Update on Effect of Interest Rate Cap on Credit Growth & Cost, & Cytonn Weekly #29/2017

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Executive Summary:

Fixed Income: During the week, T-bill subscriptions remained low at 31.3%, compared to 33.6% recorded the previous week, while yields on the 91, 182 and 364-day papers remained unchanged at 8.2%, 10.3% and 10.9%, respectively. Meanwhile, the Monetary Policy Committee (MPC) met on Monday 17th July 2017, and maintained the Central Bank Rate (CBR) at 10.0%, in line with our expectation;

Equities: During the week, the equities market was on an upward trend with NSE 25, NSE 20 and NASI gaining 2.0%, 1.6% and 1.4%, respectively, taking their YTD performance to 16.9%, 16.1% and 16.5%, respectively. The directors of Kenya Airways have called for an Extraordinary General Meeting (EGM) to pass resolutions to allow for a balance sheet restructuring and a subsequent capital raise;

Private Equity: Activity in the private equity space continues to gain traction based on investment activities witnessed during the week where (i) Actis, a London based private equity firm launched Honoris United Universities, the first African private higher education network, bringing together the leading tertiary education institutions in North and Southern Africa, and (ii) EFG Hermes Holding S.A.E, through its subsidiary Egyptian investment bank, EFG Hermes, has acquired a 51.0% stake in Frontier Investment Management Partners LTD (FIM) for USD 21.5 mn;

Real Estate: A group of 35 SACCO's unveiled a housing loans plan, Africa Tenancy Purchase Initiative, which seeks to offer their members interest-free mortgages;

Focus of the Week: Over the years, various initiatives have been implemented by the government in a bid to keep the total cost of credit at acceptable levels and hence make credit more accessible and spur economic growth. One such significant initiative is the interest rate cap legislation. This week, we seek to analyse the true cost of credit, initiatives put in place to make credit cheaper and more accessible, especially the rate cap, and the impact on private sector credit growth;

Company Updates

- On Saturday, 22nd July, our Managing Partner & C.E.O, Edwin H. Dande, honoured the invitation to speak at the Alliance High School Career Day 2017 on "Intersection between Entrepreneurship and Careers". Drawing most of his remarks from his own personal journey, Edwin challenged the students to lay down the right foundation for their careers early enough. See Event Note
- Our Investments Analyst, Caleb Mugendi, discussed the planned conversion of Kenya Airway's debt to equity, which will result in a consortium of 11 Kenyan banks becoming the airlines' second-largest shareholder. Watch Caleb Mugendi on Ebru News here
- Our Senior Manager - Regional Markets, Johnson Denge, discussed the effects of the upcoming general elections on the real estate sector. Watch Johnson Denge on Ebru News 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 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 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-bills were significantly undersubscribed for the 2nd week in a row, with the overall subscription dropping to 31.3% from 33.6% recorded the previous week. The subscription rates for the 91, 182 and 364-day papers came in at 55.6%, 40.0%, and 12.9% compared to 56.0%, 41.9% and 16.2% the previous week, respectively. Yields on the 91, 182 and 364-day papers remained unchanged at 8.2%, 10.3% and 10.9%, respectively. The overall acceptance rate came in at 86.5% compared to 97.3% the previous week, with the government accepting a total of Kshs 6.5 bn of the Kshs 7.5 bn worth of bids received, against the Kshs 24.0 bn on offer in this auction.

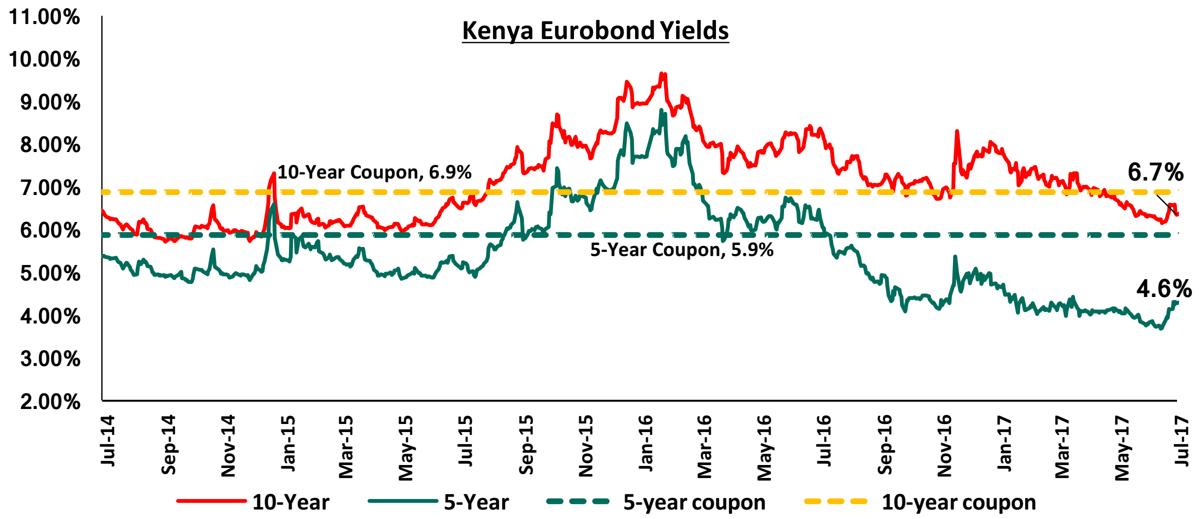
There was improved liquidity in the money markets leading to a net liquidity injection of Kshs 23.5 bn from a net liquidity reduction of Kshs 1.1 bn the previous week. Despite this, the average interbank rate rose to 7.3% from 6.0% the previous week. The improved liquidity position was mainly due to Term Auction Deposit Maturities, Government Payments and T-bill Redemptions, which in total amounted to Kshs 55.1 bn of the total of Kshs 78.7 bn liquidity injection during the week. There seems to be a market performance discrepancy since, despite an increase in liquidity in the market, the (i) interbank rate increased, (ii) volumes traded decreased, (iii) Central Bank was relatively active in the reverse repo market, and (iv) treasury bills were undersubscribed. The main explanation for this could be skewed distribution of liquidity in the banking sector and we shall carry out more research on this during the coming 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	19.8	Repos	2.7
Government Payments	17.4	Transfer from Banks - Taxes	10.9
T-bill Redemption	17.9	T-bill (Primary issues)	7.8
T-bond Interest	0.7	Term Auction Deposit	22.9
Reverse Repo Purchases	10.9	Reverse Repo Maturities	10.9
Repos Maturities	12.0		
Total Liquidity Injection	**78.7**	**Total Liquidity Withdrawal**	**55.2**
		Net Liquidity Injection	**23.5**

According to Bloomberg, yields on the 5-year and 10-year Eurobonds, with 2-years and 7-years to maturity, declined by 20 bps and 10 bps, respectively, to close at 4.6% and 6.7%, from 4.8% and 6.8% the previous week, respectively. Since the mid-January 2016 peak, yields on the Kenya Eurobonds have declined by 4.2% points and 2.9% 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+", with a negative outlook on Kenya's senior unsecured foreign-currency bond ratings at "B+"), are indications that Kenya remains stable and hence an attractive investment destination.



The Kenya Shilling remained stable during the week, to close at Kshs 103.9, mainly driven by inflows from horticulture exporters, which offset the dollar demand by oil importers. On a year to date basis, the shilling has depreciated against the dollar by 1.4%. In our view, the shilling should remain relatively stable in the short term, supported by CBK's activity as can be seen by the decline in the forex reserve levels, currently at USD 7.8 bn (equivalent to 4.6 months of import cover), compared to USD 8.3 bn (equivalent to 5.3 months of import cover) at its peak, at the end of May 2017.

The Monetary Policy Committee (MPC) met this week, on Monday 17th July 2017, to review the prevailing macroeconomic conditions and give direction on the Central Bank Rate (CBR). The MPC maintained the CBR at 10.0%, which was in line with our expectations as per our MPC Note. The Committee noted that the decision was on the back of a relatively stable macroeconomic environment, given (i) inflation declined to 9.2% in June, from a high of 11.7% in May, due to a decline in food prices brought about by the rains, albeit depressed, (ii) a relatively stable foreign exchange market, despite the current account deficit widening to 6.2% of GDP in May, from 6.0% in March, and (iii) a resilient banking sector, with the average commercial banks liquidity ratio and capital adequacy ratio at 44.7% and 19.6%, respectively, as at June 2017. The committee also noted that (i) inflation is expected to continue declining, supported by lower food and fuel prices, (ii) the current account deficit is expected to narrow in the second half of 2017, due to resilient tea and horticulture exports, and (iii) the economy has remained resilient, with economic growth in Q1'2017 coming in at 4.7%, despite the poor performance in agriculture. Despite this, we are keen to note that private sector credit growth slumped to 2.1% in May, from 3.3% in March, and this trend may well impact adversely on economic growth, which we believe will be a key driver in future monetary policy decisions.

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. Domestic government borrowing is expected to pick up in the coming weeks, with the government having fallen behind its domestic borrowing target for the current fiscal year, having recorded a borrowing deficit of Kshs 7.5 bn against a target of Kshs 18.3 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, having missed its 2016/17 fiscal year target by 9.0%, collecting Kshs 1.4 tn,***

II. ***Following the depressed rainfall witnessed over the long rains period, the agriculture sector is expected to be heavily affected, with maize production 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, in addition to the increased budget to support food importation.***

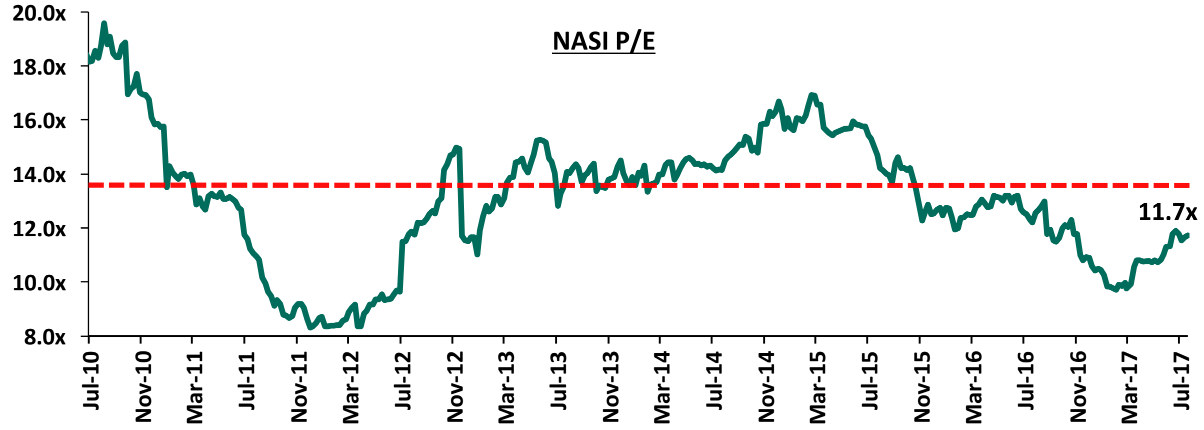
Overall, the possible deficit that is likely to result from depressed revenue collection, and the high inflationary environment that we are currently in, create uncertainty in the interest rate environment. Our view is that investors should be biased towards short-term fixed income instruments to reduce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

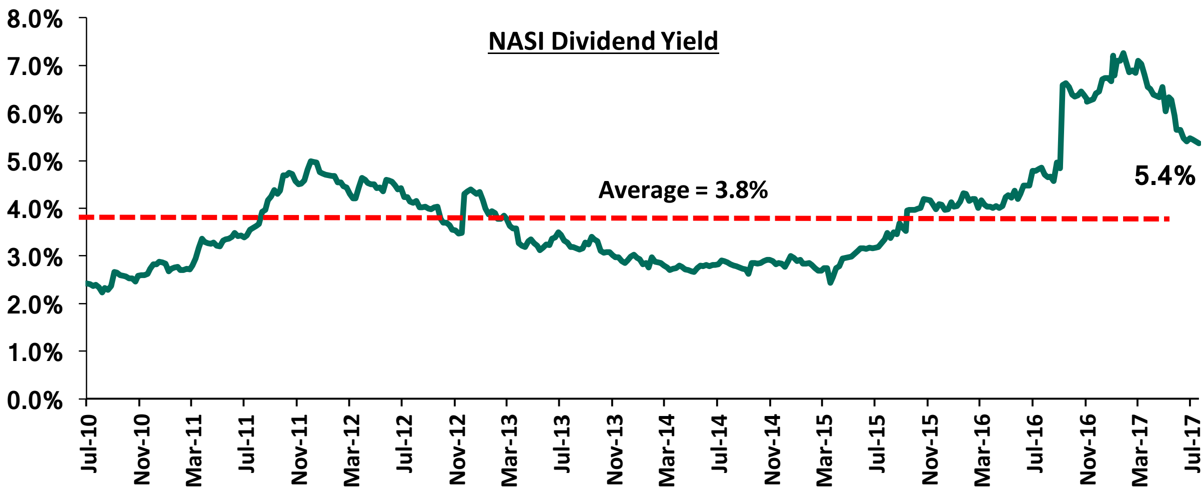
Equities

During the week, the equities market was on an upward trend with NSE 25, NSE 20 and NASI gaining 2.0%, 1.6% and 1.4%, respectively, taking their YTD performance to 16.9%, 16.1% and 16.5%, respectively. This week's performance was driven by gains in select large cap banking stocks such as Diamond Trust Bank (DTB), Co-operative Bank and Equity Group, which gained 8.5%, 6.8% and 4.6%, respectively. The gain in DTB is attributed to the completion of the Habib Bank take-over this week, while Co-operative Bank's gain was due to renewed foreign investor interest. Since the February 2015 peak, the market has lost 12.5% and 32.7% for NASI and NSE 20, respectively.

Equities turnover declined by 33.9% to close the week at USD 40.5 mn from USD 61.2 mn the previous week. Foreign investors remained net sellers with net outflows of USD 6.5 mn compared to net outflows of USD 5.8 mn recorded the previous week. Foreign investor participation increased to 63.7% from 49.0% recorded the previous week. Safaricom was the top mover for the week, accounting for 29.7% of market activity. We expect corporate earnings growth to be slower in 2017 and investor sentiment to be neutral, mainly due to the forthcoming general elections.

The market is currently trading at a price to earnings ratio (P/E) of 11.7x compared to a historical 7-year average of 13.4x, and a dividend yield of 5.4%, compared to a historical average of 3.8%. The current P/E valuation of 11.7x is 20.8% above the most recent trough valuation of 9.7x experienced in the first week of February 2017, indicating substantial recovery since February 2017, and 41.0% 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 directors of Kenya Airways have called for an Extraordinary General Meeting (EGM) to pass resolutions to allow for a balance sheet restructuring and a subsequent capital raise. The airline plans to reduce its current debt exposure of Kshs 242.0 bn by Kshs 60.5 bn through conversion to equity at a price of Kshs 2.1 per share, which will result in a 95.0% dilution effect to the existing shareholders. The table below shows the transaction details for the debt restructuring:

Kenya Airways Ownership Summary Following Debt Conversion							
Lender	**Current Shares Held**	**Current % Ownership**	**Debt (in USD mns)**	**New Shares**	**New % Ownership**	**Total Shares After Conversion**	**% Ownership After Conversion**
Government	445,920,557	29.8%	278.6	13,482,250,000	45.0%	13,928,170,557	**46.5%**
KLM	400,020,026	26.7%	76.5	3,702,053,571	12.4%	4,102,073,597	**13.7%**
KQ Lenders Co Ltd	-	0.0%	220.7	10,680,303,571	35.7%	10,680,303,571	**35.7%**
ESOP	-	0.0%	11.8	571,035,714	1.9%	571,035,714	**1.9%**
Total	**845,940,583**	**56.5%**	**587.6**	**28,435,642,857**	**95.0%**	**29,281,583,440**	**97.8%**

Following the restructuring, KQ Lenders Company, a special purpose vehicle (SPV) consisting of 11 Kenyan banks will replace KLM as the second largest shareholder with a holding of 35.7%, while the Government's holding will increase to 46.5% from the current 29.8%. Other shareholders (with exception of Government, KLM and KQ Lenders) will be given an opportunity to reinvest in the company through an open offer to raise up to Kshs 1.5 bn through an issue of new Ordinary Shares in order to defend their stakes against the significant 95.0% dilution. We view the conversion as a positive move for the airline as (i) it will boost the firm's equity position to a positive of approximately Kshs 15.6 bn, from the current negative position of Kshs 44.9 bn, (ii) it will reduce the overall debt burden, thus stabilizing the company and facilitating long term growth, in line with its turnaround strategy, and (iii) it will result in a significant boost in liquidity through savings on interest and maturity payments on debt, thus improving the airline's cash flow position. New shareholders are also likely to cause changes in governance, which we believe will be beneficial for the firm, to ensure keen oversight on the implementation of its turn-around strategy. The current overleveraged retailers such as Uchumi and Nakumatt should follow KQ's example and convert debt into equity rather than clamouring for tax payer bailouts.

Visa, a global payment technology firm, has partnered with 9 local banks; Barclays Bank, Co-operative Bank, Ecobank, Family Bank, KCB Group, National Bank, NIC Bank, Prime Bank and Standard Chartered Bank, to enable customers make free domestic mobile money transfers using mVisa. Diamond Trust Bank and Stanbic Bank are also in the process of joining the list of mVisa-enabled lenders, as banks explore more ways of generating non-funded income to compensate for declining interest income as a result of interest rates capping. Similar to the PesaLink platform, mVisa is expected to increase banks' competitiveness in the money transfer market, which has in the recent past been dominated by network operators. However, it is unlikely that this new platform will slow down mobile money growth given its utility and universality that has extended its use beyond peer transfers to include loan disbursement, receiving dividends, diaspora remittances, sports betting, e-commerce and utility bills payments, and lately, selling of government securities such as the M-Akiba bond.

Global ratings agency Moody's Investors Service released a peer comparison report for KCB Bank, Equity Bank and Co-operative Bank, which showed that the 3 banks will maintain healthy profits and strong capital buffers despite the challenging operating environment characterised by low credit growth and deteriorating asset quality. All these banks have long-term local currency deposit ratings of B1 with a stable outlook. The agency assesses Equity Bank to be the worst hit by the interest rates capping since its lending is focused on micro businesses and small-and-medium sized enterprises (SMEs), which account for 60.0% of its loan book, as opposed to KCB Bank and Co-operative Bank, whose focus is on corporates and low-risk government employees. As highlighted in our Cytonn Weekly #27/2017, the rating is beneficial to the Kenyan banking sector as (i) banks with good ratings can easily raise capital at a lower cost due to the low risk associated with the firm, and (ii) it improves the image of the sector thus building confidence among investors. Ratings also facilitate best pricing and timing of public offerings as companies with high ratings get public recognition thus can easily attract investors without incurring much cost on getting media coverage for their offerings.

Sanlam Kenya has acquired an additional 12.0% stake in its general business subsidiary Gateway Insurance, now renamed to Sanlam General, for a consideration of Kshs 213.7 mn, raising its stake to 68.0%. Sanlam Kenya first acquired 51.0% stake in Gateway Insurance in March 2015 for a consideration of Kshs 561.0 mn and later subscribed for additional shares in Gateway for Kshs 139.7 mn effectively increasing its shareholding to 56%. This first transaction valued Gateway Insurance at Kshs 1.1 bn implying that this last transaction was carried at a premium of 61.9%. Sanlam General recorded a loss of Kshs 0.03 mn in FY'2016, a 120.0% decline compared to a profit of Kshs 0.15 mn in FY'2015, mainly due to a decline in investment income as a result of fair value losses from disposal of assets, despite a growth in premiums. The increased investment in the general business line signals confidence that Sanlam has about future prospects of this subsidiary and could boost Sanlam Kenya's share in the insurance market which currently stands at 7.0% for long-term insurance and 2.2% for general business.

In order to ensure that the ranking of companies in the Cytonn Corporate Governance Report (Cytonn CGR) is up to date, 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, Wilson Irungu Nyakera resigned from the Kenya Airways (KQ) board following his redeployment from the Ministry of Transport, Infrastructure, Housing and Urban Development to the State Department for Planning and Statistics. KQ's score has now reduced to 58.3% from 60.4% due to a reduction in board size from an odd number 9 to an even number 8 following Mr. Nyakera's exit. KQ now ranks at position 40 from position 33 in which it tied with 6 other companies. We however view this decline as temporary as we expect a replacement from the Government.

- This week we recognize the efforts of 7 NSE listed firms, KenolKobil, Sanlam Kenya, Sameer Africa, KenGen, Deacons Kenya, Kenya Re-insurance Corporation and Nairobi Securities Exchange, in setting the pace on transparency and disclosures by revealing what their CEOs earned last year, even though not required to publish such information by the regulators. As emphasized in our Cytonn Corporate Governance Report – 2017, the level of governance in a firm can only be determined from its level of disclosures, and with most of the Kenyan listed entities adopting this move, it is expected to instil a proper governance culture, ultimately lead to deepening of the capital markets and provide investors detailed insights into how firms are governed.

Below is our Equities Universe of Coverage:

all prices in Kshs unless stated otherwise

No.	Company	Price as at 14/07/17	Price as at 21/07/17	w/w Change	YTD Change	Target Price*	Dividend Yield	Upside/ (Downside)**
1.	NIC	33.8	33.8	0.0%	29.8%	51.2	3.7%	55.4%
2.	KCB Group***	39.3	39.8	1.3%	38.3%	54.0	7.5%	43.4%
3.	I&M Holdings	109.0	107.0	(1.8%)	18.9%	147.5	3.4%	41.2%
4.	HF Group	10.6	10.4	(1.9%)	(26.1%)	13.9	3.6%	37.9%
5.	DTBK	165.0	179.0	8.5%	51.7%	241.1	1.7%	36.4%
6.	Barclays	9.6	9.7	0.5%	13.8%	12.1	10.4%	35.8%
7.	Co-op Bank	14.0	15.0	6.8%	13.3%	18.5	5.2%	28.9%
8.	Jubilee Insurance	430.0	417.0	(3.0%)	(14.9%)	490.5	1.8%	19.5%
9.	Liberty	11.5	12.0	4.8%	(9.1%)	13.0	0.0%	8.2%
10.	Kenya Re	20.3	20.8	2.5%	(7.8%)	20.5	4.4%	3.2%
11.	Stanbic Holdings	76.0	79.5	4.6%	12.8%	77.0	5.9%	2.7%
12.	Equity Group	38.0	39.8	4.6%	32.5%	38.4	5.0%	1.6%
13.	Standard Chartered	217.0	217.0	0.0%	14.8%	209.3	4.7%	1.2%
14.	Britam	14.3	13.8	(3.5%)	38.0%	12.8	2.0%	(5.5%)
15.	Safaricom	23.0	23.3	1.1%	21.4%	19.8	4.7%	(10.3%)
16.	Sanlam Kenya	28.0	26.5	(5.4%)	(3.6%)	21.1	0.0%	(20.5%)
17.	CIC Group	4.5	5.0	10.0%	30.3%	3.7	3.2%	(21.9%)
18.	NBK	10.9	10.9	0.0%	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 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

Actis, a London based private equity firm, launched the first African private higher education network, Honoris United Universities, bringing together the leading tertiary education institutions in North and Southern Africa. Actis is expected to spend at least USD 275.0 mn to acquire leading universities across nine African countries, which include Tunisia, Morocco, South Africa, Namibia, Mauritius, Botswana and Zimbabwe. The strategy to develop a Pan-African Higher education network began with (i) the acquisition of an undisclosed stake in Tunisia's Universite Centrale Group in 2014, (ii) investment in Morocco's Universite Mundiapolis in 2016, and (iii) their most recent buyout of the Management College of Southern Africa and the REGENT Business School, both in South Africa, in 2017. Honoris targets to build a network of 48 campuses in 30 cities, offering accredited, accessible and affordable education. According to a report, "The Business of Education in Africa" by Caerus Capital, an investment and advisory firm focused on education, the private tertiary level education has outperformed the public sector in the last 5-years, recording a 14.6% enrolment growth rate against 7.7% recorded in the public sector. The investment into higher education by Actis affirms the present demand for quality education in Africa and the available investment opportunities in the private higher education sector, which is valued between USD 2.0 bn - USD 2.2 bn. Over 40.0% of Actis' USD 7.5 bn investments portfolio are located across Africa, with USD 500.0 mn allocated to the education sector. We expect to see an increase in investment in the education sector in Sub-Saharan Africa, as investors are motivated by (i) Increasing demand for quality and affordable education, with the Gross Enrolment Ratio (GER) having doubled in the last 10-years to 8.5% in 2016 from 4.5% in 2006, and (ii) support, such as ease of approvals, offered to investors in the education sector by governments looking to meet Sustainable Development Goals (SDGs) targets of universal access to tertiary education.

Milost Global Inc, a private equity firm headquartered in New York with more than USD 25 bn in committed capital, has executed a financing deal with Eco Medical Village Limited (EMVL), a Ghana based company that is looking to develop a 700-bed hospital in Accra Ghana. Milost will provide USD 300.0 mn, in form of debt and equity; USD 200.0 mn will be debt, running at a rate of 5.0% per annum and the remaining USD 100.0 mn financing is in form of equity. The hospital to be developed targets middle and upper class citizens in the West African region. This is the firms second investment in Africa this year after it entered into a USD 19.2 mn funding agreement to provide working capital to Labat Africa, a South Africa based Investment Holding Company. The partnership between Milost and EMVL is beneficial to both parties as (i) it provides EMVL with a chance to leverage on Milost's experience in financing, development and managing projects in the health sector, and (ii) it provides Milost with an opportunity to diversify its investments in Africa. The transaction highlights the increasing interest in Africa's health sector by foreign investors driven by (i) demand for quality healthcare by the growing middle class, (ii) improving regulation in most economies, making them more accommodative of private investors in the health sector, and (iii) increased private sector involvement in the implementation of healthcare especially through innovation and healthcare product development.

EFG Hermes Holding S.A.E, through its subsidiary Egyptian investment bank, EFG Hermes, has acquired a 51.0% stake in Frontier Investment Management Partners LTD (FIM) for USD 21.5 mn, effectively valuing FIM at USD 43.0 mn. FIM is an asset manager that operates in Middle East and has USD 1.6 bn of assets under management. The acquisition will be beneficial to both parties as EFG Hermes Holding will (i) increase its assets under management to USD 4.5 bn from USD 2.9 bn in 2016, and (ii) improve their product portfolio with FIM products such as real estate investment and private equity investment. For FIM, the partnership will enable them expand their distribution network into Africa, in regions that EFG Hermes already has presence in. To further expand into frontier markets, EFG Hermes plans to begin operations in Kenya following award of brokerage and trading licenses by the CMA. With a target market share of 5.0% in the first year of operation, the firm will be offering research for Kenyan and Sub-Saharan African banks and consumer stocks. The Kenyan financial services space has witnessed increased entry of global players, as they seek to take advantage of the deepening capital market.

Private equity investments in Africa remains robust as evidenced by the increased deal flow in a number of sectors that support growth in the Continent. 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

During the week, a group of 35 savings and credit co-operative societies (SACCO's) unveiled a housing loans plan dubbed "Africa Tenancy Purchase Initiative", which seeks to offer their members interest-free mortgages. The housing plan aims at getting the credit union members to pay a deposit of 10.0% of the cost of unit upfront and then clear the balance in "rent" instalments for up to 20-years. Up to 5,000 members of the various SACCO's, including Kimisitu SACCO, Safaricom SACCO, Habitat Housing Co-operative, and Nation Housing are expected to benefit from the initiative in the next 2-years. The model is structured around the consumer behaviour of a typical Kenyan renting a house in urban areas hence making the rent-and-purchase mechanism affordable. The World Bank, through International Finance Corporation, shall offer a partial credit guarantee for the housing projects, while Co-operative Bank and Shelter Afrique will provide short-term financing to develop the units. Other stakeholders in the project are the UN-Habitat and the State Department for Housing and Urban Development.

Some of the projects in the pipeline under the tenant purchase scheme comprising high-rise apartment blocks within Nairobi Metropolitan Area include:

Projects under the Africa Tenancy Purchase Initiative				
No.	Project	Location	Concept	Project Value (Kshs bn)
1.	Sunset Boulevard Phase II	Athi River	Mixed Use Development	2
2.	Karen Heights	Bulbul	Mixed Use Development	6
3.	Art Stone	Juja	400 apartments	6
4.	Habitat Heights	Athi River	5,200 units	22

Source: Africa Tenancy Purchase Initiative

To further support the need for such a product, according to the Kenya Economic Update April-2017 by World Bank, housing the urban poor, which is approximately 61.0% of the urban population in Kenya, has always been a challenge in the Nairobi Metropolis and other urban centres in Kenya, with the estimated deficit being between 150,000 and 200,000 units per annum. The Kenyan government through its Medium Term Plan I (2009-2012) of the Vision 2030 strategy envisaged to provide 200,000 units annually to citizens of all income levels. However, there was an acute under delivery with the government only being able to supply a total of 3,000 units between 2009 and 2012. The private sector on the other hand made applications of 15,000 units in 2013, whereby 80.0% of these are targeting the upper middle (48.0%) and high income classes (35.0%) with only 2.0% targeting the lower income segments of the population and the rest being other development typologies. According to the report, majority of Kenyans have no access to affordable mortgage from commercial banks and the SACCO's seek to tap into the property market by offering cheaper mortgages to low-income earners. To put it into perspective, only 10.7% of the urban population can afford the cheapest newly built house in 2015 at a cost of approximately Kshs 1.7 mn. As a result, more than 90.0 % of Kenyans end up being tenants and such an initiative seeks to convert their rent payments to a home ownership plan.

In other news, the Capital Markets Authority (CMA) has backed the exemption of Real Estate Investment Trusts (REITs) from Value Added Tax (VAT), which accrues to both rent and professional services. The regulator hopes that this incentive will spur interest in the product that opens up the property market for retail investors. This is in addition to the exemption of REITs - related asset transfers from Stamp Duty at between 2.0% – 4.0% for rural and urban areas, respectively, and Capital Gains Tax at 5.0% of the net proceeds from sale of land and buildings back in 2015. Despite these efforts, the tax exemptions remain difficult to access because the exemptions have not been automatically coupled up with the REIT product, and in most cases require a separate engagement with the Kenya Revenue Authority, KRA, to effect. The structure of the REIT ought to be such that an approval and registration of a REIT by CMA will automatically come with all the tax benefits.

The real estate sector is expected to witness increased investments especially in the low end housing and hospitality sectors, especially if calm elections are held, supporting the recovery in tourism from its downward trend over the past 5-years, as well as more developers focusing on housing the lower income segment.

Focus of the Week: Update on Effect of Interest Rate Cap on Credit Growth & Cost

Two recent events have led us to revisit the topic of the effect of the interest rate caps on credit growth and costs:

(i) First, the Kenya Bankers Association (KBA) and the Central Bank (CBK) made public a Cost of Credit website in which commercial banks and micro-finance institutions are required to publish their true cost of credit, which revealed that the average true cost of credit is at 16.7%, and is as high as 20.6%, which is way above the statutory limit of 14.0%, based on the interest rate cap legislation that limit the lending rate to 4.0% above the Central Bank Rate (CBR), and,

(ii) CBK came out this week and set out new regulations that will see commercial banks incur heavy penalties, of up to a maximum of Kshs 20.0 mn, from Kshs 5.0 mn previously, for failure to disclose the true cost of credit to consumers.

Given that it is now almost a year since the legislation, this write up seeks to assess and update on the impact of the Banking (Amendment) Act 2015 on (i) the total cost of credit now versus pre-rate cap period, (ii) whether the interest rate cap has achieved its intention of improving access to credit, (iii) the sustainability of the rate cap, and (iv) what needs to be done to spur lending, and at what rates banks are willing to lend. We have already done three previous focus notes on the topic, namely,

(i) Interest Rates Cap is Kenya's Brexit – Popular but Unwise, which we published in August 2016, just before the bill was signed into law, making the argument that the free movement and pricing of labor, capital, goods and services, tends to be strongly correlated with stronger economic growth and prosperity,

(ii) Impact of the Interest Rate Cap, which we published in August 2016, right after the bill was signed into law, where we expressed concern that those who the amendment was meant to protect, might end up being the biggest losers, given banks would not be prepared to lend out so readily under the regulatory framework, and,

(iii) State of Interest Rate Caps, which we published in May 2017, making the argument that the interest rate caps have (i) locked out SME's and retail borrowers from accessing credit, (ii) led to widespread 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 4.0% at the time.

The total cost of credit is defined as all costs related to the issuance of credit, including interest and any fees tied to acquiring credit, usually expressed by the Annual Percentage Rate (APR), a metric that factors in additional costs and fees on the annual interest rate. The Banking (Amendment) Act 2015 was introduced in August 2016, capping lending rates at 4.0% points above the CBR and deposit rates at 70.0% of the CBR rate. The intention of the bill was to protect consumers from high cost of credit and not earning any interest on their savings accounts.

However, despite the positive intention behind the Banking (Amendment) Act, the impact has been negative, as can be illustrated in the following ways:

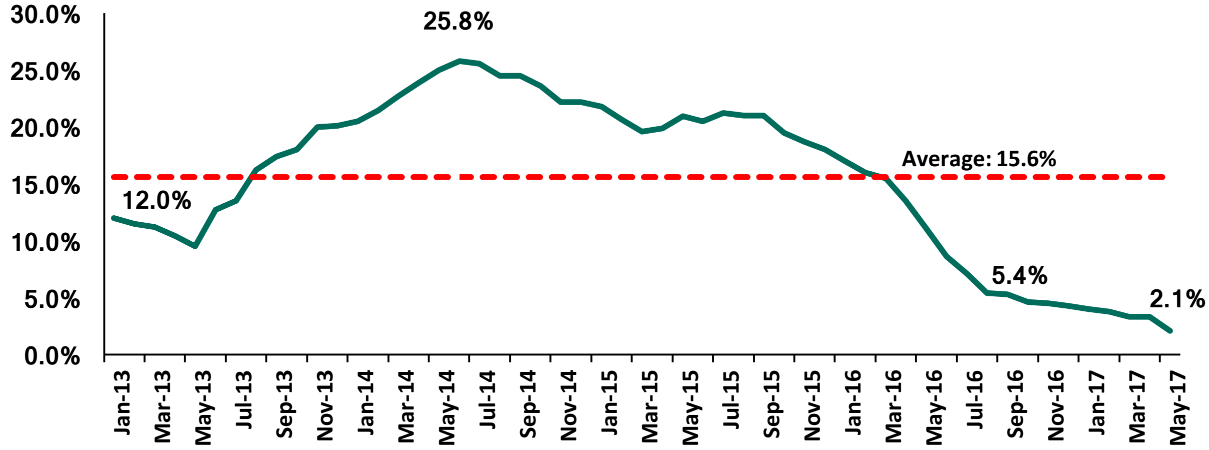
(i) Decline in private sector credit growth from a high of 25.8% in June 2014 to 2.1% recorded in May 2017,

(ii) Decline in total amounts of commercial banks loan growth, with listed banks recording a loan growth of 7.1% in Q1'2017, compared to 15.7% in Q1'2016, and,

(iii) The average cost of loans by banks, as banks are now charging excessive fees and additional costs on their loans, which would only serve to discourage potential borrowers.

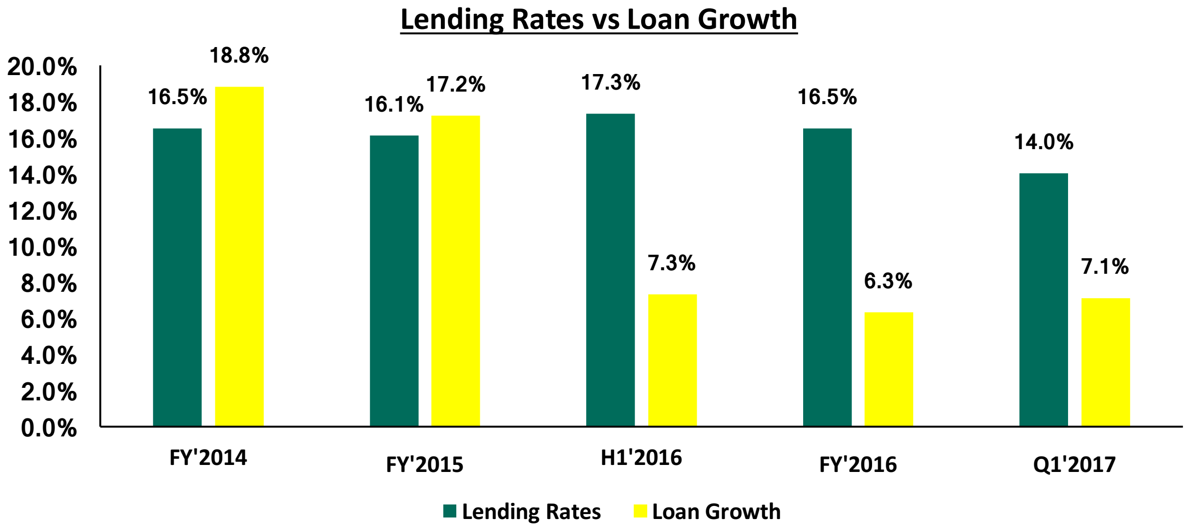
Decline in Private Sector Credit Growth: Since the Banking (Amendment) Act 2015 was introduced in August 2016, there has been a decline in access to credit, with the private sector credit growth declining to an 8-year low of 2.1% in May compared to 25.8% at its peak in June 2014, and a 5-year average of 17.7%. This decline can be attributed to the fact that banks prefer not to lend to consumers but invest in risk-free treasuries, which offer better returns on a risk adjusted basis.

Private Sector Credit Growth



Decline in Lending by Commercial Banks: The loan growth in commercial banks in Kenya has also been affected, with listed banks recording a loan growth of 7.1% as at Q1'2017, compared to 15.7% in Q1'2016 and a 5-year average growth of 14.6%. The most affected banks in terms of loan growth are those banks with a focus on SME's and the retail market, the segment that the law was meant to protect, indicating the rate cap might not have achieved its intended objective. As stated in our Cytonn Weekly #33-2016, where we firmly disagreed with the rate capping proposal as a measure to make credit more accessible, we prescribed a market with free and open information on loan pricing and alternative products as effective methods to increase competition and drive down loan costs.

Historically, as shown in the chart below, the average rates for commercial banks loans and advances have been at 16.5% and 16.1% in 2014 and 2015, respectively, while the average rate in 2016 has come in at 16.5%, with interest rate caps introduced in August 2016, and have been fixed at 14.0% throughout 2017. When this is compared to loan growth, as shown in the chart below, it is noticeable that loan growth was highest during a time of no interest rate caps, dipping to 6.3% in 2016 when the interest rate caps were introduced, and we have seen this drag on into the first quarter of 2017, with loan growth at 7.1%. With loan growth coming in at 7.3% in the first half of 2016, also attributed to structural factors in the banking sector brought about by increasing Non-Performing Loans (NPLs) due to a challenging operating environment, it is clear that the introduction of the interest rate caps has not served to increase credit growth, which has worsened since the introduction of the rate caps. As such, free pricing of loans with no government interference is associated with higher credit growth, when compared to the fixed rate regime the economy is currently under, which has only served to subdue credit growth further.



Average Cost of Loans by Banks: In line with providing the market with information, and in an effort to promote transparency and control the total cost of credit, CBK and KBA have made public a website in which commercial banks and micro-finance institutions, are required to publish their Annual Percentage Rates (APRs), loan repayment schedules and any additional details on their loans. Loans with a 1-year duration, both secured and unsecured, should attract the maximum chargeable interest of 14.0%, but banks have managed to increase the true cost of credit with bank charges varying depending on the bank.

Moving to analyse the true cost of credit, with banks levying charges above the 14.0% capped interest rate, below we have the ranking of the cheapest and costliest banks, based on the APR, assuming an individual has taken up a personal secured loan, with the average APR in the sector under this category recorded at 16.7%:

Personal Secured Loan - Cheapest Banks					
Position	**Bank**	**Annual Interest**	**Bank Charges**	**Other Charges**	**APR**
1	**Guaranty Trust Bank**	14.0%	0.0%	0.0%	14.0%
2	**CBA**	14.0%	1.0%	0.1%	15.3%
2	**Habib Bank Zurich**	14.0%	1.0%	0.1%	15.3%
2	**I&M Bank**	14.0%	1.0%	0.1%	15.3%
2	**Middle East Bank**	14.0%	1.0%	0.1%	15.3%
2	**Oriental Bank**	14.0%	1.0%	0.1%	15.3%
2	**Paramount Bank**	14.0%	1.0%	0.1%	15.3%
2	**Victoria Commercial Bank**	14.0%	1.0%	0.1%	15.3%
	Average	**14.0%**	**0.9%**	**0.1%**	**15.1%**

Personal Secured Loan - Costly Banks					
Position	**Bank**	**Annual Interest**	**Bank Charges**	**Other Charges**	**APR**
1	**Equity Bank**	14.0%	5.0%	0.5%	20.6%
2	**Barclays Bank**	14.0%	4.0%	0.9%	19.9%
3	**Prime Bank**	14.0%	4.0%	0.4%	19.2%
4	**Family Bank**	14.0%	3.2%	0.8%	18.8%
5	**Chase Bank**	14.0%	3.0%	0.3%	17.9%
5	**Eco-bank Kenya**	14.0%	3.0%	0.3%	17.9%

5	**NIC Bank**	14.0%	3.0%	0.3%	17.9%
5	**Spire Bank**	14.0%	3.0%	0.3%	17.9%
	Average	**14.0%**	**3.5%**	**0.5%**	**18.8%**

When it comes to applying for a 3-year mortgage, the APR is elevated due to third party charges such as legal fees and other related costs, with bank charges remaining relatively unchanged, and an average sector APR of 18.9% under the mortgage category.

Mortgage - Cheapest Banks					
Position	**Bank**	**Annual Interest**	**Bank Charges**	**Other Charges**	**APR**
1	**ABC Bank**	14.0%	1.0%	5.6%	18.2%
1	**Guaranty Trust Bank**	14.0%	1.0%	5.6%	18.2%
1	**I&M Bank**	14.0%	1.0%	5.6%	18.2%
1	**Middle East Bank**	14.0%	1.0%	5.6%	18.2%
1	**Victoria Commercial Bank**	14.0%	1.0%	5.6%	18.2%
	Average	**14.0%**	**1.0%**	**5.6%**	**18.2%**

Mortgage - Costly Banks					
Position	**Bank**	**Annual Interest**	**Bank Charges**	**Other Charges**	**APR**
1	**Equity Bank**	14.0%	5.0%	6.0%	21.3%
2	**Barclays Bank**	14.0%	3.0%	6.3%	20.0%
3	**NIC Bank**	14.0%	3.0%	6.3%	20.0%
4	**KCB Group**	14.0%	2.6%	6.3%	19.8%
5	**Chase Bank**	14.0%	3.0%	5.8%	19.7%
6	**Eco-bank Kenya**	14.0%	3.0%	5.8%	19.7%
	Average	**14.0%**	**3.3%**	**6.1%**	**20.1%**

From the tables above we can draw the following conclusions and insights on the total cost of credit as highlighted below;

- The total cost of credit is quite high, given the excessive fees being charged by large portions of the banking sector, with these additional costs accounting for 12.3% of the total cost of credit in the sector, and 17.7% of the 10 costliest banks, and,
- The larger banks in the industry, which control a substantial amount of the loan book, are the costliest, and hence are able to sway the market, given the low customer bargaining power.

While interest rates have remained relatively stable at low levels, following the Banking (Amendment) Act 2015, private sector credit growth has continued to dip, coming in at 2.1% in May, from 3.3% recorded in March, and 20.9% registered in May 2015, as it is still better to lend to the government as the interest rates remain high on government securities, with a 5-year trading at 12.4%.

Given the current state of low lending in the economy, and that we are under a fixed-rate regime on interest rates, below are the initiatives that need to be taken to spur credit growth once again in the economy:

1. Repeal the Banking (Amendment) Act 2015, given the current regulatory framework has proved to be a hindrance to credit growth, evidenced by the continued decline of private sector credit growth, which is at 2.1% as at March 2017, compared to 5.4% when the amendment was introduced in August 2016,

2. Diversify funding sources, which will enable borrowers to tap into alternative avenues of funding that are more flexible and pocket-friendly. In more developed economies, bank funding accounts for just 40.0% of funding for businesses, yet in this market, bank funding accounts for over 95.0% of funding. Alternative sources of funding, especially capital markets based funding and competing alternative products need not only be developed but encouraged,
3. Consumer education, where borrowers are educated on how to be able to access credit, the use of collateral and establishing a strong credit history,
4. Increased transparency, in a bid to spur competitiveness in the banking sector and bring a halt to excessive fees and costs, with recent initiatives by the CBK and KBA, such as the stringent new laws and cost of credit website, being commendable initiatives, and
5. Improved and more accommodative regulation, such as the Movable Property Security Rights Bill 2017, which seeks to facilitate use of movable assets as collateral for credit facilities, allowing borrowers to use a single asset to access credit from different lenders.

While interest rates are currently at stable low levels, the risk lies in the rigid loan pricing framework that has seen the government crowd out the private sector and lock out "high risk" borrowers, with private sector credit growth now at 2.1% as at May 2017, which could end up impacting negatively on the economy because the private sector is a major job creator. Moreover, the free pricing of loans with no government interference is associated with higher credit growth, when compared to the fixed rate regime the economy is currently under.