Kenya Listed Banks H1'2017 Report, & Cytonn Weekly #37/2017

Cytonn Weekly

Executive Summary

Fixed Income: T-bills were undersubscribed during the week, with the overall subscription rate coming in at 91.8%, compared to 153.5% recorded the previous week. Yields on the 91, 182 and 364-day papers remained unchanged from the previous week at 8.1%, 10.3% and 10.9%, respectively. The Monetary Policy Committee (MPC) is set to meet on Monday, 18th September 2017, to review the prevailing macroeconomic conditions and give direction on the Central Bank Rate (CBR) and we expect them to hold the rate stable at 10%;

Equities: During the week, the equities market was on a downward trend with NSE 20, NASI and NSE 25 losing 1.5%, 0.7% and 0.4%, respectively, taking their YTD performance to 23.4%, 22.0% and 18.8% for NASI, NSE 25 and NSE 20, respectively. The Central Bank of Kenya (CBK) has signaled its intention to push for repeal of the interest rates cap law that has been in effect for a year now, due to the negative effect it has had on private sector credit growth and the expected negative impact on the economy;

Private Equity: The private equity sector in the region remains robust with continued activity. The International Finance Corporation(IFC), the private sector arm of World Bank Group, based in Washington, DC is set to acquire an undisclosed stake valued at USD 6.0 mn in Africa's Talking, a Kenyan based firm that offers a cloud based platform to businesses and application developers;

Real Estate: International retailers aim to get a foothold of Kenya's retail sector, as CarreFour seeks protection from competition through an application for exclusive rights of occupancy at the Two Rivers Mall. Hoteliers employ innovative ways to market Kenya as a business and leisure destination in a bid to boost the hospitality industry;

Focus of the Week: Following the release of the H1'2017 results by listed banks, we analyze the results of the listed banks over the first half 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

- Julian Kyula, the CEO, Mobile Decisioning (MODE), trained at this week's Cytonn Entreprenuers Hub, Cytonn eHub. The training was about sourcing for capital and overcoming financing challenges when starting a business venture. See Event Note. Cytonn eHub focuses on training and mentoring young and upcoming entrepreneurs to enhance their knowledge and capabilities on how to run and grow successful enterprises. It is an initiative of the Cytonn Foundation that encompasses all pillars of the Foundation namely: Entrepreneurship, Financial Literacy, and Training and Mentorship

- We continue to showcase real estate developments by our real estate development affiliate, Cytonn Real Estate, through weekly site visits. Watch progress videos and pictures on The Alma, Amara, The Ridge and Taraji Heights. The site visits target both investors looking to invest in real estate directly and those interested in high yield investment products to familiarize themselves with how we support our high yield returns. To deliver high yield returns, our cost of capital is priced off the loan markets where all-in pricing ranges from 16.0% to 21.0% and our yield on real estate developments ranges from 23.0% to 25.0%, hence our top-line gross spread is about 6%. If interested in attending the site visits, kindly register here

- We continue to see very strong interest in our Private Wealth Management training (largely covering financial planning), which is at no cost, and is held bi-weekly, but is open only to pre-screened participants. We also continue to see institutions and investment groups interested in the trainings for their teams, if interested in the training for your employees or investment group please get in touch with us through our Client Services team at clientservices@cytonn.com To view the wealth management training topics click here
- For recent news about the company, see our news section here
- We have 10 investment-ready projects, offering attractive development and buyer targeted returns of around 23.0% to 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 over 20.0% p.a. returns to investors. See Amara Ridge
  - Situ Village is currently 15.0% sold. See Situ Village
  - The Ridge (Phase 1) is currently 31.0% sold. See The Ridge
  - Taraji Heights is currently 10.0% sold. See Taraji Heights
  - RiverRun Estates (Phase 1) is currently 8.7% sold after the recent launch. See RiverRun Estates

- We continue to beef up the team with ongoing hires: Careers at Cytonn

Fixed Income

During the week, T-bills were undersubscribed, with the overall subscription rate coming in at 91.8%, compared to 153.5% recorded the previous week due to reduced liquidity, which was a result of tax remittances. The subscription rates for the 91, 182 and 364-day papers came in at 103.0%, 95.5%, and 83.5% compared to 101.1%, 226.7% and 101.3%, respectively, the previous week. Yields on the 91, 182 and 364-day papers remained unchanged from the previous week at 8.1%, 10.3% and 10.9%, respectively. The overall acceptance rate came in at 94.1% compared to 93.4% the previous week, with the government accepting a total of Kshs 20.7 bn of the Kshs 22.0 bn worth of bids received, against the Kshs 24.0 bn on offer in this auction. Despite this, the government is behind its domestic borrowing target for the current fiscal year, having borrowed Kshs 17.6 bn, against a target of Kshs 67.2 bn (assuming a pro-rated borrowing target throughout the financial year of Kshs 317.7 bn budgeted for the full financial year). The deficit has been covered by an overdraft from the Central Bank, which currently stands at Kshs 27.3 bn. We expect the government to meet its domestic borrowing target for the fiscal year, as banks and institutions channel funds more actively towards government securities following the enactment of the law on capping of interest rates.

Market liquidity was relatively tight during the week due to remittance of taxes by commercial banks. There was a net liquidity withdrawal of Kshs 5.9 bn this week, compared to a net injection of Kshs 4.2 bn the previous week, with the bulk of the liquidity reduction coming from T-Bill primary issues and transfer of taxes from commercial banks at Kshs 34.4 bn and Kshs 30.3 bn, respectively.

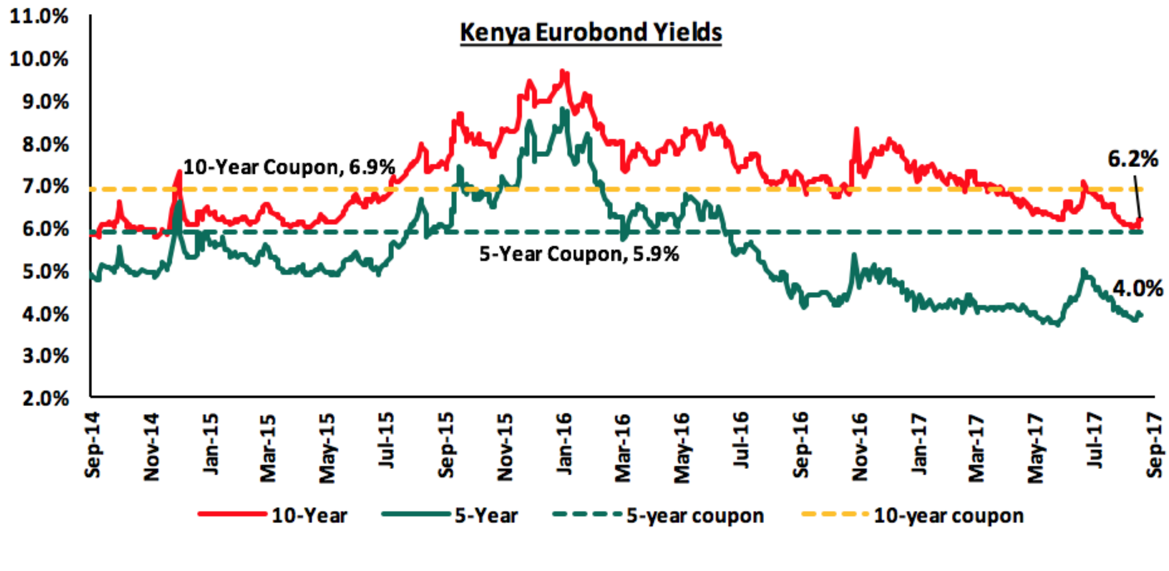
Despite the tight liquidity position in the money market, the average interbank rate declined to 4.8% from 5.3% the previous week. The average volumes traded in the interbank market declined by 40.4% to Kshs 10.2 bn from Kshs 17.1 bn the previous week, an indication that the liquidity distribution among the banks must have improved over the recent weeks.

Below is a summary of the money market activity during the week:

all values in Kshs bn, unless stated otherwise			
Weekly Liquidity Position – Kenya			
Liquidity Injection		**Liquidity Reduction**	
Government Payments	17.4	Transfer from Banks - Taxes	30.3
T-bond Redemptions	4.0	T-bill (Primary Issues)	34.4
T-bill Redemption	26.9	Reverse Repo Maturities	11.2
T-bonds Rediscounts	0.5	Repos	10.0
Reverse Repo Purchases	11.2		
Repos Maturities	20.0		
Total Liquidity Injection	**80.0**	**Total Liquidity Withdrawal**	**85.9**
		Net Liquidity Injection	**(5.9)**

For the month of September, the government is issuing a new 2-year bond (FXD 1/2017/2) and re-opening a 10-year bond (FXD 1/2017/10), with effective tenors of 2.0 years and 9.9 years, respectively, in a bid to raise Kshs 30.0 bn for budgetary support. The government is behind on its domestic borrowing target for the current fiscal year, having borrowed Kshs 17.6 bn against a target of Kshs 67.2 bn (assuming a pro-rated borrowing target throughout the financial year of Kshs 317.7 bn budgeted for the full financial year). Due to this, we expect investors to bid slightly above the secondary market yields, which are at 11.6% and 13.0% for the 2.0-year and 9.9-year bonds, respectively, and we would therefore bid at a range of between 11.6% - 11.9% for the 2.0-year bond, and 13.0% - 13.3% for the 9.9-year bond.

According to Bloomberg, yields on the 5-year and 10-year Eurobonds, with 1.9-years and 6.9-years to maturity, rose by 10 bps and 20 bps, to close at 4.0% and 6.2% from 3.9% and 6.0%, respectively, the previous week. Yields on these two bonds have been on a downward trend and this is the first time we have seen the rates go up since July and this can be attributed to the political tension on the run up to the presidential elections rerun. Since the mid-January 2016 peak, yields on the Kenya Eurobonds have declined by 4.8% points and 3.5% points for the 5-year and 10-year Eurobonds, respectively, due to stable macroeconomic conditions in the country. The declining Eurobond yields and stable rating (Fitch Ratings having affirmed Kenya's long-term foreign and local currency issuer default ratings (IDRs) at "B+", while Standard & Poor's (S&P) maintained Kenya's foreign and local currency sovereign credit ratings for the short and long term at "B+/B", respectively), are indications that Kenya's macro-economic environment remains stable and hence an attractive investment destination.



The Kenya Shilling appreciated against the USD by 0.1% during the week to close at Kshs 102.9 from Kshs 103.0 the previous week due to depreciation of the USD in the global markets. On a year to date basis, the shilling has depreciated against the dollar by only 0.3%. According to the International Monetary Fund (IMF), the dollar is overvalued by between 10.0% and 20.0%, based on near-term economic fundamentals. In our view, the shilling should remain relatively stable to the dollar in the short term, supported by both the weakening of the USD in the global markets and the CBK's activity as they have sufficient forex reserves, currently at USD 7.5 bn (equivalent to 5.0 months of import cover). However, we have seen forex reserves decline significantly from USD 8.3 bn at the peak in April this year, but not to an alarming level, as import cover currently stands at 5.0 months.

The Monetary Policy Committee (MPC) is set to meet on Monday, 18th September 2017 to review the prevailing macroeconomic conditions and give direction on the Central Bank Rate (CBR). In their previous meeting held in July 2017, the MPC maintained the CBR at 10.0% on account of; (i) decline in inflation rate to 9.2% in June from a high of 11.7% in May, due to a drop in food prices, (ii) a relatively stable foreign exchange market, with foreign reserves at USD 7.8 bn (equivalent to 5.2 months of import cover), despite the current account deficit widening to 6.2% of GDP in May from 6.0% in March, and (iii) a resilient banking sector, with the average commercial banks liquidity ratio and capital adequacy ratio at 44.7% and 19.6%, above the statutory minimum of 20.0% and 14.5%, respectively, as at June 2017. We expect the MPC to maintain rates at the current levels due to (i) inflation have eased to 8.0% from 9.2% since the last meeting despite being above the target range of between 2.5% and 7.5%, (ii) the currency have appreciated by 1.0% over this period but there is still risk of depreciation if the current political uncertainty persists for long, (iii) Economic growth is weaker than initially forecasted, and (iv) the banking sector despite remaining resilient, we have seen a drop in their first half results. For our comprehensive analysis on the same, see our MPC Note.

The Kenya National Treasury has revised its economic growth projections for Kenya downwards to 5.5% from 5.9% earlier in the year citing (i) poor agricultural sector performance on account of drought, and (ii) the repeat on presidential election, as the government has been forced to cut on essential spending to fund the election. The revision by the National Treasury on Kenya's 2017 economic growth comes after the World Bank and the International Monetary Fund (IMF) revising their projections downwards to 5.5% and 5.3%, from 6.0% and 5.7%, respectively, in June. As mentioned in our Kenya Q1'2017 GDP Review and Outlook, both institutions cited a slowdown in the agricultural sector and private sector credit growth as being the core reasons for the downward revision of the GDP growth expectation. However, the National Treasury has stated that it projects the economy to expand by 6.5% per year in the medium-term supported by increased government spending on infrastructural developments. Cytonn expects GDP growth in 2017 to average 5.0%, which is lower than the estimates by the National Treasury, World Bank, and the IMF at 5.5%, 5.5% and 5.3%, respectively. Our estimate is supported by (i) government continued expenditure on infrastructure, (ii) the recovery of the tourism sector, and (iii) the continued growth of the construction sector. This rate of economic growth is stable and quite competitive in the Sub-Saharan Africa region, which is projected to grow by 2.7% in 2017 according to the IMF.

The United States Federal Open Market Committee (FOMC) is set to meet on 19th and 20th September, 2017 to assess the current state of the US economy and give direction on the Federal Funds Rate. During the Fed's previous meeting held in July, the committee decided to maintain the Fed rate within the band of 1.00% - 1.25% due to a slowdown in labor market growth and low core inflation. Early in the year, the Fed highlighted plans to accelerate its rate-hiking pace, hinting at three rate hikes in 2017 on expectations of improved economic performance. However, we expect the Fed to take a wait and see approach based on the near-term performance of the economy before hiking rates further, and thus we expect the Fed rate to be maintained at a band of 1.00% - 1.25%, given that; (i) core inflation remains low at 1.7% y/y as at August, below the federal target of

2.0%, and (ii) a slowdown in growth in the labor market, adding approximately 156,000 new jobs in August 2017, from 209,000 in July, with the unemployment rate currently at 4.4%, which is below the full unemployment rate of 5.0%.

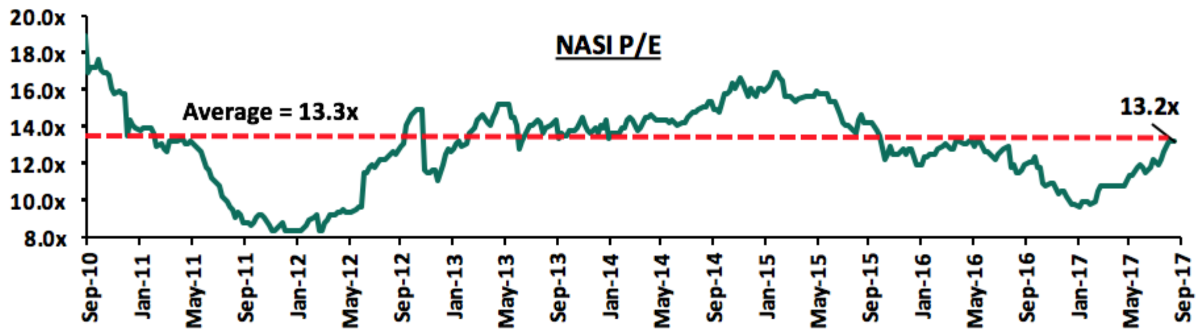
Rates in the fixed income market have remained stable, and we expect this to continue in the short-term. However, a budget deficit that is likely to result from depressed revenue collection creates uncertainty in the interest rates environment as any additional borrowing in the domestic market to plug the deficit could lead to upward pressures on interest rates. Our view is that investors should be biased towards short-to medium term fixed income instruments to reduce duration risk.

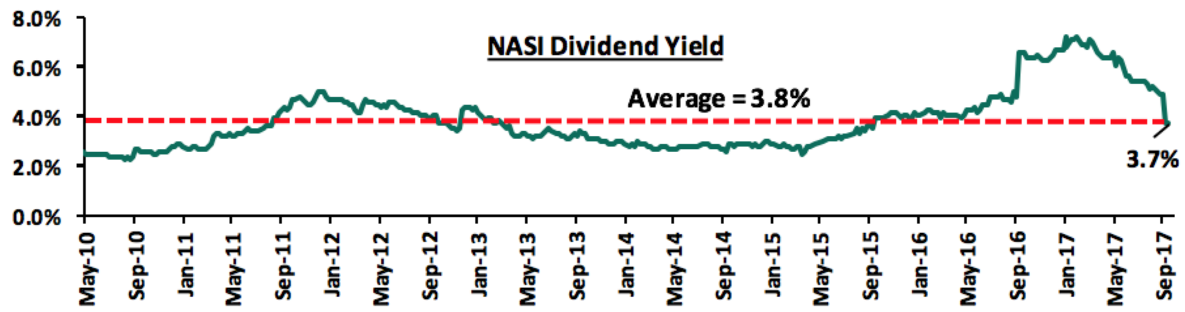
Equities

During the week, the equities market was on a downward trend with NSE 20, NASI and NSE 25 losing 1.5%, 0.7% and 0.4%, respectively, taking their YTD performance to 23.4%, 22.0% and 18.8% for NASI, NSE 25 and NSE 20, respectively. This week's performance is attributable to losses in select large-cap stocks such as Safaricom, KCB Group and Equity Group, which lost 1.9%, 0.6% and 0.6%, respectively. Since the February 2015 peak, the market has lost 7.3% and 31.2% for NASI and NSE 20, respectively.

Equities turnover decreased by 24.8% to close the week at USD 44.4 mn from USD 55.4 mn the previous week. Foreign investors remained net sellers with a net outflow of USD 18.7 mn compared to a net outflow of USD 27.0 mn recorded the previous week. We expect the market to record subdued activity over the coming few weeks as market players remain cautious of the renewed political uncertainty in the country. Despite this, we expect the market to remain supported by improved investor sentiment once the country takes to the polls for the presidential elections scheduled for mid-October, and fears and uncertainty dissipates, as investors take advantage of the attractive stock valuations in undervalued sections of the market.

The market is currently trading at a price to earnings ratio (P/E) of 13.2x versus a historical average of 13.3x, and a dividend yield of 3.7%, compared to a historical average of 3.8%. The current P/E valuation of 13.2x is 36.0% above the most recent trough valuation of 9.7x experienced in the first week of February 2017, and 58.7% 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.





The Central Bank of Kenya (CBK) has signaled its intention to push for repeal of the interest rates cap law that has been in effect for a year now, due to the negative effect it has had on private sector credit growth and the expected negative impact to the economy. This comes after a recent credit survey by the CBK showed that most commercial banks (54.0%) revealed that interest rate capping negatively affected their lending to SMEs. As highlighted in our Cytonn Weekly #29/2017, despite the positive intention behind the Banking (Amendment) Act 2016, it has not achieved its intended goal, which was to improve lending to the consumer by making credit affordable, but so far the cap has curtailed lending as evidenced by: (i) the declining private sector credit growth from a high of 25.8% in June 2014 to an eight-year low of 2.1% recorded in May 2017, (ii) decline in total amounts of commercial banks loan growth, with listed banks recording a loan growth of 5.0% in Q2'2017, compared to 5-year average loan growth of 14.6%, and, (iii) increase in the average cost of loans by banks, as banks are now charging excessive fees and additional costs on their loans, which would only serve to discourage potential borrowers. CBK has expressed interest to have this law reversed and go back to a regime where interest rates are freely determined, but in a disciplined commercial banking environment. Given that CBK has in the past failed in ensuring there is discipline in the market, we highlight specific recommendations around consumer protection and improved competition, which we believe will ensure banks remain disciplined in pricing of loans as previously stated in our Cytonn Weekly #33; it would be unwise to expect banks to voluntarily become disciplined. A reversal of the rate caps regime should be accompanied with the following:

i. Establish a strong consumer protection agency to specifically develop and enforce a consumer protection framework for the financial services sector. Just like the bankers have the Kenya Bankers Association taking care of the interest of banks, there should be an equivalent and strong association/agency taking care of the interest of consumers. It should be a strong association anchored in law and funded by statutory levies from the banking sector players and other financial services companies. The Consumers Federation of Kenya (Cofek) is one of such bodies and it has made known its intention to fight plans to amend or repeal the interest rate cap. We are however, of the view that Cofek should suggest ways to address reduction of cost of credit other than championing for the rate cap that has not benefitted the consumer, the very group that it is there to protect but has suffered the most,
ii. The aforementioned consumer protection agency would work on a consumer protection framework to include robust disclosures on cost of credit, free and accessible consumer education, enforce disclosures on borrowings and interest rates, expeditiously handle and hear clients' complaints. This would be easy to achieve given that the disclosure on cost of credit has been implemented,
iii. In addition to a financial services consumer protection agency, it should be coupled with a specialized tribunal that shall specifically handle consumer financial services matters and complaints; just the same way the National Environment Management Authority (NEMA) has a tribunal attached to the agency. For example, credit reference bureaus were to be used to for credit ratings. However, banks have used them as punishment bureaus for consumers, forwarding names to bureaus without notice to consumers and often sometimes erroneously, and there are very limited recourse consumers have against such abuses,
iv. Establish strong protection and support for alternative products that compete with banking products to allow choice for consumers and also make banking sector more innovative and competitive. For example, a revised legislation should not just be concerned with rates of borrowing, but also the meagre rates banks pay to depositors. Alternative forms of savings and investments that bypass the banking sector to enable members earn higher levels of returns, such as organized Chamaas, Saccos, Investments Cooperative and Investments Partnerships, such as our own Cytonn CMS, should have sufficient regulatory framework support and enjoy the same incentives such as banks. For example, providing alternative savings and investments organizations with the same withholding tax incentives that banking deposits enjoy, of a 15% final withholding tax,

v. In addition to supporting alternative products, the government should develop incentives and protections for product innovation, which tend to experience hostility from the banking sector, which would rather keep competing products out of the market,
vi. Finally, in order to spur private sector growth, it is crucial to develop capital markets and alternative sources of funding to bring down the 95% funding dominance by banks. In more developed markets, bank funding makes only 40% of loans granted to businesses yet in our market banks account for 95% of funding. The task to increase capital markets funding and alternative markets funding lies with the Capital Markets Authority (CMA) and capital market participants; it is essential that the CMA and market participants come up with a plan to increase fund formations and spur product innovation. For example, in more developed countries, a redemption from a money market fund and high yield investments do not take 3 days; it can be done instantaneously with a cheque that is attached to the fund. Investors are limited to, say, writing one cheque per month from their fund investments.

In an effort to keep our rankings of companies on the Cytonn Corporate Governance Ranking (Cytonn CGR) Report up-to-date, we continually update the rankings whenever there are changes on any of the 24 metrics that we track, and how this affects the company ranking. Below are the changes for this week:

- KCB Group Plc appointed Dr. Nancy Asiko Onyango to the board of directors as a non-executive director. KCB Group's score has remained unchanged at 91.7%; the reduction in score due to increase in board size to an even number 12 from an odd number 11, being offset by improvement in gender diversity to 33.3% from 27.3%. An odd number of board members is desired to avoid deadlocks in decision-making. KCB Group therefore retains its top position. On gender diversity, it now ranks at position 6 from position 10,
- Co-operative Bank appointed Mr. John Murugu as Chairman of the board following retirement of Mr. Stanley Muchiri after attaining the mandatory age of 70 years as per the CMA Code of Corporate Governance. Mr. Murugu joined Co-operative's board in 2015, thus the number of board members has reduced to an odd number 11 from an even number 12. Co-operative Bank's score has therefore improved to 81.3% from 79.2% resulting in improvement in ranking to position 6 from position 8, and
- KenolKobil appointed Ms. Ashwini Bhandari to the board of directors as a non-executive director, and announced resignation of Mr. Terence Davidson. KenolKobil's score has improved to 56.3% from 54.2% due to improvement in gender diversity score to 25% from 0%. It is notable that prior to this appointment there was no female representation on the board. The ranking has however remained unchanged at position 42.

Below is our Equities Universe of Coverage:

all prices in Kshs unless stated otherwise								
No.	**Company**	**Price as at 08/09/17**	**Price as at 15/09/17**	**w/w Change**	**YTD Change**	**Target Price***	**Dividend Yield**	**Upside/ (Downside)****
1.	NIC***	39.0	40.0	2.6%	53.8%	58.2	3.1%	48.6%
2.	KCB Group***	42.3	42.0	(0.6%)	46.1%	57.1	4.8%	40.7%
3.	HF Group***	11.5	11.1	(3.9%)	(21.1%)	14.2	2.0%	30.5%
4.	DTBK	179.0	182.0	1.7%	54.2%	234.0	1.4%	29.9%
5.	Barclays	10.4	10.4	0.5%	22.6%	12.5	9.6%	29.8%

6.	I&M Holdings	124.0	129.0	4.0%	43.3%	149.6	2.3%	18.3%
7.	Co-op Bank	16.5	16.6	0.9%	25.8%	17.5	5.6%	11.0%
8.	Equity Group	39.3	39.0	(0.6%)	30.0%	40.5	5.1%	9.0%
9.	Jubilee Insurance	476.0	475.0	(0.2%)	(3.1%)	490.5	1.8%	5.1%
10.	Stanbic Holdings	80.0	80.0	0.0%	13.5%	79.1	5.2%	4.0%
11.	Kenya Re	21.3	20.8	(2.4%)	(7.8%)	20.5	3.6%	2.4%
12.	Liberty	13.5	13.0	(3.3%)	(1.5%)	13.0	0.0%	(0.2%)
13.	Britam	14.0	14.1	0.7%	40.5%	13.2	1.9%	(4.1%)
14.	Standard Chartered	234.0	240.0	2.6%	27.0%	199.7	4.3%	(12.5%)
15.	Safaricom	25.8	25.3	(1.9%)	31.9%	19.8	4.7%	(17.0%)
16.	Sanlam Kenya	28.5	29.8	4.4%	8.2%	21.1	1.0%	(28.2%)
17.	CIC Group	5.8	5.6	(4.3%)	46.1%	3.7	1.8%	(31.4%)
18.	NBK	10.5	11.0	4.3%	52.1%	1.9	0.0%	(82.8%)
Target Price as per Cytonn Analyst estimates								
*****Upside / (Downside) is adjusted for Dividend Yield***								
******Banks in which Cytonn and/or its affiliates holds a stake***								
For full disclosure, Cytonn and/or its affiliates holds a significant stake in KCB Group, ranking as the 5th largest local institutional investor								

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

International Finance Corporation (IFC), the private sector arm of World Bank Group is set to acquire an undisclosed stake in a Kenyan based mobile technology firm, Africa's Talking, for USD 6 mn (Kshs 620.4 mn). Africa's Talking provides a cloud-based platform to businesses and developers allowing them to integrate messaging, voice and video communication services into their applications, which is similar to global firms such as IBM Bluemix and amazon. The platform provides a bridge between mobile network operators (MNOs), and developers and enable access to those locally relevant services offered by the MNOs such as Airtel, Orange and Safaricom. Africa Talking has presence in Uganda, Rwanda, Tanzania, Malawi, Nigeria and Ethiopia. This acquisition will see (i) IFC increase its investment in the technology sector in Kenya given that it was part of four investors who committed to invest in CSquared, a Google broadband infrastructure company, earlier this year as highlighted in our report here, and (ii) Africa Talking will use the investment to grow its presence in more territories across Africa and roll out more products in the market. The ICT sector in the Sub-Saharan region has potential for growth given increased automation of business processes by SMEs and large businesses hence the need of applications to act as an interface between the end users and the services required.

The Competition Authority of Kenya (CAK) has approved the acquisition of 56.2% stake in Kenya's hospitality chain, Avenue Group, by Dubai-based private equity (PE) firm Abraaj Group at an undisclosed value. On completion, this will be the second investment by Abraaj in Kenya, after it acquired Java Group earlier this year. Other deals approved by CAK include acquisition of a controlling stake in the Kenyan unit of global insurance broker Aon, by a South African private equity firm Capital Works through its newly created investment vehicle Extologix Proprietary, and acquisition of full control of Mombasa-based Associated Vehicle Assemblers (AVA) by Simba Corp, by buying out 50% stake held by Marshalls East Africa at an undisclosed value. AVA is currently owned on a 50-50 basis by Simba and Marshalls. These acquisitions, especially by international firms in Kenya, and their subsequent approval indicated a robust private equity market in Kenya driven by commercial private equity players.

Private equity investments in Africa remain robust as evidenced by the increased deal volume. The increasing investor interest is attributed to (i) rapid urbanization, (ii) a resilient and adapting middle class and increased consumerism, (iii) the attractive valuations in Sub Saharan Africa's private markets compared to its public markets, (iv) the attractive valuations in Sub Saharan Africa's markets compared to global markets, and (v) better 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

International retailers are seeking to get a foothold of Kenya's retail sector, which is currently dominated by local chains such as Nakumatt, Tuskys, Naivas and Uchumi. This week, French retailer CarreFour sought protection from competition at the Two Rivers Mall through an application to the Competition Authority of Kenya (CAK), for exclusive rights of occupancy submitted jointly with the mall owners. The Two Rivers Mall owners include Two Rivers Development Limited with a 50.0% shareholding and OMP Africa Investment Company with the other 50.0% shareholding. Two Rivers Development Limited alone comprises of Centum Investments with a 58.0% shareholding, AVIC with 39.0% shareholding and ICDC with 3.0% shareholding. The application, if approved, will bar other hypermarkets, supermarkets, butcheries, green grocers or fruit stores from setting up shop at the 67,000 SQM mall based in Runda along Limuru Road. This however only relates to new businesses and excludes existing players at the mall such as Chandarana Supermarket. In addition, the application will free CarreFour from a previous agreement barring it from opening another branch within 5 kilometers from Two Rivers Mall. In our view, CarreFour may have had to make certain concessions to obtain support from the mall owners for exclusive retailer rights. While such an arrangement would prevent healthy competition among retailers, some of the benefits would be;

1. This will create a conducive environment for the retailer having begun its operations at the mall in February this year, thus maximizing sales, and,
2. Optimization of sales will also benefit the mall owners who get rent as a percentage of the sales made. CarreFour is the anchor tenant occupying approximately 10.7% of the total lettable area of the mall with 7,200 SQM of space, and is thus a significant source of income for the mall owner

Kenya's retail sector has continued to attract international retailers driven by the rising middle-class with higher purchasing power, robust macroeconomic growth with an average GDP growth of above 5.0% over the last 5-years, thus increasing per capita wealth and a relatively higher formal retail penetration rate at 30% given that Kenya's informal retail is at approximately 70%. This has made Kenya the 2nd largest retail economy after South Africa with an estimated 60% penetration, according to Nielsen Research Firm. The move by CarreFour, however, highlights the competitive nature of Kenya's retail sector and local dominance making it difficult for international retailers to gain traction. Other international firms that have set up shop in Kenyan malls include Game by Walmart, with presence at the Garden City Mall along Thika Road, and Botswana's Choppies after acquiring 10 branches of Ukwala. In our view, local retailers will maintain dominance of the market in the short to medium term due to a strong brand heritage, visibility and customer loyalty as the international brands are perceived as 'pricey' by the middle class compared to local brands. There is however great opportunity as seen through an increase in Kenyans retail spending by 13.0% to USD 17.6 bn from according to a survey by Proctor & Gamble.

In the hospitality sector, Fairmont Hotels and Resorts Kenya has announced its new strategic direction to position its 3 Kenyan properties as a three-stop destination for both leisure and business guests to experience the best of East Africa. The three-stop experience will see leisure and business travelers begin their journey at The Norfolk, which has meeting, conference and restaurant facilities to cater for business needs. The second stop is the Fairmont Mount Kenya Safari Club, suitable for leisure with views of Mt. Kenya while the third stop will be at the Fairmont Mara Safari Club, in the north west of the Maasai Mara a well-known tourist destination for wildlife and the great wildebeest migration, which usually occurs between July and October every year. The hotelier, launched the new communications campaign mainly targeting the markets of UK and USA with Asia and Australia as secondary markets.

This campaign highlights the aggressive marketing of Kenya as a tourist and business destination by both hoteliers and government bodies, such as the Kenya Tourism Board, resulting in the recovery of the tourism and hospitality sector in 2016 and 2017, despite this being an electioneering period. In 2016, the tourism sector grew by 17.8% with earnings of Ksh 99.7 bn compared to Ksh 84.6 bn in 2015, while the accommodation and food Services sector grew by 13.3% in 2016 compared to a 1.3% decline in 2015, according to the Kenya National Bureau of Statistics (KNBS). The growth was driven by a 13.5% increase in international arrivals to 1.3 mn in 2016 from 1.2 mn in 2015 and a 16.5% increase in the number of conferences held to 3,982 in 2016 from 3,417 in 2015. The trend is likely to continue as between January and May 2017 the number of international visitor arrivals increased by 10.9% and 8.5% at Jomo Kenyatta International Airport and Mombasa’s Moi International Airport to 320,588 and 238,397 from 288,905 and 35,388, respectively, compared to the same period in 2016. Hoteliers in the Western part of Kenya, however, made losses during the elections period due to political uncertainty, according to the chairman of Western Kenya Hospitality Leaders Association. This is however likely to return to normalcy after the conclusion of the elections. We expect the continued marketing, Kenya’s renowned tourist products such as the Maasai Mara wildebeest migration, and improved security to continue boosting the hospitality sector.

This week, Data Fintech released a report indicating growth in the residential sector and a decline in the commercial office sector of Westlands. According to the report, the median sale price for office space in Westlands has declined by 10.3% between Q3’2016 and Q3’2017, while rental prices declined by 2.5% due to an oversupply. Despite the drop, commercial office space has a high rental yield of 9.9%. According to the report, apartments in Westlands have the highest returns with 7.7% rental yield and 20.0% price appreciation compared to townhouses with a 4.6% rental yield and a 5.6% decline in prices and standard houses with 4.3% rental yield and 0.0% change in prices. Overall, residential units had the highest return with an average of 10.4% while office had a low return of (0.5%) over the 12- month period between Q3’2016 and Q3’2017. The poor performance in office space witnessed across the Nairobi Commercial office sector and is likely to continue with a 1.0% decline in occupancy between 2013 and 2016, and a 6.0% decline in average price per square foot to Kshs 12,031 in 2016 from Kshs 12,776 in 2015, as highlighted in our Commercial Office Report 2017.

We expect the real estate sector to stabilize after the electioneering period supported by positive economic growth, continued infrastructural upgrade and interest from multinational firms.

Focus of the Week; Kenya Listed Banks H1’2017 Report

Following the release of the H1’2017 results by banks, we undertook an analysis on the Kenyan Banking sector to point out any material changes from the Q1’2017 Banking Report. In our H1’2017 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 ***“Transitioning to a more Disciplined and Efficient Sector”*** as the banking sector takes a more disciplined approach, following rising non-performing loans and the capping of interest rates, while also employing cost rationalization measures in a bid to enhance efficiency under the current operating environment of loan and deposit pricing regulatory framework. Below are some of the themes that shaped the banking sector in the first half of 2017:

1. **Consolidation –** Consolidation in the banking sector continued to gather pace, with weaker banks (that don't serve a niche, or don't have a clear deposit gathering strategy), being forced to merge or be acquired. During the first half of the year, Diamond Trust Bank Kenya (DTBK) completed the acquisition of Habib Bank (K) Limited (HBL), setting the platform for more consolidation this year. 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. We would have expected even a lot more consolidation by now, and we are surprised that some of the smaller banks have managed to stay independent this long. It is notable that acquisitions are also happening at much cheaper valuations, with earlier bank acquisition announcements, such as Fina, K-Rep and Equatorial Commercial Bank having been at 3.2x, 1.8x and 2.3x P/B, respectively, while recent acquisitions are happening at between 0.8x to 1.7x P/B, and hence it is a great time to be an acquirer. Below is the summary of the transaction metrics of some of the acquisitions that have happened in the banking sector.

Acquirer	Bank Acquired	Book Value at Acquisition (Kshs bn)	Transaction Stake	Transaction Value (Kshs bn)	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 half of 2017, with banks recording a decline in core EPS by 13.8% and private sector credit growth slowing to 2.1% in May, compared to 5.4% when the Banking (Amendment) Act 2015 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. The Central Bank of Kenya (CBK) has signaled its intention to push for the repeal of the interest rates cap law that has been in effect for a year now, due to the negative effect it has had on private sector credit growth and the expected negative impact to the economy. This comes after a recent credit survey by the CBK showed that most commercial banks (54.0%) revealed that interest rate capping negatively affected their lending to SMEs.
3. **Asset Quality –** The banking sector has witnessed a deterioration in asset quality over the past year, with the gross non-performing loans rising by 17.9% to Kshs 170.4 bn from Kshs 144.5 bn in H1'2016 and this has led to an increase in provisioning levels to 54.0% from 48.8% in H1'2016. We are seeing banks becoming more selective, prudent and conservative in terms of loan disbursement, since with the current pricing framework, it is difficult to price riskier clients within the loan limit cap in the cost of loans. This has led banks to reduce their unsecured and

micro loans to small businesses, which are deemed risky.

4. **Cost Rationalization –** The focus for the banking sector in 2017 will inevitably be on adjusting business models to conform to the Banking (Amendment) Act 2015. To this effect, banks have already taken 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 struggling Tier III banks. 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 the physical branch model, which is 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	Unspecified
9.	Standard Chartered Bank Kenya	300	4
10.	KCB Group	223	Unspecified
11.	Barclays Bank	301	7
12.	I&M Holdings	-	Unspecified
	TOTAL	**1,470**	**39**

Based on the above, we believe the sector is shaping up to prudence in operations, as can be seen through the increased loan loss provisioning levels, as banks adjust their business models under the current regulatory framework.

Below are H1'2017 key operating metrics for listed banks in Kenya:

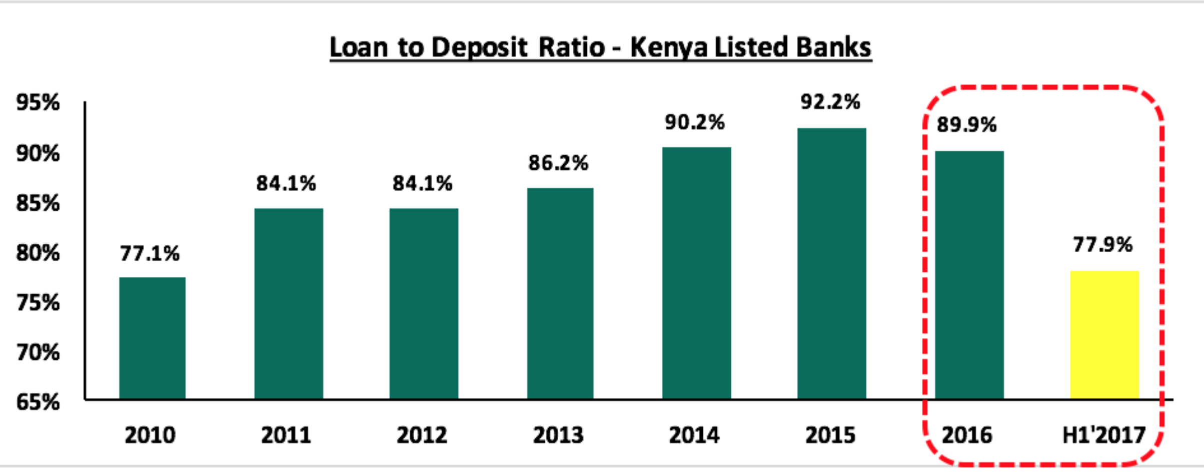
Listed Banks H1'2017 Earnings and Growth Metrics												
Bank	**Core EPS Growth**		**Deposit Growth**		**Loan Growth**		**Net Interest Margin**		**Loan to Deposit Ratio**		**Investments in Government Securities to Deposit Ratio**	
	H1'2017	**H1'2016**	**H1'2017**	**H1'2016**	**H1'2017**	**H1'2016**	**H1'2017**	**H1'2016**	**H1'2017**	**H1'2016**	**H1'2017**	**H1'2016**
KCB Group	**(0.2%)**	11.2%	1.3%	(2.2%)	16.7%	8.4%	8.7%	8.1%	84.3%	73.2%	24.0%	21.1%
DTB Kenya	**(5.8%)**	11.3%	18.6%	24.7%	7.2%	10.2%	6.8%	7.6%	74.7%	82.6%	41.1%	36.4%
Equity Group	**(7.8%)**	18.0%	13.6%	6.5%	(1.5%)	13.6%	9.7%	10.8%	73.1%	84.3%	37.2%	24.6%
NIC Bank	**(11.9%)**	2.9%	18.9%	6.5%	4.1%	3.6%	7.1%	7.7%	87.7%	100.1%	33.3%	25.9%
Stanbic	**(12.1%)**	22.2%	12.5%	(2.7%)	8.0%	0.3%	5.3%	5.6%	75.1%	78.2%	38.6%	36.3%
Barclays Bank	**(13.3%)**	(10.2%)	3.2%	11.9%	6.8%	14.8%	10.1%	10.7%	86.8%	83.8%	27.9%	26.0%
I&M Holdings	**(17.9%)**	23.0%	10.3%	13.1%	9.1%	7.6%	7.7%	7.7%	89.5%	90.5%	31.3%	35.5%
Co-op Bank	**(25.4%)**	18.7%	2.7%	12.0%	14.2%	8.0%	8.8%	8.9%	88.4%	79.5%	26.0%	29.2%
StanChart	**(34.4%)**	34.8%	17.6%	16.9%	(1.1%)	(7.3%)	8.4%	9.5%	50.4%	59.9%	47.6%	49.2%
National Bank	**(42.2%)**	(70.0%)	3.4%	(1.6%)	(12.0%)	(9.3%)	6.9%	7.2%	57.7%	67.8%	38.1%	29.5%
HF Group	**(74.0%)**	26.3%	(6.0%)	6.2%	(1.3%)	7.0%	5.7%	6.7%	89.3%***	92.1%	9.2%	9.3%
Weighted Average*	**(13.8%)***	**15.5%***	**14.4%****	**8.5%****	**9.3%**	**7.7%**	**7.7%**	**8.4%**	**77.9%**	**81.1%**	**32.2%**	**29.4%**
The weighted average is based on Market Cap as at 31st August, 2017 **Based on cumulative growth of listed banking sector												
*******For Housing Finance, given their primary business of mortgage provision, we used the Loans to Loanable funds ratio. The Loan to Deposit ratio is at 141.3%***												

Key takeaways from the table above include:

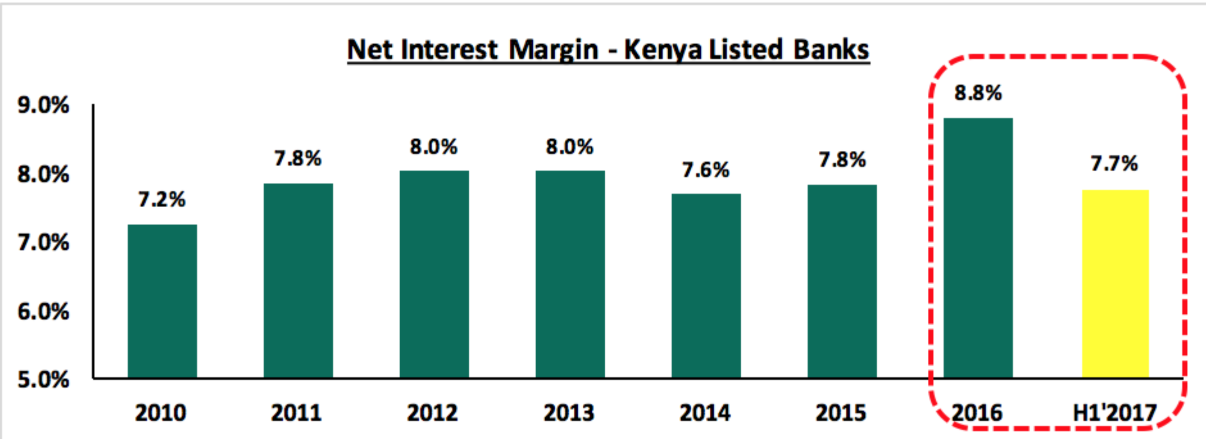
- The listed banks recorded a 13.8% decline in core EPS, compared to a growth of 15.5% in H1'2016. All the banks recorded negative growth, with KCB Group registering the least decline, a 0.2% decline, on the back of a 2.9% growth in Net Interest Income (NII),
- Deposits grew at 14.4% during the first half of the year, a faster rate than loans, which grew by 9.3%. The loan growth came in lower as private sector credit growth slowed to 2.1% in H1'2017,

below the government's set target of 18.3%, with banks adopting a more prudent credit risk assessment framework to ensure quality loan books, which saw the loan to deposit ratio drop to 77.9% from 81.1% in H1'2016. This means that even as deposits were growing, banks were not lending,

- Following the Banking Act (Amendment) 2015, banks saw their net interest margins (NIM) drop in H1'2017, which declined to 7.7% from 8.4% in H1'2016,
- Exposure to government securities recorded an increase as indicated by investment in government Securities to deposit ratio, which increased to 32.2% from 29.4% in H1'2016 as banks allocated more funds towards the government, with government securities considered risk free, depriving the private sector of credit in the process,
- The increase in the gross non-performing loan (NPL) ratio to 11.5% from 10.1% in H1'2016 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 18.1% from 20.6% in H1'2016, as the banks' profitability was affected by the capping of interest rates, which suppressed net interest income in the first half of the year.

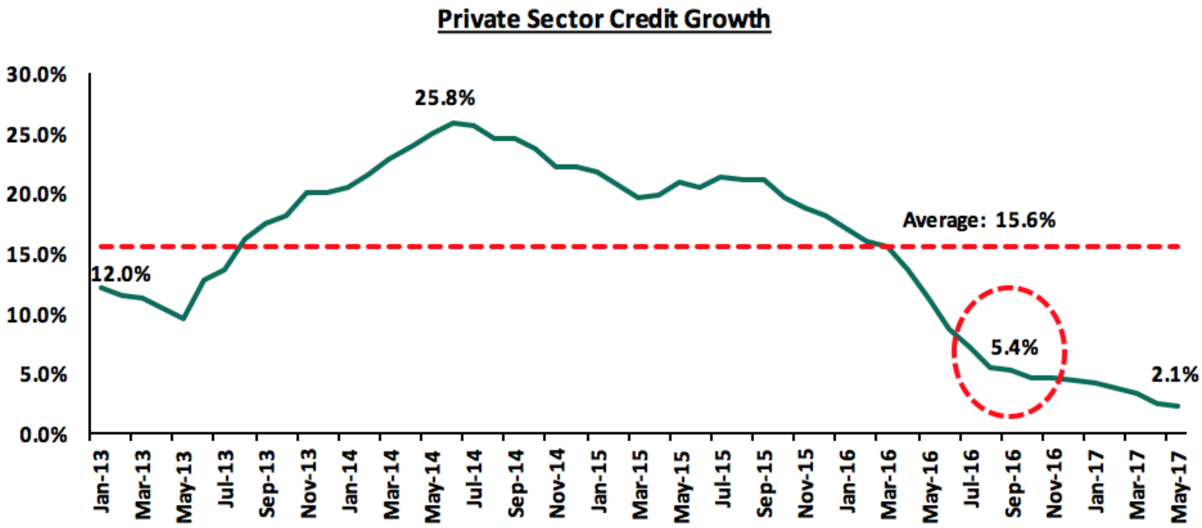


The LDR has declined to 77.9% from 89.9% in 2016, with banks adopting a more prudent credit risk assessment framework to ensure quality loan books



Bank's NIMs have declined to 7.7% from 8.8% in 2016, following the capping of interest rates, and this has affected the profitability of these banks as the current regulatory framework has compressed margins

Kenya's listed banks recorded negative EPS growth of 13.8% in H1'2017 compared to an average growth of 15.5% in H1'2016. The poor performance was primarily on the back of an 8.1% decline in NII following the capping of interest rates, with KCB Group the only bank recording growth in NII, a 2.9% rise, following a 20.8% decline in interest expense, as the bank managed to contain its cost of funding. 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 2.1% in the first half of 2017, way below the government set target of 18.3%, as banks channel funds more actively towards government securities, with exposure in government securities coming in at 32.2% in H1'2017 from 29.4% in H1'2016, depriving the private sector of credit.



Rate cap came into effect in August 2016 when private sector credit growth was at 5.4% as highlighted above, with the decline before that as a result of a challenging operating environment

In addition to the capping of interest rates being the primary reason for the poor performance by banks in H1'2017: (i) 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, and (ii) increased loan loss provisioning due to concerns around banking sector loan book quality, has seen the banking sector continue to record sluggish performance in H1'2017.

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 H1'2017 BANKING REPORT – COMPOSITE RANKINGS					
Bank	**Franchise Value Total Score**	**Total Return Score**	**Weighted Score**	**H1'2017 Rank**	**Q1'2017 Rank**
KCB Group	53.0	2	22.4	**1**	**1**
Co-operative Bank	49.0	7	23.8	**2**	**2**
DTB	64.0	4	28.0	**3**	**3**
NIC Bank	75.0	1	30.6	**4**	**5**
Equity Group	67.0	8	31.6	**5**	**6**
I&M Holdings	72.0	6	32.4	**6**	**4**
Barclays Bank	78.0	4	33.6	**7**	**7**
Stanbic Holdings	85.0	9	39.4	**8**	**8**
SCBK	84.0	10	39.6	**9**	**8**
HF Group	108.0	3	45.0	**10**	**10**
NBK	119.0	11	54.2	**11**	**11**

Major changes include:

- Equity Group climbed up 1 spot to Position 5 from Position 6 in our Q1'2017 Banking Sector Report, due to impressive NIM at 9.7%, above industry average of 8.6%, and a Return on average Equity of 19.7%, above the industry average of 18.1%, with the bank adequately diversified with Non-Funded income at 42.0%, higher than the industry average of 31.3%,
- SCBK dropped 1 position to Position 9 from Position 8 in our Q1'2017 Banking Sector Report, due to a low intrinsic valuation, coming in at 10th. The bank was also weighed down by high non-performing loans at 13.1%, versus an industry average of 11.5%.

For a comprehensive analysis on the ranking and methodology behind it, see our Cytonn H1’2017 Banking Sector Report.