Focus on Cytonn Q3?2015 Banking Sector Report, and Cytonn Weekly Report #48

Cytonn Weekly

Executive Summary

- **Fixed Income:** Yields on government securities increased for the second week. According to the Economic Insight Africa Q4?2015, Kenya is among the most vulnerable countries in Africa to the impending Fed rate hike this month;
- **Equities:** The market maintained its upward trend during the week, with NASI, NSE 20 and NSE 25 gaining 1.0%, 0.1% and 0.2%, respectively. Uchumi receives another Kshs 500 mn loan from KCB to increase stocks during the festive season;
- **Private Equity:** The PE market witnessed increased inflows driven by global capital looking for opportunities in Africa together with the increased ease of exit;
- **Real Estate:** Value of real estate developments approved by the Nairobi City Council increases by 53.1% in Q3?2015 from Q1?2015, indicating a growing and vibrant sector;
- **Focus of the Week:** Q3?2015 banking report analyzing the total return and franchise attractiveness of Kenyan listed banks;

Company Updates

- Cytonn?s Board of Directors appoints Mr. Michael Bristow to its Board of Directors. Mr. Bristow brings a wealth of financial services sector knowledge to the board. He is the Chairman of Central Depository & Settlement Corporation Limited (?CDSC?) and a director at the Financial Sector Deepening Africa. See announcement at Cytonn Appoints Mr. Michael Bristow To Its Board
- Paul Gichoro has joined the firm as a marketing and advertising associate. Prior to that he was the brand manager with Keroche Breweries and has also worked in the marketing division at Britam. Paul will join the brand team that is working to position Cytonn as the leading brand in real estate, private equity and structured investment solutions
- Cytonn Investments exits Kshs. 220 Million Structured Real Estate Note with Taaleritehdas Private Equity Funds. Find more details here:
  - Cytonn Investments Exits Kshs. 220 Million Structured Real Estate Note With Taaleritehdas Private Equity Funds
  - Cytonn pays Sh220m debt owed to Finnish PE firm
- Our Senior Investment Analyst, Duncan Lumwamu discussed the performance of the Kenya Shilling. See link on CNBC Africa Duncan on CNBC Africa
- Our Investment Manager, Maurice Oduor discussed Cytonn Q3?2015 Banking sector report and the COMESA extension of the safeguards against cheap sugar imports to Kenya. See link on CNBC Africa Maurice discussing Cytonn Q#'2015 Banking Sector Report
- We continue to beef up the team with the ongoing hires.

Fixed Income

Treasury bill auctions were undersubscribed during the week, with overall subscription coming in at 92.3%, compared to 82.6% the previous week despite high liquidity in the money market. Investors preferred to keep short as indicated by the 91 day paper which was oversubscribed (157% subscription rate) while the 182 and 364 day paper were undersubscribed. Yields on the treasury bills were on an upward trend for the 2nd week with the 91, 182 and 364 day coming in at 9.7%, 11.1% and 12.6%, respectively, from 9.2%, 10.6% and 12.2% the previous week. The Government recently issued a 9-Year amortised infrastructure bond with a weighted tenor of 7 years to raise Kshs 30 bn for financing infrastructural developments. The bond registered a subscription of 55.3% with the rate coming in at 14.8% as investors demanded a premium above the current rate. Given that this bond is tax exempt, the yield is equivalent to 17.4% for a 7-year taxable bond.

The interbank rates declined to 4.4% from 4.5% last week and the liquidity distribution has continued to improve. The high liquidity can be attributed to the Central Bank activity of pumping in money through reverse repos. Since November, the Central Bank has injected Kshs 96.7 bn in support of small banks with the aim of redistributing liquidity, which since the closure of Imperial Bank has been skewed towards large banks.

The shilling was relatively stable during the week, closing the week at Kshs 101.9 to the US$ despite the high liquidity in the money market.

The United States Federal Open Market Committee (FOMC) is expected to raise interest rates for the first time since the 2008 recession in its December 2015 meeting. This is on the back of (i) strong labour market statistics, where the US added 211,000 jobs vs an expectation of 192,000, and (ii) low unemployment rates, with the rate falling to 5.2%. The interest rate hike is expected to put pressure on the Kenya Shilling as the US Dollar strengthens. According to the Economic Insight Africa Q4?2015 report, Kenya ranks 6th on the list of the most vulnerable countries in Africa to the impending rate hike by the Fed this month. The ?Fed Proof Index? ranks the countries using the following three metrics;

- **The current account balance** - an economy with a higher current account deficit will be more vulnerable to sudden capital outflows given high dependence on imports. As its currency depreciates, imports become more expensive to the local population. Kenya?s current account deficit is at 10.4% of the GDP
- **Growth in private sector credit** - Rapid credit growth often, but not always, underpins strong growth in asset prices such as housing or equities. With the reversal of capital flows, the prices of such markets can often correct quite sharply rather quickly
- **The ratio of foreign debt to reserves** - High levels of external debt correspond to a high vulnerability to capital outflows and currency depreciation in a given economy. Kenya?s foreign debt to reserves currently stands at 2.0x. Recently the Government secured a USD 1.5 bn loan from China Exim Bank, to fund 85.0% of the extension of the Standard Gauge Railway (SGR) from Nairobi to Naivasha further adding to its foreign debt obligations

Kenya ranks poorly in the above metrics and given its high dependence on imports and foreign debt, the impending Fed rate hike is expected to have a negative impact on the Kenyan economy as the Government will face challenges in servicing the dollar denominated debt and this will exert pressure on the local currency.

COMESA has granted Kenya an extension to February 2017 on the limits of sugar imports to 350,000 tonnes per year which will avail Kenya the chance to (i) reform the sugar industry that will entail privatization of sugar mills, (ii) introduce new strains of cane that are drought resistant and (iii) improve infrastructure in cane growing areas. All these initiatives will help improve the efficiency in the sugar industry and eventually lead to the reduction of the cost of sugar production which currently stands at USD 570 per tonne, one of the highest in Africa. This will enable local sugar companies compete effectively with their COMESA counterparts. In our view the extension may not change much in the sugar industry given the time the processes take to be implemented.

Despite the Government being ahead of target in its domestic borrowing programme, having borrowed Kshs 168.2 bn (total domestic borrowing is set to be Kshs 219bn for this year) for the current fiscal year compared to a target of about Kshs 100.4 bn assuming a pro-rated borrowing throughout the financial year, the pressure on rates is expected to persist since most of these are short term instruments that mature within the current fiscal year and the Government will face pressure in refinancing the obligations as they mature. As a result of this, we maintain our view that investors should be biased towards short-term fixed income instruments given the uncertainty in the interest rate environment.

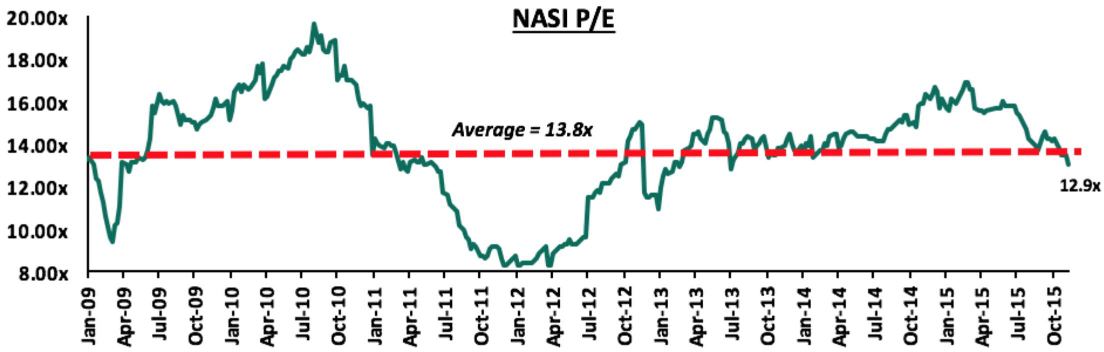
Equities

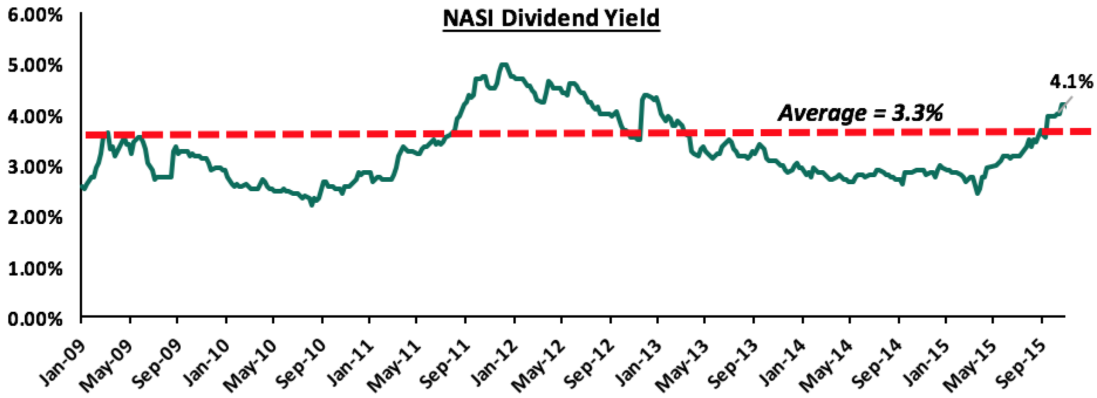
During the week, the market was on an upward trend with NASI, NSE 20 and NSE 25 gaining 1.0%, 0.1% and 0.2%, respectively, on the back of gains in large caps led by Safaricom, BAT and EABL which rose 4.5%, 0.6% and 0.4%, respectively. Since the February peak, NASI and NSE 20 have shed 18.5% and 27.4%, and 11.2% and 21.9% on an YTD basis, respectively. NSE 25 index is down 0.1% from inception to date.

Equities turnover rose by 26.8% during the week to Kshs 3.5 bn from Kshs 2.8 bn the previous week. Foreign investors were net sellers with net outflows of Kshs 75.2 mn, which was a 76.2% decline from net outflows of Kshs 316.2 mn witnessed last week. The sustained foreign investors net outflow can be linked to a shift in global investor portfolio flows based on the impeding rate increase in the US that has reduced their risk appetite for securities in emerging and frontier markets.

The market is currently trading at a price to earnings ratio of 12.9x, versus a historical average of 13.8x, with a dividend yield of 4.1% versus a historical average of 3.3%. In our view, the challenging operating environment in 2015, which has seen 12 companies at the NSE issue profit warnings surpassing last year?s 11, has resulted into low earnings growth. As a result of this, we expect market activity to remain subdued.

The charts below indicate the historical PE and dividend yields of the market.





The Competition Authority of Kenya (CAK) supports the removal of the 66.7% foreign ownership limit on Kenya Insurance companies, echoing a recent World Bank study recommendation. The CAK report noted that a market dominated by domestic insurance firms would generally lead to a slowdown in developing best industry practices, and that liberalizing ownership controls would enable the domestic firms to have access to international capital. The CAK will propose to have the recommendations included in the 2016/17 Budget and also seek to scrap minimum premiums for the underwriting business, which will lead to a decline in the cost of insurance in the long run. The World Bank report noted that liberalization of various markets, including insurance, professional services, cereals and telecommunications in Kenya could lead to a 0.4% increase in GDP growth in the first year, and between 3% and 13% over a period of 7 years.

Uchumi received a Kshs 500 mn short term loan from KCB bank to stock its shelves ahead of the festive season, taking the total amount the retailer owes the bank to Kshs 1.0 bn. This is a positive step for Uchumi, as it seeks to ensure its stores are optimally stocked during this high consumption period, and to improve foot traffic per branch to 3,700 per day up from 2,000 per day a few months ago. As highlighted in our Cytonn weekly report #46, stocking falls under Optimization, which is one of the three strategies namely Stabilization, Optimization and Growth that are being pursued to help in reviving the performance of the retail chain. In our opinion, we believe that even though Uchumi Supermarkets Ltd still present value to investors, a lot remains to be done including Uchumi curving out its niche for it to compete effectively with the already established players in the retail space, particularly in the mass-market. See our latest research note at Uchumi Supermarkets Valuation Report

We remain neutral with a bias to negative on equities given the lower earnings growth prospects for this year which has seen 12 listed companies issue profit warnings. The market is now purely a stock pickers? market, with few pockets of value.

all prices in Kshs unless stated

EQUITY RECOMMENDATIONS - MONTH OF NOVEMBER								
No.	**Company**	**Price as at 4th Dec 2015**	**Price as at 11th Dec 2015**	**w/w Change**	**Target Price***	**Div Yield**	**Upside/ (Downside)****	**Recommendation**
1.	**KCB**	40.3	40.3	0.0%	58.3	5.3%	50.1%	Buy
2.	**Equity**	41.5	40.8	(1.8%)	49.4	4.9%	26.1%	Buy
3.	**DTBK**	201.0	199.0	(1.0%)	246.1	1.3%	25.0%	Buy
4.	**Barclays**	13.2	13.1	(0.4%)	15.3	7.4%	24.2%	Buy
5.	**NIC**	42.0	41.0	(2.4%)	49.6	2.8%	23.8%	Buy
6.	**Uchumi**	8.0	8.1	0.6%	9.7	0.0%	20.2%	Buy
7.	**Stanchart**	207.0	201.0	(2.9%)	228.5	5.4%	19.1%	Accumulate
8.	**Kenya Re**	22.0	21.8	(1.1%)	24.2	3.3%	14.3%	Accumulate
9.	**Britam**	14.6	14.2	(3.1%)	15.9	0.1%	12.7%	Accumulate
10.	**I&M**	99.0	100.0	1.0%	108.8	2.7%	11.5%	Accumulate
11.	**NBK**	16.4	14.9	(8.9%)	16.1	0.0%	8.1%	Hold
12.	**Safaricom**	15.6	16.3	4.5%	16.3	4.6%	4.6%	Lighten
13.	**Pan Africa**	61.0	61.0	0.0%	62.1	0.0%	1.8%	Lighten
14.	**COOP**	18.2	18.2	(0.3%)	17.8	3.4%	1.5%	Lighten
15.	**HF Group**	22.8	21.8	(4.4%)	19.8	5.3%	(3.7%)	Sell
16.	**CIC**	6.6	6.2	(5.3%)	5.8	1.3%	(5.3%)	Sell
17.	**Liberty**	19.5	18.2	(6.7%)	16.7	0.0%	(8.4%)	Sell
18.	**CfC Stanbic**	85.0	85.0	0.0%	77.2	0.0%	(9.2%)	Sell
19.	**Jubilee**	505.0	500.0	(1.0%)	428.9	1.4%	(12.8%)	Sell
***Target Price as per Cytonn Analyst estimates**								
****Upside / (Downside) is adjusted for Dividend Yield**								
Accumulate ? Buying should be restrained and timed to happen when there are momentary dips in stock prices.								
Lighten ? Investor to consider selling, timed to happen when there are price rallies								
Data: Cytonn Investments								

Private Equity

Taaleritehdas Private Equity Funds (TTA), the leading foreign financier of real estate developments in the Eastern Africa region, and Cytonn Investments, the leading real estate development, finance and investment company in Kenya, announced a Kshs 220 million exit of a structured real estate note ? an innovative and flexible financing instrument for real estate. TTA was the lender, and Cytonn, which has now paid the note, was the borrower. The note was structured as a mezzanine instrument that ranks senior to equity in the development vehicle. The note bridges the financing gap from the start of a real estate project up to the point when the development can attract conventional bank debt financing.

The note was structured at a market rate cost of funds of 18% plus participation in the capital appreciation achieved during the period the note was outstanding, bringing the total annualized return earned by TTA to 54%. This demonstrates the appetite for alternative financing sources for real estate developments needed in the rapidly growing Eastern Africa region.

IFC has announced new financing to seven small hydropower plants (SHPs) that will generate power for tea factories affiliated with the Kenya Tea Development Agency. TheUS$55 million loan is arranged by IFC in partnership with the Global Agriculture and Food Security Program, PROPARCO, and The Netherlands Development Finance Company FMO. The SHPs are intended to reduce the cost of energy for each tea factory, which currently forms their single biggest cost component. KTDA's long-term strategy is to ensure that tea factories have access to alternative renewable forms of energy that will reduce operational costs in factories. The excess power generated will be sold to the national grid, providing farmers with an additional revenue stream, with each of the power plants having an installed capacity ranging from 1.1MW to 6.5MW. On average, individual tea factories spend approximately Kshs 30 million to Kshs 65 million annually on electricity, depending on factory size, crop level and the variable costs such as fuel cost adjustment and forex that are used by Kenya Power in the calculation of electricity bills. The loan will help bridge the high cost of energy, while creating sustainability in power.

Actis has announced an investment of US$54m in Food Lover?s Market, estimated to be the largest independent food retail group in Africa, while acquiring undisclosed minority stake in the business and backing the founders. Food Lover?s Market is an independent food retailer, with over 120 Food Lover?s Market stores and a presence in 11 countries. The investment includes funding into the business to continue the company?s growth in South Africa and other countries within Sub-Saharan Africa.

Given (i) the abundance of global capital looking for opportunities in Africa, (ii) the attractive valuations in private markets compared to public markets, and (iii) better economic growth in Sub Saharan Africa as compared to global markets, the private equity space in Sub-Saharan Africa remains very attractive.

Real Estate

This week, the Kenya Property Developers Association (KPDA), released their Q3?2015 report on Nairobi City Council Building Permit Approvals. According to the report, 722 permits were granted during this period with the value of developments approved standing at Kshs 44.7 bn up from Kshs 29.2 mn as at Q1?2015. This is a 53.1% increase in the value of developments approved pointing at increased development activity in the real estate sector. We attribute the lower number of building approvals in Q1 to the crackdown by the National Construction Authority which was aimed at reducing the incidences of building collapse which had become rampant at the time. The report further identifies Karen as the location with the highest number of building permit approvals given that 11.1% of the total building permits granted was for the Karen area. Industrial area is second behind Karen with a 4.8% proportion of the total building permits. The continued relaxation of zoning restrictions in the Karen area coupled with decreasing acreage per dwelling unit could explain the increased number of permit approvals.

Also this week, the Water Services Regulatory Board (WSRB) introduced a sewerage levy that is to be charged at 5% of the water bill. The levy will serve to fund sewerage network infrastructural development which has proven inadequate given the rising population densities in the urban and peri-urban areas. Over the past few years, there has been a population influx into satellite town areas and development has increased to cater for this rising demand for housing. However, infrastructural networks including roads and sewers have not been developing at the same pace resulting into an overload of the existing infrastructure. The National Water Master Plan is targeting to have sewerage systems developed in 95 out of the 215 urban centres by 2030. The revenue generated from this levy will thus go a long way towards achieving this goal. It is commendable that the WSRB has taken this step as we believe that real estate development should not happen in isolation. There is need to put in place the necessary infrastructure to support development.

Focus of the Week: Cytonn?s Q3?2015 Banking Sector Report

Following the release of the Q3?2015 results by banks, we carried out an analysis on Kenya?s banking sector to decipher any material changes from our H1?2015 banking report. In our analysis of the banking sector we seek to recommend to our investors which banks are the most attractive and stable for investment from a franchise value and from a future growth opportunity perspective.

In Kenya there are a total of 42 commercial banks, 12 microfinance banks and 1 mortgage finance institution. The Central Bank of Kenya regulates all banks. The Capital Markets Authority has additional oversight over the listed banks, which currently stands at 11.

Amongst the listed banks, we were able to categorize the banks into 4 main buckets based on their

Q3?15 performance:

- Negative growth banks: CFC Stanbic and Standard Charted
- Anemic growth banks, with below 10% growth: HF Group, NIC and Barclays
- The stable growth banks with 10% and above growth: Equity, KCB, I&M, and DTBK
- The strong growth, with above 20% growth: NBK and Coop. It is notable that all strong growth banks were mainly driven by either cost containment initiatives or one-off gains, leading to revenue growth outpacing expense growth, resulting into strong PAT growth

Growth in the banking sector is being driven by alternative service delivery channels, cost containment initiatives, expansion both regionally and domestically, and the growing retail segment.

Some of the developments in the banking sector during Q3?2015 include:

1. **Volatility in interest rates**: In the third quarter of 2015, interest rates were volatile with the interbank rate and 91- day T-bill touching highs of 25.8% and 22.5%, respectively. At the beginning of the third quarter the MPC raised the CBR to 11.5%, and has since then remained unchanged
2. **Low loan uptake**: Given the expensive cost of financing loans, commercial banks reported lower loan uptake by their customers. Banks also struggled in mobilizing deposits as investors preferred investing in treasury instruments which offered attractive yields during that period. Industry Deposits remained relatively flat at Kshs 2.6 tn in September 2015
3. **Lower earnings growth**: Kenyan banks recorded lower earnings growth, driven by the challenging economic environment which has reduced appetite for credit
4. **Dubai Bank Liquidation:** Dubai bank was placed under receivership with the Kenya Deposit Insurance Corporation (KDIC) for failure to meet statutory requirements. The KDIC further recommended that the bank be liquidated
5. **Moratorium on the licensing of new banks**: The Central Bank of Kenya announced a moratorium on the licensing of new banks with the exception of cases related to amalgamation and acquisition that were already ongoing at the time of issuing this directive. In our opinion, with the number of commercial banks at 42, there are advantages such as enhanced financial inclusion but also strains the thoroughness and diligence of the regulatory supervision
6. **Imperial Bank put under receivership**: Imperial Bank was closed and put under receivership, due to what was described as ?unsafe and unsound business practices?. The KDIC effected a joint agreement with Kenya Commercial Bank and Diamond Trust Bank that allowed 89% of depositors access to their deposits to a maximum of Kshs 1 mn. This is a clear indication that the bank may not reopen.

Cytonn?s analysis covers the health and future expected performance of the financial institution, by highlighting their performance using metrics to measure profitability, efficiency, growth, asset quality, liquidity, revenue diversification, capitalization and intrinsic valuation. In total, we looked at 13 different metrics to rank the banks.

1. **Net interest margin:** We used the net interest margin as a bank?s measure of core profitability;
2. **Return on average common equity**: We used the return on average common equity as a measure of profitability that flows to equity holders;
3. **Price/Earnings growth ratio:** We used the price/earnings growth ratio to determine relative valuation considering each bank?s expected growth rates;
4. **Loans to deposit ratio:** We used the loans to deposit ratio as a bank?s measure of liquidity;
5. **Cost to income ratio**: We used the cost to income ratio as a bank?s measure of efficiency;
6. **Deposits per branch:** We used a bank?s deposits per each branch as a measure of efficiency and proficiency in deposit gathering;
7. **Price to tangible book value:** We used a bank?s price to tangible book value as a measure of relative valuation;

8. **Tangible common equity ratio:** We used the tangible common equity ratio as a measure of a bank?s permanent capitalization levels;
9. **Non-performing loans to total loans ratio**: We used a bank?s non-performing loans to total loans ratio as a measure of a bank?s asset quality and credit risk;
10. **NPL Coverage:** We used a bank?s provisions to non-performing loans as a measure of a bank?s credit risk;
11. **Non-interest income to revenue:** We used the ratio of non-interest income to revenue as a measure of a bank?s revenue diversification;
12. **Camel rating:** We used our own camel rating system to assess the overall safety and soundness of the banks. We incorporated a Governance Score into our analysis, which measures the bank?s internal controls, strength, integrity and experience of the board and management, and quality of strategic shareholders;
13. **Intrinsic Valuation:** We used our analyst?s projections of the future performance of the banks to derive their intrinsic valuation.

Based on these metrics, we were able to rank the listed banks from number 1 to number 11, and get the bank that is likely to deliver the best return over a

CYTONN?S Q3?2015 BANKING REPORT RANKINGS					
Banks	**Franchise Value Total Score[a]**	**Total Return Score[b]**	**Weighted Q3 2015 Score[c]**	**Q3 2015 rank[d]**	**H1 2015 rank[e]**
Equity	60	4	**26.4**	**1**	1
DTBK	67	2	**28.0**	**2**	8
KCB	70	1	**28.6**	**3**	3
Barclays	67	3	**28.6**	**3**	4
Standard Chartered	65	6	**29.6**	**5**	2
Co-operative bank	64	9	**31.0**	**6**	5
I&M	69	7	**31.8**	**7**	6
NIC	78	5	**34.2**	**8**	6
CfC Stanbic	75	11	**36.6**	**9**	9
National Bank of Kenya	81	8	**37.2**	**10**	10
Housing Finance	96	10	**44.4**	**11**	10

It is notable that Diamond Trust Bank registered the biggest ranking improvement in the Q3?2015 Cytonn Banking Report, rising to #2 from #8 in H1?2015 based on its second highest upside of 23.7%. This was boosted by an increase in the banks? growth rate to 18.4% owing to (i) their regional expansion strategy, and (ii) increased focus on more efficient channels of distribution like agency banking. The banks? high quality loan book and risk management also boosted its franchise value.

Notes

a. **Franchise Value Total Score:** In this ranking, the banks are ranked by health, by looking at metrics for profitability, efficiency, growth, asset quality, liquidity, revenue diversification and capitalization. Banks are assigned scores ranging from 1, which is the best performing bank in the metric, till 11, which is the worst performing bank. The scores from each bank are then summated, with the bank with the lowest total score emerging on top, and that with the highest score emerging at the bottom.
b. **Total Return Score:** Potential upside for each bank based on the intrinsic valuation, and the current market price. The bank with the highest upside was ranked 1st, and that with the lowest upside, or greatest downside, was ranked last. Cytonn?s Analysts carry out this valuation, arriving at the estimate of intrinsic value of each bank based on underlying aspects of the business, in terms of both tangible and intangible factors, and future growth expectations. This value may or may not be the same as the current market value.
c. **Weighted Q3?2015 Score:** Using the Franchise Value and Total Return, banks are given a score.

Franchise value was assigned a weighting of 40%, while the intrinsic value was assigned a 60% weight.

d. **Q3?2015 Rank:** The bank with the lowest Weighted Q3?2015 Score was ranked first, and that with the highest score was ranked last.
e. **H1?2015 Rank:** The H1?2015 rank was the rank as at half year and was based on both franchise value and total return score.

The full release of the rankings and how each bank performed across the metrics is in the Cytonn Banking Report Q3?2015. See link: Cytonn Banking Report Q3'2015

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