Cytonn INVESTMENTS

Is There a Real Estate Bubble in Kenya? & Cytonn Weekly #04/2020

Focus of the Week

In 2017 we reviewed the real estate industry and prepared two topical pieces, Is There a Real Estate Bubble in Kenya? and What Real Estate Bubble?, addressing speculations that the property market was experiencing a bubble. According to the two topical reports, the Kenyan real estate market was still in its nascent stage and was just being institutionalized. The Kenyan market was thus, not experiencing a bubble but the normal real estate cycles of rising demand, peaking market, falling market then bottoming out. The rapid price increments witnessed were attributed to the real estate market being in the rising phase that was characterized by low supply and high demand leading to an increase in prices. This week, we revisit the topic by reviewing the current state of the market.

It is evident that the property market in Nairobi has been burgeoning, with buildings stretching far and beyond. In the recent years, the Nairobi Metropolitan Area has recorded increased development activities, and the same is evident throughout the country. According to Kenya National Bureau of Statistics (KNBS), 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. In terms of performance, the sector continues to record relatively high returns with the 5-year average coming in at 20.1% p.a., compared to traditional assets at 8.7% p.a. This has been boosted by;

i. The availability of development class land,
ii. Continued demand for both residential and commercial property,
iii. Positive demographics, with the population growing at an estimated rate of 2.2% p.a. compared to the global average of 1.2% p.a., in addition to a relatively high urbanization rate of 4.3% p.a. compared to the global average of 2.0% p.a.,
iv. Continued entry and expansion of multinationals companies, fueling the demand for commercial and residential space,
v. The improved ease of doing business, with the World Bank ranking Kenya as #56 in their 2019 Ease of Doing Business Ranking, from #61 in 2018 out of 190 countries, and,
vi. The improving infrastructure, which has continued to open-up areas for development.

Despite the above, real estate firms have been reporting decline in residential units’ occupancy rates especially in the high-end market segment, while the commercial office and retail sector have continued to record an oversupply estimated at 5.6 mn and 2.8 mn SQFT, respectively. This has resulted in speculation that Kenya’s property market is having a bubble or headed there. With the aim of addressing the same, this week, we shall look into;

i. Introduction – What is a Real Estate Bubble?,
ii. Case Studies (Poland and Japan Property Bubbles),
iii. Overview of the Current State of the Kenyan Real Estate Market, and,
iv. Conclusion.

I. **Introduction – What is a Real Estate Bubble?**

A real estate bubble is defined as a run-up in property prices fueled by demand, speculation, and exuberant spending, bringing the sector to the point of collapse. It usually starts with an increase in demand for property, in the face of limited supply, which takes a relatively extended period to replenish and increase. Speculators bring in money into the market, further driving up demand. At some point, the demand decreases or stagnates at the same time supply increases, resulting in a sharp drop in prices, and the bubble bursts. A housing bubble has been witnessed in mature, first world economies such as Japan, Poland, United States of America, Australia and China.

A real estate bubble is characterized by;

i. **A Rapid Increase in Property Prices** - The increase in prices is driven by speculation and impulsive pursuit driven by “investors” who want to accumulate property as they expect to reap from capital gains in future. Therefore, for a market to develop a bubble, there must be an impulsive buyer and a shallow market. As opposed to deep markets, which can absorb temporary supply shocks, a shallow market tends to react wildly to shortages or gluts in supply. Prices can shoot up quickly until they outperform other elements of the economy and then drop just as fast,
ii. **Easy Access to Credit -** Availability of cheap and affordable loans, which means inordinate credit growth in the market, increasing the demand for property, and thus, prices increase to unsustainable levels, and,
iii. **Changes in the Credit Market** - This is mainly in the form of an increase in interest rates leading to an increase in defaults levels and non-performing loans, which exposes the banking system. This results into reduced credit supply, and hence, demand suddenly falls leading to a sharp fall in prices, and loss of value for homeowners, speculators and lenders. At this point, the bubble is said to have burst.

II. Case Studies

Having looked at what a real estate bubble is and its characteristics, we now shift our focus to case studies of Poland and Japan, which experienced property bubbles that eventually burst in 2008 and 1991, respectively. The two markets were mainly characterized by availability and affordability of credit, which resulted in a relatively high demand for property outstripping the supply.

A. Poland Property Bubble

The property market in Poland experienced a housing boom following Poland’s ascension to the European Union in December 2002. Polish banks relaxed their financial regulations by making credit more readily available leading to historically low rates on the mortgage loans. The property boom was mainly driven by:

i. **Increase in Mortgage Tenors** - Banks increased maximum mortgage loan tenors from 30 to 50-years, resulting in increased mortgage uptake by households,
ii. **Foreign Currency Denominated Loans** – A large proportion of mortgages were foreign currency-denominated in currencies and comprised about 22.0% of the total loan portfolio and more than half of the mortgages, according to the International Monetary Fund (IMF). Most of the foreign currency loans mainly comprised of Swiss Franc loans, which were preferred due to the Swiss currency devaluation between 2004 and 2008 and the Swiss Franc had lower average interest rates of 4.4% compared to the Polish Zloty of 8.7% as at 2008, and
iii. **Government Interest Rate Subsidies** – In order to mitigate exchange rate risks as a result of high uptake of foreign loans, the Polish government in 2005 subsidized interest payments on local currency loans for the first eight years of the loan for first time home buyers of new housing, resulting in 2.3% points decline in interest rates to 5.8% in Q2’2006, from 8.1% in Q1’2005. This led to increased mortgage loan uptake with speculators paying as much as 10% - 20% as deposits and taking up entire phases of off-plan developments.

As a result, residential prices rose rapidly with the average residential prices increasing by a 2-year

CAGR of 13.1% between 2006 and 2008. According to REAS JLL, a real estate management services firm, residential prices in the Polish capital, Warsaw, rose by 23.0% in 2005, 28.0% in 2006, 45.0% in 2007, and 13.0% in 2008.

The residential market bubble was pricked during the global recession of 2008 as the country’s GDP growth rate declined by 1.5% while the residential market prices dropped by 13.8% between 2008 and 2013. This was attributed to a decline in the value of the local currency, the Zloty (PLN), which resulted in relatively high mortgage service costs, thus, borrowers were not able to service their mortgages.

B. **Japan Property Bubble**

The Japanese asset price bubble lasted approximately 6-years from 1986 to 1991 during which real estate prices were greatly inflated with land recording an annual appreciation of approximately 42.0%, driven by speculation. In early 1992, this price bubble burst and Japan's economy stagnated and property prices deflated through to 2001 and the 10-year period was known as "Japan's Lost Decade". The bubble mainly impacted the Tokyo Metropolis and was characterized by; (i) rapid acceleration of real estate prices, resulting from overheated property transactions with the demand outstripping the supply, (ii) relatively low interest rates which encouraged uptake of mortgages and hence increased the demand for housing units in the market, and (iii) speculation regarding property prices.

The main causes of the bubble were;

i. **Financial Liberalization -** In 1983, the United States and Japan Committee for Yen and U.S. Dollar was established to reduce the friction in exchange rate between the Japanese Yen and U.S. Dollar. Through this committee, the U.S. demanded Japan to deregulate and ease restrictions on financial and capital transactions. As a result, the restriction on future exchange transaction was removed and it became possible for not only banks but companies to be involved in currency trading. Later in the same year, regulation on converting foreign funds into Japanese Yen was also eliminated. The abolition of financial restrictions in Japan opened Japanese financial markets to those overseas, and the demand for Japanese Yen increased accordingly. At the same time, there was increasing number of loans by from banks to companies on real estate investment purpose,
ii. **Excessive Monetary Easing Policy -** Japan recorded a significant drop in short-term interest rates, notably between 1986 and 1987, with the Bank of Japan slashing the official discount rate from 5.0% (January 30, 1986) to 2.5% (February 23, 1987). As a result, money growth increased rapidly, from a growth of 8.0% for the period between 1985 to 1987 period, to 12.0% per annum by 1988. The lower rates encouraged uptake of mortgages and hence increased the demand for housing units in the market,
iii. **Distortion of the Tax System -** Minimal property taxes, in addition to expectations that land prices were likely to increase, fueled speculation and resulted in hoarding of land. For instance, given that capital gains on land were not taxed until the time of sale, offered more incentives for wealthy individuals to speculate on the asset price. In addition, land leasehold contracts automatically renew unless the landlord provides concrete reasoning to object. In the event of a dispute between the lessee and tenant, courts intervene and if the rent is set by the court, it meant landlords could not raise the rent more than the actual market price. Hence, rents are kept artificially low and thus, many landlords refused to rent out their land given the relatively low discount prices, but rather left the land deserted to reap huge capital gains should land prices increase later. This resulted in reduced land transactions and resultant decline in housing development, thus, unstainable demand for the available property, and,
iv. **Changes in Bank Behavior** - In the 1980’s, more Japanese opted to shift funding from banks to the capital markets, given that banks were not allowed to pay interest on deposits prior to the 1985 deregulation of interest rates on deposits and following the lift of a previous ban on fund-raising in the securities market. This left banks in a tight squeeze as banking spread grew smaller

with the shrinking customer base, thus, banks were forced to aggressively promote loans to individuals and smaller firms backed by properties, and this resulted in a relatively high loan uptake with the value estimated to have grown by approximately 67.9% from 1984 to 1991.

The ultra-low interest rates and relatively high money supply in the market, fueled a housing bubble in Japan by driving demand for property which eventually outstripped the supply, and resulted in a significant rise in prices of property with land and residential properties recording an annual appreciation of approximately 42.0% and 10.0%, respectively. It eventually became too expensive for the general population to afford property, which resulted in lower demand hence, property prices declining tremendously. For instance, land values corrected throughout the 1990s, by approximately 70% by 2001, and the property bubble was said to have burst.

III. **Overview of the Current State of the Kenyan Real Estate Market**

In the two case studies, real estate prices increase in response to the heightened demand and investment leading to a boom period which creates a period of irrational excitement with people demanding and taking credit to purchase houses.

For the Kenyan market, we believe this is not the case, and this is supported by;

1. **Inaccessibility and Unaffordability of Credit -** In the Japanese market, at the time of the bubble, there was excessive lending with credit being extended to un-creditworthy individuals as long as one had property to use as collateral. In Kenya, there are stringent underwriting rules and credit is extended to only creditworthy individuals. Mortgages constitute 1.0% of banks loan portfolios, an indication that the current demand for real estate is not driven by access to credit. According to the CBK's Bank Supervision Annual Report 2018, Kenya has few mortgages –with only 26,504 mortgage loans recorded by December 2018, slightly up from 26,187 recorded in December 2017, out of a population of 47.6 mn Kenyans as at 2019.

    Additionally, In Poland, the interest rates averaged at approximately 5.8%, which was a 2.3% points decline from 8.1% in 2006, leading to increased mortgage loan uptake with speculators paying as much as 10% - 20% as deposits and taking up entire phases of off-plan developments. On the other hand, in the Kenyan market, interest rates on loans have remained relatively high, over the last couple of years averaging at approximately 13.5%, with the interest rate cap, and are expected to go even higher following the repeal of the cap in 2019. It is thus high enough to prevent excessive borrowing from financial institutions or individuals to fund speculative purchase of property that may result into unsustainable demand,

2. **The Huge Housing Deficit**- Unlike in a bubble, where most of the demand is driven by speculators, Kenya has a genuine demand of approximately 2.0 mn housing units, and has been growing annually by approximately 200,000 units, according to the National Housing Corporation with majority of the demand mainly in the low and middle-income levels. Additionally, uptake of housing units remains relatively high at approximately 20.9% per annum on average, according to Cytonn Research, whereas, on the other hand, a bubble is characterized by poor property uptake of as low as 0% - 10.0%,
3. **Positive Demographics** - Kenya has a relatively high annual population growth rate estimated at 2.2%, compared to the global average of 1.2%, while the annual urbanization rate has averaged at 4.3% over the last five years, compared to the global average of 2.0%. In addition, Kenya has also seen exponential middle-class growth, which comprises of people who are able to access financing for real estate acquisition and are able to construct their own homes. We expect this to enhance demand and thus, a resultant supply aimed at serving the population, thus deepening of the real estate market and enhancing its ability to absorb temporary supply shocks,
4. **Availability of Development Class Land -** There is availability of development class land in

Kenya especially in the satellite towns at relatively affordable prices and in bulk, and this continues to allow for development activities outside the Nairobi CBD, and thus cushion the real estate market from unsustainable demand for property that would otherwise cause the prices to skyrocket,

5. **Regulatory Measures** - In the Kenyan market, there exists the Capital Gains Tax which pressurizes land owners to release land for development rather than hold on to it, while awaiting its appreciation. Other policy reforms include the adoption of a new valuation method in 2019 by the Nairobi County, which adjusted the land rates to 25.0% of the current property value as opposed to the previous unimproved site value based on the 1980 valuation roll. These measures continue to support real estate development and thus, eliminate the chances of the demand for property outdoing supply, and
6. **Entry and Expansion of Local Firms and Multinationals** - The Kenya commercial office and retail market has continued to record entry and expansion of both local and international firms, resulting in the continued uptake of commercial spaces. Therefore, despite the current oversupply, which has continued to result in marginal decline in rental prices as landlords seek to attract tenants and maintain their occupancy rates, we do not anticipate property prices to drastically drop, as the continued entry and expansion of international retailers and multinationals continue to enhance uptake of commercial space and thus, cushion the sectors.

Currently there exists an oversupply of space in the commercial office and retail sectors estimated at 5.6 mn SQFT and 2.0 mn SQFT, respectively. We attribute the surplus to relatively low uptake of space as compared to the existing supply. However, the market has continued to witness increased entry and expansion of multinationals, local and international retailers, such as French Retailer Carrefour and South African Shoprite, who have continued to take up available retail space. In addition, the market has witnessed a slow-down in incoming supply with no new developments expected to come into the retail market in 2020 and thus, we expect the market to absorb the surplus supply in the short- term. For the residential market, in Kenya, there is a need for over 200,000 houses annually according to the National Housing Cooperative (NHC) with Nairobi experiencing deficit of about 120,000. Approximately 35,000 houses are constructed each year in Nairobi meaning there is an unmet demand of 85,000 houses annually in Nairobi and its metropolis. The demand clearly outweighs the supply indicating that there is no bubble in the market and no burst is likely to be experienced, at least in the medium to long term. The sector’s resilience will thus, be backed by fundamentals that determine the demand for real estate products. There could be oversupply in some markets, especially in the upper middle income areas. Investors should conduct proper market research to identify the pockets of value.

IV. Conclusion

In conclusion, real estate prices increase in response to the increased demand and investment leading to a boom period, which creates a period of irrational excitement with people demanding and taking credit to purchase houses. That said, we do not foresee a real estate bubble occurring in Kenya, as the market is still constrained by issues such as unavailability of credit and relatively high interest rates, tight credit underwriting standards, inaccessibility of mortgage financing and thus, there lacks the possibility of unsustainable demand that will supersede the current supply across all the sectors.

Currently, the sector is just experiencing the normal real estate cycles, and the rapid price increments and declines being witnessed are a result of low supply and high demand, and vice versa in select sectors. Therefore, the real estate market still has pockets of value:

i. For direct long-term investors, the opportunity lies in; (a) differentiated concepts such as the shared offices, Grade A office spaces and serviced apartments which are in low supply and present attractive returns to investors, (b) land banking especially in satellite towns where land is available at affordable prices and in bulk in the wake of improving infrastructure, and (c) low to

mid end residential market where there lies a huge demand,

Below is a summary of the specific themes and nodes:

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, Ruaka, Athi River	Relatively high annual returns and uptake of up to 8.2% and 21.0%, respectively
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
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

ii. Alternative investment firms also offer other 'sharp' ways in the form of client-based structured products such as:
    - A short to medium-term debt obligation issued to finance a project or multiple projects such as Cytonn Project Notes (CPN), and
    - Real Estate Backed Medium-Term Notes (MTN), a debt note that usually matures in 5–10 years and is backed by cash flows from Real Estate projects.

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