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Fixed Income Note

March 2019

"Longest IFB faces market test"

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Executive Summary

- The Central Bank of Kenya (CBK) has invited bids for **IFB1/2019/25 (25 years)** with a funding target of KES.50Bn.
- The National Treasury's choice of issue (infrastructure bond) and the tenor (25 years) is a deliberate move to lengthen the maturity profile of domestic debt which stood at 4 years and 2 months as the end of the 2017/18 fiscal year in June 2018.
- In our February fixed income report titled **"A tale of missed targets and revised budgets"**, we indicated that the government had revised its total estimated receipts for the 2018/19 fiscal target lower to KES.2.6Tn.
- This was largely on account of declining tax and non-tax receipts.
- Kenya Gazette (22nd February 2019) further showed that the government had increased its domestic borrowing target for fiscal year 2018/19 by 9.9% to KES.537.5Bn.
- The two scenarios support our view that the government will continue borrowing heavily in the domestic debt market also taking advantage of the low interest rate environment to access low cost capital.
- IFB's have historically recorded higher subscription rates than other Kenya Treasury Bonds because of the tax-free incentive translating to higher investment yields.
- However, with a tenor of 25 years, the issue might prove to be less appealing to many investor segments due to duration risk associated with long-term papers.
- For this reason, we are skeptical that the issue will achieve full subscription and this is the inspiration behind our report title **"Longest IFB faces market test"**.
- We predict the **market weighted average and weighted average of accepted bids at 12.50% and 12.45% respectively.**
- Macro-economic variables will remain relatively stable with inflation expected to range between 3.5%-4.1% on account of declining fuel prices and stable food prices.
- The Shilling on the other hand will trade around KES.100-101 levels in the short term supported by strong foreign currency inflows and declining import prices.
- Due to this stability we do not expect any surprises in the next Monetary Policy Committee (MPC) meeting which will be held on 27th March 2019.

"Longest IFB faces market test"

- The Central Bank of Kenya (CBK) seeks to raise KES.50Bn through the issue of a 25 year amortized Infrastructure Bond **IFB1/2019/25** (Table.1)
- **We predict the Weighted Average Rate (WAR) of accepted bids at 12.45% for the bond issue** (Table. 2).
- Tenor of the bond coincides with the CBK's objective of lengthening the maturity profile of public debt with Average Term to Maturity (ATM) of domestic debt at 4 years 2 months as at June 2018.
- We forecast a subscription rate of about 80%-90% for the issue.

Table.1: Primary Bond issue summary

Issue Number	**IFB1/2019/25 (25Yr)**
Total Amount Offered	KES.50Bn
Tenor	25
Coupon Rate (%)	12.20%
Issue Price	Discounted/Premium/Par
Period of Sale	1st - 19th March, 2019
Auction Date	20th March, 2019
Value Date	25th March, 2019
Yield Curve (%) (Weighted Average tenor 20 Years)	12.89%

Source: Central Bank of Kenya

Table.2: Primary Market Auction Performance of Infrastructure Bonds over the last 5 years

<table>
<tr><th>Issue Number</th><th>Offered (KES.Bn)</th><th>Bids Received (KES.Bn)</th><th>Amount Accepted (KES.Bn)</th><th>Performance Rate (%)</th><th>Coupon Rate (%)</th><th>Average Yield</th></tr>
<tr><td>IFB1/2014/12</td><td>15</td><td>38.8</td><td>15.8</td><td>258.5</td><td>11</td><td>11.30</td></tr>
<tr><td>IFB1/2015/12</td><td>25</td><td>51.7</td><td>25.7</td><td>206.6</td><td>11</td><td>11.60</td></tr>
<tr><td>IFB1/2015/12 (Tap)</td><td>25</td><td>51.7</td><td>24.0</td><td>97.53</td><td>11.00</td><td>11.56</td></tr>
<tr><td>IFB1/2015/9</td><td>35</td><td>16.6</td><td>14.0</td><td>55.3</td><td>11.00</td><td>14.75</td></tr>
<tr><td>IFB1/2016/15</td><td>30</td><td>35.1</td><td>30.6</td><td>117.0</td><td>12.0</td><td>13.28</td></tr>
<tr><td>IFB1/2017/12</td><td>30</td><td>35.0</td><td>6.0</td><td>116.8</td><td>12.50</td><td>13.05</td></tr>
<tr><td>IFB1/2017/12 (Tap)</td><td>-</td><td>8.0</td><td>7.6</td><td>-</td><td>12.50</td><td>13.56</td></tr>
<tr><td>IFB1/2017/7</td><td>30</td><td>45.9</td><td>42.0</td><td>153.0</td><td>12.50</td><td>12.28</td></tr>
<tr><td>IFB1/2018/15</td><td rowspan="2">40</td><td>55.8</td><td>5.0</td><td rowspan="2">139.4</td><td>12.50</td><td>13.03</td></tr>
<tr><td>IFB1/2018/15 (Tap)</td><td>-</td><td>36.3</td><td>12.50</td><td>12.51</td></tr>
<tr><td>IFB1/2018/20</td><td rowspan="2">50</td><td>40.4</td><td>27.6</td><td>80.8</td><td>11.95</td><td>12.29</td></tr>
<tr><td>IFB1/2018/20 (Tap)</td><td>-</td><td>8.73</td><td>-</td><td>11.95</td><td>12.16</td></tr>
</table>

Source: Central Bank of Kenya & Sterling Research

IFB has an amortized redemption structure

- The infrastructure bond has an amortizing redemption structure, making its effective tenor 20 years.

Table.3: Amortized redemption tenor is 20 years

Redemption Period	% of principal amount	Tenor Calculation	Weighted Tenor
15 years (Mar-2034)	50%	50%*15 years	7.5 years
25 years (Feb-2044)	50%	50%*25 years	12.5 years
25 Years (Feb-2044)	100%	-	20 years

Source: Central Bank of Kenya & Sterling Research

Investors likely to bid at or around 12.5%

- We forecast the weighted average rate of accepted bids at around these levels: (Table.2).

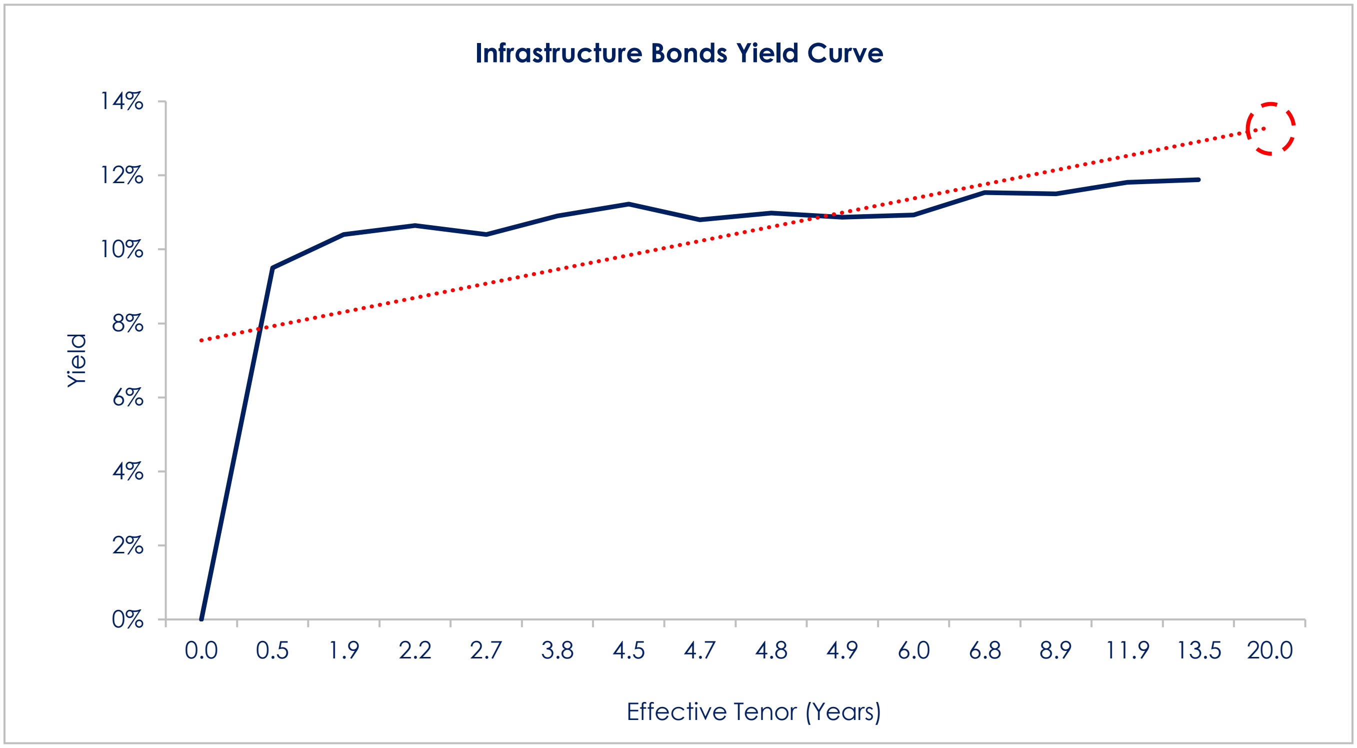
Table.2: Auction bid prediction

Security	IFB1/2019/25 (25Yr)
Market Weighted Average Rate (%)	12.50
Weighted Average Rate of Accepted Bids (%)	12.45

Source: Sterling Research

- Our bid prediction has been derived from the IFB yield curve (Fig.1) created using the ATM of each bond and implied yields on 28th February 2019).
- The current IFB issue is the longest, with an average term to maturity of 20 years.
- The IFB curve interpolates the yield for the 20-Yr IFB at about 12.5%

Fig.1: Infrastructure Bond Yield Curve

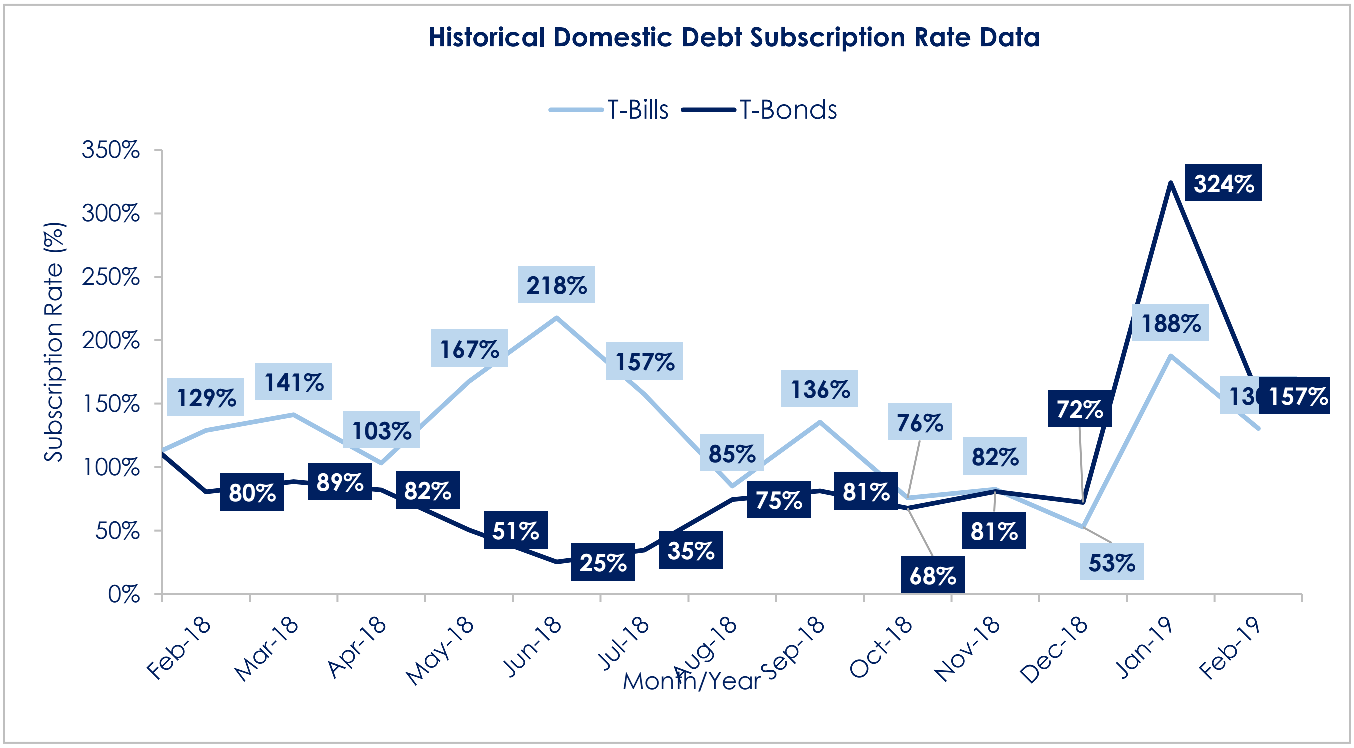


Source: Nairobi Securities Exchange & Sterling Research

Short-term debt still the preference for fixed income investors

- Aggregate rate of subscription for the T-bill papers in February 2019 declined from 173%, 141% and 240% to 101%, 115% and 157% for the 91 day, 182 day and 364 day papers respectively.
- This decline might be explained by the concurrent 5 and 10 year joint issue during the month.
- Market liquidity remained high levels as illustrated by low inter-bank rates (as low as 1.3% during the month), this also explains the high demand for short and medium term securities.
- We expect T-Bill subscription rates to remain high in March driven principally by the liquidity position of the market and slow private sector credit growth.

Fig.2: Domestic debt demand remained high in February 2019



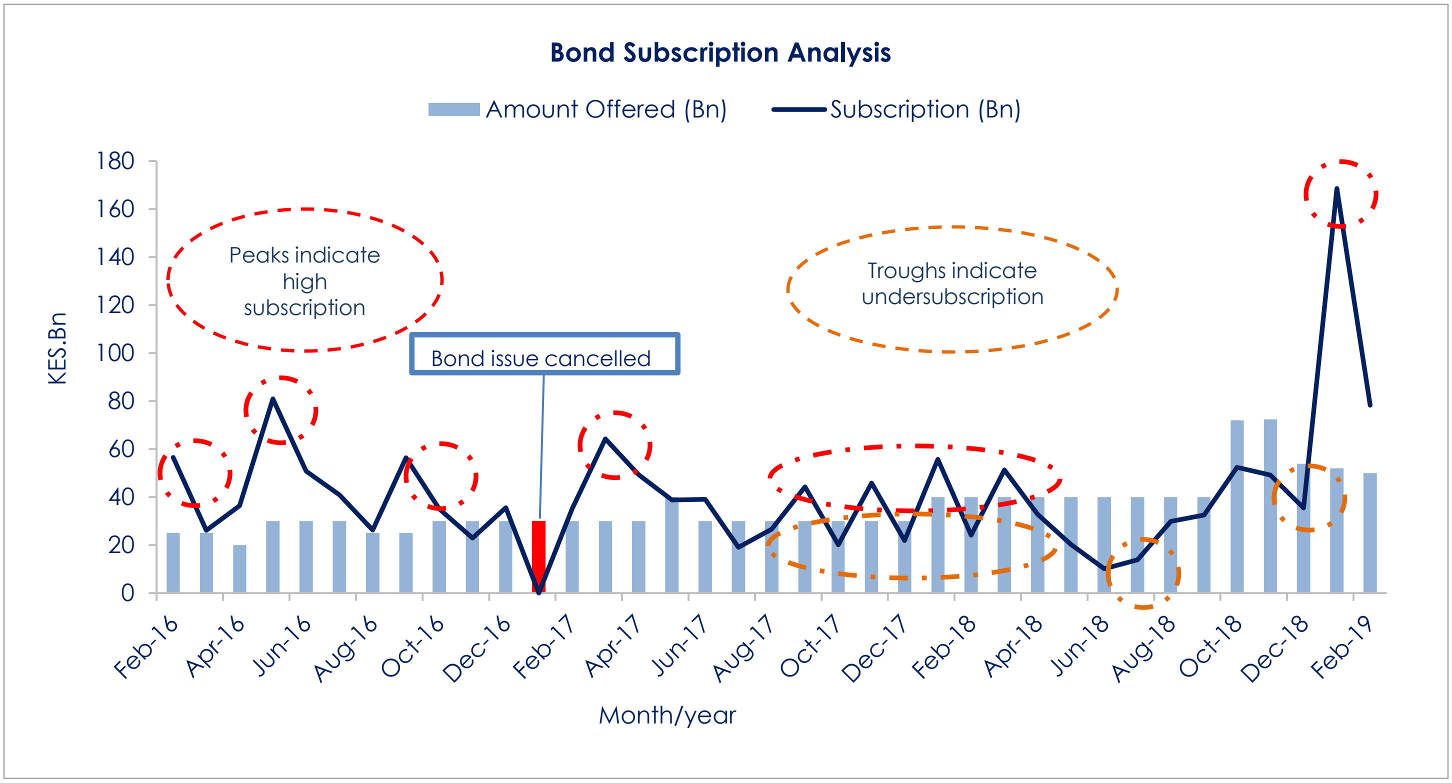
Source: Central Bank of Kenya

Medium term government debt remains popular with investors

High investor demand for medium term (5 and 10 year) issues

- High Investor demand for medium term government bonds continues to persist as reflected by oversubscription of government securities issued within the month.
- The performance rate of the joint 5 year and 10 year issue stood at 156.5%.
- The good performance posted by government securities during the month can be attributed to the excess liquidity position of the market and attractive tenors offered.
- Medium term bonds are the new preferred government tenor since they help the government lengthen its debt maturity profile while also remaining competitive investments prospects to investors.
- T-Bills & Bond subscription rates have generally been high since the beginning of the year driven largely by high liquidity levels observed in the market especially by banks which happen to be the largest holders of government debt.

Fig.3: Historical Treasury bond subscription analysis 2016-2019 - High appetite for short & medium-term bonds



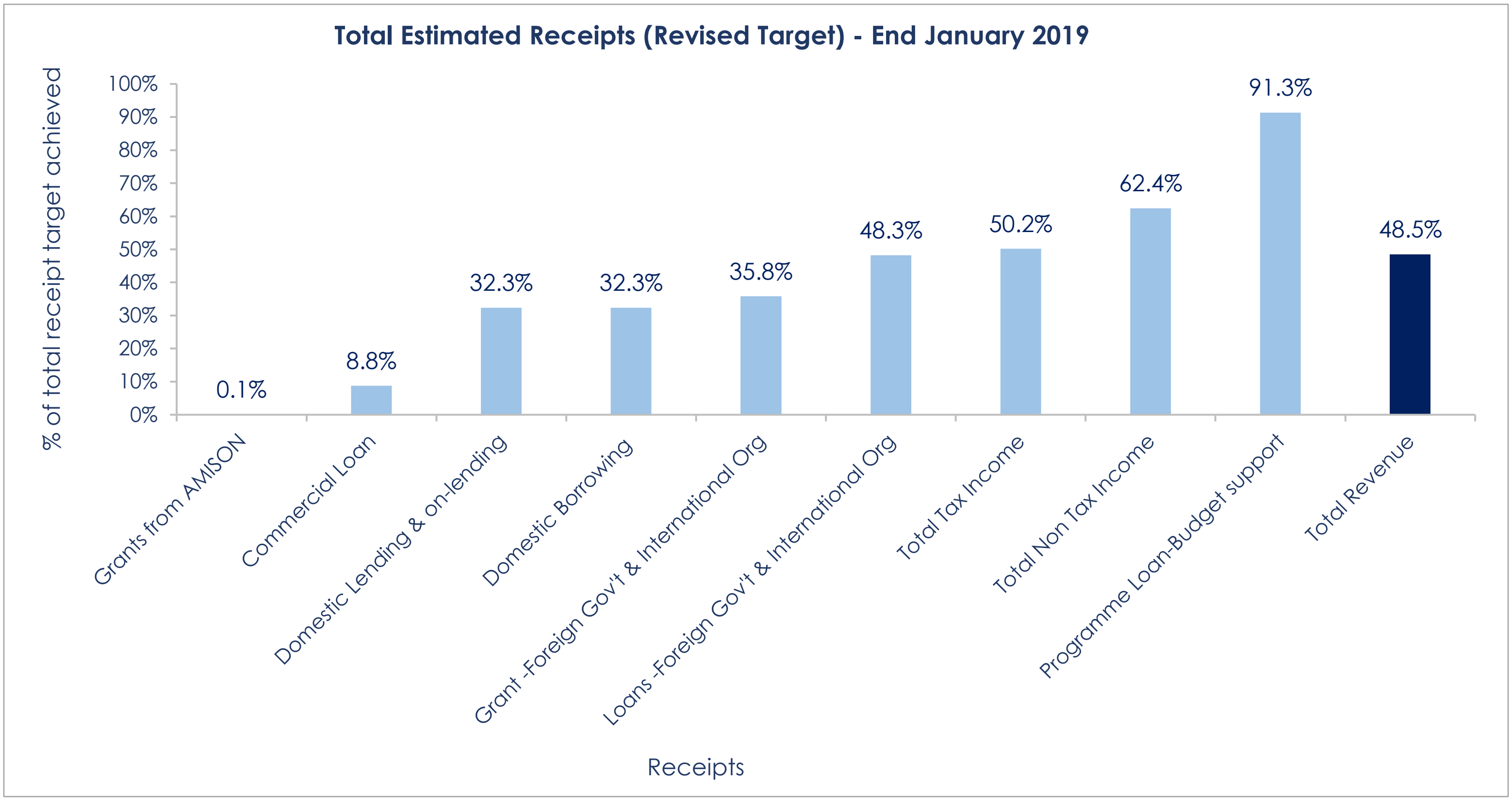
Source: Central Bank of Kenya

National Treasury has raised 48.5% of its total income target so far

Tax income receipts KES.0.86Tn - 47.7% of total 2018/19 fiscal year target.

- As at the end of January 2019, total revenue receipts amounted to KES.1.25Tn, indicating 48.5% of total revenue estimates for FY2018/19 had been achieved.
- Treasury has so far recorded 50.2% collection in tax income, (KES.0.86Tn) against the total estimates for FY2018/19.
- Domestic borrowing receipts stood at KES 234.4Bn against a target of KES.537.5Bn, indicating that treasury falling behind on its domestic borrowing targets by about 14.7%
- As a result of this we expect treasury to borrow aggressively in the domestic market in order to meet the domestic debt target.
- This explains why the CBK has been issuing KES.50Bn bonds in the recent past.

Fig.4: Actual National treasury receipts currently below target



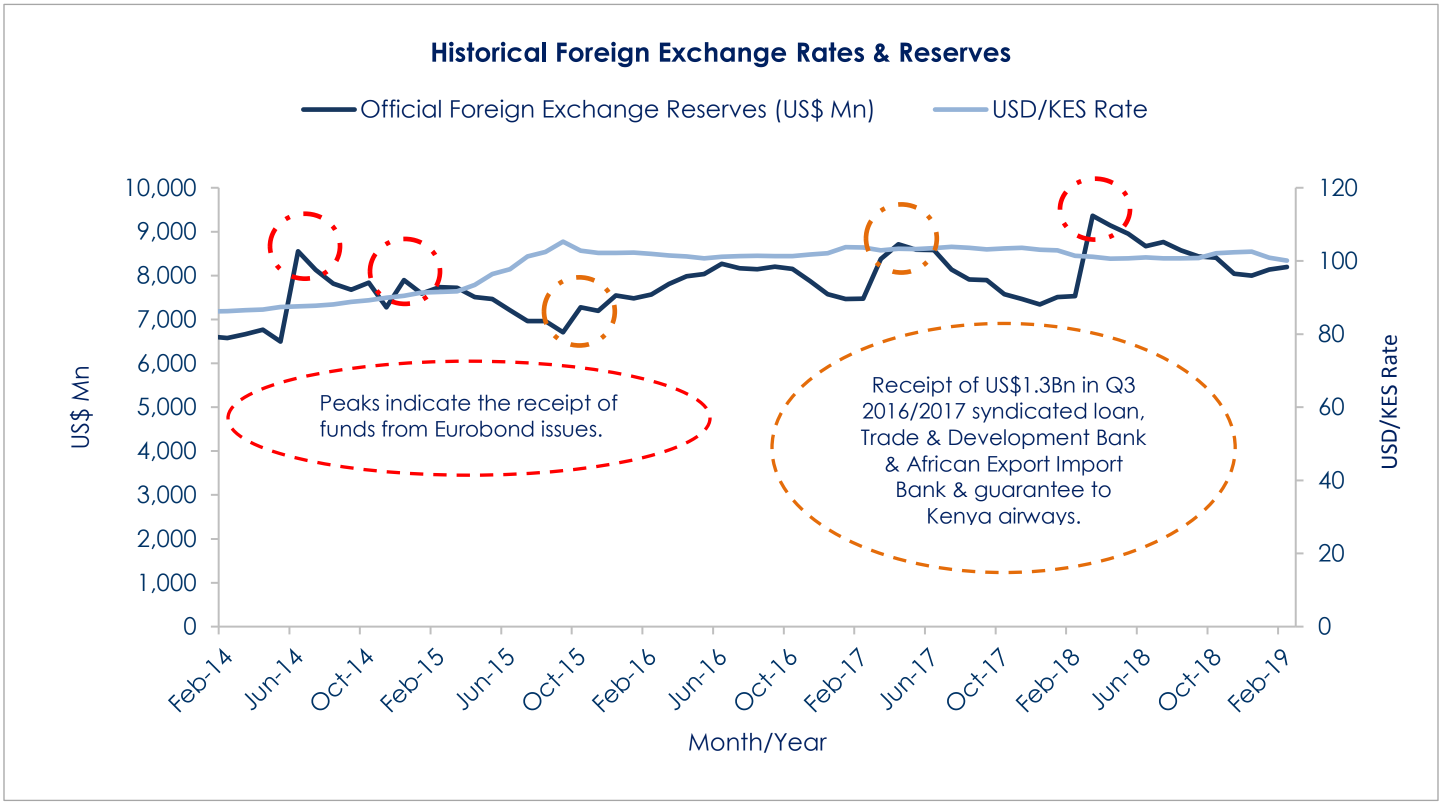
Source: The Kenya Gazette Vol. CXXI - No.12 25th January 2019

Shilling strengthens against USD as forex reserves remains stable

Kenya Shilling strengthened supported by strong US$ inflows.

- Supported by high dollar inflows from the agricultural sector, diaspora remittances and a lower import bill, the Kenya Shilling (KES) appreciated marginally by 0.8% against the US Dollar (US$) to close the month of February at KES.100.09 (Fig.4).
- KES has appreciated 1.2% against the US Dollar year-to-date in addition to 1.4% in 2018 making it one of the best performing currencies on the continent during the period in focus.
- Kenya's foreign exchange (forex) reserves stood at US$8.2Bn (KES.820.3Bn), equivalent to 5.2 month of import cover as at 28th February well within the statutory requirement (4 months) and above the EAC Region's convergence criteria of 4.5-months of import cover.
- We expect the shilling to remain stable in the short term supported by strong inflows.
- We draw attention to debt repayment obligations falling due in the second half of the 2018/19 fiscal year such as the principal and interest repayment of the 5-Year Eurobond (US$750Mn) in June 2019 and this could put the shilling under pressure.

Fig.5: Kenya Shilling makes marginal gains as forex reserve position remains strong

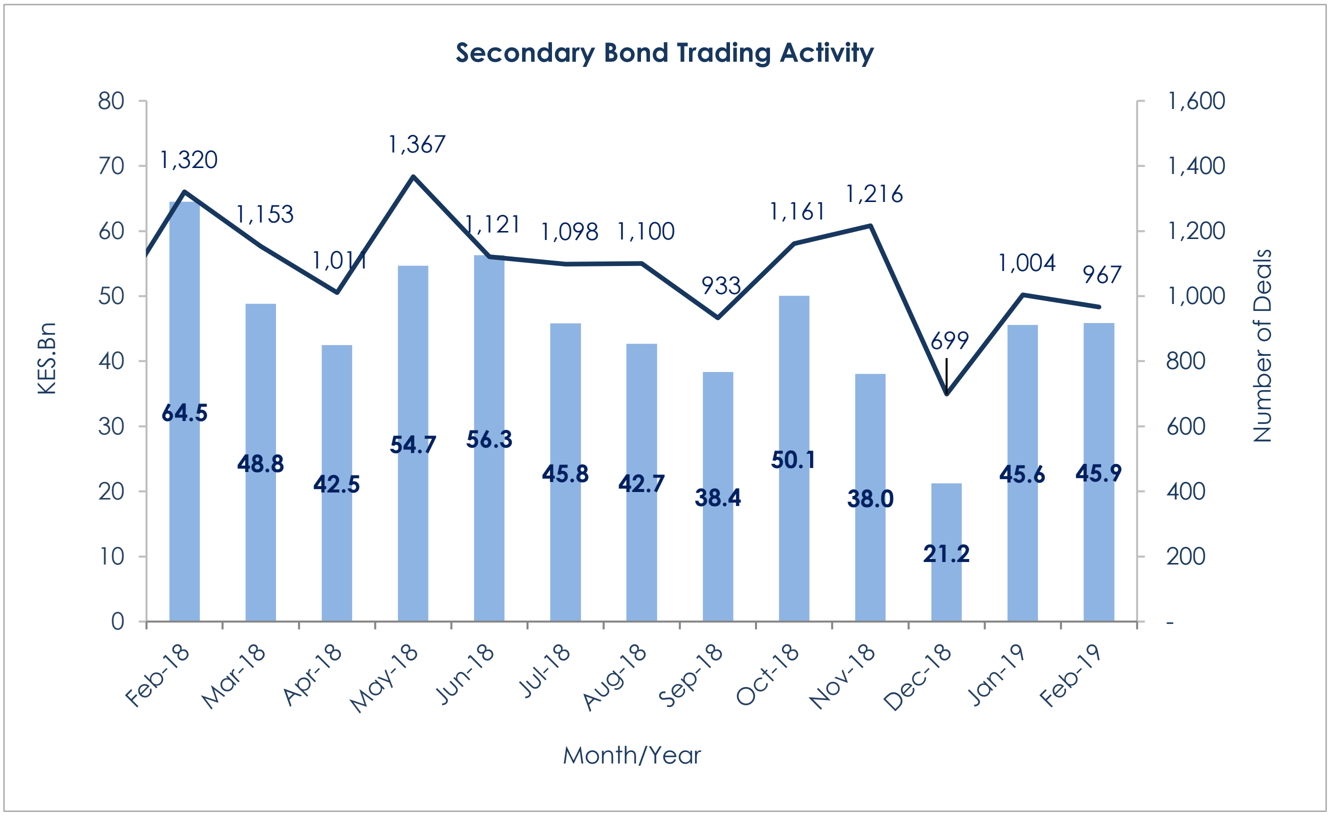


Source: Central Bank of Kenya

Secondary market trading activity remains flat in February compared to the previous month

- Bond turnover in the secondary market marginally increased 0.7% in February 2019 to KES.45.9Bn from KES.45.6Bn in January 2019 (Fig.5).
- During the month the number of deals decreased by 3.7% to 967.
- The high trading activity is attributed to improved liquidity in the market, driven by government payments and debt maturities.
- We expect the high liquidity to continue driving trading volumes in the secondary market in March.

Fig.6: Secondary trading activity remains almost unchanged in February



Source: Nairobi Securities Exchange

Yield curve shifts downwards

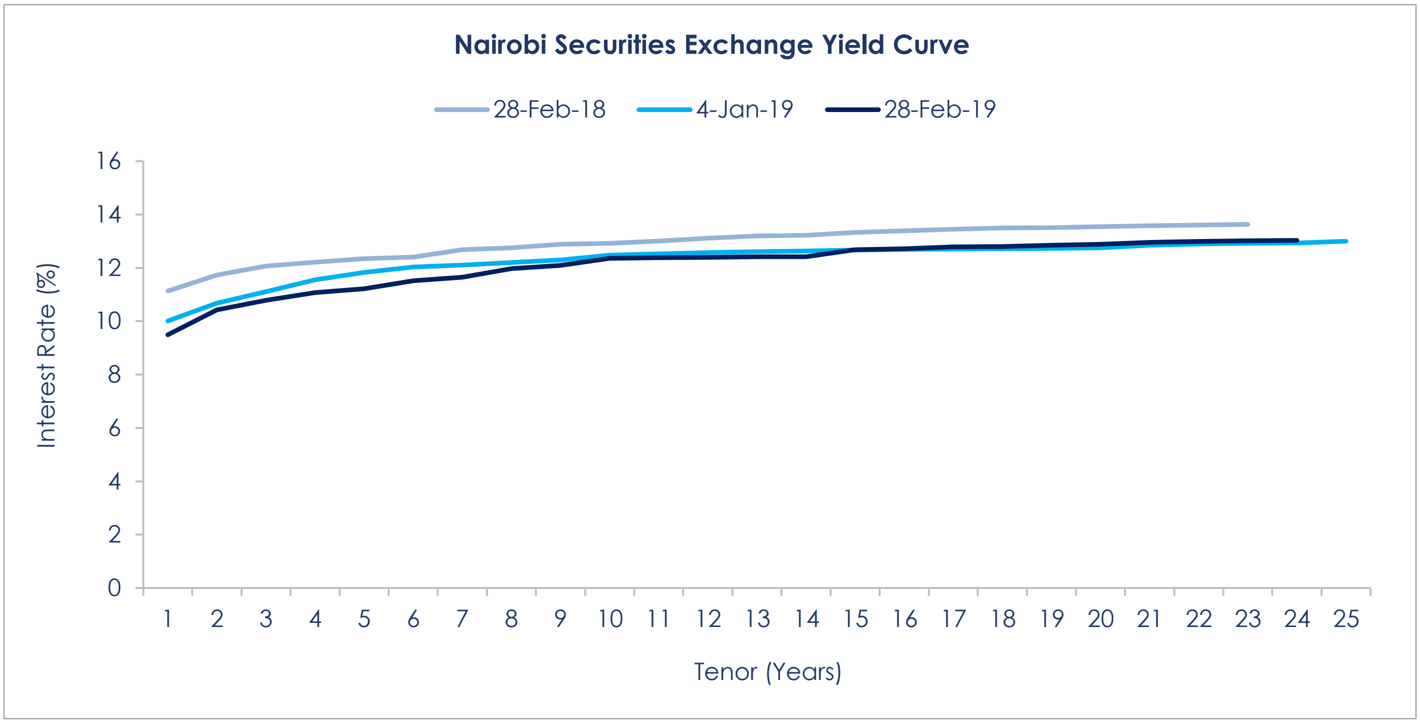
- Table 5 & Fig.6 show a comparison of yields on government securities in different periods, 28th February 2018, 4th January 2018 and 28th February 2019.
- Over the last one year, yield rates for all tenors have declined, however we observe that the shorter bonds yields have declined by a lager margin than the longer tenors.
- **We recommend a hold on the long term papers and a buy on short term and medium term papers.**

Table.5: Yield decreases for short and medium term bonds due to high demand

Tenor	Yield (28th Feb 2018)	Yield (28th Feb 2019)	% Change
1	11.1310	9.4920	↓14.72
2	11.7306	10.4244	↓11.13
5	12.3500	11.2167	↓9.18
10	12.9212	12.3603	↓4.34
15	13.3313	12.6781	↓4.90
20	13.5470	12.8900	↓4.85
23	13.6306	13.0121	↓4.54

Source: Nairobi Securities Exchange

Fig.7: Yields on the short end declined significantly while those at the tail end declined marginally over the last year

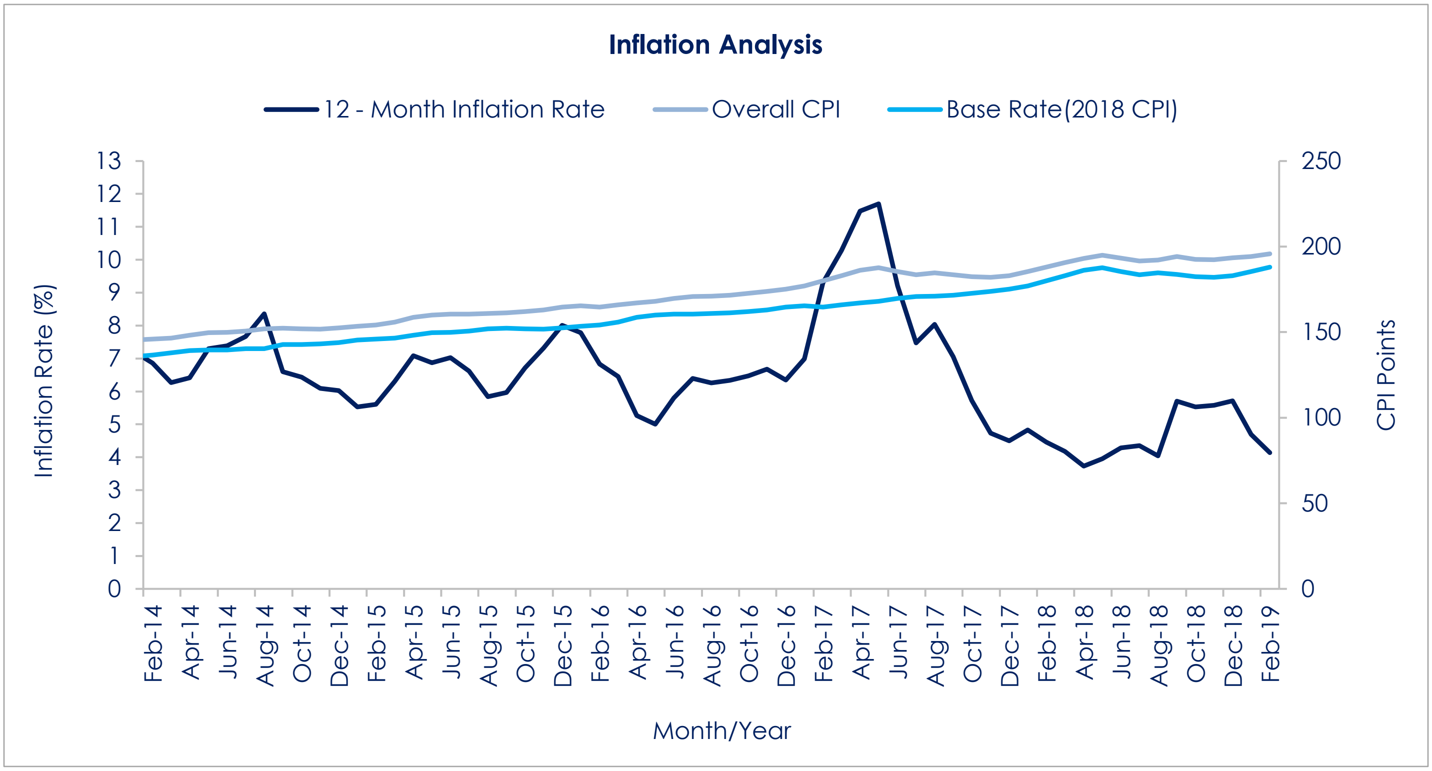


Source: Nairobi Securities Exchange

March inflation forecast - 3.5% - 4.1%

- Inflation for the month of February declined to 4.14% from 4.70% in January (Fig.7) due to a decrease in transport cost index (-0.5%) attributable to lower fuel prices and a higher base rate.
- Food and Non-Alcoholic drinks' index increased by 1.09% year on year while Housing, Water, Electricity, Gas and other Fuels went up by 12.35% year on year. Despite this the inflation rate still declined due to the relatively higher base rate (CPI).
- **We expect March inflation to range between 3.5%-4.1% on account of declining fuel prices, stable food prices and a higher base rate.**

Fig.8: February inflation to remain relatively stable and well within CBK's target range

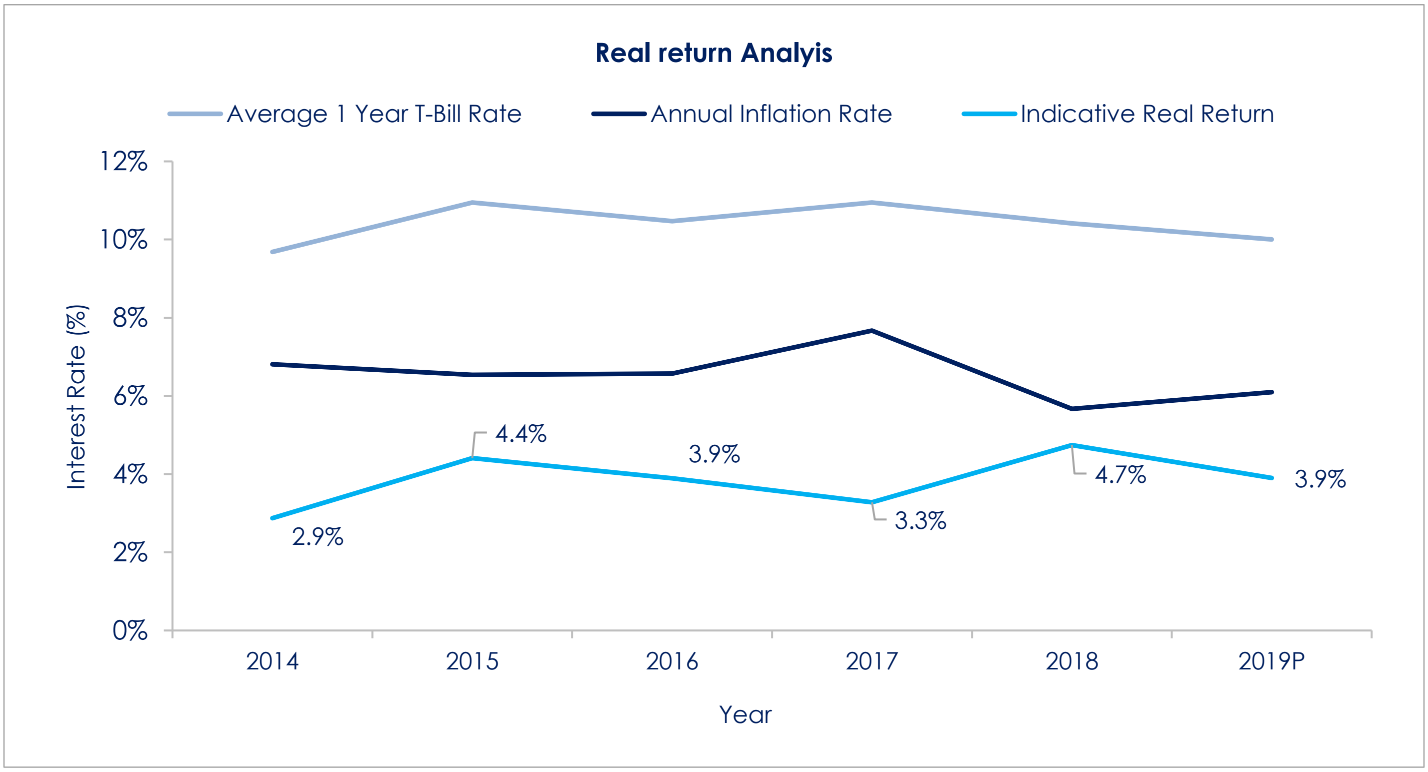


Source: Kenya National Bureau of Statistics

Real return on 1 year Kenya Government security higher yielding than Nairobi Securities Exchange equity return.

- From our analysis of real returns, average yields on the 364 day T-Bill and inflation between 2014 and 2018 (Fig.8) we observe that the average real return is 3.8%.
- Our expected real return for the 364-day paper this year is 3.9% presenting a better return than the equities market expected to return 9.7% (Source: Bloomberg) which will yield a lower real return (3.6%) than the1-Yr security.
- An investor holding the 364-day T-Bill in 2018 had a real return of 4.7%, comparatively higher than any of the preceding 4 years supported by a decline in inflation despite declining 1-Yr yield rates.
- **We advise investors to buy the short term government securities as this will yield the best returns.**

Fig.9: Strong case for investing in fixed income securities in 2019



Source: Central Bank of Kenya & Kenya National Bureau of Statistics

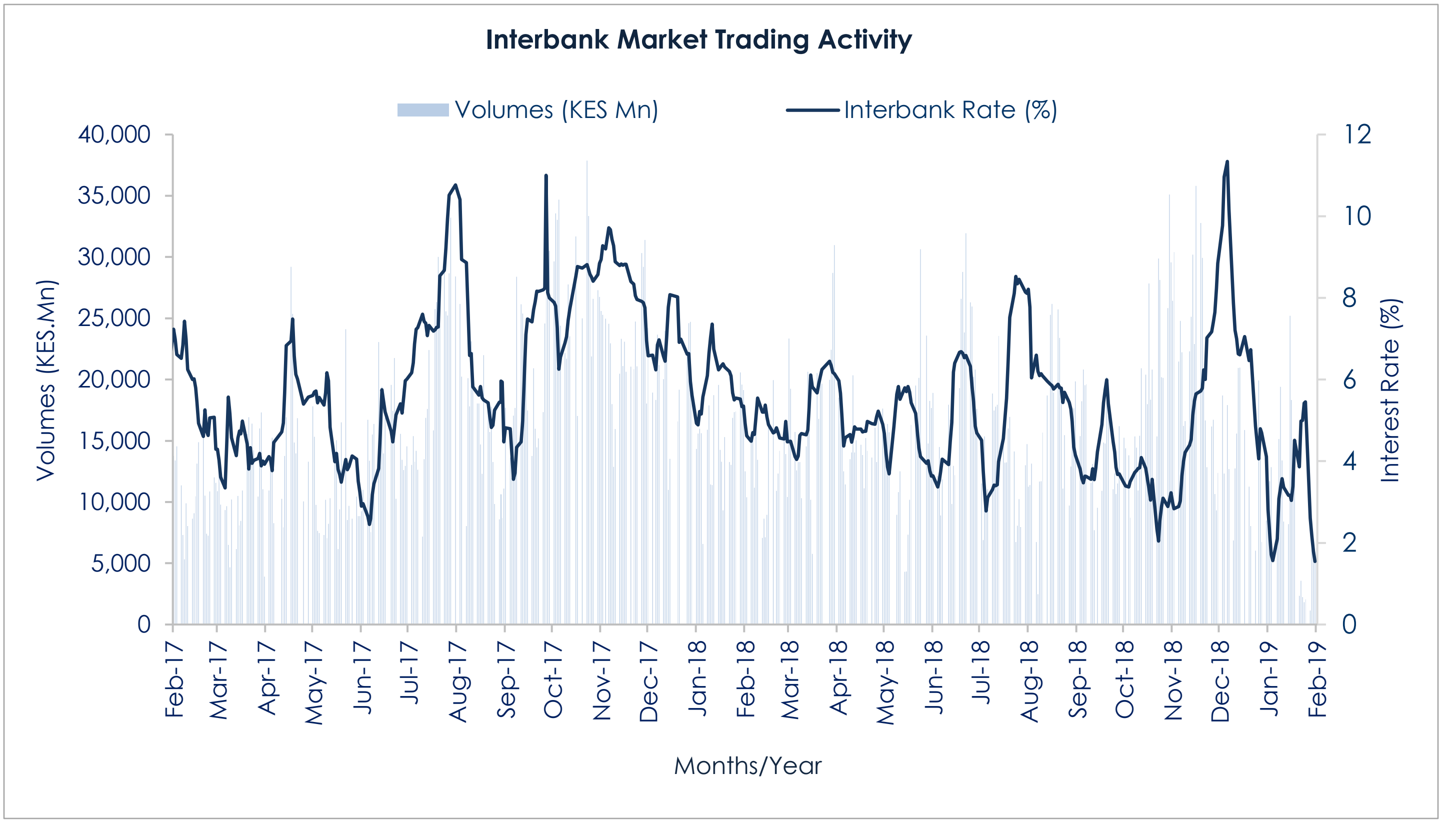
Monetary Policy Committee (MPC) to maintain CBR at 9% in March

- The next meeting of the Monetary Policy Committee (MPC) will be held on Wednesday, March 27, 2019.
- The MPC in its January 2019 meeting maintain the Central bank Rate (CBR) at 9% in line with our prediction.
- We expect the MPC to **maintain the rate at 9% on the back of stable macro-economic indicators.**

Market liquidity set to decline in March

- Interbank rate edged downwards in February from a Weighted Average Rate (WAR) of 3.44% in January to 2.64%.
- This was in line with our predictions in our February Fixed Income Report **"A tale of missed targets and a revised budget**" where we expected the average monthly WAR to be below 3%.
- The rate reached a low of 1.23% mid-month due to high liquidity.
- **This month we anticipate a slight increase (between 3.0% and 4.0%) in the rate due to a decline in market liquidity.**

Fig.10: High Liquidity suppressing interbank rates



Source: CBK

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