Cytonn INVESTMENTS

Kenya Listed Banks Q1?2017 Report, & Cytonn Weekly #24/2017

Cytonn Weekly

Executive Summary

Fixed Income: During the week, T-bills subscriptions decreased to 155.2%, compared to 209.2% recorded the previous week. Yields on the 182 and 364-day papers remained unchanged at 10.3% and 10.9%, respectively, while that of the 91-day paper declined by 10 bps to 8.4%, from 8.5% the previous week. Meanwhile, the National Treasury has cut Kenya?s GDP growth projection for 2017 down to 5.7% from 5.9% previously;

Equities: The equities market was on an upward trend with NASI, NSE 20 and NSE 25 gaining 2.4%, 2.1% and 2.1%, respectively, taking their YTD performance to 15.6%, 15.2% and 11.2% for NASI, NSE 25 and NSE 20, respectively. This performance was driven by gains in large cap stocks such as Diamond Trust Bank and Safaricom, which gained 7.0% and 3.3%, respectively. KCB Group has expressed interest to acquire at least 70.0% of issued capital in National Bank of Kenya (NBK) through a share swap deal, with full acquisition phased to follow later;

Private Equity: In acquisitions activity during the week, African Infrastructure Investment Managers (AIIM), a private equity investor in African infrastructure, through its AIIF3 fund, acquired a 44.0% stake in Albatros Energy Mali. On overall private equity activity, The East African Region recorded a 41.0% increase in the amount raised for private equity compared to the amount raised in the preceding 7-years, at Kshs 114.0 bn, from Kshs 80.9 bn in 2014, according to a sector survey done by KPMG and the East Africa Venture Capital Association (EAVCA);

Real Estate: There is increasing investment in the hospitality sector on the back of an improving tourism sector in Kenya, with a 172-key airport hotel set to open later in the year. In the retail sector, investors continue to invest in malls by supplying more retail space, despite signals of a possible oversupply in the Nairobi Metropolitan Area;

Focus of the Week: Following the release of the Q1?2017 results by listed banks, we analyze the results of the listed banks over the first quarter of the year to determine which banks are the most attractive and stable for investment from a franchise value and from a future growth (intrinsic value) perspective.

Company Updates

- On Saturday 17th June 2017, Cytonn Real Estate launched one of its largest projects, RiverRun Estates, a Kshs 15.0 bn project on a 100-acre prime location in Ruiru, Kiambu County. The project is a master planned development comprising of 1,200 residential units, social amenities such as a commercial centre, a school, several playgrounds, a water themed park, a retail promenade and an ultra-modern hotel among others. The development will have a population of 4,500, with targeted investor returns of 27.4% p.a. See Event Note, RiverRun Website and Project Video

- On Monday 12th June 2017, Cytonn Real Estate released its 2017 Cytonn Nairobi Metropolitan Area Land Report. The report themed **?Investment Grade Real Estate and Land Remains the Best Investment Bet**? focused on the performance of land in the Nairobi Metropolitan Area (NMA) between 2011 and 2016. Land in the NMA appreciated by an average of 19.4% p.a. over the period. See Press Release
- Our Senior Manager, Regional Markets Johnson Denge was on CNBC to discuss the land prices growth and the 2017 Cytonn Nairobi Metropolitan Area Land Report. Watch Johnson Denge on CNBC here
- Our Senior Manager, Regional Markets Johnson Denge and Research Analyst Juster Kendi discussed the 2017 Cytonn Nairobi Metropolitan Area Land Report on NTV. Watch Johnson Denge and Juster Kendi on NTV here
- An article by our Investments Analyst Stephanie Onchwati on **?Tax mistakes that will cost your business?** ran on The Standard. Read the article here
- We continue to showcase real estate developments by our real estate development affiliate, Cytonn Real Estate, through weekly site visits. Here are progress videos and pictures on The Alma and Amara. The site visits target both investors looking to invest in real estate directly, and also those interested in high yield investment products to familiarize themselves with how we support the high yield returns. If interested in attending the site visits, kindly register here

- We continue to see very strong interest in our Private Wealth Management training, which is at no cost, and is held bi-weekly, but is open only to pre-screened participants. The training can also be offered to institutions that would like their employees to be trained on Private Wealth Management. To get further details contact our Client Services team at clientservice@cytonn.com
- For recent news about the company, see our news section here
- We have 11 investment-ready projects, offering attractive development and buyer targeted returns of around 25.0% p.a. See further details here: Summary of investment-ready projects
- To invest in any of our current or upcoming real estate projects, please visit Cytonn Real Estate
  - The Alma, which is over 55.0% sold, has delivered an annualized return of 55.0% p.a. for investors who bought off-plan. See The Alma
  - Amara Ridge is currently 100.0% sold and has delivered 33.0% p.a. returns to investors. See Amara Ridge
  - Situ Village is currently 15.0% sold. See Situ Village
  - The Ridge Phase One is currently 31.0% sold. See The Ridge
  - Taraji Heights is currently 10.0% sold. See Taraji Heights
  - RiverRun Estates is currently 6.1% sold after the launch
- We are currently looking for 3-10 acres in Kikuyu, Lower Kabete, Upper Kabete, Loresho or Mountain View, and 7-10 acres of land in Karen, Garden Estate and Langáta for development of villas. Contact us at rdo@cytonn.com if you have any land for sale or joint ventures in the above areas.
- We continue to beef up the team with the ongoing hires: Careers at Cytonn

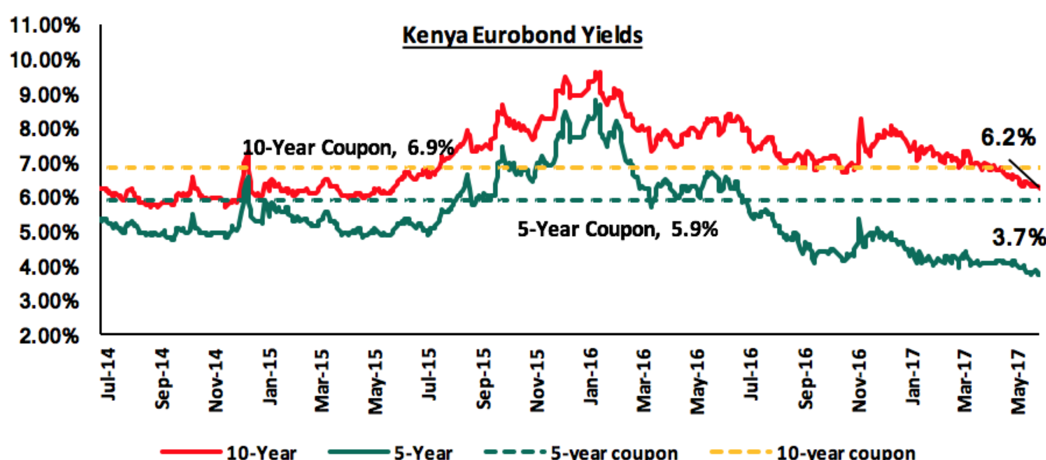
Fixed Income

T-bills subscriptions remained high during the week but decreased to 155.2%, from 209.2% recorded the previous week. Subscription rates for the 91, 182 and 364-day papers came in at 311.4%, 158.6% and 89.4% compared to 381.5%, 255.5% and 94.1% the previous week, respectively, a sign that investor preference was skewed towards shorter-dated papers due to uncertainty in the interest rate environment. Yields on the 182 and 364-day papers remained unchanged at 10.3% and 10.9%, respectively, while that of the 91-day paper declined by 10 bps to 8.4%, from 8.5% the previous week. The overall acceptance rate increased to 93.0% compared to 85.6% the previous week, resulting into government accepting a total of Kshs 34.6 bn of the Kshs 37.3 bn worth of bids received against the Kshs 24.0 on offer in this auction. This indicates that the governments? appetite

for funds to bridge the total budget deficit remains high.

This month the Kenyan government will be re-opening a 15-year fixed-coupon bond (FXD 2/2007/15) with an effective tenor to maturity of 5.0 years, in a bid to raise Kshs 30.0 bn for budgetary support. The government is ahead of its domestic borrowing target for the current fiscal year, having borrowed Kshs 425.2 bn against a target of Kshs 283.3 bn (assuming a pro-rated borrowing throughout the financial year of Kshs 294.6 bn budgeted for the full financial year) and hence is under no pressure to borrow despite (i) the Kenya Revenue Authority (KRA) being expected to miss its FY?2016/17 collection target of Kshs 1.5 tn, and (ii) having only borrowed 44.5% of its foreign borrowing target. Given that the bond (FXD 2/2007/15) is currently priced in the secondary market at a yield of 12.5%, we expect investors to bid close to the secondary market yield, and therefore we would bid at a range of between 12.5% - 12.8%.

According to Bloomberg, yields on the 5-year and 10-year Eurobonds, with 2.0 years and 7.0 years to maturity, increased by 10 bps w/w for both bonds, to close at 4.0% and 6.3%, from 3.7% and 6.2%, the previous week, respectively. Since the mid-January 2016 peak, yields on the Kenya Eurobonds have declined by 5.0% points and 3.3% points for the 5-year and 10-year, respectively, due to stable macroeconomic conditions. The declining Eurobond yields and Standard & Poor?s (S&P) having maintained Kenya?s foreign and local currency sovereign credit ratings for the short and long term at ?B+/B?, respectively, are indications that Kenya remains stable and hence an attractive investment destination.



The Kenya shilling depreciated by 0.2% against the dollar during the week to close at Kshs 103.6 from Kshs 103.3 the previous week, driven by heavy dollar demand from oil importers. On a year to date basis, the shilling has depreciated against the dollar by 1.0%. In our view, we believe that the shilling should remain relatively stable in the short term supported by: (i) forex reserve level currently at USD 8.2 bn (equivalent to 5.4 months of import cover), (ii) the IMF precautionary credit facility of USD 1.5 bn (equivalent to 1.0 more month of import cover) that Kenya can utilise to stabilize the shilling in case of adverse movement in the forex market, and (iii) increased diaspora remittances that grew by 6.2% to Kshs 44.7 bn in Q1?2017 from Kshs 42.1 bn in Q1?2016.

The National Treasury has revised downwards its 2017 GDP growth projection for Kenya to 5.7% from 5.9% previously to reflect the adverse effects of the drought. This projection is likely to decline further to 5.5% after an assessment of leading economic indicators and the March-to-May long rains season has been carried out to determine whether the effects of the drought spilled over beyond Q1?2017. This comes two months after the World Bank and IMF cut their 2017 Kenya GDP projections to 5.5% and 5.3% from 6.0% and 5.7%, respectively, citing the drought?s effect on inflation and agricultural production, slowing private sector credit growth and recovery of global oil prices. In our view, we maintain that GDP growth to slow down in 2017 and come in between 5.3% and 5.7% due to (i) the continued drought and its negative effect on agricultural sector growth, (ii) the interest rate caps which will reduce corporate earnings for commercial banks, (iii) increased

political uncertainty as investors adopt a wait and see stance, and (iv) recovering oil prices, which will increase the import bill given that Kenya is a net importer.

The US Federal Reserve?s Open Market Committee (FOMC) met during the week to assess the state of the US economy and agree on a path for the US monetary policy. The Fed decided to raise rates, in line with our expectations as highlighted in our Cytonn Weekly #23/2017, to a band of 1.00% - 1.25% from a band of 0.75% - 1.00%, previously: the second hike in 2017. The decision by the Fed to hike rates was based on (i) the decline of the unemployment rate to 4.3% in May from 4.5% in March as 138,000 jobs were created in May, and (ii) improvement in business fixed investments, despite core inflation moving marginally below the 2.0% target to 1.9% at the beginning of June from 2.2% in April. With this rate hike, we are likely to see the dollar strengthen in the international markets against other major world currencies.

Fixed Income Conclusions:

Rates in the fixed income market have remained stable supported by,

I. ***The government is significantly ahead of its domestic borrowing target for the current fiscal year, by nearly 50%, having borrowed Kshs 425.2 bn against a target of Kshs 283.3 bn (assuming a pro-rated borrowing throughout the financial year of Kshs 294.6 bn budgeted for the full financial year), and***
II. ***The government may also be looking at concessionary loans to finance the expenditure rather than borrowing from the foreign market.***

Some of the factors that could put upward pressure on interest rates are:

I. ***The government has only borrowed Kshs 205.8 bn of the budgeted foreign borrowing, representing 44.5% of its foreign borrowing target of Kshs 462.3 bn, and***
II. ***The Kenya Revenue Authority (KRA) is expected to miss its overall revenue collection target of Kshs 1.5 tn for the current fiscal year, having collected Kshs 989.9 bn, representing 64.7% of the overall target, over the first 10 months of the fiscal year.***
III. ***Increased budget spending after the tabling of the supplementary budget last week, which is anticipated to be sourced from the domestic market through debt.***

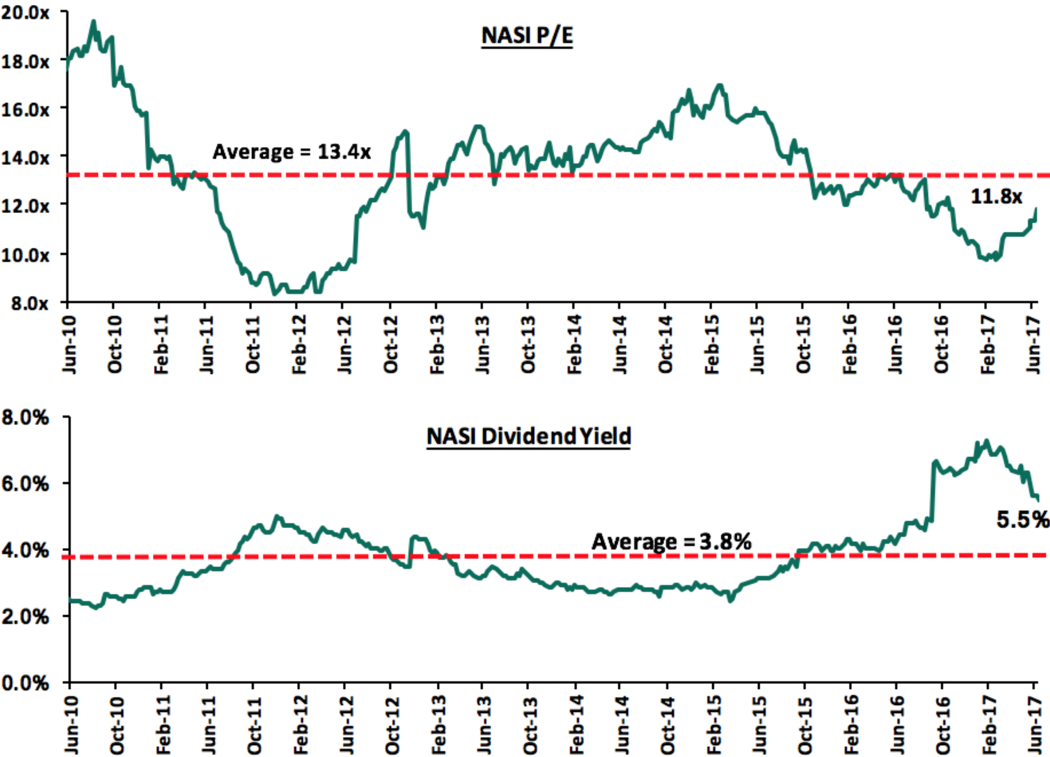
Overall, the possible budget deficit and the high inflationary environment that we are currently in, create uncertainty in the interest rate environment. Our view is that investors should be biased towards short-term fixed income instruments to reduce duration risk.

Equities

During the week, the equities market was on an upward trend with NASI, NSE 20 and NSE 25 gaining 2.4%, 2.1% and 2.1%, respectively, taking their YTD performance to 15.6%, 15.2% and 11.2% for NASI, NSE 25 and NSE 20, respectively. This week?s performance was driven by gains in large cap stocks such as Diamond Trust Bank, and Safaricom, which gained 7.0% and 3.3%, respectively. Since the February 2015 peak, the market has lost 35.6% and 13.2% for NSE 20 and NASI, respectively.

Equities turnover increased by 67.1% to close the week at USD 55.8 mn, the highest in 2017, from USD 33.4 mn the previous week. Foreign investors turned net buyers with net inflows of USD 0.7 mn compared to a net outflow of USD 6.0 mn recorded the previous week. Foreign investor participation remained relatively unchanged at 63.0% from 62.5% recorded the previous week. Safaricom remained the top mover for the week, accounting for 52.5% of market activity. We expect corporate earnings growth to be slower in 2017 and neutral investor sentiment mainly due to the forthcoming general elections.

The market is currently trading at a price to earnings ratio of 11.8x, compared to a historical average of 13.4x, and a dividend yield of 5.5%, compared to a historical average of 3.8%. The current 11.8x valuation is 21.6% above the most recent trough valuation of 9.7x experienced in the first week of February 2017, indicating substantial recovery since February 2017 and 41.6% above the previous trough valuation of 8.3x experienced in December 2011. The charts below indicate the historical P/E and dividend yields of the market.



KCB Group has expressed interest to acquire at least 70.0% of issued capital in National Bank of Kenya (NBK) through a share swap deal divided into three phases. If the deal goes through, KCB Group will temporarily manage and operate two separate brands, KCB Group and NBK in the first phase, before the planned merger of the two entities in the second phase. According to KCB estimates, this is expected to inevitably lead to closure of NBK?s branches that are unprofitable, resulting in staff layoffs at NBK, an exercise that is estimated to cost Kshs 2.8 bn and is to be footed by the National Treasury and the NSSF. In the final phase it?s proposed that KCB Group will acquire 30.0% of NBK shares owned by the public, with the shareholders being compensated with KCB Group shares in exchange for NBK shares based on market valuation of both banks. Currently KCB Group and NBK are trading at Price to Book multiples of 1.1x and 0.3x, respectively. Included in the proposal is a request by KCB Group to the government to introduce an arrangement whereby 80.0% to 90.0% of all government deposits, accounts and banking business in other banks will be centralized into a Treasury Single Account (TSA) at KCB Bank; this request to centralize government deposits is not sensible because it would amount to a preferential anti-competitive practice, which is inconsistent with our open and competitive markets regime. If this deal is successful, it will favor the going concern for NBK through enhanced efficiency levels for the bank currently operating at a cost to income ratio of 95.9% well above an industry average of 64.0%. As highlighted in our Cytonn Weekly #19/2017, regional expansion strategy seems to be eroding value for shareholders thus consolidation serves as a better option for KCB Group in cementing its market share in the country.

Centum Group released FY?2017 results:

Centum Group released their FY?2017 results, recording a 16.5% decline in core EPS to Kshs 12.5 per share from Kshs 14.9 per share in FY?2016 attributable to a 67.4% drop in operating profit from its financial services subsidiaries to Kshs 0.2 bn from Kshs 0.6 bn in FY?2016. The key highlights include:

- The trading subsidiaries (Almasi Beverages, Nairobi Bottlers and King Beverage) recorded a 76.3% growth in trading profit to Kshs 1.2 bn from Kshs 0.7 bn in FY?2016 driven by (i) cost efficiencies from investment in extra capacity and new production lines such as Returnable Glass Bottle (RGB) and Polyethylene Terephthalate (PET) lines at Almasi Beverages, and (ii) first-time consolidation of Longhorn Publishers following acquisition of control in May 2016;
- Financial services subsidiaries (Sidian Bank, Zohari, GenAfrica and Nabo Capital) recorded a 67.4% drop in operating profit to Kshs 0.2 bn from Kshs 0.6 bn in FY?2016, mainly attributable to a decline in profitability of Sidian Bank on account of one-off restructuring and rebranding program cost, coupled with the negative impact of the interest rate cap on interest income;
- Investment operations recorded a 21.4% decline in operating profits to Kshs 7.6 bn from 9.6 bn in FY?2016, following an 80.9% drop in realized gains on disposal of investments to Kshs 1.0 bn from Kshs 5.4 bn in FY?2016;
- Total costs remained within the strategic target of below 2.0% of total assets at 1.3% for the year from 1.7% of total assets in FY?2016;
- Profit before tax declined by 17.7% to Kshs 8.9 bn from Kshs 10.9 bn in FY?2016, while profit after tax declined by 16.5% to Kshs 8.3 bn from Kshs 9.9 bn in FY?2016;
- The total assets grew by 12.9% during the reporting period to Kshs 88.1 bn from Kshs 78.1 bn on account of a 65.4% y/y growth in investment property to Kshs 27.3 bn from Kshs 16.5 bn. Centum Group deployed a total of Kshs 5.5 bn in capital expenditure to the different focus areas during the year;
- The total liabilities grew by 11.8% to Kshs 38.9 bn from Kshs 34.8 bn on account of a Kshs 3.0 bn debt the company secured to fund its projects;
- Shareholders? funds grew by 13.8% to Kshs 49.2 bn from Kshs 43.2 bn in FY?2016, translating to a 14.0% growth in Net Asset Value (NAV) per share to Kshs 67.4 from Kshs 59.1 in FY?2016;
- The Board of Directors recommended payment of a dividend of Kshs 1.2 per share, a 20.0% increase from Kshs 1.0 in FY'2016.

Going forward, we expect Centum to register a high level of growth steered by;

- The growth portfolio segment consisting of Almasi Beverages, King Beverage, GenAfrica, Sidian Bank and Nabo Capital, through continued strengthening of the subsidiary companies to enhance profitability, and
- Real Estate developments especially Two Rivers and Pearl Marina projects that have progressed to a cash generating level and are expected to be substantially self-funding moving forward. The group continues to enhance value of the developments through (i) infrastructural development, and (ii) collaboration with governments and other business partners. In Healthcare and Education, significant investment has been made.

Below is our Equities Universe of Coverage:

all prices in Kshs unless stated otherwise								
Our Equity Universe								
No.	**Company**	**Price as at 09/06/17**	**Price as at 16/06/17**	**w/w Change**	**YTD Change**	**Target Price***	**Dividend Yield**	**Upside/ (Downside)****
1.	DTBK	142.0	152.0	7.0%	28.8%	241.1	2.1%	60.7%
2.	NIC	31.0	33.5	8.1%	28.8%	51.2	3.8%	56.6%
3.	KCB Group***	40.0	37.0	(7.5%)	28.7%	54.0	8.1%	54.1%
4.	I&M Holdings	93.0	101.0	8.6%	12.2%	147.5	3.6%	49.6%
5.	HF Group	10.3	10.4	1.0%	(26.1%)	13.9	3.6%	37.9%
6.	Barclays	9.8	9.6	(2.1%)	12.6%	12.1	10.3%	37.0%
7.	BAT (K)	795.0	795.0	0.0%	(12.5%)	970.8	6.2%	28.3%
8.	Liberty	10.4	11.0	5.8%	(16.7%)	13.0	0.0%	18.0%

9.	Jubilee Insurance	429.0	430.0	0.2%	(12.2%)	490.5	1.8%	15.9%
10.	Stanbic Holdings	72.0	71.5	(0.7%)	1.4%	77.0	6.6%	14.2%
11.	Co-op Bank	17.3	17.2	(0.6%)	30.3%	18.5	4.5%	12.0%
12.	Standard Chartered	206.0	207.0	0.5%	9.5%	209.3	5.0%	6.1%
13.	Equity Group	39.0	39.0	0.0%	30.0%	38.4	5.1%	3.6%
14.	Kenya Re	20.8	20.8	0.0%	(7.8%)	20.5	4.4%	3.2%
15.	CIC Group	3.8	3.9	1.3%	1.3%	3.7	3.2%	(0.4%)
16.	Britam	11.7	13.0	11.6%	30.0%	11.9	2.3%	(6.2%)
17.	Safaricom	22.8	23.5	3.3%	22.7%	19.8	4.7%	(11.2%)
18.	Sanlam Kenya	29.0	29.0	0.0%	5.5%	21.1	0.0%	(27.4%)
19.	NBK	7.0	9.9	40.7%	36.8%	4.0	0.0%	(59.2%)
Target Price as per Cytonn Analyst estimates								
****Upside / (Downside) is adjusted for Dividend Yield***								
*****For full disclosure, Cytonn and/or its affiliates holds a significant stake in KCB Group, ranking as the 14th largest shareholder***								

We remain "neutral with a bias to positive" for investors with short to medium-term investments horizon and are "positive" for investors with a long-term investment horizon.

Private Equity

The East African region continues to attract private equity investment as recorded by an increase in fundraising amounts. According to a sector survey done by KPMG and the East Africa Venture Capital Association (EAVCA), Kshs 114.0 bn has been raised by private equity investors for East African investments between 2015 and 2016, a 41.0% increase from the preceding 7-years. The report also indicates that 16 Africa focused funds have already deployed Kshs 62.0 bn in the region, with Kshs 50.0 bn of it being invested in Kenya. Kenya also had the highest number of deals in the region, with 23 out of the total 35 deals recorded in 2016, which was an 11.5% decline from the 26 of the 47 deals recorded in 2015. The increase in private equity investment in the region has been supported by (i) the attractive valuations in the region, (ii) strong demographics, such as a growing middle class and rapid urbanization, which create opportunities for private capital to support the growth, (iii) higher economic growth projections in Sub Sahara Africa compared to global markets, and (iv) increased number of exits in the market, which has increased confidence for investors in the region. The continued positive performance of the private equity sector indicates the East Africa region remains an attractive and vibrant PE investment destination.

Fanisi Capital, an East African private equity firm, has received Kshs 3.0 bn in commitments in its first phase of its second round of capital raising. The fund, dubbed Fanisi Capital Fund II, will channel funds into regional investments in healthcare, agri-business, retail and education sectors. Local Kenyan investors committed approximately Kshs 1.4 bn, which is 45.0% of the committed capital to date, with the rest coming from international investors. Fanisi Capital fund II is a closed-ended 10-year SME Venture fund that targets to raise between Kshs 7.5 bn to Kshs 10 bn. The firm managed to raise Kshs 5.0 bn between 2010 and 2015 in its first fund, whose proceeds were invested in companies such as Haltons Pharmacy, Kijenge Animal Products in Arusha, ProDev/Minimex Group in Rwanda, Live Ad Limited, an outdoor advertising firm, Hillcrest Schools and European Foods Africa Ltd. In October 2016, Fanisi Capital Fund II targeted local institutional investors with a bias to pension funds who have in the recent past improved their investment capacity after the introduction of private equity as a stand-alone investment class for the schemes allowing up to 10.0% of their exposure in this asset class. The fund had also attracted interest from the International Finance Corporation (IFC), which had planned to invest up to Kshs 750.0 mn in the fund in exchange for an equity stake not exceeding 20.0%. Proceeds will be invested across Kenya, Tanzania, Uganda and Rwanda.

African Infrastructure Investment Managers (AIIM), a private equity investor in African infrastructure, through its AIIF3 fund, has acquired a 44.0% stake in Albatros Energy Mali. Albatros

Energy Mali intends to develop Mali?s first independent power project (IPP) to feed into the national grid. The power plant will be located in Kayes, Western Mali and will have a capacity to inject 90 MW into the national grid. The plant will add a quarter of the current base-load potential, which stands at 352 MW, equivalent to power for an estimated 780,000 households. The investment in Albratos by AIIM is beneficial as (i) it will enhance the provision of the much needed sustainable energy source and the access to electricity for Mali?s citizens, (ii) Albratos will benefit from AIIMs experience in infrastructure development, and (iii) growth of industries following increased supply and distribution of electricity. Only 25.6% of Mali?s 17.6 mn population have access to electricity. This is the latest in a series of raises in the energy sector. The last being Frontier Investments Management, a Danish private equity firm, having Ksh 12.0 bn in its first close of its Frontier Energy II to finance greenfield renewable energy projects across the Sub-Sahara Africa region.

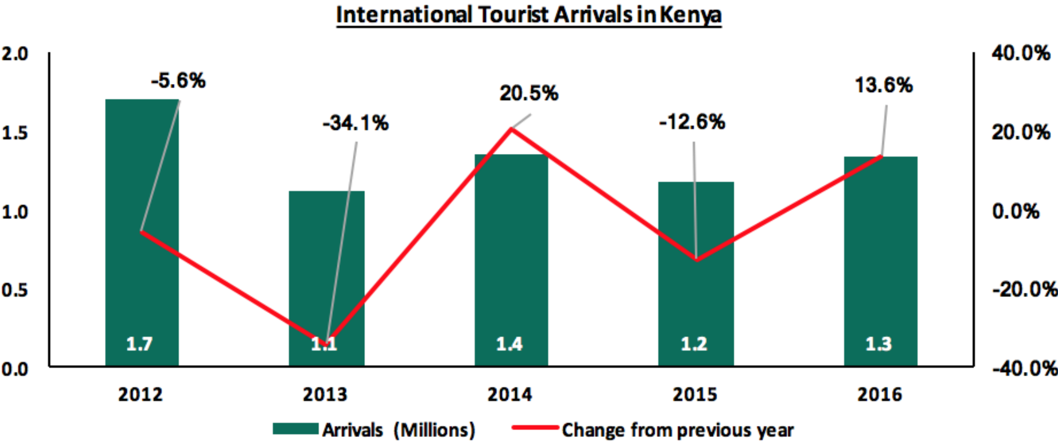
Private equity investments in Africa remain robust as evidenced by the increased deals and fundraising activities. The increasing investor interest is attributed to (i) rapid urbanization, a resilient and adapting middle class and increased consumerism, (ii) the attractive valuations in private markets compared to global markets, and (iii) higher economic projections in Sub Sahara Africa compared to global markets. We remain bullish on PE as an asset class in Sub-Sahara Africa. Going forward, the increasing investor interest and stable macro-economic environment will continue to boost deal flow into African markets.

Real Estate

Britam Group through its property development and management business unit, Britam Properties (Kenya) Limited, announced plans to put up a Kshs 12.0 bn mall in Kileleshwa during the firm?s Annual General Meeting (AGM) on Friday last week. This is despite the stagnation of rental prices and malls taking longer to let as a result of increased supply as per the Africa Report 2017 by Knight Frank. The contemplated mall will add 130,000 sqft of retail space to the current stock of 3.95 mn square feet in Kenya as at 2016, with majority being within the Nairobi Metropolitan Area (NMA) according to our *Cytonn Retail Report 2016*. Retail space has continued to increase in the country growing by a CAGR of 16.9% from 1.89 mn square feet in 2010 to 3.95 mn square feet in 2015, driven by (i) the rise of the middle class with increased purchasing power, and (ii) demand for sophisticated lifestyles coupled by a good transport network. Despite the increased supply, the overall occupancy rate averaged at 82.9% in the country with the theme recording an average rental yield of 8.7%. Mt Kenya Region and Nairobi have the highest yields averaging at 10.1% and 10.0%, respectively. We expect the stagnation of prices witnessed in the last 2-years to drive mall developers away from Nairobi towards its satellite towns and County headquarters, which are experiencing influx in population and increased local pressure for retail development through devolution.

On the hospitality front, Four Points by Sheraton announced plans to open a 172-room airport hotel in Nairobi in October this year. This is barely 6-months after Four Points by Sheraton opened its doors in Hurlingham following the rebranding of the hotel previously managed under the Best Western Premier brand. The hotel will be located near Jomo Kenyatta International Airport, targeting travelers to and from Kenya. The target clientele for the airport hotels are both transiting leisure travelers and international business travelers. Other revenue streams would be expected from airlines seeking to accommodate airline crews and distraught passengers following flight delays, reschedules or cancelled journeys. The Four Points airport hotel is owned by Kanari Ltd, Bluesky Investments Ltd, which are family businesses, and Airstar Ltd, each owning 33.3%. This will be the second operational airport hotel in Kenya, which is in addition to the 144-room Lazizi Premiere Hotel, which started operations last month. The growth opportunity for such hotels is heavily anchored on GDP growth and a steady increase in international arrivals. Last year for instance, the number of tourist arrivals experienced a rebound, expanding by 13.5% from 1.18 mn in

2015 to 1.34 mn tourists in 2016. We foresee continued improvement especially in business tourism given that Kenya has continued to be the preferred conference destination in the larger East African region.



During the week, the Transport Principal Secretary of Kenya announced that the Isiolo International Airport will start operations in 2 weeks. Isiolo town, located 285 km north of Nairobi, is a crucial and strategic gateway between Northern and Southern Kenya especially after the implementation of the Lamu Port, South Sudan, Ethiopia Transport (LAPSSET) corridor project. The Kshs 2.7 bn facility will handle up to 350,000 passengers only from domestic flights. The airport, which sits on a 260-hectare parcel of land, is one of the key Vision 2030 flagship projects in Isiolo County in addition to the Isiolo Resort City project, both of which are expected to unlock the economic potential of the region. Isiolo is also one of the major towns set to benefit from the LAPSSET corridor project. Still in the same region, the LAPSSET Corridor Development Authority (LCDA) has directed the Isiolo County Government to set aside 10,000 acres at Kula Mawe for the development of the Isiolo Resort City. We thus expect to witness an increase in real estate development and tourism in Isiolo County driven by the improved infrastructure.

A 7-storey building sunk into its foundation in Kware, Embakasi, Nairobi on Monday night. This is in addition to at least 12 other buildings that have collapsed in Kenya since 2011. In April 2016, the National Construction Authority (NCA) in coordination with the National Buildings Inspectorate started country wide building inspection to identify and demolish substandard buildings following the collapse of a 6-storey building in Nairobi?s Huruma estate. They have since earmarked over 30,000 buildings for demolition but they are yet to be demolished due to court orders. According to the County Government, the building was among those earmarked for demolition. In November last year, the Kenyan government scrapped off levies charged by the NCA & National Environmental Management Authority (NEMA). This was an effort to lower construction costs hence increase compliance facilitating the development of safer affordable housing. Though a step in the right direction, the government and the relevant authorities need to do more to prevent citizens from losing their lives including (i) sensitization on disaster management, (ii) basic first aid skills, and (iii) increasing the staff capacity of the regulatory bodies. Despite these measures, developers also have a duty to exercise responsibility through professionalism in the construction by using the right mixtures, quality of materials and employing best practices to ensure they deliver quality products and should be held responsible in incidences of buildings collapse to increase accountability.

Cytonn Real Estate, the development affiliate of Cytonn Investments, this week launched their Kshs. 15.0 bn RiverRun Estates development, sitting on a 100-acre parcel of land in Ruiru, Kiambu County. The land, which borders Tatu City to the West, is 35 minutes from Nairobi CBD and 45 minutes to the Jomo Kenyatta International Airport. RiverRun Estates comprises of over 1,200 residential units made up of 600 residential villas, townhouses & maisonettes and over 600 apartment units, with the master-planned development encompassing social amenities such as a commercial center, a school,

several playgrounds, a water themed park, a Riverfront Promenade, cottages and an ultra-modern hotel with a frontage to the dam. RiverRun Estates is Cytonn?s third development in Kiambu County, in addition to The Alma and Taraji Heights, both in Ruaka, as they take advantage of the fast-growing County, which has demonstrated demand for lifestyle developments. Ruiru was predominately an agricultural area characterized by coffee plantations and known as one of the top coffee-producing areas in the country. However, low returns from agriculture and ease of access to the area have since made most owners change their land use to real estate development. Besides demand for housing due to close proximity to employments nodes such as Kiambu town, Ruiru town and the CBD, other aspects within the Ruiru area that favor development growth include: (i) easy connectivity by road, especially Thika Superhighway, the Eastern Bypass and the Ruiru- Kamiti Road, which allow for easy access to Nairobi?s CBD, Mombasa road, Ruiru & Kiambu towns, respectively, and (ii) improved infrastructure for the area, including the proposed sewerage system, which allow for large-scale developments. The project seeks to offer the perfect home for both first time home owners as well as those seeking a quaint and serene locale away from the hustle and bustle common with most urban developments. As per our Cytonn Nairobi Metropolitan Area Land Report, land in Ruiru has appreciated by an average of 23.9% per annum over the last 5-years, which adds to the total return profile. RiverRun Estates is expected to deliver an investment return of 27.4% per annum.

The real estate sector remains resilient to the current political state of the country, witnessing increased investments especially in the retail and hospitality sectors. We expect this to continue especially if calm elections are held with tourism picking up from its downward trend over the past 5 years. Key safety issues could however curtail the development and need to be addressed.

Kenya Listed Banks Q1?2017 Report

Following the release of the Q1?2017 results by banks, we undertook an analysis on the Kenyan Banking sector to point out any material changes from the FY?2016 Banking Report. In our Q1?2017 Banking Report, we analyze the results of the listed banks in order to determine which banks are the most attractive and stable for investment from a franchise value and from a future growth opportunity perspective.

The report is themed ***?Consolidation and prudence in a challenging operating environment?*** as the banking sector is witnessing increased consolidation while remaining prudent following rising non-performing loans and the capping of interest rates. Below are some of the themes that shaped the banking sector in the first quarter in 2017:

1. **Consolidation ?** Consolidation in the banking sector continued to gather pace, with weaker banks being forced to merge or be acquired. During the year, Diamond Trust Bank Kenya (DTBK) announced plans to acquire Habib Bank (K) Limited (HBL) setting the platform for more consolidation this year, with the acquisition subject to regulatory approval in both Kenya and Pakistan. According to reports emerging recently, KCB Group has expressed interest to acquire the National Bank of Kenya (NBK) through a share swap, buying out 70.0% of the bank in the first phase, with a full acquisition to follow. As highlighted in our Cytonn Weekly #47/2016these cases of consolidation in the banking sector will lead to fewer, but larger banks, which are more stable and can withstand shocks in the economy.

Acquirer	Bank Acquired	Book Value at Acquisition (Kshs bns)	Transaction Stake	Transaction Value (Kshs bns)	P/Bv Multiple	Date
Diamond Trust Bank Kenya	Habib Bank Limited Kenya	2.38	100.0%	1.82	**0.8x**	Mar-17

SBM Holdings	Fidelity Commercial Bank	1.75	100.0%	2.75	**1.6x**	Nov-16
M Bank	Oriental Commercial Bank	1.80	51.0%	1.30	**1.4x**	Jun-16
I&M Holdings	Giro Commercial Bank	2.95	100.0%	5.00	**1.7x**	Jun-16
Mwalimu SACCO	Equatorial Commercial Bank	1.15	75.0%	2.60	**2.3x**	Mar-15
Centum	K-Rep Bank	2.08	66.0%	2.50	**1.8x**	Jul-14
GT Bank	Fina Bank Group	3.86	70.0%	8.60	**3.2x**	Nov-13
Average			**80.3%**		**1.8x**	

2. **Regulation** ? The effects of the Banking (Amendment) Act 2015 have been felt in the first quarter of 2017, with banks recording a decline in core EPS by 8.6% and private sector credit growth slowing to 4.0% compared to 5.4% when the amendment came into play. The amendment stipulates a deposit and loan pricing framework, with (i) a cap on lending rates at 4.0% above the Central Bank Rate (CBR), and (ii) a floor on the deposit rates at 70% of the CBR. In January 2017, the International Monetary Fund (IMF) expressed concerns about interest rate capping and its negative effect on private sector credit growth and banking sector earnings, noting that it may be necessary to repeal the act as maintaining the same would end up taking a toll on Kenya?s financial sector stability. Meanwhile, the Central Bank (CBK) has come out and stated that it is finalizing a study on the effects of the law and its impact on the economy, while working closely with the Kenya Bankers Association (KBA).
3. **Asset Quality ?** The banking sector has witnessed a deterioration in asset quality over the past year, with the gross non-performing loan (NPL) ratio rising to 11.6% from 8.1% in Q1?2016. This has led to an increase in provisioning levels to 54.1% from 47.2% in Q1?2016. We are seeing banks becoming more selective in terms of loan disbursement, since with the current pricing framework, it is difficult to price in risk in the cost of loans.

Based on the above, we believe consolidation is going to continue in the sector as weaker banks are acquired by the more stable banks, and foreign entities enter the Kenyan banking sector through acquisitions, while also through setting up new operations following the lifting of the moratorium to license new banks. Banks that have common significant shareholders are likely to merge and operate as one entity given the tough operating environment. The sector is shaping up to prudence in operations in the wake of increased loan loss provisioning and the capping of interest rates.

Below are Q1?2017 key operating metrics for listed banks in Kenya:

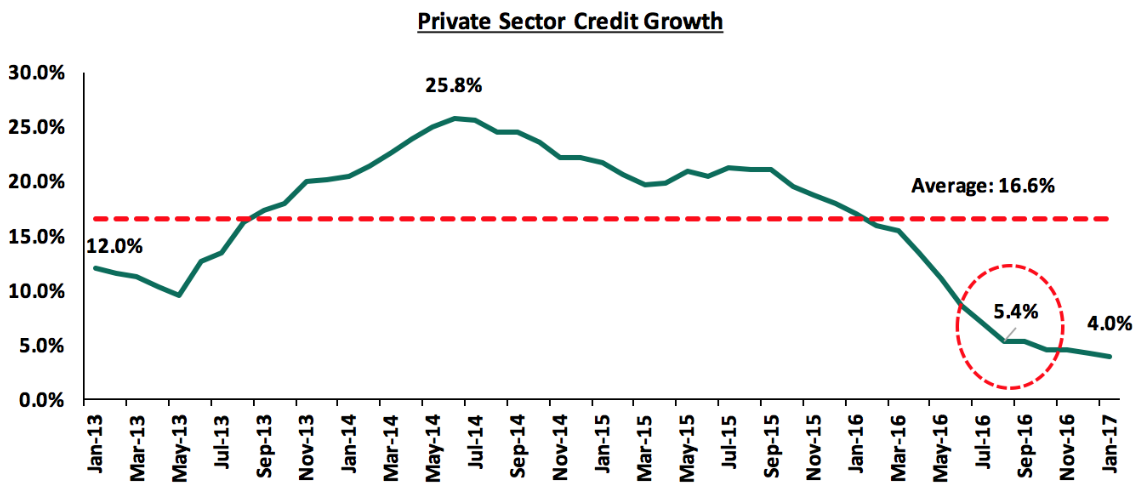
Listed Banks Q1'2017 Earnings and Growth Metrics						
Bank	**Core EPS Growth**	**Deposit Growth**	**Loan Growth**	**Net Interest Margin**	**Loan to Deposit Ratio**	**Exposure to Government Securities**
Diamond Trust Bank	**8.8%**	22.1%	4.8%	7.2%	74.9%	39.1%
KCB Group	**(3.2%)**	7.9%	14.3%	9.1%	86.6%	23.2%
NIC Bank	**(3.9%)**	6.8%	3.9%	7.9%	98.7%	26.4%
Equity Group	**(5.6%)**	16.1%	(4.8%)	10.3%	75.4%	32.5%
Co-op Bank	**(6.0%)**	6.9%	15.0%	9.5%	87.9%	23.0%
Stanbic Bank	**(9.3%)**	20.0%	11.4%	6.9%	88.4%	22.4%
I&M Bank	**(16.9%)**	14.3%	8.8%	8.0%	86.2%	34.7%
Barclays Bank	**(19.8%)**	7.6%	10.7%	10.2%	92.8%	24.2%
Standard Chartered Bank	**(20.5%)**	11.1%	6.5%	9.0%	57.0%	47.2%

Housing Finance Group	**(73.1%)**	(6.4%)	2.2%	6.2%	142.7%	11.1%
National Bank of Kenya	**(82.2%)**	(6.7%)	(12.3%)	7.5%	62.7%	38.2%
Q1'2017 Weighted Average*	**(8.6%)**	**11.7%**	**7.1%**	**9.2%**	**81.2%**	**30.0%**
Q1'2016 Weighted Average*	**13.6%**	**10.8%**	**15.7%**	**9.3%**	**85.1%**	**26.0%**
**** The weighted average is based on Market***						

Key takeaways from the table above include:

- The listed banks recorded an 8.6% decline in core EPS, compared to a growth of 13.6% in Q1?2016. All the banks recorded negative growth except for Diamond Trust Bank, which recorded a growth of 8.8%, due to flat performance in NII, meaning it was the least affected bank in Q1?2017, following the capping of interest rates,
- Deposits grew at a faster rate than loans during the first quarter of the year, which is the reverse of what was witnessed in Q1?2016. The loan growth came in lower as private sector credit uptake slumped to 4.0% in Q1?2017, with banks adopting a more prudent credit risk assessment framework to ensure healthy loan books, which saw the loan to deposit ratio drop to 81.2% from 85.1% in Q1?2016,
- Despite the Banking Act (Amendment) 2015, banks managed to preserve their net interest margins (NIM) in Q1?2017, which declined marginally to 9.2% from 9.3% in Q1?2016, despite net interest income (NII) declining by 11.3% y/y,
- Exposure in government securities rose to 30.0% from 26.0% in Q1?2016 as banks allocated more funds towards the government following the capping of interest rates, depriving the private sector of credit in the process,
- The increase in the gross non-performing loan (NPL) ratio to 11.6% from 8.1% in Q1?2016, highlights increased risks around asset quality in the sector, with banks having taken a prudent approach with the adoption of IFRS 9, and
- Listed banks recorded a decline on return on average equity to 16.8% from 17.6% in Q1?2016, as the banks? profitability was affected by the capping of interest rates, which suppressed net interest income in the first quarter of the year.

Kenya?s listed banks recorded negative EPS growth of 8.6% in Q1?2017 compared to an average growth of 13.6% in Q1?2016. The poor performance was primarily on the back of an 11.3% decline in NII following the capping of interest rates, which stipulates a rigid deposit and loan-pricing framework. The Banking Act (Amendment) 2015 was introduced with a view of making loans cheap and accessible but this has not been the case, with private sector credit growth slowing to 4.0% in the first quarter of 2017, way below the government set target of 18.3%, as banks channel funds more actively towards government securities, depriving the private sector credit.



Rate cap came into effect in August 2016 when private sector credit growth was at 5.4% as highlighted above

The focus for the banking sector in 2017 will inevitably be on adjusting business models to conform to the Banking (Amendment) Act 2015, with banks taking proactive measures aimed at increasing operational efficiency in response to the challenging operating environment, such as laying off staff, closure of branches, reviewing operating hours for some branches, or outright sales in the case of Tier III banks. Barclays Bank was the latest bank to report laying off staff, with 171 employees laid off in 2016, following reports that KCB Group laid off 223 employees within the same period, bringing to 11 the number of banks that have announced downsizing plans since the implementation of the interest rate cap. Going forward, we are likely to witness banks? push for efficiency gather pace to balance off the expected reduction in absolute profitability going forward as they shy away from physical branches model, which are very expensive compared to other alternative channels such as digital platforms.

Kenya Banking Sector Restructuring			
	Bank	**Staff Retrenchment**	**Branches Closed**
1.	Sidian Bank	108	-
2.	Equity Group	400	7
3.	Ecobank	-	9
4.	Family Bank	Unspecified	-
5.	First Community Bank	106	-
6.	Bank of Africa	-	12
7.	National Bank	Unspecified	-
8.	NIC Bank	32	-
9.	Standard Chartered Bank Kenya	300	-
10.	KCB Group	223	-
11.	Barclays Bank	171	-

Despite the capping of interest rates being the primary reason for the poor performance by banks in Q1?2017, banks with operations in South Sudan such as Equity Group, KCB Group, Co-operative Bank and Stanbic Holdings have continued to be adversely affected by political instability in the country, which has led to hyperinflation and devaluation of the South Sudanese Pound. These, coupled with increased loan loss provisioning due to concerns around banking sector loan book quality, has seen the banking sector record a sluggish performance in Q1?2017.

As per our analysis on the banking sector, from a franchise value and from a future growth opportunity perspective, below is the comprehensive ranking of the listed banks.

CYTONN?S Q1?2017 BANKING REPORT ? COMPOSITE RANKINGS					
Bank	**Franchise Value Total Score**	**Total Return Score**	**Weighted Score**	**Q1?2017 Rank**	**FY ?2016 Rank**

KCB Group	56.0	3	24.2	**1**	**1**
Co-operative Bank	53.0	8	26.0	**2**	**2**
DTB	64.0	1	26.2	**3**	**4**
I&M Holdings	69.0	4	30.0	**4**	**6**
NIC Bank	76.0	2	31.6	**5**	**9**
Equity Group	71.0	10	34.4	**6**	**3**
Barclays Bank	79.0	6	35.2	**7**	**7**
SCBK	75.0	9	35.4	**T8**	**5**
Stanbic Holdings	78.0	7	35.4	**T8**	**8**
HF Group	119.0	5	50.6	**10**	**10**
NBK	117.0	11	53.4	**11**	**11**

Major changes include:

- Equity Group dropped by 3 spots to Position 6 from Position 3 in our FY?2016 Banking Sector Report, being weighed down by an expensive valuation based on Price to Tangible Book Valuation at 2.0x, above industry average of 1.1x, and low deposits per branch at Kshs 1.3 bn, below the industry average of Kshs 2.6 bn, indicating a lower level of efficiency in utilizing its extensive branch network to mobilize deposits,
- NIC Bank rose 4 positions to Position 5 from Position 9 in our FY?2016 Banking Sector Report due to an improved intrinsic value, rising to Position 2 from Position 9 in FY?2016, given its current cheap valuation. The stock is currently trading at a P/B and P/E of 0.7x and 5.0x, versus industry averages of 1.4x and 7.2x, respectively. The bank was also boosted by its franchise value, with the bank having the lowest Cost to Income ratio, coming in at 39.3% below the industry average of Kshs 53.3%.

For a comprehensive analysis on the ranking and methodology behind it, see our Cytonn Q1?2017 Banking Sector Report.

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