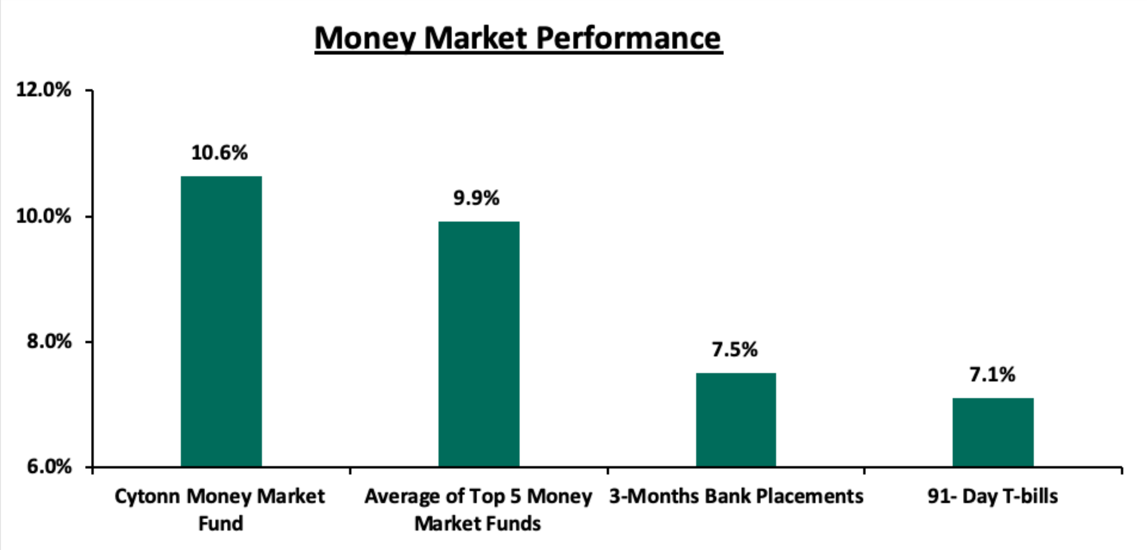
Impact of COVID-19 on Real Estate Funds, & Cytonn Weekly #25/2020

Fixed Income

Money Markets, T-Bills & T-Bonds Primary Auction:

During the week, T-bills remained oversubscribed, with the subscription rate coming in at 188.4%, down from 290.5% the previous week. The oversubscription is partly attributable to the continued favorable liquidity in the money markets, as well as the continued preference for shorter-dated papers by investors. After the reduction of the both the CRR and the CBR rate was intended to increase liquidity in the market for onward lending to the private sector but due to the ongoing uncertainties in the financial markets, the lending is yet to pick and hence partly the reason for the high liquidity in the money market. The subscription rates for the 91-day paper increased to 334.4% from the 294.0% recorded the previous week, while subscription for the 182-day and 364-day papers declined to 130.6% and 187.8%, respectively, from 265.0% and 314.7%, recorded the previous week. The yields on the 91-day, 182-day and 364-day papers declined by 17.0 bps, 32.1 bps and 36.3 bps to 7.1%, 7.7% and 8.7%, respectively. The acceptance rate declined marginally to 32.6%, from 32.8% recorded the previous week, with the government accepting only Kshs 14.7 bn of the Kshs 45.2 bn worth of bids received.

On the primary bond auction, the period of sale for the reopened five-year and ten-year bonds, FXD3/2019/5 and FXD4/2019/10 closed on Tuesday, 16th June 2020. The issue was oversubscribed with the average subscription rate coming in at 262.8% as the government received bids worth Kshs 105.1 bn, higher than the Kshs 40.0 bn offered. Key to note, investor preference was biased towards the FXD3/2019/5, with a shorter tenor, receiving bids worth Kshs 60.9 bn compared to the FXD4/2019/10, which received Kshs 44.2 bn worth of bids. The preference towards the shorter tenor paper can be attributed to investors avoiding the duration risk associated with longer-dated papers. Yields on the bonds came in at 11.5% and 12.5%, for the five and ten-year bonds respectively, which was in-line with our expectations of a range between 11.4% - 11.6% for FXD3/2019/5 and 12.3% - 12.5% for FXD4/2019/10. The government rejected high bids only accepting Kshs 49.3 bn out of the Kshs 105.1 bn worth of bids received, translating to an acceptance rate of 46.9%.



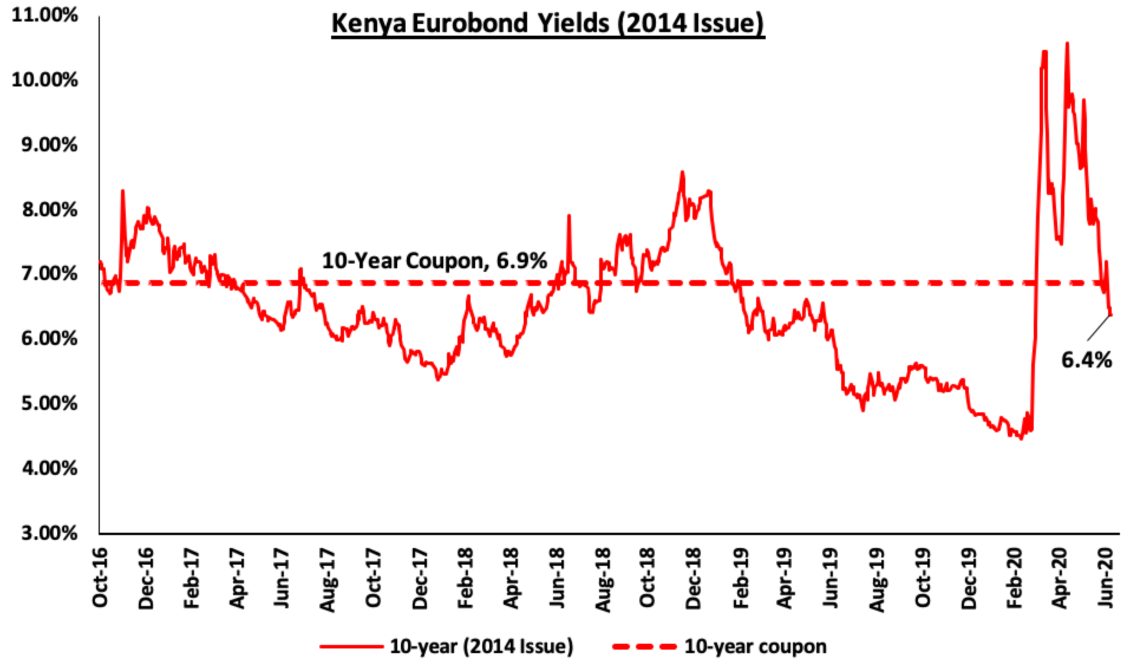
In the money markets, 3-month bank placements ended the week at 7.5% (based on what we have been offered by various banks), while the yield on the 91-day T-bill declined by 17.0 bps to close the week at 7.1%, from 7.3% recorded the previous week. The average yield of Top 5 Money Market Funds declined marginally to 9.9% from the 10.0%, recorded the previous week. The yield on the Cytonn Money Market remained unchanged at 10.6%, similar to what was recorded the previous week.

Liquidity:

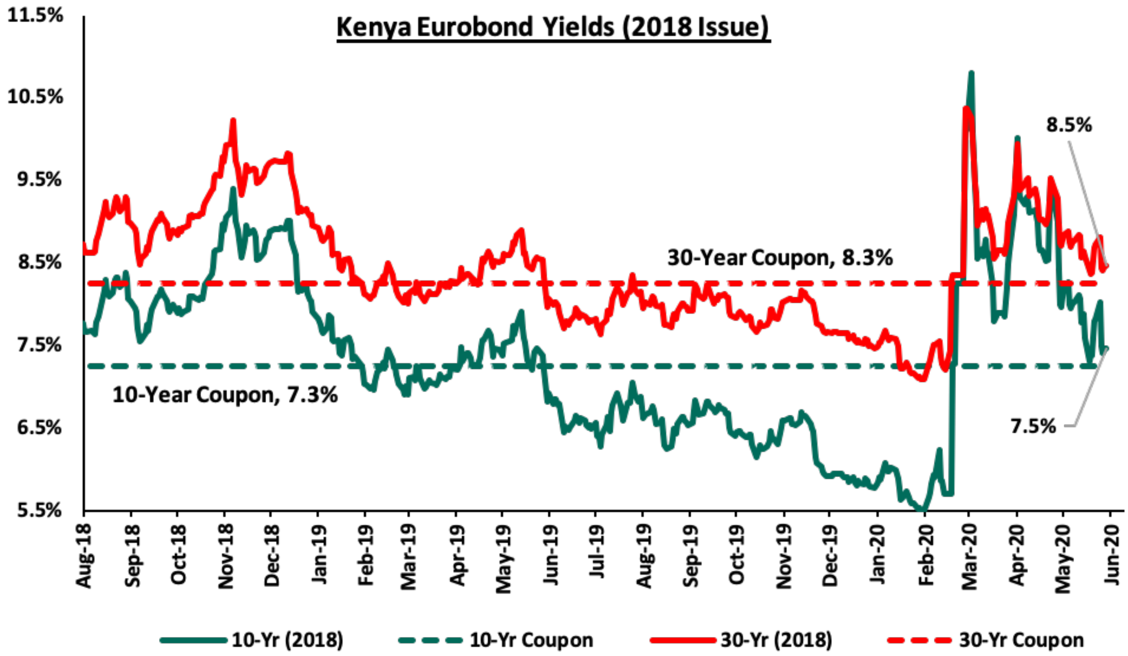
During the week, the market remained relatively liquid with the average interbank rate increasing marginally to 2.9% from 2.6% recorded the previous week, but below the 2019 average of 4.3%, supported by government payments. The week also saw the average interbank volumes increase by 21.1% to Kshs 4.1 bn, from Kshs 3.4 bn recorded the previous week. As per the Central Bank of Kenya, commercial banks' excess reserves came in at Kshs 39.1 bn in relation to the 4.25% cash CRR. The favourable liquidity in recent weeks has also partly been attributable to the reduction of the Cash Reserve Ratio (CRR) to 4.25%, from 5.25% previously, by the Monetary Policy Committee (MPC) during its March 2020 sitting, consequently freeing up additional liquidity to commercial banks for onward lending to distressed borrowers during the COVID-19 pandemic.

Kenya Eurobonds:

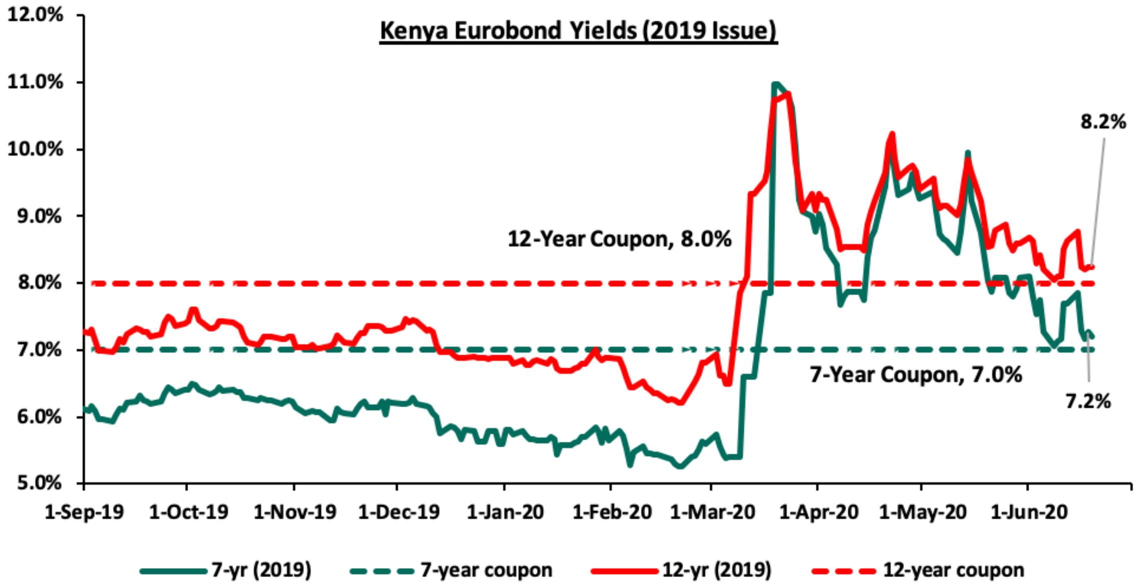
During the week, Kenyan Eurobonds were on a downward trend as all bonds saw a decline in yields. Since the jump we saw in March, the investor sentiments have been improving over the past two months. According to Reuters, the yield on the 10-year Eurobond issued in June 2014 declined by 0.7% points to 6.4%, from 7.1% recorded the previous week.



The yields on the 10-year and 30-year Eurobonds issued in 2018 declined by 0.3% points and 0.2% points to 7.5% and 8.5%, respectively, from 7.8% and 8.7% recorded the previous week, respectively.



The yields on the 7-year and 12-year Eurobonds issued in 2019 also declined by 0.5% points and 0.4% points, to 7.2% and 8.2%, respectively, from 7.7% and 8.6% recorded the previous week, respectively.



Kenya Shilling:

During the week, the Kenya Shilling appreciated by 0.2% against the US Dollar to close the week at Kshs 106.3, from Kshs 106.5, recorded the previous week, which traders attributed to low dollar demand from merchandise importers, coupled with dollar inflows from horticulture exports. On an YTD basis, the shilling has depreciated by 4.9% against the dollar, in comparison to the 0.5% appreciation in 2019. We expect continued pressure on the shilling due to:

i. Demand from merchandise and energy sector importers as they beef up their hard currency positions amid a slowdown in foreign dollar currency inflows, and,
ii. Subdued diaspora remittances evidenced by the 9.0% decline to USD 208.2 mn in April 2020, from USD 228.8 seen the previous month, mainly due to the decline in economic activities globally, coupled with increased prices of household items leading to lower disposable income. Key to note, the Central Bank of Kenya (CBK) expects a 12.0% decline in remittances in 2020.

The shilling is however expected to be supported by:

i. High levels of forex reserves, currently at USD 9.2 bn (equivalent to 5.6-months of import cover), above the statutory requirement of maintaining at least 4.0-months of import cover, and the EAC region’s convergence criteria of 4.5-months of import cover.

Weekly Highlight:

During the week, the Energy and Petroleum Regulatory Authority (EPRA) released their monthly statement on the Maximum Retail Prices in Kenya for the period 15th June 2020 to 14th July 2020. Below are the key take-outs from the statement:

- Petrol prices have increased by 6.9% to Kshs 89.1 per litre from Kshs 83.3 per litre previously, while diesel prices have declined by 4.8% to Kshs 74.6 per litre from Kshs 78.4 per litre.
- Kerosene prices, on the other hand, declined by 21.7% to Kshs 62.5 per litre from 79.8 per litre, previously,
- The changes in prices have been attributed to the increase in the average landing cost of imported super petrol by 31.5% to USD 248.1 per cubic meter in May 2020 from USD 188.7 per cubic meter in April 2020. Landing costs for diesel and kerosene however declined by 5.6% and 51.8% to USD 228.6 per cubic meter and USD 126.4 per cubic meters in May 2020, respectively, from USD 242.1 per cubic meter and USD 262.4 per cubic meter in April 2020, and,
- A 33.3%, increase in Free on Board (FOB) price of Murban crude oil lifted in May 2020 to USD 23.53 per barrel, from USD 17.6 per barrel in April 2020.

The increase will not only affect the transport index, which carries a weighting of 8.7% in the total consumer price index (CPI), but it will cut across as things like foodstuff might increase due to high transport costs.

During the week, the Departmental Committee on Finance and National Planning tabled the Finance Bill 2020 to the National Assembly for its second reading in parliament. The bill was published on 5th May 2020 to make amendments to a raft of laws in the country, among them; the Income Tax Act, the Value Added Tax Act, the Tax Procedures Act and the Excise Duty Act among others. The first reading of the bill took place on 6th May 2020. This is a departure from the status quo, where in previous years, the bill would be tabled after the reading of the national budget in June. This change was brought about by recent instruction from the court, which barred the government from collecting taxes before the relevant tax provisions were approved by the National Assembly. Normally, a bill is tabled in parliament where it undergoes the first, second and third reading. The bill is assigned to a committee for consideration, which occurs between the second and third readings before it is forwarded for presidential assent, after which it is passed into law. It is important to note that all the amendments relating to the income tax act have an effective date of 1st January 2021, while most of the other amendments will come into effect on the date of assent. Below are some of the earlier on major proposed amendments to the Finance Bill 2020:

- Under the **Income Tax Act,** the amendments included:
    i. The removal of certain existing tax incentives on income exempt from tax which includes: exception from income for the amounts contributed to a registered home ownership savings plan, income of National Social Security Fund (NSSF) and Bonus, overtime and retirement benefits not exceeding 10.0%,
    ii. Extending the upper limit of the Residential Income Tax to Kshs 15.0 mn from Kshs 10.0 mn to allow landlords with rental income of between Kshs 10.0 mn and Kshs 15.0 mn to access the more concessional tax rate of 10% of gross income, and reduce administrative costs of ascertaining profit for such landlords which was aimed at raising an additional Kshs 200 mn to finance the FY'2020/21 fiscal deficit,
    iii. Introduction of a minimum tax, to be introduced at a rate of 1% of the gross turnover. This new tax will apply to all persons whether they're making profits or incurring losses. As highlighted in the budget the main reason for the introduction of the minimum tax was to ensure that all taxpayers contribute to the construction and maintenance of the country's infrastructure, and
    iv. Introduction of Digital Service Tax, to be introduced at a rate of 1.5% of the gross transaction value, to be charged on individuals who generate income from the provision of services through the digital market place. This tax targets non-residents without permanent establishments in the country since for any individuals with permanent establishment will have the same offset from their tax payable for the year of income, which was expected to yield Kshs 2.0 bn.
- Under the **Value Added Tax Act**, the amendments included:
    i. Removal of some items such as stoves and cookers from the VAT exemptions list,
    ii. The exemption of maize seeds and ambulance services from VAT, and,
    iii. The removal of some items from the VAT Zero Rated category, which include LPG gas and materials used in the manufacture of automotive and solar batteries.
- Under the **Excise Duty Act,** the amendments include:
    i. Reduction of the threshold for alcohol strength from over 10% to 8% for tax purposes. Consequently, the reduction of the threshold will mean that beverages with an alcoholic strength of over 8% will be subject to excise duty,

The Departmental Committee on Finance and National Planning, having considered the bill, recommended that the house approves the bill with some proposed amendments as highlighted below:

i. Retain the income tax exemption of income from the National Social Security Fund to protect the benefits of members,

ii. Retaining the income tax exemption on the monthly pension granted to a person who is 65 years or more,
iii. Increasing the lower limit for the Residential Income Tax to Kshs 288,000.0, from Kshs 144,000.0 to make it consistent with changes in PAYE tax bands highlighted in the Tax Laws (Amendment) Act 2020,
iv. Zero-rate the supply of flour to make it cheaper and more affordable, by zero-rating taxes on the supply of flour, manufacturers will be able to sell at a lower cost and ultimately lower the price of flour in the market,
v. For excise duty on alcoholic beverages, further lowering the threshold for alcoholic strength to 6% instead of 8% to enhance revenue collection. Consequently, the reduction of the threshold will mean that beverages with an alcoholic strength of over 6.0% will be subject to excise duty, lower than the 8.0% that was recommended in the Finance Bill 2020 on its first reading, and
vi. The removal of excise duty on betting which has had negative effects on the industry and led to the closure of Kenyan companies and the loss of hundreds of jobs, yet international companies continue to operate. The existing 20% excise duty charged on the stake had hurt the local gaming industry,

In our view, the amendments proposed in the finance bill are a good initiative, for instance, proposal to retain the income tax exemption on pension granted to persons at the age of 65 and above. Despite the recommendations, concerns still linger on the practicability of enforcing some of the measures in the Finance Bill 2020. A good example is the introduction of a digital tax on online transactions in the digital market space. Considering the amount of regulation already in place in term of online transacting, it will require a lot of background work for the proposal to work effectively. Some proposals, on the other hand, are counter-productive, case in point, the removal of tax incentives on the contribution to a registered home ownership savings plan, which will discourage savings towards homes and ultimately contradicts the affordable housing agenda that the government is pushing.

Rates in the fixed income market have remained relatively stable as the government rejects expensive bids. We believe that the uncertainty affecting the global financial markets brought about by the novel Coronavirus will make it harder for the government to access foreign debt, and might result in investors attaching a high-risk premium on the country. As a result of depressed revenue collection with the revenue target for FY'2020/2021 at Kshs 1.9 tn, we expect a higher budget deficit, which the Treasury estimates at 7.5% of GDP, creating uncertainty in the interest rate environment as additional borrowing from the domestic market will be required to plug in the deficit. Owing to this uncertain environment, our view is that investors should be biased towards short-term fixed income securities to reduce duration risk.