Real Estate Investment Trusts (REITs) in Kenya, & Cytonn Weekly #11/2021

Real Estate

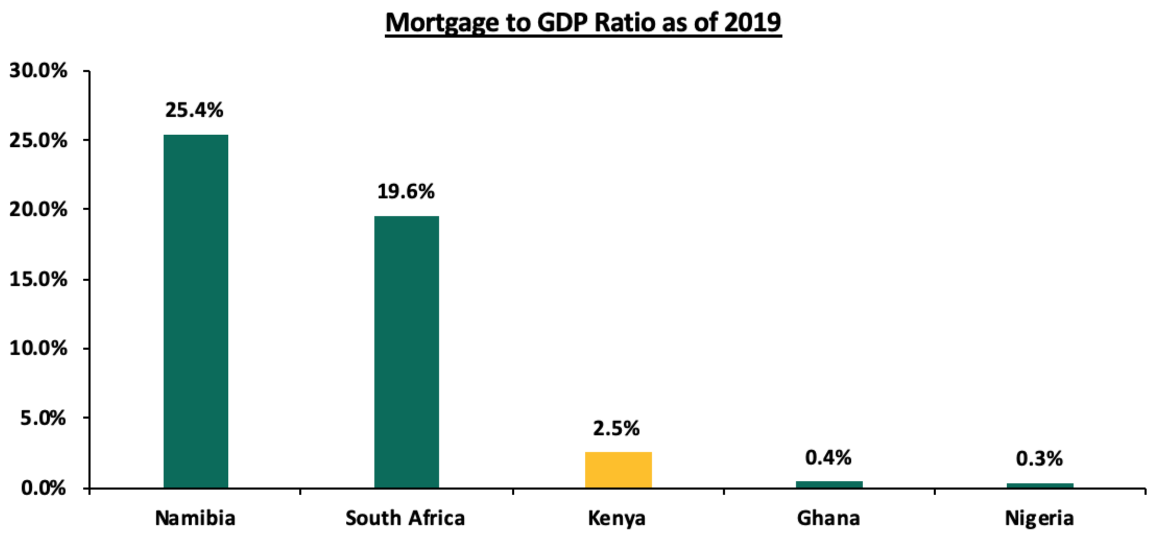
I. **Residential Sector**

During the week, the Kenya Mortgage and Refinance Company (KMRC), a treasury-backed lender, announced that it has so far advanced Kshs 2.8 bn in credit to mortgage lenders accounting for approximately 7.5% of the Kshs 37.2 bn they had planned to lend from September 2020. KMRC were to raise funds from 19 financial institutions for onward lending, out of which so far only 5 have participated with KCB bank accounting for the bulk of the lending at 2.1 bn, followed by Housing Finance(HF) at Kshs 515.0 mn, while others included Stima Sacco at Kshs 69.0 mn, Tower Sacco at Kshs 30.0 mn, and, Bingwa Sacco at Kshs 27.0 mn.

The move by KMRC has enabled them refinance a total of 1,427 mortgages with their aim of boosting the number of mortgage accounts to 60,000 in the next five years. Mortgage accounts growth is currently being constrained by; i) tough economic environment with potential home buyers suffering from job losses and salary cuts, ii) the relatively low loan size provided by KMRC capped at Kshs 4.0 mn for residents within the Nairobi Metropolitan Area (NMA) and Kshs 3.0 mn for all other areas outside the NMA, and, iii) risk of default discouraging lending.

In terms of mortgage penetration, Kenya has continued to record a relatively low mortgage to GDP ratio which stands at 2.5% as at 2019, compared to other African countries such as Namibia at 25.4%. The low mortgage uptake has been low due to; i) the high interest rates and high deposit requirements, ii) soaring of property prices, iii) low-income levels making it hard to service loans, and, iv) lack of credit risk information for those in the informal sector leading to their exclusion.

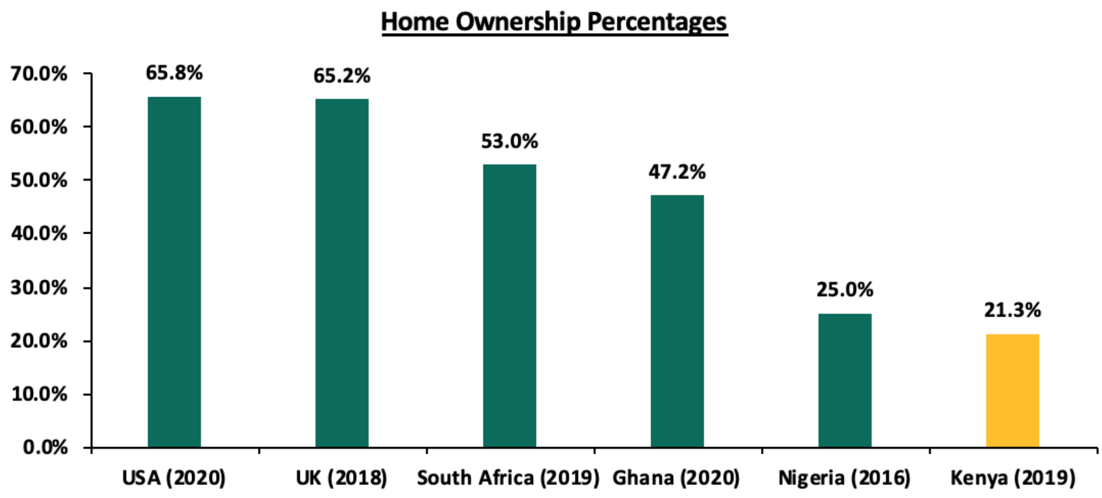
The graph below shows mortgage to GDP ratios of different countries compared to Kenya as of 2019;



Source: Centre of Affordable Housing Africa

According to the Central Bank of Kenya, the number of mortgage accounts currently stands at 27,993 as of 2019, representing a 5.6% rise from 26,504 accounts recorded in 2018. With KMRC in place we expect that they shall continue providing secure, long-term funding to mortgage lenders thus increasing the availability and affordability of mortgage loans in Kenya which will boost the mortgage market and home ownership in Kenya. However, it is still not clear how KMRC will achieve their target lending rate of 7.0% given that even the government cost of borrowing for a 20-year period is currently at about 13.2% p.a.

The graph below shows the home ownership percentages of different countries compared to Kenya as of 2019;

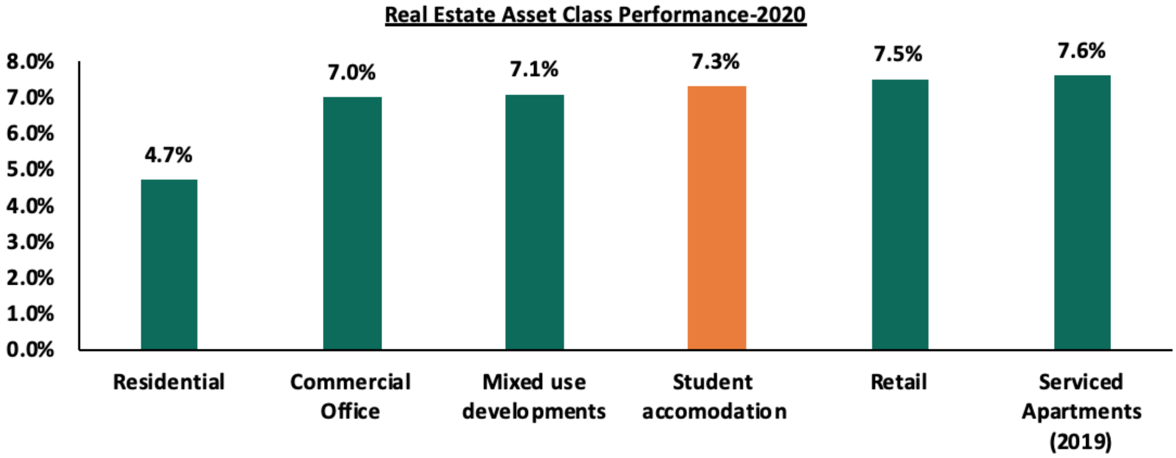


Source: Online Research

Student Factory Africa, a consortium of architects, partnered with Betonbouw B, a Dutch-based private equity firm to launch a 4,500-bed student accommodation hostel to be located next to Catholic University of Eastern Africa in Karen, at a cost of Kshs 5.0 bn. The development set to break ground in April will occupy more than 12 acres of land with the first phase anticipated to be completed in 12 months, with a third of the financing provided by Betonbouw B while the rest will come from debt as talks for financing with the International Finance Corporation(IFC) are ongoing. The hostels will be the second branded hostels after Acorn Group’s Qwetu and Qejani.

Modern student housing continues to gain traction with investors aiming to cash in on their high returns amidst the high demand for student accommodation as a result of the growing number of students. As of 2020, the number of available student housing stood at 300,000 against a university enrolment of 509,473 according to the Kenya National Bureau of Statistics data with the exclusion of technical colleges. This implies that there is a huge deficit of student accommodation which has been accelerated by i) high land rates, iii) insufficient access to funding, and, iii) and inadequate expertise to build and manage student housing. Student accommodation has relatively high yields of 7.4% as per the Cytonn Student Housing Market Kenya Research compared to other real estate sectors like the residential and Mixed-use developments which have an average rental yield of 4.7% and 7.1% respectively. In our view, the move by Student Factory Africa is a move in the right direction to gaining high returns while providing green-certified purpose-built student accommodation.

The graph below shows performance of different real estate classes in 2020;



Source: Cytonn Research

II. **Retail Sector**

During the week Kentucky Fried Chicken (KFC), a US fast food chain, opened a new branch in Mombasa County, in an expansion drive that saw it take up approximately 2200 SQFT of space in Mombasa Trade Centre, marking its first outlet in the county and raising its national branch count to 24. KFC started operations in Kenya in 2011 has 35 outlets in East Africa with the other shops located in Uganda and Rwanda. KFC, which operates locally through franchisee Kuku Foods East Africa, has also been reaping benefits from deliveries and its expansion is being supported by rising disposable household incomes, fast economic growth and a young population with upgraded tastes and preferences. In our opinion, Mombasa presents a viable opportunity for the fast-food industry as it is a tourist destination. The continued expansion of KFC and other restaurants is expected to result in increased uptake of retail real estate developments thus improving the overall performance of the retail sector.

III. **Statutory Reviews**

During the week, the Landlord and Tenant Bill of 2021 was tabled in Parliament with the aim of consolidating the laws relating to the renting of business and residential premises and regulating the relationship between the landlord and tenant in order to promote stability in the rental sector. The key take-outs from the Bill include;

- The jurisdiction of the tribunals moved from the ambit of the Minister or the Cabinet Secretary to the Chief Justice,
- Tribunals established under the Bill granted the power to enforce decrees, issue injunctive orders and execute orders in the same manner as the courts and punish for contempt in the same manner as any court of law,
- All disputes to be determined within three months to eliminate the huge backlogs currently being faced by the tribunals,
- Protection of tenants by requiring landlords to get orders from the tribunal before levying distress,
- Protection of landlords through reduction of notice period for terminating tenancy from 12 months to 60 days when the landlord requires the premises for personal use, right of a tenant to recover security deposit only after having restored the premises to the condition it was in at the time when the tenancy commenced, and the tenant having settled all utility bills, among others,
- Permits an inspector or other officer of a tribunal to institute criminal proceedings where offences under the Bill have been committed, and,
- Institution of increased penalties including; Failure to comply with lawful order of a tribunal has the fine increased to Kshs 100,000 and prison term to 12 months, or both, depriving tenant of service has the fine increased to Kshs 10,000 and prison term to six months or both, not keeping

rent records has the fine increased to one month's rent of the premises, and, subjecting tenant to annoyance has the fine increased to two months' rent of the premises

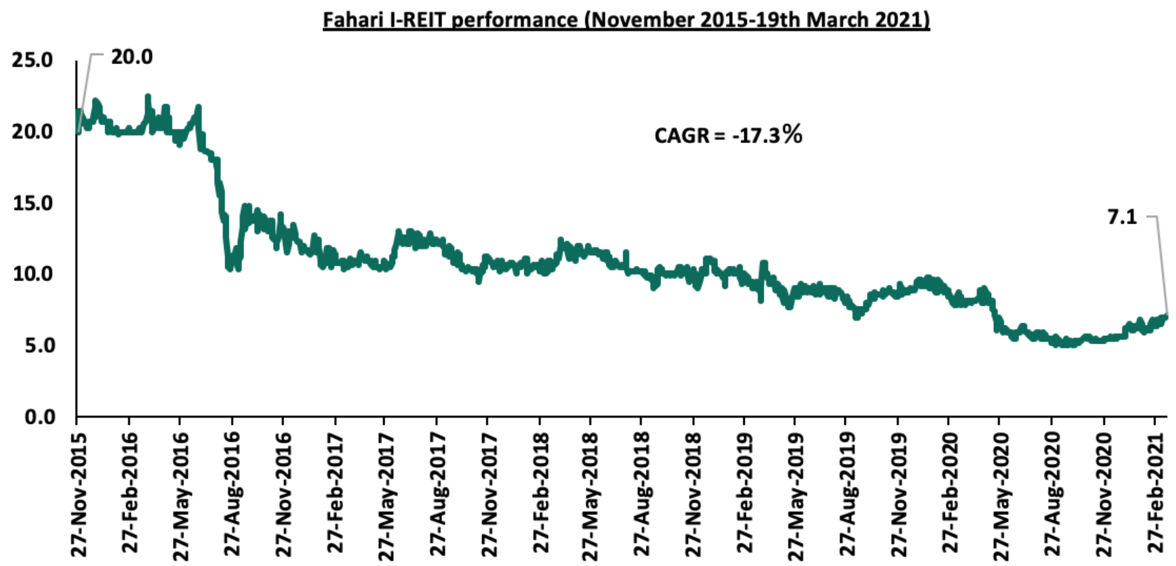
We expect the above provision to help in resolving landlord- tenant disputes by protecting both parties as widening of the mandate of the tribunal aims to protect tenants from landlords but creates some return challenges for the landlords especially if the houses have loans that one is servicing.

IV. **Listed Real Estate**

ILAM Fahari I-REIT released their FY'2020 earnings registering a 15.5% decline in earnings per unit to Kshs 0.82 in FY'2020 from Kshs 0.97 in FY'2019, driven by an 8.4% decline in total operating income to Kshs 347.5 mn, from Kshs 379.2 mn in FY'2019. Rental income declined by 0.9% to Kshs 341.2 mn, from Kshs 344.3 mn in FY'2019. Notably, the decline was mainly 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. Distributable earnings declined by 6.7% to Kshs 134.4 mn, from Kshs 144.0 mn in FY'2019. The fund manager attributed the decline to the higher property expenses arising from a significant provision for bad debts as a result of non-performance of the anchor tenant at Greenspan Mall. This was partially offset by a reduction in fund operating expenses after the REIT Manager temporarily reduced their fees by 10.0% to cushion the investors during a particularly difficult year. The REIT recommended a Kshs 108.6 mn dividend distribution to its unitholders at Kshs 0.60 per unit. At the current price of Kshs 7.0, this translated to a dividend yield of 10.7%.

For a more comprehensive analysis, please see our ILAM Fahari I-REIT FY'2020 Earnings Note.

On the bourse, the Fahari I-REIT is currently trading at an average of Kshs 6.4 per share on a YTD basis, representing a 28.1% decrease compared to the same period under review in 2020 trading at an average Kshs 8.9. Since inception, the instrument has recorded a decline of 64.5% from Kshs 20.0 in November 2015 to Kshs 7.0 as at 19th March 2020



Our outlook for listed real estate is neutral with a bias to negative, attributed to continued lack of investor appetite in the instrument due to negative investor sentiments and negative performance of the office and retail sectors, coupled with low trading prices. However, we are of the view that some effort is being put by institutions such as Acorn to boost the REIT market having announced plans to launch a D-REIT and I-REIT in the next 3 years.

The real estate sector is expected to record improved performance supported by provision of relatively affordable mortgage facilities by KMRC with the aim of increasing home ownership and the expansion of international retail chains.