Cytonn INVESTMENTS

# Cytonn Quarter 3, 2015 Report

## Cytonn Weekly

## Executive Summary

- **Global Markets Review:** Fed held rates constant, as emerging markets witnessed a slowdown in economic growth;
- **Regional Outlook:** Sub Saharan Africa stock indices continued to lose, on the back of a slowdown in economic growth and capital outflow;
- **Kenya Macro Economic Review:** Despite a challenging operating environment in Q2?2015, GDP grew by 5.5% compared to 4.9% recorded in Q1?2015;
- **Fixed Income:** Q3'2015 saw the highest increase in yields owing to tight liquidity in the money market while Kenya shilling depreciated by 6.1% against the dollar;
- **Kenya Equities Market:** NASI and NSE 20 shed off 10.6% and 14.9%, respectively in Q3?2015 as banks released the weakest earnings growth in 6 years;
- **Private Equity:** PE activity has remained robust in Q3?2015 with increased new deals and several exits being reported in the region, demonstrating the overall attractiveness of the Sub-Saharan Africa market;
- **Real Estate:** Developers and investors alike should remain cautious as the uncertainty of the interest rates environment persists in the wake of the weakening Kenya Shilling;

## Company Updates

- Due to investor demand, Cytonn reopened its recently closed private placement of real estate backed structured notes: Real Estate Private Placement; the reopening took in an additional Kshs. 600 million, which brings to Kshs. 2 billion the total amount raised over the last one month, with Taaleritehdas of Finland, as the anchor investor. The average price of the notes was 16.5% over the life of the notes, plus equity participation. We continue to see very strong global investor interest in Kenya real estate
- This past week we broke ground on Amara Ridge, an exclusive gated community in Karen, which sold 60% off-plan and is fully funded. Her Excellency Ambassador Tarja Fernandez, the Republic of Finland Ambassador to Kenya was the chief guest: Amara Ridge Ground Breaking
- This coming week we shall launch two new projects: **The Alma**, a comprehensive residential development located in Ruaka, which we have sold 20% off plan, and **Situ Village**, a comprehensive development located at Ololua Ridge in Karen. These aspirational and world-class developments are set to upgrade their respective neighborhoods.
- Cytonn Diaspora roadshow begins this week. The roadshow will highlight investment and careers opportunities in Kenya for the diaspora. If you want to partner on this roadshow to highlight investment products in Kenya, kindly contact us at roadshow@cytonn.com. Roadshow schedule.
- Shiv Arora, Head - Private Equity Real Estate was on CNBC and discussed the issues surrounding the strengthening of the Kenya shilling during the last week of September: Shiv Arora on CNBC

# Global Markets Review

**Introduction**

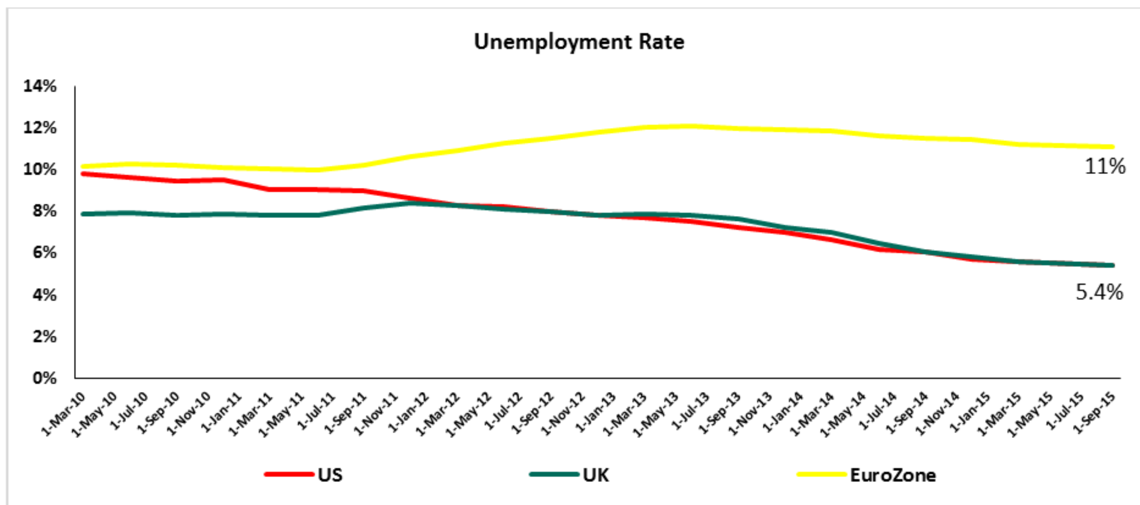
The global economic backdrop for Q3?2015 was dominated by slowing economic activity in the emerging markets, led by China. The slowdown combined with plunging commodity prices led to a downshift in global growth forecasts and increased volatility in the global investment market.

After many years of emerging markets supporting global growth, developed markets will be supporting global growth this year. Global growth is projected at 3.3% in 2015, a marginal decrease from the 3.4% registered in 2014. This is supported by a 2.1% growth in developed economies, up from 1.8% in 2014, and weighed down by a 4.2% growth in emerging economies, down from 4.6% in 2014.

Despite the growth in the more ?stable? developed markets, investors are bracing themselves for more volatility in the coming months, as a result of (i) the possibility of a rate hike by the US Fed in December, (ii) commodity prices remaining low and stifling growth in Brazil and West Africa as China cuts production, and (iii) the possibility of a further cut in rates in China to support growth.

# United States

The US Fed left interest rates unchanged at the meeting on September 17th, with the economic developments in the global markets as a cause of concern, led by the slowdown in China, as well as worries over a deflationary market. There are now expectations of a Fed rate increase in the December meeting driven by (i) strong GDP growth at 3.7% in Q2?2015, and (ii) unemployment now at a 5-year low of 5.4%, compared to the 11% in the Eurozone.




Similar to what was witnessed in Q2?2015, the US economy was driven by improved consumer confidence, spending and wage growth. This combined with a robust growth in housing, with 1.13 million new-homes per annum constructed in the US at August 2015, has driven the economy.

The stock market has been declining, with S&P 500 losing 6.9% in Q3?2015, largely driven by the uncertainty of a rate hike combined with stretched valuations in the market, with the Cyclically Adjusted Price / Earnings (CAPE) ratio at 24.3x, above the historical average of 16.0x. The market will continue to remain volatile and we expect further decline for the remainder of 2015 unless (i) Q3?2015 earnings results show a positive surprise, (ii) oil prices stabilize, (iii) China?s data improves, and (iv) there are consistent signs of improved growth in the Eurozone.

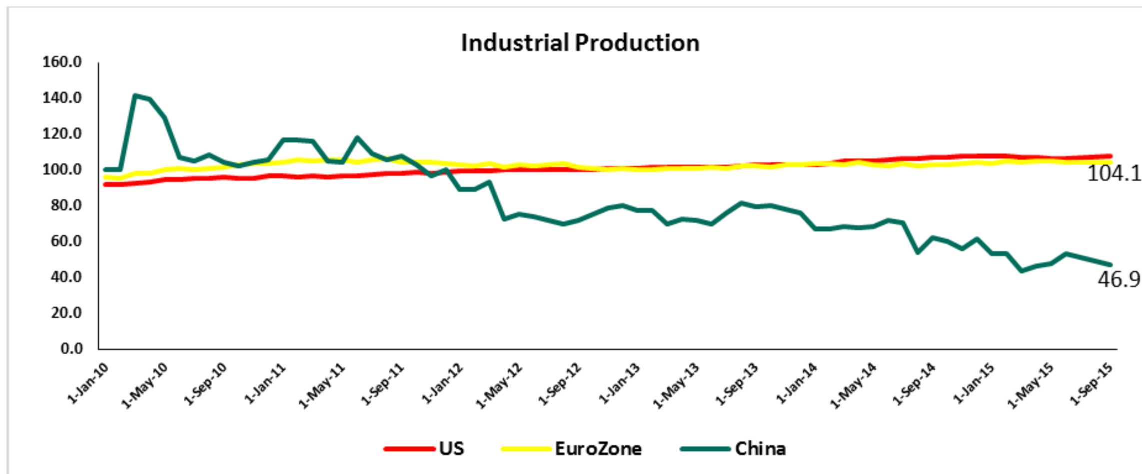
# Eurozone

Europe?s recovery is on track, with the weak euro boosting exports and corporate earnings. The positive expectations for quantitative easing (QE) by the European Central Bank (ECB) purchases is

already having a positive effect on the Eurozone, with GDP estimates rising to 1.5%. In addition, while the Fed and PBoC have kept investors guessing over when the rate hikes and cuts, respectively, will happen, the ECB has maintained a clear stance that further downside risks will drive additional QE.

# China

Economic growth is decelerating in China, with a school of thought suggesting that economic numbers maybe lower than reported given (i) the reduction in production output, (ii) flat electricity consumption, and (iii) reduced uptake of credit despite rate cuts.

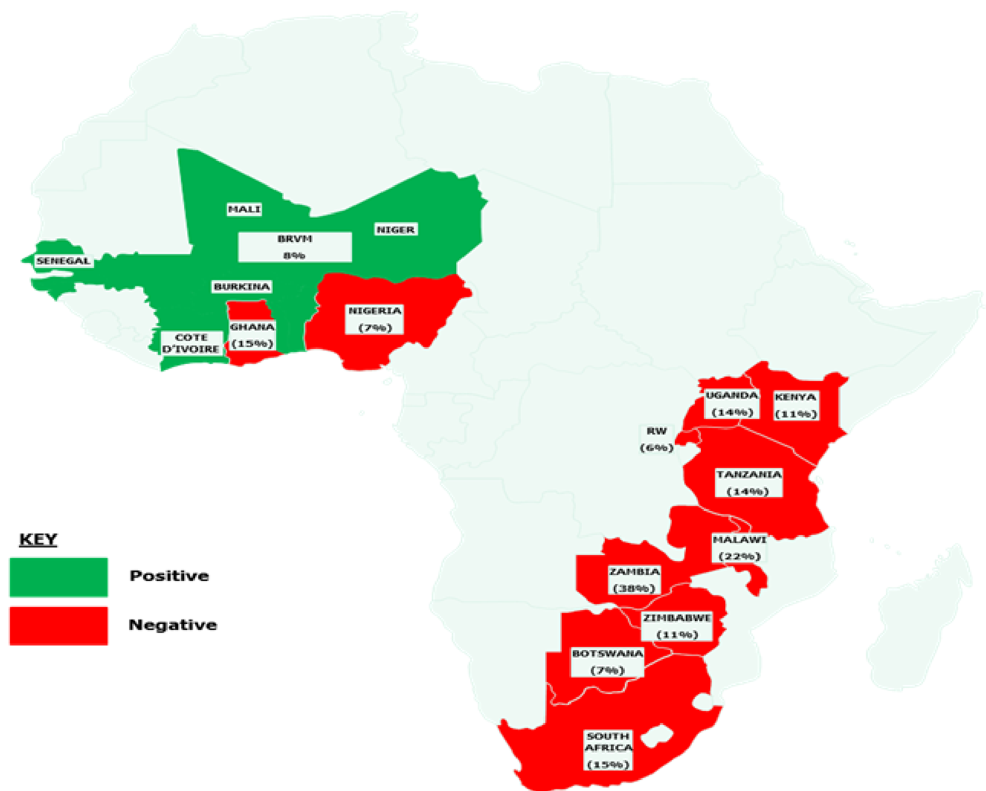



GDP growth has slowed to 7% from 7.3% but a growing consensus believes the real number is lower. In order to support growth, the PBoC has cut policy rates to 4.6%, signaled fiscal easing and devalued their currency to make their exports more competitive in the global markets. We expect the monetary and fiscal easing to help stabilize China?s growth in the next few quarters, however the contagion effect of a slowdown in China cannot be ignored, especially given their historical demand for commodities, with nations such as Brazil and those in West Africa suffering as a result.

# Regional Outlook

During the third quarter, Sub-Saharan Africa recorded a slowdown in both growth and capital ouflows. The IMF has projected that the region is expected to grow at 4.5% in 2015, a drop from 5.0% in 2014, underpinned by slow growth from West Africa as a result of plunging commodity prices and a tightening in the global financing channels, witnessed during the months of July and August, where total outflows were estimated at USD 6.7 and USD 4.5 billion, respectively. However, the region has still registered higher growth rates compared to other regions, such as Latin America and Middle East & Central Asia, which are expected to grow at 1.0% and 2.4%, respectively.

The African exchanges continue to register losses, as can be seen in the chart below. In the third quarter, Nigeria All Share, Nairobi All Share Index and Ghana Composite Index shed off 7%, 11% and 15%, respectively. These drops have been driven by (i) foreign capital outflow from the equities market, (ii) poor operating environment in Sub-Saharan economies, and (iii) anticipation of rate hike by the US Fed, which may result in further capital flight.




*Source: SSA Stock exchanges and Cytonn Research estimates*

On the currency front, major African currencies have continued to lose against the US Dollar. The Kenya Shilling, Nigerian Naira and Malawian Kwacha both lost 5.6%, 0.1% and 25.9% respectively. Ghanaian Cedi has however gained 14% during Q3?2015, driven by expectations of increased foreign inflows in the coming quarter as a result of the government?s planned Eurobond sale in Q4?2015.

# Kenya Macro Economic Review

The GDP figures for Q2?2015 were released, revealing that the economy grew by 5.5%, a slowdown compared to the 6.0% growth in Q2?2014. 10 out of the 17 sectors recorded a deceleration in growth on a y/y basis, with major emphasis being on mining/quarrying, which recorded a slowdown of 19.4%; the slowdown is mainly attributed to the revoking of 65 mining licenses by the Ministry of Mining coupled with the declining commodity prices in the global markets. The 7 sectors that had acceleration in growth include:

i. Hotel and Restaurants which improved by 18.5%,
ii. Electricity and Water Supply by 5.6%,
iii. Transport and Storage by 3.6%,
iv. Professional Administration and Support Services by 3.3%,
v. Agriculture and Forestry by 0.6%, and
vi. Health and Wholesale and Retail trade by 0.3%.

Of keynote was the performance of Hotels and Restaurants, which recorded an improvement of 18.5% y/y. The performance of Hotels and Restaurants was supported by the recovery of the tourism sector, which had suffered as a result of insecurity in the country that led to travel advisories by Western countries. In response to the poor performance, hotels changed their focus to local tourism, which in turn helped boost the sector. Moving forward, we expect the sector to pick up following (i) the Government?s allocation of Kshs. 5.2 bn to aid its recovery, (ii) the recent visit by President Obama and the hosting of the GES summit which helped in improving the profile of Kenya by recognizing it as Africa?s innovation hub, and (iii) the lifting of travel advisories by Western nations.

Q2?2015?s operating environment was more challenging compared to Q1?2015 as indicated by the

weak earnings by companies, especially with banks recording their slowest growth in 6 years, growing at 8.3% compared to 15.6% in the same period last year. The shilling also depreciated rapidly in the same period, shedding 6.8% compared to 1.4% in Q2?2014, thus increasing the cost of imports. Furthermore, the volatile interest rates environment has piled more pressure on the economic state of the country. Despite this, GDP growth for Q2?2015 was higher than our expectations of between 4.7% and 4.9%. We however expect the full year GDP to grow by 4.7% to 4.9% as we anticipate the operating environment to remain challenging throughout the remainder of the year.

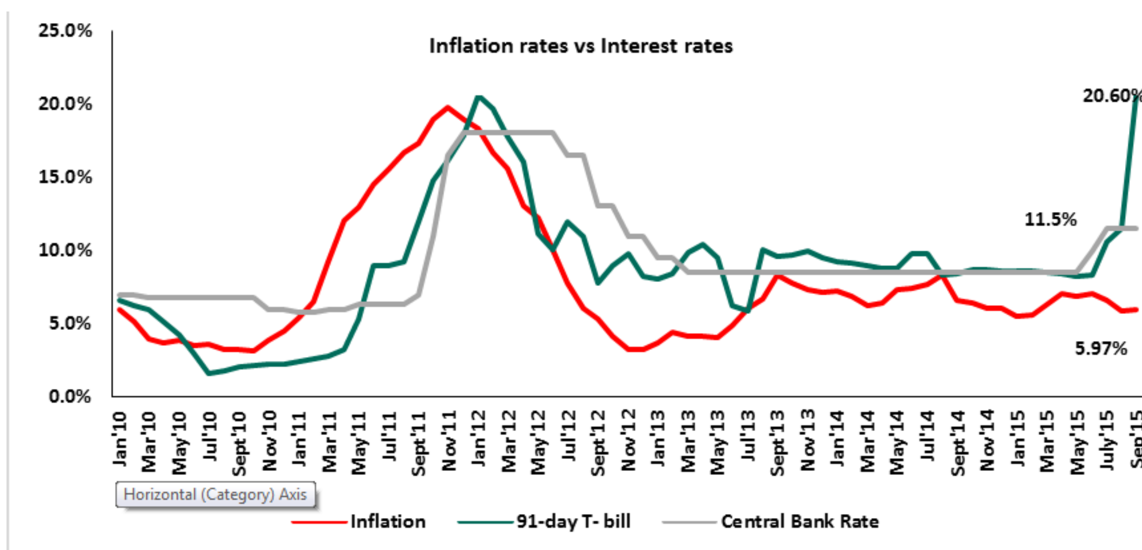
Inflation rate declined over the quarter from 7.03% in June to 5.97% in September, owing to a drop in food and fuel prices. However, the food price increases in September, combined with the expected El-Nino rains, which are expected to start this month, we expect further increments in food prices moving forward. However, the effects of the rising food prices will partly be offset by the early October harvest and a decline in fuel prices, and as a result, we expect inflation rates to remain elevated but below CBK?s upper limit of 7.5% level and end the year at 6.8%

The shilling continued to lose ground against the US Dollar touching a low of Kshs 106.2 during the quarter before strengthening as a result of dollar inflows from offshore investors interested in buying government securities to close the quarter at Kshs 105.3. The shilling depreciated by 6.7% in Q3?2015, taking its YTD loss to 16.1%. The local currency is expected to remain under pressure due to (i) a widening current account deficit currently at 10.2% of GDP, which has also contributed to a worsening Balance of Payments (BOP) position, currently at a deficit of Kshs 47.9 billion, from a surplus of 166.8 bn in Q1?2014, (ii) the growing fiscal deficit at 8.7% of GDP for the 2015/2016 fiscal year, (iii) reduced foreign exchange inflows from tourism and tea, and (iv) continued market anticipation of a rate hike by the Fed in December, which is causing the dollar to strengthen.

Increased domestic borrowing by the government has led to a challenging interest rate environment, which has led to investors shying away from longer-dated securities, and the government unwilling to issue longer-dated paper in the market. Government debt has been on the rise with the total Debt/GDP standing at 51.5% as of August 2015, compared to a target of 45.0%. Due to the high demand for money by the government to finance the budget, we expect interest rates to remain high.

# Fixed Income

During the quarter, the MPC increased the Central Bank Rate (CBR) by 150 bps to 11.5%, from 10.0% in Q2?2015. This was in a bid to strengthen the shilling in the wake of rapid depreciation against the USD. In their last meeting in September, the MPC maintained the CBR at 11.5%, citing that monetary policy measures undertaken in previous meetings were yet to be transferred into the economy. As a result of this, the Kenya Bankers Reference Rate (KBRR) increased by 133 bps to 9.87%, from 8.54% as at Q2?2015. Given the KBRR is a blend between the 91-day T-bill and CBR, going forward, we expect an upward pressure on the KBRR given the current environment where the 91-day T-bill is currently at 20.6% and CBR at 11.5%. The huge divergence between CBR and T-bill brings to questions the importance of the CBR as an effective monetary policy-signaling tool.




During Q3?2015, the Money Markets was characterized by tight liquidity as a result of (i) mop-up activities by the Central Bank in a bid to support the shilling, which saw the interbank rate touch a high of 28.0% in September, (ii) payment of tax obligations by corporates and commercial banks, and (iii) the new Cash Reserve Ratio (CRR) cycle by the Central Bank, which forces banks to shore-up their cash reserves at the end of every month.

The quarter saw the highest rate spike witnessed since 2011, with yields on treasury bills drastically increasing across all tenors, closing the quarter at 20.6%, 20.3% and 20.9% for the 91-day, 182-day and 364-day papers, respectively as compared to 8.3% 10.5% and 11.1% at the close of Q2?2015. This was as a result of:

i. The government increasing the domestic borrowing target for this fiscal year to Kshs 219 bn, from Kshs 190 bn in fiscal year 2014/15, which puts the government under pressure to raise money to finance its operations;
ii. The renewed effort by the government to step up their borrowing programme towards the end of the quarter. The government?s borrowing programme for the current fiscal year, at Kshs. 219 bn, is behind schedule. Instead of net borrowing, the government has so far made a net repayment of Kshs 14.4 bn. In response, the government has stepped up its borrowing efforts, especially in the month of September with the issue of a Kshs 30 bn one year bond for budgetary support and an increase in the amount offered for the Treasury-bills.
iii. The foreign exchange import cover declined during the quarter to 3.93 months of import cover, from 4.3 months at the end of Q2?2015. The good news is that the country is yet to draw in to the facility made available to them by the IMF, which currently stands at USD 610.7 mn, after an increment of USD 76.4 mn in the month of September.
iv. The current shift in the yield curve will result into losses in the bond portfolios. Institutional investors like pension funds that usually have higher allocation to fixed income, skewed towards government bonds, have witnessed large losses in this asset class with the bond market having made capital losses of 5.3% in Q3?2015 and a loss of 9.2% YTD.

**We expect yields on government securities to remain high due to a number of factors: (i) increased government borrowing in the domestic market to fund the 2015 / 2016 budget, and (ii) tight liquidity in the money market. We continue to hold our recommendation that investors stay biased towards short duration fixed income instruments and take advantage of any rate increases.**

# Kenya Equities Market Review

During the quarter, the Kenyan Equities market performed poorly with NASI and NSE 20 shedding 10.6% and 14.9%, respectively, as a result of declines in large cap stocks. In the banking sector,

Equity Bank and KCB fell by 5.3% and 14.5%, respectively. In the Insurance Sector, Jubilee Holdings and CIC Insurance fell by 10.3% and 11.3%, respectively. BAT and Bamburi were the only large cap stocks to record gains in Q3?2015, advancing 10.3% and 9.1%, respectively. In Q3?2015 foreigners were net buyers at the Nairobi Securities Exchange with net inflows amounting to USD 57.1 mn. The top movers for the quarter were Equity Bank and Safaricom with a turnover of USD 138.1 mn and USD 116.5 mn, respectively.

The weakening can be attributed to:

i. The high interest rate environment which has made it unfavourable for companies to operate, especially those that rely on debt to fund their operations;
ii. A weakening Kenya Shilling has affected companies that rely on imported inputs, and;
iii. Weak investor sentiment on the back of potential rate hikes in the US.

During the quarter, banks released half-year results, recording a slow-down in growth. Overall, the banking sector grew at 8.3% compared to 15.6% in 2014, with the slowdown being attributed to poor economic performance on the back of uncertainty in the interest rate environment. For more information on banking sector performance, please see our detailed analysis of the banking sector H1?2015 performance in our banking report. Banking Report.

Listed insurance companies also released their half-year results, registering mixed performance. While Kenya Re, Jubilee and CIC Insurance registered a y/y growth in earnings of 20.3%, 24.5% and 51.3%, respectively, the results were countered by declines of 8.9%, 32.5% and 77.7% by Liberty, Pan Africa and Britam, respectively. The declines were mainly as a result of the fair value losses on investments given the decline in the stock market and the increase in interest rates. We shall soon be releasing our detailed insurance report on the sector.

The Special Economic Zones Act, the Company Laws Act and the Insolvency Act were enacted into law during the quarter. Forming a company as a sole member and director has now been made possible under the Companies Act 2015, further boosting the country?s entrepreneurial spirit. This Act is in line with our view as stated in Cytonn Report #29 that improving the ease of doing business in one of the many initiatives the Government should take in order to propel entrepreneurial culture and encourage innovation among young entrepreneurs. In addition, the enacted Companies Act makes it possible for publicly listed companies to buy back their shares from the market, encouraging companies (i) to intervene when they view their shares as undervalued, and (ii) issue shares to employees, as an alignment tool. As per our Cytonn Report #31, we are of the strong view that employee share ownership plans (ESOPs) strengthens management and shareholders? alignment, effectively directing companies towards sustainable & long-term high performance.

**While the market has corrected from the February peak, with NASI and NSE 20 shedding 17.2% and 24.1%, respectively, from the peak, we still remain neutral with a negative bias on equities given the significantly lower earnings growth prospects for this year and our expectation that the market will continue on a downward trend for the remainder of the year. The market is now purely a stock pickers? market, with few pockets of value .**

# Private Equity

PE as an asset class has remained robust in Q3?2015 with increased new deals and several exits being recorded in the region, which demonstrates the overall attractiveness of the Sub-Saharan Africa market.

In the financial services sector, Helios Investment Partners fully exited its investment in Equity Bank selling its remaining 5.5% to the National Social Security Fund (NSSF). This completed the exit of 25% holding that Helios held in Equity Bank. We estimate that Helios made an annualized compounded return of over 30% per annum during the 7 years it was an investor in Equity Bank.

International Finance Corporation and CDC Group plc invested USD 24 mn to acquire a 5% holding in Tanzania?s CRDB Bank, valuing the bank at USD 480 mn and a PBV multiple of 2.3x.

Emerging Capital Partners (ECP), an international private equity firm focused on investing across the African continent, along with its investment partners, also announced the sale of Continental Re Holding Limited to Saham Finances S.A. for an undisclosed amount. Continental Re Holding holds a 53.6% stake in Continental Reinsurance Plc a private reinsurance company in Africa, excluding South Africa. During its holding period, ECP and its investment partners supported the recapitalization of the business, strengthened the senior management team and facilitated its regional expansion to support Continental Re?s growth ambitions. In other financial services transactions, Axis acquired ApexAfrica Capital, a Kenyan stockbroker, for Kshs 470 mn while Premfin Capital acquired two microfinance companies, Gatsby Microfinance in Uganda and Fanikiwa Microfinance in Tanzania.

As highlighted in our Cytonn Weekly Report #36, the interest in the overall financial services sector is hinged on (i) a rapidly growing and entrepreneurial population and demand for credit, (ii) low financial services inclusion in the region, and (iii) increasing ease of exit in the financial services sector.

Education sector has continued to attract PE funds in the third quarter of 2015 driven by a favorable demographic space and a growing aspirational population keen to invest in high quality education. This has seen several deals take place among them, AfricInvest, which held the single largest stake of 30% in Brookhouse School exiting its stake, together with Piyush Mehta and Victoria Bank to Educas, a UK-based PE fund, for Kshs 3.6 bn. Educas? 3.6 billion acquisition of Brookhouse, which has 750 students, effectively valued each student at Kshs 5.0 million. 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 perennial labour wrangles between the teachers and the government, which paralyzes learning across the country, a situation which is not faced in private schools. Additionally, the growing middle class will have a desire to send their children to aspirational private schools.

We reiterate our bullish stance on PE as an asset class driven by:

i. The abundance of global capital looking for opportunities in Africa;
ii. Attractive valuations in private markets compared to public markets, and;
iii. Better economic growth in Sub Saharan Africa as compared to global markets.

**It is evident that Sub-Saharan Africa, particularly East Africa continues to offer the most attractive returns in PE space. Helios Investment Partners realized an annual compounded return of 30% over 7 years, while AfricInvest realized an IRR of 25.6% over the 5-year investment period.**

# Real Estate

The high interest rate and the currency depreciation have been sighted as some of the challenges affecting the real estate sector. The sector players may be faced with the following challenges:

a. With reduced IRR owing to the increased cost of borrowing, potential real estate investors may prefer to allocate more of their funds to less risker assets like the 1 year treasury bond recently issued by the government at yield of 19.1%;
b. More developers will start exploring Joint Venture options so as to minimize on the cost of funding the projects. Others will take a speculative stand in the hope that interest rates will decrease;
c. Uptake of mortgages will decrease, as the high interest rates will be a deterrent to the people contemplating the purchase of a property through mortgage financing. We also expect an increase in the number of non-performing mortgages as servicing the mortgage loans will be an uphill task

for a large number of end-users.

The best ways to address these exchange and interest rate challenges, as we are doing at Cytonn Real Estate, are:

a. Develop the most competitive real estate products that are differentiated in the market. In both up and down markets, the best quality at a fair value has the highest demand
b. Implement an aggressive procurement strategy to acquire same quality of inputs, but at a cheaper price. A procurement strategy will help offset the higher cost of money with a lower cost of materials
c. Secure increased and diverse sources of funding to weather through the volatile rates environment. Illiquidity is a big risk in real estate, hence it critical to have as many lines of funding as possible.
d. With the Kenyan Shilling exchange rate being attractive to dollar holders, we are aggressively showcasing real estate investment opportunities to the diaspora, who will be paying a much lower price given dollar appreciation. Selling real estate to the diaspora is a natural hedge in a depreciating shilling environment

For institutional developers with diversified sources of funding and ability to produce quality products, a difficult operating environment offers a unique opportunity to gain market share, demonstrate differentiated capabilities and improve market positioning and brand.

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