THE CATHOLIC UNIVERSITY OF EASTERN AFRICA

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MAIN EXAMINATION

JANUARY – APRIL 2014 TRIMESTER

FACULTY OF COMMERCE

DEPARTMENT OF ACCOUNTING AND FINANCE

REGULAR/EVENING PROGRAMME

CFI 424: REAL ESTATE FINANCE

Date: APRIL 2014	**Duration: 2 Hours**
INSTRUCTIONS: Answer Question ONE and ANY OTHER TWO Questions	

Q1. a) The Prudential Banking Group, a large Kenyan financial services firm has undergone fast growth driven by expansion in emerging Eastern African markets in South Sudan, Uganda and Rwanda. The company is seeking to expand operations into Southern Africa. The company is planning entry into the Malawian and Zambian markets. To raise capital for the venture the company seeks to liquidate the financial resource tied into the bank's flagship asset the Prudential Tower, a building valued at Kes. 2.25 billion.

Mr. Yahya Kato, the Managing Director of Prudential Banking Group is considering a proposal by Corporate Leasing Limited for a sale and leaseback of the Prudential Tower. He highlights the following terms used on the proposal document.

i) Absolute net lease
ii) Attorn
iii) Assignment of a lease

Required:

Explain Mr. Kato the implications of the above mentioned terms.

(10 marks)

b) Ms. Hawa Makemba, a popular Congolese Musician, has made Kenya her second home. She has a large following within the Nairobi club scene. She has developed an interest in owning an apartment which she can use as a home, studio and hostel for her entourage. Coming from a Francophone background she finds it difficult to comprehend Kenyan interests in land. Ms. Makemba requests your counsel.

Required:

Prepare a report advising Ms. Makemba on the nature and implications of the following interests under Kenya laws.

i) Sectional properties **(3 marks)**
ii) Occupational lease **(3 marks)**
iii) Trust lands **(4 marks)**

c) Mr. Bwana Kubwa is in the process of purchasing a new home at the San Francisco Town Houses gated community. Reviewing the mortgage documents he sought an explanation of the following terms:

i) Land contract
ii) Second mortgage
iii) Prepayment penalty clause

Required:

Prepare a report explaining Mr. Kubwa the essential features of the above mentioned terms. **(10 marks)**

Q2. The Mutomo Mining and Investment Company Limited a large mining company formed to exploit the limestone resource at Mutomo is evaluating various construction loans to finance the development of a modern 2000 acre company town at a cost of Kes. 3,258,000,000. The town, which will have residential, industrial and recreational quarters, is expected to outlive the massive limestone deposits when they expire in 150 years. This is because the company will develop an industrial base producing limestone based products such as limestone aggregate for roads, white pigments and fillers for use in toothpaste paints and chemical feedstock. The construction of the town will take three years.

After rigorously evaluating construction financing facilities proposed by several local and international banks, the company has shortlisted 2 offers, one by the International Finance Company plc and the Qatar Development Bank Corporation. The following are the terms of the construction loans proposed by the above mentioned financiers.

International Finance Company plc proposed construction loan terms. The construction loan will be structured as an interest only loan with a ballon payment of the loan balance at the end of the construction activity in 36 months. A loan origination fee of 2 percent will be deducted before the loan is disbursed. Interest will be charged at 8 percent. Interest is charged on a flat rate basis (no compounding). Interest is paid monthly. The bank can originate construction loans of up to USD 40 million.

Qatar Development Bank Corporation proposed construction loan terms. The construction loan will be structured as a constant payment mortgage loan where monthly debt service payments will be made. A ballon payment of the loan balance will be made at the end of construction activities in 36 months. An origination fee of 3 percent will be deducted before the loan is disbursed. Compound interest is charged at 7 percent. Monthly debt service payments are required. Monthly payments will be Kes. 23,739,037.37. The bank can lend up to USD 42 million.

Both the construction costs and origination fee will be financed by the loan. The Mutomo Mining and Investment Company Limited seeks to minimize its effective interest cost. The prevailing exchange rate is USD 1 = Kes 86.20.

Required:

a) Loan amount to be applied for from the International Finance Company plc and the Qatar Development Bank Corporation. **(3 marks)**

b) Loan origination fee charged by the International Finance Company plc and the Qatar Development Bank Corporation. **(2 marks)**

c) Effective interest cost of the loans from the International Finance Company plc and the Qatar Development Bank Corporation.

(14 marks)

d) Advice the management of the Mutomo Mining and Investment Company Limited on which loan to take to finance the construction activity of the new company town. **(1 mark)**

Q3. Mr. Richard Hutchinson, is the owner manager of the Hutchinson Bed and Breakfast in Nanyuki. 3 years ago Mr. Hutchinson bought an abandoned farmhouse at a cost of Kes. 15 million. The acquisition was financed with a 20 year, 100 percent loan to value ratio, variable rate mortgage provided by the HSBC Bank. The initial interest rate on the mortgage was 12 percent. The Bank would review and adjust interest rates every 12 months. The mortgage is subject to an interest rate cap at 13 percent and an interest rate floor at 12.50 percent. The following are the interest rates prevailing at the end of the first through third year of the mortgage.

End of year (EOY) 1:	13.25%
(EOY) 2:	12.50%
(EOY) 3:	12.25%

Twelve months into the mortgage Mr. Hutchinson took a second mortgage of Kes. 5 million secured on the same property. The second mortgage provided by the Nedbank was used to finance the renovation of some outbuildings to make them suitable for use as guesthouses. This loan is originated at an interest rate of 16 percent. This loan is indexed on the Treasury Bill Rate. Interest on this mortgage loan is charged at the Treasury Bill Rate plus 9 percent. The following are the Treasury Bill Rates prevailing at the end of the first through the third year.

(EOY) 1:	7.75%
(EOY) 2:	7.00%
(EOY) 3:	6.75%

The second mortgage is not subject to interest caps or floors. The Hutchinson Bed and Breakfast operation has improved its financial performance steadily. The following are the gross operating incomes realized during the first three years of operation.

Year	1	2	3
Net operating income (Kes. Million)	10.2	20.8	29.8

Beyond the third year rental incomes are expected to grow at a rate of 5 per cent every year.

The St. Regis Hotel Group has made an offer to Mr. Hutchinson to acquire all property rights of the Hutchinson Bed and Breakfast at a price of Kes. 688,380,000.

Required:

Calculate:

a) The monthly mortgage debt service payments made to the two banks in the first, second and third years of the mortgage. **(6 marks)**

b) The loan balances on the two mortgages at the end of the first, second and third years of the mortgage. **(6 marks)**

c) The reversionary value of the property at the end of the third year. The capitalization rate of similar properties is 10 percent. **(2 marks)**

d) The net equity buildup at the end of the third year. **(5 marks)**

e) Advise Mr. Hutchinson on whether he should accept the proposal by St. Regis Hotel Group to purchase the property for Kes. 688,380,000. **(1 mark)**

Q4. Ms. Ellen Kizito, is the proprietor of Mzito Cakes, a business that bakes a variety of cakes. Recently she has added two supermarkets to her order book. She has ordered a commercial grade oven which cannot fit in her small residential kitchen.

Ms. Kizito has been pondering the extension of her kitchen. This improvement will cost of Kes. 300,000.

Alternatively, she has the opportunity to rent space at nearby shopping malls, namely, the Karibu Mall, Kadri Mall and Mbali Mall. The letting agents of the aforementioned malls have provided the following letting terms.

Kariubu Mall

Type of lease: Net lease with CPI adjustment
Terms of lease: 5 years
Last year's (Time 0) rent: Kes. 3,780 per square meter
Rent adjustment: The lease rental will be adjusted at 100 percent consumer price index.
Last year's operating expenses: Kes. 2,460 per square meter.
Operating expense adjustment: Operating expenses are expected to increase by Kes. 250 per square meter.

Kadri Mall

Type of lease: Gross lease with 100% CPI adjustment.
Terms of lease: 5 years
Last year's rent: Kes. 5,568 per square meter
Rent adjustment: Rent will be adjusted at 100 percent consumer price index.
Last year's operating expenses: Kes1,968 per square meter.
Operating expense adjustment: Operating expenses are expected to increase by Kes. 270 per square meter.

Mbali Mall

Type of lease: Gross lease with expense stop
Terms of lease: 5 years
Last year's rent: Kes. 6,600 per square meter
Rent adjustment: The lease rent will remain unchanged over the term of the lease.
Last year's operating expenses: Kes. 2,340 per square meter subject to an expense stop at Kes. 2,340 per square meter.
The lessee reimburses any amount of operating expenses in excess of Kes. 2,340 per square meter.
Operating expense adjustment: Operating expenses will be adjusted at 100 percent consumer price index.

Ms. Kizito's cost of capital is 10.75 percent. The following are the term of the lease.

Year	0	1	2	3	4	5
Consumer price index	258	264	270	280	292	298

Required:

a) Explain Ms. Kizito the reasons firm gives for leasing the premises they do business from. **(3 marks)**

b) Compute the effective interest cost of the three competing properties on a square meter basis. Mr. Kizito seeks the most cost effective premises. Which of the three properties would you recommend? **(15 marks)**

END