Cytonn Weekly Report #45

Cytonn Weekly

Executive Summary

- Fixed Income: Yields on government securities fell for the third straight week, with rates on T-bills declining further compared to the previous week;
- Equities: The market was on an upward trend during the week, with NASI, NSE 20 and NSE 25 gaining 2.2%, 1.2% and 1.2%, respectively. Centum released H1?2016 results posting EPS growth of 55% to Kshs. 2.6, while Kenya Airways posted a decline of 14.4% to a loss per share of Kshs 7.99;
- Private Equity: Private equity firm Helios signs its second agreement in as many weeks, as they look to purchase a majority stake in Telkom Kenya;
- Real Estate: The real estate sector continues to exhibit growth given the notable increase in value of building plan approvals, combined with the entry of international players into the sector;

Company Updates

- Our Investment Manager, Maurice Oduor discussed the rise of Kenya?s exchange reserves. See link on CNBC Africa: Maurice Oduor on CNBC
- Our Senior Investment Analyst, Duncan Lumwamu discussed Helios buying into Telkom Kenya. See CCTV Africa link: Duncan Lumwamu on CCTV Africa.
- We continue to beef up capacity, with ongoing hiring for Business Development Associates: Career Opportunities at Cytonn.
- Cytonn venturing into Rwanda received various media coverage:
  - Focus Coverage: Cytonn media coverage
  - Newtimes Coverage: Cytonn media coverage
- This coming week, we will be engaging investors in Kampala. If interested in attending the Real Estate, Private Equity and Diaspora investors forum taking place on Thursday 7.00PM at Sheraton Kampala, please contact Beverlyn Naliaka at communications@cytonn.com

Fixed Income

Treasury bill auctions were oversubscribed for the seventh straight week, with overall subscription at 382.3%, compared to 1,065.0% the previous week, on account of liquid money markets. The increased liquidity can be attributed to (i) Central Bank of Kenya (CBK) injecting liquidity into the markets through a reverse repurchasing programme to support small lenders, and (ii) competition for yields as previously heavily subscribed government auctions were rejected. Yields for the 91-day, 182-day and 364-day treasury bills came down to 9.7%, 12.3% and 13.6%, respectively, from 13.8%, 16.1% and 17.1% the previous week, respectively. The significant volatility in yields is not good for investors as it increases uncertainty, making it very difficult for investors to take positions or plan; rate stability is critical to economic growth.

Next week the Monetary Policy Committee meets and we expect them to hold rates at 11.5% since inflation has remained within the government?s target of between 2.5% - 7.5% and we have also observed a lot of currency stability recently.

Despite the increase in liquidity, the shilling weakened by only 0.1% during the week to close at 102.3 vs the US dollar, from Kshs 102.1 the previous week. This is despite clarity that the Fed is keen on increasing rates in December. The shilling benefited from reports that the oil import bill has declined and hence there could be a slight improvement in the current account position.

The current account position has benefitted from a decline in oil imports and currently it is at 10% of GDP despite a 12% shilling depreciation. Oil imports declined due to (i) low global oil prices, and (ii) reduced reliance on thermal power in favour of geothermal. The country introduced an additional 280 MW of geothermal energy into the national grid between August and September. Since January, Kenya has imported Kshs. 177.2 bn worth of petroleum products, a 53.0% y/y decline from Kshs. 271.2 bn the previous year, helping Kenya reduce its total import bill by 3.3% to Kshs. 1.1 tn. Oil currently accounts for 15.2% of the annual import bill.

Diaspora remittances remained strong during the month as they recorded a 0.9% y/y increment to USD 128.4 mn from USD. 127.4 mn in September 2014. However, remittance inflows recorded a decline of 3.4% from USD. 132.9 mn in August 2015. Diaspora remittances remain the top exchange earner for the country and have contributed majorly to the stabilization of the Kenya Shilling. As discussed in our Cytonn report #41, in order for the country to be able to tap into the full potential of the diaspora, we noted that the Kenyan Government needs to (i) formulate investment friendly policies, (ii) issue Diaspora Bonds, (iii) set up overseas diaspora facilities in order to improve on the relationships and engagement with the diaspora, (iv) establish organizations in order to encourage skill transfer back home, as well as maximize on the intellectual capital of those Kenyans in the diaspora, and (v) support and engage financial institutions and businesses trying to get the diaspora to invest back home, such as our own Cytonn Diaspora business that is based in DC Metro area in the US.

The Government?s borrowing programme for the current fiscal year, targeted at Kshs. 219 bn, has been stepped up, having borrowed Kshs 94.4 bn for the current fiscal year compared to a target of about Kshs 91.3 bn assuming a pro-rated borrowing throughout the financial year. We note the improved money market liquidity levels, which has eased borrowing pressure on the Government. However, 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 within this fiscal year. We maintain our view that investors should be biased towards short-term fixed income instruments, given the uncertainty in the interest rate environment.

Equities

During the week the market continued on an upward trend with NASI, NSE 20, and NSE 25 gaining 2.2%, 1.2% and 1.2%, respectively, on the back of gains in Centum, Barclays and Safaricom which rose by 8.4%, 7.9% and 6.3%, respectively. Equities turnover declined by 46% to Kshs 2.4 bn from Kshs 4.4 bn the previous week, which is the lowest weekly turnover since January. Foreign investor?s participation declined during the week to 61.1%, from 82.4% the previous week with the foreign investors being net sellers for the third straight week with net outflows jumping 113%w/w to Kshs 311 mn from Kshs 145.7 mn. Since the February peak, NASI and NSE 20 have been down 19.3%, and 28.8%, respectively, and down 12.0% and 23.4% on an YTD basis, respectively, while NSE 25 is down by 1.1% inception to date.

The Central Bank released third quarter banking sector results with the following the key highlights:

- Profits before tax (PBT) of Kshs 37.3 bn in Q3?2015, which was a 5.8% q/q decline from the Kshs

39.6 bn recorded in the June quarter. On a year to date basis the sector recorded a PBT of Kshs 114.2 bn, which is an increase of 9.8% from the Kshs 104.5 bn registered in a similar period in 2014.

- Total revenue of Kshs 121.5 bn for Q3?2015, which was a 4.5% q/q increase from the Kshs 116.3 bn in the June quarter. On a year to date basis, the sector recorded revenue of Kshs 347.8 bn, a 14.8% increase from the Kshs 303.1 bn recorded in a similar period in 2014.
- Total expenses rose 9.8% q/q to Kshs 84.2 bn, leading to an increase in the cost to income ratio to 44.5% from 42.5% in the June quarter. On a year to date basis, the total expenses increased to Kshs 233.6 bn, which is a 17.7% increase from the Kshs 198.4 bn registered in a similar period in 2014.
- Deposits decreased 0.2% q/q to Kshs 2.56 tn, while loans rose 6.9% q/q to Kshs 2.3 tn, resulting in an increase in the loan to deposit ratio to 90.3% from 84.4% in Q2?2015.
- Net interest margins remained unchanged at 8.7%.
- On capital adequacy and liquidity, banks remain well capitalized as evidenced by a 2.1% increase in total capital to Kshs 560.7 bn from Kshs 549 bn in Q2?2015. Average liquidity declined to 37.4% from 38.7% in the June quarter. However banks remain strongly capitalized and liquid.

The quarterly drop in profitability is mainly due to the increase in non-performing loans (NPLs) across the sector owing to the higher interest rate environment during the quarter. 8 out of 11 economic sectors registered increases in their NPLs, with the highest increases being in the Financial Services, Energy and Water sectors whose NPLs rose by 11.5% and 11.6%, respectively. Banks continue to employ alternative channels of banking since despite the number of banking transactions undertaken through agents decreasing to 19.5 mn, the value of the transactions increased by 3.1% q/q to Kshs 116.2 bn.

The key take away is that despite the difficult operating environment, banks were able to protect their interest margins and while weak, they still grew at about 10% year over year. However, it is notable that expense growth on a year to date basis of 17.7% outpaced revenue growth of 14.8%, hence the weak year to date earning growth of 10%.

On Friday CBK released a statement on the status of Imperial Bank?s expected reopening. The statement seemed to be blaming IBL?s shareholders for the delay in reopening the bank. Regardless of whether the current shareholders are culpable of any offences or not, the events that led to the current closure of IBL happened under their watch. Consequently, it would not be prudent for past shareholders to lead the resolution of the situation, especially given that a credible resolution will most likely entail wiping out the previous shareholders? stake and bringing in fresh capital and fresh management. Banking is a game of capital, confidence, and prudent management. Any delay in reopening the bank, continues to erode the little confidence left in the IBL brand, in turn reducing the likelihood of reopening. If past shareholders want to be part of recapitalizing the bank, they should bring the capital in the context of a broader recapitalization plan that is not just dependant on past shareholders. A recapitalization driven by past shareholders comes with various past baggage and vested interests and will take forever to materialize, if at all. For example, and this is just an example, any smart shareholder cannot put in rescue capital unless there was assurance against any possible prosecution. So of course it makes sense that a term sheet for any capitalization will be bogged down with all manner of non-financial deal terms. It is easier to get capital from the new shareholders, and failure to attract capital from new shareholders will be a clear and quick indicator that the bank cannot be saved hence the next steps would need to be explored. In Cytonn Weekly # 41, we expressed our reservations on two things: First, we think that CBK should have put the bank under receivership but not closed it, closure only increased panic and further damaged the IBL brand. The market understands clearly why the bank had to go under receivership, it is not clear why it had to be closed since when you close a banking institution or any financial institution, it becomes incredibly harder to operate it. Secondly, having closed IBL, CBK took too long to explain the reasons for closure, further catalysing panic into other smaller banks yet the issues at IBL were not systemic. The long silence before explanation caused the market to speculate on systemic risks. The governor has since held a press conference and explained the issues and the fear of a systemic risk has been contained given the reports of net positive flows into small banks, a big positive for the market. However, it is now taking too long to reopen the bank and the proposed plan, given its significant dependence on past shareholders, does not appear credible. Our view is that CBK should prequalify a few potential bank investors and operators, run a tight one-week auction process, choose the bid that puts the most credible recovery plan on the table and firmly stand behind the winning bid. It is our firm view that there are only 3 scenarios: (i) the aforementioned tight schedule auctioned sale, but it could also be a negotiated sale to a preferred buyer, (ii) a liquidation, or (iii) a full government bailout. The patched up recovery plan that involves hoping past shareholders will recapitalize or recovering fraudulent loans cannot be banked on because CBK does not have the power to force past shareholders to recapitalize and recovery of loans will involve court proceedings. The plan needs to be rethought quickly.

On the earnings front, Centum recorded a 55% increase in half year profit after tax to Kshs 1.9 bn, with performance driven by a Kshs 900 mn gain from the sale of its 21.5% stake in AON, as well as earning capital gains on the sale of listed stocks during the period where the firm increased its portfolio exposure to cash and fixed income securities. Centum purchased an additional stake in K-Rep bank to take its shareholding to 67.5%, which helped grow its investment and other income to Kshs 8.4 bn. The firm early this year acquired a controlling stake in Almasi, the holding company of 3 Coca-Cola bottling firms, and made an investment in capacity that has seen unit case sales grow by 47%. Centum differentiates itself as an active investment company and moving forward, the company intends to develop investment grade opportunities in 8 sectors, including power, education, agribusiness, real estate, Fast Moving Consumer Goods (FMCG) and financial services. We are finalising our valuation report on Centum and shall be releasing it soon.

Kenya Airways (KQ) reported half year results, recording losses of Kshs 11.95 bn, a 14.4% increase in losses from the Kshs 10.5 bn recorded in a similar period last year. Finance costs rose 104% to Kshs 3.4 bn while losses on foreign exchange and hedged fuel derivatives rose to Kshs 4.8 bn, from Kshs 1.2 bn in the previous year. Revenue remained flat at Kshs 56.7 bn and operating expenses, excluding financing and hedging costs, fell 8.0% to Kshs 58.9 bn from Kshs 67.2 bn recorded in a similar period last year. Consequently, appears that with revenue staying flat and operating expenses falling 8%, the core operations of the company are essentially sound. It appears a lot of the company?s issues are around fuel hedging and currency risks. As discussed in our Monthly Report - July, the airline needs a significant restructuring of its business, including

- Exit of loss making routes and concentrate on high margin routes;
- Restructuring of their capital structure,
- Exit of loss making hedging derivatives, and
- Downsize of their expansion strategy.

The firm has hired consultancy firm Seabury to help restructure its operations, and have come up with a strategy to be implemented over one and a half years that includes downsizing of staff and an expected sale of assets, including aircraft.

We remain neutral with a bias to negative on equities given the lower earnings growth prospects for this year. The market is now purely a stock pickers? market, with few pockets of value.

We continue to be avid buyers of KCB and Equity on any dips.

EQUITY RECOMMENDATIONS ? WEEK ENDED 13TH NOVEMBER 2015								
No.	Company	Price as at 6/11/15	Price as at 13/11/15	w/w Change	Target Price*	Dividend Yield	Upside/ (Downside)**	Recommendation

1.	Uchumi	8.6	8.2	(4.7%)	11.3	0.0%	38.7%	Buy
2.	KCB	42.5	41.0	(3.5%)	54.4	5.2%	37.9%	Buy
3.	Equity	41.8	40.0	(4.2%)	51.2	5.3%	33.4%	Buy
4.	Standard Chartered	207.0	215.0	3.9%	267.2	7.3%	31.6%	Buy
5.	Kenya Reinsurance	20.5	20.8	1.2%	24.2	3.4%	19.8%	Accumulate
6.	NIC	40.8	43.0	5.5%	50.3	2.5%	19.5%	Accumulate
7.	DTBK	195.0	197.0	1.0%	218.5	1.3%	12.2%	Accumulate
8.	Barclays	12.7	13.7	7.9%	14.1	8.0%	11.3%	Accumulate
9.	Britam	15.0	15.0	0.0%	15.9	0.1%	6.3%	Hold
10.	Safaricom	15.1	16.0	6.3%	16.2	4.8%	5.7%	Hold
11.	I&M	97.5	99.0	1.5%	101.9	2.7%	5.6%	Hold
12.	Pan Africa	60.5	60.5	0.0%	61.9	0.0%	2.4%	Lighten
13.	Housing Finance	21.0	21.8	3.6%	20.3	5.5%	(1.2%)	Sell
14.	Jubilee Insurance	430.0	445.0	3.5%	428.9	1.6%	(2.0%)	Sell
15.	CIC Insurance	6.5	6.3	(3.1%)	5.8	1.2%	(6.9%)	Sell
16.	Co-operative bank	17.1	18.0	5.3%	15.5	3.3%	(10.6%)	Sell
17.	Liberty	18.9	19.0	0.8%	16.6	0.0%	(12.5%)	Sell
18.	CfC Stanbic	87.0	86.0	(1.1%)	73.8	0.0%	(14.2%)	Sell
19.	National Bank	16.3	15.9	(2.5%)	6.0	0.0%	(62.3%)	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

Private equity firm Helios Investment Partners has signed a binding agreement with The Orange Group, for the sale of its entire 70% stake in Telkom Kenya for an undisclosed amount. Telkom Kenya was such a pain in the flesh for Orange Group that we suspect that Helios saving Orange Group the pain of running Telkom Kenya was sufficient consideration. This comes one week after Helios signed a Joint Venture agreement with Acorn Group Limited to partner on real estate development in the region. The sale will see France Telecom exit their holding, after coming into Telkom Kenya in 2007. The value of the transaction has not yet been announced and it awaits regulatory approvals. Telkom Kenya currently has four million mobile customers, with service offering in data, voice and SMS. In our view, Helios will be looking to a couple of things:

1. We speculate that Helios may combine Acorn and Telkom as one large real estate play. We believe Helios, through their acquisition of Telkom, will want to split Telkom?s real estate assets from the telecom business, and develop the real estate assets usingAcorn as the development manager. Acorn and Telkom separately may not look great, but together it becomes a great real estate play;
2. Gain Telkom Kenya?s wide network of telecom infrastructure, which includes a 23% ownership in TEAMs fiber optic cable network and a 10% ownership in LION2 fiber optic cable network. Helios brings extensive experience in telecom infrastructure through Helios Towers Africa Limited, which builds and maintains telecommunications towers and leases space on those towers to wireless telecommunications services providers across Africa. Helios Towers Africa has acquired, through sale and leaseback transactions, tower assets in Democratic Republic of Congo, Ghana and Tanzania. With the experience in telecom infrastructure, Helios brings in a new wave of asset yield optimization to the already expansive network owned by Telkom Kenya; and
3. We believe the entry of Helios into the Kenyan market will spur competition, particularly in internet/data offering. Helios already has an exposure into the Kenyan internet market, through a strategic holding in Wananchi Group Holdings, which provides broadband cable triple play

(internet, TV, and voice) provider, and has a mid-market direct to home (?DTH?) platform spanning Kenya, Tanzania, Uganda, Malawi and Zambia.

In other news in the financial services sector, Family bank announced plans to sell an undisclosed stake to a private equity firm. This is in a bid to raise Kshs 15 bn that will supplement the recently issued bond by the firm. The company only raised Kshs 4 bn of the target Kshs 10 bn bond it had announced, which has led to the need for further and more permanent injection of capital into the bank to facilitate its expansion to capture the unbanked population in Kenya. In our view, the company has resorted to PE due to (i) the failure to raise enough cash from the bond issue, (ii) increased interest shown by regional and global PE firms in Kenya towards investing in the financial sector industry after Helios realising a full exit in Equity Bank, and (iii) the company could be looking at PE investors to bring with them management strategy, and world-class governance frameworks and pillars, which assist in further institutionalizing firms.

Real Estate

According to the recently released KNBS report on Leading Economic Indicators, there has been an increase in the number of building plans submitted for approval from Q1?2015 to Q3?2015 compared to the same period in 2014, with Kshs 168.8 bn worth of building plans approved this year, which is a 5.9% increase from the Kshs. 158.8 bn approved within the same time period last year. This can be attributed to an increase in development activity as developers seek to identify and fill market gaps in pursuit of higher returns. Of the building approvals granted this year, residential property approvals increased by 14.1% with Kshs 103.8 bn worth of residential projects being approved, which is a Kshs. 12.8 bn increase compared to the residential projects approved within the same period last year. We continue to maintain that the outlook for the real estate industry remains positive, especially due to:

1. The growth in middle-income segment of the market, which is driven by both the formal and informal sector;
2. Growth of satellite towns in the Nairobi metropolis, which have been made accessible for development due to the infrastructural upgrades in and around Nairobi. This has opened up development areas in Ruaka, Mlolongo and Athi River to name a few;
3. The emergence of institutional developers such as Cytonn Real Estate, Athena Properties and Mentor Management, which are turning their focus towards catering for the inherent demand in the economy created by the housing shortfall and local Government?s inability to provide basic services.

Growthpoint, the largest listed REIT in South Africa is planning to enter the Kenyan real estate market via its Pan African Fund. The firm has been quite aggressive in its property acquisition and expansion strategy as it seeks to deliver sustainable, growing value to its shareholders. To this end, it has gained significant commercial and retail assets across South Africa and will be targeting to raise USD 500 mn to invest in real estate across select markets in Africa. The Pan African Fund will be targeting to invest 80% of the fund in income properties with the remaining 20% being invested in development properties. Some of the properties that the fund will be targeting to invest in include shopping malls, offices, hotels and warehouses. It is clear that the Kenyan real estate sector is attracting many international players. This can be attributed to:

1. Focusing on the high yields available in the market, given the 9% p.a. yields available in the office and retail segment of the market, and
2. Return potential from equity developments in the region. Middle income housing provides a developer return of 41% in satellite towns such as Ruaka.

Investment Company Stanlib extended the period in which investors may apply for the Stanlib Fahari I-REIT shares by a week to November 18th2015. This is to allow more time for corporate and retail investors to understand the attributes of the new investment vehicle and prepare their applications. The listing date for the I-REIT on the Nairobi Securities Exchange will be November 26th.

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