Kenya Economic Review, & Cytonn Weekly #28/2017

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Executive Summary

Fixed Income: During the week, T-bill subscriptions decreased to 33.6%, compared to 116.3% recorded the previous week due to reduced liquidity in the money market, which came in at net liquidity reduction of Kshs 1.1 bn. Yields on the 91, 182 and 364-day papers remained unchanged at 8.2%, 10.3% and 10.9%, respectively. Meanwhile, the Central Bank of Kenya (CBK) released the Quarterly Economic Review for the third quarter of the fiscal year 2016/2017, which revealed that the contribution of foreign commercial banks to Kenya's external debt continues to increase;

Equities: The equities market was on an upward trend with NASI, NSE 20 and NSE 25 gaining 0.6%, 1.1% and 0.9%, respectively, taking their YTD performance to 14.8%, 14.3% and 14.6% for NASI, NSE 20 and NSE 25, respectively. This week's performance was attributed to gains in large cap stocks such as KCB Group and Equity Group, which gained 4.0% and 2.0%, respectively. The Capital Markets Authority (CMA) has approved the global depository receipts (GDRs) policy, which will allow Kenyan firms to sell shares in other countries with similar instruments without cross-listing, while international companies will also be able to sell shares in Kenya without listing on the Nairobi Securities Exchange (NSE);

Private Equity: Activity in the private equity space continues to gain traction based on fundraising and investment activities witnessed during the week where: (i) African private equity fund manager, Phatisa, through its African Agriculture Fund has committed to increase its shareholding in KANU Equipment to 85.0%, and (ii) Digital Cabinet, a technology firm based in South Africa, seeks to raise USD 379.7 mn in equity capital;

Real Estate: Industrial real estate continues to attract investments driven by the high demand and low supply in the Kenyan market. An influx of international contractors is set to redefine construction industry in Kenya;

Focus of the Week: Following the release of a number of economic reports this month, namely the GDP Growth Report, Foreign Trade Summary Report and Producer Price Index Report, we seek to review the economic environment in Kenya in order to take a view on the likely direction of the economy going forward.

Company Updates

- On Friday we hosted over 500 of our clients to our Midyear Economic and Market update dinner. [See Event Note]

- Our Head of Private Equity, Shiv Arora, was on NTV discussing corporate governance and the importance of gender diversity in company boards. Watch Shiv on NTV here
- Our Investment Analyst, John Ndua, was on Ebru TV discussing the effect of the Salaries and Remuneration Commission's decision to cut the pay for National and County government officials. Watch John on Ebru TV here
- We continue to showcase real estate developments by our real estate development affiliate, Cytonn Real Estate, through weekly site visits. Here are progress videos and pictures on The Alma, Amara and Taraji Heights. The site visits target both investors looking to invest in real estate directly, and also those interested in high yield investment products to familiarize themselves with how we support the high yield returns. If interested in attending the site visits, kindly register here
- We continue to see very strong interest in our Private Wealth Management training, which is at no cost, and is held bi-weekly, but is open only to pre-screened participants. The training can also be offered to institutions that would like their employees to be trained on Private Wealth Management. To get further details contact our Client Services team at clientservice@cytonn.com
- For recent news about the company, see our news section here
- We have 11 investment-ready projects, offering attractive development and buyer targeted returns of around 25.0% p.a. See further details here: Summary of investment-ready projects
- To invest in any of our current or upcoming real estate projects, please visit Cytonn Real Estate
    - The Alma, which is over 55.0% sold, has delivered an annualized return of 55.0% p.a. for investors who bought off-plan. See The Alma
    - Amara Ridge is currently 100.0% sold and has delivered over 20.0% p.a. returns to investors. See Amara Ridge
    - Situ Village is currently 15.0% sold. See Situ Village
    - The Ridge (Phase One) is currently 31.0% sold. See The Ridge
    - Taraji Heights is currently 10.0% sold. See Taraji Heights
    - RiverRun Estates (Phase One) is currently 8.7% sold after the recent launch. See RiverRun Estates
- We are currently looking for 5-10 acres in Kikuyu, Lower Kabete, Upper Kabete, Loresho or Mountain View, and 7-10 acres of land in Karen, Garden Estate and Langáta for development of villas. Contact us at rdo@cytonn.com if you have any land for sale or joint ventures in the above areas.
- We continue to beef up the team with ongoing hires: Careers at Cytonn

Fixed Income

During the week, T-bill were under- subscribed for the first time in 23 weeks with the overall subscription falling dramatically to 33.6% from 116.3% recorded the previous week. The subscription rates for the 91, 182 and 364-day papers came in at 56.0%, 41.9%, and 16.2% compared to 106.1%, 152.6% and 84.2% the previous week, respectively. The significant decline

in subscription rates across the board can be attributed to reduced liquidity in the market, which came in at a net liquidity reduction of Kshs 1.1 bn, and the possibility of investors shifting their focus to the Kshs 30.0 bn, 10-year bond (FXD 1/2017/10), which is currently on offer. Yields on the 91, 182 and 364-day papers remained unchanged from last week at 8.2%, 10.3% and 10.9%, respectively. Overall acceptance rate came in at 97.3% compared to 89.2% the previous week, with the government accepting a total of Kshs 7.8 bn of the Kshs 8.1 bn worth of bids received, against the Kshs 24.0 bn on offer in this auction.

There was reduced liquidity levels in the money market leading to a net liquidity reduction of Kshs 1.1 bn from a net liquidity injection of Kshs 42.2 bn the previous week. This resulted in an increase in the interbank rate to 6.0% from 5.0% the previous week. The tight liquidity position was mainly as a result of T-bill primary issues, transfers from banks in the form of taxes and reverse repo maturities, which in total amounted to Kshs 83.8 bn against liquidity injection of Kshs 82.7 bn.

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

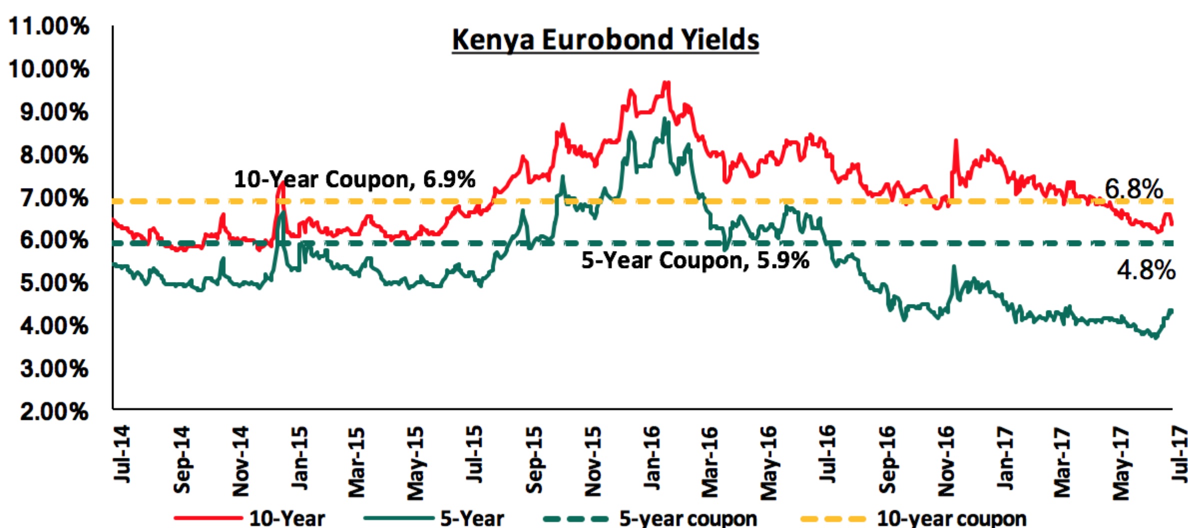
all values in Kshs bn, unless stated otherwise

Weekly Liquidity Position – Kenya			
Liquidity Injection		**Liquidity Reduction**	
Government Payments	43.6	T-bond sales	0.0
T-bond Redemptions	0.0	Transfer from Banks - Taxes	25.0
T-bill Redemption	14.8	T-bill (Primary issues)	24.9
T-bond Interest	0.0	Reverse Repo Maturities	2.1
T-bill Re-discounts	0.0	Repos	12.0
Reverse Repo Purchases	2.1	Term Auction Deposits	19.8
Term Auction Deposit Maturities	10.4		
Repos Maturities	11.8		
Total Liquidity Injection	**82.7**	**Total Liquidity Withdrawal**	**83.8**
		Net Liquidity Injection	**(1.1)**

For the month of July, the government has issued a 10-year fixed-coupon bond (FXD 1/2017/10) with an effective tenor of 10.0 years, in a bid to raise Kshs 30.0 bn for budgetary support. The government is behind on its domestic borrowing target for the current fiscal year, having borrowed Kshs 1.5 bn against a target of Kshs 12.2 bn (assuming a pro-rated borrowing throughout the financial year of Kshs 317.7 bn budgeted for the full financial year) and hence under pressure to borrow. We expect investors to bid for the bonds at yields above the secondary market yield, which is at 13.1%, and we therefore would bid at a range of between 13.1% - 13.5%.

According to Bloomberg, yields on the 5-year and 10-year Eurobonds, with 2.0-years and 7.0-years to maturity, respectively, declined by 10 bps and 30 bps respectively, to close at 4.8% and 6.8%, from 5.0% and 7.1% the previous week, respectively. Since the mid-January 2016 peak, yields on the Kenya Eurobonds have declined by 4.0% points and 2.9% points for the 5-year and 10-year, respectively, due to stable macroeconomic conditions in the country. The declining Eurobond yields and Fitch Ratings having affirmed Kenya's long-term foreign and local currency issuer default ratings (IDRs) at "B+" with a negative outlook and Kenya's senior

unsecured foreign-currency bond ratings at "B+" are indications that Kenya remains stable and hence an attractive investment destination. The negative outlook which has been maintained from the last rating in December 2016, is as a result of slowing credit growth recorded at 3.3% in March 2017, compared to 15.5% recorded the same time last year and uncertainty around the August General Elections, factors that are likely to expose investors to risk in the short term.



The Kenya Shilling depreciated by 0.1% against the dollar during the week to close at Kshs 103.9 from Kshs 103.8 the previous week, mainly driven by increased dollar demand by food and oil importers. On a year to date basis, the shilling has depreciated against the dollar by 1.3%. In our view, the shilling should remain relatively stable in the short term supported by: (i) the forex reserve level currently at USD 7.9 bn (equivalent to 4.6 months of import cover), and (ii) the IMF precautionary credit facility of USD 1.5 bn (equivalent to 1.0 more month of import cover) that Kenya can utilise to stabilize the shilling in case of adverse movement in the forex market.

The Monetary Policy Committee (MPC) is set to meet on Monday, 17th July 2017 to review the prevailing macro-economic conditions and give direction on the Central Bank Rate (CBR). In their previous meeting held in May 2017, the MPC maintained the CBR at 10.0% on account of (i) relative stability in the foreign exchange market, supported by high forex reserves, which stood at USD 8.3 bn and (ii) banking sector resilience, which had average commercial banks liquidity ratio at 44.4% and 18.8%, above statutory requirements of 20.0% and 14.5%, respectively. Despite pressure to adopt a tightening monetary policy stance, and increase the CBR in order to curb the increasing liquidity, which may lead to further inflationary pressure, we expect that the MPC will hold the CBR at 10.0% in order to support economic growth, in light of a slowdown in GDP growth at 4.7% in Q1'2017 from 5.9% in Q1'2016. For our comprehensive analysis on the same, see MPC Note.

Cytonn INVESTMENTS

The Central Bank of Kenya (CBK) released the Quarterly Economic Review for the third quarter of the fiscal year 2016/17, which revealed that the contribution of foreign commercial banks to Kenya's external debt continues to increase. Key highlights from the report include:

- There was a 26.2% increase in total external debt, to Kshs 2.1 tn recorded in the third quarter of the Fiscal year 2016/17 from Kshs 1.7 tn recorded in the third quarter of the Fiscal year 2015/16,
- Foreign commercial banks debt accounted for 28.3% of the total external debt in the third quarter of the 2016/17 fiscal year, a 330 bps increase from 25.0% recorded in the previous quarter,
- The World Bank's International Development Association (IDA), an international financial institution that offers concessional loans and grants to developing countries, reduced its contribution from 74.1% in the second quarter of the Fiscal year 2016/17 to 71.2% of the total debt in the third quarter of the same year,
- Foreign commercial banks' loans to Kenya increased by 65.0% y/y to Kshs 594.1 bn at the end of March 2017, compared to Kshs 360.2 bn at the end of March 2016, and,
- IDA's loan to Kenya recorded a 6.5% y/y increase from Kshs 473.8 bn as highlighted in the table below;

Kenya's Public and Publicly Guaranteed External Debt (Kshs Bn)					
	Q3 2016/17	Q2 2017/18	Q3 2017/18	q/q Change	y/y Change
Bilateral	522.4	577.8	689.1	19.3%	31.9%
Multilateral	766.6	781.3	806.9	3.3%	5.3%
Commercial Banks	360.2	458.1	594.1	29.7%	64.9%
Supplier Credit	16.5	15.3	11.2	(27.8%)	(32.1%)
Total	**1,665.7**	**1,832.5**	**2,101.3**	**15.7%**	**26.2%**

The increase in foreign commercial bank's loans is likely to negatively affect the economy as the foreign financing from commercial banks is relatively expensive, compared to IDA's concessional financing, which leads to an increase in Kenya's public debt service. The overall increase in external debt was driven by:

- The Kshs 101.6 bn loans advanced to Kenya by China to facilitate the completion of the Mombasa-Nairobi Standard Gauge Railway, and start the second phase of the SGR to Naivasha,
- The commercial loans from the syndicated loan and the Preferential Trade Area and African Export Import Bank of Kshs 83.0bn and Kshs 46.7 bn respectively, and
- The depreciation of the Kenyan Shilling against major currencies in Kenya's external debt basket (the US dollar, the Sterling Pound, Japanese Yen, the Euro and the Chinese Yuan) compared to the previous quarter led to the buildup in external debt in local currency terms.

We note the 26.2% increase in Kenya's total external debt, and in our view, international markets borrowings should be handled with caution since too much borrowing or reliance on global markets opens up the country to international economic trends which could negatively affect the

economy. It is imperative that we be cautious on external borrowing if we are to achieve long term economic stability.

Fixed Income Conclusions:

Rates in the fixed income market have remained stable, and we expect this to continue in the short-term supported by:

I. ***The government is expected to meet its domestic borrowing target for the 2017/18 fiscal year, as reduced credit to private sector following the capping of interest rates will make it easier for government to meet its domestic borrowing target, as institutions channel funds more actively towards government securities. This is despite the government having fallen behind its domestic borrowing target for the current fiscal year, having borrowed Kshs 1.5 bn against a target of Kshs 12.2 bn (assuming a pro-rated borrowing throughout the financial year of Kshs 317.7 bn budgeted for the full financial year), and,***
II. ***The government is expected to meet its foreign borrowing target in the 2017/18 fiscal year, as budget estimates for the current fiscal year indicate a decline to Kshs 206.0 bn from Kshs 462.3 bn in FY 2016/17.***

Some of the factors that could put upward pressure on interest rates are:

I. ***The Kenya Revenue Authority (KRA) is expected to face challenges in meeting its overall revenue collection target of Kshs 1.7 tn for the 2017/18 fiscal year, due to the expected subdued corporate earnings growth for the FY'2017,***
II. ***Maize production is expected to decline by 24.3% to 28 mn bags in 2017 from 37 mn bags in 2016, against the country's food security requirement of 40 mn bags, which is likely to exert upward pressure on food prices thus leading to an increase in the inflation rate and upward pressure on interest rates.***

Overall, the possible deficit that is likely to result from depressed revenue collection, and the high inflationary environment that we are currently in, create uncertainty in the interest rate environment. Our view is that investors should be biased towards short-term fixed income instruments to reduce duration risk.

Equities

During the week, the equities market was on an upward trend with NASI, NSE 20 and NSE 25 gaining 0.6%, 1.1% and 0.9%, respectively, taking their YTD performance to 14.8%, 14.3% and 14.6% for NASI, NSE 20 and NSE 25, respectively. This week's performance was attributed to gains in large cap stocks such as KCB Group and Equity Group, which gained 4.0% and 2.0%, respectively. Since the February 2015 peak, the market has lost 13.7% and 33.8% for NASI and NSE 20, respectively.

Equities turnover rose by 16.3% to close the week at USD 61.2 mn from USD 52.7 mn the previous week. Foreign investors remained net sellers with net outflows of USD 5.8 mn

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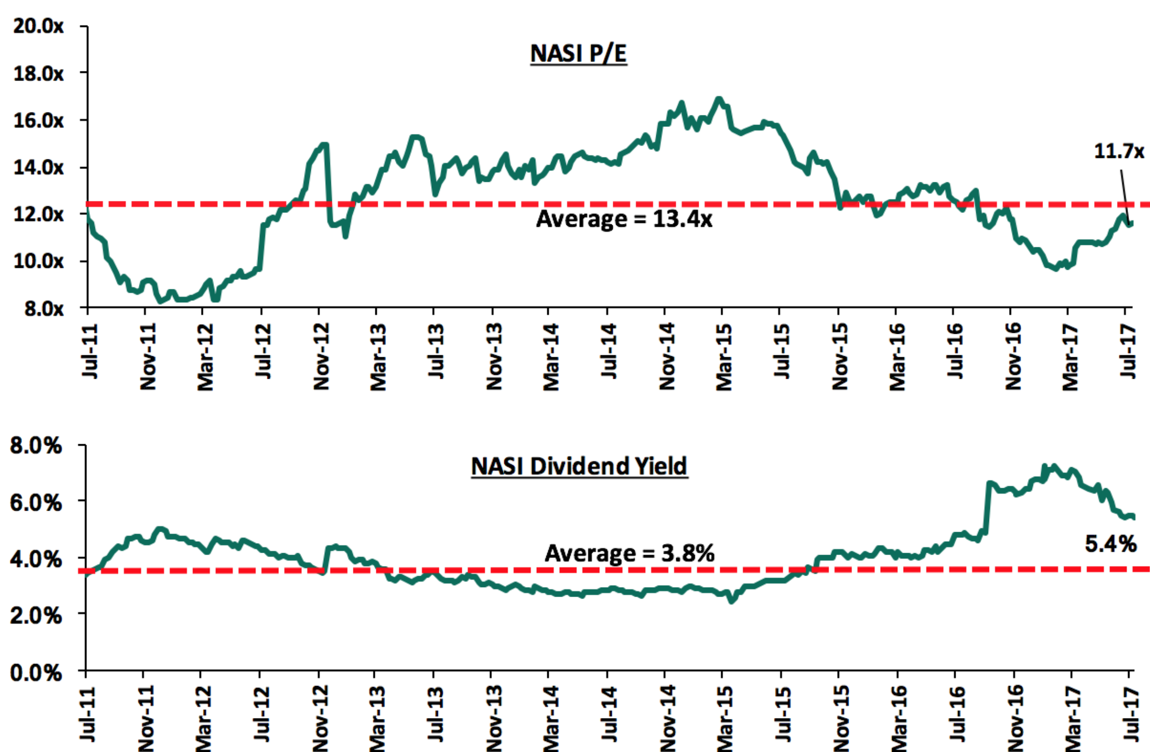
compared to net outflows of USD 0.3 mn recorded the previous week. Foreign investor participation increased to 49.0% from 37.4% recorded the previous week. Britam and Safaricom were the top movers for the week, jointly accounting for 52% of market activity; Britam had a turnover of USD 17.0 mn driven by the possibility that Plum LLP found a strategic buyer for part of its 23.4% stake in the insurer, which was acquired from the Mauritian Government. We expect corporate earnings growth to be slower in 2017 and neutral investor sentiment mainly due to the forthcoming general elections.

The market is currently trading at a price to earnings ratio of 11.7x compared to a historical average of 13.4x, and a dividend yield of 5.4%, compared to a historical average of 3.8%. The current 11.7x valuation is 20.1% above the most recent trough valuation of 9.7x experienced in the first week of February 2017, indicating substantial recovery since February 2017 and 40.2% above the previous trough valuation of 8.3x experienced in December 2011. The charts below indicate the historical P/E and dividend yields of the market.



The Capital Markets Authority (CMA) has approved the Global Depository Receipts and Notes (GDRs & GDNs) policy, which will allow Kenyan firms to sell shares in other countries with similar instruments without cross-listing, and also international companies to sell shares in Kenya without listing on the Nairobi Securities Exchange (NSE). Depository receipts and notes are negotiable financial instruments representing an interest in an underlying security or debt issued and listed in another country. Structurally, depository receipts and notes are similar, except that the underlying security for the former is equity while for the latter it is debt (bonds). This new framework will (i) enable investors to directly trade stocks listed on Kenya's market, (ii) create opportunities for international entities to raise capital in Kenya, (iii) eliminate the cost

and complexity of establishing custody arrangements in multiple countries, (iv) eliminate currency risk for the investors as in the case of Global depository notes (GDNs), debt issued in foreign markets and depository notes in Kenya will be denominated in Kenya Shilling, (v) diversify the investment options for local investors and improve the price discovery of the listed companies on the bourse as it will receive more foreign coverage, and (vi) promote Kenya as an attractive investment destination. Such facilitative regulation put in place by CMA are necessary towards achieving vibrant, transparent, and deep capital markets that are essential to funding and growing businesses, which in turn grows the Kenyan economy, creates jobs and improves the standards of living in the country.

Standard Chartered Bank of Kenya (SCBK) plans to close 4 of its 38 branches in the country at the end of August as part of a restructuring process necessitated by the current challenging operating environment. The restructuring was also informed by the bank's Digital by Design strategy, which is geared towards developing online and mobile channels. The bank reported that there would be no job cuts from this restructuring as the affected employees will be deployed to existing branches. This comes barely a week after Barclays Bank of Kenya (BBK) announced closure of 7 of its branches beginning October this year. SCBK is part of 11 banks that have announced plans to downsize through laying off of their staff, closure of branches, reviewing operating hours for some branches, or outright sales in case of Tier III banks, all in a bid to remain competitive since the implementation of the interest rate cap. The table below highlights the number of staff retrenched and branches closed by financial institutions:

Kenya Banking Sector Restructuring			
No	Bank	Staff Retrenchment	Branches Closed
1	Bank of Africa	-	12
2	Barclays Bank	301	7
3	Ecobank	-	9
4	Equity Group	400	-
5	Family Bank	Unspecified	-
6	First Community Bank	106	-
7	KCB Group	223	-
8	National Bank	Unspecified	-
9	NIC	32	-
10	Sidian Bank	108	-
11	Standard Chartered	300	4
	Total	**1,470**	**32**

Global Credit Rating (GCR) affirmed Jubilee Insurance Kenya's national scale claims paying ability of AA-, with a stable outlook. The rating was based on; (i) Jubilee Kenya has recorded a moderately strong aggregated earnings profile, with a core earnings growth of 17.7% as at FY'2016, and (ii) the firm's market leadership position evidenced by market shares of 12.0% and 15.0% in the short term and long term insurance markets, respectively, which stems from an expansive product distribution infrastructure, high franchise value and strong product support networks. As highlighted in our Cytonn Weekly #27-2017, ratings are essential for a well-functioning market as they facilitate best pricing and timing of public offerings, as companies with high ratings get public recognition thus can easily attract investors.

As highlighted in our Cytonn Weekly #27-2017, in addition to the annual Cytonn Corporate Governance Report, we shall continually be updating the rankings whenever there are changes on any of the 24 metrics that we track and how they impact on the ranking. This week, Susan Mudhune was appointed as a non-executive director to join Carbacid Investments' board; until her appointment Carbacid had no female member on the board. Carbacid's score stays at 60.4% because the improvement in gender diversity to 16.7% from 0.0% is offset by a decline in score due to change in board size to an even number 6 from an odd number 5 thus maintaining its rank at position 33. As highlighted in our Cytonn Weekly #25-2017, we believe that the Kenyan listed entities are firming up to sound corporate governance practices supported by increased regulation from various bodies and organizations responsible for corporate governance oversight, which is essential for stability of the companies and the general market.

Insurance Regulatory Authority (IRA) Q1'2017 Report

IRA released Q1'17 numbers for the insurance industry with the market recording growth in total gross insurance premiums by 14.9% y/y to Kshs 67.2 bn from Kshs 58.5 bn in Q1'16, compared to a 9.6% y/y growth registered the previous year. Below is a summary of the key metrics:

Income Statement (Kshs. Bn)	Q1'2017	Q1'2016	Annual Change (%)
Gross Premium Income	67.2	58.5	14.9%
Net Premium Income	45.4	39.8	14.1%
Other Income	(0.8)	0.8	(202.0%)
Operating Revenue	44.6	40.6	9.7%
Claims incurred and benefits paid	26.6	25.0	6.4%
Commissions and Management Expenses	14.1	13.0	8.4%
Operating Expenses	40.7	38.0	7.1%
Profit Before Tax (PBT)	3.9	2.7	47.3%
Profit After Tax (PAT)	2.8	1.8	56.6%
Balance Sheet (Kshs. Bn)	**Q1'2017**	**Q1'2016**	**Annual Change (%)**
Assets	547.4	498.5	9.8%
Shareholders' funds	138.6	130.1	6.6%
Liabilities	408.7	368.4	11.0%
Investments	436.5	398.9	9.4%

Ratios	Q1'2017	Q1'2016
Loss ratio	58.5%	62.7%
Expense ratio	31.0%	32.7%
Combined ratio	89.5%	95.4%

Key highlights of the performance in Q1'17 compared to Q1'16 include:

- Operating revenue grew by 9.7% to Kshs 44.6 bn from Kshs 40.6 bn, driven by net premium income, which grew by 14.1% to Kshs 45.5 bn from Kshs 39.8 bn. Just as is the case with most African countries with low insurance penetration rates, the non-life segment remained dominant contributing 66.9% (Kshs. 44.9 bn), while long-term business contributed 33.1% (Kshs. 22.3 bn) of the total premiums during the period,

- Operating expenses grew by 7.1% to Kshs 40.7 bn in Q1'17 driven by (i) a 6.4% increase in claims incurred and benefits paid to Kshs 26.6 bn from Kshs 25.0 bn, and (ii) an 8.4% increase in commissions and management expenses to Kshs 14.1 bn from Kshs 13.0 bn. The slower growth in claims compared to premiums led to a decline in loss ratio to 58.5% from 62.7%. This coupled with the 8.4% increase in commissions and management expenses led to the combined ratio declining to 89.5% from 95.4%,
- Total industry net profitability rose by 56.6% to Kshs 2.8 bn from Kshs 1.8 bn driven by growth in life business profitability to Kshs 1.2 bn from a loss of Kshs 0.3 bn in Q1'16. The increase in profitability is also supported by a 14.1% increase in gross premiums to Kshs 67.2 bn from Kshs 58.5 bn,
- Total assets held by the insurance sector increased by 9.8% to Kshs 547.4 bn from Kshs 498.5 bn in Q1'16 driven by an 9.5% growth in investments to Kshs 436.5 bn from Kshs 398.9 bn,
- Shareholders' funds grew by 6.6% to Kshs 138.6 bn from Kshs 130.1 bn in Q1'16, attributed to capital restructuring following the changes in regulatory capital requirements.

We expect increased product innovation and operational efficiency to drive profitability and thus growth of the sector amidst the heightened regulation. The Insurance Regulatory Authority (IRA) is at the forefront of this initiative, pushing for (i) the observance of prudential guidelines, (ii) better corporate governance of insurance companies, (iii) increased transparency in financial reporting, and (iv) use of a risk-based approach to capitalization, with varying risk charges on respective investment options.

Below is our Equities Universe of Coverage:

all prices in Kshs unless stated otherwise

Our Equity Universe

No.	Company	Price as at 07/07/17	Price as at 14/07/17	w/w Change	YTD Change	Target Price*	Dividend Yield	Upside/ (Downside)**
1.	NIC	33.5	33.8	0.7%	29.8%	51.2	3.8%	55.5%
2.	DTBK	164.0	165.0	0.6%	39.8%	241.1	2.1%	48.2%
3.	KCB Group***	37.8	39.3	4.0%	36.5%	54.0	8.1%	45.7%
4.	I&M Holdings	104.0	109.0	4.8%	21.1%	147.5	3.6%	38.9%
5.	Co-op Bank	14.0	14.0	0.4%	6.1%	18.5	4.5%	36.6%
6.	Barclays	9.6	9.6	0.5%	13.2%	12.1	10.3%	36.3%
7.	HF Group	10.4	10.6	1.4%	(24.6%)	13.9	3.6%	35.3%
8.	Jubilee	430.0	430.0	0.0%	(12.2%)	490.5	1.8%	15.9%
9.	Liberty	11.9	11.5	(3.8%)	(13.3%)	13.0	0.0%	13.4%
10.	Stanbic Holdings	74.5	76.0	2.0%	7.8%	77.0	6.6%	7.9%
11.	Equity Group	37.3	38.0	2.0%	26.7%	38.4	5.1%	6.2%
12.	Kenya Re	19.9	20.3	1.8%	(10.0%)	20.5	4.4%	5.6%
13.	StanChart	214.0	217.0	1.4%	14.8%	209.3	5.0%	1.4%
14.	Safaricom	23.0	23.0	0.0%	20.1%	19.8	4.7%	(9.3%)
15.	Britam	14.2	14.3	0.7%	43.0%	12.6	2.3%	(9.7%)
16.	CIC Group	4.2	4.5	8.4%	18.4%	3.7	3.2%	(14.4%)
17.	Sanlam Kenya	27.0	28.0	3.7%	1.8%	21.1	0.0%	(24.8%)
18.	NBK	8.9	10.9	22.5%	51.4%	4.0	0.0%	(63.1%)

**Target Price as per Cytonn Analyst estimates*

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

****For full disclosure, Cytonn and/or its affiliates holds a significant stake in KCB Group, ranking as the 14th largest shareholder*

We remain "neutral with a bias to positive" for investors with short to medium-term investments horizon and are "positive" for investors with a long-term investment horizon.

Private Equity

Acquisitions:

African private equity fund manager, Phatisa, through its USD 246.0 mn African Agriculture Fund has committed to increase its shareholding in South African based KANU Equipment to 85.0% from 40.0% by buying JSE-listed Torre Industries' stake for an undisclosed amount while the remaining 15.0% will be held by KANU's Management. KANU Equipment is a Pan-African agricultural and construction equipment distributor that has operations in Côte d'Ivoire, Ghana, Liberia, Sierra Leone, Cameroon and Botswana. This acquisition of an additional stake by Phatisa will support KANU Equipment in pursuing its strategic objectives of (i) expanding its African footprint, and (ii) its network of loyal customers across the continent leveraging on Phatisa's expertise in the sector. Demand for agricultural and construction equipment in Sub-Saharan Africa is being driven by (i) increase in mechanization of agricultural processes with agriculture contributing 24.0% of GDP across Africa, and (ii) increased performance in the real estate sector and increased infrastructural developments across Sub-Sahara Africa.

South African based private equity investor, Sanari Capital, has finalised the acquisition of a 51.0% stake in Fernridge Solutions, a technology firm based in South Africa, offering geo-spatial data and technology based solutions. The value of the deal remains undisclosed. The deal is the second investment by Sanari Growth Partners through its 12J fund, which stands at USD 15.0 mn. Sanari's 12J fund was launched in November 2015 and targets mid and small cap opportunities raising capital on a deal-by-deal basis and invests in the form of equity and Mezzanine debt. The fund has set its focus on business opportunities in the services, technology, transport, and distribution sectors.

Fundraising Front:

Digital Cabinet, a technology firm based in South Africa, offering cloud-based paperless document and workflow management solutions, seeks to raise USD 379.7 mn capital. Digital Cabinet has mandated HAVAÍC, a South Africa based investment and advisory firm, to undertake the capital raise. The raise will be done through the issue of shares and the conversion of the convertible loan, extended to investors in July 2016, into equity. Funds from the capital raise will be utilised to (i) undertake a brand campaign through marketing to create its product and brand awareness, and (ii) improve on operational efficiency of the company. We remain optimistic about investment in technology and technology backed businesses, as the Sub-Saharan region continues to witness increased integration of technology in businesses as well as increased automation of business processes by SMEs.

Yeelen Capital, a West African based private equity fund manager set up by Cauris Management and Finactu, has announced the first close of the Yeelen financial Fund at USD 34.2 mn. Yeelen

Capital was selected by the West African Development bank to raise, operate and invest the fund in companies in the financial services sector at all stages of development in countries in the West African Economic and Monetary Union (WAEMU) area. The funds will be invested in quasi-equity investments that range from USD 2.2 mn to USD 17.1 mn in size. The newly set up fund manager is seeking to have its second close at the end of 2017 at USD 85.6 mn and the final close at USD 171.2 mn by the end of the year 2018. Firms and organisations who have committed funds include: West Africa Development Bank, Atlantic Group, SGI Togo, Government Pension Fund of Cote d'Ivoire. The financial services sector in Sub-Saharan Africa continues to attract investment players driven by (i) improved regulatory frameworks, (ii) growth of the middle class population with increasing numbers seeking quality financial services, and (iii) innovation in the sector with integration of mobile technology.

Private equity investments in Africa remains robust as evidenced by the increased deals. The increasing investor interest is attributed to (i) rapid urbanization, a resilient and adapting middle class and increased consumerism, (ii) the attractive valuations in Sub-Saharan Africa markets compared to global markets, and (iii) better economic projections in Sub Sahara Africa compared to global markets. We remain bullish on PE as an asset class in Sub-Sahara Africa. Going forward, the increasing investor interest and stable macro-economic environment will continue to boost deal flow into African markets.

Real Estate

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Industrial real estate continues to attract investments into Kenya, this week, Gallagher Power Fence Systems Limited, a New Zealand security company, announced plans to construct 24 warehouses in Tatu City's industrial park as part of their planned expansion into the Kenyan market. The warehouses will be developed on a 4-acre land parcel with construction expected to begin in September this year. Gallagher is just one of the many players investing in the Kenyan warehousing industry, with the others being International Finance Corporation (IFC), CDC (the UK's development finance institution), and DOB Equity, a Dutch family office, all of whom have invested in excess of USD 50mn in Africa Logistics Park (ALP) Limited, an integrated property company that acquires, develops and manages modern logistics warehousing across Africa.

ALP has since purchased 22 and 49-acres of land in Tatu City and Tilisi, respectively, for development of light logistics parks. The industrial real estate theme has been witnessing increased investments over the last 5-years, with building approvals for warehouses growing at a 5-year CAGR of 16.9% from 128,000 square metres of space in 2010 to 279,000 square metres of space in 2015 according to the Nairobi City County building approvals data. The increased investment in industrial parks and warehousing in Kenya is driven by:

i. The shortage of Grade A warehousing in Kenya, with most of the supply being of low quality and owner occupied,
ii. Entry of multinationals in the country such as Volkswagen, Wrigley's, and Johnson & Johnson, all of which require Grade A warehousing space for their manufacturing units,
iii. Economic growth of the neighbouring landlocked countries like Uganda and Rwanda, which rely on the Kenyan port for importation of commodities,

iv. Increased infrastructural development, with construction of bypasses and development of the Lamu Port South Sudan- Ethiopia Transport(LAPPSET) Corridor, which will ease transportation in Kenya and allow for cheaper movement of goods and services, and,
v. Growth of the e-commerce sector, which has been boosted by internet penetration that has witnessed an 11.9% increase in subscribers from 35.9 mn subscribers in 2015 to 39.4 mn subscribers in 2016 as per Communications Authority of Kenya, and requires warehousing space for storage of goods before onward transmission.

The demand is thus at an all-time high with industrial parks recording off plan sales/ pre lets of on average 70% according to Mentor Management Industrial Report 2016. The new industrial parks developments are in Satellite Towns like Syokimau, Mlolongo, Limuru, Thika and Ruiru and not in the traditional zones of Industrial Area, Mombasa Road and Embakasi. Satellite Towns have witnessed investor interest due to improved infrastructure, as the bypasses have opened up these areas for development and availability of affordable land for development, with an acre of land in these Satellite Towns costing on average between Kshs 10-20 mn for parcels without main road frontage and between Kshs 25-45 mn for parcels with main road frontage as opposed to land prices in traditional Industrial Zones, which costs on average between Kshs 80-150 mn an acre. With the expansion of the port, the SGR, development of the dry port in Naivasha and development of the LAPPSET Corridor, we expect to witness increased development of industrial parks in Nairobi and its environs as developers seek to satisfy the high demand for warehousing facilities.

Chinese construction company – China Wu Yi, announced plans to purchase a 20-acre parcel of land in Kilifi at a cost of Kshs 26.5mn per acre totalling to 530 mn. The land will be used to put up a construction material manufacturing plant, with a focus on iron and steel. Last year, the company broke ground on a Kshs 10 bn materials supermarket in Athi River, scheduled for completion this year. The factories are aimed at supporting its local operations after the company won construction and development tenders in the country that are worth Kshs 10.1 bn for several projects including expansion of a 25 km stretch on Waiyaki Way from James Gichuru to Rironi. Several Chinese companies have started operations in Kenya following the rapid growth in infrastructural developments. Currently most of the mega projects have been done by Chinese companies including:

Some of the Major Private Projects Done or Being Done by Chinese Contractors		
Company	**Project**	**Theme**
China State Construction Engineering Corporation (CSCEC)	Pinnacle Towers in Upperhill	MUD (Hospitality, Residential, Office)
China Wu Yi	KCB Plaza, Waiyaki Way expansion	Office and Road Construction
China Jiangxi International	ICPAK Complex along Thika Highway,	Commercial Office

Zhongxing Construction Company	Cardinal Otunga Plaza in the CBD	Commercial Office
China National Aero- Technology Engineering Corporation (CATIC)	The Alma by Cytonn Real Estate, Two Rivers Development along Limuru Road	Residential, Mixed Use Development

Source: Cytonn Research

With other projects still in the offing, as well as the growth in the real estate sector, we expect more international companies to set up offices in Kenya; earlier in June, Bechtel – America's largest construction company opened its continental office in Nairobi in a bid to increase operations in Africa, and in Kenya and the company has expressed interest in the expansion of the Nairobi-Mombasa Highway. While the entrance of these foreign companies improves the quality of construction in the country and facilitates transfer of skills to the locals, it is likely to run the local construction companies out of business as the multinational construction companies have stronger financial backing, are well equipped, and more experienced, hence getting the major tenders. The Kenyan Government should thus aim to protect the local contractors through measures such as (i) preserving construction quotas for local firms, (ii) requiring the international firms to partner with local companies in their operations, and (iii) training and provision of financial support to the local contractors to enable them remain competitive.

Increased competition in the real estate industry is leading to innovation as real estate players seek to deliver an efficient sales services to clients and increase sales volumes. This was evidenced this week as:

i. Property portal Buyrentkenya.com launched an app that will allow agents and private sellers to create virtual tours from their mobile phones. The 360 Virtual Tour app is available on both android and iOS and the firm believes it will reduce the transaction time period by 60% leading to more sales as the users will be able to make decisions faster,
ii. The development arm of HF Group, Housing Finance Development and Investment (HFDI), signed an agreement with one of the largest Asia based facilities management consultants, Surbana Jurong Private Ltd, a consultancy firm on urbanization, affordable housing, industrialization and infrastructure owned by the government of Singapore to boost its property management capacity through audit, training as well as development of policies and guidelines for best practices. HFDI aims to tap on Surbana Jurong's expertise on property management to raise the management of its developments to international standards and for sustainability of their developments which include: Precious Gardens, Richland Pointe, Komarock Phases 1-5B and Komarock Heights.

The use of technology and adoption of international standards will revolutionize the real estate sector in Kenya especially off plan sales, enabling developers to exit quicker hence earn better returns while giving users a digital sales experience resulting in efficient transaction processes.

During the week, the secretary of the National Building Inspectorate (NBI) noted that inadequate funding and staffing are curtailing the buildings audit being undertaken by NBI and the National

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Construction Authority (NCA). According to the Secretary of NBI, the body has only 30 staff members out of the requisite 100 required to carry out the inspection hence slowing down the audit. The audit was commissioned in April 2016, following the tragic collapse of residential houses in several parts of the country including Nairobi. So far the NCA has earmarked 30,000 buildings for demolition, but has not been able to do so due to court orders and insufficient personnel. As highlighted in our Cytonn Weekly 24/2017, the government needs to train people on safety measures, increase the capacity and mandate of regulatory bodies and developers have to embrace professionalism in construction to curb incidences of building collapse due to substandard construction and disregard of zoning regulations and safety standards.

Also during the week, the Permanent Secretary of the Ministry of Housing noted that the Kenyan Government issued state officer mortgage loan scheme underperformed, with only 12.5% of the state offices (that is 24 out of the possible 168) taking up mortgages worth Kshs 500 mn, 25% of the Kshs 2 bn that had been set aside. The Permanent Secretary of the Ministry of Housing who is the administrator of the scheme attributed the low uptake to lack of flexibility in the mortgage due to terms such as, (i) the mortgage cannot be used to finance the purchase of a self-build plot and self-construction, and (ii) the loan does not cover improvement of the house and cannot takeover an existing loan. The loans were introduced in 2015 at favourable terms including a 3% annual interest on reducing balance covering up to 90% of the value of the property with a maximum of Kshs 40 mn. This portrays the dismal state of the mortgage market in Kenya. Mortgages in Kenya have a low uptake with a mortgage to GDP ratio of 4.2% in 2014, compared to more than 20.0% in developed mortgage markets of South Africa and more than 70% in USA according to the Central Bank of Kenya. Currently Kenya has only 24,458 mortgages of an average size of Kshs 8.3 mn, totalling to Kshs 203 bn. The uptake of mortgages is largely constrained by (i) the high interest rates, which averaged at more than 18% before the enactment of the Banking Amendment Act 2015 in October last year, (ii) high requirements for collateral by banks, (iii) large deposits required by the banks of up to 30% of the value of the property (iv) high house costs, and (v) misinformation or inadequate information among the potential home buyers on the mortgage rates, terms and conditions. According to our research and analysis, the Mortgage Affordability Index in Nairobi in 2016 was 66 against a minimum requirement of 100, indicating that mortgages were not affordable to the residents of Nairobi, with the incomes earned being insufficient to pay for mortgages. The mortgages would only be affordable if the interest rates were reduced to 3%. Satellite Towns had the highest affordability ratio of 91. Nairobi Mortgage and Rental Affordability Report

Mortgage Affordability Index Nairobi Metropolitan Area					
(all values in Kshs unless stated)					
Zone	**Median Monthly Household Income***	**House Price Per Square Metre****	**Monthly Mortgage Payments*****	**Qualifying Household Income******	**Mortgage Affordability Index*******
Satellite Towns	200,000	65,843	82,985	228,209	**91**
Lower Middle	200,000	74,976	100,979	252,446	**79**

Low Income	56,250	49,452	33,418	83,545	**67**
Upper Middle	450,000	130,140	460,019	1,150,048	**46**
High Income	1,300,000	247,879	1,235,790	3,089,475	**42**
Median	**200,000**	**97,295**	**135,635**	**358,070**	**66**

Mortgages are unaffordable in all areas of the Nairobi Metropolitan area, with the metro having an index of 66.

Mortgages in Satellite Towns are almost affordable with an index of 91.

High Income areas have the least affordable mortgages with an index of 42.

The difference in affordability between the high end areas of Nairobi metro and the satellite towns is as a result of the high the land prices in the city which consequently push up the house prices

***- Median monthly household income** - this is the median of the monthly income earned by households in the area under consideration. For one bedroomed houses it is assumed that a household has one breadwinner and for the rest, a household has two breadwinners

****- House price per square metre** - this is the median of the price per square metre of houses in the region under consideration obtained by market research

***** - Monthly mortgage payment** this is the monthly contribution that a household makes to the mortgage lender to service the loan. It is calculated using the excel PMT function based on the house price, at a 15% interest rate and a 20 year term

****** - Qualifying household income** - this is the monthly income that a household needs to earn to be able to afford a mortgage on a house

******* - Mortgage affordability index** - is the quotient of the qualifying income and the median monthly household income

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Source: Cytonn Research

We have a positive outlook for the real estate sector in Kenya as the sector remains resilient to the current political headwinds and continues attracting investments. We expect transaction volumes to pick up if calm elections are held and increased use of innovative techniques in selling and managing property to attract and retain clientele in the real estate industry in Kenya.

Focus of the Week; Kenya Economic Review

Introduction

There has been a couple of reports and statics that have been released which provide investors and business decision makers with insights on economic stability, growth and progression. This week, we seek to review the performance of economic environment in Kenya and take a view as to the likely direction of the country's economic performance. The upcoming general elections have been at the centre stage of influencing trends in economic activity in recent past. Political stability has complimented the economic stability of the country and infrastructural spending has supported growth of the economy with developments such as the Standard Gauge Railway being launched in June this year. Below, we discuss some of the key themes that have shaped the economic environment in Kenya.

GDP Growth

The country's GDP growth for Q1'2017 came in at 4.7%, lower than 5.9% in the same period in 2016. The decline in economic growth was attributed to a 1.1% contraction in the agricultural sector, which was due to the drought that was experienced during the last quarter of 2016, and slower growth in the financial services sector, which grew by 5.3% in Q1'2017, from 8.2% during Q1'2016. Combined, these two sectors contribution to GDP stands at 31.1% and any effect on their growth will reflect on the performance of Kenya's GDP. The slowdown in GDP growth has come at a time when the World Bank, International Monetary Fund (IMF) and Kenya National Bureau of Statistics (KNBS) have revised downwards their projections on Kenya's economic growth for 2017 to 5.5%, 5.3% and 5.7%, respectively, from 6.0% for the World Bank and IMF, and 5.9% for the KNBS at the start of the year. All these institutions cited a contraction in the agricultural sector and a slowdown in private sector credit growth being the core reasons for the downward revision of the GDP growth expectations. Economic growth for 2017 is set to be supported by increased spending on infrastructural developments by the government, with the National Treasury having presented a Kshs 2.3 tn budget for the fiscal year 2017/2018, with development expenditure allocation increasing to 33.0% from 28.0% in the previous fiscal year.

We expect GDP growth in 2017 to average between 4.7% - 5.2%, which is stable and quite competitive in the Sub-Saharan Africa region, which is projected to grow by 2.7% in 2017 according to the IMF. However, a lot more needs to be done to diversify the economy to reduce the over reliance on a few sectors to support economic growth.

Private Sector Performance

Private sector in the country has gone through a challenging period as the environment turned sour propelling a decline in the sector's growth. Some of the key challenges facing the sector is access to credit especially those players that rely on bank funding to support their activities. Private sector credit growth slumped to 3.3% as at March 2017, the lowest in 8-years, from a high of 17.0% in 2016, as a result of reduced loan disbursement by commercial banks following the enactment of Banking Act (Amendment) 2015. The challenging operating environment has seen firms restructure their operations mainly through layoffs and downsizing. Commercial

banks have been at the forefront of this, having retrenched 1,470 of their employees and shutting down 32 branches. In our view, crowding out of the private sector remains one of the key challenges that policy decision makers will continue grappling with especially in this era of interest rate caps. For Kenya to be an environment where credit is accessible and affordable there is need to diversify funding sources and reduce over reliance on bank loans as the source of funding.

In our view, in order to spur private sector growth it is crucial to develop capital markets and alternative sources of funding to bring down the 95% funding dominance by banks, as highlighted in our Cytonn Weekly #25/2017.

Public Sector Wage Bill

The public sector has witnessed an expanding recurrent expenditure with salaries and wages to civil servants currently amounting to 52.0% of the GDP above the sustainable level of 35.0% provided for by the Public Finance Management Act. In the recent past, we have experienced strikes by teachers, lecturers, doctors, and nurses, all affecting important sectors of the economy. The downing of tools by these civils servants have pushed the cost of living up as citizens have to access services at a higher cost. The collective bargaining agreements in these sectors are set to push the recurrent expenditure further from the target of 35.0% of the GDP as significant amounts have to be channelled to meet these pay demands, and this is likely to put the country into further debt or cut on development expenditure. However, there could be relief as recently the Salaries and Remuneration Commission (SRC) has recommended a pay structure that will cut salaries of state officers in the National Assembly, Senate, and the Executive arm of the National government by 12.5% to cut the unsustainable public sector wage bill. The hiring freeze by government institutions is also a step in the right direction in addressing the growing public sector wage bill.

In our view, we believe the SRC's expected wage cut is a good move that will lead to allocation of more resources towards development expenditure in infrastructure that will in turn provide conducive environment for private sector to operate and hence propelling economic growth.

Food Security

According to the Ministry of Agriculture, maize production is expected to decline by 24.3% to 28 mn bags in 2017 from 37 mn bags in 2016, against the country's strategic food reserve requirement of 40 mn bags. This expected decline is attributable to (i) an army worm invasion in the key maize-producing regions in the country that is expected to cut production by approximately 5.0%, and (ii) rainfall shortages in the main maize producing regions of Uasin Gishu and Trans-Nzoia Counties, expected to cut production by a further 20.0%. The country has undergone a wave of inflationary pressures in the first half of the year, with inflation hitting a high of 11.7% in May up from 6.4% in December 2016. The inflation rate for the first half of the year averaged 9.8%, compared to 6.2% in a similar period in 2016. The rise in inflation was primarily driven by an increase in food prices, which rose by 15.8% during the first half of the year, on account of the prevailing drought in the country. Given that a maize shortage is expected in the coming seasons, we are of the view that if the government does not put in place

precautionary measures to address food security in the country, this could lead to a higher inflationary environment in 2018, escalated by the importation of food, which will further increase Kenya's import bill.

We expect the government to step up initiatives to cure for the deteriorating food situation in the country, with a positive step being the Kshs 2.0 bn per year allocation in the budget for the National Drought Emergency Fund. Inflation rate is expected to stabilize in the second half of 2017 due to subdued food prices following the rainfall witnessed in the second quarter of 2017. For a comprehensive analysis on food security, see our report on cost of living here.

International Trade and Exchange Rate

Kenya has experienced a widening current account deficit, which expanded by 36.1% in March 2017 to USD 4.6 bn from USD 3.4 bn the same period last year. This was due to rising levels of imports, which increased by 23.6% driven by importation of fuels, maize and machinery, while exports increased marginally by 2.4% over the same period driven by tea exports. This has led to a trade deficit expansion of 43.1% in the first four months of the year to USD 3.4 bn from USD 2.4 bn in a similar period last year.

The Kenya Shilling has remained relatively stable during the year having depreciated against the US Dollar by 1.3% on a year to date basis. In our view, the shilling should remain relatively stable in the short term, supported by; (i) the high forex reserve level currently at USD 7.9 bn (equivalent to 4.6 months of import cover), (ii) the IMF precautionary credit facility of USD 1.5 bn (equivalent to 1 more month of import cover) that Kenya can utilize to stabilize the shilling in case of adverse movement in the forex market, (iii) low global oil prices, despite the decision by OPEC to extend oil production cut timelines, which is expected to provide a buffer to the current account balance as Kenya is a net importer of oil, and (iv) improved diaspora remittances, which increased by 2.2% in the first four months of the year compared to a similar period last year.

In the long term, the government needs to address structural issues that affect the stability of the shilling so that the country can benefit from a relatively stable exchange rate environment. These include; (i) promoting exports in order to address the expanding balance of trade deficit, (ii) promoting tourism so as to attract more foreign exchange income, and (iii) putting in place initiatives aimed at increasing diaspora remittances.

Foreign Direct Investments

Frontier and emerging markets have maintained positive investor sentiment in comparison to the developed economies since the beginning of the year, thus attracting foreign investors especially Sub-Saharan Africa. According to a report released by Ernst & Young (EY) Africa dubbed the *EY Africa Attractiveness Program 2017,* there was a 31.9% increase in capital investments into Africa to USD 94.1 bn in 2016 from USD 71.3 bn in 2015. Most of the FDI inflows were concentrated in the largest economies per region with South Africa in southern Africa, Egypt and Morocco in northern Africa, Nigeria in western Africa and Kenya in eastern Africa. We have witnessed foreign investors bidding for African Eurobonds at high rates, the most recent being Senegal, which recorded a subscription rate of 8.5x on its 16-year international bond, at a yield

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of 6.3%. Fitch ratings agency has affirmed Kenya's Long-Term Foreign and Local Currency Issuer Default Ratings (IDRS) at 'B+', with a negative outlook. The 'B+' rating is pinned on the country's solid growth record, strong medium-term growth potential, and a favourable business environment, while the negative outlook is as a result of increased current account deficit, slowing credit growth and uncertainty around the August General elections.

The equities market has witnessed net outflows of USD 11.1 mn since the start of the year, but we expect long term investors to enter the market seeking to take advantage of the current attractive valuations. The upcoming general election creates an uncertain environment and investors are expected to take a wait-and-see approach. We however expect security to be maintained at high levels towards and after the election period as the parliament has previously approved a supplementary budget with an allocation towards security.

Though the uncertainty is likely to affect foreign participation leading to significant foreign outflow from the market, owing to the expected stability during and after the general elections, we expect long term investors to enter the market seeking to take advantage of the current attractive valuations. Kenya's improvement in the Ease of Doing Business ranking is also set to attract more international investors as witnessed by the entry of leading multinational corporations such as Wrigleys, Johnson & Johnson and Volkswagon.

Conclusion:

For the stable economic environment to persist, the monetary and fiscal policies put in place should be geared towards price stability and revamping the private sector, which is a key driver for economic growth in any developing economy. The government should come up with policy framework aimed at providing a conducive environment for private sector to operate, thereby creating more jobs, improving the standards of living and hence spurring economic growth.

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