Cytonn INVESTMENTS

Interest Rates Cap is the Kenya?s Brexit - Popular But Unwise, & Cytonn Weekly #33

Cytonn Weekly

Executive Summary

- **Fixed Income:** Yields on Treasury bills were on an upward trend with the 91, 182 and 364-day papers coming in at 8.6%, 11.0% and 11.9% from 8.5%, 10.8% and 11.7%, respectively. The Tokyo International Conference on Africa Development (TICAD) is set to be held on August 27th to 28th at the Kenya International Conference Centre. The conference is a forum that officiates dialogue between African leaders and their development partners and it shall bring together 10,000 delegates;
- **Equities:** During the week, Equities market was on an upward trend with NASI, NSE 25 and NSE 20 indices rising by 2.0%, 0.6% and 0.4%, respectively. Co-operative Bank, Standard Chartered Bank, I&M Bank and NIC Bank released their H1?2016 results;
- **Private Equity:** Real Estate and IT sectors continue to attract private equity investment funds in the Sub-Saharan region as GreenHouse Capital plans to invest USD 10.0 mn in technology start-ups, while Old Mutual Investments Group (OMIG) and Nigeria's Sovereign Investment Authority (NSIA) have agreed to set up two funds to invest in real estate and agriculture worth USD 500.0 mn and USD 200.0 mn respectively;
- **Real Estate:** Investors are set to pay for environmental audits based on the risk levels of their projects, while Hass Consult announced the launch of off-plan sales of Montave, a Mixed Use Development in Upper Hill;
- **Focus of the week:** This week, we focus on the ongoing debate on interest rates cap in Kenya, demonstrating the effects of interest rates cap in countries that have applied it and how it may potentially impact the Kenyan economy.

Company Updates

- Cytonn Investments Management Limited, our Group Holding Company, together with Cytonn Cash Management Solutions LLP (CMS), our private wealth affiliate, will be holding their Annual General Meeting on Thursday, August 25th, 7:30 am at Villa Rosa Kempinsky. All our Company Shareholders and CMS Partners are encouraged to attend
- In order to provide more clients with access to our investment solutions, the Board of Directors of Cytonn Investments Management Limited has recently approved the formation of a regulated subsidiary, Cytonn Asset Managers Ltd, CAM. CAM will be focused on offering our unique and high return products to regulated segments such as Unit Trust investors and pension schemes. Our products have generally been restricted to institutions, private wealth investors through structured partnerships and to the ordinary investor through our investment co-operative, Cytonn

Co-operative

- In line with our strategy to establish our clients' needs and trends in the real estate market, Cytonn Investments is carrying out a survey on consumer choices when it comes to choosing a home/house. Please spend some time and help us fill the questionnaire, which shall take only three minutes. See Link: Cytonn Investments Housing Survey.
- Cytonn Real Estate would like introduce Taraji Heights, an integrated lifestyle development located approximately 2 km from Ruaka town center on a 2.8 acre site touching Limuru road. This is one of our investment ready products offering between 25% - 30% return to buyers. The project, whose estimated value is Kshs 2.5 bn, will comprise of (i) residential apartments with 2 and 3 bedroom options, (ii) a retail component, and (iii) a borehole and sewer treatment facility. We are currently at design stage and are targeting to break ground in Q12017. Our clients are our number one agenda and as such we are extending a special offer open only to them. This will be for a limited number of units at 15% discount from the introductory price. Early stage investors in our other Ruaka Development, The Alma, have recorded capital gains as high as 40% since purchasing their units less than one year ago. See introductory prices outlined below:

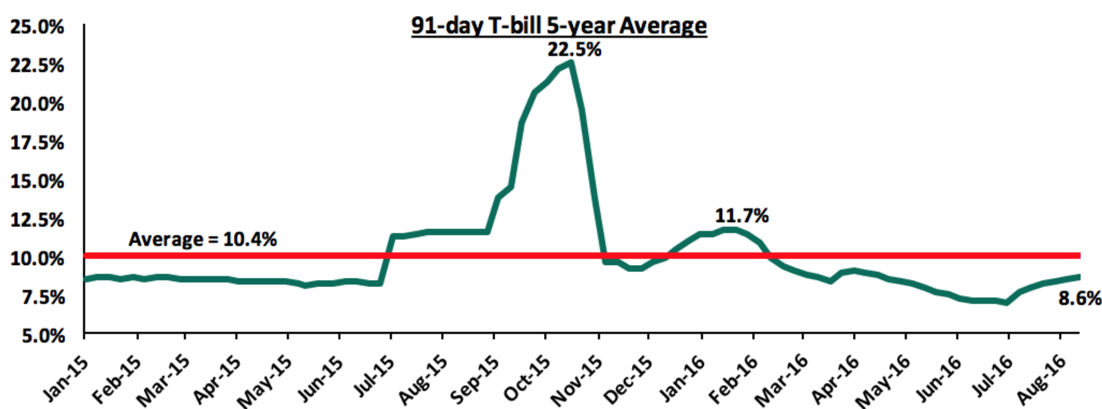
APARTMENT TYPE	UNITS ON OFFER	INTRODUCTORY PRICE(KSHS)	CLIENT OFFER PRICE(KSHS)
2 Bed Units	9	7,900,000.00	6,720,000.00
3 Bed Units	14	11,500,000.00	9,780,000.00
Total	**23**		

- To invest in any of our current or upcoming real estate projects, please visit Cytonn Real Estate. We continue to see very strong interest in our products, particularly The Alma, which is now 50% sold and has delivered an annualized return for 55% p.a. for investors who bought off-plan. We have 12 investment ready projects, offering attractive development returns and buyer's returns of a minimum of 25% p.a. See further details here: Summary of investment ready projects
- We continue to beef up the team with several ongoing hires: Careers at Cytonn.

Fixed Income

During the week, T-bills were oversubscribed but the rate of subscription declined to 118.9%, compared to 183.5% recorded the previous week. There was a change in the trend of the subscription with a lower subscription rate for the 91-day T-bill compared to 182-day and 364-day T-bills. The subscription rates for the 91-day, 182-day and 364-day papers were at 89.4%, 154.3% and 103.0%, from 350.4%, 179.3% and 76.5%, respectively, the previous week. Looking at the number of bids received for each instruments, more institutional players bid for the 182 and the 364 day and this is attributed to the uncertainty around the signing of the interest rate cap bill which if signed by the President, may lead to a downward pressure on interest rates. See link to the note on our expected outlook on interest rates cap. However, yields increased across all tenors with the 91, 182 and 364-day papers coming at 8.6%, 11.0% and 11.9% from 8.5%, 10.8% and 11.7%, respectively.

The 91-day T-bill is currently trading below its 5-year average of 10.4%, having witnessed a downward trend in the previous three months towards the close of the last fiscal year. The downward trend for the 91-day paper has since reversed and we have seen a 158.2 bps increase over the last 6 weeks. The upward pressure on rates is as a result of Government borrowing given the new fiscal year.



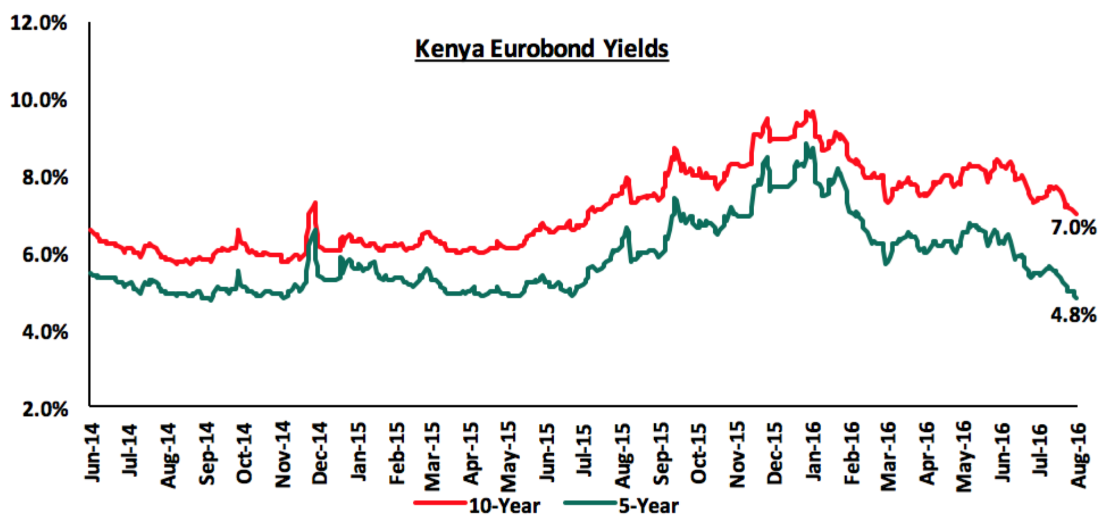
In line with the Securities Issuance Calendar, the government will be issuing a 10-year fixed coupon bond to raise Kshs 25.0 bn for budgetary support. Given that (i) a 10 year bond is currently trading in the secondary market at a yield of 14.6%, (ii) given the upward pressure on interest rates as a result of government borrowing for the 2016/2017 fiscal year, and (iii) tight liquidity in the money market, we expect investors to demand a premium above the secondary market yields and we therefore recommend a bidding range of 14.6% - 15.5%.

The Central Bank Weekly report revealed that the interbank rate decreased by 110 bps to 4.3%, from 5.4% the previous week, despite a net liquidity reduction of Kshs 20.9 bn. The liquidity reduction was as a result of T-bill issuances, reverse repo maturities and payment of taxes by Banks of Kshs 22.1 bn, Kshs. 17.5 bn and Kshs. 16.6 bn, respectively. As highlighted in our Cytonn Weekly Report #28 the interbank rate is often determined by the liquidity distributions within the banking sector as opposed to the net liquidity position in the interbank market.

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	0.0	T-bond sales	0.0
Government Payments	17.5	Transfer from Banks - Taxes	16.6
T-bond Redemptions	0.0	T-bill (Primary issues)	22.1
T-bill Redemption	16.6	Term Auction Deposit	0.0
T-bill/T-bond Rediscounting	0.0	Reverse Repo Maturities	17.5
T-bond Interest	1.2	Repos	0.0
Reverse Repo Purchases	0.0		
Repos Maturities	0.0		
Total Liquidity Injection	**35.3**	**Total Liquidity Withdrawal**	**56.2**
		Net Liquidity Reduction	**(20.9)**

According to Bloomberg, yields on the 5-year and 10-year Eurobonds issued in 2014 declined week on week by 0.3% and 0.2% to 4.8% and 7.0%, respectively, from 5.1% and 7.2% last week, respectively. Since the mid ? January 2016 peak, yields on Kenyan Eurobond have declined by 4.0% and 2.6% on account of improving macroeconomic conditions. This is an indication that Kenya remains an attractive investment destination.



The Kenya Shilling appreciated against the dollar by 0.1% this week to 101.4, on account of corporates in the agricultural sector selling dollars to pay taxes as well as significant diaspora inflows. On a year to date basis, the shilling has appreciated by 0.9%. We expect the shilling to remain relatively stable in the short to medium term supported by (i) the high levels of foreign exchange reserves equivalent to 5.1 months of import cover, and (ii) improved diaspora remittances, with cumulative 12 months? diaspora inflows to June 2016 increasing by 11.0% to USD 1.7 bn from USD 1.5 bn in the year to June 2015.

We are projecting inflation for the month of August to rise to within the range of 6.7% - 6.9%, driven by rise in fuel prices (which have increased for the past 4 months), this will lead to an increase in transportation costs while having a pass through effect towards food production, which will be passed down to the consumers. Going forward, we expect inflationary pressure to persist in the short to medium term but to remain within the government target annual range of 2.5% - 7.5%.

The Tokyo International Conference on Africa Development (TICAD) is set to be held on August 27th to 28th at the Kenya International Conference Centre. According to the Foreign Affairs Cabinet, the event is set to inject Kshs 12.0 bn into the economy, double the gains made from the United Nations Conference of Trade and Development (UNCTAD). TICAD was launched in 1993 by the Government of Japan, to promote Africa?s development, peace and security, through strengthening of relations in multilateral cooperation and partnership. In our view, we believe Kenya is set to benefit as the event will bring together 10,000 delegates and officiates dialogue between African leaders and their development partners on matters concerning (i) economic growth, (ii) trade and investment, (iii) sustainable development, (iv) human security, (v) peace and stability and (vi) government operations. From the last TICAD event, the Japanese Government contributed Kshs 320.0 bn to African development projects, which Kenya benefited through funding of various projects such as the Olkaria Geothermal project and the expansion of the Mombasa Port.

The government is within target on its domestic borrowing for this fiscal year 2016/2017 having borrowed Kshs 25.5 bn for the current fiscal year against a target of Kshs 27.6 bn (assuming a pro-rated borrowing throughout the year of Kshs 229.6 bn budgeted for the full fiscall year). Interest rates have bottomed out and we are currently witnessing upward pressure on interest rates given government borrowing for the new fiscal year. It is due to this that we advise investors to be biased towards short to medium-term papers.

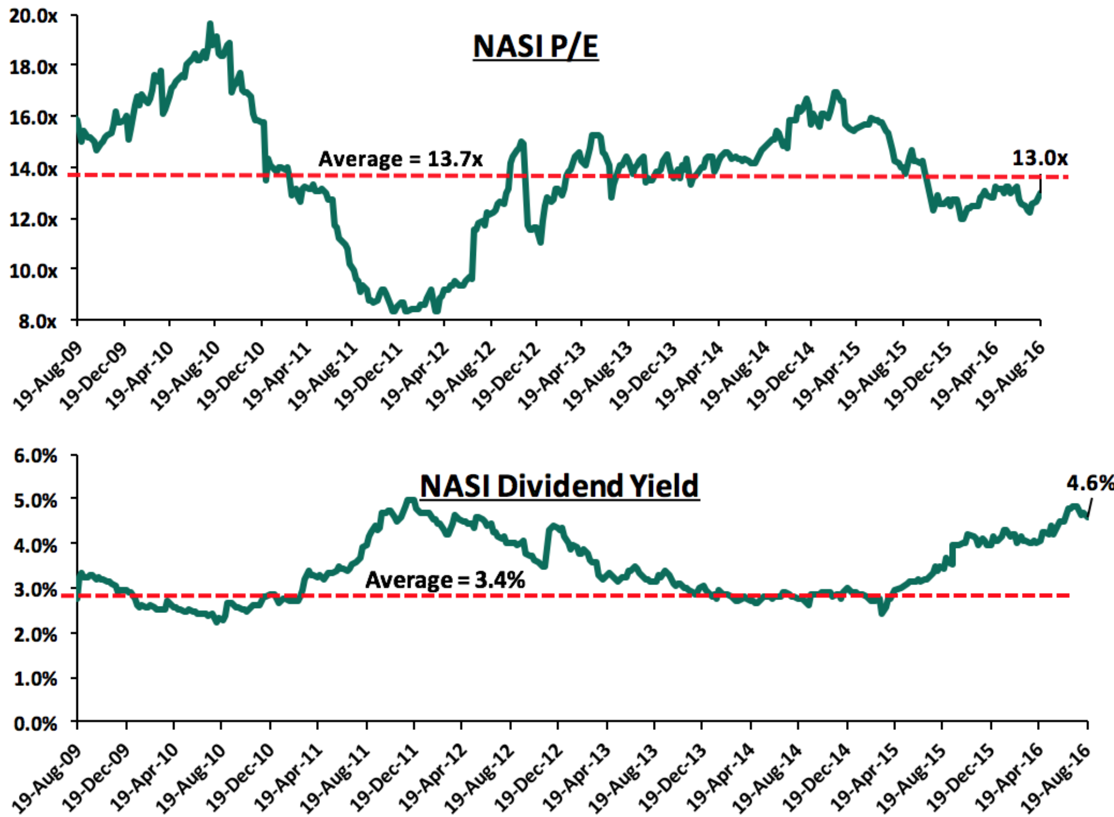
Equities

During the week, the Equities market was on an upward trend with NASI, NSE 25 and NSE 20 indices rising by 2.0%, 0.6% and 0.4%, respectively, with the YTD performance coming in at 0.7%, (5.9%) and (14.3%) for NASI, NSE 25 and NSE 20, respectively. The week?s performance was as a

result of Safaricom gaining 6.3% w/w to close at a high of Kshs 21.3 after achieving an all-time high of Kshs 21.8 during the week. Since the February 2015 peak, the market has lost 37.0% and 17.3% for NSE 20 and NASI, respectively.

Equities turnover increased by 114.3% to close the week at Kshs 3.8 bn from Kshs 1.8 bn the previous week driven by foreign investor participation, which increased to 68.1% from 55.9% recorded the previous week. Foreign investors were net buyers with net inflows of USD 15.6 mn, compared to a net inflow of USD 4.5 mn recorded the previous week. Safaricom was the top mover once again this week, accounting for 42.9% of net foreign inflows. We maintain our expectation of stronger earnings growth in 2016 compared to 2015, with an estimated growth of 12.5%, supported by a favorable macroeconomic environment. Given the low valuations, long-term investors should gradually be taking positions in the market.

The market is currently trading at a price to earnings ratio of 13.0x, versus a historical average of 13.7x, and a dividend yield of 4.6% versus a historical average of 3.4%. The charts below indicate the historical PE and dividend yields of the market.



Co-operative Bank released H1?2016 results:

Co-op Bank released their H1?2016 results recording core earnings per share (EPS) growth of 18.7% to Kshs 1.5 from Kshs 1.3 in H1?2015, against our projection of Kshs 1.4. The growth in EPS was driven by a 20.1% growth in total operating revenue to Kshs 21.3 bn despite a 21.0% increase in total operating expenses Kshs 11.0 bn.

Key highlights for the performance from H1?2015 to H1?2016 include:

- Total operating revenue grew by 20.1% to Kshs 21.3 bn from Kshs 17.7 bn, driven by Net Interest Income growth of 22.8% and 14.7% growth in Non Funded Income
- Net Interest Income grew by 22.8% to Kshs 14.5 bn from Kshs 11.8 bn supported by a 28.7% rise in interest income, despite a faster interest expense growth of 42.8% with the Net interest Margin improving to 9.1% from 8.8%

- Non-Funded Income grew by 14.7% to Kshs. 6.8 bn, from Kshs 6.0 bn, supported by a 6.2%

growth in fees and commissions to Kshs 4.6 bn and other income growth of 288.1% to Kshs 845.4 mn as the subsidiary businesses registered improved performance. The current revenue mix stands at 68:32, Funded to Non-Funded Income

- Total operating expenses grew by 21.0% to Kshs 11.0 bn from Kshs 9.1 bn on account of a 96.4% rise in loan loss provision (LLP) to Kshs 1.3 bn from Kshs 0.7 bn attributed to delayed payments by clients in real estate sector. Excluding LLP, operating expenses grew by 15.0% to Kshs 9.7 bn from Kshs 8.4 bn. Cost to income ratio remained flat at 51.4% from 51.1%

- PAT growth came in at 18.7% to Kshs 7.4 bn from Kshs 6.2 bn against our projection of 10.5% growth
- Loan and advances grew by 8.0% to Kshs 221.3 bn from Kshs 204.8 bn while Customer deposits grew by 12.0% to Kshs 278.3 bn from Kshs 248.3 bn, leading to a loan to deposit ratio of 79.5% from 82.5%.

Despite the tough operating environment in South Sudan, Co-operative Bank subsidiary reported Kshs 29.2 mn in H1?2016 profit due to its ability to leverage on the unique partnerships with the Government of South Sudan. We expect the bank to continue implementing its key transformation agenda, including automation and use of alternative channels to support future growth. Co-operative Bank plans to continue with its regional expansion strategy into Rwanda, Uganda, Tanzania and Ethiopia, through Joint Ventures as is the case in South Sudan. However, we expect the bank to focus more on the Kenyan business and tap into the wider co-operative movement network and retail space.

For a more comprehensive analysis, see our Co-op Bank H1?2016 Earnings Note.

Standard Chartered Bank released H1?2016 results:

Standard Chartered released their H1?2016 results recording core earnings per share (EPS) growth of 34.8% to Kshs 15.2 from Kshs 11.3 in H1?2015 against our projection of Kshs 14.5. The growth in EPS was driven by an 18.9% growth in operating revenue outpacing a 6.5% growth in operating expenses.

Key highlights for the performance from H1?2015 to H1?2016 include:

- Total operating revenue grew by 18.9% to Kshs 14.5 bn from Kshs 12.2 bn, driven by a 32.1% growth in Non-Funded Income to Kshs 4.6 bn from Kshs 3.4 bn and a 13.8% growth in Net Interest Income to Kshs 10.0bn from Kshs 8.8 bn
- Net interest income recorded an increase of 13.8% to Kshs 10.0 bn from Kshs 8.8 bn, driven by 20.9% growth in Interest Income despite a 51.3% growth in Interest Expense. Net Interest Margin improved to 9.5% from 9.3%
- Non Funded Income grew by 32.1% to Kshs 4.5 bn from Kshs 3.4 bn driven by a 48.8% rise in forex income to Kshs 1.6bn and a 52.4% rise in other income. The current revenue mix stands at 69:31, Funded to Non-Funded Income
- Total operating expenses grew by 6.5% to Kshs 7.0 bn from Kshs 6.6 bn driven by a 6.4% rise in staff costs. Loan loss provision (LLP) increased by 5.9% to Kshs 1.4 bn from Kshs 1.3 bn, as the bank enhanced its credit risk management. Excluding the LLP, the operating expenses grew by 6.6% to Kshs 5.7 bn from Kshs 5.3 bn. The slow growth in expenses resulted to an improvement in cost to income ratio to 48.4% from 54.1%
- PAT grew by 34.8% to Kshs 5.2 bn from Kshs 3.9 bn compared to our expectations of a 28.5% rise
- Loan and advances declined by 7.3% to Kshs 114.3 bn from Kshs 123.3 bn while Customer deposits grew by 16.9% to Kshs 190.8 bn from Kshs 163.2 bn leading to a decrease in the loan to deposit ratio to 59.9% from 75.5%.

Standard Chartered Bank?s growth going forward will be propelled by (i) managing their non-performing loans which are growing despite a decline in the loan book growth through more risk based loan supervision, and (ii) growing core business as forex income and other income growth may not be sustainable going forward.

For a more comprehensive analysis, see our Standard Chartered H1?2016 Earnings Note.

NIC Bank released H1?2016 results:

NIC Bank released their H1?2016 results recording core earnings per share (EPS) growth of 2.9% to Kshs 3.6 from Kshs 3.5 in H1?2015 in line with our projection of Kshs 3.6. The growth in EPS was driven by a 26.3% growth in operating revenue that was outpaced by the growth in operating expenses of 51.5%, with the rapid growth in operating expenses being driven mainly by Loan Loss Provisions (LLP).

Key highlights for the performance from H1?2015 to H1?2016 include:

- Total operating revenue grew by 26.3% to Kshs 8.2 bn from Kshs 6.5 bn, driven by a 34.2% growth in Net Interest Income to Kshs 6.1 bn from Kshs 4.5 bn and an 8.2% growth in Non Funded Income to Kshs 2.2 bn from Kshs 2.0 bn
- Net interest income recorded an increase of 34.2% to Kshs 6.1 bn from Kshs 4.5 bn, driven by 27.4% growth in Interest Income, which outpaced the 17.9% growth in Interest Expense. Net Interest Margin improved to 7.4% from 6.3%
- Non Funded Income grew by 8.2% to Kshs 2.2 bn from Kshs 2.0 bn supported by a 31.9% rise in other fees and commissions. The current revenue mix stands at 74:26 Funded to Non-Funded Income
- Total operating expenses grew by 51.5% to Kshs 5.0 bn from Kshs 3.3 bn driven by a 267.9% rise in loan loss provisions (LLP) to Kshs 2.1 bn from Kshs 573.4 mn. Excluding LLP, operating expenses grew by 6.2% to Kshs 2.9 bn from Kshs 2.7 bn. Cost to income ratio consequently rose to 60.9% from 50.7%
- PAT grew by 2.9% to Kshs 2.3 bn from Kshs 2.2 bn, in line with our expectations of a 2.8% rise
- Loan and advances grew by 3.6% to Kshs 112.2 bn from Kshs 108.3 bn while Customer deposits grew by 6.5% to Kshs 112.0 bn from Kshs 105.1 bn leading to a decrease in the loan to deposit ratio to 100.1% from 103.0%.

For a more comprehensive analysis, see our NIC Bank H1?2016 Earnings Note.

I&M Bank released H1?2016 results:

I&M Bank released their H1?2016 results recording core earnings growth of 21.7% to Kshs 3.5 bn from Kshs 2.9 bn in H1?2015. The growth in core earnings was driven by an 18.6% growth in operating revenue that outpaced the 15.4% growth in operating expenses.

Key highlights for the performance from H1?2015 to H1?2016 include:

- Total operating revenue grew by 18.6% to Kshs 8.3 bn from Kshs 7.0 bn, driven by a 20.9% growth in Net Interest Income to Kshs 6.3 bn from Kshs 5.2 bn and a 12.2% growth in Non Funded Income to Kshs 2.0 bn from Kshs 1.8 bn
- Net interest income recorded an increase of 20.9%, driven by a 15.8% growth in Interest Income outpacing the 9.2% growth in Interest Expense. Net Interest Margin improved to 7.7% from 6.8%
- Non Funded Income grew by 12.2% to Kshs 2.0 bn from Kshs 1.8 bn supported by an 11.8% rise in other fees and commissions. The current revenue mix stands at 75:25 Funded to Non-Funded Income
- Total operating expenses grew by 15.4% to Kshs 3.3 bn from Kshs 2.8 bn driven by a 43.5% rise in loan loss provision (LLP) to Kshs 652.3 mn from Kshs 454.4 mn. Excluding LLP, operating

expenses grew by 10.0% to Kshs 2.6 bn from Kshs 2.4 bn. Cost to income ratio improved to 39.2% from 40.3%
- PAT grew by 21.7% to Kshs 3.5 bn from Kshs 2.9 bn
- Loan and advances grew by 6.3% to Kshs 117.7 bn from Kshs 110.8 bn while Customer deposits grew by 15.9% to Kshs 130.1 bn from Kshs 112.3 bn leading to a decrease in the loan to deposit ratio to 90.5% from 98.6%.

Below is a list of the listed banks that have released H1?2016 results with the recorded Core EPS growth for H1?2016 in comparison to H1?2015;

Listed Kenyan Banks H1'2016 EPS Growth		
Bank	**H1'2015**	**H1'2016**
KCB Group	13.1%	13.6%
HF Group	2.3%	26.3%
National Bank of Kenya	123.1%	-70.0%
CfC Stanbic	-41.6%	22.2%
Co-operative Bank	32.3%	18.7%
Standard Chartered Bank	-37.6%	34.8%
NIC Bank	9.8%	2.9%
Average*	**0.0%**	**19.7%**
***-Market Cap Weighted**		

Family Bank released H1?2016 results:

Family Bank released their H1?2016 results recording a 39.8% decline in PAT to Kshs 711.5 mn from Kshs 1.2 bn in H1?2015. The decline in PAT was driven by a 30.8% growth in operating expenses that outpaced the 4.7% growth in operating revenue.

Key highlights for the performance from H1?2015 to H1?2016 include:

- Total operating revenue grew by 4.7% to Kshs 4.9 bn from Kshs 4.7 bn, driven by a 10.1% growth in Net Interest Income to Kshs 3.6 bn from Kshs 3.2 bn despite a 7.5% decline in Non-Interest Income to Kshs 1.3 bn from Kshs 1.4 bn
- Net Interest Income grew by 10.1% to Kshs 3.6 bn from Kshs 3.2 bn, supported by a 33.7% growth in interest income to Kshs 6.0 bn from Kshs 4.5 bn despite a 94.3% rise in interest expenses to Kshs 2.5 bn from Kshs 1.3 bn. Net Interest Margin came in at 10.4% compared to 9.6%
- Non Funded Income declined by 7.5% to Kshs 1.3 bn from Kshs 1.4 bn driven by a 23.5% decrease in fees and commissions on loans and advances. The current revenue mix stands at 73:27, Funded to Non-Funded Income
- Total operating expenses grew by 30.8% to Kshs 3.8 bn from Kshs 2.9 bn driven by a 709.5% rise in loan loss provision (LLP) to Kshs 299.3 mn from Kshs 37.0 mn. Excluding LLP, operating expenses grew by 22.1% to Kshs 3.5 bn from Kshs 2.9 bn. Cost to income ratio increased to 78.0% from 62.5%

- Loans and advances grew by 24.7% to Kshs 57.8 bn from Kshs 46.3 bn while Customer deposits declined by 7.2% to Kshs 54.8 bn from Kshs 59.0 bn as the bank was affected by the flight to safety following placement of Chase Bank under receivership in April 2016. This resulted into a loan to deposit ratio of 105.4% from 78.5%

Family Bank is currently sufficiently capitalized with core capital to risk weighted assets ratio at 14.6%, 2.1% above the statutory requirement.

Family Bank has put in place measures to recover from its negative growth in H1?2015 including (i) branch expansion throughout the country, targeting high traffic areas to maximize on deposits per branch, (ii) capital restructuring to explore cheaper and more reliable ways to fund its lending, and (iii) its agency banking strategy, targeting 10,000 agents from the current 4,000 agents by the end of

2016. With these strategies in place, Family Bank should be able to mobilize more deposits to loan out and cut expenses. However, the declining deposit base coupled with increasing loans, dramatic increase in interest expense and reduction of non-funded income requires a close review of the banks business model. All the core banking trends for Family Bank are pointing to the wrong direction.

We did a comparison of the performance of listed and non-listed banks that have so far released their H1?2016 results and the results were as indicated below;

Comparison between Listed and Non-Listed Banks performance									
Bank	**PAT Growth**	**Deposit Growth**	**Loan Growth**	**Net Interest Margin**	**Loan Loss Provision Growth**	**NPL Ratio**	**Cost to Income**	**RoA**	**RoE**
Average Listed	12.3%	5.8%	3.6%	8.2%	103.3%	9.4%	55.7%	3.0%	18.5%
Average Non-listed	-1.0%	-3.8%	15.9%	7.3%	334.5%	6.4%	65.9%	1.1%	6.6%
****Averages based on Market share weights***									

In this analysis, we note that;

- Listed banks are so far more profitable than the non-listed banks with an average PAT growth of 12.3% compared to -1.0% growth for non-listed banks. Listed banks rank higher both in return on assets and return on equity
- Following the closure of Chase Bank and Imperial Bank, we noted that there was a flight to safety, with depositors preferring large banks, with a skew to listed banks. This has been demonstrated by a 3.8% contraction in non-listed banks deposits, compared to a 5.8% growth in listed banks deposits
- Non-listed banks however have been more aggressive in loan disbursement compared to listed banks, which have remained conservative as they manage existing loans and control non-performing ones
- Loan Loss Provisions for non-listed banks have also increased faster at 334.5% compared to 103.3% for listed banks noting the increased level of credit risk across the whole sector
- Listed banks are more efficient in cost management with Cost to Income ratio at 55.7% compared to non-listed at 65.9%.

Chase Bank (In Receivership) has attained approval from the Central Bank of Kenya (CBK) to resume its term deposit-taking and lending activities. Tenors for the deposits will range between 6 to 12 months for fixed deposits and call deposits. Following the lender being placed under receivership in April 2016, KCB Group was appointed by Kenya Deposit Insurance Corporation (KDIC) as the receiver manager to help revive its operations. KCB Group plans to scale back 50.0% of its resources from Chase Bank (IR) by the end of August 2016 and finally 100.0% a month later. In September 2016, the CBK will call upon investors to bid for the buyout of a majority stake in Chase in order to revive its activities fully. Since re-opening of its branches after being placed under receivership and under the management of KCB Group, Chase bank has garnered 3,000 new customers and net deposits of Kshs 152.0 mn despite having a Kshs 1.0 mn cap on past deposit withdrawals (new deposits are wholly accessible). We applaud the regulator, CBK for the expedited move to reopen Chase Bank, this is the first time ever a bank has been closed, put under receivership and re-opened. This will increase confidence in the Kenyan Banking system. However, the market expects increased level of corporate governance and oversight role to be enforced by CBK going forward.

Below is our equities recommendation table. Key changes from our previous recommendation are:

- Liberty has moved from a ?Buy? recommendation, with an upside of 26.0% to an ?Accumulate? recommendation with an upside of 17.2%, following a 6.2% w/w price rise
- BAT (K) has moved from an ?Accumulate? recommendation, with an upside of 19.4% to a ?Buy?

recommendation with an upside of 26.8%, following a 6.2% w/w price decline.

all prices in Kshs unless stated									
EQUITY RECOMMENDATION									
No.	**Company**	**Price as at 12/08/16**	**Price as at 19/08/16**	**w/w Change**	**YTD Change**	**Target Price***	**Dividend Yield**	**Upside/ (Downside)****	**Recommendation**
1.	KCB Group***	32.5	32.5	0.0%	(25.7%)	50.6	6.2%	61.8%	Buy
2.	HF Group	17.4	16.1	(7.8%)	(27.9%)	22.1	9.4%	47.2%	Buy
3.	Bamburi Cement	165.0	174.0	5.5%	(0.6%)	231.7	7.5%	40.7%	Buy
4.	Centum	42.3	42.3	0.0%	(9.1%)	56.7	2.4%	36.6%	Buy
5.	ARM	30.5	30.0	(1.6%)	(28.1%)	40.2	0.0%	34.0%	Buy
6.	Kenya Re	19.9	20.8	4.5%	(1.2%)	26.6	3.6%	31.8%	Buy
7.	DTBK***	160.0	160.0	0.0%	(14.4%)	207.8	1.5%	31.4%	Buy
8.	BAT (K)	858.0	805.0	(6.2%)	2.5%	970.8	6.2%	26.8%	Buy
9.	Barclays	10.0	9.8	(1.5%)	(27.9%)	11.0	10.0%	22.0%	Buy
10.	NIC	31.8	30.5	(3.9%)	(29.5%)	36.1	3.3%	21.7%	Buy
11.	Co-op Bank	14.4	14.1	(2.1%)	(21.7%)	16.4	5.7%	21.7%	Buy
12.	Equity Group	38.3	37.8	(1.3%)	(5.6%)	42.9	5.7%	19.3%	Accumulate
13.	Britam	12.5	12.3	(1.6%)	(5.4%)	14.2	2.4%	17.8%	Accumulate
14.	Liberty	13.7	14.5	6.2%	(25.6%)	17.0	0.0%	17.2%	Accumulate
15.	CIC Insurance	4.0	4.2	3.8%	(33.1%)	4.7	2.5%	15.8%	Accumulate
16.	I&M Holdings	102.0	102.0	0.0%	2.0%	112.5	3.4%	13.7%	Accumulate
17.	CfC Stanbic	80.0	80.0	0.0%	(3.0%)	84.0	7.7%	12.7%	Accumulate
18.	Standard Chartered***	208.0	208.0	0.0%	6.7%	212.5	6.0%	8.2%	Hold
19.	Sanlam Kenya	38.0	40.0	5.3%	(33.3%)	42.7	0.0%	6.8%	Hold
20.	Jubilee Insurance	470.0	466.0	(0.9%)	(3.7%)	485.1	1.8%	5.9%	Hold
21.	Safaricom	20.0	21.3	6.3%	30.4%	16.6	3.6%	(18.2%)	Sell
22.	NBK	7.5	7.6	2.0%	(51.7%)	4.8	0.0%	(36.8%)	Sell
Target Price as per Cytonn Analyst estimates									
****Upside / (Downside) is adjusted for Dividend Yield***									
*****Indicates companies in which Cytonn holds shares in***									
Accumulate ? Buying should be restrained and timed to happen when there are momentary dips in stock prices.									
Lighten ? Investor to consider selling, timed to happen when there are price rallies									

We are neutral with a bias to positive on Equities given the higher earnings growth prospects, supported by a favorable macroeconomic environment.

Private Equity

GreenHouse Capital, a Nigerian venture capital fund managed by Venture Garden Group, plans to invest USD 10.0 mn into technology start-ups over the next two years. GreenHouse Capital has already invested over USD 3.0 mn out of the USD 5.0 mn in their first tranche, in high-growth African technology start-ups focused in banking, education, and renewable energy sectors through capital investment and support infrastructure in ICT. The fund?s portfolio currently includes 13 companies including: AppZone, a home-grown banking and payment solutions provider; Rensource, an energy company that?s built as a financial services business; and PlaySpread, an analytics company that helps businesses optimize their advertising spending by monitoring TV, radio and social media. Africa?s positive innovative trends in ICT, mean that private equity investments are likely to increase their investment in technology-driven sectors. This has been driven by demand for online commercial activities such as banking, shopping, and travel which have relatively low penetration in the Sub Saharan region, supported by a younger demography. This presents compelling opportunities for ICT companies to grow and therefore ability to attract venture capitalists.

Old Mutual Investments Group (OMIG) and Nigeria's Sovereign Investment Authority (NSIA) have agreed to set up two funds to invest in real estate and agriculture in Nigeria. This would be done through jointly raising USD 500 million fund to invest in real estate and another USD 200 million to invest in agricultural projects. The investment venture comes as a result of a slump in oil revenues in Nigeria which has had negative impacts on Nigeria?s GDP for the first quarter of 2016, declining by

0.36%. The government through this deal, will diversifying its revenue base and reduce a huge import bill as the funds will be invested in office towers, commercial real estate and equity stakes in agricultural projects with emphasis on commercial farming for export. In the recent past, Africa countries that have been dependent on oil revenues to drive their GDP have been using their sovereign funds to diversify their revenue sources through private equity ventures. Earlier in the year Angola?s sovereign wealth fund, committed more than half of its investments of USD 3.0 billion, to private equity funds with a focus on investment projects in the country and across sub-Saharan Africa. Going forward, we expect to see more sovereign funds investing in new sources of revenue such as private equity which has continued to demonstrate consistent performance despite the recent global economic turbulence.

Real Estate:

Investors are set to pay for environmental audits based on the risk levels of their projects after the sector regulator ignored the Treasury?s declaration abolishing the charges choosing instead to introduce caps on the fees. The National Environment Management Authority (NEMA) has now categorized projects into three bands based on their levels of risk, that is: high, medium and low risk to the environment.

1. **High-risk projects** include mega real estate?s developments, roads, large hotels, mining and energy plants and they will attract a maximum of Kshs 40 mn and a minimum of Kshs 50,000
2. **Medium-risk projects** include hotels with less than 150-bed capacity, petrol stations and shopping centers, office blocks and stores not exceeding 10,000 square meters. Developers will pay a minimum of Kshs 20,000 and a maximum of Kshs 10 mn, while
3. **Low-risk projects** include churches, bus parks and stadia which will attract a fee of between Kshs 10,000 and Kshs 3 mn.

Under the new regulations therefore, developers will pay the maximum of 0.1% of the project cost but within the given price ranges for the risk band. In the past, the National Environment Management Authority (NEMA) has not been differentiating projects while charging the fees. Investors have since September 2013 been paying a minimum of Kshs 10, 000 or 0.1% of project cost without an upper limit, making it costlier for big projects.

Before 2013, the environmental impact assessment (EIA) fees were set at 0.1% of the worth of the project with a maximum cap of Kshs 1.0 mn. In line with EIA fees scrapping by ministry of finance, NEMA is working administratively to reduce the timelines for processing environmental impact assessment (EIA) project reports from 45 days to 30 days. At the same time, the lands Cabinet secretary communicated that the government is crafting a land evaluation control index to tame the demand for hefty compensation by land owners during compulsory acquisition and regulate the disparities between private and state valuers which has threatened to hold back mega state development projects in the country.

During the week, Hass Consult announced the launch of Montave in Upper hill, a high-end mixed use development, whose construction is expected to begin in the second half of 2017 with a project period of three years. Montave is a proposed 40 floors and 160-meter-high mixed use development that presents an intricate mix of shopping, working, visiting, living and leisure, featuring a rooftop helipad at 3.54-acre site in the Upper Hill area of Nairobi. Hass Consult has been appointed to direct the design, construction and management of the development whose developers comprise of both local and foreign investors. Montave is currently selling, off-plan with the one-bedroom luxury apartments priced at Kshs 8.9 mn, Kshs 12.9 mn for the two bedrooms and Kshs 22.9 mn for the three bedroom apartments.

The high-rise project highlights the trend by developers to maximize on land-use due to high land costs. We therefore remain positive on the performance of the project following its location, Upper

Hill that presents a good opportunity for the development due to its improving road network, sewer lines, its proximity to the CBD and it?s a major office node in Nairobi. On the other hand, the location has very few residential units and retail, hence creating a supply to a ready market for the same. It?s also set to attract investors to tap on the market yields averaging 10% retail, 9% office and 5.5% for residential.

Interest Rates Cap Is Kenya?s Brexit ? Popular But Unwise

This week?s focus note is about the ongoing debate on interest rate caps. The Kenyan public is lately very angry with Kenyan banks for a whole list of reasons - we have had recent bank failures but there isn?t a single ongoing prosecution, livelihoods and investment deposits lost or locked up in failed banks, investments lost in bank bonds such as Chase and Imperial Bank bonds, value of investments in bank shares have almost been halved, and yet banks continue to charge high interest rates on loans coupled with low interest rates paid on deposits. Trust for the Kenyan banking sector is at its most recent low. The anger has culminated in the Kenyan people delivering an interest rate cap bill that has broad base support and is now only awaiting presidential signing to become law. We compare the interest rate cap bill to Brexit ? a very populist move, fueled by anger, but an equally unwise move that we may quickly regret.

Our view is that interest rate caps would have a clear negative effect on the Kenyan economy and ultimately to the Kenyan people. Consequently, the President should certainly demonstrate leadership by declining to sign the bill into law because it would not be good for the Kenyan public. However, the President should also understand the bill as a strong protest by an angry public, and in return deliver to the Kenyan people (i) a strong consumer protection agency and framework, and (ii) promote initiatives for competing and alternative products and channels that will make the banking sector more competitive.

The bill before the President of Kenya which seeks to (i) cap interest rates charged to borrowers to 4% above the Central Bank Rate (CBR), and to (ii) set a floor for deposit rates paid to depositors at 70% of the CBR, is a bad bill and we are confident the president will not sign the bill, simply because it would have a negative impact in the financial sector and ultimately the economy.

With CBR currently at 10.5%, the bill seeks to limit lending rates to 14.5% (CBR benchmark of 10.5% plus 4% margin cap) and enforce interest on deposits to 7.35% (70% of CBR benchmark of 10.5%). While the prospects of getting loans at 14.5% and receiving 7.35% on deposits seems attractive, a closer analysis reveals that in reality, rate caps would have significant negative effects such as reduce access to funding, slow the economic growth and ultimately reduce the standards of living.

We demonstrate these potential negative implications in various ways. First, through general observations of global trends and second, through a review of existing research on evidence on interest rate caps.

First, general observations of global trends: A general survey around the world illustrates that free movement and pricing of labor, capital, goods and services, otherwise referred to as free markets, tends to be strongly correlated with stronger economic growth and prosperity. This does not mean that there should be absolutely no government involvement, but that government involvement should be very constrained, limited and targeted for example, requiring specific disclosures. Legislating the price and terms at which private citizens access capital is wading to far into the private sector. Kenya?s own recent track record with government involvement in the private sector is not inspiring; think of Uchumi, National Bank, Mumias Sugar, and Kenya Airways - all these companies are suffering in industries where other pure private sector competitors are thriving. Governments are not good in private sector matters such as pricing of capital.

Secondly, there is just no compelling evidence that interest caps have worked. According to a World Bank report, there are 76 nations in the world that have experimented with interest rate caps. Based on a reviews of their experience, The World Bank report concludes that rate caps are blunt instruments, and supports other alternative interventions, and in many cases, there is clear evidence of negative effects. Here is a sample of experience with rate caps according to the report:

- In South Africa, some financial institutions evaded the interest rate caps by charging credit life insurance and other services, which reduced the transparency of the total cost of credit.
- In West African and Monetary Union (WAEMU) countries, the imposition of interest rate caps on micro-finance loans caused micro-finance institutions to withdraw loaning to the poor and more remote areas and to increase the average loan size to improve efficiency and returns as the interest rate ceiling was considered low
- In Japan, the supply of credit appeared to contract, acceptance of loan applications fell and illegal lending rose
- In France and Germany, Ellison and Forster (2006) found that interest rate ceilings decreased the diversity of products for low-income households
- In Nicaragua, the application of an interest ceiling caused micro-finance institutions to reduce lending and prompted a number of such institutions to leave urban areas due to high operational costs and risks. They also responded by adding fees so as to circumvent the interest rate cap hence passing on a constraint to depositors
- In India, the enacting of interest rate margin cap in 2011 led to slower borrowing and lower formal financial access
- Zambia introduced interest rate caps in December 2012 and January 2013 and removed them effectively on November 2015.

Based on the above, the proposed interest rate caps bill is most likely bad for the Kenyan economy. It is most likely going to lead to the following consequences;

- Banks will simply introduce new and lawful types of fees required to access loans, and the total cost will go back to what is commercially viable
- Loan pricing will become even less transparent given the new types of lawful fees
- Given the free flow of capital in the global markets, capital that is looking for banking exposure is likely to flow to more attractive geographies where they are no caps
- Credit would not be accessible to the most risky, who have the least access and the most need for credit; on the other hand, prime borrowers will have easier access as they would be pursued by most banks
- Shadow banking and informal credit will quickly mushroom, which will lead to even more exploitation of borrowers.

While rate caps are bad, it does not mean that the government should do nothing. Our view is that the President should send back the bill to parliament with specific recommendations around consumer protection and improved competition:

- Establish strong consumer protection agency to specifically develop and enforce a consumer protection framework for the financial services sector. Just like the bankers have the Kenya Bankers Association taking care of the interest of banks, there should be an equivalent and strong association / agency taking care of the interest of consumers. It should be a strong association anchored in law and funded by statutory levies from the banking sector players and other financial services companies
- The aforementioned consumer protection agency would work on a consumer protection framework to include robust disclosures on cost of credit, free and accessible consumer education, enforce disclosures on borrowings and interest rates, expeditiously handle and hear clients? complaints. The rumors of an office of an Ombudsman with the powers of a judge seems to be headed the right direction

- Establish strong protection and support for alternative products that compete with banking products. For example, the proposed legislation is not just concerned with rates of borrowing, but also the meager rates banks pay to depositors. Alternative forms of savings that bypass the banking sector to enable members earn higher levels of returns, such as organized Chamaas, Saccos, Investments Cooperative and Partnerships should enjoy the same incentives such as banks. For example, providing alternative savings organizations with the same withholding tax incentives that banking deposits enjoy, of a 15% final withholding tax
- In addition to supporting alternative products, the government should develop incentives and protections for product innovation, which tend to experience hostility from the banking sector.

In summary, the president should not sign the rate caps bill into law, but in return, should (i) provide fundamental and strong consumer protections for Kenyan public, (ii) support innovative and competing alternatives that will make the banking sector more competitive.

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