Cytonn Weekly Report #32, with a focus on the Ease of Doing Business in Kenya

Cytonn Weekly

Executive Summary

- **Fixed Income:** Money markets remained illiquid during the week, and interbank rates hit a high of 26.3%;
- **Equities:** NASI and NSE 20 were up during the week by 1.1% and 1.8%, respectively, on the back of strong performance by large cap stocks**;**
- **Private Equity:** Local investors fill the gap in regional private equity investment deals;
- **Real Estate:** There is a keen focus on improving infrastructure and logistics in Kenya;
- **Focus of the Week:** Kenya ranked first in East Africa in ease of doing business 2015, but a lot more remains to be done to improve our global ranking and competitiveness ? we still rank #136 out of 189.

Company Updates

- Maurice Oduor, our Investment Manager, was on CNBC Africa to address various market issues including the Kenya Shilling and Barclays Bank?s re-entry into the SME market: Maurice Oduor on CNBC Africa.
- Shiv Arora, our Investment Associate, was on KBC Channel 1, alongside Marakwet East MP David Bowen, to discuss the issues surrounding bailouts in Kenya, and whether the government should continue bailing out companies with significant government stakes
- Cytonn sponsored the Law Society of Kenya Annual Conference, held on 12th to 16th August 2015, at Leisure Lodge, Diani, Mombasa. During the conference, our team of Financial Advisors spoke to attending lawyers on the various investment opportunities for them and law firms
- We launched a real estate collaboration deal with MySpace Properties in Mombasa: Cytonn Investments Partners with Myspace Properties

Fixed Income

Under subscription of Treasury bills continued during the week, with total subscriptions declining to 79.8% compared to last week?s 89.3% due to continued money market liquidity tightness. Treasury yields were relatively unchanged with the 364 and 91-day T-bills decreasing marginally to 13.0% and 11.5%, respectively, while that on the 182-day increased slightly to 11.9%. During the week, the interbank rate hit a high of 26.3% from last week?s close of 22.9%, on the back of a low liquidity in the money markets as banks sought to increase their required Cash Reserve Ratio (CRR) to the statutory minimum of 5.25%. Despite the tight liquidity in the market, the shilling weakened 1.0% to close at 102.3 against the dollar as banks sought to cover their short dollar positions ahead of expected improvement in money market liquidity. This coming week, we expect once the new CRR cycle is implemented, liquidity levels might improve leading to a further depreciation of the shilling; the new CRR cycle gives a leeway to maintain a CRR of 3%, on condition that the monthly average ratio adds up to 5.25%,

According to the Central Bank of Kenya Bill 2015, Kenya?s statutory minimum foreign exchange reserve requirement is set to be raised to 4.5 months of import cover, from the current 4.0 months. If passed, Kenya will have to increase its current reserve which stands at USD 6.4 bn, (Kshs 645 bn), equivalent to 4.05 months of import cover reserve through buying additional dollars in the market. This is part of the East African common currency protocol signed in 2013. Kenya?s reserves have fallen by USD 1 bn since the beginning of the year due to sales in support of the shilling, debt repayment and revaluation losses amid reduced foreign exchange inflows from tourism, tea and horticulture. If the CBK was to come to the market aggressively there could be a strain on the currency; but there are other ways of increasing the reserves, for example borrowing in dollars both from the international markets and from the IMF.

As stated in our last week?s report #31, the Kenyan Government will be re-opening the two-year bond this week to raise Kshs. 20 bn for Budgetary Support. Given that the paper is currently trading at a yield of 13.8% in the secondary market, and also given the bidding pattern witnessed over the last three months, where investors have been demanding significant premiums, we anticipate bids to come in at between 14.5% and 15.0%.

We continue to maintain our recommendation that investors should be biased towards short-term fixed income instruments due to uncertainty of rates in the current environment.

Equities

The market was on a positive trend for the 2nd week, with foreign investors remaining on the net buying side. NASI and NSE 20 gained by 1.1% and 1.8%, respectively. This was due to strong performance of large cap stocks with BAT and Safaricom gaining 8.7% and 3.1%, respectively. Since the February peak, NASI and NSE 20 are down 14.3% and 18.2%, respectively.

This week, a number of banks released earnings and of key note is that CfC Stanbic is the only bank that has registered a decline in profits among the banks that have already released their earnings reports for the H1?2015. CfC Stanbic registered poor performance with profit after tax (PAT) declining 42% y/y, falling short of our 10% earnings growth expectations in the medium term. This was largely attributed to a decline in non-funded income (NFI) which declined by 33% y/y to Kshs. 3.3 bn, thereby diluting the effect of the 2.0% increase in net interest income (NII). Operating expenses decreased by 1%, resulting into an increase in cost to income ratio (CIR) to 60% from 50% in H1?2014. However, their loan book grew by 24% y/y while deposits also grew by 39% y/y leading to a loan to deposit ratio (LDR) of 76%. Our view is that for the bank to continue to grow its earnings, it should focus more on personal banking to reduce over reliance on non-funded income which is mainly from corporate investment banking. We are yet to meet management to understand what section of the non funded income underperformed.

Co-operative Bank registered a 32% y/y growth in PAT to Kshs. 6.2 bn, from Kshs. 4.7 bn in H1?2014, surpassing our 10% medium term growth assumption. The performance was driven by a 19% y/y growth in NII, to Kshs. 11.8 bn from Kshs. 9.9 bn in H1?2014. Total operating expenses declined by 4% y/y to Kshs. 9.0 bn, bringing CIR to 47%, from 59% in H1?2014. This follows the recent restructuring focused on increasing operational efficiency and minimizing staff costs. Deposits grew 24.6% y/y while loans grew 23.6% y/y, resulting in a LDR of 82.5%. In our view, these results showcase the success of the ?soaring eagle transformation agenda? to improve efficiency; which if coupled with a successful regional expansion, shall propel Co-operative Bank to a position of attractive earnings growth over the medium term.

Barclays Bank of Kenya (BBK) and Diamond Trust Bank (DTB) also announced results with PAT growth of 8% y/y and 11% y/y, respectively. BBK?s earnings were supported by strong performance in NFI which grew by 12% y/y to Kshs. 4.8 bn and a decline in loan impairments by 19% y/y to Kshs. 0.6 bn. Similarly, DTB?s growth, in line with our expectations, was supported by a strong performance in NFI which grew by 28%y/y to Kshs. 2.4 bn and a 13.3% growth in NII to Kshs. 6.9 bn. Going forward, we expect BBK to deliver single digit growth over the medium term despite the renewed focus on SME?s where there are already established players, such as KCB, Equity and other Tier II banks. With most banks having announced their earnings, we shall be working on our first half banking review.

Kenya Reinsurance released H1?2015 results, registering impressive growth, with PAT growth of 15.6% y/y to Kshs. 1.4 bn, from Kshs. 1.2 bn in H1?2014. Performance was driven by a 26% y/y growth in gross premiums to Kshs. 6.2 bn on the back of aggressive marketing in the international markets, which in turn increased their business share. Earnings growth was achieved despite net claims growing by 29% y/y to Kshs. 2.7 bn, as well as an increase in overall operating expenses by 9%. Interest income grew by 6% y/y to Kshs. 1.5 bn driven by capital gains from equity investments, interest from fixed income instruments and rental income. With the insurance penetration rate for Kenya at 3%, the insurance sector has immense growth opportunity, with Kenya Re positioned at the forefront to reap the benefits.

Oil marketer Kenol Kobil reported impressive H1?2015 results recording a 72.9% y/y PAT driven by an increase in gross profit by 14.8% y/y, and a significant reduction in finance costs by 43.3% y/y. We commend the management of Kenol, who have restored the firm to profitability by focusing attention on high margin business segments and the retail sector.

Given the high interest rate environment which may result in slower economic growth, most listed companies will report stunted earnings growth. For banks as at H1?2015, earnings grew by 8.3%, the slowest growth in the last 6 years, an indication of the impact of the high interest rate environment. With most listed stocks seemingly fairly valued, we remain neutral on equities.

Private Equity

As East Africa?s financial sector continues to attract private equity investments, the emergence of local investment players is filling a critical gap in providing equity investments to SME?s. This is evidenced by an increase in cross border investment activities in the region. During the week, Premfin Capital, a Mauritius-based financial services firm which is owned by a group of Kenyan investors, has acquired two microfinance companies, Gatsby Microfinance in Uganda and Fanikiwa Microfinance in Tanzania. The acquisitions seeks to broaden Premfin?s investment portfolio and accelerate the company?s growth, with the new expansion involving the acquisition of 6 branches of Gatsby Microfinance in Uganda and 5 outlets of Fanikiwa Microfinance in Tanzania. The emergence of microfinance institutions as a target for PE investors is driven by:

1. A rapidly growing, and entrepreneurial, population seeking access to easier forms of credit to finance growing ventures;
2. Low financial services inclusion in Uganda and Tanzania, at 43% and 35%, respectively, compared to 77% in Kenya, has seen microfinance institutions touted to grow to commercial banks;
3. Increasing ease of exit in the financial services sector, most recently witnessed by Helios? full exit of Equity Bank.

With most global investors focusing on large ticket deals, for a minimum ticket sizes of around USD 15 to USD 50 mn, the emergence of local investors who take up deals of as low as USD 1 mn are filling the funding gap.

Real Estate

Real estate developments along the Mombasa - Mariakani highway are set to be boosted as the government is seeking to start construction of a six-lane dual carriage highway. The individuals invested along the way will be affected as it is estimated that 820 structures, among them residential developments, will be demolished. The National Land Commission (NLC) will acquire 62 acres of land over the 35 km stretch, to allow the Kenya National Highways Authority (KeNHA) to kick start the Kshs 22 bn project in mid-2016. KeNHA have already secured Kshs 10 bn for construction of the 11 km Mombasa - Jomvu section from the African Development Bank (AfDB), and are in advanced stages of negotiations with the German Development Bank for the balance of the funding. Conversion of the road into a dual-carriage is aimed at reducing congestion on the road, used by trucks ferrying cargo from Mombasa port, which often results in grid locks. Cargo passing through Mombasa has been increasing by more than 6% annually, with the port facility handling 24 mn tonnes last year. This illustrates that infrastructure development will continue to increase opportunities for real estate development and investments.

TILISI Developments has put on sale 86 acres out of its 400-acre mixed-use real estate property, targeting development of warehousing and repackaging facilities along the Nairobi-Nakuru highway in Limuru. The developer is banking on the low supply of quality warehousing amid increased growth in various sectors of Kenya?s economy, such as health, to attract investors. The move by TILISI was aimed at ensuring that logistics is incorporated as part of their development, and provide infrastructure that facilitates their efficient operations.

Logistics play an important role in the development of real estate, which translates to growth of the economy, as it lays down the path to building different sectors, including wholesale and manufacturing. We believe that the identified gap between the supply and demand for quality warehousing units, away from the congested Nairobi CBD, and providing the requisite infrastructure, is an investment opportunity worth tapping into.

While we are bullish about the need for industrial, logistics and warehousing facilities due to the growing economy, we think that developments along Mombasa road are more suitable for such facilities.

Focus of the Week: Ease of doing business in Kenya

Ease of doing business is an aggregate ranking method for countries, based on indicator sets that measure and benchmark regulations applying to domestic SME businesses throughout their life cycle. The ranking is done by the World Bank, and tracks changes in the following 11 life cycle stages of a business: starting a business, dealing with construction permits, getting electricity, registering property, getting credit, protecting minority investors, paying taxes, trading across borders, enforcing contracts, resolving insolvency and labour market regulation. The countries are then ranked from 1 to 189, 1 being the best. In the 2015 survey, Kenya was ranked 136 out of 189, a marginal improvement from 137 in 2014.

This ranking is of use to (i) policy makers trying to improve their economy?s regulatory environment for business operations, with yearly changes in rankings providing some indications on the progress, and (ii) international investors, since it ranks countries relative to others and could act as a guide on which countries have more favourable operating environments. In this report, we choose to focus on Kenya?s ranking on the following 6 metrics:

1. **Starting a business:** With 10 procedures and 30 days to set up, Kenya?s ranking declined from 134 in 2014 to 143 in 2015 despite positive reforms. The reforms during the period was the improvement in the credit information sharing system. This now allows sharing of both positive and negative credit information, which in turn improves access to credit for SME?s. Additionally,

the Central Bank has licenced three credit reference bureaus which will enhance the provision of this information. On the other hand, negative reforms include (i) increase in building permit fees which makes construction permits costlier, and (ii) increase in taxation cost by increasing employer?s social security contribution to 6% of an employee?s salary.

2. **Dealing with construction permits:** The metric assesses the procedures, time and costs of acquiring construction permits. In Kenya, one has to follow 8 procedures from the submission of architectural drawings to when the water and sewerage will have been installed, and this takes approx. 125 days. Kenya?s ranking fell to 95 from 35 in 2014 with the increase in building permit fees being cited as the reason.
3. **Registering property**: It takes on average 72 days from the time of application of land clearance certificate to the payment of stamp duty (4% of property value), at an administrative cost of approx. Kshs 13,000, leading to a ranking of 136 from 131 in 2014.
4. **Getting credit**: Kenya?s rank declined to 116, from 111 in 2014. The positive reforms during the period included the adoption of a credit information system that shares both positive and negative information. The credit reference coverage is however still low at 4.9% of adult population.
5. **Protecting minority investors:** The metric assesses the extent of transparency in transactions and the extent to which minority shareholder?s rights are protected. Kenya?s ranking dropped to 122 from 118 with the trouble areas being the extent of director?s liability, strength of governance structure and extent of disclosures. This can be evidenced by the underperformance of listed companies due to mismanagement e.g. Mumias, KQ and Uchumi.
6. **Enforcing contracts:** Kenya ranks 137 on the ease of enforcing contracts with the process taking 465 days. The lengthy legal processes act as a hindrance and leads to inefficiencies in business operations.

From the above, it is evident that the process of starting a business and enforcing contracts has the least scores and as such, need for immediate reforms if Kenya is to remain attractive to investors and to continue on its journey to becoming a regional hub.

We have recently had our own experience with an ease of doing business comparison. When we recently incorporated our US affiliate, Cytonn Diaspora, the registration of the company from start to receiving the company registration certificate took 2 hours. With the registration certificate at hand, it took another 30 minutes to the tax identification number, the Kenyan PIN equivalent. With the registration certificate and tax ID number, it took one hour to open and operationalize a bank account. So in total, it took 3.5 hours to get the company registered, get a tax ID and open a bank account. Our estimation is that this would take at least two weeks if aggressively pursued in Kenya. The principal areas of improvement are to move company registration online, simplify tax registration and have company searches online.

Opportunity and difficulty are different sides of the same coin. The difficulties presented by our poor ease of doing business ranking present an opportunity for local partners, such as Cytonn, who are focused on serving foreign capital interested in the local attractive returns. ?The difficulty of doing business is a barrier to entry for foreign capital, but with local partners, foreign investors can unlock a massive opportunity for exceptional returns and the BEST asset level liquidity anywhere in East Africa?, said Antti-Jussi Ahveninen, Director of Taaleritehdas Africa Real Estate Fund, the leading global markets real estate investor in the region.

Since we have identified the issues, the next step is to identify our ability and willingness to improve. KPMG?s Change Readiness Index (CRI) which measures how effectively a government, its private enterprises and civil society anticipate and prepare for shocks, opportunities and risks, ranked Kenya 47 in enterprise capability, 84 in government capability, 65 on people and civil capability and 65 overall out of the 127 countries that were surveyed. This was a massive decline as compared to 2013 when Kenya ranked 21 in enterprise capability, 51 in government capability, 51 in people and civil capability and 37 overall. This reiterates the need for improvement in the governance and regulatory environment since government?s responsiveness has been the lowest of the three metrics consistently.

In our view, the change in the governance and regulatory environment will go a long way in improving changes in the business environment as well. As stated in our Cytonn Report #29, the highlighted challenges to entrepreneurship, which included (i) high taxes, (ii) unclear/too many conflicting regulatory hurdles, and (iii) prevalent corruption in the country, all originate from a poor governance framework. If this were to be improved on, the ease of doing business would increase, which would then foster entrepreneurship, consequently improving people and civil society capability.

However, it is worth noting that Kenya is the most responsive in East Africa, with Rwanda, Uganda and Tanzania coming in positions 69, 74 and 78, respectively. Additionally, the government is on the right path towards transformation with the earlier on mentioned transformations including the adoption of a full-file credit information sharing system, the digitization of the Company Registrar, the introduction of Huduma centres and other initiatives such as the Uwezo fund. The country has a well educated workforce with an entrepreneurial spirit and hence companies will not struggle in getting local talent while looking for employees.

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