Cytonn Weekly Report #18, with a focus on Alternative Investment Opportunities in Kenya

Cytonn Weekly

Executive Summary:

- **Fixed Income:** Interest rate risk going up due to uncertainties in the market despite the CBR rate remaining unchanged;
- **Equities:** NASI fell 1.0%, as large cap banking stocks fell following the release of weaker than expected Q1 results;
- **Real Estate**: The construction and real estate sectors are contributing more to overall economic growth as per the economic survey released by the Kenyan National Bureau of Statistics;
- **Private Equity:** East Africa has seen an increase in the number of PE investments and exits in the region, with most exits recorded in the financial sector;
- **Focus of the Week**: Investment opportunities in alternative investments markets, such as real estate, remain the most attractive.
- **Company Updates:** We completed Joint Venture Arrangements with two landowners in two highly sought after neighborhoods. Cytonn Real Estate expects to announce the aspirational development concepts to our clients within the next 1 to 2 months.

Fixed Income Update

Treasury bills registered under-subscription during the week, with the total subscription at 44%. However, rates were relatively unchanged at 8.4%, 10.3% and 10.7% for the 91, 182 and 364-day papers, respectively. The Monetary Policy Committee held the CBR rate steady at 8.5%, citing the fact that inflation is currently not demand driven, MPC however noted the shilling?s volatility. The Central Bank will be looking to raise Kshs 20.0 bn from the primary market this month by reopening a 2 and a 10-year paper; we will give our view on the bonds next week. The expected maturity this month of Kshs 11.0 bn will support liquidity in the market.

April inflation rose to 7.1% from 6.3% in March on account of increased food prices, as the delayed rains in the first quarter resulted in a 13% year-on-year increase in food prices. The current weakness in the currency could put pressure on inflation rates going forward. It is however comforting that inflation is not demand driven, as cited by MPC.

Similar to the other East African currencies, the Kenya shilling continued it?s losing streak, declining by 0.7% for the week; a total YTD decline of 5.1% to the dollar. The Central Bank?s activities in the market continue to support the shilling, currently largely relying on the high forex reserves amounting to 4.4 months of import cover and a USD 688.0 mn IMF precautionary facility.

In the near-term, the shilling?s volatility, which could lead to inflation, may cause interest rates to rise. We therefore remain biased towards short durations.

Equities

The market remained relatively flat in the week with NASI declining by 1.0% while NSE 20 declined 0.4%. The fall in NASI was attributed to a decline in the banking sector; large cap stocks like Equity Bank and Standard Chartered fell as banks continue to release their Q1 results, which were below market expectations.

KCB bank recorded a 12.0% increase in Q1 profits to Kshs 4.4 bn, edging out Equity bank to be Kenya?s most profitable bank. The performance was driven by increased interest income that rose 13.1% to Kshs 12.2 bn, and an 18.0% increase in transaction based income. NIC had 2.0% growth in profits, weighed down by an increase in the NPL ratio by 8%.

On other earnings front, Safaricom released its 2014 full year results, announcing a 38.4% increase in profit to a record Kshs 31.9 bn. While headline earnings growth of 38.4% appear very strong, the growth was driven mainly by a flat year over year depreciation number. Excluding depreciation, EBITDA growth was a respectable 17% but way below the headline 38.4% earnings growth. The 17% growth was driven mainly by growth in non-voice revenue, such as M-Pesa, data and SMS, collectively growing at 27.4% compared to anaemic voice growth of 3.7%.

The stock market continues to be driven by corporate results and corporate actions, with counters trading broadly lower as earnings growth slows. We remain neutral on equities given stretched valuations and lower earnings growth prospects. The market continues to be a stock-picker?s market to derive value.

Real Estate

The building and construction sector continues to do well as per the Economic Survey data released last week. The sector grew by 13.1% compared to 5.8% in 2013 and contributed 8.5% to overall GDP growth compared to the previous year at 6.0%. The real estate sector is poised for strong and sustained growth due to (i) continued growth of credit to the private sector, and bulk of it going towards real estate, (ii) chronic shortage of housing yet rapid urbanization continues, (iii) shortage of quality commercial and retail space.

Our immediate concern regarding the sector remains insecurity and a volatile shilling; the sector is extremely capital intensive and imports key building materials hence very sensitive to a volatile shilling.

Our thematic investment focus remains the same; we target real estate investment opportunities that address infrastructure and insecurity. Rapid urbanization has outpaced infrastructure development, hence developments that conveniently provide reliable water, power, sewer and transport access, in a secure setting, will do very well.

Private Equity

As earlier highlighted in our Cytonn Weekly Report # 16, we have seen increased partnership between government and private sector in the provision of essential services. Last week?s financial press coverage reported that Trapos Limited, an infrastructure company, is partnering with Kenya Ferry Services, a government entity, to improve the link between Mombasa Island and the mainland South coast via an express cable car service. It is however not yet clear to us why the express cable solution is superior to the earlier mooted solution of building a bridge. Other essential services entities involved in PPPs are Kenyatta Hospital and Kenyatta University.

East Africa has seen an increase in investments recording a 38.0% growth in the period 2011-2014 while both West and North Africa registered an 18.0% decline in investments over the same period. Last week Fanisi Capital invested USD 3.0m to buy a 35.0% stake in Live Ad Limited, an outdoor advertising company. The portfolio of Fanisi investment continues to grow and their focus areas include retail, media, health, agro-business, and education.

Focus of the Week: Alternative Investments in Kenya

Investors typically invest in well-known and liquid asset classes such as money markets, equities and fixed income, collectively referred to as ?traditional investments? or ?public markets?. As an ?alternative? to these traditional investments, there are other investments referred to as ?alternative investments? such as private equity, real estate and structured products. While relatively illiquid and more complex, alternative investments offer higher and more stable returns over the long-term.

Investor?s focus is gradually shifting towards alternative investments, due to increased investor education and global capital searching for lucrative returns available in the region. Demographic trends, including a young population and a growing middle class, alongside rapid urbanization and government?s sluggish pace in the provision of essential services, has created an opportunity for private capital to drive growth.

When analysing returns over the last 5 years, across various asset classes, it is evident that return in alternative investments is more lucrative than those available in traditional investments. For example locally, real estate has registered the highest returns over the last 5 years, at 24%, as compared to traditional markets that have averaged about 13%, as can be seen in the graph below.

Average per annum 5-Year Return per Asset Class

Most investment managers in the region have a primary focus towards investments in the public markets. Initially, this was largely driven by stringent regulations, however despite efforts by regulators to spur investment in the alternative space, actual asset allocations are yet to shift. This can be largely attributed to fewer investment managers focusing on the alternatives space and need for better investor awareness about opportunities in alternatives. Comparing Kenya?s market capitalization to GDP, currently at 51.0%, to South Africa?s at 155.0%, it is evident that the bulk of the Kenyan economy is still in the unlisted markets. This means that there is a lot of money chasing few listed opportunities in the public markets, creating conditions where available investment opportunities could be pricey.

Listed Equities Market Cap to Total GDP

In summary, the improved investment environment due to stable macroeconomic conditions, and lower returns in the more developed markets, point towards an increased allocation towards alternative investments. In Kenya, these trends indicate that there is still significant room for above average returns over the next 10 years in alternatives, mainly real estate and private equity.

In the upcoming Cytonn Weekly Reports, we will dig deeper into the opportunity areas we cover in real estate, private equity and demystify structured products.

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