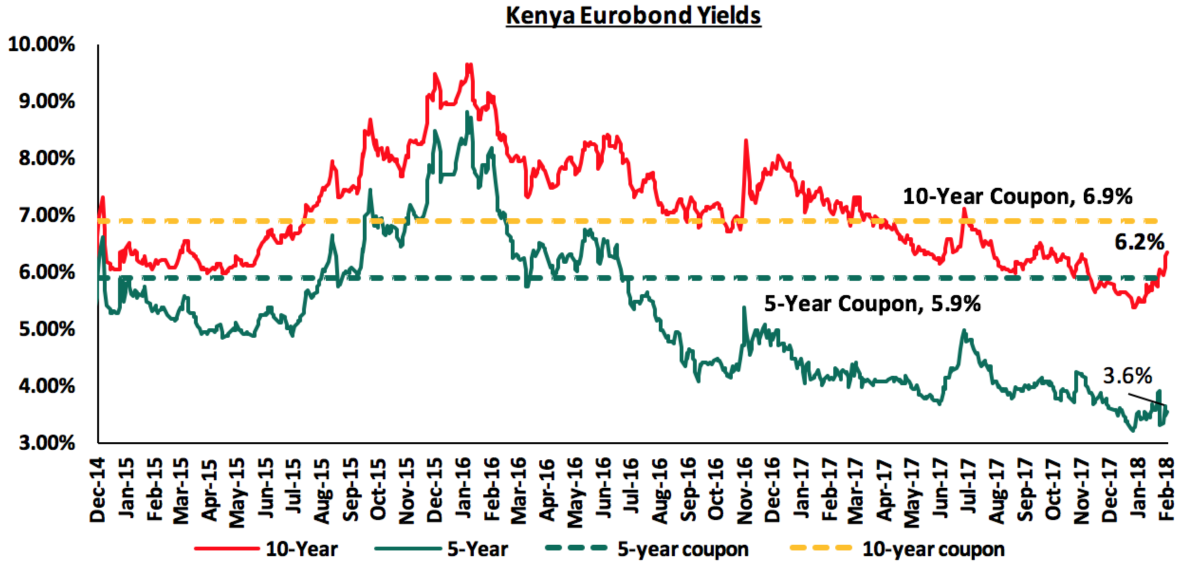
Update on Kigali Real Estate Investment Opportunity, & Cytonn Weekly #8/2018

Fixed Income

Treasury bills were oversubscribed during the week, with the overall subscription rate declining to 104.7%, compared to 140.5% recorded the previous week. The subscription rates for the 91, 182 and 364-day papers came in at 124.2%, 84.3%, and 117.3% compared to 116.8%, 112.2%, and 178.3%, respectively, the previous week. Yields on the 91 and 182-day papers remained unchanged at 8.0% and 10.4%, respectively, while the yield on the 364-day paper declined by 10 bps to 11.1% from 11.2%, the previous week. The overall acceptance rate increased to 96.3% compared to 81.4% the previous week, with the government accepting a total of Kshs 24.2 bn of the Kshs 25.1 bn worth of bids received, against the Kshs 24.0 bn on offer. The government is ahead of its domestic borrowing target for the current fiscal year, having borrowed Kshs 218.3 bn, against a target of Kshs 194.6 bn (assuming a pro-rated borrowing target throughout the financial year of Kshs 297.6 bn from the 2018 Budget Policy Statement (BPS) that was approved by the Cabinet).

Last week, the Kenyan Government re-opened two bonds, FXD 1/2010/15 and FXD 2/2013/15, with effective tenors of 7.1 and 10.2 years, and coupons of 10.3% and 12.0%, respectively, in a bid to raise Kshs 40.0 bn for budgetary support. The overall subscription rate for the issue came in at 60.4%, with the market weighted average bid rates coming in at 12.8% and 13.0%, 10 bps above the average accepted rates of 12.7% and 12.9%, respectively, in line with our expectations. The government accepted only Kshs 13.2 bn out of the Kshs 24.1 bn worth of bids received, translating to an acceptance rate of 54.7%. However, we don't expect the government to come under pressure to borrow for the current fiscal year as (i) the government is currently ahead of its domestic borrowing target now that the 2018 BPS was passed and the target reduced by 27.5%. This adjustment was most likely made to accommodate plans of a Eurobond issue by the government, as the foreign borrowing target increased by 16.6%, (ii) KRA is not significantly behind target in Revenue collection; as per the Quarterly Economic and Budgetary Review for the first half of the fiscal year 2017/18, the Kenya Revenue Authority (KRA) collected Kshs 709.4 bn in revenue, against the government's half year target of Kshs 777.7 bn and a pro-rated target of Kshs 821.6 bn (assuming a full year target of Kshs 1.6 tn), translating to 91.2% of their target and 86.0% of the pro-rated target. This figure differs slightly with KRA's H1 Performance Review and Prospects for the FY 2017/18, according to which the government had collected Kshs 712.2 bn during the same period, 92.0% of their target and 87.0% of the pro-rated target, and (iii) successful issuance of the Eurobond which raised USD 2.0 bn (approx. Kshs 202.0 bn). Adding Kshs 24.1 bn borrowed by December 2017, this translates to 69.9% of the full year foreign borrowing target of Kshs 323.2 bn, and approx. 105.0% of their pro-rated target.

According to Bloomberg, the yield on the 5-year Eurobond rose by 10 bps to 3.6% from 3.5% while the yield on the 10-year Eurobond declined by 40 bps to close at 6.2% from 6.6%, respectively, the previous week. Since the mid-January 2016 peak, yields on the Kenya Eurobonds have declined by 5.2% points and 3.4% points for the 5-year and 10-year Eurobonds, respectively, due to the relatively stable macroeconomic conditions in the country.



During the week, Kenya issued its second set of Eurobonds, a 10-year and 30-year Eurobond at coupons of 7.3% and 8.3%, both 30 bps below 7.6% and 8.6%, respectively, which had been advised by the banks working on the deal. The Eurobonds are listed on the London and Irish Stock Exchanges. The proceeds will go towards development expenditure and debt liability management. The issue was 7.0x oversubscribed with bids received at USD 14.0 bn as compared to the USD 2.0 bn target despite (i) Moody's downgrade of the government's issuer rating to "*B2*" from "*B1*" the previous week, and (ii) the International Monetary Fund (IMF) decision to withdraw their stand-by credit facility effective March 2018 citing the government's failure to have made viable arrangements to meet the condition to lower its budget deficit to 3.7% of GDP by 2018/19 in order to extend the facility. Key to note is Kenya's total public debt increased by 19.4% to Kshs 4.6 tn in December 2017 from Kshs 3.8 tn in December 2016, driven by a 23.9% increase in external debt. Domestic debt increased by a slower rate at 15.0%. The additional funds obtained from the Eurobond will add to the external debt burden which was at Kshs 2.3 tn as at December 2017, according to the latest data released by the CBK.

The Kenya Shilling depreciated by 0.5% against the US Dollar during the week to Kshs 101.7, from Kshs 101.3 the previous week due to increased end-month demand from oil and retail importers. On a YTD basis, the shilling has gained 1.4% against the USD. In our view, the shilling should remain relatively stable against the dollar in the short term, supported by:

i. Weakening of the USD in the global markets as indicated by the US Dollar Index, which shed 9.9% in 2017, and has shed 2.4% YTD,
ii. Improving diaspora remittances which increased by 26.6% to USD203.8 mn in December 2017 from Kshs 160.9 bn in December 2016 driven by a 39.2% and 30.9% increase in remittances from North America and Europe, respectively, and,
iii. CBK's intervention activities, as they have sufficient forex reserves, currently at USD 7.2 bn (equivalent to 4.8 months of import cover). Key to note is that the IMF met with the members of the National Treasury during the week and decided to withdraw the USD 1.5 bn stand-by facility with Kenya effective March 2018 as conditions previously agreed upon for the facility to be extended had not been met. This will deprive Kenya of approx. 1 month of import cover in case of any pressure on our Balance of Payment (BOP) position. Our BOP position improved to a surplus of 1.2% of GDP in November 2017 from a deficit of 1.3% of GDP in November 2016 supported by a capital & financial account balance surplus of approx. 8.0% of GDP, despite a current account deficit of 7.0% of GDP.

We are projecting the inflation rate for the month of February to range between 4.6% - 4.8%, from 4.8% in January. The y/y inflation rate is expected to decline as a result of a base effect but m/m inflation is expected to rise mainly due to (i) an increase in prices of kerosene, diesel and petrol by 2.6%, 2.3% and 1.5%, effective from 15th February to 14th March, as detailed in our Cytonn Weekly #7/2018, (ii) an increase in electricity prices, as Hydro-Electric Power (HEP) generation remains low and diesel-powered thermal generators used to fill in the gap result in a rise in the cost of electricity production with the increase in the cost of diesel, and (iii) an increase in food prices with pressure from the rice shortage and the pass through effect from transport costs increasing; despite maize flour prices remaining steady supported by cheap imports from Tanzania and Uganda, and the decline in wheat flour prices, now retailing at the same price as maize flour. There is also the threat of a drought brought about by *La Nina*, currently developing in the Equatorial Pacific Ocean. We expect inflation to average 7.5% over the course of the year down from 8.0% in 2017, which is within the government target range of 2.5% - 7.5%.

The National Treasury released the Quarterly Economic and Budgetary Review for the first half of the fiscal year 2017/18. We have summarized the report below:

amounts in Kshs bns unless stated otherwise

Quarterly Economic and Budgetary Review for H1'2017/18 - Budget Summary			
Item	H1'2017/18		
	Amount Collected/Spent	Target	% of Target Met
Total revenue	709.4	777.7	91.2%
External grants	7.8	25.4	30.8%
Total revenue & external grants	717.2	803.1	89.3%
Recurrent expenditure	647.0	616.2	105.0%
Development expenditure	173.8	258.2	67.3%
Other expenditure	84.7	148.5	57.0%
Total expenditure	905.5	1,022.9	88.5%
Fiscal deficit	(188.3)	(219.8)	
Deficit as % of GDP	*2.2%*	*2.5%*	
Net foreign borrowing	24.1	61.5	39.2%
Net domestic borrowing	183.6	163.5	112.3%
Total borrowing	207.6	224.9	92.3%
GDP Estimate	8,654.6	8,654.6	

From the table above, key take outs include:

i. The KRA met 91.2% of their HY target, having collected Kshs 709.4 bn against a target of Kshs 777.7 bn. Overall revenue and grants were at 89.3% of the target,
ii. Recurrent expenditure was above target at 105.0% while development expenditure was below target at 67.3%. Of recurrent expenditure, Kshs 154.8 bn was foreign and domestic interest payments, which comes to 21.8% of revenue. Total budget absorption was at 88.5% of the target, and,
iii. The government collected 39.2% of the net foreign borrowing target and 112.3% of the domestic borrowing target, having collected Kshs 24.1 bn and Kshs 183.6 bn from the foreign and domestic markets, respectively.

Other highlights from the report include:

i. In December 2017, Kenya's external debt was composed of 33.3% bilateral, 35.8% multilateral and 30.1% commercial debt, as compared to 33.8%, 41.2% and 24.2% in December 2016, respectively. As stated in our recent focus note on Kenya's Public Debt, multilateral debt is mostly concessional hence cheaper, accounting for 16.0% of external debt service, while commercial loans are largely non-concessional and more expensive, accounting for 50.0% of external debt service,

ii. China remains our largest bilateral lender at USD 5.2 bn as at December 2017, followed by Japan at USD 824.8 mn and France at USD 622.5 mn,
iii. Money Supply (M3) growth was at 8.4% in November 2017, up from 6.2% in November 2016 mainly due to an increase in lending to the government, and,
iv. Kenya's BOP position improved to a surplus of 1.2% of GDP in November 2017 from a deficit of 1.3% of GDP in November 2016.

In our view, the report points to a more positive outlook on government borrowing, with the government now on track towards meeting both their domestic and foreign borrowing target, though concerns still remain around the rising non-concessional debt burden.

BMI Research released their Africa Monitor for East & Central Africa dated March 2018, projecting Kenya's GDP Growth at 5.2% in 2018, expected to be driven by (i) an easing in political risk following the prolonged political impasse over the 2017 presidential elections acting as a boost to foreign Investment, and (ii) growth in information &communication technology, financial and transportation services. Key to note is according to the 2018 BPS, the National Treasury projects GDP growth of 5.3% in Q4'2017, which would bring the year average to 4.9%. As per the 2018 BPS, the Treasury projects that GDP will grow by 5.8% in 2018. Below is a table showing that the Kenyan economy is expected to grow by an average of 5.5% as projected by various research houses, global agencies and government organizations. We shall continue to update this table anytime growth outlook is adjusted by these organizations, or in the event of new research houses expressing a view.

Kenya 2018 GDP Growth Outlook		
No.	Organization	Jan-18
1	Central Bank of Kenya	6.2%
2	Kenya National Treasury	5.8%
3	African Development Bank (AfDB)	5.6%
4	Stanbic Bank	5.6%
5	Citibank	5.6%
6	International Monetary Fund (IMF)	5.5%
7	World Bank	5.5%
8	Fitch Ratings	5.5%
9	Barclays Africa Group Limited	5.5%
10	Cytonn Investments Management Plc	5.4%
11	Focus Economics	5.3%
12	BMI Research	5.2%
13	Standard Chartered	4.6%
	Average	5.5%

Rates in the fixed income market have remained stable as the government rejects expensive bids despite being behind their borrowing target. However, a budget deficit that is likely to result from depressed revenue collection creates uncertainty in the interest rate environment as any additional borrowing in the domestic market to plug the deficit could lead to upward pressure on interest rates. Our view is that investors should be biased towards short term fixed income instruments to reduce duration risk.