Wednesday, 10 November 2021

STERLING CAPITAL LIMITED

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>

Fixed Income Note

February 2021

"Public debt likley to hit KES.1Tn"

Table of Contents

Executive Summary

- **"Flurry of domestic debt issues"** is the title of our third fixed income report in 2021 with the Central Bank of Kenya (CBK) re-opening two bonds with a KES.50Bn financing target.
- We anticipate an under subscription for the issue based on low liquidity in the market and relatively short period of sale.
- Our weighted average bid predictions are as follows:

  Weighted Average Rate (WAR) of investor bids

  - **FXD1/2013/15: 11.70% - 11.80%**
  - **FXD1/2012/20: 12.35% - 12.50%**

  WAR of accepted bids

  - **FXD1/2013/15: 11.65% - 11.70%**
  - **FXD1/2012/20: 12.30% - 12.40%**

- The report summarizes trends in subscriptions for both short- and long-term debt as well as giving an analysis of short-term debt interest rates.
- Also in the report is a short-term summary of commercial bank liquidity and secondary bond trading activity
- Kenya's financial position including debt service, revenue and expenditure at the mid-point of the 2020/21 fiscal year is also discussed in the report.
- We have also done a comparison of the Nairobi Securities (NSE) yield curve over the last one year to explain the decline in short- and medium-term domestic debt yields.
- The report concludes with our review of the Monetary Policy Committee (MPC) decision in January 2021.

CBK's re-opened medium tenor issues

- The Central Bank of Kenya (CBK) invites bids for two treasury bonds **FXD1/2013/15 and FXD1/2012/20 to raise** KES.50Bn (Table.1).
- The remaining term to maturity for **FXD1/2013/15 and FXD1/2012/20** is 7.1 and 11.8 years respectively.
- We anticipate an undersubscription for the issue -40%- 60% (KES.20Bn – KES.30Bn) on account of low liquidity in the market with most interest in the market on the short-term papers.

Table.1: Primary Bond issue summary

Issue Number	**FXD1/2013/15**	**FXD1/2012/20**
Total Amount Offered	KES.50Bn	
Tenor (Years)	15 Years	20 Years
Term to Maturity	7.1 Years	11.8 Years
Coupon Rate (%)	11.250	12.000
Price Quote	Discounted/Premium/Par	
Period of Sale	26th January 2021 to 2nd February 2021	
Auction Date	3rd February 2021	
Value Date	8th February 2021	
Yield Curve (%) (Weighted Average tenor - 22nd January 2021	**11.3689**	**12.1158**

Source: Central Bank of Kenya

Our weighted average and accepted bids averages

- We arrived at our market weighted investor and CBK accepted bids estimates using an analysis of yields of securities of similar tenors on the NSE as at 22nd January 2021 and discussions with fixed income traders (Table.3).

Table.2: Auction bid predictions

Rate	**FXD1/2013/15**	**FXD1/2012/20**
Market Weighted Average Rate	11.70 - 11.80	12.35 - 12.50
Weighted Average Rate of	11.65 - 11.70	12.30 - 12.40

Source: Sterling Capital Research

Historical debt issues provide guidance

- We implied yields of bonds of almost similar tenors to maturities on the Nairobi Securities Exchange (NSE) as at 22nd January 2020 to determine possible investor bids (Table.4).

Table.3: 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
15-Year						
FXD2/2013/15	29th April 2013	12.00	10th April 2028	7.2 (2,635)	11.3796	N/A
20-Year						
FXD1/2018/15	28th May 2018	12.65	09th May 2033	12.3 (4,490)	12.1894	N/A

Source: Central Bank of Kenya

Comparatively higher subscriptions for short- and medium-term tenors

- A historical review of primary auction results for 15- and 20-year issues show low investor demand due to the long term to maturity.
- As a result, we expect the auction to be undersubscribed with most investors left out in the 2-Yr and Infrastructure bond earlier in the month likely to direct their funds to the secondary market.

Table.4: Historical primary market auction performance

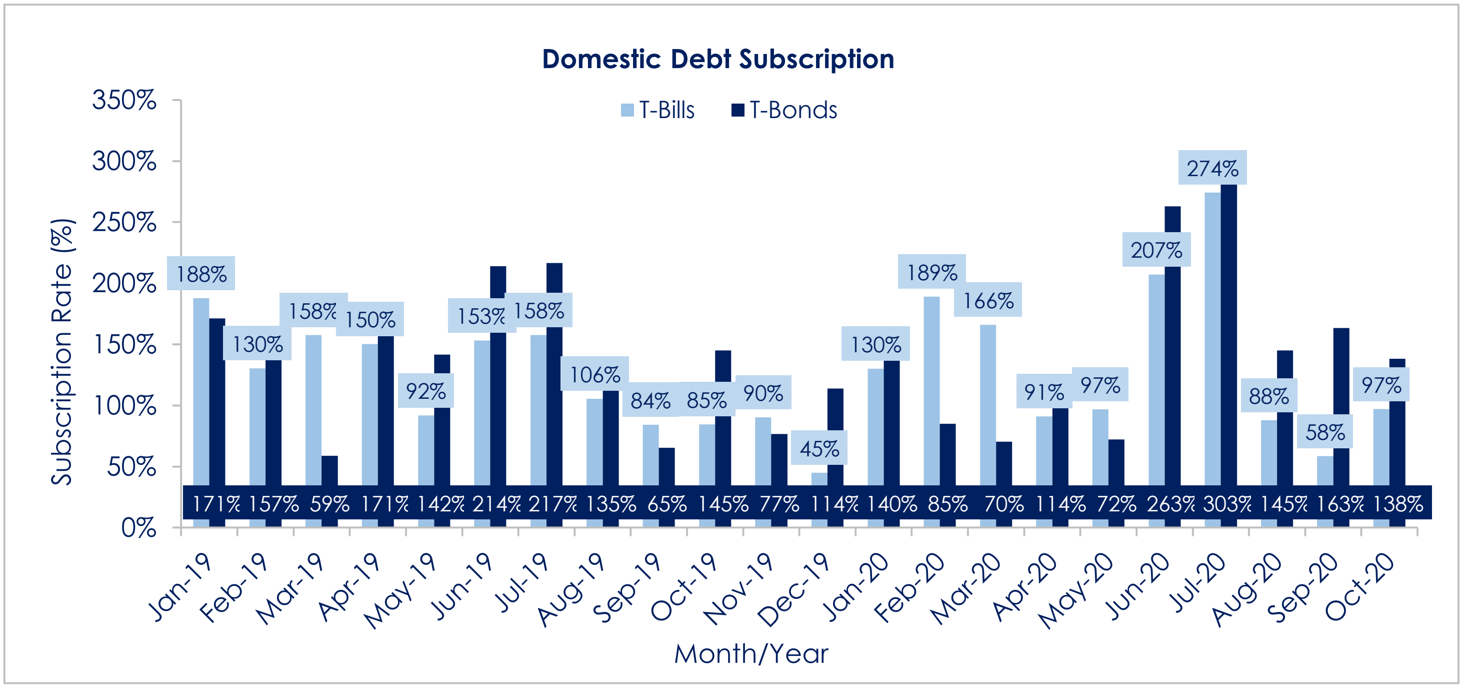
Issue	Offered (KES.Bn)	Bids Received (KES.Bn)	Amount Accepted (KES.Bn)	Performance Rate (%)	Coupon Rate (%)	Implied Yield (%)
15-Year						
FXD1/2018/15	40	20.2	12.9	50.5	12.65	11.9222
FXD2/2018/15	40	27.1	7.9	67.6	12.75	12.0153
FXD1/2019/15	40	25.1	14.7	62.7	12.86	12.0901
FXD2/2019/15	50	21.5	19.3	43.1	12.73	12.1669
FXD3/2019/15	40	86.7	50.6	216.7	12.34	12.2784
FXD1/2020/15	50	18.4	5.2	36.9	12.76	12.5664
20-Year						
FXD1/2018/20	40	13.7	8.5	34.4	13.20	12.7113
FXD2/2018/20	40	13.9	10.5	34.7	13.20	12.8087
FXD1/2019/20	40	25.1	14.7	62.7	12.86	12.8827

Source: Central Bank of Kenya

Demand for the 91-Day T-Bill and long-term T-Bonds to remain high

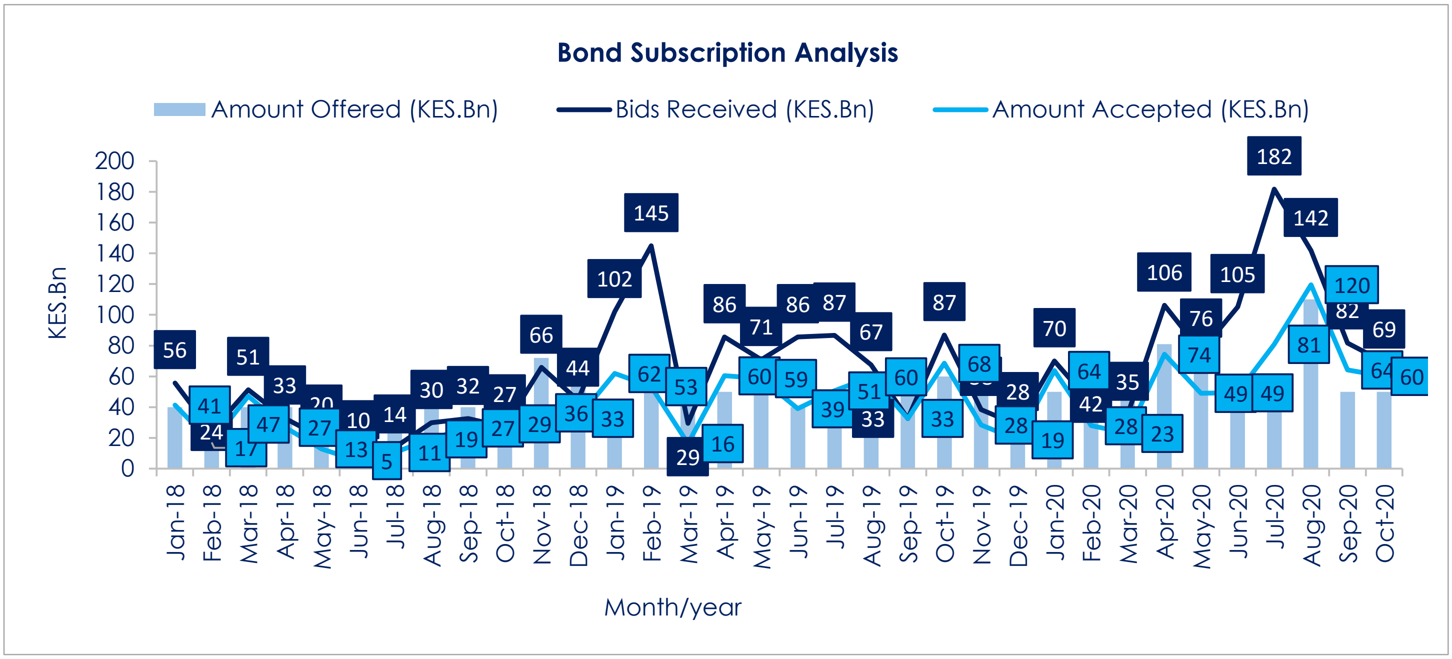
- The CBK received domestic debt bids worth KES.93.1Bn against KES.96Bn offered in October, a subscription rate of 97% (Figure.1).
- The 91-day T-Bill remained the most popular debt issue during the month, with a subscription rate of 164.8%, attributable to an expected gradual increase in short-term interest rates.
- The 182-day paper received a subscription rate of 55.8% while the 364-day paper was oversubscribed at 111%.
- The two re-opened T-Bonds in October received bids worth KES.69.1Bn (138.3% subscription rate) with FXD1/2018/25 (22.7 Years) receiving a higher subscription rate (92%) compared to 46.3% received for FXD/2011/20 (10.6 Years).
- We expect demand for the T-Bonds to remain high compared to T-Bills as a result of higher interest rate spreads, thus providing high returns.

Figure.1: Domestic debt subscriptions up in October



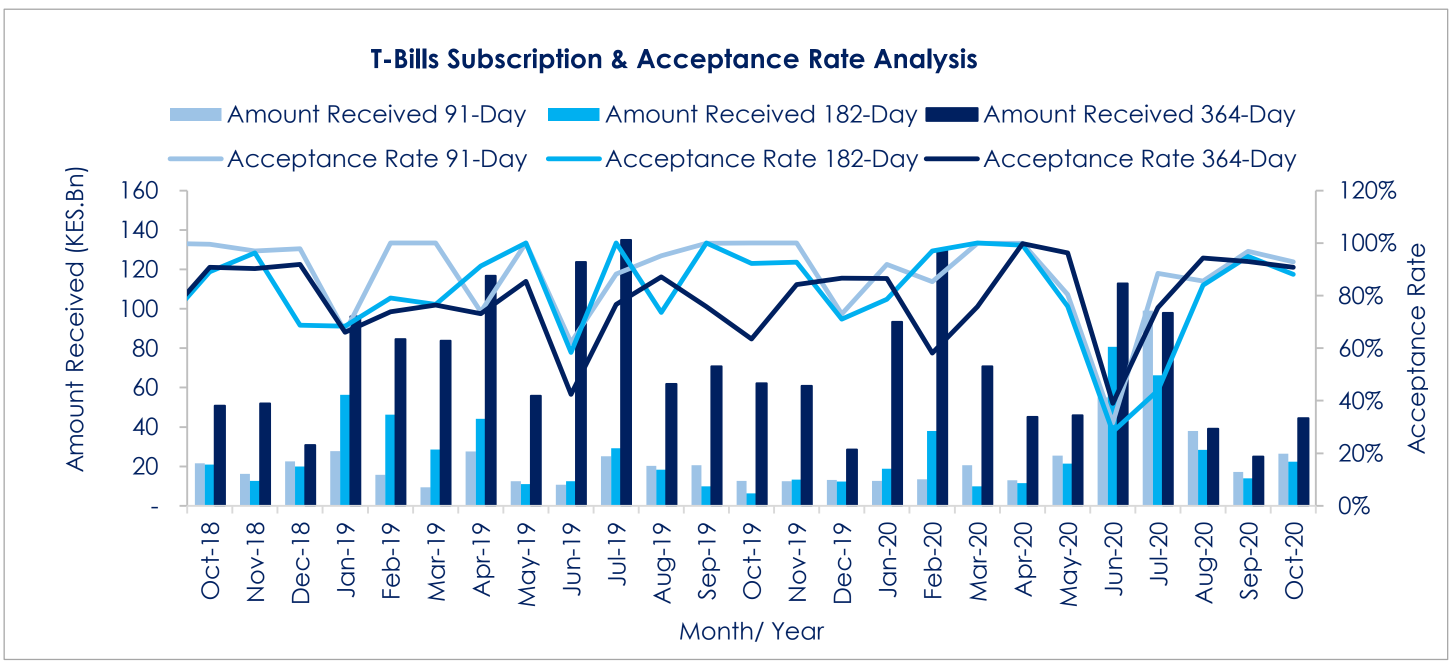
Source: Central Bank of Kenya

Figure.2: Investor auction bids received decline steadily



Source: Central Bank of Kenya

Figure.3: Acceptance rate for all T-Bill tenors declines



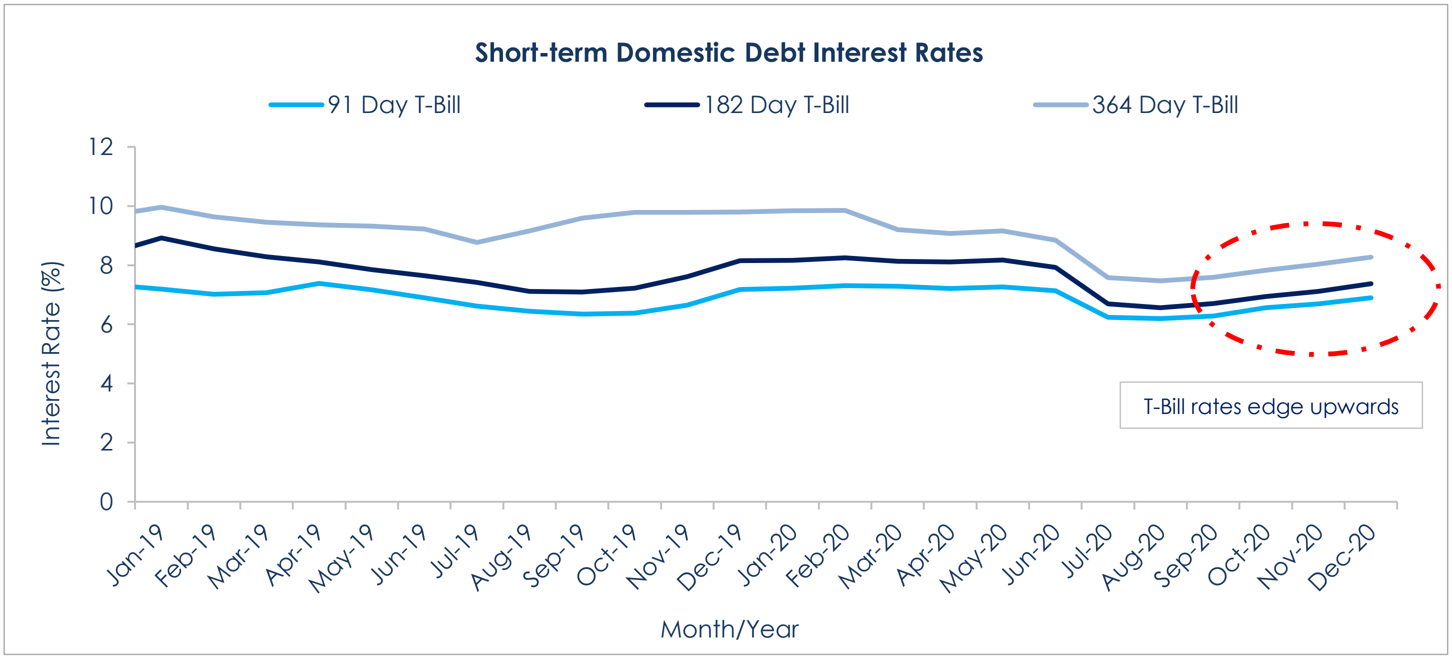
Source: Central Bank of Kenya

Average T-Bill rates have edged upwards in January 2021

Average T-Bill rates for the first three weeks of January 2021 higher than the those in December 2020.

- Interest rates on domestic debt have been rising gradually in recent months (Figure.1).
- Subscription as at the end of the first three weeks of January 2021 stood at 86.8% compared to 50.3% in December 2020.
- We attribute this to high market liquidity as well as marginal increases in T-bills' interest rates.
- The acceptance rate for the T-Bills during the period under review 91.4% compared to 93.5% in December 2020.
- Average interest rates for the 91, 182 and 364-day debt issues for the first three weeks of January stood at 7%, 7.5% and 8.5% respectively compared to the December 2020 averages of 6.9%, 7.4% and 8.4% respectively.
- We anticipate slight upward pressure on the short-end of the yield curve in upcoming auctions due to the high deficit financing demand by the National Treasury.

Figure.4: Interest rates on short-term debt securities edge upwards to 7%, 7.5% and 8.5% respectively



*Average T-Bill rates for January are up to the auction dated 25/01/2021
Source: Central Bank of Kenya

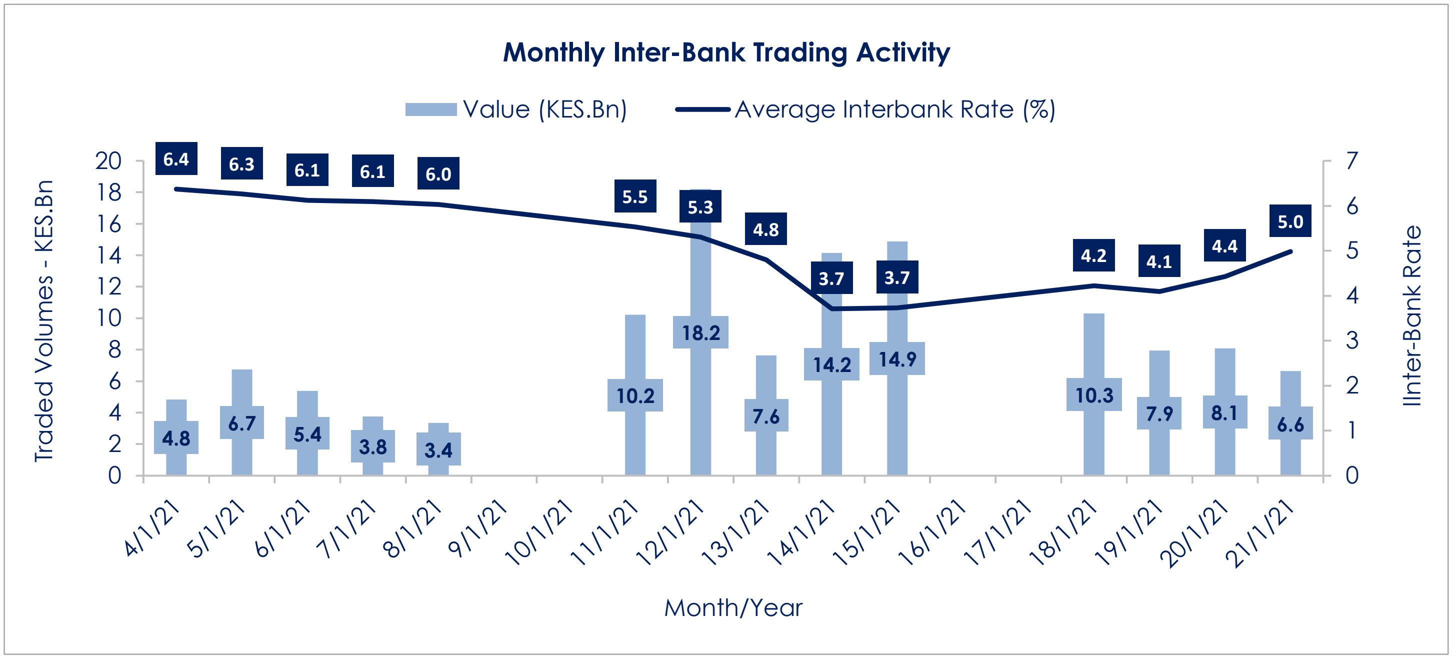
Inter-bank trading activity comparatively lower in January 2021

- The average inter-bank rate for the first three weeks ending 22nd January 2021 stood at 5.1% similar to that of the entire month of December 2020 (Figure.2).
- Total inter-bank trading volumes during the period stood at KES.128.7Bn compared to KES.259.2Bn for the entire month of December suggesting that total volumes for the month are likely to be lower than that in December.

- Excess reserves (additional liquidity above the minimum 4.25% Cash Reserve Ratio (CRR)) over the same period stood at KES.39.4 compared to KES.96.2Bn attributable to the relatively high market liquidity, mainly supported by government payments that partly offset tax remittances (Figure.3).

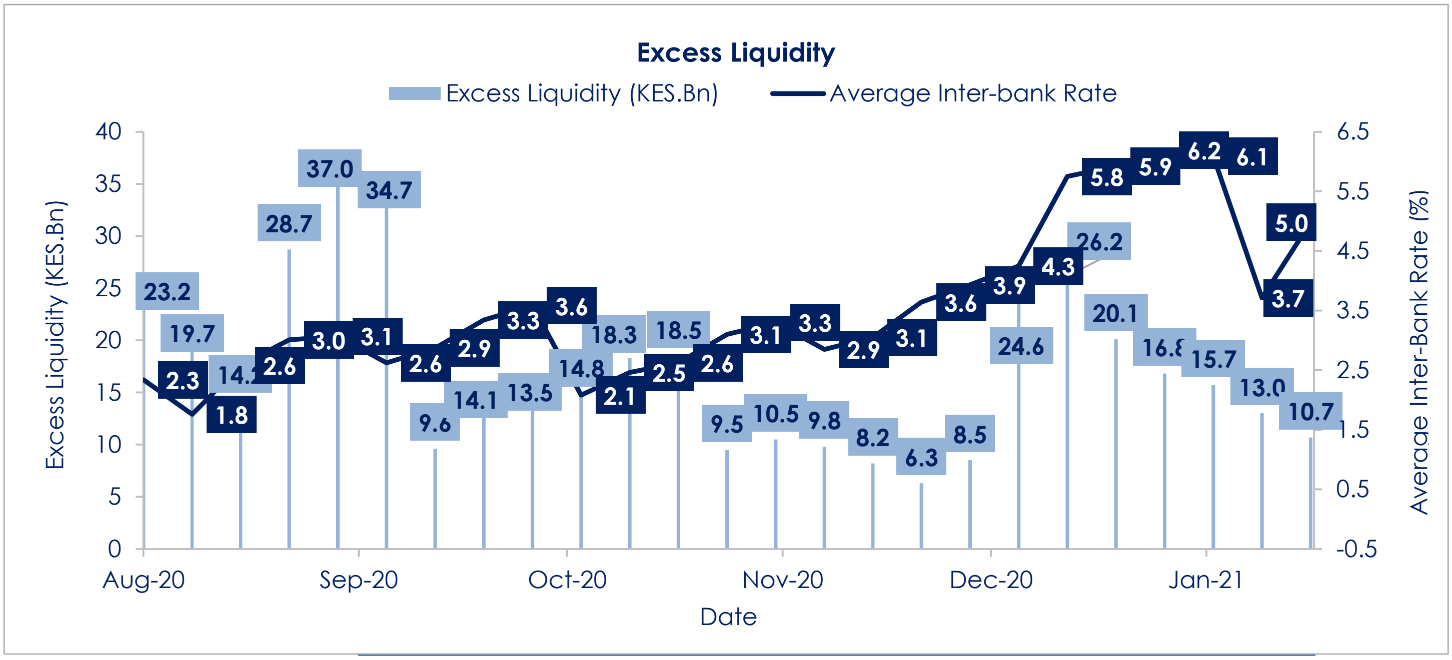
- We forecast the average inter-bank rate for January 2021 in the range of 5% and 5.5%.

Figure.5: Inter-bank rates to range between 5.0% and 5.5% in January 2021



Source: Central Bank of Kenya

Figure.6: Commercial excess reserves declining in January

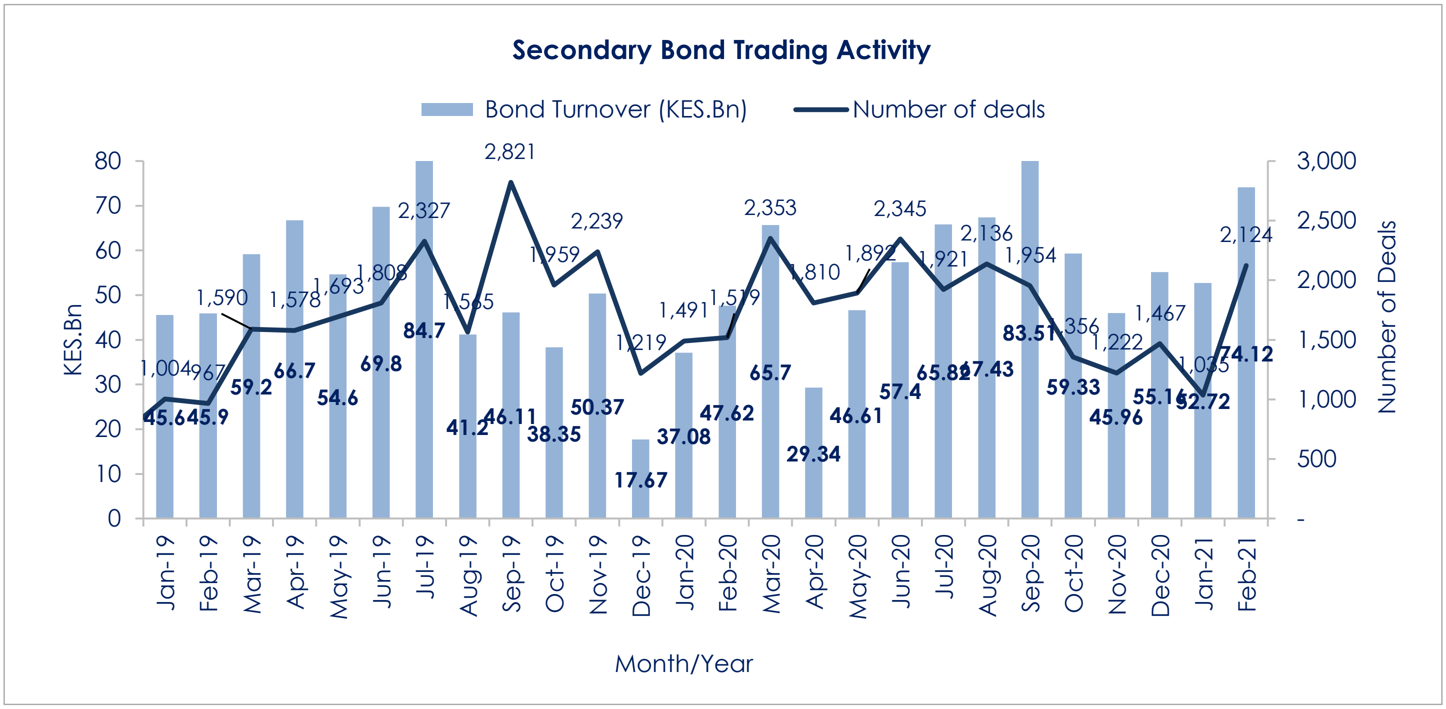


*Data is at 22nd January 2021

Source: Central Bank of Kenya

- Secondary trading up to the end of the third week of January (22nd) stood at KES.18.5Bn compared to KES.55.2Bn for the entire month of December while the number of deals stood at 599 compared to 1,467 in December (Figure.4).
- This suggests that we will see a decline in turnover for the month compared to the previous month contrary to our predictions at the beginning of the month.
- This decline in turnover can be explained by investors focus in the primary market where CBK issued two debt issues, FXD1/2021/2 and IFB1/2021/16 which were both oversubscribed at 244.6% (KES.61.1Bn) and 251% (KES.125.5Bn) respectively.

Figure.7: Secondary trading activity to decline in January 2021



Source: Central Bank of Kenya

Trading ideas - Take trading positions in the IFBs

Take trading positions in the IFBs due to higher price appreciation

- In reference to the poor performance of the NSE's equities market, we recommend investment in Government securities, specifically the Infrastructure Bonds (IFB) on the basis of lower risk and favourable return.
- IFBs offer higher price appreciation potential hence presenting better capital gain opportunities.
- **We single out IFB1/2020/6, IFB1/2020/9 and IFB1/2020/11 as offering a good investment opportunity** (Table.5.)

Table.5: Trading ideas

Bond	Tenor (Years)	Coupon (%)	Modified Duration* (%)	Sterling Capital Yield to Maturity (%)	Current Yield** (%)
IFB1/2020/06	5.56	10.20	3.99	9.85	9.61
IFB1/2020/09	8.42	10.85	5.40	10.45	10.55
IFB1/2020/11	10.79	10.90	6.11	10.80	10.58

Source: Nairobi Securities Exchange & Sterling Research

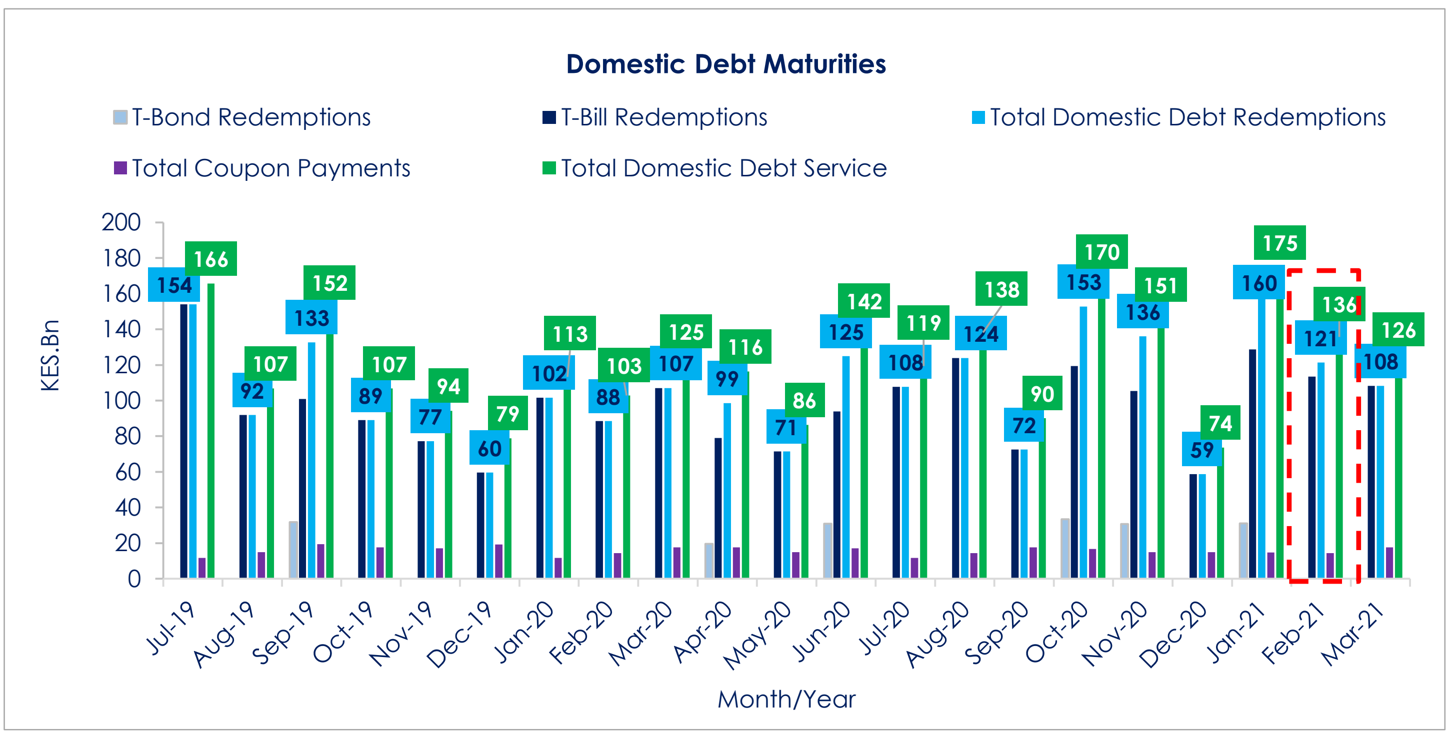
*Modified duration - Expresses the measurable change in the value of a security in response to a change in interest rates (for every 1% movement in interest rates, the bond would inversely move in price by the modified duration)
** Current Yield - Return on investment, for an investor holding a specific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

Domestic debt service to decline February 2021

KES.199.9Bn raised in January with KES.174.7Bn directed towards debt redemptions and KES.14.8Bn in coupon payments.

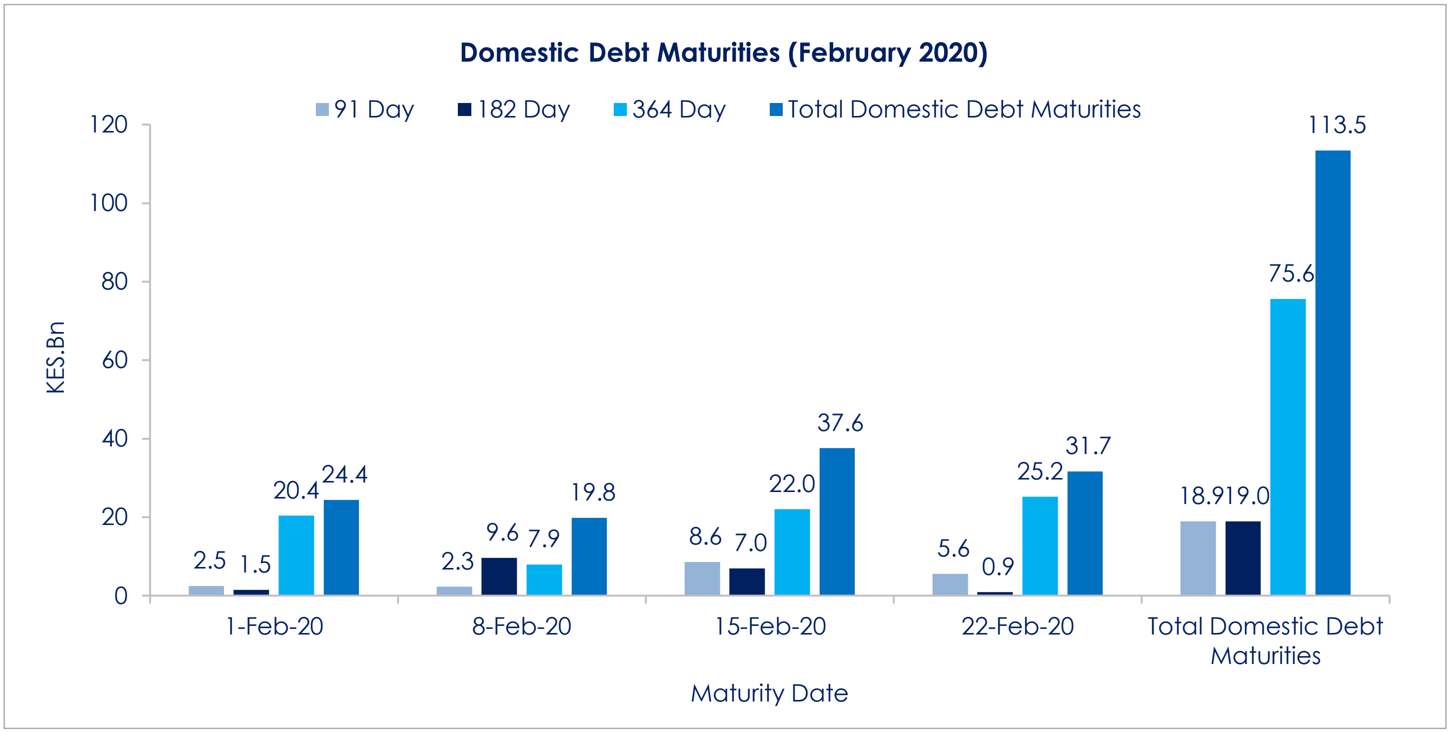
- Debt service for the month of January is KES.174.7Bn comprising of KES.128.8Bn in T-Bills, KES.31.1Bn in T-Bonds and KES.14.8Bn in coupon payments (Figure.4).
- Expected redemptions for the 91, 182 and 364-day T-Bills during the month are KES.24.5Bn, KES.29.1Bn and KES.75.2Bn respectively with the second week of the month expected to have the highest total redemptions at KES.51.4Bn (Figure.5)
- We observe that of the KES.199.9Bn raised in domestic debt auctions (KES.136.9Bn in T-Bonds and KES.63Bn in T-Bills), KES.180.1Bn has been used as new borrowing equivalent to 90.1% of total amount raised by the CBK.
- T-Bond and T-Bill redemptions are expected to fall to KES.7.9Bn and KES.113.5Bn respectively, while coupon payments decline to KES.14.5Bn, bringing the total debt service cost to KES.135.8Bn in February 2021.

Figure.4: February 2021 debt service to decline to KES.126Bn



Source: Central Bank of Kenya

Figure.5: February 2021 Weekly debt maturities



Source: Central Bank of Kenya

Fiscal deficit likely to reach KES.1Tn

Shortfalls in tax revenues FY2020/21 could result in an increase in Government borrowing to KES.1Tn.

- As we expected and stated in our January Fixed Income report titled **"Flurry of domestic debt issues continues"**, the National Treasury released its first revision to the 2020/21 fiscal budget (Table.xxx).
- Notable in the revised budget is a 0.6% and 0.4% downward revision in total and ordinary revenue respectively as well as a 0.4% decline in estimated expenditure and net lending.
- Although the revised revenue and expenditure estimates translate to a 3.5% decline in total financing to KES.967Bn, we see further downward revisions especially in tax revenues will result in a fiscal deficit in excess of KES.1Tn.
- We predict the issuance of sovereign debt (Eurobond) and possibly a sovereign Green Bond with a combined issuance amount of about KES.2Bn to add to the the already disbursed KES.2.4Bn International Mometary Fund (IMF) loan thus exceeding the external borrowing target.

Table.3: Kenya National Accounts - Fiscal deficit likely to reach KES.1Tn

Fiscal Budget Item	2019/20 Actual	2020/21 BROP* Target	2020/21 Revised Budget 1	Change
Total Revenue	**1,734**	**1,860**	**1,849**	**-0.6%**
Ordinary Revenue	**1,573**	**1,601**	**1,594**	**-0.4%**
Appropriation in Aid**	160	259	255	-1.5%

Expenditure and Net-Lending*	**2,565**	**2,919**	**2,864**	**-0.4%**
Recurrent	**1,645**	**1,844**	**1,838**	**-1.5%**
Development and Net Lending	595	675	639	-5.3%
County Allocation	325	395	383	**-3.0%**
Fiscal Balance (Excluding Grants)	**-832**	**-1,059**	**-1,015**	**-4.2%**
Grants	20	57	57	0.0%
Fiscal Balance (Including Grants)	-812	-1,002	-967	-3.5%
Total Financing	**791**	**1,002**	**967**	**-3.5%**
Net Foreign Financing	340	402	426	6.0%
Net Domestic Financing	**450**	**600**	**540**	**-10.0%**

Source: The National Treasury & Planning

2020/21 Domestic borrowing ahead of our target run rate

Total tax revenue continues to underperform

- According to data released by the National Treasury as at the end of January 2021, total domestic borrowing and total revenue stand at KES.504.2Bn and KES.784.9Bn respectively.
- This is equivalent to 64.1% and 50.1% of the total domestic and tax revenue targets for the 2020/21 fiscal year against our linear target run-rate of 58.3% (Figure.xxx).
- This is a clear indiication of the challenges faced by the Government in raising tax revenue with the economy severely affected by the Covid-19 pandemic.

Table.xxx: 2020/21 fiscal year revenues remain below target run-rate

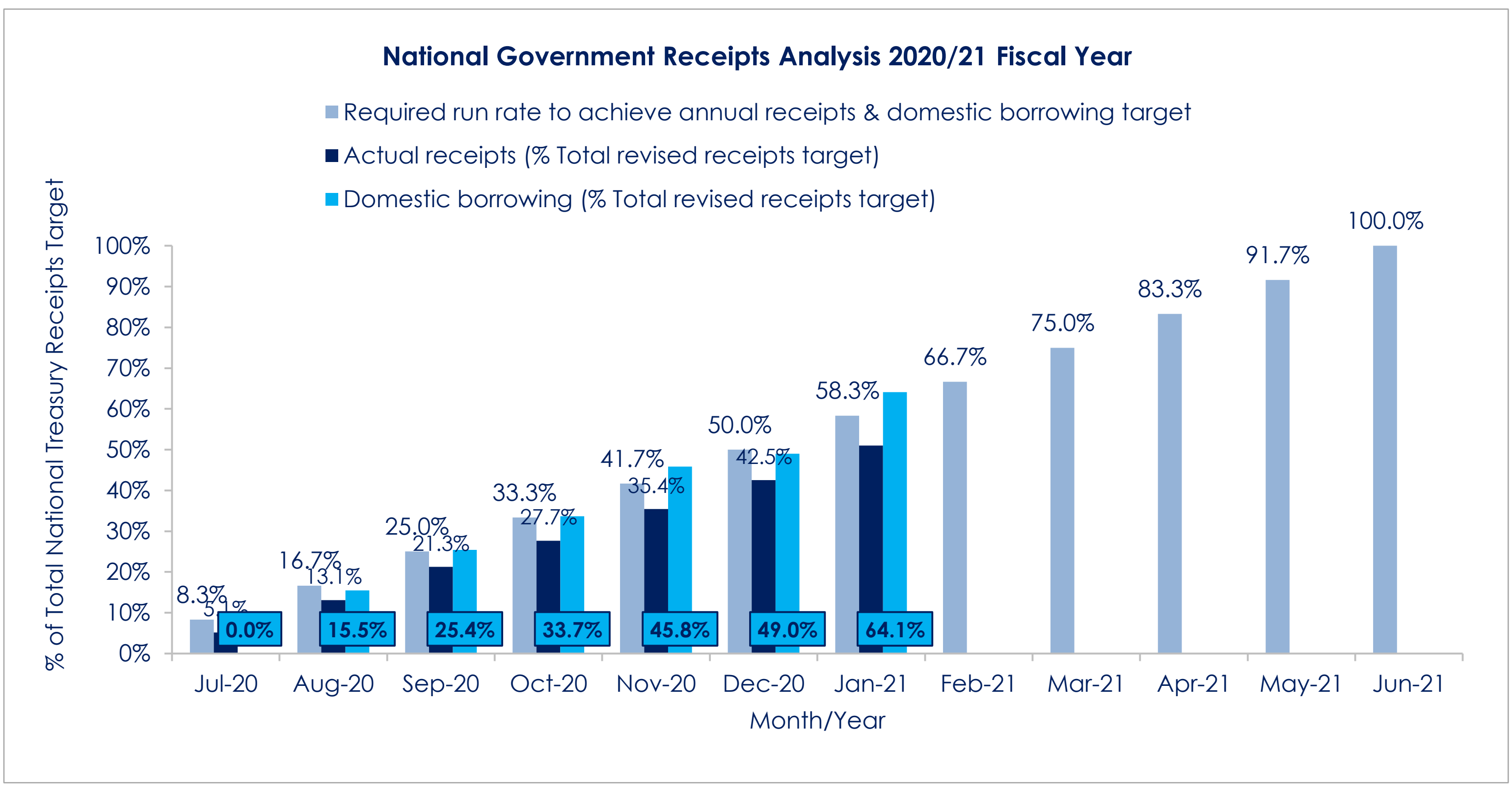
Receipts	**Original Estimates (KES)**	**Revised Estimates (KES) 31st August 2020**	**Actual Receipts (KES) 31st December 2020**	**Actual Receipts (KES) 31st January 2021**	**Proportion of Receipt Target (KES) 31st January 2021**
Opening Balance (1st July 2020)			48.0	48.0	-
Tax Revenue	**1,567.6**	**1,567.6**	673.6	784.9	50.1%
Non-Tax Income	66.1	66.1	52.9	55.1	83.2%

Domestic Borrowing	756.9	786.6	385.8	504.3	64.1%
External Loans & Grants	373.2	373.2	39.8	48.3	12.9%
Other Domestic Financing	36.8	36.9	3.0	3.0	8.3
Total Revenue	**2,800.7**		**1,203.1**	**1,203.1**	**51.0%**

* Note 1: Domestic Borrowing of KES.786.6Bn = Net Domestic borrowing KES.524.7Bn & Internal Debt Redemptions (Roll-overs) KES.262

Source: The Kenya Gazette Vol. CXXIII - No.33 19th February 2021

Figure.xx: 2020/21 Total revenue underperforming



Source: The Kenya Gazette Vol. CXXIII - No.33 19th February 2021

Yield curve expected to shift upwards as a result of budgetary pressure

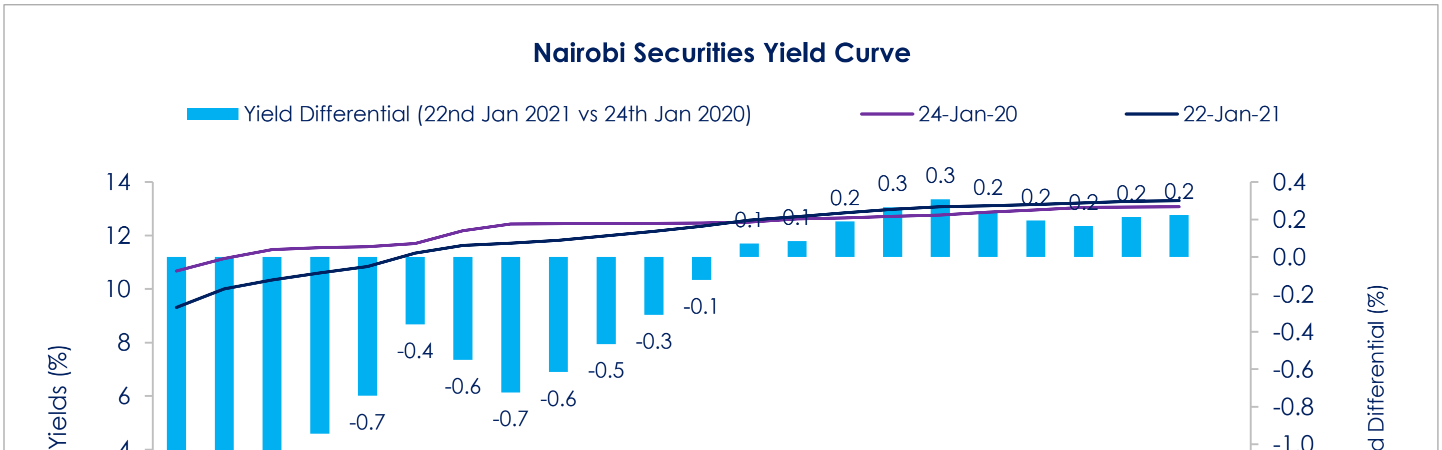
- A comparison of the NSE yield curve between 22nd January 2021 and 24th January 2020 (1 year) shows a significant decline in yields of short to medium tenor securities while those of long-term debt issues increased (Table.6 and Figure.7).
- We attribute this to Government's debt management strategy of issuing long-term debt issues in a bid to lengthen the maturity profile of public debt.
- Increased domestic debt financing in the 2020/21 fiscal year due to the growing fiscal deficit is likely to result in a gradual rise in yields.
- We maintain our recommendation of **BUY short and medium-term bonds and HOLD long term papers.**

Table.6: Yields on the short end and medium terms decline

Tenor	Yield (24th Jan 2020)	Yield (22nd Jan 2021)	YoY ∆ 22nd Jan 2021 vs 24th Jan 2020 (Bps)	Sterling Capital yield Curve (28th January 2021)
1	9.8590	8.5080	↓135.1	8.60
2	10.6757	9.3167	↓135.9	9.50
5	11.5446	10.600	↓94.5	10.65
10	12.4377	11.8223	↓61.5	11.90
15	12.6250	12.7091	↑8.4	12.60
20	12.9584	13.1529	↑19.5	12.95

Source: Nairobi Securities Exchange

Figure.7: Yields have risen in the long end of the yield curve compared to January 2020.



Source: Nairobi Securities Exchange

MPC retains CBR at 7% for sixth consecutive in January meeting

MPC retains CBR at 7% in January meeting.

- Monetary Policy Committee (MPC) retained the Central Bank Rate (CBR) at 7% In their most recent meeting on Wednesday, 27th January, 2021, in line with our expectations as stated in our January 2021 fixed income report titled "**2021 get set go!"**.
- Strong banking sector liquidity and capital adequacy ratios even with a relatively high Non-Performing Loans (NPL) ratio of 14.1%, a stable inflation rate and a relatively healthy foreign currency reserve position were quoted as some of the reasons for the decision
- We expect the resumption of most businesses that had stalled due to the pandemic, expectations of acquiring a Covid-19 vaccine and strong agricultural production to have a positive impact on the economic activity in 2021.
- The next MPC meeting will be in March 2021 where we once again expect a retention of the rate at 7%.

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.