Cytonn Quarter 1, 2015 Report

Cytonn Weekly

Executive Summary

- **Global Economic Update**: Most Central Bank actions set to boost global economic growth - the recent Quantitative Easing by the European Central Bank and the delayed interest rates hikes in the US are targeted to boosting economic growth.
- **Sub-Saharan Africa**: Africa continues to be the preferred investment destination by frontier markets focused investors; and the East African region stands out as the most attractive given diversification.
- **Kenya Equities**: The NASI gained 7.5% over the quarter, ending at a valuation of about 17x PE; compared to a 5-year average of 14x PE and expected lower teens earnings growth for 2015, valuations appear stretched. Sectors such as Banking are still attractive when compared to sectors such as Manufacturing and Insurance.
- **Kenya Fixed Income**: Notwithstanding the strong interest from Investors, yields on government securities remained sticky, with investors favoring longer dated paper. The Kenya Shilling weakened during the quarter, but CBK intervention is expected to maintain current levels.
- **Real Estate**: Release of Indices by the Kenya Bankers Association and Hass Consult are increasing transparency in the sector, a factor that will increase capital flows to the sector as SSA?s stock of investible real estate is expected to grow. We still view quality commercial and mid-income housing as the attractive sectors.
- **Private Equity**: Secondary exits were the flavour of the quarter, with corporates willing to pay premiums over market prices for strategic acquisitions, especially across the financial services sector.
- **Cytonn Updates**: We closed our Private Placement on the 31st March 2015. Proceeds of the offering will go towards strategic investments in our development affiliate, a distribution platform, and technology.

A. Global Equities Review

Global economic growth continues to face a number of challenges led by the recent decline in the oil prices, potential geo-political tension in the Eurozone, and the huge currency fluctuation in major countries. A number of emerging markets have seen a decline in economic growth rate, most evidenced in countries like China where growth is projected to be at 6.8% in 2015, compared to 7.4% in 2014.

Eurozone

The European Central Bank (ECB) announced the long awaited Quantitative Easing (QE) programme where they will be purchasing 60 billion Euros a month worth of public sector securities in the secondary market as well as asset-backed-securities. Over the next quarter, we expect that QE together with the low oil prices will boost economic activity and this should provide a bull run for European equities. The main issue that remains in the Euro zone is Greece?s potential inability to repay debt past 20th April 2015. In our view, the longer the delay in reaching an agreement between the new Greek government and its creditors, the greater the risk of damage to the euro area recovery. We don?t see this systemic risk as unmanageable, given that the economic situation now is arguably less worrying than in 2012, and with the QE, we feel the recovery could gain momentum, with 2015 real GDP achieving the 1.5% growth forecasts.

US

In the US, growth looks set to continue at a healthy pace over the next few quarters. Recent US economic data has been mixed, but improving employment numbers as well as gains in incomes, plus an extra boost from lower oil prices, should power healthy growth.

In the recent Fed meeting, the committee removed the word ?patient? as a description for when rates would rise, signaling they are on the path to raising rates, but are not in a big hurry. The USD is expected to continue strengthening versus other major currencies in the long run, however we advise caution on US equities for 2015, as there could be increased market volatility due to monetary policy evolution over the year. In addition, despite the expectation for improved earnings, valuations seem increasingly stretched with the Cyclically Adjusted Price / Earnings (CAPE) ratio currently at 27.9X, with historical averages for ?fair valuations? at 16.5X.

CAPE Ratio vs. Long-term Interest Rates

Japan

For Japan, we expect the economy will continue to grow at an annual rate above 2% in the coming quarters. Since the beginning of the year, investor worry has been that Japanese equities will not rise in USD terms given the currency depreciation and worries over deflation. However, over the remainder of the year, we expect to see investor flows back into Japan due to three key factors: earnings growth which will outweigh the negative currency movements factors, relative undervaluation versus the US, and visibility on an end to deflation.

B. Sub-Saharan Africa Review:

Despite downward revisions in GDP growth by the IMF, Sub-Saharan Africa has some of the world?s fastest growing countries. The growth is largely supported by private consumption and investment given the growth in the middle - income population in the region. The region is expected to register an annual GDP growth of 4.6% in 2015, after a 4.8% growth in 2014 according to the World Bank. The East African region is doing much better than most of the other regions due to the lower reliance on commodity exports, as well as having much more diversified economies with the Banking, Infrastructure and the ICT sectors all supporting growth. The drop in oil prices has negatively impacted the West African region over the first quarter, with the most significant effects being seen in Nigeria and Ghana. The Ebola menace is now under control, however there remains the social political tension in Nigeria due to the Boko Haram insurgents. There was a lot of capital flight in Nigeria at the beginning of the year and this led to a decline in both the stock market and the currency in the month of January. With the now peacefully completed elections, we expect less volatility in the Nigerian Stock market.

The Sub-Saharan African region has continued to see an increase in the flow of foreign capital both in the listed and unlisted markets. Of note is that the regions debt levels have also increased, both to the governments and also to the private sector. Given the low yields in developed market and the increased transparency by local governments, investors are ready to take higher yields from the African countries.

The recent tension between Kenya and Tanzania indicates that there could be challenges towards the formation of economic and political trading blocks in the continent due to the fight for supremacy among the various countries.

The stable macro economic environment outlook has led to investors positioning themselves strategically in the scramble for Africa as the final investment frontier. This is expected to lead to increased private equity flows into the region. It is estimated that over the last decade, private equity flow significantly grew in sub-Saharan Africa from less than US$1 billion in 2009 to over US$4 billion in 2014. The capital will flow to various sectors, however we view the infrastructure and real estate sectors as some of biggest beneficiaries.

C. Kenya Equities Review

During the quarter, the NASI gained 7.5% while the NSE 20 gained 2.6%. The gains were largely driven by price rallies in the large-cap stocks e.g. Safaricom, which accounts for 27.8% of the Market and rose 21.4% during the quarter.

A number of companies released the Full-Year 2014 results, which showed muted year over year growth in earnings Counters in the Insurance sector displayed mixed performance after unanticipated poor results as some of the counters missed analysts expectations e.g. CIC which reported a 28.3% year over year decline in earnings.

The re-introduction of the Capital Gains Tax (CGT) led to significant volatility in the market, which resulted in a drop in market turnover at the NSE in January to Kshs 9.8 billion from Kshs 31.1 billion in December last year. The tax was to be enforced by brokers; this would have been administratively expensive for them, leading to a legal dispute between the brokers and the Kenya Revenue Authority regarding the tax implementation and collection responsibility.

Given the significant rally in the stock market over the last 3 years, valuations are now seemingly stretched on some of the counters despite growth in earnings. As can be seen from the table below, where valuations are classified by sector, we note that sectors such as Telecommunications are expensive when compared to the market. Banking stocks remain attractive on a Price/Earnings basis, however are expensive considering current valuations versus historical Price/Book values.

Sector	**P/E Ratio**	**Dividend Yield**
Manufacturing & Allied	35.5 X	2.5%
Telecommunications	29.8 X	2.8%
Insurance	15.5 X	1.6%
Investment	14.3 X	0.4%
Banking	10.8 X	3.4%

Source: Business Daily and Cytonn Research

With the Quantitative Easing programme in the Eurozone, combined with the stretched valuations in the US, we will continue to see foreign investor activity at the local bourse increase as global capital seeks returns only available in emerging markets at favorable valuations. In addition, the stable macro-economic environment, increased growth in domestic credit and lower inflation rates are all expected to boost earnings and drive value going forward. We expect the market to remain relatively stable and register modest gains over the remainder of 2015. We hope that the recent bold actions by the President to arrest rampant corruption will be sustained; in the long-term, a war on corruption can only help the investment environment. Insecurity remains a concern even though the intensity has receded.

D. Kenya Fixed Income Review

During the quarter, the money markets were characterized by high liquidity as evidenced by the oversubscriptions of government securities. Despite the increased liquidity, yields remained sticky and ended the quarter at 8.4%, 10.3% and 10.6% for the 91-day, 182-day and 364-day T-bills respectively. There is continued high investor appetite for government securities hence the oversubscription, with investors favoring longer dated paper as the investors? anticipate rate decline in the future, however investors are cautious and not pushing down yields.

The Kenyan Shilling has gradually lost ground against the Dollar, on the back of the release of good economic data and expectations of a rate hike in the U.S. Despite weakening against the Dollar, the Shilling has gained to its East African counterparts to emerge the best performing regional currency so far this year aided by a wider export base and strong investor inflows. Despite the Shilling weakening against the Dollar, we feel that the Central Bank has been, and will continue to be active in the market in support of the Shilling.

After two months of consecutive decline due to falling oil prices, the Inflation rate increased in March to 6.3% driven by rising food prices brought about by depressed rainfall in most parts of the country. Even though there is upward inflationary pressure as a result of the soaring food prices, Kenya, being a net importer of oil, is set to continue benefiting from the declining oil prices, and hence inflation is expected to remain in check.

E. Real Estate Review

The Kenyan Real Estate sector this quarter saw a number of developments, with those worth noting being: the unveiling of the Kenya Bankers Association (KBA) Housing Pricing Index, Hass Property Report and the 2014 survey by the Lands and Urban Planning Ministry. It is evident from the three reports alone that the Real Estate sector is making massive strides towards improving transparency and availability of data.

The Hass Consult Real Estate report highlighted that land prices in Nairobi outperformed all other asset classes, rising five-fold over the last seven years. There are several factors that have led to the land prices increasing, namely changes in land zoning, improved infrastructure, preference for suburbs pushing a revolutionary growth in housing, and a surge in construction of commercial property. In addition, the emergence of Nairobi as a regional hub for multinationals has driven the demand for quality office space.

Kenya, like all the other African countries is expected to undergo increased urbanization, which will expedite the largest construction wave in emerging economies. According to PWC, investible real estate is expected to grow by 55% in the next 5 years in Sub-Saharan Africa. In Kenya, we continue to see a shortage of affordable housing, estimated to be around 200,000 units per year, for middle-income earners as well as for student accommodation.

Global Institutional Grade Real Estate Stock

Source: PWC report and Cytonn Research

F. Private Equity Review

2015 is shaping up to be the year of exits for as witnessed by the activity in the first quarter of the year. Kenya witnessed a number of secondary exits quelling exit fears for PE firms in the midst of a ready market of investors and PE firms.

Helios partners exited half of its stake worth about Kshs 23 billion in Equity Holdings Limited to Norfund while Kenyan based PE firm, Centum Investment sold its 13.75% stake at UAP Holdings Limited for Kshs 4.1 billion to Old Mutual. These transactions shed light on the huge differential between exit values and new investment value, as corporate acquirers looking to make strategic acquisitions are willing to pay a premium.

Sub Saharan Africa has witnessed increased Private Equity participation over the recent past, highlighting the investor confidence in Africa. Kenya, having been named as the best African emerging economy to invest in and the seventh globally by the Fortune Magazine, has become a land of opportunities and an attractive investment destination for foreign inflows. This is further supported by the increased investment in infrastructure development like the Standard Gauge Railway and the LAPSSET project, as well as a more transparent and conducive business environment.
