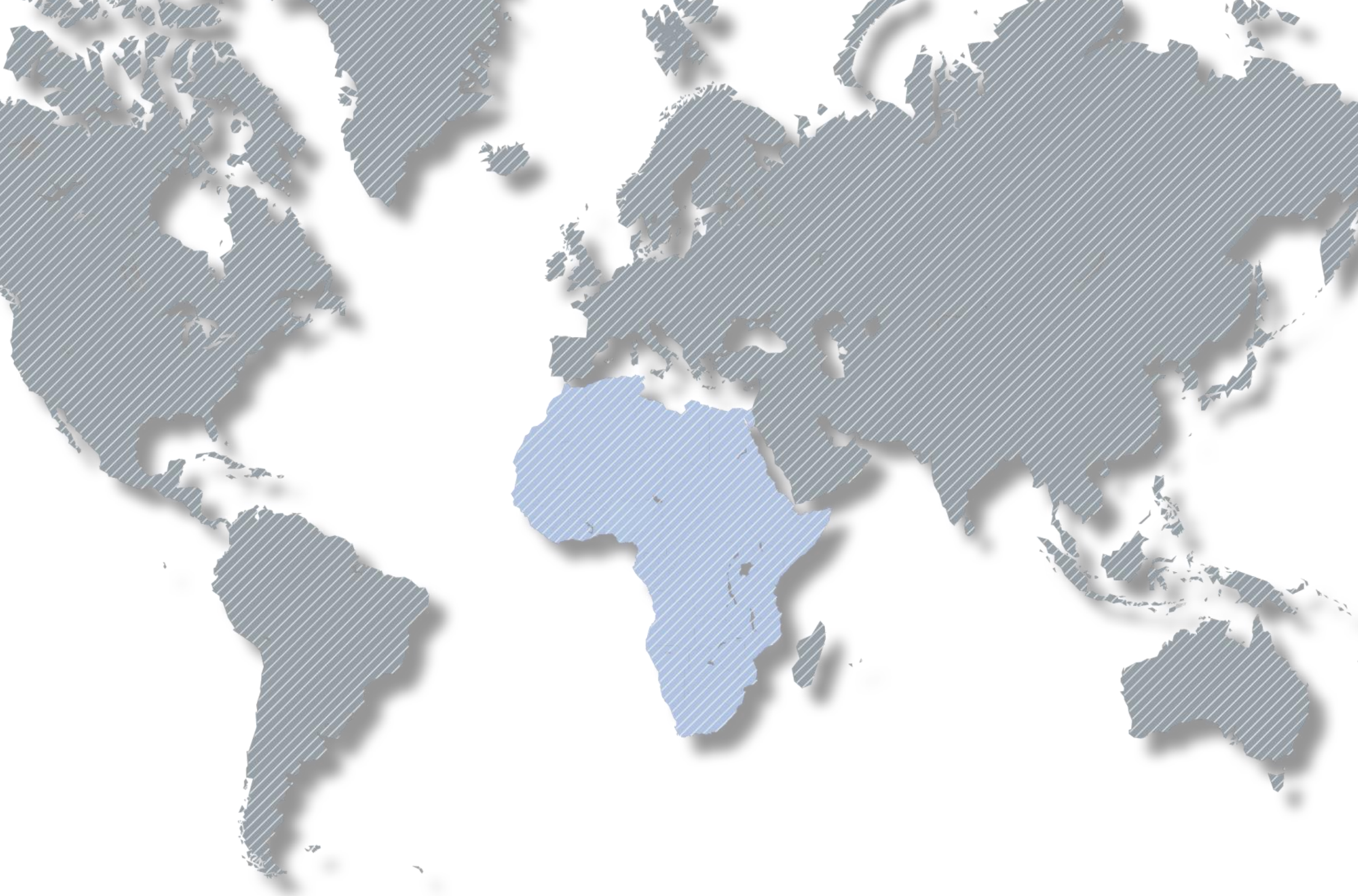

COVID-19 and the Kenyan Real Estate Market

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Summary

The real estate sector is probably the most popular source of alternative investment by investors in Kenya. Like all other sectors, it has also been affected by the COVID-19 pandemic from both a demand and supply perspective. This note aims to provide some insight into these impacts across the residential, commercial and industrial segments of the broader sector. It contends that while COVID-19 has disrupted normalcy within the real estate sector, there may be emerging opportunities as a result.

“Reports that say that something hasn't happened are always interesting to me, because as we know, there are known knowns; there are things we know we know. We also know there are known unknowns; that is to say we know there are some things we do not know. But there are also unknown unknowns – the ones we don't know we don't know.” - Donald Rumsfeld, Former United States Secretary of Defense

Introduction

The COVID-19 pandemic has been unprecedented in scale and it continues to have a truly global impact. Virtually no sector has been left unscathed by the pandemic, with most still facing increasingly uncertain outcomes. This note looks at alternative investments in a Kenyan context as represented by the real estate sector. The hope is that it will provoke the readers' thoughts as to the likely (or unlikely) impacts of the COVID-19 pandemic on the sector and possibly even highlight potential investment opportunities. Even then, the note does so with considered humility, as we acknowledge that while there may be “known knowns” with respect to the impact of COVID-19 on the Kenyan real estate sector, there are definitely also “known unknowns” and “unknown unknowns” as well.

Time will undoubtedly be the clearest indicator in so far as eventual outcomes are concerned.

Residential Sector

The residential sector can be broadly categorized into three major segments, namely: the high-end, middle and low-end residential segments. The housing supply across all three segments is likely to be negatively impacted as long as the pandemic remains in play. The ongoing social distancing measures have either dampened or altogether stopped activity at construction sites across the country in an effort to ‘flatten the curve’. This is clearly an example of a “known known”. In addition, new constructions starts are likely to be delayed for the foreseeable future. The COVID-19 pandemic has also been negative from a housing demand perspective for each of three residential segments as outlined above.

In particular, the high-end residential segment was already over-supplied pre-COVID-19, putting downward pressure on housing prices as developers re-adjusted their prices in a bid to spur buyer interest. Given the ongoing uncertainties pertaining to the pandemic, we expect the demand in this segment to remain muted at best, as prioritization of non-discretionary expenditures holds sway in the interim.

The middle and lower-end residential housing segments have also suffered negative demand pressures thanks to COVID-19. The instigation of social distancing measures has seen many Kenyans (particularly in the service sector) lose their jobs as hotels, bars, restaurants and various other social business venues have shut down in an attempt to mitigate the spread of the coronavirus. The concomitant disruptions in earnings streams via lost or garnished wages has negatively affected demand in the sub-sector as tenants struggle to pay rents and thus honour rental agreements. In some cases, property owners have had to offer rent waivers or rent reductions to help alleviate their tenants' plights in face of the pandemic. The hope remains that a quick COVID-19 resolution enables a swift resumption of economic activity, and with that, a normalization of tenancy agreement status quos. Unfortunately, the question of when this normalization will occur remains an “unknown unknown”, exacerbating the air of uncertainty within the residential real estate sector at large.

Commercial Real Estate

The commercial real estate sector was oversupplied prior to the onset of the COVID-19 pandemic, putting downward pressure on the pricing of office space within Nairobi's metropolitan area. We expect similar supply constraints to those within residential segment to play out due to the ongoing social distancing regulations that have dampened building and construction activity.

Similarly, the demand side prospects for commercial real estate also appear dim. Ongoing work-from-home initiatives imply under-utilized commercial buildings spaces around the country, while any prospective demand (clients who were looking for office space prior to the COVID-19 onset) has probably abated for now.

In the face of a protracted work-from-home dispensation, it is probable that tenants of various commercial buildings may begin to re-negotiate their leases or possibly even suspend settlement of their lease obligations. Indeed, in the United States and Europe, Tesla and Adidas recently informed their landlords that they would not be paying rents going forward, with other commercial real estate tenants citing COVID-19 as a force majeure event as they did so.

On a structural basis (i.e. longer term), it remains an "unknown unknown" as to whether work-from-home arrangements will sustainably change the nature of office space demand as organizations substitute office needs with work-from-home alternatives. Were this change to happen, the implication would be even less demand for commercial real estate (office space) and hence possibly even poorer pricing prospects going forward in the segment.

Despite these adverse possibilities, we believe an opportunity exists for nimble players within an emerging niche of the commercial real estate segment – specifically the flexible office space or co-work space. We believe that players who are able to quickly re-calibrate their flexi-office spaces to better position them relative to a post COVID-19 world in terms of emerging tenant demands will likely be early beneficiaries of the changing office space need dynamic. As an example, we expect that, post COVID-19, tenant demands are likely to place a premium on more ubiquitous sanitization and social distancing accoutrements within office spaces. We expect that this will either require a re-tooling of current office space offerings that fall short in these regards or at a minimum, a re-think of upcoming flexible office spaces in terms of structure.

Industrial Real Estate

The industrial real estate segment offers interesting points of consideration given emergent risks from the pandemic. In particular, hitherto under-appreciated supply-chain risks have emerged prominently as the world's true depth of reliance on China as a source of various goods and inputs has become apparent. The ensuing supply chain disruptions following China's lock down has likely forced a re-think regarding the future decentralization of supply chains by various multinational companies and countries alike. Near shoring is likely to become a persistent theme post COVID-19, as companies and countries shift larger portions of their supply chains or manufacturing sites closer to their domestic locations in a bid to mitigate supply-chain risks.

In addition, the vulnerabilities of just-in-time inventory management methodologies which emphasize having lean levels of inventory have come to the fore as stocks of various essential goods quickly declined. We expect that there could be a structural shift in favour of maintaining larger inventories on hand as a buffer against any supply shocks. In our view, these two trends – decentralization of supply chains/near shoring and a shift to maintaining larger inventories – will likely be positive for warehousing space demand going forward.

The meteoric rise of e-commerce during the pandemic is likely to be another supportive demand factor for industrial real estate. As an example, local retail shopping chains who had earlier begun experimenting with retail goods delivery options (whose demand has since risen exponentially during the pandemic) are likely to have a more tangible appreciation for the symbiotic relationship between warehousing space (for larger inventories) and future last-mile distribution centres from which future deliveries can be more efficiently coordinated.

Finally, pre COVID-19, the industrial real estate segment had been under-supplied in terms of high quality, cutting-edge infrastructure. The implication is that there is probably enough headroom for decent investment returns, in stark contrast to the over-supplied high-end residential and commercial real estate sub-sectors.

The Upshot

Given the foregoing, what shape would potential investment opportunities take?

In our view, setting up the industrial real estate infrastructure will require the marrying of building and construction nous with investment capital, which could be patient or opportunistic in nature.

In addition, the re-tooling requirements for commercial real estate with respect to flexible office spaces -in terms of making them more aseptic environments also offers another investment opportunity in terms of the capital investment and re-design thinking required.

The African Alliance Group is uniquely positioned to leverage on its extensive network of local, regional and international investor relationships to facilitate the merging of these investment opportunities. The Group is in a position to provide bespoke capital solutions to help finance opportunities across the Kenyan real estate sector.

It is in times of crisis that the seeds of opportunity are sown.

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