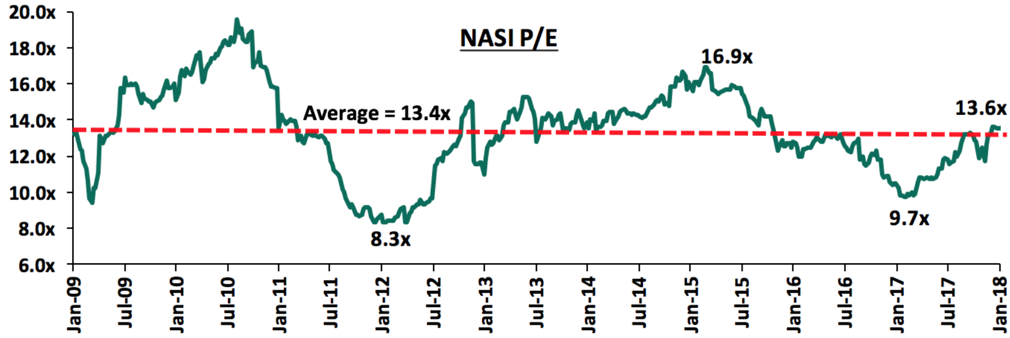
The Total Cost of Credit Post Rate Cap., & Cytonn Weekly #02/2018

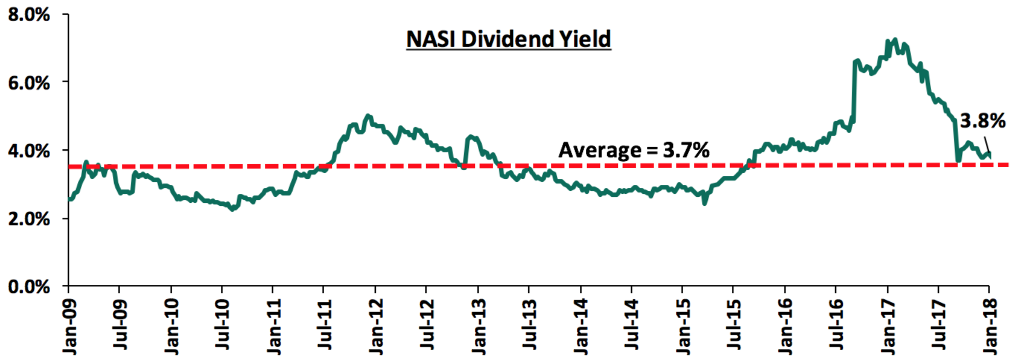
Equities

During the week, the equities market recorded mixed trends, with NASI and NSE 25 gaining 1.1% and 0.9%, respectively, while NSE 20 lost marginally by 0.1%, taking their YTD performance to 2.8%, 2.4% and (0.1%) for NASI, NSE 25 and NSE 20, respectively. For the last twelve months, NASI, NSE 25 and NSE 20 have gained 40.0%, 32.8% and 21.7%, respectively. This week's performance was driven by gains in large cap banking stocks such as KCB Group, Equity Group and Barclays Bank, which gained 3.5%, 3.1%, and 2.1%, respectively. Since the February 2015 peak, the market has lost 0.8% and 32.6% for NASI and NSE 20, respectively.

Equities turnover increased by 79.2% to USD 31.6 mn from USD 17.6 mn the previous week. Foreign investors remained net sellers with a net outflow of USD 1.8 mn compared to a net outflow of USD 1.7 mn recorded the previous week. We expect the market to remain supported by improved investor sentiment this year, as investors take advantage of the attractive stock valuations in some of the stocks.

The market is currently trading at a price to earnings ratio (P/E) of 13.6x, which is 1.4% above the historical average of 13.4x, and a dividend yield of 3.8%, compared to a historical average of 3.7%. The current P/E valuation of 13.6x is 40.2% above the most recent trough valuation of 9.7x experienced in the first week of February 2017, and 63.7% above the previous trough valuation of 8.3x experienced in December 2011. In our view, there still exist pockets of value in the market, with the current P/E valuation being 19.6% below the most recent peak of 16.9x in February 2015. The charts below indicate the historical P/E and dividend yields of the market.





According to the Central Bank of Kenya (CBK) Commercial Banks' Credit Survey for Q3'2017, gross loans increased by 1.0% to Kshs 2.39 tn from Kshs 2.37 tn in June 2017 with the industry's gross non-performing loans (NPL) ratio increasing to 10.4% from 9.9% in June, attributed to a challenging business operating environment, which was affected by political uncertainty following the long electioneering period. The perceived demand for credit remained unchanged in all sectors, except in the real estate sector, which recorded a decline due to slowdown in activities in the sector over the quarter. Most of the banks (55%) interviewed in the survey indicated that interest rate capping negatively affected their lending to SMEs as the caps compelled banks to tighten their credit standards, with 45% of the banks interviewed indicating that the caps did not affect their lending to SMEs negatively. Non-performing loans increased in 7 sectors: Building and Construction, Trade, Real Estate, Tourism, Transport and Communication, Manufacturing and Household sectors. To help mitigate against these losses, banks have intensified credit recovery efforts through;

i. Timing collections for the Tourism sector for peak seasons due to seasonal fluctuations in cash flows,
ii. Collecting amounts due in the Agriculture sector during the rainy season, since defaults mainly arise due to low harvest and persistent drought, and,
iii. Enhance collections from contractor payments by the Government, and generally improve the quality of the asset portfolio.

Non-performing loans are expected to record an increase even in the last quarter of 2017, despite the recovery efforts above, attributed to a slowdown in economic activity due to the long election period. On implementation of IFRS 9, banks expect that it will have a negative impact on their profitability, in addition to other challenges including reduction of core capital as the increased provisioning will deplete loan reserves, review of business models, and cost implications of the relevant technology and personnel training. Under-capitalized banks and banks operating just above the regulatory minimum will be required to, (i) seek additional capital from shareholders to shore up capital buffers, and (ii) enhance prudence in loan disbursement, which will ultimately have an adverse effect on private sector credit growth, which slumped to 2.0% in October 2017, way below the government target of 18.3%, and will inevitably prove detrimental to the economy. We shall be releasing a note on "IFRS 9 Transition" during the week. The note will be published on our website, Facebook and Twitter.

During the week, Kenya Airways (KQ) announced that the airline will start direct flights to the US with the first flight slated for 28th October, 2018. According to the management, the direct flights are expected to boost KQ's revenue by at least 10.0% due to a boost in tourism and trade. KQ reported revenue of Kshs 106.3 bn in FY'2017, which was an 8.5% decline from Kshs 116.2 bn recorded in FY'2016, attributed to reduction in both Available Seat Kilometres (ASKs) by 4.0% and in Yield per Revenue Passenger Kilometre by 7.4%, due to reduction in passenger capacity following phasing out of Boeing 777. We view this move by the airline to offer non-stop flights to the US as a boost to investor's confidence on successful implementation of the 'Operation Pride' strategy, whose first phase of debt and equity restructuring was completed last year. With revamped senior management and governance, we expect KQ to continue improving on the business model, which will bring back the firm to profitability and providing value to shareholders.

Below is our Equities Universe of Coverage:

all prices in Kshs unless stated otherwise

No.	Company	Price as at 05/01/18	Price as at 12/01/18	w/w Change	YTD Change	Target Price*	Dividend Yield	Upside/ (Downside)**
1.	NIC***	36.5	35.3	(3.4%)	4.4%	61.4	3.5%	77.7%
2.	DTBK	193.0	196.0	1.6%	2.1%	281.7	1.4%	45.1%
3.	KCB Group	42.8	44.3	3.5%	3.5%	59.7	6.8%	41.7%
4.	Barclays	9.6	9.8	2.1%	1.6%	12.8	10.2%	41.5%
5.	I&M Holdings	119.0	119.0	0.0%	(6.3%)	150.4	2.5%	28.9%
6.	Kenya Re	19.5	19.8	1.3%	9.1%	24.4	3.8%	27.4%
7.	Liberty Holdings	14.0	13.5	(3.2%)	10.7%	16.4	0.0%	21.5%
8.	Britam	13.7	13.0	(5.1%)	(2.6%)	15.2	1.8%	18.7%
9.	Co-op Bank	16.3	16.5	1.2%	3.1%	18.6	5.6%	18.3%
10.	Jubilee Insurance	500.0	499.0	(0.2%)	0.0%	575.4	1.7%	17.1%
11.	HF Group***	10.0	10.2	1.5%	(2.4%)	11.7	0.9%	16.4%
12.	Sanlam Kenya	29.8	27.8	(6.7%)	0.0%	31.4	1.1%	14.1%
13.	CIC Group	5.7	5.6	(2.6%)	(0.9%)	6.2	1.8%	13.5%
14.	Equity Group	40.3	41.5	3.1%	4.4%	42.3	4.3%	6.3%
15.	Standard Chartered	206.0	207.0	0.5%	(0.5%)	201.1	4.3%	1.4%
16.	Stanbic Holdings	81.0	82.5	1.9%	1.9%	79.0	5.1%	0.8%

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No.	Company	Price as at 05/01/18	Price as at 12/01/18	w/w Change	YTD Change	Target Price*	Dividend Yield	Upside/ (Downside)**
17.	NBK	9.3	9.3	0.0%	(1.1%)	5.6	0.0%	(39.8%)

****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 NIC Bank, ranking as the 9th largest shareholder

We remain neutral on equities for investors with short-term investment horizon, but are positive for investors with a long-term investment horizon since, despite the lower earnings growth prospects for 2017, 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.