Mombasa Real Estate Investment Opportunity August 2018, & Cytonn Weekly #34/2018

Real Estate

Retail Sector

During the week, Kiloran Development Group, a UK-based developer with an operational office in Nairobi, and ALL Design, a British architectural firm, announced plans of putting up a Mixed-Use Development (MUD) named, "The Beacon", to be located off Uhuru Highway towards Bunyala Road roundabout. The mall consisting of 261,563 SQFT of retail space and 45,208 SQFT of Grade A office space, is set for completion in 2020, which in our opinion may be unachievable given that the project has not broken ground yet. The project will be the developer's second in Kenya, with the first one being Cedar Mall in Nanyuki. This underlines Kenya's attractiveness to the foreign investors and multinational corporations, especially in the office and retail sectors. This has been as a result of: (i) the ever-widening middle class, evidenced by the growth in GDP per capita at a rate of 7.9% p.a. over the last 5-years from Kshs 113,539 in 2013 to Kshs 166,134 in 2017, hence increased purchasing power, (ii) Nairobi's status as a regional hub boosted by infrastructural growth, and (iii) attractive returns in the retail and office sectors, with average rental yields of 9.4% and 9.2%, respectively, compared to an average of 5.4% and 6.1% for the residential and industrial sectors, respectively. The supply has increased in the retail sector with an 8-year CAGR of 15.9%, from 2.0 mn SQFT in 2010 to 6.5 mn SQFT in 2017 and in the office sector, with a 5-year CAGR of 23.6% from 1.2 mn SQFT in 2012 to 3.5 mn SQFT in 2017. The developer intends to differentiate the mall with provision of amenities, and in addition the mall will be open air and adopt a playful theme. The combination of office and retail spaces and the differentiation is likely to boost the performance of the development, as Mixed-Use Developments outperform purely office and purely retail buildings. In Kilimani for instance, MUD's have average rental yields of 11.0%, compared to 9.2% for commercial office and 9.4% for purely retail buildings. Despite this, the development's performance may be constrained by:

i. The estimated 5.3 mn SQFT and 2.0 mn SQFT oversupply of both the commercial office and retail space, respectively, in Nairobi, which has constrained performance, with average rental yields for retail decreasing by 0.6% points over the last two-years from 10.0% in 2016 to 9.4% in 2018, and commercial office decreasing by 0.1% points from 9.3% in 2017 to 9.2% in 2018,
ii. The location is also just approximately 0.5 km from Nyayo Stadium roundabout, an area affected by traffic snarl ups, which is un-favorable for real estate developments, with Mombasa Road, which is commonly affected by traffic snarl ups, underperforming the market for both commercial office and retail developments, recording rental yields 0.7% points, and 1.6% points lower than market for retail and office space, respectively,
iii. The mall is less than 2 km from The Pinnacle, and approximately 1.2 km from Montave Mall, which are on Upper Hill and Lower Hill roads, respectively, approximately 300 metres from Highway Mall and approximately 2.2 km from Capital Center along Mombasa Road, and thus faces stiff competition.

This continued investment in the commercial sector is mainly driven by; i) the rising middle-class resulting in increased purchasing power as well as varying tastes and preferences for different goods and services which has created demand for international brands hence attracting multinational brands, ii) the current growth of the Kenyan economy, that has averaged at over 5.0% GDP growth for the past 5-years, iii) rapid improvement of infrastructure making it possible for investors to venture into otherwise inaccessible areas, iv) Kenya's high population growth of 2.6% p.a against the worlds at 1.2% p.a, which has created demand for retail goods and services, and v) Kenya's urbanization rate at 4.3%, which is relatively high compared to the world's 2.1%, has resulted in a need for retail stores and entertainment spots.

The table below shows the rental yields changes between 2017 and 2018, and the existing oversupply of space in the office and retail sector;

Nairobi Office and Retail Performance Summary 2017-2018

Theme	Rental Yield 2017	Rental Yield 2018	y/y change	Oversupply
Office	9.2%	9.3%	**0.1% points**	5.3 mn SQFT
Retail	9.6%	9.4%	**(0.2%) points**	2.0 mn SQFT

- **The retail sector recorded a 0.2% point decrease in rental yield from 9.6% in 2017 to 9.4% in 2018, attributable to the oversupply of retail space in the market**

Source: Cytonn Research

Commercial Office Sector

Emperor Plaza, a family-owned commercial building located in Nairobi CBD, is set for sale at Kshs 750 mn, exclusive of purchase costs and VAT. The 5-floor building is located at the Junction of Kenyatta Avenue and Koinange Street, and currently hosts the Kenya Institute of Management (KIM) and other tenants. According to local dailies, the vendors value the building at Kshs 750 mn, that is a sale price of Kshs 17,847 per SQFT, with a resultant rental yield of 8.4%. This is 0.3% points lower than the average rental yields of 8.7%, at 84.1% occupancy recorded in the CBD, despite the fact that the building is 100% occupied. Working backwards, from the yields and prices, the annual income is Kshs 525.0 mn and to achieve a market yield of 8.7%, the value of the building is Kshs 724.1 mn. The yield on offer is 0.3% points lower than the 8.7% yield at which Stanlib Fahari I-REIT acquired 67 Gitanga Place, a 40,673 SQFT Grade A office building with an annual income of Kshs 73.8 mn. Stanlib Fahari I-REIT acquired 67 Gitanga Place at Kshs 850 mn in April this year as analysed in the Cytonn Stanlib Fahari I-REIT Earnings Update - H1'2018. The Emperor Plaza building is a good buy, given that; it is in an ideal location, since it is located at the Junction of Kenyatta Avenue and Koinange Street. It is also fully occupied, despite the CBD recording decreased occupancy rates, which have dropped by 8.6% points from 92.7% in 2017, to 84.1% in 2018.

The main risk factors for investors in the building are; i) companies moving out of the CBD to other prime business nodes such as Upperhill and Kilimani, due to lack of good quality offices in the CBD, and ii) insufficient parking in the Nairobi CBD area. Below is a summary of the performance of the performance commercial office buildings in the Nairobi by nodes:

(All values in Kshs unless stated otherwise)

Nairobi's Commercial Office Performance 2016-2017

Area	Price Kshs/ SQFT	Rent 2017 (Kshs/SQFT)	Occupancy 2017 (%)	Yield 2017(%)	Price 2016 (Kshs/SQFT)	Rent 2016 (Kshs/SQFT)	Occupancy 2016(%)	Yield 2016 (%)	% Change in Rents Y/Y
Parklands	12,729	103	85.7%	9.7%	11,771	102	80.0%	10.0%	1.3%
Karen	13,167	113	89.2%	9.5%	13,500	107	90.0%	9.7%	5.8%
Kilimani	12,901	101	84.5%	9.5%	12,667	99	90.5%	9.3%	2.2%
Westlands	12,872	103	88.5%	9.4%	12,482	102	92.1%	9.2%	1.1%
UpperHill	12,995	99	82.0%	9.0%	12,529	102	89.8%	9.0%	(3.0%)
Nairobi CBD	12,286	88	84.1%	8.7%	11,750	92	92.7%	9.0%	(4.2%)
Thika Road	11,500	82	73.6%	8.5%	11,700	91	80.3%	8.8%	(10.3%)
Mombasa Road	11,641	82	74.2%	8.5%	10,720	80	86.1%	8.5%	2.1%
Average	**12,679**	**99**	**83.9%**	**9.2%**	**12,053**	**100**	**88.9%**	**9.2%**	**(0.6%)**

• Nairobi CBD recorded an average rental yield of 8.7% in 2017, which is a 0.3% decline from 9.0% recorded in 2016, with the occupancies declining by 8.6% points from 92.7% in 2017 to 84.1% recorded in 2018, and this is attributable to companies moving out of the node in search of better environments and better quality office spaces

Source: Cytonn Research

Other highlights of the week include;

i. In infrastructure, Marubeni Corporation, a Japanese firm involved in power generation projects through wind, solar, hydropower and biomass was awarded a tender by Kenya Electricity Generating Company Limited (KenGen), to construct a new 83 MW geothermal power plant in Naivasha for an undisclosed fee. According to the Managing Director, Rebecca Miano, the project is an extension of the existing Olkaria 1 units 4 & 5 geothermal power. The project will be financed through a Kshs 26.5 bn balance of funds saved from the completed Olkaria 280 MW geothermal project, a loan of Kshs 40 bn from Japan International Co-operation Agency (JICA) and European Investment Bank (EIA). The project is expected to result in increased electric power supply in the country and thus boost; the growth of the country's macro-economic variables such as the Gross Domestic Product (GDP) through revenue generation, creation of employment, and ease doing business;

ii. Struggling retailer, Nakumatt Holdings, closed down its Likoni Mall branch, following a court order to exit the premises due to failure to pay rent. The outlet was the only remaining branch in Mombasa, following the closure of its Nyali City Mall branch in March this year. The retailer currently has six operational branches in the country, out of a total of 62 in 2017. The operational branches are; Nakumatt Mega along Uhuru Highway, Nakumatt Prestige, Lavington, Embakasi, Mega City (Kisumu) and Nakumatt Nakuru.

Listed Real Estate

The Fahari I-REIT closed the week at Kshs 9.8, 3.9% lower than last week's average price of Kshs 10.2, and a marginal decline from the week's opening price of Kshs 10.0. During the week, it recorded an average price of Kshs 9.9, which is a decline of 25.1% from last year's trade price of Kshs 12.6 during the same period. The continued poor performance is attributed to a temporary increase in vacancies, coupled with some tenants bargaining for reduced rentals upon the renewal of leases, leading to a reduction in rental income, noted during the release of the H1'2018 results, thus resulting to low trade volumes, an indication of low investor appetite.

The Nigerian I-REIT market remained unchanged, with Union Homes, Skye Shelter, and UPDC,

retaining a price per share of N45.2, N95 and N9, respectively, throughout the week. We attribute to the inadequate investor knowledge about the market hence low investor interest in the instrument, and poor valuation of the market, which leads to lower levels of demand by potential investors**.**

We expect continued increase in activities in the real estate sector driven by; i) continued demand for quality office spaces (Grade A and B), ii) continued infrastructural development, iii) the housing deficit that currently stands at 2.0 mn units according to the National Housing Corporation (NHC), iv) positive demographics such as a high population growth rate of 2.6%, 1.4% point higher than global averages of 1.2%, and v) the relatively high urbanization rate in Kenya at 4.4% compared to the global average of 2.1%, necessitating the need for adequate housing in the urban areas.