Kenya Retail Report, & Cytonn Weekly Report #27

Executive Summary

- **Fixed Income:** Yields on treasury bills changed trend this week, for the first time in 21 weeks, with the 91-day remaining unchanged while the 182-day and 364-day increased by 20 bps and 30 bps to 9.6%, and 11.0% from 9.4% and 10.7%, respectively. Kenya continues to attract global leaders as they look for opportunities in investments;
- **Equities:** During the week the market was on an upward trend, with NASI, NSE 20 and NSE 25 gaining 0.4%, 1.0%, and 0.5%, respectively. The Central Bank of Kenya released Q1'2016 Kenya banking sector report showing a marginal growth of 2.9% in profit before tax to Kshs 38.4 bn;
- **Private Equity:** Energy sector continues to witness increased private equity activity in the region through partnerships and joint venture agreements as Helios and Vitol invest USD 210 mn to acquire a 49% stake in Oando PLC;
- **Real Estate:** We analyze returns on the Fusion D-REIT offering, and recommend our investors to participate in the offering. PDM announces plans to begin development in Uganda, while Stima Sacco seeks to raise a Kshs 5 bn bond to finance its mortgage business;
- **Focus of the Week:** This week, we report the findings of our research on retail space in Nairobi metropolitan area and key regions in the country themed ***"Investor's Perspective on Kenya's Retail Sector"***. The purpose of the research is to inform investors on the best investment areas for retail in Kenya, considering key factors, namely rental rates, occupancy levels and income yield.

Company Updates

- Cytonn Investment Co-operative membership recruitment drive is still on. For more information, please see the link: Cytonn Cooperative. The cooperative allows the ordinary investor to access above average market returns that have previously been accessible only to our private wealth investors. To join, please contact us at coop@cytonn.com or download the forms from the website on this link: Cytonn Cooperative forms.

- To invest in any of our current or upcoming real estate projects, please visit Cytonn real estate. We continue to see very strong interest in our products, particularly The Alma, which is now 50% sold and has delivered an annualized return for 55% p.a. for investors who bought off-plan. We have 12 investment ready projects, offering attractive development returns and buyer's returns of a minimum of 25% p.a. See further details here: Summary of investment ready projects

- We will be formally launching our entry level training program, Cytonn Young Leaders Program, "CYLP", on 15th July 2016 at Sarova Panafric Hotel. Through CYLP, we have trained 180 university graduates since its inception two years ago, and we have made employment offers to 57 of these program participants

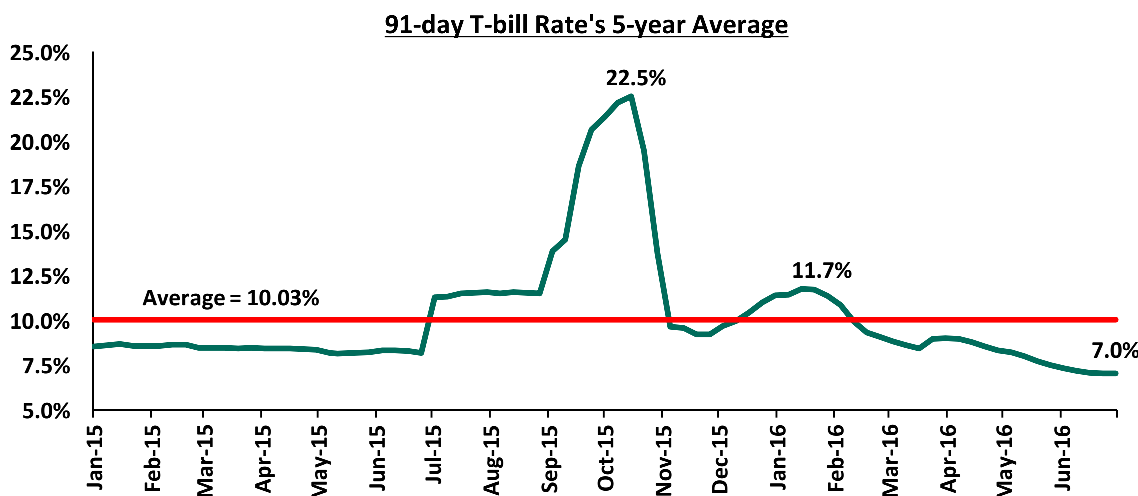
- We continue to beef up the team with several ongoing hires: Careers at Cytonn.

Fixed Income

T-bills were undersubscribed for the 2nd week, with a subscription rate coming in at 36.4% compared to 37.0% the previous week. Subscription for the 91-day, 182-day and 364-day came in at 48.9%, 46.3% and 18.1%, respectively, compared to 84.3%, 20.3% and 21.9% the previous week. The undersubscription was due to low liquidity levels in the money market and most banks, in a bid to manage liquidity and still get attractive returns on a risk adjusted basis, opted to participate in the repo market which was yielding an average of 10.3% for seven days, with a total of Kshs 17.9 bn being taken in during the week. Repo instruments is one of the money markets liquidity management tools that are used by the CBK and at times can serve as alternative to investing in Treasury bills for banking institutions especially when repos are yielding higher than the T-bills.

Yields for 91-day remained unchanged at 7.0% while there was reversal in trend in yields for the 182-day and 364-day T-bills, increasing by 20 bps and 30 bps to 9.6%, and 11.0% from 9.4% and 10.7%, respectively. This was mainly as a result of; (i) investors opting to stay short duration on the possibility of interest rates increasing as we start a new fiscal year, (ii) tight liquidity in the money market during the week with CBK seeking to reduce liquidity in a bid to tame inflationary pressures.

The 91-day T-bill is currently trading below its 5-year average of 10.0%, having witnessed a downward trend in the last two months. As per our previous reports, we believe that the rates have bottomed out and we are likely to see upward pressure due to government borrowing given the new fiscal year, which has been characterized by an uptick in inflation.



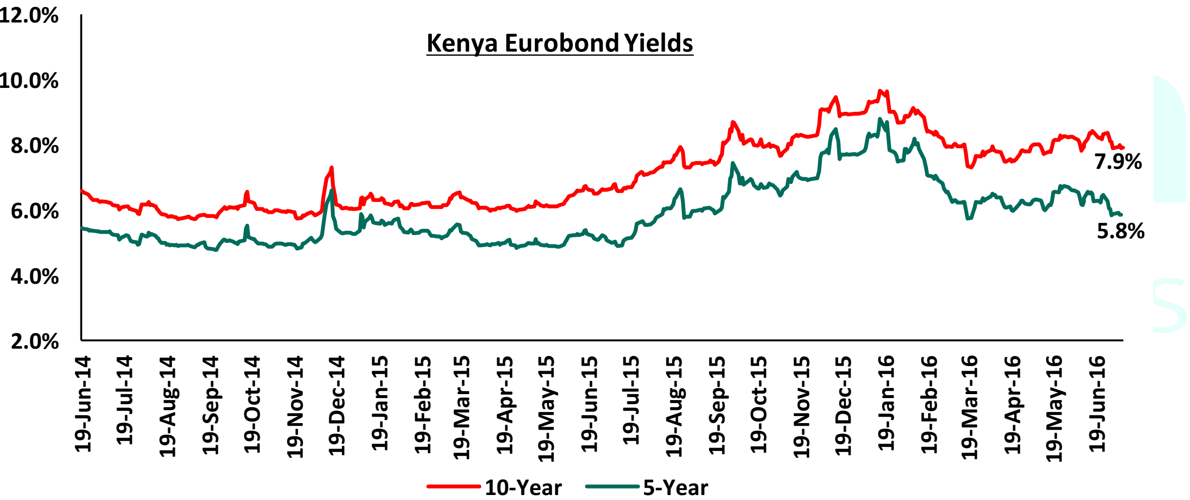
The Central Bank weekly report revealed that the interbank rate increased by 50 bps to 8.7% from 8.2% despite a net liquidity injection of Kshs 6.1 bn. The interbank rate has been low and stable for the better part of the H1'2016 but has experienced a spike in the past 2 weeks due to market liquidity tightening. Inflation is currently at 5.8% but there runs a risk that it may increase further towards the CBK upper bound.

Below is a summary of the money market activity during the week:

all values in Kshs bn, unless stated otherwise			
Weekly Liquidity Position – Kenya			
Liquidity Injection	**Kshs bn.**	**Liquidity Reduction**	**Kshs bn.**

Term Auction Deposit Maturities	0.0	T-bond sales	0.0
Government Payments	78.6	Transfer from Banks – Taxes	12.9
T-bond Redemptions	0.0	T-bill (Primary issues)	6.5
T-bill Redemptions	5.5	Term Auction Deposit	41.2
T-bond Interest	0.0	Reverse Repo Maturities	7.4
Reverse Repo Purchases	2.6	Repos	17.9
Repos Maturities	5.3		
Total Liquidity Injection	**92.0**	**Total Liquidity Withdrawal**	**85.9**
		Net Liquidity Injection	**6.1**

According to Bloomberg, yields on the 5-year and 10-year Eurobond issued in 2014 have declined by 295 bps and 175 bps from 8.8% and 9.6%, respectively, since their peak in mid-January 2016 on account of improving macroeconomic conditions. Week-on-week, the 5-year and 10-year rates were relatively unchanged ending the week at 5.8% and 7.9% respectively.



During the week, the Kenya Shilling depreciated by 0.1% against the dollar to close at Kshs 101.2 owing to corporate dollar demand at the close of the week. On a YTD basis, the shilling has appreciated against the dollar by 1.1% supported by (i) the high levels of foreign exchange reserves currently at USD 7.9 bn, equivalent to 5.2 months of import cover, and (ii) improved diaspora remittances, with cumulative 12 months' inflows to May 2016 increasing by 11.1% to USD 1.6 bn from USD 1.5 bn in May 2015. The Brexit referendum resulted in mild volatility in the market and we saw the CBK intervening in the foreign exchange market to support the shilling, leading to a decline in the foreign exchange reserves to USD 7.4 bn, representing 4.7 months of import cover as at the end of June 2016.

Over the last one year, Kenya has attracted a number of prominent world leaders among them, the US president, the Turkish president, the Israeli Prime Minister and the Indian Prime Minister. All the talks are geared towards closer investment partnerships between Kenya and the various countries, a key indication that Kenya is an attractive investment destination. Some of the key discussions are centered on investment in

infrastructure, improvement in trade among the various countries. For Kenya and Israel, security was a key point of discussions and how the two countries can partner in fighting terrorism.

The government has had a slow start to the financial year having locally borrowed only Kshs 51.3 mn for the current fiscal against a target of Kshs 8.8 bn (assuming a pro-rated borrowing throughout the financial year of Kshs 229.6 bn budgeted for the full financial year). We believe interest rates have bottomed out at the current levels and it is highly likely that the Government may find itself in the same position they were in late last year, where they funded more from domestic than they did from external markets, and this may have upward pressure on interest rates. It is due to this uncertainty that we advise investors to be biased towards short-term papers.

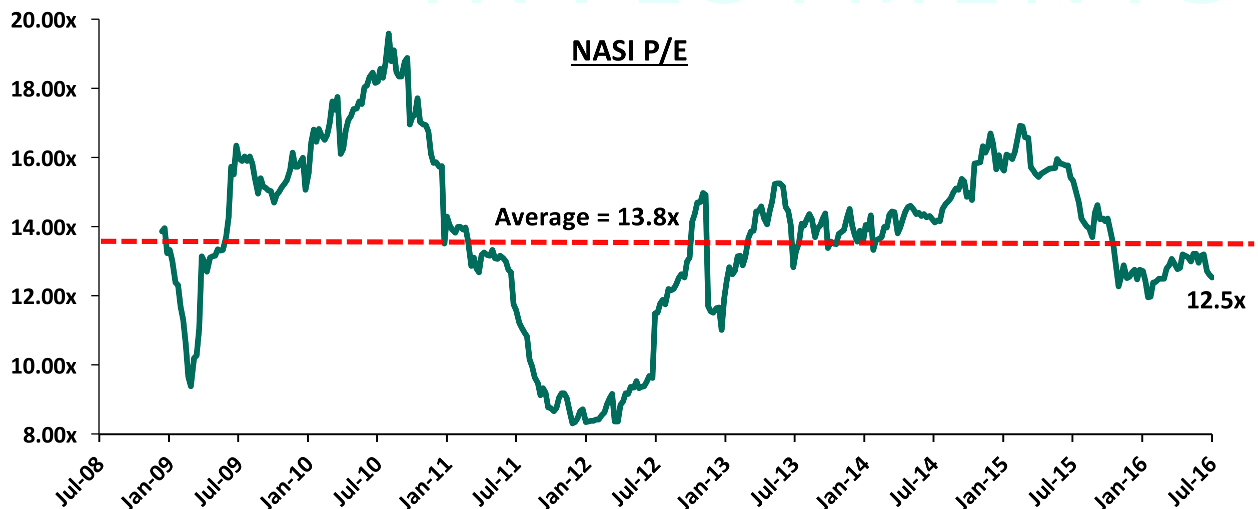
Equities

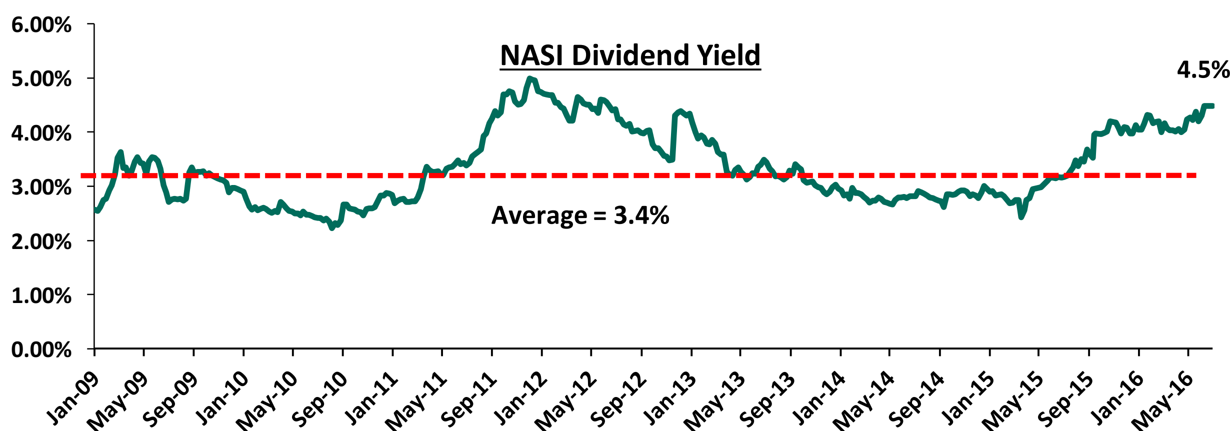
During the week the market was on an upward trend, with NASI, NSE 20 and NSE 25 gaining 0.4%, 1.0%, and 0.5%, respectively, with the YTD performance coming in at -3.2%, -8.7%, and -5.0%, respectively. The positive change in the market trend this week was driven by the performance of large cap stocks, with Equity Group, Barclays and Co-op Bank gaining 1.9%, 1.5%, and 1.2%, respectively. Since the February 2015 peak, the market has declined 32.9% and 20.6% for NSE 20 and NASI, respectively.

Equities turnover continued to decline shedding 18.9% during the week to Kshs 2.7 bn from Kshs 3.8 bn the previous week, on the back of increased foreign investors' activity on a net selling position with net outflows of USD 68,000, decline from the net outflows of USD 333,000 recorded the previous week. We expect earnings growth to improve in 2016 compared to 2015, with an estimated growth of 12.5%, supported by a favorable macroeconomic environment. Given the current low valuations, long-term investors should gradually take positions in the market.

The market is currently trading at a price to earnings ratio of 12.5x, versus a historical average of 13.8x, with a dividend yield of 4.5% versus a historical average of 3.4%. The charts below indicate the historical PE and dividend yields of the market.

Cytonn INVESTMENTS





Since its listing, the Fahari I-REIT trading activity has been substantially low with only shares worth Kshs 0.7 mn trading this week compared to a weekly average of Kshs 3.9 mn since listing. The low activity is an indication of the need for more investor education on REITs. In our view, we need to see a lot of financial education to the public, coupled with transparent frameworks for the investors to embrace and take advantage of REITs as financial products.

Kengen is seeking to acquire debt to fill the rights issue deficit, of 8.0% amounting to Kshs 2.3 bn. Last week, Kengen announced a successful rights issue which was 92.0% subscribed, raising Kshs 26.5 bn from the target of Kshs 28.8 bn. As noted in our Cytonn H1’2016 Markets Review, the rights issue has improved Kengen’s liquidity and capital structure, opening up its balance sheet to allow for more borrowing. The company now has the necessary capacity to look for concessional and sovereign-based credit as it seeks to fund its energy ventures.

Kenya Banking Sector Q1’2016 Performance:

During the week, the Central Bank of Kenya (CBK) released Kenya banking sector Q1’2016 results, showing a marginal growth of 2.9% in profit before tax to Kshs 38.4 bn, from Kshs 37.3 bn in Q1’2015. This flat performance was driven by a faster growth in total expenses, which grew at 32.5% to Kshs 96.4 bn compared to a 15.6% growth in total income, which stood at Kshs 127.2 bn in Q1’2016. The banking sector total assets grew by 3.6% to Kshs 3.5 tn from Kshs 3.4 tn in Q1’2015.

Total sector loans recorded a growth of 8.9% to Kshs 2.2 tn, from Kshs 2.0 tn in Q1’2015, while the sector deposits grew by 12.8% to Kshs 2.6 tn from Kshs 2.3 tn in Q1’2015, highlighting the slower loan uptake on the back of a high interest rates environment experienced in the last quarter of 2015 which also affected Q1’2016.

The sector gross NPLs grew by 15.8% to Kshs 170.6 bn in Q1’2016 from Kshs 147.3 bn in Q1’2015, with gross NPL ratio increasing to 6.3% from 5.8% in Q1’2015. The banking sector remains well capitalized at 18.8% and 16.0% above the statutory limit of 14.5% and 10.5% for Total Capital to Risk Weighted Assets and Core Capital to Risk Weighted Assets, respectively. Below is a summary of the performance:

Balance Sheet (Key items)	Q1'2016 (Kshs tn)	Q1'2015 (Kshs tn)	Change
Total Assets	3.5	3.4	3.6%
Loans and advances	2.2	2.0	8.9%
Customer Deposits	2.6	2.3	12.8%

Income Statement (Key items)	Q1'2016 (Kshs bn)	Q1'2015 (Kshs bn)	Change
Total Income	127.2	110.0	15.6%
Total Expenses	96.4	72.7	32.5%
PBT	38.4	37.3	2.9%

Metric	Q1'2016 %	Q1'2015 %
Gross NPL Ratio	6.3%	5.8%
Net NPL Ratio	4.0%	3.4%
Loan to Deposit Ratio	86.8%	89.9%
Total capital to total risk weighted assets	18.8%	19.2%
Core capital to total risk weighted assets	16.0%	16.2%

TransCentury has entered into an agreement with the Africa Export-Import Bank (Afreximbank) to fund its working capital and asset financing requirements of its business across Sub-Saharan Africa. According to TransCentury, the process shall involve restructuring and consolidation of all existing trade finance and term loan facilities into one global facility with Afreximbank amounting to Kshs 15.1 bn. Earlier this year, TransCentury received Kshs 2.0 bn capital injection from Kuramo Capital to settle its outstanding convertible bond of USD 76.5 mn which was due at the end of Q1'2016. We view this as a positive step for TransCentury as it seeks to fund its projects through partnership with aligned partners who will not only fund but also assist in restructuring and consolidation of its business.

Below is our equities recommendation table. Key changes from our previous recommendation are;

- Liberty Kenya has moved from a "Buy" recommendation, with an upside of 26.0% to an "Accumulate" recommendation with an upside of 15.8% following an 8.8% week on week price increase
- Jubilee has moved from a "Hold" recommendation, with an upside of 6.8% to a "Lighten" recommendation with an upside of 3.4% following a 3.3% week on week price increase.

all prices in Kshs unless stated

EQUITY RECOMMENDATION									
No.	Company	Price as at 01/07/16	Price as at 08/07/16	w/w Change	YTD Change	Target Price*	Dividend Yield	Upside/ (Downside)**	Recommendation
1.	KCB Group***	33.8	33.5	(0.7%)	(23.4%)	49.4	5.6%	53.1%	Buy
2.	Kenya Re	19.5	19.5	0.0%	(7.1%)	26.7	3.5%	40.4%	Buy
3.	Centum	44.3	45.0	1.7%	(3.2%)	57.2	2.1%	29.2%	Buy
4.	DTBK***	167.0	170.0	1.8%	(9.1%)	204.2	1.4%	21.5%	Buy

5.	Barclays	9.9	10.0	1.5%	(26.5%)	10.9	9.7%	18.7%	**Accumulate**
6.	HF Group	20.0	19.9	(0.5%)	(10.6%)	21.6	7.5%	16.0%	**Accumulate**
7.	Liberty	13.7	14.9	8.8%	(23.8%)	17.2	0.0%	15.8%	**Accumulate**
8.	Equity Group	39.0	39.8	1.9%	(0.6%)	42.1	5.4%	11.3%	**Accumulate**
9.	Standard Chartered***	204.0	205.0	0.5%	5.1%	208.6	6.1%	7.9%	**Hold**
10.	CfC Stanbic	82.0	80.0	(2.4%)	(3.0%)	83.6	0.0%	4.5%	**Lighten**
11.	I&M Holdings	109.0	109.0	0.0%	9.0%	109.5	3.5%	4.0%	**Lighten**
12.	Jubilee Insurance	455.0	470.0	3.3%	(2.9%)	477.8	1.8%	3.4%	**Lighten**
13.	NIC	36.3	35.8	(1.4%)	(17.3%)	35.7	2.7%	2.6%	**Lighten**
14.	Co-op Bank	16.2	16.4	1.2%	(8.9%)	16.0	4.3%	1.9%	**Lighten**
15.	CIC Insurance	4.6	4.7	2.2%	(24.2%)	4.7	1.9%	1.9%	**Lighten**
16.	Pan Africa	38.0	39.0	2.6%	(35.0%)	39.0	0.0%	0.0%	**Lighten**
17.	Britam	13.6	14.5	6.6%	11.5%	14.1	1.9%	(0.8%)	**Sell**
18.	Safaricom	17.6	17.6	0.0%	7.7%	16.6	4.2%	(1.1%)	**Sell**
19.	NBK	9.8	9.6	(1.5%)	(39.0%)	5.4	0.0%	(43.8%)	**Sell**

**Target Price as per Cytonn Analyst estimates*

***Upside / (Downside) is adjusted for Dividend Yield*

****Indicates companies in which Cytonn holds shares in*

Accumulate – Buying should be restrained and timed to happen when there are momentary dips in stock prices.

Lighten – Investor to consider selling, timed to happen when there are price rallies

Since last week's review of the key factors that we track, we revise our view on Equities upwards from "neutral" to "neutral with a bias to positive" given the higher earnings prospects, supported by a favorable macroeconomic environment. Read more here: Cytonn H1'2016 Markets Review

Private Equity

Helios Investment Partners (Helios), Africa-focused private equity firm and The Vitol Group (Vitol), the world's largest independent trader of energy commodities, have bought a 49% controlling stake valued at USD 210mn in Oando PLC, effectively valuing the company at USD 428.6 mn. Oando PLC is the Nigeria's leading indigenous energy group, listed on both the Nigerian and Johannesburg Stock Exchange, through a joint venture agreement, HV Investments II (HVI). This deal will see a recapitalization of Oandos PLC downstream operations and formation of a new company, OVH Energy, which will hold interests in Oando Marketing Limited, Oando Supply & Trading Limited, Apapa SPM Limited, and Oando Trippmart Limited. OVH Energy will: (i) be the second largest downstream fuel company in Nigeria, (ii) be able to establish a strategic partnership which will leverage Oando's sector dominance, considerable local knowledge and expertise; together with HVI's international, and technical capabilities, and (iii) reinvigorate Nigeria's downstream sector to one of Africa's largest downstream operations.

The energy sector has continued to attract large private equity investments through a trend of partnerships and joint ventures by private equity funds and large global energy firms, as witnessed previously by Denham Capital and GreenWish Partners who partnered to develop, build and finance a portfolio of 600 MW of renewable energy assets across Sub-Saharan Africa. This can be attributed to the fact that the industry is capital intensive, thus the need of a private equity firm to provide capital and drive strategy, and the experience and track record required, thus the need for a global energy fund to compliment this.

Real Estate

Fusion Capital D-REIT

As indicated in our Cytonn Weekly #26, this week we are taking a closer look at the Fusion Development REIT, to further analyze the potential returns for investors. A REIT is a regulated investment vehicle that enables investors to collectively contribute capital as consideration for the acquisition of rights or interests in a trust divided into units with the intention of earning profits or income from real estate as trust beneficiaries. Kenya is a new entrant into the REIT market in Africa after the listing of its first REIT in October 2015 and the REIT has been trading, albeit on thin volumes. Currently, Kenya has two major types of REITs, which are (i) Income REITs, I-REITs, which generate income from yielding real estate assets, and (ii) Development REITs, D-REITs that acquire real estate properties for development and construction purposes. These two types of REITs can either be (i) open ended in that they can issue additional units or, (ii) close ended in that you can only issue units once.

As indicated in our Cytonn Report #25:

1. Fusion Capital, the promoter of the REIT, aims to raise Kshs 2.3 bn through the sale of 100.0 mn units closing on July 15th 2016, and will be listed on the Nairobi Securities Exchange on July 28th 2016,
2. Units in the REIT are targeted to professional investors, with a minimum application size of Kshs 5.0 mn, equivalent to 218,000 units,
3. The trust will be a close-ended fund and existing unit holders will have the right to approve the additional issuance of units for further funding of the REIT'S activities,
4. The Kshs 2.3 bn of money raised will be used to develop a mixed use development comprising of residential, office and retail project in Meru, Kenya, a project known as Greenwood City,
5. The base case construction period for the development is at 24 months, with a post-development period of 12 months for the REIT to earn rental income,
6. As per estimates from Fusion, the project will deliver Kshs 1.2 bn of profit, and a project IRR of 20.3%.

We carried out a valuation on the REIT and the project to analyze the offer and project returns associated. Using their cost and price provisions and assumptions, and factoring in our assumptions where necessary, we were able to deduce an expected total residue of Kshs 1.6 bn, a project IRR of 18.0%, and a return to equity holders of 20.0% as seen in the table below:

Equity Return Analysis - FRED							
(Kshs, unless stated)		**Oct-15**	**Jan-16**	**Jul-16**	**Jan-17**	**Jul-17**	**Jan-19**
Investments							
Initial Equity	(868,860,000)	(868,860,000)					
REIT Issue	(1,431,140,000)			(1,431,140,000)			
Returns							
Initial Equity	868,860,000						868,860,000
REIT Issue	1,431,140,000						1,431,140,000
Residue	1,564,921,721						1,564,921,721
Net Inflows/(outflows)	**1,564,921,721**	**(868,860,000)**	**-**	**(1,431,140,000)**	**-**	**-**	**3,864,921,721**
Equity IRR	**20.0%**						

Despite aggressive assumptions such as (i) 100.0% uptake for the residential apartments and 100.0% occupancy for the retail and office rentals, and (ii) 24 months' construction period for an over 50,000 square meter mixed use development, the FRED – COMMERCIAL is fairly valued.

On a Net Asset Value (NAV) valuation method, the equity investor in FRED receives an IRR of 21.0%, as can be seen below:

NAV Valuation Method - FRED				
NAV at 2019 (Kshs Mns)	3,696.4			
No. of outstanding shares	100.0			
Share Price at 2019	37.0			
Current Market Price	23.0			
IRR to Investor	**01/07/2016**	**01/01/2017**	**01/07/2018**	**01/01/2019**
Net Flows	(23.0)			37.0
Equity IRR	**21.0%**			

As compared to other investment opportunities such as a 5-year Kenya T-bond currently yielding 13.2%, FRED offers equity IRR of 20.5%, with the 2 valuation methods being equally weighted. In our view, given the 700 bps spread above the yield on the 5-year bond, we recommend investors' participation in the D-REIT. However, the key risk is the ability of the development to be executed within the defined parameters.

PDM enters Uganda:

Kenyan developer PDM Holdings has announced plans to start construction of high-end residential housing in Kampala, Uganda. The USD 10.2 mn development will comprise of 30 three-bedroomed luxury apartments, which will cost between USD 200,000 and USD 500,000. The development, targeting mid to high-income individuals, is set on a 1-acre land parcel in Kololo, an exclusive suburb of Kampala. Construction of the high-end units is backed by a 105.0% increase in high-net-worth individuals in Uganda between 2005 and 2015, according to Knight Frank's Wealth Report 2016, creating demand for luxury living standards.

Real estate in Uganda is still at infancy stage with the residential sector set to grow supported by:

i. **Population Growth:** Uganda has a large population of about 37.8 mn people and a very high growth rate of 3.0% compared to the overall world population growth of 1.2% and Kenya's growth rate of 2.4%,
ii. **Large Housing Deficit:** According to the Uganda Bureau of Statistics, there exists a large housing deficit of 550,000 units, with about 160,000 of the backlog being in urban areas,
iii. **Rapid Urbanization:** Uganda's urban population stood at approximately 7.4 mn in 2014 and is likely to increase to over 20 mn in 2040, according to World Bank. This is backed by large young population, who currently account for 75% of the population, migrating to urban centers in search for employment and education especially in Kampala, and,
iv. **Infrastructural Development:** A 10-year plan to upgrade Uganda's transportation network, amounting to USD 11.0 bn, and power generation is likely to open up new areas for real estate development. Other expected infrastructural developments include construction of Kabaale airport in Hoima, upgrade of Entebbe International Airport, as well as construction of the Standard Gauge Railway from Kenya, through Uganda, Rwanda, South Sudan and Burundi.

Despite its growth potential, Uganda's real estate is likely to be set back by the following limitations:

i. **Fluctuating Ugandan Shilling:** Depreciation in Uganda's currency undermines real estate growth due to high costs of importing building material, which results in higher overall project costs. In addition, it results in buyers spending more for the dollar-denominated property prices, as seen in 2015 when Uganda recorded a 17.5% depreciation against the US Dollar,
ii. **High Mortgage Rates:** A tightened monetary policy has resulted in high mortgage rates averaging between 21.0% and 23.0%. Investors are therefore likely to defer borrowing for development purposes, and individuals less likely to take mortgages for house purchase,
iii. **Bureaucracy in Property Registration:** Developers continue to face hurdles in property registration, due to lengthened processes and exorbitant costs. According to World Bank, Uganda ranked 161st in terms of dealing with construction permits, and 120th in property registration in 2016 while Kenya ranked 149th and 115th, respectively, and,
iv. **Low Income Population:** Uganda is still ranked a low-income population with over 50.0% of its population being poor (earning less than USD 2.0 a day), according to World Bank. This means despite the high demand for housing, a large majority cannot afford a low cost home costing USD 33,000.

Stima Sacco seeks to raise Kshs 5.0 bn:

As part of its strategy to expand and diversify funding sources, Stima Sacco has announced intentions to tap into the debt market through issuing a Kshs 5.0 bn corporate bond to finance its mortgage business. The Sacco

intends to offer long-term loans of between 10 – 15 years at a fixed interest rate with reducing balance. The move is expected to increase mortgage uptake, which is currently below 25,000 mortgages due to high interest rates and lack of long-term funding. Stima Sacco has been a developer of residential properties, and now seeks to finance buyers by requiring them to raise a maximum of 20.0% of the price as a deposit, then financing the remaining amount pegged on their contribution to the cooperative. Given that a 10 year Treasury bond is currently yielding 14.0%, working with a 200 bps premium above the 10 year Treasury bond, Stima Sacco is likely to raise funds to finance these mortgages for at least 16.0%. Therefore, Stima Sacco could lend out the mortgages at 18.0%, considering a 200 bps administration cost.

Saccos are increasingly enabling property-ownership through their investment cooperatives by exploiting economies of scale to acquire property, and then sell to its members at affordable prices. In addition, they have enabled access to loans for property ownership at rates as low as 1% per month. At a period of prevailing high interest rates and a tough operating environment, homebuyers and developers are likely to shy away from bank loans. There is therefore need for developers and financiers to explore means of issuing low cost financing options so as to increase mortgage uptake and consequently uptake of housing units.

Focus of the Week: Kenya Retail Space Report – "*Investor's Perspective on Kenya's Retail Sector*"

In our Cytonn Report #16, released in April 2016, we focused on the mortgage market in Kenya, to inform households on affordable areas to either buy or rent their houses based on their household incomes. Having also analyzed the commercial office sector in Nairobi, this week we turn our attention to the retail sector in Kenya. The retail market in Kenya, following increased supply in Nairobi, is expanding to the counties. In Kenya's attractive real estate sector, where total returns remain very attractive at about 25.0% p.a. over the last 5 years, the retail market has also benefitted and grown. Expansion over the years in the retail market has been driven by (i) GDP growth, which is has averaged 5.5% over the last five years and we forecast a 5.8% growth for this year, (ii) a rising middle class, (iii) increased purchasing power of the middle-class, and (iv) shifting consumer habits that have driven the development of new shopping malls, as Kenyans more increasingly visit formal retail centers.

With the increased mall supply in Kenya, currently at 394,500 SQM, and mall space in the deal pipeline to be delivered by 2017 of an additional 220,000 SQM, the public have come up with a hypothesis that there is oversupply of shopping malls in the Nairobi Metropolitan Area. To analyze and understand the public views, our Real Estate Research team, which supports both our Real Estate Investments and Real Estate Development teams carried out a research on retail space in Nairobi Metropolitan Area and key regions in Kenya, and came up with a report dubbed **"*Investor's Perspective on Kenya's Retail Sector*"** to inform investors on the best investment areas for retail in Kenya, considering 3 key-factors which drive investment into retail real estate, namely rental rates, occupancy levels and the income yield. The analysis of the retail sector shows us that increased supply in Nairobi County has led to developers focusing on the Nairobi Metropolitan and other counties, and increased development has been recorded in satellite towns in Kiambu, Kajiado and Machakos counties. With an average yield of 10.0%, and occupancy of 89.3%, Nairobi Metropolitan Area still remains one of the most attractive investment destinations for retail real estate.

From our survey and analysis on the real estate retail sector performance, we have the following 3 takeaways on yields by various classifications:

1. There are still attractive regions to invest in the retail sector, and Karen has the best return with a yield of 12.5%.

(all values in Kshs unless stated)			
Nairobi Metropolitan Area Retail Market Performance			
Location	**Rent / SQFT**	**Occupancy (%)**	**Yield (%)**
Karen	216.7	96.3%	12.5%
Westlands	231.4	92.0%	12.3%
Kilimani	209.3	86.0%	10.6%
Kiambu Road	187.3	90.0%	10.1%
Thika Road	187.1	89.3%	10.0%
Ngong Road	170.1	93.3%	9.7%
Satellite Towns	175.0	88.3%	9.3%
Mombasa Road	157.6	83.3%	8.2%
Eastlands	148.2	85.0%	7.5%
Average	**186.9**	**89.3%**	**10.0%**

- Karen and Westlands have the highest rental yields at 12.5% and 12.3%, respectively, while Mombasa Road and Eastland's have the least yields of 8.2% and 7.5%, respectively
- The high yields in Karen can be attributed to high occupancy rates, and the second highest rents in the Nairobi Metropolitan Area, with malls charging a premium for location and spending power of residents
- The Nairobi metropolitan area register high returns of rental yield 10.0% at 89.3% occupancy levels, compared to residential space at a rental yield of 6.0% and 85.0% occupancy

Source: Cytonn Research

2. The Mount Kenya and Nairobi regions have the highest yields while the rest of the regions are slowly gaining traction,

(all values in Kshs unless stated)			
Kenyan Retail Market Performance by Key Towns/Cities			
Location	**Rent / SQFT**	**Occupancy (%)**	**Yield (%)**
Mt. Kenya	151.5	90.0%	10.1%
Nairobi & Metropolis	192.3	89.3%	10.0%
Kisumu	170.2	75.0%	9.4%
Mombasa	154.7	76.7%	7.2%
Eldoret	105.6	83.3%	6.6%
Average	**154.9**	**82.9%**	**8.7%**

Cytonn INVESTMENTS

- Mt. Kenya and Nairobi region have the highest rental yields of 10.1% and 10.0%, respectively, while Eldoret Town has the lowest rental yield of 6.6%
- High rental yields in the Mt. Kenya region are as a result of the highest occupancy country wide, with lower relative construction costs compared to other regions

Source: Cytonn Research

3. Based on the sizes of the models, we classified the malls as below and analyzed their income yield:
    - **Destination Malls:** These are the largest malls, occupying space between 400,000 – 800,000 SQFT and characteristically have two or more anchor tenants,
    - **Community Centers:** These are the second largest mall types, occupying space between 125,001 – 400,000 SQFT and characteristically have zero to two anchor tenants, and,
    - **Neighborhood Centers:** These have the minimum mall space, occupying at least 20,000 SQFT and characteristically have a maximum of one anchor tenant, however in most cases have none.

(all values in Kshs unless stated)

Kenya Retail Market by Cytonn Classification			
Class	**Rent / SQFT**	**Occupancy (%)**	**Yield (%)**
Destination	204.8	94.0%	11.7%
Community	183.5	85.0%	9.8%
Neighborhood	166.5	88.0%	9.2%
Average	**184.9**	**88.9%**	**10.2%**

- Destination malls outperforms other mall classes, with an average rental yield of 11.7% and occupancy of 94.0%. This can be attributed to destination malls commanding a premium on rents due to the amenities they provide, as well as attracting a clientele with a higher purchasing power in the formal retail centers.

Source: Cytonn Research

As per our analysis on the retail market sector, using the following 4 metrics; yield rates, current mall supply, income/ GDP per capita and upcoming mall supply, below is the comprehensive ranking of the viable retail space opportunity according to location performance.

The key takeout's being:

- Kilimani ranks the most viable location to set up a shopping mall, while Mombasa Road ranks as the least viable location. Kilimani being the most viable location can be attributed to (i) low mall supply, (ii) attractive yields of 10.6%, and (iii) a high earning population that spends in formal retail centers. Mombasa Road is the least attractive due to with high supply of retail space at low yields and low purchasing power in the area, and,
- Satellite towns along Kiambu Road rank position 4 across Kenya for attractiveness in developing retail areas, and the best location to set up a shopping mall among other satellite towns, as a result of high yields and high income levels in the area.

To understand our weighting metric, and for a comprehensive analysis on the ranking and methodology behind it, see our Cytonn Retail Space Report.

Retail Space Opportunity Across Kenya – Comprehensive Ranking	
Location	**Rank**
Kilimani	1
Karen	2
Westlands	3
Satellite Towns - Kiambu Road**	4
Ngong Road	5
Satellite Towns - Thika Road*	6
Mombasa	7
Kajiado	8
Eldoret	9
Kiambu Road	10
Thika Road	11
Satellite Towns- Mombasa Road***	12
Mt. Kenya Region	13
Eastlands	14
Kisumu	15
Mombasa Road	16

**Includes Satellite Towns in Thika Road such as Thika and Juja*
***Includes Satellite Towns in Kiambu Road such as Ruaka and Limuru*
****Include Satellite Towns in Mombasa Road such as Athi River and Syokimau,*
Source: Cytonn Research

Consumer Perspective:

We went further to find out on the consumer spending habits and the key retailer's sentiments on the market, and the following was the output.

- Kenyan consumers shop mainly on a weekly basis with 47.0% shopping weekly in supermarkets, which are mainly the anchor tenants for various malls,
- Consumers frequent the shopping centers mainly to look for food stuff, fast moving consumer goods, among other items,
- Kenyan consumers have a preference for local products as opposed to imported goods, with 63.0% of respondents indicating a local brand preference, largely driven by the affordability of local brands,
- Online shopping has affected the number of visits with 40.0% of the consumers indicating that their trips to the shopping malls have reduced due to shopping online.

Industry Players' Perspective:

On retailer's sentiments, the following was the key takeout:

Measure	Sentiment	Outlook
Current State	Young vibrant market with high population capable of driving demand	Positive
Future Expectations	Expectations of growth at a high rate. More players to enter the market, especially foreign players	Positive
Strategies	Expansionary and fundraising strategies, differentiation in terms of product offering and sector focus	Positive
Products	FMCG is the key product line in Kenya	Positive
Challenges	Challenges, which can be mitigated, include international matching and scarcity of suitable space	Positive
Last Takes	Retailers are bullish on market performance expecting revenue increases of 10.0-20.0%	Positive

In Conclusion: There is an increase in the supply of retail space with 220,000 SQM expected to be completed by 2017, and the yields remain attractive with high occupancy rates. Consumers are showing a preference for formal retail over the informal market especially due to the convenience that the stores allow them in product provision. The sector is thus headed for continued growth. The opportunity is still largely in Nairobi despite its increasing supply in some nodes. Nairobi's satellite towns, which are experiencing heavy population influx provide a good opportunity for investment as well as some nodes with little supply such as Kilimani. ***Cytonn Real Estate Retail Market Report***

Disclaimer: The views expressed in this publication, are those of the writers where particulars are not warranted- as the facts may change from time to time. This publication is meant for general information only, and is not a warranty, representation or solicitation for any product that may be on offer. Readers are thereby advised in all circumstances, to seek the advice of an independent financial advisor to advise them of the suitability of any financial product for their investment purposes.