STERLING CAPITAL LIMITED

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Fixed Income Note

June 2019

"Will Eurobond 3 alter domestic debt demand?"

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Executive Summary

- **"Will Eurobond 3 alter domestic debt demand?"** is the title of our June 2019 fixed income report.
- **The report** provides an investment analysis of two re-opened issues, FXD1/2012/15 (8.42 years and FXD1/2018/15 (13.94years).
- The coupon of the 2012 is 11% while that of the 2018 issue is 12.65% with the latter being higher than the current traded yield on the Nairobi Securities Exchange.
- The National Government has been active on the fiscal deficit funding front raising US$2.1Bn (KES.213.2Bn) from its 3rd Eurobond issue and US$1Bn (KES.101.5Bn debt from the World Bank).
- This pushes commercial and international loans well above revised receipt targets and in our opinion will go a long way in bridging the gap resulting from other receipt shortfalls.
- Amongst these receipt shortfalls is domestic debt. The increase in external funding will most likely reduce the pressure on the domestic debt primary market.
- This will in effect result in declining yields in the short term, a scenario we observed in the previous two bond issues.
- With regards to macro-economic variables and specifically inflation and the foreign exchange rate, we see some degree of decline, this behind the Monetary Policy Committee (MPC) decision to retain the policy rate.
- Over the next few months we keenly await the impact of the Government's decision to change currency notes and its impact on macro-economic stability.

CBK taps into the domestic debt market to raise KES.40Bn

- Two debt issues FXD1/2012/15 & FXD1/2018/15 (15Year) are re-opened this month aiming to raise KES.40Bn (Table.1).
- The term to maturity is 8.42 years for the 2012 issue while the 2018 issue has a one of 13.94 years.
- Our Weighted Average Rate (WAR) of bid predictions are 11.60% and 12.50% for the 2012 and 2018 issues respectively. (Table. 2).
- We expect higher investor interest in the 2012 issue due to its shorter maturity as well as declining yields on the long end of the yield curve.

Table.1: Primary Bond issue summary

Issue Number	**FXD 1/2012/15**	**FXD 1/2018/15**
Total Amount Offered	KES.40Bn	
Tenor (Years)	8.42	13.94
Coupon Rate (%)	11.000	12.65
Issue Price	Discounted/Premium/Par	Discounted/Premium/Par
Period of Sale	29th May -11th June 2019	
Auction Date	12th June2019	12th June 2019
Value Date	17th June 2019	17th June 2019
Yield Curve 31st May 2019 (%)	**11.50**	**12.40**

Source: Central Bank of Kenya

Table.2: Historical primary market auction performance

Issue Number	Amount Offered (KES.Bn)	Bids Received (KES.Bn)	Amount Accepted (KES.Bn)	Performance Rate (%)	Coupon Rate (%)	Implied Yield to Maturity
FXD1/2018/15	40	20.22	12.86	50.54	12.65	12.400
FXD2/2018/15	40	27.05	7.85	67.61	12.75	12.400
FXD2/2018/15 (Re-open)	32	25.38	21.26	79.30	12.75	12.400
FXD1/2019/15	40	25.07	14.72	62.67	12.86	12.563
FXD1/2019/15 (Re-open)	12	16.41	15.96	136.72	12.73	12.616

Source: Nairobi Securities Exchange

Bid predictions - 11.65% (2012) & 12.55% (2018)

- We predict investor bids for the 2012 issue at around 11.65% with the weighted average of accepted bids at 11.60%.
- For the 2018 issue we see bids at 12.55% with the weighted average of accepted bids at around 12.50%.

Table.3: Auction bid predictions

Security	FXD1/2018/15 (13.94Yrs)	FXD1/2012/15 (8.42Yrs)
Market Weighted Average Rate (%)	**12.55%**	**11.65%**
Weighted Average Rate of	**12.50%**	**11.60%**

Source: Sterling Capital Research

- We also use implied yields for bonds currently trading on the Nairobi Securities Exchange (as at 31st May 2019) to guide our investor bid predictions (Table.4).

Table.4: Benchmark issues to guide investor bids

Current Bond Issue	Coupon Rate (%)	Benchmark Bonds	Issue Date	Term to Maturity Years (Days)	Last traded Yield (%)	Trade Date
FXD1/2012/15	11.00	FXD1/2017/10 (10YR) Re-opened	24th Sep - 2012	8.42	11.499	31st May 2019
FXD1/2018/15	12.65	FXD2/2018/15 (15yr)	22nd Oct - 2018	13.94	12.400	31st May 2019

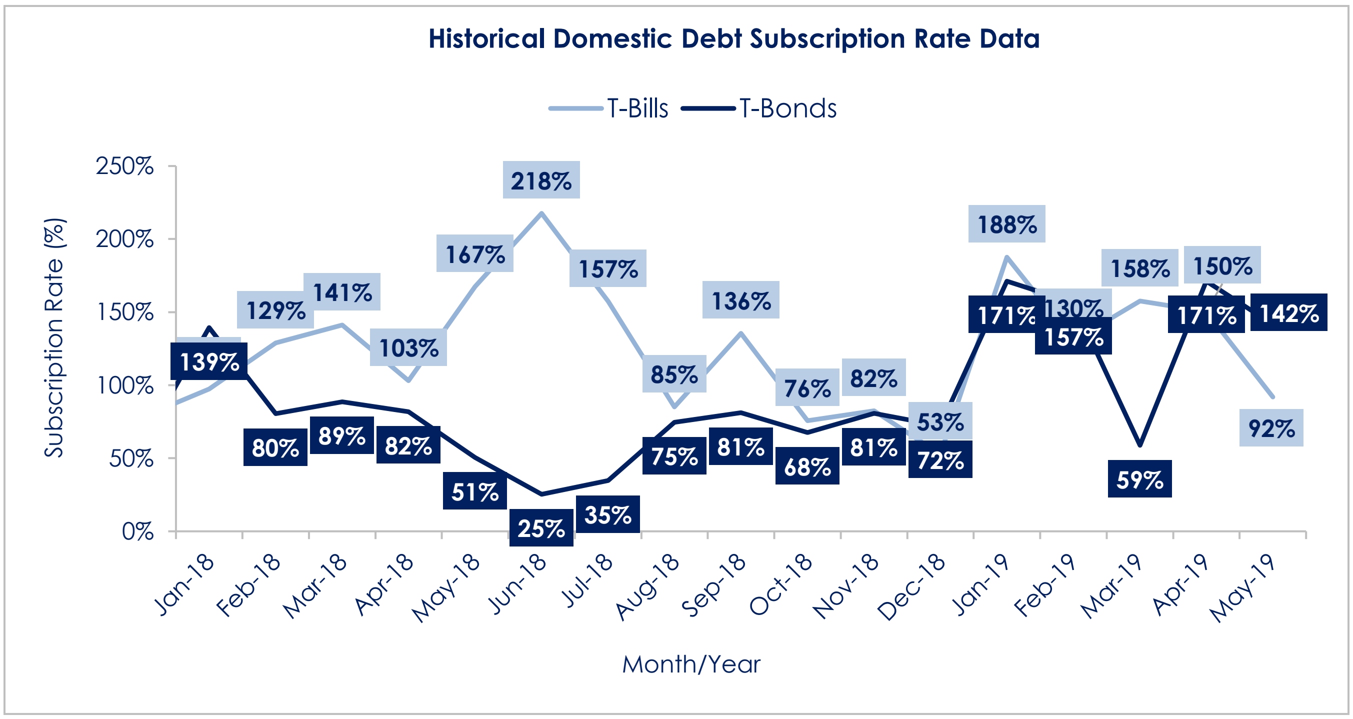
Source: Nairobi Securities Exchange

Domestic debt demand declines in May 2019

> Demand for domestic debt declined in May compared to April with T-Bills undersubscribed.

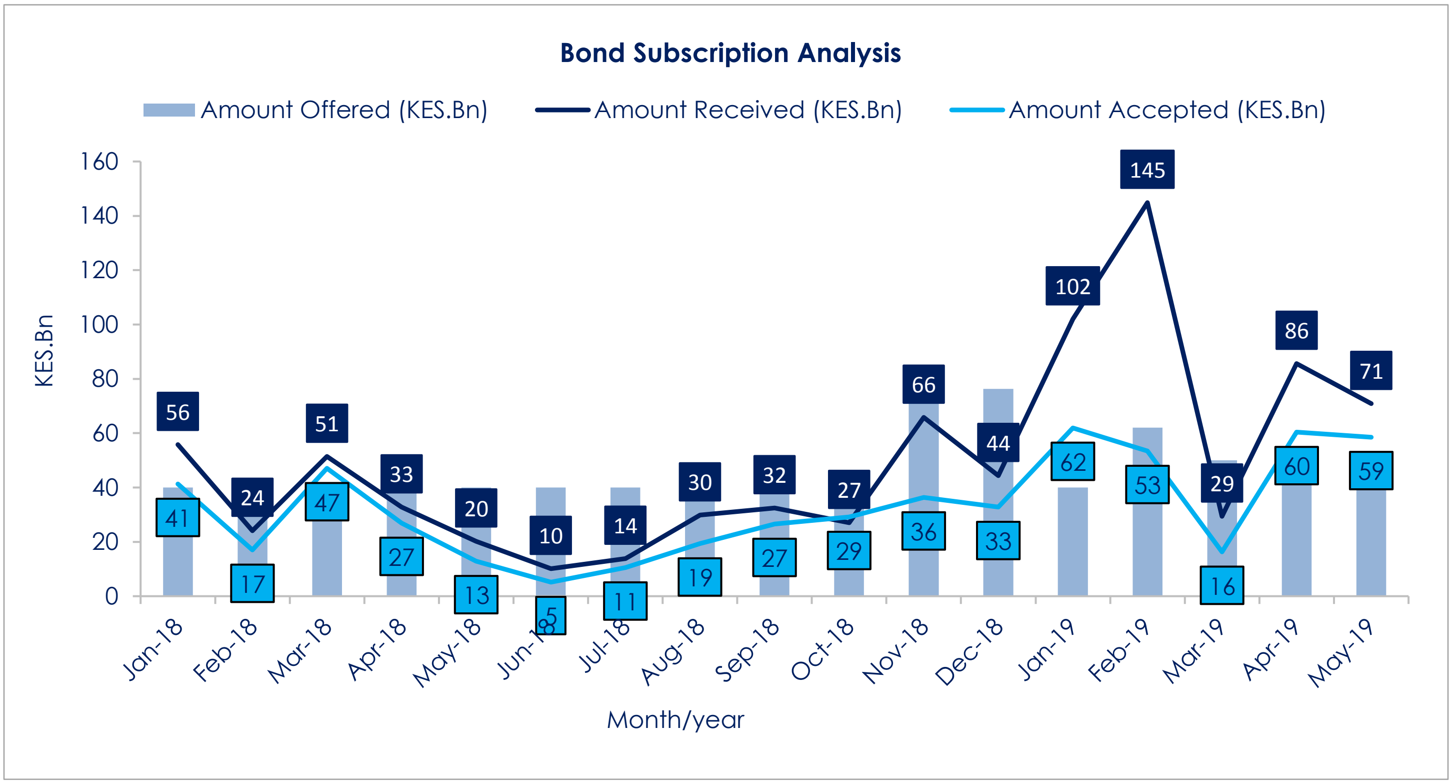
- Demand for domestic debt securities declined in May 2019 with subscription rates for T-bills and T-Bonds at 91.9% and 141.7% respectively compared to 150.4% and 171.2% in April respectively (Fig.1 and Fig.2).
- A total of KES.70.8Bn worth of investor bids was received for the KES.50Bn bond issue while KES.110.3Bn was received for T-Bills worth KES.120Bn.
- High subscription for T-Bonds was a direct result of the issuance of a 5 year bond that received KES.49Bn almost the entire KES.50Bn that the CBK wanted to raise during the month.
- Domestic debt subscription was partially impacted by market liquidity which tightened slightly during the month with an average interbank rate of 5.55% compared to 3.4% in April.
- The 364-day T-Bill extend recent trends receiving the bulk of investor subscriptions recording a 164.1% subscription rate (KES.82Bn).
- This is an indication that investors expect interest rates to either decline further or remain relatively low in the next one year and therefore wish to lock in comparatively higher rates and avoid re-investment risks associated with shorter dated securities.

Fig.1: Demand for domestic debt declines in May 2019



Source: Central Bank of Kenya

Fig.2: Historical Treasury bond subscription analysis 2018-2019 - High appetite for short dated securities



Source: Central Bank of Kenya

KES.1.4Tn in actual receipts equivalent to 55.4% of total fiscal target.

National Government receipts still fall short of revised target

- Data from the National Treasury indicates that 73.8% of the KES.2.6Tn revised fiscal receipt target had been achieved as at the end of April 2019 (Table.5) and Fig.3).
- This however is likely to be significantly impacted by the receipt of US$2.1Bn (KES.213.2Bn), US250Mn (KES.25.4Bn and US750Mn (KES.76.1Bn) through sovereign debt, and World Bank loans in April and May 2019.
- This means that Loans -Foreign Gov't & International Org and Commercial loan targets will be surpassed following the new round of funding.
- This is particularly relevant to investors in domestic debt for the following reasons:

  1) Lower National Government appetite for domestic debt funding which is likely to end the fiscal year below annual fiscal target.

  2) CBK accepting lower investor bids and rejecting aggressive bids in domestic debt auctions due to reduced pressure to raise funding from the domestic debt market.

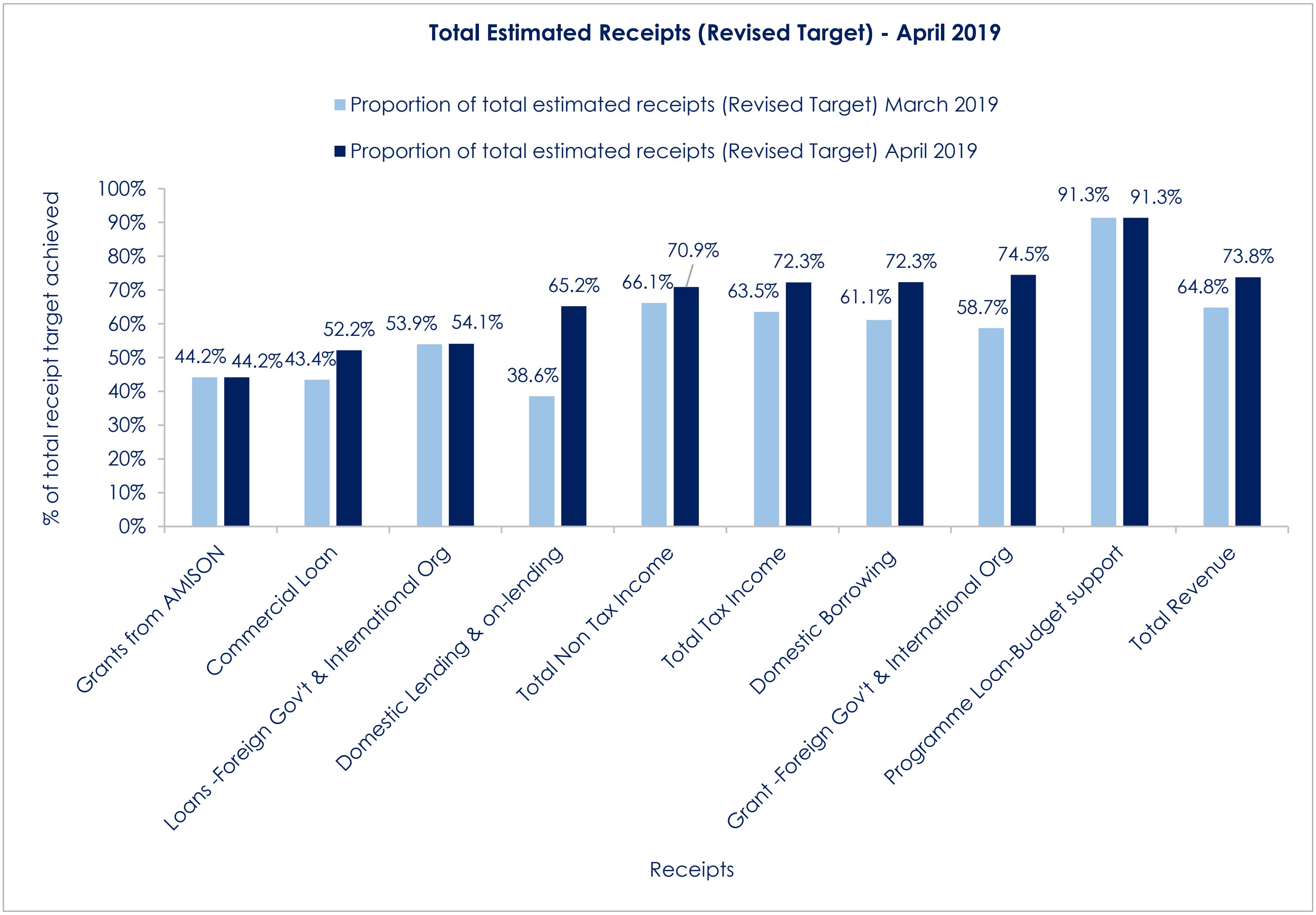
Table.5: National Government receipts for the 2018/19 fiscal year below revised target

Receipts	Original Estimates (KES.Bn)	Revised Estimates (KES.Bn)	Actual Receipts (KES.Bn) End April 2019	Proportion of Total Revised Target (End April 2019)
Opening Balance (1st July 2018)	0	0	102.79	
Grants from AMISON	8.50	8.50	3.76	44.2%
Commercial Loan	287.95	287.95	150.28	52.2%*
Loans -Foreign Gov't & International Org**	55.29	56.79	30.74	54.1%
Domestic Lending & on-lending	3.93	3.93	2.56	65.2%
Total Non-Tax Income	78.94	67.04	47.52	70.9%
Total Tax Income	1,690.29	1,605.59	1,160.73	72.3
Domestic Borrowing	**489.01**	**537.47**	**388.69**	**72.3%**
Grant -Foreign Gov't & International Org	12.92	12.92	9.62	74.5%
Programme Loan-Budget support	2.50	2.50	2.28	91.3%
Unspent Balances (Recoveries)	-	-	6.83	-
Total Revenue	**2,629.33**	**2,582.69**	**1,905.79**	**73.8%**

*Excludes US$2.1Bn (KES.213.2Bn) Euro Bond secured in May 2019.
** Excludes US250Mn (KES.25.4Bn) International Bank for Reconstruction & Development (IBRD) approved on 30th April 2019.
**Excludes US750Mn (KES.76.1Bn) International Development IDA credit approved on 28th May 2019.

Source: The Kenya Gazette Vol. CXXI - No.64 18th May 2019

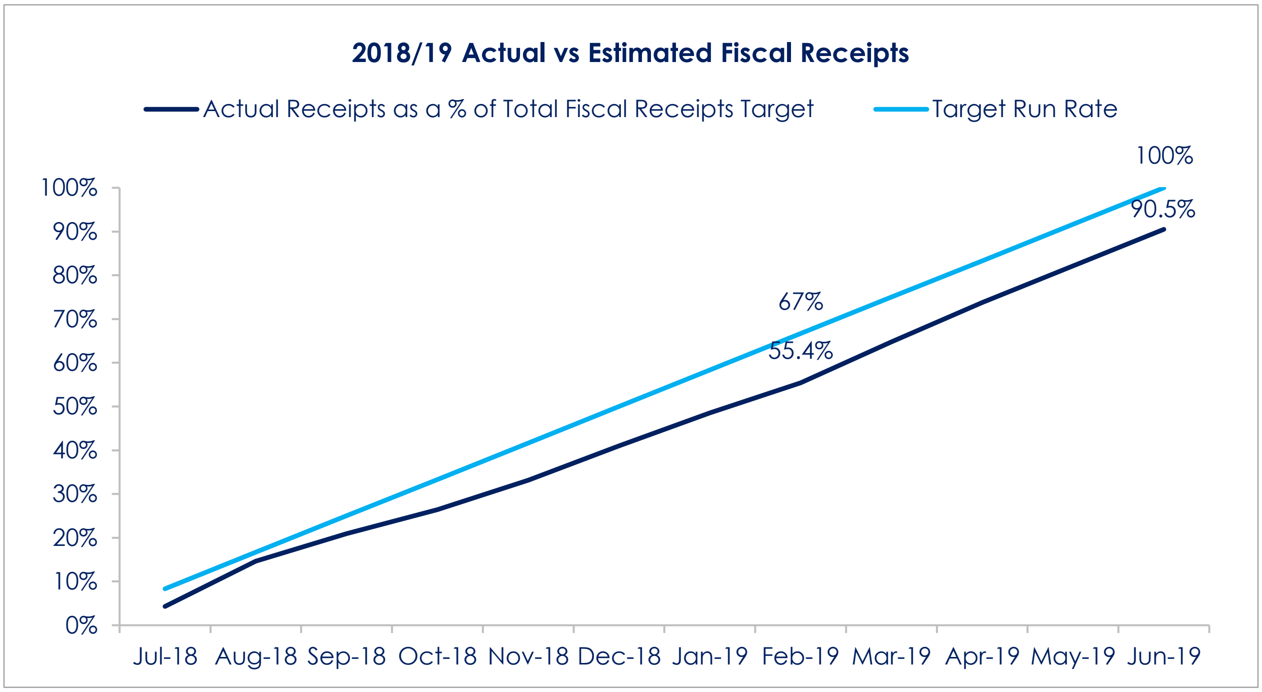
Fig.3: Actual National Treasury receipts now at 73.8% of total 2018/19 fiscal year target



Source: The Kenya Gazette Vol. CXXI - No.64 18th May 2019

- The fiscal receipt run rate is expected to improve in May and June following the issue of a Eurobond and access the funds from the World Bank (Fig.4).

Fig.4: CBK receipt run rate points to missing its 2018/19 fiscal year target



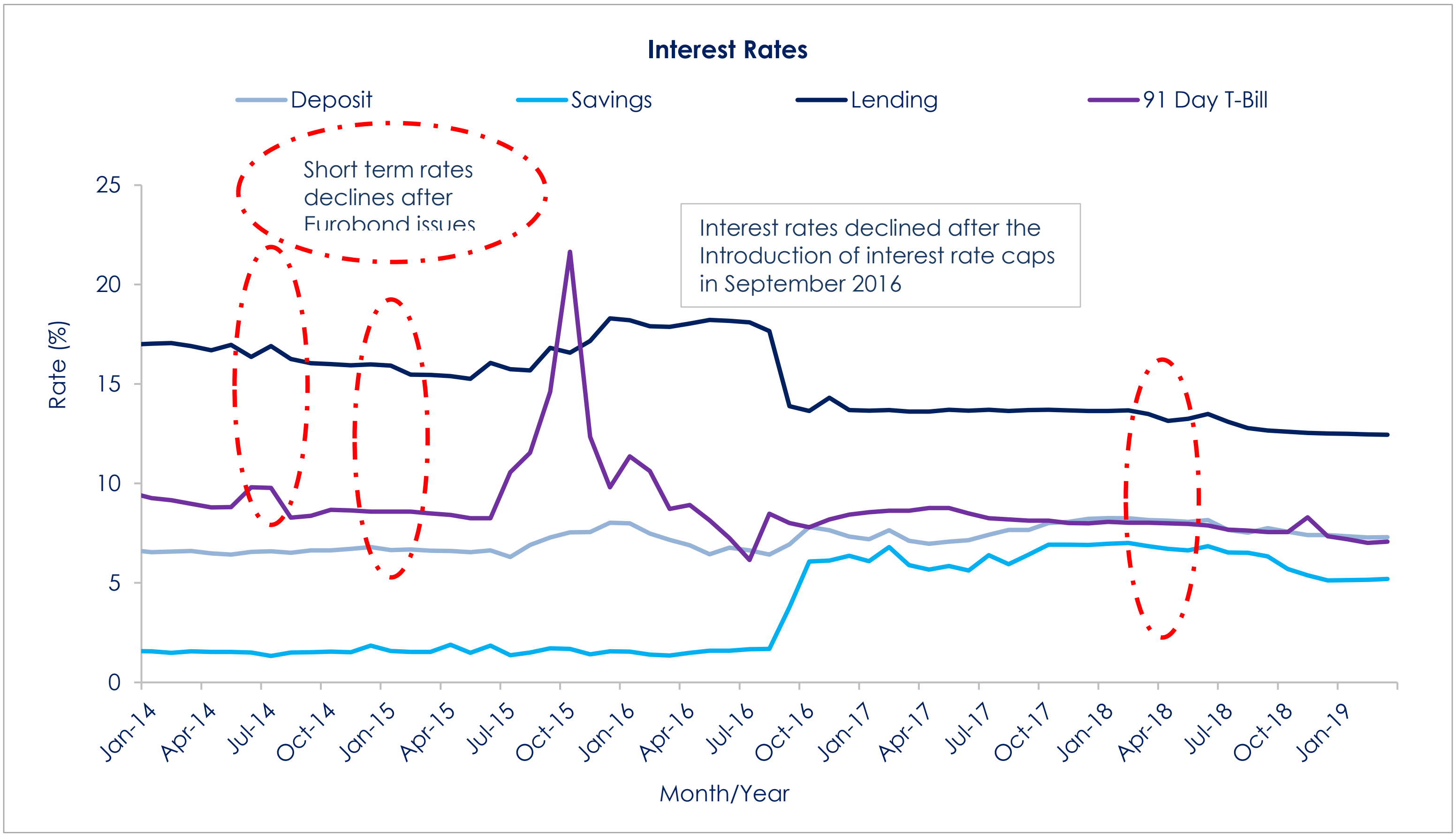
Source: The Kenya Gazette Vol. CXXI - No.64 18th May 2019 & Sterling Capital Research Estimates

Could Eurobond 3 suppress domestic interest rates as did the other two issues?

Domestic interest rates could drop marginally due to a decline in Government's appetite for domestic debt after securing international and sovereign debt.

- We attempt to determine the potential impact of the most recent Eurobond issue US$2.1Bn (KES.213.2Bn) (Eurobond 3) on domestic interest rates by looking at the impact of the other two issues in June 2014 and February 2018 (Fig.5).
- We observe a decline in commercial bank lending rates and short term debt (91 Day T-Bills) interest rates immediately after the Eurobond issues (Fig.5) particularly after the June 2014 issue.
- The effect of the reopening of the 2014 issue had little impact on short-term rates as was the case of the second Eurobond issue in February 2018.
- However, note that the impact of the second issue was significantly watered down by interest rate caps introduced in September 2016 (interest rates declined immediately after the rate caps were introduced).
- In effect, there is a likelihood of a decline in domestic debt demand by the National Government resulting in the rejection of aggressive investor bids in debt auctions.
- However, existence of interest rate caps has reduced the potential interest rate impact and decline in interest rates will be marginal if any.

Fig.5: Could Eurobond 3 suppress domestic debt interest rates further?



Source: Central Bank of Kenya

High absorption rate of Government revenue indicates an underlying funding gap

- The absorption rate of Government revenue (uptake of receipts funds for both recurrent and development expenditure) as at April 2019 remains relatively high at 98.7% (March 2019 98.8%) (Table.6).
- This means that the funding need remains high and the Government will remains active in its sources or funding from both internal and external sources.
- This also explains the need to issue the Eurobond and access funding from the World Bank in April and May 2019.

Table.6: High revenue absorption rates suggest high fiscal financing needs

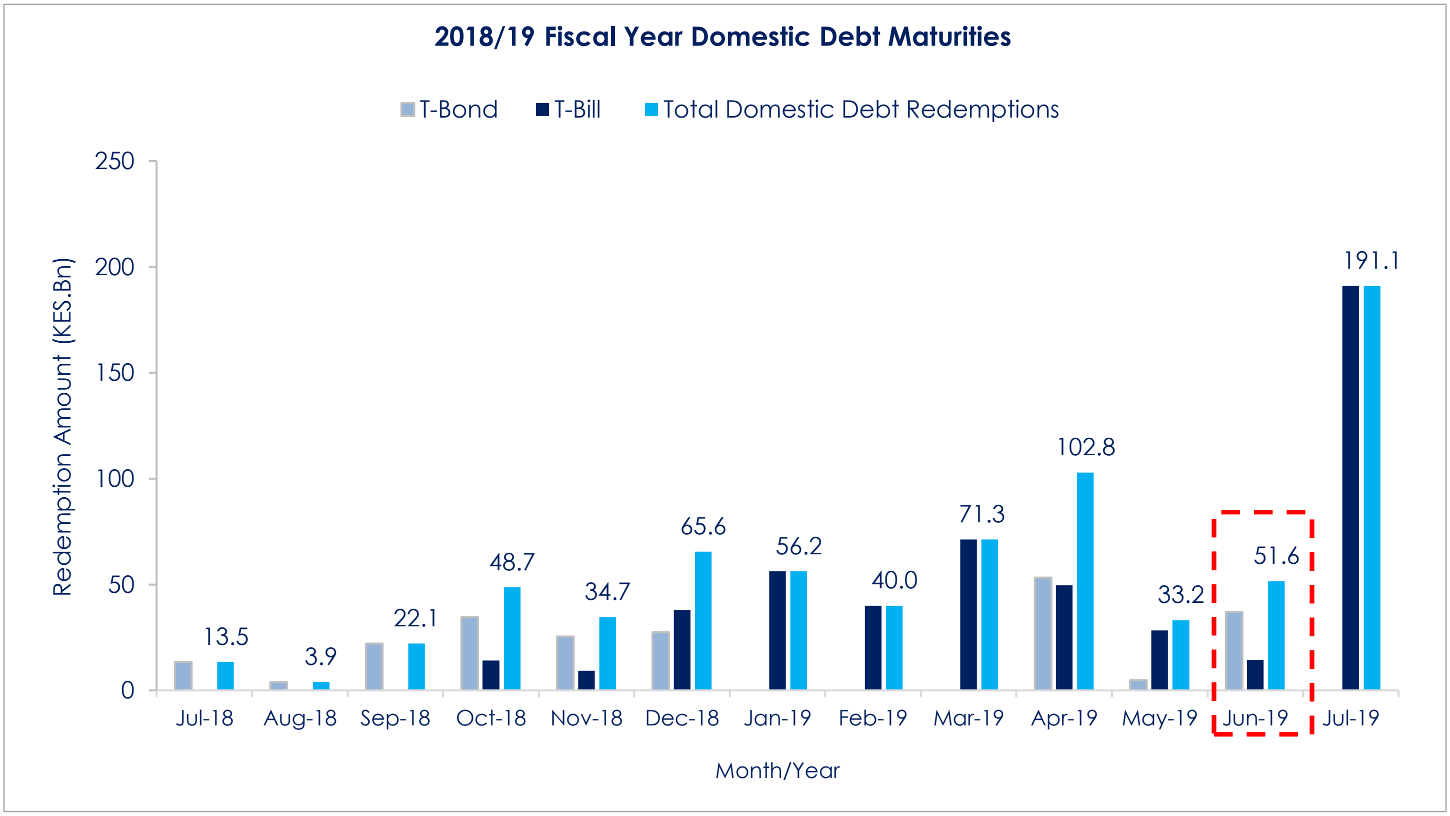
Exchequer Issue	Revised Estimate (KES)	Actual (KES)
Total Government Revenue (Actual) KES.(A)	2,582.7	1,905.8
Total National Government Expenditure	2,253.3	1,645.8
Total Expenditure (County Governments) (C)	329.3	234.3
Grand Total (B+C)	2,582.7	1,880.1
Exchequer Balance (A-B-C)	-	25.7
Absorption Rate (B+C)/A	**-**	**98.7%**

Source: The Kenya Gazette Vol. CXXI - No.47 18th April 2019& Sterling Capital Research Estimates

KES.51.6Bn in domestic debt maturities for June 2019

- KES.51.6 in domestic debt maturities (T-Bonds KES.37.1Bn and T-Bills KES.14.5Bn) in the last month of the 2018/19 financial year (Fig.6).
- This is significantly lower than April (KES.102.8Bn) but higher than May (KES.33.2Bn).
- This combined with the impact of external financing is likely to reduce demand for domestic funding.

Fig.6: June debt maturities at KES.51.6Bn

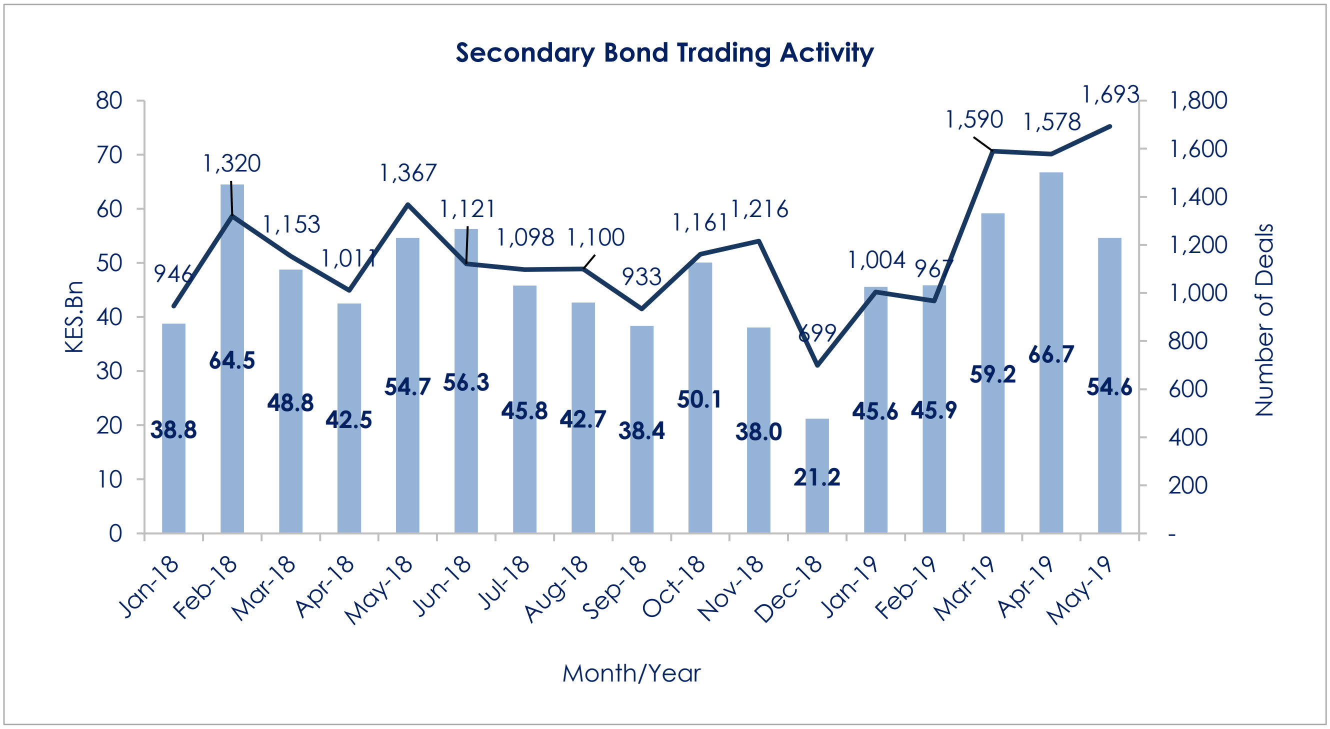


Source: Nairobi Securities Exchange

Low market liquidity suppresses secondary market trading activity in May

- May bond turnover declined to KES.54.6Bn an 18.1% decline over the previous month in spite of a 7.3% increase in the number of trading deals.
- This was largely because of a decline in market liquidity (Fig.7), albeit on fewer trades 1,578 compared to 1,590 in the previous month.
- We observed an increase in turnover over the last week of May due to an increase in liquidity (supported by Government payments) and expect trading activity in June to be higher than that in May.

Fig.7: Bond turnover declines 18% in May due to tight market liquidity



Source: Nairobi Securities Exchange

Short-end and long end of the yield curve exhibit the biggest shift

- We choose to compare two yield curves, 25th May 2018 the time of issue of FX1/2018/15 and the latest available yield curve on 31st May 2018 (Table.8 & Fig.8).
- There is a general downward shift in the curve with the biggest shifts on the short and long end of the curve.
- The big shift in the short end is a direct result of investor preference for shorter dated securities with virtually all issues receiving huge subscriptions.
- The CBK has in turn chosen to reject aggressive investor bids on these securities resulting in lower yields.
- The CBK has been issuing longer dated securities in its bid to lengthen the maturity profile of public debt and this explains the flatness of the curve on the long end.

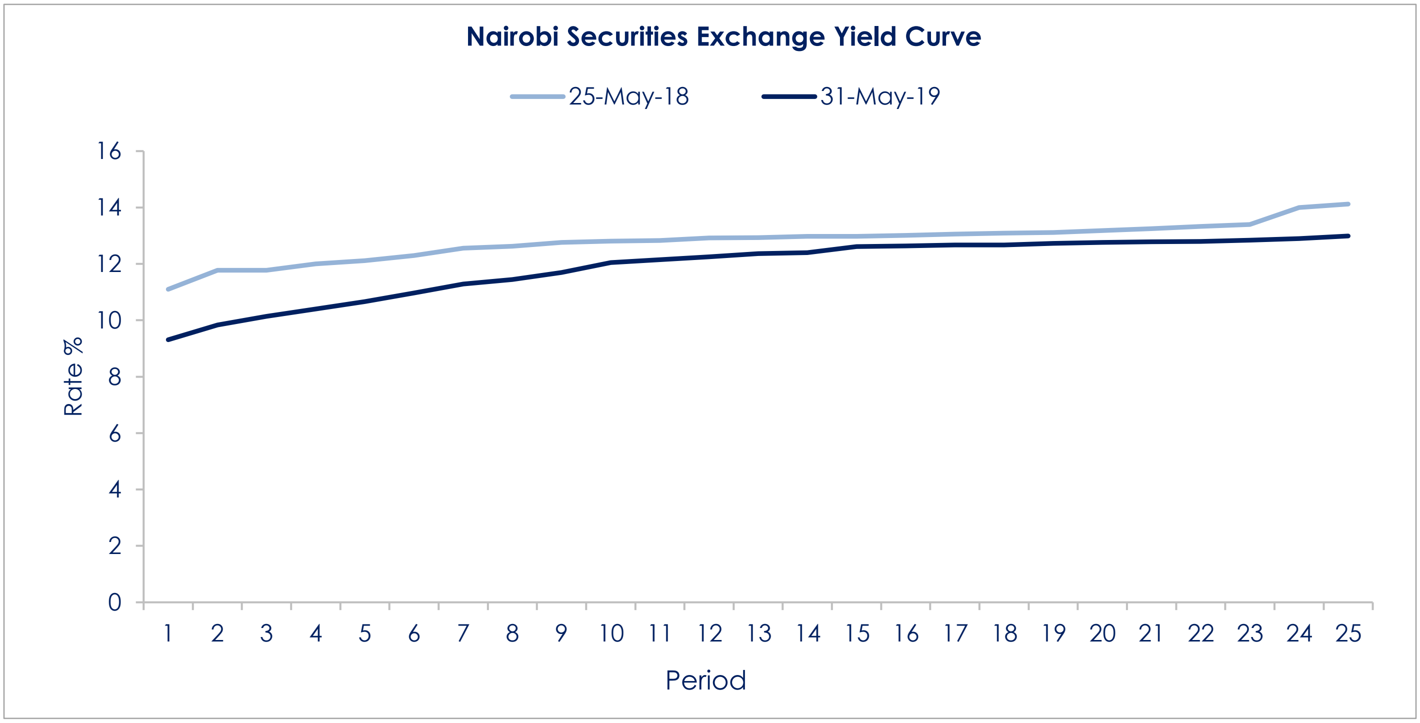
- We expect a further downward shift in the yield curve in the short term owing to increased market liquidity and lower CBK appetite for domestic funding (following the successful issuance of the Eurobond in May as well as funding from the World Bank).
- **Our fixed income investing strategy remains unchanged as we continue to advise investors to HOLD long term bonds and BUY short and medium term tenor issues.**

Table.8: Yield decreases for short and medium tenors

Tenor	Yield (25th May 2018)	Yield (31st May 2019)	Change (Bps)
1	11.1000	9.3110	↓179
2	11.7713	9.8365	↓193
5	12.1172	10.6588	↓146
10	12.8090	12.0417	↓77
15	12.9820	12.6156	↓37
20	13.1793	12.7667	↓41
25	13.1215	12.9900	↓113

Source: Nairobi Securities Exchange

Fig.8: Short-end of the yield curve exhibits biggest shift Yield curve shifts further down for the short term maturities

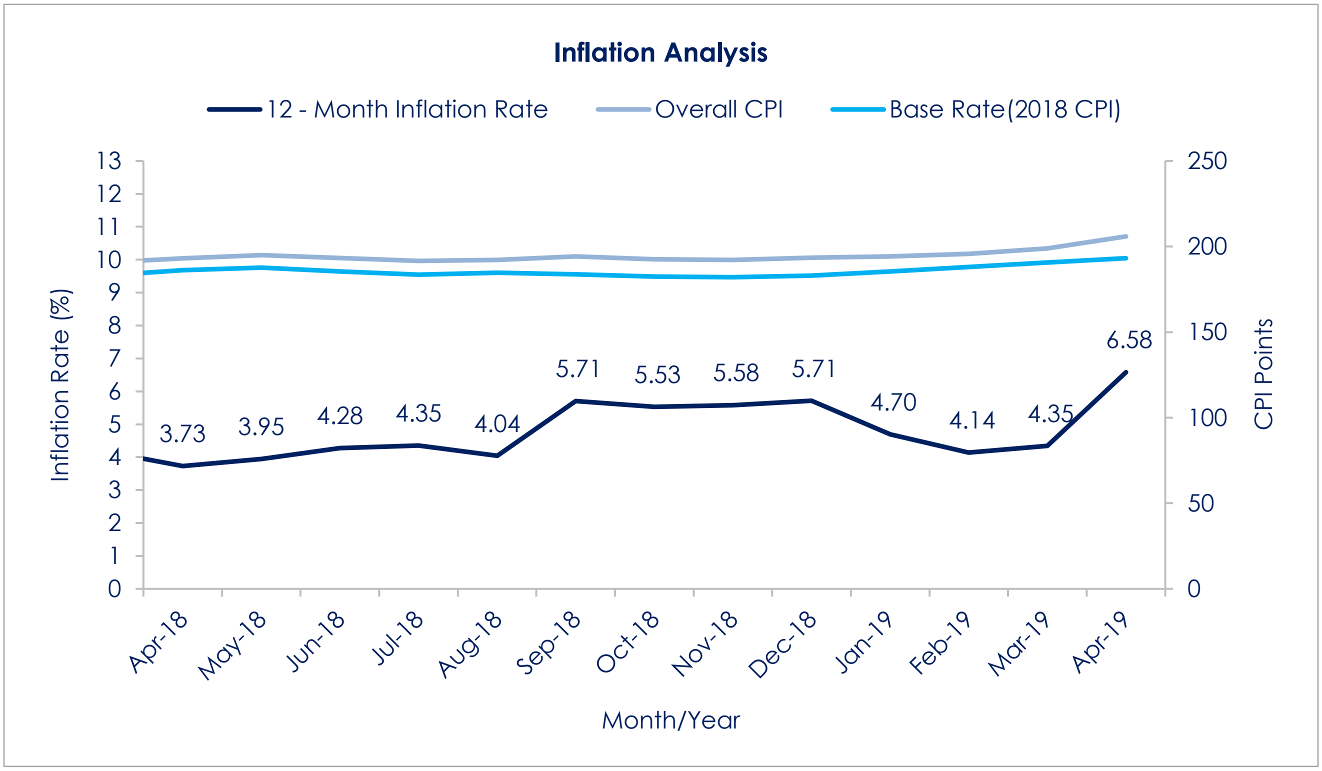


Source: Nairobi Securities Exchange

June inflation forecast - 5.0% to 6.0%

- Kenya National Bureau of Statistics (KNBS) released monthly Consumer Price Indices (CPI) and rates of inflation, for May 2019 indicating an inflation rate of 5.49% (Fig.9) a decline from 6.58% in April, 2019.
- This was largely attributable to a year on year decrease in the food component of the CPI.
- We expect relative stability in inflation in June - **5.0%-6.0% levels largely due to improved weather conditions that will see food prices decline.**

Fig.9: June Inflation rate at 5%-6% levels

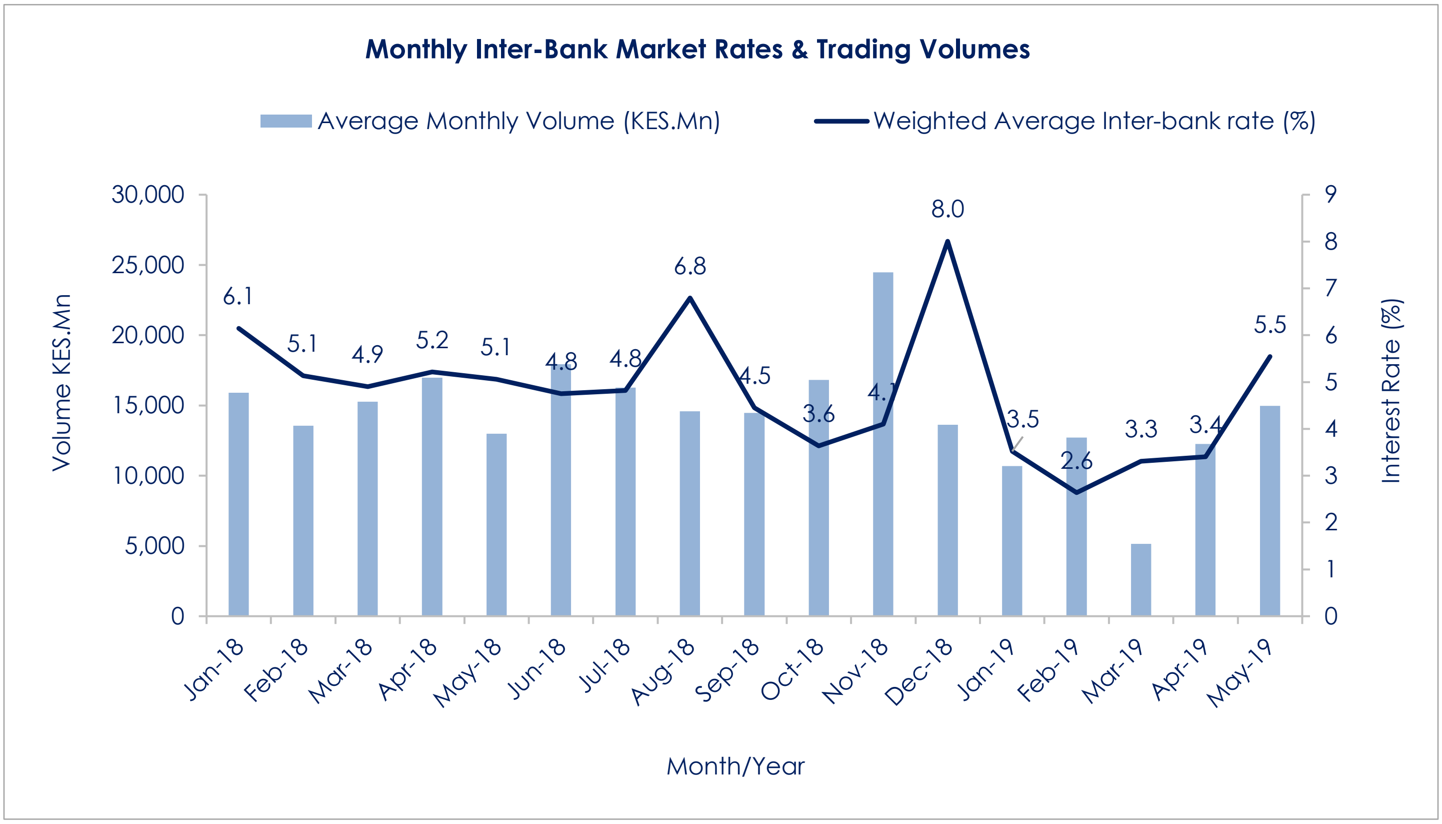


Source: Kenya National Bureau of Statistics

Interbank rates to remain relatively stable in June as the 2018/19 fiscal year draws down

- The Average Interbank Rate rose to 5.5% in May from 3.4% in April (Fig.10) on account of tax remittances during the first three weeks of the month.
- Average volumes traded over the same period declined 22.3% to KES.12.3Bn.
- Market liquidity eased towards the end of May on account of Government payments and the end of the tax remittance period.
- **We forecast the average interbank rate for the month of June to remain stable at between 4.5% and 6%.**

Fig.10: Inter-bank rates rise in May due to low market liquidity



Source: Central Bank of Kenya

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