Cytonn Annual Markets Review - 2018

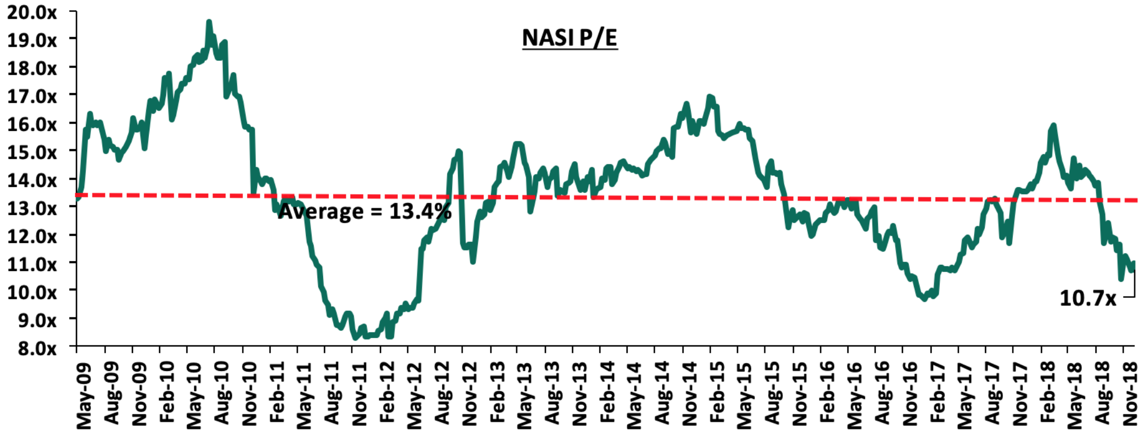
Equities

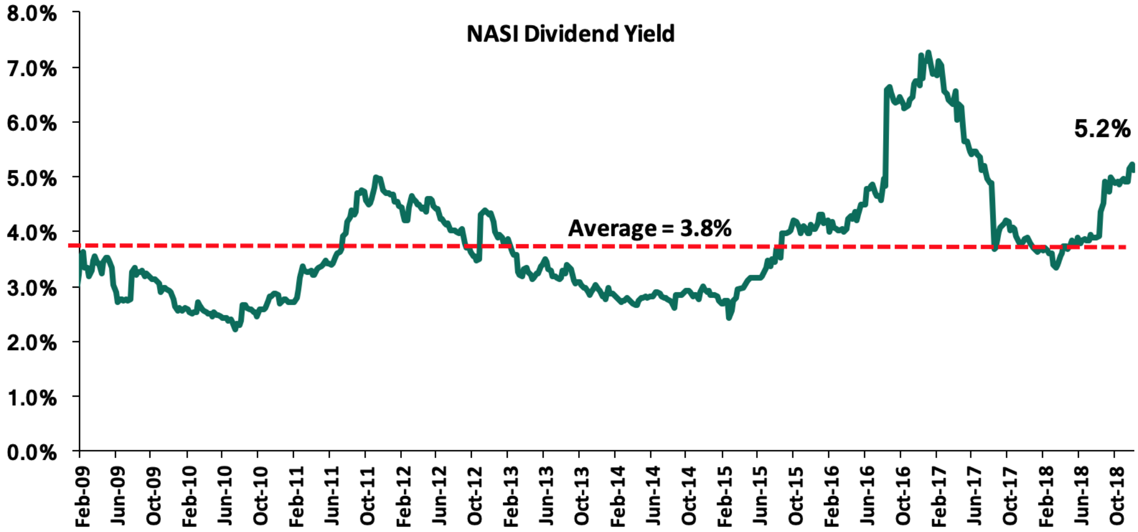
Market Performance

During the year, the Kenyan equities market was on a downward trend, with NASI, NSE 25 and NSE 20 declining by 18.0%, 17.1% and 23.7%, respectively. Since the peak in February 2015, NASI and NSE 20 are down 20.9% and 48.4%, respectively. The only large cap gainer during the year was Barclays Bank, which gained 14.1%, while the largest losers were East Africa Breweries (EABL), Bamburi Cement, Diamond Trust Bank (DTB), NIC Group and Safaricom, which lost 26.6%, 26.4%, 18.5%, 17.6% and 17.0% during the year, respectively. Key to note is that Safaricom continues to be a key part of Kenyan equities portfolios, accounting for 42.4% of Nairobi Stock Exchange (NSE's) market capitalization, and has dominated on both the market turnover and in determining the direction of the market given its weight and liquidity in the Nairobi Securities Exchange.

Equity turnover during the year rose by 2.3% to USD 1,723.8 mn from USD 1,684.4 mn in FY'2017. Foreign investors turned net sellers with a net outflow of USD 425.6 mn compared to net outflows of USD 113.7 mn recorded in FY'2017. The foreign investor outflows during the year can be attributed to negative investor sentiment, as international investors exited 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 10.7x, 19.9% below the historical average of 13.4x, and a dividend yield of 5.2%, above the historical average of 3.8%. The current P/E valuation of 11.0x is 9.6% above the most recent trough valuation of 9.8x experienced in the first week of February 2017, and 29.2% 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.





Banking Sector Earnings

During the year, Kenyan listed banks released their Q3'2018 results recording an average increase in core earnings per share of 16.2%, compared to an average decline of 9.3% in Q3'2017, owing to the improved efficiency because of digitization strategies employed by banks in streamlining operations. Only NIC Group and HF Group recorded a decline in core earnings per share, with NIC reporting a 3.3% decline while HF Group recorded a loss per share of Kshs 0.9 from a core EPS of 0.5 in Q3'2017. The table below highlights the performance of the banking sector using several metrics, and the key take-outs of the performance. The table below highlights the performance of the banking sector, showing the performance using several metrics, and they the key take-outs of the performance.

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	CIR	Loan Growth	LDR	Return on Average Equity
NBK	303.2%	(10.5%)	(11.5%)	(10.0%)	6.6%	(16.3%)	26.8%	(18.7%)	(4.7%)	3.2%	91.8%	(17.1%)	51.7%	3.2%
Stanbic Bank	46.7%	13.3%	19.7%	9.7%	4.9%	19.6%	47.0%	9.3%	20.3%	16.7%	57.9%	16.3%	77.8%	14.3%
SCBK	33.9%	4.8%	2.1%	5.9%	8.5%	9.7%	32.6%	31.2%	(8.0%)	(6.1%)	57.2%	(2.8%)	50.6%	18.6%
KCB Group	19.7%	5.1%	16.0%	1.8%	8.5%	2.6%	33.1%	(7.9%)	6.2%	15.3%	52.8%	3.8%	82.6%	21.7%
I&M Holdings	18.3%	3.3%	16.8%	(4.9%)	6.7%	38.4%	35.1%	30.1%	27.6%	8.0%	51.7%	8.6%	78.1%	17.2%
DTBK	10.0%	3.0%	3.0%	2.9%	6.1%	6.3%	21.7%	7.4%	6.5%	17.7%	56.9%	0.7%	70.0%	13.3%
Co-op Bank	8.2%	3.5%	0.7%	4.7%	8.3%	4.3%	32.7%	(29.7%)	2.5%	16.9%	55.1%	(2.0%)	85.9%	17.6%
Equity Group	8.1%	8.6%	13.5%	7.2%	8.5%	(6.7%)	40.0%	(1.7%)	9.1%	24.1%	54.6%	8.6%	71.7%	22.2%
Barclays Bank	2.0%	7.7%	30.1%	2.1%	9.1%	14.0%	30.8%	5.5%	9.9%	29.5%	65.9%	6.7%	81.0%	16.5%
NIC Group	(3.3%)	5.5%	22.2%	(5.9%)	5.8%	7.2%	30.9%	5.7%	10.3%	16.2%	60.6%	(3.1%)	79.3%	12.1%
HF Group	N/A	(14.1%)	(11.7%)	(17.8%)	4.6%	(7.2%)	25.0%	(30.9%)	3.1%	429.5%	113.5%	(11.3%)	90.7%	(3.3%)
Weighted Average Q3'2018*	**16.2%**	**6.1%**	**12.5%**	**3.8%**	**8.0%**	**5.9%**	**34.5%**	**0.6%**	**7.4%**	**17.8%**	**56.3%**	**4.2%**	**75.3%**	**18.8%**
Weighted Average Q3'2017*	**(9.3%)**	**(5.8%)**	**(0.5%)**	**(7.3%)**	**8.5%**	**10.9%**	**33.3%**	**10.5%**	**13.8%**	**10.3%**	**59.4%**	**6.1%**	**77.7%**	**17.5%**

**Market cap weighted as at 30th November 2018/2017 respectively*

Key highlights from the table above include:

i. Average deposit growth came in at 7.4%, weaker than the 13.8% growth recorded in Q3'2017. Despite the slower deposit growth, interest expenses increased by 12.5%, indicating banks have been mobilizing expensive deposits, as well as taking up borrowed funds from international financial institutions, thereby driving up the interest expense,

ii. Average loan growth was anemic at 4.2%, lower than 6.1% recorded in Q3'2017, indicating slower credit extension in the economy, due to sustained effects of the interest rate cap,
iii. Investment in government securities recorded a growth of 17.8% y/y, which was faster compared to the loan growth at 4.2%, and faster than 10.3% increase recorded in Q3'2017. This indicates that banks' continued preference towards government securities, which offer better risk-adjusted returns,
iv. Non-funded Income grew by 5.9% y/y, slower than 10.9% recorded in Q3'2017. The growth in NFI was weighed down as total fee and commission growth was flat, growing by 0.6%, slower than the 10.5% growth recorded in Q3'2017. The growth in fee and commission income continued to be subdued by the slow loan growth, and,
v. The average Net Interest Margin in the banking sector currently stands at 8.0%, down from the 8.5% recorded in Q3'2017, despite the Net Interest Income increasing by 3.8% y/y. The decline was mainly due to the faster 17.8% increase in allocation to relatively lower yielding government securities,

For a comprehensive analysis on the Kenya Listed Banks performance, see our Cytonn Q3'2018 Banking Sector Report

Other Key Results

Safaricom Limited released H1'2019 results, recording core earnings per share growth of 20.2% to Kshs 0.8 from Kshs 0.6 in H1'2018. The earnings growth was supported by a 7.7% growth in service revenue (M-PESA, messaging, mobile data and fixed service) to Kshs 118.2 bn from Kshs 109.7 bn in H1'2018 due to increased usage of non-voice services, particularly M-PESA services, coupled with a 3.5% decline in direct costs to Kshs 4.3 bn from Kshs 4.5 bn in H1'2018.

This year, 8 companies issued profit warnings to investors compared to 6 companies in 2017, despite the improving macro-economic environment in 2018. Companies are required to issue profit warnings if they project a more than 25% decline in profits year-on-year. They are namely Deacons, UAP Holdings, Bamburi, Sameer Africa, HF Group, Britam Holdings, KPLC and Sanlam:

i. Bamburi attributed the shortfall in profits to difficult market conditions and escalating energy prices in Kenya and Uganda, as well as increasing costs of power in the country,
ii. UAP Holdings attributed the drop to dwindling investment income due to the poor performance of the equities market in H2'2018, coupled with low rental yields and occupancy rates on property in Kenya and South Sudan, leading to adverse valuations on property. The drop was also on the back of one-off redundancy costs associated with staff re-organisation efforts,
iii. Sameer Africa was affected by severe stock shortages due to production bottlenecks experienced by some its major offshore trading partners,
iv. In HF Group's case, downward revisions of the Central Bank Rate (CBR) affected interest income, while a tough operating environment in 2017 occasioned a deterioration in asset quality, hence affecting business performance. The Group also undertook a redundancy exercise in tandem with implementation of its Digital Strategy, in which it incurred a one-off redundancy cost,
v. Deacons, a fashion retailer, attributes its expected loss to reduced traffic to malls where 98% of its stores, due to non-performance of major anchor tenants such as Nakumatt, coupled with the loss of revenue arising from discontinued operations and diminished operating margins which have contributed to cash flow constraints,
vi. Britam's expected decline is attributable to the downward equity markets trend that reduced returns from equity investments, and a challenging operating environment,
vii. KPLC attributed the expected decline in profits to a challenging economic environment, poor hydrological conditions and the protracted electioneering period in 2017,
viii. Sanlam attributes the expected decline in profits to the 100% impairment of Kshs 1.1 bn corporate bonds placed in currently distressed local enterprises as well as effects of the interest rate capping such as restricted access to bank credit

Listings, De-listings and Suspensions

On November 30, 2018, Rwandese firm BK Group Plc (Bank of Kigali) cross-listed its shares on the Nairobi Securities Exchange (NSE), becoming the first Rwandese company to tap into the Kenyan capital market. Established in 1966, BK Group is Rwanda's largest lender in assets with operations across banking, insurance and investments. BK Group raised Kshs 7.0 bn from the exercise, which was to be used to capitalize subsidiaries in the bank's expansion drive.

During the year, the Nairobi Securities Exchange (NSE) suspended the following companies from trading on the bourse:

a. Deacons (East Africa), with the suspension period to last 40 days from November 19th 2018, following the invocation of the Insolvency Act as the company ran into financial distress, and,
b. ARM Cement, effective August 30, 2018, following its placement under administration after it became insolvent and was unable to meet its obligations to creditors.

Legislations and other Developments

The year 2018 saw enactment of a number of legislations and other developments that affected the equities market and investor sentiment, namely:

i. The National Assembly voted to retain the cap on loans in the Finance Act 2018, effectively retaining the 4.0% cap above the Central Bank Rate (CBR) on interest chargeable on loans. However, the 70.0% of the CBR floor on interest payable on deposits was scrapped, effectively enabling banks to reduce interest payable on customer deposits. With the removal of the same, banks have adjusted accordingly, with various players indicating a lowering of their interest expense requirements, and a possible improvement in the Net Interest Margin, whose benefits will be fully realized in 2019. Regulation in the sector centered on consumer protection and promoting prudence in the financial services sector,
ii. Draft Financial Markets Conduct Bill 2018: The National Treasury completed the Draft Financial Markets Conduct Bill that sought to create effective financial consumer protection, make credit more accessible and consequently support financial innovation and competition. The Bill's main objectives thus are (i) to ensure better conduct by banks and other lenders in terms of extending credit to retail financial customers, and (ii) to provide consumer protection, mainly for retail customers by ensuring their credit contracts are clear and well understood in terms of interest, fees, charges and costs on credit facilities, thereby removing the opacity that has been existent in loan pricing. For more information, see our Draft Financial Markets Conduct Bill, 2018 Note ,
iii. Banking Sector Charter: The Central Bank of Kenya 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. It is expected to facilitate a market-driven transformation of the Kenyan banking sector, thereby considerably improving the quality of service provided, and increasing access to affordable financial services for the unbanked and under-served population,
iv. IFRS 9 Implementation: With the implementation of IFRS 9, which took effect from 1st January 2018, banks total capital position relative to their risk-weighted assets declined by an average of 0.4%. The implementation of IFRS 9 forced banks to review their business models, strategic objectives and credit policies. Thus, banks adopted stringent lending policies, and consequently skewed lending towards collateral based lending as opposed to unsecured lending. To avoid the high provisioning levels that would be required, banks unwillingness to lend to the private sector and more specifically to SMEs is likely to persist, and
v. Large Cash Transactions Restrictions by Kenya Bankers Association: The KBA, in a circular, directed bank managers to ensure customers also provide supporting evidence for their source of cash when depositing and its use while withdrawing. Bank customers planning to withdraw or deposit Kshs 10.0 mn and above in cash will now be required to give a three-day notice and get

clearance from their respective branch managers.

vi. The Nairobi Securities Exchange (NSE) launched Ibuka, an incubation and acceleration program aimed at addressing the recent lack of listings at the NSE. The program has attracted Expression of Interest from 13 companies including Tuskys Supermarket, while 10 other companies have shown a keen interest in participating. The program, in our view, is a great initiative that will go a long way in increasing the number of listings in the NSE as it will sensitize companies on the importance of listing and prepare them for the process.

vii. Kenya Commercial Bank (KCB) will acquire some prime Imperial Bank branches following a takeover of the collapsed lender's loan book. Imperial Bank had 27 branches when it went into receivership. Financial details of the takeover are however yet to be made public. Depositors now have access to approximately 12.7% of deposit balances through KCB's deposit recovery process, assisted by the Kenya Deposit Insurance Corporation (KDIC). Imperial Bank went in to receivership on October 13th, 2015, with Kshs 58.0 bn in customer deposits and 52,398 deposit accounts, and operations in Kenya and Uganda. We expect consolidation in the sector, as smaller banks with depleted capital positions and not serving a particular niche are acquired as their performance deteriorates due to the sustained effects of the Banking (Amendment) Act 2015.

In 2018, Kenya's operating environment was characterized by improving macro-economic conditions owing to a recovery in agriculture due to improved rainfall as well as low inflation and improved investor confidence. However, despite the economic recovery in 2018, the market has slumped and brought the market P/E below its' historical average of 13.4x to 10.7x, below the most recent peak of 15.9x in April, showing that pockets of value still exist. We remain neutral on equities for investors with short-term investment horizon, but are positive for investors with a long-term investment horizon.