

Post Elections Areas of Focus, & Cytonn Weekly #33/2017

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Executive Summary

Fixed Income: T-bills were oversubscribed for the first time in 5 weeks with the overall subscription rate at 144.8%, compared to 77.5% recorded the previous week as a result of improved liquidity position in the market. The yields on the 91, 182 and 364-day papers remained unchanged at 8.2%, 10.3% and 10.9%, respectively;

Equities: During the week, the equities market was on an upward trend with NSE 20, NSE 25 and NASI gaining marginally by 0.4%, 0.3% and 0.1%, respectively, taking their YTD performance to 25.3%, 25.0% and 23.9%, respectively. The impact of the rate capping can be seen in the results of most banks as HF Group, Co-operative Bank of Kenya, Barclays Bank of Kenya and Stanbic Holdings released H1'2017 results, where they all recorded decline in core earnings per share of 74.0%, 25.4%, 13.3% and 12.1%, respectively;

Private Equity: We continue to witness investment into the African private equity space by global investors, with (i) UK based private equity firm, Enko Capital has acquired an undisclosed significant minority stake in Agence Maritime Internationale (AMI) Logistics, a Dubai-headquartered logistics business with operations in East and Southern Africa for USD 7.0 mn;

Real Estate: The tourism sector proved resilient to the electioneering period with some pockets such as Maasai Mara and the Coast recording high occupancy rates as a result of aggressive marketing by the industry players and a relatively calm election period.

Focus of the Week: With Kenya's presidential electoral process almost coming to a conclusion, which will mark voting in the new government into power, this week, we highlight six key economic areas that we expect the incoming administration to focus on. These are (i) interest rate caps, (ii) government borrowing, (iii) ease of doing business, (iv) diversification of the economy, (v) Balance of Payment position (BOP) and the currency, and (vi) job creation and entrepreneurship.

Company Updates

- Our Investment Analyst, John Ndua discussed the post-election business environment. Watch John Ndua on Citizen [here](#)
- Our Investments Analyst Caleb Mugendi discussed the performance of the Kenya Shilling, which has been showing signs of stability. Watch Caleb Mugendi on CNBC [here](#)
- We continue to showcase real estate developments by our real estate development affiliate, Cytonn Real Estate, through weekly site visits. Watch progress videos and pictures on [The Alma](#), [Amara](#), [The Ridge](#) 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. To deliver high yield returns, our cost of capital is priced off loan markets where all-in pricing ranges from 16% to 18% and our yield on real estate developments ranges from 23% to 25%, hence our topline gross spread is about 6%. 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 trained on Financial Planning. 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 10 investment-ready projects, offering attractive development and buyer targeted returns of around 23.0% to 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, 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-bills were oversubscribed for the first time in five weeks, with the overall subscription rate coming in at 144.8%, compared to 77.5% recorded the previous week as a result of improved liquidity position in the market. The subscription rates for the 91, 182 and 364-day papers came in at 94.5%, 188.9% and 120.9% compared to 29.2%, 95.1% and 79.2% the previous week, respectively. Yields on the 91, 182 and 364-day papers remained unchanged at 8.2%, 10.3% and 10.9%, respectively, while the 182-day paper remains the most attractive on a risk-return proposition. The overall acceptance rate came in at 97.2% compared to 99.6% the previous week, with the government accepting a total of Kshs 33.8 bn of the Kshs 34.8 bn worth of bids received, against the Kshs 24.0 bn, which was on offer in this auction. Despite the oversubscription, the government is behind its domestic borrowing target for the current fiscal year, having recorded a net borrowing deficit of Kshs 12.2 bn, as redemptions of Kshs 139.8 bn exceeded its borrowings of Kshs 127.6 bn, against a target of Kshs 42.8 bn (assuming a pro-rated borrowing target throughout the financial year of Kshs 317.7 bn budgeted for the full financial year).

Despite an improvement in the overall market liquidity, there seems to be liquidity imbalances in the banking sector with CBK supporting banks through reverse repos. There was a net liquidity injection of Kshs 10.7 bn this week compared to Kshs 24.3 bn the previous week, on account of T-bill redemptions, reverse repo purchases and term auction deposit maturities of Kshs 28.3 bn, Kshs 23.7 bn and Kshs 12.5 bn, respectively. Despite the improved liquidity position in the money market, the average interbank rate remained high compared to its year-to-date average of 5.6%, declining to 9.4% from 10.5% the previous week, attributable to skewed liquidity in the market. The average volumes traded in the interbank market declined by 33.6% to Kshs 19.3 bn, from Kshs 29.1 bn the previous week.

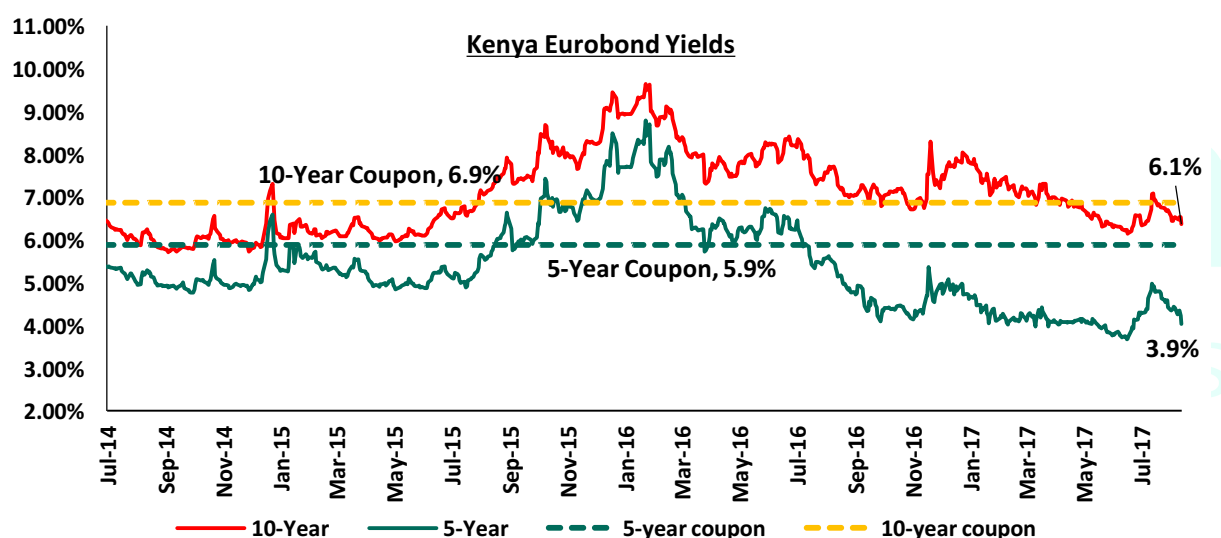
Below is a summary of the money market activity during the week:

all values in Kshs bn, unless stated otherwise

Weekly Liquidity Position – Kenya	
Liquidity Injection	Liquidity Reduction

Term Auction Deposit Maturities	12.5	T-bond sales	0.0
Government Payments	9.0	Transfer from Banks - Taxes	14.2
T-bond Redemptions	0.0	T-bill (Primary issues)	18.5
T-bill Redemption	28.3	Term Auction Deposit	10.0
T-bond Interest	0.9	Reverse Repo Maturities	21.0
T-bill Re-discounts	0.0	Repos	0.0
Reverse Repo Purchases	23.7		
Total Liquidity Injection	74.4	Total Liquidity Withdrawal	63.7
		Net Liquidity Injection	10.7

According to Bloomberg, yields on the 5-year and 10-year Eurobonds, with 1.6-years and 6.9-years to maturity, declined by 30 bps and 20 bps, respectively, to close at 3.9% and 6.1%, from 4.2% and 6.3% the previous week, respectively. Since the mid-January 2016 peak, yields on the Kenya Eurobonds have declined by 4.9% points and 3.6% points for the 5-year and 10-year Eurobonds, respectively, due to stable macroeconomic conditions in the country. The declining Eurobond yields and stable rating (Fitch Ratings having affirmed Kenya's long-term foreign and local currency issuer default ratings (IDRs) at "B+"), are indications that Kenya's macroeconomic environment remains stable and hence an attractive investment destination.



The Kenya Shilling appreciated against the USD by 0.5% during the week to close at Kshs 103.4 from 103.9 the previous week, as banks exit the short dollar positions they took against the shilling before elections. On a year to date basis, the shilling has depreciated against the dollar by 0.9%. The relative stability is because the dollar has also been depreciating against the other major currencies. Against the Euro, Yen and the Pound, the shilling has lost 11.6%, 7.3% and 5.8% YTD, respectively. The significant depreciation against the Euro, Yen and Pound is as a result of stronger economic fundamentals in the Eurozone, UK and Japan as compared to the US, that have pushed further the expected path for the US interest rate hike cycle. In our view, the shilling should remain relatively stable to the dollar in the short term, supported by CBK's activity; with the forex reserve levels currently at USD 7.4 bn (equivalent to 4.9 months of import cover) but we have seen forex reserves decline significantly from USD 8.3 bn at the peak in April this year.

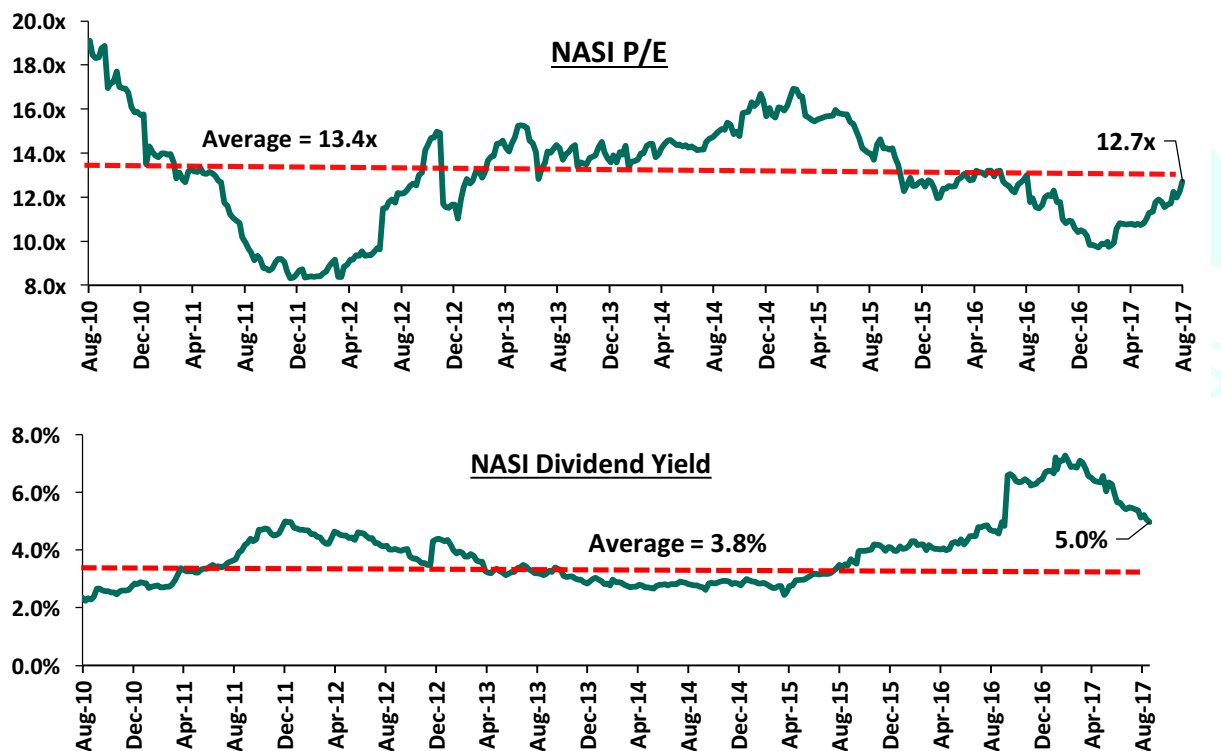
Rates in the fixed income market have remained stable, and we expect this to continue in the short-term. However, a budget deficit that is likely to result from depressed revenue collection creates uncertainty in the interest rates environment as any additional borrowing in the domestic market to plug the deficit could lead to upward pressures on interest rates. Our view is that investors should be biased towards short-to medium term fixed income instruments to reduce duration risk.

Equities

During the week, the equities market was on an upward trend with NSE 20, NSE 25 and NASI gaining marginally 0.4%, 0.3% and 0.1%, respectively, taking their YTD performance to 25.3%, 25.0% and 23.9%, respectively. This week's performance was driven by gains in select large cap stocks such as KCB Group and Equity Group, which gained 1.1% and 0.6%, respectively. Since the February 2015 peak, the market has lost 6.9% and 27.4% for NASI and NSE 20, respectively.

Equities turnover increased by 46.1% to close the week at USD 39.0 mn from USD 26.7mn the previous week. Foreign investors remained net sellers with a net outflow of USD 1.3 mn compared to a net outflow of USD 0.8 mn recorded the previous week. Foreign investor participation decreased to 56.9% from 75.5% recorded the previous week. We expect the market to remain supported by improving investor sentiment following the conclusion of Kenya's general election, and as investors take advantage of the attractive stock valuations.

The market is currently trading at a price to earnings ratio (P/E) of 12.7x, versus a historical average of 13.4x, and a dividend yield of 5.0%, compared to a historical average of 3.8%. The current P/E valuation of 12.7x is 30.9% above the most recent trough valuation of 9.7x experienced in the first week of February 2017, and 52.8% 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.



Barclays Bank of Kenya released H1'2017 results:

Barclays Bank of Kenya (BBK) released H1'2017 results, recording a 13.3% decline in core earnings per share to Kshs 0.7 from Kshs 0.8 in H1'2016, attributed to an 8.0% decline in operating income to Kshs 14.9 bn, which outpaced a 6.0% decline in operating expenses to Kshs 9.8 bn. Key highlights for the performance from H1'2016 to H1'2017 include:

- Total operating income declined by 8.0% to Kshs 14.9 bn from Kshs 16.2 bn in H1'2016, attributed to a 5.0% decline in Net Interest Income (NII) and a 14.4% decline in Non-Funded Income (NFI),

- NII dropped by 5.0% to Kshs 10.5 bn from Kshs 11.1 bn in H1'2016, following a 5.5% decline in interest income to Kshs 13.1 bn from Kshs 13.9 bn, despite a 7.6% decline in interest expense to Kshs 2.6 bn from Kshs 2.8 bn in H1'2016. This resulted in the Net Interest Margin (NIM) declining to 10.1% from 10.7% in H1'2016,
- NFI declined by 14.4% to Kshs 4.4 bn from Kshs 5.1 bn in H1'2016, attributed to a 61.1% drop in fees and commissions on loans and advances to Kshs 0.3 bn from Kshs 0.8 bn in H1'2016. The current revenue mix stands at 71:29 funded to non-funded income compared to 68:32 in H1'2016,
- Total operating expenses declined by 6.0% to Kshs 9.8 bn from Kshs 10.4 bn in H1'2016, driven by a 32.6% drop in Loan Loss Provision (LLP) to Kshs 1.4 bn from Kshs 2.0 bn in H1'2016, despite a 5.1% increase in staff costs to Kshs 5.1 bn from Kshs 4.9 bn in H1'2016,
- Cost to Income ratio worsened to 65.5% from 64.1% in H1'2016. Without LLP, Cost to Income ratio stood at 56.5% from 51.8% in H1'2016,
- Profit before tax declined by 11.5% to Kshs 5.2 bn from Kshs 5.8 bn, while profit after tax declined by 13.3% to Kshs 3.5 bn from Kshs 4.1 bn in H1'2016,
- The loan book expanded by 6.8% to Kshs 163.8 bn from Kshs 153.3 bn in H1'2016, underpinned by strong performance in the retail and SME segments of the business,
- Customer deposits grew by 3.2% to Kshs 188.7 bn from Kshs 182.9 bn in H1'2016. Consequently, the faster growth in loans compared to deposits resulted in the loan to deposit ratio increasing to 86.8% from 83.8% in H1'2016,
- The board of directors recommended payment of an interim dividend of Kshs 0.2 per share, same as in H1'2016. If the final dividend is maintained as per last year, which was Kshs 1.0 per share, then we project a total dividend of Kshs 5.4 bn hence a dividend yield of 9.2% for 2017, using the market price of Kshs 10.5 as at 18th August 2017.

Going forward, we expect BBK's growth to be driven by;

- i) Continued investment in the automation and digitization of systems, processes and solutions in a bid to enhance efficiency as well as to provide their customers with convenient access to banking products and solutions,
- ii) Revenue diversification with new business lines such as Barclays Financial Services Limited (BFSL), Bancassurance and agency banking will see the bank leverage highly on this to spur growth.

For a more comprehensive analysis, see our [BBK H1'2017 Earnings Note](#).

Co-operative Bank of Kenya released H1'2017 results:

Co-operative Bank released H1'2017 results, posting a 25.4% decline in core earnings per share to Kshs 1.1 from Kshs 1.5 recorded in H1'2016, in line with our expectations of a 23.9% decline. The decline was partly due to a 20% increase in the number of shares following their bonus share issue of 1 for every 5 shares that was issued within the first half of this year. Without the bonus shares, the core earnings per share would have declined by 10.4% to Kshs 1.4. Key highlights for the performance from H1'2016 to H1'2017 include:

- Total operating income declined by 3.7% to Kshs 20.5 from Kshs 21.3 bn in H1'2016, attributed to a 7.2% decline in Net Interest Income (NII), despite a 3.7% growth in Non-Funded Income (NFI),
- Net Interest Income (NII) declined by 7.2% to Kshs 13.4 bn from Kshs 14.5 bn in H1'2016 as a result of a 10.3% decline in Interest Income to Kshs 19.3 bn from Kshs 21.5 bn, despite a 16.7% decline in Interest Expense to Kshs 5.8 bn from Kshs 7.0 bn in H1'2016. The Net Interest Margin thus slightly declined to 8.8% from 8.9% in H1'2016,
- Non-Funded income increased by 3.7% to Kshs 7.1 bn from Kshs 6.8 bn in H1'2016, driven by a 6.1% increase in total fees and commissions to Kshs 5.3 bn from Kshs 5.0 bn in H1'2016. The current revenue

- mix stands at 65:35 funded to non-funded income from 68:32 in H1'2016,
- Total operating expenses increased by 3.5% following a 15.2% increase in Loan Loss Provisions (LLP) to Kshs 1.5 bn from Kshs 1.3 bn in H1'2016. Staff costs also increased by 8.7% to Kshs 4.7 bn from Kshs 4.3 bn in H1'2016,
- The Cost to Income ratio deteriorated to 55.3% from 51.4% in H1'2016. Without LLP, the Cost to Income ratio worsened to 47.9% from 45.3% in H1'2016,
- Profit before tax declined by 11.3% to Kshs 9.3 bn from Kshs 10.4 bn, while profit after tax declined by 10.4% to Kshs 6.6 bn from Kshs 7.4 bn in H1'2016,
- The loan book expanded by 14.2% to Kshs 252.6 bn from Kshs 221.3 bn in H1'2016,
- Customer deposits grew by 2.7% to Kshs 285.8 bn from Kshs 278.3 bn in H1'2016. The faster growth in loans compared to deposits led to an increase in the loan to deposit ratio to 88.4% from 79.5% in H1'2016. The slow growth in deposits even by leading deposit gatherers such as Co-op Bank growing at 2.7% and KCB Group growing at 1.3% shows that depositors would rather place their funds in government securities rather than with banks because of interest rate capping. The preference for government bonds rather than bank deposits, a preference that is caused by legislation distorts capital allocation in favor of government securities and effectively crowds out the private sector making it difficult for businesses to access funding for growth. The long-term effect will be negative to GDP growth, employment and standards of living; the incoming government needs to take a quick and hard look at the interest rate cap legislation
- The board of directors did not recommend payment of an interim dividend.

Moving forward, Co-operative Bank's growth will mainly be driven by:

- i) Growth in its Non-Funded income, which currently accounts for 34.6% of its total operating income. Co-op Bank recently entered into a leasing business joint venture with Super Group Limited, which will enable the bank tap into major infrastructure projects, exploration and mining activities thus boosting its strategy to diversify its revenue streams. Ideally, Co-op Bank's NFI contribution should be at least 40%, to be at par with the likes of Stanbic Bank at 45% and Equity Group at 41.6%,
- ii) Cost efficiency that was introduced by the Soaring Eagle Transformation strategy, which drove CIR from a high of 62.6% before the project to a target of 50.0% at the end of the strategy in 2018. The CIR of 55.3% needs to back to the Tier 1 average of 49.3%, and
- iii) Deposit Growth: As of the top 3 deposit gatherers in the country, alongside KCB Group and Equity Bank, it is in their interest to actively lobby for the review of the interest rate cap legislation which is hurting not just industry players, but also the economy and the very consumers it was purportedly meant to help

For a more comprehensive analysis, see our [Co-operative Bank H1'2017 Earnings Note](#).

Stanbic Holdings released H1'2017 results:

Stanbic Holdings released H1'2017 results, recording a 12.1% decline in core earnings per share to Kshs 4.4 from Kshs 5.0 in H1'2016. This was attributed to a 15.4% growth in total operating expenses as total operating revenue remained relatively unchanged. Key highlights for the performance from H1'2016 to H1'2017 include:

- Total operating income remained relatively unchanged at Kshs 9.2 bn, supported by a 10.5% growth in Non-Funded Income, despite an 8.3% decline in Net Interest Income,
- Net Interest Income (NII) declined by 8.3% to Kshs 5.0 bn from Kshs 5.5 bn in H1'2016. The Net Interest Margin thus declined to 5.3% from 5.6% in H1'2016,
- Non-Funded Income (NFI) increased by 10.5% to Kshs 4.2 bn from Kshs 3.8 bn in H1'2016. The current revenue mix stands at 55:45 funded to non-funded income from 59:41 in H1'2016. (It is noteworthy

that without the 10.5% growth in NFI, core earnings would have declined further by 32.1% from the current 12.1%. This illustrates the importance of NFI composition to banking business models going forward.)

- Total operating expenses grew by 15.4% to Kshs 7.0 bn from Kshs 6.0 bn in H1'2016, following a 118.0% growth in Loan Loss Provision (LLP) to Kshs 1.8 bn from Kshs 0.8 bn in H1'2016. Without LLP, operating expenses declined by 0.1% to Kshs 5.1 bn from Kshs 5.2 bn in H1'2016,
- Cost to Income ratio worsened to 75.9% from 65.4% in H1'2016. Without LLP, the Cost to Income ratio remained relatively flat at 56.1% from 56.3% in H1'2016,
- Profit before tax declined by 30.9% to Kshs 2.2 bn from Kshs 3.2 bn in H1'2016, while profit after tax declined by 12.1% to Kshs 1.7 bn from Kshs 2.0 bn in H1'2016, following a decrease in effective tax rate to 21.3% from 38.1% in H1'2016,
- The Loan book grew by 8.0% to Kshs 133.5 bn from Kshs 123.6 bn in H1'2016, better than our expectations of a 5.6% growth,
- Customer deposits grew by 12.5% to Kshs 177.9 bn from Kshs 158.0 bn in H1'2016, due to an increase in deposits from their Corporate and Investment Banking business. The loan to deposit ratio thus decreased to 75.1% from 78.2% in H1'2016,
- The board of directors recommended payment of an interim dividend of Kshs 1.3 per share, same as in H1'2016. If the final dividend is maintained as per last year, which was Kshs 5.3 per share, then we project a total dividend of Kshs 2.1 bn hence a dividend yield of 6.4% for 2017, using the market price of Kshs 81.5 as at 18th August 2017.

Moving forward Stanbic Holdings' growth will be driven by;

- i. Their diversified and clearly defined business strategy, with their non-funded income at 45.3% of total operating income. This enables the bank to respond effectively to shift in market dynamics following introduction of rate cap,
- ii. Cost Efficiency: Stanbic's cost to income ratio remains high compared to peers like I&M Holdings and NIC, whose CIR average stands at 40.0%. The group should adopt efficiency in servicing clients through use of digital platforms and other alternative channels that eliminate need for physical branches, and
- iii. Digital platforms and support systems following the roll out of their mobile banking app and internet banking platform as well as the establishment of new physical branches across the country.

For a more comprehensive analysis, see our [Stanbic Holdings H1'2017 Earnings Note](#).

HF Group released H1'2017 results:

HF Group released H1'2017 results, recording a 74.0% decline in core earnings per share to Kshs 0.5 from Kshs 1.7 in H1'2016. This was attributed to a 20.7% decline in operating revenue, coupled with an 8.6% increase in operating expenses. Key highlights for the performance from H1'2016 to H1'2017 include:

- Total operating income declined by 20.7%, attributed to a 25.3% decline in Net Interest Income (NII), despite a 1.8% growth in Non-Funded Income (NFI),
- NII declined by 25.3% to Kshs 1.6 bn from Kshs 2.1 bn in H1'2016, following an 18.2% decline in Interest Income to Kshs 3.7 bn from Kshs 4.5 bn in H1'2016, despite a 12.1% decline in Interest Expense to Kshs 2.1 bn from Kshs 2.4 bn in H1'2016. The Net Interest Margin thus declined to 5.7% from 6.7% in H1'2016,
- NFI increased by 1.8% to Kshs 0.42 bn from Kshs 0.41 bn in H1'2016, driven by a 4.1% increase in other income to Kshs 0.27 bn from Kshs 0.25 bn in H1'2016. The current revenue mix stands at 79:21 funded

to non-funded income from 83:17 in H1'2016,

- Total operating expenses increased by 8.6% to Kshs 1.7 bn from Kshs 1.6 bn, driven by a 24.9% increase in Loan Loss Provisions (LLP) to Kshs 0.4 bn from Kshs 0.3 bn. The increase was despite a 9.0% decline in staff costs to Kshs 0.5 bn from Kshs 0.6 bn in H1'2016,
- The Cost to Income ratio deteriorated to 88.3% from 64.5% in H1'2016. Without LLP, the Cost to Income ratio worsened to 69.1% from 52.3% in H1'2016,
- Profit before tax declined by 74.0% to Kshs 0.2 bn from Kshs 0.9 bn in H1'2016, while profit after tax declined by 74.0% to Kshs 0.2 bn from Kshs 0.6 bn in H1'2016,
- The loan book contracted by 1.3% to Kshs 52.7 bn from Kshs 53.4 bn in H1'2016,
- Customer deposits declined by 6.0% to Kshs 37.4 bn from Kshs 40.0 bn in H1'2016. The faster decline in deposits compared to loans led to an increase in the loan to deposit ratio to 141.3% from 134.5% in H1'2016. Loans to Loanable funds however decreased to 89.3% from 92.1% in H1'2016 owing to an increase in borrowings by 18.1% to Kshs 21.6 bn from Kshs 18.3 bn in H1'2016
- The board of directors did not recommend payment of an interim dividend.

Moving forward, HF Group's growth will be driven by:

- i. The group's property and investments subsidiary, HFDI, through partnerships to develop real estate products. HFDI is set to launch Clay City, a Kshs 5.0 bn development that will put up 1,520 apartments along Thika Super Highway in a joint venture strategy with Clay Works Limited, (however, there is market chatter that the project may have stalled.)
- ii. Diversification of revenue through the insurance subsidiary, Housing Finance Insurance Agency (HFIA). HFIA has already partnered with Britam and launched a retail medical cover targeted at corporate customers of the group, and
- iii. Expansion of banking channel through launch of innovative products such as the go-live banking system

Despite all of the above, the business model is questionable in this interest rate cap environment as illustrated by (i) a contracting loan and a contracting deposit book; so far HF Group is the only bank that has reported contraction in both loans and deposits, (ii) with deposit contraction far outpacing loan contraction, the loan to deposit ratio has increased to 141%. Since the interest rate cap environment has reduced access to mortgages, leading to declining interest income and made it harder to attract deposits, these two factors will make it very hard for HF Group to grow. In the long term, we see only two viable options, either (i) HF Group will have to be acquired by a bank with strong deposit gathering capability, as we don't see space for another bank to successfully compete for deposits; or (ii) it will have to run a wholesale capital markets funding model, focused on sourcing more expensive capital from capital markets and deploying into real estate development and mortgage lending, that means rationalizing the cost base, which is currently set up like a commercial bank.

For a more comprehensive analysis, see our [HF Group H1'2017 Earnings Note](#).

Of the 6 listed banks that have released their H1'2017 results, none has recorded a growth in core earnings per share, with the average decline in core earnings across the listed banking sector at 13.8%. This is a significant decrease compared to the average growth of 11.1% registered for H1'2016. The sector has, however experienced faster loan growth and all banks showed efforts to protect their Net Interest Margins given that in this half year the full effect of the law capping interest rate was in effect. Banks also reported increased lending with the average loan growth at 12.9% compared to a growth of 8.3% in H1'2016. Despite the growth in the loan book the private sector credit growth remains low, and was at 2.1% in May 2017, which is an 8-year

low. This, coupled with the slower growth in deposits of 3.1% compared to 4.4% in H1'2016, has led to an increase in the loan to deposit ratio, which increased to 85.4% from 78% in H1'2016.

Listed Banks H1'2017 Earnings and Growth Metrics												
Bank	Core EPS Growth		Deposit Growth		Loan Growth		Net Interest Margin		Loan to Deposit Ratio		Exposure to Government Securities	
	H1'2017	H1'2016	H1'2017	H1'2016	H1'2017	H1'2016	H1'2017	H1'2016	H1'2017	H1'2016	H1'2017	H1'2016
KCB Group	(3.6%)	13.6%	1.3%	(2.2%)	16.7%	8.4%	8.7%	8.1%	84.3%	73.2%	24.0%	21.1%
Stanbic	(12.1%)	22.2%	12.5%	(2.7%)	8.0%	0.3%	5.3%	5.6%	75.1%	78.2%	38.6%	36.3%
Barclays Bank	(13.3%)	(10.2%)	3.2%	11.9%	6.8%	14.8%	10.1%	10.7%	86.8%	83.8%	27.9%	26.0%
Co-op Bank	(25.4%)	18.7%	2.7%	12.0%	14.2%	8.0%	8.8%	8.9%	88.4%	79.5%	26.0%	29.2%
National Bank	(42.2%)	(70.0%)	3.4%	(1.6%)	(12.0%)	(9.3%)	6.9%	7.2%	57.7%	67.8%	38.1%	29.5%
HF Group	(74.0%)	26.3%	(6.0%)	6.2%	(1.3%)	7.0%	5.7%	6.7%	89.3%**	92.1%**	9.2%	9.3%
Weighted Average*	(13.8%)	11.1%	3.1%	4.4%	12.9%	8.3%	8.6%	8.5%	84.8%	77.5%	26.7%	25.8%

* The weighted average is based on Market Cap as at 18th August, 2017

**The Loans to Loanable funds ratio. The Loan to Deposit ratio is at 141.3%

In an effort to keep our rankings of companies on the Cytonn Corporate Governance Ranking ("Cytonn CGR") Report up-to-date, we continually update the rankings whenever there are changes on any of the 24 metrics that we track, and how this affects the company ranking. This week, the board of directors of TPS Eastern Africa announced resignation of Mr. Jack Kisa as a director, and appointment of Mr. Nooren Hirjani as the Chief Finance Officer to replace Mr. Abdulmalek Virani who retired. TPS's comprehensive score improved to 68.8% from 64.6% due to decrease in board size to an odd number 9 from an even number 10, and a decline in average age of directors to 60 from 62. Consequently, its rank improved to position 21 from position 28.

Below is our Equities Universe of Coverage

all prices in Kshs unless stated otherwise								
No.	Company	Price as at 11/08/17	Price as at 18/08/17	w/w Change	YTD Change	Target Price*	Dividend Yield	Upside/ (Downside)**
1.	NIC***	36.5	36.3	(0.7%)	39.4%	51.2	3.4%	44.7%
2.	KCB Group***	43.5	44.0	1.1%	53.0%	54.0	6.8%	29.5%
3.	DTBK	189.0	190.0	0.5%	61.0%	241.1	1.6%	28.5%
4.	Barclays	10.6	10.5	(1.4%)	23.2%	12.1	9.6%	25.4%
5.	HF Group	11.6	11.5	(1.3%)	(18.2%)	13.9	3.2%	24.6%
6.	I&M Holdings	115.0	124.0	7.8%	37.8%	147.5	2.9%	21.9%
7.	Co-op Bank	16.2	16.2	0.3%	22.7%	18.5	4.8%	19.0%
8.	Jubilee Insurance	470.0	464.0	(1.3%)	(5.3%)	490.5	1.8%	7.5%
9.	Stanbic Holdings	81.0	81.5	0.6%	15.6%	77.0	5.8%	0.2%
10.	Kenya Re	22.0	22.0	0.0%	(2.2%)	20.5	4.4%	(2.4%)
11.	Standard Chartered	230.0	233.0	1.3%	23.3%	209.3	4.4%	(5.8%)
12.	Equity Group	42.8	43.0	0.6%	43.3%	38.4	4.7%	(6.0%)
13.	Liberty	13.5	14.0	3.3%	5.7%	13.0	0.0%	(7.0%)
14.	Britam	14.9	15.2	1.7%	51.5%	13.2	1.8%	(11.1%)

15.	Safaricom	24.5	24.3	(1.0%)	26.6%	19.8	4.7%	(13.8%)
16.	Sanlam Kenya	27.8	29.8	7.2%	8.2%	21.1	0.0%	(29.2%)
17.	CIC Group	5.6	6.3	11.6%	64.5%	3.7	3.2%	(37.4%)
18.	NBK	11.0	11.5	4.5%	59.7%	4.0	0.0%	(65.0%)

**Target Price as per Cytonn Analyst estimates*

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

****Banks in which Cytonn and/or its affiliates holds a stake*

For full disclosure, Cytonn and/or its affiliates holds a significant stake in KCB Group, ranking as the 5th largest local institutional investor

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

UK based private equity firm, Enko Capital, has acquired an undisclosed significant minority stake in Agence Maritime Internationale (AMI) Logistics, a Dubai-headquartered logistics business with significant operations in East and Southern Africa for USD 7.0 mn. In Kenya, AMI operates from the port of Mombasa offering freight forwarding services and handling transit containers bound for Kampala. The deal marks the second investment for the Enko Africa Private Equity Fund (EAPEF), which held its final close in February 2016 at USD 83.5 mn. The fund has also invested in Madison Financial Services, an insurance company in Zambia. The acquisition by Enko Capital is beneficial to AMI's expansion strategy, as the partnership will enable AMI to offer its clients comprehensive logistics into and out of Africa. The transaction is also strategic for Enko Capital as it banks on the growth of the logistics industry in the region which will be supported by (i) the development of Lamu Port, South Sudan, Ethiopia Transport (LAPSSET) corridor project, (ii) the upgrade of the Mombasa port, (iii) the development of the Standard Gauge Railway, and (iv) the improved road network in Kenya.

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's private markets compared to its public markets, (iii) the attractive valuations in Sub Saharan Africa's markets compared to global markets, and (iv) 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

The hospitality sector in Kenya continued to show resilience despite the fact that the country was undergoing an electioneering period. Last week the Cabinet Secretary for tourism announced during a tourism stakeholders' forum that the Kenyan tourism sector had recovered by almost 18% since 2015 with a possibility of a 20% increase in tourist arrivals by the end of 2017. The Cabinet Secretary noted that the hotels in Diani and Maasai Mara had recorded full occupancies on the eve of the election and this is expected to continue due to the wildebeest migration at the Mara; the migration marks the peak season for the sector. This was affirmed by data from the Kenya National Bureau of Statistics (KNBS), which indicated that between January & May 2017, the number of international visitor arrivals increased by 10.97% & 8.5% at Jomo Kenyatta International Airport & Mombasa's Moi International Airport from 288,905 and 35,388 to 320,588 and 238,397, respectively compared to the same period in 2016. The Kenya Tourism Board Chairman attributed the growth to aggressive marketing, which has helped restore confidence among key international markets such as Europe and the USA and the new emerging markets in Africa and Asia as well as the domestic market. We expect bed occupancy to improve supported by (i) the continued marketing (ii) the growing position of Nairobi as a regional and continental hub and (iii) the relatively peaceful elections just held, restoring investor and tourist confidence.

To further support the tourism sector, the Kenyan government announced plans to construct a Kshs 5.5 bn cable - car to lift tourists from Mombasa Island to Diani. Diani, which is a popular destination for holidaymakers,

has had transport challenges such as congestion at the Likoni channel where travellers rely on ferries to cross from Mombasa Island to the South Coast. In our opinion, the move is a step in the right direction as it will improve the travel experience of visitors leading to an increase in tourist arrivals. The hotel industry at the coast also received a boost after the announcement of the formation of a new lobby group dubbed “The Tourism Management Company” next year. The company whose mandate will be marketing the region’s beach destinations shall be owned by private sector players and the government with 70% & 30% stakes, respectively.

Nairobi’s attractiveness as a regional and continental hub continues to improve having been ranked as the 84th best place to work worldwide by the Nestpick Survey. This is an annual survey ranking done by Nestpick, an aggregator website for furnished apartments with operations worldwide. Nairobi ranked 4th in Africa behind Johannesburg at the 71st position, Cairo at the 80th position and Tunis at the 83rd position. The survey considered five main areas namely: (i) the city’s start up ecosystem, (ii) the salaries offered, (iii) social security and benefit of the cities, (iv) cost of living, and (v) the quality of life. Another survey dubbed Economic Intelligence Unit (EIU) ranks Nairobi at position 120 as the most pleasant city to live in. This was an improvement by 5 positions from last year. The survey also ranks cities based on 5 categories namely (i) healthcare, (ii) education, (iii) infrastructure, (iv) stability, and (v) culture & environment. These surveys are tools used to guide firms setting up shop in new countries as well as a determinant of a city’s ability to attract and retain foreign investments, expatriates & tourists and with Nairobi getting global exposure, we are likely to witness more companies setting up shop in the city. Currently Nairobi hosts continental headquarters for multinationals such as IFC, GE & Google and in 2017, a number of companies have announced plans to start operations in the city including, Johnson & Johnson, Boeing, RICS among others. These multinationals increase demand for grade A office, retail and prime residential houses thus boosting the real estate market in the country.

In the retail sector, International fashion retailers LC Waikiki and Woolworths announced their plans to open a store at the Hub Mall in Karen before the end of the year. This will be the second branch in Kenya in addition to the existing outlet at Two Rivers Mall opened in February this year. There are also plans to have a 3rd store in Nairobi’s CBD which has been cited as a move to have and make the brand’s stores accessible to customers in Nairobi. The retailer cited that the reason for Kenya being its preference for its flagship store in sub-Saharan Africa is that Kenya’s stable economy is supportive of such investments hence being a gateway to growing their footprint in the country and the larger African market. This is a silver lining to the otherwise gloomy image of the sector within the Nairobi metropolis which has been characterized by a possible oversupply of space resulting in ghost malls.

Britam released their [H1 2017 Real Estate Report](#). The key takeouts from the report were:

- i. In the retail sector, the market witnessed slower uptake of space in destination malls compared to neighborhood malls and a resultant stagnation of rental prices due to fewer tenants amidst an increased supply of destination malls with Two Rivers commencing operations earlier in the year
- ii. For commercial office, there was an additional 100,000 sqm of office space contributing to an existing oversupply of office space especially Grade B type even though there is a looming shortage for Grade A office space
- iii. For the industrial sector, there is a huge opportunity in the provision of quality warehousing given that firms are opting to move away from the already congested industrial area into the periphery of the city as long as the alternative is easily accessible
- iv. In the residential sector, there are expectations of an increase in investments in the lower and middle income segments especially due to high demand of 200,000 houses p.a. and incentives for developers such as the reduction of income tax for developers constructing more than 100 houses p.a from 30% to 15%

These findings are in tandem with our analysis as outlined in our [H1’2017 Markets Review](#) where we expect to witness increased development activity in the residential and industrial sectors driven by high demand and low

supply, and reduced activity in the retail and commercial office sectors as a result of increased supply, with 3.5 mn square feet of office space and 1.67 mn square feet of retail space coming into the market in 2017.

In our view, the real estate sector is poised for further growth supported by a positive economic growth, continued infrastructural upgrade and continued investor confidence in the country's performance, especially after the relatively calm election period.

Post-Election Areas of Focus

In our report before the Kenyan 2017 General Elections, [Post-Election Business Environment, & Cytton Monthly – July 2017](#), we highlighted our expectation of the immediate business environment post-elections. Our conclusion was that we expect the post-election business environment to remain largely peaceful and non-violent. This expectation was driven by the changes and reforms we had seen in our electoral process in the years leading to this past election, the circumstances and indicators leading to the election. Specifically;

- i. Integrity and independence of the electoral body was better than before. For example, in this election, biometric voter identification worked, while at the last election this functionality failed,
- ii. Integrity and independence of the judiciary,
- iii. Election preparedness was generally better than before and the voting process went fairly smooth,
- iv. International presence and monitoring,
- v. Market sentiment leading to election was positive.

However, we already have a dispute regarding the second step of the election, which is the tallying and results announcement, which has resulted into a petition in the Supreme Court. That the dispute ended up in the Supreme Court is a vindication of our institutional reforms. The NASA coalition, which is contesting the results, had heavily relied in the courts prior to the election; it would have been difficult and contradictory for the coalition to refuse to go to court to litigate the results they dispute.

Irrespective of the outcome of the petition, there are challenges that the incoming administration will need to address. In this focus note, we highlight the key economic areas that we expect the incoming administration to focus on.

Under the administration of the previous government, Kenya experienced some key economic developments and some changes in economic policies highlighted below:

1. **Introduction of Interest Rate Cap:** In August 2016, the President signed into law The Banking (Amendment) Act 2015, which stipulates a deposit and loan pricing framework, with (i) a cap on lending rates at 4.0% above the Central Bank Rate (CBR), and (ii) a floor on the deposit rates at 70% of the CBR. We have written severally on this matter in the following articles,
 - a. [Interest Rates Cap is Kenya's Brexit – Popular but Unwise](#),
 - b. [Impact of the Interest Rate Cap](#),
 - c. [State of Interest Rate Caps](#), and
 - d. [Update on Effect of Interest Rate Cap on Credit Growth & Cost](#)
2. **Rebasing of Kenya's GDP:** In October 2014, Kenya rebased its GDP, meaning that the base year previously used for compiling the total volume and value of goods and services produced changed from 2001 to 2009. The revised GDP for 2013 rose from Kshs 3.8 tn to Kshs 4.8 tn, a 25.3% increase and subsequently moving the country from low-income status to lower middle-income status
3. **Infrastructure Development:** In the past 4.5 years, the government has invested in the development of infrastructure around the country. These developments have contributed positively to the economy through job creation and growth of the economy in various sectors. Some of the major infrastructure developments that the government has undertaken include the USD 3.2 bn Standard Gauge Railway(SGR), the continued investment in the USD 23.0 bn Lamu Port, South Sudan, Ethiopia

Transport (LAPSSET) corridor project, the upgrade of the Mombasa port, the upgrade of Jomo Kenyatta International Airport and USD 84.4 mn upgrade at Moi International Airport.

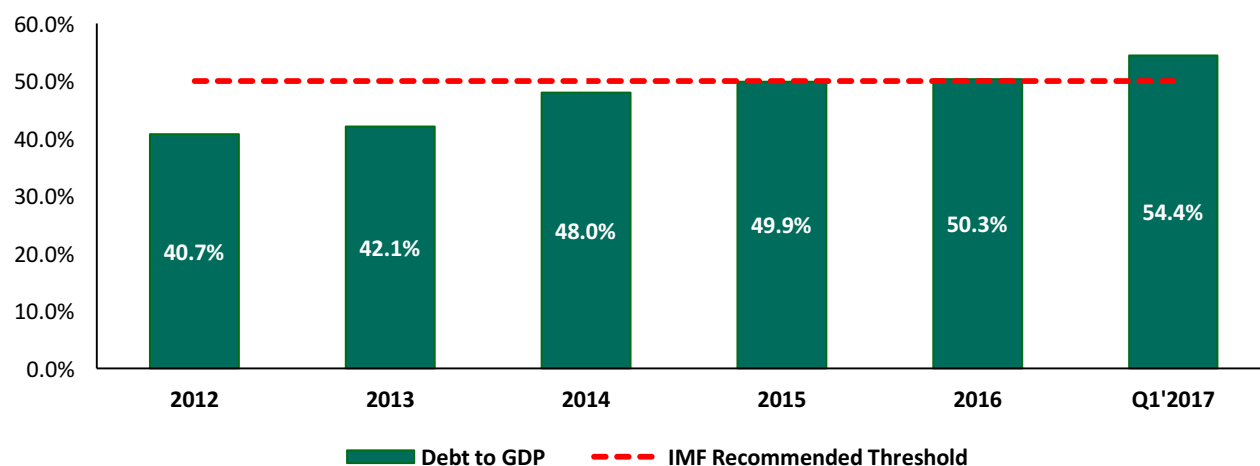
4. **Opened capital markets to international investors through the issue of the country's first Eurobond:** Kenya successfully raised USD 2.7 bn in 2014 through the issue of a USD 2.0 bn Eurobond in June and an additional USD 0.7 bn through a tap sale in December.

Looking at how Kenya's economy has evolved over the years, we find that the economy is in a position for sustained growth, with projections from IMF averaging at 6.3% GDP growth over the next 5-years. For this to happen, even as the incoming administration seeks to deliver on their manifesto, we are of the view that the government should address the following six key economic issues, in order to boost economic growth and improve the business environment in the country:

- I. **Review of Interest Rate Cap:** The interest rate cap was introduced to increase affordability of loans to the larger economy and at the same time ensure savers get returns for the money in the bank. However, the caps are yet to achieve this desired effect and have had a negative impact on the economy as they have (i) locked out SME's and retail borrowers from accessing credit, (ii) led to widespread restructuring and lay-offs in the banking sector, (iii) strained the smaller banks, who have to mobilize expensive funds and can only lend out within the stipulated margins, and (iv) continued to weigh down on private sector credit growth which stood at 2.1% as at May 2017, the lowest in 8-years, from a high of 17.0% in 2016. It is clear from the above that the effects of interest rate capping, are more disastrous than productive with the cons far out-weighing the pros. In our view, the policy makers should scrap off the interest rate caps, and instead, (i) put in place enabling regulation for the development of innovative and competing alternative sources of funding in order to bring down the 95% funding dominance by banks as compared to more developed markets where bank funding makes up only 40% of total funding. We need to spur innovation and growth of alternative and capital markets funding, and (ii) provide fundamental and strong consumer protections for Kenyan public and push for more information sharing by the banks. While we are of the view that rate caps ought to be scrapped or at least radically reviewed, the review ought to be coupled with legislation that will make funding markets more competitive.
- II. **Government Debt:** Over the past 6-years, we have seen the National Budget continue to grow with the total expenditures growing at an average of 14.7% to Kshs 2.2 tn in 2016/17 from Kshs 977.0 bn in 2010/11, while revenue growth (KRA Tax collections) has increased by 12.7% to Kshs 1.4 tn in 2016/17 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 54.4%, which is 440 basis points above IMF's threshold for developing countries.

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

Kenya Debt Evolution & Debt to GDP



Source: Central Bank of Kenya

The increase in debt levels is mainly driven by (i) slow growth in revenue collection compared to the budget growth. Revenue collection has grown by an average of 12.7% compared to the 14.7% growth in the budget, and (ii) significant investment in infrastructure projects such as the SGR, which are mainly financed through external debt. In our view, the government should strive to manage the country's debt levels going forward by (i) enhanced tax revenue collection growth, which can be achieved by developing avenues that will allow for taxation of the informal sector and enforcing efficient tax collection methods such as requiring the use of iTax for tax remittance, (ii) involve private sector in development through more Public-Private Partnerships (PPPs) so that private funding reduces the need for public borrowing and also private funding enhances the self sustainability of a project, and (iii) reduce recurrent expenditure that currently accounts for 58.8% of the 2017/2018 budget, compared to 54.3% in 2016/2017 and 50.8% in 2015/2016.

- III. Ease of Doing Business:** Ease of Doing Business is an aggregate ranking method for countries, based on indicators that measure and benchmark regulations applying to domestic SME businesses throughout their life cycle. The ranking is done by the World Bank, and tracks changes in the following 10 life cycle stages of a business: (i) starting a business, (ii) dealing with construction permits, (iii) getting electricity, (iv) registering property, (v) getting credit, (vi) protecting minority investors, (vii) paying taxes, (viii) trading across borders, (ix) enforcing contracts and (x) resolving insolvency. The results for each economy are then compared with those of 189 other economies and over time. According to World Bank Report, The Doing Business 2017 released in October 2016 Kenya was highlighted for making the biggest improvements in their business regulations leading to an improvement of 16 places to rank position 92 out of 190, which is a build-up from the improvement of 28 places to position 108 in 2015 from 136 in 2014.

Of the factors highlighted in the report that Kenya requires to improve on, the government has put effort in, (i) easing the tax remittance process through the online iTax platform, and (ii) improving the accessibility of credit information through the launch of a Cost of Credit website that is meant to provide the public with information on fees and charges relating to loan facilities offered by commercial banks and microfinance institutions. However, as highlighted in our write up, [Ease of Doing Business in Kenya](#), we maintain our view that there exists room for Kenya to improve its business climate to attract more entrepreneurs and investors to start businesses and foreign direct investment by (i) making it easier for entrepreneurs to start a business by reducing the cost and processes involved, (ii) easing the process of obtaining construction permits, (iii) heighten the fight against corruption and (iv) enhancing minority investors protection.

IV. Diversification of the Economy: The Kenyan economy relies heavily in the Agricultural sector, which contributed up to 25.7% of the GDP in Q1'2017. Owing to the fact that we are still highly dependent on rain-fed agriculture, the economy is highly affected in drought years. As highlighted in our report, [Cost of Living](#), the levels of inflation have been the highest in years during which the country has experienced drought, due to the high dependency on agriculture. As the government puts in measures such as developing irrigation schemes to reduce dependence on rain-fed agriculture and ensure food security in low rainfall seasons, it should also focus on developing a more diversified economy that is less dependent on agriculture.

Below is a table showing the sectoral contribution to 2016 GDP:

Sector	Percentage Contribution to 2016 GDP
Agriculture	23.9%
Manufacturing	11.3%
Real Estate	9.2%
Wholesale and retail trade	8.3%
Education	7.6%
Transport and Storage	7.6%
Financial & Insurance	6.8%
Construction	5.9%
Public Administration	4.2%
Information and Communication	4.2%
Electricity & Water Supply	2.7%
Professional, administration and support	2.5%
Health	2.0%
Other services	1.4%
Accommodation and Restaurant	1.2%
Mining and quarrying	1.2%

Source: Kenya Bureau of Statistics

In order to do this, the government should seek to support sectors such as (i) manufacturing, through the development of already proposed Export Processing Zones and Special Economic Zones such as the proposed Dongo Kundu SEZ, (ii) transport and storage, through the development of infrastructure such as railroad, upgrade of airports and expansion of roads, (iii) real estate, through improved legislation that will ease approvals for real estate developments and improve access to credit to both developers and homeowners through mortgages in order to improve their contribution to the GDP, and, (iv) tourism, by maintaining the effort to sell Kenya as a good tourism destination. The sector seems to be gaining traction but a lot still needs to be done to ensure that this grows further and seasonality that comes with it is countered by having more diversified tourism offering to cater for both business and leisure.

V. Balance of Payment Position (BOP) and the Currency: The country's BOP position has remained relatively stable though negative over the years supported by financial flows. However, the trade deficit has continued to fluctuate. In the last quarter we saw the trade deficit more than double due to a slowdown in exports and an increase in imports. As highlighted in our report, [Cytonn Weekly #27/2017](#), the trade deficit increased by 43.1% to Kshs 352.5 bn from January to April 2017, from Kshs 246.3 bn in a similar period in 2016 driven by, (i) increased imports, which grew by 23.6%, due to increases in imports of fuels, machinery & transport and manufactured products by 48.9%, 23.8% and 10.3%, respectively, with the three jointly contributing 62.7% to total imports, and (ii) a marginal increase in exports, which grew by 2.4%, attributed to a 7.1% increase in the value of tea exports, despite a 7.4% decline in the value of horticultural exports, with the two contributing 24.6% and 21.8% of total exports, respectively. Given the

importance of maintaining a fundamentally supported currency the government should (i) focus on improving the attractiveness of Kenya as an investment destination especially through the capital markets, by strengthening the regulations and increased investor education, (ii) look for ways to create a diversified export base to stop too much reliance on agriculture based exports. Manufacturing, being one of the sectors that could see an increase in exports but is largely hindered by the cost of power, we are of the view that the government should put effort to provide cheaper power through usage of more renewable energy, and (iii) create incentives for the Kenyan diaspora to invest back home.

- VI. Job Creation and Entrepreneurship:** One of the biggest challenge facing the country today is the huge unemployment rate that is the highest in the East African region at 39.1% in 2016 up from 24.1% in 2015, according to The 2017 Human Development Index. The government should take a deliberate effort to enhance entrepreneurship and provide the more required capital to do this by increasing the allocation to the youth fund and increasing accountability around the same. Investment in technical education will also go a long way in assisting the youth to be more self-dependent.

In conclusion even as the government seeks to carry out its manifesto, it also has its work cut out in regards to meeting the expectations outlined above with the aim of improving the country's economy. If the government would focus on these economic issues, we are of the view that (i) the economy would experience improved private sector credit growth, which will in turn spur the growth of the economy, (ii) through diversification of the economy, more jobs will be created and the risk the economy is exposed to due to climatic changes will be reduced, and (iii) with improved ease of doing business Kenya will provide an attractive destination for foreign investors increasing the country's foreign direct investments.

