Karen Investment Opportunity, & Cytonn Weekly #04/2019

Real Estate

I. Industry Reports

Hass Consult, a local real estate agency, released their house price and land index for Q4'2018. The main take-outs from the Land Index include:

- Land price growth in Nairobi's suburbs softened in 2018, recording an annual growth of 1.1% compared to 3.3% in 2017, whereas prices in Satellite Towns rose by 3.7% in 2018, 2.6% points higher than land in Nairobi suburbs, albeit 1.7% points lower than 5.4% in 2017. The softening is attributed to a shift in land pricing from speculation and sentiment to effective demand needs,
- Overall, Mlolongo registered the highest land q/q price growth at 4.6%, from Kshs 24.6 mn per acre to Kshs 26.4 mn per acre, attributable to increased preference for development, driven by the ease of accessibility into the area through Mombasa Road and the growing demand for property in the area by middle-income households,
- Juja posted the highest annual price growth at 16.4% from an average Kshs 11.4 mn per acre in 2017 to Kshs 13.3 mn per acre in 2018. The growth is attributable to improved infrastructure, and demand for development land, which is relatively more affordable,
- Among Nairobi suburbs, Gigiri registered the highest annual growth in land prices with an annual appreciation of 10.6% attributed to the ongoing commercial and residential development in the area.

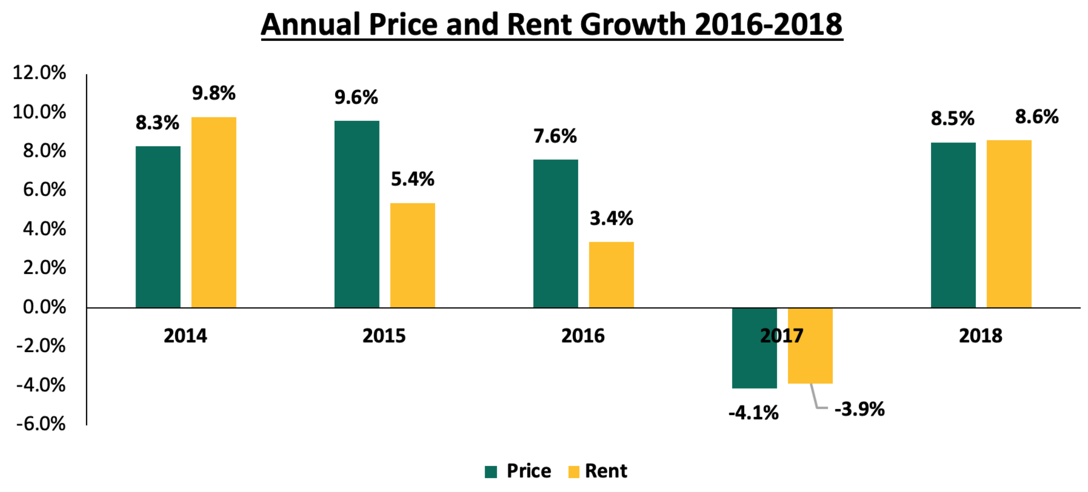
Going forward, we anticipate continued land price growth especially in Satellite Towns, driven by the expected rolling out of affordable housing projects and the continued infrastructural development that continues to open up areas for development. As per our outlook the investment opportunity in the Nairobi Metropolitan Area land sector being is in Satellite Towns such as Ruaka, Utawala, Ruiru and Thika, which posted relatively high capital appreciation of 16.2%, 17.5%, 4.7%, 7.7% y/y, respectively.

According to the House Sales and Rental Index, overall, the Nairobi Metropolitan Area registered annual increase in prices and rents of 8.5% and 8.6%, respectively, compared to the depreciation registered in 2017 of 4.1% and 3.9%. Other key take-outs were as follows:

- Apartments registered the strongest growth in rental prices at 15.9%, which is the highest increase in eight years, attributable to a decline in the development pace for apartments in Nairobi and the surrounding areas in the last two-years, correcting the previous mismatch between supply and demand, thereby boosting rental rates especially in Q4'2018,
- On the other hand, semi-detached and detached units registered an average increase in rents of 8.2% attributed to weakening demand especially as the global economy negatively affects the rate of expatriates who drive the market for temporary accommodations,
- On the sale price index, detached units registered the highest price appreciation at an average of 9.6% in comparison to apartments with 2.9%. This is attributed to growing demand for detached

units in upmarket areas whereas the slow apartment prices growth is attributed to weak mortgage and home loan support for first-time buyers,

- In Nairobi suburbs, Nyari and Karen registered the highest annual price growth among low-rise areas with 11.2% and 7.0%, respectively, while Westlands and Kileleshwa were leading in the high-rise markets with 7.8% and 6.8%, respectively,
- In Satellite Towns, Ngong and Kitengela registered the highest annual price increase with 16.7% and 10.2%, respectively,
- According to the report, apartments with appealing facilities and meeting customer needs continue to sell strongly with the negatively affected markets being in those with oversupplies.



Source: Hass Consult

According to Cytonn Research, however, 2018-recorded subdued performance with returns of 8.9% (rental yields of 4.7% and capital appreciation of 4.2%) compared to 2017 with 10.3% (Rental yields of 5.1% and capital appreciation of 5.2%). Our outlook for the sector remains neutral with selected markets continuing to exhibit positive returns and thus investors ought to exercise prudence in identifying market opportunities.

II. Residential Sector

Following the signed deal between the Kenyan Government and United Nations Project Services (UnoPs) in 2018, in which the UN subsidiary is set to deliver 100,000 low-cost homes across Kenya at an estimated cost of Kshs 64.7 bn, the organization kick started the initiative during the week by injecting Kshs 1.0 bn into the project and vowing to seek the remaining Kshs 63.7 bn from other organizations. Once complete, the project will provide a significant impetus to the Kenyan Government's affordable housing initiative, which aims to deliver 500,000 units by 2022, by catering for 20.0% of the planned units. We commend the additional funding, especially as project financing remains one of the key challenges to the affordable housing initiative. Overall, the affordable housing initiative is set to cost Kshs 1.3 tn where the government so far has allocated Kshs 6.5 bn from the 2018/19 budget and further Kshs 21.0 bn from the Supplementary Appropriation Bill No. 2 of 2018 towards the programme.

On the other hand, the Government of Kenya announced relaxation of affordable housing regulations to include high income-earners of Kshs 100,000 and above. Previously, the allocation was as below:

- Social Housing - Designated for individuals earning up to Kshs 14,999 monthly, accounting for 2.6% of the formal income earners (KNBS),
- Low-Cost Housing - Designated for individuals earning between Kshs 15,000 and Kshs 49,999 monthly, accounting for 71.8% of the formal income earners, and,
- Mortgage-Gap Housing - Designated for individuals earning between Kshs 50,000 and Kshs 100,000 monthly, accounting for 22.6% of the formal income earners.

With the new regulations, however, income-earners of Kshs 100,000 and above, who as per KNBS data make up approximately 2.9% of the working population in Kenya will be able to take up affordable housing units. This will be through the Housing Fund and government-availed mortgages to be repaid in 15-years at 7.0% p.a., whereas low-income earners will acquire the houses through tenant purchase schemes. In our view, the new redefined guidelines will enable inclusion of middle-income individuals who earn above Kshs 100,000 but still cannot afford to service a mortgage at prevailing market rates for mid-end and high-end properties costing above Kshs 7.0 mn. For example, an individual earning net income of Kshs 120,000 using a maximum of 40% of their income to pay instalments can only afford a mortgage of Kshs 3.9 mn at an interest rate of 13.5% for 20-years. With the government housing expected to cost between Kshs 600,000 and Kshs 3.0 mn, and assuming homebuyers will use 40.0% of their net income on monthly mortgage payments, only an individual earning a net income of Kshs 70,000 p.m. would be able to purchase the Kshs 3.0 mn units, at an interest rate of 7.0% for 15 years. The new regulations will provide an opportunity for more individuals to access the houses under the affordable programme and thus encourage buy-in from employees who are expected to contribute 1.5% of their income to the National Housing Development Fund. The government, however, should introduce a clear allocation criteria and a maximum qualifying income limit in order to limit purchases to prospective homeowners as opposed to speculative buyers and to ensure equitable allocation based on income and need. In our view, at the proposed the mortgage interest rate of 7.0% and the repayment period of 15-years, the qualifying cut should be at individuals earning a net income of Kshs 150,000 p.m. for a unit costing as much as Kshs 6.6 mn.

Erdemann properties launched their residential development in Ngara on approximately 5.6-acres (Costs undisclosed). The project dubbed “River Estate’’ will have eight 34-storey blocks of one and two bedroom apartments with price points of Kshs 6.0 mn, and Kshs 8.5 mn, respectively. With 340 units on each block, the project aims to house 2,720 residents as well as the rehabilitation of key roads in Ngara Estate such as Jadongo Road. Ngara as an investment location has been particularly ideal for residential development due to (i) proximity to main commercial hubs such as the CBD and Westlands, (ii) relatively high plot ratios that allow for densification, and (iii) availability of rehabilitative land as owned by the government and/or government corporations. We expect to see more private developers developing such projects going forward, especially with the intensified focus on local and global housing shortage. However, the key challenges that continue to limit developers are the restrictive land costs, relatively high cost of capital and insufficient access to the same.

We expect continued increase in activities in the real estate sector, supported by: (i) relatively high residential demand currently at 2.0 mn units, and growing at an annual rate of 200,000, and (ii) improved infrastructural developments, which will open up areas for development.