Cytonn Q1’2019 Markets Review

Equities

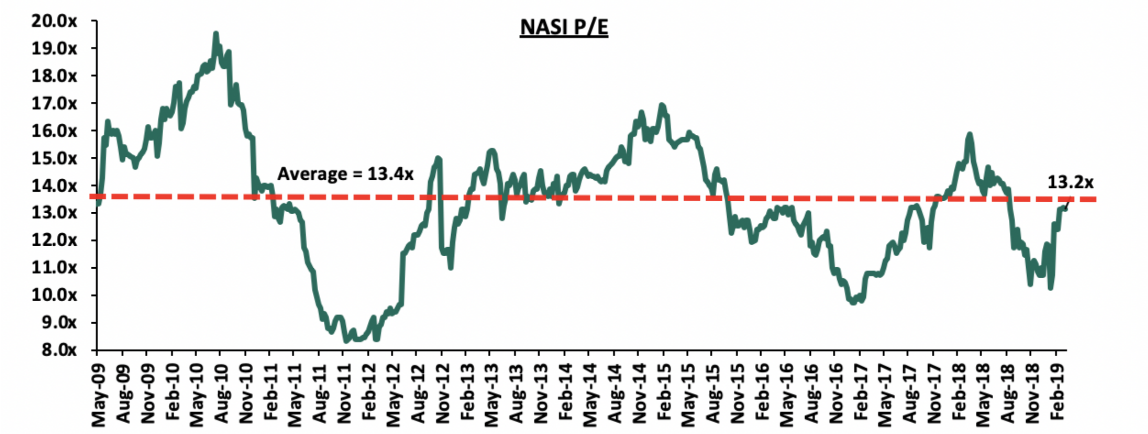
Market Performance:

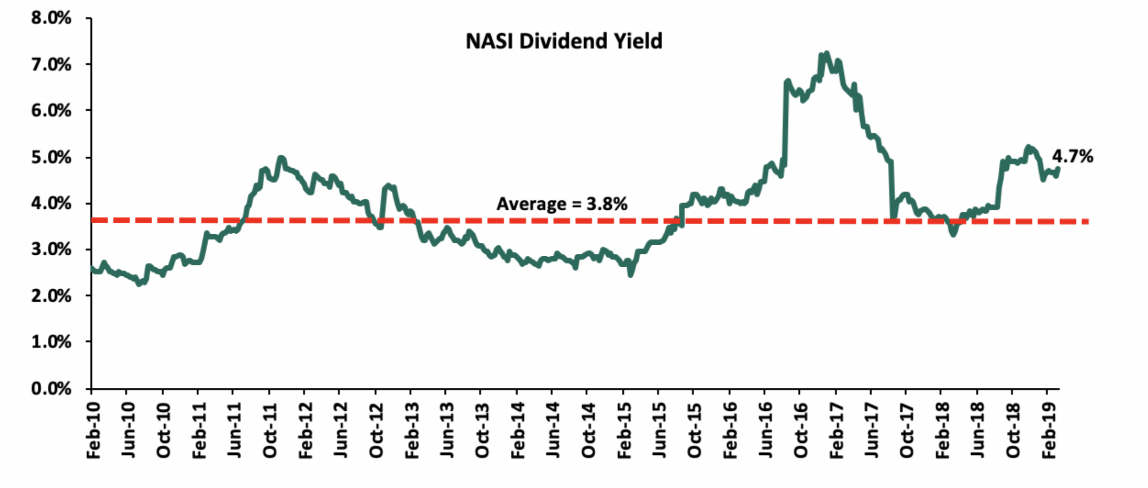
During Q1’2019, the equities market was on an upward trend, with NASI, NSE 25 and NSE 20 gaining by 12.2%, 10.8% and 0.4%, respectively, taking their YTD performance as at the end of March to 12.2%, 10.8% and 0.4% for NASI, NSE 25 and NSE 20, respectively. The equities market performance during the quarter was supported by gains in large caps such as NIC Group, Safaricom, Equity and EABL that rose by 30.8%, 24.1%, 19.4%, and 18.0%, respectively.

During the week, the equities market was on a downward trend with NASI, NSE 25 and NSE 20 declining by 0.3%, 0.1% and 1.7%, respectively, due to declines in large cap stocks such as Equity, DTB, Co-operative Bank and Safaricom, which declined by 4.4%, 4.1%, 3.9%, and 2.1%, respectively. For the last twelve months (LTM), NASI, NSE 25 and NSE 20 have declined by 17.6%, 20.7% and 26.0%, respectively.

Equities turnover gained by 29.5% during the quarter to USD 445.8 mn in Q1’2019 from USD 344.2 mn in Q4’2018, taking the YTD turnover to USD 445.8 mn. During the week, equities turnover declined by 10.7% to USD 30.7 mn from USD 34.4 mn in the previous week. Foreign investors remained net buyers this week, with a net buying position of USD 7.2 mn, which is a 166.8% increase from last week’s net buying position of USD 2.7 mn.

The market is currently trading at a price to earnings ratio (P/E) of 13.2x, 1.6% below the historical average of 13.4x, and a dividend yield of 4.7%, above the historical average of 3.7%. With the market trading at valuations below the historical average, we believe there is value in the market. The current P/E valuation of 13.2x is 35.7% above the most recent trough valuation of 9.7x experienced in the first week of February 2017, and 58.6% 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.





Kenyan Listed Banks Results

A number of Banks released their FY'2018 results during the week:

- Equity Holdings released FY'2018 results, registering an increase in its core earnings per share by 4.8% to Kshs 5.25 from Kshs 5.0 in FY'2017, slower than our projections of an 11.3% increase to Kshs 5.6. The performance was driven by a 3.3% increase in total operating income, which outpaced the 1.4% increase in total operating expenses. The variance in core earnings per share growth against our expectations was largely due to the 1.4% rise in total operating expenses to Kshs 38.8 bn from Kshs 38.3 bn in FY'2017, which was contrary to our expected 3.9% decline. For more information, see our Equity Holdings FY'2018 Earnings Note
- I&M Holdings released FY'2018 results, registering an increase in its core earnings per share by 17.1% to Kshs 20.6 from Kshs 17.6 in FY'2017, higher than our projections of a 15.3% increase to Kshs 20.3. The performance was driven by an 8.8% increase in total operating income, which outpaced the 2.6% increase in total operating expenses. The variance in core earnings per share growth against our expectations was largely due to the 2.6% rise in total operating expenses to Kshs 12.3 bn from Kshs 12.0 bn in FY'2017, which was slower than our expectation of a 5.9% rise. For more information, see our I&M Holdings FY'2018 Earnings Note
- National Bank of Kenya released FY'2018 results, registering an increase in its core earnings per share (EPS) by5% to Kshs 1.6, from Kshs 1.2 in FY'2017, exceeding our expectation of an 11.3% increase to Kshs 1.4. However, the core performance was due to the stripping out of an exceptional expense of Kshs 0.5 bn. The bank registered a 98.3% decline in profit after tax to Kshs 7.0 mn from Kshs 0.4 bn in FY'2017. The performance was as a result of a 12.4% decline in total operating income to Kshs 8.0 bn, from Kshs 9.2 bn in FY'2017, which outpaced the 9.6% decline in the total operating expenses to Kshs 7.6 bn, from Kshs 8.4 bn in FY'2017. The variance in core earnings per share growth against our expectations was largely due to the faster 9.6% decline in total operating expenses to Kshs 7.6 bn, from Kshs 8.4 bn previously, exceeding our expectation of

a 0.6% decline. For more information, see our NBK FY’2018 Earnings Note

- HF Group released FY’2018 results, recording a loss per share of Kshs 1.7 in FY’2018, from a core earnings per share of Kshs 0.4 recorded in FY’2017, which exceeded our expectations of a loss per share of Kshs 0.2. The performance was as a result of a 17.1% decline in total operating income, coupled with a 6.2% rise in the total operating expenses. The variance in core earnings per share growth against our expectations was largely due to the 17.1% decline in total operating income to Kshs 3.6 bn, from Kshs 4.3 bn in FY’2017, which outpaced our expectation of a 10.4% decline. For more information, see our HF Group FY’2018 Earnings Note

During the quarter, listed banks in Kenya released their FY’2018 results, recording average core earnings per share growth of 13.8%, against a 1.0% decline for the same time last year. The table below highlights the performance of the banking sector, showing the performance using several metrics, and the key takeaways of the performance:

Summary of Performance of Listed Banks – FY’2018

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	Cost to Income	Loan to Deposit Ratio	Loan Growth	Cost of Funds	Return on Average Equity
Stanbic	45.7%	13.8%	19.2%	14.0%	5.0%	18.3%	45.1%	15.5%	13.5%	3.7%	59.5%	79.7%	22.1%	3.5%	14.3%
NBK	33.5%	(10.5%)	(10.9%)	(22.6%)	6.5%	(30.3%)	24.8%	(72.5%)	4.9%	89.0%	94.3%	48.3%	(8.8%)	2.8%	0.1%
KCB	21.8%	4.1%	14.1%	0.9%	8.2%	(0.1%)	32.0%	(25.3%)	7.6%	9.1%	52.8%	84.8%	7.9%	3.2%	21.9%
SCBK	17.1%	2.3%	(3.0%)	4.5%	7.5%	4.9%	32.2%	19.7%	5.1%	(10.7%)	58.6%	52.9%	(6.1%)	3.3%	17.5%
I&M	17.1%	6.4%	17.3%	0.3%	7.0%	32.8%	32.8%	59.1%	25.9%	(20.0%)	53.0%	78.2%	9.0%	4.9%	17.4%
Co-op	11.6%	6.6%	(0.2%)	9.5%	9.5%	(4.4%)	29.5%	(3.0%)	6.5%	10.4%	58.8%	80.2%	(3.3%)	3.8%	18.3%
BBK	7.1%	7.0%	31.6%	0.9%	8.6%	14.7%	30.6%	6.7%	11.5%	58.9%	66.4%	85.5%	5.3%	3.5%	16.8%
Equity	4.8%	10.0%	8.9%	10.3%	8.5%	(6.3%)	38.4%	(16.6%)	13.3%	1.9%	57.7%	70.3%	6.5%	2.7%	22.5%
DTBK	2.3%	1.8%	2.0%	1.8%	6.2%	3.0%	21.3%	5.7%	6.2%	2.6%	56.9%	68.3%	(1.5%)	4.9%	13.1%
NIC	2.0%	4.8%	14.1%	(1.8%)	5.7%	11.4%	30.5%	9.2%	4.0%	12.9%	61.7%	81.7%	(1.4%)	5.2%	12.1%
HF	N/A	(15.2%)	(9.1%)	(23.9%)	4.2%	(2.0%)	36.8%	23.3%	(5.3%)	75.0%	(118.2%)	125.1%	(12.5%)	7.4%	(5.5%)
2018 Mkt cap Weighted Average	**13.8%**	**6.4%**	**10.6%**	**5.2%**	**7.9%**	**3.8%**	**33.3%**	**(1.0%)**	**10.3%**	**8.0%**	**57.5%**	**75.8%**	**4.3%**	**3.5%**	**18.9%**
2017 Mkt cap Weighted Average	**(1.0%)**	**(2.4%)**	**2.6%**	**(3.8%)**	**8.4%**	**9.1%**	**33.6%**	**13.4%**	**12.5%**	**22.2%**	**61.1%**	**80.0%**	**6.1%**	**3.6%**	**17.6%**

Key takeaways from the table above include:

i. All listed Kenyan banks have released results for FY’2018, and have recorded a 13.8% average increase in core Earnings Per Share (EPS), compared to a decline of 1.0% in FY’2017, and consequently, the Return on Average Equity (RoAE) increased to 18.9%, from 17.6% in FY’2017. All listed banks apart from HF Group have recorded growths in their core EPS, with Stanbic Holdings recording the highest growth of 45.7%, and the lowest being HF Group, which recording a loss per share of Kshs 1.7,
ii. The sector recorded weaker deposit growth, which came in at 10.3%, slower than the 12.5% growth recorded in FY’2017. Despite the slower deposit growth, interest expenses increased by 10.6%, indicating banks have been mobilizing expensive deposits. However, with the removal of the limit of interest payable on deposits, the associated interest expenses on deposits is expected to improve in 2019, and possibly improve the cost of funds,
iii. Average loan growth came in at 4.3%, which was lower than the 6.1% recorded in FY’2017, indicating that there was an even slower credit extension to the economy, due to sustained effects of the interest rate cap. Government securities on the other hand recorded a growth of 8.0% y/y, which was faster compared to the loans, albeit slower than 22.2% recorded in FY’2017. This indicates that banks’ continued preference towards investing in government securities, which offer better risk-adjusted returns. Interest income increased by 6.4%, compared to a decline of 2.4% recorded in FY’2017, as banks adapted to the interest rate cap regime, with increased allocations in government securities. The Net Interest Income (NII) thus grew by 2.5% compared to a decline of 3.8% in FY’2017,

iv. The average Net Interest Margin in the banking sector currently stands at 7.9%, down from the 8.4% recorded in FY'2017, despite the Net Interest Income increasing by 5.2% y/y. The decline was mainly due to the faster 8.0% increase in allocation to relatively lower yielding government securities, coupled with the decline in yields on loans due to the 100 bps Central Bank Rate (CBR) decline, and,
v. Non-funded Income grew by 3.8% y/y, slower than 9.1% recorded in FY'2017. The growth in NFI was weighed down as total fee and commission declined by 1.0%, compared to the 13.4% growth recorded in FY'2017. The fee and commission income continued to be subdued by the slow loan growth, coupled with the implementation of the Effective Interest Rate (EIR) model under IFRS 9, which requires banks to amortize the fees and commissions on loans, over the tenor of the loan.

For a summary of the FY'2018 banking sector results and our key takeaways from the results, please see our Cytonn FY'2018 Banking Sector Performance Note. We shall be releasing our FY'2018 Banking Report on 14th April, 2019.

Quarterly Highlights:

During the quarter;

i. 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 suspension period. For more information see our Cytonn Weekly #11/2019
ii. KCB Group has highlighted its intention to set up subsidiaries in Somalia and DRC Congo, as the bank aims to increase its regional footprint to 10 countries in the Eastern African region. This comes on the back of highlighting its intention to venture into Ethiopia, with the Ethiopian market becoming increasingly liberalized due to the reforms being implemented by the government. For more information see our Cytonn Weekly #12/2019
iii. The Central Bank of Kenya (CBK) published draft regulations for mortgage refinance companies (MRCs), setting the stage for creation of a State-backed firm that will advance cash to banks for onward lending to home buyers. Through the CBK (Mortgage Refinance Companies) Regulations 2019, the regulator provides for establishment of non-deposit taking firms under the Companies Act, licensed by the CBK to conduct mortgage refinance business. For more information see our Cytonn Weekly #08/2019
iv. The Capital Markets Authority (CMA) released The Report on the State of Corporate Governance of Issuers of Securities to The Public in Kenya. The findings suggest a "Fair" status of 55.0% weighted overall score in the application of corporate governance practices by Kenyan issuers of securities to the public. The report analyzed 62 listed companies and 5 issuers of corporate bonds. For more information see our Cytonn Monthly January 2019
v. The amendment to the Income Tax Act, included in the Finance Act 2018, was made public. The amendment introduced a requirement for Kenyan firms to pay a 30.0% tax on dividends received from their subsidiaries, and are redistributed to shareholders. This was a significant alteration to previous legislation in which a holding company would receive dividends from its subsidiary, without paying the withholding tax, if its ownership in the subsidiary exceeded 12.5%. For more information see our Cytonn Weekly #06/2019
vi. Commercial Bank of Africa (CBA) issued a cash buy-out offer of Kshs 1.4 bn to Jamii Bora bank. The Kshs 1.4 bn buyout represents a steep discount from the Kshs 3.4 bn book value as at Q1'2018. This implies the transaction, if the offer is accepted and no further injections made, would happen at a Price to Book ratio (P/Bv) of 0.4x, significantly lower than the average P/B ratio of 1.6x of recent transactions in the banking sector. For more information see our CBA Acquisition

Note. In another transaction involving CBA and following the initial announcement of negotiations in December 2018, the respective Boards of Directors of CBA and NIC Group have proposed to recommend the merger of NIC and CBA to their shareholders. For a detailed analysis of the transaction, see our NIC-CBA Merger Note

Equities Universe of Coverage:

Below is our Equities Universe of Coverage:

Banks	Price as at 22/03/2019	Price as at 29/03/2019	w/w change	q/q change	YTD Change	Year Open	Target Price*	Dividend Yield	Upside/Downside**	P/TBv Multiple
Diamond Trust Bank	135.5	130.0	(4.1%)	(16.9%)	(16.9%)	156.5	283.7	2.0%	120.2%	**0.7x**
GCB Bank	4.0	4.0	0.0%	(13.0%)	(13.0%)	4.6	7.7	9.5%	102.5%	**0.9x**
CRDB	125.0	125.0	0.0%	(16.7%)	(16.7%)	150.0	207.7	0.0%	66.2%	**0.4x**
Zenith Bank	22.1	21.8	(1.1%)	(5.4%)	(5.4%)	23.1	33.3	12.4%	65.2%	**1.0x**
I&M Holdings	94.3	113.5	20.4%	33.5%	33.5%	85.0	138.6	3.1%	25.2%	**1.0x**
UBA Bank	7.8	7.7	(1.3%)	0.0%	0.0%	7.7	10.7	11.0%	50.0%	**0.5x**
KCB Group***	44.7	44.1	(1.5%)	17.6%	17.6%	37.5	61.3	7.9%	47.1%	**1.4x**
Access Bank	6.9	6.5	(5.8%)	(5.1%)	(5.1%)	6.8	9.5	6.2%	53.5%	**0.4x**
Ecobank	7.7	8.0	3.9%	7.1%	7.1%	7.5	10.7	0.0%	33.6%	**1.7x**
CAL Bank	1.0	1.1	1.0%	7.1%	7.1%	1.0	1.4	0.0%	33.3%	**0.9x**
NIC Group	37.0	36.4	(1.8%)	30.8%	30.8%	27.8	48.8	2.8%	37.0%	**1.0x**
Co-operative Bank	15.6	15.0	(3.9%)	4.5%	4.5%	14.3	19.9	6.7%	39.8%	**1.4x**
Equity Group	43.5	41.6	(4.4%)	19.4%	19.4%	34.9	56.2	4.8%	39.9%	**2.1x**
HF Group	5.2	5.0	(3.8%)	(9.7%)	(9.7%)	5.5	6.6	7.0%	39.0%	**0.2x**
Stanbic Bank Uganda	29.0	30.0	3.6%	(3.2%)	(3.2%)	31.0	36.3	3.9%	24.8%	**2.1x**
Union Bank Plc	6.9	6.7	(2.9%)	18.8%	18.8%	5.6	8.2	0.0%	22.6%	**0.7x**
Bank of Kigali	265.0	275.0	3.8%	(8.3%)	(8.3%)	300.0	299.9	5.0%	14.1%	**1.5x**
SBM Holdings	6.0	6.0	(0.3%)	0.3%	0.3%	6.0	6.6	5.0%	14.7%	**0.9x**
Barclays Bank	12.0	11.8	(1.3%)	7.8%	7.8%	11.0	12.5	8.5%	14.4%	**1.6x**
Guaranty Trust Bank	37.5	36.1	(3.9%)	4.6%	4.6%	34.5	37.1	6.7%	9.6%	**2.3x**
Bank of Baroda	130.0	130.0	0.0%	(7.1%)	(7.1%)	140.0	130.6	1.9%	2.4%	**1.1x**
Stanbic Holdings	97.8	100.0	2.3%	10.2%	10.2%	90.8	92.6	5.9%	(1.6%)	**0.9x**
National Bank	5.0	4.9	(0.4%)	(7.3%)	(7.3%)	5.3	4.9	0.0%	(0.6%)	**0.4x**
Standard Chartered	20.0	20.0	0.0%	(4.8%)	(4.8%)	21.0	19.5	0.0%	(2.7%)	**2.5x**
Standard Chartered	217.3	215.3	(0.9%)	10.7%	10.7%	194.5	196.3	5.8%	(3.0%)	**1.8x**
FBN Holdings	8.3	8.2	(0.6%)	3.1%	3.1%	8.0	6.6	3.0%	(16.1%)	**0.5x**
Stanbic IBTC Holdings	45.5	46.0	1.1%	(4.1%)	(4.1%)	48.0	37.0	1.3%	(18.3%)	**2.3x**
Ecobank Transnational	13.4	13.2	(1.5%)	(22.4%)	(22.4%)	17.0	9.3	0.0%	(29.7%)	**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 has 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.