Cytonn INVESTMENTS

Kenya Mortgage Refinancing Company Update & Cytonn Weekly #17/2019

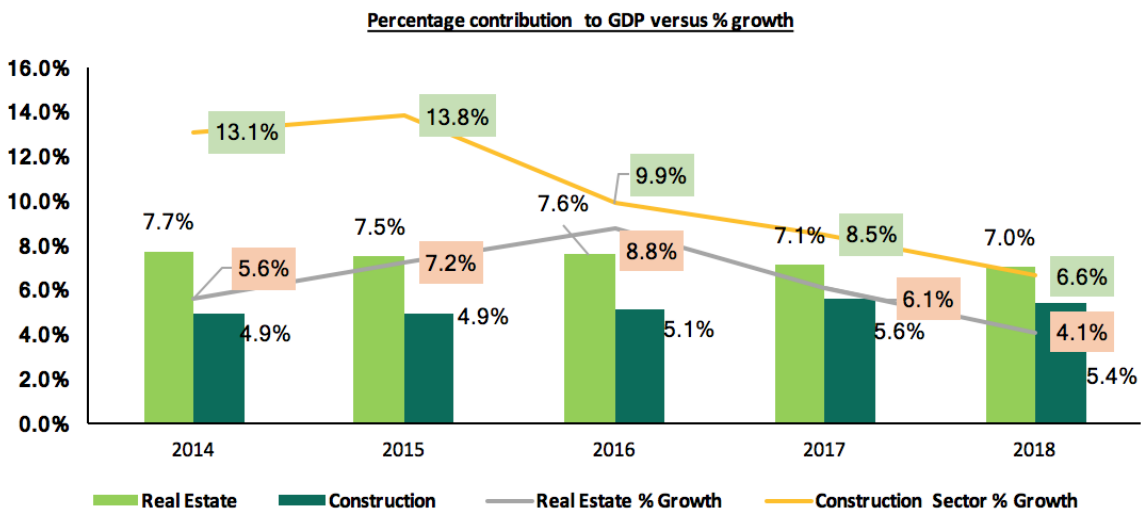
Real Estate

I. **Industry Reports**

During the week, Kenya National Bureau of Statistics released the Economic Survey 2019, which analyses the socio-economic environment in Kenya. The key take-outs in the real estate and construction industry from the report were;

?. The real estate sectors contribution to GDP declined marginally by 0.1% points to 7.0% in 2018, from 7.1% in 2017, and recorded a slowdown in terms of growth rate, having grown by 4.1% compared to 6.1% in 2017. We attribute the slower growth rate to inaccessibility and unaffordability of off-take financing, with the credit advanced to the sector recording a marginal decline of 0.5% to Kshs 368.7 bn as at end of 2018, from Kshs 370.7 bn as at the end of 2017,

i. The construction sector grew by 6.6%, 1.9% points lower from 8.5% recorded in 2017. In line with the decline in growth rate, the sector's contribution reduced slightly by 0.2% points to 5.4%, from 5.6% in 2017. The cement consumption recorded 1.6% increase from 5,856.6 mn tonnes in 2017 to 5,948.7 mn tonnes in 2018 supported by an increase in activities in the sector with the length of roads constructed increasing by 9.8% in 2018 to 18,655 km compared to 17,034 km in 2017, as shown below:



Source: Kenya National Bureau of Statistics

iii. In the infrastructural sector, the government expenditure on roads decreased by 7.4%, to Kshs 104.8 bn in 2017/18, from Kshs 113.2 bn in 2016/17. The key notable construction activities evident in 2018 were the ongoing construction of Phase Two of the Standard Gauge Railway (SGR) and other public investments in transportation infrastructure, with a 9.8% increase in the total length of bitumen roads in Kenya to 18,655 km in 2018, from 16,827 km in 2017. In addition,

the expenditure on roads is expected to rise by 23.0% to Kshs 195.1 billion in 2018/19,

iv. The value of private building plans approved in Nairobi City County (NCC) decreased by 12.7% from Kshs 240.8 bn in 2017, to Kshs 210.3 bn in 2018, while the value of completed buildings issued with certificate of occupancy in NCC increased by 5.2% to Kshs 90.6 bn in 2018. We attribute the slowdown in building approvals to reduced activities in the real estate sector due to the space surplus in the sector, evidenced by the decline in the residential sector occupancy rates, and an oversupply in the commercial sector, currently at 2.0 mn SQFT and 4.7 mn SQFT for the retail and commercial office sector, respectively,
v. Accommodation and food services retained a 0.7% contribution to GDP, similar to that of 2017, with the number of tourist arrivals increasing by 14.0%, from 1.8 mn recorded in 2017 to 2.0 mn in 2018. Consequently, hotel bed-nights occupied increased by 1.3% points, to 32.5% in 2018 compared to 31.2% in 2017, while the number of conferences increased by 7.8% to stand at 4,321 in 2018. The overall improvement in the sector's performance was attributed to introduction of charter flights from key cities in Europe, increased flight frequency and routes, the inauguration of the Nairobi-New York route in October 2018, concerted marketing efforts such as branding of tourism products, digital marketing and global campaigns, a stable economic environment, improved security and thus improved investor confidence in the country.

Overall, the slowdown in the growth of the real estate sector is in line with the Cytonn Annual Market Review 2018 which highlighted that the sector recorded a decline in performance with the returns coming in 11.2% in 2018 compared to 14.1% in 2017, thus a 2.9% points decline, attributed to a decline in demand for property despite the growing supply, across the sectors. For 2019, as per Cytonn 2019 Market Outlook, we expect the slowdown in effective demand for property to persist amid increasing supply thus a neutral outlook. In terms of performance, we expect the sector's performance to be shaped by focus on affordable housing, increased mortgage uptake and adoption of sustainable developments and technology.

II. **Listed Real Estate**

During the week, Stanlib Fahari I-REIT announced plans to acquire more properties from pension firms and insurers who will be compensated in the form of units in the REIT. The proposed structure eliminates the need for the firm to raise large sums of new capital to buy more buildings, in addition to expanding the pool of income-generating buildings owned by the REIT and raising earnings for the expanded investor base. According to the Stanlib Fahari FY'2018 Earnings Note, the firm's total assets stood at Kshs 3.9 bn in 2018, and it has continued to diversify its real estate portfolio to the office and industrial sector, through their recent purchase of the 67 Gitanga Place office building in Lavington at Kshs 895.5 mn. Other properties owned by the REIT include; (i) Greenspan Mall in Donholm, (ii) Highway House in Industrial Area, and (iii) Bay Holdings Limited in Industrial Area. On the other hand, for the insurers and pension firms, the transactions will enhance liquidity, help them diversify their portfolio into the REITs sector and enable fund managers that are currently overweight with investment property to comply with regulations by the Retirement Benefits Authority (RBA) and Insurance Regulatory Authority (IRA) that allows up to 30.0% of pension schemes and insurers' assets to be invested in real estate. The REIT's performance is currently constrained by; i) opacity of the exact returns from the underlying assets, (ii) the negative sentiments currently engulfing the sector given the poor performance of Fahari I- REIT and Fusion D-REIT (FRED), (iii) inadequate investor knowledge, and (iv) lack of institutional support for REITs. Therefore we expect the move by the I-REIT to enhance institutional support and thus result in better uptake and performance.

Other highlights during the week:

?. Transport, Infrastructure, Housing and Urban Development Cabinet Secretary, Hon. James Macharia, announced that the Kenya National Highway Authority (KeNHA) was set to sign-off on the contract initiating the construction of the Jomo Kenyatta International Airport (JKIA) -

Westlands Expressway on 27th April 2019. The Kshs 51.0 bn project will be constructed and funded by the China Road and Bridge Corporation (CRBC), through a Private Public Partnership (PPP) framework that will see the firm fund the project and later recoup its investment from toll fees. According to the KNBS Economic Survey 2019, the government has continued to focus on infrastructure with a 9.8% increase in the total length of bitumen roads recorded in 2018 to 18,655 km from 16,827 km in 2017. According to the report, infrastructure spending is expected to increase by 23.0% to Kshs 195.1 bn in 2018-19 from Kshs 158.6 bn in 2017-18 attributed to the construction of phase 2A of the Standard Gauge Railway (SGR) from Nairobi to Naivasha and the construction of new roads including the Western Bypass and dualing of Ngong Road (Dagoretti Corner - Karen Roundabout Section). We expect the 18.6 km highway to ease traffic into the Nairobi CBD, access to JKIA and areas such as Westlands, thus drive the hospitality sector given that the airport is the main entrance of international arrivals and connects the same to Westlands which is one of the best performing serviced apartments node with and average rental yield of 10.6% according to Cytonn Research.

We expect growth in the real estate sector to be fueled by the continued improvement in infrastructure that will open up areas for development in addition to the improving socio-economic environment.