**A REVIEW OF FUSION'S REAL ESTATE DEVELOPMENT TRUST, BY REGINALD OKUMU 11TH JULY, 2016**

Kenya joined the list of countries that boast of having Real Estate Investment Trusts (REITs) in November, 2015 when the Stanlib's Fahari I-REIT was listed on the Nairobi Securities Exchange. In a couple of weeks, Kenya will be celebrating its first D-REIT assuming the offer by Fusion Capital is successful. According to the Information Memorandum (IM) issued on 20th June, 2016, Fusion Capital the promoter of Fusion Real Estate Development Trust (FRED Commercial) is aiming to raise KShs 2,300,000,000/= through sale of 100,000,000 units. Each unit is being sold at KShs 23/=. The proceeds of the sale will be used to acquire a six acre plot in Meru town and develop on it a mixed used development. The development to be known as Greenwood City will comprise a retail center (291, 391 square feet approximately), six storey office block (172, 989 Square feet) and 53 apartments (with a total built up area of 84,800 square feet approximately). The offer is restricted and only Professional Investors can purchase. The Minimum units a professional investor can purchase is 218,000 translating to a minimum spend of KShs 5,014,000/=. The offer closes on 15th July, 2016.

To effectively review a D-REIT one has to take into account various factors. However for the purpose of this article, we will look at the structure of the D-REIT, its management team (both at construction and management phases), make a comparison between the proposed D-REIT returns and returns from alternative investments namely a high yielding government bond and review treatment of demand risk.

The major difference between a REIT and any other company whose business is to invest and manage real estate lies in their tax treatment. REITS are exempt from corporate tax a special treatment not available to conventional companies. FRED Commercial is structured as an incorporated common law trust which makes it qualify for exemption under Kenya's income tax laws. However the law does not exempt companies that are wholly owned by a REIT. According to the IM issued by the promoters of FRED Commercial, the proceeds of the offer will be used to acquire Meru Greenwood Park Limited a Special Purpose Vehicle which is the developer of Greenwood City currently under construction.

From a tax perspective FRED Commercial is tax exempt a position confirmed following issuance of a tax exemption certificate by Kenya Revenue Authority. On the other hand Meru Greenwood Park Limited is a company incorporated under the Companies Act and is not tax exempt. This, means that the income generated from Greenwood City, will be taxed before it is passed on to the trust. In the review of Stanlib's Fahari I-REIT, I had pointed out that the decision to acquire companies that own the underlying real estate asset is aimed at avoiding stamp duty which amounts to 4% of the assessed market value of the property. While this is true, investors need to weigh whether it is better to invest in a trust that will pay stamp duty, a one off payment or invest in a trust that will own shares in a company that pays corporation tax every year. As currently structured investors are better off putting their money in a conventional real estate company as they will save on CMA approval fees, payments to Trustees, REIT Manager and a host of other players that are riding on this REIT.

A D-REIT's offer, comes with a promise that the underlying real estate assets will be soundly conceived, professionally designed, skillfully constructed and expertly managed. Real estate developments are complex undertakings requiring specialist team to manage the construction phase, competent contractor to construct and an equally qualified team to manage the development once complete. The Construction phase of Green Wood City is under a reputable team of Architects and Engineers. Equally a professional estate management firm has been hired to handle marketing and management of the development. Investors can take comfort that at least on paper, three key stages of development that is design, construction and management of Greenwood City seem to have been assigned to the right professionals.

FRED Commercial target to sell the completed project to yield investors. The option chosen is to first lease the retail and office parts of the development for a year before selling. However the 53 residential units will be sold outright. The projected period of construction is 24 months and it is assumed that the retail center and office building will be fully let on completion. One of the major risks identified by promoters and which does not seem to have been factored is demand risk. Meru town, the 6th largest urban center in Kenya is certainly a promising real estate frontier market. However the unanswered question is whether the town with a population of 30,000 (or is it 70,000) can absorb 291,000 square feet of retail space and 172,989 square feet of high grade office development in one phase. The economic review of Meru town including the excerpts of the feasibility study quoted in the memorandum do not demonstrate a strong demand for retail as well as high grade office space. The demand for retail space is driven by growth in purchasing power (disposable income) and consumer patterns in the catchment area. For retailers to take up space, they need to be convinced that the catchment area is big and wealthy enough to patronize their establishments. On the office side, demand is driven by growth in services such as banking, insurance, administration (National and County Government) and consultancy. For a yield investor (and for such a scale, the field is limited to Pension Funds, Insurance Companies and an I-REIT) the quality of tenants (for retail the tenant mix), occupancy rates, rents receivable and covenant strengths will form key part of issues to consider when purchasing the development from the D-REIT. On the residential side, the lease market in Meru town is not developed. Accordingly the likely purchasers of the residential units are those of Meru ancestry who are currently residing in other towns both in Kenya and abroad. While this is a great potential market (due cultural affinity and emotional attachment), consideration needs to be given as those purchasing will not be the occupiers of the units and will thus require the units bought to be leased out tenants whether on short lets or long leases. No information about how much rent they are likely to earn has been provided to assist the REITs investors gauge whether the return on the residential units are attractive to potential buyers (yield investors) of the same. At 21% construction rate, it is not clear how many shops and offices have been taken up as well as the number of those who have so far booked the residential units. From this perspective and considering demand factors, the ongoing development is highly speculative for the targeted yield investors.

Real estate investors are interested in returns. Accordingly investors will put their funds in instruments that will give the greatest return from the available comparable alternatives. From the IM, the gross target IRR is 20.8% while the net is 18.25%. While these calculated rates are higher than a comparable return from a high yielding government bond (currently at 13.2%), the assumption of 100% occupancy raises a big question mark on how this IRR was arrived at. Given my earlier remarks regarding uptake (meaning lower than projected incomes as well longer time to achieve required occupancy) and now the question mark on 100% occupancy rate assumption, one can safely conclude that the actual IRR will be much lower than quoted.

The investing community in Kenya is a yearning for a great real estate investment opportunity. A REIT offers such an exciting promise given the poor performance by quoted conventional real estate companies. In addition, choice of a D-REIT by Fusion Capital is wise as it differentiates it from the earlier issued Stanlib’s Fahari I-REIT. The Promoters of FRED Commercial have done a commendable job fronting the REIT. They should also be commended for appointing a professional team to oversee the construction and management of the underlying asset. While commendations are in order, prudence dictates that this project be undertaken in phases. Phasing would enable the promoters test this frontier market and gauge demand. There are clear issues regarding the structuring of the D-REIT and the assumptions in arriving at the target IRR. On structuring the promoters have missed the main objective of providing tax exempt earnings for the investors. For investors to enjoy the benefits of putting their money in a REIT, FRED Commercial needs to directly own Greenwood City. The calculations on the IRR also needs review by restating and making reasonable assumptions on occupancy and rental rates.

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