Cytonn INVESTMENTS

Cytonn Weekly Report #33, with a focus on housing opportunities for the low to middle income bracket in Kenya

Cytonn Weekly

Executive Summary

- **Fixed Income:** Shilling depreciates 1.3% during the week, and yields on the two-year bond increased by more than 2.0%. The two-year bond came out at 14.8%, consistent with the 14.5% to 15.0% range predicted in our Cytonn report #32;
- **Equities:** NASI and NSE 20 declined during the week on the back of declines in large cap stocks. All listed banks completed their half-year result announcements, with the banking sector registering slower growth, most impacted by non-performing loans;
- **Private Equity**: Demand for power supply, coupled with the current under provision by African Governments, has led to PE investments in the energy sector;
- **Real Estate:** Lands ministry is set to begin registration process for real estate agents to streamline the sector;
- **Focus of the Week:** There is huge opportunity in providing housing for the low to middle income bracket, especially along the bypasses, which have opened up the development opportunity in Kenya.

Company Updates:

- Shiv Arora, our Investment Associate, was on CNBC Africa to address the market sentiment on liquidity and the performance of the Kenya Shilling. Shiv Arora on CNBC Africa.

Fixed Income

Under subscription of Treasury bills continued during the week, with total subscriptions declining to 42.1%, compared to last week?s 79.8% subscription rate as most investors were focused on the two-year bond, and as the market liquidity remained low. Yields increased on the 91-day and 182-day paper to 11.6% and 12.3%, respectively, from 11.5% and 11.9% the previous week. Yields on the 364-day remained flat at 13.0%. As stated in our Cytonn report #32, investors demand for higher premium saw yields on the reopened two-year bond increase from June?s 12.6% to 14.8%, with the average market bid rate at 17.0%. Of importance is that investors who invested in the bond in June have had a more than 1% capital loss on the invested amounts. Total subscriptions amounted to 97% of the Kshs 20 bn on offer, intimating to investors preference to lock in attractive yields.

As we indicated in our last week?s report, there was improved liquidity in the market, which saw the interbank rate consequently decline from last week?s close of 22.9% to 15.3%. As a result of this improved liquidity, the shilling weakened 1.3% to close at 103.5 against the dollar. In our view, the current decline of the shilling can be attributed to:

- Improved liquidity in the market leading to speculative positions against the shilling;
- Global dollar strength given the impending rate hike in the US;
- Kenyan Government?s increased appetite for dollar denominated debt which has resulted in increased demand for the greenback, and;
- Structural challenges, including a widening current account and fiscal deficit, which have left the shilling fundamentally weak.

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 took a pause from recent gains, with NASI and NSE 20 declining by 1.6% and 2.0%, respectively, due to declines in large cap stocks, namely Standard Chartered Bank Kenya, Barclays Bank and Equity Bank, which fell by 8.2%, 4.8%, and 4.8%, respectively. Foreign investors were net sellers in the market for the first time in four weeks. Since the February peak, NASI and NSE 20 are down 15.7% and 19.9%, respectively and 13.8% and 8.1% on a year to date basis, respectively.

This week saw the remaining listed banks release their earnings, with the banks registering mixed results. Standard Chartered Bank Kenya registered a 36.0% y/y decline in profit after tax (PAT) to Kshs 3.8 bn, weighed down by a 51.2% increase in loan loss provisions. Net interest income declined a marginal 0.1% y/y, while non-funded income fell by 31.2% y/y on account of a one off Kshs 1.2 bn gain last year owing to the bank?s sale of property. The loan book shrunk 6.4% y/y to Kshs 123.2 bn, while deposits grew by 11% y/y to Kshs 163.2 bn, leading to a reduction in the loan to deposit ratio (LDR) to 75.5%, from 89.6% the previous year. Operating expenses rose by 16.4% y/y, leading to an increase in the cost to income ratio (CIR) to 54.1%, from 41.2% the previous year. The overall performance missed our expectations of 10.0% growth, and we are now re-evaluating our long-term growth rate assumption for the bank with a bias to reducing it, and shall be meeting with management this coming week to discuss the bank?s strategy going forward.

I&M Bank and NIC Bank recorded PAT growth of 29.5% and 9.8% to Kshs 3.4 bn and Kshs 2.2 bn, respectively. I&M Bank?s strong performance exceeded our 10% expected growth rate, supported by an increase in non-funded income, which rose by 43.1% y/y, and a strong recovery of operations in Bank One Mauritius, which posted a 52.5% y/y increase in PAT. Net interest income rose by 18.4% on account of a 20.6% y/y growth in loans, while deposits grew 21.9% y/y resulting in a LDR of 95.1%, a 1.0% decline from 96.1% the previous year. Operating expenses rose by 21.2% y/y, raising the CIR to 37.4%, which is still far below the industry average. With the turnaround in profitability in Mauritius having gained traction, we feel that I&M is well positioned to reap the benefits of its expansion strategy and sustain future growth. NIC Bank?s performance was supported by a 19.8% y/y increase in net interest income, driven by an 18.3% y/y increase in loans and a 12.5% y/y increase in deposits. This resulted in an increase in the LDR to 103%, from 97.9% the previous year, which is being funded from their bond proceeds. Operating expenses rose by 33.2% y/y on account of an increase in the loan loss provisions, resulting in a CIR of 50.7%, from 46.1% the previous year. We retain our view on NIC, as performance was in line with our expected long-term growth rate of 10.0%.

Pan Africa Holdings released their H1?2015 results, registering a decline in PAT by 32.4% y/y to Kshs 263.9 mn, from Kshs 390.7 mn in H1?2014. Gross benefits and claims paid increased 13.3% y/y to Kshs 1.5 bn, while there was a decrease in gross written premiums which fell 6.6% y/y to Kshs 2.5 bn. Performance was weighed down by worsening claims experienced in life business, and unrealized return on equities which posted poor performance. Gateway Insurance, which was acquired during the year, also posted a loss during the period due to low production during the transition period. With the insurance penetration rate for Kenya at 3%, the insurance sector has

immense growth opportunity but a lot of education to the public needs to happen to unlock this potential. Pan Africa?s venture into non-life insurance, in addition to its life insurance business, should position the firm to capture the expected growth in the industry in the long-term.

Given the high interest rate environment, which may result in slower economic growth, most listed companies will report stunted earnings growth, as has been reflected across the financial services sector. The weak shilling will also affect the manufacturing sector companies, which rely on imported inputs. With most listed stocks seemingly fairly valued, we remain neutral on equities.

Private Equity

Nigerian based Synergy Capital Managers announced the completion of its investment of an undisclosed amount in Viathan Engineering Limited. Viathan, a developer of captive and embedded power solutions (diesel generators and solar powered systems), is aiming at producing and distributing power solutions to meet the current demand from the underserved public and government sectors across Nigeria. This investment is aimed at enabling Viathan re-structure its balance sheet and provides sufficient capital to scale up its distribution capabilities. Viathan already has a fully built distribution ring across most of Lagos to power key government infrastructure, and also serve commercial off takers. Over the next year, with the investment by Synergy, the company expects to set up a portfolio of power assets in strategic markets through acquisitions and developments. Progress on most of the new assets is advanced and the additional capital will enable the company to achieve their target capacity of 200 MW. Synergy?s investment in Viathan in based on;

1. Presence of an underserved government, combined with public and commercial off takers, which presents an opportunity for the private sector to provide basic necessities such as power;
2. The existing partnership with Green Power International, an operations and maintenance operator with deep experience and track record to deliver scalable and modular power solutions in emerging markets;
3. The opportunity to propel economic growth in Nigeria by building Viathan into a world-class provider of power solutions with sound operational expertise.

A theme across many African markets, including Kenya, is the under provision of basic services, such as power, housing and food by the governments. Synergy?s investment is another move by a private sector player to harness the opportunity where the public sector has failed. Power, alongside sectors such as housing, in Africa is an issue that needs to be addressed. With the current rate of development, population growth, and industry expansion, basic services provide the platform to drive economic growth. The most developed economies have achieved their development goals by having a reliable and sustainable energy supply. PE firms investing in power are well positioned to (i) achieve long-term and attractive returns, and (ii) make a meaningful impact to the economic growth of Africa.

Real Estate

Real estate agents are now required to register with the Ministry of Lands, Housing and Urban Development in order to operate. The Ministry will be issuing registration cards and codes as part of its efforts to guard against existing loopholes in the agency business. The registration process is expected to begin in September and is anticipated to provide a comprehensive electronic database through which members of the public will be able to easily confirm whether they are dealing with genuine agents. Though the existing Estate Agents Act (1984) clearly stipulates qualifications for practitioners and the governing codes, the industry is still porous to rogue agents that have been fleecing unsuspecting customers. This is an indicator that the Act isn?t effective, which explains this move by Ministry of Lands to increase transparency in the operations of the real estate sector.

This week, Mt. Kenya University received approval from Nakuru County to embark on a Kshs. 2 bn project geared towards expanding their University facility to include student hostels and other amenities such as a study complex and a shopping mall. The project is aimed at providing affordable housing for students so as to ease the current accommodation pressure caused by increased university intakes. This move by Mt. Kenya University echoes the actions of other higher learning institutions who are actively seeking investors and partnering with developers to meet this shortage. There has also been an increase of developments in areas surrounding universities as developers scramble to put up residential, commercial and retail facilities which will act as supporting developments for the universities. It is our expectation that the continued expansion of higher learning institutions will, on a macro level, impact the real estate industry by catalyzing the growth of new towns, which will be anchored on the institutions themselves.

Focus of the Week:Housing opportunities for the low to middle income bracket in Kenya

In October last year, Kenya was declared a middle-income country having achieved per capita income of USD 1,160, and surpassed the World Bank threshold of USD 1,036, after the GDP was rebased. The new status is an indicator of the growing Kenyan economy, which translates into increasing demand by the expanding middle class that will lead to increased demand for goods and services, including good housing. Provision of basic services to this middle class will lead to further increase in economic growth. According to the Kenya National Bureau of Statistics, the Kenyan middle class can be defined as anyone having a disposable income of Kshs. 23,670 and Kshs. 120,000 per month. However, in our view, a middle income household should have around Kshs 100,000 per month in disposable income.

With the increase in economic growth, demand for appropriate housing comes to the forefront. In most towns, access to appropriate affordable housing has been, and remains, a mirage for the majority of urban dwellers in the middle and low income bracket in Kenya. Despite the acknowledged importance of housing in Kenya, demand still far outstrips supply, particularly in urban areas. This manifests itself through overcrowding which leads to increased informal settlements in urban areas, and poor quality housing in rural areas. Delivery of housing to the low to middle income citizens is further aggravated by inequality and imbalance in housing supply among income groups. Currently, more than 80% of new houses produced are for high and upper middle-income earners, yet the greatest demand is for the low and middle income bracket, which represents 83% of the population and this can be attributed to the ease of exit by developers in the high to upper segment.

Some of the key challenges facing the lower segment of the market include:

1. Rapid urbanization,
2. Relatively high poverty levels
3. Lack of long-term financing, which when available is expensive,
4. High cost of building, and,
5. Increases in the cost of land around major towns.

To address some of these challenges, the government has sought several ways in which to encourage the construction and ownership of homes for the low to middle income groups. This can be seen in incentives such as:

1. Exemptions from income tax of housing loans and any contributions to Home Ownership Savings Plan (HOSP);
2. Lower taxation of housing bonds;
3. Allowing people to use their pensions as a guarantee for the purchase of their homes, and;

4. Through National Housing Corporation to provide affordable housing with affordable mortgage schemes.

Opportunities for the development of housing for this income bracket can be seen in the satellite towns. According to the Hass Consult Q2 land index report, satellite towns have registered a staggering 638% increase in price from 2007-2014. Ruaka, a town where we have an ongoing development, registered the highest increase in land prices. Land in satellite towns however remains considerably cheaper than in urban areas, and thus, the most ideal for development of housing for the low to middle income groups. The relative affordability of land in satellite towns coupled with the major infrastructure developments that have opened up the satellite towns make development of low to middle income housing in satellite towns a compelling theme.

Consequently, Cytonn sees huge opportunities for investors looking to invest and serve the middle income. There are number of successful developments that have come up, and many more coming up, that investors can take advantage off. We shall be focusing on some town specifics that have these opportunities, and next week we shall have a report on Ruaka.
