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Kenya- At the Heart of East Africa

By Andrea Clark
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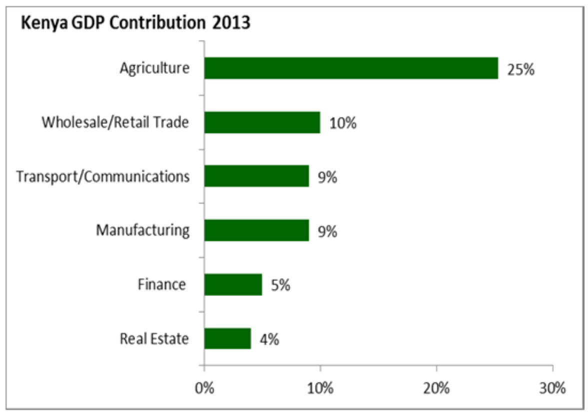
Kenya sits in the heart of East Africa; its position is vital to global trade, continental business activity and tourism. It is home to the Great Migration, the Maasai Mara, and the once popular coastal resorts of Mombasa. It is also home to a well-educated, dynamic private sector that has thrived despite periods of political instability that can sometimes define African nations. Look no further than Safaricom's M-pesa for Kenya's business success – the mobile payment system has allowed 70% of the country's population to access financial services – the highest ratio in Sub-Sahara Africa. The country has a diversified economy that is expected to grow 6-7% over the next 5 years. Kenya has also become a natural alternative to the crisis that has plagued Nigerian investors who are eager to participate in the African growth story. When you visit the country, it is easy to get taken up in its energy and promise. Africa is like that – it can be intoxicating. As investors who are passionate about the continent, we must take a step back and view its possibilities objectively. We must admit the shortcomings and determine if the potential rewards outweigh the risks.



Source: Kenya Bureau of Statistics

Challenges, but not insurmountable

Kenya is a good example of both promises and pitfalls. The country is no stranger to political turmoil; the 2008 election led to intense violence and brought President Uhuru Kenyatta to The Hague's International Criminal Court on alleged crimes against humanity. The charges have since been dropped, and politics appear to be stable, however the country's security has been anything but, with Somali al Qaeda affiliate Al Shabaab terrorizing swaths of the country's coastline. This instability has obliterated tourism in and around Mombasa. According to one of our companies, hotel operator TPS Eastern African, occupancy levels in coastal Kenya average 10-15% right now. Many of the region's hotels face bankruptcy. This is tragic for Kenya's economy and the lost tourists who will not experience this beautiful country because of Al Shabaab. The

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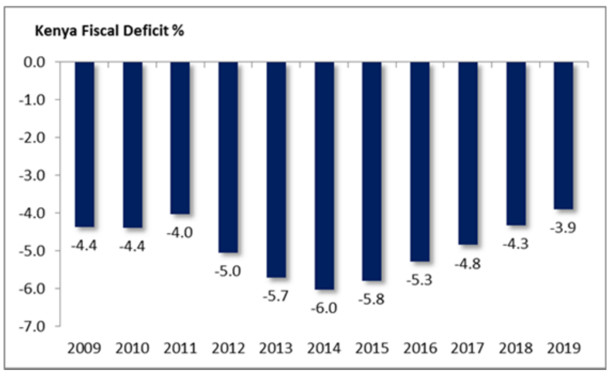
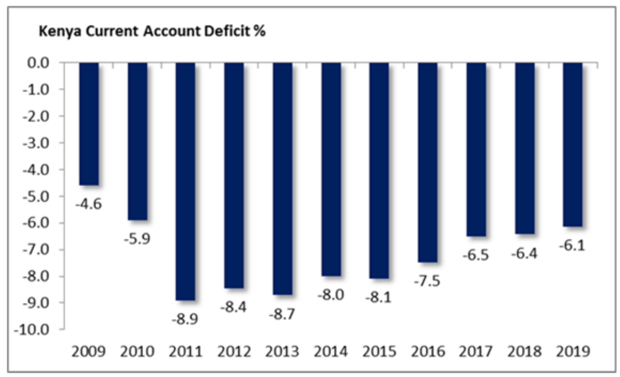
president recently fired his entire security team and one can only hope with the ICC issue behind him, battling Al Shabaab will become his foremost priority.

On the economic side, Kenya runs "twin deficits" that are known to take their toll on currency rates. Though not alarming yet, a strong USD could easily change the situation. There is already mounting concern that a weaker Kenyan Schilling (KES) will cause credit problems for banks with US dollar exposure. On the surface 6-7% GDP growth looks quite respectable, but it is below the government's 7-10% target - the level required to generate sustainable job creation. There are some positive indicators, however, and with elections 2 years away, we believe Kenya has the power to confront these challenges and deliver better economic growth.

Kenya's Twin Deficits (excluding the benefit of lower oil prices)





Source: IMF

For example, inflation has remained in check and should fall further with lower energy prices. As an oil and fuel product importer (over 20% of total imports), Kenya's current account should also improve with oil at lower price levels. The country is still expected to run a deficit, but much of it is related to capital equipment needed for crucial infrastructure investments. For developing economies, a mid to high single digit current account deficit is generally acceptable, assuming financing is diversified and not overly reliant on short-term portfolio flows. While this could be a problem for Kenya, foreign direct investing has picked up and short-term flows are mainly remittances, not speculative investment flows.

Looking forward, recent oil discoveries should allow Kenya to become more energy self-sufficient, which will decrease the pressure of the trade balances and create employment opportunities. Despite the recent fall in oil prices, Tullow, the developer, remains committed to developing Kenya's estimated 600m barrels of oil. Project costs are relatively low, and the government is looking for production to ramp up by 2018. On the FX lending side, USD loans are generally matched by USD profits. Assuming steady economic growth and only modest currency depreciation, we expect NPLs to decline, not increase.

The fiscal deficit is also high, but relatively stable. Kenya launched a highly successful Eurobond this year, and the government has allocated capital that it has not yet put to work due to capacity constraints. This could help control the fiscal deficit in the near term, but more action is required to minimize vulnerabilities. The government has stated its commitment to fiscal consolidation by improving tax collection, and it has outlined several measures including

VAT (value added tax) administration, tackling tax avoidance by multinational companies, revising excise taxes and increasing duties on iron and steel imports. At the same time, the Central Bank of Kenya (CBK) has acted as a buffer to fiscal spending by keeping inflation and credit growth under control via their monetary policy. This has also supported a relatively stable Kenya Schilling in recent years. Whether the government runs afoul of "election spending" one year from now remains to be seen, but we are confident that it recognizes the currency risk associated with ballooning deficits.

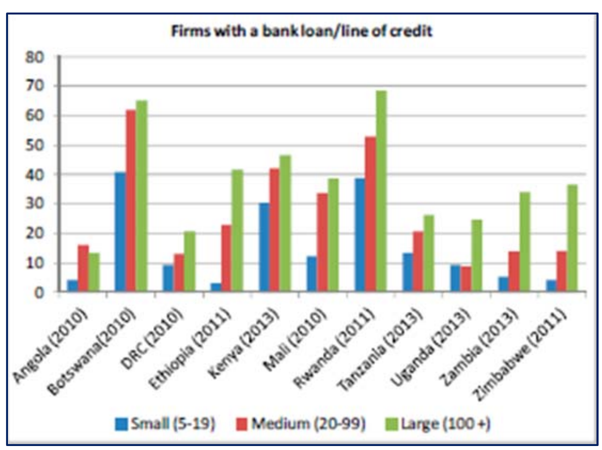
Investing in Kenya's Future

The question, then, is whether Kenya is worth the investment risk. For those willing to go the distance in Africa, we believe it most certainly is worth the risk. During my recent visit to the country, I met with many exceptionally well-managed companies with ambitious, yet realistic, business plans. Small businesses – the major job providers – thrive in Kenya, thanks to a financial system that promotes inclusion. As noted in the chart, Kenya ranks high in the percentage of small/medium companies that are actively tapping the financial system to fund growth. The opportunities are abundant. Kenya could one day be Africa's premier success story.

Economic reforms could help Kenya deliver higher GDP growth, and the government has outlined several initiatives that cover everything from infrastructure to fiscal management to poverty reduction. Many are already underway such as the New Standard Gauge Railway connecting Nairobi and Mombasa, which will reduce supply bottlenecks. And the old Rift Valley railway, a laughing stock for decades, is being refurbished. There are plans to improve agricultural production through irrigation, expand geothermal plants to increase power generation, and develop an oil pipeline. Kenya is promoting geographic integration through the East Africa Community, with the ultimate goal of creating the EAC Monetary Union by 2021. In 2010, the government structure was decentralized to facilitate the delivery of social services to areas of higher poverty via federal government funding transfers. This remains a work in progress, but should ultimately enhance the management and equality of social welfare programs.

Financial Inclusion – ***Percentage of firms using bank services***

One of the many interesting themes in Kenya includes real estate; as developers move beyond downtown Nairobi to areas such as Runda Gigiri, where Centum is developing the 2 Rivers Development. This "mixed use" development which sits on 100 acres, is 20 minutes from Nairobi's Central Business District, and will include a large scale mall, office towers, and residential apartments. Centum expects the mall, which is already 53% leased, to open at the end of 2015.



Source: IMF

A recovery in tourism could lead to substantial earnings power for TPS Eastern Africa, a hotel operator. The company is the owner and operator of Nairobi's Serena Hotel, a favorite among many international business travelers. It also operates several safari camps and has property in Tanzania, Uganda and Rwanda. With a solid balance sheet and adept management team, TPS could also consolidate its position in Kenya by taking over properties struggling to service debt due to the dramatic fall in coastal travel.

Consumption is the obvious theme across Sub-Saharan Africa, but it doesn't come cheap. Food and beverage stocks typically trade on more than 20x expected earnings. Kenya's East African Breweries trades at a punchy 30x FY1 earnings. However, there are other avenues to gain access to rising consumer spending, such as financial companies that stand to benefit from expanded mobile banking, consumer lending, credit card transactions, insurance and wealth management. Kenya Commercial Bank, for example, has elected to partner with, rather than compete with, Safaricom's M-pesa in mobile banking. This will provide the bank with a fully developed technology platform and the telecom operator with added fee revenue. Another company with broad exposure to financial services is Britam, which provides a full line of insurance products and has a sizeable asset management division.

David Kendrick Elephant Orphanage, Nairobi

We tend to travel quickly through frontier markets when doing research, as it helps us stay disconnected and objective. Like many places in Africa, it's hard to leave Kenya. But sensing that it is on a development path that will benefit its people and their amazing countryside helps one move on. I suspect the country will be even more compelling on my next trip.

About Frontier Market Asset Management

Founded in 2006, Frontier Market Asset Management holds more than 35 years' worth of investment experience including work in Emerging and Frontier Markets since 1987. For more information, please contact us at (858) 456-1440.

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