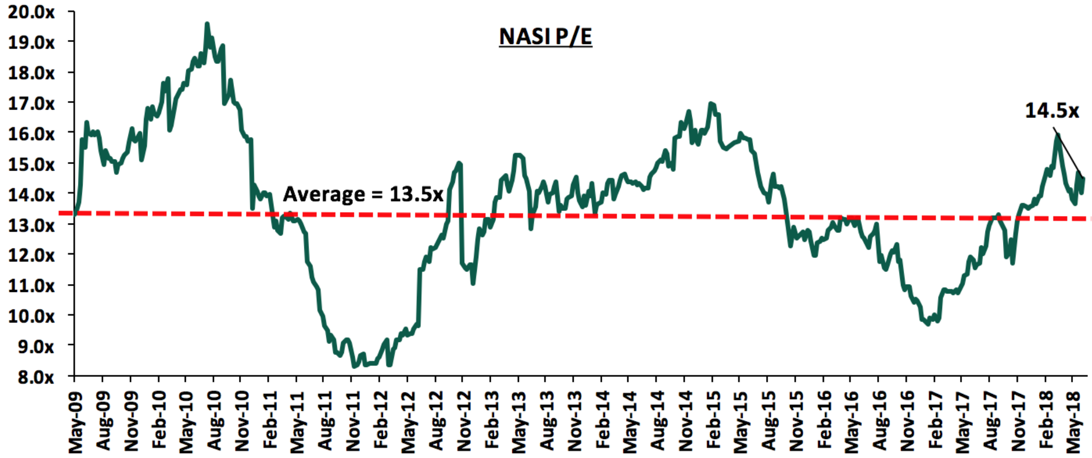
Cytonn H1’2018 Markets Review

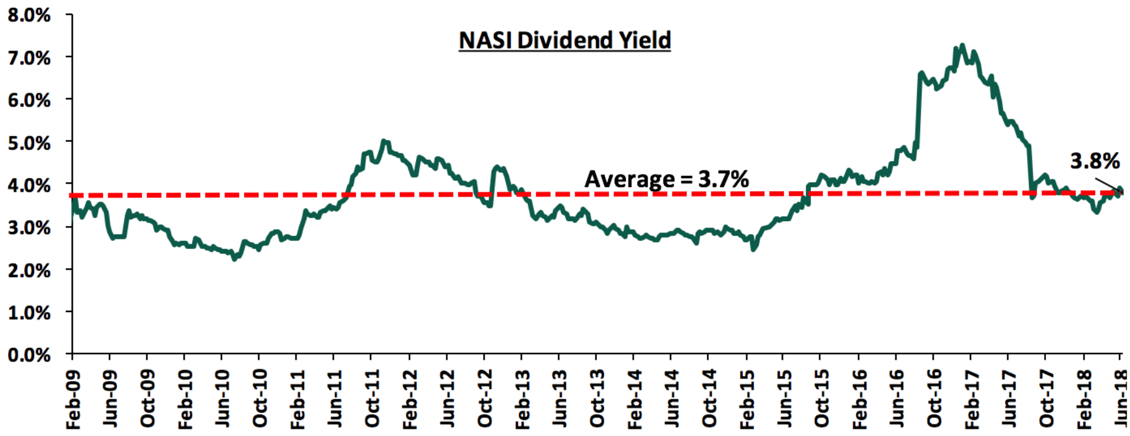
E. Equities

Market Performance:

After the bullish run experienced in the first quarter of 2018, where the Kenyan equities market gained 10.6%, the second quarter recorded a decline of 8.8%, bringing the first half gains for NASI, NSE 20 and NSE 25 to 1.8%, (11.5%) and 2.4%, respectively. The decline in market performance during Q2’2018 was as a result of declines in prices of large cap bank stocks such as Equity Group Holdings, KCB Group, Coop and Diamond Trust Bank, which declined by 14.4%, 11.9%, 10.7% and 9.1%, respectively. The declines were mainly in the banking sector stocks, mainly due to various banks closing their books, for dividends and counters beginning to trade ex-dividend. The result was that a majority of foreign investors held net-selling positions, exiting the market at expensive valuations, as the rally had brought the market above its historical P/E average. During the week, the market recorded mixed performance, as NASI and NSE 25 gained by 0.9% and 0.7% while the NSE 20 declined by 0.4%. The marginal gains recorded could be attributed to gains in counters such as Bamburi Cement, EABL and Safaricom that gained by 4.5%, 2.8% and 1.7% respectively. Profit taking investors exited the market, with possible re-entry at cheaper valuations in the future.

Equity turnover during H1’2018 rose by 34.4% to USD 1.1 bn from USD 795.7 mn in H1’2017. This can be attributed to improved investor sentiment, as a result of improved political stability after the election period, coupled with a bullish experienced in the banking sector, fueled by speculation of a repeal of the interest rate cap and investors taking positions on counters that declared profits for dividend income. The market is currently trading at a price to earnings ratio of 14.5x compared to 11.8x at the end of H1’2017. The current valuation is at 7.4% above the historical average of 13.5x. The current dividend yield of 3.8% is less than 5.5% recorded at the end of H1’2017, and is slightly above the historical average of 3.7%. The current P/E valuation of 14.5x is 49.5% above the most recent trough valuation of 9.7x experienced in the first week of February 2017, and 74.7% 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 first half of 2018, banks released their FY’2017 and Q1’2018 results, recording declining performance in FY’2017 as core EPS declined by 1.0% but recovering in Q1’2018 to record a 14.4% growth in core EPS. The growth in core EPS could largely be attributed to an 8.1% growth in Net Interest Income in Q1’2018 compared to a 3.8% decline in FY’2017, as banks adapted to operating under the interest rate cap regime, with increased focus in Non-Funded Income (NFI) as shown by the increase in NFI to total income proportion to 37.1% from 33.6% in FY’2017.

Listed Banks Q1’2018 results:

Kenyan listed banks released their Q1'2018 results, recording a 14.4% increase in core EPS compared to a decline of 8.6% in Q1’2017. The performance for Kenyan listed banks in Q1’2018 are as summarized below:

Bank	Core EPS Growth	Interest Income Growth	Interest Expense Growth	Cost of Funds	Net Interest Income Growth	NIM	NFI Growth	NFI to Total Operating Income	Growth in Total Fees & Commissions	Deposit Growth	Loan Growth	Growth in Govt. Securities	IFRS 9 Capital Ratios Effect
National Bank	348.0%	(14.2%)	(11.7%)	3.3%	(15.8%)	7.1%	(12.3%)	31.0%	91.3%	(6.3%)	(12.0%)	(9.8%)	(0.6%)
Stanbic	79.0%	17.7%	17.4%	3.3%	17.9%	7.0%	55.4%	49.0%	73.7%	13.2%	11.4%	83.5%	(0.6%)
Equity Group	21.7%	10.5%	10.5%	2.7%	10.5%	8.4%	6.3%	49.0%	7.2%	10.0%	3.5%	45.5%	(0.5%)
KCB Group	14.0%	10.9%	13.0%	3.1%	10.0%	8.2%	(1.1%)	32.8%	(2.3%)	8.7%	5.8%	(10.7%)	(0.8%)
Barclays Bank	7.7%	8.1%	6.8%	2.9%	8.5%	9.6%	5.0%	29.2%	(6.7%)	8.4%	(1.9%)	35.3%	1.00%
Co-op Bank	6.8%	9.1%	5.0%	4.0%	10.8%	8.6%	3.8%	32.0%	9.6%	5.7%	2.8%	21.3%	(0.9%)
DTB	3.0%	4.9%	4.2%	5.1%	5.4%	6.4%	4.4%	22.0%	8.3%	11.6%	3.0%	16.0%	(1.6%)
NIC Group	2.2%	8.2%	35.9%	5.2%	(8.3%)	6.3%	5.5%	29.6%	1.8%	22.1%	(0.4%)	81.2%	(0.8%)
I&M holdings	1.8%	2.5%	10.9%	4.8%	(2.7%)	7.4%	43.9%	37.0%	45.9%	3.5%	7.6%	(1.7%)	(0.2%)
StanChart	(12.5%)	7.7%	16.4%	3.6%	4.5%	7.8%	6.5%	32.0%	27.0%	13.2%	(2.6%)	12.4%	(0.5%)
HF Group	(58.4%)	(12.8%)	(13.0%)	7.2%	(12.6%)	5.1%	64.2%	28.9%	(62.7%)	(6.1%)	(12.5%)	(41.4%)	0.0%
Weighted Average Q1'2018	14.4%	9.3%	11.4%	3.4%	8.1%	8.1%	9.5%	37.1%	12.2%	9.4%	3.2%	25.0%	(0.3%)
Weighted Average Q1'2017	(8.6%)	(11.6%)	(10.3%)	3.0%	(10.1%)	9.2%	18.6%	37.8%	8.7%	11.7%	7.1%	43.1%	-

Key takeaways from the table above include:

- The listed banks recorded a 14.4% increase in core EPS, compared to a decline of 8.6% decline in Q1'2017. Only Standard Chartered Bank and Housing Finance Group recorded declines in core EPS, registering declines of 12.5% and 58.4%, respectively. HF Group recorded the biggest decline at 58.4%, on the back of a 12.6% decline in Net Interest Income (NII);
- Average deposit growth came in at 9.4%. Thus, the interest expense paid on deposits recorded a higher growth of 11.4% on average, indicating that banks are growing deposits by opening more interest earning accounts. This is also reflected by the increase in the cost of funds to 3.4% from 3.0% in Q1'2017;
- Average loan growth was recorded at 3.2%, with interest income increasing by 9.3%, as banks adapted to the interest rate Cap regime, with increased allocations in government securities;
- Investment in government securities has grown by 25.0%, outpacing loan growth of 3.2%, showing increased lending to the government by banks as they avoid the risky borrowers;
- The average Net Interest Margin in the banking sector currently stands at 8.1%, a decline from the 9.2% recorded in Q1'2017;
- Non-funded income has grown by 9.5%, which included a Fee and Commissions growth of 12.2%. This shows that banks are charging more fee income to improve their income on loans above the rate cap maximum; and;
- The sector saw a decline in total capital relative to risky assets by 0.3% due to implementation of IFRS 9, indicating the implementation of the standard affected the sector's capital position though not as much as expected. We expect this reduction to increase in the future.

Half-Year Highlights:

Consolidation in the banking sector picked up at the start of 2017, but slowed as the year progressed. In 2018, only one acquisition deal took place; SBM Bank Kenya Ltd completed the acquisition of certain assets and liabilities of Chase Bank Limited, which was under receivership. Following the agreement between the Central Bank of Kenya (CBK), Kenya Deposit Insurance Corporation (KDIC) and SBM Bank Kenya, 75.0% of the value of all moratorium deposits at Chase Bank will be transferred to SBM Bank Kenya. The remaining 25.0% will remain with Chase Bank Limited. This is a major milestone as this is the first successful instance, in the history of Kenya, of a bank being successfully brought out of receivership. Chase Bank was taken under receivership of the CBK in 2016, with customer deposits in excess of Kshs 100.0 bn. The acquisition will see SBM take control of the 62 Chase Bank branches, significantly increasing the bank's foothold in the country. SBM Bank has injected Kshs 2.6 bn in Chase Bank, and is planning to inject a further Kshs 6.0 bn after the acquisition to revive the collapsed bank. However, the transaction value is yet to be disclosed. In addition to this, the bank is expected to absorb all the 1,300 former employees of Chase Bank Limited. We shall update with the transaction multiples once the deal is fully finalized and transaction values disclosed. We are however surprised that some of the smaller banks have managed to stay independent this long, as we would have expected weaker banks (that don't serve a niche, don't have a clear deposit gathering strategy and have low capital positions), being forced to merge or be acquired as they succumb to sustained effects of the interest rate cap and the implementation of IFRS 9, which affects their profitability and capital levels. Going forward we still expect more consolidations in the industry.

Below is the summary of the transaction metrics of some of the acquisitions that have taken place in the banking sector within the last 5 years:

Acquirer	Bank Acquired	Book Value at Acquisition (Kshs bns)	Transaction Stake	Transaction Value (Kshs bns)	P/Bv Multiple	Date
Diamond Trust Bank Kenya	Habib Bank Limited Kenya	2.38	100.0%	1.82	0.8x	Mar-17

i. Ensure better conduct by banks and other lendersin terms of extending credit to retail financial customers. By categorically not defining lenders as banks, this, in our view, might be the introduction of licensing for credit companies that are not banks, and,
ii. Provide consumer protection, mainly for retail customers by ensuring their credit contracts are clear and well understood in terms of interest, fees, charges and costs on credit facilities, thereby removing the opacity that has been existent in loan prices.

However, as noted in our focus note The Draft Financial Markets Conduct Bill, 2018, the Bill only addresses consumer protection and fails to address the problem of access to credit for the private sector, mainly by SMEs. We are of the view that more still needs to be done to address the fact that banks will most likely still prefer to lend to the risk-free government as opposed to lending to a riskier retail customer at the current 13.5%, (4.0% points above the current CBR of 9.5%) as dictated by the Banking (Amendment) Act 2015. The Bill was formulated to pave way for the repeal of the Banking (Amendment) Act 2015, as a clause in the Finance Bill, presented to Parliament by the Cabinet Secretary for National Treasury Henry Rotich.

Equities Universe of Coverage:

Below is our Equities Universe of Coverage:

Bank	Price as at 22/06/2018 ****	Price as at 29/06/2018 ****	w/w change	YTD Change	LTM Change	Target Price *	Dividend Yield	Upside/Downside **	P/TBv Multiple
GCB***	5.2	5.2	0.6%	2.6%	(0.4%)	7.7	7.4%	57.3%	1.2x
NIC Bank***	36.5	35.5	(2.7%)	5.2%	21.1%	54.1	2.7%	51.0%	0.9x
I&M Holdings	116.0	115.0	(0.9%)	(9.4%)	11.7%	169.5	3.0%	49.1%	1.2x
Diamond Trust Bank	196.0	199.0	1.5%	3.6%	24.4%	280.1	1.3%	44.2%	1.1x
Zenith Bank	25.9	25.0	(3.5%)	(2.5%)	19.6%	33.3	10.4%	39.1%	1.1x
Union Bank Plc	5.9	6.1	3.4%	(21.8%)	17.1%	8.2	0.0%	38.1%	0.6x
KCB Group***	47.8	46.3	(3.1%)	8.2%	23.3%	60.9	6.3%	33.8%	1.5x
CRDB	160.0	160.0	0.0%	0.0%	(8.6%)	207.7	0.0%	29.8%	0.5x
Ecobank	8.5	8.5	(0.6%)	11.2%	32.8%	10.7	0.0%	26.2%	2.4x
Barclays	11.9	11.8	(1.3%)	22.4%	18.7%	14.0	8.4%	26.1%	1.5x
HF Group***	8.5	8.4	(0.6%)	(19.2%)	(12.9%)	10.2	3.8%	24.5%	0.3x
Equity Group	48.5	46.3	(4.6%)	16.4%	21.7%	55.5	4.1%	18.6%	2.5x
Co-operative Bank	17.5	17.5	0.0%	9.4%	26.1%	19.7	4.6%	17.1%	1.5x
Stanbic Bank Uganda	32.0	32.0	0.0%	17.4%	18.5%	36.3	3.7%	17.0%	2.0x
UBA Bank	10.6	10.5	(0.9%)	1.9%	10.9%	10.7	14.2%	15.1%	0.7x
CAL Bank	1.2	1.2	0.0%	13.0%	64.0%	1.4	0.0%	14.8%	1.0x
Bank of Kigali	290.0	286.0	(1.4%)	(4.7%)	16.7%	299.9	4.8%	8.2%	1.6x
Stanbic Holdings	92.0	92.0	0.0%	13.6%	28.7%	85.9	5.7%	(0.9%)	1.1x
Standard Chartered	201.0	198.0	(1.5%)	(4.8%)	(4.3%)	184.3	6.2%	(2.1%)	1.6x
Guaranty Trust Bank	40.7	40.5	(0.5%)	(0.6%)	13.4%	37.2	5.9%	(2.7%)	2.3x
SBM Holdings	7.2	7.3	1.4%	(2.9%)	0.3%	6.6	4.2%	(4.5%)	1.0x

attractive entry point for long-term investors, and with expectations of higher corporate earnings this year, we are "POSITIVE" for investors with a long-term investment horizon

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