Cytonn Annual Markets Review - 2017

Equities

During the year, the Kenyan equities market was on an upward trend, with NASI, NSE 25 and NSE 20 gaining by 28.4%, 21.3% and 16.5%, respectively. Since the peak in February 2015, NASI and NSE 20 are down 3.6% and 32.5%, respectively. The top five large cap stock gainers during the year were DTB, KCB Group, Safaricom, Equity Group and Co-op which gained 62.7%, 48.7%, 39.7%, 32.5% and 21.2%, respectively. Key to note is that Safaricom continues to be a key part of Kenyan equities portfolios, accounting for 44.0% of Nairobi Stock Exchange (NSE's) market capitalization, and has dominated on both the market turnover and also in determining the direction of the market given its weight, liquidity and the free float shares. See our Cytonn Weekly #50/2017 for a detailed analysis on the evolution of Safaricom's share price and market capitalisation and its effect on the performance of the NSE and portfolio construction decisions.

Equity turnover during the year rose by 14.1% to USD 1,644.0 mn from USD 1,440.7 mn in FY'2016. Foreign investors turned net sellers with net outflow of USD 88.5 mn compared to net inflows of USD 86.9 mn recorded in FY'2016. The foreign investor outflows during the year can be attributed to negative investor sentiment, as a result of political uncertainty during the election period, which saw investors take profit following the stock market rally.

The market is currently trading at a price to earnings ratio (P/E) of 13.5x, slightly above the historical average of 13.4x, and a dividend yield of 3.9%, compared to a historical average of 3.7%, having started the year at 10.3x and 6.8% for P/E and dividend Yield, respectively. The charts below indicate the historical P/E and dividend yields of the market.

Corporate Earnings

During the year, Kenyan listed banks released their Q3'2017 results recording an average decline in core earnings per share of 8.2%, compared to an average growth of 15.1% in Q3'2016, owing to the tough operating environment as a result of the interest rate capping and prolonged political uncertainty in the country that affected the business environment. Only Stanbic Bank and KCB Group recorded growth in core earnings per share of 19.7% and 5.0%, respectively. Key to note is that the EPS growth by Stanbic Bank and KCB Group was supported largely by (i) an improvement in the hyper-inflationary environment in South Sudan that saw an adjustment in the expensing of the exceptional items for Stanbic Bank, and (ii) the restatement of the Q3'2016 earnings for KCB Group, which can be considered a one-off item. Other key highlights from the Q3'2017 performance include:

i. 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 grew deposits but opening less interest earning accounts and possibly transferring some existing interest earning accounts to transaction accounts,
ii. Average loan growth was recorded at 6.3%, however interest income decreased by 6.1%, showing the effects of the rate caps,
iii. Investment in government securities grew by 15.2% outpacing loan growth of 6.3%, showing increased lending to the government by banks as they avoid the risky borrowers, and

iv. Non-funded income rose by 10.4%, which included a Fee and Commissions growth of 14.6%. This shows that banks charged more fee income to improve their total yield on loans above the rate cap maximum.

For a comprehensive analysis on the Kenya Listed Banks performance, see our Cytonn Q3’2017 Banking Sector Report

The listed insurance companies released their H1’2017 results, recording an average decline of 5.6% in core earnings per share, from an average gain of 69.4% in H1’2016. Jubilee Holdings and Liberty Holdings recorded impressive growth, but the overall performance was weighed down by Britam Holdings, which was the worst hit by the change in valuation methodology on the long-term insurance claims. The change in the valuation methodology to the Gross Premium Valuation from the Net Premium Valuation, as per the IRA requirements had a one-off effect of reducing Britam’s claims in H1’2016, due to the decline in Long-Term Insurance Liabilities by Kshs 2.2 bn in the period and hence the normalization in net insurance benefits and claims in H1’2017. The sector experienced marginal improvement in operational efficiency with the expense ratio declining to 54.3% from 55.5% in H1’2016 despite the loss ratio rising to 72.7% from 66.5% indicating increased claims in the industry. This resulted to the industry average combined ratio increasing to 127.0% from 122.0% in H1’2016 indicating that insurance companies are not profitable from their core business, and thus need to diversify to alternative revenue streams in order to boost their profitability. For more information on insurance sector H1’2017 performance, please see our Cytonn H1’2017 Insurance Report

Other key 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 (EPS) grew by 9.0% to Kshs 0.65 from Kshs 0.6 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.

This year, 6 listed companies and 1 non-listed bank gave profit warnings to investors compared 11 companies in 2016. Companies are required to issue profit warnings if they project a more than 25% decline in profits year over year. They are namely Standard Chartered Bank, Deacons, Standard Group, Bamburi, BOC Kenya, Flame Tree and Family Bank:

i. Standard Chartered Bank and Family Bank both attributed the losses to the effects of interest rate cap coupled with a slowdown in economic activity in the country,
ii. Standard Group attributed the drop to a the prolonged and disruptive election period. This is despite the expectations that most of the mainstream media houses would record booming business during election years given the demand for advertising space majorly by politicians,
iii. Bamburi attributed its drop to a weaker performance of the business in Kenya resulting from contraction of the cement market, partly due to poor private sector credit growth, drought conditions together with the effects of the pre and post-election periods as well as lower volumes to the Group's export markets,
iv. BOC Kenya attributed the drop to a lower level of sales due to depressed business activity and a credit adjustment made in prior year following a review of the methodology adopted by the Company in estimating stock obsolescence allowances,
v. Deacons, a fashion retailer, attributes its expected loss to the extended electioneering period and non-performance and closure of some branches of major anchor tenants in several shopping malls such as Nakumatt Supermarket which reduced traffic, and
vi. Flame Tree’s expected decline is attributable to the challenging trading environment and write offs made on receivables. More companies, in comparison to the previous year, issued profit

warnings mainly due to a harsher macro-economic environment mainly due to a prolonged electioneering period that did not provide a conducive environment for business.

Listings and Delistings

During the year, the Nairobi Securities Exchange (NSE) delisted the following companies:

a. Baumann Limited over failure to adhere to regulatory requirements. Baumann was an investment firm with dealings in property, construction equipment and agriculture which had been suspended from trading at the NSE on May, 2008 for failing to meet listing conditions and full disclosure of operations and financials,
b. Hutchings Biemer over failure to adhere to regulatory requirements. Hutchings was a dealer in furniture and had been suspended on February, 2001 due to non-compliance with the continuing disclosure obligations
c. Vehicle dealer Marshalls East Africa: Marshalls reverted to private ownership after Global Ltd, the firm's top shareholder with a stake of 13.9% decided to buy out retail shareholders

Legislations and other developments

The year 2017 saw enactment of a number of legislations and other developments that affected the equities market and investor sentiment, namely:

i. **Risk Based Supervision**: All banks and mortgage finance institutions were required to formulate their own ICAAP (Internal Capital Adequacy Assessment Process), and provide comprehensive reports on their revised business models, that ensures that overall internal capital levels that are adequate and consistent with their strategies, business plans, risk profiles and operating environments
ii. **Financial Services Authority (FSA) Bill 2017:** The bill seeks to create the Financial Services Authority, a body that will consolidate and take over the functions of the Capital Markets Authority (CMA), the Insurance Regulatory Authority (IRA), the Retirement Benefits Authority (RBA) and the SACCOs Societies Regulatory Authority (SASRA). This is to provide a consolidated supervisory body for the entire non-banking financial services sector to eliminate regulatory gaps
iii. **Movable Property Security Rights law 2017:** The law facilitates use of movable assets as collateral for credit facilities. This law will (i) enhance the ability to access credit using movable assets, and (ii) provide an opportunity for banks to create a niche, especially in the SME and private household loans segment
iv. **The Companies (General) (Amendment) Regulations, 2017:** Requires that companies listed on the Nairobi Securities Exchange (NSE) to publish in their annual reports a breakdown of directors' pay, in a bid to increase transparency and strengthen corporate governance
v. **Licencing of new commercial banks, following the temporary lifting of the moratorium**: The banking sector has also experienced setting up new operations following the temporary lifting of the moratorium to license new banks, which has seen the licensing of Dubai Islamic Bank Limited (DIB) and Mayfair Bank Ltd.
vi. **Chase Bank and Imperial Bank sale of majority stake:** The Central Bank of Kenya (CBK) shortlisted potential investors in Chase Bank, and received a Non-binding offer for Chase Bank from SBM Holdings and it is expected that the proposed transaction will be concluded by the end of 2017. CBK has also shortlisted investors who expressed interest in taking an equity stake in Imperial Bank and they are expected to submit their formal proposals by January 15, 2018

In 2017, Kenya's operating environment was characterised by harsh macro-economic conditions owing to prolonged electioneering period as well as drought making it unfavourable for business operation. However, despite the lower earnings growth prospects for 2017, the market has rallied and brought the market P/E back to its' historical average of 13.6x but still below the most recent peak of 16.9x at the beginning of the year showing

that pockets of value exist. We remain neutral on equities for investors with short-term investment horizon, but are positive for investors with a long-term investment horizon.

Liason House, StateHouse Avenue
The Chancery, Valley Road
www.cytonn.com