Cytonn INVESTMENTS

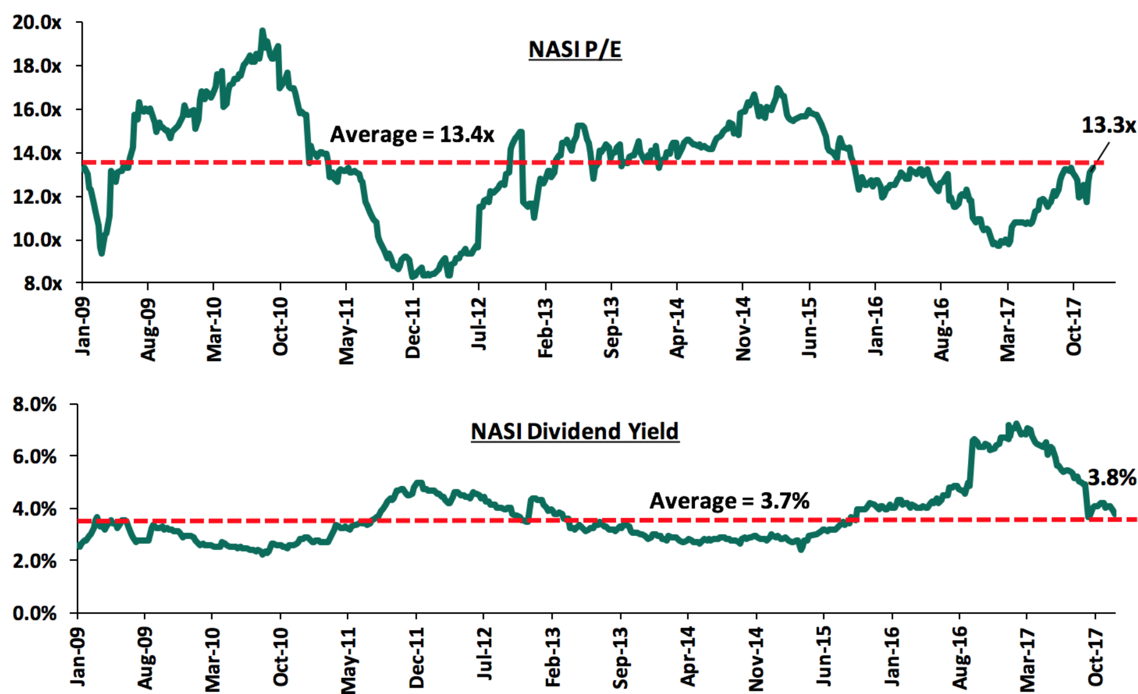
Nairobi Hospitality Report 2017, & Cytonn Monthly – November 2017

Equities

During the month of November, the equities market was on an upward trend with NASI, NSE 25 and NSE 20 gaining 6.7%, 4.8% and 2.0%, respectively, taking their YTD performance as at the end of November to 29.7%, 24.7% and 19.4% for NASI, NSE 25 and NSE 20, respectively. The equities market performance during the month was driven by gains in large caps such as Equity Group, KCB Group, Diamond Trust Bank and Safaricom, which gained 12.5%, 8.6%, 8.4% and 7.8%, respectively. For this week, the equities market recorded mixed trends with NASI and NSE 25 gaining 2.8% and 0.2%, respectively, while NSE 20 lost 0.5%, taking their YTD performance to 29.8%, 24.6% and 19.8% for NASI, NSE 25 and NSE 20, respectively. Since the February 2015 peak, the market has lost 2.5% and 30.6% for NASI and NSE 20, respectively.

Equities turnover rose by 58.5% during the month to USD 143.8 mn from USD 90.7 mn in October 2017, taking the YTD turnover to USD 1.5 bn. Foreign investors remained net buyers for this month with net inflows of USD 16.1 mn, compared to net inflows of USD 7.2 mn witnessed in October 2017. Year to date, foreign investors are net sellers with net outflows of USD 88.0 mn. We expect the market to remain supported by improved investor sentiment once political 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 13.3x, versus a historical average of 13.4x, and a dividend yield of 3.8%, 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 21.5% below the most recent peak of 16.9x in February 2015. The current P/E valuation of 13.3x is 36.9% above the most recent trough valuation of 9.7x experienced in the first week of February 2017, and 59.8% 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, Kenya Airways (KQ) completed the restructuring of its debt and equity following the signing of the agreement by main lenders including the Kenyan Government, KLM, and KQ Lenders Company, a special purpose vehicle (SPV) consisting of 10 Kenyan banks. The unsecured lenders converted their debt to equity, which resulted in a 94.8% dilution of the previous shareholders who are not lenders. Following the debt and equity restructuring, the government's ownership of KQ rose to 48.9% from the previous 29.8%, while the consortium of bank's vehicle (KQ Lenders) now own 38.1% of the airline, as highlighted in our Cytonn Weekly #46/2017. KQ's shares are back to trading on the Nairobi Securities Exchange (NSE) following completion of the restructuring process after they were suspended for 2-weeks to allow for the share split, debt conversion and subsequent share consolidation. The shares were trading at Kshs 12.5 per share as at Friday, 1st December 2017, which is a gain of 134.9% from the price of Kshs 5.3 per share as at 15th November 2017 when the trading suspension began. KQ is currently trading at price/sales ratio of 0.2x, which is low compared to other peers such as Comair and El Al Israel Airlines trading at 0.7x and 0.3x, respectively. We view the conversion as a positive move for the airline as (i) it will reduce the overall debt burden, thus stabilizing the company and facilitating long term growth, in line with its turnaround strategy, and (ii) it will result in a significant boost in liquidity through savings on interest and maturity payments of debt, thus improving the airline's cash flow position. The new shareholders are also introducing changes in governance, which we believe will be beneficial for the firm, to ensure keen oversight on the implementation of its turn-around strategy.

During the month, we had a number of earnings releases by banks reporting their Q3'2017 performance. Below is the detailed analysis of the earnings' releases for this week:

HF Group released Q3'2017 results

HF Group released Q3'2017 results, recording an 80.9% decline in core earnings per share to Kshs 0.2 from Kshs 0.8 in Q3'2016, attributed to a 25.1% decline in operating revenue coupled with a 0.9% increase in operating expenses. Key highlights of the performance from Q3'2016 to Q3'2017 include:

- Total operating revenue declined by 25.1% y/y to Kshs 2.8 bn from Kshs 3.8 bn, attributed to a 29.7% decline in Net Interest Income (NII) to Kshs 2.2 bn from Kshs 3.1 bn in Q3'2016, and a 4.0% y/y decline in Non-Funded Income (NFI) to Kshs 0.64 bn from Kshs 0.67 bn,
- Interest Income declined by 18.5% to Kshs 5.5 bn from Kshs 6.7 bn in Q3'2016, attributable to a lower yield on interest-earning assets, which came in at 12.4% from 14.9% in Q3'2016. Interest income on government securities declined by 23.9% y/y to Kshs 0.3 bn from Kshs 0.4 bn, while

interest income on loans and advances declined by 16.7% y/y to Kshs 5.1 bn from Kshs 6.1 bn, (unlike most banking peers who have increased income on government securities by 7.4%, HF's declined by 23.9%)

- Interest expense decreased by 8.7% to Kshs 3.3 bn from Kshs 3.6 bn in Q3'2016, following a decline in cost of funding to 7.4% from 8.5% in Q3'2016. Interest expense on customer deposits declined by 22.5% to Kshs 1.8 bn from Kshs 2.3 bn in Q3'2016. Owing to the faster decline in interest income, the Net Interest Income declined by 29.7% to Kshs 2.2 bn from Kshs 3.1 bn in Q3'2016. The Net Interest Margin thus declined to 5.1% from 6.4% in Q3'2016,
- Non-Funded Income (NFI) recorded a drop of 4.0% to Kshs 0.64 bn from Kshs 0.67 bn in Q3'2016. The decline in NFI is attributable to a 21.3% drop in total fees and commissions to Kshs 0.2 bn from Kshs 0.3 bn in Q3'2016, and a 3.0% decrease in other income to Kshs 0.40 bn from Kshs 0.41 bn. Given the slower decline in NFI compared to decline in NII, the proportion of NFI to total revenue increased, with the current revenue mix at 77:23 funded to non-funded income from 82:18 in Q3'2016, (unlike the industry that has recorded an increased in NFI by 10.4%, we note that HF's declined. HF's peers in Tier 2 have also recorded an average NFI growth of 3.6%. Other Tier 2 banks include Stanbic, NIC, I&M and National Bank)
- Total operating expenses increased marginally by 0.9% to Kshs 2.59 bn from Kshs 2.57 bn, attributable to an 11.8% increase in other operating expenses to Kshs 1.0 bn from Kshs 0.9 bn in Q3'2016. However, staff costs declined by 4.4% to Kshs 0.8 bn from Kshs 0.84 bn in Q3'2016, while the Loan Loss Provision (LLP) also registered a 3.2% decline to Kshs 0.47 bn from Kshs 0.49 bn in Q3'2016,
- The Cost to Income ratio drastically worsened to 91.8% from 68.1% in Q3'2016, following a 25.1% decline in operating revenue coupled with a 0.9% increase in operating expenses. Without LLP, the Cost to Income ratio worsened to 74.9% from 55.0% in Q3'2016,
- Profit before tax declined by 80.7% to Kshs 0.2 bn from Kshs 1.2 bn, while profit after tax declined by 80.9% to Kshs 0.2 bn from Kshs 0.8 bn in Q3'2016,
- Total assets declined by 3.6% to Kshs 70.8 bn from Kshs 73.5 bn in Q3'2016. This decline is attributed to a 5.0% decline in the loan book to Kshs 51.2 bn from Kshs 53.9 bn in Q3'2016 coupled with an 86.9% decline in investment in government securities to Kshs 0.7 bn from Kshs 5.6 bn in Q3'2016, it is also notable that while most banking peers increased their investment in government securities by an average of 15.2%, HF's has declined dramatically. Placements due from banks recorded an 80.1% increase to Kshs 4.5 bn from Kshs 2.5 bn in Q3'2016, following a 382.5% y/y increase in placements due from foreign banking institutions to Kshs 1.7 bn from Kshs 0.3 bn,
- Total liabilities declined by 4.4% to Kshs 59.4 bn from Kshs 62.2 bn in Q3'2016, attributed to a 19.2% decline in deposits to Kshs 33.6 bn from Kshs 41.6 bn in Q3'2016. Borrowings increased by 28.2% to Kshs 23.7 bn from Kshs 18.5 bn in Q3'2016, as HF Group mobilized cash to enable the bank pay back its Kshs 7.0 bn corporate bond that fell due in October 2017,
- The faster decline in deposits compared to the loan book led to an increase in the loan to deposit ratio to 152.3% from 129.6% in Q3'2016. However, the banks' loans to total borrowings plus deposits ratio, which is a more suitable measure given HF Group's primary business is mortgage provision, remained relatively stable at 88.8% from 88.5% in Q3'2016,
- Shareholders' funds increased marginally by 0.7% to Kshs 11.3 bn from Kshs 11.2 bn in Q3'2016, due to a 51.7% y/y increase in statutory loan loss reserves to Kshs 0.6 bn from Kshs 0.4 bn in Q3'2016.

We view HF Group's business model as not ideal in the interest rate cap environment that has hurt mortgage uptake in the market, further worsened by the challenging operating environment due to prolonged electioneering period. For these reasons, we expect the group's FY'2017 earnings to be more than 25% worse than the FY'2016 earnings. The group is however optimistic of better performance in Q4'2017 when two projects, Komarock Heights and Richland, are completed. Going forward, HF Group is leveraging on its property and investments subsidiary, HFDI, to continue

developing real estate products, which form the core part of Non-Funded Income for HF Group. This will be supported by normalization of property conveyance process at the Ministry of Lands Registries, which will ensure release of funds tied in incomplete transactions.

For a more comprehensive analysis, see our HF Group Q3'2017 Earnings Note.

I&M Bank released Q3'2017 results

I&M Bank released Q3'2017 results, recording a 23.2% decline in profit after tax to Kshs 3.9 bn from Kshs 5.1 bn in Q3'2016, attributed to a 27.4% y/y increase in operating expenses that was not offset by the 0.6% marginal increase in operating income. Key highlights for the performance from Q3'2016 to Q3'2017 include:

- Total operating income increased marginally by 0.6% to Kshs 12.6 bn from Kshs 12.5 bn in Q3'2016, driven by a 9.3% increase in Non-Funded income to Kshs 3.3 bn from Kshs 3.0 bn in Q3'2016, despite a 2.2% decline in Net Interest Income (NII) to Kshs 9.3 bn from Kshs 9.5 bn in Q3'2016,
- Interest Income declined by 4.0% to Kshs 15.2 bn from Kshs 15.8 bn in Q3'2016. This is attributable to a 7.7% decline in interest income on loans & advances to Kshs 11.4 bn from Kshs 12.3 bn, despite a 10.7% increase in interest income on government securities to Kshs 3.7 bn from Kshs 3.4 bn in Q3'2016,
- Interest expense declined by 6.7% to Kshs 5.9 bn from Kshs 6.3 bn in Q3'2016, following a 6.9% y/y decline in interest expense on customer deposits to Kshs 5.1 bn from Kshs 5.5 bn. Following a larger decline in interest income compared to interest expense in absolute terms, the Net Interest Income declined by 2.2% y/y to Kshs 9.3 bn from Kshs 9.5 bn,
- Non-Funded Income (NFI) recorded a growth of 9.3% to Kshs 3.3 bn from Kshs 3.0 bn in Q3'2016. The growth in NFI was driven by a 24.8% y/y increase in fees & commissions on loans to Kshs 0.7 bn from Kshs 0.6 bn and a 24.1% y/y increase in other fees and commissions to Kshs 1.3 bn from Kshs 1.1 bn. The current revenue mix came in at 74:26 funded to non-funded income from 76:24 in Q3'2016,
- Total operating expenses increased by 27.4% to Kshs 6.6 bn from Kshs 5.1 bn, attributed to a 103.5% increase in Loan Loss Provisions (LLP) to Kshs 1.9 bn from Kshs 0.9 bn, and an 11.7% growth in staff costs to Kshs 2.2 bn from Kshs 2.0 bn in Q3'2016. Staff costs account for 33.4% of operating expenses while LLPs account for 28.6% of operating expenses,
- The Cost to Income ratio worsened to 52.2% from 41.2% in Q3'2016, following the 27.4% increase in total operating expenses. Without LLP, the Cost to Income ratio worsened to 37.3% from 33.8% in Q3'2016,
- Profit before tax decreased by 18.2% to Kshs 6.0 bn from Kshs 7.3 bn. Profit after tax decreased by 23.2% to Kshs 3.9 bn from Kshs 5.1 bn in Q3'2016 following an increase in effective tax rate to 34.5% from 30.2% in Q3'2016,
- Total assets grew by 9.7% to Kshs 200.9 bn from Kshs 183.2 bn in Q3'2016. This growth was driven by a 16.0% y/y increase in investment securities to Kshs 48.7 bn from Kshs 42.0 bn and a 9.6% growth in the loan book to Kshs 133.2 bn from Kshs 121.5 bn in Q3'2016,
- Total liabilities rose by 10.6% to Kshs 168.5 bn from Kshs 152.3 bn in Q3'2016, driven by a 130.0% y/y increase in other liabilities to Kshs 7.3 bn from Kshs 3.2 bn and a 9.6% increase in deposits to Kshs 141.3 bn from Kshs 129.0 bn in Q3'2016,
- Shareholders' funds increased by 4.6% to Kshs 31.6 bn from Kshs 30.3 bn in Q3'2016,
- The loan to deposit ratio remained stable at 94.3% following similar increase in loans and deposits,
- I&M Bank is currently sufficiently capitalized with a core capital to risk weighted assets ratio at 16.1%, 5.6% above the statutory requirement, with total capital to total risk weighted assets exceeding statutory requirement by 2.7%.

Going forward, we expect I&M Bank's growth to be propelled by continued investment in the

innovation and digitization of systems, processes and solutions in a bid to enhance efficiency as well as to provide their customers with convenient access to products and solutions.

National Bank released Q3’2017 results

National Bank released Q3’2017 results, recording a 73.5% decline in core earnings per share to Kshs 0.4 from Kshs 1.5 in Q3’2016, attributed to a 24.4% decline in operating revenue, which outpaced a 19.6% decline in operating expenses. Key highlights for the performance from Q3’2016 to Q3’2017 include:

- Total operating revenue declined by 24.4% y/y to Kshs 6.4 bn from Kshs 8.4 bn, attributed to a 30.4% decline in Net Interest Income (NII) to Kshs 4.6 bn from Kshs 6.6 bn in Q3'2016, and a 3.1% y/y decline in Non-Funded Income (NFI) to Kshs 1.8 bn from Kshs 1.9 bn,
- Interest Income declined by 29.6% to Kshs 7.1 bn from Kshs 10.0 bn in Q3’2016, attributable to a decline in the yield on interest-earning assets to 9.8% from 12.9% in Q3’2016. Interest income on loans and advances declined by 50.7% y/y to Kshs 3.8 bn from Kshs 7.6 bn, while interest on government securities increased by 36.7% y/y to Kshs 3.2 bn from Kshs 2.3 bn,
- Interest expense decreased by 28.0% to Kshs 2.5 bn from Kshs 3.5 bn in Q3’2016, following a decline in cost of funds to 3.4% from 5.4% in Q3’2016. Interest expense on placements declined by 65.4% y/y to Kshs 0.2 bn from Kshs 0.7 bn, while interest expense on customer deposits declined by 18.7% y/y to Kshs 2.3 bn from Kshs 2.8 bn in Q3’2016. Owing to the faster decline in interest income, the Net Interest Income declined by 30.4% to Kshs 4.6 bn from Kshs 6.6 bn in Q3’2016. The Net Interest Margin thus declined to 6.3% from 7.5% in Q3'2016,
- Non-Funded Income (NFI) recorded a drop of 3.1% to Kshs 1.8 bn from Kshs 1.9 bn in Q3'2016. The decline in NFI is attributable to a 5.0% drop in total fees and commissions to Kshs 1.1 bn from Kshs 1.2 bn in Q3’2016. Given the slower decline in NFI compared to decline in NII, the proportion of NFI to total revenue increased, with the current revenue mix at 72:28 funded to non-funded income from 78:22 in Q3’2016,
- Total operating expenses decreased by 19.6% to Kshs 6.2 bn from Kshs 7.7 bn, attributable to a 72.9% decrease in loan loss provisions (LLP) to Kshs 0.5 bn from Kshs 1.9 bn in Q3’2016. However, staff costs increased by 7.6% to Kshs 2.9 bn from Kshs 2.7 bn in Q3’2016,
- The Cost to Income ratio worsened to 96.9% from 91.2% in Q3'2016, following a 24.4% decline in operating revenue, which outpaced a 19.6% decrease in operating expenses. Without LLP, the Cost to Income ratio worsened to 88.8% from 68.6% in Q3'2016,
- Profit before tax declined by 73.5% to Kshs 0.2 bn from Kshs 0.7 bn, while profit after tax declined by 73.5% to Kshs 0.1 bn from Kshs 0.5 bn in Q3’2016,
- Total assets increased by 2.4% to Kshs 116.3 bn from Kshs 113.6 bn in Q3'2016. This growth is attributed to a 319.2% growth in placements due from banks to Kshs 2.6 bn from Kshs 0.6 bn in Q3’2016. Loans and advances decreased by 6.9% y/y to Kshs 57.9 bn from Kshs 62.2 bn,
- Total liabilities increased by 2.9% to Kshs 105.1 bn from Kshs 102.1 bn in Q3'2016, attributed to an 86.8% increase in placements due to other banks to Kshs 2.2 bn from Kshs 1.2 bn in Q3'2016. Customer deposits grew marginally by 1.0% y/y to Kshs 97.4 bn from Kshs 96.4 bn,
- The faster decline in loans compared to deposits led to a decrease in the loan to deposit ratio to 59.4% from 64.5% in Q3'2016,
- Shareholders’ funds decreased by 2.4% to Kshs 11.2 bn from Kshs 11.5 bn in Q3’2016, due to a 38.3% y/y decrease retained earnings to Kshs 2.1 bn from Kshs 3.3 bn in Q3’2016.

Key to note from NBK’s results is that the bank continues to reduce its level of provisioning, despite growth in non-performing loans and contrary to the current industry trend of providing more pending adoption of IFRS 9. NBK remains under-capitalized with the total capital to total risk-weighted assets falling below the statutory requirement of 14.5% by 3.2%. Moving forward, NBK’s growth is expected to be supported by:

i. Successful revamping of its Small Enterprise banking segment and the Amanah business segment.

The bank has also partnered with institutions to offer real-time collections through its Payment Gateway platform for institutions, which is expected to drive their deposits as well as reduce its cost of funding, and,

ii. Management of expenses, which will enable the bank control its high cost-to-income ratio, currently at 96.9%.

For a more comprehensive analysis, see our National Bank Q3’2017 Earnings Note.

Below is a summary of the Q3’2017 results for the eleven listed banks and key take-outs from the results:

Listed Banks Q3'2017 Earnings and Growth Metrics

Bank	Core EPS Growth		Interest Income Growth	Interest Expense Growth	Net Interest Income Growth	Non Funded Income (NFI) Growth	NFI to Total Operating Income	Growth in total fees and commissions	Loan Growth		Deposits Growth		Growth in Govt Securities
	Q3'2017	Q3'2016	Q3'2017	Q3'2017	Q3'2017	Q3'2017	Q3'2017	Q3'2017	Q3'2017	Q3'2016	Q3'2017	Q3'2016	Q3'2017
Stanbic Bank	**19.7%**	(2.1%)	(7.3%)	(8.8%)	(6.5%)	5.1%	44.4%	45.3%	13.8%	1.9%	8.2%	22.8%	40.0%
KCB Group	**5.0%**	16.1%	(3.6%)	(10.9%)	(1.0%)	18.4%	32.9%	25.5%	15.1%	4.9%	13.6%	(7.3%)	2.8%
NIC Bank	**(1.3%)**	(6.4%)	(8.4%)	2.3%	(14.5%)	2.9%	28.2%	12.4%	7.3%	(0.7%)	21.3%	2.4%	49.7%
Equity Group	**(2.7%)**	17.7%	(11.1%)	5.9%	(15.0%)	28.3%	43.6%	24.9%	(2.2%)	3.0%	11.3%	4.8%	17.7%
DTB	**(3.5%)**	11.4%	0.8%	3.7%	(1.4%)	4.7%	21.2%	8.6%	8.1%	5.4%	16.5%	29.9%	18.2%
Co-op Bank	**(9.5%)**	22.3%	(7.7%)	(8.5%)	(7.3%)	2.7%	32.8%	5.9%	14.2%	6.9%	12.1%	1.7%	0.8%
Barclays	**(12.0%)**	(5.4%)	(4.6%)	(6.3%)	(4.2%)	(14.8%)	31.0%	(17.6%)	5.3%	14.3%	10.8%	13.4%	28.8%
I&M Bank	**(23.2%)**	16.5%	(4.0%)	(6.7%)	(2.2%)	9.3%	26.1%	24.4%	9.6%	4.5%	9.6%	9.9%	16.0%
StanChart	**(39.1%)**	24.5%	(1.4%)	19.1%	(8.0%)	(3.2%)	31.8%	(4.0%)	(5.4%)	14.1%	19.5%	19.8%	19.9%
NBK	**(73.5%)**	(76.9%)	(29.6%)	(28.0%)	(30.4%)	(3.1%)	28.3%	(5.0%)	(6.9%)	(15.5%)	1.0%	6.2%	32.1%
HF Group	**(80.9%)**	7.8%	(18.5%)	(8.7%)	(29.7%)	(4.0%)	22.8%	(21.3%)	(5.0%)	4.3%	(19.2%)	10.8%	(86.9%)
Weighted Average**	**(8.2%)**	**14.1%**	**(6.1%)**	**(1.0%)**	**(7.4%)**	**10.4%**	**34.0%**	**14.6%**	**6.3%**	**6.0%**	**12.9%**	**7.5%**	**15.2%**

*** *The weighted average is based on Market Cap as at 1st December, 2017**

Key takeaways:

- Only Stanbic Bank and KCB Group have recorded a growth in core earnings per share, with the average decline in core earnings across the banking sector at 8.2%, owing to the tough operating environment as a result of the interest rate caps and political uncertainty in the country that affected the business environment,
- Average deposit growth came in at 12.9%. However, despite the average deposits having grown, the interest expense paid on deposits recorded a negative growth of 1.0% on average, indicating that banks are growing deposits but opening less interest earning accounts and possibly transferring some existing interest earning accounts to transaction accounts,
- Average loan growth has been recorded at 6.3%, however interest income has decreased by 6.1%, showing the effects of the rate caps,
- Investment in government securities has grown by 15.2% outpacing loan growth of 6.3%, showing increased lending to the government by banks as they avoid the risky borrowers,
- Non-funded income has however grown by 10.4%, which included a Fee and Commissions growth of 14.6%. This shows that banks are charging more fee income to improve their total yield on loans above the rate cap maximum.

Below is our Equities Universe of Coverage:

We have placed all banks under review this week as we update their valuations following release of the Q3’2017 results, and we shall be releasing the Cytonn Q3’2017 Banking Sector Report in the coming week:

all prices in Kshs unless stated otherwise

No.	Company	Price as at 31/10/17	Price as at 30/11/17	m/m Change	YTD Change	Target Price*	Dividend Yield	Upside/ (Downside)**
1.	Jubilee Insurance	445.0	458.0	2.9%	(6.5%)	575.4	1.9%	27.5%
2.	Kenya Re	20.0	20.5	2.5%	(8.9%)	24.4	3.7%	22.7%
3.	Liberty	12.2	13.9	14.4%	5.3%	16.4	0.0%	18.0%
4.	CIC Group	5.9	5.9	0.0%	55.3%	6.2	1.7%	6.8%
5.	Sanlam Kenya	27.0	30.0	11.1%	9.1%	31.4	1.0%	5.5%
6.	Britam	14.5	15.1	3.8%	50.5%	15.2	1.5%	2.5%

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 and NIC Bank, ranking as the 5th largest local institutional investor and the 9th largest shareholder, respectively

We maintain a "NEUTRAL" view 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 some 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.