Cytonn Weekly Report #19, with a focus on structured products such as ?CMS?

Cytonn Weekly

Executive Summary:

- **Fixed Income:** Interest rates risk going up due to uncertainties in the market occasioned by the shilling?s volatility;
- **Equities:** NASI fell 2.2%, as large cap stocks declined due to net divestments by foreign investorsto cheaper markets such as Nigeria**;**
- **Real Estate:** Infrastructure is driving up real estate prices, as evidenced by Ruaka where land prices have increased tenfold in the last five years**;**
- **Private Equity:** Private equity activity in East and West Africa to increase on the back of strong demographics and macro-economic fundamentals;
- **Focus of the Week**: Structured products offer higher yields than would otherwise be accessible from competing investments;
- **Company Updates**: Cytonn strengthens its corporate governance by naming new Board of Directors members this coming week.

Fixed Income Update

Despite under performance for the second week running, treasury bills performance improved slightly during the week with total subscriptions at 56%, compared to 44% last week, as the market liquidity remained tight due to tax payments. There was a change in trend with yields increasing marginally, but on averagethey were relatively unchanged at 8.4%, 10.3% and 10.8% for the 91, 182 and 364-day papers, respectively.The Central Bank is set to re-open a 2and 10-yearbond, both issued in 2014, currently trading at yields of 11.1% and 12.3%, respectively. Given the increased market uncertainty and tight liquidity, we expect rates to edge up with more bids expected on the 2-year, as investors keep short on duration.

The shilling continued on a downward trend against the dollar,losing 1.2% for the week, to trade at 96.1; weattribute the loss to increased market speculation on the currency. TheCentral Bank indicated that they would continue monitoring speculative activity on the currency and take corrective actions. With the Kshs 64 bn ($673.7 mn) IMF facility and the large available forex reserves, the Central Bank can intervene to stem the shilling?s volatility.

Given theshilling?s volatility and the resultant inflationary pressures, we maintain our view that ratescould increase in the near term and we remain biased towards shorter durations.

Equities Update

The equities market was on a losing streak this week as NASI lost 2.2%, while NSE 20 was down 1.8%, on the back of declines in large capitalization stocks such asBritam (7.1%), EABL (5.6%),Safaricom(4.1%) and KCB(4.1%). Despite foreign investors being net sellers, Co-op bank gained 5.8% during the week,on the back of increased buying by foreign investors. Since the beginning of the year, we have seen investors exiting the market in favour of Nigeria,which offers cheaper valuations, after the stock market decline prior to the recent elections.

Kenya Airways is set to benefit from the declaration of Liberia as an Ebola-free country by the WHO, and the aggressive marketing of Kenya as tourist destination by the government. The company suffered significant cashflow shortages due to reduced customer and destination numbers, amidst an aggressive expansion strategy called ?Project Mawingu.?The stock has lost 19.5% YTD, however we expect improved earnings for the next financial year, as well as price correction,which could translate to upside for the stock.

On the earnings front, Family Bank, which trades over-the-counter, posted a profit before tax of Kshs 797mn in Q1 2015, a 23.5% growth compared to the same period last year. Family Bank reversed the trend of lacklustre Q1 performance by banking peers, who areso far reportinglow teens earnings growth. The bankplans to open ten branches this year,implement aKshs 1 bn ICT infrastructure upgrade, and continue focussing on the retail mass market and SME?s; these strategic initiatives should sustain a future growth earnings potentialof mid to high teens.

Thestock market continues to be largely driven by corporate announcements. We remain neutral on equities, given stretched valuations and relatively lower earnings growth prospects. The market continues to be a stock-pickers? market to derive returns.Consequently, active money managers will most likely outperform passive managers going forward.

Private Equity

The outlook for private equity in East Africa has never been glossier, as highlighted by Deloitte?s Africa Private Equity Confidence Survey. As much as South Africa has the larger slice of the private equity activity, East Africa and West Africa are seeing more growth fuelled by strong demographics,strong macro-economic fundamentals and improved political governance systems. The businesses in the regionalso have limited access to debt funding, and even when accessed, debt funding is prohibitively expensive. All these factors have led firms to consider private equity funding.

The entry of international private equityfirms and more local firms focused on PE has increased market awareness,and we expect to see an increase in competition for attractivedeals. Transaction sizes are also set to grow in East Africa, with Kenyaconsidered the most attractive investment destination in the region due to the ease of exit and relatively bigger deal opportunities. Real estate, financial services and fast moving consumer goods (FMCGs) such as food and beverages are the investments of choice in East Africa. Europe is considered as the leading source of funds.

We expect to see more funding from the Eurozone,which is currently experiencing low investment yields. The sectors set to benefit include retail and residential real estate, FMCGs, financial services and manufacturing.

Real Estate

Infrastructure development is driving real estate growth in Kenya and in the region. New roads and bridges, more reliable energy,and better intercity passenger connections are adding appeal to previously inaccessible areas. In March, we discussed how the Eastern bypass drove up real estate developments and prices in the adjacent areas. This month we focus on the Northern bypass and its impact on real estate. Towns like Ruaka are gaining traction as residential towns, due to their proximity to areas like Tigoni, Muthaiga and Runda. Karuri Water and Sewerage Company has facilitated reliable water supply, which adds to the appeal of the area. With the mushrooming of residential developments, service sectors will be in high demand to meet the needs of the surrounding population. Two Rivers mall and Rosslyn Riviera mall are some of the retail centres opening up to cater for the growing number of residential developments put up since the construction of the bypass started. This will also lead to increased demand for hotels, entertainment spots, hospitals and schools. Demand from different real estate sectors is pushing up the cost of land; for example, a 50 ft. by 100 ft. plot in Ruaka is sellingfor anywhere between Kshs 20 to 25 mn, over 10 times its price 5 years ago. Our development affiliate, Cytonn Real Estate, has a residential development in Ruaka at concept stage, which we will share with our investors when ready.

Developments in other cities and towns in Kenya are gaining a lot of prominence.For example, the English Point Marina in Mombasa is getting increased interest from investors due to the Marina, the first in East Africa.

Focus of the Week ? Structured Products

In last week?s report, we showcased alternative investments as an attractive asset class. Alternative investments can be classified as investments in real estate, private equity and structured products. While relatively illiquid and more complex than traditional investments (fixed income and equities), alternative investments offer higher and more stable returns over the long-term as illustrated in our last week?s report.

Alternative investments are also referred to as private investments because you cannot access them from the public markets. For example, public / traditional investments are reported on daily in the press. And some like unit trusts are even required by regulation to report their pricing on a daily basis. On the other hand, alternative / private investments can only be accessed by invitation or by inquiry.

Having discussed alternative investments last week, we will now delve deeper into each type of alternative investment, starting with structured products:we will explain what they are, give an investable example, how the products are able to achieve higher returns and explain the key benefits.

Structured products are investment solutions, which are packaged by investment professionals, typically tailor made for the investor, to enable them access pockets of returns in the market that are not readily accessible through traditional investment avenues. They involve adding a layer of structuring to traditional products such as stocks, bonds and bank deposits. Structured products tend to be highly complex, but that complexity is compensated by significantly higher returns relative to traditional product alternatives.

Because of the two essential aspects of structured products, (i) the adding of a structure / feature to an existing product so that (ii) it fits a tailor made / specific need of an investor; structured products are largely privately manufactured, typically by alternative investment managers such as private equity firms, and privately placed to high net-worth investors and institutions through private placements.

This is not to say we cannot have structured products manufactured by traditional managers and / or publicly placed to the investing public. Examples of publicly placed structured products exist, but they are exceedingly rare. For example, Centum?s and ARM?s equity linked notes are structured products. The issuers took a traditional product, a corporate bond, then added a structure, in this case an ?equity link?, to develop an equity-linked note, which was issued to the public.

Examples of privately placed structured products include structured notes backed by high yielding assets such as real estate and commercial paper. The most common examplesof privately structured products in Kenya are real estate backed notes and the cash management solution(?CMS?) which could yield anywhere from 12% p.a. to as high as 16% p.a. depending on the underlying alternative asset and the duration of the investment.

Real estate backed structured notes is where a developer gets high net-worth individuals to finance a development for a specific return. For example, a developer looking for Kshs. 100 million development financing can either go to a bank to get development finance at say 16% per annum or the developer can go to 10 high net-worth individuals, each investing Kshs. 10 million to get the same Kshs. 100 million. The developer can offer the individuals a 13% return, better than the individuals would otherwise get in other products, and for the developer the 13% cost would be cheaper than they would otherwise get with a bank finance.

Another growing example of a structured product is CMS, which is a privately placed high-yield product that offers investors higher returns than they would get in other competing investment cash management options.

There are several ways that enable CMS to offer better returns to the investors:

- **Consolidation:** where client?s funds are aggregated and then invested. The economies of scale lead to the investment manager having a greater bargaining power with financial institutions than if the investor approached a bank themselves;
- **Market knowledge:**Investment managers are able to understand liquidity needs in the market for banks and corporates, and hence place funds where they would attract the highest risk-adjusted return;
- **Quick decision-making:**Some investment opportunities require quick decision-making capability, and with investment managers having analysis and dealing capabilities, it is easy to execute faster hence taking advantage of the glaring opportunities;
- **Credit analysis:** Some privately placed opportunities such as high yielding private commercial paper and real estate mezzanine notes require specialized analytical capability to incorporate into a portfolio.

To enhance the security of this product, the investment managers have to put in place a strong governance structure. Some of the key things that would be important to get right are:

- Ensure a well-diversified portfolio across various investments and deposits in banks which have been analyzed and rated for financial health;
- Having a custodial arrangement where client funds are not directly handled by the investment manager;
- Having a trustee who oversees the performance of duties by all the service providers, including the investment manager;
- Simple but comprehensive incorporation and governance documents that protect all the parties inthe investments, especially the investors.

Structured products are essential to private markets development and the economy for several reasons:

- Structured products offer an option to investors that want more risk for more returns than they would get in public markets. In Kenya, these investors have typically had to go off-shore for attractive opportunities such as structured notes, but development of private markets is now keeping their money on-shore.
- Structured products encourage alternative investors from abroad to invest in the country. Allocations for alternative investments will not go into equities and fixed income. If we do not develop alternative investments, such as structured products, foreign investments targeting structured products will have limited investment opportunities.
- With Kenya?s goal to develop as a regional financial services hub, it is critical that we develop our private markets to complement our public markets. We do not know of a regional financial hub that has developed with public markets alone. The complexity, speed and innovation that

accompany structured products require an active private market. In more developed markets, they have even developed specialty private trading platforms for alternative investments.

- Most of our private market players in real estate and private equity tend to be foreign founded firms. There is no reason why local talent cannot be active drivers and participants in private markets. This would increase job creation and keep the profits from being repatriated.

A concerted effort to support the development of the private markets sector is critical and urgent.

Next week we will focus on private real estate investment product opportunities.

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