Kenya Economic Review 2018, & Cytonn Weekly #45/2018

Real Estate

1. **Commercial Office Sector**

Coca-Cola, a multi-national beverage company, intends to sell its Upperhill office, which been the company's headquarters for the East and Central Africa Region since 2008, and relocate to newly built 90 James Gichuru office in Lavington, Nairobi. This is in line with its Vision 2020 on workplace agenda that aims at achieving a new modernized space built to suit the needs of a more agile, and fast paced business. According to the dailies, the 66,360 SQFT (6,165 SQM) office building in Upperhill, sitting on 4-acres of land, was constructed at a cost of Kshs 700 mn, which equates to Kshs 10,549 per SQFT, and is being currently valued at Kshs 1.03 bn, translating to a value of Kshs 15,521 per SQFT. This is 14.0% higher than the current market average price for office space in Upperhill at Kshs 13,386 per SQFT, according to Cytonn Research. We estimate that, at the current valuation of Kshs 15,521 per SQFT, a buyer would generate a 7.0% yield, assuming rental income at the current Upperhill market average of Kshs 100.0 per SQFT and occupancy of 90.1%. Given that commercial properties in Nairobi generate yields of 9.0%-10.0%, we are, therefore, of the view that the building may not be a good bargain at the proposed value. If the building is sold at the current market average price of Kshs 13,386 per SQFT, the exit value of the same would come in at Kshs 888.3 mn, and the buyer would generate a rental yield of 8.1%. To achieve a rental yield of 10.0%, at Upperhill average market rent and assuming 100% occupancy, an investor would buy at Kshs 12,000 per SQFT and thus the building would be sold at a value of Kshs 796.3 mn.

Below is our analysis showing the same;

All values in Kshs unless stated otherwise

Coca- Cola Plaza Value Analysis

	Current Valuation	Upperhill Market Price of Kshs 13,386 per SQFT	10% Investor Yield at Upperhill Market Occupancy	10% Investor Yield assuming 100% Occupancy
Upperhill Avg Rent per SQFT	**100**	100	100	**100**
Occupancy Rate	**90.1%**	90.1%	90.1%	**100.0%**
Price Per SQFT	**15,521**	13,386	10,812	**12,000**
Exit Value	**1.03 bn**	888.3 mn	717.5 mn	**796.3 mn**
Investor Yield	**7.0%**	8.1%	10.0%	**10.0%**

· We estimate that, at the current valuation of Kshs 15,521 per SQFT, a buyer would generate a 7.0% yield, assuming rental income at the current Upperhill market average of Kshs 100.0 per SQFT (exclusive of service charge) and occupancy of 90.1%
· This is a low return compared to average market yields of 9.0%-10.0% for commercial properties, and we are, therefore, of the view that the building is not a good buy at the proposed value

· Assuming the building is sold at the current market average price of Kshs 13,386 per SQFT, the exit value of the same would come in at Kshs 888.3 mn, and the buyer would generate a rental yield of 8.1%

· To achieve a rental yield of 10%, at Upperhill average market rent and assuming 100% occupancy, an investor would buy at Kshs 12,000 per SQFT and thus the building would be sold at a value of Kshs 796.3 mn

Source: Cytonn Research

The main risk factors for investors in the building include; i) the existing oversupply of office space, which stood at 4.7 mn SQFT in 2017 undermining the performance of the office sector, ii) traffic congestion along the key access routes to the Upperhill area, Mbagathi Way and Ngong Road, which continues to discourage businesses setting up offices in the area, and iii) unavailability of social amenities such as shopping malls in Upperhill, unlike other growing business nodes such as Westlands, Lavington and Karen. Given that the office sector is currently a buyer's market, the seller is likely to accept lower bids for the building. The trend to exit Upperhill continues to gather pace after the recent exit by European Union and now Coca-Cola, this is mainly due to accessibility challenges in Upperhill.*Source: Cytonn Research*

City Clock chief, Tilman Wolfgang, has announced plans to develop a 12-floor office block along Riverside Drive in Westlands, Nairobi. The block, which is awaiting approval from the National Environment Management Authority (NEMA), will sit on a 0.85-acre parcel of land, and will bring to the market 164,440 SQFT of office and retail space, as well as a 5-floor basement parking area. This highlights the continued investor interest in development of commercial space in the Westlands node, and we attribute its attractiveness to i) the ease of accessibility given the good transport network, ii) availability of social amenities such as the Westgate Mall and Sarit Centre, and iii) relatively high returns with the average rental yield coming in at 10.0%, compared to the market average at 9.5%. According to Cytonn Q3' 2018 Market Review, the Westlands Sub- market, of which Riverside Drive is part, recorded one of highest yields of 10.0% with an average occupancy of 89.0%, as properties in the area charge a relatively high asking rent of Kshs 111 per SQFT compared to the market average of Kshs 102 per SQFT. This is because it hosts several Grade A and high-quality Grade B offices, and thus tenants are willing to pay premium rates for both the quality of the offices and the prime location.

Below is a summary of the sub-markets analysis:

(All values in Kshs unless otherwise stated)

Nairobi Commercial Office Performance by Nodes: Q3'2018

Nodes	**Price Kshs / SQFT Q3'2018**	**Rent Kshs/SQFT Q3'2018**	**Occupancy (%) Q3'2018**	**Rental Yield (%) Q3'2018**	**Price Kshs / SQFT Q2'2018**	**Rent Kshs/SQFT Q2'2018**	**Occupancy (%) Q2'2018**	**Rental Yield (%) Q2'2018**	**Q/Q Δ in Rents (%)**	**Q/Q Δ in Yields (%)**
Karen	12,888	117	89%	10.8%	13,776	118	87%	10.2%	-0.7%	0.6%
Westlands	10,667	111	89%	10.0%	12,567	109	85%	9.7%	2.0%	0.3%
Parklands	12,208	103	86%	9.8%	12,433	103	86%	9.8%	0.0%	0.0%
Kilimani	13,031	101	87%	9.6%	12,694	101	85%	9.4%	0.0%	0.2%
Nbi CBD	11,333	88	92%	9.1%	11,750	87	92%	8.7%	1.3%	0.4%
Upperhill	13,386	100	90%	9.0%	12,708	101	86%	9.0%	-1.0%	0.0%
Msa Road	11,750	82	71%	8.7%	11,770	83	68%	8.6%	-1.0%	0.1%
Thika Road	11,750	85	89%	8.7%	11,500	85	80%	8.7%	0.0%	0.0%
Grand Average	**12,202**	**102**	**87%**	**9.5%**	**12,527**	**102**	**85%**	**9.3%**	**0.1%**	**0.2%**

· Karen and Westlands recorded the highest yields of 10.8% and 10.0%, respectively, as properties in these areas charge the highest asking rents of Kshs 117 and Kshs 111 per SQFT, respectively. This is because they are regarded as prime locations with Grade A and high-quality Grade B offices, thus enabling the developers to charge premium rates

Source: Cytonn Research

Given the existing oversupply of office space, which stood at 4.7 mn SQFT in 2017, we are of the view that increasing office space supply will result in increased competition thus constraining the performance of the sector. We therefore recommend adoption of differentiated concepts such as serviced offices with average rental yields of 13.4%, in Mixed-Use Developments and Green Buildings going forward. See our Focus Note on Mixed-Use Developments here

1. **Retail Sector**

On the retail front, South African retailer, Shoprite, is set to take up space as an anchor tenant, at the proposed mall dubbed "The Beacon", set to be built off Uhuru Highway towards Bunyala Roundabout, in Nairobi. The 306,771 SQFT mall will be a Mixed-Use Development (MUD) containing 261,563 SQFT of retail, food and beverage space, as well as a 45,208 SQFT 7-storey office tower overlooking the shopping center's roof garden and bar, and is set to be complete by 2020, which in our opinion might not be achievable, given that the project is yet to be launched. Shoprite intends to take up approximately 43,055 SQFT of retail space at the mall, representing 14.0% booking at the project. This is part of the retailer's ambitious plans to open 7 other stores in malls across Kenya, including; the Garden City Mall along Thika Road, the Westgate Mall in Westlands, and the City Mall in Mombasa. We continue to see international retailers coming into Kenya and expanding rapidly demonstrating the attractiveness of the sector. Some of the other retailers who have entered the market in the last 3-years include French retailer, Carrefour, Botswana-based retailer, Choppies and South African retailer, Game. In our view, their expansion into Kenya is supported by,

?. Stable economic growth, with Kenya's GDP growth averaging at 5.1% over the last five-years, and set to come in at 5.7% in 2018, according to Cytonn Research,

i. Kenya's improvement in ease of doing business rankings, with the World Bank Doing Business Report 2019 ranking the country #61, which is a rise in 19 ranks from #80 in the 2018 Report, mainly on account of the protection of minority investors, ease of getting credit, and ease of resolving insolvency, among others. For more information, see our Topical on the World Bank Doing Business Report 2019 here,

ii. The rising middle-class that has increased purchasing power as well as varying tastes and preferences for different goods and services, thus creating demand for international brands,

iii. The provision of high-quality spaces in line with international standards with the supply of formal retail space in Nairobi growing at a 2-year CAGR of 9.5% to 6.5 mn SQFT in 2018, with an estimated pipeline of 1.3 mn SQFT set to be complete by 2020, and,
iv. The exits of struggling retailers such as Nakumatt and Uchumi, vacating prime retail stores, thus creating an opportunity for other retailers to increase their foothold.

For developers and property managers, the entry of strong anchor tenants is an added advantage as it drives footfall into a mall, and this in turn, attracts other retailers. In our view, therefore, this will have a positive impact on the performance of retail real estate developments, where we currently estimate an oversupply of 2.0 mn SQFT. As per our last research, Cytonn's Q3 2018 Market Review Report, retail developments in the Nairobi Metropolitan Area recorded an average rental yield of 9.4% with average occupancy rates of 83.7%. This is a 0.3% point's decrease q/q in rental yields from the 9.7% recorded in Q2'2018 as a result of a 5.8% decrease q/q in rental charges attributed to increased competition due to increased supply that has led to developers decreasing rents to attract retailers.

We expect global retailers to continue showing interest in the Kenyan retail sector, mainly attracted by the rise in disposable incomes, change in consumer tastes & preferences, and fast economic growth enabled by infrastructural developments.

- **Residential Sector**

During the week, Centum Investment Company announced that it had signed agreements for residential units worth Kshs 1.2 bn at its Vipingo Estate in Kilifi County. This brings the total number of stand-alone units sold so far to 46 out of 152 units, which translates to 30.2% sales, and 100% booking of the 156 apartments in the first phase of the development. Vipingo Estate is part of the mixed use Vipingo Development sitting on 10,254-acres of land. It comprises of an industrial park that covers 250-acres, Palm Ridge residential apartments on 20-acres consisting of 1, 2 and 3-bedroom units, currently being sold at Kshs 2.3 mn, Kshs 3.5 mn and Kshs 4.6 mn, respectively, and Awali Estate on 30-acres, comprising of 3-bedroom maisonettes and bungalows, currently selling at Kshs 13.0 mn and Kshs 17.0 mn, respectively. We attribute the investor interest in the coastal location to its proximity to sandy beaches and the Vipingo airstrip making it ideal as a source of rental income from visiting tourists, affordability of the units to the middle class with the apartments prices ranging from Kshs 2.3 mn to Kshs 4.6 mn per unit, ease of accessibility through two main roads, Mombasa-Malindi Road, and Mariakani-Marueni Bypass and to Mombasa Town, which is situated approximately 35 km away.

Kilifi County, like Mombasa County, has seen an influx of real estate developments as investors aim to satisfy demand for housing by the growing coastal population and for accommodation by mid to long-term stay tourists. According to Cytonn's report, Mombasa Investment Opportunity 2018 Report, residential properties in Mombasa generate an average rental yield of 4.4% and an average price appreciation of 2.5%, thus total returns of 6.9%. The best performing segment in the residential sector in 2018 is the upper mid-end sector, which recorded the highest returns to investors of 8.1% on average, that is, average rental yields of 5.5% and a capital appreciation of 2.6%, with investors in the region purchasing apartments in order to rent them to the growing middle class as well as long-stay visitors in the county.

Below is a summary of the residential sector performance for the Mombasa Market;

All values in Kshs unless stated otherwise

Mombasa Residential Sector- Segment Performance

Segment	Average Price Per SQM	Average Rent Per SQM	Average Occupancy	Average Annualized Uptake	Average Rental Yield	Average Price Appreciation	Average Total Returns
Upper Mid-End	115,199	600	81.1%	22.2%	5.5%	2.6%	**8.1%**
Lower Mid-End	60,240	288	89.2%	18.4%	4.6%	3.0%	**7.6%**
High-End	174,102	637	61.2%	15.3%	3.1%	1.8%	**4.9%**
Average	**116,514**	**508**	**77.2%**	**18.6%**	**4.4%**	**2.5%**	**6.9%**

• The upper mid-end segment recorded the highest average total returns to investors of 8.1%, attributable to the demand from the constantly growing middle class in the region particularly from the Asian families, evidenced by the relatively high annual uptake of 22.2% and average occupancy rates of 81.1%, in comparison to the high-end market average of 61.2% and 15.3%, respectively

Source: Cytonn Research

Other highlights during the week;

?. Real estate developer, Superior Homes, has launched their gated retirement village in Athi River. The development, referred to as Fadhili Care, comprises of 1 and 2 bedroom cottages, sitting on 5-acres and is located within the developer’s Green Park Estate. The project targets the elderly seeking a retirement village concept, and is set to provide 24-hour care with a 24-hour ambulance, a clubhouse, medical care, resident team of nurses who will provide psychological, physiotherapy, and social home care services.

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 entry and expansion of international retailers, and iii) positive demographics such as a high population growth rate of 2.6%, 1.4% point higher than global averages of 1.2%, and iv) 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.