Cytonn INVESTMENTS

Nanyuki Real Estate Investment Opportunity, 2019, & Cytonn Weekly #23/2019

Fixed Income

Money Markets, T-Bills & T-Bonds Primary Auction:

T-bills remained oversubscribed during the week, with the overall subscription rate declining to 116.0%, from 129.4% recorded the previous week. The continued oversubscription is attributable to favourable liquidity in the market supported by government payments. The yields on the 91-day and 182-day papers both declined by 0.1% points to 6.9% and 7.6%, from 7.0% and 7.7% recorded the previous week, respectively, while the yield on the 364-day paper remained unchanged at 9.3%. The acceptance rate declined to 62.2%, from 91.9% recorded the previous week, with the government accepting a total of Kshs 17.3 bn of the Kshs 27.8 bn worth of bids received, lower than the weekly quantum of Kshs 24.0 bn, as the government is currently under no borrowing pressure being 17.1% ahead of the FY'2018/2019 borrowing target. Investors' participation remained skewed towards the longer-dated paper, with the continued demand being attributable to the scarcity of newer short-term bonds in the primary market. The 364-day recording improved subscription to 261.1%, from 210.5% the previous week, while the subscription rates for the 91-day and 182-day papers declined to 22.6% and 8.1%, from 146.1% and 46.4% recorded the previous week, respectively.

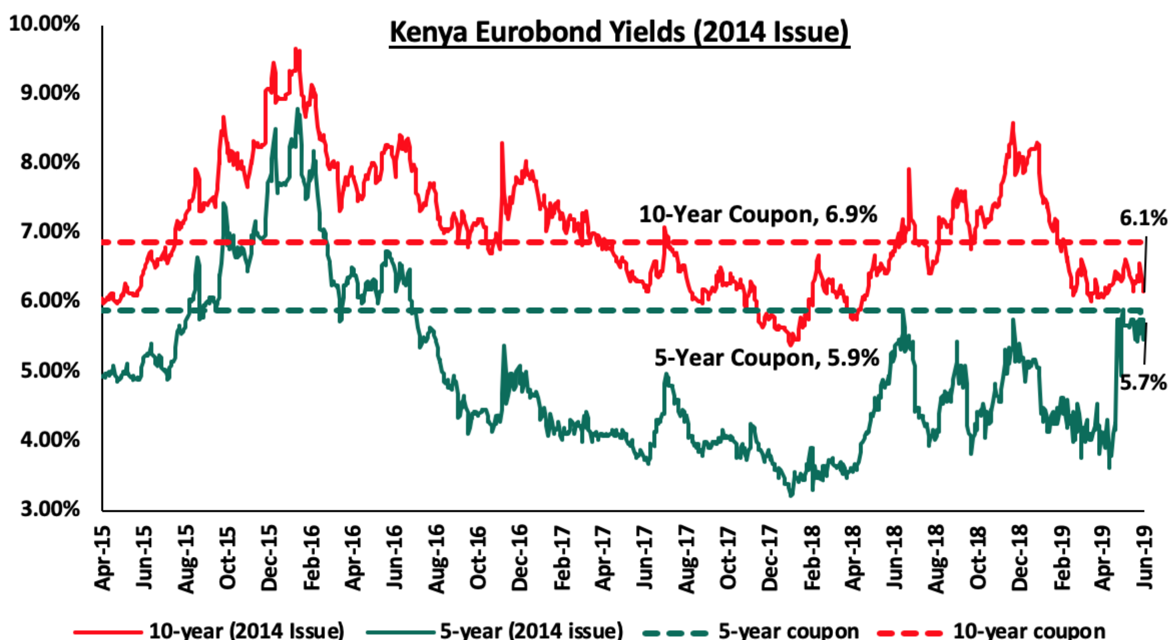
In the money markets, 3-month bank placements ended the week at 9.0% (based on what we have been offered by various banks), 91-day T-bill at 6.9%, average of Top 10 Money Market Funds at 9.3%, with the Cytonn Money Market Fund closing the week at 11.1%.

Liquidity:

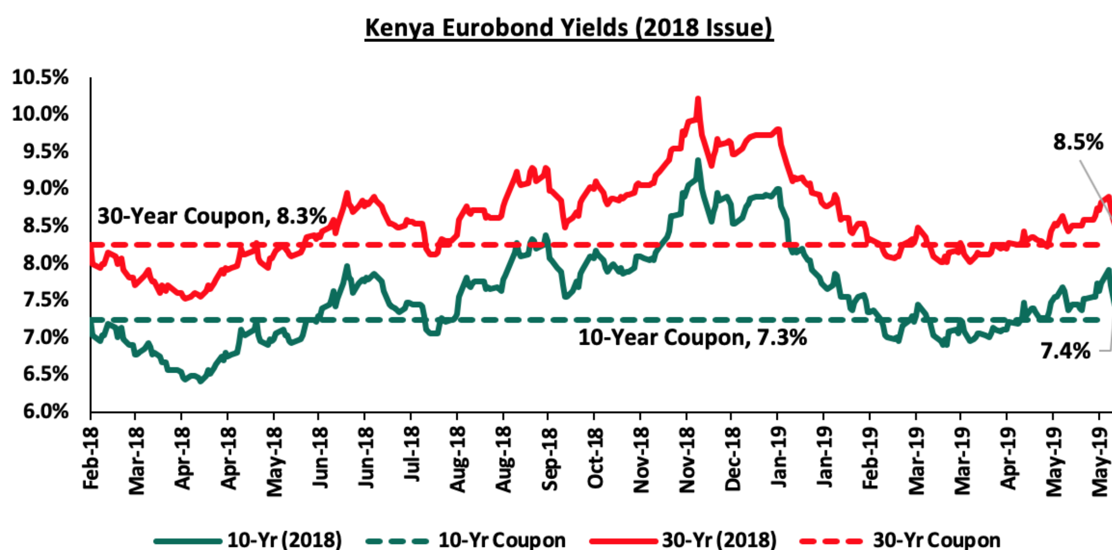
During the week, the average interbank rate declined to 3.9%, from 4.7% recorded the previous week, pointing to improved liquidity conditions in the money market supported by government payments, which saw commercial banks' excess reserves coming in at Kshs 14.5 bn in relation to the 5.25% cash reserves requirement (CRR). The average volumes traded in the interbank market also declined by 31.7% to Kshs 7.6 bn, from Kshs 11.1 bn the previous week.

Kenya Eurobonds:

The yield on the 10-year Eurobond issued in 2014 declined by 0.3% points to 6.1%, from 6.4% the previous week, while that of the 5-year remained unchanged from the previous week at 5.7%. Key to note is that these bonds have 16-days and 5.0-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 0.3% points to 7.4% from 7.7% recorded the previous week, while the yield on the 30-year Eurobond also declined by 0.3% points to 8.5% from 8.8% the previous week.



For the newly issued dual-tranche Eurobond with 7-Years and 12-years tenor, priced at 7.0% for the 7-year tenor and 8.0% for the 12-year tenor, respectively, the yield on the 7-year bond and 12-year bonds both declined by 0.2% points to 6.9% and 7.9%, respectively from 7.1% and 8.1% recorded the previous week.

The Kenya Shilling:

During the week, the Kenyan Shilling appreciated by 0.1% against the US Dollar to close at Kshs 101.3, from Kshs 101.4 the previous week, supported by inflows from diaspora remittances, which outweighed dollar demand from merchandise importers. The Kenya Shilling has appreciated by 0.5% 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 data on balance of payments indicating continued narrowing to 4.5% of GDP in the 12-months to April 2019, from 5.5% recorded in April 2018. The decline has been attributed to the resilient performance of exports particularly horticulture and coffee, strong diaspora remittances, and higher receipts from tourism and transport services. Growth of imports also slowed mainly due to lower imports of food,

ii. Improving diaspora remittances, which have increased cumulatively by 3.8% in the 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 an all-time high of USD 10.1 bn (equivalent to 6.4-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-

According to Stanbic Bank's Monthly PMI released during the week, Kenyan firms saw a solid rise in new business and a renewed improvement in operating conditions during the month of May, after recording a deterioration in April for the first time since November 2017. The headline PMI reading rose to 51.3 from 49.3 recorded in April to signal an improvement in the health of the Kenyan private sector. Readings above 50.0 signal an improvement in business conditions, while readings below 50.0 show a deterioration. This increase was the first in the last five months. In the private sector, new orders grew with several businesses reporting that they had acquired new clients including some International ones. Consequently, output levels expanded but the gain was marginal and weaker compared to the last sequence of growth that ended in March. This was as a result of cash flow problems in the economy, but many businesses remained resilient and raised activity in line with the increased demand. Notably, many firms held back on purchases with the rise in input prices. The higher demand levels contributed to modest growth in employment among Kenyan businesses in terms of increase marketing roles. Firms were, however, unable to keep up with the new orders and backlogs grew at the fastest rate since September. Going forward, risk of high input prices remains abound due to the continued rising fuel prices coupled with the effects of delayed onset of long rains this year. Should the government clear the arrears as promised, this is expected to lead to a pick up in the sector due to improved cash flows which have continued to be a major problem in recent months.

The National Treasury is set to release the 2019/2020 fiscal year (FY) budget on 13th June 2019. As such, a lot of pre-budget discussions are taking place ahead of the official release and we have written a note with our views before the budget is officially released. Below is a summary of the budget estimates as per the National Treasury FY'2019/20 budget estimates:

Key Highlights of the 2019/20 proposed Budget (Kshs. Billion)

	2018/2019	**2019/2020**	**% Change**
National Government	1,764.1	1,841.3	4.4%
Judiciary	16.1	18.9	17.3%
Parliament	35.1	43.6	24.2%
County Allocation (Inc. conditional)	376.5	371.6	-1.3%
Consolidated Fund Services	962.6	805.8	-16.3%
Overall Budget	**3,154.4**	**3,081.2**	**(2.3%)**

Source: Parliamentary Budget Office and National Treasury FY'2019/20 Budget Estimates

The Total FY'2019/20 budget inclusive of the three arms of government, county allocation and the Consolidated Fund Services (CFS) is estimated at Kshs 3.08 tn, a 2.3% reduction from the Kshs 3.2 tn upward revised FY'2018/19 budget; mainly due to a 16.3% reduced allocation to CFS. The budget, however, is expansionary compared to the initial FY'2018/19 budget, which was at Kshs 3.07 tn but was later adjusted upwards by Kshs 80.0 bn, which is equal to a 2.6% increment. Assuming the current budget ends up experiencing the same adjustments, we shall end up at Kshs 3.2 tn.

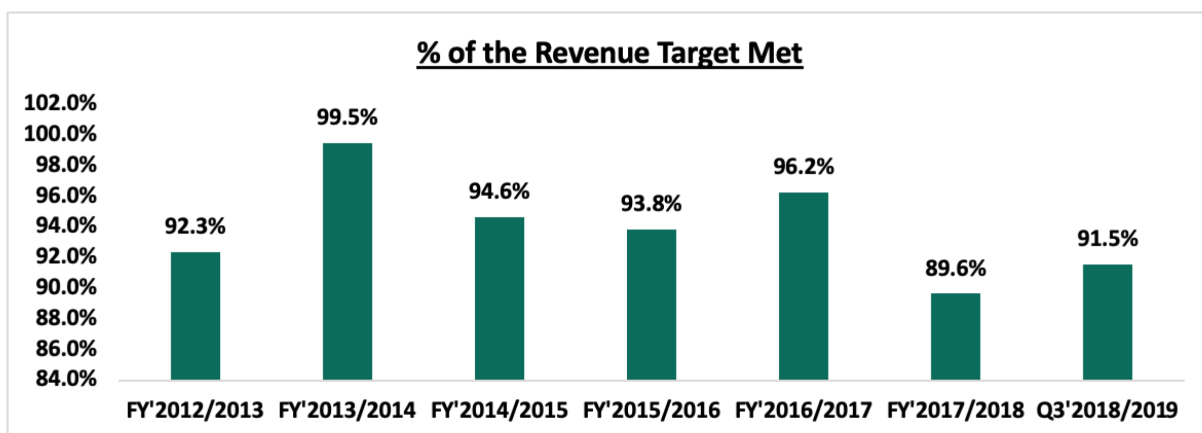
Item	FY'2018/2019 (Revised)	FY'2019/2020	Change y/y
Total revenue	1,852.6	2,115.9	14.2%
Grants	48.5	38.8	(20.0%)
Total revenue & external grants	**1,901.1**	**2,154.7**	**13.3%**
Total expenditure	**2,509.1**	**2,762.5**	**10.1%**
Fiscal deficit including grants	**(608.0)**	**(607.8)**	0.0%
Deficit(excluding grants) as % of GDP	6.6%	5.4%	
Net foreign borrowing	287.0	324.3	13.0%
Net domestic borrowing	321.0	283.5	(11.7%)
Total borrowing	**608.0**	**607.8**	**0.0%**
GDP Estimate	9,990.0	11,346.5	

Source Budget Summary, 2019

1. **Revenue**

Total revenue collected is expected to increase by 14.2% to Kshs 2.1 tn, from the Kshs 1.9 tn as per the revised FY'2018/2019 revised Budget, mainly driven by a 12.2% rise in ordinary revenue to Kshs 1.9 tn, from an estimated Kshs 1.7 tn in the revised FY'2018/19 budget.

In recent years there has been an underperformance in revenue collections and the Government has not been able to meet its revenue target with the worst year being FY'2017/18 where it only managed to raise 89.6% of the targeted total revenue mainly due to a shortfall of Kshs 195.0 bn in ordinary revenue.



As per the Q3'2018/19 Budget outturn, the Kenya Revenue Authority (KRA) had only managed to raise Kshs 1.2 tn against a target of Kshs 1.3 tn representing 91.5% of the targeted revenue collection and it is doubtful that it will meet its target. The continued underperformance has been attributed to ambitious revenue targets set by the Government masking the true budget deficit position. For instance the Kshs 2.12 tn revenue estimate is a Kshs 35.0 bn upward revision from Kshs 2.08 tn as per the 2019 Budget Policy Statement which in effect mitigates the rise in the fiscal deficit

as a percentage of GDP inclusive of grants to around 5.4% of GDP only slightly higher than the 5.1% envisioned in the BPS 2019. Despite the Government's fiscal consolidation efforts, the ambitious revenue targets have often led to the rationalization of the budget later on with the development expenditure mainly taking the hit.

2. **Expenditure**

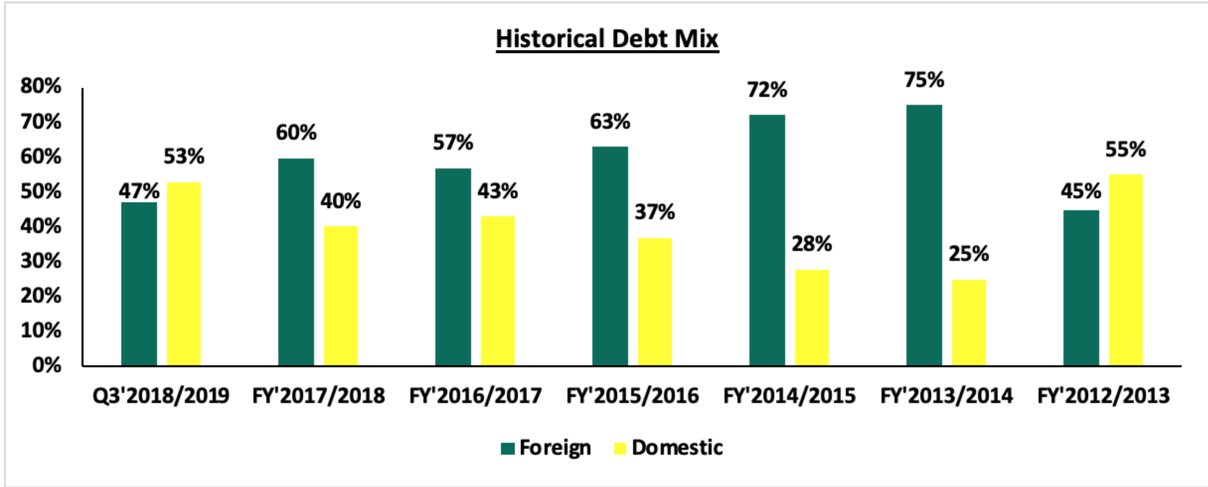
As per the budget books estimates, total expenditure is set to increase by 10.1% to Kshs 2.8 tn from Kshs 2.5 tn as per the revised FY'2018/19 Budget. Key to note

According to the budget books estimates, development expenditure is set to increase by 14.8% to Kshs 684.1 bn from Kshs 595.7 bn in FY'2018/19 with the highest percentage of the outlay expected to support critical infrastructure. Recurrent expenditure, on the other hand, is estimated to increase by 10.4% to Kshs 1.7 tn from Kshs 1.5 tn as per the revised FY'2018/19 budget.

3. **Public Debt**

From the estimates, the total public debt requirement for the FY 2019/20 is set to decline marginally by 0.03% to Kshs 607.8 bn from Kshs 608.0 bn in FY 2018/19. This is attributable to an 11.7% decline in net domestic borrowing to Kshs 283.5 bn from Kshs 321.0 bn in FY'2018/2019 coupled with a 13.0% rise in net foreign borrowing to Kshs 324.3 bn from Kshs 287.0 bn in FY'2018/19.

Key to note, public debt requirement mix, however, is changing, comprising of 53% foreign debt and 47% domestic debt, compared to 47% foreign debt and 53% domestic debt as per the revised FY'2018/19 budget. Foreign financing is higher mainly driven by increased project loans by Kshs 4.8 bn. below is a chart with the debt mix as per recent years budget estimates:



For a comprehensive analysis on this please read our FY 2019/20 Pre-Budget Discussion Note

Rates in the fixed income market have remained relatively stable as the government rejects expensive bids as they are currently 17.1% ahead of its domestic borrowing target for the current financial year, having borrowed Kshs 349.2 bn against a pro-rated target of Kshs 298.2 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.

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