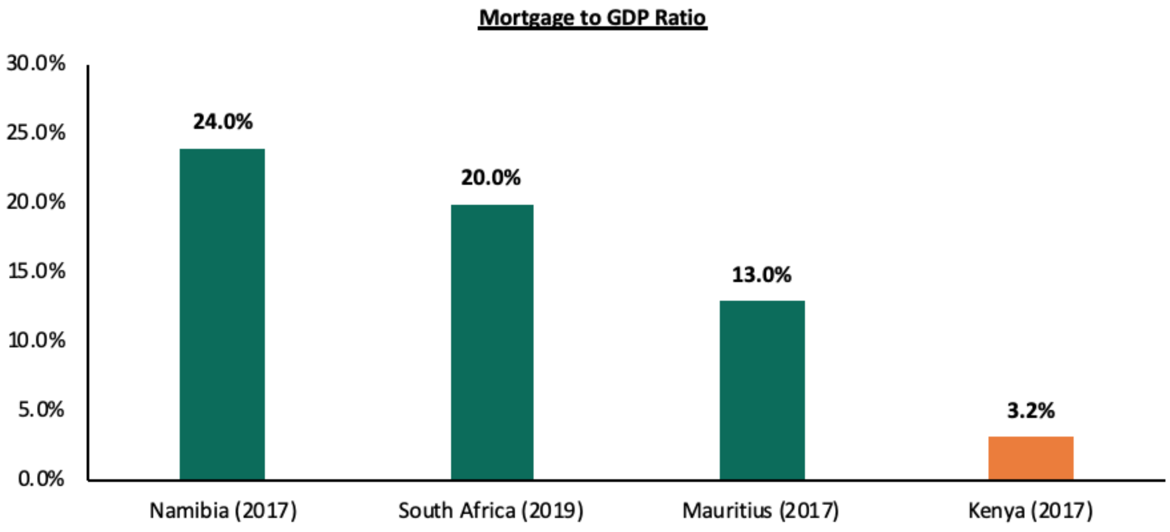
Fintech Amid COVID-19 & Cytonn Weekly #34/2020

Real Estate

1. **Residential Sector**

During the week, Kenya Mortgage Refinance Company (KMRC), a treasury backed lender, announced plans to issue a green bond*(details are yet to disclosed*) by the end of next year with the aim of raising funds for lending to retail lenders for onward lending to their customers. The funds raised from the bond will add to the existing pool of approximately Kshs 37.2 bn, including Kshs 2.2 bn in equity capital, Kshs 25.0 bn committed by the World Bank and Kshs 10.0 bn from African Development Bank. The KMRC bond will be placed privately with institutional investors, fund managers and pension funds, but is currently not contemplated to be offered to the public. A green bond is a type of fixed-income instrument that is specifically issued to raise money for positive climate and environmental projects. The green bond market was launched in Kenya in February 2019, through the Green Bonds Programme - Kenya, which is a joint initiative between the Central Bank of Kenya, Nairobi Securities Exchange, Climate Bonds Initiative and Kenya Bankers Association, with several other organizations endorsing the program. The KMRC green bond will be the second of its kind in Kenya, with real estate developer Acorn Holdings and private equity fund Helios having issued the first green bond in Kenya raising Kshs 4.3 bn of the targeted Kshs 5.0 bn in January 2020; the rate at issuance was 12.3%. The main advantage of green bonds is that they attract a wide range of investors seeking to positively impact the environment and allows traditional investors like pension funds to diversify their portfolio. The issuing of the green bond by KMRC will be a step in the right direction towards raising of funds from the capital markets to finance the facility, which is set to lend money to local financial institutions at an annual interest rate of 5.0%, enabling them to issue home loans at 7.0%, 6.0% points lower than the market rate of approximately 13.0%. However, in our view, to be able to lend at 5.0%, the green bond will have to be issued at a relatively low rate which is likely to make it unattractive to investors noting that Acorn's green bond was issued at 12.3% and attracted 85.0% subscription, in addition to facing competition from other bonds such as the 91- day bill whose yield stands at 6.3%, 1.3% above the intended 5.0%. According to Central Bank of Kenya, the value of outstanding non-performing mortgages stood at Kshs 38.1 bn as at 2018, with the mortgage to GDP ratio at 3.2%, and thus we are of the view that KMRC will have to raise a significant amount of funds to sustain the 7.0% interest rate, otherwise, once the initial capital is exhausted, the facility will need to move back to the market rate of approximately 13.0%.



Source: Centre for Affordable Housing Finance in Africa

II. **Commercial Office Sector**

During the week, Industrial and Development Corporation (ICDC), a Kenyan government owned development finance institution, completed the purchase of Development Bank-owned Finance House building, located along Loita Street in Nairobi's CBD, for Kshs 1.2 bn. The Corporation, which has been linked to real estate projects such as Two Rivers Mall owned by Centum Investments Limited, intends to sell the property and channel the proceeds to financing industrial, commercial and other entrepreneurial undertakings in the economy, citing that it is not in the business of owning property but contributing to the growth of the industries; it is not clear why ICDC would buy the property with a view to selling it, unless it bought it at a discount or it was a transaction to assist Development Bank improve its liquidity. The State-owned Development Bank of Kenya has been battling liquidity pressures thus forcing it to sell the property in 2019 in efforts to shore up its capital.

According to Cytonn H1'2020 Market Review, the commercial office sector recorded a decline in the average rental yield which came in at 7.3%, down from the 7.5% which was recorded in H1'2019. The performance is attributable to the ongoing COVID-19 pandemic which has led to reduced demand for office spaces as firms put on hold expansion plans as they adopt a wait and see approach. The Nairobi CBD recorded a relatively low rental yield of 6.8%, compared to the market average of 7.3%, due to the traffic snarl-ups and low-quality office space.

The table below shows performance by nodes of the Nairobi Commercial Office Sector in H1'2020.

Nairobi Commercial Office Sector Performance H1'2020

Location	Price Kshs/ SQFT H1'2020	Rent Kshs/SQFT H1'2020	Occupancy H1'2020(%)	Rental Yield (%) H1'2020
Gigiri	13,500	118	84.9%	**8.9%**
Karen	13,688	111	85.9%	**8.3%**
Westlands	12,328	105	79.7%	**8.2%**
Parklands	11,808	94	82.7%	**7.9%**
UpperHill	12,625	97	78.8%	**7.4%**
Kilimani	12,521	91	79.6%	**7.0%**
Nairobi CBD	12,273	83	84.2%	**6.8%**

Nairobi Commercial Office Sector Performance H1'2020

Location	Price Kshs/ SQFT H1'2020	Rent Kshs/SQFT H1'2020	Occupancy H1'2020(%)	Rental Yield (%) H1'2020
Thika Road	12,529	82	77.9%	**6.2%**
Msa Road	11,375	74	65.9%	**4.7%**
Average	**12,516**	**95**	**80.0%**	**7.3%**

Source: Cytonn Research 2020

We have a negative outlook for the commercial office sector, and expect to see a slight reduction in demand with some firms having downsized due to financial constraints resulting from the current pandemic as several others experience working from home and may make it a permanent measure. However, we expect the sector's performance to gradually recover once the economy picks up.

III. **Retail Sector**

During the week, Tuskys, a local retail chain, closed down its Kisumu branch at the United Mall due to rent arrears totaling to Kshs 26.0 mn. The Victoria Blues Services Auctioneers (VBSA), stopped the retailer from operating and is set to auction the stock for debt recovery purposes. This follows the auctioning of the Nakuru Midtown branch on 8th August 2020 due to rent arrears. The retailer also recently closed 3 other branches, along Tom Mboya in Nairobi's CBD, the Mega Branch in Kitale, and at Digo in Mombasa, citing consolidation of its services to other branches which are more spacious so as to implement social distancing and personal hygiene measures more effectively. The current financial strain is mainly attributed to strained revenues due to reduced demand, and the family wrangles among the retail chain's shareholders thus affecting its operations. In 2019, the market witnessed a similar case with Nakumatt, which completely closed down their outlets. In our view, other retailers in Kenya can mitigate similar challenges through focusing on; i) proper corporate governance, ii) partnerships with private equity funds, iii) strategic expansion, and, iv) proper supply chain management. We expect retail centers to record a slump in occupancy rates due to the exit of troubled retailers such as Tuskys, while some retailers are shutting down their operations to cushion themselves against the effects emanating from the pandemic. However, we expect to see retailers invest in their e-commerce infrastructure and also decentralize to locations that are easily accessible from people's homes.

Local and International Retailers that have exited or closed down outlets in Kenya

Name of Retailer	Initial no. of branches	Current no. of branches
Nakumatt Holdings	65	0
Botswana's Choppies	15	2
South Africa's Shoprite	4	2
Uchumi	37	4
Tuskys	63	56

Source: Online Research

Massmart, a South Africa retail chain opened a Kshs 500.0 mn building material outlet dubbed Builders Warehouse in Kenya. The new outlet will be located in Karen at the Waterfront Mall. The latest move by the retailer is part of a strategy to increase its footprint in Kenya, targeting the growing construction sector in Kenya. The retailer currently has 3 subsidiary outlets of Game Stores in Garden City, Karen Waterfront and Kisumu's Mega City Mall. The move to open a branch in Karen is supported by; i) the high consumer purchasing power as it is an affluent neighborhood hosting middle to high-end income earners, and, ii) less competition in the market given the relatively low number of similar retailers in the area. According to the Cytonn H1’2020 Markets Review, Karen was the second best performing retail node within Nairobi recording an average yield of 9.2% while the occupancy rates stood at 75.0%, compared to the market average of 7.4% and 74.0%, respectively.

The table below shows the H1’2020 Nairobi Retail market performance;

*(**All values in Kshs unless stated otherwise**)*

Nairobi Retail Market H1’2020 Performance

Location	**Rent per SQFT H1’2020 (Kshs)**	**Occupancy H1’ 2020**	**Rental Yield H1' 2020**
Westlands	207	81.2%	**9.8%**
Karen	219	75.0%	**9.2%**
Kilimani	173	83.1%	**8.7%**
Ngong Road	183	80.1%	**8.3%**
Kiambu Road	175	67.1%	**6.9%**
Thika road	164	69.3%	**6.5%**
Mombasa Road	144	69.6%	**6.0%**
Eastlands	143	69.6%	**5.9%**
Satellite Towns	128	71.4%	**5.4%**
Average	**170**	**74.0%**	**7.4%**

Source: Cytonn Research 2020

We expect continued entry of international retailers in Kenya to enhance the uptake of retail space thus heightening the returns for investors and cushioning the sector’s performance in the wake of economic slump due to the pandemic coupled by the existing oversupply of approximately 2.8 mn SQFT as at 2019.

We expect the real estate sector to continue on an upward trajectory with activity driven by expansion of international retailers, availability of relatively affordable mortgage loans through KMRC and ongoing transactions on the commercial front.