Real Estate Bubble, & Cytonn weekly #28/2021

Focus of the Week

In the beginning of 2020, we set out to address the speculation that the Kenyan market was experiencing a real estate bubble through a topical Is There a Real Estate Bubble in Kenya? We determined that there was no real estate bubble in Kenya since the market was still constrained by issues such as i) unavailability and unaffordability of credit , ii) tight credit underwriting standards from high number of non-performing loans, iii) low accessibility to mortgage financing, and, iv) slow provision of affordable housing. Thus, the sector was just experiencing the normal real estate cycles and the rapid price increments was as a result of low supply and high demand, and vice versa in select sectors. This week, we again seek to address the same concerns on whether the Kenyan market has experienced a real estate bubble through a topical as outlined below;

?. Introduction to real estate bubble
i. Is there real estate bubble in Kenya?
ii. Case Study of the 2007-2008 real estate bubble in the United States of America (USA)
iii. Recommendations to the government
iv. Conclusion:

SECTION I: Introduction to Real Estate Bubble

A real estate bubble is an increase in property prices in the market owed to increased demand against limited supply, and an eventual slump in the demand for the properties in what is called a 'burst'. This demand is usually due to increased investors need to place huge funds in the real estate sector, majorly borrowed funds, based on speculation that the rising prices will keep on rising with hope of generating high returns.

As at Q3'2020 real estate and construction's contribution to GDP stood at 16.0%, 0.9% points increase compared to 15.1% recorded in Q2'2020 according to Kenya National Bureau of Statistics. Prices of residential units have been rising with our Cytonn H1'2021 Markets Review showing that residential market average y/y price appreciation in H1'2021 came in at 0.6%, a 0.8 % points increase from the 0.2% average depreciation recorded FY'2020. Average prices per SQM increased to Kshs 117,873 in H1'2021 from Kshs 116,774 in FY'2020 despite real estate being was one of the hard hit sectors by COVID-19 pandemic and many would have expected price corrections. Investors are therefore contemplating whether these prices will keep rising in the future and if there is a possibility that we are, or could be headed into a real estate bubble in the country.

a). Main Features of a Real Estate Bubble

i. **Inflated Property Prices**: A house bubble is characterized by inflated prices which are higher than mortgage valuations making it hard for investors to meet their contractual debt obligations with credit suppliers,
ii. **Increased Uptake of Debt**: One of the major characteristic of a real estate bubble is an increase

in the uptake of loans and more debt supported by availability of cheaper credit, in order to buy more property for speculation, and ,

iii. **Increase in Property Demand**: Increase in property demand is brought about by speculation of rising prices and easy availability of funds from lenders. These prices rise to levels unaffordable by the general public as investors compete to put funds in the few real estate products available in the market.

b) Causes of Real Estate Bubble

i. **Wider Mortgage Offerings:** Property bubbles are usually caused by availability of affordable mortgages by the lending institutions which are then placed in property investments with hopes of higher and higher returns,
ii. **Access to cheaper Credit:** Easier access to credit loans with low underwriting standards and the lenders relaxing caution in terms of collaterals and risk assessment measures, this coupled with low interest rates leads to rapid increase in loan uptake which attracts and facilitates increase in demand for property causing property bubble,
iii. **Economic Prosperity:** General rise in economic activities and increased prosperity in a country causes increased purchasing power of people, and the subsequent need to invest hence high demand and affordability for property causing a boom,
iv. **Bullish Speculations for Real Estate Property Market:** Real estate bubbles are caused by investor speculations that rising prices will continue to rise causing investors to borrow and invest in the properties market with the hope of higher returns leading to them taking debts and placing funds into real estate investments thereby increasing demand beyond supply and the subsequent extra ordinary rise in prices, and,
v. **Increase in Housing Demand:** Property bubble also occurs when there is an overall genuine increase in demand for housing units against limited supply in a country, majorly from investor speculation that the rising prices will be sustained and the affordability from access to credit or economic upturn.

c) Effects of Real Estate Bubble on an Economy

i. **Decreased Homeownership Rates:** Astonishing increased prices for properties owed to a property bubble results to decreased home ownership rates in the country due to lack of affordability, especially among the low and lower-middle income earners,
ii. **Declined Property Development Activities:** Property boom eventually results to oversupply of the properties in the market thus leading to an overall decline of developments activities in a country as investors seek to dispose available property,
iii. **Reduced Property Investment Returns:** The aftermath of a property boom in the market is the bubble burst which causes huge price corrections of existing properties in an upward scale resulting to an overall demand decline as well as decline of the investment returns, and,
iv. **Poor Mortgage and Credit Sector Performance:** Real estate bubble also causes an increased uptake of credit loans and mortgages to finance developments after which the bubble bursts, leading to high number of non-performing loans from the inability to finance debt obligations causing poor mortgage and credit performance.

SECTION II. Is There a Real Estate Bubble in Kenya?

The Kenyan real estate market is not experiencing a real estate bubble but the rise in prices is attributable to rise in demand from economic fundamentals characterized by;

i. **Increasing Population:** Kenyan population has increased from 38.6 mn in 2009 to 47.6 mn in 2019 as evidenced by the Kenya National Bureau of Statistics Census Report 2019 with World Bank's population and urbanization growth rates estimated at 2.6% and 4.4% respectively with an expanding middle class with extra disposable income hence increasing real demand for property unlike in a bubble where demand is fueled by speculation which is usually short term holding expecting to resell at higher prices,

ii. **Growth in the Economy:** According to the Kenya National Bureau of Statistics-Quarterly Gross Domestic Product Report economic performance in Q3'2020 remained depressed but relatively better compared to Q2'2020 with real GDP is estimated to have contracted by 1.1% in the quarter compared to 5.5% contraction in Q2'2020 which shows that the country is on a path to economic recovery.,
iii. **Low Credit Supply:** The Central Bank of Kenya Central Bank of Kenya-Quarterly Economic Review October-December 2020 indicated that the real estate sector recorded a 6.4% increase in the gross non-performing loans in Q4'2020 to Kshs 61.4bn from Kshs 57.7bn in Q3'2020. Lenders are expected to exercise a more conservative underwriting approach as a strategy to cushion themselves against the pandemic which is marked by high loan default rates.Mortgage uptakes has remained relatively low with the number of mortgage accounts at 27,993 as at 2019 compared to an adult population of 26.0 mn according to 2019 Kenya National Population and Housing Census,
iv. **High Demand for Housing:** This is evidenced by Housing Finance Africa-Kenyan Report, which highlighted that Kenya has a housing deficit of 2.0 mn units which is expected to grow by 200,000 units annually with the government expected to provide approximately 50,000 units per year with only 2.0% of these being for the low income against an annual demand of 250,000 units. According to the report, despite 83.0% of the total employment being in the informal section, this portion lacks access to mortgage due to insufficient credit risk information for meeting criteria set in the mortgage products, and,
v. **House Price Increase in Tandem with Increase in Income Levels:** This is supported by the KNBS Economic Survey 2020 showing increase in nominal wages in both the public and private sector from Kshs 2.0 tn to Kshs 2.3 tn from 2018 to 2019 representing a 13.4% y/y increase which is higher than apartments' price appreciation which was at 0.6% in H1'2021 as evidenced by our Cytonn H1'2021 Markets Review. This indicates that there is still room for property prices to grow in order to match population's income.

SECTION III: Real Estate Bubble during the 2007-2008 United States of America (USA) Financial Crisis

Case study

The real estate bubble during the 2007 -2008 financial crisis stemmed from an expansion of mortgage credit in the United States of America. This came after the Federal Reserve continuously lowered the Federal Funds rate from 6.5% in May 2001 to 1.0% in June 2003. This was a move that was aimed at boosting the American economy which had earlier taken several hits including the bursting of the dot-com bubble involving excessive bullish speculation on the internet related companies in the late 1990s, a series of corporate accounting scandals and the September 11th 2001 terrorist attacks.

a) The Events Leading to the Pre-housing Crash in the United State of America (USA)

The reduction of the Federal Funds Rate led to an increase in mortgage uptake from both credit worthy and un-credit worthy individuals. This resulted in individuals with below average credit scores having access to mortgages, a situation that was not possible in the past unless such individuals were protected by government insurance. This increase in access to mortgages led to an upward spiral in home prices as mortgage borrowers took advantage of the low interest rates to buy homes, resulting in a real estate bubble. Meanwhile, banks sold these mortgage loans to banks in Wall Street which repackaged them into financial instruments such as Mortgage-Backed Securities (MBS) and Collateralized Debt Obligations (CDOs). This led to the emergence of a big secondary market for origination and distributing subprime mortgage loans.

By the year 2004, U.S. homeownership was at its peak at 69.2% according to the USA Census Bureau, the highest home ownership rate ever recorded in American history. As housing prices were rising rapidly and the number of subprime mortgages given out was rising even faster, the Federal Reserve raised the interest rate in an attempt to slow this down and avoid serious inflation. Eventually, interest rates started to rise with the Federal Reserve beginning to raise rates in June 2004, and two years later the Federal funds rate had reached 5.3%, where it remained until August 2007. Then during early 2006, the housing bubble burst as more people defaulted on their mortgage payments and home prices began falling rapidly.

This caused real hardship to many Americans especially the un-creditworthy individuals with mortgages, their homes became worth less than they paid for them due to the crash in prices in the housing sector. These individuals could not sell their houses to pay back their lenders as they wouldn't be able to recover enough from the sale. As for those that had adjustable-rate mortgages, their costs were going up due to the rise in interest rates as the values of their homes were going down. As 2007 got underway, one subprime lender after another filed for bankruptcy with more than 25 subprime lenders going under between February and March of the same year. This was the consequence that subprime lenders had to face for lending to individuals who could not afford mortgages. These series of events led to a severe worldwide economic crisis that was considered by many economists to have been the most serious financial crisis since the Great Depression in the 1930s.

b) The Path to Recovery

The United States of America would then implement measures on the path to economic recovery including;

i. The Troubled Asset Relief Program in October 2008, with much of the funds targeting troubled banks which were at a risk of collapse from the high non-performing loans and the low reserves to warrant operations,
ii. The Recovery and Reinvestment Act implemented in February 2009, aimed at stimulating the economy by providing funding to the energy and infrastructural projects in an aim to retain and hire new staff. This helped to jumpstart the employment sector that had been hard hit by an economic recession to enable contractual debt repayments especially for mortgages as well as compensate for a slowdown that was being experienced in the private sector that year , and,
iii. Payroll tax cuts which provided for temporal tax cuts to most households with a 2.0% reduction in payroll tax rates for workers in an aim to fiscally support the economy through increased income.

c) Lessons Kenya Can Derive from the Success and Failures of the United States of America (USA) Real Estate Bubble

i. **Proper Risk Assessment of Borrowers Before Giving Loans:** During the USA financial crisis, borrowers with poor credit scores were allowed to take out mortgages that they could not afford; these are known as subprime mortgages. As the interest rates had been earlier significantly lowered by the Federal Reserve, lenders assumed that even un-credit worthy individuals would be able to afford home loans. When the interest rates were later increased in order to avoid serious inflation, subprime borrowers could no longer afford to service their loans leading to their houses being sold off or auctioned by the lenders in order to recover the borrowed amount. This led to an excessive supply of houses in the market that caused the bubble to burst. Lending institutions in Kenya should therefore conduct proper risk assessments to ascertain credit worthiness of clients before warranting loans to reduce the value of real estate non-performing loans which expose the banks to collapse,
ii. **Proper Regulation and Monitoring of Financial Institutions:** A major reason for the occurrence of the real estate bubble in the United States of America was the inadequate regulation of financial institutions in regards to transparency and conflict of interest in financial

institutions. Credit rating agencies that graded subprime mortgages as 'investment grade' securities may have been incentivized to provide this erroneous rating due to a conflict of interest arising from them rating the issuers of the securities who paid them to conduct the rating. Regulatory authorities in Kenya such as the Central Bank of Kenya (CBK) should ensure that conflicts of interests are made known through transparent processes and addressed in order to protect investors and the economy from the consequences of such,

iii. **Strict Penalties to Firms that Engage in Industry Malpractices and Moral Hazards:** American banks gave out subprime mortgages which they sold to banks in Wall Street at a profit. Many of these mortgages were risky loans given to un-credit worthy individuals and therefore the banks did not want to keep them in their balance sheet and sold them off in order to transfer the risk to other parties. This is a case of moral hazard and industry malpractice and resulted to a lot unsecured loans. Kenya's regulatory bodies should keep a keen eye on financial institutions to ensure ethical and lawful practices among parties and place penalties to the unlawful in order to discourage malpractices, and,
iv. **Careful and Regular Monitoring of the Economic Policies:** The US Federal Funds Rate was lowered from 6.5% in May 2001 to 1.0% in June 2003 in order to spur economic growth. This continuous lowering of the interest rate triggered the real estate bubble as borrowers were taking a high number of mortgage loans. The Federal Reserve kept on lowering the rate for 2 years with members of the Federal Open Market Committee underestimating the risk that a financial meltdown could occur in the economy. Kenya's Monetary Policy Committee (MPC) should therefore take utmost care to regularly monitor the economic implications of altering the Central Bank Rate to allow a balance between credit risk and the need to spur economic growth through debt.

SECTION IV: Recommendations to the Government

From above it is clear that the real estate sector is not in a bubble but is experiencing normal sector cycles of in line with the economic cycles. The rise in prices is thus supported by fundamental factors such as rising demand and economic growth, creating a balance between demand and supply and not speculation. Mortgage access also remains low given the high adult population. However, to prevent a real estate bubble in the future we recommend below measures;

i. **Enforcing Collaterals:** A real estate bubble is followed by a burst that causes a reduction in prices below investors buying price, making them unable to meet their debt obligations with the banks, exposing the banking sector to possible collapse. For these reasons, it is important to ensure that collateral is enforced in the banking system and that risk evaluation procedures for mortgage issuance are more thorough in order to guard the banking sector and other mortgage offering institutions from the effects of a real estate bubble burst,
ii. **Economic Growth Support Policies:** The government should look into supporting policies that enhance economic growth so that citizens are economically empowered with more disposable income such that they rely on savings to own homes other than loans from banks and other financial institutions,
iii. **Public-Private Partnerships:** In the case of rising housing demand in some areas, one which is unable to be meet by the existing supply, the government of Kenya may partner with the private sector through funding, subsidies, tax exempts, relaxation of zoning regulations so that construction is easier and faster to ensure that the available demand is met, and avoid unsustainable property prices brought about by excessive demand, and,
iv. **Provision of Affordable Housing:** The government should look to keep supporting affordable housing informal settlement upgrading programs through budgetary allocations and support policies to ensure that lower-middle and low middle income earners become home owners without having to go through the mortgage debt process, which when no so thorough in assessment, may leave the banking sector exposed to high non-performing loans and possible collapse.

SECTION V: Conclusion

From the research, we therefore conclude that there is no real estate bubble in Kenya as the market is constrained by low mortgage credit from relatively high interest rates, tightened underwriting standards and inaccessibility to mortgage financing especially for the informal employment sector, and thus there lacks a possibility of un-sustained demand that is likely to exceed current supply.

The sector is thus in the normal real estate cycles with the rapid rise and fall of prices attributable to interactions of forces of demand and supply in the market. For long term investors and as evidenced our Cytonn H1'2021 Markets Review opportunities lie in the different sectors as below;

The Key Areas of Opportunities by Theme in the Real Estate Sector

Sector	Themes	Locations	Reasons
Residential Sector	**High-End (Detached)**	Kitisuru and Rosslyn	Annual returns at 6.5% and 5.5% respectively, against the high-end market average of 4.8% For speculative buyers, Lower Kabete recorded the highest annual uptake at 16.0% against a market average of 13.6%
	Upper Mid-End (Detached)	Redhill and Sigona, Ridgeways, Runda Mumwe and Loresho	Highest total average returns at 6.5% for Redhill and Sigona and 6.3% for the rest against a market average of 5.8% The areas have relatively low supply of residential units
	Low-End (Detached)	Ruiru and Syokimau/Mlolongo	Highest total average returns at 6.6% and 6.5% against a market average of 5.5% coupled with availability and affordability of land
	Upper Mid-End (Apartments)	Parklands and Kilimani	Parklands recorded the highest total average annual returns at 7.6% against the segment's market average of 5.7% while Kilimani recorded the highest annual uptake at 23.0% which is 7.7% points higher than the sector's average
	Lower Mid-End Suburbs (Apartments)	Waiyaki Way	Highest total average returns at 8.1% against a market average of 6.2% and the highest price appreciation at 2.5% against the sector's average of 0.9%
	Lower Mid-End Satellite Towns (Apartments)	Ruaka	Highest average total returns at 8.1% with the highest y/y price appreciation at 2.0%, 1.7% points higher than the market average of 0.3%
Commercial Office	**Grade A Offices**	Gigiri and Karen	Rental yields of 8.2% and 7.9%, respectively, against a market average of 6.9% and relatively good infrastructure, and low supply
Retail Sector	**High End Malls**	Westlands and Karen	Highest average rental yields of 9.7% and 9.5% respectively, compared to the overall market average of 7.6% attributable affluent residents who have a high consumer purchasing power and highest occupancy rates
Mixed- Use Developments (2020)	**Combined Themes**	Westlands, Limuru Road and Karen	Westlands was the best performing node recording an average MUD yield at 8.5% followed by Limuru Road and Karen at 7.3%
Hospitality Sector (2020)	**Serviced Apartments**	Westlands and Parklands	Westlands and Parklands was the best performing node recording an average rental yield of 6.1%, 2.1% points higher than the market average with studios being the best performing typology
Land	**High Rise Areas**	Embakasi	Embakasi was the best performing node at 6.5% mainly attributable to affordability of land prices averaging at Kshs 67.2mn mn compared to a high rise average of Kshs 132.7 mn
	Low Rise Areas (Unserviced)	Kitisuru	Annualized capital appreciation of 6.7% attributed to growing demand for land to develop and availability of good infrastructure allowing ease of access to the area.
	Satellite Towns (Unserviced)	Juja	An annualized capital appreciation of 5.5% attributed to affordability with the asking prices coming in at an average of Kshs 10.6 mn per acre compared to an average of Kshs 13.5 mn for satellite towns
	Satellite Towns (Serviced)	Ongata Rongai	An annualized capital appreciation of 8.1% compared to the satellite towns average of 2.9%

Source: Cytonn Research

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Liason House, StateHouse Avenue
The Chancery, Valley Road
www.cytonn.com