Cytonn Weekly #25, with a focus on the investment attractiveness of listed banks in Kenya

Cytonn Weekly

Executive Summary

- **Fixed Income:** Undersubscription for government securities continue due to low market liquidity, and there was an increase in government bond yields in this month's primary auction;
- **Equities:** The stock market remains sluggish as management issues hit some listed companies;
- **Real Estate:** The land bill seeking to cap the amount of land an individual can own is yet to be passed in parliament, however we do not think it will go through. The focus on middle income housing continues as NHC seeks funds to develop more units through a bond;
- **Private Equity:** Kenya continues to be a good destination for private equity capital given the ability to realize exits by firms such as Helios exiting Equity Bank;
- **Focus of the Week:** Q1'2015 banking report analysing the relative investment and franchise attractiveness of Kenyan listed banks;
- **Company Updates:**
  - This week Cytonn is hosting investors from the UK looking to invest in the Kenyan real estate market
  - Institut Choiseul of France recognized our Managing Partner, Edwin H. Dande, among the top 200 young leaders in Africa. The program recognizes economic leaders under 40 who are "building the Africa of today and preparing the one to become." Qualifiers from all over Africa attended the June 15th event in Paris. 18 Kenyans made the list of top 200. The top 3 Kenyans recognized were Peter Njonjo of Coca Cola, Joshua Oigara of KCB and Kamal Budhabhatti of Craft Silicon. For the full list of the 18 Kenyans click this link: Cytonn's Managing Partner, Edwin H. Dande, among 18 Kenyans recognized as top 200 young economic leaders in Africa

Fixed Income

Treasury bill auctions continued to be undersubscribed, with a 44.6% overall subscription this week compared to a 47.7% subscription last week. There was a change in the interest rates trend in the treasury bills market, with all the tenors showing slight decline in yields to 8.27%, 10.55% and 11.07% from 8.31%, 10.64% and 11.13% for the 91-day, 182-day and the 364-day treasury bills, respectively. We ascribe the slight decline in yields to more concentration on the primary auction. The monthly government bond auction was undersubscribed with Kshs. 16.57 bn bid compared to Kshs. 20 bn on offer. The interest rates for the two bonds, the 2 and 5 year, went up to 12.63% and 13.19% from 11.77% and 11.58%, respectively, in the previous auctions. The significant increase in the yields is a key indicator that the government remains keen to finance the budget and is taking relatively expensive money.

The Kenya Shilling continued its depreciating trend this week, losing 0.31% to close the week at Kshs 98.5 to the dollar due to increased importers dollar demand. Forex reserves held by Central Bank remain sufficient to support the shilling in the short term, despite declining to 4.29 months of import cover from 4.36 months of import cover in May 2015.

We maintain our expectations that interest rates will remain high due to increased government borrowing and the need to support the shilling.

We continue to hold our April recommendation that investors stay biased towards short duration fixed income instruments.

Equities

During the week, market indices were relatively flat with NSE 20 rising by 0.67% w/w and NASI gained by 0.07% w/w. Since peaking in February 2015, NSE 20 has fallen by 12.53% while NASI has fallen by 8.45%. At these levels, the market seems to be in correction territory.

Listed companies that have recently faced significant negative publicity (Mumias, National Bank, Kenya Airways and Uchumi) appear to have one commonality – they have the Kenyan Government as a significant shareholder. Treasury should reconsider an urgent but transparent privatization scheme for all commercial assets that are not strategic to the core functions of the government - national security, social services, justice, shared infrastructure and providing an enabling business environment. There is little justification for Government of Kenya to be involved in the business of banking, airlines, retailing and sugar milling. Privatization increases efficiency and surveillance on the management team because private shareholders exercise more governance on management than a government can. Additionally, privatization will increase market liquidity, which is essential for market price discovery. Counters where the government has significant holdings are closely held and hence the liquidity available for trading is low. Kenya Re, for example, which is 60% owned by government, has approached the government to persuade it to reduce its stake.

After the failed public bond offering of Kshs 900 mn bond last year, Home Afrika went for a smaller and private offering of Kshs 500 mn through a private placement. The cost is however expensive, at 17% in private markets, up from the initial 13.5% contemplated in public markets. The 17% appears expensive, but given the fundamental total return profile of real estate development at 25% p.a., the company should do well as long as the projects towards which the funds are being placed are successfully executed. We draw two insights from Home Afrika's private placement: First, global private placements are demanding higher returns than local private placements; we engage regularly with real estate investors in London, Finland and Turkey and they are demanding 16% to 18% p.a., very similar to Home Afrika's 17% cost, but in addition you have to give up a substantial percentage of development profits, in addition to paying off the loans. Second, Home Afrika's private placement demonstrates that there is significant supply of capital in private markets. While the capital may be more expensive, the issuer is able to transact with speed and also access an investor base that is willing to price risk and fund riskier but innovative and highly rewarding commercial ventures.

We remain neutral on equities given stretched valuations and lower earnings growth prospects for companies listed in the exchange.

Private Equity

Helios EB Investors ceded its position as the single largest shareholder at Equity Bank when it sold 2.4% of its shareholding to Uganda NSSF for Kshs 4.5 bn, which in turn led to Norfund, a

Norweigian Private Equity firm being the largest shareholder with 12.2%. Earlier this year, Helios sold a 12.2% stake to Norfininvest AS, which is jointly owned by Norfund and NorFinance AS. For the latest stake, Helios made 30.4% p.a annualized return compared to 31.0% p.a return made initially through the earlier sale in January. On average the weighted return from the exited investments in Equity Bank is 30.9% year on year over the seven years holding period. Realizing a 30%+ return is consistent with Helios' track record of mid 30s IRR returns.

Realized exits by private equity funds are a positive indicator that the region is a sufficiently deepened market where PE investors can find liquidity to exit investments. The ability to exit will continue to increase the appetite for PE funds looking to invest as they can take up huge ticket deals, which in turn increases the amount of capital to fund the region's growing economy.

We have heard market rumors that Helios is in discussions to enter the Kenya real estate development market. Exiting Equity Bank, coupled with the rumored efforts to enter real estate development could be a signal that Helios believes that valuations in banking are rather frothy and that real estate is a better risk / return proposition. However, we note that the fund holding Equity Bank is approaching its life limit, hence Helios needs to exit anyway.

The interest in Africa as an investment destination for private equity firms continues to increase. Most recently, UAE based Abraaj Group, with USD 7.5 bn under management, is venturing with three other development institutions to establish a USD 200.0 mn healthcare fund, The North Africa Hospital Holdings Group, whose main focus will be the health market in Egypt and Tunisia. They plan to venture into Sub Saharan Africa if the fund proves to be a success in North Africa. The surge in investment in healthcare in Africa is attributed to an expanding population who would rather pay for their medical services, especially in countries where state healthcare services is inadequate, which is the case in most of Africa. This affirms one of our core PE investments themes – looking for companies providing essential services where the public sector has failed. This explains why private healthcare is an attractive investment and why private players like Abraaj are investing in hospitals such as Nairobi Women's Hospital.

Real Estate

The Commission for Implementation of the Constitution (CIC) is seeking the input of the public with regard to the proposed *Kenya Minimum and Maximum Land Holding Acreage Bill 2015*. The bill seeks to cap the amount of land an individual can own, as well as to repossess private land in excess of the set maximum for redistribution to the landless. The bill also proposes the levying of punitive taxes for persons holding surplus land and is not putting it to productive use. Under the proposed law, maximum land holding for rich agricultural land is set at 24.7 acres, 61.8 acres for land in semi-arid areas and 2,471 acres for land in dry areas. We expect the bill to be met with mixed reactions and it remains to be seen how the proposed bill will fare once it reaches the National Assembly. In our view this bill is bad and populist, and it will be very difficult to pass through and implement. Passage of the bill would not be good for attracting the acutely needed private capital for development as it creates uncertainty on the land regulations, which are already complex and opaque. We are of the view that the bill should limit itself to taxation of land so that those who are not productive with their land can feel a tax pinch and either make it productive or sell the land to those who are going to put it to productive use.

For the first time in its history, the National Housing Corporation has opted to raise money to fund its housing projects by issuing a corporate bond, the Kshs 10.0 bn corporate bond. NHC plans to develop 6,000 units across Kenya with a focus on affordable housing for the middle and lower income earners.

This week Teleposta Towers, owned by Teleposta Pension Scheme and Provident Fund, was put up for sale. The sale is in compliance with the Retirement Benefit Authority regulations which require pension schemes to cap investment in real estate at 30.0% of their portfolio. Currently, the bulk of the scheme's assets are tied in land and properties. The pension scheme expects the sale to improve the scheme's liquidity. In addition to Teleposta, other significant real estate activity in the market include National Bank's selling of its branches to beef up its capital, Uchumi selling real estate as part of restructuring, Nairobi County seeking developers for old residential estates, and Kenyatta University signing a PPP agreement for student housing with Africa Integras of New York.

Focus of the Week – Cytonn's Q1 2015 Banking Report

Our private equity business includes three main businesses, traditional PE, PIPE and QPE:

- Traditional private equity attracts private capital into private businesses using either pooled or deal by deal PE fund structures;
- Public investments into private entities, ("PIPE"), attracts public capital into private companies, and
- Quoted private equity, ("QPE"), attracts private capital into public / listed businesses such as listed banks.

As part of our QPE business, we periodically do research reports for our global markets PE clients looking to invest in the region. This report looks at the relative long-term attractiveness of the listed banks as an investment.

We have tried to answer the question, from an investor point of view: which is the most attractive listed bank to invest in for the long-term?

In Kenya there are a total of 43 commercial banks, 10 microfinance banks and 1 mortgage finance institution. The Central Bank of Kenya regulates all banks. The Capital Markets Authority has additional oversight over the listed banks, which are 11 in number.

Kenya has a high relative ratio of banks to the total population, with the 43 commercial banks serving a country of 44 million people, compared with Nigeria's 22 banks for 180 million inhabitants and South Africa has 19 banks for 55 million.

Over the last few years, the banking sector in Kenya has continued to grow in assets, deposits, profitability and products offering. The banking sector's aggregate balance sheet grew by 3.4% from Kshs 3.26 trillion in December 2014 to Kshs 3.37 trillion in March 2015.

The analysis covers the long-term investment / franchise attractiveness of the bank by looking at 12 different metrics, namely:

1. **Net interest margin:** We used the net interest margin as a bank's measure of core profitability;
2. **Return on average common equity:** We used the return on average common equity as a measure of profitability that flows to equity holders;
3. **Price/earnings growth ratio:** We used the price/earnings growth ratio to determine relative valuation considering each bank's expected growth rates;
4. **Loans to deposit ratio:** We used the loans to deposit ratio as a bank's measure of liquidity;
5. **Cost to income ratio:** We used the cost to income ratio as a bank's measure of efficiency;
6. **Deposits per branch:** We used a bank's deposits per each branch as a measure of efficiency and proficiency in deposit gathering;
7. **Price to tangible book value:** We used a bank's price to tangible book value as a measure of relative valuation;
8. **Tangible common equity ratio:** We used the tangible common equity ratio as a measure of a bank's permanent capitalization levels;

9. **Non-performing loans to total loans ratio:** We used a bank's non-performing loans to total loans ratio as a measure of a bank's asset quality and credit risk;
10. **Reserves to non-performing loans:** We used a bank's reserves to non-performing loans as a measure of a bank's asset quality and credit risk;
11. **Non-interest income to revenue:** We used the ratio of non-interest income to revenue as a measure of a bank's revenue diversification;
12. **Camel rating:** We used our own camel rating system to assess the overall safety and soundness of the banks;

Based on these metrics, below is the ranking of the 11 listed banks:

Key Banking Metrics		
Bank	Total Score	Rank
CfC Stanbic	58	1
I&M Bank	59	2
Standard Chartered	61	3
Equity Bank	63	4
KCB	65	5
Diamond Trust Bank	67	6
Co-operative Bank	69	7
NIC Bank	70	8
Barclays Bank	75	9
National Bank of Kenya	100	10
Housing Finance	104	11

From our analysis, the bank that is likely to deliver the best return over the long-term, 3 to 5 years, and which has the best franchise value is CFC Stanbic. The worst performer is Housing Finance (HF), however, it is worth noting that HF is more of a mortgage finance specialty lender funded through expensive wholesale deposits and bonds, rather than a traditional bank, hence the poor ranking.

The full report with analysis across the 12 analysis metrics and how the 11 listed banks compare across the respective metrics is available for purchase at a cost of USD 1,250. In case you want to purchase a copy of the full report, kindly email cmugendi@cytonn.com or bdteam@cytonn.com.
