Cytonn Weekly Report #37, with a focus on Mortgages in Kenya

Cytonn Weekly

Executive Summary

- **Fixed Income:** Yields on treasury bills increased across all tenors, an indication that the Government is keen to step up its domestic borrowing programme to bridge the fiscal budget deficit. The shilling depreciated 0.2% w/w despite the Fed?s decision to hold off a rate hike. We expect the Monetary Policy Committee (?MPC?) to keep rates flat at the upcoming MPC meeting scheduled for September 22nd;
- **Equities:** NASI and NSE 20 gained 0.5% and 0.6%, respectively, and there are some major changes in the Companies Act
- **Private Equity:** The increase in PE investments in the education and mobile money platform highlight the potential returns to be derived from the sectors. Educas? 3.6 billion acquisition of Brookhouse, which has 750 students, effectively valued each student at about 5.0 million;
- **Real Estate:** Kenya might see the first listed REIT in the country if Stanlib manages to list by the end of the year, but significant challenges remain;
- **Focus of the Week:** There are a number of challenges facing the mortgage market in Kenya and hence the low uptake.

Company Updates

- Cytonn Released the Kenyan Banking report for H1?2015, Cytonn H1'2015 Banking Report.
- Maurice Oduor, our Investment Manager, discussed the Cytonn H1?2015 banking report on CNBC Africa: Maurice Oduor on CNBC Africa.

Fixed Income

Treasury bill auctions were undersubscribed during the week, with an overall subscription at 57.1% compared to 180.1% the previous week due to tight liquidity in the money market, as a result of tax remittances by commercial banks. The interbank rate rose to 23.4% from 15.4% the previous week. Yields on treasury bills increased across all tenors to 14.5%, 13.9% and 15.8%, from 13.9%, 12.9% and 14.9% for the 91-day, 182-day and 364-day papers, respectively. Compared to the previous auctions, this week the Government increased the offer amount for treasury bills, an indication that the that the Government is keen to step up its short-term borrowing programme to meet the Kshs 219.0 bn domestic borrowing target to fund the 2015/16 fiscal year budget and also guiding against long-term expensive borrowing by the government.

For the month of September, the Government will be issuing a 1-year bond to raise Kshs 30 bn for budgetary support, further confirming the Government?s preference for short-term borrowing as a result of the prevailing interest rate environment. A similar tenor paper is currently trading at a yield of 15.8% and the bidding pattern witnessed over the last four months have shown that investors are demanding significant premiums above the prevailing yields. We therefore anticipate bids for the 1-year bond to come in over 16.0%.

During the week, the shilling continued to depreciate against the dollar, shedding 0.2% to close the week at Kshs 105.6, a loss of 16.2% YTD; this was despite the Federal Open Market Committee (FOMC) in the US holding off an increase in rates citing concerns about global market turbulence and its potential impact on the US economy.

The International Monetary Fund (?IMF?) made available an additional USD 76.4, bringing the total amount available to Kenya under the Stand-By Arrangement (SBA) and the Standby Credit facility (SCF) to USD 610.7 mn. However, the country has not drawn down so far from this facility despite forex reserves dropping to USD 6.2 bn, equivalent to 3.94 months of import cover, which is below the 4.00 target.

The labor wrangles in the education sector in Kenya reached a climax this week when the government ordered for the closure of both public and private schools due to teachers? strike, which came as a result of government?s failure to honor a court ruling that awarded teachers between 50% - 60% pay rise. The government has expressed concerns that awarding teachers this pay rise may result into serious economic challenges in the country such as increased taxes and encouraging industrial actions by other civil servants. The implementation of teachers pay rise is estimated to cost the government an unplanned expenditure of Kshs 15bn, which may further put pressure on already strained government finances given that the government?s allocation to recurrent expenditure is still relatively high.

We expect MPC to retain the MPC rate flat at 11.5% during the upcoming September 22nd MPC meeting because any further rate increases would harm the overall economy. We should not sacrifice overall economic growth for the stability of the shilling.

The government?s borrowing programme for the current fiscal year, targeted at Kshs. 219 bn, is behind schedule; instead of net borrowing, the government has so far made a net repayment of Kshs 34.7 bn for the current fiscal year. Consequently, we expect the government to step up domestic borrowing which may further result in upward pressure on interest rates, and therefore we continue to maintain our view that investors should be biased towards short-term fixed income instruments due to the uncertainty of the rate environment.

Equities

During the week the market continued on an upward trend. NASI and NSE 20 gained by 0.5% and 0.6%, respectively, on the back of gains in Bamburi, KCB and Safaricom gaining 4.1%, 3.8% and 1.4%, respectively. Foreign participation remained high in the market at 62.4%, compared to last week's 60.7%. Foreign participation registered net inflows of Kshs 615m as some stocks are still attractively priced. Since their February peak, NASI and NSE 20 are down 17.1% and 23.0%, respectively, and 9.6% and 17.1%, respectively, on an YTD basis.

During the week, the Special Economic Zones Act, the Company Laws Act and the Insolvency Act were signed into law. The Companies Act of 2015 allows a single entrepreneur the capacity to form a private company as the sole member and director, thereby encouraging the increase in the number of entrepreneurs. This is one of the initiatives that the Government has put in place to promote entrepreneurship, in line with our view stated in Cytonn Report #29. In addition, a provision has also been made for publicly listed companies to undertake share buybacks. The ability to buy back shares should encourage companies (i) to buy back shares when they view their shares as undervalued and (ii) issue shares to key employees, as an alignment tool, and then buy back shares in the market to avoid dilution. As discussed in our Cytonn Monthly ? April 2015 and Cytonn Weekly # 31 the ability by companies to buy back shares from the market should have a significant positive impact in our capital markets. We strongly believe that share-based incentive schemes will strengthen alignment between management and shareholders, thereby improving corporate governance, and building companies geared towards sustainable & long-term high performance.

The Central Bank of Kenya (CBK) is setting up a Payment Services Management Board (PSMB) under the Payment Association of Kenya that will include electronic-money issuers, banks, telecommunication companies and other financial services providers. The association emerged as part of the efforts meant to regulate the mobile money industry. It is expected that the association will allow for harmonization and management of interchange charges as well as create regulations for members to self-regulate. This is expected to provide a dispute resolution mechanism arising from the mobile money space. Data released by the CBK shows that mobile money payments grew 18.2% y/y to Kshs 1.3 tn for 6 months to June 2015, while card payments increased by 4.2% y/y to Kshs 654.7 bn, highlighting the increase in these channels of money transfers.

As per their full year 2015 release, Atlas Development and Support Services Limited (ADSS) recorded a loss of Kshs. 1.0 bn from a loss of Kshs. 150 mn in June last year. This was as a result of an increase in operating expenses, which rose 348.8% y/y to Kshs. 1.2 bn, driven mainly by restructuring costs due to downscaling of operations. ADSS, which offers support services to oil and gas exploration companies, has faced difficulties in securing contracts. The low global oil prices have caused exploration companies to cut down on their exploration budgets, negatively impacting exploration service providers like ADSS.

We remain neutral with a negative bias on equities given the significantly lower earnings growth prospects for this year. The market is now purely a stock pickers? market, with few pockets of value.

Private Equity

Brookhouse School, one of the leading private schools in East Africa, has been sold to Educas, a UK-based PE fund, for Kshs 3.6 bn. With approximately 750 students, this values the school at about 5 million per student. This is one of the biggest transactions in Kenya?s high-end education sector. PE firm AfricInvest, which held the single largest stake of 30%, received Kshs 1 bn from the transaction, a return of 188.9% from the Kshs 346.1 mn it invested in 2010, an IRR of 25.6% over the 5-year investment period. Piyush Mehta and Victoria Bank, who had stakes of 25% and 20%, respectively, received Kshs 900 mn and Kshs 720 mn, respectively. For Educas, the acquisition is part of its global expansion strategy. The acquisition indicates increased investor interest in Kenya?s education sector, where the last major transaction was the 2011 investment in Hillcrest International Schools by PE firm Fanisi Capital for an undisclosed amount.

We see a huge opportunity for the private sector to provide education in the country given the high reliance on government / public schools. This has been brought to the forefront by the on-going teachers? strike, which has paralyzed learning across the country, save for private schools. Additionally, the growing middle class will have a desire to send their children to aspirational private schools.

Ascent Capital, a PE firm focused on investing in SMEs across the East African region, has made its debut in Uganda by acquiring a stake in the mobile money agent, Chims Africa, for an undisclosed amount. Chims Africa operates a chain of 130 MTN mobile money agencies, serving close to 7 mn customers annually. This is Ascent?s 2nd deal, after investing in an Ethiopian HealthCare company, Medipharm Holdings Africa. Funds will be used to open an additional 700 mobile cash kiosks in the rural areas in Uganda. Uganda?s volume of mobile cash has more than doubled in the past two years to hit Kshs 695 bn in 2014 from Kshs 337 bn in 2012, according to statistics from the Bank of Uganda. Uganda scores 35% to rank third globally in terms of share of adults holding a mobile money account compared to Kenya at 58%, and Somalia at 35%, according to World Bank?s Global Findex. This highlights the growing interest in the financial services industry and mobile money transactions in particular.

Real Estate

Making real estate news this week was Stanlib Kenya?s plan to roll out its Real Estate Investment Trust (REIT) by the end of 2015. We note that this is a revision from the initial projection that they would launch within the first half of the year. The Capital Markets Authority (CMA) licensed Stanlib as a REIT Manager, along with 4 other REIT Managers - Fusion Investment Management, CIC Asset Managers, Centum Investments and UAP Investments. All REIT managers are yet to launch their REITs. Kenya is the second country in Africa, after South Africa, to have a REIT Market and 41st worldwide.

Given the rising demand for real estate and subsequent exponential growth of the industry, we expect REITS to quickly gain traction as a viable investment option with the right regulatory and market support. This is because:

i. The REIT segment will open an avenue for small and large-scale investors alike to invest in the lucrative real estate sector. This therefore means that high net-worth investors who would otherwise be locked out of the real estate industry due to the high initial capital involved in purchase and development of Real Estate can now directly participate;
ii. Investors will be able to diversify their investment portfolio as the REIT prices enjoy lower volatility as compared to equity stocks;
iii. REIT?s provide investors with attractive returns as participants are able to access both the rental yields and the capital appreciation in the units they hold;
iv. Lastly, owners of REIT units will also enjoy higher liquidity compared to owners of actual property

As Kenya?s real estate industry continues to grow and mature, REITs will provide an investment instrument that can harness the opportunities that the market offers. However, as stated in our Cytonn Report #15, the success of REITs will depend on addressing a number of hurdles, including:

i. Increased investor education on the benefits of participating in the capital markets as investors
ii. The minimum amount of Kshs. 5 million is too high, it needs to be revised
iii. Scarcity of institutional grade real estate that will make up the asset base supporting the yields promised by the REITs

Product development and innovation is an iterative process with a lot of setbacks along the way. Over two years since the launching of the REITs regulatory framework and yet no REIT in the market, it is a good time to take a step back, bring industry players together to figure out how to re-energize the effort and get the momentum going. Given that the majority of the Kenyan working population is in rental housing rather than owned housing, it is critical to have a vibrant REIT market to provide financing for housing developers to serve the rental market by selling their developments into REITs. Consequently, the need for a vibrant REIT market is not just a capital markets imperative but also an important national priority.

Focus of the Week: Mortgages in Kenya

According to the Kenyan Vision 2030, access to decent and affordable housing has been identified as one of the social pillars of economic growth. Within the Vision 2030 housing pillar, the mortgage finance initiative seeks to establish a secondary mortgage finance corporation as well as a national housing fund, which will also introduce housing and infrastructure bonds to help develop affordable housing.

Kenya, a middle-income country, with a rebased per capita income of USD 1,160.0 has seen an expanding middle class, which has led to an increasing demand for housing. The ownership of houses in Kenya varies from cash purchases, own construction, or mortgage purchase options. Mortgage penetration in the Kenyan market remains low, currently standing at 4.3% of the GDP compared to developed nations, which usually are above 50%. Despite the low mortgage penetration rate, there are considerably good numbers of mortgage lenders in the country currently at 15, including banks and micro lenders.

According to the Central Bank?s report, the number of mortgage accounts in Kenya was estimated at 22,013 as at December 2014, having increased by 2,134, or 10%, year-on-year from 2013. The size of the Kenyan mortgage portfolio is estimated to have been valued at Kshs 164.0 bn as of December 2014 from Kshs 138.1 bn in 2013, representing a growth of 18%. On the other hand, the average mortgage loan size grew from Kshs 6.9 mn in 2013 to Kshs 7.5 mn in 2014, a growth of 8.7%. Despite the 18% growth in the overall loan book, the number of mortgage accounts increased only by 10%, an indication of low mortgage uptake.

Despite having 15 mortgage lenders in the market in a country of 43 million people, we only have 22,000 mortgages. The demand for mortgages is still relatively low because of the following reasons:

i. Kenya is an agricultural based economy and most rural citizens live in their own houses;
ii. Low incomes levels that cannot service a mortgage;
iii. Soaring property prices,
iv. High interest rates, which discourage potential homeowners from borrowing. High interest rates in the market have become the major hindrance for home ownership with commercial banks offering mortgages at an average rate of 15%, with the most expensive at 18% and the cheapest being 12.9%;
v. Expensive initial costs when taking a mortgage.

With the increased urbanization and the growth of the middle class in the country there is need to look at better ways to address the housing issues in the country. The following are some of the ways that this can be achieved:

i. Provide avenues and incentives for private sector involvement in the provision of affordable quality houses, such as what the Nairobi county is doing with the redevelopment of the city estates to increase the density of most of them;
ii. The development of infrastructure to open up satellite towns will enable developments in areas where land prices remain affordable;
iii. Improved access to credit information and analytics to better price risk and also increase information in the market;
iv. Deepen capital markets products that promote real estate development for affordable segments. It should concern us that since the 2007 approval of regulatory framework for asset backed securities, ABS, and the 2013 approval of the regulatory framework for REITs, there isn?t a single product from either.

In summary there is a huge opportunity in the provision of affordable mortgages in the country given the demographic trends in the Kenyan economy: a young and growing population, growth of the middle class and rapid urbanization.

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