Cytonn Monthly - October 2017

Real Estate

As has been the case since Q2’2017, the real estate sector’s performance has been constrained by the extended electioneering period among other factors with several reports indicating softening in performance.

Knight Frank released their H1’2017 reports whose key highlights were;

1. In H1’2017 the residential sector recorded a 2.75% reduction in rental rates, compared to a 4.36% decrease in the same period H1’2016 with prime residential prices growth rates softening by 0.9% in H1’2017, compared to 1.3% increase in growth rates in the same period last year. The decline is attributed to an oversupply in some market segments giving tenants and buyers a negotiating leverage over their landlords
2. In the retail sector, there was stagnation in rental rates, which averaged at USD 55 per SQM per month with an average service charge of Kshs 430-600 per SQM per month. The stagnation in rents is as a result of increased supply of retail space in the market. As per our research, retail space in Nairobi increased by 41.6% to 5.6 mn SQFT from 3.9 mn SQFT in 2016;
3. In the commercial office sector, prime rents stabilized at USD 1.4 per SQM per month in H1’ 2017. Nonetheless, downward pressure on rentals is expected in future as a result of downsizing of multinationals that take up Grade A office space and an oversupply of space in some nodes such as Upperhill; and
4. The hospitality sector is expected to experience continued growth following increased investment in the sector with Funds such as French based Proparco that injected USD 20.0 mn debt in TPS Serena to facilitate the hotel group’s expansion with an upgrade worth Kshs 2.2 bn expected to be complete by April 2018.

In our view, the reduced transaction volumes are as a result of the electioneering period and the oversupply in some market segments with other factors such as credit constraints straining the market. However, we expect the market to pick up following the conclusion of the repeat presidential election

The Kenya National Bureau of Statistics released their Leading Economic Indicators Report, for the period up to August 2017, which had the following key highlights were:

1. Between January and July, the value of building approvals in Nairobi declined by 18.4% to Kshs 149.5 bn from Kshs 183.2 bn in the same period in 2016;
2. The value of commercial approvals declined by 15.1% to Kshs 61.0 bn in 2017 from Kshs 76.1 bn in 2016
3. The value of residential approvals declined by 17.4% to Kshs 88.5 bn in 2017 from Kshs 107.2bn in 2016.

In our view the decline was as a result of (i) The enactment of the Banking Amendment Act 2015 that led to the reduction of credit advancement to the private sector; credit growth stood at 25.8% in June 2014, declined to 5.4% in August 2016, and then to 1.6% in August 2017, and (ii) the wait and see attitude developed by investors due to the electioneering period.

During the month, the performance and activities of the various themes is as below:

Residential

During the month, the government, through the State Department of Housing and Urban Development unveiled the Building Research Centre. This was in a bid to address the current housing shortage, which as per the World Bank Report, Kenya Economic Update 2017, stands at 2.0 mn housing units with 61.0% of urban dwellers living in slums. The research centre will bring together both private practitioners and housing sector stakeholders in joint efforts to address the shortage. In our view, the centre is an important step towards addressing the housing shortage and will enhance consultations among the stakeholders, enabling innovation and solution-oriented policies against factors that have been hindering the success of provision of low cost housing in the region such as alternative building technology to hasten development, cost effective building materials and training of construction technical capacity.

In tandem with this, the State Department of Housing and Urban Development also reached out to private contractors to partner in the construction of 8,000 houses on a pilot scheme on 55-acres of land in Mavoko, Machakos County. With an estimated cost of Kshs 21.0 bn. The partnership involves contractor designing, procuring, construction, commissioning and handing the houses over to the buyers with the government providing land. In our view, this is a positive step towards reducing the housing deficit that grows by 200,000 p.a.

Bucking the trend being witnessed among real estate developers, Mortgage Finance provider, Housing Finance launched Phase 2 of their Komarock Heights Estate, which is set to cost Kshs 3.3 bn. The estate will consist of 480 1, 2 and 3-bedroom units selling at Kshs 3.0 mn, Kshs 4.9 mn and Kshs 5.9 mn, respectively. Komarock had returns to investors of 8.0% and 12.7% for detached and apartment units, respectively, against a market average of 9.4% for detached units and 9.5% for apartments as per the Cytonn Residential Report 2017.

We expect consistent growth in the residential sector as well as a transitioning operational landscape as developers strive to address the housing deficit on the back of an improved macroeconomic environment.

Commercial

The commercial office theme reported minimal activity as a result of the extended electioneering period. The key activity witnessed in the sector in October was the launch of 25-storey FCB Mihrab building by Mihrab Development Limited, The Arabic architecture building is located in Kilimani and is currently 50% sold out with First Community Bank as the anchor tenant. Kilimani is an attractive investment opportunity with attractive returns with rental yields of 9.3%, with average market occupancy rates at 90.5% against market averages of 9.2% and 88.9%, respectively.

We expect slowed performance of the commercial office sector due to the tough economic environment that have curtailed expansion of businesses as well as the extended electioneering period.

Retail

The retail sector recorded heightened activity with more foreign retailers announcing plans to enter the Kenyan market. South African Retail giant ShopRite Holding announced plans of making a debut in the Kenyan market. ShopRite will join other international brands operating within the country such as the French based Carrefour, South Africa based Game and Botswana based Choppies all having entered the market in the last two years. These international retailers are attracted to the Kenyan market due to;

1. A robust macroeconomic growth with GDP at an average of 5.2% p.a over the past 5-years and is

expected to grow at between 4.7% - 5.2% in 2017, thus increased per capita wealth;
2. A rising middle class with higher purchasing power;
3. A high formal retail penetration rate ranging between 25% and 30% making Kenya the largest retail economy after South Africa which has a 60% penetration according to the Nielsen Q'2 2017 Consumer Confidence and Spending Intentions Survey.

Other key highlights in the retail sector include:

1. Naivas announced plans to start an outlet at Bank House located within Nairobi's Central Business District. This is in addition to its plans to open other branches in Utawala, Mountain View along Waiyaki Way, Kitengela, Kericho and Mombasa. The retailer continues to remain bullish on market performance evidenced by its expansion strategy the despite the tough operating environment characterized by increased competition and low bank credit accessibility,
2. Next Gen Mall, located along Mombasa Road, announced that a new anchor tenant - Souk Bazaar- will take the 60,000 SQFT space vacated by Nakumatt. The new anchor tenant, currently on a 20-year lease is set to open its doors to shoppers in the month. The retail outlet is owned by the developer of Nextgen Mall, and
3. At a planned cost of Kshs 2.99 bn, Choppies is set to open 40 new stores across Africa by venturing into Namibia and building on its current portfolio in Kenya, Tanzania, South Africa and Zambia. The Botswanan retailer currently has 10 stores in Kenya and is set to be the anchor tenant in the soon to be opened Kiambu malls and Southfield located in Kiambu Town and Embakasi, respectively.

In our view, the retail sector is set for a paradigm shift following the recent crisis faced by anchor tenants such as Nakumatt. We expect malls to shift focus from supermarkets as the anchor tenants to other retail outlets such as fast food stores that also attract high foot fall.

Hospitality

In the hospitality sector, the following were the main activities witnessed in the month of October:

1. South Africa's hospitality group, City Lodge, announced plans to open a 171-room hotel in Two Rivers Mall in November 2017. The move by the hotel chain is in line with its local and regional expansion plans, where hoteliers target to venture into Eastern and Southern Africa markets. According to the PWC's African Insights Hotels Outlook: 2017-2021, hotel revenue growth in Kenya is projected to increase by 6.2% and 8.9% in, 2018 and 2019, respectively. With the drivers to the hotel industry being: (i) Travel tourism: due to the presence of wildlife, beaches as well as scenic natural features that creates demand for hotel accommodation (ii) Improved infrastructure: that has enabled ease of access to information, online booking and payment and cashless payment systems for tourists
2. The Kenyan hotel industry has depicted an upward trend according to the Leading Economic Indicators (LEI) by KNBS, August 2017 release. Visitors arriving through Jomo Kenyatta International Airport (JKIA) and Moi International Airport (MIA) increased by 12.6% to 543,154 between January and July 2017 from 482,470 during the same period in 2016. Overall, the number of visitors has increased by 32.1% between January and July 2017. In Nairobi alone, the sector's improvement is depicted by high hotel occupancy during the same period, increasing by 17.3% points to 56.5% in July 2017 from 39.2% occupancy in January 2017, according to STR Global Hospitality Group. However, from August as a result of the cancellation of the presidential election result, the number of arrivals declined with hotels recording cancellations and thus lower occupancy rates. For instance, The Albtaros a luxury ship scheduled to voyage to Mombasa was canceled.

In our view, the hospitality sector is expected to pick up after the election period boosted

by increased marketing by the Kenya Tourism Board and improved infrastructure which has facilitated online booking and cashless payment systems for tourists.

Industrial

In the industrial sector, China Wu Yi is set to complete the construction of its Industrial Research, Development, Production and Construction Material Supermarket in Athi River in March 2018 with a total space of 75,970 SQM. The development will comprise of an exhibition area, office block, service block, building material supermarket and a hotel. Tatu City, a controlled master planned development in Ruiru, Kiambu County is set to release an additional 435 acres of land for sale in its industrial park in the course of next year after selling its industrial plots at an annualized compounded growth rate of 37.5% from 2016 to date. This has seen companies such as Bidco, Chandaria industries and Unilever, among others, take up serviced plots in Tatu City industrial park for light industrial assembly, warehouse and logistic buildings. In our view, the sector is set to witness increased developmental activity with better quality warehouses being built leading to higher rents and thus high rental yields

The high uptake rates of the industrial precinct can be attributed to the lower land costs and ease of access given their prime location in Ruiru easily accessible by both the Northern and Easter Bypasses as well as Thika Road.

Land

The Hass consult Q'3 2017 report on land and house prices in the market highlighted the softening of property prices and rental rate by 1.8% and 0.3% respectively q/q this was a decline in performance as compared 2016 where there was a rise in both asking prices and rental rates by 1.2% and 0.7% q/q respectively. The decline this year was attributed to reduced credit levels and a decline in investment activities due to political uncertainty following the annulment of the August 2017 presidential elections.

Hass Consult Land Price Index summary 2016-2017

	Q1 16	Q2 16	Q3 16	Q4 16	Annual 2016	Q1 17	Q2 17	Q3 17	Annual 2017
Nairobi Suburbs	(0.2%)	2.5%	1.4%	0.8%	5.1%	1.3%	0.7%	0.4%	3.2%
Nairobi Satellite Towns	1.1%	8.1%	7.0%	2.3%	21.8%	3.4%	1.0%	(1.7%)	5.0%
Average	**0.5%**	**5.3%**	**4.2%**	**1.6%**	**13.5%**	**2.4%**	**0.9%**	**1.1%**	**4.1%**

• Land prices in Nairobi recorded 0.4% q/q and 3.2% y/y. In Satellite towns however, land prices recorded declines of 1.7% q/q and 5.0% y/y attributable to declined demand from investors as a result of the political risk due to the extended electioneering period.

Source: Hass Consult

Statutory actions

Under statutory actions, the National Construction Authority (NCA), has made it mandatory for foreign contractors to work with local contractors by ceding at least 30% of the contract sum. This is in a bid to cushion local contractors from their foreign counterparts. The NCA Project Registration Guidelines stipulate that foreign contractors willing to register with the NCA must pay Kshs. 100,000 in registration fees and only undertake tenders they win. Temporary registered foreign contractors are expected to commit to sub-contracting at least 30.0% of contract value to their local counterparts. The effect of the NCA guidelines has been seen in the Kshs. 2.8 bn Karen Water Front project where Kenyans firm are expected to bag around 25.0% of the total contract costs and Runda Paradise, the Kshs 1.3bn project by Nachang Foreign Engineering Firms, where Kenyan firms generated Kshs 307mn that accounts for 23.6% of the contract costs. This, as the authority seeks to amend the Construction Act to give NCA the powers to arrest and prosecute developers who put up buildings that do not meet the regulator's standards and reduce its reliance on other entities in administration of its duties. In our view, even if this move is granted, it will barely solve the issues of sub-substandard buildings cases since such incidences arise due to the use of unqualified personnel, poor workmanship, substandard building material and poor loading in buildings, which should be dealt with at initial stages during building plan approvals and with all the professionals involved.

Listed Real Estate

In the listed real estate sub-sector, the Fahari I-REIT's share price declined by 6.4% during the month closing at Kshs. 10.25. Since its inception, the instrument has shed 50.6% of its value, from Kshs 20.75 the price at which it was floated at, in November 2015.

Generally, the price of the instrument has been on a steady decline attributable to (i) relatively lower dividend yield of 5.9% compared to brick and mortar real estate returns which offer average rental yields of 9.6% in the retail sector, (ii) the negative sentiment following the poor performance of Fusion D-REIT, which was undersubscribed in 2016 and (iii) information asymmetry in the market regarding REITs

We expect the slowdown in the real estate industry activities to persist till the end of Q4' 2017. However, the sector should pick up in 2018 after the end of the electioneering period.