Cytonn INVESTMENTS

Cytonn Weekly Report #36, with a focus on the analysis of listed banks in Kenya

Cytonn Weekly

Executive Summary

- **Fixed Income:** Yields increase across all tenures indicating the pressure on the government as they seek to finance the budget;
- **Equities**: NASI and NSE 20 gained 1.7% and 1.8%, respectively, during the week on the back of gains in large cap stocks;
- **Private Equity:** East Africa's financial sector continues to attract investments, highlighting the attractiveness of the industry and deepening of the market;
- **Real Estate:** The successful implementation of new reforms in the construction industry is hindered by the gap in coordinating regulatory bodies;
- **Focus of the Week:** H1'2015 banking report analysing the total return and franchise attractiveness of Kenyan listed banks.

Company Updates

- In our Cytonn Weekly Report #34, we focused on Ruaka, which is an attractive real estate investment satellite town with two prime developments within its vicinity – Two Rivers and Riviera malls. Research by our Real Estate Services team shows that Ruaka developments can deliver between 28% p.a. and 41% p.a., compounded, for completed units and development equity investments, respectively. Cytonn is undertaking a development in Ruaka called "The Alma", which is now 17% pre-sold. To reserve a unit now or to attend the official launch of The Alma development scheduled for October 5, please contact our sales associates at sales@cytonn.com
- We added two new team members to the Cytonn Family:
  - Julius Kibanya joined Cytonn Investments as Head of Private Distribution. Julius has 10 years experience in financial services distribution, having been a branch manager at Madison, and unit manager Britam & Jubilee. Julius will head our single distribution for real estate sales, private equity and structured products;
  - Duncan Musasia joins our global markets investments and research team. Duncan has extensive experience in finance and investments having been at Britam Asset Managers, ABC Capital, and most recently as Head of Research at Dyer & Blair.

Fixed Income

Treasury bill auctions were highly oversubscribed during the week, with a 180.1% overall subscription; this is the first time we have seen this level of subscription for more than two months. The increased subscription is evidence to the increased liquidity in the market, brought about by government expenditure, Kshs. 16.6 bn worth of government securities maturities during the week, and Term Auction Deposit maturities. Despite the high liquidity, investors continue to demand a huge premium to invest in treasuries and hence we saw a significant jump in treasury bill yields

across all tenors, with yields at 13.9%, 12.9% and 14.9% from 11.5%, 12.3% and 13.9% for the 91-day, 182-day and 364-day paper, respectively. For the 2015/16 fiscal year, the government has experienced a net redemption in their borrowing of Kshs. 29.6 bn, and given the current net redemption position, the government is under pressure to finance the budget hence the reason they are taking expensive money from the market.

This month, the government will be auctioning a 1-year bond to raise Kshs. 30 bn for budgetary support. The last time a 1-year bond was issued in Kenya was in January 2012. Given the expensive rates that they are borrowing at, it is prudent that the government issues short-term debt. Given this week’s auction results where the 364-day T-bill had a market average bid rate of 15.7%, we expect the yields on the 1-year bond to be high, at over 15%. We shall be providing a recommendation on the bidding range for the 1-year bond in our next report.

Despite the Central Bank intervening mid-week to mop up liquidity, the shilling continued to depreciate against the dollar, losing 0.2% in the week to close at Kshs. 105.4, taking the total YTD loss to 16.2%. In the coming week, we expect the shilling to be under pressure as investors speculate over the possibility of a rate hike in the September 16th US Fed meeting. The forex reserves for Kenya are currently at 3.98 months, which is still sufficient for Kenya to meet its dollar obligations, however has now fallen below the 4.0 months statutory minimum, the first time this has happened since April 2013, and from 4.85 months of import cover in January 2015. However, key to note is that so far the government has not drawn down from the IMF facility approved at the beginning of the year.

The government’s borrowing programme for the current fiscal year is behind schedule; instead of net borrowing, the government has so far made a net repayment of Kshs. 29.6 bn for the current fiscal year. Consequently, we expect the government to step up domestic borrowing in a bid to raise the Kshs. 219 bn budgeted for the year. The stepped up domestic borrowing will further result in upward pressure on interest rates, and therefore we continue to maintain our view that investors should be biased towards short-term fixed income instruments due to the uncertainty of the rate environment.

Equities

During the week the market was on an upward trend. NASI and NSE 20 gained by 1.7% and 1.8%, respectively, on the back of gains in large cap stocks, with BAT, EABL and Equity Holdings gaining 12.4%, 7.9% and 7.2%, respectively. The equities market was driven by active foreign participation on the buy side, at Kshs. 24.9 mn, the highest in 2015, highlighted by BAT with net inflows of Kshs 19.2 mn. Foreign participation remained high in the market at 60.7%, compared to last week's 65.1%. Since their February peak, NASI and NSE are down 17.5% and 23.4%, respectively, and 10.1% and 17.7%, respectively, on a YTD basis.

I&M Holdings released a cautionary announcement for the proposed acquisition of Giro Commercial Bank, stating that they had come to an agreement with the shareholders of Giro Commercial Bank to purchase 100% of their issued share capital. The proposed acquisition will have a significant change in the share value and further details will be made available later. Giro bank as at H1’2015 had an asset base of Kshs. 16.2 bn and the PAT grew by 0.9% y/y to Kshs. 237.9 mn.

Flame Tree Group announced its intention to acquire 4 brands from Beauty Plus Trading East Africa. The management stated that the acquisition of the 4 hair care and cosmetics brands is based on increased consumer expenditure on hair care products. Consumer spending has been on the rise due to (i) increased knowledge and product awareness in the market, and (ii) increase in the affordable products range manufactured locally. This comes after the acquisition of four food and snack brands from Chirag Kenya in March 2015, which provided Flame Tree with an entry into the food space. In their H1’ 2015 results, FTGH recorded a growth in revenues of 43.1% y/y to Kshs. 1.1 bn while the

PAT grew by 3.8% y/y to close at Kshs. 81.2 mn. These acquisitions are in line with the company's strategy of creating a diversified FMCG business model. Following the news the stock price rose 7.7%.

Kenya Airways is once again on the bad side of publicity, this time being under investigation by Liberian Government on account of hiking fares between the capital Monrovia and Accra, Ghana. According to the Ministry of Transport in Liberia, investigations are currently underway targeting airlines that have increased fares and Kenya Airways stood out as being one. The Ministry of Transport and the Liberian Civil Aviation Authority (LCAA) are spearheading this investigation and has already asked Kenya Airways to provide technical data and justification for the price increase. This investigation comes after Kenya Airways resumed flights to the nation after the Ebola outbreak led to suspended flights.

We remain neutral with a negative bias on equities given the low earnings growth prospects for this year. The market is now purely a stock pickers' market, with few pockets of value.

Private Equity

Interest in East Africa's financial sector continues to rise, highlighted by the recent investment in Tanzania's CRDB Bank by the International Finance Corporation (**"IFC"**) and CDC Group plc (**"CDC"**), who have invested USD 24 mn to acquire a 5% holding in the lender, valuing the bank at USD 480 mn. CRDB recently announced a rights issue, which was underwritten by CDC and the IFC. The two underwriters have now subscribed to the rights not taken up by existing shareholders. The investment will enable CRDB (i) continue its growth strategy, (ii) further improve access to financial services with the aim of helping to build businesses that create jobs, and (iii) grow the branch network to target the unbanked and those in the rural areas, from the current 120 branches, to be able to cover 75% of the country.

The acquisition was made at a PBV multiple of 2.3x, higher than the current trading PBV multiple of 1.9x, which highlights the premium investors are willing to pay above market value to drive growth in financial inclusion and services in the country. The emergence of the financial services sector as a target for PE investors in East Africa is mainly driven by:

i. A rapidly growing, and entrepreneurial, population seeking access to credit to finance growing ventures;
ii. Low financial services inclusion in the region, as measured by the percentage of people within a 5 km radius of a financial access point, with Kenya leading at 77% while Uganda and Tanzania are at 43% and 35%, respectively;
iii. Increasing ease of exit in the financial services sector, most recently witnessed by Helios' full exit of Equity Bank.

Given (i) the abundance of global capital looking for opportunities in Africa, (ii) the attractive valuations in private markets compared to public markets, and (iii) better economic growth in Sub Saharan Africa as compared to global markets, we remain bullish on PE activity in financial services, retail and FMCG, services, and manufacturing sectors.

Real Estate

The National Construction Authority (NCA), the agency charged with regulation and coordination of the construction sector, has attributed the rampant collapse of buildings to little coordination among regulatory bodies overseeing different segments of the construction industry. Cases of buildings collapsing while still under construction, or soon after completion, have been rife in the recent years. This has resulted not only in loss of lives but also draining of millions in investments. Nairobi, which

is experiencing a construction boom due to the growing demand in the lower end housing segment, has been the hardest hit.

There are different supervisory entities involved in the construction chain that are independent of the NCA. These include engineers, architects and quantity surveyors. For them, their respective professional bodies regulate them in cases of misconduct and this ultimately leads to a regulatory gap in the construction industry.

To enhance supervision, the various regulatory bodies involved in the various facets of development – engineers, architects, surveyors and NCA - should either come under an umbrella coordinating body or constitute a regulators forum to share information. For example, the various regulators within the financial services industry – banks, investment managers, retirement schemes and insurers have a Financial Services Regulators Forum to enhance coordination. NCA should lead the formation of such a coordination forum.

Focus of the Week: Cytonn's H1'2015 Banking Report

Following the release of the H1'2015 results by banks, we carried out an analysis on Kenya's banking sector to decipher any material changes from our Q1'2015 banking report. The aim of the analysis is to answer the question: from an equity 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 42 commercial banks, 12 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.

As at H1' 2015, the banking sector recorded a slow-down in growth, growing at 8.3% compared to 15.6% in 2014, with the slowdown being attributed to poor economic performance on the back of increased non performing loans and the uncertainty in the interest rate environment. On the PAT y/y growth, National Bank of Kenya (NBK) and Co-operative bank registered the highest growth of 123.0% and 32.3%, respectively. NBK's growth was due to a robust growth in non-funded income of 227%, driven mainly by sale of property. Net Interest Income (NII) grew by 18.8%, supported by a 30.6% growth in the loan book and 6.4% increase in deposits. Co-operative Bank's performance was driven by a 19% y/y growth in NII, to Kshs. 11.8 bn from Kshs. 9.9 bn in H1'2014. Total operating expenses declined by 4% y/y to Kshs. 9.0 bn, bringing the cost to income ratio (CIR) to 47%, from 59% in H1'2014.

CfC Stanbic and Standard Chartered registered the largest declines of 42% and 36%, respectively. CfC's decline was largely attributed to a decline in non-funded income (NFI), which declined by 33% y/y to Kshs. 3.3 bn thereby diluting the effect of the 2.0% increase in net interest income (NII). Standard Chartered banks results were weighed down by a 51.2% increase in loan loss provisions. NII declined a marginal 0.1% y/y, while NFI fell by 31.2% y/y on account of a one off Kshs. 1.2 bn gain last year owing to the bank's sale of property

On the operating environment, increases in the Kenya Banker's Reference Rate by 133 bps to 9.87% has resulted in an upward repricing of loans, raising the risk that more loans issued might fall into a non-performing territory. Discussions with various bank management teams indicate that a further increase of 300 bps in the KBRR will see a negative impact on the NPLs in the industry. Other challenges in the banking industry include the Consumer Protection Act, that allows customers to prepay their loans and not be subject to a charge, and the Banking Act that allows customers who had placed term deposits to recall them before maturity and only be charged the foregone interest payment. This has affected commercial bank's asset liability matching, and poses further risks in the medium term.

Some of the developments in the banking sector include:

i. **Increase in interest rates:** The KBRR increased by 133 bps to 9.87% largely as a result of an increase in the CBR by 300 bps to 11.5%. This will raise interest on all loans pegged on the KBRR;
ii. **Lower earnings growth:** Banks recorded the slowest year on year growth in 6 years of 8.3% during H1'2015, as compared to 15.6% in H1' 2014;
iii. **Core Capital:** Rejection of increase in Core Capital Requirements to Kshs. 5 bn as proposed in the 2015/2016 Budget, which would have seen 20 commercial banks make shareholders' cash calls, merge or sell equity stakes to comply with the law. Parliament rejected the proposal to increase core capital in banks to Kshs. 5 bn by 2018;
iv. **Dubai Bank Liquidation:** Dubai bank was placed under receivership with the Kenya Deposit Insurance Corporation (KDIC) for failure to meet statutory requirements since July and for failure to honour a Kshs. 48.2 mn financial obligation due to Bank of Africa. The KDIC further recommended that the bank be liquidated.

Our banking report examines the health and future expected performance of the bank, by looking at metrics for profitability, efficiency, growth, asset quality, liquidity, revenue diversification, capitalization and intrinsic valuation. In total, we looked at 13 different metrics to rank the banks.

i. **Net interest margin**: We used the net interest margin as a bank's measure of core profitability;
ii. **Return on average common equity**: We used the return on average common equity as a measure of profitability that flows to equity holders;
iii. **Price/Earnings growth ratio:** We used the price/earnings growth ratio to determine relative valuation considering each bank's expected growth rates;
iv. **Loans to deposit ratio:** We used the loans to deposit ratio as a bank's measure of liquidity;
v. **Cost to income ratio:** We used the cost to income ratio as a bank's measure of efficiency;
vi. **Deposits per branch:** We used a bank's deposits per each branch as a measure of efficiency and proficiency in deposit gathering;
vii. **Price to tangible book value:** We used a bank's price to tangible book value as a measure of relative valuation;
viii. **Tangible common equity ratio:** We used the tangible common equity ratio as a measure of a bank's permanent capitalization levels;
ix. **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;
x. **Provisions to NPLs:** We used a bank's provisions to non-performing loans as a measure of a bank's credit risk;
xi. **Non-interest income to revenue:** We used the ratio of non-interest income to revenue as a measure of a bank's revenue diversification;
xii. **Camel rating:** We used our own camel rating system to assess the overall safety and soundness of the banks;
xiii. **Intrinsic Valuation:** We used our analyst's projections of the future performance of the banks to derive their intrinsic valuation.

Based on these metrics, we were able to rank the listed banks from number 1 to number 11, and get the bank that is likely to deliver the best return over a long term period of 3 to 5 years, based on the best franchise value and future growth opportunities.

It is notable that CFC Stanbic registered the biggest ranking deterioration in the H1'2015 Cytonn Banking Report. The bank declined from Rank #1 in Q1'2015 to Rank #8 in H1'2015 because of a high cost to income ratio of 60.0% vs. an industry average of 48.1%, and low net interest margin of 5.3% vs. an industry average of 8.3%.

CYTONN'S H1'2015 BANKING REPORT RANKINGS

Banks	Franchise Value Total Score [a]	Total Return Score [b]	Weighted H1’2015 Score [c]	H1’2015 Rank [d]	Q1’2015 Rank [e]
Equity	55	2	23.2	**1**	4
Standard Chartered	54	3	23.4	**2**	3
KCB	70	1	28.6	**3**	5
Barclays	67	4	29.2	**4**	9
Co-operative	68	8	32	**5**	7
NIC	73	5	32.2	**6**	8
I&M	67	9	32.2	**6**	2
Diamond Trust	73	7	32.8	**8**	6
CfC Stanbic	75	10	36	**9**	1
National Bank	92	11	43.4	**10**	10
Housing Finance	98	6	43.4	**10**	11

Source: Cytonn Investments

Notes

a. **Franchise Value Total Score:** In this ranking, the banks are ranked by health, by looking at metrics for profitability, efficiency, growth, asset quality, liquidity, revenue diversification and capitalization. Banks are assigned scores ranging from 1, which is the best performing bank in the metric, till 11, which is the worst performing bank. The scores from each bank are then summated, with the bank with the lowest total score emerging on top, and that with the highest score emerging at the bottom.
b. **Total Return Score:** Potential upside for each bank based on the intrinsic valuation, and the current market price. The bank with the highest upside was ranked 1st, and that with the lowest upside, or greatest downside, was ranked last. Cytonn’s Analysts carry out this valuation, arriving at the actual value of each bank based on an underlying perception of its true value, including all aspects of the business, in terms of both tangible and intangible factors, and future growth expectations. This value may or may not be the same as the current market value.
c. **Weighted H1’2015 Score:** Using the Franchise Value and Total Return, banks are given a score. Franchise value was assigned a weighting of 40%, while the intrinsic value was assigned a 60% weight.
d. **H1’2015 Rank:** The bank with the lowest Weighted H1’2015 Score was ranked first, and that with the highest score was ranked last.
e. **Q1’2015 Rank:** The Q1’2015 rank was based only on franchise value.

The full release of the rankings and how each bank performed across the metrics is in the Cytonn Banking Report H1’2015. See link: Cytonn Banking Report H1'2015

We will be discussing this report tomorrow, September 14th 2015 at the Nairobi Serena at 7.00 AM.

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