Thursday, 02 November 2023

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

November 2023

"No surprise as CBK floats last IFB of 2023"

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Executive Summary

- Our fixed income report for the month of November 2023 titled **"No surprise as CBK floats last IFB of 2023"** is an analysis of the Central Bank of Kenya's (CBK's) third and first infrastructure bond **(IFB1/2023/6.5)** in 2023 and 2023/24 fiscal year respectively.
- The IFB with a weighted average term to maturity tenor of 4.85 years seeks to raise KES.50Bn for the purpose of funding infrastructure projects in the FY2023/2024 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: 17.80% - 17.99%

- 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 2023/24 fiscal year with new rules

- The Central Bank of Kenya (CBK) has invited bids for a 6.5-year amortized Infrastructure Bond **(IFB1/2023/6.5)**, with a market-determined coupon to raise KES.50Bn (Table.1).
- This is the third IFB issue in 2023 and first issue in 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.
- An oversubscription is expected on account of the relatively attractive tenor, tax-free status, liquidity and capital gains potential.
- We note that the implied yield on a debt tenor with 4.85 years to maturity is 17.5056% but this related mainly to Treasury Bonds (T-Bonds) which are subject to withholding tax of 15%.
- In recent times, we have however seen IFBs (tax exempt) with yields relatively similar to T-Bonds and this should be the case of the latest debt issue.

Table.1: Infrastructure Bond issue summary

Issue Number	**IFB1/2023/6.5**
Total Amount Offered	KES.50Bn
Tenor (Years)	6.5
Effective Tenor (Years)	4.85
Coupon Rate (%)	Market Determined
Issue Price	Discounted/Premium/Par
Period of Sale	20th October 2023 to 8th November 2023
Auction Date	8th November 2023
Value Date	13th November 2023
Yield Curve (%) (Weighted Average tenor - 4.85 years) 31st October 2023	**17.5056**

Source: Central Bank of Kenya & Sterling Capital Research

- We take note of a few changes in the auction terms of **IFB1/2023/6.5** a move we attribute to CBK's strategy of encouraging new investors (particularly retail), discouraging aggressive investor bids, encouraging Non-Competitive bids and thus managing the cost of borrowing (Table.2).
- The first and third changes have also been effected in the Treasury Bill (T-Bill) auctions with maximum Non-Competitive bids per CDS account unchanged at KES.20Mn.

Table.2: Key changes in prospectus terms

Change	**Bond prospectus terms**	**Previous**	**New**
1.	Minimum competitive bid per CDS account	No minimum	KES.2Mn
2.	Maximum Non-competitive bids per CDS account	KES.20Mn	KES.50Mn
3.	Minimum face value of Non-Competitive individual bids	KES.100,000	KES.50,000

Source: Central Bank of Kenya

IFB1/2023/6.5 amortized redemption structure

- **IFB1/2023/6.5** amortized redemption structure is equivalent to a tenor of 4.85 years (Table.3).

Table.3: Effective debt tenor is 4.85 years

Redemption Period	% of principal	Tenor Calculation	Weighted Tenor
3.5 Years (Nov 2023 - May 2027)	50%	50%*3.5 years	1.75 years
5.5 Years (Nov 2023 - May 2029)	30%*(100%-50%) = 15%	15%*5.5 years	0.825 years
6.5 Years (Nov 2023 - May 2030)	[1-(50%+15%)] = 35%	35%*6.5 years	2.275 years
Effective tenor			1.75 + 0.825 + 2.275 = 4.85 years

Source: Central Bank of Kenya & Sterling Capital Research

Our market weighted average bid predictions

- In the absence of benchmark issues for this debt issue, we arrived at our market-weighted average rate of accepted investor bid prediction using a combination of NSE implied yields of securities as at 31st October 2023 as well as views of fixed income traders and other market players (Table.4).

Table.4: Auction bid predictions

Rate	IFB1/2023/6.5
Market Weighted Average bid prediction (%)	17.80 - 17.99

Source: Sterling Capital Research

Historical debt issues guide our predicted rates

- We note overall high subscription rates for previous IFB issues (Table.5).
- The most recent IFB issues **IFB1/2023/17** and **IFB1/2023/7** recorded 119.5% and 367.5% subscription rates respectively.

Table.5: Historical IFB primary market auction performance

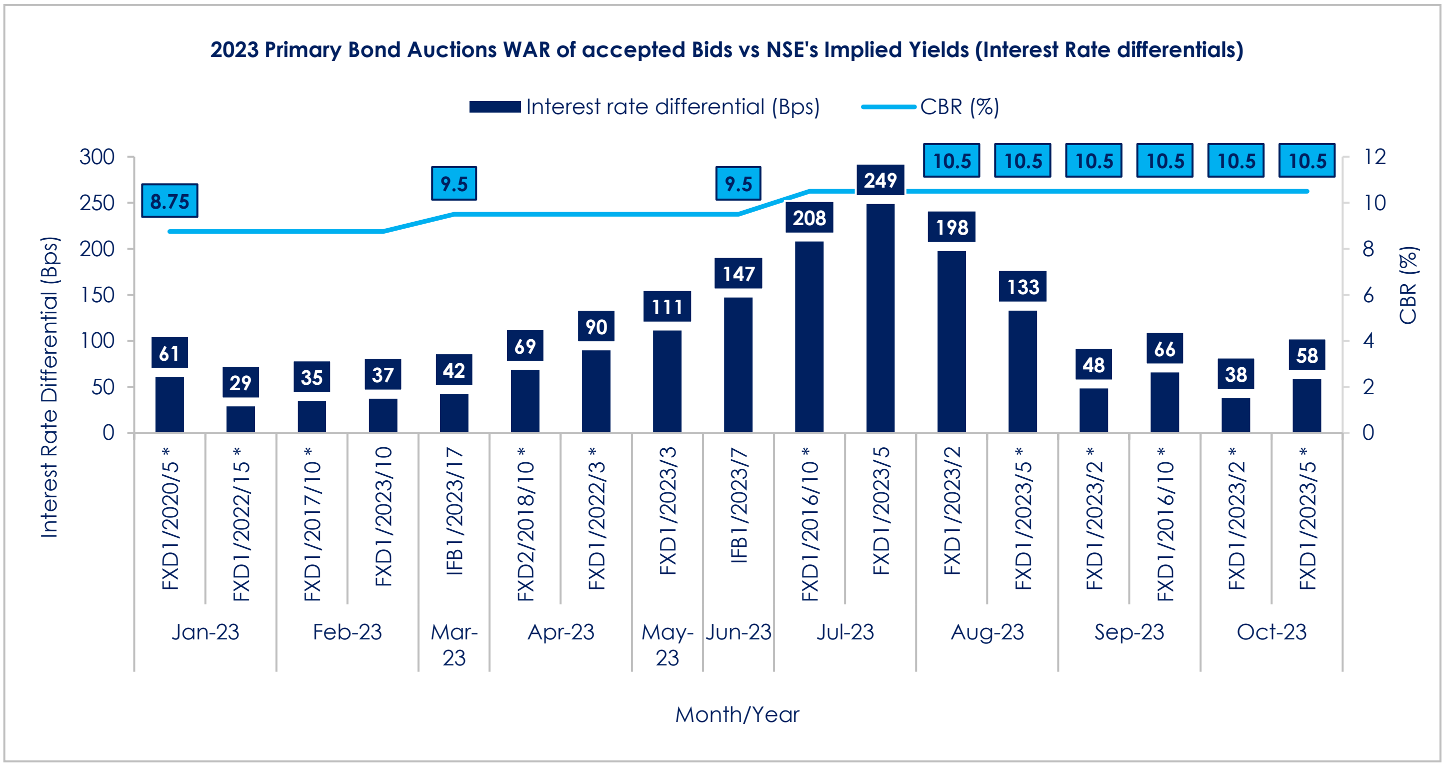
Issue	Issue Date	Offered (KES.Bn)	Bids Received (KES.Bn)	Amount Accepted (KES.Bn)	Performance Rate (%)	Coupon Rate (%)	Implied Yield (%)
IFB1/2014/12	Oct-2014	15	38.8	15.8	258.7	11.00	12.5525
IFB1/2015/12	Mar-2015	25	51.7	25.7	206.8	11.00	12.7500
IFB1/2015/12 (Tap)	Apr-2015	25	51.7	24	206.8	11.00	12.7500
IFB1/2015/9	Dec-2015	30	16.6	14	55.3	11.00	12.5500
IFB1/2016/9	May-2016	30	39.4	34.9	131.3	12.50	12.3000
IFB1/2016/15	Oct-2016	30	35.1	30.6	117	12.00	14.3400
IFB1/2017/12	Feb-2017	30	35.0	6	116.7	12.50	12.9000
IFB1/2017/12 (Tap)	Mar-2017	24	8	7.6	33.3	12.50	12.9000
IFB1/2017/7	Nov-2017	30	45.9	42.0	153	12.50	12.2100
IFB1/2018/15	Jan-2018	40	55.8	5	139.5	12.51	13.6500
IFB1/2018/15 (Tap)	Feb-2018	35	36.2	36.2	103.4	12.51	13.6500
IFB1/2018/20	Nov-2018	50	40.4	27.6	80.8	11.95	14.5000
IFB1/2018/20 Tap	Nov-2018	22.4	8.8	8.7	39.3	11.95	14.5000
IFB1/2019/25	Mar-2019	50	29.4	16.3	58.8	12.20	14.0250
IFB1/2019/16	Oct-2019	60	86.9	68.5	144.8	11.75	14.8500
IFB1/2020/9	Apr-2020	60	68.4	39	114	10.85	14.0125
IFB1/2020/9 (Tap)	Apr-2020	21	37.8	35.4	180	10.85	14.0125
IFB1/2020/6	Jun-2020	26	21.2	19.3	81.5	10.20	12.4000
IFB1/2020/11	Aug-2020	70	101.5	78.6	145	10.90	15.0000
IFB1/2021/16	Jan-2021	50	125.5	81.1	251	12.26	15.3851
IFB1/2021/18	Apr-2021	60	88.6	81.9	147.7	12.67	14.5052
IFB1/2021/21	Sep-2021	75	151.3	106.8	201.7	12.74	14.5505
IFB1/2022/19	Feb-2022	75	132.3	98.6	176.3	12.97	14.1875
IFB1/2022/18	Jun-2022	75	76.4	73.8	101.8	13.74	14.3525
IFB1/2022/18 (Tap)	Jul-2022	20	6.4	6.4	32.1	13.74	14.3525
IFB1/2022/14	Nov-2022	60	91.8	75.6	153.1	13.94	14.8100
IFB1/2022/14 (Tap)	Nov-2022	5	19.1	19.1	382	13.94	14.8100
IFB1/2022/6 (Switch)	Dec-2022	20	10.8	10.8	54	13.22	13.2533
IFB1/2023/17	Mar-2023	50	59.8	50.9	119.5	14.40	15.0067
IFB1/2023/17 (Tap)	Mar-2023	20	12.7	12.7	63.5	14.40	15.0067
IFB1/2023/17 (Tap)	Apr-2023	10	5.1	5.1	51	14.40	15.0067
IFB1/2023/7	Jun-2023	60	220.5	213.4	367.5	15.837	15.5083

Source: Central Bank of Kenya

Primary bond auction differentials have narrowed in recent auctions

- We note that there has been a general decline in the difference between the WAR of accepted bids and the NSE's implied yields in recent months (Figure.1).
- This indicates some degree of stability in the rise in interest rates also taking into consideration that most auctions have been for re-opened debt issues with a more or less pre-determined yields leaving less room for speculative bidding.

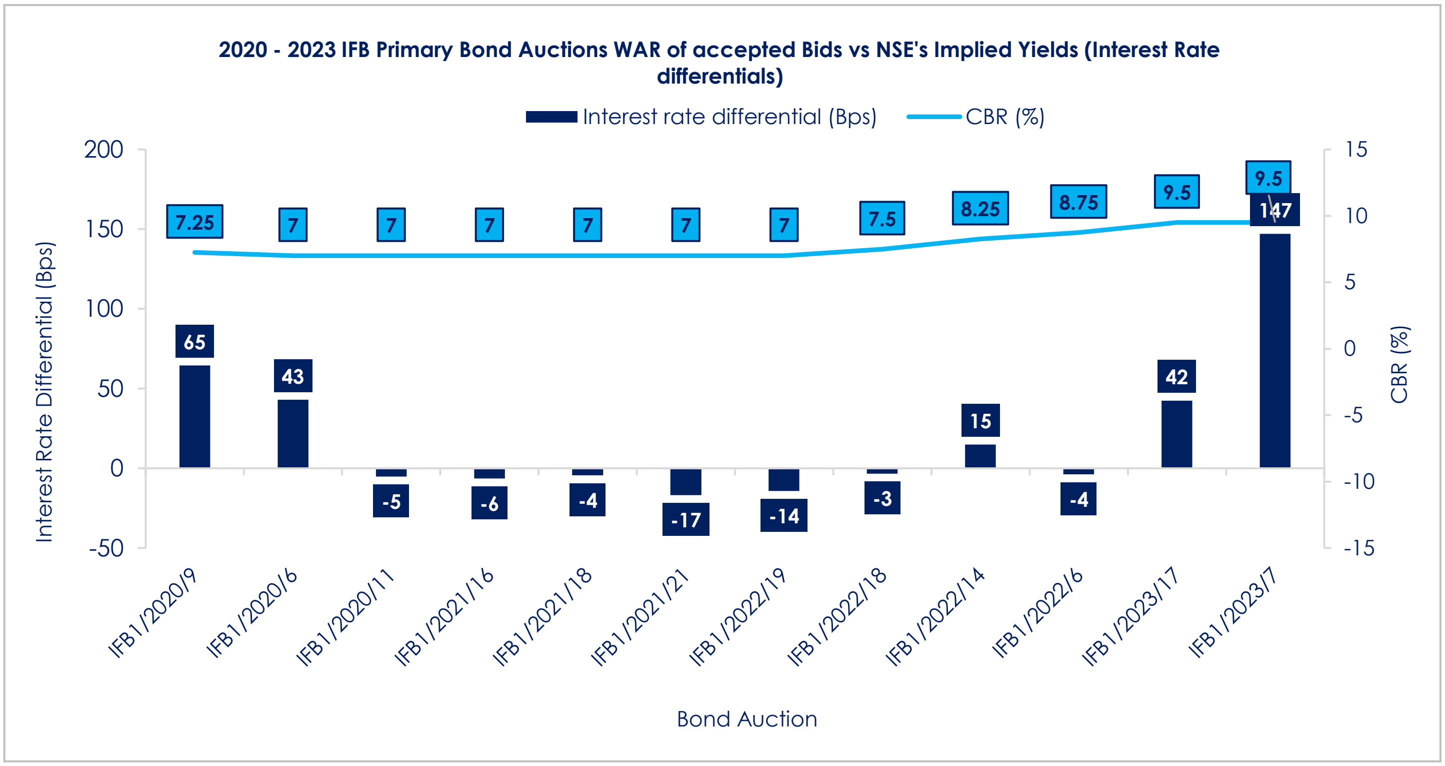
Figure.1: The difference between WAR of accepted bids and NSE's implied yields have declined



Source: Central Bank of Kenya

- With regards to IFBs, we note that there has been a significant difference between the WAR of accepted bids and the NSE's implied yields in recent auctions (Figure.2).
- Most notable was the 147Bps differential for **IFB1/2023/7** which we attribute to aggressive bidding on speculation of an upward CBR revision, which was actioned from 9.5% to 10.5%.
- We however see a decline in the differential just like has been the case in recent auctions with interest rates normalizing.

Figure.2: The difference between WAR of accepted bids and NSE's implied yields have declined

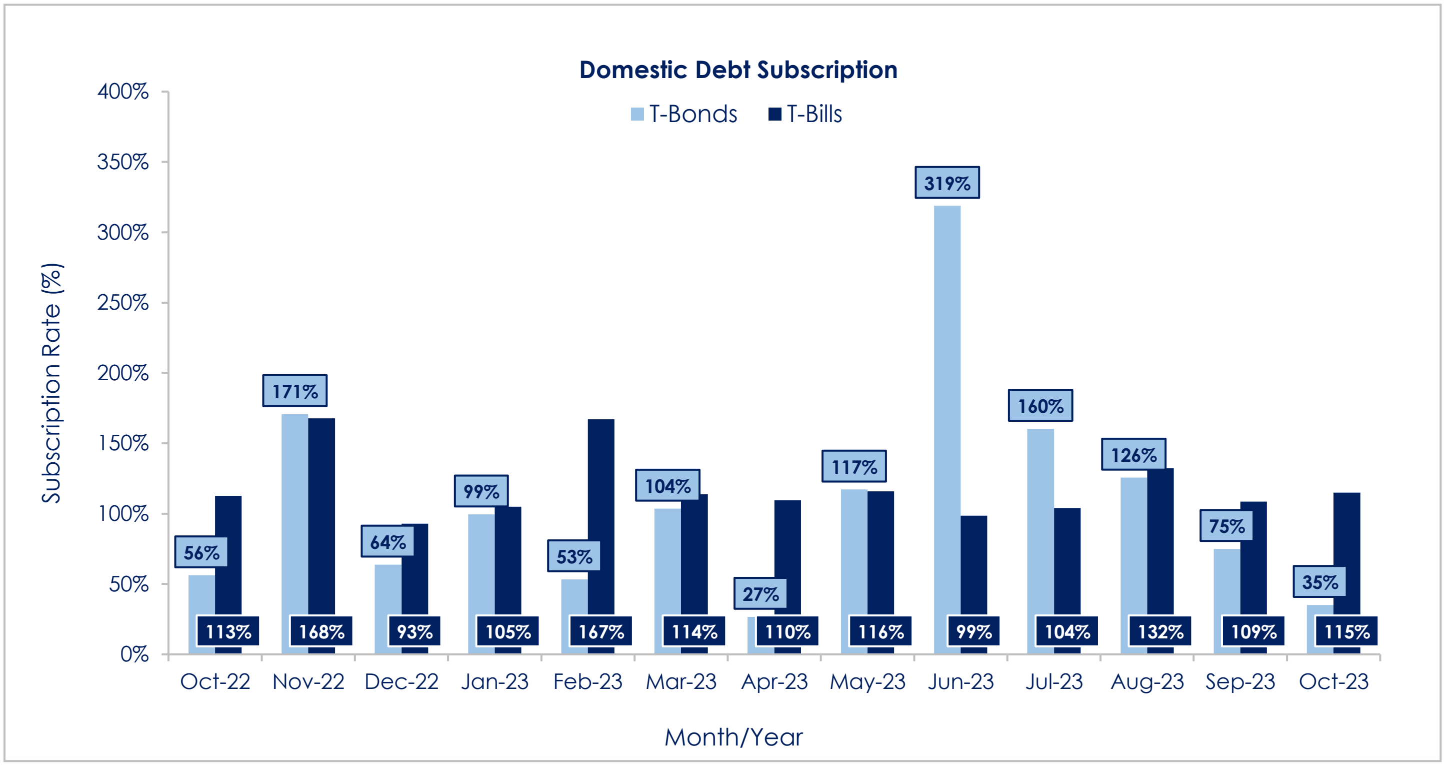


Source: Central Bank of Kenya

Demand for domestic debt issues declines in October 2023

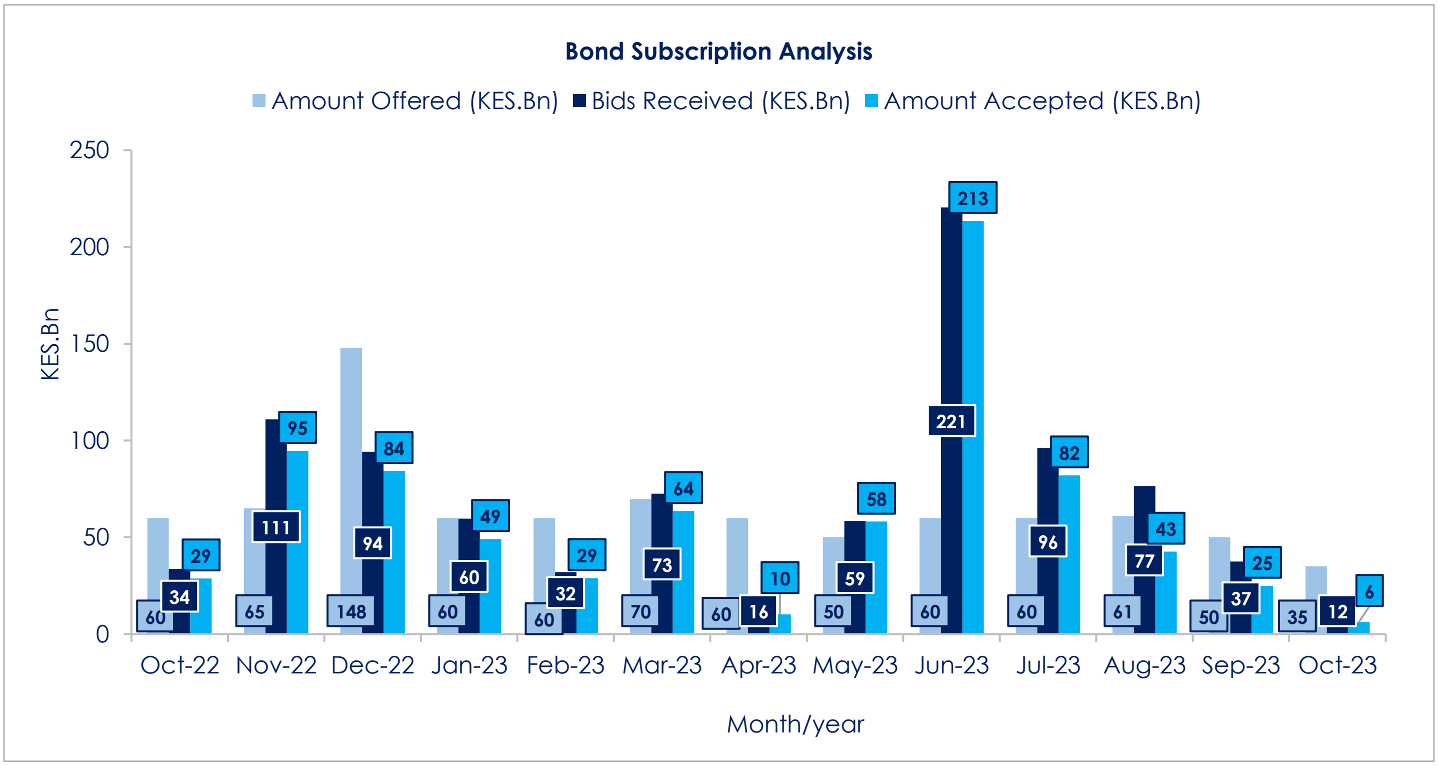
- Total demand for domestic debt (both T-Bills and bonds) increased 5.9% to KES.150.1Bn in October compared to KES.141.8Bn in September with this growth largely attributable to an increase in T-Bill subscription.
- T-Bills subscription over the same period stood at 114.8% compared to 108.6% in September with KES.137.8Bn worth of bids received against KES.120Bn offered (Figure.3).
- The 91, 182 and 364-Day T-Bills recorded 556.4%, 28.9% and 24.1% in subscription rates compared to 565.6%, 11.2% and 23.3% in September 2023 respectively.
- However, T-Bond demand declined to 35.1% from 74.9% in September with KES.12.3Bn received in bids against the KES.35Bn offered probably due to the expectations of an IFB issue in November (Figure.4).

Figure.3: T-Bond subscription on a declining trend since beginning of Fiscal Year 2023/24



Source: Central Bank of Kenya

Figure.4: T-Bond subscriptions dip in October 2023 in anticipation of November IFB

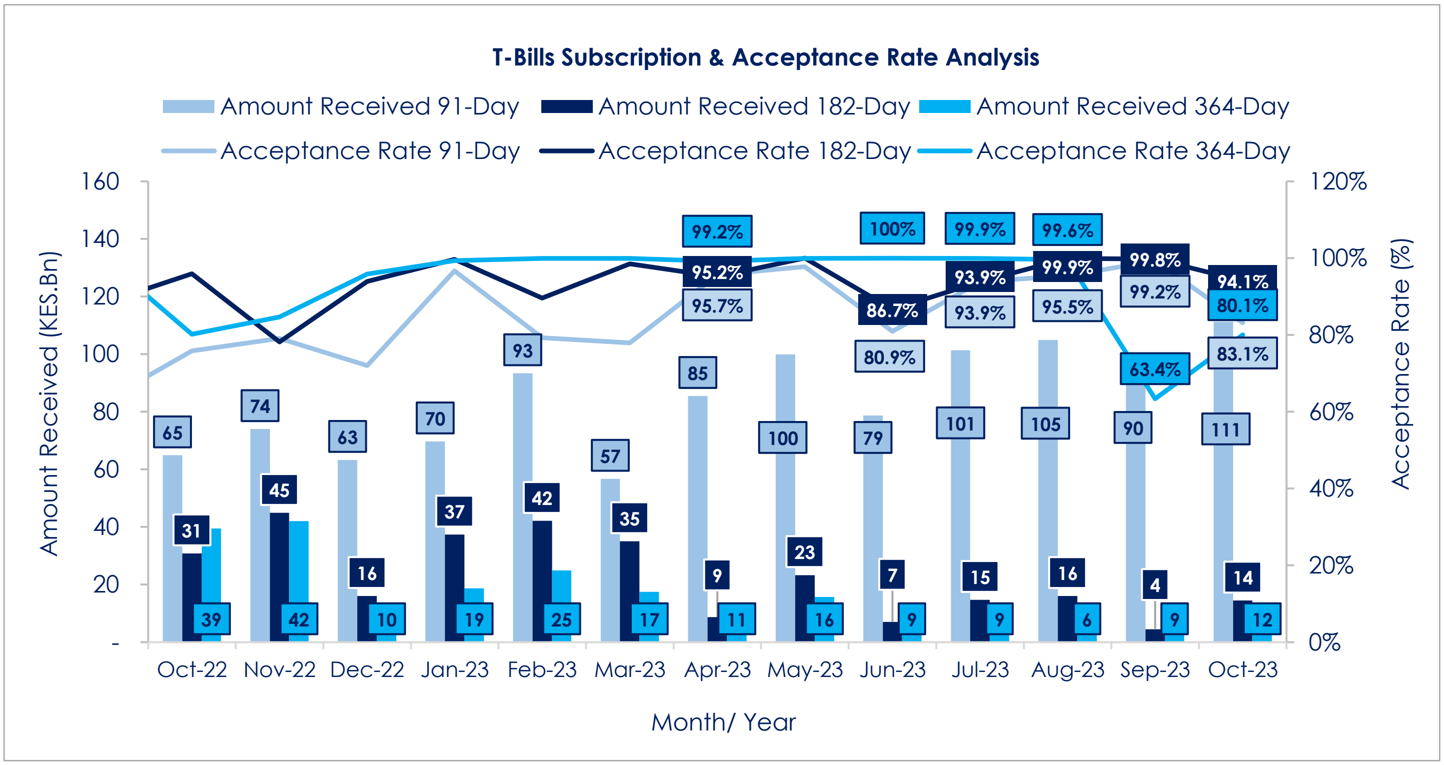


Source: Central Bank of Kenya

Decline in the 91 and 182-Day T-Bill acceptance rates in October 2023

- The CBK's acceptance rate for the 91-Day, 182-Day and 364-Day T-Bills stood at 83.1%, 94.1% and 80.1% in October 2023 (Figure.5).
- While T-Bill acceptance rates for the 91-Day and 182-Day declined when compared to 99.2% and 99.8% performance in September 2023, the 364-Day T-Bill rate rebounded from 63.4% over the same period.
- We attribute the latter to the CBK's strategy of rejecting aggressive bids to control the rise in interest rates.

Figure.5: 364-Day T-Bill acceptance rate rebounds in October 2023

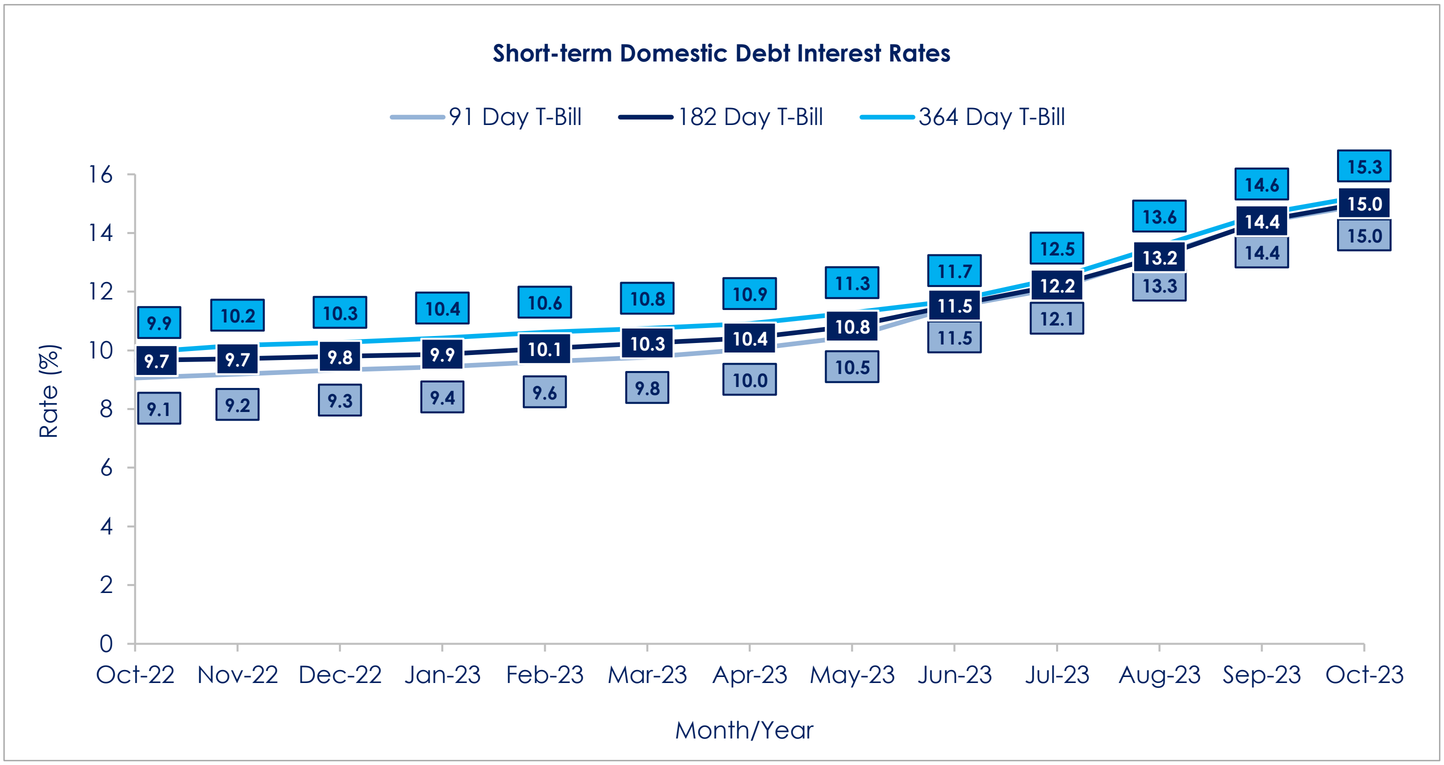


Source: Central Bank of Kenya

Average T-Bill rates cross 15% in October 2023

- T-Bill rates continued in an upward trajectory in October 2023 with the average 91, 182 and 364-Day rates up to 15%, 15% and 15.3% from 14.4%, 14.4% and 14.6% in September 2023 respectively (Figure.6).
- This as mentioned earlier is attributable to upward CBR revisions, high budget financing needs, relatively high inflation as well as investor expectations.

Figure.6: T-Bill rates hit 15% in October 2023

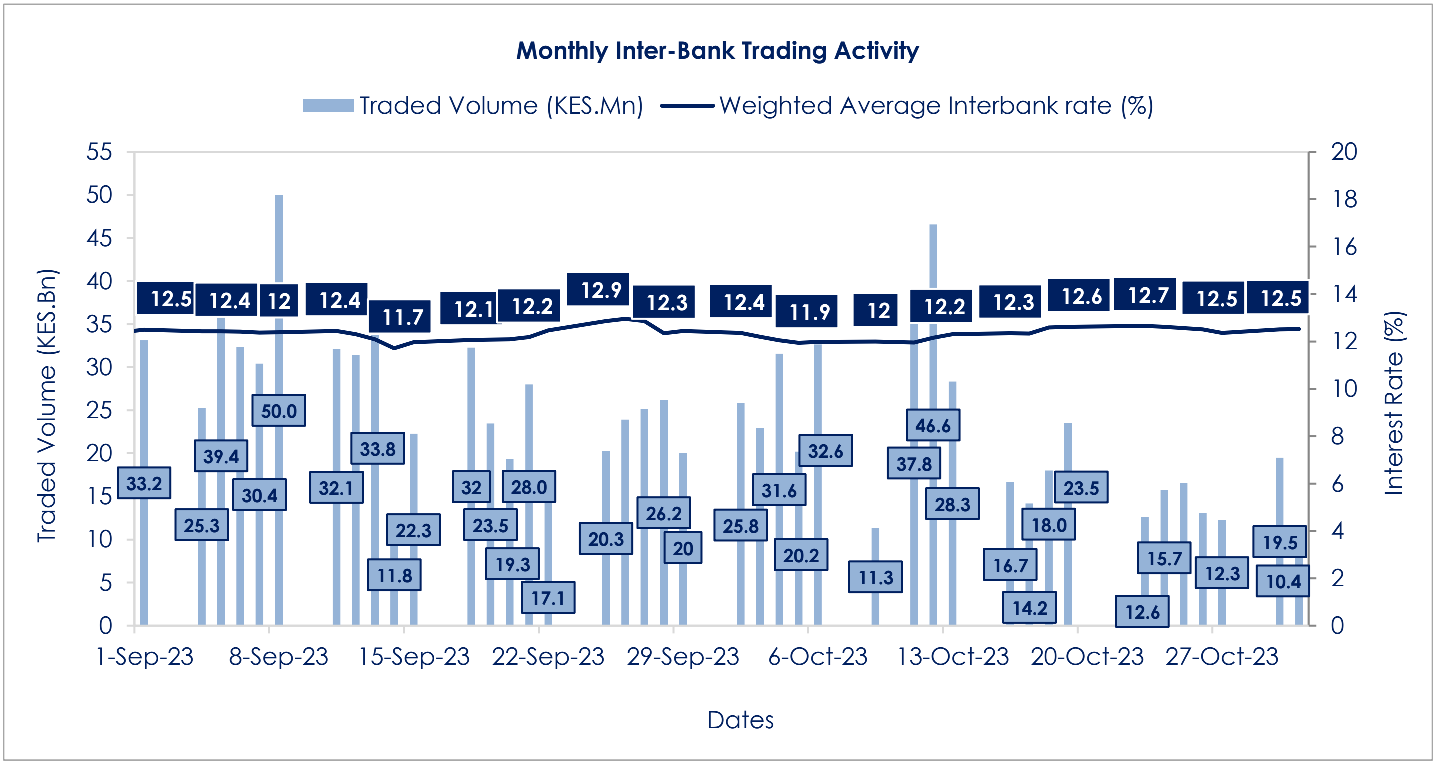


Source: Central Bank of Kenya

Average interbank rates and volumes decline in October 2023

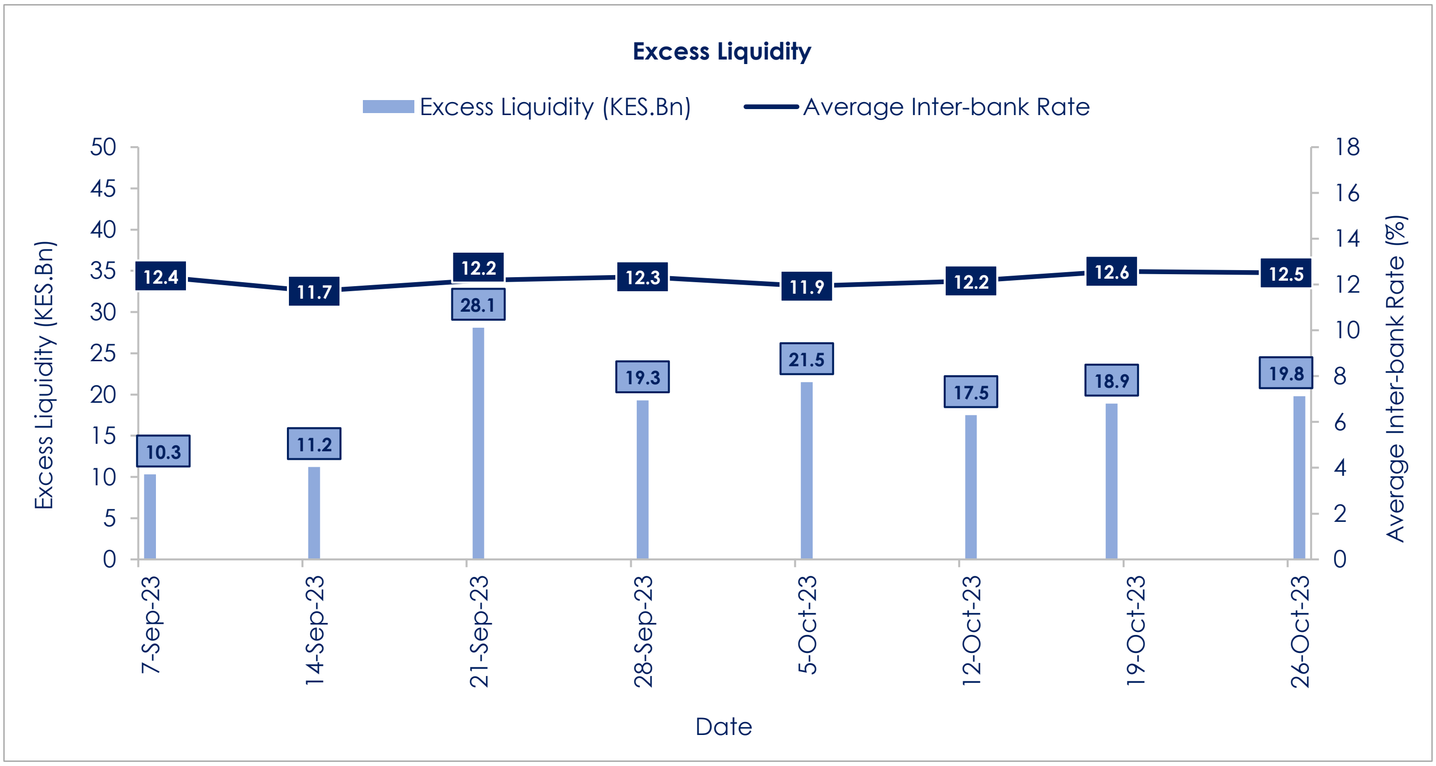
- Average inter-bank rates declined slightly to 12.33% in October compared to 12.35% in September (Figure.7).
- Trading volumes also declined 25.6% to KES.429.8Bn (KES.577.7Bn in September).
- Over the same period, excess reserves which is the additional liquidity above the minimum 4.25% Cash Reserve Ratio (CRR) rose 12.8% to KES.77.7Bn (Figure.8).

Figure.7: Average inter-bank lending rates slightly decline in October 2023



Source: Central Bank of Kenya

Figure.8: Excess commercial bank reserves ticks up further in October 2023

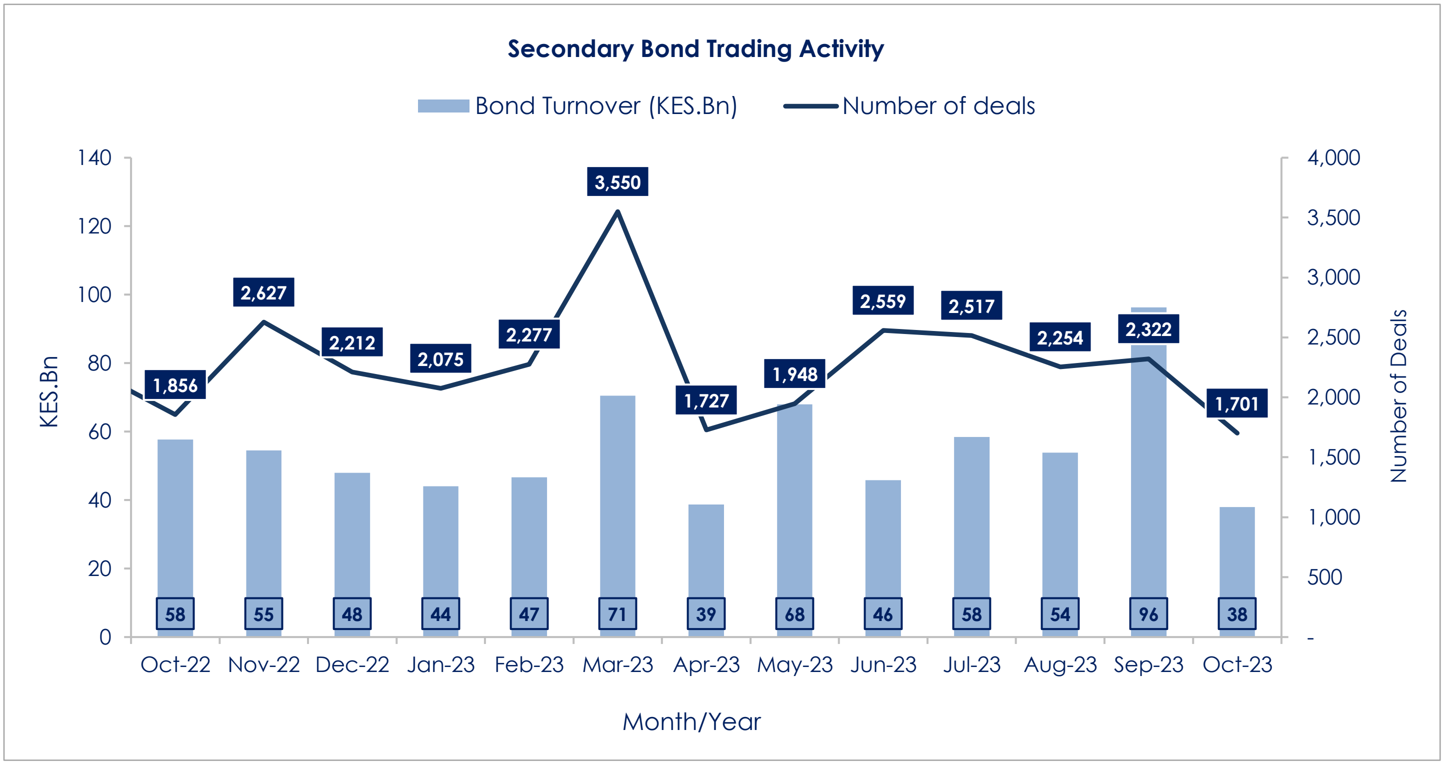


Source: Central Bank of Kenya

October Bond turnover lowest since April 2023

- Secondary bond market turnover and number of deals declined 60.5% and 26.7% respectively to KES.38Bn and 1,701 in October 2023 from KES.96.2Bn and 2,322 the previous month (Figure.9).
- The decline can be attributed to the low trading activity of the recent re-opened short term debt issues and increased interest in the 91-Day T-Bills given rising yields.

Figure.9: Secondary trading activity declines 60.5% in October 2023

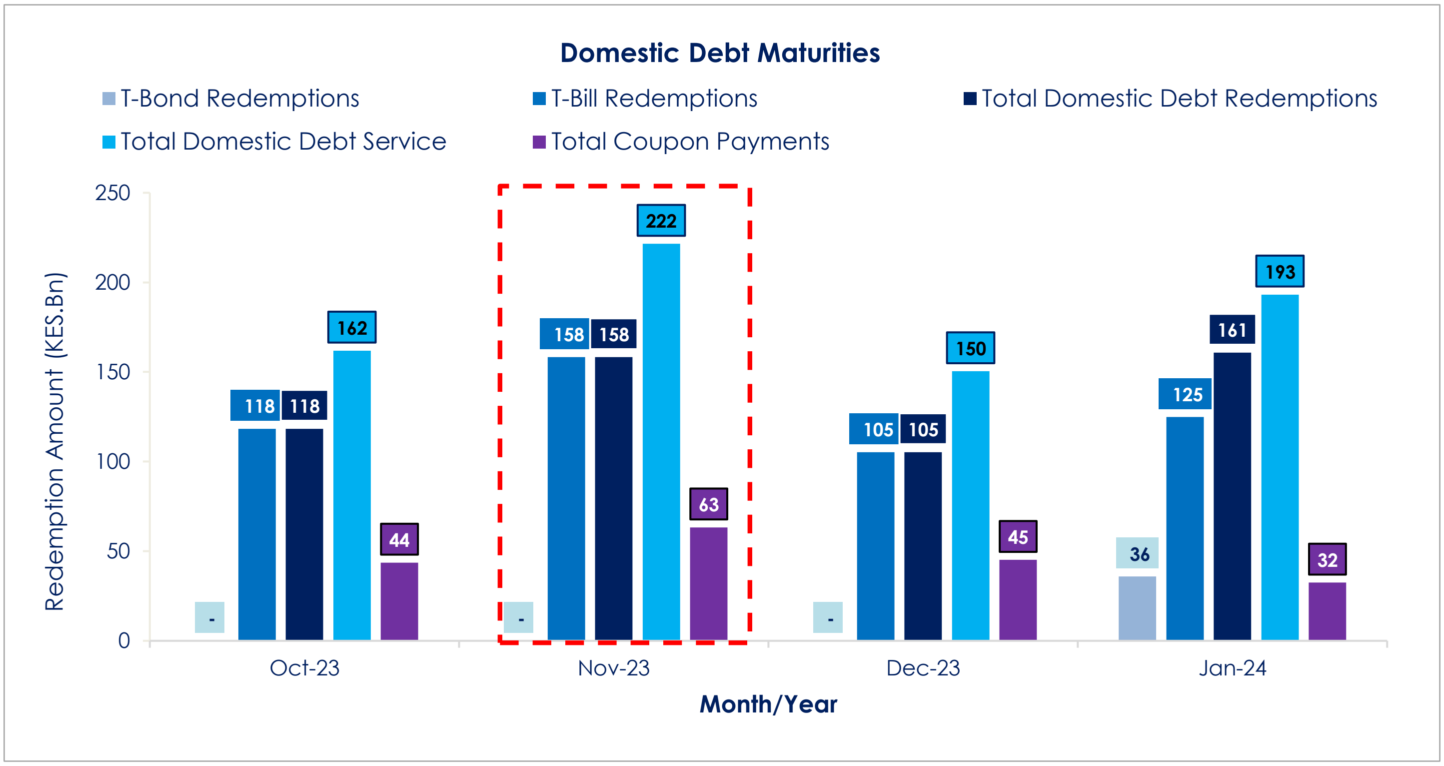


Source: Central Bank of Kenya

Domestic debt service to increase sharply in November 2023

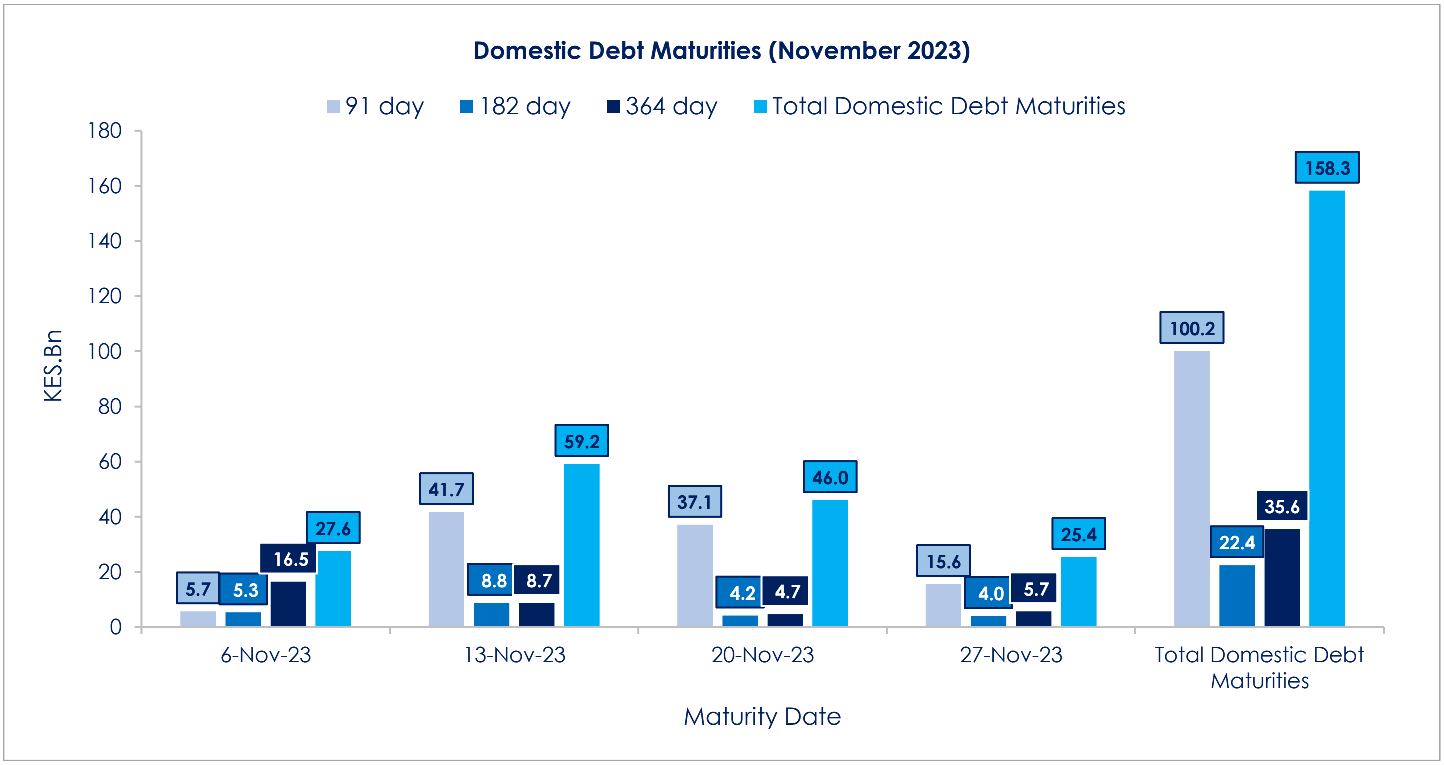
- Total domestic debt service will increase 36.8% in November 2023 to KES.221.5Bn from KES.162Bn in October 2023. (Figure.10).
- This includes KES.158.3Bn and KES.63.3Bn in T-Bill redemptions and coupon payments respectively.
- Redemptions for the 91, 182 and 364-day T-Bills amount to KES.100.2Bn, KES.22.4Bn and KES.35.6Bn respectively with the second week of the month having the highest redemptions at KES.59.2Bn (Figure.11).

Figure.10: Uptick in debt service set for November 2023 with a steep rise in T-Bill redemptions



Source: Central Bank of Kenya

Figure.11: Second week of November 2023 with highest T-Bill redemption at KES.59.2Bn



Source: Central Bank of Kenya

Actual 2023/24 domestic borrowing remains above our linear target run rate

- Government receipts data at the end of the third month of the 2023/24 fiscal year (Q3 20223/24) shows underperformance of tax revenue, domestic borrowing external loans and grants and overall receipts (Table.6 & Figure.12).
- This is a concern even at this early stage of the fiscal year.
- In previous reports we have stated that 27% year on year increase in tax and overall revenue is overly optimistic given the challenging economic environment and this will translate to increased deficit financing.
- Based on the KES.2.495Tn fiscal year tax revenue target, we can assume that tax revenue has fallen KES.110Bn short of its linear target run rate.
- With regards to the annual receipts for the year, the Government is running a deficit of KES.287.8Bn having raised KES.745.4Bn in Q1 2023/24.

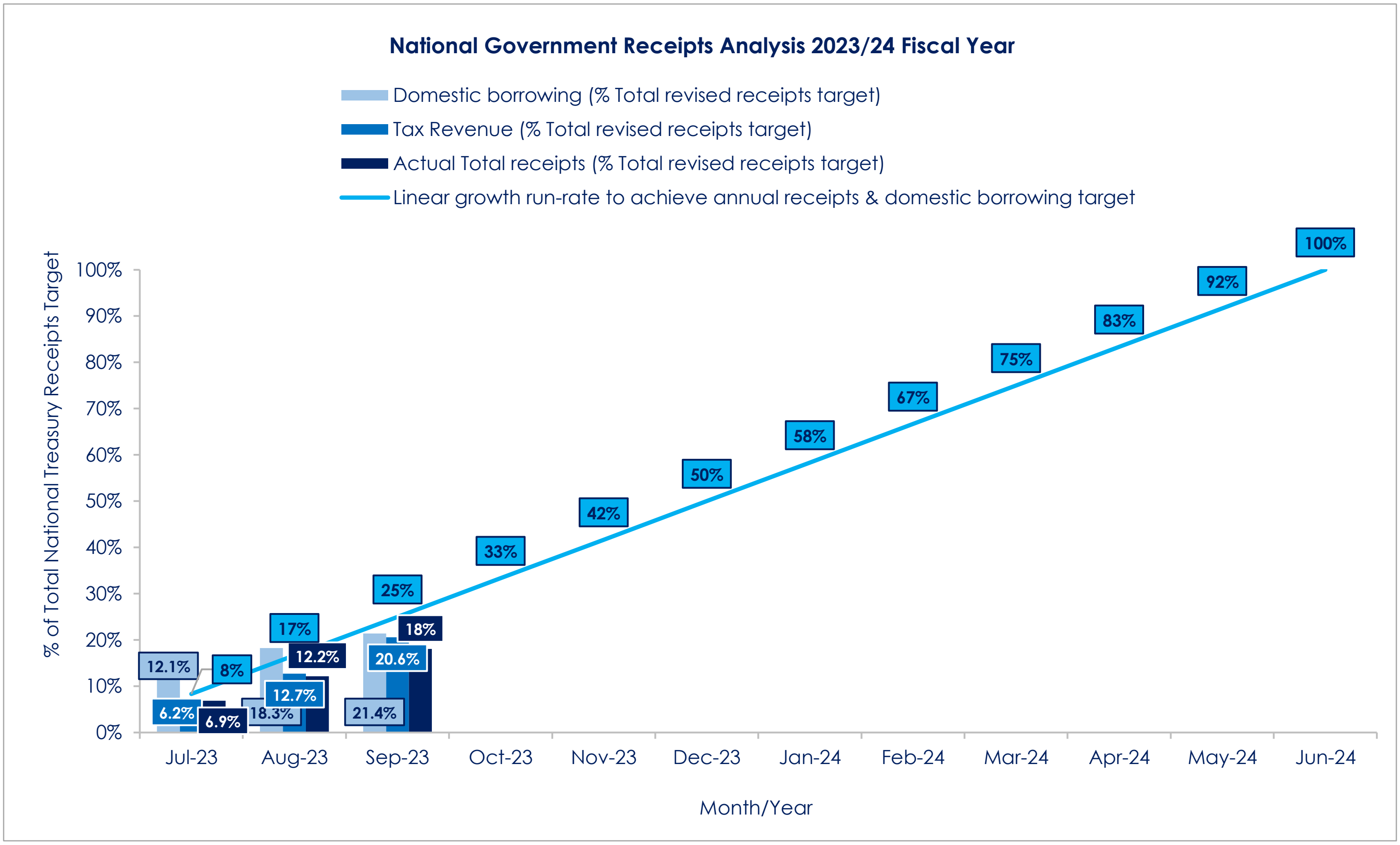
Table.6: Q1 2023/24 Total revenue remains below linear target run rate

Receipts	Actual Receipts 2022/23 (KES.Mn)	Original Estimates 2023/24 (KES.Mn)	Variation 2023/24 vs Actual 2022/23	Actual Receipts (KES.Mn) 29th September 2023	Proportion of Total Receipts 29th September 2023
Opening Balance (1st July)	616.5			2.6	
Tax Revenue	**1,962**	**2,495.8**	**27.2%**	**514.3**	**20.6%**
Non-Tax Income	82	75,3	**-8.2%**	23.1	30.6%
Domestic Borrowing*	**696.4**	**688.2**	**-1.2%**	**147.2**	**21.4%**
External Loans & Grants	488.3	870.2	**78.2%**	57.8	6.6%
Other Domestic Financing	16.1	3.2	**-80.1%**	3	95.4%
Total Revenue	**3,244.8**	**4,132,7**	**27.4%**	**745.4**	**18%**
Linear Run Rate target 2023/24 (3 months of fiscal year)					**25%**

* Note 1: Domestic Borrowing of KES.688.2Bn = Net Domestic borrowing KES.313.7Bn & Internal Debt Redemptions (Roll-overs) KES.374.5Bn

Source: The Kenya Gazette Vol. CXXV - No.225 13th October 2023

Figure.12: All Q1 2023/24 Government receipts below linear target run rate

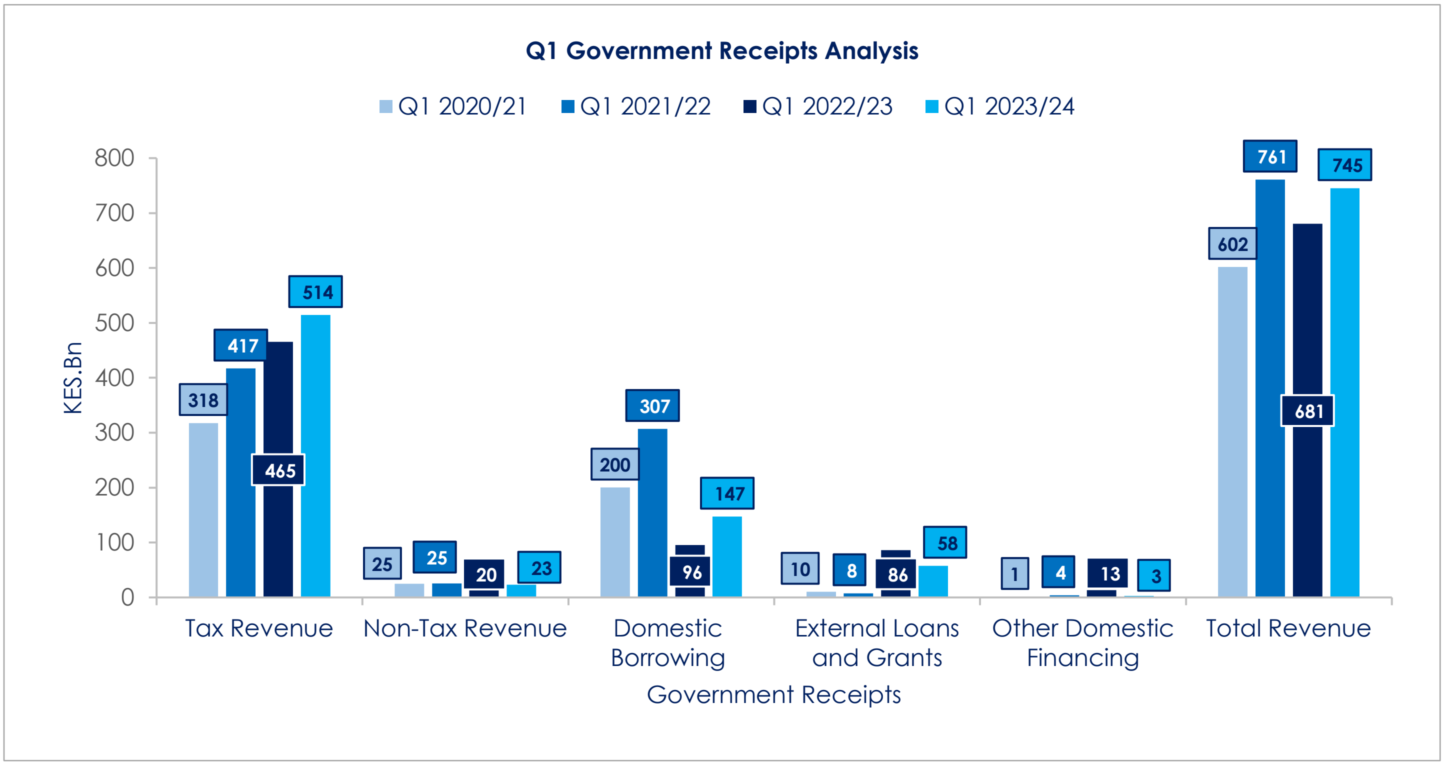


Source: The Kenya Gazette Vol. CXXV - No.225 13th October 2023

Quarterly Government receipts data highlights 2023/24 revenue growth challenge

- We have analysed Government receipts in the first quarter of the fiscal years beginning with 2020/21 to emphasis the difficulty faced by Government to meet its ambitious 2023/24 revenue targets (Figure.13).
- From this analysis we even observe that total revenue Q1 2021/22 although largely driven 52% growth in domestic borrowing was 2% higher than Q1 2023/24.
- Tax revenue for the current fiscal year has also increased by a comparatively modest 9.5% over 2022/23 keeping in mind that the fiscal year's target is 27.2% higher.
- The above means that we should continue seeing increased effort by the tax authorities to increase tax collection as well as increased domestic and external borrowing.
- This also means upward pressure on domestic interest rates which the Government through the CBK wishes to contain.

Figure.13: Q1 Government receipts data shows sluggish revenue growth in 2023/24

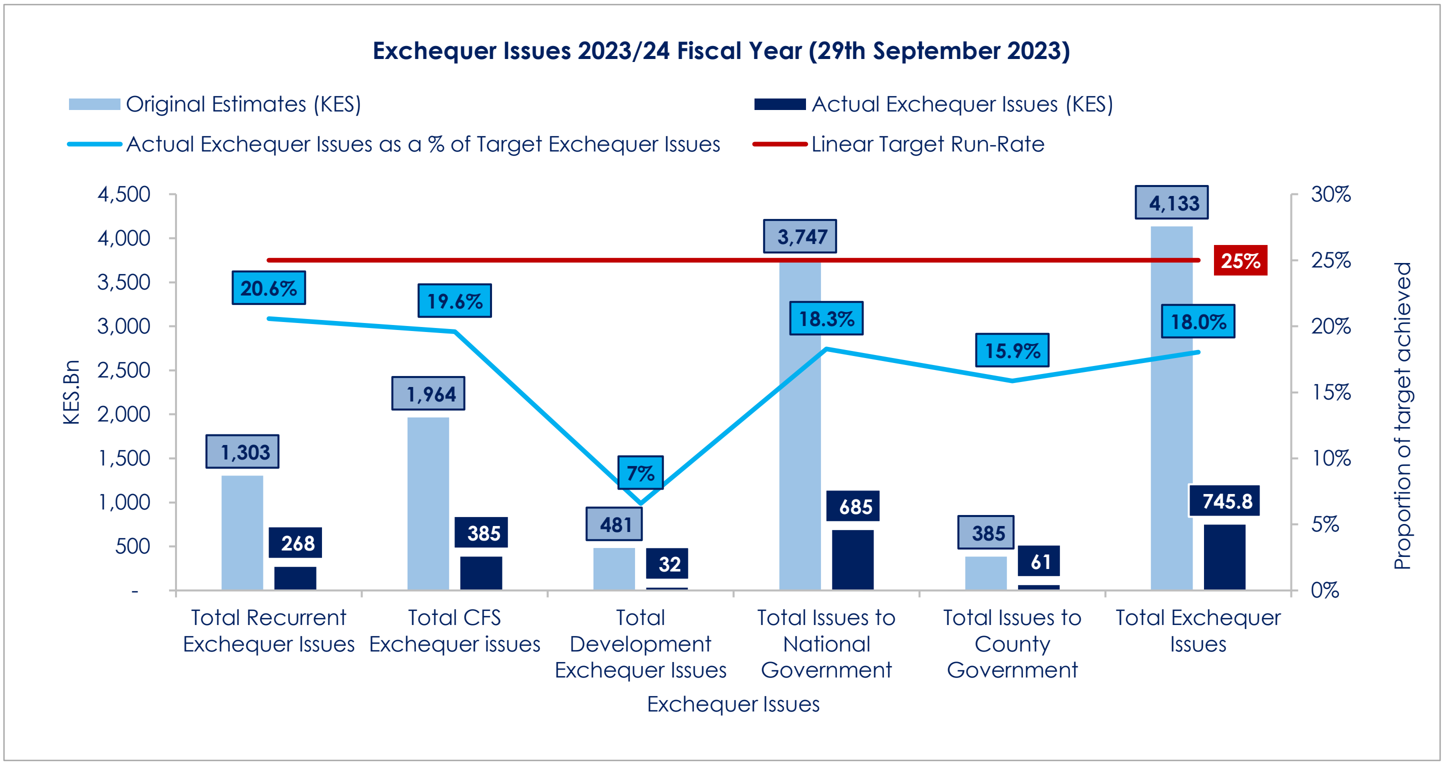


Kenya National Treasury

2023/24 exchequer issues fell below revised targets

- All e exchequer issues remain below our linear target run rate of 25% after Q1 2023/24 (Figure.14).
- As has been the case for recent periods, this is largely due to the underperformance of revenues with Government particularly cutting down on development expenditure which has the lowest performance.

Figure.14: Total 2023/24 exchequer issues constrained by slow growth in Government revenue

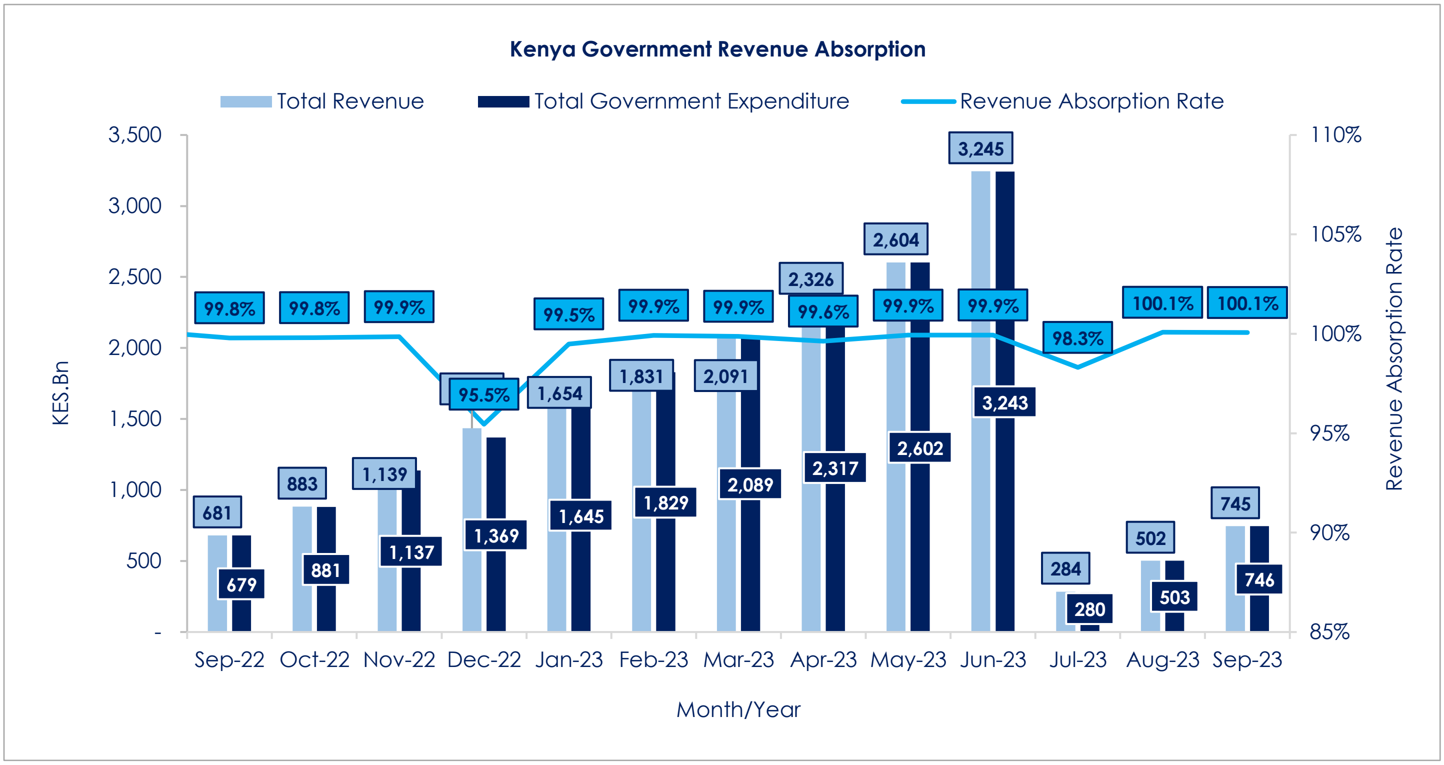


Source: The Kenya Gazette Vol. CXXV - No.225 13th October 2023

Full Government revenue for the second month running

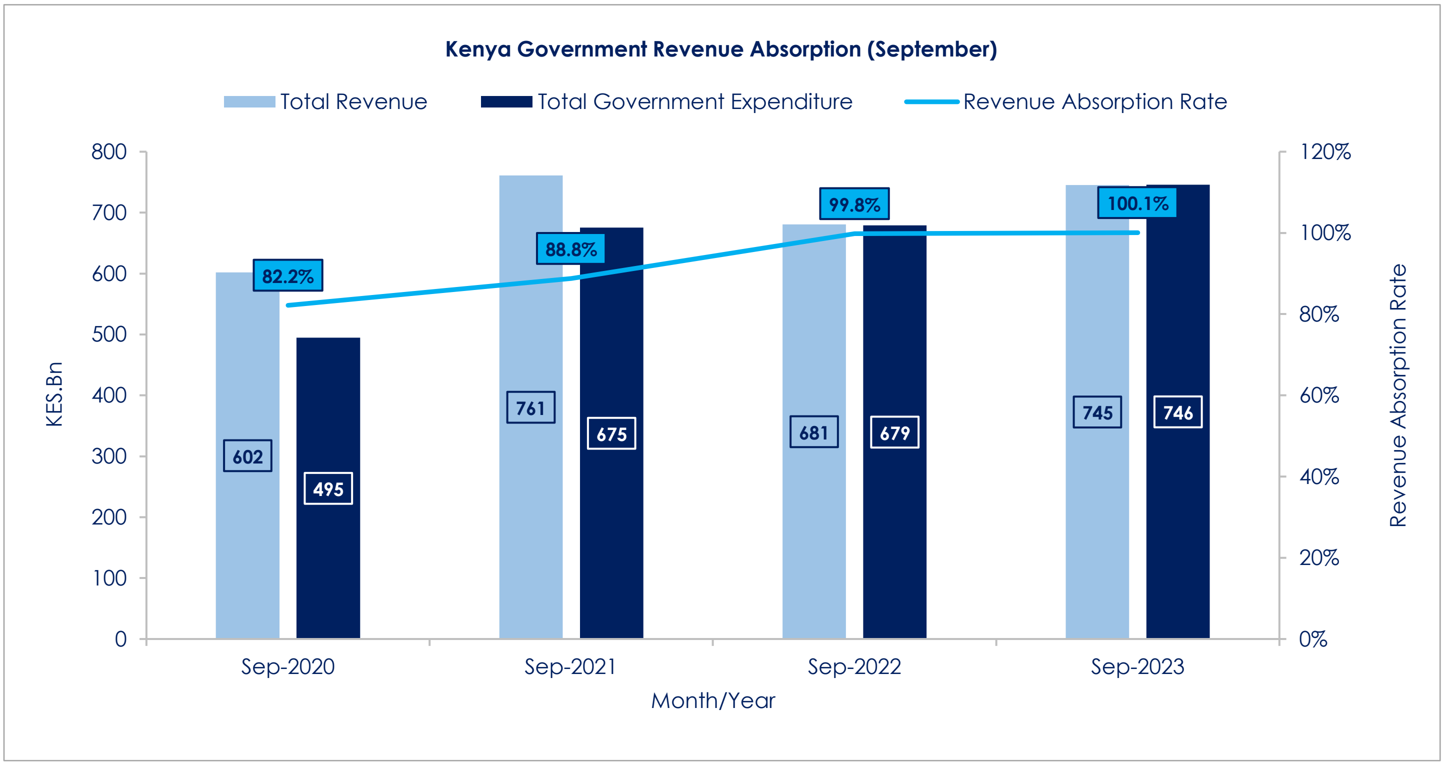
- For the second month running we observe full Revenue Absorption Rate (RAR) in September 2023 (Figure.15).
- As mentioned earlier in the report, this points to revenue constraints with all Government receipts being used to meet its expenditure.
- Likewise, this also means that the CBK will face pressure to raise capital to the debt market while the tax authorities will be strained to increase tax revenues.
- On a year on year comparison, we see higher revenue absorption in the current compared to previous years (Figure.16).

Figure.15: Full Revenue Absorption Rate reported in September 2023



Source: The Kenya Gazette Vol. CXXV - No.225 13th October 2023

Figure.16: 100% revenue absorption in September 2023

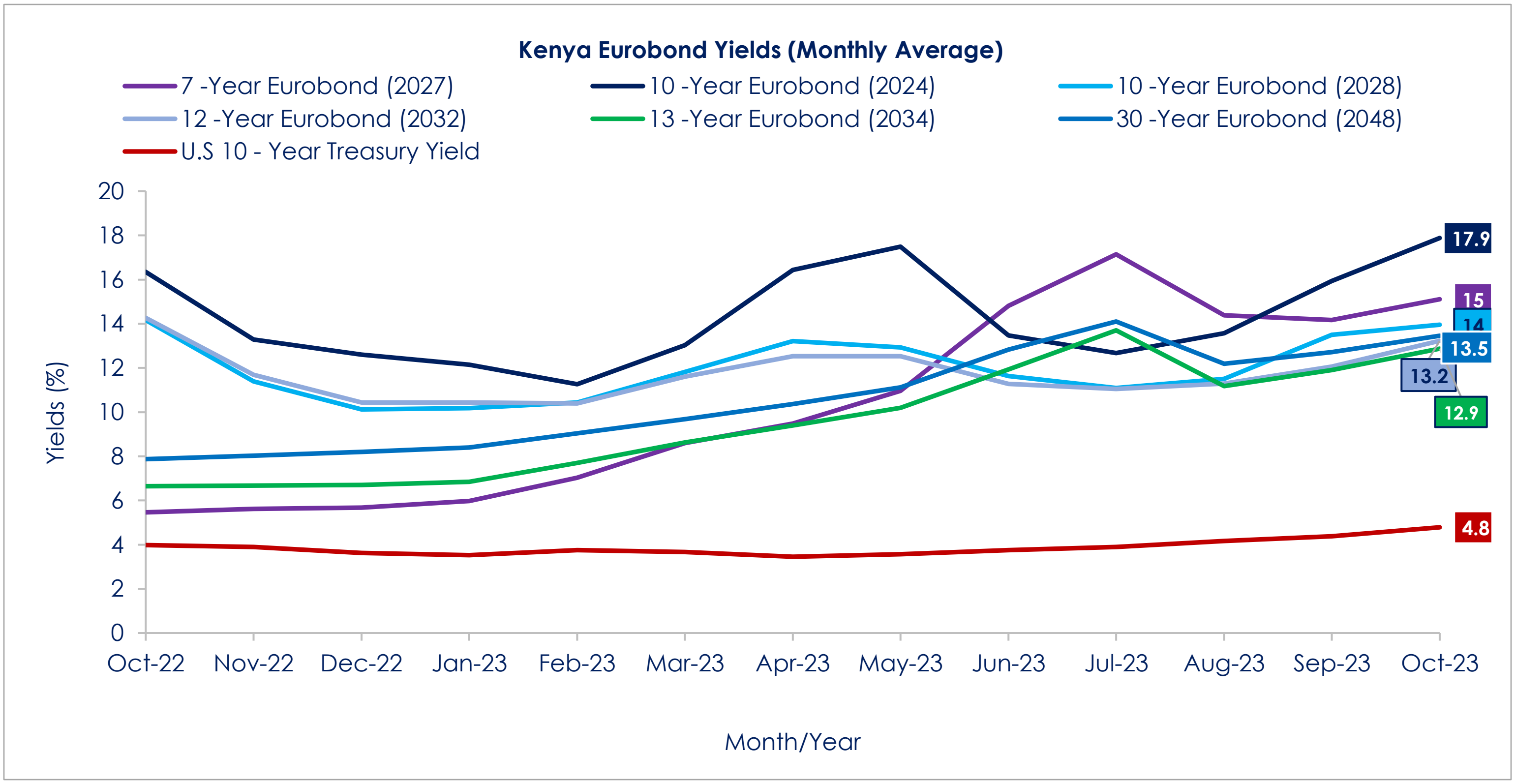


Source: The Kenya Gazette Vol. CXXV - No.225 13th October 2023

Kenya Eurobond yields rise then fall in October on credit fears

- Average yields on Kenya Eurobonds rose 126 bps in October over the previous month with the 10 - Year Eurobond (2024) and the 7 - Year Eurobond (2027) showing the biggest average increases of 195 and 161Bps respectively (Figure.17).
- The increase as was the case the previous month was largely driven by investor concerns about the country's' creditability and to a lesser extent the rise in US treasury yields.
- Over the same period, the average US 10-year treasury yield rose 41 bps to 4.79% with the rise attributed to investor uncertainty over the Federal Reserve's (Fed) indication that there will be one more rate hike before the end of 2023.
- The Fed Rate had crossed over the 5%-mark last week for the first time in 16 years following bond sell offs.
- The FED meets again this week with most investors and analysts predicting that the Fed rate will remain unchanged.
- Key economic data will be released later this week and this could form the basis of the Fed's decisions in coming months.

Figure.17: Kenya Eurobond yields up in August 2023



Source: Central Bank of Kenya

Domestic debt yields to continue to rise in the short to medium term

- A comparison of average debt security NSE yields as at 27th October 2023 against those as at 16th June 2023 (Close to issuance of **IFB1/2023/7**) and a year ago shows a sharp in interest rates increase across the curve for the reasons mentioned earlier in this report. (Table.7 and Figure.18).
- We expect this upward shift in the yield curve to continue in the short to medium term.

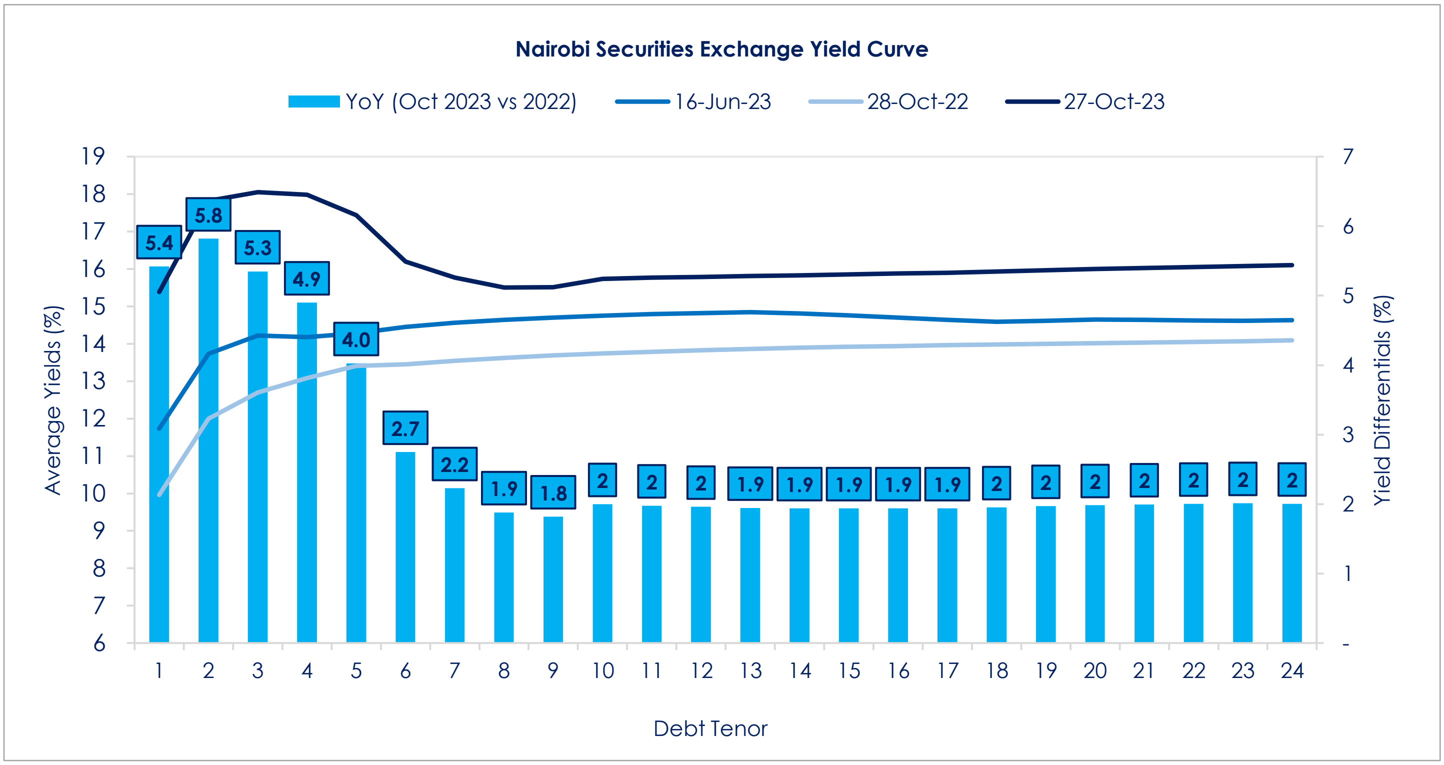
Table.7: Yields have increased significantly across all tenors

Tenor	Yields (16th June 2023)	Yields (28th Oct 2022)	Yields (27th Oct 2023)	∆ 27th Oct 2023 vs 16th June 2023) Bps	YoY ∆ (27th Oct 2023 vs 28th Oct 2022) Bps
1	11.7340	9.9650	15.3867	↑ 365.3	↑ 542.2
2	13.7298	11.9969	17.8170	↑ 408.7	↑ 582.0
5	14.2767	13.4045	17.4315	↑ 315.5	↑ 402.7
10	14.7527	13.7372	15.7367	↑ 98.4	↑ 199.5
15	14.7586	13.9171	15.8563	↑ 109.8	↑ 193.9
20	14.6501	14.0137	15.9978	↑ 134.8	↑ 198.4

Source: Nairobi Securities Exchange

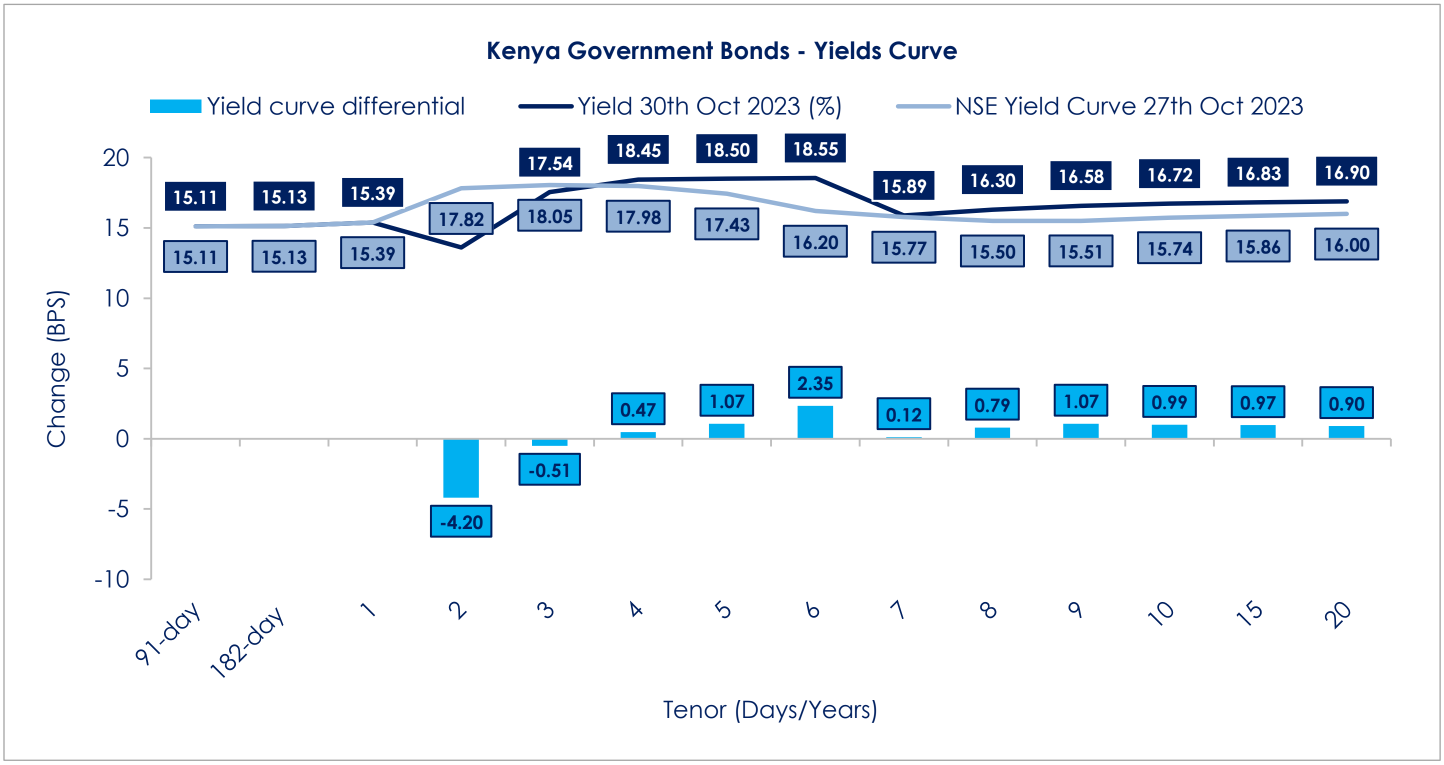
- We also use the Kenya Government bonds yield curve (source: World Government bonds) to determine possible investor bidding levels (Figure.19).
- We continue to notice disparities in yields in the short and medium end of the curve.
- This curve puts the 2-year yield at 13.62% which is 420Bps below the current NSE yield curve and 18.55% for the 6-year bond which is 235Bps above the NSE yield curve.
- Given that this bond is an infrastructure bond which is a non-benchmark bond hence not reflected in both these yield curves, we dissuade investors from setting their bidding levels based on these two yield curves.

Figure.18: Higher year on year differentials across all tenors



Source: Nairobi Securities Exchange

Figure.19: Notable disparities in Kenya Government bond yield curves



Source: World Government bonds

Trading ideas - Invest in Kenya Eurobonds & short-term domestic debt

- Investors with a high tolerance for risk and those with US$ exposure should consider investing in Kenya Eurobonds and in particular, **XS1028952403** maturing in June 2024.
- This is on account of high yields with investors also having the option of holding till maturity or disposing if trading opportunities arise (Table.8).
- **XS1028952403** had a yield of 15.198% as at 26th October with about seven months until maturity.
- The bond has seen a steep decline in yields in recent weeks for the reasons mentioned earlier in this report under Kenya Eurobond yields.
- Investors looking for higher yields on domestic debt could dispose their current bond holdings in favour of new short term bonds but be wary of actualizing price losses.
- The comparatively higher yields on the new investments however might be sufficient to compensate them for the losses incurred combined with coupons already earned from the previous holdings.
- We encourage investors to consider the bond currently being issued **IFB1/2023/6.5** due to its relatively short tenor and tax free status.

Table.8: Trading ideas - Consider Kenya Eurobonds

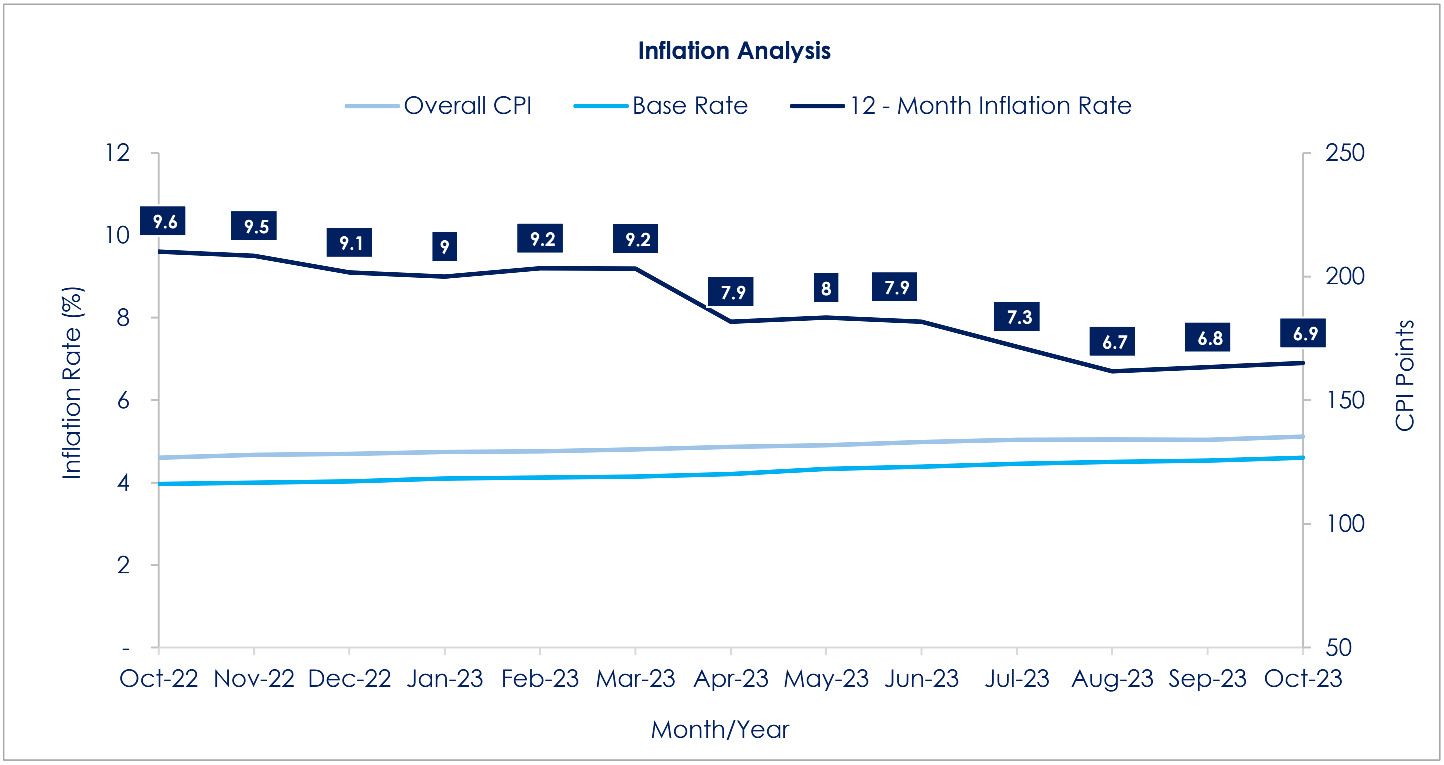
ISIN Code	Issue date	Tenor (Years)	Maturity	Outstanding amount (US.$ Bn)	Coupon	Yield to maturity (28th Oct 2023)
XS1028952403	Jun -14	10	Jun-24	2	6.875%	15.198%
XS1843435840	May -19	7	May-27	0.9	7%	14.099%
XS1781710543	Feb -18	10	Feb-28	1	7.25%	13.628%

Source: Bloomberg & Central Bank of Kenya

October 2023 inflation increases slightly to 6.9%

- October 2023 inflation increased marginally to 6.9% from 6.8% in September on account of a general rise in prices. This was in line with our October forecast (Figure.20)
- Prices of commodities under transport; food and non-alcoholic beverages; housing, water, electricity, gas and other fuels increased 13.6%, 7.8% and 7.8% respectively accounting for over 57% of overall inflation.
- We expect fuel inflation to continue rising due to an uptick in global fuel prices and further currency depreciation.
- Due to mixed communication on the expected El Nino rains, we continue to monitor the intensity of rains in the country as the degree of intensity may lead to destruction of certain crops due to flooding thus resulting in shortages of certain food crops and rise in prices.
- Our expectation is inflation in the range of 6.5% - 7.5% in November.

Figure.20: November 2023 inflation forecast at 6.5% - 7.5%



Source: Kenya National Bureau of Statistics

MPC retained CBR at 10.5% in October 2023 meeting

- The Monetary Policy Committee (MPC) is set to meet in December 2023 (date yet to be announced) to review the impact of previous monetary policy measures on the economy.
- In its last meeting on 3rd October 2023, the MPC retained the CR at 10.5% informed by the following reasons;
  1) Overall inflation was within the CBK's target band of 5% (+/-) 250bps in September (6.8%) with food expected to come down further due to the upcoming harvest season and global food prices easing.
  2) Non-food non-fuel inflation is expected to decline indicative of easing underlying inflationary pressures.
  3) The impact of the latest monetary policy tightening that occurred in June 2023 is still being transmitted into the economy.
- Given that these variables have remained relatively unchanged going into November, we maintain a high probability of a retention of the CBR.

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