Probable Direction of Kenya Equities Market in 2017, & Cytonn Weekly #3/2017

Cytonn Weekly

Executive Summary

Fixed Income: During the week, T-bills were undersubscribed for the fourth week running, with overall subscription coming in at 82.5%, compared to 74.9% recorded the previous week. Yields on the 91-day T-bill increased by 10 bps to 8.7%, from 8.6% the previous week, while yields on the 182-day and 364-day T-bills remained unchanged during the week, closing at 10.5% and 11.0%, respectively;

Equities: During the week, the Kenyan equities market registered mixed performance, with NASI & NSE 25 both gaining 0.1%, while NSE 20 lost 1.9%. Globally, NASI is the worst performing index year to date, registering a 7.0% decline since the start of the year;

Private Equity: Africa continues to witness increased private equity activity as Nakumatt Holdings Ltd finally lands a strategic investor to inject Kshs 7.7 bn for a 25.0% stake to boost the retailer, while Abraaj expresses interest in acquiring a stake in Barclays Africa Group;

Real Estate: JLL Cities Research Center released a City Momentum Index (CMI) 2017 teaser, which has ranked Nairobi as the world?s 10th most dynamic city, while the Nairobi Urban Transport Improvement Programme announced plans to invest in the Intelligent Traffic Light System (ITS) aimed at easing traffic congestion within the capital;

Focus of the Week: This week we focus on the trends in the local equities market, and the factors that affect the stock market performance, in an effort to forecast the probable direction of the equities market going forward.

Company Updates

- Deputy Governor of Kiambu County, His Excellency Hon. Gerald Gakuha Githinji, was the Chief Guest at the opening of our Ruaka office at The Alma site on Friday, 20th January 2017. **See Event Note**.
- On Monday, 16th January 2017, our Investment Analyst Caleb Mugendi discussed Uchumi Supermarket?s franchise model to expand business in a bid to move into the lower end market, by allowing smaller businesses to use the brand. Watch Caleb on CNBC **here**
- On Wednesday, 18th January 2017, our Investment Analyst John Ndua discussed the World Health Organization?s proposal to hike tax on tobacco in Kenya as a move to curb smoking. Watch John Ndua on CNBC **here**
- On Friday 20th January 2017, our Investments Analyst John Ndua discussed the equities markets in Kenya and East Africa. Watch John Ndua on K24 **here**

- For recent news about the company, see our news section **here**
- In a bid to continue showcasing the real estate developments for Cytonn Investments, we shall be organizing site visits every two weeks right after the Private Wealth Management trainings. If interested in attending the Wealth management training, click here for booking. If interested in attending the site visits, kindly email **clientservices@cytonn.com**
  - The Alma, which is now 55.0% sold and has delivered an annualized return of 55.0% p.a. for investors who bought off-plan. **See The Alma.**
  - Amara Ridge is currently 100.0% sold. See **Amara Ridge**
  - Following the completion of sales for Amara Ridge, we are currently looking for land in Karen for our next development. Contact us at **res@cytonn.com** if you have any land for sale or joint ventures in Karen
- We have 12 investment-ready projects, offering attractive development returns and buyer's targeted returns of around 25.0% p.a. See further details here: **Summary of investment-ready projects**
- 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:
- We continue to beef up the team with the ongoing hires: **Careers at Cytonn**

Fixed Income

During the week, T-bills were undersubscribed for the fourth week running with overall subscription coming in at 82.5%, compared to 74.9% recorded the previous week. Liquidity remained tight in the market and we saw the Central Bank of Kenya (CBK), in a bid to ease the liquidity situation in the market, participate in the reverse repo market, injecting Kshs 8.9 bn during the week. The participation in the Treasury Bills market remained low, but the acceptance rate improved to 97.3% compared to 52.7%, the previous week, an indication that investors pricing was within the government?s acceptable boundaries. Subscription rates on the 91, 182 and 364-day papers came in at 123.3%, 93.1% and 44.6%, from 86.2%, 93.7% and 48.7%, respectively, the previous week. Yields on the 91-day T-bill increased by 10 bps to 8.7% from 8.6% from the previous week while yields on the 182-day and 364-day T-bills remained unchanged during the week, closing at 10.5% and 11.0%, respectively. Going by the subscription rates, investors prefer the 91-day and 182-day papers, an indication of the uncertainty in the interest rates environment.

The CBK Weekly Report revealed that the interbank rate increased by 80 bps to 8.3%, from 7.5% registered the previous week, a reflection of the skewed liquidity distribution in the money market towards larger banks. The volumes transacted in the interbank market declined significantly to Kshs 12.7 bn from Kshs 23.1 bn transacted the previous week. The net liquidity injection of Kshs 13.1 bn was driven by government payments of Kshs 19.1 bn, T-bill redemptions of Kshs 12.4 bn and Reverse Repo purchases of Kshs 8.9 bn, offsetting tax remittances by banks of Kshs 11.4 bn, Reverse Repo maturities of Kshs 9.6 bn and T-bill issuances of Kshs 6.3 bn. As highlighted in our Cytonn Weekly #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.

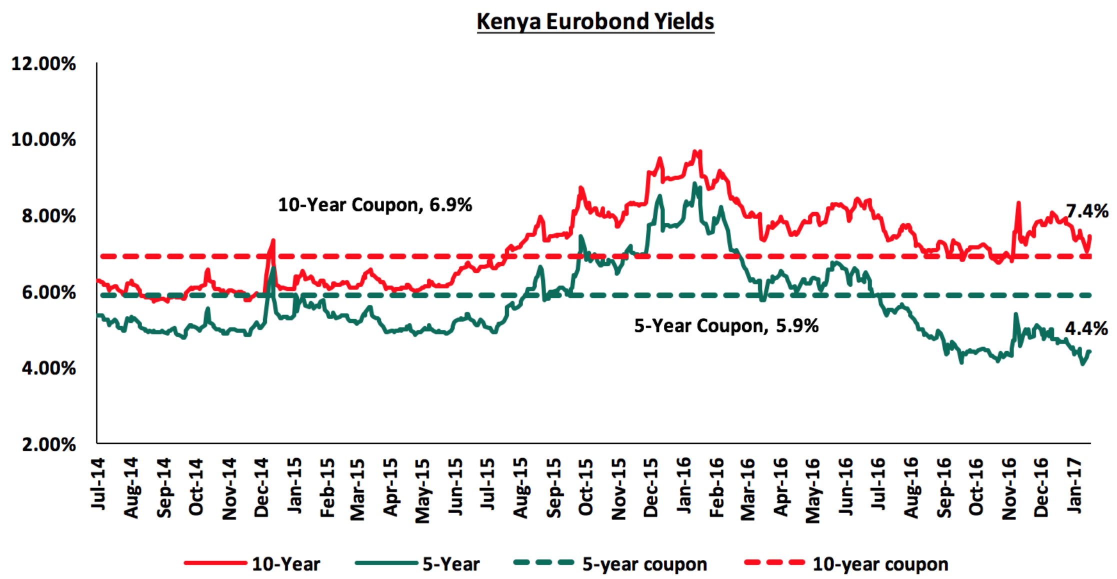
Below is a summary of the money market activity during the week:

all values in Kshs bn, unless stated otherwise			
Monthly Liquidity Position ? Kenya			
Liquidity Injection		**Liquidity Reduction**	
Term Auction Deposit Maturities	0.0	T-bond Sales	0.0
Government Payments	19.1	Transfer from Banks ? Taxes	11.4
T-bond Redemptions	0.0	T-bill (Primary issues)	6.3
T-bill Redemption	12.4	Term Auction Deposit	0.0
T-bond Interest	0.0	Reverse Repo Maturities	9.6
Reverse Repo Purchases	8.9	Repos	0.0
Repos Maturities	0.0	OMO Tap Sales	0.0

Total Liquidity Injection	**40.4**	**Total Liquidity Withdrawal**	**27.3**
		Net Liquidity Injection	**13.1**

The Kenyan Government has re-opened a 15-year bond with an effective tenor of 5.4 years, to raise Kshs 30.0 bn for budgetary support. In the last 2 auctions, the government rejected expensive bids from investors, given that they are ahead of their domestic borrowing target and hence under no pressure to borrow expensively. However, it is important to note that (i) the government has only borrowed Kshs 45.8 bn from the foreign market against its foreign borrowing target of Kshs 462.3 bn, and (ii) the Kenya Revenue Authority (KRA) has already missed its first quarter of 2016/17 fiscal year revenue collection target by 18.4%, and is also expected to miss its overall revenue collection target of Kshs 1.5 tn for the current fiscal year. Given that (i) a 5-year bond is currently trading at a yield of 13.4% in the secondary market, and (ii) there is skewed liquidity currently being witnessed in the market, we expect investors to bid for the bond at yields above the secondary market yield, at a bidding range of 13.6% - 14.5%.

According to Bloomberg, the yield on the 10-year Eurobond increased week on week by 10 bps to 7.4%, from 7.3% the previous week, whereas that of the 5-year Eurobond increased week on week by 20 bps to 4.4%, from 4.2% the previous week. The increase could be a reflection of the increased perceived risk levels as the country heads into an election in August this year. Since the mid-January 2016 peak, yields on the Kenya Eurobonds have declined by 2.2 percentage points and 4.4 percentage points for the 5-year and 10-year bond, respectively, due to improving macroeconomic conditions. This is an indication that Kenya remains an attractive investment destination.



The Kenya Shilling remained steady during the week to close at Kshs 103.9, the same rate as recorded the previous week, on account of the CBK intervention with the forex reserves declining by USD 91.0 mn to support the shilling to counter pressure from the global dollar strengthening. On a year to date basis, the shilling has depreciated against the dollar by 1.3%. In recent months, we have seen the forex reserves reduce to USD 6.9 bn (equivalent to 4.5 months of import cover), from USD 7.8 bn in October 2016 (equivalent to 5.2 months of import cover). As stated in our Cytonn Weekly #45, this is worrying as the rate of decrease in the forex reserves could be an indication that the CBK is using significant reserves to support the shilling. However, it is important to note that if the reserve levels drop too low, the government can access the IMF credit facility, comprised of a USD 989.8 mn 24-month Stand-By Agreement (SBA) and USD 494.9 mn 24-month Stand-By Credit Facility (SCF), bringing the combined facility to USD 1.5 bn.

We are projecting inflation for the month of January to rise slightly to the range of 6.5% - 6.7%, from 6.4% in December 2016, driven by a rise in food prices caused by the ongoing drought, and an increase in fuel prices, which have been pushing up the cost of energy. In as much as upward inflationary pressures are expected to persist, we expect inflation to be within the government target annual range of 2.5% - 7.5%. We shall witness upward inflationary pressures from (i) the food component of the CPI basket due to the persistent dry weather expected to carry on for the first half of the year, (ii) global recovery of oil prices spurring cost-push inflation, and (iii) the weakening shilling due to global strengthening of the dollar increasing the cost of imports thus importing inflation.

The Central Bank of Kenya (CBK) released its quarterly economic review for the first quarter of fiscal year 2016/17, comparing the data to the fourth quarter of the fiscal year 2015/16. The report reviews the key macroeconomic indicators during the quarter. The key highlights from the report include:

- Money supply declined by 0.2% in Q1?2016/17 compared to an increase of 3.5% witnessed in Q4?2015/16 attributed to a slowdown of 9.6% in call and savings deposits, following the reclassification of savings accounts by commercial banks after the capping of interest rates in September last year,
- The weighted average interbank rate increased by 1.0 percentage point, to 5.2% in Q1?2016/17 from 4.2% in Q4?2015/16. This has been driven by uneven distribution of liquidity in the money market, with Tier I banks trading high volumes at low rates amongst themselves, while the smaller banks have to settle for higher rates,
- The average lending rate by commercial banks declined by 4.4% to 13.8% in Q1?2016/17, from 18.2% in Q4?2015/16, reflecting the impact of the interest rates capping. The average deposit rate improved marginally to 6.9% from 6.8% in the same period, reducing the banks? spread to 6.9% from 11.4%, and,
- The total public and publicly guaranteed debt increased by 2.4% during the first quarter of fiscal year 2016/17 attributed to a 2.5% rise in foreign borrowing and a 2.2% rise in domestic borrowing, a slower growth compared to 10.2% and 8.3% for foreign and domestic borrowing in Q4?2015/16, respectively. This led to an increase of 1.3 percentage points in the total public debt to GDP ratio at the end of the period to 53.8%, from 52.5% previously.

The data for the first quarter of the fiscal year indicates stabilized macroeconomic conditions despite the uneven money market liquidity distribution and rising government borrowing. The government projects the external debt and domestic debt to account for 24.1% and 26.7% of the GDP, respectively, by the end of the current fiscal year. As highlighted in our Cytonn Weekly #2/2017, the government has initiated plans to raise USD 1.1 bn through syndicated loans as part of the budget financing for this fiscal year, and to assist the government in boosting its foreign reserves, and in the process, bring stability to the shilling. The debt sustainability update in March 2016 indicated that Kenya faces low risk to external debt distress as we also highlighted in our Cytonn Weekly #49. However, going forward, there are risks associated with the changing funding patterns that could see the debt levels continue to rise, and are already above the 50.0% threshold set by International Monetary Fund (IMF) for developing economies.

The (IMF) released its January 2017 World Economic Outlook (WEO) report highlighting key movements in global economic growth with a focus on advanced economies and emerging economies. The table below summarizes the key changes from the October WEO report:

Economies	January 2017 WEO Projections			% Points Change from October 2016 WEO Projections	
	2016e	2017f	2018f	2017f	2018f
Advanced Economies	1.6%	1.9%	2.0%	**0.1%**	**0.2%**
United States	1.6%	2.3%	2.5%	**0.1%**	**0.4%**
Euro Area	1.7%	1.6%	1.6%	**0.1%**	**0.0%**
Emerging Markets	4.1%	4.5%	4.8%	**(0.1%)**	**0.0%**
China	6.7%	6.5%	6.0%	**0.3%**	**0.0%**

Sub- Sahara Africa	1.6%	2.8%	3.7%	**(0.1%)**	**0.1%**
Nigeria	(1.5%)	0.8%	2.3%	**0.2%**	**0.7%**

- Advanced economies positive change in growth will be attributed to the expected fiscal stimulus in the US that will spur GDP growth to 2.3% in 2017 and 2.5% in 2018 as well as stronger economic performance during the second half of 2016,
- Emerging and developing economies are expected to gradually stabilize from the current harsh macroeconomic conditions in large economies to attain a growth of 4.1% in 2016 and 4.5% in 2017,
- The growth forecast for China in 2017 was revised upwards attributed to the expectation of continued fiscal policy stimulus. However, continued reliance on stimulus of fiscal policy and a rapid expansion of government debt levels raises the risk of a slowdown and sustainability in China?s economic growth,
- In Sub-Saharan Africa, the annual economic growth in 2017 was revised downwards as the region continues to experience wavering macroeconomic conditions while the growth projection for 2018 was increased. However, growth in Nigeria was adjusted upwards on account of increased oil production as global oil prices set in for a resurgence, as well as improved security.

According to the report, low-income and developing economies such as Kenya continue to experience the effect of low commodity prices, including agricultural produce, and expansionary budgetary policies, which have seen the erosion of fiscal buffers leading to increased risks in the respective economies and heightened vulnerability to external shocks. The IMF recommends such economies to (i) prioritize restoration of fiscal buffers by reducing public debt and saving budgetary resources, (ii) continue efficient spending on critical infrastructural developments, (iii) strengthen debt management in order to improve domestic revenue mobilization, and (iv) implement structural reforms that will pave the way for economic diversification and higher productivity in order to reduce vulnerability to changing global financial conditions.

The Government is ahead of its domestic borrowing for this fiscal year having borrowed Kshs 164.0 bn for the current fiscal year against a target of Kshs 132.5 bn (assuming a pro-rated borrowing throughout the financial year of Kshs 229.6 bn budgeted for the full financial year). It is important to note, however, that the government is in the process of revising its domestic borrowing target upwards to Kshs 294.6 bn, which will take the pro-rated borrowing target to 170.0 bn, meaning that the government will fall slightly behind its borrowing target, especially in a tight money market liquidity condition such as we are now experiencing. The government has only borrowed Kshs 45.8 bn from the foreign market against its foreign borrowing target of Kshs 462.3 bn, and the Kenya Revenue Authority (KRA) having already missed its first quarter of 2016/17 fiscal year revenue collection target by 18.4%, is expected to miss its overall revenue collection target of Kshs 1.5 tn for the current fiscal year. This creates uncertainty in the interest rate environment as the government might have to plug in the deficit likely to arise from the lag in revenue collection and foreign borrowing from the domestic market, a move which may exert upward pressure on interest rates. It is due to this that we think it is prudent for investors to be biased towards short-term fixed income instruments.

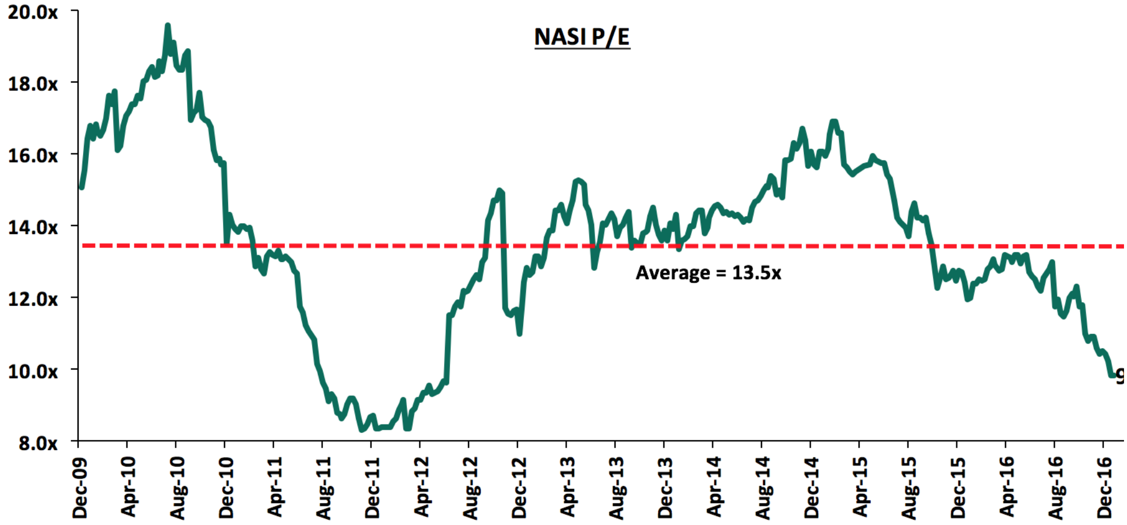
Equities

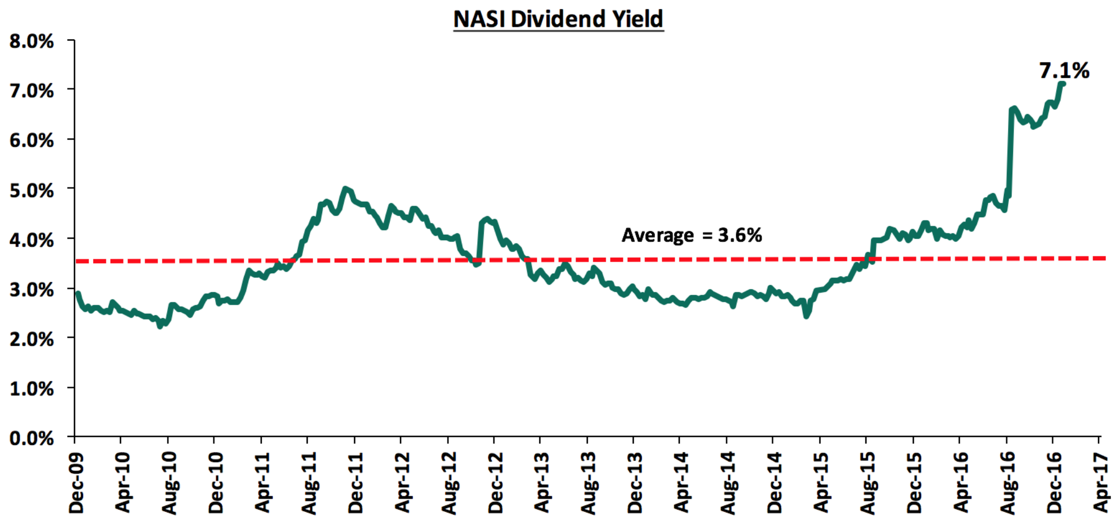
During the week, the Kenyan equities market registered mixed performance, with NASI & NSE 25 both gaining 0.1%, while NSE 20 lost 1.9%. This takes the YTD performances for the NASI, NSE 20 and NSE 25 to (7.0%), (8.5%) and (8.5%), respectively. Despite gains in large cap stocks such as BAT, EABL and Safaricom, which gained 7.1%, 3.3% and 1.1%, respectively, these gains were offset by losses in other large cap stocks such as Standard Chartered, Barclays and Bamburi Cement, which lost 7.2%, 4.9% and 3.2%, respectively. Since the February 2015 peak, the market has lost

47.0% and 30.1% for NSE 20 and NASI, respectively.

Equities turnover increased by 6.5% to close the week at USD 28.6 mn from USD 26.9 mn the previous week. Foreign investors were net buyers with net inflows of USD 829,000, a decline of 67.1% compared to a net inflow of USD 2.5 mn recorded the previous week, with foreign investor participation decreasing to 12.9%, from 86.1% recorded the previous week. Safaricom and EABL were the top movers for the week, jointly accounting for 65.4% of market activity. We expect the Kenya equities market to be flat in 2017, driven by slower growth in corporate earnings, neutral investor sentiment on the coming general elections and the rate hike cycle in the US.

The market is currently trading at a price to earnings ratio of 9.8x, versus a historical average of 13.5x, with a dividend yield of 7.1% versus a historical average of 3.6%. The current 9.8x valuation is only 18.1% above the most recent trough valuation of 8.3x experienced in December of 2011. The charts below indicate the historical P/E and dividend yields of the market.





Kenya?s NASI is the worst performing index globally, having dropped by 7.0% since the beginning of the year. This comes after poor performance of the stock market in 2016, which saw NASI, NSE 20 and NSE 25 lose 8.5%, 21.1% and 15.8%, respectively. The decline has been attributed to (i) uncertainty surrounding the upcoming August general elections as investors take a wait-and-see approach, and (ii) the decline in the price of banking stocks due to anticipated decrease in interest income as a result of the Banking (Amendment) Act, 2015, which stipulates the loan and deposit pricing frameworks for banks. As highlighted in our focus of the week for this week, we expect the prices to remain flat given the prospects for the macroeconomic environment for 2017 being less positive compared to 2016.

During the week, the Communications Authority of Kenya (CAK) released Telecommunications Sector statistics for Q3?2016. Key highlights from the report were:

- Mobile subscriptions declined by 3.0% to 38.5 mn, from 39.7 mn registered in the previous quarter, taking the y/y growth to 1.9%, with mobile penetration decreasing by 2.7 percentage points to 87.3% from 90.0% registered in the previous quarter. This decline is attributed to Telkom revising its subscribers to exclude non-active subscribers as per the regulatory requirements,
- The minutes of use per subscriber per month in the industry increased by 4.0% to 89.4 minutes, from 86.0 minutes registered the previous quarter,
- The total number of Short Messaging Service (SMS) sent during the quarter increased significantly by 5.2% to 12.2 bn messages from 11.6 bn registered in the last quarter,
- The number of internet broadband subscriptions increased during the quarter under review to 11.9 mn from 10.8 mn recorded in the previous quarter, attributed to increased digitization of services and high uptake of internet enabled mobile phones that are affordable and readily available in the market. The broadband penetration closed at 27.0%, up from 24.5% the previous quarter, and,
- Internet subscriptions stood at 25.6 mn subscribers during the quarter under review, down from 26.8 mn registered in the previous quarter, which was a decline of 4.5% as a result of removal of non-active subscribers. Despite this, the number of internet users remained steady at 37.7 mn, with one subscription able to serve a number of users.
- Important to note is that ?internet broadband subscriptions? include those subscriptions to homes and offices, while ?internet subscriptions? refer to those offered by mobile operators.

Safaricom gained market share across all categories except mobile money and minutes of use. Other service providers? highlights from the report were:

- Safaricom?s subscriber market share increased by 3.7 percentage points to 68.9% from 65.2% while its minutes? market share decreased by 1.5 percentage points to 76.3%. Safaricom?s SMS market share increased from 93.9% to 94.4% on account of its new SMS bundle offers,
- Airtel?s total mobile subscriptions increased by 3.1% to stand at 6.7 mn during the period under review from 6.5 mn in the previous quarter while the pre-paid subscriptions increased by 2.7% and post-paid subscriptions increased by 2.2%. Airtel market share by subscriptions increased by 0.9% to 17.5% in Q3?2016 from 16.6% registered in the previous quarter,
- Equitel?s mobile subscriptions increased by 13.3% to stand at 2.3 mn during the period under review from 2.0 mn the previous quarter. Equitel?s total subscriber market share increased by 0.8 percentage points to stand at 5.9%,
- Orange Kenya had a subscription growth of 44.0% at 2.9 mn down from 5.2 mn recorded in the previous quarter, while the total number of pre-paid subscriptions dropped by 44.1%, with the post-paid subscriptions dropping by 8.0%. Orange Kenya?s market share by subscriptions decreased by 5.6 percentage points to 7.6% in the quarter under review from 13.2% recorded in the previous quarter,
- The mobile money statistics, however, indicated that Safaricom?s market share of the value of transactions declined to 78.7% from 84.3% and transaction numbers declined to 81.6% from 81.9% in Q3?2016 from Q2?2016, respectively. The loss in market share is mainly attributed to Equitel, though Equitel has an additional banking channel and hence banking transactions have been included in its market share data whereas Safaricom exclusively focuses on money transfer and payments.

Similar to the last quarter, the industry has recorded improved growth in terms of mobile subscriptions and data consumption. Given the rapid population growth and technological advancements, we expect the industry to continue experiencing strong growth.

Commercial banks in the country continue to experience a difficult operating environment after the enactment of the Banking (Amendment) Act 2015, which saw the interest rates capped on both loan pricing and deposit pricing, reducing interest margins significantly. In the recent past, we have witnessed several banks announce plans to cut on costs by laying off employees and shutting down some branches and adopt alternative banking channels, which are cheaper and more efficient. This week, we witnessed Bank of Africa indicating a planned closure of 12 branches in a bid to increase efficiency through alternative banking channels.

Of the 40 operating banks in Kenya, 9 have already announced restructuring plans, equating to 22.5% of the entire sector. This is a worrying statistic, and given the expected continuation of consolidation in the banking sector, we expect this trend to continue going forward as the banks optimize on digital banking platforms and reduce staff costs in a bid for efficiency.

KENYA BANKING SECTOR RESTRUCTURING			
No.	**Bank**	**Staff Retrenchment**	**Branches Closed**
1.	Sidian Bank	108	-
2.	Equity Bank	400	-
3.	Eco bank	-	9
4.	Family Bank	Unspecified	-
5.	First Community	106	-
6.	Bank of Africa	-	12
7.	National Bank	Unspecified	-
8.	NIC	32	-
9.	Standard Chartered	300	-

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

- We have placed ARM Cement under review and will give an updated valuation next week.

all prices in Kshs unless stated									
EQUITY RECOMMENDATION									
No.	**Company**	**Price as at 13/01/17**	**Price as at 20/01/17**	**w/w Change**	**YTD Change**	**Target Price***	**Dividend Yield**	**Upside/ (Downside)****	**Recommendation**
1.	Bamburi Cement	155.0	150.0	(3.2%)	(3.1%)	231.7	7.8%	62.3%	Buy
2.	KCB Group***	26.5	26.5	0.0%	(7.8%)	39.6	7.5%	56.9%	Buy
3.	Britam	10.4	9.9	(4.8%)	3.5%	13.5	2.9%	39.9%	Buy
4.	NIC	22.5	22.8	1.1%	(13.5%)	30.8	3.5%	38.9%	Buy
5.	Sanlam Kenya	24.5	22.3	(9.2%)	(10.9%)	30.5	0.0%	37.1%	Buy
6.	Stanbic Holdings	65.5	69.0	5.3%	(7.1%)	84.7	7.9%	30.7%	Buy
7.	Equity Group	25.8	26.3	1.9%	(14.2%)	31.3	7.7%	26.9%	Buy
8.	CIC Insurance	3.8	3.6	(5.3%)	0.0%	4.4	2.5%	24.7%	Buy
9.	HF Group	11.9	12.0	1.3%	(15.4%)	13.8	9.2%	24.2%	Buy
10.	Co-op Bank	12.1	11.8	(2.9%)	(8.3%)	13.6	6.8%	22.5%	Buy
11.	Kenya Re	21.8	23.0	5.7%	(3.3%)	26.9	3.6%	20.6%	Buy
12.	I&M Holdings	87.0	81.0	(6.9%)	(3.3%)	90.7	3.9%	15.9%	Accumulate
13.	Liberty	13.5	12.2	(9.3%)	2.3%	13.9	0.0%	13.9%	Accumulate
14.	BAT (K)	850.0	910.0	7.1%	(6.5%)	970.8	6.2%	12.9%	Accumulate
15.	Barclays	8.2	7.8	(4.9%)	(10.4%)	7.6	9.7%	7.8%	Hold
16.	DTBK***	116.0	114.0	(1.7%)	(1.7%)	116.8	1.8%	4.3%	Lighten
17.	Standard Chartered***	180.0	167.0	(7.2%)	(4.8%)	157.7	6.6%	1.0%	Lighten
18.	Jubilee Insurance	495.0	494.0	(0.2%)	1.0%	482.2	1.8%	(0.6%)	Sell
19.	Safaricom	18.0	18.2	1.1%	(6.3%)	16.6	3.6%	(4.9%)	Sell
20.	NBK	6.5	6.9	6.2%	(10.4%)	3.8	0.0%	(44.5%)	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 remain ?neutral with a bias to positive? for investors with short to medium-term investments horizon and are ?positive? for investors with long-term investments horizon.

Private Equity

Nakumatt Holdings Ltd, Kenya?s biggest retail chain by sales and network presence, has landed a strategic investor to inject Kshs 7.7 bn for a 25.0% stake, valuing the business at Kshs 30.8 bn. Nakumatt has been considering having a strategic investment partner to inject capital, in order to support its operational costs and boost its expansion strategy but has often settled on bank loans and commercial paper, which have been an expensive source of financing in the short-term, as well as constrained their cash flows away from working capital. Nakumatt, which is owned by the Atul Shah family, has been facing a number of challenges, with increasing debt levels in the last five-years from Kshs 4.7 bn in 2012 to Kshs 18.0 bn in 2016, in order to manage their working capital needs given high competition and low margins. The liquidity position was worsened by the drying up of liquidity in the commercial paper market post the collapse of Chase Bank and non-performance of other commercial paper. This injection will enable the company to reduce its debt burden. Despite the difficulties in paying suppliers and keeping some outlets stocked, the retailer has maintained its plans to expand its presence in the region by adding 14 branches in two-years to the currently existing 63 branches across Kenya, Uganda, Rwanda and Tanzania. This will enable them to strengthen their foothold in the region and remain competitive given the new entry of global brands such as Botswana-based Choppies and Carrefour SA of France. Alongside the stake sale, the company has also improved its corporate governance by naming three professionals to its management team; Mr Andrew Dixon, Mr Manoj Warrier and Mr James Gakumo to spearhead Marketing, Information Technology and Risk Management, respectively. The expansion of the core management team beyond just the family is a positive development for Nakumatt.

Dubai based Abraaj Group, a private equity firm with focus on emerging markets, has expressed renewed interest to buy into the remaining 50.1% Barclays? International stake in Barclays Africa Group. The bank attracted attention of several investors including Public Investment Corporation, the Group?s second largest shareholder with a 6.8% stake and Atlas Mara, a firm founded by Bob Diamond, ex-Barclays CEO. In a plan to cut its holdings in Barclays Africa Group to 20.0%, Barclays International sold 103.6 mn shares for about USD 80.0 mn (12.2%) to a group of new and existing investor with 1.2% of this taken up by Public Investment Corporation. Barclays Africa Group is also selling or closing its other non-core operations to strengthen its balance sheet and improve overall efficiency. Abraaj, which manages about USD 10.0 bn in assets globally, may bid for up to 35.0% of Barclays Africa, which is valued at about USD 2.6 bn at market price. The South African Reserve Bank however cautioned that it would oppose a full buy-out from a private bidder. The successful bidder will benefit from the banks strong platform across the continent with more than twelve thousand branches and have the opportunity to tap into the banks large client base of more than twelve million customers.

Private equity investment activity in Africa has continued to improve, as evidenced by the increase in the number of deals and deal volumes in the region. In East Africa, preference this week has been skewed towards the financial and retail industries. We remain bullish on PE as an asset class in Sub-Saharan Africa given (i) the abundance of global capital looking for investment opportunities in Africa, (ii) attractive valuations in the private sector, and (iii) strong economic growth projections, compared to global markets.

Real Estate

During the week, JLL Cities Research Centre released a teaser for their City Momentum Index (CMI) 2017. According to the teaser, Nairobi was ranked as the world?s 10th most dynamic city among the

134 Cities sampled, an improvement from its 11th position in 2016 .

The Index tracks the speed of change of a city's economy and commercial real estate market by assessing a broad range of socio-economic and real estate factors to identify a city?s momentum. The following are the variables used:

- **Short-term Momentum:** City gross domestic product, population, corporate headquarter presence, commercial real estate construction and rents, and foreign direct investments, and,
- **Long-term Momentum:** Education, innovation and environment.

The Index also captures the signals of change that are likely to underpin future city success. The report indicates that Nairobi is characterised by low costs, rapid consumer market expansion and high levels of foreign direct investment (FDI). All of these factors have necessitated the improvement of infrastructure and boosted real estate development to support the city?s expansion. We will be analysing the report further once it is released on 1st February 2017.

During the week, the Nairobi Urban Transport Improvement Programme announced plans to invest in the Intelligent Traffic Light System (ITS) aimed at easing traffic congestion within the city. The system is to be implemented by Kenya Urban Roads Authority and HP Gauff Consultants, a German based firm. It will be funded by the World Bank and the Government of Kenya at an approximate cost of Kshs 1.4 billion and is set to kick off after the design and planning stage. The system will involve installation of new sensor-powered traffic lights and the redesigning of junctions. The system will comprise of cameras at intersections that will determine the most clogged roads through vehicle number plates embedded with microchips that Kenya is moving to adopt, and automatically synchronise traffic lights resulting in roads with heavy traffic to flow freely.

This project will have a positive impact through easing traffic congestion especially on roads such as Mombasa Road, Langata Road and Thika Road, among others. The ease in congestion will lead to:

- Improving performance of real estate in areas such as Mombasa Road through boosting uptake. In specific, poor performance in the commercial and retail sector has been attributed to traffic jams in comparison to other areas such as Kilimani and Gigiri. This is evidenced by low uptake of both offices and retail space at 72% and 83%, respectively, in comparison to other areas with an average uptake of above 90%, and,
- Opening up of satellite towns such as Mlolongo, Thika and Athi River within the Nairobi Metropolis, through increased developments and higher uptake for housing. This will be a result of the new traffic system easing the movement to CBD and other commercial nodes.

We are of the view that this initiative will improve real estate industry once accomplished, since traffic has mainly affected various nodes in the city rendering them under-utilized, and creating an environment of efficient movement of goods and services throughout the Nairobi Metropolis.

Retail developers in Kenya are seeking to improve the quality of their offering in a bid to be competitive in the market. This was evident this week as the developers of Two Rivers Mall Developers, Centum Investments, hired a German realtor, Ms. Agnieszka Mielcar,z to serve as head of the Two Rivers Mall, the largest shopping complex in Eastern Africa, ahead of its opening scheduled for February 2017. The mall located along Limuru Road is in close proximity to the affluent neighbourhoods of Runda, Nyari and Gigiri, which create the key market and foot fall for the approximately 700,000 SQFT destination mall. This mall is expected to increase retail space supply in Nairobi by 16% in 2017 and it is targeting the high rental yields averaging 10% and occupancy rates of approximately 90% being witnessed in the retail sector.

The Government, through lands cabinet secretary, has reassured land owners on the validity of their title deeds. This is a follow up to the ruling by the high court in a landmark judgement, delivered this week, declaring invalid all forms, regulations and forms of titles such as Title Deeds promulgated by the ministry of lands in an effort to bring onto operation provisions of the Land Act, 2012. The ruling would affect over 3 mn land title deeds issued by the Jubilee Administration since 2013. The judgement however has accommodated the following clauses that will protect the earlier affected land owners, as it states:

- The judgement will not be retroactive, meaning the transactions that had been completed would not be affected by the judgement, and,
- The coming into effect of the judgement would be suspended for 12-months to allow for public participation and consultation with the National Land Commission.

This Judgement is, in our view, a step in the right direction as it not only reinforces the rule of law, which is a critical element in providing a conducive environment for a vibrant real estate sector but also extols the values of public participation as espoused in our 2010 Constitution. This is a definite step in the right direction where courts are in step with economic realities of the day and goes a long way in building investors? confidence.

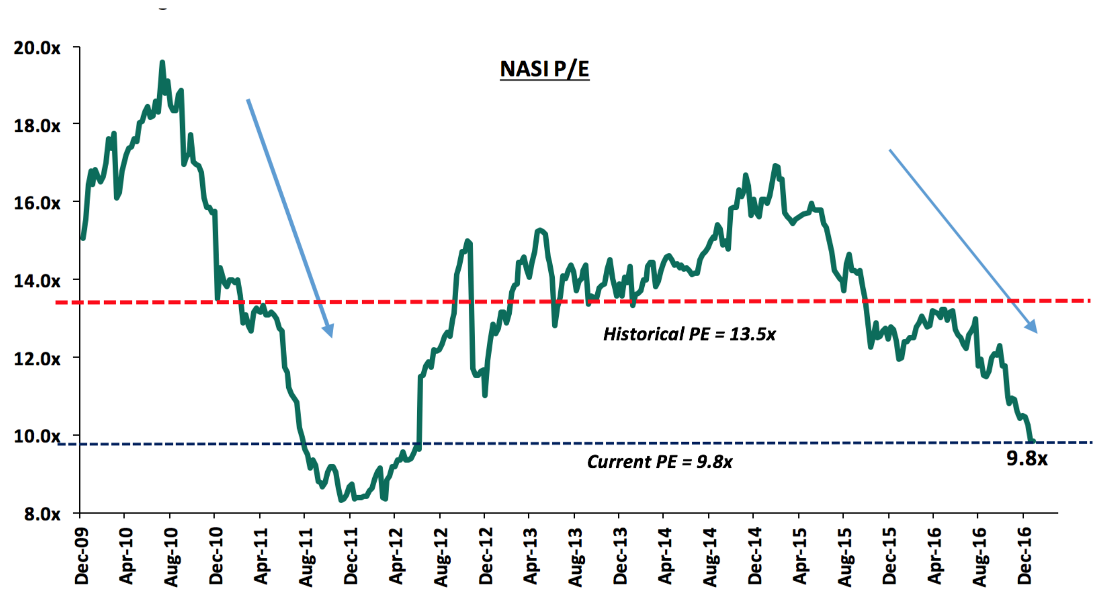
We expect increased development activity and investments into real estate as an asset class supported by the improvement of infrastructure to support the city?s expansion and the high returns being earned in the sector.

Probable Direction of Kenya Equities Market in 2017

In our topical ?Probable Direction of Equities Market in 2016?, we analyzed the trend in the local equities market and the factors that determine the stock market performance in an effort to forecast the direction of the equities market. The Kenyan Equities market saw a year of poor performance in 2016 with NASI, NSE 20 and NSE 25 losing 8.5%, 21.1% and 15.8%, respectively. So far the market has continued with its downward trend with NASI, NSE 20 and NSE 25 having lost 7.0%, 8.5% and 8.5%, respectively on a year to date.

Since the inception of the all share index in 2008, valuations, as measured by price to earnings ratio (?**PE**?), have peaked twice; once in August 2010 and the other in February 2015. Since the August 2010 peak of 19.6x, prices went on a downward spiral for 16-months to hit a low of 8.3x in December 2011, registering an annualized loss of 47.5% over the 16-month decline period. The market then picked up with prices rising for a period of 38-months to peak on February 2015 at a valuation of 16.9x, registering an annualized gain of 25.2% over the 38-month increase period. Since then, the market has steadily declined over the last 23-months, currently at 9.8x, registering an annualized loss of 24.7% over the 23-month decline period. Currently the market valuations are below the historical average, and just 18.1% above the most recent trough of 8.3x, and long-term investors can now access the market at cheap valuations. However, the question still remains, have the markets troughed? Or are we up for a further decline in the future?

Currently, the market is on a bear run, mirroring the decline from the August 2010 peak to the December 2011 trough. A casual glance at the PE chart indicates the PE may be in store for a further decline for a few months before reversing tren



How ever, in-order to properly understand what direction the market might take, several key metrics need to be analyzed. These metrics will be compared over the two periods i.e. July 2011, when the market was at the same valuation as the current period and also in a downward trend, to December 2011, when it troughed. Through analyzing and comparing the market conditions during the last 2 periods of persistent decline in market prices, and our outlook for 2017, we can make a judgement as to whether this trend will continue as per the previous cycle due to similar market conditions, or recover due to better market conditions compared to the last cycle. The 6 metrics to be observed include:

GDP Growth

From July 2011 to December 2011, GDP growth averaged 4.2% underpinned by tough macroeconomic conditions such as high inflation, high interest rates and at one point a rapidly depreciating currency. This poor economic performance was also reflected in the stock market, which lost 21.3% in the same period. However, the following year saw the stock market rebound, delivering a return of 38.7%, a positive correlation with the higher GDP growth of 4.6%. Despite a projection of a slower GDP growth for 2017 than 2016 at between 5.4% - 5.7%, we do not expect this to significantly affect the stock market thus we remain **neutral**.

Interest Rates

The volatility in interest rates as indicated by (i) the 91-day T-bill rising from 9.0% in July 2011 to 18.9% in December 2011, later falling back to 10.1% in June 2012, and (ii) the CBR being increased by 11.0% to 18.0% in June 2012, from 7.0% previously, led to poor performance of the stock market as most debt reliant companies struggled to fund their operations while others preferred to invest in fixed income instruments as opposed to the stock market. The following period witnessed stability of interest rates with the 91-day T-bill averaging at 9.2%, a positive for the stock market. This year we expect some upward pressure on interest rates as the government plugs in the deficit that may arise from foreign borrowing and tax collection from the local borrowing program. We however don?t anticipate the upward pressure to reach the levels in 2011, thus having a **neutral** effect on the stock market performance.

Inflation

The inflation trend in 2011 was unsettling, averaging at 14.0%, having peaked at 19.7% in November. This affected the stock market negatively. We expect 2017?s inflation to rise slightly but be contained within the government target of 2.5% - 7.5%. This is not likely to trigger any monetary action from the CBK and as a result, we expect the stable inflation levels to provide some levels of support to the local stock market performance. This will have a **neutral** effect on the equities market.

Exchange Rate

In 2011, the Kenya Shilling hit a low of 105.9 against the dollar in October 2011, a depreciation of 11.6% in one year?s period, resulting in sell-offs in the stock market triggering a downward trend in the market performance. However, the depreciation of the shilling was then as a result of speculation, as opposed to the current expected weakening of the shilling, which is due to structural issues and the recovery of the US economy with the Fed citing a possibility of three rate hikes this year. Additionally, the reliance of dollar denominated foreign debt has increased since 2011 further piling pressure on the shilling when it comes to servicing. This will have a **negative** effect and add to the downward pressure on the equities market.

Corporate Earnings

2011 witnessed strong corporate earnings with the banking sector recording earnings growth of 20.5% from July 2011 to June 2012. During the year, only 5 listed companies issued profit warnings compared to 4 in 2016. In 2016, earnings growth is expected to be lower at 12.5%, with banks recording earnings growth of 9.3% in Q3?15. We expect earnings growth to remain subdued in 2017, with expectations of an earnings growth of 8.0%, especially given the enactment and operationalization of the Banking (Amendment) Act 2015. Given this corporate earnings growth rate, this gives a forward P/E of 9.6x, relatively cheaper than historical average of 13.6x. As a result of this, we expect a **neutral** effect the market.

Investor Sentiment

The Eurozone crisis led to poor investor sentiment especially for the risky frontier markets that led to a reduction in foreign investors? activities at the Nairobi Securities Exchange. The US economy was also on a recovery path and still struggling. Furthermore, the elections to be held this year might have some negative impact as investors take a wait-and-see approach. For the year 2017, the world economy is bound to recover with the Chinese economy stabilizing, commodity prices expected to rebound and the US economy at its strongest level since 2008. We also believe that the impacts of the expected increased rate hike cycle in the US and the general elections is likely to affect foreign participation in the market therefore leading to significant foreign outflow from the market, however, we remain **neutral**.

Market valuations in 2011 were low bottoming at a PE of 8.3x. Currently, the market is trading at a PE of 10.6x with projected earnings growth of 8.0%, leading to a forward PE of 9.6x indicating the market is trading at the same level compared to where it was in 2011.

These factors have been summarized in the table below: -

Macro-Economic Indicators	July 2011 ? December 2011 Experience	2016 Experience	2017 Projections	Effect (2017)

GDP growth	3.7% growth in Q3?11 and 4.6% growth in Q4?11	GDP growth during the year was at: - i) 5.2% growth in Q1?16 ii) 5.6% growth in Q2?16 iii) 6.3% growth in Q3?16	GDP growth is expected to come between 5.4% - 5.7% supported by (i) Government continued expenditure on infrastructure, (ii) the recovery of the tourism sector, and (iii) the continued growth of the construction sector	**Neutral**
Interest Rates	The CBR rate was at 6.25% in June 2011 and was increased to 18.0% by December 2011 91 Day T-Bill was at 8.99% in July 2011. It increased to 18.95% by December 2011	CBR stood at 11.5% up to April. It then it was reduced by 100 basis points to 10.5%. It was later reduced by 50 points in August to 10% which stood for the remainder of the year	Expected upward pressure on interest rates as government seeks to plug deficit, but not to the levels witnessed in 2011	**Neutral**
Inflation	Inflation stood at 14.5% in June 2011 and increased to 18.93% by December 2011. The inflation rates decreased gradually remaining in double digits to 10.1% by June 2012	Inflation remained within CBK?s expectations of 2.5%-7.5%. The highest inflation was in January which stood at 7.8%	We expect upward inflationary pressure in 2017 but average within the government target driven by (i) drought which will persist until mid-2017 driving food prices up, (ii) currency depreciation as the dollar strengthens globally, and (iii) the expected rise in oil prices	**Neutral**
Exchange Rate	The Shilling depreciated 25.2% against the USD from an average of 89.3 in June 2011 to highs of 105.96 in Oct 2011. The foreign reserves hit a low of 3.59 months of import cover, but climbed to 3.74 months in December 2011	The Kenya shilling remained stable during the year, depreciating by 0.2% to close at 102.5. Forex reserves hit a high of 5.2 months and closed the year at 4.6 months	We expect the shilling to depreciate against the dollar driven by (i) continued global strengthening of the dollar as the Fed plans to increase their rate hiking cycle in 2017, and (ii) recovery of the global oil prices	**Negative**

Security & Investor Sentiment	The Euro crisis led to reduced foreign investor activities at the Nairobi Securities Exchange which dampened investor sentiment, setting the NSE on a bear run, losing 29%. The country also faced insecurity due to the rising Al-Shabaab threat	Uncertainties such as Brexit and the US general elections caused concern for investors in the global market. Security remained relatively stable during the year as a result of various security measures implemented during the year	We expect 2017 to register reduced net foreign outflows due to uncertainties regarding political and social risks as Kenya undertakes general elections, and expectations of a more aggressive rate hike cycle by the Fed. We expect security to be maintained in the country supported by government initiatives towards improving internal security	**Neutral**
Corporate Earnings Growth and Valuation	The banking sector pre-tax profit grew 20.5% from December 2010 to December 2011, with an overall growth of 7.8% for the same period	NASI and NSE 20 Index fell 8.5% and 21.1% respectively	We expect corporate earnings growth of 8.0% in 2017 due to lower earnings for financial companies attributed to the implementation of the Banking Act (Amendment) ,2015	**Neutral**
	NASI and NSE 20 Index fell 21.3% and 29.0% respectively. 5 listed companies issued profit warnings	4 Listed companies issued profit warnings	Assumption of corporate earnings growth rate of approximately 8.0% gives a forward P/E of 9.6x, relatively cheaper than historical average of 13.6x	

Way Forward in 2017:

Following the above comparison, we find that out of the 6 key metrics that we are analyzing, only one is negative while the rest remain neutral. The only metric that is negative is the exchange rate. This is primarily because the shilling will probably weaken due to (i) global strengthening of the dollar as the Fed hikes the fed rate, and (ii) increase in global oil prices. Key to note, there is no metric that favors a positive performance of the stock market. This supports the hypothesis that the equities market will most likely remain flat for 2017, at best or continue to decline given its an election year and the valuations are yet to hit the troughs experienced in December 2011.

We would recommend a gradual increasing of equities allocation during 2017, and even then have a long-term view and pick stocks that are deeply undervalued but with strong earnings prospects.

Liason House, StateHouse Avenue
The Chancery, Valley Road