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STERLING CAPITAL LIMITED

Fixed Income Note

June 2022

"Bridging the funding gap with an IFB"

STERLING CAPITAL LIMITED

Table of Contents

Executive Summary

- Our fixed income report for the month of June 2022 titled **"Bridging the funding gap with an IFB"** is an analysis of the Central Bank of Kenya's (CBK) second and third Infrastructure Bond **(IFB1/2022/18)** in the current calendar and fiscal year respectively.
- The IFB with an implied term to maturity tenor of 13.5 years seeks to raise KES.75Bn for the purpose of funding infrastructure projects in the FY2021/2022 budget.
- We expect the IFB to be oversubscribed with our weighted average rate of investor bids prediction as follows:

  Weighted Average Rate (WAR) of investor bids: 13.80% - 13.99%

- The report covers primary auction outcomes, secondary market trading trends, short-term domestic debt interest rates and market liquidity.
- Domestic maturities have a huge impact on CBK's borrowing strategy and this debt service is analysed in the report.
- This month's fixed income report also covers the country's fiscal position including Government revenue, expenditure and fiscal deficit as well as its borrowing needs.
- The report includes an analysis of the yield curve over selected periods showing trends in yields of different tenors.
- We give our inflation expectations towards the end of the report, which concludes, with our view on the Monetary Policy Committee (MPC) decision in the short term.

CBK issues third IFB in the 2021/22 fiscal year

- The Central Bank of Kenya (CBK) invites bids for an 18-Year amortized Infrastructure Bond (IFB) with a market determined coupon **(IFB1/2022/18)**, to raise KES.75Bn (Table.1).
- This is the second IFB issue in 2022 and the third in the 2021/22 fiscal year with the first and second issued in September 2021 and February 2022 respectively.
- Redemption will be in two tranches, with the first tranche of 50% redeemed in June 2031 and the remaining 50% at expiry in May 2040.
- Our expectation is an oversubscription on account of its tax free status as well as capital appreciation potential.

Table.1: Infrastructure Bond issue summary

Issue Number	**IFB1/2022/18**
Total Amount Offered	KES.75Bn
Tenor (Years)	18 Years
Effective Tenor	13.5 Years
Coupon Rate (%)	Market Determined
Issue Price	Discounted/Premium/Par
Period of Sale	23rd May 2022 to 7th June 2022
Auction Date	8th June 2022
Value Date	13th June 2022
Yield Curve (%) (Weighted Average tenor - 13.5 years) 27th May 2022	**13.9226**

Source: Central Bank of Kenya & Sterling Capital Research

IFB1/2022/18 Amortized redemption structure

- **IFB1/2022/18** amortized redemption structure make its effective tenor 13.5 years (Table.2).

Table.2: Effective debt tenor is 13.5 years

Redemption Period	**% of principal**	**Tenor Calculation**	**Weighted Tenor**
9 Years (June 2022 - June 2031)	50%	50%*9 years	4.5 years
18 Years (June 2022 - June 2040)	50%	50%*18 years	9 years
Effective tenor			4.5 + 9 = 13.5 years

Source: Central Bank of Kenya & Sterling Capital Research

Our weighted average rate of investor bids

- We arrived at our market weighted average rate of investor bids estimate by analysing yields of securities of similar tenors on the Nairobi Securities Exchange (NSE) as at 27th May 2022 and discussions with fixed income traders (Table.3).

Table.3: Auction bid predictions

Rate	IFB1/2022/18
Market Weighted Average Rate (%) of investor bids	13.80 - 13.99

Source: Sterling Capital Research

Our predicted rates are guided by historical debt issues

- We used implied yields of bonds of almost similar tenors to maturity on the NSE as at 27th May 2022 as a guide for possible investor auction bid levels (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
IFB1/2021/18	12th Apr 2021	12.667	21st Mar 2039	(16.8) 6,142	12.9500	13.2582
IFB1/2022/19	21st Feb 2022	12.965	28th Jan 2041	(18.7) 6,821	12.9933	13.7076

Source: Central Bank of Kenya

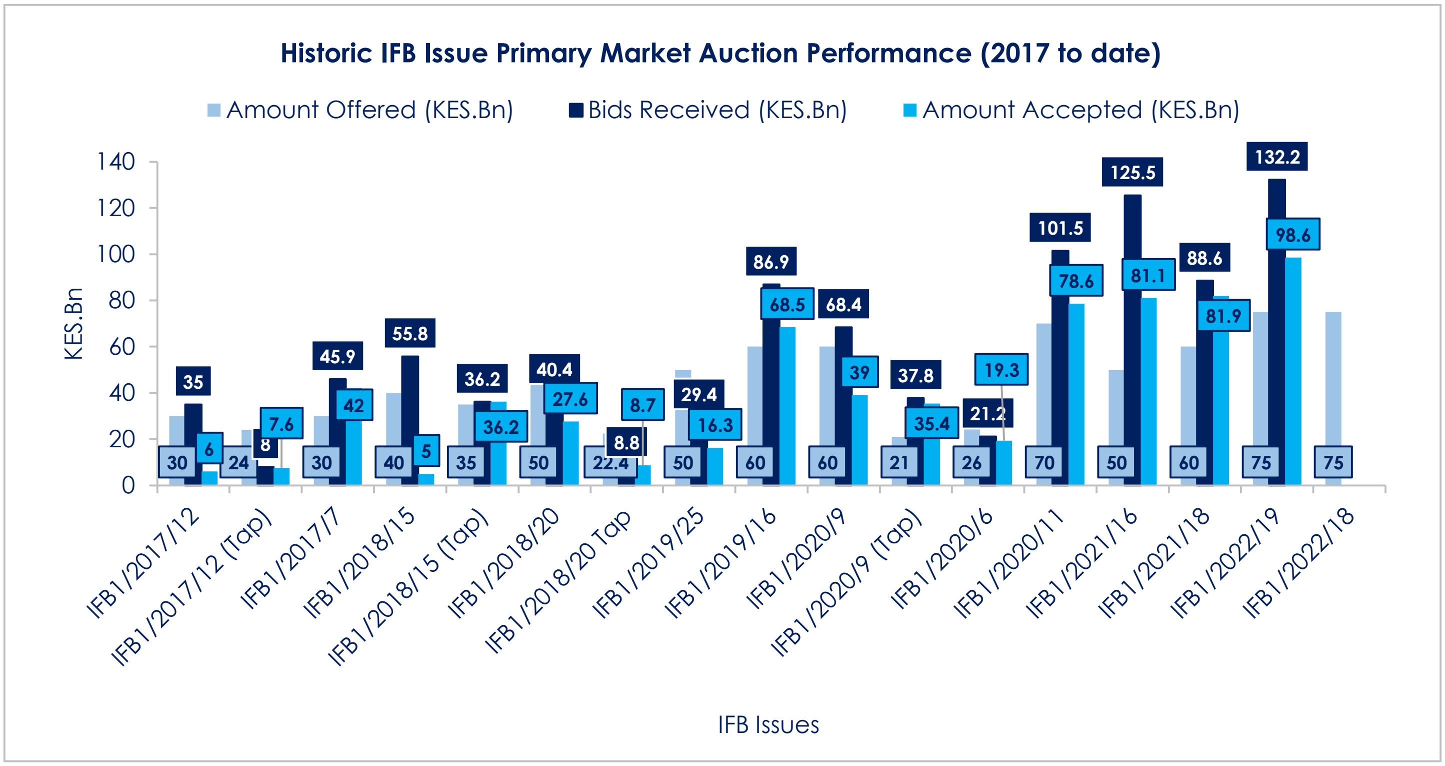
- Reviews of historical IFB auction results show high subscriptions for IFBs (Table 5 & Figure.1).
- Only five of the last 16 IFBs issued over the last five years (since 2017) have been undersubscribed and only one of the last five issues IFB1/2020/6 received less than full subscription showing high demand for the tax free debt issue.
- **IFB1/2021/21** and **IFB1/2022/19** were the most recent issues receiving subscription rates of 201.7% and 176.3% respectively driven by high market liquidity levels, attractiveness of the coupon and capital gains potential in the secondary market.
- The CBK is lagging behind its fiscal deficit financing target and this means that it is likely to accept investor bids in excess of KES.75Bn

Table.5: Historical IFB primary market auction performance

Issue	Issue Date	Offered (KES.Bn)	Bids Received (KES.Bn)	Amount Accepted (KES.Bn)	Performance Rate (%)	Coupon Rate (%)	Implied Yield (%)
IFB1/2014/12	Oct-2014	15	38.8	15.8	258.7%	11.00	10.9500
IFB1/2015/12	Mar-2015	25	51.7	25.7	206.8%	11.00	10.9750
IFB1/2015/12 (Tap)	Apr-2015	25	51.7	24	206.8%	11.00	10.9750
IFB1/2015/9	Dec-2015	30	16.6	14	55.3%	11.00	10.4250
IFB1/2016/9	May-2016	30	39.4	34.9	131.3%	12.50	11.3100
IFB1/2016/15	Oct-2016	30	35.1	30.6	117%	12.00	12.8500
IFB1/2017/12	Feb-2017	30	35.0	6	116.7%	12.50	11.1000
IFB1/2017/12 (Tap)	Mar-2017	24	8	7.6	33.3%	12.50	11.1000
IFB1/2017/7	Nov-2017	30	45.9	42.0	153.0%	12.50	10.9366
IFB1/2018/15	Jan-2018	40	55.8	5	139.5%	12.51	12.6311
IFB1/2018/15 (Tap)	Feb-2018	35	36.2	36.2	103.4%	12.51	12.6311
IFB1/2018/20	Nov-2018	50	40.4	27.6	80.8%	11.95	12.6400
IFB1/2018/20 Tap	Nov-2018	22.4	8.8	8.7	39.3%	11.95	12.6400
IFB1/2019/25	Mar-2019	50	29.4	16.3	58.8%	12.20	12.9500
IFB1/2019/16	Oct-2019	60	86.9	68.5	144.8%	11.75	12.9993
IFB1/2020/9	Apr-2020	60	68.4	39	114.0%	10.85	12.2820
IFB1/2020/9 (Tap)	Apr-2020	21	37.8	35.4	180.0%	10.85	12.2820
IFB1/2020/6	Jun-2020	26	21.2	19.3	81.5%	10.20	11.5651
IFB1/2020/11	Aug-2020	70	101.5	78.6	145.0%	10.90	12.7326
IFB1/2021/16	Jan-2021	50	125.5	81.1	251.0%	12.26	12.9188
IFB1/2021/18	Apr-2021	60	88.6	81.9	147.7%	12.67	12.9500
IFB1/2021/21	Sep-2021	75	151.3	106.8	201.7%	12.74	13.0320
IFB1/2022/19	Feb-2022	75	132.3	98.6	176.3%	12.97	12.9933

Source: Central Bank of Kenya

Figure.1: IFBs have historically received high subscription

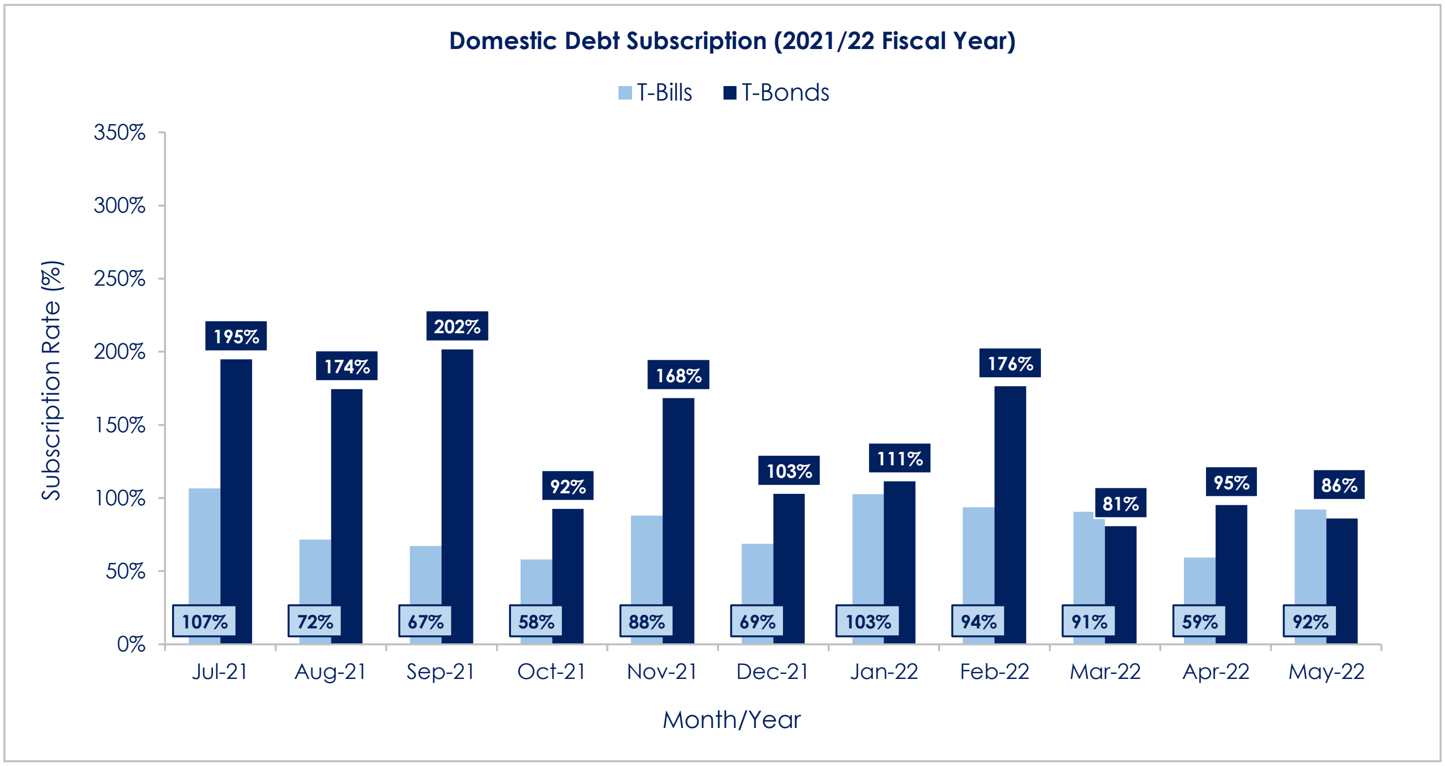


Source: Central Bank of Kenya

91 & 364 Day T-Bills oversubscribed in May 2022

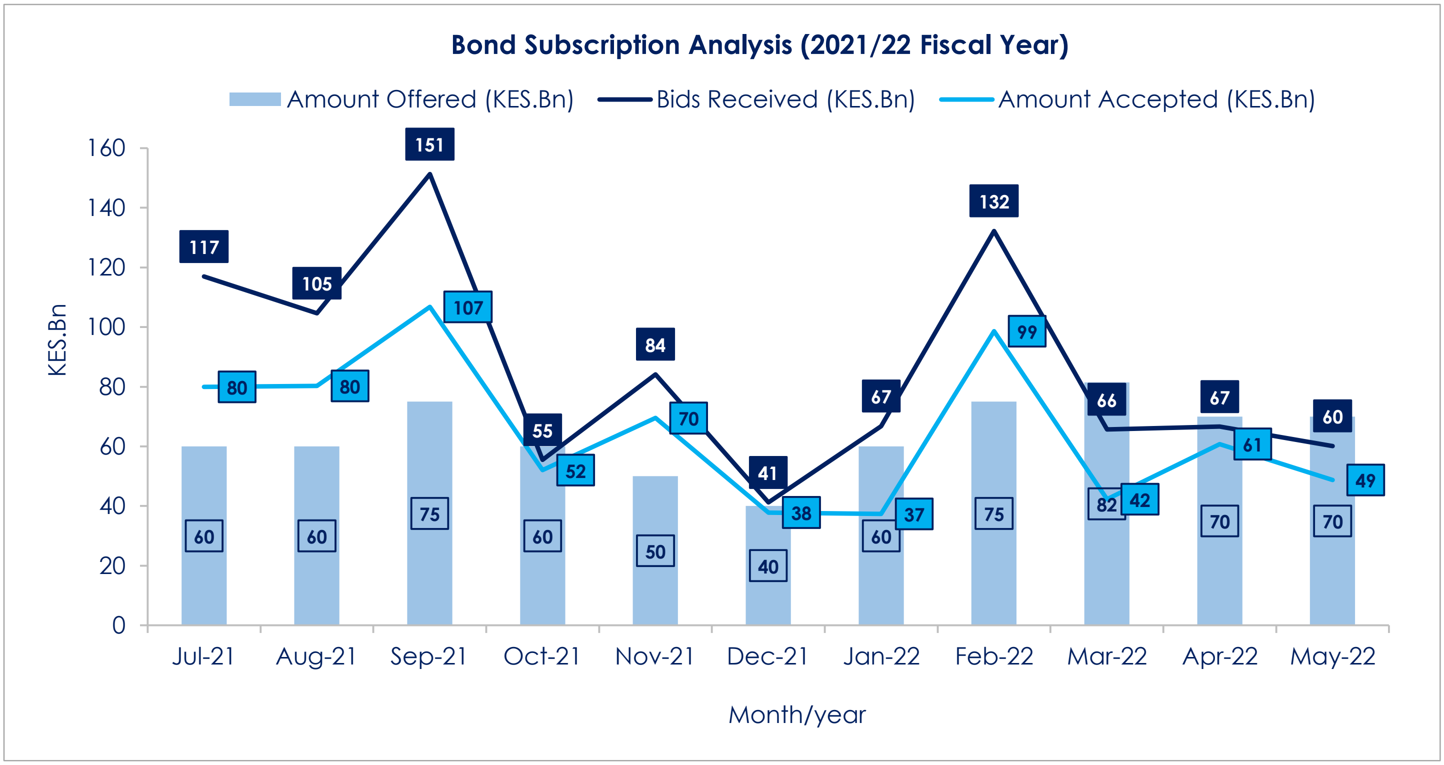
- Aggregate investor subscription for Treasury Bills (T-bills) rose sharply in May 2022 with KES.110.6Bn in bids received against KES.120Bn offered equivalent to a 92.2% subscription rate which was higher than 59.4% in April (Figure.1).
- The 91 and 364-Day T-Bills were oversubscribed at 133.4% and 101% respectively with the 182 reporting a subscription rate of 66.9%.
- It is possible that investors unwilling to lock in their capital for a longer period in an environment of rising interest rates invested in the 91-Day T-Bill.
- The relatively attractive yield of close to 10% on the 364 Day T-Bill explains the high demand for the longer dated issue.
- With regards to T-Bonds, **FXD1/2022/10** was issued and **FXD1/2021/25** re-opened in May with both having a tap-sale.
- A total of KES.43.1Bn of the KES.60Bn (71.9% subscription rate) was received in the first auction with a bulk of bids (KES.32.9Bn or 54.8% of total bids received) on the shorter dated issue.
- We attributed this undersubscription to low market liquidity levels at the time.
- The CBK then issued a tap sale In line with our expectations for both issues with a target amount of KES.10Bn, receiving and accepting KES.17.01Bn and KES.16.97Bn respectively.
- In aggregate subscription for both the primary and the tap-sale issues was KES.60.1Bn compared to an offer amount of KES.70Bn, this equivalent to an 85.9% subscription rate (Figure.2 and Figure.3).

Figure.2: T-Bill subscriptions rise while T-Bond subscriptions remain relatively low in May 2022



Source: Central Bank of Kenya

Figure.3: Bond subscriptions decreased in May 2022

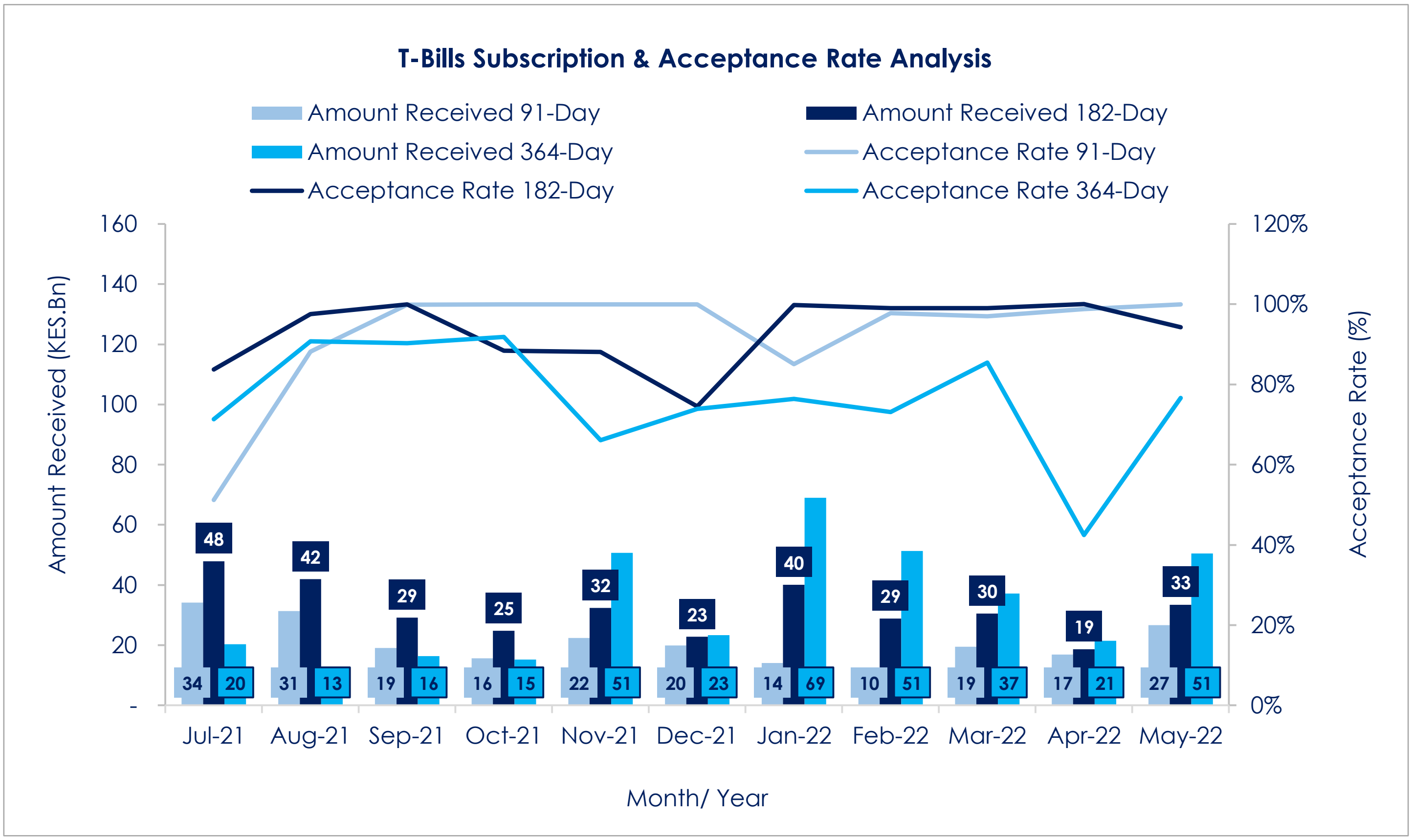


Source: Central Bank of Kenya

T-Bill acceptance rates decline in May given CBK bid to manage borrowing cost

- CBK acceptance rates for the 91, 182 and 364-Day T-bills in May 2022 declined to 88.8%, 94.3% and 95.5% respectively compared to 99.9%, 100% and 99.2% respectively in April. (Figure.4).
- The low acceptance can be attributed to the CBK strategy of managing short-term borrowing costs by rejecting aggressve investor bids.

Figure.4: Acceptance rate for T-Bills goes down despite increased subscription

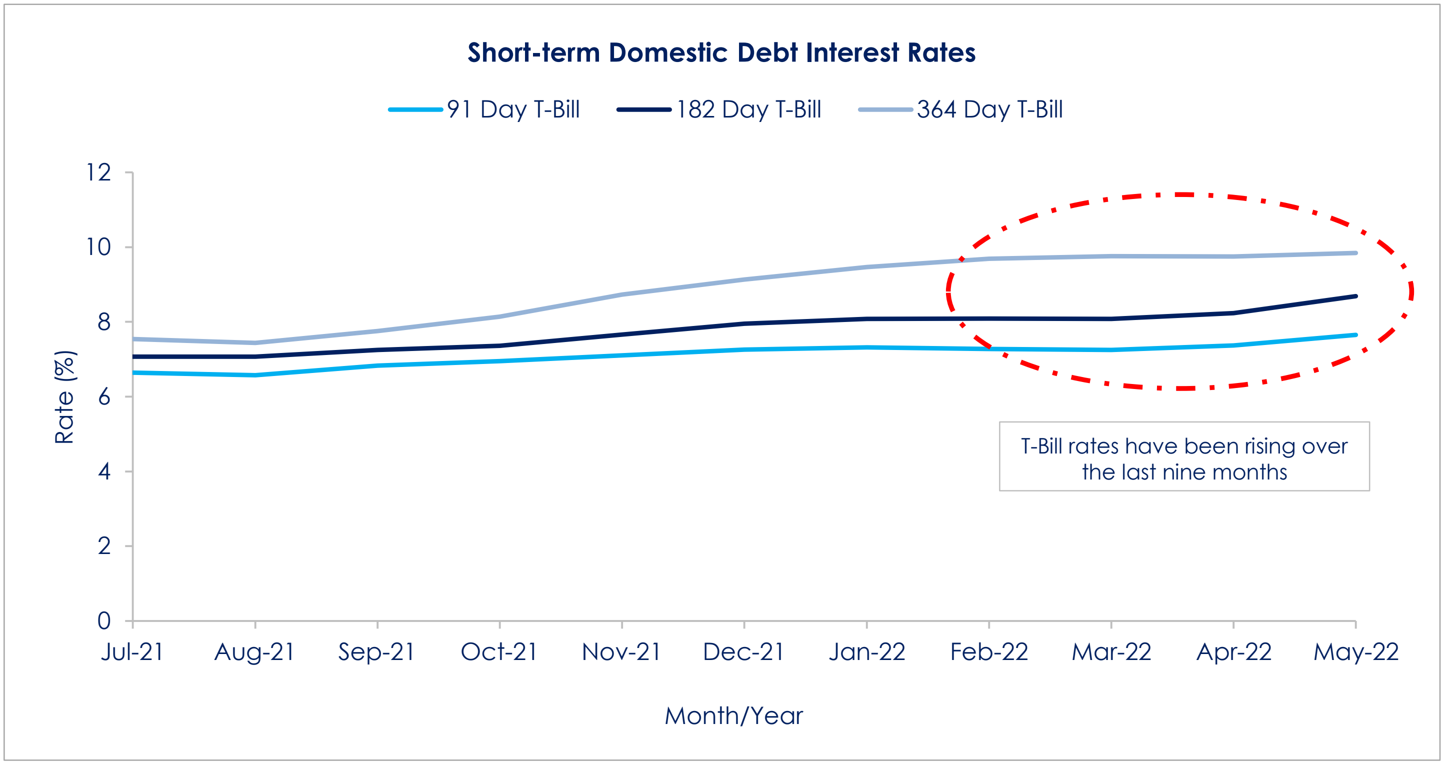


Source: Central Bank of Kenya

Short-term interest rates maintain the positive trend in May 2022

- Average short-term interest rates maintained the upward trajectory that started in the third quarter of the 2021 calendar year.
- The average 91, 182 and 364-day T-Bills rates rose to 7.7%, 8.7% and 9.9% in May 2022 from 7.4%, 8.2% and 9.8% in April 2022 respectively (Figure.5).
- We continue to attribute the rising interest rates to budget deficit financing pressure.
- Our position is that short-term interest rates will maintain this trend for the reason mentioned above combined with the gradual rise in commercial bank interest rates.

Figure.5: Short-term debt securities interest rates rise

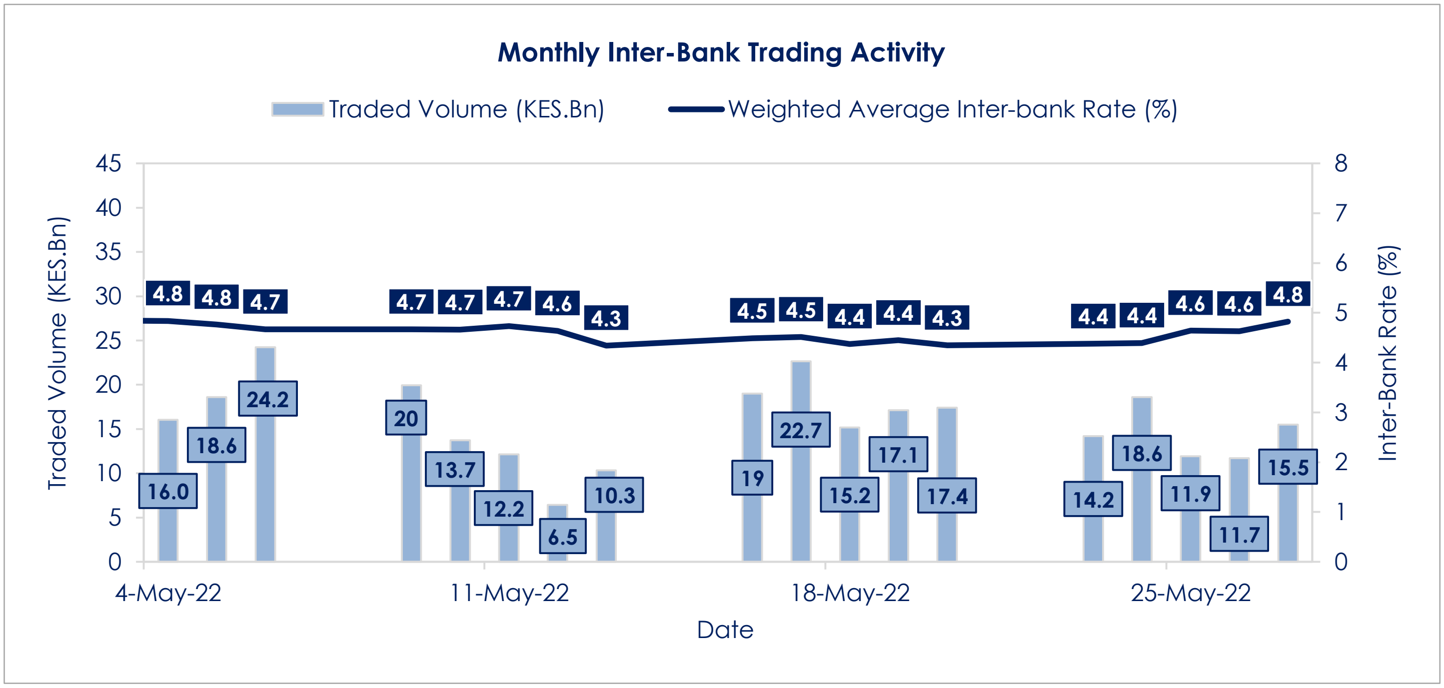


Source: Central Bank of Kenya

Average inter-bank lending rates dip in May 2022

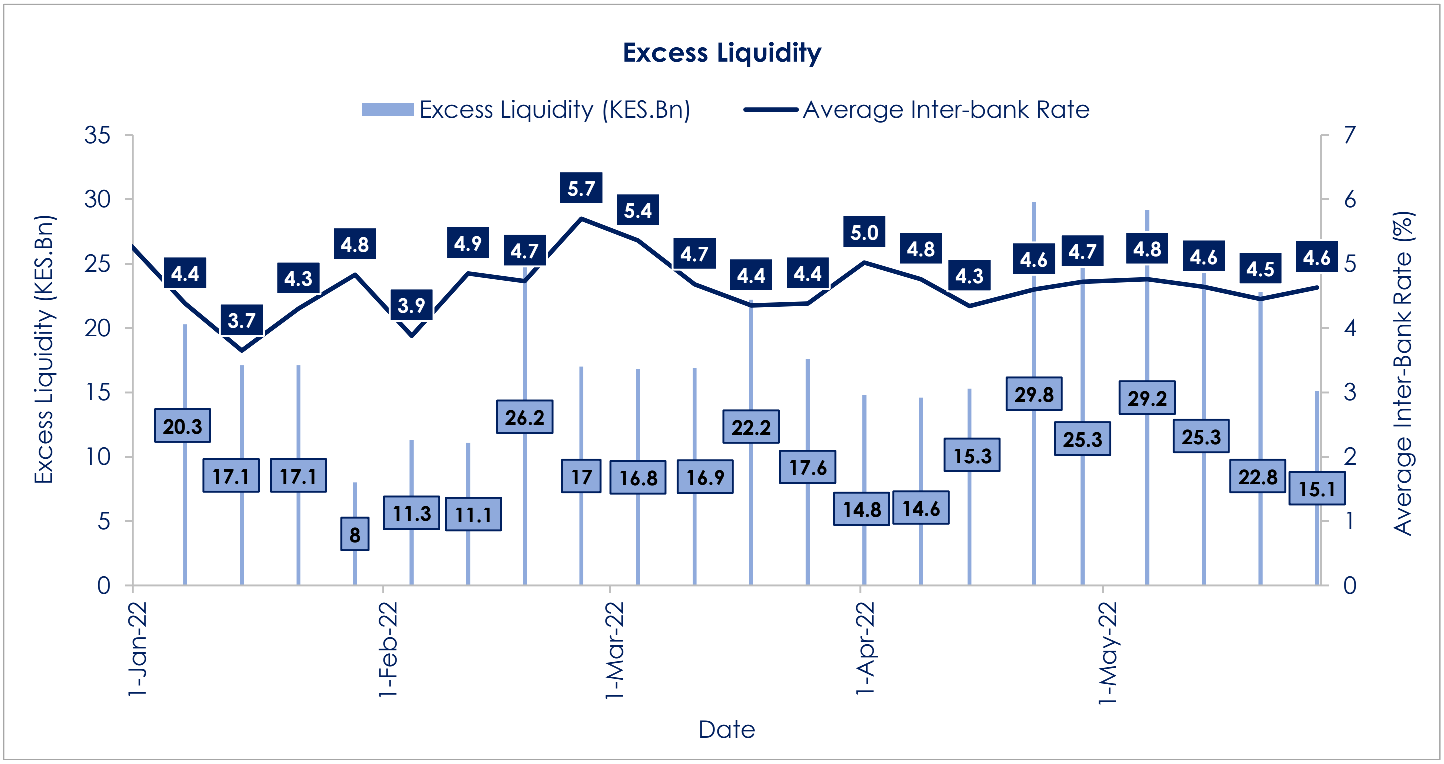
- Average inter-bank rates declined marginally to 4.6% in May 2022 compared to 4.7% in April 2022 while total inter-bank trading volumes over the same period declined significantly (29.8%) to KES.284.8Bn from KES.405.9Bn. (Figure.6).
- Over the same period, excess reserves (additional liquidity above the minimum 4.25% Cash Reserve Ratio (CRR)) declined 7.4% to KES.92.4Bn, compared to KES.99.8Bn (Figure.7).
- Our forecasted average inter-bank rate for June 2022 is between 4.4% - 4.9% with the expectation of lower liquidity post the **IFB1/2022/18** issue.

Figure.6: Inter-bank lending rates to range between 4.4% and 4.9% in June 2022



Source: Central Bank of Kenya

Figure.7: Excess commercial bank reserves remain consistent in May 2022

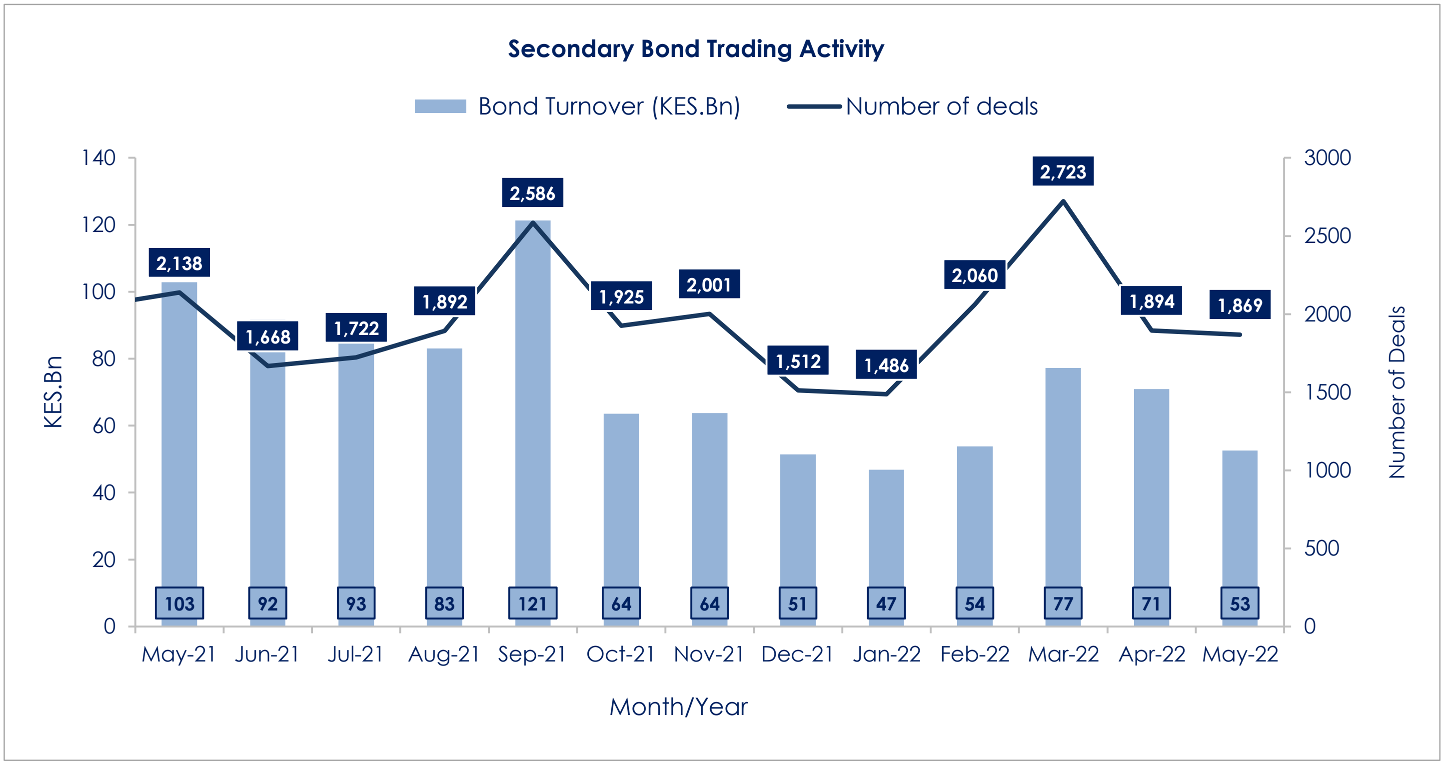


Source: Central Bank of Kenya

Secondary market bond turnover decreases in May 2022

- Secondary market trading activity declined 26% in May 2022 to KES.52.5Bn (KES.70.9Bn in April 2022) with the number of deals over the same period declining to 1,869 from 1,894 (Figure.8).
- This decline is explained by low market liquidity levels as well as the primary and tap sale debt issues that reduced market liquidity levels.
- It is worth noting that **FXD1/2022/10** is currently yielding 13.52% while **FXD1/2021/25** is yielding 14% with both trading at a discount.
- However, we expect number of deals and turnover to pick up in June 2022 following the timely **IFB1/2022/18** issue that will appease the market and ease pressure on the interest rates given its high traction.

Figure.8: Secondary trading activity decreases in May 2022

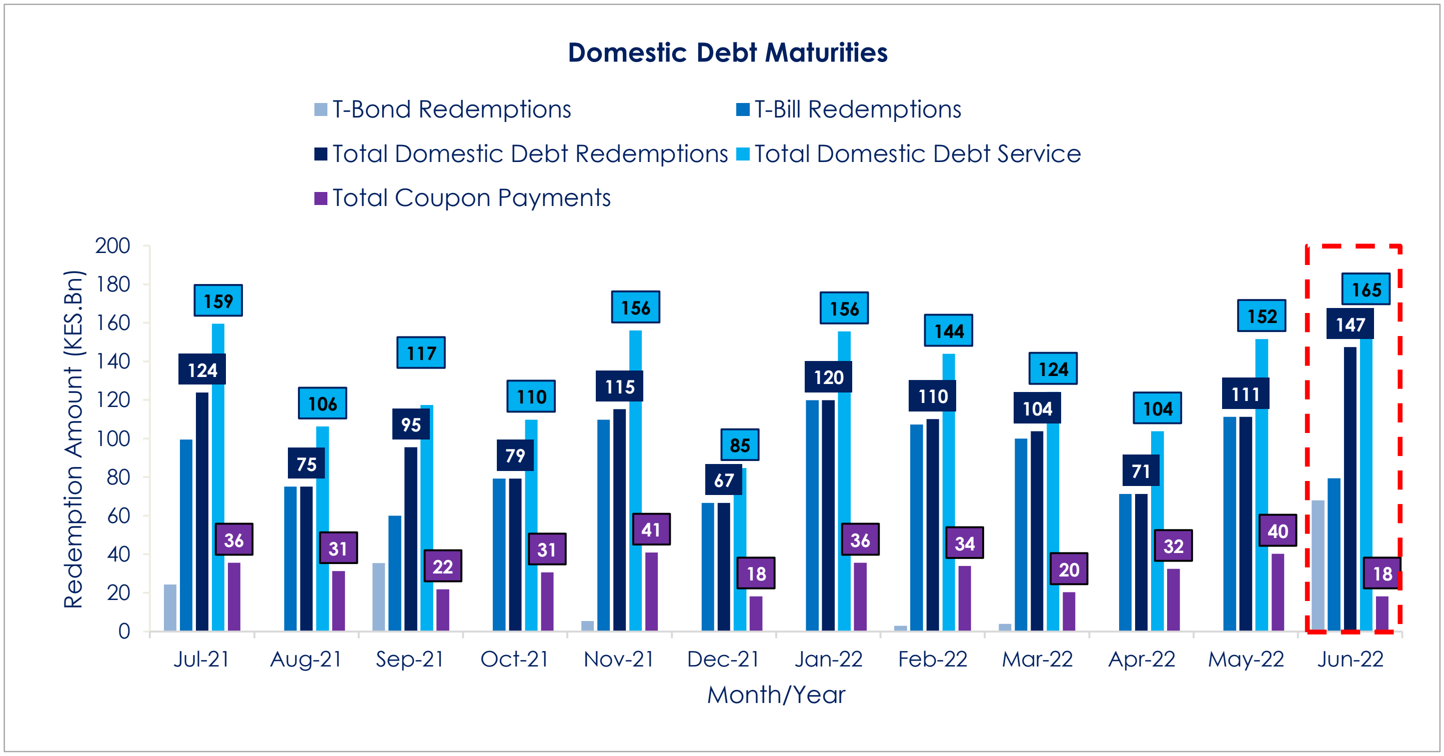


Source: Central Bank of Kenya

Domestic debt service for June 2022 at KES.165.5Bn

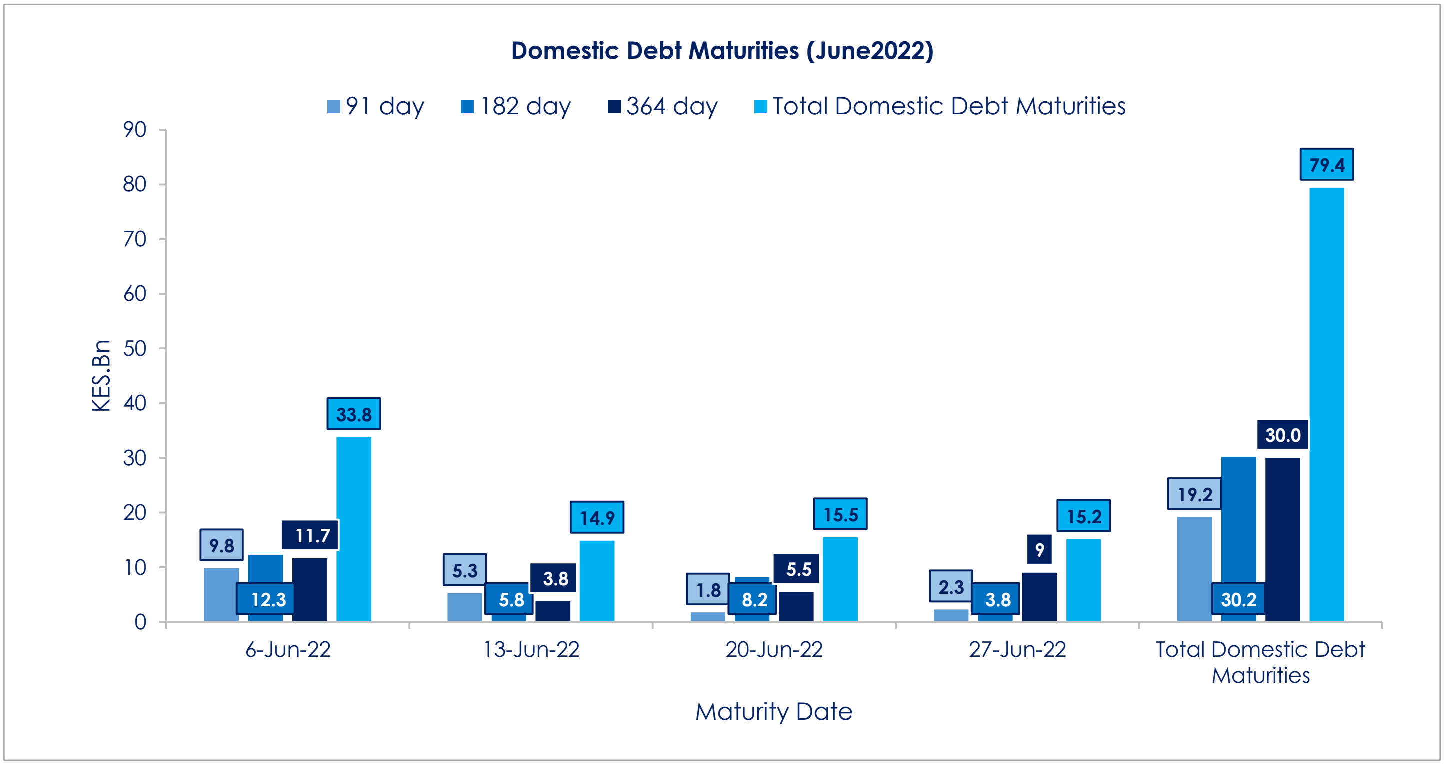
- Total domestic debt service for June is KES.165.5Bn, 9.1% higher than the KES.151.6Bn in May 2022.
- This comprises of KES.79.4Bn and KES.18.1Bn in T-Bill and coupon payments respectively as well as the redemption of FXD2/2007/15 and FXD1/2012/10 amounting to KES.68Bn (Figure.9).
- Expected redemptions for the 91,182 and 364-day T-Bills during the month are KES.19.2Bn, KES30.2Bn, and KES.30Bn respectively with the first week of the month having the highest redemptions at KES.33.8Bn (Figure.10).

Figure.9: June debt service KES.165Bn



Source: Central Bank of Kenya

Figure.10: Weekly debt maturities June 2022

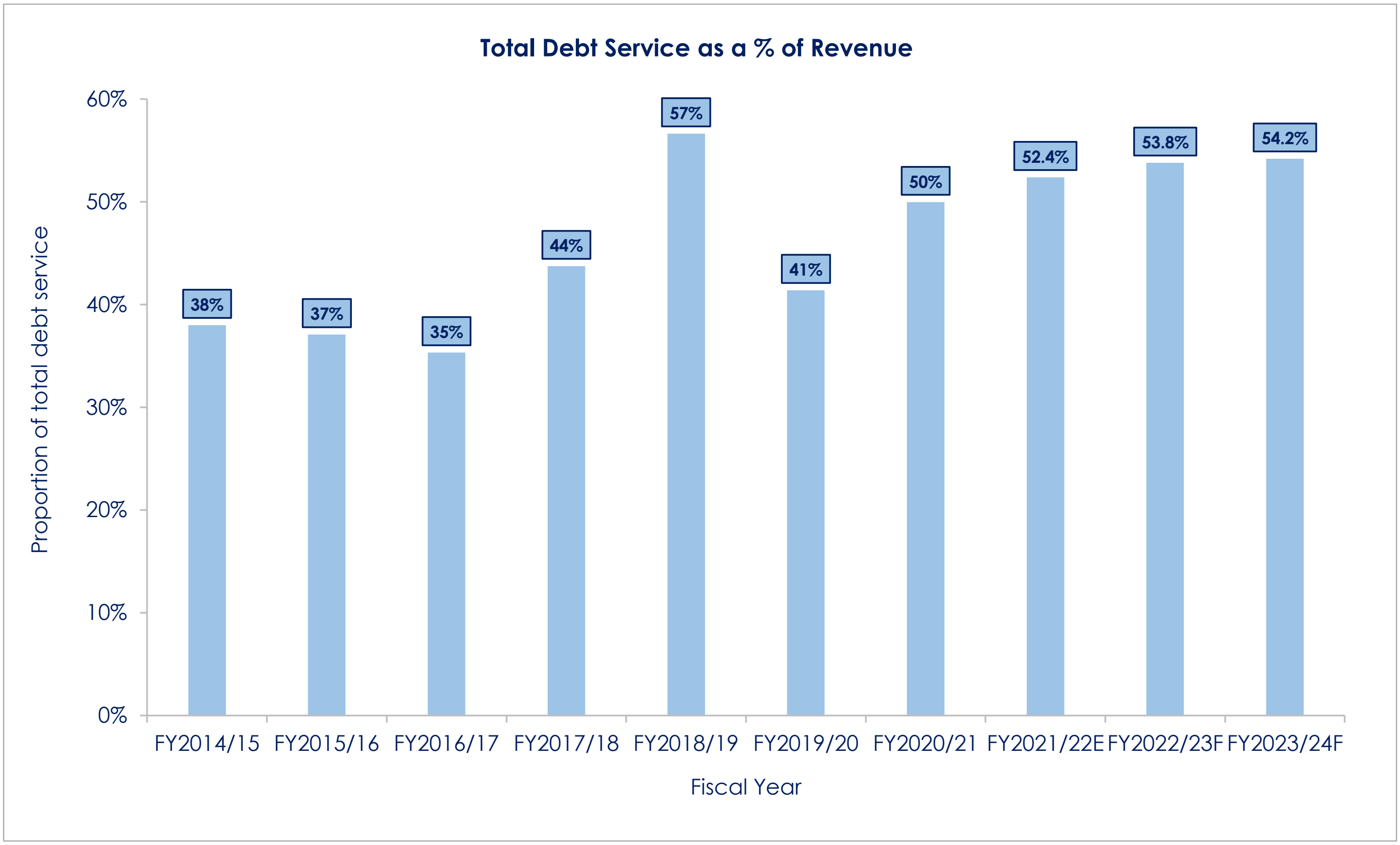


Source: Central Bank of Kenya

High debt service cost poses huge risk to long-term public debt sustainability

- The National Treasury in its Medium-Term-Debt-Management-Strategy-2022 estimates total public debt service as a proportion of Government revenue at 50% and 52.4% FY2020/21 and FY2021/22 respectively with forecasts showing a further increase FY2022/23 and FY2023/24 (Figure.11).
- This means that a huge proportion of Government revenue is directed towards debt repayment obligations rather than financing development expenditure.
- This scenario also increases the pressure on tax authorities to exceed revenue targets.
- A growing fiscal deficit however means that this ratio will continue to deteriorate, a trend that will be worsened by rising interest rates locally and globally together with a depreciating local currency.

Figure.11: Huge proportion of Government revenue used to finance public debt service



Source: The National Treasury

National Treasury below domestic borrowing target as 2021/22 fiscal year draws to a close

- Data from the National Treasury as at the end of April 2022 shows KES.735Bn in domestic borrowing against a revised target of KES.1.008Tn (Table.6 and Figure.12).
- This is equivalent to 72.9% of the revised target which falls below our linear target run-rate of 83.3% after 10 months of the fiscal year.
- This suggests heightened CBK borrowing as the fiscal year draws to a close and partially explains why the CBK has issuance of a debt issue popular with both local and foreign investors **IFB1/2022/18**.
- With regards to tax receipts, the National Treasury has collected KES.1.46Tn equivalent of 83.6% of the KES.1.74Tn revised target meaning it's slightly above our linear target run-rate.
- Non-tax receipts at KES.59.3Bn are now well ahead of the target run rate.
- Most notable is the increase in external borrowing from KES.50Bn at the end of February 2022 (11.5% of revised target) to KES.162.5Bn (37.5% of revised target).
- This included the U.S$750Mn (KES.87.4Bn) from the World Bank as Development Policy Operation (DPO) funding.

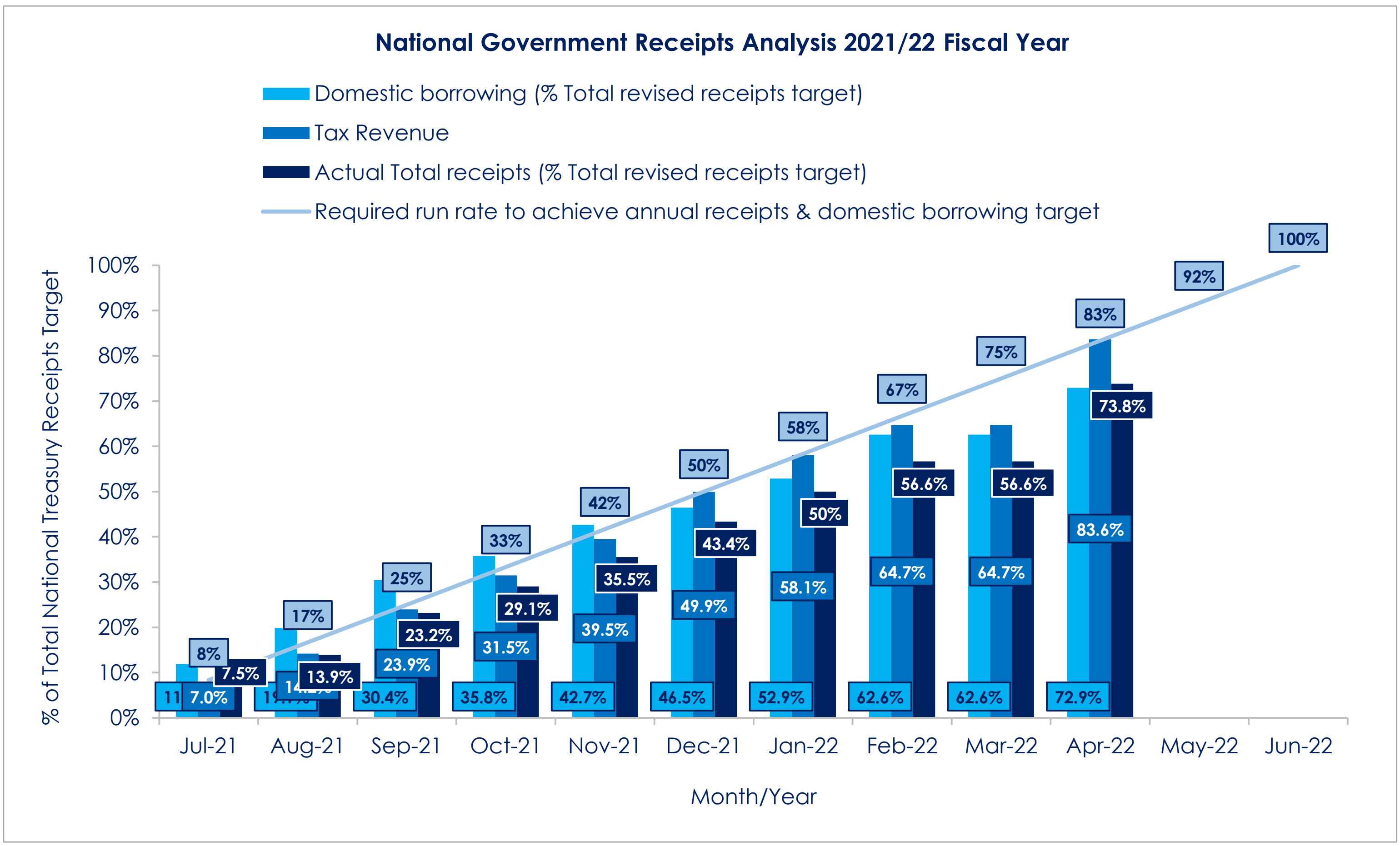
Table.6: 2021/22 Tax & Non-tax receipts above linear target run-rate

Receipts	Original Estimates July 2021 (KES.Bn)	Revised Estimates Mar 2022 (KES.Bn)	Actual Receipts 28th Feb 2022 (KES.Bn)	Actual Receipts 28th Apr 2022 (KES.Bn)	Proportion of Total Receipts 28th Feb 2022 (KES.Bn
Opening Balance (1st July 2021)		21.3	21.3	21.3	
Tax Revenue	**1,707.4**	**1,741.1**	**1,126.4**	**1,456.2**	**83.6%**
Non-Tax Income	68.2	67.1	45.1	59.3	88.4%
Domestic Borrowing*	**1,008.4**	**1,008**	**631.1**	**735**	**72.9%**
External Loans & Grants	379.7	433.2	50	162.5	37.5%
Other Domestic Financing	29.3	30.4	5.3	8	26.3%
Total Revenue	**3,193**	**3,279.8**	**1,857.9**	**2,421.1**	**73.8%**
Linear Run Rate target (8 months of fiscal year)					**83.3%**

* Note 1: Domestic Borrowing of KES.1, 008.4Bn = Net Domestic borrowing KES.664Bn & Internal Debt Redemptions (Roll-overs) KES.343.9

Source: The Kenya Gazette Vol. CXXIV - No.87 13th May 2022

Figure.12: National Treasury at 43% of 2021/22 fiscal year domestic borrowing target

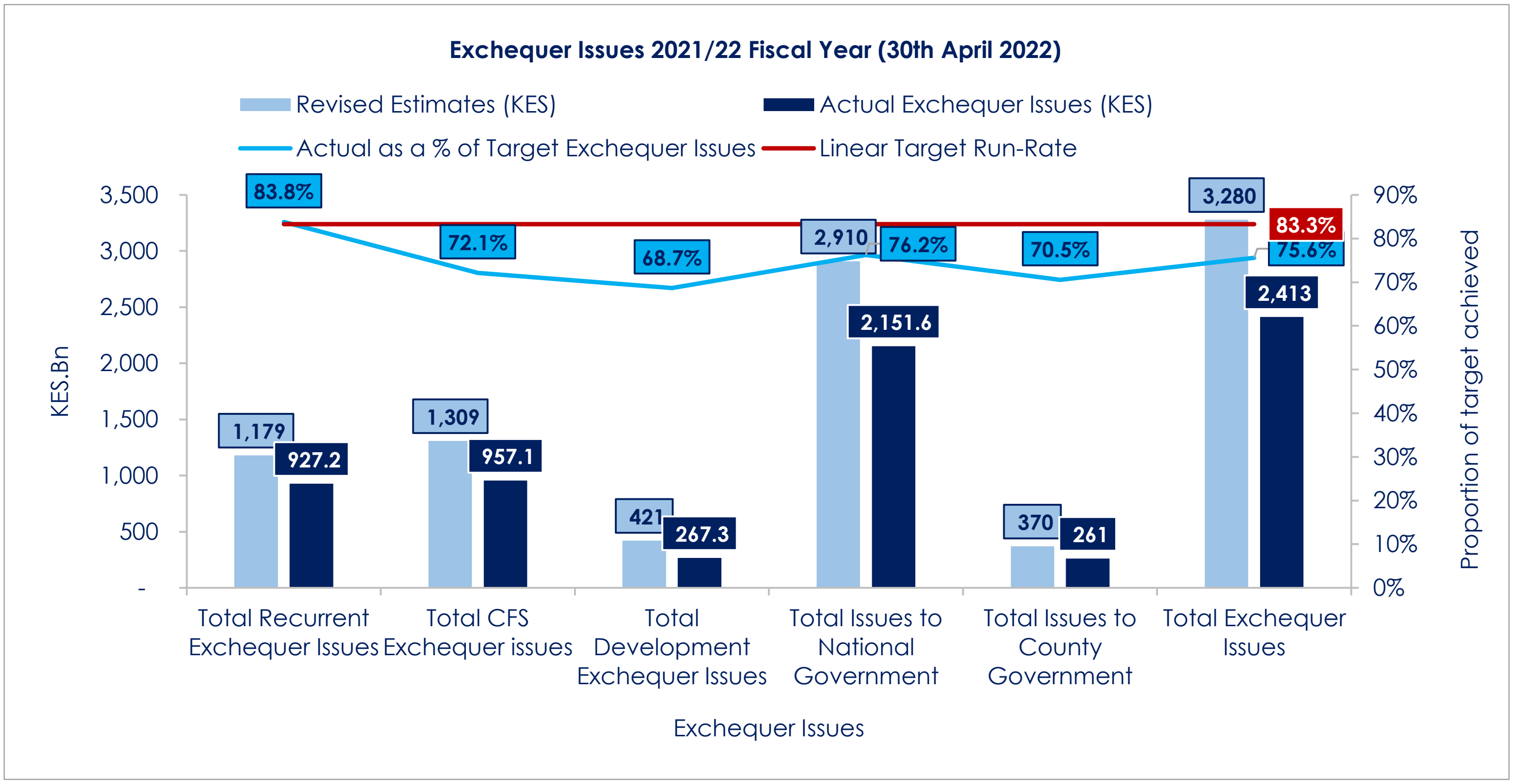


Source: The Kenya Gazette Vol. CXXIV - No.87 13th May 2022

Government expenditure remains below 2021/22 fiscal year expenditure run-rate targets

- Actual total Government expenditure stood at KES.2.41Tn equivalent to 75.6% of the total fiscal year target of KES.3.28Tn (Figure.13) and below our 83.3% linear target run-rate for the 10 months of the 2021/22 fiscal year.
- Total recurrent expenditure was slightly above our linear target run-rate at KES.927.2Bn or 83.8%.
- The underperformance of development expenditure and transfers to county Government continues at 68.7% and 70.5%.

Figure.13: Government expenditure remains below target run-rate estimates

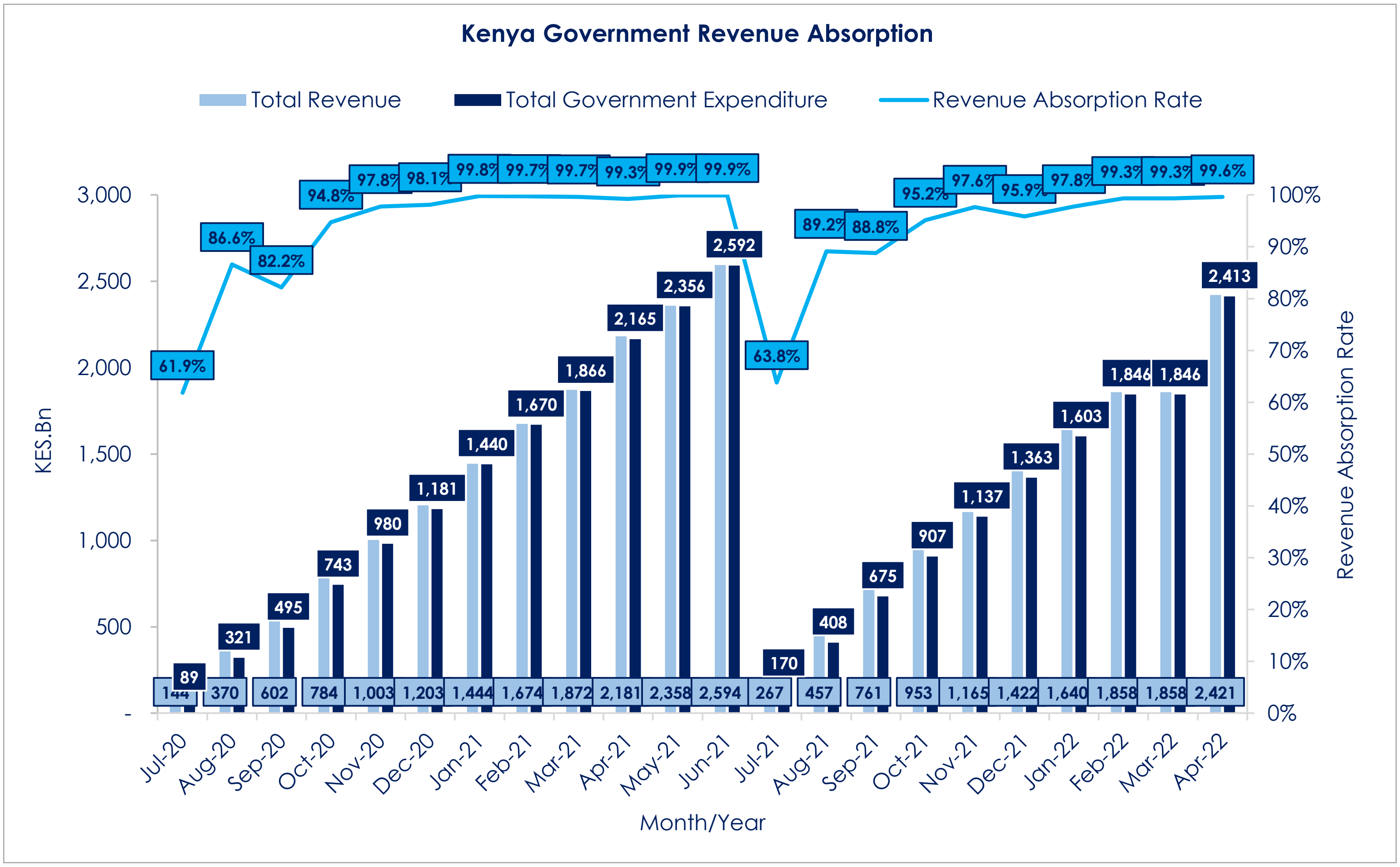


Source: The Kenya Gazette Vol. CXXIV - No.87 13th May 2022

Government Revenue Absorption dips in December 2021

- The proportion of Government receipts used to finance expenditure also known as the Revenue Absorption Rate (RAA) stood close to full absorption at 99.6% in April 2022 compared to 99.3% in February 2022 (Note that March 2022 data is unavailable) (Figure.14).
- This appears to be the trend as the fiscal year draws to a close with the RAA in April 2021 at 99.3%.
- The above means that the National Treasury is utilizing almost its entire revenue on its expenditure and this will necessitate additional funding through both domestic and external borrowing.

Figure.14: Revenue absorption is high showing close to full utilization

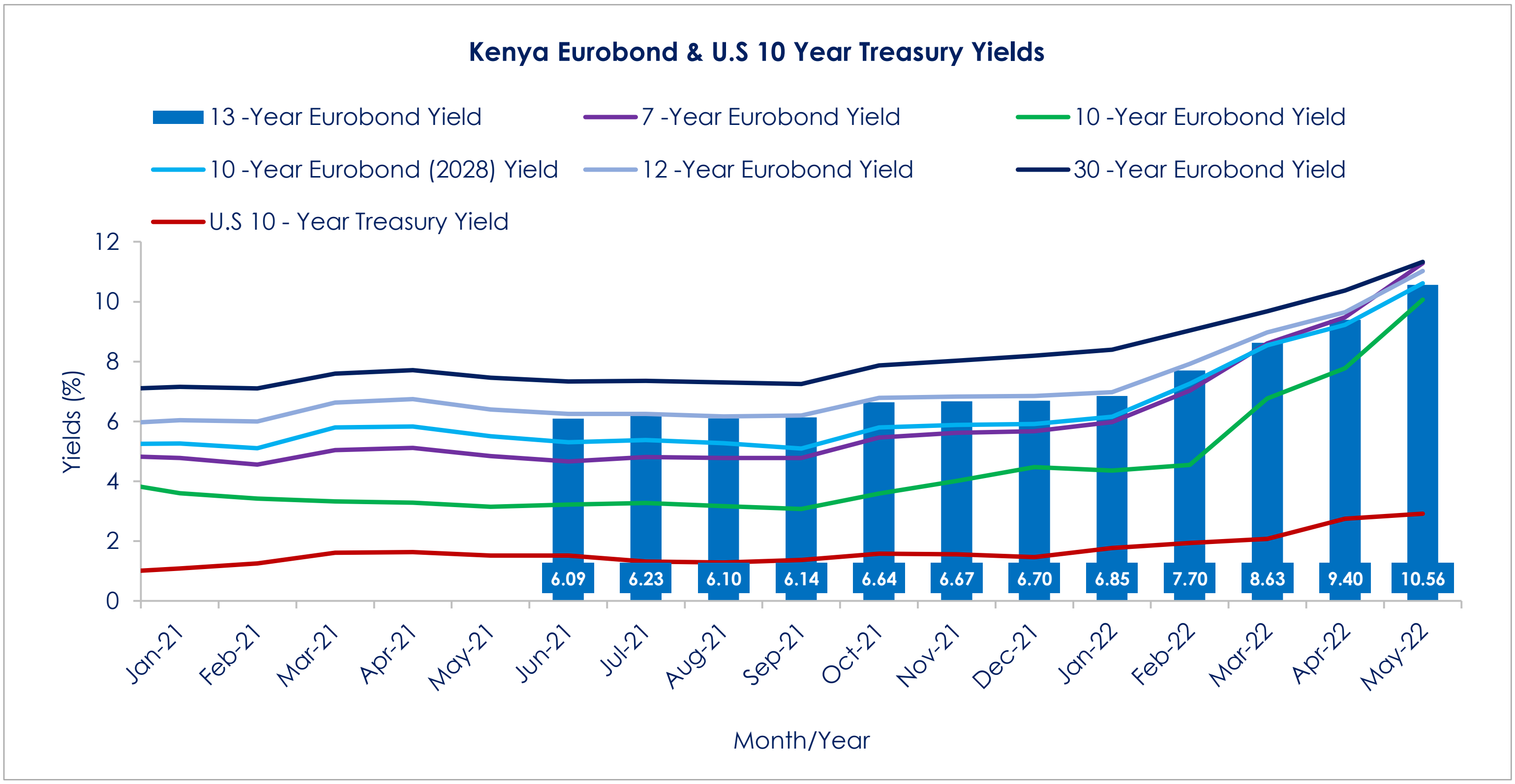


Source: The Kenya Gazette Vol. CXXIV - No.87 13th May 2022

Spike in Kenya Eurobond yields as global interest rates rise

- We observe a spike in average yields for all Government of Kenya Eurobonds as is the case with other African sovereign debt issues following an increase in global interest rates (Figure.14).
- Average yields for Kenya Eurobonds have risen 150 and 451Bps since April 2022 the end of 2021 respectively.
- Average yields on the U.S 10-Year Treasury increased 17Bps between April and May 2021 and 145 bps since the end of 2021.
- The above is in response to inflationary pressure and the two hikes in the benchmark Fed Rate (from 0.25% to 0.5% in March and 5.5% to 1% in May) to reign in the highest inflation rate in over forty.
- We expect a further increase in Kenya Eurobond bond yields in the short-term as investors expect a further increase in inflation and several fed rate hikes in June and July 2022.

Figure.15: Kenya Eurobond yields flat in November 2021

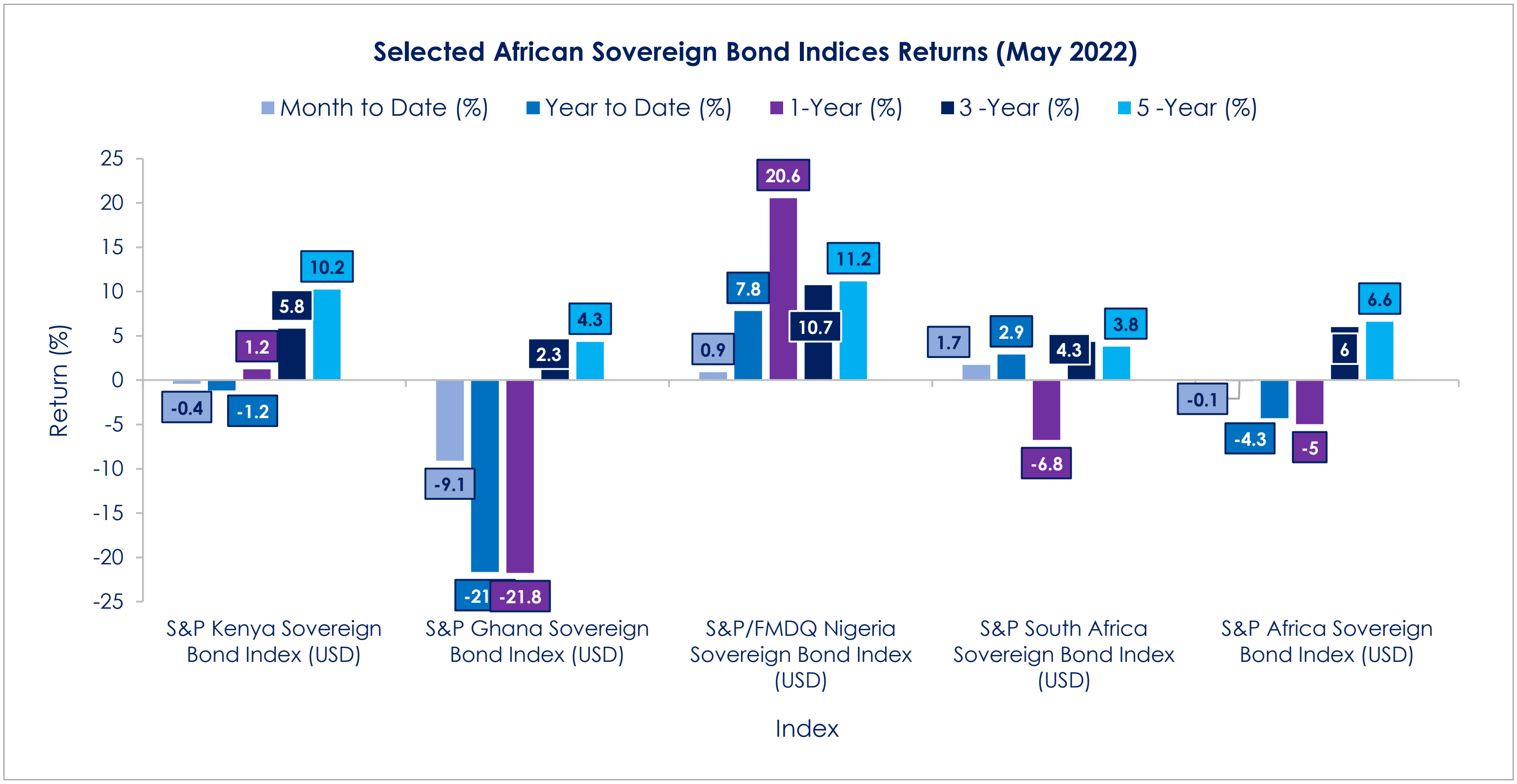


Source: Central Bank of Kenya

Ghana sovereign bond index tops month and annual performance

- The S&P/FMDQ Nigeria Sovereign Bond Index is the best performing sovereign bond index amongst our comparables year to date and over the last 1 year with a return of +7.8% and +20.6% (Figure.16).
- Over the same period, the S&P Ghana Sovereign Bond Index (USD) was the worst performing index a trend we attribute to a huge currency depreciation (-35.2%).
- The Kenya sovereign Bond Index has returned -1.2% and +1.2% year to date and over the last one year in spite of a 0.7% and 8.7% depreciation against the United States Dollar (U.S$) respectively.

Figure.16: S&P Ghana sovereign bond outperforms our comparable sovereign bond indices over 1 year



Source: S&P Global

Yield curve shifts further northwards

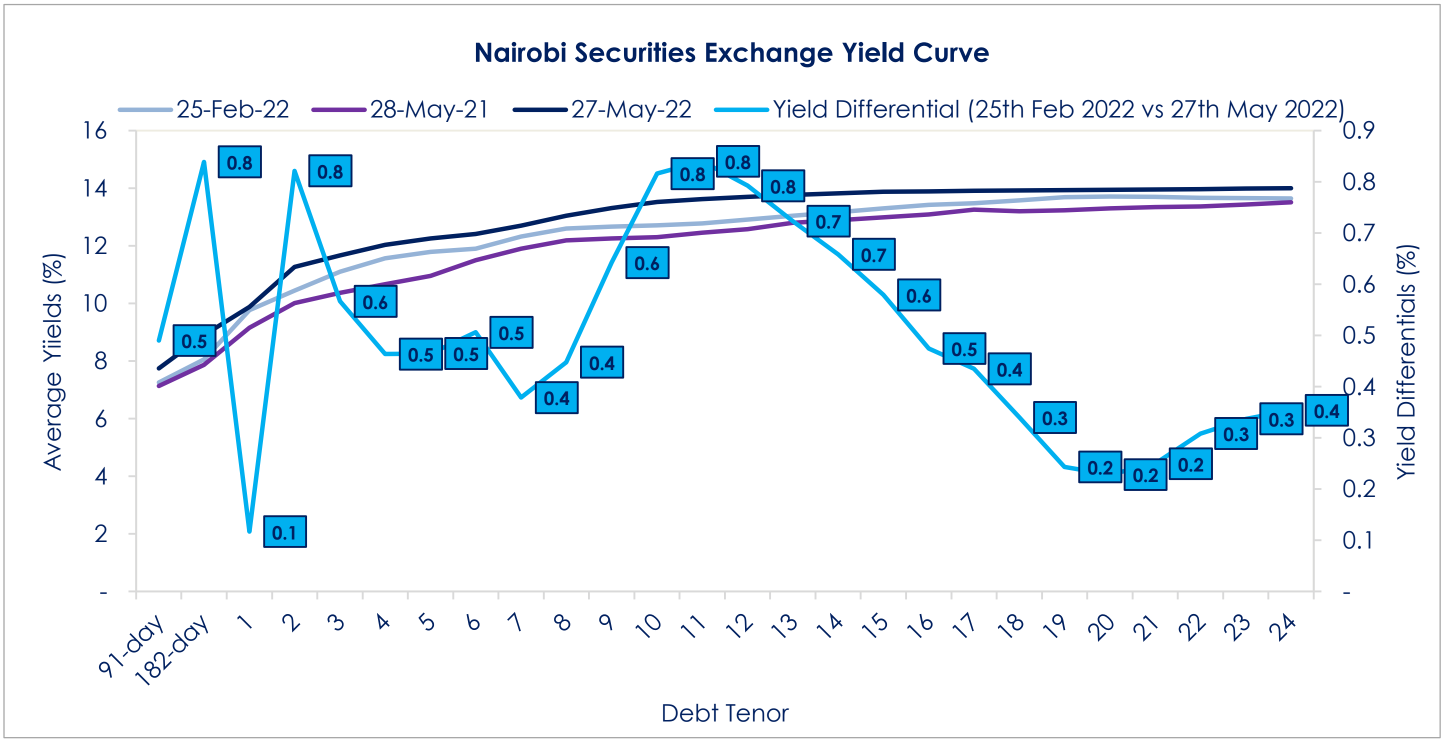
- A comparison of average yields on the NSE on 25th February 2022 (issuance of **IFB1/2022/19**) and 27th May 2022 (latest yield curve) shows an uptick across all tenors of the yield curve. (Table.7 and Figure.17).
- Further, a comparison of current yields and those during a similar period in the previous year shows an uptick across all tenors of the yield curve.
- The CBK has been driving demand for longer dated debt by accepting higher investor bids in debt auctions as its strategy to lengthen the Average Tenor to Maturity (ATM) of public debt.
- As has been mentioned in previous fixed income reports, we expect the gradual increase in rates across the yield curve to continue throughout 2022 due to an increased domestic debt financing demand pressure.
- We maintain our recommendation of **BUY short** and **HOLD medium-term** and **long term papers.**

Table.7: Yield curve has shifted upwards since the issuance of IFB1/2022/19

Tenor	Yields (25th Feb 2022)	Yields (28th May 2021)	Yields (28th May 2022)	Δ May 2022 vs Feb 2022) (Bps)	YoY Δ May 2022 vs May 2021 (bps)	Sterling Capital Yield Curve (June 2022)
1	9.7640	9.1560	9.8810	↑11.7	↑72.5	10
2	10.4500	10.0133	11.2716	↑82.2	↑125.8	11.3
5	11.7877	10.9555	12.2524	↑46.5	↑129.7	12.35
10	12.7117	12.2979	13.5278	↑81.6	↑123	13.5
15	13.2973	12.9869	13.8766	↑57.9	↑89	13.95
20	13.7173	13.3003	13.9456	↑22.8	↑64.5	13.95

Source: Nairobi Securities Exchange

Figure.17: Short, medium and long-term tenors rise



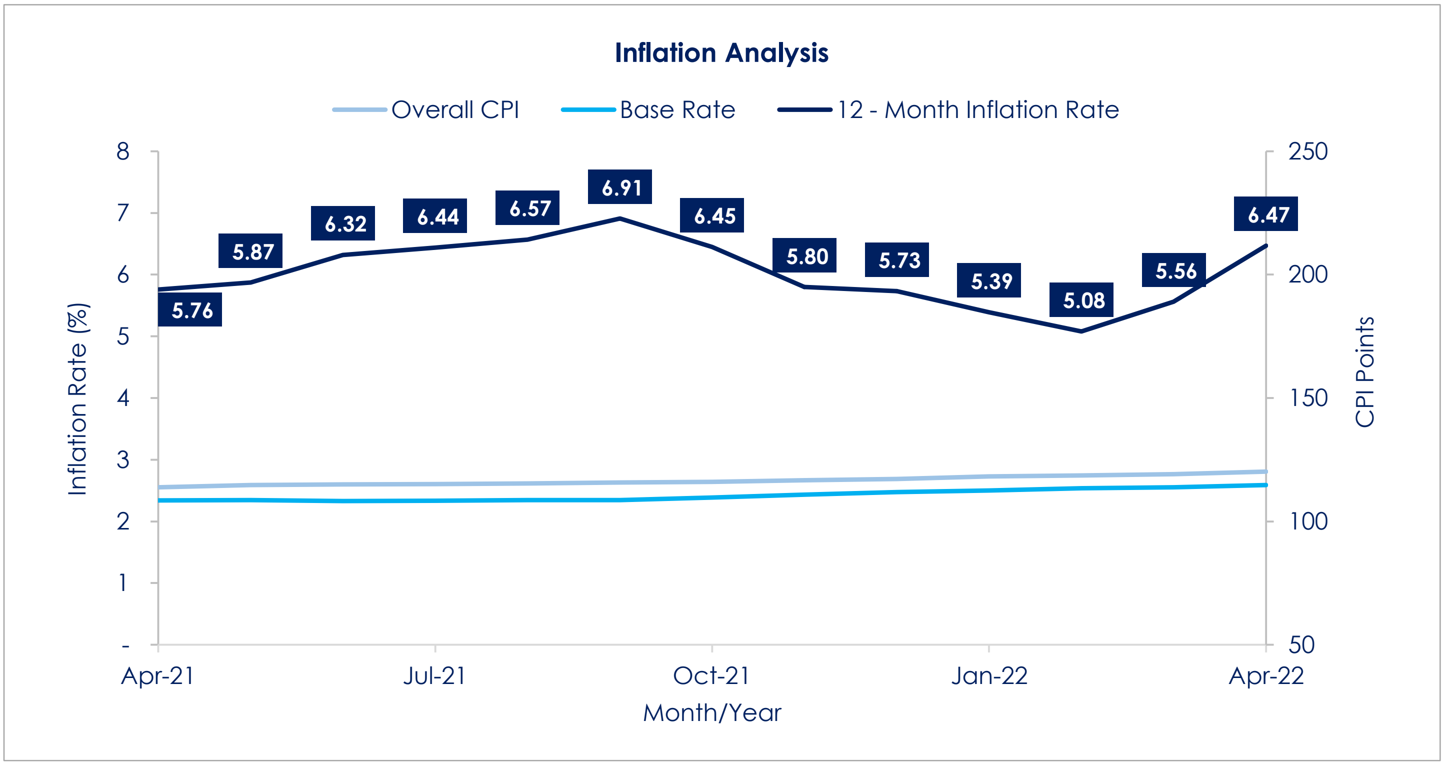
Source: Nairobi Securities Exchange

May and June 2022 inflation to rise on supply-side pressures

- Inflation for the month of April 2022 stood at 6.47%, up from 5.56% a month earlier largely due to an increase in the prices of commodities. (Figure 15).
- The marked increase in the prices was a result of an increase in food and non-alcoholic beverages (12.2%), household maintenance (7.2%), transport (6.9%); and housing, water, electricity, gas and other fuels (5.5%) between April 2021 and April 2022 (Figure.18).

- Our short term forecast is that inflation will stay elevated between the range of 6% - 7% in both May and June on account of continued supply-side pressures such as elevated global fuel prices and supply-chain constraints.
- Further, an increase in Kenya's imports amid a declining Shilling will serve to keep inflation elevated throughout 2022.
- To this effect, we see inflation remaining within the medium and upper inflation bands of 5% - 7.5% through 2022.
- The rise in inflationary pressure will be of great concern to the monetary policy makers in 2022 and has, as at 31st May 2022, led to an increase in the Central Bank Rate (CBR) by 50 basis points (bps) from 7% to 7.5%.
- Depending on further upticks in inflation, we see the CBK taking steps to increase benchmark rates.

Figure.18: Short-term inflation forecast 6% - 7%



Source: Kenya National Bureau of Statistics

MPC revises CBR upwards to reign in inflation and currency depreciation

- The Monetary Policy Committee (MPC) met on Monday, 30th January 2022 to review the impact of previous monetary policy measures on the economy.
- The main points of discussion were;

    1) The increase in inflation largely attributable to higher food and fuel prices.

2) The uncertain global economic outlook particularly due to the Russia-Ukraine conflict and persistent supply chain disruptions. The committee observed that global inflationary pressures remain elevated reflecting the impact of the sharp increase in prices of commodities such as fuel, fertilizer, edible oils and wheat.

3) The recently released Economic Survey 2022 which highlighted the Kenyan economy's strong rebound in 2021, particularly in key sectors such as manufacturing, wholesale and retail trade, education, accommodation and food services, transport and storage as well as the financial and insurance sectors.

   The committee also observed that leading economic indicators show strong continued performance in the first quarter of 2022, supported by robust activity in construction, information and communication, wholesale and retail trade, transport as well as manufacturing sectors.

4) The MPC observed that exports have remained strong, growing by 11.1% in the 12 months to April 2022 compared to a similar period in 2021. However, the pace of imports surpassed those of exports, growing 29% in the 12 months to April 2022 compared to a decline of 5.7% in the 12 months to April 2021, mainly reflecting increased imports of oil and intermediate goods.

5) The CBK foreign exchange reserves currently stand at USD.8,197Mn (4.86 months of import cover) continue to provide adequate cover against short-term shocks.

6) The Gross non-performing loan (NPL) ratio stood at 14.1% in April 2022 compared to 14% in February due to notable defaults in the building and construction, manufacturing, trade, transport and communication sectors.

7) Growth in private sector credit increased to 11.5% in April 2022, form 9.1% in February. Growth was observed in transport and communication (28.9%), manufacturing (12%), trade (10.7%), consumer durables (16.1%) and business services (12.2%).

- The committee noted elevated risks to the inflation outlook due to increased global commodity prices and supply chain distruptions and concluded a need to tighten monetary policy in order to anchor inflation expectations. The MPC therefore raised the CBR from 7% to 7.5%.

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