Status of Rate Cap Review in Finance Bill, 2018, & Cytonn Weekly #32/2018

Equities

Market Performance:

During the week, the equities market was on a downward trend, with NASI, NSE 20 and NSE 25 declining by 0.9%, 1.2% and 1.4%, respectively; taking their YTD performance to 1.0%, (11.2%) and 1.6%, for NASI, NSE 20 and NSE 25, respectively. This week's performance was driven by declines in most of the large-cap counters; with NIC Group, EABL, KCB Group, Co-operative Bank and Barclays Bank declining by 5.8%, 3.3%, 3.0%, 2.9% and 2.1%, respectively. For the last twelve months (LTM), NASI has gained 2.5%, while NSE 20 and NSE 25 have declined by 18.7% and 0.5%, respectively.

Equities turnover decreased by 35.9% this week to USD 17.3 mn from USD 26.9 mn the previous week, with foreign investors dominating market with a net selling position. On a YTD basis, foreign investors have remained net sellers, recording a net outflow of USD 195.2 mn as they exit the market at relatively expensive valuations so as to realize capital gains earned from the bullish rally witnessed from Q2'2017 to March 2018, for possible re-entry at cheaper valuations. 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 13.8x, which is 2.2% 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 13.8x is 40.8% above the most recent trough valuation of 9.8x experienced in the first week of February 2017, and 66.3% 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.

Weekly Highlights:

Standard Chartered Bank Kenya released H1'2018 results during the week;

Standard Chartered Bank released H1'2018 results, with core earnings per share growth of 30.3% to Kshs 13.0 from Kshs 10.0 in H1'2017, slightly higher than our expectation of a 26.0% increase to Kshs 12.6. The improvement in performance was driven by a 9.0% rise in total operating income coupled with a 4.5% decline in total operating expenses.

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

- Total operating income increased by 9.0% to Kshs 14.7 bn in H1'2018 from Kshs 13.5 bn in H1'2017. Performance was driven by a 7.5% increase in Net Interest Income (NII) to Kshs 9.8 bn from Kshs 9.2 bn in H1'2017, coupled with a 12.2% increase in Non-Funded Income (NFI) to Kshs 4.8 bn from Kshs 4.3 bn in H1'2017,
- Interest income increased by 7.9% to Kshs 13.7 bn from Kshs 12.7 bn in H1'2017 bn, driven by an

increase in interest income on government securities that rose by 23.2% to Kshs 6.4 bn in H1’2018 from Kshs 5.2 bn in H1’2017. However, interest income on loans and advances declined by 2.0% to Kshs 6.7 bn from Kshs 6.9 bn in H1’2017. The yield on interest earning assets increased slightly to 11.3% in H1’2018 from 11.2% in H1’2017, due to the relatively faster increase in the interest income by 7.9% compared to the 3.1% rise in interest earning assets to Kshs 241.8 bn from Kshs 234.6 bn in H1’2017,

- Interest expense increased by 8.8% to Kshs 3.9 bn from Kshs 3.6 bn in H1’2017, following an 11.0% increase in the interest expense on customer deposits to Kshs 3.4 bn from Kshs 3.0 bn in H1’2017. Other interest expenses also increased by 11.3% to Kshs 0.51 bn in H1’2018 from Kshs 0.46 bn in H1’2017, while interest expense on bank placements declined by 68.5% to Kshs 0.03 bn from Kshs 0.1 bn. Consequently, the cost of funds increased to 3.6% from 3.5% in H1’2017, while the Net Interest Margin declined to 8.0% from 8.2% in H1’2017,
- Non-Funded Income increased by 12.2% to Kshs 4.8 bn from Kshs 4.3 bn in H1’2017. The growth in NFI was driven by a 35.6% increase in other fees and commissions to Kshs 2.8 bn from Kshs 2.1 bn in H1’2017, and an 11.6% rise in foreign exchange trading income to Kshs 1.4 bn from 1.2 bn in H1’2018. The current revenue mix stands at 67:33 funded to non-funded income as compared to 68:32 in H1’2017. The proportion of non-funded income to total revenue increased slightly owing to the faster growth in NFI as compared to NII,
- Total operating expenses declined by 4.5% to Kshs 8.1 bn from Kshs 8.5 bn in H1’2017, largely driven by a 45.2% decline in loan loss provisions to Kshs 1.3 bn in H1’2018 from Kshs 2.3 bn in H1’2017. However, other operating expenses increased by 27.5% to Kshs 2.6 bn from Kshs 2.1 bn in H1’2017. Staff costs increased marginally by 1.9% to Kshs 3.33 bn from Kshs 3.23 bn in H1’2018,
- The cost to income ratio improved to 55.2% from 63.0% in H1’2017. Without LLP, the cost to income ratio deteriorated to 46.6% from 45.8% in H1’2017,
- Profit before tax increased by 32.0% to Kshs 6.6 bn from Kshs 5.0 bn in H1’2017. Profit after tax rose by 30.3% to Kshs 4.5 bn in H1’2018 from Kshs 3.4 bn in H1’2017,
- Standard Chartered Bank declared an interim dividend of Kshs 5.0 per share. We expect a final dividend per share of Kshs 17.0, taking the total dividend for 2018 to Kshs 22.0 per share, translating to a dividend yield of 10.6%,
- Total assets increased by 2.4% to Kshs 296.0 bn from Kshs 289.1 bn in H1’2017. This growth was driven by a 3.5% increase in government securities to Kshs 120.9 bn from Kshs 116.8 bn in H1’2017. The loan book declined by 1.1% to Kshs 111.7 bn in H1’2018 from Kshs 113.0 bn in H1’2017,
- Total liabilities rose by 2.4% to Kshs 251.3.7 bn from Kshs 245.5 bn in H1’2017, driven by a 2.8% increase in customer deposits to Kshs 230.8 bn from Kshs 224.5 bn in H1’2017. Deposits per branch increased by 2.8% to Kshs 6.4 bn from Kshs 6.2 bn in H1’2017 as the bank’s branches declined to 36 from 40 in 2017,
- The growth in deposits coupled with the decline in loans led to a decline in the loan to deposit ratio to 48.4% from 50.4% in H1’2017,
- Gross non-performing loans increased by 9.7% to Kshs 18.5 bn in H1’2018 from Kshs 16.9 bn in H1’2017. As a consequence, the NPL ratio deteriorated to 15.5% in H1’2018 from 13.5% in H1’2017. Loan loss provisions increased by 4.4% to Kshs 7.1 bn from Kshs 6.8 bn in H1’2017. The NPL coverage increased to 75.0 % in H1’2018 from 71.9% in H1’2017,
- Shareholders’ funds increased by 2.4% to Kshs 44.6 bn in H1’2018 from Kshs 43.6 bn in H1’2017,
- Standard Chartered Bank Kenya Limited is currently sufficiently capitalized with a core capital to risk weighted assets ratio of 15.8%, 5.3% above the statutory requirement. In addition, the total capital to risk weighted assets ratio was 18.6%, exceeding the statutory requirement by 4.1%. Adjusting for IFRS 9, the core capital to risk weighted assets stood at 16.1%, while total capital to risk weighted assets came in at 19.0%, indicating that the bank’s total capital relative to its risk-weighted assets declined by 0.3% due to implementation of IFRS 9,
- Standard Chartered Bank currently has a return on average assets of 2.7% and a return on

average equity of 18.0%, compared to the Tier 1 and 2 average of 21.0%

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

a. Growth in NFI which increased by 12.2% in H1'2018. We expect the growth in NFI to be driven by increased adoption of alternative channels with the implementation of their "Digital by Design strategy" which is targeting to migrate over 80% of transactions to alternative non-bank channels by 2020. This 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 their mobile banking platform in the future, and
b. Better loan underwriting to improve non-performing loans; as the bank's NPL ratio is currently at 15.5% compared to tier 1 average of 11.6%,

For a comprehensive analysis, see our Standard Chartered Bank H1'2018 Earnings Note

NIC Group Plc released H1'2018 results during the week;

NIC Group released H1'2018 results, with core earnings per share declining by 2.1% to Kshs 2.8 from Kshs 2.9 in H1'2017, which fell below our expectation of a 7.5% growth to Kshs 3.1. The variance in core earnings per share growth against our expectations was largely due to a 4.9% decrease in net interest income (NII) against a projected 11.1% increase to Kshs 6.0 bn. The performance was driven by a 1.7% decline in operating income to Kshs 7.3 bn from Kshs 7.4 bn in H1'2017, which declined faster than a 1.2% decline in operating expenses to Kshs 4.4 bn from Kshs 4.5 bn.

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

- Total operating income decreased by 1.7% to Kshs 7.3 bn in H1'2018 from Kshs 7.4 bn in H1'2017. This was due to a 4.9% decrease in Net Interest Income (NII) to Kshs 5.1 bn from Kshs 5.4 bn in H1'2017, despite a 7.0% increase in Non-Funded Income (NFI) to Kshs 2.2 bn from Kshs 2.0 bn in H1'2017,
- Interest income increased by 8.6% to Kshs 9.6 bn from Kshs 8.8 bn in H1'2017. The interest income on loans and advances decreased by 6.5% to Kshs 6.2 bn from Kshs 6.6 bn in H1'2017. Interest income on government securities increased by 52.8% to Kshs 3.3 bn in H1'2018 from Kshs 2.1 bn in H1'2017. The yield on interest earning assets however declined to 10.9% in H1'2018 from 11.0% in H1'2017, due to the relatively faster increase in low-yielding government securities by 25.7% to Kshs 55.7 bn from Kshs 44.3 bn in H1'2017,
- Interest expense increased by 30.0% to Kshs 4.4 bn from Kshs 3.4 bn in H1'2017, as interest expense on customer deposits increased 37.7% to Kshs 3.7 bn from Kshs 2.7 bn in H1'2017. Interest expense on deposits from other banking institutions rose by 70.4% to Kshs 104.8 mn from Kshs 61.5 mn in H1'2017. The cost of funds rose to 5.4% from 4.5% in H1'2017. The Net Interest Margin declined to 6.0% from 7.1% in H1'2017,
- Non-Funded Income increased by 7.0% to Kshs 2.2 bn from Kshs 2.0 bn in H1'2017. The increase in NFI was driven by a 16.9% increase in forex trading income to Kshs 0.7 bn from Kshs 0.6 bn in H1'2017, coupled with a 24.1% increase in other income to Kshs 0.4 bn from Kshs 0.3 bn in H1'2017. Other fees and commissions increased by 13.5% to Kshs 0.5 bn from Kshs 0.4 bn in H1'2017. However, fees and commissions on loans declined by 13.6% to Kshs 0.6 bn from Kshs 0.7 bn in H1'2017. The revenue mix shifted to 70:30 funded to non-funded income in H1'2018 from 73:27 in H1'2017, owing to the increase in NFI, coupled with the decline in NII,
- Total operating expenses decreased by 1.2% to Kshs 4.4 bn from Kshs 4.5 bn, largely driven by a 23.0% decrease in loan loss provision (LLP) to Kshs 1.1 bn in H1'2018 from Kshs 1.4 bn in H1'2017. Staff costs, however, increased by 7.7% to Kshs 1.7 bn in H1'2018 from Kshs 1.6 bn in H1'2017,
- The cost to income ratio deteriorated marginally to 60.9% from 60.6% in H1'2017. Without LLP,

the cost to income ratio deteriorated to 45.6% from 41.1% in H1’2017,

- Profit before tax decreased by 2.4% to Kshs 2.8 bn, up from Kshs 2.9 bn in H1’2017. Profit after tax decreased 2.1% to Kshs 1.99 bn in H1’2018 from Kshs 2.03 bn in H1’2017,
- The balance sheet recorded an expansion with total assets growth of 6.0% to Kshs 201.0 bn from Kshs 189.5 bn in H1’2017. This growth was largely driven by a 25.7% increase in government securities to Kshs 55.7 bn from Kshs 44.3 bn in H1’2017, The loan book contracted by 1.5% to Kshs 115.0 bn in H1’2018 from Kshs 116.8 bn in H1’2017,
- Total liabilities rose by 7.5% to Kshs 168.7 bn from Kshs 156.9 bn in H1’2017, driven by a 10.0% increase in total deposits to Kshs 149.4 bn from Kshs 135.7 bn in H1’2017. Deposits per branch increased by 2.2% to Kshs 3.6 bn from Kshs 3.5 bn in H1’2017, as bank branches increased to 42 from 38; while deposit growth was strong, the cost of deposits is very costly given one of the highest cost of funds at 5.4%, compared to tier 1 and 2 average of 3.2%,
- The growth in deposits coupled with the decline in loans led to a decline in the loan to deposit ratio to 78.2% from 88.7% in H1’2017,
- Gross non-performing loans increased by 12.7% to Kshs 16.2 bn in H1’2018 from Kshs 14.3 bn in H1’2017. Consequently, the NPL ratio deteriorated to 13.1% in H1’2018 from 11.7% in H1’2017.General Loan loss provisions increased by 33.0% to Kshs 6.8 bn from Kshs 5.1 bn in H1’2017. Consequently, the NPL coverage improved to 52.2% in H1’2018 from 48.1% in H1’2017,
- Shareholders’ funds decreased marginally to Kshs 31.8 bn in H1’2018 from Kshs 32.1 bn in H1’2017,
- NIC Group is currently sufficiently capitalized with a core capital to risk weighted assets ratio of 17.8%, 7.3% above the statutory requirement. In addition, the total capital to risk weighted assets ratio was 20.4%, exceeding the statutory requirement by 5.9%. Adjusting for IFRS 9, the core capital to risk weighted assets stood at 18.1%, while total capital to risk weighted assets came in at 20.7%, indicating that the bank’s total capital relative to its risk-weighted assets decreased by 0.3% due to the impact of IFRS 9,
- NIC Group currently has a return on average assets of 2.1% and a return on average equity of 12.8%. This compares to a tier 1 and 2 average of 21.0% in H1’2017, with the bank’s RoE falling below its peers due to the low trailing PAT,

Going forward, we expect the bank’s growth to be further driven by;

a. **Non-Funded Income Growth Initiatives** – NIC Bank’s NFI is improving as the bank focuses on digital innovation and alternative banking channels to augment transaction volumes and increase fee income. The bank needs to increase capacity of its brokerage and advisory business, in addition to setting income targets for these entities so as to increase fee income from investment and advisory services,
b. **Loan growth** – The bank needs to grow its loan book aggressively so as to increase interest income on loans and advances. The bank is shying away from lending to the SME segment, which forms much of its clientele base. With the rate capping legislation expected to be repealed, the bank should grow its market reach to include retail and corporate clients in order to increase loans and maximize interest income,
c. **Better underwriting** in order to reduce the proportion of non-performing loans and improve the bank’s asset quality as the bank’s NPL ratio currently stands at 13.1% compared to the Tier 1 and 2 banks’ average of 11.6%.
d. **Funding Structure** - The bank needs to relook at its funding structure as it is not clear why the bank was accumulating expensive deposit only to invest in low yielding assets,
e. **Operational efficiency** - Recording a staff cost growth of 7.7% with such a poor bottom line performance in the era of bank processes automation and digitisation is worrying and not in the best interest of shareholders.

For a comprehensive analysis, see our NIC Group H1’2018 Earnings Note

National Bank of Kenya released H1'2018 results during the week;

National Bank released H1'2018 results, with core earnings per share growth of 39.3% to Kshs 0.7 from Kshs 0.5 in H1'2017, compared to our expectation of a 54.9% increase to Kshs 0.8. The variance in core earnings per share growth against our expectations was largely due to a decrease of 120.3% in loan loss provisions (LLP) to Kshs 0.1 bn against a projected increase of Kshs 38.2% to Kshs 0.3 bn. Performance was driven by a 10.1% decrease in total operating income, which outpaced the 8.3% decrease in the total operating expenses.

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

- Total operating income declined by 10.1% to Kshs 3.7 bn from Kshs 4.1 bn in H1'2017. This was due to an 8.9% decrease in Net Interest Income (NII) to Kshs 2.6 bn from Kshs 2.9 bn in H1'2017, coupled with a 13.1% decline in Non-Funded Income (NFI) to Kshs 1.1 bn from Kshs 1.2 bn in in H1'2017,
- Interest income declined by 9.6% to Kshs 4.1 bn from Kshs 4.6 bn in H1'2017, driven by the decline in interest income on loans and advances which declined by 14.4% to Kshs 2.1 bn from Kshs 2.4 bn in H1'2017. Interest income on government securities also declined by 3.7% to Kshs 2.0 bn from Kshs 2.1 bn in H1'2017. As a result, the yield on interest earning assets declined to 10.1% in H1'2018 from 10.3% in H1'2017,
- Interest expense declined by 10.1% to Kshs 1.5 bn from Kshs 1.7 bn in H1'2017, following a 27.1% decline in the interest expense on deposits and placements from banking institutions to Kshs 153.9 mn from Kshs 211.0 mn in H1'2017. Interest expense on customer deposits declined by 8.6% to Kshs 1.4 bn from Kshs 1.5 bn in H1'2017. Consequently, the cost of funds declined to 3.0% from 3.5% in H1'2017. Net Interest Margin improved to 6.9% from 6.5% in H1'2017, due to the faster decline in the interest expense, coupled with a 0.7% decline in interest earning assets to Kshs 94.4 bn from Kshs 95.1 bn,
- Non-Funded Income declined by 13.1% to Kshs 1.1 bn from Kshs 1.2 bn in H1'2017. The decline in NFI was driven by a 59.4% decrease in fees and commissions on loans and advances to Kshs 37.6 mn from Kshs 92.7 mn in H1'2017, coupled with a 9.8% decline in other fees and commissions to Kshs 0.6 bn from Kshs 0.7 bn in H1'2017. However, foreign exchange trading income increased marginally by 1.3% to Kshs 285.0 mn from Kshs 281.3 mn in H1'2017. The current revenue mix stands at 71:29 funded to non-funded income as compared to 70:30 in H1'2017. The proportion of funded income to total revenue increased slightly owing to the faster decline in NFI as compared to NII,
- Total operating expenses decreased by 8.3% to Kshs 3.5 bn from Kshs 3.8 bn, largely driven by the write back in provisions of Kshs 47.9 mn in H1'2018, as compared to the Kshs 235.3 mn loan loss provision expense incurred in H1'2017. The decline in the operating expenses could also be attributed to the 17.4% decline in other operating expenses to Kshs 1.0 bn from Kshs 1.2 bn in H1'2017. Staff costs rose marginally by 0.5% to Kshs 1.89 bn in H1'2018 from Kshs 1.88 bn in H1'2017,
- The cost to income ratio deteriorated to 95.6% from 93.7% in H1'2017. Without LLP, the Cost to income ratio also deteriorated to 97.0% from 87.9% in H1'2017,
- Profit before tax decreased by 37.9% to Kshs 0.2 bn, down from Kshs 0.3 bn in H1'2017. The bank incurred an undefined exceptional item of Kshs 0.5 bn in H1'2018, and as a result, the bank recorded a loss after tax of Kshs 282.7 mn in H1'2018, compared to the profit of Kshs 59.5 mn in H1'2017. Stripping off the exceptional item, the profit before tax decreased by 37.9% to Kshs 159.4 mn from Kshs 256.9 mn in H1'2017
- The balance sheet experienced a contraction, as total assets declined by 2.8% to Kshs 113.3 bn from Kshs 116.6 bn in H1'2017. This decline was largely due to by a 16.1% decrease in loans and advances to Kshs 47.8 bn from Kshs 57.0 bn in H1'2017,
- Government securities increased by 9.8% to Kshs 41.3 bn from Kshs 37.6 bn in H1'2017,
- Total liabilities increased by 2.2% to Kshs 107.5 bn from Kshs 105.2 bn in H1'2017, driven by a

170.4% increase in placements by other institutions to Kshs 6.8 bn from Kshs 2.5 bn in H1’2017, coupled with a 20.1% increase in other liabilities to Kshs 4.7 bn from Kshs 3.9 bn in H1’2017,

- Customer deposits declined by 2.8% to Kshs 96.0 bn from Kshs 98.8 bn in H1’2017. Deposits per branch increased by 4.1% to Kshs 1.4 bn from Kshs 1.3 bn in H1’2017, as the bank closed 5 branches,
- The faster decline in loans as compared to deposits led to a decline in the loan to deposit ratio to 49.8% from 57.7% in H1’2017,
- Gross non-performing loans increased by 2.5% to Kshs 30.1 bn in H1’2018 from Kshs 29.4 bn in H1’2017. Consequently, the NPL ratio increased to 46.5% from 44.2% in H1’2017. General provisions increased by 109.5% to Kshs 13.1 bn from Kshs 6.3 bn in H1’2017. The NPL coverage thus increased to 56.5% in H1’2018 from 32.5% in H1’2017. The bank had a write back in provisions of Kshs 47.9 mn in H1’2018,
- Shareholders’ funds decreased by 48.8% to Kshs 5.9 bn in H1’2018 from Kshs 11.4 bn in H1’2017, mainly due to a decline in the retained earnings owing to an accumulated loss of Kshs 4.9 bn from a retained earnings position of Kshs 3.3 bn in H1’2017,
- National Bank is currently severely undercapitalized with a core capital to risk weighted assets ratio of 2.0%, 8.5% below the statutory requirement. In addition, the total capital to risk weighted assets ratio was 3.4%, below the statutory requirement by 11.1%. Adjusting for IFRS 9, the core capital to risk weighted assets stood at 2.4%, while total capital to risk weighted assets came in at 3.9%, indicating that the bank’s total capital relative to its risk-weighted assets declined by 0.5% due to implementation of IFRS 9,
- National Bank currently has a return on average assets of 0.0% and a return on average equity of (0.6%).

The bank could improve its poor performance, and needs to focus on the following to improve:

a. **Privatisation:** We are of the strong view that the bank needs to be privatized as the core step to address its underperformance
b. **Improve the asset quality**: National bank has the worst asset quality in the listed banking space, with an NPL ratio of 46.5%. At this level of NPL, a restructuring to separate the “good bank” from the “bad bank” is necessary to resolve the bad portfolio. It will be difficult for the bank to focus on growth with such a bad portfolio,
c. **Improve the capital position:** The bank is currently undercapitalized and needs to improve its capital position, to meet the regulatory requirements. The bank has stated its efforts to raise both Tier I and Tier II capital in the form of subordinated debt, and a rights issue. Other capital raising initiatives would be the sale of non-core assets such as land. However, we believe the fastest way to raise capital would be a privatization of the bank

For a comprehensive analysis, see our National Bank H1’2018 Earnings Note

Bank	**Core EPS Growth**	**Interest Income Growth**	**Interest Expense Growth**	**Net Interest Income Growth**	**Net Interest Margin**	**Non-Funded Income (NFI) Growth**	**NFI to Total Operating Income**	**Growth in Total Fees & Commissions**	**Deposit Growth**	**Growth in Govt. Securities**	**Loan Growth**	**LDR**	**Cost of Funds**	**IFRS 9 Impact on Capital**	**Return on Average Equity**
Stanbic Holdings	104.5%	15.4%	21.7%	11.9%	4.9%	34.0%	50.0%	(4.2%)	21.3%	26.9%	15.4%	71.4%	3.1%	(0.9%)	14.8%
National Bank	39.3%	(9.6%)	10.1%	(8.9%)	6.9%	(13.1%)	28.8%	(15.7%)	(2.8%)	9.8%	16.1%	49.8%	3.0%	(0.5%)	(0.6%)
Stanchart	30.3%	7.9%	8.8%	7.5%	8.0%	12.2%	32.9%	36.2%	2.8%	3.5%	(1.1%)	48.4%	3.6%	(0.3%)	18.0%
KCB Group	18.0%	6.1%	11.9%	4.3%	8.6%	(0.1%)	32.2%	(6.0%)	8.7%	(2.8%)	3.6%	80.3%	3.0%	(1.0%)	21.9%
Equity Group	17.6%	10.2%	14.0%	9.1%	8.8%	1.5%	40.2%	(1.0%)	8.5%	18.7%	3.8%	69.9%	2.7%	(0.8%)	23.9%
Co-op Bank	7.6%	7.9%	2.2%	10.4%	8.6%	(1.6%)	32.1%	(3.0%)	3.9%	12.0%	(0.6%)	84.6%	3.9%	(0.9%)	18.0%
Barclays Bank	6.2%	7.6%	22.4%	4.0%	9.0%	6.9%	30.0%	1.9%	14.9%	33.6%	7.5%	81.2%	2.6%	(0.2%)	17.5%
NIC Group	(2.1%)	8.6%	30.0%	(4.9%)	6.0%	7.0%	29.5%	(3.0%)	10.5%	25.7%	(1.5%)	78.2%	5.4%	(0.3%)	12.8%
Weighted Average H1'2018*	**21.4%**	**8.6%**	**12.9%**	**7.1%**	**8.3%**	**4.6%**	**35.4%**	**1.6%**	**8.7%**	**15.9%**	**3.4%**	**73.7%**	**3.2%**	**(0.7%)**	**20.1%**

Bank	Core EPS Growth	Interest Income Growth	Interest Expense Growth	Net Interest Income Growth	Net Interest Margin	Non-Funded Income (NFI) Growth	NFI to Total Operating Income	Growth in Total Fees & Commissions	Deposit Growth	Growth in Govt. Securities	Loan Growth	LDR	Cost of Funds	IFRS 9 Impact on Capital	Return on Average Equity
Weighted Average H1'2017*	(13.8%)	(8.3%)	(9.3%)	(6.9%)	7.1%	(6.9%)	36.1%	16.9%	6.0%	17.2%	6.8%	77.9%	2.9%	-	21.0%

**Market Cap weighted average as per 24-8-2018*

Key takeaways from the table include:

- All listed banks recorded an increase in core EPS growth with the exception of NIC Group, with the weighted average increase coming in at 21.4% compared to a decrease of 13.8% for the same period last year. Growth is driven by an increase in the Net Interest Income (NII), which came in at 7.1%, and a 4.6% growth in NFI. This indicates that the banking industry has adjusted to the new operating environment;
- Average deposit growth came in at 8.7%. Interest expense paid on deposits recorded a faster growth of 12.9% on average, indicating that more interest earning accounts have been opened. Deposits are expected to grow going forward as the proposed changes regarding financial inclusion in the Banking Sector Charter take effect;
- Average loan growth came in at 3.4%, while investment in government securities has grown by 15.9%, outpacing the loan growth, showing increased lending to the government by banks as they avoid the risky borrowers. The loan to deposit ratio thus declined marginally to 73.7% from 77.9% in H1'2017; and,
- The average Net Interest Margin in the banking sector currently stands at 8.3%, an increase from the 7.1% recorded in H1'2017.

Highlights of the Week:

The Central Bank of Kenya (CBK) has downgraded the banking sector rating to "satisfactory", from a previous rating of "strong" in 2016. According to the Bank Supervision Annual Report 2017 released by the regulator, the downgrade was as a result of a decline in capital adequacy, as well as a deterioration in asset quality in the sector. Specifically:

i. core capital to total risk-weighted assets (TRWA) for the banking sector declined to 16.5% in 2017 from 17.0% in the 2016 financial year,
ii. total capital relative to total risk-weighted assets (TRWA) declined to 18.8% from 19.8% over the same period,
iii. core capital as a ratio of total deposit liabilities also declined to 18.9% in 2017 from 20.0% in 2016, and,
iv. non-performing loans (NPLs) for the year increased by 23.4% to Kshs 264.6 bn from Kshs 214.3 bn in December 2016 consequently, the NPL ratio increased to 12.3% in December 2017 from 9.3% in December 2016

Despite the decline in capital adequacy ratios, the banking sector remained well capitalized with sufficient buffers above the minimum required ratios. The deterioration in asset quality came as a result of a challenging business environment in 2017, occasioned by poor weather conditions, delayed payments from both private and public institutions and the upheavals due to the protracted electioneering period last year. The key highlights of the performance of the banking sector include:

- Gross loans and advances decreased by 5.7% to Kshs 2.2 tn in December 2017 from Kshs 2.3 tn in December 2016. However, total net assets grew by 8.1% to Kshs 4.0 tn from Kshs 3.7 tn in December 2016, with the growth being supported by investments in government securities,
- Customer deposits increased by 10.8% to Kshs 2.9 tn from Kshs 2.6 tn in December 2016. The growth was attributed to increased deposit mobilization by banks as they expanded their outreach and leveraged on digital platforms,
- The profit before tax decreased by 9.6% to Kshs 133.2 bn in December 2017 from Kshs 147.4 bn

in December 2016. The decrease in profitability was attributed to a faster decrease in income which outpaced a marginal decrease in expenses. The banking sector income declined by 3.1% in the period ended December 2017 whereas expenses marginally decreased by 0.5% over the same period,

- The banking sector remained well capitalized with capital adequacy ratio of 18.8% in 2017, well above the regulatory requirement of 14.5%,
- The banking sector average liquidity ratio stood at 43.7% as compared to 40.3% in December 2016, mainly attributed to a higher growth in total liquid assets, compared to the growth in total short-term liabilities. Total liquid assets grew by 16.3% while total short-term liabilities grew by 10.4%. The banking sector's average liquidity in the twelve months to December 2017 was above the statutory minimum requirement of 20.0%.

The Central Bank uses the Capital Adequacy, Asset Quality, Management Quality, Earnings and Liquidity (CAMEL) rating framework in assessing the soundness of commercial banks. Below is a summary of the banking sector performance rating:

Banking Sector Performance Rating

Performance	**2016**			**2017**		
	No. of Institutions	**Total Net Assets (Kshs '000')**	**Market Share**	**No. of Institutions**	**Total Net Assets (Kshs '000')**	**Market Share**
Strong	11	1,845,960	49.95%	9	1,234,627	30.94%
Satisfactory	16	1,438,960	38.93%	16	2,285,671	57.84%
Fair	11	295,908	8.01%	12	132,835	8.37%
Marginal	1	115,114	3.11%	3	349,608	2.85%
Unsatisfactory						
Total*	**39**	**3,695,943**	**100.00%**	**40**	**4,002,741**	**100.00%**
Rating	**Strong**			**Satisfactory**		

***Charterhouse Bank in Statutory Management, and Imperial Bank and Chase Bank in Receivership have been excluded in the 2017 statistics**

Source: CBK

From the table above, the 25 banks with strong/satisfactory rating command a cumulative market share of 88.8%, while the 3 banks with a "marginal" rating have a mere 2.9% market share. The declining capital adequacy may be a signal of looming consolidation in the sector as weaker banks are absorbed by their larger, more stable counterparts in order to recapitalize as per the statutory requirements.

Corporate Governance Changes:

KCB Group Plc announced the appointment of Mr. Lawrence Mark Njiru as a non-executive director for the Group.

Following the KCB Group Board Changes:

- The board size has increased to 10 from 9 hence a deterioration of the metric score to 0.5 from 1.0 since the board consists an even number of members, raising the possibility of a tie in case board members decide to vote on a decision;
- Gender diversity has declined slightly to 20.0% from 22.2%,

- Ethnic diversity remained unchanged at 20.0%, which is less than 50.0% from one ethnicity;
- The proportion of non-executive members has improved slightly to 20.0% from 22.2% previously but the score remains the same as it is still greater than 70.0%;

Overall, the comprehensive score has deteriorated to 85.4% from 87.5%, although the bank has remained at position 1 in the 2017 Cytonn Corporate Governance Index.

Equities Universe of Coverage:

Below is our Equities Universe of Coverage:

Banks	Price as at 17/08/2018	Price as at 24/08/2018	w/w change	YTD Change	LTM Change	Target Price*	Dividend Yield	Upside/ Downside**	P/TBv Multiple
NIC Bank***	34.8	32.8	(5.8%)	(3.0%)	(2.0%)	54.1	3.1%	58.7%	**0.8x**
Zenith Bank***	23.6	22.0	(7.0%)	(14.4%)	(5.0%)	33.3	12.3%	53.5%	**1.0x**
Ghana Commercial Bank***	5.3	5.3	0.8%	5.7%	4.5%	7.7	7.1%	52.8%	**1.3x**
I&M Holdings***	115.0	105.0	(8.7%)	1.0%	(16.0%)	169.5	3.3%	50.7%	**1.2x**
UBA Bank	8.4	8.0	(4.2%)	(22.3%)	(17.6%)	10.7	18.8%	46.9%	**0.6x**
Diamond Trust Bank***	197.0	193.0	(2.0%)	0.5%	1.6%	280.1	1.3%	43.5%	**1.1x**
Union Bank Plc	5.9	5.6	(5.1%)	(28.8%)	(7.5%)	8.2	0.0%	39.3%	**0.6x**
HF Group***	7.9	7.5	(5.1%)	(27.9%)	(27.3%)	10.2	4.3%	33.4%	**0.3x**
CRDB	160.0	160.0	0.0%	0.0%	(20.0%)	207.7	0.0%	29.8%	**0.5x**
KCB Group***	49.5	48.0	(3.0%)	12.3%	6.1%	60.9	6.3%	29.3%	**1.6x**
Barclays	12.0	11.8	(2.1%)	22.4%	11.4%	14.0	8.5%	25.2%	**1.5x**
Co-operative Bank	17.1	16.6	(2.9%)	3.8%	(0.6%)	19.7	4.8%	20.0%	**1.5x**
Ecobank	9.0	9.0	0.1%	18.0%	41.0%	10.7	0.0%	19.8%	**2.5x**
Equity Group	50.0	50.0	0.0%	25.8%	15.6%	55.5	4.0%	15.0%	**2.5x**
Stanbic Bank Uganda	33.0	33.0	0.0%	21.1%	21.1%	36.3	3.5%	13.5%	**2.1x**
Bank of Baroda	120.0	145.0	20.8%	28.3%	31.8%	130.6	1.7%	10.6%	**1.0x**
CAL Bank	1.3	1.3	0.0%	17.6%	48.1%	1.4	0.0%	10.2%	**1.1x**
Bank of Kigali	290.0	290.0	0.0%	(3.3%)	13.7%	299.9	4.8%	8.2%	**1.6x**
Guaranty Trust Bank	38.0	37.5	(1.3%)	(8.0%)	(7.6%)	37.1	6.4%	4.0%	**2.1x**
Access Bank	9.6	9.0	(6.3%)	(13.9%)	(10.1%)	9.5	4.4%	3.4%	**0.6x**
SBM Holdings	6.7	6.7	0.0%	(10.7%)	(14.8%)	6.6	4.5%	2.4%	**1.0x**
Standard Chartered	206.0	206.0	0.0%	(1.0%)	(11.2%)	184.3	10.6%	(4.5%)	**1.6x**
Stanbic Holdings	106.0	107.0	0.9%	32.1%	30.5%	85.9	2.1%	(16.9%)	**1.3x**
Stanbic IBTC Holdings	50.1	49.5	(1.1%)	19.3%	28.5%	37.0	1.2%	(24.9%)	**2.6x**
Standard Chartered	26.1	26.5	1.7%	5.0%	16.2%	19.5	0.0%	(25.3%)	**3.3x**
FBN Holdings	9.8	9.7	(1.5%)	9.7%	61.4%	6.6	2.6%	(29.8%)	**0.5x**
National Bank	6.1	6.1	0.0%	(35.3%)	(47.4%)	2.8	0.0%	(53.7%)	**0.4x**

Banks	Price as at 17/08/2018	Price as at 24/08/2018	w/w change	YTD Change	LTM Change	Target Price*	Dividend Yield	Upside/ Downside**	P/TBv Multiple
Ecobank Transnational	21.1	20.0	(5.0%)	17.6%	11.1%	9.3	0.0%	(55.9%)	**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.