Cytonn Real Estate Annual Market Outlook – 2017

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Executive Summary

- **Real Estate Outlook**: Real estate in Kenya is expected to maintain the high performance across all sectors, with increased development activity expected in low to middle income residential segment, three and four star hotels, mixed use developments and warehouses. Development activity is expected to slow down in commercial office space, retail spaces and land development.

Real Estate Outlook

In 2016 real estate delivered high returns averaging 25.8% across all themes, with the best performing themes being retail and offices with average yields of 10.0% and 9.4%, respectively. In 2017, we expect the sector to continue with the good performance across all themes compared to traditional asset classes.

The key drivers of real estate in 2017 will be:

- **Demographic Trends** – Such as the growing middle class, rapid urbanization, rapid population growth and the youth bulge (21 to 35 years) will drive real estate development in 2017. This is as developers work towards satisfying their housing, entertainment and consumption needs thus boosting developments in the residential and retail themes
- **Large Housing Deficit** - According to the National Housing Corporation (NHC), there is an effective housing deficit of over 200,000 units per annum to cater for the low to middle income market with Nairobi and its metro accounting for over 50% of this deficit. Hence we will witness increased development activity in a bid to tap into this market, especially through affordable housing initiatives that cater to the segment, and reduce the deficit,
- **High Returns** - Real estate has consistently outperformed other asset classes in the last 5-years, generating returns of over 25.0% p.a., compared to an average of 10.0% p.a. in the traditional asset classes. In 2016, real estate delivered returns of 25.8%, against (8.5%) in equities and an average of 14.7% for the 10-year government bond. This significantly higher returns will thus lead to increased investments in the real estate sector, and especially from global and institutional investors seeking attractive risk-adjusted returns in the market,
- **Growing Businesses and Entry of Global Brands –** In 2016, a number of global brands including Wrigley's entered the Kenyan market with Volkswagen announcing plans to put up shop in Kenya in 2017. These together with the growing small and medium businesses will lead to increased demand for office, industrial as well as residential real estate to house the offices, products and employment, respectively,
- **Continued Infrastructure Development** - Infrastructural development has led to opening up of new areas for development e.g. along the Northern Bypass, Eastern and upcoming Western Bypass. The LAPPSET Corridor, SGR, expansion of airports and seaports are all opening up Kenya to real estate development and will lead to increased development along the hubs in towns such as Ruaka, Kikuyu and Athi River. Projects in the pipeline include the Standard Gauge Railway (SGR), which is expected to be operational by December of 2017,
- **Better Operating and Legal Environment** – 2017 will have a better legal and operational environment for real estate investments as several policies enacted in 2016 come into action. These policies include: (i) The 50% reduction in tax for developers constructing more than 400 units p.a., (ii) the Banking (Amendment) Act, 2015, capping interest rates at 14.0%, (iii) the proposal to remove NEMA and NCA,

(iv) digitization of land records, and (v) increased transparency in the lands ministry as well as issuing of title. The above, if implemented, will boost real estate development by reducing construction costs, and fastening transaction process in the development process,

- **Domestic and MICE Tourism** – Increased domestic tourism as well as the growing Meetings Incentives, Conferences and Exhibitions (MICE) segment of the market will drive real estate in 2017. This is driven by improved security, growing businesses, SME's as well as county governments will greatly boost the hospitality industry in 2017,
- **Devolution** – Devolution is boosting real estate development as it is placing onus on the County Governments to improve the real estate landscape, which has led to reduced bureaucracy and investment in infrastructure as well as creating demand for real estate, especially residential units, office space and retail to cater for population moving to the county headquarters. Nevertheless, the upcoming general election in 2017 may see a slowdown in selected markets especially areas previously affected by political tensions in the past. For instance, parts of Rift Valley, Nyanza region and the Coastal regions, and
- **Increased financing** – From both local and international players to real estate will boost investments in the real estate sector.

The sector will however face a number of challenges in 2017 that will include:

- **High Land and Construction Costs -** This will continue to be a challenge in 2017 as land in Nairobi and other main town centers across the country is increasingly becoming expensive. Developers are likely to concentrate on areas in the outskirts of Nairobi where land is more affordable. While an acre of land in Donholm would cost Kshs 60 mn and that in Mlolongo would cost Kshs 40 mn, a similar parcel in Juja would cost between Kshs 10 mn - Kshs 15 mn. Construction costs will nevertheless remain high as developers have to incur infrastructural costs to make their developments viable in satellite towns,
- **Difficulty in Fundraising for Developments-** Being a capital-intensive sector, developers will need to adopt innovative ways to finance developments. Following the poor performance of REITs in the last year, they are likely to shy away from the capital markets. In addition, banks are less likely to advance loans to small and medium sized companies with interest rates capped at 14%, banks will prefer to lend to the government since it is considered risk free,
- **Increased Supply and Competition-** Increased supply in some sectors such as the upper mid-end residential sector will result in competition and thus lower returns for investors. The commercial office segment is likely to experience high competition with the increasing office space supply in Nairobi's key nodes such as Upperhill and Westlands. This is expected to lead to lower occupancy and thus lower yields for investors,
- **Political Uncertainty -** As we enter the election year, we expect investors to shy away from long-term investments as the 'wait and see phenomena' sets in. We therefore expect prices and rents to stagnate during the first half of the year, then pick up once the state has stabilized. Risk-averse investors may however choose to lock positions during this period through purchase of property at low prices then exit after the election period at higher prices.

Thematic Performance Review and Outlook			
Theme	**2016 Performance**	**2017 Outlook**	**Effect**
Residential	• Performance has remained stable with rental yields averaging at 5%-6% • Developments in the lower-mid end recorded the highest price appreciation due to high demand	• Stagnation of prices during the first half of the year, then increase after the election period • Demand for housing will remain high but highly	**Positive**

	• Developments in the upper-mid end recorded lower price appreciation due to increased supply in these areas • Ruaka, Ridgeways and Kikuyu were the best performing markets with 18.4%, 18.1% and 17.3% total returns, respectively • Kisumu market is picking up with average returns ranging from11% to 13% • Mombasa market has recorded low to negative returns especially in the high-end segment as developers reduce prices so as to boost uptake	concentrated in the lower income segment • Increased investment in satellite towns due to affordability and availability of land for development	
Commercial Office	• The Sector performed well with high occupancy rates of on average 88%, high yields at 9.4% and prices of Kshs 13,000 per square foot • There was increased development with notable developments being launched including Montave in Upperhill by Hass Consult and Abcon international Limited • Approximately 3.6 mn square foot of office space was added to the market	• The high returns in the sector expected to be sustained though we are likely to witness a slowdown in construction as a result of the high supply and subsequently lower occupancy rates in some submarkets especially in Mombasa Road and Upperhill • Development in the sector will be construed to grade A offices, which are in short supply and renovation of existing buildings	**Neutral**
Retail	• The sector earned high returns driven by high demand • On average rental yields were 10.1% and occupancy levels of 89.3% • 2016 saw opening of the Hub and entry of global chains such as Choppies of Botswana • As of 2016 Nairobi had more than 5.5 mn square feet of retail space creating fears of oversupply	• High returns to be sustained by demand and demographics • More international developers expected to enter the market seeking to cash in on the middle-class population and changing lifestyles • A slowdown in the development in Nairobi and increased development in the counties	**Positive**

Industrial	• High returns with rents of Kshs 35 per square foot rental yield of 5.8%, and an occupancy of 85% • The sector witnessed increased development both in warehouses and serviced industrial plots • Leather city phase one and infinity industrial park were launched	• We expect to witness increased development activity in the sector with better quality warehouses being constructed and hence higher rents and rental yields	**Positive**
Hospitality	• Increased arrivals witnessed in the country as a result of global conferences and improved security hence attracting tourists • Serviced apartments enjoyed high occupancy rates of on average 90% and high returns, with TRevPAR of USD 127 against USD 98 for hotels	• Increased domestic tourism expected as well as increased MICE tourism boosting revenues in the sector • Rates expected to remain largely the same in 2017 • Increased developments in the sector especially of three and four star hotels	**Positive**
Listed Real Estate	• Listed real estate performed poorly with the only listed REIT shedding 50% of its value in 2016 • The only other listing FRED – Commercial, a D REIT from fusion capital failed to meet the minimum requirement to list	• Low performance of listed real estate expected to persist as there are no measures to increase public awareness and boost the returns of the underlying assets • No public listings expected as investor sentiments towards REITS remain largely negative	**Negative**

Our outlook for real estate remains positive in 2017, driven by the high returns being earned in the sector, the huge housing deficit, increased financing and infrastructural developments in the country and largely in Nairobi Metropolitan Area. Investors will however have to be cautious in their investments, ensuring that proper research and due diligence is done before investing and matching the right products to the right market to boost uptake and ensure they earn the high returns in the sector.