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Fixed Income Note

September 2022

“Slow start to 2022/23”

Analysts:

Renaldo D’Souza
Renaldo.DSouza@sterlingib.com

Davis Gathinji
Davis.Gathinji@sterlingib.com

Isabel Chakairu
Isabel.Chakairu@sterlingib.com

Email: research@sterlingib.com

Bond Dealing: +254 (20) 2213914/0723 153 219

Email: invest@sterlingib.com

Office Address: Delta Corner Annex, 5th Floor, Ring Road Westlands.

Website www.sterlingib.com

Bloomberg Code: SCLK <GO>

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Executive Summary

- Our September 2022 fixed income report is titled **"Slow start to 2022/23"** in reference to the Central Bank of Kenya's (CBK) re-opening of ten-year and fifteen-year fixed coupon treasury bonds.
- The apex bank seeks to raise KES.50Bn through two re-opened bond issues, **FXD1/2022/10** and **FXD1/2022/15.**
- Our view is that the two bonds are likely to be undersubscribed due to the rising interest rate environment that dissuades investors from holding medium to long-term bonds, however, we also note that there is likely to be aggressive bidding to test the CBK's resolve to keep interest rates low.
- Our weighted average bid predictions are as follows:

  FXD1/2022/10: 13.85% - 13.95%
  FXD1/2022/15: 13.95% - 14.05%

- 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.
- Also covered in the report is the country's current fiscal position including Government revenue, expenditure, and fiscal deficit as well as its borrowing needs.
- We also include an analysis of the yield curve over selected periods showing trends in yields of different tenors.
- Our report concludes with our inflation expectations as well as the expected outcome of the Monetary Policy Committee (MPC) decision in September.

CBK re-opens two bonds to raise KES.50Bn in September 2022

- The Central Bank of Kenya (CBK) invites bids to raise KES.50Bn through two re-opened Treasury Bonds (T-Bonds); **FXD1/2022/10** and **FXD1/2022/15** (Table.1).
- While we expect the two bonds to be undersubscribed and investors to bid aggressively to test the resolve of the CBK to maintain interest rates near current levels.
- As has been mentioned in previous reports, the CBK appears intent on keeping interest rates below 14% as observed in recent medium and long-term debt auctions where it rejected investor bids above this rate.
- This situation has meant that the yield curve from the 10-year tenor has largely remained flat.
- If CBK insists on suppressing long tenor interest rates, the yield curve may begin to invert.
- To subvert the foregoing, the apex bank is likely to accept increasingly aggressive investor bids in this and subsequent auctions.

Table.1: Primary Bond issues' summary

Issue Number	**FXD1/2022/10**	**FXD1/2022/15**
Total Amount Offered	KES.50Bn	
Tenor	9.6 Years	14.5 Years
Coupon Rate (%)	13.490%	13.942%
Price Quote	Discounted/Premium/Par	
Period of Sale	25/08/2022 to 13/09/2022	
Auction Date	14/09/2022	
Value Date	19/09/2022	
Yield Curve (%) (Weighted average tenor – 2nd Sept 2022)	**13.6305**	**13.9000**

Source: Central Bank of Kenya & Sterling Capital Research

Our market weighted average bid predictions

- We arrived at our market-weighted average bid predictions by analysing implied yields of securities of similar tenors on the Nairobi Securities Exchange (NSE) as of 2nd September 2022 and discussions with several fixed income traders (Table.2).

Table.2: Auction bid predictions

Rate	**FXD1/2022/010**	**FXD1/2022/015**
Weighted Average bid predictions (%)	13.85 – 13.95	13.95 – 14.05

Source: Sterling Capital Research

Our predicted rates are guided by historical debt issues

- We used implied yields of bonds of similar tenors to maturity on the NSE as of 2nd September 2022 as a guide for possible investor auction bid levels (Table.3).

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
FXD1/2022/10	16th May 2022	13.490	5th May 2032	3,504	13.6305	12.3024
FXD1/2022/15	27th June 2022	13.942	6th July 2037	5,329	13.9000	12.8841

Source: Central Bank of Kenya

- Historical auction results of 10 and 15-year debt issues since 2018 show that both tenors are largely undersubscribed in primary auctions as investors shy away from longer-dated debt issues due to perceived higher duration risk.
- The above supports our view that these re-opened issues are likely to be undersubscribed. (Table.4).

Table.4: Historical primary market auction performance

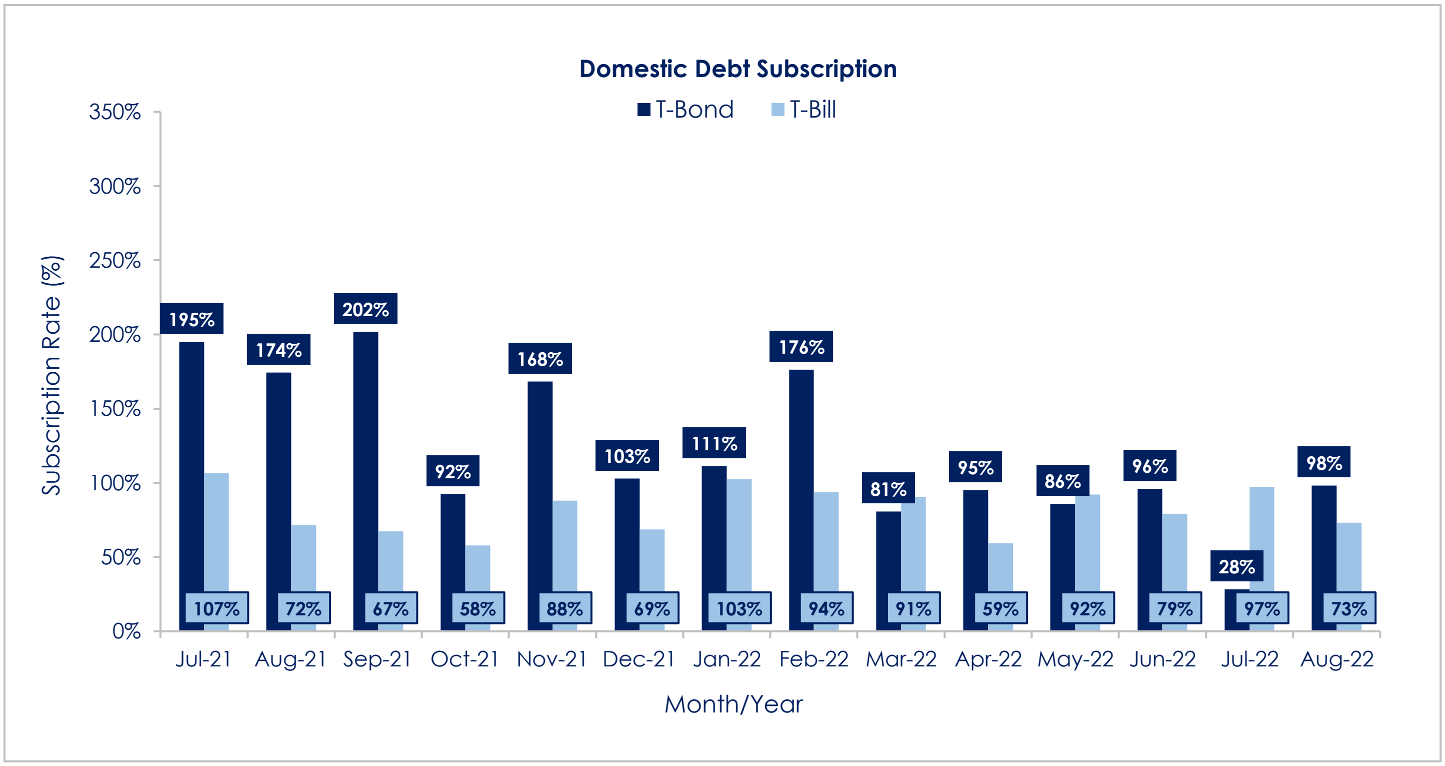
Issue	Issue Date	Offered (KES.Bn)	Bids Received (KES.Bn)	Amount Accepted (KES.Bn)	Performance Rate (%)	Coupon Rate (%)	Implied Yield (%)
10-Year							
FXD1/2018/10	27th Aug 2018	40	29.8	19.4	74.6	12.686	13.3593
FXD2/2018/10	17th Dec 2018	40	28.9	26.2	72.2	12.502	13.3889
FXD1/2019/10	25th Feb 2019	50	36.3	32.8	72.7	12.44	13.4060
FXD2/2019/10	15th April 2019	50	70.9	51.3	141.9	12.30	13.4185
FXD3/2019/10	19th Aug 2019	50	52.8	45.0	105.5	11.52	13.4484
FXD4/2019/10	25th Nov 2019	50	38.4	28.4	76.8	12.28	13.4723
FXD1/2022/10	16th May 2022	60	32.9	28.7	54.8	13.49	13.6305
15-Year							
FXD1/2018/15	28th May 2018	40	20.2	12.9	50.5	12.65	13.6925
FXD2/2018/15	22nd Oct 2018	40	27	7.9	67.6	12.75	13.7206
FXD1/2019/15	28th Jan 2019	40	25.1	14.7	62.7	12.86	13.7382
FXD2/2019/15	13th May 2019	50	21.5	19.3	43.1	12.73	13.7562
FXD3/2019/15	29th July 2019	40	86.7	50.6	216.7	12.34	13.7688
FXD1/2020/15	21st Sept 2020	50	49.8	45.7	99.6	12.76	13.8011
FXD1/2022/15	27th June 2022	25	16	16	64	13.94	13.9000

Source: Central Bank of Kenya

T-Bond subscription increases as T-Bill uptake declines in August 2022

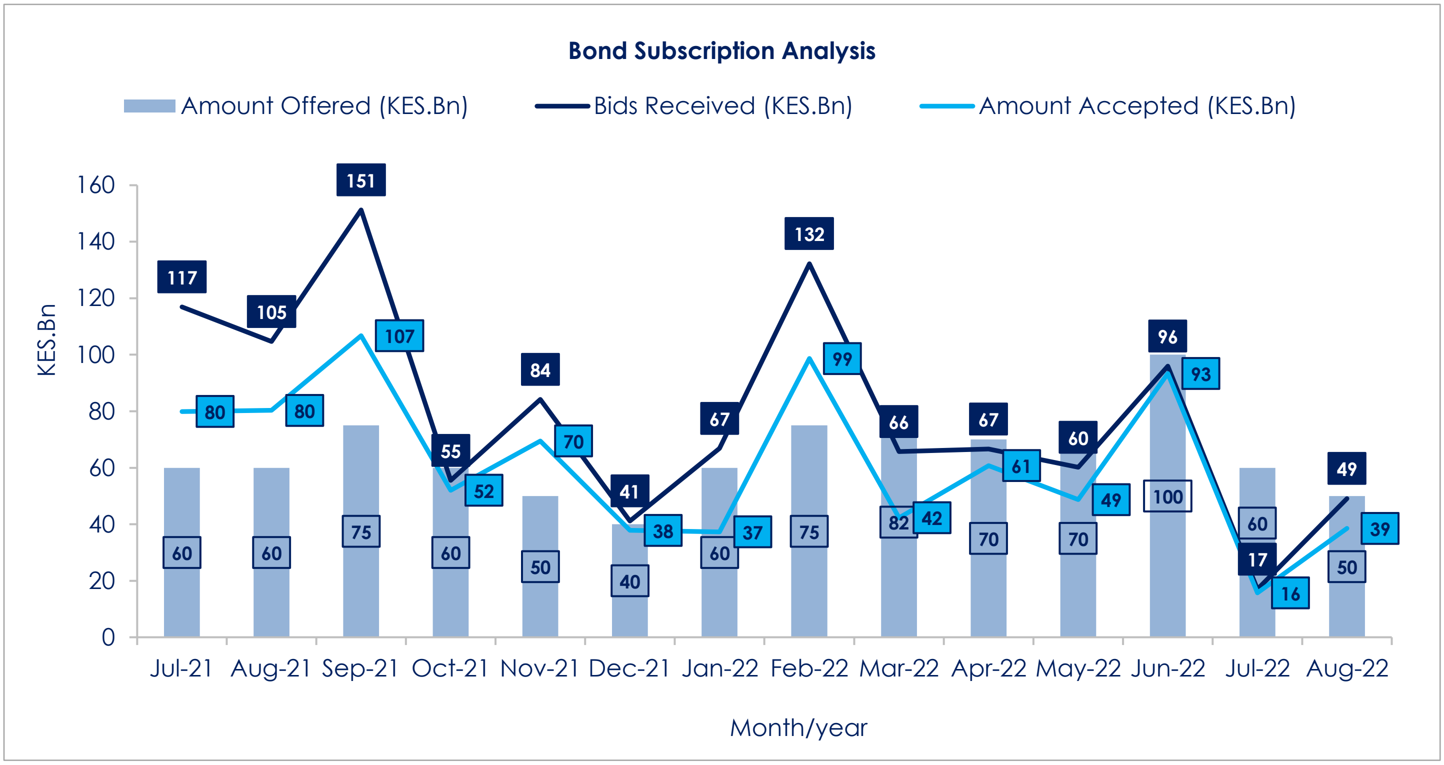
- Aggregate T-Bills subscription declined slightly in August 2022 with KES.87.8Bn bids received against KES.120Bn offered equivalent to a 73% subscription rate which was lower than 97.4% the previous month (Figure.1).
- 91-Day T-Bills recorded a 280.6% subscription rate compared to 278.1% in July 2022, while the 182-Day T-Bills and 364-Day T-Bills reported 40.4% and 22.9% compared to 74.8% and 47.6% in July respectively.
- It is evident from these auctions that investors are reluctant to lock-in their capital for longer periods in an environment of rising interest rates.
- During the month of August, the CBK re-opened three bonds - **FXD1/2022/3, FXD2/2019/10,** and **FXD1/2021/20** all of which raised KES.49Bn against a target amount of KES.50Bn.
- This represented subscription rates of 43.6%, 17.9%, and 36.6% for the three debt issues respectively (Figure.2).
- We attribute the above to investors strategy to lower duration risk in a rising interest rate environment also aggravated by uncertainty on the outcome of the general election.
- This undersubscription will be a cause of concern for the Government which has a domestic borrowing target of KES.1.04Tn.
- This suggests that the CBK is increasingly likely to accept more aggressive investor bids in upcoming debt auctions and the 14% psychological mark could be breached before the end of the calendar year.

Figure.1: T-Bond subscriptions up in August 2022



Source: Central Bank of Kenya

Figure.2: Bond subscriptions near full subscription in August 2022

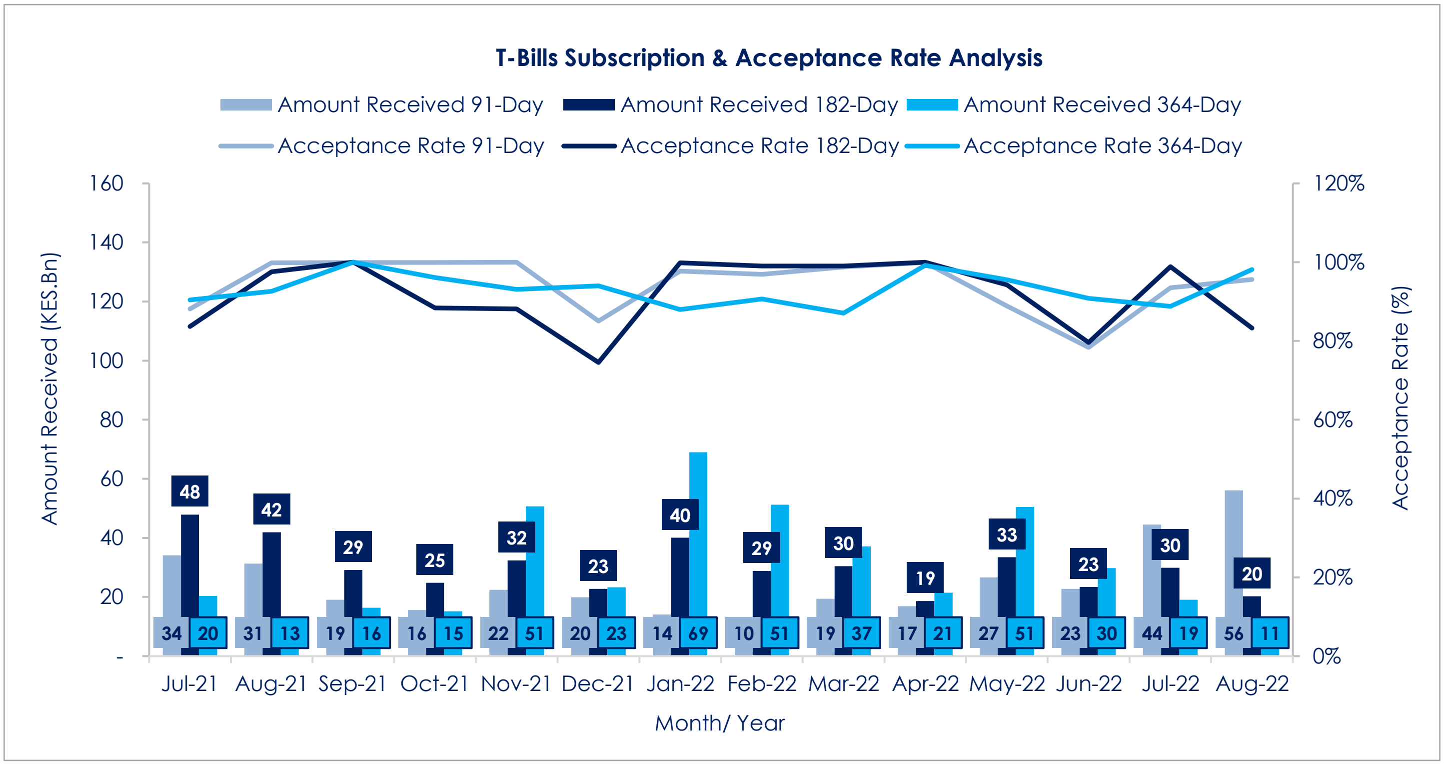


Source: Central Bank of Kenya

91 and 364-Day T-Bill acceptance rates close to full subscription

- CBK's acceptance rate for the 91, 182-Day and 364-Day T-Bills stood at 95.6%, 83.3% and 98.2% in Aug 2022 compared to 93.5% and 98.9% and 88.8% in July given increased uptake and historically low bond subscriptions during the month (Figure.3).
- The declines on the 182-Day and 364-Day T-Bill acceptance rates is explained by the mix of a relatively lower pool of investors allocating capital towards short-term debt issues as well as increasingly aggressive investor bids.

Figure.3: High 91 and 364-Day T-Bill acceptance rate in August 2022

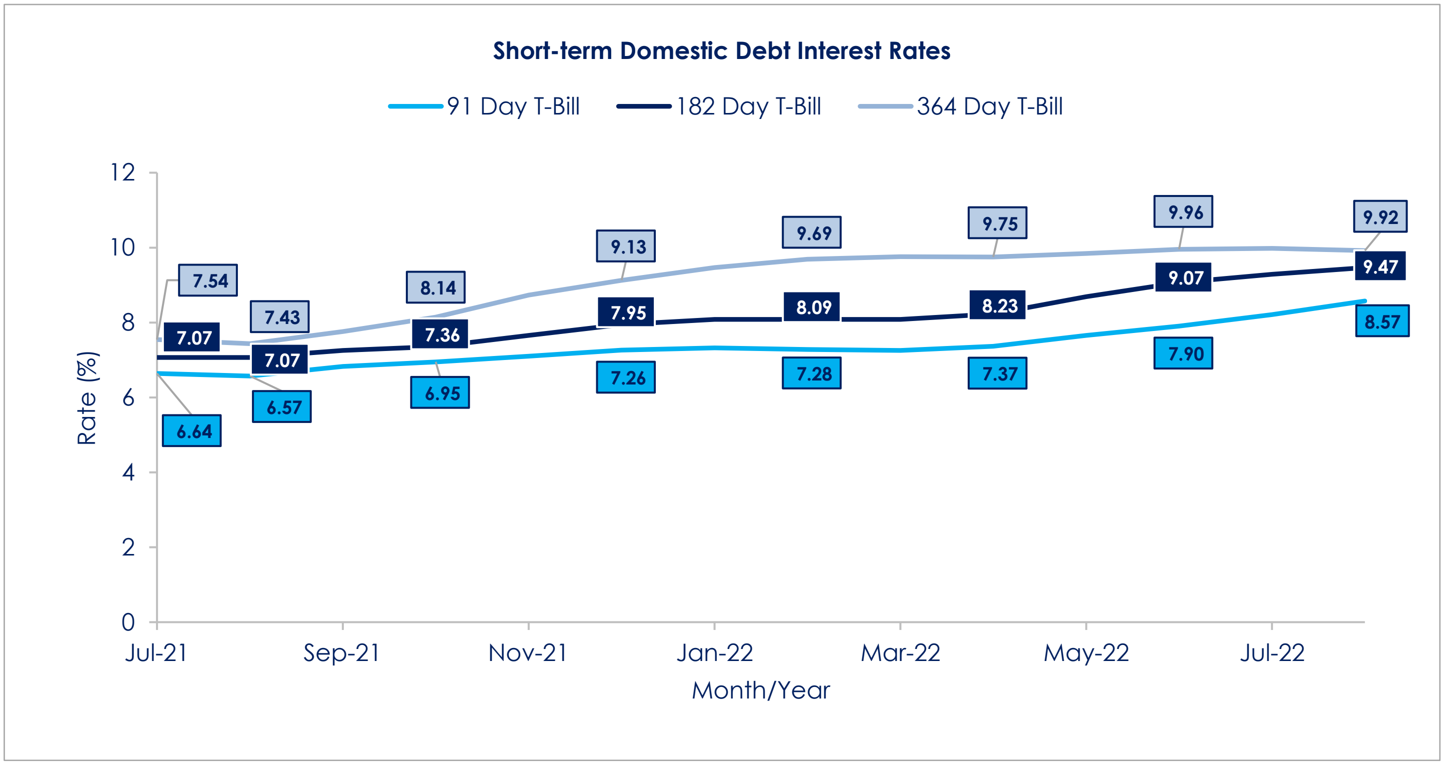


Source: Central Bank of Kenya

T-Bill rates further rise in August 2022 but fail to breach 10%

- Average 91 and 182 T-Bill rates rose marginally to 8.6%, and 9.5%, in August 2022 from 8.2%, and 9.3% in July 2022, while the 364 T-Bill rate declined marginally to 9.92% from 9.98% (Figure.4).
- We attribute the above to relatively higher inflation and investor expectations of a general rise in the level of interest rates.
- The CBK is intent on keeping the T-Bill rates low and particularly the 364 Day below what would be a psychological mark at 10%. This attribute shows a slight decline in its subscription rate.
- Given shortfalls in revenue collection and pressure to meet expenditures, we see this barrier being broken in the next few months.

Figure.4: T-Bill rates upward trajectory continues

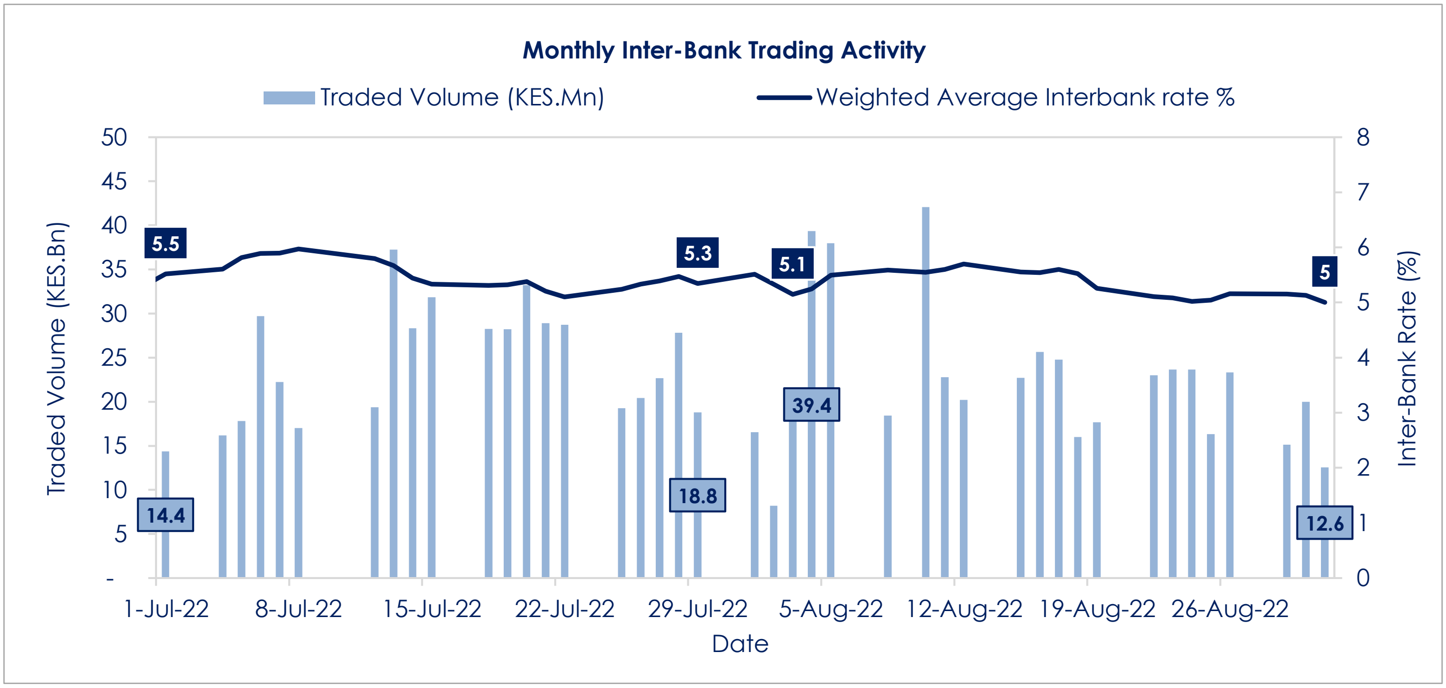


Source: Central Bank of Kenya

Average inter-bank lending rates to remain flat in September 2022

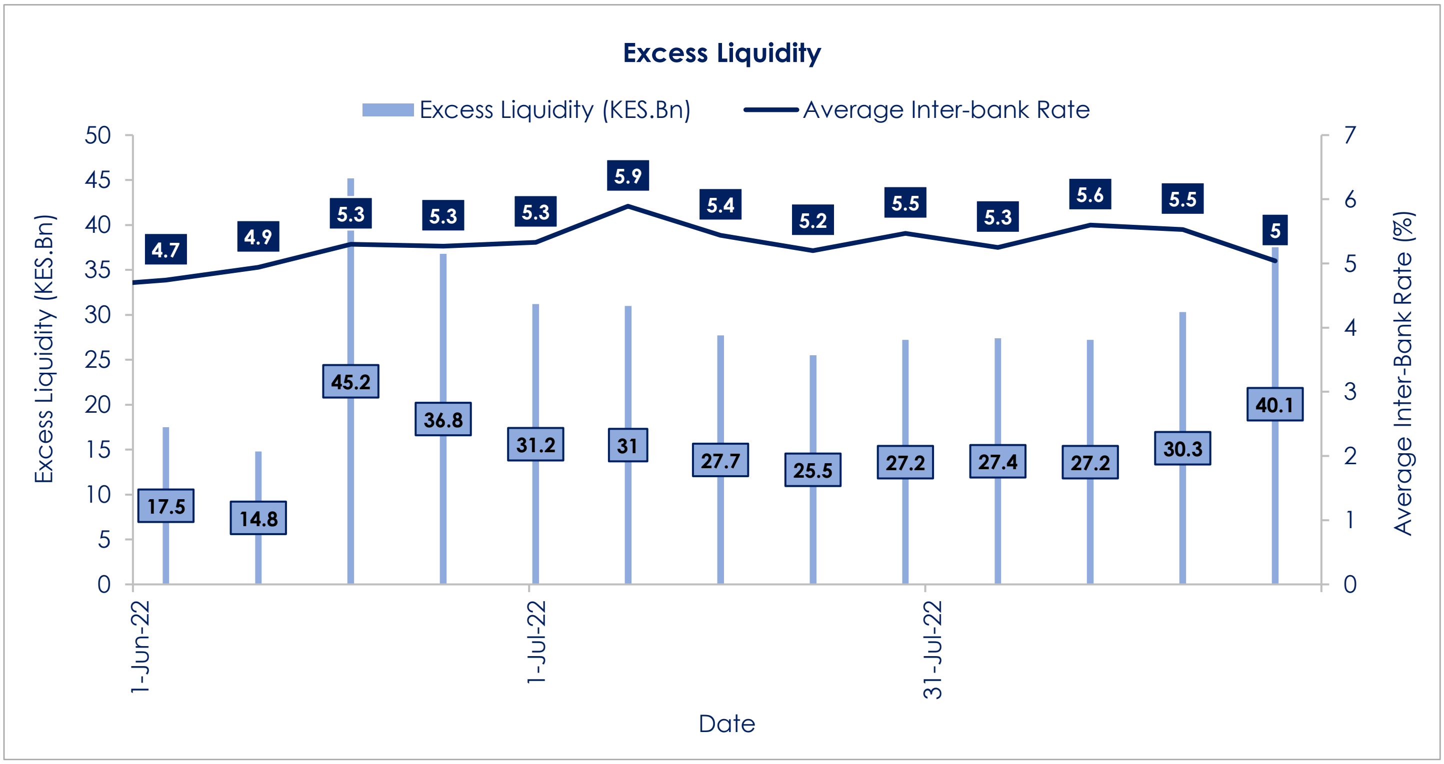
- Average inter-bank rates decreased marginally to 5.3% in August 2022 compared to 5.5% in July 2022 while total inter-bank trading volumes largely remained flat at KES.491.4Bn compared to KES.490.5Bn in July 2022 (Figure.5).
- However, over the same period, excess reserves (which is the additional liquidity above the minimum 4.25% Cash Reserve Ratio (CRR)) decreased 12.3% to KES.125.0Bn, compared to KES.142.6Bn in July (Figure.6).
- We do expect moderate market liquidity levels in September and forecast average inter-bank rates at 5% - 6%.

Figure.5: Inter-bank lending rates to range between 5% and 6% in September 2022



Source: Central Bank of Kenya

Figure.6: Excess commercial bank reserves decline in August

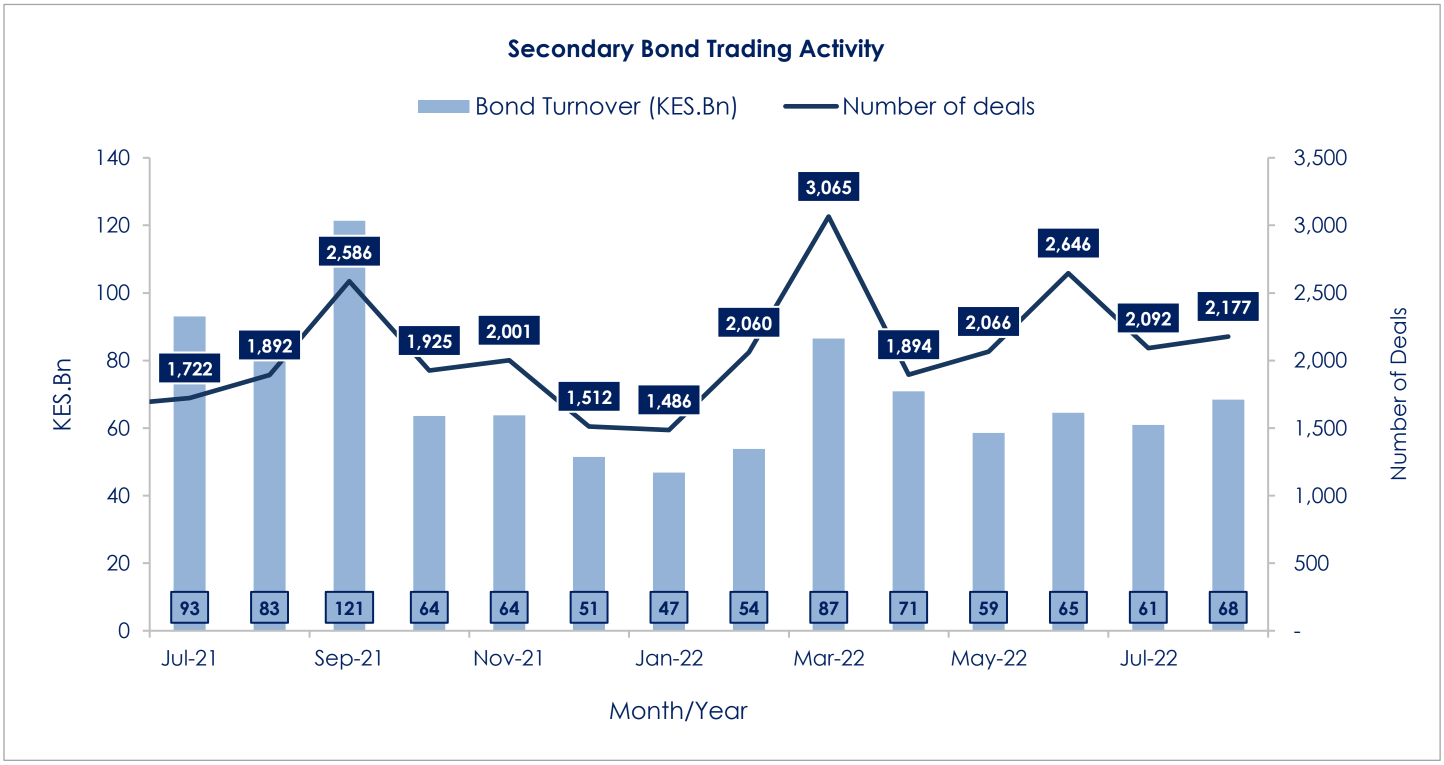


Source: Central Bank of Kenya

Secondary market activity rises 12% in August 2022

- Secondary market trading activity rose 12.2% in August 2022 to KES.68.4Bn from KES.60.9Bn in July 2022 with the number of deals over the same period increasing 4.1% to 2,177 from 2,092 (Figure.7).
- This can be explained by increased trading on the 3-year bond issue, **FXD1/2022/03,** as well as different IFB's.
- We note that significant interest in the 91-Day T-Bill is shifted investor capital largely away from secondary market trading going forward as investors hedge against duration risk given rising interest rates.
- We expect activity to pick up in September now that the presidential election dispute has been resolved.

Figure.7: Secondary trading activity increases in August 2022

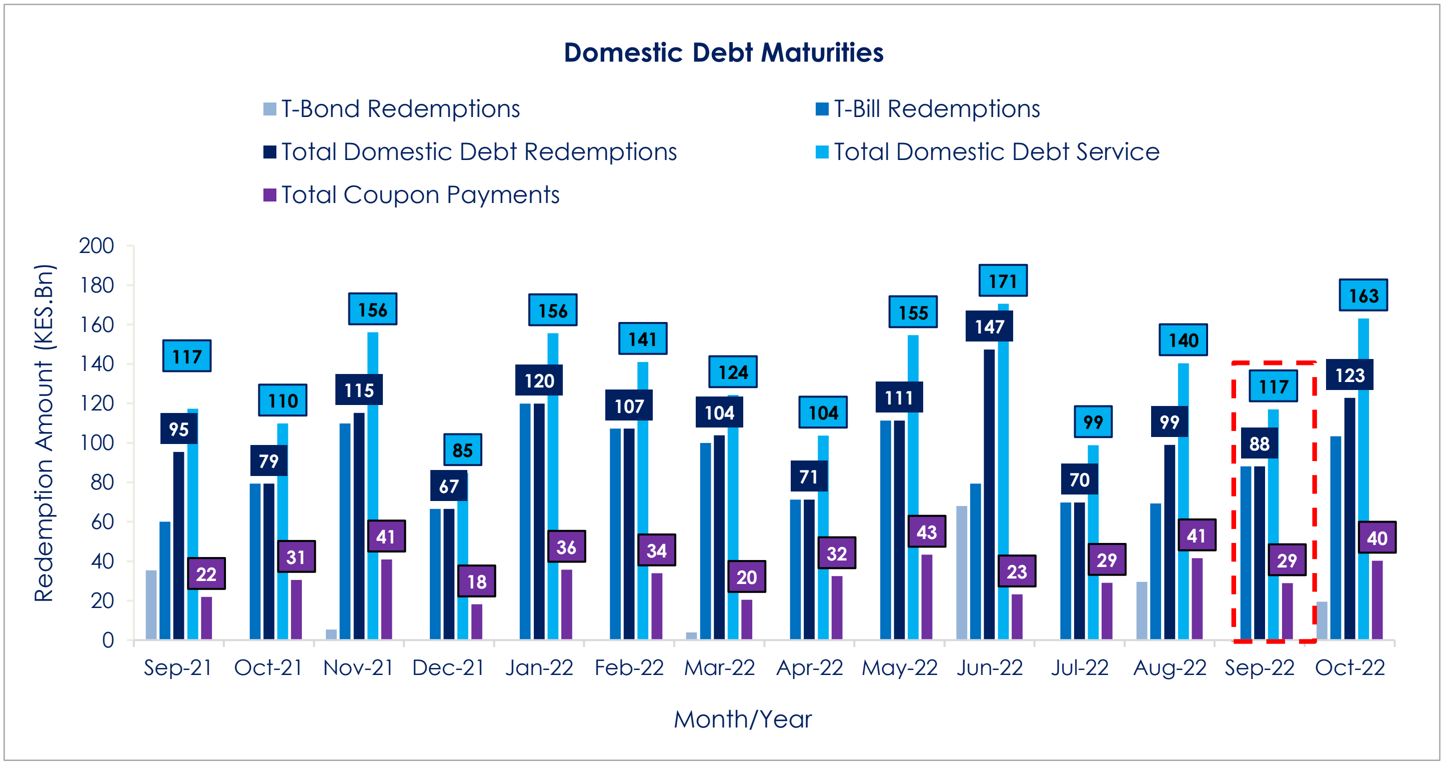


Source: Central Bank of Kenya

KES.117Bn in total domestic debt service for September 2022

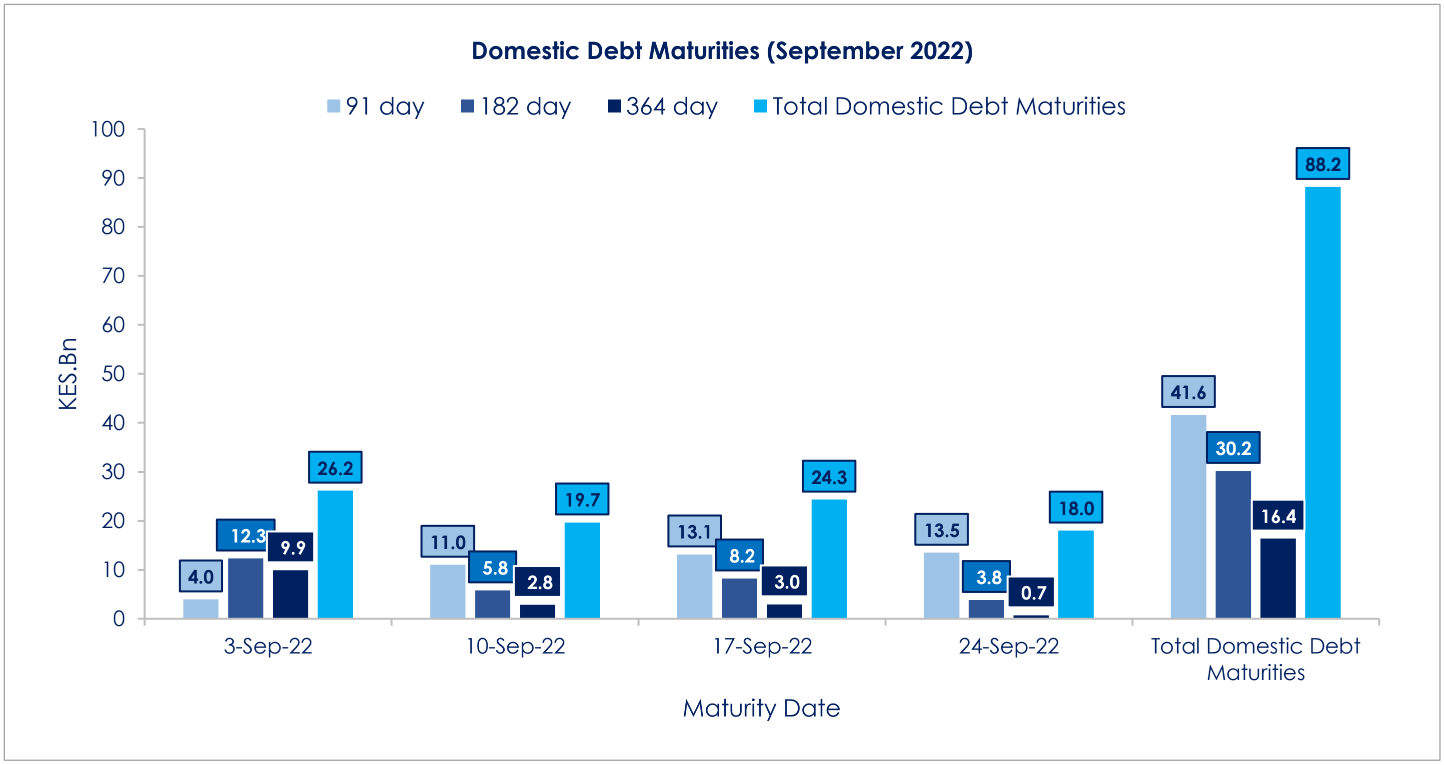
- Total domestic debt service for September is KES.117.1Bn a 16.6% decline from KES.140.4Bn August 2022 (Figure.8).
- This comprises redemptions of T-Bills (KES.88.2Bn) and T-bond coupon payments (KES.28.9Bn).
- Redemptions for the 91, 182 and 364-day T-Bills during the month are KES.41.6Bn, KES.30.2Bn and KES.16.4Bn respectively with the first week of the month having the highest redemptions at KES.26.2Bn (Figure.9).

Figure.8 September debt service KES.117Bn



Source: Central Bank of Kenya

Figure.9: Weekly debt maturities September 2022



Source: Central Bank of Kenya

2022/23 receipts target revised upwards by 6.5%

- Data from the National Treasury after the first month of the 2022/23 fiscal year (31st July 2022) exemplifies the slow start to the year on all National Government receipts with the exemption of other domestic financing (Table.5 and Figure.10).
- Although this is often the case, the comparatively slow start to the previous year could be linked to subdued economic activity in the run-up to the August general election.
- We also feel that the disputed outcome of the presidential election will also have a negative impact on receipts and particularly tax revenue and domestic borrowing.
- From the National Treasury data, we note an upward revision of the domestic borrowing closer in line with our forecast of +KES.1Tn.
- This follows failure to achieve both domestic and external borrowing targets of the previous fiscal year (2021/22).
- The shortfall in external borrowing resulted from the shelving of the US$1Bn (KES.120Bn) Eurobond over the concerns around cost under the current high interest environment and depreciation of the Kenya Shilling (KES).
- While we note a modest 6.5% increase in the total receipts target to KES.3.5Tn, we see more aggressive revisions in the tax revenue target.
- Also notable is that Debt Redemptions (Roll-overs) account for 44.3% of the KES. 1,044Tn domestic borrowing target equivalent to KES.461.4Bn compared to 33.6% (KES343.9Bn) in 2021/22.
- This is a great concern with regards to the proportion of the country's borrowing used to finance debt repayment.
- We believe that a timely resolution to the election dispute will be important in realization of the tax revenues and borrowing targets.

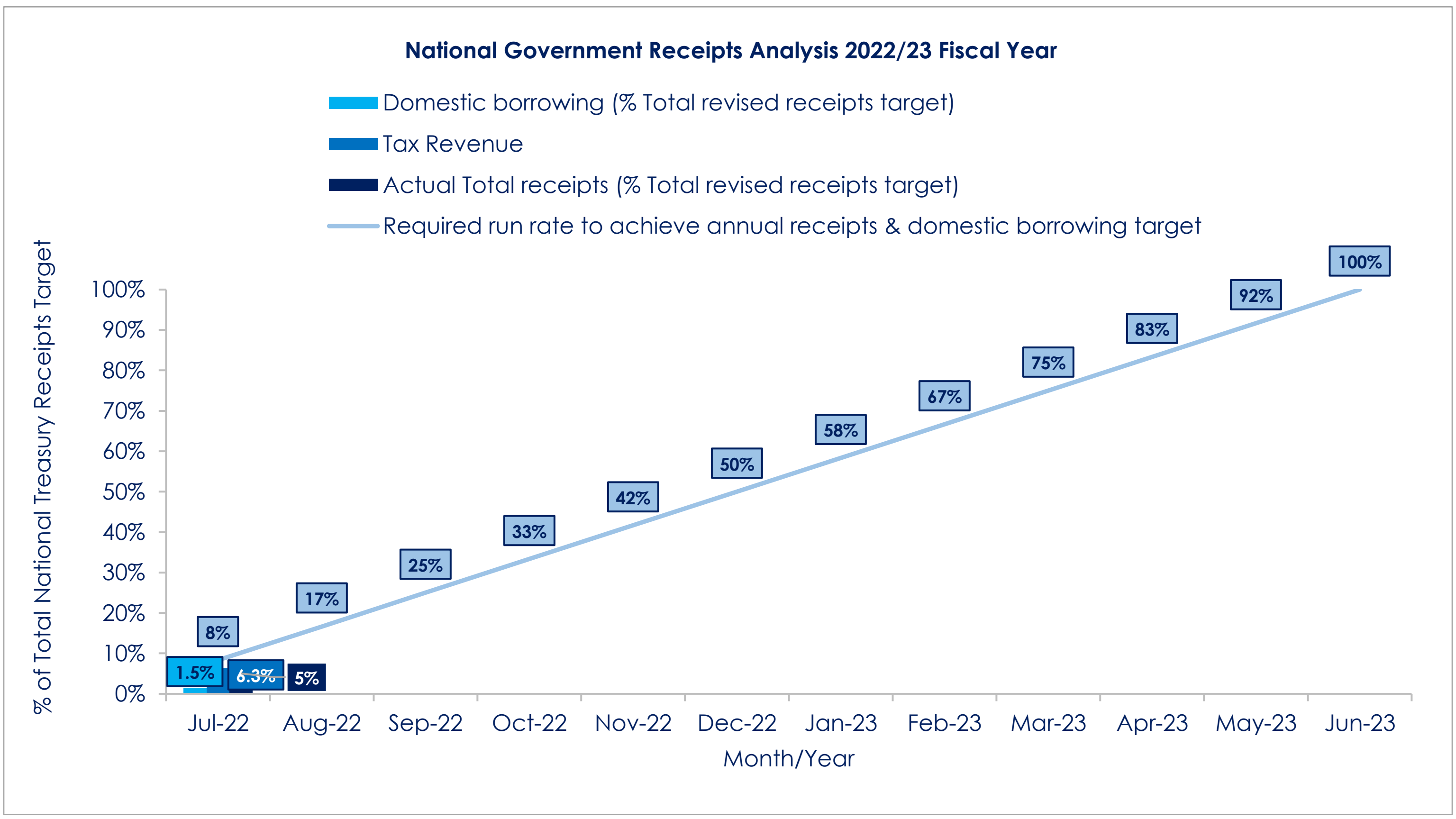
Table.5: Actual 2022/23 receipts below linear target run-rate

Receipts	Original Estimates 2022/23 (KES.Mn)	Original Estimates 2022/23 (KES.Mn)	Variation 2022/23 vs 2021/22	Actual Receipts 31st July 2022 (KES.Mn)	Proportion of Total Receipts 30th Jun 2022
Opening Balance (1st July 2021)	21.3			616.5	
Tax Revenue	**1,784.4**	**2,071.9**	**16.1%**	**130.6**	**6.3%**
Non-Tax Income	67.1	69.7	3.9%	1.9	2.7%
Domestic	**1,022**	**1,040.5**	**1.8%**	**15.6**	**1.5%**
External Loans & Grants	421.2	349.3	-17.1%	27.9	8%
Other Domestic Financing	40.1	13.2	-67.1%	2.8	21.2%
Total Revenue	**3,334.8**	**3,544.6**	**6.3%**	**178.8**	**5%**
Linear Run Rate target (12 months of fiscal year)					**8.3%**

* Note 1: Domestic Borrowing of KES. 1,040.5Bn = Net Domestic borrowing KES.579.1Bn & Internal Debt Redemptions (Roll-overs) KES.461.4

Source: The Kenya Gazette Vol. CXXIV - No.166 19th August 2022

Figure.10: National Treasury lags behind our 2022/23 fiscal year linear target run-rate

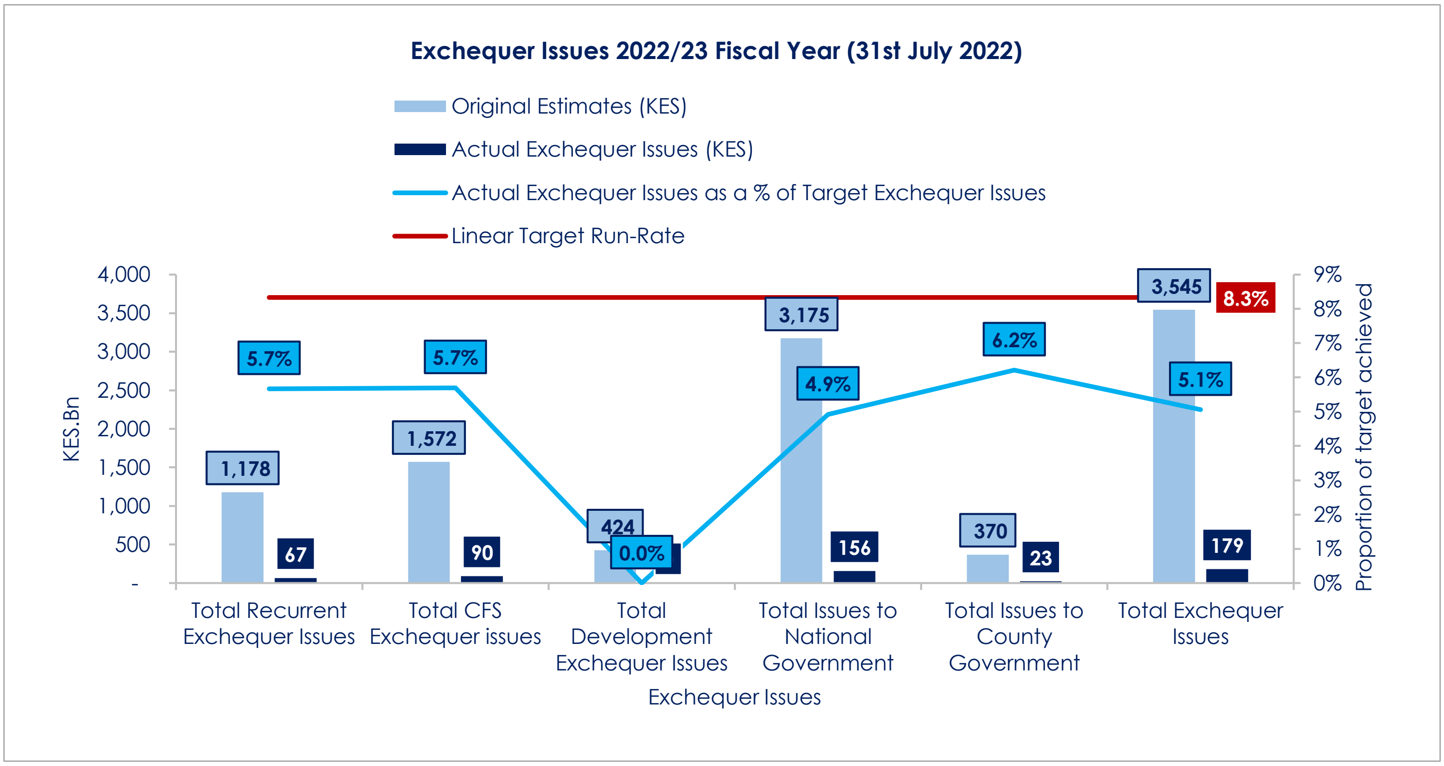


Source: The Kenya Gazette Vol. CXXIV - No.166 19th August 2022

Government fails to meet 2021/22 fiscal year expenditure targets

- Actual total Government expenditure stood at KES.179.3Bn equivalent to 5.1% of the total fiscal year target of KES.3.54Tn (Figure.11).
- This falls below our one-month linear target run rate of 8.3%.
- All other expenditure issues have fallen below the linear target as is expected in the early months of a new fiscal year.
- We note that National expenditure did not meet the 2021/22 fiscal year with 92.3% (KES.3.07Tn) against a revised expenditure target of KES.3.33Tn.
- This we attribute to challenges experienced in Government borrowing a scenario that has seen an upward revision to the borrowing targets in the current fiscal year.

Figure.11: Government expenditure remains below target run-rate estimates

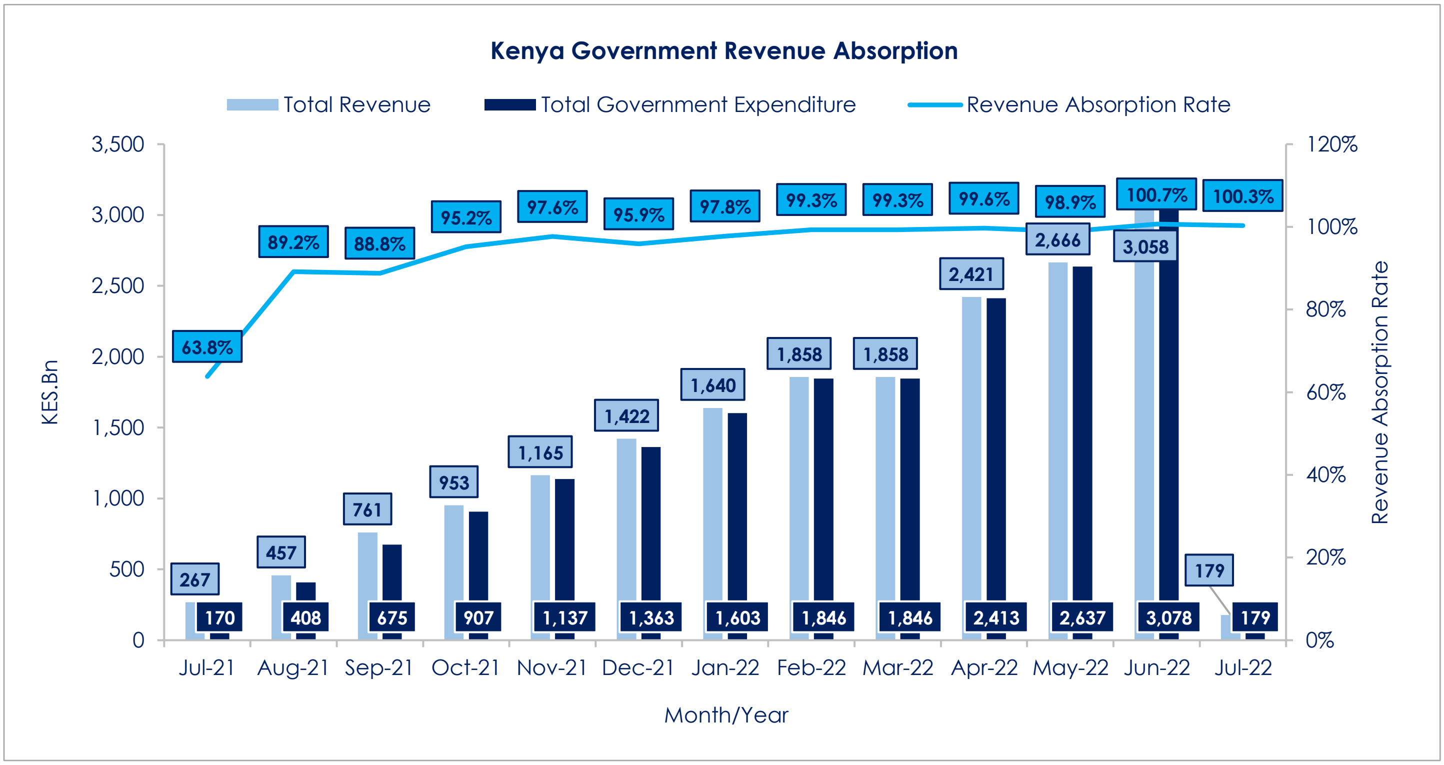


Source: The Kenya Gazette Vol. CXXIV - No.166 19th August 2022

National Treasury reports full revenue absorption in July 2022

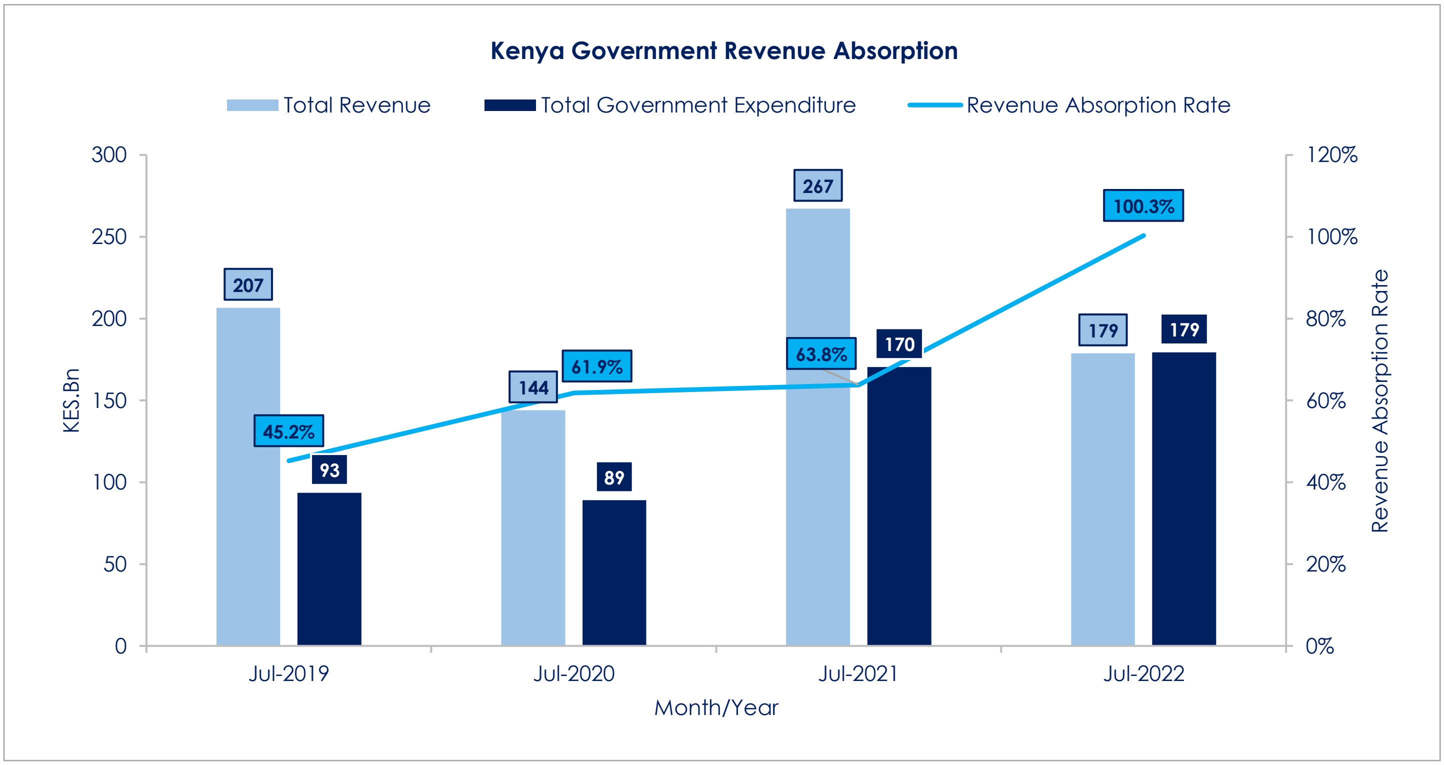
- Full (100%) Revenue Absorption Rate (RAA) - The proportion of Government receipts used to finance expenditure was reported in July (Figure.12 &13).
- We further compared the RAA in July 2022 to corresponding periods in 2019, 2020 and 2021 and observe a significant increase in July 2022 (Figure.13)
- Also observed is a 33.1% decline in revenue collection in July 2022 to KES.178.8Bn compared to July 2021 (KES.267.1Bn) which largely explains the high RAA in July 2022.

Figure.12: Revenue absorption is high showing close to full utilization



Source: The Kenya Gazette Vol. CXXIV - No.166 19th August 2022

Figure.13: 33% decline in revenue collection in July 2022 compared to July 2021

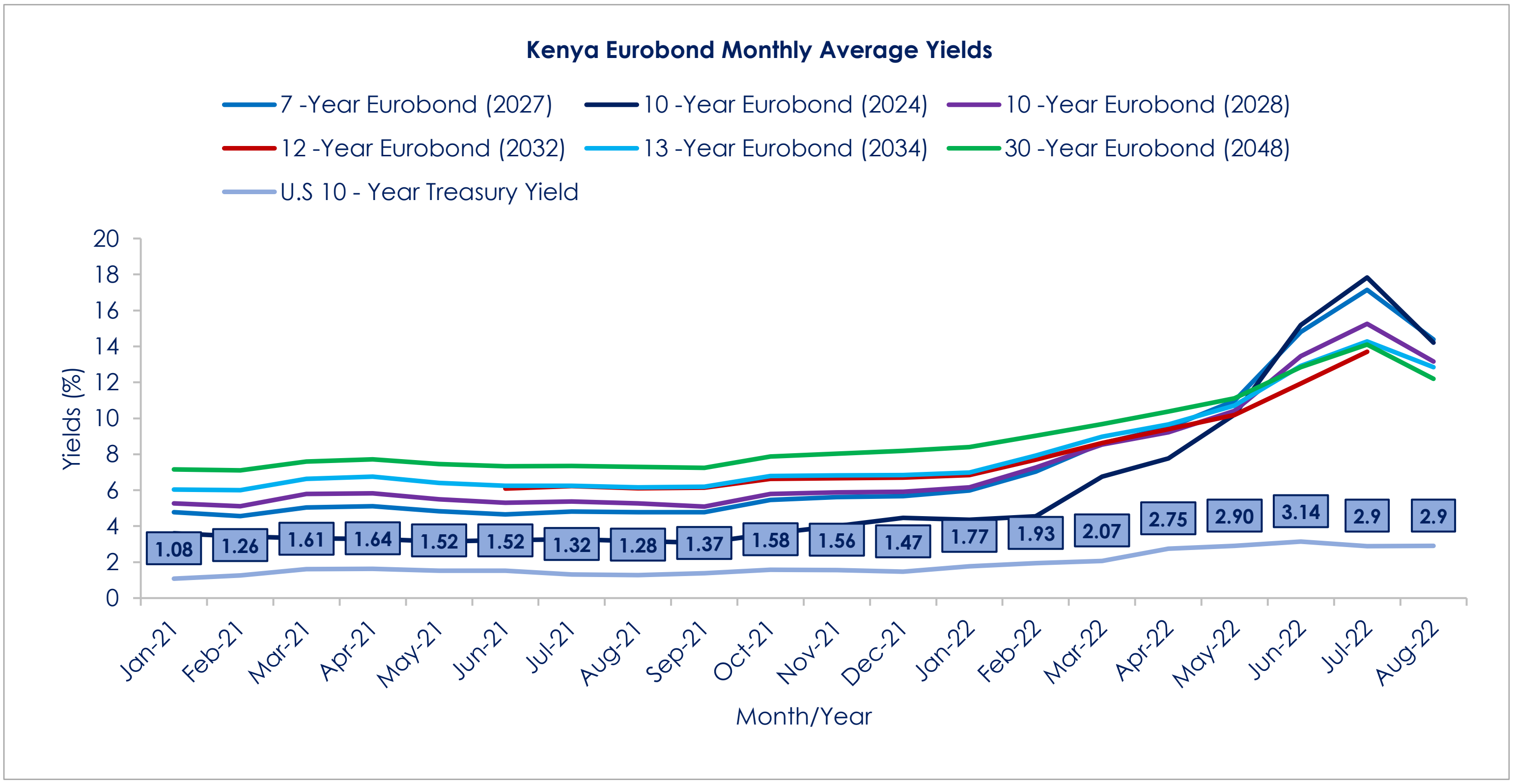


Source: The Kenya Gazette Vol. CXXIV - No.166 19th August 2022

Spike in Kenya Eurobond yields as global economic uncertainty and interest rates rise

- Average Kenya Eurobond yields rose 316 bps in July compared to June 2022 and 908 bps year to date (Figure.14).
- This is attributed to a combination of the impact of the Russia-Ukraine crisis on inflationary pressure and in turn global benchmark interest rates and more specifically the Federal Reserve rate (Fed Rate).
- Average yields on the U.S 10-Year Treasury have increased 143 bps year to date in spite of a decline of 25 bps between June and July 2022.
- We expect Kenya Eurobond yields to remain elevated in the near term, a trend that presents a huge investment opportunity for investors with a high-risk tolerance.
- However, we also noted a decline in yields, particularly on the Eurobond maturing in 2024, from 15% to 13.8% on the 5th of September 2022 following the outcome of the general election supreme court verdict.
- The foregoing points to increased confidence in the country given the increase in perceived stability, however, the continued rise in global interest rates and Kenya's fiscal deficit is likely to suppress this trend going forward.

Figure.14: Kenya Eurobond yields remain elevated

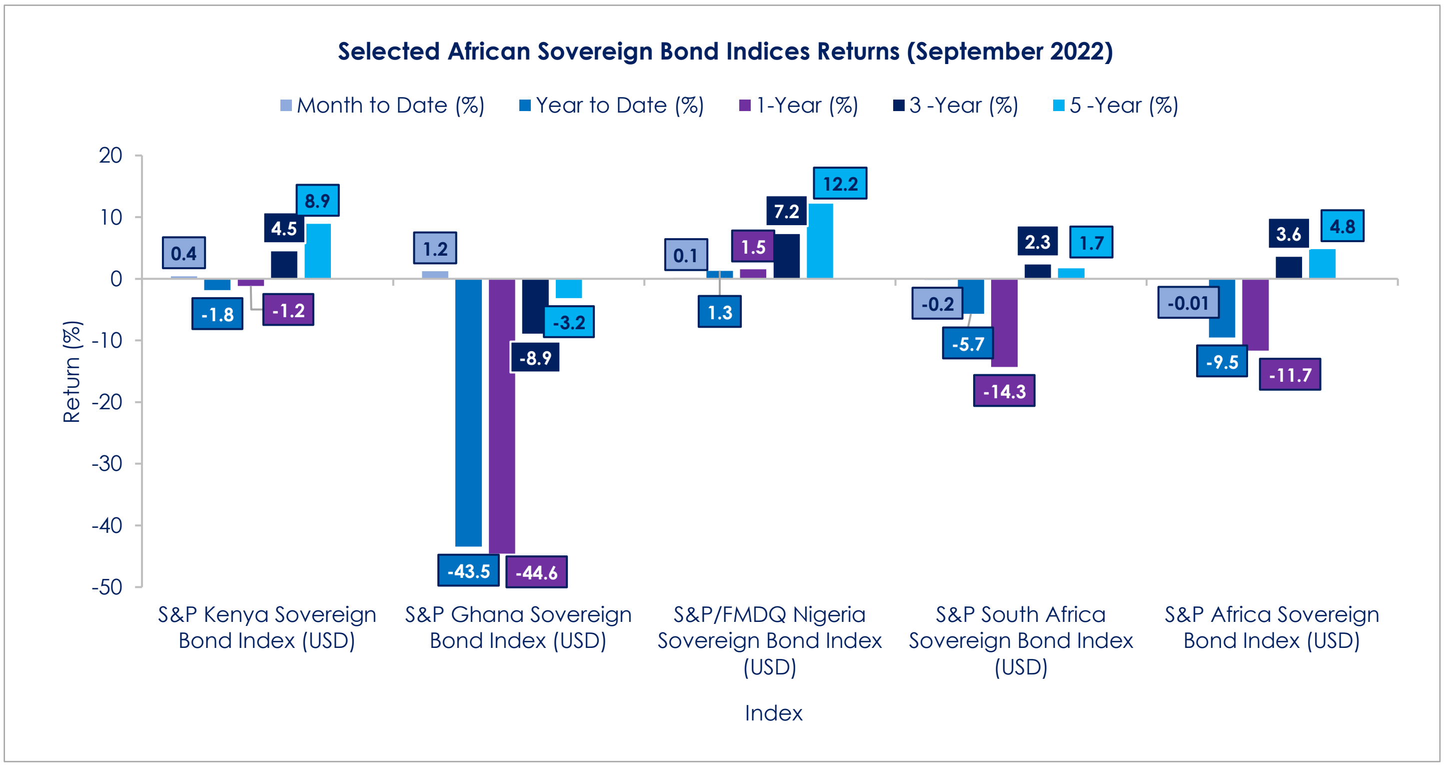


Source: Central Bank of Kenya

Nigeria sovereign bond index outperforms selected African sovereign bond indices

- The S&P/FMDQ Nigeria Sovereign Bond Index remains the best performing sovereign bond index amongst our five comparable indices over selected time periods (Figure.15).
- We attribute this to the comparatively good performance of the Nigerian Naira against the United States Dollar (US$).
- Over the last one year, the Naira has depreciated 5.1% lower than the Kenya Shilling (10.3%), South African Rand (20.7%) and Ghanaian Cedi (65.3%).
- The Kenya Eurobond index reports positive performance month to date and over the three and five years' periods respectively.
- Currency depreciation and rising global interest rates will continue to impact the performance of African sovereign bond indices in the short-term.

Figure.15: S&P Nigeria bond index outperforms selected African sovereign bonds



Source: S&P Global

Yield curve continues to shift upwards

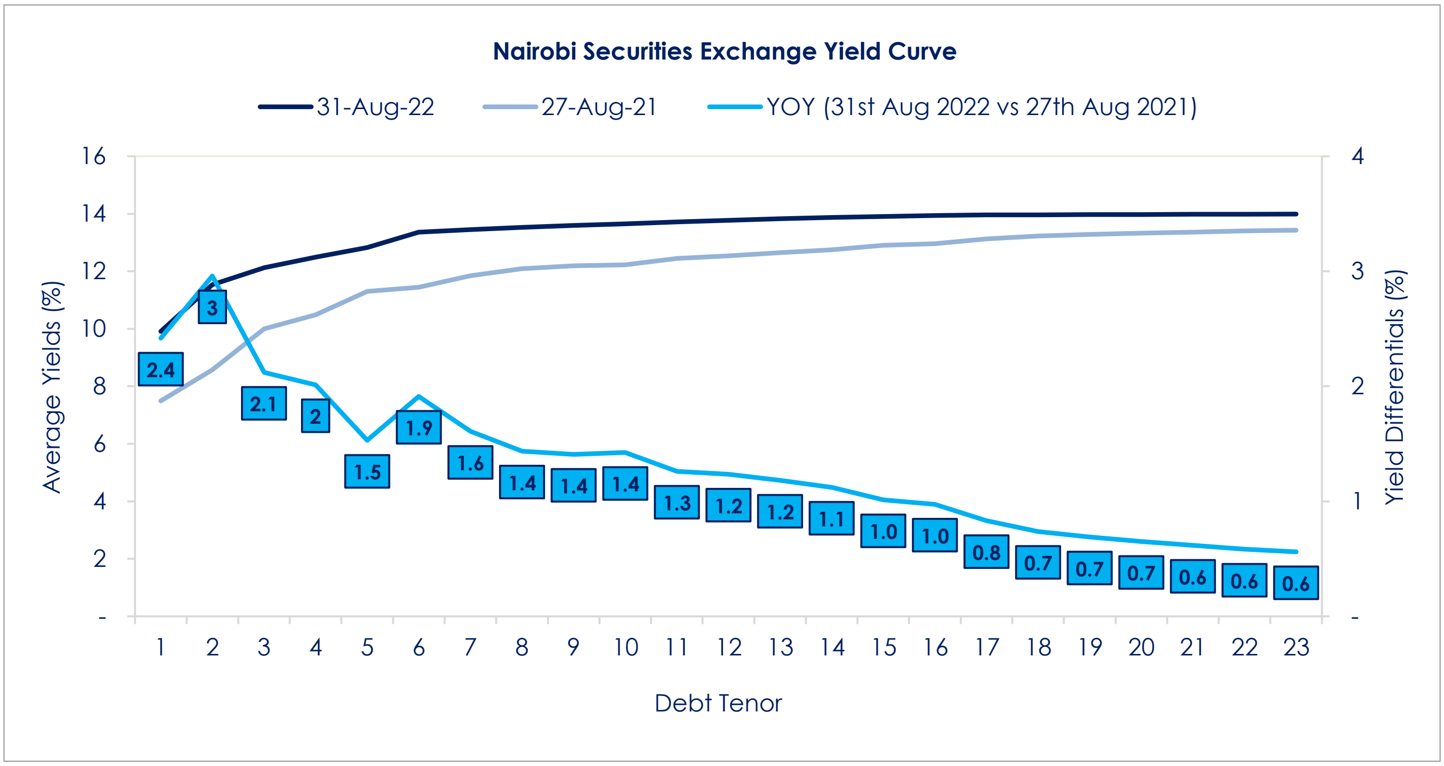
- A comparison of average yields on the NSE on 22nd April 2022 (closest to issuance of **FXD1/2022/15**) and 13th May 2022 (closest to issuance of **FXD1/2022/10**) to 31st August 2022 shows a general increase in yields across the curve. (Table.6 and Figure.16).
- This is also the case when we compare current yields at a similar time last year.
- This is in light of investors taking advantage of the Government's fiscal situation and rising inflationary pressure to bid aggressively in domestic debt auctions.
- On its part, the CBK has been intent to keep interest rates below 14% as observed in recent debt auctions, a situation that has resulted in flattening of the yield curve in tenors of 10 years and beyond.
- In fact, the difference between the 23-year tenor and the 10-year tenor is a mere 34.5 Bps narrowing from 120.9 Bps YoY.
- Despite these attempts however, we are of the opinion that the fiscal deficit and upward revision of the Central Bank Rate (CBR) to 7.5% from 7% in May 2022 signals further upward pressure in domestic interest rates.
- We forecast a normalization of the yield curve with rates for longer tenors rising gradually in the next few months as the CBK bows to investor pressure.
- With the above in mind, we expect the average yields on the short-end (91 days - 2 years) to increase by 80 -100 Basis Points (Bps), medium-end (3 - 9 years) to increase by 100 - 150 Basis Points (Bps) and long-end (10+ years) increasing by 60 - 80 Bps in 2022.
- Investors with a high risk tolerance should consider buying the US$ denominated Kenya Eurobonds to take advantage of current attractive yields with an option of holding till maturity or disposing when trading opportunities arise (Table.7).
- We maintain a **BUY** recommendation on medium and long-term papers for interest income play given prevailing rates.
- IFBs are generally attractive due to their tax-free component.

Table.6: Yield curve has significantly shifted upwards on the short-end tenors

Tenor	Yields (22nd Apr 2022)	Yields (13th May 2022)	Yields (27th Aug 2021)	Yields (31st Aug 2022)	Δ 31st Aug vs 22nd Apr 2022 (Bps)	Δ 31st Aug vs 13th May 2022 (Bps)	YoY Δ 31st Aug 2022 vs 27th Aug 2021 (Bps)	Sterling Capital Yield Curve (Sep 2022)
1	9.7550	9.8600	7.4920	9.9100	↑ 15.5	↑ 5.0	↑ 241.8	9.90
2	11.2222	11.6100	8.5750	11.5343	↑ 31.2	↓ 7.6	↑ 295.9	11.55
5	12.1767	12.2195	11.3000	12.8294	↑ 65.3	↑ 61.0	↑ 152.9	12.85
10	13.1903	13.4886	12.2198	13.6441	↑ 45.4	↑ 15.6	↑ 142.4	13.70
15	13.9366	13.8383	12.8983	13.9106	↓ 2.6	↑ 7.2	↑ 101.2	13.93
20	13.8495	13.9302	13.3248	13.9753	↑ 12.6	↑ 4.5	↑ 65.1	13.98

Source: Nairobi Securities Exchange

Figure.16: Higher year on year differentials across short and medium tenors



Source: Nairobi Securities Exchange

Table.7: Trading ideas - Consider Kenya Eurobonds

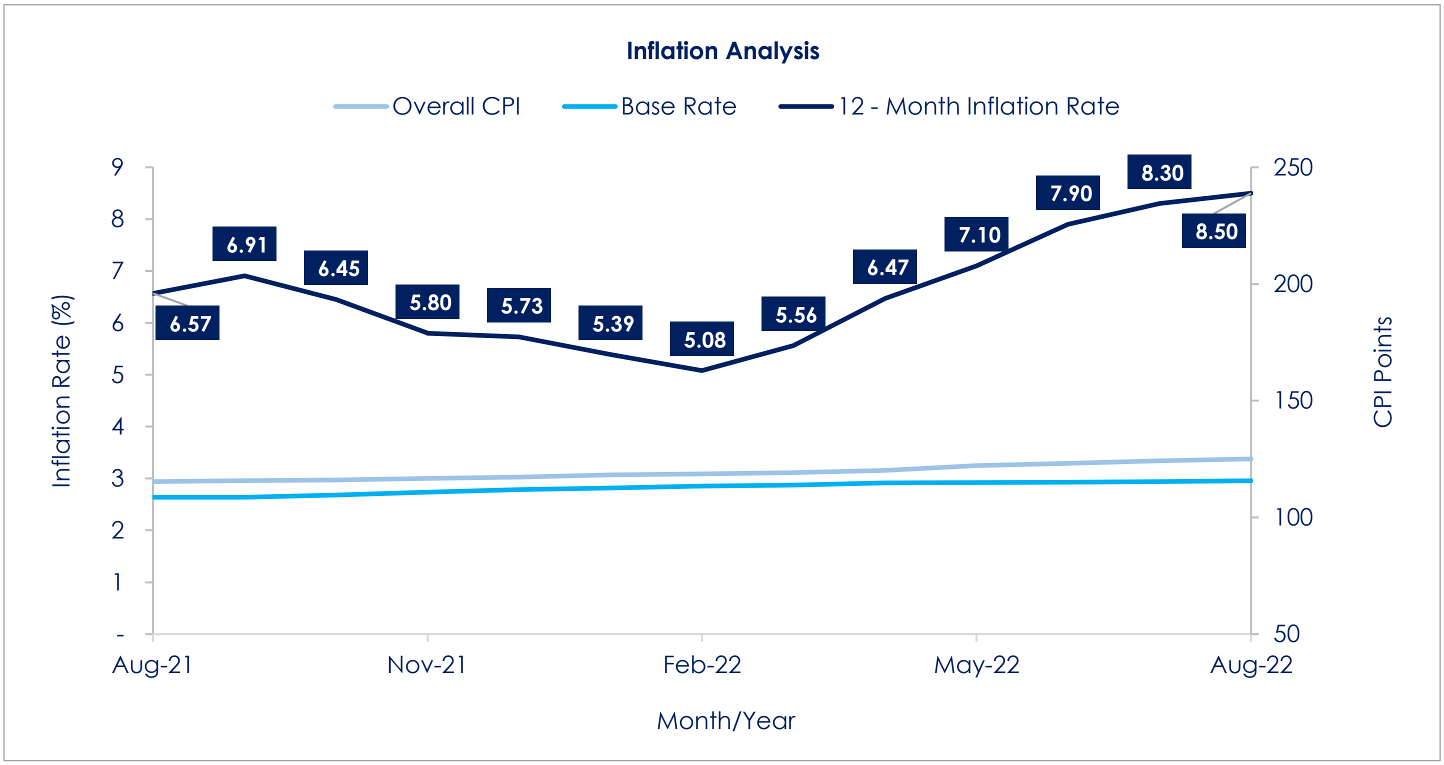
ISIN Code	Issue date	Tenor (Years)	Outstanding amount (US.$ Bn)	Coupon	Yield to maturity (5th September 2022)	Maturity
XS102895240	Jun-14	10	2	6.875%	14.124	Jun-24
XS184343584	May-19	7	0.9	7%	13.478	May-27
XS178171054	Feb-18	10	1	7.25%	12.646	Feb-28

Source: Bloomberg

Inflation to remain elevated on supply-side pressures through to the end of 2022

- Inflation for the month of August 2022 rose to 8.5% from 8.3% a month earlier this being the third month that the inflation rate has been above the CBK's medium term upper band range of 7.5% since the Covid-19 pandemic begun (Figure.17). Click here.
- The marked increase in the prices was a result of an increase in food and non-alcoholic beverages (15.3%), transport (7.6%) and housing, water, electricity, gas and other fuels (5.6%) between August 2021 and August 2022.
- These three weights account for over 57% of the weights of the thirteen broad categories Kenya National Bureau of Statistics (KNBS) measures to assess inflation.
- Our September inflation forecast is 8% - 9% on account of continued supply-side pressures such as elevated global fuel and food import prices, supply-chain constraints with the former hanging in the balance given risk of Government subsidy withdrawal.
- The depreciation of the Kenya shilling keep inflation elevated throughout 2022.
- To this effect, we see inflation above 7% throughout the rest of 2022.

Figure.17: September inflation forecast 8% - 9%



Source: Kenya National Bureau of Statistics

MPC to hold monetary policy steady in September meeting

- The Monetary Policy Committee (MPC) will meet on Thursday, 29th September 2022 to review the impact of previous monetary policy measures on the economy.
- We see the following as the main points of discussion:

1) The status of the Russia-Ukraine conflict and its impact on the global commodity prices.

The global economic outlook remains uncertain reflecting the adverse effects of the ongoing war in Ukraine, continuing pandemic-related disruptions and supply chain challenges.

2) Supply chain challenges that continue driving supply-side inflation.

Inflation for the month of August 2022 rose to 8.5% from 8.3% in July this being the third month that the inflation rate has been above the CBK's medium term upper band range of 7.5% since the Covid-19 pandemic begun.

3) Developments in Private Sector Credit (PSC), banking sector credit quality, HY2022 banking performance, public debt, exports and imports.

4) Foreign currency reserves and the country's current account deficit.

The usable foreign exchange reserves have remained adequate at U.S$.7.6Bn (4.39 months of import cover) as at 25th August 2022. However, risks exist especially with regards to rising external debt service, a widening current account and depreciating KES.

- With regards to the political landscape, a new Government takes over on 13th September
- We feel that the above developments will not be sufficient for a revision to the Central Bank Rate (CBR) and Cash Reserve Ratio (CRR), especially considering that a new Government takes over on 13th September and would hope for lower interest rates to enable them finance their election promises.
- The MPC might also want to adopt a "wait and see" approach to the new Government's economic policy one of which includes lowering the cost of living.
- In light of this, we expect the CBR and CRR to remain unchanged at 7.5% and 4.25% respectively.

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