Cytonn INVESTMENTS

Joint Ventures in Real Estate & Cytonn Weekly #21/2017

Cytonn Weekly

Executive Summary

Fixed Income: During the week, the level of T-bill subscriptions remained high but declined to 141.9% compared to 172.5% recorded the previous week. Yields on the 182 and 364-day papers remained unchanged at 10.4% and 10.9%, respectively, while that of the 91-day paper declined by 10 bps to 8.6%, from 8.7% the previous week. According to the African Economic Outlook 2017, Africa is expected to grow by 3.4% and 4.3% in 2017 and 2018, respectively, from 2.2% in 2016 due to the continued recovery of global commodity prices;

Equities: The equities market was on an upward trend with NASI, NSE 25 and NSE 20 gaining 5.5%, 5.4% and 4.8%, respectively, driven by gains in select stocks such as Britam, Stanbic, Bamburi and Equity Group which gained 15.0%, 14.3%, 9.4% and 8.6%, respectively**.** Standard Chartered Bank, Barclays Bank and Equity Group released Q1?2017 results, with all the banks recording declines in core earnings per share of 20.5%, 19.8% and 5.6%, respectively;

Private Equity: Hospitality, technology and FMCG sectors continue to witness increased private equity activity as seen in, (i) Craft Silicon?s acquisition of an undisclosed stake in restaurant listing portal, EatOut, and (ii) XSML?s first investment in Uganda?s KARE;

Real Estate: The real estate sector recorded increased activity in (i) the up-market hospitality segments through the launching of large hotel and serviced apartment developments in Upperhill, Kilimani and Westlands, and (ii) the industrial sector as Africa Logistics Properties broke ground on a Grade A industrial facility in Tatu City;

Focus of the Week: This week, we demystify joint ventures, how landowners can partner with developers and what are the benefits of such partnerships.

Company Updates

- During the week, Cytonn Investments and University of Embu signed an MOU to offer internship opportunities to the best students from Embu University through our Cytonn Young Leaders Program (CYLP). CYLP has so far trained 423 graduates and Cytonn has offered jobs to 118 of them. The students joining CYLP benefit from intensive on-the-job training that will equip them with the necessary job market requirements. See event note here
- Our Investment Manager, Maurice Oduor, discussed different ways to make good investments in Kenya. Listen to Maurice on KBC (English Service) here
- Our Business Development Analyst, Maryline Kiptoo, discussed youth in the business environment. Watch Maryline on KTN here
- The Annual General Meeting of the Cytonn Investment Co-operative Society Limited, shall be held on 2[nd]June 2017, at 7:30 A.M. at The Nairobi Club, Nairobi. See AGM Notice here

- We continue to showcase real estate developments by our real estate development affiliate, Cytonn Real Estate, through weekly site visits. Here are progress videos and pictures on The Alma and Amara. The site visits target both investors looking to invest in real estate directly, and also those interested in high yield investment products to familiarize themselves with how we support the high yield returns. If interested in attending the site visits, kindly register here
- We continue to see very strong interest in our Private Wealth Management training, which is at no cost, and is held bi-weekly, but is open only to pre-screened participants. The training can also be offered to institutions which would like their employees to be trained on Private Wealth Management. To get further details contact our Client Services team at clientservice@cytonn.com
- For recent news about the company, see our news section here
- We have 13 investment-ready projects, offering attractive development and buyer 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
  - The Alma, which is over 55.0% sold, 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 and has delivered 33.0% p.a. returns to investors. See Amara Ridge
  - The Ridge Phase One is currently 31.0% sold. See The Ridge
  - Taraji Heights is currently 10.0% sold. See Taraji Heights
- We are also looking for 5 - 10 acres of land in Karen, Garden Estate and Lang?ata. Contact us at rdo@cytonn.com if you have any land for sale or joint ventures in the above areas.
- We continue to beef up the team with the ongoing hires: Careers at Cytonn

Fixed Income

T-bills subscriptions remained high but declined during the week to 141.9%, compared to 172.5% recorded the previous week. The subscription rates declined across the board with the 91, 182 and 364-day papers receiving subscriptions of 129.3%, 150.7% and 138.2% compared to 221.2%, 168.2% and 157.5% the previous week, respectively. Yields on the 182 and 364-day papers remained unchanged at 10.4% and 10.9%, respectively, while that of the 91-day paper declined by 10 bps to 8.6% from 8.7% the previous week. The accepted yields on all three papers came in at the same rate as the weighted average market yields, with the overall acceptance rate was at 82.6% compared to 78.5% the previous week. Bank?s holdings in government papers has increased to 55.0% of total debt equivalent to Kshs 1.1 tn from 51.1% equivalent to Kshs 1.0 tn at the beginning of the year as investing with the Government offers a better risk return proposition for the banks given the capping of interest rates. The increase is equivalent to 23.3% on an annualized basis, indicating that banks find it better to lend to the government than to the private sector due to the interest rate cap.

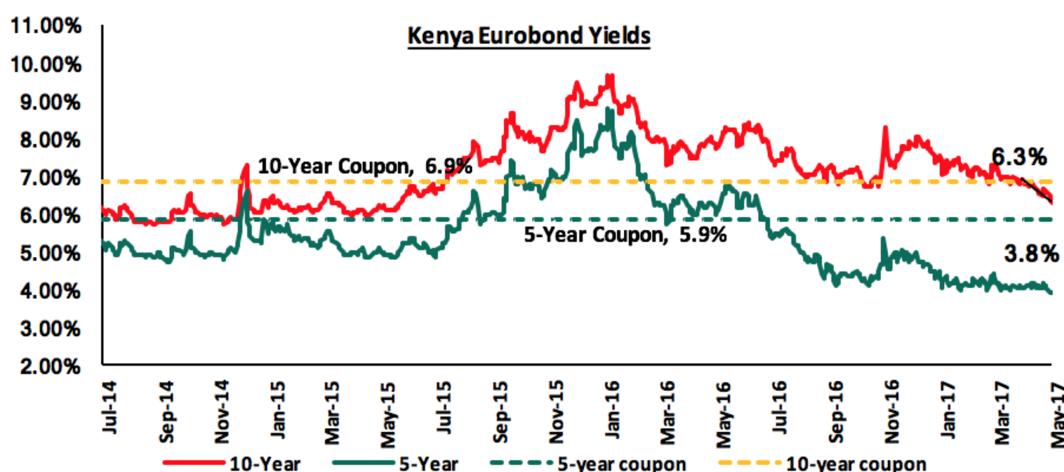
The market liquidity increased as can be seen by the decline in the average interbank rate, which closed the week at 5.0% compared to 5.6% recorded the previous week. During the week there was a net liquidity injection of Kshs 8.4 bn compared to a Kshs 25.7 bn withdrawal the previous week. The net liquidity injection was due to T-bond redemptions and government payments amounting to Kshs 36.1 bn and Kshs 25.9 bn, respectively. In a bid to mop up excess liquidity from the market, the Central Bank was in the repo market and managed to clear Kshs 15.8 bn in repos.

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

all values in Ksh bn, unless stated otherwise			
Weekly Liquidity Position ? Kenya			
Liquidity Injection		**Liquidity Reduction**	
Term Auction Deposit Maturities	24.0	T-bond sales	0.0
Government Payments	25.9	Transfer from Banks - Taxes	34.5
T-bond Redemptions	36.1	T-bill (Primary issues)	32.5
T-bill Redemption	15.1	Term Auction Deposit	0.0

T-bond Interest	11.9	Reverse Repo Maturities	14.0
T-bill Re-discounts	0.0	Repos	15.8
Reverse Repo Purchases	12.2	OMO Tap Sales	20.0
Repos Maturities	0.0		
Total Liquidity Injection	**125.2**	**Total Liquidity Withdrawal**	**116.8**
Net Liquidity Injection			**8.4**

According to Bloomberg, yields on the 5-year and 10-year Eurobonds, with 2.1 years and 7.1 years to maturity, declined by 10 bps w/w for both bonds, to close at 3.8% and 6.3%, from 3.9% and 6.4%, the previous week, respectively. Since the mid-January 2016 peak, yields on the Kenya Eurobonds have declined by 3.3% points and 5.0% points, respectively, for the 5-year and 10-year Eurobonds due to stable macroeconomic conditions. The declining Eurobond yields and Standard & Poor?s (S&P) having maintained Kenya?s foreign and local currency sovereign credit ratings for the short and long term at ?B+/B?, respectively, are indications that Kenya remains stable and hence an attractive investment destination.



The Kenya shilling remained unchanged against the dollar during the week closing at Kshs 103.3. However, the shilling is likely to come under pressure in the coming week on account of the usual end month dollar demand from oil importers. On a year to date basis, the shilling has depreciated against the dollar by 0.8%. With the current forex reserve level, currently at USD 8.2 bn (equivalent to 5.4 months of import cover), and the IMF maintaining Kenya?s precautionary credit facility at USD 1.5 bn (equivalent to 1.0 more month of import cover) that Kenya can draw on in case of any balance of payment emergencies, we believe that the shilling should remain stable in the short term.

We are projecting inflation for the month of May to rise to between 12.3% - 12.5%, from 11.5% in April, mainly driven by a rise in food prices caused by the ongoing drought. Going forward, we expect upward inflationary pressures to persist, driven by (i) the food component of the Consumer Price Index (CPI) basket due to the persistent dry weather that is expected to carry on for the first half of the year, with depressed rainfall in the long rains season that comes in between March and May, and (ii) the price of cereals is likely to increase given that the cost of army worm pesticide has been increased to Kshs 2,000 for pesticide enough for a 90-kg maize bag, from Kshs 1,700 previously, considering that 15 agriculture-rich counties have been affected by the pest. We expect upward inflationary pressures to persist and inflation to average 11.8% in 2017.

The Monetary Policy Committee (MPC) is set to meet on Monday 29th May, 2017, to review the prevailing macro-economic conditions and give the direction of the Central Bank Rate (CBR). In their previous meeting, held in March 2017, the MPC maintained the CBR at 10.0%. We expect the MPC to maintain the CBR at 10.0% due to the pressure to support growth, the need to support private sector credit and the shilling as the USD strengthens in the global markets, despite pressure to increase the CBR due to the rising inflation. Key to note also is that we are currently experiencing cost-push inflation and hence increasing the CBR will not be as effective in curbing inflationary pressure; raising the CBR is only effective when dealing with demand-pull inflation. For our

comprehensive analysis on the same, see MPC Note.

The African Economic Outlook 2017 released during the week, indicated that Africa is expected to grow by 3.4% and 4.3% in 2017 and 2018, respectively, from 2.2% in 2016. The growth is expected to be supported by (i) recovery of global commodity prices, and (ii) increased capital flows into Africa projected at 1.1% in 2017 to USD 179.7 bn from USD 177.7 bn in 2016, with the bulk of this expected to come from diaspora remittances and Foreign Direct Investment (FDI) at 36.8% and 32.0% of the total capital flows, respectively.

Conclusions: Rates in the fixed income market have remained stable, despite indications of possible upward pressure. The main factors supporting the low rates are:

i. ***The government is ahead of its domestic borrowing target for the current fiscal year, having borrowed Kshs 358.8 bn against a target of Kshs 266.3 bn (assuming a pro-rated borrowing throughout the financial year of Kshs 294.6 bn budgeted for the full financial year),***
ii. ***The government may also be looking at concessionary loans to finance the expenditure rather than borrowing from the foreign market.***

Some of the factors putting upward pressure on interest rates are:

i. ***The government is catching up on its spending target, with total expenditure for the third half of the 2016/17 fiscal year coming in at Kshs 1.49 tn, which represents 97.7% of the pro-rated target of Kshs 1.53 tn, while development expenditure for the third half of the 2016/17 fiscal year had an absorption rate of 109.5% against 96.2% for recurrent expenditure. Given that spending is picking up, there may exist upward pressure on interest rates,***
ii. ***The government has only borrowed Kshs 205.8 bn of the budgeted foreign borrowing, representing 44.5% of its foreign borrowing target of Kshs 462.3 bn, and***
iii. ***The Kenya Revenue Authority (KRA) is expected to miss its overall revenue collection target of Kshs 1.5 tn for the current fiscal year having missed its third quarter target.***

In conclusion, the possible budget deficit and high inflationary environment that we are currently in, create uncertainty in the interest rate environment as domestic borrowing may exert an 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.

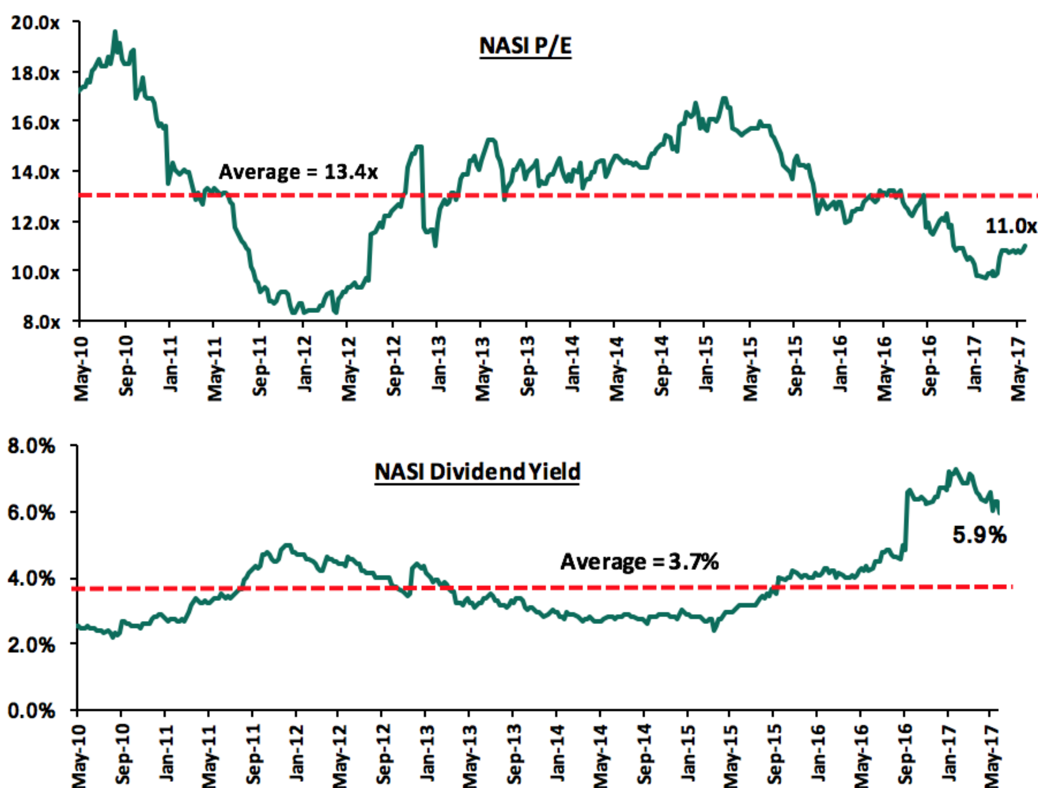
Equities

During the week, the equities market was on an upward trend with NASI, NSE 25 and NSE 20 gaining 5.5%, 5.4% and 4.8%, respectively, taking their YTD performances to 10.3%, 10.7% and 8.0%, respectively. This week?s performance was driven by gains in select stocks such as Britam, Stanbic, Bamburi and Equity Group, which gained 15.0%, 14.3%, 9.4% and 8.6%, respectively. The recovery of banking stocks is seen as a correction by investors following uncertainty caused by the law capping interest rates. The case of reviewing the rates caps seems to be consolidating given, (i) the increased bank allocation to government debt rather that lending to private sector illustrates that banks prefer government debt compared to lending, (ii) the drop in private sector growth to 4.0%, which is way below the CBK target of 18.3%, and (iii) the increased industry push for a review as can be seen from Dr. James Mwangi, CEO of Equity Group, who said that ?we strongly believe that interest rate capping is not sustainable for financial institutions. One way or another, it will have to be amended?. Since the February 2015 peak, the market has lost 37.4% and 17.1% for NSE 20 and NASI, respectively.

Equities turnover decreased by 18.5% to close the week at USD 38.0 mn from USD 46.4 mn, the

previous week. Foreign investors remained net sellers with a net outflow of USD 8.5 mn compared to a net outflow of USD 5.6 mn recorded the previous week. Foreign investor participation rose to 65.1% from 59.3% recorded the previous week. Safaricom and KCB Group were the top movers for the week, jointly accounting for 62.3% of market activity. We expect the Kenyan equities market to be flat in 2017, driven by (i) slower growth in corporate earnings, and (ii) neutral investor sentiment mainly due to the forthcoming general elections.

The market is currently trading at a price to earnings ratio of 11.0x, compared to a historical average of 13.4x, and a dividend yield of 6.0%, compared to a historical average of 3.7%. The current 11.0x valuation is 13.5% above the most recent trough valuation of 9.7x experienced in the first week of February 2017 and 32.5% above the previous trough valuation of 8.3x experienced in December 2011. The charts below indicate the historical P/E and dividend yields of the market.



A couple of companies released their results during the week and generally the results were lower than last year. Below is the summary:

Standard Chartered Bank released Q1?2017 results

Standard Chartered Bank released Q1'2017 results posting a 20.5% decline in core earnings per share (EPS) to Kshs 6.0 from Kshs 7.5 in Q1'2016, attributed to a 6.7% decrease in operating income to Kshs 6.8 bn from Kshs 7.2 bn in Q1?2016 and a 5.8% increase in operating expenses to Kshs 3.8 bn from Kshs 3.6 bn in Q1?2016.

Key highlights for the performance to Q1?2017 from Q1?2016 include:

- Total operating income declined by 6.7% to Kshs 6.8 bn from Kshs 7.2 bn, attributed to a 10.1% decline in Non-Funded Income (NFI) and a 5.1% decline in Net Interest Income (NII),
- Net Interest Income (NII) declined by 5.1% to Kshs 4.6 bn from Kshs 4.9 bn in Q1?2016, following an 11.8% growth in interest expense to Kshs 1.7 bn from Kshs 1.5 bn in Q1?2016 as a result of higher deposit balances coupled with higher cost of funding in line with the new regulation, and a 1.1% decline in Interest Income to Kshs 6.3 bn from 6.4 bn in Q1?2016. The Net Interest Margin (NIM) came in at 9.8% from 9.7% in Q1?2016,

- Non-Funded Income (NFI) recorded a decline of 10.1% to Kshs 2.1 bn from Kshs 2.4 bn in Q1?2016 attributed to a 1% decline in fees and commissions on loans to Kshs 0.06 bn from Kshs 0.08 bn in Q1?2016 and a 48.7% decline in other income to Kshs 0.3 bn from 0.6 bn in Q1?2016. The current revenue mix stands at 69:31 funded to non-funded income from 67:33 in Q1?2016,
- Total operating expenses increased by 5.8% to Kshs 3.8 bn from Kshs 3.6 bn in Q1?2016 following an 8.8% increase in staff costs to Kshs 1.6 bn from Kshs 1.5 bn in Q1'2016. Loan Loss Provisions increased by 6.0% to Kshs 0.8 bn from Kshs 0.7 bn in Q1'2016. Without LLP, operating expenses grew 5.7% to Kshs 3.0 bn from Kshs 2.8 bn registered in Q1?2016,
- Cost to Income ratio worsened to 55.6% from 49.0% in Q1'2016. Without LLP, the CIR still worsened to 44.1% from 39.0% in Q1?2016,
- Profit before tax decreased by 18.7% to Kshs 3.0 bn from Kshs 3.7 bn in Q1?2016, while profit after tax declined by 20.5% to Kshs 2.1 bn from Kshs 2.6 bn in Q1?2016, as a result of increase in the effective tax rate to 8% from 30.7% in Q1?2016,
- The loan book expanded by 5% to Kshs 116.9 bn from Kshs 109.8 bn in Q1?2016, while customer deposits grew by 11.1% to Kshs 205.0 bn from Kshs 184.5 bn in Q1?2016,
- The faster growth in deposits led to a decline in the loan to deposit ratio to 0% from 59.5% in Q1?2016,
- Standard Chartered is currently sufficiently capitalized with a core capital to risk weighted assets ratio at 17.4%, 6.9% above the statutory requirement of 10.5%, with total capital to total risk weighted assets exceeding statutory requirement of 14.5% by 6.1% to close the period at 20.6%.

Moving forward, Standard Chartered Bank?s performance shall be driven by:

- Continued investment in digital infrastructure through its Digital by Design strategy that aims to migrate over 80.0% of transactions to non-branch channels by 2020. This is expected to promote efficiency and enhance risk management. In 2016 the bank introduced a mobile app, a revamped online platform, fingerprint log-in technology, video banking and cash deposit machines all aimed at achieving its Digital by Design strategy target, and
- Growth in deposits via revamped mobile and online banking products, particularly targeting SME and retail businesses.

For a more detailed analysis, see our Standard Chartered Bank Q1?2017 Earnings Note.

Equity Group released Q1?2017 results

Equity Group released their Q1'2017 earnings posting a 5.6% decline in core earnings per share (EPS) to Kshs 1.3 from Kshs 1.4 in Q1'2016, attributed to a 2.7% decline in operating income to Kshs 15.2 bn from Kshs 15.6 bn registered in Q1?2016, which outpaced a marginal decline in operating expenses of 0.5% to Kshs 8.3 bn from Kshs 8.4 bn registered in Q1?2016.

Key highlights for the performance to Q1?2017 from Q1?2016 include:

- Total operating income declined by 2.7% to Kshs 15.2 bn from Kshs 15.6 bn in Q1?2016 attributed to a 14.8% decline in Net Interest Income (NII), despite a 21.5% growth in Non-Funded Income (NFI), underlining the importance of revenue diversification in the midst of a tough operating environment,
- Net Interest Income declined by 14.8% to Kshs 8.9 bn from Kshs 10.4 bn in Q1?2016, following an 11.0% decrease in interest income to Kshs 11.5 bn from Kshs 12.9 bn in Q1?2016, and a 5.3% growth in interest expense to Kshs 2.6 bn from Kshs 2.4 bn in Q1?2016. This resulted in a decline in the Net Interest Margin (NIM) to 10.3% from 11.0% in Q1?2016,
- Non-Funded Income increased by 21.5% to Kshs 6.3 bn from Kshs 5.2 bn in Q1?2016 driven by a 47.9% increase in fees and commissions on loans to Kshs 1.4 bn, from Kshs 0.9 bn in Q1?2016, and foreign exchange trading income, which rose by 8.8% to Kshs 0.9 bn, from Kshs 0.8 bn in Q1?2016. The current revenue mix stands at 58:42 funded to non-funded income from 67:33 in

Q1?2016,

- Total operating expenses declined marginally by 0.5% to Kshs 8.3 bn from Kshs 8.4 bn in Q1?2016 attributed to a 17.4% decrease in staff costs to Kshs 2.5 bn from Kshs 3.0 bn in Q1?2016, despite a notable rise in loan loss provision (LLP) by 13.0% to Kshs 0.8 bn, from Kshs 0.7 bn in Q1?2016. The decline in staff costs could be attributed to the bank?s aggressive digitization. Without LLP, operating expenses declined by 1.7% to Kshs 7.5 bn from Kshs 7.7 bn registered in Q1?2016,

- Cost to income ratio worsened to 54.7% from 53.4% in Q1?2016. Without LLP, Cost to Income ratio worsened slightly to 49.4% from 48.9% in Q1?2016,
- Profit before tax (PBT) decreased by 5.3% to Kshs 6.9 bn from Kshs 7.3 bn in Q1?2016, while profit after tax declined by 5.6% to Kshs 4.9 bn from Kshs 5.1 bn in Q1?2016. The effective tax rate remained relatively stable at 29.7% from 29.5% in Q1?2016,

- The loan book contracted by 4.8% to Kshs 261.9 bn, from Kshs 275.0 bn in Q1'2016, while customer deposits grew by 16.1% to Kshs 347.5 bn from Kshs 299.2 bn in Q1?2016 bringing the loan to deposit ratio to 75.4% from 91.9% in Q1?2016,
- Equity Group is currently sufficiently capitalized with a core capital to risk weighted assets ratio of 14.8%, 4.3% above the statutory requirement of 10.5%, with total capital to total risk weighted assets exceeding statutory requirement of 14.5% by just 1.6% to close the period at 16.1%.

Moving forward, Equity Group?s performance will be driven by:

i. Diversification of revenue streams, which will support the growth in non-funded income, now accounting for 41.6% of total operating income, following the capping of interest rates,
ii. Implementation of cost rationalization measures, through adoption of a digital platform and other alternative channels of distribution, for both loan disbursement and deposit mobilization. This will help the bank achieve efficiency and keep the cost to income ratio at manageable levels, and
iii. The group?s plans to shelve regional expansion, having closed down 7 of the 12 branches in South Sudan, given the challenges faced by Kenyan banks operating in South Sudan.

For a more detailed analysis, see our Equity Group Q1?2017 Earnings Note.

Barclays Bank of Kenya released Q1?2017 results

Barclays Bank released Q1'2017 results posting a 19.8% decline in core earnings per share (EPS) to Kshs 0.3 from Kshs 0.4 in Q1'2016 attributed to a 7.3% decline in operating income to Kshs 7.4 bn from Kshs 8.0 bn in Q1?2016, which outpaced the 1.2% decrease in operating expenses to Kshs 4.88 bn from Kshs 4.95 bn in Q1?2016.

Key highlights for the performance to Q1?2017 from Q1?2016 include:

- Total operating income declined by 7.3% to Kshs 7.4 bn from Kshs 8.0 bn in Q1?201 This was attributed to declines in both Net Interest Income and Non Funded Income of 7.1% and 7.8%, respectively,
- Net Interest Income (NII) declined by 7.1% to 5.0 bn from Kshs 5.4 bn in Q1?2016 attributed to a 5.0% drop in interest income to Kshs 6.4 bn from Kshs 6.7 bn in Q1?2016, outpacing a 3.4% decline in interest expense to Kshs 1.4 bn from Kshs 1.3 bn in Q1?2016. This resulted in the Net Interest Margin declining to 10.2% from 10.4% in Q1?2016,
- Non-funded income (NFI) recorded a decline of 7.8% to Kshs 2.4 bn from Kshs 2.5 bn in Q1?2016. This is attributable to a 59.4% drop in fees and commissions on loans to Kshs 0.2 bn from Kshs 0.4 bn in Q1?2016. The revenue mix remained stable at 68:32 funded to non-funded income,
- Total operating expenses declined by 1.2% to Kshs 4.88 from Kshs 4.95 attributed to an 8.4% decline in other expenses to Kshs 1.0 bn from Kshs 1.1 bn in Q1?2016 and a 2.9% drop in loan loss

provisions to Kshs 0.77 bn from Kshs 0.79 bn in Q1?2016. Without LLP, operating expenses declined marginally by 0.9% to Kshs 4.11 bn from Kshs 4.15 bn registered in Q1?2016,

- Cost to income ratio worsened to 66.0% from 61.9% in Q1?2016. Without LLP, Cost to Income ratio still deteriorated to 55.5% from 51.9% in Q1?2016,
- Profit before tax decreased by 17.2% to Kshs 2.5 bn from Kshs 3.0 bn in Q1?2016, while profit after tax declined by 19.8% to Kshs 1.7 bn from Kshs 2.2 bn in Q1?2016. The effective tax rate increased to 6% from 28.3% in Q1?2016,
- The loan book expanded by 10.7% to Kshs 168.7 bn from Kshs 152.4 bn in Q1'2016, while customer deposits grew by 7.6% to Kshs 181.8 bn from Kshs 168.9 bn in Q1?2016 driven by growing savings and transactions accounts owing to the bank?s efforts to strengthen its network channels through opening up an additional 181 service outlets across the country,
- The faster growth in loans led to an increase in the loan to deposit ratio to 92.8% from 90.2% in Q1?2016,
- 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 of 10.5%, with total capital to total risk weighted assets exceeding statutory requirement of 14.5% by 3.3% to close the period at 17.8%.

Moving forward, Barclays Bank?s performance shall be driven by:

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), Bancassurance and agency banking will see the bank leveraged highly on this to spur growth.

For a more detailed analysis, see our Barclays Bank Q1?2017 Earnings Note.

Of the 7 listed banks that have released their Q1?2017 results, only DTB has recorded an increase in core earnings per share, with the average decline in core earnings across the listed banking sector at 7.2%. This is a significant decrease compared to the average growth of 14.7% registered for Q1?2016. The sector has however experienced faster deposit growth and all banks showed efforts to protect their Net Interest Margins given that this was the quarter when the full effect of the law capping interest rate was in effect. Key to note is that most of the banks, namely DTB, NIC, Co-op, Equity and StanChart have increased their exposure to government securities. This could be attributed to the change in loan and deposits pricing framework brought about by the interest rate caps that has made most lenders increase exposure to the risk-free government as opposed to other risky borrowers. The interest rate cap was meant to improve lending to the consumer, but so far the cap has curtailed lending as evidenced by the declining private sector credit growth at 4.0% as at March 2017, which is an 8-year low.

Listed Banks Q1'2017 Earnings and Growth Metrics												
Bank	Core EPS Growth		Deposit Growth		Loan Growth		Net Interest Margin		Loan to Deposit Ratio		Exposure to Government Securities	
	Q1'2017	Q1'2016	Q1'2017	Q1'2016	Q1'2017	Q1'2016	Q1'2017	Q1'2016	Q1'2017	Q1'2016	Q1'2017	Q1'2016
DTB	**8.8%**	9.5%	22.1%	26.1%	4.8%	24.1%	7.4%	7.4%	74.9%	87.3%	39.1%	30.1%
KCB	**(3.2%)**	6.1%	7.9%	6.6%	14.3%	16.5%	8.6%	8.4%	86.6%	81.7%	23.2%	24.8%
NIC	**(3.9%)**	-0.3%	6.8%	14.8%	3.9%	6.1%	7.9%	8.1%	98.7%	101.5%	26.4%	23.2%
Equity	**(5.6%)**	19.8%	16.1%	8.1%	(4.8%)	22.4%	10.3%	11.0%	75.4%	91.9%	32.5%	20.8%
Co-op	**(6.0%)**	7.7%	6.9%	11.9%	15.0%	16.1%	8.8%	9.5%	87.9%	81.7%	23.0%	17.2%
Barclays	**(19.8%)**	2.6%	7.6%	8.3%	10.7%	21.7%	10.2%	10.4%	92.8%	90.2%	24.2%	27.2%
StanChart	**(20.5%)**	42.7%	11.1%	12.9%	6.5%	(3.7%)	9.8%	9.7%	57.0%	59.5%	47.2%	37.5%
Weighted Average*	**(7.2%)**	**14.7%**	**11.4%**	**10.6%**	**6.7%**	**16.0%**	**9.3%**	**9.6%**	**80.0%**	**83.5%**	**30.2%**	**24.6%**
**** The weighted average is based on Market Cap as at 26th May, 2017***												

Kenya Airways released FY?2017 results

Kenya Airways (KQ) released their FY?2017, recording an improvement in its loss per share to Kshs 6.8 from Kshs 17.5 in FY?2016 driven by a 12.4% decline in operating costs to Kshs 105.4 bn from Kshs 120.3 bn in FY?2016, despite a drop in top line revenue by 8.5% to Kshs 106.3 bn from Kshs 116.2 bn in FY?2016. KQ made an operating profit of Kshs 897.0 mn but this was depleted by other costs that amounted to Kshs 11.1 bn.

Key highlights for the performance to FY?2017 from FY?2016 include:

- Operating revenue declined by 8.5% to Kshs 106.3 bn from Kshs 116.2 bn due to reduction in Available Seat Kilometres (ASKs) by 4.0% and in Yield per Revenue Passenger Kilometre, which declined by 7.4%. The passenger numbers increased by 5.4% to 4.5 mn but the cargo volumes declined by 15.0% due to phasing out of Boeing 777 and entry of Boeing 787,
- Operating expenses declined by 12.4% to Kshs 105.4 bn from Kshs 120.3 bn in FY?2016 as a result of a 47.5% reduction in fleet ownership costs to Kshs 15.5 bn following fleet rationalization that involved the leasing out of some aircraft. Despite a decline in operating expenses, overhead costs increased by 7.4% y/y as a result of a one-off impact of restructuring costs incurred during the reporting period,
- Operating profit increased to Kshs 0.9 bn from an operating loss of Kshs 4.1 bn in FY?2016. This led to an improvement in the EBITDA margin to 0.8% from (3.5%),
- Shareholders equity declined to a further negative position of Kshs 45.0 bn from Kshs 35.7 bn in FY?2016.

During the year, Kenya Airways continued the business turnaround strategy ?Operation Pride?, which focuses on three key objectives, namely: (i) closing the profitability gap through revenue enhancement and cost containment, (ii) improving the business model and enhancing partnerships, and (iii) restructuring the capital of the company. Going forward, the airline aims to leverage on gains made in its turnaround strategy, whose near term focus is completing the capital restructuring plan to reduce the firm?s financial leverage and increased liquidity.

Below is our Equity Universe of Coverage:

- We have placed all banking stocks under review as we update our valuations following release of their Q1?2017 results

all prices in Kshs unless stated otherwise								
OUR EQUITY UNIVERSE								
No.	**Company**	**Price as at 19/05/17**	**Price as at 26/05/17**	**w/w Change**	**YTD Change**	**Target Price***	**Dividend Yield**	**Upside/ (Downside)****
1.	BAT (K)	784.0	799.0	1.9%	(12.1%)	970.8	6.2%	27.7%
2.	Liberty	10.5	10.5	0.0%	(20.8%)	13.0	0.0%	24.2%
3.	Jubilee Holdings	470.0	460.0	(2.1%)	(6.1%)	482.2	1.8%	6.7%
4.	CIC Group	3.7	3.7	0.0%	(3.9%)	3.7	3.2%	4.8%
5.	Kenya Re	19.5	20.5	5.1%	(8.9%)	20.5	4.4%	4.4%
6.	Britam	10.3	11.9	15.0%	18.5%	11.9	2.3%	2.7%
7.	Safaricom	20.5	21.8	6.1%	13.6%	19.8	4.7%	(4.4%)
8.	Sanlam Kenya	25.0	27.0	8.0%	(1.8%)	21.1	0.0%	(22.0%)
***Target Price as per Cytonn Analyst estimates**								
****Upside / (Downside) is adjusted for Dividend Yield**								

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 investment horizon.

Private Equity

Craft Silicon, a multinational software development company providing customized software solutions for the financial sector, has acquired an undisclosed minority stake in restaurant listing portal EatOut, valued at Kshs 51.5 mn. This is their second major investment in a local technology company as it also backed Safaricom in founding Little Limited, the taxi hailing app. Their latest investment is an indication of optimism by investors in the growth of tech-supported businesses. The investment in EatOut will be beneficial to both parties as (i) EatOut, which has 3,183 restaurant listings from Kenya, Uganda, Tanzania and Rwanda, will take advantage of Craft Silicon?s expertise in mobile payment gateways to develop a digital payment platform that will allow customers to pay for meals bought at the listed restaurants, and (ii) use the investment to grow its presence across Africa. As for Craft Silicon, the investment will help them have a foothold in the hospitality sector. We remain optimistic about investment in technology and tech-backed businesses, as the Sub-Saharan region continues to witness increased integration of technology in businesses as well as increased automation of business processes by SMEs.

XSML, a fund manager with presence in Central & East Africa, is undertaking its first investment in Uganda through KARE Distribution (KARE), a company that deals in the distribution and wholesale of essential consumer goods such as locally produced cooking oil, water and detergent. The investment is among the first of XSML?s second fund, Africa Rivers Fund (ARF), which held its final close in early May 2017, at USD 50.0 mn. The investment by XSML will help KARE (i) open a supermarket outlet in one of Kampala?s highly populated neighbourhoods where no outlet existed before, and (ii) grow its distribution network across other cities in Uganda. ARF aims to garner attractive returns to its investors through providing equity, debt and mezzanine financing to growing, well-managed small and medium-sized enterprises (SMEs) in the Central & East African region. In our view, the increase in investment in SMEs in the region is evidence of investor confidence in the region and the growth potential in the private sector in Sub-Saharan region.

Private equity investments in Africa remain robust as evidenced by the increased deals and deal volumes in the region?s key note sectors; FMCGs, and hospitality. The increasing investor interest is attributed to (i) rapid urbanization, a resilient and adapting middle class and increased consumerism, (ii) the attractive valuations in private markets compared to global markets, and (iii) better economic projections in Sub Sahara Africa compared to global markets, we remain bullish on PE as an asset class in Sub-Sahara Africa. Going forward, the increasing investor interest and stable macro-economic environment will continue to boost deal flow into African markets.

Real Estate

The real estate sector recorded activity in the up-market hospitality segment through launching of several developments in prime parts of Nairobi;

i. Pinnacle Towers, a 70-storey mixed-use development was launched in Upperhill. The Kshs 20.6 bn joint venture project between Jabavu Village Limited, a subsidiary of Hass Petroleum Group, and White Lotus Group, a Dubai-based investment firm, will feature a 5-star Hilton Hotel, luxury apartments, office space, a mall and an entertainment centre on a 2-acre plot,
ii. Britam Holdings Limited through their development affiliate, Britam Properties broke ground on construction of Kshs 3.3 bn serviced apartments in Kilimani. The 11-floor development will comprise of 117 2-bedroom and 46 1-bedroom units on a 1.6acre plot along Nyangumi Road, Kilimani area in Nairobi,
iii. Lazizi Premiere, Kenya?s first airport hotel with 144-rooms on 1.5 acres was opened at the Jomo Kenyatta International Airport (JKIA). The hotel that will be managed by Sarovar Group aims to cash in the growing passenger traffic at the airport with a 9.7% increase recorded in 2016,

iv. The 140-room Park-Inn Hotel by Radisson was officially opened at Westlands. The 11-floor tablet shaped hotel will be managed by the Carlson Rezidor Hotel Group.

The above developments highlight a notable increase in interest in the hospitality sector as the serviced apartments and hotel developments aim to serve the demand for short to medium-stay accommodation driven by the growth of business tourism and the overall recovery of the tourism sector. Upperhill, Kilimani and Westlands have become preferred locations for hotels and serviced apartments as they are key commercial nodes, have good road networks and easy access to key amenities.

In our view, serviced apartments still remain the more lucrative investment with higher occupancy rates of 90.0% compared to hotels at 33.0% in 2016 as they charge lower rates in comparison to hotels and have a homely feel making them more ideal for longer stay. In terms of serviced apartment performance by nodes, Upperhill was the best-performing node in 2016 driven by high occupancy and higher daily rates averaging USD 172.0 compared to other nodes such as Westlands at USD 151.0 and Kilimani at USD 141.0.

Overall, the hospitality sector is poised for growth driven by the recovery of the tourism sector as seen through an increase in earnings for the first time since 2012 posting Kshs 99.7 bn in 2016 from Kshs 84.6 bn in 2015, while the number of international arrivals rose by 13.5% from 1.2 mn in 2015 to 1.3 mn in 2016, of which 85.0% were holiday and business travellers. We expected continued improvement in performance in the sector driven by measures by the government including aggressive local and international marketing, introduction of Charter Flights and other incentives such as VAT exemption from Park fees and reduction of Park entry fees.

In the industrial sector, Africa Logistics Properties (ALP) broke ground on their 50,000 sqm Grade-A commercial office development on 22 acres in Tatu City. ALP also intends to put up another warehouse on 49 acres at Tilisi, Kiambu. The firm will provide modern logistics services to retail, light industrial, fast moving consumer goods as well as service the growing e-commerce segment. The warehousing sector in Kenya has seen increased investment driven by (i) demand for high-quality warehousing space as growing local and international companies need to improve their distribution and supply chains, (ii) improving infrastructure, (iii) expansion and modernisation of ports, (iv) demand for warehouse space by landlocked neighbouring countries that rely on Kenyan ports, and (v) the rise of e-commerce which has created demand for storage space for distribution centres. Earlier this year, Kenya was ranked 2nd in Sub-Saharan Africa after South Africa in a Logistics Performance Index by Knight Frank. Furthermore, a report by Broll for 2016 showed that the industrial market in Nairobi recorded positive growth with rentals rising by 11.0% on average. They also projected an 8.0% - 10.0% rental growth rate in the first half of 2017. The table below shows the rental and occupancy rates of warehouses in various nodes of Nairobi in 2016;

Summary of Industrial Market Performance in Nairobi by Nodes								
Area	**Unit Height (Meters)**	**Occupancy (%)**	**Unit Plinth Sqft**	**Rent per Sqft Kshs**	**Price per Sqft Kshs**	**Price Appreciation (%)**	**Rental Yield (%)**	**Uptake %**
Industrial Area	10	90%	7,144	43	7,522	6.8%	7.2%	68%
Baba Dogo	10	88%	9,206	40	6,175	5.1%	7.0%	70%
Ruiru	8	89%	6,917	35	6,000	9.1%	6.2%	66%
Syokimau	7	92%	9,822	36	5,882	2.7%	5.7%	98%

Mombasa Road	9	82%	7,769	30	7,568	13.9%	4.8%	50%
Athi River	8	71%	7,916	23	4,735	6.9%	4.2%	44%
Grand Total	**9**	**85%**	**8,129**	**35**	**6,313**	**7.4%**	**5.8%**	**66%**
Industrial Area was the best performing market with average rental yields of 7.2% and a high occupancy of 90%. This can be attributed to the high demand for warehousing space in the area due to presence many manufacturing companies within								
Source: Cytonn Research								

We expect increased investment in the industrial sector driven by the rapid infrastructural development in the country. Construction of roads and the launch of the Standard Gauge Railway will ease transport and accessibility to various parts of the country, thus leading to growth of warehouses and industrial parks along their courses. The ongoing development of modern ports in Lamu and Kisumu will improve international trade and enable handling of larger volumes of goods. Logistics firms are therefore likely to position themselves in close proximity to such ports.

On the statutory front, the Kenya Revenue Authority (KRA) intends to intensify collection of rental income tax and increase compliance by obtaining basic information on tax defaulters from 3rd parties including Kenya Power, Kenya Bankers Association, the Ministry of Land, and county governments. Through automation and interfacing of databases, KRA hopes to increase compliance as it 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. The real estate sector is one of the fastest growing sectors in the economy expanding by 8.8% in 2016, and thus ought to reflect parallel growth in terms of revenues to the government.

Other highlights in real estate and construction this week include;

i. Ahcof Investments announced plans to construct a 10-floor residential complex in Lavington at a cost of Kshs 522.0 mn. The project will have 160 2-bedroom units on a 1-acre plot along Mbaazi Avenue,
ii. An Egyptian construction firm, Arab Contractors Company, is set to enter Kenya. The move is likely to step up competition for local contractors who are already facing the same from their Chinese counterparts,
iii. The launch of the Standard Gauge Railway (SGR) is set for next week. The railway is likely to boost the growth of the trade and industrial sectors, and create new fronts for development,
iv. Mombasa will get a commuter railway service to ease congestion as the Kenya Railway Corporation (KRC) invited bids for firms to provide consulting services for the feasibility studies and design of the proposed railway network.

Real estate remains resilient with increased investment in the residential, hospitality and industrial sectors driven by increased demand and infrastructural development in various parts of the country while the commercial and retail sectors slow down with speculations of oversupply.

Focus of the Week: Joint Ventures in Real Estate

In the last 5-years, the Kenyan real estate sector has performed well realizing returns of above 20.0% p.a for investment grade real estate and thus attracting the interest from landowners and investors. The main ways to invest in real estate include (i) development and exit through selling or renting out, (ii) buying real estate products to realise capital gains and rental yields, and (iii) buying real estate-backed structured products such as project notes and Real Estate Investment Trusts (REITS). Land owners in particular are increasingly interested in real estate development but are

constrained by (i) financial capability, (ii) development expertise, and (iii) time to do the development themselves. Unknown to many, joint venture arrangements with reputable developers is the most prudent way to tap into the real-estate-benefits. This week, we demystify real estate joint ventures and highlight their benefits.

What is a Joint Venture?

A joint venture (JV) refers to a business arrangement under which two or more parties come together to undertake a project by pooling their resources together. In their most distinctive form, real estate joint ventures combine the real estate development expertise and financing capability of a developer with the landowner?s contribution in the form of land.

The Joint Venture Process

The following are the steps involved in a joint venture;

Both parties sign the Agreement once they agree on the terms and conditions laid out.

1. **Project Appraisal -** The first step always involves appraisal and usually begins with a site visit by the developer to identify the location of the property, its accessibility, the availability of infrastructure, the soil type, the terrain and other factors that affect development. The developer will then conduct a feasibility study to establish the best use for the property, project costs, revenues and the resulting potential returns from such an investment,
2. **Project Proposal -** The developer will then come up with proposal for the landowner showcasing the proposed concept, the budget, the revenues and the profit-sharing between the two parties,
3. **Legal Due Diligence -** When the landowner accepts the developer?s proposal, they are required to avail copies of the land title deed and deed plans for verification by the developer?s advocate. The advocate will conduct a search to establish the authenticity of the title deed, true ownership and that the land is free of any encumbrances. A surveyor will then be engaged to verify the beacons on the ground and confirm acreage on the title compares with the one on ground,
4. **Signing of Agreements -** Once due diligence is complete and is satisfactory, the developer drafts a Joint Venture Agreement (JVA) and sends to the landowner?s advocate. Of the many challenges inherent to a JV, an agreement outlines all possible scenarios that might be a source of conflict and forges a path forward in the event that anything does not go according to plan. The following are some of the common clauses found in a JVA:
    i. The capital obligations of each party,
    ii. The partnership management structure,
    iii. The rights and responsibilities of each party,
    iv. Exit rights and transfer rights with respect to the sale or transfer of membership interests in the JV,
    v. The downside protection for the land value contributed by the landowner, and
    vi. The profit sharing mechanism.
5. **Formation of a Special Purpose Vehicle (SPV) -** Upon signing of a JVA, a special purpose company is formed with the aim of fulfilling the objectives of the JVA. The company is then registered as a private Limited Liability Company (LLC) or as a private Limited Liability Partnership (LLP) by the registrar of companies,
6. **Transfer of Land to the SPV -** Once the company is formed, the landowner is required to avail the title deed and other relevant documents required for the transfer of the land ownership in favour of the SPV,
7. **Project Commencement -** The developer then begins execution of the project through procuring of the project team including the architect, project manager, the engineers and other consultants. The developer oversees the project through to completion,
8. **Project Completion -** Once construction is complete, the landowner and the developer share

profits in accordance to the terms of the JVA. Profits shared may be in form of cash or units such as houses or apartments.

Benefits of a Joint Venture

Joint ventures, if done correctly, can be a source of financial fulfilment for both parties. The following are some of the benefits of a JV;

i. **Increased capital base -** In a JV, partners contribute capital into the project in the form of land and/or cash. This is beneficial considering the capital-intensive nature of real estate development. Furthermore, with seed capital, the partners are able to access debt capital easier as they have a higher bargaining power,
ii. **Development expertise -** The developer in a JV provides development expertise in terms of concept development, design and project management; and oversees the project to completion. With the right partner, the landowner is relieved of the day-to-day hustle of supervising a project and assured of a professional workmanship,
iii. **Access to market distribution channels -** Partnering with a reputable real estate firm that has been in the market ensures the real estate product reaches its suited market, and thus is able to exit faster either by renting or selling, thus realize returns sooner,
iv. **Can provide partial liquidity for landowner without having to sell the entire land ?** In a JV, the land owner can get some cash exit for their land to meet their liquidity needs and also maintain interest in the development,
v. **Preferred Returns ?** Landowners should insist on either preferred or guaranteed minimum returns to ensure that in the event that the project does not materialize, they do not lose the value of their land, and
vi. **Shared risks and gains -** Ultimately, a successful JV will generate the expected high returns for both partners. A partnership also enables spreading of economic and other market risks that might result from undertaking any worthy real estate investment, and that would otherwise be borne alone.

The biggest risk and challenge in joint ventures is getting the right JV partner and having the right governance structure to manage conflicts when they arise. For the investors as you get into a joint venture, it is good to set out the rights and obligations of the various parties in the SPVs and ensure you have downside protection for the value of the land.

Cytonn Real Estate has now engaged in over 1,150 acres of joint ventures in Nairobi Metropolitan Area. To explore JV opportunities with Cytonn Real Estate, contact rdo@cytonn.com

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