Cytonn 2020 Markets Outlook

Real Estate Outlook

In 2019, the real estate sector grew by 4.8% on average from Q1’2019 to Q3’2019, 0.3% points higher than the growth rate recorded over the same period in 2018, according to Kenya National Bureau of Statistics (KNBS) Quarterly Gross Domestic Product Report Q3'2019. The growth was supported by:

i. Continued National Government support for the affordable housing initiative,
ii. Increased entry of multinational corporations and retailers into the country,
iii. Infrastructural improvements, boosting Nairobi’s positioning as a regional hub,
iv. Rapid population growth, creating demand for more properties, especially housing, and,
v. Improving macroeconomic environment, with the country’s GDP growing by 6.3% in 2018, 1.4% points higher than the 4.9% recorded in 2017 and is expected to come in at 5.6% in 2019 according to Cytonn Research.

In terms of performance, commercial office, retail, residential, mixed-use developments and serviced apartments sectors registered average rental yields of 7.5%, 7.8%, 5.0%, 7.3%, and 7.6%, respectively, resulting to an average rental yield for the real estate market of 7.0%, 0.4% points lower compared to 7.4% recorded in 2018. Therefore, with a capital appreciation for existing properties at 2.0%, average total returns came in at 9.0%, 2.2% points decline from 11.2% recorded in 2018. For a detailed review of 2019 performance, see Cytonn Annual Real Estate Markets Review Note 2019.

In 2020, we expect the **key drivers** of real estate to be as follows:

i. **Improving Macroeconomic Environment -** The country’s GDP grew by 6.3% in 2018, 1.4% points higher than the 4.9% recorded in 2017 and is expected to come in at 5.6% and 5.7% in 2019 and 2020, respectively, according to Cytonn Research. We expect that the improvement will enhance the growth of business and thus increased real estate activities,
ii. **Attractive Demographic Profile** – Demographic trends such as (i) rapid urbanization, currently at 4.3% p.a. in Kenya, against global and Sub-Saharan averages of 2.0% and 4.1%, respectively, (ii) an expanding middle class evidenced by growth in net disposable income, which increased to Kshs 7.1 tn in 2017 from Kshs 6.6 tn in 2016, and (iii) rapid population growth rates currently at 2.2%, 1.3% points higher than global averages of 0.9%, will continue to support demand in the real estate sector, and,
iii. **Sustained Infrastructural Development** – The government increased the 2019/2020 budget allocation towards infrastructural development to Kshs 435.1 bn, 3.9% higher than 418.8 bn allocated for FY 2018/19, which shows the government’s efforts aimed at transforming the country to middle-income status by 2030 through infrastructural upgrades, which we expect will continue opening up new areas for real estate development and boosting performance in upcoming markets, especially satellite towns in Kenya.

Despite the above drivers, the sector is expected to be constrained by the following factors in 2020;

i. **Delay in Processing of Construction Permits -** Continued delays in the processing of

construction permits by some Kenyan County Governments, namely, Nairobi, Kisumu, Kiambu, and Mombasa, was a major setback for private developers in 2019 as it resulted in prolonged project implementation timelines. Given that the issue is yet to be resolved, we expect this to continue crippling the sector in 2020,

ii. **Oversupply in Select Sectors** - The real estate sector has witnessed increased space supply over the last 5-years;
    a. Increased supply in the middle and high-end residential sector (houses with prices above Kshs. 119,535 per SQM) with a decreasing effective demand, hence recording 3.4% points decline in annual uptake from 22.8% in 2018 to 19.4% in 2019,
    b. The commercial office sector has an oversupply of 5.2 mn SQFT and this is expected to grow to 5.6 mn SQFT in 2020, with completion of buildings such as Kenya Institute of Supplies Management (KISM) headquarters along Ngong Road and Parliament Tower in the CBD, and,
    c. The retail sector, which has an existing oversupply of 2.8 mn SQFT.

iii. **Inaccessibility and Unaffordability of Off-take financing** - Access to mortgages in Kenya remains low mainly due to; (i) low-income levels that cannot service a mortgage, (ii) relatively high property prices, (iii) high interest rates and deposit requirements which lock out many borrowers, (iv) exclusion of the informal sector due to insufficient credit risk information, and (v) lack of capital markets funding towards real estate purchases for end buyers. According to Central Bank of Kenya, there were only 26,504 active mortgage accounts in Kenya as at December 2018 against a total adult population of approximately 23 mn persons, leading to low real estate uptake,

iv. **Ineffectiveness of Public-Private Partnerships (PPPs) for Housing Development** - The government has previously enlisted the help of the private sector for financing and development of affordable housing. This has however not achieved the optimal intended objective this far as a result of; (i) regulatory hindrances such as lack of a mechanism to transfer public land to a Special Purpose Vehicle (SPV) to facilitate access to private capital through the use of the land as security, (ii) lack of clarity on returns and revenue-sharing, (iii) the extended time-frame of PPPs while private developers prefer to exit projects within 3-5 years, and (iv) bureaucracy and slow approval processes,

v. **Despite being successfully launched in 2019, we expect the KMRC to face challenges such;** (i) difficulty in raising funds through issuing of bonds, due to competition from government instruments such as treasury bills and government stocks, (ii) prolonged due diligence processes due to bureaucracy in departments offering critical services such as registration of properties, (iii) lack of access to long term funding, and (iv) a high cost of debt as the investors of the mortgage-backed bonds are likely to demand a relatively high rental yield of approximately 13.5%%, assuming a 1.0%-point margin above the minimum of the risk-free rate for a 15-year bond, which currently stands at 12.5%, yet KMRC’s target is providing mortgages at 9.0% interest. For more details, see our KMRC Topical,

vi. **The unavailability of proper guidelines on the way forward for the newly approved institutions that can hold Home Ownership Savings Plan (HOSP) deposits.** These include; (i) the general framework for business principles and general contract terms with respect to institutions that offer HOSPs, (ii) rules on permissible business activities by the Fund Managers, (iii) approved methods of investing the savings whether in the stock market or government securities, and (iv) guidelines on granting of loans after the ten years have elapsed and the appropriate loan-to-value ratio. For more details, see HOSP Update Topical, and

vii. **Restrictive Capital Markets Structure**: The current capital markets structure is restrictive for market players looking to raise capital and deploying it towards real estate. The primary reason for the same is that Kenyan businesses currently face challenges raising capital due to dominance by the banking sector, and a framework that favors banking products. Some of the challenges include:
    a. Conflicts of interest as only banks are currently licensees to be Trustees of Collective

Investment Schemes (CIS's) in Kenya, and this can lead to frustration of market players,

b. There are players in the banking sector that are firmly in control of the capital markets. Similar to the way the banking sector has undergone reforms and in recent times been liberalized, there need to be similar reforms in the capital markets,
c. A lot of capital raised towards real estate comes in the form of private offers. However, there is still not a lot of clarity on private offers and private equity for raising capital towards real estate, which needs to be provided, as not every offer needs to be regulated. This will ultimately lead to more private sector players raising and deploying capital to real estate, and,
d. In order to spur deployment of capital towards growing home ownership, the Finance Bill of 2019 had a number of key measures. One of which was Inclusion of Unit Trust Fund Managers as Registered Home Ownership Savings Plan in the Finance Bill 2019. However, unless operationalized and specialized funds approved by CMA, there will be no benefit towards the Affordable Housing Big 4 Agenda. The effective date was January 1, 2020 and there has been no movement at all.

In 2020, some of the key factors expected to shape the real estate sector include;

i. **The Affordable Housing Initiative -** The Kenyan Government's affordable housing initiative focused on delivering 500,000 units by end of 2022, is expected to push developers' effort towards provision of more housing for the lower middle- and low-income earners' segment. In support of the initiative, several tax incentives through the Financial Act of 2019, which include:

For developers:

a. A reduction in the Import Declaration Fee (IDF) on inputs for the construction of houses under the affordable housing scheme approved by the CS Finance from 2.0% to 1.5%,
b. Exemption of companies implementing projects under the affordable housing scheme from the application of thin capitalization rules, and,
c. Exemption of goods supplied for the direct and exclusive use houses under the affordable housing scheme approved by the Cabinet Secretary (CS) for Finance from Value Added Tax (VAT).

For home buyers:

a. An exemption of stamp duty for the transfer of a house constructed under the affordable housing scheme,
b. Exemption from income tax of withdrawals from the NHDF to purchase a house by a first-time home owner, and,
c. Exemption of the National Housing Development Fund from income Tax.

With the above tax and policy reforms, we expect more potential homeowners to join the affordable housing program in 2020, given the significantly reduced financial burden in the strive towards home ownership, and developers and other private sector players taking up affordable housing projects as they are bound to maximize on the reduced costs.

In addition, the government allocated Kshs 10.5 bn of the Kenya National Budget 2019/20 in support of the initiative.

ii. **Improved Mortgage Market** – Following the National Treasury's launch of the Kenya Mortgage Refinancing Company (KMRC) in 2019 and its successful mobilization of capital, we expect the institution to become fully operational in 2020, stimulating the mortgage market by enabling lenders to offer long-term mortgages. In addition, we expect the recent interest rate cap repealing will result in borrowers being able to access housing finance as banks increase credit advancement to the private sector,
iii. **Devolution -** Devolution has led to increased population at County Government headquarters and neighboring towns through the relocation of County Government officials and businesses creating

demand for commercial office and retail spaces as well as residential units. In addition, counties were allocated Kshs 371.6 bn in the 2019/2020, and we expect this to support infrastructural development,

iv. **Government Partnerships –** In 2020, the government is expected to enter into various partnerships such as Public-Private Partnerships (PPPs), County Government & National Government partnerships and government & government partnerships, which we expect will support development and financing for the real estate sector, especially affordable housing and infrastructure**.**

Some of the challenges likely to face the sector include;

i. **Ineffectiveness of Public-Private Partnerships (PPPs) for Housing Development** - The government has previously enlisted the help of the private sector for financing and development of affordable housing. This has however not achieved the optimal intended objective this far as a result of; (i) regulatory hindrances such as lack of a mechanism to transfer public land to a Special Purpose Vehicle (SPV) to facilitate access to private capital through the use of the land as security, (ii) lack of clarity on returns and revenue-sharing, (iii) the extended time-frame of PPPs while private developers prefer to exit projects within 3-5 years, and (iv) bureaucracy and slow approval processes,

ii. **Despite being successfully launched in 2019, we expect the KMRC to face challenges such;** (i) difficulty in raising funds through issuing of bonds, due to competition from government instruments such as treasury bills and government stocks, (ii) prolonged due diligence processes due to bureaucracy in departments offering critical services such as registration of properties, (iii) lack of access to long term funding, and (iv) a high cost of debt as the investors of the mortgage-backed bonds are likely to demand a relatively high rental yield of approximately 13.5%%, assuming a 1.0%-point margin above the minimum of the risk-free rate for a 15-year bond, which currently stands at 12.5%, yet KMRC's target is providing mortgages at 9.0% interest. For more details, see our KMRC Topical,

iii. **The unavailability of proper guidelines on the way forward for the newly approved institutions that can hold Home Ownership Savings Plan (HOSP) deposits.** These include; (i) the general framework for business principles and general contract terms with respect to institutions that offer HOSPs, (ii) rules on permissible business activities by the Fund Managers, (iii) approved methods of investing the savings whether in the stock market or government securities, and (iv) guidelines on granting of loans after the ten years have elapsed and the appropriate loan-to-value ratio. For more details, see HOSP Update Topical.

The table below summarizes our outlook on the various real estate themes and the possible impact on the business environment in 2020***:***

Real Estate Thematic Performance Review and Outlook

Thematic Performance Review and Outlook

Theme	2019 Performance	2020 Outlook	Effect
Residential	• The residential market recorded a 3.4%-point drop in annual uptake, as more homebuyers opted for rental units amid a tough economic environment • However, average occupancy rates increased by 4.7% points resulting in a 0.3% points increase in average rental yields • Overall, apartments performed better with average total returns to investors of 6.8% compared to detached units with 5.3% • Apartments continued to be in high demand evidenced by average annual uptake and occupancy rates of 20.2% and 88.7%, respectively, in comparison to detached units with 18.7% and 82.6%, respectively	• We expect that uptake will remain subdued as the negative effects of a sluggish economy persist into the year. However, renters market will continue to perform reasonably well and thus, occupancy rates will remain stable as development activity in matured markets such as Nairobi's upper mid-end and high-end areas such as Kilimani, Upperhill, Parklands and others, also remains modest amid decline in available land for development • In 2020, we expect lower mid-end markets such as Riruta, Ruaka, Athi River, Runda Mumwe and Ridgeways, to continue attracting buyers and more developers owing to their relative affordability and good infrastructure • The sector will be highly defined by the focus on affordable housing, which we expect will begin to peak this year as the government rushes to deliver its 500,000 units promise in the next two years and the private sector becomes more engaged	**Neutral**
Commercial Office	• The performance of commercial office sector performance softened recording 0.6% points and 3.1% points' y/y decline in average rental yields and occupancy rates, to 7.5% and 80.2% in 2019, from 8.1% and 83.3%, respectively, in 2018 • Most notable openings included Xinhua Tower in Kilimani, Park Medical Centre in Parklands and Garden City Business Park along Thika Road • There's an oversupply in the sector with the Nairobi region having an oversupply of 5.6 mn SQFT in 2019, that is forecasted to increase to 5.8 mn SQFT in 2020	• We forecast a decline of the average rental yield to 7.3% from 7.5% in 2019 as a result of the oversupply with the average occupancy rates expected to decline by 2.0% points from 80.2% to 78.2% • We expect monthly rental charges to stagnate at Kshs. 96 per SQFT per Month, just as the market has been charging over the last three years, as the market absorbs the current vacant stock of 5.6mn SQFT • The investment opportunity is in Grade A offices in zones with low supply and high returns such as Gigiri and in differentiated concepts such as serviced offices recording relatively high rental yields of up to 13.4%	**Negative**
Retail Sector	• The performance of the retail sector softened with rental yields declining by 1.2% points to 7.8% in 2019 from 9.0% due to constrained consumer spending power and an introduction of 0.4 mn SQFT of retail space into the Nairobi Metropolitan Area (NMA) market • Retail spaces introduced in 2019 included The Well in Karen and the expansion of Sarit Centre in Westlands • Occupancy rates declined by 3.1% points, to 80.2% in 2019 from 83.3% in 2018 while rental rates recorded a 4.5% decline to Kshs 96 per SQFT in 2019 from Kshs 101 per SQFT in 2018	• We expect a drop in retail returns by 0.4% points as a result of the retail space oversupply currently at 2.8mn SQFT • We expect occupancy rates to decline by 2.2% points to 73.7% and rents to soften by 2.1% to Kshs 171.9 from Kshs 175.5 in 2019 • We forecast continued expansion efforts by both local and international retailers due to attractive rents and vacant spaces left by troubled retailers such as Nakumatt and Choppies, • The opportunity remains in county headquarters in some markets such as Kiambu and Mt. Kenya that have retail space demand of 0.8mn and 0.2mn SQFT, respectively,	**Neutral**
Hospitality Sector	• In 2019, the hospitality sector registered improvement in performance, evidenced by the 0.2% points increase in the serviced apartments rental yield to 7.6%, from 7.4% recorded in 2018, attributable to increased demand, which triggered an increase in charge rates • The improved performance was supported by a stable political environment and improved security, thus making Nairobi an ideal destination for both business and holiday travelers	• Given the country's improved security, political stability, the continued marketing of Kenya as an experience destination and improved air transport and flight operations we expect the number of international arrivals to grow by an annual appreciation of 6.7% to approximately 2.3 mn in 2020, resulting in a greater demand for hospitality services • We therefore expect occupancy rates for serviced apartments to grow to above 80%, with the investment opportunity being in Westlands & Parklands and Kilimani submarkets, which recorded relatively high rental yields of above 10.8% and 9.5%, respectively, in 2019	**Positive**
Land Sector	• In 2019, asking land prices within the NMA recorded an 8- year CAGR of 11.9% and a 2.0% y/y asking price change • The performance was driven mainly by; (i) the growing demand for development land especially in the satellite towns as developers strive to drive the government's Big Four government agenda on the provision of affordable housing, (ii) improving infrastructure, and (iii) reduced supply of development class land at affordable prices in areas close to the Nairobi CBD	• In 2020, we expect an annual capital appreciation of 3.9% in 2019, fueled by; (i) the growing demand for development land, (ii) improving infrastructure with projects such as the expansion of Waiyaki Way and the dualling of the Northern by-pass, set for completion in 2020, and (iii) positive demographics • For 2020, the investment opportunity within the Nairobi Metropolitan Area land sector lies in satellite towns (unserviced land) such as Utawala and Limuru, and suburbs such as Karen, Kitisuru, Runda and Kilimani supported by the relatively high annual capital appreciation of above 10.0%	**Positive**

Thematic Performance Review and Outlook

Theme	2019 Performance	2020 Outlook	Effect
Infrastructure	• The infrastructural sector remained vibrant in 2019, in line with the country's economic expansion goals to make Kenya the African hub for transportation, industrial, and service sectors • The government expenditure continued to increase, albeit at a decreasing rate following the realization of majority of the projects such as the completion of Phase 2A of the Standard Gauge Railway (SGR) project and the Outer Ring Exchange	• ·The government allocated Kshs 435.1 bn in 2019/2020, which is 3.9% higher than 418.8 bn allocated for FY 2018/19 budget to infrastructural development • The increased allocation shows the government's efforts aimed at transforming the country to middle-income status by 2030 • We expect execution of the planned infrastructure development such as sewer connection in Ruiru and Kitengela, water improvement program and the ongoing road projects such as the dualling of Ngong Road Phase 2 and the expansion of Waiyaki Way which will open up areas for development	**Positive**
Listed Real Estate	• In 2019, the Fahari I-REIT closed the year at Kshs 9.4 per share, 6.9% lower than its opening price of Kshs 10.1 per share • The REIT's value declined by 16.0% y/y trading at an average of Kshs 8.9 per share in comparison to Kshs 10.6 in 2018 • The poor performance is attributable to; (i) opacity of the exact returns from the underlying assets, (ii) the negative sentiments currently engulfing the sector given the poor performance of Fahari and Fusion REIT (FRED), (iii) inadequate investor knowledge, and (iv) lack of institutional support for REITs	• Having opened the year with a trading price of Kshs 9.2 we expect the REIT to continue trading at low prices and in low volumes in 2020	**Negative**

Our outlook is positive for three themes, neutral for two and negative for two, thus, the general outlook for the sector in 2020 is **NEUTRAL.** This is similar to our outlook that we presented for 2019. The sector will be supported by; (i) the National Government's support for the affordable housing initiative, (ii) continued entry and expansion of international retailers into the country, (iii) improving infrastructure, and (iv) the improving macroeconomic environment. The real estate sector has pockets of value in themes such as housing for lower-middle to low-income earners in the residential sector, land in satellite towns and differentiated concepts such as serviced apartments and serviced offices.

THE KEY AREAS OF OPPORTUNITIES BY THEME IN REAL ESTATE SECTOR

Based on returns, factors such as supply, demand, infrastructure, land prices and availability of social amenities the following are the ideal areas for investment;

The Key Areas of Opportunities by Theme in Real Estate Sector

Sector	Themes	Locations	Reasons
Residential Sector	**High End- (Detached)**	Runda, Karen	Annual returns at 6.4% and 5.5%, respectively, against the high-end market average of 5.0% For speculative buyers, Karen and Kitisuru recorded the highest annual uptake in this segment with 21.0% and 21.8%, respectively, against the high-end market average of 19.9%
	Upper- Mid End (Detached)	Runda Mumwe, Ridgeways/Garden Estate	Relatively high uptake at 22.7% and 25.0%, respectively. The areas also have relatively low supply coupled by availability of development land in comparison to other upper mid-end areas such as Lavington and Lang'ata
	Upper Mid- End (Apartments)	Parklands, Kileleshwa	Relatively high annual returns of 7.5% and 7.1%, respectively, against upper mid-end market average of 6.1%
	Low End (Detached)	Athi River, Kitengela	Relatively high returns averaging 7.1% and 7.0%, respectively, in comparison to the respective market average of 6.6%
	Low End (Apartments)	Thindigua, Athi River	Relatively high annual returns at 8.2% and 7.6%, respectively, against lower mid-end market average of 6.5%
Commercial Office Sector	**Grade A Offices**	Gigiri, Karen	Relatively low supply, proximity to commercial hubs and high yields of 9.2% and 8.3%, respectively
	Serviced Offices	Westlands	Prime commercial hubs with high occupancy of 85.5% and yields of 15.8%
Retail Sector	**Suburban Malls**	Counties such as Mt. Kenya Regions and Kiambu	Mt. Kenya Regions and Kiambu with attractive yields at 8.6% and 8.0% and occupancy rates at 82.3% and 79.4%, respectively

The Key Areas of Opportunities by Theme in Real Estate Sector

Sector	Themes	Locations	Reasons
Mixed Use Developments (MUDs)	**MUD**	Kilimani, Limuru Road	Affluent neighborhoods with high rental yield return of 9.1% and 8.0%, respectively
Hospitality Sector	**Serviced Apartments**	Westlands & Parklands, Kilimani	Relatively high rental yields of above 10.8% and 9.5%, respectively, compared to the market average of 7.6%
Land Sector	**Satellite Towns**	Utawala and Limuru	Relatively high capital appreciation of above 10.0% y/y, the provision of trunk infrastructure such as road networks and the growing demand for development land
	Suburbs	Karen, Runda, Kitisuru and Kilimani	Relatively high capital appreciation of above 10.0% y/y and proximity to amenities

Source: Cytonn Research

For the detailed real estate market outlook report, see our Real Estate Sector 2020 Market Outlook Note.

Outlook Summary

Our outlook for Fixed Income is "**neutral**", and our view is investors should be bias towards short-term fixed income securities, in a bid to reduce duration risk. Our outlook for equities is "**positive**", while our outlook for real estate is "**neutral**". In summary, our Outlook for 2020 Asset Classes is Neutral.

Key: Green – POSITIVE, Grey – NEUTRAL, Red – NEGATIVE

	Fixed Income & Equities Outlook for 2020
Fixed Income	Our view is that investors should be biased towards **SHORT-TERM FIXED INCOME INSTRUMENTS** in a bid to reduce duration risk. We expect upward pressure on interest rates following the repeal of the interest rate cap which in effect is expected to result in increased competition for bank funds from both the private and public sectors as the Government tries to raise funds to plug in the budget deficit
Kenya Equities	We are **POSITIVE** for equities in 2020. We market activity in 2020 to be driven by; (i) a stable macro-economic environment, with the GDP growth rate for the year projected to come in at 5.7%, slightly higher than our 5.6%, 2019 expectations, (ii) a 12.4% growth in corporate earnings, (iii) attractive valuations in a majority of the counters, with the market currently trading at P/E of 12.1x, 9.1% below the historical average of 13.3x, and, (iv) strong foreign inflows following the repeal of the interest rate cap.

Real Estate Outlook Summary

Real Estate Sector	We have a **NEUTRAL** outlook for the real estate sector in 2020, with positive performance expected in the hospitality and land sectors, negative performance in the listed real estate and commercial office sectors, while the residential and retail sectors' performance stagnate.

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