Nairobi Metropolitan Area Commercial Office Report 2019 & Cytonn Weekly #14/2019

Focus of the Week

The Nairobi Metropolitan Area (NMA) Commercial Office Report released annually aims to inform on supply, performance and the investment opportunity in the NMA Commercial Office Market. As per the Report-Market Review 2017, released in 2018, the commercial office sector had a surplus of 4.7 mn SQFT of office space, with average occupancy rates and rental yields coming in at 82.6% and 7.9%, respectively, 5.4% points and 0.6% point lower than 2016's performance at 88.0% and 8.5%, respectively. The subdued performance was mainly attributed to a tough operating environment in 2017, with i) low credit supply as a result of the implementation of the Banking Amendment Act 2015, and ii) political uncertainty as 2017 was an election year, both factors leading to slower commercial activities thus reduced demand for office space amid the increasing supply of the same.

In this report in 2019, we updated our findings with data from 2018, where we found that performance improved, albeit marginally. The sector recorded a 0.2% points and 0.7%-points y/y increase in average rental yields and occupancy rates, to 8.1% and 83.3%, respectively, on account of an improved macroeconomic environment and the continued positioning of the Nairobi Metropolitan Area (NMA) as a regional hub, thus attracting investors who require office spaces.

This week, we cover the Nairobi Metropolitan Area Commercial Office market by looking at the following:

1. Introduction to the Commercial Office Sector in the Nairobi Metropolitan Area (NMA),
2. Commercial Office Supply in the Nairobi Metropolitan Area,
3. Commercial Office Performance, by Location and by Grades, and
4. Office Market Outlook and the Investment Opportunity in the Sector.

1. Introduction to the Commercial Office Sector in the Nairobi Metropolitan Area (NMA):

The Nairobi Metropolitan Area's positioning as a regional hub continues to set it apart as an investment destination, supporting the growth of the office sector.

The commercial office sector continued to record increased supply, with 4.3 mn SQFT of new office stock being delivered into the NMA market in 2018, 23.9% higher 3.5 mn SQFT completed in 2017. The main factors that have contributed to NMA's attractiveness to investors include;

i. Recognition as a Regional Hub - This has seen international organizations such as Nairobi Overseas Centre by Enterprise Singapore open offices in the Nairobi Metropolitan Area (NMA) signaling the robustness of NMA's commercial scene,
ii. Positive Investment Ranking - In 2019, Nairobi was ranked #6 as the most dynamic city in the world according to JLL's City Momentum Index, up 4 positions from #10 in 2018, attributable to infrastructural investment and the robust start-up culture. In addition, the EY Attractiveness

Report 2018, recorded a 68% increase in inward investment projects within the country. This has, in turn, boosted the appeal of the city to local and international firms and favored property development by investors, and,

iii. The Growth of Small and Medium Sized Enterprises (SMEs) – SMEs contribute approximately 45% of Kenya's GDP, 80% of employment in Kenya and constitute 98% of businesses locally according to a CNBC News Report 2014 and are thus a key driver for the commercial office sector.

In spite of the highlighted drivers, a number of factors have constrained performance in the sector including:

i. Accessibility to Finance - Despite the capping of banking interest rates, the actual cost of credit remains high averaging at 16.7% due to additional administration fees, which raises the cost of development, thus making real estate development expensive for both developers and off-takers. This lack of affordable funding for development has resulted in the use of expensive debt in the funding structure thus affecting the supply of office spaces due to its capital-intensive nature,
ii. Oversupply of office Space – Real estate developers have focused heavily on construction of office buildings attributed to the relatively high yields in the commercial office market at 8.1%, compared to the real estate market average of 7.4%, leading to a supply of 9.0 mn SQFT in 2018, against a demand of 3.8 mn SQFT, hence an oversupply of 5.2 mn SQFT, and
iii. Insufficient Infrastructure- The rate of real estate development and increased commercial activity has by far exceeded the rate of infrastructural improvement causing strains on the trunk infrastructure driving up real estate development costs as developers resort to financing any infrastructural inadequacies.

2. Commercial Office Supply in Nairobi Metropolitan Area

Total commercial office stock increased by 10.4% to 35.5 mn SQFT in 2018 from 31.5 mn SQFT in 2017.

In 2018, the total office stock in Nairobi increased by 10.4% to 35.5 mn SQFT, from 31.5 mn SQFT in 2017, driven by completion of office complexes such as Prism Towers (482,000 SQFT) in Upper Hill, One Africa Place (138,004 SQFT) and The Promenade (215,999 SQFT) in Westlands, and Victoria Towers (85,002 SQFT) in Two Rivers along Limuru Road. Office space supply has grown at a 23.6% CAGR between 2012 and 2018, driven by demand from growing SMEs and multinationals setting up operations in the country being the regional hub for East Africa.

The table below summarizes the commercial office space supply over time:

Commercial Office Space Supply Analysis

Year	2011	2012	2013	2014	2015	2016	2017	2018	2019F	2020F	2021F	2022F	6-yr (2012-2018) CAGR
Stock (mn SQFT)	6.7	7.7	9.7	15.4	22.9	28.9	31.8	35.5	38.2	41.2	44.1	47.0	28.9%
Completions (mn SQFT)		1.2	2.1	5.9	7.8	6.5	3.5	4.3	3.4	3.8	3.8	3.8	23.6%
Vacancy Rate (%)	9.0%	9.0%	10.0%	10.0%	11.0%	12.0%	16.8%	16.7%	16.7%	16.0%	15.0%	14.0%	10.9%
Vacant Stock (mn SQFT)	0.6	0.7	1.0	1.5	2.5	3.5	5.3	5.9	6.4	6.6	6.6	6.6	42.9%
Occupied Stock (mn SQFT)	6.1	7.1	8.8	13.9	20.3	25.4	26.5	29.6	31.8	34.6	37.5	40.4	27.0%
Net Absorption (mn SQFT)		1.0	1.7	5.1	6.5	5.1	1.0	3.1	2.2	2.8	2.9	2.9	21.1%
Demand (mn SQFT)		1.1	1.9	5.3	6.8	5.6	1.6	3.7	2.9	3.5	3.7	3.8	22.6%
Available Supply, AS(T)		1.7	2.6	6.5	8.8	8.4	6.3	9.0	8.6	9.0	9.5	9.4	32.5%
Under(Over)supply		(0.5)	(0.8)	(1.2)	(2.1)	(2.9)	(4.7)	(5.2)	(5.6)	(5.8)	(5.7)	(5.6)	

Commercial Office Space Supply Analysis

Year	2011	2012	2013	2014	2015	2016	2017	2018	2019F	2020F	2021F	2022F	6-yr (2012-2018) CAGR
· *Assuming we retain the 2018 occupancy rates and the expected 2019 commercial office completions at 3.4 mn SQFT, we expect oversupply to increase by 7.6% to 5.6 mn SQFT in 2019 from 5.2 mn SQFT in 2018*													

Source: Cytonn Research 2018, Building Plan Approvals Data from the Nairobi City County

Over the next two-years, we expect the forces of demand and supply to come into play and office space completions to decline by a 2-year CAGR of 6.0% to 3.8 mn SQFT in 2020, from 4.3 mn SQFT recorded in 2018. Assuming we retain the 2018 occupancy rates and the expected 2019 commercial office completions at 3.4 mn SQFT, we expect oversupply to increase by 7.6% to 5.6 mn SQFT in 2019 from 5.2 mn SQFT in 2018. For more information on the commercial office supply calculation, see the Nairobi Metropolitan Area Commercial Office Report 2019.

3. Commercial Office Performance, by Location and by Grades:

The sector recorded a 0.2% points increase in rental yields to 8.1% in 2018, from 7.9% in 2017, driven by an improved macroeconomic environment and the positioning of Nairobi Metropolitan Area as a regional hub.

In 2018, the commercial office sector recorded an average rental yield of 8.1%, at an average occupancy of 83.3%, monthly rental charges of Kshs 103 per SQFT, and price per SQFT of Kshs. 12,719. The overall performance improved marginally in 2018, recording 0.2% points and 0.7% points y/y increase in average rental yields and occupancy rates, to 8.1% and 83.3% from 7.9% and 82.6%, respectively, in 2017. The positive performance was largely driven by:

i. Political stability that led to an improved macroeconomic environment and attracted more tenants to office space, with the GDP growing to 6.0% in Q3’2018, higher than the 4.7% recorded in Q3’2017, and expected to close at 5.8% for the year 2018, and,
ii. The positioning of the Nairobi Metropolitan Area as a regional hub and thus increased entrance of multinationals creating demand for commercial offices.

Asking rents increased marginally by 1.6% to an average of Kshs 103 per SQFT, from Kshs 101 per SQFT in 2017, while asking prices increased by 0.6% to Kshs 12,719 in 2018, from Kshs 12,649 in 2017. The slow rise in rents and prices is attributed to the oversupply of 5.2 mn SQFT office space as at 2018, which has created a bargaining chip for firms forcing developers to reduce or maintain prices and rents in order to remain competitive and attract occupants to their office spaces.

The table below summarizes the performance of the commercial office theme over time:

(All Values in Kshs Unless Stated Otherwise)

Commercial Office Market Performance Summary

	2011*	2013*	2015*	2016*	2017*	2018	y/y Δ 2017	y/y Δ 2018
Occupancy (%)	91.0%	90.0%	89.0%	88.0%	82.6%	83.3%	(5.4%)	0.7%
Asking Rents (Kshs/SQFT)	78	95	97	97	101	103	4.2%	1.6%
Average Prices (Kshs/SQFT)	10,557	12,433	12,776	12,031	12,649	12,719	5.1%	0.6%
Average Rental Yields (%)	8.1%	8.3%	8.1%	8.5%	7.9%	8.1%	(0.6%)	0.2%

(All Values in Kshs Unless Stated Otherwise)

Commercial Office Market Performance Summary

	2011*	2013*	2015*	2016*	2017*	2018	y/y Δ 2017	y/y Δ 2018

**Rental yields for FY'11 to FY'17 restated to include average market occupancy rates. The average rental yield for offices published in our previous reports assumed 100% occupancy rates*
· Average rental yields and occupancy rates increased by 0.2% points and 0.7% points, respectively to 8.1% and 83.3% in 2018 from 7.9% and 82.6%, respectively in 2017, due to the increased demand driven by increased economic activities as a result of the improved macroeconomic environment and positioning of the Nairobi Metropolitan Area as a regional hub
· Asking rents increased marginally by 1.6% to an average of Kshs 103 per SQFT in 2018, from Kshs 101 per SQFT in 2017 attributed to an oversupply of 5.2 mn SQFT office space as at 2018, which has created a bargaining chip for firms forcing developers to reduce or maintain prices and rents in order to remain competitive and attract occupants to their office spaces

Source: Cytonn Research 2018

a. Performance by Nodes: Gigiri and Karen recorded the highest yields of 10.5% and 9.2%, respectively, being prime locations with quality offices

For submarket analysis, we classified the main office nodes in the Nairobi Metropolitan Area into 9 nodes: i) Nairobi CBD, ii) Westlands, covering environs including Riverside, iii) Parklands, iv) Mombasa Road, v) Thika Road, vi) Upperhill, vii) Karen, viii) Gigiri, and ix) Kilimani, which includes offices in Kilimani, Kileleshwa and Lavington.

Gigiri, Karen and Westlands were the best performing nodes in 2018, recording rental yields of 10.5%, 9.2%, and 9.0%, respectively, attributed to increased demand by businesses and multinational companies due to their proximity to the Central Business District (CBD) and other business nodes, high quality office space and relatively good infrastructure network.

Thika Road and Mombasa Road were the worst performing nodes recording rental yields of 6.7% and 5.8%, respectively, due to the lack of quality offices and the prevalence of traffic snarl-ups that have made them generally unattractive to firms.

The nodal office performance is as summarized in the table below:

(All Values in Kshs Unless Stated Otherwise)

Commercial Office Market Performance by Node

Commercial Nodes	Price Kshs/SQFT FY 2018	Rent Kshs/SQFT FY 2018	Occupancy FY 2018(%)	Rental Yield (%) FY 2018	Price Kshs/SQFT FY 2017	Rent Kshs/SQFT FY 2017	Occupancy FY 2017(%)	Restated Rental Yield (%) FY 2017	Δ Rent Y/Y	Δ Occupancy Y/Y (% points)	Δ Rental Yields Y/Y (% points)
Gigiri	13,833	141	88.3%	10.5%	13,750	138	81.4%	9.8%	1.9%	6.9%	0.7%
Karen	13,666	118	88.6%	9.2%	13,167	113	89.2%	9.2%	4.7%	(0.6%)	0.0%
Westlands	12,050	110	82.1%	9.0%	12,872	103	88.5%	8.5%	6.5%	(6.4%)	0.5%
Parklands	12,494	102	86.0%	8.4%	12,729	103	85.7%	8.3%	(0.9%)	0.3%	0.1%
Kilimani	13,525	99	88.3%	8.0%	12,995	99	82.0%	7.5%	(0.1%)	6.3%	0.5%
Upperhill	12,560	100	80.7%	7.9%	12,901	101	84.5%	7.9%	(1.2%)	(3.8%)	(0.1%)
Nairobi CBD	12,425	89	88.3%	7.6%	12,286	88	84.1%	7.2%	0.9%	4.2%	0.4%
Thika Road	12,517	86	81.5%	6.7%	11,500	82	73.6%	6.3%	5.3%	7.9%	0.4%
Msa Road	11,400	79	65.6%	5.8%	11,641	82	74.2%	6.3%	(4.0%)	(8.6%)	(0.5%)
Average	12,719	103	83.3%	8.1%	12,649	101	82.6%	7.9%	1.6%	0.7%	0.2%

· Gigiri, Karen and Westlands recorded the highest rental yields at 10.5%, 9.2%, and 9.0%, respectively, attributed to increased demand by businesses and multinational companies due to proximity to CBD and other business nodes, high quality office space and relatively good infrastructure network,
· Thika Rd and Mombasa Rd, had the lowest returns with average rental yields of 6.7% and 5.8%, respectively attributed to traffic snarl-ups and low-quality office space

Source: Cytonn Research 2018

b. Commercial Office Performance by Class/Grade: Grade B office spaces had the highest rental yields at 8.4%

We also analysed performance in terms of class/grade where we classified commercial office buildings into three main categories based on size and quality of office spaces. These are:

- Grade A: Office buildings with a total area ranging from 100,001 - 300,000 square feet that are pacesetters in establishing rents and that generally have ample natural good lighting, good views, prestigious finishing, and on-site undercover parking, and a minimum parking ratio of 3:1000 SQFT,
- Grade B: Office buildings with a total area ranging from 50,000 to 100,000 SQFT. They have good (but lower than Grade A) technical services and ample parking space, and,
- Grade C: These are buildings of any size, usually older and in need of renovation, they lack lobbies and may not have on-site parking space. They charge below average rental rates.

In terms of supply, Grade B offices are the most common, accounting for 58.1% of commercial offices in the Nairobi Metropolitan Area. The market witnessed an increase in Grade A office supply with offices such as FCB Mihrab (298,000 SQFT) and Prism towers (482,000 SQFT) coming into the market and therefore increasing the market share of Grade A offices from approximately 24.0%, to approximately 25.0% of our sample size. Gigiri has the highest percentage of its offices being Grade A at 66.7%. Nairobi CBD has the highest percentage of its offices being Grade B at 84.6% and no Grade A office space, while Mombasa Road has the highest percentage of its offices being Grade C at 50%.

With regard to performance, Grade B office spaces had the highest rental yields at 8.4% driven by a 0.8% and 3.0% points increase in occupancy and rental rates, respectively. Rental yields for Grades B and C increased by 0.5% and 0.9% points, respectively, to average at 8.4% and 7.9%. Grade A office yields however declined by 0.3% points from 8.4% to 8.1%, due to a decline in occupancy rates, with new completions recording lower occupancy rates, and as they charge high rental rates, 12.5% above the market thus tenants opt for Grade B offices.

The performance according to grades/class is as summarized in the table below;

(All Values in Kshs Unless Stated Otherwise)

Commercial Office Performance by Grade

Office Grade	Price 2018 Kshs/ SQFT	Rent 2018 (Kshs/SQFT)	Occupancy 2018 (%)	Yield 2018(%)	Price Kshs/ SQFT	Rent 2017 (Kshs/SQFT)	Occupancy 2017(%)	Yield 2017(%)	Δ Rent Y/Y	Δ Occupancy Y/Y (% points)	Δ Rental Yields Y/Y (% points)
Grade A	13,006	113	74.3%	8.1%	13,053	112	81.5%	8.4%	0.7%	(7.2%)	(0.3%)
Grade B	12,615	102	85.9%	8.4%	12,804	99	85.1%	7.9%	3.0%	0.8%	0.5%
Grade C	11,022	86	87.6%	7.9%	11,929	84	83.1%	7.0%	2.4%	4.5%	0.9%
Average	12,215	100	82.6%	8.1%	12,595	98.3	83.2%	7.8%	2.0%	(0.6%)	0.3%

· Grade B office spaces had the highest rental yields at 8.4% driven by a 0.8% and 3.0% points increase in occupancy and rental rates, respectively
· Grade A office yields declined by 0.3% points from 8.4% to 8.1%, due to decline in occupancy rates, given that they are new in the market hence occupancy rates haven't stabilized and they charge high rental rates, 12.5% above the market thus tenants prefer Grade B offices

Source: Cytonn Research 2018

c. Class and Node Analysis: Gigiri, Westlands and Parklands nodes present the best investment opportunity in Grade A, B and C offices, respectively

Combining the analysis of performance by nodes and by class, we found that for Grade A offices the opportunity is in Gigiri with high yields of on average 12.0%. For Grade B, the opportunity is in Westlands with an average rental yield of 9.6%. For Grade C, the opportunity in lies in Parklands with rental yields of on average 8.9%.

Commercial Office Performance in 2018 by Nodes and Grades

Typology	Grade A		Grade B		Grade C	
Location	Rental Yield (%)	Occupancy (%)	Rental Yield (%)	Occupancy (%)	Rental Yield (%)	Occupancy (%)
Gigiri	12.0%	90.0%	7.6%	85.0%		
Karen	9.1%	84.5%	9.2%	89.7%		
Parklands	8.6%	87.6%	7.7%	81.9%	8.9%	90.2%
Westlands	8.4%	74.8%	9.6%	83.6%	8.2%	92.7%
Upper Hill	7.7%	66.0%	7.9%	85.8%	8.3%	96.0%
Kilimani	6.3%	69.5%	8.4%	90.7%	6.2%	92.0%
Msa Road	4.7%	62.5%	6.9%	73.3%	5.4%	60.0%
Thika Road	3.6%	40.0%	6.9%	86.6%	7.8%	94.5%
Nairobi CBD			7.5%	88.0%	8.3%	89.9%

· *Gigiri and Karen offered the highest returns for Grade A offices, with average rental yields of 12.0% and 9.1%, respectively as they enjoy a superior location characterized by a serene and low-density environment*
· *For Grade B, Westlands has the highest rental yield of 9.6% and hence present an investment opportunity for the same in the market*
· *Parklands offer the best investment opportunity for Grade C with average rental yields of 8.9% attributed to its proximity to the CBD and Westlands, ample infrastructure and favorable zoning regulations facilitating densification*
· *Location and quality of office space continue to be the main factors determining office performance*

Source: Cytonn Research 2018

4. Office Market Outlook and the Investment Opportunity in the Sector

In conclusion, having looked at supply, demand and investor returns, we have a general Negative outlook for the commercial office sector theme in Nairobi Metropolitan Area (NMA) given the increased office space supply and expected stagnation in performance in 2019, and thus investment in the sector should be geared to the long-term horizon for gains when the market picks up. Investment opportunity exists in zones with low supply and high returns such as Gigiri and in differentiated concepts such as serviced offices recording a rental yield of up to 13.5% to boost returns.

Commercial Office Outlook

Measure	2017 Sentiment	2018 Sentiment	2018 Review	2019 Outlook
Supply	· We had an oversupply of 4.7 mn SQFT of office space in 2017, which impacted the performance negatively, lowering commercial office rental yields and occupancy rate to 7.9% and 82.6%, respectively, from 8.5% and 88.0% recorded in 2016	· We had an oversupply of 5.2 mn SQFT of office space in 2018, and it is expected to grow by 7.6% to 5.6 mn SQFT in 2019, compared to 10.8% in 2018 due to decreasing supply with completions expected to decrease by 21.4% from 4.3 mn SQFT to 3.4 mn SQFT in 2019	Negative	Negative

Measure	2017 Sentiment	2018 Sentiment	2018 Review	2019 Outlook
Demand	· There was reduced demand for office space in the Nairobi Metropolitan Area (NMA) evidenced by the 4.8% y/y decline in occupancy mainly attributable to a tough operating environment characterized by low credit supply and political uncertainty as a result of the protracted electioneering period	· There was increased demand for office space in the Nairobi Metropolitan Area (NMA) evidenced by the 0.7% y/y increase in occupancy mainly attributable to political stability that has led to increased economic activities, positioning of the NMA as a regional hub and thus increased entrance of multinationals and improving macroeconomic environment, with the GDP growing at 6.0% in Q3'2018, higher than the 4.7% recorded in Q3'2017, and expected to close at 5.8% for the year 2018	Neutral	Neutral
Office Market Performance	· The performance of the office market softened, with yields reducing by 0.6 % points to 7.9% in 2017 from 8.5% in 2016, and occupancy rates reducing by 5.4% points from 88.0% in 2016 to 82.6% in 2017	· The performance of the office market improved with yields increasing by 0.2% points to 8.1% in 2018 from 7.9% in 2017, and occupancy rates increased by 0.7% points from 82.6% in 2017 to 83.3% in 2018.	Neutral	Neutral
General Outlook and Opportunity	· We have a negative outlook for the commercial office theme in the Nairobi Metropolitan Area (NMA) given the increased office space supply and expected stagnation in performance in 2019, and thus investment in the commercial office theme should be geared to the long-term horizon for gains when the market picks up · Investments should be made in zones with low supply and high returns such as Gigiri and in differentiated concepts such as serviced offices recording a rental yield of up to 13.5% to boost returns			

For 2019, we have a negative outlook for the commercial office market in the Nairobi Metropolitan Area (NMA), with one out of three metrics we looked at being negative and two metrics being neutral. Investments in the commercial office sector should therefore, be aimed towards long-term gains when the market picks up; but if you have to invest in commercial office, we would pick Gigiri, Westlands and Karen. We continue to track performance of the office sector, and as per our Cytonn Q1'2019 Markets Review, the sector recorded 0.1% and 0.9% points decline in average rental yields and occupancy rates, to 8.0% and 82.4%, respectively. For more information click here*. For the full Commercial Office Report 2019, click* here*.*