Cytonn Weekly Report #50

Cytonn Weekly

Executive Summary

- **Fixed Income:** Yields for government securities were on an upward trend for the fourth week. Inflation set to increase for the month of December, with Cytonn?s expectations at between 7.5% - 7.6%;
- **Equities:** The market performance was on a downward trend during the week, with NASI, NSE 20 and NSE 25 declining 2.1%, 0.9% and 1.4%, respectively. Britam issues a FY?2015 profit warning, while Uchumi seeks a strategic investor to fund its turnaround strategy;
- **Private Equity:** Financial services and health care sectors continue to attract investment in the Sub-Saharan Africa region supported by strong fundamentals;
- **Real Estate:** Foreign investment into the real estate sector has been active in the year as investors venture into emerging markets. The trend is expected to continue into 2016.

Company Updates

- 2015 has been a successful year at Cytonn, registering tremendous growth across all business lines. Read our Managing Partner & Chief Executive Officer?s yearly review.
- Our Senior Investment Analyst, Duncan Lumwamu discussed the outcomes of the concluded World Trade Organisation (WTO) 10th Ministerial Conference. Duncan Lumwamu on KTN.
- We continue to beef up the team with the ongoing hires: Careers at Cytonn.

Fixed Income

There was an under subscription in the Treasury bill auctions, with overall subscription coming in at 81.8%, compared to 122.0% the previous week. For the second week running, the 91-day T-bill was oversubscribed, receiving subscriptions of 147.3% compared to last week?s subscriptions at 320.0%, an indication of investors? preference to keep short on duration. The 364-day T-bill received subscriptions of 29.1% while the 182-day was 91.3% subscribed this week. Yields on treasury bills were on an upward trend with the 91-day, 182-day and 364-day bills up to 10.4%, 12.3% and 12.8% respectively from 10.0%, 11.7% and 12.5% respectively last week. As stated in our Cytonn Report #48, the Tap Sale for the Infrastructure Bond is still on going and is set to close on Monday 28th December 2015. The bond is yet to trade in the secondary market and this is not good for investors who took positions earlier with the hope of trading. Of key note is that there is no other bond on offer this month.

The interbank rate rose in the week to settle at an average of 5.8% up from an average of 4.6% last week. The market remained relatively liquid supported by both maturities of government securities and government payments but was partially offset by tax payments. This week the net redemption from reverse repos stood at Kshs 13.1 bn.

The Kenyan shilling remained stable during the week despite the recent rate increase by the Fed, to close the week at Kshs 102.3 against the dollar, unchanged from last week. The continued increase in forex reserves to stand at USD 7.2 bn remains supportive of the Kenya shilling, with months of import cover currently at 4.6 months, from 4.5 months last week.

Inflation rose from 6.7% in October to 7.3% in November due to increased food prices brought about by the El-Nino rains that washed away roads hampering transportation of produce to the markets. The Central Bank Governor however indicated that they will not undertake any monetary policy actions now to intervene since the rising inflation caused by heavy rains is transitory in nature. We expect inflation for the month of December to come in at between 7.5% - 7.6%, surpassing CBK?s target range of 2.5% - 7.5%.

The World Trade Organisation members concluded their 10th Ministerial Conference on 19th December after securing a series of trade initiatives dubbed ?The Nairobi Package? that seeks to benefit the Least Developed Countries (LDCs). Among the items on the agenda was further development of the Doha agreement, agricultural subsidies, food security, empowering the LDCs and passing the trade facilitation agreement. It was the first time that the WTO conference was held on African soil and made good headway compared to previous meetings. Some of the decisions made include;

i. ***Removal of export subsidies to support increased competition***: This was a big boost to Kenya, as it will make agricultural exports more competitive in the foreign markets. Currently under the WTO rules, 16 WTO members are allowed to subsidize exports of certain agricultural products. Following this decision, any form of export subsidies will be fully eliminated. This will level the playing field for farmers in poor countries who cannot afford to compete with rich countries which artificially boost their exports through subsidies,
ii. ***Improved reforms to enhance Food Security***: While food security is a legitimate policy objective, the public stockholding system programme used by some developing countries to purchase food at administered prices is considered to distort trade when it involves purchases at prices fixed by the government. Members shall ensure that food is purchased in a way that prevents commercial displacement,
iii. ***Empowering LDCs to use tariffs***: LDCs will now have the right of recourse to a special safeguard mechanism which will allow LDCs to temporarily raise import tariffs on agricultural products in cases when imports surge or prices decline,
iv. ***Passing of the Trade Facilitation Agreement***: The ministerial decision on the Preferential Treatment in Favour of Services and Service Suppliers of LDCs and increasing LDC participation in service trade will be implemented. This will enable LDCs to benefit from preferential market access for their goods.

Gains from the WTO ministerial conference were modest. However, they were a big leap from the two deals that had been passed since its inception 14 years ago. Practical solutions from the ratification of the agreement ought to be the focal point going forward.

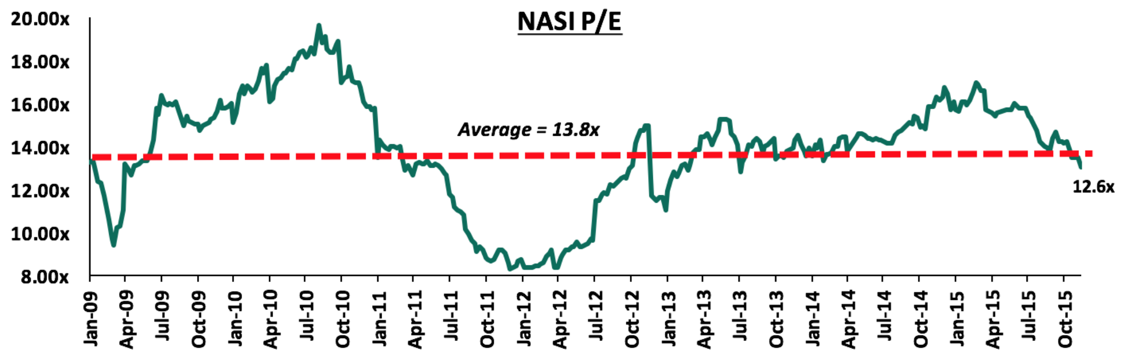
Despite the Government being ahead of target in its domestic borrowing programme, having borrowed Kshs 175.5 bn (total domestic borrowing is set to be Kshs 219 bn for this year) for the current fiscal year compared to a target of about Kshs 109.5 bn assuming a pro-rated borrowing throughout the financial year, the pressure on rates is expected to persist. Most of these borrowings are short-term instruments that mature within the current fiscal year and the Government will face pressure in refinancing the obligations as they mature. As a result, we maintain our view that investors should be biased towards short-term fixed income instruments given the uncertainty in the interest rate environment.

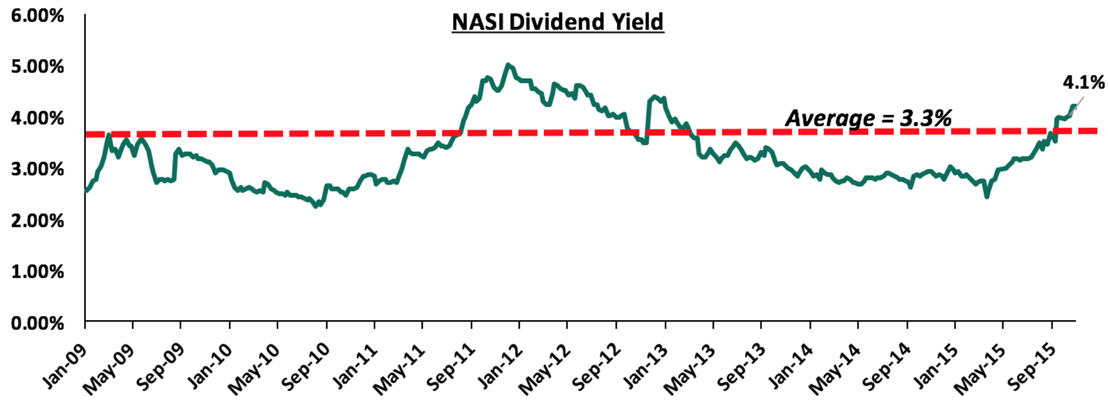
Equities

During the week, the market registered declines, with NASI, NSE 20 and NSE 25 falling 2.1%, 0.9% and 1.4%, respectively. Declines were registered in BAT and Safaricom, which fell by 8.0% and 4.8%, respectively. Since the February peak, NASI and NSE 20 have shed 19.7% and 28.1%, and down 12.5% and 22.6% on an YTD basis, respectively. NSE 25 index is down 1.7% from inception to date.

Equities turnover fell by 66.5% during the week to Kshs 1.6 bn from Kshs 4.8 bn the previous week. Foreign investors were net sellers for the ninth straight week with net outflows of Kshs 54.2mn, which was a 74.8% decline from net outflows of Kshs 214.8 mn witnessed last week. The sustained foreign investors? net outflow can be linked to a shift in global investor portfolio flows based on the recent rate increase in the US that has reduced their risk appetite for securities in emerging and frontier markets and made the US market more attractive.

The market is currently trading at a price to earnings ratio of 12.6x, versus a historical average of 13.8x, with a dividend yield of 4.1% versus a historical average of 3.3%. In our view, given the challenging operating environment in 2015, which has resulted in low earnings growth, we expect market activity to remain subdued. The charts below indicate the historical PE and dividend yields of the market.





Britam became the 14th listed company to issue a profit warning in 2015. This followed the company announcing a 77% decline in their H1?15 results owing to a 129% y/y decline in fair value changes on financial assets, which saw the insurer record fair value losses of Kshs 842.9 mn, compared to a gain of Kshs 2.9 bn in H1?14. As indicated in our Cytonn Report #34, Britam needs a clear diversification strategy to reduce the extreme earnings fluctuations. We recommend an Accumulate on Britam, with a Target Price of Kshs 15.9, a 19.9% upside from the current price of Kshs 13.3, but we shall review our recommendations after their earnings release.According to the IRA report, Insurance companies posted a total of Kshs 5.8 bn in profit after tax for the 9 months ended Q3?2015, which was a 28.0% decline in PAT from the Kshs 8.1 bn registered in the same period last year. The total industry premiums grew by 12.8% from Kshs 119.7 bn to Kshs 135.0 bn, total expenses grew by 25.8% to Kshs 37.7 bn, while total claims grew by 18.1% to Kshs 68.6 bn from Kshs 58.1 bn last year. The poor performance was brought about (i) expenses and claims growth outpacing premium growth and (ii) by the bad performance of the equities market that led to a

22.4% decline in investment income, to Kshs 3.8 bn from Kshs 4.8 bn last year.

Uchumi Supermarkets is seeking a strategic investor to inject Kshs 5.0 bn into its business. The cash will be raised either through equity, convertible debt or a combination of both. However, of keynote is that their current market-capitalization is Kshs 3.3 bn, and hence will have to issue new shares, or take a combination of debt and equity. We feel that this move is positive, and will help Uchumi in funding its turnaround strategy following the difficulties the retailer has faced in terms of selling its land assets to raise capital. Following its Q3?2014 rights issue, where the retailer was able to raise Kshs 895.8 mn, Jamii Bora Bank became the largest shareholder with a 15.7% stake, while the Government of Kenya is second with a 14.6% stake. We are of the view that the entry of a cash rich strategic investor will be positive for Uchumi, which needs (i) the funds to recover its position in the market and manage a complete turnaround, and (ii) will most likely be a private investor who will add management expertise and give additional direction to the Board, similar to what Choppies is aiming to achieve with Ukwala but what is key to watch is who that investor shall be as they could come in at a huge discount and dilute the existing shareholders.

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 price dips.

all prices in Kshs unless stated

EQUITY RECOMMENDATIONS - WEEK ENDED 24.12.2015

No.	Company	Price as at 18/12/15	Price as at 24/12/15	w/w Change	Target Price*	Dividend Yield	Upside/ (Downside)**	Recommendation
1.	KCB	40.0	40.1	0.2%	58.3	5.4%	50.8%	Buy
2.	Equity	39.0	40.1	2.8%	49.4	5.1%	28.3%	Buy
3.	DTBK	195.0	195.0	0.0%	246.1	1.4%	27.6%	Buy
4.	Barclays	13.4	13.3	(0.4%)	15.3	7.3%	22.3%	Buy
5.	Britam	13.8	13.3	(3.3%)	15.9	0.1%	19.9%	Accumulate
6.	Kenya Reinsurance	21.5	21.0	(2.3%)	24.2	3.2%	18.2%	Accumulate
7.	NIC	42.5	43.0	1.2%	49.6	2.7%	18.0%	Accumulate
8.	Standard Chartered	206.0	202.8	(1.6%)	228.5	5.2%	17.9%	Accumulate
9.	I&M	101.0	100.0	(1.0%)	108.8	2.7%	11.5%	Accumulate
10.	National Bank	14.6	14.5	(0.7%)	16.1	0.0%	11.0%	Accumulate
11.	Safaricom	16.7	15.9	(4.8%)	16.3	4.6%	6.8%	Hold
12.	Co-operative bank	18.0	17.6	(1.9%)	17.8	3.5%	4.6%	Lighten
13.	Uchumi	8.7	9.5	9.8%	9.7	0.0%	2.1%	Lighten
14.	Pan Africa	61.5	61.5	0.0%	62.1	0.0%	1.0%	Lighten
15.	Jubilee Insurance	459.0	440.4	(4.1%)	428.9	1.6%	(1.0%)	Sell
16.	Housing Finance	21.3	21.7	2.1%	19.8	5.4%	(3.4%)	Sell
17.	CfC Stanbic	84.0	80.0	(4.8%)	77.2	0.0%	(3.5%)	Sell
18.	CIC Insurance	6.4	6.4	0.0%	5.8	1.3%	(7.5%)	Sell
19.	Liberty	20.0	20.0	0.0%	16.7	0.0%	(16.4%)	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

LeapFrog Investments got a USD 200 mn commitment from the Overseas Private Investment Corporation (OPIC), the U.S. Government?s development finance institution, bringing commitments to LeapFrog to over USD 1 bn. This is the first billion-dollar group dedicated to equity impact investing. The capital will be used for financial services and healthcare deals in Africa and emerging Asia. Other investors who have committed to the fund include AIG, J.P. Morgan, MetLife, Prudential Financial, TIAA_CREF and Alliance Trust, AXA, HESTA, Partner Re, Swiss Re, XL Catlin and Zurich. LeapFrog has already invested in Kenya in financial services and healthcare, through APA and Resolution Health.

As highlighted in our *Cytonn Monthly October 2015*, the attractiveness of financial services is based 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.

In other news, private equity firm The Abraaj Group (Abraaj) and development finance institution Proparco have successfully exited 83% of their combined stake in Tunisian pharmaceutical company Unimed. Abraaj and Proparco exited the investment to a consortium of investors including Washington-based SQM, Blakeney Asset Management, the Tunisian-Kuwaiti Consortium of Development (CTKD), and two local investors at an undisclosed amount. Unimed is the second largest local pharmaceutical company in Tunisia, specializing in sterile dosage forms such as liquid and powder injectables and intravenous (IV) solutions and a range of ophthalmic products. Unimed manufactures for global partners such as Pfizer and Mylan, and is the first company in Tunisia to be AFFSAP-certified. This is the third exit by Abraaj in Q4?2015, coming after exiting its stakes in Network International and Saham Finances in November 2015. Abraaj exits seem as a realignment of its business strategy across all markets where it has presence.

Real Estate

In the news this week is a highlight of foreign financed real estate developments. Notably is Avic **Industry Corporation of China (AVIC)** that bought a 38.9% stake in Centum?s Two Rivers mixed development for Kshs 6.4 bn in April. The firm has also entered the development scene and currently has 2 ongoing projects in the Nairobi area; (i) a 43 story integrated mixed use development fronting Chiromo Lane valued at Kshs 9.6 bn, and (ii) a residential apartment complex consisting of 110 units in Kileleshwa with a project value of Kshs 4 bn. Though it has not been a smooth ride for the corporation given the opposition it is facing in its project in Chiromo Lane, the impact it has made on the Kenyan real estate scene has been immense.

The retail mall scene has also attracted serious interest from international firms both in development and investment. The Garden City project by the UK based private equity firm, Actis is one example. The project is valued at Kshs 54 bn and has facilitated the entry of international retail brands like The Game who are seeking to tap into the increased purchasing power of the middle class. South Africa?s Delta Africa Property Holdings also reached an agreement to purchase a 45% stake in Buffalo Mall, which marked its entry into the Kenyan property sector. With the improved ease of doing business and the superior returns in the real estate sector, we expect to see more inflows of funds in the new year as international investors continuously venture into emerging markets.
