Impact of the Interest Rate Cap, & Cytonn Weekly Report #34

Cytonn Weekly

Executive Summary

Fixed Income: Yields on Treasury bills were relatively unchanged with the 91-day, 182-day and 364-day papers coming in at 8.6%, 11.1% and 12.0% from 8.6%, 11.0% and 11.9%, respectively. The Treasury has postponed its external borrowing programme to Q4?2016 due to the high cost of borrowing for frontier market bond issuers brought about by the flight to safety following Brexit;

Equities: During the week, the Equities market was on a downward trend with NASI, NSE 25 and NSE 20 losing 8.0%, 10.1% and 7.1%, respectively, driven by significant downward movement on the banking stocks following the signing of the Interest Rates Cap Bill by the president. Equity Group, Diamond Trust Bank, Bamburi Cement and ARM Cement released their H1?2016 results;

Private Equity: The FMCG and Technology sectors continue to attract private equity funding in Africa from Foreign Direct Investors. Last week The International Finance Corporation (IFC) announced that it shall lend up to USD 4.5 mn to Tropical Heat Limited, while Zoona, has successfully raised USD 15.0 mn in a second round of financing;

Real Estate: Fusion D-REIT fails to list on the Nairobi Securities Exchange after being undersubscribed by 62.1%, raising only Kshs 878.3 mn against a target of Kshs 2.3 bn. Chinese construction company, China Wu Yi (Kenya), launches a Kshs 10.0 bn factory on Mombasa Road, Nairobi, for use in production of alternative building materials;

Focus of the Week: This week, we focus on the signing of the Interest Rate Cap Bill, and what it means for the financial sector and the economy as a whole.

Company Update

- Cytonn Investments Management Limited, our Group Holding Company, released its 2015 financial year results posting a record Kshs. 630.8 mn in group profits and a strong balance sheet of Kshs. 6.5 bn. For more details, see the Press Release and full set of the Consolidated Annual Statement for the Year Ended December 31st 2015. Speaking at the Annual General Meeting, Prof. Daniel Mugendi, Chairman of the Board, emphasized that ?Cytonn?s very capable and committed pool of talent, its differentiated products with market leading investment returns, and its risk management process, all brought together within highest levels of corporate governance and ethical practices has delivered and will continue to deliver stellar results for our shareholders and clients?
- Shareholders of Cytonn Investments Management Limited, our Group Holding Company, together with Investment Partners of Cytonn Cash Management Solutions LLP (Cytonn CMS), our private wealth affiliate, held a successful Annual General Meeting on Thursday, August 25th, 7:30 am at Villa Rosa Kempinski. The AGM, which was well attend with over 300 shareholders and investors,

approved the audited financials and ratified the board of directors for the group. For Cytonn CMS, the AGM ratified the Advisory Board, effectively giving CMS investors governance rights in the management of their investments and ratified the audited financials for Cytonn CMS. Cytonn CMS is the only private high yield investment vehicle in this market that holds AGMs for its Investment Partners, releases audited financials and gives investors enormous governance rights. Speaking at the Cytonn CMS AGM, Elizabeth Nkukuu, CFA, our Chief Investment Officer said ?We are committed to the highest level of corporate governance and transparency even as we relentlessly pursue the best returns for our investors.?

- 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
- Cytonn Real Estate would like to 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 Q1?2017. 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:

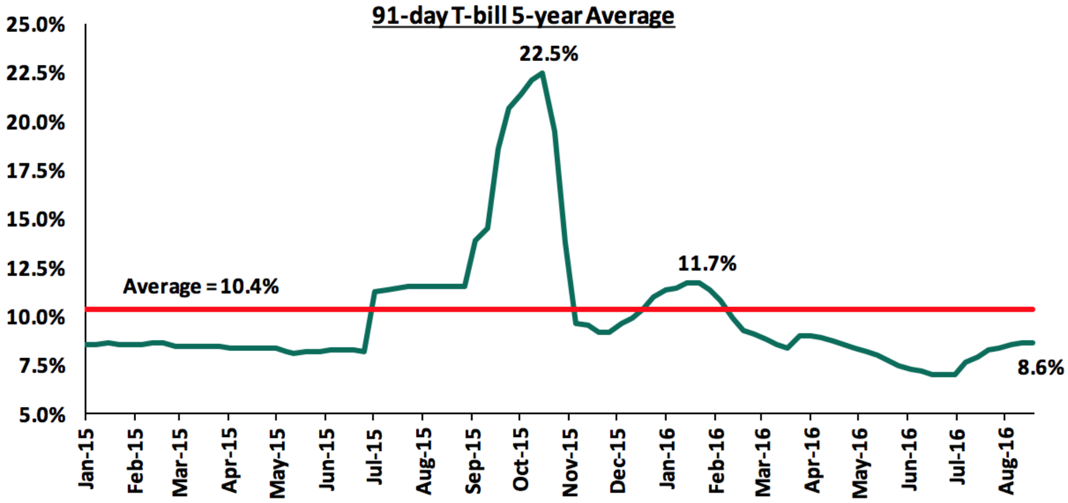
APARTMENT TYPE	UNITS ON OFFER	INTRODUCTORY PRICE(KSHS)	CLIENT OFFER PRICE(KSHS)
2 Bed Units	9	7,900,000.0	6,720,000.0
3 Bed Units	14	11,500,000.0	9,780,000.0
Total	23		

- 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 undersubscribed with overall subscription declining to 96.8%, compared to 118.9% recorded the previous week. Subscription rates declined across all tenors with the 91-day, 182-day and 364-day papers coming in at 42.1%, 132.7% and 97.5%, from 89.4%, 154.3% and 103.0%, respectively, the previous week. Looking at the number and amount of bids received for each instruments, more players bid for the 182-day and the 364-day papers, with preference to the former, and this can be attributed to the uncertainty around the signing of the Interest Rate Cap Bill which was eventually signed on 24th August, 2016 and is likely to result in downward pressure on interest rates. The yield on the 91-day T-bill remained unchanged at 8.6%, while for the 182-day and 364-day papers increased marginally to 11.1% and 12.0% from 11.0% and 11.9%, respectively, the previous week.

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.



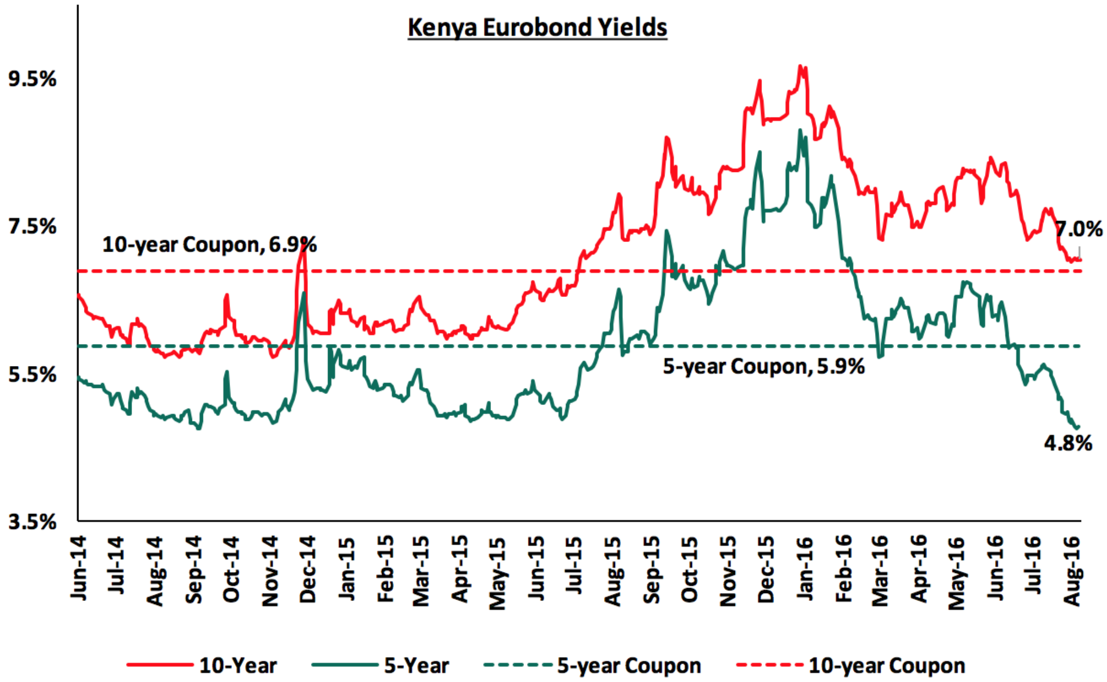
In line with the Securities Issuance Calendar, the government issued a 10-year fixed coupon bond to raise Kshs 25.0 bn for budgetary support. The bond was oversubscribed with a performance rate of 105.2%. Yields on the bond came in at 15.0%, in line with our recommendation that investors should bid within the range of 14.6% - 15.5%. Given (i) the upward pressure on interest rates as a result of government borrowing for the 2016/2017 fiscal year, and (ii) the disparity in liquidity distribution in the money market, investors demanded a 40 bps premium compared to the secondary market yield of 14.6%.

The Central Bank Weekly report revealed that the interbank rate decreased by 20 bps to 4.1%, from 4.3% the previous week, due to a net liquidity injection of Kshs 6.0 bn. The liquidity injection was as a result of T-bill redemption, Government payments and T-bond redemptions of Kshs 19.2 bn, Kshs. 18.4 bn and Kshs. 14.1 bn, respectively.

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	18.4	Transfer from Banks - Taxes	26.0
T-bond Redemptions	14.1	T-bill (Primary issues)	16.8
T-bill Redemption	19.2	Term Auction Deposit	0.0
T-bill/T-bond Rediscounting	0.0	Reverse Repo Maturities	7.6
T-bond Interest	6.8	Repos	2.1
Reverse Repo Purchases	0.0		
Repos Maturities	0.0		
Total Liquidity Injection	58.5	Total Liquidity Withdrawal	52.5
Net Liquidity Injection	6.0		

According to Bloomberg, yields on the 5-year and the 10-year Eurobond issued in 2014 remained unchanged week on week at 4.8% and 7.0%, 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 was stable against the dollar at Kshs 101.4, on account of end month dollar demand from importers being offset by (i) dollar inflows from the tourism sector and (ii) inflows from offshore investors buying government securities. On a year to date basis, the shilling has appreciated by 0.9% against the dollar. Going forward, the shilling is likely to come under pressure in the short term as foreign investor exit banking stocks listed on the Nairobi Securities Exchange, following the signing of Interest Rate Cap Bill, which is likely to affect the banks? profitability. We however expect the Central Bank to utilise the foreign exchange reserve, which current stands at 5.1 months of import cover, to support the currency in case the adverse forex market movement.

The Treasury has postponed its external borrowing programme to Q4?2016 due to the high cost of borrowing for frontier market bond issuers brought about by the flight to safety following the Brexit, leading to foreign investors demanding higher premiums for these securities. The Treasury cited turbulence in the global markets and the perceived riskiness of these economies as the reason for the postponement. In our view, the Treasury?s position on the external borrowing and the yields on the Eurobonds are inconsistent. The current yields on the 5-year and a 10- year Eurobonds which incorporate the risk highlighted above by the Treasury, are at a premium and par, respectively, and it may be relatively cheaper to issue the Eurobond now compared to 2014, when the current Eurobonds were issued.

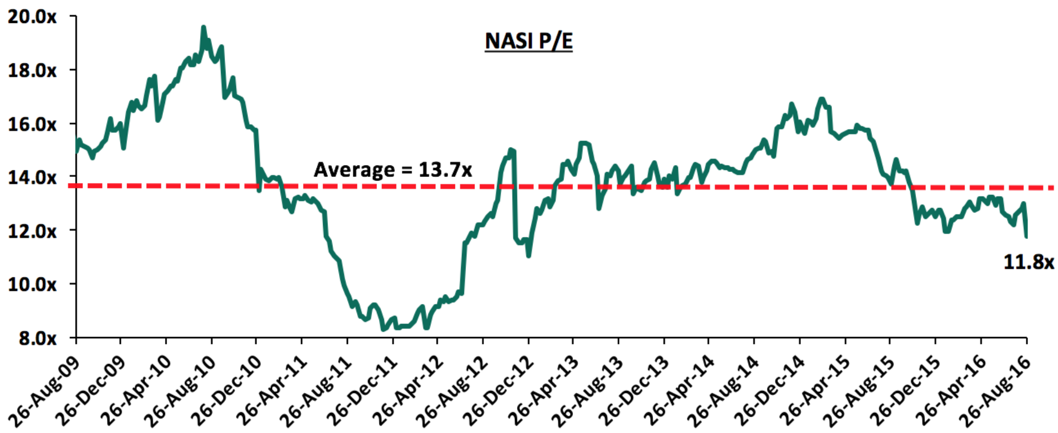
The government is ahead of its domestic borrowing target for this fiscal year 2016/2017, having borrowed Kshs 44.7 bn for the current fiscal year against a target of Kshs 28.7 bn (assuming a pro-rated borrowing throughout the year of Kshs 229.6 bn budgeted for the full fiscal year). Interest rates have bottomed out and we are currently witnessing upward pressure on interest rates given government domestic borrowing for the new fiscal year. It is due to this that we advise investors to be biased towards short to medium-term papers.

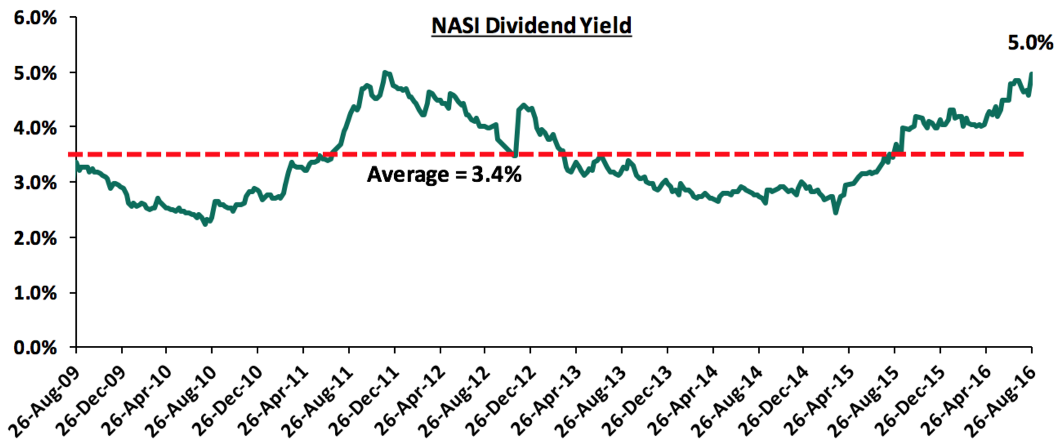
Equities

During the week, the Equities market was on a downward trend with NASI, NSE 25 and NSE 20 losing 8.0%, 10.1% and 7.1%, respectively, with the YTD performance coming in at (7.4%), (15.3%) and (20.4%) for NASI, NSE 25 and NSE 20, respectively. Since the February 2015 peak, the market has lost 41.5% and 24.0% for NSE 20 and NASI, respectively. The week?s performance was as a result of poor performance on all large cap stocks, with the exception of BAT (K) which was up 6.8%. All banking stocks were down following the signing of the bill to cap interest rates, with large caps such as Co-op, Equity and KCB Group shedding 23.4%, 21.9% and 16.9%, respectively. This week alone, banking stocks lost 16.5% in market capitalization equivalent to Kshs 95.4 bn.

Equities turnover declined by 28.9% to close the week at Kshs 2.7 bn from Kshs 3.8 bn the previous week. Foreign investors were net buyers with net inflows of USD 11.4 mn, compared to a net inflow of USD 15.6 mn recorded the previous week, with foreign investor participation decreasing to 57.9% from 68.1% recorded the previous week. Foreign investor activity during the week was mainly on Safaricom and BAT (K) with inflows of 74.6% and 7.9% of the total net foreign inflows, respectively. Safaricom was the top mover once again this week, accounting for 48.8% of market activity. We maintain our expectation of stronger earnings growth in 2016 compared to 2015, with an estimated earnings growth of 12.5%, supported by a favorable macroeconomic environment.

The market is currently trading at a price to earnings ratio of 11.8x, versus a historical average of 13.7x, and a dividend yield of 5.0% versus a historical average of 3.4%. The charts below indicate the historical PE and dividend yields of the market.





Equity Group released H1?2016 results:

Equity Group released their H1?2016 results recording core earnings per share (EPS) growth of 17.6% to Kshs 2.7 from Kshs 2.3 in H1?2015, against our projection of Kshs 2.6. The growth in EPS was driven by a 21.9% growth in operating revenue despite a 25.6% growth in total operating expenses.

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

- Total operating revenue grew by 21.9% to Kshs 32.1 bn from Kshs 26.3 bn driven by Net Interest Income growth of 36.9% to Kshs 21.2 bn from Kshs 15.5 bn, despite a flat growth in Non-funded income at Kshs 10.8 bn

- Net Interest Income grew by 36.9% supported by a 35.4% growth in interest income, with interest expense growing by 29.3% to Kshs 4.9 bn from Kshs 3.8 bn. Net interest margin improved to 10.8% from 10.5%
- Non-Funded Income remained flat at Kshs. 10.8 bn, with fees and commissions income declining by 24.2% to Kshs 2.0 bn from Kshs 2.7 bn. The current revenue mix stands at 66:34, Funded to Non-Funded Income. The flat Non-funded income raises questions about the positioning of Equity Bank as a fee driven transaction bank with growth coming from interest income and not fee income
- Total operating expenses grew by 25.6% to Kshs 17.9 bn from Kshs 14.2 bn on account of a 181.5% rise in loan loss provision to Kshs 1.9 bn from Kshs 0.7 bn. Excluding LLP, the operating expenses grew by 17.7% to Kshs 15.9 bn from Kshs 13.5 bn. Cost to income ratio increased marginally to 55.6% from 54.0%
- PAT growth came in at 17.6% to Kshs 10.1 bn from Kshs 8.6 bn against our projection of 16.1% growth
- Loan and advances grew by 13.6% to Kshs 269.0 bn from Kshs 236.8 bn while customer deposits grew by 6.5% to Kshs 319.2 bn from Kshs 299.7 bn leading to an increase in the loan to deposit ratio to 84.3% from 79.0%. Excluding regional businesses, deposits grew by 9.6% to Kshs. 260.5 bn from 237.7 bn highlighting the impact of the local alternative channels of distribution and deposit mobilization such as mobile banking and agency banking.

Key to note is that Equity Group earnings for H1?2016 were majorly from core business with net interest income growing by 36.9% as compared to non-interest income growth of 0.4%. However, profitability of the regional business contracted with the DRC business profitability declining by 5.0%, except for Uganda business that recorded a 330.0% growth.

For a more comprehensive analysis, see our Equity Group H1?2016 Earnings Note.

Diamond Trust Bank released H1?2016 results:

Diamond Trust Bank released their H1?2016 results recording core earnings per share (EPS) growth of 11.3% to Kshs 13.6 from Kshs 12.2 in H1?2015 against our projection of Kshs 12.8. The growth in EPS was driven by a 30.8% growth in operating revenue despite a 49.3% growth in operating expenses.

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

- Total operating revenue grew by 30.8% to Kshs 12.1 bn from Kshs 9.2 bn driven by Net Interest Income growth of 39.3% to Kshs 9.6 bn from Kshs 6.9 bn, and a 6.0% growth Non-funded income to Kshs 2.5 bn, from Kshs 2.4 bn
- Net Interest Income grew by 39.3% supported by a 42.9% growth in interest income to Kshs 16.7 bn from Kshs 11.7 bn, despite a faster interest expense growth of 47.9% to Kshs 7.2 bn from Kshs 4.8 bn. Net interest margin increased slightly to 6.8% from 6.7%
- Non-Funded Income grew by 6.0% to Kshs 2.5 bn, from Kshs 2.4 bn, supported by a 14.2% growth in fees and commissions from loans. The current revenue mix stands at 79:21, Funded to Non-Funded Income
- Total operating expenses grew by 49.3% to Kshs 6.8 bn from Kshs 4.6 bn on account of a 249.6% rise in loan loss provision (LLP) to Kshs 2.2 bn from Kshs 0.6 bn and a 23.3% growth in other operating expenses to Kshs 1.9 bn from Kshs 1.6 bn. Excluding LLP, the operating expenses grew by 17.4% to Kshs 4.6 bn from Kshs 3.9 bn. The high growth in expenses led to an increase in cost to income ratio to 56.5% from 49.5%
- PAT growth grew by 11.3% to Kshs 3.6 bn from Kshs 3.3 bn against our projection of 4.9% growth
- Loan and advances grew by 10.2% to Kshs 178.5 bn from Kshs 162.0 bn while Customer deposits grew by 24.7% to Kshs 216.1 bn from Kshs 173.3 bn leading to a decrease in the loan to deposit ratio to 82.6% from 93.5%.

The results were in line with our expectations, with the bank delivering good growth in earnings. Loan loss provision, in line with the industry trend, continues to claw back earnings growth for DTB. However, we expect stabilization in level of provisioning going forward. The regional businesses and alternative channels remain the strong areas for growth and we expect the bank to leverage on these two areas for growth.

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

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;

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%
Cooperative Bank	32.3%	18.7%
Standard Chartered Bank	(37.6%)	34.8%
NIC Bank	9.8%	2.9%
Equity Group	11.8%	18.0%
DTB	10.7%	11.3%
Average*	3.1%	18.6%
**-Market Cap Weighted*		

We also did a comparison 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 still remain 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%.

Britam Holdings released H1?2016 results:

Britam Holdings released their H1?2016 results, reporting earnings per share growth of 184.8% to Kshs 0.9 from Kshs 0.3 in H1?2015 against our projection of Kshs 0.4. This growth was driven by a

14.8% growth in total revenue to Kshs 12.7 bn and a 0.9% decline in total expenses to Kshs 11.1 bn. The 0.9% decline in total expenses was as a result of a 29.4% decline in net claims due to a change in valuation methodology for the long term business. However, without the decline in net claims of Kshs 2.3 bn as a result of the change in valuation methodology, the performance was poor, recording a 41.9% decline in adjusted core EPS to Kshs 0.2 from Kshs 0.3.

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

- Total revenue grew by 14.8% to Kshs 12.7 bn from Kshs 11.0 bn supported by a 6.4% growth in net earned premiums to Kshs 9.4 bn and a 37.9% growth in investment income to Kshs 2.4 bn from Kshs. 1.7 bn
- Gross written premiums rose marginally by 3.5% to Kshs 11.0 bn from Kshs 10.6 bn on account of moderate uptake of Britam?s insurance products. Retention ratio increased to 85.1% from 82.8%
- Investment income rose by 37.9% to Kshs 2.4 bn from Kshs 1.7 bn, driven by more proactive portfolio allocation taking advantage of the high yields in the fixed income market, while scaling back from the equities market. Investment income currently accounts for 19.0% of the total income, an improvement from 15.8%
- Total expenses declined by 0.9% to Kshs 10.1 bn from Kshs 10.2bn, driven by a 29.4% decline in net claims and loss adjustment expenses to Kshs 3.6 bn from Kshs 5.1 bn. The decline in net claims and loss adjustment expenses was due to a change in valuation methodology for the long term business, from the Net Premium Valuation (NPV) methodology to Gross Premium Valuation (GPV), necessitated by the Insurance Act (Cap. 487) and amendments of the Finance Act 2015. This translated to a combined ratio of 108.0%, down from 115.9% in H1?201 Without the change in valuation methodology to GPV from NPV, total expenses would have grown by 21.5% to Kshs 12.4 bn from Kshs 10.2 bn
- Reported PBT grew by 175.3% to Kshs 2.9 bn from Kshs 1.0 bn in H1?2015, while Reported PAT was up 184.8% to Kshs 1.8 bn from Kshs 0.6 bn in H1?2015. Adjusted PAT, removing the impact of the change in valuation methodology, declined by 41.9% to Kshs 0.4 bn from Kshs 0.6 bn.

The Britam results were below our expectations, characterised by a poor performance as a result of a 21.5% growth in total expenses (adjusted). The reported 0.9% decline in operating expenses can only be attributed to the change in valuation methodology. Going forward, cost containment measures will be key in driving Britam?s growth.

For a more comprehensive analysis, see our Britam Holdings Earnings Note H1?2016.

Bamburi Cement Limited released H1?2016 results:

Bamburi released their H1?2016 results recording a 6.0% decline in core earnings per share to Kshs 8.0 from Kshs 8.5 in H1?2015 driven by a Kshs 95.0 mn foreign exchange loss on the USD denominated liquid assets given the appreciation of the Kenyan Shilling against the USD, from a Kshs 397.0 mn gain in H1?2015.

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

- Revenue declined by 1.1% to Kshs 19.1 bn from Kshs 19.3 bn driven by slow growth in the individual home builder segment that was largely affected by rising interest rates in Q4?2015 which affected 2016 construction activity
- Operating costs declined by 2.1% to Kshs 15.0 bn from Kshs 15.3 bn supported by prudent cost management and specialization with regards to operation of plant and machinery
- Investment income grew by 41.6% to Kshs 218.0 mn from Kshs 154.0 mn benefiting from the higher interest rate environment in 2015
- PBT declined by 5.1% to Kshs 4.3 bn from Kshs 4.5 bn while PAT declined by 6.0% to Kshs 2.9 bn from Kshs 3.1 bn
- Total assets declined by 6.8% to Kshs 41.1 bn from Kshs 44.1 bn driven by an 8.6% decline in cash

and cash equivalents to Kshs 10.5 bn from Kshs 11.4 bn

- Total liabilities declined by 9.6% to Kshs 11.5 bn from Kshs 12.7 bn driven by a 19.0% decline in current liabilities to Kshs 6.9 bn from Kshs 8.6 bn. Shareholders? funds declined by 5.6% to Kshs 29.7 bn from Kshs. 31.4 bn.

The results were lower than expected mainly due to exchange losses in their US Dollar denominated liquid assets given the appreciation of the shilling against the dollar, compared to the gains recorded in 2015 as a result of the depreciation of the shilling against the dollar. The group has approved the Phase 1 of their capacity expansion project in Kenya and Uganda that will increase cement capacity by 1.7 mn tonnes at a cost of Kshs 8.3 bn. We expect Bamburi to remain profitable given stable prices and continued growth in the real estate and construction industries that it supplies.

For a more comprehensive analysis, see our Bamburi Cement Earnings Note H1?2016.

ARM Cement Ltd released H1?2016 results:

ARM Cement released their H1?2016 results recording a 25.0% increase in their bottom line but remained in a loss position. The loss per share came in at Kshs 0.5 from Kshs 0.7 in H1?2015, driven by 6.2% decline in operating costs to Kshs 5.7 bn from Kshs 6.1 bn despite a 13.2% decline in revenue.

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

- Revenue declined by 13.2% to Kshs 6.7 bn from Kshs 7.7 bn due to increased competition in the Tanzania cement market coupled by cheap imports and slow growth in the individual home builder segment in Kenya that was largely affected by rising interest rates in Q4?2015
- Operating costs decreased by 6.2% to Kshs 5.7 bn from Kshs 6.1 bn in line with the decline in revenue, attributed to distribution efficiency
- Finance costs were up 134.3% to Kshs 1.5 bn from Kshs 627.0 mn as a result of interest expenses that had been capitalized in 2015 and were finally expensed after the clinker plant in Tanga was commissioned
- Loss before tax decreased by 23.1% to Kshs 363.9 mn from Kshs 473.5 mn while loss after tax was down 25.0% to Kshs 266.8 mn from Kshs 355.8 mn
- Total assets increased by 42.6% to Kshs. 52.5 bn from Kshs. 36.8 bn driven by a 49.3% growth in non-current assets to Kshs. 43.7 bn from Kshs. 29.3 bn
- Total liabilities increased by 28.6% to Kshs. 35.9 bn from Kshs. 28.0 bn driven by a 53.5% increase in current liabilities to Kshs. 22.2 bn from Kshs. 14.4 bn.

The results were lower than expected and this was due to the 134.3% increase in finance costs. We expect the USD 140.0 mn from CDC Group to be used to retire their short term debt and capacity expansion.

For a more comprehensive analysis, see our ARM Cement Earnings Note H1?2016.

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

- *We have placed all banks in our universe of coverage under review following the signing of the bill to cap interest rates in the country. We shall be releasing the revised recommendation with our Q2 Banking Sector Report*
- Liberty has moved from an ?Accumulate? recommendation, with an upside of 17.2% to a ?Lighten? recommendation with an upside of 4.7%, following a 13.4% w/w price rise
- BAT (K) has moved from a ?Buy? recommendation, with an upside of 26.8% to an ?Accumulate? recommendation with an upside of 19.1%, following a 6.8% w/w price decline

all prices in Kshs unless stated									
EQUITY RECOMMENDATION									
No.	Company	Price as at 19/08/16	Price as at 26/08/16	w/w Change	YTD Change	Target Price*	Dividend Yield	Upside/ (Downside)**	Recommendation
1.	Centum	42.3	38.0	(10.1%)	(18.3%)	56.7	2.4%	51.6%	Buy
2.	Bamburi Cement	174.0	167.0	(4.0%)	(4.6%)	231.7	7.8%	46.5%	Buy
3.	ARM	30.0	28.5	(5.0%)	(31.7%)	40.3	0.0%	41.4%	Buy
4.	Kenya Re	20.8	20.0	(3.6%)	(4.8%)	26.6	3.6%	36.6%	Buy
5.	Britam	12.3	11.6	(6.1%)	(11.2%)	14.2	2.4%	25.3%	Buy
6.	CIC Insurance	4.2	3.9	(6.0%)	(37.1%)	4.7	2.5%	23.0%	Buy
7.	BAT (K)	805.0	860.0	6.8%	9.6%	970.8	6.2%	19.1%	Accumulate
8.	Sanlam Kenya	40.0	36.8	(8.1%)	(38.8%)	42.7	0.0%	16.2%	Accumulate
9.	Jubilee	466.0	470.0	0.9%	(2.9%)	486.6	1.8%	5.4%	Hold
10.	Liberty	14.5	16.5	13.4%	(15.6%)	17.2	0.0%	4.7%	Lighten
11.	Safaricom	21.3	19.7	(7.5%)	20.6%	16.6	3.6%	(11.9%)	Sell
*Target Price as per Cytonn Analyst estimates									
**Upside / (Downside) is adjusted for Dividend Yield									
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

The International Finance Corporation (IFC), has this week committed to lend up to USD 4.5 mn to Tropical Heat Limited, a spices and snacks maker in Kenya, in order to assist the company to finance their expansion plans, which include the construction of a new factory on an eight-acre piece of land in Limuru. The project development will: (i) help the company reduce risks of raw materials scarcity along the company?s supply chain by improving storage capacity and duration, and (ii) lead to an increase in production thus enhancing its product distribution, with only about 35.0% of its products currently in major supermarkets in East Africa. Being a Development Finance Institution (DFI), IFC considered various development factors in making the commitment, which are consistent with their investment strategy, involving creating jobs and improving the standards of living. The increase in Kenya?s quality of life, combined with the trend toward increased urbanization, is leading to a shift in focus for much of the region?s Foreign Direct Investment (FDI), from extractive to consumer-facing and Fast Moving Consumer Goods (FMCG) industries.

In another investment by IFC this week, Zoona, an African financial technology company that offers emerging entrepreneurs a platform to provide money transfer and other services to unbanked consumers, has successfully raised USD 15.0 mn in a second round of financing, with main participants being IFC, Accion and Quona Capital, 4Di Capital, Omidyar Network and The Lundin Foundation. This fund will be channelled towards scaling up Zoona?s operations as the technology firm aims to reach 10 markets and 30 million active consumers across Africa by 2020. The demand for improved technology in the African financial sector has been underpinned by: (i) transition of world economies from cash-based to cashless transactions both in the form of a money transfer or a cash collection, (ii) the willingness to accept and adopt the new form of money by the growing African population, and (iii) the growing use of mobile money platforms in Africa with Zoona having over 1.5 million active users across the region.

Real Estate

This week, China Wu Yi (Kenya) Ltd, a local subsidiary of the giant Chinese construction and engineering Company, China Wu Yi, broke ground on a Kshs 10.0 bn factory for Alternative Building Technology (ABT) along Mombasa Road in Nairobi, Kenya. The ABT to be manufactured will include pre-fabricated and pre cast building material using Expanded Polystyrene (EPS) Technology. The factory will sit on 30-acres of land and is set for completion in June 2017. The factory will encompass (i) a design and construction area, (ii) a marketing and display area complete with a supermarket, and (iii) a research lab, for production for their own consumption and also for sale. China Wu Yi will work in collaboration with two German companies that will provide design software and material for use in construction of the pre-cast wall panels, stair cases, lift shafts, foundation piles and hollow core slabs. The company decided to construct the factory, which has been fully funded by Chinese investors after they won construction tenders worth more than Kshs 10.0 bn in the country. These include the construction of the University of Nairobi Tower and the expansion of Waiyaki way from James Gichuru Road junction to Mai Mahiu turnoff on the Nairobi-Eldoret Highway. Other companies also engaged in production of ABT include: National Housing Cooperation (NHC), Boleyn Magic Wall Panel Limited in Kitengela and C Max in Ruiru. The production of pre-cast blocks has been on an upward trend in recent years, as the market has started accepting and using the technology though the uptake is still low. This is mainly due to insufficient information on the technology and mistrust on its quality and strength. ABT?s have a lot of advantages to developers including:

1. Shorter construction periods ? it is estimated that the use of ABT and EPS in particular can reduce construction time by up to 50.0% as they come ready for installation and fitting,
2. Lower construction costs ? this comes about as they are light hence lower excavation costs and are more efficient. Due to shorter construction periods, if uptake is fast, financing costs are reduced and in large scale construction they offer economies of scale as well,
3. Durability - they are stronger and more efficient as they are fire and earthquake resistant, and are of no nutritional value to moles hence more durable.

In our view the use of ABT is an ideal solution to the undersupply of residential units in Kenya, as even though they are not cheaper than brick and mortar, their ability to shorten construction time will aid in the delivery of large-scale housing. For instance, the technology is being used in construction of houses for the Police Service which has a 78.0% shortfall from the initial estimates. The project, which is being developed by the Ministry of Lands and Housing in conjunction with several contractors in different parts of the country including Kisumu and Ruiru, will deliver 1,850 units a year and the construction will be 38.0% cheaper, costing Kshs 20.0 bn from the initial Kshs 32.0 bn.

The results of the Fusion D-REIT were announced this week, recording a 37.9% subscription rate, raising Kshs 873.8 mn out of a targeted Kshs 2.3 bn. This was from four investors, three of whom were shareholders of the asset to be acquired. It hence failed to meet the listing requirements of the Capital Market Authority requiring a minimum of 7 investors and a minimum subscription rate of 50.0%. This undersubscription was despite extending the closing date twice, which was initially set for 15th July, 2016.

We attribute the under subscription to the following:

1. Insufficient knowledge among investors on the key advantages as well as return profiles of the REITs,
2. Opacity of returns of assets in the REITs,
3. Preference to other investment instruments like government securities, and
4. Poor investor sentiments on the performance of listed Real Estate such as;
    a. The Stanlib Fahari I-REIT which achieved only 29.1% subscription, and is now trading 50.0% below its issue price of Kshs 20.0. Additionally, the REIT has recently applied for regulatory extension to meet reporting obligations
    b. Home Afrika went public in 2013 at Kshs 12.0 per share and is now trading at Kshs 1.2, which is 90.4% below its issue price

The unsuccessful listing of the D-REIT is a big blow to the real estate investment sector in Kenya. This is because an active real estate capital market not only provides the much needed financing for developers but also boosts returns for investors. Real Estate generally offers higher returns compared to both equities and government securities, with a 5-year annualized return at 25.0% compared to 9.6% and 10.0% for 91-day T-bill and equities (NASI), respectively. Real Estate investments has low correlation with traditional asset classes making it an important diversifying tool in portfolios.

As outlined in our Cytonn Report #32, to boost investment in this sector stake holders need to do the following:

1. The government or stake holders in the industry need to sponsor a REIT to proof the REIT concept to the market and boost investor sentiments,
2. The promoters should get broad institutional support before launching another real estate listing. They should thus educate and bring on board the main institutional investors to commit to supporting the REIT before launching,
3. The CMA needs to lower the minimum amounts required for investments. The current amounts of a minimum of Kshs 5.0 million restricted only to professional investors locks out most investors,
4. The promoter and manager should ensure that the investment provides some level of principal plus minimum return guarantees to the buyers to get them comfortable that issuers are convinced about their REIT,
5. The assets selected for the portfolio should be compelling and capable of delivering superior returns. For instance, commercial real estate should have minimum rental yields of 12.0%.

We expect investors to shy away from listing REITs in the Nairobi Securities Exchange (NSE) in the short to medium term following Fusion?s poor run. However, if the above factors are implemented, a successful listing of a REIT will not only be viable but also profitable to the investors.

Hotels in Nairobi recorded full bookings this past week as a result of the Tokyo International Conference on African Development (TICAD) that is being held in Nairobi and Africa for the first time. Meetings, Incentives, Conferences and Exhibition tourism (MICE) continues to boost the tourism and hospitality sector in Kenya. This is supported by country continuing to host a number of global conferences from the Global Entrepreneurship and Ministerial Conference in 2015, the UNCTAD and TICAD conferences in July and August 2016 to the upcoming Global Partnership for Effective Development Co-operation Conference (GDPEC) in September 2016. This has led to an increase in the number of hotels especially three, four and five star hotels with the Tune Inn, Hilton Garden Inn and Golden Tulip hotels being among sixteen hotels unveiled and/or opened this year. MICE tourism will continue to thrive especially if the current security situation is maintained.

Our outlook on the real estate market in Kenya remains positive given its continued high returns and its resilience to macro-economic factors. It is hence prudent to invest in the sector but after careful evaluations of the return prospects and market trend to gain maximum returns.

Impact of the Interest Rate Cap

As per our Cytonn Weekly Report #33, we noted that the Interest Rate Cap Bill was one fuelled by anger and we went further to compare the Bill to Brexit ? a very populist move, fuelled by anger, but an equally unwise move that we may quickly regret; and just like Brexit, it came to pass, with President Uhuru Kenyatta on Wednesday 24th August signing the Interest Rate Cap Bill into law.

We were very surprised by the enactment; we did not think that the president would sign the Bill. But now that the Bill is law, this week we look at the effect of the Bill, what we expect going forward and what Kenyan banks should do to avoid any pitfalls.

As can be witnessed in any developed economy, free movement of goods and services is essential to correct pricing mechanisms, determined by the forces of demand and supply. Anytime there is external interference, such as with quotas or minimum wages, there is either excess supply or demand, and leads to a deadweight loss in the economy and ineffective allocation of resources. While many Kenyans may rejoice in lower interest rates, the truth of the matter is simply that there is an excess demand for bank credit, with financial institutions not willing to meet the demand at set prices.

The effect of signing the Bill was felt immediately within the financial markets:

1. Banking sector stocks declined by 15.6% in 2-days of trading since the close of the market on Wednesday,
2. Investors lost Kshs 88.9 bn in the same span of 2-days, highlighting the immediate negative impact of the decision on foreign sentiment towards the banking sector?s future,
3. Banks with large retail bases such as Equity Group and Co-operative Bank were the worst affected, both losing 20.3% and 20.6%, respectively, while the least affected counters were for CfC Stanbic and Standard Chartered, both losing 6.3% and 7.8%, respectively. It is quite clear that banks whose clientele are more inclined to retail and SME?s are bound to suffer more in this regime, given the high spreads they enjoy, and those that serve corporate clients will not be affected as much,
4. A number of banks informed their clients of their intentions to do away with savings accounts, leading to a reduced number of attractive banking products in Kenya, and,
5. Lending towards motor vehicles and providing unsecured loans was stopped by a number of banks.

In as much as we share the President?s sentiments to increase affordability of financial products for the end consumer, such regulation of the main financial intermediary in the economy will only lead to more suffering of the ?bracket? this Bill seeks to protect. The Bill is oblivious of other factors that affect pricing of loans and deposits such as risk profile, term structure of interest rates, cost of funds and macroeconomic variables. Furthermore, pegging it to the Base Lending Rate will depend largely on the transmission mechanism of monetary policy decision into the economy and the effectiveness of the Monetary Policy Committee in assessing the state of the economy. Though the monetary policy is gaining relevance, we are yet to see it a true pricing mechanisms for investors and banks, who have largely maintained their margins despite volatility in interest rates.

As stated in our Cytonn Weekly #33, several countries around the world, 76 to be exact, have put in place interest rate caps for various reasons but ended up with more problems to solve and eventually scrapped them off. We are of the view that capping interest rates might solve the high interest rate spreads in the banking sector, but what we expect going forward will be challenges such as:

i. Locking out of SMEs and other perceived ?high risk? borrowers from accessing credit, as banks will prefer to loan to the Government,
ii. Straining of small banks who effectively have been shut out from the interbank market and now have to mobilize funds at higher rates,
iii. Banks are likely to introduce bank accounts with zero interest features to bypass the minimum interest payable. For example, Co-operative Bank affirmed compliance with the 14.5% maximum rate on bank loans, but was silent on the minimum rate on deposits,
iv. Pricing will be opaque as the Bill is based on an unreasonable premise that the highest extra risk premium in the Kenya market is 4.0%,
v. Banks may resort to colluding so as to push up the yields on the Treasury instruments, and find other ways of maintaining their margins, most likely at the expense of everyday savers who will be forced to move to current accounts, which carry zero interest features,
vi. Banks may resort to cheaper dollar funding, which will lead to a dollarization of the Kenyan economy, eroding all gains made so far in stabilizing the Kenyan Shilling,
vii. The emergence of strong shadow banking systems, which may result into inefficiencies in terms of transmitting the effects of monetary policy decision into the economy,
viii. Risk of job losses as banks cut jobs to maintain their cost base due to the lower margins, and

ix. Lower standards of living in the economy as the lower access to credit leads to a decline in both consumption and investment expenditure, reducing aggregate demand in the economy.

Below is a summary of the winners and losers from the Interest Rate Cap Bill. We will analyse the impact to the banking sector in detail in the upcoming banking sector report:

Summary of Winners and Losers from the Interest Rate Cap Bill	
THE WINNERS	THE LOSERS
· Banks that lend primarily to the prime individual and corporate commercial segments because they have the most clients that can fit within the 4.0% risk premium. For example, Standard Chartered Bank	· Banks that lend primarily to the SME and sub prime segment because majority of their clients can?t fit into the 4.0% risk premium. For example, Equity Group, KCB Group and Co-operative Bank
· Prime individual clients, because they will be highly sort after by the main stream banks since they will be seeking to bank prime clients, with assets to provide collateral	· Sub-prime clients because they will experience even most constrained access to conventional credit and will have to seek alternative & more expensive credit
· Corporate commercial segments because they will be highly sort after	· The SME sector since access to credit will be limited
· The government as banks will prefer to place money in Treasury instruments that are considered risk free	· The Kenyan economy, which is very reliant on SME sector. If there is less access to credit, the economy will register slow growth unless it adjusts very quickly by moving a lot of SME funding to the informal financing market
· Alternative finance and credit players that are outside the ambit of the amended Banking Act, 2015, since they can still price credit based on market dynamics	· Small depositors are likely to be pushed to no interest accounts
· Banks with multinational links as they can mobilize cheaper dollar funding from their parent company	· Government since banks will record low earnings, reducing their taxable income

The intent of the Bill was not to attack banks profitability but to protect the consumer from exploitation through unreasonable interest rates. We are concerned that those whom this Bill was intended to protect may end up being the biggest losers, with non-interest earning accounts and reduced access to mainstream bank loans such as bank unsecured loans whose pricing has to be way above 14.5%. We will monitor how the implementation unfolds, but so far banks have already eliminated some unsecured loans, emergency loans and motor vehicle loans.
