Cytonn INVESTMENTS

Capital Markets as a Catalyst for Economic Growth, & Cytonn Weekly #36/2019

Real Estate

1. **Industry Reports**

During the week, Knight Frank released Kenya's H1'2019 Market Update, highlighting a slow-down in the real estate sector. The key take-outs were as follows:

- In the office sector, prime rents remained unchanged in H1'2019 at Kshs 135 per SQFT per month, while uptake of Grade A and B office space declined by 8.0%, attributed to a continued oversupply of office space in some locations and the current economic slowdown. Serviced offices recorded increased demand from Small & Medium Enterprise's, maturing start-ups and multinational firms, attributed to their flexible lease agreements, lower operating costs and location in prime areas,
- In the retail sector, rents came in at an average of Kshs 489 (US$ 4.8) per SQFT in H1'2019, 5.9% lower than Kshs 520 (US$ 5.1) per SQFT recorded in FY'2018, while the service charge ranged between Kshs 45 and Kshs 60 per SQFT per month. The decline in rental rates was attributed to the current economic credit crunch resulting in reduced consumer spending, in addition to the oversupply of retail space, which has pressured landlords to provide concessions to attract or retain tenants. Occupancy levels for established malls averaged at 90% while new retail spaces ranged between 45% and 55%, indicating a slow uptake of new retail space, and,
- In the residential sector, prime residential prices decreased by 1.8% in H1'2019 compared to a 0.4% decline in H1'2018, while the rents declined by 1.7% in H1'2019 compared to a 0.3% decline within the same period in 2018. The decline in residential prices and rents was attributed to the current credit crunch and the oversupply of residential developments in high end segment of the market.

The above report is in line with Cytonn H1'2019 Markets Review, which highlighted that the real estate sector recorded subdued performance in H1'2019, with the office and retail sector recording a decline in average yields by 0.3% points and 0.8% points to 7.8% and 8.2% in H1'2019 from 8.1% and 9.0% in FY'2018, respectively. The residential sector recorded a marginal 0.2% points appreciation in average yields to 4.9% in H1'2019, from 4.7% in FY'2018. The overall performance of the sector was mainly constrained by (i) oversupply in selected sectors such as the commercial office and retail sectors, with a surplus of 5.2 mn SQFT and 2.0 mn SQFT, respectively, as at 2018, and (ii) inaccessibility of financing by both developers and off-takers.

However, the market still has pockets of value in differentiated concepts such as i) serviced offices, which have continued to record relatively high rental yields of 13.4% p.a, and ii) serviced apartments, with average rental yields of 7.4% and relatively high occupancy rates of above 80%. 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 and continued government support through the affordable housing initiative.

2. **Retail Sector**

Quick Mart Limited and Tumaini Self Service Limited announced the commencement of a merger and business integration of the two companies. This follows the approval by industry regulator Competition Authority of Kenya (CAK), of a majority stake acquisition by Sokoni Retail Kenya, a special purpose vehicle controlled by private equity firm Adenia Partners, in local retailer Quick Mart. Sokoni Retail Kenya is also a majority shareholding in Tumaini Self Service Limited. The merger of Quick Mart and Tumaini Self Service operations into a single retail operation, under the brand name Quick Mart, is set to give the investor;

i. A stronger footing in Kenya's competitive formal retail space, ranking as the 3rd largest retailer by the number of branches. Currently, Quick Mart Supermarket and Tumaini have 11 and 13 branches, respectively,
ii. Strengthen operational efficiencies in line with international retail standards, in order to gain a competitive edge among the incoming international retailers, and,
iii. Expand their market share by tapping into the growing population and middle class.

We therefore are of the view that the retailers' merger is a good move that will enhance continued operation of the retailers. This would therefore be an option for struggling retailers to consider merging rather than closing down their branches.

Nevertheless, amid the growing retail sector in Kenya, marked by the expansion of both local and international retailers such as South African retailer, Game and French retailer, Carrefour supermarket, some retailers have been downsizing as a result of;

i. Financial constraints led by poor governance and oversight,
ii. The growing competition in the sector from both international brands and the informal sector, and,
iii. Market saturation making selection of catchment areas to launch new stores a challenge.

Owing to the above, during the week, South African retailer, Choppies Supermarkets, announced plans to exit the Kenyan market, where it currently has 12 stores. The retailer, which marked its debut in Kenya's market by acquiring Ukwala Stores for Kshs 1.0 bn in 2016, has been struggling to grow its market share mainly due to financial difficulties.

In terms of performance, Kenya's retail real estate sector has been on a decline with rental yields and average occupancy of 8.2% and 75.6%, respectively according to the Cytonn H1'2019 Report, in comparison to 9.7% and 82.7% in H1'2018, partly attributable to the growing supply of retail space.

3. **Hospitality Sector**

During the week, Eighteen Seventy Lower Kabete Limited, a real estate developer, announced plans to develop a 27-floor hotel and residence complex in Westlands, Nairobi. The development will be located at the junction between Peponi Road, Karuna Road and Lower Kabete Road. The development will comprise of 399 apartments: 46 studio apartments, 86 1-bedroom, 243 2-bedroom and 24 duplexes of 3-bedroom apartments. The amenities and facilities will include; a lounge, meeting rooms and a restaurant which will be situated on the top floors, in addition to a gym, sauna, a swimming pool and 251 parking bays. This is an indication of the continued increase in activities in the hospitality sector, with existing players looking to expand and refurbish their facilities to remain competitive in the market in the wake of continued entry of global brands, leverage from the growing demand of hospitality services due to the growing international arrivals and as well as land

use maximization following the relaxation of zoning regulations.

In addition, serviced apartments have continued to gain popularity in the Kenyan hospitality market, as an alternative to hotel accommodation, especially for guests looking for an extended stay, as they provide a homely feeling especially for guests who travel as families. According to Cytonn Research, Westlands is one of the best performing areas with an average rental yield of 10.6%, compared to the market average at 7.4%, attributed to presence of recreational amenities such as high-end shopping facilities, good infrastructure, which enhances their accessibility and interconnectivity with other nodes such as Upperhill, Gigiri, and CBD, and the availability of high quality apartments. This has thus led to the continued focus by investors evidenced by entry of other developments such as CySuites by Cytonn Investments, a 40-unit project in Westlands, Movenpick Hotel and Residences opened in 2018, and the 38-unit Gem Suites development also situated in Westlands, off Riverside Lane.

Below is a summary of the performance per node;

All values in Kshs unless stated otherwise

Nairobi Metropolitan Area Serviced Apartments Performance 2018

	Sizes (SQM)				Monthly Rates 2018 (Kshs)						
Node	**Studio**	**1 bed**	**2 bed**	**3 bed**	**Studio**	**1 Bed**	**2 Bed**	**3 Bed**	**Occupancy 2018**	**Monthly Charge per SM(Kshs)**	**Rental Yield**
Kilimani	39	69	110	149	197,850	266,915	319,304	361,421	86%	3,567	10.9%
Westlands& Parklands	33	85	115	177	282,938	260,928	300,492	340,000	76%	4,044	10.6%
Limuru Road		51	137		107,438	193,621			84%	3,685	9.7%
Kileleshwa& Lavington	38	70	134		100,000	231,000	285,750	337,000	83%	2,686	7.8%
Nairobi CBD	51	90	115	137	120,000	199,500	294,917	320,000	74%	2,374	5.7%
Upperhill		75	110	156		274,680	300,492	310,000	60%	2,580	5.3%
Msa Road	34	90	107	151	114,912	120,000	201,096	258,552	85%	1,642	5.0%
Thika Road		70	100	144		100,646	128,375		90%	1,361	4.4%
Average	**39**	**75**	**116**	**152**	**153,856**	**205,911**	**261,489**	**321,162**	**80%**	**2,742**	**7.4%**

• Serviced apartments recorded an 80.0% occupancy rate in 2018, compared to 72.0% recorded in 2017, attributed to the improved security and political stability,
• Kilimani and Westlands were the best performing nodes recording high occupancy rates of 86.0% and 76.0%, and a rental yield of above 10.0%, attributed to the easy access from Jomo Kenyatta International Airport (JKIA), proximity to business nodes such as Upperhill, and the good transport network thus ease of accessibility

Source: Cytonn Research

We expect the serviced apartments concept to continue gaining popularity in Kenya, supported by (i) relatively high returns to investors, (ii) growing middle class creating demand for different luxury hospitality products, and (iii) increased number of long-stay international tourists and expatriates, and therefore, recording relatively good performance going forward. For investors seeking to venture into the theme, the investment opportunity lies in Kilimani, Westlands and Parklands, which are the best performing areas with average rental yields of above 10.0% and occupancy rates of above 75.0%.

Other highlights during the week:

i. Realtor Enkavilla Properties is set to put up a Kshs 1.7 billion gated estate in Isinya to host 290 households, on a 70- acre parcel of land. The develop-and-sell units will comprise of 30 4-bedroom units, 15 bungalows and 25 maisonettes with 3-bedrooms each, and a privately-owned luxury

resort. According to online sources, the residential units are set for completion within the next 24 months. This is an indication of the developers continued focus on satellite towns such as Isinya, where land is available both in bulk and at relatively affordable prices.

We expect the real estate sector to continue recording increased activities, mainly in the differentiated concepts such as serviced apartments, serviced offices, and the restructuring by retailers with the aim of growing their market share.
