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STERLING CAPITAL LIMITED

Fixed Income Note
August 2020

“CBK issues Kenya’s biggest IFB”

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

Email: research@sterlingib.com

Bond Dealing: +254 (20) 2213914, 3315414; 2244077
+254 723153219, +254 734219146
Email: invest@sterlingib.com

Website www.sterlingib.com
Bloomberg Code: SCLK <GO>

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Executive Summary

- Our fixed income report for the month of August 2020 titled **"CBK issues Kenya's biggest IFB"** is an analysis of the Central Bank of Kenya's (CBK) third and first infrastructure bond in the current calendar and fiscal year (2020/21) respectively.
- The infrastructure bond **IFB1/2020/11** is the biggest issue ever at KES.70Bn and has an implied term to maturity tenor of 8.5 years.
- Our weighted average bid predictions are as follows:

Weighted Average Rate (WAR) of bids: 11.55%
Weighted average rate of accepted bids: 11.40%

- The report highlights both primary market auction and secondary market trading activity for the previous month while giving our view on what to look out for in August 2020.
- Domestic debt maturities have a huge impact on CBK's borrowing strategy and this debt service is analysed in the report.
- We also give trading recommendations for investors with both income and trading portfolios in our 'trading ideas' section.
- The report includes an analysis of the yield curve over selected periods in the last one year.
- We give our inflation expectations towards the end of the report which concludes with our view on the monetary Policy Committee (MPC) meeting later this month.

CBK issues 11-Year amortized Infrastructure Bond

- Central Bank of Kenya (CBK) is inviting bids for a 11-Year amortized infrastructure bond (**IFB1/2020/11**), as it seeks to raise KES.70Bn in this month's infrastructure bond (Table.1).
- The third IFB issue in 2020 but the first in the 2020/21 fiscal year has a pre-determined coupon rate of 10.90%.
- We believe CBK has issued the infrastructure bond to take advantage of high market liquidity and Government debt demand to bridge its fiscal deficit and lengthen public debt maturity.
- Redemption will be in two tranches, with the first tranche of 50% redeemed in August 2026 and the remaining 50% at expiry in August 2031.
- We expect the issue to be oversubscribed due to the bond's tax-free status, market liquidity levels and capital flight by risk averse investors from the underperforming equities market.

Table.1: Infrastructure Bond issue summary

Issue Number	IFB1/2020/11
Total Amount Offered	KES.70Bn
Tenor (Years)	11 Yrs.
Effective Tenor	8.5 Yrs.
Coupon Rate (%)	10.90
Issue Price	Discounted/Premium/Par
Period of Sale	28th July - 18th Aug 2020
Auction Date	19th Aug 2020
Value Date	24th Aug 2020
Yield Curve (%) (Weighted Average tenor – 8.5 years) 7th Aug 2020	11.5489

Source: Central Bank of Kenya

IFB1/2020/11 amortized redemption structure

- IFB1/2020/11 has an amortizing redemption structure making its effective tenor 8.5 years (Table.2).

Table.2: Amortized redemption tenor is 8.5 years

Redemption Period	% of principal redeemed	Tenor Calculation	Weighted Tenor
6 Years (Aug 2020- Aug 2026)	50%	50%*6 years	3.0 years
11 Years (Aug 2020- Aug 2031)	50%	50%*11 years	5.5 years
Effective tenor			3.0 + 5.5 = 8.5 years

Source: Central Bank of Kenya & Sterling Capital Research

Our weighted average and accepted bids averages

- We used implied yields provided by the NSE as at 7th August 2020, discussions with our fixed income traders and other market players as a guide for our investor and CBK accepted bid predictions (Table.3).

Table.3: Auction bid predictions

Rate	IFB1/2020/11
Market Weighted Average Rate (%)	11.55%
Weighted Average Rate of Accepted Bids (%)	11.40%

Source: Sterling Capital Research

Existing debt issues used to provide provided guidance to our predicted rates

- We used implied yields of bonds of almost similar remaining terms to maturity from the Nairobi Securities Exchange (NSE) as at 7th August, 2020 to determine possible investor bids (Table.4).

Table.4: Benchmark issues to guide investor bids

Treasury Bond	Issue Date	Coupon Rate (%)	Maturity Date	Term to Maturity Years (Days)	Implied Yield to maturity (%)	Yield Curve at time of issue
IFB1/2014/12	27th Oct 2014	11.00	12th Oct 2026	6.2 (2,257)	9.8090	12.4320
IFB1/2015/12	30th Mar 2015	11.00	15th Mar 2027	6.6 (2,411)	9.8630	12.8040
IFB1/2017/12	27th Feb 2017	12.50	12th Feb 2029	8.5 (3,111)	10.6640	13.7712

Source: Central Bank of Kenya

Popularity of IFB unchanged and this issue likely to be oversubscribed

Medium-term IFB auctions have historically exhibited high demand.

- Historic IFB auction results show high demand for issues with tenors less than 20 years (Table.5).
- The 12, 15- and 16-year issues in particular have been oversubscribed.
- IFB1/2015/9 issued in 2015 to raise KES.30Bn went against the IFB demand craze with a 55.3% subscription rate (KES.16Bn) with KES.14Bn accepted.
- This was before the introduction of interest rate caps when banks were heavily skewed towards higher yielding private sector lending than investment in Government securities.
- IFB1/2020/6 a switch security issued in May 2020 to raise KES.26Bn was also undersubscribed at 82.7% (KES.21.2Bn) due to limited eligibility (investors who had holdings in T-Bill Issue No. 2236/364).
- Increased market liquidity and the “flight to safety” by equity investors to the more predictable fixed income securities during the uncertain times of Covid-19 pandemic will also support our view on the subscription rate for this issue.

Table.5: Historical primary market auction performance

Issue	Offered (KES.Bn)	Bids Received (KES.Bn)	Amount Accepted (KES.Bn)	Performance Rate (%)	Coupon Rate (%)	Implied Yield
IFB1/2014/12	15	38.8	15.8	258.5	11.00	9.8090
IFB1/2015/12	25	51.7	25.7	206.6	11.00	9.8630
IFB1/2015/12 (Tap)	25	51.7	24.0	97.5	11.00	9.8630
IFB1/2015/9	30	16.6	14.0	55.3	11.00	9.5910
IFB1/2016/15	30	35.1	30.6	117.0	12.00	10.6640
IFB1/2017/12	30	35.0	6.0	116.8	12.50	10.6640
IFB1/2017/12 (Tap)	-	8.0	7.6	-	12.50	10.6640
IFB1/2017/7	30	45.9	42.0	153.0	12.50	9.6500
IFB1/2018/15	40	55.8	5.0	139.4	12.50	11.1625
IFB1/2018/15 (Tap)		-	36.3		12.50	11.1625
IFB1/2018/20	50	40.4	27.6	80.8	11.95	11.3800
IFB1/2018/20 (Tap)		-	8.73	-	11.95	11.3800
IFB1/2019/25	50	29.4	16.3	58.8	12.20	11.7892
IFB1/2019/16	60	86.9	68.5	144.9	11.75	11.1500
IFB1/2020/9	60	68.4	39.0	114.0	10.85	10.4200
IFB1/2020/9 (Tap)	21	37.8	35.4	-	10.85	10.4200
IFB1/2020/6	26	21.2	19.3	82.7	10.20	9.9500

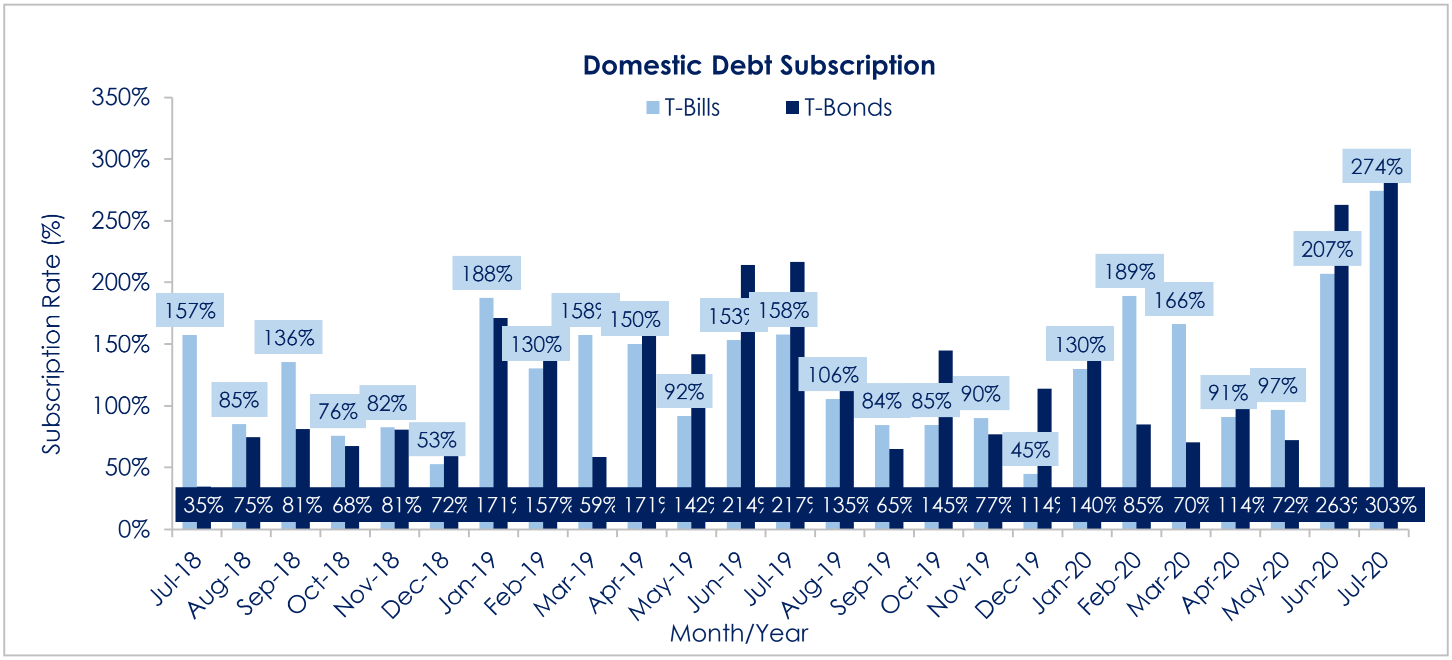
Source: Central Bank of Kenya

High market liquidity continues to drive domestic debt demand

High market liquidity the biggest driver of domestic debt demand.

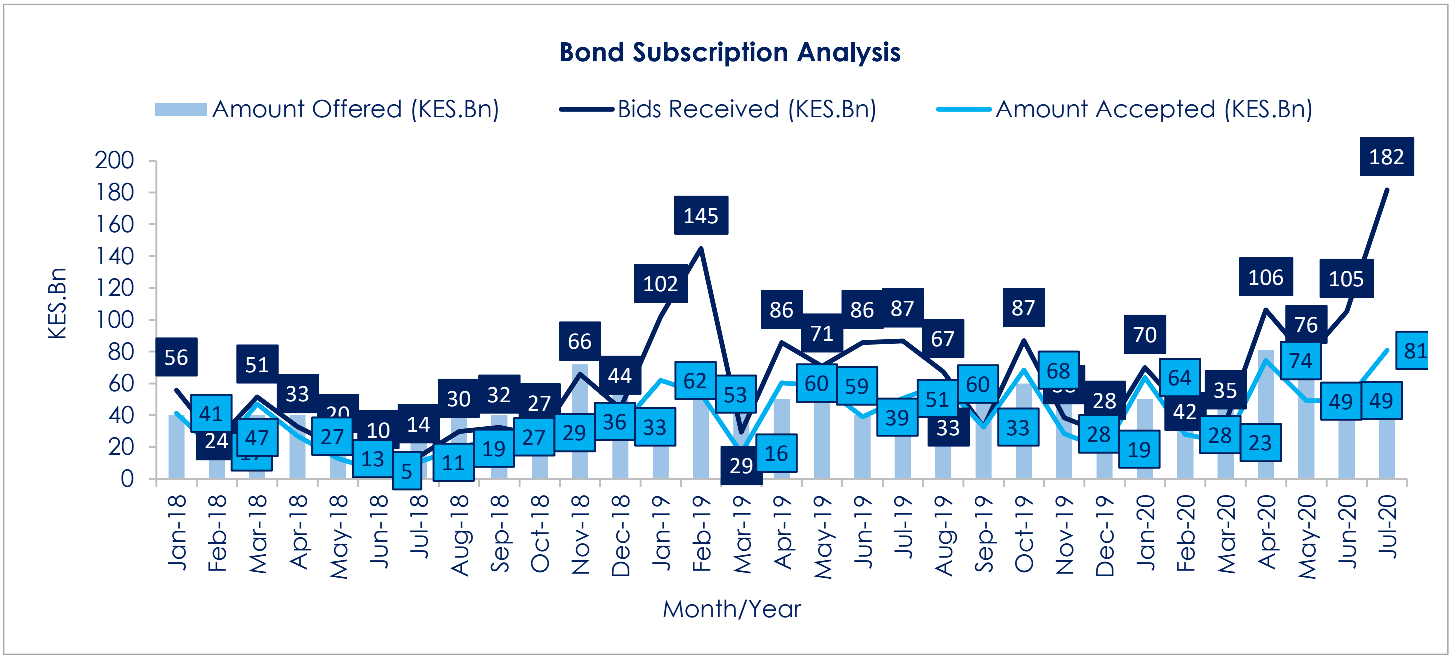
- CBK re-opened three bonds in July 2020, with tenors of 5, 10 and 15 years receiving subscriptions worth KES.181.8Bn against KES.60Bn on offer, a subscription rate of 302.9% (Figure.1 and Figure.2).
- T-Bills on offer during the month amounted KES.96Bn with the CBK receiving bids worth KES.263.21Bn, a subscription rate of 274% (Figure.3).
- The CBK accepted KES.80.9Bn for the T-bonds rejecting aggressive bids and accepting majority of funds from the 15-year bond. This falls in line with the CBK's plan to lengthen the maturity profile of domestic debt.
- The 91-day,182-day and 364-day papers were oversubscribed at 619%,166% and 245% and acceptance rate for the papers stood at 88.4%, 43.9% and 75.4% respectively (Figure.3).
- Demand for the T-Bills remain high as investors are unwilling to tie their capital for a longer period due to uncertainty over the performance of the economy and direction of interest rates.
- Market liquidity remains high and we expect this together with the flight of capital from the equities market and other riskier assets to short-term Government debt securities to dictate debt subscription patterns.

Figure.1: T-Bill subscriptions soar due to high demand for short-term debt



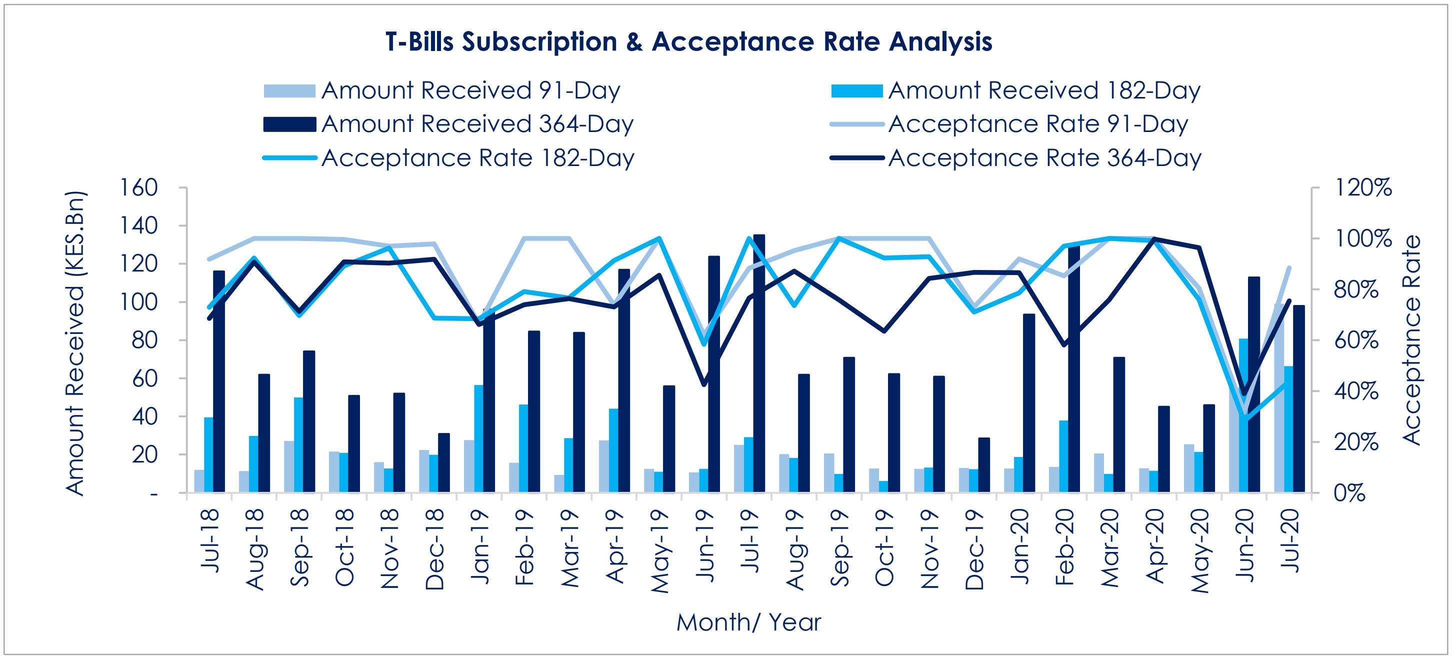
Source: Central Bank of Kenya

Figure.2: CBK continues to reject majority of the investor bids to suppress interest rates



Source: Central Bank of Kenya

Figure.3: CBK Acceptance rates across all tenor's plunge

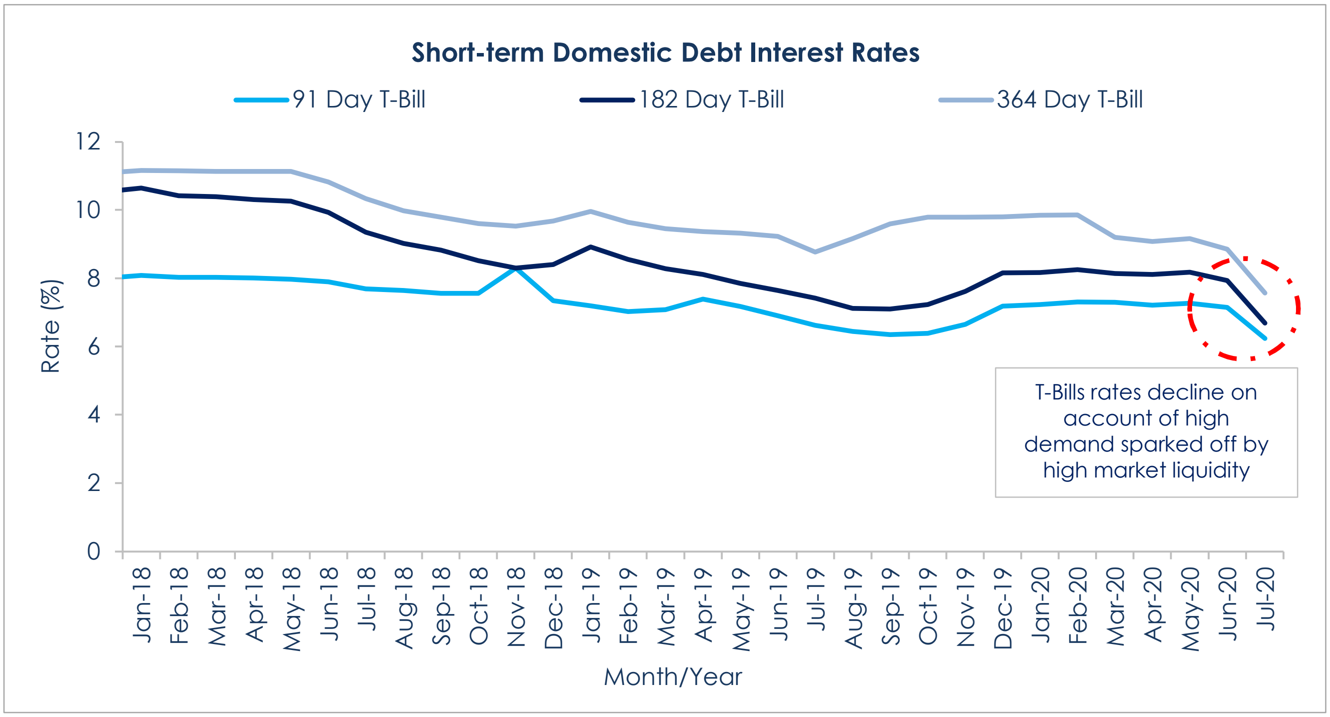


Source: Central Bank of Kenya

T-Bill rates to decline further on high demand and market liquidity

- T-Bill yields for the 91, 182 and 364-day papers declined 91bps, 124bps and 128bps to 6.24%, 6.69% and 7.58% in July 2020 respectively (Figure.4).
- The CBK is using high market liquidity levels to its advantage by rejecting aggressive investor bids.
- We anticipate liquidity to remain high in the coming months as banks become averse to private sector lending during the Covid-19 pandemic to manage credit quality.

Figure.4: Interest rates on short-term debt securities on a steady decline

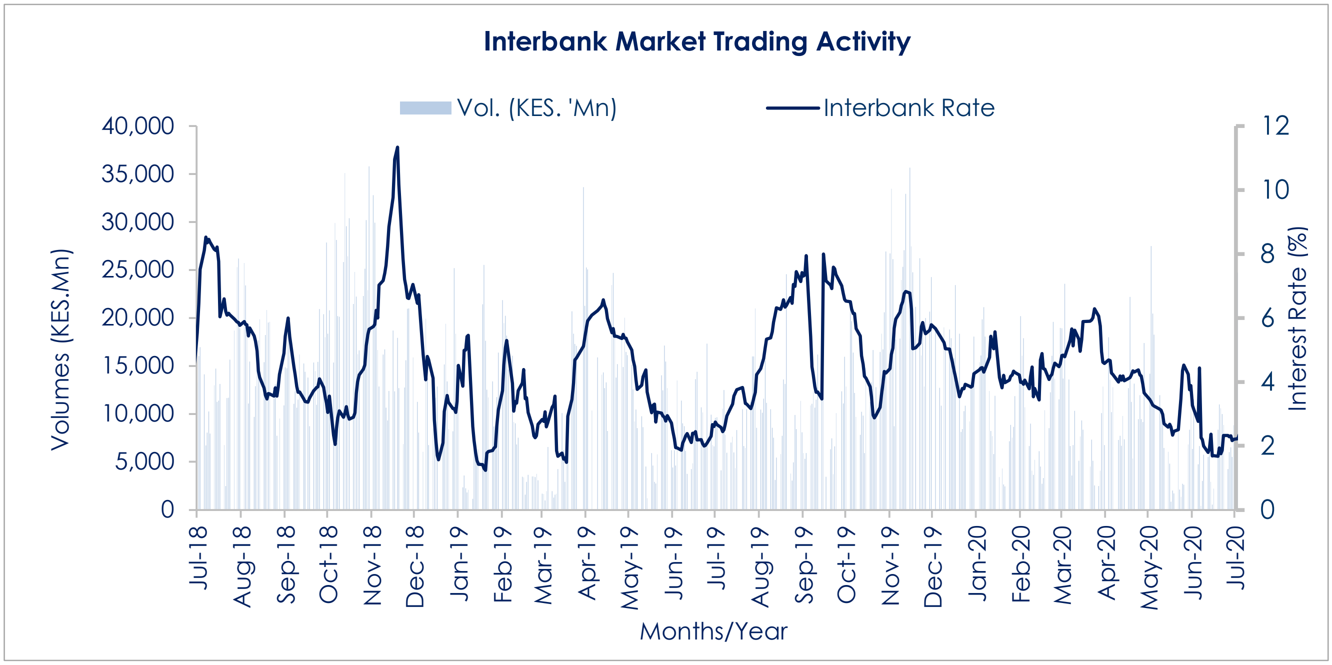


Source: Central Bank of Kenya

Inter-bank lending rates to remain subdued in August 2020

- High market liquidity resulted in a further decline in the average weighted inter-bank lending rate to 2.2% in July 2020 from 3.2% in June (Figure.5).
- Total volumes increased from KES.128.2Bn in June to KES.200.8Bn, attributable to investor flight to safety from the equities market.
- We expect inter-bank rates to remain low in August due to high market liquidity resulting from government payments at the beginning of the 2020/21 fiscal year.

Figure.5: Inter-bank rates continue to dip on high market liquidity

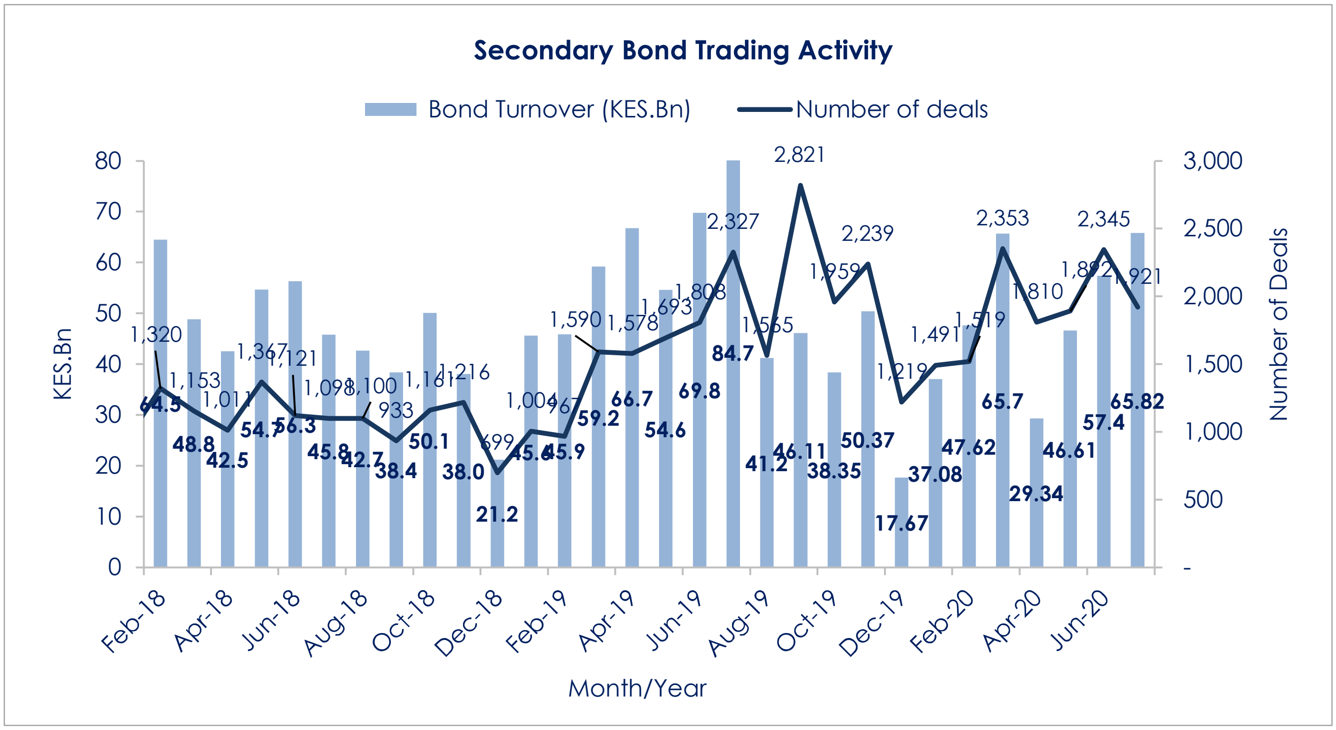


Source: Central Bank of Kenya

High market liquidity to continue driving secondary market trading activity

- Bond turnover in the secondary market rose 14.1% in July over June 2020 to KES.65.8Bn, while the number of deals fell 18.1% to 1,921 (Figure.6) in what we attribute to high liquidity especially amongst banks.
- We expect trading activity to remain high in August for the same reason as well as investors re-allocating capital from the equities market.

Figure.6: High secondary trading activity expected in August 2020



Source: Central Bank of Kenya

Trading ideas - Trading portfolio buy short, income portfolio go long

Trading portfolio - short end /Income portfolio – long end.

- Government securities remain a favourable investment option during the Covid-19 pandemic with most investors looking for predictable and less risky returns on capital invested.
- Our investment strategy remains unaltered where we recommend that investors with a trading portfolio focus on the short end of the yield curve (FXD1/2019/05, FXD2/2019/05, FXD1,2020/05) while investors with an income portfolio to invest in long term papers (FXD2/2018/20) and take advantage of higher yields on that end of the curve (Table.6).
- Market liquidity remains high with most investor interest in the short and medium-term papers.
- We however see rising subscription on the long end due to the absence of better yielding investment alternatives.
- We do not expect the CBK to issue sole short dated bonds with the most likely being combined issues with long dated paper where they will accept majority of the long-dated bond auction bids.

Table.6 - Trading ideas

Bond	Tenor (Years)	Coupon (%)	Modified Duration* (%)	Sterling Capital Yield to Maturity (%)	Current Yield** (%)
FXD1/2019/5	3.54	11.304	2.73	10.20	10.40
FXD2/2019/5	3.75	10.872	2.95	10.20	10.37
FXD1/2020/5	4.75	11.670	3.51	10.40	10.84
FXD2/2018/20	17.96	13.200	6.81	12.80	12.90

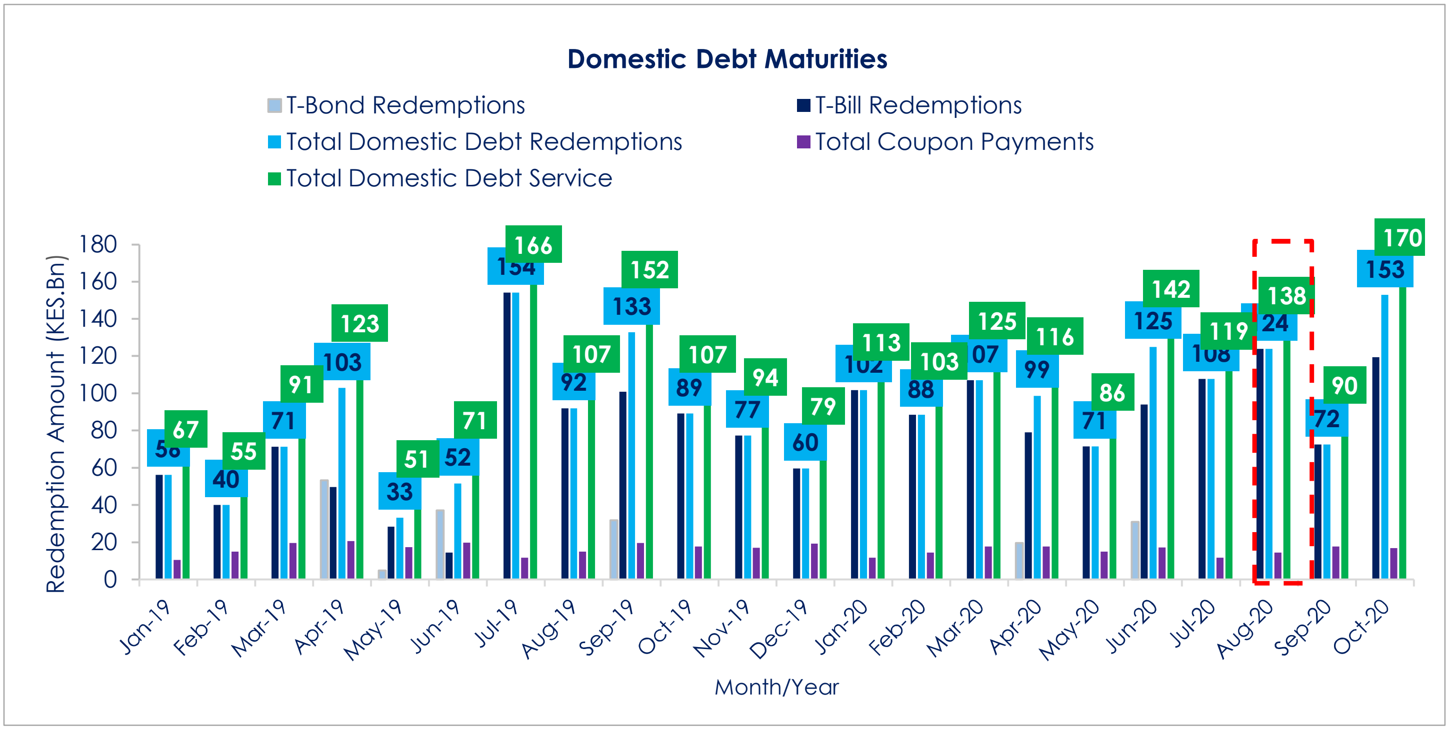
Source: Nairobi Securities Exchange & Sterling Research

*Modified duration - Expresses the measurable change in the value of a security in response to a change in interest rates (for every 1% movement in interest rates, the bond would inversely move in price by the modified duration)
** Current Yield - Return on investment, for an investor holding a specific bond for 1 year

Debt Service for August 2020 up 16% to KES,138Bn

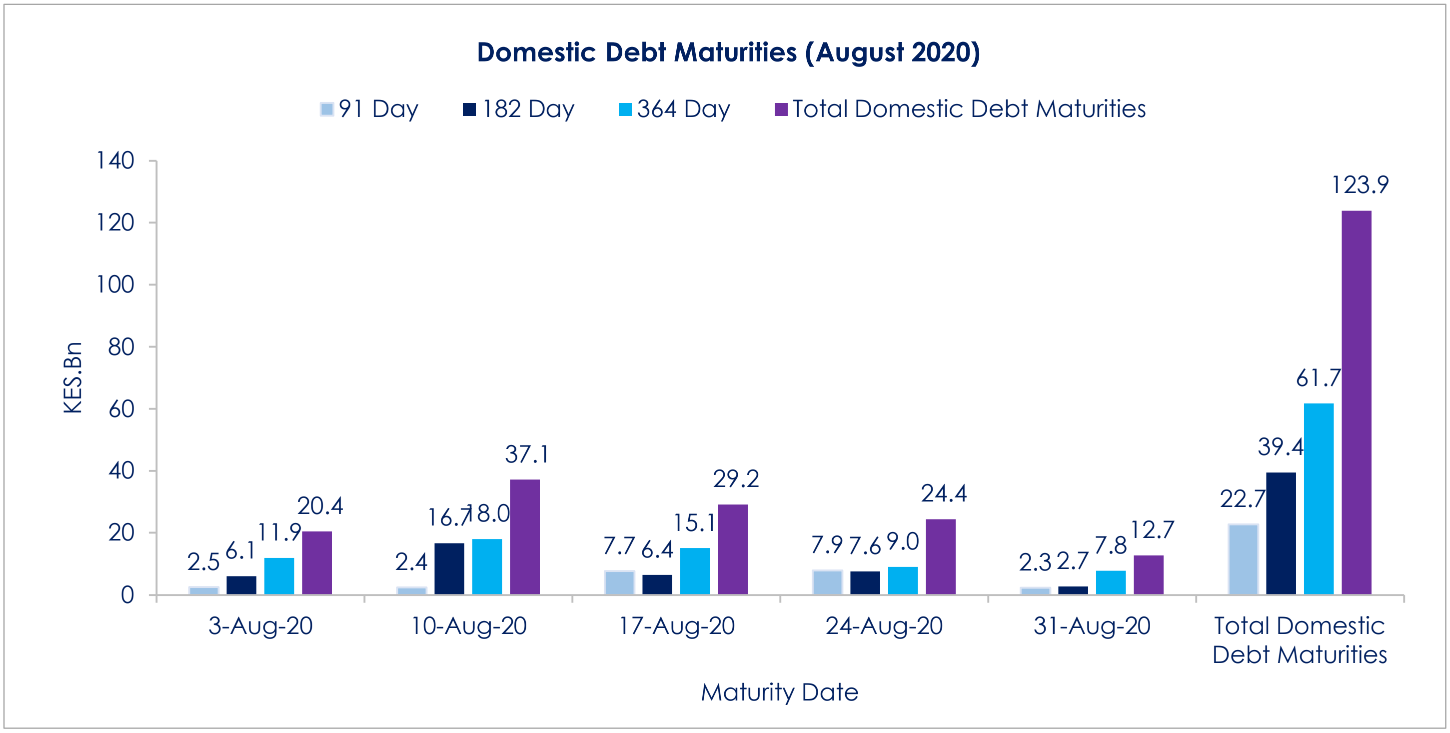
- Total domestic debt service amounts to KES.138.3Bn in August 2020, an increase of KES.19.0Bn from KES.119.3Bn in June 2020 (Figure.7).
- This is due to a 15.1% and 23.8% increase in the T-bill redemptions and coupon payments over the previous month to KES.123.9Bn and KES.14.5Bn respectively.
- Redemptions for the 91, 182- and 364-day T-Bills include KES.22.7Bn, KES.39.4Bn and KES.61.7Bn respectively (Figure.8).
- Domestic debt maturities will decline in September as a result of a significant dip in T-bill redemptions to KES.72.5Bn, there are no bond redemptions for August and September 2020.

Figure.7: August 2020 debt service KES.138Bn



Source: Central Bank of Kenya

Figure.8: August 2020 Weekly debt maturities



Source: Central Bank of Kenya

Expected Shortfall in revenue collection to result in an upward revision in domestic borrowing target

Government revenue likely to fall below estimated KES.1.9Tn target.

- We believe that total revenue target for the 2020/21 fiscal year will fall short of the estimated KES.1.9Tn (exclusive of KES.57.2Bn grants) due to the negative impact of the Covid-19 pandemic on economic activity and particularly on tax revenue.
- This together with a rising possibility of increased expenditure to contain the impact of the pandemic means that there is a high likelihood that there will be several upward adjustments to 2020/21 fiscal budget net domestic borrowing estimate of KES.493.7Bn.
- Assuming that market liquidity levels remain around current levels at least for the rest of the year, the CBK will maintain its long-dated auction bid acceptance and rejection strategy.
- In the event liquidity dries up, we could see the CBK accept higher investor bids although this is looks like a remote possibility in 2020.

Yield curve to expected to steepen in the short term

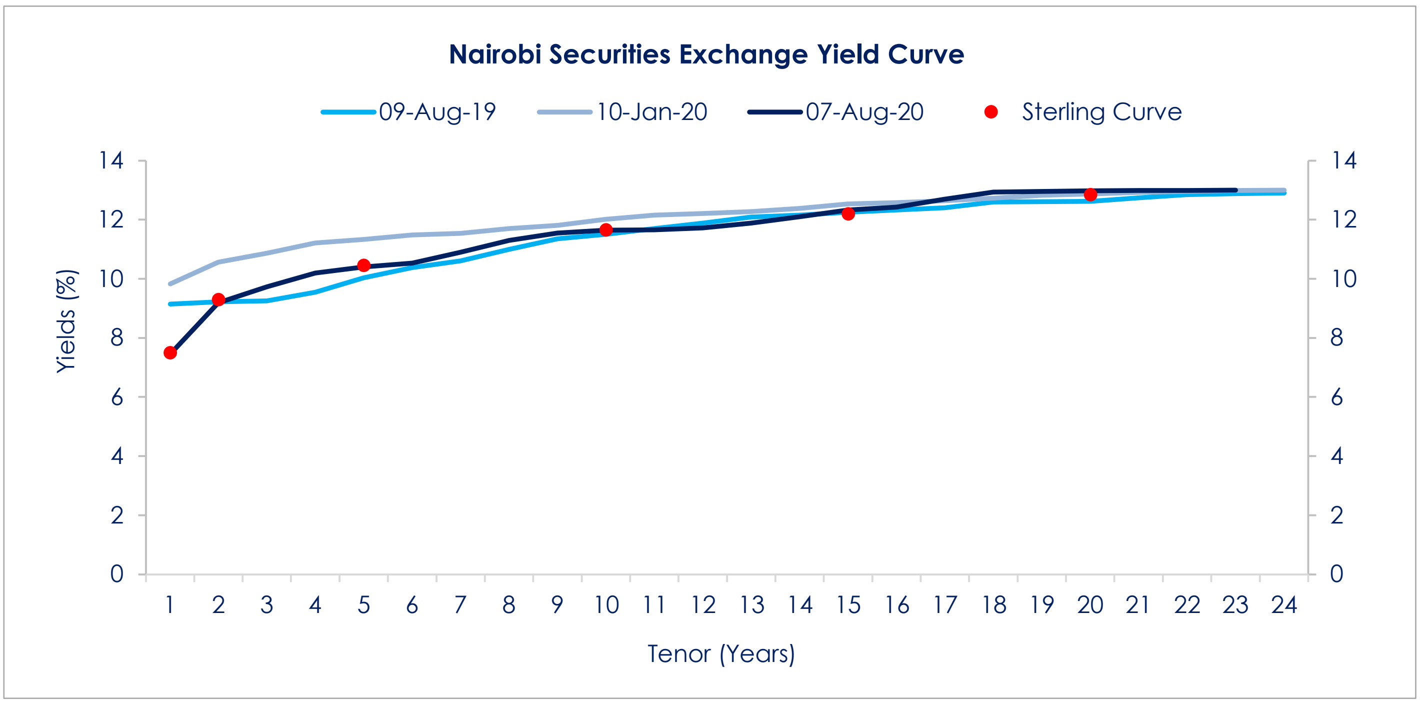
- Comparison of domestic debt yields on 9th August 2019, 10th January 2020 and 7th August 2020 show a decline in the 1Year and 2Year papers but marginally increased for the 20-year bond. (Table.7 and Figure.9).
- Forecasted average interest rates in December 2020 for the 2, 5, 10 and 15- and 20-year T-Bonds are 7.501%, 9.432%, 11.176%, 12.613% and 13.165% respectively.
- With regards to primary debt auctions, the CBK is expected to continue issuing multiple tenor issues, accepting lower rates for shorter dated bonds and accommodating fairly aggressive bids for longer dated papers in an attempt to lengthen the maturity profile of public debt.
- As a result, we expect further steepening of the yield curve in the short term largely due to high market liquidity with declines recorded in shorter term yields and uptick in the long-term yields. Subsequently this will increase the spread between the short and long term papers.
- **Our recommendation still stands; BUY short and medium-term bonds and HOLD long term papers.**

Table.7: Short-end falls sharply while long end rises gradually

Tenor	Yield (09th Aug 2019)	Yield (10th Jan 2020)	Yield (07th Aug 2020)	YOY ∆ 7th Aug 2020 vs 9th Aug 2019 (Bps)	YTD ∆ 7th Aug 2020 vs 10th Jan 2020 (Bps)	Sterling Capital yield Curve (7th Aug 2020)
1	9.1520	9.8330	7.4550	↓169.7	↓237.8	7.50
2	9.2231	10.5570	9.1180	↓3.4	↓136.8	9.30
5	10.0325	11.3250	10.3998	↑36.7	↓92.5	10.45
10	11.5000	12.0071	11.6436	↑14.4	↓36.4	11.65
15	12.2500	12.5331	12.3220	↑7.2	↓21.1	12.20
20	12.6167	12.8709	12.9770	↑36.0	↑10.6	12.85

Source: Nairobi Securities Exchange

Figure.9: 1Yr and 2Yr rates in a steady decline



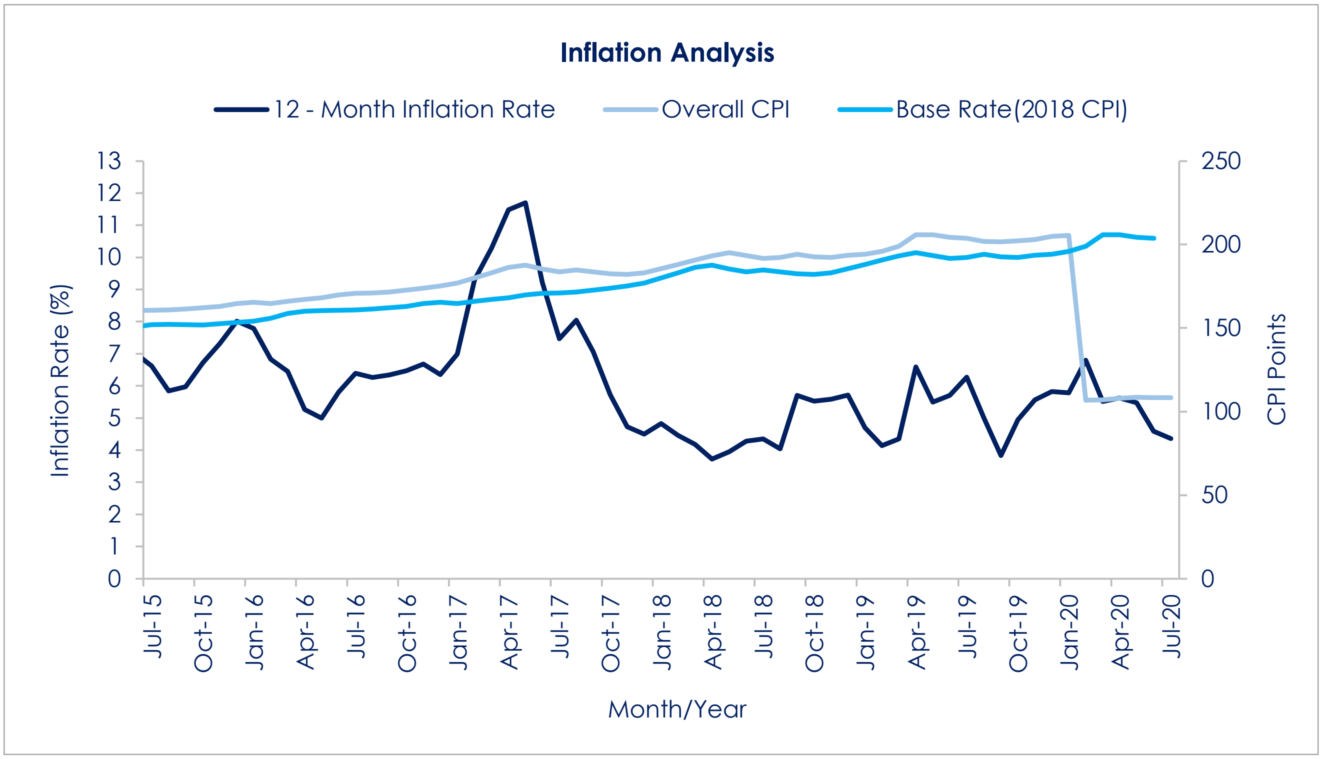
Source: Nairobi Securities Exchange

Inflation rate to range between 4.5-5.5% for the remaining months of 2020

Inflation to range between 4.5% and 5.5%.

- July inflation fell to 4.36% compared to 4.59% in June driven by a decline in the food and Non-alcoholic beverages and housing, water, electricity as well as gas indices that declined 0.8% and 0.4% respectively.
- The two indices make up 48% of the Consumer Price Index (CPI).
- The transport Index increased by 4.01% mainly due to increase in the pump prices of diesel and petrol by 22.3% and 12.2%, respectively
- **The low inflation is favorable for investors in Government securities in the face of declining yields as it boosts real returns which we long-term forecast between 3% - 4% for a one-year investment horizon.**
- We expect good weather conditions across agricultural regions to have a favorable impact on food prices which will ease the pressure on inflation.
- However, international oil prices will continue to increase due to the gradual increase in global demand following easing of pandemic containment measures.
- Murban oil price increased to USD.44.05 per barrel on 6th August 2020 from USD.43.35 per barrel on 30th July.
- We expect inflationary pressure to range between 4.5% - 5.5% in the short term.

Figure.10: Short term Inflation forecast 4.5% - 5.5%



Source: Kenya National Bureau of Statistics

MPC to retain CBR at 7% in September 2020

MPC to retain CBR at 7%.

- In line with our expectations as stated in our July 2020 fixed income report titled "Kick-off 2020-21", the Monetary Policy Committee (MPC) retained the Central Bank Rate (CBR) at 7% on 29th July.
- The MPC noted that the package of policy measures implemented since March were having the intended effect on the economy and so no reason to revise the policy rate.
- Inflation declined and is expected to remain within the target range in the near term on account of lower food prices, the impact of the reduction of VAT and muted demand pressures.
- Private sector credit grew by 7.6% in the 12 months to June 2020 supported by the KES.35.2Bn that was released by the lowering of the Cash Reserve Ratio (CRR) in March. KES.31.4Bn (89.1%) has been used to support lending, especially to the tourism, transport and communication, real estate, trade and manufacturing sectors.
- We expect economic activity to improve in the next two months due to the MPC to lifting of the inter-county travel ban and the resumption of local and international flights.
- On the basis of the above-mentioned variables, we expect a retention of the CBR at 7% in the meeting scheduled for September.

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