Cytonn Monthly - October 2017

Equities

During the month of October, the equities market was on a downward trend with NASI, NSE 20 and NSE 25 losing 0.1%, 0.6% and 1.6%, respectively, taking their YTD performance as at the end of October to 21.5%, 19.0% and 17.1% for NASI, NSE 25 and NSE 20, respectively. The equities market performance during the month was attributable to losses in large caps, led by KCB Group, Coop Bank and DTBK, which lost 7.3%, 6.5% and 3.2%, respectively. For this week, the equities market was on an upward trend with NSE 20, NSE 25 and NASI gaining 4.2%, 3.8% and 2.9%, respectively, taking their YTD performance to 23.4%, 21.9% and 19.3% for NASI, NSE 25 and NSE 20, respectively. The performance during the week was driven by gains in large caps such as Equity Group, Barclays Bank and KCB Group, which gained 11.0%, 10.9% and 7.8%, respectively. Since the February 2015 peak, the market has lost 7.5% and 30.9% for NASI and NSE 20, respectively.

Equities turnover declined by 36.0% during the month to USD 90.7 mn from USD 141.7 mn in September 2017, taking the YTD turnover to USD 1,399.2 mn. Foreign investors turned net buyers for this month with net inflows of USD 7.2 mn, compared to net outflows of USD 50.9 mn witnessed in September 2017. Year to date, foreign investors are net sellers with net outflows of USD 104.1 mn. We expect the market to record subdued activity over the coming few weeks as market players remain cautious of the political uncertainty in the country. Despite this, we expect the market to remain supported by improved investor sentiment once fear and uncertainty dissipates, as investors take advantage of the attractive stock valuations.

The market is currently trading at a price to earnings ratio (P/E) of 12.5x, versus a historical average of 13.4x, and a dividend yield of 4.0%, compared to a historical average of 3.7%. Despite the valuations nearing the historical average, we believe there still exist pockets of value in the market, with the current P/E valuation being 26.3% below the most recent peak in February 2015. The current P/E valuation of 12.5x is 28.7% above the most recent trough valuation of 9.7x experienced in the first week of February 2017, and 50.2% 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.

During the month, Moody's, a global ratings agency placed KCB Bank, Equity Bank and Co-op Bank under review for a possible downgrade of their 'B1' global scale long-term local currency deposit ratings and 'b1' baseline credit assessment (BCA). This rating action was driven by the agency's view of a potential weakening of the Kenyan Government's credit profile as captured by its decision to place Kenya's 'B1' Government ratings on review for downgrade. Ratings as highlighted in our Cytonn Weekly #40/2017 are essential for a well-functioning market as they facilitate best pricing and timing of public offerings, as companies with good ratings get public recognition thus can easily attract investors.

The Attorney General published the Companies (General) (Amendment) Regulations, 2017. The regulations which are effective from August 28, 2017 are set to increase transparency among listed firms in a move towards further improving corporate governance. Below is a summary of the regulations:

1. Quoted companies shall be required to prepare directors' remuneration report, which shall be included in the annual financial statement for the relevant financial year summarizing the major decisions on directors' remuneration,
2. In addition, companies will be required to explain any significant changes to shares or long-term investment schemes awarded to directors, as well as offer detailed accounts as to why directors have been granted remuneration options that are not tied to performance,
3. The rules further require directors to publish in the financial report the justification for their remuneration, detailing the salaries and fees earned during the year as well as other benefits such as bonuses, pension and gratuity,
4. The new rules require companies to disclose the number of shares accruing to each director, when they were awarded, as well as those exercised and those that have since expired before being exercised, and
5. In addition, they will also have to prepare a detailed account of how directors have performed in order to qualify for share options or other long-term investment schemes.

Under these new rules, shareholders will have the power to approve directors' pay, a move that may see boards of loss-making companies take a pay cut to match the dwindling earnings of the firms they lead. As highlighted in our Cytonn Weekly #30/2017, this move is beneficial to investors since it will ensure information symmetry amongst shareholders, and is expected to result in greater disclosure, which is key to investors for decision-making thus boosting investor confidence.

During the week, we had a number of earnings releases. Below is the detailed analysis of the earnings' releases:

Equity Group released Q3'2017 results

Equity Group released Q3'2017 results, recording a 2.7% decline in core earnings per share to Kshs 3.87 from Kshs 3.98 in Q3'2016, driven by a 0.3% decline in total operating revenue, and a 2.2% increase in operating expenses. Key highlights for the performance from Q3'2016 to Q3'2017 include:

- Total operating revenue dipped slightly by 0.3% to Kshs 48.7 bn from Kshs 48.9 bn in Q3'2016. The stable performance was supported by a 28.3% growth in Non-Funded income to Kshs 21.3 bn from Kshs 16.6 bn in Q3'2016, despite a 15.0% decline in Net Interest Income(NII),
- Interest Income declined by 12.4% to Kshs 35.4 bn from Kshs 39.8 bn in Q3'2016 attributed to a 26.4% decline in income from loans and advances to Kshs 25.0 bn from Kshs 34.0 bn. Interest expense increased by 5.9% to Kshs 7.9 bn from Kshs 7.5 bn in Q3'2016, leading to a 15.0% drop in the Net Interest Income to Kshs 27.5 bn from Kshs 32.3 bn. The Net Interest Margin thus declined to 9.4% from 11.0% in Q3'2016,
- Non-Funded Income (NFI) recorded a growth of 28.3% to Kshs 21.3 bn from Kshs 16.6 bn in Q3'2016. The growth in NFI was driven by an increase in total fees and commissions on loans that rose by 47.8% to Kshs 4.3 bn from Kshs 2.9 bn in Q3'2016, a 16.7% increase in other fees and commissions to Kshs 9.6 bn from Kshs 8.3 bn in Q3'2016, and a 5.3% increase in foreign exchange trading income to Kshs 2.6 bn from Kshs 2.4 bn. The current revenue mix stands at 56:44 funded to non-funded income from 66:34 in Q3'2016,
- The 47.8% increase in total fees and commissions on loans, despite a 2.2% contraction in the value of total loans issued, is attributed to increase in fees charged on loans by banks following the operationalization of Banking (Amendment) Act, 2016, which resulted into compressed Net Interest Margins. This increase in fees charged on loans, does not entirely cushion the bank from the effect of interest rate caps. Assuming the increased amount in fees charged on loans was to be added to the bank's Net Interest Income, the Net Interest Margin would only improve slightly to 9.5% from the current 9.4%,
- The 16.7% increase in other fees and commissions was driven by a growth in commissions from alternative banking channels including digital platforms and agency banking. The value of

transactions made through these alternative channels increased by 50.0% to Kshs 934.0 bn from Kshs 622.6 bn in Q3’2016,

- Total operating expenses increased by 2.2% to Kshs 28.0 bn from Kshs 27.4 bn, driven by other expenses, which increased by 16.3% to Kshs 11.9 bn from Kshs 10.3 bn in Q3'2016. This was despite a decline in staff costs, which declined by 10.7% to Kshs 7.8 bn from Kshs 8.7 bn in Q3'2016 attributed to a shift in channels of delivery, to automated options. Loan Loss Provisions (LLP), also declined by 13.2% to Kshs 2.8 bn from Kshs 3.3 bn,
- The Cost to Income ratio deteriorated to 57.5% from 56.0% in Q3'2016 following a 2.2% increase in total operating expenses coupled with a 0.3% decline total operating income. Without LLP, the Cost to Income ratio worsened to 51.6% from 49.2% in Q3'2016
- Profit before tax decreased by 3.6% to Kshs 20.7 bn from Kshs 21.5 bn, while profit after tax decreased by 2.7% to Kshs 14.6 bn from Kshs 15.0 bn in Q3’2016.
- The balance sheet recorded an expansion in Q3’2017, with total assets increasing by 10.7% to Kshs 518.3 bn from Kshs 468.0 bn in Q3'2016. This growth was driven by a 37.2% increase in investment in government and other securities to Kshs 127.5 bn from Kshs 93.1 bn in Q3'2016. Loan book, which is 51.2% of the total assets book, contracted by 2.2% to Kshs 265.4 bn from Kshs 271.4 bn in Q3’2016 leading to the 10.7% growth despite the significant growth in investment in government securities. The value of property and equipment declined by 7.2%, attributed to the closure of 8 of its 13 branches in South Sudan,
- Total liabilities rose by 10.9% to Kshs 428.1 bn from Kshs 386.4 bn in Q3'2016, driven by an 11.3% increase in deposits to Kshs 368.8 bn from Kshs 331.3 bn in Q3'2016. Shareholders’ funds increased by 10.5% to Kshs 90.1 bn from Kshs 81.6 bn in Q3’2016,
- The increase in deposits coupled with a decline in the loan book led to a decline in the loan to deposit ratio to 72.8% from 81.9% in Q3'2016, indicating shift in funds allocation from loans to other less risky assets like government securities following the enactment of the law on loan pricing framework,

Going forward, Equity Group Holdings is leveraging on its heavy investment in technology to boost its growth and increase its profitability by reducing its operating costs. By Q3'2017, 91.1% of the bank's transactions were handled through alternative channels such as mobile, internet, merchant and agency banking with the remaining 8.9% being ATMs and Branch transactions. In our view, the investment on digital platforms made by the bank over the last 5 years should enable the bank achieve the much needed efficiency in this era of compressed NIMs and hence supporting the profitability going forward.

For a more comprehensive analysis, see our Equity Group Q3’2017 Earnings Note.

Safaricom Limited released H1’2018 results

Safaricom Limited released H1’2018 results, recording a normalized EBITDA growth of 14.4% to Kshs 54.3 bn from Kshs 47.5 bn in H1’2017, after adjusting for a one-off item in 2016 of Kshs 3.4 bn. Core earnings per share grew by 9.0% to Kshs 0.65 from Kshs 0.6 in H1’2017. Adjusting for the one off item in 2016, core earnings per share grew by 21.4% to Kshs 0.65 from Kshs 0.54 in H1’2017. The earnings growth was supported by a 12.0% growth in service revenue (M-PESA, messaging, mobile data, fixed service) to Kshs 109.7 bn from Kshs 98.0 bn in H1’2017 due to growth in active users and increased usage of non-voice services. Key highlights for the half year performance include:

- Voice revenue grew by 3.6% to Kshs 47.4 bn from Kshs 45.7 bn in H1’2017, while messaging revenue grew by 3.4% y/y to Kshs 8.9 bn from Kshs 8.6 bn. This growth was supported by a 10.8% y/y growth in the number of total customers to 29.5 mn from 26.6 mn in H1’2017. However, the voice monthly average revenue per user (ARPU), declined by 7.8% to Kshs 271.2 per user from Kshs 294.0 per user, indicating that the traditional revenue streams are not benefitting as much from the increasing customer base. Voice revenue now accounts for 43.2% of service revenue, down from 46.6% in H1’2017;

- M-Pesa revenue rose 16.2% to Kshs 30.1 bn from Kshs 25.9 bn in H1’2017. This was supported by the 12.1% growth in registered M- Pesa customers to 27.8 mn, and an increase in activity as measured by users who were active in the last 30 days by 9.5% to 19.3 mn from 17.6 mn. M-Pesa currently accounts for 27.4% of total revenue, a slight improvement from 26.4% in H1’2017. The cashless platform, Lipa na M-Pesa, continues to be adopted by firms and currently has over 70,000 merchants on a 30-day active basis;
- Mobile data revenue grew by 31.0% y/y to Kshs 17.6 bn from Kshs 13.4 bn, driven by a 13.5% increase in 30-day active mobile data customers to 17.0 mn from 14.9 mn in H1’2017 and increased smartphone penetration. Currently there are over 90,000 homes and 1,670 commercial buildings with FTTH network, further driving the growth in data usage;
- Fixed service revenue grew by 34.7% to Kshs 3.2 bn from Kshs 2.4 bn driven by a 24.9% growth in 30-day active fixed service customers to 14.1 mn from 11.3 mn;
- Return on Average Assets improved to 26.0% in H1’2018 from 24.2% in H1’2017 while Return on Average Equity increased to 57.1% in H1’2018 from 51.2% in H1’2017;
- The Board of Directors did not recommend payment of an interim dividend.

Safaricom’s strategy going forward will be driven by:

1. Investing in their network to enhance capacity, coverage and quality, including the rolling out of 4G network to additional sites in 40 out of 47 counties
2. Improving customer experience by investing in additional call centres. Safaricom has started the creation of additional 300 customer care jobs and opening a new centre in Eldoret
3. Increased localization as the company subdivides the business into regions each with its own head to provide tailor- made regional promotions and offers with the strategy being driven forward by the new Regional Operations division

For a more comprehensive analysis, see our Safaricom Limited H1’2018 Earnings Note.

Below is our Equities Universe of Coverage:

all prices in Kshs unless stated otherwise

No.	Company	Price as at 29/09/17	Price as at 31/10/17	m/m Change	YTD Change	Target Price*	Dividend Yield	Upside/ (Downside)**
1.	NIC***	38.5	37.5	(2.6%)	44.2%	58.2	3.4%	58.6%
2.	KCB Group***	41.0	38.0	(7.3%)	32.2%	57.1	5.5%	55.7%
3.	Barclays	10.1	10.0	(1.5%)	17.3%	12.5	11.1%	36.7%
4.	Liberty	13.0	12.2	(6.5%)	(8.0%)	16.4	0.0%	35.0%
5.	DTBK	185.0	179.0	(3.2%)	51.7%	234.1	1.4%	32.2%
6.	Jubilee Insurance	475.0	445.0	(6.3%)	(9.2%)	575.4	1.8%	31.1%
7.	HF Group***	10.5	11.4	8.6%	(18.9%)	14.2	2.1%	27.2%

8.	Kenya Re	20.0	20.0	0.0%	(11.1%)	24.4	3.8%	25.8%
9.	I&M Holdings	130.0	124.0	(4.6%)	37.8%	149.6	2.4%	23.1%
10.	Sanlam Kenya	28.0	27.0	(3.6%)	(1.8%)	31.4	1.1%	17.3%
11.	Co-op Bank	17.1	16.0	(6.5%)	20.8%	17.5	5.7%	15.5%
12.	Equity Group	38.8	38.0	(1.9%)	26.7%	40.5	5.5%	12.1%
13.	CIC Group	5.4	5.9	10.3%	55.3%	6.2	2.0%	7.1%
14.	Britam	15.0	14.5	(3.3%)	45.0%	15.2	1.7%	6.5%
15.	Stanbic Holdings	79.0	79.5	0.6%	12.8%	79.1	5.2%	4.7%
16.	Standard Chartered	231.0	220.0	(4.8%)	16.4%	199.8	4.8%	(4.4%)
17.	NBK	9.9	9.8	(0.5%)	36.1%	5.2	0.0%	(47.1%)

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***

We have placed Safaricom Limited under review as we update the valuation following release of its H1'2018 results

For full disclosure, Cytonn and/or its affiliates holds a significant stake in KCB Group and NIC Bank, ranking as the 5th largest local institutional investor and the 9th largest shareholder, respectively

Equities Asset Class Review

The table below summarizes the various equities market indicators, the outlook for the remaining part of 2017, and our expectations going forward:

Equities Market Indicators	Outlook	Current View
Macro-economic Environment	• GDP growth is expected to recover over the remaining part of 2017, from the depressed 4.7% experienced in Q1'2017, and come in at 4.7% - 5.2%, following the long rains between March and May, albeit depressed, which has served to ease the food shortage in the country. Key risk lies in the subdued private sector credit growth, that came in at 1.6% in August, from 2.1% in May, and this trend may well impact adversely on economic growth • Interest rates are expected to remain at the current levels as the CBK monitors inflation and exchange rates, which are expected to remain within government bound and depreciate, respectively	**Neutral**
Corporate Earnings Growth and Valuations	• We expect corporate earnings growth of 6.0% in 2017 due to lower earnings for financial companies attributed to the implementation of the Banking Act (Amendment) ,2016. For the year 2018, we expect earnings growth of 7.0% • We expect corporate earnings growth rate of approximately 7.0% in 2018 translating to a forward P/E of 11.7x, which is 14.5% cheaper than historical average of 13.4x	**Neutral with a bias to Positive**

Investor Sentiment and Security	• We expect 2017 to register reduced net foreign inflows due to uncertainties regarding political and social risks as Kenya undertakes general elections, and expectations of a more aggressive rate hike cycle by the Fed. However, we expect long term investors to enter the market looking to take advantage of the current low valuations in sections of the market. • We expect security to be maintained in the country supported by government initiatives towards improving internal security	**Neutral**

We therefore maintain a "NEUTRAL" recommendation on equities for investors with short-term investment horizon since, despite the lower earnings growth prospects for this year, the market has rallied and brought the market P/E closer to its' historical average. Pockets of value exist, with a number of undervalued sectors like Financial Services, which provide an attractive entry point for long term investors and thus we are positive for investors with a long term investment horizon.