Cytonn Weekly Report #27, with a focus on the Global Entrepreneurship Summit in Kenya

Cytonn Weekly

Executive Summary

- Fixed Income: The Monetary Policy Committee (MPC) increased the Central Bank Rate (CBR) rate by 150 bps to 11.5% in a bid to curb the weakening shilling; this is on the back of the 150 bps increase done a month ago. Despite the increase, the shilling lost 1.2% during the week;
- Equities: The stock market declined during the week with NASI down 1.3%. We continue to be neutral equities given valuations, and the events in Greece and China further entrench the stance. The low insurance penetration gives room for growth in the insurance sector;
- Private Equity: The East African region remains a good PE investments opportunity given the ease of exits, but a lot more needs to be done to improve exits through listings given our very low ratio of listed companies to population;
- Real Estate: There are increased real estate development opportunities in the counties due to devolution leading to increased demand for infrastructure;
- Focus of the Week: Kenya to host the 6th annual GES summit showcasing its innovation and entrepreneurial potential. The country is set to benefit from the summit;

Company Updates:

- Two of our real estate investment partners, Farazad Investments from Turkey and Taaleritehdas from Finland paid a courtesy call to the Nairobi City County Governor, Dr. Evans Kidero. The visit by Taaleritehdas and Farazad, coming on the back of UK?s London-Africa?s visit the previous week, continues to underscore global investors? interest in East African real estate opportunities. See link for brief update;
- Beverlyn Naliaka has joined the management team as Communications & PR Associate. Prior to joining Cytonn, Beverlyn was an Account Manager at Gina Din Communications where she covered accounts such as Orange Telkom, Old Mutual, Seacom, UAP, Samsung & Unilever. She will be responsible for positioning the Cytonn brand as the premium brand for real estate finance, investments & development platform for our high net-worth, global and diaspora clients;
- Our Cytonn Young Leaders Program on technology program is currently taking interns, see https://www.cytonn.com/careers/22, deadline is July 15th

Fixed Income

Despite an improvement in liquidity in the week, the Treasury bill auction continued to be undersubscribed, with a 30% subscription this week compared to a 39% subscription last week. The 91-day Treasury bills registered a dramatic jump in yield, increasing by 3.1% to end the week at 11.3%. We attribute the significant increase to the CBR rate increase in the week, together with a correction since the T-bill rate had remained relatively sticky in the previous weeks, despite the first CBR rate increase. The 182-day and the 364-day rates increased to 12.1% and 11.1% from 11.3% and 11.0% recorded the previous week. There is increased uncertainty in the market on how far the interest rates will increase and hence most investors prefer to keep short duration and are also seeking a premium to invest. This continues to affirm our call from earlier in the year that investors stay invested in short duration pending rate certainty.

The MPC actions during the week (increasing the CBR by 150 bps to 11.5% and the introduction of a 3-day repo as an additional liquidity management instrument) did little to stem the shilling weakness. The Kenya Shilling lost 1.2% during the week to end the week at 100.7. In our view, the rate increase may not be significantly effective in stabilizing the shilling since the shilling weakness could be as a result of some underlying structural issues which include (i) a widening current account deficit estimated at 9% of GDP for the FY2015/2016 (up from 7.3% the previous year) on the back of increased importation of capital goods for infrastructure development, (ii) the growing fiscal deficit currently at 5% of GDP, and (iii) reduced inflows from tourism and other foreign exchange earners such as horticulture.

We expect market interest rates to continue increasing in the short-term given the CBR rate increases, coupled with the huge government budget deficit that is being financed locally. The high rates will lead to the crowding out of the private sector by the government and lead to lower GDP growth figures for the year. Unfortunately, Treasury?s official 7% estimated GDP growth rate would most likely be revised downwards. The weak currency will also not help much when it comes to the cost of doing business in the country given that we are net importers.

We continue to hold our earlier recommendation that investors should invest in short duration fixed income instruments as we await certainty of the rate environment.

Equities

During the week, market indices dropped with NSE 20 shedding 1.8% w/w and NASI losing 1.3% w/w to close at 4,812.6 and 159.4, respectively. Declines were experienced in Crown Berger, Britam, Nation Media Group and National Bank, which fell by 12.1%, 8.0%, 7.5% and 7.3%, respectively. However there were gains recorded in East Africa Portland Cement, Williamson Tea and TPSE Serena, which gained 16.1%, 10.3% and 8.3%, respectively. Since the peak in February, NASI is down 9.0% while for NSE 20 is down 12.5%.

On the recent release of the insurance sector Q1?2015 report by IRA, the insurance industry recorded growth in gross premiums written by 16.4% y/y to Kshs 50.4 bn. The growth was on the back of strong topline performance of both the general and the life businesses whose premiums grew by 14.6% and 20.3% y/y to Kshs 34.4 bn and Kshs 16.0 bn, respectively. However, claims growth in general business far outpaced revenue growth; claims incurred by the general business grew by 27.3% y/y to Kshs 12.4 bn shedding off the gains in the premiums. Claims growing by almost double the premiums growth subsequently raised the claims ratio to 64.0% as compared to 57.5% in Q1?2014. For Life business, policyholder benefits grew by 28.2% to Kshs. 13.1 bn in Q1?2015 offsetting the growth in premiums written. Total industry assets grew by 17.7% y/y to Kshs 452.8 bn with investment accounting for 81.6% of total assets. Kenya?s insurance industry has high growth prospects due to (i) high premium growth rate, (ii) an increasing asset base, and (iii) a low penetration rate standing at 3.4% of GDP. We shall give a more comprehensive view on insurance companies after H1?2015 results.

The Government, through the Ministry of Industrialization, plans to make co-operative society shares transferable and more valuable to members through the establishment of a trading platform at the Nairobi Securities Exchange. Kenya?s co-operative sector is a fast growing sector with assets close to Kshs 700 bn, and savings of more than Kshs 500 bn. This is a positive step by the government and a positive development for the sector, as listing of co-operatives will attract more investors to the co-operative movement. We however see two main issues that may hinder fast implementation of this initiative: (i) the structure of co-operatives must change as the current structure of unlimited share capital where members can increase their ownership indefinitely without buying from others will hinder the pricing and trading of their shares; open ended companies are not eligible for listing by the Capital Markets Authority, and (ii) given that SACCOs are primarily savings structures targeted at serving the interests of its members, listing may change the primary focus from serving member interest to maximizing share values.

With the recent action by the MPC to increase the CBR by 150 bps to 11.5% and the KBRR to 9.9%, we expect to see a change in the equities market, especially the banking sector. We expect a decline in the loan books as credit uptake falls and an increase in non-performing loans as increased rates are passed on to the borrowers. We expect a slowdown in the economy and the earnings growth for most sectors will be significantly hampered by more expensive cost of credit.

We maintain our neutral stance on equities given stretched valuations and lower earnings growth prospects; lower earnings growth prospects just got magnified with the recent rate increases. And the probability of default in Greece and the stock market plunge in China cannot be good for the local equities market.

Private Equity

African Alliance Asset Management has invested in logistics firm Atlas Development and Support Services, placing its ownership at 5.5%, by purchasing an additional 4.27 million shares, at a price of Kshs 11.0 per share, to take total ownership to 23.69 million shares. Atlas is cross-listed at both Nairobi Securities Exchange and London Stock Exchange, enhancing the firm?s liquidity, hence increasing the ease of exit for investors. In our view, it would be beneficial for young companies in search of capital to pursue listing as we expect increased appetite for quoted private equity in the region. PE funds can increase the ticket sizes on their deals without having to worry about the ability to exit, in turn increasing the amount of private capital available to drive the economy.

However, the process of listing and the requirements for listing would have to be significantly reviewed in order to make it attractive for the many private companies to consider listing. For a country of over 40 million people, the number of listed companies is exceedingly low. As seen below, the ratio of listed companies for every 1 million people is 16x for the US, 6x for South Africa and only 1x for Kenya. The number is so low that it should be of great worry since it is not viable to deepen our private equity markets without a deep listed capital market. To improve that ratio to even 1.5 times means listing another 30 companies in Kenya, yet the trend is moving backwards given the delistings of CMC, Rea Vipingo, & Access.

Private equity firm Kibo Capital Partners has exited the Uganda Healthcare industry after selling its 40% stake in International Medical Group (IMG) to a consortium of Indian and Mauritian strategic investors, barely a year after buying IMG from TBL Mirror Fund to become the largest investor in IMG. IMG operates outpatient centers, a 120-bed hospital in Uganda, a diagnostics centre, a drugs distribution company and a university. For the PE industry, this is a positive as it demonstrates ability to exit to strategic investors. (Note: When a PE fund exits to a buyer who is buying solely for financial gain, such as Helios? exit of its stake through a sale to Norfund, that is an exit to a financial investor. When a PE fund exits to a buyer who is buying to operate the asset as a business, such as Kibo?s exit of IMG to Fortis Healthcare, that is an exit to a strategic investor.)

The surge in investment in healthcare in Africa can be attributed to inadequate provision of public healthcare services to cater for the growing population and increasing middle class that can afford well-priced services. This provides an opportunity for investors to make lucrative returns while contributing to (i) economic development through provision of basic services, (ii) improved standard of living, and (iii) creating jobs through institutional provision of basic necessities. For the PE industry, the ability to exit through sale to

Real Estate

In the recently concluded Meru County Investment Conference, the real estate sector was identified as one of the key sectors driving the county?s development. This is attributed to the fact that there has been an upsurge in construction, fueled by devolution, improved infrastructure and the strategic location in relation to future planned infrastructural developments such as the Lapsset project. The county revealed that it is especially focused on promoting Public-Private Partnerships (PPPs) in order to develop adequate commercial and residential buildings to meet the rising demand for office, retail and residential space. Already, private investors like CPF Group and Fusion Capital are in negotiations with the Meru County. The PPP deal between the county and the CPF group will involve a 115,000 square feet, 15-storey office complex. CPF group is looking to invest Kshs 1bn while the County will provide land as well as an additional Kshs 200 mn capital. From what we can see happening in Meru it is clear that devolution has provided a platform for the private sector and the counties to partner, and as such expect the framework to be replicated in other counties over the next few years. This however, will be hugely dependent on (i) the development plans that each individual county has outlined for themselves, (ii) how aggressive and effective the counties are in pursuing their development goals, (iii) the timeliness of project implementation since private capital, which has to be deployed to earn returns, tends to shy away from long drawn out investment conversations, and (iv) the ability to showcase a successful PPP, outside the energy sector, in order to alleviate investor concerns over feasibility of public partnerships. Currently, there are several high profile PPPs announced and whose success the investment community is watching: KNH to extend the children?s hospital, Kenyatta University to build student hostels, and Konza City to build a technology city. If none of these begin to show a credible path to delivery, investors will quickly sour on PPPs.

This week, the National Construction Authority issued a public notice setting the window for registration of Contractors? annual licenses from 1st - 31st July every year. This action is in line with the NCA?s mandate of providing a regulatory framework for registration and renewal of contractors? licenses. It is a good initial step towards eliminating rogue contractors and malpractices in the building and construction industry in Kenya. However, the key question would be whether the NCA has the capability and resources to enforce the regulatory policies both in Nairobi and the other counties as well. If not well executed, the NCA could have a situation where the building and construction industry in other counties is to a large extent unregulated and still plagued by the problems that the Authority is mandated to eradicate.

Focus of the Week: The effects of the Global Entrepreneurship Summit being held in Kenya

The Global Entrepreneurship Summit (GES) is a global forum that brings together business owners, young innovators, educationalists, policymakers, thought leaders and investors from across the globe to support developing regions. Since 2010, the U.S has elevated entrepreneurship to the forefront of its engagement with the world and the GES is a formal annual forum for the engagement. The 6th annual gathering is being held in Kenya on 25th - 26th July 2015, and is being co-hosted by U.S. president Barrack Obama and Kenya?s president Uhuru Kenyatta. This will be the first time that the summit is held in Sub-Saharan Africa, and the decision to hold it in Kenya showcases the country?s huge economic potential. Kenya join?s Turkey, UAE, Malaysia and Morocco as previous hosts of GES.

The country is blessed in numerous enviable ways ? a great geographical location that makes it a regional hub; great weather; an educated, numerate, literate and welcoming population with an entrepreneurial spirit; a magnet for tourists given breathtaking landscapes, pristine beaches and unique wildlife. Kenya is home to the world?s best marathoners, the world?s best mobile money platform, MPesa and a lineage to the first black president of the U.S. We have always held that the country?s biggest challenge is its reluctance or inability to step up to its vast potentials. The GES is a significant opportunity and reminder for the country and its entrepreneurs to take advantage of the country?s vast economic potential.

Entrepreneurship and innovation are essential to economic prosperity; and economic prosperity is in turn essential to addressing some of our most intractable challenges such as poverty, hunger, unemployment, inequity, insecurity and a weak shilling due to net importation.

Past summits have opened new markets for products and encouraged policy makers to break down barriers to business. Morocco for instance, following the 5th Global Entrepreneurship Summit, received considerable investments. First, there was an innovation in Science and Technology Network, which is aimed at providing Science and Technology entrepreneurs with online resources and mentorship to collaborate seek funding and grow their businesses. Second, Morocco received a USD 50 mn investment through the Millennium Challenge Corporation that is set to promote PPPs to encourage and support entrepreneurs. Third, a new vocational school for mechanics in Morocco through UN agency UNIDO, USAID, the OCP Foundation and Sweden?s Volvo Group was set up and this will push up the employment numbers in the industry that stood at 26% in 2012. Fourth, a credit guarantee from USAID in partnership with Spain to help finance a new cold storage facility at Morocco?s Tangier Med Port will support the expansion of Morocco?s agricultural value chain, resulting in growing exports and job creation.

As with most conferences and summits, what really matters is what happens after the summit. For Kenya, fortunately we already have an entrepreneurial spirit and culture. Consequently, the most effective area for government and policy makers is to focus efforts on breaking barriers to entrepreneurship in Kenya. We identify the following key areas as means to enhance entrepreneurship in the country:

1. Improve access to capital for entrepreneurs. We believe that both a local and a global access strategy are essential. Locally, the government can explore ideas such as a professionally run Kenya sovereign venture fund, in partnership with commercial oriented development agencies such as the Millennial Challenge Corporation, to fund proven ventures. A shilling for shilling matched funding of a ventured fund between the GoK and MCC is a viable idea. Globally, working to make Kenya a regional financial hub and establishing free trade districts would improve access to capital
2. Create a specific agency / authority to nurture entrepreneurship in the country, especially for women and youth. For example, in the US, the Small Business Administration exists specifically to assist small businesses. While initiatives like *Kazi Kwa Vijana* are good starting steps, they are not sustainable. An agency that is professionally administered, with specific accountability and deliverables for developing entrepreneurs and enabling entrepreneurship is the more sustainable approach
3. Improve ease of doing business by making processes such as company registration, searches, compliance, title documents more efficient
4. Improve commercial dispute resolution process and speed in order to stop the common abuse of court process to stifle competition and innovation. For example, while the judicial system is essential to a functioning free market, we think that Equitel?s launch has been unnecessarily slowed down by court process
5. Make it fairly easy for companies to access capital markets, especially through initial listings and structured products. The ratio of Kenya?s listed companies to every 1 million people, at 1x,

compared to South Africa?s 6x or the United States 16x is unacceptably low. A vibrant and transparent capital market is essential to attracting foreign direct investments and risk capital to fund entrepreneurs

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