Cytonn Monthly February 2015

Cytonn Weekly

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Executive Summary

- Monetary Policy Committee maintained the Central Bank Rate at 8.5% yet again
- Greece secured a four-month extension with its debtors subject to adopting major reforms
- Both NSE-20 and NASI indices rallied with increased foreign investor participation
- Global equity markets rallied driven by Greece negotiations, Crude price volatility and positive Fed policies
- Kenya leads Africa in the number of Private Equity deals
- Kenya Bankers Association introduces a Housing Price Index that is set to boost Kenya?s Real Estate Sector

Fixed Income Update

Kenya?s money market was relatively liquid during the month with the average interbank rate declining to 6.2%, from 8.8% at the beginning of the month. Despite the high liquidity, the yields on Treasury securities were highly unchanged, especially the 91-day Treasury bill. There were significant over-subscriptions of this month?s Treasury bonds with total subscriptions at Kshs 51 billion compared to Kshs 25 billion offer amounts.

The Monetary Policy Committee (MPC) met on the 26th of February and decided to leave the Central Bank Rate at 8.5% citing the fact that the inflation rate of 5.6% was well within the government?s target. Further, the MPC noted that the currency was well supported given that the CBK?s level of usable foreign reserves of USD 7,224.2 million which is equivalent to 4.7 months of import cover and also the IMF?s precautionary support facility of USD 700 million extended earlier in the month.

On the global front, Greece managed to secure a four-month extension to its debt but it was granted subject to the country adopting major reforms; among them being combating tax evasion and corruption, reviewing public spending, modernizing the pension system and reforming the judicial system, which helped it remain part of the Euro zone. Following the deal breakthrough, we expect to witness increased investor confidence in the Euro area since the risk of a default has been mitigated, at least for the next few months.

Equity Market Update

The Nairobi Securities Exchange (NSE) in February rallied, with the NSE All share index and the NSE 20 Index registering gains of 5.7% and 5.1% respectively. Both local and foreign investors supported this, where average foreign participation stood at 46.2%. We saw a number of large capitalization counters rally in the month among them being Safaricom which recorded a return of 11.2%. Not all was rosy since we saw some companies issuing profit warnings; including Crown

Berger, Sameer Africa, Sasini, Williamson Tea, Transcentury and Rea Vipingo. Moving forward, we expect to see active trading at the NSE as companies announce their 2014 results. Furthermore, with the interest rates in developed markets being low, foreign funds are bound to keep flocking into emerging markets like Kenya were potential returns are higher.

Across the globe, the S&P 500 and Dow Jones Industrial Average were on an upward trend for the month. The movement in the indices was mainly hinged on the Greece debt negotiations, crude oil prices and the Federal Reserve decision to postpone raising of interest rates. The S&P 500 and Dow attained record highs gaining 4.1% and 4.4% respectively for the month.The NASDAQ managed to attain 10 straight daily rises in the month and gained 6.1% for the month. The outlook in the global arena remains positive. With the Greece and Euro zone deal, investors? confidence that the Union will stay together is high. Furthermore, the European Central Bank Quantitative Easing program will continue to support the economy in Europe.

Private Equity Update

Kenya continued to lead its East African peers in attracting Private Equity (PE) funding. According to a report done by consulting firm Deloitte, out of every 26 deals done in the region, Kenya attracted 12 deals which amounted to Kshs 9.6 billion. The report dubbed *Private Equity confidence Survey-2014,* showed that majority of the deals focused on agribusiness, healthcare and the financial sector that targeted small and medium enterprises. This continues to highlight that local entrepreneurs and businesses are continuously accepting more attractive and flexible funding options as they seek regional expansion and business competitiveness. However, the report further noted that the region would have more growth if various challenges such as human capital deficiency, a lack of sophistication among portfolio companies, lack of quality deals as well as transparency issues are addressed. Despite these obstacles, the region and moreover Kenya, still remains an attractive investment destination for PE firms amidst a growing middle class, heavy infrastructure investments and macroeconomic stability.

In other news, Kenya based PE firm, Ascent Capital through its Ascent Rift Valley Fund invested Kshs 228 million in Medpharm holdings Africa, an Ethiopian Medical diagnostic. This is the first deal done by the private equity firm which raised Kshs 4.56 billion last year from international and local firms with an inclusion of Kshs 456 million from Kenyan pension funds. Kenya Power pension fund became the first retirement scheme to invest in the PE firm having committed Kshs 365 million and was followed by Nation Media Group pension fund that invested Kshs 92 million. This has signalled an urge by pension funds as well as fund managers seeking to diversify their portfolios and increase their exposure to alternative assets that have historically outpaced traditional assets in terms of returns.

Real Estate Update

The Kenyan Real Estate sector this month received a major boost with the unveiling of the Housing Pricing Index. The index, which was released by the Kenya Bankers Association, is set to provide market players and policy makers with an analytical tool that is useful in tracking the housing sector based on locational, qualitative and quantitative characteristics. The index is also poised to increase transparency in the real estate sector as well as improve market research. In addition, bankers will also benefit since the index will serve as a risk management tool for financial market players who use real estate property as collateral.

A recent market study revealed that the thriving real estate sector is spreading from Nairobi to other counties such as Nakuru. The value of land in Nakuru County has grown by more than ten-fold in four years, evidencing a high demand for real estate in the county. An acre of land in the CBD that traded for between Kshs 1 and Kshs 5 million four years ago, currently has an asking price of between Kshs 100 and kshs 200 million. Also, old buildings are now being pulled down following a directive by the county government so as to pave way for high rise buildings that will offer commercial spaces. The huge interest in real estate in the county can be attributed to a growing middle class and the devolved county government system, leading to the rise of individuals with more disposable income. The booming real estate sector in the county is set to continue as the county pushes to become a 24 hour economy.

Focus of the Month is Private Equity

Private Equity involves investments in private companies, those not listed on any securities exchange. The investors in these companies believe in the strong growth potential of the investee company, where what is lacking is additional capital as well as management expertise.

There are two broad types of Private Equity Investors:

1. **Financial Investors:** These are investors who come into the business to get the potential high returns that the business can generate. There are usually in the company and once they have made a decent return they are ready to sell. The average investment horizon is 5 to 7 years
2. **Strategic Investors:** These are investors that invest in the company due to the strategic fit with what the company needs to achieve their overall objectives. They usually have no exit horizon

Most of the financial investors will raise funds for investment through a fund, where various investors will commit to put in a certain amount into the fund as and when capital is required. Some of the key funds which have played in the local market include Helios, Norfund, Catalyst and Phatisa. Some of the well-known businesses bought by PE firms are Alliance Boots, Odeon and Hilton Hotels on a global scale, and Java & Mimosa pharmacy an example of local deals.The difference between private equities and venture capital is private equities focus on mature businesses in which it sees operational improvement and business growth potential. Venture capital invest in development stage businesses with little track record and which may have negative cash flows. Venture capital investors believe largely in the story of the investee company.

How Private Equities create value:
What do private equities do to the business that wasn?t being done before?
Contrary to Bill Clinton?s famous statement, "*I?ve got a friend who buys failing companies, and he tries to turn them around. And he?s turned a bunch of them around, but not all of them. So sometimes he tried and failed. The effort was honourable. That?s a good thing*", private equities do not only invest in distressed businesses, and in fact distressed businesses are a small speck in the portfolios of Private Equities.

Private equity firms invest in companies in which they see potentially successful businesses that underperform for lack of resources, whether finance or management skills. To ensure that investee companies do well the private equity investors will push for two key things:

1. **Alignment of owners and managers interests:** high, performance-tied incentives for both the private equity portfolio managers and the operational managers of the investment company. These make it more attractive to the managers to achieve results. Growth is achieved by partnering with the management to improve performance and sometimes giving more autonomy. PE firms are experts at putting up strong and highly motivated teams together and coming up with very clear performance measurement criteria.
2. **Cutting down inefficiencies:**Private Equity firms have good experience in identifying and cutting down operational efficiencies. They also bring new ideas for growth, and many times change management for more sector focused leaders. Private Equity forms know how to identify critical strategic levers that shift the gear of the business and are famous for tight financial control, persistent focus on improving margins, revenues and cash flows.

To achieve the stated investment returns to the investors, the financial investors will be consistently looking for exit mechanisms, and below are the key exit options:

- Sale to a strategic buyer. A good example is the recent sale of UAP to Old Mutual in Kenya as it to helps Old Mutual expand its reach in the Insurance market
- Sale to another PE firm. An example being the recent sell of Equity Bank from Helios to Norfund
- Listing on the public markets through an IPO

Private Equity in East Africa and Cytonn Investments products
The Private Equity landscape has remained vibrant in Kenya in the recent past with the country contributing about 46% of the total number of PE deals in East Africa and 69% of the value according to the Private Equity Confidence Survey by Deloitte. The deals were concentrated in agribusiness, healthcare, real estate and financial services. These sectors will continue seeing concentration on them besides infrastructure power and logistics unlike economies like South Africa and Nigeria which are biased towards extractive industries.

With a slowing global growth and Quantitative Easing reducing investment opportunities globally, emerging markets pose an attractive investment opportunity with above-average returns for most investors. Cytonn seeks to provide a platform for investors seeking good investment returns to access the good companies in different sectors. We invest in industries and sectors that we understand and in companies with strong competitive advantages in their industry supported by favourable track records. The companies have to be market leaders or exhibit the potential to be market leaders and are non-cyclical companies that have long-term value creation potential. We believe talented management plays a key role in long term company success.

Below are the three sectors that we are currently investing in:

- Financial Services
- Education and Human Resources
- Information Technology

Cash Management Rates for The Week

Date	Currency	3 Months	6 Months	12 Months
March 2, 2015	KES	12%	12%	12%
	USD	5%	5%	5%

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