Cytonn Annual Market Outlook – 2017

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Executive Summary

- **Global Market Outlook:** Global market outlook is likely to be shaped by enhanced political risk driven by major elections in the Eurozone and increased anti-trade populism in the US. In addition, tightening of monetary policy in the US, where the Fed plans 3 interest rate hikes in 2017, and stability in oil prices will also be consistent themes throughout the year;
- **Regional Market Outlook:** Sub-Saharan Africa is projected to grow by 3.0% in 2017 compared to the expected 1.4% in 2016, according to the International Monetary Fund (IMF). Economic diversification and improved governance are key to the sustenance of the regions' long term growth;
- **Kenya Macroeconomic Outlook:** The Kenyan economy is expected to grow at a rate of 5.4% - 5.7% in 2017, supported by a stable macro-economic environment, despite declining private sector credit growth which will impact businesses negatively;
- **Fixed Income Outlook:** The Government is expected to remain under no pressure to borrow domestically for the 2nd half of the 2016/2017 fiscal year following the enactment of the Banking (Amendment) Act, 2015, and hence we expect secondary bond market activity and turnover to remain high in 2017;
- **Equities Outlook:** The Kenya equities market is expected to be flat in 2017, driven by investor sentiment on the coming general elections and the rate hike cycle in the US, as corporate earnings growth slows. Market valuations remain attractive and provides attractive entry points for long term investors;
- **Private Equity Outlook:** Private equity (PE) in Kenya is expected to continue attracting global capital flows with a preference towards the Financial Services and Information and Technology sectors, as Kenya remains an attractive and vibrant PE investment destination;
- **Real Estate Outlook**: Real estate in Kenya is expected to maintain the high performance across all sectors, with increased development activity expected in low to middle income residential segment, three and four star hotels, mixed use developments and warehouses. Development activity is expected to slow down in commercial office space, retail spaces and land development.

Company Updates

- On 5th January, 2017, Cytonn Real Estate released the 'Cytonn Real Estate Markets Review 2016'. The report indicates that the real estate sector continued to outperform other asset classes in 2016, supported by high demand from both individuals looking to purchase real estate, as well as increased institutional investor demand. See review here
- Edwin H. Dande, Cytonn Investments C.E.O, was nominated for the *"2016 100 Most Influential Young Kenyans"* awards. The initiative is spearheaded by a social enterprise named Avance Media, alongside other organizations. Edwin's nomination is for the "Business" category, which recognizes young Kenyans who have made a difference and impacted the lives of Kenyans across the world through exemplary stories, which are told through their work. In addition, one must have been able to motivate and inspire a younger generation of Kenyans with their work. Click here to vote for Edwin
- We have released our Private Wealth Management Training calendar for Q1'2017. The trainings are at no cost, held bi-weekly and are open only to pre-screened individuals. To register, kindly visit Wealth Management Training
- This coming week, on Monday 9th, we shall be releasing Cytonn's Business and Market Outlook for 2017 at Sarova Stanley Hotel from 7:30 am, in order to inform our investors on what to look out for in the investment landscape in 2017

- We continue to beef up the team with the ongoing hires: Careers at Cytonn

Introduction

In our last Cytonn Report, the Cytonn Annual Markets Review - 2016, we analyzed the key market happenings that shaped the investment environment during the year 2016. This week we turn our focus to the future with the Cytonn Annual Market Outlook – 2017, where we provide our investors with key insights and analyze the trends that will shape the investment landscape over the next 12-months.

Global Market Outlook

2016 was characterised by uneven economic growth, with China and the US driving the global growth, growing their GDP at 6.7% and 3.5%, respectively, while countries in the European Union continued to struggle to grow, with the region registering overall GDP growth of 1.6% as per the IMF. The four key events that shaped the global markets were:

(i) **Fed Change in Monetary Policy:** The US Fed raised the Federal Funds Rate by 25 bps to a bound of 0.50% - 0.75% in December, amid improved economic growth, a strengthening labour market and increasing inflation, in a move that signalled a trend towards stronger economic growth in the US,

(ii) **US Elections:** The conclusion of US elections whereby the Republican candidate Donald J. Trump won by defeating Hillary Clinton. Some of the key things that the US president elect is pushing for is enabling anti-trade populism, thereby leading to a decrease in world trade and ramping up spending in the economy,

(iii) **Brexit:** Britain pulled out of the European Union (EU), coined as "Brexit", in a move that brought uncertainty in the global market, and the first move in an anti-trade movement that swept the developed markets, and,

(iv) **Oil Prices Fluctuations**: An agreement between OPEC members to cut down on production in November saw oil prices surge upwards, hitting an 18-month high of USD 58.4 per barrel, from USD 37.0 per barrel at the start of the year.

The major events laid down a foundation for the key economic themes that we believe will shape the global markets in 2017. Below, we look at the key themes that will shape the global markets in 2017:

Political uncertainty looms?

The US president elect is set to take office later in January and two major members of the European Union (EU), France and Germany, will hold general elections in 2017. Key among the discussions facing the two countries are security concerns following the violent attacks in both countries and the public outcry over the level of immigrants; which have dominated the political agendas. A widening prosperity gap in developed economies has led to the emergence of populist movements, which are expected to add more uncertainty in these economies and possibly sway elections towards movements that promise radical changes.

Global trade slowdown…

The growth in world trade is expected to decline driven by a slowdown in trade liberalization and the recent rise in protectionist policies from the developed markets. The anti-trade populism movement that emerged in the recently concluded US elections threatens to disrupt established trade alliances. Instead of protectionism, trade reforms that lower barriers should be pursued, which will improve global growth.

Stability in oil prices…

The World Bank raised its 2017 forecast for crude oil prices to USD 55.0 per barrel, from USD 53.0 per barrel in October 2016, as members of the Organization of the Petroleum Exporting Countries (OPEC) reached an agreement to cut down on oil production by 1.2 mn barrels per day from January 2017. The capping of production will put a lid on oil supply, coupled with an improvement in demand from emerging markets that drive oil demand, namely China, should see relative stability in oil prices during the year, with estimates of prices between USD 50 – USD 60 per barrel.

Having considered the key themes that will drive 2017, we now look at specific economic regions and expectations on their GDP performance in 2017:

World GDP Growth Rates						
	Region	**2013a**	**2014a**	**2015a**	**2016e**	**2017f**
1.	India	6.6%	7.2%	7.6%	**7.6%**	7.6%
2.	China	7.8%	7.3%	6.9%	**6.7%**	6.4%
3.	United States	1.7%	2.4%	2.6%	**3.5%**	2.2%
4.	Middle East, North Africa	2.4%	2.7%	2.3%	**3.4%**	3.4%
5.	United Kingdom	1.9%	3.1%	2.2%	**1.8%**	1.1%
6.	Euro Area	(0.3%)	1.1%	2.0%	**1.6%**	1.5%
7.	Sub-Saharan Africa	5.2%	5.1%	3.4%	**1.4%**	3.0%
8.	Japan	1.4%	0.0%	0.5%	**0.5%**	0.6%
9.	South Africa (SA)	2.3%	1.6%	1.3%	**0.1%**	0.8%
10.	Brazil	3.0%	0.1%	(3.8%)	**(3.3%)**	0.5%
	Global Growth Rate	**2.9%**	**3.4%**	**3.2%**	**3.1%**	**3.4%**

Source-IMF

United States:

The US Fed raised the Federal Funds Rate by 25 bps to a bound of 0.50% - 0.75% in December, amid improved economic growth, a strengthening labour market and increasing inflation. During the last meeting the Fed indicated plans for 3 interest rate hikes in 2017, a more aggressive rate hike cycle than previously expected and this could negatively impact growth going forward. According to the most recent forecast released at the US Fed meeting in December, GDP growth is expected to rise to 2.1% in 2017, from the estimated 1.9% previously, as the manufacturing sector does better than the overall GDP, and is projected to grow by 3.0%. The unemployment rate is estimated to drop to 4.5% in 2017, from 4.6% in 2016 driven by increased activity and demand for labor in the growing economy, and fiscal policies that target job creation. Meanwhile, inflation is expected increase to 1.9% in 2017, from 1.5% experienced in 2016, driven by increased consumer spending and the projected global increase in oil prices.

The results of the recently concluded US elections also point towards a stronger economy in 2017, with president elect Donald Trump looking to implement pro-growth policies during his term through boosting government spending in the economy. A key risk to the US growth comes in the form of the strengthening dollar as a result of the accelerated rate hikes, putting a strain on the competitiveness of all US exports, rendering them more expensive.

The stock market is expected to do well supported by strong earnings growth, as consumer sentiment improves. However, the current high valuations, as measured by the Cyclically Adjusted Price/Earnings (CAPE) ratio is currently near historical highs at 27.8x, far above the historical average of 16.7x, indicating an overvaluation of the market, which may limit how far the markets can go without any significant growth in earnings.

Eurozone:

The IMF revised its growth forecast downwards for the Eurozone to 1.4% in 2017, from 1.6% earlier, following the biggest significant geo-political event during 2016 in the form of Brexit, which is expected to adversely affect the United Kingdom and the Eurozone region as well. To spur growth and look to mitigate any negative political repercussions on the economies of the Eurozone, the European Central Bank (ECB) extended the quantitative easing program to December 2017 from March 2017, however, with a reduction in the amount of purchases to EUR 60 bn a month from earlier EUR 80 bn per month. The current negative investment rates are expected to persist in 2017 and are expected to impact growth and investment, largely in the financial services sector.

A key risk to the region comes in the form of political risk, with two of the region's largest economies, France and Germany, set to hold elections, with both countries having been targets of violent attacks in 2016. Germany Chancellor Merkel is expected to win a fourth term in office despite rising support for extremist parties and opposition on Merkel's refugee policy, while in France, conservative candidate Francois Fillon is leading in the polls with 28.0%, ahead of his main opponent, who has an anti-immigrant and anti-Euro stance.

All in all, despite the uncertainty expected to be brought about by Brexit, the culmination of the concluded US elections and the migrant crisis, the region's growth, albeit slow, is expected to persist on account of (i) easing monetary policy, and (ii) private consumption driven by expected employment growth and higher wages.

China:

The Chinese economy, despite showing signs of a slowdown, has continued to register strong growth with the average projected growth at between 6.3% and 6.7% for 2017, after registering a 6.7% growth in the first three quarters of 2016, from 6.9% in 2015. Following the decline in growth over the years, China has embraced monetary and fiscal stimulus measures in a bid to support the country's growth, in the process causing the country's total debt to GDP to rise to approximately 250.0% of GDP with the bulk being private sector as the local government debt is equal to 41.0% of GDP. The country remains a significant contributor to GDP as it contributed a third of global GDP growth in 2016 and hence any sway in the economy will lead to a ripple effect that will be felt worldwide. The continued implementation of positive structural reforms, as well as a focus towards an economy driven by market forces, rather than political intervention, remains a bright spot for China, aimed at focusing on long-term stability, which should come good for both China and the broad Asian growth in the years to come, and drive growth in 2017.

Regional Market Outlook

Sub Saharan Africa is expected to register the slowest growth in 2016 estimated at 1.4% according to International Monetary Fund. This has been brought about by a slowdown in some of the largest economies in the region like Nigeria and Angola that rely on commodities, which are set to experience slower growth, given the low oil and commodity prices that prevailed in 2016. With the recovery of global prices in 2017, growth prospects should be better for these economies. However, the International Monetary Fund (IMF) projected that SSA region will grow by 3.0% in 2017, which is higher than their 2016 projection of 1.4%, compared to a growth of 4.9% in 2017 from 3.9% in 2016, excluding Nigeria and South Africa, highlighting the drag that the major commodity driven countries will have on overall growth for this region.

Kenya Macroeconomic Outlook

2016 was characterized by a stable macroeconomic environment, which saw GDP growth for the first three quarters average 5.9% from 5.4% same time in 2015. The growth was supported by (i) low oil prices, given Kenya is a net importer of oil, (ii) stable performance in agriculture as a result of favourable weather conditions, (iii) accommodative monetary policy, (iv) ongoing infrastructure projects being undertaken by the government, and (v) recovery of tourism sector, which grew 13.8% y/y during the third quarter of 2016, with tourist arrivals into the country increasing significantly by 25.8% y/y over the same period. The improved macroeconomic environment led to a couple of positive pointers into the economy; (i) there was an improved outlook from the rating agencies e.g. Moody's rating agency upgraded Kenya's credit rating outlook from stable to positive, and (ii) the country improved its ranking on ease of doing business by rising 21 places to position 92 from position 113 in 2016.

Going into 2017, which is an election year, politics is bound to take center stage and be among the key determinants of spending and government policy. We expect an increase in government spending on infrastructure as the current administration aims to regain power in the upcoming elections, as well as recover from the low absorption rates for development expenditure, which stood at 69.2% as at June 2016. Security is expected to be firm as a result of government initiatives towards improving internal security. However, it is also worth noting that the current political stand-off between the government and the opposition is not good for business and may result in an increase in Kenya's political risk, which may negatively affect the level of private sector investments in the country.

Private sector credit growth has been on a free-fall for 16 consecutive months, coming in at 4.6% in October 2016 from a high of 21.0% in August 2015. The decline was due to reforms in the banking sector brought about by the increase in Non-Performing Loans (NPLs), which prompted banks to reassess their risk assessment framework, preferring to lend to the government as it is risk free as opposed to the private sector, which is considered riskier. This trend is expected to persist in the year 2017 as a result of the enactment of the Banking (Amendment) Act, 2015, which outlines the loan pricing framework, thus SMEs and subprime borrowers are likely to be locked out. This is because it will be difficult for commercial banks to fit SMEs and subprime borrowers in the current pricing framework that is capped at 4.0% above the Central Bank Rate (CBR) - currently at 10.0% - effectively capping the lending rates at 14.0%. The expected downward trend in growth in private sector credit will have a negative effect on the contribution by the private sector to GDP growth in 2017.

In the 2016/17 fiscal year, overall expenditure was projected at Kshs 2.3 tn (35.2% of GDP), up by 13.2% from Kshs 2.0 tn (30.6% of GDP) for the 2015/16 fiscal year. This expenditure is to be financed by tax collection (Kshs 1.5 tn), domestic borrowing (Kshs 236.1 bn), foreign borrowing (Kshs 462.3 bn) and the balance of Kshs 101.6 bn from grants and aid. The Kenya Revenue Authority is expected to miss its revenue target for the fiscal year, as even for the first quarter it was 18.4% behind the revenue collection targets. This is due to: (i) the expectation of subdued corporate earnings especially from the banking sector in 2017, and (ii) ineffectiveness of attempts by the Kenya Revenue Authority (KRA) to increase the tax base by taxing the informal sector, which contributes 38.8% to GDP. Given the conditions in the global markets, floating of a sovereign bond might be challenging and will only be possible at a significant premium, especially given the uncertainty around the political environment in the country. This would mean that government may end up borrowing more from the domestic market, further crowding out the private sector, which would be negative to the economy. The country debt levels may continue to deteriorate, further increasing from the current 50.3% of GDP, which is above the IMF recommended limit of 50.0% for frontier markets.

The GDP growth is expected to slow down and come in between 5.4% and 5.7% due to a slowdown in agriculture and financial Intermediation owing to (i) the continued drought, which is expected to persist until mid-2017, and (ii) the interest rate caps which will reduce corporate earnings for commercial banks, (iii) increased political uncertainty forcing investors to take a wait and see stance, (iv) pressure on the shilling given the strengthening of the USD in the global markets, and (v) high oil prices, which will increase the import bill. Despite these challenges, we expect the growth to be supported by (i) government continued expenditure on infrastructure, (ii) the recovery of the tourism sector, and (iii) the continued growth of the construction sector.

After a stable period in 2016, losing only 0.1% to the USD, the shilling is expected to be under pressure in 2017 due to:

- Strengthening of the dollar in the global market after the Fed rate hike coupled with expectations that the Fed will accelerate its rate-hike cycle in 2017, given that the economy is expected to do even better in 2017,
- Continued infrastructure and real estate investments, which require imported capital goods, which will have a negative effect on the current account position,
- Pressure on the current account position due to increased importation bill, resulting from the recovery of global oil prices following a deal by Oil Producing and Exporting Countries (OPEC) to cut global oil supply,
- Reduced capital inflows into the capital markets due to uncertainty caused by general elections, and
- Reduced forex reserves. Currently the reserves stand at USD 7.1 bn equivalent to 4.6 months of import cover.

The inflation rate remained relatively stable in 2016 averaging 6.3% compared to 6.6% in 2015 driven by low oil prices, despite an 11.2% rise in the Food and Non-alcoholic beverages index. Going forward, we expect higher inflation due to: (i) prolonged dry weather, which will persist until mid-2017 driving food prices up, (ii) higher oil prices, (iii) depreciation of the currency, and (iv) increased money supply due to the campaign money. We project inflation rates for 2017 to average between 6.7% - 7.2%, which is within the 2.5%-7.5% government target.

The table below summarizes the various macro-economic factors and the possible impact on the business environment in 2017:

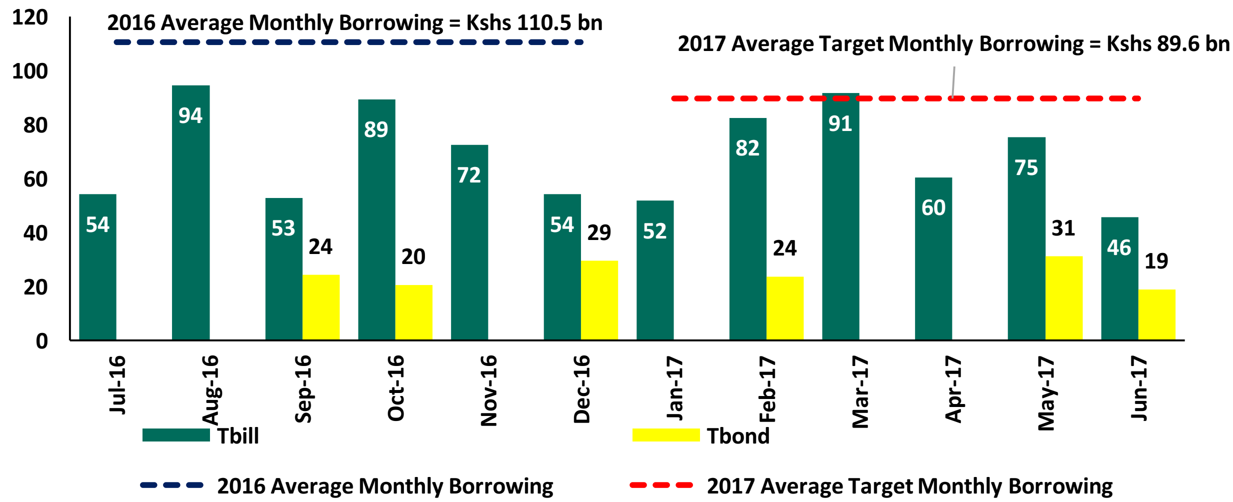
Macro-Economic & Business Environment Outlook		
Macro-Economic Indicators	**2017 Outlook**	**Effect**
Government borrowing	• Government to meet its domestic borrowing target although likely to come under pressure due to KRA missing its revenue collection target	**Neutral**
Exchange Rate	• Shilling to depreciate against major currencies	**Negative**
Interest Rates	• A stable outlook on interest rates in 2017 with CBR maintained at 10.0%	**Neutral**
Inflation	• To average 7.2%, which is within the 2.5%-7.5% government target	**Neutral**
GDP	• 5.4%-5.7% growth projected in 2017, a slight decline from the expected growth rate of 6.0% in 2016	**Neutral**
Investor Sentiment	• Given (i) global uncertainties due to political/ economic risks as major economies vote and, (ii) expectations of an increased rate hike cycle by the Fed we expect foreign investors to be weary and demand higher premiums from riskier frontier markets. However, we expect long term investors to enter the market seeking to take advantage of the current low valuations	**Neutral**
Security	• Expect the government to put initiatives in place to ensure improved security, however, the main challenge remains that 2017 is an election year	**Neutral**

<u>Fixed Income Outlook</u>

The Government domestic borrowing has been ahead of target since the beginning of the fiscal year, currently having borrowed Kshs 169.2 bn domestically, against the pro-rated old target of Kshs 123.6 bn and the pro-rated new target of Kshs 158.6 bn. There are huge maturities of Kshs 106.0 bn and Kshs 91.5 bn coming in February and March 2017, respectively, and hence the domestic borrowing for the two months is expected to be higher than the average monthly borrowing target of Kshs 89.6 bn. The expected significant maturities, coupled with the expected increase in the domestic borrowing target from the tax deficit and the foreign borrowings delays, could result in an upward pressure on interest rates. However, we expect this to be mitigated by the improved liquidity position in the money market given the expected maturity levels.

Below is a summary of treasury bills and bonds maturities and the expected borrowings over the same period. The government will need to borrow Kshs 89.6 bn on average each month for the rest of the fiscal year in order to meet its domestic borrowing target of Kshs 229.6 bn and also cover the arising T-bill and T-bond maturities, as illustrated in the graph below. Of importance is that this figure is likely to increase to Kshs 100.4 bn per month should Parliament pass the motion to increase the domestic borrowing target to Kshs 294.6 bn.

Fiscal Year 2016/17 Government Domestic Borrowing Programme



Treasury bill rates declined during the year with the 91-day, 182-day and the 364-day closing at 8.7%, 10.5% and 11.0%, from 10.4%, 12.4% and 12.8%, respectively, at the beginning of 2016. The low interest rate environment in the second half of 2016 was mainly attributed to the signing of the Banking (Amendment) Act, 2015, in August that led to interest rates reversing trend and have bottomed out at their current levels. Liquidity has been skewed towards the larger banks due to flight to safety from smaller banks following the collapse of Imperial Bank and Chase Bank. Going forward, we expect liquidity distribution in the money market to improve given the Central Bank of Kenya's (CBK's) efforts to distribute liquidity within the banking sector. There is increased uncertainty on the interest rate environment in 2017, as even though the government is ahead of its domestic borrowing target, upward pressure on interest rates might arise from (i) the likelihood that KRA will miss its collection target given the expectation of subdued corporate earnings, (ii) the fact that the government has not yet started its foreign borrowing schedule, and (iii) the expectation that the shilling will come under pressure during the year due to the strengthening dollar as the Fed embarks on a rate-hiking cycle and global oil prices recover.

In 2016, secondary bond market activity increased, with bond turnover rising by 39.4% to Kshs 428.3 bn from Kshs 307.2 bn in 2015 as interest rates remained stable. We expect activity and turnover to remain high in 2017 given commercial banks are likely to increase their exposure to government securities as they shy away from lending to the private sector following a mandatory reduction in the lending rate brought about by the enactment of the Banking (Amendment) Act, 2015.

Government is ahead of its domestic borrowing for this fiscal year having borrowed Kshs 169.2 bn for the current fiscal year against a target of Kshs 123.6 bn (assuming a pro-rated borrowing throughout the financial year of Kshs 229.6 bn budgeted for the full financial year). It is important to note, however, that the government is in the process of revising its domestic borrowing target upwards to Kshs 294.6 bn, which will take the pro-rated borrowing target to Kshs 158.6 bn, and the government will still be ahead of the borrowing target. Interest rates, which had reversed trends due to the enactment of the Banking (Amendment) Act, 2015, appear to have bottomed out in July and we expect them to persist at the current levels, having risen slightly over the last few months. However, there is uncertainty in the interest rate environment as the government might have to plug in the deficit likely to arise from revenue collection and foreign borrowing, from the domestic market, which might exert upward pressure on interest rates. It is due to this that we think it is prudent for investors to be biased towards short-term fixed income instruments.

<u>Equities Outlook</u>

During the year 2016, the Kenya equities market registered negative performance with NASI, NSE 20 and NSE 25 losing 8.5%, 21.1% and 15.8%, respectively, as a result of declines in large cap stocks. The year also saw 4 listed companies issue profit warnings to investors compared to 16 companies that issued profit warnings in 2015.

Going into 2017, the factors that will affect the direction of the Kenyan equities market include:

i. **Corporate Earnings**: On average, we expect earnings growth for the year 2017 to come in at an average of 8.0%, lower than our 2016 expectation of 12.5%. The lower earnings growth is attributed to expectation of depressed earnings for commercial banks due to the implementation of the Banking (Amendment) Act, 2015, which placed regulations on banks' loan and deposit pricing framework, thereby reducing the net interest margin for banks. Non-financials are expected to perform better since they are less affected by the interest rate environment. Additionally, key risks still remain with regards to the 2017 general elections, which might affect Kenya's business operating environment and thus corporate earnings growth;

ii. **Capital Markets Investor Sentiment**: We expect the equities market to register a decline in net foreign inflows in 2017 as investors exit stocks listed on the Nairobi bourse due to (i) expected lower earnings from commercial banks, (ii) uncertainties over political and social risks as Kenya undertakes general elections, and (iii) expectations of a more aggressive rate hike cycle by the Fed that will make the US market more attractive. Despite this, we still expect Kenya to attract flows from long-term investors in preference to other frontier markets;

iii. **Interest Rates**: We expect the Monetary Policy Committee (MPC) to maintain the Central Bank Rate (CBR) relatively at the current 10.0% as the Central Bank monitors Kenya's inflation rate and exchange rate expectation. The inflation rate is expected to continue rising steadily due to rising food and oil prices, while the currency is expected to depreciate further on account of continued strengthening of the dollar;

iv. **Diversification of Capital Markets and New Listings**: We do not expect any major listing on the Nairobi Securities Exchange in 2017. However, we expect increased products offerings with (i) the expected launch of trading of derivatives that was delayed in 2016, and (ii) possible setting up of a commodities exchange. The Central Depository & Settlement Corporation (CDSC) is also set to launch a new trading platform in April 2017 that will allow a settlement cycle of 1 day (T+1). Additionally, the CDSC is looking to add listed equities from other African countries, starting with Nigeria. This is expected to (i) increase liquidity in the market, (ii) make pricing of bonds and equities easier as it improves price discovery mechanisms in the securities exchange, and (iii) improve depth of the capital market;

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v. **Regulation:** We expect corporate governance practices on issuers of securities to the public to be significantly enhanced after the implementation of the Code of Corporate Governance and the Stewardship Code for Institutional Investors. This, together with other regulations put in place by the Capital Markets Authority in 2016 highlighted in Cytonn Annual Markets Review – 2016, are expected to increase investor confidence in the equities market.

As can be seen in the table below, we expect equities market activity in 2017 to be driven by (i) expected high GDP growth rate for the year at between 5.4% -5.7%, (ii) relative stability in the corporate earnings growth, (iii) attractive valuations, with the market currently at a PE of 10.5x compared to 12.5x at the same time last year and a historical average of 13.6x, and (iv) political themes with regards to the upcoming general elections.

Equities Market Outlook Table		
Equities Market Indicators	**2017 Outlook**	**Effect**
Macro-economic Environment	• We expect 2017 GDP growth to be between 5.4% - 5.7% supported by (i) the Government's continued expenditure on infrastructure, (ii) recovery of the tourism sector, and (iii) the continued growth of the construction sector. • Interest rates are expected to remain at the current levels as the CBK monitors inflation and exchange rates, which are expected to remain within government bound and depreciate, respectively	**Neutral with a bias to Positive**
Corporate Earnings Growth and Valuations	• We expect corporate earnings growth of 8.0% in 2017 due to lower earnings for commercial banks attributed to the implementation of the Banking (Amendment) Act, 2015. • Assumption of corporate earnings growth rate of approximately 8.0% gives a forward P/E of 9.6x, relatively 41.7% cheaper than the historical average of 13.6x	**Neutral with a bias to Positive**
Investor Sentiment and Security	• We expect 2017 to register a decline in net foreign inflows due to uncertainties regarding political and social risks as Kenya undertakes general elections, and expectations of a more aggressive rate hike cycle by the Fed. However, we expect long term equity investors to make an entry into the stock market in order to take advantage of the current low valuations • We expect security to be maintained in the country supported by (i) government initiatives towards improving internal security, and (ii) September's approval of an electoral reform which eases the risk of a violent election	**Neutral**

We maintain a NEUTRAL recommendation on equities for investors with a short-term investment horizon since, despite the lower earnings growth prospects for this year, the market decline so far has made valuations attractive. The low valuation provides an attractive entry point for long term investors and thus we are positive for investors with a long term investment horizon.

Private Equity Outlook

The year 2016 saw an increase in private equity deals in the Sub-Saharan Africa region, with the first three quarters of 2016 registering 140 deals. 33 of these deals, with a disclosed value totaling Kshs 48.0 bn (average of Kshs 1.5 bn per deal) came from East Africa, and 14 of them with a disclosed value of Kshs 30.6 bn came from Kenya. In 2017, we expect a continuation of this trend, especially in Kenya, which remains an attractive destination for investors because of: (i) improvement in ease of doing business, (ii) high return potential across all sectors, (iii) a well-diversified economy, (iv) consolidation in sectors such as financial services, creating an avenue for increased private equity activity, and (v) exits of deals adding confidence for PE investors on the depth of liquidity in the Kenyan market.

We expect investors to remain focused on the following key sectors:

- **Financial Services:** Of key focus in 2017 for the financial services sector will be the consolidation in the banking sector, which has already begun, with 3 deals recorded in 2016, namely (i) SBM Holdings, a

Mauritian Bank, which is set to acquire 100.0% stake in Fidelity Commercial Bank, (ii) Bank M, a Tanzanian bank, acquiring 51.0% of Oriental Commercial Bank, and (iii) I&M Holdings 100% acquisition of Giro Commercial Bank. With the enactment of the Banking (Amendment) Act 2015 that has placed a cap on interest rates charged on loans, banks will have to be innovative to find their niche in the market and remain competitive. Weaker banks will have to merge or be acquired so as to remain competitive and shore up their capital base, creating an avenue for PE investors to invest in the sector.

With the moratorium on licensing new banks still in play, all international banks and investors looking for exposure to the Kenyan banking sector will have to enter via way of acquisition. We expect to see more foreign entries into the market, e.g. the International Finance Corporation (IFC) and QNB Group, following SBM Holdings and M Bank, chasing value in the financial services sector. Given the cheap valuations, with the banking and insurance sectors trading at a price to book value of 0.9x and 1.1x, compared to the 10-year average of 2.1x and 1.7x, respectively, there is immense opportunity for investors to realize returns.

In addition for the need for consolidation, the focus on the financial services sector is driven by (i) the increasing demand for credit, (ii) the growing financial services inclusion in the region through alternative banking channels, (iii) increased innovation and new product development within the financial services sector, and (iv) the growing middle class supporting an inherent increase in consumption expenditure, and an increase in the percentage of the population that will require financial services.

- **Information and Communications Technology (ICT):** Kenya continues to register growth in ICT, driven by a young and innovative Kenyan generation. Interest in the ICT sector has continued to grow and diversify to subsectors such as Agritech and Fintech. The sector will remain attractive to investors as it is supported by (i) support for innovation by the government, (ii) increased exposure of Kenya's tech products to the global market and foreign investors, and (iii) relative ease of entry into the sector.

  Sectors likely to benefit from investment in technology innovations are (i) health sector, with an aim to increase efficiency and improve service delivery, (ii) the government, in a bid to increase transparency and reduce corruption in government dealings, (iii) the agricultural sector with a focus on providing information to farmers and easier sourcing of market for farm produce, and (iv) financial services sector, as financial service providers strive to be innovative in their products thus improving customer reach and satisfaction, and also reducing operational costs.

- **Renewable Energy Sector:** Kenya's renewable energy sector will continue to attract private equity investments with growth being driven by (i) increase in demand, with the peak demand in 2015 being 1,512 MW, and growing at 7% annually, mainly attributed to growth in industrialization and increased connectivity of the rural areas, (ii) investor friendly regulations put in place by the industry regulators including, (a) tax exemption and import duty on material used for renewable energy plant development, and (b) the Feed-in-Tariff that offer investors guarantee of return on their investments, and (iii) high potential for wind, solar and geothermal energy generation in the country as indicated in the table below:

Energy Potential Sites in Kenya		
	Potential Areas	**Projects Connected to Grid**
Solar	Marsabit, Turkana, Malindi, Magadi, Meru, Garissa	Strathmore Power Plant (600kW)
Wind	Marsabit, Turkana, Ngong, Isiolo, Samburu, Wajir, Kilifi	Lake Turkana Wind Project (310MW), Kinangop(60MW), Kipeto(100MW)
Geothermal	Olkaria, Menengai, Suswa, Longonot , Lake Baringo, Eburru	Olkaria I, II, and , IV (430MW)

We also expect long term investments targeting the Vision 2030 flagship projects that are expected to further drive energy demand, as indicated in the table below:

Kenya Vision 2030 Flagship Projects Energy Demands						
Projects		**Energy Demand(MW)**				
	Completion Date	**2015**	**2020**	**2025**	**2030**	**2035**
Konza Techno City	2017		104	334	603	832
Special Economic Zones	2019		41	170	317	482
LAPSSET oil pipeline and port	2025			325	650	975
LAPSSET refineries/industries	2025				346	745
Rapid transit system Nairobi	2030				105	315
Electrified railways						
• **Mombasa-Nairobi**	2030				153	456
• **Nairobi-Kampala**	2035					97
Total			**145**	**829**	**2,174**	**3,901**

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- **Education:** We expect an increase in deal volume in the education sector, with a focus on private primary and secondary level education. The key drivers of investment in the sector will be (i) demand for quality education and a more comprehensive curriculum, (ii) the entry of international brands over the past years such as the Nova Academies, and (iii) a shift of demand from government funded education towards private education providers driven by the frequent disruptions in public schools. Informed by demand for education and the ability to afford the education provided, PE investors in the education sector can focus on the following counties to provide either, Early Childhood Development (ECD), Primary or Secondary level education, as highlighted in the table below:

Education Sector Investment Opportunities				
	County	**ECD Level**	**Primary Level**	**Secondary Level**
1.	West Pokot County	√		

2.	Turkana County	√		
3.	Samburu County	√		
4.	Isiolo County	√		
5.	Kilifi County	√		
6.	Nairobi City County	√		
7.	Kwale County	√		
8.	Nyandarua County		√	
9.	Trans-Nzoia County		√	
10.	Lamu County	√	√	
11.	Nyamira County	√	√	
12.	Busia County	√	√	
13.	Vihiga County		√	√
14.	Embu County		√	√
15.	Tharaka County		√	√
16.	Kiambu County		√	√
17.	Kisumu County		√	√
18.	Machakos County		√	√
19.	Muranga County		√	√
20.	Nakuru County		√	√
21.	Elgeyo Marakwet County	√	√	√
22.	Kirinyaga County	√	√	√
23.	Taita Taveta County	√	√	√
24.	Laikipia County	√	√	√
25.	Nyeri County	√	√	√

*- √- *Shows an investment opportunity in the level of education*

Our outlook for private equity remains positive. We expect an increase in the number of deals and deal volume in education, technology and long term investments in the renewable energy sector. For the financial services sector, we expect increased consolidation in the industry and more PE investors to take advantage of the cheaper market valuations. We remain bullish on PE as an asset class given (i) the abundance of global capital looking for opportunities in Africa, (ii) the attractive valuations in private markets compared to public markets, and (iii) better economic growth in Sub Saharan Africa as compared to global markets.

<u>Real Estate Outlook</u>

In 2016 real estate delivered high returns averaging 25.8% across all themes, with the best performing themes being retail and offices with average yields of 10.0% and 9.4%, respectively. In 2017, we expect the sector to continue with the good performance across all themes compared to traditional asset classes.

The key drivers of real estate in 2017 will be:

- **Demographic Trends** – Such as the growing middle class, rapid urbanization, rapid population growth and the youth bulge (21 to 35 years) will drive real estate development in 2017. This is as developers work towards satisfying their housing, entertainment and consumption needs thus boosting developments in the residential and retail themes
- **Large Housing Deficit** - According to the National Housing Corporation (NHC), there is an effective housing deficit of over 200,000 units per annum to cater for the low to middle income market with Nairobi and its metro accounting for over 50% of this deficit. Hence we will witness increased development activity in a bid to tap into this market, especially through affordable housing initiatives that cater to the segment, and reduce the deficit,

- **High Returns** - Real estate has consistently outperformed other asset classes in the last 5-years, generating returns of over 25.0% p.a., compared to an average of 10.0% p.a. in the traditional asset classes. In 2016, real estate delivered returns of 25.8%, against (8.5%) in equities and an average of 14.7% for the 10-year government bond. This significantly higher returns will thus lead to increased investments in the real estate sector, and especially from global and institutional investors seeking attractive risk-adjusted returns in the market,
- **Growing Businesses and Entry of Global Brands –** In 2016, a number of global brands including Wrigley's entered the Kenyan market with Volkswagen announcing plans to put up shop in Kenya in 2017. These together with the growing small and medium businesses will lead to increased demand for office, industrial as well as residential real estate to house the offices, products and employment, respectively,
- **Continued Infrastructure Development** - Infrastructural development has led to opening up of new areas for development e.g. along the Northern Bypass, Eastern and upcoming Western Bypass. The LAPPSET Corridor, SGR, expansion of airports and seaports are all opening up Kenya to real estate development and will lead to increased development along the hubs in towns such as Ruaka, Kikuyu and Athi River. Projects in the pipeline include the Standard Gauge Railway (SGR), which is expected to be operational by December of 2017,
- **Better Operating and Legal Environment** – 2017 will have a better legal and operational environment for real estate investments as several policies enacted in 2016 come into action. These policies include: (i) The 50% reduction in tax for developers constructing more than 400 units p.a., (ii) the Banking (Amendment) Act, 2015, capping interest rates at 14.0%, (iii) the proposal to remove NEMA and NCA, (iv) digitization of land records, and (v) increased transparency in the lands ministry as well as issuing of title. The above, if implemented, will boost real estate development by reducing construction costs, and fastening transaction process in the development process,
- **Domestic and MICE Tourism** – Increased domestic tourism as well as the growing Meetings Incentives, Conferences and Exhibitions (MICE) segment of the market will drive real estate in 2017. This is driven by improved security, growing businesses, SME's as well as county governments will greatly boost the hospitality industry in 2017,
- **Devolution** – Devolution is boosting real estate development as it is placing onus on the County Governments to improve the real estate landscape, which has led to reduced bureaucracy and investment in infrastructure as well as creating demand for real estate, especially residential units, office space and retail to cater for population moving to the county headquarters. Nevertheless, the upcoming general election in 2017 may see a slowdown in selected markets especially areas previously affected by political tensions in the past. For instance, parts of Rift Valley, Nyanza region and the Coastal regions, and
- **Increased financing** – From both local and international players to real estate will boost investments in the real estate sector.

The sector will however face a number of challenges in 2017 that will include:

- **High Land and Construction Costs -** This will continue to be a challenge in 2017 as land in Nairobi and other main town centers across the country is increasingly becoming expensive. Developers are likely to concentrate on areas in the outskirts of Nairobi where land is more affordable. While an acre of land in Donholm would cost Kshs 60 mn and that in Mlolongo would cost Kshs 40 mn, a similar parcel in Juja would cost between Kshs 10 mn - Kshs 15 mn. Construction costs will nevertheless remain high as developers have to incur infrastructural costs to make their developments viable in satellite towns,
- **Difficulty in Fundraising for Developments-** Being a capital-intensive sector, developers will need to adopt innovative ways to finance developments. Following the poor performance of REITs in the last year, they are likely to shy away from the capital markets. In addition, banks are less likely to advance

loans to small and medium sized companies with interest rates capped at 14%, banks will prefer to lend to the government since it is considered risk free,

- **Increased Supply and Competition-** Increased supply in some sectors such as the upper mid-end residential sector will result in competition and thus lower returns for investors. The commercial office segment is likely to experience high competition with the increasing office space supply in Nairobi's key nodes such as Upperhill and Westlands. This is expected to lead to lower occupancy and thus lower yields for investors,
- **Political Uncertainty -** As we enter the election year, we expect investors to shy away from long-term investments as the 'wait and see phenomena' sets in. We therefore expect prices and rents to stagnate during the first half of the year, then pick up once the state has stabilized. Risk-averse investors may however choose to lock positions during this period through purchase of property at low prices then exit after the election period at higher prices.

Thematic Performance Review and Outlook			
Theme	**2016 Performance**	**2017 Outlook**	**Effect**
Residential	• Performance has remained stable with rental yields averaging at 5%-6% • Developments in the lower-mid end recorded the highest price appreciation due to high demand • Developments in the upper-mid end recorded lower price appreciation due to increased supply in these areas • Ruaka, Ridgeways and Kikuyu were the best performing markets with 18.4%, 18.1% and 17.3% total returns, respectively • Kisumu market is picking up with average returns ranging from11% to 13% • Mombasa market has recorded low to negative returns especially in the high-end segment as developers reduce prices so as to boost uptake	• Stagnation of prices during the first half of the year, then increase after the election period • Demand for housing will remain high but highly concentrated in the lower income segment • Increased investment in satellite towns due to affordability and availability of land for development	**Positive**
Commercial Office	• The Sector performed well with high occupancy rates of on average 88%, high yields at 9.4% and prices of Kshs 13,000 per square foot • There was increased development with notable developments being	• The high returns in the sector expected to be sustained though we are likely to witness a slowdown in construction as a result of the high supply and subsequently lower occupancy rates in some submarkets	**Neutral**

	launched including Montave in Upperhill by Hass Consult and Abcon international Limited • Approximately 3.6 mn square foot of office space was added to the market	especially in Mombasa Road and Upperhill • Development in the sector will be construed to grade A offices, which are in short supply and renovation of existing buildings	
Retail	• The sector earned high returns driven by high demand • On average rental yields were 10.1% and occupancy levels of 89.3% • 2016 saw opening of the Hub and entry of global chains such as Choppies of Botswana • As of 2016 Nairobi had more than 5.5 mn square feet of retail space creating fears of oversupply	• High returns to be sustained by demand and demographics • More international developers expected to enter the market seeking to cash in on the middle-class population and changing lifestyles • A slowdown in the development in Nairobi and increased development in the counties	**Positive**
Industrial	• High returns with rents of Kshs 35 per square foot rental yield of 5.8%, and an occupancy of 85% • The sector witnessed increased development both in warehouses and serviced industrial plots • Leather city phase one and infinity industrial park were launched	• We expect to witness increased development activity in the sector with better quality warehouses being constructed and hence higher rents and rental yields	**Positive**
Hospitality	• Increased arrivals witnessed in the country as a result of global conferences and improved security hence attracting tourists • Serviced apartments enjoyed high occupancy rates of on average 90% and high returns, with TRevPAR of USD 127 against USD 98 for hotels	• Increased domestic tourism expected as well as increased MICE tourism boosting revenues in the sector • Rates expected to remain largely the same in 2017 • Increased developments in the sector especially of three and four star hotels	**Positive**
Listed Real Estate	• Listed real estate performed poorly with the only listed REIT shedding 50% of its value in 2016 • The only other listing FRED – Commercial, a D REIT from	• Low performance of listed real estate expected to persist as there are no measures to increase public awareness and boost the returns of the underlying assets	**Negative**

	fusion capital failed to meet the minimum requirement to list	• No public listings expected as investor sentiments towards REITS remain largely negative	

Our outlook for real estate remains positive in 2017, driven by the high returns being earned in the sector, the huge housing deficit, increased financing and infrastructural developments in the country and largely in Nairobi Metropolitan Area. Investors will however have to be cautious in their investments, ensuring that proper research and due diligence is done before investing and matching the right products to the right market to boost uptake and ensure they earn the high returns in the sector.

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