Cytonn First Half, 2015 Report

Cytonn Weekly

Executive Summary

- **Global equities:** Global growth faces a number of key challenges but expected to register a 3.5% growth;
- **Sub-Sahara:** Africa?s economies are getting more diversified and there is an expected increase in foreign direct inflows into the region;
- **Kenya Economy:** Good growth projections but the current account position remains a key challenge;
- **Equities:** The market performed dismally for the first six months and high valuations not supportive of market increases going forward;
- **Fixed Income:** Yields on treasury bills remain stable but expectations of rate increases still remain due to the depreciating shilling;
- **Private equity:** Interest in Africa as a private equity destination continues to increase as we see a number of PE funds eye the market;
- **Real Estate**: The sector remains an attractive investment asset class and there is increased coupling of financing and development capability as one platform, a strategy validated by the increased interest in Cytonn?s real estate project pipeline from global institutional investors.

Global Markets Review

Despite the expected slight increase in global GDP growth to 3.5% from 3.4% in 2014, there are a number of challenges facing global economic growth prospects: (i) uncertainty surrounding the timing and impact of a Federal Reserve rate hike in the US given the low inflation levels globally and mixed economic data in the US, (ii) Eurozone quantitative easing yet to take full effect on growth going forward, (iii) fear of a Greece default and a possible expulsion from the Eurozone and what that would mean to the global economy, and (iv) lower growth rates in emerging markets for example macroeconomic indicators point to China missing its 7% GDP growth target.

United States:

The US economy appears to have taken off in the second quarter of the year, driven by improved consumer confidence, spending and wage growth. In addition, the manufacturing Purchasing Managers Index (PMI) reached a four-year high in June 2015, adding a layer of diversification to the growth sectors. The housing market is showing signs of a pick-up, with new and existing home sales rising.

The stock market has been trading sideways with S&P 500 remaining relatively flat for the first half of the year, largely driven by the uncertainty of a rate hike amidst high valuations after a two-year stock market rally. The market will continue to be volatile until when there is clear direction on the rate increases.

Eurozone:

The Eurozone is on a better growth trajectory than it has been for several years thanks to the recent quantitative easing started at the beginning of this year. The banking sector is improving. Weaker Euro in addition to lower oil prices are positive contributors to higher expected growth. The main issue affecting the Eurozone is the possibility of a Greece exit given the default issues that Greece has been facing with their creditors over their bailout programme. Though the Greece situation is not news, the recent call for a referendum to vote on the proposal by the creditors has surprised many and this has led to increased political tension and market uncertainty. Analyst expects a ?Yes? vote supporting the creditors and this may be followed by an immediate withdrawal of market liquidity due to a potential technical default and capital controls.

The contagion effects of a Greek exit have been greatly reduced compared to previous periods. The European economy and financial system are stronger. The European Central Bank (ECB) has increased emergency liquidity assistance, allowing Greek banks to borrow more from the ECB to ensure that there was no bank run while negotiations between Greece and its creditors were being held.

China:

Despite past strong economic performance in emerging markets, going forward economic growth will start to slow down given the increasing correlation with more advanced economies. China, which consistently had above 8% in GDP growth, is expected to struggle to attain a 7% growth this year. In order to support growth, the Peoples Bank of China cut the policy rate by 25bps to 2%; this is the fourth time they have cut rates in eight months.

The Shanghai Composite index has been very volatile this year driven by an increased number of IPOs in the market: the index peaked on the 12th of June but has lost 17.3% from that peak as at the end June, bringing the 6 months return on the index to 13.9%.

Regional Markets Review

Sub-Saharan Africa continues to grow much faster than most of the other regions; in 2015 the expected growth rate is 4.5% compared to 5.0% in 2014 as per IMF. The region expected to do much better is the East African region due to the diversified nature of its economies. There are a lot of flows into the region from new countries like China and India, and the investments are diversifying away from the traditional commodity explorations to consumer goods and services, targeting the rising middle class.

The region continues to improve its governance and political systems as can be seen by the positive government transition in Nigeria after the elections. The ease of doing business is also improving across the region and hence the increase in global companies setting shop in the region.

With the exception of the Malawian Kwacha, most of the currencies lost against the dollar due to the dollar strengthening in the international markets. Compared to previous years, foreign investor participation in the regional stock markets has been lower and in some countries like Kenya there has been negative outflow. This can be attributed to better returns expected elsewhere and the high valuations of some of the stock markets.

The region is bound to experience increased foreign direct inflows as investors divest their portfolios from low yield developed markets to the markets in Africa that offer attractive, long-term and stable returns to investors. This coupled with the increased expenditure on development initiatives should see the region?s economic growth pick up in the coming years, and we continue to view real estate and infrastructure as the biggest beneficiaries.

Kenya Macro Economic Review

As per our expectations, first quarter GDP growth was muted at 4.9%. Despite overall lower growth rate, some sectors did very well with construction, financial intermediation and electricity & water growing at 11.3%, 9.1% and 8.4%, respectively. Accommodation & food services contracted by 7.5%, which can be attributed to the insecurity situation that faced the country in the first half of the year. Given the weaker start to the year, we think that the budget for the financial year 2015/2016, which was underpinned on a 7% growth projection, is highly ambitious and might not be achievable.

The Kenya shilling has continued to lose ground against the US Dollar declining by close to 10% for the first 6 months of the year with 7.9% of that being in the second quarter. The decline can be attributed to: a strong global dollar in the international markets, the lack of clear direction from the central bank, and the continued deterioration of the current account position due to increased imports for infrastructure investments amidst declining exports. The balance of payment position has deteriorated from a surplus of Kshs 8.8 billion in the first quarter of 2014 to a deficit of KShs 14.3 billion due to a worsening current account. However there has been an increase in the net financial account supported by 13.2% increase in diaspora remittances in the first quarter and a more than double growth in the net inflows from the financial account from a surplus of KSh 75.7 billion in the first quarter of 2014 to a surplus of KSh 219.3 billion 2015. Overall, the shilling will remain under pressure but the central bank has sufficient reserves in the short term to cushion against significant volatility.

Inflation rate has increased gradually over the first half of the year from 6.0% in December to 7.0% in June. At the beginning of the year, low oil prices lead to a slight decline but with the increased global oil prices and the weakening shilling the gains are slowly being eroded. We expect inflation to remain in check, due to (i) CBK?s market activity to tame the weakening shilling, (ii) low global oil prices which will offer some cushion as Kenya is a net oil importer, and (iii) sufficient food stuffs in the short term due to good rainfall experienced in the second quarter.

Fixed Income Review

During the second quarter, the money markets were characterized by tight liquidity as evidenced by the under-subscription of government securities as a result of the CBK?s mop up activity in support of the shilling as well as corporate tax remittance. Treasury Bill rates remained relatively unchanged, with only the 364-day yield increasing by 50 bps, closing the quarter at 8.3%, 10.5% and 11.1% for the 91-day, 182-day and 364-day papers, respectively as compared to 8.4%, 10.6% and 10.6% for Q1 2015. However, investors remained biased towards shorter durations as they expected the rates to rise.

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.

Kenya Equities Market Review

After a strong first quarter, the stock market had a rough second quarter with NASI and NSE 20 declining by 6.1% and 6.5%, respectively. The negative performance was caused by share price declines across various sectors: Housing Finance and National Bank in the banking sector falling by 26.8% and 19.6%, respectively; Britam and CIC Insurance in the insurance sector fell by 24.1% and 19.3%, respectively and; Trans-Century and Olympia Capital in the investments sector declined by

26.4% and 17.5%, respectively. There was also a lot of profit taking in some of the large-cap counters like Equity, KCB, Safaricom and EABL leading to a decline of 9.1%, 9.1%, 3.5%, and 2.3%, respectively. Foreigners were net sellers at the Nairobi Securities exchange amounting to outflows of Kshs 2.6 bn as they sought more attractively priced markets like the Nigerian Stock Exchange.

Banks released their Q1?2015 results that showed slower growth in loans and deposits in the first quarter, with the banking average growth at 3.6% and 3.4%, respectively, compared with the similar period growth of 7.0% and 5.2% in 2014, respectively. The slowdown was a result of shrinking net interest margins and an increase in provisions for bad loans as the aggressive loan policy by some of the banks have impacted them negatively.

The market has since corrected from the all-time highs seen in February, with NASI down 7.4% and NSE 20 down 10.8%. Notwithstanding the projected high GDP growth rate in the country, and Kenya?s good rating in global markets, we expect the stock market to underperform in the near term. The market has pockets of value and it remains a stock pickers market to derive value.

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

Private Equity

There has been increased investment appetite by global private equity funds into the Sub Saharan market. This can be largely attributed to positive economic growth potential of the region. Increasing consumer power, a growing population and a growing mid-class is driving economic growth in the region. TPG Capital is looking to invest USD 1 bn in Africa in various sectors. TPG is the third large American PE firm to enter the African market after Carlyle and KKR. The entry of such big American PE funds (TPG, KKR and Carlyle are all top 10 global PE firms) 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 due to attractive returns supported by fundamentals.

In Kenya, there has been an increased exit activity in the private equity sector with both strategic and financial investors taking stakes in already existing businesses. This is a clear affirmation of our view that there is liquidity available in the Kenyan market. Some of the key private equity deals in the first half include, among others: Helios? gradual exit of Equity Bank where it has relinquished a 14.7% stake, of which 2.4% was ceded to Uganda NSSF in June 2015 following the 12.2% sale to Norfininvest AS in January 2015, Old Mutual purchase into UAP insurance from Centum, and also the Barclays purchase of First Assurance.

During this year?s budget, the Treasury Secretary of Kenya proposed an increase in bank?s minimum core capital requirements from Kshs 1.0 bn to a level of Kshs 5.0 bn by 2018, while that of insurance companies is set to rise to Kshs 600 mn and 400 mn for general insurers and life insurers from Kshs 450 mn and Kshs 150 mn, respectively. This is set to lead to increased mergers and acquisitions, rights issues and debt issues in the financial services industry, as companies seek to raise capital to be in compliance with the new standards. As a result, we expect increased competition in the industry as smaller banks and insurance companies merge or get acquired.

Real Estate

The real estate sector continues to provide a good investment option for investors looking for long-term stable returns. The increased investment in infrastructure by the government has continued to open up more areas for growth especially along the bypasses. Some of the key drivers for the sector include among others: Rapid urbanization, growing middle class, and availability of capital both in the developed markets and locally. In Kenya the sector still faces some challenges among them: (i) the opaqueness of the land dealings (ii) the land registry yet to be fully automated (iii) lack of central data points, and (iv) the expensive credit making property purchase difficult.

Given that real estate is a capital-intensive business and there are very few institutional developers, a business model of coupling up financing capability and development capability to form an end-to-end real estate finance and development platform is essential. We have seen a number partnerships formed to do that among them: AMS Properties and Hass Consult entering into a deal with a Mauritian private equity firm, Xterra Capital Advisors, Centum Investment creating and coupling up with Athena Properties, Cytonn Investments (CI) creating and coupling up with Cytonn Real Estate (CRE). There is significant demand for institutional grade real estate investment opportunities, as witnessed by CI's and CRE's coupling up creating large interest in Cytonn's project pipeline from international institutional investors from US, UK, Turkey, Finland and Mauritius. While the financier-developer coupling strategy enables faster and more responsive execution, it is very hard to align the interest of respective parties hence very hard to manage.

Disclaimer: The views expressed in this publication, are those of the writers where particulars are not warranted- as the facts may change from time to time. This publication is meant for general information only, and is not a warranty, 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.