Kenya?s 2016/2017 National Budget, and Cytonn Weekly #23

Cytonn Weekly

Executive Summary

- **Fixed Income:** Yields on T-bills continued on a downward trend with the 91, 182 and 364 day dropping to 7.3%, 9.6% and 10.8%, respectively. Kenya?s tourist arrivals have increased by 14.0% compared to a similar period last year, marking a steady recovery in the sector;
- **Equities:** During the week the market was on an upward trend with the NASI, NSE 20 and NSE 25 gaining 2.4%, 0.8% and 1.2%, respectively. Centum Investments released their FY?2016 earnings recording a core EPS growth of 12.4%;
- **Private Equity:** The ICT sector has proven to be a key driver for innovation in Africa, and is beginning to attract capital as Convergence Partners invest USD 1mn in South Africa?s ICT firm, Snapt;
- **Real Estate:** Real estate sector set to benefit from tax incentives for low cost housing development and removal of construction levies; Increased foreign investment highlights positive investor sentiments on the Kenya real estate market
- **Focus of the Week:** The Treasury Cabinet Secretary announced the 2016/2017 budget for Kshs. 2.3 tn, an 11.2% increment from the 2015/2016 budget

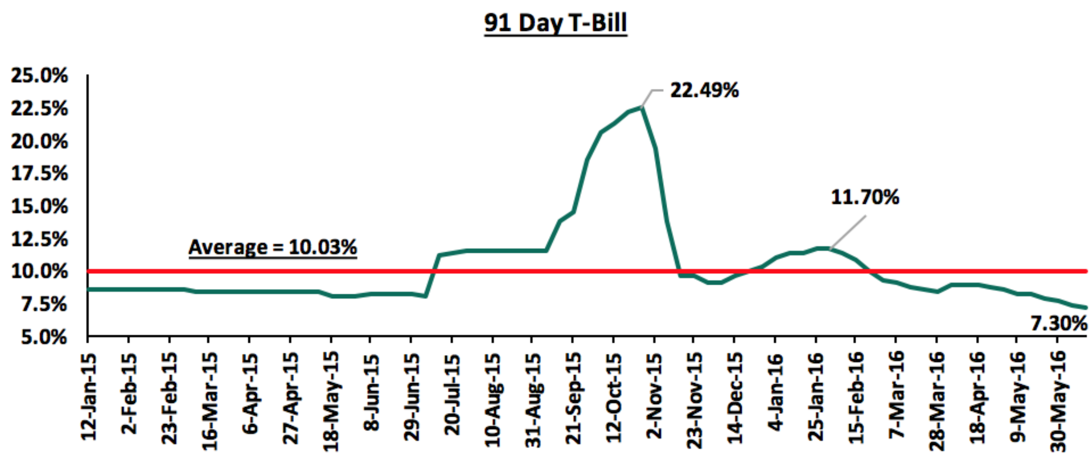
Company Updates

- This week we took the Kenyan real estate opportunity to a roadshow in Helsinki, Finland. The team met both institutional investors, such as Taaleri, FinnFund, OP Financial Group, individual high networth investors, and also the Kenyan diaspora in Helsinki. There is very strong interest in the attractive returns in Kenyan real estate
- The Cytonn Q1?2016 Banking Report has been postponed to 19th June 2016 and will not be released on 13th June 2016 as earlier communicated.
- We continue to beef up the team with other ongoing hires: Careers at Cytonn.

Fixed Income

During the week, Treasury bills were oversubscribed with overall subscriptions coming in at 182.9% compared to 146.6% the previous week. Subscriptions for the 91, 182 and 364-day papers increased to 166.7%, 166.2% and 210.4%, respectively, from 130.7%, 153.2% and 150.6%, respectively. Investor preference shifted to the 364-day paper since on a risk-adjusted basis, investors stand to get higher returns and it also offers lower re-investment risks compared to the other papers. Yields declined to 7.3%, 9.6% and 10.8% for the 91, 182 and 364-day papers, respectively, compared to 7.5%, 9.8% and 11.0%, the previous week.

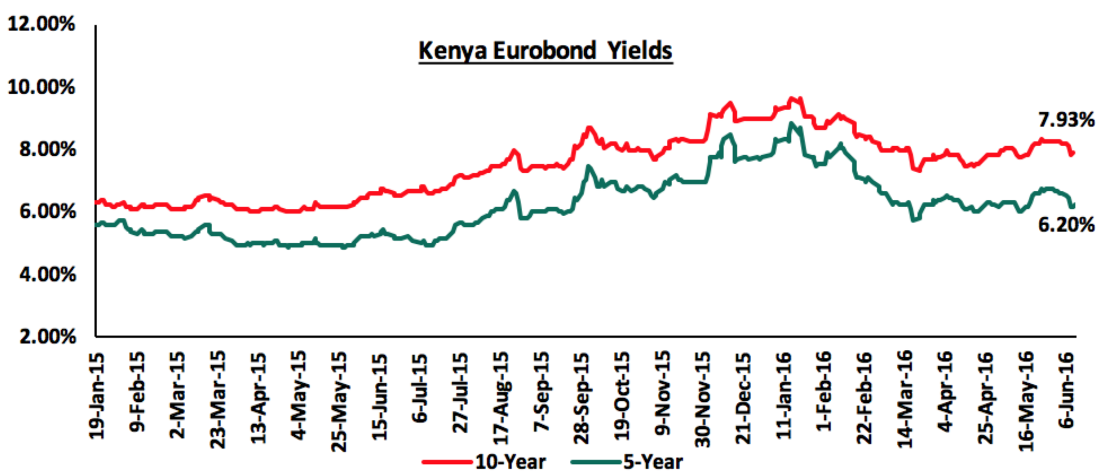
The 91-day T-bill is trading at 270 bps below its 5-year average of 10.0%, having been coming down steadily over the past 2 months. Despite the CBK reducing the policy rate by 100 bps, we believe that the rates have bottomed out and is likely to stabilise at the current level especially given that we have come to the end of the fiscal year.



The money markets were liquid during the week as evidenced by the interbank rate declining to 2.3%, from 3.2% at the close of last week. Below is a summary table of the money market activity, which indicated a marginal reduction in liquidity week on week:

all values in Kshs bn, unless stated otherwise			
Weekly Liquidity Position ? Kenya			
Liquidity Injection		**Liquidity Reduction**	
Term Auction Deposit Maturities	2.0	T-bond sales	0.0
Government Payments	34.4	Transfer from Banks ? Taxes	14.4
T-bond Redemptions	7.6	T-bill (Primary issues)	17.8
T-bill Redemptions	0.0	Term Auction Deposit	8.0
T-bond Interest	0.0	Reverse Repo Maturities	10.8
Reverse Repo Purchases	6.6		
Total Liquidity Injection	**50.6**	**Total Liquidity Withdrawal**	**51.0**
		Net Liquidity Withdrawal	**0.4**

According to Bloomberg, yields for the 5 Year and 10 Year Eurobonds declined week on week by 0.4% and 0.3% to 6.2% and 7.9% from 6.6% and 8.2%, respectively. Since the mid ? January 2016 peak, yields on Kenyan Eurobond have declined by 2.6% and 1.7% and this can be attributed to the improving macroeconomic conditions in the country. Other similar bonds have traded range bound over that same period, like Ghana Euro bond which is currently trading at a yield of 10.8%.



The Government is ahead of its domestic borrowing schedule by Kshs 121 bn having borrowed Kshs. 326.3 bn compared to, pro-rated borrowing target of Kshs. 205.5 bn. This is positive for Government financing as the surplus can be used to plug in the deficit arising from foreign borrowing and tax collection. Below is a summary of the performance of the various modes of budget funding plus the summary expenditure table.

(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	376,585	296,650	(79,935)	**Negative**
Domestic Borrowing	219,200	205,500	326,312	120,812	**Positive**
KRA Collections	1,254,867	1,176,438	1,184,766	8,328	**Positive**
Total Funding	**1,875,758**	**1,758,523**	**1,807,728**	**49,205**	**Positive**

(all values in Kshs. Mn, unless stated otherwise)				
2015/2016 Budget Expenditure as at December 2015				
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**	**727.4**	**269.6**	**Positive**

The Kenya Shilling depreciated slightly against the dollar by 0.2%, to close the week at 101.1 compared to 100.9 the previous week due to strong USD demand in the international markets. On a YTD basis, the shilling has appreciated against the dollar by 1.2% supported by (i) the high levels of foreign exchange reserves currently at USD 7.6 bn, equivalent to 5.0 months of import cover, and (ii) improved diaspora remittances, with cumulative 12 months inflows to March 2016 increasing by 10.2% to USD 1.6 bn from USD 1.5 bn in March 2015.

Kenya?s tourist arrival for the first four months of 2016 increased by 14.0% compared to a similar period last year. The Cabinet Secretary for Tourism, Hon. Najib Balala attributed the growth to (i) aggressive marketing done by the country to attract tourist, and (ii) improvement of security within the country. Also key to note is that arrivals through Jomo Kenyatta International Airport (JKIA) rose by 13.6%y/y while Mombasa?s Moi International Airport recorded a 9.8%y/y increase. The cabinet secretary also said that the ministry will allocate Kshs. 250 mn to further their marketing efforts in Africa with 60% being allocated to the East African region. This was prompted by the fact that arrivals from Tanzania, Uganda and Rwanda declined by 17.3%y/y, 8%y/y and 1.3%y/y respectively. Restoration of tourism as a main foreign exchange earner will be beneficial to the country and will further boost the stability of the currency. However, with the political climate heating up given the recent protests, the Governments efforts may be diluted unless the political class reaches a consensus over the IEBC issue.

The government is ahead of its domestic borrowing schedule, having borrowed Kshs 326.3 bn for the current fiscal year compared to a target of Kshs 205.5 bn (assuming a pro-rated borrowing throughout the financial year of Kshs 219.0 bn budgeted for the full financial year). With only three weeks left to the end of the current fiscal year, the government has surpassed its local borrowing target. The additional Kshs 121.0 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

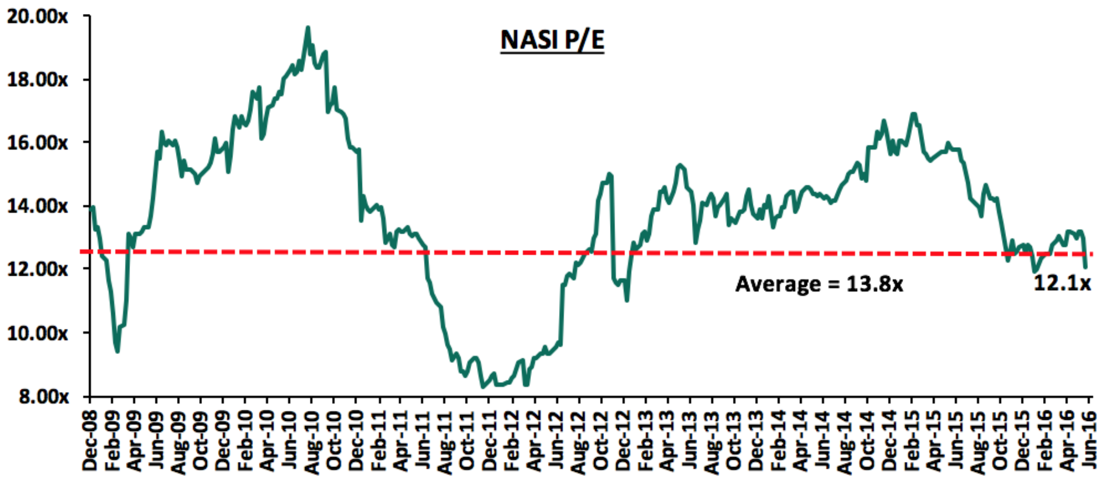
basis.

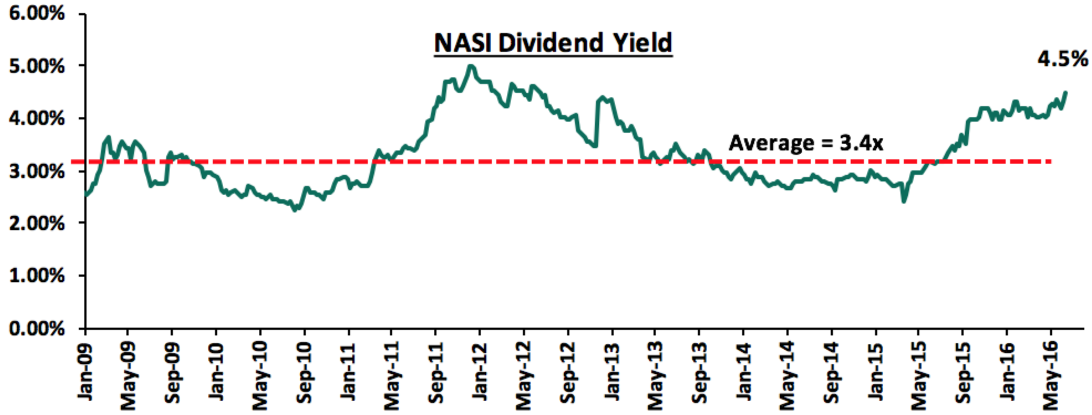
Equities:

During the week, the equities market was on an upward trend with NASI, NSE 20 and NSE 25 gaining 2.43%, 0.84% and 1.23%, respectively, taking the YTD performance to 0.9%, -5.1% and -0.7%, respectively. The upward performance this week was on the back of gains in large cap stocks, led by Safaricom, which gained 7.6%. Since the February 2015 peak, the market has been down 30.3% and 17.2% for NSE 20 and NASI, respectively.

Equities turnover rose by 187% during the week to Kshs 5.8 bn from Kshs 2.0 bn last week on the back of increased foreign investors? activity in large cap stocks. Foreign investors were net buyers with net inflows of USD 3.17 mn, compared to net outflows of USD 7.61 mn witnessed the previous week, with investors taking advantage of the relatively lower prices. We expect earnings growth to improve in 2016 compared to 2015 supported by a favourable macroeconomic environment. In our view the slow start to the year has created an opportunity for long-term investors to gradually take up positions in the market due to the attractive valuations.

The market is currently trading at a price to earnings ratio of 12.1x, versus a historical average of 13.8x, with a dividend yield of 4.5% versus a historical average of 3.4%. The charts below indicate the historical PE and dividend yields of the market.





Centum released FY?2016 results:

Centum released their FY?2016 results, recording a growth of 12.4% in core EPS to Kshs 11.75 from Kshs 10.45. EPS growth was driven by a Kshs 5.4 bn realized gain from the exit of AON and disposal of quoted and unquoted investments. Key highlights include:

- Total income grew by 104.3% to Kshs 24.2 bn in FY?2016, from Kshs 11.8 bn in FY?2015, driven by (i) Kshs 8.1bn bn from the sale of beverages from Kshs 37mn FY?2015 from their King Beverages and Almasi subsidiaries, which represents a growth of 21,903.0%, and (ii) 199.0% growth in unrealised gain in investment properties of Kshs 5.2 bn, from Kshs 1.7 bn previously
- Total expenses grew by 341.7% to Kshs 13.3 bn, from Kshs 3.0 bn in FY?2015, driven by a 23,226.1% surge in cost of sales of beverages to Kshs 5.4 bn from Kshs 23 mn in FY?2015
- The surge in expenses can be attributed to business acquisitions during the year pushing their ownership to a level that requires consolidation for financial reporting purposes
- Profit after tax increased by 25.3% to stand at Kshs 9.9 bn, from Kshs 7.9 bn in FY?2015
- Total assets grew by 8.0% to Kshs 78.1 bn, from Kshs 72.3 bn in FY?2015, supported by a 77.3% increase in levels of investment in subsidiaries to Kshs 25.4 bn from Kshs 14.3 bn, as the company continues to increase investments across its focus sectors, driven by FMCG and real estate
- Shareholders? funds grew by 12.2% to Kshs 43.3 bn, from Kshs 38.6 bn in FY?2015, leading to an improvement in Net Asset Value per share by 23.1% to Kshs 59.1 from Kshs 48.0 in FY?2015
- For the first time since listing, Centum has declared a dividend of Kshs 1.0 per share, translating into a dividend yield of 2.1%.

Going forward, we expect Centum to register faster growth in income underpinned by;

a. Realization of gains across its real estate portfolio, including the Two Rivers Development, which is set to be completed in their FY?2017 reporting year
b. Tactical reallocation of portfolio to cash and fixed income securities as the company exhibits a dynamic portfolio approach; Cash accounts to 53% of the portfolio in 2016, compared to 10% in 2015, while equities account for 23% in 2016 from 70% in 2015

For a more comprehensive analysis, refer to the Centum note.

I&M Holdings is set to acquire Giro Bank for Kshs 5.0 bn, through a cash offer of Kshs 2.5 bn to Giro Bank shareholders, and an additional offer of shares for the remaining Kshs 2.5 bn into I&M Holdings. The transaction is valued at 1.7x price to book, compared to an industry average price to book average of 1.3x, highlighting the premium that I&M is willing to pay for the strategic acquisition. As highlighted in our Cytonn Weekly #46, the impending acquisition of Giro bank is likely to increase market share for I&M Holding?s, and position the bank to reap the benefits of its expansion strategy and sustain future growth. In such a period of consolidation in the banking sector, we would not be surprised if other smaller Tier II and III banks were bought out or merged with the larger banks to create a safer, more transparent and efficient banking industry.

On the corporate fundraising front, Home Afrika has announced plans to raise up to Kshs 5.5 bn in capital from investors. The company plans to raise Kshs 500 mn through a rights issue from its current shareholders, and additionally raise up to Kshs 5.0 bn by way of debt capital and issuance of convertible debt instruments to investors. Home Afrika has continued to face capitalization challenges, making it lag behind in execution of its real estate portfolios. In our opinion, upon a successful capital raising, the company will be able to allocate additional resources to the development of its deal pipeline. It is also commendable that they recently expanded their board of directors to bring in more independence and experience into the board.

Below is our equities recommendation table:

all prices in Kshs unless stated
EQUITY RECOMMENDATION

No.	Company	Price as at 3/06/16	Price as at 10/06/16	w/w Change	Target Price*	Dividend Yield	Upside/ (Downside)**	Recommendation
1.	KCB Group***	37.3	36.3	(2.7%)	53.7	4.9%	53.0%	Buy
2.	Kenya Re	21.0	21.0	0.0%	26.7	3.5%	30.6%	Buy
3.	Centum	41.3	46.8	13.3%	57.2	2.1%	24.5%	Buy
4.	DTBK***	188.0	178.0	(5.3%)	214.0	1.2%	21.4%	Buy
5.	NIC	37.5	36.8	(2.0%)	42.9	2.7%	19.4%	Accumulate
6.	Co-op Bank	16.6	16.6	0.0%	18.0	4.3%	13.1%	Accumulate
7.	Barclays	9.9	10.1	2.5%	10.3	9.7%	11.6%	Accumulate
8.	Liberty	15.3	15.7	2.6%	17.2	0.0%	9.9%	Hold
9.	Equity Group	39.8	40.0	0.6%	41.9	4.9%	9.7%	Hold
10.	CfC Stanbic	85.0	85.0	0.0%	85.4	7.2%	7.7%	Hold
11.	Jubilee Insurance	480.0	456.0	(5.0%)	477.8	1.8%	6.5%	Hold
12.	I&M Holdings	110.0	110.0	0.0%	112.0	3.1%	4.9%	Lighten
13.	Standard Chartered***	212.0	211.0	(0.5%)	207.2	5.9%	4.1%	Lighten
14.	Pan Africa	39.0	37.5	(3.8%)	39.0	0.0%	4.0%	Lighten
15.	Britam	14.9	14.0	(6.0%)	14.1	1.9%	2.6%	Lighten
16.	HF Group	19.2	20.8	8.4%	19.6	6.5%	1.0%	Lighten
17.	CIC Insurance	5.0	4.8	(3.0%)	4.7	1.9%	(0.2%)	Sell
18.	Safaricom	17.0	18.3	7.7%	16.6	4.2%	(4.8%)	Sell
19.	NBK	11.2	10.5	(5.8%)	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 of value.

Private Equity

Convergence Partners, an investment management firm focused on the telecommunications, media and technology sector in Africa, has invested USD 1mn in Snapt, a South African ICT software development firm that develops high end solutions for load balancing, web acceleration and security software. Snapt has a client base of over 10,000, with customers stretching across 50 countries globally, since its inception in 2012, an indication of the growing demand for ICT services and software development in African as many businesses seek to: (i) improve excellence in client servicing through web based client service applications, (ii) increase efficiency in running their businesses, and (iii) to increase their competitive advantage in their specific industries and sectors by improving their ICT. The investment by Convergence partner will assist Snapt in its bid to become a major player in the USD 6.5bn US market for application delivery software as the South African firm has already shown a lot of interest in venturing into the international markets in the e-commerce segment. The opportunity in ICT investment for Africa is significant, with the ICT sector displaying impressive double-digit growth since 2005, with expenditures in ICT within Africa forecasted to exceed USD 150 bn by end of 2016, according to eTransform Africa report by World Bank and the African Development Bank.

Real Estate

This week saw the reading of the Kenya 2016/17 Budget Statement, which contained several key highlights focusing on the Kenyan real estate sector. Key areas to note are:

1. **Corporate Tax Rate Incentives:** Key from the 2016/17 Budget was the incentive that Government has provided developers with reduced corporate tax rates from 30% to 20% for developers that construct at least 1,000 units of low-cost housing per year. We applaud this action by the Government, which is a key step in increasing housing supply to cater for the annual supply

deficit of 200,000 housing units. These incentives to increase construction of low cost housing, combined with the deepening of the Capital Markets through REIT regulations are positive steps towards increasing the number of real estate developers in the country.

2. **Removal of NEMA and NCA Levies**: Government has scrapped NEMA and NCA fees, which were previously charged at 0.1% and 0.5% of construction costs, in an effort to reduce the cost of construction. In our view, removal of these fees will encourage increased development in the Kenyan market, as well as allow developers to reallocate project budgets towards additional value-adds, rather than paying it towards fees.
3. **Funding for Low Cost Housing**: Government is working on putting in place a mortgage liquidity facility, which will provide long-term funding to financial institutions, including Saccos, to enable them to provide longer-term mortgages to their clients and members. The world bank estimates, that Saccos have issued approximately 40,000 housing loans, indicating they?re a preferred source of housing finance compared to banks. At the same time, this will help improve both the formal and informal mortgage market reach, as currently less than 10% of all housing credit comes from the banking sector.

Implementation of these actions will benefit the provision of low cost housing which has been difficult to achieve due to high costs of construction and credit and the rising land prices.

This week also saw increased foreign investment in Kenya?s real estate sector, with activity from both Actis and China Africa Development Fund (CADFund). Actis closed out Actis Africa Real Estate Fund (AAREF) 3, with commitments totalling USD 500 mn, surpassing its initial USD 400 mn target. The fund will invest predominantly in retail, office and industrial developments, with AAREF 3 coming after AAREF 2, which closed in October 2012 with commitments of USD 278 mn. AAREF 2?s major investment in Kenya was the Garden City integrated mixed-use development, which was completed in 2015. The continued fundraising by large institutional players highlights the attractive returns and demographics driven opportunity in real estate in Africa, and Actis and their investors have shown commitment to being an institutional player positioned to harness the opportunity.

China Africa Development Fund (CADFund) has partnered with Kenya?s Government to fund housing development, with CADFund keen on addressing the housing shortage in the Country. One of the projects earmarked to benefit from the partnership is the Ngara City, a redevelopment project that involves pulling down old houses in the old Ngara Estate and constructing new ones. The goal of this project is to increase the capacity of residential dwellings through constructing high-rise developments and providing affordable housing. CADFund is an Africa focussed equity investment fund that seeks to partner with Chinese firms and support them in the form of infrastructure, funding and skilled personnel. Already, CADFund has partnered with Suraya and a Chinese contractor in provision of 20,000 housing units for the police force. In addition, they plan to develop 10,000 housing units at discounted prices for civil servants. Overall, increased foreign interest from institutional funds highlights the positive investor sentiments towards investment in Kenya. Real estate was ranked as one of the leading sectors attracting investment in the FDI report 2016 by the World Bank. Kenya was shown to have recorded the fastest rise in FDIs in Africa at 47%. The main drivers include:

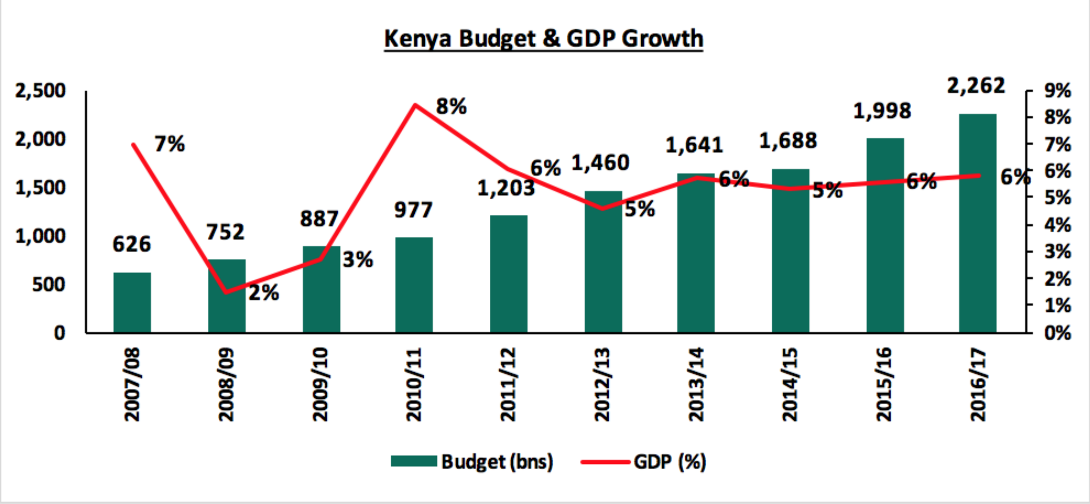
i. High returns from real estate which have averaged over 25% p.a over the last 5 years,
ii. Large housing market from the growing population and middle-income,
iii. Improved infrastructure development, with construction of roads opening up new areas for development, and,
iv. Improved operating environment such as technological advancement, ease of doing business backed by reforms in business and property registration and access to credit.

The market outlook points to increased housing supply as both local and foreign developers break ground on projects in various parts of the country, with increased focus on low-cost housing. In addition, we expect increased fundraising initiatives through

capital markets as developers seek financing through issuance of debt instruments and REITs due to the capital-intensive nature of real estate sector.

Kenya?s 2016/2017 National Budget

This week the East African countries read their budgets for the 2016 / 2017 financial year. In Kenya, the Government Budget continues to grow with total budget expected to increase to Kshs 2.3 tn, representing an 11.2% increase from the Kshs. 2.0 tn budget for 2015/2016 budget. Key to note is that the Kenyan GDP has grown at a CAGR of 5.3% over the last 10 years while the budget has grown at a CAGR of 15.3%, this indicates the impact of the budget to economic growth



Source: Cytonn Investments

As has been the case in previous years, majority of allocation from the budget expenditure was towards recurrent expenditure however there is a lot of emphasise on reducing this and for this financial year this reduced to 11.5% of GDP from 12.2% last year. The total allocation of recurrent expenditures was down to 37.5% of the total budget compared to 39.5% last year. Of Key note is that the cost of servicing the debt continues to grow with projected increases of 29.2% from Kshs 240 bn to Kshs 310 and will increase further in the coming years.

There is also an increase in development expenditure by 13.5%, from Kshs 712.5 bn to Kshs 809.0 bn, equating to 35.7% of the total estimated expenditure. With the increased development being undertaken in the economy, development expenditure is important in supporting ongoing infrastructure projects in roads, railways, energy provision and distribution, and the cementing of Kenya?s position as the key port of trade and innovation in East Africa. Despite high allocation toward development expenditure in the past, the absorption rate has remained low and last year the supplementary budget indicated a reduction of allocation towards development expenditure by 9.9% to Kshs 641.9 bn from Kshs 712.5 bn initially allocated in the Budget Policy statement.

However, in as much as the development projects, and other necessary recurrent expenditures, being undertaken are key in boosting medium to long-term growth of the Kenyan economy, they come with their own additional challenges.

1. **Ability to finance the budget:** Ordinary revenue to the Kenyan government through the collection of taxes is projected to come in at Kshs 1.37 trillion (18.6% of GDP) in 2016/17, an increase of Kshs 1.18 (18% of GDP) trillion in the 2015/16 fiscal year. Government has already missed tax collections by Kshs 255.5 bn as of December 2015 in the current fiscal year, hence projecting increased collections of 16.1% is ambitious. There are however measures being undertaken to improve tax efficiencies but it is still taking time to increase the tax net.

2. **Increased reliance on debt:** There have been continued increases in both domestic and foreign debt.
    1. There is a projected increase in domestic borrowing in the 2016/17 budget by 10.0%, to Kshs 241 bn, from the Kshs 219 bn in the current fiscal year and Kshs 120bn five years ago. Last years the mismatch between fiscal and monetary policy led to confusion in the market resulting into a high interest rates environment, which further led to crowding out effect in the economy. The continued increase in the domestic borrowing could mean that rates may increase which would not be good for the economy.
    2. Foreign borrowing currently finances majority of development expenditure in the economy, both in the form of direct foreign borrowing as well as bilateral trade agreements. The most worrying statistic is that our bilateral debt stock has increased by 171.8% over the last 2 fiscal years alone, from Kshs 248.6 bn in June 2014, to Kshs 674.2 bn in June 2016. Majority of this debt has been coming from China and now the bilateral trade with them is at 70.5% of the total bilateral trade compared to about 9% five years ago. Such heavy exposures, as well as rapid increase in borrowing levels, leave Kenya vulnerable to exogenous shocks in the global markets.

Overall, the 2016/17 budget is again an ambitious budget, with the key question being the ability of the Government to collect tax revenue to fund expenditures. Steps are being made in the right direction, with a simplified VAT legislation, Excise Duty and Tax Procedure legislation, and a review of the Income Tax Act. However, one area that has not been addressed keenly is how to cast a wider tax net over the Kenya economy, with there being only 2 million tax payers in the formal Kenyan economy, representing 4.4% of the population. In summary, the continued emphasis on infrastructure development, providing social services and investments in education is positive to the economy, but we need to be (i) disciplined and stick to the budget, (ii) manage recurrent expenditures, and (iii) be careful not to borrow excessively.
