Newsletter

Quarter 3 | 2016

ECONOMIC Roundup

SUB-SAHARAN AFRICA

In June 2016, the World Bank projected that sub-Saharan Africa's (SSA) economic growth will slow to 2.5% in 2016 (down from an estimated 3.0% in 2015) as commodity prices remain low, global activity weakens and financial conditions further tighten. However, SSA's economic growth is expected to rise to 3.9% in 2017 and 4.4% in 2018. According to the World Bank, the projected pickup in growth is contingent on commodity prices stabilizing and on improvement in conditions in the region's largest economies. Moreover, SSA countries - particularly commodity exporters - need to adjust to a protracted period of lower commodity prices by finding new sources of growth via appropriate policy responses. Oil exporters are not likely to experience any significant pickup in consumption growth, while lower inflation in oil importers should support consumer spending. However, food price inflation due to drought, high unemployment and the effect of currency depreciation could offset some of this advantage. Investment growth is expected to slow in many countries as governments and investors cut or delay capital expenditures in a context of fiscal consolidation.

KENYA

Economic update

The performance of the economy remains strong. According to the Kenya National Bureau of Statistics, the economy grew by 5.9% in the first quarter of 2016, compared to 5.0% in a similar period of 2015. Positive growth rates were registered across all economic sectors. Improved security and confidence in the economy continue to support the recovery in tourism. The private sector remains optimistic for higher growth in 2016 supported by macroeconomic stability, infrastructure investment, strong performance in the agricultural sector and tourism recovery. According to the most recent World Bank Group economic update for Kenya, the economy will grow at 5.9% in 2016, rising to 6% in 2017.

The FY 2016/17 budget statement contained increased budget allocations towards infrastructure investment, security and irrigation projects, which should continue to improve the business environment and lower food prices in the medium term. The budget provided additional measures to address the high cost of credit, including use of movable assets as collateral, setting up of an electronic collateral registry and the ongoing digitisation of land registries.

Kenya's economy projected to grow at 5.9% in 2016

Inflation and interest rates

Month-on-month overall inflation declined to 6.26% in August 2016, from 6.39% in July and remained within the government target range. The CPI category, food and non-alcoholic beverages, declined by 0.19% between July and August 2016. During the last Monetary Policy Committee (MPC) meeting held in July 25th 2016, the CBR at 10.5% in order to anchor inflation expectations and maintain market stability. The Committee however revised the Kenya Banks' Reference Rate (KBRR) to 8.90% from 9.87% effective from July 25th 2016 in line with the framework.

UGANDA

Economic update

The economy continues to grow at a moderate pace and is projected to expand by 4.6% in 2016 down from an earlier projection in January of 5.0%. The downward revision reflects the adverse impact of the weak external economic environment, soft commodity prices, tight financial conditions and subdued domestic demand. Going forward, economic activity is expected to improve with domestic demand being the key contributor to economic growth amidst continued weakness in the external sector. However, the recovery is expected to be slow with downside risks.

Ugandan Central Bank
reduces benchmark
lending rate by 100 basis points to 14%

Inflation and interest rates

In July 2016, the annual headline and core inflation declined to 5.1% and 5.6% respectively from 5.9% and 6.8% respectively in the prior month. The stability of the exchange rate, lower fuel and subdued domestic demand has contributed to the gradual dampening of inflation pressures over the last seven months. Annual core inflation is now expected to converge to the medium term target of 5% slightly faster than was anticipated. Given that inflation is forecast to stabilize around the policy target of 5% over the next 6 months, the Bank of Uganda (BoU) believes that a continued easing of monetary policy is warranted. This will also help to support a recovery of private sector credit and hence support real economic growth. Accordingly, the BoU reduced the CBR by 1% to 14% in August 2016.

Tanzania's economy expected to grow by 7% over the medium term

TANZANIA

Economic update

According to the World Bank's latest economic update, the Tanzanian economy is forecasted to expand at an annual rate of around 7% in 2017–2018. Tanzania's economic growth will be driven by hospitality, construction, finance and trade. Strong growth in these sectors will be supported by the demand side with a continued growth in private consumption and private investment. These projections are based on the assumption that world commodity prices will remain at roughly their current levels and that the Chinese economy will not experience major additional slowdowns.

Inflation and interest rates

The Bank of Tanzania reported a decline in headline inflation to 5.5% in the year ending June 2016 from 5.2% in the prior month. The World Bank projects the annual rate of inflation to decline to approximately 5% in 2017-2018.

The annual inflation rate which excludes food and energy for the month of June, 2016 stagnated at 3.0% relative to the prior month.

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Our feature segment for this newsletter is by Joy D'Souza, Head of Research at ApexAfrica Capital Ltd (ApexAfrica). Established in 1994, ApexAfrica is one of Kenya's premier brokerage houses. ApexAfrica also forms part of the AXYS Group (Mauritius) and is affiliated with Horizon Africa.

The focus of this newsletter feature is to provide further insight and analysis on the amendment to the banking law in Kenya which puts a cap on commercial bank lending rates.

Capping of bank rates in Kenya

1. What will be the implication of the new law to the banking sector?

On lending…

The whole idea of having floating rates is to allow banks to cushion themselves for taking on risk by charging premiums that are commensurate to the risk undertaken. While interest rates have been relatively higher than the SSA average, the countries within the East African region pretty much mirror each other with respect to the macroeconomic indicators, including interest rates. No doubt, the spreads have been relatively high as indicated by an average Net Interest Margin (NIM) of 7.4% for the entire sector in FY15, with the 6 Tier 1 banks recording an NIM of 9.2% and Equity Bank leading the pack with a 12.3% NIM. However, a look at the portfolios handled by these banks would explain why Equity Bank spreads would be that high, given that 82% of its loans are lent to the high risk SME sector and 76% of deposits being current and savings accounts mostly from retail customers and SMEs which attract low rates.

Capping interest rates would result in the following:

- Increased lending (volume over margin) causing a significant rise in NPLs and consequently increased provisions;
- Increased investment in processing loans which would result in higher overheads and a longer duration for the whole loan processing cycle; or
- Lending only to customers with a good repayment potential.

All these three instances would result in margin erosion for the banks.

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Capping of bank rates in Kenya

As such, the sensible thing to do would be to restrict lending to customers whose risk margin would be adequately covered by the rates stipulated by law, which currently would be 14.5%. That said, most of the mid to low tier banks are exposed to high risk customers, so what happens to them?

We therefore expect to see the following:

- Reduced lending as the banks re-evaluate their strategies. We believe it will be a quiet period for banks at least for the next few months as they evaluate how best to tackle the new development. We therefore expect this to impact in the second half of 2016 performance figures;
- An increase in fees for transactional services as well as loan processing in a bid to make up for lost income. Banks will be desperate seek new money making avenues and given that the regulation does not place any restriction on fees charged, this would serve as an obvious opportunity;
- A consolidation of the banking sector may finally be happening as most of the smaller banks will not be able to survive given that their cost of funds is extremely high and capping lending rates would most probably render their operations loss making.

On deposits…

Banks with largely retail oriented deposits will get hit the hardest given that corporate accounts already earn high rates that are pegged on the T-bill.

2. Which bank will get affected the most?

Equity Bank:

As of the first half of 2016, 42% of Equity Bank's deposits comprised of savings accounts and 24% fixed deposits, implying that 66% of its deposits would automatically demand a minimum of 7.35% deposit rate compared to the average cost of fund of 2.7% reported in the first half of 2016.

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Capping of bank rates in Kenya

Co-op Bank:

With only 33.0% of its total deposits being current accounts, the bank may face significant cost increases once it is forced to reprice the 67% of the deposits which are interest earning. Co-op Bank management pointed out during the H1 2016 investor briefing that should the bill be passed, its NIMs (currently at 9.2%) would decline by 40% further reiterating our concerns.

3. Which bank would least feel the impact?

- Banks that are more reliant on corporate/wholesale deposits including CFC Stanbic and Stanchart Bank;
- Banks with a smaller portion of interest earning deposits such as KCB Bank and Barclays Bank; and
- Banks with a huge chunk of high net worth deposits and are already paying relatively high rates for those deposits. Case in point DTB Bank.

KCB Bank:

We note that as of H1 2016, only 34% of KCB Bank's deposits were interest earning and out of this, 42% were from corporate accounts (meaning that they were already earning high rates). This is quite a small chunk compared to its peers but at the same time, we do not underestimate the impact that an upward revision of deposit rates would have on the bank's margins.

DTB Bank:

With a predominantly high SME and high net worth clientele, DTB's interest earning deposits account for 70% of total deposits. The bank's cost of funds at 6.0% is the highest in the Tier I space. This would imply that the bank is already compensating its depositors at rates that are higher than the average rates and implementation of the new law may not impact its cost base as much.

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Capping of bank rates in Kenya

4. How does this affect the economy?

Government borrowing remains substantially high in Kenya further exacerbating the high interest rate problem. In an auction conducted recently for the 10 year bond, the government accepted 70% of the bids at an average rate of 15.267%. This implies how desperate the government is for financing. It would seem reasonable then, to conclude that banks will revert to lending to the government which is desperately in need of cash and avoid the risky private sector as much as possible? According to 2015 stats, government's domestic debt accelerated by156.5% y/y to KES 524.1 Billion, accounting for 18.8% of total credit while private sector credit grew by 18.0% to KES 2.2 Trillion to account for 79.6% of total credit.

Of course as banks divert most of their assets to government securities, the government will be spoilt for choice which will see rates decline like they did in the first half of the year. The short end of the yield curve has eased since the president assented to the Bill and we therefore expect Treasury Bill and Bond rates to continue on a downward trajectory.

The whole idea of capping rates and introducing a floor on deposits is to reduce the cost of borrowing and encourage a saving culture which will only be advantageous to a certain segment of the economy. The low income earners will probably care less about high deposit rates and will most likely not qualify for the 14.5% loans owing to high risk profiles, sending them to MFIs and shylocks.

The bulk of lending to the private sector in 2015 was to the wholesale and retail sector (13.5%), personal services (12.9%), manufacturing (10.4%) and real estate (10.1%). The SME sector is the engine of a developing country's economy and the impact of reduced lending to this sector (owing to its risky nature) may have catastrophic effects on economic growth. As such, achieving the forecasted 6.0% GDP growth this and next year will certainly be a tall order, not forgetting the disruptions that the upcoming General Elections will cause.

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Capping of bank rates in Kenya

5. How have listed banking stocks reacted to the new regulation?

We have witnessed a major downslide in the banking sector share prices, with approximately KES 100 Billion worth of market cap being wiped off on day one of trading. However, stability has resumed and most banks are even beginning to see interests as inventors try to take advantage of the historically low valuations.

We believe that banks with diversified income and exposure to regional markets will aggressively pursue growth in the two in order to enhance bottom line performance. Overall, while we think capping of interest rates may have a major impact in earnings growth in the near term, we remain bullish on the Tier I banks (KCB Bank, Co-op Bank, Equity Bank and DTB Bank) over the long term. Digitalization will also be key in delivering growth going forward.

We however advice investors to keep off the banking sector until CBK issues guidance on the operationalization of the law .

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Capping of bank rates in Kenya

The table below represents a summary of the key matrices of the banks

Key matrices	KCB Bank	Equity Bank	Co-op Bank	Barclays Bank	Stanchart Bank	DTB Bank
Yield on interest earning assets	13.00%	14.00%	14.00%	11.70%	11.20%	13.80%
Cost of funds	4.00%	2.70%	4.80%	3.10%	3.00%	6.00%
NIM	9.00%	11.30%	9.20%	8.60%	8.20%	7.80%
Non-interest to total income	31.60%	33.80%	32.10%	32.20%	31.30%	20.50%
Cost to income ratio	47.90%	49.60%	45.30%	51.90%	48.40%	41.70%
NPL ratio	9.10%	4.70%	4.60%	4.30%	13.30%	3.90%
ROaE	23.10%	27.00%	25.40%	21.30%	24.00%	21.10%
EPS	6.86	4.99	2.63	1.56	21.65	25.19
NAV	29.67	19.8	11.93	7.79	115.79	132.03
DPS	2	2	0.8	1	12.5	2.5
P/E	4.1	5.3	4.4	5.6	8.8	5.5
P/B	1	1.3	1	1.1	1.6	1.1
Price 31/12/2016	40	40	17.6	13.55	202	184
Price 24/08/2016	32.75	36	13.25	9.7	207	159
Price 09/09/2016	28.26	26.25	11.5	8.75	190	139
YTD % return	-29.40%	-34.40%	-34.70%	-35.40%	-5.90%	-24.50%
% return Post assenting to the Bill	-13.70%	-27.10%	-13.20%	-9.80%	-8.20%	-12.60%

Source: Company fillings, ApexAfrica

Worth Noting…

Japan pledges USD 30 billion for Africa over three years

During the recently held Sixth Tokyo International Conference on African Development (TICAD VI) in Nairobi, Japanese Prime Minister Shinzo Abe committed USD 30 billion in public and private support for infrastructure development, education and healthcare expansion in the continent. The USD 30 billion announced on 27th August 2016 is in addition to USD 32 billion that Japan pledged to Africa over a five-year period at the last TICAD meeting in 2013. Abe said 67% of that had already been put to use in various projects.

Tanzania opts out of deal between EAC and EU

Tanzania cited the economic and constitutional uncertainties arising from British voters' decision to leave the EU as the main reason for opting out of the EU-EAC Economic Partnership Agreement. In the short run, Kenya will be the biggest loser if Tanzania makes good its threat not to sign the partnership agreement by October 1, 2016. Unlike its partners in the EAC, Kenya is considered a lower-middle-income country. Without the agreement, Kenyan exports would therefore be subject to at least 25% taxation across the EU market. However, exports from other EAC member states would continue enjoying the "Everything But Arms" trade arrangement with the EU.

Kenya expects to earn its first oil export revenue in June next year

The Government remains adamant that it will reap its first dividend from crude oil export by mid next year. According to Deputy Chief of Staff Nzioka Waita, the first export cargo is expected to be via road and railway transport as pipeline development continues.

Fitch Affirms the Republic of Congo at 'CCC'

Fitch Ratings has affirmed the Republic of Congo's Long-Term Foreign and Local Currency Issuer Default Ratings (IDRs) at 'CCC'. The issue ratings on Congo's senior unsecured foreign-currency bonds are also affirmed at 'CCC'. The Short-Term Foreign- and Local-Currency IDRs are affirmed at 'C'. The Country Ceiling has been downgraded to 'B+' from 'BBB-'.

Transaction Highlights in East Africa

Sector	Acquirer	Target	Transaction Description
June 2016			
Banking	Bank M	Oriental Bank	Bank M completed the purchase of a 51% stake in Oriental Commercial Bank in Kenya, in a transaction valued at KES 1.3 bn. The transaction was carried out at a 1.4x price-to-book valuation; a 9.0% premium on the market price-to-book of 1.3x.
Financial Services	IFC	Equity Group Holdings	IFC committed KES 10 bn in debt to Equity Group Holdings to be used to loan out to SMEs. The largest proportion of these loans will target women entrepreneurs and will enable Equity Group to cement their footprint in the SME sector.
July 2016			
Technology & E-Commerce	CDC	AIG	CDC injected USD 55 million in Africa Internet Group (AIG), a parent group of Jumia, Easy Taxi, Hellofood, Jovago, Lamudi and Kamuyu. The funding will enhance AIG's presence in Africa and allow it to further expand its operations.
Financial Services	DEG	Zep-Re	DEG acquired an additional 5.4% stake in Zep-Re for KES 1.4 bn, increasing its total stake to 14.9%, valuing the re-insurance firm at KES 25.9 bn. The capital acquired will be used in expanding its business realising growth through enhancement of its operations in a bid to attain a stronger international rating as a reinsurer and widening its agenda for development across COMESA member states.
August 2016			
Financial Services	Pamoja Capital	Genghis Capital	A consortium of investors led by the regional corporate advisory firm Pamoja Capital Ltd has received regulatory approval to take over investment bank Genghis Capital Ltd at an undisclosed price. The shares will be sold by Zafrullah Khan, the former chairman of the troubled lender Chase Bank and his co-owners. The new investors will acquire the entire issued share capital of Genghis through a special purpose vehicle called Goodison Two Seven Three Ltd.
Food wholesalers	DOB Equity	Twiga Foods	DOB Equity, a leading Dutch family office, announced that it had taken a minority stake in Twiga Foods, the Kenyan tech-enabled food wholesaler, to expand its reach in the fast growing African micro-vendor food market.

7 years old....we have Rebranded!

News from Horizon

We have delivered in:

Agriculture & Agro-processing

Real Estate

Energy, Oil & Gas

Fast-Moving Consumer Goods

Financial Services

Hospitality

Heavy & Light Manufacturing

Information and Communication Technology

Infrastructure

Telecommunications

Transport & Logistics

Our New Logo

Over the past 7 years in our dealings in Sub Saharan Africa, it has become important for us to express ourselves and continue to develop our corporate identity and ensure this is reflected in the way we present our brand.

Horizon Africa would like to formally announce that from September 2016, we unveiled our new brand identity, which embodies our core values and vision. We are also taking this opportunity to differentiate ourselves and respond to what our research said about what is critical to our business.

Our Values

We partner with businesses that are shaping the economies in Africa. Horizon Africa's relationship-focussed approach ensures that we are a trusted provider of financial advisory services. Our clients trust us to deliver day in day out. We are very proud to play a critical role in positively influencing the environments in which we work.

Our values therefore inform everything we do:

- Our Clients come first
- We act with integrity and honesty, always
- Creativity and innovation
- People and Reputation are our core assets

News from Horizon

Horizon's Sector Expertise

Agriculture & Agro-processing

Real Estate

Energy, Oil & Gas

Fast-Moving Consumer Goods

Financial Services

Hospitality

Heavy & Light Manufacturing

Information and Communication Technology

Infrastructure

Telecommunications

Transport & Logistics

Transactions Update

Selected Completed Transactions: 2016

- Restructure and refinancing of bank facilities for a manufacturing company in Kenya
- Restructuring advisory for a hospitality group in Kenya
- Capital raise for a capacity expansion being undertaken by a Kenyan manufacturing company
- Working capital financing for a technology retailer

Selected Ongoing Transactions: 2016

Mergers & Acquisitions

- Buy-side advisor for a manufacturing company in Tanzania
- Sell-side advisor for a financial services company in East Africa
- Sell-side advisor for a logistics company in East Africa
- Sell-side advisor for an agricultural business in Kenya

Capital Raising

- Debt raise for three manufacturing companies in East Africa
- Debt raise for the development of three real estate projects in East Africa
- Refinancing of bank facilities for a hospitality business in Kenya
- Restructure and refinancing of a manufacturing business in Kenya
- Capital raise for a microfinance institution in Kenya

Advisory

- Business planning and feasibility study for a medical services company in West Africa
- Due diligence for an agro-processing company in Kenya
- Project management, structuring and financial modelling for a commercial development in Kenya
- Financial feasibility for a large mixed use development in Kenya
- Business plan development for a financial services company in Kenya

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