Effects of Elections on the Investment Environment in Kenya & Cytonn Weekly #12/2017

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Executive Summary

Fixed Income: T-bills were oversubscribed for the 8th week running, with overall subscription coming in at 145.6%, compared to 135.0% recorded the previous week. Key to note, for the 3rd week running, the 182-day T-bill was not on offer, as the government aims to spread maturity concentration risk evenly across the three papers. We are projecting inflation for the month of March to increase by between 50bps – 80bps, to the range of 9.5% - 9.8%, from 9.0% in February, driven by a rise in food and fuel prices. However, we expect the Monetary Policy Committee (MPC) to maintain the CBR at 10.0% as inflation is currently supply rather than demand driven;

Equities: During the week, the equities market was on an upward trend with NASI, NSE 20 and NSE 25 gaining 3.2%, 3.2% and 3.4%, respectively. A number of companies released earning results during the week, notably Standard Chartered, DTB and NSE, which recorded core earnings per share (EPS) growth of 43.9%, 16.6% and (39.8%), respectively, whereas Britam registered a core EPS of Kshs 1.1 for the period ended 31st December 2016, from a loss per share of Kshs 0.5 in the period ended 31st December 2015;

Private Equity: Energy, financial services and hospitality sectors continue to witness increased private equity activity in Sub-Sahara Africa as (i) Sanlam Group is set to acquire an undisclosed majority stake in PineBridge Investments East Africa Limited (PIEAL), and (ii) South African pension fund, Public Investment Corporation (PIC), raises its stake in KenGen, Kenya's largest power producing company, to 6.6% by acquiring an additional 85.1 mn shares in the open market whose current price is at Kshs 6.6 per share;

Real Estate: Stanlib Fahari I-REIT records Kshs 106.0 mn in profit in its first year since listing on the bourse. This week, Nairobi hosted the Africa Green Building Summit convened by the World Green Building Council, at a time where there is an increased focus on green-buildings and sustainable construction in Nairobi;

Focus of the Week: In our Cytonn Weekly #7/2017, we analyzed the possible effects of the upcoming election on the performance of the real estate sector in Kenya. This week, we turn our focus on the effect of elections on the investment environment in Kenya, and give our outlook on the same;

Company Updates

- Cytonn Real Estate, the development affiliate of Cytonn Investments, has awarded a Kshs 2.5 bn construction contract for its second Ruaka project, Taraji Heights, (See Taraji Heights) to Landmark Holdings Limited, ahead of the ground-breaking ceremony set for Monday, 27th March. This project, which is located on Limuru road right by where the new Western bypass is designated to pass, is already 10.0% sold before ground breaking, and is conservatively targeting a 26.0% per annum return to investors. The project comes on the back of the very successful development in Ruaka, The Alma (See The Alma) which has delivered up to 55.0% return to early investors and buyers. See event note here
- Our Investments Analyst, John Ndua, discussed the FY'2016 earnings for Diamond Trust Bank and I&M Bank, and Sanlam Group's planned acquisition of PineBridge. Watch John Ndua on CNBC here
- Our Investments Analyst, Caleb Mugendi, discussed CBK's lending to small banks of Kshs 96.0 bn, in order to boost liquidity within the banking system. Watch Caleb on CNBC here

- We continually showcase real estate developments by our real estate development affiliate, Cytonn Real Estate, through weekly site visits. 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
- For recent news about the company, see our news section here
- We have 12 investment-ready projects, offering attractive development returns and buyer's 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 20.0% sold. See The Ridge
    - Taraji Heights is currently 10.0% sold. See Taraji Heights
- Following the completion of sales for Amara Ridge, we are currently looking for land in Karen for our next development. We are also looking for 3-10 acres of land in Garden Estate, Muthaiga North, South C and Lang'ata. Contact us at res@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-bill were oversubscribed for the 8th week running, with overall subscription coming in at 145.6%, compared to 135.0% recorded the previous week. This is despite the withdrawal of the 182-day paper from the auction market for the 3rd week in a row, a move aimed at the management of maturities by spreading the concentration risk evenly across the three papers. Subscription rates for the 91 and 364-day papers came in at 88.1% and 203.1%, compared to 75.0% and 195.0% the previous week, respectively. The continued under subscription of the 91-day T-bill could be attributed to a lower real return - given that with the current inflation rate of 9.0%, and the 91-day T-bill yielding 8.7%, investors are getting a negative real return of 0.3%. Yields on the 91-day and 364-day papers during the week remained unchanged, closing at 8.7% and 10.9%, respectively.

In the recent T-Bill auctions, there has been upward pressure on interest rates as investors demand higher yields, given the high inflation rate at 9.0%. This pressure has been more on the 91-day paper, as it currently offers a negative real return of 0.3%. However, the government has continued to remain disciplined and reject bids above market, as indicated by (i) the lower acceptance rate for the 91-day paper at 61.8% as compared to the 364-day paper at 85.2%, and (ii) the high variance be2tween the market average yield and the accepted average yield for the 91-day T-bill at 0.3%, compared to 0.0% for the 364-day papers, respectively. The table below highlights this trend:

Treasury Bills Yields and Variance		
	91-Day	364-Day
Market Weighted Average Yield*	9.0%	10.9%
Weighted Average Accepted Yield*	8.7%	10.9%
Variance	**0.3%**	**0.0%**
Acceptance Rate	61.8%	85.2%
Average Real Return	(0.3%)	1.9%

**Average yield for the last 3 Auctions*

Last week, the Kenyan Government re-opened two bonds (FXD 2/2014/5 and FXD 3/2013/5), with effective tenors of 2.2-years and 1.7-years, and coupons of 11.9% and 12.0%, respectively, in a bid to raise Kshs 30.0 bn for budgetary support. Yields on the bonds came in at 12.4% and 11.8%, below our recommended bidding range of between 12.8% - 13.4%, and 12.3% - 13.0% for the 2.2-year and the 1.7-year, respectively. The bonds were oversubscribed, with a performance rate of 214.2%, attracting Kshs 64.2 bn. Given that the market weighted average rates came in at 12.7% and 12.2%, respectively, above the accepted rate of 12.4% and 11.8%, respectively, it is clear from this auction that the government will not accept expensive bids, having only accepted Kshs 24.9 bn out of the Kshs 64.2 worth of bids received, translating to an acceptance rate of 38.7%. However, as indicated previously, despite the resilience demonstrated by the Central Bank, there exists possible upward pressure on interest rates as (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 the balance is most likely to be plugged from the domestic market, and (ii) the Kenya Revenue Authority (KRA) has already missed its first half of 2016/17 fiscal year revenue collection target by 3.2%, which may trigger increased borrowing to meet expenditure requirements.

Kenya's National Treasury has finally launched its mobile-phone bond auction platform, "M-Akiba'', following its postponement in October 2015, with the Central Depository & Settlement Corporation (CDSC) acting as the agent, and Safaricom and Airtel as the mobile virtual network operators. The M-Akiba platform will look to raise Kshs 5.0 bn, though the government has taken a prudent approach, through a pilot issue, in order to gauge market subscriptions, practicability in terms of administration of the funds and any unforeseen eventualities that may arise. The pilot issue will seek to raise Kshs 150.0 mn from the local market for infrastructure development, through the three-year fixed coupon retail infrastructure bond that will pay investors a tax-free interest income of 10.0% p.a. Adjusting for 15.0% withholding tax, the yield on the 3-year issue comes in at 11.5%. The period of sale on the bond commenced on 21st March and is set to conclude on 10th April, prior to the value date of the issue, 11th April, from where it shall be traded on the Nairobi Securities Exchange (NSE) via mobile phone, with the NSE acting as the market maker. Analyzing the progress to date we notice some inconsistency in the offer touted to have raised Kshs 2.4 mn as at Friday 24th March, from 1,720 users translating to Kshs 1,395 per user, which is less than the minimum investible amount of Kshs 3,000. The effort is commendable as we believe the platform will open the bond market to low income investors; the market has historically been dominated by financial institutions and high net-worth individuals, and hence a larger number of investors will be able to invest in government securities through the mobile platform. However, as highlighted in our Cytonn Weekly #36-2016, the platform may end up not achieving its intended purpose, given (i) the lower end of the market is largely made up of net borrowers seeking capital, and hence it remains to be seen if the attractive government rates will spur savings, (ii) the low denominations will make it very difficult for bond holders to trade, and (iii) there still exists a large need for investor education targeted towards the retail investors that this bond is targeting. If successful, the launch of this platform will have a positive impact in the money market, accelerating the level of financial inclusion in the country.

The average interbank rate rose by 90 bps w/w to 4.8% from 3.9% the previous week, as the liquidity in the money market tightened, with a net liquidity reduction of Kshs 0.6 bn. The tightened liquidity position during the week was attributed to a reduction in T-bill redemptions and government payments, which came in at Kshs 22.0 bn and Kshs 20.5 bn, from Kshs 27.2 bn and Kshs 26.5 bn, respectively, the previous week. The volumes transacted in the interbank market decreased to Kshs 7.9 bn from Kshs 9.6 bn the previous week.

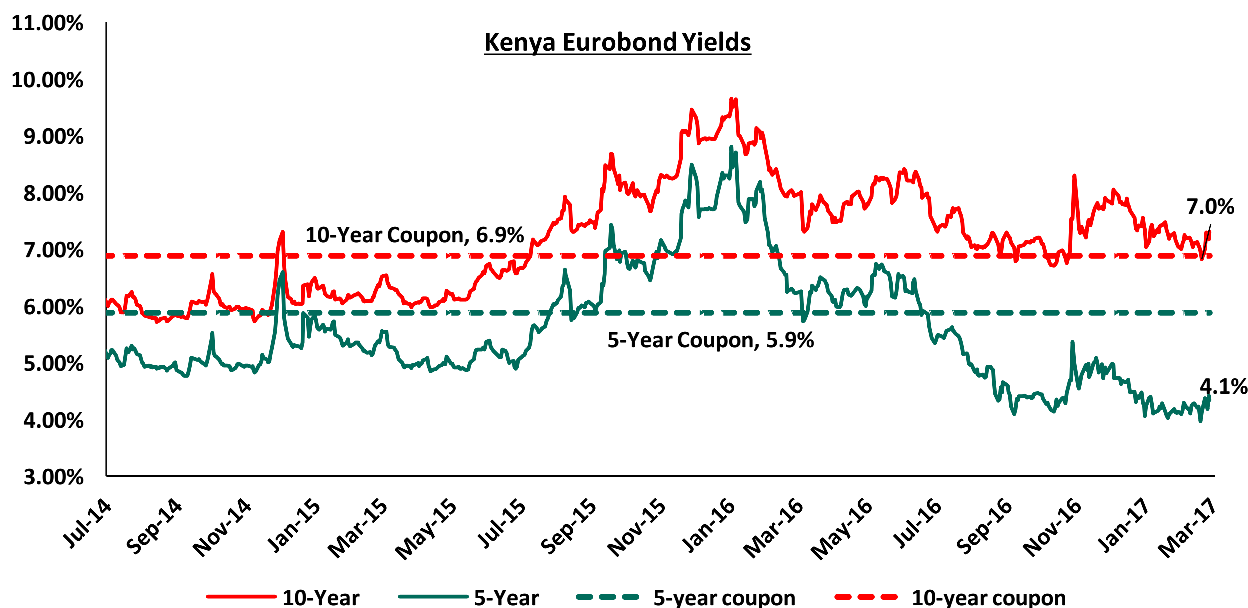
Below is a summary of the money market activity during the week:

all values in Kshs bn, unless stated otherwise

Weekly Liquidity Position – Kenya

Liquidity Injection		Liquidity Reduction	
Term Auction Deposit Maturities	38.0	T-bond sales	0.0
Government Payments	20.5	Transfer from Banks - Taxes	34.1
T-bond Redemptions	0.0	T-bill (Primary issues)	21.9
T-bill Redemption	22.0	Term Auction Deposit	35.0
T-bond Interest	3.3	Reverse Repo Maturities	13.1
T-bill Re-discounts	0.0	Repos	10.0
Reverse Repo Purchases	9.7	OMO Tap Sales	0.0
Repos Maturities	20.0		
Total Liquidity Injection	**113.5**	**Total Liquidity Withdrawal**	**114.1**
		Net Liquidity Injection	**(0.6)**

According to Bloomberg, the yield on the 5-year and 10-year Eurobonds declined by 10 bps each w/w to 4.1% and 7.0%, from 4.2% and 7.1%, respectively, the previous week. Since the mid-January 2016 peak, yields on the Kenya Eurobonds have declined by 4.7% points and 2.6% points, respectively, for the 5-year and 10-year bond due to improving macroeconomic conditions. This is an indication that Kenya remains an attractive investment destination.



The Kenya Shilling appreciated by 0.1% against the dollar to close the week at Kshs 102.9 compared to Kshs 103.0 recorded the previous week, supported by dollar inflows from tea exporters. On a year to date basis, the shilling has depreciated against the dollar by 0.4%. This week, we have seen the forex reserves move up to USD 7.8 bn (equivalent to 5.1 months of import cover) as a result of the USD 800 mn (Kshs 82.3 bn) syndicated loan signed this week, which will provide an adequate buffer and aid in the Central Bank's efforts to stabilize the shilling. This is a significant rise from the previous week where reserves stood at USD 7.0 bn (equivalent to 4.6 months of import cover), which has seen the reserves revert back to the high levels of USD 7.8 bn witnessed in October 2016 (equivalent to 5.2 months of import cover).

As stated above, during the week, Kenya's National Treasury signed a USD 800 mn syndicated loan with four banks: Standard Chartered Bank, Standard Bank, Citi Bank and Merchant Bank, in a bid to plug the budget deficit, which is estimated at 9.7% of GDP for the fiscal year 2016/17. In January, the government borrowed

USD 750 mn (Kshs 77.2 bn) through syndicated loans to support the budget and boost foreign reserves, which now brings the total amount borrowed from the foreign market to USD 1.6 bn (Kshs 159.5 bn) since the turn of the year, and may serve to relieve some of the pressure on government to borrow heavily in the domestic market, given it has reduced its foreign borrowing deficit, which currently stands at 55.5% of the foreign borrowing target of Kshs 462.3 bn, from 73.3% previously. Despite this, the current levels of government debt are a potential threat to economic stability, with debt levels currently at 52.3% of GDP. With the global strengthening of the dollar, dollar denominated debt repayments are likely to be more expensive thus exerting adverse effects on economic growth. Kenya's 5-year Eurobond matures in the fiscal year 2018/19, which will see the government make a huge repayment despite a persistent expansionary fiscal policy and budget deficit. As noted in our Cytonn Weekly #51, the trend in Kenya's debt position is concerning and will only add to the country's rising debt burden, which has grown to 52.3%, from about 40.0% 3-years ago, already above the IMF recommendation of 50.0% of debt to GDP for frontier and emerging markets.

We are projecting inflation for the month of March to rise to the range of 9.5% - 9.8%, from 9.0% in February, driven mainly by a rise in food prices caused by the ongoing drought, and an increase in fuel prices, which have been pushing up the cost of energy. Going forward, we expect upward inflationary pressures to persist from (i) the food component of the Consumer Price Index (CPI) basket due to the persistent dry weather that is expected to carry on for the first half of the year, with depressed rainfall in the long rains season that comes in between March and May, (ii) the global recovery of oil prices spurring cost-push inflation, and (iii) the global strengthening of the dollar increasing the cost of imports, as it results in a weaker shilling. We expect upward inflationary pressures to persist in the first half of 2017, and average 8.6% over the course of the year, which is above the upper bound of the government target range of 2.5% - 7.5%.

The Monetary Policy Committee (MPC) is set to meet on Monday 27th March, 2017, to review the prevailing macroeconomic conditions and give the direction of the Central Bank Rate (CBR). In their previous meeting, held in January 2017, the MPC maintained the CBR at 10.0%. We expect the MPC to maintain the CBR at 10.0%, given:

(i) The currency has appreciated by 1.0% since the last meeting, supported by high forex reserve levels at 5.1 months of import cover and the stand-by credit facility from the IMF, and
(ii) The resilience of the Central Bank of Kenya (CBK) in stabilizing interest rates at low levels, supported by reduced credit to the private sector, which may make it easier for government to bridge the foreign borrowing deficit through local domestic borrowing.

For our comprehensive analysis on the same, see MPC Note.

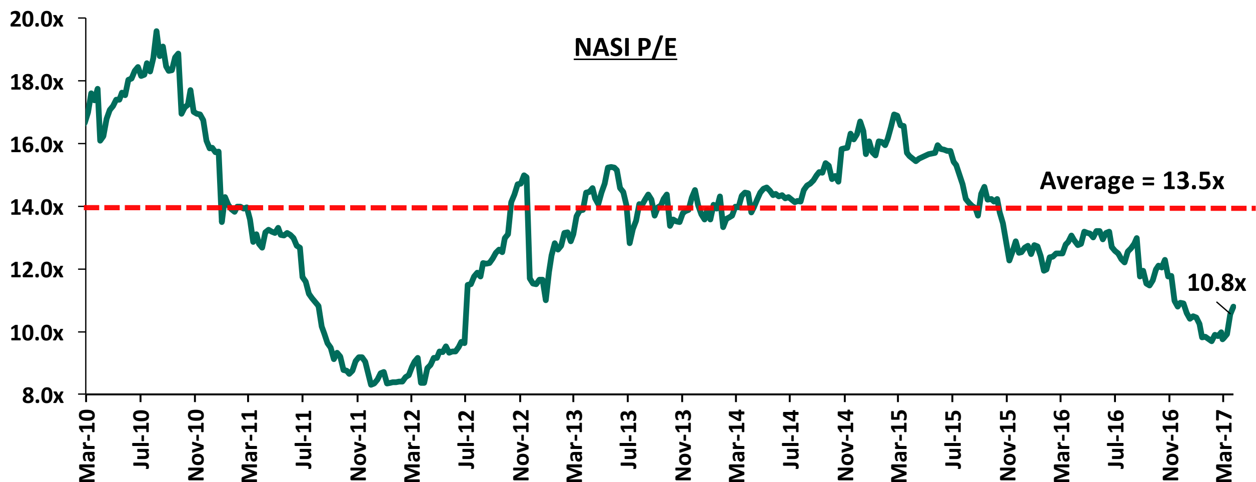
The Government is ahead of its domestic borrowing for the current fiscal year, having borrowed Kshs 216.1 bn against a target of Kshs 172.2 bn (assuming a pro-rated borrowing throughout the financial year of Kshs 229.6 bn budgeted for the full financial year). It is important to note, however, that the government is in the process of revising its domestic borrowing target upwards to Kshs 294.6 bn, which will take the pro-rated borrowing target to Kshs 221.0 bn, implying that the government will fall slightly behind its borrowing target. 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 given Kenya Revenue Authority (KRA) has already missed its first half of 2016/17 fiscal year revenue collection target by 3.2%, and it is expected to miss its overall revenue collection target of Kshs 1.5 tn for the current fiscal year. This creates uncertainty in the interest rate environment as the government might have to plug in the deficit by borrowing more from the domestic market, a move that may exert 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.

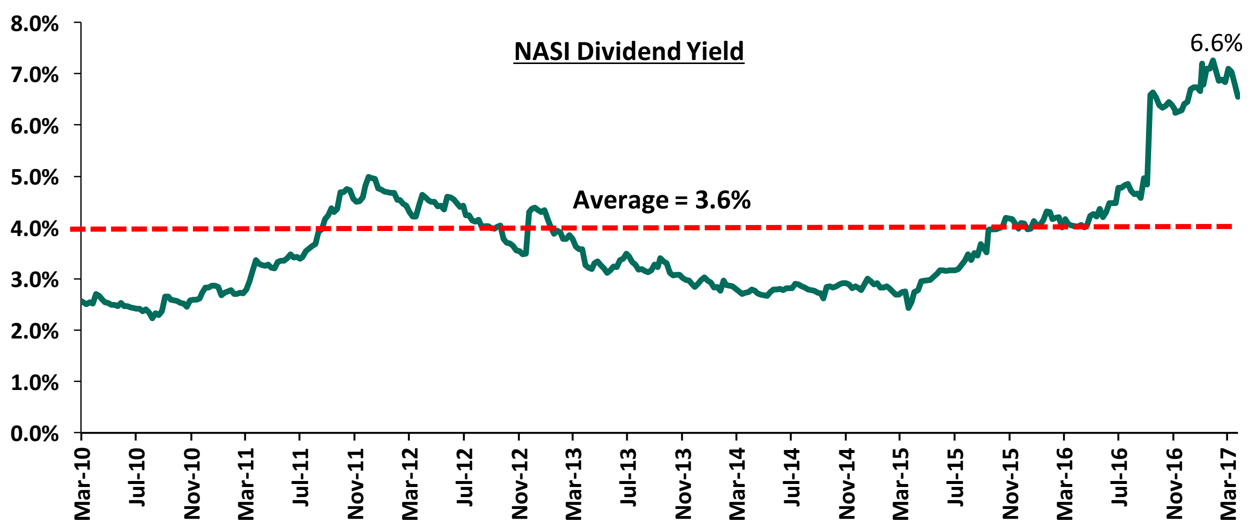
Equities

During the week, the equities market was on an upward trend with NASI, NSE 20 and NSE 25 gaining 3.2%, 3.2% and 3.4%, respectively, taking their YTD performances to (2.0%), (3.4%) and (2.7%), respectively. This week's performance was supported by gains in select large cap stocks such as Safaricom, Equity Group and KCB Group, which gained 2.8%, 5.2% and 5.0%, respectively. Since the February 2015 peak, the market has lost 44.0% and 26.4% for NSE 20 and NASI, respectively.

Equities turnover decreased by 42.4% to close the week at USD 24.5 mn from USD 42.5 mn the previous week. Foreign investors turned net sellers with net outflows of USD 2.5 mn, compared to a net inflow of USD 1.5 mn recorded the previous week, with foreign investor participation decreasing to 65.1%, from 84.5% recorded the previous week. Safaricom remained the top mover for the week, accounting for 38.3% of market activity. We expect the Kenyan equities market to be flat in 2017, driven by slower growth in corporate earnings, neutral investor sentiment mainly due to the forthcoming general elections and the aggressive rate hike cycle in the US, which may reduce the level of foreign investors' participation in the local equities market.

The market is currently trading at a price to earnings ratio of 10.8x, versus a historical average of 13.5x, with a dividend yield of 6.6% versus a historical average of 3.7%. The current 10.8x valuation is 30.1% above the most recent trough valuation of 8.3x experienced in December of 2011. The charts below indicate the historical P/E and dividend yields of the market.





Kenyan tax payers may have to bear the financial burden of paying back a government backed, USD 200.0 mn loan that was advanced by Afrexim bank last year to Kenya Airways at a rate of 6.8% to the dollar. The funds were borrowed to fund the airlines' turnaround strategy, dubbed 'operation pride', which focuses on 3 key aspects to bring back the airline to profitability, namely: (i) improving its current business model, (ii) closing the profitability gap, and (iii) optimization of capital, which involves entering negotiations with different financial stakeholders to recover its financial position. The loan which is due in 2018 was given based on hope that the airline would fall back to profitability, which it has failed to do so. The airline's borrowings stood at Kshs 116.7 bn as at the end of H1'17, with a debt to equity position of (300.0%). We are of the view that the airline will continue facing challenges going forward in terms of operations given: (i) the high competition in the airline industry, and (ii) slim profit margins in the airline industry. As indicated in our Cytonn Weekly #6/2017, companies such as Kenya Airways, where the government has a significant stake, need to be privatized and subject to market discipline, to avoid tax payers paying the price for mismanagement that leads to financial troubles.

Starting next week, Kenyan investors will be able to buy units of gold backed assets on the NSE through a gold backed Exchange Traded Fund (ETF). An ETF is an investment fund, holding assets such as stocks, commodities, or bonds, and are traded on stock exchanges. The value of an ETF is derived from its Net Asset Value (NAV), which is tracked on a daily basis. The ETF will be priced based on the real time price of gold, on a per unit basis of a troy ounce of gold at the headline shilling to dollar exchange rate. The minimum amount of units to trade will be 100 units. Given the current price of gold in the international markets is around USD 1,200 per 100 troy ounces, investors would have to fork out at least Kshs 120,000. We are of the view that the introduction of the ETF will help pave the way for other ETFs in the country thus increasing investment diversification through introduction of a different asset class. This will however be primarily for institutional investors compared to retail buyers, mainly due to the high trading amount needed to access the ETF. In order for the ETF to be successful, the NSE should focus on investor education highlighting the pros and cons of such a platform.

Chase Bank is set to be out of receivership as soon as the end of H1'2017, dependent on the bank's ability to obtain a strategic investor. The bank was previously under statutory management by Kenya Commercial Bank (KCB) since being placed under receivership in April 2016, following dubious insider lending practices. Currently, Chase bank is under the management of the CBK. Chase Bank was one of 3 local banks that faced closure, the others being Imperial Bank, another mid-sized lender and Dubai Bank, a smaller lender. We are of the view that the reopening of Chase Bank will improve, albeit slightly, confidence in the banking industry. This, coupled with the recent process of lifting of the bank licensing moratorium, is also bound to improve competitiveness in the local banking sector whereby a key few banks hold majority of the country's customer deposits.

There were a number of companies that released their earnings this week, including Diamond Trust Bank, I&M Bank, Standard Chartered Bank, Britam and NSE;

Diamond Trust Bank released FY'2016 results

DTB released their FY'2016 earnings, recording an increase in core EPS by 16.6% to Kshs 28.9 per share from Kshs 24.8 per share in FY'2015, above our expectation of a 12.9% increase. This was due to a 22.6% increase in operating revenue despite a 30.1% increase in operating expenses.

- The 22.6% increase in operating revenue to Kshs 24.4 bn from Kshs 19.9 bn in FY'2015 was driven by Net Interest Income that rose 27.4% to Kshs 19.4 bn from Kshs 15.2 bn in FY'2015, following a 30.8% growth in Interest Income despite Interest Expense increasing by 35.7%
- Despite Interest Expense outpacing Interest Income, the Net Interest Margin increased to 7.4% from 7.2% in FY'2015 as the Net Interest Income growth of 27.4% was faster than the growth of average interest earning assets of 22.2% to Kshs 286.7 bn from Kshs 234.6 bn in FY'2015

- Non-Funded income increased by 7.3% to Kshs 5.1 bn from Kshs 4.7 bn in FY'2015, driven by an increase in other fees and commission by 12.0% to Kshs 2.0 bn from Kshs 1.8 bn in FY'2015. This takes the revenue mix to 79:21, Funded: Non-Funded from 76:24, previously
- Operating expenses increased by 30.1%, driven by a 96.0% increase in Loan Loss Provisions (LLP) to Kshs 4.3 bn from Kshs 2.2 bn in FY'2015. This increase in LLP was due to the increase in Non-Performing Loans (NPLs) evidenced by the NPL ratio increasing to 3.9% from 2.7% in FY'2015. Staff costs increased slightly by 2.9% to Kshs 3.4 bn from Kshs 3.3 bn in FY'2015.
- The Cost to Income ratio deteriorated to 55.1% from 52.0% in FY'2015. Without LLP, the CIR improved to 37.6% from 41.0% in FY'2015
- Total assets increased by 20.8% to Kshs 328.0 bn from Kshs 271.6 bn, driven by a 97.1% increase in Government securities holdings to Kshs 92.8 bn from Kshs 47.1 bn in FY'2015. This is mainly due to the interest rate caps that have prompted banks to prefer lending to the government
- Loans increased by 4.9% to Kshs 186.3 bn from Kshs 177.5 bn in FY'2015. Total liabilities increased by 20.9% to Kshs 282.2 bn from Kshs 233.3 bn in FY'2015, driven by a 22.7% increase in deposits to Kshs 238.1 bn from Kshs 194.1 bn. The high increase in deposits could be attributed to the fact that DTB was among the payout agents for Imperial Bank's depositors. The deposit growth outpacing loan growth is good for the bank as this improves their capital position as they have more capital vs risk assets. This is evidenced by their Tier 2 ratio improving to 16.2% from 14.8% in FY'2015
- Given that deposit growth outpaced loan growth, the Loan to Deposit ratio declined to 78.2% from 91.5% in FY'2015
- The bank recommended payment of a final dividend of Kshs 2.6 per share translating into a dividend yield of 1.8%

Going forward, DTB's growth will be driven by: (i) increased efficiency through cutting down of costs by opening more digital branches offering 24/7 customer service, (ii) a continued branch expansion strategy having opened 3 new branches in 2016, which is expected to drive increased deposit mobilization, (iii) increasing exposure to government securities as they have done throughout the year, as growth of their loan book continues to slow down due to the cap on interest rates given DTB is largely an SME bank, and (iv) 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. Challenges they face include: (i) stiff competition in the SME banking market, (ii) exposure to different political, economic and regulatory environments, and (iii) decreasing asset quality as is evident from the sudden increase in the NPL ratio to an average of 4.0% in 2016 from an average of 1.8% in 2015.

In addition, DTB announced their intention to acquire Habib Bank. This will be carried out through a share swap transaction, which will involve issuance of 13.3 mn new shares at a price of Kshs 137.4 per share, at a premium of 33.4% compared to the its current share price of Kshs 103.0, and will dilute existing shareholders by 4.8%. This translates to an acquisition multiple of 0.8x price to book, compared to 0.9x for current market average and 2.0x for recent bank transactions. This highlights the low valuations in the market as the transaction was carried out at a 60.0% discount, when compared to recent bank transactions of 2.0x.

For further analysis on this transaction, kindly see the Diamond Trust Bank acquires Habib Bank Note. For more detailed analysis on Diamond Trust Bank FY'2016 earnings, see our Diamond Trust Bank Earnings Note.

I&M Bank released FY'2016 results

I&M Bank posted a 10.3% growth in PAT to Kshs 6.5 bn from Kshs 6.0 bn in FY'2015. This was driven by a 20.6% growth in operating revenue to Kshs 17.6 bn from Kshs 14.6 bn in FY'2015, despite a higher growth in operating expenses that grew by 46.7% to Kshs 8.6 bn from Kshs 5.8 bn in FY'2015. Key to note, these are the results for the bank, the results for the holding company, which is the listed entity, is to be released at a later date.

- The 20.6% increase in operating revenue to Kshs 17.6 bn from Kshs 14.6 bn in FY'2015, was driven by Net Interest Income which grew by 23.1% to Kshs 13.6 bn from Kshs 11.0 bn in FY'2015, following a 10.7% growth in Interest Income to Kshs 21.8 bn from Kshs 19.7 bn in FY'2015 outpacing a 5.0% decline in Interest Expense to Kshs 8.2 bn from Kshs 8.6 bn in FY'2015
- The Net Interest Margin improved to 10.9% from 9.4% in FY'2015
- Non-Funded Income increased by 12.8% to Kshs 4.0 bn from Kshs 3.6 bn in FY'2015, owing to an increase in other fees and commissions that rose by 27.5% to Kshs 1.5 bn from Kshs 1.2 bn. This takes the revenue mix to 67:33, Funded: Non-Funded from 71:29 in FY'2015
- The 21.6% increase in operating expenses was due to a 314.9% growth in Loan Loss Provisions (LLP) to Kshs 2.9 bn from Kshs 0.7 bn in FY'2015. This was due to the NPLs ratio increasing to 6.8% from 4.4% in FY'2015. Staff costs also rose by 4.8% to Kshs 2.5 bn from Kshs 2.4 bn in FY'2015
- The Cost to Income ratio (CIR) increased to 48.6% from 39.9% in FY'2015. Without LLP, the CIR declined to 32.2% from 35.2% in FY'2015
- Total Assets increased by 10.5% to Kshs 182.1 bn from Kshs 164.8 bn driven by an increase in net loans by 5.0% to Kshs 120.7 bn from Kshs 114.9 bn in FY'2015
- Total Liabilities increased by 8.7% to Kshs 150.1 bn from Kshs 138.0 bn, as deposits rose by 10.9% to Kshs 129.6 bn from Kshs 116.8 bn in FY'2015. The faster growth in deposits than loans led to the loan deposit ratio declining to 93.1% from 98.4% in FY'2015

Going forward, we expect growth to be driven by: (i) high operating efficiency, and (ii) full adoption of internet banking to enhance loans disbursement and deposit mobilization, which will further drive up efficiency. However, a major challenge they face is stiff competition for clients from larger existing Tier 1 banks in the SME and retail sectors.

Standard Chartered Bank released FY'2016 results

Standard Chartered Bank released their FY'2016 results, recording a core EPS growth of 43.9% to Kshs 25.9 from Kshs 18.0 in FY'2015, higher than our expected 8.2% growth. This was driven by a 10.3% growth in operating revenue that outpaced a 9.3% decrease in operating expenses.

- The 10.3% increase in operating revenue to Kshs 28.0 bn from Kshs 25.4 bn was driven by Net Interest Income which grew by 7.1% to Kshs 19.4 bn from Kshs 18.1 bn in FY'2015, following a 12.7% growth in Interest Income to Kshs 25.8 bn from Kshs 22.9 bn in FY'2015, despite a 34.0% increase in Interest Expense to Kshs 6.4 bn from Kshs 4.7 bn in FY'2015. The Net Interest Margin was flat at 9.6%
- Non-Funded income increased by 18.5% to Kshs 8.6 bn from Kshs 7.3 bn in FY'2015, driven by a 22.0% increase in forex income to Kshs 2.8 bn from Kshs 2.3 bn in FY'2015, and a 58.0% increase in other income to Kshs 1.2 bn from 0.7 bn in FY'2015. As a result, the revenue mix changed to 69:31, Funded: Non-Funded from 72:28 in FY'2015,
- The 9.3% decrease in operating expenses was driven by a 55.1% fall in Loan Loss Provisions (LLP) to Kshs 2.7 bn from Kshs 4.9 bn. This decline is mainly due to the one-off provisioning they had to make in FY'2015 after NPLs rose by 36.7% to Kshs 14.7 bn from Kshs 10.8 bn. However, staff costs increased by 15.3% to Kshs 7.0 bn from Kshs 6.1 bn in FY'2015
- The Cost to Income ratio (CIR) improved to 53.0% from 64.0% in FY'2015. Without LLP, the CIR deteriorated slightly to 44.7% from 44.6% in FY'2015
- Total assets increased by 7.0% to Kshs 250.3 bn from Kshs 234.0 bn in FY'2015, driven by a 6.6% increase in loans to Kshs 122.8 bn from Kshs 115.1 bn in FY'2015. Total liabilities increased by 7.1% to Kshs 206.4 bn from Kshs 192.7 bn in FY'2015, driven by an 8.5% increase in deposits to Kshs 186.6 bn from Kshs 172.4 bn in FY'2015
- The faster growth in deposits than loans led to the Loan to Deposit ratio decreasing to 65.8% from 66.9% in FY'2015

- The bank recommended payment of a total dividend of Kshs 20.0 per share, comprising of a final dividend of Kshs 14.0 per share, having paid an interim of Kshs 6.0 per share. This translates to an increase in the dividend yield to 9.2% compared to 7.2% for 2015

Going forward, we expect the bank's growth to be driven by: (i) strong growth in the corporate banking sector, and (ii) reduction in the level of non-performing loans due to the adoption of more prudent screening criteria. For more detailed analysis on Standard Chartered Bank FY'2016 earnings, see our Standard Chartered Bank FY'2016 Earnings Note.

Of the 8 listed banks that have released their FY'2016 results, Co-op Bank, Standard Chartered and Diamond Trust Bank have recorded an increase in core earnings per share, with the average increase in core earnings across the banking sector at 6.1%; this is an increase compared to the 3.8% registered for FY'2015. The sector has however experienced lower loan and deposit growth, with the only metric that banks have been able to protect so far being their Net Interest Margins. Key to note also is that half of the banks, namely KCB Group, NIC Bank, Equity Group, Stanbic bank and DTB have increased their exposure to government securities. This could be attributed to the change in loan and deposits pricing framework brought about by the interest rate caps that has made most lenders increase exposure to the risk-free government as opposed to other risky borrowers. Interest rates cap was meant to improve lending to the consumer, but so far the cap has curtailed lending and it is time to review them. The remarks by President Kenyatta last week that the government intends to rectify the decline in private sector credit growth, as a result of reduced lending by banks, signals the intention to review the rates cap law in some way.

Listed Banks FY'2016 Earnings and Growth Metrics

Bank	Core EPS Growth		Deposit Growth		Loan Growth		Net Interest Margin		Loan to Deposit Ratio		Exposure to Government Securities	
	FY'2016	FY'2015	FY'2016	FY'2015	FY'2016	FY'2015	FY'2016	FY'2015	FY'2016	FY'2015	FY'2016	FY'2015
SCBK	**43.9%**	(45.3%)	7.6%	51.8%	6.6%	(6.2%)	10.1%	9.6%	64.7%	66.9%	31.5%	32.6%
DTBK	**16.6%**	11.4%	22.7%	23.9%	4.9%	29.0%	7.4%	7.2%	78.2%	91.5%	28.3%	17.3%
Co-op Bank	**8.3%**	46.0%	(2.0%)	21.9%	11.0%	16.2%	9.0%	8.8%	91.1%	80.4%	23.8%	24.5%
KCB Group	**(0.5%)**	12.1%	5.6%	12.5%	11.5%	21.9%	8.8%	7.9%	86.1%	81.5%	22.9%	22.8%
NIC Bank	**(3.3%)**	2.6%	(0.5%)	11.9%	(1.3%)	13.7%	8.0%	6.1%	94.6%	103.2%	27.2%	24.8%
Equity Group	**(4.6%)**	1.0%	11.6%	23.1%	(1.4%)	26.0%	11.0%	10.6%	89.3%	78.9%	29.8%	14.2%
Stanbic Bank	**(9.9%)**	(13.7%)	1.4%	18.7%	3.4%	26.6%	5.8%	6.4%	85.1%	83.4%	32.1%	29.5%
Barclays Bank	**(12.6%)**	(0.2%)	7.9%	0.2%	15.9%	15.9%	10.5%	10.2%	94.6%	88.1%	27.3%	29.1%
Weighted Average*	**6.1%**	**2.3%**	**7.2%**	**22.4%**	**6.7%**	**17.5%**	**9.5%**	**9.0%**	**84.8%**	**80.6%**	**26.7%**	**24.0%**

The weighted average is based on Market Cap as at 25th March 2017

Britam released FY'2016 results

Britam Holdings Limited released their FY'2016 results with EPS coming in at Kshs 1.1, from a loss per share of Kshs 0.5 in FY'2015, driven by the change in reserving methodology as per the Insurance Regulatory Authority (IRA), which required life insurers to prepare their FY'2016 financials based on gross premium valuations which is less conservative compared to the previously used net premium valuation.

Key highlights for the performance from FY'2015 to FY'2016 include:

- Operating revenue grew by 11.1% to Kshs 22.4 bn, from Kshs 20.1 bn in FY'2015, attributed to Gross written premiums rising by 3.5% to Kshs 20.3 bn, from Kshs 19.6 bn in FY'2015. Operating revenue

growth was also supported by a 35.3% rise in interest and dividend income to Kshs 4.2 bn from Kshs 3.1 bn, and a 29.3% rise in fund management fees to Kshs 0.9 bn from Kshs 0.7 bn,

- The loss ratio decreased to 28.8% from 64.8% due to a decline in insurance claims and loss adjustment expenses by 12.3% to Kshs 9.0 bn from Kshs 10.3 bn,
- Total expenses declined by 15.3% to Kshs 18.6 bn from Kshs 21.9 bn attributed to net insurance benefits and claims, which recorded a 52.9% decrease to Kshs. 5.0 bn from Kshs 10.6 bn, despite a 7.8% rise in commission expense to Kshs 3.5 bn, from Kshs 3.3 bn. This is due to the valuation methodology to gross premium valuations from net premium valuation. This led to the combined ratio declining to 89.9% from 126.0%, indicating that the core business is profitable. The Board proposed a dividend payment of Kshs 0.3 per share, amounting to a total payment of Kshs 581.5 mn. This translates to a dividend yield of 2.9%
- There has also been increased mergers and acquisition activity with the recent Plum LLP's Acquisition of a 23.3% stake while IFC recently announced plans of acquiring a 10.4% stake valued at Kshs 3.6 bn.

Britam outperformed our expectations, mainly attributed to a change in the methodology used to account for long-term insurance liabilities to the Gross Premium Valuation from the Net Premium Valuation as per the IRA requirements. Unlike in their H1'2016 results where they disclosed the impact of the change methodology for accounting for claims, the management did not disclose the impact in the full year earnings.

Going forward, Britam's growth will be driven by: (i) solid regional presence to drive growth as evidenced by operations in Uganda, Rwanda and the subsequent acquisition of Real Insurance Company Ltd in 2014 that led to expansion into Tanzania, Malawi and Mozambique, (ii) a strong distribution channel, coupled with the roll out of the first phase of its financial advisor portal, (iii) a diversified business strategy as evidenced in the Holdings' interests in insurance, asset management, real estate and strategic holdings in banks enabling the group to respond effectively to shifting market dynamics. A few challenges they face include: (i) poor real estate development strategy, and (ii) overexposure to equities, particularly banking stocks, which have underperformed due to the implementation of the interest rate cap.

For more detailed analysis on Britam Holdings Ltd FY'2016 earnings, see our Britam Holdings Ltd FY'2016 Earnings Note

Of the 4 insurance companies that have released their FY'2016 results, CIC and Liberty have registered a decrease in core EPS of (83.3%) and (12.4%), respectively, with the average decrease in core earnings per share across the insurance sector at 2.0%. This is however less than the 18.0% decrease in core earnings per share seen in 2015. The loss ratio has improved to 39.3% from 53.8% while the combined ratio has also improved to 84.2% from 101.0%.

Listed Insurance Companies FY'2016 Earnings and Growth Metrics

Bank	Core EPS Growth		Loss Ratio		Combined Ratio		ROE		ROA		Investment Income to Total Income	
	FY'2016	FY'2015	FY'2016	FY'2015	FY'2016	FY'2015	FY'2016	FY'2015	FY'2016	FY'2015	FY'2016	FY'2015
Britam	*	*	28.8%	64.8%	89.9%	126.0%	14.0%	(5.0%)	3.1%	(1.3%)	23.4%	21.6%
CIC	**(83.3%)**	**(6.9%)**	63.5%	67.9%	110.1%	116.4%	13.5%	14.5%	4.0%	4.5%	9.9%	10.9%
Sanlam	**157.9%**	**(97.9%)**	86.8%	75.5%	135.6%	136.5%	1.8%	0.8%	0.2%	0.1%	35.2%	33.0%
Liberty	**(12.4%)**	**(36.0%)**	70.9%	56.6%	145.0%	132.4%	11.3%	11.9%	1.3%	2.2%	28.9%	21.7%
Weighted Average	**(2.0%)**	**(22.0%)**	**53.6%**	**65.7%**	**111.4%**	**126.0%**	**11.7%**	**4.0%**	**2.6%**	**1.1%**	**22.4%**	**20.4%**

*** Britam's EPS cannot be calculated since it registered a loss in 2015***

NSE released FY'2016 results

NSE released FY'2016 results, posting a 39.8% decline in core earnings per share to Kshs 0.7 from Kshs 1.2, driven by a 20.6% decline in operating revenue to Kshs 527.2 mn from Kshs 663.9 mn in FY'2015, coupled with a higher growth in operating expenses of by 8.7% to Kshs 487.3 mn from Kshs 448.3 mn in FY'2015.

- The 20.6% decline in operating revenue was driven by a 30.0% decrease in equity turnover to Kshs 294.0 bn in 2016 from Kshs 419.0 bn in 2015, despite an increase in fixed income turnover that increased 39.4% to Kshs 428.3 bn from Kshs 307.2 bn in FY'2015
- Interest income declined by 6.2% to Kshs 94.8 mn from Kshs 101.0 m, mainly attributed to prevailing lower interest rates on deposits held in the year compared to 2015. Other income increased by 119.8% to Kshs 95.3 mn from 43.3 mn mainly driven by a gain of Kshs 27 mn from the sale of investment in shares and higher market access fees on the admission of a new member
- Despite cost management measures undertaken, there was an 8.7% increase in operating expenses resulting in the cost to income ratio worsening to 67.9% in 2016 compared to 55.5% in 2015
- Profit after tax declined 39.8% to Kshs 184.0 mn from Kshs 305.6 mn in FY'2015
- Total assets increased by 5.0% to Kshs 2.0 bn from Kshs 1.9 bn with current assets increasing by 7.8% to Kshs 1.0 bn from Kshs 927.4 mn, while non-current assets increased by 1.4% to Kshs 1.0 bn from Kshs 990.8 mn
- Total Liabilities increased by 5.0% to Kshs 150.6 mn from Kshs 143.5 mn, as shareholders' funds increased by 5.0% to Kshs 1.9 bn from Kshs 1.8 bn
- The management recommended a decreased dividend payment by 44.9% to Kshs 0.3 per share from Kshs 0.5 per share in FY'2015. This translated to a dividend yield of 2.5%

Going forward, we expect growth to be driven by: (i) continuous product innovation & offerings, and technology enhancements such as the expected kickoff of trading of exchange traded funds (ETFs), and (ii) enhanced regulation towards increasing liquidity which has seen the introduction of a market making framework and securities lending and borrowing legislations. However, a major challenge they may face going forward is reduced equity trading on the bourse due to tougher market conditions.

Below is our Equities Recommendation table. Key changes from last week include;

- BAT is still under review following the release of its FY'2016 earnings. We will be meeting with management to discuss the FY"2016 results and the business strategy going forward in order to update our valuation,
- Liberty Holdings has been placed under review following the announcement of weak earnings growth,
- We have placed Standard Chartered Bank and Diamond Trust Bank under review and shall give an updated valuation in the next Weekly Report.

all prices in Kshs unless stated

EQUITY RECOMMENDATION

No.	Company	Price as at 17/03/17	Price as at 24/03/17	w/w Change	YTD Change	Target Price*	Dividend Yield	Upside/ (Downside)**	Recommendation
1.	ARM	19.5	19.4	(0.3%)	(23.9%)	31.2	0.0%	60.8%	Buy
2.	Bamburi Cement	147.0	160.0	8.8%	0.0%	231.7	7.8%	52.6%	Buy
3.	Kenya Re	19.3	19.4	0.5%	(14.0%)	26.9	3.6%	42.6%	Buy
4.	Stanbic Holdings	64.5	63.5	(1.6%)	(9.9%)	84.7	7.9%	41.3%	Buy
5.	Britam	9.5	10.1	6.3%	1.0%	13.5	2.9%	36.5%	Buy
6.	KCB Group***	30.0	31.5	5.0%	9.6%	39.6	10.2%	35.9%	Buy
7.	NIC	22.8	24.5	7.7%	(5.8%)	30.8	5.1%	30.8%	Buy
8.	HF Group	11.4	11.8	4.0%	(15.7%)	13.8	9.2%	26.1%	Buy

9.	Sanlam Kenya	25.0	25.3	1.0%	(8.2%)	30.5	0.0%	20.8%	Buy
11.	Safaricom	18.0	18.5	2.8%	(3.7%)	19.8	4.7%	11.9%	Accumulate
12.	Equity Group	28.8	30.3	5.2%	0.8%	31.3	7.7%	11.2%	Accumulate
13.	Jubilee Insurance	485.0	473.0	(2.5%)	(3.5%)	482.2	1.8%	3.8%	Lighten
14.	Co-op Bank	14.1	14.0	(1.1%)	5.7%	13.6	5.7%	3.2%	Lighten
15.	I&M Holdings	84.0	93.5	11.3%	3.9%	90.7	3.9%	0.9%	Lighten
16.	Barclays	8.8	9.0	2.9%	6.1%	7.6	9.7%	(5.9%)	Sell
17.	NBK	6.3	6.5	3.2%	(10.4%)	3.8	0.0%	(41.1%)	Sell

**Target Price as per Cytonn Analyst estimates*
***Upside / (Downside) is adjusted for Dividend Yield*
****For full disclosure, Cytonn and/or affiliates holds a significant stake in KCB Group, ranking as the 14th largest shareholder in the Group*
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 with a bias to positive" for investors with short to medium-term investments horizon and are "positive" for investors with long-term investments horizon

Private Equity

Sanlam Group, through its subsidiary, Sanlam Emerging Markets, is set to acquire an undisclosed majority stake in PineBridge Investments East Africa Limited (PIEAL), subject to regulatory approval. This will see PIEAL rebrand to Sanlam Investments East Africa Limited (SIEAL). PIEAL has its presence in both Kenya and Uganda, and is licensed by both the Kenyan and Ugandan Capital Market's Authority and Retirements Benefit Authority. With USD 1.5 bn worth of assets under its management, PIEAL was ranked the largest fund manager in Kenya, according to a survey conducted in 2014 by Alexander Forbes Consulting Actuaries Schemes. The acquisition will increase Sanlam's asset management presence and capability in the region, hence enabling the group to build a leading position in institutional, affluent and retail investment management across East Africa. The move is strategic as it will see PineBridge maximize future business growth and honor fiduciary, client and employee agreements as Sanlam Group is one of Africa's largest financial services providers, with a market capitalization in excess of USD 11.0 bn and operations in 34 African countries. A similar transaction was witnessed in 2013 when Centum Investments Group acquired 73.4% stake in GenAfrica Asset Managers (formerly Genesis Kenya Investment Management Limited). This is in a bid by firms in the financial services sector to consolidate in order to (i) obtain an opportunity to expand to new markets, (ii) expand their product offering, (iii) attract experienced portfolio managers, and (iv) benefit from economies of scale. These two transactions effectively ended the independence of the two largest managers in the market, Genesis and PineBridge, by bringing them under a diversified financial services group.

A South African pension fund, Public Investment Corporation (PIC) has raised its stake in KenGen, Kenya's largest power producing company, to 6.6% by acquiring an additional 85.1 mn shares in the open market whose current share price is at Kshs 6.6, which is equivalent to a 1.2% stake. The transaction was carried out at a EV/EBITDA multiple of 7.0x, against the industry average of 7.7x, hence a discount of 9.2%. PIC is set to be allocated 351.2 mn KenGen shares, equivalent to 5.3% equity offered at the rights issue price of Kshs 6.6 per share. The additional shares will place PIC as the second largest shareholder of KenGen after the Kenya National Treasury that holds a 70.0% equity stake. This indicates PIC's confidence in the power producer's prospects. The purchase of the additional shares is in line with PIC's strategy to diversify outside South Africa where it is among the largest investors in publicly traded shares

Private equity investments in Africa remains robust as evidenced by the increased deals and deal volumes in the region key note sectors; financial services and energy. Given (i) the high number of global investors looking to cash in on the growing middle class of Africa, (ii) the attractive valuations in private markets compared to global markets, (iii) better economic projections in Sub Sahara Africa compared to global

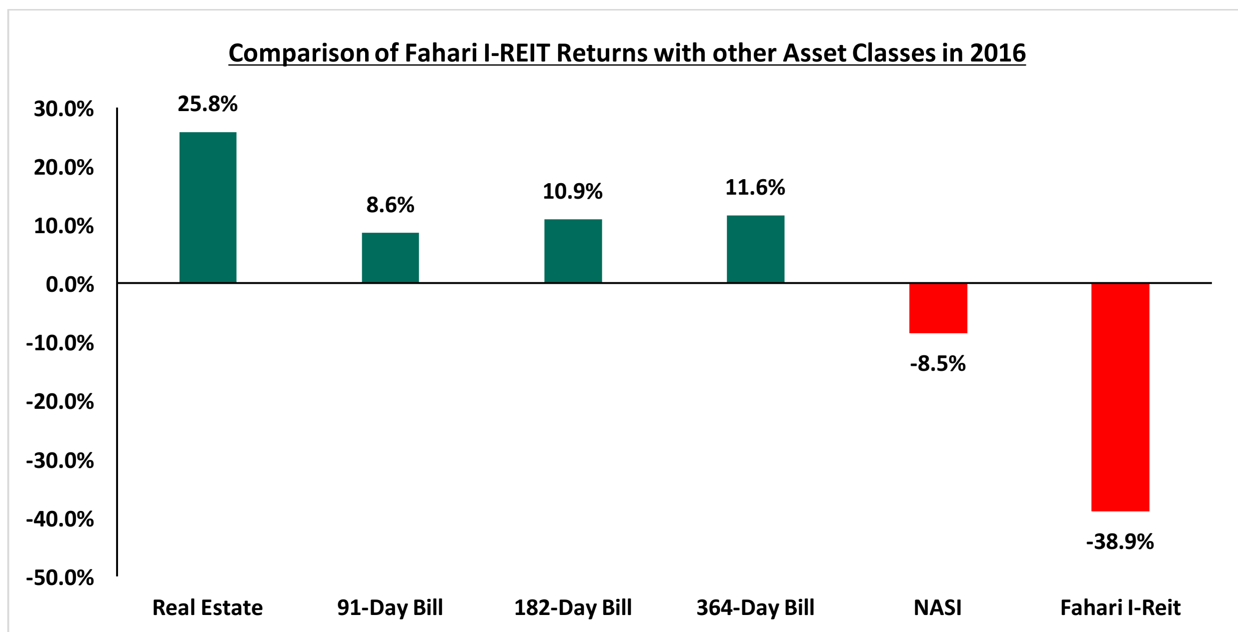
markets, and (iv) the high number of exits that is evidence of the attractiveness of the region, we remain bullish on PE as an asset class in Sub-Sahara Africa.

Real Estate

Stanlib Fahari I-REIT released earnings, posting earnings per unit of Kshs 0.59 for the 13-month period ending December 2016, having started operations in November 2015. This was driven by rental and lease income totaling Kshs 248.6 mn, with income from other sources totaling Kshs 137.9 mn. Stanlib currently manages 3 real estate assets; Greenspan Mall, Bay Holdings and Signature International properties.

- Operating revenue stood at Kshs 475.4 mn with rental and lease income accounting for 71.0% of the total operating revenue, while income from other sources including interest income accounting for 29.0% of the total operating revenue. Key to note however, is that straight-lining of lease income accounted for 18.7% of income. This may include lease rental income recognized and not necessarily due during the financial year
- Operating expenses stood at Kshs 265.0 mn of which 68.0% was attributed to fund-operating expenses including audit, trustee fees and license fees while property expenses accounting for 32.0% including maintenance of tenants and properties, filling vacancies, marketing and public relations. This is very concerning as it shows that majority of the revenues, Kshs 265.0 mn out of Kshs 475.0 mn, almost 56%, is going to all manner of professional fees; a clear indicator that the whole arrangement is primarily in the interest of the commercial interests around the REIT rather than the investor
- Operating Profit stood at Kshs 129.4 mn, adjusted for fair value gains of Kshs 81.0 mn. Factoring Kshs 23.4 mn in finance costs, Fahari I-REIT recorded a Kshs 106.0 net profit
- The Net Asset Value (NAV) closed at Kshs 19.8 per unit while the stock currently trades at Kshs 10.5 per unit, an undervaluation of 89.6%
- The REIT Manager (Stanlib Kenya Limited) and the Trustee (Cooperative Bank of Kenya) has approved a first and final distribution of Kshs 90.5 mn in earnings to unit holders at Kshs 0.50 per unit bringing the dividend yield to 4.7% of market price. The distribution is favourable at 92.6% of the distributable earnings compared to the statutory minimum of 80.0%
- The distribution is payable by 30 April 2017 to unitholders who are on the register on 31 March 2017

The Fahari I-REIT has delivered at total return of (38.9%), made up of 2.6% dividend yield (based on an investor who invested during the November 2015 listing at the then Kshs 20.0 per unit) and (41.5%) capital appreciation to investors in 2016. This is lower than all comparable classes, a clear indicator that it has been a very bad investment for investors. The only beneficiary in this REIT has been the team of professional services providers given that over half of the rental income is going into fees; the investor has been dealt heavy losses and this puts into jeopardy the future of any REITs. To align their interests with that of investors, service providers should consider cutting down their fee drawings.



The REIT is likely to maintain stable, albeit low, income streams in the next 2-years with Greenspan Mall at 94.0% occupancy and the other 2 properties being fully let as at June 2016. Greenspan Mall has a Gross Lettable Area (GLA) of 16,105 SQM whose larger percentage, at 68.0%, is due for expiry after 2020. Bay Holdings, with a GLA of 2,566 SQM is fully occupied and has 3 tenants only whose lease expire in 2024, while Signature Holdings with a GLA of 710 SQM has a single tenant whose lease expires in 2018.

This week, Nairobi hosted the Africa Green Building Summit convened by the World Green Building Council. The 3-day summit holds significant importance for the future of green building construction in the country as the world embraces energy and resource-efficiency, and environmental-friendly designs to address climate change and resource scarcity. According to statistics from UN-Habitat, it is estimated that 40% of the total electricity generated in the region is used in buildings alone and this shows how necessary it is to shift focus into the green technology. In terms of value gain in real estate, green building realizes value through (i) higher rental charges, (ii) higher workplace preference for employees, and (iii) lower operational costs. Data from the World Green Building Council shows that 20 - 25% of workers prefer to continue working in green working spaces compared to a 40.0% of workers leaving ordinary work spaces while demand for green buildings rose from 33% in 2013 to 40.0% in 2015 with the green building activity expected to double from 18.0% to 37.0% in developing countries by 2018. On value appreciation of green buildings, a report by The International Federation of Consulting Engineers (FIDIC), indicates that green buildings—whether new or renovated—command a 7.0% increase in asset value (The sale value should one opt to sell the building) over traditional buildings. United States Green Building Council (USGBC) report of 2013 says that annual utility costs per employee in green facilities was Kshs 67,526 lower than in non-green facilities showing operational efficiency realizable.

In Kenya, we have seen several buildings developed using green technology, with the latest being Dunhill Towers, which is set for a 5-star green recognition in May 2017 as the first green-certified commercial property in Kenya. Other notable eco-friendly buildings in Kenya include; Pope Paul VI Learning Resource Centre at The Catholic University of East Africa, UNEP Nairobi building, Strathmore University building and Vienna Court in Milimani. While green building requires a large capital outlay, we endorse their use in commercial construction due to the potential long-term benefits.

On the hospitality front, the Kenyan hospitality sector continues to see increased activity as we see more franchises and international entrants in the sector. This week, global hotel chain Best Western International has given two Kenyan hotels, Meridian Hotel and Mombasa's Creekside Hotel, the nod to use its brand name. The two hotels will now trade as Best Western Plus Meridian Hotel and Best Western Plus Mombasa's Creekside Hotel, respectively. This will bring to total number of its local franchise to four including the Executive Residency at Riverside and The Alba in Westlands.

Hotel franchising is a growing trend and has benefits including i) upgrading of hotel standards to match the franchiser's brand through renovation, (ii) training of staff and improvement of services, and iiI) access to a larger clientele from the franchiser's client base. This week also, Mumbai-based hotelier Sarovar announced plans to open a budget hotel under the Hometel Brand in Nairobi by 2019. Both franchising and the entrance of international brands highlight desire of investors to venture into hotels in Kenya. According to business advisory firm PKF, more than 2,000 hotel rooms will be added in the country over the next 2-years as more hotels are developed. Other hotels in the pipeline include Park-Inn, Lazizi Premiere, Pullman and Hilton Garden Inn.

Major drivers for the growth in the hospitality sector include:

- Growth of tourism in the country at 6% according to World Bank projections,
- Planned direct flights to the US from Jomo Kenyatta International Airport (JKIA), which recently attained the Category One status,
- Conference tourism which grew to 15.6% in 2015 from 12% of total number of international arrivals in 2014, with further growth expected in 2017. Conference tourism (MICE) is valued at Kshs 30 bn, with hotels accounting for 60% of this total value, according to the Kenya Hospitality Report, 2017 by Jumia Travel,
- Ranking of Kenya as the second best destination for conference tourism in sub-Saharan Africa after South Africa by the International Congress and Convention Association (ICCA), and,
- Ranking of Kenya as the leading tourist destination by the World Travel Awards in 2015

The hospitality sector is poised for growth this year with major conferences slated for this year including Africa Renewable Energy Leaders' Summit, SKAL International World Congress, Aid and Development Africa Summit, American Society of Travel Agents (ASTA) Destination Expo and the Africa Sugar Conference, among others.

We expect continued investment in the hospitality sector driven by improved security, infrastructure and government efforts to boost tourism and increased focus on green commercial building in the long-term.

Focus of the Week: Effects of the Election on the Investment Environment in Kenya

Introduction

In our Annual Market Outlook, we analyzed key trends we think will affect the investment environment this year, with specific factors affecting the Kenyan macro-economic outlook and the equities market outlook. We also did a topical on the probable direction of equities market this year, having seen a poor performance of the Kenyan equities market in 2016, in which we concluded that the equities market will most likely remain flat in 2017, but recommended a gradual increase in equities allocation, with a long-term view, in stocks that are deeply undervalued and have strong long-term earnings prospects.

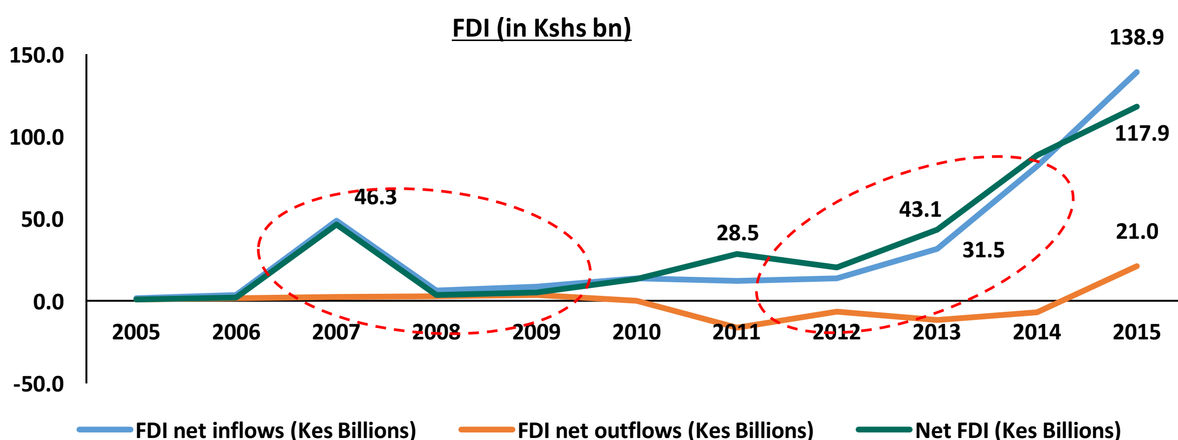
This week we turn our focus to the upcoming general election, and the effect it could have on the performance of the investment environment in Kenya. We start by analyzing the performance of equities and government securities in previous election years through the election impact on the following influencing factors: (i) Foreign Direct Investment, (ii) government borrowing, (iii) interest rates, (iv) corporate earnings, and (v) market valuation. We then give our outlook on the impact of the upcoming election on the above factors and conclude

what effect this will have on the investment environment in the country, specifically on the performance of public markets.

Of the 5 factors, we track to determine the impact of elections to the investment environment, 4 were neutral (Foreign Direct Investments, interest rates, corporate earnings and market valuations) and 1 was negative (Government borrowing), hence our conclusion is that the election is likely to have a **neutral** effect to the investment environment other than a slowdown of risk taking, which creates opportunity.

1. **Foreign Direct Investments (FDI)**

FDI's are an integral part of Kenya's economy and the general investment environment, with over 70.0% of market activity in the Nairobi bourse driven by foreign investors. The election period normally produces an air of uncertainty, which makes most investors adopt a wait-and-see approach opting to make their investments when there is a stable government in office.

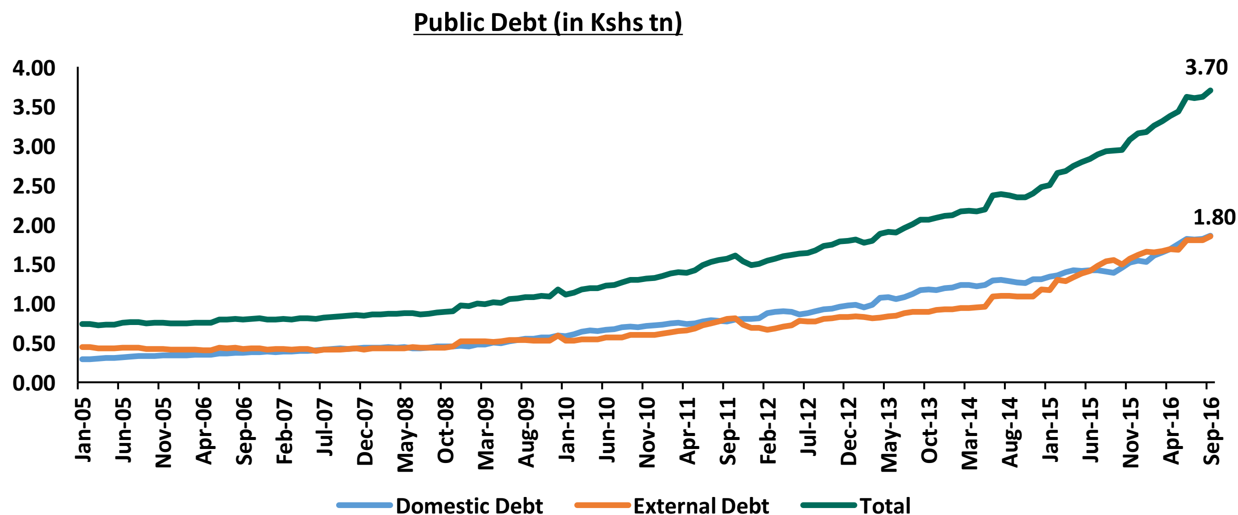


Toward the end of 2007, FDI inflows peaked at Kshs 46.3 billion, indicating foreign investors did not shy away during the run-up to the 2007/2008 election. However, as a result of the post-election violence, FDIs drastically reduced to their lowest level in the last 7-years, which also contributed to Kenya recording its slowest GDP growth of 0.2%. In the 2013 election period, the election had no noticeable impact on FDI flows, where there was a continued steady increase in FDI inflows. This is an indication that investors do not entirely use the election as a basis to determine whether and when to invest, rather it is the political goodwill and commitment of the government to ensure there is political stability during and after the election period. We do not expect this year's election to negatively affect the foreign direct investments as the government has increasingly invested in security; through measures such as CCTV installation, higher police recruitment which has brought the police officer to population ratio below the UN's recommended 400 to 1, and investment in equipment such as armored personnel carriers; re-assuring investors of their commitment to maintain an investment-friendly country. Additionally, the number of terrorism attacks within the country have reduced since 2013, with almost nil of late, emphasizing commitment to security and peace. A number of international brands have announced planned entry into the Kenyan market this year with examples of Volkswagen, Wrigley's, and Johnson and Johnson, which are evidence of investor confidence in the government to fulfil this commitment. We expect the general elections to have a **neutral** effect on FDI's.

2. **Government Borrowing**

As we highlighted in our Cytonn Weekly #7/2017, the election period is usually characterized by increased infrastructure development expenditure, as incumbent leaders seek re-election by selling a track record to

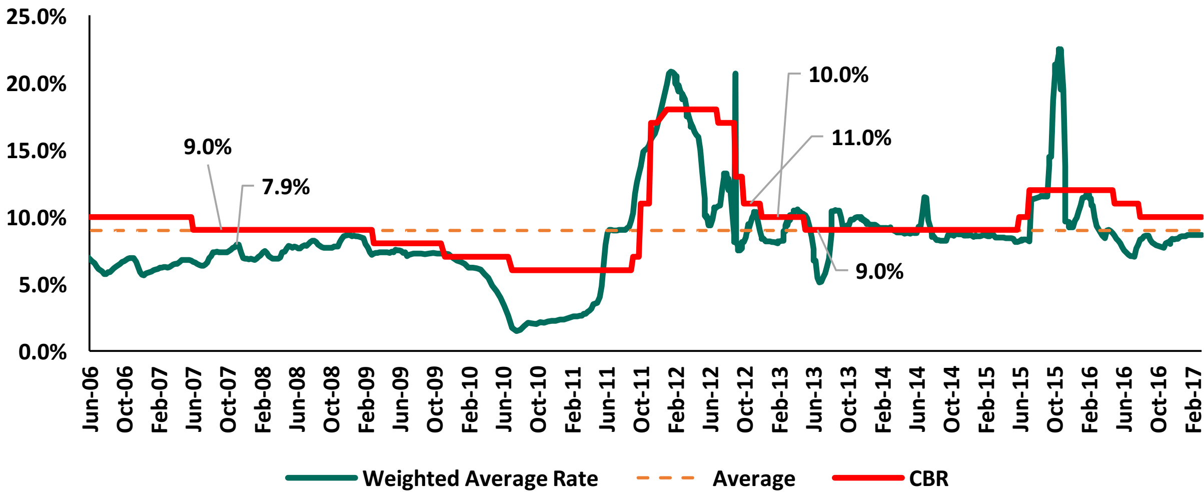
endear themselves to the electorate. Historically, the public debt (both domestic and external) has been on the rise as can be seen from the graph below.



Generally, government borrowing has never taken a back foot due to elections and Kenya has always had an expansionary budget in the last decade. This fiscal year, the government is likely to come under pressure to meet its foreign borrowing target of Kshs 462.3 bn of which they have borrowed only 44.5%, despite being ahead of its domestic borrowing by 25.6%. We are of the view that this lag may force the government to increase the amounts accepted on the securities to meet their target and finance various infrastructural projects in water, roads and energy sectors, even as national and county governments seek to meet their expectations with the electorates. Therefore, we expect the elections to have a **negative** impact on government borrowing, where the government will come under pressure to borrow.

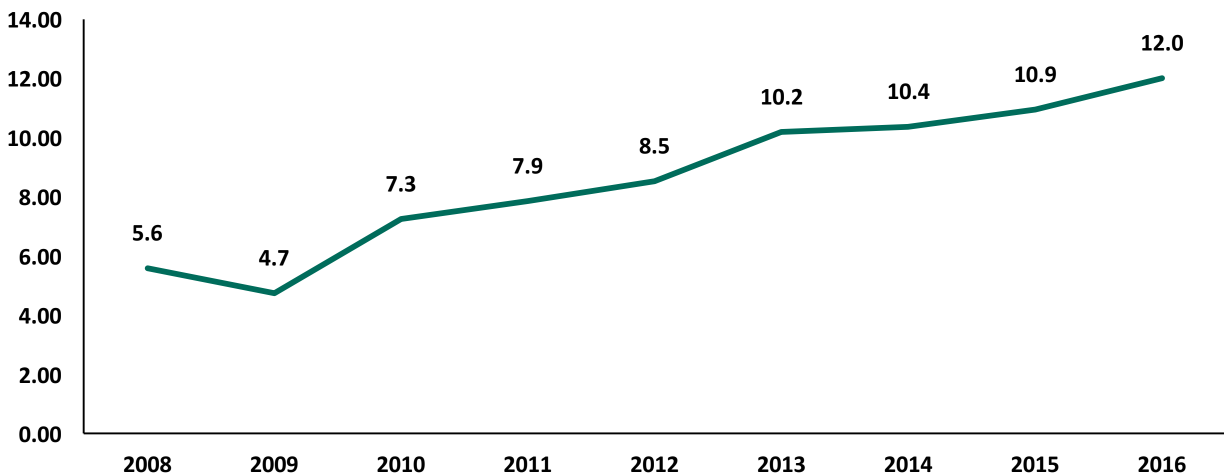
3. Interest Rates

From the graph below, it is evident that the last 2 election years have been characterized by an increase in the 91-day T-bill rates immediately before the election, which is mainly attributed to the uncertainty of the transition to a new government, as well as the possibility of political instability and violence following disputed elections, as was the case in 2007. The government has also in the past used the Central Bank Rate to induce expenditure in the economy and appeal to the public by reducing the cost of borrowing, lowering the CBR twice to a low of 9.0% in May 2013, from 11.0% in December 2012. Last year, the President assented to the Banking (Amendment) Act, 2015 effectively capping the lending rates at 4.0% above the CBR of 10.0% and the deposit rate at 70.0% of the CBR in what he termed a fulfilment to the promise to make access to funds cheap. Therefore, despite pressures from government borrowing, we are not expecting a significant increase in the interest rates this election year, especially since the CBK has remained disciplined in stabilizing interest rates in the auction market by rejecting bids that it considers as above market. We therefore expect the elections to have a **neutral** effect on interest rates. The chart below illustrates the interest rate movements for the past 10-years;



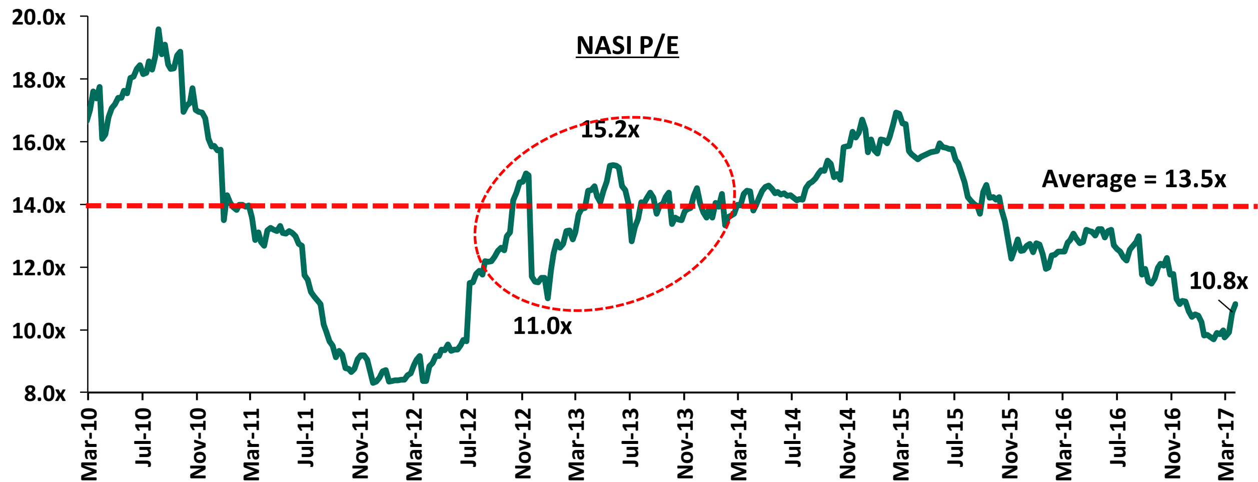
4. Corporate Earnings

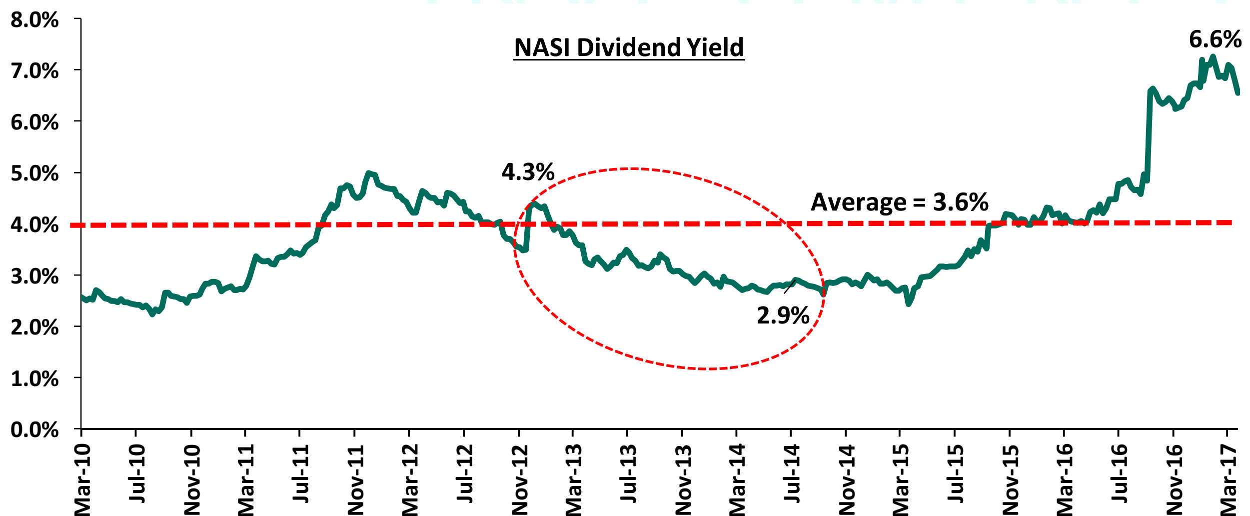
Corporate earnings as a factor influencing the investment environment has remained rather independent of the effects of a general election as evidenced from the graph below, which shows that a strong growth trend for corporate earnings of listed companies over the last 6-years, was not easily swayed by the 2013 election period. Corporate earnings registered a 19.4% growth registered in 2013 compared to 8.5% in 2012 and 1.8% in 2014. This is partly because (i) earnings reported by companies are earned over a specific period, usually one year, (ii) disruptions caused by an election rarely last for long with exception of the 2007/2008 post-election violence, and (iii) there is usually increased public expenditure during an election that eventually trickles down to the companies, especially those in FMCG sector. This year however, we are expecting subdued corporate earnings growth of 8.0% attributed to expectation of depressed earnings for commercial banks due to the implementation of the Banking (Amendment) Act, 2015, therefore not due to the fact that this is an election year. Generally, we are expecting the election to have a **neutral** effect on this year's corporate earnings. The chart below highlights the steady growth in corporate earnings over the years;



5. **Market Valuations**

Historically, market valuations of listed companies have remained independent of the effect of a general election. In the months surrounding the March 2013 election, the NASI P/E ratio was on the rise, while the NASI dividend yield was on the decline, as can be seen in the graphs below, attributable to a general rise in stock prices during the period, where between January 2012 and December 2014, the NASI experienced a steady growth, gaining 59.5%. This was on the back of gains of 29.0%, 19.2%, and 3.8% in 2012, 2013, and 2014, respectively. It indicates that the market's confidence during this period was not swayed by the election. Recently, NASI has been on a bear run, and going forward, we expect the equities market to remain flat, particularly due to depressed corporate earnings, as opposed to the effect of elections. Therefore, we expect the elections to have a **neutral** effect on market valuations.





Effect of Elections on Investment Environment in Kenya Outlook Summary Table

Public Market Indicators	2017 Outlook	Impact on Public Markets
Foreign Direct Investments	We expect that the upcoming electioneering period will not have significant effect on FDI as foreign investors with a long-term view of the market to continue driving FDI inflows	**Neutral**
Government borrowing	The government is currently ahead of its domestic borrowing target but may come under pressure to increase this to make up for the un-met foreign borrowing target. The increased issuance of bonds for infrastructural projects may also be a sign that the incumbent government is seeking to achieve milestone in development so as to appeal to the voters. This may lead to increased pressure to borrow	**Negative**
Interest Rates	Interest rates have maintained at low levels since the operationalization of the Banking (Amendment) Act, and we do not expect the election to influence this. The President recently made remarks that the government intends to rectify the decline in private sector credit growth, which signals an intention to rates cap law in some way but this may happen after the election period	**Neutral**
Corporate Earnings	Growth in corporate earnings is expected to slow down due to implementation of the Banking (Amendment) Act 2015, not because of the election period, but some industries are likely to benefit from an increase in government expenditure	**Neutral**
Market Valuations	NASI has been on a bear run, and going forward, we expect NASI to remain flat, particularly due to depressed corporate earnings, as opposed to the effect of elections	**Neutral**

Conclusion

In our view, the upcoming elections will have a general **neutral** effect on the investment environment even as we expect the government to fulfil its commitment to a politically stable business environment during and after elections, as the main factor that will influence both local and foreign investor sentiments. Otherwise, we are of the view that the markets are driven by other stronger forces, which we do not expect to be easily swayed by the election climate.

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