Cytonn Corporate Governance Report - 2018, & Cytonn Weekly #39/2018

Fixed Income

T-Bills & T-Bonds Primary Auction:

T-bills were under-subscribed during the week, with the overall subscription rate coming in at 63.7%, a decline from 120.9% recorded the previous week. The subdued uptake of T-bills this week was despite improved liquidity during the week, as evidenced by the declined interbank rate, which hit a 3-month low at 3.4% as at 9th October, 2018. We attribute the low uptake to investors eyeing the ongoing 15-year tenor primary bond sale that closes this coming week on 16th October 2018. The yields on the 91-day and 364-day papers remained unchanged at 7.6% and 9.6%, respectively, while the yield on the 182-day paper declined by 10 bps to 8.5%, from 8.6% the previous week. The acceptance rate for T-bills improved to 99.3%, from 80.8% the previous week, with the government accepting Kshs 15.2 bn of the Kshs 15.3 bn worth of bids received, against the Kshs 24.0 bn on offer. The subscription rate for the 91-day paper increased to 157.6%, from 98.5% the previous week, while the subscription rate for the 182-day and 364-day papers declined to 26.4% and 63.4%, from 65.4% and 185.3% recorded the previous week, respectively.

For the month of October, the Kenyan Government has issued a new bond; issue no FXD 2/2018/15, with 15.0-years to maturity, and a coupon rate of 12.75%. The government will be seeking to raise Kshs 40.0 bn for budgetary support. The issuing of the longer-term bond is in a bid to lengthen the average time to maturity for the Kenyan Government's debt portfolio. The Central Bank of Kenya (CBK), in their Financial Sector Stability Report 2017, identified the continued shortening of debt maturities as posing potential rollover risks in the medium term if the trend is not reversed, having reduced to 4.1-years as at the end of 2017, from 4.5-years at the end of 2016, and highs of 8.9-years as at 2010. We are of the view that the continued issuance of medium to long-term domestic securities is well guided as lengthening the average maturity will reduce the pressures on the domestic debt market. The issuance of medium to long-term securities have however been having a lackluster performance, which we attribute to the saturation of long end offers, with the last relatively shorter paper with a 5-year tenor having been offered in March, leading to a relatively flat yield curve on the long-end. Given that the Treasury bonds with the same tenor are currently trading at a yield of 12.6%, we expect bids to come in at between 12.6% and 12.8%.

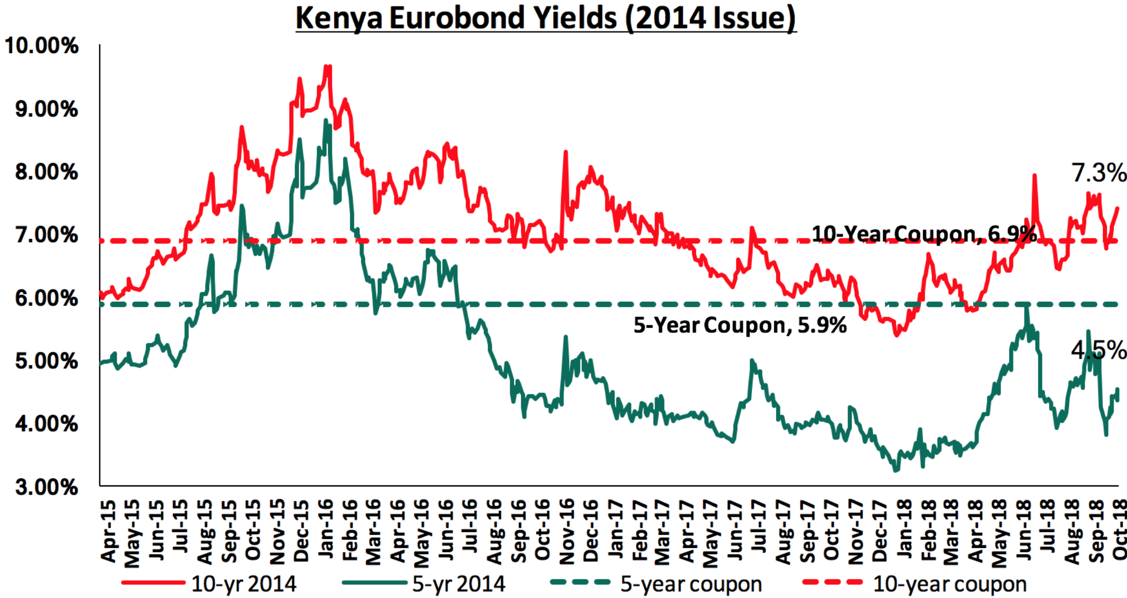
Liquidity:

The average interbank rate declined to 3.7%, from 5.4% the previous week, while the average volumes traded in the interbank market remained stable, increasing marginally by 1.0% to Kshs 14.3 bn, from Kshs 14.2 bn the previous week. The interbank rate, which hit a 3-month low at 3.4% as at 9th October, 2018, points to improved liquidity, which the CBK attributed to government payments.

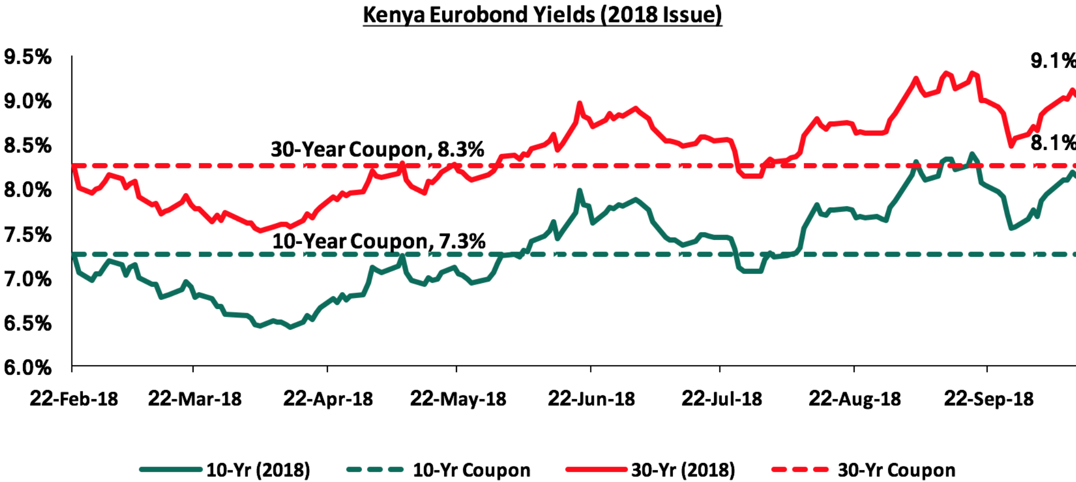
Kenya Eurobonds:

According to Bloomberg, the yields on the 10-year and 5-year Eurobonds issued in 2014 gained by

0.2% points and 0.1% points to 7.3% and 4.5% from 7.1% and 4.4%, the previous week, respectively. Since the mid-January 2016 peak, yields on the Kenyan Eurobonds have declined by 2.3% points and 4.3% 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 0.7-years and 5.7-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 both gained by 0.2% points to 8.1% and 9.1% from 7.9% and 8.9%, the previous week, respectively. Since the issue date, the yields on the 10-year and 30-year Eurobonds have both increased by 0.9% and 0.8% points, respectively.



Kenya Shilling:

During the week, the Kenya Shilling remained stable against the US Dollar, gaining marginally by 0.03% from Kshs 101.0 to Kshs 100.9, supported by inflows from diaspora remittances and reduced dollar demand from importers, which is countering the excess liquidity in the money markets. The Kenya Shilling has appreciated by 2.2% year to date, and in our view the shilling should remain relatively stable to 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 1.7% during the month of July to Kshs 24.7 bn, from Kshs 24.3 bn in June, with the exports from horticulture improving by 9.1%,
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 levels of forex reserves, currently at USD 8.4 bn, equivalent to 5.6-months of import cover, compared to the one-year average of 5.4-months.

Highlights of the Week:

During the week, the World Bank released the Kenya Economic Update, October 2018. Below are the key take-outs from the report:

i. **Kenya's GDP growth is projected to rise to 5.7% in 2018, an upward revision from 5.5% projected in April 2018** - Citing improved rains, better business sentiment and easing of political uncertainty, the World Bank Revised their projected 2018 GDP growth for Kenya upwards by 0.2% points to 5.7%, from 5.5% in the April 2018 Economic Update. Growth in H2'2018 is expected to remain strong supported by recovery in agriculture owing to favorable rains and stronger domestic demand, particularly from the recovery in private consumption and investment. The country's external position is also expected to remain favorable as evidenced by the current account deficit improvement in Q2'2018, coming in at Kshs 85.8 bn, from Kshs 130.4 bn in Q2'2017, a decline of 34.2%, equivalent to 7.1% of GDP from 11.4% recorded in Q2'2017. This was mainly due to the 57.1% increase in the Secondary Income (Transfers) Balance, largely attributed to a 56.9% increase in diaspora inflows to Kshs 74.7 bn from Kshs 47.6 bn in Q2'2017. However, partially mitigating economic growth during the year will be the effects from the government's fiscal consolidation efforts, the recent uptick in oil prices and sub-optimal private sector credit growth that has improved to 4.3% as at August 2018, but still remains well below the 5-year historical average of 13.0%. Below is a table showing that the Kenyan economy is expected to grow by 5.5% to 5.6% in 2018 according to projections by the organizations that we track. We shall continue to update this table as these organizations release their updated 2018 projections:

Kenya 2018 Annual GDP Growth Outlook

No.	Organization	Q1'2018	Q2'2018	Q3'2018	Q4'2018
1.	Central Bank of Kenya	6.2%	6.2%	6.2%	
2.	Kenya National Treasury	5.8%	5.8%	6.0%	
3.	Oxford Economics	5.7%	5.7%	5.7%	
4.	African Development Bank (AfDB)	5.6%	5.6%	5.6%	
5.	Stanbic Bank	5.6%	5.6%	5.6%	
6.	Citibank	5.6%	5.6%	5.6%	
7.	International Monetary Fund (IMF)	5.5%	5.5%	5.5%	
8.	World Bank	5.5%	5.5%	5.5%	5.7%
9.	Fitch Ratings	5.5%	5.5%	5.5%	

Kenya 2018 Annual GDP Growth Outlook

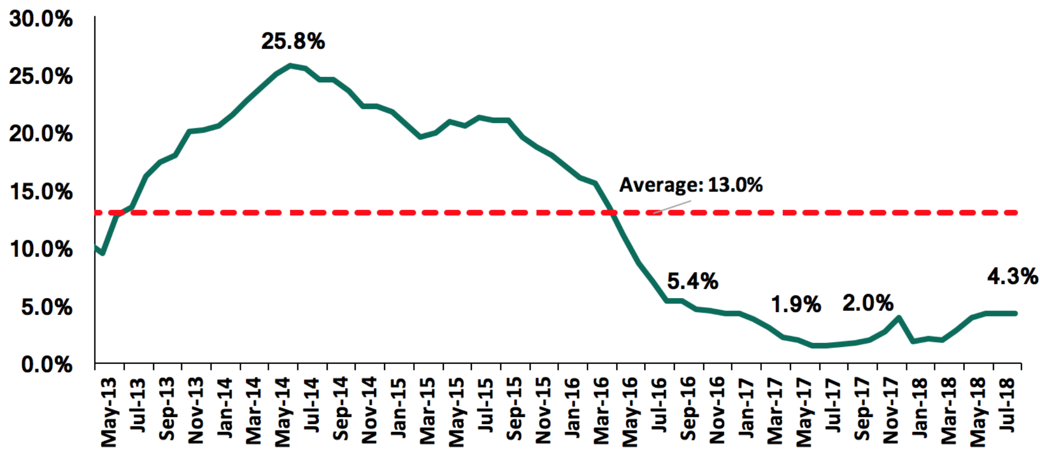
No.	Organization	Q1'2018	Q2'2018	Q3'2018	Q4'2018
10.	Barclays Africa Group Limited	5.5%	5.5%	5.5%	
11.	**Cytonn Investments Management Plc**	**5.4%**	**5.5%**	**5.5%**	**5.5%**
12.	Focus Economics	5.3%	5.3%	5.3%	
13.	BMI Research	5.3%	5.2%	5.2%	
14.	The Institute of Chartered Accountants in England and Wales		5.6%	5.6%	
15.	Standard Chartered	4.6%	4.6%	4.6%	
	Average	**5.5%**	**5.5%**	**5.5%**	**5.6%**

ii. **Private consumption and investment are driving recovery in economic growth** – Private consumption remains the largest demand component of GDP, accounting for 75.0% of total GDP. The recent pickup in private consumption having grown by 7.0% in 2017, up from 4.7% in 2016 has been attributed to favorable agricultural harvests, low inflation and remittance inflows. We expect the effects of the assent of the Finance Bill 2018, which has led to the introduction of an 8.0% VAT on petroleum products, as well as other tax policy measures to be passed on to final consumer prices, moderating growth in private consumption in 2018.

iii. **Fiscal consolidation is gathering momentum** – According to the National Treasury's FY'2017/2018 budgetary review, Kenya's overall fiscal deficit (including grants) reduced to 6.8% of GDP, from 8.9% recorded in FY'2016/2017. The largest share of fiscal consolidation was however, shouldered by a 24.8% contraction in development spending, from Kshs 645.8 bn in FY'2016/2017 to Kshs 485.7 bn in FY'2017/2018. This prompted the concern by the World Bank on the quality of fiscal consolidation over the past year citing that it was not friendly considering that the majority cuts to government expenditure fell on development spending, which could potentially compromise the growth potential of the economy.

iv. **The upward trend in Kenya's overall public debt moderated in FY'2017/18 -** After a steady climb from about 42.1% of GDP in June 2013 to 57.5% of GDP as at June 2017, debt moderated to 57.0% of GDP as of June 2018. The drop is partly attributed to a narrowing of the fiscal deficit in FY'2017/18 as well as the resilient growth in GDP and a relatively stable exchange rate. The World Bank noted that Kenya's debt remains below the low-income countries Debt Sustainability Analysis (DSA) debt thresholds of 74.0% of GDP in present value terms, with Kenya's debt to GDP in present value terms at 57.0%.

v. **Private sector credit growth has picked up in recent months** - Private sector credit growth has improved from 2.0% in March to 4.3% in August 2018, signifying a slow but steady pick up, but remains subdued and well below the 5-year historical average of 13.0%, which is mainly attributed to the implementation of the interest rate cap. The World Bank noted that the recent removal of the floor rate on deposit could increase banks profitability without necessarily increasing lending to SMEs, as it would lead to reduced cost of funding. Whether the amendment will translate to higher lending will be dependent on the "risk free" rate of government securities. If yields on government securities remain high, banks will continue to be incentivized to lend to the government rather than customers perceived to be riskier, and with lower cost of funds for the banks, return on equity could be higher. However, were yields on government securities to decline, the combination of greater spreads from the lower funding costs and diminished attractiveness of government securities could reignite lending to the private sector.



In summary, the report paints the picture that the country's macro-economic fundamentals are still stable and the outlook going forward is positive with the World Bank projecting the GDP growth to come in at 5.7% from the 4.9% recorded in 2017. The Kenyan Government's fiscal consolidation strategy has resulted in the narrowing of the country's fiscal deficit and is still one of the key agendas in FY'2018/2019. This is as outlined in the FY'2018/2019 budget where the government is aiming at narrowing the deficit to 5.7% of GDP, with strengthening revenues through tax policy measures and other revenue administrative measures at the core of achieving this target. Private sector credit growth however still remains a key concern, due to the retaining of the interest rate, which has constrained the effectiveness of monetary policy to influence private sector credit access, with the National Assembly having only removed the floor rate on deposit rates. We also expect the introduction of the various tax policy measures under the Finance Bill 2018 to have a negative effect on private consumption, which has been identified as a major driver to the country's economic growth. 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 as the cost burden will be passed on to final consumer, raising prices of commodities and services.

Rates in the fixed income market have been on a declining trend, as the government continues to reject expensive bids, as it is currently 74.6% ahead of its pro-rated borrowing target for the current financial year, having borrowed Kshs 146.1 bn against a pro-rated target of Kshs 83.7 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 assented 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 instrument.