Cytonn Monthly - July 2020

Real Estate

I. **Industry Reports**

During the week, Knight Frank released the Kenya Markets Update Report H1'2020, which tracks the status and trends in various economic sectors in Kenya including prime real estate. The key highlights from the report are:

- In the retail sector, monthly rents for prime stores reduced by 8.5% to Kshs 450 per SQFT from Kshs 492. The decline is attributable to oversupply in select nodes as well as reduced consumer spending due to declines in disposable incomes amidst the current economic environment. However, occupancy rates remained relatively high averaging 80% with established retail developments recording up to 90%. Footfall is expected to continue to rise as the economy gradually reopens although rental rates are expected to continue on a downward trend due to an unfavourable business climate,
- In the commercial office sector, monthly rents in prime nodes remained unchanged in H1’2020 at Kshs 139 per SQFT. The stagnation is attributed to the continued office glut in key commercial nodes as well as the economic slowdown that has seen businesses continue to reduce office space in a bid to reduce operational expenses. Occupancy rates averaged 73% as at the end of H1’2020 with nodes such as Westlands continuing to outperform the market, and
- In the residential sector, prices in prime markets reduced by 2.9% in H1’2020 compared to 1.8% in H1’2019 while rents also declined by 6.6% compared to a decline of 1.7% in H1’2019. The decline is attributable to oversupply in the prime residential markets, unfavourable economic environment, low liquidity, continued relocation of expatriates and reduced transactions due to the prolonged closure of land registries. Residential prices are expected to continue declining in the near term although at a slower rate as the economy gradually reopens and land registries resume operations.

The report findings are in line with our views in the Cytonn H1’2020 Markets Review according to which, average rental yields softened across all sectors coming in at 7.4%, 7.3% and 5.0%, for retail, office and residential sectors, respectively from 7.7%, 7.8% and 5.2% in Q1’2020 attributable to the negative impact of COVID-19 pandemic. Overall, we expect the real estate sector's performance to improve as economic activity regains momentum.

II. **Residential sector**

During the month, the residential sector recorded various activities:

i. Cytonn Investments, an investments management firm and real estate developer, announced that construction activities had resumed in phase 2 of their 500-unit comprehensive residential development in Ruaka, Kiambu County. For more information, see Cytonn Weekly #30/2020,
ii. Shelter Afrique, a pan-African housing development financier, announced plans to issue a bond in the Nairobi Stock Exchange (NSE) aimed at raising funds to develop new real estate projects. For more information, see Cytonn Weekly #29/2020,
iii. Stima Sacco, a local deposit-taking SACCO, announced that it had retracted its plans to raise Kshs

5 bn through a corporate bond to finance its mortgage business. Instead, the SACCO will partner with Kenya Mortgage Refinancing Company (KMRC), a State-backed home loans financier, in its goal of acquiring long term financing for onward lending. For more information, see Cytonn Weekly #29/2020, and,

iv. The Principal Secretary of the State Department of Housing and Urban Development, Mr Charles Hinga, issued a decree that all affordable housing development projects under the nation's Big 4 Agenda will be required to meet the International Finance Corporation's (IFC) Excellence in Design for Greater Efficiencies (EDGE) green buildings standard. For more information, see Cytonn Weekly #28/2020.

We expect to continue seeing momentum in the lower mid-end residential markets. In light of the current tough economic environment, we expect to see developers seek alternative sources of funding especially for projects geared towards the supply of low-cost housing.

III. **Retail Sector**

During the week, L.C Waikiki, a Turkish fashion retailer, opened a new store in Nairobi Mega Mall along Uhuru Highway, Nairobi, marking the retailer's 7th branch locally since opening its first store in 2017, with some of the other outlets being located at; The Hub in Karen, City Mall in Nyali, Mombasa, Two Rivers Mall in Ruaka, Thika Road Mall (TRM) along Thika Road, Sarit Centre mall in Westlands, and, The Junction Mall along Ngong Road. The retailer's latest store seeks to leverage on increased consumer traffic at the premises that has been brought about by the recent opening of Carrefour Mega in June this year. The increased expansion by the international retailer is supported by; (i) growing demand for international brands from an expanding middle class thus creating demand for differentiated retail products, and, (ii) the availability of high-quality retail spaces in line with international standards. We expect the expansion of multinational retailers such as L.C Waikiki to help cushion the retail sector amidst increasing vacancy rates due to the tough economic climate attributed to the ongoing COVID-19 pandemic that has seen occupancies decline by 1.8% to 74.0% in H1'2020 from 75.9% in FY'2019, according to the Cytonn H1'2020 Markets Review. The table below shows the Nairobi Metropolitan Area (NMA) retail performance over time:

Summary of Retail Sector Performance Over Time

Item	Q1' 2019	H1' 2019	Q3' 2019	FY' 2019	H1' 2020	Δ Y/Y	Δ H1'2020
Average Asking Rents (Kshs/SQFT)	174.3	170	167	175.6	**170.3**	(0.2%)	**(3.1%)**
Average Occupancy (%)	76.8%	75.6%	74.5%	75.9%	**74.0%**	(1.6%) points	**(1.8%) points**
Average Rental Yields	8.5%	8.2%	8.0%	7.8%	**7.4%**	(0.8%) points	**(0.4%) points**

Source: Cytonn Research

Also during the month:

i. Naivas Supermarket, a local retailer, opened its 64th store along Mombasa Road opposite the Syokimau Railway station dubbed Naivas Airport view. The store sits on 21,000 SQFT of retail space and is the retailer's second store in Syokimau with the first one located at Gateway Mall, it is also the fourth branch that Naivas has opened in 2020. The retailer aims to open an additional branch in Kisumu at the Mega City Mall soon as it seeks to grow its footprint across the country in the fight for market share in an increasingly competitive market after it recently sold 30% of its stake to the French private equity firm, Amethis Finance. The new store targets the; (i) the growing population in such satellite towns especially with the increased relocation of Nairobi's middle class from the suburbs, and, (ii) commuters using the CBD-Syokimau commuter train service that was introduced by the Kenya Railways Corporation in November last year, in a move aimed at helping ease congestion along Mombasa Road. In our view, the continued focus on satellite towns by the retailer is attributed to; (i) the relatively low rents of approximately Kshs 127.5 per SQFT, 33.6% lower than the market average of Kshs 170.3 per SQFT according to our Cytonn H1'2020 Markets Review, and, (ii) the low formal retail space penetration of approximately 35.0% in Kenya especially in satellite areas, compared to 60.0% in developed countries such as South Africa according to a Nielsen Report,

ii. Tuskys Supermarket, a local retailer, announced that it was seeking a strategic investor to inject Kshs 2 bn in a deal that would see the prospective investor gain majority stake. The announcement comes amidst soaring debt by the retailer that has seen it owe suppliers about Kshs 1.2 bn. In April, the retailer was forced to shut down 3 of its branches attributed to declining revenues and poor corporate governance. We expect the retailer's efforts of relinquishing majority stake coupled with the expected injection of new capital to help keep the retailer afloat and safe from suffering a similar fate to Nakumatt and Uchumi, and
iii. Artcaffe restaurant opened its third store in Nairobi's Central Business District (CBD), located in Chester House, along Kimathi Street. For more information, see Cytonn Weekly #29/2020.

The recent easing of movement restrictions coupled with the expansion of various local and international retailers is expected to sustain the sector as it grapples with reduced occupancy rates attributed to the ongoing pandemic and the existing oversupply of formal retail space.

IV. **Hospitality Sector**

Activity in the hospitality sector in July remained muted. The key highlights were:

i. The Ministry of Tourism and Wildlife Cabinet Secretary, Najib Balala, announced that the National Government had set aside Kshs 10 bn aimed at offering cheap loans to hotels and firms operating in the tourism sector through a state-backed credit scheme. For more information, see Cytonn Weekly #30/2020, and
ii. Global hotel groups, Accor Hotels and Radisson Hotel Group announced that they would continue with their expansion plans in Kenya and the African region as a whole despite the slump in the sector due to the COVID-19 pandemic. For more information, see Cytonn Weekly #28/2020.

We expect the sector to embark on a recovery path as domestic tourism slowly picks up due to the easing of movement restrictions and the expected resumption of international passenger flights on August 1st 2020.

V. **Industrial Sector**

During the week, Purple Dot International Limited, a local real estate developer, kicked off construction of phase 4 of their Graylands Industrial Park in Athi River which is expected to comprise of 36 warehouses each set on 7,750 SQFT and selling for Kshs 19.5 mn each which translates to Kshs 2,516 per SQFT. In total, the development is expected to comprise of 8 phases totalling to about 296 warehouses. Phase 4 follows the completion of phase 3 in March 2020 that commenced in November 2018 and has seen investors receiving at least Kshs 180,000 in monthly rental income, which translates to Kshs 23 per SQFT with a similar plinth area and thus, a gross rental yield of 9.4% assuming average occupancy rate of 85.0% as per the Broll Report Q4'2018. This is the 5th industrial project by the developer, the others include;

Other industrial Developments by Purple Dot International Limited

Development	Location	No. of Units	Plinth Area (SQFT)
Swastik investment Park	along Mombasa Rd.	12	8,000
Ashapura Business Park	Athi River	23	6,600 – 7,200
Ridhi Business Park	Athi River	20	8,000
proposed Kongoni Business Park	Wuyi Rd., Athi River	64	7,750

Online sources

We continue to see an increase in warehouse developments attributed to the continued (i) growth of SMEs which is expected to increase the rate of manufacturing, and (ii) increased online shopping and near sourcing of inputs by local industries and retailers which is expected to accelerate owing to the current disruption in global supply chains. Athi River as an industrial sector node is boosted; (i) availability of development land in bulk and at relatively affordable prices with serviced land in the area going for Kshs 12 mn per acre according to our Nairobi Metropolitan Area (NMA) Land Report 2020, (ii) proximity to key logistics hubs, namely JKIA, Standard Gauge Railway and the Inland Container Depot, as well as (iii) improved infrastructure such as the ongoing expansion of Mombasa Rd, and thus, we expect to continue seeing demand for warehouse space in the area.

Also during the month, Cold Solutions Kenya Limited, a leading temperature-controlled warehouse and logistics service provider, announced that it will invest Kshs 7.5 bn in constructing, grade 'A' temperature-controlled cold storage warehouses in Tatu City Development special economic zone. For more information, see Cytonn Weekly #29/2020.

We expect to see continued demand for warehouse space especially in satellite towns due to; (i) availability of development land in bulk and at relatively affordable prices, (ii) improved infrastructure, and, (iii) increased online shopping and near sourcing of inputs by local industries and retailers due to the current disruption in global supply chains.

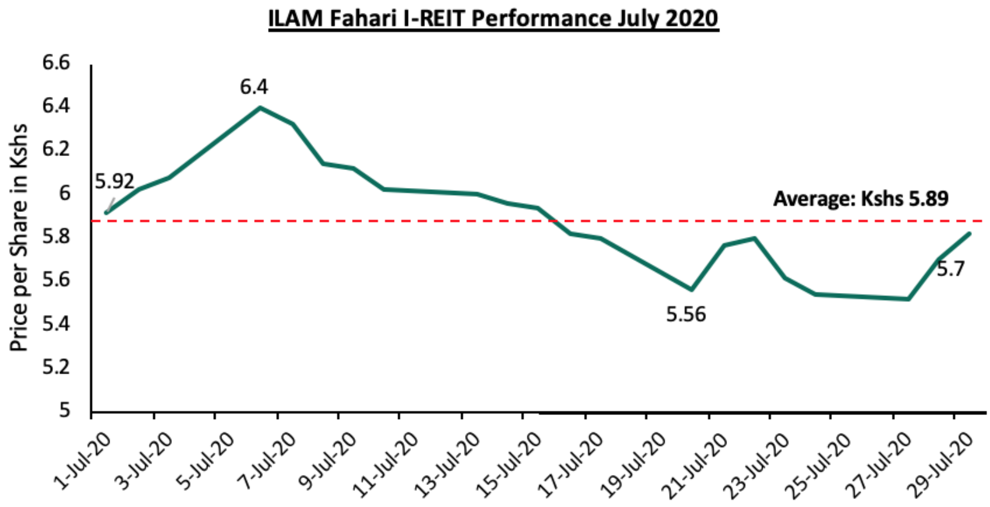
VI. **Listed Real Estate**

ILAM Fahari I-REIT (formerly Stanlib Fahari) released their H1'2020 earnings registering a 14.3% growth in earnings per unit to Kshs 0.48 in H1'2020 from Kshs 0.42 in H1'2019. This was due to an increase in net profits by 12.6% to Kshs 86.0 mn in the period under review from Kshs 76.4 mn in H1'2019, attributable to increase in fair value of investment property to Kshs 7.8 mn in H1'2020, from a loss of Kshs 10.3 mn in H1'2019, as well as reduced operating expenses by the manager in a bid to cushion the REIT from the adverse impact of the ongoing pandemic. Rental income grew by 2.4% to Kshs 174.7 mn from Kshs 170.7 mn in H1'2019. However, the growth was slower compared to the 26.3% increase recorded in H1'2019, attributable to the COVID-19 impact on the retail and commercial office sectors which has led to rent rebates for struggling tenants thus, suppressing rental income growth. The REIT did not recommend an interim distribution of dividends for the period ended 30th June 2020. It was noted that a full distribution will be declared in line with the requirements of the REITs Regulations to distribute a minimum of 80% of distributable earnings within four months after the end of the financial year, which ends on 31st December 2020.

We project a FY'2020 dividend yield of 12.7% assuming the dividend pay-out ratio remains similar to the 4-year average of 96.0% (2016-2019). This is in comparison to the average commercial real estate sector yields of 7.4% as at H1'2020 (Office – 7.3% and retail – 7.4%). However, the expected high dividend yield is largely attributable to the low trading price of the I-REIT, at Kshs 5.9 per unit as at 30th June 2020 compared to Kshs 9.2 as at 29th June 2019. Additionally, dividends are likely to remain weak due to COVID-19 and the resultant unfavourable economic environment.

For a more comprehensive analysis on the REIT's H1'2020 performance, see our ILAM Fahari I-REIT Earnings Note - H1'2020.

On the bourse, the REIT continued to perform poorly, trading at an average of Kshs 5.89 per share during the month of July and closing at Kshs 5.82, representing a 39.5% loss in value YTD and 70.9% lower than its initial listing price of Kshs 20.0. This indicates the continued lack of investor appetite for the instrument. Going forward, we expect the REIT's revenue to continue declining in the near term due to COVID-19's impact on commercial office and retail sectors, thereby suppressing rental income growth for the REIT.



Our outlook for listed real estate is neutral with a bias to negative, attributed to continued lack of investor interest for the instruments and the continued subdued performance of the real estate sector as it continues to grapple with the effects of the COVID-19 pandemic.

We expect the real estate sector to continue recording minimal activities as investors hold on to the wait-and-see attitude amidst the ongoing tough economic climate. However, the sector is expected to recover in the near term supported by (i) investor confidence in the hospitality sector's resilience, (ii) the continued expansion of retailers, and, (iii) the ongoing demand for high-quality warehousing.