

CAP
RATE

2014

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Real Estate المقارنة



اتحاد العقاريين
Real Estate Association

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INTRODUCTION

Investment Properties

Cap rate (short form of Capitalization Rate) is a remarkable tool for property valuation. Like any other tool, it is not perfect but it is simple and works well in all market conditions. It is used, almost exclusively, for income generating properties. Income of a property is capitalized at a benchmark rate of similar properties in similar locations to arrive at the property valuation. This rate is the cap rate and the valuation method is termed as income capitalization method.

In any property valuation exercises, it is common to employ multiple methods of valuations. Cost plus is prevalent where a property is valued as sum of its parts. Sales comparison approach is employed where a property is valued by comparing recent sale prices of similar properties at similar locations.

However, the income capitalization method using cap rates remains the most effective method for valuing income generating properties. The method recognizes that post completion; such properties should be valued solely on their income generating potential.

A great feature of Cap rates is that they have the current market conditions and the future expectations rolled into one. A property with 7.00% cap rate gives annual cash returns of 7.00%. However, it does not mean that investor's expected return is 7.00%.

In case the rental income is expected to grow in the next few years, investors will accept lower current returns, which will show as low cap rate. If investors expect the rental income to fall in the next few years, they will demand higher current returns that will show as high cap rate. This way the cap rate represents the collective judgment of the investors on the current market conditions and the future expectations.

Please see Appendix 1 for a detailed definitions of various terms including the cap rate.

Kuwait is a big market for income generating properties. As per the Public Authority for Civil Information (PACI) data, there are close to 12,000 income generating properties with nearly 300,000 apartments in Kuwait. Additionally, there are a couple of thousands commercial, retail and industrial properties.

Recognizing the importance of the subject, this guide is an attempt to establish a comprehensive framework for cap rates in Kuwait real estate market. Cap rates vary with location, age of property, grade of property and several other factors. Cap rates also vary with time. Thus, a scientific study for measuring cap rates periodically is critical to bring about transparency and stability to the market.

Executive Summary

Use of “Capitalization Rate” (Cap Rate for short) is one of the most widely used method in property valuation. Income of a property is capitalized at a benchmark rate of similar properties in similar locations to arrive at the property valuation. This rate is the Cap Rate and the valuation method is termed as» Income Capitalization Method».

Kuwait real estate market enjoys a large pool of income generating properties. A sizeable chunk of these income generating properties are mortgaged to various banks in Kuwait who maintain yearly valuation records. Hundreds of these properties are transacted every year. Thus, the Cap Rates are used extensively for property valuations.

Recognizing the importance of the subject, this guide is an attempt to establish a comprehensive framework for Cap Rates in Kuwait real estate market. Cap Rates vary with location, age of property, grade of property and several other factors.

Investment Properties

For the investment properties, we compiled data on 330 investment properties after filtering out hundreds of other properties for which complete and accurate information was not available. Table 1 shows the results of this analysis.

- The combined value of the 330 investment properties transactions and offers was KD 506.68 million. The average transaction size was around KD 1.53 million.
- The average Cap Rate of all transactions was 6.40%.

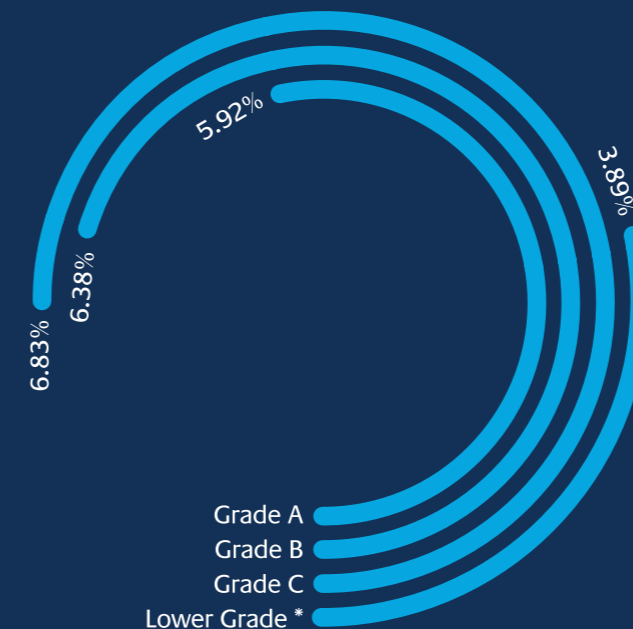
Cap Rate for Investment Properties Segment in Kuwait	
No. of Investment Properties Covered	330
Total Transaction Value	KD 506,687,930
Average Transaction Price	KD 1,535,418
Average Cap Rate *	6.40%

* adjusted to remove the lower grade properties as these transactions resembled buying lands

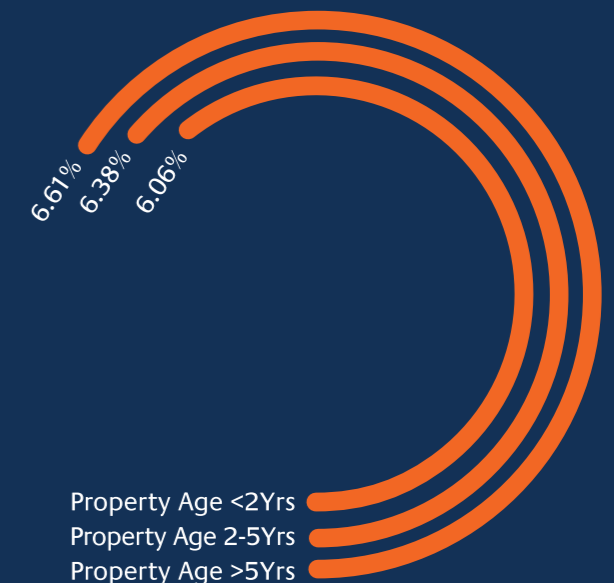
While the headline number of the Cap Rate for Kuwait is important, experienced real estate professionals know that the Cap Rates vary with property grades and property age. Chart 1 shows the variations in the Cap Rates of properties of different grades. Chart 2 shows the variations in Cap Rates in different age groups.

1. The average Cap Rate for Grade A properties is 5.92%, Grade B properties 6.38% and Grade C properties 6.83%.
2. Due to the differences in the Cap Rates, three properties of three different grades with exactly the same monthly rentals are valued differently. This is due to different expectations of rental growth with properties of different grades.
3. The Lower Grade properties have the lowest Cap Rate of 3.89%. Most of the Lower Grade properties covered in this study are very old and the transaction is done more for the land parcel than for an income generating asset. Thus, the Cap Rate for the Lower Grade is not representative.
4. The Cap Rate for properties in less than 2 years age group is the lowest at 6.06%. The Cap Rate for properties in 2 to 5 years age group is 6.38% and the Cap Rate for properties in age group more than 5 years is 6.61%.
5. The difference in age group means that other things being constant, properties in less than 2 years of age have 5.3% higher value than properties in 2 to 5 years age, which in turn have 3.5% higher value than properties of more than 5 years age.

Average Cap Rates of Properties of Different Grades



Average Cap Rates of Properties of Different Age Groups



Variations of Cap Rates for properties of different grades across various locations are shown in Table 2.

Location Wise and Property Grade Wise Variations in Cap Rates

	Grade A	Grade B	Grade C
	Locations with Adequate Data		
Kuwait City	5.82%	5.90%	5.93%
Hawalli	5.92%	6.23%	6.67%
Salmiya	5.63%	6.11%	6.44%
Abu Halifa	6.29%	6.34%	7.01%
Fahaheel	6.02%	6.27%	6.65%
Fintas	NA	NA	6.75%
Mahboula	5.96%	6.59%	7.49%
Mangaf	6.56%	6.81%	6.91%
Farrwaniya	5.65%	6.19%	6.67%
Khaitan	5.69%	6.27%	6.48%
Riggai	NA	6.31%	7.48%
	Locations without Adequate Data		
Shaab	5.94%	NA	NA
Jabriya	5.82%	6.27%	NA
Jleeb Al Shuyoukh	NA	6.44%	NA
Jahra	5.89%	6.12%	6.32%

Variations of Cap Rates for properties of different age categories across various locations are shown in Table 3.

Location Wise and Property Age Wise Variations in Cap Rates			
	Property Age < 2 Yrs	Property Age 2 - 5 Yrs	Property Age > 5 Yrs
	Locations with Adequate Data		
Kuwait City	5.82%	5.90%	5.58%
Hawalli	5.95%	6.32%	6.51%
Salmiya	5.70%	6.24%	6.22%
Abu Halifa	NA	6.58%	7.22%
Fahaheel	5.96%	6.43%	6.64%
Fintas	NA	NA	6.75%
Mahboula	6.05%	6.55%	6.89%
Mangaf	6.67%	6.71%	7.10%
Farrwaniya	5.68%	6.20%	7.00%
Khaitan	5.77%	6.61%	7.08%
Riggai	NA	6.49%	6.87%
	Locations without Adequate Data		
Shaab	NA	NA	5.94%
Jabriya	NA	5.82%	6.27%
Jleeb Al Shuyoukh	NA	6.44%	7.14%
Jahra	6.15%	NA	7.27%

Commercial Properties

As part of the study, we received complete information total 27 commercial properties. We note that both the office space and retail properties are mixed in this data. Table 4 shows the results:

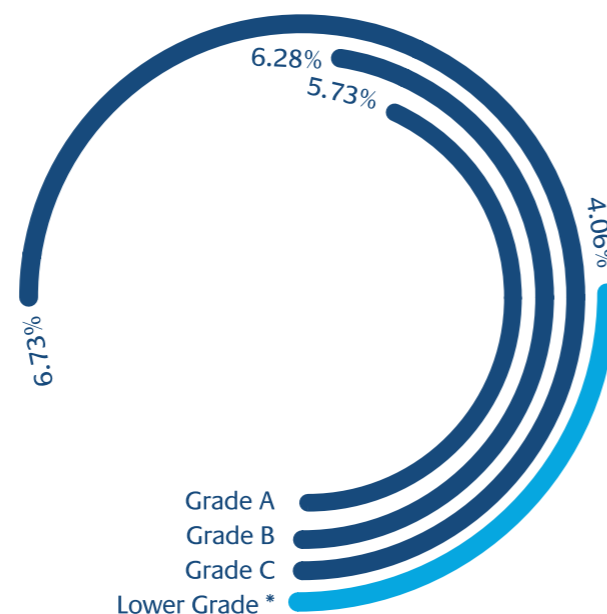
- ==> The combined value of 27 commercial properties was KD 145.1 million, which gives an average value of KD 5.37 million.
- ==> We note that this is substantially higher than the average value of investment properties that was just KD 1.53 million.
- ==> The average Cap Rate is 6.09%.

Cap Rate for Commercial Properties Segment in Kuwait	
No. of Investment Properties Covered	27
Total Transaction Value	KD 145,172,614
Average Transaction Price	KD 5,376,763
Average Cap Rate *	6.09%

* adjusted to remove the lower grade properties as these transactions resembled buying lands

The Cap Rate for commercial properties is around 30 basis points lower than the Cap Rate for investment properties. Much like the investment properties, Cap Rates for commercial properties also vary with property grades. This is shown in Chart 3.

- ==> Similar to the trend in the investment properties, the Grade A properties have the lowest Cap Rate of 5.73%. This Cap Rate is around 20 basis points lower than the Cap Rate of investment properties of similar grade.
- ==> For Grade B, the Cap Rate is 6.28%, which is 10 basis points lower than the Cap Rate of comparable investment properties.
- ==> For Grade C, the Cap Rate is 6.73%, which is again 10 basis points lower than the Cap Rate of comparable investment properties.
- ==> The Lower Grade properties in this segment also are being transacted as land and thus, the Cap Rate is not representative.



Not enough data is available to carry out the analysis of Cap Rate variations by property age. We expect the commercial properties to display similar behavior to the investment properties when it comes to variations with property age. We expect to include these analyses over the forthcoming issues of this guide.

Table 5 shows the Cap Rate variations of different locations with property grades:

- ==> For Kuwait City, the Grade A Cap Rate is just around 4.00%.
- ==> In Hawalli, new Grade A commercial properties are valued at 5.57% Cap Rate. This Cap Rate is 34 basis point lower than the corresponding investment properties Cap Rate.
- ==> For Mangaf the Grade A Cap Rate is 6.60%, which is almost the same as the investment property Cap Rate.
- ==> For Jleeb Al Shiyoukh, the Grade A Cap Rate is 6.24% that increases to 6.78% for Grade B.
- ==> For Jahra, the Cap Rates for Grade A commercial properties is 6.20%, for Grade B it is 6.42% and for Grade C it is 6.96%.

Property Grade Wise Cap Rate Variations for Different Locations			
	Grade A	Grade B	Grade C
Kuwait City	4.00%	NA	NA
Hawalli	5.57%	5.99%	6.62%
Mangaf	6.60%	NA	NA
Jleeb Al Shiyoukh	6.24%	6.78%	NA
Jahra	6.20%	6.42%	6.96%

Overall, we believe that for any location in Kuwait the commercial property Cap Rates are around 20 – 30 basis points lower compared to the corresponding Cap Rates of investment properties.

PREFACE

In any property valuation exercise, it is common to employ multiple methods of valuations. Cost plus approach is prevalent where a property is valued as sum of its parts. Sales comparison approach is employed where a property is valued by comparing recent sale prices of similar properties at similar locations.

One of the most widely used method is the application of «Capitalization Rate» (Cap Rate for short). Income of a property is capitalized at a benchmark rate of similar properties in similar locations to arrive at the property valuation. This rate is the Cap Rate and the valuation method is termed as «Income Capitalization Method».

The Cap Rate method is considered one of the major tools in property valuation. Like any other tool, however, its utilization is highly dependent on the efficiency of the market. It is used, almost exclusively, for income generating properties. The method recognizes that post completion; such properties should be valued solely on their income generating potential. It remains the most effective method for valuing income generating properties.

A great feature of Cap Rates is that they have the current market conditions and the future expectations rolled into one. Thus, Cap Rate can be a great tool to gauge current and future market rental income. If market participant expect rental income to grow in the next few years, investors will accept lower current returns, and consequently lower Cap Rate. If investors, however, expect the rental income to fall in the next few years, they will demand higher current returns and thus higher Cap Rate. Accordingly, Cap Rate represents the collective judgment of the investors on the current market conditions and future expectations.

For example, a property with 7.00% Cap Rate gives annual cash returns of 7.00%. However, it does not mean that investor's long-term expected rate of return is 7.00%. As explained above, expectations of future rental income determine the current Cap Rate.

Please see Appendix 1 for detailed definitions of various terms including the Cap Rate.

ABOUT THIS GUIDE

Kuwait real estate market enjoys a large pool of income generating properties. As per the Public Authority for Civil Information (PACI) data, there are close to 12,000 income generating properties with nearly 300,000 apartments in Kuwait. The market also houses couple of thousands of commercial, retail and industrial properties.

A sizeable chunk of these income generating properties are mortgaged to various banks in Kuwait who need to maintain yearly valuation records to track their exposure level. Hundreds of properties are transacted every year where property valuation plays a crucial part.

Recognizing the importance of the subject, this guide is an attempt to establish a comprehensive framework for Cap Rates in Kuwait real estate market. Cap Rates vary with location, age of property, grade of property and several other factors. Cap Rates also vary with time. Thus, a scientific study for measuring Cap Rates periodically is critical to bring about transparency and efficiency to the market.

For the study, we have analyzed hundreds of transactions and offers in the market in the first half of 2014 and compiled data to establish Cap Rates for different locations. We have also carried out field surveys of each of these properties to classify them into different age groups, grades, location features, etc. The result is a robust framework that, we believe, can evolve into a true guide for real estate community in Kuwait.

The report is divided into two segments – investment properties and commercial properties. For the investment properties, the report first establishes a detailed framework of analysis and different determinants of Cap Rates by analyzing data for whole of Kuwait. Subsequently, Cap Rates for different locations across each category are given.

For the commercial properties, the available data is not sufficient to present analysis of all locations in Kuwait. Nonetheless, we have provided the analysis for whichever locations are available.

INVESTMENT PROPERTIES

Market Snapshot

For the investment properties, the largest real estate segment in Kuwait real estate, we assembled data on nearly 875 properties, which were either transacted or offered in the market in the first half of 2014. The information on these properties was received from a variety of sources including government agencies, real estate owners, financial institutions and real estate agents. We note that the market may well have more cases of property transactions and offers for the same period.

The data was then put to rigorous screening and verification process. This led to a number of cases being removed from this sample due to the following reasons:

1. Information on certain properties was incomplete and thus, these properties could not be located.
2. Several transacted properties were very old and they were purchased for demolition and re-development. By the time, our team went for their surveys, the demolition of these properties was underway and therefore, no further information could be attained.
3. In some cases, the transaction price was completely out of sync with the transactions prices of other properties in the same location. Presence of unknown factors rendered such cases as outliers and thus, these were removed.

After all cleaning and verification, we compiled data on 330 investment properties. Please see Appendix 2 for a detailed note on the methodology of this report.

Our sample covers all locations and adequately represents properties of different grades, age groups, features, etc. We note that the accuracy of data was kept as the prime criterion for selection of properties in our analysis as any wrong or biased data can skew the entire result. Table 5 shows the results of this analysis.

==> The combined value of the 330 investment properties transactions and offers was KD 506.68 million.
The average transaction size was around KD 1.53 million.

==> The average Cap Rate of all transactions was 6.40%.

Cap Rate for Investment Properties Segment in Kuwait	
No. of Investment Properties Covered	330
Total Transaction Value	KD 506,687,930
Average Transaction Price	KD 1,535,418
Average Cap Rate *	6.40%

* adjusted to remove the lower grade properties as these transactions resembled buying lands

The historical data on the trend of the Cap Rate is not available but anecdotal evidences suggest that the Cap Rates in Kuwait were close to 8% until 2010. The Cap Rates have dropped by 160 basis points over the last four years. All other things being constant, this means the property values have increased by 25.3% over the last four years.

As part of another publication Al Murshid Al Aqari, we have seen that the rentals have increased significantly over the last four years. The combined effect of increase in rentals and drop in Cap Rates has resulted in more than 50% increase in property values over the last four years.

Food for Thought: Macro Economic Factors as Determinants of Cap Rate

Several macro economic factors such as bank rates are one of the key determinants of the Cap Rates in any economy. If the bank rates are lower than the property returns and the credit is available easily, it gives an arbitrage opportunity. Investors can execute leveraged transactions to buy income generating properties and service the bank financing through the property income. Strong demand in real estate sector reduces the risk and fuels rapid growth in transactions. In such a scenario, the Cap Rates start declining till they reach a level where the arbitrage is no longer available.

Many suspects that this is the case in Kuwait as the Cap Rates were close to 8.00% in 2009 – 2010 and the credit was available at 5.50%. Strong rental demand fueled the transactions in income generating properties and resulted in sharp decline in the Cap Rates. With the Cap Rates at 6.40%, the arbitrage opportunity is nearly gone as the transactions costs such as brokerage, registration, etc. add up to reduce the margin further.

A detailed analysis of the inter-relation between the bank rate and Cap Rate is beyond the scope of this document. Macro factors affect the Cap Rates of all properties in all locations equally. This document focuses more on the property wise and location wise variations in the Cap Rates given a certain macro-economic environment. Having said that, we will keep an eye on the development of the interplay between the bank rates and the Cap Rates in the property market.

Determinants of Variations in the Cap Rate

While the headline number of the Cap Rate for Kuwait is important, experienced real estate professionals know that the Cap Rates vary with a number of factors. The most important determinant is the location of the property. We have discussed the location wise variations in the Cap Rates in a separate section later in this report. Here we discuss some of the other determinants of the Cap Rates:

1. Property Grades – Property grades are used to segregate properties with different build quality, features, design, facilities, etc. Detailed definitions are given in Appendix 1. The Cap Rates vary with property grades because of the differences in the cost of construction, expected life of the property, expected change in the rental growth, etc.
2. Property Age – The effect of property age is quite pronounced on the rentals and their growth rates in Kuwait. We have noticed sizeable variations in Cap Rates of properties in different age groups.
3. Land Features: The importance of location in real estate cannot be overstated. However, very rarely location is defined in concrete terms. We have attempted to introduce a combination of factors that define the location of a property. Since the location features are essentially the features attached to the land parcel, we term these as lead features. These are:
 - a. No. of access streets
 - b. The frontage of the land parcel
 - c. The orientation of the property (north, south, east or west)
 - d. Presence of a setback

We have observed that having better land features lead to better potential for rental growth, which is why properties with better land features have lower Cap Rates than properties with not-so-good land features.

We will explore each of these determinants in details and the market data to support the observations.

Variations in Cap Rates with Property Grades

Since the year 2011, the rental market in Kuwait has evolved very rapidly. Political unrest in the region led to a sizeable increase in the immigration to Kuwait, which resulted in spurt in demand. Due to acute shortage of vacant investment zoned land, the supply did not match up to the demand and therefore, the rentals increased substantially. The rental prices were also supported by a growing shortage of homes for Kuwaiti families, who were then forced to rent apartments.

Different grade of properties experienced different rental growth rates. We have taken out information that we have published earlier in Al Murshid Al Aqari in 2013 and shown here in Table 6.

- ==> The table shows that for entire Kuwait between Q3 2011 and Q2 2013, the average monthly rent of Grade A properties have increased from KD 527 to KD 562 – a growth of 3.7% annual rate.
- ==> For the same period, the growth rate of monthly rent is 3.3% for Grade B properties.
- ==> The growth rates are much lower for Grade C and Lower Grade Properties for the same period.
- ==> Numbers for 2014 are not yet available but the trend is expected to be intact.

Table 6: Variations in Rental Growth Rates by Property Grades - Q3 2011 to Q2 2014			
	Q3 2011	Q2 2013	Average Yearly Rent Growth
Grade A	KD 527.7	KD 561.9	3.7%
Grade B	KD 304.9	KD 322.9	3.3%
Grade C	KD 243.7	KD 252.2	2.0%
Lower Grade	KD 194.2	KD 201.6	2.2%

Source: Al Murshid Al Aqari, 2013 for Real Estate Association

We segregated properties in different grades based on our algorithm, which is explained in Appendix 3-. Table 7 shows the number of properties covered in each grades for the Cap Rate analysis and the average transaction value.

- ==> For Grade A, we have 48 properties covered with average transaction value of KD 2.11 million.
 - ==> For Grade B we have 122 properties with average transaction of KD 1.59 million and for Grade C 60 properties with average transaction value of KD 1.28 million.
 - ==> For the Lower Grade, we have 100 properties with average transaction size of KD 1.34 million.
- We note that the land sizes in some of the Lower Grade properties are big.

Coverage of Properties of Various Grades				
	Grade A	Grade B	Grade C	Lower Grade
No. of Properties Covered	48	122	60	100
Total Transaction Value	KD 101,496,390	KD 194,021,836	KD 76,925,252	KD 134,244,452
Average Transaction Price	KD 2,114,508	KD 1,590,343	KD 1,282,088	KD 1,342,445

Chart 4 shows the variations in the Cap Rates of properties of different grades:

- The average Cap Rate for Grade A properties is 5.92%, Grade B properties 6.38% and Grade C properties 6.83%.
- Due to the differences in the Cap Rates, three properties of three different grades with exactly the same monthly rentals are valued differently.
- Going by the Cap Rates shown here, a Grade A property will have 7.6% higher value than a Grade B property and the Grade B property will have 7.1% higher value than a Grade C property. The Grade A property will command 15.3% higher value than the Grade C property.
- The Lower Grade properties have the lowest Cap Rate of 3.89%, which may give an impression that the properties in this grade command the highest value but this is misleading.
- Most of the Lower Grade properties covered in this study are very old and the transaction is done more for the land parcel than for an income generating asset. Thus, the Cap Rate for the Lower Grade is not representative.
- We note that the Cap Rates for different grades include properties across all locations in Kuwait. Despite mixing up the good and the not-so-good locations, the higher grades properties command lower Cap Rates compared to the lower grade properties.

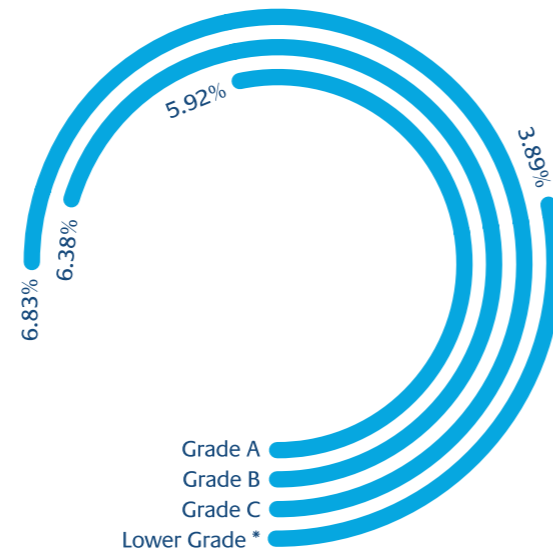


Table 6 shows the historical trend in the rental growth rates for properties of different grades. The better grade properties have enjoyed higher rental growth compared to lower grade properties. However, that is history and the rentals have already increased. So why will an investor now pay higher price for a Grade A than a Grade C property and accepts lower current returns? What explains this market behavior?

As mentioned before, the Cap Rate is a forward looking tool. The market is willing to pay a premium for Grade A properties because it expects the differential growth rates to continue for the coming years.

We also note that a part of the Cap Rate differential may also be due to the fact that higher grade properties have better build quality and therefore, lower maintenance cost over the lifetime. Thus, with other factors being constant, the net income from higher grade properties over the long term is expected to be more than the net income from lower grade properties. Collectively, the two factors result into Grade A properties enjoying the lowest Cap Rate in Kuwait.

We reckon that the rental growth expectations are playing a bigger part than the lower maintenance cost in the Cap Rate differential. The market expects the higher grade properties to witness higher demand and higher prices. In expectations of higher returns in future the investors are accepting lower returns today.

This gives rise to a question that for how long the market expects the rental growth to sustain? We have addressed this in the next section where we analyze the Cap Rate variations with property age.

Variations in Cap Rates with Property Age

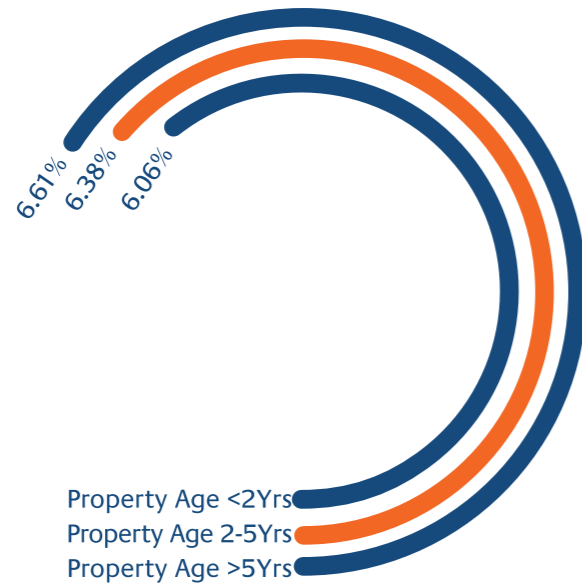
We have highlighted in Al Murshid Al Aqari that properties of different age groups have different market dynamics in Kuwait. We have taken the numbers shown in Table 8 from Al Murshid Al Aqari 2013 publication.

- ==> Between Q3 2011 and Q2 2013, the average rental for property with less than 2 years of age (new properties) jumped by an annual growth rate of 13.3%.
- ==> The corresponding growth rate for properties in 2 to 5 years age group was 6.6%.
- ==> The annual growth rate was negative for the age group of more than 5 years. However, we noted in the publication that this is misleading. The underlying sample of properties in Q3 2011 and Q2 2013 were different as we expanded the coverage to cover more properties in several areas. Most of the newly covered properties were more than 5 years old and thus, the average became lower. This is a temporary issue and the trend will be well established once the survey sample is stabilized.

Variations in Rental Growth Rates by Property Age Groups - Q3 2011 to Q2 2014			
	Q3 2011	Q2 2013	Average Yearly Rent Growth
Property Age < 2 Yrs	KD 285.3	KD 355.2	13.3%
Property Age 2 - 5 Yrs	KD 267.3	KD 298.7	6.6%
Property Age > 5 Yrs	KD 233.1	KD 224.0	-2.2%

The moot point is that there are substantial difference in the rental growth rates of properties of different age groups and thus, we expected the Cap Rates to reflect these differences. Chart 5 shows the variations in Cap Rates in different age groups.

- ==> The Cap Rate for properties in less than 2 years age group is the lowest at 6.06%. Note that this is the average of all locations and includes properties of all grades.
- ==> The Cap Rate for properties in 2 to 5 years age group is 6.38% and the Cap Rate for properties in age group more than 5 years is 6.61%.
- ==> The differences of Cap Rates in various age groups means that other things being constant, properties in less than 2 years of age have 5.3% higher value than properties in 2 to 5 years age, which in turn have 3.5% higher value than properties of more than 5 years age.



Combining the Effect of Property Grades and Property Age for Cap Rate Variations

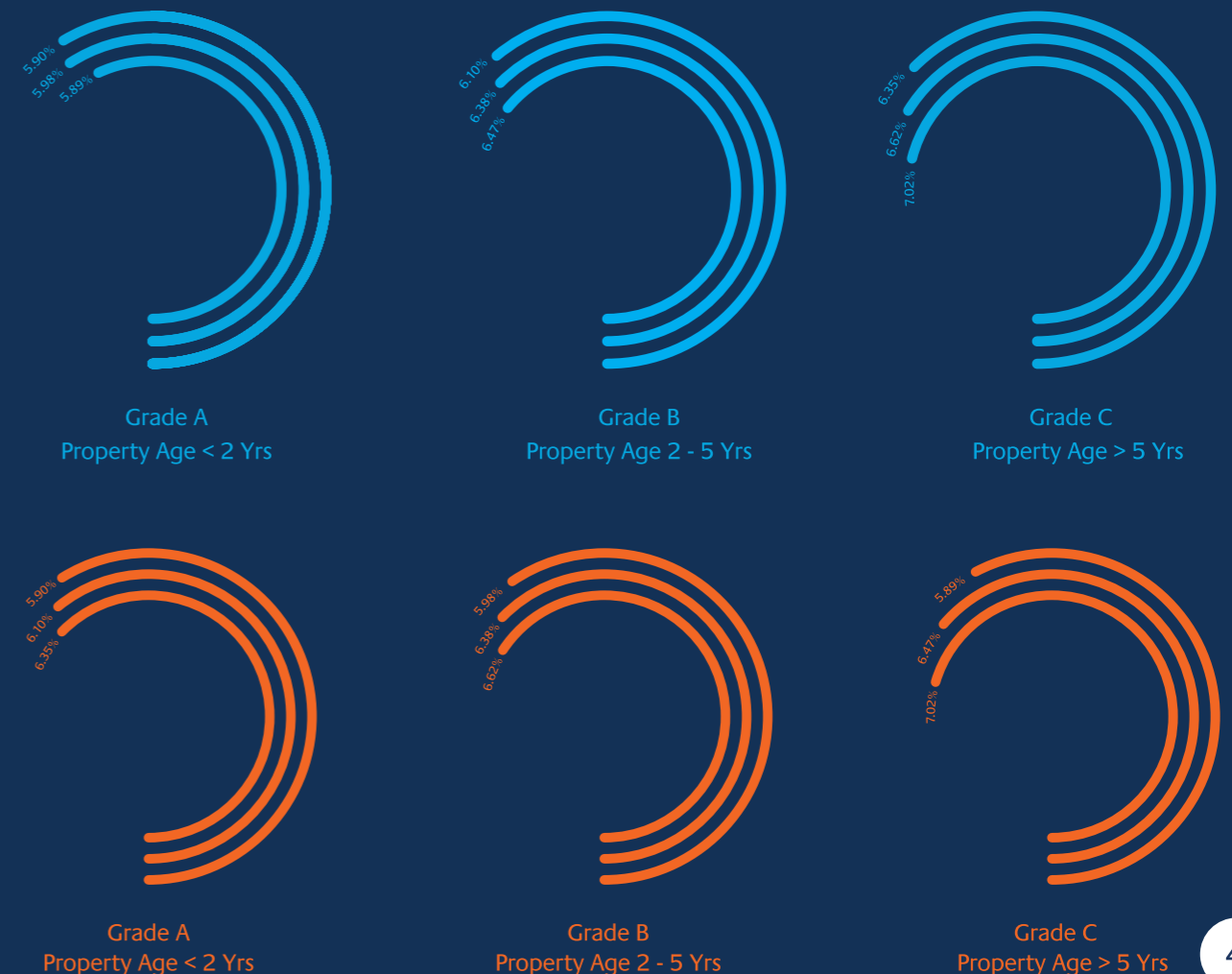
The difference in the rental growth rates across the property age groups (refer to Table 8) are far higher than the rental growth difference across different grades (refer to Table 6). However, the variations in the Cap Rates across age groups are not as pronounced as those across the property grades. Is there a disconnect?

To analyze the reasons behind this, we have combined the effect of variations in the Cap Rates across the property grades and the property age groups in Table 9 and Chart 6 and 7.

- ==> Table 9 can be studied left – right and top – down. Across left – right, it shows the variations in the Cap Rates across property age groups within a property grade. This part of the analysis refers to Chart 6. Across top – down the table shows the variations across property grades within a property age group. This part of the analysis refers to Chart 7.
- ==> Within Grade A, the Cap Rates are almost similar across all the three property age groups (Chart 6).
- ==> The difference emerges as we shift to Grade B properties where properties with less than 2 years of age command the lowest Cap Rate and it progressively increases as with move to properties with more than 5 years of age.

- ==> The same trend is observed in Grade C category where Cap Rates increase as the property age increases.
- ==> Chart 7 shows that within the three age groups, properties show progressive increase in Cap Rates as one moves from Grade A to Grade C category. There are no exceptions to this trend in this chart.

Table 9: Variations in Cap Rates Across Property Grades and Property Age Groups			
	Property Age < 2 Yrs	Property Age 2 - 5 Yrs	Property Age > 5 Yrs
Property Age < 2 Yrs	5.90%	5.98%	5.89%
Property Age 2 - 5 Yrs	6.10%	6.38%	6.47%
Property Age > 5 Yrs	6.35%	6.62%	7.02%



In simple terms, the analysis reveals that within Grade A, the Cap Rates do not change much for properties of different age. However, within Grade B and Grade C, the Cap Rates are low for new properties and increase for old properties.

Being a forward looking indicator of the rental growth expectations, the Cap Rate behavior says that the market expects Grade A properties' rentals to increase for the foreseeable future. This is the reason the Cap Rates for Grade A properties do not show much variations across the age groups.

For Grade B, the rental growth expectations are not as strong because the Cap Rate increases by 37 basis points between Grade A and Grade C properties. The market expects the rental growth rates to slow down beyond the next couple of years for Grade B properties.

For Grade C, investors demand even higher compensation for age as the Cap Rate increases by 67 basis points from Grade A to Grade C. The market expects that the rentals in Grade C may stagnate and therefore, investors demand higher returns today.

The analysis also reveals that the market rewards the property grade more than the property age. It is remarkable to see is that the Cap Rate for Grade A properties of any age group is lower than the Cap Rate of even the brand new properties of Grade B and Grade C. The grade of a property is the overbearing consideration for the investors of income generating properties.

Properties of Grade A category retain their value even when they get old. Grade B properties lose around 5.7% of their value from the time they are built till they become more than 5 years old and Grade C properties lose 9.5% over the same period.

The conclusion is clear. The most effective way to preserve the value of an income generating property over its lifecycle is to construct it with Grade A quality and features. It ensures that the property enjoys rental growth and retains its value over a long term.

Variations in Cap Rates with Land Features

Location of a property is a much touted yet less defined term. It is often defined, albeit loosely, as a combination of accessibility, visibility and orientation of a land parcel or a property. In this document we have, may be for the first time in Kuwait, attempted to define a property's location in observable terms and its effect on the Cap Rates and the market value.

We have identified four key factors that are critical in defining the location of a property. We note that the location factors are essentially attached to the land parcel of a property. Therefore, we have termed these factors as land features. We have not used the term "location" in order to avoid confusion with the term "neighborhood" (such as Salmiya Block 6), which is also called as location. The four features of land parcels are:

1. No. of Access Streets – The number of access streets for a land parcel determine its accessibility and therefore, has effect on its value. The possible values are single street, two street, three street, etc.
2. Length of the Open Frontage – The length of the open frontage of a land parcel provides visibility to the property. Long frontage length also gives flexibility in property design as the main entry and the parking entry / exit points can be planned easily. Generally, properties having multiple access streets have longer open frontage compared to properties having single access street.
3. Setback from the Road – A setback is the open space that is available between the edge of the road and the closest edge of the land parcel. The land parcel owner does not own this space but by virtue of its location in front of the land parcel, it provides higher visibility, better access and open space for parking.
4. Orientation of the Open Sides – While personal preferences may vary, consumers on average prefer properties that are east or north facing. This is because these two orientations offer better sun light and airflow characteristics.

Advancements in Geographical Information System (GIS) methods have enabled large-scale information creation on the above listed features for all the properties covered under this study. We have shown below these features, their possible values and the percentage weight given to each feature in the calculation.

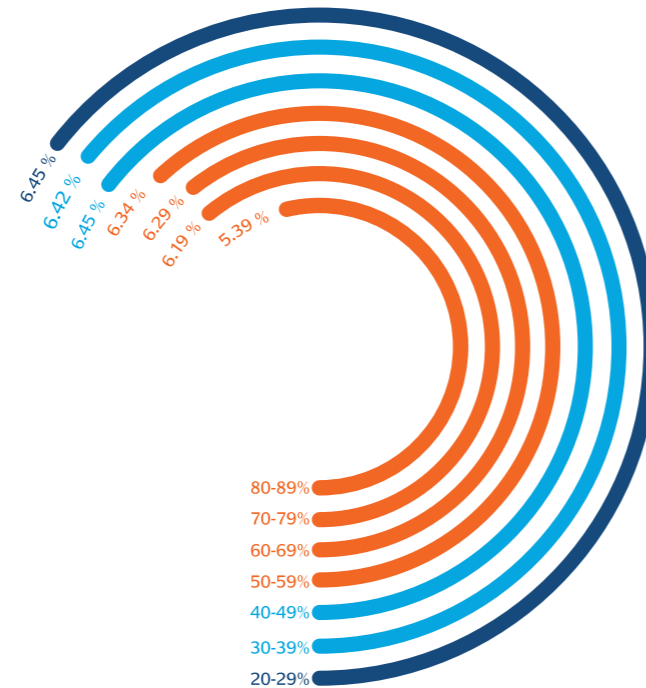
Feature	Possible Values	Percentage Weight in the Calculation
No. of Access Streets	1. Single Street 2. Two Street 3. Three Street 4. Four Street	40%
Length of Open Frontage	Actual length measured in meters	30%
Setback from the Road	Yes or No	15%
Orientation of the Open Side	1. North 2. South 3. East 4. West	15%

While the percentage weights given to individual features are subjective in nature, we have relied on the feedback of market professionals and our understanding of the local market to assign these values. Without these values, it would be impossible to carry out any useful analysis. Properties that receive lower marks have poor land features and those with higher marks have better land features.

All properties were assigned marks on each of the features and segregated into groups with ten percentage point differences. These are shown in Chart 8. Properties with 20-29% marks have poor land features and properties with 80-89% marks have the best land features. Due to the methodology, no property gets less than 20% marks or more than 90% marks.

==> The Cap Rate for properties varies from 6.45% for properties with 20-29% marks to 6.19% for properties with 70-79% marks.

==> The highest category of 80-89% has just one property and therefore, we do not consider the Cap Rate of 5.39% to be representative of this category.



Variations of Cap Rates with Land Features and Property Grades

Looking at Chart 8 may give an impression that there is very little variation of the Cap Rates between the properties with the best land features and those with the worst land features. However, the chart does not reveal the complete picture.

We have seen previously that the property grade is the predominant factor with the maximum impact on the Cap Rate of a property. In Chart 8, property grades are mixed for every category of the land features.

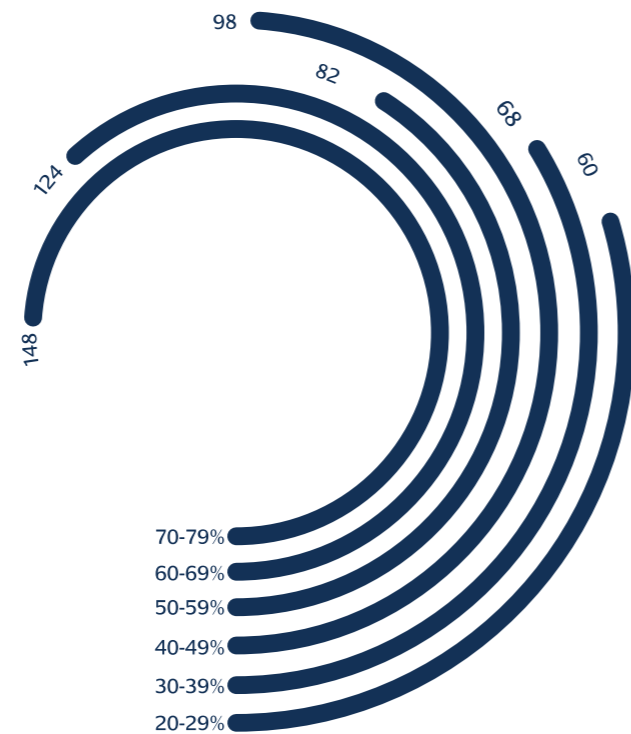
The separate effect of property grades and land features is shown in Table 10. In every single category of the land features, the Cap Rate is the lowest for Grade A properties and the highest for the Grade C properties. Given a certain category of land parcel features, the higher grade properties command better value than the lower grade properties.

Adequate data is not available for category of 80-89% marks and thus, it is removed from the analysis.

Variations in Cap Rates with Property Grades and Land Parcel Features	
Properties with Land Features Marks 20-29%	
Grade A	6.02%
Grade B	6.53%
Grade C	6.62%
Properties with Land Features Marks 30-39%	
Grade A	5.90%
Grade B	6.50%
Grade C	6.58%
Properties with Land Features Marks 40-49%	
Grade A	5.95%
Grade B	6.34%
Grade C	6.93%
Properties with Land Features Marks 50-59%	
Grade A	5.93%
Grade B	6.37%
Grade C	6.75%
Properties with Land Features Marks 60-69%	
Grade A	5.90%
Grade B	6.40%
Grade C	7.14%
Properties with Land Features Marks 70-79%	
Grade A	5.60%
Grade B	6.03%
Grade C	7.08%

Chart 9 shows the percentage basis point difference between Grade A and Grade C properties for every category of land features. It shows a very interesting market phenomenon.

- ==> For the properties with land features in 20-29% and 30-39% categories, the difference in the Cap Rates between Grade A and Grade C is around 60 – 70 basis points. This translates to a difference of around 10 to 11% in values of properties of Grade A and Grade C categories.
- ==> This difference increases to 80 – 100 points for properties with land features marks from 40 to 60%. This is a difference of around 14 to 16% in values of properties of Grade A and Grade C categories.
- ==> For the properties with the best land features, the Cap Rate difference between Grade A to Grade C ranges 125 to 150 basis points. This is a difference of around 21 to 26% in values of properties of Grade A and Grade C categories.
- ==> While the result may appear very intuitive, its implications are quite important.
- ==> For the properties with relatively poor land features, developers can expect to increase the property values by around 10% if they develop Grade A property instead of Grade C.
- ==> For land parcels with very good features, developers can expect to increase property values by around 25% if they develop Grade A properties instead of Grade C.
- ==> All the effect on the property value is transmitted through expectations of rental growth rates. With better land features, a developer can create better grade properties that are expected to stay in demand for a longer period and thus, command better value today.



Variations of Cap Rates with Land Features and Property Age and Property Grades

With the effect of property grades and land features explained, we have introduced the third element of property age into the equation for this analysis. The combined effect of the three factors is shown in Table 11.

The table shows that for every property grade, how the Cap Rate moves with property age by keeping the land features constant. We note that with 330 transactions and offers that we have analyzed for the first six months of 2014, there is not enough data to generate a Cap Rate value for every category and thus, some categories show NA that stands for “Not Available”.

It is clear that given a land features category the Cap Rate increases for any property grade with the increase in the age of the property. Most Grade A categories are exceptions to this trend as the Cap Rates do not change much with property age. The biggest increase in the Cap Rate with property age is observed in Grade C category.

This once again shows that only Grade A properties are able to retain their value with age. Grade C category properties lose their value rapidly with age.

Variations in Cap Rates with Property Grade, Property Age and Land Parcel Features			
	Property Age < 2 Yrs	Property Age 2 - 5 Yrs	Property Age > 5 Yrs
Properties with Land Features Marks 20-29%			
Grade A	6.10%	5.93%	NA
Grade B	NA	6.63%	6.32%
Grade C	NA	6.46%	6.79%
Properties with Land Features Marks 30-39%			
Grade A	5.99%	5.67%	NA
Grade B	6.20%	6.32%	6.74%
Grade C	6.32%	6.59%	6.63%
Properties with Land Features Marks 40-49%			
Grade A	NA	6.03%	6.06%
Grade B	5.87%	6.37%	6.40%
Grade C	6.13%	6.57%	7.13%
Properties with Land Features Marks 50-59%			
Grade A	5.81%	6.06%	6.08%
Grade B	6.03%	6.59%	6.37%
Grade C	6.36%	6.53%	7.13%
Properties with Land Features Marks 60-69%			
Grade A	NA	5.43%	5.95%
Grade B	6.26%	6.49%	6.37%
Grade C	6.09%	6.89%	7.39%
Properties with Land Features Marks 70-79%			
Grade A	5.60%	NA	NA
Grade B	NA	6.30%	NA
Grade C	NA	7.04%	7.12%

* After removing one outlier

This completes the analysis where we have laid down a robust framework for Cap Rate analysis in Kuwait. The Cap Rate is a forward looking tool and conveys collective expectations of the market. Current expectations are the most favorable for Grade A properties and thus, such properties command the best value.

In the next section, we have shown the Cap Rates for each location in Kuwait for properties of different grades and different age groups.

Location Wise Cap Rate Trends – Investment Properties

The locations covered in our study are shown in Table 12 below:

- ==> The most number of properties for the study are covered in Salmiya and Mahboula area. Salmiya is the largest location for investment properties in Kuwait and Mahboula is one of the most active location for transactions.
- ==> The average value is the highest for Kuwait City with KD 2.65 million per property. This is followed by Fintas, Shaab and Jabriya. However, we caution not to read too much in this indicator. The average value is a function of the land area and the property size and it can be skewed by a couple of large transactions.
- ==> A better indicator is the average property price per sq.m. of land area, which brings all transactions on a common scale of per unit of land area. On this scale, the most expensive locations are Kuwait City, Shaab, Salmiya and Khaitan.
- ==> Some locations of investment properties are missing from our analysis. This is because no accurate data on property transactions was available for these locations. We will attempt to cover more locations in the subsequent issues of this publication.
- ==> In Shaab, Jabriya, Jleeb Al Shiyoukh and Jahra, we have less than 10 properties in the sample. The Cap Rates for these locations, relatively speaking, is less representative as the sample is not large enough to draw definitive conclusions. These locations are shown in a separate section.

Location Wise Coverage of Properties in the Study				
	No. of Properties Covered	Total Value	Average Value	Average Property Price per sq.m. of Land Area
Kuwait City	10	KD 26,552,563	KD 2,655,256	KD 3,093
Shaab	2	KD 4,400,000	KD 2,200,000	KD 2,906
Hawalli	38	KD 58,576,620	KD 1,541,490	KD 1,889
Salmiya	73	KD 132,502,858	KD 1,815,108	KD 2,005
Jabriya	4	KD 8,170,358	KD 2,042,590	KD 1,916
Abu Halifa	13	KD 20,407,156	KD 1,569,781	KD 1,497
Fahaheel	15	KD 21,674,801	KD 1,444,987	KD 1,802
Fintas	10	KD 22,450,000	KD 2,245,000	KD 1,898
Mahboula	73	KD 78,222,690	KD 1,071,544	KD 1,648
Mangaf	29	KD 42,110,335	KD 1,452,081	KD 1,632
Farwaniyah	26	KD 38,150,000	KD 1,467,308	KD 1,920
Jleeb Al Shiyoukh	4	KD 3,914,738	KD 978,685	KD 1,660
Khaitan	12	KD 17,961,215	KD 1,496,768	KD 1,957
Riggai	16	KD 24,571,330	KD 1,535,708	KD 1,670
Jahra	4	KD 6,200,000	KD 1,550,000	KD 1,673

We now show the Cap Rates for each of these areas with variations as per property grades and property age groups. In several cases, some categories show no value because there are not enough transactions to generate a Cap Rate for every category for all locations.

Similarly, the land features analysis of Cap Rates for the location is not possible with the current data. Such an exercise would require thousands of transactions, which given the size of Kuwait market is not possible.

Nevertheless, we believe that the Cap Rate values across property grades and property age groups are very useful benchmark. Not only these can be used by the market participants to value properties, but the Cap Rates also communicate the collective market expectations of rental growth and demand.

Kuwait City

Average Cap Rate = 5.72%

==> Table 13 shows the Cap Rates with property grades and age groups.

==> For Grade A, there is just one transaction with Cap Rate of 5.24%. This property is more than 5 years old.

==> For Grade B, the Cap Rates are around 5.9% and for Grade C, marginally higher at 5.93%.

==> Cap rates for Lower Grade properties is not representative as these properties are being transacted as land.

Cap Rate Variations in Kuwait City with Property Grade and Property Age

	Property Age < 2 Yrs	Property Age 2 - 5 Yrs	Property Age > 5 Yrs
Grade A	NA	NA	5.24%
Grade B	5.82%	5.90%	NA
Grade C	NA	NA	5.93%
Lower Grade	NA	NA	4.03%

Hawalli

Average Cap Rate = 6.25%

==> In Hawalli, the Cap Rate for Grade A properties is just around 5.90%.

==> For Grade B properties, the new properties attract Cap Rate of 6.00%. This increases to 6.20% for properties with age 2 – 5 years and further to 6.40% for properties with age more than 5 years.

==> For Grade C properties, the only Cap Rate available is 6.69% for properties with more than 5 years age. Going by the trend of Grade B, it is likely that the Cap Rate for Grade C properties with less than 2 years age could be around 6.30% and for properties with age 2 – 5 years around 6.50%.

Table 14: Cap Rate Variations in Hawalli with Property Grade and Property Age

	Property Age < 2 Yrs	Property Age 2 - 5 Yrs	Property Age > 5 Yrs
Grade A	5.91%	5.93%	NA
Grade B	5.99%	6.20%	6.40%
Grade C	NA	6.65%	6.69%
Lower Grade	NA	NA	2.54%

Salmiya

Average Cap Rate = 6.03%

==> With sufficient number of properties covered, we have almost Cap Rates for all the categories in Salmiya.

==> For Grade A, the Cap Rate ranges from 5.50% to 5.75% within the three age categories. It is a tight band of just 25 basis point.

==> For Grade B, the variation in Cap Rates is from 5.70% for properties with less than 2 years age to 6.27% for properties with more than 5 years age. The variation bank is around 75 basis points.

==> For Grade C, the range starts from 5.95% and goes till 6.80% - a gap of 85 basis points.

Cap Rate Variations in Salmiya with Property Grade and Property Age

	Property Age < 2 Yrs	Property Age 2 - 5 Yrs	Property Age > 5 Yrs
Grade A	5.54%	5.73%	5.62%
Grade B	5.70%	6.13%	6.27%
Grade C	5.95%	6.52%	6.80%
Lower Grade	NA	7.23%	3.51%

Abu Halifa

Average Cap Rate = 6.61%

==> Abu Halifa falls in Ahmadi Governorate and the Cap Rates are somewhat higher than the Cap Rates in the locations of Hawalli Governorate.

==> In Abu Halifa, the Cap Rate for Grade A properties is 6.29% for age group of 2 – 5 years. However, we caution that we did not cover any property on the Coastal Road part of Abu Halifa where the Cap Rate might be somewhat lower.

==> The Cap Rate for Grade B property is 6.34% for the age group of 2 – 5 years.

==> For Grade C, the Cap Rates range from 6.58% to 7.22%, which is quite high.

Cap Rate Variations in Abu Halifa with Property Grade and Property Age

	Property Age < 2 Yrs	Property Age 2 - 5 Yrs	Property Age > 5 Yrs
Grade A	NA	6.29%	NA
Grade B	NA	6.34%	NA
Grade C	NA	6.58%	7.22%
Lower Grade	NA	NA	4.55%

Fahaheel

Average Cap Rate = 6.41%

- ==> Cap Rates are available for most categories for Fahaheel in Table 17.
- ==> Grade A Cap Rate varies from 5.88% for new properties to 6.07% for properties of more than 5 years age – a tight range of 19 basis points.
- ==> For Grade B, the Cap Rate starts from 6.03% for new properties to 6.74% for properties with more than 5 years age.
- ==> For Grade C, we do not have the Cap Rate for new properties. Going by the trend of the two other grades, we believe that it should be around 6.30%. The Cap Rate for properties with more than 5 years age is 7.12%, which would have given a range of 82 basis points.

Cap Rate Variations in Fahaheel with Property Grade and Property Age

	Property Age < 2 Yrs	Property Age 2 - 5 Yrs	Property Age > 5 Yrs
Grade A	5.88%	NA	6.07%
Grade B	6.03%	6.38%	6.74%
Grade C	NA	6.65%	7.12%
Lower Grade	NA	NA	4.08%

Fintas

Average Cap Rate = 6.75%

- ==> Fintas is the most curious case where we have total 10 properties under coverage (refer to Table 12). However, of these just one property falls into Grade C category and the remaining properties are of Lower Grade.
- ==> Thus, the Cap Rate for more categories is not possible to estimate.
- ==> The Grade C Cap Rate for properties with more than 5 years age is 6.75% but this data is based on just one observation and therefore, less reliable.

Cap Rate Variations in Fintas with Property Grade and Property Age

	Property Age < 2 Yrs	Property Age 2 - 5 Yrs	Property Age > 5 Yrs
Grade A	NA	NA	NA
Grade B	NA	NA	NA
Grade C	NA	NA	6.75%
Lower Grade	NA	NA	2.59%

Mahboula

Average Cap Rate = 6.53%

- ==> For Mahboula, the Grade A Cap Rates range from 5.83% to 6.06% - a narrow range of 23 basis points.
- ==> For Grade B, the range starts from 6.27% for new properties and goes till 6.90% for properties with more than 5 years age.
- ==> For Grade C, the Cap Rate for new properties is not available but we estimate that is closer to 6.60%. The highest Cap Rate for properties with more than 5 years age is 7.61%.

Cap Rate Variations in Mahboula with Property Grade and Property Age

	Property Age < 2 Yrs	Property Age 2 - 5 Yrs	Property Age > 5 Yrs
Grade A	5.83%	6.04%	6.06%
Grade B	6.27%	6.61%	6.90%
Grade C	NA	6.89%	7.61%
Lower Grade	NA	NA	5.82%

Mangaf

Average Cap Rate = 6.84%

- ==> In Mangaf, Grade A Cap Rates are the highest for any location in Kuwait. The data is based on six properties and therefore, reasonably representative. The market expectations for rental growth in this area appears to be quite low even for Grade A properties.
- ==> For Grade B properties, the Cap Rate ranges from 6.67% to 6.99% and for Grade C it is 6.78% to 7.20%.

Cap Rate Variations in Mangaf with Property Grade and Property Age

	Property Age < 2 Yrs	Property Age 2 - 5 Yrs	Property Age > 5 Yrs
Grade A	6.52%	6.75%	NA
Grade B	6.67%	6.89%	6.99%
Grade C	6.78%	6.92%	7.20%
Lower Grade	NA	NA	5.01%

Farwania

Average Cap Rate = 6.31%

- ==> In Farwania, the Grade A properties with less than 2 years age are attracting 5.63% Cap Rate, which increases to 5.97% for properties with 2 – 5 years age. The Cap Rate for properties with more than 5 years age is not available but we estimate it should be close to 6.00%.
- ==> For Grade B, the Cap Rate for new properties is 5.97%, which goes up to 6.83% for properties with more than 5 years age.
- ==> For Grade C, the Cap Rate for new properties is not available but we estimate it to be around 6.25%. The Cap Rate increases to 7.17% for properties with more than 5 years age.

Cap Rate Variations in Farwania with Property Grade and Property Age

	Property Age < 2 Yrs	Property Age 2 - 5 Yrs	Property Age > 5 Yrs
Grade A	5.63%	5.97%	NA
Grade B	5.97%	6.21%	6.83%
Grade C	NA	6.67%	7.17%
Lower Grade	NA	NA	3.95%

Khaitan

Average Cap Rate = 6.42%

- ==> Khaitan is an interesting location that has benefitted a lot from the development of The Avenues Mall. Anecdotal evidences show that the Cap Rates in Khaitan has dropped considerably over the last 4-5 years due to increase in demand.
- ==> Table 21 shows that for Grade A, the Cap Rate for new properties is 5.69%. No data is available for other two age groups but we believe that generally, the Cap Rates in Grade A category are below 6.00% level.
- ==> For Grade B, the new properties have 6.13% Cap Rate that increases to 6.34% for properties of 2 – 5 years age. For more than 5 years age, while the data is not available, we believe the Cap Rate is close to 6.60%.
- ==> For Grade C, the Cap Rate for new properties is not available but our estimate is around 6.50%. It goes all the way to 7.08% for properties with more than 5 years age.

Cap Rate Variations in Khaitan with Property Grade and Property Age

	Property Age < 2 Yrs	Property Age 2 - 5 Yrs	Property Age > 5 Yrs
Grade A	5.69%	NA	NA
Grade B	6.13%	6.34%	NA
Grade C	NA	6.88%	7.08%
Lower Grade	NA	NA	3.65%

Riggai

Average Cap Rate = 6.74%

- ==> For Riggai, the covered properties were only from Grade B and Grade C categories.
- ==> In Grade B, the data shows anomaly as the Cap Rate drops from 6.49% for properties of 2 – 5 years age to 6.25% for properties of more than 5 years age. Such anomalies are common in the market and do not represent any trend.
- ==> For Grade C, the only Cap Rate is 7.48% for properties with more than 5 years age. This shows that even for Grade B, for the same age group, the Cap Rate should be close to 6.90%.

Cap Rate Variations in Riggai with Property Grade and Property Age

	Property Age < 2 Yrs	Property Age 2 - 5 Yrs	Property Age > 5 Yrs
Grade A	NA	NA	NA
Grade B	NA	6.49%	6.25%
Grade C	NA	NA	7.48%
Lower Grade	NA	NA	3.36%

Cap Rates of Locations with Inadequate Data – Investment Properties

There are a handful of locations with less than 10 properties under coverage. The Cap Rates in these locations might not be representative of the market conditions as the sample data is not adequate. These locations are shown in this section.

Shaab

Average Cap Rate = 5.94%

- ==> In Shaab we have Cap Rate for only Grade A for properties with age more than 5 years. The Cap Rate is 5.94%.

Cap Rate Variations in Shaab with Property Grade and Property Age

	Property Age < 2 Yrs	Property Age 2 - 5 Yrs	Property Age > 5 Yrs
Grade A	NA	NA	5.94%
Grade B	NA	NA	NA
Grade C	NA	NA	NA
Lower Grade	NA	NA	3.60%

Jabariya

Average Cap Rate = 6.05%

==> With just a handful of properties in Jabriya, the available Cap Rates are for Grade A in the property age group of 2 – 5 years. The level is 5.82%, which is marginally higher than comparable benchmark for Salmiya and marginally lower than Hawalli.

==> For Grade B, the Cap Rate for properties with more than 5 years age is 6.27%, which is the same as the corresponding value for Salmiya.

Cap Rate Variations in Jabariya with Property Grade and Property Age

	Property Age < 2 Yrs	Property Age 2 - 5 Yrs	Property Age > 5 Yrs
Grade A	NA	5.82%	NA
Grade B	NA	NA	6.27%
Grade C	NA	NA	NA
Lower Grade	NA	NA	4.48%

Jleeb Al Shiyoukh

Average Cap Rate = 6.79%

==> In Jleeb Al Shiyoukh, we have just four properties under coverage and thus, Cap Rates for most categories are missing.

==> We believe that given the demographic profile of the location, there are not many Grade A properties here.

==> In Grade B, the Cap Rate goes from 6.44% for properties with age 2 – 5 years to 7.14% for properties with more than 5 years age.

==> While the Cap Rates for Grade C are not available, we believe this grade Cap Rates may vary from 6.5% to 7.5% for different age groups.

Cap Rate Variations in Jleeb Al Shiyoukh with Property Grade and Property Age

	Property Age < 2 Yrs	Property Age 2 - 5 Yrs	Property Age > 5 Yrs
Grade A	NA	NA	NA
Grade B	NA	6.44%	7.14%
Grade C	NA	NA	NA
Lower Grade	NA	NA	3.66%

Jahra

Average Cap Rate = 6.36%

==> In Jahra, the Cap Rates are available for all three grades for new properties. For Grade A, it is 5.89% that increases to 5.98% for Grade B and to 6.32% for Grade C.

==> Cap rates are not available for most of the other age groups, except for properties of more than 5 years for Grade B where the Cap Rate is 7.27%.

==> We believe that for Grade C, the Cap Rate should go up to 7.50% for properties of more than 5 years.

Cap Rate Variations in Jahra with Property Grade and Property Age

	Property Age < 2 Yrs	Property Age 2 - 5 Yrs	Property Age > 5 Yrs
Grade A	5.89%	NA	NA
Grade B	5.98%	NA	7.27%
Grade C	6.32%	NA	NA
Lower Grade	NA	NA	NA

COMMERCIAL PROPERTIES

As part of the study, we received information on transactions and offers involving 39 properties. Of these several properties cases were cancelled due to the following reasons:

1. Incomplete information – Cases where some critical information was missing and thus, it was not possible to estimate the Cap Rate of the transaction.
2. New Properties – In a couple of cases, market quotes were received for brand new properties, which are not yet leased. In such cases, the estimation of rental income was quite subjective as no benchmark rate for the property was established. Thus, such cases were also cancelled.

After this filtration, in total 27 properties qualified for the calculations of Cap Rates for this segment. We note that both the office space and retail properties are mixed in this data as most of the qualified properties were mixed use and therefore, it was not feasible to do separate calculations office space and retail space segments. Table 28 shows the results:

==> The combined value of 27 commercial properties was KD 145.1 million, which gives an average value of KD 5.37 million.

==> We note that this is substantially higher than the average value of investment properties that was just KD 1.53 million.

==> The average Cap Rate is 6.09%.

Cap Rate for Commercial Properties Segment in Kuwait	
No. of Investment Properties Covered	27
Total Transaction Value	KD 145,172,614
Average Transaction Price	KD 5,376,763
Average Cap Rate *	%6.09

* adjusted to remove the lower grade properties as these transactions resembled buying lands

The Cap Rate for commercial properties is around 30 basis points lower than the Cap Rate for investment properties. Does it mean that the commercial property investors have lower return expectations or higher rental growth expectations? We have addressed this issue a little later in this section. First, we show the grade wise variations in commercial properties Cap Rates.

Variations in Cap Rates with Property Grades

Much like the investment properties, Cap Rates for commercial properties also vary with property grades. We note that out of 27 properties qualified for the analysis, eight properties are of the Lower Grade and therefore, not included in this analysis. We have 19 properties spread over different grades that gave just sufficient data for grade wise analysis.

Before we show the Cap Rate variations, we have shown in Table 25 data for office space lease rates from Al Murshid Al Aqari 2013. The office space segment suffered sizeable demand contraction post the financial crisis of 2008. The market remained stagnant till 2013 where the demand picked up. As a result, Table 29 shows, the lease rates increased by average 6.3% per annum for Grade A properties between 2011 and 2013. Grade B and Grade C lease rates in 2013 were still lower than the lease rates in 2011.

Most of the increase in the lease rates of Grade A properties took place in 2013.

Variations in Rental Growth Rates by Property Grades (Office Space) - Q3 2011 to Q2 2014			
	Q3 2011	Q2 2013	Average Yearly Rent Growth
Grade A	KD 6.96	KD 7.75	6.3%
Grade B	KD 6.90	KD 6.66	-2.0%
Grade C	KD 6.18	KD 5.92	-2.4%

While the data for 2014 is not yet available, recent market trends show that the occupancy rates for office properties for all grades have gone well above 80% and the lease rates have improved substantially. Such has been the pace of lease rate improvement in 2014 that the lease rates for all property grades are now higher than their level in 2011.

For the retail properties, we have organized data for only the higher grade properties which is shown in Table 30. It shows the benchmark lease rates for ground floor shops of around 150 sq.m. at various prime retail clusters in Kuwait.

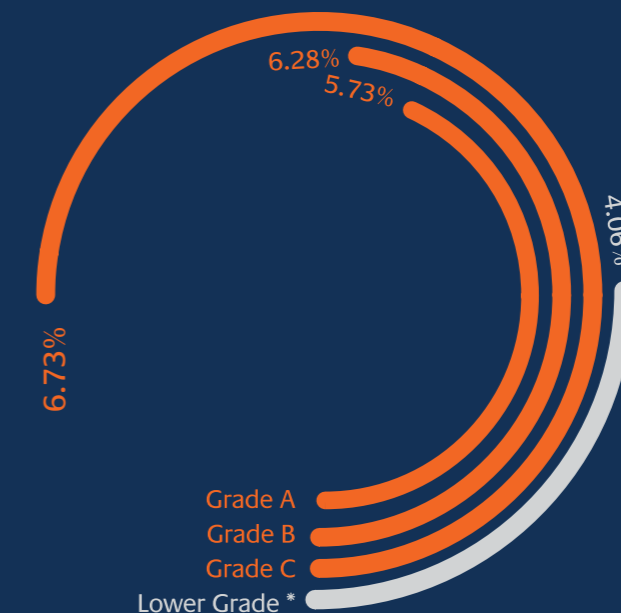
- ==> On the Gulf Street. The retail lease rates have gone from KD 22 in 2011 to KD 30 per sq.m. in 2014 - annual rate of growth of 10.9%.
- ==> The other retail clusters have experienced even higher rental growth rates.
- ==> While the rentals have increased in the retail properties of all grades, the higher grade properties, that generally occupy prime locations, have witnessed higher than normal rental growth rates.

Benchmark Ground Floor Retail Lease Rates (per sq.m.) of Grade A Properties - 2011 to 2014			
	2011	2014	Average Yearly Rent Growth
Gulf Street	KD 22.00	KD 30.00	10.9%
Hawalli	KD 17.00	KD 25.00	13.7%
Salmiya	KD 20.00	KD 30.00	14.5%
Coastal Road	KD 18.00	KD 28.00	15.9%
Kuwait City	KD 15.00	KD 25.00	18.6%

The combined results of Table 29 and 30 show that in the commercial segment, the rental growth rates of higher grade properties have been more than the growth rate in lower grade properties. This is reflecting in the Cap Rates of commercial properties of different grades.

Chart 10 shows the grade wise variations of Cap Rates of commercial properties in Kuwait.

- ==> Similar to the trend in the investment properties, the Grade A properties have the lowest Cap Rate of 5.73%. This Cap Rate is around 20 basis points lower than the Cap Rate of investment properties of similar grade.
- ==> For Grade B, the Cap Rate is 6.28%, which is 10 basis points lower than the Cap Rate of comparable investment properties.
- ==> For Grade C, the Cap Rate is 6.73%, which is again 10 basis points lower than the Cap Rate of comparable investment properties.
- ==> The Lower Grade properties in this segment also are being transacted as land and thus, the Cap Rate is not representative.



The commercial property Cap Rates for various grades are 10 – 20 basis points lower than the corresponding investment property Cap Rates. Overall, the headline commercial Cap Rate is 30 basis points lower than the headline investment properties Cap Rate. This means that the commercial Cap Rates are tightly distributed around their average than the investment properties Cap Rates.

Using the logic of Cap Rates being forward looking indicator and assuming the commercial property investors have the same return expectations as the investment property investors, the market expects the commercial rentals to move at a faster rate than the investment rentals.

Analysis of Cap Rates with Property Age and Land Features not Feasible due to Lack of Data

Not enough data is available to carry out the analysis of Cap Rate variations by either age group or by land features. With just 19 properties outside of Lower Grade, the age group wise analysis and the land feature analysis is meaningless as the sample is not representative.

We expect the commercial properties to display similar behavior to the investment properties when it comes to variations with property age or with land features. The importance of having better land features is more in commercial properties than it is in investment properties. Better access and higher visibility gives higher rentals to retail and commercial units.

We expect to include these analyses over the forthcoming issues of this guide.

Location Wise Cap Rate Trends – Commercial Properties

The locations covered for commercial properties are shown in Table 31:

- ==> With the exception of Hawalli where we covered 15 commercial properties, all other locations have just a couple of properties in this segment.
- ==> There are far fewer commercial properties compared to the investment properties in Kuwait and due to higher average value, the number of transactions are fewer also.

Location Wise Coverage of Commercial Properties in the Study				
	No. of Properties Covered	Total Value	Average Value	Average Property Price per sq.m. of Land Area
Kuwait City	1	KD 50,000,000	KD 50,000,000	KD 13,678
Hawalli	15	KD 61,795,000	KD 4,119,667	KD 4,055
Mangaf	2	KD 5,000,000	KD 2,500,000	KD 3,333
Jleeb Al Shiyoukh	5	KD 13,394,000	KD 2,678,800	KD 3,742
Jahra	4	KD 14,983,614	KD 3,745,904	KD 3,844

Table 32 shows the Cap Rate variations of different locations with property grades:

- ==> For Kuwait City, the Grade A Cap Rate is just around 4.00%. This is a one off transaction with very high value. We believe that this is not fully representative of the market Cap Rate, which could be around 5.25%.
- ==> In Hawalli, new Grade A commercial properties are valued at 5.57% Cap Rate. This Cap Rate is 34 basis point lower than the corresponding investment properties Cap Rate.
- ==> In Grade B in Hawalli, the commercial Cap Rate is 5.99%, which is almost the same as investment property Cap Rate. We believe that this is a data anomaly due to a small sample size. For Grade C, the commercial Cap Rate is 6.62%; a comparable investment property Cap Rate is not available.
- ==> For Mangaf the Grade A Cap Rate is 6.60%, which is almost the same as the investment property Cap Rate.
- ==> We noted previously in this report that Mangaf has the highest Cap Rate for Grade A properties amongst all locations of investment properties. This is the same case with commercial properties as well. Clearly, the rental growth expectations from properties of any segment are the lowest at Mangaf.
- ==> For Jleeb Al Shiyoukh, the Grade A Cap Rate is 6.24% that increases to 6.78% for Grade B.
- ==> For Jahra, the Cap Rates for Grade A commercial properties is 6.20%, for Grade B it is 6.42% and for Grade C it is 6.96%.

APPENDIX 1: DEFINITION OF TERMS

Property Grade Wise Cap Rate Variations for Different Locations

	Grade A	Grade B	Grade C
Kuwait City	4.00%	NA	NA
Hawalli	5.57%	5.99%	6.62%
Mangaf	6.60%	NA	NA
Jleeb Al Shiyoukh	6.24%	6.78%	NA
Jahra	6.20%	6.42%	6.96%

Overall, we believe that for any location in Kuwait the commercial property Cap Rates are around 20 – 30 basis points lower compared to the corresponding Cap Rates of investment properties.

The key reason for this differential is the higher rental growth expectations from the retail segment. It is quite likely that pure retail properties trade at Cap Rates that are 50 – 60 basis points lower than the corresponding investment properties. This will put the Cap Rates for new retail properties around 5.25% at several locations.

Investors expect that the retail rentals to rise rapidly for the foreseeable future. With very few vacant lands that are suitable for retail development in Kuwait, there is not much potential supply in the pipeline.

Cap Rate

Simply put a Cap Rate of a property is equal to its yearly income divided by its price. For example if a property is priced as KD 1 million and it generates KD 80,000 of yearly income, the Cap Rate is 8.00%.

Property Price = KD 1,000,000

Yearly Income = KD 80,000

Cap Rate = $\text{KD } 80,000 / 1,000,000 = 8.00\%$

In practice, hundreds of income generating properties are traded in the market across several locations. For all these properties, the combination of income and price gives the Cap Rates. These Cap Rates become well known in the market and then these are used to value a property whose income is known. This method is called as income capitalization approach in property valuation.

Cap Rate = 8.00%

Yearly Income = KD 80,000

Property Value = $\text{KD } 80,000 / 8.00\% = \text{KD } 1,000,000$

The income that is used in the calculation can be gross income or net income (post any operations and maintenance expenses). Throughout this study, we have used only the gross income to calculate all Cap Rates, which is in line with the market practices.

Commercial Properties

The commercial properties are those which are used by commercial entities. Normally, all types of properties such as offices, retail, industrial, etc. can be included in the definition of commercial properties. However, in this document, we have addressed only the office and retail properties as commercial properties.

Comparable Sale Method of Property Valuation

Comparable sales approach of property valuation says that a property should be valued by comparing what the buyers are willing to pay recently for similar properties in similar locations. This approach is very useful in valuing land and residential properties that do not have any income component.

Care must be taken in identifying properties similar to the property that is to be valued and only those transactions must be selected where the buyers are under no pressure to buy and the sellers are under no pressure to sell. In other words, the selected transactions should be “arms length transactions”.

The key shortcomings of this approach is that identifying if two properties are similar or not is quite complicated and sometimes subjective in nature. In some cases, recent transactions in similar locations are not available, particularly in small markets where there are not enough trading in properties to generate benchmark for all types of properties for all locations.

Despite its shortcomings, comparable sales approach remains one of the most practiced approach for valuation of residential properties and land parcels.

Cost Plus Approach of Property Valuation

The cost plus approach says that a property’s value is equal to the sum of its parts. The land can be valued using comparable sales method and the build up part should be valued using prevailing cost of construction in the market. If the property is old, adequate depreciation is used to reduce the value of the build up part.

Cost plus approach is frequently used for all types of properties, particularly in cases where due to lack of data, comparable sales approach is not possible to use.

The key criticism of the cost plus approach is that it ignores the market part. In cases where the market rentals go up substantially a couple of years after the property is constructed, the cost plus approach may under estimate the value of a property compared to the income capitalization approach. On the contrary, if the rentals decline substantially after a property is constructed, the cost plus approach may over estimate a property value compared to the income capitalization approach.

Income Capitalization Approach

The income capitalization approach values a property solely based on its income that is capitalized at a Cap Rate (see definition above). The Cap Rate to be used should be the market benchmark for similar class properties at similar locations. The approach is very suitable for any kind of income generating properties.

In simple terms, the income approach takes the last 12 months rental income and use a Cap Rate to value a property. However, there are more complicated methods available as well. In case, the rental income is expected to be different for the next few years, each years income is discounted using a different Cap Rate for each year. In this manner, this approach works somewhat like discounted cash flow method of valuation that is prevalent in the valuation of equities.

While very useful in valuing income generating properties, the approach has its fair share of shortcomings. The approach requires extensive data of Cap Rates for properties of all grades, age, features and for all locations. In cases, where recent transactions at some locations are not available the approach fails to offer any alternative.

Investment Properties

As per the municipality regulations in Kuwait, several areas are designated as investment areas where it is permissible to develop apartments for rent or sale. Since foreign nationals are not permitted to buy apartments in Kuwait, the apartments for sale is a very small segment of the market and most of the properties in these are developed with apartments for rent. These properties are called as investment properties.

Globally, an investment property is a property that investors buy to earn returns via income or resale. It different from a property that is bought for self use such as a family buying a house to live. Since most of the apartment properties are used by investors in Kuwait to earn returns and not for self use, there is no contradiction in the way the term is used in Kuwait or globally.

APPENDIX 2: REPORT METHODOLOGY NOTE

The Cap Rate guide is prepared using data on 330 investment properties and 27 commercial properties. These properties are spread all across Kuwait and have different grades, age and features. We have the following note on the report methodology:

1. Of 330 investment properties selected for the study, 276 properties were sold in the first half of 2014. The prices for these properties were collected from various sources such as government agencies, property owners and agents.
2. For these properties, field surveys were organized in the month of May and Jun 2014 to check their occupancy status, monthly rentals for various types of apartments and shops.
3. The Cap Rates estimated for these properties are real Cap Rates as the prices are the actual prices at which the properties were traded in the market.
4. In order to add more properties to the sample, Kuwait Finance House (KFH) was approached and they agreed to provide their valuations for 54 properties. Detailed information on selected properties at various locations were given to them and they provided their valuation for these properties in the month of Sep 2014. We express our sincere appreciation to KFH for their support.
5. Field surveys were organized these properties also to check their occupancy status, monthly rentals for various types of apartments. Since these properties were not traded in the market, the estimated Cap Rates are nominal Cap Rates as the prices are estimated at which the properties may trade in the market.
6. For all 330 properties detailed information on indicators for construction quality, common amenities, property maintenance, life maintenance, quality of doors and windows, parking facilities, etc. was also collected in the field surveys. In total, 75 features of each property were covered to segregate properties into various grades.
7. For the commercial properties, all 27 selected properties were sold during the first half of 2014 and there Cap Rates are real Cap Rates.
8. Detailed field surveys were organized for these properties also to estimate their rental income, occupancy, construction quality, maintenance, parking facilities, etc.
9. Despite best efforts, several locations and several categories could not be addressed properly in this report.
10. We are confident that we will be able to cover them up in the upcoming issues of this report.

APPENDIX 3: PROPERTY GRADING METHODOLOGY

The grading of Investment Properties is done in the most logical manner possible. The grading methodology gives weight to every single feature of the property (other than the basic house and common areas) that cost the developer extra money to construct. These features or amenities are constructed to offer better service to the residents. Therefore, we followed the following method:

1. Investment properties have a wide range of facilities such as swimming pool, gymnasium, steam & sauna room, tennis court, security features, etc. Each of such facilities is given an appropriate weight and points have been given to properties with such facilities.
2. Property design, construction quality and maintenance status were observed and given appropriate weights.
3. Weights were also given to the number of lifts, their brands and capacity, guest lobby finishing, quality of window panels and doors, etc.
4. Parking is one of the most important feature for investment and commercial properties. For each property, ratio of parking per unit (apartment or commercial unit) was estimated. Different weights were given to basement / podium parking and shaded parking. Open parking outside a property was not given any weight for the property grade.

After giving points on all the above mentioned parameters, simple mathematical techniques were used to define the thresholds for various property grades. Using trial and error, properties with similar rental levels were identified and their points were compared to create thresholds for Grade A, Grade B, Grade C and Lower Grade categories.