Cytonn Weekly Report #29, with a focus on Entrepreneurship, its drivers and challenges

Cytonn Weekly

Executive Summary

Fixed Income: Kenya Shilling strengthens by 1.7% given Central Bank?s activity;

Equities: Equity markets on a losing streak, and companies report lower earnings growth as early expected;

Private Equity: Africa, and Kenya in particular, is a rich ground for private equity investments, and the Global Entrepreneurship Summit is expected to offer greater opportunity for small and medium enterprises in Kenya to access foreign capital investments;

Real Estate: Developers are largely focusing on low cost housing, while Safaricom partners with developers to offer internet in office buildings;

Focus of the Week: Despite challenges faced by entrepreneurs in the country, there are vast opportunities in Kenya.

Company Updates

- Helsingin Sanomat, Finland?s leading newspaper, highlights real estate opportunities in East Africa and discusses the partnership between Taaleritehdas Real Estate of Finland and Cytonn Investments. (Use Google translate to read Finnish text, but video is in English.) See link: An investment company, Taaleritehdas, to invest in new buildings in Kenya, Rwanda and Mozambique
- In an interview with Bloomberg on Obama's legacy on Africa, Edwin Dande, our Managing Partner, described Obama's main legacy for Africa as mainly inspiring young people to focus on the opportunities and possibilities of the future, as Obama did, rather than being caught up focussing on past negatives such as ethnicity. See link: Obama Says Kenya Visit Is Down Payment on Post-Presidential Era
- Cytonn Investments is currently recruiting for the following positions. Refer a candidate and get a referral bonus, see our referral bonus program. Open positions include:
  - Business Development Intern
  - Business Manager, Cytonn Technologies
  - Private Wealth Advisors

Fixed Income

Treasury bill auction subscriptions declined this week to 33% from the previous week?s 69%; the decline was due to tight liquidity in the money markets. Tight liquidity was caused by Central Bank?s mop up activities in support of the shilling and also the maturity and subsequent payment of the 5 year treasury bond. The tight liquidity led to a jump in the interbank rate to 16.4% from 13.6% last week. Similar to the previous week, there continues to be higher appetite for shorter dated securities, indicating investors expect interest rates to continue increasing. Yields on the 364-day T-bills increased by 50.2 bps to 13.0%, while yields on the 182-day and 91-day T-bills registered marginal increases to 12.4% and 11.5%, respectively. The 5-year reopened bond received total subscriptions of 85% with the average yield increasing to 14.3%, a 108 bps increase from last month?s auction. The huge increase in this bond?s yield means that investors who invested in the bond have lost more than 2% of the value of the bond on a Mark-to-Market basis. Assuming that the increase in yield cuts across all the tenors in a parallel manner, bond portfolios might have lost close to 10% over the last two months given the average duration of the market is slightly over 5 years.

Just weeks after raising the base lending rate to 11.5%, the Central Bank has issued a directive that limits commercial banks? daily forex transactions to 10% of their core capital. With reduced transaction volumes, there will be less speculative trading, which should in turn reduce volatility of the shilling. During the week the shilling gained 1.7% to the dollar to close the week at 100.7, bringing the year to date decline to 11.1%. We are of the view that CBK?s actions will offer support to the shilling in the short term, however, for longer term stability, the government and market players need to address the underlying structural problems cited in our Cytonn Weekly Report #28, which include: (i) allowing time for the Central Bank Rate increases to be transmitted into the market, (ii) reduce the rate of the budget growth, (iii) manufacture locally to reduce importation, and (iv) diversify the economy away form agriculture and tourism.

We expect inflation figures for July to be much higher than in the previous months driven by (i) the revision of electricity tariffs, (ii) increase in fuel prices by Kshs 4.34 per litre of petrol and Kshs 3.97 per litre of diesel, and (iii) currency depreciation, which affects most components of the inflation basket both directly and indirectly.

We maintain our expectation that 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 correction of the rate environment.

Equities

The market continued its losing streak in the week. NASI fell by 1.8% and NSE 20 lost 3.0%, on the back of declines in Liberty Kenya Holdings Limited, Britam, Centum and Barclays that fell by 8.7%, 6.5%, 4.7% and 4.7%, respectively. Key to note during the week was that there was a net positive inflow from foreign investors for the first time in five weeks, an indication that they could be taking advantage of the weak shilling and the market correction to invest back into the market. Since its February peak, NASI is down by 14%, while NSE 20 has declined by 18%; this is clear correction territory, but given slower earnings growth and a rising rate environment, it is too early to review our neutral stance on equities.

A number of companies announced results during the week. As we had earlier projected, earnings growth were muted across the industries. Housing Finance registered a profit after tax (?PAT?) growth of 2.3% y/y to Kshs 485 mn in H1?2015, down from the 19% growth recorded in H1?2014. This deceleration in PAT is attributed to increases in interest expense following overall increases in deposits by 35.3% y/y compared to an increase in loans of 28.8% y/y. Non-performing loans ratio however declined by 1.6% y/y to 8.1%, now well below the industry average of 8.6%, supported by an improved loan book quality. The operating expenses for the period increased by 16.4% y/y largely driven by increases in staff costs in anticipation of expansion. Following the current interest rate scenario in the country, the mortgage market may be dampened by the increased lending rates. As such, we expect to see a slower growth from the bank going forward. We shall be releasing our comprehensive banking report upon release of all banks H1?2015 results.

In other earnings news, British American Tobacco (BAT) and WPP Scangroup released their H1?2015 results. BAT registered an 8.3% increase in PAT to Kshs 1.9 bn, compared to Kshs 1.8 bn in H1?2014. The company benefitted from the weak shilling with the gross revenue increasing by 3%. The tobacco industry globally continues to face issues driven by different regulatory proposals, and the company must come up with innovative ways to grow its business. WPP Scangroup?s half-year results were relatively flat with PAT growing by 1.4% to Kshs 185 mn, while revenues increased by 2.3% y/y to Kshs 2.3 bn. Despite huge expansions into the region, we are yet to see growth in this company.

All the reporting companies this week ? HF, BAT and WPP Scangroup reported anaemic earnings growth of less than 10%, so far affirming our view that earnings growth will slow this year.

As we pointed out last week, mobile money is the next growth area for banks, and in line with this, Equity Bank last week launched Equitel, a mobile money transfer service that rides on Airtel?s infrastructure for voice, data and SMS services. The bank is targeting 5 mn customers by the end of 2015, which coupled with increased transaction volumes, should (i) boost transaction revenues in the increasingly competitive industry, and (ii) gear the bank towards revenue diversification by increase their non-interest income.

We remain neutral on equities given the lower earnings growth prospects in most industries due to lower projected economic growth rate.

Private Equity

Private equity (PE) investment in Sub Saharan Africa continues to improve, as evidenced by the increase in the number of deals and deal volumes into the region, and the closing of various fund raising activities by funds focused on investing in Africa. With investors eager to derive returns from the high GDP growth in the region, firms are opting to invest both in private and listed companies. However, we do not have a lot of listed stocks in the market, though we have seen this grow over time. We have seen major stock exchanges across Africa register negative returns in 2015, and a good alternative to quoted equities would be investments in private companies, where the returns are more attractive and stable. Kenya in particular continues to attract PE investments supported by a number of factors including (i) positive demographics driven by rapid urbanisation and the growing middle class, (ii) entrepreneurial spirit of Kenyans leading to increased number of businesses and a quality deal flow, (iii) stretched valuations in public equity markets, (iv) improving security measures in the country undertaken by the Government, and (v) ability to exit, which is key for PE investors.

With any huge opportunity there must be challenges that comes with it; the challenges facing PE investments in the region include (i) poor transparency in the market which may lead to mispricing of deals, (ii) lack of many qualified and experienced alternative investment managers in the region to extract value from private companies, (iii) the unwillingness of entrepreneurs in the region to cede equity in their companies, (iv) expensive debt which reduces the leveraging power to the investor, and (v) lack of investor knowledge to make informed decisions while negotiating deals.

We expect Kenya to continue to be an attractive destination for PE investment given the positive sentiments in the country, especially with the hosting of the Global Entrepreneurship Summit.

Real Estate

There continues to be a lot of interest in housing for the low to medium income given the huge opportunity in the market. Last week, a local real estate development firm, Peninsula, announced that it will be undertaking a Kshs 400 mn low cost housing project in Mlolongo. The project?s target group comprises of low and middle-income earners, and more specifically, first time homebuyers. Peninsula is undertaking the project through joint ventures with landowners and is being financed by the Cooperative Bank of Kenya. The development will include studio, 1 and 2 bedroom apartment units, with selling prices ranging from Kshs 1.5 mn to Kshs 4 mn. Other developers like Karibu Homes and Rogam Properties are also undertaking similar projects in the area. Developers and financiers alike have for a long time leaned towards developing high-end residential properties. However, this is gradually changing given the high-end residential property market in Nairobi has been showing indication of nearing saturation, based on decreasing occupancy rates. Our expectation is that low cost housing developments will be on the rise and will be concentrated in satellite towns where land is readily available and is significantly cheaper as compared to the Nairobi area.

Also this week, Safaricom launched Jiji Smart, an initiative that will see the telecommunications company partner with real estate developers in a bid to create new internet ready business premises. Under the initiative, Safaricom will provide fiber and other internet infrastructure while the developers will only pay for the internet bandwidth. Safaricom has already signed a seven year contract with the Hub, which is an upcoming mixed use complex in Karen scheduled to open in November this year. For Safaricom, the end goal of the initiative is most likely to command a larger share of the country?s growing broadband market. However, the trickle-down effect of the initiative for the real estate industry is a positive contribution towards the development of smart buildings. We expect that demand for office space in such buildings will be high since users will spend less money and time in getting their premises ready for operation.

Focus of the Week: Entrepreneurship, its drivers and challenges

Entrepreneurship is the capacity and willingness to develop, organize and manage a business venture along with any accompanying risks. Over the years, entrepreneurship, along with innovation, has carved its role in the economic and social development of the society, transforming the lives of millions of people around the globe.

The stand-alone trait that makes an entrepreneur is the entrepreneurial spirit that inspires one from within to be the best they can be. It develops within an individual who demonstrates a true passion for building something great from nothing and the will to push themselves to the limits to achieve their goals. An entrepreneur (i) is always passionate about what they do, (ii) always welcomes improvement in every aspect of their lives, (iii) optimistic about all possibilities, while taking challenges and obstacles as learning opportunities, (iv) takes calculated risks, and above all, (v) executes their ideas. This combination of traits nurtures the entrepreneurial spirit within him that drives his ambitions.

Entrepreneurship in Kenya has evolved through the years driven by the political, social and economic changes that the country has undergone. In the past, entrepreneurship in Kenya lacked diversity, being reserved to family businesses, cultural lines, the older generation, and predominantly men; but over the years Kenya has transformed into a cosmopolitan economy that spurs innovation and partnerships along diverse cultural differences and has seen youth and women step up. The key factors that encourage entrepreneurial development in the country are:

- Challenges such as unemployment and poverty: The unemployment rate in Kenya as at 2014 was 40% of the total population, with a large percentage comprising youth and women. This has led to innovations and entrepreneurial activities with the aim of improving their standards of living, especially in the informal sector. The inability of a large proportion of school leavers to secure jobs has left many to come up with their own businesses as a means of livelihood.
- Economic growth: The Kenyan economy is expected to continue growing strongly given the high

infrastructural developments, which provide ample opportunities for entrepreneurial developments. Kenya being a developing nation, the opportunities for entrepreneurship brought about by economic growth are large and far-reaching ranging from technology to agriculture, manufacturing to service, education to finance and real estate to infrastructure.

- Technological advancements: Global technological advancements and local innovations such as M-Pesa have greatly enhanced convenience and the ease of doing business.
- Government initiatives: The government has come up with several initiatives aimed at promoting entrepreneurship in the country, with the most recent being the Uwezo Fund, which targets the youth, women and the physically disabled.
- Education levels: We have seen a lot of growth in the tertiary education sector with a lot of new campuses being opened up. This will definitely lead to a lot of growth in the knowledge base and is bound to improve the rate of discovery in the country.

However, the Kenyan population faces obstacles that hinder them from exploiting their full potential. These obstacles are statutory, economic or social:

- Exam-based education system: Education nurtures talent from an early stage. A good education backbone in the country serves as a strong foundation on which entrepreneurship thrives. Our education system has been criticized for being rigid and exam based, hence limiting creativity and innovation, which are key for entrepreneurship. We need to review the system to one that nurtures talent and creativity from an early stage rather than one that focusses solely on examination.
- High taxes: High taxes have a significant impact on entrepreneurial activity hindering innovation. Entrepreneurs are discouraged to invest their ideas in the formal sector that have strict statutory regulations and will rather work in the informal sector where they can evade tax.
- Unclear and/or too many conflicting regulatory hurdles: It should be easy for any entrepreneur to register and run their business as long as they can comply with the required regulations. Streamlining the regulatory authorities so that there is minimum waiting time to receive service should be key across all sectors.
- Difficulty in attracting and retaining a quality workforce: A good entrepreneurial venture requires a skilled and dedicated workforce. The difficulty and the expenses associated with sourcing or training such a workforce discourages entrepreneurial activity as entrepreneurs try to minimize their startup costs. Improvement of the education system to a problem solving based and rounded education system will help, as the quality of graduates will be improved thus reducing the cost of training.
- Prevalent corruption in the country: Corruption within public and private sectors make it hard for ambitious entrepreneurs to pursue their ideas, as they have to pay bribes to attain the necessary statutory approvals. The Government?s war on graft is a step to curb the challenge of corruption in turn inspiring the public to innovation. We should all support the President?s ongoing fight against corruption.

Despite these challenges, the opportunities for entrepreneurial activities present an attractive prospect for economic diversity and growth. The 6th annual Global Entrepreneurship Summit recently held in Kenya highlights the promise of entrepreneurship. With the right governance, Kenya is poised to be Africa?s leading entrepreneurship hub.

A rich entrepreneurial culture in Kenya will create jobs, grow the economy and uplift the standards of living. The current depreciation in the Kenya Shilling, in the long-term, can be well addressed by entrepreneurs manufacturing more locally to reduce imports, exporting more to global markets, and thereby strengthening the Kenya Shilling.

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