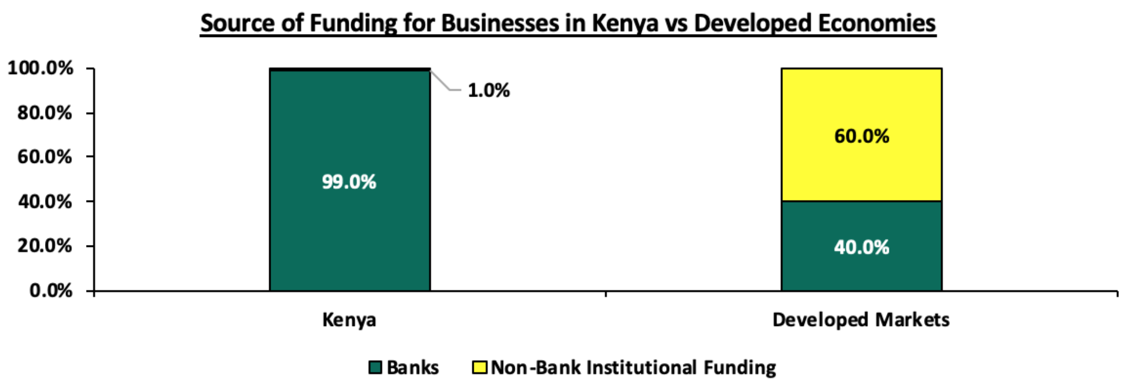
Off Plan Real Estate Investing, & Cytonn Weekly #02/2022

Real Estate

I. **Residential Sector**

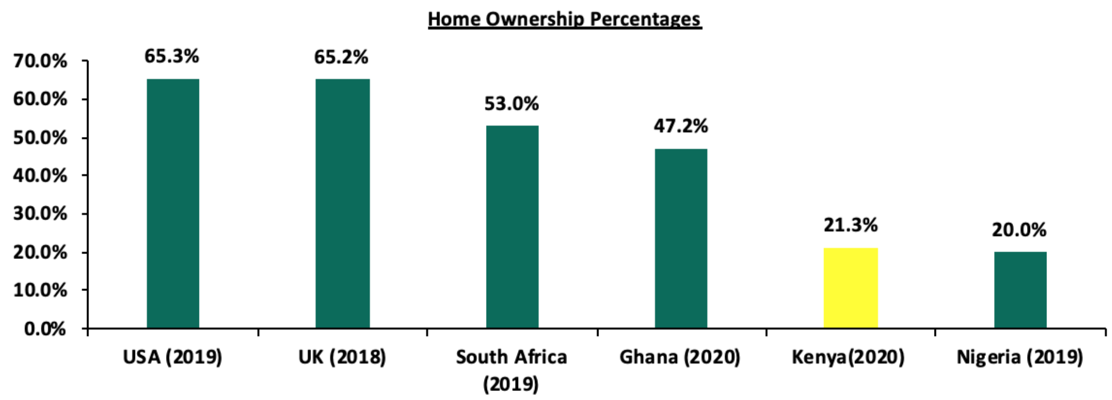
During the week, the Kenya Mortgage Refinance Company, a treasury backed lender, got approval from the Capital Markets Authority (CMA) to roll out a Kshs 10.5 bn medium-term bond programme. The firm aims at raising a total of Kshs 1.4 bn during the first tranche of issuance, which will be disbursed to participating primary mortgage lenders (PMLs), such as banks, microfinance institutions and Savings and Credit Cooperatives (SACCOs) at a 5.0% rate, for onward lending to homebuyers at single digit rates. KMRC also seeks to build its profile as a regular issuer of bonds in the Kenyan capital markets, as they work to raise more long-term capital. The firm has raised about Kshs 37.0 bn since 2020, with the World Bank having extended approximately Kshs 25.0 bn to KMRC in the form of a concessional loan through the National Treasury, while the African Development Bank (AfDB) injected Kshs 10.0 bn, and, the remaining Kshs 2.0 bn was in equity capital. Furthermore, KMRC already acquired a good credit rating of AA- in August 2021, from South African agency GCR, and this is expected to boost the subscription rate of the bond.

The KMRC bond comes after CMA approved issuance of a Kshs 3.9 bn corporate bond to finance construction of the ongoing Pangani Affordable Housing Project in November 2021. We believe that the bond programme will position the capital markets as a source of funding that supports the affordable housing initiative, which is one of the pillars of the 'Big Four Agenda. Obstacles in the capital markets in terms of access to financing have limited private sector's participation in the development of affordable housing in Kenya due to unavailability and the high dominance on banks as a source of funding. This implies that capital markets contribute a mere 5.0% of real estate funding, compared to 60.0% in developed countries. The graph below shows sources of funding businesses in Kenya compared to developed countries;



We are of the view that in order to deepen our capital markets and stimulate its growth, these obstacles can be addressed by; i) bridging regulatory framework to allow unit holders to invest in sector funds dedicated to affordable housing, ii) reduce high minimum investments in REITs to reasonable amounts given that the national median income for employed individuals is estimated at around Kshs 50,000., and, iii) eliminate conflicts of interest in the governance of capitals markets to a structure that is more responsive to market participants and market growth.

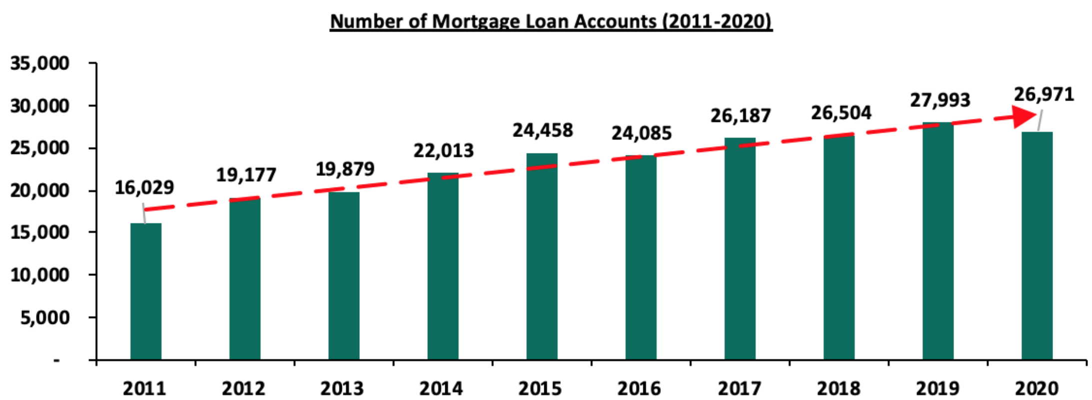
Additionally, through the bond, KMRC will be able to refinance more loans, having already processed Kshs 6.2 bn worth of loans by November 2021 to cover 4,000 mortgages from 11 lenders. This will boost home ownership in Kenya which has remained low at 21.3% in urban areas as at 2020, which is low compared to other African countries such as Ghana with a 47.2% urban home ownership rate in the same period. The low home ownership rate is attributed to; i) high property prices, ii) lack of real estate finance to fund large scale developments due to an under developed and non-supportive capital market, and, vi) the high initial deposits required to access mortgages. The graph below shows the home ownership percentages of different countries compared to Kenya;



Source: Centre for Affordable Housing Africa, Federal Reserve Bank

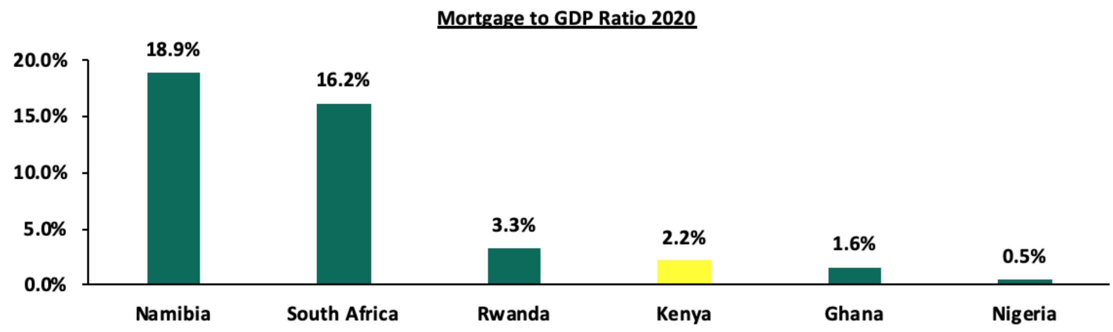
From the assumed mortgage loan size of Kshs 3.5 mn, this funding is therefore expected to increase the number of mortgage accounts in Kenya, which recorded a 3.7% decline to 26,971 in December 2020, from 27,993 in December 2019 according to the Central Bank of Kenya- Bank Supervision Annual Report 2020.

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



Source: Central Bank of Kenya (CBK)

Additionally, the Kenya 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 as shown in the graph below;



Source: Centre for Affordable Housing Africa

So far, KMRC has performed well by; i) boosting liquidity to Primary Mortgage Lenders through its debut lending of Kshs 2.8 bn in FY'2020/21 and Kshs 7.0 bn budgeted in FY'2021/22, ii) increasing mortgage uptake in the country by so far refinancing 1,427 mortgages as at 2020 with others under review currently, iii) encouraging mortgage market competition for the benefit of borrowers through low rate lending, iv) increasing capital for refinancing with total Kshs 40.0 bn under management by the firm as at June 2021. However, KMRC is likely to face stiff competition from government instruments offering higher rates as the firm seeks to borrow from the market and lend at low rates. With 20-year bonds attracting an average yield of 13.5%, KMRC would have to offer a premium above this in order to attract investors in the fixed income market, which would consequently lead to a negative spread between the lending rate and borrowing rate. It is therefore not clear how the firm will borrow from the market and sustain lending at a 5.0% rate. Despite this, the residential sector is expected to improve supported by efforts being made to offer affordable mortgages to a diverse number of clients at bespoke terms.

II. **Mixed-Use Developments**

During the week, CCI Group of companies, a business process outsourcing (BPO) provider, and, nutrition supplements distributor Max International took up approximately 60.0% of the 270,000 SQFT space at Garden City Business Park along Thika Road. CCI and Max International are taking up six-and-a-half floors, and, half-a-floor, respectively, at the business park with East Africa Breweries limited having being the other corporate giant that took up space at the development in November 2019. This move has seen the development realize a 93.0% occupancy, following the closure of major commercial leases. As a result, its developer, British private equity investor Actis, is expected to collect Kshs 226.0 mn annually in rent.

Garden City Business Park is phase two of Kenya's first mixed-use project by Actis which once complete will offer lettable Grade A offices, a healthcare facility, hotel and over 400 new Mi Vida, middle income homes within one 47.0-acre integrated plan. The decision to take up space in Garden City Business Park was informed by MUDs along Thika Road recording a relatively high average rental yield of 6.1%, 0.6% points higher that the market average of 6.0%, according to our Cytonn NMA MUDs Report 2021. The area is also served by a good road network, i.e, Thika Road Super Highway hence easily accessible, boasts of high-quality finishes in the development, and, is a commercial hub attracting a high footfall. Overall, Mixed-Use Developments recorded an average rental yield of 7.2% in 2021, 0.3% points higher than the respective single-use themes which recorded an average rental yield of 6.9% in the same period in 2020. The relatively better performance by MUDs compared to single-use developments was attributed to the prime locations mostly serving the high and growing middle income class, coupled with the concept's convenience that incorporates working, shopping and living spaces. The table below shows the performance of Mixed-Use Developments by node in 2021;

(All Values in Kshs Unless Stated Otherwise)

Nairobi's Mixed-Use Developments Market Performance by Nodes 2021

	Retail Performance				Commercial Office Performance				Residential Performance				
Location	**Price/SQFT**	**Rent/SQFT**	**Occup. (%)**	**Rental Yield (%)**	**Price/ SQFT**	**Rent/SQFT**	**Occup. %)**	**Rental Yield (%)**	**Price/ SQM**	**Rent/ SQM**	**Annual Uptake %**	**Rental Yield %**	**Average MUD yield**
Karen	23,333	196	86.7%	**8.8%**	13,233	117	85.0%	**9.0%**					**8.7%**
Westlands	15,833	173	70.8%	**9.5%**	12,892	110	71.7%	**7.3%**	211,525	1,226	15.6%	**7.0%**	**7.8%**
Kilimani	18,500	162	79.0%	**8.3%**	13,713	106	79.0%	**6.7%**					**7.4%**
Mombasa Rd	20,000	185	70.0%	**8.4%**	13,000	100	60.0%	**5.5%**	156,079	853	13.3%	**6.6%**	**7.4%**
Thika Rd	23,750	215	82.5%	**9.2%**	13,250	105	72.5%	**6.9%**	128,545	612	17.9%	**6.1%**	**7.0%**
Upper Hill	15,485	130	62.5%	**6.4%**	12,000	102	70.0%	**7.0%**					**6.8%**
Eastlands	20,000	124	75.0%	**5.5%**	12,000	80	62.5%	**5.0%**	72,072	360	10.0%	**4.2%**	**5.1%**
Average	**18,759**	**170**	**75.9%**	**8.4%**	**12,924**	**106**	**73.6%**	**7.1%**	**142,055**	**763**	**15.0%**	**6.0%**	**7.2%**

The average MUDs performance is based on areas where sampled projects exist

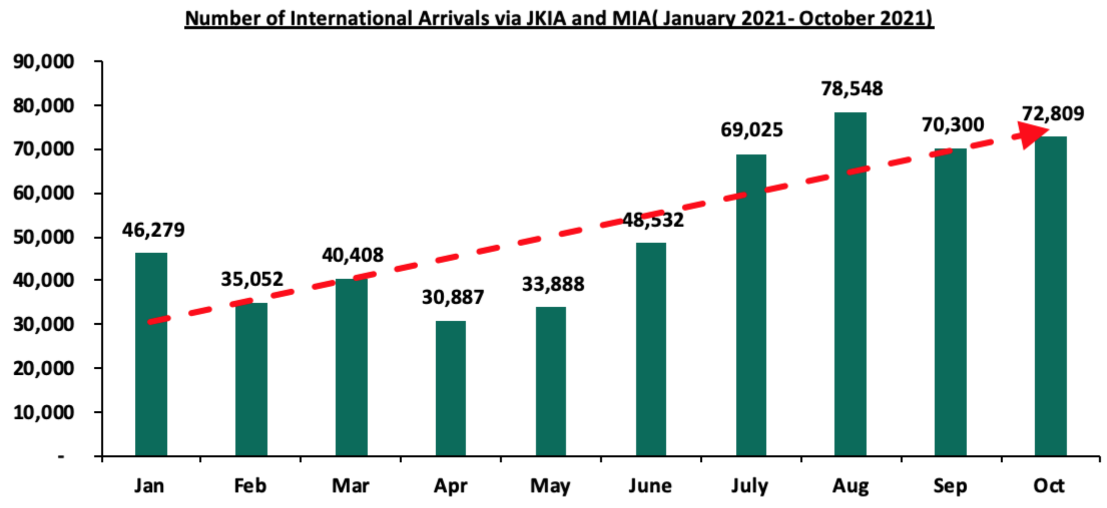
Source: Cytonn Research

We expect an increase in uptake of Mixed-Use Development investments due to the integration benefits which provide a live, work and play environment. The developments also offer better returns compared to single use themes.

III. Hospitality Sector

During the week, the Kenyan government suspended all inbound and transit passenger flights from the United Arabs Emirates (UAE) for seven days effective 10th January. This move was in retaliation to the United Arab Emirates (UAE) issuing a ban on all inbound and transit passengers from Kenya in December 2021, citing fake COVID-19 certificates from Kenyan travellers. Additionally, the United States of America (USA), raised Kenya's travel advisory alert from Level One to Level Three, amidst concerns of the increasing COVID-19 infections following the emergence of the Omicron variant. This decision comes barely less than three months after Kenya had attained the Level One alert in October 2021, which is a much safer classification that only requires citizens to follow standard procedures such as putting on face masks. The move by the US government is expected to weigh down the performance of the tourism and hospitality sectors in general as its citizens will cancel or postpone their travel plans to cushion themselves against the Omicron variant. The United States is a top source tourism market for Kenya ranking at position one with 49,178 visitor arrivals, representing 16.1% of the total visitor arrivals according to the International Tourism Performance Report January to June 2021 by Tourism Research Institute of Kenya.

The graph below shows the number of international arrivals from January 2021 to October 2021;



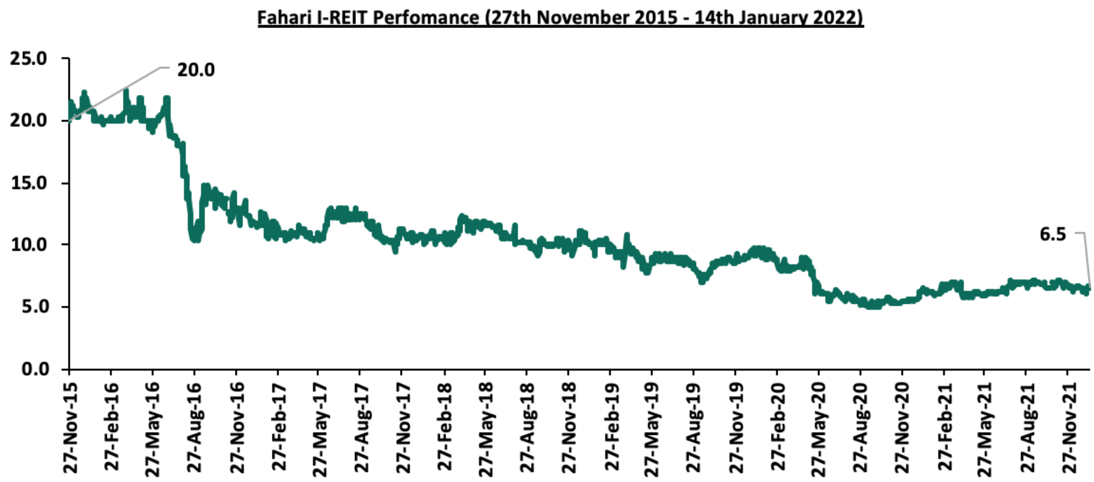
Source: Kenya National Bureau of Statistics

Despite the strategies implemented to promote the performance of the tourism sector such as; i) gradual lifting of travel restrictions and lockdowns, ii) international marketing, iii) positive accolades for Kenya's tourism market, and, iv) mass vaccinations, the hospitality sector is still expected to be weighed down. This will be mainly attributed to factors constraining tourism sector such as the expected low visitor number arrivals from key source markets like US, and the reduced budget allocation for the tourism sector by 11.3% to Kshs 18.1 bn in FY 2021/22 from Kshs 20.4 bn in FY'2020/21.

IV. **Listed Real Estate**

During the week, Fahari I-REIT closed the week trading at Kshs 6.5 per share, an increase of 1.6% compared to Kshs 6.4 per share recorded the previous week. On a YTD basis, the share price recorded a 1.2% points increase from Kshs 6.42 recorded at the beginning of the year. However, on an Inception to Date (ITD) basis, the share price declined by 67.5% from the listing price of Kshs 20.0 per share. The performance of the REITS market in Kenya continues to be subdued by factors such as inadequate investor knowledge on the instrument, lengthy approval process, high minimum capital requirements for a trustee at Kshs 100 mn and, high minimum investments amount.

The graph below shows the performance of the Fahari I-REIT from 27th November 2015 to 14th January 2022;



Other Highlights;

During the week, Centum Real Estate (Centum RE), a fully owned subsidiary of Centum Investment PLC announced that it had signed an agreement with GEM Global Yield LLC SCS (GEM), a Luxembourg based private alternative investment group to provide Centum Real Estate with a share subscription facility of up to Kshs 17.0 bn for a 36-month term following a public listing. This means that for Centum RE to access the aforementioned funds, they will have to go public.

The share subscription facility, which is an agreement between a company and an investor at a fixed price, will allow Centum Real Estate to draw funds by issuing shares of common stock to GEM. As such, Centum will control the timing and maximum size of drawdowns and has no minimum drawdown obligation which is aimed at ensuring Centum RE does not have to take up the funds in unfavourable market conditions. The plans by Centum to list its Real Estate Subsidiary is a continuation of Centum Investments active strategy to reduce concentration of assets in the Real Estate sector.

In the FY'2021 Annual report, Centum Investments announced plans to partially exit Centum RE to a strategic investor by 2024 in order to achieve the intended rebalancing of its portfolio. Key to note, in the year ended March 2021, Centum held 63.5% of its Kshs 47.5 bn worth of assets in Real Estate which exceeded the target maximum of 55.0% by 8.5% points. Centum RE is currently valued at Kshs

16.6 bn which is a significant 112.8% mark up from the Kshs 7.8 bn that had been invested in acquiring and developing the assets making up Centum RE's portfolio.

Key to note, in FY'2021, Centum RE was less profitable, recording a significant 71.7% reduction in its Profit after tax (PAT) to Kshs 0.7 bn, from Kshs 2.3 bn in FY'2020, mainly attributable to a 64.3% decline in Investment income to Kshs 1.4 bn from Kshs 3.9 bn in FY'2020. However, in H1'2022, Centum RE posted an improved performance, with the PAT improving by 26.8% to a loss of Kshs 0.3 bn, from Kshs 0.4 bn during a similar period last year. This loss weighed down Centum Investments H1'2022 PAT of Kshs 0.4 bn. We are of the view that the potential listing of Centum RE and the share subscription facility will play an important role in helping Centum Investments to reduce its risk exposure in Centum RE and allow it to invest in other more profitable asset classes.

The Real Estate sector in 2022 is expected to be on an upward trajectory as markets recover. However, the Real Estate sector performance is expected to be constrained by travel bans and restrictions amid rises cases of COVID-19 infections, which are expected to have a down turn on the hospitality industry. Low investor appetite for Real Estate Investments Trusts (REITS) also continues to be a challenge affecting Real Estate investments.