Cost of Living, & Cytonn Weekly #20/2017

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Executive Summary

Fixed Income: During the week, the level of T-bills subscription remained high but declined slightly to 172.5% compared to 176.3% recorded the previous week. Yields on the 91, 182 and 364-day papers remained unchanged at 8.7%, 10.4% and 10.9%, respectively, from the previous week. According to data released by the National Treasury in the Quarterly Economic and Budgetary Review for the third quarter of financial year 2016/2017, Kenya's Public debt has hit 52.6% of the GDP as at March 2017 from 51.5% in December 2016;

Equities: The equities market was on an upward trend with NSE 20, NASI and NSE 25 gaining 1.3%, 1.2% and 2.0% due to gains in select large caps such as DTB, KCB Group and Equity which gained 9.5%, 8.6% and 6.9%, respectively**.** Cooperative Bank and DTB released Q1'2017 results, Cooperative Bank recording a decline in its core earnings per share (EPS) by 6.1% to Kshs 0.66 from Kshs 0.7, while DTB EPS grew by 8.8% to Kshs 6.3 from Kshs 5.8;

Private Equity: Activity in the private equity space continues to gain traction based on acquisitions, capital commitments and fundraising activities in the week. Edmond de Rothschild Group through Moringa, a Paris based impact investment fund, acquired an undisclosed stake valued at USD 3.0 mn in Asante Capital, a Kenyan Agro-forestry company;

Real Estate: We continue to witness increased investments in the industrial real estate theme driven by increased demand from international firms being established in the country and infrastructural development. The outlook is positive in the long term for the commercial office sector as more multinationals continue setting up regional headquarters in Nairobi,

Focus of the Week: This week we focus on the cost of living in the wake of drought. We identify the main factors that affect the cost of living, look back at periods that have had similar prevailing conditions and how these affected the cost of living, and finally, conclude by looking at the government's preparedness and how they can improve on this going forward to avoid pressure on the cost of living.

Company Updates

- Cytonn Real Estate, the development affiliate of Cytonn Investments, on Monday 15th May 2017 broke ground on its latest project, The Ridge. The Ridge is a Kshs 12 bn comprehensive, luxurious, mixed use development on 10 acres in Ridgeways, Nairobi, which will have residential apartments, retail and office space and serviced apartments. The ground breaking was officiated by the governor of Nairobi County, His. Excellency Governor. Evans Kidero. Phase I of the development is already 31.0% sold at ground breaking and has delivered a 27.0% return to early buyers. In addition to a place to live, the development will create over 1,000 jobs. See event note here
- The Annual General Meeting of the Cytonn Investment Co-operative Society Limited, shall be held on 2nd June 2017, at 7.30 A.M. at The Nairobi Club, Nairobi
- Our Real Estate Research Analyst, Nancy Murule discussed effects of 2017 elections on real estate in Kenya. Watch Nancy Murule on NTV Property Show here
- We continue to showcase real estate developments by our real estate development affiliate, Cytonn Real Estate, through weekly site visits. Here are progress videos and pictures on The Alma and Amara. The site visits target both investors looking to invest in real estate directly, and also those interested

in high yield investment products to familiarize themselves with how we support the high yield returns. If interested in attending the site visits, kindly register here

- We continue to see very strong interest in our Private Wealth Management training, which is at no cost, and is held bi-weekly, but is open only to pre-screened participants. To register for the training kindly use this link. The training can also be offered to institutions which would like their employees to be trained on Private Wealth Management. To get further details contact our Client Services team at clientservice@cytonn.com
- For recent news about the company, see our news section here
- We have 12 investment-ready projects, offering attractive development and buyer targeted returns of around 25.0% p.a. See further details here: Summary of investment-ready projects
- To invest in any of our current or upcoming real estate projects, please visit Cytonn Real Estate
    - The Alma, which is over 55.0% sold, has delivered an annualized return of 55.0% p.a. for investors who bought off-plan. See The Alma.
    - Amara Ridge is currently 100.0% sold and has delivered 33.0% p.a. returns to investors. See Amara Ridge
    - The Ridge Phase One is currently 31.0% sold. See The Ridge
    - Taraji Heights is currently 10.0% sold. See Taraji Heights
- We are also looking for 3-10 acres of land in Karen, Garden Estate, Muthaiga North, South C and Lang'ata. Contact us at rdo@cytonn.com if you have any land for sale or joint ventures in the above areas.
- We continue to beef up the team with the ongoing hires: Careers at Cytonn

Fixed Income

T-bills subscription remained high but declined slightly during the week to 172.5%, compared to 176.3% recorded the previous week. The subscription rates for the 91, 182 and 364-day papers came in at 221.2%, 168.2% and 157.5% compared to 298.6%, 196.2% and 107.5% the previous week, respectively. Yields on the 91, 182 and 364-day papers remained unchanged at 8.7%, 10.4% and 10.9%, respectively, from the previous week. The accepted yields on all three papers came in at the same rate as the weighted average market yields, with the overall acceptance rate at 78.5% compared to 70.4% the previous week. The government accepted Kshs 32.5 bn of the Kshs 24.0 bn on offer for this auction an indication that the market has reacted to the government's efforts to maintain the yields low by bidding at rates equivalent to the accepted weighted average yields on all short-term papers. Bank's holdings in government papers has increased to 55.3% of total debt equivalent to Kshs 1.1 tn from 51.1% equivalent to Kshs 1.0 tn at the beginning of the year as investing with the Central Bank offers a better risk return proposition for the banks given the capping of interest rates. The increase is equivalent to 23.2% on an annualized basis, indicating that banks find it better to lend to the government than to the private sector due to the interest rate cap.

The market liquidity was stable as can be seen by the average interbank rate, which closed the week at 5.6% compared to 5.5% recorded the previous week while the average volumes transacted declined to Kshs 7.9 bn from Kshs 14.7 bn. During the week there was a net liquidity withdrawal of Kshs 25.7 bn compared to a Kshs 12.4 bn injection the previous week. The net liquidity withdrawal was due to T-bond sales and term auction deposits amounting to Kshs 20.0 bn and Kshs 24.0 bn, respectively.

Below is a summary of the money market activity during the week:

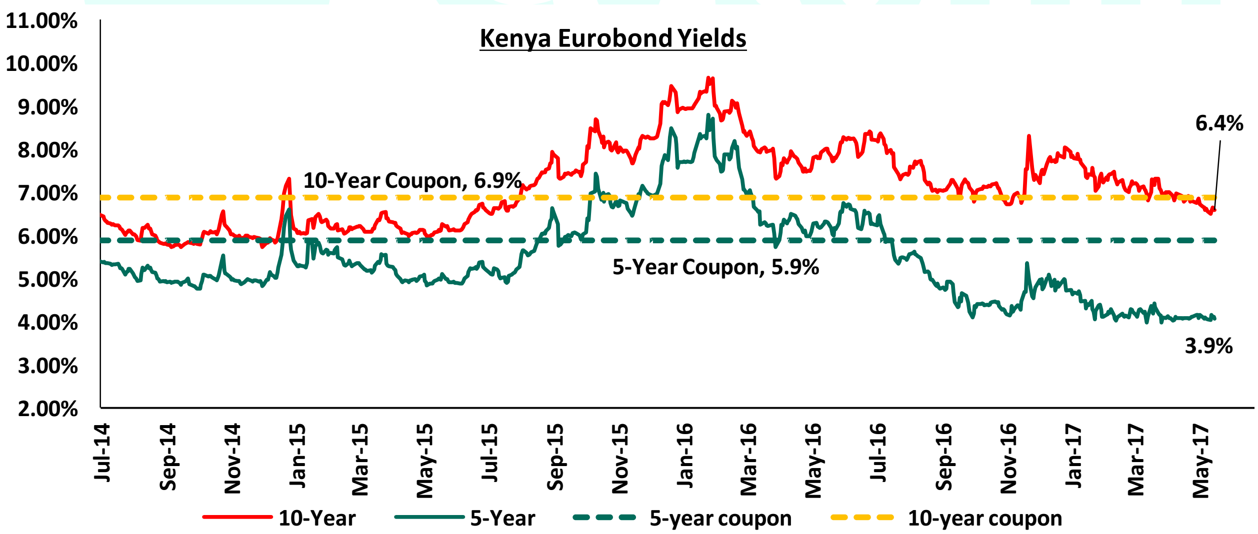
all values in Kshs bn, unless stated otherwise

Weekly Liquidity Position – Kenya			
Liquidity Injection		**Liquidity Reduction**	
Term Auction Deposit Maturities	0.0	T-bond sales	20.0
Government Payments	30.2	Transfer from Banks - Taxes	20.6

T-bond Redemptions	0.0	T-bill (Primary issues)	29.8
T-bill Redemption	14.9	Term Auction Deposit	24.0
T-bond Interest	2.4	Reverse Repo Maturities	3.8
T-bill Re-discounts	0.0	Repos	0.0
Reverse Repo Purchases	3.0	OMO Tap Sales	0.0
Repos Maturities	22.0		
Total Liquidity Injection	**72.5**	**Total Liquidity Withdrawal**	**98.2**
		Net Liquidity Injection	**(25.7)**

Last week, the Kenyan government re-opened two bonds (FXD 2/2010/10 and FXD 1/2009/15), with effective tenors of 3.4 and 7.4 years, and coupons of 9.3% and 12.5%, respectively, in a bid to raise Kshs 40.0 bn for budgetary support. The market average rates for the bids came in at 12.6% and 13.4% while the average yields of the accepted bids were 12.5% and 13.1% for the two bonds, respectively. The government did not accept expensive bids, having only accepted Kshs 20.0 bn out of the Kshs 38.8 bn worth of bids received, translating to an acceptance rate of 51.5%.

According to Bloomberg, yields on the 5-year and 10-year Eurobonds, with 2.2 years and 7.2 years to maturity, declined by 10 bps w/w for both bonds, to close at 3.9% and 6.4%, from 4.0% and 6.5%, the previous week, respectively. Since the mid-January 2016 peak, yields on the Kenya Eurobonds have declined by 4.9% points and 3.2% points, respectively, for the 5-year and 10-year Eurobonds due to stable macroeconomic conditions. The declining Eurobond yields and Standard & Poor's (S&P) having maintained Kenya's foreign and local currency sovereign credit ratings for the short and long term at "B+/B", respectively, are indications that Kenya remains stable and hence an attractive investment destination.



The Kenya shilling remained relatively stable against the dollar during the week to close at Kshs 103.3, from Kshs 103.2 recorded the previous week. However, the shilling is likely to be under pressure in the coming weeks on account of (i) increased dollar demand from oil importers as we expect oil prices to increase after the OPEC meeting, scheduled next week, to decide on production policy for the second half of 2017, with expectations that the group will cut down further on production, and (ii) sugar imports, as production declined due to low rainfall experienced in October and November 2016, thus requiring the government to import an additional 400,000 tones over the course of the month in order to meet the demand for sugar in the country. On a year to date basis, the shilling has depreciated against the dollar by 0.8%. With the current forex reserve level, currently at USD 8.2 bn (equivalent to 5.5 months of import cover), we believe the CBK will be able to support the shilling in the short term.

According to data released by the National Treasury in its Quarterly Economic and Budgetary Review for the third quarter of financial year 2016/2017, Kenya's Public debt stands at 52.6% of the GDP as at March 2017 from 51.5% in December 2016. The key take outs from the report were;

i) Public debt increased by 23.9% to Kshs 4.0 tn in March 2017 from Kshs 3.3 bn in March 2016 mainly attributed to exchange rate fluctuations, disbursements from external loans and an increased uptake of domestic debt,
ii) Kenya's public debt comprised of 51.9% foreign borrowings and 48.1% domestic borrowings. The total external debt amounted to Kshs 2.1 tn comprising of 38.4% multilateral debt, 32.8% bilateral debt and 28.8% commercial banks debt,
iii) Revenues collected by the government amounted to Kshs 984.6 bn against a target of Kshs 1,050.0 bn for the period ending March 2017 representing a shortfall of 6.2%,
iv) Loan repayments to China stood at Kshs 18.0 bn during the quarter ending March 2017, representing more than 50.0% of total bilateral borrowings even as the country continues to pursue China for more financing to its infrastructural projects.

The government has plans underway to acquire funding for one of the infrastructural projects, the Standard Gauge Railway (SGR), which might take the public debt to past 60.0% of the GDP. According to the International Monetary Fund (IMF), the target debt to GDP for developing countries should be at or below 50.0%, meaning that the current debt level in the country has surpassed the standard set by the global lender, and this may pose fiscal challenges if mechanisms are not put in place to improve on Kenya's fiscal and public finance management framework. As highlighted on our report on Kenyan Debt Sustainability, the government should consider to achieve: (i) enhanced tax revenue collection growth, (ii) involve private sector in development through Public-Private Partnerships (PPP's), (iii) reduce recurrent expenditure and improve on development budget absorption rates, and (iv) come up with innovative products like diaspora targeted bonds.

The International Monetary Fund (IMF), released a regional economic outlook report on Sub-Saharan Africa (SSA) indicating that the region is expected to grow by 2.4% this year compared to 1.9% registered last year. Some of the key positives supporting growth include (i) recovery of commodities prices in the global market, and (ii) fiscal consolidation in countries like Angola and Nigeria. IMF however, pointed out a couple of challenges facing the region among them (i) the rising debt levels, on average the public debt to GDP averaged 42.0% in 2016 from 32.0% in 2014, (ii) financial sector weakening due to weak commodity prices and increase in the nonperforming loans (NPLs). The IMF projects the SSA region to grow by 2.4% in 2017 from 1.9% in 2016 and forecast's Kenya to grow by 5.3% in 2017 down 5.8% in 2016 as a result of adverse effects of the current drought. We still believe that the economy will do well in 2017, and as per our Kenya 2016 GDP Growth and Outlook and we estimate 2017 GDP growth of 5.4%.

Global investors continue to look for attractive yields in the African markets. During the week, Senegal issued a new 16-year Eurobond, which is the country's fourth Eurobond since the last issue in 2014, to raise USD 1.1 bn. The bond's yield came in at 6.3%, below the initial expectation of 6.5%, and received a subscription rate of 845.5%, with investor bids amounting to USD 9.3 bn. This performance was better than expected with investors betting on political stability and stable economic growth in the country, which is estimated to come in at 6.8% in 2017 from 6.6% in 2016 by the IMF. This issue comes after Nigeria raised USD 1.0 bn in February at an average yield of 7.9% through a 15-year Eurobond. Despite the successful issuance African countries should be careful given the expected global strengthening of the dollar as such significant foreign borrowing will leave them exposed to shocks in the global economy and also make repayments expensive, further leading to currency depreciation.

Summary: Rates in the fixed income market have remained stable, despite indications of possible upward pressure on interest rates. The main factors supporting the low rates are:

i. ***The government is ahead of its domestic borrowing target for the current fiscal year, having borrowed Kshs 348.5 bn against a target of Kshs 260.6 bn (assuming a pro-rated borrowing throughout the financial year of Kshs 294.6 bn budgeted for the full financial year),***
ii. ***The government is behind its spending target, with total expenditure for the first half of the 2016/17 fiscal year coming in at Kshs 928.5 bn, which represents 83.6% of the pro-rated target of Kshs 1.1 tn, while development expenditure for the first half of the 2016/17 fiscal year had an absorption rate of 73.8% against 92.5% for recurrent expenditure. Given that the government has historically exceeded the absorption rate on recurrent expenditure, averaging 103.5%, while the development expenditure has averaged 65.0%, leaving the overall budget absorption rate below 100.0% consistently in the last 5 fiscal years, there still exists upward pressure on interest rates, but may be subdued unless spending picks up, and***
iii. ***The government may also be looking at concessionary loans to finance the expenditure rather than borrowing from the foreign market.***

Some of the factors putting upward pressure on interest rates are:

i. ***The government has only borrowed Kshs 205.8 bn of the budgeted foreign borrowing, representing 44.5% of its foreign borrowing target of Kshs 462.3 bn, and***
ii. ***The Kenya Revenue Authority (KRA) is expected to miss its overall revenue collection target of Kshs 1.5 tn for the current fiscal year having missed its third quarter target.***

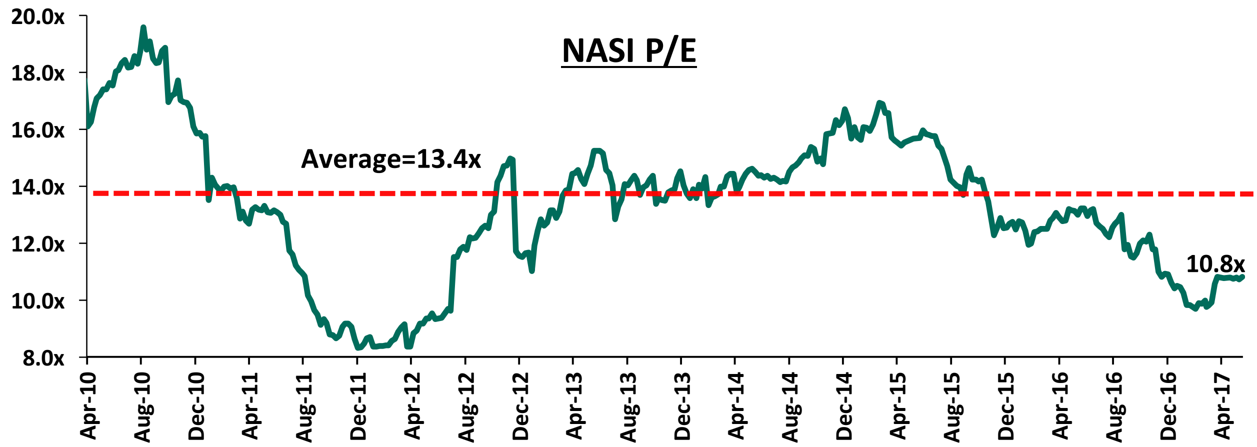
In conclusion, the possible budget deficit and high inflationary environment that we are currently in, create uncertainty in the interest rate environment as domestic borrowing may exert an upward pressure on interest rates, and result in longer term papers not offering investors the best returns on a risk-adjusted basis. It is due to this that we think it is prudent for investors to be biased towards short-term fixed income instruments.

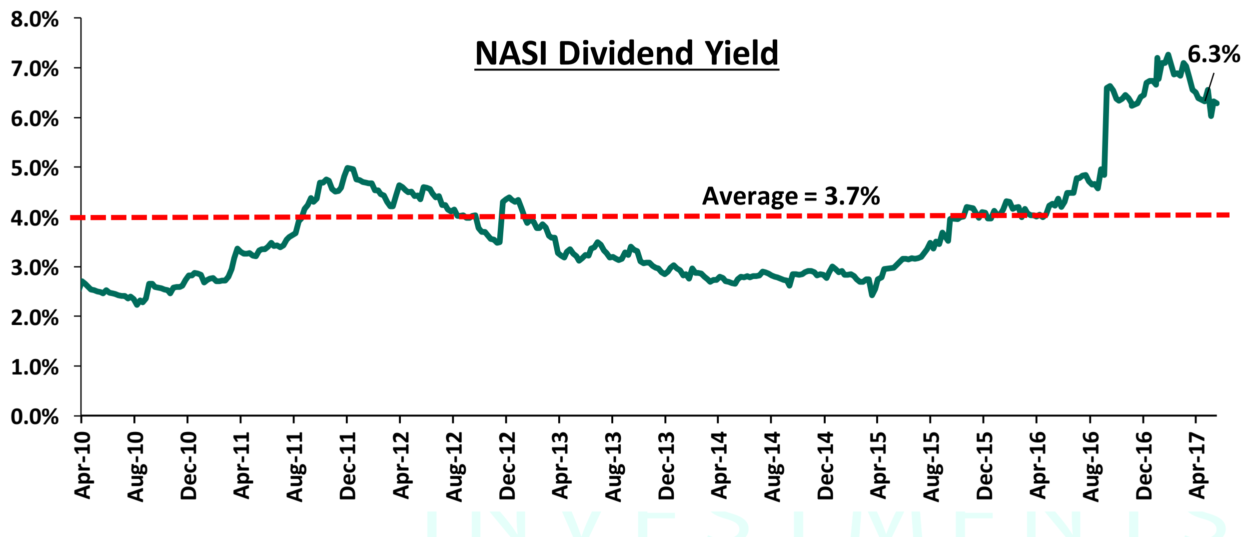
Equities

During the week, the equities market was on an upward trend with NSE 20, NASI and NSE 25 gaining 1.3%, 1.2% and 2.0%, respectively, taking their YTD performances to 3.1%, 4.6% and 5.1%, respectively. This week's performance was driven by gains in select large cap stocks such as DTB, KCB Group and Equity, which gained 9.5%, 8.6% and 6.9%, respectively. Since the February 2015 peak, the market has lost 40.3% and 21.4% for NSE 20 and NASI, respectively.

Equities turnover increased by 46.2% to close the week at USD 46.4 mn from USD 31.8 mn, the previous week. Foreign investors turned net sellers with a net outflow of USD 5.6 mn compared to a net inflow of USD 0.2 mn recorded the previous week. Foreign investor participation decreased to 59.3% from 62.7% recorded the previous week. Safaricom, KCB Group, EABL, Bamburi and Equity were the top movers for the week, jointly accounting for 80.9% of market activity. We expect the Kenyan equities market to be flat in 2017, driven by (i) slower growth in corporate earnings, and (ii) neutral investor sentiment mainly due to the forthcoming general elections.

The market is currently trading at a price to earnings ratio of 10.8x, compared to a historical average of 13.4x, and a dividend yield of 6.3%, compared to a historical average of 3.7%. The current 10.8x valuation is 11.5% above the most recent trough valuation of 9.7x experienced in the first week of February 2017 and 30.4% above the previous trough valuation of 8.3x experienced in December 2011. The charts below indicate the historical P/E and dividend yields of the market.





Vodacom Group is set to acquire 34.9% ownership of Safaricom in a share swap deal with Vodafone Kenya, which is a shareholder in both companies. Vodafone Kenya, which has a 39.9% stake in Safaricom, will cede 34.9% of its shareholding in return for a 5.0% stake in Vodacom Group for an estimated Kshs 266.6 bn, increasing its stake in Vodacom Group from 65.0% to 70.0%. The proposed transaction is at a price-to-earnings valuation of 15.7x, which is a 7.6% discount to market, as Safaricom is currently trading at a P/E of 16.9x and EV/EBITDA of 16.3x. Vodafone will continue to hold a 5.0% interest in Safaricom following the transfer, in addition to the indirect interest held through Vodacom Group. The transaction is aimed at simplifying Vodafone's operations in Africa, as it has been focusing on reorganizing its portfolio of global assets, through refocusing on fewer regions and stabilizing its emerging markets businesses. On the other hand, it will expose Vodacom Group to the attractive high growth Kenyan market, which has made significant steps in technological innovation and give it greater access to M-PESA, hence promoting expansion of the M-PESA business in Africa, and consequently promoting growth of Safaricom, as M-PESA remains a key growth driver of the company. This translates to a win-win situation for all the parties - Vodafone Kenya, Vodacom group and Safaricom. We do not expect a significant change in Safaricom strategy, given (i) the current Safaricom directors also sit on Vodacom's board and (ii) Vodafone Kenya will maintain a 5.0% stake in Safaricom hence maintaining a seat on the board. Despite the shift in shareholding structure, there will be no change in shares outstanding. The proposed transaction is subject to regulatory and shareholder approval.

Cooperative Bank released Q1'2017 results

Co-op Bank released Q1'2017 results posting a 6.1% decline in core earnings per share (EPS) to Kshs 0.66 from Kshs 0.7 in Q1'2016 attributed to a 1.8% decline in operating revenue to Kshs 10.1 bn from Kshs 10.3 bn registered in Q1'2016. The revenue decline was far outpaced by a 6.5% growth in operating expenses to Kshs 5.6 bn from Kshs 5.2 bn registered in Q1'2016.

Key highlights for the performance from Q1'2016 to Q1'2017 include:

- Total operating revenue declined by 1.8% to Kshs 10.1 bn from Kshs 10.3 bn, driven by a decline in both Non-Funded Income (NFI) and Net Interest Income (NII) by 1.6% and 2.2%, respectively.
- Net interest income (NII) declined by 1.6% to Kshs 6.7 bn from Kshs 6.8 bn in Q1'2016, following a 10.8% decrease in interest income to Kshs 9.5 bn from Kshs 10.7 bn in Q1'2016. This was outpaced by a 27.3% decline in interest expense to Kshs 2.8 bn from Kshs 3.9 bn in Q1'2016, thus the Net Interest Margin (NIM) came in at 9.5% from 8.8% in Q1'2016,
- Non-Funded Income (NFI) recorded a decline of 2.2% to Kshs 3.4 bn from Kshs 3.5 bn in Q1'2016 attributed to a 52.3% decline in other income, which came in at Kshs 0.3 bn, from Kshs 0.5 bn in Q1'2016. Forex income also recorded a 12.5% decline, coming in at Kshs 0.5 bn from Kshs 0.6 bn in Q1'2016, owing to the devaluation of the South Sudanese Pound and a slowdown in the South Sudan business, which is mainly forex business. The current revenue mix stands at 66:34 funded to non-funded income same as what was recorded in Q1'2016,
- Total operating expenses grew by 6.5% to Kshs 5.6 bn from Kshs 5.2 bn in Q1'2016, driven by a 20.0% increase in Loan Loss Provisions (LLP) to Kshs 0.8 bn from Kshs 0.6 bn in Q1'2016. Staff costs also increased by 6.9% to Kshs 2.3 bn from Kshs 2.2 bn in Q1'2016,
- Cost to Income ratio worsened to 55.4% from 51.4% in Q1'2016. Without LLP it worsened to 47.9% from 45.0% in Q1'2016,
- Profit before tax declined by 8.7% to Kshs 4.5 bn from Kshs 4.9 bn in Q1'2016,
- The Loan book expanded by 15.0% to Kshs 245.9 bn from Kshs 213.7 bn in Q1'2017, while customer deposits grew by 6.9% to Kshs 279.8 bn from Kshs 261.7 bn in Q1'2016,
- The faster growth in loans led to an increase in loan to deposit ratio to 87.9% from 81.7% in Q1'2016,
- Co-operative Bank is currently sufficiently capitalized with a core capital to risk weighted assets ratio of 17.0%, 6.5% above the statutory requirement, with total capital to total risk weighted assets exceeding statutory requirement by 10.3% to close the period at 24.8%

Moving forward, Cooperative Bank performance shall be driven by:

i. Gains from continued implementation of the "Soaring Eagle" transformation agenda focusing on improved operational efficiencies, cost management and innovative customer delivery systems,
ii. Revenue diversification with expected strong growth in its subsidiaries' including Co-op Consultancy and Insurance Agency as well as Co-op Trust Investments Limited, through the introduction of new business lines such as Unit trusts and the expansion of the insurance agency to all of Co-operative's bank branches. Just like KCB Group, we think the Coop Bank brand is underutilized in non-funded income businesses and has great potential to grow non funded income businesses.

For a more detailed analysis, see our Co-operative Bank Q1'2017 Earnings Note.

Diamond Trust Bank released Q1'2017 results

DTB released their Q1'2017 earnings posting an 8.8% increase in core earnings per share (EPS) to Kshs 6.3 from Kshs 5.8 in Q1'2016, driven by a 0.1% decrease in operating expenses and a 2.3% increase in operating revenue.

Key highlights for the performance from Q1'2016 to Q1'2017 include:

- Total operating revenue grew by 2.3% to Kshs 5.9 bn from Kshs 5.8 bn in Q1'2016, in line with our estimate of a 2.7% growth. This was supported by a 0.8% growth in Net Interest Income and an 8.3% growth in non-Funded income,
- The 0.8% increase in Net Interest Income was supported by the slower decline in Interest Income at (0.1%) to Kshs 8.18 bn from Kshs 8.19 bn in Q1'2016, than the decline in Interest expense at 1.2% to Kshs 3.57 bn from Kshs 3.61 bn in Q1'2016. The Net Interest Margin thus remained flat at 7.4%,
- Non-funded income (NFI) increased by 8.3% to Kshs 1.3 bn from Kshs 1.2 bn in Q1'2016, against our expectation of an 18.7% increase. The increase in NFI was driven by a 21.4% increase in fees and commissions on loans and advances to Kshs 326.5 mn from Kshs 269.0 mn in Q1'2016. The current revenue mix stands at 78:22 funded to non-funded income from 79:21 in Q1'2016,
- Total operating expenses declined marginally by 0.1% to Kshs 3.28 bn from Kshs 3.29 bn in Q1'2016 following a 28.4% y/y decline in Loan Loss Provisions (LLP) to Kshs 635.0 mn from Kshs 886.4 mn. Without LLP, operating expenses grew 10.3% to Kshs 2.7 bn from Kshs 2.4 bn registered in Q1'2016. Staff costs grew by 7.7% to Kshs 1.0 bn from Kshs 0.96 bn in Q1'2016,
- Cost to Income ratio improved to 55.7% from 57.1% in Q1'2016. Without LLP, Cost to Income ratio deteriorated to 44.9% from 41.7% in Q1'2016,
- Profit before tax (PBT) increased by 5.7% to Kshs 2.6 bn from Kshs 2.5 bn in Q1'2016. The effective tax rate declined to 33.1% from 35.0% in Q1'2016, owing to an increase in profit before tax as the current tax remained flat in Q1'2016,
- The loan book grew by 4.8% to Kshs 188.4 bn from Kshs 179.8 bn in Q1'2016, while customer deposits grew by 22.1% to Kshs 251.4 bn from Kshs 206.0 bn in Q1'2016, due to the bank's efforts to strengthen its network channels through opening up an additional 3 new branches in 2016, partnering with PCK to increase its agency network, and it's gain from Imperial Bank Ltd (IR) clients, whereby Imperial Bank depositors were allowed access to their funds under the management of DTB and KCB Group; it seems DTB was the greatest beneficiary of IBL deposits
- The faster growth in deposits led to a decline in the loan to deposit ratio to 74.9% from 87.3% in Q1'2016,
- DTB Kenya is currently sufficiently capitalized with a core capital to risk weighted assets ratio at 15.9%, 5.4% above the statutory requirement, with total capital to total risk weighted assets exceeding statutory requirement by 3.6% to close the period at 18.1%

Moving forward, DTB performance will be driven by:

a) Increased efficiency through cutting down of costs by opening more digital branches offering 24/7 customer service similar to those already at The Oval, Westlands and Garden City, hence cutting staff costs, increasing working hours and still providing all banking services,
b) Leveraging on new and innovative products such as bancassurance through Diamond Trust Insurance Agency Ltd and increased card partnerships like those with Nakumatt, NationHela and MI-Card; in a bid to increase non-funded income which grew by 8.3% y/y.

For a more detailed analysis, see our DTB Kenya Q1'2017 Earnings Note.

Below is our Equity Universe of Coverage.

all prices in Kshs unless stated otherwise								
OUR EQUITY UNIVERSE								
No.	**Company**	**Price as at 12/05/17**	**Price as at 19/05/17**	**w/w Change**	**YTD Change**	**Target Price***	**Dividend Yield**	**Our Estimated Upside/ (Downside)****

1.	Bamburi	159.0	160.0	0.6%	0.0%	231.7	7.8%	52.6%
2.	BAT (K)	819.0	784.0	(4.3%)	(13.8%)	970.8	6.2%	30.0%
3.	Liberty	8.9	10.5	17.4%	(20.8%)	13.0	0.0%	24.2%
4.	Britam	10.1	10.3	2.0%	3.0%	11.9	2.7%	18.2%
5.	KCB Group ***	35.0	38.0	8.6%	32.2%	41.0	7.0%	14.9%
6.	Kenya Re	18.8	19.5	3.7%	(13.3%)	20.5	4.4%	9.5%
7.	Barclays	8.1	8.0	(0.6%)	(5.7%)	7.9	10.0%	8.8%
8.	CIC Group	3.7	3.7	(1.4%)	(3.9%)	3.7	3.2%	4.8%
9.	Jubilee	452.0	470.0	4.0%	(4.1%)	482.2	1.8%	4.4%
10.	Stanbic	64.0	63.0	(1.6%)	(10.6%)	60.2	8.1%	3.6%
11.	Safaricom	20.3	20.5	1.2%	7.0%	19.8	4.7%	1.1%
12.	I&M	91.0	91.0	0.0%	1.1%	88.0	4.0%	0.7%
13.	SCBK	197.0	205.0	4.1%	8.5%	189.5	6.7%	(0.8%)
14.	HF Group	10.0	10.0	0.0%	(28.6%)	9.2	4.7%	(3.2%)
15.	NIC	27.0	28.3	4.6%	8.7%	26.4	3.0%	(3.5%)
16.	Equity	32.8	35.0	6.9%	16.7%	30.7	5.1%	(7.2%)
17.	Co-op Bank	16.7	17.2	3.3%	30.3%	14.4	5.7%	(10.8%)
18.	Sanlam	25.0	25.0	0.0%	(9.1%)	21.1	0.0%	(15.8%)
19.	DTBK	126.0	138.0	9.5%	16.9%	104.0	2.2%	(22.4%)
20.	NBK	7.0	7.9	12.9%	9.7%	1.7	0.0%	(78.5%)

**Target Price as per Cytonn Analyst estimate*

***Upside / (Downside) is adjusted for Dividend Yield*

****For full disclosure, Cytonn and/or its affiliates holds a significant stake in KCB Group, ranking as the 14th largest shareholder*

We remain "neutral with a bias to positive" for investors with short to medium-term investments horizon and are "positive" for investors with long-term investment horizon.

Private Equity

Edmond de Rothschild Group through Moringa, a Paris based impact investment fund, has acquired an undisclosed stake valued at USD 3.0 mn in Asante Capital EPZ, a Kenyan Agro-forestry company. This is the second investment from the USD 84.0 mn fund that closed in late 2015. The investment will be utilised in the establishment of a plywood industry, production of essential oils and foodstuffs in Kenya. The partnership with Moringa will assist Asante to (i) scale up its operations, and (ii) take advantage of the growing wood market in the Middle East and Asia as well as Kenya's vibrant construction market.

XSML, a fund manager active in central and East Africa has announced its final close of the Africa Rivers fund (ARF) at USD 50.0 mn. This is XSML's second fund after the USD 19.0 mn, Central Africa SME Fund (CASF), this brings a total of USD 69.0 mn under XSML's management. ARF will adopt CASF's strategy to fund businesses through equity, debt and mezzanine financing. With seven investors in ARF from the previous three investors in CASF fund and the reinvestment by the initial investors (IFC, FMO and Lundine foundation) in the second fund reflects investor confidence in the Sub-Saharan Africa region. ARF has already invested 26.0% of the ARF fund in the first year. This is evidence that the private sector in Sub-Saharan region has potential for growth and has a high appetite for long-term capital that can be attributed to lack of risk capital.

Four investors- Google, Convergence Partners (Pan-African ICT–focused private equity firm), the International Finance Corporation (IFC), and Mitsui & Co, have committed to invest USD 100.0 mn in CSquared, a Google broadband infrastructure company. CSquared will establish its headquarters in Kenya with its main focus being to build a wholesale metro fibre optic network to enable internet access in Africa. The ICT sector in the Sub-Saharan region has potential for growth given (i) low internet penetration in the region which is at a low of 6%

for the whole of Africa, and (ii) increased automation of business processes by SMEs and large businesses hence fibre becoming an important way for end users to directly access the internet including the increased automation of banking products and services.

Private equity investments in Africa remain robust as evidenced by the increased deals and deal volumes. Given (i) the high number of global investors looking to cash in on the growing middle class of Africa, (ii) the attractive valuations in frontier markets compared to global markets, and (iii) better economic projections in Sub Sahara Africa compared to global markets, we remain bullish on PE as an asset class in Sub-Sahara Africa.

Real Estate

Despite the current oversupply constraining performance, the commercial office sector in Nairobi is set to pick up in the long run. This follows the continued announcement by several multinationals to set up operations in the country. This week, CSquared, a broadband infrastructure company established by Google in 2011, announced plans to enter the market and set up its regional headquarters in Nairobi joining other companies which have done the same in the recent past as tabulated below: -

Some of International firms that have entered the Kenyan market in the recent past

No.	Firm	Type of Set Up	Location	Date of Announcement
1.	Volvo	Assembly Plant	Mombasa	May 2017
2.	Johnson & Johnson	Regional Headquarters	Nairobi	March 2017
3.	Boeing	Regional Office	Nairobi	March 2017
4.	Catalan Government Trade & Investment Offices	Offices	Nairobi	February 2017
5.	Peugeot	Assembly plant	Nairobi	February 2017
6.	RICS	Regional Offices	Nairobi	January 2017
7.	Volkswagen	Assembly plant	Thika	September 2016
8.	IE Singapore	Regional Offices	Nairobi	August 2016
9.	Fieldstone Africa	Regional Headquarters	Nairobi	August 2016
10.	Wrigleys	Factory	Machakos	April 2015

This comes in the wake of PwC's 6^{th} Edition of The Africa Business Agenda Report that revealed that most CEO's in Africa are looking beyond their home markets for growth. A majority of these CEO's – 14.0% cited Kenya as the most ideal location for expansion outside their home countries closely followed by South Africa at 13.0% with Nigeria coming in third at 11.0%. 1,379 CEOs participated in the survey. The CEOs cited that (i) improving infrastructure (ii) big pool of skilled workers, and (iii) a young population were their biggest attraction to the country. We thus expect to witness more multinationals having a presence in Nairobi as it continues to solidify its position as not just a regional but also a continental hub. This will in the long run translate to an increase in demand for commercial office space and boost economic development.

Also in the commercial office sector, Kasarani Investments Holdings, a subsidiary of Actis – The Garden City developer is looking at building a business complex in Ruaraka. The National Environmental Management Authority (NEMA) invited public opinion on the complex in the dailies over the week. The complex, named Garden City Business Park will consist of approximately 640,000 square feet of Grade A office space in two office blocks with parking ratios of 6 parking lots per 1,000 square feet at a cost of Ksh 2.7 bn. In addition, the developer will put up a hospital as well as a 286-key 3-star and a 216-key 4-star hotels on the 23.5 acre land parcel. The developer mentioned that a leading mobile operator has already committed to relocating its headquarters to one of the office blocks by June 2018 when the offices are due for completion. This indicates that there is still demand for office space particularly Grade A office space. Developers should thus aim to provide Grade A office space which continues to enjoy higher returns with average rental yields of on average 10.0% p.a against 9.2% and 8.6% for Grade B & C office space, respectively.

The logistics industry in Kenya continues witnessing increased investment activity; this week we witnessed a number of firms announcing intentions to invest in the sector including:

i) DOB Equity, a Dutch PE firm, announced plans to invest up to Kshs 413.0 mn in Africa Logistics Properties Holding (ALP). ALP is a developer and manager of modern grade-A warehousing in Kenya. The funds will allow the firm to build warehousing developments and expand its operations across East Africa,

ii) Volvo Group which announced its plans to invest in a Kshs 2.5 billion assembly plant in Mombasa in Q1'2018. This shall be their 3rd assembly plant in Africa and 16th worldwide after other plants in South Africa and Morocco**.** Besides shippers, manufacturers are also a target market for warehouses and industrial space at large such as Volkswagen, the German carmaker, Peugeot, the French car manufacturer, and Volvo Group, a track manufacturer**.** The plant is expected to create approximately 300 direct jobs in addition to the recently opened Volvo Trucks regional office in Nairobi in its bid to expand the footprint in the East African region market,

iii) Tianlong, a Chinese family-owned gas cylinder manufacturer got the nod from Kenya Bureau of Standards to locally manufacture canisters for the East and West African market. The firm acquired 7 acres of industrial land within Tatu Industrial Park which shall be its African Hub. The new plant which shall offer direct employment to 200 skilled locals in the next year is among other brands which have set up shop in Tatu Industrial Park including but not limited to Unilever, Bidco Africa, Dormans, Kim-Fay and Maxam.

We expect the development activity in the industrial sector to continue with better quality warehouses being constructed to meet the high demand for warehouses among businesses locally. The higher quality will also lead to higher rents and rental yields. As at last year, warehouses in Kenya have rents averaging at Kshs 35 per sqft with rental yield of 5.8%, and occupancy rate of 85%. The industry will also be boosted by the improving infrastructure leading to growth of industrial parks along transport corridor such as the SGR, the LAPSSET Corridor and the network of By-passes within the Nairobi Metropolis.

The Transport Principal Secretary announced that the portion of the Standard Gauge Railway (SGR) running from Mombasa to Nairobi shall begin cargo haulage operations in December 2017 and not in June 2017 as earlier expected. This is due to slow expansion and modernization of the Nairobi Inland Container Depot (ICD) from a capacity of 180,000 to 450,000 containers ready to handle increased cargo. The SGR project is important for the growth of Mombasa as a transhipment hub as it will ease the congestion at the port when it begins to haul cargo to Nairobi by the end of the year especially after the completion of the ongoing port upgrade. The city's port is undergoing dredging to allow for larger ships which cannot dock anywhere else in the region to use the Kenyan port as they offload their cargo onto smaller vessels which eventually complete the journey to other ports in the region. Over the past one year, transhipment cargo volumes have increased by 87.0% from 10,262 Twenty-Foot Equivalent Unit (TEUs) in 2016 to 19,225 TEUs in 2017 indicating the need to expand the ports capacity. Still on the SGR, Kenya is seeking an additional Kshs 370 bn Chinese loan to extend the 3rd phase of the 270km standard gauge railway (SGR) from Naivasha to Kisumu, pushing the total construction cost of the railway to Kshs 847 bn.

The real estate sector remains resilient to the current political and economic headwinds with increased investment being witnessed in the sector. We expect this to continue especially if calm elections are held with the industrial sector finally picking up as a result of increased demand and infrastructural development.

Focus of the Week: Cost of Living

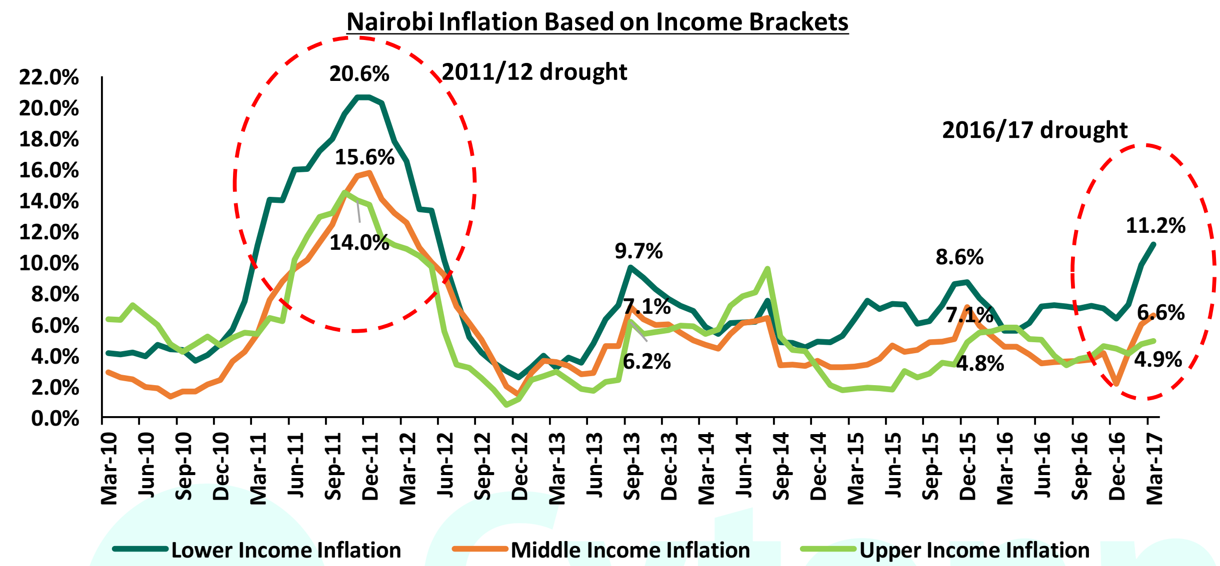
The Economic Survey 2017, published annually by the Kenya National Bureau of Statistics, revealed that GDP is estimated to have grown by 5.8% in 2016 from 5.7% in 2015; this was in line with our expectation of a band of 5.7% - 6.0%. In order to assess the cost of living, we have picked two components of GDP, agriculture and financial intermediation, because (i) food is a big component of the Consumer Price Index (CPI) and a necessity that is produced through agricultural activities, hence knowing how the agriculture sector performed will give us insight on food supply and prices, and (ii) knowing about the growth of money supply in the economy and credit accessibility to households will give us an indication of household income and whether they can easily subsidize this with credit when the need arises. Agriculture's contribution to GDP declined by 0.4% to 21.8% and its weighted y/y growth rate slowed down to 4.0% from 5.5% in 2015. This was attributed to the drought experienced from the 2nd half of the year that rendered the weather conditions unfavorable for agricultural activities. Financial sector growth also slowed down, growing by 6.9% in 2016 from 9.4% in 2015 driven by (i) slow private sector money supply growth of 3.6% in 2016 from 14.1% in 2015, and (ii) a slump in domestic credit growth to 6.4% from 20.8% in 2015. These two prevailing conditions have had an effect on the cost of living. Consequently, this week we focus on the main factors that affect the cost of living, look back at periods that have had similar prevailing conditions and how these affected the cost of living, and finally, conclude by looking at the government's preparedness and how they can improve on this going forward to avoid pressure on the cost of living.

Cost of living is simply what one needs to sustain their daily needs and is a function of one's disposable income and one's expenses. Below, we explore the factors that affect the cost of living and look at whether the factor is prevalent in the Kenyan scenario and how it has affected the cost of living:

Factor	Effect on Cost of Living	Kenyan Scenario	Current effect on cost of living?
Cost of Necessities*	The more basic goods and services cost, the more you have to pay for them. Hence, the cost of necessities and the cost of living have a direct and positive relationship in that, holding all other factors constant, if the cost of necessities increases, then the cost of living also rises and vice versa. Inflation is covered in this bucket	• The April 2017 inflation rate came in at 11.5%, having risen 6.2% y/y and 5.1% from December 2016 • Food & non-alcoholic beverages index increased by 3.5% m/m and by 21.0% y/y in April 2017 • The clothing & footwear index rose by 4.0% y/y in April 2017 • The housing, water, electricity, gas & other fuels index rose by 2.9% y/y in April 2017 • Health, transport and education indices rose by 3.1%, 5.1% and 2.9% y/y in April 2017	**Negative**
Level of Disposable Income**	The less you have to spend, the less you can afford. Hence, the level of disposable income and the cost of living have an inverse relationship in that, holding all other factors constant, if the level of disposable income increases, the cost of living decreases and vice versa. Unemployment and credit accessibility are covered in this bucket	• The 2017 Human Development Index revealed that Kenya's 2016 unemployment rate was the highest in East Africa at 39.1% up from 24.1% in 2015, meaning that the general population's disposable income declined in 2016 • According to the Economic Survey 2017, there was a slump in domestic credit growth in 2016 to 6.4% from 20.8% in 2015 and M3 money supply growth declined in 2016 to 3.6% from 14.1% in 2015, meaning that there was less money in circulation and a larger part of the population was able to subsidize their income with debt to improve their living standards	**Negative**

**Necessities in this case refer to goods and services that a household needs on the regular like common food items, utilities, housing, clothing, education and healthcare*
***Disposable Income refers to the income one has after deductions such as taxes and additions such as subsidies and donations*

Looking at the current trends, inflationary pressure has been felt more by the low middle income people given that they spend most of their incomes on basic necessities like food whose inflation has been quite high. From the chart below, we can see that the lower income class inflation has been high especially during the two drought seasons (circled in red), where food and utilities inflation are usually at their peak due to subdued rainfall leading to lower food, electricity and water production/availability.



Now that we have seen the main factors that affect the cost of living and how these factors have taken shape in the Kenyan scenario, we now look into the past because history has a tendency to repeat itself. We want to look at periods with similar prevailing conditions and how these conditions affected the cost of living.

Period	Prevailing Conditions	Measures Taken by The Government	Effect on Cost of Living
2004/05	• The prevailing drought had pushed up the inflation rate to highs of 18.3% in October 2004 • The food & non-alcoholic drinks index had risen by 24.8% y/y • The fuel & power index had risen by 33.8% y/y • The transport & communications index had risen by 24.6% y/y	• The government ensured that there were food reserves in form of maize for the FY 2004/05 • The government imported 180,000 tonnes of maize to supplement the strategic grain reserves • The government appealed to the international community and development partners to donate 166,000 tonnes of assorted food stuff • The government set aside Kshs 65.0 mn to supply seeds to farmers across the country as a long term measure	**Negative**
2008/09	• The drought had stricken once again, pushing up the inflation rate to highs of 31.5% in May 2008 • The food & non-alcoholic drinks index had risen by 44.2% y/y • The housing, transport & communication, fuel & power, medical goods and education indices had risen by 6.5%, 20.3%, 17.9%, 8.3% and 6.8%	• The government appealed to the international community to assist through donations to deal with the crisis • The government embarked on activities of water trucking, borehole digging, destocking-slaughter and animal health & feed programmes to help livestock farmers and pastoralists • The government increased the budgetary allocation to agriculture as a long term	**Negative**

		measure. The government would buy surplus production from farmers for storage in preparation for the next cycle	
2011/12	• The drought pushed inflation to highs of 19.7% November 2011 once again • The food & non-alcoholic drinks index had risen by 26.2% y/y • The clothing & footwear index rose by 10.6% y/y in April 2017 • The housing, water, electricity, gas & other fuels index rose by 17.0% y/y in April 2017 • Health, transport and education indices rose by 8.2%, 28.0% and 4.7% y/y in April 2017	• The government declared the drought a national disaster and called for local and international aid to counter the situation • Food distribution programmes were started • To stabilize high prices of cereals, the government allowed importation of cereals • A drought intervention strategy was embarked on with the government allocating funds and disbursing them in tranches/phases to cater for intervention in various sectors	**Negative**

From the table above, we see that most instances of a spike in the cost of living are brought about by cost-push inflation and an increase in cost of necessities, usually in drought years. This is mainly because as a country, we are still highly dependent on rain-fed agriculture and a large portion of our electricity is still hydro-electric power (HEP). We also see that as a country, we have been putting in place short term measures to cushion us against the negative effects on the cost of living, and the long term measures such as setting up large irrigation schemes might not be taking place as fast as the country demands them. The drought is a cyclical natural catastrophe that the government can strategically plan for and mitigate against.

To help curb recurrence, the following are some of the long-term solutions we would suggest:

(i) Developing irrigation schemes to reduce dependence on rain-fed agriculture and ensure food security in low rainfall seasons,
(ii) Encouraging a culture change in the population to embrace all food types and enable us depend on drought resistant crops, such as sorghum and millet, in times that we have to,
(iii) Better budgetary disaster management allocation,
(iv) Diversifying sources of electricity to reduce dependence on HEP which is reliant on good rainfall,
(v) Investing in water reservoirs across the country to harvest rain water and ensure water is stored for use in times of low rainfall,
(vi) Doing more to preserve water catchment areas especially forests,
(vii) Investing in proper national food storage facilities to enable us store enough food for drought seasons, and
(viii) Improving the food distribution and preservations channels in the country to ensure food moves swiftly from areas with a surplus to areas with a deficit.

We are of the view that the government needs to embark on these longer term solutions to prevent a recurrence of similar conditions going forward. This way, we will ensure that economic growth achieved in 5 years will not be wiped out by a single 2-year Act of God come the next drought.