Cytonn INVESTMENTS

Kenya?s Debt Levels, & Cytonn Weekly Report #21

Cytonn Weekly

Executive Summary

- **Fixed Income:** During the week, yields on government securities declined marginally ending the week at 7.7%, 10.0% and 11.3% for the 91, 182 and 364-day T-bills, respectively. The Monetary Policy Committee met during the week and lowered the Central Bank Rate by 100 bps to 10.5% on account of improving macro-economic environment;
- **Equities:** During the week, the market was on a downward trend with the NASI 25 declining 0.8% while NSE 25 and NSE 20 lost 0.6% each. So far, 10 of the 11 listed banks have released their Q1?2016 earnings recording an average core EPS growth of 13.8% with an average loan growth of 15.1% outpacing deposit growth of 11.2% across the sector;
- **Private Equity**: The Mara Group, Atlas Merchant Capital and General Electric have announced an initiative to create a joint venture dedicated to investing in the highly underdeveloped African infrastructure sector;
- **Real Estate:** British standards of construction will be discarded in favour of European norms that are currently approved and used globally. The residential real estate sector in Kenya is set for a major facelift as several county governments have launched plans to either develop or redevelop estates through private public partnership;
- **Focus of the week:** We examine the current debt levels in Kenya and review the sustainable levels and the overall impact on the economy.

Company Updates

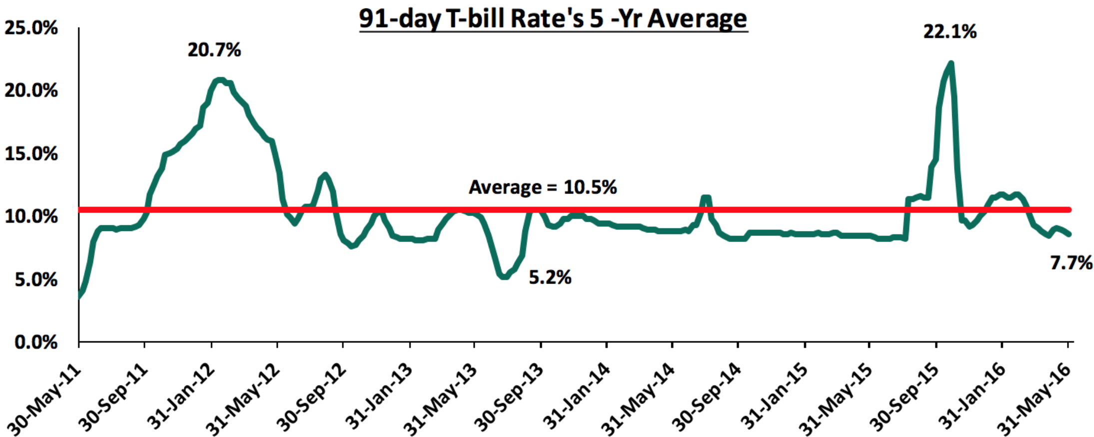
- We held Diaspora professional dinner in Johannesburg, South Africa on 24th May 2016 engaging with investors and investment management firms
- Our Senior Investment Analyst, Duncan Lumwamu, discussed the outcome of the MPC on CBR on CNBC Africa. Duncan Lumwamu on CNBC.

Fixed Income

During the week Treasury bills subscriptions increased to 230.3% from 145.1% the previous week with subscriptions for the 91-day, 182-day and 364-day increasing to 255.3%, 175.7% and 268.2%, from 182.5%, 141.2% and 124.4%, respectively. Investors seem indifferent among the three tenors, indicating that the rates are expected to stabilize at the current levels and the pricing is fair on a risk adjusted basis. The yields declined marginally this week with rates declining to 7.7%, 10.0% and 11.3% for the 91, 182 and 364 day T-bills, respectively, compared to 8.0%, 10.1% and 11.6%, the previous week.

The 91-day T-bill is currently trading below its 5-year average of 10.5%, having witnessed significant stability in the last two months. The Central Bank of Kenya (CBK) is keen on interest rates reduction

supported by the monetary policy stance of lowering the CBR by 100 bps to 10.5%. However, despite the reduction in CBR, we expect the rates to bottom out at the current levels as we close out on the current fiscal year.

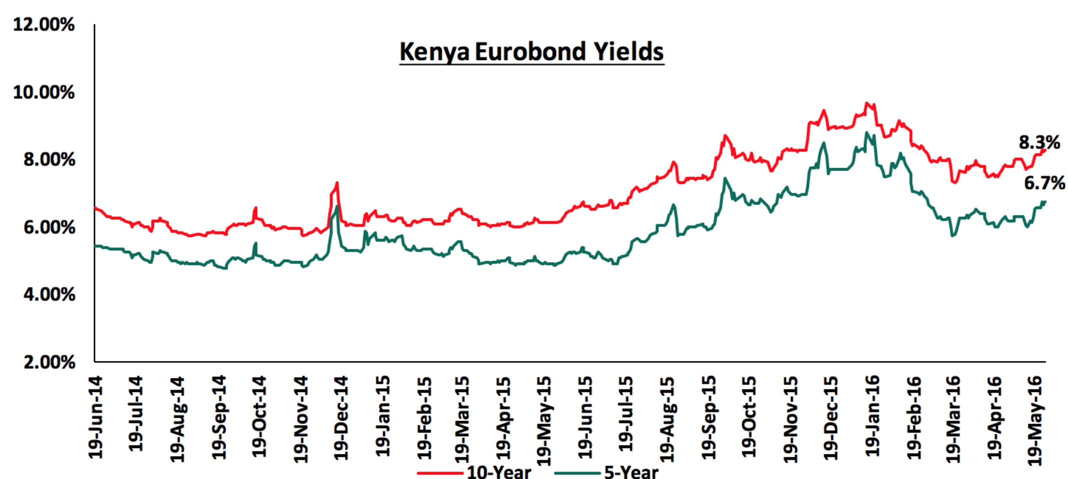


Based on the Central Bank weekly report, the interbank rate increased by 76 bps to 4.3% from 3.6% the previous week on the back of a net liquidity reduction of Kshs 7.8 bn in the money market as shown below:

all values in Kshs bn, unless stated otherwise			
Weekly Liquidity Position - Kenya			
Liquidity Injection	**Kshs bns**	**Liquidity Reduction**	**Kshs bns**
Term Auction Deposit Maturities	25.6	T-bond sales	39.6
Government Payments	20.8	Transfer from Banks ? Taxes	27.6
T-bond Redemptions	20.1	T-bill (Primary issues)	16.9
T-bill Redemptions	12.9	Term Auction Deposit	10.0
T-bond Interest	7.0	Reverse Repo Maturities	3.9
Reverse Repo Purchases	3.8		
Total Liquidity Injection	**90.2**	**Total Liquidity Withdrawal**	**98.0**
		Net Liquidity Injection/Withdrawal	**(7.8)**

Source: CBK

According to Bloomberg, yields on the 5-year and 10-year Eurobonds issued in 2014 have declined 208bps and 139bps, respectively since their peak in mid-January 2016 on account of improving macroeconomic conditions. Week on week, the rates rose to 6.7% and 8.3% from 6.5% and 8.1% with a noticeable upward trend over the last month with yields increasing by approximately 43bps. The rise in yields can be attributed to the perceived increase in political risk associated with weekly demonstrations against the IEBC causing investors to demand a premium to hold the Kenyan Eurobonds. There have been heightened concerns over the amount of debt held by African countries through Eurobonds, which might put the continent, Kenya included, in a precarious position. With only one month left to the close of the current fiscal year, and the government still pursuing the Eurobond route to raise additional funds, we are of the opinion that the proceeds of the Eurobond, if successful, will be used to finance the budget in the next fiscal year.



Government is still ahead of its borrowing schedule having borrowed from the domestic market Kshs 316.0 bn for the current fiscal year against a pro-rated borrowing of Kshs 200.9 bn. The domestic borrowings will help plug the deficits in foreign borrowing of Kshs. 71.6 bn and tax collections of Kshs. 23.5 bn, as shown below.

(all values in Kshs mn, unless stated otherwise)					
2015/2016 Budget Financing					
Source of Financing	**2015/2016 FY Target**	**Pro-rated Target**	**Actual Collection**	**Variance**	**Possible Effect on Interest Rates**
Foreign Borrowing	401,691	368,217	296,650	(71,567)	Negative
Domestic Borrowing	219,200	200,933	315,958	115,025	Positive
KRA Collections	1,254,867	1,150,295	1,126,844*	(23,451)	Negative
Total Funding	**1,875,758**	**1,719,445**	**1,739,452**	**20,007**	Positive

(all values in Kshs bn, unless stated otherwise)				
2015/2016 Budget Expenditure as at December 2015				
Area of Expenditure	**2015/2016 FY Target**	**Actuals**	**Variance**	**Possible Effect on Interest Rates**
Recurrent	501.7	416.5	85.2	Positive
Development	332.2	204.4	127.8	Positive
Other	163.1	106.5	56.6	Positive
Total Expenditure	**997.0**	**727.4**	**269.6**	Positive

Source: The Treasury/CBK

On a net basis the government is not under pressure to fund the budget as the already borrowed funds more than compensates the shortfall in KRA collections. There is no updated data on the expenditure but according to the last published data the expenditure is much slower than projected. As at December 2015, the total expenditure was Kshs 727.4 bn below the target of Kshs 997.0 bn with recurrent expenditure of Kshs 416.5 bn, development of Kshs 204.4 bn and other expenditure of Kshs 106.5 bn.

The Kenyan shilling remained steady ending the week at Kshs 100.7. On a YTD basis, the shilling has appreciated by 1.6% against the dollar supported by (i) the high levels of forex reserve currently at USD 7.6 bn, equivalent to 5.0 months of import cover, and (ii) improved diaspora remittances, with cumulative inflows for 12 months to March 2016 increasing by 10.2% to USD 1.6 bn from USD 1.5 bn over the same period in 2015. These flows were mainly from North America and Europe. The constant growth in inflows will also boost dollar reserves which will keep holding the shilling steady.

The Monetary Policy Committee (?MPC?) met this week to review the prevailing macroeconomic conditions and give the direction of the Central Bank Rate (?CBR?). The MPC lowered the CBR for the first time in 9 months by 100 bps to 10.5% on account of declining inflation (currently at 5.3% from 6.5% in March) and a stable shilling supported by the higher forex reserves equivalent to 5 months of import cover. The move is different from our projections on the MPC note. Despite improvements in macroeconomic environment we see inherent risks and that is why we thought holding the rate at 11.5% would have been in the best interest of the economy; risks include, (i) upward pressure on inflation in the coming months driven by excise duty, VAT on petroleum products and the rising oil prices globally, (ii) spill-over effects if the fed increases rates in June, and (iii) possible increase in the fiscal deficit due to low tax collections.

During the week, credit rating agency Moody?s released a status update on Sub-Sahara Africa, which is undergoing a slowdown in growth as a result of a global economic downturn. According to the report, Kenya?s is among the few Sub-Saharan African (SSA) countries that will experience robust growth and maintain a good credit quality. This shows the importance of economic diversification given that commodity dependent countries continue to suffer from the low commodity prices like oil that have prevailed this year.

The World Bank has approved a Kshs 1.5 bn business grant programme for Kenya to finance initiatives to boost job creation for the youth. If successful, this program will (i) strengthen Kenya?s policy on youth development, (ii) cut poverty levels in the country, and (iii) grow employment numbers. Kenya enjoys a demographic dividend with 72% of its population below 30 years according the Kenya National Bureau of Statistics and the unemployment rate is at about 40.0% according to the World Fact Book. Increased youth engagement in development will help boost economic growth significantly.

We are projecting inflation to remain relatively unchanged in the month of May at around 5.3% in April since the low food and electricity prices are expected to more than compensate the rise in fuel prices. The impact of the increase in excise duty shall be felt in the third quarter as they take effect in July.

The government is ahead of its domestic borrowing schedule, having borrowed Kshs 316.0 bn for the current fiscal year compared to a target of Kshs 200.9 bn (assuming a pro-rated borrowing throughout the financial year of Kshs 219.0 bn budgeted for the full financial year). With one month left to the end of the current fiscal year, the government has surpassed its local borrowing target. The additional 97.0 bn above the target will go towards plugging the tax collection deficit by KRA. The government will look to shift their attention to achieve the foreign borrowing target and start front-loading for the next fiscal year. With interest rates still coming down, but showing signs of bottoming out at the current levels, we advise investors to lock in funds in short to medium term paper for tenors between six months and one year as the rates are attractive on a risk-adjusted basis.

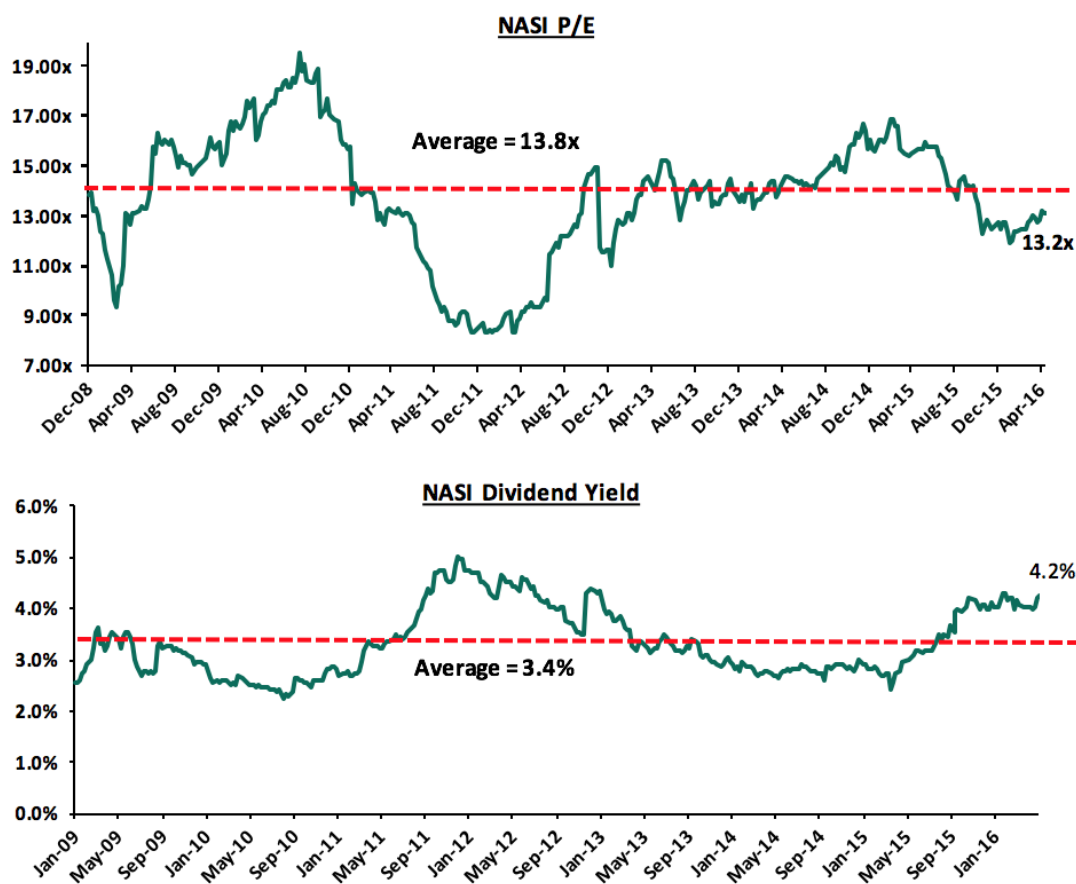
Equities

During the week, the market was on a downward trend with the NASI, NSE 20 and NSE 25 losing 0.6%, 0.6%, and 0.8%, respectively, taking their YTD performance to (0.1%), (4.3%) and (0.1%), respectively. The top movers for the week were EABL and Equity Group accounting for 48.5% of market turnover. KCB group recorded the highest net foreign outflows of USD 1.8 mn after recording an anemic growth in its EPS in Q1?2016. Since the peak in February 2015, NASI and NSE 20 are down 18% and 29.7%, respectively.

Equity turnover rose by 32.2% during the week to USD 27.2 mn from USD 18.4 mn last week. Foreign investors remained net buyers this week, with net inflows increasing to USD 6.0 mn from net inflows of USD 0.4 mn last week. The foreign participation increased slightly to 69.5% from

64.2% last week.

The market is currently trading at a price to earnings ratio of 13.2x versus a historical average of 13.8x, with a dividend yield of 4.2% versus a historical average of 3.4%. The charts below indicate the historical PE and dividend yields for the market;



KCB Group released their Q1?2016 results:

KCB Group released Q1?2016 results recording core earnings per share growth of 6.1% to Kshs 6.1 from Kshs 5.8 in Q1'2015, driven by an 11.5% growth in operating revenue in Q1?2016 which was outpaced by a 15.9% growth in operating expenses in Q1?2016. Key points to note are:

- Operating revenue grew by only 11.5% to Kshs 15.5 bn from Kshs 13.9 bn in Q1?2015 despite a 7% increase in net interest income, which was supported by the relatively high interest rate environment but was offset by a 12.9% decline in non-funded income to Kshs 4.0 bn from Kshs 4.6 bn in Q1?2015
- Operating expenses grew 15.9% to Kshs 8.9 bn from Kshs 7.7 bn on account of: (i) a 149.1% increase in loan loss provision to Kshs 1.4 bn from Kshs 0.5 bn, and ii) increase in staff costs by 7.3% to Kshs 4.1 bn from Kshs 3.8 bn. The faster growth of operating expenses to operating revenue resulted in an increase in the cost to income ratio to 57.3% from 55.1% in Q1?2015. Excluding Loan Loss Provisions (LLPs), operating expenses grew by 5.6% to Kshs 7.5 bn from Kshs 7.1 bn in Q1?2015
- Customer deposits grew by 6.6% to Kshs 423.4 bn from Kshs 397.1 bn in Q1?2015 while loan growth came in at 16.5% to Kshs 345.9 bn from Kshs 297.0 bn in Q1?2015 supported by the retail and corporate business coupled with increased use of KCB Mpesa. Digital platforms currently account for 70% of the Group businesses transactions. Loans to deposit ratio increased to 81.7% from 74.8% in Q1?2015, slightly lower than the industry average of 82.5%
- The yield on interest earning assets decreased to 11.0% from 12.0% in Q1?2016 while the cost of funds decreased to 3.1% from 3.2% leading to a decrease in the net interest margin to 7.9% from 8.8%

- Non-interest income to operating income declined to 26% from 33.3% in Q1?2015 attributable to: i) a 14.5% drop in forex income to Kshs 746.7 mn from Kshs 873.6 mn in Q1 2015 attributable partly to the South Sudan business on the back of currency devaluation and ii) a 51.9% drop in other income to Kshs 258.9 mn from 538.1 mn in Q1 2015

KCB Group?s Q1?2016 results were concerning in three main areas. First, fee income to total revenue actually declined, pulling down overall performance. Cost of deposits and borrowing increased an astronomical by 74%, and loan loss provisions increased by over two times. For a bank with an extensive branch network, the weak deposit growth and high cost of borrowing is puzzling. Rather than focus on regional expansion, KCB Group is better off focussing on optimizing its current franchise particularly on fee income business. The group?s formidable brand should be easily extended to fee income businesses. For more details on KCB Bank Q1?2016 results; please see KCB Group Earnings Note.

Standard Chartered Bank released their Q1?2016 results:

Standard Chartered Bank released Q1?2016 results recording an impressive core earnings per share growth of 42.7% to Kshs 8.4 per share in Q1?2016 from Kshs 5.9 per share in Q1?2015, driven by a 24.0% growth in operating revenue in Q1?2016 outpacing the marginal growth in operating expenses of 6.6% in Q1?2016. Key Points to note are:

- Operating revenue grew by 24.0% to Kshs 7.2 bn in Q1?2016 from Kshs 5.8 bn in Q1?2015 driven by a 66.2% increase in non-interest income to Kshs 2.4 bn from Kshs 1.4 bn in Q1?2015 and a 10.4% increase in net interest income to Kshs 4.9 bn from Kshs 4.4 bn in Q?12015
- Non funded income grew 66.2% supported by: i) 171.6% growth in foreign exchange trading income to Kshs 826.0 mn from Kshs 304.1 mn in Q1 2015, which however is not sustainable due to volatility in the exchange rates, ii) a 10.1% growth in fees and commissions to 76.9 mn from Kshs 69.8 mn, and iii) a 352.3% growth in other income to Kshs 557.5 mn from Kshs 123.2 mn in Q1?2015
- Operating expenses grew by a marginal 6.6% to Kshs 3.6 bn in Q1?2016 from Kshs 3.3 bn in Q1?2015 as the 9.5% rise in staff costs was offset by the 11.6% decrease in loan loss provision. The slower growth in expenses resulted in a significant decrease in cost to income ratio to 49.0% from 57.0% in Q1?2015
- Customer deposits increased by 12.9% to Kshs 184.5 bn, and the growth can be attributed to the aggressive mobilization campaigns rolled out in Q4 to grow deposits. Loans disbursed decreased by 3.7% to Kshs 109.8 bn from Kshs 114.1 bn in Q1?2015 showing a conservative approach to lending leading to a decrease in the loan to deposit ratio to 59.5% from 69.8% in Q1?2015, lower than the industry average of 82.5%

Standard Chartered Bank?s growth going forward will be supported by:

1. Managing the non-performing loan book which has grown to Kshs 15.5 bn in Q1?2016 from Kshs 8.4 bn in Q1?2015 despite a stagnation in the loan book growth through more risk based loan supervision
2. Growing core business as forex income and other income growth may not be sustainable going forward. For more details on Standard Chartered Bank Q1?2016 results; please see Standard Chartered Bank Earnings Note.

National Bank of Kenya released their Q1?2016 results:
National Bank of Kenya released Q1?2016 results recording a core earnings per share decline of 38.4% to Kshs 1.09 per share in Q1?2016 from Kshs 1.77 per share in Q1?2015, driven by a 31.8% growth in operating expenses in Q1?2016 outpacing the 14.5% growth in operating income. Key Points to note:

- Operating revenue grew by 14.5% to Kshs 3.0 bn in Q1?2016 from Kshs 2.6 bn in Q1?2015 driven

by a 22.4% growth in net interest income to Kshs 2.3 bn from Kshs 1.9 bn in Q1?2015

- Operating expenses grew by 31.8% to Kshs 2.5 bn in Q1?2016 from Kshs 1.9 bn in Q1?2015 driven by a 347.7% rise in loan loss provision despite the decline in staff costs by 3.5%. The high growth in expenses resulted in a significant increase in cost to income ratio to 84.1% from 73.1% in Q1?2015
- Customer deposits increased by 16.6% to Kshs 99.4 bn from Kshs 85.3 bn in Q1?2015 showing the prevailing positive sentiment customers have towards the bank despite the recent headwinds on the leadership of the bank. The bank?s loan book declined by 5.3% to Kshs 66.3 bn from Kshs 70.1 bn in Q1?2015 leading to a decrease in the loan to deposit ratio to 66.7% from 82.2% in Q1?2015, lower than the industry average of 82.5%.

National Bank?s growth going forward will be propelled by:

1. The ability to raise funds to shore up their capital requirements which are below Central Bank minimum statutory requirements in order to meet the required threshold and be able to grow the loan book
2. Management of expenses which will enable the bank to control the run-away cost to income ratio, which currently stands at 84.1%, the highest in the industry
3. Removing the overhand associated with the conversion of the preferred shares. Investors need clarity around the conversion terms
4. Improving sentiment towards the bank by clearing out on issues of corporate governance that had resulted in ballooning of Non-performing loans within the lender. For more details on NBK Bank Q1?2016 results; please see NBK Bank Earnings Note.

I&M Bank released their Q1?2016 results:

I&M Bank released Q1?2016 results recording a profit after tax growth of 10.3% y/y to Kshs 1.7 bn from Kshs 1.6 bn in Q1?2015 driven by a 12.5% growth in total operating revenue, which outpaced a 11.3% growth in operating expenses. Key points to note:

- Operating revenue grew 12.5% to Kshs 3.9 bn from Kshs 3.4 bn in Q1?2015 supported by a 14.9% growth in net interest income to Kshs 2.9 bn from Kshs 2.6 bn in Q1?2015. Interest income grew by 14.5% to Kshs 5.1 bn from Kshs 4.5 bn which is marginally higher than the growth in interest expense which grew by 14.0% to Kshs 2.2 bn from Kshs 1.9 bn in Q1 2015
- Operating expenses grew by 11.3% to Kshs 1.4 bn from Kshs 1.3 bn on account of increased loan loss provision that grew by 52.4% to Kshs 219.9 mn from Kshs 144.3 mn in Q1?2015 as well as an 8.3% growth in other operating expenses to Kshs 402.9mn from Kshs 372.9 mn in Q1?2015. The slower growth in expenses, relative to operating income, led to a decrease in the cost to income ratio to 36.0% from 36.4% in Q1?2015. This makes I&M one of the most cost efficient banks.
- Customer deposits grew by 15.7% to Kshs 122.1bn from Kshs 105.5 bn in Q1?2015 outpacing the loan growth of 11.3% to Kshs 117.4 bn from Kshs 105.5 bn in Q1?2015 leading to a decrease in LDR to 96.1% from 100% in Q1?2015 against the industry average of 82.5%

I& M holdings future growth is anchored on:

1. Realization of the regional expansion strategy into Rwanda, Tanzania, Mauritius and other African countries,
2. Diversification of its revenue streams with the acquisition of Burbidge capital,
3. Embracing alternative distribution channels such agency and mobile banking that will improve efficiency as well as cost management. For more details on I&M Bank Q1?2016 results; please see I&M Bank Earnings Note.

Diamond Trust Bank released their Q1?2016 results:

Diamond Trust Bank released their Q1?2016 results recording a core EPS growth of 9.5% y/y to Kshs

6.09 from Kshs 5.56 in Q1?2015. The growth was driven by a 27.9% growth in operating revenue that was outpaced by a 47.4% growth in operating expenses. Key points to note:

- Operating revenue grew 27.9% to Kshs 5.8 bn from Kshs 4.5 bn in Q1?2015 driven by a 39.3% increase in net interest income to Kshs 4.6 bn from Kshs 3.3 bn in Q1?2015. Interest income growth of 45.9% to 8.2 bn from 5.6 bn was outpaced by interest expenses growth of 55.3% to Kshs 3.6 bn from Kshs 2.3 bn in Q1?2015. The growth in interest income was driven by a 24.1% growth in the company loan book while interest expense growth was due to a 1% growth in customer?s deposits,
- Operating expenses grew by 47.4% to 3.3 bn from Kshs 2.2 bn in Q1?2015 driven by: i) a 283% increase in loan loss provision to Kshs 0.89 bn from Kshs.0.23 bn in Q'1 2015 ii) a 19% growth in staff costs to Kshs 960.0 mn from Kshs 806.5 mn in Q1?2015 and (iii) a 20.1% increase in other expenses to Kshs 0.98 bn from Kshs 0.81 bn in Q1'2015. The faster growth in operating expenses to operating revenue led to an increase in cost to income ratio to 57.1% from 49.5% in Q1?2015
- Customers deposits grew by 26.1% to Kshs 206.0 bn from Kshs 163.3 bn in Q1?2015 while the company's loan book increased by 24.1% to Kshs 179.8 bn from Kshs 144.9 bn in Q'1 2015. The banks LDR declined slightly to 87.2% from 88.7 in Q1?2015 higher than the industry average of 82.5%

Moving forward, the bank?s growth will leverage on:

1. Sustainable growth of subsidiaries in Tanzania, Uganda and Burundi that contribute approximately 26% of the banks revenue in full year 2015
2. DTB?s widening footprint in the region, characterized, most notably, by the growing number of branches, which stood at 55 in Kenya, 37 in Uganda, 25 in Tanzania and 4 in Burundi
3. Embracing technology with the launch of 24-hour digital branch concept operating will also offer conventional face- to face interactions between DTB staff and customers. For more details on DTB Bank Q1?2016 results; please see DTB Bank Earnings Note.

In summary, among the listed banks, HF Group has recorded the highest core EPS growth of 47.6%, even though the growth may not be sustainable given that it was driven by significant real estate exists, while NBK has recorded a 38.4% decline in earnings. The average growth in reported earnings across the banking sector stands at 13.6%, attributed to a relatively higher interest rate environment. On average, loan growth has outpaced deposits growth with loans growing by 18.2%, higher than the 9.5% deposit growth, albeit both growths declining from Q1?2015. Below is a summary of the key metrics:

Listed Banks Q1'2016 Earnings and Growth Metrics											
Bank	**Core EPS Growth**		**Deposit Growth**		**Loan Growth**		**Net Interest Margin**		**Fee income to operating revenue**		**LDR**
	Q1'2016	**Q1'2015**	**Q1'2016**	**Q1'2015**	**Q1'2016**	**Q1'2015**	**Q1'2016**	**Q1'2015**	**Q1'2016**	**Q1'2015**	**Q1'2016**
HF Group	47.60%	-33.70%	23.60%	15.90%	12.10%	28.00%	6.60%	6.20%	20.00%	16.70%	130.8%
Stanchart	42.70%	-28.00%	12.90%	9.20%	-3.70%	-10.60%	9.40%	9.20%	32.60%	24.30%	59.5%
Equity Group	19.80%	10.50%	8.10%	34.60%	22.40%	34.60%	11.00%	10.70%	33.30%	42.50%	81.2%
DTB Bank	9.50%	9.40%	26.10%	21.60%	24.10%	26.00%	1.80%	1.70%	20.50%	27.00%	87.2%
Co-op Bank	7.70%	28.70%	11.90%	24.90%	16.10%	19.00%	16.90%	9.80%	33.80%	33.70%	81.7%
KCB Group	6.10%	6.50%	6.60%	26.70%	16.50%	27.10%	8.50%	8.80%	26.00%	33.30%	81.7%
NIC Bank	0.00%	-4.90%	14.80%	4.10%	6.10%	25.30%	8.10%	7.50%	26.80%	31.30%	101.5%
National Bank	-38.40%	20.50%	16.60%	4.30%	-5.30%	48.40%	6.80%	7.80%	24.50%	29.30%	66.7%
I&M Bank	-	-	15.70%	18.30%	11.30%	21.50%	1.80%	1.70%	25.60%	25.70%	96.1%
CFC Bank*	-	-	3.20%	17.30%	14.70%	19.50%	5.90%	5.70%	41.00%	45.00%	95.2%
Weighted Average**	13.8%	4.8%	11.2%	23.6%	15.1%	22.5%	9.1%	8.1%	26.3%	27.9%	82.5%
CFC and I&M numbers are for the bank only. We have excluded them in calculation of the weighted average											
*****Average is Market cap weighted***											

Below is our equities recommendation table, with the following changes:

- Liberty Holdings moved from a ?Hold? to an ?Accumulate? while Diamond Trust Bank moved from

a ?Lighten? to ?Hold? following loses of 6.5% and 2.9%, respectively during the week

all prices in Kshs unless stated								
EQUITY RECOMMENDATION								
No.	**Company**	**Price as at 27/05/16**	**Price as at 20/05/16**	**w/w Change**	**Target Price***	**Dividend Yield**	**Upside/ (Downside)****	**Recommendation**
1.	KCB Group***	39.5	40.8	(3.1%)	53.7	4.9%	40.9%	Buy
2.	Centum	41.5	42.3	(1.8%)	57.2	0.0%	37.8%	Buy
3.	Kenya Re	21	21.5	(2.3%)	26.7	3.5%	30.6%	Buy
4.	NIC	38	37.3	2.0%	42.9	2.7%	15.6%	Accumulate
5.	Liberty	15	16.1	(6.5%)	17.2	0.0%	14.7%	Accumulate
6.	Barclays	10.1	10.4	(2.9%)	10.3	9.7%	12.1%	Accumulate
7.	Equity Group	40.0	40.5	(1.2%)	41.9	4.9%	9.7%	Hold
8.	DTBK***	202.0	208.0	(2.9%)	214.0	1.2%	7.1%	Hold
9.	Stanchart***	207.0	195.0	6.2%	207.2	6.4%	6.5%	Hold
10.	I&M Holdings	110.0	112.0	(1.8%)	112.0	3.1%	4.9%	Lighten
11.	HF Group	20.0	20.0	0.0%	19.6	6.5%	4.5%	Lighten
12.	Co-op Bank	18.2	18.4	(1.4%)	18.0	4.3%	3.7%	Lighten
13.	CfC Stanbic	90.0	85.0	5.9%	85.4	7.2%	2.1%	Lighten
14.	Safaricom	17.1	17.4	(1.4%)	16.6	4.2%	1.4%	Lighten
15.	Jubilee	484.0	483.0	0.2%	477.8	1.8%	0.5%	Lighten
16.	Britam	14.8	15.5	(4.8%)	14.1	1.9%	(2.5%)	Sell
17.	Pan Africa	40.0	40.0	0.0%	39.0	0.0%	(2.5%)	Sell
18.	CIC Insurance	5.2	5.3	(1.9%)	4.7	1.9%	(6.8%)	Sell
19.	National Bank	10.5	10.2	2.9%	8.5	0.0%	(19.0%)	Sell
Target Price as per Cytonn Analyst estimates								
****Upside / (Downside) is adjusted for Dividend Yield***								
*****Indicates companies in which Cytonn holds shares in***								
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								

We remain neutral on equities given the low earnings growth prospects for this year. The market is now purely a stock picker?s market with few pockets

Private Equity

The Mara Group, Atlas Merchant Capital and General Electric have announced an initiative to create a joint venture dedicated to investing in the highly underdeveloped African infrastructure sector. The joint venture will seek to invest in infrastructure equity projects in selected countries throughout Africa to help increase the currently very low connectivity among the 54 countries. This will improve the Intra-African trade, a key driver for economic growth, which currently has been largely affected by the growing shortfall in infrastructure development. The joint venture will focus on power generation, transport, oil & gas and other infrastructure areas including mining.

Private equity investments in Africa remain robust as evidenced by the increased deals and deal volumes in the region key note sectors; financial services, energy, FMCG, real estate, and technology. Given (i) the high number of global investors looking to cash in on the growing middle class of Africa, (ii) the attractive valuations in private markets compared to global markets, (iii) better economic projections in Sub-Sahara Africa compared to global markets, and (iv) the high number of exits that is evidence of the attractiveness of the region, we remain bullish on PE as an asset class in Sub-Sahara Africa.

Real Estate

The government approved new building regulations in Kenya in which British standards will be discarded in favor of European norms that are currently approved and used globally. This comes at a period when the current legislation governing the practice of surveyors and architects needs to be

reviewed since its provisions have become outdated. The legislation was passed in 1934 and it?s too old to accommodate today?s innovative construction methods.

Professionals in the construction industry in Kenya will have to undergo retraining, which will take a maximum of five years before being certified as Eurocode compliant. Moi University will carry out the retraining process and it is in process of developing the curriculum.

European standards are preferred over British standards due to the following factors:

- Require uniformity in structural designs of buildings and other civil engineering works comprising of geotechnical aspects and structural features
- Eurocodes embody the most up to date research on aspects of structural behaviour
- Less prescriptive approach of the Eurocodes allows greater slope for innovation and encourage designers to use advanced analysis techniques which will lead to better value for money

The adoption will curb the incidents of substandard buildings, unqualified personnel and achieve global construction standards in the Kenyan construction industry.

The residential real estate sector in Kenya is set for a major facelift as several county governments have launched plans to either develop or redevelop estates in county government headquarters. For instance, this week the Nairobi County government announced a plan to construct 100,000 housing units?, approximated to cost Kshs 300 billion in a public private partnership (PPP) in Old and New Ngara, Pangani, Jeevanjee-Bachelors, Ngong Road inspectorate staff quarters, Uhuru and Suna Road estates. The construction is expected to be completed in phases, the first phase scheduled to begin in July 2016 with 14,000 units constructed in seven estates and the second phase following immediately after phase one completion. These estates currently comprise of old houses, constructed horizontally hence occupying a lot of space. This comes a few months after KCB placed a bid to redevelop Old and New Ngara, Pangani, estates in a PPP with the County government as well as NHC biding to construct 1,050 housing units for the national police service

The trend is not limited to Nairobi with several other county governments adopting the Public private partnership way of financing their projects. They include:

- Mombasa county in a project dubbed ?urban renewal and redevelopment of old estates? aimed to renovate 10,000 houses in estates like Khadija, Miritini, Changamwe, Tudor, Mzizima, Buxton, Likoni among others with modern ones working with private developers.
- Kakamega county in partnership with housing finance to put up 1,000 houses for county staff
- A PPP deal between the Meru County and the CPF group which will involve an 115,000 square feet, 15-storey office complex.
- Uasin Gishu county in Partnership with Wiehai International Economic and Technical Corporation of China for the project to renovate 3,000 houses owned by the county government

The current trend of the county governments engaging in Public private partnership to redevelop the existing old estates if successful may see a reduction in the housing deficit. This is as the already signed up memorandums have a big housing pipelines with Nairobi alone expecting over 100,000 houses by the end of year. This will also lead to a great reduction in informal settlements that stands at 60% of the residents in Nairobi according to African Development Bank research in 2013.

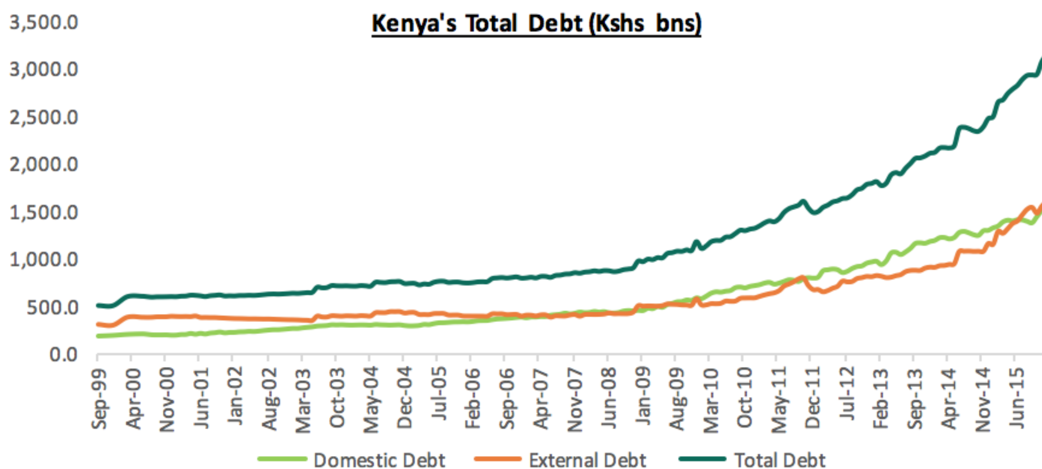
However, we remain highly skeptical about the ability of PPPs working for the real estate sector because in order to attract private capital into a project, the respective land has to be separated and moved into a special purpose development vehicle that has title to the land. There is currently no framework to enable transfer of public land into special purpose vehicles that can attract private capital and bank debt. For example, the Kenyan University student hostels PPP between KU and Africa Integras, which was announced in July 2015 is yet to take off.

Focus of the Week. Kenya?s Debt Levels: Are we on sustainable path?

In our previous weeklies, we have discussed about the state of the Kenyan economy, delving into interest rates, performance of the Kenya shilling and the overall impact on economic growth. We also examined the financing avenues that the Treasury has undertaken to fund the budget. This week, given that the budget shall be read in a week?s time, we focus on the level of debt in Kenya.

We examine the key factors driving the debt levels, the impact of the debt levels to the economy. We shall review what is considered sustainable levels and close out on the expectation going forward. Kenya, historically has evolved from a system of donor and bilateral-based lending structures to a much more commercial funding like the Eurobond issuance. We shall also look at the levels of both domestic and external debt.

The level of government debt has continued to increase from the early 2000. As at December 2016, Kenya?s total debt stood at Kshs 3.2 tn compared to Kshs 0.6 tn in December 2000. The composition of the debt is both domestic and also external with the external debt increasing more recently.



Source: The Treasury/CBK

The main factors driving the rise in debt levels in Kenya include:

i. **Low level of investments in infrastructure** in the earlier years meaning that the government has to increase spending currently to bring the infrastructure levels up to speed with the vision of the country as contained in the visions 2030,
ii. **Expansive budget:** Over the years Kenya?s budget has expanded year on year to hit an expected high of Kshs 2.2 tn in 2016/2017. As the economy grows, there has been need to increase both recurrent and non-current expenditures to support; (a) increased wage bill, and (b) increased infrastructural investment
iii. **The devolved governance structure:** With the onset of devolution, the government has continued to raise extra debt to finance expenditure, in particular to support the increased need for cash to fund county governments
iv. **Shortfall in tax revenues:** The Kenya Revenue Authority (KRA) has consistently fallen short on its tax revenue targets, which has been complemented by increased borrowing both locally and from foreign markets

Domestic borrowing consists of debt raised by the government from the local market primarily through auction of bonds and treasury bills. Domestic borrowing currently constitutes 48.8% of the total borrowing, with the portion increasing in tandem to the increase in the size of the budget. The Kenya Treasury bills market is one of the most developed markets in the region with bonds tenors

straddling from 2 years all the way to 30 years at the time of issue. The capital markets have benefitted enormously from this and now the total value of bonds listed on the Nairobi securities exchange stands at Kshs 1.2 tn with an average monthly turnover of Kshs 34 bn over the last 5 years. Local borrowing offers a much convenient avenue for raising funds by the government. The government has continued to come in and borrow a lot from the market and given the growth of the institutional investors? base, i.e. pension schemes, insurance companies, banks etc., the borrowing has been of great success. There are however risks to this as the government has tended to borrow much at higher rates hence depriving credit to the private sectors as the returns from the government securities are great on a risk adjusted basis. The more aggressive the government is in borrowing locally, the greater the pressure on interest rates. As highlighted in our Cytonn Weekly #42, the aggressive local borrowing by the government has been the main factor behind the surge in interest rate environment in 2015.

On foreign borrowing, the government has pursued several means to fill this basket, currently accounting for 51.2% of the total debt. Through syndicated facilities, Eurobond(s) and direct bilateral/concessional loans, the government has been able to raise funds year on year to support its expenditure. Whereas some of these funds come priced at much more favorable rates compared to domestic borrowing, and could have other fringe gains like trade expansion, they pose risks performance of the local currency. Increased foreign debt obligations, increases the level of repayments, which have a rundown effect on the currency as there is increased demand for forex to repay the debt.

Usually like any person, borrowing for investments is usually a great thing as there are ways to amplify the returns. The repayment cash flows could be a strain especially if there is a mismatch of the investment and the debt, however, this can be structured around in most cases. In Kenya, the investment in infrastructure has been great as it has supported trade, both in the country and in the region and hence has been good for economic growth. However, key to note is that the absorption rates in the previous budgets have been low for development expenditure and the worry is that some of the borrowing meant for development could have been used for recurrent expenditure which has continued to grow though at lower rate.

Sustainable Debt levels:

According to the IMF, the sustainable debt levels for the emerging market is 50% to GDP. Kenya currently stands at 52.0%, indicating that we have surpassed the average target. With this high exposure we could be forced to pay a premium if we are to borrow money from the international markets. However, it?s important to note that Kenya?s current debt levels have risen much faster and crossed the sustainable target within the fiscal year 2015/2016, from 41.8% in 2014/2015. The growth has been driven majorly by the external borrowing window, where the government has progressively raised from the global markets. Of importance to note is that commercial external debt has grown significantly, highlighting the overall attractiveness of the said debt in the global market. Kenya has also continued to enjoy the support of international multilateral lenders, including the IMF, who recently extended their standby credit facility to Kenya.

Kenya External Public Debt								
	2012		2013		2014		2015 ? September	
	Amount (USD Bn)	Share	Amount (USD Bn)	Share	Amount (USD Bn)	Share	Amount (USD Bn)	Share
Multilateral Creditors	5.6	57.6%	6.5	60.5%	7.1	49.2%	7.2	49.0%
Bilateral Creditors	2.7	28.1%	2.8	26.6%	3.9	26.9%	4.1	27.7%
Commercial Creditors	0.7	7.0%	0.7	6.5%	2.8	19.6%	2.8	19.1%
Others (supplier)	0.2	1.9%	0.2	1.7%	0.2	1.3%	0.2	1.2%

Total (Excl. guarantees)	**9.1**	**94.6%**	**10.2**	**95.2%**	**13.9**	**96.9%**	**14.3**	**96.9%**
Publicly guaranteed debt	0.5	5.4%	0.5	4.8%	0.4	3.1%	0.5	3.1%
Total (incl. guarantees)	**9.7**	**100.0%**	**10.7**	**100.0%**	**14.4**	**100.0%**	**14.7**	**100.0%**

Source: IMF/The Treasury

So, how do we maintain, if not reduce our debt levels, in line with the IMF sustainable levels? There are a myriad of factors and steps the government could consider to achieve this:

i. **Enhance tax revenue collection:** As highlighted earlier, KRA has consistently fell behind in its target in tax revenue collection. There is need to review the whole tax collection process and implementation. In our view, the government needs to; (a) improve efficiency in tax collections, and (b) create incentives for the tax payers on tax collections, and (c) widen its tax net instead of having a few individuals and institutions pay taxes
ii. **Involvement of Private Sector in development:** With public debt always rising on the dawn of every new infrastructure project, the government should look to partner with private sector to reduce its debt load. Through Public-Private Partnerships (PPPs), the private sector will have a significant role to play in financing of the development expenditure, reducing the burden from the government. To do this well there, would be need to reduce the level of bureaucracies and make it easy to own/develop property with government as a partner
iii. **Reduce the recurrent expenditure:** Currently, the mix of recurrent to development expenditure in Kenya is 78:22 as at December 2015. There is need to reduce the portion of recurrent expenditure, which majorly encompasses public wages. This will in effect reduce the overall expenditure basket, freeing up the debt level.
iv. **Come up with innovative products** like diaspora targeted bonds as it has the benefits of local borrowing yet helps bring money back home.

In conclusion, Kenya currently lies with the safer bounds on debt levels. However, going forward, there are risks associated with the changing funding patterns that could see the debt levels rise. The international markets borrowings should be handled with care as too much borrowings or reliance on global markets open?s up the country to international economic happenings which could be bad for the economy. It is imperative that we be cautious on borrowings if we are to achieve the long term economic stability.

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