Focus on the Kenyan Economic Growth, and Cytonn Weekly Report #46

Cytonn Weekly

Executive Summary

- Fixed Income: Yields on Government securities decline for a fourth straight week, with T-bills receiving an overall subscription of 103.5%;
- Equities: The market remained on its upward trend during the week, with NASI, NSE 20 and NSE 25 gaining 2.6%, 1.9% and 2.1%, respectively. Barclays and I&M bank released Q3?2015 results posting EPS growth of 2.7% to Kshs 1.2, and 13.4% to Kshs 10.9, respectively;
- Private Equity: Increased activity in the healthcare sector in Africa as private sector players target the provision of basic services;
- Real Estate: Delta Africa Property Holdings of South Africa enters the Kenya Market and LSK sets stringent conditions of sale;
- Focus of the Week: Kenya?s economic growth expected to be below the target set at the start of the year, however economic prospects remain positive.

Company Updates

- Amara Ridge, our signature development in Karen featuring two distinct architectural designs ? classical and modern, is now 80% sold with only two units remaining. Amara Ridge Video.
- Our Senior Investment Analyst, Duncan Lumwamu discussed the performance of the Kenya Shilling ahead of the MPC meeting, and the return of Jambojet to profitability. Duncan Lumwamu CNBC Africa.
- This week, our Cytonn Team engaged investors on Thursday 19th November at Sheraton Kampala. The team met with investors and real estate developers in order to discuss investment and real estate opportunities in the region;
- We continue to beef up capacity, with ongoing hiring for Business Development Associates: Career Opportunities at Cytonn

Fixed Income

Due to the decline in interest rates the subscriptions on Treasury bill have continued to decrease and this week auctions received overall subscription of 103.5%, compared to 382.3% the previous week, with the 91-day and 364-day undersubscribed at 78.1% and 77.3%, respectively, while the 182-day was oversubscribed at 155.1%. Yields on the 91-day, 182-day and 364-day treasury bills came down to 9.6%, 10.2% and 12.1%, respectively, from 9.7%, 12.3% and 13.6% the previous week, respectively. The interbank rates declined to 6.4% from 11.0% the previous week on the back of improved liquidity in the money market. Liquidity was skewed towards some large banks even though the Central Bank supported the small banks through reverse repos. We expect yields to remain flat in the coming weeks but in the medium term we expect to see slight increases due to pressure on government to borrow in support of the budget.

This week the Monetary Policy Committee (MPC) met, and in line with our view in Cytonn Report #45, they maintained the Central Bank Rate (CBR) at 11.5% noting the following key developments:

i. Liquidity conditions in the money market have improved in November evidenced by the decline in the interbank rates from a high of 25.8% at the close of September, to 6.4% currently;
ii. Inflation is still within the CBK target of 2.5% to 7.5% and is expected to remain range bound in the short term. In our projection, inflation for the month of November will come in at between 6.9% and 7.1%;
iii. Foreign exchange reserves are currently at 4.3 months of import cover from 3.9 months at the close of September due to (i) CBK?s purchases of foreign exchange from the market and (ii) receipts of proceeds from the Government?s syndicated loan. CBK noted that the reserves, together with SDR agreement with the International Monetary Fund (IMF), would provide sufficient buffer against unexpected economic shocks.

During the week the shilling remained relatively flat against the dollar, gaining by 0.1% to close at Kshs. 102.2, and has shed 12.7% YTD.

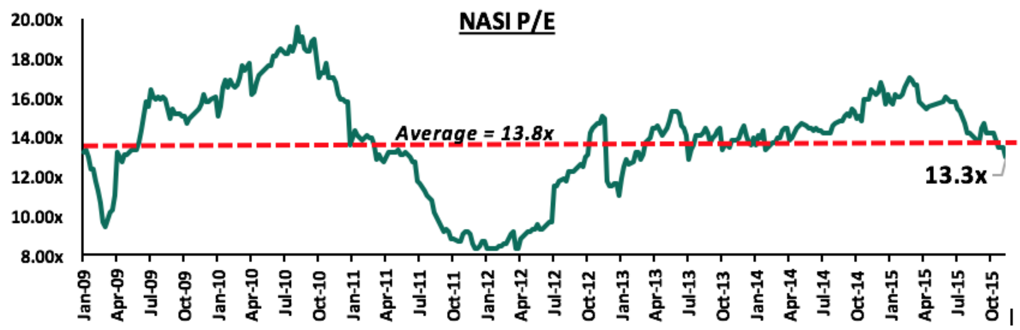
In the coming week the Government will be issuing a 5-year bond to raise Kshs. 20 bn for budgetary support, an indication that the Government views the interest rate environment to have normalized, and as such are comfortable issuing a medium tenor bond. A similar tenor paper is currently trading at a yield of 13.3%, and given (i) the volatility in interest rates witnessed over the last two months, (ii) reduced foreign investors activities in the fixed income market, and (iii) the disparity in liquidity across the banking sector, we anticipate investors to demand a premium above the current yield, and bid in the region of 13.5% to 14.5%.

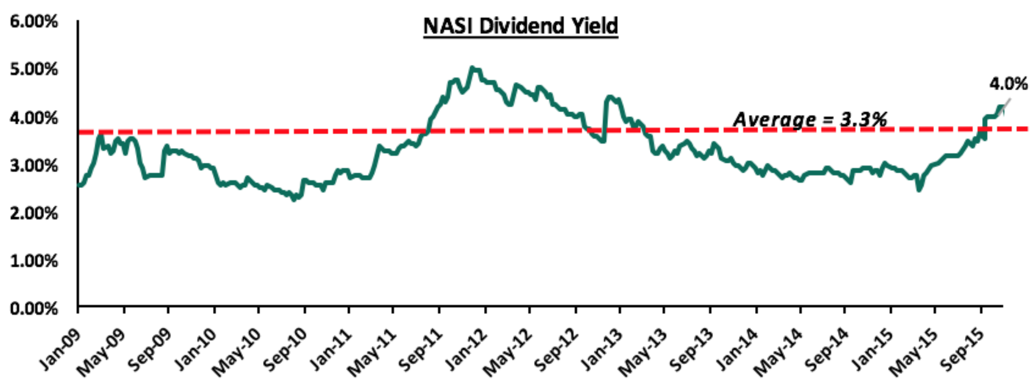
The National Treasury announced that they had revised their GDP forecast down to 5.8% from 6.9% at the beginning of the year. They noted that (i) a tight monetary policy, and (ii) the apparent effects of the El-Nino rains will stifle growth. According to our Cytonn Report #38, we noted that the economy could not grow at the 6.9% rate they had stipulated given (i) weaker than expected company earnings which affects revenue collection, (ii) a depreciating shilling which has affected companies which rely on imported inputs, (iii) the high interest environment which discourages credit uptake, and (iv) increased cases of corruption and mismanagement of public funds. According to our projections we expect the economy to grow at between 4.7% - 4.9%, so we expect the National Treasury to further revise downwards their most recent 5.8% estimate. It is also notable that IMF also revised down their Kenya GDP estimate from 6.5% to 6.0%.

The Government?s borrowing programme for the current fiscal year, targeted at Kshs. 219 bn, has been stepped up, having borrowed Kshs 105.0 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. 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. In the month of December alone total government debt maturities stand at Kshs. 58.0 bn, and this is without taking into account the dollar denominated Eurobond interest payment of Kshs. 9.0 bn, which brings total debt due in December to Kshs. 67.0 bn. In January 2016, the figure is much higher at Kshs. 86.0 bn. Inflation, which in this fiscal year remained low is steadily approaching the CBK upper limit of 7.5%, and given the high liquidity in the money market and the El-Nino rains, inflation may surpass this limit. All these factors point to an eventual rate spike in the near future, and we are of the view that the current decline in interest rates is not sustainable. 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 for the fourth straight week, with NASI, NSE 20, and NSE 25 gaining 2.6%, 1.9% and 2.1% respectively, on the back of gains in Jubilee Insurance, Equity and Safaricom which rose by 11.2%, 4.4% and 4.1%, respectively. Equities turnover rose by 52.1% to Kshs 3.6 bn from Kshs 2.4 bn the previous week. Foreign investor?s participation increased during the week to 68.5%, from 61.1% the previous week with the foreign investors being net sellers for the fourth straight week with net outflows declining 10% w/w to Kshs 275.9 mn from Kshs 311 mn. The persistent exit of foreign investors from the market can be linked to a shift in global investor portfolio flows based on the impeding rate increase in the US that has reduced their risk appetite for securities in emerging and frontier markets. Since the February peak, NASI and NSE 20 are down 17.2% and 27.4%, respectively, and down 9.7% and 21.9% on an YTD basis, respectively, while NSE 25 is up by 0.9% inception to date. The market is currently trading at a price to earnings ratio of 13.3x, versus a historical average of 13.8x, with a dividend yield of 4.0% versus a historical average of 3.3%.





Barclays bank reported Q3?2015:

- PAT growth of 2.7% y/y to Kshs 6.4 bn from Kshs 6.2 bn in Q3?2014. Operating revenues grew by 2.4% driven mainly by loan growth since non-interest income stayed flat, while operating expenses growth of 3.9% driven by a 15.0% y/y growth in staff costs from Kshs. 6.0 bn to Kshs. 7.0 bn, leading to cost to income ratio staying relatively at 58.0% from 57.2%
- Loan growth of 10.1% y/y outpaced deposit growth of 4.3%, raising loan to deposit ratio to 87.2% from 82.6%
- Net interest margin of 10.3% from 10.7% because of an increase in the cost of funds to 2.7% from 1.9% outpacing yields from interest earning assets which increased to 13.0% from 12.6% in Q3?2014
- Non-performing loans (NPLs) rose by 31.5% y/y to Kshs 5.7 bn, raising the NPLs to total loans ratio to 4.1%, from 3.1% in Q3?2014
- With regard to Capital adequacy, Barclay?s capitalisation improved with the total capital to risk weighted assets currently at 19.1% from 16.4% in Q3?2014, 4.6% above the statutory requirement of 14.5%

- Barclays has renewed its focus on the growing SME sector, including launching a Kshs 30 bn SME loan fund, a 48-hour loan approval turnaround time, and an upward revision of the unsecured lending cap to Kshs 6 mn
- Barclay?s earnings per share came in at Kshs 1.18, lower than our expectation of Kshs 1.26. We expect the bank to deliver single digit growth over the medium term despite the renewed focus on SME?s where there are already established players, such as KCB, Equity and other Tier II banks.

I&M bank reported Q3?2015

- PAT growth of 13.1% y/y to Kshs 4.4 bn from Kshs 3.9 bn in Q3?2014. Operating revenue grew by 19.2% driven by Net interest income which rose 19.7% y/y to Kshs 7.9 bn from Kshs 6.6 bn last year. Operating expenses were up 24.8% y/y (far outpacing the 19.2% revenue growth) to Kshs 4.2 bn from Kshs 3.4 bn owing to a 20.7% y/y increase in staff costs to Kshs 1.8bn from Kshs 1.5 bn in Q3?2014, raising the Cost to Income ratio to 40.1% from 38.3% in the same period last year
- Loan growth of 17.9% y/y to Kshs 116.2 bn was outpaced by deposits which grew by 24.1% y/y to Kshs 117.4 bn, resulting in a LDR of 99.0%, from 104.2% in Q3?2014; the high LDR remains a concern and indicates funding pressures that can only be alleviated by more aggressive deposits gathering
- The yield from the bank?s interest earning assets stood at 12.0%, while the cost of funds came in at 5.7%, resulting in a net interest margin of 6.3%. Non-interest income rose by 18.0% y/y to Kshs 2.3 bn
- NPLs rose by 217.6% y/y to Kshs 3.0 bn, resulting into a NPLs to total loans ratio of 2.6%, from 0.9% in Q3?2014
- With regard to Capital adequacy, I&M?s capitalisation improved with the total capital to risk weighted assets currently at 17.7% from 17.3% in Q3?2014, 3.2% above the statutory requirement of 14.5%
- With I&M?s Mauritius subsidiary having become profitable, and the impending acquisition of Giro bank likely to increase market share among their customer group, we feel that I&M is well positioned to reap the benefits of its expansion strategy and sustain future growth. However we remain concerned about the high LDR and the low Net Interest Margin.

Family Bank reported Q3?2015

- PAT growth of 36.1% y/y to Kshs 1.8 bn from Kshs 1.4 bn in Q3?2014. Operating revenue grew by 23.7% driven by Net interest income which rose by 28.7% y/y to Kshs 5.0 bn from Kshs. 4.0 bn in Q3?2014. Operating expenses rose 18.1% y/y to Kshs 4.5 bn owing mainly to staff costs which grew by 26.7%. The revenue growth of 23.7% out paced expense growth of 18.1% hence lowering the CIR to 62.5% from 65.4% last year and also leading to the 36.1% PAT growth. The only two banks that have so far reported over 30% growth are Family Bank and Cooperative Bank, and in both cases containing expense growth to below revenue growth led to the above average PAT growth
- Loan growth of 47.6% y/y to Kshs 52.8 bn outpaced deposit growth which grew 45.8% y/y to Kshs 63.5 bn, resulting in LDR of 83.1% from 82.1% in Q3?2014
- The yield from the bank?s interest earning assets was 13.3%, while the cost of funds came in at 4.0%, resulting in a net interest margin of 9.3%
- NPLs declined 4.8% y/y to Kshs 2.5 bn, resulting into NPLs to total loans ratio of 4.8%, from 7.4% in Q3?2014.
- The bank?s capital ratios are strained, with total capital to total risk weighted assets ratio at 15.4%, just 0.9% above the minimum statutory ratio of 14.5%. Their recent bond worth Kshs 2 bn, in addition to the possibility that the bank will get long term private equity funding, will help the bank shore up its capital base and aid in its growth plans.

Following the change of leadership at Uchumi, our research team met the management team to understand the retailer?s strategy going forward. The company has embarked on a turnaround strategy to revive the retailer, using a three-point approach:

i. Stabilization: Under the stabilization strategy, the main aim was to focus only on profitable and manageable stores. During this phase, management has (i) closed all the regional stores in Tanzania and Uganda, (ii) improved liquidity by negotiating for an extended overdraft facility from KCB, and (iii) put on sale their three properties on Langata road, Ngong road and Kasarani. *Closing loss-making stores reduces bleeding and focuses resources on profit making stores. We view that positively.*
ii. Optimization: The primary objective of this phase is restocking the stores with a pilot store being Uchumi Koinange Street, which is now fully stocked. We paid visits before and after the restocking and we affirm that the store is now optimally stocked . *We however note that this process is slow and most of the stores still lag behind. In our other store visits, we observed that a number of the retailer?s stores remain understocked, yet this is considered the key objective of this phase .*
iii. Growth Phase: Uchumi has defined its niche, the mass market. As we had earlier noted in our reports, we expected Uchumi to identify a target market and move away from their model of flying blind. The defined niche will enable the retailer reposition its strategy definitively, and compete with the right peers in the Kenyan market. *However, we note that the local retail market remains competitive and Uchumi will play catch-up given that there are already established players like Tuskys and Naivas in the mass market.*

Despite the challenges facing Uchumi ahead, we believe there is still value in the retail chain but they have to work extra hard to catch up with their peers. For once, Uchumi has a clear and cut out plan regarding their strategy and we commend them for this. However, the execution of the initiatives are still at very initial stages as evidenced by the fact that only one store is now optimally stocked. Consequently, we raise our valuation discount rate from the original 16.6% to current 20.1% to reflect the riskiness of the expected cash flows. The high discount effectively revises our target price downwards from Kshs 11.2 to Kshs 9.7, representing a potential upside of 19.7% from the current price of Kshs 8.1. We also revise our recommendation from a Buy to Accumulate.

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 price dips.

all prices in Kshs unless stated

EQUITY RECOMMENDATIONS - WEEK ENDED 20/11/2015								
No.	Company	Price as at 13/11/15	Price as at 20/11/15	w/w Change	Target Price*	Dividend Yield	Upside/ (Downside)**	Recommendation
1.	KCB	41.0	41.5	1.2%	54.4	5.2%	36.3%	Buy
2.	Equity	40.0	41.8	4.4%	51.2	5.1%	27.8%	Buy
3.	Standard Chartered	215.0	223.0	3.7%	267.2	7.1%	26.9%	Buy
4.	NIC	43.0	42.0	(2.3%)	50.3	2.5%	22.2%	Buy
5.	Kenya Re	20.8	20.8	0.0%	24.2	3.4%	19.8%	Accumulate
6.	Uchumi	8.2	8.1	(1.2%)	9.7	0.0%	19.7%	Accumulate
7.	DTBK	197.0	195.0	(1.0%)	218.5	1.3%	13.4%	Accumulate
8.	Barclays	13.7	13.7	0.0%	14.1	7.4%	10.7%	Accumulate
9.	I&M	99.0	98.0	(1.0%)	102.8	2.7%	7.6%	Hold
10.	Britam	15.0	15.0	0.0%	15.9	0.1%	6.3%	Hold
11.	Safaricom	16.0	16.7	4.1%	16.3	4.6%	2.2%	Lighten
12.	Co-operative	18.0	18.2	1.1%	17.0	3.3%	(3.1%)	Sell
13.	Pan Africa	60.5	65.0	7.4%	62.1	0.0%	(4.4%)	Sell
14.	HF	21.8	23.0	5.7%	20.3	5.2%	(6.5%)	Sell
15.	CIC Insurance	6.3	6.6	4.0%	5.8	1.2%	(10.4%)	Sell
16.	Jubilee	445.0	495.0	11.2%	428.9	1.4%	(12.0%)	Sell
17.	Liberty	19.0	19.9	4.7%	16.7	0.0%	(16.2%)	Sell
18.	CfC Stanbic	86.0	90.0	4.7%	73.8	0.0%	(18.0%)	Sell
19.	National Bank	15.9	15.9	0.0%	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

Amethis Finance, the French private equity firm focused on Africa, has ventured into the West Africa healthcare sector by acquiring a minority equity investment in HMAO Group. HMAO is a group composed of clinics and laboratories and is the leader in the healthcare market in the West Africa region. Amethis will support the management?s take-over of the Group, which includes:

i. Consolidation and optimization of the existing network: capacity extension, increase in the number of beds, modernization of the equipment, namely radiology and function tests,
ii. Launch and development of new offers (radiotherapy), and,
iii. Regional expansion with the acquisition of medical facilities in the neighboring countries.

The entry into the West Africa healthcare sector signifies the huge opportunity available in Sub-Saharan Africa with respect to the provision of basic services. Healthcare continues to be an attractive but challenging area for PE investment in Sub-Saharan Africa. With a population of over one billion people, with rapid growth in the respective economies, there is increased pressure in the already struggling and strained healthcare systems.

Several players have already set up Funds to specialize in the Africa health sector. For example Aureos Africa Health Fund is a private equity fund which seeks to develop small and medium sized enterprises in health related services and industries. Africa Health Fund targets small and medium sized companies that help low-income Africans gain access to affordable but high-quality health services. The fund is managed by Aureos Capital and has total commitments of USD 105 million, of which Norfund has committed USD 10 million.

Real Estate

South Africa based Delta Africa Property Holdings has entered into an agreement to buy 45.5% equity in Buffalo Mall for KES 418 mn. The deal is estimated to be finalised by March 2016. The purchase at Kshs 418 mn values Buffalo Mall at approximately Kshs 1 bn. Given that the mall started construction in December 2013, was opened in February 2015, a 2016 exit is positive to the development industry because demonstrates the ability to develop, operate and exit.

The new Law Society of Kenya Conditions of Sale 2015 are set to greatly reduce cases of manipulation on sale and transfer of property in Kenya. Under the new conditions, property sellers are required to prove payment of land rent for three consecutive years as well as produce all legal consent necessary to effect registration of transfer. The new sales conditions provide a standard on the transfer process as opposed to previous cases where lawyers from both parties decided on contents of the sales agreement. As a result, it is expected that manipulations and post transfer disputes will reduce and mediocre property dealers will have a hard time moving their property.

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