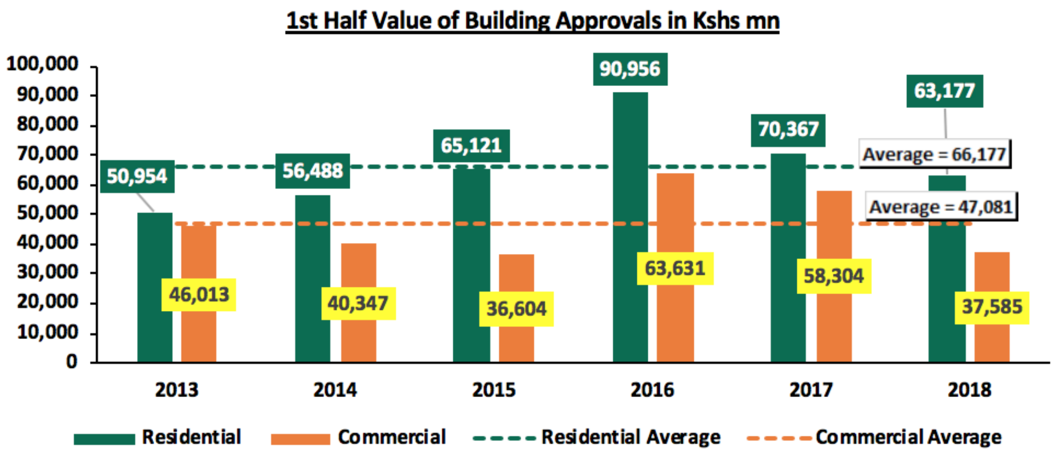
Nakuru Real Estate Investment Opportunity, & Cytonn Weekly #30/2018

Real Estate

Industrial Report:

During the week, The Kenya National Bureau of Statistics (KNBS) released its June issue of Leading Economic Indicators (LEI), which showed a decline in activity in the building and construction sector in H1'2018 and slight growth in the tourism and hospitality sectors. The key take-outs were as follows:

i. The value of building approvals at the Nairobi City Council in H1'2018 came in at Kshs. 100.8 bn, 21.7% lower than the total value of approvals recorded in H1'2017 of Kshs 128.7 bn. The drop is primarily attributable to the generally slower issuance of approvals by the current Nairobi County Government; and in some cases like April 2018, there was non-issuance of approvals,
ii. The value of approvals for commercial developments declined at a significantly higher rate of 35.5% to Kshs 37.6 bn from Kshs 58.3 bn in H1'2017 in comparison to the 10.2% drop for residential developments to Kshs 63.2 bn from Kshs 70.4 bn in H1'2017, this we attribute partly to increased competition especially in the office market with an oversupply of 4.7 mn SQFT as at 2017, therefore giving buyers a bargaining power and leading to lower returns for developers; however a 35.5% drop is worrying considering the overall improvement in the economic environment in 2018. We have compared the annual change during the first half over the last 5-years and we found that the value of approvals for commercial developments has been declining y/y except in 2016 when the approvals increased by 73.8%, as indicated in the table below. It is likely that the decline is in response to the increased supply and slow uptake of the new completions especially in the office sector. On the other hand, excluding April, approvals for residential developments in H1'2018 have been higher in comparison to 2017 on account of increased focus on development of affordable housing since its inclusion among the 4 key pillars of economic growth for Kenya by the Jubilee Government during the 5-year period till 2022,



Sour

ce: KNBS

iii. Cement production came in at 2.8 mn tonnes in H1’2018, a 10.0% decline from 3.2 mn tonnes in H1’2017, while consumption stood at 2.7 mn tonnes in H1’ 2018, a 7.4% decline from 2.9 mn tonnes in H1’2017. This decrease is largely attribute to the slow-down in construction activity during H1’2018 and the effects of reduced credit supply in the market, and,
iv. International arrivals on the other hand, recorded a 0.9% increase coming in at 443,950 in H1’2018 compared to 439,807 H1’2017, the increase in arrivals in the country has driven by; i) restoration of political calm, ii) the revision of negative travel advisories, warning international citizens, e.g. from the United States against visiting Kenya, iii) positive reviews from travel advisories such as Trip Advisor who ranked Nairobi as the 3rd best place to visit in 2018, and iv) improved hotel standards with the entry of global hotel brands like Hilton Garden Inn along Mombasa Road, DoubleTree, a brand by Global chain Hilton Group along Ngong Road, and Swiss hotelier while existing hotels refurbish their developments some including Hilton located within Nairobi CBD along Mama Ngina street and Sarova Panafric along Valley road.

We expect increased supply, primarily in the residential sector with a focus on housing for the lower-middle and low-income segments of the market, whereas the commercial sector is likely to witness a slow-down in supply as the market grapples with surplus stock and as newly completed buildings struggle to reach optimal occupancies. The growth in tourism is likely to boost the hospitality sector as increased international arrivals will create demand for accommodation and conferencing space.

Residential Sector:

In the residential sector, affordable housing continues to draw a lot of interest as various stakeholders push for policies that would make the initiative a success. This week, the UN – Habitat advised the Kenyan Government to intervene through policies to ensure that the 23,000 Savings and Credit Co-operative Organizations (SACCO’s), who have close to Kshs 1 trillion in savings, have access to serviced land, professional expertise, and reduced tax on building materials that would facilitate provision of mass affordable housing to low income earners. If implemented, these policies will create an enabling environment for SACCO’s and other players on the supply side to produce low-income housing and thus contribute towards the achievement of the Jubilee Government’s Big 4 Agenda. Policies that the government has already put in place are mainly geared towards facilitating home-ownership and offtake, they include: i) the Income Tax Act, which will allow the buyers get a 15.0% tax relief to a maximum of Kshs 108,000 p.a., or Kshs 9,000 p.m., under the newly introduced Affordable Housing Relief Section, and ii) the amendment of the Stamp Duty Act, to enable exemption of first time home buyers from paying Stamp Duty Tax, which normally is 2.0% or 4.0% of the property value. In addition, the government has initiated plans to set up a Mortgage Refinance Facility by 2019 that will create liquidity for primary lenders and thus enable them to give long-term loans at attractive rates and thus boosting the uptake of the affordable housing units by prospective homeowners. In our opinion, there’s also need for consideration of policies that will enable not only SACCO’s, but also other developers, save on development costs in order to partake in the success of the affordable housing initiative. The key areas that require attention are on i) construction costs as they contribute to approximately 50%-70% of development costs and increase year on year driven by inflation and increased reliance on imported materials, ii) provision of offsite infrastructure and serviced land so that developers save on costs that would have otherwise been incurred, and iii) access to finance through advocacy for alternative sources of development funding such as structured products and REITs.

In Nairobi, the partnership between the National Government and Nairobi County Government has led to acquisition of land parcels that will be used for the development of affordable houses. Areas in which land has been acquired include; Kibera, Mariguni, Parkroad, Starehe, Shauro Moyo and Makongeni. The acquisition of land is the first huddle to implementing the initiative of provision of affordable housing to the government and is evidence to their efforts in achieving the goal of developing 500,000 units by 2022.

Commercial Sector:

In the commercial sector, Prism Towers, a 33 –storey building of 133m in height, developed by Kings Developers Ltd officially opened for occupation. The building, situated in Upperhill, and whose construction began in 2014 will bring to the market a total of 250,000 SQFT of lettable office space. It is now one of Nairobi's tallest buildings, only 4^{th} to Britam Tower, UAP Old Mutual Tower and the Times Tower with 200m, 163m and 140m in height, respectively. This adds to the stock of office space in Nairobi where office completions have been increasing at a 5-year CAGR of 23.6% between 2012 and 2017 as per Cytonn Nairobi Commercial Office Report 2018. According to the report, the average rent of office space in Upperhill stood at Kshs 99 per SQFT in 2017, while the selling price stood at an average of Kshs 12,995 per SQFT. We, however, note that the market has been undergoing a price correction that saw rents reduce by 2.9% y/y from Kshs 102 per SQFT in 2016. The reduction is attributed to increased supply of office space in the node with no commensurate demand to take it up. As a result, occupancy has declined by 7.8% points from 89.8% in 2016 to 82.0% in 2017 while yields remained flat at 9.0%. The overall performance of the office market in Nairobi softened in 2017, with yields reducing by 0.1% points to 9.2% from 9.3% in 2016, and occupancy rates reducing by 4.8% points from 88.0% in 2016 to 83.2% in 2017, as per the report. We expect the performance of the office sector to continue declining given the Nairobi oversupply, which stands at 4.7 mn SQFT as at 2017 and with other new buildings such as the Tourism Fund Complex and Britam Towers in Upperhill, both completed in 2017 and One Africa Place in Westlands targeting completion in August 2018. We recommend that investments in the office market should be made in zones with low supply and high returns such as Karen by offering differentiated concepts such as serviced offices and green buildings to boost returns.

Retail Sector:

In the retail sector, Burger King, an American fast food franchise, announced opening of a new outlet at the Thika Road Mall (TRM) bringing its total count to four outlets in the country with the rest located at Nextgen Mall in South C, The Hub in Karen and The Two Rivers Mall in Runda. Expansion of international retailers within the country is largely driven by i) economic growth rate with an attractive GDP growth rate averaging at 5.3% over the last 5-years, which boosts the purchasing power in the country, ii) shifting consumer habits as Kenyans increasingly shop in formal retail centres and are increasingly appreciating international brands, and iii) Kenya's growing position as a regional and continental hub hence witnessing an increase in multinationals operating in the country. We expect the expansion of retailers to result in increased uptake of retail space where occupancy stood at 81.2% in H1'2018 a 0.9% points increase from 80.3% in FY'2017 according to Cytonn H1' 2018 Markets Review.

Infrastructure:

In the infrastructure sector, the government continues to increase its investments in order to boost the country's economic growth through i) revenue generation, ii) increased employment opportunities, iii) betterment of services and facilities, and iv) improving the ease of doing business in Kenya. Some of the highlights during the week were as follows;

- Kenya Railways Managing Director, Atanas Maina, announced the construction of a 22 km Standard Gauge Railway (SGR) line costing Kshs. 200 mn set to link the Miritini passenger terminus to the Mombasa CBD that will commence at the end of this month. The aim of this railway line is to facilitate transit by individuals moving from the terminus to Mombasa CBD and back. Plans are also underway to extend the railway line past the Mombasa CBD and to the Mombasa Port with the aim of facilitating cargo transportation to Nairobi. If successfully completed, the railway will not only boost the various sectors that rely on rail for goods' transportation, but also the tourism and hospitality sectors as it will ease the travel experience for local travellers,

- The government has set aside Kshs. 1.5 bn for the construction of 2 bypass roads in Thika Town. The construction of the two roads is expected to take 2-years and will be done in two phases. The first phase will involve a 10 km road linking Garissa Road and the Thika Superhighway passing through Kivulini, Athena and Witeithie while the second phase will involve a 15 km road linking Kenyatta Highway and Garissa Road through Munene Industries, UTI, Pilot, Umoja and Kenyatta Leather. The construction of these roads will ease traffic congestion within the town, improve the productivity and increase investments in Thika, being an industrial hub,
- The Nairobi Satellite Towns Water and Sanitation Development Programme Project, funded by KfW (Kreditanstalt für Wiederaufbau) Development Bank, based in Germany, and the National Government, is set to be completed in 18-months. The first phase of the project, which will be executed by Athi Water Services Board (AWSB) on behalf of the government, will be at a total cost of Kshs 3.6 bn for the Ruiru – Juja water project and Kiserian – Ongata Rongai Project. The project will involve creating a new distribution line system that will enable the satellite towns to enjoy uninterrupted water supply. We commend this project as it will improve living standards in the targeted areas and make them more viable for real estate investment.

Statutory Actions:

This week, sector several stakeholders in the real estate sector were affected by operations by the Nairobi River Regeneration committee, an intergovernmental agency tasked with the role of rehabilitating the Nairobi River. The committee led by the National Environment Management Authority (NEMA), a government agency responsible for environmental management and defining environmental policies, embarked on plans that seek to alleviate the encroachment on riparian land, the move, has affected developers who have set up developments that restrict flow of rivers and thus cause flooding. Buildings affected include; Sunflower Apartments and Mituntu Apartments comprising residential furnished and serviced apartments, respectively and located along Ring Road, Kileleshwa, Caribbean Park Apartments, comprising 3-bed unfurnished units along Fips Drive in Kileleshwa, South End Mall, a retail mall located along Lang'ata road, and Nakumatt Ukay in Westlands. Upon completion, the crackdown could lead to the demolition of approximately 4,000 real estate developments within Nairobi.

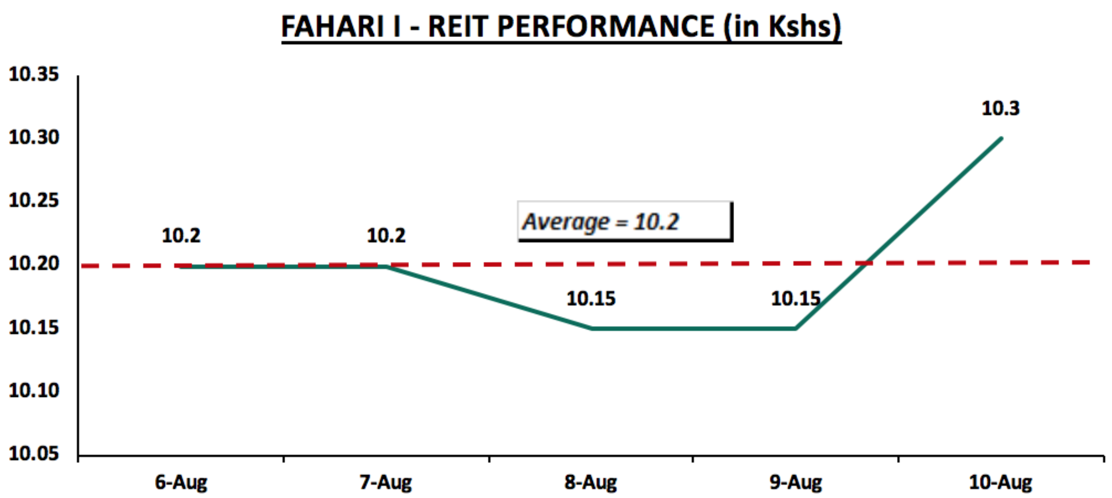
Furthermore, during the week, an in-house audit conducted by the National Construction Authority (NCA) that found that 16.0% of the 5,000 developments in Nairobi were unsafe. 18.3%, 146 of the 800 buildings required structural adjustments to meet required standards while, 81.7%, 654 buildings did not obtain statutory approvals and had thus been earmarked for demolition. In our view, these challenges are as a result of (i) inadequate due diligence that has thus led to losses due to demolitions, and (ii) corruption in the Lands Ministry that have led to the issuance of public land to private real estate stakeholders.

Members of Parliament (MPs) have repealed the solar water heater law, which imposed a fine of Kshs 1.0 mn or a one – year jail sentence to developers who fail to install solar water heating systems in their developments. The law was nullified because it would be an inhibitor to access to affordable housing and the fine contravenes the Statutory Instruments Act, which caps the fines payable to a maximum of Kshs. 20,000 or a prison sentence not exceeding 6 months.

Listed Real Estate Sector:

I. **The Fahari I- REIT, Kenya**

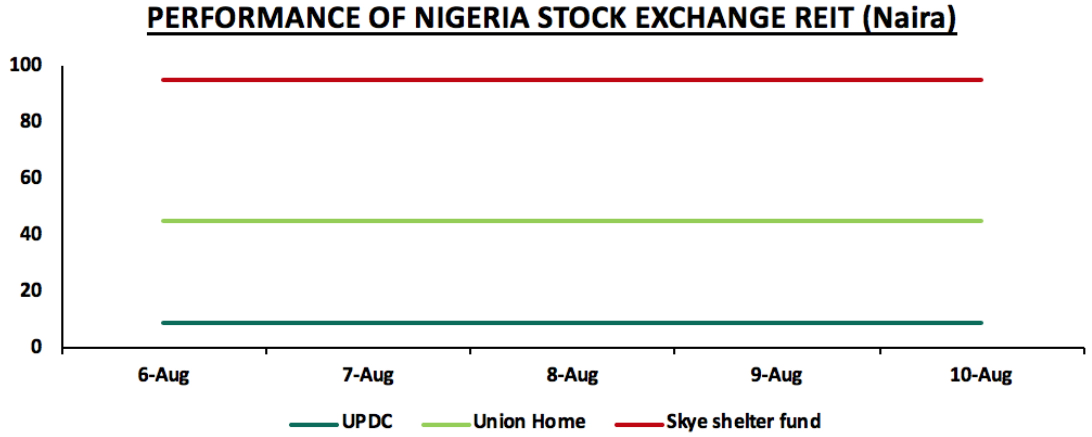
During the week, Fahari – I REIT closed at a price of Kshs 10.3 per share, 0.9% higher than its opening price of Kshs 10.2 per share. On average, however, the REIT traded at Kshs 10.2, a 12.1% drop from an average of Kshs 11.6 last week and 2.9% below its opening price of Kshs 10.5 per share at the beginning of the year. The REIT is trading at low volumes with a relatively stable price, an indication of continued low investor appetite for the instrument. This follows the release of their H1'2018 earnings, with the REIT registering a 16.3% y/y decline in earnings to Kshs 0.36 per unit from Kshs 0.43 per unit in H1'2017. The decline in performance was attributed to a temporary increase in vacancies, coupled with some tenants bargaining for reduced rentals upon the renewal of leases, leading to reduction in rental income. However, we note that overtime the REIT is operating efficiently indicated by a better expense ratio. The REIT,s expense ratio came in at 3.0% of its total assets in H1' 2018, which is 0.05% improvement y/y from the same period in 2017, this is attributed to a 0.9% decline in operating expenses from Kshs 112.5 mn in H1' 2017 to Kshs 111.5 mn in H1' 2018 and a 0.8% increase in assets from Kshs 3.69 bn to Kshs 3.72 bn between H1' 2017 and H1'2018, respectively. For a more comprehensive analysis see our Stanlib Fahari I-REIT Earnings Note.



Source: Bloomberg

II. **West Africa**

REITS in Nigeria on the other hand, continued to plateau with the three REITS i.e. Union Home, Skye Shelter and UPDC attaining a constant price per share of N45.2, N95 and N9, respectively, throughout the week. This is as a result of inadequate investor knowledge about the market hence low investor interest in the instrument, and poor valuation of the market by valuers, which leads to lower levels of demand by potential investors.



Source: Bloomberg

We expect the real estate sector in Kenya to continue on an upward trajectory given (i) government efforts in bridging the housing deficit in the country through provision of affordable housing, (ii) continued improvement in infrastructure by the central government, and (iii) expansion by global retailers into the country.