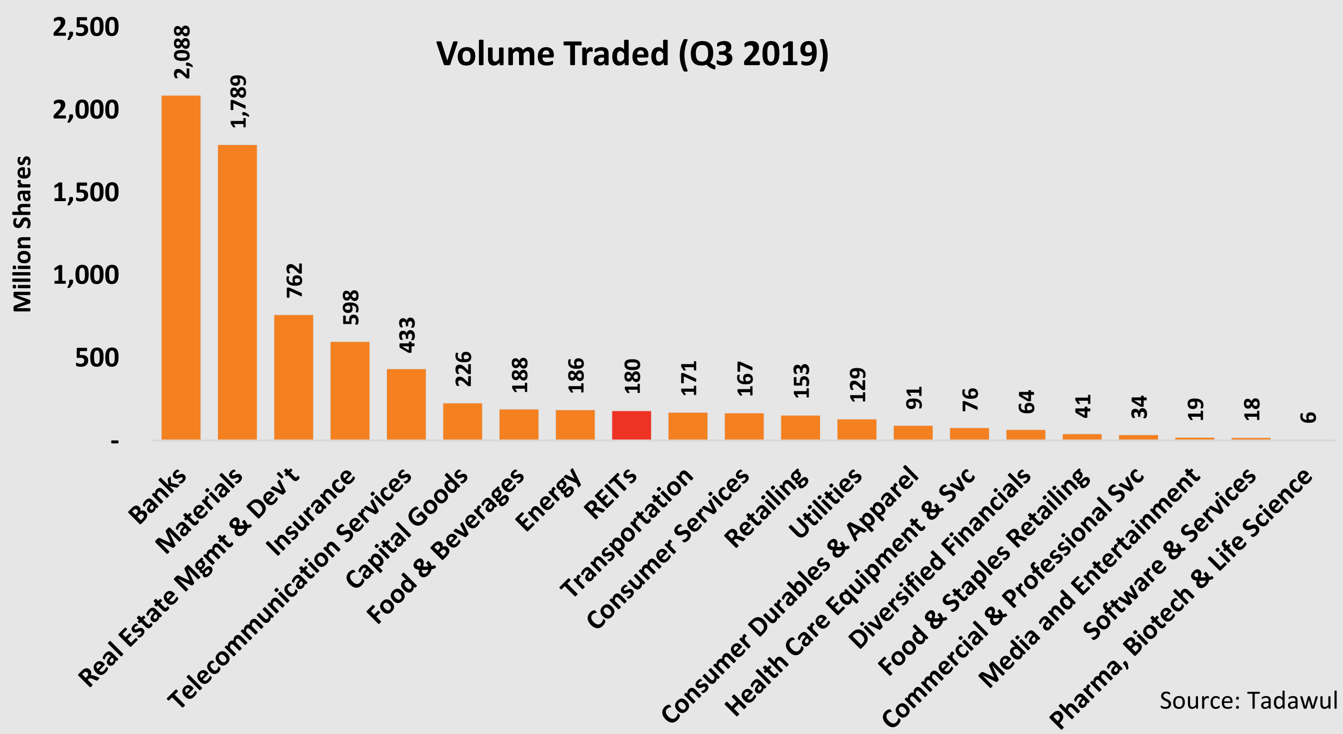
- **While the introduction of REITs is expected to pave the way for institutionalizing the real estate market** and provide a rather stable type of investment in the kingdom to cater to the risk averse investor, the performance of REITs in the capital market since 2018 hasn't been encouraging.

- **The Saudi capital market started on a positive territory in 2019 and was set to benefit from the relaxed budget of spending policy.** However, the sluggish performance in the real estate sector negatively impacted the REITs capital market performance.

- **Lack of liquidity in the Saudi capital market is another factor that affected the REIT capital market performance.** In 2019, the REIT sector's volume traded represented only 2.5% out of total volume traded in the capital market as of November 2019. This can be attributed to the fact that REITs are a fairly new sector for the Saudi investor coupled with their unwillingness to invest in the capital markets given challenging macroeconomic conditions.

- **Aramco's IPO is expected to have a huge** impact on the investing pattern within the market and is expected to hog a large sum of the sector's liquidity, further impacting REITs capital market performance.

- **On a more positive note,** on June 20th, 2018, MSCI Inc. announced the reclassification of MSCI Saudi Arabia Index from Standalone Market to Emerging Markets (EM) status, recognizing the Kingdom's efforts to modernize its capital market. Furthermore, during September 2019, it was announced that AlRajhi REIT and Jadwa REIT have been included in FTSE EPRA Nareit Global Emerging Index. Moreover, Al Riyad REIT and SEDCO Capital REIT have been also been included during 2019, in addition to FTSE's recent announcement of including both AlAhli REIT (1) and Musharaka REIT in the index. The recent inclusions, in FTSE EPRA Nareit Global Emerging Index, are bound to boost activity and motivate foreign investments, which will eventually reflect on the REIT sector's liquidity; as the inclusion is considered a good exposure for the Saudi Arabian REITs market.



Source: Tadawul

3 KSA Real Estate Market Overview

The introduction of REITs paved the way for institutionalizing the real estate market. The real estate market and REITs have been historically co-dependent in the global market. However, the REITs market is a fairly new one in the Kingdom. Consequently, in order to further understand and estimate the future of REITs in Saudi Arabia, it is important to explore the drivers in the real estate market and how they will impact the performance of REITs.

• Retail Market:

Mixed performance was registered across different types of retail asset classes in 2019. Despite the delay experienced in the retail projects that are under construction in the kingdom, a strong pipeline is expected in the coming 12 months, which is expected to be tenant favorable as it will impose pressures on rental rates in retail complexes.

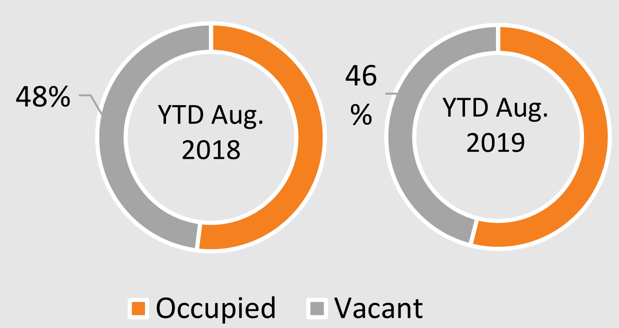
Outlook: Vacancy levels are expected to remain under pressure due to the abundance of new projects, as the focus now is on renovation of the lesser-quality centers to fit in cinemas and other entertainment offerings. The outlook is positive on the long term, as the introduction of cinemas in retail centers is expected to boost the footfall and maintain overall performance.

• Hospitality Market:

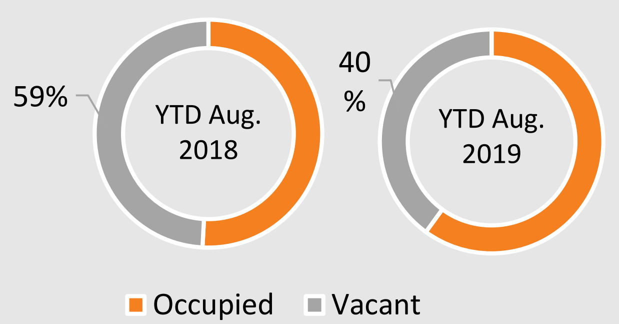
Saudi Commission for Tourism and National Heritage (SCTH) has formally announced the launch of tourist visas for international visitors, which is bound to boost the hospitality sector's performance. Additionally, the recent official opening of the new King Abdelaziz International Airport (KAIA) is expected to stimulate growth in business travel which is bound to reflect on hospitality.

Outlook: Hospitality sector is expected to recover in the short and medium term, as highlighted by the government's diversification efforts, tourism initiatives and major infrastructure projects that include a lot of entertainment. The government's attempt to create viable leisure-based destinations through mega projects; Red Sea Project, Amaala and Al Qiddiyah coupled with the introduction of tourist visa "Sharek visa" is bound to significantly boost the tourism and hence the hospitality market.

Hotel Occupancy In Riyadh



Hotel Occupancy In Jeddah



Source: STR Global

3 KSA Real Estate Market Overview Con'td

• Residential Market:

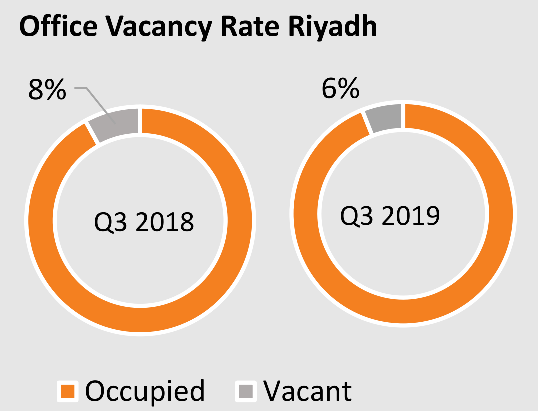
2019 witnessed a slowdown in the number of completions in addition to a decline in sales prices and rental rates in the residential sector by Q3 2019. The pipeline in the residential market does not match the weak demand for residential units in the Kingdom. As a result of major pressures on the population's income due to the recent government reforms, the demand shifted towards smaller and more affordable units.

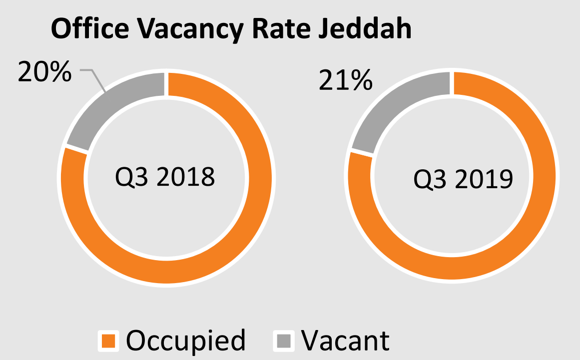
Outlook: On the medium term, further pressure on sales and rental prices are due given the strong pipeline. However, as the supply adjusts to more affordable, medium-sized units, the residential market will regain momentum. We remain positive in our long-term outlook as the market is expected to pick up on the back of housing initiatives, which tackle the shortage of affordability and increase homeownership rates in line with vision 2030.

• Office Market:

During 2019, Grade A offices showed more resilience compared to lower grades. The supply slightly increased in Q3 2019, moreover, a significant increase in the supply of office space is expected in the last quarter of 2019. The demand is currently driven by large government inquiries, mainly from entities linked to Vision 2030, however it's not limited to the government. The socioeconomic reforms motivated the emergence of a large sum of entrepreneurs and SME's. Consequently, we expect the demand on offices will be specific to smaller, Grade A office spaces with competitive prices.

Outlook: The market is likely to remain tenant favorable as supply increases while demand remains sluggish. We expect the office market – particularly high-quality Grade A office space with better connectivity & amenities – to regain some momentum. Furthermore, landlords are expected to become more responsive to the current economic climate by shifting parts of their premises to flexible smart offices targeting the young entrepreneurs.





4 KSA REITs Analysis

Given that most REITs were recently listed, it was deemed unfair to base our REIT ranking solely on valuation. Instead, the criteria we used to rank Saudi REITs are based on various performance indicators, yet it is still purely on a fundamental basis.

We reviewed the following ratios for the 17 REITs through 10 indicators in order to assess them based on their valuation, growth potential, and risk appetite.

Given that 4 of the REITs were recently listed over the past 12 months, and the ratios are calculated based on trailing twelve months (TTM) for all REITs, we have excluded *Alkhabeer Reit, Bonyan REIT, Swicorp Wable REIT and MEFIC REIT* for fair comparison.

Valuation

1

$$\textbf{Cap Rate} = \frac{\textbf{Net Operating Income}}{\textbf{Property Market Value}}$$

Capitalization rate (cap rate) is a real estate valuation measure used to compare different real estate investments, showing the rate of return earned on the REIT's real estate investments. It is an estimate of the investor's return on the real estate investments.

2

$$\textbf{P/FFO} = \frac{\textbf{Current Market Price}}{\textbf{Funds from Operations per share}}$$

P/FFO is a multiple showing the REIT's market price compared to the fund from operations it generates for the investors. A relatively low P/FFO shows that the REIT's market price is low compared to its funds from operations, and accordingly indicate that the company might be currently undervalued. Accordingly, the lower the P/FFO of the REIT, the better.

3

$$\textbf{Dividend Yield} = \frac{\textbf{Dividend per Share}}{\textbf{Market Price}}$$

Dividend yield represents the main investor's return from their investment in the REIT which is provided in the form of dividends. Unlike equities, REITs are stipulated by law to distribute at least 90% of its net income as dividends. Dividend yield represents the investor's rate of return on the purchased share.

Growth

4

$$\textbf{Assets Growth} = \frac{\textbf{Properties Expected Value}}{\textbf{Properties at Book Value}}$$

Assets Growth ratio is considered as a potential growth indicator for the REIT based on the funds' announcements of future acquisitions.

5

$$\textbf{Debt to Assets} = \frac{\textbf{Total Debt}}{\textbf{Assets}}$$

Debt to Assets ratio is considered as a potential growth indicator for the REIT given that REITs are required by law to maintain a debt to assets ratio of a maximum of 50%. If the REIT reached its maximum debt to assets ratio, this gives little opportunity for growth especially given that REITs are required to distribute at least 90% of net income.

6

$$\textbf{FFO Payout Ratio} = \frac{\textbf{Declared Dividends}}{\textbf{Funds from Operations}}$$

FFO payout ratio is another measure for the REIT's long-term growth; in terms of growth, the lower the REIT's FFO payout ratio the higher growth potential the company has. Low FFO payout ratio indicates higher retained earnings per year, which if accumulated over the years might be used to finance growth opportunities.

Risk

7

$$\textbf{NOI to Interest} = \frac{\textbf{Net Operating Income}}{\textbf{Interest Expense}}$$

NOI to interest is a measure of the company's debt coverage, showing the number of times FFO generated by the company can cover the interest paid on debt. FFO to interest is considered as a measure of risk.

8 **Income Risk**

Income risk is assessed based on the contract period with tenants for each of the REIT's properties, taking into consideration the weight of each property in the REIT's portfolio. The longer the contract period signed with tenants, the safer and more guaranteed the REIT's income is.

9

$$\textbf{Impairment} = \frac{\textbf{Impairment expense}}{\textbf{Investment Properties}}$$

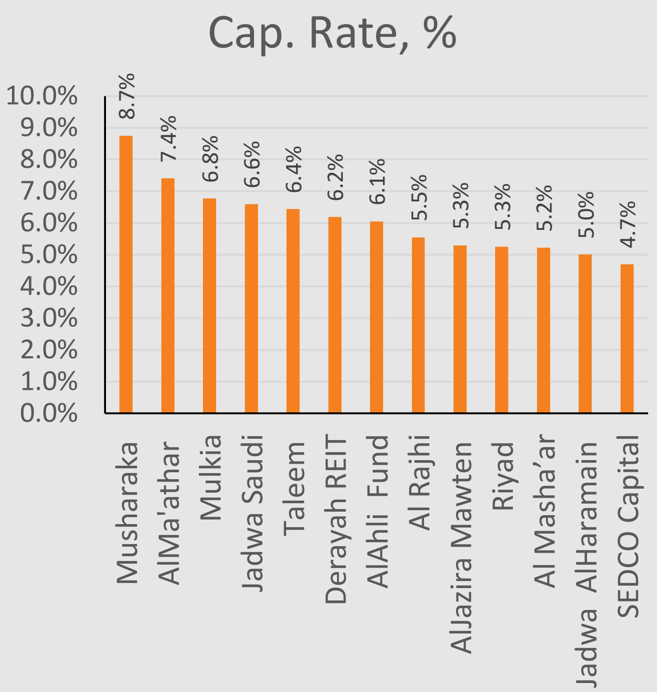
Impairment investigates the amount of impairment reported on the company's investment properties since inception as it indicates expected decrease in future cash flows generated from the investment property.

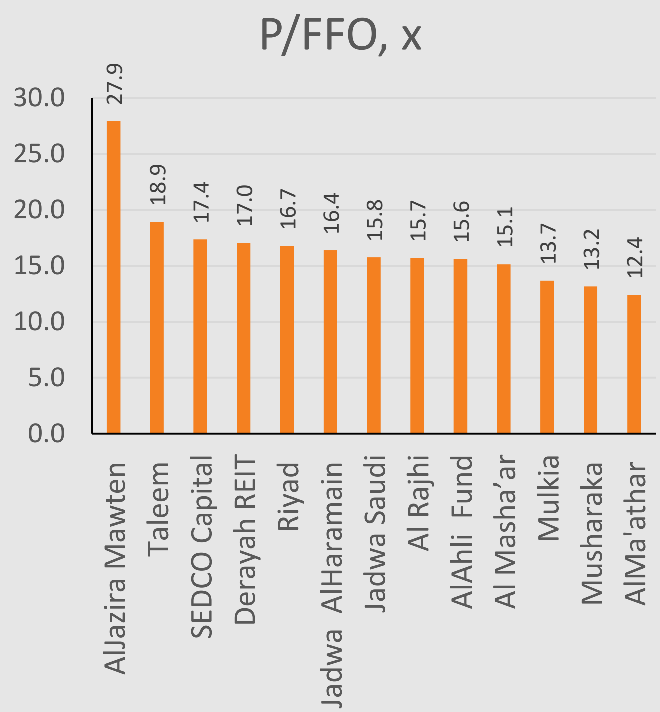
10 **Diversification**

Diversification assesses the fund's portfolio concentration in terms of sector involvement.

4.1

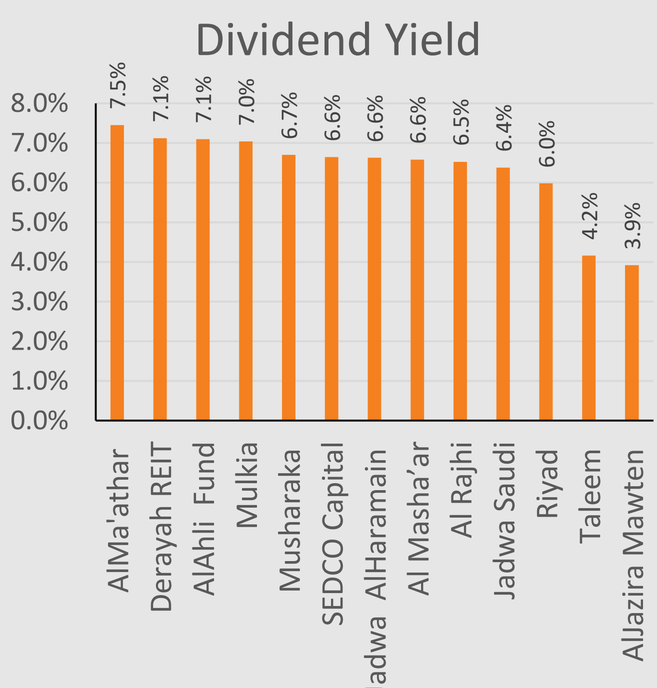
Valuation





Musharaka REIT provided the highest return in TTM with almost 1% difference to the second highest return followed by **AlMa'thar REIT.** Musharaka REIT's portfolio includes 9 buildings that vary between hospitality, industrial, commercial and residential sectors , similarly, Musharaka's properties are concentrated on residential complexes, as well as hospitality and commercial properties. On the other hand**, SEDCO REIT** reported an extremely low cap rate as a result of below average NOI due to impairments in TTM.

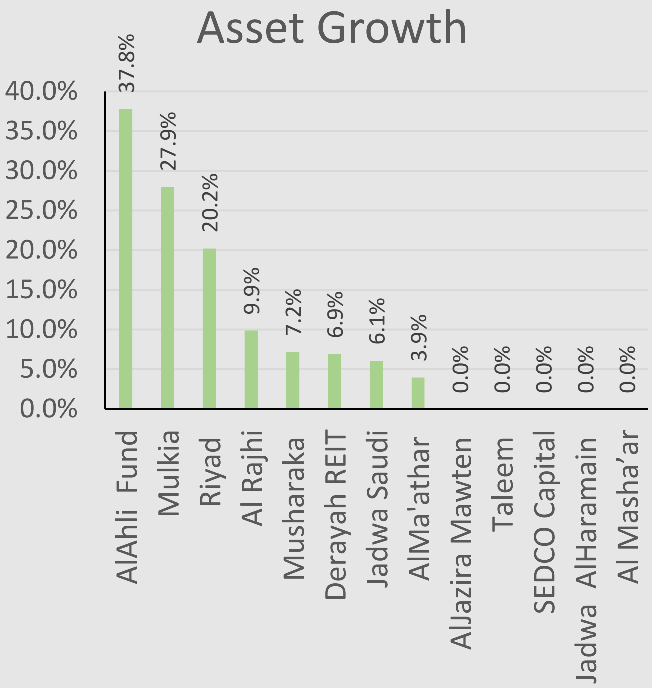
AlMa'athar REIT and **Musharaka REIT** are the most undervalued based on TTM FFO and market price with P/FFO ranging from 12.4x to 13.2x compared to a sector average of 16.6x (excluding Al Jazira). On the other hand, **Al Jazira Mawten** is currently significantly overvalued given its low FFO in TTM, where it recorded P/FFO of 27.9x, as a result of its significantly low TTM results.



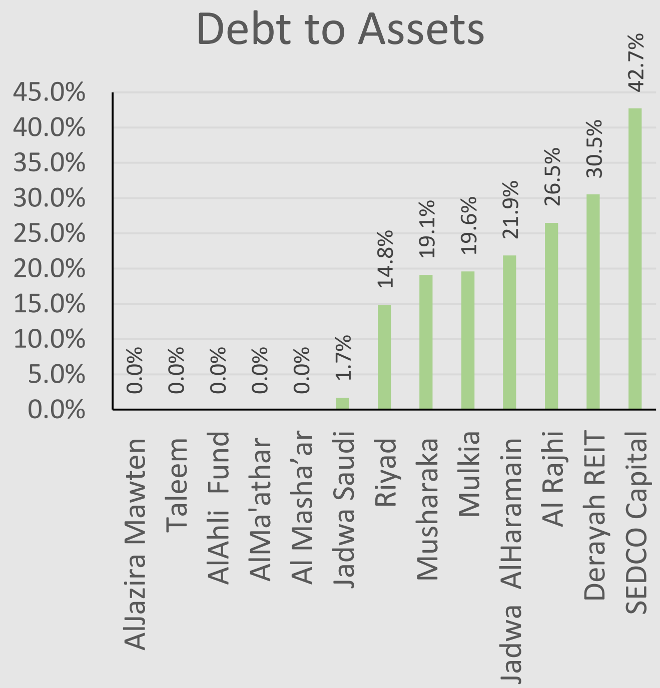
AlMa'athar REIT paid the highest dividend yield of 7.5% of stock price, over the period of TTM, followed closely by **Derayah REIT** and AlAhli REIT with yields of 7.1%. On the other hand, **Al Jazira Mawten REIT** recorded the lowest Dividend yield due to the fact that it only paid a total of SAR5.9mn of dividends over the period of TTM.

4.2

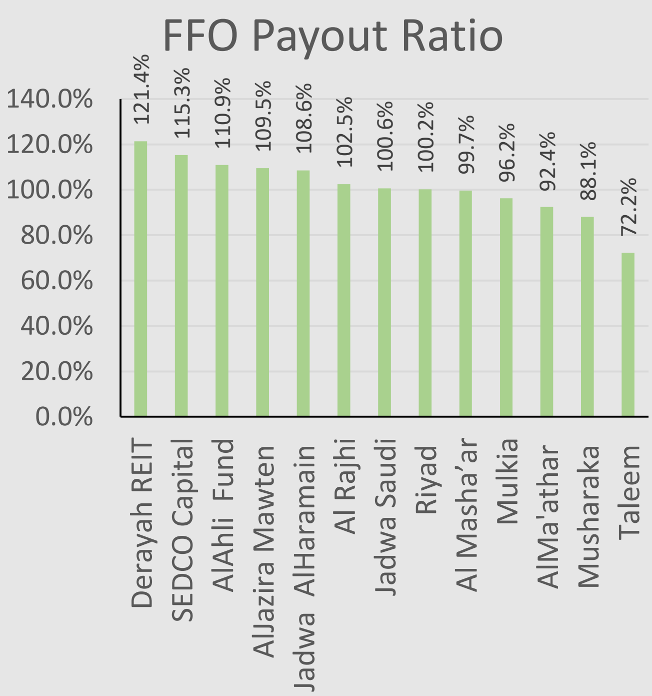
Growth



AlAhli REIT Fund scored the highest following its announcement of adding 2 new office buildings to its portfolio with the value of SAR505mn, funded through a bank facility. It was fairly expected as AlAhli has only 2 properties in its current portfolio, however, **Riyad REIT** recently announced the acquisition of 3 class A buildings in the US, being the first KSA REIT to invest in the US.



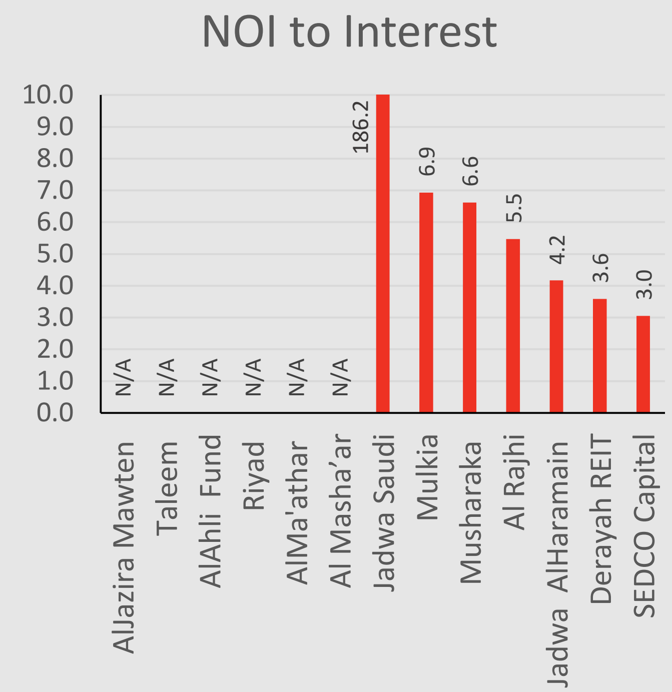
5 out of the 13 REITs did not acquire debt since inception, which leaves more room for growth. It is worth mentioning that according to the CMA, the ceiling for REIT's leverage is 50% out of the fund's total assets. **SEDCO Capital** reported the highest debt ratio of 42.7%.



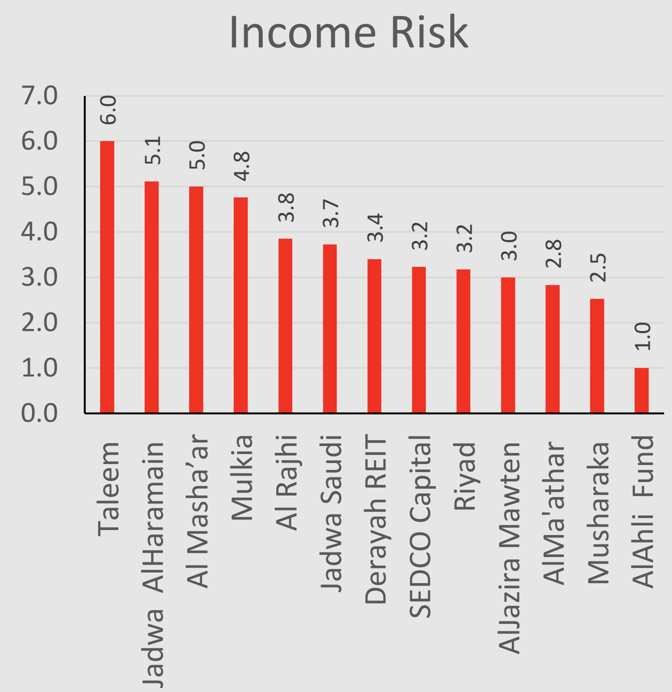
Taleem REIT and **Musharaka REIT** distributed the lowest dividends compared to their funds from operations, leaving them with higher opportunity for growth on the long-term, if such relatively low payout ratios are sustained on the long term. The average payout ratio for the 13 REITs was 101.3%. **Derayah REIT** reported the highest FFO payout ratio of 121% over TTM , thus giving it the lowest opportunity for growth.

4.3

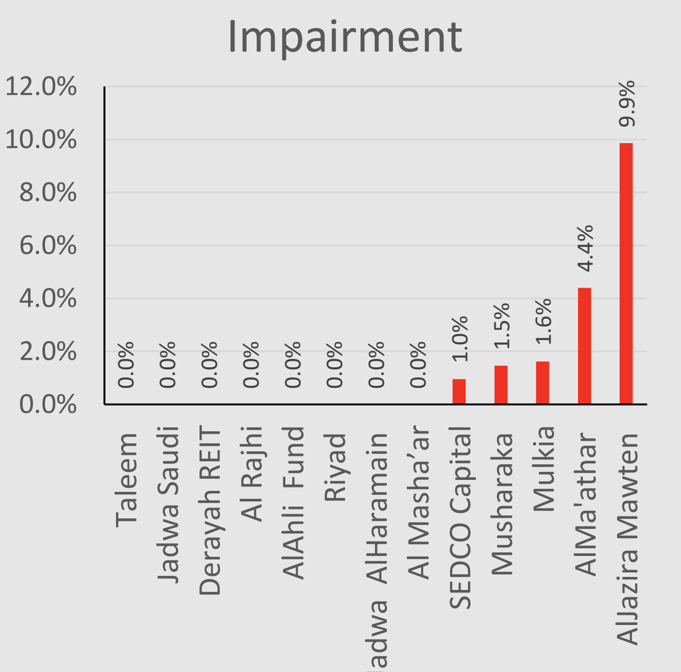
Risk



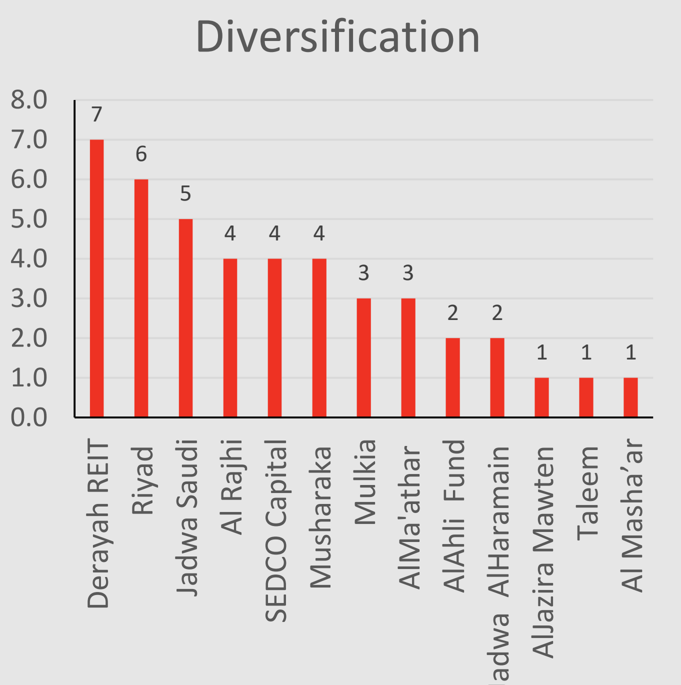
The NOI to Interest indicator was only applicable on the 8 REITs that have acquired debt over the TTM period. **Jadwa Saudi REIT** reported the highest NOI to interest due to the extremely low financing fees reported during the period. Meanwhile, **SEDCO Capital** reported the lowest due to it high cost of debt.



Income risk investigates the REITs' contract period, the longer the contracts with the tenants, the more revenue-stable the REIT is. **Taleem REIT** came first as a result of the longterm contracts with its tenants (30 years), meanwhile, **AlAhli REIT** came last as its contracts did not surpass 1 year each.



Only 5 REITs reported impairments of the TTM period, although impairments are considered a non-accruing expense, once a REIT reports impairment, it is a subject of future impairments. **Aljazira Mawten** reported the highest level impairment over the period with a value of 9.9% out of investment properties.



The KSA REIT sector is fairly diversified, however, 3 REITs showed thematic portfolios through investing in only 1 sector. On the more diversified end of the sector, lies **Derayah** and **Riyad REITs**. Derayah is involved in 7, Riyad REIT takes after it as its involved in 6 sectors(and subsectors). As the KSA economy recovers, the more diversified REITs will be able to capitalize on different sectors, especially the Retail and Hospitality sectors.

5 Conclusion & Outlook

Criteria	Valuation			Growth			Risk			
Indicator	Cap. Rate	P/FFO x	Div. yield	Assets Growth	Debt to Assets	FFO Payout Ratio	NOI to interest	Income risk	Impairment	Diversification
AlJazira Mawten REIT	5.3%	27.9	3.9%	0.0%	0.0%	109.5%	N/A	3.0	9.9%	1
Taleem REIT	6.4%	18.9	4.2%	0.0%	0.0%	72.2%	N/A	6.0	0.0%	1
Jadwa Saudi REIT	6.6%	15.8	6.4%	6.1%	1.7%	100.6%	186.2	3.7	0.0%	5
Derayah REIT	6.2%	17.0	7.1%	6.9%	30.5%	121.4%	3.6	3.4	0.0%	7
Mulkia – REIT Fund	6.8%	13.7	7.0%	27.9%	19.6%	96.2%	6.93	4.8	1.6%	3
Al Rajhi REIT	5.5%	15.7	6.5%	9.9%	26.5%	102.5%	5.5	3.8	0.0%	4
SEDCO Capital REIT	4.7%	17.4	6.6%	0.0%	42.7%	115.3%	3.0	3.2	1.0%	4
Musharaka REIT	8.7%	13.2	6.7%	7.2%	19.1%	88.1%	6.6	2.5	1.5%	4
AlAhli REIT	6.1%	15.6	7.1%	37.8%	0.0%	110.9%	N/A	1.0	0.0%	2
Riyad REIT	5.3%	16.7	6.0%	20.2%	14.8%	100.2%	N/A	3.2	0.0%	6
AlMa'athar REIT	7.4%	12.4	7.5%	3.9%	0.0%	92.4%	N/A	2.8	4.4%	3
Jadwa REIT Alharamain	5.0%	16.4	6.6%	0.0%	21.9%	108.6%	4.2	5.1	0.0%	2
Al Masha'ar REIT	5.2%	15.1	6.6%	0.0%	0.0%	99.7%	N/A	5.0	0.0%	1

- Note: the higher the score in the "Income risk" and "Diversification" criteria, the less risky the REIT is in terms of this indicator.
- Market prices used in the calculation of ratios are prices as of 26/12/2019.

- **On the short and medium term, it seems that REITS like Taleem REIT and Masha'ar REIT** are more on the stable end of the market due to their more thematic portfolio and relatively long tenancy contracts. However, as the economy picks up and the government reforms come into effect, we expect that the more diversified REITs; Jadwa Saudi REIT, Riyad REIT, SEDCO REIT and Derayah REIT have the most potential on the longer term, as they will be able to capitalize on the improvement of all sectors at once.

- **The Saudi economy underwent a lot of pressure since 2016, however the government has been relentless in facing these challenges. As the National Transformation Plan (NTP) and 2030 vision come in to effect, the Saudi economy will reach a level of stability that will allow sectors across the country to flourish**. Vision 2030 and the programs under it will have a significant impact on the development of the capital markets enabling Tadawul to further enhance its position as a financial center in the region. As part of its long-term strategic plan Tadawul aims to be a fully integrated financial exchange by 2025. Additionally, on the domestic front, Saudi Arabia's reforms program continued on track and received a boost from FTSE and MSCI inclusion, thereby setting up greater foreign investor participation and further progress in terms of diversification of the economy. The exposure of the Saudi REITs globally is especially highlighted following the inclusion of Riyad REIT and SEDCO Capital REIT in FTSE EPRA Nareit Global Emerging Index.

- **The outlook for the real estate market is optimistic on the long-term**. As residential and office real estate suppliers start adjusting their supply to cater to the socioeconomic changes in the country, in terms of the quality of the facilities, size and rental rates, the occupancy will pick up again. Moreover, the demand on the retail sector is bound to significantly improve following the introduction of major entertainment events and the introduction of cinemas after a35-year ban. While Cinemas will improve the footfall in malls and shopping centers, entertainment events will simply attract more tourists in the kingdom, significantly affecting the retail sector. The newly introduced tourism visa, coupled with the new Airport (KAIA), are just a few of the government's attempts of positioning the kingdom as a leisure destination, which are bound to significantly improve the performance of the hospitality and retail sector.

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