Kenya Listed Banks Q1’2020, & Cytonn Weekly #24/2020

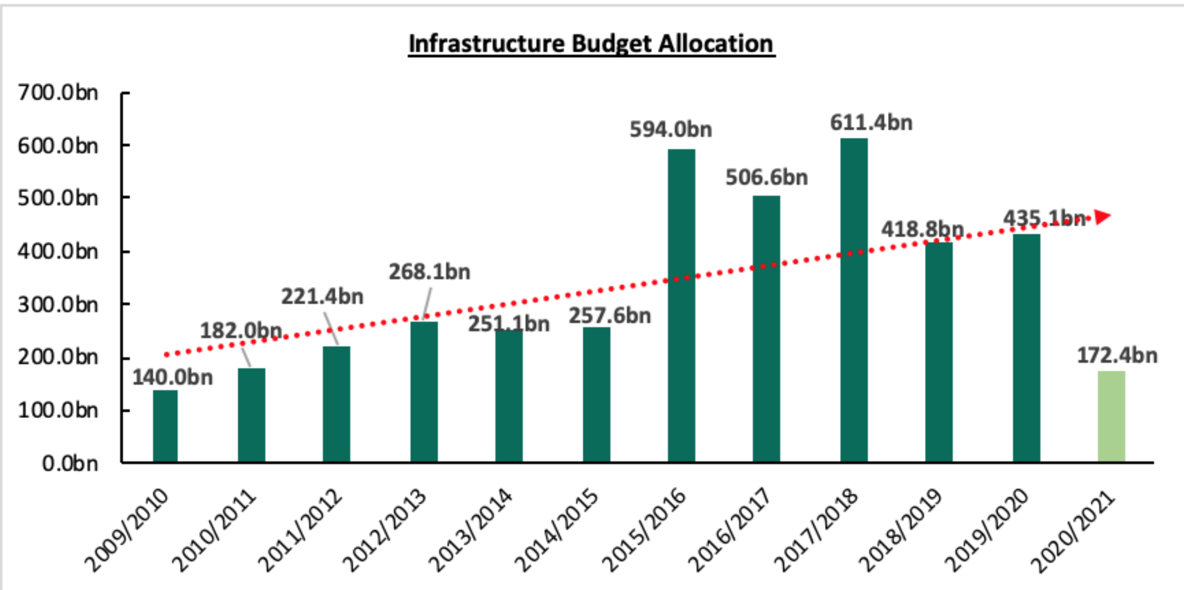
Real Estate

I. Industry Reports

During the week, the National Treasury read the FY 2020/21 budget statement themed, “*stimulating the Economy to Safeguard Livelihoods, Jobs, Businesses and Industrial Recovery.*” According to CS Treasury, Ukur Yatani, the budget seeks to implement a rapid economic stimulus programme and lay down a firm post COVID-19 economic recovery strategy. The key take outs relevant to the real estate sector were;

?. **Infrastructure: The infrastructure sector was allocated Kshs 172.4 bn, 60.4% lower than the 435.1 bn allocated in the 2019/2020 budget. This is the lowest allocation in the last 10 financial years attributed to a projected revenue shortfall in the wake of a slowdown in the economy due to disruptions by the COVID-19 pandemic. The funds will mainly be channeled towards the Standard Gauge Railway (SGR) Phase II (Nairobi-Naivasha), Lamu Port and Lamu-Southern Sudan-Ethiopia Transport Corridor Project (LAPSSET), and, Mombasa Port Development Project. The reduced allocation towards infrastructure is attributed to the constrained budgetary room that the government finds itself in as it grapples with economic effects of the COVID-19 pandemic. We expect the reduced budget allocation to result in subdued real estate development activities especially in areas that are yet to witness the much needed infrastructural development such as roads and other trunk infrastructure.**

Below is the budget allocation towards infrastructure over the last 11 years:



Source: National Treasury

ii. **Affordable Housing Programme: The affordable housing sector was allocated Kshs 6.9 bn, a 34.3% reduction from the Kshs 10.5 bn allocated in 2019/2020. This coupled with the proposed removal of the home ownership savings plan tax relief, is expected to severely dent the National Government's Big Four Agenda on improving the home ownership rate in the country, leading to slowed supply of affordable housing units,**
iii. **Removal of the House Ownership Savings Plan tax relief:** The National Treasury proposed removal of the HOSP tax relief under the Income Tax Act, with the aim of boosting tax collections. Currently, depositors are allowed tax rebates of Kshs 8,000 per month maximum or Kshs 96,000 per annum (effectively reducing an individual's taxable income by the amount of their monthly contribution). If approved, we expect this to cripple home ownership especially among low middle-income households, thus slowing down the government's affordable housing initiative,
iv. **Residential Income Tax:** The National Treasury proposed expansion of the bracket of individuals paying rental income tax on the total annual rental income collected to up to Kshs 15 mn, up from the previous threshold of Kshs 10 mn. The monthly rental income tax was introduced in 2016 under the Income Tax Act stating that any individual collecting rental income between Kshs 140,000 – 10 mn, pays a 10.0% rental income tax on total rent collected annually. In our view, the expansion of the bracket will lead to an uptick in revenue collections by the government from landlords at a time when the government is experiencing reduced revenue collections, however, some property owners may opt to raise their rents in a bid to cover for the lost margins, and,
v. **Hospitality Sector:** Under the 8-point stimulus programme, the hospitality sector was allocated Kshs 3 bn in support of the post COVID-19 tourism marketing and hotel refurbishment through soft loans to be channeled through the Tourism Finance Corporation (TFC). This is in addition to the Kshs 2.5 bn set aside for the Tourism Promotion Fund (TPF), and, a further Kshs 3.8 bn set aside for the Tourism Fund. We expect the funding to ease financial distress on hospitality facilities in the wake of reduced revenue inflows due to the COVID-19 pandemic.

We expect the government to sustain the real estate sector through measures such as; (i) issuance of infrastructure bonds such as the Kshs 25.6 bn infrastructure bond floated by the Central Bank of Kenya (CBK) in May this year aimed at assisting the Government in financing various infrastructure projects, and, (iii) incentives introduced by the National Government aimed at private developers who intend to undertake affordable housing projects such as reduced custom tariffs on imported inputs for construction of houses under the affordable housing scheme. For instance, Import Declaration Fee (IDF) has been reduced from 2.0% to 1.5%. Additionally NEMA and NCA levies of 0.1% and 0.05% of the cost of construction respectively, have been scrapped. Also, the government has reduced corporate tax for property developers who build a minimum of 100 low-cost units under the affordable housing programme by half, from 30.0% to 15.0%. We expect to see private sector developers undertaking affordable housing projects targeting the low and middle income earners as the segment presents an investment opportunity supported by the growing demand and the tax incentives associated with the same.

II. Residential Sector

During the week, six banks committed Kshs 335 bn in mortgages to fund the Affordable Housing Programme. The institutions include Equity Bank, Kenya Commercial Bank (KCB), NCBA, Stanbic Bank, Absa, and, Housing Finance. According to the Ministry of Housing Principal Secretary, Charles Hinga, the banks will finance potential home owners to purchase both government-built houses and units delivered by private developers registered on the Boma Yangu portal. Key to note, the government will offer partial credit guarantee that will cover up to 20.0% of the approved loans. The move is part of the ongoing efforts by the private sector to support the National Government's goal of increasing home ownership in the country. This comes at a time when the Government struggles to raise funds geared towards implementation of the affordable housing programme which has led to a reduced budgetary allocation to the programme alongside the prolonged operationalization of the Kenya Mortgage Refinancing Company (KMRC) which seeks to create liquidity for primary mortgage lenders making it possible for mortgage originators to offer long-term mortgages, at relatively low interest rates and better terms and conditions. Home ownership in Kenya has mainly been constrained by the relatively high cost of housing units and limited access to affordable long-term finance as mortgage uptake remains low with 26,187 mortgage accounts as at December 2017 out of an adult population of 23 million. The low uptake of mortgages is mainly attributed to; (i) low-income levels that cannot service a mortgage, (ii) soaring property prices, (iii) high interest rates and deposit requirements which lock out many borrowers, (iv) exclusion of employees in the informal sector due to insufficient credit risk information, and, (v) lack of capital markets funding towards real estate purchases for end buyers. In our view, the above move will enhance availability of home loans thus resulting in an increase in mortgage uptake. It is good to note that approximately 25,000 Kenyans are actively making contributions through the Boma Yangu portal, according to online sources. In addition, we expect the partial guarantee by government to attract potential home buyers and enable self- employed and informal sector employees to access bank mortgages, hence facilitating home ownership. However, we expect to see more public private partnerships between private developers and county government aimed at producing more housing units to cure the expected demand.

III. Retail Sector

During the week, Carrefour Supermarket, an international retailer, opened a new store along Uhuru Highway in Nairobi, taking up 40,000 SQFT of space previously occupied by Nakumatt Mega, who vacated the premises last September. This marks the retailer’s 8th branch locally, with some of the other outlets being located at; The Hub in Karen, Village Market in Gigiri, Two Rivers Mall in Ruaka, Thika Road Mall (TRM) along Thika Road, Sarit Centre mall in Westlands, The Junction along Ngong road, and, Galleria Mall in Karen. The multinational retailer has continued to expand its foothold in the Kenya retail market since its first store in 2016 supported by; (i) its ability to leverage on its scale and operational know-how to become one of the leading retailers locally. The company’s revenues recorded a 28.0% rise in 2019 to Kshs 18.7 bn from Kshs 14.6 bn in 2018, (ii) availability of funding evidenced by the Kshs 3.0 bn loan from Standard Bank Group in May this year, and, (iii) availability of prime locations vacated by struggling supermarket chains such as Nakumatt and Uchumi. The continued expansion of local and international retailers such as Carrefour and Quickmart is a welcome move for retail sector investors, following the increased vacancy rates in the sector driven by retailers shutting down their operations to cushion themselves against the impact of the Coronavirus pandemic and the fall of struggling retailers namely, Nakumatt, Uchumi and Botswana’s Choppies. Despite effects of the Coronavirus pandemic, we expect the retail sector to be cushioned by the increased prevalence of e-commerce by consumers and the gradual easing of movement restrictions by the National Government, especially within Nairobi Metropolitan Area, resulting in a slight increase in footfall in the CBD and other retail nodes.

IV. Hospitality Sector

During the week, Tourism Finance Corporation (TFC), a financial institution with the mandate of facilitating and providing affordable development funding and advisory services to the Kenyan tourism industry, restructured Kshs 634 mn loans to hospitality facilities affected by the Covid-19 pandemic. The move is a measure by the National Government to ease financial distress on hospitality facilities in the wake of reduced revenue inflows attributed to the ongoing COVID-19 pandemic. The sector has been impacted due to its reliance on tourism and conferencing which has meant that the travel restrictions, social distancing rules, and, the current ban on international flights has led to reduced demand for hospitality services. TFC also initiated talks with local banks to ensure the Kshs 2 bn tourism stimulus package released by the National Government, reaches hotel operators in a deal expected to see TFC, banks and individual lenders agree on restructuring packages before the money is released to the banks. The funds are expected to be utilized in the renovation of existing facilities and the restructuring of business operations, thus boosting the sector. We expect the move by TFC, coupled with other government measures such as the formation of the National Tourism and Hospitality Protocols Taskforce meant to develop tourism and hospitality protocols and guidelines in response to COVID-19, to support the sector's recovery.

V. Industrial Sector

During the week, Tatu City, a comprehensive mixed use development and special economic zone, received approval from the National Environment Management Authority (NEMA) for the development of its second phase, which will cover 2,500 acres. The first phase of the city also covered 2,500 acres which comprised of 520 acres designated for residential developments, commercial land, and, 457 acres of industrial land under the Tatu Industrial Park that has seen Africa Logistics Properties (ALP) launch the ALP North Industrial Park, a 49,000 SQM warehouse facility in Tatu City. The go ahead will see Kenya Wine Agencies become the first company to set up base in the city's second phase adding to the list of 50 other companies that developed within the city's first phase, among them; Chandaria Industries, Dormans, and, Davis & Shirtliff. In addition to the availability of high quality industrial space, the continued demand for industrial space by local and international companies has mainly been bolstered by Tatu Industrial Park's Special Economic Status which provides companies with incentives such as;

?. Business enterprises operating in SEZs are allowed a deduction of 100% investment costs on building construction, machinery purchase, and, machinery installations in the first year of utilization, and,
a. Reduction of withholding tax rates for businesses in SEZs as follows; (i) management and professional fees from 20.0% to 5.0%, (ii) interests from 15.0% to 5.0%, and, (iii) royalty from 20.0% to 5.0%,

The establishment of SEZs under the Special Economic Zone Act, 2015 confirms the National Government's commitment towards facilitating the growth of the manufacturing sector by providing a platform through which Kenya can attract Foreign Direct Investments, thus driving the growth of the economy. Other SEZs in the pipeline include; Africa Economic Zones Limited in Eldoret County, Northlands City along the Thika Super Highway, Dongo Kundu in Mombasa, Naivasha Industrial Park, and, Konza City in Athi River. SEZs are more attractive to industrial clientele due to special tax incentives and infrastructure that facilitate a wide range of activities such as storage, export and re-export.

VI. Listed Real Estate

During the week, the Cabinet Secretary for the National Treasury and Planning, Ukur Yatani, drafted rules under the Income Tax (Real Estate Investment Trusts) Rules, 2020 that will require Real Estate Investment Trusts (REITs) to apply for tax exemptions from Kenya Revenue Authority (KRA) during registration. According to the Income Tax Act, REITs in Kenya have a number of tax benefits, among them being;

?. A listed REIT allows underlying owners of the real estate assets to enjoy corporate tax exemptions, currently at 30% per annum. The only taxation is on distribution of profits to the unit-holders, which is subject to withholding tax ("WHT") at the rate of 5.0% for resident and 10.0% for non-resident unit-holders,
i. The amendment of Section 20 of the Income Tax Act as per Finance Act 2019 also saw REITs' investee companies being exempted from income tax. This will allow REITs to invest more in companies that develop real estate, rather than going through the process of transferring properties to the REIT, and,

ii. Transfer of properties to a REIT also attracts a stamp duty exemption, as per Section 96A (1) (b) of the Stamp Duty Act.

As per the proposed rules;

?. The application for registration shall be made to the KRA Commissioner General at any time during the authorization of the REIT Scheme by the Capital Markets Authority or during the process of acquiring the REIT Controlled Entity,
i. Where a REIT or a REIT Controlled Entity fails to satisfy the requirements of the Capital Markets (Real Estate Investment Trusts) (Collective Investment Schemes) Regulations, or the Income Tax Act for purposes of maintaining its exemption status;

?. The exemption granted to the REIT or REIT controlled entity shall cease to apply, and,
a. All the applicable taxes in accordance with the Income Tax Act shall fall due, and shall be payable, from the date of such failure.

The proposed rules seek to assure investors of the tax exemptions and seal any possible loopholes in tax collection. Previously, a REIT was only required to get the Capital Markets Authority (CMA) approval. The exemptions ensure that the objectives of REITs are fully achieved as it exempts the income of Investee Company fully controlled or owned by the REITs. However, despite the tax exemptions, the REIT market in Kenya has remained underdeveloped with only one publicly listed REIT, Fahari I-REIT, which has been recording poor performance since its listing, trading at an average of Kshs 7.5 per unit share in May 2020, a 63.9% drop from its initial price of Kshs 20.8 in November 2015. Some of the challenges facing the REIT market include; (a) the relatively high minimum subscription amount per investor at Kshs. 5 million which is too high to attract significant interest from investors, (b) inadequate investor knowledge, (c) negative investor sentiments, (d) opacity of exact returns for underlying assets, (e) shallow investment-grade asset pipeline, and, (f) lack of institutional support. We expect continued engagement of the Investors, fund managers, the developers and the regulators to help unlock capital as investors take advantage of the tax benefits. Please see our note on tax incentives for REITS as an investment alternative here.

Despite the continued negative impact of the COVID-19 pandemic on the real estate sector and the reduced budget allocation by the National Government towards infrastructure and the affordable housing programme, we expect the sector to be cushioned by the growing demand for low income housing and the National Government's use of monetary and fiscal policies to sustain liquidity in the economy and ease financial distress for sectors such as tourism and hospitality.