Investing in Unit Trust Funds, & Cytonn Weekly #20/2019

Fixed Income

T-Bills & T-Bonds Primary Auction:

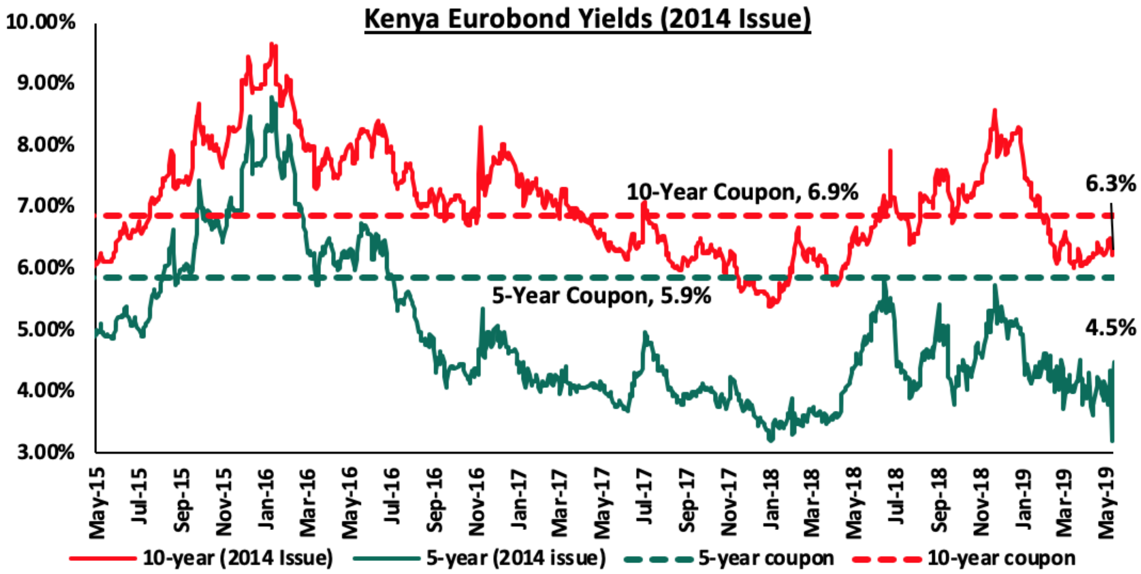
T-bills remained undersubscribed during the week, with the overall subscription rate increasing to 92.3%, from 57.9% recorded the previous week. The improved subscription was attributable to improved liquidity in the market following the end of the monthly Cash Reserve Requirement (CRR) cycle. The yields on the 91-day, 182-day and 364-day papers declined by 3.6 bps, 8.3 bps and 0.4 bps to 7.2%, 7.8% and 9.3%, respectively. The acceptance rate declined to 75.0% from 99.9% recorded the previous week, with the government accepting a total of Kshs 16.6 bn of the Kshs 22.1 bn worth of bids received. Investors' participation was skewed towards the longer dated paper, with the 364-day recording improved subscription to 193.0%, from 59.7%, the previous week, while the subscription rates for the 91-day and 182-day papers declined to 49.8% and 8.0%, from 88.0% and 44.1% recorded the previous week, respectively.

Liquidity:

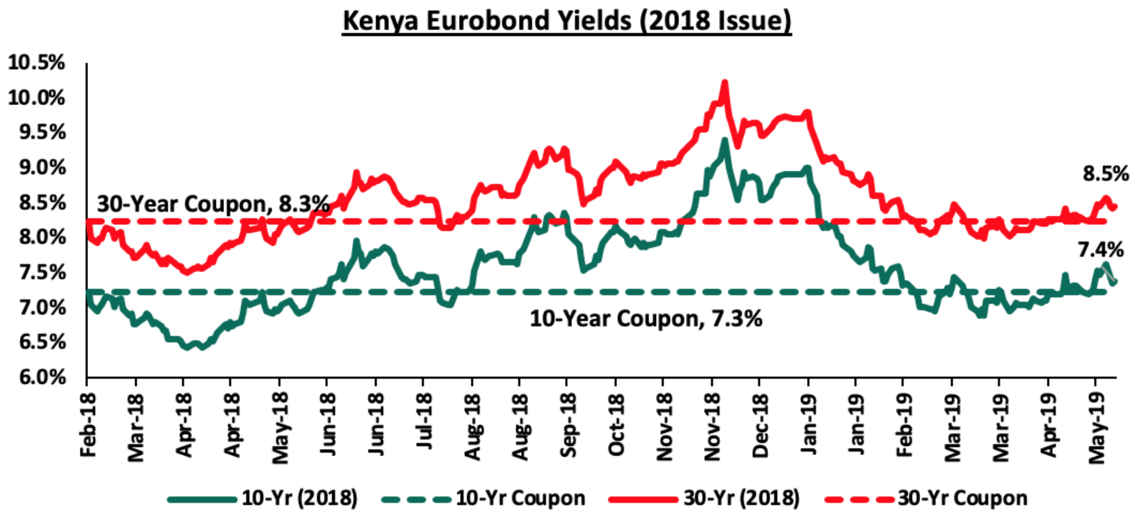
During the week, the average interbank rate declined to 5.7%, from 6.4% recorded the previous week, pointing to improved liquidity conditions in the money market, following the end of the monthly Cash Reserve Requirement (CRR) cycle and supported by government payments, which offset tax remittances by banks. The average volumes traded in the interbank market rose by 46.8% to Kshs 20.0 bn, from Kshs 13.6 bn the previous week.

Kenya Eurobonds:

According to Bloomberg, the yield on the 10-year Eurobond issued in 2014 declined by 0.1% points to 6.3% from 6.4% the previous week, while that of the 5-year rose by 0.3% points to 4.5% from 4.2% the previous week. Key to note is that these bonds have 1.3-months and 5.1-years to maturity for the 5-year and 10-year, respectively.



For the February 2018 Eurobond issue, yields on the 10-year Eurobond declined by 0.1% points to 7.4% from 7.5%, recorded the previous week while the yield on the 30-year Eurobond remained unchanged at 8.5% from the previous week. Since the issue date, the yields on both the 10-year Eurobond has increased by 0.1% points while the yields on the 30-year Eurobond has increased by 0.2% points.



The Kenya Shilling:

During the week, the Kenya Shilling remained stable against the US Dollar to close at Kshs 101.1, unchanged from the previous week, supported by inflows from investors buying government securities that matched dollar demand from merchandise importers. The Kenya Shilling has appreciated by 0.7% year to date in addition to the 1.3% appreciation in 2018, 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 with preliminary data on balance of payments indicating continued narrowing to 4.7% of GDP in the 12-months to February 2019, from 5.5% recorded in February 2018. The decline has been attributed to improved agriculture exports, increased diaspora remittances, strong receipts from tourism, and lower food and SGR-related equipment relative to 2017,
ii. Improving diaspora remittances, which have increased cumulatively by 3.8% in Q1’2019 to USD 665.6 mn, from USD 641.5 mn recorded in a similar period of review in 2018. The rise is due to:
   a. Increased uptake of financial products by the diaspora due to financial services firms, particularly banks, targeting the diaspora, and,
   b. New partnerships between international money remittance providers and local commercial

banks making the process more convenient,

iii. CBK's supportive activities in the money market, such as repurchase agreements and selling of dollars, and,
iv. High levels of forex reserves, currently at USD 8.0 bn (equivalent to 5.2-months of import cover), above the statutory requirement of maintaining at least 4-months of import cover, and the EAC Region's convergence criteria of 4.5-months of import cover.

Highlights of the Week

During the week, Kenya issued its 3rd Eurobond, raising USD 2.1bn (Kshs 210.0 bn) through a dual-tranche Eurobond of 7-year and 12-year tenors, value dated 15th May 2019. A longer-term issuance would have been more preferable, though it comes at a trade-off on the yields as investors would demand a higher risk premium to compensate for the risk in tandem with the repayment period of the loan. The Eurobond will be listed on the London Stock Exchange (LSE). The issue was 4.5x oversubscribed attracting orders worth USD 9.5 bn. The Eurobond was priced at 7.0% for the 7-year tenor and 8.0% for the 12-year tenor with the proceeds expected to go towards:

i. Refinancing the obligations outstanding from the USD 750.0 mn Eurobond issued in 2014, which is due on 24th June, 2019, and,
ii. Financing development infrastructure projects as well as the general budgetary expenditure.

The additional funds obtained from the Eurobond will add to the public debt burden, which stood at Kshs 5.4 tn as at March 2019, according to the latest data released by the CBK. As at the end of 2018 the debt to GDP ratio stood at 57.5%. We expect the new issue to drive the debt to GDP ratio to "around" 60.0%, which continues to raise concern mainly driven by the inability of KRA to meet the set revenue collection targets. As at the end of March, ordinary revenue hit Kshs 1.1 tn against a target of Kshs 1.4 tn. The performance of the issue was commendable considering the current market conditions, with the International Monetary Fund (IMF) having withdrawn their stand-by credit facility in 2018, coupled with the downgrading of Kenya's growth prospects by both the IMF and the World Bank. Key to note is that, unlike the previous issues, with expected bullet payments on the maturity date, both the 7-year and the 12-year tenors are sinkable which means that the repayment of the principal will be amortized equally, at USD 300 mn and USD 400 mn, respectively, per year in the last three years to maturity, as opposed to a full repayment of the principal on redemption. This is commendable as it will avoid a spike in repayments in one particular year. The pricing is also fairly favourable, in comparison to the coupon on similar tenor bonds issued by Nigeria on 23rd November 2018, priced at 7.6% and 8.7% for the 7-year and 12-year Bond. Nigeria and Kenya have a similar B+ Long-Term Foreign-Currency Issuer Default Rating (IDR) with a Stable Outlook. Concerns however remain on the use of the proceeds. For a country to be able to refinance its debt obligations, funds ought to be directed to projects whose economic rate of return is higher than the cost of debt. The debt is however expected to repay maturing obligations as well as fund infrastructure projects whose economic rate of return continue to be in contention. The maturity profile of the debt also raises concerns as it's relatively short, which raises maturity concentration risk as the country will be in a continuous state of maturing obligations between 2024 and 2028 since:

i. The 10-year Eurobond issued in 2014 will be maturing in 2024,
ii. There will be the yearly repayments of USD 300.0 mn for the 7-year Eurobond issued in 2019 will be maturing in May 2027, whose repayments, are set to start in 2025, and,
iii. The 10-year Eurobond issued in 2018 will be maturing in 2028.

The Energy and Petroleum Regulatory Authority released their monthly statement on the maximum retail fuel prices in Kenya effective from 15th May 2019 to 14th June 2019. Below are the key take-outs from the statement:

i. Petrol prices have increased by 5.1% to Kshs 112.0 from Kshs 106.6 per litre previously, and,
ii. Diesel and kerosene prices have increased by 2.2% and 2.3% to Kshs 104.4 and Kshs 104.6 per litre, respectively, from Kshs 102.1 and Kshs 102.2 per litre, previously.

The changes in prices are attributable to:

i. An increase in the average landing cost of imported super petrol by 11.4% to USD 691.3 per ton in April 2019, from USD 620.5 per ton in March 2019, diesel increasing by 2.8% to USD 641.7 per ton from USD 624.5 per ton and Kerosene increasing by 2.0% to USD 675.8 per ton, from USD 662.6 per ton,
ii. The Free on Board (FOB) price of Murban crude oil lifted in April 2019 also increased by 6.5% to USD 73.1, from USD 68.6 per barrel in March 2019, and,
iii. The mean monthly US Dollar to Kenya Shilling exchange rate also depreciated by 0.7% to Kshs 101.1 in April, from Kshs 100.5 in March.

Consequently, we expect a rise in the transport index, which carries a weighting of 8.7% in the total consumer price index (CPI), due to the increased petrol and diesel prices. We shall publish our inflation projections in next week's report.

Rates in the fixed income market have remained relatively stable as the government rejects expensive bids as they are currently 18.0% ahead of its domestic borrowing target for the current financial year, having borrowed Kshs 330.6 bn against a pro-rated target of Kshs 280.3 bn. A budget deficit is likely to result from depressed revenue collection, creating uncertainty in the interest rate environment as additional borrowing from the domestic market goes to plug the deficit. Despite this, we do not expect upward pressure on interest rates due to increased demand for government securities, driven by improved liquidity in the market owing to the relatively high debt maturities. Our view is that investors should be biased towards medium-term fixed income instruments to reduce duration risk associated with long-term debt, coupled with the relatively flat yield curve on the long-end due to saturation of long-term bonds.
