Nakuru Real Estate Investment Opportunity, & Cytonn Weekly #30/2018

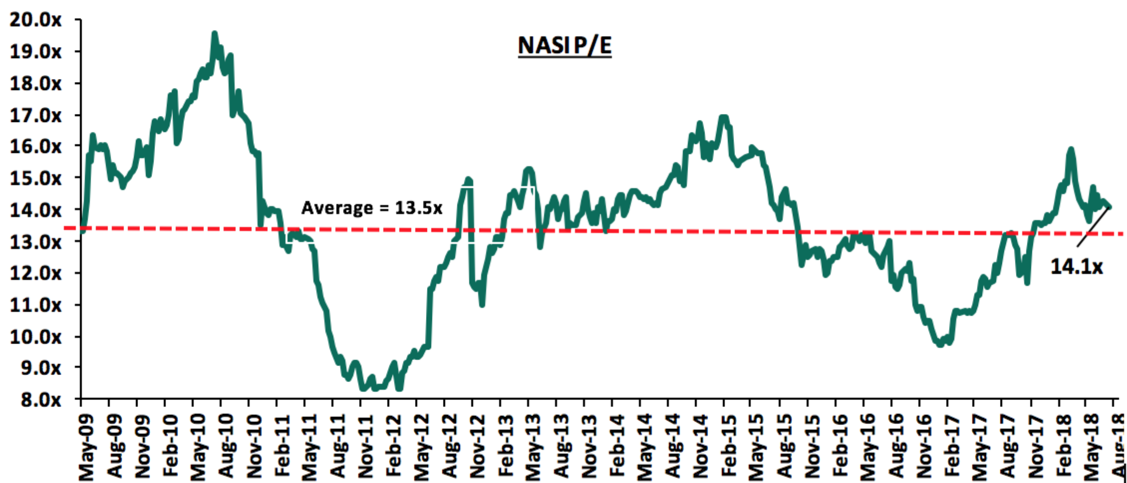
Equities

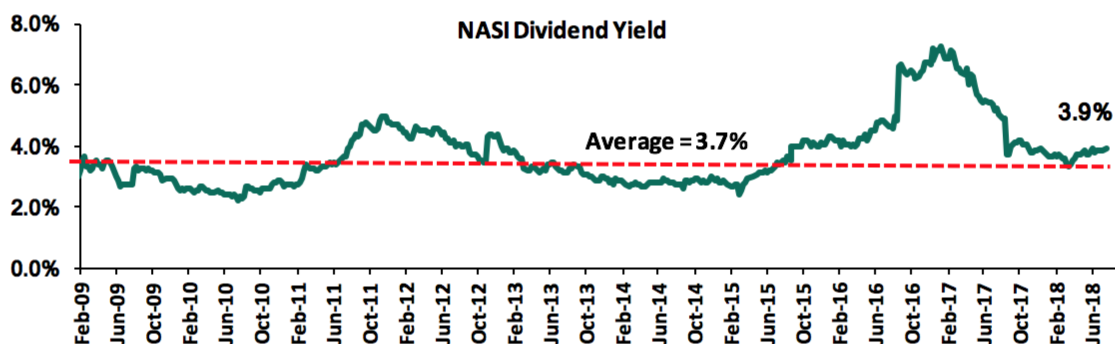
Market Performance:

During the week, the equities market was on an upward trend, with NASI, NSE 20 and NSE 25 gaining 1.0%, 0.1% and 2.1%, respectively; taking their YTD performance to 1.0%, (10.7%) and 5.6%, for NASI, NSE 20 and NSE 25, respectively. This week's performance was driven by a rally in the banking stocks as the Q2'2018 earnings season approaches; with KCB Group, Equity Holdings, Barclays Bank and Standard Chartered gaining 6.3%, 4.6%, 3.4% and 2.5%, respectively. For the last twelve months (LTM), NASI, NSE 20 and NSE 25 have gained 9.1%, (15.1%) and 4.5%, respectively.

Equities turnover decreased by 44.0% this week to USD 17.3 mn from USD 30.9 mn the previous week, with foreign investors dominating market with a net selling position. We expect the market to remain resilient this year supported by positive investor sentiment, as investors take advantage of the attractive stock valuations in select counters.

The market is currently trading at a price to earnings ratio (P/E) of 14.1x, which is 4.4% above the historical average of 13.5x, and a dividend yield of 3.9%, which is higher than the historical average of 3.7%. The current P/E valuation of 14.1x is 43.9% above the most recent trough valuation of 9.8x experienced in the first week of February 2017, and 69.9% 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.





Stanbic Holdings released H1'2018 results during the week;

Stanbic Holdings released H1'2018 results, with core earnings per share increasing by 104.5% to Kshs 9.0 from Kshs 4.4 in H1'2017, exceeding our expectation of a 14.6% growth to Kshs 5.0. The performance was driven by a 21.9% increase in total operating income, coupled with a 14.0% decrease in the total operating expenses. Growth in operating income was largely driven by a 34.0% increase in Non-Funded Income (NFI); and the decrease in operating expenses was largely driven by an 86.7% reduction in LLP.

Highlights of the performance from H1'2017 to H1'2018 include:

- Total operating income increased by 21.9% to Kshs 11.2 bn in H1'2018 from Kshs 9.2 bn in H1'2017. This was due to a 34.0% increase in Non-Funded Income (NFI) to Kshs 5.6 bn from Kshs 4.2 bn in H1'2017, coupled with an 11.9% increase in Net Interest Income (NII) to Kshs 5.6 bn from Kshs 5.0 bn in H1'2017,
- Total interest income increased by 15.4% to Kshs 9.1 bn from Kshs 7.9 bn in H1'2017. The interest income on loans and advances increased by 15.3% to Kshs 6.7 bn from Kshs 5.8 bn in H1'2017. Interest income on government securities increased by 20.2% to Kshs 2.3 bn in H1'2018 from Kshs 1.9 bn in H1'2017. The yield on interest earning assets however declined to 11.3% in H1'2018 from 11.8% in H1'2017, due to the relatively faster growth in the low-yielding government securities by 18.1% to Kshs 157.6 bn, from Kshs 133.5 bn in H1'2017,
- Interest expense increased by 21.7% to Kshs 3.5 bn from Kshs 2.9 bn in H1'2017, following a 27.7% increase in the interest expense on customer deposits to Kshs 2.2 bn from Kshs 1.7 bn in H1'2017. Other interest expenses increased by 24.1% to Kshs 0.32 bn in H1'2018 from Kshs 0.26 bn in H1'2017. The cost of funds thus increased slightly to 3.1% from 3.0% in H1'2017. Net Interest Margin declined to 4.9% from 5.3% in H1'2017,

- Non-Funded Income increased by 34.0% to Kshs 5.6 bn from Kshs 4.2 bn in H1'2017. The growth in NFI was largely driven by a 163.0% increase in other income to Kshs 1.6 bn from Kshs 0.6 bn in H1'2017, and a 12.0% increase in foreign exchange trading income to Kshs 1.7 bn from Kshs 1.5 bn in H1'2017. Fees and commissions on loans however declined by 25.7% to Kshs 0.1 bn from Kshs 0.2 bn in H1'2017. The current revenue mix stands at 50:50 funded to non-funded income as compared to 55:45 in H1'2017. The proportion of non-funded income to total revenue increased owing to the faster growth in NFI as compared to NII,

- Total operating expenses decreased by 14.0% to Kshs 6.0 bn from Kshs 7.0 bn, largely driven by an 86.7% decrease in Loan Loss Provisions (LLP) to Kshs 0.3 bn in H1'2018 from Kshs 1.9 bn in H1'2017. Staff costs increased by 16.2% to Kshs 2.8 bn in H1'2018 from Kshs 2.4 bn in H1'2017. Other operating expenses also increased by 1.3% to Kshs 1.9 bn in H1'2018 from Kshs 1.8 bn in H1'2017,
- The cost to income ratio improved to 53.5% from 75.9% in H1'2017. Without LLP, the Cost to income ratio also improved to 51.3% from 56.1% in H1'2017,
- Profit before tax increased by 135.3% to Kshs 5.2 bn, up from Kshs 2.2 bn in H1'2017. Profit after tax increased 104.5% to Kshs 3.6 bn in H1'2018 from Kshs 1.7 bn in H1'2017,

- The directors declared an interim dividend of Kshs 2.3 per share, which is 80.0% above the Kshs 1.3 per share interim dividend declared in H1'2017. We expect a final dividend per share of Kshs 4.0, taking the total dividend for 2018 to Kshs 6.3 per share, translating to a dividend yield of 6.4%,
- The balance sheet recorded an expansion as total assets increasing by 19.0% to Kshs 278.8 bn from Kshs 234.3 bn in H1'2017. This growth was largely driven by a 15.4% increase in net loans and advances to Kshs 154.0 bn from Kshs 133.5 bn in H1'2017, coupled with a 26.9% increase in government securities to Kshs 87.0 bn from Kshs 68.6 bn in H1'2017,
- Total liabilities rose by 22.3% to Kshs 236.6 bn from Kshs 193.5 bn in H1'2017, driven by a 21.3% increase in total deposits to Kshs 215.8 bn from Kshs 177.9 bn in H1'2017. Deposits per branch increased by 21.3% to Kshs 8.3 bn from Kshs 6.8 bn in H1'2017,
- The faster growth in deposits as compared to loans led to a decline in the loan to deposit ratio to 71.4% from 75.1% in H1'2017,
- Gross non-performing loans increased by 62.7% to Kshs 10.6 bn in H1'2018 from Kshs 6.5 bn in H1'2017. Consequently, the NPL ratio deteriorated to 6.7% in H1'2018 from 4.7% in H1'2017 as NPLs grew faster than the loan book,
- Shareholders' funds increased by 3.5% to Kshs 42.2 bn in H1'2018 from Kshs 40.8 bn in H1'2017.
- Stanbic Holdings is currently sufficiently capitalized with a core capital to risk weighted assets ratio of 15.6%, 5.1% above the statutory requirement. In addition, the total capital to risk weighted assets ratio was 18.3%, exceeding the statutory requirement by 3.8%. Adjusting for IFRS 9, the core capital to risk weighted assets stood at 14.7%, while total capital to risk weighted assets came in at 17.4%, indicating that the bank's total capital relative to its risk-weighted assets decreased by 0.9% due to implementation of IFRS 9,
- Stanbic Holdings currently has a return on average assets of 2.4% and a return on average equity of 14.8%.

We expect the bank's growth to be further driven by:

a. Stanbic Bank's NFI, which is above the industry average, coming in at 50.0%, which is above the industry average of 33.6%. Increased adoption of alternative channels by the customers will improve operational efficiency, as well as increase the bank's transactional income. The bank is poised to see the commission and fee income from the online platforms increase in the future, as more customers increase their usage, and,
b. The bank has adopted increased measures to improve its asset quality. This include; (i) launch of a collaborative curing between businesses and the remedial department, and (ii) outsourcing of collection of loans.

For more information, see our Stanbic Holdings H1'2018 earnings note.

Highlights of the Week:

HF Group is set to lay off some employees in a downsizing move that will see it merge some staff positions. The restructuring will result in a merger of jobs, redundancy and creation of new roles for its recently launched digital banking strategy. The lay-offs will target up to 9.0% of the workforce, which translates to about 36 employees as per the closing employee register of 400 staff in December 2017. The latest lay-off plans will bring the total number of employees laid off by HF Group to 112 in the last two years, since December 2016. The lender joins the growing list of financial institutions that have undertaken downsizing measures in the past two years, including KCB Group, Barclays Bank, Family Bank, Standard Chartered, National Bank, Sidian Bank and First Community Bank. The total number of lay-offs has risen to 1,642 employees since the amendment of the Banking Act (Amendment) 2015, that capped interest rates on loans at 4.0% above the benchmark CBR rate. Below is a summary of the banking sector restructuring since the introduction of the interest rate cap:

Kenya Banking Sector Restructuring

No.	Bank	Staff Lay-off	Branches Closed
1	Bank of Africa	0	12
2	Barclays Bank	301	7
3	Ecobank	0	9
4	Equity Group	400	7
5	Family Bank	Unspecified	0
6	First Community Bank	106	0
7	KCB Group	223	Unspecified
8	National Bank	150	0
9	NIC Group	32	Unspecified
10	Sidian Bank	108	0
11	I&M Holdings	0	Unspecified
12	Standard Chartered	300	4
13	HF Group	112	0
Total		**1,732**	**39**

The Central Bank of Kenya has proposed to introduce a Banking Sector Charter that will guide service provision in the sector. The Charter aims to instil discipline in the banking sector in order to make it responsive to the needs of the banked population. It is expected to facilitate a market-driven transformation of the Kenyan banking sector and bring about tangible benefits for Kenyans, specifically to increase access to affordable financial services for the unbanked and under-served population. In achieving its purpose, the Banking Sector Charter will be guided by the following objectives:

1. To enhance the quality of financial services to the banked population that is negatively affected by the high prevailing interest rates,
2. To create a roadmap that will guide in the development of a more resilient, competitive and dynamic financial system based on the four central pillars of the banking sector's vision,
3. To ensure that institutions proactively engage their customers in financial literacy and consumer education drives, to enhance customers' financial knowledge and skills for them to make informed financial decisions,
4. To provide the basis for the sector's engagement with other stakeholders,
5. To establish targets and quantified responsibilities with respect to each objective and outline processes for implementing the Charter as well as mechanisms to monitor and report on progress towards given goals which are aligned with Kenya Vision 2030,
6. To ensure institutions develop and submit a time bound plan approved by the Board in compliance with the Charter for CBK's monitoring purposes, and
7. To ensure institutions submit quarterly reports to CBK on the progress of their implementation of the Charter by timelines determined by the CBK.

The achievement of the above objectives will be hinged on transformation of financial institutions around key areas such as; fairness, transparency, financial inclusion and access to financial services. The CBK is seeking input from the public, in line with the constitutional requirement for public participation in legislative and policy development. The public participation window is set to close on Friday 24th August, 2018. We are of the view that, if adopted, the Banking Sector Charter will go a

long way towards removing the existing opacity in loan prices and promote the adoption of the risk-based loan-pricing framework in the event that the interest capping legislation is repealed by Parliament. However, we are even of the stronger view, as captured in our Focus Note titled *"Rate Cap Review Should Focus More on Stimulating Capital Markets"*, that the best way to bring discipline in the banking sector is to reduce banking sector dominance by promoting alternative products. In a developed economy, bank funding makes about only 40% of business funding, while in Kenya, it makes up 95% of business funding, meaning businesses are over reliant on bank funding. To stimulate competing products, we recommend the following measures:

i. **Legislation and policies to promote competing sources of financing should be the centrepiece of the repeal legislation:**A lot of legislative action has focused on the banks, yet we also need legislation to promote competing products that will diversify funding sources, which will enable borrowers to tap into alternative avenues of funding that are more flexible and pocket-friendly. This can be done through the promotion of initiatives for competing and alternative products and channels, in order to make the banking sector more competitive. In developed economies, 40% of business funding comes from the banking sector, with 60% coming from non-bank institutional funding. In Kenya, 95% of all funding is from banks, with only 5% from non-bank institutional funding, showing that the economy is highly dominated by the banking sector and should have more alternative and capital market products for funding businesses. Alternative investment managers and the capital markets regulators need to look at how to enhance non-bank funding, such as high yield investment vehicles, some of which include High Yield Solutions. The products offer investors with cash to invest at a rate of about 18% to 19% per annum, equivalent to what the fund takers, such as real estate developers, would have to pay to get funds from the banks. Instead of a saver taking money to the bank and getting negligible returns, they can invest in a funding vehicle where the business would pay them the same 18% to 19% per annum that they would pay to get the same money from the bank. For the saver, it helps improve their rate from low rates, from 7% per annum at best, to as high as 18% per annum, and for the business seeking funding, it helps them access funding much faster to grow their business. Promoting alternative funding is also essential to the affordable housing piece of the "Big Four" government agenda, which requires capital markets funding,

ii. **Consumer protection:**The implementation of a strong consumer protection, education agency and framework, to include robust disclosures on cost of credit, free and accessible consumer education, enforcement of disclosures on borrowings and interest rates, while also handling issues of contention and concerns from consumers,

iii. **Promote capital markets infrastructure:** This is necessary in both regulated and private markets. The Capital Markets Authority (CMA) could aid in enhancing the capital markets' depth by making it easier for new and structurally unique products to be introduced in the capital and financial markets. This may then enhance returns, with the benefits of reduced risk compared to the traditional conventional investment securities. This will then enable the diversion of the funds from banks into other investment vehicles that yield returns that far eclipse those obtained from deposits in banks, thereby leading to a faster capital formation in the economy. Advocacy groups, such as the East African Forum for Alternative Investments (EAFAI) and East Africa Venture Capital Association (EAVCA), should engage policy makers on the need for alternative and structured products as viable options to bank funding, hence reducing overreliance on bank funding and thereby spurring competition in the credit market, which would eventually lead to cheaper debt costs for borrowers,

iv. **Addressing the tax advantages that banks enjoy:**Level the playing field by making tax incentives available to banks to be also available to non-bank funding entities and capital markets products such as unit trust funds and private investment funds. For example, providing alternative and capital markets funding organizations with the same withholding tax incentives that banking deposits enjoy, of a 15% final withholding tax so that depositors don't feel that they have to go to a bank to enjoy the 15% withholding tax; alternatively, normalize the tax on interest for all players

to 30% to level the playing field,

v. **Consumer education**: Educate borrowers on how to be able to access credit, the use of collateral, and the importance of establishing a strong credit history,
vi. **The adoption of structured and centralized credit scoring and rating methodology:** This would go a long way to eliminate any biases and inconsistencies associated with accessing credit. Through a centralized Credit Reference Bureau (CRB), risk pricing is more transparent, and lenders and borrowers have more information regarding credit histories and scores, thus enabling banks price customers appropriately, spurring increased access to credit, and,
vii. **Increased transparency:** This can be achieved through a reduction of the opacity in debt pricing. This will spur competitiveness in the banking sector and bring a halt to excessive fees and costs. Recent initiatives by the CBK and Kenya Bankers Association (KBA), such as the stringent new laws and cost of credit website being commendable initiatives.

In conclusion, a free market, where interest rates are set by market participants coupled with increased competition from non-bank financial institutions for funding, will see a more self-regulated environment where the cost of credit reduces, as well as increased access to credit by borrowers that have been shunned under the current regime. Consequently, a repeal needs to be comprehensive and contain the 7 elements above for it to be effective, but the centre-piece of the legislation should be stimulating capital markets to reduce banking sector dominance.

Equities Universe of Coverage:

Below is our Equities Universe of Coverage:

Banks	Price as at 10/08/2018	w/w change	YTD Change	Target Price*	Dividend Yield	Upside/Downside**	P/TBv Multiple
NIC Bank***	34.8	0.7%	3.0%	54.1	2.9%	59.7%	**0.8x**
Ghana Commercial Bank***	5.2	1.4%	2.4%	7.7	7.5%	58.8%	**1.2x**
Zenith Bank***	23.6	(1.0%)	(8.0%)	33.3	11.3%	51.0%	**1.0x**
I&M Holdings***	115.0	0.0%	10.6%	169.5	3.0%	50.4%	**1.2x**
Diamond Trust Bank***	197.0	(1.0%)	2.6%	280.1	1.3%	42.1%	**1.1x**
Union Bank Plc	5.9	0.0%	(25.0%)	8.2	0.0%	39.3%	**0.6x**
KCB Group***	51.0	6.3%	19.3%	60.9	6.3%	33.1%	**1.5x**
Ecobank	8.3	0.6%	9.2%	10.7	0.0%	30.1%	**2.3x**
CRDB	160.0	0.0%	0.0%	207.7	0.0%	29.8%	**0.5x**
UBA Bank	9.5	0.0%	(8.3%)	10.7	15.9%	29.1%	**0.6x**
Barclays	12.1	3.4%	26.0%	14.0	8.5%	28.2%	**1.5x**
HF Group***	8.0	(5.3%)	(23.1%)	10.2	3.8%	24.5%	**0.3x**
Co-operative Bank	17.2	1.5%	7.5%	19.7	4.7%	20.9%	**1.5x**
Equity Group	51.5	4.6%	29.6%	55.5	4.1%	16.8%	**2.5x**

Banks	Price as at 10/08/2018	w/w change	YTD Change	Target Price*	Dividend Yield	Upside/Downside**	P/TBv Multiple
Stanbic Bank Uganda	33.0	0.8%	21.1%	36.3	3.6%	14.3%	**2.1x**
CAL Bank	1.2	(3.1%)	13.9%	1.4	0.0%	10.2%	**1.1x**
Bank of Kigali	290.0	0.0%	(3.3%)	299.9	4.8%	8.2%	**1.6x**
Access Bank	10.0	0.0%	(4.3%)	9.5	4.0%	(1.0%)	**0.7x**
Guaranty Trust Bank	39.0	(2.6%)	(4.3%)	37.2	6.0%	(1.1%)	**2.3x**
Standard Chartered	205.0	2.5%	(1.4%)	184.3	6.3%	(1.6%)	**1.6x**
Stanbic Holdings	98.0	7.1%	21.0%	85.9	6.4%	(7.2%)	**1.1x**
Bank of Baroda	140.0	0.0%	23.9%	130.6	1.8%	(4.9%)	**1.2x**
SBM Holdings	7.0	(5.9%)	(6.9%)	6.6	4.0%	(7.5%)	**1.1x**
Stanbic IBTC Holdings	49.4	(0.9%)	18.9%	37.0	1.2%	(24.5%)	**2.6x**
Standard Chartered	26.1	0.2%	3.2%	19.5	0.0%	(25.2%)	**3.3x**
FBN Holdings	9.6	(4.0%)	9.1%	6.6	2.5%	(31.2%)	**0.6x**
National Bank	6.0	3.4%	(35.8%)	2.8	0.0%	(51.7%)	**0.4x**
Ecobank Transnational	21.2	0.2%	24.4%	9.3	0.0%	(56.0%)	**0.8x**

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 5th largest shareholder*
*****Stock prices indicated in respective country currencies***

We are "NEUTRAL" on equities for investors with a short-term investment horizon since the market has rallied and brought the market P/E slightly above its' historical average. However, pockets of value exist, with a number of undervalued sectors like, financial services, which provide an 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.