Thursday, 09 February 2023

STERLING CAPITAL LIMITED

Analysts:

Renaldo D'Souza
+254 (20) 2222651
Renaldo.DSouza@sterlingib.com

Davis Gathinji
+254 (20) 2222651
Davis.Gathinji@sterlingib.com

Isabel Chakairu
+254 (20) 2222651
Isabel.Chakairu@sterlingib.com

Email: research@sterlingib.com

Bond Dealing: +254 (20) 2213914, 3315414; 2244077
+254 723153219, +254 734219146

Email: invest@sterlingib.com

Website www.sterlingib.com

Bloomberg Code: SCLK <GO>

Fixed Income

Primary Auction Update

FXD1/2017/10 and FXD1/2023/10

February 2023

Table of Contents

February 2023 Treasury Bond Primary Auction Results Update 3
Subscription Rates 3
Weighted Average Rates 4
Our view 4
Disclosures 6

February 2023 Treasury Bond Primary Auction Results Update

- The Central Bank of Kenya (CBK) re-opened (**FXD1/2017/10**) and new bond issue (**FXD1/2023/10**) sought to raise KES.50Bn for budgetary support;

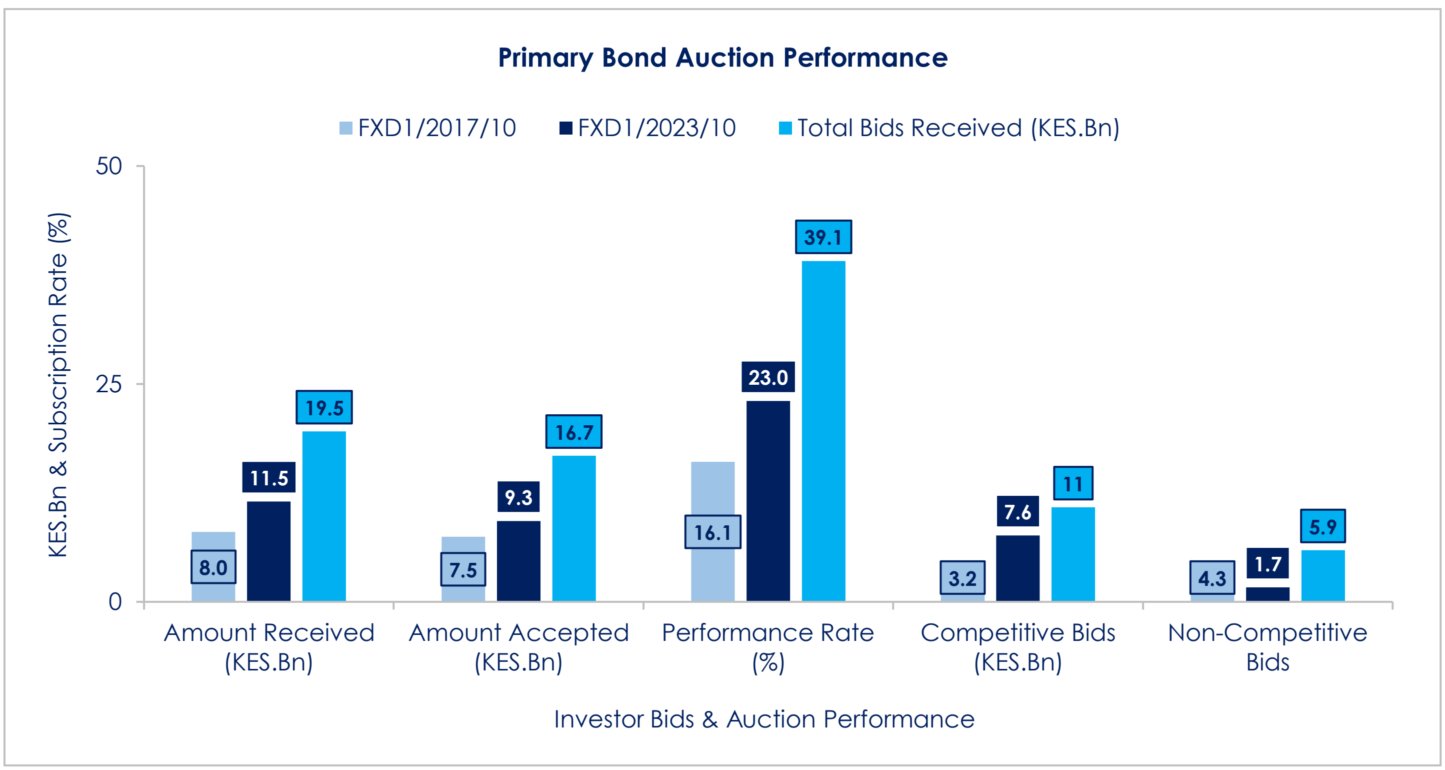
  FXD1/2017/10 (4.5*),
  FXD1/2023/10 (10*).
  ***Years to maturity**

- The bonds had a period of sale between 17th January and 7th February 2023.

Subscription Rates

- As per expectations highlighted in our February 2023 fixed income report - Has the CBK changed tact, the issues were undersubscribed. (Figure.1).
- This we attribute to investor capital allocation to short-term debt securities particularly the 91-Day T-bill given expectations of rising interest rates.
- We note that the 91-Day T-Bill subscription over the last three auctions were at 718.6% (6th February 2023), 458.9% (30th January 2023) and 354.3% (23rd January 2023).
- This was also during the same period that the current bonds were on offer showing the disparity in demand.
- This amounted to KES.61.3Bn in bids received and KES.45.7Bn bids accepted both of which are 214.4% and 173.7% higher than February Bonds' KES.19.5Bn and KES.16.7Bn bids received and accepted respectively.

Figure.1: Primary Bond Auction subscription



Source: Central Bank of Kenya

Weighted Average Rates

- An analysis of our predicted Weighted Average Rates (WAR) ranges as indicated in our February 2023 Fixed Income report compared to accepted WARs by the CBK are shown below. (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)
FXD1/2017/10	13.84 - 13.94	13.875	-1.5
FXD1/2023/10	14.04 - 14.14	14.151	+6.1

Source: Central Bank of Kenya

Our view

1) **Nairobi Securities Exchange (NSE) yield curve** - We continue to observe an upward shift in the yield curve with the latest bonds' auction weighted average rates of accepted bids higher than the implied yields on similar tenured bonds.

   We expect a further increase for the following reasons:

   A) The Monetary Policy Committee (MPC) revised the Central Bank Rate (CBR) upwards three times between May and November 2022 - 7% to 8.75% to counter the impact of inflationary pressure and currency depreciation.

   Although we see a moderate to high possibility of the CBR rate remaining unchanged in Q1 2023 with revisions thereafter depending on inflation and rate of KES depreciation, previous revisions signal the direction of both domestic debt and commercial bank rates.

   B) Bond investors bidding aggressively in domestic debt auctions to maintain positive real return in following a spike in inflation.

   January inflation at 9%, which while lower than December's rate of 9.1%, it's still way above the CBK's upper band target of 7.5% and contributes significantly to real return erosion.

   C) Investors are fully aware of the Government's fiscal position where it is lagging behind its domestic borrowing targets.

   In such situations, the CBK will be forced to accept more aggressive investor bids in debt auctions to finance its deficit and also encourage future subscription.

   The 2022/23 Supplementary estimates 1 (Recurrent expenditure) shows a 7.3% and 3.2% increase in recurrent expenditure against a 9.3% and 23% cut in development expenditure and appropriations in aid (Table.2).

   The above only emphasizes the fiscal financing pressure faced by the Government.

Table.2: 2022/23 Supplementary Budget 1

	Recurrent Expenditure		Development Expenditure		Total Expenditure
	Net Total (KES.Bn)	Appropriations in Aid (KES)	Net Total	Appropriations in Aid (KES)	(KES.Bn)
Approved Expenditure Estimates	1,178.40	225.5	424.4	291	2,119.2
Supplementary Estimates I	85.7	7.2	-39.5	-66.8	-13.3
TOTAL	**1,264.1**	**232.7**	**384.9**	**224.1**	**2,105.9**
Increase/Decrease	**7.3%**	**3.2%**	**-9.3%**	**-23%**	**-0.6%**

Source: National Treasury

2) **Market Liquidity** - There has been no change in repo rate since our January results' update (7.1%). However, the reverse repo and inter-bank rates increased to 10.4% and 6.5% from 9.9% and 5.3% respectively signaling tight market liquidity.

   A bulk of liquidity has been directed to the 91-day T-Bill as mentioned previously and as shown in the latest auction dated 6th February 2023.

3) **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 as well as the higher 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.

4) **Secondary market trading** - We do not expect high secondary market trading activity on the two debt issues.

   We however expect a tap sale issue on both due to their low subscription rate (39.1%) given March debt service is at KES.199Bn which is highest Year on year (Yoy).

   Repayment pressure could further force the CBK to issue an IFB.

   Still, investors are likely to continue allocating their capital to short-tenured paper such as the 91-day T-bill to hedge against duration risks in the current rising interest rate environment.

Ownership and material conflicts of interest:
The authors or a member of their household, of this report do not hold a financial interest in the securities of this company. The authors or a member of their household, of this report do not know of the existence of any conflicts of interest that might bias the content or publication of this report.

Position as an officer or director: The authors or a member of their household, do not serve as an officer, director or advisory board member of the subject company.

Research analyst certification:
The research analyst(s) primarily responsible for the preparation and content of all or any identified portion of this research report hereby certifies that all of the views expressed herein accurately reflect their personal views. Each research analyst(s) also certify that no part of their compensation was, is, or will be, directly or indirectly, related to the view(s) expressed by that research analyst in this research report.

Additional Disclosures:
This research report is for distribution only under such circumstances as may be permitted by applicable law. This research report has no regard to the specific investment objectives, financial situation or particular needs of any specific recipient, even if sent only to a single recipient. This research report is not guaranteed to be a complete statement or summary of any securities, markets, reports or developments referred to in this research report. Neither SCL nor any of its directors, officers, employees or agents shall have any liability, however arising, for any error, inaccuracy or incompleteness of fact or opinion in this research report or lack of care in this research reports preparation or publication, or any losses or damages which may arise from the use of this research report.

Disclaimer:
This research report was prepared under the supervision of the Research Department of Sterling Capital Limited (SCL), a company authorized to engage in securities activities in Kenya, and with partnerships in Uganda, Rwanda, Zimbabwe, and Tanzania. Data used in this report was gathered from reliable sources, but the analyst(s) and the publishers of this report do not hold themselves responsible for the accuracy or completeness of data used. The report provides the opinions, analyses and conclusions of the Research division only and is provided without any warranties of any kind.

This report does not constitute an offer, or the solicitation of an offer, for the sale or purchase of any security. The reader should independently evaluate the investment risks and is solely responsible for their investment decisions. Whilst every care has been taken in preparing this report, no representation, warranty or undertaking (express or implied) is given and no responsibility or liability is accepted by SCL or any employee of SCL as to the accuracy, timeliness, completeness merchantability or fitness for any particular purpose of any such recommendation or information contained and opinions expressed herein. SCL do not accept any liability for any direct or remote loss or damage arising out of the use of all or any part of the information contained in this report.

This report is published for information purposes only and is not an offer to solicit, buy or sell any security of any kind. This report does not provide customized investment advice. It has been prepared without regard to the individual financial circumstances and risk and return objectives of individuals who receive it. The appropriateness of a particular investment will depend on an investor's individual circumstances, risk tolerance and return objectives. The investments securities referred to in this document may not be suitable for all or certain categories of investors. The Research Division and SCL have implemented Chinese walls procedures to prevent any conflict of interest. Other additional information may be available at SCL.

Further disclosure regarding SCL policy on potential conflicts of interest in the context of investment research and SCL policy on disclosure and conflicts in general are available on request. The opinions presented in this note may be changed without prior notice or cannot be depended upon if used in the place of the investor's independent judgment. The historical performance of a security is not representative of the security's future returns. Investment in securities can be highly risky as security prices may go down in value as well as up and you may not get back the full amount invested. Where an investment is denominated in a currency other than the local currency of the recipient of the research report, changes in the exchange rates may adversely affect the value, price or income of that investment. In case of illiquid investments for which there is no organized market it may be difficult for investors to exit investment positions or to obtain reliable information about its value or the extent of the risk to which it is exposed. The information contained in this report is confidential and is solely for use to those persons to whom it is addressed and may not be reproduced, further distributed to any other person or published, in whole or in part, for any purpose.