INVESTMENT IN PROPERTY

For a long time, property has been known to have high leverage and yield greater returns despite being illiquid and having a low correlation with other major asset classes.

The government, in one of its big four agendas, seeks to provide affordable housing to its citizens. One of the most popular ways of acquiring a house is through mortgage financing. In Kenya, one gets a mortgage loan from a financial institution at an interest rate in which the property is the security. The mortgage agreement gives you the ownership of the property and one can start living in it as soon as the loan has been approved and paid to the property owner.

The Kenya Mortgage Refinance Company was formed to loan primary lenders including Banks, Microfinance Banks and Saccos so that they can refinance mortgage loans capped at Kshs 4 million in the Nairobi Metropolitan area. Its main aim is to increase the availability and affordability of home loans to Kenyans, whose monthly household income is not more than Kshs 150,000.

The Retirement Benefits Act also allows a member of a pension scheme to use a portion of the member's accrued benefits to purchase a residential house from an institution. The portion shall be the lower of 40% of the member's accrued benefits, Kshs 7 million, or the purchase price of the residential house which shall not exceed its market value.

One can invest in property through the following ways:

A) Directly by buying land and developing the place in order to earn rental income or to sell in the near future.

B) Indirectly through real estate investment trusts (REITs), real estate company stocks, mutual funds and exchange-traded funds (ETFs), mortgage bonds and mortgage-backed securities.

Both ways have advantages and disadvantages.

Advantages of Direct Investment

1. Greater leverage

   An investor is assured of greater returns when investing in property as a landlord.

Disadvantages of Direct Investment

1. One needs to be more hands-on full time or pay a property manager who will be in charge of advertising, collecting rent and dealing with delinquent tenants.
2. There are numerous expenses involved such as repairs and maintenance, that may eat into the landlord's profit.
3. There is a compromised quality of life. A landlord may receive numerous calls at odd hours in case of any tenant's queries.
4. Illiquidity when one wants to dispose of the asset. Disposing property is an uphill task, especially when there is an urgent liquidity need.
5. Difficulty in the diversification of the portfolio. A lot of time, money and expertise may be needed in case one needs to diversify the portfolio of property.

Advantages of Indirect Investment

- It is a simple and secure way of investing.
- There is consistent income through dividends when one invests in real estate company stocks.
- It is cheap and easy to diversify one's portfolio.
- They can easily be redeemed for cash, hence they are very liquid.
- They are exempted from double taxation. These investments are only subject to withholding tax, unlike property where one needs to renew a lease agreement and pay income tax as well.

Disadvantages of Indirect Investment

- Less control is conferred to investors regarding the direct property where the funds have been invested in.
- The upside is lower than that of rental property. The growth rate of share prices is slower than the appreciation value of direct property.
- Lack of leverage since the real estate companies also need to make their profits for smooth running of these companies.

FACTORS TO CONSIDER BEFORE INVESTING IN PROPERTY

1. Location

Property location determines the profitability of the real estate investment. A profitable real estate investment should have proximity to social amenities, scenic views, security, and the investor should be aware if the neighbourhood is controlled or not. Tax-exempt areas are also ideal when considering investing in commercial property.
An investor should collect information about the prospects of the vicinity in the medium and long term from agencies in charge of zoning. This will enable them make appropriate decisions regarding their choice of investments.

2. Legitimacy of the Investment Agency

An investor should carry out due diligence if they want to invest in property through agencies. The agencies should be regulated and should have a good reputation on payment of investment sums to investors when they fall due.

3. Valuation of Property

An investor should be aware of how property is valued, the listing price, insurance and tax payable for the given property. Investment analysis is also prudent as this helps the investor to understand the risks involved, the resale value of the property and expected cash flows from the investment.

4. Investment Purpose and Horizon

Since property is characterised by low liquidity and high value, lack of a clear understanding and financial objectives may lead to unexpected results including financial distress.

- Buying property for use implies that rent is saved and the property's value appreciates.
- Buying property for lease implies that an investor will get regular income while the property appreciates. However, one has to deal with frequent repairs and maintenance, tenancy disputes, renewal of lease agreements and occupancy issues.
- Buying property to sell in the short term implies that the investor will make averagely less profit, while selling in the long term means there will be large intrinsic value appreciation and the returns will be high.

5. Leverage

In as much as loans are convenient, they tend to be costly. This may lead to liquidity shortages and over-leverage when market conditions deteriorate.

6. Type of Property- New Construction Versus Existing

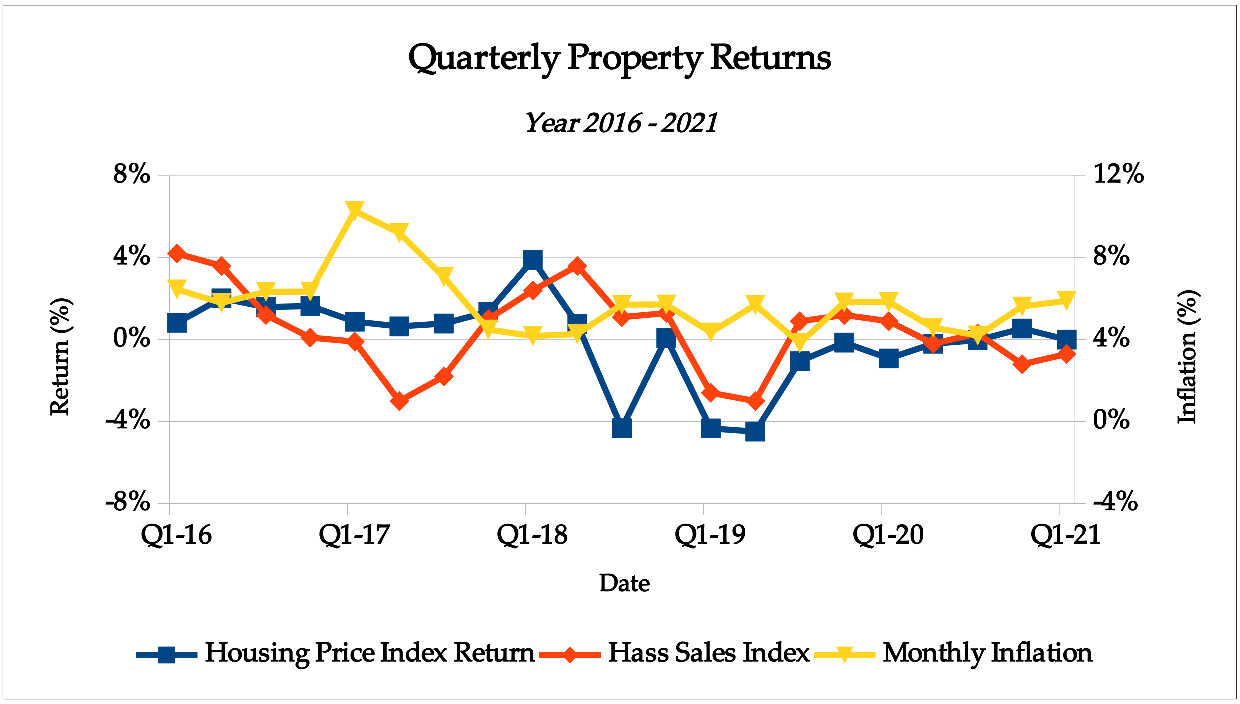
New construction offers attractive pricing. However, they are costly and time-consuming, and there are uncertainties of a newly developed neighbourhood.
Existing property on the other hand offers convenience and lower costs are incurred. An investor should therefore carry out due diligence on past projects, the company's reputation, property deeds and recent surveys and appraisal reports for existing property. For leased property, find out if property is rent-controlled, rent-stabilised or free market.

7. Overall Demand and Supply in the Real Estate Market

An investor should be aware of the mortgage rates as well as trends in the real estate market. Buy when prices are low and sell when prices rebound.
An investor should also stay updated on the statistics of home prices, home sales, and foreclosures both overall and in the desired market. This helps them undertake flipping activities efficiently.

Trends In The Property Market

The property market has faced a lot of challenges during this pandemic period. There has been subdued demand for both office spaces and residential property especially in the Nairobi suburbs compared to Nairobi satellite towns. The following graphs represent the performance index of property in the last few years.

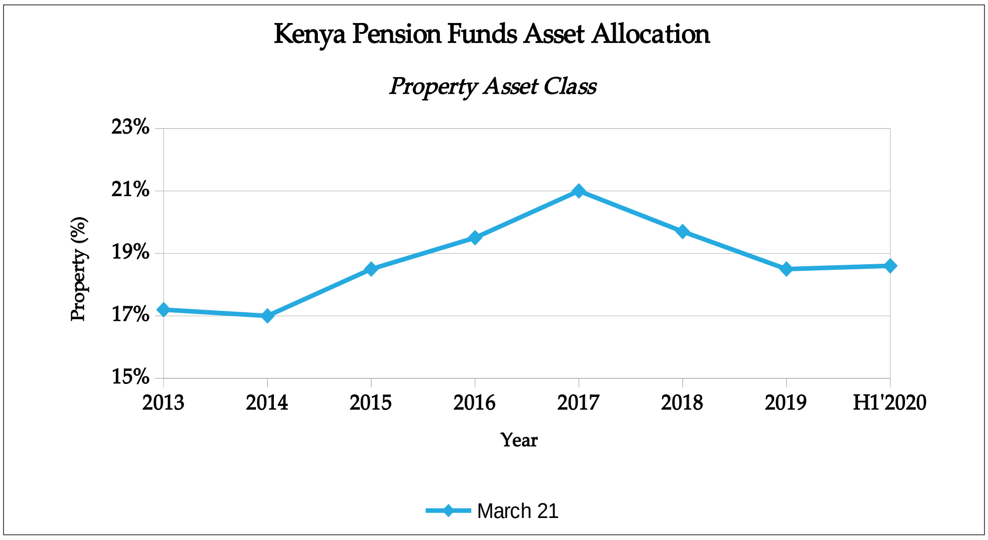


In 2016, the Banking Act was amended to cap interest rate on borrowing. This reduced access to credit by developers and buyers since banks became conservative at lending. Kenya's real estate sector was set to see significant growth in 2020 on the back of its growth recorded in 2019.

During the year to Q3 2019, the Hass Sales index fell by 3.4% from an 8.1% year-on-year rise in a similar period in 2018. The year was also characterised by an oversupply of high-end property. This was worsened in 2020 after the country reported the first case of Covid-19 that disrupted the economy, leading to a drop in new activities and depressed sales.

Rising fears of a recession has caused banks in the country to become more reluctant in granting new loans which has further led to a decline in mortgage uptake by home buyers. On the rental front, landlords remain sceptical about losing their tenants. For that reason, most of them were forced to renegotiate their payment terms or agree to a lesser amount for leased properties.

In the recent past, pension schemes have increased their fund allocations to property until 2017 as highlighted in the graph below:



Source: Cytonn Investments

Most pension schemes gave more allocations to property between Q4 2014 and Q1 2017. This was because investors sought safer and higher returns yielded in the property asset class compared to other asset classes. The period was also characterised by increased rate of asking rents as well as a steady pick up in property prices. As the elections drew nearer and investors became cognizant of the post-polls uncertainties, most schemes backed off from investing in property. Inflation in the same year hit an all-time high of 9.04% in February, due to an increase in the cost of fuel. Cement consumption also shrank by 5.91% despite an increase in production.

This was worsened by the Covid-19 pandemic that was first reported in the country in March 2020 which increased investors' jitters in the economic outlook. The closing of the country's borders also led to the disruption of supply chains, which further resulted in longer development periods.

The Covid-19 pandemic has negatively impacted the growth potential of the real estate sector to a large extent. In the last six months, the pandemic has created economic distress and the pressure has been felt by this sector as well. According to Hass Property Index, buyers, in the quest for both space and affordability, prefer semi-detached houses over apartments and detached houses.

In the near future, we expect a decline in the demand for both commercial and residential spaces due to the flexible working environment provided by employers and undertaking businesses online. Inflation, which currently stands at 6.32% has been on the rise since the start of the year, and this has reduced disposable income in many households as a result of the increased cost of foodstuffs and fuel. The cost of credit is also set to rise due to an increase in excise duty on commissions and fees levied by banks to 20%, which will be transferred to consumers. This will also affect mortgage uptake and the real estate sector at large.