Cytonn 2019 Markets Outlook

Cytonn

Date: Monday, January 14th 2019

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I. Global Markets Outlook

Global Market Summary

India and China have the highest expected 2019 GDP growth rates of major economies at 7.5% and 6.2%, respectively

World GDP Growth Rates					
Region	2015a	2016a	2017a	2018e	2019f
1. India	8.2%	7.1%	6.7%	7.3%	**7.5%**
2. China	6.9%	6.7%	6.9%	6.5%	**6.2%**
3. Kenya	5.7%	5.9%	4.9%	6.0%	**5.8%**
4. Sub-Saharan Africa	3.1%	1.3%	2.6%	2.7%	**3.4%**
5. United States	2.9%	1.6%	2.2%	2.9%	**2.5%**
6. Brazil	(3.5%)	(3.3%)	1.1%	1.2%	**2.2%**
7. Middle East, North Africa	2.8%	5.1%	1.2%	1.7%	**1.9%**
8. Euro Area	2.1%	1.9%	2.4%	1.9%	**1.6%**
9. United Kingdom	2.3%	1.8%	1.7%	1.3%	**1.4%**
10. South Africa (SA)	1.3%	0.6%	1.3%	0.9%	**1.3%**
11. Japan	1.4%	0.6%	1.9%	0.8%	**0.9%**
Global Growth Rate	**2.8%**	**2.4%**	**3.1%**	**3.0%**	**2.9%**

Source – World Bank/ Cytonn Research

Factors Shaping Global Markets in 2019

Tightened monetary policy, a slow down in trade and falling commodity prices are the factors that will likely shape Global Markets in 2019

Monetary Policy Stance

- The US Federal Open Market Committee (FOMC) is expected to continue the tightening of monetary policy, with expectation of two further rate hikes in 2019
- The European Central Bank (ECB) is expected to maintain its benchmark interest rates through the first half of 2019

Global Trade

- Escalating trade tensions between major trade partners and the potential shift away from a multilateral, rules-based trading system are key threats to the global economic trade in 2019
- An intensification of trade tensions, and the associated rise in policy uncertainty, could dent business and financial market sentiment, trigger financial market volatility, and slow investment and trade.

Falling Commodity Prices

- Global commodities registered declines in 2018, with agriculture, non-energy commodities, Brent oil and metals & minerals registering declines with energy the only gainer
- According to the World Bank, oil prices are forecasted to decline marginally to an average of USD 67.0 a barrel in 2019 from an average of USD 68.0 per barrel in 2018

Global Market Outlook

The US, Eurozone and China are all expected to see a deceleration in growth in 2019

United States

- The US economy is expected to grow by 2.5% in 2019, 0.4% points lower than the 2.9% growth expected in 2018
- The stock market is expected to be bearish weighed down by negative investor sentiments owing to slower global economic growth, tighter monetary conditions, increased trade and expected lower corporate earnings

Eurozone

- The Eurozone is expected to grow by 1.6% in 2019, 0.3% points lower than the 1.9% growth expected in 2018
- The stock market is expected to be bearish weighed down by negative investor sentiments owing to slower global economic growth, and heightened geopolitical tensions, and increased uncertainty on Britain's withdrawal from the EU ("Brexit")

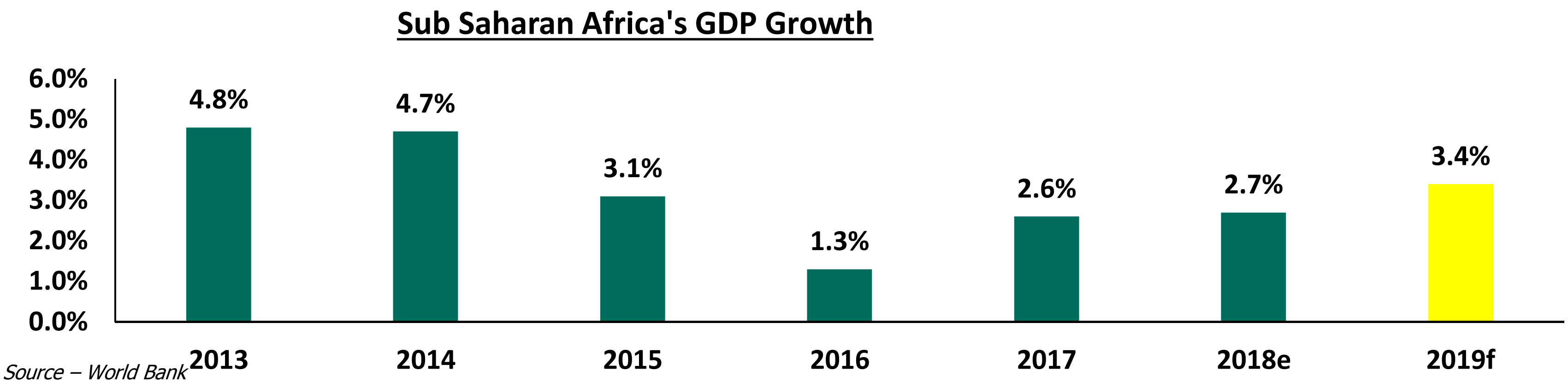
China

- The Chinese economy is expected to grow by 6.2% in 2019, slower than the 6.6% expected growth in 2018
- The stock market is expected to be bearish weighed down by negative investor sentiments owing to the prolonged trade tensions with the US, heightened geopolitical tensions, and an overall slower economic growth

II. Regional Markets Outlook

Regional GDP Growth

Sub Saharan Africa Region is expected to grow by 3.4% in 2019 according to World Bank



Source – World Bank

- Sub Saharan Africa (SSA) is expected to register economic growth of 3.4% in 2019, higher than the 2.7% expected in 2018
- Countries expected to drive growth in 2019 are Ethiopia at 8.8%, Ghana at 7.3%, and Kenya at 5.8% GDP growth rates
- Despite the expected growth, the regional economic growth still faces downside risks of;

   i. Difficult business conditions and poor infrastructure,

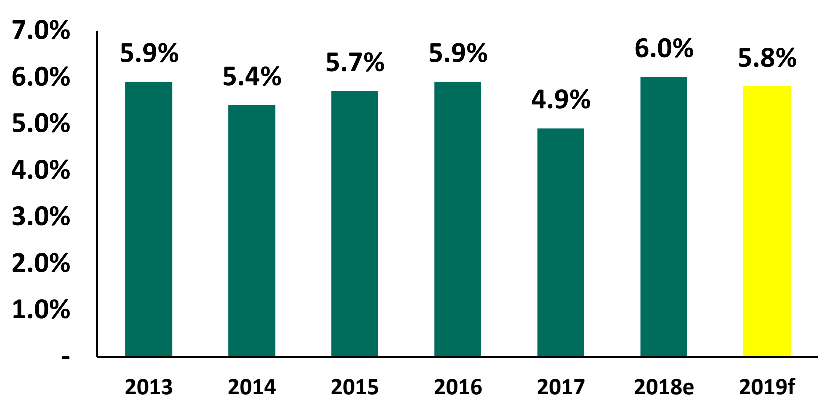
   ii. High levels of public debt in most economies in the region, and

   iii. Political uncertainties in some countries like Nigeria and South Africa ahead of the elections scheduled this year

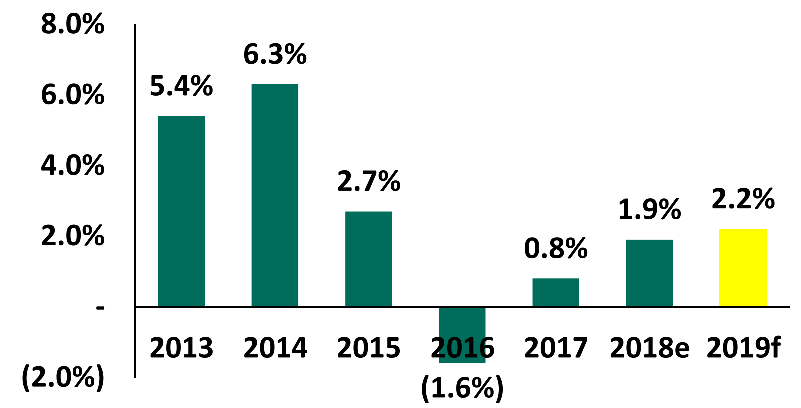
GDP Growth-Selected SSA Countries

Sub Saharan Africa Region is expected to grow by 3.4% in 2019, with the main countries driving growth being Nigeria, Kenya, Ethiopia and Ghana

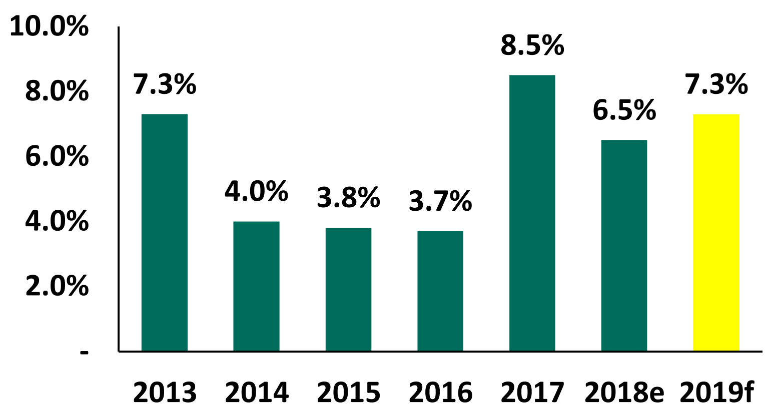
Kenya



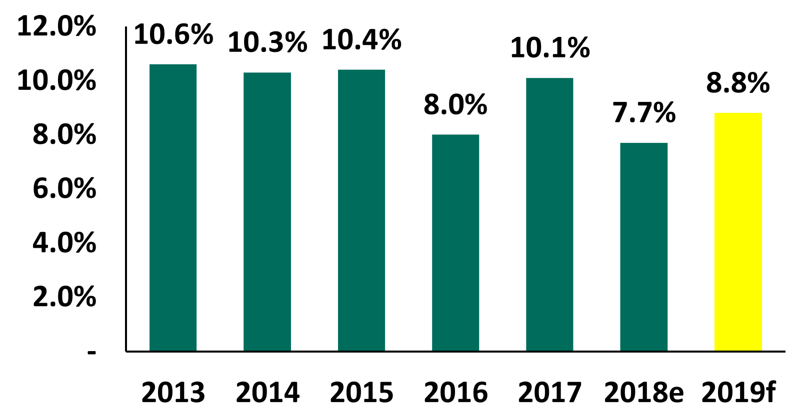
Nigeria



Ghana



Ethiopia



Source-World Bank

III. Kenya Macro Economic Outlook

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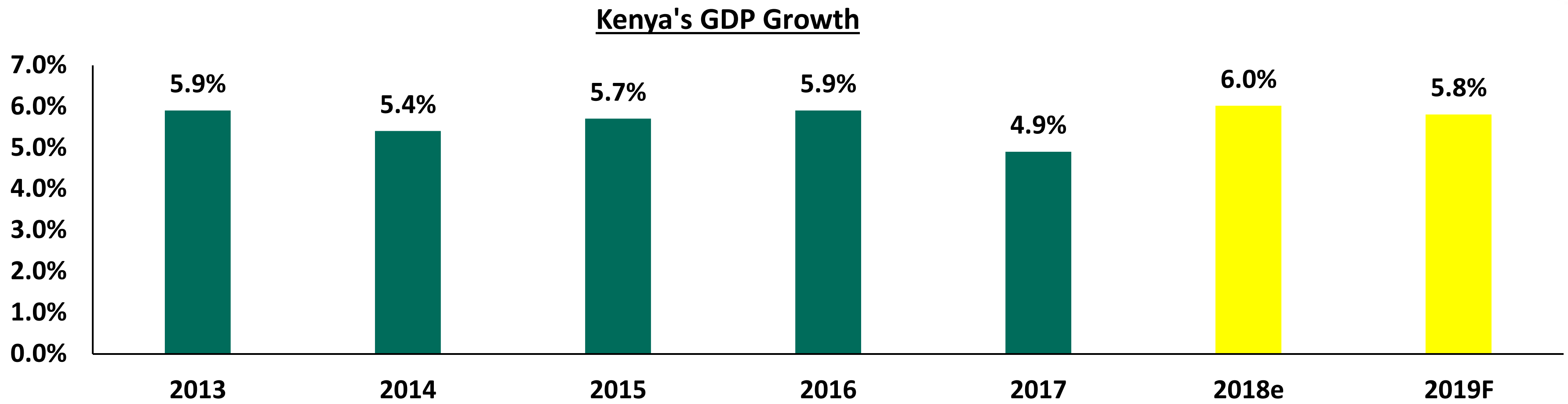
Kenya GDP Growth

Kenya's economy is expected to grow by 5.7%-5.9% in 2019



We expect 2019 GDP growth between 5.7% - 5.9%, driven by:

i. Continued recovery of the agriculture sector, on account of favorable weather conditions. Food security and nutrition being a key pillar on the "***Big 4***" Agenda, there was increased budgetary allocation for ongoing irrigation projects, strategic food reserves, cereal and crop enhancement

ii. Growth in the tourism sector, driven by continued efforts of marketing of the country's tourist attraction sites. The sector averaged 15.1% growth in the 1st three quarters of 2018 mainly boosted by a rise in the number of visitors' arrivals as well as a notable rise in conference activities,

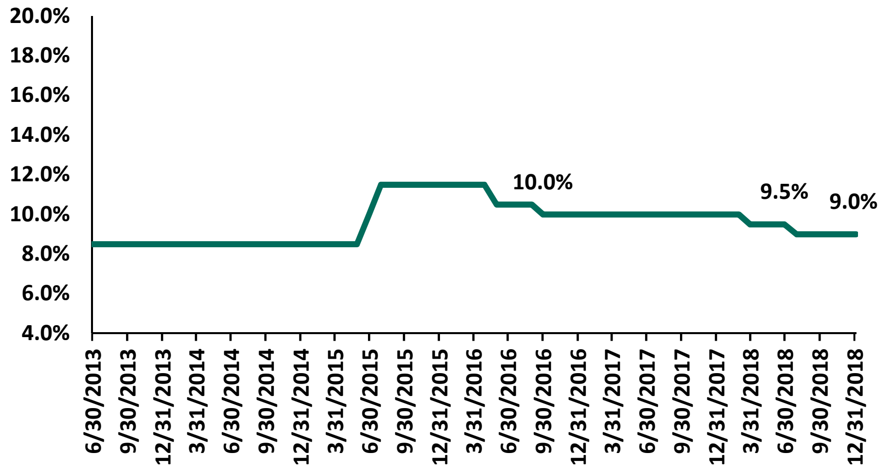
iii. Continued strong growth in the real estate sector supported by the increased focus on affordable housing initiative which in effect is also expected to boost the construction sector, and

iv. Growth in the manufacturing sector, partly due to improved food manufacturing driven by the continued growth in the agriculture sector as well as support from the budgetary allocations to support leather industrial parks, textiles, and dairy processing

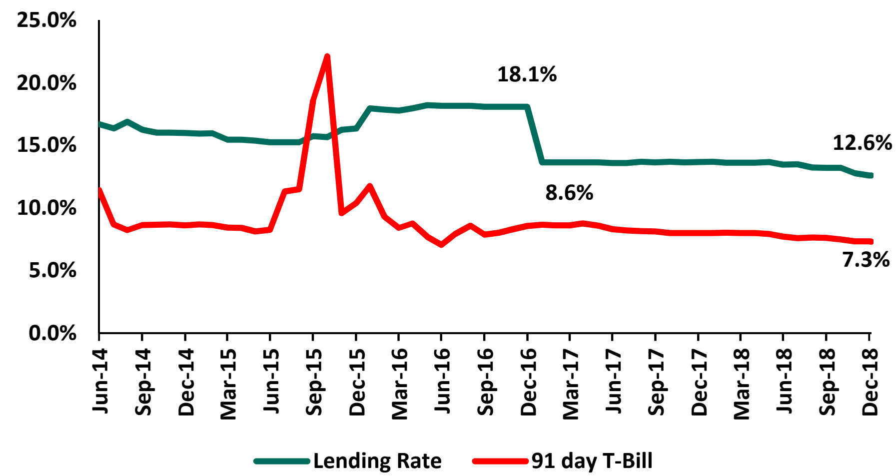
Interest Rates and Monetary Policy

We expect interest rates to remain stable in 2019, with the interest rate cap still in place

Kenya Central Bank Rate



Interest Rates: Lending Rates vs 91-day T-bill



- 2018 saw the CBR was lowered by a total of 100 bps in 2018, to close at 9.0%, with the Monetary Policy Committee (MPC) citing that economic output was below its potential level, and there was some room for further accommodative monetary policy

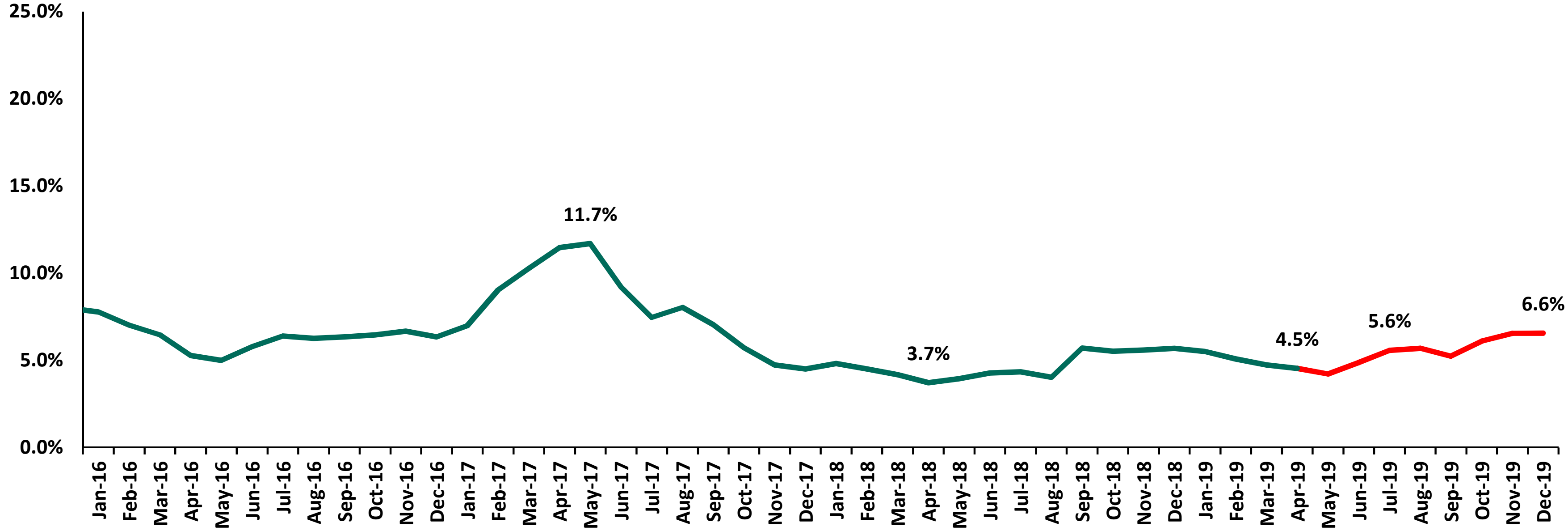
We expect monetary policy to remain RELATIVELY STABLE IN 2019, and lean to a possible easing

Source – Central Bank of Kenya

Inflation Forecast

Kenya inflation rate is expected to average 5.4% in 2019, within the Government's target of 2.5%-7.5%

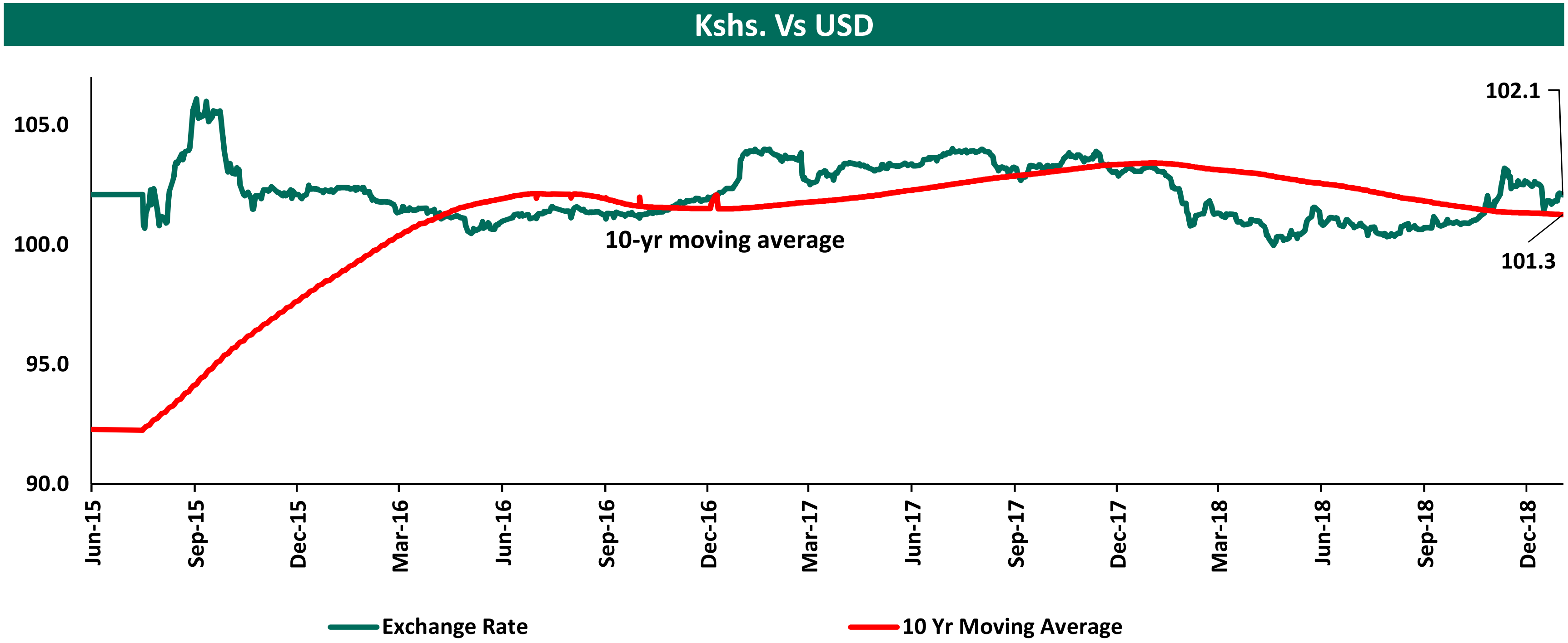
Kenya's Inflation Rate Forecast 2019



In 2019, we expect inflation to average 5.4%, within the Government target range of 2.5% - 7.5%

Exchange Rate

We expect the Shilling to range between Kshs 101.0 and Kshs 104.0 to the USD in 2019



- ***In 2019, the shilling is likely to come under pressure due to an increased oil imports bill; but remain supported by (i) declined food imports and improved agricultural exports as production improves due to improved weather conditions, (ii) the CBK's foreign exchange reserves of USD 8.0 bn (equivalent to 5.2 months of import cover),***

2019 Macroeconomic Outlook - Summary

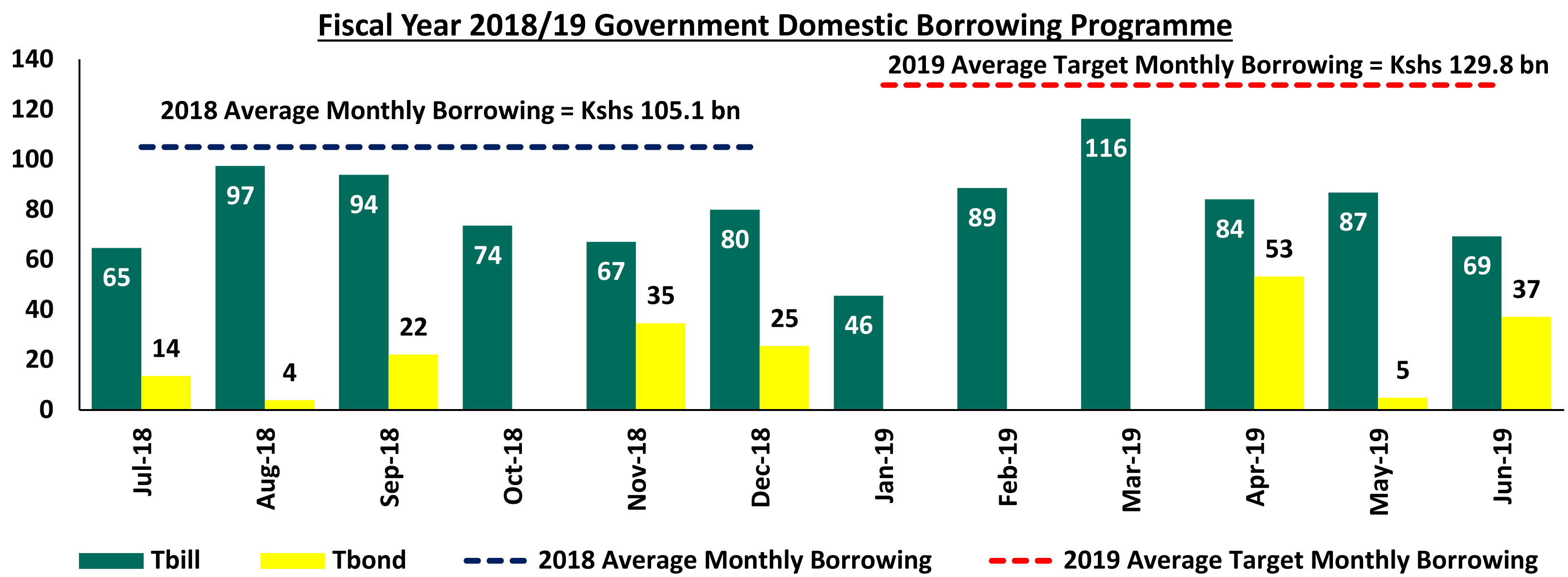
3 indicators are positive and 3 are neutral and 1 is negative. Overall effect is *POSITIVE*

Macro-Economic & Business Environment Outlook		
Macro-Economic Indicators	**2019 Outlook**	**Effect**
Government borrowing	• With the expectations of KRA not achieving the revenue targets, we expect this to result in further borrowing from the domestic market to plug in the deficit • The government has a net external financing target of Kshs 272.0 bn to finance the budget deficit, coupled with the need to retire 3 commercial loans maturing in H1’2019	**Negative**
Exchange Rate	• We project that currency will range between Kshs 101.0 and Kshs 104.0 against the USD in 2019, with continued support from the CBK in the short term through its sufficient reserves of USD 8.0 bn (equivalent to 5.2 months of import cover)	**Neutral**
Interest Rates	• We expect slight upward pressure on interest rates, especially in H1’2019, as the government falls behind its domestic borrowing targets for the fiscal year coupled with heavy domestic maturities	**Neutral**
Inflation	• We expect inflation to average 5.4% and within the government target range of 2.5% - 7.5%	**Positive**
GDP	• 5.8% growth projected in 2019, lower than the expected growth rate of 6.0% in 2018, but higher than the 5-year historical average of 5.4%	**Positive**
Investor Sentiment	• We expect 2019 to register improved foreign, mainly supported by long term investors who enter the market looking to take advantage of the current low/cheap valuations in select sections of the market	**Neutral**
Security	• We expect security to be maintained in 2019, especially given that the political climate in the country has eased, with security maintained and business picking up	**Positive**

IV. Fixed Income Market Outlook

Government Domestic Debt

The government will have to borrow Kshs 129.8 bn locally on a monthly basis to meet both its domestic borrowing target and maturity obligations



- Government is currently 35.9% behind its target on its FY'2018/2019 domestic borrowing schedule, having borrowed Kshs 107.2 bn against a pro-rated target of Kshs 167.2 bn
- 2019 current Maturities = Kshs 950.2 bn
- Domestic borrowing target = Kshs 299.8 bn

Target Monthly Borrowing = Kshs 129.8 bn

Fixed Income Market Outlook, continued…

Of the 7 indicators we track, 3 are positive, 3 are neutral, and 1 is negative. It is due to this that we think it is prudent for investors to be biased towards short-term to medium-term papers

Macro-Economic Indicators	2019 Outlook	Current View
Domestic Borrowing	• With the Government still behind its borrowing target, we expect slight pressure on the domestic borrowing front, which might see it start issuing shorter tenor bonds at the expense of the debt maturity profile, as well as a slight uptick in yields on Government papers	**Neutral**
Revenue Collection	• KRA is unlikely to meet its collection target due to the expected slower growth in corporate earnings in 2019, compared to the expected 24.6% rise in total revenue to Kshs 1.9 tn from Kshs 1.5 tn collected in FY'2017/2018	**Negative**
Monetary Policy	• With the expectations of inflation being within the government's target, continued growth in GDP growth, and a relatively stable interest environment, we expect the CBR to be maintained at 9.0% with a bias to expansionary monetary policy by further cuts	**Positive**
Inflation	• We expect inflation to average 5.4% and within the government target range of 2.5% - 7.5%	**Positive**

Fixed Income Market Outlook, continued…

Of the 7 indicators we track, 3 are positive, 3 are neutral, and 1 is negative It is due to this that we think it is prudent for investors to be biased towards short-term to medium-term papers

Macro-Economic Indicators	2019 Outlook	Current View
Exchange Rate	• We project that currency will range between Kshs 101.0 and Kshs 104.0 against the USD in 2019 with continued support in the short term by the CBK through its sufficient reserves	**Neutral**
Investor Sentiments	• We expect 2019 to register improved foreign inflows from the negative position in 2018, mainly supported long term investors who enter the market looking to take advantage of the current low/cheap valuations in select sections of the market. • The re-classification of Kenya's debt distress from low to moderate in October, is however expected to result in investors demanding a higher return for the risk	**Neutral**
Security	• We expect security to be maintained in 2019, especially given that the political climate in the country has eased, with security maintained and business picking up	**Positive**

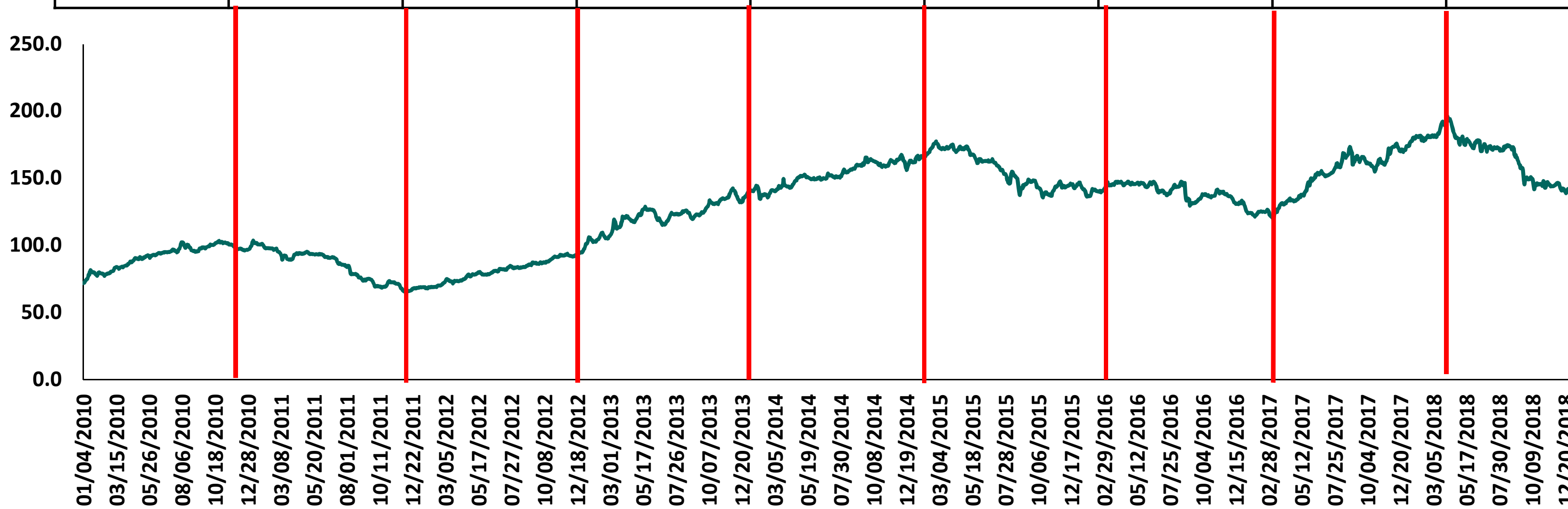
Our view is that investors, should be biased towards:
MEDIUM-TERM FIXED INCOME INSTRUMENTS
Investors need to reduce duration associated with the long-term debt coupled with the relatively flat yield curve on the long-end due to saturation of long-term bonds

V. Kenya Equities Market Outlook

Kenya Equities Performance

NASI declined 18.0% in 2018, compared to the 28.4% gain in 2017

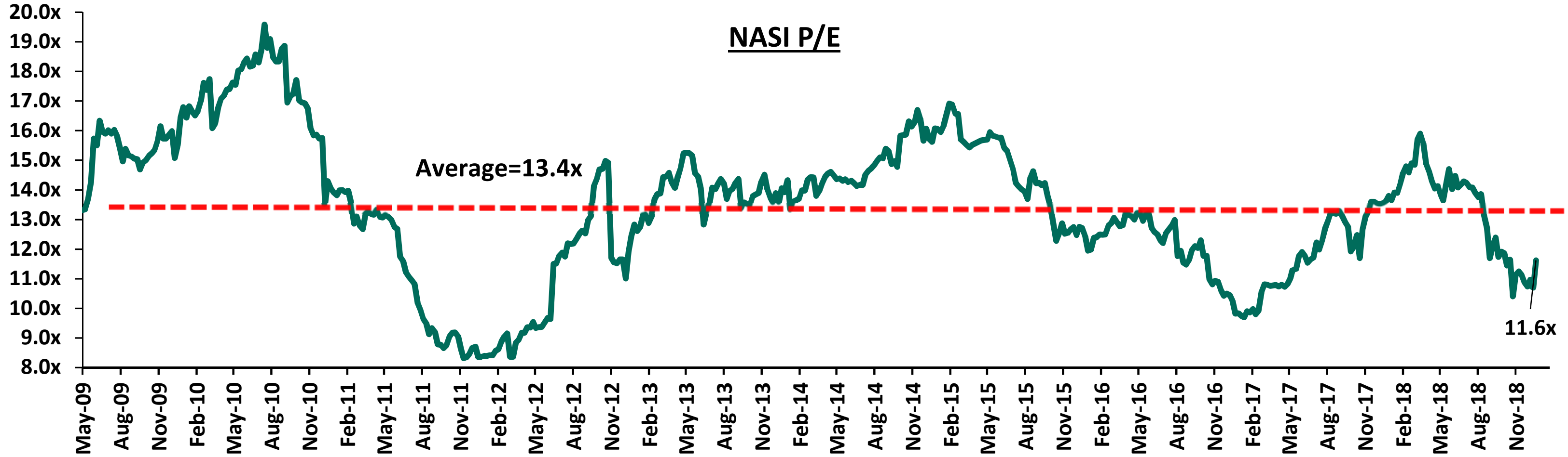
Annual NASI Performance								
2010	2011	2012	2013	2014	2015	2016	2017	2018
37.3%	(30.6%)	39.3%	42.6%	18.5%	(11.0%)	(8.5%)	28.4%	(18.0%)

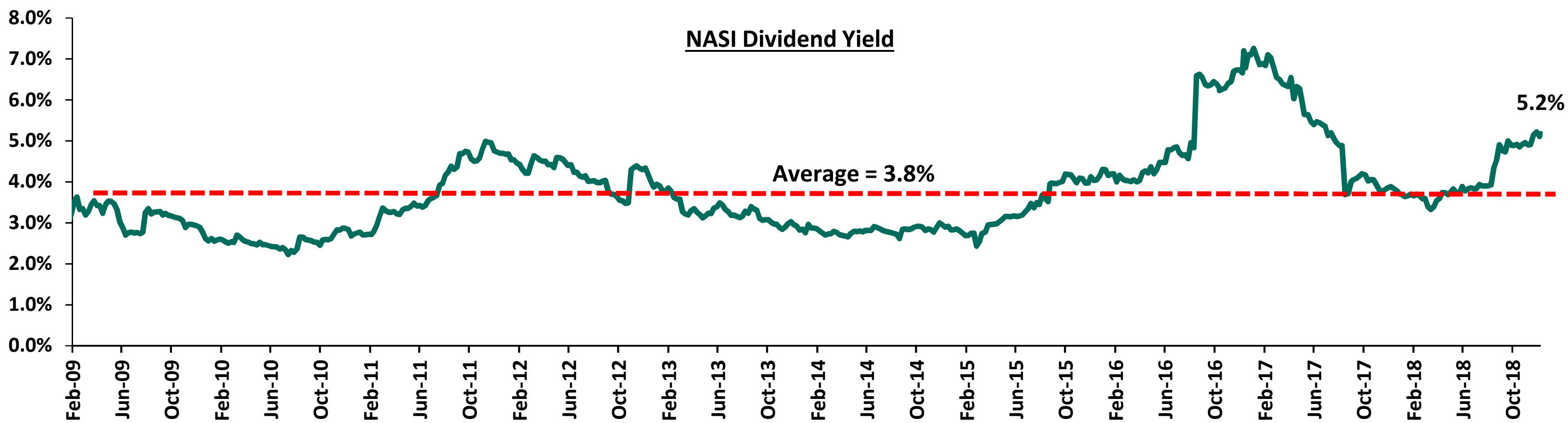


- The declining performance in 2018 was driven by declines in select large caps such as East Africa Breweries (EABL), Bamburi Cement, Diamond Trust Bank (DTB), NIC Group and Safaricom, which lost 26.6%, 26.4%, 18.5%, 17.6% and 17.0% during the year, respectively

NASI P/E and Dividend Yield

NASI is currently trading at a P/E of 11.6x, below the historical average of 13.4x. This point is 13.4% below the historical average level





Equities Outlook – Positive for 2019

Of the 4 indicators that we track for Equities market performance, 2 present a positive outlook, while 2 have a Neutral outlook

Equities Market Indicators	Outlook 2019	Current View
Macro-economic Environment	• GDP growth is expected to continue recovery in 2019, and come in at between 5.7%-5.9%. This will be driven by recovery of agriculture and tourism • Interest rates are expected to remain at the current levels, as the CBK monitors inflation and exchange rates	**Positive**
Corporate Earnings Growth	• We expect corporate earnings growth of 8.1% in 2019, lower than the expected 12.0% growth for 2018, weighed down by the relatively tougher operating environment, as several firms cite lack of credit access, and the base effect of relatively higher earnings in 2018	**Neutral**
Valuations	• With the market currently trading at a P/E of 11.6x, and expected earnings growth of 8.1%, the market is currently trading at a Forward P/E of 10.7x, representing a potential upside of 24.9% compared to historical levels	**Positive**
Investor Sentiment and Security	• We expect 2019 to register improved foreign inflows from the negative position in 2018, as investors possibly balance out the slower expected global growth, and mainly supported by long term investors who enter the market looking to take advantage of the current low/cheap valuations in the market • We expect security to be maintained in the country supported by government initiatives towards maintaining internal security	**Neutral**

VI. Private Equity Outlook

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Key Private Equity Sectors in 2019

We expect Fintech, Financial Services, and Education sectors to take centre stage in 2019

Key Private Equity Sectors		
Sector	**Driving Factors**	**2019 Outlook**
Fintech	• Africa's low penetration rates for traditional banking while mobile penetration is high this effectively makes it easier for the population to access financial services on their mobile phones, • Fintech lending, in particular continues to draw most interest from investors. Fintech lending addresses the credit gap in Africa by providing access to credit via convenient and already established channels	**Positive**
Financial Services	• The increasing demand for credit, • The growing financial services inclusion in the region through alternative banking channels, • Increased innovation and new product development within the financial services sector, and • Need for consolidation in the sector which has led to entry of various private equity investors in the past	**Positive**
Education	• Demand for quality education and a more comprehensive curriculum, • The entry of international brands over the past years such as the Nova Academies, GEMS Cambridge, JSE listed ADvTech Limited and bridge schools, • A shift of demand from government funded education towards private education providers driven by the frequent disruptions in public schools, Despite this, the market still seems opportunistic, and the regulation landscape is still very uncertain in Kenya.	**Positive**

Kenya Private Equity Indicators

Of the five indicators of private equity environment we track, three present a positive outlook while two present a neutral outlook

Private Equity Indicators		
Factor	**2019 Outlook**	**Effect**
Economic Growth	• 5.8% growth projected in 2019, lower than the expected growth rate of 6.0% in 2018, but higher than the 5-year historical average of 5.4%	**Positive**
Foreign Direct Investments	• FDI into the country steadily decreased at a CAGR of 27.3% from USD 1.38 bn in 2012 to USD 0.39 bn 2016. • Kenya however saw FDI increase by 71.0% in 2017, to USD 0.67 bn. This is a reflection of the degree of foreign interest in the Kenyan business environment. We expect this growth to continue albeit at a slower pace given concerns of slowing global growth.	**Neutral**
Doing Business Environment	• Kenya has been improving steadily in the World Bank's Doing Business Report, from position #136 in 2015 to position #61 in the 2019 report, with the score improving to 70.3 from 55.0, out of a possible 100 points. This indicates a more accommodative business environment	**Positive**
Political Stability	• Political climate in the country has cooled with security maintained and business picking up. Kenya now has direct flights to and from the USA, a signal of improving security in the country	**Positive**
Exit Routes	• Kenya still lags behind other African economies in regard to Exits. IPO's are among the most common PE exit routes. However, out of the 134 IPO's recorded in the last 5-years in Africa, Kenya only managed to attract 2 IPOS. • As a remedy, The Nairobi Securities Exchange has introduced Ibuka Program, a platform that will help address the listing drought at the bourse and we expect that will open up more private equity exit channels	**Neutral**

We maintain a POSITIVE outlook on private equity investments in Africa as evidenced by the increasing investor interest, which is attributed to economic growth , attractive valuations and untapped opportunities in key sectors

VII. Real Estate Market Outlook

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Factors that Will Shape the Real Estate Sector in 2019

In 2019, we expect the real estate sector performance to be shaped by focus on affordable housing, increased mortgage uptake and adoption of sustainable developments and technology among others

Factors	DESCRIPTION
Affordable Housing initiative	• The government kicked off its affordable housing initiative focused on delivering 500,000 units by end of 2022, with a price range of 0.6mn – 3.0mn , to address the housing deficit • The government provided Kshs 6.5 bn allocation in Kenya National Budget 2018/19 and Kshs 21.0bn in supplementary Appropriation Bill No. 2 of 2018, in support of the initiative • Incentives and policy reviews in support of affordable housing initiative are expected to push developers' effort towards provision of more housing for the lower middle and low income
Increased Traction in Mortgage Market	• Subject to its successful launch, the Kenya Mortgage Refinancing Company is expected to increase mortgage uptake • Mortgage home buyers will access mortgages with longer tenures, pay affordable instalments and thus it will reduce the financial burden for buyers thus scaling up the rate of uptake • There'll be healthy competition in the mortgage market by promoting entry of new primary lenders

Government Partnerships	• The government is expected to enter into various partnerships in development and financing to support the real estate sector mainly in the housing sector and in infrastructure
	• Expected partnerships are such as;
	  • PPPs – Public private partnerships in affordable housing sector
	  • County & National government partnerships in affordable housing and infrastructure provision
	  • Government & government partnerships in the infrastructure sector
	  • International bodies & government partnerships in affordable housing and in infrastructure

Factors that Will Shape the Real Estate Sector in 2019

The affordable housing initiative, increased traction in the mortgage market and devolution are the key factors expected to shape the real estate market in 2019

Factors	DESCRIPTION
Devolution	• Devolution has led to increased population at the County Government headquarters through relocation of County government officials and businesses hence created demand for office spaces, retail space and residential units and thus increased real estate development • Increased government budget allocation to county governments to support infrastructural development as well as the growth of other sectors including housing. In 2018, the government increased county budget allocation to Kshs 376.4 bn in 2018/19 from Kshs 345.7bn in 2017/18

Sustainable Developments & Technology	• Developers will adopt sustainable development practices and incorporation of technology as part of value addition in an effort to differentiate their offering in Real Estate to remain competitive
	• Adoption of the technology to differentiate Real estate products such as;
	    • Virtual Reality (VR) that enables customers to tour predevelopment or ready house units from anywhere in the world, and
	    • Building technology which include using prefab building material such as Expanded Polystyrene Panel (EPS) technology and other Alternative Building Technology (ABT)

Real Estate Themes Outlook

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2019 Real Estate Sector Outlook

With 3 themes having a positive outlook, 3 neutral and 2 having a negative theme, the general outlook for the sector in 2019 remains *NEUTRAL*

Thematic Performance and Outlook		
Themes	**2019 Outlook**	**Effect**
Residential	We expect the sector's performance to remain flat with select markets continuing to exhibit a positive performance supported by their appeal to homebuyers based on location and accessibility, availability for affordable land for development, as well as availability of key amenities	**Neutral**
Commercial Office	We forecast a decline of the average rental yield to 8.0% from 8.1% as a result of the oversupply with the average occupancy rates expected to decrease by 1.3% points from 83.3% to 82.0%,	**Negative**
Retail	Returns are expected to soften as a result of increased supply. Occupancy rates are expected to decline by 2.9% points to 76.9% from 79.8% leading to reduced yields of 8.7% from 9.0%. However, we expect an increase in the number international retail stores who will cushion the sector	**Neutral**
MUD	The real estate sector is to embrace the concept of MUDs as investors diversify their real estate portfolios, given the thematic real estate space surplus	**Positive**
Hospitality	We expect, the occupancy rates in the serviced apartments sector to remain above 80.0% and resulting in a rental yield of above 7.0%, with the investment opportunity being in Kilimani and Westlands markets with rental yields of above 10.0%	**Positive**
Land	We expect an annual capital appreciation of 4.9% in 2019, fuelled by demand for development land, improving infrastructure and demographics	**Positive**
Infrastructure	We expect reduced infrastructural activities in 2019 due to the reduced budget allocation from the previous year attributable to the government's financial constraints, given the country's public debt which currently stands at 56.4% of the GDP, in addition to the national revenue collection deficit of 38.0% as at June 2018	**Neutral**
Listed Real Estate	Having opened the year with a trading price of Kshs 10.75, we expect the REIT to continue trading at low prices and in low volumes in 2019. The dividend yield is expected to increase by 1.3% to 6.8% in 2018 earnings (at a price of Kshs 10.25 per share as at 11th January 2019), from a 6.5% yield recorded from 2017 earnings	**Negative**

2019 Key Areas of Opportunities by Sector

Karen, Kilimani, Juja and Runda Mumwe present the best investment opportunity for housing units

Sector	Themes	Locations	Reasons
Residential Sector	**Detached Units**	Runda Mumwe, Juja, Kitisuru, and Karen	Relatively high returns of approximately 14.8%, 10.3%, 8.9% and 8.8% respectively
	Apartments	Riverside, Kilimani, Donholm/Komarock	Relatively high returns of approximately 11.6%, 11.5& and 14.4% respectively, availability of amenities, infrastructural development
Commercial Office Sector	**Grade A offices**	Gigiri, Karen	Relatively low supply, proximity to commercial hubs and high yields of 10.5% and 9.2%, respectively
	Serviced Offices	Westlands	Prime commercial hubs with high occupancy of 85.5% and yields of 15.8%
Retail Sector	**Suburban Malls**	Counties such as Mombasa and Mt. Kenya regions	Mombasa and Mt. Kenya regions, record attractive yields at 8.3% and 9.9% and occupancy rates at 96.3% and 84.5%, respectively
Mixed Use Developments (MUDs)	**MUD**	Limuru road, Karen	Affluent neighbourhoods with high rental yield return of 9.7% and 9.4%, respectively
Hospitality Sector	**Serviced apartments**	Kilimani and Westlands	Attractive rental yields of 10.9% and 10.6% respectively, easy access from Jomo Kenyatta International Airport (JKIA), proximity to business nodes such as Upperhill, and the good transport network thus ease of accessibility
Land Sector	**Satellite towns**	Ruaka, Utawala, Ruiru and Thika	The relatively high capital appreciation of above 10.0% y/y, the provision of trunk infrastructure such as road networks and the growing demand for development land
	Suburbs	Kilimani, Karen and Kitisuru	The relatively high capital appreciation of above 10.0% y/y, proximity to amenities

Q&A

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Appendix

Kenya GDP Growth

Kenya's economy is expected to grow by 5.7%-5.9% in 2019

Agriculture

- Growth in agriculture is set to recover with improving weather conditions and driven by the government's efforts towards food security through re-engineering and mechanization

Manufacturing

- The manufacturing sector is set to grow rapidly with the government's plan to re-vamp industries and encourage further growth in agro-processing, to increase contribution to a government set target of 15.0% of GDP from 9.6% as at Q3'2018

Real Estate

- Real estate will continue to exhibit growth in 2019 driven by private sector investments and government plans under affordable housing to build 500,000 new homes in the next 5 years

Construction

- Growth in construction will mainly be driven by government spending on projects such as phase II of the SGR with an allocation of Kshs 74.4 bn, LAPSSET with an allocation of Kshs 8.9 bn as per the FY'2018/2019 budget as well as by projects in real estate

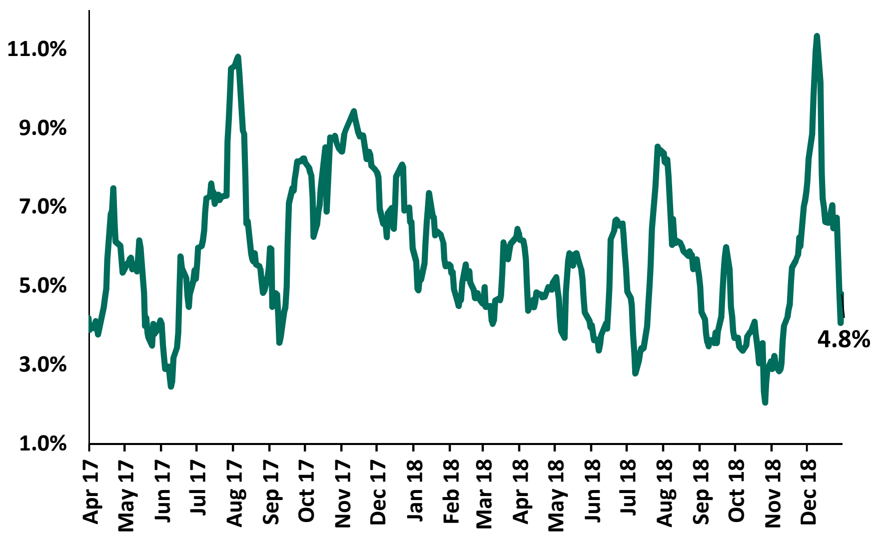
Accommodation & Food Services

- Tourism is one of the sectors of focus, exhibiting double digit growth in 2018. We expect this to continue in 2019 driven by better security, budgetary allocation towards recovery of the sector and effective tourism promotion strategies

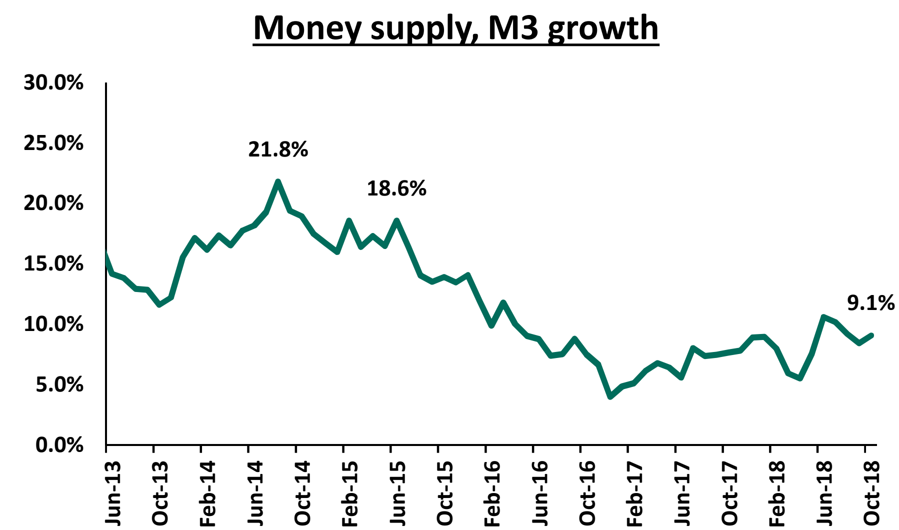
Market Liquidity and Money Supply

We expect liquidity to improve in 2019 driven by heavy domestic debt maturities

Interbank Rates (%)



Money Supply Growth (M3) (y/y)



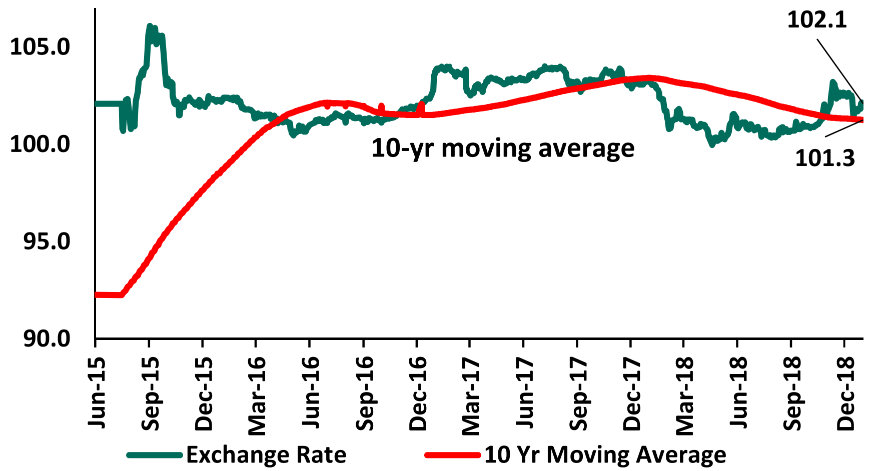
- In 2018, the interbank rate averaged 5.2%, lower than 6.3% in 2017, indicating improved liquidity levels in the money market, in line with money supply growth which improved in the 10 months to October to an average of 8.3% compared to 6.6% recorded in the same period in 2017. Liquidity however remained skewed towards larger banks

- The improved liquidity was mainly attributed to heavy maturities of domestic debts during the period as well as increased government payments. Going forward into 2019, we expect liquidity to improve supported by heavy domestic maturities currently at Kshs 958.9 bn

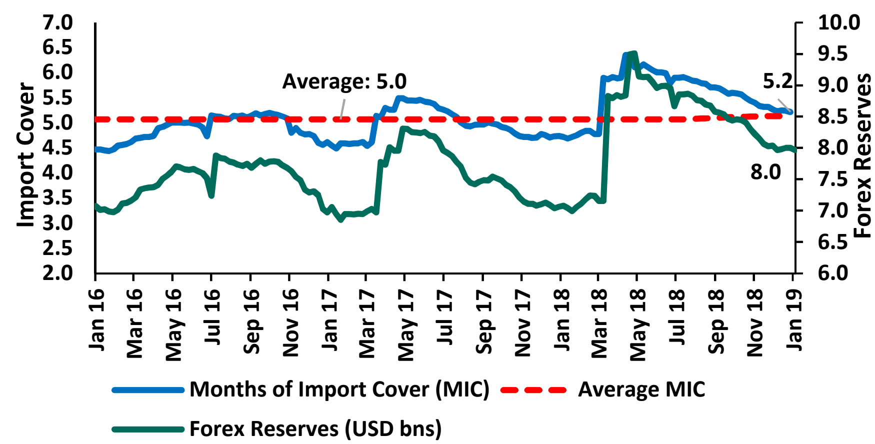
Exchange Rate

We expect the Shilling to range between Kshs 101.0 and Kshs 104.0 to the USD in 2018

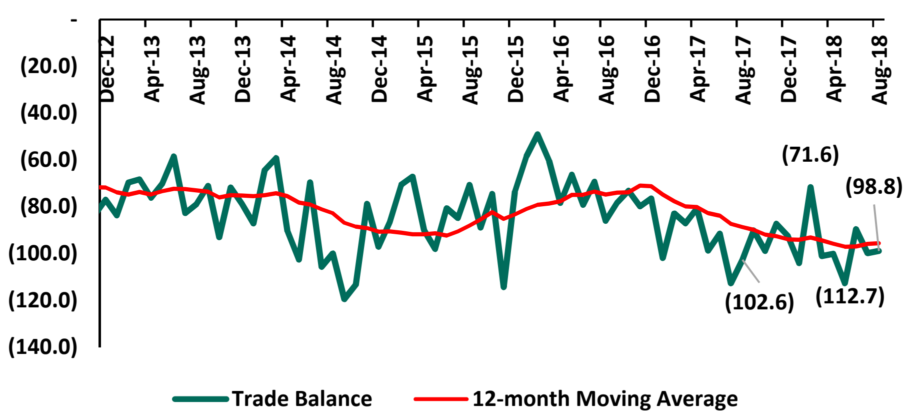
Kshs. Vs USD



Kenya Months of Import Cover and Forex Reserves



Trade Balance(bns)

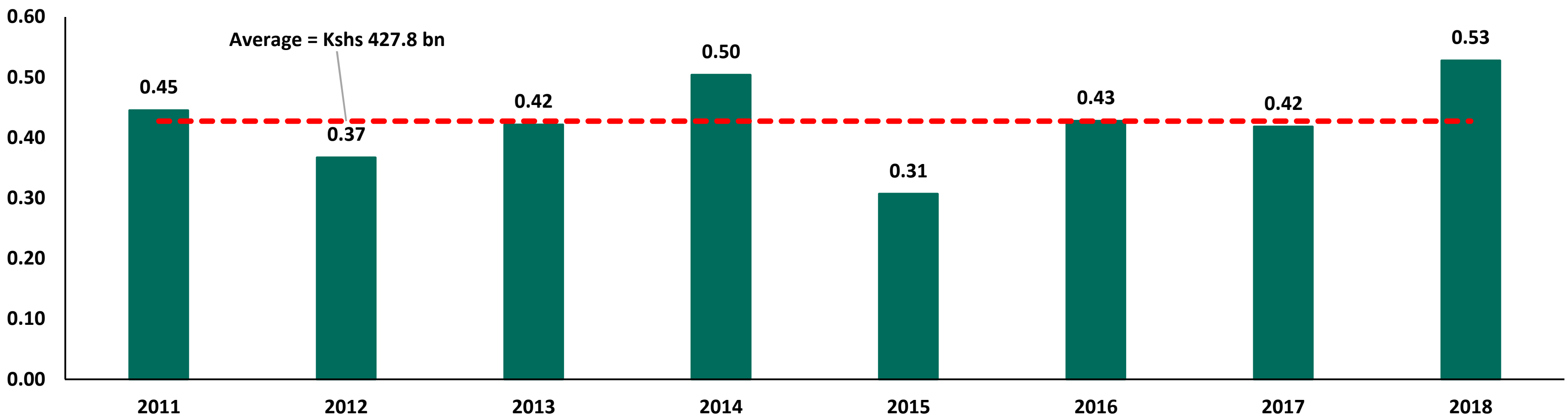


- In 2019, the shilling is likely to come under pressure due to an increased oil imports bill; but remain supported by (i) declined food imports and improved agricultural exports as production improves due to improved weather conditions, (ii) the CBK's foreign exchange reserves of USD 8.0 bn (equivalent to 5.2 months of import cover),

Fixed Income Market Outlook

We expect secondary bond market activity and turnover to continue with its improvement in 2019 as interest rates remain stable, coupled with improved liquidity

Bond Turnover (Kshs tns)



- In 2018, secondary bond market turnover rose by 26.1% to Kshs 528.2 bn from Kshs 419.0 bn in 2017, with yields for all the papers declining across the board
- In 2019, we expect secondary bond market activity and turnover to continue improving as the interest rate environment remains stable coupled with improved liquidity

Source- Central Bank of Kenya (CBK)

2019 Macroeconomic Outlook –Government Borrowing

Government borrowing is overall Neutral with pressure mounting on the government to borrow to meet its budget targets

Macro-Economic & Business Environment Outlook			
Macro-Economic Indicator	**Factors**	**2019 Outlook**	**Effect**
Government borrowing	**Revenue Collection**	• The total cumulative revenues collected as at November 2018 amounted to Kshs 555.7 bn with the monthly collection at Kshs 116.2 bn. Overall, the tax revenue performance fell short by Kshs 113.3 bn against its pro-rated target • The continued underperformance in revenue collection is expected to put pressure on borrowing in order to plug in the deficit from revenue collections	**Negative**
	Foreign Borrowing	• The Government needs to retire 3 commercial loans maturing in H1'2019 totaling to Kshs 200 bn, including the repayment of about Kshs 78.3bn of the debut Eurobond in June • The government has a foreign borrowing target of Kshs 272.0 bn and we believe that the market environment is not favorable with the country's chance of external debt distress having been re-classified to moderate from low due to increasing refinancing risks and thus investors would require higher yields to match the risk profile	**Negative**
	Domestic Borrowing	• The primary market has seen the prominence of longer-term duration papers as a way to curb short-term refinancing risk. The long-end papers have however fallen short of attaining the monthly quantum set by the CBK • With the Government behind its borrowing target, we expect pressure on the domestic borrowing front, which might see it start issuing shorter tenor bonds at the expense of the debt maturity profile, as well as a slight uptick in yields on Government papers	**Neutral**

2019 Macroeconomic Outlook -Currency

The currency is largely expected to be relatively stable from the support of the Central Bank, thus we are Neutral

Macro-Economic & Business Environment Outlook			
Macro-Economic Indicator	**Factors**	**2019 Outlook**	**Effect**
Currency	Current Account Position	• The current account deficit was on a decline in 2018, coming in at 5.3% in the 12-months to September 2018, from 6.5% in September 2017 and the Treasury projects it to have narrowed to 5.2% of GDP in 2018 • We expect the current account position to continue improving driven by improved agriculture exports, increased diaspora remittances, strong receipts from tourism, and lower food imports. We however expect this to be mitigated by a higher fuel import bill due to higher global oil prices as well as a general pick-up in domestic demand	Neutral
	Forex Reserves	• We are Neutral on forex reserves mainly because they have been on a decline having hit a high of USD 9.5 bn in April 2018 but closed at 8.0 bn in 2018. With the foreign debt maturities in 2019, we expect the forex reserves to continue declining • We however expect reserves to remain adequate and still fulfill the EAC region's convergence criteria of 4.5 months	Neutral
	Federal Reserve Rate Hikes	• The Federal Reserve will possibly hike rates twice in the year as the economy continues to improve amid weakening of the USD, however, we expect the rate hikes to have minimal impact on the Kenya shilling	Neutral
	Diaspora Remittances	• Cumulatively, total diaspora remittances rose by 39.5% in the 12 months to October 2018, to USD 2.6 bn, from USD 1.9 bn recorded in a similar period in 2017 • We expect the foreign exchange market to remain relatively balanced supported by strong diaspora remittances	Positive

2019 Macroeconomic Outlook –Interest Rates

We expect interest rates to remain relatively stable as the CBK continues to reject expensive bids

Macro-Economic & Business Environment Outlook			
Macro-Economic Indicator	**Factors**	**2019 Outlook**	**Effect**
Interest Rates	Liquidity	• There was improved liquidity in the money markets due to high debt maturities experienced during the year as evidenced by a decline in the average interbank rate to 5.2%, lower than 6.3% in 2017 • With the expectations of continued liquidity in the money markets during the year due to the heavy domestic maturities, we expect this to stabilize the interest rate environment due to an uptick in the demand side on government securities	Positive
	Domestic Borrowing	• Despite the Government currently being 46.5% behind its domestic and the KRA still unlikely to meet its collection target as per the historical trend, we still don't expect the government to be under pressure in accessing domestic debt, given the relatively low interest rate environment as a result of the interest rate cap coupled with the reduced Central Bank Rate currently at 9.0%	Neutral
	Inflation	• We expect inflation to average 5.4%, higher than 4.7% recorded in 2018 but still within the government target range of 2.5% - 7.5%, as such we don't expect the MPC to be under any pressure to implement a contractionary monetary policy stance to mute inflation	Neutral

2019 Macroeconomic Outlook - GDP

GDP growth remains positive mainly driven by key sectors, which we expect to perform well in 2019

Macro-Economic & Business Environment Outlook			
Macro-Economic Indicator	**Drivers**	**2019 Outlook**	**Effect**
GDP	**Private Sector Credit Growth**	• Private sector credit growth has shown recovery in 2018, rising to an average of 3.4% in the 10 months to October from an average of 2.3% recorded in a similar period in 2017 but still below the 5-year average of 12.4%. • With the interest rate cap still in place, we expect private sector credit growth to remain at low levels	**Negative**
	Infrastructural Development	• Infrastructure is expected to be driven by budgetary allocations in infrastructural projects, with the highest allocation being on road constructions at Kshs 87.5bn (domestically financed) and Kshs 34.2bn (foreign financed) as well as allocations in energy, rail and ports construction, ICT and on sustaining water supplies	**Positive**
	Key Sectors (Agriculture, Manufacturing, Construction, Tourism, Real Estate)	• Growth in **Agriculture** is set to recover with improving weather conditions and driven by the government's efforts towards food security through re-engineering and mechanization • The **Manufacturing** sector is set to grow rapidly with the government's plan to re-vamp industries and encourage further growth in agri-processing • **Real estate** will continue to exhibit strong growth in 2018 driven by private sector investments and government investment in affordable housing • Growth in **Construction** will be driven by growth in the real estate sector as well as the budgetary allocations set aside for infrastructural development • **Tourism** is one of the sectors of focus, exhibiting double digit growth in 2018. We expect this to continue in 2019 driven by better security and budgetary allocation towards recovery of the sector	**Positive**

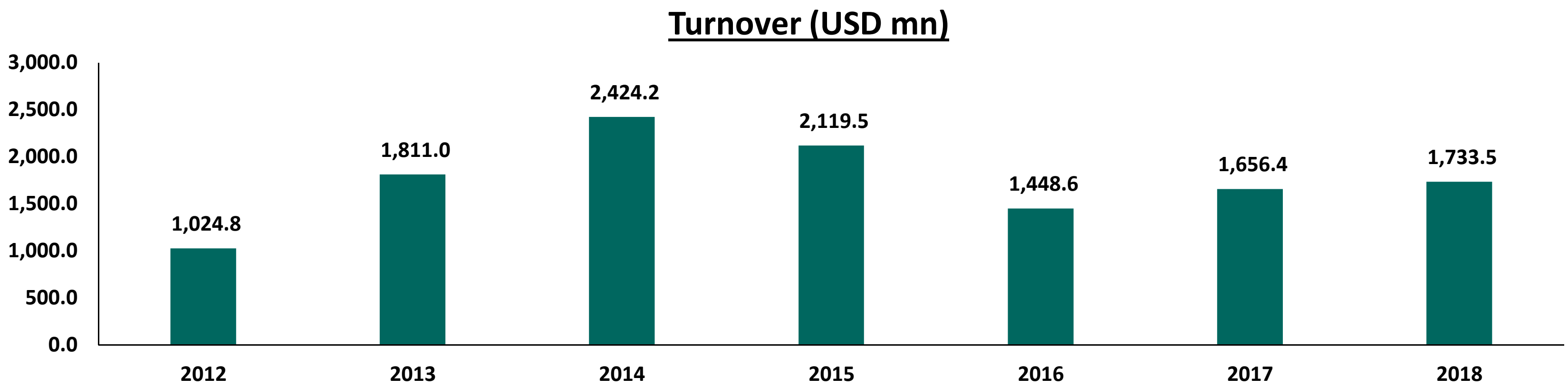
2019 Macroeconomic Outlook – Investor Sentiment

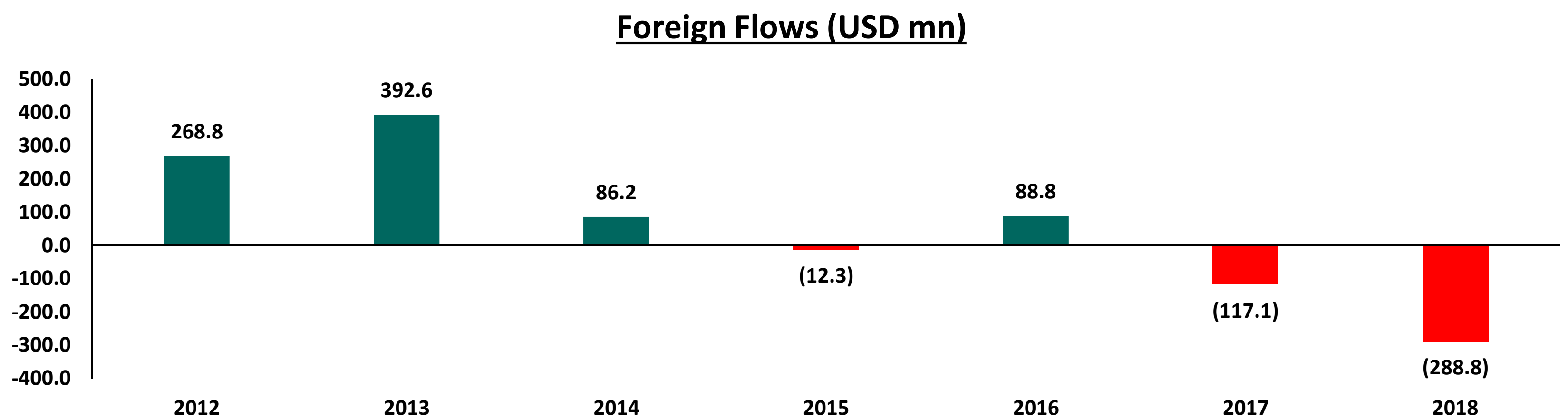
Investor sentiment is Neutral, with a positive outlook in the equities market

Macro-Economic & Business Environment Outlook			
Macro-Economic Indicator	Measures	2019 Outlook	Effect
Investor Sentiment	Eurobond Yields	• Kenyan Eurobond yields were on a rise in 2018. We expect the trend to continue mainly due to higher country risk perception by investors, partly attributed to the International Monetary Fund (IMF) raising the risk of Kenya's debt distress from low to moderate on October, coupled with the aggressive tightening monetary policy regime adopted by the U.S Federal reserve, exacerbating the rise in yields as most foreign investors continue pulling out their capital in the wake of rising US treasury yields and a strong dollar	Negative
	Foreign Direct Investment (FDI)	• Foreign direct investment (FDI) into the country has declined at a compounded annual growth rate (CAGR) of (13.4%) in the 5-year period from 2012 to 2017 • Concerns of slowing global growth are expected to hamper foreign investment, although the continued economic growth is likely to keep attracting foreign capital	Neutral
	Stock Market Valuations	• The market has slumped and brought the market P/E below its' historical average of 13.4x to 10.7x, below the most recent peak of 15.9x in April 2018, showing that value exists at current valuations. However, on poor investor sentiment and slower earnings growth, • The current valuations present attractive entry points and consequently a higher upside potential to be aided by earnings recovery and improved investment sentiment a long-term investment horizon	Positive
	Currency	• We expect the shilling to remain stable fluctuating between Kshs 101.0-Kshs 104.0 against the dollar, thus reduced currency risk for foreign investors	Neutral

Market Turnover and Foreign Flows

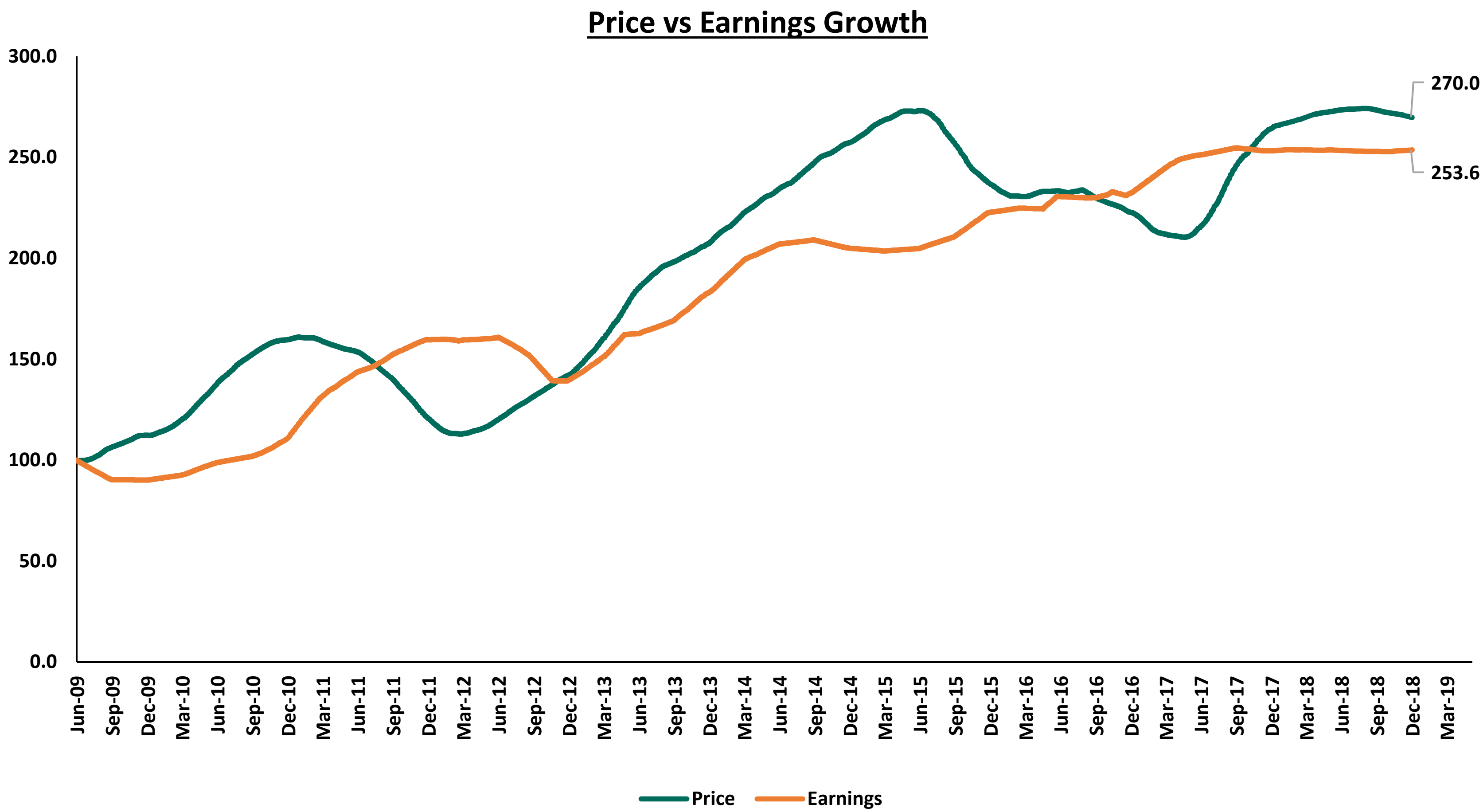
Equity turnover during the year rose by 2.3% to USD 1,723.8 mn. Foreign investors remained net sellers with a net outflow of USD 288.8 mn





NASI Price vs Earnings Growth

The declining prices were not driven by earnings growth, as the market recorded an 18.0% decline in price while earnings grew 3.3%. The dampened investor sentiment weighed on prices



Factors That Will Affect the Equities Market in 2019

We expect relatively slower average earnings growth in 2019, largely due to the base effect, as firms report earnings from a relatively higher level in 2018

Factor	Effect on Equities market
Corporate Earnings	• We expect corporate earnings to average 8.1% for 2019, supported by a relatively stable business operating environment, aiding recovery in various sectors such as manufacturing
Capital Markets Investor Sentiment	• We expect the equities market to register improved foreign inflows in 2019, as opposed to the outflows witnessed in 2018, as foreign investors take advantage of the attractive stocks in various under-valued segments of the market, especially in large cap blue chip stocks, and generally, Kenya remains more attractive compared to other frontier markets, which will attract investors seeking the high growth in frontier markets
Interest Rates	• We expect the MPC to maintain the Central Bank Rate at the current rate of 9.0% as the CBK monitors the inflation rate • Inflation rate is expected to remain within the government target of 2.5% - 7.5% due to improved weather conditions, while the currency is expected to remain stable supported by CBK

Factors That Will Affect the Equities Market in 2019

Increased regulation is expected to build more stable sectors thus boosting investor confidence in the Kenyan equities market

Factor	Effect on Equities market

Diversification of Capital Markets and New Listings	• We expect new listings on the Nairobi Securities Exchange (NSE) in 2019. Key initiatives that the CMA and NSE will be implementing include:
	  ◦ possible the commencing of derivatives trading in 2019 with the testing phase complete,
	  ◦ CDSC's plan to launch a new trading platform that will allow a settlement cycle of 1 day (T+1),
	  ◦ Cross-listing of equities from other African countries, starting with Rwanda
	• All these are expected to increase liquidity in the market and improve depth of the capital market

Equities Market Outlook

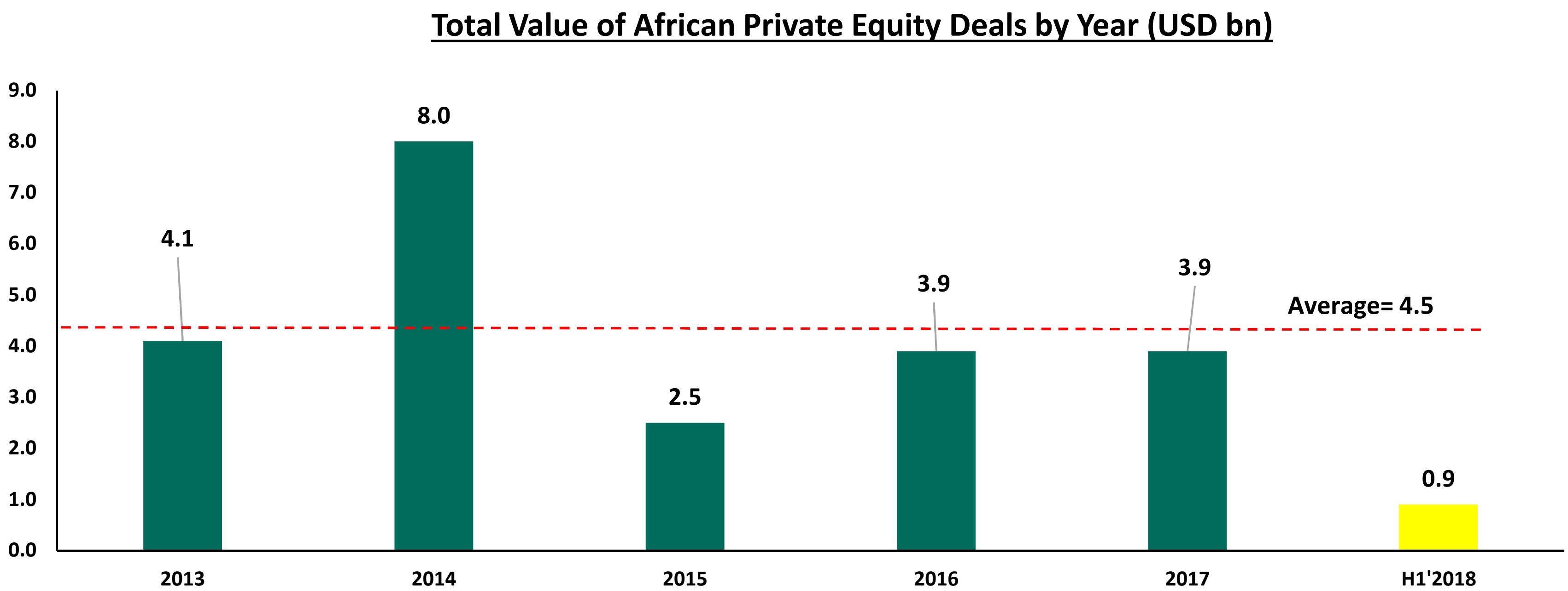
We are "Positive" on equities for investors as the conducive macroeconomic environment and attractive valuations in the market should support a positive performance

- Of the 4 indicators we track:
  - ✓ 2 are positive (Macroeconomic Environment, Valuations)
  - ✓ 2 are neutral (Corporate Earnings Growth, Investor sentiments and Security
- It is due to this that we are "Positive" on equities for investors as the conducive macroeconomic environment and attractive valuations in the market should support a positive performance

We are "POSITIVE" on equities for investors as the sustained price declines has seen the market P/E decline to below its historical average. We expect increased market activity, and possibly increased inflows from foreign investors, as they take advantage of the attractive valuations.

Private Equity Activity In 2018

PE activity by deal value dropped by 10.0% in H1’2018



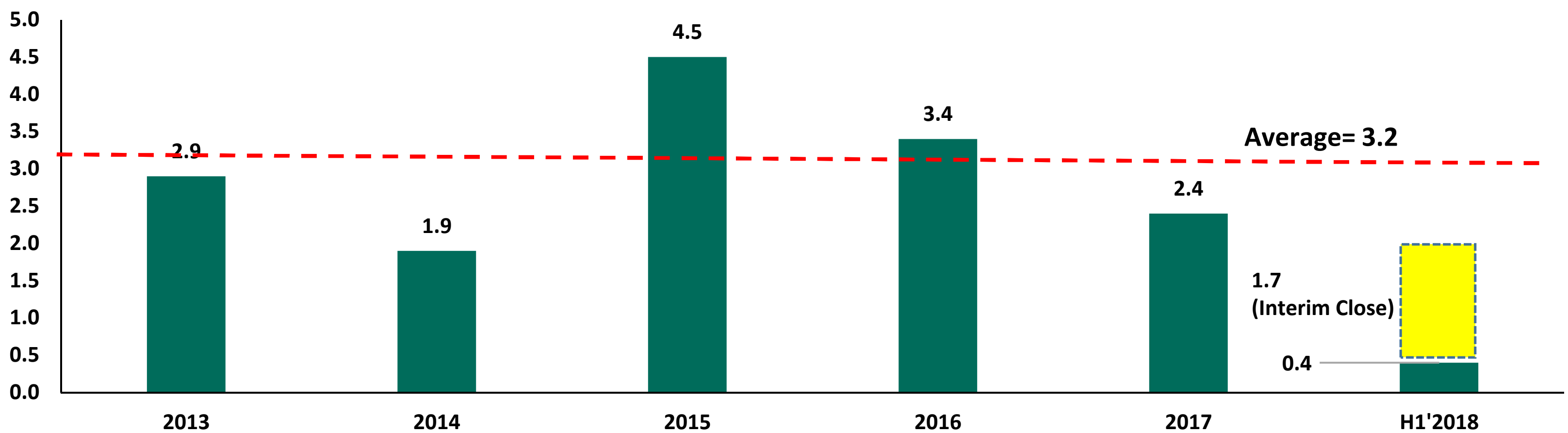
Source: AVCA

- The total value of reported African private equity deals in H1’2018 was USD 0.9 bn, a 10.0% drop from USD 1.0 bn reported in H1’2017. In terms of the share of deal value, the utilities sector was the largest sector in H1’2018, coming in at USD 0.3 bn or 37.0% of total value of deals, up from only USD 30.0 mn (3.0% of total value of deals) in H1’2017. The financial services sector’s deal volume share increased to USD 144.0 mn (or 16.0% of the total deal volume) in H1’2018 from USD 100.0 mn (or 10.0% of the total deal volume) in H1’2017.

Private Equity Fundraising

PE Fundraising by value increased by 5.0% in H1’2018

Total Value of African Private Equity Fundraising by Year of Final Close (USD bn)



Source: AVCA

- The total value of African PE fundraising in H1’2018 was USD 2.1 bn, comprised of USD 1.7 bn in interim closes (as highlighted in the yellow column above) and USD 0.4 bn in final closes. This is a 5.0 % improvement compared to the total value fundraising in H1’2017, which was reported at USD 2.0 bn

Africa Private Equity Outlook

Our long-term outlook for Private Equity is positive, supported by an expected shift in investor sentiment

- In 2016 and 2017 we witnessed macroeconomic headwinds hitting two of Africa's most developed PE markets; South Africa and Nigeria, coupled with a slump in oil prices which negatively affected private investments
- Policy shocks, such as the interest rate caps in Kenya, Africa's third largest developed PE market, slowed credit growth, which also had a negative effect on economic growth
- Despite this, we view the long-term growth trajectory for PE as positive, supported by improving investor sentiment. We expect this growth to be driven by the following key factors;

    i. **Economic Growth:** According to IMF analysis, private investment increases when GDP growth is high; a 1% point increase in GDP growth rates leads to a 0.21% points increase in the private investment rate. We expect this positive correlation to hold and as a result, private equity activity is set to improve,

    ii. **Political Stability**. Democratic elections have passed in multiple African countries, including Angola, which saw its first transfer of power to the opposition party since peacetime in 2002. This should provide investors in those countries with much greater confidence than in previous years, and,

    iii. **Economic recovery in West Africa.** Improvements in commodity prices combined with the regions expected economic recovery will drive further investment in West Africa.

Key Factors Driving the Real Estate Sector

Positive demographics, focus on affordable housing and infrastructural development are some of the factors that will drive real estate performance in 2019

Factors	DESCRIPTION
Demographic Trends	• High urbanization rates of 4.3% against global averages of 2.1% • High population growth rate at 2.5% compared to 1.1% global average • Expanding middle class with increased purchasing power due to higher net disposable income, which increased to Kshs 7.1 tn in 2017 from Kshs 6.6 tn in 2016 and Kshs 5.7 tn in 2015
Focus on Affordable Housing	• Progressing of the affordable housing agenda with an aim to develop 500,000 units by end of 2022 • Increased development as a result of government incentives such as the 15% tax relief to developers who develop 100 affordable units annually • The establishment of funding solutions aimed at aiding in development and uptake eg Kenya Mortgage Refinancing Company (KMRC) as well as National Housing Development Fund (NHDF) if successful
Sustained Infrastructural Development	• Increased government investment on infrastructure, in order to boost the country's economic growth and open up more areas for development. For example, the budget allocation towards infrastructural development has been growing by a 6- year CAGR of 7.7% to Kshs 611.4 bn in 2018/19 from Kshs 251.1 bn in 2013/14
Kenya as a Regional Hub	• Increasing Foreign Direct Investments(FDI) in Kenya, which came in at Kshs 67.1 bn in 2017 from Kshs 39.3 bn in 2016 and Kshs 61.9 bn in 2015 • Expansion of international firms with South African retailer Shoprite among others expected to increase their foothold in Kenya • Kenya named as East Africa US strategy "anchor" country in the US Africa Policy 2018 and thus is expected to attract more international investors looking to venture into East Africa

Key Challenges Facing the Real Estate Sector

Access to funds and increased supply and competition are some of the key challenges that will constrain the real estate sector's performance in 2019

Factors	DESCRIPTION
Inadequate and High cost of Funds	• Reduced credit advancement to SMEs as a result of the interest rates cap, hence private sector credit growth came in at 4.4% in October 2018 compared to a 5-year (2013-2018) average of 14.0% • The actual cost of credit is still high averaging at 18.0% due to additional administration fees, which then raise the cost of development thus making construction expensive
Inaccessibility and Unaffordability of Mortgages	• Access to mortgages in Kenya remains low mainly due to i) low-income levels, ii) soaring property prices, iii) high interest rates and deposit requirements, iv) exclusion of employees in the informal sector due to insufficient credit risk information, and v) lack of capital markets funding towards real estate purchases • There were only 26,187 active mortgage accounts in Kenya as at December 2017 against a total adult population of approximately 23 mn persons, thus there's low real estate uptake using mortgages
Increased Supply and Competition	• The real estate sector has witnessed increased space supply over the last 5 years with the market recording surplus space which is likely to lower the market returns in 2019 • The commercial office has an oversupply of 5.3mn SQFT and is expected to grow to 5.7 mn SQFT in 2019 • The retail sector has an oversupply of 2.0mn SQFT that is expected to increase with the opening of malls such as Crystal Rivers in Athi River • The residential sector has increased supply in the middle - high end residential sector with a decreasing effective demand, hence recording a 3.0% decline in occupancy rates in 2018

Residential Sector Demand Outlook

Of the five factors we expect to affect residential demand, two are positive, two are neutral and one is negative, thus our outlook for demand this year is neutral with bias to positive

Metric	2019 Outlook	Effect
Demographics	• The housing deficit in the Nairobi metropolitan area is expected to come in at 2.1 mn units in 2019 • Rapid population growth at 2.5% as at 2017 compared to a global average of 1.1% • A high urbanization rate at 4.3% compared to the global average of 2.1% • This will sustain demand for more dwelling units with 70.7% of the demand being in the lower mid-end and low-end segments, who according to KNBS, earn below Kshs 50,000 p.m.	**Positive**
Infrastructure	• In 2019, we expect the anticipated completion infrastructural projects such as parts of the ongoing Ngong Road expansion, Standard Gauge Railway Phase 2, water and sewer enhancements to boost demand for residential properties in these locations	**Positive**
Investor Returns	• In 2018, the residential sector recorded a decline in investor returns to 8.9% from 10.3% in 2017 on account of increased supply amid reduced effective demand • We expect investors to focus on selected markets such as Kilimani, Riverside, Thindigua, and Runda Mumwe which recorded attractive returns of 11.5%, 11.6%, 13.8% and 14.8%, respectively	**Neutral**
Purchasing Power	• Average real earnings growth declined by 5.8% points to (2.9%) in 2017 from 2.9% in 2015 according to KNBS, implying a decline in purchasing power • With the expected growth of inflation in 2019 to an average of 5.4% from 3.8% in 2018, we expect real earnings to continue declining, thus, hampering effective demand for residential units	**Negative**
Access to Credit	• Subject to the launch of the Kenya Mortgage Refinance Company (KMRC), set for February 2019, we expect growth in the local mortgage market by creating liquidity for primary lenders	**Neutral**

Residential Sector Supply Outlook

Of the five factors that we expect to shape residential supply, two are negative, one is neutral, whereas two are positive, and thus, our outlook is neutral

Metric	2019 Outlook	Effect
Developer Returns	• In 2018, the residential market recorded slower uptake at 22.8% and occupancy of 81.0% compared to 2017 with 26.6% and 84.0%, respectively due to increased supply amid reduced effective demand • However, developer returns for institutional grade real estate remain high at above 20% p.a. Developers are likely to invest in research in order to identify market niches to ensure profitability of their projects	**Neutral**
Access to Credit	• According to CBK Financial Stability Report, 73.1% of Non-performing loans in 2018 were from real estate, trade and manufacturing, highlighting developer's financial constraints • Average private sector credit growth in 2018 came in at an average of 3.8%, and is tipped to remain low in 2019 owing to the capping of interest rates. We, therefore, expect developers to continue experiencing barriers to adequate financial access which is expected to affect housing supply in 2019	**Negative**
Development Costs	• We expect land prices in 2019 to grow at 4.9%, 1.6% points higher than the 3.3% recorded in 2018. This, coupled with the expected rise in construction materials as a result of inflation is expected to curtail supply due to increase in construction costs	**Negative**
Infrastructure	• In 2019, we expect the ongoing infrastructural projects such as the dualling of Ngong Road and the Western Bypass, and water and sewer improvement to boost new developments in these areas	**Positive**
Government Incentives	• We expect to see more government incentives geared towards creating an enabling environment for home-buyers and developers such as the introduced 50.0% corporate tax cuts and scrapped housing levies, as well as statutory reforms aimed at improving the land sector's efficiency thus cutting developers' costs	**Positive**

2019 Residential Sector Outlook

With a neutral with a positive bias outlook on demand and a neutral outlook on supply, our general outlook for the residential sector is neutral with a bias to positive. The performance of the sector is likely to remain flat with occupancy rates and transaction rates stagnating, and thus, moderate price and rent growth rates

Thematic Performance Review and Outlook			
Theme	**2018 Performance**	**2019 Outlook**	**Effect**
Residential	• The sector recorded a decline in performance with average rental yields dropping marginally by 0.5% points, from 4.7% in 2017 to 4.2% in 2018 attributable to a decline in occupancy rates, which declined by 3.0% points from 84.0% in 2017 to 81.0% in 2018, attributable to increased stock in the market against minimal uptake	• We expect occupancy and uptake rates to stagnate at 81.0% and 22.8%, respectively owing to slow housing completions. Additionally, the continued housing deficit and expected improvement in the mortgage market are set to boost market prices, with the current price appreciation standing at 4.2% p.a. • We expect select markets to continue exhibiting a positive performance supported by their appeal to homebuyers based on location and accessibility, availability for affordable land for development, as well as availability of key amenities	**Neutral**

For apartments, the opportunity is in areas like Kilimani and Thindigua due to relatively high uptake and returns whereas for detached the opportunity is in areas such as Runda Mumwe and Juja.

Commercial Office Market Performance Outlook

The office sector performance is expected to stagnate recording a rental yield of 8.0% due to the current office oversupply at 5.3mn SQFT and decreasing new office stock supply in the market

Summary of Commercial Office Returns in Nairobi Over Time

Year	FY'13	FY'15	FY'16	FY'17	FY'18	Annualized Change 2013-2018	2019F	Reason for Forecast	Outlook
Occupancy (%)	90.0%	89.0%	88.0%	82.6%	83.3%	(1.5%)	82.0%	We expect occupancy rates to stagnate or decline slightly by 1.3% points to average at approximately 82.0% in 2019 given the current oversupply of 5.3mn SQFT in 2018 and expected to increase to 5.7mn in 2019	Negative
Asking Rents (Kshs/Sqft)	95	97	103	101	102	1.4%	102	We expect monthly rental charges to remain at Kshs. 102 per SQFT per month, just as the market has been charging over the last three-years, as the market absorbs the current stock	Neutral
Average Prices (Kshs/Sqft)	12,433	12,776	13,003	12,649	12,573	0.2%	12,485	Asking prices have been declining between 2015-2018 due to the oversupply of office space We therefore expect the prices to drop by 0.7% to average at Kshs 12,485 in 2019	Negative
Average Rental Yields (%)	8.3%	8.1%	8.4%	7.9%	8.1%	(0.4%)	8.0%	We expect office yields to average at 8.0%, 0.1% points lower than 2018 average, in the Nairobi market mainly as a result of increase in supply and thus lower occupancy rates	Negative

- The performance of the commercial office theme is expected to decline slightly in 2019 with average rent, price, occupancy and yields rates coming in at Kshs 102 per SQFT, Kshs 12,485 per SQFT, 82.0% and 8.0%, respectively from Kshs 102 per SQFT, Kshs 12,573 per SQFT, 83.3% and 8.1%, respectively in 2018 mainly due to the current office oversupply at 5.3mn SQFT and increasing supply with expected opening of Garden City Business Park along Thika Road and Global Trade Centre in Westlands

2019 Commercial Office Sector Outlook

The office sector performance is expected to stagnate recording a rental yield of 8.0% due to the current office oversupply at 5.3mn SQFT and decreasing new office stock supply in the market

Commercial Performance Review and Outlook			
Theme	**2018 Performance**	**2019 Outlook**	**Effect**
Commercial	• The performance of commercial office sector improved slightly recording 0.2% points and 0.7% points y/y increase in average rental yields and occupancy rates, to 8.1% and 83.3% from 7.9% and 82.6%, respectively, in 2017 • Various developments were launched during the year including The Federation of Kenya Employers (FKE) 8-storey office building in Upper Hill and Zamara Umbrella Solutions a 16 and 30 floor twin tower in Westlands, respectively • There's an oversupply in the sector with the Nairobi region having an oversupply of 5.3mn SQFT in 2018, that is forecasted to increase to 5.7mn SQFT in 2019	• We forecast a decline of the average rental yield to 8.0% from 8.1% as a result of the oversupply with the average occupancy rates expected to decrease by 1.3% points from 83.3% to 82.0%, • We expect monthly rental charges to stagnate at Kshs. 102 per SQFT per Month, just as the market has been charging over the last three years, as the market absorbs the current vacant stock of 5.3mn SQFT,	**Negative**

Our outlook for the commercial sector is neutral as the sector's performance continues to be constrained by oversupply, with the Nairobi region expected to experience an oversupply of up to 5.7mn SQFT

The sector however has pockets of value in differentiated concepts such as serviced offices that attract yields of 13.4% such as Westlands, as well as areas with low supply office spaces such as Gigiri and Karen recording a rental yield of 10.5% and 9.2% respectively

Retail Market Performance Outlook

The retail sector is expected to soften as a result of increased supply with yields expected to decline by 0.3% from 9.0% to a projected 8.7% in 2019

Nairobi's Retail Sector Performance 2016-2019F							
Item	FY'16	FY'17	FY' 18	Annualized Change 2016-2018	2019F	Reason for Forecast	Outlook
Asking Rents (Kshs/SQFT)	186.9	185.2	178.2	(1.6%)	175.4	We expect asking rents to soften, reducing by 1.6% to Kshs 175.4 from Kshs 178.2 as a result of the retail space oversupply currently at 2.0mn SQFT	Negative
Supply in Nairobi (mn SQFT)	5.9	6.2	6.5	3.3%	7.3	Supply of retail space has grown at an average rate of 3.3% p.a from 2016 to 2018 and is expected to increase by 12.3% to 7.3mn SQFT in 2019 due to opening of malls such as The Well in Karen and Mt. View mall along Waiyaki way that will add 78,000 SQFT and 91,000 SQFT, respectively.	Negative
Occupancy (%)	89.3%	80.3%	79.8%	(3.7%)	76.9%	Due to the current oversupply of retail space and expected opening of malls in the pipeline, we expect occupancy rates to decline by 2.9% points to 76.9%	Negative
Average Rental Yields	10.0%	9.6%	9.0%	(3.3%)	8.7%	Mainly as a result of increase in supply and thus lower occupancy rates, we expect retail yields in Nairobi to soften slightly by 0.3% points to an average of 8.7%	Negative

- The performance of the retail sector is expected to soften, with asking rents, occupancy rates and yields declining by 1.6%, 2.9% points and 0.3% points, respectively to average at Kshs. 175.4, 76.9% and 8.7%
- However, we expect an increase in the number international retail stores who will cushion the sector, thus we have a neutral outlook for the sector

2019 Retail Sector Outlook

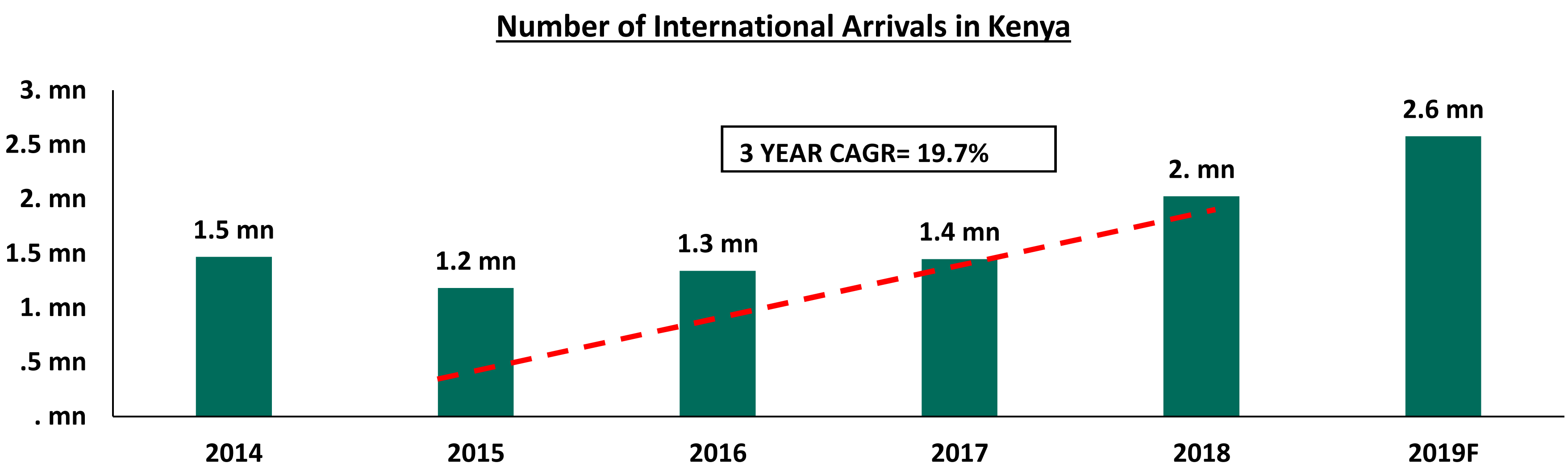
The retail sector is expected to soften as a result of increased supply with yields expected to decline by 0.3% from 9.0% to a projected 8.7% in 2019

Thematic Performance Review and Outlook			
Theme	**2017 Performance**	**2018 Outlook**	**Effect**
Retail	• The performance of the retail sector softened in as a result of increased supply of mall space, and the tough operating environment characterized by low private sector credit growth, • Occupancy rates declined by 9.0% points, from 80.3% to 79.8% between 2017 and 2018 in Nairobi triggered by an increase in of mall space by 4.8% y/y from 6.2mn SQFT to 6.5mn SQFT in 2018. Notable malls opened in 2018 include Waterfront in Karen and Signature Mall in Mlolongo, • Rental yields declined from 9.6% in 2017 to 9.0% as a result of lower occupancy rates, occasioned by increased supply, • There was increased entry of international retailers such as Carrefour, Shoprite and Game as well as the expansion of local retailers such as Naivas	• Returns are expected to soften as a result of increased supply. Occupancy rates are expected to decline by 2.9% points to 76.9% from 79.8% leading to reduced yields of 8.7% from 9.0%, • However, we forecast an increase in international retailer foothold such as South African based Shoprite supermarket and The Game as they try to cash in to the increasing middle-income earners in Kenya, • The opportunity is in county headquarters in some markets such as Mombasa and Mt. Kenya regions that have retail space demand of 0.3mn and 0.2mn SQFT, attractive yields at 8.3% and 9.9% and occupancy rates at 96.3% and 84.5%, respectively	**Neutral**

Our outlook for the retail sector is neutral occasioned by an over supply currently at 2.0mn SQFT. However, we expect an increase in the number international retail stores translating to stability in occupancy rates.

Hospitality Sector Performance Outlook

We expect the number of international arrivals to grow to approximately 2.6 mn in 2019



Source: KNBS, Cytonn Research

- The hospitality sector recorded a 5-year slump between 2011 and 2015 caused by insecurity and terrorism
- The sector has been on the recovery path with the number of international arrivals into the country growing by a 3 year CAGR of 19.7% since 2015 and by an annual growth rate of 39.8% to 2.0 mn in 2018
- Given the country's political stability, the continued marketing of Kenya as an experience destination and improved air transport and flight operations we expect the number of international arrivals to grow by an annual appreciation of 30.0% to approximately 2.6 mn in 2019, resulting in a greater demand for hospitality services
- We therefore expect the occupancy rates for serviced apartments to remain above 80%

Hospitality Sector 2019 Outlook

The outlook for the hospitality sector is positive with the number of international arrivals expected to grow to approximately 2.6 mn in 2019, resulting in a greater demand for hospitality services

Sector	2018 Performance	2019 Outlook	Effect
Hospitality Sector	In 2018, serviced apartments recorded improved performance in 2018 with the average rental yield coming in at 7.4%, which is 2.1% points higher than 5.3% recorded in 2017, attributable to the increased demand, which has triggered an increase in charge rates, as well as increased occupancy rates with an average of 80.0% in 2018, compared to 72.0% in 2017	• Given the country's political stability, the continued marketing of Kenya as an experience destination and the improved air transport with several airlines that increased their flight frequencies in and out of the country, we expect the number of international arrivals to grow to approximately 2.6 mn in 2019, resulting in a greater demand for hospitality services • We thus expect, the occupancy rates in the serviced apartments sector to remain above 80.0% and resulting in a rental yield of above 7.0%, with the investment opportunity being in Kilimani and Westlands markets with rental yields of above 10.0%	**Positive**

we expect the number of international arrivals to grow to approximately 2.6 mn in 2019, resulting in a greater demand for hospitality services

Land Sector Performance Outlook

We expect an annual capital appreciation of 4.9% in 2019

All values in Kshs unless stated otherwise

Summary of the Performance Review and Outlook across all regions										
Location	*Price in 2011	*Price in 2015	*Price in 2016	*Price in 2017	2018	2019f	7-year CAGR	% Price change from 2011	Annual Capital appreciation (2018)	Annual Capital appreciation (2019)f
Satellite Towns - Unserviced Land	9m	16m	21m	22m	23m	24m	14.1%	3.5	5.7%	**6.7%**
Nairobi Suburbs - Low Rise Residential Areas	56m	91m	106m	109m	86m	91m	6.5%	2.6	4.6%	**5.3%**
Nairobi Suburbs - Commercial Areas	156m	377m	458m	478m	493m	517m	17.8%	3.3	5.4%	**4.9%**
Nairobi Suburbs - High rise residential Areas	46m	80m	97m	103m	135m	140m	16.8%	2.4	0.2%	**3.9%**
Satellite Towns - Site and service schemes	6m	13m	14m	15m	14m	15m	13.3%	3.5	0.6%	**3.5%**
Average							**13.7%**	**3.1**	**3.3%**	**4.9%**

Source: Cytonn Research

- In 2019 we expect an annual capital appreciation of 4.9% in 2019, as the market slowly recovers from the 3.3% appreciation recorded in 2017/2018, fueled by the availability of development land, improving infrastructure and demographics
- Unserviced land in satellite towns is expected to record the highest capital appreciation of 6.7%, attributable to high demand as developers and investors prefer to buy unserviced plots and service instead of paying a premium as developers double the price the land for the services, facilities and amenities provided, in addition to their affordability compared to land in urban areas and availability in bulk

2019 Land Sector Outlook

The outlook for the land sector is positive with a projected annual capital appreciation of 4.9% in 2019

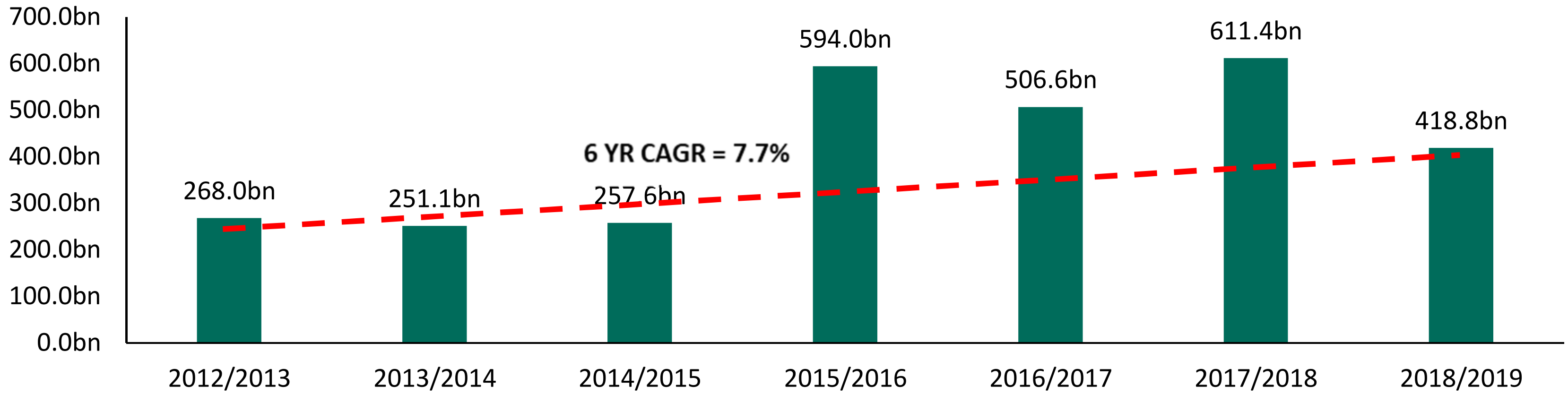
Sector	2018 Performance	2019 Outlook	Effect
Land Sector	The Nairobi Metropolitan Area land prices recorded a 7- year CAGR of 13.7%, and a 3.3% y/y price change in 2018, compared to a 17.4% and 4.2%, respectively recorded in 2017, uncertainty surrounding statutory approvals particularly in light of the ongoing demolitions of legally approved buildings, thus decreased transactions in the land sector	• We expect an annual capital appreciation of 4.9% in 2019, fueled by the availability of development land, improving infrastructure and demographics • For 2019, the investment opportunity in the Nairobi Metropolitan Area land sector lies in Satellite Towns such as Ruaka, Utawala, Ruiru and Thika, supported by high capital appreciation of 16.2%, 17.5%, 4.7%, 7.7% y/y capital appreciation, respectively, in addition to other areas such as Kilimani, Karen and Kitisuru, which had rates of 10.7%, 8.2% and 10.5% y/y capital appreciation, respectively	**Positive**

We retain a positive outlook for the land sector with a projected annual capital appreciation of 4.9% in 2019 supported by the availability of development land, demographics and the improving infrastructure in the areas

Infrastructure Sector Outlook

Budget allocation towards infrastructure has been growing by a 6- year CAGR of 7.7%

Infrastructure Budget Allocation



Source: The National Treasury

- The government's budget allocation towards infrastructural development has been growing by a 6- year CAGR of 7.7% to Kshs 611.4 bn in 2018/19 from Kshs 251.1 bn in 2013/14
- For financial year 2018/19 the budget allocation at Kshs 418.8 bn was 31.5% lower than the Kshs 611.4 bn allocated for the financial year 2017/18
- Our outlook for infrastructure is therefore **neutral** as we expect reduced infrastructural activities during H'1 2019 due to the reduced budget allocation attributable to the government's financial constraints, given the country's public debt which currently stands at 56.4% of the GDP, in addition to the national revenue collection deficit of 38.0% as at June 2018
- We, however, expect execution of the planned infrastructural projects such as roads, sewer connection in Ruiru and Kitengela, water improvement programme and proposed light rail which will allow for higher density construction and boost real estate

2019 Infrastructural Sector Outlook

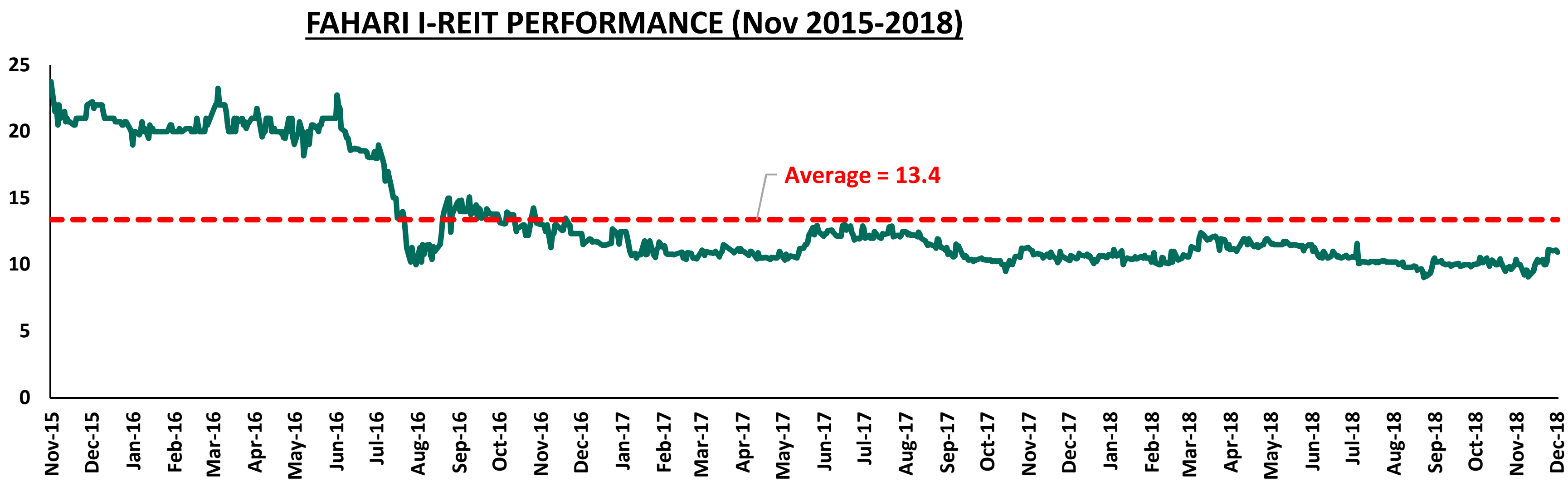
We expect reduced infrastructural activities during H'1 2019 due to reduced budget allocation

Infrastructural Sector Performance Review and Outlook			
Theme	**2018 Performance**	**2019 Outlook**	**Effect**
Infrastructure Sector	• In 2018, the infrastructure sector recorded several activities among them; the launching of the construction of Western Bypass, and the dualling of Ngong Road Phase 2, aimed at opening up areas for development • In terms of budget allocation, the sector was allocated 611.4 bn in the 2017/2018 budget and 418.8 bn in the 2018/2019	• We expect reduced infrastructural activities during H'1 2019 due to the reduced budget allocation from the previous year attributable to the government's financial constrains, given the country's public debt which currently stands at 56.4% of the GDP, in addition to the national revenue collection deficit of 38.0% as at June 2018	**Neutral**

Nairobi and Kiambu Counties offer the best real estate investment opportunity due to presence of a relatively adequate transport network and good water & sewerage coverage. In 2019, we expect the counties to remain attractive and real estate developers to align their projects with the ongoing infrastructural projects given the expected benefits including higher demand, price appreciation and savings on construction costs.

Listed Real Estate Performance Outlook

Fahari REIT average share price in 2018 at Kshs 10.6 was 6.0% lower than 2017 at Kshs 11.3



Source: Bloomberg

- The average share price in 2018 was Kshs 10.6, 6.0% lower than the average price of Kshs 11.3 in 2017
- The REIT's performance in 2018 was been largely limited by a poor market sentiment with investors inclining towards brick and mortar real estate which offered higher yields for retail, office sector and government securities' at 9.0%, 8.1% and 8.7% respectively in 2018, against an average yield of 5.7% earned from the REIT in H1'2018
- Having opened 2019 with a trading price of Kshs 10.75, we expect the REIT to continue trading at low prices and in low volumes in 2019, thus we have a **negative** outlook for the sector
- We expect growth in revenues as a result of the new property acquisition, and project a 0.3% points increase in dividend yield to 6.8% from 2018 earnings (at a price of Kshs 10.25 per share as at 11th January 2019), from a 6.5% yield recorded from 2017

2019 Listed Real Estate Outlook

Listed Real Estate performance will be constrained by continued lack of investor appetite

Listed Real Estate Outlook			
Theme	**2018 Performance**	**2019 Outlook**	**Effect**
Listed Real Estate	• Fahari I-REIT closed the year with a trading price of Kshs 10.95, a 4.8% rise from Kshs 10.45 at the beginning of 2018 and 47.4% decline its initial price of Kshs 20.8 in November 2015. The average share price in 2018 was Kshs 10.6, 6.0% lower than the average price of Kshs 11.3 in 2017	• Having opened the year with a trading price of Kshs 10.75, we expect the REIT to continue trading at low prices and in low volumes in 2019. • With the new acquisition, we expect growth in revenues and project a 0.3% points increase in dividend yield to 6.8% from 2018 earnings (at a price of Kshs 10.25 per share as at 11th January 2019), from a 6.5% yield recorded from 2017 earnings	**Negative**

Our outlook for listed real estate is negative as the performance will be constrained by continued lack of investor appetite for the instrument and poor performance of the assets in its portfolio

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