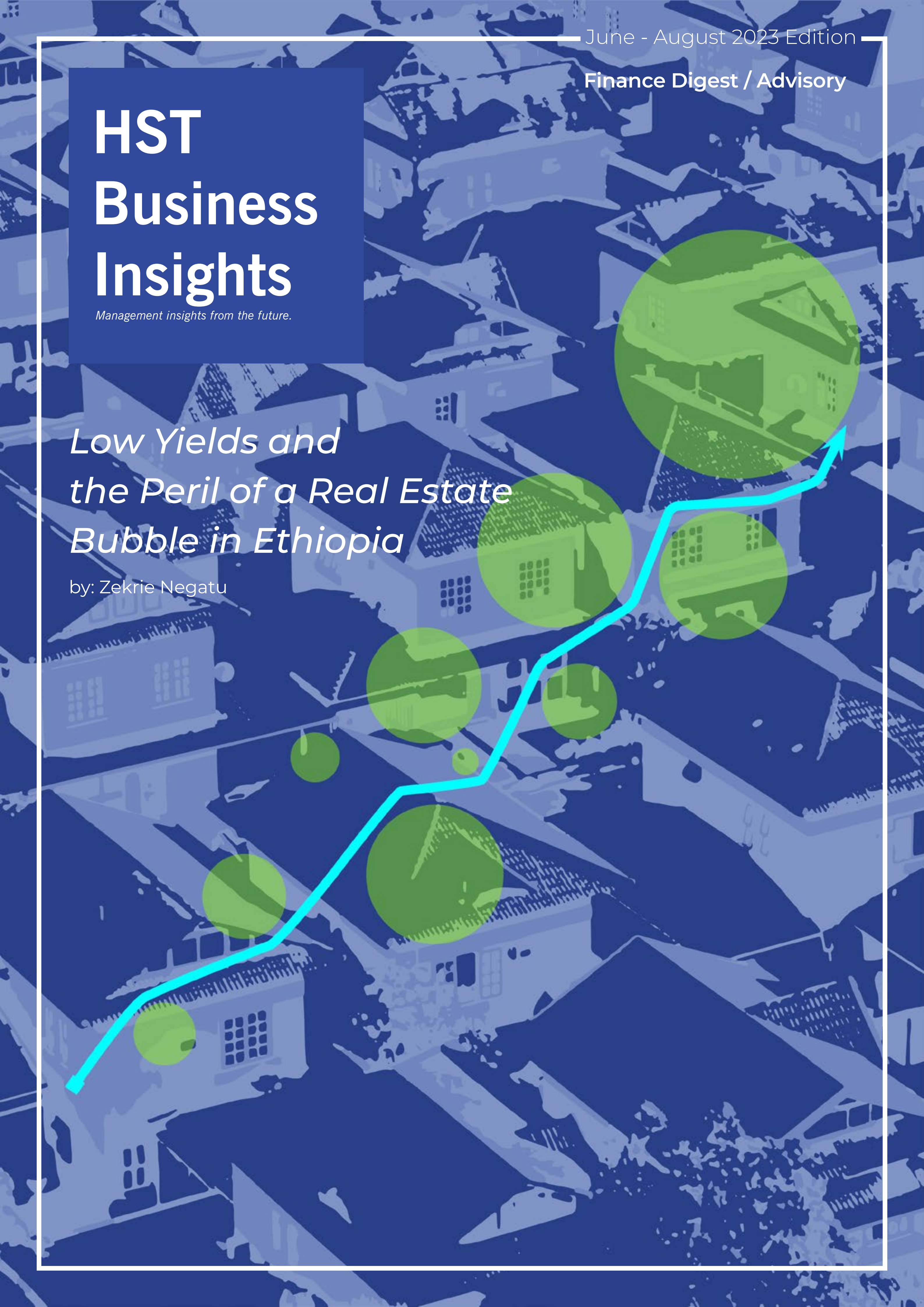

June - August 2023 Edition

Finance Digest / Advisory

HST Business Insights

Management insights from the future.

Low Yields and the Peril of a Real Estate Bubble in Ethiopia

by: Zekrie Negatu

Low Yields and the Peril of a Real Estate Bubble in Ethiopia

by: Zekrie Negatu
Managing Director at HST

Real estate investment holds a paramount position in the minds of Ethiopian investors, both within the country and the diaspora. Consequently, the emotional aspect of property ownership forms the backbone of many real estate firms in Ethiopia. However, amidst the flourishing real estate market, a concerning trend has emerged – one that should raise alarms, particularly for long-term investors and those attuned to financial principles.

For finance professionals, a property's intrinsic value lies in its capacity to generate future cashflows, usually through rental income. This is why experts analyzing real estate often employ property yield as a basic gauge of investment appeal.

Property yield, a straightforward but somewhat crude metric, assesses the return on a property investment. It is computed by dividing the property's annual rental earnings by its current market value.

In essence, the ratio reflects the prospective earnings relative to the property's present worth. This ratio can be either gross yield or net yield, with the former using total rental income in the numerator and the latter factoring in all property ownership costs. For example, if a 3-bedroom apartment in Addis Ababa is purchased for 14.5 million ETB and is expected to yield 35,000 ETB monthly in rent, the gross yield stands at 2.9%.

Though this example may be dismissed as anecdotal, it is not far from the overall reality of the local market because casual discussions with people who have intimate knowledge of the real estate market in Addis Ababa generally produce gross yield rates below 3%[1].

The website of the Global Property Guide which calculates rental yield rates from more than 60 countries reports the following under the "Very Poor" or "Poor" category:

Country	Gross Yield	Yield Rating
Taiwan	2.09%	Very Poor
Luxembourg	2.59%	Very Poor
Hong Kong	2.78%	Very Poor
Switzerland	2.94%	Poor

Source: Rental Yields Compared (globalpropertyguide.com)

Unfortunately, the database does not include Ethiopia, but it is reasonable to expect that it could easily join this league of low-yield countries if a similar survey is done on the subject.

In a balanced real estate market, property yields tend to align with prevailing interest rates and borrowing costs. Healthy yields that equal or exceed borrowing expenses signify fair property valuations and a sustainable investment climate. Conversely, persistently low property yields that significantly lag behind borrowing costs indicate overpriced properties and a disconnect between property prices and their income-generating potential.

Evidence from other economies demonstrates that excessive overpricing and low yields can serve as early warnings of impending real estate bubbles. When demand surges due to a fervent belief in continuous price appreciation, investors and speculators drive prices to unsustainable levels. This speculative behavior creates a stark mismatch between property market prices and their future income-generating ability. The trend continues as long as irrational exuberance dominates the market, but the situation collapses when the next buyer, often referred to as the 'next fool', fails to materialize.

The highest bids recently submitted by investors for undeveloped land in Addis Ababa (USD 7,500 and USD 12,630 per square meter) may be considered outliers, yet they hint at the overall trajectory of the local property market. The Global Property Guide cited earlier reveals that countries like France, Israel, and Taiwan have some of the most expensive developed property prices (e.g., France at USD 14,808/m2). The average selling prices reported for developed properties in some African countries are enviable by Ethiopian standards: USD 1,700 per m2 for South Africa and USD 831 per m2 for Egypt. It's essential to note that these figures pertain to developed properties, not undeveloped land as cited above for Addis Ababa.

The question of whether a real estate bubble is imminent is complex and contextual. Ethiopian investors face unique circumstances, limited investment options, and other factors that make real estate investment a more accessible option, despite its low yield. Many local investors view real estate as a hedge against inflation rather than a purely commercial endeavor, allowing for greater tolerance of low yields.

Moreover, unlike other parts of the world, local property buyers, especially in the residential sector, have limited access to mortgage loans. As a result, they rely heavily on personal and family savings for property acquisition. These funding sources are more patient during financial hardships and may not lead to widespread foreclosures by banks as seen in other countries during real estate bubbles.

While predicting real estate bubbles and their eventual bursts is challenging, one thing is clear: even with Ethiopia's unique circumstances and mitigating factors that can delay market corrections, economic principles cannot be disregarded in the long run. Property yields that fall significantly below the economy's cost of money are unsustainable and untenable in the long term. ■

Zekrie Negatu is a Managing Director of Consulting at HST and he can be reached at zekrie.negatu@hst-et.com

[1] A recent publication by the Accounting & Auditing Board of Ethiopia was brought to my attention after I submitted the draft for this article to HST's Editorial Team. Interestingly, the publication had an article from Million Kibret of BDO on the same topic with almost the same example. I hereby recognize the seniority of Million's article but also declare that, despite the timing and similarity of the topic, this is my independent work.