Impact of COVID-19 on Kenya's Real Estate Sector, & Cytonn Weekly #23/2020

Focus of the Week

On 15th March 2020, we wrote about the Impact of Coronavirus to the Kenyan Economy where we analysed the resultant effect on the Kenyan economy given the negative impact that the pandemic is having on international trade, the financial and commodity markets, and the global macroeconomic environment; and, The Potential Effects of COVID – 19 on Money Market Funds, where we highlighted the macro-economic environment in the country and the effects on the fixed-income market, having reported the first infection on 13th March 2020. This week, we focus on the impact COVID-19 has had on the real estate sector where various emerging trends have shown varied implications on the different sectors of real estate. We shall therefore cover:

?. Brief Analysis of the Real Estate Performance in Q1'2020,
i. Effects of COVID-19 on the Real Estate Sector,
ii. Case Study – United Arab Emirates,
iii. Future of Real Estate Post-COVID-19, and,
iv. Conclusion and Recommendations.

I. Brief Analysis of the Real Estate Performance in Q1'2020

The real estate sector, just like the country's economy, was poised for growth in 2020 having began to show signs of recovery in 2019 from the sluggish growth experienced in 2017 and 2018. This was evidenced by the sector's growth, which came in at 5.3% in 2019, 1.2% points higher than 4.1% in 2018 according to KNBS Economic Survey 2020. In terms of performance, according to our Cytonn Q1'2020 Markets Review, the real estate sector recorded moderate activity with average rental yields improving marginally in the residential and commercial office sectors to 5.2% and 7.8%, respectively, from 5.0% and 7.5% in Q4'2019 as the retail sector registered 0.1% points drop in rental yields to 7.7% in Q1'2020, from 7.8% in Q4'2019. It is, however, important to note that, while the first Kenyan case of Coronavirus was reported in March 2020, its effects on the real estate sector had not been fully felt by the end of Q1'2020.

II. Effects of COVID-19 on the Real Estate Sector

COVID-19 has caused unprecedented disruption to the Kenyan economy over the past few months. The immediate impact on the sector has been:

?. Reduction of the labour force and disruption of supply chains, which is expected to translate to longer development periods,
i. A slowdown in building approvals as public offices such as City Hall remain closed,
ii. Reduced construction activities by developers in a bid to reserve their cash at a time when market liquidity is likely to decline,

iii. Little to no collections as Lands Registry was closed hence banks and mortgage buyers not releasing funding,
iv. A slowdown in collections for those who have purchased off-plan real estate on instalment plans, and,
v. Reduced funding to the sector due to general risk aversion during the pandemic.

Real estate sectors namely; residential, office, retail, and, hospitality particularly have been hit by lockdown measures and diminishing disposable income by a majority of Kenyans in the following ways:

Residential Sector

?. **Lower Rents and Prices -** Decline in income will ultimately lead to homebuyers and renters having lower funds to spend on their monthly housing costs, thus decline in effective housing demand leading to lower home prices and lower market rents. We expect occupancy rates and uptake to record flat growth, largely attributable to restrictions on individual contact or movement during this pandemic.

Office Sector

?. **Reduced Occupancy Rates** - Office buildings' occupancies are set to decline as companies resort to make working remotely a permanent feature. The market turbulence will see businesses scaling down operations and might, therefore, lead to increased vacancy rates in the near term,
i. **Reduced foreign investments** - Firms globally have put on hold expansion as they adopt a wait and see approach, leading to a drop in office space demand, and,
ii. **Collections** - Challenges in the collection of rents and as such the yields in commercial offices are expected to fall in the near term.

Retail Sector

?. **Shops' Closures -** Retailers such as Shoprite, Naivas, and, Tuskys have shut down some of their branches as an attempt to cushion themselves against the impact of the Coronavirus amidst declining revenues from reduced footfall, and,
i. **Increased Focus on E-commerce –** There has been increased sales of fast-moving consumer goods by retailers through e-commerce firms such as Jumia, as most Kenyans continue to stay at home so as to adhere to the government's social distancing rules.

Hospitality Sector

?. **Closure of Major Hotels -** The hospitality sector has been the hardest hit owing to its heavy reliance on tourism and the MICE (Meetings, Incentives, Exhibitions and Conferencing) sectors. In 2019, Kenya's international tourist arrivals from Europe and Asia accounted for the majority share in 2018 at 56.8% and 13.9%, respectively. Travel restrictions, which have completely stopped international tourist arrivals, have led to the closure of various popular hotels such as Sarova Hotels and Fairmont Hotels**,**
i. **Lay Offs –** For hotels still in operation, reservations are low as locals shy away from hotel stays in a bid to cut down on consumer discretionary spending. This has led to a majority of hotel staff getting laid off, and,
ii. **Marginal Revenues for Serviced Apartments -** Unlike hotels which tend to attract short-stay visitors, serviced apartments revenues will continue to be sustained by the presence of long-stay visitors in the near-term.

Construction Sector

?. **Disruption of Supply Chains** – There has been a negative impact on the supply chains as most developers source for construction materials from nations such as China. We expect this to translate to longer development periods owing to a shortage of resources and ultimately reduced building completions,

i. **Lack of Project Finance** - Decline in project financing will be apparent as lenders would be uneasy to finance construction projects owing to the current uncertainty in the economy coupled with delayed project completion dates thus, it will take longer for them to get returns on their investment,
ii. **Reduction of Labor** - The pandemic's direct impact in the real estate sector has been the immediate reduction in the labour force as construction sites adhere to guidelines issued by the National Construction Authority (NCA) requiring contractors on-site to reduce the number of workers to a level that can allow workers keep at least a metre apart, and,
iii. **Absorption of Surplus Space** - In the short term, we expect the slowdown in construction activities to help accelerate the movement of existing property inventory, thus, facilitating a demand-supply equilibrium in sectors experiencing oversupplies such as the retail sector.

What the Government Has Done so Far

The government continues to adopt policy reforms geared towards cushioning the real estate sector through bills and regulations such as;

?. The Central Bank through the Monetary Policy Committee announced various monetary measures such as; lowering of the Central Bank Rate (CBR) to 7.0%, and, lowering of the Cash Reserve Ratio (CRR) by 1% to 4.25%, to increase the available cash for on lending,
i. The Central Bank has provided flexibility for loan classification and provisioning for loans that were performing on 2ndMarch but need to be restructured because of COVID-19. These measures are expected to increase the supply of credit to the private sector and therefore improve their cash flows,
ii. The government also recently announced a Kshs 53 bn 8-point stimulus programme which, among others, seeks to offer soft loans to hotels and related establishments through the Tourism Finance Corporation (TFC) thus stimulating the hospitality sector,
iii. The Tax Laws (Amendment) Act 2020 amendment to the Retirement Benefits Act, which will allow the use of pension savings towards purchasing a residential home in addition to securing a mortgage loan, at a time when household incomes have been adversely affected by the economic downturn,
iv. The Business Laws Amendment Act 2020 recognizes the use of advanced electronic signatures and electronic signatures as a valid mode of execution of documents in Kenya. This is poised to improve the ease at which land transactions are carried out, at a time when government offices such as lands registries remain closed, and,
v. The Pandemic Response and Management Bill 2020, which proposes a loans and mortgages moratorium preventing lenders from imposing penalties or credit reference bureau listing for borrowers unable to meet their monthly payment obligations, and a directive for landlords to enter into tenancy agreements with tenants unable to meet their rent obligations until after the pandemic.

In our view, the steps taken by the government are positive and could help stimulate the growth of the real estate sector in the long-run. However, it faces various headwinds in its plan to actualize some of its ambitions especially in the wake of weak revenue collections and huge budget deficits which have resulted in various fiscal consolidation measures such as a reduction in funds meant for the affordable housing initiative.

III. Case Study – United Arab Emirates

Abu Dhabi is the largest of the seven emirates that comprise the UAE in terms of both its landmass and economy. Its Real estate and construction sectors are strong contributors to economic diversification accounting for 14.4% of Abu Dhabi's GDP in 2018 while recording 34.4% of the total stock of foreign direct investment in Abu Dhabi in the same year. The Abu Dhabi government rolled out a 16-point strategy to help limit the adverse impact of the COVID-19 pandemic, with some of the measures aimed at directly cushioning the real estate sector.

Abu Dhabi's Strategy to Mitigate the Adverse Impact of COVD-19 on the Real Estate Sector

Action	Relevant Real Estate Sector
· Suspension of real estate registration fees until the end of 2020 · Reduction of industrial land leasing fees by 25% on new contracts · Allocating USD 1.4 bn to subsidize water and electricity for citizens and firms undertaking commercial and industrial sector activities. Subsidies will also be provided for the electricity connection fee for start-ups connecting in 2020	**All**
· Suspension of tourism and municipality fees for the tourism and entertainment sectors until the end of 2020 · Rebates of up to 20% on rental values for restaurants, tourism and entertainment sectors	**Hospitality**
· Exempting all commercial and industrial activities from Tawtheeq fees till the end of 2020 (Tawtheeq is a system under which the government regulates tenancy contracts for rental properties in Abu Dhabi. It helps formalise tenancy agreements in Abu Dhabi and ensures transparency between the landlord and tenant, to avoid any future disputes.)	**office, Retail, and, Industrial**
· Allocating USD 817 mn to the SME credit guarantee scheme managed by Abu Dhabi Investment Office to stimulate financing by local banks and enhance SME's ability to navigate the current market environment	**All**
· Waiving current commercial and industrial penalties	**All**
· Establishing a new committee headed by the Department of Finance, with members from the Department of Economic Development and local banks to review lending options to support local companies	**office, Retail, Hospitality, and, Industrial**

Across the globe, various governments have initiated various measures aimed at cushioning the real estate sector.

Response Measures by Various Countries

Country	Measure
Spain	· Three-month moratorium on mortgage payments for the most vulnerable, including households, self-employed, and, homeowners who have rented out their mortgaged properties · Automatic moratorium on rent payments for vulnerable tenants whose landlord is a large public or private housing holder during the COVID-19 crisis period · Suspension of interest and repayment of loans granted by the Secretariat of State for Tourism for one year with no need for prior request Introduction of a special credit line for the tourism sector through the Instituto de Crédito Oficial(ICO) (€400 million)
Egypt	· Energy costs have been lowered for the entire industrial sector · Real estate tax relief has been provided for industrial and tourism sectors · As part of a USD 6.2 bn stimulus announced to stimulate the economy, USD 3.1 bn will be directed towards the tourism sector
Czech Republic	· The state will cover 50% of rents of businesses after mandating a reduction of 30% from landlords · The loan to value limit (LTV) on new mortgage loans has been relaxed from 80% to 90%, and providers may apply a 5% exemption to mortgages with higher LTVs

Response Measures by Various Countries

Country	Measure
Australia	· Under the Homebuilder Programme, the government will provide all eligible owner-occupiers (not just first home buyers) with a grant of USD 17,400 to build a new home or substantially renovate an existing home. Homebuilder applicants will be subject to eligibility criteria, including income caps of USD 87,000 for singles and USD 140,000 for couples based on their latest assessable income. The program is expected to provide around 27,000 grants at a total cost of around USD 474 mn

Source: International Monetary Fund (IMF)

IV . Future of Real Estate Post-COVID-19

The scale at which the Coronavirus has spread across the world has been immense. Its implications on economies and health have been dire, leading to an abrupt change in people's way of life. This is expected to continue over a sustained period thus influencing occupiers and end users of real estate in unprecedented and unique ways, which are expected to have implications for the real estate sector such as;

a. Residential Sector

?. In the long term, middle-income households may opt to buy housing units in anticipation of situations due to the sense of security that physical assets provide during such shocks as the current global pandemic,
i. We also expect huge demand for affordable housing with most aspiring homebuyers tipped to reduce their housing budgets while the pandemic is expected to lead to households seeking functionality based on their current needs only.

b. Office Sector

?. Occupancy rates in office buildings are expected to decline as companies resort to make working remotely a permanent feature,
i. We expect tenants to seek safeguards against instances such as the current situation in future lease contracts with the inclusion of clauses allowing landlords and tenants to discuss options and come to an arrangement short of termination either through rent-free periods, deferrals or other concessions that benefit both parties, and,
ii. We expect uptake of serviced offices to pick after the pandemic as they offer companies preconfigured space on flexible terms which will then give them an option to scale down accordingly in the event of another global shock.

c. Retail Sector

?. Before the pandemic, some consumers were already shifting their spending away from physical stores. This long-term trend may accelerate even faster after the crisis. As such, we expect to see retailers invest in their e-commerce infrastructure, and,
i. Some retailers may opt to go completely cashless underpinned by Kenya's prevalent use of mobile money transactions, according to World Bank's Mobile Money and Digital Financial Inclusion report, 3 in every 4 Kenyan adults use digital payments, translating to 80% of the adult population, which is approximately twice the average in other developing economies.

d. Hospitality Sector

?. In the medium term, majority of demand is expected to come from local tourists and virtual tourism,
i. As the hospitality sector starts to recover, travel patterns are expected to shift toward drive-to-

resort destinations and less dense markets where tourists can be in open spaces and avoid large groups of people, and,

ii. The COVID-19 experience could also permanently change habits by business persons as video conferences prove cheaper and more convenient alternatives, this may affect the demand for hotels.

e. Industrial Sector

?. Higher demand for warehousing space from retailers is expected, with increased online shopping,
i. With the current disruption in supply chains, we expect to see local sourcing of inputs by industries and some retailers thus creating demand for extra storage space, and,
ii. However, we might see a de-globalising tendency as some international companies might opt to mitigate business risks by shutting down local subsidiaries.

V. Conclusion and Recommendations

Overall, the impact of the pandemic on the real estate sector will be determined by its duration. The market is expected to experience a slow recovery post-COVID-19 as uptake will be subdued due to depressed income levels and changed priorities by prospective investors. The government is expected to continue putting in place sound fiscal policies to cushion businesses and people's disposable incomes.

In our view, to stimulate the real estate sector, the following steps should be taken;

?. With the ban on international flights expected to be upheld, the tourism sector should repackage their products to appeal to a wider scope of domestic tourists,
i. With massive jobs on the line and the anticipated economic downturn, we expect the government and the lending sector to come up with prudent measures to prevent massive loan defaulting by homebuyers such as increasing the current mortgage relief, modifying the loan repayment due dates, waiving of various incidental fees as well as a moratorium on any property auctions,
ii. There should be more public-private partnerships between the national government, county governments, and, private developers geared towards developing more affordable housing units especially as the national government faces reduced tax revenue collections that will result in fewer resources being deployed towards the big four agenda, and,
iii. Commercial office properties may consider leasing out their office space as serviced offices to attract budding SMEs and international companies in the wake of reduced occupancies in traditional offices.

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