Cytonn Monthly Report October 2015

Cytonn Weekly

Executive Summary

- **Fixed Income:** Yields on T-bills rose month on month, while auctions continue to be oversubscribed. The shilling appreciates during the month, while KRA misses quarterly revenue collection targets;
- **Equities:** NASI and NSE 20 have shed 6.6% and 7.3% during the month, respectively. NSE 25 has lost 2.9% since its inception on 9th October 2015. Banks start releasing their Q3 reports and there is a slight slowdown in earnings;
- **Private Equity:** Private equity flows into East Africa continue, with the financial sector in Kenya remaining attractive;
- **Real Estate:** Kenya improves in its ease of doing business; house prices for middle income apartment units continue on an upward trend.

Company Updates

- Shiv Arora, our Head, Private Equity Real Estate, discussed the proposed tax reforms by the Kenyan Government, and the saga surrounding Imperial Bank. Shiv Arora on CNBC.
- Our diaspora road show continues. We note strong interest in investment products targeting diaspora, through trusted partners. Diaspora Roadshow Schedule.
- Cytonn Investments is currently recruiting for the following positions. Refer a candidate and get a referral bonus, referral bonus programme. Open positions include:
  - Project Manager - Real Estate
  - Business Development Associate, Diaspora
  - Business Manager, Technology

Fixed Income

Government securities were highly oversubscribed this month, especially towards the end of the month, with the Treasury bills overall subscription at 357.2%, compared to an undersubscription of 80.1% in the month of September. The 1-year amortized bond offered received a 157.3% subscription, and the yield was 22.9%, which is the highest yielding government instrument. The oversubscription was as a result of:

i. Investors locking in attractive yields in short-term government instruments;
ii. Foreign investment flowing into the local debt markets as returns are attractive on a risk-adjusted basis;
iii. Improved liquidity levels in the money market as a result of investors preferring to allocate funds towards attractive treasury instruments.
iv. The increased liquidity saw the interbank rate decline to 13.2%, from a high of 22.4%. Treasury bill yields peaked at 22.5%, 22.3% and 22.4% for the 91-day, 182-day and 364-day, respectively, during the month, and this week declined to 19.5%, 21.0% and 21.2%, respectively, following

comments from the CBK Governor that they will be looking to drive down interest rates and the increased interest in government securities.

The shilling appreciated 3.6% against the dollar during the month, to close at Kshs 101.80 from Kshs 105.30 at end of September. This was on account of increased dollar inflows into local government securities. The government received a syndicated loan amounting to USD 750 mn (Kshs 75 bn), at a rate of 5.7% for two years, which equates to 20% of their net foreign borrowing target of Kshs. 340.5 bn. Of keynote is that the Central Bank of Kenya?s foreign exchange reserves have improved to 4.1 months of import cover, after touching a 30-month low, at 3.9 months.

Kenya Revenue Authority missed its first quarter 2015/16 fiscal year revenue collection target by 8.5%, collecting Kshs 300 bn against a target of Kshs 328 bn. 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 enterprises (SMEs) category, which have previously avoided tax payments, as well as improve the i-Tax platform. In as much as these efforts will be beneficial in collection of taxes, we believe (i) educating Kenyans on the benefits of tax compliance is necessary, (ii) Kenyans need to see their taxes put to good use through increased transparency and reporting, and (iii) the new i-Tax platform needs country wide roadshows to educate Kenyans on it?s use and benefits.

The interest rate environment has become more uncertain owing to recent developments, where the government has aggressively stepped-up borrowing to meet collection targets. While interest rates have been hitting highs, we feel that the rates have peaked at the current levels given the levels of subscriptions witnessed recently. The Government?s borrowing programme for the current fiscal year, targeted at Kshs 219 bn, has been stepped up, having borrowed Kshs 63.6 bn. Given that the Government has resorted to funding the budget through short-term borrowings, which mature within the current fiscal year, we expect the aggressive borrowing to continue, as pressure remains to re-finance their obligations. We maintain our view that investors should be biased towards short-term fixed income instruments.

Equities

During the month, the market was on a downward trend with NASI and NSE 20 shedding 6.6% and 7.3%, respectively, on the back of losses in large caps, led by KCB and Equity Bank which lost 14.4% and 6.7%, respectively. Since the February Peak, NASI and NSE 20 have shed 22.7% and 29.7%, and 15.7% and 24.3%, respectively, on an YTD basis. NSE 25 index was set up this month to (i) 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), and (iii) provide investors with investable benchmarks, in line with global benchmarking best practices. The index has shed 2.9% since its inception.

Equity, KCB and Housing Finance (HF) released Q3?2015 results recording growths in PAT of 14.2%, 10.2% and 8.0%, respectively, against our research expectations of 16.7%, 11.9% and 1.3%, respectively. Equity bank?s growth was largely attributed to high growth in non-funded income, at 29.4% to Kshs. 16.8 bn, from Kshs. 13.0 bn in Q3?2014. Net interest income grew by 17.9% supported by a strong growth in loans, which grew by 27.4%. Deposit growth came in at 30.1% y/y, from Kshs 243.0 bn in Q3?2014, to Kshs 316.1 bn; loan to deposit ratio fell to 83.3% from 85.1% in Q3?2014. The net interest margin however dropped by 1.2% to 9.9% largely due to a drop in yields on interest earning assets by 1.0% to 12.5%. Total operating expenses rose by 28.3% y/y to Kshs 24.2 bn, from Kshs 18.8 bn in Q3?2014, mainly on an increase in the loan loss provision by 88.5% y/y, with the cost to income ratio increasing to 57.0%, from 52.0% in Q3?2014.

KCB?s growth was attributed to a 9.8% growth in net interest income from Kshs. 25.8 bn to Kshs. 28.4 bn, supported by a high growth in loans of 31.5% to Kshs 347.7 bn in Q3?2015. Deposit growth was at a faster rate, at 34.6% y/y, to Kshs 471.1 bn, from Kshs 350.1 bn in Q3?2014, leading to a fall in the loan to deposit ratio to 73.8%, from 75.5% in Q3?2014. Interest expense on KCB rose by 34.5% y/y to Kshs 11.3 bn, from Kshs 8.4 bn in Q3?2014, against a 15.9% y/y growth in interest income to Kshs 39.7 bn from Kshs 34.2 bn. The yield on interest earning assets was down 1.0% y/y, at 11.2%, from 12.2% in Q3?2014, while non-interest income grew a marginal 2.3%, to Kshs 17.3 bn, from Kshs 16.9 bn in Q3?2014. Total operating expenses rose by 4.9% y/y to Kshs 26.3 bn from Kshs. 25.1 bn, effectively bringing their cost to income down by 1.0% to 57.6% on account of lower loan loss provision, at Kshs 3.9bn, from Kshs 4.4 bn in Q3?2014, a drop of 13.0%.

Housing Finance growth was largely attributed to a high growth in net interest income of 24.4% supported by a high growth in loans, which advanced 19.5%. Cytonn?s estimates for PAT growth came in 6.7% lower than actual as a result of higher estimated operating costs at Kshs 2.4 bn, versus actual reported figures of Kshs 2.1 bn, resulting to a decline in the cost to income ratio by 2.8% to 52.0%, from 54.8% in Q3?2014. We will be revisiting our view on HF after meeting with the management, and for now recommend a lighten with a total upside (including expected dividend yield) of 4.3% from the current price of Kshs 20.5.

As per our Cytonn Report #42, we expect slow earnings growth compared to Q3?2015, as a result of;

- High costs of funds given the spike in interest rates in the market, with the 91-day Treasury bill at 20.6% as at the end of September;
- Lower loan uptake given the expensive costs of financing loans. This was driven by actions by the Central Bank, which raised the Central Bank?s base lending rate by 300 bps in the quarter;
- A shrinking net interest margin for banks given the time lag between re-pricing of loans and adjustments on the cost of funding, which is immediate once a bank takes on expensive deposits, and;
- Banks that have portfolios with Mark-to-Market government securities will report huge unrealized losses as a result of the high interest rate environment.

We recommend a buy on the KCB and Equity stock with a target price of Kshs. 54.3 and Kshs. 49.2 representing a total upside of 40.2% and 22.5%, respectively. We note that our investment team has been building positions in KCB and Equity.

We shall be releasing our insurance report on the 2nd of November.

Economic Drivers of Stock Market Performance					
Of the 7 indicators of equities market performance tracked by Cytonn, 6 have worsened over the year, hence pointing to a gloomy equities performance expectation through year-end					
Drivers	**Expectations - Jan 2015**	**YTD 2015 Experience**	**Medium-term Outlook**	**Effect on Stock Market**	**Trend**

GDP	5.0% - 6.9% growth in 2015	(i) 4.9% growth in Q1' 2015 (ii) 5.5% growth in Q2'2015 (iii) IMF and World Bank downgrade their GDP projections to 6.0% and 5.4%, respectively	Growth to be below target, with Cytonn's estimate for GDP at 4.9%	Negative		
Interest Rates	Low and stable	(i) CBR increased 300 bps to 11.5% (ii) 91 Day T-Bill hitting a high of 22.5%	Rates to remain high given government?s heavy borrowing	Negative		
Inflation	Low and stable at 6.0% as at December	(i) April inflation at 7.1% (highest for year) (ii) October inflation at 6.71%	Expected to remain relatively stable within the CBK target of 2.5% - 7.5%	Neutral		
Exchange Rate	Shilling to remain under pressure	Shilling depreciated 12.0% against the dollar YTD	Further depreciation given the increased debt payments liabilities and Kenya?s structural weaknesses	Negative		

Corporate Earnings	Improve on credit expansion and a favorable macroeconomic environment	(i) Weak earnings from banking sector. Banks recorded slowest growth in 6 years of 8.3% (15.6% in 2014) (ii) Weak shilling affected import reliant companies	Weak earnings given the high interest rates and depreciating shilling	Negative		
Valuations (P/E)	Multiples to come down to historical averages as a result of earnings growth	PE multiples below historical average, currently at 13x, compared to 16x at the start of the year	To continue to fall further below the historical average	Positive		
Investor sentiment	Positive, supported by re-allocation of funds from the Nigerian market	(i) Peaceful conclusion of Nigerian election resulting to re-allocation to other cheaper markets (ii) Increased flows into Kenya's debt market, however few flows into the equities market	Negative on the back of anticipated rate hikes in the United States and attractive money market yields in the country	Negative		
Source: Cytonn Investments						

As shown in the table above, the operating environment has remained difficult for businesses to operate. While valuations are not as stretched as at the beginning of the year, (market valuation currently at 13x PE compared to 16x PE as at the beginning of the year) earnings growth is much weaker, and the operating environment continues to be unfavorable. Despite the fact that some of the above factors have already been priced into the market, as can be seen by a 15.7% YTD decline in NASI, we feel that the market is now purely a stock pickers? market, with few pockets of value. As a result of this, we maintain our view of ?neutral with a negative bias?.

EQUITY RECOMMENDATIONS - WEEK ENDED 30/10/2015								
No.	**Company**	**Price as at 30/09/15**	**Price as at 30/10/15**	**m/m Change**	**Target Price**	**Dividend Yield**	**Upside/ (Downside)**	**Recommendation**
1.	Standard Chartered	231.00	201.00	(13.0%)	267.0	8.1%	40.9%	Buy
2.	KCB	47.00	40.25	(14.4%)	54.3	5.3%	40.2%	Buy
3.	NIC	43.00	38.75	(9.9%)	50.3	2.9%	32.6%	Buy
4.	Equity	45.00	42.00	(6.7%)	49.2	5.3%	22.5%	Buy
5.	Uchumi	10.05	9.20	(8.5%)	11.3	0.0%	22.4%	Buy
6.	Barclays	13.15	12.65	(3.8%)	14.1	8.5%	20.0%	Buy
7.	DTBK	200.00	189.00	(5.5%)	218.5	1.4%	17.0%	Accumulate
8.	I&M	107.00	100.00	(6.5%)	101.9	2.7%	4.6%	Lighten
9.	Housing Finance	22.25	20.50	(7.9%)	20.3	5.3%	4.3%	Lighten
10.	Co-operative bank	18.20	16.90	(7.1%)	16.8	3.6%	3.2%	Lighten
11.	CfC Stanbic	87.00	84.50	(2.9%)	73.8	0.0%	(12.7%)	Sell
12.	National Bank	16.85	15.80	(6.2%)	6.0	0.0%	(61.8%)	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

Lighten ? Investor to consider selling, timed to happen when there are price rallies

Data: Cytonn Investments

Private Equity

The month of October witnessed increased PE activity in the East African region with a bias to Kenya. A big portion of the private equity capital was invested in the financial services sector, especially in micro finance. The ability of other International private equity institutions to exit from the banking sector has influenced regional private equity companies like Catalyst Principal Partners and Centum to inject more capital to the banks they have stakes in, namely Jamii Bora bank and K-rep bank, respectively. Old Mutual Group has also moved to consolidate its banking business with plans to expand Faulu Microfinance Institution, which is set to open 10 branches by the end of the year at a cost of Kshs 200 mn in a bid to increase their distribution channels.

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.

Other private equity deals of note in the region include the plans by Fanisi Capital to invest Kshs 2 bn in the expansion of Haltons Pharmacy chain; a move intended to quadruple the drug retailer?s stores in the next two years. This move will be implemented through a strategic partnership with Vivo Energy in which Haltons Pharmacy will open stores in all the 150 Vivo energy retail branches in Kenya to increase the number of its outlets to 200. Fanisi will be looking to invest in the health sector in Kenya, which has remained underserved across the whole value chain; Dispensaries, Hospitals and Pharmacies driven by (i) low level of investment into the sector, and (ii) relative high cost of medical services, and (iii) failure of the Government to provide basic services which has created room for private capital to drive growth.

Real Estate

As indicated in our Cytonn Report #42, the Nairobi Securities Exchange became the 4th African bourse (behind South Africa, Nigeria and Ghana) to launch a Real Estate Investment Trust (REIT) market, in what coincided with the opening of the Stanlib Fahari I-REIT public offer. The Stanlib Fahari I-REIT public offer, to be issued at a minimum subscription of Kshs 20,000 (1,000 units) and a nominal value of Kshs 20 each will close on November 12th. This offer is to an unrestricted initial public offer, hence the waiver not to be issued solely to professional investors, where the minimum issue price should be at least Kshs 5 mn. This is a very positive and historic step by both Stanlib and the regulator and if well executed, should both deepen our capital markets and give access to retail investors seeking real estate exposure. Our principal concern with the offering remains clarity around the yield expectations.

The Kenya Bankers Association released their Q3 Housing Index earlier this week. According to the report, average-housing prices in Kenya increased by 1.3% between July and September 2015. This indicates a faster increase relative to the 0.2% increase recorded in the second quarter, but slower compared to the 2.75% increase recorded in the first quarter. This overall slowdown in the rate of increase in house prices can be attributed to:

i. The stabilization of the house prices in line with the demand-supply dynamics, where the poor operating environment in the country has led to a lower uptake of residential properties, which were usually purchased by those working for corporates, and;
ii. The unfavorable interest rate environment in the country has seen a lower uptake of mortgages.

The report also highlights some of the popular middle income estates within Nairobi such as Buruburu, Komarock and Imara Daima as destinations where house prices, in particular apartment prices, are on an upward trend while apartment prices in some of the affluent areas of Nairobi such as Kilimani and Kileleshwa are stagnating. This corroborates our own market research, as we have noted a decrease in occupancy rates in Kilimani, which indicates that the market for residential apartment developments in the area is nearing saturation point. Apartment prices in satellite towns such as Athi River, Syokimau and Ruaka are also on an upward trend albeit at a lower rate compared to middle income estates.

We maintain that the satellite towns show a lot of promise for both investors and developers given the comparatively lower land prices to maximize return while meeting the persistent demand for housing.

Also this month, the World Bank released the 2016 Ease of Doing Business report that places Kenya in the 108th position, an improvement of 21 positions from its 129th position in 2015. Out of the parameters that are used to grade countries worldwide on their ease of doing business, there are directly linked to the real estate industry of each country. These include (i) dealing with construction permits, (ii) registering property, and (iii) getting credit. It is worth noting that the improvements in dealing with construction permits and registering property are marginal with the percentage improvement being 2.0% and 2.3% respectively. This is actually a true reflection of what is happening on the ground considering the bureaucracy that persistently riddles the approval process as well as the title registration process. We however acknowledge that this year especially, there has been some government effort geared towards easing this processes and this is what could have led to the improvement in Kenya?s performance in these two areas.

For the last parameter, ease of getting credit, there was an impressive 35% improvement for Kenya in 2016 as compared to 2015. This has especially boosted the real estate sector as developers are now able to access mezzanine funding for their projects much more easily and prospective buyers as well can access mortgage facilities easier. Though the process of getting credit facilities has been made easier, servicing the loans remains a challenge owing to the high interest rate environment.

This has led to the public being wary of getting financing and has consequently resulted in low uptake of loans.

In summary Kenya? remains an attractive place to do business and the real estate sector has benefitted a lot from the reforms put in place.

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