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STERLING CAPITAL LIMITED

Fixed Income Note

January 2021

"2021 get set, go!"

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Executive Summary

- **"2021 get set go!"** is the title of our first fixed income report in 2021 with the Central Bank of Kenya (CBK) floating a KES.50Bn Infrastructure Bond (IFB) with a tenor of 16 years (IFB1/2021/16).
- We anticipate an over subscription for the issue with an amortized redemption structure resulting in an effective tenor of 12.5 years.
- Our weighted average bid predictions are as follows:

  Weighted Average Rate (WAR) of investor bids: 12.50% - 12.60%

  WAR of accepted bids: 12.40% - 12.50%

- 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 giving our expectations for the month of January 2021.
- The trading ideas section gives our investment recommendation.
- Debt service and Kenya's financial position at the end of the first five months of the 2020/21 fiscal year is discussed in the national accounts section.
- in the latter section of the report which concludes, where we anticipate an upward revision of the domestic borrowing target as actual receipts fall short of the annual target.
- Yield curve movements and comparisons over time are graphically illustrated and explained in the report.
- The report concludes with our views on inflation and our expectations of the Monetary Policy Committee (MPC) decision on the Central Bank Rate (CBR) later this month.

CBK's 16-year amortized IFB the first of 2021

KES.50Bn IFB, with an effective tenor of 12.5 years

- The Central Bank of Kenya (CBK) is back in the domestic debt primary bond market with the first Infrastructure Bond (IFB) of 2021 and the second of the 2020/21 fiscal year (Table.1).
- The 16-Year amortized infrastructure bond (IFB1/2021/16) seeks to raise KES.50Bn and comes soon after the re-opening and tap sales of FXD1/2012/15 and FXD2/2019/15 in December 2020.
- Being an amortized bond, investors will be able to redeem 50% of the outstanding principal amounts in January 2030 with final redemption on all outstanding amounts in January 2037.
- We anticipate an oversubscription on account of tax benefits translating to higher returns with Kenya Government bonds also considered a comparatively low risk investment option to the volatile and underperforming Nairobi Securities Exchange (NSE) equities market.

Table.1: Infrastructure Bond issue summary

Issue Number	**IFB1/2021/16**
Total Amount Offered	KES.50Bn
Tenor (Years)	16 Years
Effective Tenor	12.5 Years
Coupon Rate (%)	Market Determined
Issue Price	Discounted/Premium/Par
Period of Sale	21st Dec 2020 to 19th Jan 2021
Auction Date	20th Jan 2021
Value Date	25th Jan 2021
Yield Curve (%) (Weighted Average tenor - 12.5 years) 31st Dec 2020	**12.2807**

Source: Central Bank of Kenya

IFB1/2021/16 amortized redemption structure

- IFB1/2021/16 has an amortizing redemption structure making its effective tenor 12.5 years (Table.2).

Table.2: Amortized redemption tenor is 12.5 years

Redemption Period	**% of principal**	**Tenor Calculation**	**Weighted Tenor**
9 Years (Jan 2021 - Jan 2030)	50%	50%*9 years	4.5 years
16 Years (Jan 2020 - Jan 2037)	50%	50%*16 years	8 years
Effective tenor			4.5 + 8.0 = 12.5 years

Source: Central Bank of Kenya & Sterling Capital Research

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 31st December 2020 and discussions with fixed income traders (Table.3).

Table.3: Auction bid predictions

Rate	IFB1/2021/16
Market Weighted Average Rate (%)	12.50% - 12.60%
Weighted Average Rate of Accepted Bids (%)	12.40% - 12.50%

Source: Sterling Capital Research

Our predicted rates are guided by historical debt issues

- In our determination of possible investor's bids, we used implied yields of bonds of almost similar tenors to maturities on the NSE as at 31st December, 2020 (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
IFB1/2018/15	29th Jan 2018	12.5	10th Jan 2033	12.2 (4,393)	11.1074	13.2032

Source: Central Bank of Kenya

IFBs generally attract heavy investor demand due to tax status.

- A historical review of IFB auction results show the popularity of issues with tenors of less than 20 years, more so the 12 and 15 years (Table 5).
- The last most recently issued IFB (August 2020) - IFB1/2020/11 had a coupon rate of 10.9% and was oversubscribed (145%) largely due to its short-amortized tenor of 8.5 years.
- Notable undersubscriptions included IFB1/2015/9 issued during a period of high private sector lending and IFB1/2020/6 whose subscription was limited to investors in the maturing Treasury Bill Issue No. 2236/364.
- IFB1/2018/20 was undersubscribed due to the uncertainty in the interest rate environment at the time coupled with a short bidding period of only two days whereas issue IFB1/2019/25 had a long tenor.
- Therefore, prevailing market and economic conditions such as interest rates, market liquidity, equities' market performance and other factors have an impact on the performance of the respective auctions.
- We expect investors to bid aggressively for the bond with the CBK likely to accept more than its borrowing target due to high financing needs brought about by a shortfall in revenue collection targets for short-amortized the current fiscal year.

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	10.0304
IFB1/2015/12	25	51.7	25.7	206.6	11.00	10.0594
IFB1/2015/12 (Tap)	25	51.7	24.0	97.5	11.00	10.0594
IFB1/2015/9	30	16.6	14.0	55.3	11.00	9.8681
IFB1/2016/9	30	39.4	34.9	269.8	12.50	9.9000
IFB1/2016/15	30	35.1	30.6	117.0	12.00	10.6832
IFB1/2017/12	30	35.0	6.0	116.8	12.50	10.5903
IFB1/2017/12 (Tap)	-	8.0	7.6	-	12.50	10.5903
IFB1/2017/7	30	45.9	42.0	153.0	12.50	9.9869
IFB1/2018/15	40	55.8	5.0	139.4	12.50	11.1074
IFB1/2018/15 (Tap)		-	36.3		12.50	11.1074
IFB1/2018/20	50	40.4	27.6	80.8	11.95	11.2617
IFB1/2018/20 (Tap)		-	8.73	-	11.95	11.2617
IFB1/2019/25	50	29.4	16.3	58.8	12.20	11.7376
IFB1/2019/16	60	86.9	68.5	144.9	11.75	11.1942
IFB1/2020/9	60	68.4	39.0	114.0	10.85	10.6000
IFB1/2020/9 (Tap)	21	37.8	35.4	-	10.85	10.6000
IFB1/2020/6	26	21.2	19.3	82.7	10.20	9.8500
IFB1/2020/11	70	101.5	78.6	145.0	10.90	10.7000

Source: Central Bank of Kenya

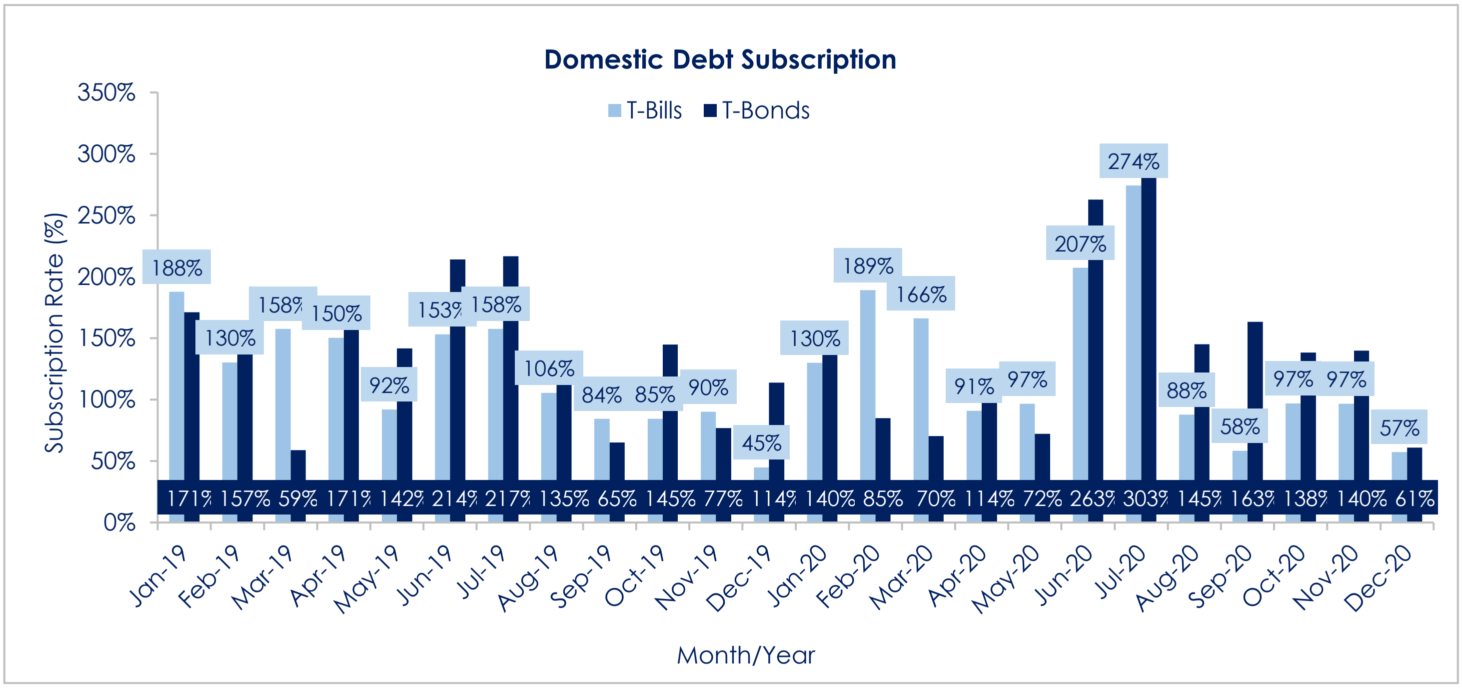
Domestic debt demand falls sharply in December 2020

Primary domestic debt activity - Sharp decline in demand for domestic debt in December.

- CBK re-opened two 15 - Year bonds in December 2020 (FXD1/2012/15 and FXD2/2019/15) receiving subscriptions worth KES.24.3Bn against KES.40Bn on offer, a subscription rate of 60.9% (Figure.1 and Figure.2).
- Additionally, there was a tap sale for the same bonds which was undersubscribed with CBK receiving bids worth KES.10Bn against KES.22Bn offered equivalent to a 45.5% subscription rate.
- During the month CBK accepted KES.28.2Bn for the T-bonds, with acceptance rate of 82%.
- T-Bills on offer during the month amounted to KES.96Bn with the CBK receiving bids worth KES.55.1Bn, a subscription rate of 57.4% (Figure.3).
- The 91-day T-Bill was oversubscribed at 118.2% while the 182-day and 364-day papers were undersubscribed at 40.2% and 50.4% respectively.
- Acceptance rates for the 91-day, 182-day and 364-day papers was high at 96%, 99.3% and 84.3% respectively, as the Government bridges the high fiscal deficit caused by declining revenues (Figure.3).
- We expect T-Bills to be undersubscribed in the month of January as investors shift focus to the 2-year bond FXD1/2021/2 and this IFB.

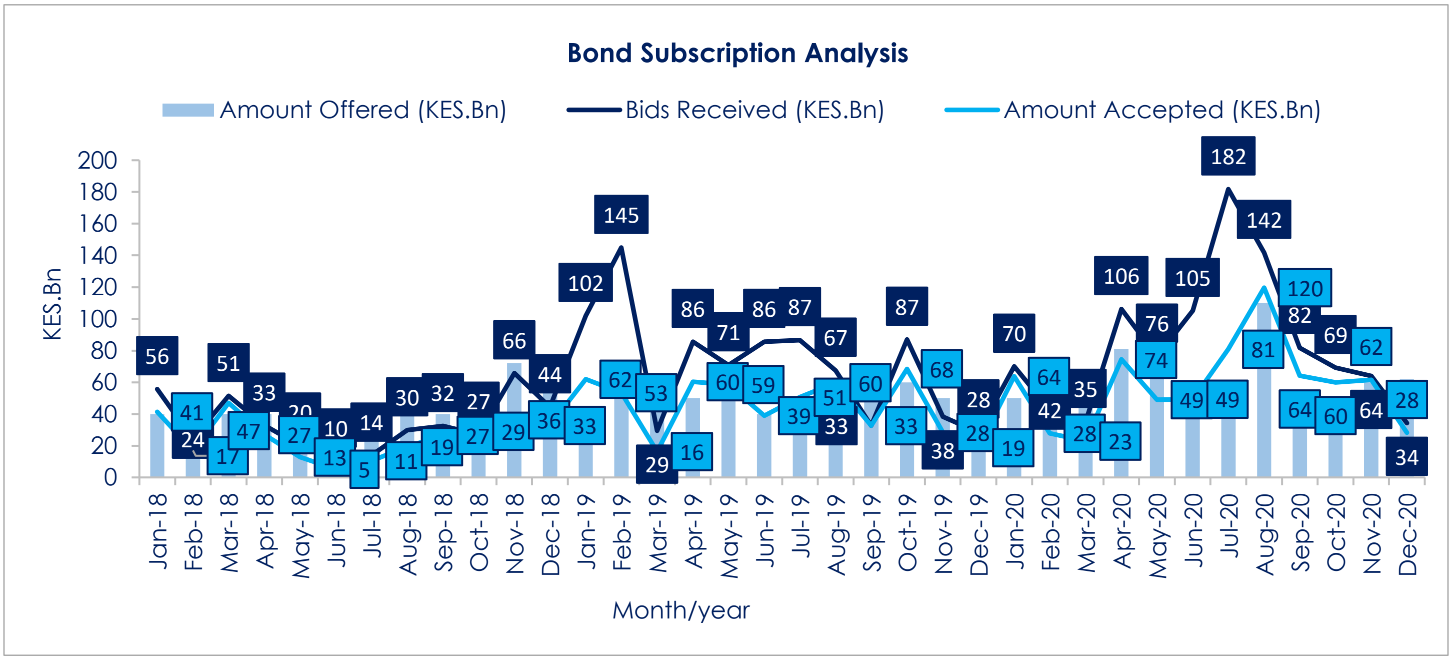
- However, demand for the 91-day T-Bill is likely to remain high with some investors unwilling to tie their capital for a longer period.

Figure.1: T-Bills undersubscribed in December as investors opt for the 91-day paper



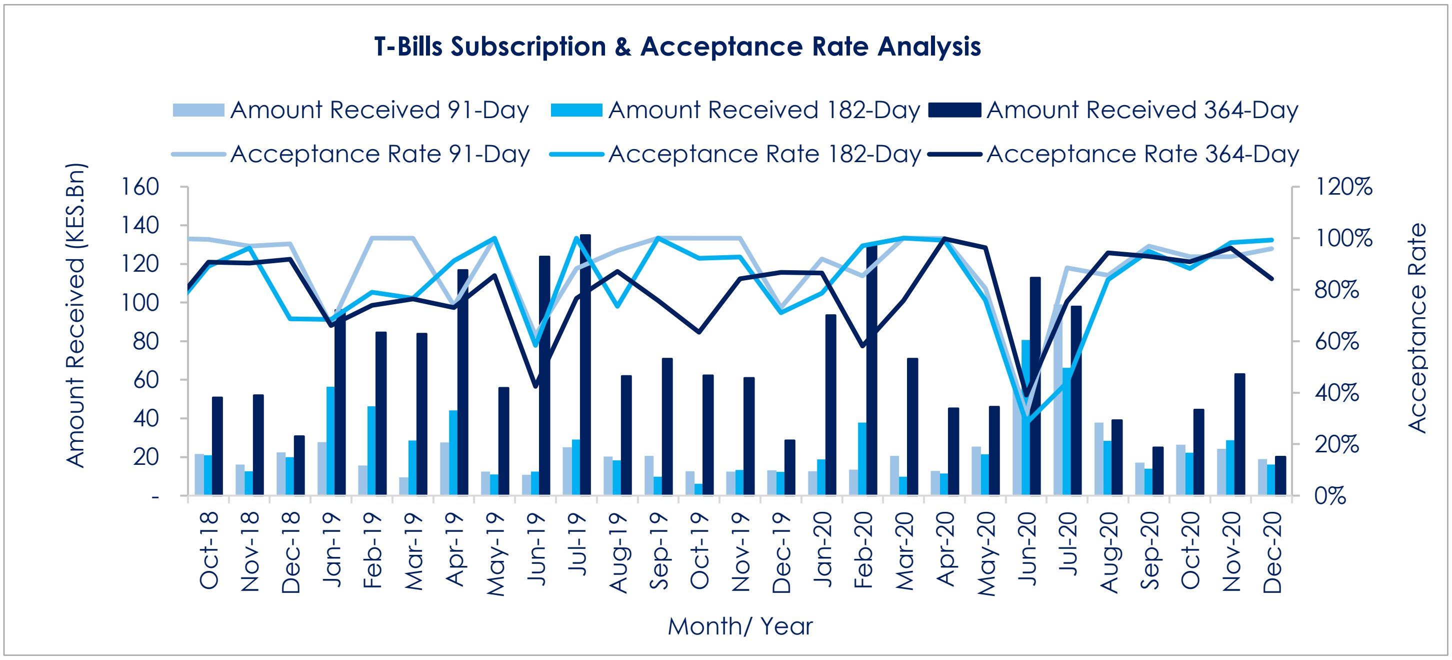
Source: Central Bank of Kenya

Figure.2: Investor bids for bond issues fall in December 2020



Source: Central Bank of Kenya

Figure.3: Acceptance rates for 91 and 182-day T-Bills up while for the 364-day plunge



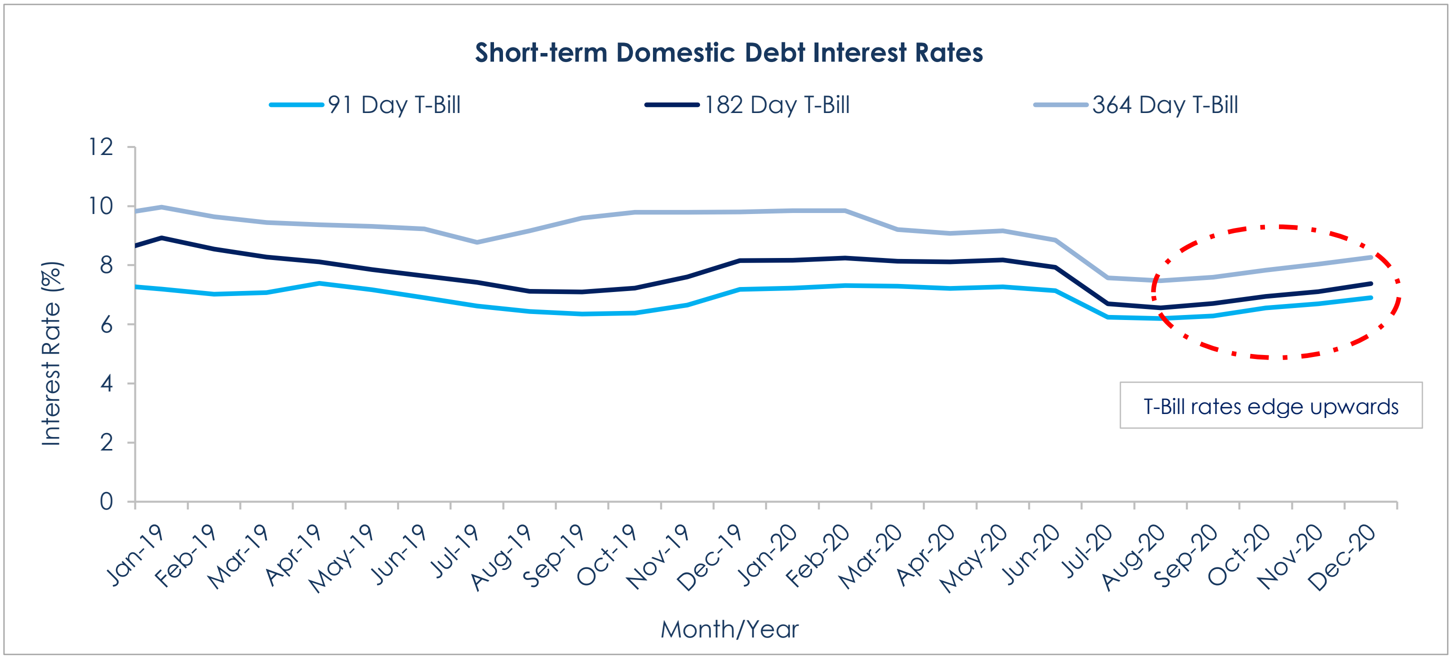
Source: Central Bank of Kenya

T-Bill rates heads north

T-Bill rates have been rising gradually with the yield curve shifting upwards especially on the short-end.

- Subscription for T-Bills plunged to 57.4% in December 2020 from 96.6% in November due to tightening market liquidity and suppressed auction activity during the festive season.
- The acceptance rate for the T-Bills declined to 92.7% from 96% the previous month.
- Average T-Bill yields rose in December with the 91, 182 and 364-day papers recording an increase of 21bps, 26bps and 23bps to 6.9%, 7.4% and 8.3% respectively (Figure.4).
- We anticipate slight upward pressure on the short-end of the yield curve in upcoming auctions as the CBK looks to entice investors.

Figure.4: Interest rates on short-term debt securities edge upwards as liquidity declines

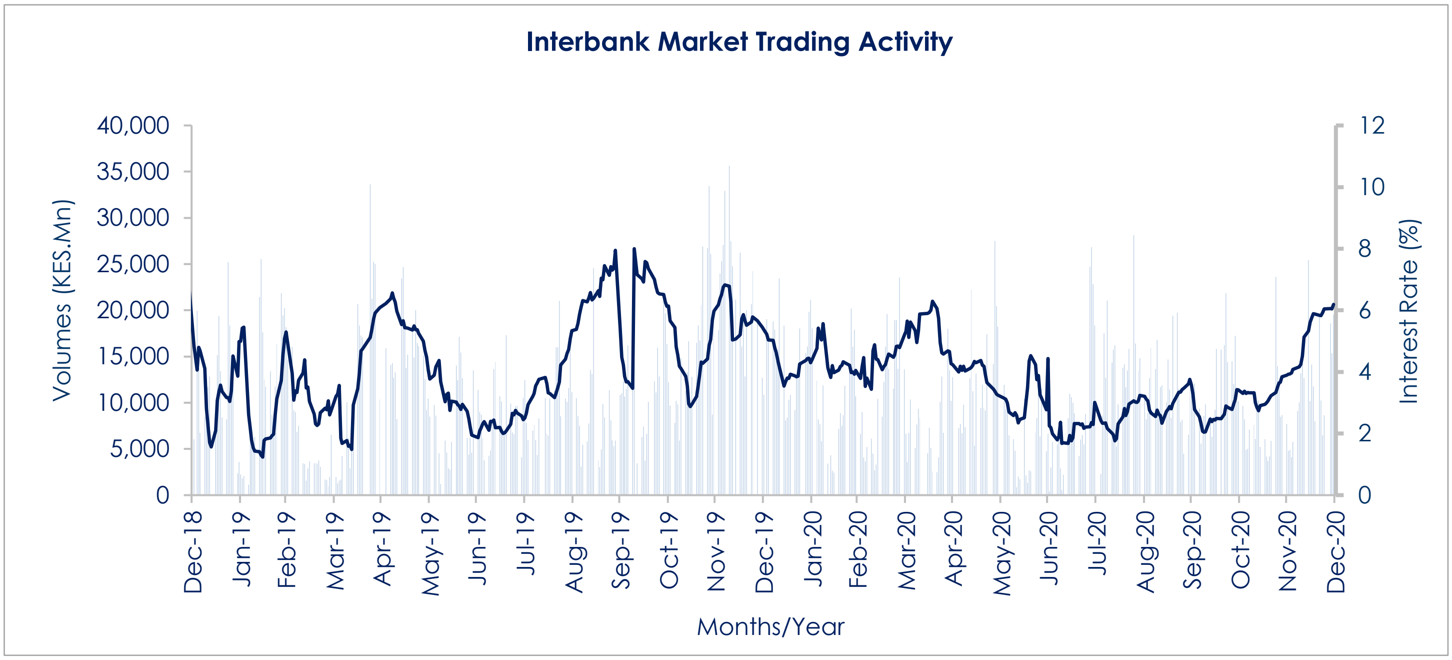


Source: Central Bank of Kenya

Government payments drive commercial bank liquidity in December 2020

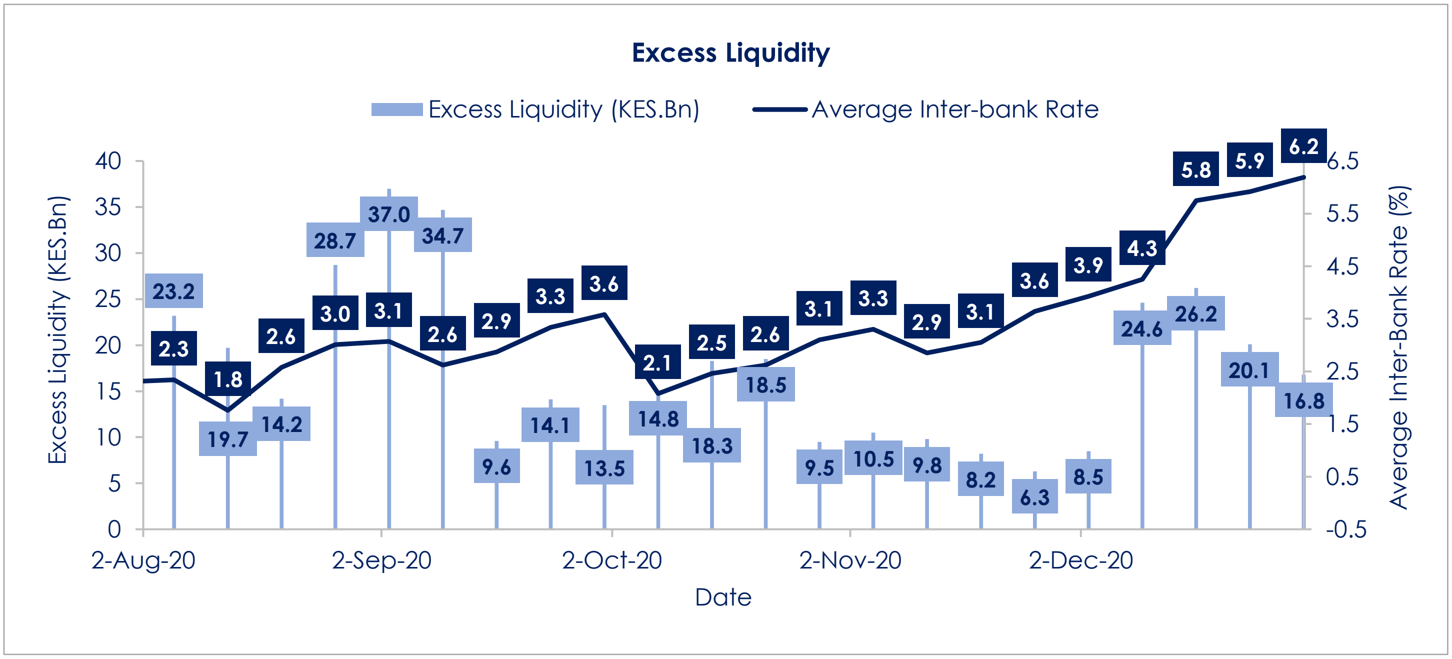
- The average weighted inter-bank lending rate rose to 5.1% in December 2020 from 3.2% in November (Figure.5).
- During the month total volumes increased 50.2% to KES.259.2Bn from KES.172.6Bn in November.
- Excess reserves (additional liquidity above the minimum 4.25% Cash Reserve Ratio (CRR)) rose 176.4% from KES.34.8Bn to KES.96.2Bn in December supported by government payments (Figure.6).
- We expect average inter-bank rates to remain between 5.5% and 6.5% in January attributable to comparatively lower market liquidity.

Figure.5: Inter-bank rates edge higher



Source: Central Bank of Kenya

Figure.6: Commercial excess reserves rose in December

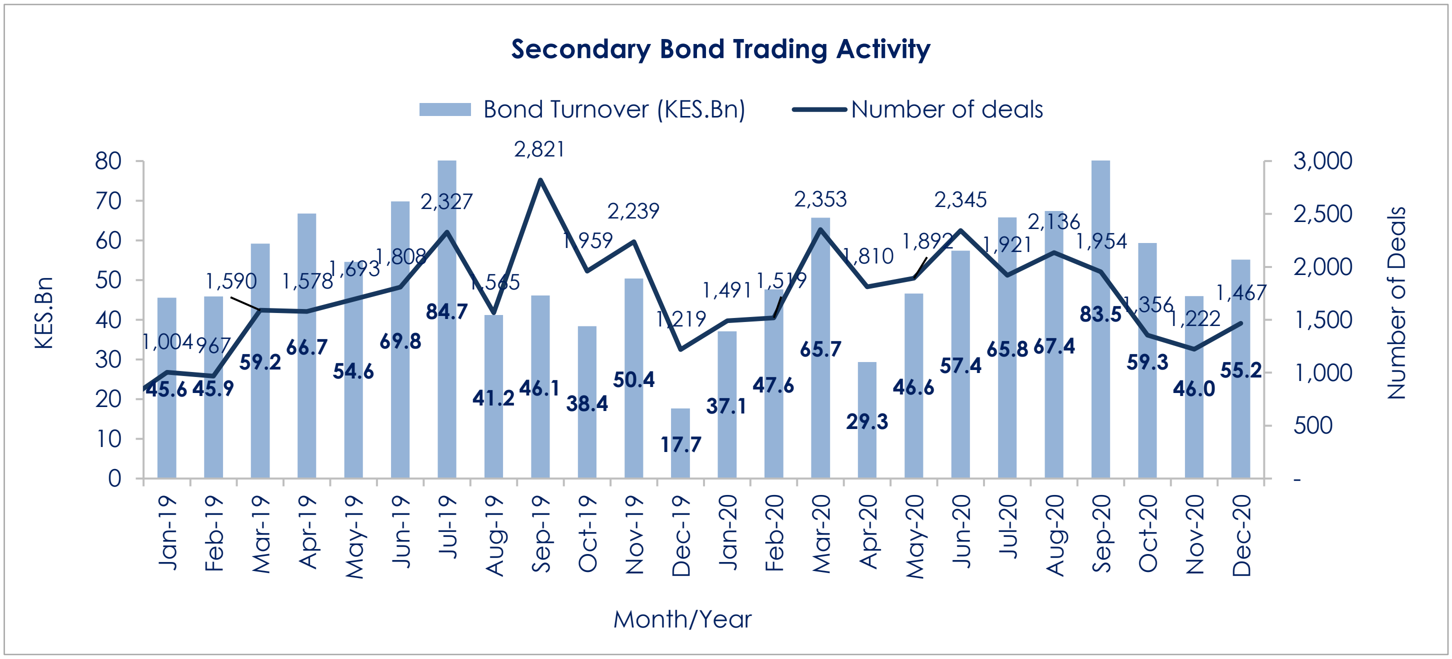


Source: Central Bank of Kenya

Secondary market trading activity set to increase in January 2021

- Secondary bond trading turnover rose 20% in December 2020 to KES.55.2Bn from KES.46Bn in November while the number of deals increased 20% to 1,467 (Figure.7).
- This can be attributed to higher trading turnover per deal and increased investor interest particularly on IFBs which have high capital appreciation.
- We expect increased trading in January 2021 partially attributed to investors who missed out on the 2-Year bond issued this month active in the secondary market.

Figure.7: Secondary trading activity defies the festive season and rises in December



Source: Central Bank of Kenya

Trading ideas - Investors with trading portfolios should continue investing in IFBs

Investors with trading portfolios should continue investing in IFBs.

- We advise investors with trading portfolios to stick to IFBs for the following reasons:

  1) We still expect high supply of Kenya Government Bonds (FXDs) in the mid to long end of the yield curve. This high supply limits price appreciation for these tenors.

  2) IFB's tend to have comparatively higher price appreciation thus presenting better capital gain opportunities.

- Specifically, we advise the purchase of the following bonds (Table.6):

Table.6: Trading ideas - Invest in IFBs

Bond	Tenor (Years)	Coupon (%)	Modified Duration* (%)	Sterling Capital Yield to Maturity (%)	Current Yield** (%)
IFB1/2020/6	5.40	10.20	4.03	10.00	9.98
IFB1/2020/11	10.63	10.90	5.97	10.85	10.33

Source: Nairobi Securities Exchange & Sterling Research

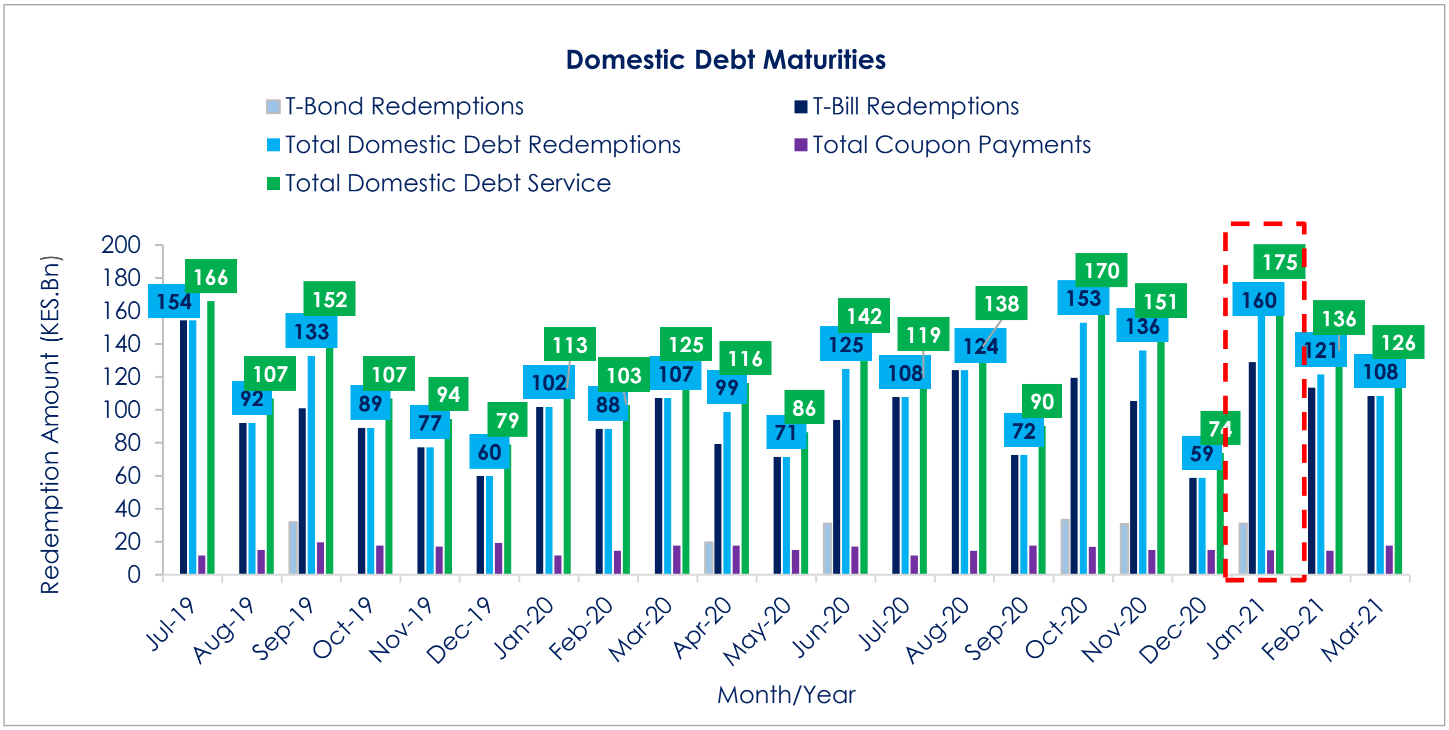
*Modified duration - Expresses the measurable change in the value of a security in response to a change in interest rates (for every 1% movement in interest rates, the bond would inversely move in price by the modified duration)
** Current Yield - Return on investment, for an investor holding a specific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

Domestic debt service peaks in January 2021

Domestic debt service for January 2021 - KES.175Bn

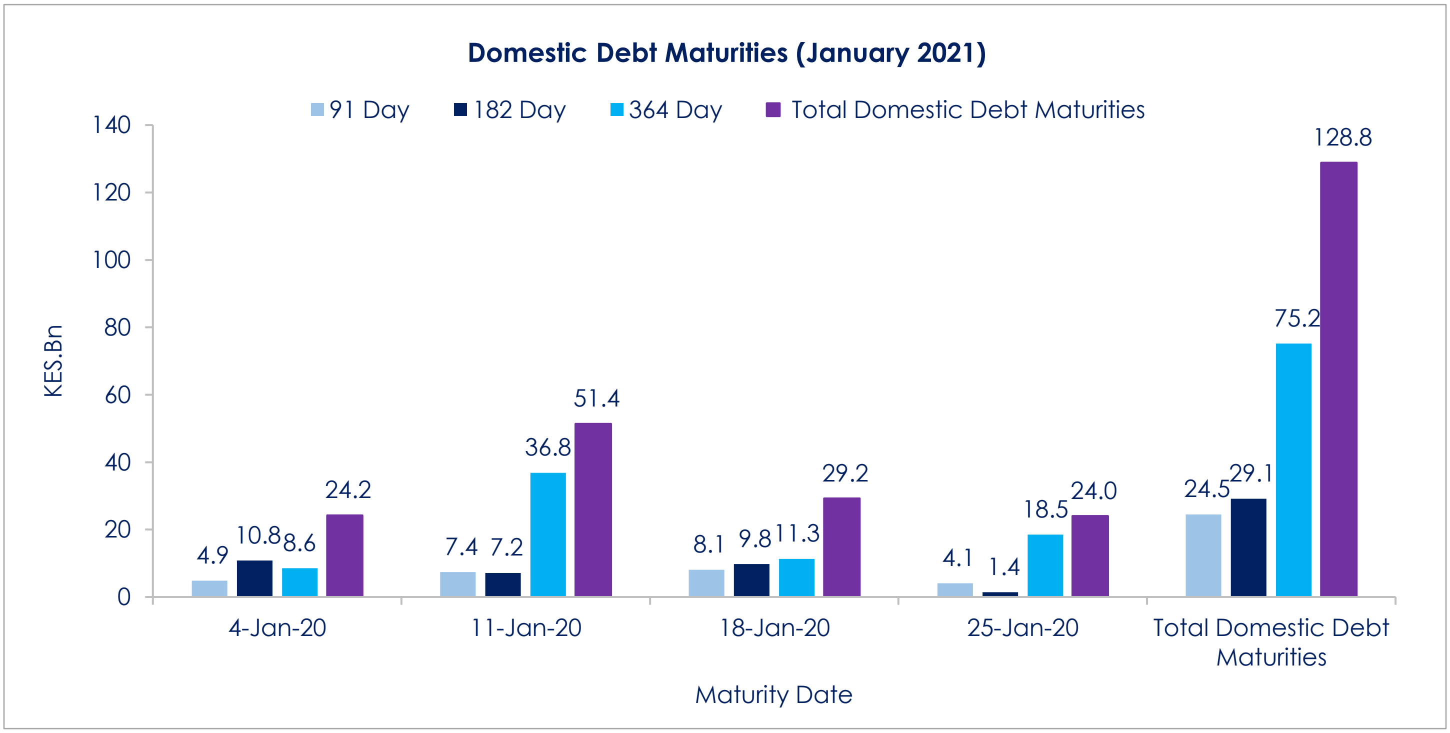
- Debt service for the month of January 2021 amounts to KES.174.7Bn, a 137.3% increase over debt service in December 2020 (Figure.8).
- This comprises of KES.128.8Bn in T-Bills, KES.31.1Bn in T-Bonds and KES.14.8Bn in coupon payments.
- Redemptions for the 91, 182 and 364-day T-Bills are KES.24.5Bn, KES.29.1Bn and KES.75.2Bn respectively.
- The second week of the month will have the highest debt redemptions at KES.51.4Bn (Figure.9).
- The sharp increase in domestic debt service this month implies that a big proportion of funds raised particularly in T-Bill auctions will be directed towards debt redemptions rather than new borrowing.
- In addition, the CBK is likely to be more accommodative of higher investor bids and is likely to increase its acceptance levels as was the case with this month's 2-year bond auction (KES.25Bn target) where it accepted KES.55.9Bn of the KES.61.2Bn received

Figure.8: January 2021 debt service highest in the 2020/21 fiscal year at KES.175Bn



Source: Central Bank of Kenya

Figure.9: January 2021 Weekly debt maturities



Source: Central Bank of Kenya

Upward revision to domestic borrowing target likely as actual total receipts to fall short of annual target

Tax receipts continue to fall short of revised target resulting in increased domestic borrowing.

- Most recently available data (as at the end of November 2020) shows that the Government is ahead of its 2020/21 fiscal year domestic borrowing target, assuming a linear run-rate) for the 2020/21 fiscal year.
- That is, KES.360.6Bn or 45.8% of the KES.786.6Bn had been borrowed from the domestic debt market in the five months of the current fiscal year against a linear target of 41.7% (Table.7 and Figure.10).
- This is in sharp contrast with total receipts that stood at KES.1Bn or 35.2% of the KES.2.8Tn total revised annual target.
- We believe that the challenge experienced by treasury in raising revenue to finance the fiscal budget (largely due to a decline in tax collection during the pandemic) has been the driving force behind increased borrowing during the period in review.
- It is also increasingly evident that the above trend will influence revisions to the annual fiscal budget estimates where we expect Treasury to revise total national Government receipts downwards and the domestic borrowing target revised upwards.
- This essentially means an increase in domestic borrowing in the remainder of the 2020/21.

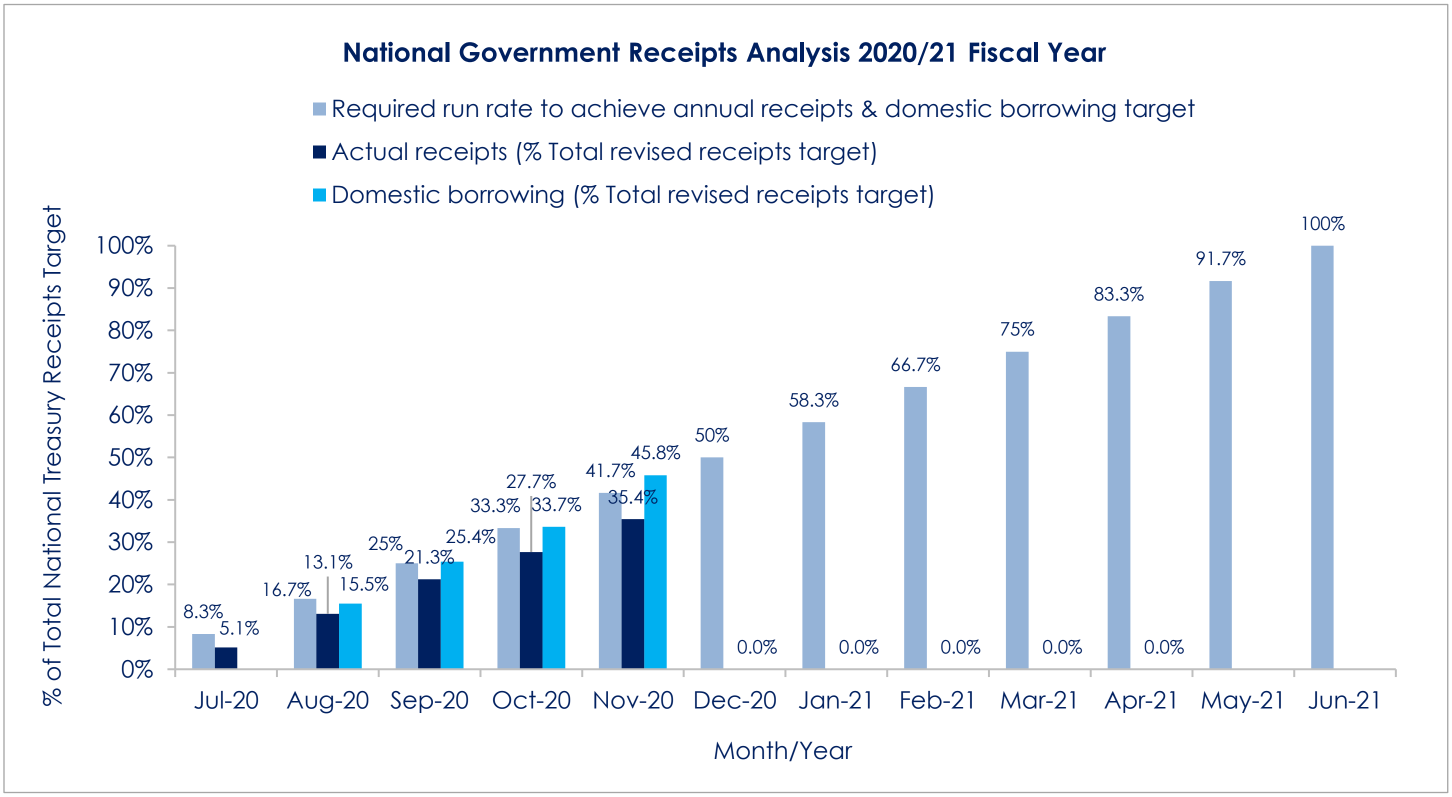
Table.7: Domestic borrowing above target run rate

Receipts	**Original Estimates (KES)**	**Revised Estimates (KES) 31st August 2020**	**Actual Receipts (KES) 31st October 2020**	**Actual Receipts (KES) 30th November 2020**	**Proportion of Receipt Target (KES) 30th November 2020**
Opening Balance (1st July 2020)			48.0	48.0	-
Tax Revenue	**1,567.6**	**1,567.6**	426.4	527.7	33.7%
Non-Tax Income	66.1	66.1	31.9	37.0	56%
Domestic Borrowing	756.9	786.6	264.8	360.6	45.8%
External Loans & Grants	373.2	373.2	11.7	26.2	7%
Other Domestic Financing	36.8	36.9	0.9	3.0	8.3
Total Revenue	**2,800.7**		**783.8**	**1,002.6**	**35.4%**

* 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. CXXII - No.226 18th December 2020

Figure.10: Government unlikely to achieve KES.2.8Tn fiscal year receipts target with huge shortfall in tax receipts



Source: Central Bank of Kenya

Yield curve has shifted upwards since the last IFB issue in August 2020

Yield curve has shifted upwards across all tenors during the last quarter of 2020.

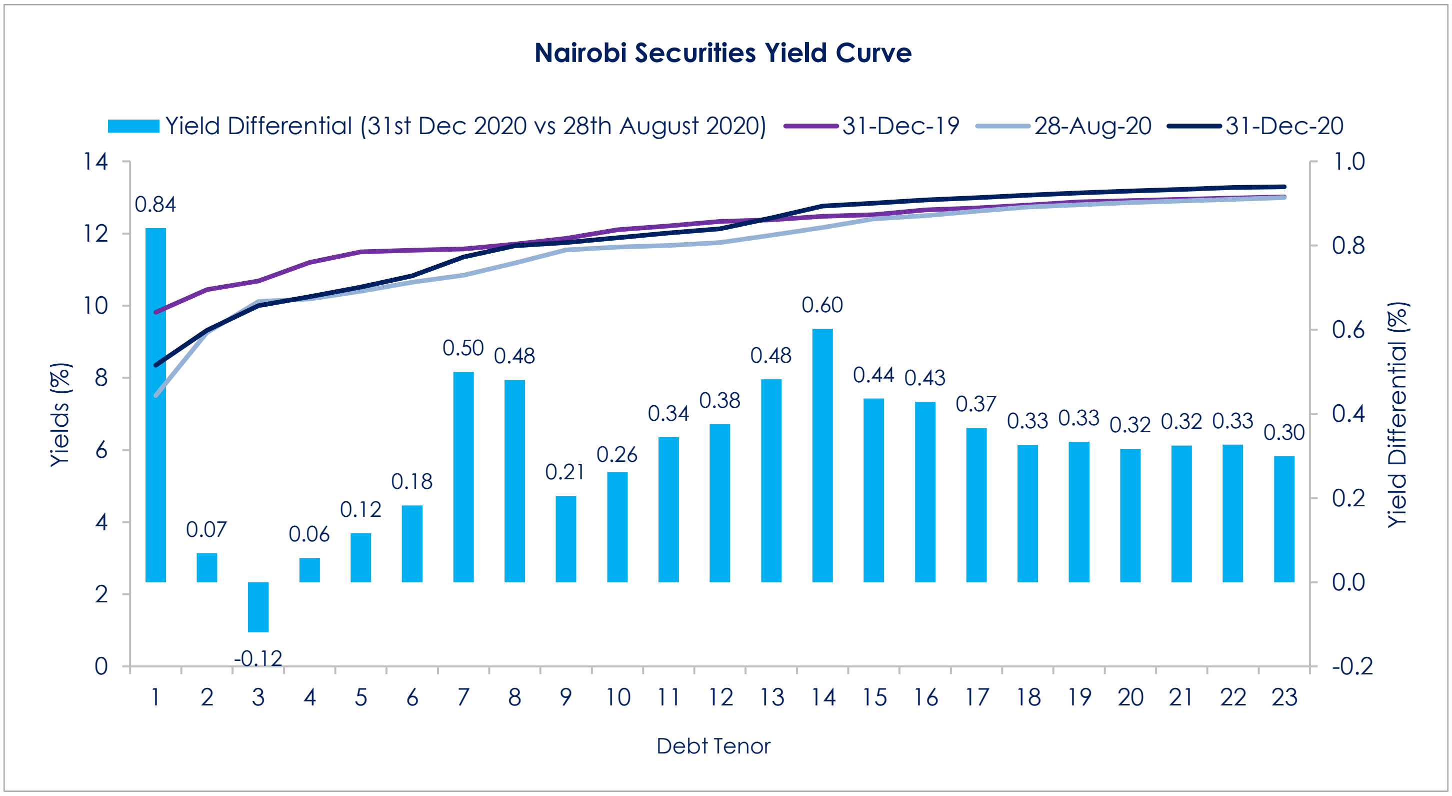
- We have done a year on year (YoY) yield curve comparison (31st December 2020 against 31st December 2019 and one between 31st December and 28th August 2020 (time of issue of the last IFB - **IFB1/2020/11**) Table.8 and Figure.11.
- While short- and medium-term yields have declined and long-term yields have risen over the last year, yields on all tenors have risen since the last IFB issue.
- This rise in yields on the long-end over the year can be explained by the CBK's strategy of not only issuing longer dated debt but also accepting higher rates for such issues.
- Interest rates have generally been on a rise across all tenors over the last few months in response to increased budget financing pressure and this explains the upward shift of the yield curve since the last IFB issue.
- We forecast a slight upward shift in the yield curve in the short-term as yields rise and maintain our recommendation to investors that **they BUY short and medium-term bonds and HOLD long term papers.**

Table.8: Short-end of the yield curve declines significantly

Tenor	Yield (31st Dec 2019)	Yield (24th August 2020)	Yield (31st Dec 2020)	YoY ∆ 31st Dec 2020 vs 31st Dec 2019 (Bps)	∆ 31st Dec 2020 vs 24th August 2020 (Bps)	Sterling Capital yield Curve (7th January 2020)
1	9.8150	7.5070	8.3480	↓146.7	↑84.1	8.4
2	10.4458	9.2500	9.3187	↓112.7	↑6.9	9.5
5	11.4867	10.3960	10.5125	↓97.4	↑11.7	10.50
10	12.1035	10.6221	11.8834	↓22	↑26.1	11.85
15	12.5211	12.4076	12.8437	↑32.3	↑43.6	12.75
20	12.9125	12.8558	13.1725	↑26	↑31.7	13.10

Source: Nairobi Securities Exchange

Figure.11: Yields have risen across the yield curve since the last IFB issue in August 2020



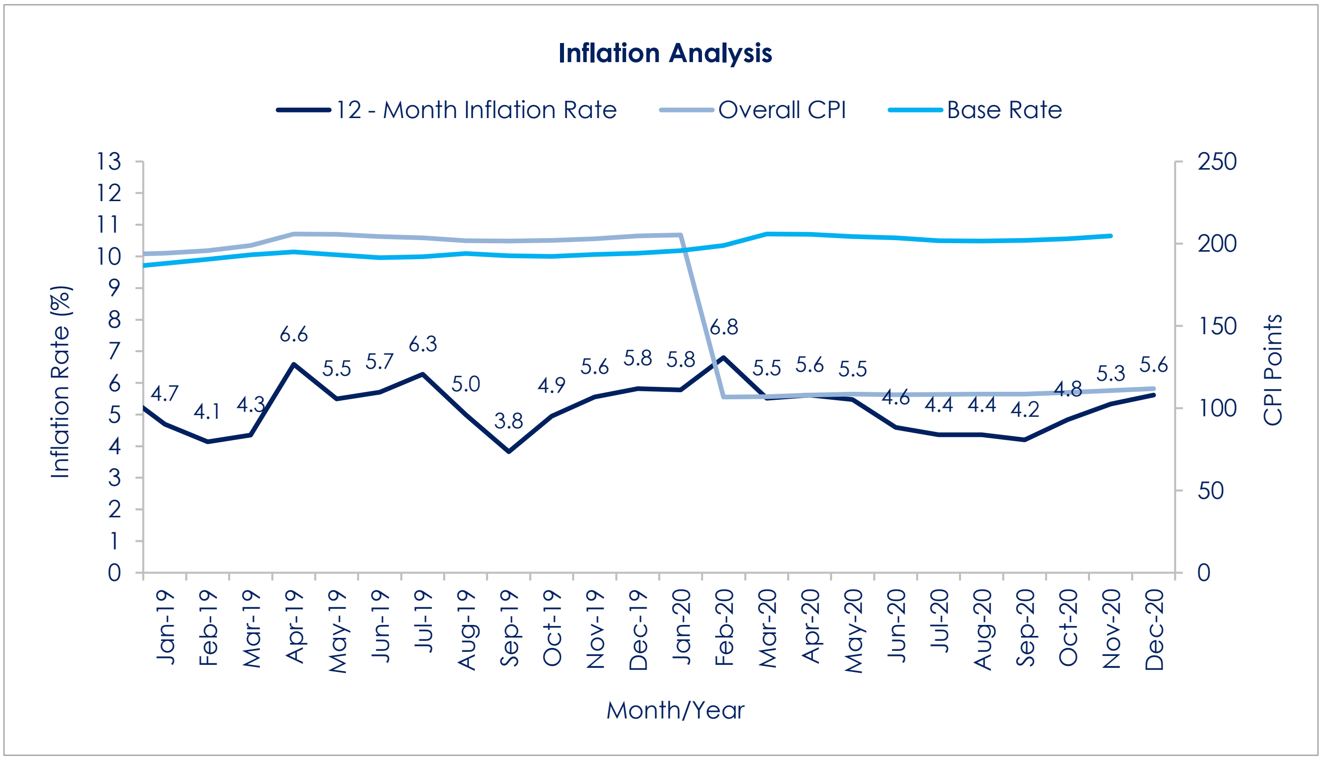
Source: Nairobi Securities Exchange

Inflation hits eight-month high in December 2020, prices expected to stabilize in the short-term

December 2020 inflation at 5.62% is the highest in eight months.

- December 2020 inflation rose to a 5.62% high compared to 5.33% in November mainly supported by an increase in food and non-alcoholic beverages that went up 2.5% (Figure.12).
- The year-on-year rise in cost of food was 7.2% due to increased consumer demand especially during the festive period.
- The rise in retail prices of diesel and petrol by 1.2% and 0.9% caused the transport index to increase by 1.2% attributable to rebounding international crude prices along with a weakening shilling.
- December inflation has nevertheless remained within the government targeted band of 2.5% to 7.5%.
- We expect inflation to range between 5.5% to 6. % in the short term.

Figure.12: Short term Inflation forecast 5.5% - 6%



Source: Kenya National Bureau of Statistics

MPC to retain CBR at 7% in January 2021 meeting

No revision to the CBR expected in Jnauary 2021 inspite of an uptick in inflation.

- In the November 2020 meeting, the Monetary Policy Committee (MPC) retained the Central Bank Rate (CBR) at 7% backed by optimism over the performance of the economy in the second half of the current fiscal year.
- The Committee quoted stable inflation rate and a relatively healthy foreign currency reserve position being quoted as some of the reasons for the retention.
- Oil prices have been on the rise and this together with the weakening of the Kenya Shilling is likely to increase inflationary pressure.
- The MPC is set to meet on 27th January despite the rise in inflation we expect a retention of the CBR at 7%.

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