Five reasons to be bullish on

Nigerian Real Estate in 2018

Nigeria is finally coming out of recession. The currency uncertainty, falling production and double digit inflation that saw the country fall into negative growth and weighed heavily on investor confidence are giving way to a brighter picture. As the economy improves, the picture for real estate, both for occupational and capital markets will start to improve through 2018.

Of course, there will be the usual lag between economic recovery and market recovery but real estate, which has suffered from a sharp supply demand imbalance, widening vacancy rates and falling realised rents, looks, in our view, close to bottoming. In our view 2018 will be a year of consolidation and recovery.

In our view, this improving sentiment, will be underpinned by more quantifiable progress in a number of areas:

• First, importantly for real estate investors the market is starting to gain more confidence in the economy backed by an improving external environment.

• Second, government policy making is gaining some credibility through coherent plans to support diversification and fiscal consolidation with the backing of external bodies.

• Third, we are starting to see evidence that the decline in rental rates in Lagos is reaching the bottom of the cycle.

• Fourth, the legislative framework is in place for real estate pricing to mitigate the impact of a volatile economy.

• Fifth, for an economy and population the size of Nigeria's, we still think there is a structural undersupply of investment grade real estate stock. This is changing, which will provide increasing opportunities, for both local and international investors.

The impact on real estate markets

What does this more benign outlook mean for real estate? Granted, growth is likely to be pretty modest in the short term, as the country exits recession. But at least with inflation easing as pressure on the naira dissipates, disposable income growth should have a chance to recover giving some fillip to consumer demand; a welcome break for real estate landlords.

Office rentals which have seen a 20-40% reduction over the past two years are bottoming out. In retail, the slowdown in demand which has impacted footfall and pushed vacancy rates up should stabilise.

Most importantly for tenants and owners, the FX market is starting to function again. As the central bank reiterates its support for the Nafex currency window currency markets can begin to function with some degree of normality which should prove supportive for tenants struggling to balance the spread between a myriad of competing rates.

Of course it will take time for confidence to return fully to real estate markets. As in all emerging economies there is a lag between economic recovery and the recovery in real estate market and of course, Nigeria faces its own distinct set of challenges, particularly regarding the country's leadership and an election cycle kicking in through 2018.

Foreign investors remain wary given the supply that is already in the market and the pipeline that is coming in the short term. Rental expectations as well as pricing need to adjust to the new reality.

However, Nigeria remains a core investment destination for anyone looking at Sub-Saharan African markets. In an environment where it is increasingly hard to find returns any evidence that the country is making serious progress in implementing structural reforms and breaking the historical reliance that the country has on oil exports, will be welcomed by investors.

Below we look in more detail at the five drivers and above and why believe that it pays to be bullish on Nigeria in 2018.

1. The economy is kicking into gear

As discussed above we are turning increasingly optimistic about the economy in Nigeria, albeit we recognise that the rate of recovery will be modest. Furthermore, our constructive view is supported by a broader recovery across Sub Saharan Africa, with the other two big economies, Angola and South Africa also starting to crawl into gear as the external environment has improved.

Of course the inefficiencies inherent in a country which has relied for too long on the export of crude oil to satisfy its spending needs have created a challenging headwind. GDP growth is unlikely to pick up much above 1% in 2018. However, looking ahead of the next five years, the outlook looks more encouraging. At an average annual growth rate of 3.7% over the next five years, Nigeria's economy is in line with the Sub-Saharan average at 4%.

As the external environment improves and the government bolsters its fiscal position, so too will sentiment for the naira. Pressure on the naira and the mismatch between local currency and USD leases has been a major headwind for the real estate market. Not only does the weaker naira erode the USD value of the earnings of Nigerian corporates it also drives inflation which undermines the spending power of Nigerian consumers. At least now, this part of the cycle is also turning. Inflationary pressures are under control and the outlook for household income is reasonably robust.

Finally, the recovery in the oil price is, in the short term, clearly, the main driver behind the turnaround for Nigeria. This is supported by a recovery in oil production. A combination of inefficient policy implementation and infrastructure sabotage which mean that oil production fell from 2.1 million barrels per day (bpd) in 2015 to 1.9 million bpd in 2016 only exacerbating the problem caused by the slump in commodity pricing in 2014.

2. The government has a (relatively) credible plan.

Nigeria's tendency to overspend when times are good has meant that the economy tends to suffer from comparatively short lived economic cycles, relative, even to most other emerging markets. Being heavily reliant as it is, on the export of minerals (some 97% of total exports), the economy outperforms heavily when the oil price is recovering, yet tends to crash badly when the cycle turns. This creates a particularly challenging environment for real estate investors who have struggled to find liquidity or been forced to bring assets to the market at the wrong stage of the cycle.

Encouragingly, therefore, not only is Nigeria coming out of recession it is doing so with a relatively coherent plan to build a credible platform to break this cycle. The Economic Recovery and Growth Plan (ERGP) for 2017–2020 should go some way to break the historic leanings towards heavily pro-cyclical fiscal policies and build fiscal buffers to mitigate the volatility the country imports form commodity price swings and which are so detrimental to real estate investor sentiment.

As with many plans that have been introduced by previous administrations it is ambitious and there remains considerable uncertainty about its efficacy. Unlike previous initiatives, however, the ERGP however, does appear clearer in its strategy, setting accountability, targets and allocating resources

There is also evidence that debt and equity markets are also pricing growing confidence in the economy's long term prospects. Nigeria, has been successful in accessing international debt markets through 2017. The over-subscription of the recent Eurobond issuance indicates decent investor appetite for sovereign risk. Indeed Nigeria is currently planning a further issuance to replace naira debt by the end of 2017. In addition, there is evidence of foreign capital being more involved in the equity market. The value of foreign transactions on the stock exchange was roughly 60% higher in H1 2017 against last year.

3. Rents will bottom out through 2018.

As the economy comes out of recession, in our view, the real estate market is also closing in on the bottom of the cycle. The downward correction of rental rates in the greater Lagos Island market has been tough for landlords. Buildings which had previously demanded rentals of US\$1,000m^2 are closer to US\$650m^2. It is telling that new, quality supply to the market, can still attain rents in the region of US\$800-850m^2.

There has been equal pressure on the retail space as well of course. Currency pressures, high inflation rates and an overall slowdown in economic activity in the country has combined with oversupply to create a challenging environment. Retail centres in Lagos have witnessed declining footfalls in the larger shopping centres, which has translated into reduced demand for large-sized retail outlets. This has left high vacancies in some shopping centres.

In this context, market penetration for international brands has proven particularly difficult. Last year, fashion chain, Truworths pulled out of the market siting high rentals and import restrictions. While Shoprite expansion plans have reduced.

As with the office market the advantage still rests firmly with the tenant, though we think this will close through 2018 as the economy recovers and tenants take advantage of more favourable terms.

4. The legislation is in place to support more liquidity

Over the longer term, a key pillar of mitigating volatility in the real estate market and providing greater visibility to investors is through the creation of a robust legislative framework to support greater liquidity. It is vital for the real estate market that there is a robust framework in place that allow for a more efficient mediation of capital between the interests of a growing class of savers and alternative asset classes that can provide annuity income, such as real estate.

The first stage in this for the sub Saharan real estate market is to create the linkages between the pension fund industry and a listed real estate market. Fortunately, in Nigeria, the legislation exists, however it remains an undeveloped sector which faces a number of challenges such as an absence of investment grade stock, poor valuation standards, a broad lack of market understanding and high interest rates which support higher returns in less risky asset classes.

These issues have meant that the industry remains relatively undeveloped. There are currently three REITs in Nigeria that together account for less than 0.5% of the entire stock exchange roughly a tenth of what would be typical in developed markets.

Because the market remains shallow it is difficult for institutional capital build a meaningful position. Currently Nigerian pension funds have less than 0.4% of their total AuM in REITs. Rather than diversifying through alternative asset classes, in fact, Nigeria's bias towards conservative fixed income instruments is growing. Compared to the OECD average of 51% Nigeria has 85% of the country's pension fund AuM in fixed income instruments.

This mismatch restricts both the ability of institutional capital to diversify its income stream, and also limits the long term development capital that the real estate market needs to grow. The real estate and pension fund industries are in effect caught in a catch 22 position. Without the provision of a natural buyer through institutional capital, liquidity in the sector remains comparatively low as development financing is restricted. Pension funds will continue to be unable to invest, and because they cannot invest, the pool of trade-able, investment grade stock will remain limited.

Since the regulation is largely in place to support larger allocations to real estate, the key to solving this dilemma is by providing more instruments for pension funds to invest in real estate. This can come through the continued support for development of the REIT industry and to educate the investor market to support inflows into the sector. Furthermore, given that the pools of investable real estate stock remain low compared to developed markets, pension funds should be structured to provide the capital that is required to deepen liquidity in the sector. This can come through enabling, pension funds to invest through public debt (in instruments such as CMBS) or also gain exposure via private equity or by lending directly to real estate developers.

5. More quality product is coming to market

One of the consequence of the heavily pro-cyclical fiscal policies that the Nigerian authorities have historically pursued is that it creates a construction and investment market that is restrained by economic cycles. Together with poor policy implementation which has meant that the city's infrastructure has struggled to keep on top of the demands of a rapidly expanding urban population the result has been that there remains comparatively little quality, investable real estate stock.

This absence of quality space has meant that even if capital is willing and able to hold on to assets through a cycle, it is difficult to source the asset in the first place and the cost of the asset tends to make it uncompetitive versus other emerging markets.

There is a perception that there is a significant overhang of office space in the Lagos market. Whilst this may be true in the short term, in our view this is perception only, because demand has been so weak due to the oil price cycle. Longer term, as the market rebalances, Lagos remains fundamentally and structurally undersupplied in all forms of commercial real estate. Rather, we would argue that in a growing frontier economy, new stock, and a relatively high vacancy rate are required to absorb the recovery in demand when it occurs. Furthermore, as the supply of quality real estate space grows and liquidity improves, it provides more access points for investors.

Our experience for example, of other heavily pro-cyclical markets, with a close tie in to commodity exports, such as Russia suggests that in high growth markets, large vacancy rates and volatile rental growth, are necessary at the early stage of the real estate cycle.

Below, we look in a bit more detail at some of the pipeline projects that perhaps whilst having given rise to the perception of oversupply in the short term, over the longer term will support the institutionalisation of the market and greater liquidity.

Wings Office Complex

Developed by RMB Westport, The Wings development of close to 27,000m^2 GLA is situated in one of Nigeria's most exclusive addresses right in the heart of the CBD on Victoria Island and is anchored by Oando Plc.

The development is directly accessible from the recently upgraded Ozumba Mbadiwe arterial route and the Five Crowrie Creek water transportation route and is one of the very few prime offices with waterway access, providing greater commuting flexibility.

The development comprises two towers allowing for approximately 27,000m^2 of lettable area. The building is a game changer in the way developers are fusing sophistication, design, and functionality in office development with high quality finishes, 360-degree views and energy efficient features.

Royal Gardens Mall

Developed by RMB Westport, the Royal Gardens Mall will offer just shy of 30,000m^2 of quality retail space. The mall is strategically located next to the entrance for the Royal Gardens Estate where approximately 126 000 vehicles pass daily. The mall will also be competing closely with Novare Lekki Mall owned by Novare Equity Partners.

Eko Atlantic

Eko Atlantic is a brand-new city that is being developed on reclaimed land adjacent to Victoria Island. The city has created 10 million m^2 of prime real-estate on which office and residential developments are breaking ground. The Business District alone will have approximately 650,000m^2 of GLA to offer the market.

Upon completion of the city, Eko Atlantic will be home to 500,000 residents with an expected commuter volume of approximately 300,000 people. Eko Pearl Towers is the first completed residential building of a five-tower proposed development in the cities marina district. The development comes in addition to the completion of the major road infrastructure.

Lekki City, Lagos

Rendeavour's Lekki project development site is located on 1,000 ha within the Lekki Free Trade Zone, the largest free trade zone in West Africa. The site is adjacent to the approved location for the proposed Lekki International Airport and in close proximity to the deep sea port and a number of planned industrial developments. The project is currently at planning stage, and is a joint venture with the Lagos State Government.

Landmark Village

Landmark Village is a mixed-use development by Landmark Africa, a leading real estate and property development company in Nigeria. The 38,000m^2 development in Victoria Island will embody the "live, work, play" concept that is central to Landmark Africa's developments and will be the first of its kind in Nigeria. It is aimed to mirror nodes like Melrose Arch, Rosebank and Illovo in Johannesburg and developments like Canary Wharf in London. The development will have two office towers offering grade A accommodation, residential apartments, retail outlets, a 250 room 4 star hotel and a convention centre. The development will offer other amenities like leisure and recreational facilities.

Challenges

The unwinding of quantitative easing (QE) will create uncertainty.

Of course, in the near term, Nigeria remains highly exposed to external forces and front and centre of many investment strategies through 2018 will be the unwinding of quantitative easing (QE). QE has of course been highly distortive to global markets and its unwinding will create a headwind for frontier real estate markets, though we doubt it derail any recovery.

Whilst QE has been a major driver for developed market real estate the impact has been negligible on frontier real estate markets in Sub Saharan Africa. Where there has been a distortive impact it has been in debt markets. The challenge for Nigeria will be how they service their $15bn of external debt (which has grown by almost 50% in the last 12 months). The good news though is that for most commodity exporters, what they lose through the extra cost of servicing FX debt, can be balanced by the improvement in export revenues that a stronger dollar provides, thus helping to consolidate their fiscal positions.

As far as the naira is concerned, we are less worried. Largely because the unwinding of QE is so well flagged now by the Federal Reserve we feel confident that the market is now far less likely to respond as it did when Bernanke surprised the market by hinting at an accelerated unwinding of QE in 2013 which pushed out EMBI spreads and EM currencies.

Rising public sector indebtedness

The trend of rising public sector indebtedness is a risk across most of Sub Saharan Africa. The IMF note that on average public sector debt to GDP in Sub Saharan Africa has increased by 10% since 2014 to 42% of GDP which is the highest in almost two decades. Commodity exporters in SSA are particularly vulnerable where debt service to revenue ratios have increased by some seven times from an average of 8% of revenues in 2013 to 57% in 2016. Nigeria, where the external debt service ratio will rise to 6.1% of exports in 2018 is particularly vulnerable to external shocks. A more expensive dollar will make servicing this debt increasingly expensive

Political cycle

There remains considerable uncertainty around a potential succession of President Buhari which has the potential to impact the momentum around the reforms that are so important for the economy. Presidential elections will be held on 16 February 2019 to elect the President and the National Assembly. Whilst Buhari is allowed by the constitution to seek a second term, his health issues suggest that it may be unlikely that he will do so, throwing open the field to a range of candidates.

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