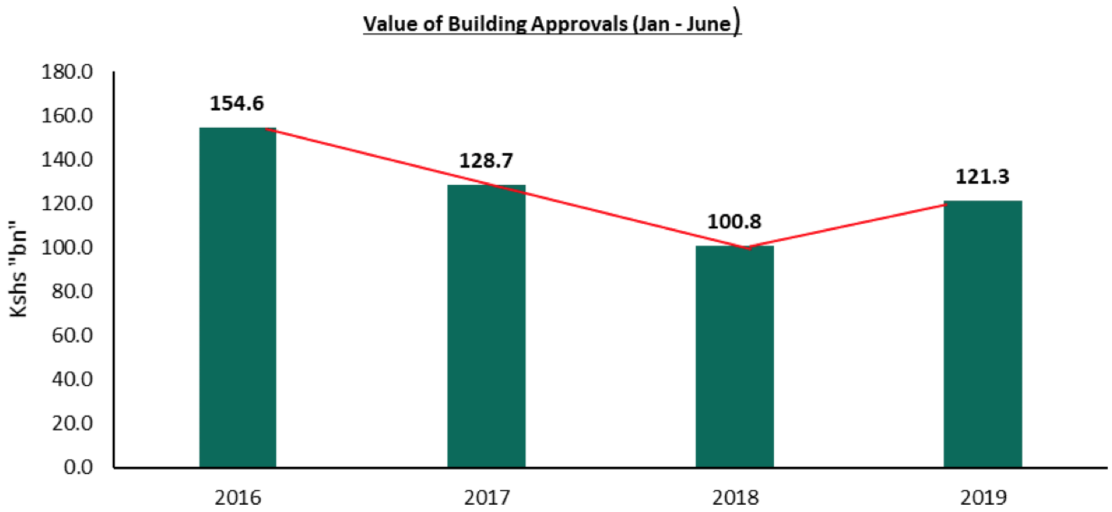
Market Post Interest Rate Cap & Cytonn Weekly #50/2019

Real Estate

I. **Industrial Reports**

During the week, Kenya National Bureau of Statistics released the Leading Economic Indicators December 2019 Report. As per the report, the value of buildings approved during the first half of the year came in at Kshs 121.3 bn, a 20.3% increase from Kshs 100.8 bn during the same period in 2018, bucking the trend that has been witnessed over the past three years, as shown below:



Source: KNBS

The increase is largely attributable to the launching of mass affordable housing projects in the past two year. However, according to the report, consumption of cement dropped to 492,695 metric tons in August 2019 from 500,601 metric tons in July 2019, indicating a slowdown in real construction activity. This is attributable to;

a. Reduced developer activity in sectors such as office and retail, which according to Cytonn Research, registered oversupplies of 5.2 mn and 2.0 mn SQFT, respectively, as of Q3’2019,
b. Government delays in processing building approval permits especially in 2019, and
c. Insufficient access to developer funding owing to a tough financial environment that has persisted for the past two years owing to the recently repealed interest rate capping law.

However, in our view with the repeal of the interest rate cap and the continued launch of mass affordable housing projects, we expect increased construction activities, and therefore, cement consumption, to pick up in 2020.

II. **Residential Sector**

Following the signing of a Memorandum of Understanding with the United Nations Office for Project

Services and the Kenya National Government for construction of a 100,000 affordable housing units, H.E President Kenyatta, during the week, launched construction of the project's first phase, dubbed 'Habitat Heights', which will see 8,888 affordable housing units delivered in Lukenya, Mavoko sub-county within the next three to five years. The Habitat Housing Society is set to provide offtake guarantee to the developers of the project, Singapore-based consortium Afra Holdings, via their subsidiary Singapura Developers. The project will sit on 78-acres of land and will comprise of 576 studios of 22 and 28 SQM; 972 one-bedrooms of 44 SQM; 2,912 two-bedrooms of 75 SQM; and 4,368 three-bedroom units of 95 SQM.

In terms of pricing, the units have price points of Kshs 3.5 mn, 4.8 mn, and 5.8 mn, for one, two and three-bedroom units, respectively, which translates to an average price per SQM of Kshs 68,199, which is 3.1% higher than the average price per SQM for Athi River at Kshs 66,156; this indicates that affordable housing does not have to be outside the market parameters.

All Values in Kshs Unless Stated Otherwise)

	Government Framework			Habitat Heights				
Typology	**Unit Plinth Area (SQM)**	**Selling Price**	**Price Per SQM**	**Unit Plinth Area (SQM)**	**Selling Price**	**Price Per SQM**	**Unit Size Difference**	**Price per SQM Difference**
1	30	1.0mn	33,333	44	3.5mn	79,545	46.7%	138.6%
2	40	2.0mn	50,000	75	4.8mn	64,000	87.5%	28.0%
3	60	3.0mn	50,000	95	5.8mn	61,053	58.3%	22.1%
Average	43	2.0mn	44,444	71	4.7mn	68,199	64.2%	62.9%

- ***Habitat Heights unit sizes are on average 64.2% larger than the government affordable housing units while the average price per SQM is on average 62.9% higher than the proposed government prices. This indicates that affordable housing projects for private developers do not have to be outside market parameters***

Satellite Towns such as Mavoko, Athi River, and Ruiru continue to attract mass housing projects due to availability of land for development in bulk, and at relatively affordable prices. Additionally, in a bid to reduce the cost of construction inputs, and commensurately reduce the cost for homebuyers, the government has continued to offer incentives to affordable housing developers such as provision of bulk infrastructure, national land at no cost, waiving of National Environment Management Authority (NEMA) and National Construction Authority fees; and as per the Head of State, there's also a proposal for waiving development fees at the county level. We therefore, expect to see more projects undertaken in 2020 as the government rushes to fulfil its objective of 500,000 units by 2022.

In a bid to ensure the full implementation of the National Housing Development Fund (NHDF), the President also, during the week, officially directed The National Treasury to revise the legal requirement for mandatory contributions of the National Housing Development Fund Levy and make it voluntary, with immediate effect. The Fund, which was launched in 2017 was aimed at providing offtake financing for developers while helping homebuyers save towards homeownership. So far, according to Housing Principal Secretary Charles Hinga, only 14,800 Kenyans have made voluntary contributions with the main challenge being attributable to a tough financial environment that has discouraged household savings. We expect the directive to come as a relief for the average Kenyans who were heavily opposed to the housing levy due to relatively huge tax burdens pushing the cost of living higher. We are supportive of the new direction to do away with the mandatory contribution for two reasons: first, it would have likely just been another pot of money susceptible to massive corruption and tenderprenuers, and second, given the significant tax incentives and enabling legislation that the government has put in place so far to enhance affordability, the affordable housing agenda is now very realizable even at market rates. Some of the incentives include:

i. Stamp duty exemption for first time home buyers,
ii. Waiving for NCA and NEMA fees,
iii. Exemption of goods supplied for affordable housing from Value Added Tax (VAT),
iv. Reduction of Import Declaration Fee, IDF, on inputs for the construction of houses under the affordable housing scheme from 2.0% to 1.5%,

v. Exemption of companies implementing projects under the affordable housing scheme from the application of thin capitalization rules,
vi. Allowing of Unit Trust Funds under the CMA Act to qualify as Home Ownership Saving Plan, and,
vii. The incorporation of the Kenya Mortgage Refinance Company (KMRC).

The sum total of the legislations and incentives is that the government has made the affordable housing achievable.

However there remains three key stumbling blocks to the President's affordable housing agenda, which needs to be expeditiously addressed for the private sector to start a mass implementation of affordable housing projects:

i. KMRC needs to be operationalized; KMRC would allow long tenor mortgages, and improve affordability by an estimated 14%, as discussed in our topical KMRC Update . It is not clear when KMRC will start its writing business. A certain date would enable developers to plan,
ii. Operationalization of the many legislations passed so that affordable housing developers can begin to access the incentives. The government has done a very good job passing enabling legislation, however the respective agencies need to operationalize the legislations. For example, the legislation to reduce corporate tax to 15% from 30% for those building at least 100 affordable housing units was passed in 2017, however, up to today it is not clear how this tax incentive can be accessed. There are no application forms and the application criteria remains unknown, so it remains an incentive on paper, but can't be accessed by developers, and,
iii. Pass regulations that open up capital markets funding of real estate through Collective Investment Schemes regulated by the Capital Markets Authority. Specifically, (a) pass legislation allowing for specialized schemes focussed on real estate, and (b) allow for non-banks to be Trustees just as in the case with Pensions schemes. The current regulation, that a scheme trustee must be a bank, restricts the market, not to mention that it is discriminatory and unconstitutional.

III. **Retail Sector**

During the week, cash-strapped retailer, Nakumatt, closed its Lavington and Ngong Road branches, leaving it with just two branches, that is, High Ridge in Parklands and Nakuru Westside Mall. This comes barely two weeks after it shut down its Kisumu Megacity Mall branch. The retailer's woes are mainly due to unique challenges in strategy and governance as well as financial constraints, because we continue to see other brands like Quickmart, Naivas, and Carrefour continue to open branches. Such closures have also allowed international retailers to expand their local footprint as they take up vacated spaces, thus, cushioning developer returns in the sector. For instance, Carrefour has a branch in all arterial roads in Nairobi occupying spaces previously vacated by Nakumatt. We, however, expect the closures will manifest through (i) decline in rental yields due to the increased vacancy rates in affected nodes, such as Ngong Road and (ii) further expansion by international retailers such as Shoprite and Game as they move in to fill the vacuum left by Nakumatt. In terms of performance, according to the Cytonn Retail Report 2019, occupancy rates in Nairobi dropped by 4.8% points in 2019 to 75.0% from 79.8% in 2018 consequently leading to 1.0% drop in rental yields to 8.0% from 9.0% in 2018, as shown below attributable to decreased rental rates as developers attempt to reduce the rate of vacancies:

(all values in Kshs unless stated otherwise)

Summary of NMA's Retail Market Performance 2018-2019

Location	Rent Per SQFT 2019	Occupancy Rate 2019	Rental Yield 2019	Rent Per SQFT 2018	Occupancy Rate 2018	Rental Yield 2018	Change in Rents	Change in Occupancy	Change in Rental Yields
Kilimani	170.4	87.2%	**9.9%**	167.1	97.0%	**10.7%**	2.0%	(9.8%)	**(0.9%)**

Summary of NMA's Retail Market Performance 2018-2019

Location	Rent Per SQFT 2019	Occupancy Rate 2019	Rental Yield 2019	Rent Per SQFT 2018	Occupancy Rate 2018	Rental Yield 2018	Change in Rents	Change in Occupancy	Change in Rental Yields
Ngong Road	179.4	83.1%	**9.2%**	175.4	88.8%	**9.7%**	2.3%	(5.7%)	**(0.5%)**
Westlands	203.6	84.6%	**9.2%**	219.2	88.2%	**12.2%**	(7.1%)	(3.6%)	**(3.0%)**
Karen	207.9	77.0%	**9.1%**	224.9	88.8%	**11.0%**	(7.6%)	(11.8%)	**(1.9%)**
Eastlands	145.0	74.5%	**7.5%**	153.3	64.8%	**6.8%**	(5.4%)	9.7%	**0.7%**
Thika road	165.4	73.5%	**7.5%**	177.3	75.5%	**8.3%**	(6.7%)	(2.0%)	**(0.8%)**
Kiambu Road	166.0	61.7%	**6.8%**	182.8	69.5%	**8.1%**	(9.2%)	(7.8%)	**(1.4%)**
Mombasa Road	148.1	64.0%	**6.3%**	161.5	72.4%	**7.9%**	(8.3%)	(8.4%)	**(1.6%)**
Satellite Towns	131.4	70.3%	**6.0%**	142.1	73.7%	**6.7%**	(7.5%)	(3.3%)	**(0.7%)**
Average	**168.6**	**75.1%**	**8.0%**	**178.2**	**79.8%**	**9.0%**	**(5.4%)**	**(4.7%)**	**(1.0%)**

Source: Cytonn Research 2019

IV. **Hospitality Sector**

Air transport is a crucial development driver bringing both economic benefits, and also has major rippling effects on trade and tourism sectors. More so, the availability of efficient airports in a region is identified as one of the key factors influencing investor's decision on whether or not to invest in the region since air transport enables faster commute. To this end, the Mombasa tourism sector is set to receive a major boost after the Kenya Airports Authority revealed plans of revamping various airstrips in the region including the Ukunda and improving parking aprons at the Malindi airport at an estimated cost of Kshs 1.5 bn within the next three years. The expansion of Ukunda Airstrip, in particular, is aimed at enabling the accommodation of larger aircraft as local airlines expand to new international routes following demand for air travel, thus opening up Kwale County's tourism sector and the overall South Coast region whose tourism sector has been hindered by the inefficient infrastructure as tourists have to use the Likoni Ferry crossing channel. We expect this will pave way for direct flights, especially from European nations and Eastern countries who have shown great interest in Kenyan travel evidenced by the introduction of direct flights from countries such as Qatar and United States.

To boost the tourism sector further, the government revealed plans of setting up a tourism centre at the Kenyatta University in partnership with the Jamaican Government. The centre, dubbed "Global Tourism Resilience and Crisis Management Centre", is set to help address challenges that affect the tourism sector, such as terrorism, and political tensions. We expect that the centre will play a key role in positioning Kenya as a leading hospitality hub globally, shielding the tourism sector's performance from the negative effects of travel bans such as those issued in the past by Western nations due to insecurity hiccups thus, affecting the number of international visitor arrivals and consequently affecting the hospitality sector's performance.

Our short-term outlook for the real estate sector remains neutral with a bias to positive. Investment opportunities are in (i) affordable housing in Satellite Towns such as Athi River, Ruiru, and Ruaka, (ii) serviced apartments in nodes such as Westlands and Kilimani, (iii) serviced offices in areas such as Karen and Limuru Road, and (iv) mixed-use developments in nodes such as Kilimani and Karen, as they continue to register above market returns to investors. We expect the sector to continue being boosted by continued

improvements in infrastructure, increase in foreign direct investments, and the anticipated improvement of the credit environment following the rate cap law repeal.
