Understanding the Derivatives Market and Cytonn Weekly #27/2019

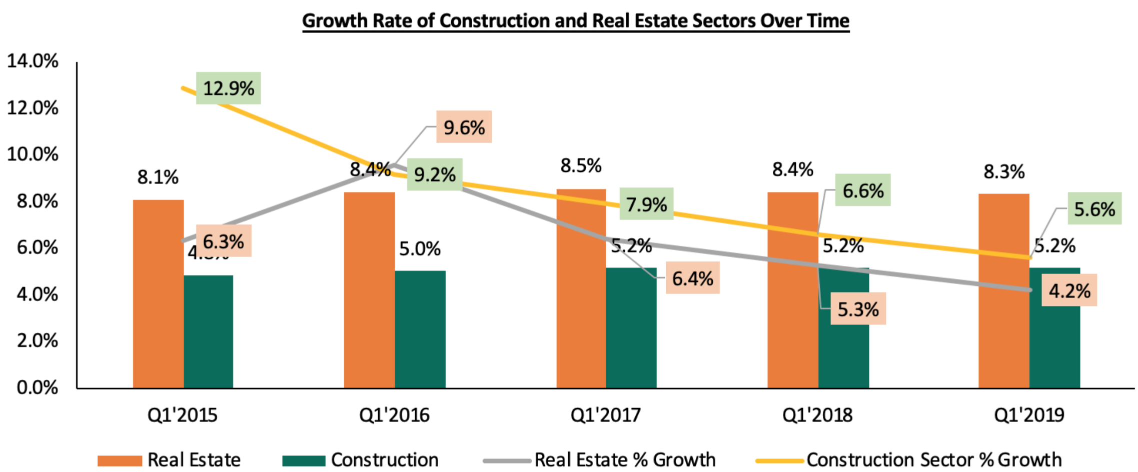
Real Estate

I. Industrial Reports

During the week, Kenya National Bureau of Statistics released the Quarterly Gross Domestic Product Report Q1'2019, indicating a decline in performance, with the economy expanding by 5.6%, 0.9% points lower than the 6.5% growth recorded in Q1’2018. The key take-outs for the real estate sector were as follows;

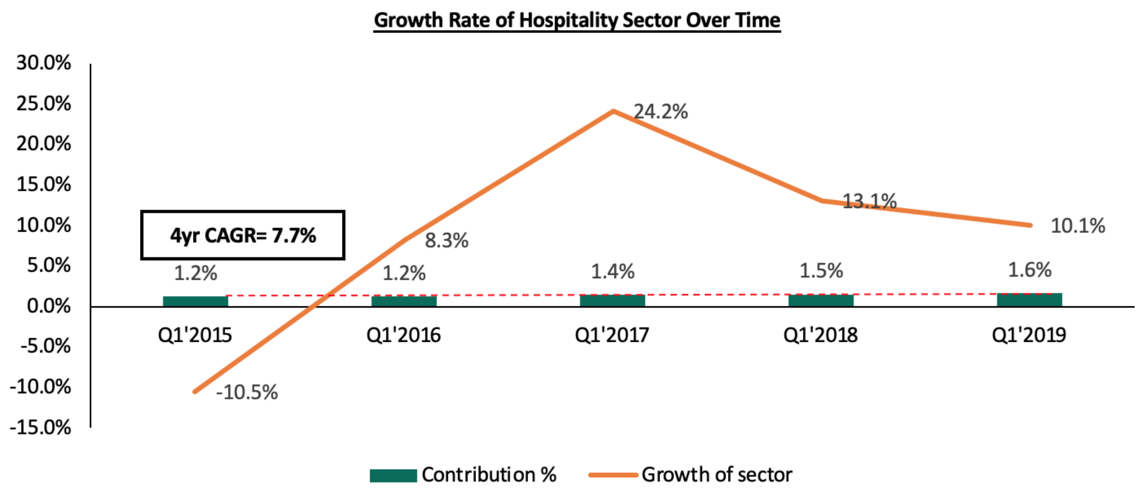
- The construction sector’s contribution to GDP remained constant at 5.2% in Q1’2019, similar to Q1’2018, while recording a 1.0% point decline in growth rate from 6.6% in Q1’2018 to 5.6% in Q1’2019, attributable to a decline in real estate activities, in addition to government slowdown on infrastructural developments. Despite the decline, the sector growth was supported by the continued construction of the second phase of the Standard Gauge Railway (SGR) and other public infrastructural developments, especially road construction,
- The slowdown in construction activities was evidenced through a 3.1% decline in cement consumption and a 1.0% decline in credit advanced to the construction sector during the quarter under review, and,
- The real estate sector contribution to GDP decreased marginally by 0.1% points, from 8.4% in Q1’2018 to 8.3% in Q1’2019, while the growth rate of the sector declined by 1.1% points to 4.2% in Q1’2019, from 5.3% in Q1’2018, attributed to a decline in activities in the sector during the quarter.

The graph below shows the growth of the construction and real estate sectors over the years:



Source: Kenya National Bureau of Statistics (KNBS)

- In hospitality, the contribution of the accommodation and food service activities to GDP recorded a 0.1% points increase to 1.6%, from 1.5% in Q1’2018, despite the sector recording reduced growth by 3.0% points to 10.1% in the Q1’2019, from 13.1% in Q1’2018. We attribute the decline in growth of the sector to an estimated 0.5% decline in tourist arrivals through Jomo Kenyatta International Airport and Moi International Airport from 0.236 mn arrivals in Q1'2018 to 0.235 mn during a similar period in 2019. However, the sector continues to expand supported by; (i) the recognition of Nairobi as a regional hub, (ii) the improving air travel in the country, and (iii) political stability.



Source: Kenya National Bureau of Statistics

The above statistics are in line with our Cytonn Q1'2019 Market Review, which highlighted a slowdown in the real estate sector during the quarter, with sectors such as office and retail registering a decline in rental yields by 0.1% points and 0.5% points, to 8.0% and 8.5% from 8.1% and 9.0%, respectively in FY'2018, while the residential sector recorded 0.5% annualized price appreciation, 3.7% points lower than 4.2% in FY'2018. The performance was constrained by; (i) limited access to financing by developers and end users, with private sector credit growth coming in at 4.9% in April 2019, compared to a 5-year (2014-2019) average of 12.4%, and (ii) increased supply in selected sectors such as the commercial office and retail sectors with a surplus of 5.3 mn SQFT and 2.0 mn SQFT, respectively, as at 2018.

We, however, expect the trend to reverse driven by; (i) continued National Government support for the affordable housing initiative, (ii) the continued infrastructural improvement, which is opening up new areas for development, and (iii) the improving macroeconomic environment.

II. Residential Sector

Indian firm, Shapoorji Real Estate (SPRE) and UK equity investor-developer Actis, is set to begin development of a 624-units, middle-class, residential development on a 4.5-acre parcel of land at the Garden City Mall, along Thika Road. The construction of the first phase of the project, dubbed Mida Vida Homes, is set to commence in Q3'2019. The phase will consist of 208 units, of 1, 2- and 3-bedroom units, priced at Kshs 6 mn, Kshs 9 mn and Kshs 14 mn, respectively. However, key to note, the unit sizes are yet to be disclosed. For more details on the joint venture structure of the project, see Cytonn Weekly#10/2019.

Thika Road hosts a large, young and working population and we thus expect the project to contribute in meeting the large housing deficit mainly among the middle and low-income earners in Kenya. In terms of performance, the area, which is covered under Thome submarket, recorded total returns of 6.7% in 2018, compared to the market average of 8.8%, according to Cytonn Research. We attribute the relatively poor performance to the low rental prices charged in the area at approximately Kshs 297 per SQM, compared to the market average of Kshs 423 per SQM.

The table below shows the performance of the lower- mid-end suburbs in Nairobi:

Nairobi Metropolitan Area Apartments Performance - Lower Mid End Suburbs

Submarket	Average Price Per SQM	Average Rent Per SQM	Average Annual Sales(%)	Average Rental Yield(%)	Average Price Appreciation(%)	Average Total Returns(%)
Upper Kabete	86,344	429	27.4%	6.3%	5.6%	11.9%
South B & C	107,819	510	26.5%	5.7%	4.4%	10.1%
Donholm & Komarock	75,072	374	20.3%	6.0%	3.9%	9.9%
Ngong Road	99,630	453	25.6%	5.9%	4.0%	9.9%
Imara Daima	74,232	381	26.2%	6.3%	3.0%	9.4%
Kahawa West	82,166	416	22.9%	6.2%	1.8%	8.1%
Dagoretti	98,038	482	22.5%	6.2%	1.7%	7.8%
Thome	124,554	297	22.3%	2.8%	3.9%	6.7%
Langata	107,374	462	23.2%	5.3%	0.3%	5.6%
Average	95,025	423	24.1%	5.6%	3.2%	8.8%

• *Thome submarket, recorded total returns of 6.7% in 2018, compared to the market average of 8.8%, according to Cytonn Research. We attribute the relatively poor performance to the relatively low rental prices charged in the area at approximately Kshs 297 per SQM, compared to the market average of Kshs 423 per SQM*

Source: Cytonn Research 2018

III. Retail Sector

Kenya's retail sector has been vibrant over the past few years, attracting interest from renowned international retailers as well as the robust expansion of local retailers. In line with this, during the week, fast food chain Big Square, opened their 13th branch at Shell Service Station in Mountain View, with some of the other branches being in the Nairobi CBD, Lavington and along Lang'ata Road. The South African owned eatery joins other food chains such as KFC and Java Coffee that have continued to expand their footprint in the Kenyan market. This continued expansion by retailers is supported by;

I. Increased disposable income because of an expanding middle class thus creating demand for high-end restaurants and casual dining areas. According to KNBS Economic Survey 2019, private consumption expenditure recorded a growth of 5.9% in 2018, 0.4% points higher than the previous 4 year average growth of 5.5%,
II. A positive demographic dividend, with a population growth rate of approximately 2.6% p.a. and a rapid urbanization rate of 4.3%, in comparison to the global 1.2% and 2.1%, respectively, hence an increase in demand for restaurants, and,
III. Stable economic growth, with Kenya's GDP growth coming in at 5.6% in Q1'2019, thus, creating an enabling environment for the retailers to make desirable profits.

In our view, the Mountain View area, which is located along Waiyaki Way, presents a viable opportunity for the business as it hosts high to middle-income earners with high purchasing power, which will sustain demand from the restaurant's target market. The continued expansion of Big Square and other restaurants such as Java and KFC in Nairobi will result in increased uptake of retail real estate developments thus improving the overall performance of the sector. For investors in retail real estate, with an average rent of Kshs 209 per SQFT, retail space in Westlands Submarket, under which Mountain View area is covered, records a high yield of 12.0%, 3.8% points higher than the market average of 8.2%, with an average occupancy rate of 89.0% compared to the market average of 75.6%. This, therefore, portrays Westlands as a viable investment destination for both retailers and retail real estate developers. The table below shows a summary of the Nairobi retail market performance in H1'2019:

Summary of Nairobi's Retail Market Performance H1' 2019

Location	Rent Kshs/SQFT H1' 2019	Occupancy H1' 2019	Rental Yield H1' 2019	Rent Kshs/SQFT FY' 2018	Occupancy FY' 2018	Rental Yield FY' 2018	H1' 2019 Δ in Rental Rates	H1' 2019 Δ in Occupancy (% points)	H1' 2019 Δ in Rental Yield (% points)
Westlands	209	89.0%	12.0%	219	82.2%	12.2%	(4.7%)	6.8%	(0.2%)
Kilimani	173	91.4%	10.5%	167	97.0%	10.7%	3.6%	(5.6%)	(0.2%)
Ngong Road	171	87.5%	9.3%	175	88.8%	9.7%	(2.3%)	(1.3%)	(0.4%)
Karen	219	71.8%	8.8%	225	88.8%	11.0%	(2.5%)	(17.0%)	(2.2%)
Eastlands	145	74.2%	7.5%	153	64.8%	6.8%	(5.6%)	9.4%	0.7%
Kiambu Road	169	65.3%	7.3%	183	69.5%	8.1%	(7.6%)	(4.2%)	(0.8%)
Thika road	168	66.5%	6.8%	177	75.0%	8.3%	(5.4%)	(8.5%)	(1.5%)
Mombasa road	144	65.5%	6.3%	162	72.4%	7.9%	(10.7%)	(6.9%)	(1.6%)
Satellite Towns	129	69.2%	5.7%	142	73.7%	6.7%	(9.2%)	(4.5%)	(1.0%)
Average	170	75.6%	8.2%	178	79.1%	9.0%	(4.9%)	(3.5%)	(0.8%)

- *Westlands and Kilimani were the best performing submarkets, with a yield of 12.0% and 10.5% respectively, driven by relatively higher rental rates as the areas are affluent neighborhoods hosting middle – high-end income earners with high consumer purchasing power and thus investors are willing to pay higher rents for retail space in the area*

Source: Cytonn Research

We maintain a neutral outlook for the real estate sector supported by; (i) the continued entry and expansion of local and international retailers, (ii) the improving infrastructure, (iii) positive demographics and (iv) a stable economic environment. The investment opportunity in the sector lies in areas such as Westlands for the retail sector, with relatively high rental yields of 12.0%, differentiated concepts for the commercial office sector, that is serviced offices which have continued to record relatively high rental yields of 13.4% on average, and the serviced apartments for the hospitality sector with average rental yields of 7.4%. For the residential sector, the investment opportunity lies in the lower mid-end sectors, which continue to exhibit fast growing demand from the majority of Kenyans seeking to buy affordable homes amidst a tough financial environment.