Cytonn INVESTMENTS

Nairobi Metropolitan Area (NMA) Residential Report 2018/2019, & Cytonn Weekly #28/2019

Focus of the Week

This week, we look at performance in the residential sector over the 2018/2019 period, as we update the findings of the Nairobi Metropolitan Area Residential Report 2017/2018, which we released in July 2018. According to the report, residential sector in 2017/2018 registered an average return to investors of 8.2% (price appreciation and rental yields of 2.8% and 5.4%, respectively), which was 1.2% points lower than 9.4% in 2016/2017 (rental yields and capital appreciation of 5.6% and 3.8%, respectively). The decline in performance was attributed to a tough macroeconomic environment characterized by relatively low private sector credit growth, and the spillover effects of the protracted 2017 political elections.

This year, we update the findings of the 2017/2018 report by looking at the residential market performance in 2018/2019 covering 41 markets across the Nairobi Metropolitan Area. As such, we shall cover the following:

A. Overview of the Residential Sector,
B. Market Performance in the Residential Sector,
C. Investment opportunity in the Sector, and,
D. Outlook and Conclusion.

A. Overview of The Residential sector

According to the March 2019 issue of the KNBS Leading Economic Indicator, the residential sector posted a 10.3% drop in the value of approvals to Kshs 33.0 bn in Q1'2019, from Kshs 36.8 bn in Q1'2018, an indicator of decreased building activity in the sector. However, the entire real estate market also posted a decline in contribution to the national GDP, which came in at 11.3% in Q1'2019, from 14.4% in Q4'2018 and 12.4% in FY'2018. From our research, transaction volumes were also on the decline with average residential unit's annual uptake coming at 20.9%, in comparison to 23.3% in 2017/2018.

i. Residential Sector Trends in 2018/2019

Below, we recapture key developments that occurred in the residential sector:

a. Launching of the Kenya Mortgage Refinancing Company: The National Treasury officially launched the Kenya Mortgage Refinancing Company in June 2019. The company is set to enhance mortgage affordability in Kenya by enabling long-term loans at attractive market rates through the provision of affordable long-term funding and capital market access to primary mortgage lenders such as banks and financial co-operatives. However, as per our Note, in addition to the

availability of low-cost homes in the market, the right amount of investing in the capital markets to be able to realize its funding needs, is needed to ensure KMRC achieves its objectives,

b. Launch of the Boma Yangu Portal: National Housing Corporation established the Boma Yangu portal where all stakeholders in the housing sector, including end-buyers and investors, interact with the Housing Fund. The portal will also serve as evidence of aggregating demand from potential homebuyers to developers and other investors in the affordable housing initiative, while also serving as a platform for prequalifying eligible individuals for the affordable homes under development,
c. National Housing Development Fund: During the period, the proposed Housing Fund levy was increased to 1.5% from the initial 0.5%. However, this yet to be affected due to public opposition as to its being a mandatory contribution while remaining unclear as to how the contributors shall benefit. For our analysis on this, see here
d. Statutory Changes: In regards to housing, the President of Kenya signed various bills into law, including (i) Amendment of the Income Tax Act to allow buyers get a 15.0% tax relief up to a maximum of Kshs 108,000 p.a., or Kshs 9,000 p.m., under the introduced Affordable Housing Relief section, and, (ii) Amendment of the Stamp Duty Act, to allow for exemption of first time homebuyers under the affordable housing scheme from paying the Stamp Duty Tax, which is normally set at 2.0% - 4.0% of the property value depending on the location,
e. Capital Gains Tax Increment: The National Treasury through the Finance Bill 2019 proposed to increase Capital Gains Tax from 5.0% to 12.5%. If enacted, the increase will have only negative effects on real estate investors, which is already burdened by financial constraints. Therefore, the tax will most likely lead to a decline in transaction volumes as it (i) as investors attempt to avoid paying the increased tax, and (ii) will lead to a hike in prices as the liability will be transferred to the end buyers.

We expect the focus on affordable housing to intensify with developers scaling back on upscale markets to partner with the government to tap into the low-end markets where the majority of the housing deficit falls.

ii. Factors Influencing Residential Demand

Going forward, we expect the following factors to shape demand:

a. Access to Mortgages: With the stringent lending practices, private sector credit still remains low with April 2019 posting 4.9% as at April 2019, compared to a five-year average of 14.0%. However, with the launch of the Kenya Mortgage Refinance Company (KMRC), which occurred in June 2019, we expect growth in the primary mortgage market, which according to Central Bank of Kenya, has 26,187 mortgages as at 2017 out of a total adult population of 23.0 mn persons,
b. Demographic Growth: The housing deficit in the Nairobi Metropolitan Area is expected to come in at 2.1 mn units in 2019 according to our estimations, compared to 2.0 mn in 2018, owing to a rapid population growth rate and high urbanization rate at 2.6% and 4.3%, respectively, compared to a global average of 1.2% and 2.1%, respectively. The high demographic growth is expected to continue sustaining demand for more dwelling units with 97.1% of the demand being in the lower mid-end and low-end segments, who according to KNBS Statistics, earn below Kshs 50,000 p.m.,
c. Purchasing Power: The Kenyan economy expanded by 6.3% in 2018 and according to KNBS Economic Survey 2019, average real earnings grew by 3.2% in that period, in comparison to a 2.7% decline in 2017. The increasing household incomes have increased demand for formal housing, thus pushing prices up, albeit marginally in the period under review due to a tough economic environment as a result of a persistent drought, driving the cost of living up.

Therefore, we expect positive demographic growth coupled with growing disposable incomes to support residential demand. However, our outlook on the anticipated KMRC effect occurring this year on the mortgage market is neutral due to government delays in fully rolling it out.

iii. Factors Influencing Residential Supply

The following factors are likely to affect the level of supply going forward:

a. Government Incentives: The affordable housing initiative has gained substantial progress in 2018/2019 period. However, with the initiative lagging behind on its timelines ahead of 2022, we, therefore, expect to see more government incentives geared towards creating an enabling environment for developers to roll out more mass housing projects within the short period remaining, while also improving the land sector’s efficiency, particularly through digitization. The unlocking of prime government-owned land for development by private developers as well as continued infrastructural support should encourage more development activity, while also enabling the delivery of actual affordable homes,
b. High Development Costs: Development costs remain high subject to high land and financing costs. According to Cytonn Markets Review H1'2019, the average land price per acre within Nairobi County is currently at Kshs 220.3 mn, compared to Satellite Town’s average of Kshs 23.7 mn per acre. Additionally, despite continued infrastructural improvements, developers still continue to face challenges in form of insufficient sewer lines, access roads and water supply,
c. Access to Finance: With the interest rates cap law still in effect, we expect developers to continue experiencing barriers to adequate financial access, which is expected to affect housing supply in 2019. We, therefore, expect to see developers opting for alternative sources of finance such as Real Estate Investment Trusts and more partnerships with foreign investment institutions seeking to enter the market, and local pension funds seeking to diversify their investments with their growing portfolio of assets under management.

We expect reduced supply in the high-end and upper mid-end sectors given the existing supply against waning demand with developers shifting focus to differentiated concepts such as mixed-use developments, especially in the upper mid-end markets, as well as niche markets in the lower mid-end and low-end segments, which have the highest uptake, thus potential for better returns.

B. Market Performance in the Residential Sector

To gauge residential performance in 2018/2019, we carried out research in 41 areas within the Nairobi Metropolitan Area (NMA).

In our submarket analysis, we classified the various suburbs in the Nairobi Metropolitan Area into three segments:

- High-End Segment – Consists of prime suburbs in Nairobi, such as Karen, Runda and Kitisuru. Most of these zones have been zones for low rise residential developments, and are characterized by palatial villas and bungalows on half acre parcels,
- Upper Middle-Income Segment – Consists of suburbs such as Kilimani, Lavington, Kileleshwa, Loresho and Ridgeways, among others. The population in these zones are middle class but with higher incomes than the average characterization of the middle class. They are zones for both high rise and low-density houses, and,
- Lower Middle-Income Segment – Consists of suburbs in Nairobi habited by middle class such as Kahawa West, Imara Daima, as well as Satellite Towns such as Ngong, Ruiru, and Juja.

We also analyzed detached units and apartments separately;

- Detached units refer to stand-alone houses such as townhouses, maisonettes and bungalows, and,
- Apartments refer to self-contained housing units occupying part of a building, also called flats.

According to the research, prices in the NMA region appreciated marginally by 0.3% in 2018/2019, which is 2.5% points lower than the 2.8% growth recorded in 2018. The sluggish growth in capital

gains could be attributed to the tough financial environment in Kenya on account of the interest rates capping law, with has led to stringent underwriting practices by lending institutions affecting homebuyers, hence a decline in effective demand. In addition, increased residential stock in some markets, especially high-end and upper mid-end segments, has slowed down the rate of price appreciation as supply surpasses effective demand. Rental yields in 2018/19 declined by 1.1% points, coming in at 4.3%, on average, from 5.4% in 2017/2018. We attribute this to increased supply stock, especially in high-end and upper mid-end markets, leading to investors having to keep rents stable at an average of Kshs 532 per SQM to attract and retain existing clients, while prices have generally been increasing from an average of Kshs 109,000 per SQM in 2017/2018 to approximately Kshs 119,000 per SQM in 2018/2019.

Therefore, on the overall performance, with price appreciation of 0.3% in 2018/19 and rental yields averaging at 4.3%, total returns per annum in the residential market averaged at 4.7%, with the best performing market being Ruaka which posted 8.0%.

(All Values in Kshs Unless Stated Otherwise)

Residential Performance Summary 2018/2019

Segment	Typology	Average Price Per SQM	Average Rent Per SQM	Average Annual Uptake	Average Occupancy	Average Rental Yield	Average Y/Y Price Appreciation	Average Total Returns
High End	Detached	201,275	735	18.5%	83.5%	3.7%	0.1%	3.8%
Upper Mid-End	Detached	142,303	535	21.5%	87.5%	4.1%	0.1%	4.2%
Lower Mid-End	Detached	77,396	335	18.5%	73.3%	3.9%	0.4%	4.3%
Upper Mid-End	Apartments	129,598	720	25.6%	82.7%	4.9%	0.4%	5.3%
Lower Mid-End	Apartments	88,731	472	20.0%	85.9%	4.8%	0.4%	5.3%
Satellite Towns	Apartments	76,676	395	21.4%	79.6%	4.5%	0.6%	5.1%
Residential Market Average		119,330	532	20.9%	82.1%	4.3%	0.3%	4.7%

The residential market has an average total return of 4.7% in 2017/18 with rental yield averaging at 4.3% while price appreciating averaged at 0.3%.

Source: Cytonn Research

Price appreciation declined by 2.5% points y/y to 0.3% p.a., from 2.8% in 2017/2018, while rental yields declined by 1.1% points to 4.3% from 5.4% in 2017/2018. The low performance compared to prior years is due to a challenging financial environment, leading to sluggish growth in prices and uptake. However, innovative investment methods such as off-plan purchases are guaranteed to offer double-digit returns albeit in niche markets. Thus, investors ought to conduct market research to identify niches in the market.

Residential Performance Summary 2018/2019: Y/Y Change

Segment	Average Rental Yield 2018/19	Average Y/Y Price Appreciation 2018/19	Average Total Returns 2018/19	Average Rental Yield 2017/18	Average Y/Y Price Appreciation 2017/18	Average Total Returns 2017/18	Change in Rental Yield	Change in Y/Y Price Appreciation	Change in Total Returns
Detached: High-End	3.7%	0.1%	3.8%	4.7%	3.5%	8.3%	(1.0%)	(3.4%)	(4.5%)
Detached: Upper Mid-End	4.1%	0.1%	4.2%	5.1%	2.4%	7.5%	(1.0%)	(2.3%)	(3.3%)

I. Detached Units Performance

Detached units registered average total returns of 4.1%, 0.6% points lower than the residential market average of 4.7%. This is attributable to slow price growth owing to decline in demand for maisonettes and bungalows, possibly due to the growing need for affordability with apartments costing Kshs 98,335 per SQM compared to detached units at Kshs 140,325 per SQM. This is evidenced by the lower annual uptake of 20.0%, in comparison to apartments with 22.3%.

The high-end market registered average price appreciation of 0.1% and a rental yield of 3.7%, thus average annual returns of 3.8%, 4.5% points lower than 8.3% in 2017/18. The subdued returns are attributable to increased supply amidst stagnated demand.

Upper mid-end markets registered average rental yields of 4.1% and a price appreciation of 0.1%, thus average annual returns of 4.2%, and also registered the highest average annual uptake in the detached category at 26.5%, owing to demand from the growing middle class as evidenced by relatively high annual uptake in markets like Lavington and Runda Mumwe at 27.3% and 26.4%, respectively.

Lower mid-end satellite areas posted the highest average price appreciation for detached units at 0.4%, compared to the detached market average of 0.2%, due to increased demand for units in these areas boosted by infrastructural improvements, and affordability in comparison to the upper markets.

Loresho and Ruiru markets registered the highest returns in the detached unit's market with 6.2% and 6.0%, respectively. Loresho appeal to investors is attributable to its proximity to neighborhoods such as Kitisuru, thus, attracting the middle-income class clientele seeking exclusivity but in relatively affordable areas. The area is also well-connected with the newly finished Westlands Link Road boosting accessibility hence increased prices. Ruiru's performance is on account of the presence of good infrastructure such as the Eastern bypass, Thika Superhighway for Ruiru, and upcoming master-planned cities, such as Tatu City and Northlands driving speculative demand due to expected developments in terms of infrastructure and social amenities.

Juja and Rosslyn registered the lowest returns with 0.7% and 1.7%, respectively. Rosslyn continues to face challenges in form of competition from other surrounding neighborhoods such as Gigiri, Runda, and Muthaiga in addition to the market's inadequacy in terms of what it offers investors while Juja's decline is attributable to declined effective demand in the area as a result of competition from other satellite towns, namely Ruiru, and its increased densification due to demand by the relatively high student population in the area.

The performance of detached units in Nairobi Metropolitan Area is as summarized below;

(All values in Kshs Unless Stated Otherwise)

Nairobi Metropolitan Area Detached Units Performance 2018/2019

Area	Average Price per SQM	Average Rent per SQM	Average Annual Uptake	Average Occupancy	Average Rental Yield	Average Price Appreciation	Average Total Returns
Runda	234,697	888	17.8%	83.8%	4.0%	1.8%	5.8%
Karen	205,087	659	20.0%	76.6%	3.0%	1.8%	4.8%
Kitisuru	223,310	903	19.4%	83.3%	3.7%	(0.4%)	3.2%
Rosslyn	178,237	757	19.1%	84.3%	4.3%	(2.6%)	1.7%
Lower Kabete	165,043	467	16.3%	89.5%	3.3%	0.0%	3.3%
High–End Average	201,275	735	18.5%	83.5%	3.7%	0.1%	3.8%

II. Apartments Performance

Apartments performed better, registering average capital gains of 0.4%, with average rental yields of 4.8%, thus, average total returns of 5.2%, compared to detached units with 4.2%. Apartments also registered higher uptake and occupancy which averaged at 21.4% and 82.8%, respectively compared to detached units with 20.0% and 81.4%, respectively.

Upper mid-end markets registered the highest annual uptake at 25.6%, on average, attributable to strong investor demand. This is as the upper mid-end market attract high rental income of Kshs 720 per SQM compared to market average at Kshs 532 per SQM, hence registering relatively high average rental yields, which came in at 4.9%, in comparison to the residential market average of 4.3%, with select markets such as Kilimani, Riverside, Imara Daima, and Ruaka offering yields of up to 5.6%.

Lower mid-end suburbs recorded average rental yields of 4.8%, price appreciation of 0.4%, thus, total returns averaging at 5.3%, and also notably, the highest average occupancy in the residential market at 85.9%, attributable to these areas' appeal to Nairobi's working class due to their proximity to key commercial nodes, amidst growing need for affordable formal housing.

Satellite towns posted the highest average annual price appreciation of 0.6%, with average rental yields of 4.5%, thus, average total annual returns of 5.1%. This is attributable to the infrastructural improvements ongoing in these areas such as roads, sewerage and water improvements, thus, attracting high demand translating to increase in prices as developers try to match the supply to demand.

Ruaka and Langata were the best performing towns with average returns of 8.0% and 6.8%, respectively, driven by the continued demand from young middle and working populations while still offering affordability and ample social amenities. Ruiru and Thika recorded the lowest returns on account of decline in asking prices in the areas, which are more popular for detached units from families seeking to settle down. This has been witnessed through various price offers as developers attempt to attract their target clientele, which has also had the effect of increasing uptake for units in these areas.

(All Values in Kshs Unless Stated Otherwise)

Nairobi Metropolitan Area Apartments Performance 2018/2019

Area	Average Price per SQM	Average Rent per SQM	Average Annual Uptake	Average Occupancy	Average Rental Yield	Average Price Appreciation	Total returns
Riverside	135,813	737	22.9%	76.2%	5.1%	0.9%	5.9%
Loresho	113,122	479	20.9%	95.4%	4.3%	1.4%	5.7%
Kilimani	121,845	852	30.4%	76.8%	5.6%	0.0%	5.6%
Westlands	145,042	665	27.8%	80.4%	5.2%	0.2%	5.4%
Parklands	123,146	744	23.3%	85.7%	5.1%	(0.3%)	4.8%
Kileleshwa	138,619	846	28.1%	81.7%	4.2%	0.0%	4.2%
Upper Mid-End Average	129,598	720	25.6%	82.7%	4.9%	0.4%	5.3%
Lang'ata	97,012	544	15.0%	85.4%	5.5%	1.3%	6.8%
South B/C	99,059	497	20.6%	88.8%	4.8%	0.8%	5.6%
Imara Daima	63,203	354	22.3%	98.9%	5.6%	(0.2%)	5.4%

C. Investment Opportunity

Whereas the overall market performance has declined, there exists an opportunity in some sub-markets. To identify the developer's investment opportunity in the sector and single out the specific suburbs that would be best to invest in, we used the following metrics;

- Annual Uptake- This refers to how fast developments sell on average per annum, the higher/ faster the sales rate, the higher the points allotted,
- Average returns- This is the sum of the rental yield and price appreciation for each suburb. The higher the return the more points allotted,
- Amenities – areas with a regional mall in close proximity among other social amenities scored high with areas that lack a mall scoring low,
- Distance from Main Business Nodes- This is to establish the commute distance for the majority of the working population, where we assumed Nairobi Central Business District as the common node,
- State of infrastructure - Here we looked at bits of infrastructure that affect real estate heavily, that is, roads and sewer systems. For the purpose of the ranking, for detached properties, we used the status of the roads only, while the following factors were used to rank the state of the infrastructure for high rise areas;
  - Good-Access mainly through tarmac Roads and main sewer line,
  - Average- Access mainly through tarmac roads but lack main sewer line,
  - Poor- Access mainly through earth roads and lack main sewer line,

With the above considerations, we allotted the highest weighting to uptake, and average returns at 30.0% and 35.0%, respectively. This is because for the investors these are the most important factors to consider when investing in an area. The lowest weighting was allotted to distance from the main business node and amenities at 5.0%. This is as these factors are catered for in the pricing while for infrastructure (incoming and existing), we allocated 15.0% as it is what attracts both developers and buyers. Thus, the best ranking areas for investment opportunity are as shown below:

InvestmentOpportunity:Top5DetachedUnits

[illegible]	Location
310	Runda Mumwe
320	Ruiru
330	Loresho
340	Karen

Runda

Runda Mumwe and Ruiru present the best investment opportunity for detached units development driven by returns and relatively higher uptake

For apartments, Ruaka and Kilimani emerged the best ranking areas.

Investment Opportunity: Top 5 Apartments

Location	Distance from Main Business Node	Social Amenities	Infrastructure	Annual Uptake	Returns	Availability of Development Land	Total Points	Rank
Ruaka	2.0	3.0	3.0	2.0	3.0	3.0	2.7	1
Kilimani	3.0	3.0	3.0	3.0	2.0	2.0	2.6	2
Westlands	3.0	3.0	3.0	3.0	2.0	1.0	2.6	3
Thindigua	3.0	2.0	2.0	2.0	3.0	2.0	2.4	4
Upper Kabete	3.0	3.0	2.0	3.0	2.0	1.0	2.4	5

Ruaka and Kilimani presents the best opportunity for residential development driven by uptake, good infrastructure and market returns

D. Outlook and Conclusion

For the key metrics that have been used to determine the performance of the sector, two are positive, that is, demand and infrastructure; one is neutral, that is, access to developer and end buyer credit, and a negative on performance with the returns this year being below the government risk-free rate, thus our outlook for the sector is neutral.

Residential Report Outlook

Measure	2018/2019 Experience and Outlook Going Forward	2018 Outlook	2019 Outlook
Demand	·The Housing deficit in the Nairobi Metropolitan Area continues to grow driven by rapid population growth rate at an average of 3.3%, compared to the national average of 2.6%, with 97.1% being lower middle-income and low-end income earners, creating demand for affordable homes ·The number of wealthy Kenyans has been on the rise and is expected to grow by 60.5% by 2022, creating demand for luxury homes ·In terms of delivered stock, Nairobi Metropolitan Area had an estimated supply of 20,771 units in 2018 according to KNBS data, a 19.5% decline from 25,819 units in 2017. For 2019, we anticipate 26,000 units to be delivered, bringing the total number of units available to 1.97 mn. Therefore, with an estimated constant population growth of 3.3%, the projected number of units required in 2019 is 4.0 mn units, and therefore, the deficit in Nairobi Metropolitan Area in 2019 will be approximately 2.1 mn units	Positive	Positive
Credit	·In 2018, private sector credit growth was relatively lower coming in at 2.1% as at April 2018 compared to a 5-year average of 14.0% between 2013 and 2018 ·In 2019, this was still relatively low coming in at 4.9% as at April 2019, ·The introduction of innovative financial credit solutions through the recently launched Kenya Mortgage Refinancing Company, is set to link real estate and capital markets which will create a better credit financing environment for developers and end buyers alike	Neutral	Neutral
Infrastructure	·The government continued to realize most of its infrastructural development plans with works ongoing for key roads including duelling of Waiyaki way and Ngong Road ·Westlands Link Road which connects Waiyaki Way and Limuru Road was completed, a boost for high-end areas such as Loresho, Kitisuru and Lower Kabete as well as areas along Limuru Road such as Ruaka ·More infrastructural improvements are expected especially to pave way for the Bus Rapid Transit system. Notable projects include the incoming Western Bypass, expansion of the Northern Bypass, Kiambu Road and Mombasa Roads as well as the planned sewer and water improvements in areas such as Ruiru and Kitengela	Positive	Positive
Performance	·In 2017/18, average annual returns in the residential sector came in at 8.2%, with a price appreciation of 2.8% and rental yields at 5.4%, with the best-performing markets have returns of up to 13.9% ·In 20118/2019, performance continued to slow down with the average change in price across the sector coming in at 0.3% and rental yields at 4.3%, thus average annual returns at 4.7%. However, the best performing market recorded returns of 8.0% ·However, we expect investors to scale back on new developments in a bid to get rid of existing stock especially in oversupplied markets, which will boost prices up ·For investors, off-plan investments in niche markets will give better returns, and therefore, trend analysis and proper research is required to identify these markets	Neutral	Negative

Conclusion

Despite the subdued performance, housing deficit continues to be a major concern in Kenya, with Nairobi Metropolitan Area accounting for a substantial amount of the deficit owing to rapid population growth and urbanization. Therefore, we expect the residential sector to continue growing, with growth in prices to pick up on the back of improved mortgage market following the launch of Kenya Mortgage Refinancing Company, whereas developers will shift focus to the lower end market segment, in a bid to tap into government's initiatives amidst a tough financial environment, and differentiated concepts in the upscale markets especially as mixed-use developments in an attempt to diversify their returns from the real estate sector.

For the full report, download here.

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