“ Should you be moving into somewhere new? ”

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3 African real estate: the missing link

SUMMARY: Thomas Reilly, Managing Director, Africa Real Estate, Investec Asset Management, explores the cyclical differences between developed and African real estate markets, structural developments, and their risk and expected return profiles. He argues that African real estate markets offer an interesting proposition in terms of timing and supply/demand. Is this the missing link required to mobilise this asset class in Africa?

Is pricing dispersion at extreme levels?

The current pricing trends in global real estate has resulted in levels of dispersion seldom seen. Developed world real estate has arguably never been as expensive. Recent sales in leading global cities, such as London, have reached all-time highs, while emerging market commercial property has, in many cases, fallen sharply.

Despite a lack of reliable data, the consensus is that the differential is close to unprecedented. For example, two London office towers sold for more than £1 billion this year to foreign investors. The so-called 'Cheese Grater', sold for £1.15 billion in March, while the 'Walkie Talkie' for £1.3 billion – the two most expensive property sales in UK history. These sales were completed despite Brexit and a hung British Parliament at a time when stability mattered the most.

Quantitative easing and low interest rates since the global financial crisis have fuelled the appreciation of real estate across the developed world. The resulting cheap leverage has turned an otherwise expensive and low-yielding asset into one that provides an acceptable geared return. As a result of the sector's growth, real estate recently formally joined cash, stocks and bonds as the fourth asset class. The developed world real estate market has grown to be worth more than US$1.7 trillion, with access provided through a large and liquid property sector.

Emerging market cyclical downturn

In contrast, Africa, specifically sub-Saharan Africa, has experienced a cyclical downturn. Certain markets, particularly in oil-producing countries such as Nigeria, have experienced asset price corrections. In addition, the buoyancy of the West African real estate market during the period 2011 to 2015, boosted new property supply. This new supply, alongside a pressurised economy, meant property values have decreased by as much as 35% in certain nodes.

Meanwhile, in Nairobi's finance district, East Africa's central business hub, the continent's second tallest building is nearing completion. The Kenyan economy is far more diversified than Nigeria's, and as an oil importer, the lower oil price should provide support.

However, this market has suffered from drought and an impaired ability for the local market to borrow due to a debt interest rate cap policy, which has affected local asset pricing. The Nairobi skyscraper as an example lags comparable assets in Nigeria or Ghana by as much as 50%.

Regionally, the asset price corrections, coupled with an improving outlook, should add to a more sustainable investment proposition. For example, Nigeria has seen a significant narrowing between the official and unofficial exchange rates, highlighting a correction in supply and demand differences for the currency. Kenya, meanwhile, looks set to restructure the debt cap following the August 2017 elections. The cyclical gap that has opened between the global and developed markets could present a long-term opportunity.

The 'supply story' — potential for growth

A number of specific themes are driving real estate across the major industrialised countries. E-commerce, for example is transforming the way people shop, with direct effects on the retail sector, and sparking a surge in demand for logistics properties. The real estate opportunity in Africa, and specifically sub-Saharan Africa, with the exception of South Africa, is very different.

Although E-commerce is in its infancy in South Africa, the logistics infrastructure is reasonably well developed. The base is, therefore, in place to plausibly grow this opportunity over the medium-term. In contrast, the logistics opportunity in the rest of sub-Saharan Africa, is far more rudimentary. Simply identifying well-constructed and reasonably well-located space is almost impossible.

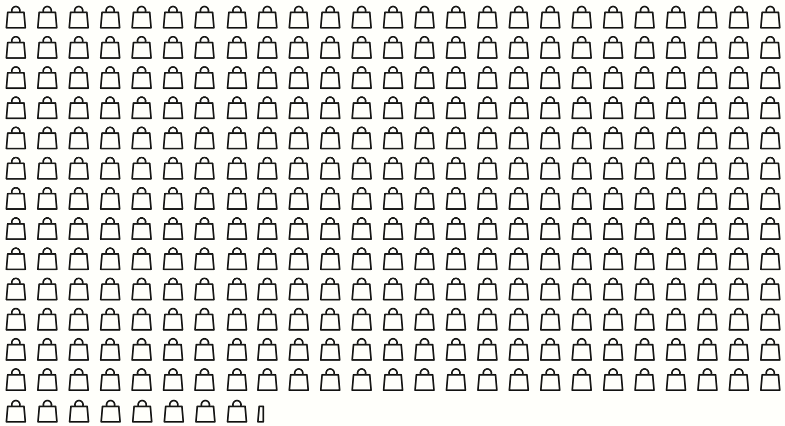
Africa Logistics Properties, recently funded by the Commonwealth Development Corporation, is as an example, focusing on the opportunity to develop this sector in Nairobi. Developed market style E-commerce in Africa is at this stage conceptual. The current needs in sub-Saharan Africa are far more basic and immediate.

Over the last 20 years, the South African real estate market has grown to a market cap of around $55 billion, with 46 listed property stocks. It has the sixth-largest number of shopping centres globally, with a total floor area of 23 million m^2. In contrast, the rest of sub-Saharan Africa, which has a population of 950 million people, totals only about 3 million m^2 of

Shop ‘til you drop

Comparison of shopping malls across Africa

2,000 malls across South Africa



6 malls per country across sub-Saharan Africa

6 shopping malls =

formal retail. It averages about six shopping centres per country, compared to South Africa’s 2,000.

The potential for long-term growth is obvious. Africa has an estimated 56 cities with a population of more than one million – Europe has only 33. By 2025, an estimated 15 African cities will have more than five million inhabitants (Figure 1).

Extracting value from sub-Saharan African real estate will require a long-term commitment. However, the building blocks are there. The banking sector has grown significantly over the past decade, with many international banking groups active across the region’s larger countries. The timing of the proposition is further enhanced by the decline in valuations sparked by declining resource prices and currency devaluations. As an opportunity, this compares very favourably to developed property markets.

The supply of investable real estate across sub-Saharan Africa has continued to grow, driven by private equity development funds, which are bringing new assets to the market worth approximately US$5.05 billion. Many of the world’s largest conglomerates are either establishing or growing their African footprint, fuelled by the continent’s growing consumer population and burgeoning middle class (Figure 2, overleaf).

Many of these corporates have previously built their own buildings, simply because the market was unable to provide them. These are assets which real estate investors should be able to invest in, and professionals in the industry should manage. Although the scale of the market is expanding, the ability for the average investor to access these opportunities remains limited.

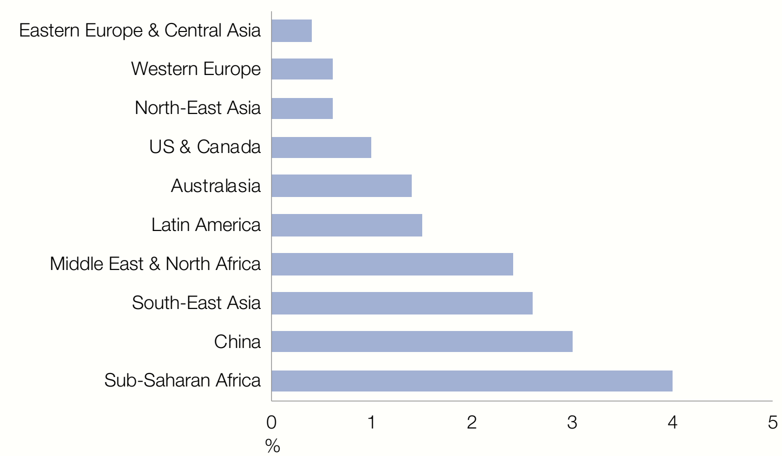
The ‘demand story’ — patience is a virtue

The global investor community is increasingly intrigued with the idea of sustainable long-term investing. The opportunity to invest in the ‘last frontier’ real estate market truly meets the thesis of long-term investing. The asset class also offers long-term investors the opportunity to capture an illiquidity premium as the market grows.

Figure 1: The rate of urbanisation is growing faster on the continent than anywhere else around the globe, adding an estimated 24 million people to its cities each year until 2035

Urban population growth

Compound annual growth rate, % 2010-2015



Source: 'Urban world: Meeting the Demographic Challenge'. McKinsey, October 2016.

Figure 2: The rising African consumer and business spending opportunity is worth US$4 trillion, and estimated to grow by over 40% to almost US$5.6 billion by 2025

Consumer and business spending, 2015 US$ bn	Growth 2015-25 US$ bn	Growth rate 2015-25
Consumer 1,420	645	3.8%
Business 2,560	970	3.3%
Total 3,980	1,615	3.5%

Source: Oxford Economics: IHS, McKinsey Global Institute analysis. 2015 prices. Diagram is not to scale.

The levels of absolute risk in terms of asset ownership, liquidity and transparency in Africa are greater than those of most developed economies, hence the increased levels of expected return. However, in our view, much of the perceived additional risk can be mitigated through local and specialist management.

The larger developing economies in Africa have also developed robust legal systems to protect and enforce shareholder rights. Real estate will also benefit from growing access to developing capital markets, particularly debt capital markets and related mortgage bond financing.

Some of the largest economies in sub-Saharan Africa, including Nigeria and Ghana, recently held democratic elections and experienced remarkably smooth transitions of power. Kenya's election received a lot of negative press prior to the vote, but it was minimal compared to previous elections. The subsequent invalidation of the election is not positive news, but the fact that such a decision could be taken should be seen as a decisive victory for African democracy. As major African countries, including Ghana and Nigeria, show signs of stability and transparency, the world will be watching Kenya closely. A positive result will add to the notion that regional political risks may be reducing (Figure 3).

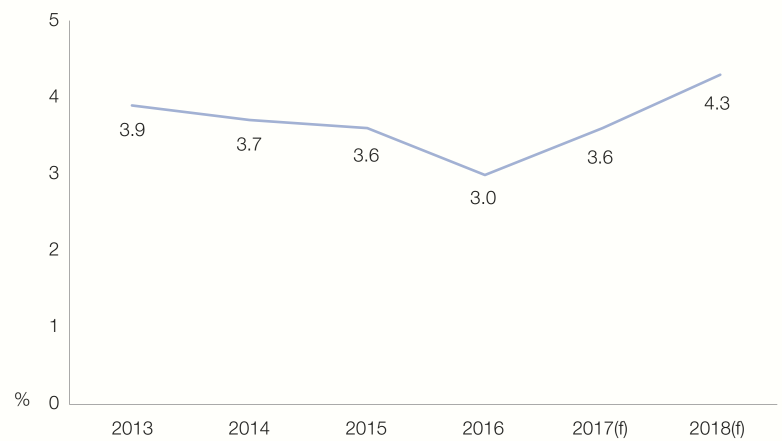
Timing matters

In our experience, the higher perceived risk for new entrants, versus the risks understood by experienced players, often appears disconnected, leading to differing return expectations. However, most long-term investors understand that the opportunity to capture a liquidity premium should not be missed. These scenarios have played out over the past 10 to 20 years across many emerging countries in Latin America, Asia Pacific and South Africa, with core yields in the latter having moved from the mid-teens to current levels of approximately 8%. The investor thesis of buying into a market which has been through a major correction arguably presents an attractive entry point.

Accessing the market

While the investment case and long-term value creation potential is evident, as is the case for sustainable development impact, an obvious question remains: how to access this market? Large and sophisticated aggregators that play a central role in developed markets simply aren't there. This represents a missing link. A secondary capital market, where vehicles can provide the means for developers to release their capital and allow investor access to the opportunity is likely to grow strongly over the medium term. With increased inflows of international capital, closing the missing link in the chain is most likely inevitable and will no doubt further mobilise the industry.

Figure 3: Africa's forecast GDP growth 2013-2018



Forecasts are inherently limited and are not a reliable indicator of future results. Source: African Development Bank, 2017.