Cytonn Monthly January 2015

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Executive Summary

· Oil prices continued to decline globally due to contracting demand and increased oversupply. Kenya and other countries that are net importers of oil have reaped numerous benefits including low fuel prices and declining inflation; net exporters have been negatively impacted

· Global equity markets experienced volatility attributed to various economic forces. In the US, stock price declines correlated with the movement in oil prices, while in Europe, stocks declined significantly after the Swiss National Bank?s unexpected removal of the cap against the Euro. Kenyan equities turnover declined due to the confusion caused by the implementation of the Capital Gains Tax

· The Eurozone announced on 22nd January its quantitative easing program where it plans to buy Euros 60 billion of bonds every month to stimulate the economy. The program is set to continue until September 2016 or until inflation reaches the medium term target of 2%

· Kenya?s attraction as an investment hub continues to improve. In the February issue of Fortune magazine, Kenya has been named the best African emerging economy to invest in due to accelerated infrastructure development and a stable political and macroeconomic environment

Key Theme of the Month of January is Oil Prices

From mid-2014, oil prices have plummeted from approximately USD 100 a barrel to the current USD 44.48 translating to a 60% decline in prices. The reasons behind this trend lie on both demand and supply side. The oil glut is attributed to the discovery of shale oil in the USA combined with OPEC refusing to reduce production. Conversely, the World Bank?s forecast of a global economic slowdown coupled with stalled recovery in many economies from Japan and the Eurozone are the cause of the deteriorating demand for oil. China, the largest net oil importer is experiencing a declining GDP growth, after more than a decade of very strong growth, which translates to less economic activity hence a decline in demand for oil.

The declining oil prices are expected to decrease inflation rates in Kenya as evidenced by the downward trend of inflation for the fifth month in a row. Inflation declined to 5.53% in January 2015 from 6.02% in December 2014. As of 2014, Kenya?s imports totalled Ksh 160 billion of which 25% was oil. The economy therefore stands to gain from low oil prices as we could see an improvement in the current account position.

On the flip side, the declining oil prices may negatively impact the oil exploration efforts in Kenya. For example, Swala Energy, an Australian firm operating in western Kenya, is already considering closure even before it has started drilling operations. According to a Standard Chartered report, Kenya can only enjoy profits if oil is exported at USD 70 per barrel so the recent declines may lead to lower investments into this sector.

Equities Update

Activity at the Nairobi Securities Exchange (NSE) started on a low note in January as investors and stockbrokers remained apprehensive of the re-introduction of the Capital Gains Tax. Nonetheless, the NASI closed at 165.80, a 2.56% gain. There were a number of recommended changes that were proposed by both the government and the NSE. For starters, the Treasury announced that it will fast-track regulations that will eliminate the cap that limits foreigners from owning more than 75.0% of listed companies. Another important change at the NSE was the Central Depository and Settlement Corporation planning to introduce a settlements platform that will allow for same day transactions. This upgrade will enable investors to buy and sell shares on the same day and possibly gain margins during the day.

Despite the sluggish start to trading at the NSE, we expect activity to pick up. The increased activity will mainly be attributed by the positive economic growth projected for the country as well as the lined up NSE reforms. The changes are expected to boost foreigners? activities and improve capital inflows as the NSE as well as increase liquidity and traded volumes.

The equity markets across the globe experienced mixed fortunes during the month of January largely attributed to the various economic forces, especially the substantial decline in crude oil prices. In the U.S., the DJIA lost 3.7% to close at 17,164.95 while the S&P 500 lost 3.1% to close at 1994.99. The Nikkei, however, gained 4.1% attaining its best January performance in 13 years to close at 17,674.39. In Europe, stocks declined significantly after the Swiss National Bank?s unexpected removal of the cap against the Euro. Even so, markets in Europe, Asia and the U.S. experienced some respite when the European Central Bank announced it would roll out its Quantitative Easing program. Despite the volatility experienced in the global arena as well as declining oil prices, expectations of bullish markets in 2015 remain high.

Fixed Income Update

Inflation declined to 5.53% in January from 6.02% in December driven by petroleum prices and primary food items. Inflation has been declining 5 months in a row from 8.36% in August 2014 nudged by sliding oil prices. There was a slight uptick in Treasury bills rates this month with rates from 8.6%, 10.3% and 10.9% from 8.5%, 10.0% and 10.7% in December 2014 for 91, 182 and 364 day bills respectively; this increase was driven by increased government borrowing in the month.

KBRR rates were revised from 9.13% to 8.54% in mid-January by the Central Bank in a bid to lower lending rates. Whether lending rates will fall remains to be seen. In the past the introduction of KBR has had minimal impact on the lending rates.

The Budget Policy Statement was released with a Kshs 1.9 trillion budgeted expenditure bill, of which Kshs 1.3 trillion will be financed through revenues and the balance through both foreign and domestic borrowings. Kshs. 287 billion will be financed through foreign borrowing and the balance of Kshs. 187 billion from the local markets. The danger we see is that a significant increase in borrowing could lead to the country debt levels rising, as well as exposure to external shocks through foreign financing. However, with Kenya on a trajectory for positive economic growth, the debt levels can be supported.

Eurozone finally announced its Quantitative Easing (QE) program this month where it plans to buy Euro 60 billion of bonds every month until September 2016 to stimulate the Economy. QE is expected to prompt investors to shift into riskier assets rallying the bond and equities in emerging markets compelled by interest rates that are too low in the Eurozone to provide any incentive to invest there. Emerging markets should take a cautionary view and need to plan ahead to mitigate tapering-induced effects when the Eurozone starts to recover and their interest rates are raised. Adequate foreign currency reserves should be built up and exposure diversified in anticipation of capital flight.

In the US, S&P DJI announced its new S&P Aggregate Bond Index covering around 20,000 securities. This is an effort to aggressively augment its fixed income business globally on the back of a clear, growing trend for passive investments worldwide.

Private Equity Review

Here comes the money Africa seems to be the new chorus for foreign investors. Africa continues to be the land of prospect and growth as private equity (PE) firms seek out opportunities to tap in, driven by enthusiasm and need to put capital to work. This was evident in January where Helios partners raised a record USD 1.1 billion for their third African fund

In Kenya, the Egyptian firm Qalaa holdings, formerly Citadel Holdings invested USD 70 million to acquire an 85 % stake in Rift Valley Railways (RVR). The funds are to be invested in hastening cargo handling as well as enhancing efficient cargo movement at the port of Mombasa. This comes at time when the government of Kenya has begun the construction of a second container terminal in Mombasa port as well as the Standard Gauge Railway that will run through Uganda, Rwanda, Burundi, and South Sudan. It is not yet clear how both and RVR and the Standard Gauge Railway will work together in the rail sector.

Unlike in the past where PE firms were inapprehensive about exit options in Africa, January witnessed a number of PE firms that successfully exited after deriving value for their investors. For instance, Helios partners exited by selling half of its stake worth about Kshs. 23 billion in Equity Holdings Limited to Norwegian private equity firm, Norfund while Kenyan based PE firm, Centum Investment sold its 13.75% stake at UAP Holdings Limited for Kshs. 4.06 billion to Old mutual. This quashes exit fears for PE firms amidst a ready market by other investors and PE firms desiring to realise full potential as local firms seek to become local or regional champions.

The increase in PE firm?s participation in Kenya and Africa at large is a clear indication of heightened investor confidence in Africa. This comes at a time when Kenya has been named as the best African emerging economy to invest in and the seventh globally. Kenya has become an attractive investment destination for foreign inflows that has been accelerated by increased infrastructure development and a conducive business environment. The rapid growth of Kenya?s economy and an expanding middle class has resulted in plenty of opportunities available in various sectors such as retail and infrastructure for PE firms to invest in.

Real Estate Review

A study by Hass Consult Real Estate revealed that the land prices in Kenya?s capital city, Nairobi, rose by a five-fold margin over the last seven years. The index, which compares Nairobi?s land price movements to other asset classes and commodities, found that the city?s land had outperformed all other asset classes in return on investment. Further, Nairobi?s Upper hill was listed as the most expensive place to acquire land where currently an acre of land goes for about Kshs. 470 million. The increased movement in land prices has slowly locked out individual buyers from owning land in the prime areas of the city leaving only Institutions and Investment groups to snap up such opportunities.

Kenya has been active with construction and development of residential areas and community projects. The notable ones being the Garden City, Two Rivers Project and the Migaa project among others. This has been attributed to a rising middle-income class and a low supply of housing to meet the high demand. Seeking to address part of this demand, the Kenyan government owned body, National Housing Corporation announced that it was preparing to float a Kshs. 5 billion housing bond in the second half of the year through a listing at the Nairobi Securities Exchange (NSE). The proceeds will be used to increase the annual supply of homes which currently stands at 35,000 against a demand of 200,000 homes annually. The NHC has currently set a target of delivering more than 3,000 residential houses in Nairobi, Mombasa and Kisumu.

As a boost to potential investors in the Real Estate sector, the Kenyan Capital market is setting the stage for the introduction of REITs to the Kenyan market. Kenyan capital markets regulator CMA this month licensed KCB, a leading commercial bank in Kenya, to act as a Real Estate Investment Trust (REIT) trustee. This is part of a strategy by the bank to raise its potential in earning more non-interest income. According to the CMA, the bank had met all the legal requirement to operate as a trustee. The CMA had earlier on licensed several companies which include Centum, UAP, CIC and Stanlib to operate as REIT managers. REITS will offer an opportunity for small investors to participate in the Real estate Industry and for developers to raise capital. Through REITS investors will get an access to income in form of dividends and capital gains, as well as diversification benefits of the Real Estate sector. The introduction of REITs into the Kenyan market will surely be something to watch out for. Currently Kenya only has one company - Home Afrika, as the only developer company that is listed in its bourse.

Conclusion and Summary:

The investment landscape continues to improve for both listed and unlisted securities. The government of Kenya continues to set up regulations that are pro business. Given the low growth levels in the more developed countries, the emerging markets with good growth prospects like Kenya are set to benefit. It is now very important for investors to seek to partner with various good investment firms to take advantage of the positive outlook to invest for the long term among the various asset classes.
