Cytonn INVESTMENTS

Nairobi Metropolitan Area Mixed-Use Developments (MUDs) Report 2018, & Cytonn Weekly #44/2018

Fixed Income

T-Bills & T-Bonds Primary Auction:

T-bills were under-subscribed during the week, with the overall subscription rate coming in at 93.8%, up from 87.4% recorded the previous week. The under-subscription is partly attributable to the 20-year tenor infrastructure bond sale that closed this week. The subscription rate for the 91-day and 182-day paper increased to 182.1% and 24.4% from 49.1% and 23.0%, recorded the previous week, respectively, while the subscription rate for the 364-day paper declined to 127.9%, from 167.1% recorded the previous week. The yields on the 91-day, 182-day, and 364-day paper remained unchanged at 7.3%, 8.3% and 9.5%, respectively. The acceptance rate for T-bills improved to 96.0%, from 89.0% the previous week, with the government accepting Kshs 21.6 bn of the Kshs 22.5 bn worth of bids received.

This week, the Kenyan Government issued a Kshs 50.0 bn, 20-year infrastructure bond, issue No. IFBI/2018/20 at a coupon of 11.95%, aimed at funding infrastructure projects in the road, water and energy sectors. The issue was under-subscribed, with the subscription rate coming in at 80.8%, with bids worth Kshs 40.4 bn received against the Kshs 50.0 bn on offer. This was lower in comparison to the 15-year infrastructure bond issue No. IFB1/2018/15 floated in January 2018, which recorded a 139.5% subscription with the total bids coming in at Kshs 55.8 bn of the Kshs 40.0 bn on issue. In this issue, the government accepted Kshs 27.6 bn out of the Kshs 40.4 bn worth of bids received, translating to an acceptance rate of 68.3%. The average accepted yield for the issue came in at 12.2%. The low subscription rate can be attributed to:

i. Uncertainty over the interest rate environment that has made investors reluctant to commit to long-term bonds,
ii. Relatively low returns due to the continued decline of yields in the primary auction as the government continues to reject expensive bids. The 20-year bond's coupon was set at 11.95% with the accepted yield coming in at 12.2%, which is relatively low compared to the shorter tenor 15-year infrastructure bond issued in January, which had a coupon of 12.5% with the accepted yield coming in at 12.5%, and,
iii. Short bidding period of only 2-days with the period of sale being 12/11/2018 to 13/11/2018.

It is evident that there is a low appetite for the long-dated papers as evidenced by the six bonds, issued from the start of the FY'2018/2019 in July, worth Kshs 242.0 bn, only managing to raise Kshs 113.1 bn hence the Treasury has to heavily rely on the short-term treasury bills to meet its domestic borrowing target.

(All figures in Kshs bn)

FY2018/2019 Long-Term Bonds Issue

Issue No.	Issue Amount	Bids Received	Bids Accepted	Coupon Rate
FXD2/2018/20	40.0	13.8	10.5	13.2%
FXD1/2018/10	40.0	29.8	19.4	12.7%
FXD1/2018/10 & FXD2/2018/20	40.0	32.5	26.6	12.9%
FXD2/2018/15	40.0	27.0	7.9	12.8%
FXD2/2018/15	32.0	25.4	21.3	12.8%
IFB1/2018/20	50.0	40.4	27.6	12.0%
	242.0	**168.9**	**113.1**	

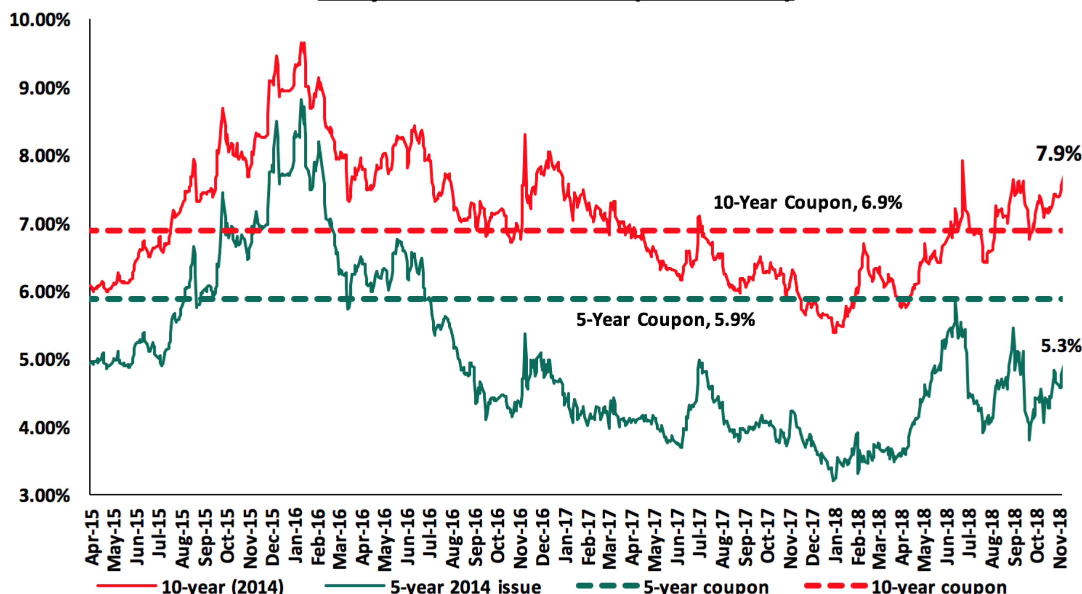
We are of the view that the continued issuance of medium to long-term domestic securities is well guided as lengthening the average maturity will reduce the potential rollover risks in the medium term. The issuance of medium to long-term securities have however been having a lacklustre performance, which we attribute to the saturation of long-end offers, leading to a relatively flat yield curve on the long-end and the government will need to offer more incentive for the long-term bonds by increasing the yields to attract investors.

Liquidity:

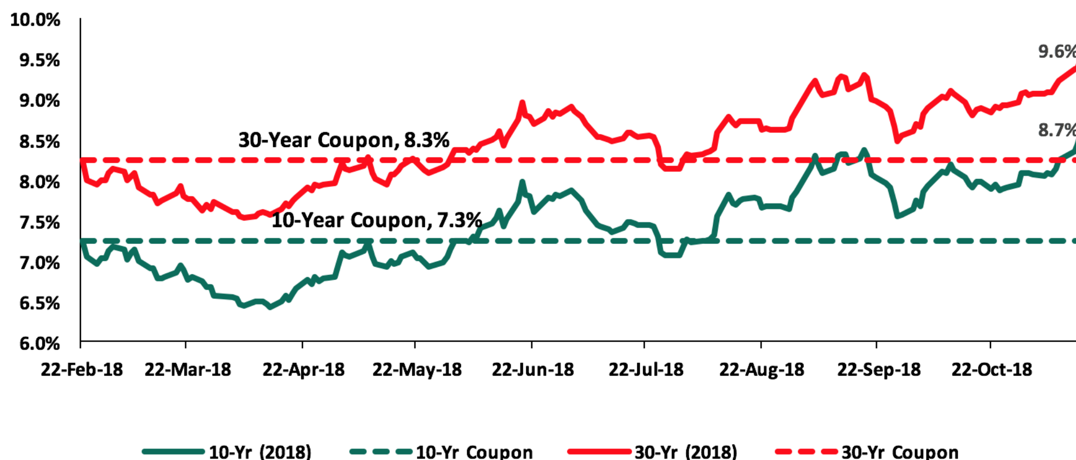
The average interbank rate increased to 3.3%, from 3.0% the previous week, while the average volumes traded in the interbank market declined by 31.3% to Kshs 20.3 bn, from Kshs 29.5 bn the previous week. The higher interbank rate points to tightened liquidity conditions attributed to mobilization of funds by banks for VAT and excise duty remittances that were due.

Kenya Eurobonds:

According to Bloomberg, the yields on the 5-year and 10-year Eurobonds issued in 2014 both increased by 0.5% and 0.4% points to 5.3% and 7.9%, from 4.8% and 7.5% recorded the previous week, respectively. Since the mid-January 2016 peak, yields on the Kenyan Eurobonds have declined by 1.7% points and 3.5% points for the 10-year and 5-year Eurobonds, respectively, an indication of the relatively stable macroeconomic conditions in the country. Key to note is that these bonds have 0.6-years and 5.6-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 rose by 0.5% and 0.4% points to 8.7% and 9.6% from 8.2% and 9.2% the previous week, respectively. Since the issue date, the yields on the 10-year and 30-year Eurobonds have both increased by 1.4% and 1.3% points, respectively.



Key to note, the yields on all the Eurobonds have been on the rise in recent weeks. The rising yield on all the Eurobonds signals higher country risk perception by investors, partly attributed to International Monetary Fund (IMF) raising the risk of Kenya's debt distress from low to moderate on October, resulting in investors demanding a higher return for the risk. In November, the yields on the 5-year and 10-year Eurobonds have both increased by 0.5% points while the yields on the 10-year and 30-year 2018 issues have increased by 0.6% points and 0.5% points, respectively. The increment in the Federal Rate twice this year, currently at 2.0% - 2.25% has also led to market correction in Eurobond yields in the emerging markets with the 2014 Eurobond issues having increased by 1.9% points and 2.3% points for the 5-year and 10-year 2014 Eurobond issues, respectively.

Kenya Shilling:

During the week, the Kenya Shilling depreciated by 1.3% against the US Dollar to close at Kshs 103.2, from Kshs 101.9 recorded the previous week, attributed to increased dollar demand by companies in the oil, manufacturing and energy sectors to close end of year orders ahead of the

December holidays. The shilling has continued to slide over the week, mainly due to the levels of dollar inflows failing to meet the demand mainly from oil importers, which has also seen the oil import bill rise on the back of a rally in fuel prices. This coupled with the declined value of Kenya's principal exports, with the average price of tea having declined by 15.5% since January and the average price of horticulture declining by 19.7% has led to a deteriorating external position eating into the forex reserves and exerting pressure on the local currency. Tea and horticulture contributed to 19.5% and 16.2% of the total August 2018 export bill. Key to note, Kenya's forex reserves have fallen by 8.9% to USD 8.1 bn, from USD 8.9 bn since the start of the FY'2018/2019 in July.

All the gains made by the Kenya Shilling this year were eroded this week as it reached a 10-month low at Kshs 103.2, the same price it closed the year 2017. In our view, the shilling should remain relatively stable to the dollar going forward, supported by:

i. CBK's activities in the money market, such as repurchase agreements and selling of dollars,
ii. High levels of forex reserves, currently at USD 8.1 bn, equivalent to 5.3-months of import cover, compared to the one-year average of 5.5-months, which is above the IMF threshold for emerging markets, which is 3-months, and,
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.

Highlight of the Week:

During the week, the Energy Regulatory Commission (ERC) released their monthly statement on the Maximum Retail Prices in Kenya effective from 15th November 2018 to 14th December 2018. Below are the key take-outs from the statement:

i. Petrol prices have increased 2.1% to Kshs 118.1, from Kshs 115.7 per litre previously. Similarly, diesel and kerosene prices have increased by 2.9% and 2.8% to Kshs 112.8 and 111.8 per litre, from Kshs 109.7 and Kshs 108.8 per litre recorded previously, respectively,
ii. The changes in prices have been attributed to the increase in average landing costs of imported super petrol by 4.0% to USD 758.3 per ton in October, from USD 729.0 per ton in September. Landing costs for diesel and kerosene increased by 5.8% and 5.8% to USD 741.3 per ton and USD 763.5 per ton in October, respectively, from USD 700.4 per ton and USD 721.6 per ton in September,
iii. The mean monthly USD to Kenyan Shilling exchange rate depreciated by 0.3% from Kshs 100.8 per USD in September to Kshs 101.7 per USD in October,
iv. Kerosene prices have been on a steady rise due to the continued effects of the anti-adulteration levy 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. The levy was introduced 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, and,
v. A weakening Kenya Shilling has also weighed in on the pump price, as it costs importers more to import the fuel.

We shall highlight the implication of the higher fuel prices on inflation in our inflation projection for November 2018 on next weeks' Cytonn Weekly Report.

The National Treasury released the budgetary review for the first quarter of the 2018/2019 financial year. Below are the key take-outs:

(All Amounts in 'Kshs bn' unless stated otherwise)

Q1' FY 2018/2019 Budget Outturn

Item	**Q1'2018/2019**		
	Collected/Spent	**Target**	**% met**
Total revenue	366.0	438.3	83.5%
External grants	3.6	8.1	44.4%
Total revenue & external grants	**369.6**	**446.4**	82.8%
Recurrent expenditure	345.4	360.0	96.0%
Development expenditure & Net Lending	83.6	87.8	95.2%
County governments+ contingencies	23.5	55.2	42.6%
Total expenditure	452.5	502.9	90.0%
Fiscal deficit	**(82.9)**	**(56.6)**	
Deficit as % of GDP	0.8%	0.6%	
Net foreign borrowing	16.8	14.9	113.1%
Net domestic borrowing	69.2	40.7	170.1%
Other domestic financing	2.6	4.0	65.0%
Total borrowing	88.7	59.6	148.7%
GDP Estimate	9,990.0	9,990.0	

i. The total revenue collected amounted to Kshs 366.0 bn, a 5.9% increase from Kshs 345.6 bn collected during the same period the previous year. The government managed to hit 83.5% of the Kshs 438.3 bn target. Ordinary revenue collection from taxes excluding Appropriation in Aid was at Kshs 332.2 bn, against a target of Kshs 400.9 bn, thus the Kenya Revenue Authority managed to meet 82.9% of the set target as per the budget. The revenue was 3.7% of GDP,
ii. The total expenditure amounted to Kshs 452.5 bn, a 9.8% increase from Kshs 412.3 bn recorded the same period last year. This was 90.0% of the Kshs 502.9 bn target, with a significant share of the expenditure being on recurrent expenditure, which accounted for 76.3% of total expenditure. Development expenditure only accounted for 18.5%. Total expenditure was, however, 10.0% lower than the targeted expenditure as per the budget an indication that the austerity measures undertaken by the government were taking effect. The lower expenditure was mainly attributed to lower expenditure recorded in domestic interest payment, wages and salaries and pension expenditures, which came in at Kshs 19.1 bn, Kshs 16.1 bn, and Kshs 9.9 bn, respectively

We are of the view that revenue mobilization still remains a key concern, with the government having managed to meet 83.5% of its target, which is a decline from the 89.1% recorded in Q1'2017/2018 indicating that the government efforts of improving revenue mobilization have not been successful. The key concern, however, remains on the expenditure side, which has continued to grow faster recording a 9.8% growth, compared to the 5.9% growth in revenue collection. This has led to widening of the fiscal deficit to Kshs 82.9 bn, 0.8% of GDP from Kshs 65.1 bn, 0.7% of GDP in Q1'2017/2018. This in effect has led to increased total government borrowing, both foreign and

domestic to plug in the deficit, with domestic borrowing having increased by 40.7% to Kshs 69.2 bn from Kshs 49.2 bn in Q1’2017/2018, while foreign borrowing has increased by 124.0% to Kshs 16.8 bn, from Kshs 7.5 bn in Q1’2017/2018. We are of the view that the government efforts of raising revenue through the implementation of the 8.0% VAT on fuel might not be effective as evidenced by the 25.0% drop in petrol and diesel sales to 255,450 tons in September after its implementation, from 338,460 tons recorded in August. The declined sales might also have a trickle effect in the corporate earnings from oil marketers, due to dampened profits and eventually reduced revenue collections from corporate tax.

Rates in the fixed income market have been on a declining trend, as the government continues to reject expensive bids, as it is currently 33.2% ahead of its pro-rated domestic borrowing target for the current financial year, having borrowed Kshs 146.2 bn against a pro-rated target of Kshs 109.8 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.