Cytonn Corporate Governance Report - 2018, & Cytonn Weekly #39/2018

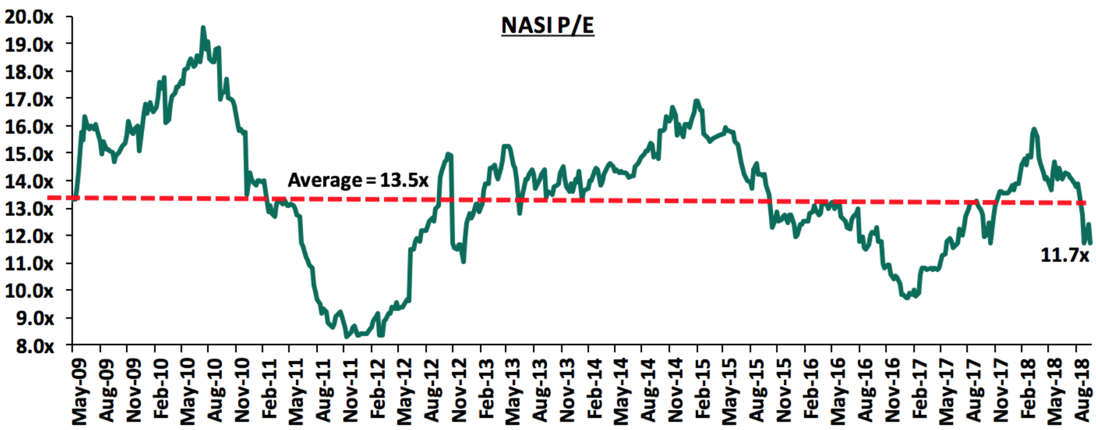
Equities

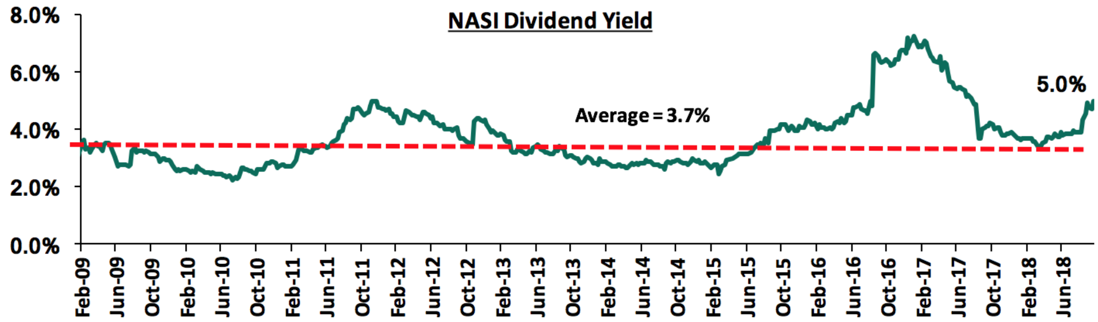
Market Performance:

During the week, the equities market was on downward trend with NASI, NSE 20 and NSE 25 declining by 4.4%, 2.0% and 4.3%, respectively, taking their YTD performance to declines of 15.7%, 24.4% and 17.5%, respectively. This week's performance was driven by declines in large cap counters such as Safaricom, Equity Group, KCB Group, Barclays Bank of Kenya and Standard Chartered Bank, which declined by 7.1%, 6.2%, 5.2%, 2.8% and 2.1%, respectively. For the last twelve months (LTM), NASI, NSE 20 and NSE 25 have declined by 9.3%, 22.9% and 11.9%, respectively.

Equities turnover decreased by 66.7% to USD 11.3 mn from USD 34.0 mn the previous week, bringing the YTD turnover to USD 1.5 bn. Foreign investors remained net sellers, with net weekly outflows decreasing by 12.5% to USD 7.0 mn, from USD 8.0 mn previously. We expect the market to remain subdued in the near-term as international investors exit the broader emerging markets due to the expectation of rising US interest rates coupled with the strengthening US Dollar.

The market is currently trading at a price to earnings ratio (P/E) of 11.7x, which is 12.8% below the historical average of 13.5x, and a dividend yield of 5.0%, higher than the historical average of 3.7%. The current P/E valuation of 11.7x is 19.8% above the most recent trough valuation of 9.8x experienced in the first week of February 2017, and 41.3% 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:

The Central Bank of Kenya (CBK) released the Kenya Financial Sector Stability Report 2017, highlighting the stability of the banking sector over the period between January to December 2017. Key highlights for the banking sector in the period covered in the report include:

- The banking industry comprised 42 commercial banks, 1 mortgage finance company, 13 microfinance banks, 8 representative offices of foreign banks, 73 foreign exchange bureaus, 19 money remittance providers, 8 non-operating bank holding companies and 3 credit reference bureaus in 2017. DIB (Dubai Islamic Bank) Bank Kenya Limited and Mayfair Bank Limited were licensed to operate banking businesses in Kenya, while Société Générale of France opened a Representative Office in Kenya, while Central Bank of India (CBI) closed down its Representative Office;
- Three acquisitions were completed in the period; Fidelity Commercial Bank Ltd was acquired by SBM Holdings Ltd, Giro Commercial Bank Ltd was also acquired by I&M Holdings Ltd, while Habib Bank (K) Ltd was acquired by Diamond Trust Bank Kenya Ltd. Below is a summary of the completed deals in the last 5 years;

Summary of Acquisition Transactions

Acquirer	**Bank Acquired**	**Book Value at Acquisition (Kshs bns)**	**Transaction Stake**	**Transaction Value (Kshs bns)**	**P/Bv Multiple**	**Date***
SBM bank Kenya	Chase Bank ltd	Unknown	75.0%	Undisclosed	**N/A**	Aug-18
Diamond Trust Bank Kenya	Habib Bank Limited Kenya	2.38	100.0%	1.82	**0.8x**	Mar-17
SBM Holdings	Fidelity Commercial Bank	1.75	100.0%	2.75	**1.6x**	Nov-16
M Bank	Oriental Commercial Bank	1.80	51.0%	1.30	**1.4x**	Jun-16
I&M Holdings	Giro Commercial Bank	2.95	100.0%	5.00	**1.7x**	Jun-16
Mwalimu SACCO	Equatorial Commercial Bank	1.15	75.0%	2.60	**2.3x**	Mar-15
Centum	K-Rep Bank	2.08	66.0%	2.50	**1.8x**	Jul-14
GT Bank	Fina Bank Group	3.86	70.0%	8.60	**3.2x**	Nov-13
Average			**80.3%**		**1.8x**	
***Announcement date**						

- Banks were generally well capitalized during the period, with capital adequacy ratios remaining above minimum regulatory requirements. Total Capital to Total Risk Weighted Assets ratio increased to 18.8% as at December 2017, from 16.6% as at March 2017, which was higher than the minimum requirement of 14.5%;

- The aggregate banks' balance sheet expanded in 2017, with total net assets growing by 8.1% to Kshs 4.0 tn in December 2017 from Kshs 3.2 tn in December 2016. Growth in assets was attributed to increased investment in government securities, which grew by 15.3% to Kshs 998.4 bn in 2017, from Kshs 865.9 bn in 2016. There was slower private-sector credit growth of 2.5% in the period compared to 9.4% in 2016. This was attributed to increased uncertainties during the election period, which limited banks' ability to price risk appropriately in an interest rate-cap environment. Majority of loans were allocated to Manufacturing, Real Estate, Energy and Water, and Personal/Household sectors;
- Aggressive mobilization of deposits by banks saw a 10.8% growth in deposits to Kshs 2.9 tn in December 2017 from Kshs 2.6 bn in 2016. However, most deposits were local currency deposits from transactional accounts, hence limiting banks' capacity to finance long-term assets. The faster growth in deposits compared to loans led to a decrease in the loan to deposit ratio (LDR) to 83.1% in December 2017 from 87.4% in December 2016;
- The asset quality, as measured by the non-performing loans ratio, deteriorated to 11.0% in December 2017 from 9.3% in December 2016, signifying increased credit risks in 2017. Gross non-performing loans (NPLs) grew by 23.4% to Kshs 264.6 bn in December 2017 from Kshs 214.4 bn in December 2016. Trade, personal/household, real estate and manufacturing sectors accounted for the largest share of NPLs, at 73.1% of gross NPLs. The decline in asset quality was attributed to sluggish economic growth, occasioned by a prolonged election period, coupled with the effects of drought in 2017. The NPL coverage ratio decreased to 34.5% in December 2017 from 37.6% in December 2016, implying more exposure to credit risks;
- The banking sector's pre-tax profits decreased by 9.6% to Kshs 133.2 bn in December 2017 from Kshs 147.3 bn in December 2016. Total operating income decreased by 3.1% in 2017 to Kshs 486.3 bn, while total expenses fell by 0.5% to Kshs 353.1 bn in December 2017. The decrease in profitability resulted from reduced lending to the private sector, high cost of deposits and slow economic growth in 2017 compared to 2016. We are of the view that banks' earnings will increase going forward as banks adjust their business models by lowering the deposit rates to increase their net interest spreads to reflect the scrapping of the floor on deposits, which had been pegged at 70% of the prevailing CBR rate;
- Return on Equity (ROE) and Return on Assets (ROA) of the banking sector have declined since 2016, with ROA declining to 2.6% from 3.2% in December 2016 while ROE declined to 20.6% from 24.4% in December 2016. This indicates a decrease in profitability of the banking sector over the period, with earnings being affected by the interest rates capping legislation that came into law in September 2016;
- Banks' overall liquidity rose to 43.7% in December 2017 from 41.4% in December 2016, against a minimum ratio of 20.0%. The increase in liquidity is attributed to 16.3% growth in total liquid assets, which were mainly government securities.

The data shows that commercial banks adjusted their business models in favor of lending to large corporate borrowers and purchase of government debt. This in turn reduced lending to small borrowers who were perceived as risky by the lenders. Overall, the banking sector remained resilient despite interest rates caps. As at December 2017, banks were well-capitalized with core and total capital to risk weighted assets averaging 16.5% and 18.8% above the regulatory requirements of 10.5% and 14.5%, respectively.

From our Kenya Listed Banks H1'2018 report, we saw that the banking sector has had an improvement in performance in H1'2018, largely aided by the improving economic conditions and a more conducive operating environment compared to a similar period last year. However, the banking sector continues to be fraught by two main challenges: (i) the deteriorating asset quality brought about by spilled over effects of the challenging operating environment experienced in 2017, and (ii) the capping of interest rates, which has led to subdued growth in the credit extended to the private sector. We believe the key factors banks need to consider going forward are asset quality management, continued revenue diversification, efficiency, and downside regulatory compliance risks amid tighter regulatory requirements. We believe the banking sector is well poised to grow in future and continue to outperform other sectors.

Equities Universe of Coverage:

Below is our Equities Universe of Coverage:

Equities Universe of Coverage

Banks	Price as at 5/10/2018	Price as at 12/10/2018	w/w change	YTD Change	LTM Change	Target Price*	Dividend Yield	Upside/Downside**	P/TBv Multiple
NIC Bank***	24.5	24.5	0.0%	(27.4%)	(25.1%)	48.8	4.1%	103.3%	**0.6x**
KCB Group	38.8	36.8	(5.2%)	(14.0%)	(1.7%)	61.3	8.2%	75.0%	**1.2x**
Diamond Trust Bank***	165.0	165.0	0.0%	(14.1%)	(9.3%)	283.7	1.6%	73.5%	**0.9x**
Union Bank Plc	5.0	5.0	(1.0%)	(36.5%)	(13.9%)	8.2	0.0%	64.6%	**0.5x**
Zenith Bank***	21.6	22.2	3.0%	(13.4%)	(12.1%)	33.3	12.2%	62.3%	**1.0x**
Equity Group	40.5	38.0	(6.2%)	(4.4%)	7.0%	56.2	5.3%	53.2%	**1.9x**
Ghana Commercial Bank***	5.3	5.4	0.2%	5.9%	33.8%	7.7	7.1%	51.4%	**1.3x**
I&M Holdings***	91.0	95.0	4.4%	(25.2%)	(21.5%)	138.6	3.7%	49.6%	**0.9x**
UBA Bank	8.2	8.1	(1.2%)	(21.4%)	(12.0%)	10.7	10.5%	42.6%	**0.5x**
Co-operative Bank	15.4	15.4	0.0%	(4.1%)	(7.0%)	19.9	5.2%	34.9%	**1.4x**
Ecobank	8.5	8.0	(5.3%)	5.3%	22.4%	10.7	0.0%	34.1%	**1.9x**
Barclays	10.7	10.4	(2.8%)	7.8%	6.7%	12.5	9.7%	30.4%	**1.5x**
CRDB	160.0	160.0	0.0%	0.0%	(8.6%)	207.7	0.0%	29.8%	**0.5x**
Access Bank	8.1	8.0	(0.6%)	(23.4%)	(17.9%)	9.5	5.0%	23.8%	**0.5x**
CAL Bank	1.2	1.2	(0.9%)	7.4%	32.6%	1.4	0.0%	20.7%	**1.0x**
Stanbic Bank Uganda	33.0	33.0	0.0%	21.1%	21.1%	36.3	3.5%	13.5%	**2.3x**
HF Group***	5.9	6.2	4.2%	(40.9%)	(37.9%)	6.6	5.7%	13.0%	**0.2x**
Standard Chartered	190.0	186.0	(2.1%)	(10.6%)	(17.3%)	196.3	6.7%	12.3%	**1.5x**
SBM Holdings	6.3	6.3	(0.6%)	(16.3%)	(19.1%)	6.6	4.8%	9.2%	**0.9x**
Bank of Kigali	289.0	289.0	0.0%	(3.7%)	1.4%	299.9	4.8%	8.6%	**1.6x**
Guaranty Trust Bank	36.4	36.5	0.4%	(10.4%)	(12.5%)	37.1	6.6%	8.2%	**2.3x**
Bank of Baroda	140.0	126.0	(10.0%)	11.5%	14.5%	130.6	2.0%	5.6%	**1.2x**
Stanbic Holdings	90.0	91.0	1.1%	12.3%	14.5%	92.6	2.5%	4.2%	**0.9x**
National Bank	5.2	5.2	0.0%	(44.4%)	(47.2%)	4.9	0.0%	(5.8%)	**0.4x**
Stanbic IBTC Holdings	42.5	45.1	6.1%	8.7%	9.5%	37.0	1.3%	(16.6%)	**2.2x**
FBN Holdings	8.9	9.1	2.2%	3.4%	48.9%	6.6	2.7%	(24.4%)	**0.5x**
Standard Chartered	26.1	26.1	0.0%	3.4%	54.8%	19.5	0.0%	(25.4%)	**3.3x**
Ecobank Transnational	17.5	17.5	0.0%	2.9%	4.5%	9.3	0.0%	(47.0%)	**0.6x**

***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 since the markets are currently trading below historical P/E averages. However, pockets of value continue to exist, with a number of undervalued sectors like Financial Services, which provide an attractive entry point for medium and 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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