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Fixed Income Note

Medium Term Note (MTN) Programme

Kenya Mortgage Refinance Company PLC (KMRC)

February 2022

Table of Contents

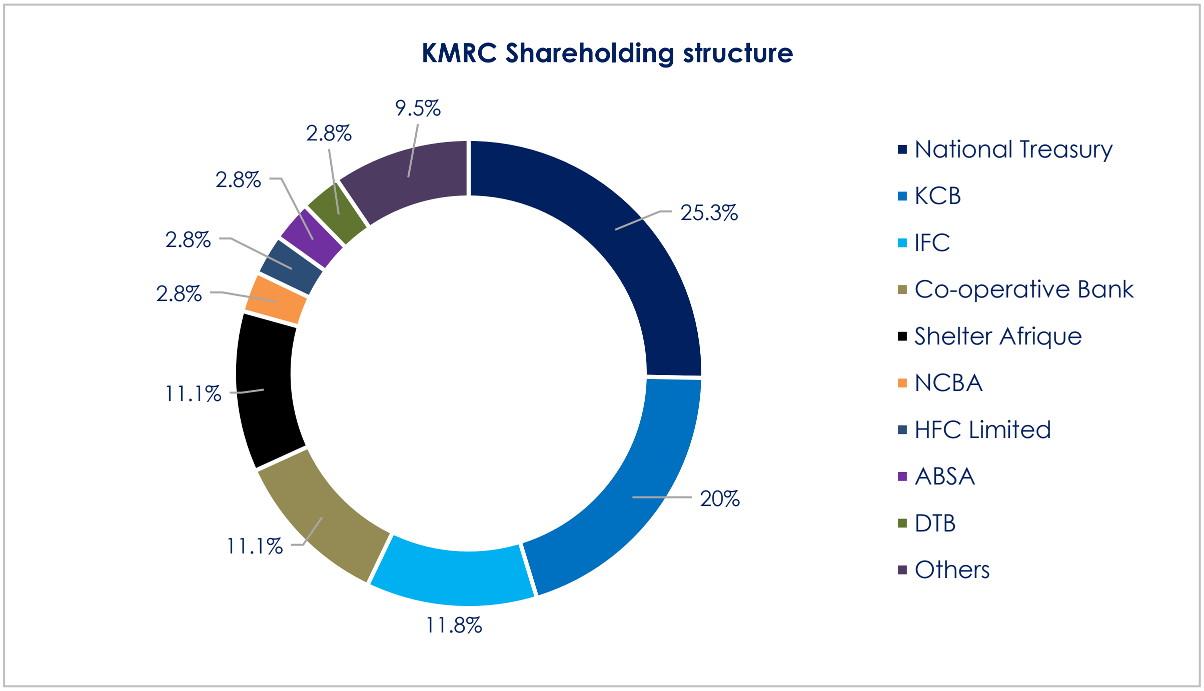
Executive Summary

- The **KMRC Medium Term Note (MTN) Programme** note is an analysis of the Kenya mortgage refinance company's first ever bond tranche.
- The Medium Term Note (MTN) has an implied term to maturity tenor of 4.5 years and seeks to raise KES.1.4Bn.
- The report gives a brief overview of KMRC by breaking down its shareholding structure and analyzing both its historical and forecasted financial performance.
- We analyze the opportunity cost associated with investing into this particular bond by looking at comparative bonds and the returns they offer on a risk-adjusted basis.
- The report includes a comparative analysis of the yield being offered by the issue vis-à-vis the yield curve over different periods.
- Towards the end of the report, we delve into key investment considerations and risks that investors ought to consider when investing into the issue.
- The report concludes with our subscription expectations and investment recommendation.

Introducing the Kenya Mortgage Refinance Company

- Kenya Mortgage Refinance Company PLC (KMRC) is a Kenyan mortgage refinance company formed in April 2018 with the mandate of increasing the country's home ownership rate which has been limited by access to credit.
- It is a partnership between the National Treasury and several financial institutions which own a majority stake (Figure.1).
- The company seeks to increase access to credit through extending long-term fixed-rate loans to Primary Mortgage Lenders (PMLs), secured against a portfolio of underlying mortgages.
- It also intends to provide alternative collateral allowing lenders to extend maturity of mortgages thus making them more affordable to households in the lower middle income segment who reportedly account for 95% of the Kenyan population.
- KMRC has received funding from both the public and private sectors, including KES.34Bn as concessional funding from the Word Bank and the Africa Development Bank (AfDB).
- The KMRC has a sizable market share since 4 of the top 6 mortgage lenders are its owners accounting for 60% of Kenya's mortgage industry.

Figure.1: KMRC Shareholding structure



Source: KMRC Information Memorandum

Financial performance Review

- KMRC's unaudited **income statement** for the 9 months period to the end of their financial year 2021 shows after-tax profits of KES.107.1Mn against revenues of KES.466.9Mn (Table.1).
- It forecasts revenues growth to KES.1.7Bn by 2023, mainly driven by increased lending which will have a similar impact on interest income.
- However, this revenue line comes with an increase in both interest and general expenses which will result in a decline in after-tax profits FY2023 (Table.1).
- The **balance sheet** is set to expand significantly as it increases its debt obligations from the current KES.6.7Bn to an estimated KES.32Bn through a mix of bonds, subordinated loans and credit lines.
- The company has credit lines amounting to KES.19Bn from the World Bank and a further KES.8Bn from the African Development Bank (AfDB), both backed by the National treasury.
- These funds will be supplemented by additional bond tranches going forward.
- As expected, the company is mainly debt financed with its gearing ratio standing at 4.1, a metric that is estimated to grow to 10.4 by 2023.
- While the commercial debt advanced by the World Bank and AfDB are backed by the Government, bond tranches issued are not.

Table.1: KMRC's financial performance and outlook

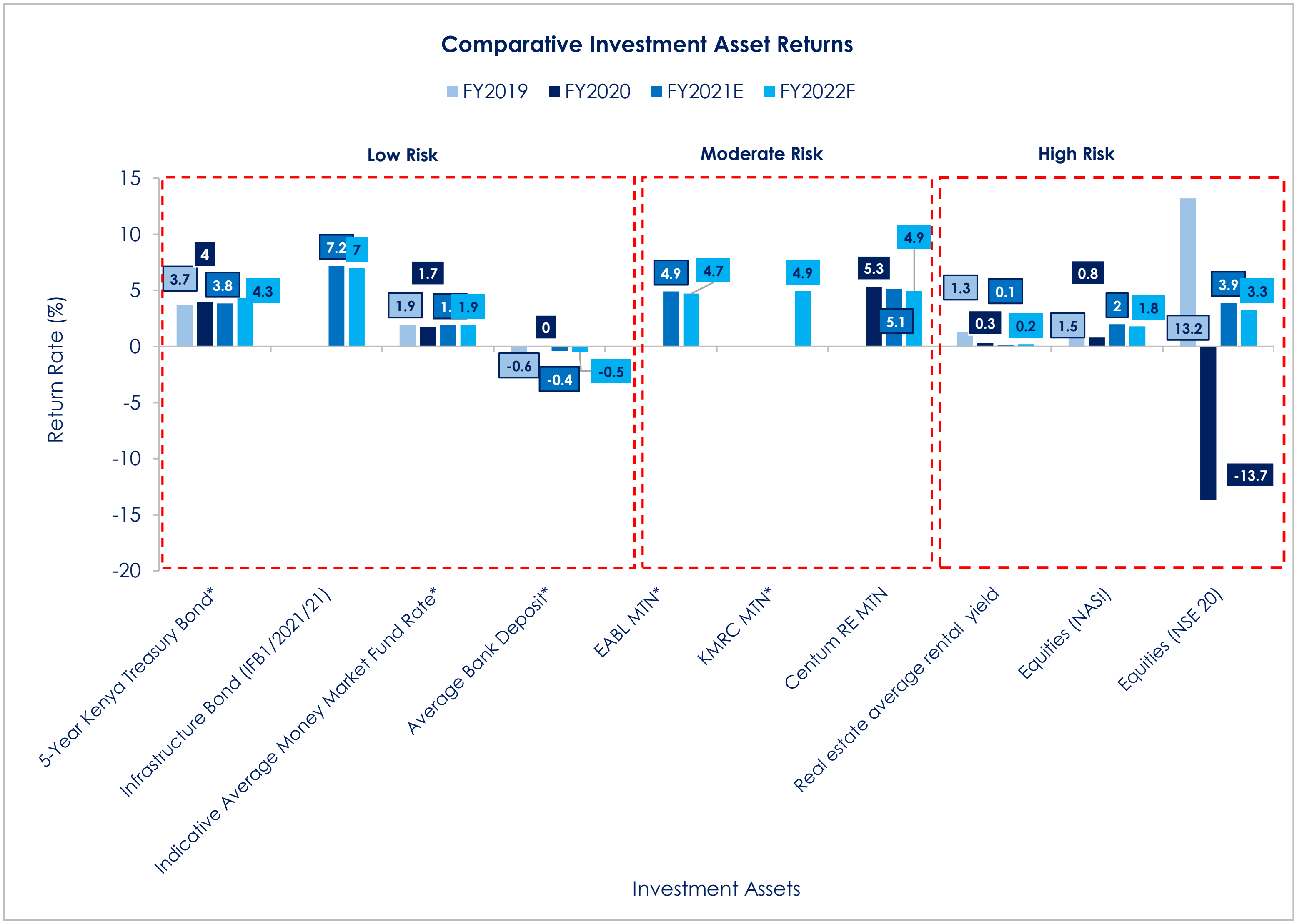
Income Statement (KES.Mn)	2019A	2020A	Unaudited 9 months to Dec 2021	2022F	2023F
Revenue	325.7	221.1	466.9	1,409	1,701.9
Interest income	125.7	221.1	466.9	1,409	1,701.9
Interest expense	-	(25.4)	(173.1)	(874.7)	(1,348.2)
Gross income	325.7	195.7	293.8	534.3	353.7
Comprehensive income	264.5	77.2	107.1	228.4	69.7
Earnings per share	4.99	5.98	5.92	12.63	3.85
Balance Sheet (KES.Mn)					
Assets	2,274.9	6,309.8	9,593.8	22,703.6	35,066.1
Liabilities	719.4	4,677.1	7,336.6	20,270.1	32,562.8
Equity	1,555.5	1,632.7	2,257.1	2,433.5	2,503.2
Ratios					
ROA	11.6%	1.2%	0.4%	1.2%	0.2%
ROE	17%	4.7%	2.0%	7.9%	2.3%
Cost to income	-	11.5%	35.0%	13.5%	14%
Debt to Equity	-	2.3	4.1	6.5	10.4

Source: KMRC Information Memorandum

Investment case - Is the 12.5% return on investment compelling enough?

- We have compared the real returns (return on an investment asset after taking inflation into consideration) from selected local currency investment instruments to determine the attractiveness of the KMRC MTN (Figure.2).
- With a forecasted real return of 4.9% for 2022, the return on the KMRC MTN is higher than our comparables with the exception of the Infrastructure Bond (**IFB1/2021/21**) issued in September 2021.
- It however is expected to yield a competitive returns when compared with investment assets within its moderate risk category (Figure.3).

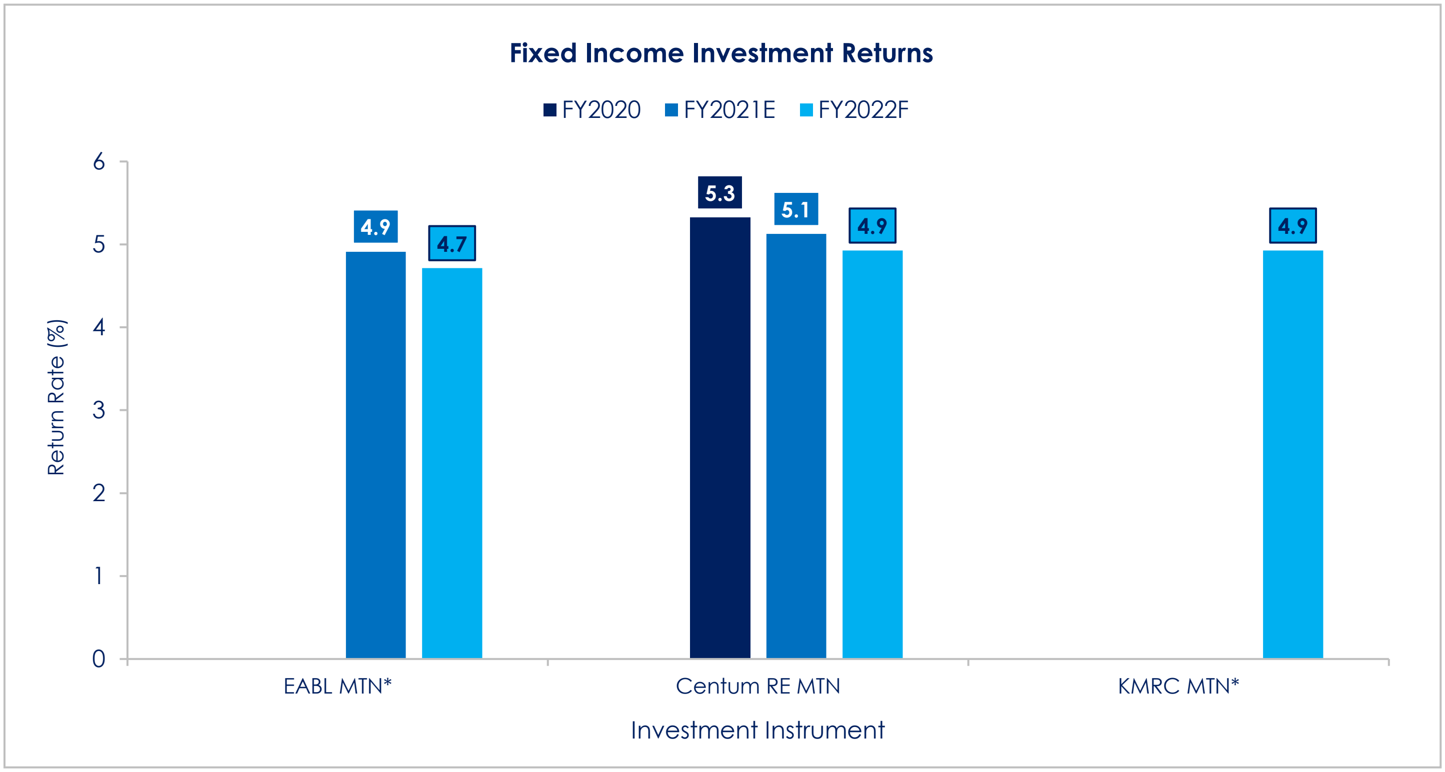
Figure.2: Investment asset returns



* Return is net of withholding tax

Source: Nairobi Securities Exchange, Central Bank of Kenya, Kenya National Bureau of Statistics & Capital Markets Authority

Figure.3: Fixed income investment asset returns



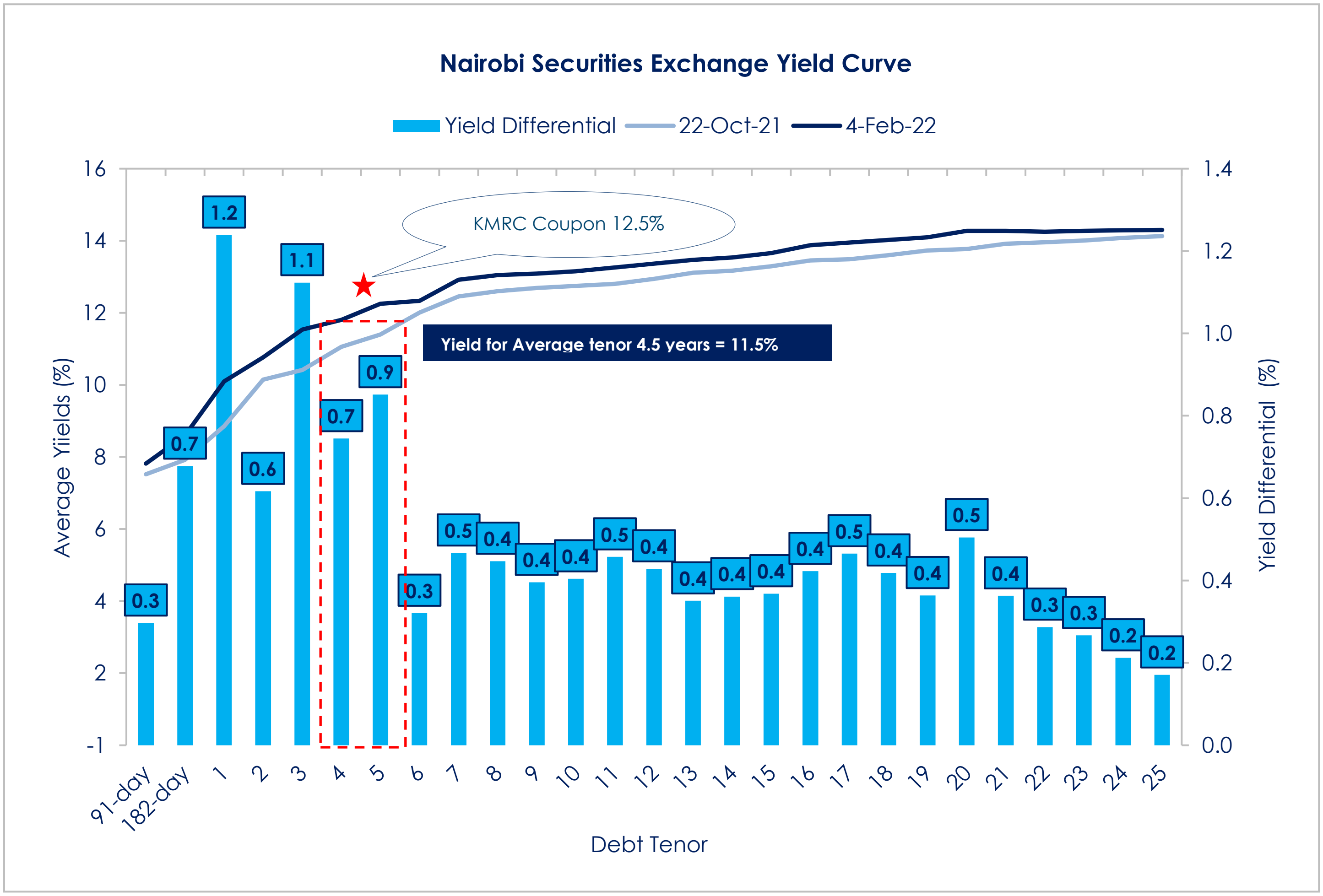
* Return is net of withholding tax

Source: Nairobi Securities Exchange, & Kenya National Bureau of Statistics

Yield curve analysis - KMRC is offering a premium rate above current yield curve levels

- Our analysis of the Nairobi Securities Exchange (NSE) yield curve on 4th February 2022 shows that the KMRC MTN coupon of 12.5% is a premium rate for a fixed interest instrument with an average tenor of 4.5 years (Figure.4).
- Kenya Treasury bonds with this tenor currently have an average yield of 11.5% equivalent to 100 Bps below the KMRC MTN coupon.
- The 12.5% yield would be equivalent of a Government of Kenya treasury bond with a term to maturity of 7.5 years.
- To put this premium rate into context, we also compare it with that of the most recent Medium Term Note issue (EABL 5 year MTN) in October 2021.
- This one had a coupon of 12.25% at a time the average yield to maturity was approximately 11.43% translating to a premium of approximately 82 bps.
- On the basis of these differentials, the KMRC MTN offers an attractive return to investors.

Figure.4: Nairobi Securities Exchange (NSE) yield curve



Source: Nairobi Securities Exchange

Key investment considerations

1) **Liquidity** - Kenya corporate bonds are significantly less liquid on the Nairobi Securities Exchange (NSE) secondary market than Government bonds with the latter accounting for an average of 99.3% of total annual bond turnover between 2010 and 2021. There are currently six corporate bonds listed and trading NSE.

   As at 4th January 2022, the total outstanding amount of corporate debt issues was KES.23.4Bn (0.6%) compared to KES.3.2Tn for Kenya Government Bonds (Fixed Treasury and Infrastructure Bonds).

2) **Investors' concern over credit worthiness of bond issuers** – The collapse of bond issuers Imperial and Chase Banks in 2016 hurt investor confidence in Kenya corporate bonds.

   Real People, another issuer, is currently facing difficulties in meeting debt obligations.

   Little is known of KMRC as it is considered a relatively new issuer with a short history and investors could be hesitant to commit capital on its MTN on this basis.

   However, it is owned by the National Treasury (25.3%), the International Finance Corporation (IFC) (11.8%), Shelter Afrique (11.1%) and other financial institutions including commercial banks, Savings and Credit Co-Operative Societies (SACCOs).

   Based on this shareholding, we see low risk of financial distress and default of obligations arising from this MTN.

3) **Increase in fiscal deficit financing (Crowding out effect)** - Growing fiscal deficit and heavy borrowing by the Government from the domestic debt market has resulted in an increase in the number, size and tenor of primary debt issues.

   These has given fixed income investors a variety of investment options which would compete with the KMRC issue.

Investment Risks

- We see the following as key risks to investing in KMRC's MTN.

1) **Interest rate risk** - Fluctuations in interest rates will have a material impact on investor appetite for and pricing of the bond issue.

   A rise in interest rates will expose investors in the KMRC MTN to re-investment risk while prices of the bond in the secondary market will decline.

2) **Liquidity risk** - Corporate bonds in Kenya are generally illiquid and investors in the KMRC MTN are likely to adopt a buy and hold until maturity strategy.

   This means that investors who may wish to liquidate their bond holdings before maturity could fail to find buyers or would be forced to accept prices far below their preferred valuations.

3) **Regulation/Taxation risk** - An increase in withholding tax on interest earned or an introduction of capital gains tax or other tax measures will have a negative impact on investor returns from investing in the MTN.

4) **Credit risk** - There exists potential default risk with any corporate bond issue without a guarantor.

   The KMRC MTN debt issue is senior unsecured debt and therefore does not provide full comfort to risk averse investors.

   However, the company has reputable shareholders including Kenyan tier 1 banks and the IFC plus a fairly sustainable business model.

   KMRC is rated by the Global Credit Rating Company (GCR) at AA1. Rating by other renown credit rating agencies would provide further comfort to investors.

   Credit risk exposure has to some extent been managed by the issue's amortized redemption structure with an effective tenor to maturity of 4.5 years.

   Any occurrence that could reduce uptake and servicing of mortgages could drive KMRC into financial distress considering that its predominant source of capital is debt that would still need to be serviced.

Subscription expectation

- We are cautiously optimistic of a full subscription for the full KES.1.4Bn for the following reasons:

  1) **Small issue size** - The bond has a relatively small target amount of KES.1.4Bn in its first tranche which despite being issued at the same time as a more attractive Infrastructure Bond IFB1/2022/19 is relatively easy to attain.

  2) **A relatively liquid market** - The market has remained relatively liquid over the past few weeks as evidenced by the inter-bank rate that has averaged 4.5% since the beginning of 2022. Further, the Central Bank has been injecting market liquidity throughout January and February by issuing reverse repos which have exceeded KES.110Bn.

  3) **Comparatively higher coupon rate** - The bond's amortized structure gives it an effective tenor of 4.5 years. This means that the rate of 12.5% this bond offers is at a premium above the current yield on a similar 5-year bond issued by the Government (11.75%).

     The KMRC MTN offers a slightly more attractive return compared to the 5-year EABL MTN which had a coupon of 12.25%.

     This can be explained by the upward shift of the yield curve over the last few months.

- We expect the bulk of subscriptions to come from local pension schemes, impact investors whose mandate revolves around housing and fund managers looking to diversify their investment portfolios rather than banks whose preference is skewed to Government bonds.

- We do not see heavy foreign investor interest on account of the small issue size, the bond's expected illiquidity, Kenya Shilling depreciation and rising interest rates in developed markets.

Investment Recommendation

- While the bond might be attractive in terms of return for those looking for above average market yields and investment portfolio diversification, we recommend a **HOLD** on this bond for the following reasons;

  1) The bond is not guaranteed by the Government meaning that in case of default, bond holders would have to rely on the equity investors of KMRC to bail them out.

  2) Liquidity risks associated with such bonds meaning that investors who wish to exit in the secondary market may have to sell at a discount.

  3) Further, the yield curve is expected to gradually shift upwards over the next few months which will have a negative impact on bond prices and thus marketability of the bond.

- Our preference would be the concurrently issued **IFB1/2022/19** which we expect to have a slightly higher coupon than that of the KMRC MTN, is tax exempt and highly liquid in the secondary market.

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Appendix

Table.2: Offer Details

Description of the Notes	
Issuer	Kenya Mortgage Refinance Company PLC
Status of the Notes	Senior, unsecured
Principal Amount	Up to KES.10,500,000,000
Coupon Rate	12.5% per annum
Default Rate	Fixed Rate of Interest + 2%
Specified Denomination of the Notes (Minimum Subscription Amount)	KES.100,000 with integral multiples of KES.10,000 thereof
Offer opens	4th February 2022
Offer Closes	18th February 2022
Allotment Date	22nd February 2022
Payment Date	4th March 2022
Issue Date	7th March 2022
Trade Date	14th March 2022
Interest Commencement Date	14th March 2022
Interest Termination Date	23th February 2029
Redemption Date	23th February 2029

Source: KMRC Information Memorandum

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