Cytonn INVESTMENTS

The Impact of the ongoing Drought on the Kenyan Economy, & Cytonn Weekly #8-2017

Cytonn Weekly

Executive Summary

Fixed Income: During the week, T-bills were oversubscribed for the fourth week running, with overall subscription coming in at 185.4%, compared to 182.5% recorded the previous week. Kenya has entered into an agreement with Egypt to increase bilateral trade between the two countries;

Equities: During the week, the equities market was on an upward trend with NASI, NSE 20 and NSE 25 gaining 1.5%, 2.5% and 1.5%, respectively. KenGen sold a 5.3% stake to South Africa?s pension fund, Public Investment Corporation (PIC), for Kshs 2.3 bn, with the proceeds being used to reduce its debt load and fund new power projects;

Private Equity: Africa continues to witness increased private equity activity as (i) Nairobi businessman, Chris Kirubi moves to buy back his previously owned 51.0% stake in Haco Industries from South Africa?s Tiger Brands, (ii) France?s Amethis Finance and South Africa?s Metier jointly acquired a 40.0% stake in Kenafric Industries, and (iii) mobile credit firm Tala raises Kshs 3.0 bn in new capital for expansion;

Real Estate: Shelter Afrique and Thika Royal Palms benefit from equity injections from AfDB and Fusion Capital, respectively; while the hospitality sector is poised for growth as the government, through the Tourism Ministry has put in place measures to boost holiday and business travel;

Focus of the Week: Earlier in the month, the government declared drought a national disaster, appealing for aid through the National Drought Emergency Fund, in a bid to mitigate the effects of the ongoing drought that has crippled parts of the country. We analyse the potential effects of the drought on the economy.

Company Updates

- On Saturday, Cytonn Investments organized a site visit to its signature developments in a bid to showcase the real estate products of its real estate development affiliate, Cytonn Real Estate. See Event Note here To visit any of our 12 ongoing developments or sites for our upcoming developments, which support our above average market returns, please sign up for an upcoming site visit here
- In September 2016, the President assented into law a bill capping lending rates at 4.0% above the Central Bank Rate (CBR), currently at 10.0%, and the deposit rates at 70% of the CBR. We held a client training session at our Chancery offices along Valley Road on the effects of this law on the available investments opportunities. See Training. To sign up for any of our upcoming Wealth Management Trainings, visit this link here

- Our Investment Manager, Maurice Oduor, discussed the state of the economy with a focus on housing accessibility in Kenya. Watch Maurice Oduor on KTN News here
- Our Investment Analyst, Caleb Mugendi, discussed the Capital Markets Authority?s decision to allow pension schemes to invest in the exchange traded derivatives a move which will post higher benefits for retirees. Watch Caleb Mugendi on CNBC here
- Our Market Research and Site Acquisition Manager, Johnson Denge, gave an insight on the growth of the retail sector in Kenya. Watch Johnson Denge on CNBC here
- For recent news about the company, see our news section here
- 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:
  - The Alma, which is over 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
  - The Ridge Phase One is currently 20.0% sold. See The Ridge
  - Taraji Heights is currently 10.0% sold. See Taraji Heights
- 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.comif you have any land for sale or joint ventures in Karen
- We continue to beef up the team with the ongoing hires: Careers at Cytonn

Fixed Income

During the week, T-bill auctions were oversubscribed for the fourth week running, with overall subscription coming in at 185.4%, compared to 182.5% recorded the previous week. Subscription rates for the 91, 182 and 364-day papers came in at 96.2%, 412.5% and 17.7%, compared to 37.8%, 300.4% and 161.1% the previous week, respectively. The 91-day and 364-day papers witnessed under subscription during the week as investor preference was more skewed towards the 182-day paper, which continues to offer investors higher returns on a risk-adjusted basis. Yields on the 91, 182 and 364-day T-bills remained relatively unchanged during the week, closing at 8.6%, 10.5% and 10.9%, respectively. The Central Bank (CBK) has remained disciplined in stabilizing interest rates in the auction market by rejecting bids that CBK considers as above market, and we have seen the market respond to this, with the current overall bids received acceptance rate of 75.8%, compared to 71.6% at the beginning of the year. Given the possible upward pressures on interest rates, we maintain our recommendation for investors to be biased towards short-term fixed income instruments.

The average interbank rate declined by 30 bps w/w to 6.5% from 6.8%, despite tight liquidity in the money market with an overall liquidity reduction of Kshs 12.2 bn; the interbank volumes transacted decreased to Kshs 9.2 bn from Kshs 10.4 bn the previous week. There was a decline in Government Payments and Term Auction Deposit Maturities, which came in at Kshs 9.7 bn and Kshs 3.3 bn, from Kshs 21.8 bn and Kshs 19.7 bn, respectively, the previous week, while Repo sales and T-bill issues increased to Kshs 19.7 bn and Kshs 26.5 bn, from Kshs 12.8 bn and Kshs 22.9 bn, respectively, the previous week.

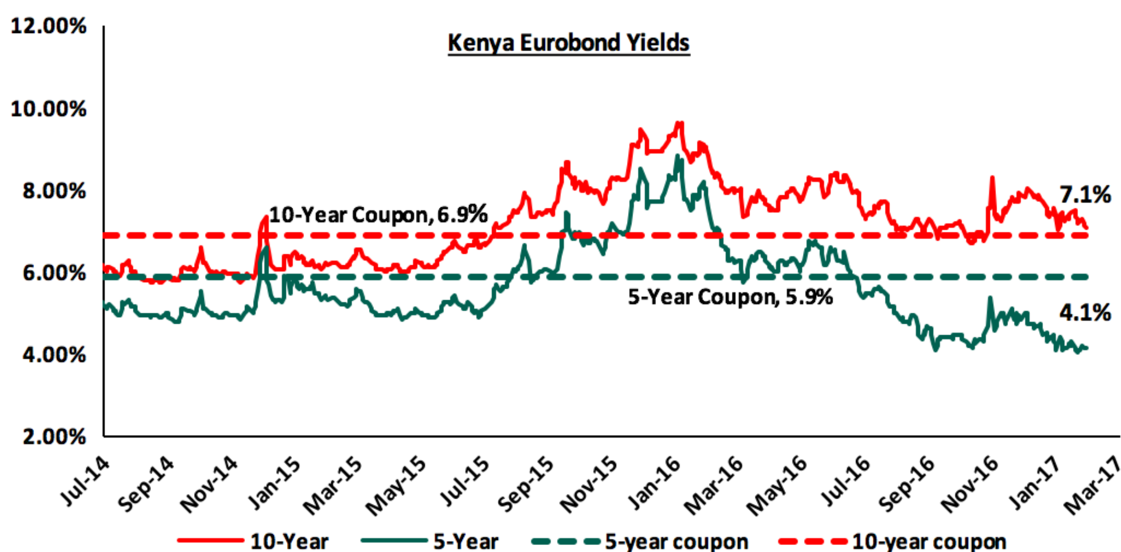
Below is a summary of the money market activity during the week:

all values in Kshs bn, unless stated otherwise			
Weekly Liquidity Position ? Kenya			
Liquidity Injection		**Liquidity Reduction**	
Term Auction Deposit Maturities	3.3	T-bond sales	6.0
Government Payments	9.7	Transfer from Banks - Taxes	32.6

T-bond Redemptions	23.6	T-bill (Primary issues)	26.5
T-bill Redemption	20.8	Term Auction Deposit	3.3
T-bond Interest	6.5	Reverse Repo Maturities	7.4
T-bill Re-discounts	0.0	Repos	19.7
Reverse Repo Purchases	6.6	OMO Tap Sales	0.0
Repos Maturities	12.8		
Total Liquidity Injection	**83.3**	**Total Liquidity Withdrawal**	**95.5**
		Net Liquidity Injection	**(12.2)**

Last week, the Kenyan government offered a 12-year amortized Infrastructure Bond (with an effective tenor of 8.8 years), at a coupon rate of 12.5%, to raise Kshs 30.0 bn for partial support of infrastructural projects in the roads, energy and water sectors. Yields for the bond came in at 13.6%, which was within our bidding recommendation of 13.5% and 14.3% as highlighted in our Cytonn Weekly #7/2017. The government continues to reject expensive money from investors, only accepting Kshs 6.0 bn from total bids received worth Kshs 35.0 bn, which translates to an acceptance rate of only 17.1%. Given that (i) the government has only borrowed Kshs 123.5 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 half of 2016/17 fiscal year revenue collection target by 3.2%, and is expected to miss its overall revenue collection target of Kshs 1.5 tn for the current fiscal year, we expect the government to come under pressure to borrow from the domestic market to meet the high level of debt maturities, which may result into an upward pressure on interest rates.

According to Bloomberg, the yield on the 5-year and 10-year Eurobonds declined by 20 bps and 10 bps w/w to 4.1% and 7.1%, from 4.3% and 7.2%, respectively, the previous week. Since the mid-January 2016 peak, yields on the Kenya Eurobonds have declined by 4.7% points and 2.5% points, respectively, for the 5-year and 10-year bond due to improving macroeconomic conditions. This is an indication that Kenya remains an attractive investment destination.



The Kenya Shilling remained relatively firm this week, closing the week at Kshs 103.6 on account of reduced dollar demand from manufacturing firms and improved remittances from donors. On a year to date basis, the shilling has depreciated against the dollar by 1.0%. In recent months, we have seen the forex reserves reduce to USD 6.9 bn (equivalent to 4.6 months of import cover), from USD 7.8 bn in October 2016 (equivalent to 5.2 months of import cover). The level of forex reserves has now stabilised, an indication of the confidence of the Central Bank with the current levels of the shilling.

Kenya has entered into an agreement with Egypt to increase bilateral trade between the two countries in the coming years. This comes after a state visit of the Egyptian president, where the two heads of state agreed to implement agreements on trade that had been pending from earlier years. The agreements will see Kenya reach a double-taxation treaty consensus with Egypt to protect traders from double taxation and implementation of regulations on protection of investments. Egypt

is a key trading partner to Kenya after the Eastern African Region countries, with exports to Egypt amounting to Kshs 20.2 bn as at full year 2015, approximately 3.5% of the country?s total exports. Egypt is the second largest importer of Kenyan Tea after the Euro Area and the largest exporter to Kenya in the Common Market for Eastern and Southern Africa (COMESA) region. We expect this move to boost trade between the two countries given the current political stability in Egypt.

The Kenya Bankers Association (KBA), has established talks with the government on the withdrawal of interest rates cap, which has seen loans and deposits priced based on the Central Bank Rate (CBR), currently at 10.0%. The private sector credit growth has stagnated at 4.3% as at December 2016, a 16-month low attributed to the law that came into effect in August last year, locking out ?risky? borrowers from accessing funds. KBA is assessing the impact of the interest rate cap in the economy and will present the findings to the parliament for assessment and in support of change in the law. The international Monetary Fund (IMF) has recently warned Kenya on the adverse effects of the interest rate caps citing that it would hinder economic growth, which is forecasted to come in at 5.7% for the year 2016. As highlighted in our Cytonn Weekly #46, we do not expect the private sector credit to pick up if the interest rate cap law is retained and a reverse impact will be expected on economic growth for the year, which is projected at 6.1% in 2017 as per the IMF. As detailed in our piece against the bill, the rate cap remains bad for the economy: Cytonn Weekly #34.

The Kenyan Government is set to sign a USD 800.0 mn syndicated loan from four banks to finance its infrastructural projects and support the weakening shilling. The government last month borrowed USD 750 mn through syndicated loans to support the budget and boost foreign reserves. The current levels of government debt are a threat to economic stability, given that, debt repayments for the country came in at Kshs 15.5 bn for the quarter ending September 2016, with most of the payments being interest. The global strengthening of the dollar is likely to make the dollar denominated debt repayments more expensive thus exerting adverse effects on economic growth. Kenya?s 5-year Eurobond matures in the fiscal year 2018/19, which will see the government make a huge repayment despite a persistent expansionary fiscal policy and budget deficit. As noted in our Cytonn Weekly #51, the trend in Kenya?s debt position is concerning and will only add to the country?s rising debt burden currently at 52.3% of GDP, from about 40.0%, 3-years ago, already above the IMF recommendation of 50.0% of debt to GDP for frontier markets.

The Government is ahead of its domestic borrowing for the current fiscal year having borrowed Kshs 198.7 bn against a target of Kshs 154.5 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 Kshs 198.2 bn, implying that the government will be on target on its borrowing. The government has only borrowed Kshs 123.5 bn, of the budgeted foreign borrowing, representing 26.7% of its foreign borrowing target of Kshs 462.3 bn, and given Kenya Revenue Authority (KRA) has already missed its first half of 2016/17 fiscal year revenue collection target by 10.6%, and it 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 by borrowing from the domestic market, a move that may exert upward pressure on interest rates, and result in longer term papers not offering investors the best returns on a risk-adjusted basis. It is due to this that we think it is prudent for investors to be biased towards short-term fixed income instruments.

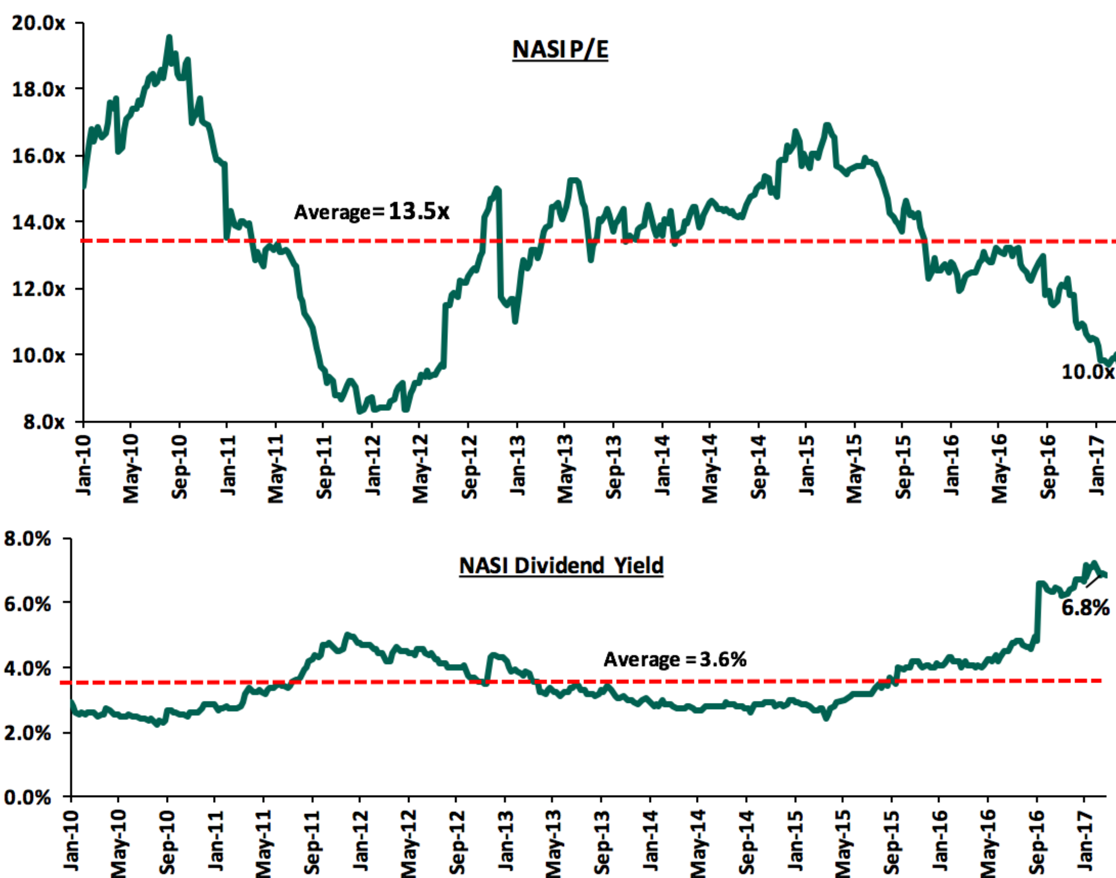
Equities

During the week, the equities market was on an upward trend with NASI, NSE 20 and NSE 25 gaining 1.5%, 2.5% and 1.5%, respectively, taking their YTD performances to (5.1%), (5.1%) and

(6.6%), respectively. This week?s performance was supported by gains in select large cap stocks such as KCB and EABL, which gained 5.1% and 0.9%, respectively. Since the February 2015 peak, the market has lost 45.0% and 28.7% for NSE 20 and NASI, respectively.

Equities turnover increased by 7.2% to close the week at USD 28.6 mn, from USD 26.7 mn the previous week. Foreign investors were net buyers with net inflows of USD 1.9 mn, an increase of 89.3% compared to a net inflow of USD 1.0 mn recorded the previous week, with foreign investor participation decreasing to 76.9%, from 81.0% recorded the previous week. Safaricom was the top mover for the week, accounting for 54.3% of market activity. We expect the Kenyan equities market to be flat in 2017, driven by slower growth in corporate earnings, neutral investor sentiment on the coming general elections and the aggressive rate hike cycle in the US.

The market is currently trading at a price to earnings ratio of 10.0x, versus a historical average of 13.5x, with a dividend yield of 6.8% versus a historical average of 3.6%. The current 10.0x valuation is only 20.5% 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.



KenGen has sold a 5.3% stake to South Africa?s pension fund, Public Investment Corporation (PIC), for Kshs 2.3 bn, effectively valuing the company at Kshs. 43.4 bn. Use of proceeds is to reduce its debt load and fund new power projects. The Kshs 351.2 mn shares offered at rights issue price of Kshs 6.6, will fill the funding gap that was left in the last year?s cash call, where KenGen raised Kshs 26.4 bn against a Kshs 28.7 bn target. The funds raised in the sale will boost KenGen?s financial position and help it in implementation of the robust expansion project pipeline as highlighted in our Cytonn Weekly #42, which when completed, will be geared towards meeting the increasing demand for power, leading to sustained earnings for the company.

Barclays Bank released FY?2016 results

Barclays Bank of Kenya Ltd released their FY?2016 results recording core earnings per share decline of 12.3% to Kshs 1.4 from Kshs 1.6 in FY?2015, against our expectation of Kshs 1.3. The drop in core

earnings was driven by a 19.8% growth in total operating expenses which outpaced a 7.5% growth in total operating revenue;

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

- Total operating revenue grew by 7.5% to Kshs 31.7 bn from Kshs 29.5 bn in FY?2015. This was supported by a 9.4% growth in Net Interest Income and a 3.3% growth in Non-Funded income
- Net Interest Income grew by 9.4% to Kshs 22.3 bn from Kshs 20.4 bn supported by 11.2% growth in interest income to Kshs 28.1 bn from Kshs 25.3 bn in FY?2015, despite a faster growth in interest expense of 18.7% to Kshs 6.0 bn from Kshs 5.9 bn in FY?2015, resulting into a Net Interest Margin of 10.5% from 10.4% in FY?2015
- Non-funded income (NFI) recorded an increase of 3.3% to Kshs 9.3 bn from Kshs 9.1 bn in FY?2015. The increase in NFI was driven by a 161.0% rise in other income from fixed income trading and Bancassurance, to Kshs 1.0 bn from Kshs 0.4 bn in FY?2015, and a 28.8% increase in forex income to Kshs 2.6 bn from Kshs 2.0 bn in FY?2015. The current revenue mix stands at 70:30 funded to non-funded income from 69:31 in FY?2015
- Total operating expenses grew by 19.8% to Kshs 20.8 bn from Kshs 17.4 bn in FY?2015 following a 122.4% y/y growth in Loan loss provision (LLP) to Kshs 3.9 bn from Kshs 1.8 bn. Without LLP, operating expenses grew 8.2% to Kshs 16.9 bn from Kshs 15.6 bn registered in FY?2015. Staff costs grew marginally by 4.6% to Kshs 9.7 bn from Kshs 9.3 bn In FY?2015;
- Cost to income ratio worsened to 64.3% from 59.0% in FY?2015. Without LLP, cost to Income ratio stood at 53.4% from 53.0% in FY?2015;
- Profit after tax declined by 12.3% to Kshs 7.4 bn from Kshs 8.4 bn in FY?2015;
- Loan and advances grew by 15.9% to Kshs 168.5 bn from Kshs 145.4 bn while customer deposits grew by 7.9% to Kshs 178.2 bn from Kshs 165.1 bn leading to an increase in the loan to deposit ratio to 94.6% from 88.1%; the LDR has reached unacceptably high levels
- Barclays Bank Kenya is currently sufficiently capitalized with a core capital to risk weighted assets ratio at 15.7%, 5.2% above the statutory requirement, with total capital to total risk weighted assets exceeding statutory requirement by 3.4% to close the period at 17.9%.

Going forward, Barclays Bank will thrive on (i) continued investment in the automation and digitization of systems, processes and solutions in a bid enhance efficiency as well as to provide their customers with convenient access to products and solutions**,** and (ii) revenue diversification with new business lines such as Barclays Financial Services Limited (BFSL) coupled with stronger focus on SMEs and agency banking leveraged by the bank to spur growth.

For a more comprehensive analysis, see our Barclays Bank FY?2016 Earnings Note.

Stanbic Holdings released FY?2016 results

Stanbic Holdings released FY'2016 results posting a 9.9% decline in core EPS to Kshs 11.2 from Kshs 12.4 in FY'2015 driven by a 30.1% growth in operating expenses to Kshs 12.5 bn from Kshs 9.6 bn, which outpaced operating income that grew by 9.3% to Kshs 18.5 bn from Kshs 16.9 bn.

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

- Total operating revenue grew by 9.3% to Kshs 18.5 bn from Kshs 16.9 bn, driven by a 16.7% growth in Net Interest Income and a 0.2% growth in Non Funded Income;
- Net Interest Income grew by 16.7% to Kshs 10.9 bn from Kshs 9.3 bn, resulting into a Net Interest Margin of 5.8% from 5.5% in FY?2015

- Non-funded income (NFI) remained flat at Kshs 7.7 bn from Kshs 7.6 bn in FY?2015, a marginal growth of 0.2%. The current revenue mix stands at 59:41 Funded to Non-Funded Income from 55:45 in FY?2015;

- Operating expenses grew by 30.1% to Kshs 12.5 bn from Kshs 9.6 bn driven by a 93.1% growth in credit impairment charges to Kshs 1.8 bn from Kshs 0.9 bn in FY?2015; excluding the impairment charges, operating expenses grew by 23.4% to Kshs 10.7 bn from Kshs 8.7 bn in FY?2015;
- Cost to income ratio deteriorated to 67.3% from 56.6% in FY?2015 and excluding LLP, cost to income ratio stood at 57.9% from 51.2% in FY?2015
- Profit after tax declined by 9.9% to Kshs 4.4 bn from Kshs 4.9 bn in FY?2015.
- Loans and advances grew by 3.4% to Kshs 132.6 bn from Kshs 128.2 bn while customer deposits grew by 1.4% to Kshs 155.8 bn from Kshs 153.7 bn leading to an increase in the loan to deposit ratio to 85.1% from 83.4%.

Stanbic earnings were below expectations especially given that it recorded a decline in profitability in FY?2015. Compared to Barclays Bank, which has also released FY?2016 results, both the deposit gathering and loan disbursement were poor, with loan and deposit growing at 3.4% and 1.4%, respectively. Despite the decreased profitability, going forward we expect Stanbic Holdings? growth to be propelled by their diversified and clearly defined business strategy, enabling the bank to respond effectively to shifting market dynamics, with their non-funded income at 41.4% of total operating income, coupled with the roll out of their new digital platform and support systems.

For a more comprehensive analysis, see our Stanbic Holdings FY?2016 Earnings Note.

BAT released FY?2016 results

BAT released their FY?2016 results, recording core earnings per share decline of 14.9% to Kshs 42.3 from Kshs 49.8 in FY?2015, driven by a 10.8% decline in net revenue to Kshs 19.9 bn from Kshs 22.3 bn as a result of a 24.1% y/y increase in excise tax to Kshs 16.8 bn from Kshs 13.6 bn.

Key points to note include:

- Operating revenue declined by 10.8% to Kshs 19.9 bn from Kshs 22.3 bn despite a 2.4% increase in gross revenue to Kshs 36.7 bn from Kshs 35.8 bn. This was mainly attributed to the shift in the excise duty regime in Dec 2015 to a uniform rate system from a tiered approach that saw cigarette prices increase, hence impacting volumes especially of the mainstream brands;
- Operating expenses declined by 8.8% to Kshs 13.3 bn from Kshs 14.5 bn, owing to stringent cost management, productivity and overhead savings. The company also undertook a reorganization in the second half of 2016 at a cost of Kshs 338.0 mn to enhance organizational effectiveness. These included process changes in the factory, arising from the commencement of printing of graphic health warnings on cigarette packets from September 2016 in compliance with the new Tobacco Control Regulations;
- EBITDA margin dropped to 16.9% from 21.4% in FY?2015;
- Finance costs declined by 44.8% to Kshs 0.3 bn from 0.5 bn, due to lower foreign exchange related losses and interest expenses;
- Profit after tax declined by 14.9% to Kshs 4.2 bn from Kshs 5.0 bn as a result of decline in net revenue offset by lower costs;
- The Board of Directors recommended the payment of a final dividend of Kshs 39.5 per share, bringing total dividend to Kshs 4.3 bn, which equals to 4.4% dividend yield.

BAT continues to operate in a highly regulated environment, with constant upward review of excise tax continuing to suppress margins. However, the company has consistently grown its revenue base while keeping costs low. Going forward, we expect sustained growth in earnings for BAT to be driven by efficiency and cost reduction initiatives to ensure it remains profitable.

KPLC released H1?2017 results

KPLC released their H1?2017 results recording core earnings per share increase of 11.4% to Kshs

2.2 from Kshs 1.9, driven by a 5.1% increase in total revenue to Kshs 59.6 bn from Kshs 56.7 bn, and a 22.9% decline in fuel costs to Kshs 6.2 bn from Kshs 8.1 bn owing to a decline in the unit cost of fuel.

Key points to note include:

- Operating revenue increased by 9.9% y/y to Kshs 45.7 bn from Kshs 41.7 bn, driven by rising electricity sales due to expanded customer base;
- Operating expenses increased by 5.2% y/y to Kshs 51.6 bn from Kshs 49.1 bn, driven by a 4.6% y/y increase in power purchase costs to Kshs 26.1 bn from Kshs 25.0 bn, due to (i) a 5.6% increase in unit purchases to 4,786 GWh from 4,532 GWh, and (ii) a 23.6% increase in transmission and distribution costs to Kshs 16.1 bn from Kshs13.1 bn as a result of expansion of the company?s electricity network. Fuel costs however decreased by 22.9% to Kshs 6.2 bn from Kshs 8.1 bn, due to a decline in the unit cost of fuel;
- This led to a reduction in the EBITDA margin to 13.2% from 14.6% in FY?2015;
- Finance costs decreased by 11.6% to Kshs 2.3 bn from Kshs 2.6 bn, attributed to reduced short term borrowing arising from restructuring of the balance sheet;
- Cash balances decreased by 93.2% to Kshs 0.9 bn from Kshs 13.5 bn due to aggressive implementation of capital projects;
- Profit before tax declined by 1.7% to Kshs 5.6 bn from Kshs 5.7 bn, attributed to a decline in finance income by Kshs 0.7 bn as a result of reduced bank balances;
- Profit after tax increased by 11.4% to Kshs 4.2 bn from Kshs 3.7 bn despite the 1.7% decline in profit before tax, as a result of a tax credit;
- The Board of Directors did not recommend the payment of an interim dividend for the period.

Going forward, we expect sustained earnings for KPLC to be driven by (i) Kenya?s growing demand for power supported by the Kenyan government?s Last Mile Connectivity Project that seeks to have at least 70% of Kenyans connected to electricity by end of 2017, and (ii) implementation of key capital projects through expansion and continued upgrade of the distribution network, which will generate higher sales.

Below is our Equities Recommendation table. Key changes include:

- Liberty moved to an ?Accumulate? recommendation with an upside of 12.1% from a ?Buy? recommendation with an upside of 20.9%, following a 2.1% w/w price increase
- NIC Bank moved to a ?lighten? recommendation with an upside of 1.3% from an ?Accumulate? recommendation with an upside of 17.6% following a 13.0% w/w price increase
- We have placed Stanbic Holdings under review and shall give an updated valuation next week

all prices in Kshs unless stated									
EQUITY RECOMMENDATION									
No.	**Company**	**Price as at 17/02/17**	**Price as at 24/02/17**	**w/w Change**	**YTD Change**	**Target Price***	**Dividend Yield**	**Upside/ (Downside)****	**Recommendation**
1.	Bamburi	148.0	146.0	(1.4%)	(8.8%)	231.7	7.8%	66.5%	**Buy**
2.	KCB Group***	25.5	25.0	(2.0%)	(13.0%)	39.6	7.5%	65.9%	**Buy**
3.	ARM	19.4	19.8	1.8%	(22.5%)	31.2	0.0%	58.0%	**Buy**
4.	Kenya Re	20.0	19.2	(4.3%)	(14.9%)	26.9	3.6%	44.1%	**Buy**
5.	HF Group	10.7	11.1	3.8%	(21.1%)	13.8	9.2%	34.1%	**Buy**
6.	Britam	10.0	10.7	7.0%	7.0%	13.5	2.9%	29.1%	**Buy**
7.	Equity Group	27.0	27.0	0.0%	(10.0%)	31.3	7.7%	23.6%	**Buy**
8.	Sanlam Kenya	25.0	25.5	2.0%	(7.3%)	30.5	0.0%	19.6%	**Accumulate**
9.	I&M Holdings	74.5	79.5	6.7%	(11.7%)	90.7	3.9%	18.0%	**Accumulate**
10.	Co-op Bank	12.5	12.5	0.0%	(5.3%)	13.6	6.8%	15.6%	**Accumulate**
11.	BAT (K)	906.0	902.0	(0.4%)	(0.8%)	970.8	6.2%	13.8%	**Accumulate**

12.	Liberty	12.2	12.4	2.1%	(6.1%)	13.9	0.0%	12.1%	**Accumulate**
13.	DTBK***	107.0	107.0	0.0%	(9.3%)	116.8	1.8%	11.0%	**Accumulate**
14.	NIC	27.0	30.5	13.0%	17.3%	30.8	3.5%	4.5%	**Lighten**
15.	Jubilee	480.0	490.0	2.1%	0.0%	482.2	1.8%	0.2%	**Lighten**
16.	Barclays	8.8	8.8	0.0%	(3.8%)	7.6	9.7%	(3.4%)	**Sell**
17.	Safaricom	18.5	18.0	(2.7%)	(6.0%)	16.6	3.6%	(4.1%)	**Sell**
18.	StanChart***	175.0	203.0	16.0%	7.4%	157.7	6.6%	(15.7%)	**Sell**
19.	NBK	6.3	6.0	(4.8%)	(16.7%)	3.8	0.0%	(36.7%)	**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 we have now turned ?positive? for investors with long-term investments horizon.

Private Equity

This week, Amethis Finance, a French based Private Equity (PE) fund focused on long term investment in Africa, and Metier, a South African PE fund, partnered to jointly acquire a 40.0% stake in Kenafric Industries for an undisclosed amount. Kenafric Industries is one of the largest manufacturers of confectionery, culinary, stationery, and footwear products in Kenya, of which 45.0% are sold in 10 African countries outside of Kenya through its impressive distribution network. Amethis Finance, having completed 14 successful investments across Africa, brings to the table valuable expertise in expansion across the continent. Metier has a successful track record in private equity investing in Southern Africa, and has experience in similar transactions in the packaged foods industry. The transaction is limited to the confectionary and culinary business lines, with the footwear and stationery business lines being operated separately by the Shah family. The partnership will allow Kenafric to utilise Amethis? and Metiers? experience and relationships in the region, along with a strong capital base, to expand in the East African region, with Kenafric first targeting expansion into Ethiopia. Amethis and Metier plan to benefit from a fragmented East African market by investing in Kenafric?s existing manufacturing and distribution base to turn it into a regional market leader.

Kenyan businessman Chris Kirubi, has begun the process of buying back the 51.0% stake of Haco Industries at an undisclosed amount that he had sold to Tiger Brands for around Kshs 363.0 mn in 2008. He will pay a premium to have total control of the Kenyan based Fast Moving Consumer Goods companies (FMCG) company which deals in the manufacture and distribution of plastics, cosmetics and food products. Tiger Brands, one of Southern Africa?s largest FMCG companies with an extensive distribution network that spans across 22 countries, is exiting Haco Industries due to (i) a financial scandal at the Haco Industries that saw the parent company make a loss of Kshs 312.0 mn in 2015, (ii) disagreements on the current business model adopted by Haco Industries which is not aligned to Tiger?s business model of fully owning leading brands, and (iii) Tiger?s strategic plan to promote its own products across the market, which has conflicted with Haco?s licencing agreements. Tiger acquired Haco Industries back in 2008 with the aim of entering the East African market. Haco will remain under local leadership, with Mr. Kirubi owning a 100% stake, and will continue working with its strategic international partners including Societe Bic and Jeyes Plc.UK among others, to grow penetration of their products across the East African market.

Kenya?s FMCG sector continues to attract private equity investments as a result of (i) well established distribution network, (ii) growth in retail sector, (iii) increase in disposable income to be spent on consumables, and (iv) infrastructural developments in the country. The sector is however facing challenges including (i) counterfeit goods, (ii) low export levels of FMCG products and cheaper imports, and (iii) poor infrastructure and high energy costs. Despite these challenges, the FMCG sector can make significant growth by (i) adopting technological innovations, and (ii) targeting the untapped demand from the rural population.

CapitalWorks, a South African private equity firm, is going to buy out AON?s shareholdings from ten of its African operations, for an undisclosed amount. AON is a leading global insurance broker and provider of risk management and human resource consulting, with a market leading operation in Africa. CapitalWorks, specialised in investing on the continent, manages over USD 515.0 mn in assets for investors, and brings to the table a sound understanding of local market conditions, strong governance and operational experience. The deal is structured to allow AON to operate through exclusive correspondent networks, which offers them success in a number of markets. AON will benefit from reduced risks, and dealing with one large, comprehensive and exclusive correspondent network, which is backed by an African focused company. CapitalWorks will benefit from AON?s global experience, economies of scale and extensive African network. The new entity will retain the current leadership and staffing to benefit from consistency.

On the fund-raising front, Mobile credit firm Tala, formerly known as Mkopo Rahisi, has raised more than USD 30.0mn in series B financing from IVP, Rabbit Capital and existing investors including Lowercase Capital, Data Collective, Collaborative Fund, and Female Founders Fund (F3). The collected funds will be used to (i) accelerate product development, (ii) expand to new markets, and (iii) build its international team. Tala currently operates in East Africa and South East Asia targeting 2.0 bn people globally underserved by traditional finance companies. Based on customer profile and the loan size, Tala gives loans of up to Kshs 50,000 via Mpesa at 15.0% interest rate per annum with a repayment period of six months. Tala has successfully delivered loans USD 50 mn with a track record repayment rate of 90.0%. Online credit platforms have attracted many investors with new entrants including Branch International Inc, Okoa Stima and KCB Mpesa among others. We expect to record an increase in mobile credit lending driven by (i) accessibility of the loans, (ii) high demand from the middle income population, (iii) instant loans that take five minutes unlike long approval processes in traditional banking methods, and (iv) growth of alternative lending channels in Kenya, given the banking rate caps, which has orphaned most unsecured borrowers from the bank lending.

The financial services sector continues to attract private equity investments driven by (i) technological advancement that has improved efficiency and reduced operation costs, (ii) innovative distribution channels like use of agents and mobile banking, and (iii) stable regulatory environment. The sector is however facing challenges including (i) interest caps that limit the interest lenders can charge, hence risky borrowers and unsecured borrowers are largely orphaned, (ii) non-compliance of financial institutions that has seen some banks being placed under receivership reducing customer confidence in the financial industry, and (iii) cyber security threats mostly affecting the online services. Despite these challenges, the financial sector can make significant growth by (i) risk management measures like cyber security management, (ii) adopting technological innovations, and (iii) being open to new entrants in the market who will inject capital and encourage competition.

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 services 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

Real estate has continued to attract institutional investors and this week saw the following investment in the various real estate firms;

i. Fusion Capital acquired a 75% stake in Thika Royal Palms, a subsidiary of Hand in Hand Development Company Limited based in the UK. Thika Royal Palms is a special purpose vehicle whose objective is to acquire land, sub-divide, put in infrastructure and sell plots to individuals. The firm currently has land in Thika and intends to sell plots to people wishing to build their own

houses in a site and service scheme

ii. AFDB approved a USD 8.2 mn equity investment in Shelter Afrique, a development finance institution, which invests in affordable housing in Africa. The investment is a sign of confidence in the firm despite corporate governance and financial woes linked to lax lending practises, speculations of overstated asset quality and sub-standard management operations in the recent past. With additional equity support, Shelter Afrique will meet its liquidity needs, and thus be in a stronger position to finance projects including the 20,000 housing units-project for the National Police Service in Kenya. Other projects set to benefit from Shelter Afrique in Kenya include Glenwoods Apartments in Ruaka and Everest Park II in Athi River.

The real estate sector in Kenya remains attractive for investors looking for attractive long term return as a result of (i) high Population growth at 2.7% per annum creating demand for real estate, (ii) high urbanization rate at 4.3% annually, (iii) a growing middle class with increased purchasing power and more sophisticated tastes and preferences, and (iv) improving infrastructure opening up new fronts for development. These factors have made real estate the highest returning asset class and thus a haven for investors. In Thika where Thika Royal Palms seeks to acquire land, for example, land has appreciated on average by 23% in the last 3 years with an acre previously selling at Kshs 9.0 mn, now going for Kshs 17.0 mn. The value of property in the area has grown due to demand from the middle-income population who are now keen on settling in satellite towns and improved infrastructure such as the Thika Superhighway.

Other firms that have recently invested in real estate companies include Cytonn Investments Private Equity business, which acquired a 25.0% stake in Superior Homes in January this year. Some of the benefits of such partnerships include;

i. Matching capital with investment opportunities whilst providing funding for development
ii. Formation of symbiotic partnerships that enable syncing of different capabilities e.g. project management, fund-raising, construction and product distribution capabilities
iii. Portfolio diversification through increasing of the range of products under mandate

With increased investment and institutionalization of real estate, the impact is that developers will secure financing for development, bring projects to completion and thus meet the housing and other real estate demand. The government has put in place measures that will boost the tourism sector and in turn the hospitality sector in Kenya. First, Kenya in collaboration with Uganda and Rwanda launched a portal in a bid to jointly market the region?s tourism products. The portal will enable travel and tourism players, including hoteliers, from the three nations showcase their products on a common platform and thus reach regional and international markets. Secondly, a special task force formed to evaluate Kenya as a destination for conference tourism has proposed formation of a National Convention Bureau to foster growth in business tourism. The intention is to position Kenya as not only a leisure and wildlife destination, but also a business conferences and exhibitions hub. This will cushion both the tourism and the accommodation and food services industry during off-peak travel seasons.

If the above efforts are well-implemented, they will further spur inbound tourism and thus drive significant growth opportunities for the hospitality industry. We will then expect improvement in the sector, whose contribution to GDP declined from 1.3% in 2011 to 0.8% in 2015, due to reduced revenues attributed to insecurity and negative travel advisories issued by Western countries.

Other real estate highlights this week include:

i. Dubai-based firm, Deyaar Development visited Kenya seeking investors for their real estate projects. The firm is targeting wealthy Kenyans to invest in their Kshs 22.5 bn project dubbed ?The Atria?, citing Dubai a great investment destination due to UAEs tax-free status, a stable political environment, and returns of about 14.0%. In our opinion, Kenya is a better investment

destination with returns above 20% and a GDP of 5.7% compared to UAE?s at 3.9%

ii. Tests on the Standard Gauge Railway (SGR) will begin March to ensure optimum performance ahead of its launch in June. The 472 km railway line from Mombasa to Nairobi, is part of the line set to connect Kenya, Uganda, Rwanda and South Sudan, and pass through Nakuru, Eldoret and Malaba in Kenya. The railway and other on-going infrastructural projects will not only ease transport but also spur economic development and increase the value of property in areas it passes through

We expect continued investment in real estate driven by i) increased financing for development from institutional investors ii) infrastructural development iii) high returns and iv) growth opportunities in the hospitality sector.

The Impact of the Ongoing Drought on the Kenyan Economy

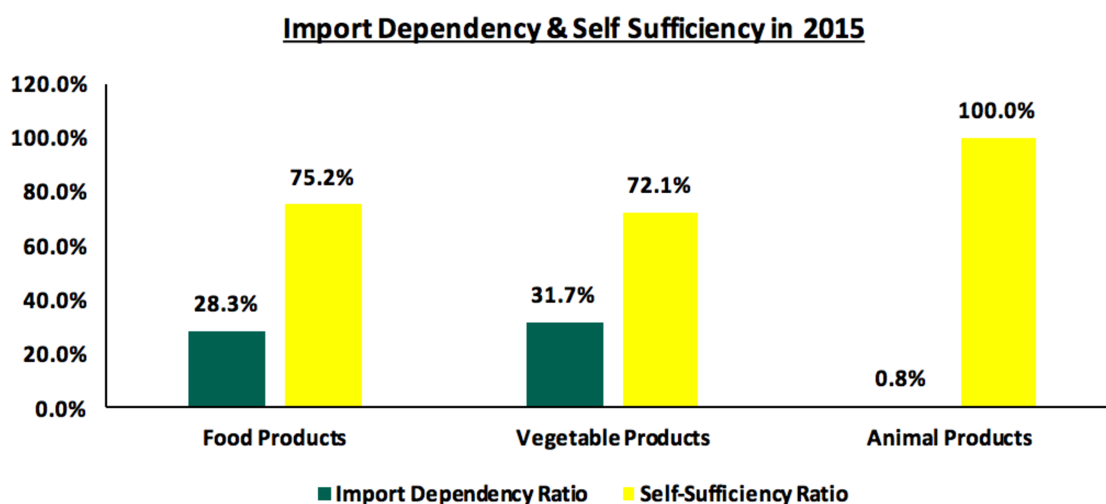
The government has declared drought a national disaster, appealing for aid through the National Drought Emergency Fund, in a bid to mitigate the effects of the ongoing drought that has seriously affected different parts of the country. The number of people in need of food assistance has more than doubled to 3.0 mn in February 2017, from the 1.3 mn in August 2016, according to the National Drought Management Authority (NDMA), highlighting the magnitude of the crisis. This write up aims to analyse the potential effects of the drought on the economy.

Kenya is generally a highly drought prone country with only 20.0% of the country receiving high and regular rainfall, with the remaining 80.0% being arid or semi-arid. Previously, the country has experienced severe droughts over the past 10 years, most notably, (i) in 2011, when the United Nations (UN) termed the drought that had hit parts of the Horn of Africa, as the worst in 60 years, with 13.2 mn Kenyans affected, especially in Northern Kenya, (ii) in 2005, when the government declared drought a national catastrophe, following the drought that had affected 2.5 mn in Northern Kenya, and (iii) in 2004, when the country witnessed depressed rainfall in the second quarter of the year, and the resulting crop failure ended up leaving 2.3 mn Kenyans affected. Despite this, the economy has proved resilient and managed GDP growth of 6.1%, 5.9% and 5.1% in 2011, 2005 and 2004, respectively.

While drought is known to affect the agricultural sector, which contributes about 23.0% to the Kenyan economy, as a result of crop failure and in turn reduced food security, poor rainfall has the potential effects of (i) hampering hydro-electric power generation which results in power rationing. The government has assessed options of using geothermal power in the recent past, with the high initial costs of setting up a processing plant and maintaining the same, proving to be the main obstacles; and (ii) reduced water supply and in the process water rationing ends up affecting households and industries heavily dependent on the resource, impacting on production and hence putting a strain on the economy. In such tough times, companies find it hard to sustain production and in turn lead to lay-offs as was witnessed in various parts of the country in 2011.

The two major rainfall seasons in Kenya are (i) the long rains that come in between March and May, and (ii) the short rains witnessed in the months between October and December. The Kenya Meteorological Department (KMD) earlier in the month revealed the country is expected to witness depressed rainfall in the period between March and May 2017, with the food security situation expected to deteriorate in most parts of the country. This is due to the La-Nina phenomenon which follows the El-Nino rains, resulting into dryer than normal conditions in East Africa and the greater Horn of Africa. The government has been tipped to step in to alleviate the impending food situation in the country, with reports suggesting that the government has approved the importation of 5.0 mn bags of yellow corn from Ukraine. Despite this, the country is still at manageable levels when it comes to import dependency, a measure of dependency on importation for domestic consumption

and self-sufficiency, which is the capacity to meet consumption needs from production, in terms of food, vegetables and animal products, as demonstrated in the graph below.



Source: KNBS Economic Survey 2016

Kenya?s dependency on imported food has improved over the last five years, with the import dependency ratio on food products, vegetable products and animal products having declined by 0.8% points, 0.9% points and 0.3% points, to 28.3%, 31.7% and 0.8%, from 29.1%, 32.6% and 1.1%, respectively. The country?s ability to cater for its food needs without external assistance has also improved over the last five years, with the country?s self-sufficiency ratio on food products, vegetable products and animal products having risen by 0.6% points, 0.6% points and 0.1% points, to 75.2%, 72.1% and 100.0%, from 74.6%, 71.5% and 99.9%, respectively.

Despite the data pointing to the country being self-sufficient, coupled by the fact that the situation was anticipated, past and current events, mostly due to poor planning by the government, will mean that the ongoing drought is bound to affect the economy in the following ways;

- **Agriculture** - The agriculture sector has been the most affected following a run of two consecutive poor rain seasons, with tea production expected to underperform this year following last year?s bumper harvest of 426,000 metric tons, which will have an adverse effect on the country?s forex income, given Kenya is a major tea exporter,
- **Energy** - Areas hosting power dams are expected to be affected by the drought, though Kenya Power has stepped in to assure that power rationing may not be required, as the electricity reserve of 27.1% from its energy mix is expected to supplement any shortcomings. However, should the situation become untenable, this could force the government?s hand,
- **Water Supply** - The water shortage has hit the country, with the Nairobi City Water and Sewage Company (NCWSC) having published a water rationing program, that will see several industries that are heavily dependent on the resource get cut down and in turn bear down on productivity in these sectors, and the economy in general,
- **Currency** - The government is exploring options of importing food so as to fill the expected food deficit in the country and massive importation of food, coupled with a reduction in forex income as a result of reduced tea production, may serve to deplete the country of its forex reserves and in turn put pressure on the shilling that has so far stabilized since the turn of the year,
- **Inflation** - The food situation in the country has deteriorated and this has had a massive impact on inflation, as the food component of the Consumer Price Index (CPI), which carries a weighting of 36.0% has been on a gradual increase over the past three months, clocking month on month changes of 1.2%, 1.3% and 1.7% in November, December and January 2017, respectively,

Following initiatives by the government to cure for the deteriorating food situation in the country, where it has set aside Kshs 2.0 bn per year in the budget for the National Drought Emergency Fund,

we believe the government can do more to improve the food situation in the country through (i) putting up measures to stimulate the agricultural sector by reducing over-reliance on rain-fed agriculture, such as the implementation of garden projects, (ii) increased focus on food storage programs and water harvesting schemes, and (iii) the implementation of contingency plans, such as deployment of water tanks.

Despite the drought having a contagion effect on most of the economic sectors in the country, we still maintain that the economic growth this year will be strong. We therefore expect 2017 to deliver a GDP growth of between 5.4% - 5.7%, a slowdown from the 6.0% expected for 2016.

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