Cytonn INVESTMENTS

# Cytonn Weekly Report #28, with a focus on the performance of the Kenya Shilling

## Cytonn Weekly

## Executive Summary

- **Fixed Income:** Money markets were illiquid during the week and interest rates remained high, with the yield on the 364?day Treasury bill rising by 1.4% to 12.5%. Investor preference remains towards shorter dated securities as the direction of rates is not yet clear;
- **Equities**: The stock market continued on a downward trend, with NASI down 2.2% and NSE 20 down 1.9%. Mobile money is the next key growth area for both banks and telecommunication companies;
- **Private Equity:** Africa as an investment destination for private equity funds continues to improve driven by the ability to exit;
- **Real Estate**: Rental increases slows down in Q1?2015, but expected to increase going forward;
- **Focus of the week:** The shilling continues to depreciate despite CBK?s efforts, due to underlying structural challenges. To support the shilling, long-term solutions to the economy need to be thought of.

## Company Updates

- To better serve the Kenyan Diaspora in the US, Cytonn Investments established a US affiliate, Cytonn Diaspora, a Delaware registered company. Cytonn Diaspora will have a staffed office in the East Coast to bring Kenyan real estate opportunities closer to both the Kenyan Diaspora and also interface with North American institutional investors. For more details, see link: Cytonn Diaspora press statement

- Cytonn?s Managing Partner, Edwin H. Dande, hosted Kenyans in the diaspora looking to invest back home. The interest of the diaspora to invest back home is significant as evidenced by the increase remittances from the diaspora. Cytonn Diaspora will fulfill the gap of a trusted institutional partner for the diaspora. See link: Cytonn targets Kenyan diaspora with US subsidiary

- Media coverage of highlights by Cytonn of the expected benefits of the upcoming Global Entrepreneurship summit:
  - Form agency to nurture entrepreneurs, says firm
  - It matters what happens after Obama summit ? Cytonn
  - Kenya: It Matters What Happens After Obama Summit - Cytonn

## Fixed Income

There was an improvement in Treasury bill auction subscriptions in the week, with the total subscriptions at 69% compared to 30% experienced the previous week; and this is despite tight liquidity in the money market due to tax payments and mop up by the Central bank in support of the

shilling. Key to note is that the 91-day bill was highly oversubscribed, at a 200.3% subscription rate, while the 364-day received a 19% subscription, indicating that the market prefers to invest in shorter duration securities, with the market expecting that rates will continue rising while Central Bank seeks to raise more long-term funds. Yields on the 364-day T-bills increased by 140 bps to 12.5% from 11.1% while the yields on 91-day and 182-day T-bills remained relatively unchanged at 11.3% and 12.2%, respectively. There will be a five-year bond re-open next week and we will give a more detailed report next week on the same, but our preliminary thoughts are that the average yield could be above 13.5%.

In a bid to further review the recent poor performance of the Kenya Shilling, The Monetary Policy Committee (MPC) has scheduled its next meeting for 5th August 2015, only a month after the last meeting. The recent interest rate hike by the MPC has done little to stem the shilling?s depreciation. During the week the shilling lost 1.7% to the dollar to close the week at 102.5, bringing the year to date decline to 13.0%.

We maintain our expectation that market interest rates will remain high because of (i) the government?s need to finance its budget deficit through local borrowing, and (ii) the need to support the shilling.

***We 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 continued on a losing streak with NASI falling by 2.2% while NSE 20 lost 1.9%, bringing the year to date performance to -9.3% and -4.4% for NSE 20 and NASI, respectively. During the week, the key declines were Kenya Power and Lighting Company, Britam and Centum Investments that fell by 7.8%, 8.2% and 9.7%, respectively. The market continues to undergo correction, as it has lost 12.1% for NASI and 15.7% for NSE 20 since its February peak.

Safaricom stock price has been on a losing trend since the first quarter of 2015, initially because it had really rallied in quarter one and investors were taking profit; and most recently, we have seen the company being investigated by Communications Authority of Kenya as to whether that they are a dominant player, which is bad for competition. In the week, the stock lost 5.3% and it is down 15.4% from its all time high reached in February 2015. In our view, Safaricom has a number of key positives supporting it, which include (i) a strong brand and customer loyalty, and we have not seen significant churn rates in the past, (ii) wide reach in the country which makes it very easy for clients to remain in the network irrespective of where they are, (iii) innovation and use of partnerships which has made them remain ahead of the competition, and (iv) with the current price correction in the stock, the company is trading close to its historical PE and is comparable to other listed telecommunication stocks. In our view, this is a stock to watch closely given that it has the largest market capitalisation and is liquid, hence any positive sentiments in the country will lead to an increase in its price.

Partnerships between money transfer companies and the banks continues to gain traction, a move that is expected to create a lot of efficiencies in the banking sector, which could lead to increased financial penetration rates. This week, Standard Chartered Bank announced that they have partnered with Safaricom to introduce a platform that allows business customers and M-Pesa agents to deposit and access up to Kshs 50 mn per transaction. The minimum amount transferrable also reduced from Kshs 35,000 to Kshs 10,000, enabling merchants with lower turnover who were previously locked out to access M-Pesa to bank transfers. Safaricom also signed an M-Pesa deal with NIC bank, with the bank seeking to offer transactional services including the purchase of virtual cash balances to M-Pesa agents. These, alongside other earlier partnerships, will go a long way in cementing Safaricom?s place in the market as a leading mobile transfer company; and the trend will

continue enhancing the future earnings prospects for both banks and the mobile transfer companies.

***Despite correction in valuations given the market decline, we remain neutral on equities due to lower earnings growth prospects and especially given the high interest rates in the market, which is likely to impact economic growth.***

# Private Equity

Private equity investment in Sub Saharan African continues to improve, and one of the key beneficiaries has been the financial sector due to the high return potential, given the low penetration rates in the continent. Emerging Capital Partners, one of the largest Pan African focused private equity players which has raised USD 2bn towards investment in Africa and deployed USD 1.3 bn, this week exited La Nouvelle Societe d?Assurance Participations SA (NSIA), a West and Central African insurance group, through the sale of its 26.2% stake to the National Bank of Canada and Amethis Africa Finance for an undisclosed amount. NSIA is a major financial services group that provides a wide range of banking and insurance products to individuals and corporate clients. It is the leading insurance group in West and Central Africa with 25 subsidiaries, 58 bank branches, 42 insurance agencies and assets totaling over 1.2 bn Euros. ECP?s initial investment was made in 2008 for USD 47.7 mn through the purchase of common shares, making it the firm?s largest investment in an African financial services firm.

ECP?s exit is among the high profile exits in the financial services sector in Africa, and this has gone a long way in alleviating the fear by private equity firms on whether they will be able to exit their investments when they want to. There are a number of possible exit opportunities in the continent, which include (i) exiting to the public markets. We have seen an in increase in the number of listed exchanges growing to 29 from 5 over the last 25 years, (ii) exit to strategic investors who want to expand into the region, and (iii) exit to other private equity funds who do not want to take a significant risk initially.

According to ECP, and something that we fully agree with, successful private equity investment in Africa requires an experienced, on the ground investment team, collaborating with investors and portfolio companies to source and deliver value. Getting an experienced team has been a challenge given the nascent nature of the industry, however we are seeing a lot of companies and individuals committed to the sector and the continent spending time to grow the required skill sets.

# Real Estate

According to the Knight Frank Prime Global Rental Index Q1, the demand and activity in the prime residential rental market has remained flat, registering an average increase of 1.3% for the quarter compared to 3.5% a year ago, with the slow down being driven by the emerging markets. Despite Africa registering strong growth, Nairobi?s rent increase was minimal at 0.7% compared to 4.3% for the rest of Africa. This can be attributed to higher rental increases in the previous years and also the insecurity situation that faced the country in the first half of the year. With all the measures taken to curb insecurity, together with Kenya attracting a number of conferences aimed at increasing economic growth rate in the region, we expect an increase in people looking for housing and this will lead to increased rental rates.

This week, the Westgate Shopping Mall outlet in Nairobi, which was shut down nearly two years ago after a terrorist attack, reopened its doors. The refurbishment of the mall cost approximately Kshs 3.7 bn. We believe the reopening will change the global perceptions regarding security in the country and restore confidence. To increase confidence further, the International Reserve Group, an Israeli firm that has more than 10 counterterrorism experts, will be in charge of security at the mall, which will additionally lead to skill transfer to the security personnel and staff they will be working with closely.

# Focus of The Week: The performance of the Kenya Shilling

Emerging market currencies have been under pressure during the year because of the US Federal Reserve?s announcement of an intention to raise interest rates. The expectation of a rate hike by the Fed has sent capital flowing out of emerging markets, causing a depreciation of most currencies. Additionally, the possibility of a ?Grexit? is exacerbating the need for investors to invest in safer regions, such as the US. As expected, the impact of this on the currencies differs from country to country depending on the strength of the country?s macroeconomic fundamentals, with countries that have weaker fundamentals experiencing higher currency volatility.

The Kenya Shilling has witnessed a downward pressure against the dollar since the beginning of the year, losing 13.0% YTD to close at 102.5 as of Friday 17th July from a rate of 90.6 at the start of the year. The depreciation of the shilling can be attributed to a number of factors, namely:

- The strengthening US Dollar in the global markets due to a possible rate increase, given the improvements in economic performance in the US;
- Insecurity situation in Kenya, which has led to delayed investments into the country. Also, this came with the President?s directive to shut down some money transfer companies that handled money transactions into the region;
- The fact that the Central Bank stayed for sometime without a substantive governor led to uncertainty in the market;
- Reduced foreign inflows from tourism and agriculture. These are two of Kenya?s key exports and foreign exchange earners. Tourism as a sector in Kenya has suffered given the insecurity situation towards the end of last year, with agriculture suffering from the inadequate rainfall experienced in the country in the first quarter and also volatile commodity prices in the global markets;
- A widening current account deficit at 9% of GDP for FY2015/2016, up from 7.3% the previous year. This is on the back of a rising import bill especially on capital goods necessary for the increased infrastructure development. Data from the KNBS shows that the current account balance recorded a deficit of Kshs 101.5 bn in Q1?2015 compared to a deficit of Kshs 63.8 bn in Q1?2014, and;
- The growing fiscal deficit, currently at 5% of GDP, will lead to increased government borrowing both from the domestic and international markets. Increased borrowing from international markets will open up the country to shocks, leading to increased currency volatility.

The situation is actually replicated across the larger East African region and in Africa, where most currencies have depreciated against the dollar, with the exception of the Malawian Kwacha. In East Africa, the Tanzania Shilling has lost 24% YTD to the dollar, while the Uganda Shilling has lost 16% YTD to the dollar. Uganda?s current account deficit is projected to widen to 10.3% of GDP in FY2015/2016, from 8.4% in FY2014/2015, on the back of higher infrastructure related imports and weaker exports owing to subdued global commodity prices. Tanzania, on the other hand, has a current account deficit of 11.1% for FY2015/2016. Compared to Kenya?s 13% depreciation YTD, it is clear that the larger the current account deficit, the more the currency is vulnerable to external shocks.

In the recent months, we have seen the Monetary Policy Committee aggressively raise interest rates to curb further depreciation of the shilling. In our view, the benefits derived from the aggressive rate increases could be minimal since most of the issues we are facing are structural, rather than a result of interest rates parity issues. Comparing this with what happened in 2011, the rate increases were more effective because the inflation rates were really high, peaking at 19.7% in November 2011; the rate increase then helped reduce money supply, which was more inflationary. However, the current situation is different. At the moment the inflation rate is at 7.0%, and though we expect it to

increase, it could be gradual. The sudden rate increases will stifle the already fragile economic growth, and in our view the effects would be significant. Last week, we saw the Uganda Monetary Policy Committee raise the CBR to 14%, leading to a strengthening of the currency. In our view, the Kenya shilling is not reacting to the rate increases because the MPC?s actions are anticipated, hence already priced in by the market.

Despite the school of thought that the currency is over valued, the rate of currency depreciation is what is of key concern for any investor. We would have expected a more gradually depreciation of the shilling. In our view, the Central Bank and the government at large could take the following measures to curb significant further depreciation in the future:

- To avoid panic buying and speculation on the currency, rates should be moderately raised while allowing for the impact of the presiding increases to take effect. Any sudden increases should be well explained and understood by the market;
- Involve market participants while coming up with the policies, as they have positive contributions that may add value to policy makers and policy direction;
- Reduce the rate at which the country?s budget is growing. Balancing between current consumption and expenditure for future benefits remains a delicate balancing act; and could be achieved;
- Diversification of the economy to avoid over-reliance on agriculture and tourism. A good example is Mauritius, which is primarily a financial hub and benefits greatly from that. Kenya?s brand, location and skilled workforce uniquely positions the country to be financial hub, but we will have to fundamentally rethink our capital markets infrastructure and regulatory frameworks;
- Continue with the good initiatives of youth empowerment as it increases economic activity and may lead to increased exports. In addition, there is need to continue supporting entrepreneurial activities through the ways we identified in the Cytonn Weekly Report # 27. We won?t be able to sustainably address currency depreciation if we do not manufacture more locally in order to reduce importation;
- Work with the private sector to encourage Kenyan?s living abroad to invest back in the country. Despite the fact that the remittances have increased, there is potential for much more to come into the country if we develop and implement an active diaspora investment strategy and engagement plan;
- Diversification of the reserve holding from only USD based to a pool of other currencies to avoid significant reliance on the US economic performance.

In conclusion, our view is that the performance of the currency will be largely dependent on the performance of the USD. Since the rate of expected Fed increases is already priced in the market, we might not see a lot of further dollar strengthening. We expect to see the recovery of the tourism sector given the semblance of calm on the security side. With the many infrastructural projects ongoing in the country, we are seeing global capital flowing in, and if well matched with the expected infrastructural expenditure, it might alleviate further pressure on the currency. The activity of the Central Bank will be key, but of note is that forex reserves have really declined to 4.14 months of import cover, from 4.90 months at the start of the year, and the minimum target is 4 months of import cover. We should see CBK drawdown on the USD 700 mn financing facility approved in February by IMF to support the shilling. The declining oil prices in the international market will also help support the shilling as it reduces the level of imports in USD terms. In our opinion, we expect to see stability in the currency in the coming months, but we reiterate that the country needs to come up with a long-term plan to reduce importation by spurring local manufacturing.

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