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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>

Fixed Income Note

March 2023

"CBK issues IFB in the face of low long-term debt demand"

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Executive Summary

- Our fixed income report for the month of March 2023 titled **"CBK issues IFB in the face of low long-term debt demand"** is an analysis of the Central Bank of Kenya's (CBK's) first and second infrastructure bond **(IFB1/2023/17)** in 2023 and 2022/23 fiscal year respectively.
- The IFB with a weighted average term to maturity tenor of 13.5 years seeks to raise KES.50Bn for the purpose of funding infrastructure projects in the FY2022/2023 budget.
- We expect oversubscription with our Weighted Average Rate (WAR) of accepted investor bids prediction as follows:

  Weighted Average Rate (WAR) of accepted investor bids: 14.09% - 14.19%

- 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 first IFB of the 2023 calendar year

- The Central Bank of Kenya (CBK) has invited bids for a 17-year amortized Infrastructure Bond **(IFB1/2023/17)**, with a market-determined coupon to raise KES.50Bn (Table.1).
- This is the first IFB issue in 2023 and second issue in the 2022/23 fiscal year with the first issued in November 2022.
- Redemption will be in two tranches, 50% redeemed in February 2033 and the remaining 50% at maturity in February 2040.
- We expect oversubscription as is often the case with IFBs due to its tax-free status and high capital appreciation potential.

Table.1: Infrastructure Bond issue summary

Issue Number	IFB1/2023/17
Total Amount Offered	KES.50Bn
Tenor (Years)	17
Effective Tenor (Years)	13.5
Coupon Rate (%)	Market Determined
Issue Price	Discounted/Premium/Par
Period of Sale	15th February 2023 to 7th March 2023
Auction Date	8th March 2023
Value Date	13th March 2023
Yield Curve (%) (Weighted Average tenor - 13.5 years) 28th February 2023	**13.9877**

Source: Central Bank of Kenya & Sterling Capital Research

IFB1/2023/17 amortized redemption structure

- **IFB1/2023/17** amortized redemption structure is equivalent to a tenor of 13.5 years (Table.2).

Table.2: Effective debt tenor is 13.5 years

Redemption Period	% of principal	Tenor Calculation	Weighted Tenor
10 Years (February 2023 - 2033)	50%	50%*10 years	5 years
17 Years (February 2023 - 2040)	50%	50%*17 years	8.5 years
Effective tenor			5 + 8.5 = 13.5 years

Source: Central Bank of Kenya & Sterling Capital Research

Our market weighted average bid predictions

- Our market-weighted average rate of accepted investor bid predictions were arrived at by analysing implied yields of securities of similar tenors on the Nairobi Securities Exchange (NSE) as at 28th February 2023 and in consultation with fixed income traders (Table.3).

Table.3: Auction bid predictions

Rate	IFB1/2023/17
Market Weighted Average bid prediction (%)	14.09 - 14.19

Source: Sterling Capital Research

Historical debt issues guide our predicted rates

- We used implied yields of bonds on the NSE as at 28th February 2023 as a guide for possible investor auction bid levels (Table.4).
- The best benchmark in relation to active trading and 13.5-year effective tenor is **IFB1/2022/14**, the most traded infrastructure bond in the secondary market since November 2022, report here.
- Notably, benchmark in relation to **IFB1/2023/17**'s 17-year tenor is **IFB1/2022/18**.

Table.4: Benchmark issues to guide investor bids

Bond Issue	Issue Date	Coupon Rate (%)	Maturity Date	Term to Maturity Years (Days)	Implied Yield to maturity (%)	Yield Curve at time of issue
IFB1/2022/18	13th Jun 2022	13.742	21st May 2040	(17.2) 6,292	13.7625	13.8970
IFB1/2022/14	14th Nov 2022	13.938	27th Oct 2036	(13.7) 4,990	13.6138	13.8954

Source: Central Bank of Kenya

- Only eight of the last twenty-eight issues (since 2014) have been undersubscribed (Table.5 & Figure.1).
- The most recent IFB issues **IFB1/2022/18** and **IFB1/2022/14** recorded subscription rates of 101.8% and 153.1% respectively.
- The tap sale for **IFB1/2022/14** was also oversubscribed (382%).
- However, the tap sales for **IFB1/2022/18** and **IFB1/2022/6** (switch auction) were undersubscribed (32.1% and 54%) because of low market liquidity.
- We believe that the CBK is likely to accept investor bids in excess of KES.50Bn especially given a series of undersubscriptions on FXD issues in the last three months.
- In the event that there is high demand and aggressive bidding, we could see the CBK reject bids and then issue a tap sale at its preferred cost at a later date.

Table.5: Historical IFB primary market auction performance

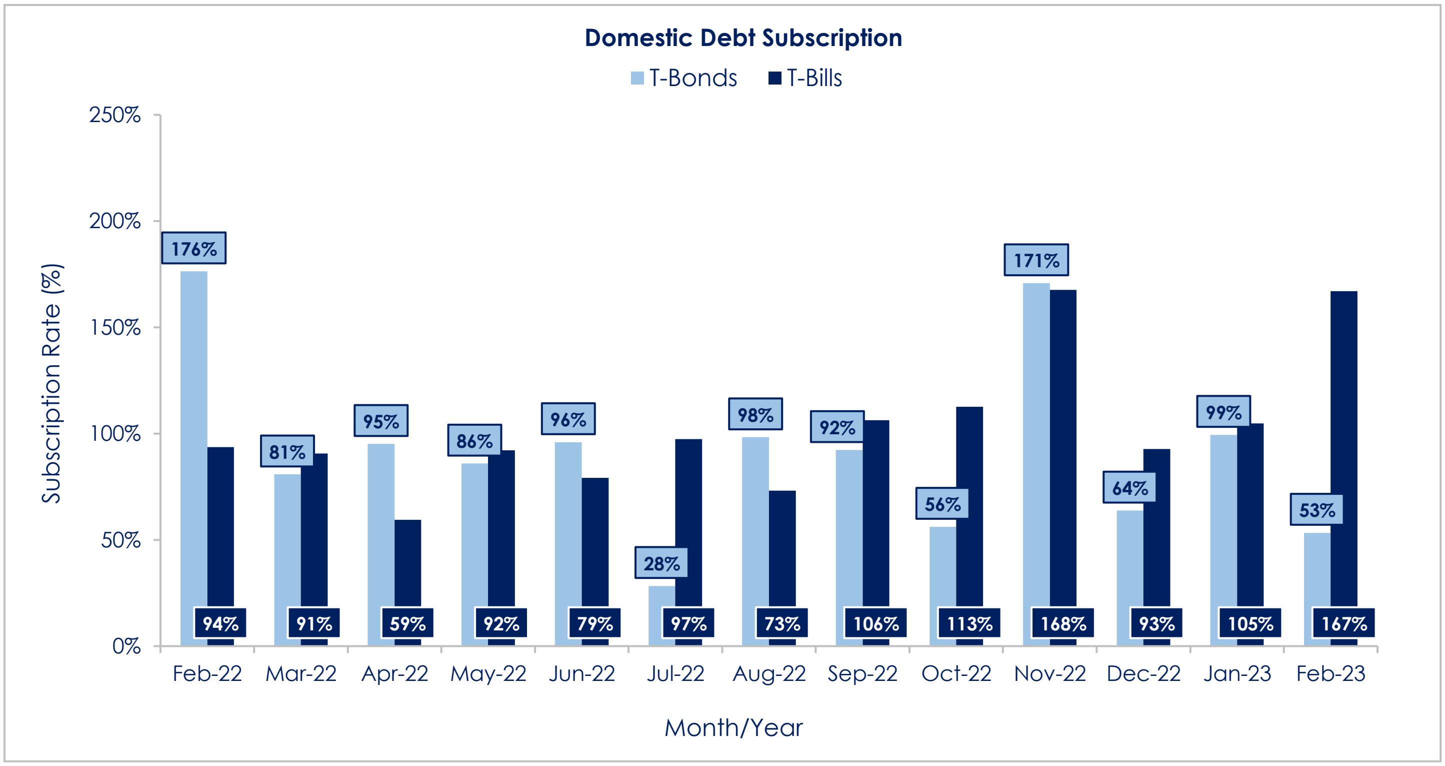
Issue	Issue Date	Offered (KES.Bn)	Bids Received (KES.Bn)	Amount Accepted (KES.Bn)	Performance Rate (%)	Coupon Rate (%)	Implied Yield (%)
IFB1/2014/12	Oct-2014	15	38.8	15.8	258.7%	11.00	12.5775
IFB1/2015/12	Mar-2015	25	51.7	25.7	206.8%	11.00	12.6025
IFB1/2015/12 (Tap)	Apr-2015	25	51.7	24	206.8%	11.00	12.6025
IFB1/2015/9	Dec-2015	30	16.6	14	55.3%	11.00	12.4400
IFB1/2016/9	May-2016	30	39.4	34.9	131.3%	12.50	12.2671
IFB1/2016/15	Oct-2016	30	35.1	30.6	117%	12.00	13.5290
IFB1/2017/12	Feb-2017	30	35.0	6	116.7%	12.50	12.7343
IFB1/2017/12 (Tap)	Mar-2017	24	8	7.6	33.3%	12.50	12.7343
IFB1/2017/7	Nov-2017	30	45.9	42.0	153.0%	12.50	12.1300
IFB1/2018/15	Jan-2018	40	55.8	5	139.5%	12.51	13.3800
IFB1/2018/15 (Tap)	Feb-2018	35	36.2	36.2	103.4%	12.51	13.3800
IFB1/2018/20	Nov-2018	50	40.4	27.6	80.8%	11.95	13.2000
IFB1/2018/20 Tap	Nov-2018	22.4	8.8	8.7	39.3%	11.95	13.2000
IFB1/2019/25	Mar-2019	50	29.4	16.3	58.8%	12.20	13.8275
IFB1/2019/16	Oct-2019	60	86.9	68.5	144.8%	11.75	13.6275
IFB1/2020/9	Apr-2020	60	68.4	39	114.0%	10.85	12.9155
IFB1/2020/9 (Tap)	Apr-2020	21	37.8	35.4	180.0%	10.85	12.9155
IFB1/2020/6	Jun-2020	26	21.2	19.3	81.5%	10.20	12.2600
IFB1/2020/11	Aug-2020	70	101.5	78.6	145.0%	10.90	13.3600
IFB1/2021/16	Jan-2021	50	125.5	81.1	251.0%	12.26	13.5357
IFB1/2021/18	Apr-2021	60	88.6	81.9	147.7%	12.67	13.6575
IFB1/2021/21	Sep-2021	75	151.3	106.8	201.7%	12.74	13.3000
IFB1/2022/19	Feb-2022	75	132.3	98.6	176.3%	12.97	13.9321
IFB1/2022/18	Jun-2022	75	76.4	73.8	101.8%	13.74	13.7625
IFB1/2022/18 (Tap)	Jul-2022	20	6.4	6.4	32.1%	13.74	13.7625
IFB1/2022/14	Nov-2022	60	91.8	75.6	153.1%	13.94	13.6138
IFB1/2022/14 (Tap)	Nov-2022	5	19.1	19.1	382%	13.94	13.6138
IFB1/2022/6 (Tap)	Dec-2022	20	10.8	10.8	54%	13.22	13.1500

Source: Central Bank of Kenya

T-Bill subscriptions in February 2023 highest over the last one year

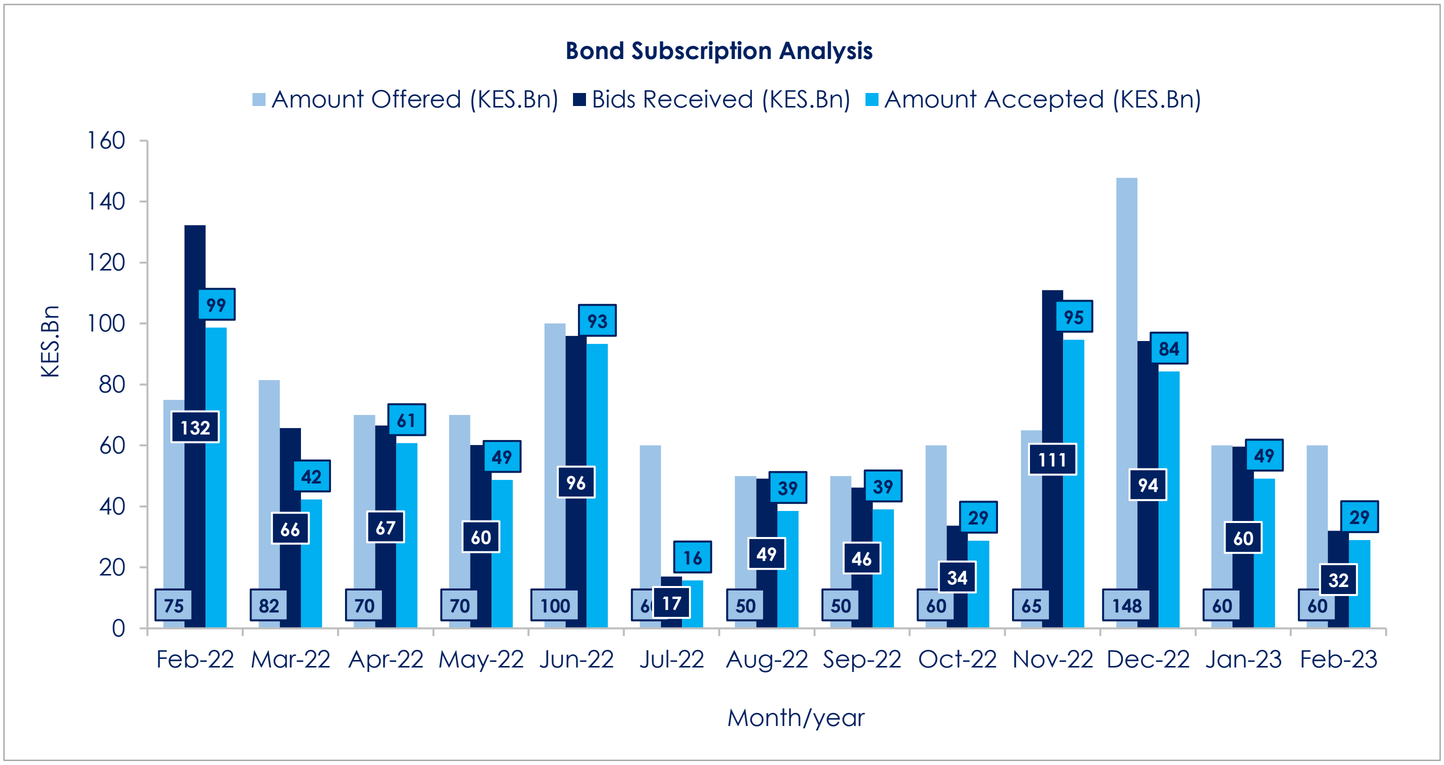
- T-bill subscription rate increased to 167.1% in February with KES.160.4Bn bids received against KES.96Bn offered, higher than the 104.8% recorded in January (Figure.1).
- The 91, 182 and 364-Day T-Bills recorded subscription rates of 583.7%, 105.3% and 62.2% subscription rate in February compared to 348.6%, 74.7% and 37.4% respectively in January.
- This was also the highest subscription recorded over the last one year signaling high preference for the shortest dated debt security in a period of rising interest rates.
- T-Bond subscription at 53.3% was the second lowest over the reviewed period with KES.32Bn bids received against KES.60Bn offered (Figure.2).
- This was also considerably lower than the 99.4% subscription rate recorded in January.
- The decline in T-bond subscription was due to the relatively long tenor of **FXD1/2023/10** whose 10-year tenor elicited weak demand.
- **IFB1/2023/17** will alter the trend of declining monthly T-Bond subscriptions with strong demand expected.

Figure.1: T-Bill subscriptions hit one year high as demand for T-Bonds slumps



Source: Central Bank of Kenya

Figure.2: T-Bond subscriptions slump in February 2023

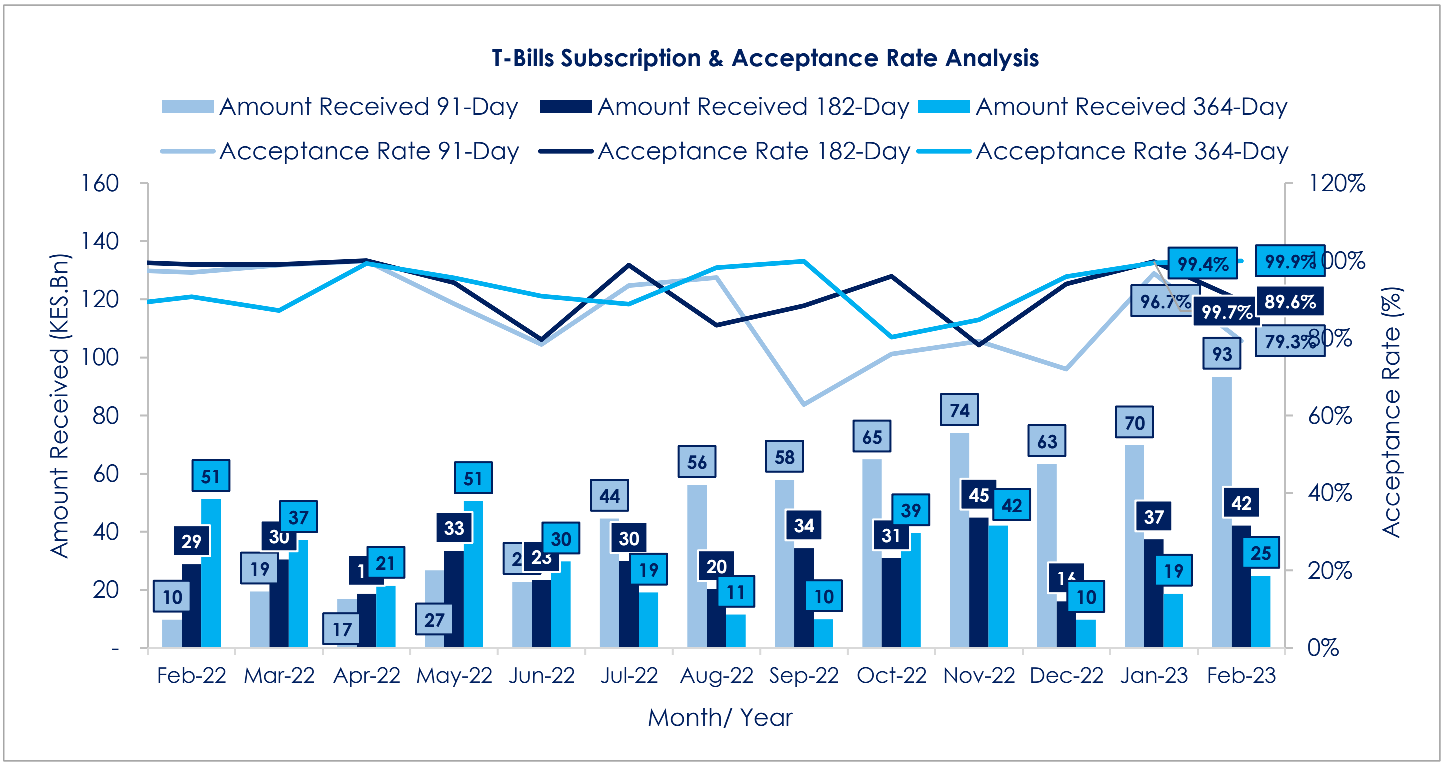


Source: Central Bank of Kenya

CBK's acceptance rate declines in February in a bid to manage refinancing risk

- There was a general decline in the CBK's acceptance rate for T-Bills in February 2023 compared to January, this being its continuous attempts to find a balance between financing the Government's fiscal deficit and managing the Average Term to maturity of public debt (Figure.3).
- Acceptance rates for the 91-Day, 182-Day and 364-Day T-Bills stood at 79.3%, 89.6% and 99.9% in February 2023 compared to 96.7%, 99.7% and 99.4% in January. (Figure.3).
- The higher acceptance rate for the 182 and 364-Day T-Bills is consistent with the CBK's strategy of lengthening the average term to maturity of domestic debt.

Figure.3: Comparatively lower acceptance rate for 91 Day T-Bill in February 2023

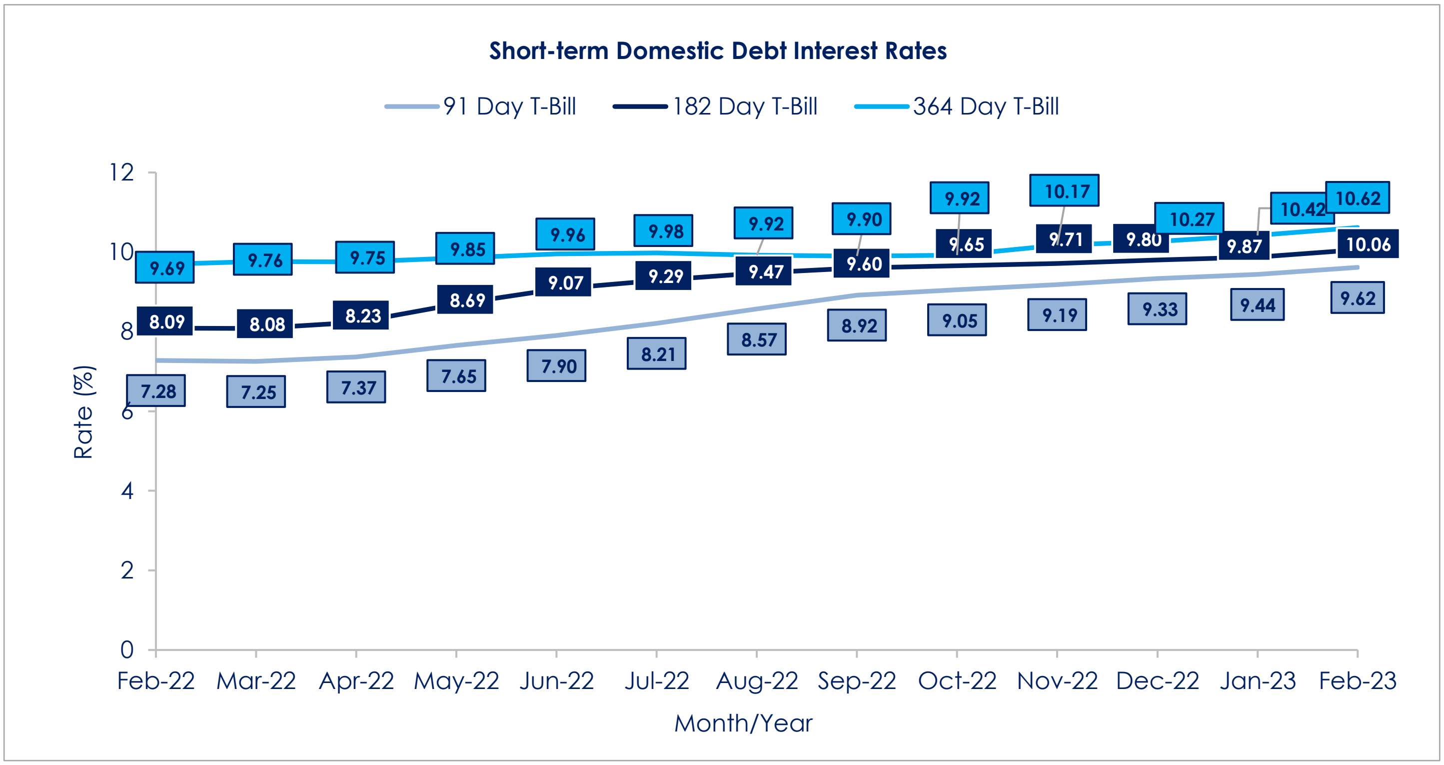


Source: Central Bank of Kenya

182 Day T-Bill crosses above 10% in February 2023

- Average T-Bill rates rose in February compared to the previous month with the 182-Tbill more noticeable as it crossed above 10% (Figure.4).
- We notice a 20 bpd average increase on the 91, 182 and 364 day tenors to 9.6%, 10.1% and 10.6% respectively.
- Over the one year, average T-Bill rates have increased 234, 197 and 93 bps showing the lasting impact of CBR revisions, high inflation and increased fiscal deficit financing.
- The gradual but continual implementation of risk based credit pricing models by banks will put further pressure on both short and long tenor domestic debt rates as banks look at private sector lending as an attractive option to investing in Government debt.

Figure.4: T-Bill rates continue upward trajectory in January 2023

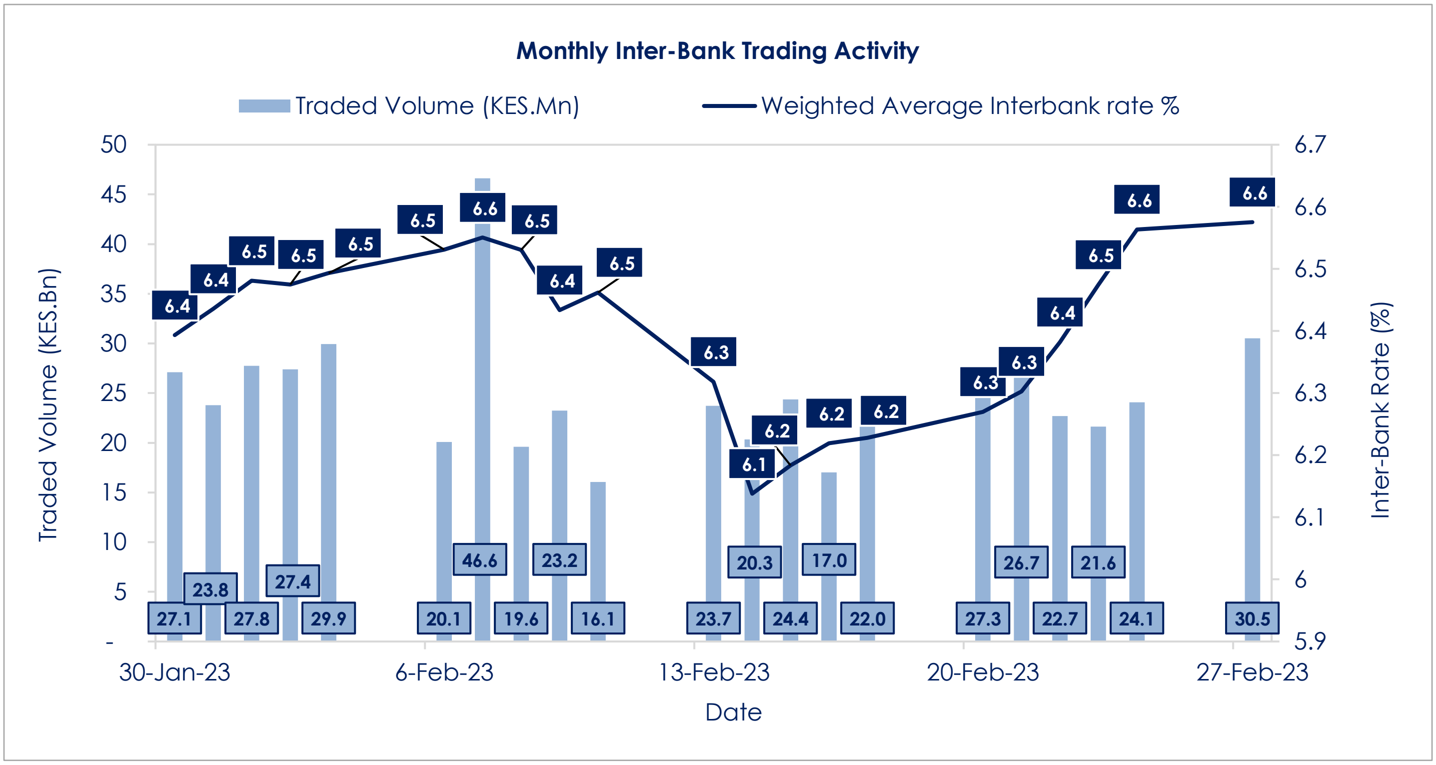


Source: Central Bank of Kenya

Average inter-bank rates tick up in February 2023

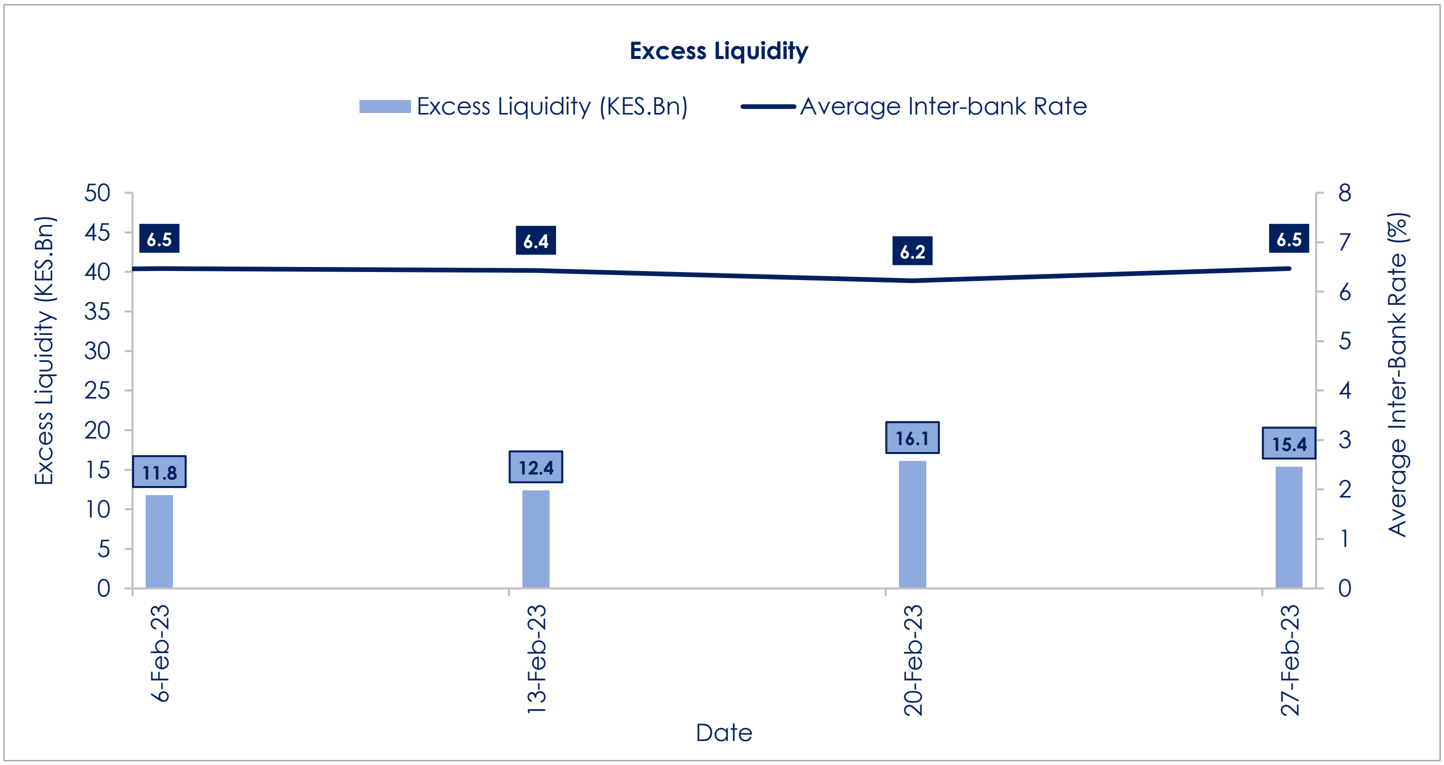
- Average inter-bank rate and trading volumes increased in February 2023 compared to the previous month (Figure.5).
- The average inter-bank rate increased to 6.4% from 6% pointing to relatively low market liquidity.
- Trading volumes also increased to KES.471Bn from KES.375.9Bn over the period in focus.
- Over the same period, excess reserves (the additional liquidity above the minimum 4.25% Cash Reserve Ratio (CRR)) increased 80.3% from KES.30.9Bn in January 2023 to KES.55.7Bn in February (Figure.6).

Figure.5: Uptick in average inter-bank lending rates in February due to tightening market liquidity



Source: Central Bank of Kenya

Figure.6: Excess commercial bank reserves rise in February 2023

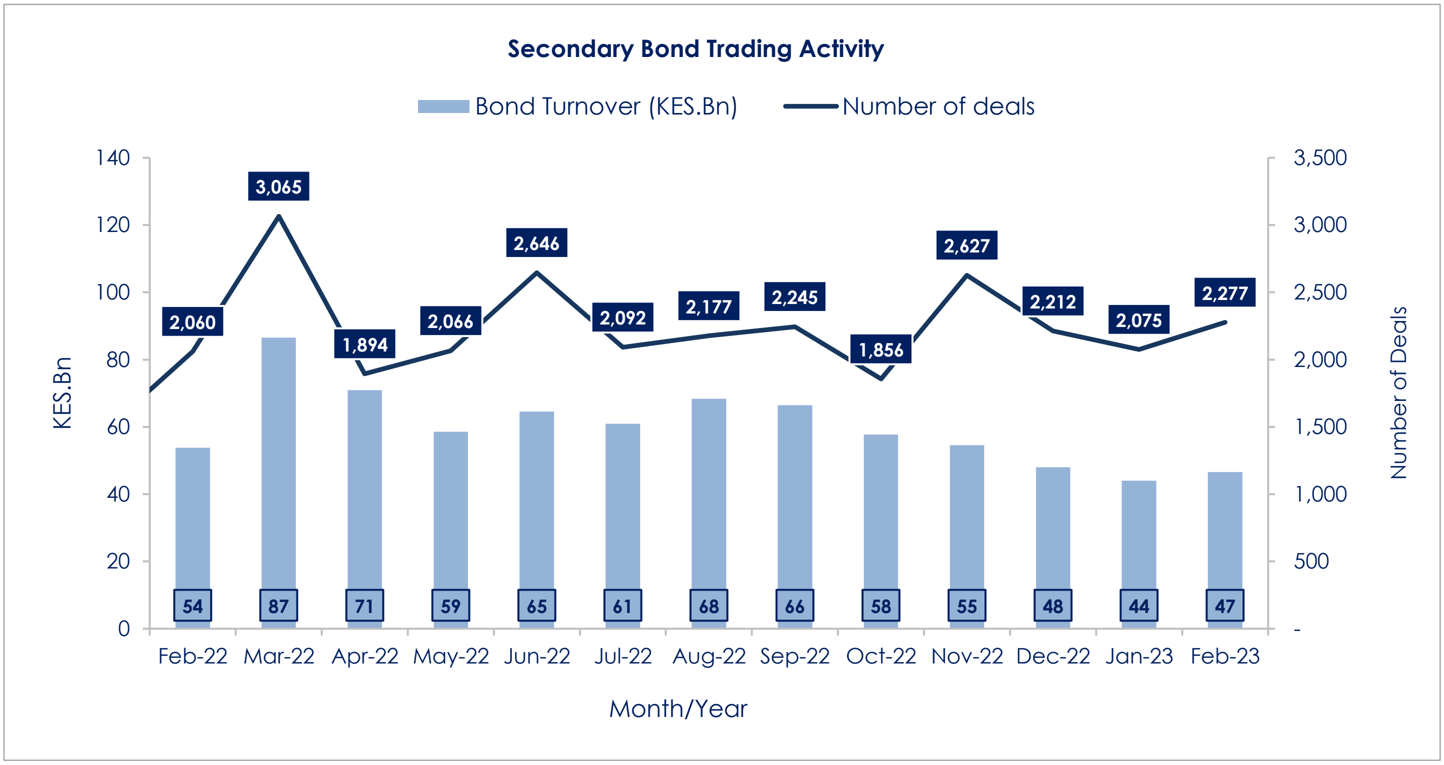


Source: Central Bank of Kenya

Secondary market trading up 5.9% in February 2023

- Secondary bond market trading increased 5.9% to KES.46.6Bn in February 2023 from KES.44Bn in January while the number of deals increased 9.7% to 2,277 from 2,075 (Figure 7).
- The two bonds on issue; **FXD1/2017/10** and **FXD1/2023/10** contributed to the increase in trading given their relatively high yields that inverted the yield curve.
- We expect trading to increase in March due to the issuance of **IFB1/2023/17.**

Figure.7: Secondary trading activity remains subdued in January 2023

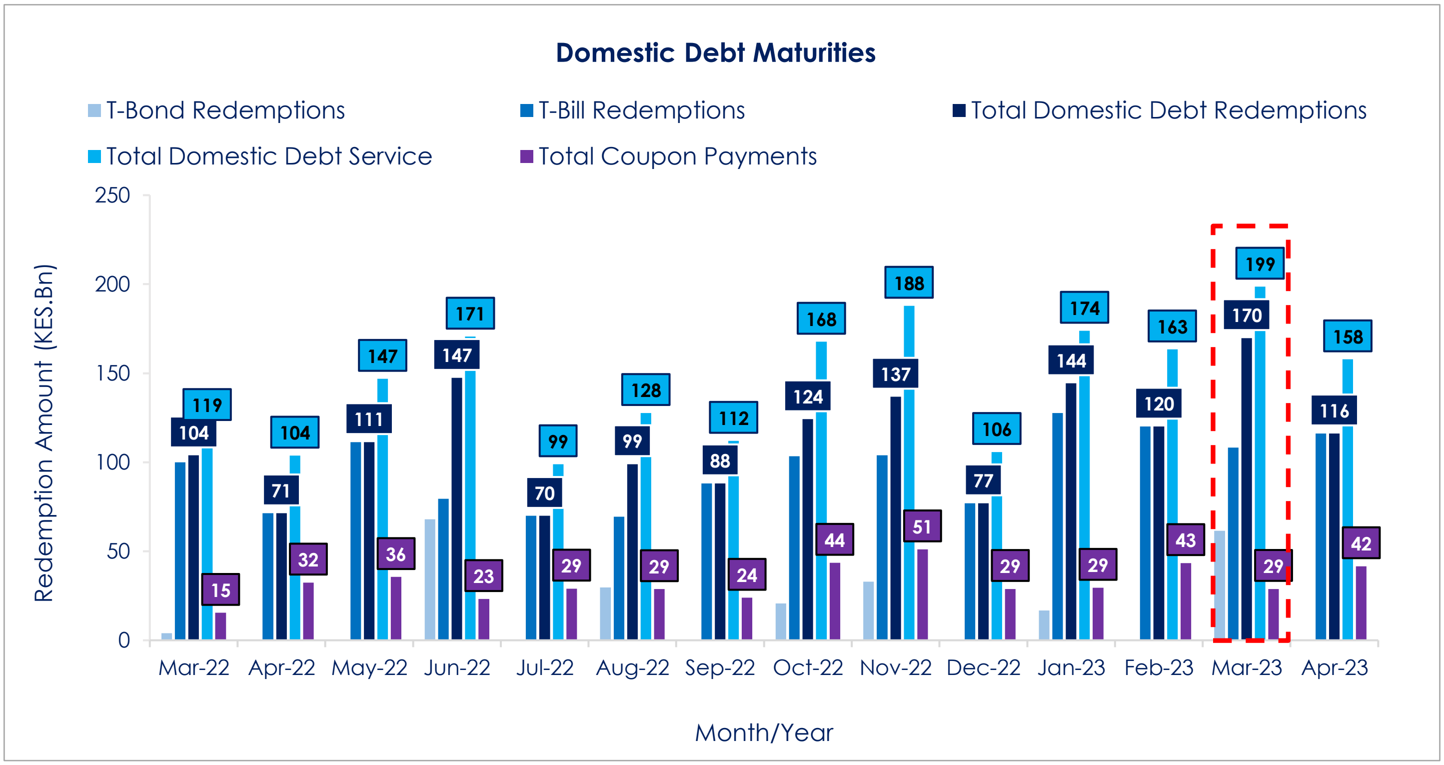


Source: Central Bank of Kenya

Domestic debt service in March 2023 at KES.198.6Bn

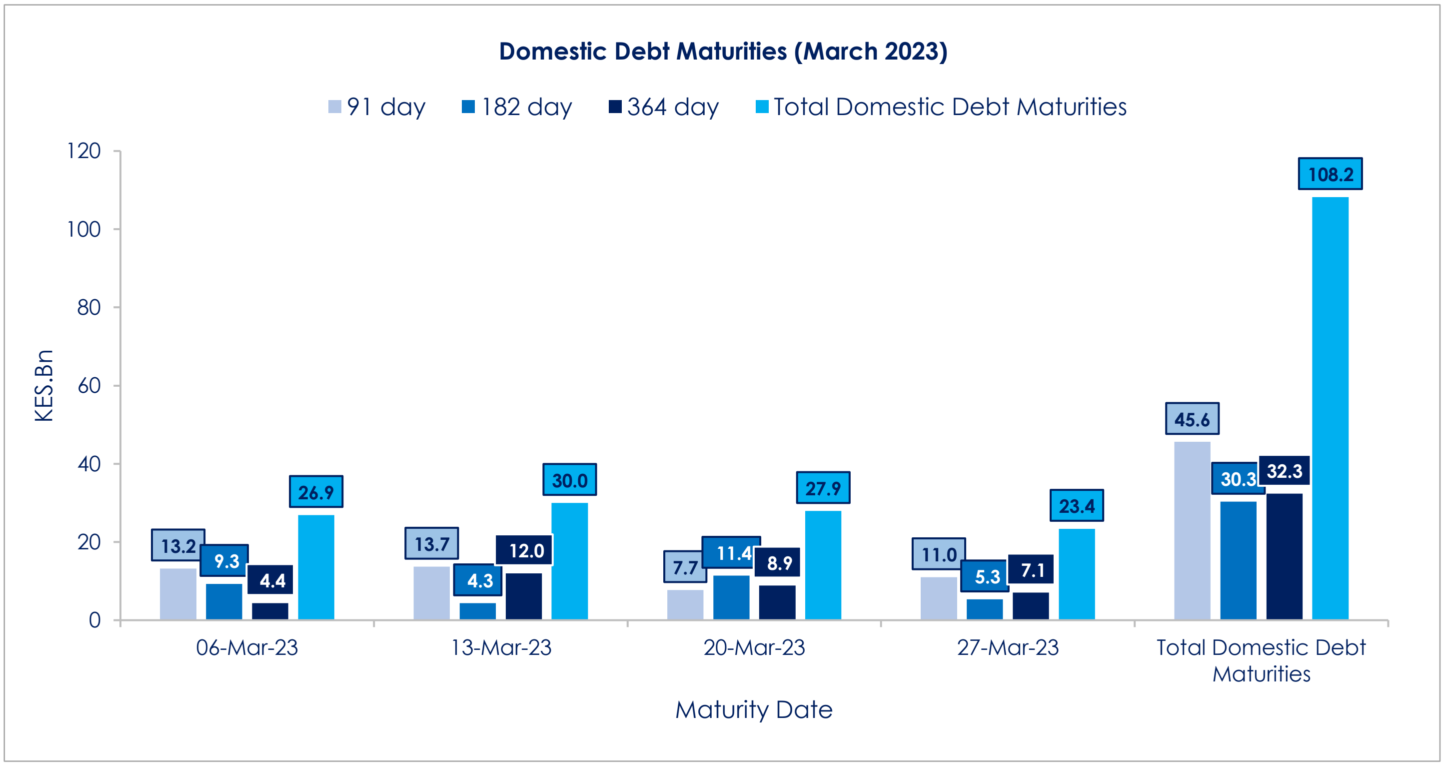
- Total domestic debt service for March 2023 is KES.198.6Bn 21.6% higher than February 2023 (KES.163.4Bn) (Figure.8).
- This comprises of KES.108.2Bn in T-Bill redemptions, KES.28.9Bn in coupon payments and KES.61.5Bn in T-bond maturities (FXD1/2008/15 and FXD1/2018/5).
- Redemptions for the 91, 182 and 364-day T-Bills amount to KES.45.6Bn, KES.30.3Bn and KES.32.3Bn respectively with the second week (week ending 13th March) of the month having the highest redemptions at KES.30Bn (Figure.9).

Figure.8: March debt service at KES.198.6Bn



Source: Central Bank of Kenya

Figure.9: Weekly debt maturities March 2023

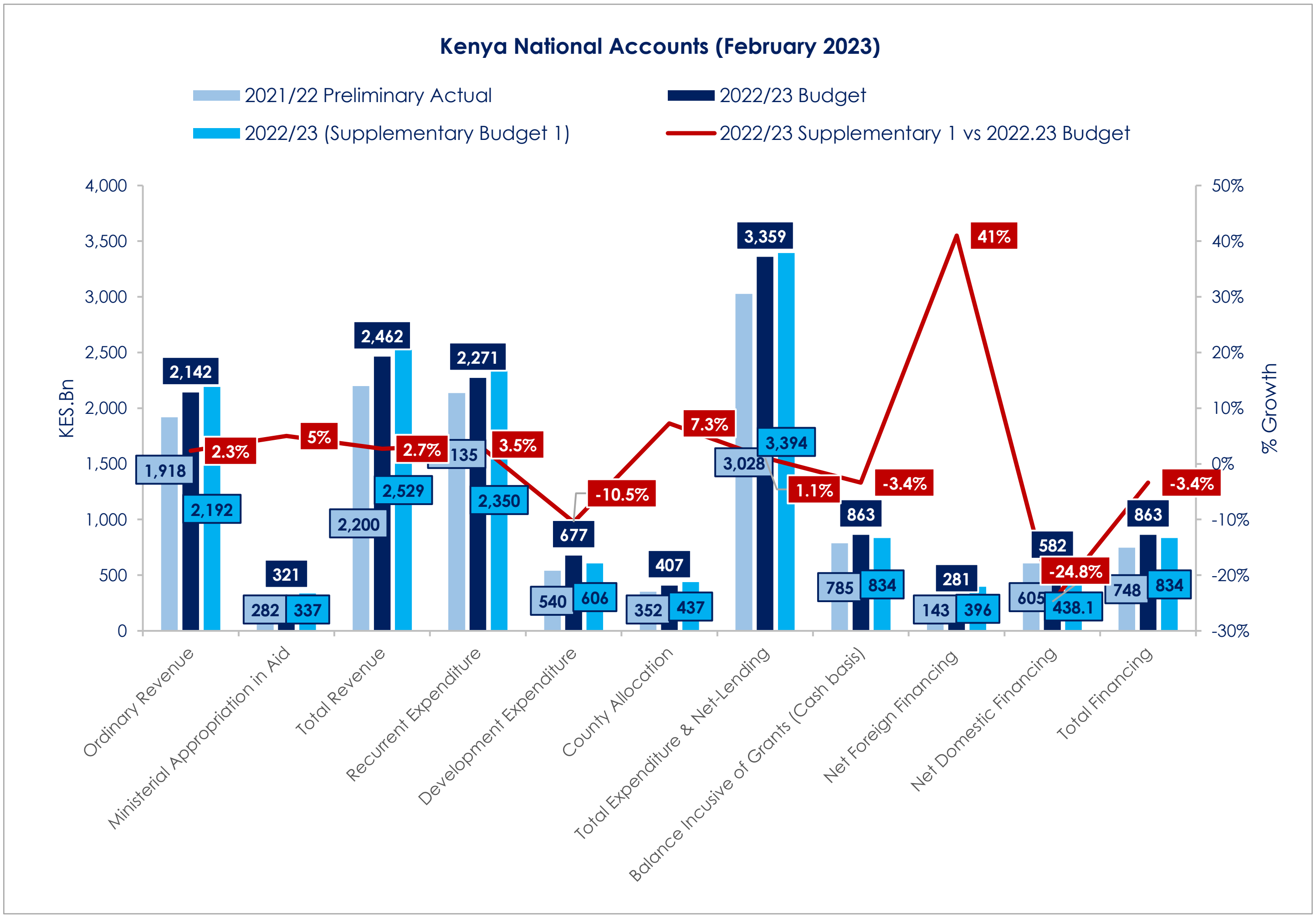


Source: Central Bank of Kenya

National Treasury releases Medium term 2022/23 budget Policy Statement

- The National Treasury released its [2023 Medium Term Budget Policy Statement (BPS)]() in February 2023 showing modest 1.1% increase in total expenditure and net lending compared to the 2022/23 budget against a 2.7% increase in total revenue (Figure.10).
- This is a result of a 10.5% cut in development spending to KES.606Bn which offset the 3.5% increase in recurrent expenditure to KES.2.35Tn.
- However, most noticeable is the deviation in financing with net foreign financing up 41% compared to the 2022/23 budget and net domestic financing cut 24.8% to KES.582Bn
- The overall effect is 3.4% decline in total financing to KES.834Bn which is still 11.5% higher than in 2021/22 (KES748Bn).
- The decline in net domestic borrowing could be in response to the slow uptake of domestic bonds in debt auctions.
- It is however unclear at this point how the national treasury intends to increase external borrowing considering elevated global interest rates and further deterioration of the KES expected.

Figure.10 2022/23 Supplementary budget unveils 41% increase in net foreign financing



Source: National Treasury

National Treasury receipts remains below linear run rate target

- Data from the National Treasury as at the end of January 2023 shows underperformance in almost all receipts based on our seven months linear target run rate of 58.3% (Table.5 and Figure.11).
- Domestic borrowing is however of greater concern at 29.2% which to a greater extend explains why the supplementary budget shows a downward revision in favour of an increase in external borrowing.
- The underperformance of domestic borrowing can be explained by low subscription for long term debt issues with most investors piling their capital into T-Bills and particularly the 91 Day T-bill.
- We also feel that this is the same reason why the CBK has opted to issue an IFB instead of a fixed treasury bond.

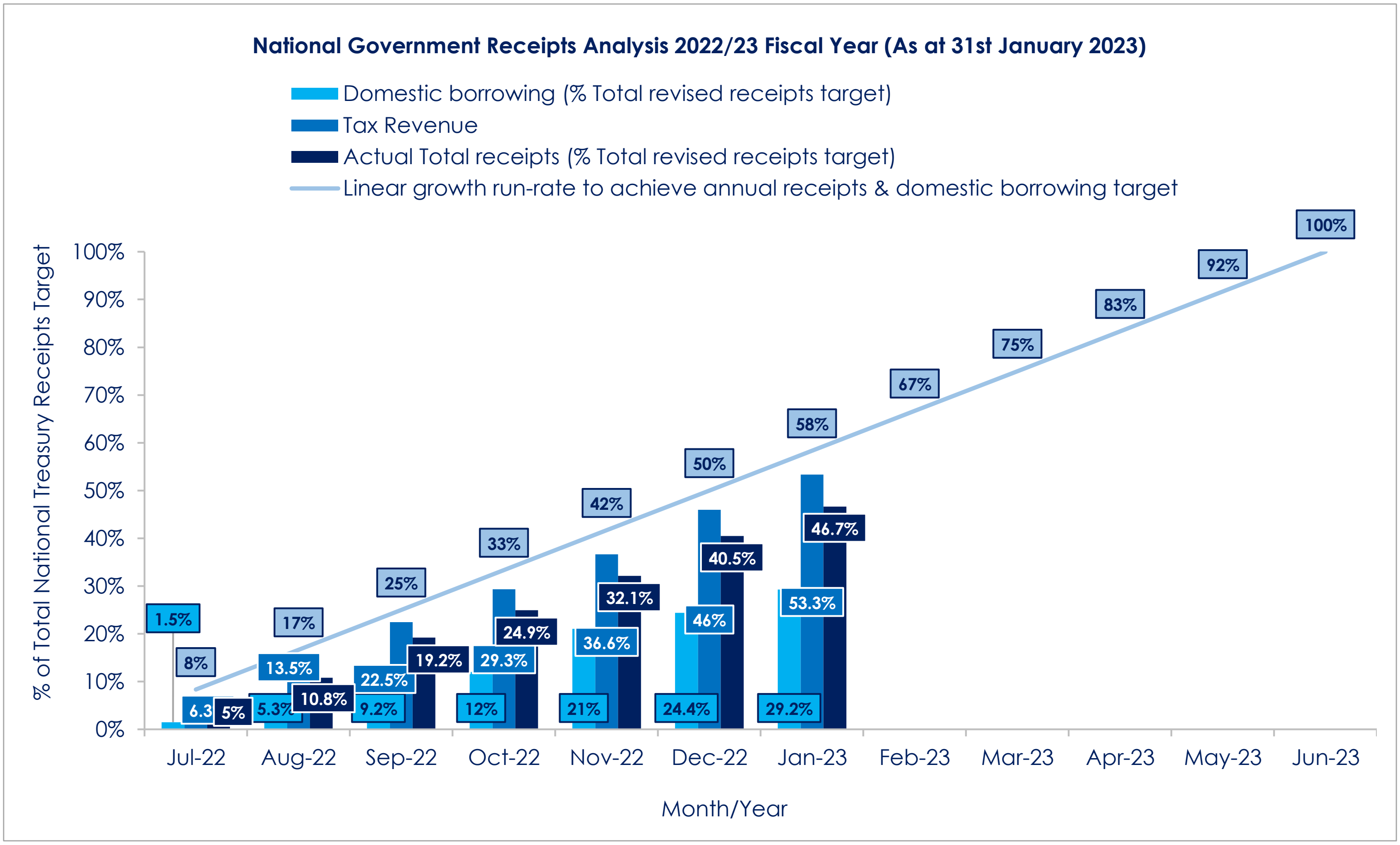
Table.5: Total Government receipts underperforming after H1 2022/23

Receipts	Original Estimates 2022/21 (KES.Mn)	Original Estimates 2022/23 (KES.Mn)	Variation 2022/23 vs 2021/22	Actual Receipts (KES.Mn) 30th December 2022	Proportion of Total Receipts 30th December 2022
Opening Balance (1st July)	21.3			616.5	
Tax Revenue	**1,784.4**	**2,071.9**	**16.1%**	**1,104.8**	**53.3%**
Non-Tax Income	67.1	69.7	3.9%	36.2	52%
Domestic Borrowing*	**1,022**	**1,040.5**	**1.8%**	**304.2**	**29.2%**
External Loans & Grants	421.2	349.3	-17.1%	193.2	55.3%
Other Domestic Financing	40.1	13.2	-67.1%	15.3	115.9%
Total Revenue	**3,334.8**	**3,544.6**	**6.3%**	**1,653.8**	**46.7%**
Linear Run Rate target (7 months of fiscal year 2022/23)					**58.3%**

* 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. CXXV - No.36 17th February 2023

Figure.11: Domestic borrowing continues to underperform linear target due to low debt subscription

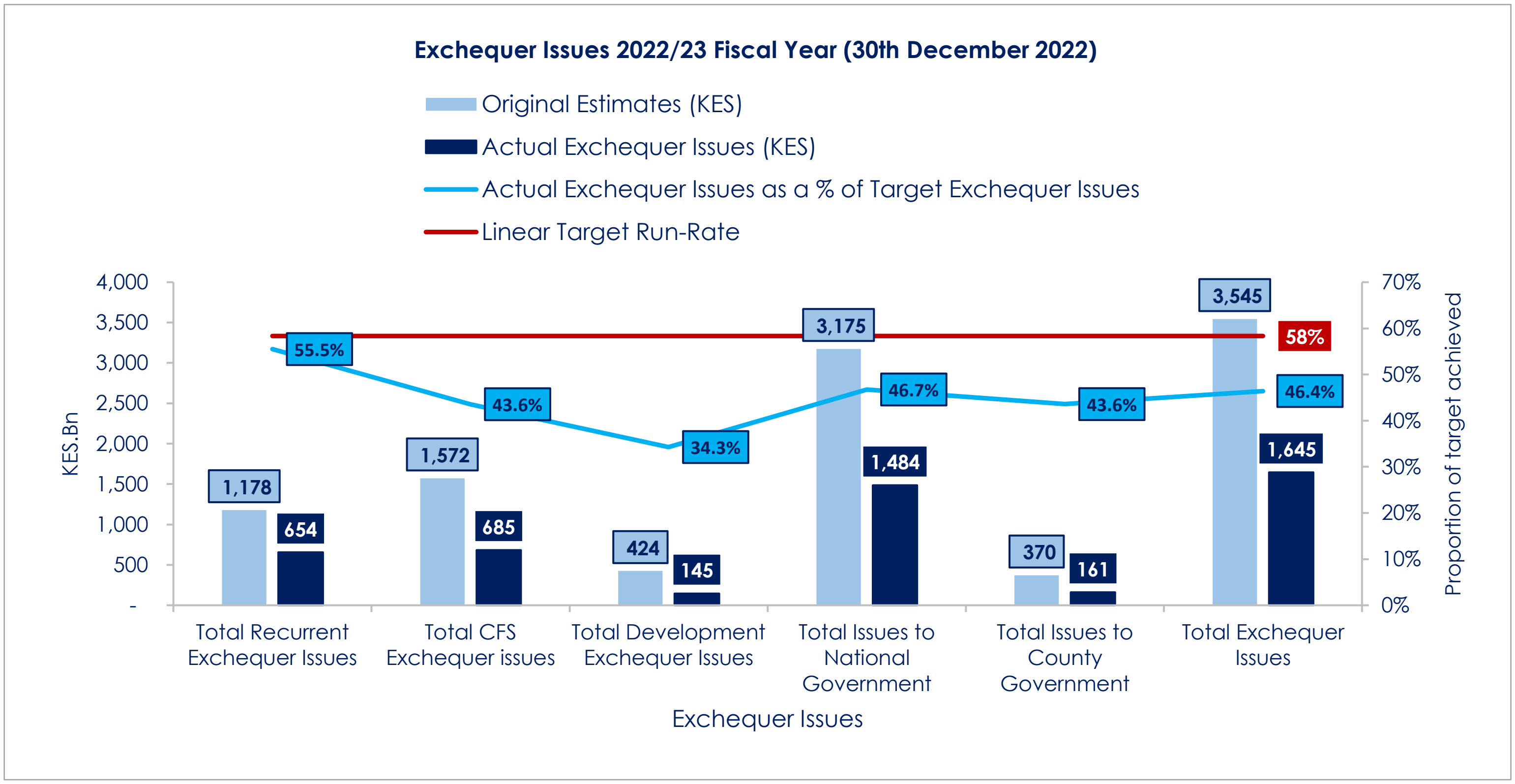


Source: The Kenya Gazette Vol. CXXV - No.36 17th February 2023

Total Government expenditure remains below 2022/23 target run rate

- We note that Government expenditure after the first seven months of the 2022/23 fiscal year are still behind the target run rate of 58.3% with total recurrent expenditure the highest (Figure.12).
- We expect a noticeable change in development expenditure following the release of the 2022/23 supplementary budget in February 2023.

Figure.12: Recurrent expenditure at 47% of total budget in H1 2022/23

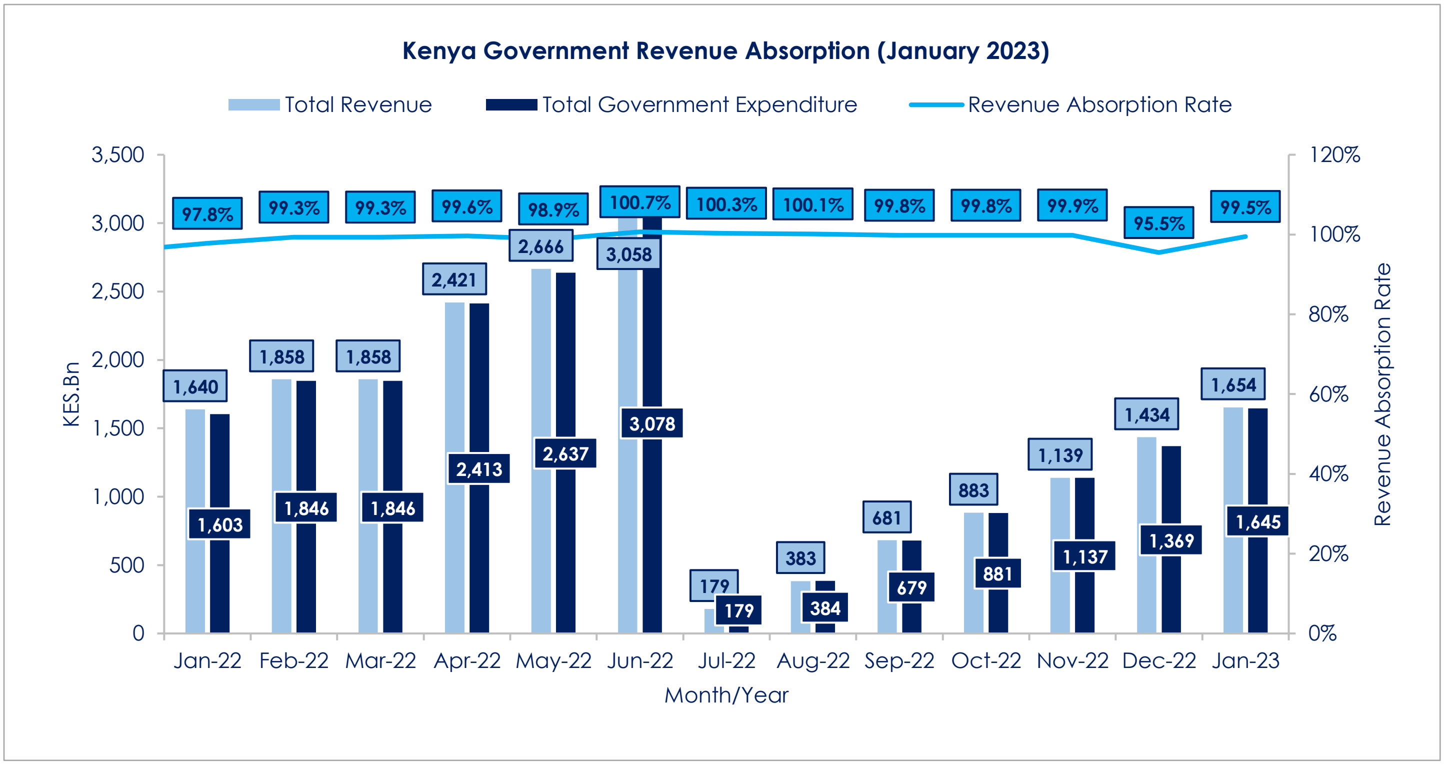


Source: The Kenya Gazette Vol. CXXV - No.36 17th February 2023

Government Revenue Absorption declines in December 2022

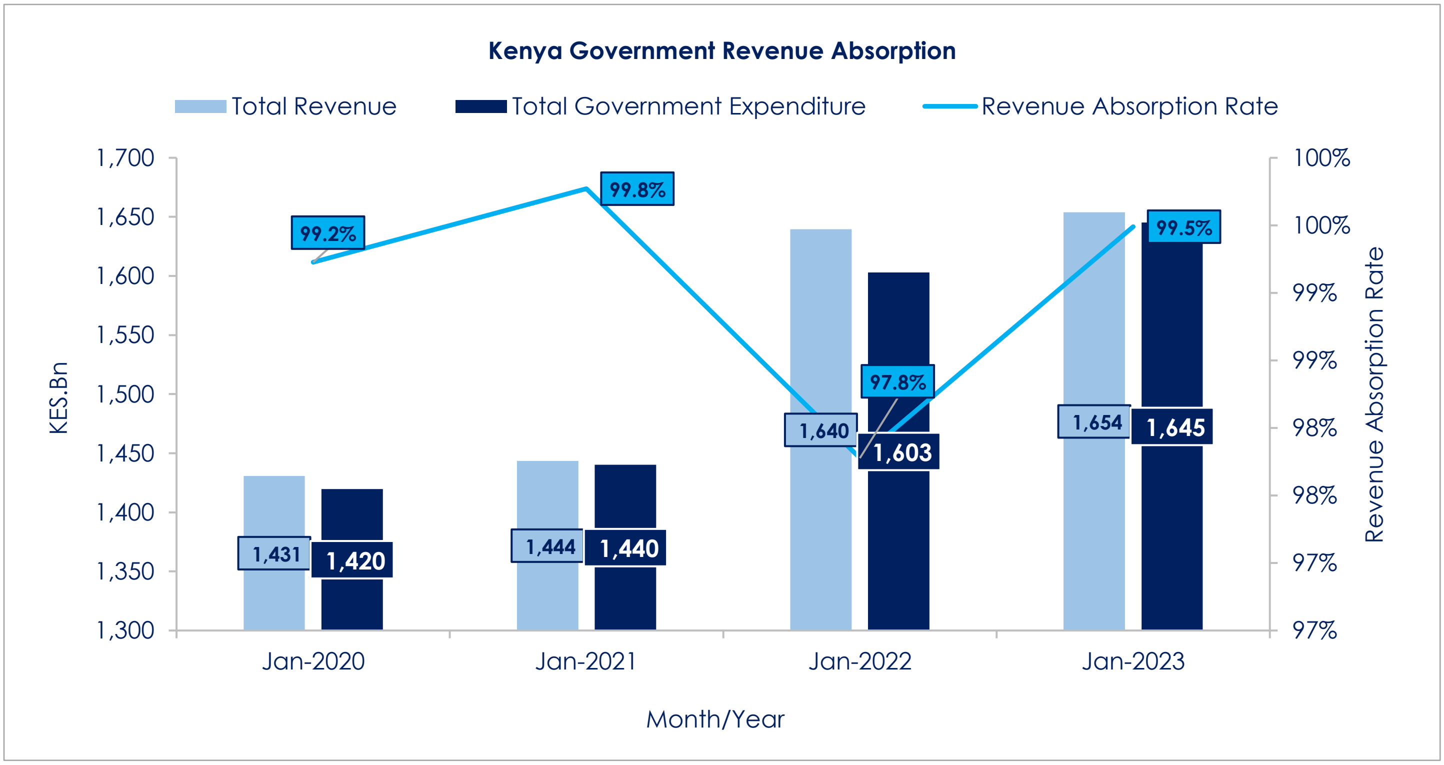
- Government Revenue Absorption Rate (RAR) is the proportion of Government receipts used to finance its expenditure. This rose to 99.5% in January 2023 compared to 95.5% in December 2022 (Figure.13).
- Likewise, our comparison over the last three years shows high RAA in 2023 which is an indication of sluggish revenue growth amid high expenditure needs (Figure.14).
- In essence it shows that revenue in January 2023 compared to the corresponding period in 2022 grew 0.9% while expenditure grew 2.6%.
- This is also the reason why the new Government focus is on increasing the tax base and enforcing compliance.

Figure.13: Government revenue utilization declines to 96%



Source: The Kenya Gazette Vol. CXXV - No.36 17th February 2023

Figure.14: Revenue absorption historically high in January

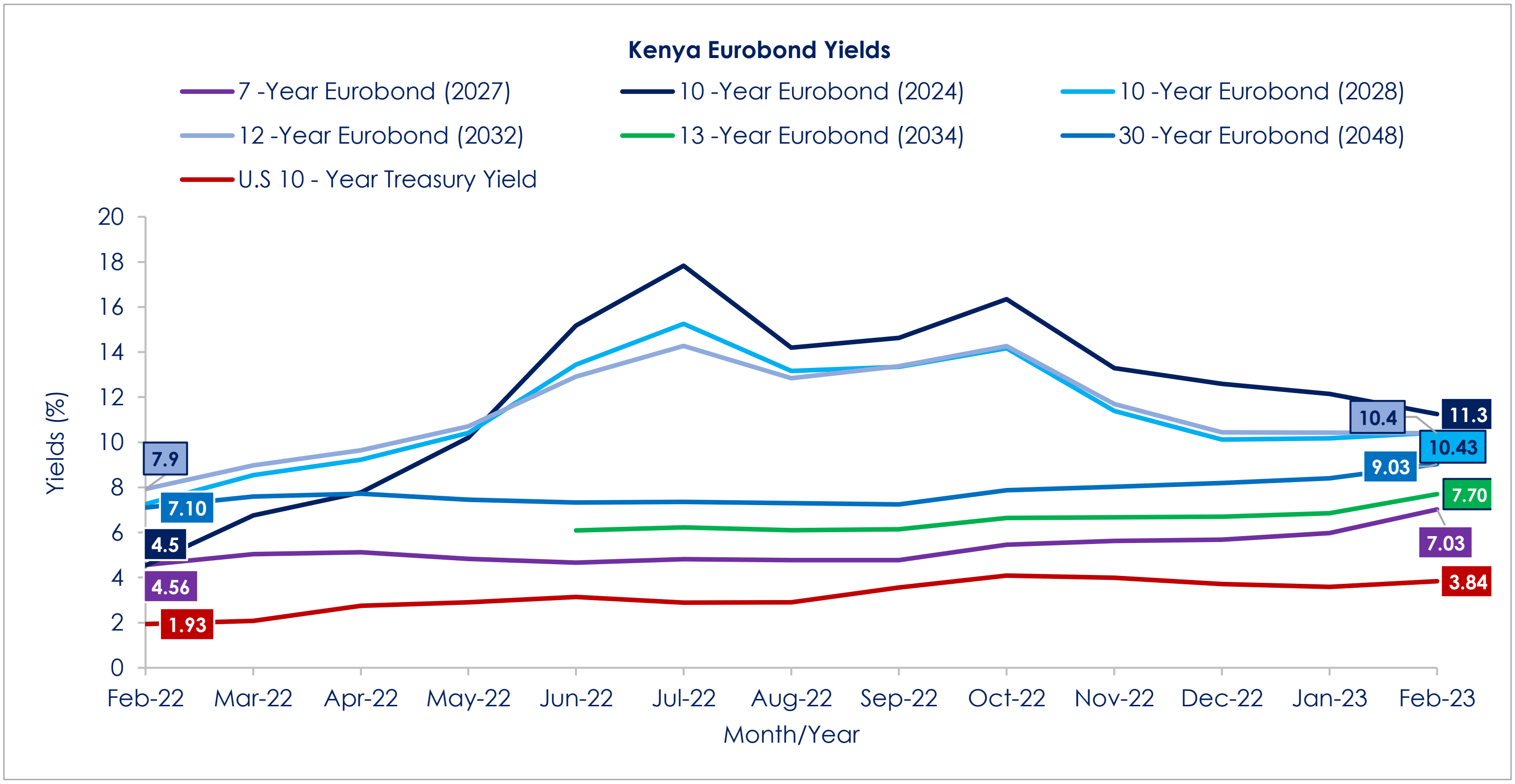


Source: The Kenya Gazette Vol. CXXV - No.36 17th February 2023

Kenya Eurobond yields trend lower in January 2023

- Kenya Eurobond yields declined marginally by 5 bps on average in the month of February 2023 compared to the previous month (Figure.15)
- This was largely due to 84 bps decline in the Eurobond maturing in June 2024 (**ISIN - XS1028952403)** which offset the increase in other bond yields.
- This we attribute to comparatively lower risk attached to this debt issue compared to bonds maturing at later dates.
- On a year on year basis, Kenya Eurobond yields are 327 bps higher in February 2023 compared to the same period in 2022.
- We still maintain the view that the Eurobond (**ISIN - XS1028952403)** presents a good investment opportunity in consideration of current yields, short term to maturity and expected U.S$ appreciation.

Figure.15: Kenya Eurobond yields decline in December but are expected to remain elevated



Source: Central Bank of Kenya

Yield curve continues to shift upwards

- A comparison of average yields on the NSE on 10th June 2022 (close to issuance of **IFB1/2022/18** which is the IFB with an almost similar term to maturity as to **IFB1/2023/17** currently in issue on 24th February 2023 (latest yield curve) and 25th February 2022 (a year ago) shows an increase in yields across the curve. (Table.6 and Figure.16).

- The upward shift in the yield curve over the last one year is a direct result of the following:

    1) Upward revisions of the CBR, with three revisions between May 2022 and November 2022 - 175bps to 8.75%.
    2) Increased budgetary financing pressure resulting from revenue shortfalls with the CBK borrowing aggressively in the domestic debt market.
    3) CBK has accommodated more aggressive investor bids to encourage subscription following a decline in investor demand for short-term debt instruments.
    4) Rising inflation with investors bidding higher to maintain positive real return on capital invested.

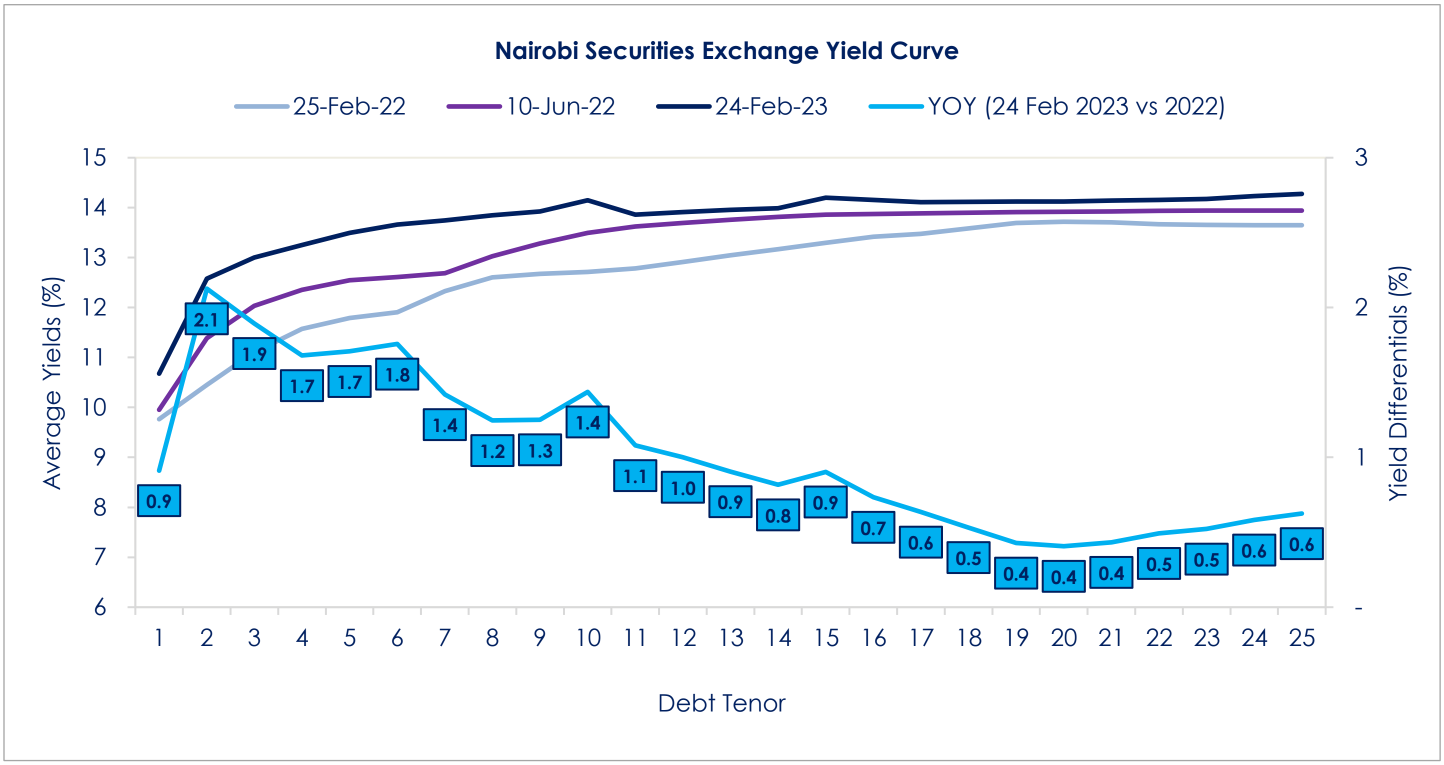
- We expect the yield curve to continue shifting upward in 2023 on account of the aforementioned factors.
- Further, we note that the yield curve is inverted on the 10 and 15-year tenors.
- Data from the NSE indicates that the 10-year implied yield as at 24th February stood at 14.1490% while the 11, 12, 13 and 14-year yields stood at 13.8624%, 13.9125%, 13.9528% and 13.9874% respectively.
- Similarly, the 15-year implied yield came in at 14.2004% which surpassed all subsequent yields until the 23-year tenor which currently stands at 14.2321%.
- This trend will force the CBK to accept aggressive investor bids as they seek to normalize the curve and subsequently raise rates further.

Table.6: Significant upward shift in yields in all tenor debt

Tenor	Yields (10th June 2022)	Yields (25th Feb 2022)	Yields (24th Feb 2023)	Δ 24th Feb 2023 vs June 2022 (Bps)	YoY Δ 24th Feb 2023 vs Feb 2022 (Bps)	Sterling Capital Yield Curve (Mar 2023)
1	9.9520	9.7240	10.6760	↑ 72.4	↑ 95.2	10.70
2	11.3884	10.4500	12.5758	↑ 47.6	↑ 212.6	12.75
5	12.5449	11.7877	13.4949	↑ 95.0	↑ 170.7	13.60
10	13.4931	12.7117	14.1490	↑ 65.6	↑ 143.7	14.10
15	13.8566	13.2973	14.2004	↑ 34.4	↑ 90.3	14.15
20	13.9172	13.7173	14.1241	↑ 20.7	↑ 40.7	14.20

Source: Nairobi Securities Exchange

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



Source: Nairobi Securities Exchange

Trading ideas - Invest in IFBs and Kenya Eurobonds

- Recently issued IFBs offer immense value with the relatively recent "switch bond" **IFB1/2022/6** particularly attractive because of its comparatively short tenor.
- 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).

Table.7: Trading ideas - Consider Kenya Eurobonds

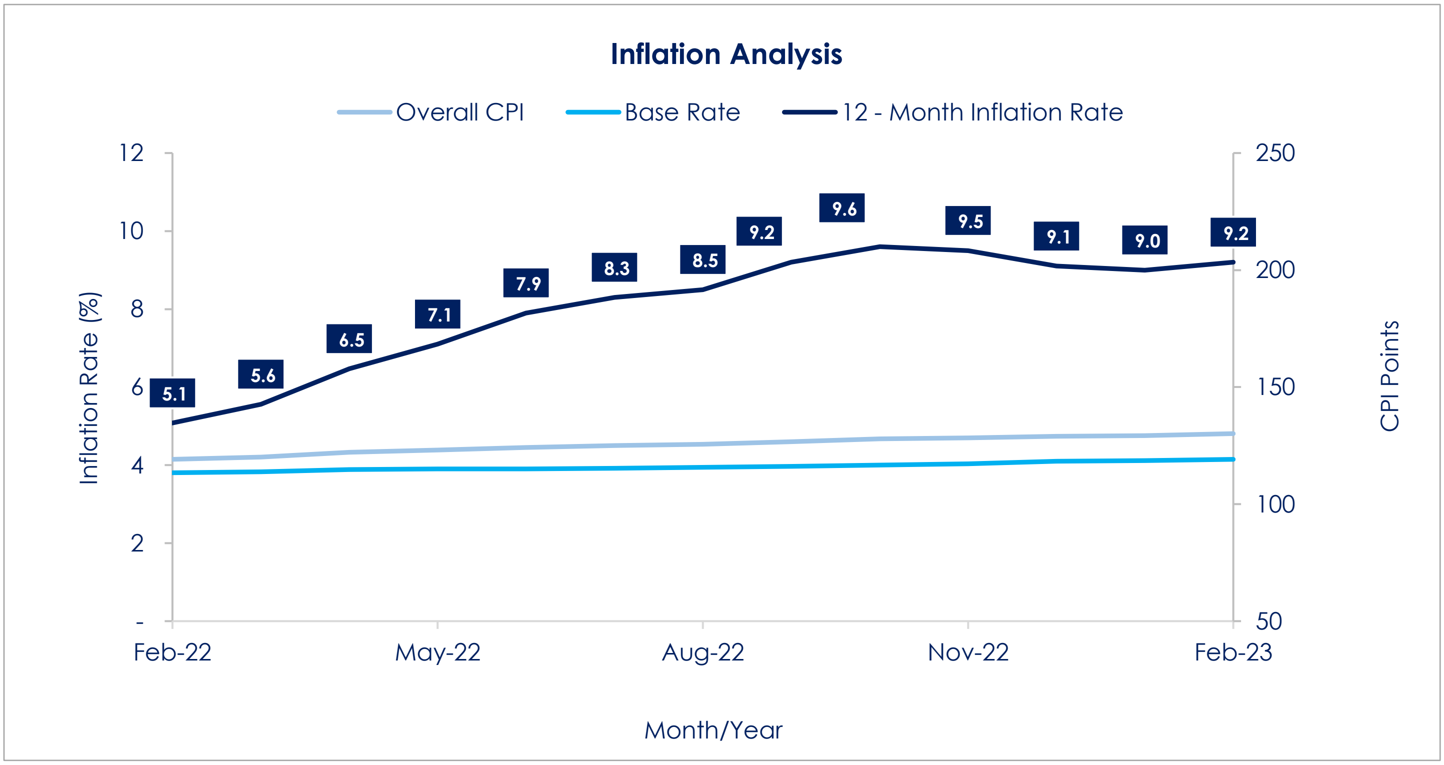
ISIN Code	Issue date	Tenor (Years)	Outstanding amount (US.$ Bn)	Coupon	Yield to maturity (23rd February 2023)	Maturity
XS102895240	Jun-14	10	2	6.875%	11.883	Jun-24
XS184343584	May-19	7	0.9	7%	10.888	May-27
XS178171054	Feb-18	10	1	7.25%	10.706	Feb-28

Source: Bloomberg

Inflation ticks up for the first time since November

- February 2023 inflation rose to 9.2% from 9% in January, bringing to a halt the decline in inflation since November (Figure.17).
- This was also outside our estimated range of 8.5% - 9% primarily driven by an increase in the prices of food and non-alcoholic beverages.
- Our March inflation forecast is 8.9% - 9.3% which takes into account the impact of declining global fuel and commodity prices alongside the prevailing drought, trends that imply a mixed bag going forward.

Figure.17: March 2023 inflation forecast 8.9% - 9.3%



Source: Kenya National Bureau of Statistics

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MPC expected to retain the CBR at 8.75% in March meeting

- The Monetary Policy Committee (MPC) is set to meet in March 2023 (date yet to be announced) to review the impact of previous monetary policy measures on the economy.
- In its last meeting on the 30th of January 2023, the MPC retained the CBR at 8.75% informed by expectations of a decline in overall inflation and an improved macro-economic outlook.
- We expect the committee to retain the CBR at the same level given the factors mentioned above as well as the minimal impact further rate hikes would have given the supply-side nature of inflation.

- Other points of discussion during the meeting will include;

  1) The impact of the Russia-Ukraine conflict on global commodity prices and current developments around it such as the uptick in flows of grain from Russia that are set to ease flour prices.

  2) Trends in Private Sector Credit (PSC) given further approval of bank risk-based pricing models.

  3) Banking sector asset quality, foreign currency reserves as well as the country's international trade data against the backdrop of the shilling's continued depreciation.

  4) The adequacy of the CBK's foreign exchange reserves which fell below 4 months of import cover in January 2023.

- We maintain that an upward revision in the CBR will have a minimal impact in managing inflation and currency depreciation, as the current inflationary pressure is a direct effect of supply side and not demand effects that cannot be controlled by a revision of the policy rate.

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