Cytonn INVESTMENTS

Nairobi Commercial Office Report 2017, & Cytonn Weekly #16-2017

Cytonn Weekly

Executive Summary

Fixed Income: The level of T-bill subscription remains high, with overall subscription coming in at 166.7% compared to 117.3% recorded the previous week. The 182-day paper was not on offer for the 7th week in a row, as the government aims to spread maturity concentration risk across the three papers. Kenya National Bureau of Statistics (KNBS) released the 2017 economic survey report, indicating that GDP growth for 2016 came in at 5.8%, which is in line with our expectations of a 5.7% - 6.0% growth. We are projecting inflation for the month of April to increase to between 10.7% - 11.0%, from 10.3% in March, with the increase being driven by a rise in food prices;

Equities: During the week, the equities market recorded mixed trends with NSE 20 gaining 0.8%, while NASI and NSE 25 declined by 1.2% and 0.5%, respectively. The Communications Authority of Kenya (CA) reported in its FY?2015/16 report that the three mobile operators, Safaricom, Airtel, and Telkom Kenya, failed to meet the quality standards of voice services, with their overall performance on indicators such as speech quality, completed calls, call success rate and drop rate for the year to June 2016 coming in at 50.0%, lower than the regulator?s requirement of 80.0%;

Private Equity: Activity in the private equity space in Africa continues to gain traction based on fundraising and investment activities witnessed during the week as: (i) Naspers plans to inject more capital into Takealot Online, which will make it a majority shareholder with a 53.5% stake, (ii) IFC is set to make a capital commitment of USD 25.0 mn into Leap Frog?s Emerging Consumer Fund III, and (iii) AfricInvest has launched its second-generation financial sector fund targeting to raise USD 211.5 mn;

Real Estate: The real estate sector expanded by 8.8% in 2016, compared to 7.2% in 2015, driven mainly by increased investments into the sector and government incentives aimed at boosting real estate development, while the hospitality sector grew by 13.3%, supported by the recovery of the tourism sector;

Focus of the Week: This week we focus on the office market in Nairobi. We cover the supply over time, the performance in terms of rents, yields and occupancy rates by nodes and by grades in 2016, the opportunity in the sector and conclude by giving an outlook for 2017 for the theme. According to the report, increased supply has constrained performance, with occupancy rates and prices declining, as rents and yields flat lined and hence the market is in transition to a buyers? market. Despite this, pockets of value for investors exist in markets with low supply, differentiated office concepts such as green buildings, smart offices and serviced offices;

Company Updates

- We continue to diversify our real estate portfolio, aimed at providing housing across the Nairobi Metropolitan Area, with a purchase this week of a two-acre prime piece of land at Lower Kabete for the development of a comprehensive lifestyle apartment community. Commenting on the development, Elizabeth Nkukuu, CFA, Chief Investment Officer and Head of Real Estate said, ?this diversifies our apartment community developments beyond Ruaka, where we have The Alma and Taraji Heights, and Ridgeways, where we have The Ridge, to a new neighborhood in need of our unique comprehensive apartment community. Our plan is to increase lifestyle apartment developments from the current 4 to 10.?
- On Thursday 20th April, Cytonn Investments held an award ceremony for its top Independent Financial Advisors (IFAs), at the Sarova Panafric Hotel. The forum also served as a training to boost their capacity in a dynamic alternative investments market. See Event Note. To join our Independent Financial Advisor network, kindly email IFA@cytonn.com
- Our Investments Manager, Maurice Oduor, was on Citizen TV to discuss reservations expressed by IMF on capping of interest rates. Watch Maurice on Citizen TV here
- We continually showcase real estate developments by our real estate development affiliate, Cytonn Real Estate, through weekly site visits. The site visits target both investors looking to invest in real estate directly, and also those interested in high yield investment products to familiarize themselves with how we support the high yield returns. If interested in attending the site visits, kindly register here
- We continue to see very strong interest in our Private Wealth Management training, which is at no cost, and is held bi-weekly, but is open only to pre-screened participants. To register for the training kindly use this link
- For recent news about the company, see our news section here
- We have 12 investment-ready projects, offering attractive development and buyer targeted returns of around 25.0% p.a. See further details here: Summary of investment-ready projects
- We are inviting proposals from eligible candidates for services required in the structuring and issuance of Kshs 5.0 bn real estate medium term notes via a contemplated public offer to provide the following services; (i) lead transaction services, (ii) note trustee services, and (iii) tax consultancy. For more details, see here
- To invest in any of our current or upcoming real estate projects, please visit Cytonn Real Estate
    - The Alma, which is over 56.0% sold, has delivered an annualized return of 55.0% p.a. for investors who bought off-plan. See The Alma
    - Amara Ridge is currently 100.0% sold and has delivered 33.0% p.a. returns to investors. See Amara Ridge
    - The Ridge Phase One is currently 20.0% sold and has delivered an average return of 29.5% for investors who bought off plan. See The Ridge
    - Taraji Heights is currently 10.0% sold. See Taraji Heights
- Following the completion of sales for Amara Ridge, we are currently looking for land in Karen for our next development. We are also looking for 3-10 acres of land in Garden Estate, Muthaiga North, South C and Lang?ata. Contact us at rdo@cytonn.com if you have any land for sale or joint ventures in the above areas
- We continue to beef up the team with the ongoing hires: Careers at Cytonn

Fixed Income

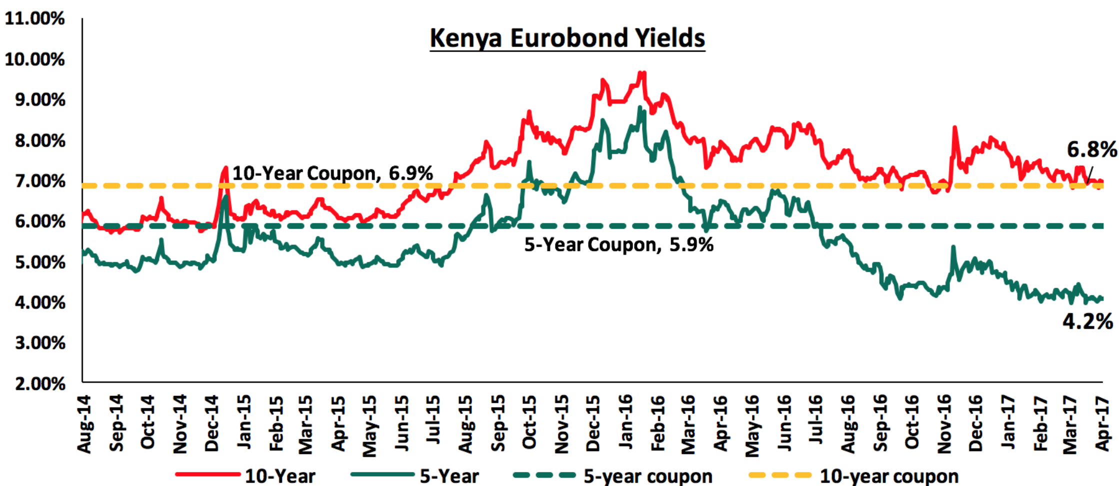
T-bills were oversubscribed for the 12th consecutive week, with the overall subscription rate coming in at 166.7%, compared to 117.3% the previous week. The 182-day paper was not on auction for the 7th week in a row, a move aimed at managing maturity concentration by spreading risk across the three papers. Subscription rates for the 91 and 364-day papers came in at 136.7% and 196.6%, compared to 127.5% and 107.1% the previous week, respectively. Yields on the 91 and 364-day

papers remained unchanged at 8.8% and 10.9%, respectively.

Recently, there has been an upward pressure on interest rates as investors continue to demand higher yields, given the high inflation rate, currently at 10.3%. The 91-day T-bill has been the main focus, as it currently offers a negative real return of 1.5%. However, the government has continued to remain disciplined by rejecting bids that are above market, as indicated by the current low acceptance rate for the 91-day paper at 48.8%, with the 364-day paper at 98.8%, compared to 100.0% for the 91-day and 87.1% for the 364-day paper witnessed at the beginning of January.

Last week, the Kenyan Government re-opened two bonds (FXD 3/2008/10 and FXD 1/2009/10), with effective tenors of 1.4 and 2.0 years, respectively, and a coupon of 10.8% for both, in a bid to raise Kshs 30.0 bn for budgetary support. Yields on the bonds came in at 11.3% and 12.0%, below our recommended bidding range of between 12.1% - 12.6%, and 12.6% - 13.1% for the 1.4-year and the 2.0-year, respectively. The bonds were oversubscribed, with a performance rate coming in at 164.6%, attracting Kshs 49.4 bn. Given that the market weighted average rates came in at 11.5% and 12.2%, respectively, above the accepted rate of 11.3% and 12.0%, respectively, it is clear from this auction the government did not accept expensive bids, having only accepted Kshs 32.8 bn out of the Kshs 49.4 bn worth of bids received, translating to an acceptance rate of 66.3%. However, as indicated previously, despite the discipline demonstrated by the Central Bank, there exists possible upward pressure on interest rates since (i) the government has only borrowed Kshs 205.8 bn, of the budgeted foreign borrowing, representing 44.5% of its foreign borrowing target of Kshs 462.3 bn and the balance is most likely to be plugged by borrowing from the domestic market, and (ii) the Kenya Revenue Authority (KRA) has already missed its first half of 2016/17 fiscal year revenue collection target by 3.2%. It is important to note that the government is also behind its spending target, with total expenditure for the first half of the 2016/17 fiscal year coming in at Kshs 928.5 bn, which represents 83.6% of the pro-rated target of Kshs 1.1 tn. However, given that the government has historically exceeded the absorption rate on recurrent expenditure, which was at 92.5% in the first half of the 2016/17 fiscal year, this may trigger increased domestic borrowing to meet expenditure requirements.

According to Bloomberg, the yields on the 5-year and 10-year Eurobonds, with 2.2 years and 7.2 years to maturity, remained relatively flat, closing the week at 4.2% and 6.8%, respectively. Since the mid-January 2016 peak, yields on the Kenya Eurobonds have declined by 4.6% points and 2.8% points, respectively, for the 5-year and 10-year bonds due to improving macroeconomic conditions. The declining Eurobond yields and Standard & Poor?s (S&P) having maintained Kenya?s foreign and local currency sovereign credit ratings for the short and long term at ?B+/B?, respectively, are an indication that Kenya remains a stable and hence attractive investment destination.



The Kenya Shilling remained relatively flat against the dollar during the week to close at Kshs 103.3, from Kshs 103.4 recorded the previous week, on account of diaspora remittances offsetting dollar

demand from oil importers. On a year to date basis, the shilling has depreciated against the dollar by 0.8%. The forex reserve level currently stands at USD 8.0 bn (equivalent to 5.3 months import cover) from USD 7.0 bn (equivalent to 4.6 months import cover) recorded on 17th March 2017, largely as a result of the receipt of the Kshs 82.3 bn syndicated loan. Going forward, we expect the shilling to come under pressure from (i) global strengthening of the dollar due to the expected series of rate hikes by The Federal Reserve during the year, and (ii) recovery of global oil prices. However, with the current forex reserve level, we believe the CBK will be able to support the shilling in the short term.

We are projecting inflation for the month of April to rise to between 10.7% - 11.0%, from 10.3% in March, driven mainly by a rise in food prices caused by the ongoing drought. Going forward, we expect upward inflationary pressures to persist, driven by (i) the food component of the Consumer Price Index (CPI) basket due to the persistent dry weather that is expected to carry on for the first half of the year, with depressed rainfall in the long rains season that comes in between March and May, (ii) the global recovery of oil prices, which will lead to cost-push inflation, and (iii) the global strengthening of the dollar increasing the cost of imports, as it results in a weaker shilling. We expect upward inflationary pressures to persist in the first half of 2017, and average above the upper bound of the government target range of 2.5% - 7.5%.

This week, the Kenya National Bureau of Statistics (KNBS) released the 2017 Economic Survey, with GDP growth for 2016 coming in at 5.8%, up from 5.7% in 2015, in line with our projection of a 5.7% - 6.0% growth. Growth in the fourth quarter of the year was hampered by the drought that took a toll on agriculture and electricity supply, whereas accommodation and food service registered the biggest improvement, growing at 13.3% in 2016, from a decline in growth of 1.3% in 2015, in line with our outlook of a recovering tourism sector. Agriculture experienced subdued growth of 4.0% in 2016, from 5.5% in 2015, with the slow-down attributable to unfavorable weather conditions on account of depressed rainfall in the second half of the year. Real Estate, meanwhile, registered an 8.8% growth in 2016, up from 7.2% in 2015, highlighting the increased confidence and growth in the sector. For a more comprehensive analysis on the economic growth review, see Kenya 2016 GDP Growth and Outlook.

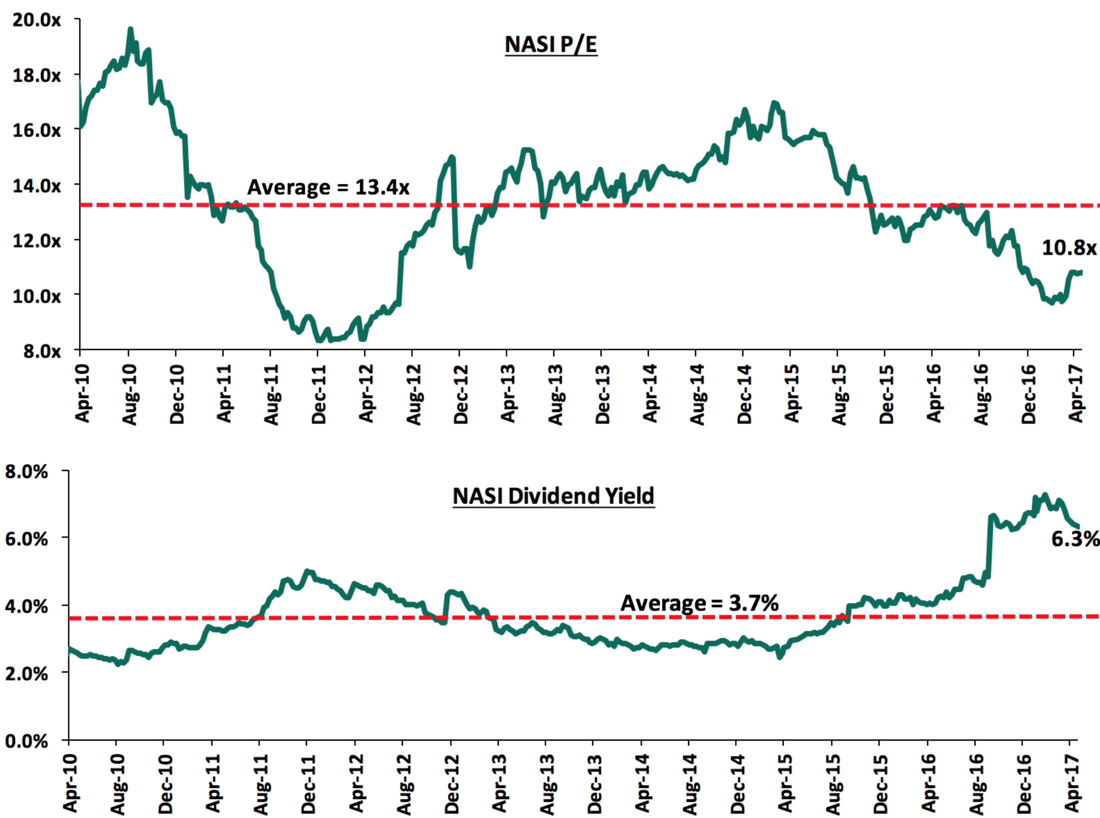
The rates on the fixed income front have remained stable, despite indication of possible upward pressure on interest rates. The Government is ahead of its domestic borrowing for the current fiscal year, having borrowed Kshs 274.4 bn against a target of Kshs 181.9 bn (assuming a pro-rated borrowing throughout the financial year of Kshs 229.6 bn budgeted for the full financial year). The government has only borrowed Kshs 205.8 bn, of the budgeted foreign borrowing, representing 44.5% of its foreign borrowing target of Kshs 462.3 bn, and the Kenya Revenue Authority (KRA) has already missed its first half of 2016/17 fiscal year revenue collection target by 3.2%, and it is expected to miss its overall revenue collection target of Kshs 1.5 tn for the current fiscal year. It is important to note that the government is also behind its spending target, with total expenditure for the first half of the 2016/17 fiscal year coming in at Kshs 928.5 bn, which represents 83.6% of the pro-rated target of Kshs 1.1 tn. However, given that the government has historically exceeded the absorption rate on recurrent expenditure, which was at 92.5% in the first half of the 2016/17 fiscal year, this may trigger increased borrowing to meet expenditure requirements. This creates uncertainty in the interest rate environment as domestic borrowing may exert an upward pressure on interest rates, and result in longer term papers not offering investors the best returns on a risk-adjusted basis. It is due to this that we think it is prudent for investors to be biased towards short-term fixed income instruments.

Equities

During the week, the equities market recorded mixed trends with NSE 20 gaining 0.8%, while NASI and NSE 25 declined by 1.2% and 0.5%, respectively, taking their YTD performances to (1.8%), 0.1% and 0.1% for NSE 20, NASI and NSE 25, respectively. This week?s performance was driven by gains in large cap stocks such as KCB Group and Barclays, which gained 3.0% and 1.9%, respectively, while BAT (K), Kenya Re and Safaricom declined by 9.3%, 6.6% and 2.3%, respectively. Since the February 2015 peak, the market has lost 43.1% and 24.8% for NSE 20 and NASI, respectively.

Equities turnover decreased by 19.0% to close the week at USD 25.2 mn from USD 31.1 mn, the previous week. Foreign investors remained net buyers with a net inflow of USD 4.0 mn, a 301.7% increase from a net inflow of USD 1.0 mn recorded the previous week, with foreign investor participation decreasing to 69.5%, from 88.1% recorded the previous week. Safaricom and KCB remained the top movers for the week, jointly accounting for 49.0% of market activity. We expect the Kenyan equities market to be flat in 2017, driven by slower growth in corporate earnings, neutral investor sentiment mainly due to the forthcoming general elections, and the aggressive rate hike cycle in the US, which may reduce the level of foreign investors? participation in the local equities market.

The market is currently trading at a price to earnings ratio of 10.8x, compared to a historical average of 13.4x, and a dividend yield of 6.3%, compared to a historical average of 3.7%. The current 10.8x valuation is 11.2% above the most recent trough valuation of 9.7x experienced in the first week of February of 2017 and 29.8% above the previous trough valuation of 8.3x experienced in December of 2011. The charts below indicate the historical P/E and dividend yields of the market.



In a recent report by the Communications Authority of Kenya (CA) on quality standards in Kenya?s telecommunications industry, Safaricom, Airtel and Telkom Kenya failed to meet the quality standards of voice services, with their overall performance for the year to June 2016 coming in at 50.0%, lower than 62.5% recorded in FY?2014/15, and the regulator?s requirement of an 80.0% score on indicators such as speech quality, completed calls, call success rate and drop rate. Below is a summary of the performance of the three companies under various metrics.

Key Performance Indicator	Airtel Networks		Telkom Kenya		Safaricom		Status
	2014/15	2015/16	2014/15	2015/16	2014/15	2015/16	
Call set up time (in seconds)	5.3	5.6	7.8	7.4	6.0	6.9	Compliant
Call set up success rate	91.1%	94.0%	85.6%	93.3%	90.7%	92.7%	Not Compliant
Call drop rate	1.5%	2.3%	1.9%	2.2%	2.0%	6.5%	Not Compliant
Speech Quality	3.1	3.2	3.4	3.5	3.5	3.4	Compliant
Block Rate	8.9%	6.1%	14.5%	6.9%	9.3%	7.4%	Not Compliant
Call completion rate	89.6%	91.5%	83.6%	90.8%	88.8%	85.6%	Not Compliant
Received signal level (dBm)	(75.7)	(76.7)	(71.1)	(72.5)	(70.5)	(79.4)	Compliant
Call handover rate	98.2%	97.5%	95.8%	96.6%	97.3%	97.2%	Compliant

The CA levies a fine equal to 0.1% of the gross annual revenue of a telecom firm for failing to meet these quality standards, with Safaricom, the largest operator in the industry, likely to bear the heaviest burden. Last year the industry was fined Kshs 190.0 mn for poor quality services, and the continued poor quality performance this year raises concerns on the effectiveness of hefty fines in pushing the operators to comply, despite the increase in fines from a flat rate of Kshs 500,000 to the current 0.1% of gross annual revenue. The industry players are however not in agreement with the ratings and measurement criteria, with Safaricom arguing that the tests are based on a sample of the most congested cell sites as opposed to the overall network, and they do not consider the number of subscribers in each network. We are of the view that this is likely to lead to increased regulatory interventions even as the CA plans to shift to quarterly quality tests done by a private firm from the current annual reviews. Moreover, the CA proposes to expand its oversight to data and SMS services in addition to the existing checks on the quality of voice services, which should lead to an improved quality of services in the telecommunications sector.

Equity Group has acquired an additional 7.0% in its DRC subsidiary, Pro Credit Bank, for Kshs 2.2 bn in cash, raising its interest to 86.0% from the previous 79.0% acquired in September 2015 through a share swap deal in which Equity Group issued 70.8 mn shares worth Kshs 4.5 bn to exiting investors. The new deal effectively values Pro Credit Bank at Kshs 31.4 bn, a premium of 451.7% compared to a value of Kshs 5.7 bn in 2015. Pro Credit Bank is the second-largest subsidiary of Equity Group after the Kenyan subsidiary, with its contribution to the group?s deposits, loans and total assets increasing to 6.7%, 6.4% and 6.7% in FY?2016, from 5.9%, 5.0% and 6.2% in FY?2015, respectively. This increased investment in Equity?s DRC subsidiary confirms the bank?s confidence in the future prospects for this subsidiary, which reported a 16.7% growth in profit before tax to Kshs 0.7 bn from Kshs 0.6 bn in FY?2015, and is likely to drive growth especially with the challenges facing the South Sudan subsidiary.

In response to the challenging operating environment, banks are increasingly adopting cost rationalization measures such as laying off of staff, closure of branches, reviewing operating hours for some branches, or outright sales in the case of Tier III banks. KCB Group is the latest to report laying off 223 employees in 2016, as highlighted in our Cytonn Weekly #15. Additionally, the bank is now offering a voluntary employee buyout programme estimated to save the bank Kshs 2.0 bn per annum and should recover the buyout costs within 18 months. This step is part of its transformation strategy, which began with an investment of Kshs 2.5 bn in upgrading the bank?s technology infrastructure to reduce operational costs and improve clients? convenience. Other than KCB Group, Standard Chartered Bank has also intensified the push for customers to embrace digital banking by reducing the number of working hours at some of its branches in Nairobi, leaving customers with the option of transacting through mobile applications and online banking platform. This comes after the bank recently undertook a digitization process involving replacement of all its ATMs with advanced

Cash Deposit Machines (CDMs), an exercise expected to cost Kshs 200.0 mn, as the bank targets to migrate 80.0% of all its transactions to non-branch channels by 2018. 2017 being the year in which the full impact of the Banking (Amendment) Act, 2015 will be felt, we are likely to witness banks? push for efficiency gather pace to balance off the expected reduction in absolute profitability going forward as they shy away from physical branches model, which are very expensive compared to other alternative channels such as digital platforms.

Below is our Equities Recommendation table. Key changes from last week include:

- NIC Bank moved from a ?Sell? recommendation with a downside of 5.2%, to a ?Lighten? recommendation with an upside of 1.7%, following a 3.6% price decrease;
- We have placed all Insurance stocks under review as we update our valuations following release of their FY?2016 results;

all prices in Kshs unless stated otherwise									
EQUITY RECOMMENDATION									
No.	**Company**	**Price as at 13/04/17**	**Price as at 21/04/17**	**w/w Change**	**YTD Change**	**Target Price***	**Dividend Yield**	**Upside/ (Downside)****	**Recommendation**
1.	Bamburi Cement	160.0	162.0	1.3%	1.3%	231.7	7.8%	50.8%	Buy
2.	ARM	20.8	23.0	10.8%	(9.8%)	31.2	0.0%	35.7%	Buy
3.	BAT (K)	849.0	770.0	(9.3%)	(15.3%)	970.8	6.2%	32.3%	Buy
4.	KCB Group***	33.0	34.0	3.0%	18.3%	40.1	9.1%	27.0%	Buy
5.	Stanbic Holdings	58.0	58.0	0.0%	(17.7%)	60.2	8.1%	11.8%	Accumulate
6.	Barclays	7.9	8.0	1.9%	(5.7%)	7.9	10.0%	8.8%	Hold
7.	Safaricom	19.6	19.2	(2.3%)	0.0%	19.8	4.7%	7.9%	Hold
8.	Co-op Bank	14.0	14.1	0.7%	6.8%	14.4	5.7%	7.6%	Hold
9.	NIC	27.8	26.8	(3.6%)	2.9%	26.4	3.0%	1.7%	Lighten
10.	I&M Holdings	90.0	90.0	0.0%	0.0%	88.0	3.9%	1.7%	Lighten
11.	Equity Group	33.0	32.8	(0.8%)	9.2%	30.7	6.1%	(0.2%)	Sell
12.	StanChart	206.0	208.0	1.0%	10.1%	189.5	6.7%	(2.2%)	Sell
13.	HF Group	10.7	10.7	(0.5%)	(23.9%)	9.2	4.8%	(8.7%)	Sell
14.	DTBK	120.0	120.0	0.0%	1.7%	104.0	2.2%	(11.1%)	Sell
15.	NBK	6.0	6.2	3.3%	(13.9%)	1.7	0.0%	(72.6%)	Sell
Target Price as per Cytonn Analyst estimates									
****Upside / (Downside) is adjusted for Dividend Yield***									
*****For full disclosure, Cytonn and/or its affiliates holds a significant stake in KCB Group, ranking as the 14th largest shareholder***									
Accumulate ? Buying should be restrained and timed to happen when there are momentary dips in stock prices									
Lighten ? Investor to consider selling, timed to happen when there are price rallies									

We remain "neutral with a bias to positive" for investors with short to medium-term investment horizon and are "positive" for investors with long-term investment horizon.

Private Equity

Acquisition:

Naspers, Africa's biggest e-commerce and digital company, is investing USD 69.4 mn into Takealot Online, South Africa's largest e-commerce company. The deal, which is subject to Competition Commission approval, will increase Naspers? stake in the South African e-commerce company to 53.5% from 41.0% (acquired in 2015), effectively valuing Takealot Online at USD 555.2 mn, a premium of 249.6% compared to a value of USD 222.4 mn in 2015 and placing Naspers as the majority shareholder. Naspers is Africa's largest listed company and the 7th largest internet company in the world, with a market capitalization of over USD 66.0 bn. It is a broad-based multinational internet and media group, offering services in more than 130 countries. Its principal operations are in Internet communication (classifieds, online shopping, marketplaces, online payments and online services), video entertainment and print media.

This transaction was driven by (i) the alignment of Takealot Online?s goal to increase its growth in the market, which offers a huge potential, (ii) growth and strong adoption of e-commerce in South Africa, and (iii) robust growth of Takealot, which boasts a stable of businesses, including general online retailer Takealot.com? fashion online platform Superbalist.com? restaurant food delivery service Mr. D Food and Mr. D Courier? a courier service. The e-commerce industry, in Africa, remains bullish as it is projected to make up to 10.0% of total retail sales in key markets by 2025 from the current range of 1.0% to 3.0%, with a 40.0% annual growth over the next 10 years. This is attributed to factors such as increasing mobile penetration, increased consumerism as well as a tech savvy population.

On the Fundraising Front:

International Finance Corporation (IFC) is considering a potential capital commitment of USD 25.0 mn to Leap Frog Emerging Consumer Fund III, a 10-year closed-end fund that will look to back mid-market growth capital opportunities in Africa as well as South and South East Asia. The fund, which is targeting USD 800.0 mn at final close, will be managed by Leap Frog Investments. Approximately 30.0% of the fund is set to be allocated to healthcare investments, with the balance being reserved for opportunities in the financial services sector. The firm?s investment team is looking to make equity and quasi-equity opportunities averaging USD 25.0 mn to USD 30.0 mn. The fundraising for the healthcare sector is driven by (i) under provision of quality and efficient health services from the public sector, and (ii) strong economic growth projections compared to global markets, which are supported by positive demographics such as a growing middle class, driving demand for quality healthcare.

AfricInvest, a Tunis-based private equity fund, is targeting to raise USD 211.5 mn through a new fund (AFSH). The funds will be invested in the financial services sector. AFSH is AfricInvest?s second financial sector private equity fund. This fund was launched to take advantage of growth opportunities in the continent. Africa?s financial sector is undergoing a profound transformation, through the strategic expansion of financial institutions and digitalization of operations. These trends are resulting in an acceleration of financial inclusion and tremendous growth in the sector. AfricInvest leverages on the track-record and experience of its first financial sector fund, AfricInvest Financial Sector (AFS) which successfully invested in 21 financial institutions across 16 countries. The AFS was initially launched in June 2007 with a capital commitment of USD 20.0 mn by Netherlands Development Finance Company (FMO), the Dutch development bank, and was then increased to USD 31.0 mn in April 2010 with additional capital commitments by Proparco through its FISEA fund, and by Développement international Desjardins (DID). It is one of the first funds to focus on financial inclusion in Africa through investments in financial institutions that service micro, medium-sized enterprises. The fund makes investments in the range of USD 1.0 to 5.0 mn with the objective to grow, develop and build sustainable Financial Institutions in Africa. The financial services sector continues to attract private equity investments driven by (i) technological advancement that has improved efficiency and reduced operation costs, and (ii) innovative distribution channels like use of agents and mobile banking,

Private equity investments in Africa remain robust as evidenced by the increased deals and deal volumes in the region?s key sectors; financial services, healthcare and retail industry. Given (i) the high number of global investors looking to cash in on the growing middle class of Africa, (ii) the attractive valuations in frontier markets compared to global markets, and (iii) better economic projections in Sub Sahara Africa compared to global markets, we remain bullish on PE as an asset class in Sub-Sahara Africa.

Real Estate

According to the 2017 Economic Survey report by KNBS, the real estate sector grew by 8.8% in 2016, compared to a 7.2% growth in 2015, highlighting the continued expansion of the sector. The

real estate sector?s contribution to the overall GDP was relatively flat at 8.4% in 2016 compared to 8.2% in 2015. The key take outs from the survey were:

- The estimated value of building works completed in Nairobi City County increased by 7.5% to Kshs 76.2 bn in 2016 from Kshs 70.9 bn in 2015, mainly driven by increased value of residential developments,
- The value of reported building plans approved in Nairobi increased by 43.3% to Kshs 308.4 bn in 2016 from Kshs 215.2 bn in 2015. The rise in building approvals was as a result of increased investment in real estate development and can be attributed to increased foreign investments and the government?s effort to provide both financial and non-financial incentives to the private sector to help alleviate the gap in housing, especially in the lower income market spectrum,
- The overall expenditure on roads construction, maintenance and repair increased by 38.3% to Kshs 156.5 bn in 2016 from Kshs 113.2 bn in 2015/16. More infrastructural development is likely to be witnessed especially as we are in the electioneering period, as it is a common campaign tactic for incumbent leaders seeking re-election. This will have a positive impact on real estate through opening up of areas for development, improved accessibility and general increase in property value due to higher demand.

Real estate was one of the sectors which recorded an improved performance, together with storage, transport and ICT. The growth can be attributed to (i) high population growth and urbanization which drives real estate demand, (ii) increased infrastructural development, and (iii) government incentives such as provision of serviced land to developers, access to affordable financing, tax incentives and reforms of land administration.

Hospitality sector

The hospitality sector grew in 2016 as the accommodation and food services registered the highest growth at 13.3% from a contraction of 1.3% in 2015 as a result of acts of terrorism and insecurity experienced in 2015. According to KNBS data, local conferences increased by 17.4%, with international conferences increasing by 4.1%. There was a 17.8% increase in tourist arrivals, while earnings improved to Kshs 99.7 bn in 2016 from Kshs 84.6 bn in 2015.

According to World Tourism Organization, 1.3 mn tourists spent Kshs 100.0 bn in Kenya last year, a 17.0% increase from 2015. The satisfactory performance in this sector was as a result of:

- Increased activity in conference tourism, that comprised of visits by heads of states and high-profile figures,
- Government efforts to market Kenya as a preferred tourist destination,
- Reversal of travel advisories, and
- Programs such as charter incentive programs, as well as waiving of visa fees.

The hospitality industry in Kenya continues to look up. Business is expected to increase due to a continued robust growth in the tourism sector as well as investments by government, private, local and international investors.

This week we have seen the following activities:

- Uriithi Co-operative Society, a site & service and housing firm, announced plans to construct a high-end gated mixed use development in Nairobi-Tala, along Kangundo Road. The development will be built on 10 acres of land and will have a 24-hour commercial center, in addition to housing 301 families. The project is dubbed Osten Terrace Gardens,
- Tata Housing development, a subsidiary of Tata Group, entered into a deal with Indian National Housing Bank and an unnamed real estate firm to develop projects throughout the globe, starting with Kenya and Tanzania. The aim is to develop more than 4.5 mn square feet of mixed-use townships starting in 2018. This development is targeting to fulfill the middle-income earners?

appetite for superior quality homes in Kenya,
- Tatu City is set to construct a residential development, dubbed Tatu Waters, in Ruiru, which will comprise of 2,715 townhouse and apartment units at an approximate cost of Kshs 35.0 bn

There have been two differing reports on the attractiveness of Nairobi as an investment destination. On one hand, Nairobi was ranked as one of the top destinations for Fast-moving Consumer Goods, multinational companies and organizations looking to set up operations in the East African region. This is according to a recent survey by global business research firm, Infomineo. According to the report, there was a 17.0% increase in the number of Fortune 500 companies in the region in 2016 as compared to 2015. Nairobi has been a preference for multinational firms seeking to expand their presence in Africa due to its central location as well as an enabling business environment. Kenya, which has evolved as a regional hub for financial and technology services also remains the biggest economy in East and Central Africa and because of its stable macro-economic environment, and is expected to continue attracting multi-national companies that are looking to set up operation within the region. We expect this to result in increased demand for office space as more multinational firms set their headquarters in the Nairobi?s business districts.

On the contrary, US Consultancy firm, Mercer ranked Nairobi two positions lower in their latest survey list for the best cities to live in. Nairobi came in at position 186 out of 231 cities, surpassed by Kampala, which was ranked at 173. Kigali and Dar es Salaam were ranked position 192 and 199 respectively. The survey, which is based on views from foreigners working abroad, examined factors such as levels of traffic congestion, supply of electricity, drinking water, traffic congestion as well as social unrest. Nairobi?s drop in the ranking could be attributed to the frequent political unrests as well as traffic snarl ups that have seen the city ranked the second worst city to live in globally in a separate report by a Serbia-based website. However, plans are underway to improve this through the government?s establishment of the Nairobi Metro Area Transport Authority (NAMATA), covering the Counties of Nairobi, Muranga, Kajiado, Kiambu and Machakos, state-of-the-art Mass Rapid Transit System (MRTS) project which will see 600 buses and a commuter train transporting the 5.0 mn population in Nairobi via five transit routes. The phase 1 of the project, which commenced in 2017, is expected to be in full operation by 2030.

We expect the real estate sector to continue doing well due to continued investment in the residential sector by private developers as well as through public-private partnerships to take advantage of the housing gap. The rise in building approvals as per the 2017 Economic Survey indicates that several real estate projects are set to be launched this year. We also project a continued positive performance from the hospitality sector mainly supported by the recovery of tourism sector.

Focus of the Week: Nairobi Commercial Office Report 2017

Last year, we released a Commercial Office Report that covered the performance of the sector between 2011 and 2015. According to the report, the office theme remained attractive with an average rental yield of 9.3%, despite increasing supply, with opportunity in the sector being in Grade A offices in areas such as Gigiri. This week, we thus update the report with findings from data collected last year that summarizes the performance of the office theme in Nairobi in 2016. We start with an introduction then cover the performance summary by sub-markets and by grades and conclude by highlighting the opportunity in the sector.

Introduction

The commercial office theme witnessed rapid growth in both supply and performance between 2011 and 2015 buoyed by increased demand for office space by multinationals firms setting up regional headquarters in Nairobi such Google, IBM, Global Visa International and Panasonic, growth in SME?s as well as growth in the financial services sector whose contribution to GDP increased from 5.7% in 2011 to 6.9% in 2015. This created demand for office space, resulting in increased supply, with completions growing at a 5 year CAGR of 52.5% between 2011 and 2015, from 1.7 mn square feet in 2011 to 7.6 mn square feet in 2015. In 2016, however, a tough operating environment characterized by lower turnover and business restructuring led to several companies reducing their operations in the country such as Coca-ColaThe SME and financial services sectors growth also slowed down as a result of the Banking Act (Amendment) 2015, which led to slower credit growth. This led to a reduction in demand for office space and hence negatively affected performance of the sector with growth rates for rents declining from 22.0% between 2011 and 2013 to 2.0% between 2013 and 2015 to a flat growth between 2015 and 2016 as prices and occupancy rates declined by 6.0% and 1.0% points, respectively. The yields however remained unchanged at 9.3%. The market then responded to the lower returns by delivering less office space of 6.5 mn square feet in 2016, a 14.0% decline from 7.6 mn square feet delivered in 2015.

The performance of the commercial office theme is as summarized below:

Performance of Commercial Office Space Overtime							
Year	**2011**	**2013**	**2015**	**2016**	**? (2013)**	**? (2015)**	**? (2016)**
Occupancy (%)	91.0%	90.0%	89.0%	88.0%	(1.0%)	(1.0%)	(1.0%)
Completions (Sqft)	1.7 mn	2.1 mn	7.6 mn	6.5mn	23.5%	261.9%	(14.5%)
Asking Rents (Kshs/Sqft)	78	95	97	97	21.8%	2.1%	0.0%
Average Prices (Kshs/Sqft)	10,557	12,433	12,776	12,031	17.8%	2.8%	(5.8%)
Average Rental Yields (%)	**9.8%**	**10.0%**	**9.3%**	**9.3%**	**2.0%**	**(7.0%)**	**(0.0%)**
· The occupancy rates have remained fairly stable with a 1.0% decline between 2013 and 2016 as a result of increased supply · The average price per square foot in 2016 was Kshs 12,031, a decline of 6.0% from Kshs 12,776 in 2015 also as a result of increased supply affecting demand							

Source: Cytonn Research

Sub Market Analysis

The main office nodes in Nairobi remain Upperhill, Westlands, Kilimani and CBD. The CBD saw companies relocate in search of better quality office space, convenience, ease of access and more space. These include KenInvest, which moved from its headquarters in railways to UAP ? Old Mutual Towers in Upperhill and Ecobank Kenya that moved from Ecobank Towers in the CBD to Fortis Office Park in Westlands. Upperhill and the CBD have the highest supply of office space with market shares of 24.4% and 24.3%, respectively, with Thika Rd having the lowest supply with a market share of the total office space of 0.8%. The best performing office submarkets in 2016 were Parklands and Karen with average rental yields of 10.0% and 9.7%, respectively due to prime locations enabling them to charge premium rents and attract quality tenants. The worst performing markets were Mombasa Road and Thika Road, constrained by poor locations, with Mombasa Road being affected by its zoning for industrial use and traffic congestion and Thika Road zoned for lower mid income residential with low quality office space.

Summary of Office Market Performance in 2016 by Nodes					
Area	Price (Kshs/Sqft)	Rents (Kshs/Sqft)	Occupancy (%)	Rental Yields 2015 (%)	Rental Yields 2016(%)
Parklands	11,771	102	80.0%	10.0%	**10.0%**
Karen	13,500	107	90.0%	10.1%	**9.7%**
Kilimani	12,667	99	90.5%	9.5%	**9.3%**
Westlands	12,482	102	92.1%	9.3%	**9.2%**
UpperHill	12,529	102	89.8%	9.0%	**9.0%**
Nairobi CBD	11,750	92	92.7%	9.3%	**9.0%**
Thika Road	11,700	91	80.3%	8.3%	**8.8%**
Mombasa Road	10,720	80	86.1%	8.3%	**8.5%**
Average	**12,053**	**100**	**88.9%**	**9.2%**	**9.2%**
· ***In 2016, Parklands had the highest returns since it is in a prime location and has a premium on rents at a yield of 10.0% while Mombasa Road had the lowest at 8.5%, mainly as a result of traffic congestion and zoning regulations for industrial use in the area, with the market average at 9.2%***					

Source: Cytonn Report

Class Analysis

In terms of grades/class, grade B offices have the highest supply from our sample size with a 60.0% market share with grade A offices accounting for only 10.0%. Key to note is that there is a short supply of purely grade A office space in the market. In terms of performance, grade A offices have the highest rents, which yield at an average 10.0%, while Grade B offices have the highest occupancy levels at 90.6% and Grade C are the worst performing with average rental yields of 8.6%.

Performance of Office Space by Grades				
Grade	Price (Kshs/Sqft)	Rents (Kshs/Sqft)	Occupancy (%)	Rental Yields (%)
Grade A	12,889	112	85.7%	10.0%
Grade B	11,959	98	90.6%	9.2%
Grade C	11,245	82	87.5%	8.6%
Average	**12,031**	**97**	**88.0%**	**9.3%**
· ***Grade A offices offer the highest yields at 10.0%, Grade B offer 9.2% yields while Grade C offices yield the lowest returns at 8.6%. Grade A offices offer a premium on services that enable them to charge higher rents hence higher yields*** · ***Occupancy rates remain high with Grade B offices having the highest occupancy at 90.6%, they are fairly cost effective and offer good services***				

Class and Nodes Analysis

A combination of performance analysis by grades and class shows that for grade A offices, the opportunity is in Westlands and Karen with yields of more than 10.0%. For Grade B offices, the opportunity is in Parklands, which offers an average rental yield of 10.2% yield, with Kilimani offering the highest returns for Grade C offices with yields of on average more than 9.0%

Office Performance by Nodes and Grades						
	GRADE A		GRADE B		GRADE C	
Area	Yield	Occupancy	Yield	Occupancy	Yield	Occupancy
Kilimani	9.2%	81.2%	9.4%	93.2%	**9.0%**	**95.3%**
Upperhill	9.3%	60.0%	8.8%	94.0%	7.7%	81.7%
Parklands	9.8%	80.0%	**10.2%**	**83.3%**	9.1%	60.0%
Westlands	**10.3%**	**94.2%**	8.8%	94.0%		91.5%
Karen	**10.4%**	**90.0%**	9.6%	90.0%	-	-

Mombasa Rd			8.2%	85.3%	9.0%	87.6%
Thika Rd			9.0%	91.5%	8.7%	58.0%
CBD			9.0%	93.0%	8.5%	90.0%
· ***Kilimani has the highest occupancy and yield at 9.0% for Grade C offices, while Parklands has the highest occupancy for Grade B offices at 83.35 with a yield of 10.2%. Kilimani is easily accessible from the CBD, while Parklands is located in a prime location*** · ***For Grade A offices, Karen and Westlands offer the best returns with a yield of 10.4% and occupancy rates of 90.0% and 94.2%, respectively, mainly because they are located in prime locations and can charge a premium on rents.***						

Source: Cytonn Research

Office Market Conclusion and Outlook	
Measure	**Sentiment**
Supply	We have an oversupply of 3.2 mn square feet of office space in 2017 and it is expected to grow by 21.0% to 3.9 mn square feet by 2018
Office Market Performance	Increased supply is constraining performance with occupancy rates and yields declining as rents and prices experience slower growth rates Based on the supply pipeline, the trend may continue before the market picks up. Despite this, the sector offers attractive returns in selected markets of up to 12.0% yields, with 90.0% occupancy
Serviced Offices Performance	Serviced offices offer attractive returns with average yield of 12.0%, at 50.0% occupancy. They are also in low supply, accounting for only 0.35% of the office space supplied in Nairobi and are hence a good investment opportunity
Outlook	We expect reduced development activity as the market reacts to the stagnating prices and returns For 2017, we expect the prices to remain at 2016 levels or decline as the office market transitions from a developer?s market to a buyers? market
Opportunity	The opportunity in the sector thus lies in specific pockets of value such as in office zones with low supply like Gigiri, office grades with low supply and high returns such as grade A offices, with only a 10.0% market share and a 10.0% rental yield on average. Differentiation will also give an investor an edge, which can be achieved through investing in serviced offices, with average rental yields of 13.4% and green buildings which are gaining traction in the market

Conclusion

The market is currently oversupplied, constraining performance and this market is now a buyers? market. To gain value, investors will thus have to seek specific pockets of value with regards to:

i. **Grade A Office Space** ? Invest in Grade A office space which is undersupplied in the Nairobi market,
ii. **Low Supply Zones** ? Invest in low supply markets with proper access and relatively better access to land such as Gigiri and Karen,
iii. **Returns** ? Seek regions which despite the oversupply, still have attractive returns such as Parklands,
iv. **Differentiation** ? Invest in differentiated concepts such as serviced offices, mixed use development, green building and smart offices
v. **Yielding Property** ? Investment in yielding property, with already locked in lease and best returns

For the general market performance, we expect the slow-down to continue, driven by the factors mentioned above as well as the upcoming elections which has created anxiety and hence a slow-down in economic activities. For more on the commercial office market performance, see the full report here.

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