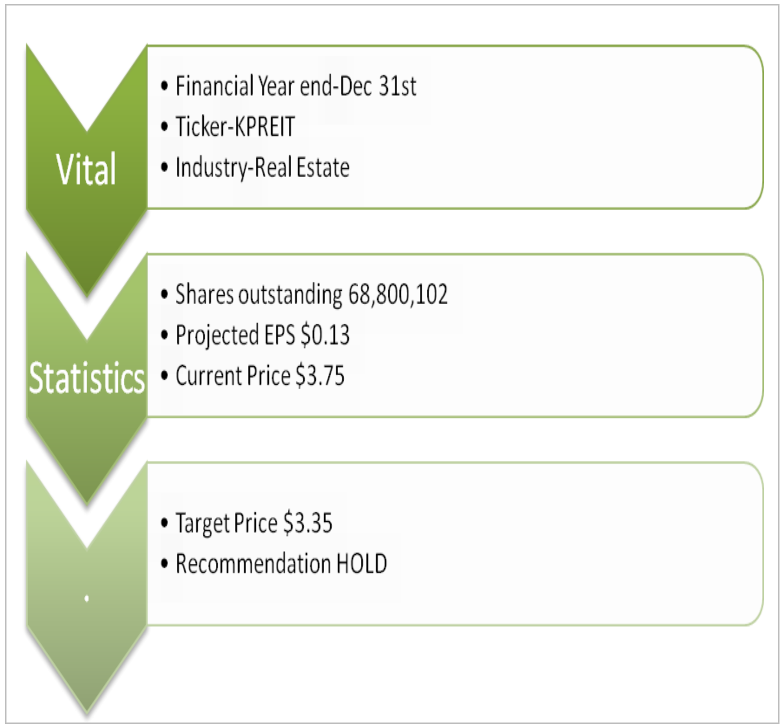
RESEARCH ANALYSIS

KINGSTON PROPERTIES LTD (KPREIT)

Introduction

Kingston Properties REIT (KPREIT), formerly Carlton Savannah REIT, was capitalized via an Initial Public Offering (IPO) in 2008, and is the only publicly traded Real Estate Investment Trust (REIT) in Jamaica.[1] The REIT's current portfolio comprises 19 condominiums in South Florida and a commercial property in Jamaica.



Having raised $406.6Mn in equity financing via IPO in June 2008, KPREIT initiated its investment strategy through a greenfield investment in the Carlton Savannah Hotel & Health Club and Spa (CSH) in Trinidad. Subsidiary, Carlton Savannah ST. Lucia was created as a vehicle through which the property was purchased. With a down payment of $282Mn, KPREIT acquired 7 apartment units in the hotel which was undergoing construction. However, projected rental income failed to materialize given the onset of the global financial crisis which stalled construction. With no rental income, the majority of shareholders' funds were invested in interest bearing assets. In Q4 2009, KPREIT disposed of its interest in the hotel and shifted its investment strategy to acquiring existing tenanted properties rather than new developments. Generally, we believe that acquiring pre-existing tenanted properties is more conducive to achieving predictable returns rather than ground up developments. Despite the change in strategy, KPREIT is yet to meet its profitability and dividend targets.

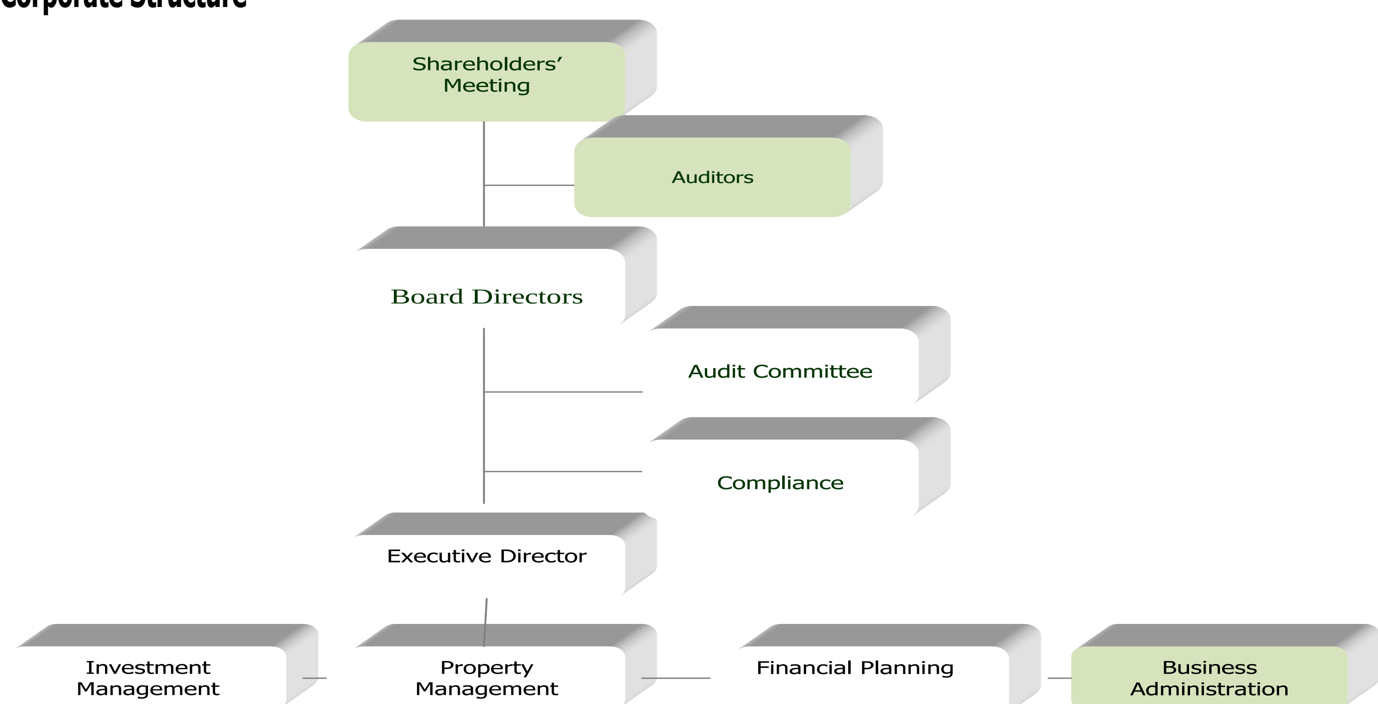
[1] REITs own and manage income producing real estate for the benefit of investors.

Board & Management

The Board chaired by Garfield Sinclair comprises 5 directors, 3 of whom are independent. Despite having a non-executive chairman, which is an ideal governance standard, a greater percentage of independent directors is preferred, as international best practice for corporate governance recommends that 75% of the board be independent. With a small management team, core activities such as accounting and real estate expertise are outsourced from independent consultants. This allows for more extensive professional experience while maintaining a low cost structure.

Professional Experience of Directors					
	Communications	Investments	Accounting	Real Estate	Law
Independent					
Garfield Sinclair	✓	✓	✓		
Lisa Gomes		✓	✓		
Peter Reid		✓			
Non-Independent					
Fayval Williams		✓		✓	
Nicole Foga	✓				✓

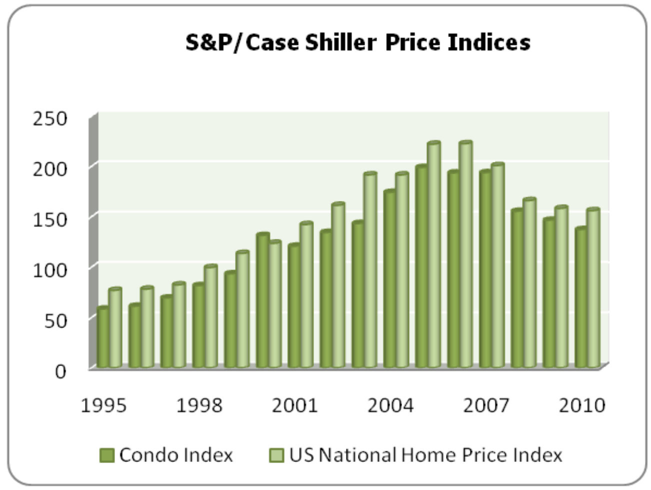
Corporate Structure

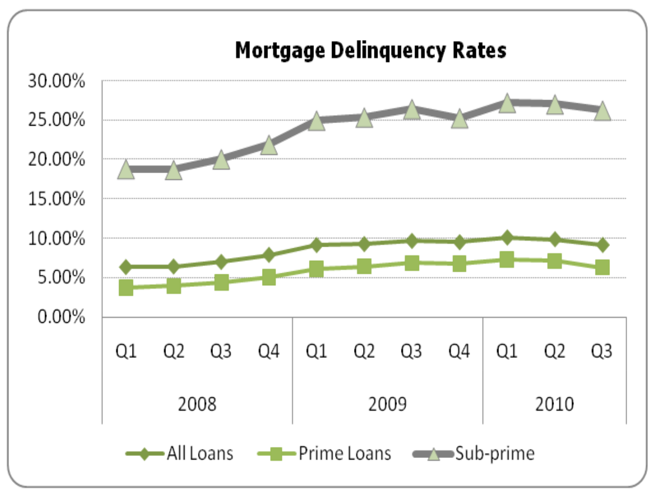


Industry Analysis

The bursting of the US real estate bubble in late 2006 into 2007 led to a steady decline in property values, a rise in foreclosures and tightened credit, and has had lingering effects despite signs of economic recovery. US housing prices have fallen to 2003 levels as foreclosures depressed property values and unemployment hovers at 9%. US commercial property transactions declined 89% to $66Bn in 2009 from a peak of $579Bn in 2007, as investors incurred difficulties in securing financing. Tighter credit standards in the aftermath of the financial crisis and elevated unemployment, have caused prospective US home buyers to reduce their buying interests, resulting in a decline in the single-family home ownership rate across the US.

However, there have been signs of stabilization given several stimulus packages by the US government aimed at stemming the slide in property values. While the housing market remains broadly depressed, there are pockets of recovery as depressed property values have led to increased buying interest from discerning investors for certain types of properties.





Notably in the condominium market, inventories have fallen due to the emergence of strong foreign property ownership. In Miami, where KPREIT has its single foreign investment, international clients purchased 60% of existing houses and 90% of newly built condominiums, as depressed property prices and the weakening of the US$ against other currencies have spurred demand.[2] Brazilian investors have dominated the market as the 45% strengthening of the Real against the US dollar has increased the affordability of US properties.[3] For the year to May 2011, condo sales in Miami have increased by 79%.

While there has been a broad decline in US property buyers, the rental market has been buoyant as renting has become more attractive for persons who are either unable to secure mortgages or currently uninterested in home ownership. Throughout the US, rental rates are expected to increase by 5.9% in FY2011.[4]

In Miami the demographic changes - an increase in the urban core population and young professionals - have also fuelled rental demand resulting in a 4% increase in rental rates in 2010, up from a decline in 2009. Occupancy rates in South Florida have increased to 96%.

[2] As at May 2011(Bloomberg)
[3] The Brazilian Real is now at a 12 year high against the US$
[4] American Apartment Owners Association

ECONOMIC

- Any slowing of economic recovery could negatively impact the demand for properties.
- Higher unemployment and shrinking disposable incomes could lead to a softening of rental rates and lower occupancy levels for KPREIT's properties.
- Lower interest rates (IR) reduce financing costs and increase the opportunities for debt financed property acquisitions.

SOCIAL

- Demographic factors such as population growth and size, influence the demand for real estate, which impacts the projected earnings of REITS. It is projected that the US population could increase in June 2012 by 4Mn.
- The performance of apartment REITs is susceptible to shifts in consumer preferences from rentals to home ownership.

POLITICAL

- Tighter reins on credit, limits the access to mortgages which in turn softens property demand**.**
- Legislations limiting the securitization of mortgages, limits the loan turnover rate of lending institutions.
- Tax credits, deductions and subsidies can be used by governments to temporarily boost the demand for real estate. This was used by the US government in 2009 to stem the slide in the housing market

PEST ANALYSIS OF REAL ESTATE MARKET

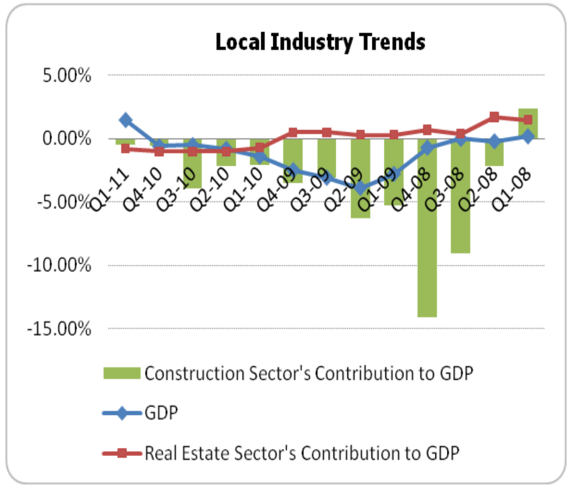
While tighter reins on credit has reduced the demand for home ownership, it has positively fuelled the demand for apartments which is reflected in the year to date growth in apartment REITS and is a promising sign for KPREIT given that so far the bulk of its investment is in apartments. Demographic changes are expected to benefit apartment REITS but this may be mitigated by weakening economic factors which could see a rise in delinquency.

TECHNOLOGY

- Given the link between construction activity and the real estate market, technological advancements and innovation could further increase real estate supply. Commensurate demand could limit the upside potential for price.
- Higher building standards have been cited as a factor in boosting tenant retention, which positively impacts the performance of REITS

Local Industry Analysis

While the local real estate market is relatively soft given weak economic conditions, there has been a notable shift from residential to commercial properties. As businesses restructure operations with the intent to reduce costs, there has been increased demand for smaller commercial spaces of approximately 500 square feet between US$11 to US$14 per sq ft. There has also been a marked increase in buying interests fuelled by lower mortgage rates. However, limited new commercial property developments have resulted in reduced inventory levels.[5]



[5] Given the limited documented data regarding the performance of the local real estate market, anecdotal evidence was obtained from local realtors .

Business Strategy

KPREIT's business strategy focuses on actively managing its real estate portfolios, identifying potential high yielding investments while limiting the company's exposure to investments with below average future cash flows. The REIT's current strategy focuses on properties with existing "auditable" cash flows, in which medium to long term tenancy agreements allows for greater predictability of returns which reduces business risks. KPREIT also attempts to limit concentration risks through geographic diversification with the aim of minimizing the correlation among investments. This was the primary motivator behind its foray into the Florida real estate market, where a sharp falloff in property values allowed for the acquisition of attractively priced condominiums that had in place tenants with existing lease arrangements.

Over, the short to medium term, management is also open to the possibility of investing in joint ventures where skills and expertise can be shared, while widening its investment ownership and sharing the risks associated with the investment.

SWOT

Strengths

The company's investment in a commercial property provides more stable rental income as a result of the long term lease arrangements.

Diversification into residential and commercial investments also allow for less sensitivity in rental income to changes in the economic cycles.

Carlton Savannah St. Lucia was incorporated as an International Business Company (IBC) which allows for tax advantages.

Weaknesses

Management has not been able to generate the level of returns promised to shareholders in its prospectus.

The absence of a proven track record heightens the perceived risks to investors which limits KPREIT's ability to raise funding.

KPREIT has promised to pay out 95% of taxable income to shareholders which limits the ability to retain excess cash for investment opportunities and increases its dependence on the capital market for funding major initiatives.

REITS have often been able to sell underperforming properties to generate cash flow, however high transaction costs in Jamaica will limit the effectiveness of this strategy in the local market.

Opportunities

The fall in property prices following the global economic recession provides an opportunity for KPREIT to pick up investments at fairly attractive prices.

The low interest rate environment should favourably impact revaluations gains and boost the performance of KPREIT.

An improving rental market creates the opportunity to benefit from higher rental and occupancy rates.

Growing buying interest in cities such as Miami, New York and San Diego should boost revaluation gains.
Investment in properties allows for an inflation hedge as rent tends to increase with inflation.

Threats

Slower than projected global recovery could adversely impact the demand for rental properties

Unemployment in the major economies remains stubbornly high which could limit the increase in rental prices.

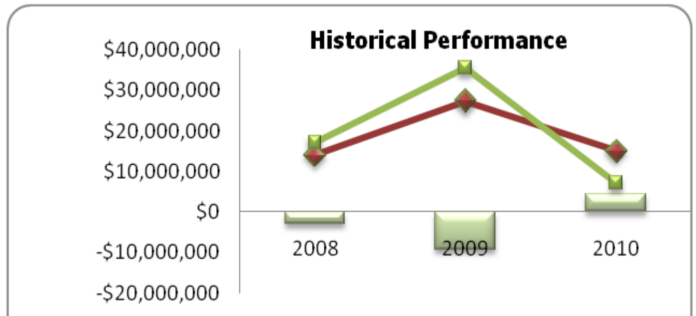
Appreciation of the JMD against the USD could result in significant translation losses.

Historical Performance

Since coming to the market, KPREIT has experienced marked fluctuations in earnings which peaked at $27.2Mn (EPS:$0.40) and later declined to $15.1Mn. The movement in earnings reflects the shift in its earnings source from non-core[6] to core activities. Funds from operations (FFO) which is a customary metric used in REIT analysis also exhibited marked fluctuations[4][7]

Given interest income from liquid asset investment was the only source of income in the first two years, KPREIT incurred significant operating losses which were offset by FX gains[8].

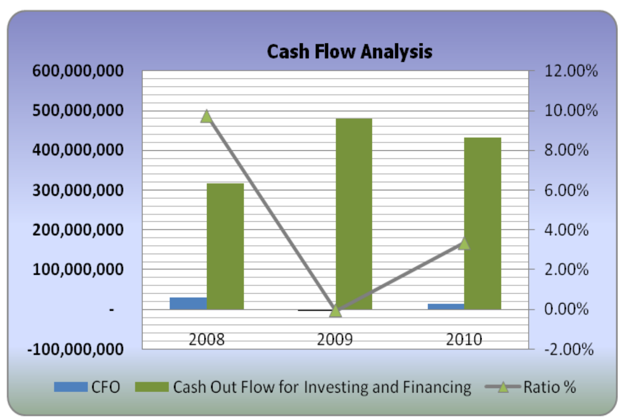
Following the acquisition of fully tenanted commercial and residential properties, it generated interest income for the first time since inception. However operating expenses increased two fold reflecting property related expenses, with margin of 13.2%.



	Dec-08	Dec-09	Dec-10
NOI for Company	-3,041,316	-9,467,667	4,377,971
Net Profit	14,011,316	27,215,275	15,106,156
Net Finance Income	17,052,632	35,549,921	7,133,949

Cash Flow Analysis

A strong cash flow position is critical given that KPREIT aims to distribute 95% of its net taxable income as dividends. Early setbacks relating to returns from its investments impeded its ability to consistently generate strong operating cash flows (CFO). With significant financing outflows and strained cash flows from core activities, KPREIT has had to draw on existing cash balances or rely on finance income in order to meet dividend payments.



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[6] Interest income from funds invested in anticipation of property purchases.

[7] Funds From Operations (FFO) which =Net Income + Depreciation, is a metric that is predominately used to evaluate the performance of REITs instead of net income, as REITs tend to incur property devaluation/ depreciation charge given the nature of the business. Given that the properties were recently acquired and have not be re-appraised, there is only minimal depreciation expense, which results in FFO mirroring net income.

[8] The 26.9% depreciation of the JMD relative to the USD between 2008 and 2009 assisted in augmenting earnings and limited the downside risks related to its investment in CSH

The ratio of CFO to cash outflows for investing and financing activities, which measures the ability to acquire assets, pay debts and make distributions to shareholders, has been markedly low highlighting the company's reliance on non-core cash flows. Additionally, KPREIT's cash on cash margin for FY2010 was razor thin at 1.27%, reflecting significant investment outlay relative to net operating income (NOI).[9]

Q1 Financial Highlights

- Earnings declined 17.3% to $2.9Mn (EPS$0.04) reflecting higher operating costs given additional acquisitions.

- There was a marked increase in rental income from $1.7Mn in Q1 2010 to $10.4Mn, reflecting rental income from its 'Miami Loft 2' units purchased in March 2010.

- Operating expenses more than doubled to $7.4Mn given increased property related costs. Net operating income (NOI) stood at $2.9Mn ($1.2Mn loss in Q1 2010), with operating margin at 29%.

- Net finance losses totaled $295,000 reflecting lower balances in interest bearing assets and higher finance costs[10]. In the prior year the REIT benefited from robust interest income and FX gains resulting in net finance income of $4.4Mn.

- With soft core earnings and net finance losses, KPREIT's pre-tax earnings were 15.16% lower at $2.6Mn.

Geographic Segment Performance

The $2Mn earnings from KPREIT's US property eclipsed the combined earnings from its Jamaican and St. Lucian operations, which stood at $896,000. Net profit margin on KPREIT's US investment was 34.55% compared to 20.01% locally. The buoyancy of the rental market in Miami, boosted earnings as the condos were fully occupied, attracting market level rent of US$1300 per month. Despite current high occupancy levels for its overseas properties, the weighted average lease expiry (WALE) stands at 11 months. Cash flows are not guaranteed beyond this point and this increases the unpredictability of future earnings[11].

While the commercial property had a lower return on investment, the double net lease agreement in place assisted in tempering property related expenses.[12]

[9] Cash-on-Cash return measures cash received in any given year relative to initial investment in property. Cash-on-Cash return=(NOI-Total Debt Service) divided by Cash Investment

[10] Finance costs are inclusive of interest expenses related to vendor mortgage and its credit facility.

[11] The weighted average unexpired lease term is the average lease term remaining to expiry across the portfolio, weighted by rental income.

[12] Double net leases implies that tenants assume costs relating to property maintenance, landscape and repairs, while the owner is responsible for property taxes, insurance etc

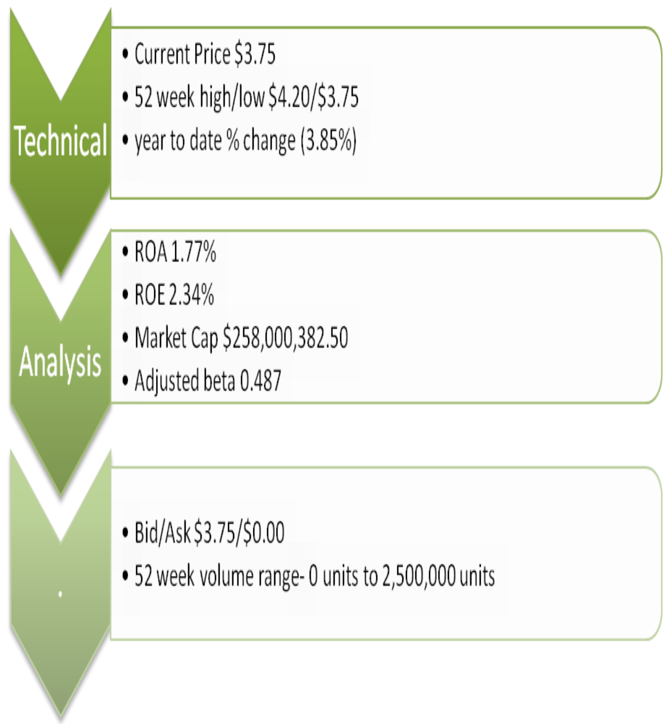
Balance Sheet

At the end of March assets totaled $684Mn with a notable shift in the composition of the balance sheet as property investment increased and cash and cash equivalents declined. Shareholders' Equity declined to $504Mn reflecting translation losses. Return on assets (ROA) and return on equity (ROE) were markedly thin at 1.77% and 2.34%, indicative of soft earnings.[13] Debt to equity stood at 5% representative of the REIT's limited use of leverage.

Technical Analysis

At the end of Q1, KPREIT's FFO yield stood at 1.02% implying an annualized yield of 4.14%. This suggests that the yield to shareholders was markedly lower than KPREIT's average capitalization rate of 8%, indicating an erosion of shareholder value.[14]

KPREIT's stock is very illiquid owing to infrequent trades and a small number of shareholders (187). Year–to-date the stock has traded 8 trading days out of a possible 130days, and has traded 54X since its IPO in 2008. The top ten shareholders own 75% of outstanding shares which suggest a relatively small free float. Further, there has been limited trading on the remaining 17Mn as most investors are holding the stock in anticipation of future returns from planned and current investments.



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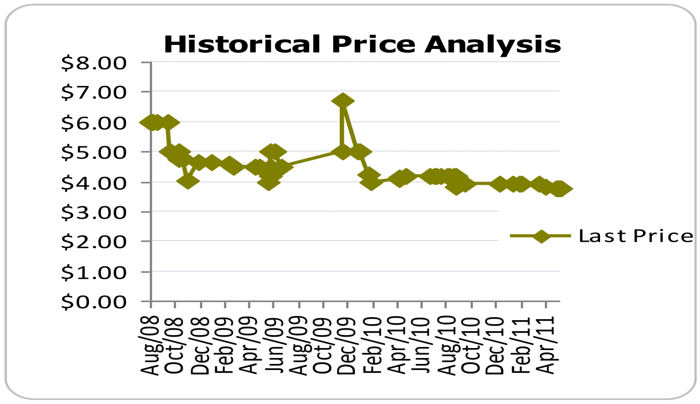
[13] ROE and ROA computed as annualized returns assuming stable performance for the remainder of the year. This is a Fair assumption given lease arrangements on existing properties with a WALE of 11mths.

[14] FFO yield= FFO/Price. This metric is similar to earnings yield (EPS/Price) which is used to evaluate non –REIT stocks.

Year to date the stock has declined 5% and with volumes averaging 20,137, markedly lower than the average market volumes of other stocks. KPREIT's adjusted beta of 0.487 is due to its infrequent trading which artificially reduces the level of volatility in the stock by lowering its standard deviation.[15]



Qualitative Comparative Analysis

As the only publicly traded REIT in Jamaica, the ability to assess KPREIT against a local counterpart using financial metrics is limited. Further, marked differences in the size and scope of its business also limit the use of certain financial metrics for comparisons with international players. As such, a qualitative comparison was done.

Qualitative Metrics	US REIT	KPREIT
Distribution of over 90% of net taxable income to shareholders	✓	✓
Real Estate is the sole focus of the REIT	✗	✓
No more than 50% of the REIT's shares held by 5 or fewer shareholders	✓	✗
Consistent Premium Returns-outpacing equity indices	✓	✗
Large Capital Base	✓	✗
REIT Beta relative to domestic stock market less than 0.8	✓	✓
Strong Dividend Yield-outperforming benchmark fixed income investment	✓	✗

[15] Asynchronous trading

KPREIT's business model mirrors US REITS, but there is disparity between the performances and operating frameworks, which is reflective of the 70% difference in qualitative metrics. As KPREIT evolves into a full fledged REIT with its sole focus being on real estate, its earnings will be more vulnerable to changes in the real estate market compared to US REITS which invest at least 75% of assets in real estate. Additionally, KPREIT's low dividend yield and low liquidity has limited a return premium above equities.

Dividend Policy

The REIT targets quarterly dividend payments of 95% of net taxable income. Although KPREIT had forecasted a dividend yield of 6.3% in years 1-2 of operation and 6.5% in year three, the actual returns have been markedly lower. With the setbacks following the IPO and the limited ability to generate robust core cash flows, the dividend yield was 1% and 3% in its first two years, while no dividends were paid last year.

Earnings Projections

- Buoyancy in Miami's rental market should allow for rental rate appreciation. The cap on rental increase on local commercial leases of 7½ was also considered in the projections. Total rental income is expected at $35.1Mn.

- We expect further acquisitions will materialize in FY2012 considering that the company has already entered the middle of its FY2011. As such, KPREIT's operating framework will mirror that of prior years with operating margin of 87%. Total operating expenses should amount to $30.5Mn, with direct property related expenses accounting for $17.7Mn. Net Operating Income (NOI) is expected to region $17.4Mn.

- Operating profit should close at $4.5Mn.

- Finance costs are expected to close the FY2011 slightly higher considering the 1% rate increase on its vendor mortgage and higher funding costs relating to a significant drawdown on its credit facility.

- Assuming net finance income of $5.1Mn, pre-tax earnings should amount to 9.6Mn

- Net profit is expected to total $8.7Mn(EPS:0.13)[16]

[16] We assumed a conservative tax rate of 10%

Valuation

Traditional valuation metrics such as price multiples are inappropriate for REIT valuations, as significant depreciation charges tend to understate earnings and book value. Although KPREIT has not incurred extensive depreciation charges given that the properties were recently acquired and have not been re-appraised, the price multiples approach was excluded in keeping with customary REIT valuation methodology.[17]

Net Asset Value (NAV)

The NAV approach relies on the use of the capitalization rate (cap rate) to distinguish between high and low yielding assets and captures internal growth prospects.[18] The approach also attempts to reconcile assets and equity to fair value, in order to yield the stock's intrinsic value. With a NOI of $17.4Mn and an average cap rate of 8%, the fair value of KPREIT's properties and NAV approximate to $217Mn and $191.6Mn respectively.[19] This yields a fair value price estimate of $2.79.

Funds from Operations Multiple (FFO)

The FFO yield is a proxy for earnings yield, which measures earnings relative to the price that investors are willing to pay for the stock. With no depreciation on property and with no expected sale of current property investments, the FFO for FY2011 mirrors the projected EPS of $0.13. An FFO yield of 3.4% relative to an average cap rate of 8%, suggests shareholders are receiving a significantly lower return relative to the return from the REIT's properties. This means that operating costs unrelated to the properties are eroding the returns to shareholders.

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[17] Given the nascent stage of KPREIT's operations and the obscurity surrounding the earning potential of future acquisitions, the Dividend Discount Model and the Discounted Cash Flow models were also excluded, as reliability would be compromised with excessive assumptions.
[18] The cap rate discounts future Net Operating Income (NOI) in order to determine the fair value of properties.
[19] Market Value(Fair Value of Properties)=NOI/Cap Rate
NAV per share= [(NOI/Cap Rate)-Long term Debt] divided by the number of shares

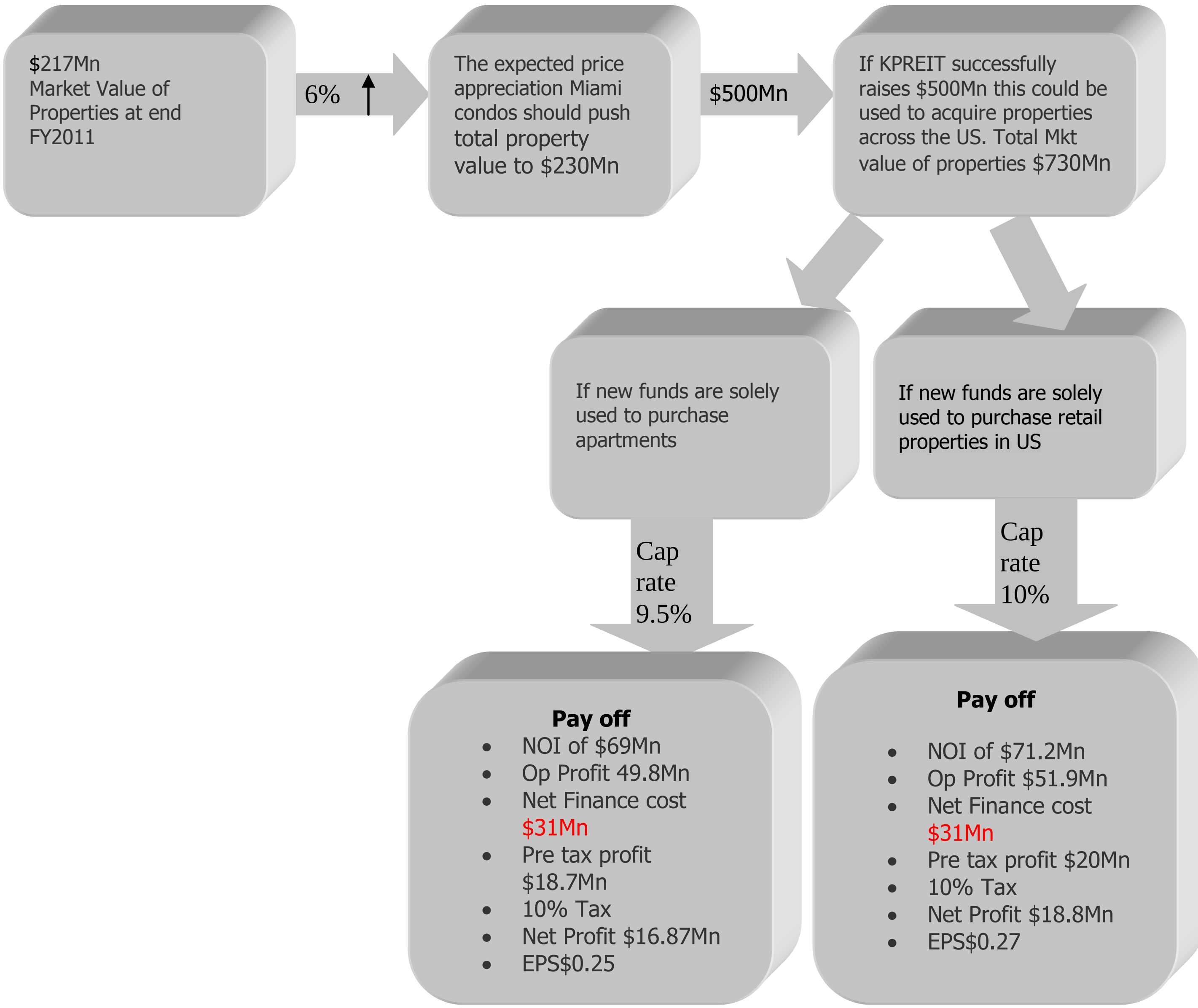
Recommendation

Both valuation methods result in a fair value estimate below the stock's current market price of $3.75. KPREIT estimated dividend yield of 3.56% coupled with negative capital gains implied by our fair value estimates is not compelling given the illiquidity of the stock. The opportunity costs of holding the stock is high given that the dividend yield falls below the risk free rate of 8.5% on a long term GOJ bond.[20]

However, if management successfully expands its property portfolio through the proposed $500Mn debt offering,[21] there may be some upside potential to holding the stock long term. With the expected recovery in key US markets, employing leverage to strategically acquire properties could improve earnings.[22] The scenario analysis below outlines the prospect for increased earnings in FY2012 contingent on KPREIT's $500Mn investment in the US market. Using a scenario of 100% investment in retail properties, it is possible that earnings could increase to $18.8Mn, with a $0.29 dividend and yield of 7.7%.[23] That said, with possible upside potential a HOLD is recommended on the stock**.** Our HOLD recommendation is also supported by the fact that the REIT is trading at a discount to its net book value which means that value of the underlying real estate is greater than the REIT's current price. While the cash flows to investors have been lower than expected, management is in the process of executing its strategy. There is the possibility of improved earnings prospects with the purchase of additional properties.

[20] YTM on GOJ 12.875% 2024
[21] At its AGM Management signaled its intent to build out the REIT's real estate portfolio by raising funds through a debt offer.
[22] New York, Miami, Los Angles and San Diego are expected to lead in the recovery process in terms of development and acquisitions
[23] The dividend per share may fall marginally below estimate depending on unrealized FX gains or losses

Scenario Analysis



OUTLOOK

KPREITs new investment strategy augurs well for greater returns to shareholders. However, growth prospects are hinged on the potential for rent increases and high occupancy rates. The current buoyant demand for apartments in the US and the expected increase in rental rates should support more robust rental income. In the local real estate market, investors have shifted their focus from residential to commercial properties which support revaluation gains on its current local investment and any new investment in commercial properties. Additionally, increased demand for commercial spaces by lessees should support high occupancy levels.

It is expected that KPREIT will further diversify its investment portfolio to include other properties in the US, as cities such as Miami, New York and Los Angeles are expected to lead the recovery in the real estate market. We would like to see further diversity of its tenant base in order to have defensible steady growing cash flows. Importantly though, we would like to see acquisition of properties with longer lease terms to boost the REIT's WALE (weighted average lease expiry) and support the stability of rental income. Further geographic diversification in markets with low correlation allows for the reduction in risks and also limits earnings volatility. That said, a slower global recovery could erode potential earnings. While, foreign exchange exposure from its international investments could potentially result in translation losses.

Company Analysis as at July 7th 2011

Appendix: Historical Performance

Kingston Properties Limted Comprehensive Income Statement Year End Dec 31	Audited 7Mths to Dec 31st 2008	Audited 2009	Audited 2010
JA Commercial Property			13,443,069
US Condo			19,676,498
Revenue			
Rental Income		-	33,119,567
Company formation,share issue and listing net	-370,375		
Property Expenses			**-16,714,993**
Other Expenses			**-12,026,603**
NOI			
	-2,670,941	**-9,467,667**	**-28,741,596**
Results from operating activities	-3,041,316	-9,467,667	4,377,971
Finance Income	17,052,632	35,549,921	18,219,256
Finance Costs	-	-	-11,085,307
Net Finance Costs	17,052,632	35,549,921	7,133,949
Profit before income tax	**14,011,316**	**26,082,254**	**11,511,920**
Income Tax Credit	-	1,133,021	3,594,236
Profit for the Year	**14,011,316**	**27,215,275**	**15,106,156**
Other comprehensive expense/income			
Foreign currency translation differences for		35,781,838	-17,765,164
foreign operations being		**62,997,113**	**-2,659,008**
total other comprehensive expense/income			
Total comprehensive expense/income			
EPS	**$0.20**	**$0.40**	**$0.22**

Projections FY2011

FY 2011	
NAV Approach	
NOI	17,394,297.58
Average Cap Rate	8%
MKT value	217,428,719.70
Long term debt	25,755,000
NAV	191,673,719.70
# of shares	68,800,102
NAV Per share	2.786

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