Kenya Listed Banks H1'2018 Report, & Cytonn Weekly #36/2018

Fixed Income

T-Bills & T-Bonds Primary Auction:

T-bills were oversubscribed during the week, with the overall subscription rate coming in at 123.9%, a decline from 181.1% recorded the previous week. The yields on the 91-day and 364-day papers remained unchanged at 7.6% and 9.7%, respectively, while the yield on the 182-day paper declined by 10 bps to 8.7% from 8.8%, the previous week. The acceptance rate for T-bills improved to 95.8% from 59.8% the previous week, with the government accepting Kshs 28.5 bn of the Kshs 29.7 bn worth of bids received. The subscription rate for the 91-day, 182-day and 364-day papers declined to 143.5%, 111.6% and 128.3% from 182.9%, 170.9% and 190.7%, recorded the previous week, respectively.

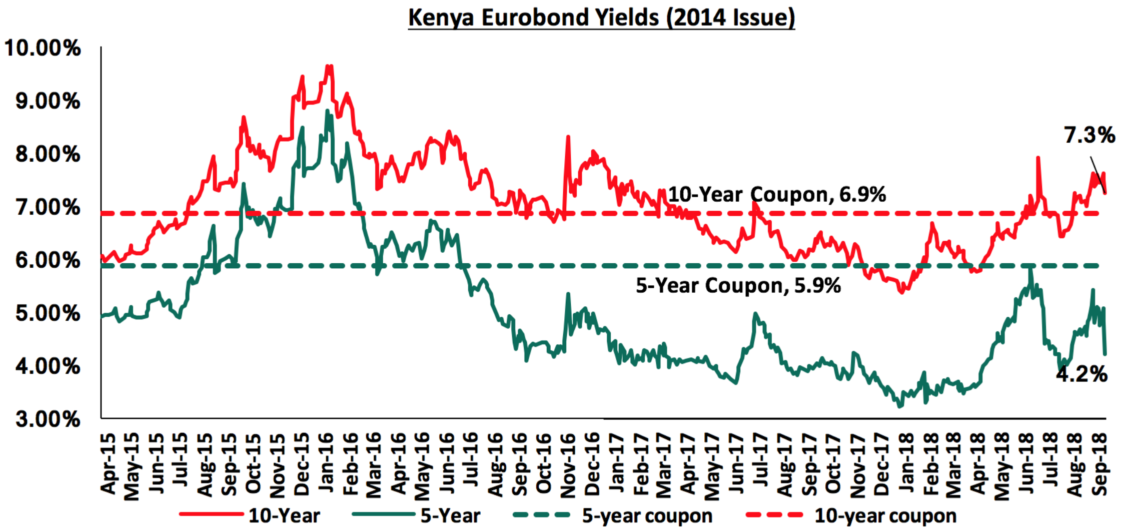
For the month of September, the Kenyan Government re-opened 2 bonds, FXD 1/2018/10 and FXD 2/2018/20, with 10-years and 19.9-years to maturity, and coupon rates of 12.7% and 13.2%, respectively in a bid to raise Kshs 40.0 bn for budgetary support. The issue was under-subscribed at an overall subscription rate of 81.2%, while the weighted average rate of accepted bids came in at 12.7% and 12.9%, for the 10-year and 20-year bonds, respectively in line with our expectations of 12.5%-12.7% for the FXD 1/2018/10, and 12.8%-13.1% for the FXD 2/2018/20. The government accepted Kshs 26.6 bn out of the Kshs 32.5 bn worth of bids received, translating to an acceptance rate of 81.8%. The 10-year bond had a subscription rate of 55.3% while the 20-year bond recorded poor performance with the subscription rate coming in at 25.8% which we attribute to the relatively flat yield curve on the long-end as compared to the relatively steep short-end of the yield curve, making it unattractive to hold longer-term bonds.

Liquidity:

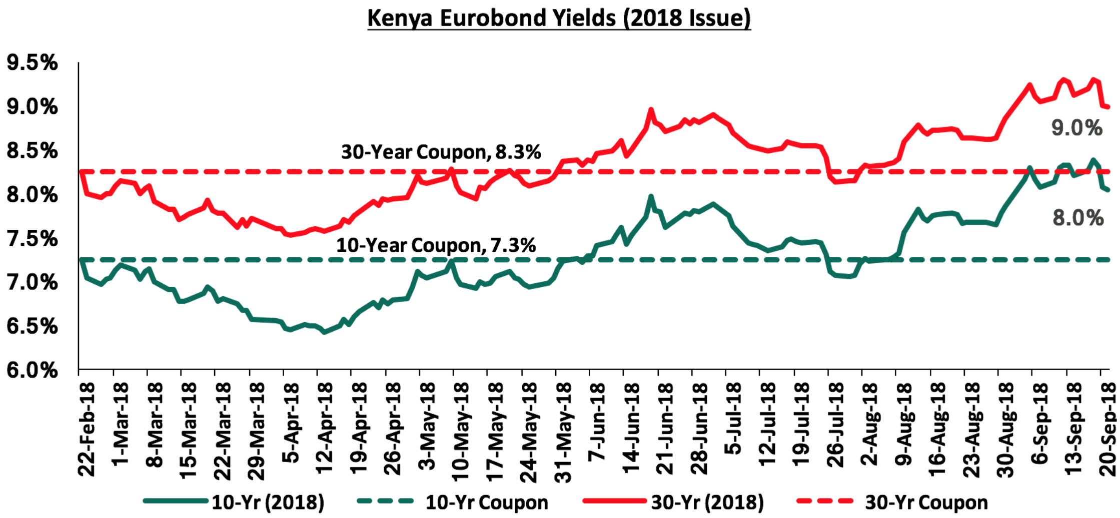
The average interbank rate declined to 3.6%, from 4.2% the previous week, while the average volumes traded in the interbank market declined by 22.2% to Kshs 14.3 bn, from Kshs 18.4 bn the previous week with the decline in activity being attributed to the reduced demand for liquidity by banks following the beginning of the new Cash Reserve ratio (CRR) cycle. The decline in the average interbank rate points to improved liquidity, attributed to large banks trading at lower interest rates.

Kenya Eurobonds:

According to Bloomberg, the yield on the 10-Year and 5-year Eurobonds issued in 2014 declined by 0.1% points and 0.6% points to 7.3% and 4.2% from 7.4% and 4.8%, the previous week, respectively. Since the mid-January 2016 peak, yields on the Kenya Eurobonds have declined by 4.6% points and 2.3% points for the 5-year and 10-year Eurobonds, respectively, an indication of the relatively stable macroeconomic conditions in the country. Key to note is that these bonds have 0.8-years and 5.8-years to maturity for the 5-year and 10-year, respectively.



For the February 2018 Eurobond issue, during the week, the yields on both the 10-year and 30-year Eurobonds declined by 0.2% and 0.1% points to 8.0% and 9.0% from 8.2% and 9.1%, the previous week, respectively. Since the issue date, the yields on the 10-year and 30-year Eurobonds have both increased by 0.7% points.



The Kenya Shilling:

During the week, the Kenya Shilling appreciated by 0.4% against the US Dollar to close at Kshs 100.8 from Kshs 101.2, the previous week, mainly driven by reduced dollar demand from importers as well as recovery from the uncertainties regarding the IMF stand-by arrangement that were there the previous week. The Kenya Shilling has appreciated by 1.9% year to date and in our view the shilling should remain relatively stable against the dollar in the short term, supported by:

i. The narrowing of the current account deficit to 5.8% in the 12-months to June 2018, from 6.3% in March 2018, attributed to improved agriculture exports, and lower capital goods imports following the completion of Phase I of the Standard Gauge Railway (SGR) project,
ii. Stronger inflows from principal exports, which include coffee, tea, and horticulture, which increased by 10.8% during the month of May to Kshs 24.3 bn from Kshs 21.9 bn in April, with the exports from coffee, tea and horticulture improving by 11.0%, 19.1% and 2.0% m/m, respectively,
iii. Improving diaspora remittances, which increased by 71.9% y/y to USD 266.2 mn in June 2018 from USD 154.9 mn in June 2017 and by 4.9% m/m, from USD 253.7 mn in May 2018, with the largest contributor being North America at USD 130.1 mn attributed to; (a) recovery of the global economy, (b) increased uptake of financial products by the diaspora due to financial services firms, particularly banks, targeting the diaspora, and (c) new partnerships between international

money remittance providers and local commercial banks making the process more convenient, and,

iv. High forex reserves, currently at USD 8.5 bn, equivalent to 5.6 months of import cover, compared to one-year average of 5.4 months.

Monetary Policy Committee Meeting:

The Monetary Policy Committee (MPC) is set to meet on Tuesday 25th September 2018 to review the prevailing macroeconomic conditions and give direction on the Central Bank Rate (CBR). Key factors that will shape MPC's decision include:

i. Inflation that has averaged 4.2% in the first 8-months of 2018 compared to 9.3% experienced in a similar period in 2017, and is expected to remain within the government target of 2.5% - 7.5%, despite the expectations of upwards inflationary pressure in H2'2018 due to the imposition of the 8.0% VAT charge on fuel as well as other tax measures as introduced in the Finance Bill,
ii. The currency that has lost by 0.4% since the last meeting on July 30th 2018 to Kshs 100.8 from Kshs 100.5, and,
iii. The macroeconomic environment that has remained relatively stable despite the low private sector credit growth, which came in at 4.3% in July 2018. This was the fastest growth rate since December 2016, pointing to a recovery albeit slow and still way below the 5-year average of 13.0%

We are of the view that the MPC will adopt a wait and see approach, holding the Central Bank Rate(CBR) at 9.0% as they monitor the effects of the July rate cut by 50 bps to 9.0%. For a comprehensive analysis, read our Cytonn Note on the MPC Meeting for September 2018.

Inflation Projection:

We are projecting the inflation rate for the month of September to range between 5.3% - 5.7%. We expect the month on month inflation to rise mainly due to:

i. An increase in petrol prices that increased by 10.4% to Kshs 125.6 from Kshs 113.7 per litre, while diesel and kerosene prices increased by 12.4% and 15.0% to Kshs 115.5 and 97.7 per litre from Kshs 102.7 and Kshs 85.0, respectively, from the end of August – 20th September 2018, following the earlier imposition of the 16.0% VAT on fuel for the better part of the month before the assent of the Finance Bill 2018 that halved the charge to 8.0%. The price increase will directly affect transport costs and indirectly affect food prices in September,
ii. On the housing, water, electricity, gas and other fuels index, Kerosene prices went up during the month by 15.0%. This is however expected to be mitigated by a decline in electricity costs as per comments by the Energy Regulatory Commission (ERC) citing that homes and business were due for a refund of Kshs 1.3 per kilowatt hour (kWh) after it used a higher dollar rate to compute the foreign exchange levy last month which had brought a rise in tariffs of up to 52.8% in August, and
iii. An increase in some food prices such as beans and kales outweighing a decline in others as well as the pass through effect from transport costs.

We expect inflation in H2'2018 to experience upward pressure but at a lower rate following the reduction in the rate of VAT charge to 8.0% from 16.0%, affirming the expectations of inflation for the year averaging within the government's set target of 2.5%-7.5%.

Following the signing of the Finance Bill 2018, the ERC has released an addendum revising the prices released on 14th September 2018, adjusting for the halving of the VAT charged on fuel from the earlier 16.0% to 8.0%. The adjustments have also taken into account the anti-adulteration levy of Kshs 18.0 per liter of kerosene. As a result, the prices of petrol and diesel declined by 7.0% and 6.4% to 116.8 and Kshs 108.1 from 125.6 and 115.5, respectively, while the prices of kerosene have increased by 11.0% to Kshs 108.4 from Kshs 97.7. The new prices take effect from 21st September to

14th October. The reduction in the prices as a result of halving of the VAT charge is expected slightly to mitigate the earlier concerns of inflationary pressures in H2'2018. The housing, electricity, gas and other fuels index is however expected to be adversely affected by the anti-adulteration levy which will effectively increase kerosene prices which is used by a large percentage of the population.

Highlights of the Week:

During the week, the National Assembly convened for special parliamentary sittings held on 18th September and 20th September to discuss the budget supplementary estimates and the President's reservations against the Finance Bill through his memorandum. All the proposals as per the president's memorandum tabled in parliament were passed despite a chaotic sitting, after which the president assented to the Finance Bill 2018 on 21st September 2018.

The major adjustments made on the Finance Bill 2018 as a result of passing of the proposals from the memorandum include;

i. Deletion of Clause 18(b) of the Finance Bill which sought to postpone the imposition of VAT on fuel by another 2 years to commence in September 2020: The President had argued that the postponement of the VAT charge on fuel would affect the estimated revenue targets for FY'2018/2019 creating a budget deficit that would require use of other measures to bridge. He further proposed an amendment of the VAT Act 2013, to reduce the VAT charge on fuel to 8.0% from the earlier 16.0% which was passed by the National Assembly, to take effect upon enactment of the supplementary Appropriation Act and is projected to raise close to Kshs 35.0 bn in revenue,
ii. Imposition of excise duty: There will be an increase on the excise duty charged on excisable value on telephone and internet data service to 15.0% from the earlier 10.0%, as well excise duty fees charged for money transfer services by banks, agencies and other financial services providers to 20.0% from the earlier 10.0%. Excise duty charge on other fees charged by financial institutions will also be increased to 20.0% from the earlier 10.0%. The imposition of these would replace the robin hood tax deemed more expensive and complicated to implement and the projected Kshs 20.2 bn revenue to be collected is set to be channeled to finance universal health care,
iii. A further reduction in taxation on winnings: There will be a reduction in the taxation on winnings under the betting, lotteries and gaming Act to 15.0% from the earlier proposed 20.0% as per the Finance Bill which had been submitted to the president which was still a decline from the initial 35.0% in order to enhance equity and fairness by distributing the tax burden fairly between the winnings and the companies which is expected to have a net effect of encouraging players to continue betting on local platforms as the higher taxes would be punitive forcing players to bet on other international platforms. The National Treasury expects to raise revenue from Kshs 8.7 bn to an estimated Kshs 24-30 bn.
iv. An amendment to the employment Act: This will see employees contribute 1.5% of the monthly basic salary while the employer will match the same amount provided that the sum of the employer and employee contributions do not exceed Kshs 5000 monthly, payable to the National Housing Development Fund. The introduction of the contributory scheme is in a bid to support the housing pillar under the government's Big 4 Agenda, which is set to enable contributors own houses upon the maturity of the individual schemes, and,
v. An amendment to the miscellaneous fees and levies Act: There will be an introduction of an anti-adulteration levy on kerosene at the rate of Kshs 18.0 per litre of the customs value of kerosene payable by the importer at the time of entry of the Kerosene into the country. This is in a bid to harmonize the prices of kerosene and diesel thus eliminating fuel adulteration that has led to pollution, damage to vehicle engines as well as adversely affecting government's revenue.

The National Assembly also discussed the supplementary estimates for FY'2018/2019 presented by the Budget and Appropriations Committee, which proposed a reduction in the total budget estimate by Kshs 55.1 bn due to the expected shortfall in revenue arising from the amendments made in the Finance Bill 2018. The National Assembly however passed an expenditure reduction of Kshs 37.6 bn, which is to be achieved through a reduction in recurrent expenditure and capital expenditure for FY'2018/2019 by Kshs 9.1 bn and Kshs 28.5 bn, respectively coupled with a reinstatement of Kshs 1.5 bn to the judiciary. The most hit budgetary allocations as per the adjusted estimates include, the National Treasury set to lose Kshs 6.6 bn, the ministry of Information communications and Technology which is set to lose Kshs 5.9 bn, State department of Infrastructure set to lose Kshs 8.7 bn under emergency road repairs, among others.

Due to assent of the Finance Bill 2018, we are of the view that imposition of some of the tax measures as introduced in the Finance Bill raise a concern in the country's economic growth, especially on corporate earnings this year with the main focus being on the Telecommunication and Financial services industry due to the increased excise tax on both money transfers and internet charges which could slow down consumption of these services. In other sectors, consumers will also be faced with the additional taxes on fuel as well as the housing levy, which we believe will put a strain on overall consumption. This is because consumers will have to rationalize their consumption on goods and services due to the dilution of their purchasing power, which effectively means a reduction in the quantity of goods and services a single unit of currency can buy. This will lead to reduced demand of goods and services across various economic sectors. We also expect inflation to rise in H2'2018 but a lower rate than earlier anticipated due to the halving of the VAT charge on fuel to 8.0% from the earlier 16.0%. Inflation is however still expected to be within the government set target of 2.5%-7.5%.

Rates in the fixed income market have been on a declining trend, as the government continues to reject expensive bids as it is currently 83.9% ahead of its pro-rated borrowing target for the current financial year, having borrowed Kshs 125.0 bn against a pro-rated target of Kshs 68.0 bn. The 2018/19 budget had given a domestic borrowing target of Kshs 271.9 bn, 8.6% lower than the 2017/2018 fiscal year's target of Kshs 297.6 bn, which may result in reduced pressure on domestic borrowing. With the rate cap still in place, with the president having ascended to the Finance Bill 2018, we maintain our expectation of stability in the interest rate environment. With the expectation of a relatively stable interest rate environment, our view is that investors should be biased towards medium-term fixed-income instruments.
