Cytonn Q3'2018 Markets Review

Equities

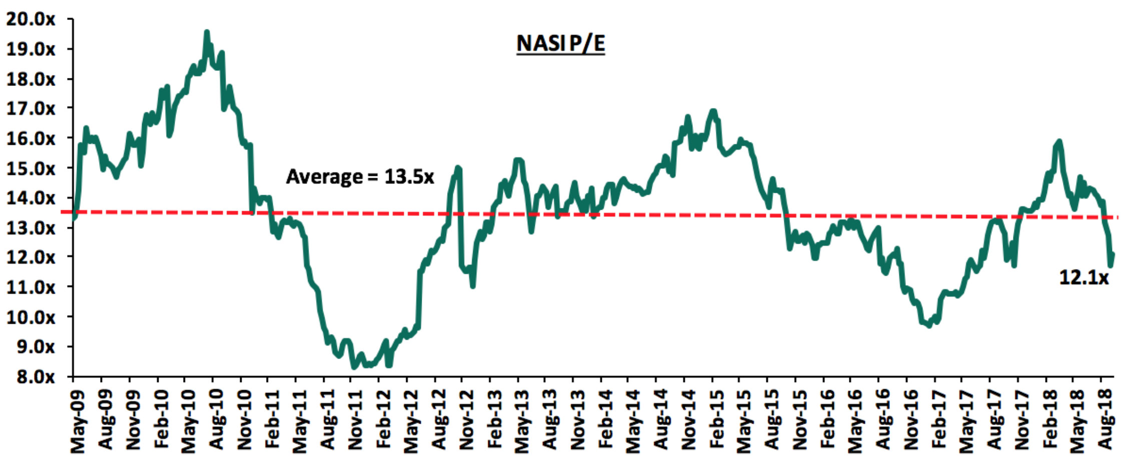
Market Performance:

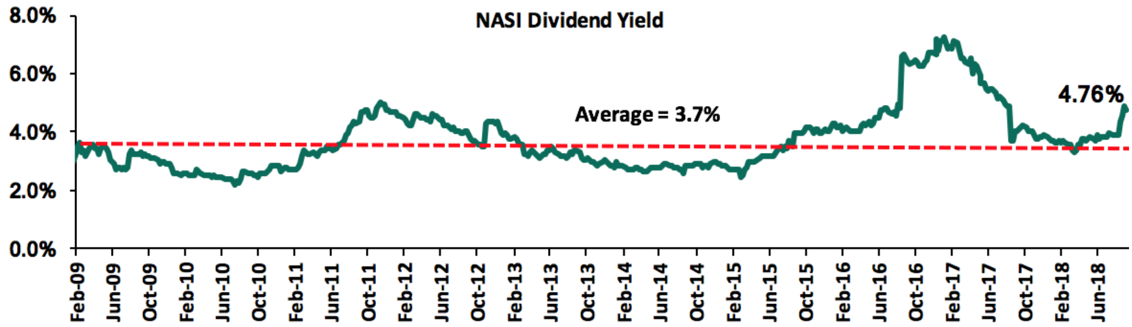
During Q3'2018, the equities market was on a significant downward trend, with NASI, NSE 25 and NSE 20 declining by 14.2%, 15.6%, and 12.5%, respectively; taking their YTD performance as at the end of September to (12.6%), (22.5%), and (13.6%) for NASI, NSE 20 and NSE 25, respectively. The equities market performance during the quarter was shaped by declines in large caps such as NIC Group, Bamburi, Safaricom, and EABL by 31.0%, 18.5%, 16.2%, and 13.6%, respectively.

During the week, the equities market was on an upward trend with NASI, NSE 20 and NSE 25 gaining by 2.9%, 1.5% and 2.7%, respectively, due to gains in large cap stocks such as Co-operative Bank, EABL and KCB which gained by 9.4%, 5.6% and 5.3%, respectively. For the last twelve months (LTM), NASI, NSE 20 and NSE 25 have declined by 8.4%, 22.6% and 10.5%, respectively.

Equities turnover declined by 32.0% during the quarter to USD 319.5 mn from USD 469.8 mn in June, taking the YTD turnover to USD 1.4 bn. For this week, equities turnover rose by 50.5% to USD 41.0 mn from USD 27.2 mn in the previous week. Foreign investors remained net sellers this week, with a net selling position of USD 12.0 mn, which is a 48.1% increase from last week's net selling position of USD 8.1 mn. We expect the market to remain subdued in the near-term as international investors exit the broader emerging markets due to the rising interest rates in the US, coupled with strengthening US dollar.

The market is currently trading at a price to earnings ratio (P/E) of 12.1x, 10.1% below the historical average of 13.5x, and a dividend yield of 4.8%, slightly above the historical average of 3.7%. Despite the current valuations being around the historical average, we believe there still exist pockets of value in the market. The current P/E valuation of 12.1x is 24.7% above the most recent trough valuation of 9.7x experienced in the first week of February 2017, and 45.6% 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.





Quarterly Highlights:

During the quarter;

?. President Uhuru Kenyatta signed the Finance Bill, 2018 into law on Friday 21st September, 2018, after Members of Parliament passed the proposed amendments to the Bill as highlighted in our Cytonn Weekly #36/2018. Key to note is that the assented Finance Bill 2018 does away with the floor on deposit pricing, which was initially set at 70.0% of the Central Bank Rate (CBR) but retains the cap on loan pricing at 4.0% above the CBR. This gives lenders flexibility on deposit pricing, which may see banks reduce their cost of funds. We are of the view that the new legislation will mean increased net interest margins (NIM) for banks due to reduced interest expense on deposits going forward,

i. The Central Bank of Kenya (CBK) proposed to introduce a Banking Sector Charter that will guide service provision in the sector as highlighted in our Cytonn Weekly #30/2018. 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 sources of credit to the economy such as privately placed investments solutions,

ii. The Central Bank of Kenya (CBK) downgraded the banking sector rating to "satisfactory", from a previous rating of "strong" in 2016 as highlighted in our Cytonn Weekly #32/2018. 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. 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 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,

iii. KCB Group emerged as the only bidder for a stake in Imperial Bank Limited (IBL), which is under receivership, after Diamond Trust Bank (DTB), having also expressed interest, pulled out of the deal. IBL was put under receivership in August 2015, with a loan book of Kshs 41.0 bn and deposits of Kshs 58.0 bn. The Central Bank of Kenya (CBK) and KDIC is to engage KCB in discussions with the aim of maximizing the value for depositors. If successful, this would mark the second instance a bank is brought out of receivership, after the recently concluded deal that saw SBM Kenya complete the acquisition of certain assets and Liabilities of Chase Bank Limited (under Receivership). For more information, see our Cytonn Weekly #29/2018, and

iv. Barclays Africa Group Limited changed its name to Absa Group following the London-based Barclays Plc's exit from the African market to concentrate on European and United States markets. Barclays Plc had acquired a majority stake of 56.4% in Absa Group in 2005, gradually increased its stake to 62.0% but reduced to 14.9% after selling to the large institutional investor Public Investment Corporation of South Africa (PIC). Its Kenyan subsidiary, however, is looking to complete the rebranding process by 2020 and will continue operating as Barclays Bank Kenya until then. We are of the view that with the exit of the London-based parent company, Barclays will be able to compete more favorably with its peers, as it plans to increase its market share in the region by 5 million customers by 2020. Thus, with more localized decision-making, the lender is well positioned to quickly exploit any opportunities that arise as well as build on their innovative profile that has seen the bank offer efficient services to its customers. For more information, see our Cytonn Weekly #27/2018.

Kenyan Listed Banks Results

During the quarter, listed banks in Kenya released their H1'2018 results, recording average core earnings growth of 19.0%. The table below highlights the performance of the banking sector, showing the performance using several metrics, and the key take-outs of the performance:

Listed Banking Sector Operating Metrics

Bank	Core EPS Growth	Interest Income Growth	Interest Expense Growth	Net Interest Income Growth	Net Interest Margin	Cost to Income Ratio	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%	50.1%	34.0%	50.0%	(4.2%)	21.3%	26.9%	15.4%	71.4%	3.1%	14.8%
NBK	39.3%	(9.6%)	(10.1%)	(8.9%)	6.9%	95.6%	(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%	61.0%	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%	52.0%	(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%	52.8%	1.5%	40.2%	(1.0%)	8.5%	18.7%	3.8%	69.9%	2.7%	23.9%
I&M	11.7%	5.1%	13.2%	0.1%	7.1%	53.7%	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%	54.9%	(1.6%)	32.1%	(2.6%)	3.9%	12.0%	(0.6%)	84.6%	3.9%	18.0%
Barclays	6.2%	7.6%	22.4%	4.0%	9.0%	66.3%	6.9%	30.0%	1.9%	14.9%	33.6%	7.5%	81.2%	2.60%	17.5%
DTB	2.5%	3.9%	3.0%	4.6%	6.5%	57.4%	8.0%	21.6%	7.2%	9.9%	22.5%	3.5%	70.4%	5.0%	15.5%
NIC Group	(2.1%)	8.6%	30.0%	(4.9%)	6.0%	60.9%	7.0%	29.5%	(3.0%)	10.5%	25.7%	(1.5%)	78.2%	5.4%	12.8%
Housing Finance	(95.7%)	(13.2%)	(12.7%)	(13.9%)	4.9%	99.3%	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%**	**55.7%**	**6.9%**	**34.3%**	**4.6%**	**10.0%**	**13.7%**	**3.8%**	**73.8%**	**3.4%**	**19.5%**
Weighted Average H1'2017**	**(14.4%)**	**(7.2%)**	**(6.0%)**	**(6.9%)**	**8.0%**	**59.2%**	**5.1%**	**34.0%**	**12.5%**	**9.4%**	**21.5%**	**7.3%**	**77.9%**	**3.4%**	**17.9%**

***** 31st August 2018**
****** 31st August 2017**

Key takeaways from the table above include:

?. The listed banks recorded a 19.0% average increase in core Earnings Per Share (EPS), compared to a decline of 14.4% in H1'2017. Only NIC Group and Housing Finance Group recorded declines in core EPS, registering declines of 2.1% and 95.7%, respectively. CFC Stanbic recorded the highest growth at 104.5% y/y, supported by 21.9% increase in total operating income, coupled with a 14.0% decrease in total operating expenses. HF Group recorded the biggest decline at 95.7%, on the back of a 13.9% decline in Net Interest Income (NII), and a high cost to income ratio of 99.3%;

i. The sector recorded a relatively strong deposit growth, which came in at 10.0%. The strong deposit growth led to a 12.0% growth in the interest expenses. However, the cost of funds remained flat at 3.4%, an indication that the greater proportion of deposit accounts were non-interest bearing;

ii. Average loan growth was anomic coming in at 3.8%, which was lower than 7.3% recorded in H1'2017, indicating that there was an even slower credit extension in the economy, due to sustained effects of the interest rate cap. Government securities on the other hand recorded a growth of 13.7% y/y, which was faster compared to the loans, albeit slower than 21.5% recorded in H1’2017. This indicates that banks’ continued preference towards investing in government securities, which offer better risk-adjusted returns. Interest income increased by 7.2%, as banks adapted to the interest rate cap regime, with increased allocations in government securities. This, however, should be a point of concern as it points to a reduction in the banking sector’s primary function of intermediation between depositors and credit consumers, with the loan to deposit ratio declining to 73.8% from 77.9% in H1’2017. Reduced credit extension especially to the private sector comprised mainly of the MSMEs, curtails both the short and long-run economic growth;

iii. The average Net Interest Margin in the banking sector currently stands at 8.1%, a slight improvement from the 8.0% recorded in H1’2017. The improvement was mainly due to the increase in Net Interest Income by 6.4% y/y, aided by the 7.9% improvement in the interest income y/y; and

iv. Non-funded Income grew by 6.9% y/y, faster than 5.1% recorded in H1’2017. The growth included a total fee and commission’s growth of 4.6% although it was slower than 12.5% recorded in H1’2017. The growth in fee and commission income was however subdued by the slow loan growth, thus impacting the fee and commission income from loans. Banks have however been focusing on expanding the other fee and commission income, with increased focus on transactional income from alternative transaction channels. Banks have been shifting focus to this revenue space, by offering holistic banking services such as advisory. With increased focus on other NFI sources such as transaction income from mobile and online channels, bancassurance, money remittance, and payment services etc., banks will likely see expansion in NFI going forward as net interest income remains somewhat subdued under the current interest rate cap regime.

For more information on the Kenyan listed Banks H1’2018 results, see our Kenya H1’2018 Banking Sector Report.

Equities Universe of Coverage:

Below is our Equities Universe of Coverage:

Banks	Price as at 29/06/2018	Price as at 21/09/2018	Price as at 28/09/2018	w/w change	q/q change	YTD Change	LTM Change	Target Price	Dividend Yield	Upside/ Downside
NIC Bank	35.5	26.5	25.3	(4.7%)	(28.9%)	(25.2%)	(28.3%)	48.8	4.0%	97.2%
Zenith Bank	25	20.8	21.5	3.4%	(14.0%)	(16.1%)	-7.70%	33.3	12.6%	67.5%
Diamond Trust Bank	199	172	174	1.2%	(12.6%)	(9.4%)	(4.9%)	283.7	1.5%	64.5%
Union Bank Plc	6.1	5.8	5.1	(12.1%)	(16.4%)	(34.6%)	(11.5%)	8.2	0.0%	59.8%
KCB Group	46.3	38	40.5	6.6%	(12.4%)	(5.30%)	(1.8%)	61.3	7.4%	58.8%
Ghana Commercial Bank	5.2	5.3	5.4	0.8%	3.9%	5.9%	29.5%	7.7	7.1%	51.4%
Equity Group	46.3	38.8	40	3.2%	(13.5%)	(0.6%)	2.6%	56.2	5.0%	45.5%
I&M Holdings	115	90	99	10.0%	(13.9%)	(1.0%)	(23.3%)	138.6	3.5%	43.5%
UBA Bank	10.5	8	8.4	5.0%	(20.0%)	(18.4%)	(0.7%)	10.7	10.1%	37.5%
Co-operative Bank	17.5	13.9	15.2	9.7%	(13.1%)	(5.0%)	(10.1%)	19.9	5.3%	36.2%
Ecobank	8.5	8.1	8	(1.6%)	(5.3%)	5.3%	25.7%	10.7	0.0%	34.1%
CRDB	160	160	160	0.0%	0.0%	0.0%	(8.6%)	207.7	0.0%	29.8%
Barclays	11.5	10.2	10.6	4.4%	(7.4%)	10.4%	5.0%	12.5	9.4%	27.4%

Banks	Price as at 29/06/2018	Price as at 21/09/2018	Price as at 28/09/2018	w/w change	q/q change	YTD Change	LTM Change	Target Price	Dividend Yield	Upside/ Downside
Access Bank	10.4	8.2	8.2	0.00%	(21.3%)	(22.0%)	(14.3%)	9.5	4.9%	21.5%
HF Group	8.5	6.7	5.8	(13.4%)	(31.8%)	(44.2%)	(39.5%)	6.6	6.0%	19.8%
CAL Bank	1.3	1.2	1.2	(0.8%)	(8.6%)	8.3%	33.7%	1.4	0.0%	19.7%
Stanbic Bank Uganda	32	33	33	0.0%	3.1%	21.1%	20.0%	36.3	3.5%	13.5%
Standard Chartered	198	195	192	(1.5%)	(3.0%)	(7.7%)	(16.2%)	196.3	6.5%	8.8%
Guaranty Trust Bank	40.5	34.7	36.4	4.8%	(10.2%)	(10.8%)	(9.1%)	37.1	6.6%	8.7%
Bank of Kigali	286	290	289	(0.3%)	1.0%	(3.7%)	3.20%	299.9	4.8%	8.6%
Bank of Baroda	150	126	126	0.0%	(16.0%)	11.5%	14.5%	130.6	2.0%	5.6%
SBM Holdings	7.3	6.6	6.5	(0.9%)	(10.7%)	(13.3%)	(17.7%)	6.6	4.6%	5.5%
Stanbic Holdings	91.5	90	90	0.0%	(1.6%)	11.1%	13.9%	92.6	2.5%	5.4%
National Bank	6.3	5.5	5.8	6.4%	(7.2%)	(38.0%)	(38.3%)	4.9	0.0%	(15.5%)
Stanbic IBTC Holdings	52	42	46	9.5%	(11.5%)	10.8%	15.0%	37	1.3%	(18.3%)
FBN Holdings	10.6	8.6	8.9	3.5%	(16.0%)	1.1%	62.7%	6.6	2.8%	(22.7%)
Standard Chartered	23.1	26	26.1	0.3%	12.8%	3.4%	54.5%	19.5	0.0%	(25.4%)
Ecobank Transnational	20	18	17.9	(0.6%)	(10.5%)	5.3%	1.1%	9.3	0.0%	(48.2%)

***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 are in respective country currency**

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.

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