Cytonn Weekly report #22, with a focus on Karen Real Estate Investment Opportunity

Cytonn Weekly

Executive Summary

Fixed Income: Money markets remain illiquid leading to an increase in the interbank rate to 13.5%. Bias to short duration remains and we still expect a rate increase. The appointment of the new governor was well received by the markets;

Equities: Market recovers marginally while companies take on restructuring to improve efficiency;

Private Equity: Kenya continues to receive a lion's share of private equity deals in the region;

Real Estate: The investment opportunity in real estate remains significant, driven by the housing deficit coupled with the on-going inspection of buildings in Nairobi; the land, housing and urban planning ministry at Nairobi County estimates that up to 50% of buildings in Nairobi may need fixing to bring them up to acceptable occupancy standards;

Focus of the week: Karen is an attractive real estate investment suburb, with annualized rental yield, total return and development returns, as per Cytonn Real Estate research, at 5% p.a., 15% p.a., and 27% p.a., respectively;

Company Updates:

- We continued to strengthen our platform, with Jackline Nzau joining us from PwC as finance associate.
- View summary of "Re-imagining Nairobi Lifestyle" event: Re-Imagining Nairobi lifestyle

Fixed Income

Treasury bills auctions continued to be undersubscribed with a 45% overall subscription, however there was more interest on the 91-day T-bill with Kshs 3.2 bn subscribed versus Kshs 1 bn offered. The yields however remained relatively unchanged at 8.2%, 10.5% and 10.8% for the 91, 182 and 364-day papers, respectively. Despite the unchanged rates on T-bills, the interbank rates have been on an upward trend ending the week at 13.5% from 12.3% the previous week due to market liquidity tightness as the Central Bank was actively mopping up to support the shilling.

The Kenya shilling strengthened during the week by 2.1% to end the week at Kshs 96.1/USD due to the indication that the MPC will be meeting next week to address shilling volatility and also due to President Uhuru's nomination of Dr. Patrick Njoroge as the new CBK governor.

We are highly encouraged by Dr. Njoroge's nomination. He is highly qualified, with a brilliant academic and professional track record, culminating with a PhD in economics from Yale, an Ivy

League school, and senior adviser at IMF. His relationship with the IMF will also go along way in enhancing the Kenya – IMF relationship. Additionally, his being a "new face" should be helpful in terms of bringing new ideas and perspectives to the job. Also, coming "out of the system" should shield the office and CBK from patronage. We think the president made an excellent choice that calmed the markets a bit and the shilling strengthened. However, insecurity remains a concern.

The 2015/2016 budget was tabled and approved in parliament last week on Thursday. The current years budget is 10% higher than the previous year's, with an increase in both the recurrent and the development expenditure. There has been continued increased allocation towards development expenditure over the years but the absorption has been much lower. On the financing side the government is projecting a 17.2% increase in ordinary revenue collection through the streamlining of tax payment by digitizing and simplifying the tax system. However, given that this year there has been a lag in collections, it is yet to be seen how the increased revenue collection target will be achieved. There is no provision for foreign debt to finance the budget but there is a 34% increase in domestic borrowing target to Kshs 201.92 bn.

Despite relatively lower inflation levels, we expect interest rates to increase in the short term due to the current volatility in currency coupled with increased demand for domestic borrowing by the government. Consequently, nvestors should be holding short duration fixed income investments.

Equities

During the week the market indices had mixed performances with NASI edging up 1.0% while NSE 20 lost 0.6% to close at a 2015 low of 4,784.1. The performance was backed by gains in Safaricom (3.2%) and KCB (4.4%) as investors came back to the stocks after weeks of price correction. There were however some loses reported on BAT (6.7%) due to a negative global outlook on the tobacco industry and StanChart (6.9%) after disappointing first quarter results, as there was an increase in non performing loans.

There were no significant results announcements during the week but key to note is that many companies are looking at restructuring their operations to improve efficiency and increase earnings growth. There has been number of success stories of restructuring, such as KCB, which reduced cost-to-income ratio from over 60% in 2010 to around 50% in 2014. Recently Co-operative Bank, whose first quarter PBT grew by 30%, is also undergoing efficiency restructuring. We saw Kenya Airways hire a New York consultancy firm, Seabury Group, to help restructure their business. This comes in the wake of a very difficult operating time for Kenya Airways due to a strain in cashflows as they were impacted by the closure of some West African routes due to Ebola and the low tourism season in Kenya due to the insecurity concerns.

Given the relatively lower earnings growth prospects and stretched valuations, we remain neutral on equities and are of the view that active money managers will be able to derive returns through prudent stock picking. However, we are watching two main indicators: (i) the balance between valuations versus earnings growth prospects, and (ii) interest rates and currency volatilities, in order to reassess our stance.

Real Estate

Kenya's housing market has huge investment opportunities given the annual housing deficit of 200,000 units, and with the government's on-going inspections in areas of Nairobi such as Kahawa West, Umoja, Githurai and Roysambu, this may lead to greater housing needs. It is estimated that close to half of the buildings in some of these areas are defective and this could be reason for the recent cases of collapsed buildings. Majority of developments in growing towns in Kenya are unplanned and haphazard, and as such lead to low levels of safety for their residents. A large opportunity hence exists for developers who strive to provide affordable housing while still adhering to quality standards.

City Hall has drafted a Valuation and Rating Bill that could have several key effects. First, the obligation to pay land rates will shift from the landlord to the tenant in order to improve collection. Second, the bill provides for revaluation of properties since current valuations are out-dated, in some cases by more than 30 years; this could put pressure on landowners with idle land to rethink ownership of unproductive land.

Private Equity

A joint PE survey between KPMG and the East Africa Venture Capital Association (EAVCA) indicates that there were 79 disclosed private equity deals worth USD 800 mn in the region between 2007 and 2014. Of these, Kenya accounted for 63% of the deals, Tanzania at 15%, Uganda at 10%, Rwanda at 8% and Ethiopia at 4%. Some of the targeted sectors include the agricultural, financial services, energy and natural sectors.

Helios acquired a 12.4% stake in Africa Oil, a deal worth Kshs 10 bn. The funding will be used to support on-going appraisal and development work program in East Africa. If the appraisal is successful, we shall see an increase in Private Equity firms focused on oil exploration targeting Kenya to exploit the vast opportunities.

Kenya, East Africa's biggest economy, has also experienced an increase in private equity deals in the fast moving consumer goods (FMCG) sector. This is evidenced by Botswana's retail chain Choppies striking a deal with Ukwala, a mid-tier Kenyan supermarket, for Kshs 1 bn. The deal will see Choppies take on 10 Ukwala stores located in Nairobi, Nakuru and Kisumu. Similarly, Kevian Kenya, manufacturer of Afia Juice and Mt Kenya water, has acquired the water bottling plant from Thika-based bread maker, Kenblest in a bid to consolidate its water bottling business. Despite the stiff competition in the industry, demographic trends, including a young population and a growing middle class, alongside rapid urbanization, have made the sector lucrative.

Focus of the week: Karen Real Estate Investment Opportunity

Cytonn Real Estate, our development affiliate, last week highlighted Amara Ridge, a development coming up in Karen, a leafy suburb of Nairobi: Amara Ridge flythrough .

Amara Ridge, which is breathtaking, distinct and luxurious, showcases Cytonn's unique platform of bringing financing, landowners and development capability together using innovative Joint Venture structures.

We have picked Karen as one of our key areas of focus because it is one of the few areas in Nairobi that still offers serene country living coupled with significant potential for attractive financial returns. Essentially, it offers an opportunity to not only own and enjoy a home, but also to build financial affluence driven by 3 main factors:

1. Improving infrastructure, the dualing of Ngong road, Langata road and the southern bypass, when completed, will dramatically improve the accessibility of Karen;
2. The on-going relaxation of zoning restrictions allowing for more comprehensive and higher density development, which increases real estate values;
3. Karen has unique historical heritage and also close proximity to amenities such as a city park, an abundance of quality school choices, a country club, several shopping malls, tranquil leafy suburban life, upcoming international conference centre at Bomas, etc.

The above unique factors have seen land prices in Karen increase almost 6 times over the last 7 years, yet Karen still remains the most affordable prime residential address compared to other areas like Lavington, Runda and Spring Valley.

All values in Kshs Millions unless stated otherwise		
Prime Residential Areas	% Change from 2007	Average Value (in Kshs. Mn)
Karen	575%	45
Lavington	488%	202
Runda	482%	67
Langata	427%	46
Spring Valley	392%	147

Source: Hass Consult Q4 2014 Land Index

Despite the attractiveness of Karen as both a living and real estate investment destination, Karen faces two key challenges that are faced by almost all residential development concepts in Kenya:

1. Rapid urbanization and population growth has far outpaced infrastructure development, hence most residential developments do not have reliable water, sewer, power and good roads;
2. Increased insecurity.

Taking into account the opportunities that Karen offers (country living, amenities and real estate potential), and the challenges it faces (inadequate infrastructure and insecurity), the most appropriate residential concepts ought to be gated communities where families can share the costs of infrastructure and enhanced security.

This explains why the choices of housing in Karen are rapidly shifting from traditional stand-alone bungalows to shared but exclusive, gated communities.

Gated communities can be the typical small scale of 10 to 14 homes sitting on half-acres, similar to Cytonn's Amara Ridge; or they can be more comprehensive, with a comprehensive clubhouse, coffee shop and light retail and commercial conveniences. This typically requires about 50 to 60 homes sitting on half-acres. Cytonn's upcoming Situ Village will be a comprehensive lifestyle gated community.

Having chosen Karen as one of the Nairobi surburbs that Cytonn Real Estate will focus on, and gated communities as a core concept for Karen, then the next step was to quantify the return potential for gated communities in Karen through market research.

Market Research on Gated Communities:

We carried out market research, targeting at finding four key assumptions for gated communities in the Karen region, to provide us with valuable information before undertaking any development:

Sales Price Research							
Project Name	Location	No. of Bedrooms	No. of Units	Sale Achieved %	Selling Price Kshs Millions	Size per unit SQM	Price per SQM
Tai Woods	Murisho Rd	5	10	100%	50	250	200,000
Pergola Villas	Karen plains	4	10	100%	65	250	260,000
Dik Dik Gardens	Karen Hardy	4	9	100%	65	350	185,714

Miotoni Ridge	Miotoni	5	14	86%	110	500	220,000
Muhugu Park 11	Kerarapon Rd	5	20	85%	75	450	166,667
Marula Gardens	Marula Lane	5	6	83%	82	300	273,333
Miotoni Woods	Miotoni	5	14	71%	75	460	163,043
Primary Mean*		**5**	**13**	**80%**	**77**	**403**	**201,014**
Total Mean		**5**	**12**	**89%**	**75**	**366**	**209,823**
Primary Mean- includes; Muhugu Park 11, Marula Gardens and Miotoni Woods*							

Summary of research finding:

1. **Plinth Area:**

Research showed us that Primary Mean plinth area is 403 square metres. However, we also note there are many gated communities with houses above 450 square metres, offering a high-end development feel and providing a sense of openness and grandeur in the houses. So for Karen gated communities, we recommend developments of about 400 to 450 square metres for high-end homes.

2. **Sale Price:**

Our research showed us that units in gated communities in Karen have sold for an average of Kshs 209,000 per square metre, while achieving a sale target of above 80% during construction. The price of a unit ranges between Kshs 50 mn to Kshs 110 mn, which highly depends on location, size per unit and provision of social amenities. But the average price is about Kshs 75 million.

3. **Rental Income:**

Our research showed us that units in gated communities in Karen have average rental rates of Kshs 333,000 per month, exclusive of service charge. Another interesting aspect is that the rental rate is not very dependent on the size of the house; rather we see the location of Karen sells itself as a high-end area for rentals.

All values in Kshs unless stated otherwise

Rental Rates Research					
Project Name	Location	No. of Bedrooms	Size per unit SQM	Rental per Month	Rental per SQM
Miotoni Woods	Miotoni	5	460	350,000	761
Muhugu Park 11	Kerarapon Rd	5	450	300,000	667
Dik Dik Gardens	Karen Hardy	4	350	350,000	1,000
Tai Woods	Murisho Rd	5	250	300,000	1,200
Miotoni Ridge	Miotoni	5	500	400,000	800
Pergola Villas	Karen plains	4	250	200,000	800
Marula Gardens	Marula Lane	5	300	350,000	1,167

Primary Mean*		**5**	**403**	**333,333**	**865**
Total Mean		**5**	**366**	**321,429**	**913**
Primary Mean- includes; Muhugu Park 11, Marula Gardens and Miotoni Woods*					

4. **Land and constructions costs:**

Based on our consultations with quantity surveyors, a decent house in Karen should cost about Kshs 55,000 to Kshs 60,000 per square metre in constructions costs, giving a mid point of Kshs 57,500 per square metre. Given the average plinth area of about 400 square metres, then the average construction costs, excluding land is about Kshs 23,000,000, using a mid range Kshs 57,500 per SQM of construction costs multiplied by 400 SQM. With land at about Kshs 45 million per acre, a half-acre would be acquired at a cost of about Kshs 22,500,000, bringing total construction plus land costs to Kshs 45,500,000, before financing costs.

Assuming 60% debt (45,500,000 * 60%) at a cost of 18% per annum for 18 months, the financing costs would be approximately Kshs 8 million, uncompounded, bringing total costs of approximately Kshs 53,500,000.

Bringing it all together:

Rental Yield: Given a monthly rent of about Kshs 320,000 per month, that works out to be Kshs 3.8 million per year. Given that house prices are about Kshs 75,000,000, it means that the gross rental yield for Karen should be about 5% p.a., which is consistent with prime residential property yield expectations.

Total Return: Rental Yield + Projected Capital Appreciation. Over the last 7 years, the annualized total capital appreciation has been 28% per annum. However, we will be conservative and assume that despite the on-going infrastructure and zoning changes going on in Karen, the next 5 years will not be as good as the last 5 years, so we estimate projected capital appreciation at about a third of historical, hence a projected appreciation of 10%. A 10% projected appreciation plus the above 5% rental yield brings a projected total return of 15% per annum for Karen over the next 5 to 10 years. Given a 10-year government bond is at 12%, the conservative 15% total return, which has a potential to increase, is attractive.

Development Return: Developer return on investment, including financing costs, given sales price of Kshs 75,000,000 and total investments of Kshs 53,500,000, gives a total return of about 40% over 18 months, which works out to an annualized return of about 27%, which is attractive.

In conclusion, a 5% p.a. rental cash yield, a 15% p.a. total return, and 27% annualized development return make Karen a very attractive long-term real estate investment destination for both investors and home owners.
