Cytonn Monthly- August 2020

Fixed Income

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

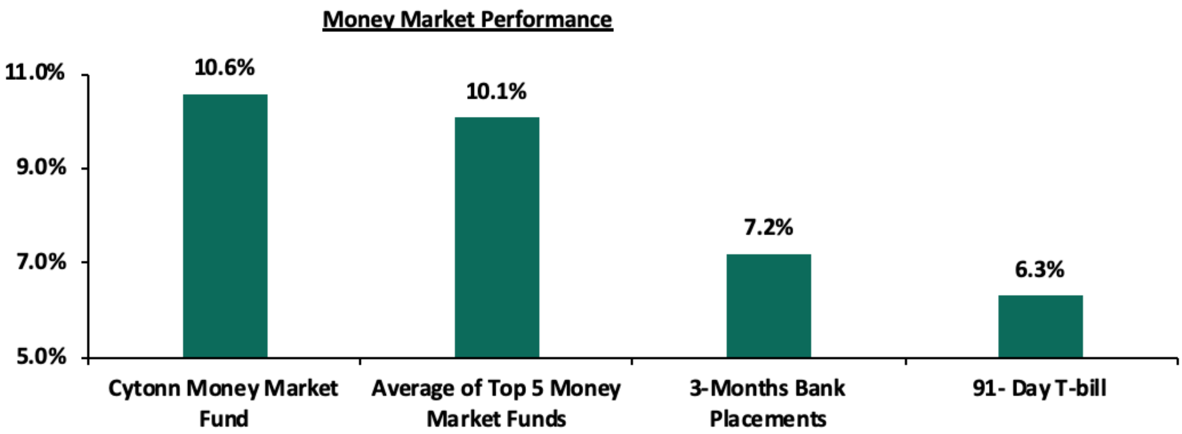
During the month of August, T-bill auctions recorded an undersubscription, with the overall subscription rate coming in at 80.1%, compared to 243.1% recorded in the month of July. The subscription rates for the 91-day, 182-day and 364-day papers all declined to 137.8%, 64.9% and 72.2%, respectively, from 574.7%, 137.5% and 216.0%, recorded in July. The yields on the 91-day, 182-day and 364-day papers remained unchanged at 6.2%, 6.6% and 7.5%, respectively. The T-bills acceptance rate rose to 90.4% during the month, compared to 66.9% recorded in July, with the government accepting a total of Kshs 69.5 bn of the Kshs 76.9 bn worth of bids received.

During the week, T-bills remained undersubscribed, with the subscription rate coming in at 49.6%, down from 52.3% the previous week, despite high liquidity in the money market. The subscription rates for the 91-day and 182-day papers declined to 68.5% and 31.6%, respectively, from 113.3% and 61.0%, while that of the 364-day paper increased to 60.0%, from 19.3%. The acceptance rate increased to 91.8% from 85.4% the previous week. The yields on the 91-day, and 182-day papers remained unchanged at 6.3% and 6.6%, while that of the 364-day paper rose marginally to 7.6% from the 7.5% recorded last week.

For the month of August, the Kenyan government issued an Infrastructure bond, IFB1/2020/11 which was oversubscribed with the average subscription rate coming in at 145.0%, with bids worth Kshs 101.5 bn received compared to the offered amount of Kshs 70.0 bn offered and the government only accepted 77.5% of the amounts i.e. Kshs 78.6 bn. The market weighted average rate for the bond came in at 11.4%, which was in-line with our expectations of 11.4%-11.6%.

Additionally, the treasury opened a tap sale for a 20-year bond, FXD2/2018/20, with an effective tenor of 18 years. The issue was oversubscribed with the subscription rate coming in at 100.7% and the whole amount was accepted, as the government received bids worth Kshs 40.3 bn, higher than the Kshs 40.0 bn offered, mainly attributable to the high liquidity in the money markets. The yield on the bond came in at 12.9%.

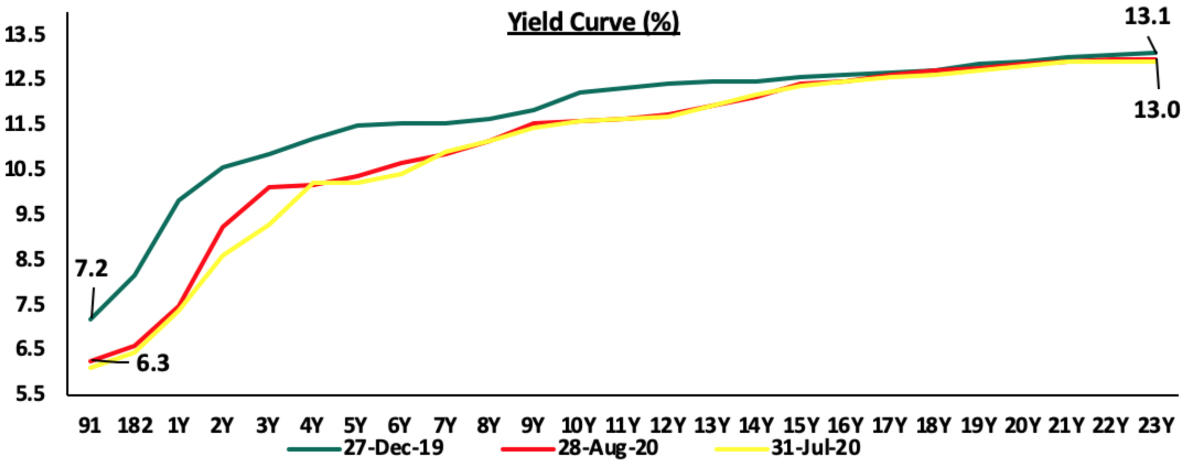
For the month of September, the Government has floated a triple issues, namely, FXD2/2010/15, FXD1/2020/15 and FXD1/2011/20 with effective tenors of 5.3, 14.5 and 10.7 years respectively, for a total value of Kshs 50.0 bn for budgetary support. The bonds have coupon rates of 9.0%, 12.8% and 10.0%, respectively with the period of sale set to end on 15th September 2020. Our recommended bidding range is 10.3% - 10.5% for FXD2/2010/15, 12.2% - 12.4% for FXD1/2020/15, and 11.7% - 11.9% for FXD1/2011/20 which is in line with the trading yields in the secondary market.



In the money markets, 3-month bank placements ended the week at 7.2% (based on what we have been offered by various banks), while the yield on the 91-day T-bill remained unchanged at 6.3%. The average yield of Top 5 Money Market Funds increased marginally to 10.1%, from 10.0% previously. The yield on the Cytonn Money Market remained unchanged at 10.6%, similar to what was recorded the previous week.

Secondary Bond Market:

In the Month of August, the yields on government securities remained relatively stable and the bond turnover decreased by 15.1% to Kshs 59.0 bn, from Kshs 69.4 bn recorded last month. The FTSE NSE bond index declined marginally by 0.1% to close the month at 97.5 from 97.9 in July, and bringing the YTD return to 0.1%. The chart below is the yield curve movement.



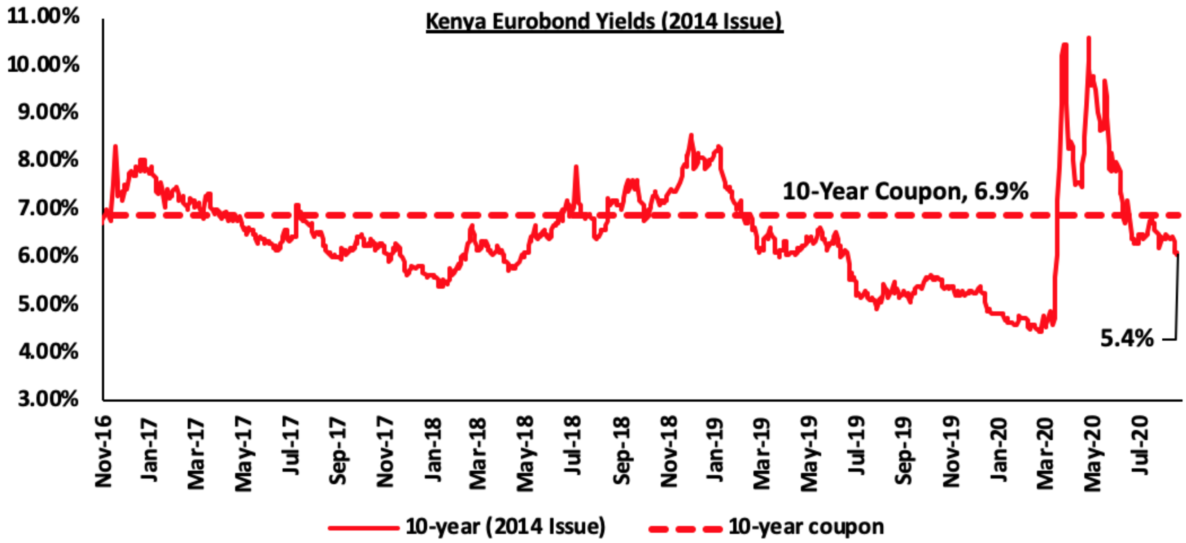
Liquidity:

The money markets remained liquid in the month of August, with the average interbank rate rising marginally to 2.5%, from 2.3% recorded in July supported by government payments. During the week, the market remained liquid with the average interbank rate rising marginally to 3.2% from 3.0% recorded the previous week, which the Central Bank of Kenya in their weekly bulletin attributed this to government payments which offset tax remittances. The average interbank volumes declined by 39.4% to Kshs 10.0 bn, from Kshs 16.5 bn recorded the previous week.

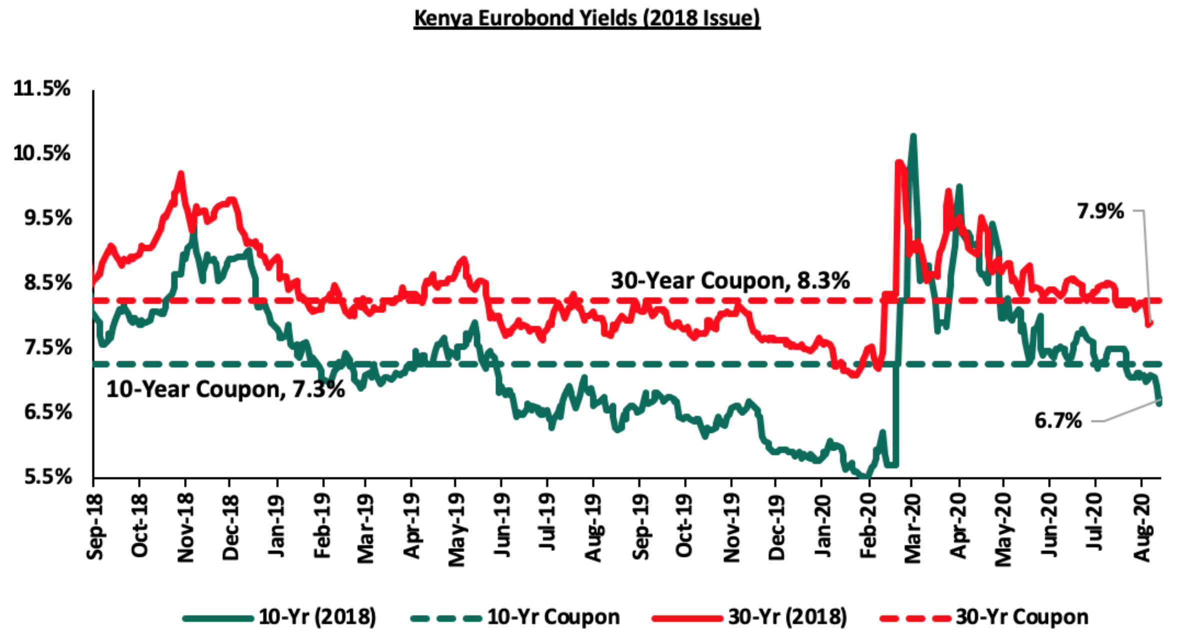
Kenya Eurobonds:

During the month of August, the yields on Kenyan Eurobonds were on a declining trend pointing to improved investor sentiments supported by the confidence in the country following the easing of movement restrictions in the country and resumption to work for most businesses. According to Reuters, the yield on the 10-year Eurobond issued in June 2014 declined by 0.4% points to 6.0% in August, from 6.4% in July. During the week, the yield on the 10-year Eurobond declined by 0.6%

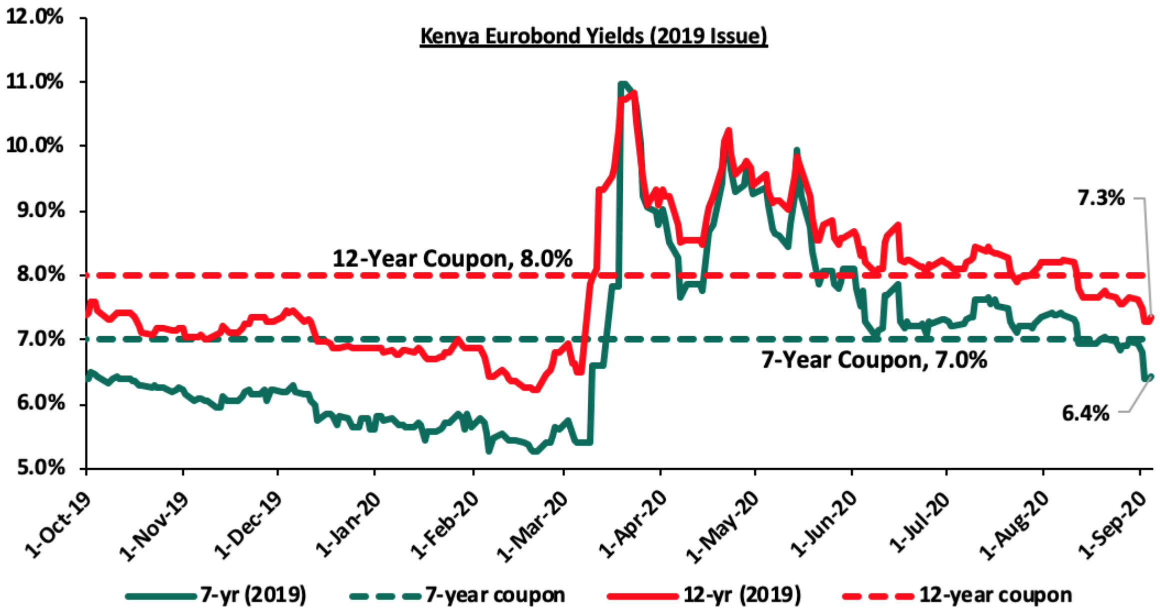
points to 5.4%, from the 6.0% recorded the previous week.



During the month, the yields on the 10 year Eurobonds issued in February 2018 declined by 0.4% points to close at 7.1% in August, from the 7.5% recorded in July. The 30 year Eurobond also declined by 0.2% points to 8.2%, from 8.4% in July. During the week, the yield on the 10-year Eurobond declined by 0.4% points to close at 6.7% from 7.1% recorded the previous week. The 30-year Eurobond declined by 0.3% point to 7.9%, from 8.2% recorded the previous week.



During the month, the yields on the newly issued dual-tranche Eurobond with 7-years declined by 0.4% points to 7.0% in August, from 7.4% in July. The 12-year Eurobond also declined by 0.6% points to 7.6%, from 8.2% recorded in July. During the week, the yields on both the 7-year and 12-year Eurobonds decreased by 0.6% points and 0.4% points, to 6.4% and 7.3%, respectively, from 7.0% and 7.7% recorded the previous week.



Kenya Shilling:

During the month, the Kenyan shilling remained under pressure against the US dollar, losing by 0.5%, to close the month at Kshs 108.2 from Kshs 107.7 in July, mainly attributable to increased importer dollar demand amidst lacklustre dollar inflows. During the week, the Kenya Shilling remained unchanged against the US dollar to close Kshs 108.2. On an YTD basis, the shilling has depreciated by 6.3% against the dollar, in comparison to the 0.5% appreciation in 2019.

In the short term, the shilling is expected to be supported by:

i. The high levels of forex reserves, currently at USD 8.9 mn (equivalent to 5.4-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;
ii. Relatively strong Diaspora remittances that increased by 23.4% to USD 277.0 million in July compared to USD 225 million in July 2019, despite being 4.0% lower than the USD 288.5 million in June 2020, leading to the narrowing of the country's current account deficit to 4.7% of GDP in the 12 months to July 2020, compared to 5.0% of GDP in the 12 months to June.

Weekly Highlight:

The y/y inflation for the month of August remained unchanged at 4.4%, similar to what was recorded in July 2020. Month-on-month inflation came in at 0.2%, which was attributable to:

i. A 1.0% decline in the food and non-alcoholic drinks' index,
ii. A 1.2% increase in the housing, water, electricity, gas and other fuels index, as a result of an increase in the cost of electricity and kerosene by 0.5% and 27.4% respectively,
iii. 2.1% increase in the transport index on account of an increase in the pump prices of petrol and diesel by 3.4% and 3.0%, respectively.

Major Inflation Changes – August 2020

Broad Commodity Group	Price change m/m (August-20/July-20)	Price change y/y (August-20/August-19)	Reason
Food & Non-Alcoholic Beverages	(1.0%)	5.4%	The m/m decline was due to a decline in prices of some food items such as onions, tomatoes and spinach

Major Inflation Changes – August 2020

Broad Commodity Group	Price change m/m (August-20/July-20)	Price change y/y (August-20/August-19)	Reason
Transport Cost	2.1%	13.1 %	The m/m increase was mainly on account of increases in the pump prices
Housing, Water, Electricity, Gas and other Fuels	1.2%	2.1%	The m/m increase was as a result of the increase in the cost of electricity and kerosene
Overall Inflation	**0.2%**	**4.4%**	**The m/m increase was due to a 2.1% increase in the transport cost, mainly driven by the increase in fuel prices which was mitigated by the decline of 1.0% in the Food and non-alcoholic foods index**

Going forward, we expect the inflation rate to remain within the government set range of 2.5% - 7.5% as the supply-side disruption due to COVID-19 are offset by lower demand for commodities and as food prices remain low.

Weekly Highlight:

Stanbic Purchasing Manager's Index

The Stanbic Bank's Monthly Purchasing Manager's Index (PMI) for August was released, highlighting that Kenyan firms have seen improvement in economic conditions for the second month with the output and new orders rising solidly, export sales reached a new high, amid looser travel restrictions. Business expectations improved for the first time in six months leading to new investment in branches but employment continued to fall. The seasonally adjusted PMI came in at 53.0 in August, an improvement from the 54.2 recorded in July. Key to note, a PMI reading of above 50 indicates improvements in the business environment, while a reading below 50 indicates a worsening outlook.

Also, during the week, Amana Capital Limited (ACL) disclosed to its shareholders that Kshs 255.0 mn which represents 59.0% of class B units had been impaired, following the losses incurred by Amana Unit Trust Scheme in the Nakumatt Holdings Limited Commercial paper program. Consequently, the scheme indicated that every unit holder in the scheme would have their investments in the Amana Shilling Fund Class B, impaired by 59.0%. (Class B shares are a classification of common stock that may be accompanied by more or fewer voting rights than Class A shares, depending on how the company decides to structure its stock). As highlighted in our Cytonn Weekly, the Capital Markets Authority (CMA) placed a 28-day freeze on the withdrawal of funds from Amana Capital owing to the investments lost in Nakumatt's commercial paper. The 28-day moratorium would enable ACL to work with the Trustee, (NatBank), and Investments Services Limited to improve its liquidity position in order to meet the redemption obligations of the unitholders. Key to note, the freeze has been in place for 2 years following losses from investing in the Commercial Paper programme for Nakumatt and the reported loss on Amana Shilling Fund was at Kshs 275.0 mn equivalent to 49.6% of the Fund.

Additionally, the scheme has indicated that unit holders of Class B shares should consider the below 3 options in regards to their shares;

1. **Option A**: Unit holders will be offered the option of recovering their investment through their acquisition of an equity stake in ACL. Unit holders who opt for this option will be subject to the terms and conditions of the Subscription Agreement which states that;
   a. The 59.0% funds written off in the Amana UTS Shilling Fund Class B be substituted for a 30% equity stake in ACL,

    b. The 30% equity shares will be issued proportionally to individual holdings of funds lost in the Amana UTS Shilling Fund Class B, and,
    c. The dilution of shareholding of ACL would be;
        i. A new investor has been identified to take up a 60.0% stake (down from 70.0%) and,
        ii. Existing shareholders ownership will be reduced from 100.0% to 30.0% and further to 10.0%.
2. **Option B:** If option A is rejected by the Unit Holders; then without accepting any liability whatsoever resulting from the losses incurred in the Amana Shilling fund, the ACL shareholders (i.e. the new investor and existing shareholders) would propose to dilute their shareholding to 51.0% and issue new shares worth 49.0% to the Unit Holders under the following conditions;
    a. Unit Holders will be eligible for a seat in the Board in ACL in proportion to their 49.0% ownership,
    b. The preference shares currently issued to the new investor in ACL would be redeemed and not converted into equity, resulting in the new investor's automatic exit from ACL within a maximum period of 1 year, and,
    c. Unit Holders who choose this option would be required to waive the right of any legal action against ACL.
3. **Option C:** Unit Holders who reject the above two options will be requested to either;
    a. Forfeit their investments in the fund in accordance with the funds Trust Deed Rules, or,
    b. To continue their investment in the Fund through the conversion of the available balance of their investments in the Fund into equity in ACL in the manner set out under either Option B or Option C

The move is commendable as it finally offers clarity for the investors of the fund, whose funds have been frozen for the past 2 years now. As highlighted in our Cytonn weekly, the 59.0% impairment would lead to a haircut in the value of investments for the unit holders given that for instance, an investor who had invested Kshs 10,000 in the fund stands to lose Kshs 5,900 following the impairment. We had highlighted the below as the possible remedies to settle the conundrum and unlock liquidity for the unit holders:

1. Run a quick sale process of the Amana Money Market Fund to a fund manager that enjoys market confidence of money market investors,
2. The new manager would write down the value of each investor's unit to 80.0% their statement value, and then,
3. Give Amana unit holders units in the new manager's fund, equivalent to the value of the written down Amana units. This would preserve the most value for Amana unit holders, provide immediate liquidity to Amana unit holders, and prevent unnecessary market disruption. We believe freezing a fund destroys the maximum value for unit holders and brings unnecessary market jitters, and should be avoided.

We however still maintain our view that it is easier to assist a fund in distress while it is still open for business, once it closes its doors, the task becomes rather impossible

Rates in the fixed income market have remained relatively stable due to the high liquidity in the money markets, coupled with the discipline by the Central Bank as they reject expensive bids. The government is 69.4% ahead of its prorated borrowing target of Kshs 102.9 bn having borrowed Kshs 174.2 bn. In our view, the government will not be able to meet their revenue collection targets of Kshs 1.9 tn for FY'2020/2021 because of the current subdued economic performance in the country brought about by the spread of COVID-19, and therefore leading to a larger budget deficit than the projected 7.5% of GDP, ultimately creating uncertainty in the interest rate environment as additional borrowing from the domestic market may be required to plug in the deficit. Owing to this uncertain environment, our view is that investors should be biased towards short-term to medium-

term fixed income securities to reduce duration risk.

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