Ruaka Real Estate Investment Opportunity, & Cytonn Weekly #11_2019

Equities

Market Performance:

During the week, the equities market recorded mixed performances, with NASI and NSE 25 gaining by 1.3% and 0.9%, respectively, while NSE 20 declined by 0.7%, taking their YTD performance to gains of 12.5%, 2.2%, and 10.9%, for NASI, NSE 20 and NSE 25, respectively. The performance in NASI was driven by gains in large cap stocks such as Equity Group, Barclays Bank of Kenya, and Safaricom, which gained by 4.9%, 3.9% and 2.8%, respectively.

Equities turnover declined by 45.1% during the week to USD 30.7 mn, from USD 55.8 mn the previous week, taking the YTD turnover to USD 380.7 mn. Foreign investors turned net buyers for the week, with a net buying position of USD 3.2 mn, a decline from last week's net buying position of USD 4.6 mn.

The market is currently trading at a price to earnings ratio (P/E) of 13.1x, 2.2% below the historical average of 13.4x, and a dividend yield of 4.7%, above the historical average of 3.8%. With the market trading at valuations below the historical average, we believe there is value in the market. The current P/E valuation of 13.1x is 35.1% above the most recent trough valuation of 9.7x experienced in the first week of February 2017, and 57.8% 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

During the week, Barclays Bank of Kenya released their FY'2018 financial results. Core earnings per share increased by 7.1% to Kshs 1.4, from Kshs 1.3 in FY'2017, above our expectation of a 2.7% increase to Kshs 1.31. The performance was driven by a 4.7% increase in total operating income, despite the 5.8% increase in total operating expenses. The variance in core earnings per share growth against our expectations was largely due to the 24.3% increase in Loan Loss Provisions (LLP) to Kshs 3.9 bn, from Kshs 3.1 bn in FY'2017, against our expectation of a 4.1% decline in LLP to Kshs 3.0 bn. Highlights of the performance from FY'2017 to FY'2018 include:

- Total operating income increased by 4.7% to Kshs 31.7 bn, from Kshs 30.3 bn in FY'2017. This was due to a 0.9% increase in Net Interest Income (NII) to Kshs 22.0 bn, from Kshs 21.8 bn in FY'2017, coupled with the 14.7% rise in Non-Funded Income (NFI) to Kshs 9.7 bn, from Kshs 8.5 bn in FY'2017,
- Interest income increased by 7.0% to Kshs 29.1 bn, from Kshs 27.2 bn in FY'2017. This was driven by a 27.8% growth in interest income from government securities to Kshs 7.4 bn, from Kshs 5.8 bn in FY'2017, and a 1.3% increase in interest income on loans and advances to Kshs 21.5 bn, from

Kshs 21.3 bn in FY’2017. The yield on interest-earning assets however declined to 11.4% from 12.1% in FY’2017, attributed to a decline in yields on government securities as well as a decline in lending rates due to the two CBR cuts last year, coupled with the faster 19.2% y/y increase in interest earning assets to Kshs 276.9 bn, from Kshs 232.2 bn in FY’2017,

- Interest expenses increased by 31.6% to Kshs 7.1 bn, from Kshs 5.4 bn in FY’2017, following a 76.2% increase in the interest expense on placement liabilities to Kshs 0.9 bn, from Kshs 0.5 bn in FY’2017, as the bank sought to support deposit growth amidst tight liquidity in the money market. Moreover, interest expense on customer deposits rose 26.7% to Kshs 6.1 bn, from Kshs 4.8 bn in FY’2017, on the back of the strong deposit growth of 11.5% y/y experienced in 2018. Consequently, the cost of funds rose to 3.5% from 2.9% in FY’2017. Thus, the Net Interest Margin (NIM) declined to 8.6%, from 9.1% in FY’2017,
- Non-Funded Income (NFI) rose by 14.7% to Kshs 9.7 bn, from Kshs 8.5 bn in FY’2017. The growth was mainly driven by a 65.5% growth in fees and commissions on loans to Kshs 1.1 bn, from Kshs 0.6 bn in FY’2017, coupled with the 14.5% rise in forex trading income to Kshs 3.3 bn from Kshs 2.9 bn, which outpaced the 1.4% decline in other fees and commissions to Kshs 4.57 bn from Kshs 4.64 bn. As a result, the revenue mix shifted to 69:31 funded to non-funded income from 72:28 in FY’2017, as NFI grew faster than NII,
- Total operating expenses increased by 5.8% to Kshs 21.1 bn from Kshs 19.9 bn, largely driven by a 24.3% increase in Loan Loss Provisions (LLP) to Kshs 3.9 bn in FY’2018, from Kshs 3.1 bn in FY’2017, coupled with an 11.1% increase in other operating expenses to Kshs 7.4 bn in FY’2018, from Kshs 6.7 bn in FY’2017, which outweighed the 3.4% decline in staff costs to Kshs 9.8 bn from Kshs 10.1 bn in FY’2017, with the bank having laid off 323 staff in 2017,
- Consequently, the Cost to Income Ratio (CIR) deteriorated, albeit marginally, to 66.4%, from 65.8% in FY’2017. Without LLP, the cost to income ratio improved to 54.2%, from 55.5% in FY’2017, highlighting the rise in the cost of risk to 12.2% from 10.3% in FY’2017,
- Profit before tax increased by 2.7% to Kshs 10.7 bn, up from Kshs 10.4 bn in FY’2017. Profit after tax grew by 7.1% to Kshs 7.4 bn in FY’2018, from Kshs 6.9 bn in FY’2017, due to the effective tax rate declining to 30.0% from 33.0% in FY’2017,
- The bank recommends a final dividend of Kshs 0.9 per share, having already paid an interim dividend of Kshs 0.2 per share, translating to a total dividend payout of Kshs 1.1 per share, a 10.0% rise from Kshs 1.0 paid in FY’2017, which translates to a dividend yield of 9.3%,
- The balance sheet recorded an expansion as total assets increased by 19.8% to Kshs 324.8 bn, from Kshs 271.2 bn in FY’2017. This growth was largely driven by a 58.9% increase in government securities to Kshs 92.9 bn, from Kshs 58.5 bn in FY’2017, coupled with a 5.3% increase in their loan book to Kshs 177.4 bn, from Kshs 168.4 bn in FY’2017,
- Total liabilities rose by 23.6% to Kshs 280.6 bn, from Kshs 227.1 bn in FY’2017, driven by a 73.5% increase in Placement Liabilities to Kshs 5.3 bn, from Kshs 3.1 bn in FY’2017, coupled with a 78.5% increase in other liabilities to Kshs 67.9 bn from Kshs 38.0 bn in FY’2017. Customer deposits also increased, as they rose by 11.5% to Kshs 207.4 bn, from Kshs 186.0 bn in FY’2017. Deposits per branch increased by 20.8% to Kshs 2.5 bn, from Kshs 2.0 bn in FY’2017, with the number of branches having reduced by 7 to 84 from 91 as at the end of 2017,
- The faster growth in deposits as compared to loans led to a decline in the loan to deposit ratio to 85.5% from 90.5% in FY’2017,
- Gross Non-Performing Loans (NPLs) rose by 10.3% to Kshs 13.9 bn in FY’2018 from Kshs 12.6 bn in FY’2017. The NPL ratio thus deteriorated to 7.4% in FY’2018 from 7.1% in FY’2017. General Loan Loss Provisions rose by 17.5% to Kshs 6.5 bn from Kshs 5.6 bn in FY’2017. However, The NPL coverage declined marginally to 69.2% in FY’2018 from 70.0% in FY’2017, as interest in suspense declined by 5.2% to Kshs 3.1 bn from Kshs 3.3 bn in FY’2017,
- Shareholders’ funds increased marginally by 0.2% to Kshs 44.2 bn in FY’2018 from Kshs 44.1 bn in FY’2017, as the 6% increase in the revaluation reserve to Kshs 0.5 bn from Kshs 0.3 bn in FY’2017, was weighed down by the 1.9% decline in retained earnings to Kshs 35.9 bn from Kshs 36.6 bn in FY’2017,

- Barclays Bank Kenya is currently sufficiently capitalized with a core capital to risk-weighted assets ratio of 14.4%, 3.9% above the statutory requirement. In addition, the total capital to risk-weighted assets ratio was 16.4%, exceeding the statutory requirement by 1.9%. Adjusting for IFRS 9, the core capital to risk weighted assets stood at 14.7%, while total capital to risk-weighted assets came in at 16.7%,
- The bank currently has a Return on Average Assets (ROaA) of 2.7%, and a Return on Average Equity (ROaE) of 16.8%.

Key Take-Outs:

1. The bank's asset quality deteriorated albeit marginally, with the NPL ratio deteriorating to 7.4% from 7.1% in FY'2017, as the gross NPLs rose by 10.3%. This was attributed to the corporate, real estate and SME book, as various entities cited the delayed payments by government and a relatively tougher operating environment in 2018. However, the bank continued to demonstrate prudence, as the NPL coverage remained relatively high, at 69.2%, albeit slightly lower than the 70.0% in FY'2017. With the ongoing economic recovery, the bank's asset quality is likely to continue improving, across the other segments such as SMEs and the real estate segments,
2. There was a rapid expansion of Non-Funded Income, as it expanded by 14.7% y/y. The growth was largely driven by increased usage of the Bank's digital application platform, "Timiza", which was launched in March 2018, and has already disbursed approximately Kshs 10.0 bn, to its approximately 3.0 mn client base. Furthermore, with increased transactions (70.0% of all transactions) being done via alternative channels, the bank benefited from higher transactional revenue. This has increased Barclay's NFI contribution to revenue to 31.0%, which is still lower than its peer average at 35.0% NFI contribution to revenue, indicating the bank can still do more to grow its alternative revenue streams, and,
3. The bank recorded relatively strong growth in its balance sheet, as deposits grew by 11.5% y/y, and were channeled to Government Securities Investments, which grew by 58.9% and loans and advances that grew by 5.3%y/y, the highest recorded by the bank in the rate cap era. The growth in interest earning assets helped support increased interest income revenue, despite the decline in yields of both the government securities and loans, with the Central Bank Rate (CBR) declining by 100 bps during the year.

For more information, please see our Barclays Bank of Kenya FY'2018 Earnings Note

With 3 banks having released their FY'2018 results, the table below highlights their key operating metrics;

Bank	Core EPS Growth	Interest Income Growth	Interest Expense Growth	Net Interest Income Growth	Net Interest Margin	Non-funded income Growth	NFI to Total Operating Income	Growth in Total Fee and Commissions	Deposit Growth	Growth in Govt Securities	Loan to Deposit ratio	Loan Growth	Return on average equity
Stanbic Bank	45.7%	13.8%	19.2%	14.0%	5.0%	18.3%	45.1%	15.5%	13.5%	3.7%	79.7%	22.1%	14.3%
KCB Group	21.8%	4.1%	14.1%	0.9%	8.2%	(0.1%)	32.0%	(25.3%)	7.6%	9.1%	84.8%	7.9%	21.9%
Barclays Bank	7.1%	7.0%	31.6%	0.9%	8.6%	14.7%	30.6%	65.5%	11.5%	58.9%	85.5%	5.3%	16.8%
Weighted Average*	**21.7%**	**6.6%**	**19.9%**	**3.1%**	**7.8%**	**7.2%**	**33.8%**	**7.4%**	**9.7%**	**22.3%**	**84.1%**	**9.6%**	**19.2%**
Weighted Average 2017	**(1.0%)**	**(2.4%)**	**2.6%**	**(3.8%)**	**8.4%**	**9.1%**	**33.6%**	**13.4%**	**12.5%**	**22.2%**	**80.0%**	**6.1%**	**17.6%**

**Weighted By Market cap as at December 31st 2018*

Key take-outs from the table above include:

?. Three listed banks have released results for FY'2018, and have recorded a 21.7% average increase in core Earnings Per Share (EPS), compared to a sector average decline of 1.0% in FY'2017,

i. The banks recorded weaker deposit growth, which came in at 9.7%, slower than the 12.5% growth recorded in FY’2017. Despite the slower deposit growth, interest expenses increased by 19.9%, compared to a growth of 2.6 % in FY’2017 indicating that the banks have been mobilizing expensive deposits,

ii. Average loan growth came in at 9.6%, which was higher than 6.1% recorded in FY’2017, indicating an improvement in credit extension to the real economy, despite the interest rate cap. Government securities on the other hand recorded a growth of 22.3% y/y, just above the 22.2% recorded in FY’2017, and which outpaced the growth in loans. This indicates that banks’ continued preference towards investing in government securities, which offer better risk-adjusted returns. Interest income increased by 6.6%, compared to a decline of 2.4% recorded in FY’2017, as banks adapted to the interest rate cap regime, with increased allocations to government securities. The Net Interest Income (NII) thus grew by 3.2% compared to a decline of 3.8% in FY’2017,

iii. The average Net Interest Margin for the three banks currently stands at 7.8%, down from the sector average of 8.4% recorded in FY’2017, despite the Net Interest Income by increasing 3.2% y/y, and,

iv. Non-funded Income grew by 7.2 % y/y, slower than 9.1% recorded in FY’2017. The growth in NFI was weighed down as total fee and commissions grew by 7.4%, slower than the 13.4% growth recorded in FY’2017.

Weekly Highlights

A ruling by a three-Judge High Court Bench in Nairobi declared the Banking (Amendment) Act 2016 to be unconstitutional. Enacted in in 2016, the law stipulates a deposit and loan-pricing framework that provided for: (i) a cap on lending rates at 4.0% above the Central Bank Rate (CBR), and (ii) a floor on the deposit rates at 70.0% of the CBR, which was scrapped in October 2018. Following the ruling, the cap on lending rates at 4.0% above the Central Bank Rate (CBR) will no longer be effective, after the 12-months implementation period. Noting that the implementation of this rule would come with a lot of disruption to the Financial Services sector, the High Court suspended the effect of the declaration for 12-months, thus allowing Parliament time to reconsider sections that were declared unconstitutional by the High Court. The ruling follows a series of calls to amend the Act with the most recent being a proposal that was tabled by Mr. Moses Kuria, the Member of Parliament for Gatundu South in January 2019. The proposal made was to amend the Act to allow credit consumers negotiate for interest rates on loans, depending on their risk profile, with an upper limit of up to 6.0% above the existing interest rate cap levels. This would have seen borrowers be able to access credit at rates of a maximum of 19.0% per annum compared to the current rate of 13.0 %. The Central Bank of Kenya echoed this sentiment and lauded the members of parliament for acknowledging the negative effect of interest rate capping on the economy. CBK Governor Dr. Patrick Njoroge has also maintained his stand that the law should be completely overhauled to encompass a system that allows banks to adopt a risk-based lending approach. These efforts have been in a bid to try and improve credit extension to the private sector, comprised largely of the Micro, Small and Medium Enterprises (MSMEs), as private sector credit growth (highlighted in the chart below) averaged 3.3% in 2018, way below the 5-year average of 11.8%.

The suspension duration is expected to serve as a transition period to avoid disruption of current contractual agreements between banks and their customers and, on the other hand, allow parliament to assess and ammend the provisions in contention. As such, the status of the rate cap law still hangs on the balance and we expect the final outcome to be determined by:

?. **Political Motives**: Nothing fundamental has been put on the table to make the members of parliament change their mind on the rate cap. As we get closer to the next general election, the resolve by parliamentarians to side with the electorate can only get stronger,

i. **Excecutive Influence**: In our view, the Executive’s stand is what will determine whether the repeal of the rate cap goes through or not. As witnessed recently during the revision of the budget allocations, it is clear that the Executive can decide the direction they want parliament to vote on a matter.

Universe of Coverage

Below is a summary of our SSA universe of coverage:

Banks	Price as at 8/03/2019****	Price as at 15/03/2019****	w/w change	YTD Change	Target Price*	Dividend Yield	Upside/Downside**	P/TBv Multiple
Diamond Trust Bank	140.0	139.0	(0.7%)	(11.2%)	283.7	1.9%	106.0%	**0.8x**
GCB Bank	3.8	4.0	5.0%	(13.0%)	7.7	9.5%	102.5%	**0.9x**
Access Bank	6.0	6.0	(0.8%)	(12.5%)	9.5	6.7%	66.4%	**0.4x**
CRDB	135.0	125.0	(7.4%)	(16.7%)	207.7	0.0%	66.2%	**0.5x**
Zenith Bank	25.0	22.2	(11.0%)	(3.7%)	33.3	12.2%	62.3%	**1.1x**
I&M Holdings	90.0	90.0	0.0%	5.9%	138.6	3.9%	57.9%	**0.9x**
UBA Bank	7.7	7.7	0.0%	(0.6%)	10.7	11.1%	51.0%	**0.5x**
KCB Group***	44.0	44.3	0.7%	18.3%	61.3	7.9%	46.3%	**1.4x**
Ecobank	7.8	7.7	(0.1%)	3.2%	10.7	0.0%	38.6%	**1.7x**
Co-operative Bank	14.6	15.0	2.4%	4.5%	19.9	5.4%	38.5%	**1.3x**
CAL Bank	1.0	1.0	5.1%	5.1%	1.4	0.0%	35.9%	**0.8x**
Equity Group	41.0	43.0	4.9%	23.4%	56.2	4.7%	35.3%	**2.0x**
NIC Group	37.0	37.1	0.1%	33.3%	48.8	2.7%	34.4%	**1.0x**
Stanbic Bank Uganda	29.0	29.0	0.0%	(6.5%)	36.3	4.0%	29.1%	**2.1x**
HF Group	6.0	5.4	(9.3%)	(1.8%)	6.6	6.4%	27.8%	**0.2x**
Bank of Kigali	275.0	265.0	(3.6%)	(11.7%)	299.9	5.2%	18.4%	**1.5x**
Union Bank Plc	7.0	7.0	0.0%	25.0%	8.2	0.0%	16.4%	**0.7x**
SBM Holdings	6.1	6.0	(1.3%)	0.7%	6.6	5.0%	14.3%	**0.9x**
Barclays Bank	11.4	11.9	3.9%	8.2%	12.5	8.4%	13.9%	**1.6x**
Guaranty Trust Bank	37.3	35.4	(5.1%)	2.8%	37.1	6.8%	11.6%	**2.3x**
Standard Chartered	199.0	197.5	(0.8%)	1.5%	196.3	6.3%	5.7%	**1.6x**
Bank of Baroda	134.0	130.0	(3.0%)	(7.1%)	130.6	1.9%	2.4%	**1.2x**
Stanbic Holdings	93.0	100.0	7.5%	10.2%	92.6	5.9%	(1.6%)	**0.9x**
National Bank	5.7	5.0	(11.9%)	(5.6%)	4.9	0.0%	(2.4%)	**0.4x**
Standard Chartered	21.0	21.0	0.0%	0.0%	19.5	0.0%	(7.3%)	**2.6x**
FBN Holdings	8.1	8.2	1.2%	3.1%	6.6	3.0%	(16.1%)	**0.4x**
Stanbic IBTC Holdings	48.0	48.1	0.2%	0.3%	37.0	1.2%	(21.8%)	**2.5x**
Ecobank Transnational	14.0	13.5	(3.6%)	(20.6%)	9.3	0.0%	(31.3%)	**0.5x**

**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.*

*****Stock prices indicated in respective country currencies*

We are "Positive" on equities for investors as the sustained price declines have seen the market P/E decline to below its historical average. We expect increased market activity, and possibly increased inflows from foreign investors, as they take advantage of the attractive valuations, to support the positive performance.
