STERLING CAPITAL LIMITED

Wednesday, 20 May 2020

Fixed Income Note-3

May 2020

"CBK's unusual offer"

Analysts:

Renaldo D'Souza
+254 (20) 2222651
Renaldo.DSouza@sterlingib.com

Susan Makena
+254 (20) 2222651
Susan.Makena@sterlingib.com

Elizabeth Njenga
+254 (20) 2222651
Elizabeth.Njenga@sterlingib.com

Justina Vuku
+254 (20) 2222651
Justina.Vuku@sterlingib.com

For queries call: +254 (20) 315414; 2244077 or
Email: research@sterlingib.com
Website www.sterlingib.com
Bloomberg Code: SCLK <GO>

Table of Contents

Executive Summary

- Our third fixed income report for the month of May 2020 titled **"CBK's unusual offer"** is an analysis of the Central Bank of Kenya's (CBK) third bond issue in the month of May 2020 an Infrastructure Bond IFB1/2020/6.
- The bond that seeks to raise KES.25.6Bn has an implied term to maturity tenor of 4.5 years and is exclusively open to holders of the 364-day T-Bill issue No. 2236/364, and for this reason we do not expect the bond to be oversubscribed as seen in previous IFBs.
- Our expectation is that investors will bid above current yield curve levels with our investor and CBK accepted bid predictions as follows:

  Weighted Average Rate (WAR) of bids: 11.75% - 11.90%
  Weighted average rate of accepted bids: 11.70% - 11.75%

- We include our analysis the rationale of this debt issue, potential re-financing and debt sustainability risks and give an opinion as to whether the Government is facing difficulties meeting its debt obligations.
- The report also discusses Kenya's national accounts detailing the current and upcoming fiscal year budgets.
- The final section of this report highlights our expectations for the MPC meeting to be held on 27th May 2020.

CBK's exclusive Infrastructure Bond offer

- Central Bank of Kenya (CBK) has returned to the primary bond market for the third time in the month of May 2020 but this time with a unique debt issue.
- It is inviting bids for a new 6-Year amortized infrastructure bond (IFB1/2020/6), **eligible only to investors with holdings in T-Bill issue No. 2236/364.**
- The bond seeks to raise KES.25.6Bn, slightly above KES.23.5Bn that was accepted for the 364-day paper (2236/364) at issuance suggesting that proceeds from this bond issue will be used to rollover the 364-day T-Bill
- We believe issuance of three bonds in one month is an indication of the huge deficit financing needs faced by the National Treasury particularly in the face of the negative impact of the Covid-19 pandemic on its receipts.

Table.1: IFB1/2020/6 Infrastructure bond Summary

Issue Number	**IFB1/2020/6**
Total Amount Offered	KES.25.6Bn
Tenor (Years)	6 Years
Coupon Rate (%)	10.200%
Issue Price	Discounted/Premium/Par
Period of Sale	14th May 2020 – 26th May 2020
Auction Date	27th May 2020
Value Date	1st June 2020
Yield Curve - 5 years tenor (%) 15th May 2020	**11.6718**

Source: Central Bank of Kenya

KES.28.3Bn T-Bill - 2236/364 matures in June 2020

- The T-bill 2236/364 that matures in June 2020 was oversubscribed an indication of the high demand on short-term domestic debt (Table.2).

Table.2: 364 Day T-bill summary

T-Bill Issue Number	**2236/364**
Date of Issue	03/06/2019
Date of Maturity	01/06/2020
Total Amount Offered	KES.10Bn
Tenor (Years)	1 Year (364 Days)
Bids Received	KES.26.26Bn
Performance Rate	262.62%
Bids Accepted	**KES.23.51Bn**
Weighted Average Rate of Accepted Bids (%)	9.311
Yield Curve (%) (At time of issue) 3rd June 2019	**9.299**

Source: Central Bank of Kenya

IFB subscription could be negatively impacted by the limitation on eligibility and market liquidity

IFB1/2020/6 likely to be undersubscribed due to limited eligibility and tight market liquidity

- The eligibility for investment in IFB1/2020/6 is limited to investors holding T-Bill issue No. 2236/364 with participation being voluntary although and investors will need to re-invest their entire maturity amounts in the issue.
- In normal circumstances the bond would be oversubscribed due to its comparatively short tenor and tax-free status.
- However, the limited eligibility to affect subscription rate which we expect to be around 75% (KES.19.2Bn).
- It is possible that the CBK expects the issue to be undersubscribed and we believe this is why it seeks to raise KES.25.6Bn against T-bill maturities of KES.23.5Bn.
- Another possible reason to support the view that the IFB might not be fully subscribed is that the market liquidity is relatively tight and CBK has been in the reverse repo market to pump in liquidity.
- CBK is in this market to even issue a 91-days reverse repo as opposed to the conventional 7-28 days reverse repos. An indication of the extent to which the regulator is willing to support the market especially during this pandemic.
- Investors are also expected to bid aggressively for the bond due to rising concerns over the Government's ability to service its debt with limited receipts as well as perceived desperation for the need to finance its fiscal deficit.

Investors continue to bid above yield curve levels

- We expect investors to continue the trend of bidding above yield curve levels as they demand higher returns for increased risk in the wake of the Coved -19 pandemic,
- We expect the bids on this issue to mirror the recently re-opened bond (FXD1/2020/5) which had an almost similar average tenor,
- Our Weighted Average Rate (WAR) of investor and accepted bids are shown in Table 3.

Table.3: Auction bid predictions

Rates	IFB1/2020/6
Market Weighted Average Rate (%)	11.75% - 11.90%
Weighted Average Rate of Accepted Bids (%)	11.70% - 11.75%

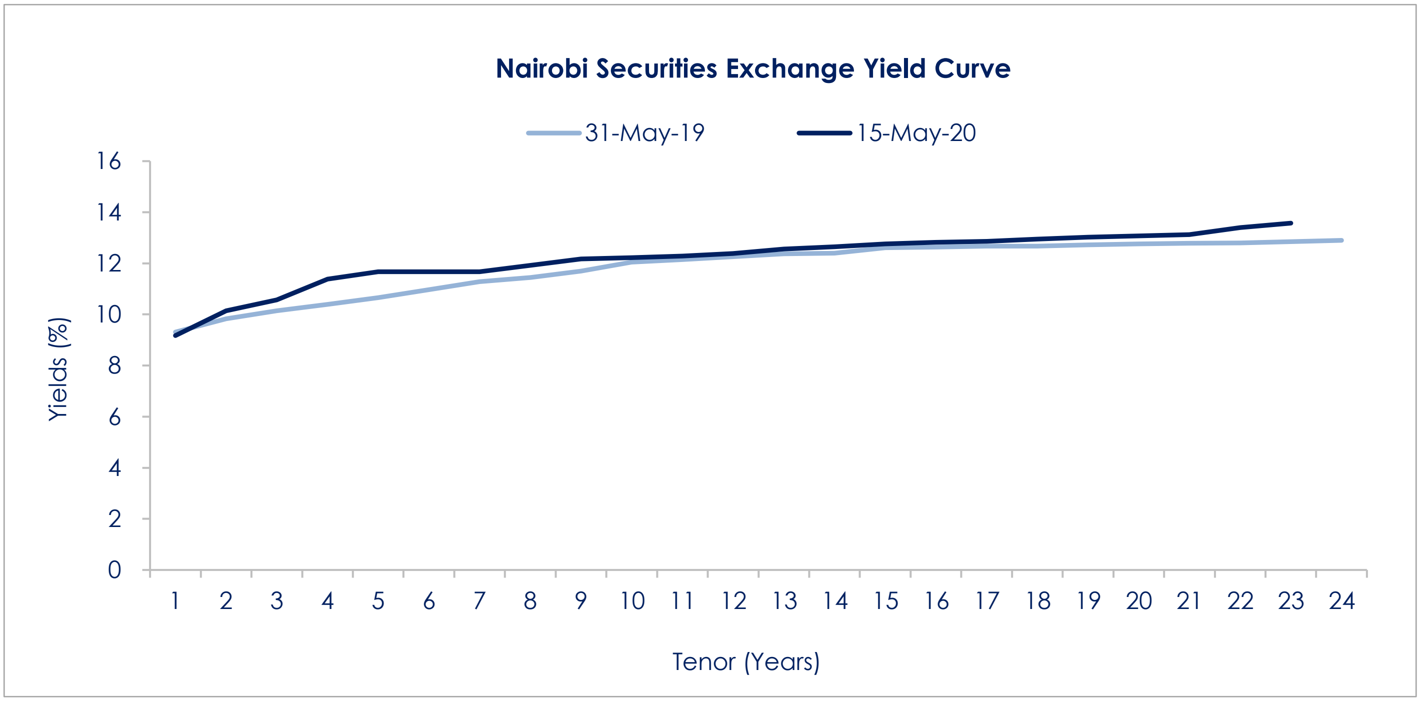
Source: Sterling Capital Research

Investors to bid above current yield curve levels

Investors have been bidding above yield curve levels

- A comparison of implied yields at 15th May 2020 and 31st May 2019 (time of issue of T-Bill No. 2236/364 shows a 104bps rise in yields securities with a 4.5 years term to maturity 10.5375% to 11.5799% (Figure.1).
- We expect the yield curve to shift upwards with the highest increase at the short-end considering that the last three T-Bonds have been short-term issues and investors have been bidding above the yield curve levels at the time of issue.
- Since the eligibility for this bond is only limited to the holders of T-Bill No. 2236/364, CBK could accept higher investor bids.
- Going forward we see a possibility of the CBK giving pre-determined coupons for such securities switches especially if investors bids are significantly higher than acceptable levels.

Figure.1: Yield curve expected to shift upwards with the biggest shift on the short-end



Source: Nairobi Securities Exchange

What is the rationale behind this debt issue?

- CBK is issuing a third bond in the month of May due to high financing pressure the government is facing at the moment.
- It is likely that the CBK's preference for the IFB as opposed to any other bond is because its tax-free status making it enticing to the 364-day T-Bill holders.
- The pegging of this issue to a maturing 364-day T-Bill is an indication of the refinancing risk faced by the Government due to declining receipts worsened by the pandemic.

Government has huge debt service financing requirements

- It is expected that a portion of the proceeds from the IFB will be used to roll over the 364-day paper worth 23.5Bn which falls due in June 2020.
- In the event of undersubscription, CBK might reopen to all investors because of high financing needs due to widening fiscal deficit.
- With only 1.5 months remaining to the end of the FY2019/20, we expect the government to remain active on the domestic debt front to plug-in the fiscal deficit.
- With the tax revenues expected to decline in the near to medium term and the budget deficit expected to widen due to the negative impact of COVID-19 on the economy, we believe this could be the beginning of a trend where the CBK matches the maturity of a debt security with a new debt issue.

Similar debt issues could present new risks to medium and long-term debt sustainability

An increase in shorter dated debt securities presents re-financing risks

- With the government issuing a medium-term paper we expect to see refinancing risk build up in the next 3-5 years as repayments for several debt issues fall due.
- It would also reverse gains made by the CBK over the last five years as the Average Term to Maturity (ATM) of domestic debt increased to 5.7 years in December 2019 from 5 years in June 2015.
- We expect this new trend to have an impact on future T-Bill and bond auctions as investors make aggressive bids to compensate for higher risk as they feel that the Government is struggling to meet its debt obligations.
- However, the concern is if CBK will accept these aggressive bids considering that banks have limited investment options at the moment.
- Investors are expected to remain active in the T-bill space due to uncertainty of the long-term performance of the economy.
- We also expect to see an uptick in secondary market activity for the 364-day paper 2236/364 since it's the 'pass' for participating in the IFB issue this month.
- This issue may also encourage investors to participate in primary T-bill auctions so as to gain access to similar bond issues, that is if this will be a trend.

Is GOK struggling with debt service or just managing its liquidity position?

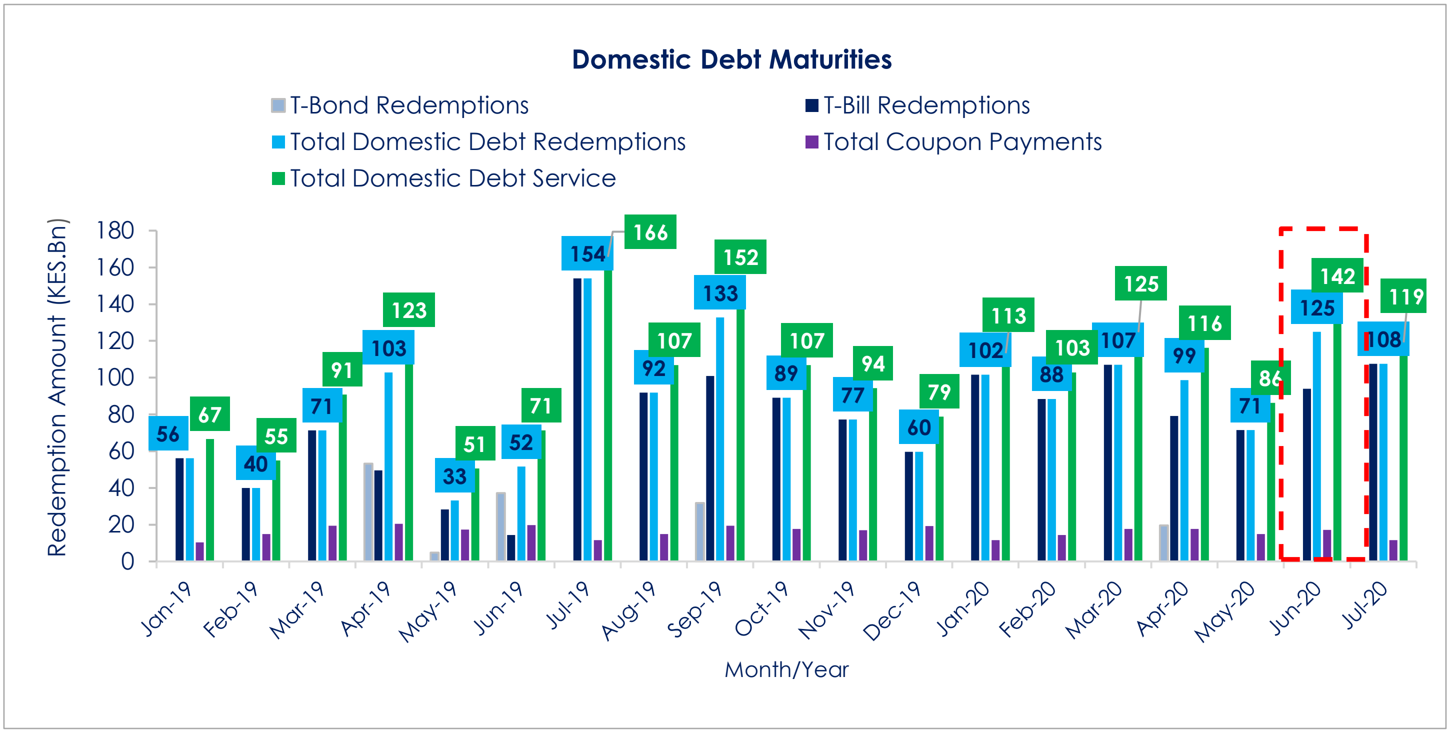
- Possible reasons for the significant increase in the number of debt issues include:

  1. Government is struggling to meet its debt service obligations amid declining receipts with total debt service obligations for June and July 2020 standing at KES.142Bn and KES.119Bn respectively (Figure.2).

     We expect to see a further increase in the its debt appetite as it strives to meet its financing needs with new debt issues likely to match redemptions.

  2. Government is using this "switch bond" strategy to manage its liquidity position and not necessarily an indication that it is struggling to meet its debt repayment commitments.

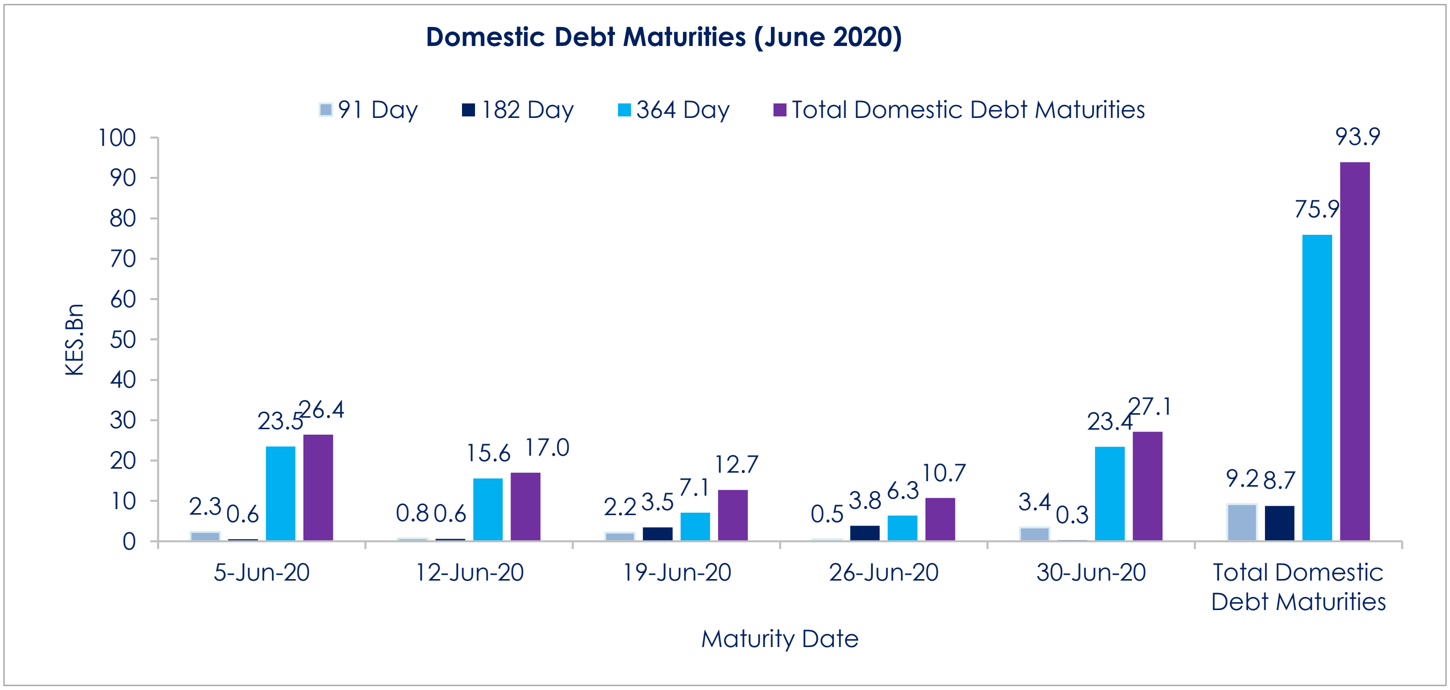
Figure.2: KES.125Bn debt redemptions, KES.17Bn in coupon payments set for June 2020



Source: Central Bank of Kenya

3. Total T-bill maturities for June 2020 stand at KES.93.9Bn comprising of KES.9.2Bn, KES.8.7Bn and KES.75.9Bn in 91,182- and 364-day T-Bills respectively (Figure.3).

Figure.3: Weekly debt maturities in June 2020



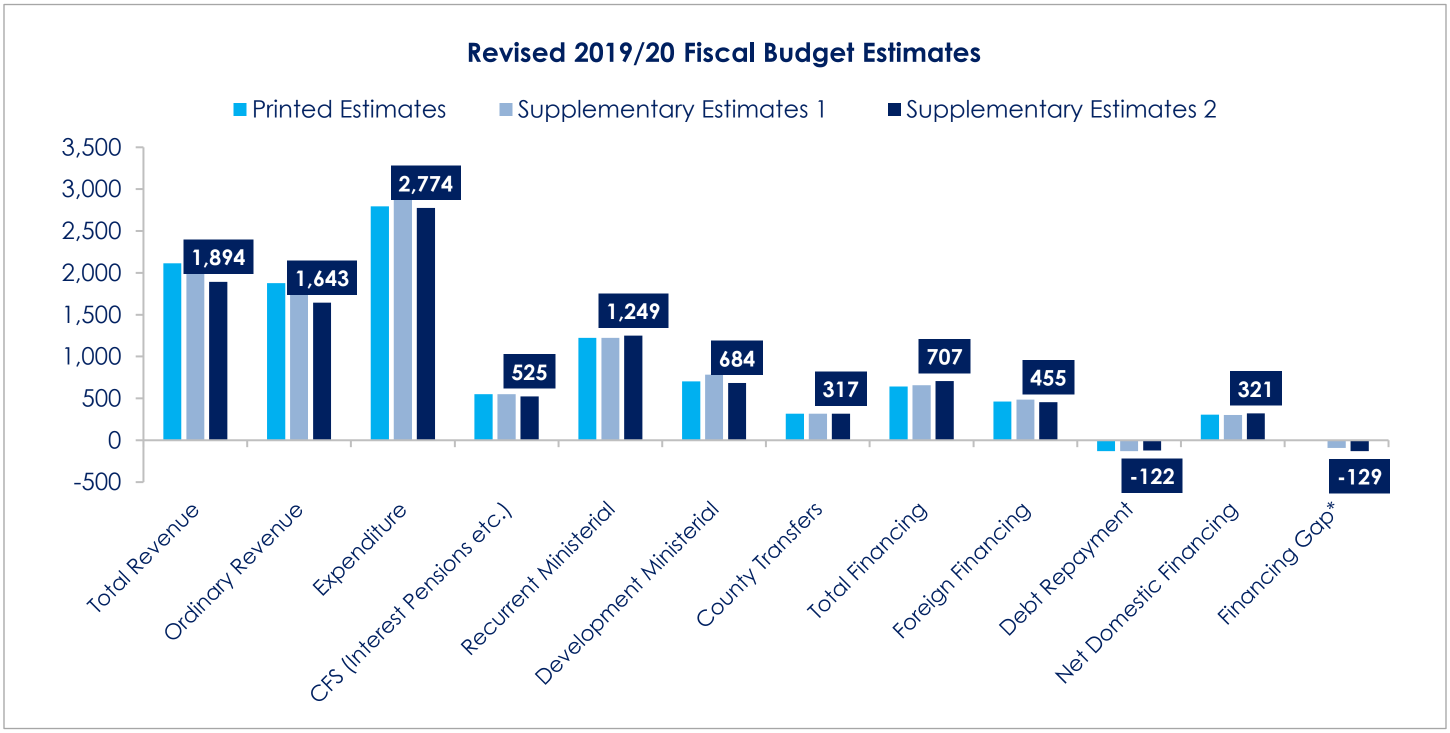
Source: Central Bank of Kenya

National Treasury's KES.129Bn funding gap for current fiscal year

IMF credit facility to partially offset KES,129Bn fiscal budget deficit

- The Supplementary budget 2 for the 2019/20 fiscal year (ending 30Th June 2020) released in April 2020 shows significant revisions to fiscal revenue targets (Table.4).
- These revisions are largely a result of the disruption of the COVID-19 pandemic on economic activity.
- The revisions include 12.5% and 10.5% downward adjustments to ordinary and total revenue estimates to KES.KES.1.6Tn and KES.1.9Tn respectively.
- There is also a 2.9% cut in development expenditure to KES.684Bn with recurrent expenditure estimated to increase by 2% to KES.1.2Tn.
- Domestic funding is estimated to increase 4.7% to KES.321.1Bn but this together with external funding is insufficient to meet the resulting KES.129.1Bn fiscal deficit shortfall.
- The International Monetary Fund disbursed US$739Mn (KES.79Bn) under the Rapid Credit Facility (RCF) in May to enable the National Treasury maintain "adequate level of international reserves and help provide the budget financing needed to respond to the pandemic."
- This support although needed will still leave a funding gap to be met with both domestic and external sources.
- We see an increasing possibility of the Government engaging its financing partners in the next few months for additional financing or to restructure its debt service obligations, taking into consideration further revenue shortfalls.

Table.4: Supplementary budget shows KES.129.1 fiscal budget deficit



*During Supplementary 1 Cash Adjustment of KES.90Bn

Source: Parliamentary Budget Office

National Government's big challenge financing the 2020/21 fiscal budget

National Government receipts to fall significantly due to the impact of COVID-19

- The biggest concern for the National Treasury is financing the 2020/21 fiscal budget.
- The initial budget estimates released in February 2020 showed a 3.2% decline in total expenditure compared to the 2019/20 fiscal year to KES.2.7Tn (Table.4).
- The budget books released in April however, shows a 1.3% increase from the proposed budget to KES.2.8Tn (Table.5).
- Initial estimates had also projected a 0.3% increase in total revenue to 2.1Tn including an ordinary revenue estimate of KES.1.9Tn.
- Total financing was estimated at KES.569.4Bn a 11.1% decline over the previous fiscal year.
- On the basis of the current economic conditions and the expected decline in revenue estimate, we see could see a 15%-20% reduction in actual ordinary revenue resulting in a similar increase in both external and domestic financing.
- This means that we expect to see a significant increase in domestic debt issues in the next fiscal year which will increase re-financing risks particularly if investors continue show a preference for short dated debt (T-Bills).
- A bulk of the proceeds of new debt issues will be used for redemptions if this situation persists and the CBK could adopt a similar borrowing strategy as where a bond is used as a roll-over option for maturing debt.

Table.4: 2020/21 fiscal budget estimates shows higher revenue, lower expenditure and fiscal deficit estimates

Budgetary Item	2019/20 BROP*	2019/20 Supplementary Budget	2020/21 Estimate
Total Revenue	**2,090.5**	**2,084.2**	**2,133.5**
Ordinary Revenue	1,851.8	1,843.8	1,856.7
Ministerial Appropriation in Aid	238.7	240.4	276.8
Total Expenditure & Net Lending	**2,835.7**	**2,874.2**	**2,743.8**
Recurrent Expenditure	1,744.9	1.760.0	1,786.9
Development Expenditure	707.4	730.8	576.0
County Transfer	378.4	378.4	376.0
Contingency Fund	5	5	5
Balance Exclusive of Grants	(745.2)	(789.9)	(610.3)
Grants	38.8	41.8	40.9
Balance Inclusive of Grants	(706.4)	(748.1)	(569.4)
Adjustments to Cash	66.2	90.7	-
Balance Inclusive of Grants	(640.2)	(657.4)	(569.4)
Total Financing	**640.2**	**657.4**	**569.4**
Net Foreign Financing	331.3	353.5	247.3
Other Domestic Financing	3.2	3.2	3.2
Net Domestic Financing	**305.7**	**300.7**	**318.9**
Nominal GDP (Fiscal Year)	**10,355.4**	**10,355.4**	**11,633.4**

BROP - Budget Review and Outlook Paper

Source: National Treasury

Table.5: Revised 2020/21 fiscal budget shows an increase in Government expenditure

Budgetary Item	Gross Approved Expenditure 2019/20 (KES.Bn)	Gross Estimates 2020/21 (KES.Bn)
Total Government Expenditure	**2,873.2**	**2,779.8**
Total Recurrent Expenditure	**2,090.2**	**2,195.5**
Total Voted Expenditure	1,224.3	1,167.4
Total Consolidated Fund Service	866	1,028.1
Total Development	**783**	**584.3**
Net Estimates		351.6
Appropriations in Aid		233
SOURCE OF FINANCE		
Total External Funding		**274.6**
Bilateral Funding		106.2
Multilateral Funding		168.4

Source: Parliamentary Budget Office

Kenya's amended fiscal budget includes a KES.53.7 Post COVID-19 economic stimulus

- On 14th May 2020, the President approved a proposed amendment to the 2020/21 fiscal budget totaling KES.85.7Bn that included a KES.53.7Bn economic stimulus package aimed at mitigating the impact of the COVID-19 pandemic (Table.6).

Table.6: Proposed amendments to the 2020/21 fiscal budget

Budgetary Item	Total (KES.Bn)
Additional Funding	**85.7**
Total cost of post COVID-19 Economic Stimulus Package (ESP) Programme	**53.7**
Other Additional Expenditure	31.9
Donor Financed Project	0.1
Available Financing (Restructuring of the budget)	**29.8**
Available Budget	21.4
Budget Rationalization	8.3
Donor Financed Project	0.1
Other Financing Measures	**43.6**
EU-Budget support	3
EU-Credit Guarantee	2
Denmark - Budget Support	0.2
Sports Fund	5
Road Annuity Fund	7
Nairobi Metropolitan Services	26.4
Unfunded	**12.3**
Surpluses from state corporations	12.3
Surplus/Deficit	-

Source: National Treasury

Monetary Policy Committee (MPC) expectations for 27th May 2020

Expect the MPC to maintain the CBR at 7% in the May 2020 meeting

- The Monetary Policy Committee (MPC) is set to meet on Wednesday, 27th May 2020, to review the outcome of its previous policy decisions and recent economic developments, and to make a decision on the direction of the Central Bank Rate (CBR).
- The committee lowered the CBR from 7.25% to 7.00% in their last review meeting in April citing that previous revisions had begun to have a positive impact particularly on private sector credit growth which had increased to 8.9% in March from 7.7% in February and 7.3% in January.
- We expect the committee to **maintain the CBR rate at 7% on account of the positive impact of previous monetary policy actions.**
- In addition, inflation is expected to remain stable as oil prices have declined significantly despite an expected increase in the food index due to floods and an anticipated second wave of locust invasion.
- Pressure on the local currency will also be alleviated temporarily by the rapid credit facility worth KES.78.4Bn approved by the IMF for emergency funding in response to Covid-19.
- We maintain our view that monetary policy stimulus measures may not be highly effective in combating low private sector credit and we expect banks to continue lending cautiously.

Disclosures

Ownership and material conflicts of interest:
The authors or a member of their household, of this report do not hold a financial interest in the securities of this company. The authors or a member of their household, of this report do not know of the existence of any conflicts of interest that might bias the content or publication of this report.

Position as an officer or director: The authors or a member of their household, do not serve as an officer, director or advisory board member of the subject company.

Research analyst certification:
The research analyst(s) primarily responsible for the preparation and content of all or any identified portion of this research report hereby certifies that all of the views expressed herein accurately reflect their personal views. Each research analyst(s) also certify that no part of their compensation was, is, or will be, directly or indirectly, related to the view(s) expressed by that research analyst in this research report.

Additional Disclosures:
This research report is for distribution only under such circumstances as may be permitted by applicable law. This research report has no regard to the specific investment objectives, financial situation or particular needs of any specific recipient, even if sent only to a single recipient. This research report is not guaranteed to be a complete statement or summary of any securities, markets, reports or developments referred to in this research report. Neither SCL nor any of its directors, officers, employees or agents shall have any liability, however arising, for any error, inaccuracy or incompleteness of fact or opinion in this research report or lack of care in this research reports preparation or publication, or any losses or damages which may arise from the use of this research report.

Disclaimer:
This research report was prepared under the supervision of the Research Department of Sterling Capital Limited (SCL), a company authorized to engage in securities activities in Kenya, and with partnerships in Uganda, Rwanda, Zimbabwe, and Tanzania. Data used in this report was gathered from reliable sources, but the analyst(s) and the publishers of this report do not hold themselves responsible for the accuracy or completeness of data used. The report provides the opinions, analyses and conclusions of the Research division only and is provided without any warranties of any kind.

This report does not constitute an offer, or the solicitation of an offer, for the sale or purchase of any security. The reader should independently evaluate the investment risks and is solely responsible for their investment decisions. Whilst every care has been taken in preparing this report, no representation, warranty or undertaking (express or implied) is given and no responsibility or liability is accepted by SCL or any employee of SCL as to the accuracy, timeliness, completeness merchantability or fitness for any particular purpose of any such recommendation or information contained and opinions expressed herein. SCL do not accept any liability for any direct or remote loss or damage arising out of the use of all or any part of the information contained in this report.

This report is published for information purposes only and is not an offer to solicit, buy or sell any security of any kind. This report does not provide customized investment advice. It has been prepared without regard to the individual financial circumstances and risk and return objectives of individuals who receive it. The appropriateness of a particular investment will depend on an investor's individual circumstances, risk tolerance and return objectives. The investments securities referred to in this document may not be suitable for all or certain categories of investors. The Research Division and SCL have implemented Chinese walls procedures to prevent any conflict of interest. Other additional information may be available at SCL.

Further disclosure regarding SCL policy on potential conflicts of interest in the context of investment research and SCL policy on disclosure and conflicts in general are available on request. The opinions presented in this note may be changed without prior notice or cannot be depended upon if used in the place of the investor's independent judgment. The historical performance of a security is not representative of the security's future returns. Investment in securities can be highly risky as security prices may go down in value as well as up and you may not get back the full amount invested. Where an investment is denominated in a currency other than the local currency of the recipient of the research report, changes in the exchange rates may adversely affect the value, price or income of that investment. In case of illiquid investments for which there is no organized market it may be difficult for investors to exit investment positions or to obtain reliable information about its value or the extent of the risk to which it is exposed. The information contained in this report is confidential and is solely for use to those persons to whom it is addressed and may not be reproduced, further distributed to any other person or published, in whole or in part, for any purpose.