RISK MANAGEMENT APPROACHES TO INVESTING IN KENYA

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EXECUTIVE SUMMARY

The asset class in Kenya continues to attract investor flows and the outlook for returns remains positive. Recent investor demand however, has been more balanced, with a rise in the number of properties coming to market. This reflects an element of profit taking as well as an increasing interest in the Kenyan real estate industry. The financial picture is okay with widespread increases in tenant demand supporting rental growth due to more money in circulation from FDI. The key driver of the economy is tourism but the prospects look good with the discovery of oil in Kenya. Once we can address the mitigating risks, investment should thrive.

INTRODUCTION

The housing deficit in Kenya stood at 2 million in 2012 and continues to grow at the rate of over 200,000 units a year. There is a proliferation of informal settlements in urban areas with 60% of the population living in informal settlements. Families live in overcrowded homes typically with one room and no adequate ventilation. These families are at high risk of diseases such as malaria, respiratory infections and jigger infestation. The poor, especially children and women, elderly and persons with disabilities are the most at risk. Under the new devolved government system, housing delivery is the responsibility of the county's government. Limited access to land (68 percent of Kenyans are without land documentation or tenure security), insufficient income, lack of affordable housing options are all limiting foreign investment in the real estate sector. Yes, there is demand for real estate investment. Equally significant risks abound.

INVESTING IN KENYA

Now seems a better time to invest in Kenya due to an increase in its middle class population and more favourable government policies. Muthini (2015) makes the bold claim that many people in Kenya usually get money and do not know what to do with it! He argues that nowadays, especially with lotteries gaining popularity in Kenya, anyone can become a millionaire. So, it is an escape from the era when only accountants and lawyers had real money in Kenya and going by Muthini's claim, the problem is not how to become rich, the problem in Kenya is how to distribute wealth. If this assertion is anything to go by, then it sure promises a good market for fund investors to play in.

Kenya has been in the Global limelight as a favorable investment destination, especially after the GES summit that happened in Nairobi in July 2015. International media has picked this up as expected with Forbes labelling Kenya as Africa’s Fastest growing economy. It is an open secret that the business environment in Kenya has been great, with many multinational companies setting up office in recent history; big names like Google, IBM, Microsoft, ORACLE, SAP, Coca Cola, GE just to mention a few.

Despite the positive on the Kenyan economy, most people in Kenya still prefer investing in real estate in Kenya (Muthini, 2015). Real estate business in Kenya entails buying a house, and it seen as one of the safest ways to investing one’s money in Kenya. This is mostly due to the factor that portfolio of real estate assets fare well in the Kenyan market as with Kenya’s growing population, the demand for houses is on the rise. This informs a popular saying in the Kenyan real estate industry that a Kenyan with the money to buy a house can prefer to buy a house and make use of the money used to pay rent for investment somewhere else in Kenya. It shows an encouraging rate of returns on real estate investments.

KENYAN REAL ESTATE INDUSTRY

The real estate sector in Kenya has seen a boom that began somewhere in the mid to late 2000s because the property market is responding to increased demand. The growth in real estate in Kenya is mainly driven by a huge housing deficit being experienced in housing in Kenya. Currently, the Kenya urban population is growing at an average rate of 4.2% annually resulting in a demand of about 150,000 new housing units every year. The market is only supplying about 20,000 units per year, leaving a yawning deficit. In Nairobi alone, the housing deficit stands at 80,000 units annually according to the Planning and Housing Executive Committee, Kenya. These factors present a superb opportunity for those wishing to invest in property in Kenya. With rental returns having grown by 9.7% over the past year and property prices having increased 3.46 times over the last 15 years, the prospect of making a neat return on investment in real estate in Kenya is almost given (Villacare, 2015).

However, there are several things to consider before investing in real estate in Kenya. The problem of investing in Kenya, with emphasis on the real estate industry is partly that of fraudsters. Today, it is almost a risky business to buy property in Kenya as one may be given fake title deeds. In some other climes, one can purchase title deeds only later to find that one is the fifth person to be sold the same property in Kenya. One is not expected to be downhearted by this development as Estate Surveyors and Valuers and Lawyers (one might add) are on hand to escort and advice the buyer on the intricacies of land matters in the country. The cost of employing such services usually defrays that which would have been incurred in losses to fraudsters. It is also pertinent to engage researchers who monitor and report on market situations which offer a direction to the investor on whether to go ahead or hold on.

While the Kenyan land commissions must be involved in cconsiderations of investing in the real estate industry in Kenya, one can equally buy land in Kenya at a cheaper price, build a house and sell it. This can also be achieved via constructive investments in a construction company in Kenya. By so doing, not only would the investor be dealing on real estate for profit, the investor can also make money managing real estate concerns of others. This is a truism since given that the economy of Kenya is growing, Kenyans want to invest, which makes it almost difficult to lack a buyer for a house. The advantage of constructing a house for sale is, unlike vehicles, houses mainy appreciate. A Kenyan is always guaranteed to sell a house at a profit (Muthini, 2015).

An international survey by the African Business Report (2015) highlights Nairobi and Mombasa as the leading prime property performers in the world. Knight Frank (2015) concurs with the assertion that properties in Kenya experienced the highest rises in prices globally. The report illustrates that the performance of the Kenyan real estate sector has helped debunk the myth that all safe haven locations are in the Western world. The emergence of new urban locations, the availability of new investment opportunities and access to new technology are set to shake up prospects for Kenya's real estate sector, new research by Lamudi (2016) has revealed. The report suggests that "migration away from metropolitan areas, infrastructure improvements and increased international interest from investors are just some of the expected developments for real estate markets within emerging nations.

RISKS ASSOCIATED WITH REAL ESTATE INVESTMENT IN KENYA

Of course, not all risk is negative as it only represents a difference between expected return and actual return. However, the possibility of the actual return being lesser than the expected return in investing in the real estate industry in Kenya forms the majority of this section. First, key risks can be monitored, including: real estate exposure; vintage year exposure; property sector exposure; leverage; and other exogenous variables.

- **Security Risk**

It is no secret that investing in the high-end segment of the market is desired by all ardent investors especially in Kenya with the abundant tourism potential. Income is normally secure, it has adequate government attention in terms of provision of infrastructure (including security) and demand is substantial. However, we live in a terrorized world where group names such as ISIS, Al Qaeda, Al Shabaab, AQIAP (Al Qaeda in the African Peninsula), Boko Haram, Al Aqsa Brigade etc. are as common as UN, WHO, World Bank and AU. The times have brought with it great security challenges and in Kenya activities of these groups, especially Al Shabaab and AQIAP has greatly affected real estate investments in these areas. This has led to a decrease in the influx of multinationals who express interest in the uptake of such homes (Muiriri, 2016).

- **Corruption**

The incidence of corruption has been documented in the earlier segments of this paper as it mostly affects purchase of real estate interests. Also, for certain progresses to be made; certain hands have to be greased due to the rampant corruption in almost all levels of government.

- **Real Estate Finance**

The Monetary Policy Committee usually meet to address the Kenyan currency issues in a bid to stop the fall of the Kenyan Shilling and reduce inflation. By so doing, they usually raise the interest rate to encourage spending and discourage borrowing. This seems to be the very antidote of real estate investment as it means that banks would increase their lending rates to real estate developers. While this may discourage real estate investment, assuming the fund is exhaustive equity for our proposed investment; it has also been recorded that high interest rates culminate in low demand for housing. This is in addition to the already cumbersome requirements in sourcing funds for real estate investment in Kenya.

RISK MANAGEMENT APPROACHES TO INVESTING IN KENYA

Risk management is the identification, assessment, and prioritization of risks followed by coordinated and economical application of resources to minimize, monitor, and control the probability and/or impact of unfortunate events or to maximize the realization of opportunities. Risk management's objective is to assure uncertainty does not deflect the endeavor from the business goals. A part of risk management approach is monitoring and research. Christner (2009) argues that in monitoring host country data, historical changes in housing prices, historical currency changes, inflation rates and taxation should be subjected to critical evaluations.

Similarly, real estate is inherently cyclical, as witnessed by the three property downturns over the past 20 years. Given that cyclicality, cost basis is a critical variable, driving performance. In real estate, cost basis is a function of vintage year. To address vintage year risk, investors have turned to pacing strategies and models designed to set the rate for deploying capital. Investors should also monitor property sector exposure. The key elements of property sector exposure include: property type; geography; risk classification; life cycle of the asset; investment structure; and manager. Investors should look at their overall exposure to each of these components, on both a gross and net basis.

In addressing the financial risk in the Kenyan economy, the loan-to-value (LTV) ratio as a metric of financial risk measurement should be reviewed. The reason is that since LTV tends to decline when values are rising, pairing LTV together with the loan-to-cost (LTC) ratio is one way to mitigate the risk of adding to leverage when values rise. Neither LTV nor LTC capture the impact of leverage on returns or cash flow. For that, the debt service coverage ratio and net operating income metrics can help ensure that a property is not overleveraged.

The foundation of the risk management approaches adopted by this paper can be summarized as employing a well-devised investment program and thorough monitoring and research of economic variables. While the monitoring approach has been discussed, a well devised investment program can be achieved using eFront. eFront is a real estate software solution which simplifies information management and accelerate decision making for fund managers, fund administrators and limited partners. eFront solutions for real estate offer an integrated, end-to-end approach for automating and streamlining important aspects of the real estate investment lifecycle and enable investors to manage all aspects of their real estate investment business and complement property management and property-level cash flow forecasting applications. Fund managers of real estate investment vehicles can make more informed decisions and operate many of their business processes more efficiently using analytical capabilities; track investment performance by analyzing time weighted return, IRR and income yield across varying time periods and property types; slice and dice data across variables in real time to monitor and analyze financial and operational performance metrics at the property, fund and portfolio level.

CONCLUSION

Despite the activities of terror groups in the country, profit taking as well as an interest in the Kenyan real estate industry is increasing. The number of Kenyan millionaires has significantly increased and the middle class is becoming more sophisticated and informed. There is reported widespread increases in tenant demand supporting rental growth due to more money in circulation from FDI. The key driver of the economy is tourism but the prospects look good with the discovery of oil in Kenya. There are mitigating risks which must be addressed through the employment of a well-devised investment program and thorough monitoring and research of economic variables.

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