Cytonn Monthly Report - July 2015

Cytonn Weekly

Executive Summary

- **Fixed Income:** Interest rates increased significantly during the month across all tenors, and Kenya Shilling lost 3.9% during the month;
- **Equities:** NASI and NSE 20 continued on their downward trend, losing 9.7% and 10.2% during the month, respectively;
- **Private Equity:** Sub-Saharan Africa is an attractive investment destination given the increased ease of exit;
- **Real Estate**: Performance of the real estate sector slows in Q2?2015, but the prospects remain high given the focus Kenya is getting as an investment destination.
- **Company Updates**:
  - We continue to strengthen the team in order to best serve our clients. Collina Milimu and Milka Njoroge joined the real estate team from Pinnacle and PRC, respectively;
  - Maurice Oduor joins the global institutions team as a Manager, from Britam Asset Managers. Maurice has deep financial markets experience from strong local brands such as Britam and Genesis, has worked with members of our team for over 5 years, has strong relationships with clients and is a CFA finalist;
  - We continue to pursue our strategy as the real estate investment partner for global institutional investors. We reached agreement with one additional global markets PE investor, bringing our global investment partners to four.

Fixed Income

Treasury bill auctions witnessed low subscription rates in the month of July, with the overall subscription at 42% due to (i) corporate tax payments, (ii) reopening of a 5-year bond, which raised Kshs 12.9 billion amidst no bond maturities in the month, and (iii) mop-up activities by the Central Bank of Kenya (CBK) in support of the Kenya Shilling. There was tight liquidity in the market as evidenced by the sharp increase in the interbank rate to 19.2% at the end of the month, from 9.5% at the beginning of the month and 7.0% in January. Treasury bill yields increased significantly across all tenors, with the 91-day recording the highest increase of 3.3% to close the month at 11.5%. The 182-day yield increased by 1.4% to 11.9% and the 364-day yield increased by 2.4% to 13.5%.

In the bond market, the 5-year primary bond yield increased from the previous month?s 13.2% to 14.3% in July, while the secondary bond market registered subdued activity with bonds valued at Kshs 9.5bn transacted. Investors remained inclined towards shorter duration investments as uncertainties in the interest rate environment persisted. Both pension schemes and banks with trading books will register significant losses in their bond portfolios this year due to the huge increase in yields.

Despite aggressive measures by the Monetary Policy Committee (MPC), raising the Central Bank Rate by 300 basis points and introducing a new repo in the market, the shilling lost 3.9% during the month of July against the dollar to close the month at Kshs 102.5, bringing the total year to date decline to 13.0%. The Central Bank also introduced a cap on potential trade volumes to 10% of banks? core capital to avoid excessive speculation on the currency. The underlying structural challenges affecting the currency and the dollar strength in the international markets are the main reasons why the shilling did not respond to the measures undertaken. In next week?s MPC meeting, we wait to see if there will be another rate increase. However, in our view, any further rate increases will not be good for the economy since GDP growth is already slowing.

We maintain our expectation that yields on government securities will remain high due to a number of factors:

- Increase in the CBR,
- Increased government borrowing in the domestic market to fund the 2015 / 2016 budget, and
- Tight liquidity in the market as CBK maintains its mop up activity.

We continue to be biased towards short duration fixed income instruments.

Equities

During the month, NASI and NSE 20 continued on a downward trend, falling 9.7% and 10.2%, respectively. The last two weeks of the month saw foreign investors turn into net buyers, an indication that the market is starting to look more attractive to them due to currency weakness and also price declines which have made valuations appealing. The continued decline was as a result of expected lower than historical earnings growth and much worse earnings for some of the companies that reported, such as TPSE and KQ. Large capitalization stocks continued on their losing streak with Centum declining by 21%, Equity Bank 17%, Britam 15%, Safaricom 12% and KCB 9%.

Since their February peak, NASI and NSE 20 have declined by 16.4% and 19.9% respectively. This is a clear correction territory, but given slower than expected earnings growth and a rising interest rates environment, we maintain our neutral stance on equities.

Kenya Airways released full year results for the year ended 31st March 2015, recording losses for the third year running, a loss of Kshs 25.7 bn, from the previous year?s loss of Kshs 3.4 bn. KQ?s Project *Mawingu*, a 10 year transformational strategy, seems to have flopped, pushing the firm deeper into losses with the fleet ownership costs edging up 107% to Kshs 26 bn, from Kshs 12.5 bn the previous year. The firm?s finance costs were up 95.3% as the firm took on more loans to sustain its short-term commitments, as well as purchase new aircrafts. The firm attributes its losses to i) a drop in international oil prices that resulted in a Kshs 5.8 bn loss in their hedging agreement, ii) the impact from the 11% decline in tourism arrivals, and iii) heavy investment in new aircrafts that failed to generate the expected revenue, as it coincided with travel advisories due to insecurity in Kenya and Ebola outbreak in West Africa. The firm seems to need a significant restructuring of its business, including;

- Exit loss making routes and concentrate on high margin routes,
- Restructure their capital structure, and
- Downsize the expansion strategy.

The major shareholder being the Kenyan government means that they can get some bailing out, but this will need to come with much more stringent measures to management and a clear turn around strategy needs to be thought of. As discussed in our Weekly Report #25, a full privatisation is critical to long-term sustainability of KQ. Continued government ownership comes with a moral hazard where management knows that in case the company runs into trouble, there will be a government rescue. Given the troubles at Uchumi, Mumias and KQ, the government should consider an aggressive privatisation strategy.

Growth in the banking sector?s core business was much slower than we have seen in the recent past. NBK registered earnings growth of 123% supported by both funded and non-funded income. The non-funded income increased by 227%, driven mainly by sale of property. Net Interest Income (NII) grew by 18.8% supported by a 30.6% growth in the loan book and 6.4% increase in deposits; the two resulted in an improvement in the loan to deposit ratio to 74%, from 60% same time last year. Net Interest Margin (NIM) came in at 4.9% while operating expenses grew by 4.1%, resulting into cost to income ratio of 54.3% from 71.2% in June 2014. We will need the exact amount of one time income related to the sale of properties in order to derive the core earnings growth. However, the NII, NIM, cost to income ratio reduction, and loan to deposit ratio growth indicate that NBK franchise is improving. The overall performance is better than our expectations. In our latest banking sector report, we had projected NBK?s long-term growth rate at 5% over the next 5 years, and we are now re-evaluating that assumption with a bias to increasing it. NBK is another institution that can benefit from full privatisation. Going forward, the bank has a lot of room for potential growth and management seems keen to do that.

KCB registered a 13% growth in its PAT supported by 13.5% growth in the NII and 8.5% growth in the Non Funded Income. NIM?s declined to 3.8% from 4.4% as the interest expense grew by 21.5%. Loan book grew by 31.4% while customer deposit grew by 26.0%, bringing the loan to deposit ratio to 72%, well within the banks long-term average. Total operating cost grew by 10.50% driven mainly by growth in staff cost which grew at 12.1%. However the cost to income ratio remained low at 48.6%. It is expected that KCB will continue growing their SMEs book and also leverage on the alternative distribution channels to drive earnings growth, as it has been a success this far. KCB?s performance is in line with our expectations of a 15% long-term earnings growth, as discussed in our last banking report.

A number of other companies reported their earnings during the week. TPS registered a loss for the second year in a row. The poor performance can be attributed to the impact of a slow down in tourism due to the travel bans into the country as a result of insecurity in the first half of the year, and the Ebola scare which reduced tourist travel across all African countries. EABL performed well supported by a lower tax rate for the year, restructuring of the company?s debt to slightly cheaper long-term loans, and growth in the export market despite the currency weakness. ARM registered a loss for the year driven by slower growth in revenue amidst increases in financing costs and forex losses during the first half. With the completion of the plant in Tanzania, the company has room for growth by exploring more markets, which should lead to increased capacity utilization and more revenue diversification.

The high interest rates environment may lead to a slowdown in economic growth, which will negatively impact the performance of listed stocks. High rates may lead to an increase in the non-performing loans for banks and weakening quality of earnings. Despite the fact that the market has come down considerably, almost a 20% drop, and valuations are now not too stretched, earnings growth is weak and seems to match the revised valuations. Consequently, we maintain a neutral stance on equities. However, we will be doing analysis to identify companies that can keep growing earnings at high teens in this environment, and those will be the companies to invest in.

Private Equity

During the month, there were a number of high profile exits that helped alleviated fears that Africa fails to offer attractive exit options for investors. Emerging Capital Partners 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. Additionally, global alternative asset manager, The Carlyle Group, announced its intention to sell its current minority shareholding in Export Trading Group (ETG) to the company?s management team/founders, representing Carlyle?s first exit in the continent.

In July, major PE deals that made headlines were African Alliance Asset Management investing in logistics firm Atlas Development and Support Services by purchasing 4.3 mn shares, at a price of Kshs. 11.0 per share, to take total ownership to 23.7 mn shares, representing a 5.5% stake. This is an example of a quoted private equity transaction. Adenia Partners, a private equity firm investing in Sub-Saharan Africa, also announced an investment in Cresta Paints based in Ghana, an auto-refinish and industrial coatings manufacturer by partnering with the company?s founders, Mr. Abhay and Mrs. Pradnya Salunkhe through Adenia Capital (III), a USD 125 mn fund closed in February 2012. The objective of the partnership is to pursue growth opportunities linked to exports, international expansion, product development and implementation of the best and most efficient industrial practices. Adenia plans to offer support in strategic and financial advisory and use its vast network to source new business opportunities for Cresta.

This month?s activities reaffirms that Africa has great prospects for private capital to propel economic growth, and is increasingly becoming attractive to foreign investors. Factors attracting foreign participation in the alternative markets are:

- Positive demographics driven by both a young population and rapid urbanisation,
- A growing middle class that provides a ready market willing to spend on consumables and essentials,
- Availability of deals due to an increased number of businesses seeking alternative channels of raising finance, and
- Ability to exit, which is key for PE investors.

Deep, active and vibrant private markets, (such as private equity, venture capital, quoted private equity, and structured products) are critical for economic growth, and this is an area that the country needs to aggressively develop.

Generally, the key challenges facing investments in private equity, and private markets in Africa, has been:

- Limited local talent and experience with the asset class. This is being addressed, as more entities such as Cytonn, Centum, Fusion Group, Ascent Capital founded by David Owino, and Fanisi, all locally driven, focus on the asset class.
- Deal size has been historically an issue since most global private equity funds focus on only huge deals with minimums of around USD 25 to USD 50 million per transaction. However, the emergence of local players is filling the gap. For example, at Cytonn, we will do deals as low as USD 1.5 million. We believe that emergence of local players fill a critical gap.
- Lack of appreciation for the importance of private markets.

Real Estate

According to the Kenya Bankers Association Q2?2015 Housing Price Index released this week, there were signs of stagnation of house prices across the property market. This was reflected by slower increase in property prices, which grew by 0.2% in Q2?2015 compared to 2.8% increase in Q1?15. This was also echoed by the Knight Frank Prime Global Rental Index report, released this month, which showed Nairobi?s rent increase was minimal at 0.7% compared to 4.3% for the rest of Africa. In our view, the insecurity situation in the first half of the year contributed to a slowing growth as investors adopted a wait and see attitude towards real estate investments.

From the KBA report, there seems to be a negative supply relationship between apartments and bungalows as most bungalows are converted to apartments. This confirms that the rising middle class prefer apartments to bungalows and maisonettes, as they are relatively more affordable and increases security within the developments. Preference for apartments, coupled with the increased purchasing power of the middle class, suggests that development of residential apartments for the low to middle income earners would be an investment opportunity worth tapping into.
