Cytonn Monthly – April 2016

Executive Summary

- **Fixed Income:** Yields on government securities were on a downward trend during the month with signs of having bottomed out. Kenya's inflation rate for the month of April came in at 5.3%, from 6.5% recorded in March, on account of a decline in food and transport indices;
- **Equities:** During the month of April, the equities market had a mixed trend with NASI and NSE 25 declining 0.4% and 0.1%, respectively, while NSE 25 gained 0.7% compared to gains of 3.8%, 4.3% and 3.1%, respectively, in March. During the week, HF Group released their Q1'2016 earnings, recording an impressive core EPS growth of 47.6% with key metrics pointing the right direction;
- **Private Equity:** Energy, financial services and FMCG sectors continued to witness increased private equity activity during the month; Catalyst Principal Partners invested in a minority stake into Orbit chemicals during the week;
- **Real Estate:** Hospitality, industrial, lower middle and low income residential sectors continue attracting investments as growth slows down in the commercial office sector;

Company Updates

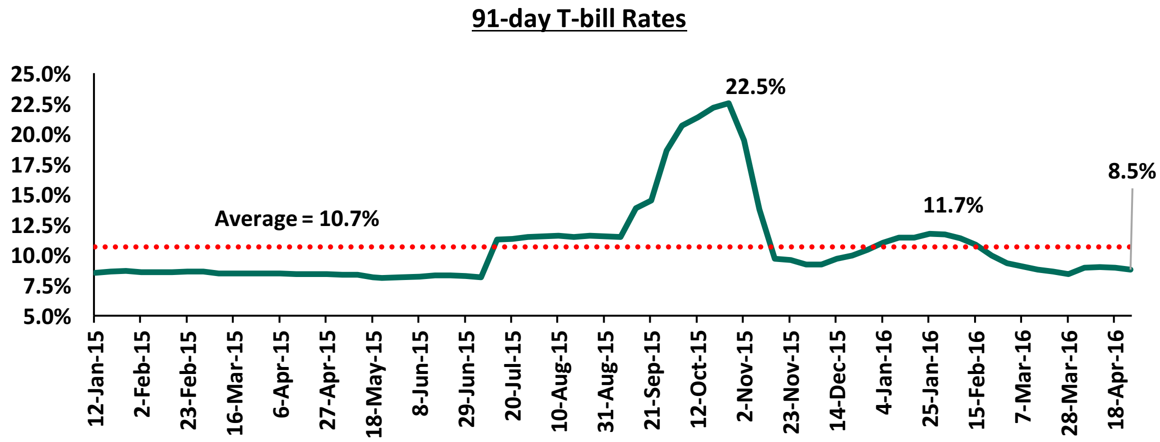
- We thank you for taking part in our Athi City naming competition. We are compiling the results and we shall announce the winner(s) in the next Cytonn Weekly
- Our Managing Partner and CEO, Edwin H. Dande, discussed the Kenyan property market on NTV AM Live Show. Edwin H. Dande on NTV AM Live Show
- Our Partner and CIO, Elizabeth N. Nkukuu, CFA was featured in Lifestyle Magazine in Standard Newspaper discussing the rise of Cytonn. Elizabeth N. Nkukuu in Lifestyle Magazine
- This week, we released our Mortgage and Rental Affordability Index Report, which got mentions in several media: See Links below
    - The Cytonn Report link
    - KBC TV
    - K24
- Our Real Estate Services Manager, Johnson Denge, discussed the Mortgage and Rental Affordability report findings on KTN News. Johnson Denge on KTN
- Our Senior Investment Analyst, Duncan Lumwamu, discussed the profit-warning announcement by Atlas on CNBC. See Link: Duncan Lumwamu on CNBC
- We continue to beef up the team with other ongoing hires

Fixed Income

Treasury bill subscriptions declined during the month of April, with overall subscriptions at 186.2% compared to 192.3% in March. Yields on T-bills declined by 40 bps, 20 bps and 20 bps for the 91-day, 182-day and 364-day bills, respectively, closing the month at 8.6%, 10.5% and 11.7%, down from 9.0%, 10.7% and 11.9%, respectively, at the end of March 2016. Yields have remained relatively stable on account of:

i. Government being ahead of its domestic borrowing target of Kshs 219.0 bn which has eased up pressure on interest rates, and,
ii. Increased liquidity as evidenced by the decline in the interbank rate to 3.9% at the end of April, from 4.4% in March, as a result of (i) T-bill and T-bond maturities of Kshs 53.6 bn, (ii) reverse repo purchases of Kshs 38.6 bn, and (iii) government payments of Kshs 106.5 compared to Kshs 122.0 bn in March.

Last week, treasury bills subscription levels remained high, coming in at 269.5%, although lower compared to 307.2% the previous week on the back of high liquidity in the money markets. Subscription rates for the 91, 182 and 364-day T-bills remained high at 416.4%, 271.3% and 169.7%, respectively, compared to 563.0%, 292.5%, and 151.4% the previous week, respectively. Yields for the 91-day, 182-day and 364-day came in at 8.6%, 10.5% and 11.7% from 8.8%, 10.7% and 11.8% last week, respectively, with the rate of decline in yields decreasing week on week, indicating the bottoming out of interest rates at the current level as we had highlighted in Cytonn Weekly Report #16. The reduced subscription rates also indicate the "flight to safety" sparked by the Chase Bank failure is abating. The chart below shows the 91-day T-bill rates for the past 16 months, with yields trading below the 16-month average:



During the month, Government issued a 5-year FXD 1/2016/5 bond to raise Kshs 20.0 bn for budgetary support and accepted Kshs 19.5 bn at 14.3%, 39 bps higher than the re-opened 5-year FXD 1/2015/5 bond issued in February. The slightly higher rate is due to financial risks associated with financial markets during the month. Activity in the secondary market was lower than the previous month with bond turnover declining by 39.0% to Kshs 37.3 bn, from Kshs 61.1 bn in March. The FTSE bond index has gained 2.1% YTD, which is attributable to the declining yields during the month.

Kenya's inflation rate for the month of April came in at 5.3%, from 6.5% recorded in March, against our projections of 5.5% - 5.6% as highlighted in our Cytonn Weekly #16. The decline in inflation was on account of a decline food and transport indices. This is the lowest level since June 2013, and is currently at the lower half of the Government target of 2.5% - 7.5%. We expect the inflation rate to remain low supported by lower global oil prices.

In April, the shilling strengthened by 0.2% against the dollar, closing at Kshs. 101.1 compared to Kshs 101.3 at the end of March. On an YTD basis the shilling has appreciated by 1.1% on account of (i) improved forex reserves currently at USD 7.6 bn, equivalent to 5.0 months of import cover, (ii) improved diaspora remittances, and (iii) the recently approved increment in the precautionary facility offered to Kenya by the IMF. We expect the shilling to remain stable during the year supported by favourable macro-economic factors as well as the holding of rates constant by the Fed at 0.25% - 0.50% during their April meeting.

The US Fed met during the month of April and decided to maintain the Federal Funds Rate at the current band of 0.25% - 0.5%. This was on the back of the Federal Open Market Committee seeking to foster maximum employment and dollar stability before adjusting the monetary policy as we had highlighted in Cytonn Weekly #16.

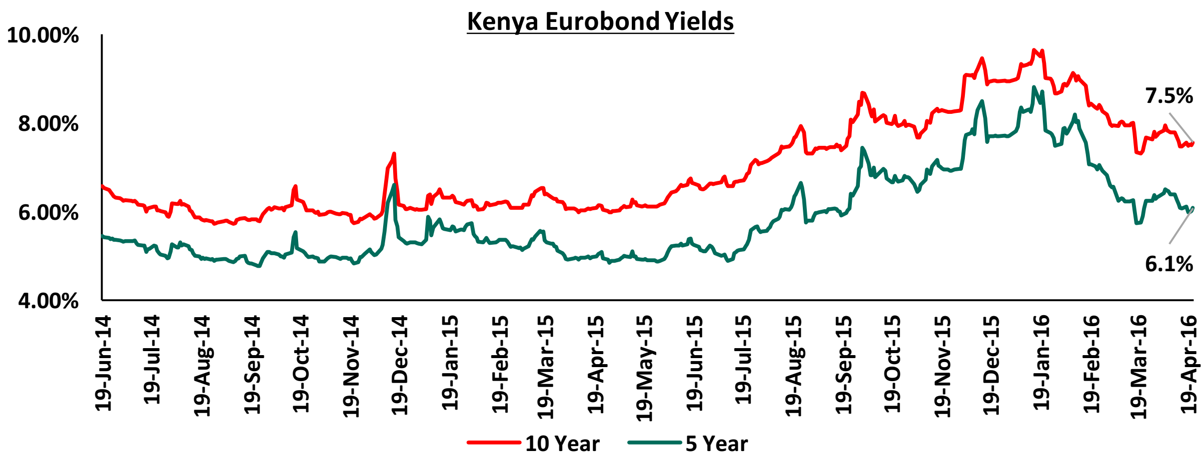
The key highlight of the month has been government borrowing, both in the domestic and foreign markets and the factors surrounding it. On foreign borrowing, the Treasury carried out a Eurobond roadshow to gauge prospective investor interest. In addition to this prospective Eurobond, Kenya has also been in the process of raising additional funds which include securing a USD 600.0 mn loan from China and a bilateral loan from France to the tune of Euros 250.0 mn. On domestic revenue collection, the Kenya Revenue Authority (KRA) will miss the full year target of Kshs 1.2 tn by approximately Kshs 94.0 bn on account of lower income tax collection. However, this will not add significant pressure on interest rates as the government has already surpassed the domestic borrowing target for the year by Kshs 80.5 bn, offsetting the KRA revenue collection shortfall.

Below is a summary of the 2015/2016 fiscal year budget financing progress:

(all values in Kshs mn, unless stated otherwise)					
2015/2016 Budget Financing					
Source of Financing	**2015/2016 FY Target**	**Pro-rated Target**	**Actual Collection**	**Variance**	**Possible Effect on Interest Rates**
Foreign Borrowing	401,691	200,846	296,650	95,804	Neutral
Domestic Borrowing	219,200	182,500	263,003	80,503	Positive
KRA Collection	1,254,867	911,600	842,500	(69,100)	Negative
Total Funding	**1,875,758**	**1,290,546**	**1,402,153**	**107,207**	**Positive**

Source: Cytonn Investments

According to Bloomberg, the yields on the 5-year and 10-year Kenyan Eurobonds closed at 7.5% and 6.1%, respectively, in the month of April, down from 7.7% and 6.3% as at the end of March, highlighting increased investor confidence on Kenya's credit worthiness. However, there has been a small but noticeable uptick in the yields, which may be attributable to the recent increase in bickering in the Kenyan political environment. See chart below:



Global Rating Services Firm S&P affirmed Kenya's credit rating at B+ for long-term debt and B for short-term debt, placing Kenya in a better position to acquire funding and negotiate for interest rates in the global markets. We still maintain our view as stated in **Cytonn Weekly #14** that the extra foreign borrowing poses risks to the country in terms of: (i) increased foreign currency risk exposure which could have an impact on the Kenyan shilling, (ii) increased debt to GDP levels currently at 57.5%, above the 50.0% target levels generally prescribed for emerging and frontier markets by the IMF, and (iii) making the country more exposed and interconnected to global markets and external markets conditions, which we have very little to no control over.

The government is ahead of schedule with its borrowing programme, having borrowed Kshs 263.0 bn for the current fiscal year compared to a target of Kshs. 182.5 bn (assuming a pro-rated borrowing throughout the financial year of Kshs. 219.0 bn budgeted for the full financial year). This shows that the government has surpassed its domestic borrowing target, and will therefore shift their attention to achieve the foreign borrowing target. With interest rates coming down, we advise investors to lock in their funds in short to medium-term papers of tenors between six months and one-year, as the rates are attractive on a risk-adjusted basis.

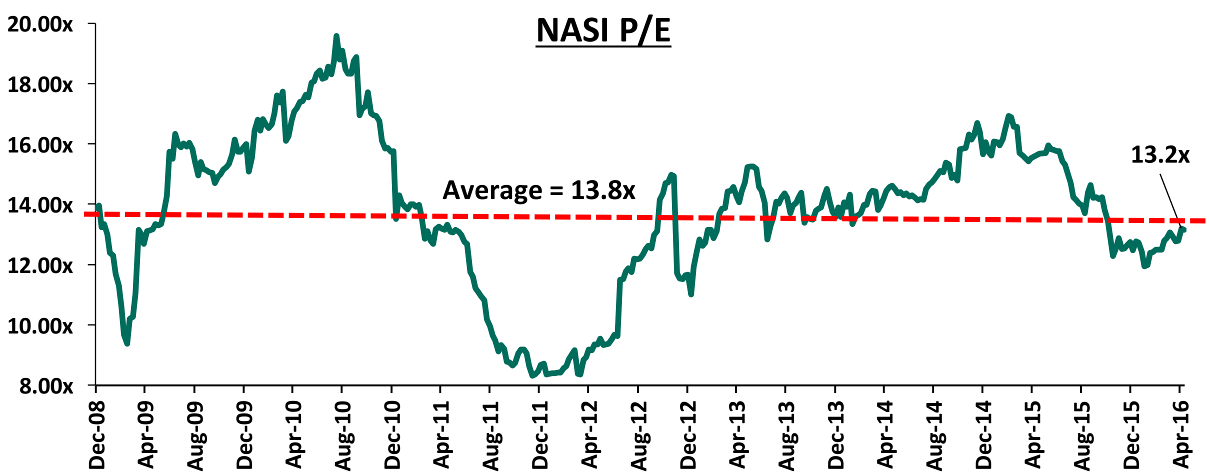
Equities

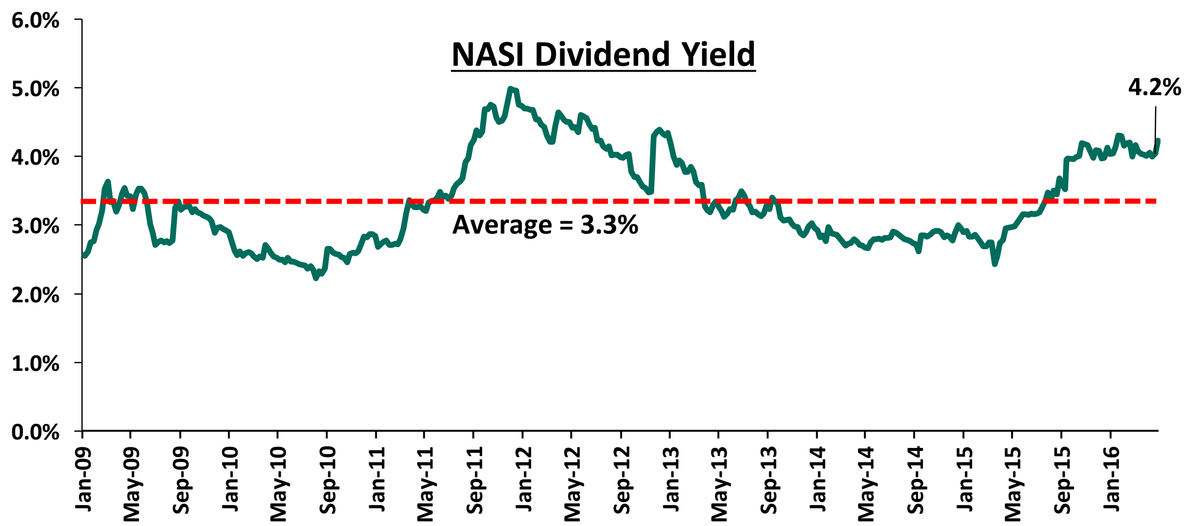
During the month of April, the equities market was on a mixed trend with NASI and NSE 25 declining 0.4% and 0.1%, respectively while NSE 25 gained 0.7% compared to gains of 3.8%, 4.3% and 3.1%, respectively in March, on the back of losses in large cap stocks such as Standard Chartered, Diamond Trust Bank and Cooperative Bank, which declined 7.2%, 6.5% and 6.7%, respectively. Safaricom was the top mover recording the highest net foreign inflows of USD 26,000. During the week, the upward trend persisted, with NASI, NSE 20 and NSE 25 rising 0.4%, 0.5% and 0.5%, respectively, taking their YTD performance to 0.8%, (1.3%) and 1.4%, respectively. Since the February 2015 peak, the market is now down 27.1% and 17.2% for the NSE 20 and NASI, respectively.

Equity turnover declined by 24.2% during the month to Kshs 9.7 bn from Kshs 12.8 bn in March on the back of decreased foreign activity in large cap stocks. Foreign investors were net buyers during the month with net inflows rising 12 folds to USD 3.5 mn compared to net inflows of USD 0.27 mn witnessed last month, taking advantage of the relatively lower prices. We expect earnings to improve during the year by about 10.0% due to a favourable macroeconomic environment.

The market is currently trading at a price to earnings ratio of 13.2x versus a historical average of 13.8x, with a dividend yield of 4.2% versus a historical average of 3.3%.

The charts below indicate the historical PE and dividend yields of the market.





HF Group released their Q1’2016 results

HF Group released their Q1’2016 earnings recording an impressive core EPS growth of 47.6% y/y to Kshs. 3.8 per share from Kshs. 2.5 per share in Q1’2015, driven by 30.8% growth in operating revenue, outpacing operating expenses growth of 15.2%.

- Operating revenue grew by 30.8% to Kshs 1.2 bn in Q1'2016, compared to Kshs 0.95 bn in 2015 driven by a 28.0% increase in net interest income to Kshs. 1.0 bn from Kshs. 0.8 bn in Q1'2015 and a 43.5% increase in non-interest income,
- Non-interest income grew by 43.5% to Kshs. 241.8 mn, from Kshs 168.5 mn in Q1'2015, supported by other income growth which grew by 136.5%, comprising of property sales from the completed K-Mall, 500 units in Komarock 5B, Kahawa Downs and Precious Heights Phase 1. The current revenue mix stands at 81%:19% funded to non-funded income, respectively,
- Operating expenses increased by 15.2% to Kshs. 0.8 bn from Kshs 0.7 bn in Q1'2015, driven by (i) a reduction in the loan loss provision by 5.4% to Kshs 136.9 mn from Kshs. 144.7 mn in Q1'2015, and (ii) a reduction in staff costs by 3.6% to Kshs 248.8 mn from Kshs. 258.2 mn in Q1'2015. The slower expense growth resulted to a reduction in the cost to income ratio to 62.2% from 70.6% in Q1'2015, higher than the industry average, which is at 59.4%
- PAT growth came in at 47.8% y/y, to Kshs. 0.3 bn from Kshs. 0.2 bn compared to our projection of an 18.4% increase

HF group posted impressive results and is in tandem with its 2016 strategic agenda having launched a new core banking system that will enhance customer service in the banking arm and broke ground for the construction of 1,500 residential units in the Komarock Heights and Richland projects. However, in our view the group has to embrace alternative deposit mobilization avenues such as agency banking and mobile banking to drive growth.

For more details on HF Group Earnings please see our Earnings note at: HF Group Earnings

During the month of April, insurance companies continued releasing results for FY'2015, with Britam Holdings Limited recording a loss per share of Kshs 0.5 in FY'2015, a 138.2% decline from an EPS of Kshs 1.3 in FY'2014 driven by higher operating expenses which grew by 23.6% and yet revenues declined by 2.7%.

The listed insurance sector recorded an average core EPS drop of 39.1% for FY'2015 as highlighted in the table below.

Listed Insurance Core EPS growth		
Insurance Company	**Core EPS Growth 2014**	**Core EPS Growth 2015**
Kenya Re	12.3%	**13.3%**
CIC Insurance	5.0%	**4.4%**
Jubilee Holdings	24.0%	**0.6%**
Pan Africa	(30.3%)	**(32.1%)**
Liberty Holdings	(4.5%)	**(35.7%)**
Britam Group	7.9%	**(138.2%)**
Average	**10.3%**	**(39.1%)***
***Market Cap Weighted**		

Following the release of the FY'2015 results by insurance companies, we are updating our coverage of the listed insurance companies, which will be releasing in the coming week.

During the month, NSE 20 index was reconstituted with inclusion of CIC insurance and Diamond Trust Bank, which replaced Kenya Airways and Standard Chartered Bank with effect from 19th April 2015. The price-weighted index constitutes companies selected on a weighted market performance during the period under review. On an YTD basis NSE 20 has declined 1.3% on the back of losses in large cap stocks such as Barclays Bank and KCB Group, which have declined 19.5% and 5.1%, respectively. This regular re-allocation is important to maintain the index as a relevant market performance indicator. For more details on the NSE index please see our Cytonn Weekly Report # 16

The banking sector was eventful during the month with price dips in most listed banks on the back of price corrections after corporate actions during the last week of March and the placement of Chase bank into receivership by the Central Bank of Kenya following a liquidity crunch, leading to an overall scare in the banking sector. Chase Bank was put under receivership following frightened withdrawals after resignation of the banks directors and restatement of financial statements that received a qualified opinion. Chase Bank has since reopened with KCB Group appointed as the receiver manager, which sends a positive sentiment on the stability of the sector. In our view, improved supervision by the Central Bank of Kenya will lead to a more stable and secure banking system.

During the month, we released our FY'2015 Banking Sector Report themed: ***"A Sector In Volatile Transition"***, which highlighted the Kenyan banking sectoral alignment, need for improved and better governance and regulation. [Cytonn Banking Report]

The table below show stock price movements in the month of April to reflect the investor's reactions to the events of the month.

Listed banks price movements m/m			
Banks	**31-03-15**	**29-04-14**	**m/m change**
I&M Holdings	104.0	112.0	**7.7%**
HF Group	20.3	21.5	**6.2%**
KCB Group	41.5	41.5	**0.0%**
Equity Group	40.3	40.0	**(0.6%)**
CFC Stanbic	94.0	93.0	**(1.1%)**
Barclays Kenya	11.2	11.0	**(2.2%)**
DTB Kenya	214.0	200.0	**(6.5%)**
COOP Bank	21.0	19.6	**(6.7%)**
Standard Chartered	231.0	193.0	**(7.2%)***
NIC Bank	40.5	37.5	**(7.4%)**
NBK Bank	13.0	9.2	**(29.3%)**

**Adjusted for Bonus Shares*

HF Group and I&M Holdings were the highest gainers during the month of April after posting impressive results with core EPS growth coming in at 47.6% in Q1'2016 and 26.2% in FY'2015, respectively, which are the highest growths in the sector. National bank lost 30% during the month on the back of poor FY'2015 results, registering a 232.5% decline in core EPS and poor corporate governance that culminated in the sacking of the CEO by the Board of Directors. Standard Chartered Bank lost 7.2% (adjusting for the bonus issue) as the stock traded ex-dividend following payment of a bonus issue of 1 for every 9 and final dividend per share of Kshs 12.50.

During the month Longhorn Publishers undertook a rights issue selling 126 million newly created shares for Kshs 4.20, which was a discount of 8.3% from the price of Kshs 4.60 on announcement date. Centum, the single largest shareholder with a 31.3% stake in Longhorn Publishers intends to take up its rights in the upcoming rights issue at the current offer price of Kshs 4.20. Of the 126 million new shares on offer, Centum plans to spend about Kshs 390 mn to take up about 50% of the offered rights, which will effectively take its shareholding in the firm to about 51%. The company does not however plan to take over control of the NSE listed firm. Longhorn Publishers currently has contracts to supply text books and learning materials worth Kshs 856.4 mn to regional Governments. Centum eyes growth and attractive returns in the educational sector having recently bought a Kshs 10.2 mn stake in Elimu TV, a television station that provides a secondary education curriculum.

Below is our equities recommendation table. Key changes for the week include:

- Standard Chartered has moved from a ***"Sell"*** to an ***"Accumulate"***, following a week on week decline after the books closure on 22nd April 2016 for the 1:9 bonus share issue and the Kshs 12.5 final dividend.

all prices in Kshs unless stated

EQUITY RECOMMENDATION								
No.	**Company**	**Price as at 31/03/16**	**Price as at 29/04/16**	**m/m Change**	**Target Price***	**Dividend Yield**	**Upside / (Downside)****	**Recommendation**
1.	KCB Group***	41.5	41.5	0.0%	53.7	5.5%	34.9%	Buy
2.	Centum	46.0	44.8	(2.7%)	57.2	0.0%	27.8%	Buy
3.	Kenya Reinsurance	20.0	19.5	(2.8%)	23.5	3.3%	24.1%	Buy
4.	NIC	40.5	37.5	(7.4%)	42.9	2.7%	17.1%	Accumulate
5.	Standard Chartered***	231.0	193.0	(16.5%)	207.2	5.5%	12.9%	Accumulate
6.	CIC Insurance	6.1	5.3	(13.2%)	5.8	1.8%	12.3%	Accumulate
7.	Equity Group***	40.3	40.0	(0.6%)	41.9	5.2%	9.9%	Hold
8.	DTBK***	214.0	200.0	(6.5%)	214.0	1.3%	8.3%	Hold
9.	Liberty	15.8	16.0	0.9%	16.7	0.0%	4.7%	Lighten
10.	I&M Holdings	104.0	111.0	6.7%	112.0	2.6%	3.5%	Lighten
11.	Britam***	10.7	13.3	23.8%	13.4	2.3%	3.4%	Lighten
12.	Safaricom	16.9	17.1	1.2%	16.6	5.1%	2.2%	Lighten
13.	Barclays	11.2	11.0	(2.2%)	10.3	7.7%	1.8%	Lighten
14.	Pan Africa	39.5	43.8	10.8%	44.0	0.0%	0.6%	Lighten
15.	HF Group	20.3	21.5	6.2%	19.6	5.7%	(3.1%)	Sell
16.	Co-operative bank	21.0	19.6	(6.7%)	18.0	3.8%	(4.2%)	Sell
17.	Jubilee Insurance	473.0	470.0	(0.6%)	440.7	1.5%	(4.7%)	Sell
18.	National Bank of Kenya	13.0	9.2	(29.3%)	8.5	0.0%	(7.1%)	Sell
19.	CfC Stanbic	94.0	93.0	(1.1%)	85.4	0.0%	(8.2%)	Sell

**Target Price as per Cytonn Analyst estimates*

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

****Indicates companies in which Cytonn holds shares in*

Accumulate – Buying should be restrained and timed to happen when there are momentary dips in stock prices.

Lighten – Investor to consider selling, timed to happen when there are price rallies

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

Private Equity

During the month, the energy, FMCG and financial services sectors reported a number of deals.

Akiira Geothermal secured funding to drive its power generation expansion plans as it seeks to supply an additional 140 MW to the National grid through a power purchase agreement with Kenya Power. With the country striving to supply 5,000 MW within the next five years, the government is pursuing Private Public Partnerships to deliver a substantial portion of this required capacity. Kenya Power will pay Akiira Kshs 9.3 per KwH for onward feeding into the national grid, higher than the Kshs 7.0 per KwH it pays Kengen for geothermal and Kshs 3.0 per KwH for hydroelectric power.

PROPARCO, a French Development Agency and DEG – the German Investment & Development Company exited their combined 10.68% equity stake (4.43% and 6.25%, respectively) in I&M Holdings to CDC Group Plc. The two exited at an estimated IRR of 45.6% from an equity investment of Kshs 337.0 mn in 2007 and

Kshs 1.7 bn in 2010, highlighting the high potential returns from investments in the financial sector and the availability of exits from the investments.

During the week Catalyst Principal Partners, a private equity fund that specializes in emerging and mid-sized companies invested part of its USD 125 mn Fund I into Orbit Chemicals. The fund has made investments locally in retail pharmaceutical chain Goodlife and SME lender Jamii Bora Bank. Orbit chemicals deals with industrial supplies to manufacturers of soaps, petroleum jelly, hand gels, detergents, fertilizers and other home care products. The sector has attracted a lot of private equity activity given acquisitions of Canon Chemicals by Godrej and Flame Tree acquiring local start-up, Suzie beauty. The deals are expected to bring annual returns of between 25% and 35% for the investment period.

Private equity investment in Africa remains robust evidenced by the increase in deals and deal volumes in the region especially in financial services, energy, FMCG, real estate and technology sectors. 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 projections in Sub Sahara Africa compared to global markets, we remain bullish on PE as an asset class in Sub Sahara Africa

Real Estate

This month, we saw continued institutionalization of the sector with Home Afrika making significant changes in its Board of Directors by exiting some founding Board Members, and bringing on board professional corporate managers such as Linus Gitahi, who will Chair the Board. This is a positive development for the market, which is better off with a few professional, well governed players rather than many mom and pop players.

There was also an increased focus in the residential and hospitality sectors. Increased investment into the lower middle and low income residential segments by developers was driven by the need to satisfy the high demand for low-end residential housing and the high returns in this segment with yields of about 6.7%. Some of the developers in this segment include Kenya Projects limited who broke ground on a low-end residential product in Ruiru. The Kshs 100.0 mn development will consist of two bedroom semidetached units each costing Kshs 2.5 mn. Cytonn Real Estate also broke ground on The Alma a signature development in Ruaka targeting mid-income earners.

The hospitality industry is also picking up especially with improved security and government support. This month Chinese developers launched serviced apartments in Kilimani. The project dubbed "Soho Apartments" will be an 11-storey building with a Kshs. 1.8 bn project cost. Serviced apartments are becoming increasingly popular due to their home feel and convenience as well as relatively lower costs as compared to hotels. Swiss International hotels also made its debut to the Kenyan market in a partnership with Mount Kenya Homes Limited. The two will construct a 5-star hotel in Naromoru with a project cost of Kshs 7.0 bn. Another entrant into this segment is Dubai based group Abcon International LLC, which has partnered with a consortium of local investors including Hass Consult and Signature Development Limited to construct a 35-storey MUD in Upperhill comprising of apartments, retail and a hotel. The hotel will be on 18 floors and is modelled after Singapore's Marina Bay Sands. The project is on 3.6 acres on former railways land staff pension scheme near the Railways Golf Club, 500 metres from the CBD. It is expected to cost Kshs. 5.52 bn.

In this month, a number of quarter one reports were released by key industry players. They include;

1. The Industrial Market report by Mentor management Limited
2. Kenya Market Update, 2nd half of 2015 by Knight. Kenya Market Update
3. The Hass Consult House Price Index
4. The Hass Consult Land Price Index
5. Mortgage and Rental Affordability Index by Cytonn Real Estate. See Link: Residential Research Report
6. Kenya Bankers Association Housing Price Index

In general, the reports point to a maturing real estate market with prices normalizing in most segments. The most attractive segment being residential especially the low end market and the high end market, the hospitality industry and the largely untapped industrial sector that is starting to pick. The commercial office sector is softening after a massive growth in the last five years (Cytonn Commercial Office Report) but we see this as a normal market trend where following a high supply, there is a slow down before the market picks up again. The retail market following increased supply in Nairobi, is expanding to the counties.

Table showing performance of various real estate themes

Segments with high growth rates	Segments with moderate growth rates	Segments experiencing slow growth rates
Lower Middle and Low Income Residential Markets	Prime Residential Market	Upper Middle Residential Market
Hospitality Industry	Land Prices in Satellite Towns	Commercial Office
Industrial Sector	Retail in the city	Land Prices in the City
We hence expect a slowdown in the Upper Middle residential market, commercial office market, land prices in the city and retail in the city even as Prime Residential market, Lower middle and low income residential market, Hospitality, industrial and land prices in Satellite towns continue peaking.		

The major challenges facing the industry remain high land, infrastructure and financing costs for both developers and buyers. However, with expected returns of more than 20% p.a. Real estate still remains the best investment asset class in the country especially as the stock market continues on its bearish run.
