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STERLING CAPITAL LIMITED

Fixed Income

Primary Auction Update

IFB1/2023/6.5

November 2023

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November 2023 Treasury Bond Primary Auction Results Update

- The Central Bank of Kenya (CBK) issued a new 6.5-year amortized Infrastructure Bond **(IFB1/2023/6.5*)**, with a market-determined coupon to raise KES.50Bn.

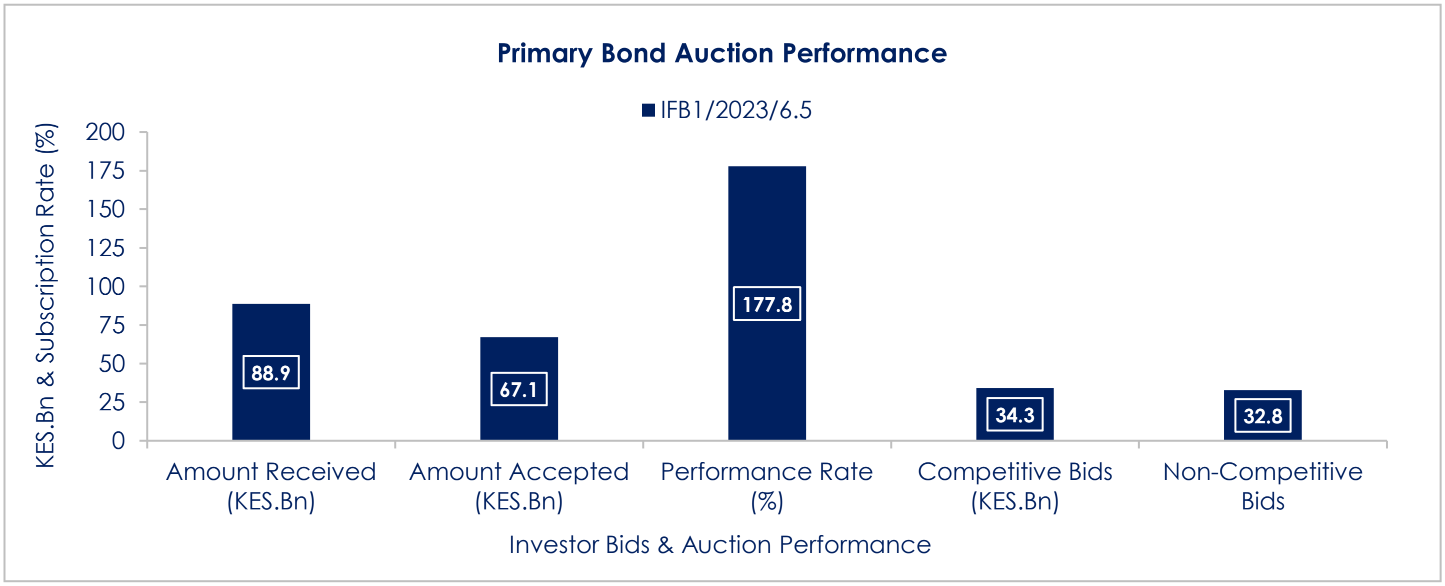
  ***Years to maturity**
  Weighted average term to maturity of 4.85 years

- The period of sale was from 20th October to 8th November 2023.
- This was the third and last IFB issue in 2023 and first issue of the 2023/24 fiscal year.
- Redemption will be in three tranches, with the first tranche of 50% redeemed in May 2027, second tranche of 30% redeemed in May 2029 and the remaining 20% at expiry in May 2030.

Subscription Rates

- The auction was oversubscribed with a performance rate of 177.8%, consistent with prediction in our November fixed income report (Figure.1).
- This is on account of its relatively attractive tenor, tax-free status, liquidity and its high potential for capital gains.
- As expected, investors priced in the Government's current fiscal deficit and the ensuing high interest rate environment which led to aggressive bidding at an average of 18.1037%.
- The Weighted Average Rate of Accepted bids fell at 17.9327% with an acceptance rate of 75.4%.

Figure.1: Primary Bond Auction subscription



Source: Central Bank of Kenya

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Weighted Average Rates

- We have compared our predicted Weighted Average Rates (WAR) ranges as indicated in our November 2023 Fixed Income Report with the CBK's accepted WAR and observe that our predictions were within the outcome of the auction (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)
IFB1/2023/6.5	17.80 - 17.99	17.9327	3.8

Source: Central Bank of Kenya

Our view

1) **Nairobi Securities Exchange (NSE) yield curve** - The yield curve remains inverted and the results of this auction means a further shift in the short end given that **IFB1/2023/6.5** effective tenor is 4.85 years.

   We note that the WAR of accepted bids for **IFB1/2023/6.5** (17.9327%) is higher than those of debt tenors of around 4.85 years by 45.5Bps (17.4777%) as at 3rd November 2023.

   This has been influenced by the:

   a) CBR revisions - From 7% in March 2022 to 10.5% in June 2023.

   b) Underperforming Government revenues which have resulted in a huge budget deficit. The Government also remains behind both its domestic and external borrowing targets.

   c) Investors demanding a higher return for capital invested due to rising inflationary pressure.

- Higher yields on the secondary bond market will prompt investors to price future primary bond auctions upwards meaning rising rates in subsequent auctions in the short term (At least 1 year).
- The above trend combined with the need to finance the budget deficit will force the CBK to continue accepting aggressive investor bids.

2) **Market Liquidity** - The CBK has solely been issuing reverse repos since the beginning of September 2023 in a bid to boost out liquidity in the market. The latest repo and reverse repo rates stood at 8.9% and 11.7% respectively as at 7th November 2023.

   We note that the adopted interest rate corridor that pegs the interbank rate within 250Bps of the CBR continues to be effective with the highest interbank rate hitting 12.3% thus far in November. Higher rates continue to be dissuaded by the CBK's discount window which currently sits at 400Bps above the CBR (14.5%).

   In layman's terms, this means that the inter-bank rate cannot presently move above or below 13% and 8% respectively with the CBK acting as a lender of last resort through the discount window at 14.5%.

We continue to note that a bulk of investor capital continues to be directed to the 91-day T-Bill as shown in the latest auction dated 6th November 2023.

3) **Investment Case** - We recommend the following fixed income investment strategies on account of rising interest rates:

   a) Invest in T-Bills and short-term bonds (below 3 years) to avoid locking capital for longer periods in a rising interest environment.

      The 91-day T-Bill appears to be the most attractive investment option under the current interest environment with a yield of 15.1863 per annum which is 8.5 and 25.3Bps below the 182 and 364-day T-Bill rates as at the most recent auction dated 6th November 2023.

      The comparatively high increases in subsequent auctions offers a good investment case for the 91 day T-Bill.

   b) Consider investing in high yielding new Infrastructure Bonds (IFB).

   c) Look out for bonds matching your maturity profile that are currently trading at huge discounts in the secondary market.

   d) Avoid revaluation losses (selling bonds at lower prices than their purchase prices) by holding on to your existing bond investment portfolio till maturity if possible.

   e) We advise active traders and investors with high risk tolerance and US$ liquidity to consider buying the Kenya Eurobonds **XS1028952403** maturing in June 2024 with a current yield of 15.4406% as at 9th November 2023.

4) **Secondary market trading** - We see a moderate to high likelihood of a tap sale for this debt issue which should have a bearing on its trading patterns in the secondary market.

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