RESEARCH

Knight Frank

KENYA

MARKET UPDATE - 1ST HALF 2016

The Hub Shopping Mall, Karen

HIGHLIGHTS

- Kenya's economic outlook remains positive
- Kenya shilling stabilises
- Government incentives boost real estate sector
- Development REIT launched
- Prime retail rents plateau
- The Hub opens for business
- Office absorption levels on the rise
- Slight dip in prime residential rental market
- Residential mortgage market on steady rise
- Prime residential sale prices plateau
- Diversification in the hospitality sector through MICE
- Hotel rankings released

The Economy

The Kenyan economy has seen a similar growth pattern as experienced in 2015. Q1 of 2016 had a 5.9% growth rate in comparison to the 5.0% GDP rate in 2015 of the same review period. The World Bank has predicted the GDP levels of 2016 will remain at 5.9%, which is an increase from 2015's 5.6%. These expansions are indicators that the economic sectors have had signs of positive growth specifically agriculture, construction, real estate, finance and insurance. The Sub-Saharan Africa annual GDP rate is expected to drop from 3.0% in 2015 to 2.5% in 2016. The main factors that are expected to contribute to this drop include low commodity prices, tightening financial conditions, droughts within certain Sub-Saharan Africa parts, natural disasters, and security and political challenges within the region.

Construction and real estate were some of the key sectors that have contributed to Kenya's GDP growth in 2016. The construction industry expansion experienced a slight reduction of 9.9% in Q1 2016 compared to 12.6% in Q2 2016. Consumption of cement increased from 3.0 million MT in the 2nd half of 2015 to 3.1 million MT in the 1st half of 2016. Production of cement also experienced an increase from 2.9 million MT in the 2nd half of 2015 to 3.0 million MT in the 1st half of 2016. Similar to the 2nd half of 2015 developers maintained a positive outlook towards the future as the value of approved building plans increased from circa KSh140 billion in the 2nd half of 2015 to KSh157 billion in the 1st half of 2016.

The Monetary Policy Committee (MPC) has implemented several changes within the 1st half of 2016. The Government's target range of inflation was achieved when rates dropped to 5.3% in April due to the fall in prices of food items and fuel. The National Government budget deficit is expected to narrow in the financial year 2015/2016 which will ease pressure on interest rates. The Central Bank of Kenya maintained the Kenya Bank's Reference Rate at 9.87% all through the 1st half of 2016 while the Central Bank Rate reduced from 11.5% by 100 basis points to 10.5% within the 2nd quarter of 2016. Commercial banks' lending rates started decreasing within the 1st quarter of 2016 from 19.96% in January to 17.79% in March, however the 2nd quarter of 2016 saw a marginal increase up to 18.53% in June. Month-on-month inflation generally fluctuated between 7.78% and 5.80% but were largely contained within the Central Bank's target rate throughout the year.

The Kenya Shilling remained within the same range within the 1st half of 2016 as the 2nd half of 2015 against the US dollar, Euro and Sterling Pound. Towards the end of the 1st half, the Sterling Pound had a significant drop against the Kenyan Shilling that was mainly attributed to the United Kingdom's exit from the European Union (Brexit). The currency gained by 916 basis points to close at KSh136.29 against the pound.

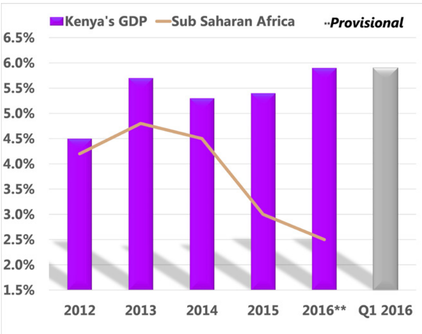
Diaspora remittances increased to circa US$446 million in Q2 of 2016 compared to US$390 million in a similar period in 2015. The share of diaspora remittances to Kenya from North America showed a similar pattern as the last half of 2015, by contributing 49% of the total cash inflows. The amount remitted from North America as of Q2 2016 was US$218 million.

The first half of 2016 saw the reading of the Kenya 2016/17 Budget Statement, which touched on the real estate market. Some of the key proposals included:

Corporate Tax Rate Incentive: Key from the 2016/17 Budget was the incentive through the Finance Bill 2016 that the Government has provided developers with reduced corporate tax rates from 30% to 20% for developers who construct at least 1,000 units of low-cost housing per year. As noble as the incentive is, it targets less than 1% of the developers in the market.

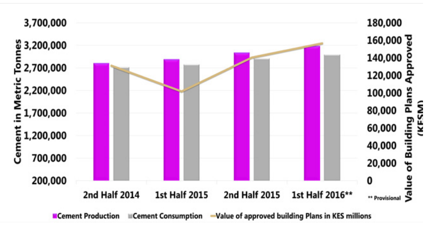
Capital Gains Tax Incentive: The Finance Bill 2016 proposed to scrap the Capital Gains Tax (CGT) on transfer of property from parents to their children and those of former spouses. In the past, only spouses and immediate family

FIGURE 1:
GDP Rates



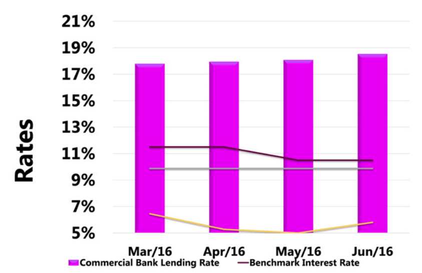
Source: KNBS & World Bank

FIGURE 2:
Value of Building Plans Vs Cement Consumption



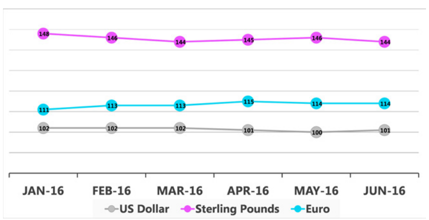
Source: KNBS

FIGURE 3:
Benchmark Economic Rates



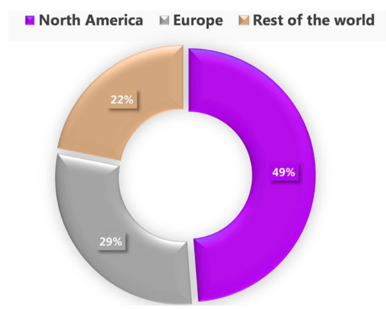
Source: Central Bank of Kenya

FIGURE 4:
Foreign Currency Exchange Rates



Source: KNBS

FIGURE 5:
Remittance Inflow Share by Source Q2 2016



Source: Central Bank of Kenya

members in cases of divorce settlements were exempted from CGT. This will correct the anomaly in taxation of land whose gains have not been realised. The move will ease the succession process which traditionally would take much longer to effect property transfers. While this is likely to reduce revenues for the government, it goes a long way to easing land ownership barriers, as a large majority of Kenyans own land through succession. However, this will further aggravate the inequality in the Kenyan society where heirs will get assets without paying any taxes to the public.

Regulatory Authorities Fees Incentive: The government has scrapped NEMA and NCA fees, which were previously charged at 0.1% and 0.5% of construction costs, in an effort to reduce the cost of construction. Though the incentives are admirable, they are yet to be backed up by the requisite statutes.

The 1st half also saw increased foreign investment in Kenya's real estate sector, with activity from Actis, Helios Investment Partners and China Africa Development Fund (CADFund).

Actis closed the Actis Africa Real Estate Fund 3 (AAREF3) with commitments totalling US$500 million, surpassing its initial US$400 million target. The fund will invest predominantly in retail, office and industrial developments in the capital cities of 7-8 Sub-Saharan Africa markets. AAREF 2, which developed Kenya's Garden City, closed in October 2012 with commitments of US$278 million.

China Africa Development Fund (CADFund) in the 1st half of 2016 partnered with the government to fund housing development in an attempt to address the housing shortage in the country. One of the projects earmarked to benefit from the partnership is Ngara City, a redevelopment project that involves pulling down old houses in Ngara Estate and constructing new ones. The goal of this project is to increase the capacity of residential dwellings through the construction of high-rise developments to provide affordable housing.

Helios investment partners, the new majority shareholder of Telkom Kenya, announced plans to set up a real estate division to tap into the company's multibillion property holdings that span the country. Amongst its prime assets is a 39.1 hectare piece of land along Ngong Road in Nairobi City County.

Financial Market

REITs continued to debut in the financial markets, with the approval of first Development REIT in the country.

According to the Information Memorandum issued on 20th June, Fusion Capital, the promoter of the Fusion Real Estate Development Trust (FRED Commercial), aimed to raise KSh2.3 billion through sale of 100,000,000 units, each at KSh23. The proceeds of the sale were to be used to acquire a six-acre plot in Meru town to develop a mixed-used project. Known as Greenwood City, it would comprise a retail centre (27,000 sqm), a six-storey office block (16,000 sqm) and 53 apartments (7,878 sqm). The offer was restricted and only professional investors were permitted to buy. Investors in the D-REIT required a minimum of KSh5 million, equivalent to 218,000 units, to participate in the offer, which primarily targeted fund managers and high net worth individuals.

REITS remain a new product and may initially require an industry initiative or a government sponsorship to attract investors. This may be in the form of providing some level of principal plus minimum return guarantees to buyers to make them comfortable that issuers are convinced about their REIT's returns. So far, all the real estate-related listings (Home Africa and Fahari I-REIT) have not been successful in the market, making it extremely difficult for future offers.

Infrastructure

The Kenya National Highways Authority (KeNHA) and the China Road and Bridge Corporation (CRBC) signed a deal for the engineering procurement and construction of the proposed 17-kilometre Nairobi Western Bypass Project at a cost of KSh17.3 billion. The Western bypass will link Ruaka to the Nairobi-Nakuru Highway. Similarly, China Wu Yi Co. Ltd was awarded the contract for the reconstruction and capacity enhancement of the James Gichuru junction-Rironi (A8) road at a cost of KSh16.4 billion. The reconstruction works of the 25-Km section will be funded by the World Bank Group and Government of Kenya under the National Urban Transport Improvement Project (NUTRIP) and will take a period of 36 months.

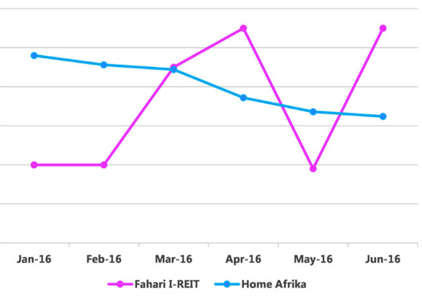
More than 75% of the civil works of the KSh420 billion Standard Gauge Railway Phase I, Mombasa to Nairobi, has been completed, with an over 235Km trackline laid between Voi and Sultan Hamud. Major progress has been made on construction of 33 stations, including 23 passing stations, eight intermediary stations and two major stations in Mombasa and Nairobi.

The second phase of the project will cover 487Km from Nairobi-Kisumu-Malaba and it is divided into three sub-phases. These phases include 2A, which is 120Km from Nairobi to Naivasha. Financing has been identified and construction is expected to start in the 2nd half of 2016.

Phase 2B, which is 262Km, will stretch from Naivasha-Narok-Bomet-Ahero-Kisumu, while Phase 2C will cover 107Km from Kisumu-Yala-Mumias-Malaba.

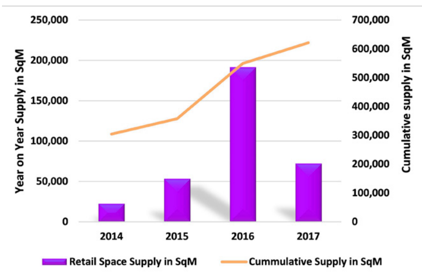
Ngong Road's Phase 1 dualisation started in April after the contract was awarded to World Kaihatsu Kogyo Ltd, a Japanese construction company. The expansion to dual carriageway will cover a 2.6Km stretch from the Kenya National Library to the Ring Road Kilimani junction.

FIGURE 6:
Real Estate-Related Listings



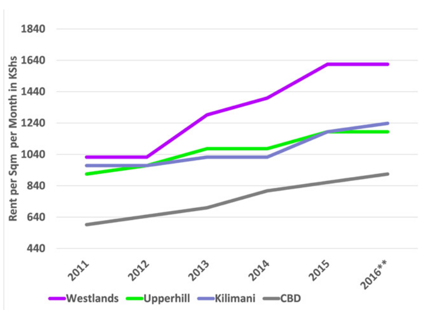
Source: Nairobi Securities Exchange

FIGURE 7:
Nairobi Supply of Retail Space



Source: Knight Frank Kenya

FIGURE 8:
Average Prime Rental Rate per Year per Sqm (2016)



Source: Knight Frank Kenya

The programme is sponsored through a grant from the Japanese government's Economic Cooperation Programme Project at a cost of KSh1.3 billion.

Retail

- Asking rents stagnate
- The Hub opens for business
- More retail outlets in pipeline

Carrefour, the French retail chain, opened its doors in the early part of 2016 at The Hub, an upmarket shopping mall in Karen. The retail giant, whose target clientele is mid to high-end, took up 7,000 sqm of the 34,000 sqm facility representing 20% of the development. This is the first entry of the chain store into the market, with the second outlet expected to be in the Two Rivers Mall in Ruaka where it will take up almost 10,000 sqm and is expected to open in the 2nd half of 2016.

Other major takers at The Hub include Adidas, Reebok, Ocean Basket, Bossini, Burger King, Dominos, Knight Frank and various retail banks. The mall is also targeting commercial office occupiers through the provision of office space on the upper floors. The opening of the mall resulted in a tangible decline in foot and vehicular traffic in existing neighbouring retail centres, with the most adversely affected being Crossroads Mall in Karen.

Occupancy levels in well-established malls in Nairobi such as The Junction and Sarit Centre remain high, indicating strong demand for retail units in the right location.

In Nairobi, the introduction of new centres and expansion of existing ones is likely to place a downward pressure on rents in the short to medium term. Landlords are becoming more flexible on lease terms, offering partially fitted out premises, longer rent-free periods, a freeze on rent escalations and exploring other alternatives such as revenue-based rents, all in an effort to attract and retain the right occupiers to meet their tenant-mix strategies.

Prime retail rents remained unchanged in the 1st half of 2016 at US$48/sqm/month. We anticipate that this trend will continue into the 2nd half of 2016 as new retail developments come online.

The absorption levels remained stable in the 1st half of 2016 with the supply making conditions ideal for incoming tenants.

Sarit Centre in Westlands broke ground on Phase 3 of the mall that will inject another 30,000 sqm of retail space into the Westlands sub-market. This is expected to be completed in 2019.

Major retail announcements in the 1st half of 2016 include: The Montave at The Hill (18,000 sqm); Athi River Centre in Athi River, a project by Stanlib that is to be developed in phases with phase one comprising of circa 13,000 sqm; Mlolongo Mall in Machakos County, a mixed-use development that will comprise approximately 16,000 sqm of retail space; Kileleshwa Mall, a development by BRITAM; Vantage Mall along Thika Road; and Enterprise Mall along Mombasa Road that is to be developed by the Sameer Group.

Office

- Absorption levels of new office stock on the rise
- Asking rents remain stable
- Supply of office space steady

TThe 1st half of 2016 experienced a 28% rise in the absorption of Grade A and B office space compared to the 2nd half of 2015, and a 22% rise compared to a similar period in 2015.

The increase in absorption of office space is attributed to the increased supply of prime Grade A offices, coupled by the fact that some multinationals are upgrading or consolidating their offices to one location. Despite this, asking rents remained stable as developers looked to counter the increasing supply. In addition, government institutions, which were traditionally major takers of the space, are devolving their functions to county levels. The upward trend in the absorption of office space will continue into the 2nd half of 2016 as the bulk of circa 300,000 sqm of commercial office space in the Nairobi office market comes online and as prospective tenants close on the available stock.

As forecasted, prime headline rents remained stable in the 1st half of 2016 at US$21/sqm/month, although these are expected to increase marginally in the 2nd half of 2016 with prime asking levels remaining steady in the US$14/sqm/month range.

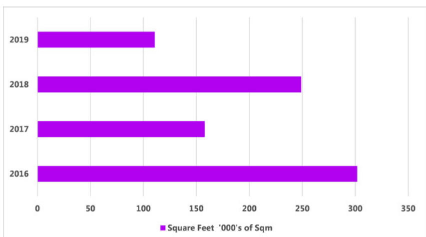
Typically, lease take-up has continued to be in the range of 1,000-3,500 sqft, with large occupiers of office space being the exception rather than the norm.

The sales market remained stable in the 1st half of 2016 with several office developments up for sale in the market. These include; The Watermark in Karen, FCB Mihrab in Kilimani and Fortis Office Park in Westlands. Demand for strata sales remained steady as the supply fell in the period under review, with prices in the range of KSh130,000-150,000 per sqm, exclusive of VAT.

Notable completions in the 1st half of 2016 are UAP Old Mutual Tower with a lettable area of 30,000 sqm, of which 45% had been let. Other major completions in Upper Hill include Flamingo Towers (13,000 sqm) and Mwalimu Cooperative Credit Society (10,000 sqm). The major completion in Westlands was the 6,600 sqm Rivaan Centre, a development by the Sameer Group. Also in Westlands, Alexander Forbes broke ground on its 12,500 sqm office block along Peponi Road.

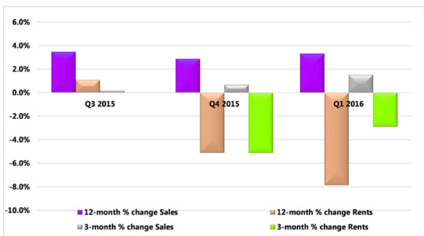
Major pipeline developments include the KSh4 billion commercial office building by the Kenya Reinsurance Company in Upper Hill which is still in its planning stages, and the Hass Tower also in Upper Hill purportedly Africa's tallest building.

FIGURE 9:
Prime Rental Rate per Month per Sqm (2009-2015) & Yields



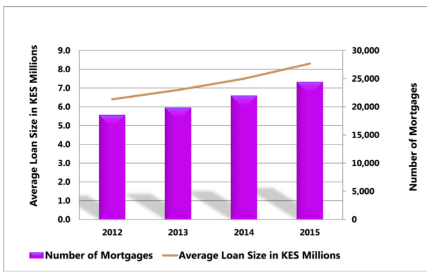
Source: Knight Frank Kenya

FIGURE 10:
Prime Nairobi Residential % Change Over Time



Source: Knight Frank Kenya

FIGURE 11:
Average Mortgage Size Vs Number of Mortgages



Source: Central Bank of Kenya

Residential

- Marginal price increases
- Falling prime rents
- Increase in size and number of mortgages
- Developers remain bullish supported by government incentives

Sale prices of luxury homes in Nairobi increased by a modest 1.3% in the first six months of the year compared to a 2% appreciation over a similar period in 2015.

While supply in the prime residential market has been growing gradually, local high net worth individuals looking to buy are only settling for best-in-class properties, with currently more options to choose from.

The stability in luxury residential prices also reflects the relatively steady macroeconomic conditions, without major impacts from external shocks. Transactions are still happening in low volumes, as is the nature of this niche market.

In contrast, prime residential rental prices in Nairobi decreased by circa 8% between December 2015 and June 2016 compared to a nil percentage decline over the same period last year.

The decline was occasioned by increased supply, giving tenants choice and room to negotiate with landlords. The top-end market segment is dominated by expatriate tenants, who pay out of their accommodation allowances or are housed under corporate arrangements. The slowdown in the oil industry resulted in downsizing of operations by firms in the sector and allied service providers.

This trend is expected to continue into the 2nd half of 2016 as corporate budgets for housing costs remain under pressure.

In the middle income residential market, major residential developments that began in the 1st half of 2016 include a 130 apartment complex in Spring Valley being developed by Bric Company Limited and a middle income residential housing complex comprising of 560 2-bedroom and 3-bedroom units being developed by Agricultural and Industrial Holdings Limited at a cost of approximately KSh3 billion.

The biggest influence for the low income earners continues to be the national government through the Kenya Slum Upgrading Programme (KENSUP) under the Ministry of Housing. Consequently, approvals were granted for the development of residential flats and social amenities in Kibra at a cost of Ksh1.3 billion.

Another major proposed mixed-use development in the pipeline is The Montave, a 35-storey development by Greenfield Developers Limited in Upper Hill at a cost of approximately KSh5.6 billion.

In Mombasa, the county government has initiated plans to redevelop its 11 housing estates through a short-term public-private-partnership (PPP) venture. Private investors are expected to inject in excess of KSh5 billion.The first phase of the project is aimed at developing two new estates and redeveloping seven old ones into modern housing estates with improved facilities and infrastructure to meet the rising demand for housing in the county. The estates earmarked for modernisation are Khadija Estate, Miritini Greenfields, Shimo La Tewa Greenfields, Changamwe, Tudor, Buxton, Mzizima, Likoni and Nyerere Estates. This comes as Nairobi County government awarded contracts for the redevelopment of its old residential estates.

The recently released Central Bank of Kenya statistics show the number of mortgages increased in 2015 by circa 11.1% as a result of the relatively favourable interest rates. Similarly, the average mortgage size increased by 11% to KSh8.3 million in 2015, from KSh7.5 million in 2014.

The main impediments to the mortgage market include high property costs and high interest rates.

Hotel & Tourism

- Diversification of tourism
- Hotel rankings released
- Pipeline establishments on track

Kenya is diversifying its tourism portfolio from its traditional beach and wildlife parks to include gastronomy, cultural festivals and conferences. To this end, the Ministry of Tourism in the 1st half of 2016 established the Hotel Refurbishment Fund that will be used to renovate and expand existing hotel facilities. The funds were sourced from World Bank and the French Government and will be issued to qualifying hotels at rates of between 6% and 9%.

The Kenya Tourism Regulatory Authority concluded its recent hotel rankings for Mt. Kenya, Coast, Western Kenya and the Greater Rift Valley regions. The Mt. Kenya region stood out with five developments getting 4-star ratings and above. This comes amidst poor performance in the hotel sector, particularly in the coastal region as a result of low international tourist arrivals. It is expected that this rating will open the Mt. Kenya region to a wider target market of both local and international tourists as it continues to offer packages for the domestic market such as weekend getaways and family packages. In addition, we expect the decrease in arrivals to reverse in the 2nd half of 2016 as several international conferences have been lined up that will greatly boost the tourism sector.

Hemingways announced plans to put up a 39-room boutique hotel and 15 luxury apartments at its Hemingways Watamu Resort. The facelift of the already existent 74-key resort will be at a cost of US$9 million and it is scheduled to open in February 2018. The need to undertake the improvement was to match the standards of the other developments by Hemingways in Nairobi and Olseki in the Maasai Mara.

Major hotels in the pipeline include Park Inn by Carlson Rezidor, JW Marriot, and Four Points by Sheraton. Tune Inn and Pullman by Accor Hotels have now opened their doors for business.

Industrial Market & Redevelopment Land

- Special Economic Zones receive boost
- More industrial parks in pipeline

Special Economic Zones are set to receive a boost through the enactment of the Finance Bill 2016 that seeks to amend The Special Economic Zones Act (No.16 of 2015) so as to provide tax incentives in respect to Special Economic Zones. This will create competition for traditional industrial areas and Export Processing Zones, as investors in these areas will be tax exempt. Apart from Mombasa, the government also targets to set up SEZs in Kisumu and Lamu to spur regional trade. The Kisumu facility is aimed at growing export trade within the East Africa Community (EAC) and the Great Lakes region.

We expect that these areas will gain popularity in the long term as demand for new and quality stock in the right locations remains high. Infrastructure improvements such as the Mombasa Port Area Development Authority will also assist in attracting more occupiers.

With regard to the existing secondary industrial stock, we expect elevated vacancy levels, underpinned by an increase in prime grade options as tenants upgrade and consolidate from multiple sites into purpose built facilities. Prime industrial rentals for secondary stock remained in the region of between KSh270-475 per sqm per month depending on location and build quality.

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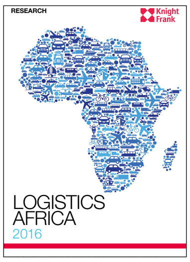

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