Cytonn Annual Markets Review - 2020

Equities

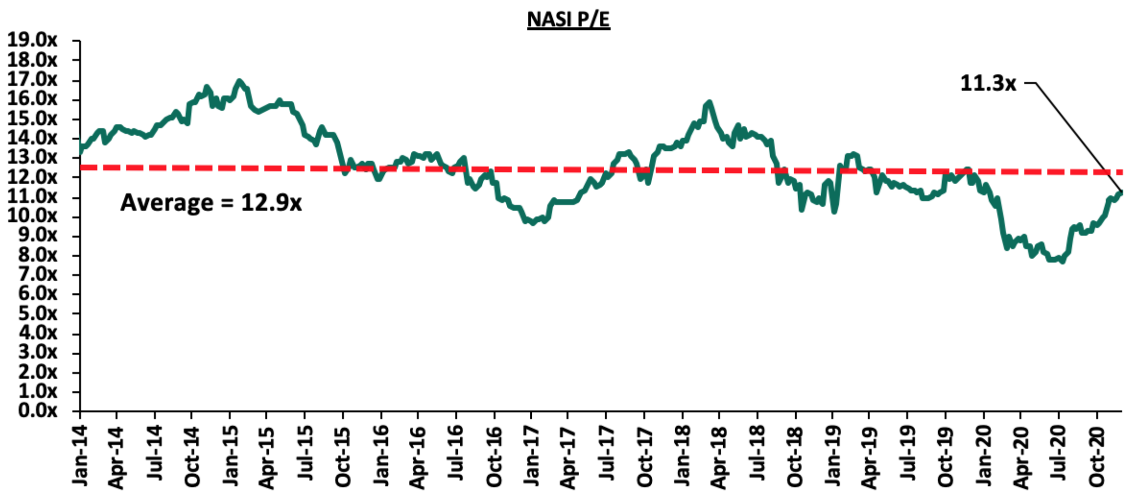
Market Performance

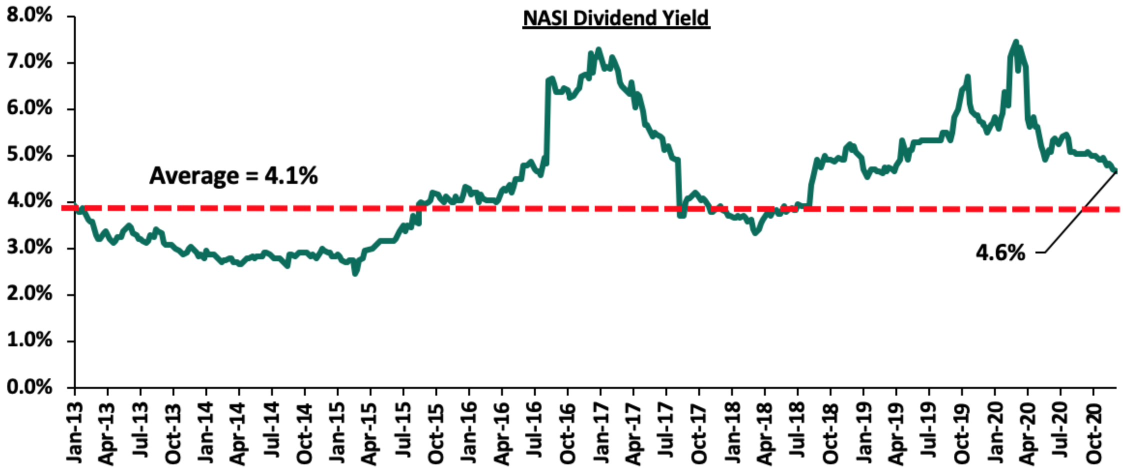
During the year, the Kenyan equities market was on a downward trajectory, with NASI, NSE 25, and NSE 20 declining by 8.6%, 16.7%, and 29.6%, respectively. Large-cap decliners during the year included Bamburi, Equity Group, Diamond Trust Bank, KCB Group, and Standard Chartered which declined by 52.7%, 31.7%, 31.2%, 29.4%, and 28.8%, respectively. Key to note, Safaricom recorded gains of 8.7% YTD as they benefited from the working from home environment and increased digitization trends. Safaricom continues to be a key part of Kenyan equities portfolios, accounting for 59.6% of Nairobi Stock Exchange (NSE's) market capitalization and has dominated on both the market turnover and in determining the direction of the market given its weight and liquidity in the Nairobi Securities Exchange.

Equity turnover during the year declined by 5.9% to USD 1.4 bn, from USD 1.5 bn in FY'2019. Foreign investors turned net sellers, with a net outflow of USD 280.9 mn, compared to net inflows of USD 10.7 mn recorded in FY'2019. The foreign investor outflows during the year can be attributed mainly to the COVID-19 pandemic which saw an increased flight from the Equities Markets as investors sought for safe-havens.

The market is currently trading at a price to earnings ratio (P/E) of 11.3x, compared to 11.8x at the end of 2019, and is 12.9% below the 11-year historical average of 12.9x. The average dividend yield is currently at 4.6%, 0.5% points above the historical average of 4.1%.

With the market trading at valuations below the historical average, we believe there are pockets of value in the market for investors with higher risk tolerance and are willing to wait out the pandemic. The current P/E valuation of 11.3x is 46.4% above the most recent valuation trough of 7.7x experienced in the first week of August 2020. The charts below indicate the market's historical P/E and dividend yield.





Banking Sector Earnings:

As per the Q3'2020 results, banks have recorded a weighted average decline in core earnings per share of (32.4%), compared to a weighted growth of 8.7% in Q3'2019. The table below highlights the performance of the banking sector, showing the performance using several metrics, and the key take-outs of the performance.

Bank	Core EPS Growth	Interest Income Growth	Interest Expense Growth	Net Interest Income Growth	Net Interest Margin	Non-Funded Income Growth	NFI to Total Operating Income	Growth in Total Fees & Commissions	Deposit Growth	Growth in Government Securities	Loan to Deposit Ratio	Loan Growth	Return on Average Equity
NCBA	(67.3%)	4.8%	4.1%	5.3%	3.2%	11.8%	48.7%	47.7%	8.1%	12.5%	63.0%	0.4%	3.9%
ABSA	(65.4%)	1.4%	0.8%	1.6%	7.1%	4.5%	32.7%	(10.7%)	4.7%	13.1%	84.9%	7.8%	15.2%
KCB	(43.2%)	23.0%	20.8%	23.7%	7.8%	1.5%	30.8%	(14.2%)	31.7%	83.9%	74.7%	18.7%	13.1%
I&M	(30.8%)	3.0%	8.9%	(1.7%)	5.3%	1.1%	38.1%	(5.9%)	7.0%	70.9%	73.4%	6.7%	2.4%
SCBK	(30.4%)	(5.8%)	(17.3%)	(2.4%)	7.0%	(8.8%)	31.1%	(9.7%)	8.0%	7.6%	1.5%	11.2%	12.9%
Stanbic	(30.2%)	(5.4%)	(3.1%)	(7.3%)	5.9%	(18.4%)	44.5%	(33.3%)	18.2%	103.8%	70.3%	7.5%	12.0%
DTBK	(27.8%)	(3.4%)	(8.9%)	0.9%	5.5%	15.3%	26.6%	17.7%	1.8%	5.1%	71.4%	7.1%	9.2%
Equity	(13.9%)	21.7%	21.6%	21.8%	7.6%	10.1%	38.7%	(1.3%)	44.5%	37.2%	65.7%	30.1%	16.9%
Co-op	(10.2%)	7.1%	(3.5%)	11.7%	8.0%	(3.5%)	36.5%	(31.7%)	16.4%	50.5%	75.7%	5.7%	16.4%
HF Group	N/A	(12.2%)	(16.9%)	(1.1%)	4.2%	(62.2%)	20.0%	11.8%	9.9%	65.6%	98.8%	(4.1%)	(7.6%)
Q3'20 Mkt Weighted Average*	**(32.4%)**	**10.8%**	**8.2%**	**11.7%**	**7.0%**	**2.1%**	**35.9%**	**(7.9%)**	**23.1%**	**47.4%**	**65.6%**	**15.0%**	**13.0%**
Q3'19Mkt Weighted Average**	**8.7%**	**4.5%**	**4.3%**	**4.9%**	**7.7%**	**15.8%**	**37.9%**	**22.6%**	**11.0%**	**3.3%**	**75.7%**	**11.6%**	**19.3%**

***Market-cap-weighted as at 01/12/2020**

****Market-cap-weighted as at 29/11/2019**

Key takeaways from the table above include:

i. Core Earnings Per Share (EPS) recorded a weighted (32.4%) decline in Q3'2020, compared to a weighted growth of 8.7% in Q3'2019,
ii. The sector recorded a weighted average deposit growth of 23.1%, faster than the 11.0% growth recorded in Q3'2019,
iii. Interest expense, grew faster by 8.2%, compared to 4.3% in Q3'2019. Cost of funds, however, declined, coming in at a weighted average of 2.9% in Q3'2020, from 3.1% in Q3'2019, owing to the faster growth in average interest-bearing liabilities, an indication that the listed banks were able to mobilize cheaper deposits,
iv. Average loan growth came in at 15.0%, faster than the 11.6% recorded in Q3'2019, but slower than the 47.4% growth in government securities, an indication of the bank's preference of investing in Government securities as opposed to lending due to the elevated credit risk occasioned by the pandemic,
v. Interest income rose by 10.8%, compared to a growth of 4.5% recorded in Q3'2019. Despite the rise in interest income, the Yield on Interest Earning Assets (YIEA) declined to 9.5% from the

10.3% recorded in Q3'2019, an indication of the increased allocation to lower-yielding government securities by the sector. The decline in the YIEA can also be attributed to the reduced lending rates for customers by the sector, in line with the Central Bank Rate cuts. Consequently, the Net Interest Margin (NIM) now stands at 7.0%, 0.7% points lower than the 7.7% recorded in Q3'2019 for the whole listed banking sector, and,

vi. Non-Funded Income grew by 2.1% y/y, slower than 15.8% growth recorded in Q3'2019. The performance in NFI was on the back of declined growth in fees and commission of (7.9%), which was slower than the 22.6% growth recorded in Q3'2019. The poor performance of the growth in fees and commission can be attributed to the waiver on fees on mobile transactions below Kshs 1,000 and the free bank-mobile money transfer. Banks with a large customer base who rely heavily on mobile money transactions are likely to take the biggest hit.

For more information, see our Kenya Listed Banks Q3'2020 Report.

Other Key Results

Safaricom Limited released the H1'2021 results, recording core earnings per share decline of 5.7% to Kshs 0.83 from Kshs 0.88 in H1'2020. The decline in the earnings growth was attributable to the 14.5% decline in M-PESA revenue to Kshs 35.9 bn from Kshs 42.0 bn, following the Central Banks directive to waiver fees on Person to Person and Lipa na M-PESA transactions for amounts below Kshs 1,000. This was an initiative that was to support Safaricom's customers and the government's initiatives of curbing the spread of the virus.

This year, 15 companies issued profit warnings to investors compared to 10 companies in 2019, attributable to the tough macro-economic environment amid the COVID-19 pandemic. Companies are required to issue profit warnings if they project a more than 25.0% decline in profits year-on-year. Below is the summary of the said companies:

Companies that issued profit warnings Comparison

No	2020	2019
1	ABSA Kenya	Nairobi Stock Exchange
2	Diamond Trust Bank	BOC Kenya Plc
3	Standard Chartered	UAP Holdings Limited
4	I&M Holdings	Kenya Power and Lighting Company
5	NCBA Group	Eaagads
6	Britam Holdings	Williamson Tea Kenya
7	East African Breweries Limited	Standard Group Plc
8	Nation Media Group	CIC Insurance
9	Longhorn Publishers	Kenya Airways
10	Kenya Power	Kapchorua Tea Company
11	Unga Group	
12	East Africa Cables	
13	Kenya Orchards	
14	TPS East African	
15	Nairobi Business Ventures	

The key take-outs from the table above include:

i. ABSA Bank attributed the shortfall in profits to the exceptional costs incurred during the year in relation to the rebranding from Barclays Bank to Absa Bank Kenya. Additionally, the projected decline in the profits is also on the back of the increased provisions amid the pandemic,

ii. Diamond Trust Bank issued a profit warning statement attributing dismal performance to the increased impairment provisions following the pandemic coupled with the increase in restructured and delayed loan repayments as the COVID-19 impact on their customers intensified during the year,
iii. Standard Chartered also issued a profit warning citing that the pandemic which has adversely affected the economy, has also affected the bank's operations. However, the bank indicated that pandemic reinforced the relevance of their three strategic priorities such as their investments in digital channels which have enabled the bank to continue supporting their clients digitally through video conferencing as well as enabling the bank's employees to work remotely,
iv. KPLC cited that the pandemic had adversely affected the company leading to a slower growth in their electricity sales coupled with the increase in financing costs which is set to reduce their earnings,
v. In Britam's case, the anticipated slide in earnings is attributed to the impact the pandemic has had on their business more so in real estate, which has affected the appetite for property and mortgage. Additionally, the management pointed out that the poor performance of the stock market has led to reduced returns from their Equity Investments,
vi. Nation Media's expected decline is attributable to the unprecedented restriction of movement seen during the year which dampened the Group's newspaper sales. The Group also attributed the expected low earnings to be driven by the low marketing and advertising activities as most firm's cash flows were affected by the pandemic,
vii. Longhorn Publishers has witnessed a declining trend in profitability attributed to the suspension of learning in schools seen during the year. The group however indicated that the full optimization of the digital learning solutions would support the recovery of the group's performance in the long run,
viii. East African Cables attributed the decline in earnings to the one-off writeback that was recorded as other income in FY'2019. The Group noted that the impact of the pandemic will reduce the chances of a more aggressive top-line growth to match the performance of the previous year, and,
ix. East African Breweries expects the decline in profits to emanate from the COVID-19 disruptions that have affected its business across the region. The closure of bars as well as the ban on social gatherings and other leisure activities seen during the year negatively affected the demand for alcoholic beverages and products supplied by EABL.

Listing and Suspensions

During the year, we witnessed the Nairobi Securities Exchange (NSE) take actions towards the listing and suspension of listed companies as highlighted below;

i. In July 2020, Kenya Airways was suspended from trading on the securities exchange following the companies operational and corporate restructuring, coupled with the eminent Government buy-out following the publication of the National Management Aviation Bill,
ii. In October 2020, Nairobi Business Ventures (NBV) was suspended from trading for a period of one month, to allow the completion of the company's restructuring. The restructuring exercise included a share split, allotment, and issuance of shares to Delta International FZE and a subscription agreement between NBV and Delta. Key to note, the suspension in trading was lifted in November 2020, and,
iii. In December 2020, HomeBoyz Entertainment Plc (HEL) was listed by way of introduction on the Growth Enterprise Market Segment (GEMS). Notably, 63.2 mn Ordinary shares at a listing price of Kshs 4.66 per ordinary shares were listed. The listing will enable HEL to cement itself as the first company in the Media and Entertainment Sector to be listed in on the GEMS.

Legislations and other Developments

The year 2020 saw a number of legislative changes and other developments that affected the equities market and investor sentiment, namely:

a. **Guidance on Loan Restructuring:** The Central Bank of Kenya on March 27th, 2020 provided commercial banks and mortgage finance companies with guidelines on loan reclassification, and provisioning of extended and restructured loans as per the Banking Circular No 3 of 2020. The key take-outs from the circular included:
   i. Central Bank stipulated that banks would be allowed to extend loan repayments for their customers for a period not more than one year,
   ii. The cost of restructuring and extension of loans would be met by the banks and the banks would have to report any restructuring in relation to the COVID-19 pandemic to the Central Bank monthly,
   iii. Banks would be required to keep a record of all restructured and extended loans with the details of how the pandemic has affected specific customers whose loans are restructured and monitoring measures adopted by the bank, and,
   iv. Personal loans that have been extended or restructured by banks would not be subjected to the classification of renegotiated loans stipulated in CBK's prudential guidelines meaning that banks would not have to classify the loans as non-performing loans.

b. **Capital Preservation:** The Central Bank of Kenya on 14th August 2020, directed that Banks will have to get approval before declaring dividends for the current financial year, in a bid to ensure that the banks have enough capital that will enable them to respond appropriately to the COVID-19 pandemic. The Central Bank gave guidance to lenders asking them to revise their ICAAP (Internal Capital Adequacy Assessment Process) based on the pandemic as highlighted in the Banking Circular No 11 of 2020. Subject to the submission of the revised Internal Capital Adequacy Assessment Process, (ICAAP), CBK will determine if it will endorse the board's decision to pay out dividends. A similar trend has been mirrored globally by both financial and non-financial businesses frantically seeking ways to save money with several regulators encouraging companies to cease the discretionary payments of dividends to shareholders. For instance, in the United Kingdom (UK), the seven largest banks sought to cancel dividend pay-outs despite having solid capital bases, due to fears of an economic recession. Additionally, the Central Bank of most countries has offered guidelines to the banks on dividend payments with, for instance, the Federal Reserve announcing on 25th June 2020 that it would cap dividend payments and prevent share repurchases up to the end of 2020. Closer home, on 6th April 2020, the South African Reserve Bank's Prudential Authority advised banks not to pay out dividends this year and that the bonuses for senior executives should also be put on hold during this period as well. The authority highlighted that this directive would ensure banks conserve their capital and as such, enable the banks to fulfill their fundamental roles,

c. **Mobile Money Transactions:** In an effort to reduce the risk of transmission of COVID-19 through the handling of banknotes, the Central Bank of Kenya announced emergency measures that would increase the use of mobile money transactions as opposed to cash. The measures that were put in place by CBK include;
   i. Free mobile money transactions for amounts up to Kshs 1,000,
   ii. Increase in the mobile wallet limit to Kshs 300,000 while the daily transaction limit was increased to Kshs 300,000, and,
   iii. Elimination of charges for transfers between mobile wallets and bank accounts for Payment Service Providers (PSP) and Commercial Banks.

Notably, the CBK announced in June 2020 that the measures put in place to facilitate mobile transactions such as the free bank-mobile money transfer and the waiver on fees on mobile transactions below Kshs 1,000 had been extended to 31st December 2020. These regulations saw the listed banking sector record a decline in their Non-Funded Income in Q3'2020, growing by a weighted average of 2.1%, slower than the 15.8% growth recorded in Q3'2019,

d. **Unquoted Securities Platform:** Following the approval granted by the Capital Markets Authority (CMA), the Nairobi Securities Exchange (NSE) launched the Unquoted Securities Platform (USP), a market infrastructure that will facilitate the trading, clearing, and settlement of securities of unlisted companies. For trading purposes, an investor will be required to open and maintain a USP securities trading account, identified by a unique trade identification code, generated by the platform. An investor shall then trade their USP securities by placing a buy or sale order through their USP securities dealer.

   i. Some of the offerings that the platform will provide to issuer companies include:
   ii. Offering issuers an opportunity to access the capital markets for long term funding through private placements whilst enjoying flexibility in listing requirements and obligations,
   iii. Enabling unquoted companies that have a register of shareholders to enjoy price discovery and increase the liquidity of their shares, and,
   iv. The platform will also increase transparency and accessibility to information for investors given that prices will be published daily.

The move is in line with the objectives of the CMA's 10-year strategic plan Capital Market Master Plan (2014-2023) of developing a deeper and more liquid domestic equities market through increased listings,

e. **Consolidation:** Consolidation activity remained one of the key highlights witnessed in 2020, as players in the sector were either acquired or merged, leading to the formation of relatively larger, well-capitalized, and possibly more stable entities. The following were some of the major M&A's activities witnessed during the year:

   a. On 27th January 2020, Nigerian lender, Access Bank PLC completed the acquisition of a 100% stake in Transnational Bank PLC for an undisclosed amount, with Access Bank PLC targeting to enhance its corporate and retail banking business in Kenya through the acquisition. Access Bank is Nigeria's largest lender by assets, with an asset base of USD 16.7 bn (equivalent to Kshs 1.7 tn) as at Q1'2020. The deal will see Nigerian banks deepen their presence in Kenya with the United Bank of Africa (UBA) and Guarantee Trust Bank already in the market. Read more information on the transaction here,
   b. On 4th May 2020, the Central Bank of Kenya approved the acquisition of Imperial Bank's assets and assumption of liabilities worth Kshs 3.2 bn each by KCB Group effective 2nd June 2020. The move will see Imperial Bank depositors paid a total of Kshs 3.2 bn over a period of 4 years and will have cumulatively recovered 37.3% of the deposits since 2015 when payments commenced. Imperial Bank was put under receivership (a process that can assist creditors to recover funds in default and can help troubled companies to avoid bankruptcy) in October 2015 due to inappropriate banking practices, with the CBK transferring Imperial Bank's management and control to the KDIC. Read more on the same here,
   c. On 25th August 2020, Co-operative Bank Kenya completed the 90.0% acquisition of Jamii Bora Bank and rebranded it to Kingdom Bank Limited. The transaction that had started in March for a 100.0% purchase of the Bank at Kshs 1.1 bn, was completed in August after receiving all the approvals, with Co-operative Bank varying its initial offer of 100.0% stake to a 90.0% stake. Read more information on the transaction here,
   d. Equity Group Holdings completed the 66.5% stake acquisition of the Banque Commerciale Du Congo (BCDC) at a cost of USD 95.0 mn (Kshs 10.3 bn). Initially, the deal was to cost USD 105.0 mn (Kshs 11.4 bn), however factoring in the adverse effects of the COVID-19 pandemic on the two economies, the two parties agreed to reduce the amount to USD 95.0 mn (Kshs 10.3 bn). Read more information on the transaction here,
   e. I&M Holdings plc issued a cautionary statement to its shareholders on its intention to acquire 90.0% of the share capital of Orient Bank Limited Uganda (OBL). Subsequently, in the fourth quarter, the shareholders have given the approval to proceed with the acquisition. Read more on the same here.

f. On 25th November 2020, KCB Group disclosed that it had entered into an agreement with Atlas Mara Limited (ATMA) to acquire 62.1% stake in Banque De Populaire du Rwanda (BPR) in Rwanda and a 100.0% stake in African Banking Corporation Ltd Tanzania (ABC Tanzania). Key to note, Equity Group had previously entered into a binding agreement in April 2019 with Atlas Mara on the acquisition of banking assets in four countries (Rwanda, Tanzania, Zambia, and Mozambique);0% of the share capital of Banque Populaire du Rwanda (BPR); 100.0% of the share capital of Africa Banking Corporation Zambia (ABCZam) Ltd; 100.0% of the share capital of Africa Banking Corporation Tanzania (ABCTz); and, 100.0% of the share capital of Africa Banking Corporation Mozambique Ltd (ABCMoz). In the 62.1% BPR acquisition, KCB will pay a cash consideration based on the net asset value of the BPR at the completion of the transaction using a price to book multiple of 1.1x. Key to note, according to the latest BPR financials, the bank had a book value of Rwf 46.6 bn (Kshs 5.2 bn), and thus at the trading multiple of 1.1x, we estimate KCB will have to part with Kshs 5.7 bn. The Group also separately intends to make an offer to acquire the remaining shares from the respective shareholders. Read more on the same here.

Below is a summary of the deals in the last 5-years that have either happened, been announced or expected to be concluded:

Acquirer	**Bank Acquired**	**Book Value at Acquisition (Kshs. Bns)**	**Transaction Stake**	**Transaction Value**	**P/Bv Multiple**	**Date**
KCB Group	Banque Commerciale Du Congo	5.2	62.1%	5.7	1.1x	Nov-20*
KCB Group	ABC Tanzania	Unknown	100.0%	Undisclosed	0.4x	Nov-20*
Co-operative Bank	Jamii Bora Bank	3.4	90.0%	1	0.3x	Aug-20
I&M Holdings	Orient Bank Ltd	3.5	90.0%	3.6	1.1x	Jul-20*
Commercial International Bank	Mayfair Bank Limited	1	51.0%	Undisclosed	N/D	May-20*
Access Bank PLC (Nigeria)	Transnational Bank PLC.	1.9	100.0%	1.4	0.7x	Feb-20*
Equity Group **	Banque Commerciale Du Congo	8.9	66.5%	10.3	1.2x	Nov-19*
KCB Group	National Bank of Kenya	7	100.0%	6.6	0.9x	Sep-19
CBA Group	NIC Group	33.5	53%:47%	23	0.7x	Sep-19
Oiko Credit	Credit Bank	3	22.8%	1	1.5x	Aug-19
CBA Group**	Jamii Bora Bank	3.4	100.0%	1.4	0.4x	Jan-19
AfricInvest Azure	Prime Bank	21.2	24.2%	5.1	1.0x	Jan-18
KCB Group	Imperial Bank	Unknown	Undisclosed	Undisclosed	N/A	Dec-18
SBM Bank Kenya	Chase Bank Ltd	Unknown	75.0%	Undisclosed	N/A	Aug-18
DTBK	Habib Bank Kenya	2.4	100.0%	1.8	0.8x	Mar-17
SBM Holdings	Fidelity Commercial Bank	1.8	100.0%	2.8	1.6x	Nov-16
M Bank	Oriental Commercial Bank	1.8	51.0%	1.3	1.4x	Jun-16
I&M Holdings	Giro Commercial Bank	3	100.0%	5	1.7x	Jun-16
Mwalimu SACCO	Equatorial Commercial Bank	1.2	75.0%	2.6	2.3x	Mar-15
Centum	K-Rep Bank	2.1	66.0%	2.5	1.8x	Jul-14
GT Bank	Fina Bank Group	3.9	70.0%	8.6	3.2x	Nov-13
Average			**74.7%**		**1.2x**	

*** Announcement Date**
**** Deals that were dropped**

In 2020, Kenya's operating environment was characterized by challenging macro-economic conditions owing to the adverse effects of the COVID-19 pandemic that disrupted business operations. In 2020, the market remained slumped with P/E below its' historical average of 12.9x to 11.3x, below the most recent peak of 15.9x in April 2018, showing that pockets of value still exist. We are "Neutral" on the Equities markets in the short term but "Bullish" in the medium to long term. We expect the recent discovery of a new strain of COVID-19 coupled with the introduction of strict lockdown measures in major economies to continue dampening the economic outlook. However, we believe there exist pockets of value in the market, with a bias on financial services stocks given the resilience exhibited in the sector. The sector is currently trading at historically cheaper valuations and as such, presents attractive opportunities for investors.
