Regulatory Changes in the Kenyan Pensions Industry, & Cytonn Weekly #47/2021

Real Estate

I. **Residential Sector**

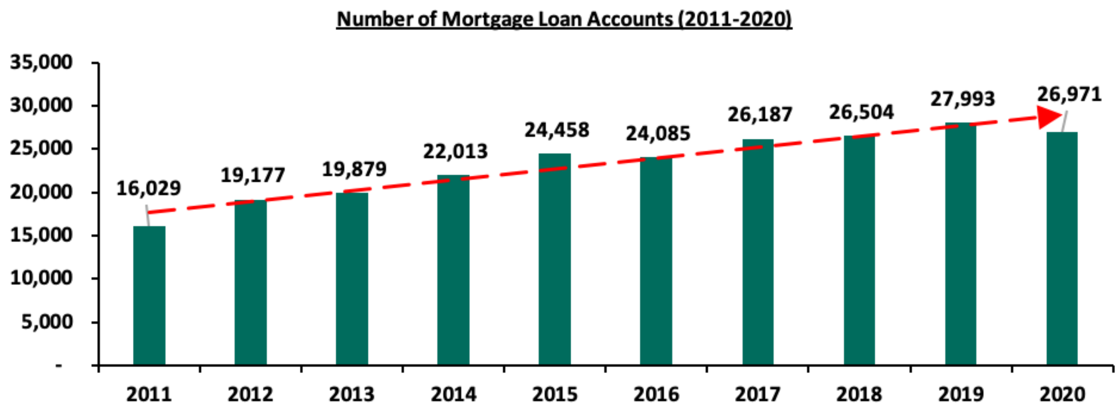
During the week, Kenya Mortgage Refinance Company (KMRC), a treasury backed mortgage lender, announced that it is holding talks with the Kenya Bankers Association (KBA) and other relevant stake holders in the financial sector, to develop a secondary mortgage market in the country. The firm expects to work in conjunction with Primary Mortgage Lenders (PMLs) such as banks, Savings and Credit Co-Operative Societies (SACCOs) and microfinance institutions to develop mortgage-backed securities, where lenders will pull home loans with similar characteristics (such as interest rates, risk and repayment terms) and sell to third party investors such as Pensions funds and Insurers as asset backed securities. The investors will buy the packaged securities, lend to homebuyers and get returns through monthly repayments on interests and principal sums. KMRC hopes to overcome the current challenge of lack of uniformity in mortgage lending terms such as interest rates and repayment periods across the various PMLs in order to achieve this. The uniformity of terms is not only important in the packaging of loans but also in enhancing the sector's bargaining power to third party buyers for a holistic mortgage market development.

The key advantages of a secondary mortgage market include;

i. Improved liquidity and loan capacity since after the sale of the asset backed securities to third party investors, PMLs have access to funds that can be used to generate more loans for other clients,
ii. Increased lending scope of PMLs by including third party investors such as Pension funds, Insurers and Mutual Funds, who will be clients of grouped mortgage loans of similar characteristics. The investors will then be able to target and accommodate a vast diversified number of mortgage clients,
iii. Fall in interest rates as market competition increase from the increased number of players thereby accommodating more low income mortgage clients, and,
iv. Solving the balance sheet mismatch for PMLs who have to use short term deposits to service long term mortgage loans. The secondary mortgage market will solve this problem of lack of long-term funds by transferring servicing rights to third parties.

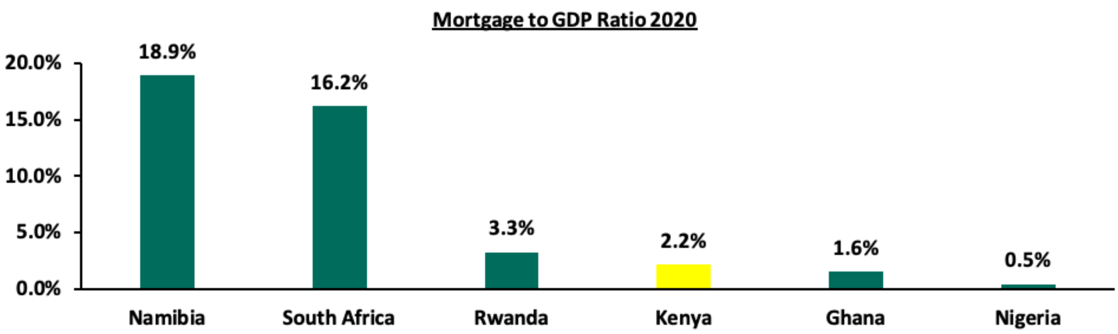
The move by KMRC is expected to improve the residential mortgage market which has not been performing well. According to the Central Bank of Kenya- Bank Supervision Annual Report 2020, the residential mortgage market recorded a 3.7% decline in the number of mortgage loans accounts, to 26,971 in December 2020 from 27,993 in December 2019. The overall value of mortgage loans outstanding therefore registered a 2.1% decline to Kshs 232.7 bn in December 2020, from Kshs 237.7 bn in December 2019. The performance decline of the mortgage market was mainly attributed to fewer mortgage loans advanced by banks to the Real Estate sector with the mortgage defaults in Q1’2021 increasing by 14.8%.

The graph below shows the number of mortgage loan accounts in Kenya over the last 10 years;



Source: Central Bank of Kenya (CBK)

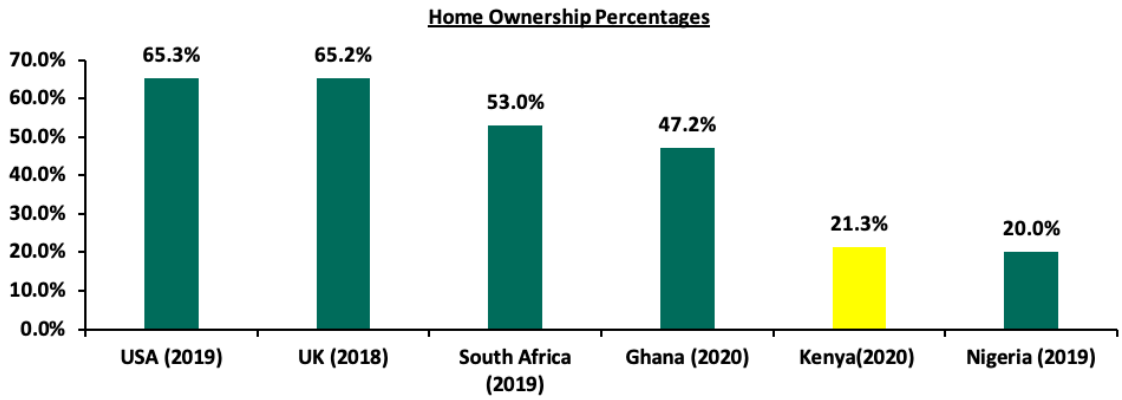
Kenya’s mortgage to GDP ratio continues to lag behind at 2.2% as of 2020, compared to countries such as Namibia and South Africa at 18.9% and 16.2%, respectively, due to high mortgage interest rates, high initial deposits and lack of information on criteria threshold for mortgage products. The graph below highlights the Mortgage to GDP ratio in select African countries in 2020;



Source: Center for Affordable Housing Africa

The home ownership in Kenya therefore remains low at 21.3% in urban areas as at 2020, compared to other African countries such as South Africa and Ghana at 53.0% and 47.2%, respectively. The low home ownership rate is attributed to; i) the increasing number of Non-Performing Loans (NPLS) in the Real Estate sector, by 14.8 % to Kshs 70.5 bn in Q1’2021, from Kshs 61.4 bn recorded in Q4’2020 leading to tighter underwriting standards, ii) high property costs, iii) high initial deposits required to access mortgages, iv) sluggishness in the affordable housing initiative, and, v) an under-developed capital markets that makes it hard for businesses and individuals to raise funds aimed at mortgage finance.

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



Source: Centre for Affordable Housing Africa, Federal Reserve Bank

The intended increase in mortgage lending by means of a secondary market is expected to support the performance of the residential sector, coupled by regulatory efforts such as those by Competition Authority of Kenya (CAK) to streamline the sector by ensuring transparency and efficiency in mortgage lending.

II. Retail Sector

During the week, Papa John's International Inc. announced a partnership deal with Kitchen Express to open 60 new fast-food outlets in Kenya and Uganda from 2022. Papa John's boasts of over 5,500 outlets, behind Domino's and Pizza Hut chains with over 18,057 and 17,809 outlets worldwide as at August 2021, respectively. Papa John's outlets will be opened in select Hass Petroleum properties, given that Kitchen Express is a subsidiary of AAH Limited, the majority shareholder of Hass Petroleum Group. Locally, Papa Jones will be competing with rivals such as Pizza Inn with 38 outlets. The entry of the fast-food retail chain into the Kenyan and Ugandan market is attributable to; i) the brand's need to increase its geographical footprint, ii) the strategic market approach by Hass to attract tenants for rental income and subsequent fuel revenues from clients, iii) the vibrant youthful population in the country who are expected to form a large part of the firms targeted clientele particularly through e-commerce, and, iv) Nairobi's rise as a hub for international corporations supported by the developing infrastructure.

The Kenyan retail sector performance is expected to be supported by the opening of new franchises such as Papa John's and the rise of e-commerce through online payments and deliveries complementing sales in physical outlets. However, rise of e-commerce has also led to reducing need for physical retail space, and hence, the retail market continues to experience an oversupply of 1.7 mn SQFT in the Kenyan retail sector and 3.0 mn SQFT in the NMA retail sector.

III. Mixed-Use Developments (MUDs)

During the week, Tatu City, a Mixed-Use developer, announced a partnership deal with Stecol Corporation, a Chinese construction and engineering firm, to develop supporting infrastructure in the final phase of Kijani Ridge located in Ruiru, Kiambu County. The project's cost is estimated at Kshs 1.0 bn and is expected to be completed by the end of 2022. The deal will see the firm build 12.0 Km of roads and footpaths, a 5.0 Km underground storm water conduit, 2.7 Km of sewer line, water supply pipeline, streetlights, fibre optic cables and connect power lines. Kijani Ridge is a premier community set on 350 acres of land in the larger 5,000 acre Tatu City and comprises of 439 quarter and half acre serviced plots divided among phases. The project is now in Phase III which has been announced to be 60.0% sold. Currently, Kijani Ridge has 75 homes under construction by individual owners, while 100 others are under the statutory approval processes. Over 50 firms have already taken space at Tatu City including; Mountain Top Publishers, Kenya Wine Agencies, Chandaria Industries, Crawford International School, Nova Pioneer School, among others. We expect Tatu City's development of amenities to keep attracting investors coupled with the Special Economic Zone

Status that comes with reduced corporate taxes and zero Value Added Tax (VAT).

Mixed-Use Developments continue to gain traction with our Nairobi Metropolitan Area (NMA) Mixed-Use Development Report 2021 indicating that developments recorded an average rental yield of 7.2% in 2021, 0.7% points higher than the respective single-use themes, which recorded average rental yield of 6.5% in the similar period. The relatively better performance was mainly attributed to; i) an improved business environment, ii) strategic and prime locations of the developments with the capability to attract prospective clients, and, iii) preference by target clients due to their live, work and play convenience leading to improved demand.

The table below shows the performance of single-use and mixed-use development themes between 2020 and 2021;

Thematic Performance of MUDs in Key Nodes 2020-2021

	MUD Themes Average			Market Performance Average		
	Rental Yield 2021	**Rental Yield 2020**	**Δ in y/y MUD Rental yield**	**Rental Yield 2021**	**Rental Yield 2020**	**Δ in y/y Market Average Rental Yield**
Retail	8.4%	7.1%	**1.3%**	7.8%	7.7%	**0.1%**
Offices	7.1%	6.9%	**0.2%**	6.6%	6.8%	**(0.2%)**
Residential	6.0%	6.3%	**(0.3%)**	5.2%	5.8%	**(0.6%)**
Average	**7.2%**	**6.9%**	**0.3%**	**6.5%**	**6.8%**	**(0.3%)**

**** Market performance is calculated from nodes where sampled MUDs exist***

Source: Cytonn Research 2021

We expect MUDs to continue performing well due to the integration benefits they offer such as easier access to retail services and amenities, as well as residential and working spaces all in one location.

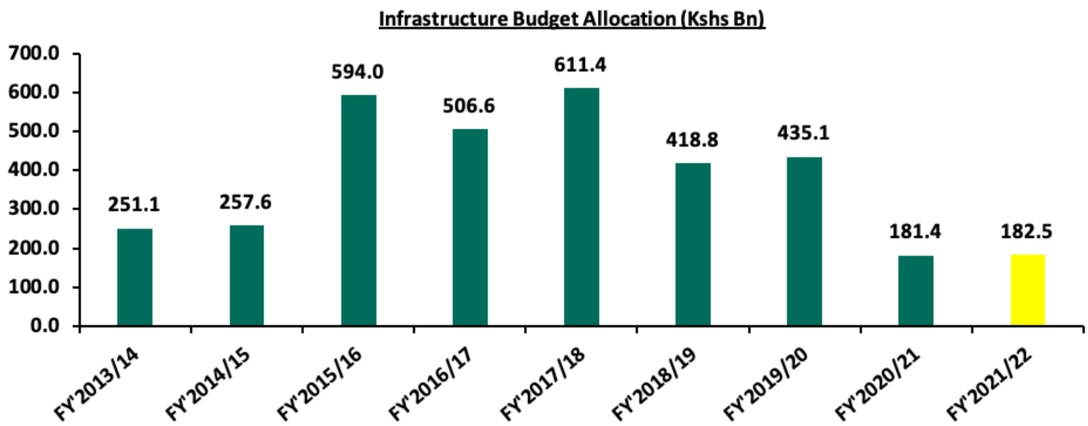
IV. **Infrastructure Sector**

During the week, Kenya National Highways Authority (KeNHA) announced that they had contracted Victoria Engineering Company, to tarmac the 35.8 Km Kopasi River- Lomut – Sigor- Marich link road, in West Pokot County, at a cost of Kshs 4.4 bn. The road is expected to be done by October 2024 and will connect to the Kitale – Lodwar- South Sudan Highway at Marich Pass. Additionally, there will be a parking bay for long distance trucks at Sigor and Lomut, street lights all through the line of the road, access roads at Sigor and an interchange at Marich Pass. The road forms part of the 124.5 Km road running through the counties of West Pokot, Elgeyo Marakwet and Baringo, to be constructed at a cost of Kshs 14.4 bn, from January 2022. Upon completion, the link road is expected to;

i. Link Nakuru and Lodwar Towns, and reduce travel distance through current routes by an estimated 70.0 Km
ii. Open up the Kerio Valley for investments including Real Estate investments by improving connectivity for developers and buyers,
iii. Enhance market accessibility especially for agricultural and industrial products thereby boosting economic activities, and,
iv. Generate county revenues in areas like Sigor and Lomut where construction of a parking bay for long distance trucks has been planned.

The government continues to finance FY'2021/2022 infrastructure budget at Kshs 182.5 bn through internal and external borrowing from countries such as China and Korea, in order to see infrastructure projects to completion. This year's budget represents a 0.6% increase from Kshs 181.4 bn allocation for FY'2020/2021 indicating government's commitment to infrastructural development. We therefore expect infrastructure major projects in the pipeline particularly in the NMA such as the Nairobi Express Way which has been announced to be 75.0% complete, Western Bypass (linking the towns of Kikuyu and Ruaka) and the conversion of Eastern Bypass into a dual carriage way to be done to completion. This will open up more areas for Real Estate investments through enhanced accessibility.

The graph below shows the budget allocation to the infrastructure sector over the last nine financial years:



Source: National Treasury

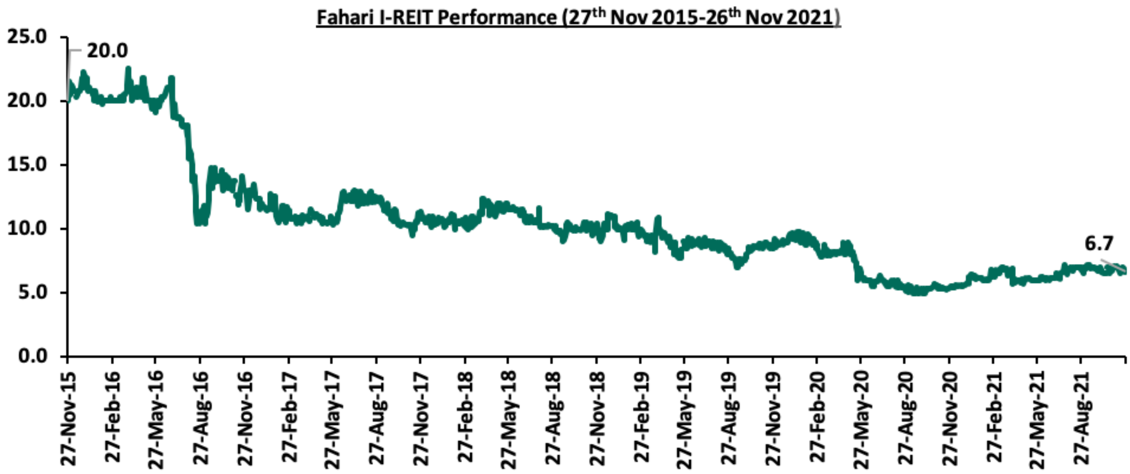
We expect the government's continued focus on initiation and completion of infrastructure developments to support the realization of the Vision 2030 Agenda on developing quality, safe and adequate roads to make Kenya an intra-regional hub for trade in East Africa, and support Real Estate investments through accessibility.

V. **REIT Performance**

During the week, Fahari I-REIT price declined by 2.3% to close at Kshs 6.7 per share, compared to Kshs 6.8 per share recorded the previous week. On a YTD basis, the listed REIT has gained by 18.4% from Kshs 5.6 recorded at the beginning of the year. The REIT's closing price also represented a loss in the Inception to Date (ITD) performance declining by 66.6% from the inception price of Kshs 20.0 per share. Additionally, according to NSE's Unquoted Securities Platform (USP) report, the Acorn REITs performance remained unchanged, with the DREIT closing at Kshs 20.2 while the I-REIT closed at Kshs 20.6 per unit, as was recorded the previous week. This performance represented a 0.9% and 3.1%, gain for the DREIT and I-REIT, respectively, from the Kshs 20.0 Inception price. The volumes traded for the D-REIT and I-REIT remained unchanged at 5.4 mn and 12.3 mn, respectively, with a turnover of Kshs 108.9 mn and Kshs 254.1 mn, respectively.

The Kenyan REIT market continues to record subdued performance, forming a mere 0.04% of the total market cap compared to the REIT Market in South Africa at 1.6% of the total market capitalization. This is due to constraining by factors such as i) lack of general knowledge about the REIT market and products, ii) high minimum investment amounts set at Kshs 5.0 mn for the D-REIT which 100x the medium income at Kshs 50,000, iii) lengthy regulatory processes discouraging promoters, and, iv) few REIT Trustees currently at 3, due to the high minimum requirements at Kshs 100.0 mn.

The graph below shows Fahari I-REIT's performance from 27th November 2015 to 26th November 2021:



The Real Estate sector performance is expected to be supported by i) plans to develop a secondary mortgage market in the country thereby increasing the mortgage loan lending capacity, ii) Kenya's preference as a retail market destination by international retailers, iii) partnerships to enhance Mixed-Use Developments performance, and, iv) government's focus on infrastructure developments in the country in an aim to enhance accessibility, thereby supporting Real Estate investments.

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