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Overview of Private Offers

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Cytonn

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Table of Contents

Introduction to Investments

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Overview of Investments By Asset Class / Type

Investments can be classified into two categories - traditional and alternative investments.

	Description	Characteristics
Traditional Investments	i. Equities	• Liquid • Price visible on stock exchange
	ii. Fixed Income	• Liquid • Highly sensitive to interest rates • Returns made of both coupon and principal
Alternative Investments	i. Private Equity	• Illiquid • Difficult to price • Lack of availability of transaction data • Relatively high returns compared to Equities
	ii. Real Estate backed investments	• Illiquid • Provides inflation hedge (have their own value) • Low correlation with traditional investments • Lack of availability of transaction data • Relatively high returns compared to Fixed Income

Introduction to Investments

Factors to consider before making an investment decision

i. **Risk Appetite:** An investor has to evaluate the two types of categories and then make a call on the uncertainty that an investment may not earn its expected rate of return
ii. **Return:** These are the earnings from investments, and they vary depending on the type of investment e.g. dividends, rent, interest and capital appreciation. Investors should ask themselves whether the return profile meets the risk-reward proposition
iii. **Liquidity:** This is a definition of how quickly an asset can be converted into cash. Traditional asset classes tend to be more liquid than alternative assets
iv. **Taxation:** It is critical for investors to understand their tax status for tax planning purposes. Regulated products such as bank deposits and Unit Trust Funds in Kenya attract a final 15% withholding tax
v. **Governance:** Governance around regulated products usually involves a Regulator, Trustee, and Custodian, who provide oversight over funds being invested. In unregulated products, governance is usually done by select investors who are investors in the funds themselves, alongside the Investment Manager and their Investment Committee
vi. **Sophistication:** Regulation exists to provide oversight for less sophisticated investors. These include retail investors who may not fully understand the characteristics of products they are investing in. Unregulated products are for sophisticated investors who understand the characteristics of their investments and have taken time to understand the underlying asset class / economic activity that is delivering the return

Regulated vs Unregulated Markets

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Regulated vs Unregulated Markets

Regulated Markets are also know as Public Markets and Unregulated as Private Offers

Regulated Markets

- Are often referred to as public markets are controlled by a regulatory body whose key mandate is to protect the public interest. The offering of the product needs to have been reviewed and approved by the respective regulator before the investment products can be sold to the public. The products in the public markets tend to be standardized and easily accessible to the public.
- Examples include: Shares purchased at the securities exchange, Fixed Deposits offered by Banks, Collective Investment Schemes such as Money Market Funds, among others

Unregulated Markets

- They are governed by the prevailing contracts between the participating parties and therefore they are not regulated by a specific regulator; however, the process of offering is usually regulated so that it follows a set of defined rules and guidelines. The manner of offering is usually private; hence they are also loosely referred to as private products or private offers. Since they are an alternative to public markets products, they are also referred to as alternative market products.
- Examples include: Real Estate Notes, Private Equity, Commercial Papers and Structured Products

Regulated vs Unregulated Markets

Capital Markets (Securities) (Public Offers, Listings and Disclosures) Regulation, 2002 lists 9 conditions

1. The securities are offered to not more than one hundred persons,
2. The securities are offered to the members of a club or association and the members can reasonably be regarded as having a common interest with each other,
3. The securities are offered to a restricted circle of persons whom the offeror reasonably believes to be sufficiently knowledgeable to understand the risks involved in accepting the offer,
4. The securities are offered in connection with a bona fide invitation to enter into an underwriting agreement with respect to them,
5. The minimum subscription for securities per applicant is not less than Kenya Shillings one hundred thousand (Kshs. 100,000),
6. The securities result from the conversion of convertible securities and a prospectus relating to the convertible securities was approved by the Authority and published in accordance with these Regulations
7. The securities of a listed company are offered in connection with a take-over scheme approved by the Authority
8. The securities are not freely transferable, and,
9. The securities are of a private company and are offered by that company to members or employees of the company or a restricted circle of persons whom the offeror reasonably believes to be sufficiently knowledgeable to understand the risks involved in accepting the offer,

Regulated vs Unregulated Markets

Common myths associated with Regulated products

i. **Very Liquid:** While regulated funds are likely to be a lot more liquid than unregulated, there are times when a regulated business or fund undergoes a strain, and as such, there shall be periods where funds are not easily accessible. This could be in the case of a Unit Trust Fund being closed for withdrawals, or a bank under receivership; a good example is what Amana Money Market Fund has recently experience

ii. **Don't Invest in Alternatives:** The simplest example is that any deposit in a bank is then pushed forward by a bank and lent to an individual for a mortgage, or a developer to undertake a development project. Unit Trust Funds in Kenya as well, as per the regulations, are allowed to invest in alternative investments such as real estate and private equity

iii. **That the Regulator Fully Understands the Investments:** Whether regulated or unregulated, investments always entail risks that even the best analysts, let alone a regulator, may not uncover. Investors should not think that just because it was signed off by a regulator, that they totally understood the investment; investors should still do their own due diligence

iv. **Always Safer:** The myth has always been that regulated products are safer and investors will not lose money in regulated products. However, experience in Kenya has shown that investors in regulated products such as banking and capital markets have lost funds due to isolated cases of lapses in corporate governance. As such, investing in a regulated institution is no guarantee over the safety of your investment. The Kenya Deposit Insurance Fund, for example, only guarantees Kshs 500,000 worth of deposit for each account in a banking institution

Regulated vs Unregulated Markets

The myth that regulated funds are safer does not hold as seen in cases below where investors lost their funds

Shareholders' Loss for Regulated Entities Largely Due to Poor Corporate Governance				
Firm	**Peak Share Price**	**Current Share Price**	**No. of Shares (bn)**	**Loss in Value (Kshs bn)**
Kenya Airways**	58.0	3.8	1.5	81.5
Mumias Sugar	20.7	0.3	1.5	31.2
Athi River Mining (ARM)	33.0***	5.6*	1.0	27.4
Transcentury	57.0	1.4	0.4	22.2
Uchumi	10.9	0.3*	0.4	3.9
Imperial Bank				36.0
Chase Bank				4.8
Real People				1.6
CMC Motors				1.2
Amana Capital				0.3
Total				**210.1**

**Last trading price before suspension*

***Peak share price since the 2012 rights issue*

**** Represents the median share price for the 10 years to the suspension*

Regulated vs Unregulated Markets

Common myths surrounding Private offers hinders its uptake

i. **Risky Investments:** Unregulated products are not necessarily more risky, especially when they are sourced through a competent research and investment team, and one that has experience in managing illiquid and alternative assets.,

ii. **They Are Too Complex:** Unregulated investments are really not more complex than regulated products, in spite of the jargon that usually accompanies them. Accessing private or unregulated markets is down to experience and skill of the management and investment team, and their ability to package the unregulated asset class into investible security,

iii. **They cannot be offered by Regulated Entities:** Regulated entities can offer both regulated and unregulated products. For any regulated product, it is approved by the respective regulator, similarly, any unregulated product also needs to pass through the respective regulator.

iv. **They are unlawful:** Unregulated products are often viewed as unlawful and with a lot of suspicion, mainly because they do not require regulatory approval. However, it is important for investors to note that even without regulatory approval, the unregulated products are still issued within the confines of set guidelines by the regulators. We have recently filed a petition in the High Court for an interpretation on what constitutes a private offer,

v. **Have to only be distributed to a Few Individuals:** There is a myth that unregulated private products must only be distributed to a few individuals. There is ample case laws to demonstrate that what matters is the manner of offering, and not the number of investors. Courts have concluded that an offer even to one person is deemed a public offer if it was offered in a public manner, and an offer even to a million people is a private offer if it was offered in a private manner

Regulated vs Unregulated Markets

Case laws in developed markets shows us that unregulated products can be widely distributed

a. **United States:** The leading case in the United States with regard to 'transactions by an issuer not involving any public offering' is ***Securities Exchange Commission vs Ralston Purina Company 346 US 119 Supreme Court,*** where an offering was made to at least 7,000 members of staff. The eligibility criteria were simply an employee eligible for a promotion, an individual sympathetic to management, the courts concluded that it was not a public offer because there was an eligibility criteria, even though the regulator wanted it deemed a public offer.

b. **United Kingdom:** In ***Nash vs Lynde***, a case where a question was raised over the distribution of shares, the questions framed by the Court were, amongst others, whether a private company could be held to have offered and issued its shares to the public as 20-30 prospectus was issued. The Court in this matter held as follows '*The public is a general word and no particular numbers are described. Anything from two to infinity may serve perhaps even one ….*'. The Offer, in this case, was therefore not deemed a Public Offer, **as those the offer was being made to were specific and shared a common goal**. A key takeout is that numbers are not a determining factor as to whether an offer is made to the Public or a Section of the Public.

c. **Australia:** The leading case for Australia is ***Corporate Affairs Commission (SA) VS Australian Central Credit Union (1985),*** where it was held that an Offer to 23,000 persons would not amount to a Public Offer. This was on the basis **that the law expressly allowed for this exemption** on the basis of persons with a common interest

Overview of Private Offers

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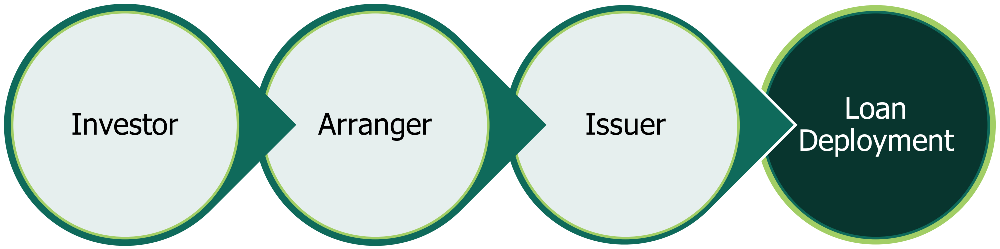
Overview of Private Offers

The following are examples of Private Offers in the Kenyan Market

Loan Fund	Company Logo	Type of Loan Fund	Issuer rate
ASL Credit Short Term Note Program		Commercial Paper	10.5% - 12.0%
Car & General Short Term Note Program		Commercial Paper	12.0% - 13.0%
KK Security Short Term Note Program		Commercial Paper	13.25%
Fusion Capital - Meru Greenwood City		Real Estate Equity	N/A
Heri Homes Capital LLP		Real Estate Note	13.0%-15.0%
Cytonn Projects Notes (CPN)		Real Estate Note	19.0% -21.0%

Key Players in Private Offers Markets

There are 4 key players in Private Offers markets



Summary of Roles:

1. **Investor:** Individual who aims to make a return and has the cash to invest; ***done through buying a commercial paper or a real estate backed note***

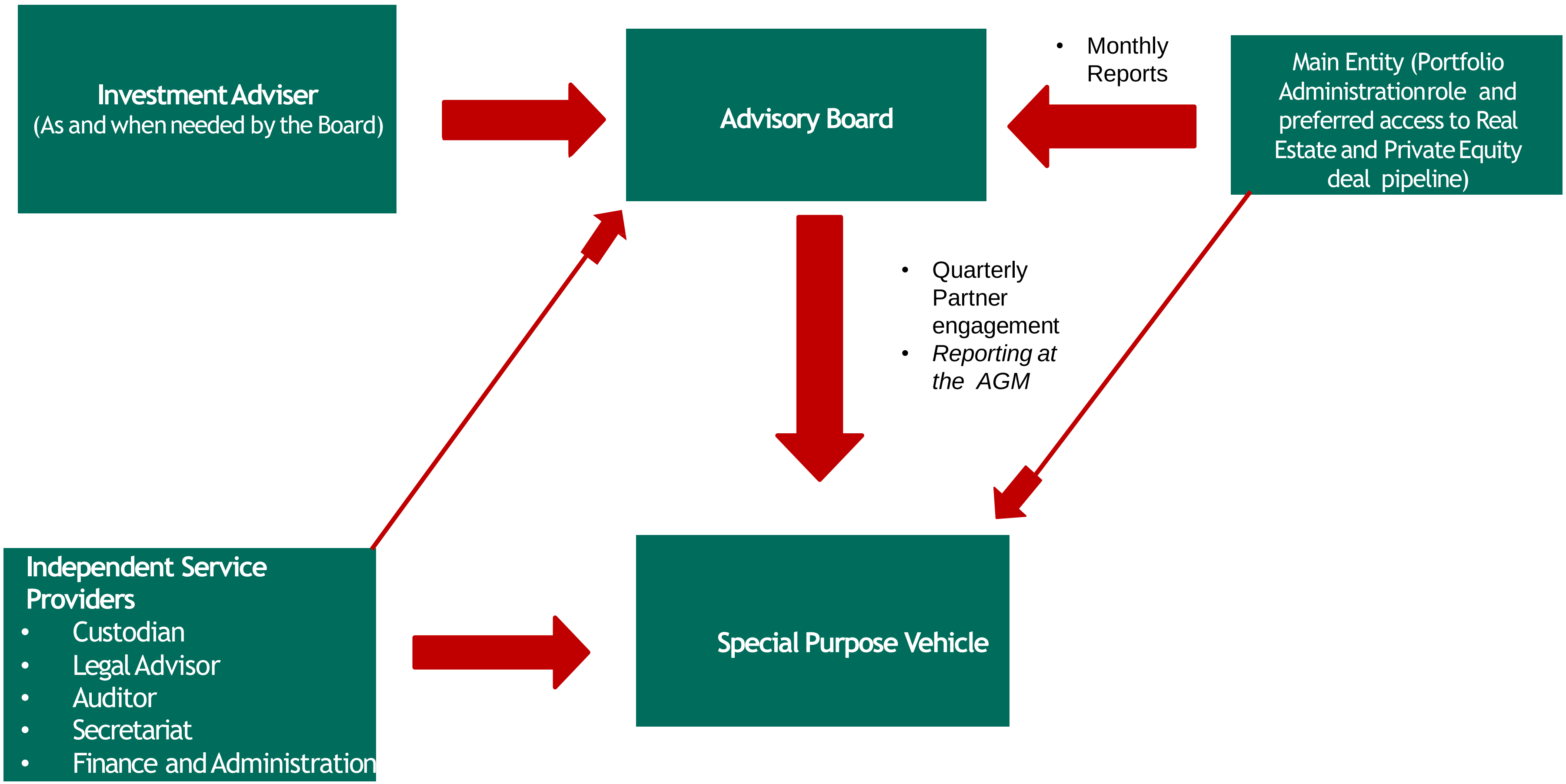
2. **Arrangers:** An intermediary who brings parties together – in essence an investment bank

3. **Issuer**: This is the entity that is in need of funds from the investor, ***e.g. Cytonn High Yield Solutions or Cytonn Project Notes***

4. **Loan Deployment:** Deployment of funds raised from an investor towards a commercial activity such as real estate development ***e.g. The Alma by Cytonn***

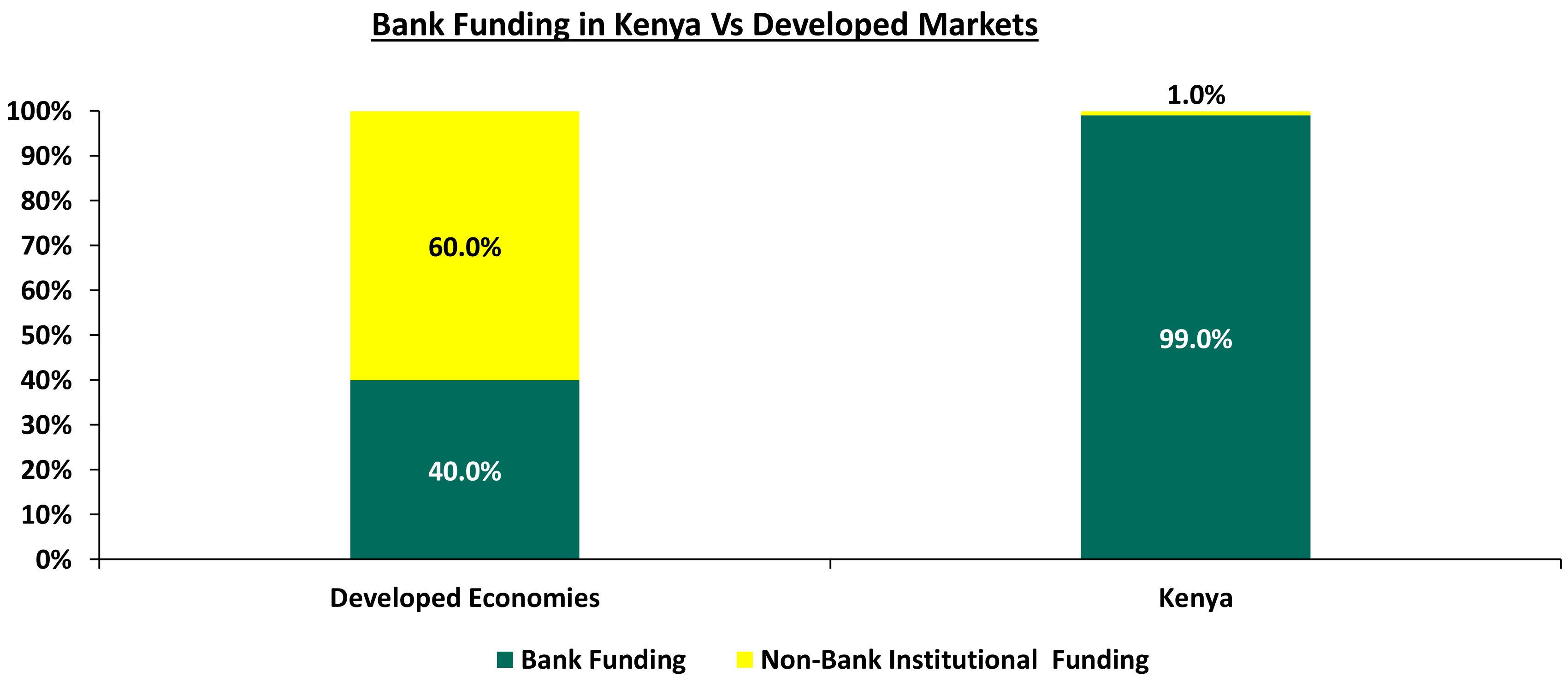
Overview of Private Offers

Typical governance structure for private offers



Why use Private Offers?

Private offers are used to bridge the funding gap existing in businesses



- In Developed markets, bank credit to total credit makes up 40.0% of credit with the balance of 60.0% coming from Capital Markets, however according to the world bank, Kenya relies on banks for 99.0% of credit with only 1.0% coming from capital markets, making it difficult for business such as developers to access credit

Benefits of Investing in the Private Offers

Investing in consumer loans is more lucrative than typical investments

Potential for Principal Protection	• Structured products like those in are designed to secure the principal of the investor, compared to equity markets investments
Enhanced Returns	• Loan markets offer investors better returns than traditional investments such as bank deposits
Reduced Volatility	• Investments are usually backed by alternative assets, such as real estate, which are not subject to market volatility
Inflation Hedge	• Structured products have consistently generated returns above inflation rate, ensuring investors are earning a “real return”
Diversification	• Investors are able to diversify their portfolio away from traditional assets, which reduces investment risk
Relatively Low Capital Needed	• Investments in loan markets requires less capital than say buying property directly

Risks of Investing in Private Offers

Investing in Private Offers carries some risks, including Default & Liquidity risks

Default Risk

The investors may invest in unsecured loans that carry a higher relative default risk. The same way a bank has a good book of performing loans, coupled with a bad book of Non Performing loans (NPLs), the investor is also exposed to possibility of NPLs when investing in the loans market,

Liquidity Risk

Given the returns are supported by relatively illiquid investments, there exists periods of liquidity pressure

Re-Investment Risk

This is the risk that the prevailing investment opportunities at the time of receiving cash flows like interest payments shall be lower than at the onset of your investment, thus investing at a lower rate of return

Challenges in Private Offers Development

Privately offered investments tend to be complex and hard to value

1. They tend to be complex, opaque and hard to value or even understand. This then limits their growth

2. Continuous education of potential investors to understand the products and returns prospects of the product and how they fit into their portfolios

3. The mentality that every financial instrument needs to be regulated, yet private markets is a well understood concept in more developed markets

4. Because its threating to competing products such as bank deposits, they can be viewed suspiciously …"the returns are too high", "it's a Ponzi scheme", "why are they not regulated", etc.

Appendix

Private Offers in the Kenyan Market

Summary of Private Offers in the Kenyan Market

	Name of Private Offer	Type of Private Offer
1.	Car & General Short Term Note Program	Commercial Paper
2.	ASL Credit Short Term Note Program	Commercial Paper
3.	KK Security Short Term Note Program	Commercial Paper
4.	Premier Credit Note Program	Commercial Paper
5.	Watu Credit Note Program	Commercial Paper
6.	My Credit Note Program	Commercial Paper
7.	Maiyan Holdings	Real Estate Note
8.	Heri Homes Capital LLP	Real Estate Note
9.	Cytonn Projects Notes (CPN)	Real Estate Note
10.	Two Rivers Development Fund	Real Estate Note
11.	Meru Greenwood City***	Real Estate Equity
12.	Cytonn High Yield Solutions (CHYS)	Structured Product
13.	Britam Wealth Management Fund LLP	Structured Product

**** Raised funds from international investors from UK and Finland*

Q&A

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