Kenyan Debt Sustainability, & Cytonn Weekly #49

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Executive Summary

Fixed Income: During the week, T-bills were oversubscribed with overall subscription remaining relatively the same at 106.4% compared to 105.5% recorded the previous week. The yields on the 91 and the 182 day T-bills were unchanged at 8.4% and 10.5%, while the 364 day increased to 11.1% from 10.9% the previous week. The National Treasury is set to reduce its capital expenditure budget by 25.8% for the fiscal year 2016/2017;

Equities: During the week, the Kenyan equities market was on a downward trend with NASI, NSE 20 and NSE 25 losing by 3.1%, 2.7% and 2.8%, respectively. The Central Bank of Kenya (CBK), issued a circular to all commercial banks requiring them to hold capital that is consistent with their risk profile and business strategy;

Private Equity: Financial services and technology sectors continue to witness increased private equity activity in Kenya as Equator Capital Partners converted their debt of Kshs 600.0 mn in Jamii Bora Bank for a 15.0% equity stake at a valuation of 1.3x price to book, which is cheaper than the recent acquisition of Fidelity Bank by SBM Holdings, which was at 1.6x price to book, while Toyota Tusho acquired a 9.5% equity stake in Seven Seas Technology for Kshs 300.0m;

Real Estate: The opening of a mixed-use development in Rwanda, Kigali Heights, highlights the investment opportunity in Sub-Saharan Africa; Players in the hospitality industry remain bullish on performance through opening of hotels and serviced apartments in various parts of the country;

Focus of the Week: This week we take a look at Kenya's debt levels and give our view on the future outlook with regards to Kenya's debt sustainability;

Company Updates

- Cytonn Investment's key development partners, Taaleri of Finland, visited the company this week. Taaleri is a NASDAQ listed investment company with over USD 5 billion of funds under management. Juhani Elomaa, Chief Executive Officer of Taaleri of Finland, led a team of executives for their visit to Cytonn Investments and the projects funded by Taaleri, and developed by Cytonn Real Estate (CRE), the development affiliate of Cytonn Investments. See Event Note
- Following the visit, the event received significant coverage:
    - The Business Daily
    - Daily Nation

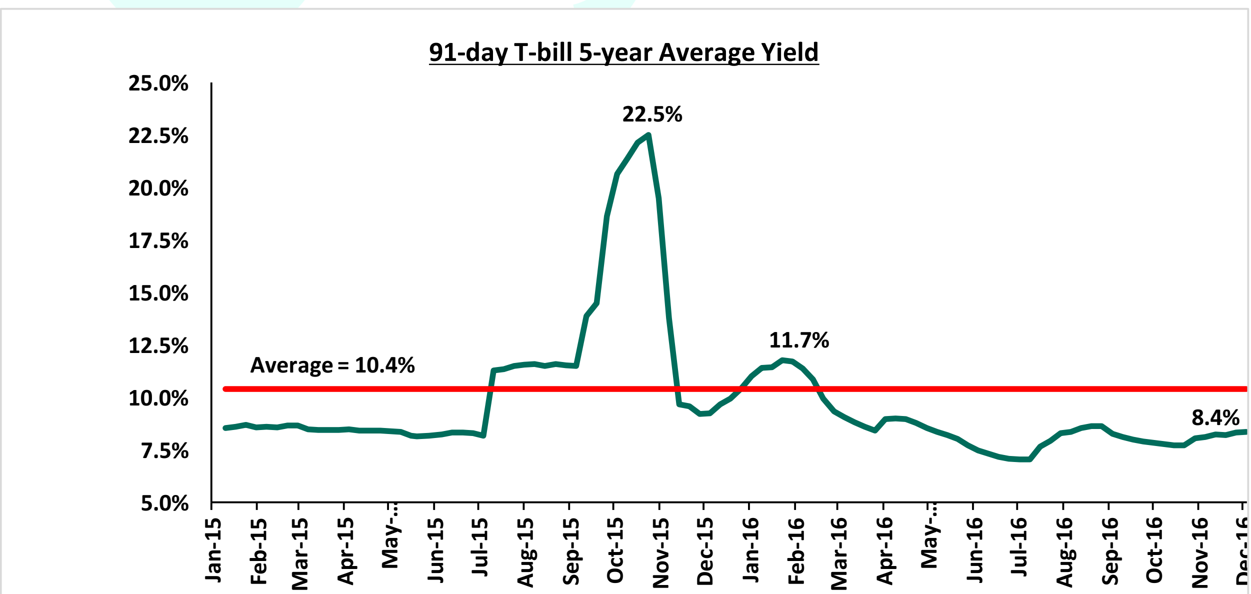
- Cytonn Foundation, the corporate social responsibility (CSR) affiliate of Cytonn Investments, hosted the annual eHub Forum, which connects entrepreneurs in Kenya with funding opportunities from investors. See Event Note
- The Cytonn eHub training is an intense 12-week training programme that selects current and potential entrepreneurs who need training support. Out of an initial 20 participants, 9 met the stringent graduation requirements. See eHub Entrepreneurs' Profile
- Cytonn Investments Clients trained on Estate Planning during the biweekly trainings on Wealth Management. See Event Note
- We had several research engagements this week:
    - Caleb Mugendi, our Investments Analyst, discussed Kenya Airway's technical staff strike and Cytonn's Q3'2016 Banking Sector Report. See Caleb on CNBC
    - John Ndua, our Investment Analyst, discussed business optimism among Kenyan firms and the Kenyan Treasury's move to cut the country's development budget. See John on CNBC
    - Maurice Oduor, our Investments Manager, discussed on why bond turnover at the Nairobi Securities Exchange grew by 42% to USD 3.9 bn in the first eleven months of 2016, and the state of sugar industry in Kenya. See Maurice on CNBC
- Cytonn Investments released the Q3'2016 Banking Sector Report, which focused on the analysis of the 11-listed commercial banks in Kenya. The analysis is used for our quoted private equity investors, to determine which banks are the most stable from a franchise value and a future growth opportunity perspective. Cytonn Q3'2016 Banking Sector Report
- Cytonn Diaspora requests applications from qualified firms interested in selling products and services to Kenyans in the Diaspora. If you are interested in applying to be a Cytonn Diaspora partner, please find the RFP at Diaspora Partner Applications
- The free first class Cytonn diaspora bus tour will be on 17th December 2016. The aim of the tour is to take diaspora clients and potential clients to our property sites. The tour starts from the Chancery to Karen to see Amara Ridge, to Ridgeways, to see The Ridge site and ends at Ruaka, to see The Alma and Taraji Heights See Diaspora Bus Tour
- To invest in any of our current or upcoming real estate projects, please visit **Cytonn Real Estate**. We continue to see very strong interest in our products:
    - The Alma, which is now 55.0% sold and has delivered an annualized return of 55.0% p.a. for investors who bought off-plan. See The Alma. We will be having site visits to showcase this iconic development every two weeks, right after the wealth management trainings. If interested in attending the site visit, email clientservices@cytonn.com
    - Amara Ridge is currently 100.0% sold. See Amara Ridge
    - We have 12 investment-ready projects, offering attractive development returns and buyer's targeted returns of around 25.0% p.a. See further details here: Summary of investment-ready projects

We continue to beef up the team with several ongoing hires: **Careers at Cytonn**.

Fixed Income

During the week, T-bills subscription remained relatively the same increasing by 0.9% to 106.4%, compared to 105.5% recorded the previous week. The slight increase in subscription levels for treasury bills can be attributed to increased subscription in the 364-day paper coming at 121.8% from 73.6% recorded the previous week as the paper offered investors the best returns on a risk-adjusted basis. Subscription rates on the 91-day paper decreased significantly during the week coming in at 54.4% from 141.6% the previous week. The significant drop in the subscription level for the 91-day T-bill can be attributed to investors opting for the 182 – day and 364 -day papers that are now offering relatively better yields. The subscription rate for the 182-day and 364-day paper increased to 125.8% and 121.8% from 113.4% and 73.6%, respectively the previous week. Yields on the 91-day and 182-day T-bills remained stable during the week coming in at 8.4% and 10.5% similar to the previous week, respectively while yields on the 364-day increased to 11.1% from 10.9%, the previous week.

The 91-day T-bill is currently trading below its 5-year average of 10.4%. The decline on the 91-day paper is mainly attributed to the expected low interest rates environment following (i) the operationalization of the Banking Act (Amendment) 2015, which led to more liquidity in the market, and (ii) reduced pressure from the government borrowing program as they are currently ahead of the pro-rated domestic borrowing target of Kshs 106.0. bn, having borrowed Kshs 147.1 bn, which is 138.8% of the pro-rated target. It is important to note that the government is in the process of revising its domestic borrowing target upwards to Kshs 294.6 bn from Kshs. 229.6 bn which if passed by Parliament will take the pro-rated borrowing target to Kshs 136.0 bn, meaning that the government will still be ahead of the borrowing target. Key to note is that as indicated in our Cytonn Weekly #42, the interest rates have bottomed out and we expect them to persist at the current levels.



For the month of December, the Government of Kenya will be issuing a 2-year fixed coupon bond of which the coupon rate will be market determined targeting to raise Kshs 30.0 bn for budgetary support. Given that (i) a 2-year bond is currently trading in the secondary market at a yield of 12.3%, and (ii) interest rates are expected to be relatively stable on account of reduced pressure on government borrowing for the 2016/2017 fiscal year, we expect investors to bid within the secondary market yields and we therefore recommend a bidding range of 12.3% - 13.0% on the FXD 3/2016/2. In the recent past, we have noted the inconsistency between what Central Bank is effectively forcing banks to reduce lending rates, and the higher yields that government is accepting in the treasury securities auction. As previously indicated, we are of the view that this will lead to crowding out of the private sector, as the government is a safer investment, further reducing credit growth to the private sector which will negatively affect economic growth.

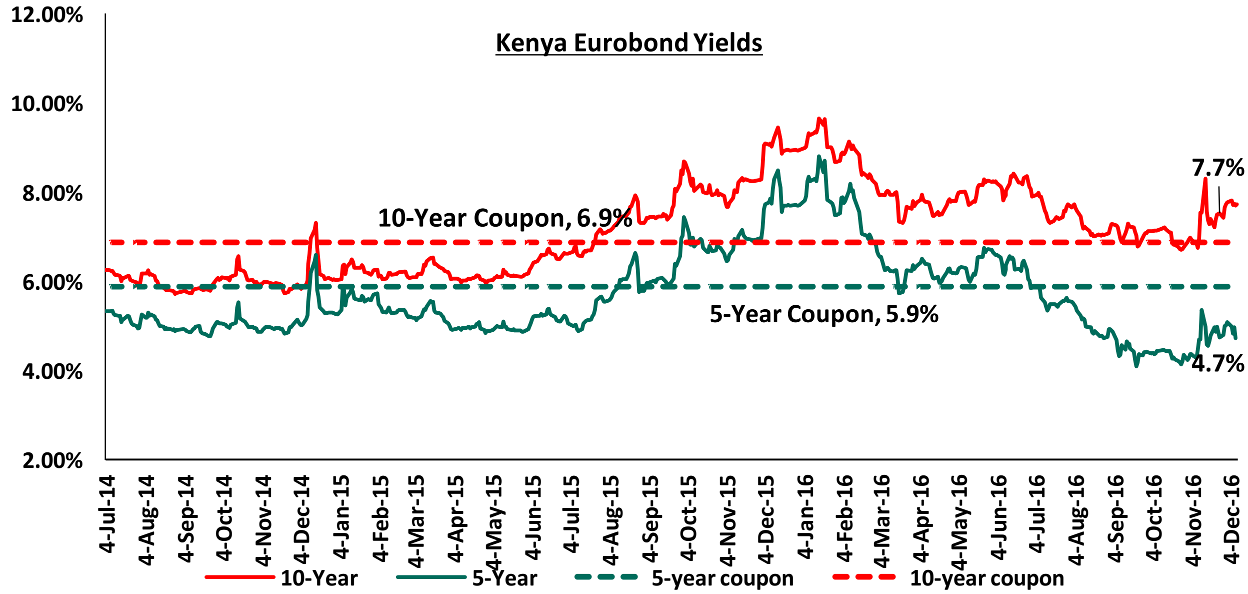
The Central Bank Weekly report revealed that the interbank rate remained stable at 6.1% similar to the rate registered the previous week, on account of improved liquidity conditions in the money market attributable to increased government payments. As highlighted in our **Cytonn Weekly Report #28** the interbank rate is often determined by the liquidity distributions within the banking sector as opposed to the net liquidity position in the interbank market.

Below is a summary of the money market activity during the week:

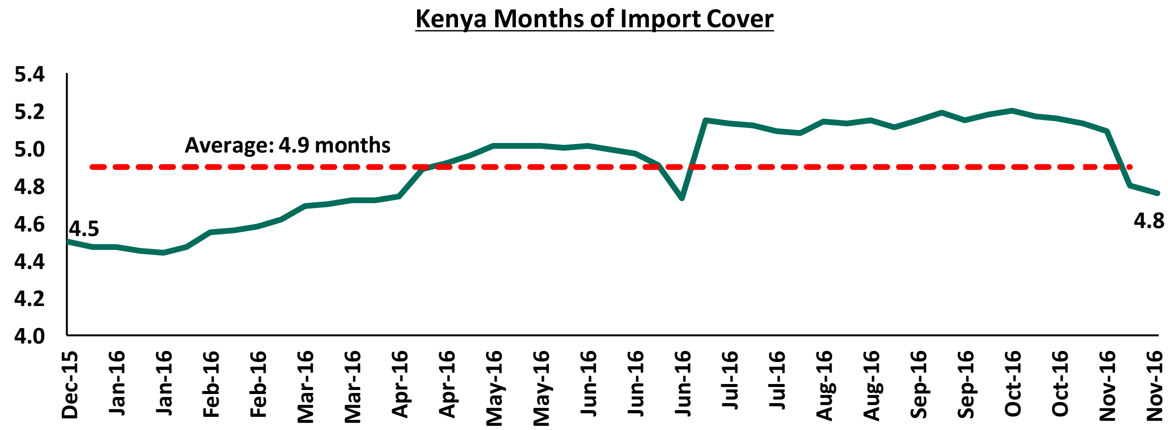
all values in Kshs bn, unless stated otherwise

Weekly Liquidity Position – Kenya			
Liquidity Injection		**Liquidity Reduction**	
Term Auction Deposit Maturities	0.0	T-bond sales	0.0
Government Payments	36.7	Transfer from Banks - Taxes	15.2
T-bond Redemptions	0.0	T-bill (Primary issues)	16.7
T-bill Redemption	16.2	Term Auction Deposit	0.0
T-bond Interest	0.0	Reverse Repo Maturities	29.4
Reverse Repo Purchases	16.5	Repos	0.0
Repos Maturities	21.7	T-Bills/T-Bonds Tap Sale	0.0
Total Liquidity Injection	**74.6**	**Total Liquidity Withdrawal**	**61.3**
		Net Liquidity Injection	**13.3**

According to Bloomberg, yields on the 5-year and 10-year Eurobonds decreased week on week to 4.7% and 7.7% from 5.0% and 7.8%, respectively, the previous week. Since the mid-January 2016 peak, yields on the Kenya Eurobonds have declined by 2.8% and 1.9%, respectively, for the 5-year and 10-year bond due to improving macroeconomic conditions in the country. This is an indication that Kenya remains an attractive investment destination.



The Kenyan Shilling remained relatively stable against the dollar, closing the week at Kshs 102.0, from Kshs 101.9 the previous week on account of increased demand from oil importers. On a YTD basis, the shilling has appreciated by 0.3% against the dollar. In recent weeks, we have seen the months of import cover decline to below the 1-year average of 4.9 months, and is currently at 4.8 months, similar to the previous week. Just 2-months ago, on 6th October 2016, there was 5.2 months of import cover. As stated in our [Cytonn Weekly #45](), this is worrying as the rate of decrease in the reserve could be an indication that the CBK is using a lot of reserves to support the shilling. This comes at a time when the US Federal Reserve's Open Market Committee (FOMC) is set to meet on Wednesday 14th December, 2016 to agree on the path of monetary policy. We expect the FOMC to increase the federal funds rate by 25 bps to a minimum of 0.5% owing to; (i) the rising inflationary demand pressure that pushed the inflation rate to a two year high inflation of 1.6%, just below the target of 2.0%, (ii) the improvement in the labour market as evidenced by the drop in unemployment rate to 4.6% compared to 5.0% for a similar period last year, and (iii) increased GDP growth where the US economy grew by 2.9% in the 3rd quarter which is the highest quarterly growth in two years. This is likely to see the dollar strengthen against other major global currencies, hence may have an adverse effect on the shilling in the short to medium term.



The National Treasury is set to reduce its project spending budget by 25.8% to Kshs 606.5 bn from Kshs 817.3 bn, contrary to the 26.5% change it had earlier indicated in the 2016 Budgetary Review Outlook Paper (BROP) as highlighted in our Cytonn Monthly – October 2016. Key project budget cuts will include (i) power generation and transmission by Kshs 57.8 bn, (ii) rail transport by Kshs 43.4 bn, (iii) roads budget by Kshs 27.7 bn, (iv) water projects by Kshs 18.0 bn, and (v) tourism promotion by Kshs 1.5 bn. However, despite cuts in development expenditure, recurrent expenditure is expected to increase by 1.3% to Kshs 1,183.5 bn from Kshs 1,168.5 bn. This comes at a time when the government is projected to spend 40.0% of tax revenue on debt repayments in the next financial year compared to 32.0% in the current fiscal year 2016/17 year, much higher than the IMF recommended level of 22.0% debt service to revenue. Given that Kenya Revenue Authority (KRA) has missed its first quarter target of Kshs 328.0 bn by 4.4%, we are not certain that it will achieve its 2016/17 revenue collection target. With debt obligation rising faster than revenue collection and given the slowdown in credit growth, this may impact the economic performance of the country and may affect the country's debt sustainability. We have discussed this in more detail in this week's topical, Kenyan Debt Sustainability in the focus of the week.

The government has once again postponed the launch of the much awaited 5-year mobile-phone based bond, named M-Akiba bond. The product aims to encourage individuals to purchase government securities for as little as Kshs 3,000 up to a maximum of Kshs 140,000 daily through the system. The government has cited high transaction charges that will range between 2.0% and 3.0% as the major challenge, which could significantly erode investors' expected earnings. The government had already postponed the launch in October 2015, citing volatile interest rates. If implemented it will be a cheaper way for the government to fund its budget as highlighted in our Cytonn Weekly #36. We are of the view that the fruition of the project will be challenging given that historically, Kenyans, especially at the bottom of the pyramid have been net borrowers and we are yet to see a saving culture. Due to this, we see the project being entirely cancelled in the near future.

The number of tourist arrivals through the country's two major airports, Jomo Kenyatta International Airport (JKIA) and Moi International Airport (MIA), went up 27.6% y/y during the month of September. This is majorly as a result of lifted travel advisories from countries such as

US, UK and France, which had placed them as a result of attacks from terrorist organisation Al-Shabaab. The government has also increased its initiatives to revive the sector, which was once the country's highest foreign exchange earner.

The parliamentary budget office has questioned the 6.0% growth projection for 2017 cited by the National Treasury and they had revised GDP growth forecast downwards from 6.5% to 6.0% primarily due to slowing private sector credit growth. The parliamentary budget office cited several challenges going forward, among them being (i) erratic weather patterns due to climate change which would have an overall effect on agricultural production, (ii) reduced private sector credit growth following the implementation of the Banking Act Amendment 2015, (iii) a delay in implementation of the flagship infrastructure projects such as the Standard Gauge Railway, which are not expected to come online in the coming year, (iv) investors having a wait-and-see approach on the forthcoming general elections, and (v) increasing oil prices following OPEC's decision to cut down on oil production in a bid to stabilise the market, that resulted in oil prices hitting a 16-month high of USD 54.9 per barrel during the week. Despite this, we still maintain our GDP growth outlook for 2016 at 6.0% as stated in our Cytonn Weekly #42, supported by Agriculture, Tourism, Energy and the Real Estate sector which we project to grow by 2.8%, 7.0%, 7.4% and 9.0%, respectively.

The Kenya Pipeline Company (KPC) is on track with the construction of the Mombasa-Nairobi oil pipeline. The project is currently 68.0% complete with an expected completion date of April 2017. This is in anticipation of the country's fast paced economic growth, which is projected to cause an increase in the country's oil demand. This will help reduce reliance on trucks to transport oil since truck transport is costlier and inefficient, which will also reduce degradation of the Nairobi-Mombasa road network. The project is one of the government's flagship projects which are still underway, others including (i) the Lamu Port and Lamu-Southern Sudan-Ethiopia Transport (LAPSSET) Corridor, and (ii) the Standard Gauge Railway (SGR). Interesting to note, the Ministry of Energy and Petroleum's budget has been slashed by 48.5% to Kshs 60.3 bn from Kshs 117.0 bn so we are yet to see how this shall be funded. Some projects affected by the budgetary cut include geothermal projects, power transmission and oil production, which is still on a pilot basis. Given the importance of affordable and reliable energy to sustain the country's economic growth, this might impact the realization of the country's development goals. Development of the energy sector would help cushion the economy against the volatility of global oil prices considering imported oil is still the country's primary source of energy.

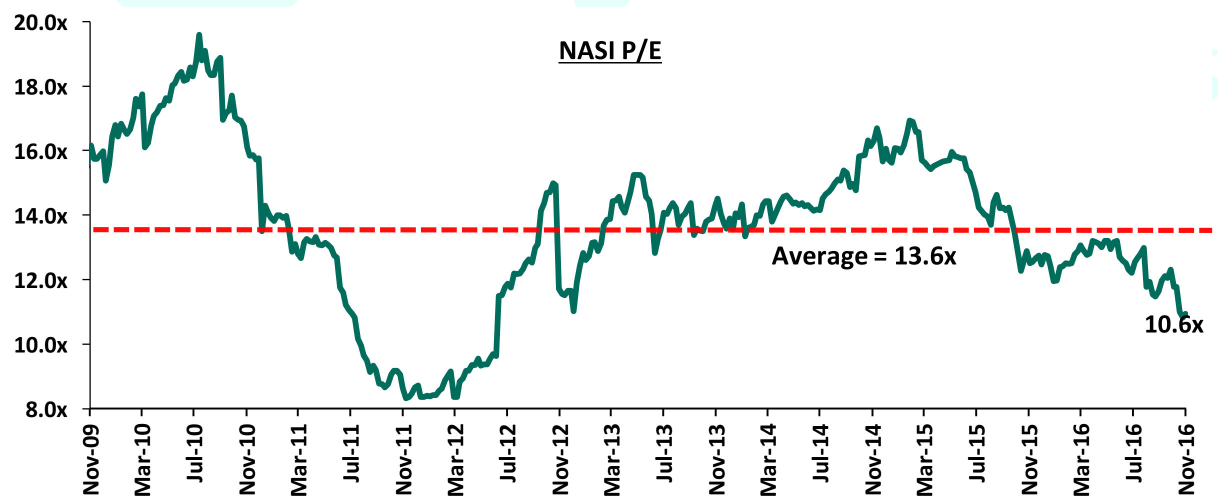
The Government is ahead of its domestic borrowing for this fiscal year having borrowed Kshs 147.1 bn for the current fiscal year against a target of Kshs 106.0 bn (assuming a pro-rated borrowing throughout the financial year of Kshs 294.6 bn budgeted for the full financial year). It is important to note, however, that the government is in the process of revising its domestic borrowing target upwards to Kshs 294.6 bn, which will take the pro-rated borrowing target to Kshs 136.0 bn, and the government will still be ahead of the borrowing target. Interest rates, which had reversed trends due to the enactment of The Banking Act (Amendment), 2015, appear to have bottomed out and we expect them to persist at the current levels. It is due to this that we think it is prudent for investors to be biased towards short-term fixed income instruments given the prevailing interest rates environment.

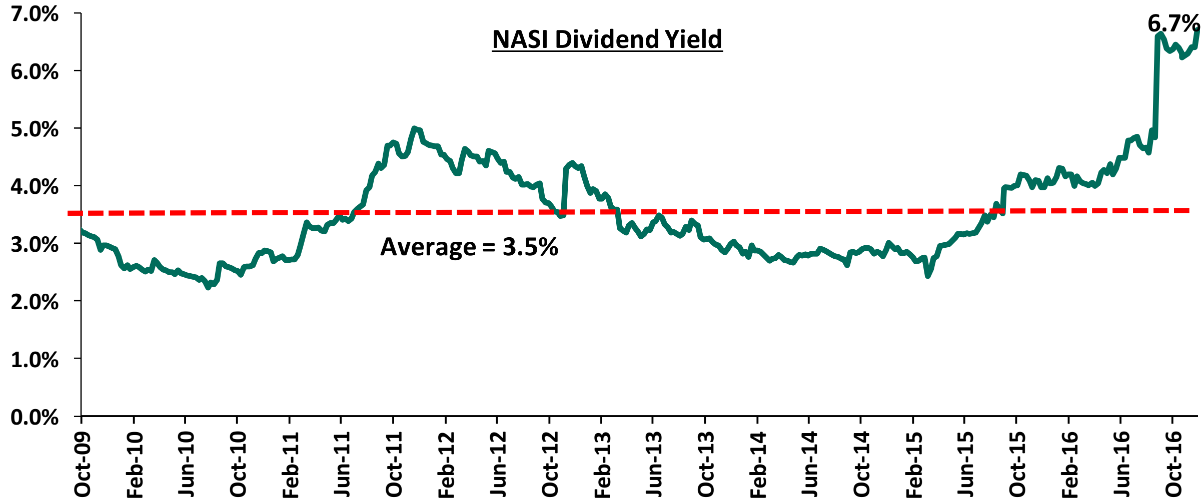
Equities

During the week, the Kenyan equities market was on a downward trend, with NASI, NSE 20 and NSE 25 losing by 3.1%, 2.7% and 2.8%, respectively, taking their YTD performances to (9.2%), (21.8%) and (16.7%), respectively. Performance was driven by losses in select large cap stocks, with KCB Group, Safaricom, and Co-operative Bank losing 5.0%, 4.8% and 3.6%, respectively. Since the February 2015 peak, the market has lost 42.6% and 25.5% for NSE 20 and NASI, respectively.

Equities turnover declined by 35.1% to close the week at USD 17.9 mn from USD 27.6 mn the previous week. Foreign investors turned net sellers with a net outflows of USD 0.6 mn, compared to a net inflow of USD 2.3 mn recorded the previous week, with foreign investor participation declining to 71.1% from 75.9% recorded the previous week. EABL was the top mover accounting for 30.9% of market activity and losing 2.5% during the week. We maintain our expectation of stronger earnings in 2016 compared to 2015 supported by a favourable macroeconomic environment. However, the key risk is the banking sector, following the implementation of the Banking Act (Amendment) 2015, which stipulates loans and deposit pricing framework. With the banking sector still dependent on interest income, which as per Q3'2016 results was at 72.0% of total operating income, volatility in this revenue stream may depress earnings for banks especially during the fourth quarter.

The market is currently trading at a price to earnings ratio of 10.6x, versus a historical average of 13.6x, with a dividend yield of 6.7% versus a historical average of 3.5%. The charts below indicate the historical PE and dividend yields of the market.





The Central Bank of Kenya (CBK), has issued a circular to all commercial banks stating that from April 2017, each bank will be required to hold capital that is consistent with its risk profile and business strategy, under the Internal Capital Adequacy Assessment Process (ICAAP) document. Institutions are to design the ICAAP to cater for their own individual needs and circumstances and the capital held by each bank will be consisent to its risk profile and business strategy as opposed to the past where all banks regardless of the size and risk profile held similar capital requirements. The move to introduce risk-based supervision by the CBK is likely to see some of the commercial banks in the industry raise more funds to cover on their risks and exposure leading to increased mergers and acquisitions in the industry as highlighted in our Q3'2016 Banking Sector Report. Corporate governance, a core part of any effective institution will be a key metric in assessing the capital adequacy as the banking sector has already seen the fall of three banks, Imperial Bank, Dubai Bank and Chase Bank under receivership due to mismanagement brought about by poor corporate governance. This will result into improved investor confidence in the country's financial services sector, further leading to a formation of a sustainable financial system.

The CBK released Q3'2016 credit survey report which highlighted the key perfomance of the banking sector during the quarter. The key highlights include;

- The total assets increased by 2.9% to Kshs 3.8 tn in Q3'2016 from Kshs. 3.7 tn in Q2'2016 with gross loans issued remaining relatively flat recording a growth of 0.4% to 2.3 tn in Q3'2016 from Kshs 2.29 tn in Q2'2016, highlighting the slowdown in credit uptake
- Total deposits rose by 2.1% to Kshs 2.9 tn from Kshs 2.8 tn in Q2'2016. This led to a decline in the Loan to Deposit Ratio to 79.8% from 81.1% in Q2'2016
- The gross NPL's ratio increased to 9.1% in Q3'2016 from 8.4% in Q2'2016 which has mainly been attributed to challenges in the business environment which led to constrained cashflows for borrowers with non-listed banks registering 11.3% NPL ratio and listed banks registering 9.0% NPL ratio. The rise in levels of NPLs has brought into question the risk assessment framework currently in use by commercial banks. This further led to an increase in Loan Loss Provisions in listed and non-listed banks by 93.8% and 175.9%,

respectively in Q3'2016, highlighting the effect of cost of risk on the performance of commercial banks in the period under review

- On capital adequacy, the core capital to total risk-weighted assets ratio and Total capital to risk-weighted assets remained unchanged at 16.3% and 19.0%, respectively, well above the statutory limit of 5% and 14.5% for core capital and total capital,respectively
- Return on Assets decreased to 3.3% in Q3'2016 from 4.2% in Q2'2016 while the Return on Equity decreased to 27.0% in Q3'2016 from 33.8% in Q2'2016
- The sectors with the highest increase in credit demand from commercial banks in the quarter were trade, households and real estate at 48.0%, 43.0% and 40.0%, respectively, as per the results from the survey
- The listed commercial banks continues to post better performance driving the banking industry and in our view this is likely to continue in the long-term as the listed institutions continue to drive alternative revenue creation strategies to bolster performance, despite the interest rate cap which will negatively affect Interest Income for commercial banks.

During the week, Kenya Airways saw its engineers go on a strike citing several reasons, which include, (i) poor pay, (ii) lack of promotions and, (iii) unfavorable shift patterns. This led to delay in flights paralysing the operations of the carrier majorly to African destinations. The carrier has already lost over 60 pilots to its rivals in the last one year on claims of poor pay and unfavorable working environment. This comes as the carrier embarks on transformation through restructuring with Mr. Michael Joseph as the new Board Chairperson while Mbuvi Ngunze leaves the offices of the Chief Executive Officer early next year. The 30.0% state owned carrier has been reporting poor results over the recent past having posted a loss of Kshs 4.7 bn before tax for half year ending september 2016. The carrier loses Kshs. 200.0 mn in revenues per day on every strike as indicated in our Cytonn Weekly Report #41. The recent boardroom change in the company has already had a positive impact, having resolved the strike in less than 24 hours with the engineers promised pay rise and favourable shift patterns starting January next year. Through the airline's transformation agenda moving forward, we expect Kenya Airways to focus on its turnaround strategy "Operation Pride", which will focus on (i) closing the profitability gap, (ii) improving the business model, and (iii) optimizing on capital.

Below is our equities recommendation table. Key changes from our previous recommendation are:

- *HF Group moved to an ''Accumulate'' recommendation with an upside of 16.2% from a ''Hold'' recommendation with an upside of 8.4%, following a 7.9% w/w price decline*

all prices in Kshs unless stated

EQUITY RECOMMENDATION

No.	Company	Price as at 2/12/16	Price as at 9/11/16	w/w Change	YTD Change	Target Price*	Dividend Yield	Upside/ (Downside)**	Recommendation
1.	Bamburi Cement	158.0	156.0	(1.3%)	(10.9%)	231.7	7.8%	56.3%	Buy
2.	ARM	25.5	25.0	(2.0%)	(40.1%)	37.0	0.0%	48.0%	Buy

3.	KCB Group***	29.8	28.3	(5.0%)	(35.4%)	39.6	7.5%	47.7%	Buy
4.	Britam	10.1	10.2	1.0%	(21.5%)	13.2	2.4%	31.8%	Buy
5.	Stanbic Holdings	69.5	70.0	0.7%	(15.2%)	84.7	7.9%	28.9%	Buy
6.	Kenya Re	22.0	21.8	(1.1%)	3.6%	26.9	3.6%	27.3%	Buy
7.	BAT (K)	850.0	840.0	(1.2%)	7.0%	970.8	6.2%	21.8%	Buy
8.	NIC	27.3	26.8	(1.8%)	(38.2%)	30.8	3.5%	18.6%	Accumulate
9.	HF Group	14.0	12.9	(7.9%)	(42.0%)	13.8	9.2%	16.2%	Accumulate
10.	CIC Insurance	4.0	4.0	1.3%	(35.5%)	4.4	2.5%	12.5%	Accumulate
11.	Equity Group	30.0	30.0	0.0%	(25.0%)	31.3	7.7%	12.0%	Accumulate
12.	Co-op Bank	13.9	13.4	(3.6%)	(25.8%)	13.6	6.8%	8.7%	Hold
13.	I&M Holdings	91.0	90.0	(1.1%)	(10.0%)	90.7	3.9%	4.7%	Lighten
14.	Sanlam Kenya	32.5	29.3	(10.0%)	(51.3%)	30.5	0.0%	4.3%	Lighten
15.	Liberty	14.0	13.5	(3.9%)	(31.0%)	13.9	0.0%	3.3%	Lighten
16.	Jubilee Insurance	480.0	485.0	1.0%	0.2%	482.2	1.8%	1.3%	Lighten
17.	DTBK***	129.0	127.0	(1.6%)	(32.1%)	116.8	1.8%	(6.2%)	Sell
18.	Barclays	9.2	9.1	(1.1%)	(33.5%)	7.6	9.7%	(6.3%)	Sell
19.	Safaricom	20.0	19.0	(4.8%)	16.6%	16.6	3.6%	(9.0%)	Sell
20.	Standard Chartered***	190.0	189.0	(0.5%)	(3.1%)	157.7	6.6%	(10.0%)	Sell
21.	NBK	7.8	7.6	(2.6%)	(51.7%)	3.8	0.0%	(50.0%)	Sell

**Target Price as per Cytonn Analyst estimates*

***Upside / (Downside) is adjusted for Dividend Yield*

****Indicates companies in which Cytonn holds shares in*

Accumulate – Buying should be restrained and timed to happen when there are momentary dips in stock prices.

Lighten – Investor to consider selling, timed to happen when there are price rallies

Private Equity

Equator Capital Partners, a US based private equity fund, has invested Kshs 600 mn through its ShoreCap II Fund into Jamii Bora Bank, for an equity stake of 15%. The investment is by way of conversion into equity of a convertible debt Equator Capital Partners held of Jamii Bora Bank. As per our Cytonn Weekly #15, total debt was provided by Equator Capital Partners and Progression Capital Africa Limited of Kshs 1.2 bn, which was to be used to grow Jamii Bora Bank's rural and urban network and also increase its capacity to lend to the SME sector, as part of their Kshs 5.0 bn financing plan. As at Q3'2016, the bank had a book value of Kshs 3.1 bn as such the transaction is being carried out at a 1.3x price-to-book valuation, relatively cheaper than the average banking sector transactions over the last three-years, which have been carried out at a price to book multiple of 1.9x.

For more details on this deal see our note on Equator Capital Partners invests in Jamii Bora Bank

In further investment into Kenya's technology sector, Japan's Toyota Tusho, owned by one of the world's leading auto-mobile makers, Toyota Group, have bought a 9.5% stake in Kenyan-based tech firm Seven Seas Technology for Kshs 306.0 mn, valuing the tech firm at Kshs 3.2 bn. The investment by Tusho was through their social venture fund, CSV Africa, a Toyota Tsusho venture fund set up in 2014. CSV Africa will also help Seven Seas Technology in the efforts to enhance quality and access to medical services in Kenya over the next 5 years.

Seven Seas Technology is a provider of integrated business and technology solutions, involved in the provision of medical infrastructure, health care programs and solutions for enhanced management of healthcare institutions and resources including; turnkey healthcare project management, healthcare information technology and health information systems. This is the second private equity investment received by Seven Seas, which follows the investment by the Abraaj Group in 2008 for an equity stake of 21%.

Other investments in Africa by CSV Africa Fund include a USD 0.3 mn investment in Hiroki Addis Manufacturing S.C - a leather business in Ethiopia and a USD 3.0 mn investment in Katonga Farm Ltd - large-scale agricultural project in Zambia. The investment is attractive due to:

i. Seven Seas' recent partnership with GE Healthcare through the Kenya Ministry of Health's Managed Equipment Services (MES) project for the installation and upgrading of medical infrastructure in 98 hospitals distributed in the 47 Kenyan Counties
ii. Demand for technology based healthcare services in Kenya, and,
iii. The potential of the fund to exit its investment through the proposed initial public offering set for 2020 by Seven Seas.

Private equity investment activity in Africa has continued to improve, as evidenced by the increase in the number of fundraises, exits and deal volumes in the region. Preference is still skewed towards financial services, energy, real estate, healthcare, education, and IT sectors although infrastructure, Fast Moving Consumer Goods (FMCG) industries have now gained traction. We remain bullish on PE as an asset class in Sub-Saharan Africa given (i) the abundance of global capital looking for investment opportunities in Africa, (ii) attractive valuations in the private sector, and (iii) strong economic growth projections, compared to global markets.

Real Estate

Kenyan private equity firm, Fusion Capital, has officially opened the Kshs 4 bn Mixed Used Development in Rwanda dubbed 'Kigali Heights'. 75% of the 30,000 SQM development will comprise of Grade-A offices while the remaining 25% will be for retail use. The project, started in 2014, obtained funds from both institutional clients and international investors including Finland Based firm, Taaleri Private Equity Funds Ltd. The investment in Rwanda highlights the opportunity in countries in Sub-Saharan Africa driven mostly by high GDP growth of above 5% annually. Rwanda has been marked as one of the fastest growing economies, and was recently ranked the 2nd country in Sub-Saharan Africa in World Banks' 'Ease of Doing Business Report 2017'. Increased investment in Rwanda's real estate sector is driven by the following factors;

i. Ease in property registration through introduction of a fast track procedure for commercial property transfers and implementation of a web-based Land Administration Information System to improve transparency,
ii. Ease in access to credit through improved Information Technology Systems and introduction of credit scoring in 2015 which enables lenders to easily assess the credit-worthiness of potential borrowers,

iii. High urbanization rate with the National Institute of Statistics of Rwanda projecting that the urban population will increase from 16.5% of Rwanda's population in 2012 to 30% by 2032, and,
iv. Housing demand estimated to be 344,068 Dwelling Units by 2022 in Kigali alone with 78% of the demand for households with income less than RWF 300,000/month (Kshs 38,000).

For an investor, the Rwandan market provides high returns in both the commercial and residential sectors. As per our Cytonn Research carried out in May 2016, with an average selling price of USD 918.8 per SQM, apartments in Kigali have an uptake of 91.3% and generate yield averaging at 9.7%, while stand-alone units recorded 96.3% uptake and 8.8% yield. The high residential uptake is driven by the high housing shortage of 300,000 units. The commercial sector largely concentrated in Kigali is also an attractive avenue with retail and office space recording 13.4% and 12.9% yields, respectively. With an average rent of USD 19.1 per SQM for retail space and USD 18.2 per SQM for office space, commercial space in Kigali has high uptake averaging at 94.0% due to undersupply in the market. The summary of the research is as shown:

Theme	Price per SQM (USD)	Price Per SQM (Kshs)	Occupancy (%)	Yield (%)
Apartments	918.8	93,652.0	91.3%	9.7%
Stand alone	967.0	98,565.0	96.3%	8.8%
Office	1,714.2	174,707.0	97.0%	13.1%
Retail	1,714.2	171,420.0	91.0%	12.9%
High rental yields ranging from 8%-13% indicate demand for both commercial and residential real estate in Kigali				

Source: Cytonn Research, May 2016

Development in Rwanda is however constrained by high construction costs, ranging from USD 400 to as high as USD 600 per SQM, compared to USD 280-USD 500 (Ksh 29,000-Ksh 50,000) per SQM for Kenya, due to unavailability of building materials locally and the steep terrain that characterises land in the country. In addition, residents have low purchasing power with GDP per capita of USD 638.0 in 2013 compared to Kenya's USD 1,245.5. Investment in Rwanda should therefore be geared towards provision of housing for low and middle income groups with preferred pricing of USD 61,000 (Kshs 6.2 mn) and below, for a unit.

In Kenya, investors have shown sustained interest in the recovering hospitality sector through construction of hotels and serviced apartments in key travel and MICE tourism hotspots. Global hospitality brand Best Western has opened serviced apartments in Nairobi's Riverside Drive in a bid to tap into demand for accommodation from both tourist and business travellers in Nairobi. As per our Cytonn Research, serviced apartments in Nairobi are a good investment opportunity with high occupancy rates averaging at 90% thus recording a high Total Revenue per Available Room of USD 127 per night, on average. Serviced apartments have become a preferred form of accommodation as they are suitable for both short and long-stay due to their home-away-from-home feel and relative affordability compared to hotels. While a standard five-star hotel charges on average USD 350 per night, a three-star serviced apartment will charge USD 120-150 per night. The above notwithstanding, we have also seen increased development of hotels with the Sarova group announcing plans to open a 5-star 140-room hotel in Nakuru in March 2017. Other hotel chains set to open hotels in the country include Royal Orchid in Maasai Mara, the Acacia Hotels in Naivasha and the Carlson Rezidor Hotel Group in Westlands. This indicates positive market sentiments despite the 5-year slump that resulted in declined earnings in the hospitality industry due to insecurity and negative travel advisories. In our view, revenues in the hospitality sector will increase on the back of (i) improved security, (ii) increased budgetary allocation to tourism promotion to enable marketing and (iii) improved facilities and service provision in the sector as seen through the increased number of hotels attaining 5-star rating by the Tourism Regulatory Authority. In the short-term, we expect increased room rates and consequently increased revenues as hoteliers gear up for the festive season that is likely to attract high demand for accommodation. In the long-term we expect increased room supply with focus on serviced apartments especially in Kenya's business hubs. Hoteliers will need to differentiate their product or customer service to ensure high occupancy and efficiently manage costs to maintain profitability. For insight into the hospitality industry with focus on occupancy, demand, revenues and the market outlook, see our Hospitality Sector Report.

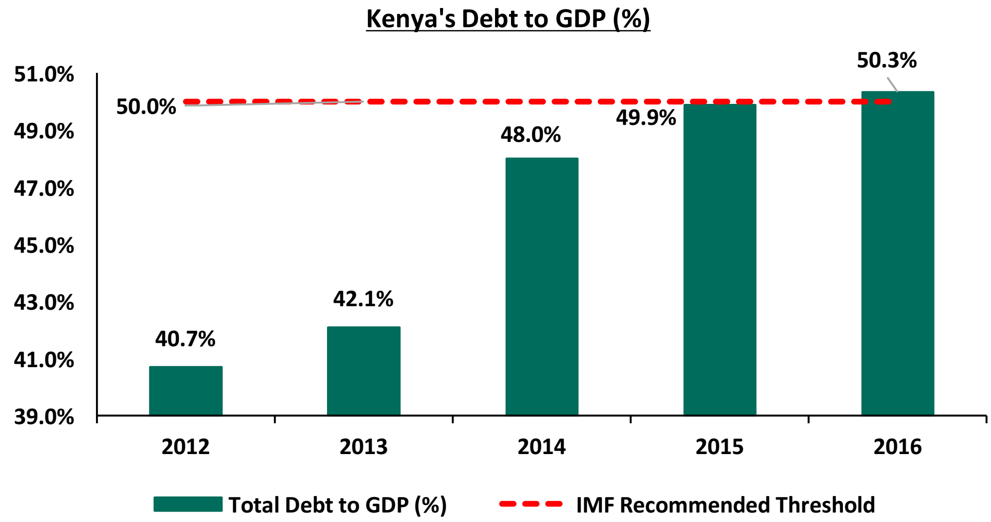
In the retail sector, the opening of Nextgen mall in South C along Mombasa Road brings the total mall space supply in Nairobi to almost 4.4 Mn square feet. The 700,000 square-foot mall, whose anchor will be Nakumatt will comprise of not only the supermarket but also a food court, 180 retails shops and office space. Retailers in the mall will benefit from the large population in South B and C as well as users along the busy Mombasa Road. The investment opportunity in retail space in Nairobi is still high with malls recording high occupancy rates of 90% and thus, high yields of more than 9% on average. Demand for retail space is backed by retailers keen on expansion and growth, the increasing middle-class with higher purchasing power and shoppers who are increasingly showing preference for formal retail over informal stores due to the convenience of a one-stop shop. We project a total supply of 5.62 Mn square feet of mall space in Nairobi by the end of 2017 with malls such as the Two Rivers Mall, the Rosslyn Riviera and KU Unicity in the development pipeline. For insight into Kenya's retail sector, see our Retail Report.

Kenyan Debt Sustainability

There has been a lot of discussion on whether Kenya as a country is able to sustain the current debt levels and as to whether the economy has the capacity to service the outstanding government debt. This week, we seek to look at the status of the debt level and what this means for the economy.

Over the years, we have seen the national budget continue to grow with the total expenditures growing at an average of 15.4% to Kshs 2.0 tn in 2015/16 from 977.0 bn in 2010/11, while revenue growth (KRA Tax collections) has increased by 14.2% to Kshs 1.3 tn in 2015/16 from Kshs 670.0 bn in 2010/11 meaning that the difference has been funded through borrowing. This has led to an increase in the debt level from 40.7% debt to GDP in 2011 to the current level of 50.3%. According to the IMF, the target debt to GDP for developing countries should be at or below 50%, meaning that the current debt level in the country has surpassed the standard set by the global lender, and this may pose fiscal challenges if mechanisms are not put in place to improve on Kenya's fiscal and public finance management framework.

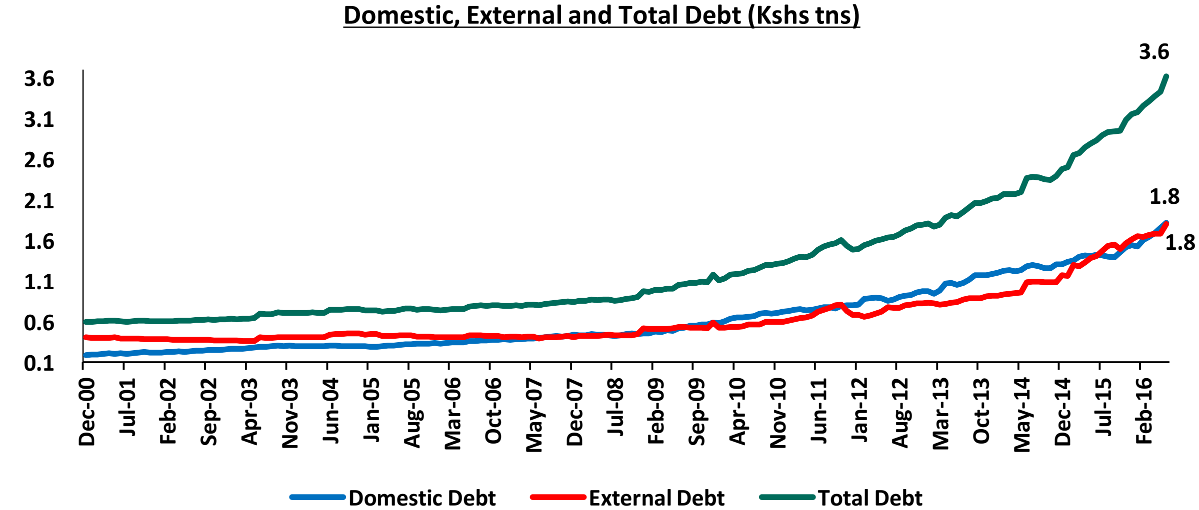
Below is a chart showing the evolution of the debt to GDP over the years:



There are two avenues that the government can use for borrowing, either from the domestic markets through issuance of treasury bills and bonds, or can seek to borrow from the international markets through direct government-to-government negotiations or from the international capital markets through the issuance of sovereign bonds/Eurobonds. Raising funds from the domestic market is much easier and faster and there is already a defined time table for this i.e. weekly through treasury bills and monthly through treasury bonds and for this, the Central Bank acts as the borrowing agent of the Treasury. Local borrowing is also advantageous as it is faster and simple to administrate, but the main issue is that government competes with the private sector for funds from banks which leads to crowding out of private sector and slowdown in economic growth as the contribution by the private sector to economic growth reduces. On the foreign borrowing, though it gives the government another borrowing avenue apart from the domestic market, the challenge is that it opens up the country to trends in the global market, which may destabilise the economy in times of global crisis.

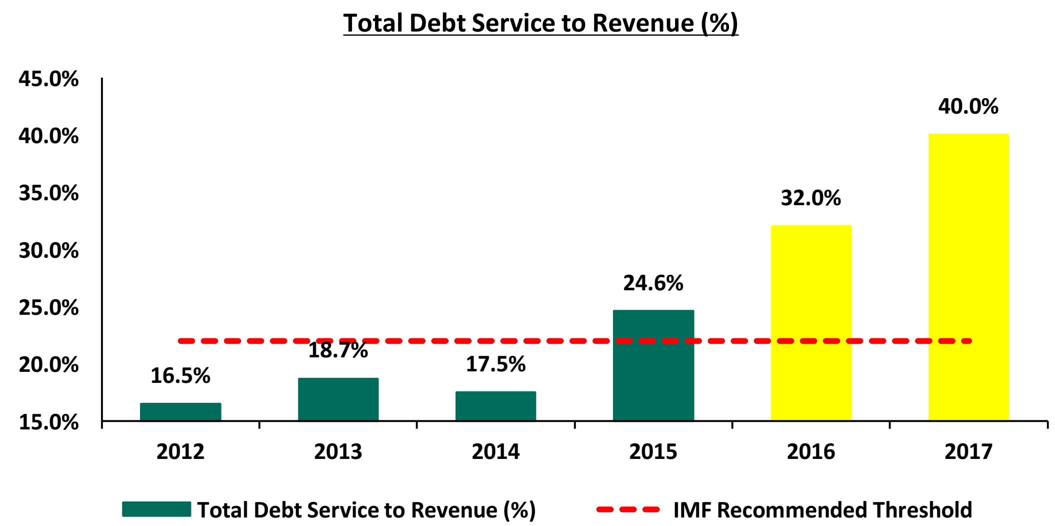
According to the Central Bank of Kenya, the country debt mix currently stands at 50:50 for external and domestic debt at Kshs 1.8 tn each, bringing the total debt to Kshs 3.6 tn. The bulk of the government's foreign borrowings is through bilateral agreements as only Kshs 270.0 bn was issued in the 5 and 10 year Eurobonds. From the last budget the split in the local and foreign borrowing was at 42.6% and 56.9%, respectively and this has now been revised as per the Budget outlook paper to 49.4% and 50.6%, respectively. With no funds having been raised from the international markets yet, we might see a lot of reliance on domestic borrowing. If the government is to raise funds from the international markets, the rates might also be high given that the country is headed into an election year, and investors could price in additional risks.

Below is a summary of the growth of the debt:



The ability to service debt is key and is usually measured by revenue collection to total outstanding payments required, both in principal and interest payment. The government at times borrows to pay off their debt but usually ability to pay off the debt with revenue collections would be ideal. For the current fiscal year, the total allocation to debt servicing was Kshs 250.0 bn and has increased from Kshs 173.3 bn in 2011, a growth rate of 44.3% over the last five years. According to a report on Division of Revenue Bill by the Treasury, the government is expected to utilize 40.0% of tax revenue collection for debt repayments in 2017, up from 32.0% in the current fiscal year 2016/17.

Below is a chart of the debt service to revenue from 2012 with expected levels for 2016 and 2017.



Looking at the current debt levels, the main issue is that if the current trend continues, the economy is likely to face fiscal challenges which may further affect negatively Kenya's credit ratings in the international market. In order to address this, we need first to look at the factors that has led to the acceleration in government borrowing over the last three years;

- **Slow growth in revenue collection compared to the budget growth:** The revenue growth has averaged 14.2% over the last five years while budget growth has been at 15.4% over the same period resulting into more borrowings to fund the budget deficit,
- **Significant investment in infrastructure projects**: Though investment in infrastructure will eventually result in an increase in economic activity, it will take time for the economy to start benefitting from such investments,
- **Misalignment of Fiscal and Monetary Policy decisions:** The government continues to borrow money from the market at high rates despite the initiatives being in place to achieve a low interest rate environment.

In conclusion, Kenya currently lies within the safer bounds on debt levels. However, going forward, there are risks associated with the changing funding patterns that could see the debt levels continue to rise. As per our topical on Kenya's debt levels: Are we on a sustainable path?, we still maintain our view that in order to reduce our debt levels, in line with the IMF sustainable levels, the government should consider to achieve: (i) enhanced tax revenue collection growth, (ii) involve private sector in development through Public-Private Partnerships (PPP's), (iii) reduce recurrent expenditure and improve on development budget absorption rates, and (iv) come up with innovative products like diaspora targeted bonds. The international markets borrowings should be handled with care as too much borrowing or reliance on global markets opens up the country to international economic trends which could be bad for the economy. It is imperative that we be cautious on borrowing if we are to achieve the long term economic stability.