

# Cytonn Weekly Report #38, with a focus on the impact of the high interest rates on investments and the economy

## Executive Summary:

**Fixed Income:** Yields on the 91-day T-bill increased by 4.1% while the 1-year bond yield averaged at 19.1% above the market expectations and was undersubscribed. After a long weakening streak, the shilling appreciated by 0.3% during the week as there were foreign inflows into both the equities and the fixed income market;

**Equities:** NASI gained 0.8% while NSE 20 shed 0.4% during the week. The telecommunications sector Q2 2015 report released this week showed a decline in mobile penetration after the revision of the base population;

**Private Equity:** Private Equity flows continue to increase in the Kenyan housing and real estate sector, underpinned by increased demand and under provision of housing;

**Real Estate:** The Kenya Revenue authority seeks agents to collect data on rental income tax, while Property developers seek to bridge the gap between the production of real estate development and the uptake;

**Focus of the Week:** The high interest rate environment to affect investment activities in Kenya.

## Company Updates:

- This week we are ground breaking on Amara Ridge project, an exclusive gated community in Karen. [Amara ridge](#)
- Maurice Oduor, our Investment Manager, discussed the issues surrounding the decision by the MPC to maintain the CBR at 11.5%: [Maurice Oduor on CNBC Africa](#).

## Fixed Income

Treasury bill auctions continued to be undersubscribed during the week, with overall subscription at 48.5%, compared to 57.1% the previous week. There was a significant jump in yields across all tenors to 18.6%, 14.6% and 16.3%, from 14.5%, 13.9% and 15.8% for the 91-day, 182-day and 364-day papers, respectively, the short term yield curve is now inverted. Of significance was a 412 bps jump in yields for the 91-day paper, combined with the 128.5% subscription rate on the paper is an indicator of investor's preference to keep short on duration while demanding significant premiums, owing to the prevailing interest rate environment.

During the week, the government auctioned a 1-year bond to raise Kshs 30 bn for budgetary support. This is the first time a 1-year bond has been issued since 2012 and of key to note was that the bond results were released with a day lag compared to the norm. The 1 – year bond auction saw a performance rate of 88.3%, with yields rising to 19.1%, a 325 bps increase compared to the yield on a similar tenor bond in the secondary market; the 19.1% rate was much higher than our expectations of “over 16%” as discussed in our [last week's report](#). While we expected a price of above 16% given paper of similar tenor was trading at about 16%, we did not expect a 300 bps premium, as this would increase the government's burden of servicing debt. The last time a paper with 1 – year to maturity traded at these levels was in February 2012, which resulted into an inverted yield curve almost similar to what we have currently. While February 2012 was the last phases of high interest rate environment, which was followed by a correction of the yield curve, we believe the high interest rates environment will persist

for the remainder of this year. We expect the government to continue issuing short term paper in order to avoid carrying long term expensive money. Additionally, if the yield curve for other tenors were to undergo a parallel shift in the direction of the 1 year bond, the impact on mark to market portfolios would be substantial, with possible declines of more than 12%.

[As highlighted in our Cytonn Report #37](#), the MPC maintained the Central Banks Rate (CBR) at 11.5% in line with the low inflation expectations, while stating that the monetary policy measures taken in the previous meetings were yet to be fully transmitted into the economy. In our view, the economy was not ready for another rate hike as (i) it would have slowed down economic growth, and (ii) inflation has remained within the target of 2.5% - 7.5%, and hence no need to action any measure to control price increases. The MPC further noted that inflation is expected to remain relatively stable for the rest of 2015, supported by relatively lower food and oil prices. We project inflation for the month of September to come in at between 6.0% - 6.1%, slightly higher than the August rate of 5.8%, owing to an expected rise in food prices.

During the week, the shilling strengthened slightly against the dollar, appreciating by 0.3% to close the week at Kshs 105.3, on a YTD basis the shilling has lost 16.1%. The appreciation during the week was as a result of dollar inflows from offshore investors interested in buying government securities. In addition, the money market witnessed a tight on liquidity, evidenced by the rise in the interbank rate, which touched a new high of 27.8%, compared to 24.6% the previous week.

**The Government's borrowing programme for the current fiscal year, targeted at Kshs. 219 bn, is behind schedule; instead of net borrowing, the government has so far made a net repayment of Kshs 15.4 bn for the current fiscal year. As a result, we expect the Government to continue with its effort to step up domestic borrowing which may further result in upward pressure on interest rates. We maintain our view that investors should be biased towards short-term fixed income instruments due to the uncertainty of the rate environment.**

## Equities

During the week the market displayed mixed trends with NSE 20 shedding 0.4% and NASI gaining 0.8% on the back of gains in BAT, Equity and Safaricom which gained 6.5%, 3.4% and 2.7%, respectively. Foreign investors participation remained high during the week at 61.3% compared to 62.4% the previous week as investors took advantage of the price dips and the currency weakness. Since the February peak, NASI and NSE 20 have been down 16.4%, and 23.2% and 8.9% and 17.4% on a YTD basis, respectively.

The Communications Authority of Kenya released the Q2'2015 statistics for the telecommunications industry. Mobile penetration declined to 83.9%, from 85.5% the previous quarter following the revision of the total population to 43.0 mn, up 6.4% from 40.7 mn in the Economic Survey of 2015, despite total subscribers increasing by 3.7% q/q to stand at 36.1 mn. Market share for Orange and Finserve Africa (Equitel) grew to stand at 11.2% and 2.4% from 10.8% and 1.9% in Q1'2015, respectively. Safaricom remained flat at 67%, with Airtel losing ground to stand at 19.4% from 20.2% in Q1'2015. The Minutes of Use (MoU) per month per subscriber increased to 84.9 minutes in Q2'2015, up from 84.1 minutes the previous quarter; this represented a 5.4% growth compared to Q1'2014, which averaged at 80.3 minutes. The total number of SMS sent has continued on an upward trend despite the stiff competition from Over-The-Top Content (OTTs) such as Whatsapp. In Q2'2015, local SMS traffic stood at 6.57 bn, up from 6.55 bn messages in Q1'2015. This is attributed to the lower SMS tariffs, and preference SMS

bundles by most mobile operators, which offer promotions based on the MoU. The competition in the telecommunications sector is spurring growth and innovation with new players such as Equitel offering products that are convenient and user friendly. Going forward we expect growth of the mobile telephony companies due to growth in population and also as the spending power improves, however diversification of revenue streams remains important.

Kenya Airways is in talks with the Pakistan Government to settle a deal that will see the airline lease 3 Boeing 777 to Pakistan's national carrier, Pakistan International Airlines (PIA). This comes after Kenya Airways announced plans to dispose some of its assets including 7 aircrafts and a parcel of land in Embakasi, Nairobi. The deal with the Pakistani Government is expected to cost Kshs. 1.4 bn with a cash security deposit amounting to Kshs. 464.0 mn with the aircrafts expected to be handed over to Pakistan in December. This deal is expected to benefit both Pakistan Airlines and Kenya Airways greatly as both airlines are loss making. For Kenya Airways this serves as an opportunity to (i) yield returns on some of its idle assets, (ii) improve efficiency in terms of utilization of their remaining assets, and (iii) help negotiate for a loan from Afreximbank to rescue it from its cash crisis. Additionally, the sale of assets to raise financing reduces the moral hazard that the loss-making airline would be bailed out by the government, opening the door for a private investor to return the airline to profitability.

KCB has announced its partnership with GoSwift, a global mobile commerce firm, to pioneer a new mobile payment service that will allow merchants to make use of GoSwift's mobile Point of Sale (mPOS) facility. The mPOS, which is a Bluetooth reader, will enable users who have Visa, MasterCard and JCB cards, to transact with merchants in remote areas, offering an alternative way of receiving payments in a form other than cash, which in turn makes transactions convenient, safer and more efficient. KCB stated that they are targeting the retail bracket and SME's such as taxi drivers, restaurants and schools that are in need of e-payment systems. KCB's venture is aligned with the government's efforts to increase electronic payments in vital sectors such as public transportation and government procurement. For KCB, this is a great step into alternative delivery channels, enabling the bank to (i) efficiently offer services to their customers, and (ii) improve on their non-funded income, which reduces the over-reliance on the loan book as the main driver of revenue growth. In our view, for banks to deliver their services more efficiently and conveniently to their customers, technology and banking must co-exist to drive innovation in a market where all players benefit from large spreads.

***We remain neutral with a negative bias on equities given the significantly lower earnings growth prospects for this year. The market is now purely a stock pickers' market, with few pockets of value. As part of our intention to provide investors with actionable recommendations on a weekly basis, we have included an equities action table based on the potential upside of equities in our coverage area.***

All values in Kshs unless stated

| EQUITY RECOMMENDATIONS - WEEK ENDED 25/09/2015 |                               |                        |                  |                   |                          |                    |
|------------------------------------------------|-------------------------------|------------------------|------------------|-------------------|--------------------------|--------------------|
| Company                                        | Current Price<br>(25/09/2015) | w/w<br>Price<br>change | Target<br>Price* | Dividend<br>Yield | Upside /<br>(Downside)** | Recommendati<br>on |
| Standard Chartered                             | 224.0                         | (3.9%)                 | 271.2            | 7.4%              | 28.5%                    | Buy                |
| KCB                                            | 48.8                          | 2.1%                   | 57.9             | 5.4%              | 24.2%                    | Buy                |
| Equity                                         | 46.3                          | 3.4%                   | 51.9             | 4.7%              | 17.0%                    | Accumulate         |
| NIC                                            | 43.5                          | (0.6%)                 | 49.5             | 2.6%              | 16.4%                    | Accumulate         |
| Barclays                                       | 13.2                          | 1.9%                   | 13.9             | 7.7%              | 13.3%                    | Accumulate         |
| DTBK                                           | 200.0                         | 0.0%                   | 215.2            | 1.3%              | 8.9%                     | Hold               |
| Housing Finance                                | 22.8                          | 3.4%                   | 21.0             | 5.4%              | (2.1%)                   | Sell               |
| Co-operative bank                              | 18.4                          | (1.1%)                 | 16.6             | 3.3%              | (6.7%)                   | Sell               |
| I&M                                            | 107.0                         | (7.0%)                 | 99.6             | 2.5%              | (15.2%)                  | Sell               |
| Cfc Stanbic                                    | 92.0                          | 2.2%                   | 72.5             | 0.0%              | (21.2%)                  | Sell               |
| National Bank of Kenya                         | 16.9                          | (0.9%)                 | 6.6              | 0.0%              | (60.6%)                  | Sell               |

\*Target Price as per Cytonn Analyst estimates

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

Accumulate – Buying should be calibrated by market dynamics/ sentiments for better prices

Data: Cytonn Investments

### Private Equity

Private Equity firm Phatisa, through its Pan African Housing Fund (PAHF) has entered into an agreement with a Kenyan real estate development firm, Tamarind Properties, to develop 140 single-family homes. The residential development, Nakuru Meadows, will be located on a 10-acre piece of land in Nakuru Town, Kenya. The construction of the units will be done in two phases, with the first phase comprising of 104 units and the second phase 36 units. Phatisa established the PAHF to provide risk capital to real estate projects on a joint-venture basis to selected local developers, an initiative to respond to the ever-increasing housing shortage in Eastern and Southern Africa. Tamarind Properties Ltd is a medium-sized real estate development company specializing in the development of multi-unit residential estates in Kenya and Uganda; Tamarind Properties is an experienced developer that has undertaken a number of successful residential units in Nairobi and is led by Joe Mungai.

Kenya has seen a high and steady inflow of funds through private equity, being channeled towards real estate projects. The alternative asset class has outperformed all the asset classes over the last five years and is expected to continue with the strong performance in the next 5 – 10 years. We remain bullish on private equity activity in the region and further in Africa. As highlighted in our Cytonn Monthly - August, private equity players will continue to be attracted to Africa and the East Africa region.

Nairobi Java house (Java Group) is reported to have announced an annual turnover of Kshs 3.0 bn for 2014. The growth is attributable to its expansion strategy that has seen it grow its foot print from 26 to the current 43 branches. Nairobi Java house owns and operates 360 degrees Pizza and Planet Yoghurt, a frozen yoghurt shop. Java group plans to invest USD 7 mn in expansion by opening 12 outlets across major towns in Kenya in the coming year using internal funds. This highlights the attractiveness of

serving the growing middle class in the region. Kenya remains an attractive space for investment in the chain fast and casual dining sector given, (i) supportive demographics of a growing and expanding middle class, which is keen on spending on retail outlets that enhance lifestyles, and (ii) increase in disposable income driven by increased employment and entrepreneurial opportunities.

## **Real Estate**

With the increased pressure to collect revenues, Kenya Revenue Authority (KRA) announced that in the next few weeks it will appoint agents to collect data relating to buildings and their owners to establish their rental income tax status. KRA expects to bring in approximately 20,000 building owners and collect not less than Kshs 3 bn by the end of the year. The authority will also appoint independent entities – who are not necessarily property agents or government ministries – to collect the data. Where property agents collect rental income, they will also be expected to withhold taxes on income and submit to KRA. Many property owners have failed to comply due to several factors: (i) low level of formal education, (ii) ignorance of tax obligations, (iii) complexities of compliance system, and (iv) poor record keeping.

Property owners without any kind of records will be allowed to deduct up to 40% of their gross rental income as expenses with income tax calculated on the remaining 60% for 2014 and 2015. Owners of buildings have up to the end of June 2016 to pay tax for 2014 and 2015 rental income - including any interest or penalties. After that, KRA will move in to establish tax compliance status. Taxes for 2013 and the years before will be forgiven. Amnesty for previous years not only includes interest and penalties but also the principal amount of tax due. From January 2016 onwards, rental taxes will be based on gross annual income at 12% for persons whose annual rental income is less than Kshs 10 mn. This is, in effect, a measure taken to increase the revenue generated from the property rental sector, which has not been prior subject to taxation.

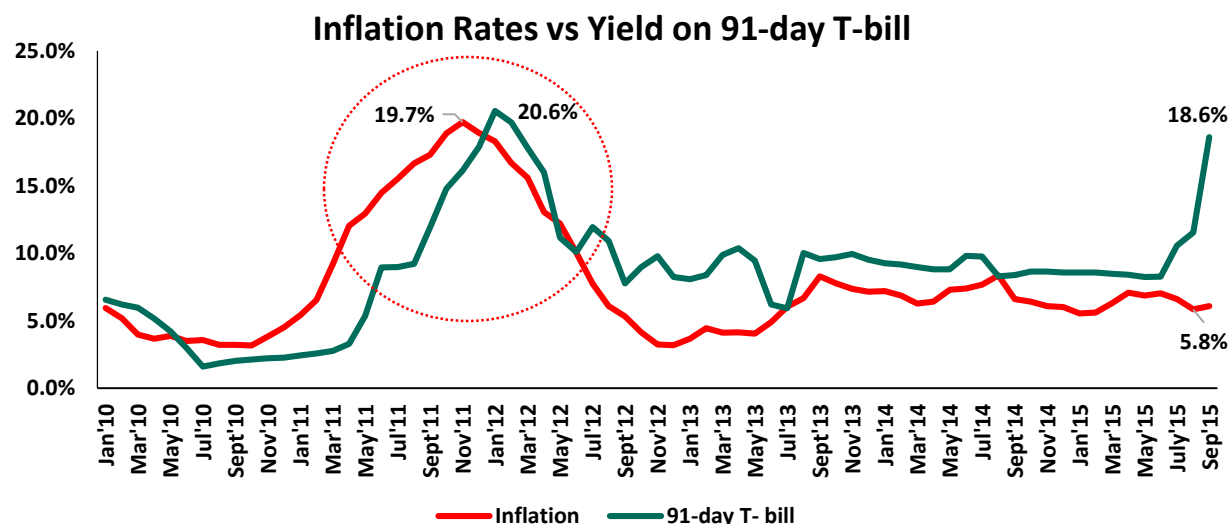
This week, a housing firm, Superior Homes Ltd, introduced a new product in the market that targets the low to middle income buyers and gives them an opportunity to own a piece of Greenpark Estate, one of their developments, within a period of three years. It is for those who are unable or unwilling to take up mortgage financing to own homes. The plan, dubbed Buy Over the Long Term (BOLT), will include a deposit payment of at least 10% of the selling price. The instalments will then be calculated to pay for at least 80% of the remainder by three years. The emergence of such innovative payment plans should help, although marginally, with increasing affordability of real estate.

## **Focus of the Week: The impact of the high interest rates on the Kenyan economy and investments**

With the recent developments in Kenya's interest rate environment i.e. (significant increase in yields on government securities and bank deposit rates), the key question in every investors mind is how this will impact the economy and the investments environment in the country.

This week the government issued a 1-year bond at a yield of 19.1%, and the 91-day T-bill was at 18.6%. It is evident that interest rates have significantly moved higher in the recent past and we expect an increase across all tenors and this will be passed through to the rest of the economy e.g. bank loans. The last time such an interest rate environment was witnessed was in 2011; then the 91-day T-bill peaked at 20.6%. In 2011 the high interest rates had been driven by the weakness in the currency coupled with the high inflation rates where inflation rate reached a peak of 19.7%.

The chart below shows a 5-year trend analysis of interest rates and inflation and of note is that in the current environment there is a significant divergence between the two, an indication that the current increase is driven by other factors and in our view this is due to pressure to finance the budget for the 2015/16 fiscal year and we are yet to see the revenue collections figures versus target.



Below is a quick comparison between the operating environment in 2011 and 2015:

1. **Interest rate and Inflation Comparison:** In 2011, the 91-day T-bill rose from a low of 2.4% in January 2011, to peak at 20.6% in January 2012, with inflation rising from 5.4% to peak at 19.7% in November 2011. In the current environment, we are seeing relatively lower and stable inflation rates at 5.8% and the 91-day T-bill at 18.6% as at September 2015. We note the difference between these two periods being:
  - a. In 2011, the country was experiencing food shortage, which saw prices rise due to the subdued supply,
  - b. In 2015, the country has seen relatively higher food supplies given the favorable harvests, combined with the cushion from falling oil prices globally, which have benefited net importers such as Kenya.
2. **Exchange Rate Comparison:** In 2011, Kenya Shilling reached a low of 107.0 against the dollar; in the current environment we have seen the shilling depreciate by 16% YTD 2015 to stand at 105.5 against the dollar.
  - a. We note in 2011, the depreciation of the shilling was as a result of speculative position taking,
  - b. In the current environment, the weakening of the shilling has been due to a structurally weak Kenyan economy, and the recovery of the US economy.
  - c. In June 2014, the Government issued a Eurobond to fund infrastructural projects. This is an additional dollar obligation, which was not present in 2011, further adding to the headwinds that are facing the Kenya Shilling. Any additional weakening of the shilling increases the government obligation to finance expensive dollar debt.

### 3. Policy Actions Comparison:

- a. In order to address these macroeconomic challenges in 2011, the Central Bank of Kenya (CBK) intervened by aggressively increasing the Central Bank Rate (CBR) by 11% in 6 months to stand at 18% at the end of 2011. These measures were finally able to contain the inflationary pressures, resulting in the inflation levels declining over the following year, with yields coming down as well. However, the economy was not left unscathed, as the country experienced a drop in GDP growth in 2012 to 4.6% from 2011's 6.1%. In the current environment, we have seen the CBK responding with aggressive mop-up activities and increasing the CBR rate, so far by 300 bps, to 11.5%.
- b. With a focus on the current environment in 2015, Kenya's inflation has remained within CBK's target range of 2.5% - 7.5%, and the high interest rate environment is being propelled by the Government's efforts to step up its domestic borrowing in order to meet the Kshs 219.0 bn target to fund the 2015/16 fiscal year budget. With the ongoing major government sponsored infrastructural projects like the Standard Gauge Railway, and the current labour wrangles, which will affect the public wage bill, the Government faces significant headwinds in slowing down its appetite for debt, which will keep interest rates high and crowd-out the private sector.

With the high interest rates, below are some of the expected effects:

- i. **Increase in the cost of borrowing:** Higher interest rates will result in an increase in the cost of borrowing, owing to higher interest payments on loans and mortgages. This will lead to higher interest obligations for individuals who already have loans, reducing their disposable income and consumption as well;
- ii. **Slow down in economic growth rate:** as the corporates and individuals take a wait and see stand as they do not want to get into expensive borrowings, the economic performance is expected to slow down. We expect the Kenya GDP growth rate for this year to come in at between 4.7% - 4.9%, compared to 5.3% last year;
- iii. **Increase in the non performing loans:** given the high increase in cost of borrowing and no increases in the disposable income, banks are likely to experience above average non performing loans on the already issued loans;
- iv. **Slower corporate earnings:** The high interest rate environment will negatively affect the earnings of corporates as a result of increased financing costs, and lower consumption in the general economy;
- v. **Slow-down in the stock market:** usually when the less riskier assets like government bonds are yielding higher, investors usually prefer to allocate more to this and shun the more riskier assets like the stock exchange
- vi. **Real estate** might be negatively affected owing to (i) the higher costs of funding projects. This reduces the internal rate of return an investor would otherwise receive from the project on completion when funding using the current interest rates, thus slowing down investment in the sector, and (ii) the expensive borrowing rates brought about as a result of the high interest rate environment will reduce the uptake of mortgages in the market, which diminishes sales uptake;
- vii. **Attracting Foreign Investments:** On a positive note, this environment presents an attractive entry point for foreign investors looking to capitalize on the high – yields available in the market, and weaker shilling, which may see their real return rise above what was anticipated in the long term.

This week's auction results indicate that there is a disconnect between monetary policy, which is the mandate of CBK, and fiscal policy, which is the mandate of Treasury, in Kenya. MPC on one hand is championing price and interest rate stability, whereas from the auction results, it is evident that the Treasury has a significant appetite for expensive funds. This has placed the Central Bank with the delicate balancing act of maintaining price stability and supporting favourable conditions for economic growth while acting as the agent of Treasury to collect funds by issuing government securities.

**Cytonn's recommendation to investors in this challenging environment is:**

- 1. Increase asset allocation to short-term interest earning securities, which include debt instruments and government securities, with an overweight allocation in money-market instruments;**
- 2. As stated in our Cytonn Report – August 2015, we maintain our view that investors should be neutral with a bias to negative on equities, with few pockets of value available to extract return;**
- 3. Increase asset allocation to real estate as this ensures stability in the portfolio return given the inelasticity between inflation and re-pricing of rental incomes. We expect that as institutional investors review their portfolios for the period ending December 2015, those who do not have real estate in their portfolios will see significant erosion of value.**



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