Cytonn INVESTMENTS

Fintech Impact on Kenya’s Financial Services Industry, & Cytonn Weekly #07/2019

Real Estate

1. **Industry Reports**

During the week, Vaal Real Estate, a local realtor, released a report titled ‘Investing in Nairobi, Real Estate Opportunities Report’ highlighting the performance of the Nairobi real estate sector in 2018. Some of the major highlights include:

- The **Retail Sector** recorded rental yields of 9.0% - 10.0%, with a 6.0% points increase in occupancy to 84.0% in 2018 from 78.0% in 2017 attributed to attractive lease terms offered by landlords and increased demand for retail space from local and international retailers. Increment in retail supply declined by 79.7% to 24,000 SQM in 2018, from 118,000 SQM in 2017, attributable to the high cost of financing and slowdown of activities following the electioneering period. The retail outlook for 2019 is generally positive with consumer spending and online retailing expected to grow,

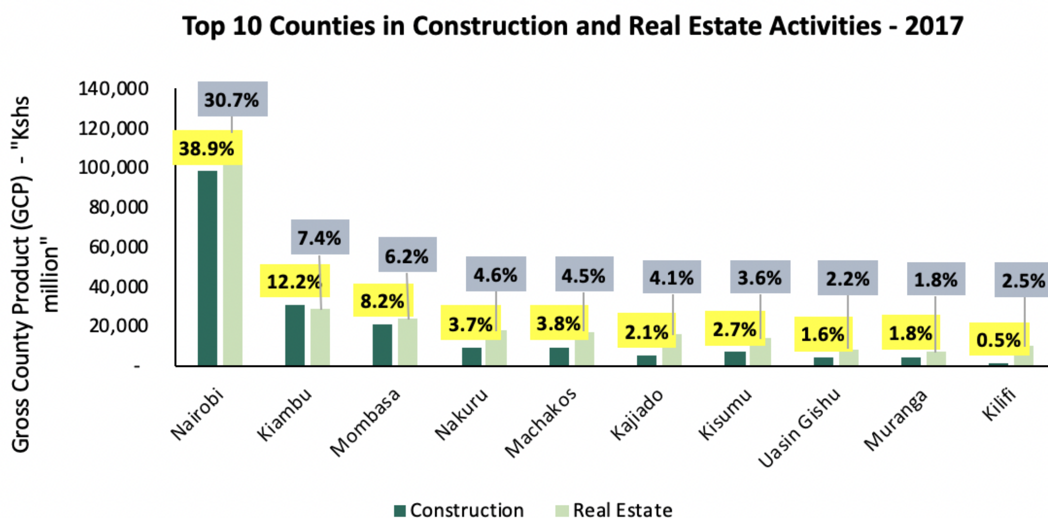
- The **Commercial Office Sector** recorded yields of 7.0% to 8.0% in 2018, with average prices of Kshs 13,000 per SQFT to Kshs 15,000 per SQFT and average rental rates of Kshs 149.2 per SQFT (Kshs 185.6 per SQFT and Kshs 113.0 per SQFT for ground floor and upper floor rent, respectively). Westlands, Kilimani and Upperhill recorded the highest occupancy rates at 83.0%, 79.0% and 71.0%, respectively. The outlook in the sector remains positive with investment opportunities in smaller working spaces of less than 250 SQM, serviced shared spaces and long-term leases for larger spaces,
- The **Residential Sector** recorded yields ranging from 4.0% to 6.0% with Westlands, Parklands and Kilimani recording the highest occupancy rates at 92.0%, 89.0% and 84.0%, respectively. 3-bed and 2-bed units were the most popular typologies with a market share of 42.0% and 27.0%, respectively. The outlook for the sector is positive as investors increasingly embrace the off-plan sales model in order to buy at discounted prices and realise capital gains upon completion. There’s an investment opportunity in i) studio units preferred by young first-time buyers due to their affordability, ii) penthouses preferred by investors due to their extraordinary views and being spacious, and iii) Mixed-use Developments as they provide a ‘play, work and stay’ environment, though regarded as a new concept but interesting to the target market,
- In the **Hospitality Sector,** serviced apartments recorded a 5-year CAGR of 15.0% in supply to 4,582 units in 2018 from 2,320 units in 2013 driven by the increase in tourists looking for extended stay facilities. The sector recorded yields of between 6.0% and 9.0% at an average occupancy rate of 74.0% in 2018, with the highest demand for the units coming from corporate and private residents recording 62.0% and 30.0%, respectively. Serviced apartments had 20.0% higher occupancy rates than hotels recording three-year occupancy rates of 72.0% compared to 52.0% for hotels. The outlook for the year is positive with the investment opportunity in lower

grade serviced apartments that provide basic facilities at an affordable cost.

Overall, the report demonstrated a positive outlook for the real estate market with unique opportunities for each sector. We retain a neutral outlook for the real estate market in 2019, as the slowdown in demand for property persists amid increasing supply particularly in the commercial office, retail and upper-income residential sectors. Nevertheless, the market still holds opportunities in the land sector, undersupplied segments such as lower middle to low-income housing, suburban malls in counties such as Mombasa and the Mt. Kenya Region and differentiated themes such as Mixed-use Developments (MUDs) and serviced offices. For more information, see our Cytonn 2019 Markets Outlook.

Kenya National Bureau of Statistics (KNBS) released the Gross County Product 2019 highlighting the economic performance of Kenya's 47 Counties between 2013 and 2017, detailing the net value of goods and services produced and the size and structure for each County's economy. In 2017, the construction and real estate activity sectors accounted for 16.0% of the Kshs 3.9 tn total Gross County Product recording Kshs 252.0 bn and Kshs 385.0 bn value of production, respectively. Nairobi, Kiambu and Mombasa Counties were the main contributors to real estate and construction sectors recording 33.9%, 9.3% and 7.0% contribution, respectively. In our view, this is mainly due to the positioning of Nairobi as the country's capital city and the main commercial hub locally and in the region thus attracting investors and residents, whereas Kiambu County hosts several fast-growing dormitory towns such as Kikuyu, Ruiru, Ruaka and Thika, where several people working in Nairobi live. Mombasa, on the other hand, is the 2nd largest city in Kenya, and benefits from economic growth mainly through tourism and the maritime business activities.

Below is a graph showing the Top 10 Counties with the highest contribution to construction and real estate activities:



Source: KNBS GCP 2019

**Values at 2009 prices (base year)*

We expect devolution to continue playing a key role in offering opportunities for growth in the real estate sector by creating demand for residential units, commercial office and Mixed-use Developments. The government increased its budget allocation to County Governments to support infrastructural development as well as the growth of other sectors including housing. In 2018, the government increased county budget allocation by 8.9% from Kshs 345.7 bn in 2017/18, to Kshs 376.4 bn in 2018/19.

II. Retail Sector

During the week, Grill Shack, a Dubai-based food chain, opened a restaurant at the Westgate Shopping Mall in Westlands, Nairobi. The Kshs 70 mn outlet is the chain's first store in the country. The Westlands retail sector continues to attract international vendors driven by its positioning as an affluent neighbourhood hosting middle to high-income earners with relatively high purchasing power, the supply of high-quality retail spaces and growing demand for international brands from the expanding middle and wealthy classes. As a result, Westlands continues to be the best performing retail market in the Nairobi Metropolitan Area recording an average rental yield of 12.2%, 3.2% points higher than the 2018 market average of 9.0%. We, however, note that rental rates in the area, as in other markets, declined by 6.6% attributed to developers decreasing rents to attract retailers and boost occupancy, given the increasing supply of retail space in the market. The continued expansion of both local and international retailers, however, indicates confidence in the retail consumer market, and thus we anticipate that this will cushion the retail real estate market going forward.

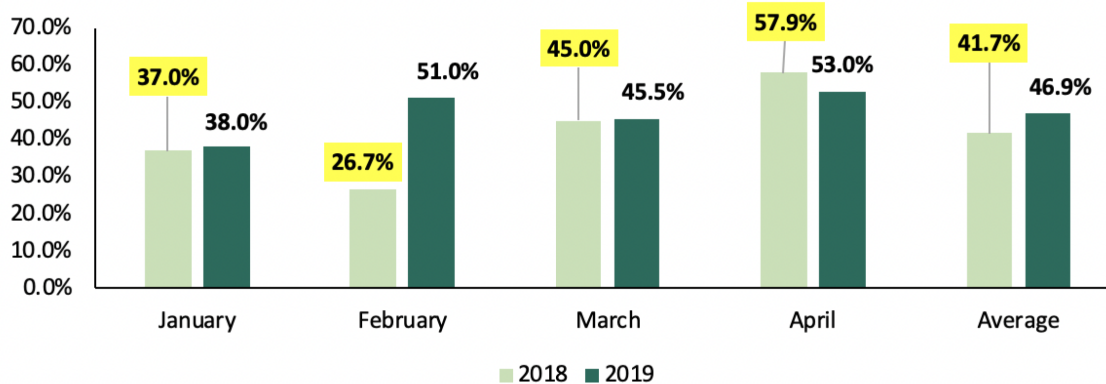
Summary of Nairobi's Retail Market Performance 2017-2018

Location	Rent Kshs/SQFT 2018	Occupancy Rate 2018	Rental Yield 2018	Rent Kshs/SQFT 2017	Occupancy Rate 2017	Rental Yield 2017	Δ Y/Y in Rental Charges	Δ Y/Y in Occupancy Rates (%points)	Δ Y/Y in Rental Yields (% points)
Westlands	219.2	88.2%	**12.2%**	234.7	91.0%	13.5%	**(6.6%)**	(2.8%)	(1.3%)
Karen	224.9	88.8%	**11.0%**	206.2	96.3%	11.2%	**9.1%**	(7.6%)	(0.3%)
Kilimani	167.1	97.0%	**10.7%**	181.0	87.0%	10.3%	**(7.7%)**	10.0%	0.4%
Ngong Road	175.4	88.8%	**9.7%**	170.7	81.8%	8.7%	**2.7%**	7.0%	1.0%
Thika road	177.3	75.5%	**8.3%**	199.2	75.3%	8.7%	**(11.0%)**	0.3%	(0.4%)
Kiambu Road	182.8	69.5%	**8.1%**	216.1	78.2%	10.6%	**(15.4%)**	(8.7%)	(2.4%)
Mombasa road	161.5	72.4%	**7.9%**	180.4	68.8%	8.3%	**(10.4%)**	3.7%	(0.5%)
Eastland's	153.3	64.8%	**6.8%**	148.9	61.8%	6.1%	**3.0%**	3.1%	0.7%
Satellite Towns	142.1	73.7%	**6.7%**	130.1	82.5%	7.7%	**9.2%**	(8.8%)	(0.9%)
Average	**178.2**	**79.8%**	**9.0%**	**185.3**	**80.3%**	**9.6%**	**(3.8%)**	**(0.4%)**	**(0.6%)**

1. **Hospitality Sector**

During the week, the Central Bank of Kenya (CBK) released the Market Perceptions Survey of January 2019 Report, which among other insights, highlighted optimism in the tourism and hospitality sectors. The report showed an increase in the median of monthly forward hotel bookings by 5.2% points to an average of 46.9% for January to April 2019, compared to 41.7% during the same period in 2018. According to the report, the increased demand for accommodation is attributable mainly to improved business environment, and enhanced security. Other factors expected to fuel performance of the sector include; i) valentine's season's booking, ii) resumption of corporate bookings, and iii) reduction of cost of travel boosted by affordability of budget airlines and the Standard Gauge Railway (SGR).

Below is a graph showing hotel booking projection in 2018 and 2019:



Source: Central Bank of Kenya (CBK)

The report is in tandem with the Cytonn Annual Outlook 2019, which forecasted increased demand for accommodation services in 2019, with a projected increase of 23.1% in tourist arrivals to 2.6mn from 2.0 mn recorded in 2018. According to the report, some of the key factors likely to boost the sector include; country's political stability, the continued marketing of Kenya as an experience destination and the improved air transport with several airlines that increased their flight frequencies in and out of the country. We, however, note that the recent terrorist attack at the DusitD2 Hotel could negatively affect the sector in the short-term given the recent issuances of travel warnings by the United States (US) and United Kingdom (UK) governments for their citizens. We, therefore, expect hoteliers to leverage on the growth of domestic tourism, with domestic bed-nights growing by 9.03% in 2018 to 3.97 mn from 3.65 mn in 2017, and Meetings, Incentives, Conference and Events (MICE) tourism to support the sector.

We maintain a neutral outlook for the real estate sector in Kenya as the sector is mainly constrained by high financing cost for both developers and buyers. However, the sector has pockets of value driven by positive demographics characterized by a high population growth rate of 2.5% p.a., urbanization rate of 4.3%, and increasing purchasing power with GDP per Capita growing at a rate of 7.9% p.a. over the last 5-years, from Kshs. 113,539 in 2013 to Kshs. 166,314 in 2017.