Fixed Income Note:

FXD1/2023/2 & FXD1/2023/5

PRIVATE AND CONFIDENTIAL

ABC CAPITAL LTD
•MEMBER OF THE NSE SINCE 1954•

Issue Summary

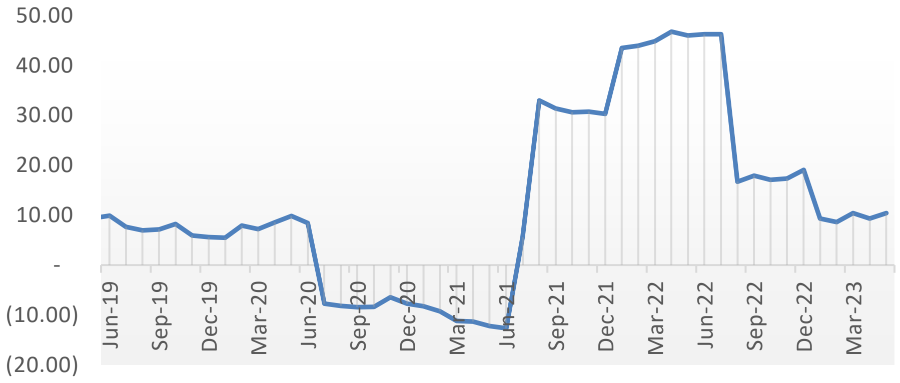
Item	Comment
Issue No.	FXD1/2023/2 & FXD1/2023/5
Total Amount offered (Kes.)	40 Billion
Tenor	1.9 & 4.9 Years
Coupon Rate	FXD1/2023/2 = Market Determined & FXD1/2023/5 = 16.844%
Period of sale	31/07/2023 to 16/08/2023
Auction date	16/08/2023
Value date	21/08/2023
Taxation	Discount/ Interest is subject to withholding tax at the rate of 15% for both.
Minimum Amount	50,000

Key Highlights of the Report

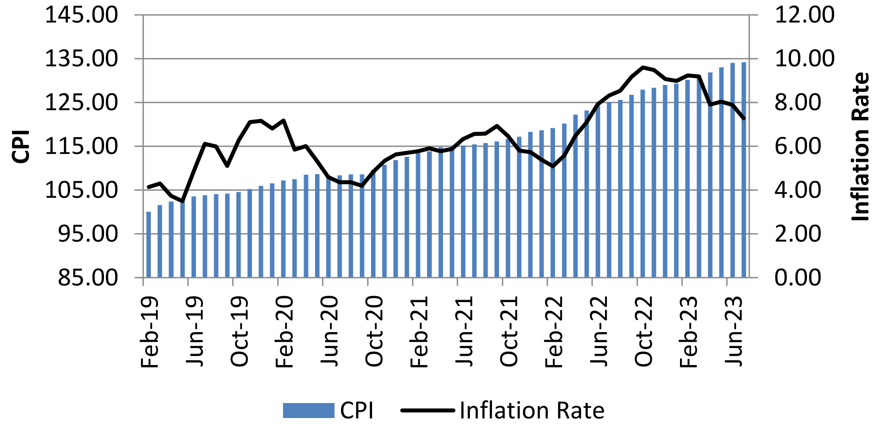
- Govt seeks to raise a total of Kes. 40bn via issue of the FXD1/2023/2 & FXD1/2023/5.
- Economic environment is pointing towards higher interest rates because of high probability of macro-economic instability
- Government expenditure still surpassed revenues causing a fiscal deficit.
- Government however, is trying to mitigate the fiscal deficit and ease pressure on the foreign exchange reserves through a raft of measures.
- Our view: Buy but price aggressively above 18% for both.

General Investment Environment – Factors affecting Interest Rates

Year on Year M3 Changes



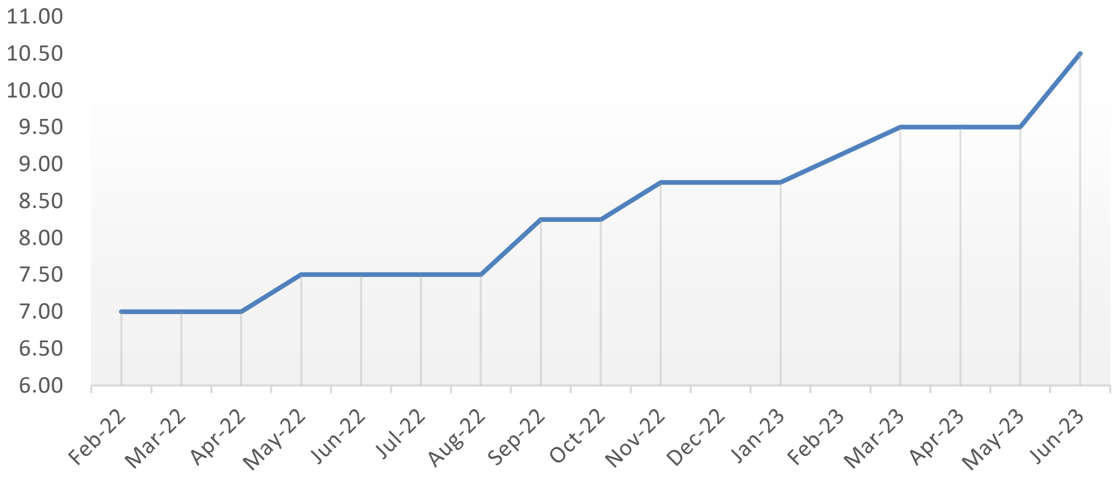
CPI vs Inflation



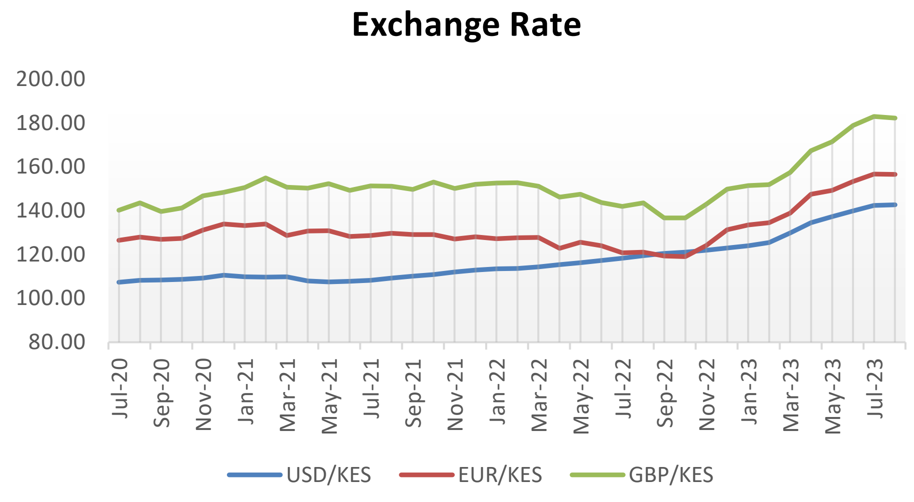
Source: Central Bank of Kenya

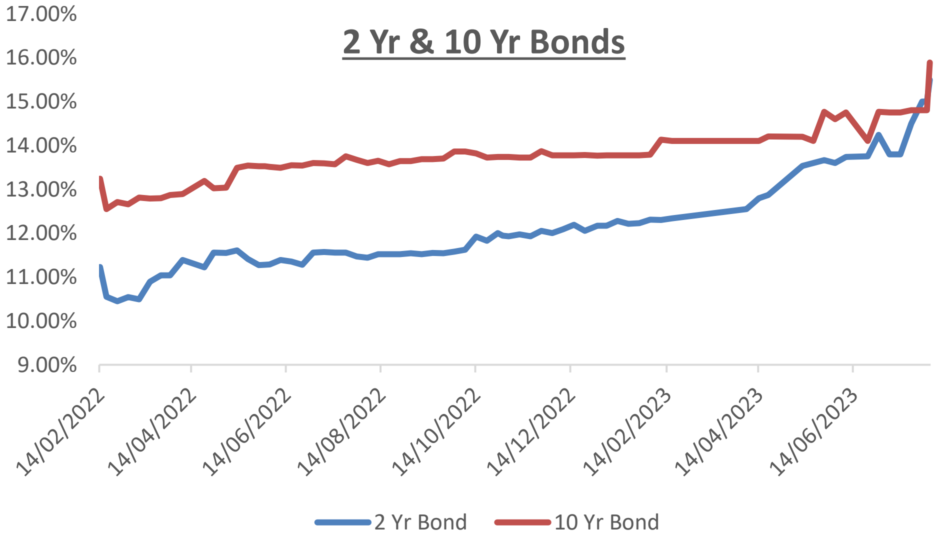
- The first few months of the year saw inflation rates peak at 9.23% in February. Inflation has since decreased from 8% in May to 7.9% in June
- The CBK's efforts to lower inflation saw an increase of the CBK rate to 10.5% from 9.5% in July.
- Money supply in the country has largely decreased compared to last year causing strains in the market leading to high interest rates due to the scarcity in money supply.

CBK Rates



Macroeconomic Analysis



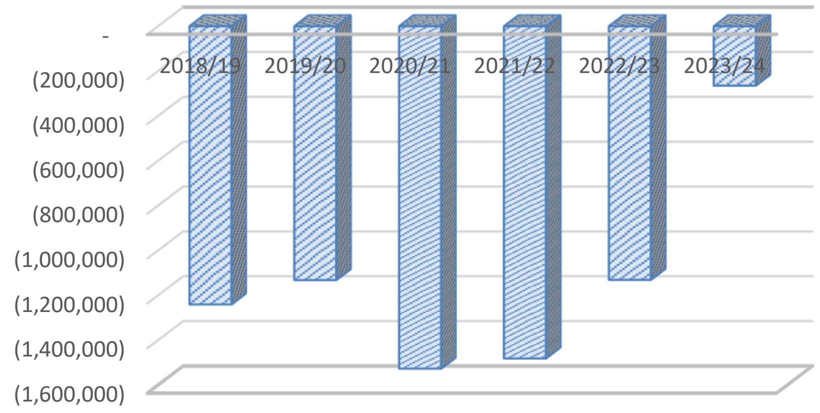


Source: Central Bank of Kenya

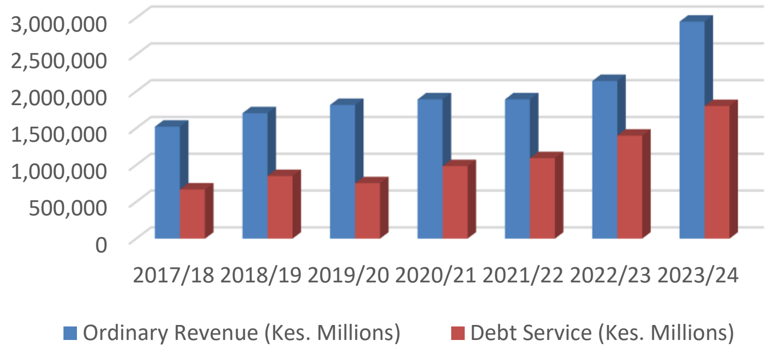
- The CBK noted sustained inflationary pressures driven by fuel, food and non-food non-fuel (NFNF) prices.
- The global economic outlook remains uncertain, reflecting continuing concerns about financial sector stability in advanced economies.
- The CBK foreign exchange reserves, which currently stand at USD 7,379 million (4.07 months of import cover), continue to provide adequate cover and a buffer against any short-term shocks in the foreign exchange market.
- Leading economic indicators of the Kenyan economy pointed to strong economic performance in the first half of 2023, mainly driven by activity in the services sector and recovery in agriculture.
- Exports of goods have remained strong, growing by 5.5% in the 12 months to May 2023 compared to a similar period in 2022.
- The banking sector remained stable and resilient, with strong liquidity and capital adequacy ratios.
- Growth in the private sector stood at 13.2% in both April and May 2023.
- In Kenya, the GDP grew by just 4.8% while projected growth decreased to 5.8% from 6.1% because of lower growth in the agricultural sector.

Credit Review: Analysis of GOK Fiscal Position

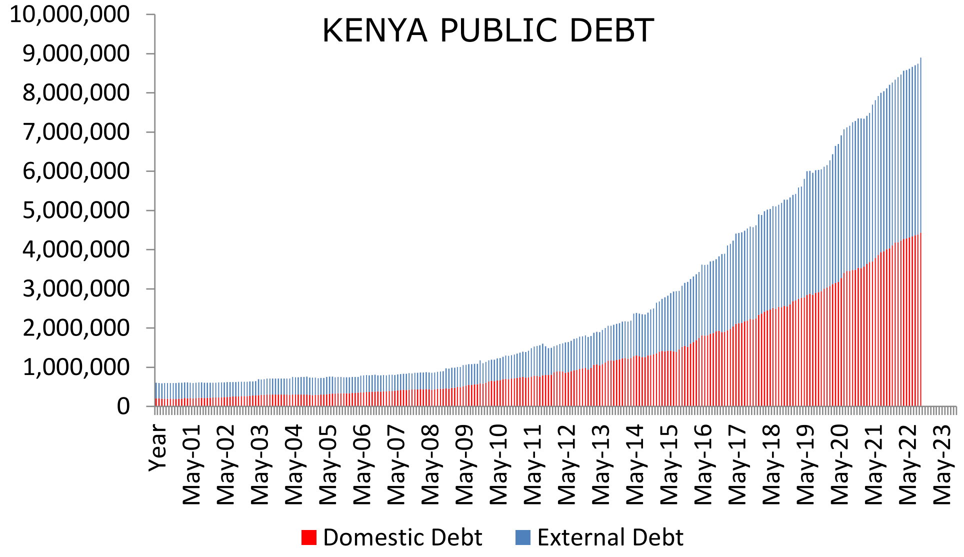
FISCAL DEFICIT



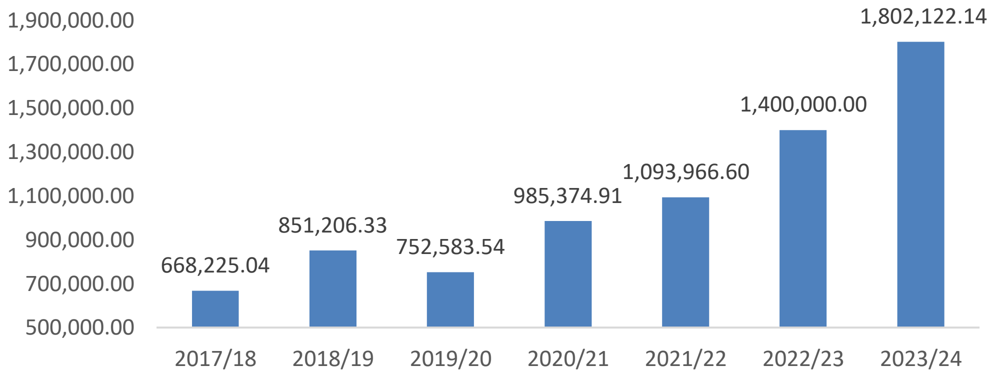
DEBT SERVICE VS ORDINARY REVENUE



- The Government succeeded in passing the Finance bill 2023 which targets to raise total revenue including appropriation-in-aid of kes. 2.9 trillion equivalent to 17.9% of GDP in the FY 2023/24.
- Total expenditure for FY 2023/24 is estimated to be kes. 3.7 trillion equivalent to 22.6% of GDP.
- Given the commitment to contain expenditures and boost revenues, fiscal deficit is projected at kes. 718 billion (4.4% of GDP) in the FY 2023/24.
- Kenya's public debt has been on a parabolic increase over the years. This has led to an increase of debt service costs which is estimated to hit kes. 1,802.122 billion for the FY 2023/24. This is a cause for concern as it may impair the government's ability to deliver essential services.



Debt Service (in Kes. Million)



Government Initiatives

The CBK took the initiative, owing to sustained inflationary pressures, increased inflationary outlook, and their potential impact to the domestic economy, to tighten money supply. This has seemingly worked to curb inflation which was on the rise and has now lowered to 7.28% currently.

Duty-free import sugar have failed to cool off high retail prices of the commodity despite being shipped into the country since January when the window was first opened. Locally production has been inhibited by the diminishing cane supply on the farms on the back of poor rains in the previous seasons. The diminishing supply of cane to factories which has cut down on production activities, saw the total sugar bagged in review decline by 26% to 49,761 tonnes. The decline in production has ultimately pushed customers to pay more for the commodity due to its limited availability in the market.

The Finance Bill 2023, aimed at increasing tax revenue, has been passed which indicates tax measures by the National Government that come against a backdrop of increasing costs of production and high inflation rates recorded at 7.3% in July.

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, expenditure continues to increase.

Analysis

Concept	Analysis
Proposed Yield to Maturity	FXD1/2023/2 = 18% & FXD1/2023/5 = 18%
Modified Duration	FXD1/2023/2 = 3.98 to 3.88 @ 18% to 18.5% FXD1/2023/5 = 6.46 to 6.50 @ 18% to 18.5%
Our recommended bids on yields	FXD1/2023/2 = 18% to 18.5% & FXD1/2023/5 = 18% to 18.5%

Our View

Money supply

- We expect continued tightening and expect the CBK to maintain the central bank rate at the same level of 10.5%.

Inflation

- Overall inflation has decreased from 7.9% in June having peaked at 9.23% in February to 7.3% in July.
- The CBK's initiative seems to be working.

Interest rates

- Interest rates have continued to tick upward, from inflationary pressures, tightening of CBK rate and default fears.
- Moody's downgrade of Kenyan government's credit rating to B3 with negative outlook further exacerbates the concerns surrounding the bonds' risk profile.

Fiscal deficit

- The government's total tax revenue as of June 2023 was 2.044 trillion, compared to total expenditure of 3.242 trillion. Its fiscal deficit was 1.198 trillion
- 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 with the effect of 2023 Finance Bill.
- Government spending has however remained relatively high.

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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