Fixed Income Note:

IFB1/2023/007

PRIVATE AND CONFIDENTIAL

Issue Summary

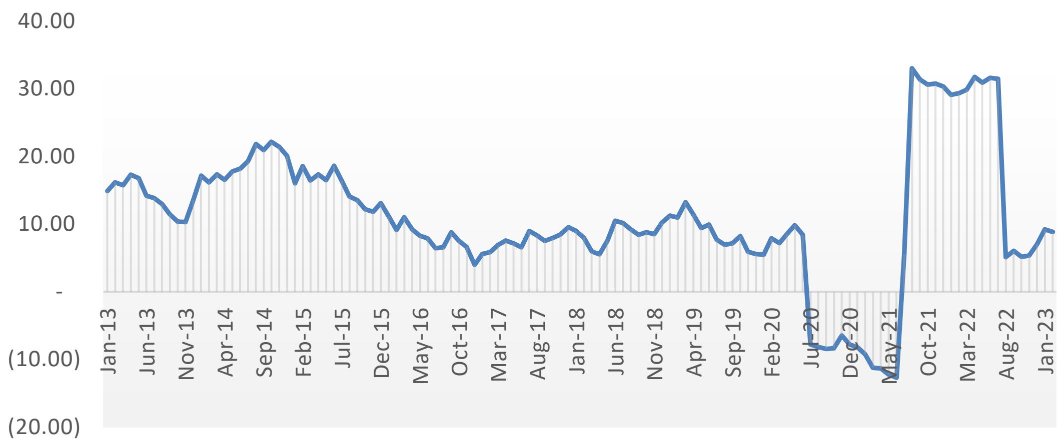
Issue No.	IFB1/2023/007
Total Amount offered	60 Billion
Tenor	7 Years
Coupon Rate	Market Determined
Period of sale	26/05/2023 to 13/06/2023
Auction date	14/06/2023
Value date	19/06/2023
Taxation	Tax-exempt
Minimum Amount	100,000
Yield	14.5694%
Modified Duration	3.59 to 3.56 @ 14.5% to 15%
Our recommended bids on yields	14.5% to 15%

Key Highlights of the Report

- Govt seeks to raise Kes 60bn via issue of the IFB1/2023/007.
- Economic environment is pointing towards higher interest rates because of high probability of macro-economic instability.
- Government finances are strained and this creates higher probability of capital loss as a result of higher interest rates.
- Government however, is taking some steps to mitigate the macro-economic environment and to stabilize its fiscal position.
- Our view: Buy but price aggressively.

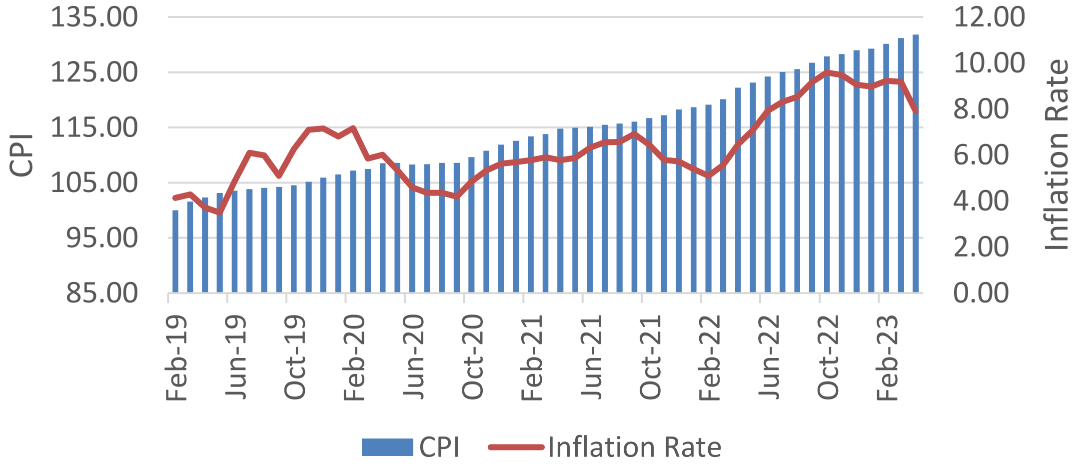
General Investment Environment – Factors affecting Interest Rates

YoY M3 Changes

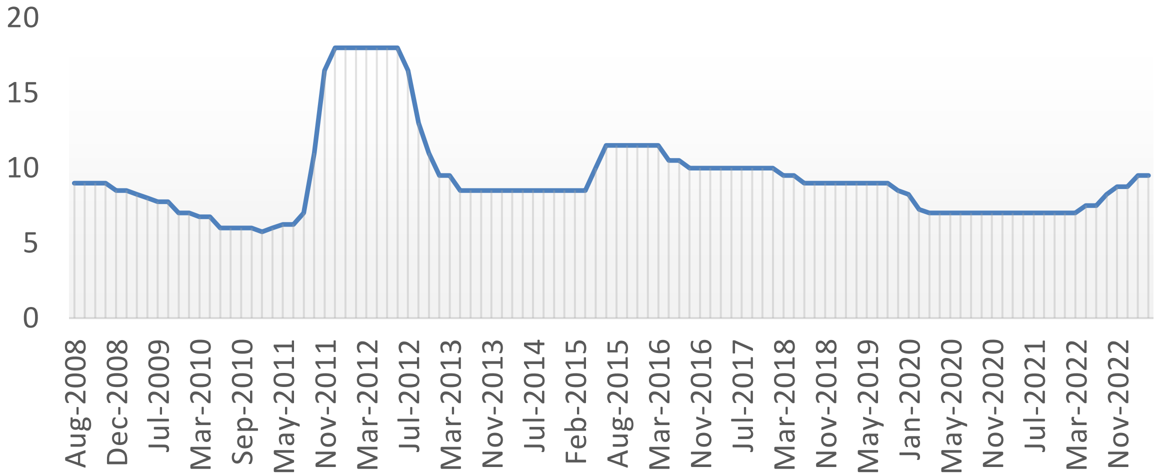


- Continuing geopolitical tensions in the Russia-Ukraine War causing supply chain issues have steamrolled inflation rates around the world in 2022, causing an economic slowdown. In Kenya, the GDP grew by just 4.8%, against a 7.6% projected growth.
- The first few months of the year saw inflation rates peak at 9.23% in February, against a backdrop of a weakening Kenya Shilling and higher food inflation, as a result of a dry spell.
- The CBK's efforts to curb inflation saw an increase of the CBK rate to 9.5% from 8.75% in March, which was maintained in May. Inflation has since eased in April to 7.9%, as food inflation decreased by 10.1%

CPI vs Inflation

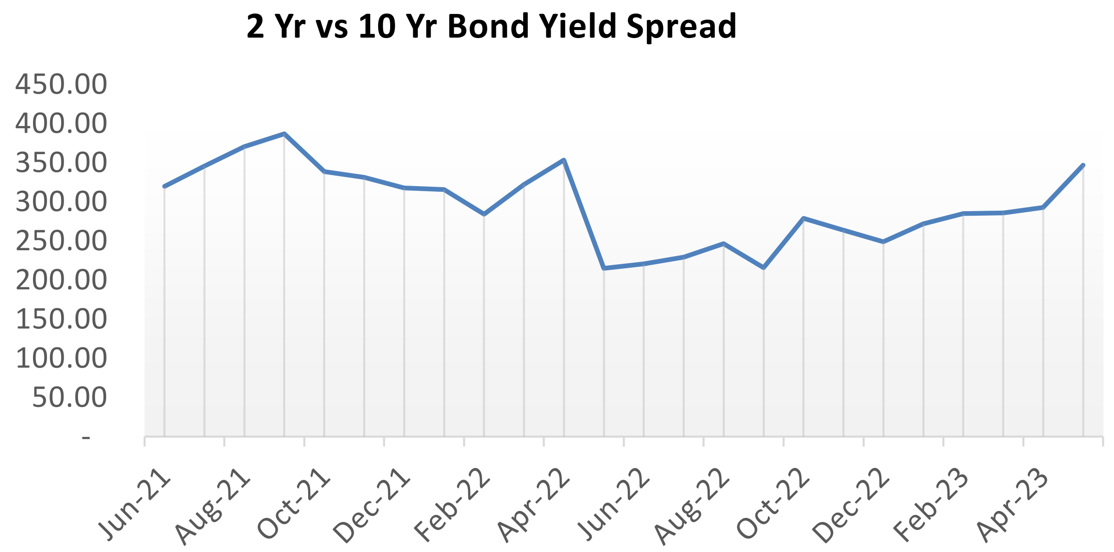


CBK Central Bank Rate

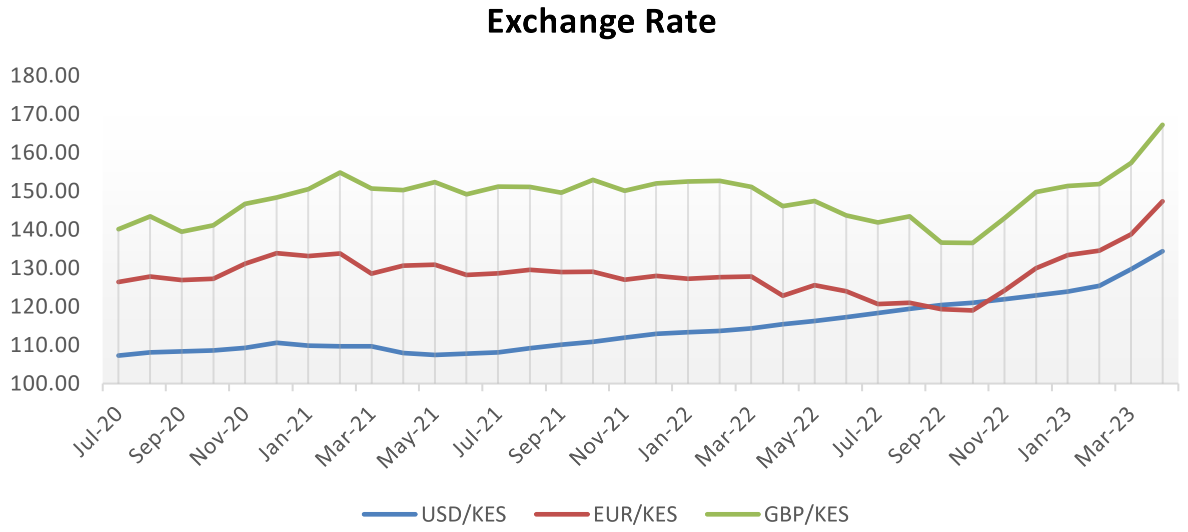


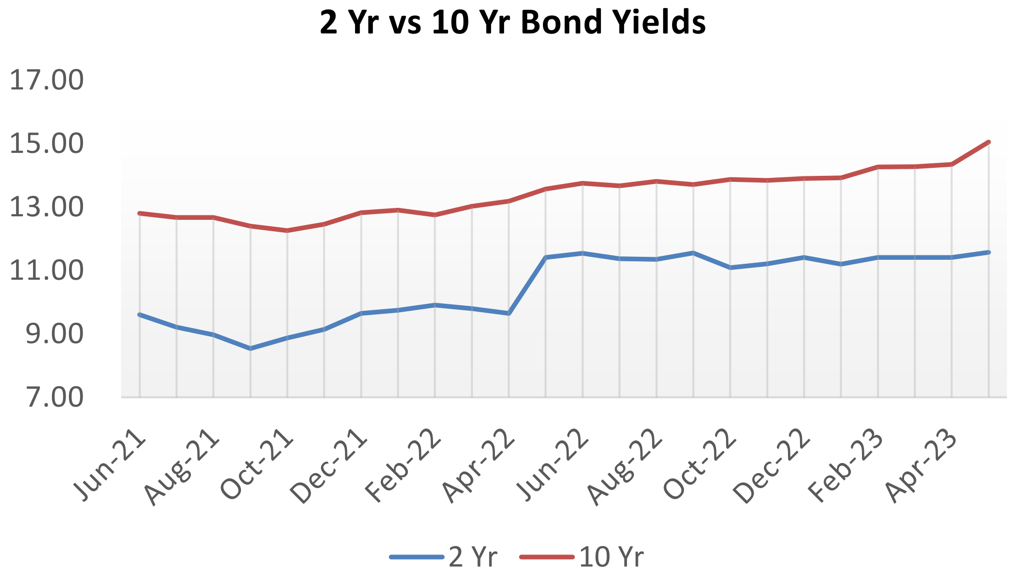
Source: Central Bank of Kenya

Macroeconomic Analysis



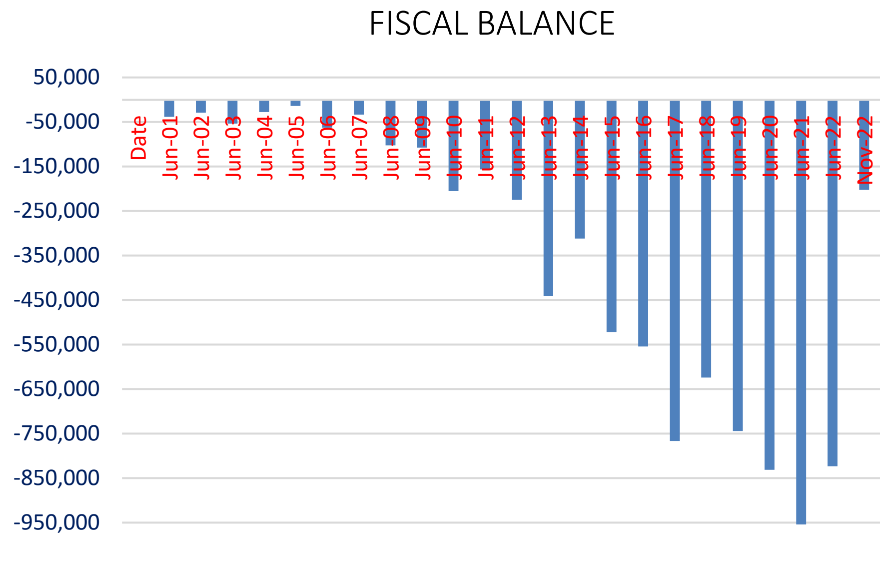
- Nevertheless, the CBK expects upward inflationary pressures from increased sugar prices as supply dipped, the removal of the fuel subsidy and a recent increase in electricity prices.
- Higher Federal rates in the US reduced the demand for the shilling, and made dollar-denominated interest payments more expensive, causing a weakening shilling.
- As a direct consequence, the country has experienced a dollar shortage, and there are fears the government will be unable to meet its debt obligations leading to a rise in interest rates, as seen by the graph below.

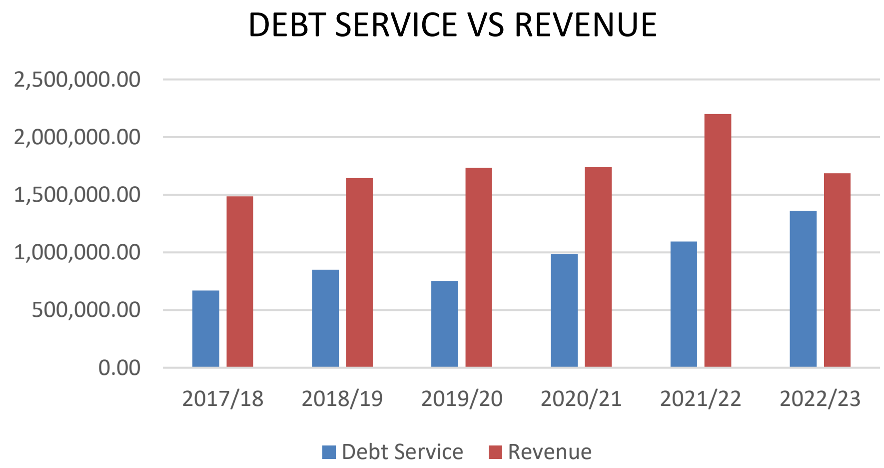




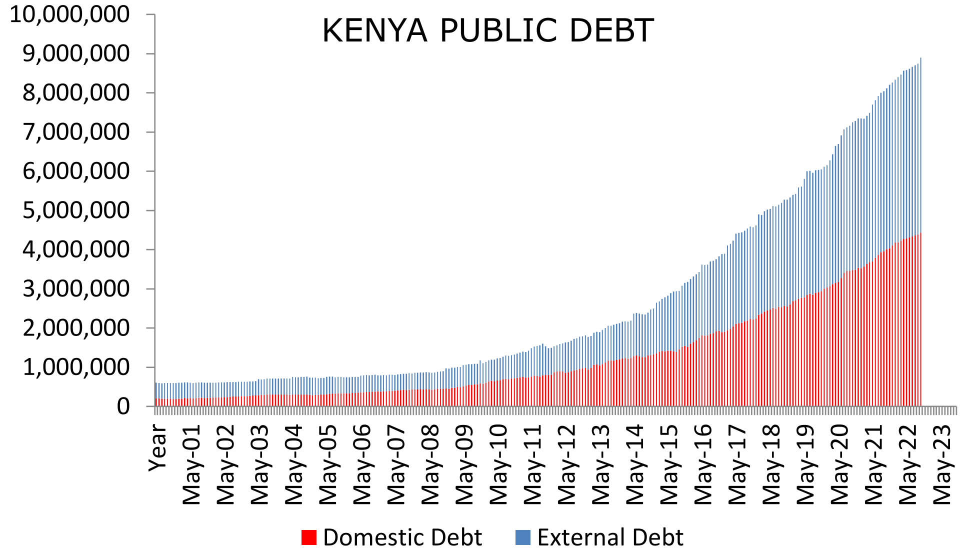
Source: Central Bank of Kenya

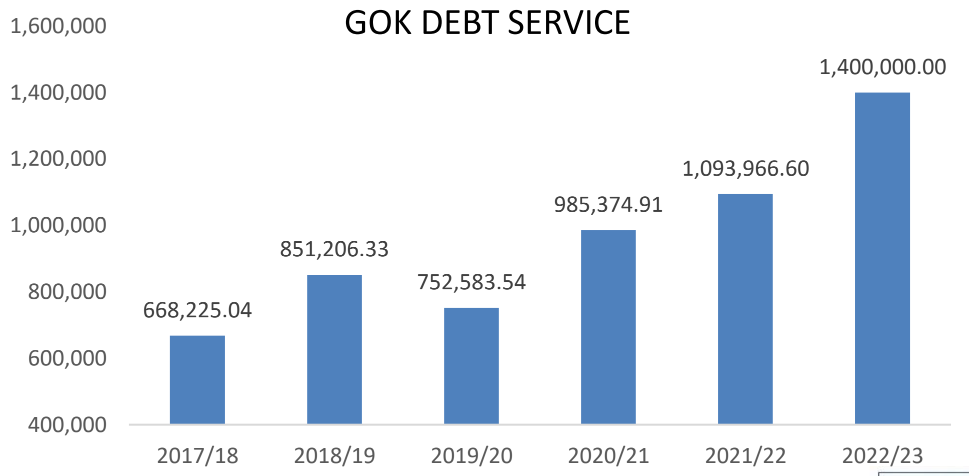
Credit Review: Analysis of GOK Fiscal Position





- With the high amount of debt the government is currently servicing, and a deteriorating economy (NPLs have increased leading to increased provisioning by banks), the government is pushing for the passing of the Finance Bill 2023, aimed at increasing revenue.
- The government's deficit as of March 2023 is 522 billion. The government has not slowed spending, even as KRA missed it revenue collection targets, and there is no indication of this changing.
- In the FY 2022/23, government spending is however expected to decrease by 6% to 3.17 trillion.
- In the first few months of the year undersubscription of Kenyan bonds with short-term bias for the 91-day T-Bill by investors raised interest rates, likely to lead to increased borrowing costs in long-term domestic financing.





Government Initiatives

To ease the dollar shortage the incoming Central bank of Kenya governor has proposed plans to issue a dollar denominated bond, aimed at targeting local holders of the dollar. The government has also encouraged other African nations to take first steps to ditching the globally-bullish US Dollar by signing up to a pan-African payments system to facilitate trade within the continent. The Pan-African Payments and Settlements System (PAPSS) was launched in January 2022 and was developed by Afreximbank. Earlier this year the government of Kenya reached a deal with Saudi Aramco to import oil and defer payment, the goal being to ease pressure on Kenya’s foreign reserves and influence the spot price of the dollar. In March of 2023, the government issued a directive for the revival of the interbank foreign exchange market, aiming to reduce distortions in the market.

In February of 2023, the GoK also unveiled plans to forgo import duty on sugar. Sugar prices have however skyrocketed as a result, as importers fear the influx of cheaper sugar, and local production dipped, decreasing supply.

The Finance Bill 2023, aimed at increasing tax revenue, will likely raise the cost of living further and aid inflation. The Bill’s major contentious issues include the doubling of the fuel VAT to 16% from a 2018 decrease, a new tax on indemnified losses from insurance products, and an increase in the turnover tax from 1% to 3% as well as a decrease in the minimum turnover where this is applicable to 500,000 from 1 million. The Finance Bill also seeks to increase the excise duty on betting, beauty products, and on the advertisement of alcoholic beverages. It was introduced in line with IMF’s recommendations to the Kenyan government to reduce its fiscal deficit by reducing spending and increasing revenue. The IMF also noted the importance of reforming state-owned enterprises and stopping the drain on budget resources stemming from, among others, Kenya Airways and Kenya Power and Lighting Company.

To match the government's attempts to boost revenue through initiatives like raising tax rates, the Kenya Revenue Authority's intensified collection efforts following revenue target shortfalls, insufficient action has been taken to reduce expenditures. The implementation of the Hustler Fund in late 2022 has further complicated this matter.

Our View

Money supply

- We do not expect further tightening, but expect the CBK to maintain the central bank rate at the same level.

Inflation

- With the decrease in food inflation, inflation rate in April decreased.
- It is however likely to increase with increased sugar prices and elevated fuel inflation, causing surging electricity prices.

Interest rates

- Interest rates have continued to tick upward, from inflationary pressures and default fears.
- We expect the upward trend to continue as inflationary concerns have yet to cease.
- Moody's downgrade of Kenyan government's credit rating to B3 further exacerbates the concerns surrounding the bond's risk profile.

Fiscal deficit

- The government's total tax revenue as of March 2023 was 1.3 billion, compared to total expenditure of 2.2 billion. Its fiscal deficit was 522 billion
- The fiscal deficit is likely to increase, and not decrease with more government spending and increased borrowing costs.

Total public debt

- The government is already trying to remedy the huge fiscal deficit through an increase in its tax revenue. It has however failed to cut spending as a result of continuing and new subsidies, and the introduction of the hustler fund.

Recommendation

- **Buy with aggressive bids.**

Key Risks to watch

Inflation Risk

- This risk of diminished real returns because of erosion of purchasing power.

Interest Rate Risk

- This is the risk of capital loss as a result of rising interest rates

Duration risk

- This is the risk of capital loss because of holding long term bonds.

Default risk

- This is the risk that the borrower will not honor the agreement. The rising borrowing costs and the recent controversy surrounding the non-payment of civil servants' salaries in April have intensified concerns about default. These concerns have been fueled by deteriorating domestic financing conditions in early 2023, ultimately resulting in a credit rating downgrade by Moody's to B3.

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