Diaspora Importance to Economic Growth, & Cytonn Weekly Report #40

Cytonn Weekly

Executive Summary

- **Fixed Income:** Interest rates still on an upward trend and the shilling appreciated by 1.3% during the week as there were foreign inflows into the fixed income market owing to the high yields. Rates may stabilize if the government succeeds in the contemplated Kshs. 70 bn borrowing from international lenders;
- **Equities:** NASI and NSE 20 shed 0.9% and 2.2%, respectively, during the week. NSE 25 index launched by the Nairobi Securities Exchange will offer the much-needed support for the upcoming derivatives market;
- **Private Equity:** Private Equity firms continue to attract global capital seeking high returns in the African region;
- **Real Estate:** The construction industry provides investment opportunities not only in the conventional brick and mortar but also in education and training;
- **Focus of the Week:** The Kenyan Diaspora continues to be a major foreign exchange earner for the country through remittances. Cytonn Investments through their Cytonn Diaspora platform serves to offer the Kenyan Diaspora a trusted investment partner through whom they can invest back home.

Company Updates

i. Cytonn Real Estate launched two real estate projects this past week:
   a. The Alma, which is now 25% sold off plan. See sales presentation at The Alma in Ruaka Presentation and for product brochure The Alma Bronchure
   b. Situ Village is a comprehensive lifestyle development in Karen. See product brochure at Situ Village Digital Bronchure and development video on Youtube
ii. Cytonn Diaspora started a U.S. one month roadshow. More information can be found on our website through this Cytonn Diaspora link. To be a part of this road show, please contact us at roadshow@cytonn.com. Cytonn Diaspora, with offices in DC Metro, is our U.S affiliate dedicated to facilitating diaspora investments into real estate in Kenya
iii. Our Investment Manager, Maurice Oduor, was on CNBC Africa to discuss the issues surrounding regional integration in East Africa and Kenyans? participation in the equities market. See link

Fixed Income

Treasury bill auctions were oversubscribed for the second week running, with overall subscription rising significantly to stand at 295%, compared to 120.4% the previous week. Yields rose to 21.4%, 21.6% and 21.5%, from 20.6%, 20.3% and 20.8% for the 91-day, 182-day and 364-day papers, respectively. This oversubscription was as a result of (i) increased foreign interest in Kenya?s high yielding government securities, and (ii) a relatively liquid money market as the banking sector Cash

Reserve Ratio cycle came to an end. The high liquidity in the money market saw the interbank rate decline to close the week at 14.6%, from 19.6% last week.

Despite the high liquidity in the market, the shilling appreciated against the dollar due to increased amounts of foreign inflows into government securities; hence the 1.3% appreciation of the shilling against the dollar, which closed the week at Kshs 103.1, having lost 13.7% YTD.

A report by World Bank indicated that Kenya is set to have one of the highest GDP growth rates in Sub-Saharan Africa, at 6.2% over the next 15 years to 2030. The report highlighted China?s transition from an investment-led to a consumption-based growth model. The growth of consumption in China is expected to lead to overall GDP gains for the Sub-Saharan Africa region, supporting the 4.7% growth (USD 181 bn) by 2030, owing from an increase in export levels to China by 13.2% (USD 30.6 bn). Kenya is expected to enjoy the highest relative gains from the rebalancing, as China?s demand of products will be biased towards services. Kenya?s trade in international services, which posted a surplus of Kshs 24.7 bn in Q2?2015, from a surplus Kshs 23.7 bn in Q1?2015, is set to continue. In addition to trade with China, we believe growth will be driven by (i) the on-going infrastructural projects such as the Standard Gauge Railway and the LAPPSET corridor, (ii) growth in Kenya?s service sector, (iii) Kenya?s position as a regional hub, and (iv) a booming middle-class, which will increase consumption expenditure.

Kenya Revenue Authority (KRA) has moved to widen its tax base in an ambitious plan seeking to raise the number of active Kenyan taxpayers to 4 mn by 2018, from the current 1.6 mn. Under this new plan, the KRA will seek to capture more businesses in the informal small and medium sized enterprises (SMEs) category, which has previously avoided tax payments. KRA will engage SMEs under a door-to-door approach targeting entrepreneurs around the country with a view to improving their tax compliance. In our view, this is a step in the right direction to improve revenue collection given the ballooning budget and the growing wage bill, as evidenced by the Kshs 2 bn increase in the National Assembly and the Senate wage bill to Kshs 11.2 bn, from Kshs 9.2 bn last year. Of key note is that there was a meeting held between KRA and treasury to discuss the lower tax collection for the first quarter of the current financial year. Our view is that the slow economic growth may lead to slower earnings and hence a decline in tax collection.

In order to finance its budget for fiscal year 2015/16 and also control the impacts of high interest rates environment, the government of Kenya is about to conclude the talks for a syndicated loan of up to USD 750m. Though the details on pricing are not out, we expected it to be lower than CFC Stanbic?s 290 basis points above LIBOR, cost of borrowing from the international markets. This will be a step towards meeting the global borrowing target of Kshs 340 bn for the 2015/16 fiscal budget. In our view, this may help stabilize the domestic interest rates environment as it reduces pressure on local borrowing. But on the negative side is that this is additional dollar obligation for the government, which may continue worsening the fundamentals that affect the strength of the local currency.

Family Bank is set to launch its maiden Kshs 10 bn bond aimed at supporting its expansion plans and strengthening its capital base. The bond will have a tenor of 5.5 years, and will be available in multiple currencies. The Kshs 10 bn will be offered in two tranches, with the first tranche of Kshs 4 bn having a green shoe option of Kshs 2 bn, on either a floating or fixed-rate coupon. The fixed-rate coupon is set at 13.75% p.a., while the floating rate coupon is 250 bps above the prevailing 182-day T-bill rate. The floating rate will have a cap at 17.5% and a floor at 12.5%. Given investors recent bidding patterns to similar tenor corporate offering, in particular the recently closed Imperial Bank bond which was offered at 15% and had a total subscription of 101%, we expect investors to be biased towards the fixed-rate bond, and again demanding premium above the 5-year Treasury bond which currently trades at 15.0%. While we believe that Family Bank is on the right path towards funding their expansion strategies with long-dated paper, the offering however appears ill-timed given that the rate offered, 13.75%, is lower than a similar tenor treasury bond at 15%.

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 1.5 bn for the current fiscal year but this gap has reduced significantly from the previous weeks. We expect the Government to continue with its effort to step up both domestic and foreign borrowing. The success of foreign borrowing may lead to a temporary reduction of pressure on local interest rates environment. However, we 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 a downward trend with NSE 20 shedding 2.2% and NASI losing 0.9% on the back of losses in British American Tobacco and East African Breweries which shed 6.5% and 6.1%, respectively. Foreign investor?s participation was high during the week at 82.7% compared to 67.6% the previous week; foreigners we net sellers from KCB stock and Net buyers into Safaricom. Since the February peak, NASI and NSE 20 have been down 20.1%, and 27.0% and down 12.9% and 21.4% on an YTD basis, respectively.

This week, the Nairobi Securities Exchange approved the launch of the NSE 25 Share Index. In coming up with the Index, The NSE selected stocks that (i) had their primary listing in the Nairobi Securities Exchange, (ii) have at least 20.0% of its shares quoted on the Exchange, (iii) have been in the exchange for at least 1 year, (iv) have a minimum market capitalization of Kshs. 1 bn and (v) should ideally be a ?blue chip? stock with a superior profitability and dividend record. Financial services firms, including all listed banks except National Bank, dominated constituents and four listed insurance companies also feature on the index. The index will (i) serve to provide the bourse with the chance to develop structured products in both the equities and upcoming derivatives market, (ii) provide the right platform for the exchange to begin the trading of Exchange Traded Funds (ETF?s), which are indexed funds for investors who wish to spread their exposure, and (iii) provide investors with investable benchmarks, in line with global benchmarking best practises.

CfC Stanbic Bank announced they have signed both a 2 year and a 3-year USD 155.0 mn loan to fund the bank?s core business. The facility is priced at 245 basis points over the London Interbank Offered Rate (LIBOR) for the 2-year tenor and 290 basis points over LIBOR for the 3-year tenor. The initially set amount for the loan was USD 100.0 mn but was increased owing to an overwhelming interest from international banks backing the deal. The participants to the loan are a syndicate of international banks, which include AfrAsia Bank, Al Khaliji France, Commerzbank Aktiengesellschaft, Filiale Luxemburg and Doha Bank. Multinational banks are able to source cheaper funds abroad given their reach from being affiliated with their parent banks, and loan it out locally at high rates which eventually results into high interest margins. This is a positive step for CfC Stanbic as it seeks to grow its loan book and diversify its revenue sources away from non-funded income, which currently stands at 42.7%, compared to the market average of 31.8%. Factoring this capital raise into our valuation, we arrive at a revised Intrinsic Valuation of Kshs 75.3, a 4.4% improvement from Kshs 72.2, which was our last valuation after the release of their Q2?2015 results. The bank still remains a sell, with a potential downside of 16.3% based on Fundamental and Intrinsic Valuation.

Uchumi Supermarket Ltd announced the closure of two branches in Uganda, following the shutdown of two of its other non-performing branches in Maua and Syokimau in Kenya in Q3?2015. The closure is as a result of the branches review and refurbishment process initiated by the new CEO, Julius Kipng?etich, who is championing the restructuring of the retail store following their recent struggles. Uchumi is set to benefit, as the closure of non-performing branches will free up misallocated working capital, which they need to pay suppliers, allowing them to shift other funds to growth. In addition, in our view, Uchumi can undertake a turnaround by doing the following:

i. Have a complete overhaul of its old retail outlets to improve the ambience and layouts to create brand loyalty and improve the customer experience;

ii. Uchumi needs to differentiate its product base to appeal to the different consumer classes. They have no clear idea on whether they serve the affluent or the B & C class of consumers, and hence are losing positioning, and will continue to lose, unless addressed;

iii. Address corporate governance issues. They fired their CEO in public and yet the Board had to have been aware of the issues that they couldn't pay suppliers. However, Uchumi have made very positive strides towards achieving this through the hiring of Julius Kipng?etich to steady the ship.

Factoring the closure of the branches in our analysis, we recommend an ?accumulate? on the Uchumi stock with a target price of Kshs 11.25, representing a potential upside of 12.5% from the current price of Kshs 10.0. An ?accumulate? recommendation indicates that buying should be restrained and timed to happen when there are momentary dips in stock prices.

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.

all prices in Kshs unless stated

EQUITY RECOMMENDATIONS - WEEK ENDED 9/10/2015

No.	Company	Price as at 2/10/15	Price as at 9/10/15	w/w Change	Target Price*	Dividend Yield	Upside/ (Downside)**	Recommendation
1.	KCB	45.00	44.00	(2.2%)	58.2	6.0%	38.3%	Buy
2.	Standard Chartered	227.00	221.00	(2.6%)	273.0	7.5%	31.0%	Buy
3.	NIC	41.75	40.50	(3.0%)	49.8	2.8%	25.8%	Buy
4.	Equity	44.75	45.00	0.6%	52.3	4.9%	21.0%	Buy
5.	Barclays	12.90	12.65	(1.9%)	14.0	8.0%	18.5%	Accumulate
6.	Uchumi	9.60	10.00	4.2%	11.3	0.0%	12.5%	Accumulate
7.	DTBK	200.00	200.00	0.0%	216.6	1.3%	9.6%	Hold
8.	I&M	104.00	101.00	(2.9%)	100.9	2.6%	2.5%	Sell
9.	Housing Finance	21.75	22.25	2.3%	21.2	5.5%	0.7%	Sell
10.	Co-operative	18.05	17.40	(3.6%)	16.7	3.5%	(0.7%)	Sell
11.	CfC Stanbic	90.50	90.00	(0.6%)	75.3	0.0%	(16.3%)	Sell
12.	National Bank	16.75	16.50	(1.5%)	6.5	0.0%	(60.4%)	Sell

*Target Price as per Cytonn Analyst estimates
**Upside / (Downside) is adjusted for Dividend Yield
Accumulate ? Buying should be restrained and timed to happen when there are momentary dips in stock prices.
Data: Cytonn Investments

Private Equity

Sub-Saharan Africa has continued to attract global capital, driven by (i) the potential for high returns generated in the region, (ii) the stable macro-economic environment and political reforms which have improved the transparency in companies in the region and improved the ease of doing business, and (iii) increased exits in the market which have alleviated fears of global institutional investors. According to a report published by Burbidge Capital, PE firms have invested nearly USD 1bn into the

Kenyan market in the first eight months of 2015, with a large portion of the inflows having been channelled towards the financial services sector.

In line with this increased interest in Kenya and the region, Ascent Capital Africa Ltd announced a close on its debut fund, The Ascent Rift Valley Fund, raising USD 80 mn from a consortium of investors, including local pensions, CDC Group, FMO, Norfund and OeEB from Austria. The Ascent Rift Valley Fund is aimed at providing small and medium-sized enterprises with equity capital, with a focus on healthcare, Fast Moving Consumer Goods (FMCG), processing of agricultural products, and financial services. SMEs account for 90% of businesses in East Africa, employing about half of the working population, and given the entrepreneurial spirit of those running businesses in East Africa, the SMEs have a huge appetite for growth capital to capture the market opportunity.

Ascent Capital?s close of their fund is alongside recent raises by Cytonn Investments which has raised and deployed Kshs 2.0 bn in several real estate projects in the Kenyan market, Abraaj Group which announced the close of the third Sub-Saharan Africa Fund at US$ 990 million, and TPG, Carlyle and KKR entering the African market as well. To see the presence of large commercial PE players begin to look keenly into Africa is a clear indicator of the continent?s investment attractiveness and we expect the asset class to see increased competition. As we indicated in our Cytonn Weekly #24, in real estate, we would be surprised if Blackstone did not enter the sub-Saharan market soon.

We expect an increased inflow of global capital into the East African region market channelled towards PE deals.

Real Estate

The construction industry in Kenya has seen an increased number of international entrants, with the most recent firm being America-based X-Calibur Construction Systems Inc. The firm, which has been supplying big industrial projects in the country with its products for several years, plans to make Nairobi its African and Middle East headquarters, shifting their headquarters from United Arab Emirates where operations are currently run. Some of the local projects that have used X-Calibur products include Muthaiga Heights, Bidco, Tuskys in Naivasha, Karen Hub, Tullow Oil, Lab and Allied and Imperial Health Services. The company also supplied aluminium joints for the construction of the new terminal at the Jomo Kenyatta International Airport in Kenya.

The firm not only provides quality products but also has programs that seek to equip the Kenyan market with professional skills in the construction industry. X-Calibur sponsors a certification course being conducted by the University of Johannesburg.

This week, Avic International obtained approval to construct what will be the most expensive luxury apartments in Kilimani. The development, dubbed ?Avic Park?, shall comprise of four-bedroom luxury apartments that will each cost Kshs. 88 mn. Within the same development, Avic will also construct two and three-bedroom units, each going for Kshs. 27 mn and Kshs. 38 mn respectively. The total cost of the housing project is Kshs. 4 bn.

It is clear that Kenya, more so Nairobi and its metropolis, exhibits a lucrative opportunity for international players in the construction industry to tap into.

Focus of the Week: Diaspora Importance to Economic Growth

A diaspora is a group of people, similar in heritage and origin that have migrated out from their homeland, but still maintain a significant interest and connection back home. According to the United Nations, over the last 45 years, the number of persons living outside their country of birth has more than tripled from an estimated 75 million in 1960 to over 231 million in 2013, representing 3% of the world?s population. Out of this, 18.6 million are from Africa.

In this investment opportunity focus, we wish to highlight the importance of the diaspora, their location, needs from an investment perspective, challenges when it comes to investment in Kenya, how private sector players such as Cytonn can position to be their trusted partner, and the ultimate benefits to the Kenyan economy. However, it is first important to showcase a country that has done well based on the effect of their diaspora, and we wish to showcase India.

Diaspora remittances are an integral part of the economy and if utilized well can contribute largely to the socioeconomic development of its people. Taking India for example, as at 2013, it received USD 70 bn from remittances emerging as the top beneficiary in the world followed by China. According to the Ministry of Overseas Indian affairs, the total remittances back to India from the Indian diaspora accounts for 22% to 23% of the country?s total foreign exchange earnings. From an economic standpoint, remittances contribute about 4% of the total GDP of India, helping to support the overall Balance of Payments. Since 1991, remittances amounted to USD 2.1 bn and have since grown by compounded annual growth rate (CAGR) of 17.3% to USD 70.0 bn as at December 2013. This growth is highly attributed to (i) the boom of the IT industry that saw immigration of skilled IT professionals from India to the US, who accounted for USD 65 bn of the total USD 70 bn, (ii) the Government?s initiative to de-regulate the interest rates on the remittance accounts making the cost of sending money to India cheaper than other countries, (iii) the focus on enabling Diaspora engagement, such as the creation of the Ministry of Overseas Indian, which is dedicated to Diaspora matters, (iv) the existence of a Diaspora Policy, and (v) the strength of the dollar with respect to the Indian rupee that led to more Indians remitting back money

The relationship between India and its diaspora has been strengthened over the past years owing to the contribution of the diaspora to the economy in the following ways:

i. The improvement of the socioeconomic status of the Indian population owing to the contribution of the remittances to economic growth by reducing the poverty levels;
ii. Transfer of knowledge and entrepreneurial skills which has built India, and especially the cities of Bangalore and Delhi as global IT hubs and services centres;
iii. Contribution to the rise of the service sector in India especially in the IT sector, which has provided an avenue for employment, growing wages with the skilled labour set and improving the standard of living in India.

Having seen the benefits that an economy like India has gained from the diaspora, we now analyse the diaspora in Kenya. The number of Kenyans living in the diaspora has steadily been on the rise and currently stands at over 3 million, with United Kingdom and United States of America having the highest concentration of the Kenyan Diaspora, each with approximately 152,000 and 102,000 Kenyans, respectively.

Taking US as a case study for where the Kenyan Diaspora live and their characteristics, we note that the majority of the Kenyan population is located in Texas and California, with Dallas having the majority at 7.8%. The Kenyan born population in the US is fast growing and is now the 2nd highest contributor to diaspora remittances into the country after the United Kingdom. Kenyans have been legally admitted into the US either through (i) family sponsorship (3%), (ii) employment sponsorship (7%), (iii) as a refugee and asylee (26%), (iv) the diversity VISA programme (28%), or (v) being an immediate family member to a US citizen (35%).

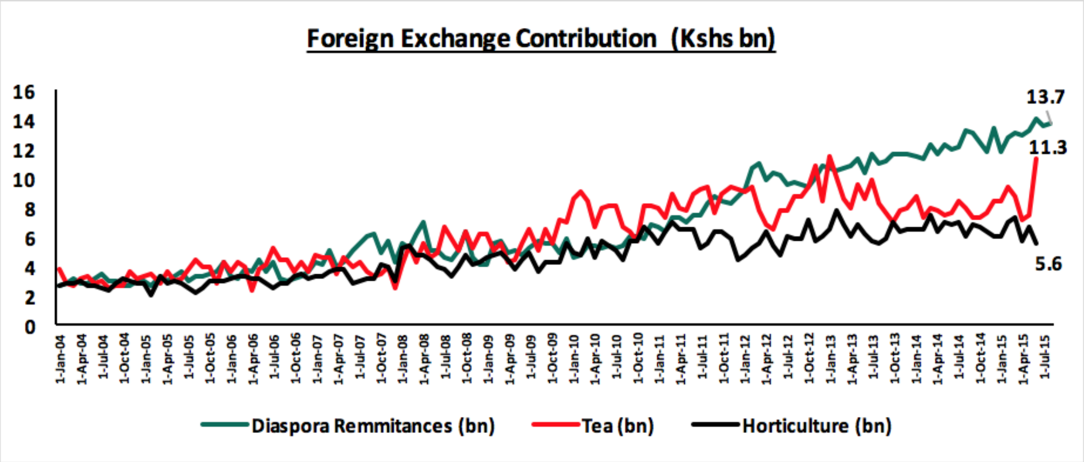
The characteristics of the Kenyan diaspora population in the US are very unique:

i. **Highly Educated:** 30% of the Kenyan population in the US aged 25 years and older possess a bachelor?s degree as opposed to the US national average of 20%; 16% of whom possess an advanced degree as their highest credentials against an 11% US national average;

ii. **Economically Successful:** In 2014, Kenyan diaspora households in the US recorded a high median annual income of USD 61,000, USD 11,000 higher than U.S households. 31% of Kenyans reported incomes of above USD 90,000, the threshold for the top 25% of the US population while 13% reported incomes of above USD 140,000, the threshold for the top 10% of the US population. With the average members per household coming in at 2.6 members, which is marginally equal to the US national average of 2.5 members, the amount of disposable income among the Kenyan Diaspora is high, of which they can channel into investments;

iii. **Hardworking:** With this high level of education, it is easier for Kenyans to join the workforce as evidenced by the fact that 80% of Kenyans in the US are in the workforce as opposed to a 64% US national average.

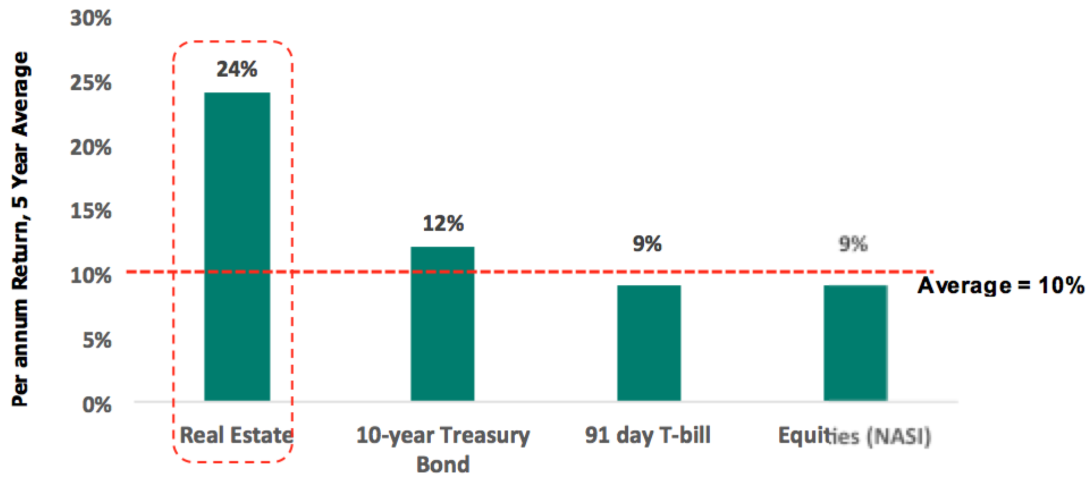
In the past 5 years, total diaspora remittances into Kenya have increased by 156% overtaking tea and horticulture as the top foreign exchange earner. It is a more stable source of inflows as it is not susceptible to changes in weather and world prices, which have seen tea and horticulture lose their top status.



Despite this rosy outlook, the Kenyan diaspora lacks a trusted partner to whom they can invest with. According to the Rockefeller Foundation-Aspen Institute Diaspora Program, the Kenyan diaspora are less likely to report annual income from investment sources, which include dividends, rent and interest income. In 2014, about 12% of Kenyans received income from dividends against the 15% US average. In addition, the share of Kenyans earnings from rent was negligible and the median interest income stood at USD 100 compared to USD 157 from US households. This highly affirms the fact that the Kenyan Diaspora is faced with investment challenges, which include:

1. **Special Products:** lack of structured investment products that are tailor-made to address their needs, and these exist mainly in real estate and fixed income investment opportunities;
2. **Partners:** lack of a trusted partner who truly represents their interests, and is an institutional firm providing institutional grade investment solutions and client service;
3. **Platforms:** the inability to safely and conveniently remit funds back to their country.

Cytonn Investments through Cytonn Diaspora, a platform that serves to bridge this gap and offer the Kenyan Diaspora a trusted investment partner, is addressing these challenges. Over the past 5 years, returns in the alternatives market classes, Private Equity and Real Estate, have outperformed other traditional investment classes, thus the reason why Cytonn focuses on these investments solutions. The chart below is an indicator of the same:



However, despite the attractive returns offered by alternative investments solutions as shown above, there are very few products of this nature being offered to the diaspora, other than the real estate brick and mortar. Cytonn Diaspora fills this gap by providing a unique platform that has:

1. **Investment Opportunities:** The platform links Kenyans in the diaspora to trusted investment opportunities in Kenya, in real estate and fixed income products. Cytonn identifies an investment opportunity, does due diligence and confirms its suitability for diaspora investment;
2. **Development Partners:** Cytonn partners with developers, namely Cytonn Real Estate, to provide institutional grade real estate products that the diaspora can invest in. For Cytonn Real Estate developments such as The Alma in Ruaka, Cytonn Real Estate will provide full facilities management for the units to remove the operational burden of real estate for the diaspora investor;
3. **Lending:** Preferred banking partners will provide lending for those investors who wish to access end-user financing to access real estate investment opportunities.
4. **Research and Investor education:** Cytonn believes that all investors should have adequate information as they make investment decision and hence the reason why, we publish the key trends in the market to aid in investments.

As we provide these benefits to the diaspora investors, we are able to have a positive impact, which will also build the Kenyan economy, similar to the example shown for India. The benefits of the Kenyan Government focusing on the diaspora are significant:

i. **Foreign Exchange Earner:** On an YTD basis, the Kenyan Shilling has depreciated 13.7% and a major factor leading to this is the decline of foreign exchange inflows from the traditional forex earners such as tea, tourism and horticulture. Diaspora remittances has recently emerged as the top exchange earner for the country and due to the potential it possesses, the right platform to which Kenyans in the diaspora can remit back funds will go a long way into addressing such challenges facing the economy;
ii. **Trade:** The connection between the diaspora and the country of origin facilitates trade, as a natural connection is created between consumers and producers, in that people in the diaspora procure goods and introduce them to the global markets;
iii. **Investment:** Kenyans in the diaspora who invest directly have the opportunity to introduce other investors into investing in Kenya, which mobilizes wealth for development;
iv. **Real Estate:** Kenyans in the diaspora are looking for opportunities to settle back in their homeland, or to provide for family members back home. Given the importance of real estate to the GDP, by providing a trusted platform and partner through whom they can access the opportunity, the country will benefit and the sector will grow even further to promote growth and create employment;

v. **Skills Transfer:** Diaspora gain valuable skills, experiences and contacts abroad that they can transfer back to Kenya, which will create new ideas and encourage entrepreneurship and grow the economy away from a dependence on agriculture, to one based on skills and services;
vi. **Improving Standards of Living:** Through increased investment opportunities, skills transfer and real estate access, an avenue is provided to create employment, grow wages, enhance the skills of the population, encourage new ideas and innovations, and improve efficiency in our operations. Through this avenue, Kenya will benefit by improved standards of living in the country and ultimately see a significant positive contribution to GDP growth.

Given the significant benefits we stand to gain from the diaspora, it is critical that the private sector and the government work closely to create an enabling environment for the diaspora.

For Cytonn, we believe that our Diaspora platform will be an important contribution to improving diaspora engagement. Further to this, we have a team with vast knowledge and experience in the Financial and Real Estate sectors currently in the United States on the Cytonn Diaspora Roadshow. More information can be found on our website through this link

To be a part of this roadshow, please contact us at roadshow@cytonn.com, and for investment opportunities in real estate and fixed income, please e-mail us at sales@cytonn.com

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