Cytonn Weekly #24, with a focus on the economic impact of the budget

Cytonn Weekly

Executive Summary

- **Fixed Income:** Currency weakness continues and rates remained flat despite last week?s 150 bps increment;
- **Equities:** Market remained flat in absence of major corporate news;
- **Private Equity:** TPG, a top 10 global PE firm with USD 80 billion of assets under management, becomes the 3rd large US PE firm to enter Africa, after Carlyle and KKR;
- **Real Estate:** Treasury announces landlords to pay 12% of rental revenues in taxes;
- **Focus of the Week:** An increase in the government budget and a widening current account deficit poses additional threats to the shilling?s volatility;

House View: Our view is that in the short term, investors shy away from equities and long dated fixed income, because of stretched valuations and risk of rate increases, respectively; and park money in high yielding short dated instruments and money markets as they await better entry points.

Company Updates:

- We continue to see significant interest in real estate asset class ? this week we trained Catholic University Trustees and CentSavvy Capital Ventures on real estate investment products
- Amara Ridge development is now 40% taken, with only 6 units remaining: Amara Ridge flythrough
- Our diaspora business staff is in London this week discussing real estate investment solutions for the diaspora, contact Hetal Nathwani at hnathwani@cytonn.com to schedule diaspora meetings in London
- We are currently hiring for the following two open positions: Legal Analyst and Real Estate Sales & Marketing Associate, see the following link: Open Positions

Fixed Income

Treasury bill auctions continued to be undersubscribed, with a 23.7% overall subscription this week after a 47.7% subscription last week; undersubscription is due to tight liquidity in the money markets as a result of corporate tax payments and mop-up activity by the CBK to support of the shilling. However, investors continue to prefer short-term investments, as seen in the 91-day T-bill subscription, which had Kshs 1.1 bn subscribed versus Kshs 1 bn offered.

Despite the recent 150 bps rate increase by MPC, yields remained relatively unchanged at 8.3%, 10.6% and 11.1% for the 91, 182 and 364-day papers, respectively. The fact that yields have not changed despite a 150 bps MPC rate increase is an indicator that the Central Bank Rate (CBR) has not been fully accepted by the market as a policy tool hence raising doubt about its effectiveness as a monetary tool.

Despite a depreciating dollar in the global markets, the Kenya Shilling still depreciated by a further 1.0% against the dollar during the week to close at Kshs 98.2 on the back of dollar demand from the manufacturing sector for imports. We expect further weakening in the shilling driven by end-month demand by importers, however this will be cushioned by Central Bank?s activity in the market and a weaker dollar given expectations of a more prolonged rate increase timeframe by the Fed.

In a bid by investors to diversify their fixed income portfolios into corporate bonds, Centum Investment?s 5-year, Kshs 6 bn corporate bond received bids worth Kshs 8.31 bn, a 38% oversubscription. The equity-linked note (?ELN?), which will offer investors higher returns based on the performance of the company's net asset value in addition to the 12.5% coupon, received subscription worth Kshs 3.5 bn (42%), while the 13.0% fixed coupon portion received subscription worth Kshs 4.8 bn (58%). The 42% ELN subscription is higher than the last time Centum offered an ELN, a clear indication that investors are seeking higher risk-adjusted returns and willing to look at unconventional investment instruments.

We expect yields on government securities to increase due to a number of factors: (i) increase in the CBR, a portion of which will eventually pass through to market rates, (ii) increased government borrowing in the domestic market to fund the 2015 / 2016 budget and (iii) tight liquidity in the market. ***We continue to hold our April recommendation that investors stay biased towards short duration fixed income instruments.***

Equities

Stock market indices registered mixed performance during the week, with NSE 20 rising by 0.3% while NASI lost a marginal 0.3% during the week as the market continues to seek direction.

On the earnings front, Centum announced a 162.0% increase in net profit to Kshs 7.94 bn from Kshs 3.05 bn in FY 2014, with performance driven by the company?s divestment from UAP that earned Kshs 2.8 bn over the carrying book value. The firm is relying on various sources of funding for its strong real estate and infrastructure deal pipeline: (i) it has a current Kshs 9 bn in cash, (ii) maintaining a no dividend policy (iii) exiting minority stakes, and (iv) using funds from its recently concluded debt offering. Centum differentiates itself as an active investment company, exiting investments where valuations appear full and reinvesting the proceeds into real estate, energy and infrastructure.

Uchumi Supermarkets relieved CEO Jonathan Ciano and CFO Chadwik Okumu of their duties on accounts of ?gross misconduct and negligence?. The nature of the ?misconduct and negligence? remains vague, but the retailer owes suppliers Kshs 1 bn and is unable to adequately restock its stores. The board said it plans to sell Kshs 2 bn worth of non-core assets such as land and use the funds to pay suppliers. The board is also going to conduct a forensic audit, though the nature of the forensic audit also remains vague. Given that Uchumi is undergoing distress too soon after its last restructuring, (and the distress has been so evident to any shopper at Uchumi given insufficient stocks and limited variety), it raises concerns about corporate governance adequacy on yet another listed company. It is curious that the board had to call a press conference to fire the CEO in front of cameras ? boards don?t need a press conference to fire a CEO. It appears the board was caught flat-footed and is now staging an appearance of acting boldly as it plays catch up. We became bearish on Uchumi in August 2013 after the SBG Securities annual conference where we met with the CEO. Three things troubled us. First, only one individual, the CEO, was representing Uchumi at the conference. Second, in discussions on strategic initiatives, there was a lot of ?I? not ?we?. These two signalled a lack of management team approach to strategic initiatives; we always worry for investors whenever there is a lack of a strong bench around the CEO because it could mean that initiatives are not borne out of vigorous debates by the top team. And finally, the branch expansion was too aggressive yet the shopping experience at existing branches was below peers. We left the conference and exited the entire position we were holding on Uchumi at Kshs 21 per share.

We remain neutral on equities given stretched valuations and lower earnings growth prospects.

Private Equity

TPG Capital, a leading American private equity firm, intends to invest up to USD 1 bn in Africa targeting healthcare, information technology, consumer and financial services, among other sectors. This highlights the increased interest in Africa from global players seeking attractive opportunities in Africa. TPG is the third large American PE firm to enter the African market after Carlyle and KKR. To see big American PE funds (TPG, KKR and Carlyle are all top 10 global PE firms) begin to look keenly into Africa is a clear indicator that Africa is becoming important to commercial PE players, in addition to the DFIs, and the asset class will see increased competition. In real estate, we would be surprised if Blackstone did not enter the sub-Saharan market soon.

Real Estate

Safaricom staff pension scheme is set to launch a Kshs 3.4 bn real estate project in Machakos County. The project, Crystal Rivers, is a mixed-use development targeting mid income market segment.

Treasury last week announced that landlords will now be required to pay a flat rate of 12% income tax on gross rental incomes. This came about as the government attempts to simplify tax collection hence improve revenue collection. However, the fact that the tax will be on revenue rather than on income tax raises questions about its fairness. Given the already high cost of housing coupled with housing deficits, this action effectively antagonizes other government efforts to addressing housing costs and deficits.

Effect of the 2015/2016 budget on the economy

Kenya?s 2015/2016 budget presented last week outlined a planned expenditure of Kshs 2.2 trillion, representing a 20% increase from the 2014/2015 budget. The increase in expenditure is going to be financed through both normal revenue collections increases (Kshs 1.3 bn) and also increased borrowing both in the local (Kshs 229.7 bn) and international markets (Kshs 340.5 bn).

To attain the economic growth rate of 7%, the budget allocation was guided by the following key sub objectives:

1. **Improving the business environment through** (a) enhancement of security, (b) improving the ease of doing business, (c) maintenance of a stable macro economic environment, and (d) deepening of the financial sector;
2. **Better infrastructure development.** We continue to see a lot of allocation towards development expenditure and streamlining of procurement procedures, which has increased absorption of the allocated funds;
3. **Continued investment in agriculture and industrialization** to continue increasing employment in the sector and take up better farming activities;
4. **Increased investment in the social sector** like education, health and training to support the youth and women and enhance economic inclusivity.

On the back of stable macroeconomic variables both in the local and international markets, the Treasury is projecting a 7% growth rate this year. However, in our view, given the high reliance on rain fed agriculture in our country, and agriculture being the backbone of the economy, together with lower tourism arrival figures, we think the projections are overly ambitious and may not be achievable.

The investment in development expenditure is expected to go a long way in enhancing economic growth rate; however in the past the budget utilization has remained low, though there have been improvements over the years. The continued confusion between the national and county governments roles in development remain a key challenge but there is more clarity now and that will go a long way in improving accountability by both arms of government.

With the increased borrowing to finance the budget we see a number of key challenges:

- The government may crowd out the private sector as it has continued to borrow more from the domestic market making it difficult for companies to borrow as interest rates remain high;
- Increased international borrowing may lead to the country being opened to any significant shocks in the international market;
- With increased borrowings by the government, which has led to uncertainty in interest rates, the development of the government?s secondary bond market has remained sluggish compared to other market;
- Increased currency volatility since, despite the normal market forces for dollars, the government will be in the market to finance debt repayment.

The country is however on the right track towards the achievement of the vision 2030 despite the roadblocks that it is currently facing. The inflation rates have remained low and stable, and despite the recent weakness of the currency, the volatility is low. The Monetary Policy Committee has been alert in reviewing the performance of the economy and taking the necessary actions but more vigilance to this end will go a long way in increasing investor confidence in the economy. The currency may remain under pressure due to the expected increase in the current account deficit since the country is at an investment phase and so importation of machinery and capital goods are high, but in the past we have seen increased capital flow offset the negative current account.

Lastly, the government revenue collections targets are high but we have seen KRA become more aggressive in revenue collection. Despite the efforts, consistent growth might be difficult given that the targets have continued to increase but in the past they have constantly missed targets. This has resulted in continued increases in domestic borrowing. The country?s debt levels remain sustainable at about 43.7% of GDP but we need to be careful not to get to the 50% level, which would be a concern for an emerging markets country like Kenya. Government?s discipline in following the budget provisions to the latter will also be important to increase investor confidence and also assist in easily predicting the economic performance by the public.

In conclusion, in as much as the economic growth forecast of 7% may not be achievable, we are of the view that the macroeconomic fundamentals are attractive and offer a solid foundation for investments, especially given the relatively low Debt / GDP levels and stable levels of single ? digit inflation. However, there are some areas of concern to monitor:

1. Government?s level of borrowing in the domestic market has been increasing, and at Kshs 229.7 bn, is the highest on record for the 2015 / 2016 fiscal year. Government has to be wary to not crowd out the private sector which is key to driving growth, improving efficiency and creating jobs;
2. Kenya Shilling?s depreciation is worrying and government should take steps to ensure its stability. With Kenya currently importing majority of capital equipment, the shilling shall only stabilise and stop depreciation in the long-term, once we transform to a manufacturing economy and import less machinery and capital equipment.

----

representation or solicitation for any product that may be on offer. Readers are thereby advised in all circumstances, to seek the advice of an independent financial advisor to advise them of the suitability of any financial product for their investment purposes.

Liason House, StateHouse Avenue
The Chancery, Valley Road
www.cytonn.com