Nairobi Metropolitan Area Mixed-Use Developments (MUDs) Report 2018, & Cytonn Weekly #44/2018

Focus of the Week

Kenya's real estate and construction market has grown over the last 8-years, with its contribution to GDP increasing from 12.6% in 2010 to 14.1% in 2017, as per statistics from Kenya National Bureau of Statistics (KNBS). The growth has been fuelled primarily by:

i. Demand as a result of rapid population growth at 2.6% p.a compared to the global average growth rate of 1.2% as at 2017 according to the World Bank,
ii. High rate of urbanization at 4.4% p.a, compared to the global average of 2.1%,
iii. Infrastructural development in various parts of the country, which has opened up areas for development and improved the ease of doing business in the country,
iv. Entrance of multi-national firms such as Wrigley and Volkswagen & Swarovski, who demand institutional grade commercial and residential real estate,
v. Relatively high real estate developer returns of over 20.0% p.a. on average over the last 5- years, compared to an average of 13.2% p.a for traditional asset classes, and,
vi. Nairobi's positioning as the regional hub for East Africa.

As the market peaks, however, there has been increased supply of office space, retail space and residential units in the upper segment of the market, against shrinking demand, resulting in increased competition among developers and thus subdued returns. In order to differentiate their products, we are now seeing more developers undertaking Mixed-Use Developments (MUDs), which integrate various uses (residential, commercial, hospitality, retail, etc.) in one so as to maximise land use whilst increasing uptake through creation of a live, work, play and invest environment for building occupants. This week, we look into MUDs in the Nairobi Metropolitan Area by covering the following:

1. Introduction to Mixed-Use Developments,
2. Advantages of Mixed-Use Developments,
3. Limitations of Mixed-Use Developments,
4. Performance of Mixed-Use Developments in the Nairobi Metropolitan Area, and
5. Recommendations and Conclusions.

1. **Introduction to Mixed-Use Developments**
   A Mixed-Use Development (MUD) refers to a real estate development containing more than one real estate theme. Such a development would, therefore, have 2 or more uses, that is, residential, retail, office, and hospitality, all in one location. MUDs are not a new trend in Kenya with several developments particularly in the commercial zones having a mix of office and retail space, while those in townships areas have retail space on the ground floors and residential areas on the upper floors. In the recent years, however, we have seen the emergence of large-scale integrated mixed-

use developments, composed of extensive retail malls, Grade A office spaces, residential precincts with apartments and/or villas, restaurants, hotel rooms and serviced apartments. Some of the recently completed MUDs in the Nairobi Metropolitan Area include Garden City along the Thika Super Highway, Two Rivers along Limuru road, Le Mac in Westlands, NextGen along Mombasa road, Yaya centre in Kilimani, and 14 Riverside in Riverside; while some of those in the pipeline include Montave and Pinnacle Towers in Upper Hill, and Global Trade Center in Westlands.

2. **Advantages of Mixed-Use Developments**
   The growing popularity of mixed-use developments is mainly driven by the following advantages;

   a. **Higher Returns** - According to our research, MUDs perform better, recording an average rental yield of 8.0% (*retail, offices and residential spaces in MUDs recording a rental yield of 8.5%, 8.2% and 5.6%, respectively*), compared to a market average of 7.5% for single-themed developments (*retail, offices and residential spaces recording a rental yield of 9.5%, 7.9% and 5.0%, respectively*),
   b. **Operational Synergies** - The various themes in an MUD can generate operational synergies whereby one's performance complements the others. For instance, building residents will create a ready market for retail services while firms occupying office space are potential clients for hotel, restaurant and conferencing space in the hotel. As a result, improvement of performance of one theme leads to better performance in other themes,
   c. **Risk Diversification** - Having multiple components in the development creates multiple revenue streams that help to diversify the risk of a project. In case uptake for one of the themes is low, the developer or property manager will continue to receive revenues from the other themes. The developer can also opt to alter uses, depending on each theme's performance; for example, underperforming residential units can be converted to office space if zoning regulations allow for it,
   d. **Economies of Scale** - MUDs enable effective use of space/land hence maximisation of returns while shared infrastructure and facilities such as lifts, parking, and lobbies result in savings on construction and operational costs, and,
   e. **Greater Efficiency for Occupants** - MUDs create an environment where occupants can live, work, play and invest all in one location, hence reducing time and cost incurred while commuting. By creating convenience, therefore, MUDs attract demand from both prospective homeowners and corporations.
3. **Limitations of Mixed-Use Developments**
   Despite the highlighted benefits, Mixed-Use Developments have downsides, including;

   a. **High Construction and Development Costs** - MUDs are costly to construct attributable to the intricacy of the architectural designs aimed at ensuring functionality, proper interfacing across the incorporated uses and the overall aesthetic appeal of the project, soaring land prices in urban areas and lengthened time-frames of large-scale developments which results in higher financing costs,
   b. **Cannibalisation Risk** – If not well-planned, MUDs face the risk of cannibalisation due to having competing concepts in the same development such as serviced apartments and hotel, and,
   c. **Congestion** – If an MUD is constructed on a small piece of land, it may result in congestion causing problems such as noise transfer from commercial to residential areas and inadequacy of facilities such as parking spaces, making it less appealing for prospective residents/firms.

From the above, we can see that the success of a Mixed-Use Development significantly depends on how it is executed right from the site selection, concept design and user/tenant mix. Developers, therefore, need to identify suitable locations based on market demand and also establish how to strike the right balance between the incorporated uses in a Mixed-Use Development in order to achieve optimal returns.

4. **Performance of Mixed-Use Developments (MUDs) in the Nairobi Metropolitan Area**

We undertook market research on MUDs in the Nairobi Metropolitan Area to determine their returns and issue recommendations on the best areas to invest. We also compared returns in MUDs to single-themed developments. In our research, we focussed on projects with a Total Built Area (TBA) of at least 60,000 SQFT and analyzed the performance of the residential, commercial office and retail segments of Mixed-Use Projects. The key metrics we looked into include;

1. **Prices** – This is a measure of how much developers are asking for sale units in the market,
2. **Rental Rates** – This is the amount tenants pay per unit of space in a specific market. This will inform potential investors on the rental income they are likely to gain from investing in an MUD,
3. **Annual Uptake** – This measures the number of units in a development that are sold out per annum. This allows the investor to appreciate the rate at which available units are sold over a specific period and gauge whether it is profitable to invest in a given area,
4. **Occupancy Rates** -This measures the number of units or the size of the development that is let out, in order to inform on the expected rental yield of the building, and,
5. **Rental Yield** - This measures the return on real estate property value, from the rental income collected. This informs potential investors on the return they are likely to get from a property and hence the time it will take for an investor to get back the money invested. This is calculated as ((Rent x Occupancy Rate x 12 months)/Price) X 100%

In our analysis of the MUD market performance in 2018, we will start by covering the general market performance in Nairobi per location then proceed to compare real estate themes in MUD versus single themed developments' performance.

A. **Mixed-Use Development Performance per Node**

From our research, MUDs encompassing office, retail and residential themes have an average rental yield of 8.0%. MUDs in the Limuru Road and Karen nodes are the best performing, recording a rental yield of 9.6% and 9.4%, respectively. The performance is attributable to the fact that these developments are located in high-end neighbourhoods (Karen, Runda, Rosslyn, Kitisuru, among others) hosting Nairobi's middle-end and high-end population, with higher purchasing power and who are thus willing to pay a premium for class and amenities provided. Areas characterized by traffic congestion and a low-income population with low purchasing power such as Mombasa road and Eastlands, are the worst performing nodes recording average rental yields of 5.7% and 5.4%, respectively.

The performance of the key nodes in the Nairobi Metropolitan Area is as summarized below:

All values in Kshs unless stated otherwise

Nairobi's Mixed-Use Developments Market Performance by Nodes 2018

Development Composition %				Retail Performance				Office Performance				Residential Performance				
Location	**Retail %**	**Office %**	**Resi. %**	**Price Kshs / SQFT**	**Rent Kshs /SQFT**	**Occup. (%)**	**Rental Yield (%)**	**Price Kshs / SQFT**	**Rent Kshs/SQFT**	**Occup. %)**	**Rental Yield (%)**	**Price Kshs /SQM**	**Rent Kshs /SQM**	**AnnualUptake %**	**Rental Yield %**	**Average MUD yield**
Limuru Rd	60.0%	20.0%	19.0%	23,975.0	277.0	80.0%	11.1%	13,500.0	103.0	70.0%	6.4%	177,935	1,259	25.0%	8.5%	9.6%
Karen	51.0%	48.0%	5.0%	23,333.0	186.0	99.0%	9.4%	13,409.0	120.0	87.0%	9.3%	215,983	821	27.0%	4.6%	9.4%
UpperHill	10.0%	90.0%		15,903.0	147.0	72.0%	7.7%	13,095.0	113.0	86.0%	8.8%					8.7%
Kilimani	25.0%	75.0%		19,571.0	168.0	87.0%	9.1%	12,875.0	102.0	82.0%	7.7%					8.6%

Nairobi's Mixed-Use Developments Market Performance by Nodes 2018

Development Composition %					Retail Performance				Office Performance					Residential Performance		
Location	**Retail %**	**Office %**	**Resi. %**	**Price Kshs / SQFT**	**Rent Kshs /SQFT**	**Occup. (%)**	**Rental Yield (%)**	**Price Kshs / SQFT**	**Rent Kshs/SQFT**	**Occup. %)**	**Rental Yield (%)**	**Price Kshs /SQM**	**Rent Kshs /SQM**	**AnnualUptake %**	**Rental Yield %**	**Average MUD yield**
Thika Rd	36.0%	14.0%	50.0%	35,000.0	297.0	95.0%	9.7%	12,500.0	111.0	90.0%	9.6%	161,849.0	756.0	20.0%	5.6%	7.6%
Westland	27.0%	58.0%	59.0%	16,399.0	179.0	65.0%	8.1%	12,845.0	113.0	76.0%	8.1%	201,274.0	636.0	31.0%	3.8%	7.0%
Msa Rd	51.0%	10.0%	39.0%	20,000.0	180.0	50.0%	5.4%	13,200.0	96.0	75.0%	6.5%	171,304.0	843.0		5.9%	5.7%
Eastlands	25.0%		75.0%	20,000.0	132.0	76.0%	6.0%					81,717.0	351.0	20.0%	5.1%	5.4%
Average	58.1%	30.9%	41.3%	19,663.5	181.2	76.9%	8.5%	13,014.6	110.3	81.1%	8.2%	168,343.5	777.5	24.5%	5.6%	8.0%

- **Retail space outperforms other themes, recording a rental yield of 8.5%, followed by office space at 8.2% and the residential theme at 5.6%, translating to a weighted average rental yield of 8.0% p.a.**
- **Limuru Road and Karen are the best performing nodes, recording a rental yield of 9.6% and 9.4%, respectively. The performance is attributable to the fact that these are high-end neighbourhood hosting most of Nairobi's middle-end and high-end population, with higher purchasing power and thus willing to pay a premium for class and amenities provided**
- **Mombasa road and Eastland's are the worst performing nodes, attributable to traffic congestion in Mombasa road and competition from informal real estate developments in Eastlands hence leading to low market price and rental charges**

Source: Cytonn Research

B. Performance of Real Estate Themes in MUDs versus Single-themed Developments' Performance

We looked at the prices, rents and returns of each theme in mixed-use developments in comparison to the theme's average performance in the market, to determine the return margin of investing in an MUD. The findings are as summarised below;

1. Retail Space

Retail space in mixed-use developments record an average rental yield of 8.5% with an average occupancy of 76.9%. This is 1.1% points and 4.3% percentage points lower than the market average at 9.5% yield and 81.2% occupancy. This indicates that retail space performs worse in an MUD context in comparison to being in isolation and we attribute this to competition from shopping centres and malls, strategically located in residential areas, making them easier to access. We, however, note that in destination mixed-use developments, retail space performs better due to the state-of-the-art facilities provided that attract clientele who are looking for an experience.

Below is a summary of the performance of retail space in MUDs versus market performance:

All values in Kshs unless stated otherwise

Performance of Retail Space in MUDs versus Market Performance 2018

	MUD Performance			Market Performance			
Location	**Rent Kshs/SQFT**	**Occupancy (%)**	**Rental Yield (%)**	**Rent Kshs/SQFT**	**Occupancy (%)**	**Rental Yield (%)**	**Rental Yield Difference**
Limuru Road	277.0	80.0%	11.1%	199.9	67.0%	8.7%	2.4%
Thika Road	296.7	95.0%	9.7%	194.3	76.5%	8.8%	0.8%
Eastlands	132.5	76.0%	6.0%	149.1	68.2%	7.0%	(1.0%)
Karen	186.3	99.0%	9.4%	212.8	96.0%	10.8%	(1.4%)
Kilimani	168.3	86.7%	9.1%	177.3	95.9%	11.0%	(1.9%)
Mombasa Road	179.7	50.0%	5.4%	156.2	74.4%	7.8%	(2.4%)
Westlands	179.5	65.0%	8.1%	218.8	90.2%	12.4%	(4.2%)

Performance of Retail Space in MUDs versus Market Performance 2018

Location	MUD Performance			Market Performance			
	Rent Kshs/SQFT	Occupancy (%)	Rental Yield (%)	Rent Kshs/SQFT	Occupancy (%)	Rental Yield (%)	Rental Yield Difference
UpperHill	147.3	71.7%	7.7%				
Average	181.2	76.9%	8.5%	186.9	81.2%	9.5%	(1.1%)

• Retail space in MUDs records a rental yield of 8.5%, 1.1% points lower than the market average at 9.5%, attributable to the competition from malls that are located in key residential areas

• Retail spaces in MUDs in the Limuru road and Thika road nodes have a positive margin of 2.4% and 0.8% points, respectively, as they charge higher rental rates and have higher occupancies with projects such as Two Rivers mall and Garden City mall, which are destination malls thus attracting higher footfall

• Retail spaces in MUDs in Westlands, Mombasa Road, Kilimani and Karen nodes record a negative margin, due to competition from community malls in these nodes that are strategically located in residential areas, while Eastlands' performance is negatively impacted by competition from the informal retail shops such as Kiosks

Source: Cytonn research

2. **Commercial Office Space**

Commercial offices in mixed-use developments record higher rental yields of 8.2%, 0.3% points higher than the market average at 7.9%. This is attributable to high rental charges of Kshs 110.3/SQFT compared to the market average at Kshs 99.2/SQFT, given that they are mainly Grade A offices with state-of-the-art technical services provided such as high-quality elevators, fittings and automation systems and ample parking at a minimum ratio of 3:1000 (3 parking slots for every 1000 SQFT), which lack in Grade B and C offices, hence tenants are willing to pay a premium.

Below is a summary of the performance of commercial offices in MUDs versus market performance:

All values in Kshs unless stated otherwise

Performance of Commercial Offices in MUDs versus Market Performance 2018

Location	MUD Performance				Market Performance				
	Price Kshs / SQFT	Rent Kshs/SQFT	Occupancy (%)	Rental Yield (%)	Price Kshs / SQFT	Rent Kshs/SQFT	Occupancy (%)	Rental Yield (%)	Rental Yield Difference
Thika Road	12,500.0	111.0	90.0%	9.6%	11,750.0	85.0	89.0%	7.7%	1.9%
UpperHill	13,095.0	113.0	86.0%	8.8%	13,385.7	99.6	89.5%	7.9%	0.9%
Karen	13,409.0	120.0	87.0%	9.3%	12,887.5	116.7	82.5%	9.0%	0.4%
Mombasa Road	13,200.0	96.0	75.0%	6.5%	11,750.0	81.7	71.0%	6.2%	0.4%
Kilimani	12,875.0	102.0	82.0%	7.7%	13,031.4	101.4	80.9%	7.7%	0.0%
Westlands	12,845.0	113.0	76.0%	8.1%	11,346.2	111.2	89.0%	9.1%	(1.0%)
Limuru Road	13,500.0	103.0	70.0%	6.4%					
Average	13,014.6	110.3	81.1%	8.2%	12,358.5	99.2	83.7%	7.9%	0.4%

The average rental yield for offices published in our previous reports assumed 100% occupancy rates

• Offices in MUDs records a rental yield 8.2%, 0.4% points higher than the market average at 7.9%, attributable to higher rental charges due to a live work play environment provided by MUD and a state-of-the-art technical services provided such as high-quality elevators, fittings and automation systems and ample parking at a minimum ratio of 3:1000 (3 parking slots for every 1000 SQFT) which lack in Grade B and C offices which are common in the market

Source: Cytonn research

3. **Residential Space**

Incorporation of the residential theme in large scale integrated mixed-use developments in the Nairobi Metropolitan Area is growing in popularity, and we have seen this in developments such as Two Rivers along Limuru road, Garden City along Thika road and Nextgen along Mombasa road among others. Residential units in MUDs record higher prices at Kshs 168,343.5/SQM and rental yield at 5.6%, compared to the market average price at

Kshs 127,895.3/SQM and rental yield at 5.0% due the convenience, that MUDs create, therefore, attract demand from prospective homeowners who are willing to pay a premium on the same.

Below is a summary of the performance of residential units in MUDs versus market performance:

All values in Kshs unless stated otherwise

Performance of Residential Units in MUDs versus Market Performance 2018

	MUD performance				Market performance				
Location	**Price Kshs /SQM**	**Rent Kshs /SQM**	**Uptake %**	**Rental Yield %**	**Price Kshs /SQM**	**Rent Kshs /SQM**	**Uptake %**	**Rental Yield %**	**Rental Yield Difference**
Thika Road	161,848.5	756.1	20.1%	5.6%	124,554.0	297.0	22.3%	2.8%	2.8%
Mombasa Road	171,304.2	842.5		5.9%	107,819.4	510.4	26.5%	5.7%	0.2%
Karen	215,982.7	820.7	26.7%	4.6%	194,340.6	799.5	28.3%	4.7%	(0.2%)
Eastlands	81,717.2	350.6	20.0%	5.1%	80,635.0	370.7	21.5%	5.6%	(0.5%)
Westlands	201,273.9	635.9	30.5%	3.8%	132,127.6	635.9	26.1%	6.0%	(2.2%)
Limuru Road	177,934.7	1,258.9	25.0%	8.5%					
Average	168,343.5	777.5	24.5%	5.6%	127,895.3	522.7	24.9%	5.0%	0.0%

Key to note, Thika Road represents Kasarani area, Mombasa Road represents South B & C area, while Eastlands represents the Donholm & Komarock area

- **Residential units in MUDs record a rental yield 5.6%, 0.6% points higher than the market average, attributable to higher prices and rental charges due to the premium charged on amenities and trunk infrastructure provided and convenience enjoyed due to a live-work-play environment in MUDs**
- **MUDs in Thika road and Mombasa road have the highest positive margin of 2.8% and 0.2% points, respectively due to higher rental charges of 154.5% and 65.1% above market, with MUD targeting high-end income earners willing to pay a premium for class, hence a different market niche**
- **MUDS in Karen, Eastlands and Westlands record a negative margin of 0.2%, 0.5% and 2.2% points, respectively. The Karen and Westlands performance is attributable to the fact that the target market is looking for privacy and exclusivity that MUDs don't offer, while Eastlands the market is more low income thus looking for affordability**

Source: Cytonn Research

C. Summary of Thematic Performance in MUDs in Comparison to General Market Performance

When we compare the average rental yields of themes in MUDs to the overall market performance for each theme, we find that office space and residential units in MUDs have higher rental yields at 8.2% and 5.6% compared to the market average at 7.9% and 5.0% mainly attributed to higher rents and prices charged due to amenities and facilities provided.

All values in Kshs unless stated otherwise

Thematic Performance in MUDs in Comparison to Overall Market Performance in the Highlighted Nodes 2018

Themes	**MUD Themes Average Rental Yield %**	**Market Average Rental Yield %**	**Rental Yield Difference**
Retail	8.5%	9.5%	(1.0%)
Offices	8.2%	7.9%	0.3%
Residential	5.6%	5.0%	0.6%
Average	7.4%	7.5%	0.0%

Thematic Performance in MUDs in Comparison to Overall Market Performance in the Highlighted Nodes 2018

Themes	MUD Themes Average Rental Yield %	Market Average Rental Yield %	Rental Yield Difference

- Office space and residential units in an MUDs have higher rental yields at 8.2% and 5.6% compared to the market average at 7.9% and 5.0% mainly attributed to higher rents and prices charged due to amenities and facilities provided
- Retail sector records 1.0% points, lower than the market average due to competition from destination and community malls that are located strategically in residential areas

Source: Cytonn research

5. **Recommendations and Conclusion**

With an average weighted rental yield of 8.0%, (*8.5% for retail space accounting for 30.9% of MUD lettable area on average, 8.2% for office space accounting for 58.1% of MUD lettable area on average and 5.6% for residential space accounting for 41.3% of MUD lettable area on average*) mixed-use developments have higher returns compared to market average at 7.5%. MUDs are, therefore, a viable investment mainly for office and residential spaces recording a high rental yield of 8.2% and 5.6%, 0.3% and 0.6% points, above the market average at 7.9% and 5.0%, respectively and minimal allocation to retail space. They are suitable for developers and investors looking to diversify their real estate portfolio, given that some themes such as office and retail having an oversupply of 4.7mn and 2.0mn SQFT space, respectively in Nairobi Metropolitan Area. The investment opportunity within the Nairobi Metropolitan Area is, thus, in areas such as Limuru road, Karen, Upperhill and Kilimani recording the highest rental yield returns of 9.7%, 9.4%, 8.7%, and 8.6%, respectively.