Kenya Retail Sector Report 2018, & Cytonn Monthly – August 2018

Equities

Market Performance

During the month of August, the equities market was on a downward trend with NASI, NSE 20 and NSE 25 declining by 1.7%, 2.8% and 3.2%, respectively, taking their YTD performance as at the end of August to (2.1%), (13.7%) and (2.7%) for NASI, NSE 20 and NSE 25, respectively. The equities market performance during the month was driven by declines in large caps stocks such as East Africa Breweries Limited (EABL), Equity Group Holdings, Barclays Bank, Diamond Trust Bank (DTB) and KCB Group, which declined by 11.6%, 10.0%, 5.2%, 5.0% and 4.1%, respectively.

During the week, the equities market was also on a downward trend with NASI, NSE 20 and NSE 25 declining by 3.1%, 2.8% and 4.2%, respectively, due to declines in counters such as Equity Group Holdings, Barclays Bank and KCB Group, which declined by 10.0%, 6.4% and 6.3%, respectively. Banking stocks declined owing to investors' reaction to Parliament's vote to retain the 4.0% cap above the Central Bank Rate (CBR), on interests charged on loans.

Equities turnover rose by 30.7% during the month to USD 99.8 mn from USD 76.3 mn in July, taking the YTD turnover to USD 1.2 bn. For this week, equities turnover rose by 55.2% to USD 26.8 mn from USD 17.3 mn in the previous week with foreign investors remaining net sellers. Foreign investors remained net sellers for this month, with a net selling position of USD 15.3 mn. We expect the market to remain supported by improved investor sentiment as the economy recovers from shocks experienced last year.

The market is currently trading at a price to earnings ratio (P/E) of 13.9x, 3.0% above the historical average of 13.5x, and a dividend yield of 3.9%, slightly above the historical average of 3.7%. Despite the valuations nearing the historical average, we believe there still exist pockets of value in the market. The current P/E valuation of 13.5x is 43.3% above the most recent trough valuation of 9.7x experienced in the first week of February 2017, and 67.5% 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.

Earnings Releases

I&M Holdings released H1'2018 results during the week;

I&M Holdings released their H1'2018 results, registering core earnings per share growth of 11.7% to Kshs 8.8 from Kshs 7.9 in H1'2017, lower than our expectation of a 14.7% increase to Kshs 9.0. Performance was driven by a 9.9% increase in operating income to Kshs 10.6 bn from Kshs 9.6 bn in H1'2017, despite a 15.8% increase in operating expenses to Kshs 5.7 bn from Kshs 4.9 bn. Highlights of the performance from H1'2017 to H1'2018 include:

- Total operating income increased by 9.9% to Kshs 10.6 bn from Kshs 9.6 bn in H1'2017. This was due to a 34.4% increase in Non-Funded Income (NFI) to Kshs 3.7 bn from Kshs 2.8 bn in H1'2017, while Net Interest Income (NII) remained flat at Kshs 6.9 bn,
- Interest income increased by 5.1% to Kshs 11.7 bn from Kshs 11.1 bn in H1'2017. The interest income on loans and advances increased by 7.3% to Kshs 9.0 bn from Kshs 8.4 bn in H1'2017. Interest income on government securities remained flat at Kshs 2.6 bn in H1'2018. The yields on interest earning assets stood at 11.3% in H1'2018, a decline from 12.0% recorded in H1'2017,
- Interest expense increased by 13.2% to Kshs 4.8 bn from Kshs 4.2 bn in H1'2017, as interest expense on customer deposits increased by 16.6% to Kshs 4.2 bn from Kshs 3.6 bn in H1'2017. Interest expense on deposits from other banking institutions declined by 30.4% to Kshs 112.5 mn from Kshs 161.6 mn in H1'2017. The cost of funds decreased to 4.6% from 4.9% in H1'2017, indicating that cheaper non-interest bearing accounts were opened as deposits grew by 30.6%. The Net Interest Margin declined marginally to 7.1% from 7.2% in H1'2017,
- Non-Funded Income increased by an impressive 34.4% to Kshs 3.7 bn from Kshs 2.8 bn in H1'2017. The increase in NFI was driven by a 64.2% increase in fees and commission income on loans to Kshs 0.8 bn from Kshs 0.5 bn in H1'2017, coupled with a 39.2% increase in other income to Kshs 0.5 bn from Kshs 0.4 bn in H1'2017. Other fees and commissions increased by 27.0% to Kshs 1.2 bn from Kshs 1.0 bn in H1'2017, while forex trading income rose by 25.5% to Kshs 1.2 bn from Kshs 1.0 bn in H1'2017. The revenue mix shifted to 65:35 funded to non-funded income from 71:29 in H1'2017, owing to the faster increase in NFI compared to NII,
- Total operating expenses increased by 15.8% to Kshs 5.7 bn from Kshs 4.9 bn, largely driven by a 26.2% increase in loan loss provisions (LLP) to Kshs 1.4 bn in H1'2018 from Kshs 1.0 bn in H1'2017. Staff costs increased by 10.2% to Kshs 2.0 bn in H1'2018 from Kshs 1.9 bn in H1'2017,
- The cost to income ratio deteriorated marginally to 53.7% from 51.0% in H1'2017. Without LLP, however, the cost to income ratio improved to 40.4% from 41.0% in H1'2017, implying a higher cost of risk due to the increase in LLP,
- Profit before tax increased by 3.8% to Kshs 4.9 bn, up from Kshs 4.7 bn in H1'2017. Profit after tax increased by 12.8% to Kshs 3.9 bn in H1'2018 from Kshs 3.4 bn in H1'2017,
- The balance sheet recorded an expansion with total assets growth of 23.5% to Kshs 283.1 bn from Kshs 229.2 bn in H1'2017. This growth was largely driven by a 12.6% increase in net loans and advances to Kshs 162.8 bn in H1'2018 from Kshs 144.5 bn in H1'2017, and a 502.4% growth in deposits and balances due from banking institutions abroad to Kshs 38.6 bn from Kshs 6.4 bn in H1'2017. Government securities decreased by 28.3% to Kshs 36.1 bn from Kshs 50.4 bn in H1'2017,
- Total liabilities rose by 27.2% to Kshs 235.3 bn from Kshs 184.9 bn in H1'2017, driven by a strong 30.6% increase in customer deposits to Kshs 210.9 bn from Kshs 161.5 bn in H1'2017. Deposits per branch increased by 30.6% to Kshs 5.2 bn from Kshs 4.0 bn in H1'2017 as the bank has not increased its branch network from the current 42 branches,
- The faster growth in deposits compared to loan growth led to a decline in the loan to deposit ratio to 77.2% from 89.5% in H1'2017,
- Gross non-performing loans increased by 118.1% to Kshs 22.4 bn in H1'2018 from Kshs 10.3 bn in H1'2017. Consequently, the NPL ratio deteriorated to 13.0% in H1'2018 from 6.0% in H1'2017. General Loan loss provisions increased by 64.1% to Kshs 5.9 bn from Kshs 3.4 bn in H1'2017, hence an improvement in NPL coverage to 43.4% in H1'2018 from 33.6% in H1'2017,
- Shareholders' funds increased by 7.5% to Kshs 45.1 bn in H1'2018 from Kshs 41.9 bn in H1'2017,
- I&M Holdings is currently sufficiently capitalized with a core capital to risk weighted assets ratio of 16.5%, 6.0% above the statutory requirement. In addition, the total capital to risk weighted assets ratio was 18.2%, exceeding the statutory requirement by 3.7%. Adjusting for IFRS 9, the core capital to risk weighted assets stood at 16.5%, while total capital to risk weighted assets came in at 18.6%, indicating that the bank's total capital relative to its risk-weighted assets decreased by 0.4% due to the impact of IFRS 9,
- I&M Holdings currently has a return on average assets of 3.0% and a return on average equity of

17.2%.

Going forward, we expect the bank's growth to be further driven by:

a. Non-Funded Income Growth Initiatives – I&M Holdings' NFI growth is improving as the bank focuses on digital innovation to augment transaction volumes and increase fee income. The bank needs to increase the capacity of its brokerage and advisory businesses so as to increase income contribution from investment and advisory services. The acquisition of Youjays Insurance Brokers provides the bank with an avenue to grow its bancassurance business, thereby putting the firm's NFI on a positive growth trajectory.

For a more comprehensive analysis, see our I&M Holdings H1'2018 earnings note.

Diamond Trust Bank released the H1'2018 results during the week;

Diamond Trust Bank released their H1'2018 results during the week, with core earnings per share growing by 2.5% to Kshs 12.5 from Kshs 12.2 in H1'2017, lower than our expectation of a 16.6% increase to Kshs 13.8. Performance was driven by a 5.3% increase in total operating income to Kshs 12.7 bn from Kshs 12.0 bn in H1'2017, which outpaced a 4.0% increase in total operating expenses to Kshs 7.3 bn from Kshs 7.0 bn. The variance in core earnings per share growth, relative to our expectations, was as a result of a slower growth in Net Interest Income (NII) of 4.6% against our expectation of an 11.7% increase to Kshs 10.6 bn. Highlights of the performance from H1'2017 to H1'2018 include:

- Total operating income increased by 5.3% to Kshs 12.7 bn from Kshs 12.0 bn in H1'2017. This was due to an increase of 8.0% increase in Non-Funded Income (NFI) to Kshs 2.7 bn from Kshs 2.5 bn in H1'2017, coupled with a 4.6% increase in Net Interest Income (NII) to Kshs 9.9 bn from Kshs 9.5 bn in H1'2017,
- Interest income increased by 3.9% to Kshs 17.5 bn from Kshs 16.9 bn in H1'2017. The interest income on loans and advances decreased by 0.9% to Kshs 11.1 bn from Kshs 11.2 bn in H1'2017. Interest income on government securities increased by 13.5% to Kshs 6.3 bn in H1'2018 from Kshs 5.6 bn in H1'2017. The yield on interest earning assets declined to 11.0% in H1'2018 from 12.0% in H1'2017, due to the relatively faster growth in interest-earning assets by 12.1% to Kshs 338.6 bn from Kshs 302.2 bn in H1'2017, with the increase mainly being government securities that have a lower yield than loans,
- Interest expense increased by 3.0% to Kshs 7.6 bn from Kshs 7.4 bn in H1'2017, as interest expense on customer deposits increased by 1.6% to Kshs 6.8 bn from Kshs 6.7 bn in H1'2017. Interest expense on deposits from other banking institutions increased by 68.3% to Kshs 371.9 mn from Kshs 221.1 mn in H1'2017. The cost of funds decreased to 5.0% from 5.3% in H1'2017. The Net Interest Margin declined to 6.5% from 6.8% in H1'2017,
- Non-Funded Income increased by 8.0% to Kshs 2.7 bn from Kshs 2.5 bn in H1'2017. The increase in NFI was driven by a 70.4% increase in other income to Kshs 0.2 bn from Kshs 0.1 bn in H1'2017, coupled with an 11.7% increase in other fees and commission income to Kshs 1.0 bn from Kshs 989.9 mn in H1'2017. Fees and commissions on loans increased by 4.3% to Kshs 0.7 bn from Kshs 0.6 bn in H1'2017, while forex trading income rose marginally by 0.3% to Kshs 795.9 mn from Kshs 793.8 mn in H1'2017. The revenue mix shifted to 78:22 funded to non-funded income in H1'2018 from 79:21 in H1'2017, owing to the faster increase in NFI compared to NII,
- Total operating expenses increased by 4.0% to Kshs 7.3 bn from Kshs 7.0 bn, largely driven by a 7.3% increase in other operating expenses to Kshs 3.5 bn in H1'2018 from Kshs 3.3 bn in H1'2017. Staff costs increased by 3.8% to Kshs 2.1 bn in H1'2018 from Kshs 2.0 bn in H1'2017. Loan loss provision expense (LLP) declined by 2.2% to Kshs 1.68 bn from Kshs 1.72 bn in H1'2017,
- The cost to income ratio improved to 57.4% from 58.1% in H1'2017. Without LLP, however, the cost to income ratio deteriorated to 44.2% from 43.9% in H1'2017,

- Profit before tax increased by 7.0% to Kshs 5.4 bn, up from Kshs 5.0 bn in H1'2017. Profit after tax increased by 2.5% to Kshs 3.5 bn in H1'2018 from Kshs 3.4 bn in H1'2017,
- The balance sheet recorded an expansion with total assets growth of 9.4% to Kshs 376.1 bn from Kshs 343.7 bn in H1'2017. This growth was largely driven by a 22.5% increase in government securities to Kshs 129.2 bn in H1'2018 from Kshs 105.4 bn in H1'2017. The loan book expanded by 3.5% to Kshs 198.2 bn in H1'2018 from 191.5 bn in H1'2017,
- Total liabilities rose by 8.8% to Kshs 321.1 bn from Kshs 295.2 bn in H1'2017, driven by a 9.9% increase in customer deposits to Kshs 281.8 bn from Kshs 256.3 bn in H1'2017. Deposit per branch increased by 3.5% to Kshs 4.1 bn from Kshs 3.9 bn in H1'2017, with the branches increasing from 65 in H1'2017 to 69 in H1'2018,
- The faster growth in deposits compared with loan growth led to a decline in the loan to deposit ratio to 70.4% from 74.7% in H1'2017,
- Gross non-performing loans increased by 65.6% to Kshs 15.3 bn in H1'2018 from Kshs 9.2 bn in H1'2017. Consequently, the NPL ratio deteriorated to 7.1% in H1'2018 from 4.5% in H1'2017. General Loan loss provisions increased by 40.4% to Kshs 8.5 bn from Kshs 6.0 bn in H1'2017. However, the NPL coverage decreased to 70.7% in H1'2018 from 86.8% in H1'2017 due to the faster increase in NPLs,
- Shareholders' funds increased by 14.9% to Kshs 50.0 bn in H1'2018 from Kshs 43.5 bn in H1'2017,
- DTB Kenya Limited is currently sufficiently capitalized with a core capital to risk weighted assets ratio of 17.4%, 6.9% above the statutory requirement. In addition, the total capital to risk weighted assets ratio was 18.7%, exceeding the statutory requirement by 4.2%. Adjusting for IFRS 9, the core capital to risk weighted assets stood at 18.5%, while total capital to risk weighted assets came in at 19.8%, indicating that the bank's total capital relative to its risk-weighted assets decreased by 1.1% due to the impact of IFRS 9,
- DTB currently has a return on average assets of 1.8% and a return on average equity of 14.0%.

Going forward, we expect the bank's growth to be further driven by:

a. Non-Funded Income Growth Initiatives – DTB's partnership with the Postal Corporation of Kenya has expanded its agency banking reach across the country. This is expected to increase transactional volumes, which will in turn contribute to NFI generation through fees and commissions. DTB should also increase the capacity of its bancassurance business to acquire more customers through cross-selling insurance products to existing customers.
b. Better underwriting of loans to ascertain and minimize risks associated with every market segment in which it operates, in order to mitigate the bank's deteriorating asset quality. The bank obtained a credit facility from Africa Development Bank (AfDB), which it will use to extend credit to SME businesses. It is important for the bank to adopt appropriate risk management policies in order to reduce its bad loan portfolio.

For a more comprehensive analysis, see our Diamond Trust Bank H1'2018 earnings note.

HF Group released the H1'2018 results during the week;

HF Group released their H1'2018 financial results, with core earnings per share declining by 95.7% to Kshs 0.02 from Kshs 0.5 in H1'2017, in line with our expectations of a 95.0% decline. Performance was driven by a 9.4% increase in total operating expenses to Kshs 1.9 bn from Kshs 1.8 bn in H1'2017, coupled with a 1.5% decline in total operating income to Kshs 1.9 bn from Kshs 2.0 bn in H1'2017. The bank recorded a profit after tax of Kshs 6.8 mn. Highlights of the performance from H1'2017 to H1'2018 include:

- Total operating income declined by 2.7% to Kshs 1.9 bn in H1'2018 from Kshs 2.0 bn in H1'2017. Performance was driven by a 13.9% decline in Net Interest Income (NII) to Kshs 1.3 bn from Kshs 1.6 bn in H1'2017, despite a 38.2% increase in Non-Funded Income (NFI) to Kshs 586.8 mn from

Kshs 424.5 mn in H1’2017,

- Interest income declined by 13.2% to Kshs 3.2 bn from Kshs 3.7 bn in H1’2017 bn, due to a decline in interest income on loans and advances by 12.4% to Kshs 3.0 bn from Kshs 3.4 bn in H1’2017, and a 34.2% decline in interest income on government securities to Kshs 145.7 mn from Kshs 221.5 mn in H1’2017. The yield on interest earning assets consequently declined to 11.7% in H1’2018 from 13.0% in H1’2017,
- Interest expense declined by 12.7% to Kshs 1.9 bn from Kshs 2.1 bn in H1’2017, following a 3.4% decline in the interest expense on customer deposits to Kshs 1.1 bn from Kshs 1.2 bn in H1’2017. Other interest expenses declined by 27.1% to Kshs 677.4 mn from Kshs 928.9 mn in H1’2017. Consequently, the cost of funds declined to 7.0% from 7.5% in H1’2017, while the Net Interest Margin declined to 4.9% from 5.7% in H1’2017,
- Non-Funded Income increased by 38.2% to Kshs 586.8 mn from Kshs 424.5 mn in H1’2017. The growth in NFI was driven by a 163.0% increase in other income to Kshs 433.0 mn from Kshs 265.6 mn in H1’2017. Fees and commissions on loans declined by 59.9% to Kshs 18.0 mn from Kshs 44.9 mn in H1’2017. Total fees and commissions however increased by 7.2% to Kshs 129.4 mn from Kshs 120.1 mn in H1’2017 due to a 47.0% increase in other fees to Kshs 111.4 mn in H1’2018 from Kshs 75.8 mn in H1’2017. The current revenue mix stands at 70:30 funded to non-funded income as compared to 79:21 in H1’2017. The proportion of non-funded income to total revenue increased owing to the faster growth in NFI, coupled with the decline in NII,
- Total operating expenses increased by 9.4% to Kshs 1.9 bn from Kshs 1.8 bn in H1’2017, largely driven by a 37.0% increase in other operating expenses to Kshs 845.4 mn from Kshs 616.9 mn in H1’2017, as well as a 13.8% rise in staff costs to Kshs 601.4 mn from Kshs 528.4 mn in H1’2017. Loan loss provisions however declined by 40.1% to Kshs 228.1 mn in H1’2018 from Kshs 380.9 mn in H1’2017,
- The cost to income ratio deteriorated to 99.3% from 88.3% in H1’2017. Without LLP, the cost to income ratio also deteriorated to 87.5% from 69.1% in H1’2017,
- Profit before tax declined by 94.5% to Kshs 12.6 mn from Kshs 231.1 mn in H1’2017. Profit after tax declined by 95.7% to Kshs 6.8 mn in H1’2018 from Kshs 159.0 mn in H1’2017,
- The balance sheet recorded a contraction as total assets declined by 8.5% to Kshs 65.5 bn from Kshs 71.6 bn in H1’2017. This decline was driven by a 9.8% decline in the loan book to Kshs 47.6 bn from Kshs 52.8 bn in H1’2017. Government securities increased by 17.3% to Kshs 4.0 bn in H1’2018 from 3.4 bn in H1’2017,
- Total liabilities declined by 9.9% to Kshs 54.4 bn from Kshs 60.3 bn in H1’2017, driven by a 3.1% decline in customer deposits to Kshs 36.2 bn from Kshs 37.4 bn in H1’2017. Furthermore, borrowings declined by 27.7% to Kshs 15.6 bn in H1’2018 from Kshs 21.6 bn in H1’2017. However, deposits per branch increased by 10.2% to Kshs 1.6 bn from Kshs 1.5 bn in H1’2017 with the number of branches declining to 22 from 25 as at H1’2017,
- The loans to loanable funds ratio increased to 91.1% from 89.3% in H1’2017, due to an 11.6% decline in loanable funds to Kshs 52.2 bn from Kshs 59.1 bn in H1’2017,
- Gross non-performing loans increased by 12.0% to Kshs 8.9 bn in H1’2018 from Kshs 7.9 bn in H1’2017. As a consequence, the NPL ratio deteriorated to 17.4% in H1’2018 from 14.2% in H1’2017. General loan loss provisions increased by 15.4% to Kshs 2.0 bn from Kshs 1.7 bn in H1’2017. Thus, the NPL coverage improved to 39.0% in H1’2018 from 36.0% in H1’2017, due to the relatively faster increase in loan loss provisions,
- Shareholders’ funds declined by 9.9% to Kshs 54.4 bn in H1’2018 from Kshs 60.3 bn in H1’2017,
- HF Group Limited is currently sufficiently capitalized with a core capital to risk weighted assets ratio of 15.5%, 5.0% above the statutory requirement. In addition, the total capital to risk weighted assets ratio was 16.9%, exceeding the statutory requirement by 2.4%. Adjusting for IFRS 9, the core capital to risk weighted assets stood at 16.5%, while total capital to risk weighted assets came in at 18.0%, indicating that the bank’s total capital relative to its risk-weighted assets declined by 1.1% due to implementation of IFRS 9,
- HF Group currently has a return on average assets of (0.04%) and a return on average equity of

(0.2%).

Given the poor performance, HF Group could improve in the future by:

a. NFI growth expansion: HF Group's NFI is below the industry average, coming in at 30.0%. vs industry average of 34.3%. The growth in NFI could to be driven by increased adoption of alternative channels with the Group shifting focus to deepening its digital banking proposition having launched their digital banking platform in July, dubbed HF Whizz, which will enable customers to open an account, access loans, and deposit and transfer cash on mobile phones in a bid to grow non – funded income streams. This will improve operational efficiency as well as increase the bank's transactional income,
b. Aligning the staff headcount to the bank's operational needs: The Bank is set to lay off 36 employees in a cost-cutting drive that will see it merge some staff positions. The move will provide clarity on operational accountabilities and curb the high operational costs, thereby improving operational efficiency,
c. Fundamentally, we think HF Group as a conventional bank is a long stretch given inability to gather deposits. Ultimately, it seems that the end game will be coupling up with a strong bank with a sizeable asset base and a strong deposit gathering capability, thereby complementing HF's strength in mortgages and real estate development.

For a more comprehensive analysis, see our Housing Finance Company Limited H1'2018 earnings note.

The performance of the listed banking sector is summarized in the table below:

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	Return on Average Equity
Stanbic	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%	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%	(0.6%)
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%	18.0%
KCB Group	18.0%	6.1%	11.9%	4.3%	8.6%	(0.1%)	32.2%	(6.0%)	8.7%	8.7%	3.6%	80.3%	3.0%	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%	23.9%
I&M Holdings	11.7%	5.1%	13.2%	0.1%	7.1%	34.4%	35.1%	39.5%	30.6%	(28.3%)	12.6%	77.2%	4.6%	17.2%
Co-op Bank	7.6%	7.9%	2.2%	10.4%	8.6%	(1.6%)	32.1%	(2.6%)	3.9%	12.0%	(0.6%)	84.6%	3.9%	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%	2.60%	17.5%
DTBK	2.5%	3.9%	3.0%	4.6%	6.5%	8.0%	21.6%	7.2%	9.9%	22.5%	3.5%	70.4%	5.0%	14.0%
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%	12.8%
HF Group	(95.7%)	(13.2%)	(12.7%)	(13.9%)	4.9%	38.2%	30.4%	7.2%	(3.1%)	17.3%	(9.8%)	131.4%	7.0%	(0.2%)
Weighted Average H1'2018	**19.0%**	**7.9%**	**12.0%**	**6.4%**	**8.1%**	**6.9%**	**34.3%**	**4.6%**	**10.0%**	**13.7%**	**3.8%**	**73.8%**	**3.4%**	**19.3%**
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%**

**Weighted average as at 31/8/2018*

Key takeaways from the table include:

- All listed banks recorded an increase in core EPS growth with the exception of only NIC Group and HF Group, with the weighted average increase coming in at 19.0% compared to a decrease of 13.8%, for the same period in 2017. Growth was driven by an increase in the Net Interest Income (NII), which came in at 6.4%, and a 6.9% growth in NFI. This indicates that the banking industry has adjusted to the new operating environment;
- Average deposit growth came in at 10.0%. Interest expense paid on deposits recorded a faster growth of 12.0% 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 3.8%, while investment in government securities has grown by 13.7%, 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 to 73.8% from 77.9% in H1’2017; and,
- The average Net Interest Margin in the banking sector currently stands at 8.1%, an increase from the 7.1% recorded in H1’2017.

Monthly Highlights

The Central Bank of Kenya (CBK) proposed to introduce a Banking Sector Charter that will guide service provision in the sector. The Charter aims to instill discipline in the banking sector in order to make it responsive to the needs of the banked population. The charter 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. 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. However, we are even of the stronger view, as captured in our Focus Notes titled *“Rate Cap Review Should Focus More on Stimulating Capital Markets”* and *Status of Rate Cap Review in Finance Bill,* 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:

1. **Legislation and policies to promote competing sources of financing should be the centerpiece 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 bank funding, and 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, such as High Yield Solutions. The products offer investors with cash an opportunity 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 just 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, at best 7% per annum, 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,
2. **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,
3. **Promote capital markets infrastructure:** Efficient capital markets infrastructure is necessary in both regulated and private markets. The Capital Markets Authority (CMA) could aid in enhancing the capital markets’ depth in various ways such as (i) making it easier for new and structurally unique products to be introduced in the capital and financial markets, (ii) institute

predictable deadlines for processing submissions from market applicants and expedite processing of applications, (iii) push for a one stop shop for applicants such that an approval from the authority on products such as REITS would suffice, as opposed to current structure where applicants have to chase other approvals from other agencies such as KRA.

4. **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,
5. **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,
6. **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,
7. **Increased transparency:** This can be achieved through a reduction in 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,

During the week, the Nairobi Securities Exchange (NSE) hosted London Stock Exchange Group (LSEG) officials, with the discussions centred on dual listing by Kenyan companies on the London Stock Exchange (LSE). This is part of LSE's initiative to get more African companies listed on the exchange. To date, there are 111 African firms listed on the London Stock Exchange, the greatest number on any international exchange, with a combined market cap of over USD 149.0 bn. The London Stock Exchange has been partnering with African exchanges, such as the Nigerian Stock Exchange, where most recently Seplat Petroleum Development PLC was listed on both the London Stock Exchange and the Nigerian Stock Exchange in 2014, and raised USD 500.0 mn. In March 2016, LSEG formed an Africa Advisory Group, to act as a forum to discuss the development of Africa's capital markets and how best to address the challenges and opportunities which this presents. Some of the challenges that have been faced by companies seeking to dual-list include; (i) lack of sufficient information on foreign investor appetite, (ii) arcane procedures associated with listing on a foreign exchange and, (iii) regulatory impediments associated with listing on a foreign exchange. A partnership between the LSE and the NSE is important, as it will provide a host of benefits to Kenyan companies, among them being;

i. Opening up these companies to a larger pool of potential investors (both retail and institutional), thereby deepening of local capital markets,
ii. Allowing companies to take advantage of economic conditions in different markets at different times, for instance when there is a slowdown in the Kenyan market, foreign markets can act as a buffer,
iii. Local companies will uphold the highest standards of governance, given the regulatory requirements by foreign markets such as the UK, which will boost the credibility of local markets, and,
iv. Increasing the standards of listing and turnaround time in the local market if we were to benchmark and aspire to the global markets standards.

This will be the second time that the LSEG will be collaborating with the NSE, the first being the LSEG's FTSE Russell benchmarking business collaborated with the Nairobi Securities Exchange in 2011, and Namibian Stock Exchange in 2016 to launch Kenyan and Namibian-focused Index Series.

Corporate Governance Changes:

Standard Chartered Bank Kenya Limited announced the appointment of Mr Imtiaz Khan as an independent Non-Executive director of the company.

Following the Standard Chartered Bank Board Changes:

i. The addition of one director brings the sum of board members to 12 (even number) thus the score on board size reduces to 0.5 from 1;
ii. Gender diversity declined to 25.0% from 27.2%, but the score remains unchanged at 0.5, as it is still less than 30.0%;
iii. The proportion of Non-Executive members improved slightly to 66.7% from 63.6%, thus the score remains the same at 1, as it is still greater than 50.0%.

Overall, the comprehensive score is reduced to 79.2% from 81.3% and as a result, Standard Chartered drops from 5th position to 6th in the 2017 Cytonn Corporate Governance index.

Universe of Coverage

Banks	Price as at 31/07/2018	Price as at 24/08/2018	Price as at 31/08/2018	w/w change	m/m change	YTD Change	Target Price*	Dividend Yield	Upside/ Downside**	P/TBv Multiple
NIC Bank***	34.5	32.8	30.0	(8.4%)	(13.0%)	(11.1%)	54.1	3.3%	68.5%	**0.8x**
I&M Holdings***	110.0	105.0	100.0	(4.8%)	(9.1%)	0.0%	169.5	3.5%	64.9%	**1.1x**
Zenith Bank***	21.2	22.0	21.2	(3.6%)	0.0%	(17.5%)	33.3	12.8%	64.6%	**1.0x**
Ghana Commercial Bank***	5.1	5.3	5.4	0.2%	5.3%	5.9%	7.7	7.1%	51.7%	**1.3x**
Diamond Trust Bank***	200.0	190.0	190.0	0.0%	(5.0%)	(1.0%)	280.1	1.4%	48.8%	**1.1x**
Union Bank Plc	5.9	5.6	5.9	5.4%	(0.8%)	(25.0%)	8.2	0.0%	46.8%	**0.6x**
UBA Bank	9.6	8.0	8.1	1.3%	(15.2%)	(21.4%)	10.7	10.5%	44.2%	**0.5x**
HF Group***	8.0	7.5	7.8	3.3%	(3.1%)	(25.5%)	10.2	4.1%	40.1%	**0.3x**
KCB Group***	47.0	48.0	45.0	(6.3%)	(4.3%)	5.3%	60.9	6.7%	33.5%	**1.5x**
CRDB	160.0	160.0	160.0	0.0%	0.0%	0.0%	207.7	0.0%	29.8%	**0.5x**
Barclays	11.6	11.8	11.0	(6.4%)	(4.8%)	14.6%	14.0	9.1%	28.2%	**1.6x**
Co-operative Bank	17.0	16.6	16.5	(0.6%)	(2.7%)	3.1%	19.7	4.8%	23.5%	**1.5x**
Ecobank	8.2	9.0	9.0	0.0%	9.0%	18.0%	10.7	0.0%	19.6%	**2.0x**
Equity Group	48.0	50.0	45.0	(10.0%)	(6.3%)	13.2%	55.5	4.4%	15.4%	**2.4x**
Stanbic Bank Uganda	32.8	33.0	33.0	0.0%	0.8%	21.1%	36.3	3.5%	13.5%	**2.3x**
CAL Bank	1.3	1.3	1.1	(13.4%)	(13.4%)	1.9%	1.4	0.0%	10.2%	**1.1x**
Access Bank	10.0	9.0	9.4	3.9%	(6.5%)	(10.5%)	9.5	4.3%	9.8%	**0.6x**
Bank of Kigali	290.0	290.0	290.0	0.0%	0.0%	(3.3%)	299.9	4.8%	8.2%	**1.6x**
Guaranty Trust Bank	40.1	37.5	37.0	(1.3%)	(7.6%)	(9.2%)	37.1	6.5%	5.4%	**2.3x**
SBM Holdings	7.4	6.7	6.6	(1.5%)	(10.8%)	(12.0%)	6.6	4.5%	2.5%	**1.0x**
Standard Chartered	203.0	206.0	205.0	(0.5%)	1.0%	(1.4%)	184.3	6.1%	(4.4%)	**1.7x**
Bank of Baroda	140.0	145.0	144.0	(0.7%)	2.9%	27.4%	130.6	1.7%	(8.2%)	**1.3x**
Stanbic Holdings	93.5	107.0	100.0	(6.5%)	7.0%	23.5%	85.9	2.3%	(17.5%)	**1.0x**
Stanbic IBTC Holdings	49.8	49.5	48.0	(3.0%)	(3.5%)	15.7%	37.0	1.2%	(24.0%)	**2.5x**

Banks	Price as at 31/07/2018	Price as at 24/08/2018	Price as at 31/08/2018	w/w change	m/m change	YTD Change	Target Price*	Dividend Yield	Upside/ Downside**	P/TBv Multiple
Standard Chartered	26.0	26.5	26.0	(1.8%)	0.1%	3.0%	19.5	0.0%	(26.6%)	**3.3x**
FBN Holdings	10.1	9.7	9.0	(7.3%)	(11.4%)	1.7%	6.6	2.8%	(28.5%)	**0.5x**
Ecobank Transnational	20.6	20.0	19.6	(2.3%)	(5.1%)	15.0%	9.3	0.0%	(53.6%)	**0.7x**
National Bank	5.8	6.1	5.8	(4.1%)	0.0%	(38.0%)	2.8	0.0%	(53.7%)	**0.4x**

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.