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STERLING CAPITAL LIMITED
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Fixed Income

Primary Auction Results Update

(IFB1/2022/006)

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December 2022 Treasury Bond Primary Auction Results Update

- The Central Bank of Kenya (CBK) issued a "Switch infrastructure bond" in December 2022, **IFB1/2022/006**, seeking to raise KES.87.8Bn;

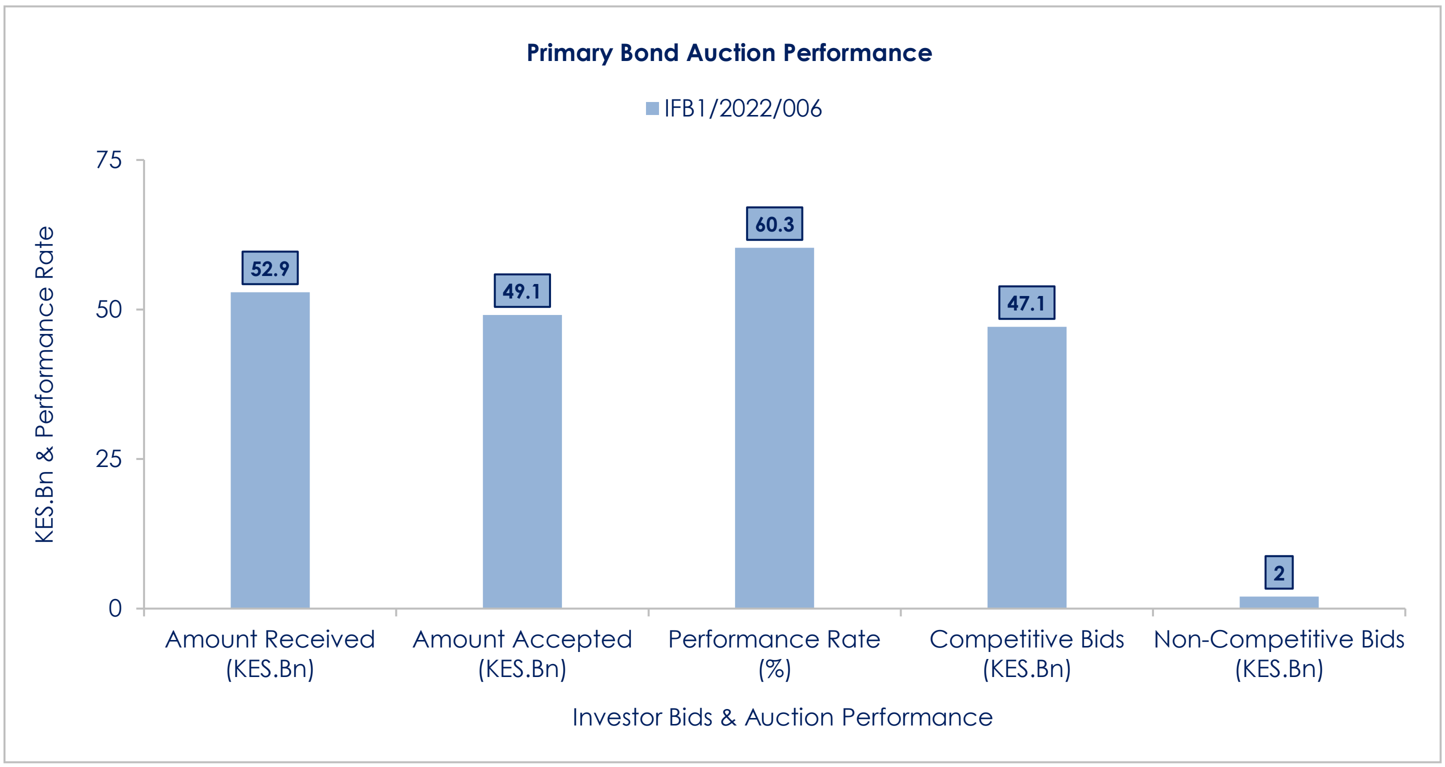
  IFB1/2022/006 (6*)
  **Years to maturity*

- The period of sale was between 22nd November - 30th November 2022 with the auction date on 1st December 2022, results linked here.

Subscription Rates

- While we highlighted our expectation of undersubscription in our "CBK suprises with KES.88Bn switch bond," note, the undersubscription came in below our minimum estimate of 80% (Figure.1).
- We attribute the undersubscription to liquidity needs from investors that dissuaded them from having their capital locked in for a longer period of time as participating in the switch bond would necessitate.
- Given the high acceptance rate of 92.8% of total bids received, budgetary shortfalls and fast-maturing short-term debt, we see an increasing likelihood of the CBK issuing a tap sale to open the offer up to the rest of the market and garner the pending amount.

Figure.1: Primary Bond auction performance



Source: Central Bank of Kenya

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Weighted Average Rates

- The CBK's Weighted Average Rate (WAR) of accepted bids was below our predicted range (Table.1).

Table.1: Predicted and actual Weighted Average Rates (WAR)

Domestic Debt Issue	SCL Accepted Bids WAR Prediction (%)	CBK Accepted Bids WAR (%)	CBK Accepted Bids WAR vs SCL Predicted WAR Range Average (Bps)
IFB1/2022/006	13.35 - 13.50	13.215	-21

Source: Central Bank of Kenya

Our view

1) **Nairobi Securities Exchange (NSE) yield curve** - The latest yield curve (30th November 2022) shows the 4.5-year indicative debt tenor yield on an FXD (used due to the IFB's amortized redemption structure) at 13.25% which is only 3.5bps above this IFB's accepted bid rate of 13.215%.

   Generally in the past, coupons on IFBs were generally lower than those of similar tenor Fixed Treasury Bonds (FXD) by a larger margin than that exhibited in this auction. This was due to the fact that returns from FXD were subjected to 15% withholding tax and therefore investors accounted for this in their pricing of these securities.

   Therefore the relatively high yield of 13.215% on **IFB1/2022/006** speaks to the impact of fiscal deficit pressures, high inflation and the CBR revisions on interest rates which has forced the CBK to accept increasingly higher yields on debt issuances to attract investor funds.

   To this effect, we expect that the yield curve will shift further upwards with every new debt issue,

   We forsee the CBK accepting even more aggressive bids above 14.5% in subsequent long-tenured auctions such as the recently issued **FXD1/2022/25** as has been highlighted in our December report.

   The yield curve has been shifting upwards since the second quarter of 2021 with average yields expected to rise in the near term for the following reasons:

   1) Upward revision of the Central Bank Rate (CBR) from 7.5% to 8.25% on 29th September 2022.

   2) High inflationary pressure with November inflation at 9.5% (October 2022 - 9.6%) meaning that investors will demand higher rates to compensate for the real return erosion.

      Important to note is that despite revisions of the CBR in May and September inflation has breached the CBK's medium term upper band limit of 7.5% showing the ineffectiveness of the monetary measure at least in the short-term.

      Notably, as some global economies such like the United States continue to increase their benchmarke rates, the KES will continue to depreciate against these currencies.

   3) Government is lagging behind its revenue targets and will need to increase borrowing to

bridge the funding gap.

A) Market Liquidity - The repo, reverse repo and inter-bank rates as of 1st December 2022 were 7.1%, 9.6% and 5.1% compared to 7.1%, 9.8% and 4.5% during our last results update note on the 8th November 2022 pointing to tightening liquidity within the market prompted by **IFB1/2022/14**'s 153.1% oversubscription.

Notably, the 91-day T-bill received bids worth KES.13.2Bn (330% performance rate) as at the latest auction dated 5th December 2022 an indication that available liquidity was channeled towards the short-term debt security and the IFB issue.

B) Investment Case - We recommend the following investment strategies on account of rising interest rates:

- Invest in T-Bills and short-term debt to avoid locking capital for longer periods in a rising interest environment and high yielding new Infrastructure Bonds (IFB).
- Look out for bonds matching your maturity profile trading at huge discounts in the secondary market.
- Avoid revaluation losses (selling bonds at lower prices than their purchase prices) by holding on to your existing bond investment portfolio.
- We advise active traders and investors with high risk tolerance to consider buying the US$ denominated Kenya Eurobonds to take advantage of current attractive yields.

  This however, is suitable to high net-worth investors (considering the high minimum amount of US$200,000) with US$ holdings or those willing to incur the cost of currency conversion.

C) Secondary market trading - We expect active trading on **IFB1/2022/006** in the secondary market given high investor appetite and the attractive yield.

However, this is pegged on the expectation of a tap sale which is increasingly likely given the undersubscription. Should a tap sale occur, trading on the bond will likely be muted as investors opt to acquire the bond from the CBK rather than at a premium in the open market.

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