STERLING CAPITAL LIMITED

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Fixed Income Note

October 2019

"Biggest IFB goes on sale"

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Table of Contents

Executive Summary

- The Central Bank of Kenya (CBK) issues the biggest Infrastructure Bond yet at KES.60Bn **IFB1/2019/16**.
- This is the second IFB this calendar and the first the 2019/20 fiscal year.
- The previous largest issues were IFB1/2018/20 and IFB1/2019/25 (also the longest tenor - 25 years).
- Market liquidity has declined significantly since the last IFB issue thanks to CBK Repurchase Agreements (Repos) that have mopped up close to KES.100Bn in market liquidity.
- This together with the magnitude of the current issue is likely to have an impact on its subscription rate.
- **In terms of expected yields on the issues, we predict the Weighted Average Rate (WAR) of bids at between 12.20 and 12.50% and a weighted average rate of accepted bids at between 12.20% and 12.30%.**
- On Government accounts we see the National Treasury slightly behind our linear required run rate estimate for receipts after the first two months of the fiscal year.
- CBK action resulted in a significant reduction in secondary market trading activity in September and we expect this to continue in October.
- The macro-economic environment remains stable and we expect this to remain for the rest of the calendar year, a reason why we do not expect any revisions to monetary policy.

CBK issues 16Yr Infrastructure bond seeking KES.60Bn

Bonds issue likely to be under subscribed on account of low liquidity due to mop ups by the CBK and the size of the issue.

- The Central Bank of Kenya (CBK) invites investor bids to raise KES.60Bn through the sale of **IFB1/2019/16** (Table.1).
- The 16-year tax free bond will have a coupon determined by market auction.
- IFB will have an amortized redemption structure making its effective tenor 13.5 years.
- Redemption will take place in phases; the first one (50%) scheduled for October 2030 and the second one set for October 2035, which is also the full maturity date of the issue.
- We expect a KES.40-50Bn in subscription for the issue largely on account of the large issue size.

Table.1: Primary Bond issue summary

Issue Number	IFB1/2019/16
Total Amount Offered	KES.60Bn
Tenor (Years)	13.50 Yrs
Coupon Rate (%)	Market Determined
Issue Price	Discounted/Premium/Par
Period of Sale	2nd Oct -22nd Oct 2019
Auction Date	23rd October 2019
Value Date	28th October 2019
Yield Curve (%) (Weighted average tenor 13.5 years) 11th October 2019	**12.22**

Source: Central Bank of Kenya

Investor bid predictions -12.20%-12.50%

- **We predict market bids for the IFB to be around 12.20-12.50% with the weighted average of accepted bids at 12.20-12.30%** (Table. 2).
- The last infrastructure bond was floated in March 2019 (IFB1/2019/25) it had a coupon rate of 12.2% and received subscription of 58.75% due to its tenor.

Table.2: Auction bid predictions

Security	IFB1/2019/16
Market Weighted Average	12.20-12.50
Weighted Average Rate of Accepted Bids (%)	12.20-12.30

Source: Sterling Capital Research

- We reviewed historic IFB auction results which show heavy demand for issues with tenors less than 20 years. 12 and 15 year issues in particular have been oversubscribed (Table.3).
- We however note that prevailing market and economic conditions such as market liquidity, interest rates and other factors had an impact on the performance of the respective auctions.

Table.3: Historical primary market auction performance

Issue	Offered (KES.Bn)	Bids Received (KES.Bn)	Amount Accepted (KES.Bn)	Performance Rate (%)	Coupon Rate (%)	Average Yield
IFB1/2014/12	15	38.8	15.8	258.5	11	11.30
IFB1/2015/12	25	51.7	25.7	206.6	11	11.60
IFB1/2015/12 (Tap)	25	51.7	24.0	97.53	11.00	11.56
IFB1/2015/9	35	16.6	14.0	55.3	11.00	14.75
IFB1/2016/15	30	35.1	30.6	117.0	12.0	13.28
IFB1/2017/12	30	35.0	6.0	116.8	12.50	13.05
IFB1/2017/12 (Tap)	-	8.0	7.6	-	12.50	13.56
IFB1/2017/7	30	45.9	42.0	153.0	12.50	12.28
IFB1/2018/15	40	55.8	5.0	139.4	12.50	13.03
IFB1/2018/15 (Tap)		-	36.3		12.50	12.51
IFB1/2018/20	50	40.4	27.6	80.8	11.95	12.29
IFB1/2018/20 (Tap)		-	8.73	-	11.95	12.16
IFB1/2019/25	50	29.4	16.3	58.75	12.20	12.89

Source: Central Bank of Kenya

IFB1/2019/16 amortized redemption structure

- IFB1/2019/16 has an amortizing redemption structure, making its effective tenor 13.5 years.

Table.4: Amortized redemption tenor is 13.5 years

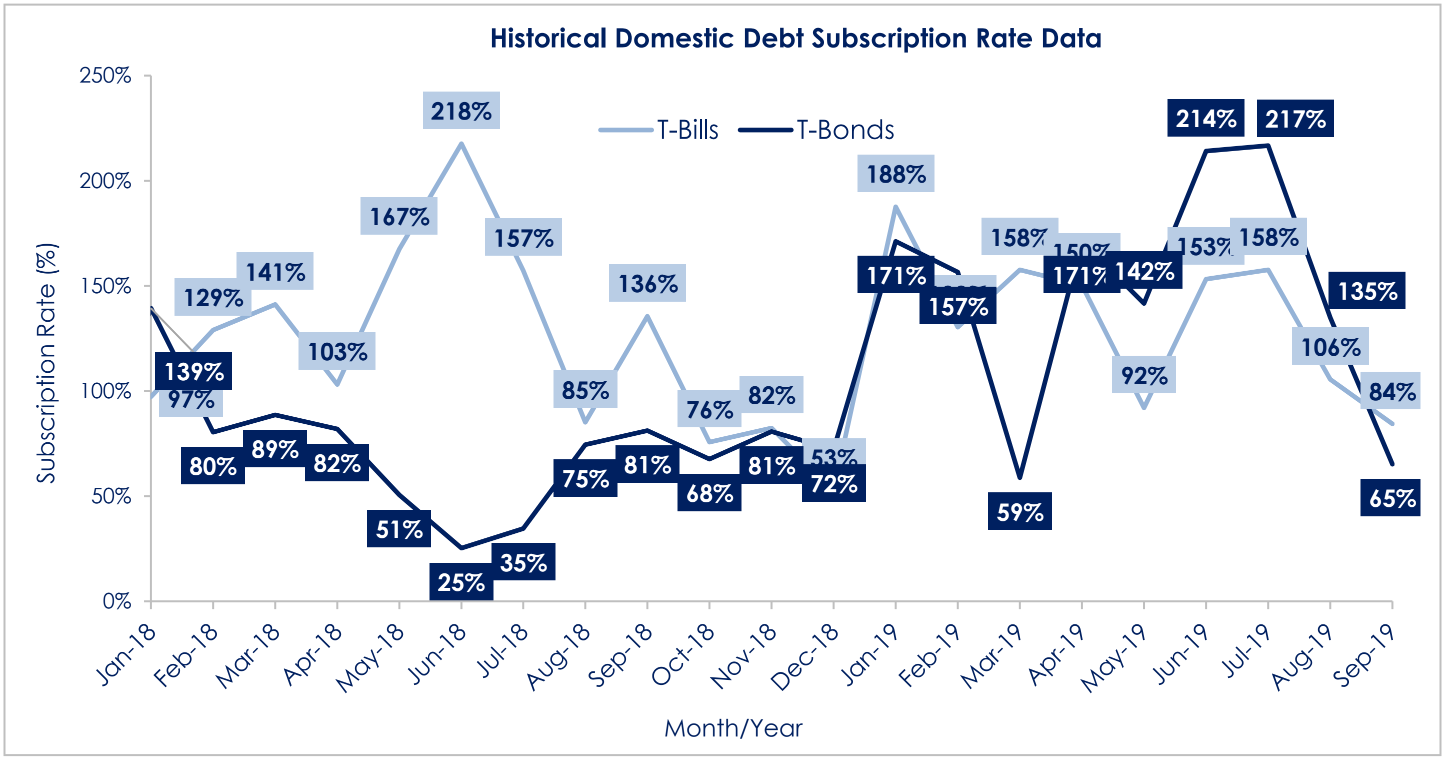
Redemption Period	% of principal amount	Tenor Calculation	Weighted Tenor
11 years (Oct 2019-2030)	50%	50%*11 years	5.5 years
16 Years (Oct 2019-2035)	50%	50%*16 years	8.0 years
Effective tenor			5.5 + 8.0 =13.5 years

Source: Central Bank of Kenya & Sterling Capital Research

Demand for 364 Day T-Bill remains high as investors lock-in yields

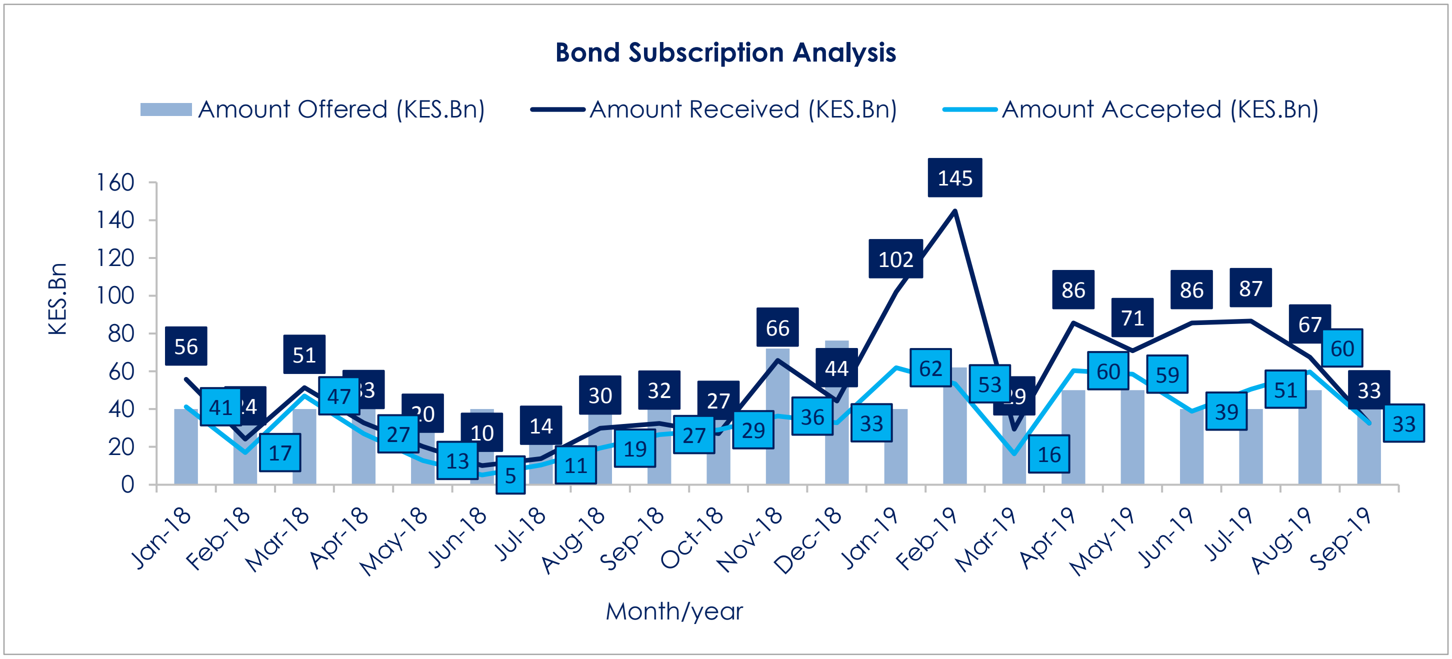
- CBK received bids worth KES.32.6Bn against a KES.50.Bn target a subscription rate of 65.3% for the two issues in September (Fig.1 & Fig.2).
- The two bond issues were opened for a tap sale later in the September, seeking to raise KES.30Bn receiving KES.9.4Bn equivalent to a 31.2% subscription rate.
- T-Bill subscriptions declined to 84.3% (KES.101.2Bn against a target of KES.120Bn) during the month compared to 105.5% in August (KES.101.3 against a target of KES.96Bn).
- The low subscription rate is attributable to the long tenor of the two issues as well as the low market liquidity as a result of CBK mopping up market liquidity through Repurchase agreements (Repos) during the month.
- The 91, 182 and 364-Day T-Bills recorded subscription rates of 102.9% (KES.20.6Bn), 19.7% (KES.9.8Bn) and 141.6% (KES.70.8Bn) respectively.
- Both yields and demand for the 364 day paper have been on the rise with demand attributed to investors who prefer to lock-in comparatively high rates for a longer period and we expect this trend to continue in the short term.

Fig.1: Domestic debt subscription rates decline in September



Source: Central Bank of Kenya

Fig.2: CBK accepts KES.60Bn of the KES.67.4Bn received in August T-Bond auctions

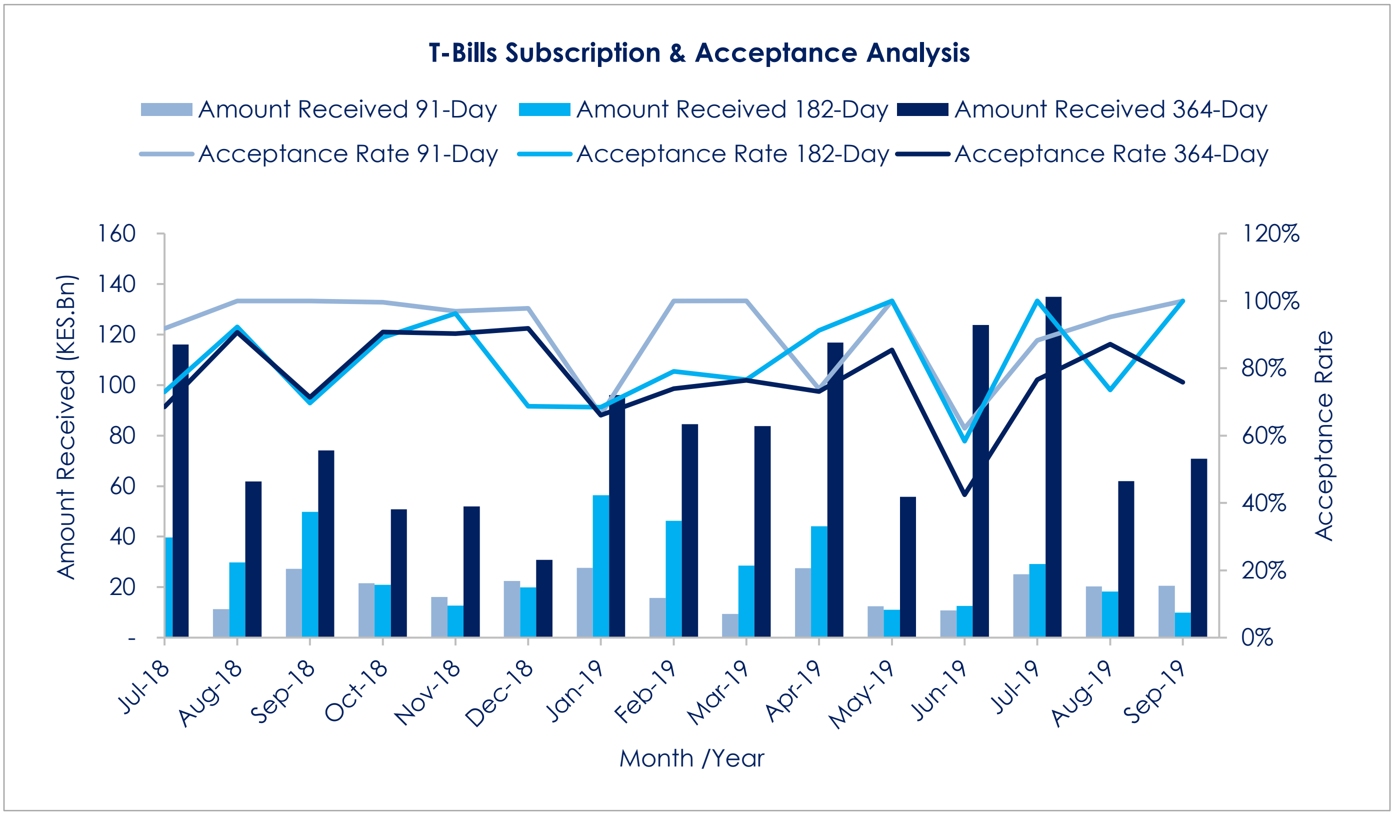


Source: Central Bank of Kenya

Significant increase in subscription rates for the 364-Day paper

- The average yields for 91-day and 182-day debt issues declined in September by 0.1% and 0.03% to 6.4% and 7.1% while the 364-day T-Bill rate increased 0.4% to 9.6% (Fig.3).
- There has been a high demand for the 364-Day T-Bill during the year as investors lock-in the rates in anticipation for a further decline in yields for the short term papers.
- The aggregate T-Bill acceptance rate declined to 83.1% (KES.84.1Bn) compared to 86.3% (KES.86.73Bn) in August against the amount offered KES.96Bn and KES.120Bn respectively.
- The 91 day and 182 day treasury bills are expected to decline further in the short term as CBK continues to reject expensive auction bids.
- For the period under consideration (Jul 2018-Sep 2019) the 91 day, 182 day and 364 day T-Bill acceptance rates stood at 91%, 82% and 77% respectively.
- The 364 day T-Bill seems to have the lowest acceptance rate despite the high demand due to relatively high investor bids.

Fig.3: Significant increase in subscription rates for the 364 day T-Bill

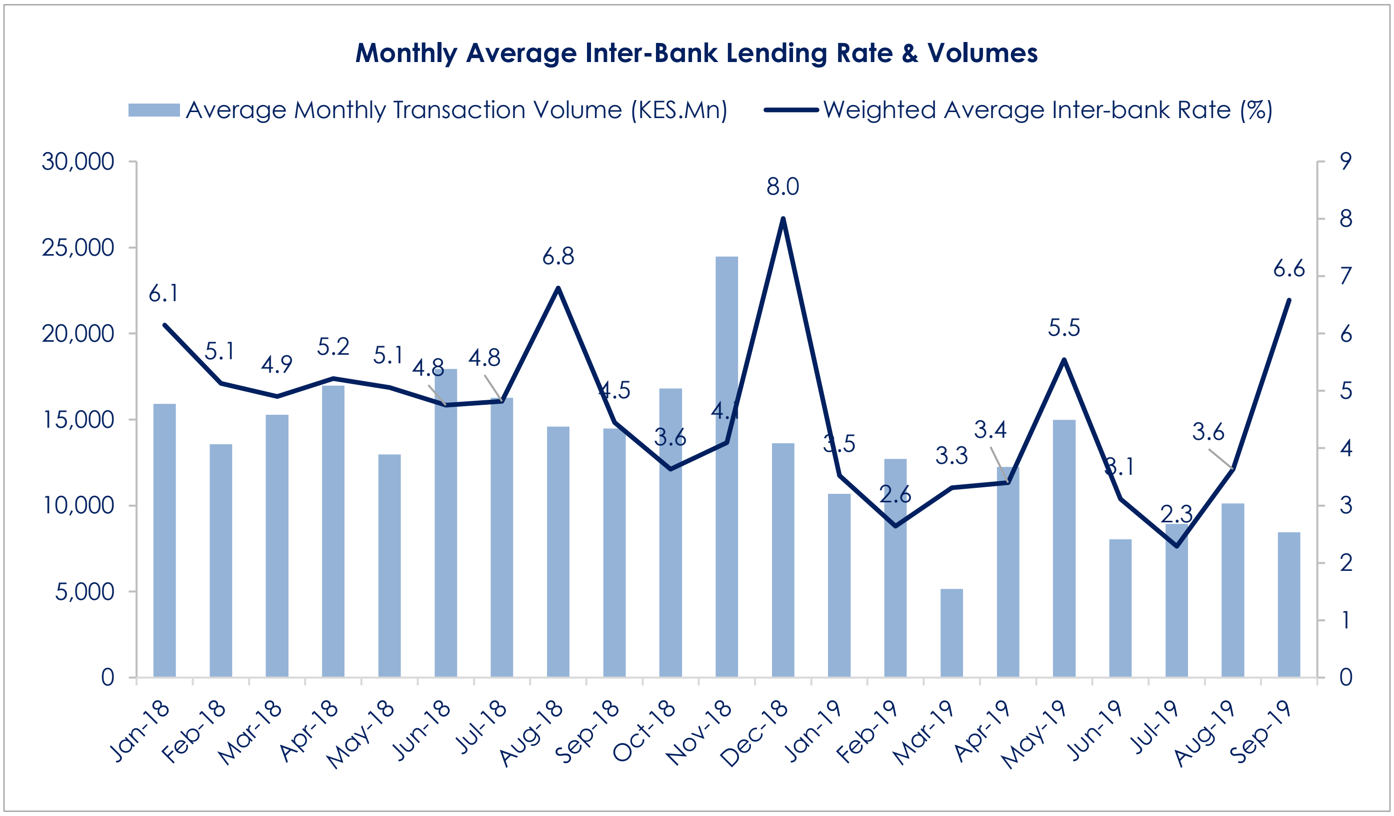


Source: Central Bank of Kenya

CBK repos cuts down excess market liquidity

- Average market weighted inter-bank rates increased from 3.6% in August to 6.6% in September, while volumes declined slightly from KES.10.1Bn to KES.8.4Bn (Fig.4).
- The rise in inter-bank rates is attributable to CBK's action of mopping up excess market liquidity through repos.
- Market liquidity still remains high and we expect the CBK to remain active in the repo market in the month of October.
- For this reason we have adjusted our initial expectations of the inter-bank rate for the rest of the year which we estimate to remain above 5%.
- The liquidity mop up however is likely to have a slight impact on primary domestic debt auction demand and a much felt impact on secondary trading activity.

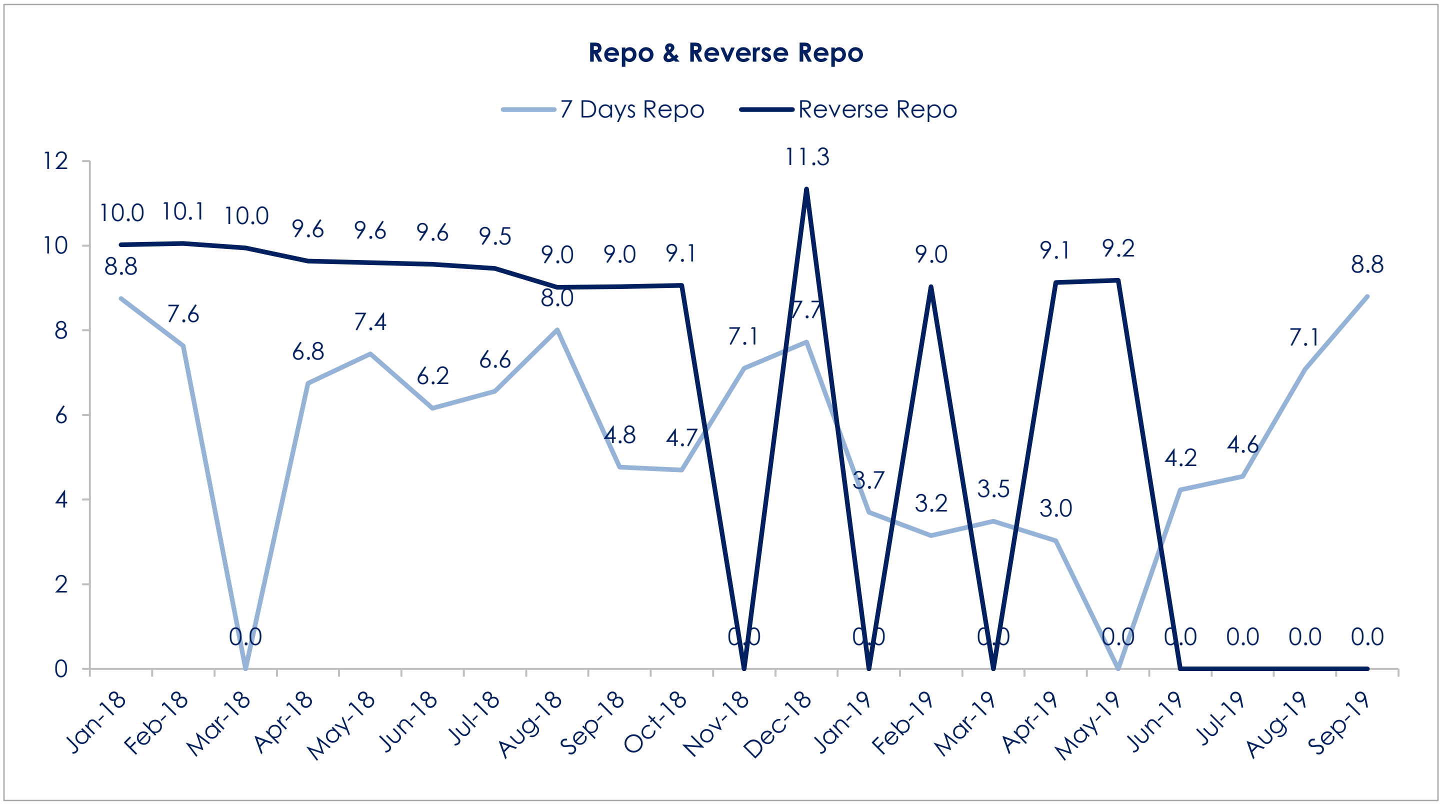
Fig.4: CBK's mopping up activity has resulted in a rise in inter-bank lending rates



Source: Central Bank of Kenya

- The CBK continued to mop up excess market liquidity in September 2019 (Fig.5).
- Data on repos are scanty as it is not published by the CBK. However, it is estimated that at least KES.65Bn was mopped up during the month at an average rate of 8.96% near the maximum rate allowable in repos is the Central Bank Rate (9%).
- The impact of the CBK action was a rise in inter-bank rates to an average of 6.6% compared to 3.6% the month earlier.
- We believe that CBK intends to mop up more liquidity in October with controlling inflation and reigning excess commercial bank liquidity (51% average liquidity in July) amongst they key reasons for this activity.

Fig.5: CBK active in the repo market to reign in on excess market liquidity

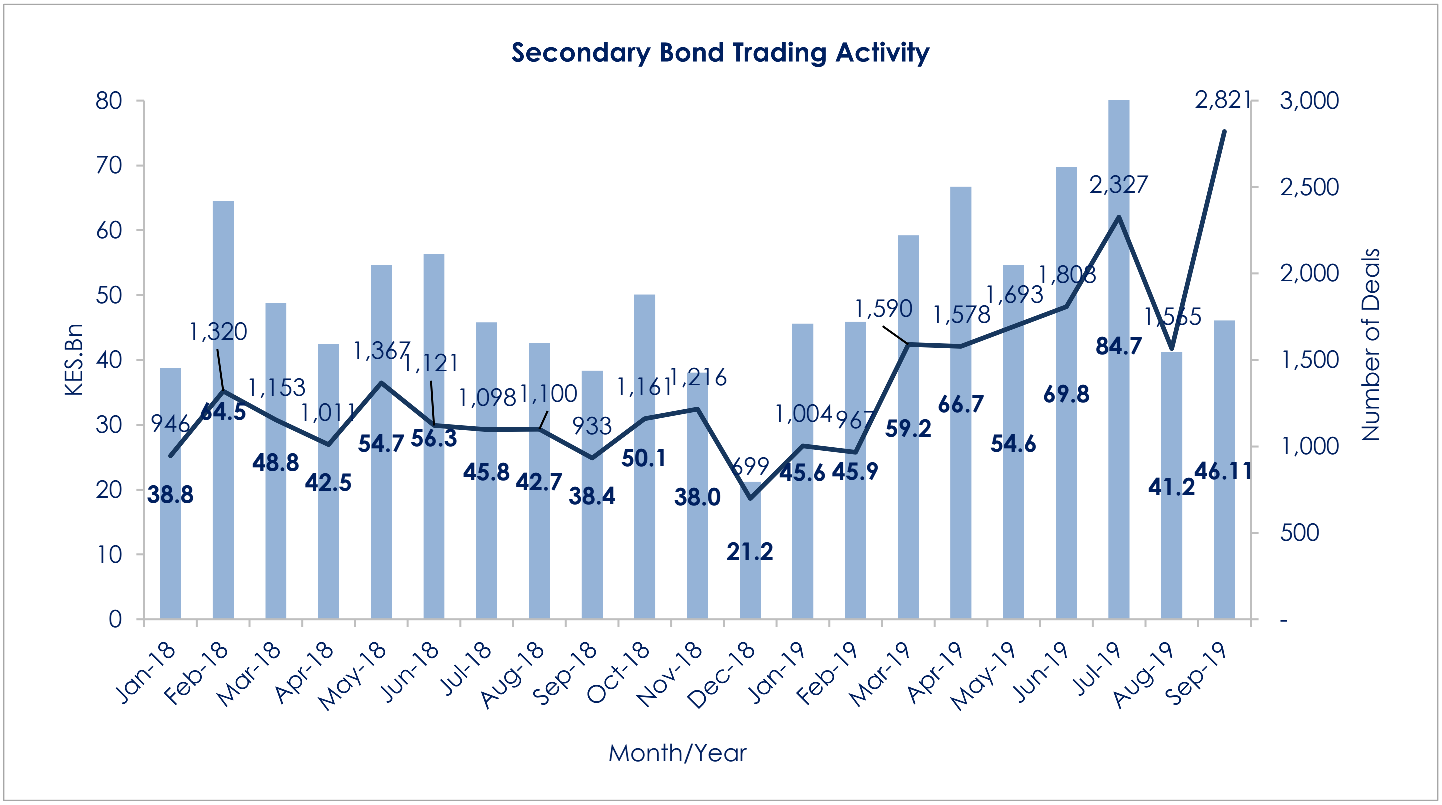


Source: Central Bank of Kenya

Secondary market trading activity in September exhibits modest growth

- Secondary market bond trading turnover rose 12% month on month to KES.46.1Bn with the number of deals increasing by 80% to 2,821 (Fig.6).
- The high trading activity was supported by the central government's KES.316Bn cash allocation to the counties flowing through the banking system.
- We expect a significant reduction in secondary market trading turnover in October as a result of CBK mop ups through Repos.

Fig.6: Secondary market trading activity set to decline in October

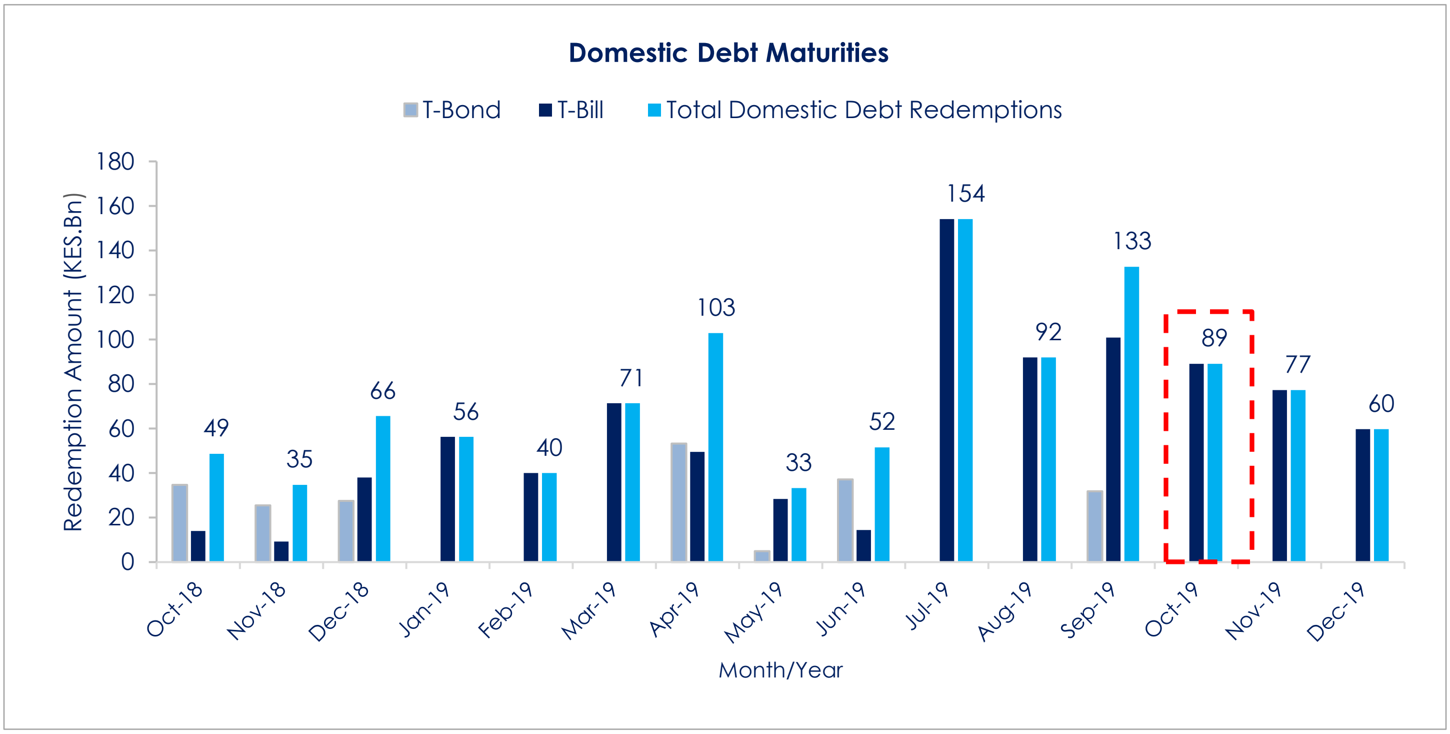


Source: Central Bank of Kenya

KES.89Bn in domestic debt redemptions slated for October 2019

- Total bond redemptions for October 2019 stand at KES.89.1Bn a decline from KES.132.7Bn in September (Fig.7).
- No bond maturities are expected in October 2019 with the entire KES.89Bn in T-Bill maturities.
- Domestic debt maturities are expected to decline to KES.77Bn in November, and lower to KES.60Bn in December 2019, implying a reduction in government appetite for borrowing towards the end of the calendar year.

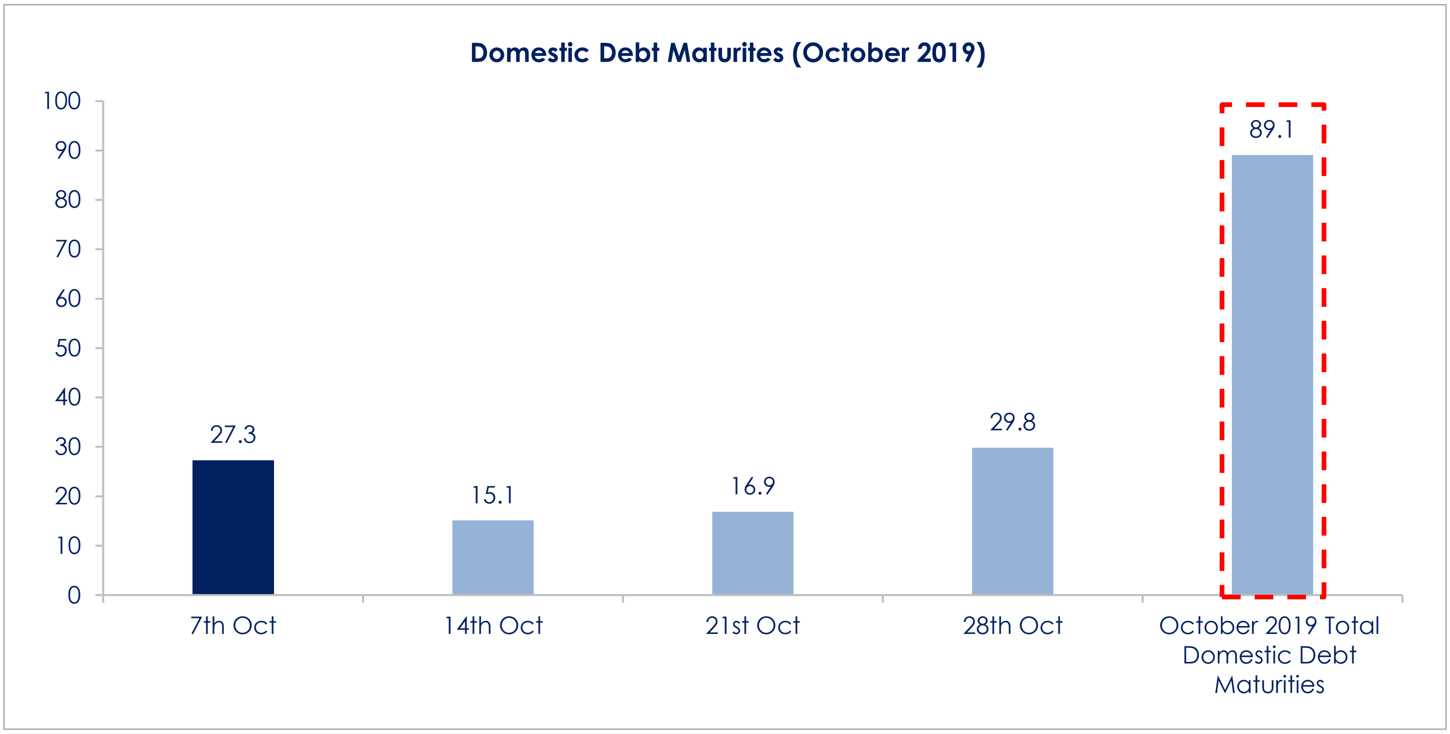
Fig.7: September debt maturities at KES.123Bn



Source: Central Bank of Kenya

- Our analysis of weekly debt maturities shows a growing number of maturities in the weeks ahead of the bids closure date for the IFB1/2019/16 (Fig.8).
- We do not expect this to have a significant impact on the government's acceptance rate, as the overall level of maturities has fallen to KES.89Bn compared to KES.133Bn in September.

Fig.8: Weekly debt maturities in October 2019



Source: Source: Central Bank of Kenya

Both total tax income and domestic borrowing are below our required run rate which could be a concern if it

National Treasury revenues marginally below target in first two months of 2019/20 fiscal year

- Data provided by the National Treasury as at the end of August 2019 the second month of the 2019/20 fiscal year indicates that it has collected KES.394.1Bn equivalent to 15.2% of its annual revenue target (Table.5).
- Assuming a linear growth rate in revenue collection, the National Treasury is marginally below the required run rate (16.7%) to achieve its annual target (Fig.9).
- KES.67.5Bn has been borrowed from the domestic debt market against a target of KES.422.9Bn which equates to 16%.
- We would be concerned if total tax income which currently falls below the 16.7% (KES.301.3Bn) required run rate at 12.2% (KES.221.4Bn. of the annual target persists.
- We however see decisive action from the tax authorities to enforce tax compliance and collections including prosecution of suspected tax defaulters and evaders.
- This means that the National Treasury would need to tap in alternative funding sources to bridge the budget deficit as was the case in the last financial year.
- We can therefore not rule out an upward revision to the domestic borrowing targets possibly in the second or third quarter of the fiscal year.

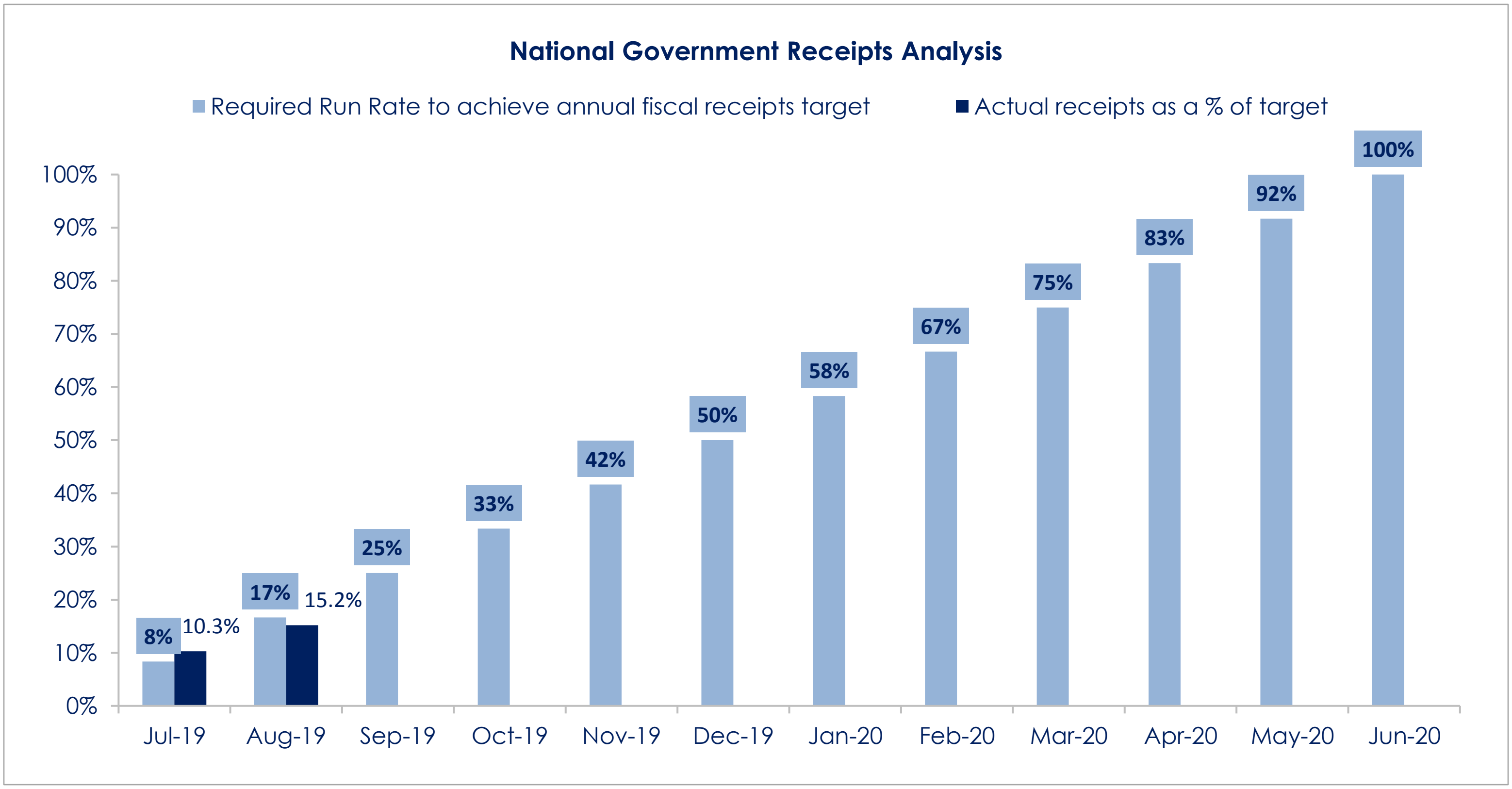
Table.5: Total receipts as at end of august 2019 at KES.394 equivalent to 15% of annual revenue target

Receipts	2019/20 Estimates (KES)	Actual Receipts (KES) End Aug 2019	Proportion of Receipt Target Achieved
Opening Balance (1st July 2019)		98.9	
Total Tax Income	1,807.6	221.4	12.2%
Total Non-Tax Income	69.5	1.6	2.4%
Domestic Borrowing*	422.9	67.5	16.0%
Loans -Foreign Gov't & International Org	65.2	0.0	0.0%
Programme Loan-Budget support	2.0	0.0	0.0%
Domestic Lending & on-lending	4.3	0.6	14.9%
Grant -Foreign Gov't & International Org	14.5	2.0	13.9%
Grants from AMISON	5.0	0.0	0.0%
Commercial Loan	200.0	0.0	0.0%
Unspent Balances (Recoveries)		2.1	-
Total Revenue	**2,591**	**394.1**	**15.2%**

Source: Source: The Kenya Gazette Vol. CXXI - No.125 20th September 2019

Note 1: Domestic Borrowing of KES. 422.9 = Net Domestic borrowing KES.300.3 & Internal debt redemptions (Roll-overs) KES.122.6.

Fig.9: Actual National Treasury receipts at 15.2% of total 2019/20 fiscal year



Source: Source: The Kenya Gazette Vol. CXXI - No.125 20th September 2019

Short and medium term bonds exhibit the biggest shift in yields year on year

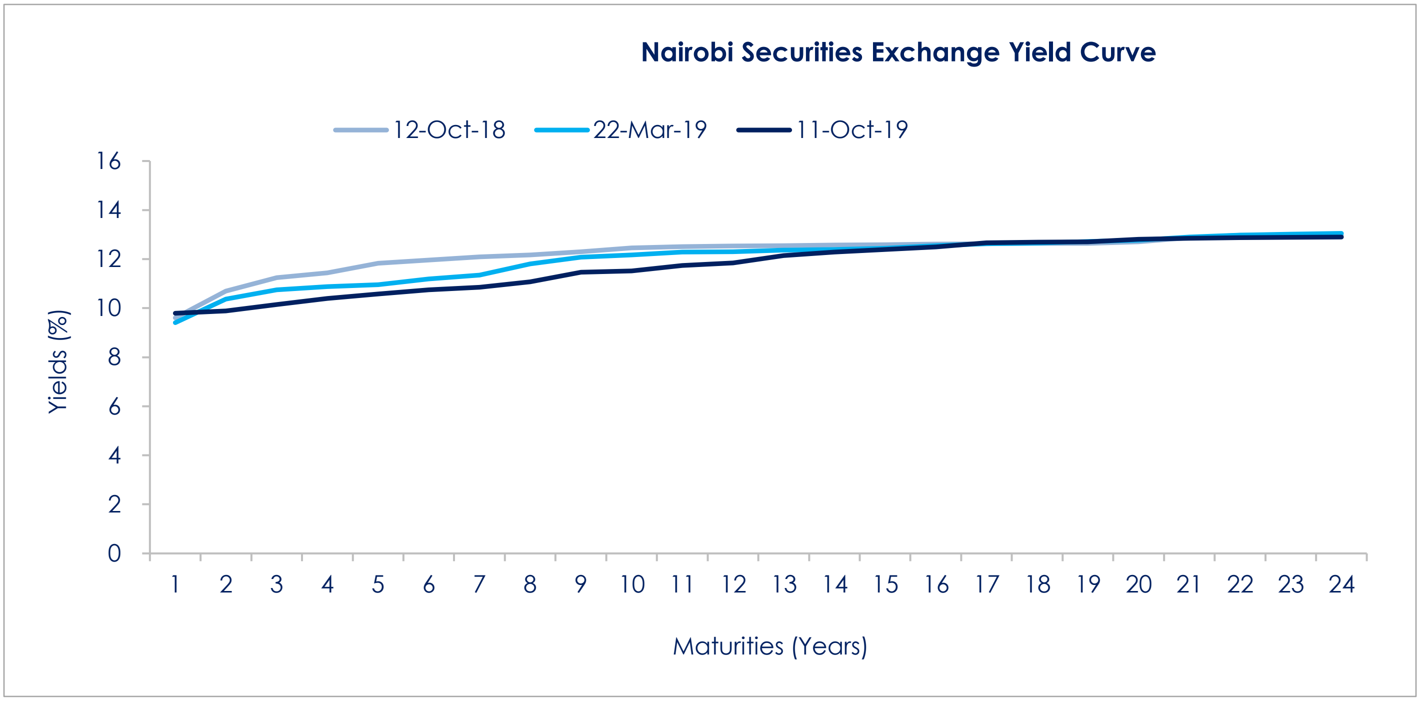
- Yields on Government securities exhibit mixed reactions with short and medium term papers experiencing bigger shifts y/y compared to long-term papers (Table.6 and Fig.10).
- The 2Yr, 5Yr and 10Yr papers declined by 82.0bps, 125.5bps and 94.3bps respectively during the period under review.
- High demand for the 364-days (1Yr) T-Bill has seen an 18.5bps increase in yields to 9.8%.
- With the interest rate cap still in place, we do not expect significant shifts in the yield curve.
- **Our recommendation remains: HOLD long term papers and BUY short and medium term bonds.**

Table.6: Mixed reactions on yields for benchmark domestic debt maturities

Tenor	Yield (12th Oct 2018)	Yield (11th Oct 2019)	Change Oct 2018/Oct 2019(Bps)	Sterling Capital yield Curve (11th Oct 2019)
1	9.61	9.79	↑18.50	9.90
2	10.70	9.88	↓81.96	10.03
5	11.83	10.57	↓125.49	10.70
10	12.46	11.52	↓94.25	11.60
15	12.58	12.40	↓18.72	12.53
20	12.70	12.81	↑10.94	12.80

Source: Nairobi Securities Exchange

Fig.10: Yields on short & long end shift upwards

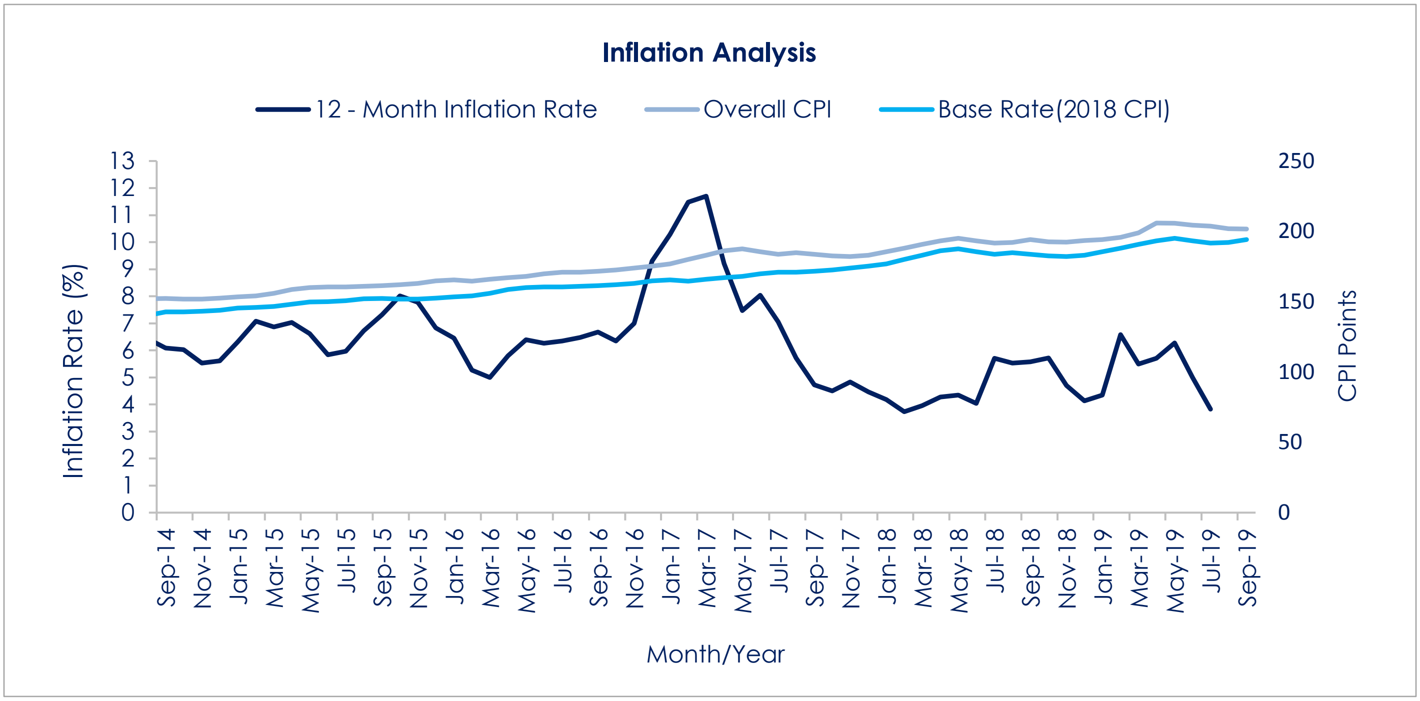


Source: Nairobi Securities Exchange

Inflation falls to 17-month low in September

- Inflation rate declined to 3.8% in September 2019 from 5.0% in August (Fig.11).
- This is the lowest rate since April 2018, thus moving below the mid-point of the CBK's 2.5%-7.5% target range.
- Annual average inflation inched down to 5.2% in September from 5.4% in August.
- The monthly decline in inflation was due to 0.4% decrease in prices for food and alcoholic beverages index.
- This drop was driven by a decline in prices of carrots, cabbages and tomatoes which decreased by 9.8%, 6.3% and 4.1% respectively.
- During the month the prices of other essential services increased. The transport index grew by 0.48% because of an increase in the price of petrol and diesel.
- The real rate of return on long term fixed income deposits will be boosted by this fall in inflation rate.
- We expect October inflation rate to range between **4.0-4.5%** due to lower food prices owing to favourable weather prices.
- **"Recent increase in international oil prices following Saudi Attack is expected to exert moderate upward pressure on fuel prices, but with limited pass-through effects on inflation"** ~ CBK Monetary Policy Committee (MPC)

Fig.11: October inflation forecast 4.0-4.5%



Source: Kenya National Bureau of Statistics

Monetary Policy Committee retained CBR at 9% on reduced inflation

- The Monetary Policy Committee (MPC) retained the Central Bank Rate (CBR) at 9.00% in their 23rd September meeting.
- MPC reported that inflation remained within the target range (2.5%-7.5%) and that the economy was "operating close to its potential".
- Inflation fell to 5.0% in August from 6.3% in July. September inflation declined further to 3.8%.
- The committee also noted that the foreign exchange market remained relatively stable, supported by narrowing of the current account deficit to 4.2% of GDP in the 12 months to July 2019 from 5.5% in July 2018.
- Narrowing of the current account deficit is driven by strong diaspora remittances, exports for horticulture and higher receipts from tourism.
- We do not expect a revision to the CBR on 25th November 2019 due to stable macroeconomic conditions.

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