Financial Analysis of Taleem REIT

Unhedged Interest Rate Exposure Threatens Dividend Sustainability

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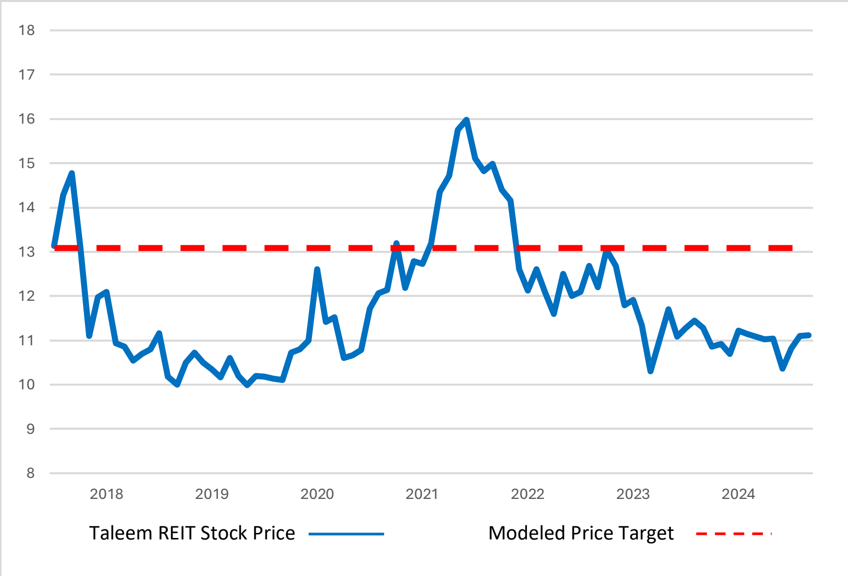
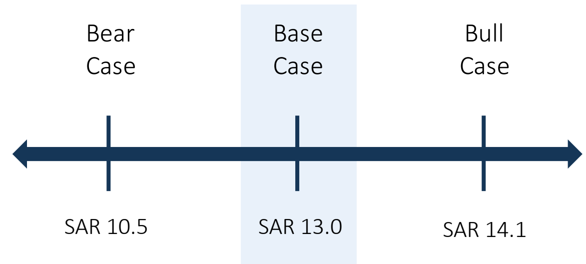


Taleem REIT Fund
(TASI: 4333)

Current Price: SAR 11.2
Modeled Price Target: SAR 13.0
Market Cap: SAR 569 million



1. Executive Summary

Introduction

Taleem REIT is a publicly traded Real Estate Investment Trust specializing in educational properties. The portfolio of Taleem REIT consists of seven properties, six schools in Riyadh, and one in Dammam. The fund's strategy is to acquire high-quality educational properties and enter into long-term triple net lease agreements with educational institutions. The book value of the fund's portfolio is around SAR 780 million.

Performance

The capital decisions made by the fund's management in 2022 — acquiring four educational properties and expanding an existing one, grew the top line from SAR 50.6 million at the end of 2021 to SAR 66.4 million at the end of 2023. However, such growth was not captured due to increasing financing costs, leading to an 8% drop in net income during the same period. These decisions were made just before the Federal Reserve's interest rate hike campaign and were financed through a floating-rate bank loan. The decline in profitability is the result of the combined poor macroeconomic foresight and the failure to hedge interest rate exposure.

Price Drivers

The price multiples of Taleem REIT are primarily driven by movement in interest rates because the fund generates stable fixed income like cashflows with limited internal growth potential. Interest rate sensitivity was evident from the significant price-to-earnings ratio expansion coinciding with the near-zero interest rates of 2021, and the subsequent contraction resulting from monetary policy tightening. While other REITs may experience multiple expansion through increasing rents and occupancy rates, Taleem REIT's price multiples are constrained by fixed rent escalations and full occupancy, limiting its capacity for internal growth.

Future Material Capital Requirement

The fund is due to pay the principal on its loans of SAR 294 million on June 30th, 2027. This sum is expected to be financed through issuing new units or refinancing measures.

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2. Overview

2.1 Introduction to Taleem REIT Fund

Taleem REIT Fund (TASI:4333) is a publicly traded real estate investment trust that is focused on investing in educational assets. The fund generates revenue through rent collection from the 7 educational properties it owns. The strategy of the fund is to structure their lease agreements so that they are triple net- tenant pays all expenses-, long-term in nature, with periodic escalation clauses. Such removes the risk of operational exposure, provides stability and predictability, and ensures protection from inflation. Taleem REIT's property portfolio is book-valued at SAR 780 million, with 51 million units outstanding, and is managed by Saudi Fransi Capital.

2.2 Review of Performance

Taleem REIT was able to increase its total income from SAR 45.7 million in 2019 to SAR 66.4 million in 2023 (Table.1), primarily by acquisitions, where it went from collecting rent from 2 properties in 2019 to 7 properties in 2023 (Table.2). The fund's expenses have increased substantially during the period 2019-2023 (Table.1), mainly driven by financing cost incurred as a result of borrowing that was used to finance acquisitions (Table.2). The increased financing costs have effectively offset total income growth, resulting in stagnation in net income during the period 2019-2023.

	2023	2022	2021	2020	2019
Total Income	66,397,361	62,446,254	50,633,548	48,786,213	45,724,145
Total Expense	(27,490,613)	(16,918,657)	(7,393,611)	(6,164,314)	(4,818,897)
Depreciation	(6,320,504)	(5,858,903)	(3,836,722)	(3,180,314)	(2,502,816)
Impairment reversal / (charge)	3,732,857	(3,779,534)	2,187,062	(2,191,982)	-
Zakat expense	(20,596)	(2,730,537)	(2,132,036)	(1,748,511)	(1,529,806)
Net Income	**36,298,505**	**33,158,623**	**39,458,241**	**35,501,092**	**36,872,626**

Table.1 Selected items from the income statement.

	2023	2022	2021	2020	2019
Number of properties	7	7	3	3	2
Built-up Area m^2	134,336	123,503	96,997	96,997	79,089

Table.2 changes in Taleem REIT property portfolio.

3. Industry & Market Analysis

3.1 REITs in the Saudi Market

The REIT industry is relatively new in the Saudi market, with the first REIT being listed in 2016. Most Saudi REIT funds own diversified portfolios, with significant portions of their assets in core properties—high-quality office, residential, retail, or industrial real estate that generate stable income streams and located in prime areas. Educational REITs such as Taleem REIT, however, are not typically classified as core REITs, rather they can be more appropriately grouped under specialized REITs.

3.2 Macroeconomic Factors

3.2.1 Growing demand

According to a report from GMI (2024) on the education sector in Saudi Arabia, an increase in demand of 1.1-2.1 million school seats is projected by 2030, driven by population growth (Fig.1) and increased awareness of the importance of education. Consistent with GMI projection, the MD&A section within Taleem REIT's 2023 annual report cites a similar number and estimates that additional 500 schools will be required by 2030. Furthermore, the MD&A mentions the under-penetration of private education sector in Saudi Arabia as a good opportunity for expansion.

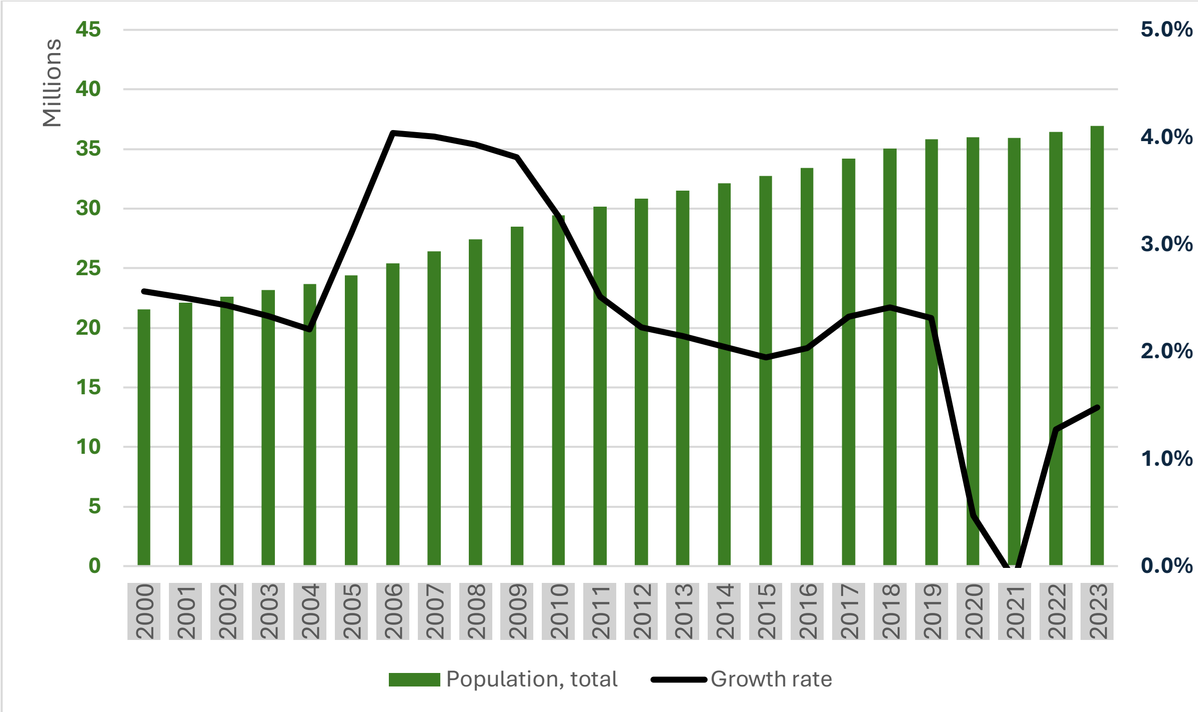

Fig.1 Total Population and population growth in Saudi Arabia (World Bank Group, 2024)

3.2.2 Price Multiple Expansion Drivers for REITs

Price multiple changes can be thought of as a function of growth and discount rate. As for growth in REITs, it is based on increases in rent and occupancy rates. In terms of discount rate, since REITs generate bond-like income streams, they are particularly more interest rate sensitive compared to other equities. Thus, the most favorable conditions for multiple expansion to a REIT is high rent escalation, increasing occupancy rate, and falling interest rates, which leads to lower discount rates and make future cash flows more valuable.

Examining price-to-earnings multiple of Taleem REIT (Fig.2), certain observations can be made. In Fig.2a, the trailing P/E ratio tends to expand when interest rates are low, particularly during periods of aggressive monetary easing and near-zero interest rates seen in 2021. As interest rates started to rise, the P/E ratio correspondingly contracted. Of note, the P/E multiple began to decline before the increase in real interest rates (Figure.2b). This is likely due to the forward-looking nature of markets. Before increasing rates, central banks, especially the U.S. Federal Reserve, signaled upcoming rate hikes to fight inflation, prompting investors to adjust their portfolios before the actual increases.

Stemming from the discussion above, the primary driver of Taleem REIT's price multiples appears to be interest rate rather than growth. Since Taleem REIT properties are fully occupied (0% vacancy rate) and have contracted rent escalations built into their leases, its capacity for internal growth is relatively limited. In this sense, Taleem REIT behaves more like a bond, offering stable income with minimal room for price appreciation unless driven by macroeconomic shifts. This contrasts with retail REITs, for example, which often have higher vacancy rates and the potential for increased rental income through percentage lease arrangements, especially during peak sales seasons. In a percentage lease, the landlord receives a base rent and an additional portion of the tenant's sales revenue, meaning that the landlord's income directly benefits from the tenant's performance. This structure enables retail REITs to experience higher growth during strong economic cycles.

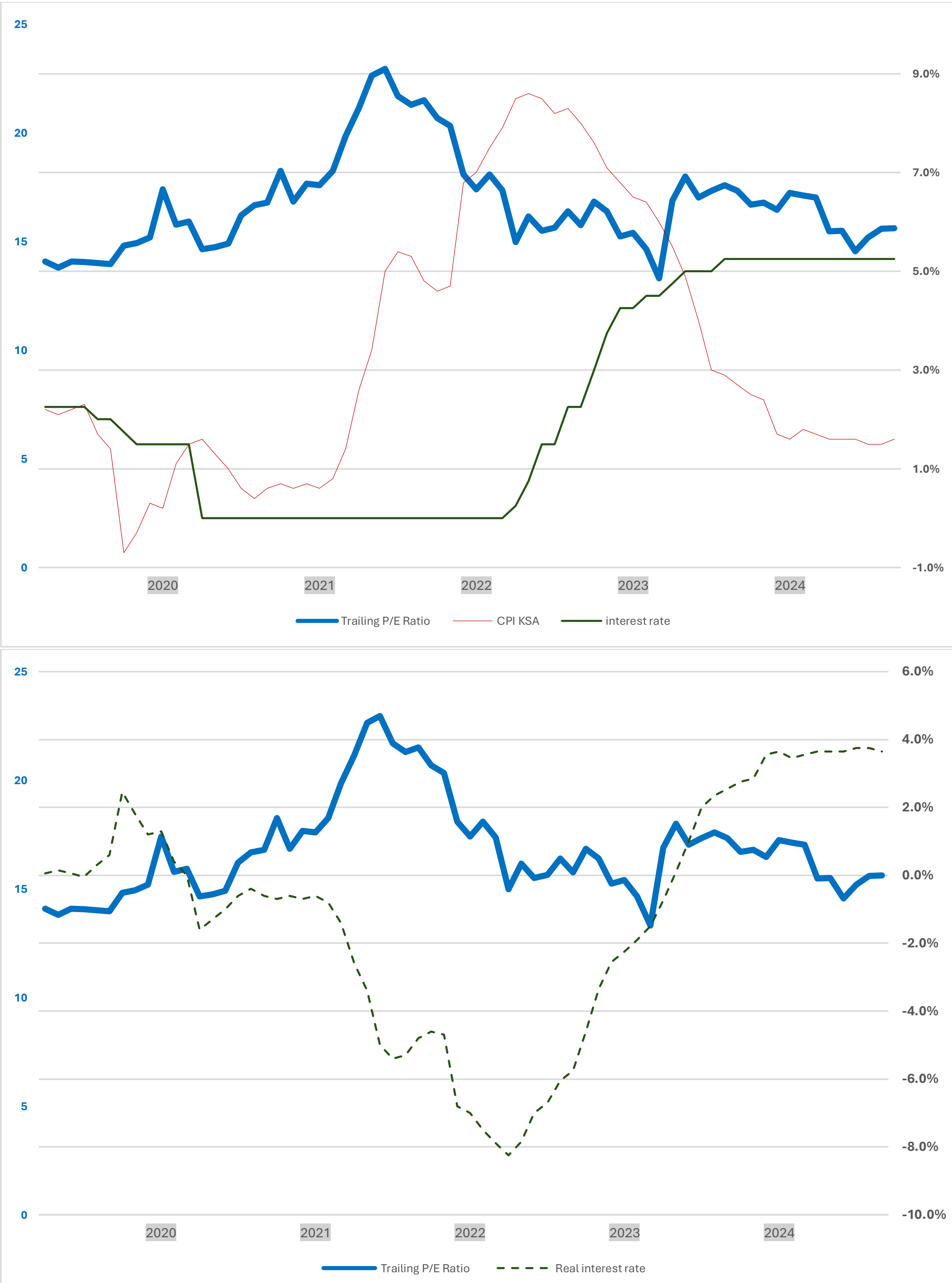

Figure.2a) shows the trailing P/E ratio of Taleem REIT, Consumer Price Index (CPI) of Saudi Arabia, and nominal interest rates over time. The graph demonstrates the relationship between inflation, interest rates, and the REIT's price-to-earnings ratio, highlighting the sensitivity of REIT prices to these macroeconomic factors, 2b) shows the relationship between Taleem REIT's trailing P/E ratio and real interest rates (nominal interest rates minus inflation) over time. The graph highlights how changes in real interest rates impact REIT valuations

3.3 Comparison Between Educational REITs

Based on my research, Taleem REIT stands as the sole education-only REIT in both the local and global market, making it difficult to find direct comparable. However, many REITs include educational properties within their portfolios, offering potential benchmarks for comparison. In this section, educational properties from local REITs, such as Al Rajhi REIT (TASI: 4340), Derayah REIT (TASI: 4339), and Al Khabeer REIT (TASI: 4348), as well as regional REITs like Emirates REIT (Nasdaq Dubai: REIT), and global REITs such as ERP Properties (NYSE: ERP) are considered for comparison (Table 3).

3.3.1 Revenue per meter squared (revenue/ m^2) for educational properties:

Taleem REIT has the highest revenue per square meter among the local REITs, with Al Rajhi REIT following closely behind. There is significant difference in revenue/ m^2 between the educational properties of Taleem REIT and Al Rajhi REIT (494, 449) compared to those owned by Derayah and Al Khabeer REIT (301, 309) (Table.3). One potential reason for the lower Revenue/ m^2 for the Derayah educational property is the location of the school as it is in a relatively distal area of Riyadh. As for Al Khabeer's educational properties, they are all colleges, which may inherently have lower Revenue/ m^2 than private schools. Universities and colleges often have larger spaces like lecture halls, recreational areas, and administrative offices that might not generate revenue directly in the same way classroom spaces do in private schools.

Regionally, revenue/ m^2 for Emirates REIT (Nasdaq Dubai: REIT) is 65% higher than that of Taleem REIT. Also, ERP Properties (NYSE: ERP) significantly outperforms local REITs in revenue per square meter, achieving nearly 3x higher rate compared to Taleem REIT (Table 3). This may be due to market conditions in the U.S. being different than Saudi. Potentially more importantly, the majority of educational properties held by ERP are early childhood education centers rather than private schools, the former may have inherently higher rates than the latter due to more specialized facilities and services.

3.3.2 Average Annual Rent Escalation

Average annual rent escalation is a reflection of a property's perceived quality, with higher-quality properties typically able to secure better rent escalators. Among educational properties held by local REITs, Taleem REIT stands out with the highest average annual rent escalation rate at 1.57% surpassing other local REITs, such as Al Rajhi REIT with a 1.125% rate, and Al Khabeer REIT with a 1% rate.

3.3.3 Occupancy Rate and Average remaining lease term

Educational REITs are typically single-tenant-properties with long lease terms. Thus, they almost always have 100% occupancy rate.

REIT Security	# educational properties	Revenue/ m^2	Average Annual Rent Escalation	Occupancy Rate	Average Remaining Lease Term
Taleem REIT	7	494	1.57%	100%	17
Al Rajhi REIT	4	449	1.125%	100%	8.9
Derayah REIT	1	301	N/A	100%	17
Al Khabeer REIT	3	309	1%	100%	21.3
Emirates REIT	3	816	N/A	100%	16
ERP Properties	70	1187	N/A	100%	N/A

Table.3 Cross sectional comparison between educational properties of different REITs.

4. Taleem REIT Portfolio

The portfolio of Taleem REIT is composed of six schools in Riyadh, ad a school in Dammam, each is single-tenant-occupied, leased on triple net basis with 100% occupation rate (Table.4, Fig.4). The fund grew its asset base through acquisitions, detailed in Table.5. In addition, the lease expiration profile (Fig.3) shows that 76% of the total income is set to expire on 4041.

Properties	Location	Rental Income	Book Value	Built-up Area	Remaining lease term	Rent Escalation
		SAR million	SAR million	m^2	Years	
Tarbiya Islamya Schools	Riyadh	31	250	40,955	19	5% every 3 years
Al Rowad International Schools	Riyadh	18	210	48,967	18	10% every 3 years
Al-Ghad National Schools	Riyadh	6	89	17,908	22	10% every 5 years
Al-Malqa School	Riyadh	3	36	5516	16	5% every 5 years
Al - Ishraq school	Dammam	2	27	8,019	13	5% every 5 years
Al-Yasmeen School	Riyadh	3	37	4,792	16	5% every 5 years
Hitten School	Riyadh	4	55	8,179	17	5% every 5 years

Table.4 Details the portfolio properties of Taleem REIT. Rental income numbers are based on the agreed upon rents in the lease agreement for 2023

Acquisition/ Large Projects	Date	Cost (SAR million)	Leased to
Tarbiya Islamya Schools	May 2017	250	Al Tarbiah Islamiah School
Al Rowad International Schools	September 2018	225	Al Rwad International School
Al-Ghad National Schools	June 2020	94.3	Al Ghad National School
Al-Malqa School	February 2022	148.5	Al Khaleej Education and Training Co.
Al - Ishraq school	February 2022		
Al-Yasmeen School	February 2022		
Hitten School	February 2022		
Tarbiya Islamya Schools Expansion	February 2022	33.3	Al Tarbiah Islamiah School

Table.5 Acquisition history

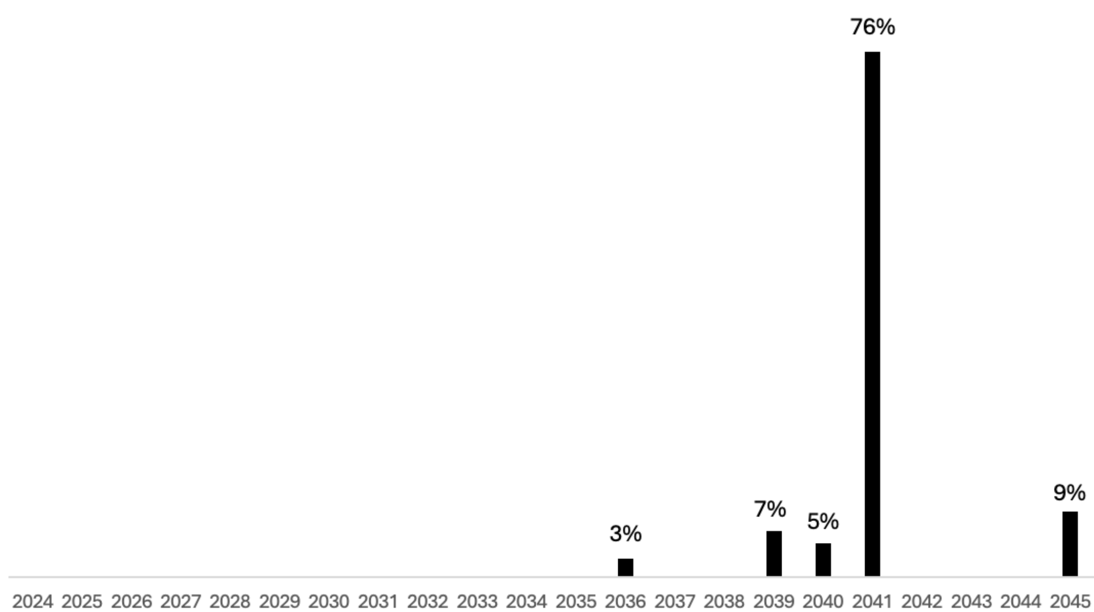

Figure.3 Taleem REIT's lease expiry profile by income

Figure.4a) Satellite imagery of Taleem REIT's properties in Riyadh (TIS: Tarbiya Islamya Schools, RIS: Al Rowad International Schools GNS: Al-Ghad National Schools AMS: Al-Malqa School, Yasmeen: Al-Yasmeen School, Hitten: Hitten School), 4b) Satellite imagery of Taleem REIT's property in Dammam (AES: Al - Ishraq school)

5. Financial Statements Analysis

	2023	2022	2021	2020	2019
Income					
Income from investment properties	61,580,546	60,097,281	48,287,290	46,286,681	43,074,265
Finance lease income	4,816,815	2,348,973	2,346,258	2,419,729	2,423,724
Total Income	66,397,361	62,446,254	50,633,548	48,786,213	45,724,145
Expenses					
Finance cost	(22,593,316)	(11,336,578)	(2,190,014)	(1,195,348)	-
Management fees	(3,825,000)	(3,825,000)	(3,825,000)	(3,825,000)	(3,825,000)
Custodian fees	(276,526)	(271,277)	(231,975)	(188,175)	(136,876)
Other expenses	(795,771)	(1,485,802)	(1,146,622)	(955,791)	(857,022)
Total Expense	(27,490,613)	(16,918,657)	(7,393,611)	(6,164,314)	(4,818,897)
Depreciation expense	(6,320,504)	(5,858,903)	(3,836,722)	(3,180,314)	(2,502,816)
Impairment reversal / (charge)	3,732,857	(3,779,534)	2,187,062	(2,191,982)	-
Net Income Before Zakat	36,319,101	35,889,160	41,590,277	37,249,603	38,402,432
Zakat expense	(20,596)	(2,730,537)	(2,132,036)	(1,748,511)	(1,529,806)
Net Income After Zakat	**36,298,505**	**33,158,623**	**39,458,241**	**35,501,092**	**36,872,626**

Table.6 shows the income statement of Taleem REIT from 2019-2023.

5.1 Income Generation

Taleem REIT generates income through collecting rent from its operating leases, referred to as income from investment properties, and finance leases (Table.6). All properties are leased under operating leases except Tarbiya Islamya Schools buildings that are leased under a finance lease. Tarbiya Islamya School alone accounts for around half of the REIT's total income, followed by Al Rowad International Schools contributing around 27% of total income, and Al-Ghad National Schools by 9%. These three properties account for more than 80% of total income while the 4 more recently acquired properties account for less than 20% of total income. (Fig.5, Table.7)

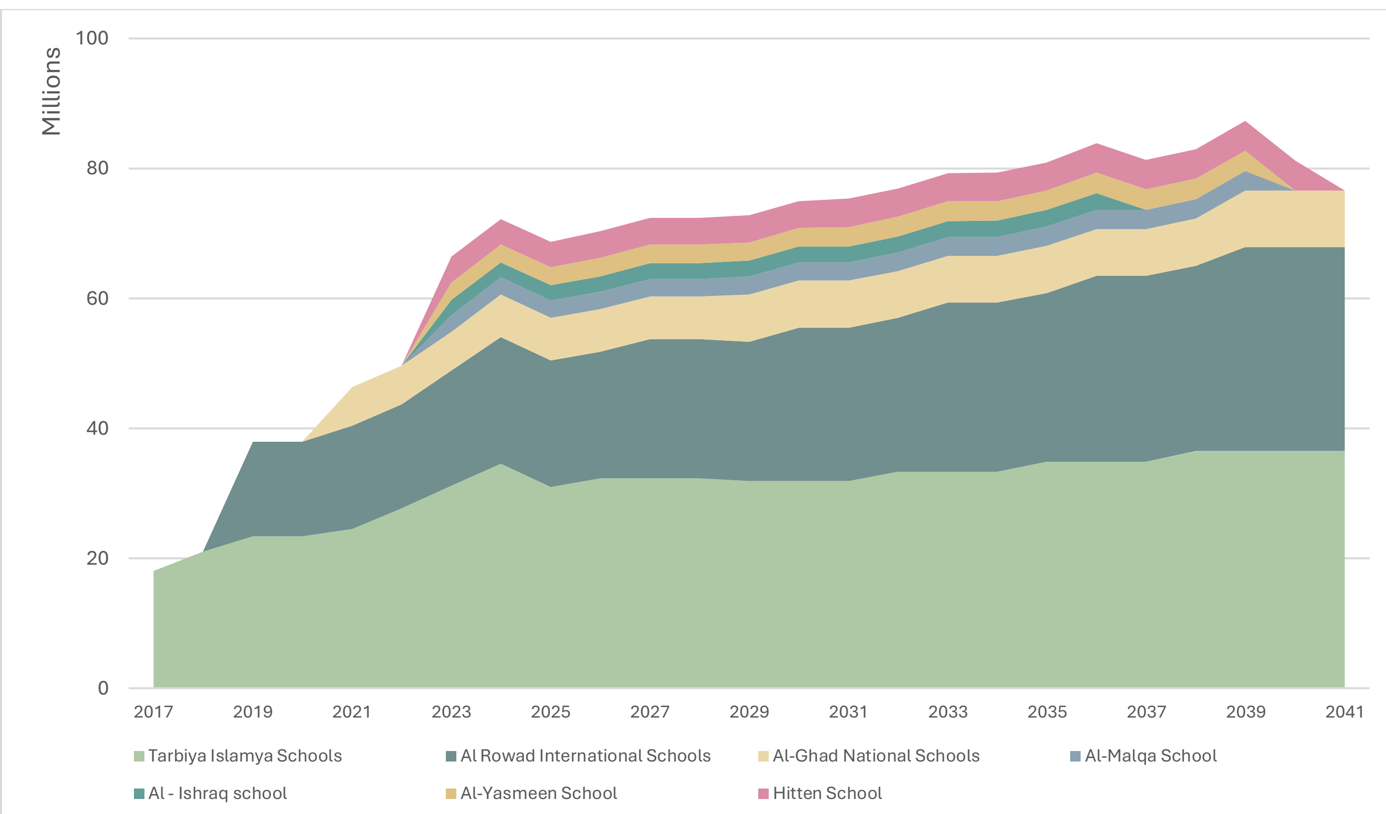

Fig.5 graphical representation of the total income of Taleem REIT's properties from 2017-2041. Data is based on the lease document, as per the valuation reports

		2023	
	Property	SAR	%
1	Tarbiya Islamya Schools	31,159,248	46.9
2	Al Rowad International Schools	17,746,667	26.7
3	Al-Ghad National Schools	5,950,000	9.0
4	Al-Malqa School	2,595,400	3.9
5	Al-Ishraq school	2,310,000	3.5
6	Al-Yasmeen School	2,722,198	4.1
7	Hitten School	3,926,232	5.9
	Total	66,409,745	**100**

Table.7 Breakdown of Income generated from each property. Numbers are based on the lease document, as per the valuation reports

5.2 Expenses

The two main expenses the fund incurs are financing cost, and management fees.

5.3.1 Financing Cost

Taleem REIT Fund has two major outstanding bank loans from Banque Saudi Fransi (Table.8) giving rise to financing cost (Table.9). The increase in financing cost from 2021 to 2022 can be explained by taking on the second loan (Table.8, Table.9). As for 2023, the SAR 22.6 million financing cost is almost double that of 2022 due to raising interest rates. Financing cost has rather quickly became a more significant expense, which may impact dividend sustainability (addressed in section 5.7).

	Date	Principal	Purpose	Maturity	Rate	Collateral
1	2020	94,318,624	Acquisition of Al Ghad National School	30 June 2027	SIBOR + Spread	Rowad International School
2	2022	200,500,001	Acquisition of Hitten, Al Malqa, Al Narjis and Aleshraq schools	30 June 2027	SIBOR + Spread	Rowad International School

Table.8 Details Taleem REIT's outstanding bank loans.

	2023	2022	2021	2020	2019
Beginning borrowing balance	295,702,107	94,300,000	94,300,000	0	0
Additional borrowing	-	201,402,107	-	98,900,000	-
Repayment	0	0	0	(4,600,000)	-
End Borrowing Balance	**295,702,107**	**295,702,107**	**94,300,000**	**94,300,000**	**-**
Financing cost	22,593,316	11,336,578	2,208,638	1,176,724	-
Implied interest rate	7.6%	3.8%	2.3%	1.2%	-

Table.9 Reconciliation of Taleem REIT borrowings

5.3.2 Management Fees

The Terms and Conditions document of the fund states that management fee is 0.75% of net asset value. However, during 2018, the board decided that management fees will be 0.75% from the capital base of SAR 510 million, amounting to a flat 3,825,000 (Table.5).

5.3 Impairment Analysis

Impairments are inherently complex and often obscure aspects of financial statement analysis. This section seeks to critically examine the impairment line item for Taleem REIT. Looking at Table.10, an impairment charge was recorded in 2022, followed by a reversal in 2023. Taleem REIT attributes these change to variations in the fair value of Al Yasmeen and Hitten Schools.

Upon further investigation, the fair value adjustments appear to stem from subtle changes in assumptions used by the external valuers (whom Taleem REIT seek to get fair value). For instance, in 2022, one of the valuers, utilized an 8% cap rate for valuing Al Yasmeen School (June 2022 Valuation Report 2, page 275), resulting in a fair value that is below the book value triggering an impairment. However, in the following year, the same valuer adjusted the cap rate a slight bit to 7.9% (December 2023 Valuation Report 2, page 269), seemingly deeming it a more accurate reflection of the property's underlying risk, which led to the reversal of the previous impairment. The same trend is applied for the Hitten school where a 7.5% cap rate was used in 2023 (December 2023 Valuation Report 2, page 225), reversing the impairment triggered by the 7.7% cap rate in 2022 (June 2022 Valuation Report 2, page 341).

Year	2023	2022	2021	2020	2019
Impairment reversal / (charge)	3,732,857	(3,779,534)	2,187,062	(2,191,982)	-

Table.10 Taleem REIT's impairment charges and reversal from 2019 to 2023

5.4 Assessment of Major Capital Decisions

It is worth taking the chance in this section to talk about the major capital decisions made by the fund's management. In 2022, Taleem REIT acquired 4 properties and expanded an existing property with total cost of SAR 182 million, financed through a floating-rate bank loan. The following discussions aims to assess the value added to shareholder by this decision.

Table.11 shows that despite the growth in asset, net income has been basically flat. When adjusting for impairments, net income in 2023 is 13% lower than it was in 2019 (Table.11), primarily due to the increased financing cost. This suggests that the discussed capital decisions made in 2022 eroded shareholder value. Although the acquisitions were aligned with Taleem REIT's need for external growth, given its limited internal growth potential (discussed in Section 3.2.2), the timing of these acquisitions was particularly problematic; they were made in February 2022, just before the Federal Reserve began its aggressive interest rate hike campaign. In addition, the choice of financing source that is floating rate borrowing left the REIT vulnerable to interest rate risk. By failing to foresee the change in macroeconomic environment and managing interest rate risk, the mentioned decisions effectively reduced profitability (Table.12).

Year	2023	2022	2021	2020	2019
Total Assets	858,633,416	854,038,090	646,969,980	634,043,072	535,504,271
Net Income After Zakat	36,298,505	33,158,623	39,458,241	35,501,092	36,872,626
Net income after Zakat Adjusted for impairment	32,565,648	36,938,157	37,271,179	37,693,074	36,872,626

Table.11 Taleem REIT's net income and adjusted net income from 2019- 2023

Year	2023	2022	2021	2020	2019
Total Income	66,397,361	62,446,254	50,633,548	48,786,213	45,724,145
Net Income	32,565,648	36,938,157	37,271,179	37,693,074	36,872,626
Net Margin	49%	59%	74%	77%	81%

Table.12 Taleem REIT's profitability from 2019- 2023

5.5 Debt Obligation

The fund is due to pay the principal of both loans totaling SAR 294,800,001 in one bullet payment on June 30th, 2027. Considering the financial position of the fund, it is obvious that the current cash balance of the fund and the future cash flows to be received until the due date will not be sufficient to repay the principal in one bullet payment. Thus, the fund will probably choose to refinance or issue more units.

5.6 Growth opportunities

The capacity of Taleem REIT to grow internally is limited to the agreed upon rent escalation because all of its properties are 100% occupied for an average lease term of 17 years. Thus, the fund relies on external growth.

5.7 Dividend Analysis

In light of discussion on eroded profitability in section 5.4, it would make sense to delve deeper to examine dividends sustainability. Table.13 shows that Taleem REIT was able to maintain its dividends despite the eroded profitability. I am interested to see how. To answer this, cash flow analysis would help. The points below serve as a summary of the analysis:

- In 2019, significant amount of dividends was paid from cash reserves as FCFE only covered 83% of dividends paid (Table.14, Table.15).
- In 2020, FCFE has increased due to higher operating cash flow allowing most dividends to be paid from core operation. The cash generated through the sale of investments measured at FVTPL was kept in cash reserves. (Table.14, Table.15).
- In 2021, Dividends were cut by 19% due to the significant drop in operating cash flows induced by financial stresses weighting on the fund's tenants due to the COVID-19 pandemic (Table.13, Table.14).
- In 2022, the increased operating cash flow and cash left from borrowing allowed the fund to resume the previous dividend level and build a stronger cash reserve.
- In 2023, though cash from operations increased, the significant financing cost (more than 100% increase in financing cost YoY) forced the REIT to consume substantial amount of its cash reserves to maintain the dividend level. FCFE only covered 68% of dividends paid, whereas the rest was distributed to shareholders from the cash reserves (Table.14, Table.15)

Based on the analysis above, the increased financing cost has been putting significant pressure on the ability of the REIT to sustain its current dividend levels using its core operations. For 2024, the June earnings shows that the REIT maintained its dividends level, effectively burning through the last bit of cash they have (Cash balance on 30 June 2024 =SAR 553,002). Even with the 50bps rate cut in September 2024, the REIT's ability to maintain its dividend policy for the second half of 2024 is seriously questioned.
On the bright side, the U.S. Federal Reserve projects based on its last FOMC meeting that rates will drop by an additional percentage point in 2025, followed by a final 50bps reduction in 2026 (Federal Reserve, 2024). Thus, depending on the path of the interest rate going forward, the REIT may or may not be able to meet its current dividend level.

	2023	2022	2021	2020	2019
Dividends	32,640,000	33,655,291	26,505,687	32,620,419	32,640,000
Dividend per share	**0.64**	**0.66**	**0.52**	**0.64**	**0.64**

Table.13 Taleem REIT dividends and dividends per share for 2019- 2023

Year	2023	2022	2021	2020	2019
CFO	51,207,413	46,893,660	27,869,817	32,469,281	27,008,778
New debt issuance	-	200,500,001	-	94,318,624	-
Investments FVTPL, netted*	-	-	-	6,986,763	(3,349,622)
CAPEX	(6,931,648)	(191,972,927)	-	(94,340,476)	-
Financing cost	(22,593,316)	(11,336,578)	(2,208,638)	(1,176,724)	
FCFE	**21,682,449**	**44,084,156**	**25,661,179**	**31,270,705**	**27,008,778**
Dividend paid	32,640,000	33,655,291	26,505,687	32,620,419	32,640,000
FCFE / Dividend Paid	**68%**	**137%**	**97%**	**96%**	**83%**

Table.14 Free cash flow analysis between 2019- 2023.

** Investment FVTPL is not typically considered in the FCFE calculations. However, it has been included in here as it is a major cash outlay*

	2023	2022	2021	2020	2019
Cash at the beginning of the year	16,845,637	4,511,655	5,633,083	14,622	8,995,466
Cash at the end of the year	6,497,565	16,845,637	4,511,655	5,633,083	14,622

Table.15 Taleem REIT cash position from 2019-2023

6. Valuation

6.1 Valuation Method

One way to value Taleem REIT fund is through the Net Asset Value (NAV). As of June 30th, 2024, the book value of Taleem REIT's NAV stands at SAR 548,980,383 or SAR 10.76 per share. However, a more meaningful measure for investors is the NAV based on market value of assets. According to the regulations of the Capital Market Authority (CMA), all REITs are required to publish valuation reports for each of their properties reflecting market value. Such reports have to be prepared by independent and licensed valuers that are accredited by the Saudi Authority for Accredited Valuers, TAQEEM. Those reports provide one straightforward way to obtain the market value of Taleem REIT's properties. However, as discussed in section 5.3, I find that some assumptions in these reports lack sufficient justification. As a result, I have decided to conduct my own independent valuation.

In my modeling, I used the discounted cash flow (DCF) method. The cash inflows come from the agreed-upon rents in the lease agreements, while the primary cash outflows include management fees and financing costs. Projected cash flows are discounted using two different discount rates to reflect expected changes in interest rates over time: a higher short-term rate for 2024 and 2025, and a lower long-term rate for 2026 and beyond. The terminal value was estimated on property-by-property basis reflecting the differing capacity of rental growth between properties. To account for uncertainties in future interest rates and growth, I also introduced three scenarios—bear, base, and bull—providing a range of potential outcomes from conservative to aggressive.

6.2 Qualitative Account of Cashflow Riskiness

Before delving into numbers, I would like to discuss on qualitative basis the riskiness of cashflows. Below are the main risks associated with the fund.

6.2.1 Credit risk

This risk is especially significant as the credit risk is amplified by concentration risk, where the fund's assets are leased by only three tenants. There is not much information on the creditworthiness of the tenants, which complicates credit risk analysis. Credit risk has materialized in 2020-2021, where the impact of the COVID-19 pandemic led to the tenants being financially stressed. As a result, the fund offered discounts to tenants representing 10.3% of the total rental income for the fiscal year 2020. In addition, the effect of the pandemic included delaying rent escalation for a period of one year from 2021 to 2022. This credit event was triggered by a left tail event and does not seem to be the norm. Further investigation into the school's profitability and credit worthiness is needed to establish better understanding of cashflow riskiness related to credit risk.

6.2.2 Interest rate and liquidity risks

As postulated in section 5.4, the management decisions of financing acquisitions and expansions through floating rates exposed the fund to interest rate risks that negatively impacted profitability. From the footnotes to the financial statement of Taleem REIT, keeping all other factors constant, a 1% change in interest rate will increase/decrease financing cost by SR 306,881.

The exposure to interest rate risk is directly related to liquidity risk as financing cost is a major cash drain for REITs. To evaluate this risk, interest coverage ratio is computed (Table.16). The current interest coverage ratio is 3; as long as it is above 1 the fund will be able to continue satisfying its debt obligations. However, the clear substantial decline of the coverage ratio is worrying. Fortunately, the future outlook suggests that monetary policy is expected to ease gradually, which should alleviate this pressure.

	2023	**2022**	**2021**	**2020**	**2019**
Total Income	66,397,361	62,446,254	50,633,548	48,786,213	45,724,145
Less Operating expenses	(4,897,297)	(5,582,079)	(5,203,597)	(4,968,966)	(4,818,898)
Add Depreciation	6,320,504	5,858,903	3,836,722	3,180,314	2,502,816
EBIT	67,820,568	62,723,078	49,266,673	46,997,561	43,408,063
Financing cost	22,593,316	11,336,578	2,208,638	1,176,724	-
Interest coverage Ratio	**3.00**	**5.53**	**22.50**	**39.32**	**-**

Table.16 interest rate coverage ratio

6.2.3 Real estate investment risk

This risk refers to the possibility that real estate properties lose value or generate lower income due to changes in the real estate market. Rental income and corresponding growth rates are a significant assumption in valuation, and lower rates will result in materially lower valuation.

6.2.4 Vacancy risk

Vacancy risk refers to the possibility that properties may remain unoccupied for a period, particularly when current leases expire or if tenants default. Vacancy can lead to lost rental income, which directly affects cash flows.

6.3 Quantitative Account of Assumptions

6.3.1 Cashflows

Cash inflows are known with a good degree of certainty from the lease agreements (Appendix I). As for outflows, the major cash outflows are financing costs and management fees (Appendix II). Financing costs as an input presents more uncertainty due to the unclear future interest rate path and the timeline for debt repayment. The fund has an outstanding debt of 294,800,001, and the uncertainty lies in how long it will take to fulfill these obligations and whether the debt will be refinanced, or equity will be raised to cover it. For this valuation, it is assumed that debt will be refinanced, and financing cost will continue as cash outflows until the end of the forecast period in 2041. The base case assumes the implied interest rate on the 294,800,001 loans to be 3.5% throughout the period (Table.17, Appendix II).

Case	**Bear case**	**Base case**	**Bull case**
Implied interest rate	4.0%	3.5%	3.0%
Financing cost	11,828,084	10,349,574	8,871,063

Table.17 details the three cases pertaining to financing cost as a cash outflow

6.3.2 Discount rate

A major area of uncertainty resides in estimating the discount rate representing the riskiness of cashflows. The reason for such is the lack of clarity on the path of future interest rate. The Capital Asset Pricing Model CAPM is used to determine the discount rate appropriate:

$$Required\ Return\ on\ Equity = Risk\ free\ rate + \beta eta\ (Market\ Risk\ \text{Premium})$$

6.3.2.1 CAPM: βeta

Beta measures how sensitive an asset is to market changes. Due to their steady cash flows, REITs typically exhibit lower volatility compared to the broader market (Fig.6). To come up with a βeta for Taleem REIT, its returns were regressed against the TASI's index returns, resulting in a beta of 0.44. This indicates that for every 1% movement in TASI, the REIT would experience a 0.44% change in the same direction. While this beta might appear low, it aligns with expectations for REITs with long-term leases and low operating costs.

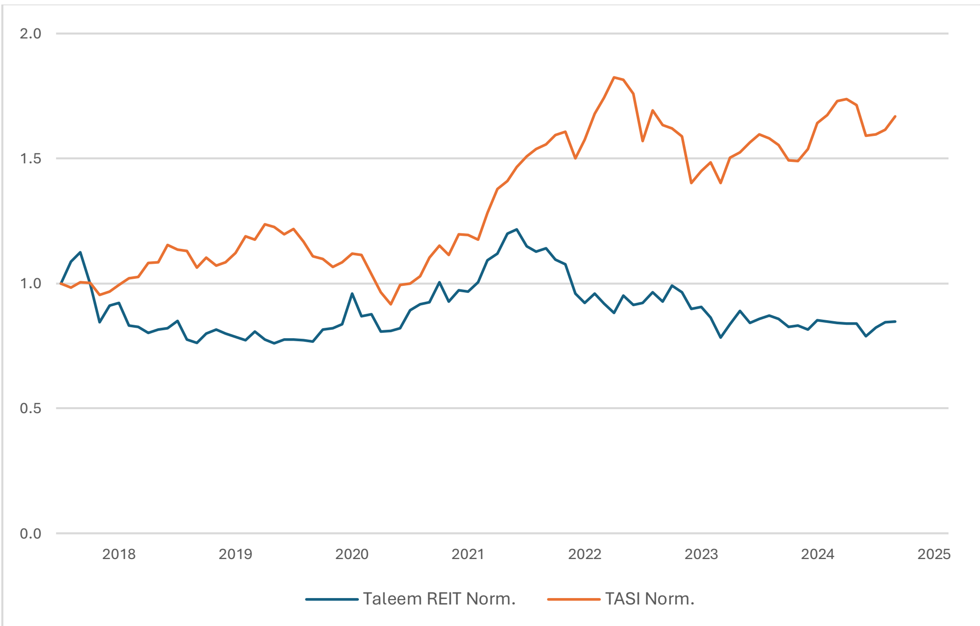

Figure.6 Indexed movement of Taleem REIT and TASI from July 2017 – September 2024.

6.3.2.2 CAPM: Market Risk premium

The market risk premium for the U.S. market ranges from 5-6%. For emerging market like the Saudi's, market risk premium would be notably higher. 8% market risk premium is assumed

6.3.2.3 CAPM: Risk-free rate

From the elements of the CAPM, the risk-free rate is the most relevant factor for Taleem REIT (Section 3.2.2), and it is the one with the highest uncertainly, warranting the use of different scenarios. The valuation this report provides is based on two discount rates, a higher short-term discount rate, and a lower long-term discount rate reflecting the anticipated evolution of the risk-free rate. Such is anchored by the latest economic projections provided by the Federal Reserve (Federal Reserve, 2024), and the treasury yields.

The short-term rate here is the rate used to discount cash flows to be received in 2024 and 2025 and is based on short-term U.S. Treasuries, which act as a proxy for the risk-free rate (Table 18). As for the long-term discount rate, it is the rate used to discount cash flows to be received in 2026 and beyond, and it is also based on U.S. Treasuries (Table 19).

Discount rate for 2024-2025	**Bear case**	**Base case**	**Bull case**
U.S. Short term treasuries*	5.0%	4.5%	4.0%
Beta	0.44	0.44	0.44
Market risk premium	8.0%	8.0%	8.0%
Discount rate	**8.52%**	**8.02%**	**7.52%**

Table.18 computation of the short-term discount rate used for the yeasr 2024 and 2025 under different scenarios, based on the CAPM

**The U.S. Short term treasuries are experiencing high volatility at the time of writing the report.*

Discount rate for 2026 and beyond	**Bear case**	**Base case**	**Bull case**
U.S. 10-year treasuries	4.25%	3.75%	3.25%
Beta	0.44	0.44	0.44
Market risk premium	8.0%	8.0%	8.0%
Discount rate	**7.77%**	**7.27%**	**6.77%**

Table.19 computation of the long-term discount rate used for the years 2026 and beyond under different scenarios, based on the CAPM

**The U.S. 10-year treasuries are experiencing high volatility at the time of writing the report.*

6.3.3 Long term growth rate assumption

The terminal value is the more significant part of a discounted cash flow model, and the long-term growth rate is a major assumption in its computation. Here, the growth rate represents the capacity of the property to grow its rent beyond the lease agreement.

In this valuation, terminal value is estimated separately for each property to capture the varying capacity for rental growth. The general intuition is that older buildings will have their cash generating potential decline unless significant capital expenditure is made either for maintenance or complete redevelopment. Thus, applying a blanket rate on all properties may lead to inaccurate estimation of terminal value. The growth rate used is dependent on property age; Table.20 and Appendix III detail the growth rate assumption for the different ages and cases.

Age	Properties between 15-25 years			Properties between 26-45 years			Over 45 years		
Case	Bear case	Base case	Bull case	Bear case	Base case	Bull case	Bear case	Base case	Bull case
Rent growth	**1%**	**1.5%**	**2%**	**0.5%**	**0.5%**	**0.5%**	**0%**	**0%**	**0%**

Table.20 Long-term growth rate assumption

6.3.4 Summary of assumptions

	Bear case	**Base case**	**Bull case**
Short term discount rate	8.52%	8.02%	7.52%
Long term discount rate	7.77%	7.27%	6.77%
Growth rate	Property-specific. Refer to Table.19		
Implied interest rate on floating rate loan	4.0%	3.5%	3.0%

Table.21 Summary of modelling assumptions.

6.4 Results

Case	**Bear**	**Base**	**Bull**
Sum of discounted cashflows	568,966,220	605,027,276	643,416,417
Discounted TV	261,429,806	354,630,670	369,373,869
Value of properties	830,396,026	959,706,124	1,012,790,286
Debt	(295,702,107)	(295,702,107)	(295,702,107)
Number of Units	51,000,000	51,000,000	51,000,000
Equity per Unit	**10.48**	**13.02**	**14.06**

Table.22 Summary of modelling results.

7. Where I Might Have Gone Wrong

a) Not considering land appreciation.

There has been significant surge in land prices in Riyadh, where Taleem REIT has most of its assets. According to Knight Frank (2023), land prices increased by an average of 14% in Riyadh in 2022 alone. This may result in materially higher asset values for Taleem REIT.

b) Assuming too long of debt repayment timeline

The model used assumed the financing cost will persist throughout the modeling period with a constant implied interest rate. Debt maybe repaid via issuing new units, or interest rate may materially change within the forecast period

c) Too low of a discount rate

The accredited valuator who applied the DCF method to Taleem REIT used a 9% discount rate, but did not provide a justification for this choice. One reason the model presented in this report results in a higher valuation is, at least partially, due to the use of a lower discount rate. While I have made reasonable efforts to verify the assumptions and justify my choice of discount rate, it is possible that I may have overlooked some factors, leading to the discount rate used in this report being too low. The volatile nature of the treasuries at the time of writing this report is a major source of uncertainty

8. Conclusion

a) **Interest Rate Sensitivity**: Taleem REIT produces stable, bond-like cashflows with limited internal growth. As a result, its valuation is more sensitive to interest rate movements than to earnings or growth potential.

b) **Unhedged Interest Rate Risk**: The capital decisions made by Taleem REIT's management in February 2022 were financed through a floating-rate bank loan without hedging interest rate exposure. The restrictive monetary policies implemented by central banks from March 2022 led to significantly higher financing costs, ultimately eroding shareholder value.

c) **Dividend Sustainability**: The sustainability of the SAR 0.64 per share annual dividend for 2024 and 2025 is seriously questioned. Future relief may depend on how quickly central banks unwind their restrictive monetary policies.

9. Disclaimer

The information contained in this report is for informational purposes only and does not constitute investment advice. The analysis and opinions expressed herein are my own and are based on my independent research as a CFA Level 2 candidate. While I strive to ensure the accuracy and reliability of the information provided, I make no representations or warranties as to its completeness or accuracy. Investors should consider their financial situation and consult with their own financial advisors before making any investment decisions. I do not accept any liability for any loss or damage resulting from the use of this report. This report may contain forward-looking statements that are based on current expectations and projections about future events. Such statements are subject to risks and uncertainties that could cause actual results to differ materially. I am under no obligation to update or amend any information contained in this report following the publication date. I currently hold 1663 shares in Taleem REIT. This may be considered a conflict of interest, and readers should take this into account when considering the information and opinions presented in this report.

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11. Appendices

Appendix I: Cash inflows as model input

	TIS old building		TIS new buildign		RIS	GNS	AMS	AES	Al Yasmeen	Hitten	Sum
	Ops L. CFs	Finl L. CFs	Ops L. CFs	Finl L. CFs	Ops L. CFs	Ops L. CFs	Ops L. CFs	Ops L. CFs	Ops L. CFs	Ops L. CFs	
2024	23,152,500	2,324,141	3,189,933	5,849,886	19,521,333	6,545,000	2,660,285	2,310,000	2,722,198	3,926,232	72,201,508
2025	23,152,500	2,235,566	3,189,933	2,352,423	19,521,333	6,545,000	2,725,170	2,310,000	2,722,198	3,926,232	68,680,355
2026	24,310,128	2,235,566	3,349,430	2,352,423	19,521,333	6,545,000	2,725,170	2,310,000	2,858,308	4,122,544	70,329,902
2027	24,310,128	2,235,566	3,349,430	2,352,423	21,473,467	6,545,000	2,725,170	2,425,500	2,858,308	4,122,544	72,397,536
2028	24,310,128	2,235,566	3,349,430	2,352,423	21,473,467	6,545,000	2,725,170	2,425,500	2,858,308	4,122,544	72,397,536
2029	25,525,632	1,493,708	3,516,901	1,349,224	21,473,467	7,199,500	2,793,299	2,425,500	2,858,308	4,122,544	72,758,083
2030	25,525,632	1,493,708	3,516,901	1,349,224	23,620,813	7,199,500	2,861,429	2,425,500	2,858,308	4,122,544	74,973,559
2031	25,525,632	1,493,708	3,516,901	1,349,224	23,620,813	7,199,500	2,861,429	2,425,500	3,001,223	4,328,671	75,322,601
2032	26,801,914	1,493,708	3,692,746	1,349,224	23,620,813	7,199,500	2,861,429	2,546,775	3,001,223	4,328,671	76,896,003
2033	26,801,914	1,493,708	3,692,746	1,349,224	25,982,894	7,199,500	2,861,429	2,546,775	3,001,223	4,328,671	79,258,084
2034	26,801,914	1,493,708	3,692,746	1,349,224	25,982,894	7,199,500	2,932,964	2,546,775	3,001,223	4,328,671	79,329,619
2035	28,142,010	1,493,708	3,877,384	1,349,224	25,982,894	7,199,500	3,004,500	2,546,775	3,001,223	4,328,671	80,925,889
2036	28,142,010	1,493,708	3,877,384	1,349,224	28,581,182	7,199,500	3,004,500	2,546,775	3,151,284	4,545,104	83,890,671
2037	28,142,010	1,493,708	3,877,384	1,349,224	28,581,182	7,199,500	3,004,500		3,151,284	4,545,104	81,343,896
2038	29,549,111	1,493,708	4,071,253	1,349,224	28,581,182	7,199,500	3,004,500		3,151,284	4,545,104	82,944,866
2039	29,549,111	1,493,708	4,071,253	1,349,224	31,439,302	8,711,395	3,004,500		3,151,284	4,545,104	87,314,881
2040	29,549,111	1,493,708	4,071,253	1,349,224	31,439,302	8,711,395				4,545,104	81,159,097
2041	29,549,111	1,493,708	4,071,253	1,349,224	31,439,302	8,711,395					76,613,993

Appendix II: Cash outflows as model input

Cash Outflows				
	Financing cost			mngmt fees
	4% I/R	3.5% I/R	3% I/R	-
	Bear	Base	bull	-
2024	11,828,084	10,349,574	8,871,063	3,825,000
2025	11,828,084	10,349,574	8,871,063	3,825,000
2026	11,828,084	10,349,574	8,871,063	3,825,000
2027	11,828,084	10,349,574	8,871,063	3,825,000
2028	11,828,084	10,349,574	8,871,063	3,825,000
2029	11,828,084	10,349,574	8,871,063	3,825,000
2030	11,828,084	10,349,574	8,871,063	3,825,000
2031	11,828,084	10,349,574	8,871,063	3,825,000
2032	11,828,084	10,349,574	8,871,063	3,825,000
2033	11,828,084	10,349,574	8,871,063	3,825,000
2034	11,828,084	10,349,574	8,871,063	3,825,000
2035	11,828,084	10,349,574	8,871,063	3,825,000
2036	11,828,084	10,349,574	8,871,063	3,825,000
2037	11,828,084	10,349,574	8,871,063	3,825,000
2038	11,828,084	10,349,574	8,871,063	3,825,000
2039	11,828,084	10,349,574	8,871,063	3,825,000
2040	11,828,084	10,349,574	8,871,063	3,825,000
2041	11,828,084	10,349,574	8,871,063	3,825,000

Appendix III: Growth rate assumed for different properties according to criteria in Table.19

Property Name	Building age at current lease expiry	Bear case	Base case	Bull case
Tarbiya Islamya Schools old	48	0%	0%	0%
Tarbiya Islamya Schools new	19	1.0%	1.5%	2.0%
Al Rowad International Schools	28	0.50%	0.50%	0.50%
Al-Ghad National Schools	27	0.50%	0.50%	0.50%
Al-Malqa School	20	1.0%	1.5%	2.0%
Al - Ishraq school	32	0.50%	0.50%	0.50%
Al-Yasmeen School	19	1.0%	1.5%	2.0%
Hitten School	20	1.0%	1.5%	2.0%

Appendix IV: Cases (model output)

Bear Case

	Discounted Inflows	Discounted Outflows	Discounted CFs
2024	66,532,905	14,424,147	52,108,758
2025	58,319,388	13,291,695	45,027,694
2026	56,196,182	12,507,391	43,688,791
2027	53,680,043	11,606,172	42,073,871
2028	49,812,131	10,769,890	39,042,241
2029	46,453,116	9,993,866	36,459,250
2030	44,418,511	9,273,759	35,144,752
2031	41,409,830	8,605,539	32,804,291
2032	39,228,723	7,985,467	31,243,256
2033	37,520,294	7,410,075	30,110,220
2034	34,848,196	6,876,142	27,972,054
2035	32,987,901	6,380,682	26,607,218
2036	31,732,416	5,920,923	25,811,493
2037	28,552,011	5,494,291	23,057,720
2038	27,016,153	5,098,400	21,917,753
2039	26,390,313	4,731,035	21,659,277
2040	22,762,279	4,390,141	18,372,138
2041	19,939,254	4,073,810	15,865,444
		Sum of discounted CFs	568,966,220
		TV	1,082,510,286
		TV discounted	261,429,806
		Property Value	830,396,026
		Debt	295,702,107
		Equity	534,693,919
		Number of shares	51000000
		Per Share	10.48

Base Case

Discounted Inflows	Discounted Outflows	Discounted CFs
66,840,870	13,122,175	53,718,695
58,860,532	12,147,913	46,712,619
56,985,702	11,483,524	45,502,178
54,687,949	10,705,252	43,982,697
50,983,964	9,979,726	41,004,238
47,767,556	9,303,371	38,464,186
45,888,289	8,672,854	37,215,435
42,979,466	8,085,070	34,894,396
40,905,474	7,537,121	33,368,353
39,306,394	7,026,308	32,280,085
36,677,266	6,550,115	30,127,152
34,881,169	6,106,195	28,774,975
33,710,034	5,692,360	28,017,674
30,472,806	5,306,572	25,166,234
28,968,029	4,946,930	24,021,099
28,428,875	4,611,663	23,817,212
24,634,887	4,299,117	20,335,770
21,680,207	4,007,753	17,672,454
	Sum of discounted CFs	605,075,454
	TV	1,345,437,799
	TV discounted	354,630,670
	Property Value	959,706,124
	Debt	295,702,107
	Equity	664,004,017
	Number of shares	51000000
	Per Share	13.02

Bull Case

	Discounted Inflows	Discounted Outflows	Discounted CFs
2024	67,151,700	11,808,095	55,343,606
2025	59,409,243	10,982,231	48,427,012
2026	57,790,080	10,432,355	47,357,725
2027	55,719,623	9,771,325	45,948,298
2028	52,189,034	9,152,180	43,036,854
2029	49,125,595	8,572,266	40,553,329
2030	47,413,913	8,029,098	39,384,815
2031	44,616,354	7,520,346	37,096,007
2032	42,662,237	7,043,831	35,618,406
2033	41,186,466	6,597,510	34,588,956
2034	38,611,566	6,179,469	32,432,098
2035	36,892,716	5,787,916	31,104,800
2036	35,821,017	5,421,174	30,399,843
2037	32,532,715	5,077,669	27,455,046
2038	31,071,051	4,755,931	26,315,120
2039	30,635,558	4,454,578	26,180,980
2040	26,671,401	4,172,321	22,499,080
2041	23,582,390	3,907,948	19,674,442
		Sum of discounted CFs	643,416,417
		TV	1,281,195,344
		TV discounted	369,373,869
		Property Value	1,012,790,286
		Debt	295,702,107
		Equity	717,088,179
		Number of shares	51000000
		Per Share	14.06