Understanding Retirement Benefits Schemes in Kenya & Cytonn Weekly #19/2019

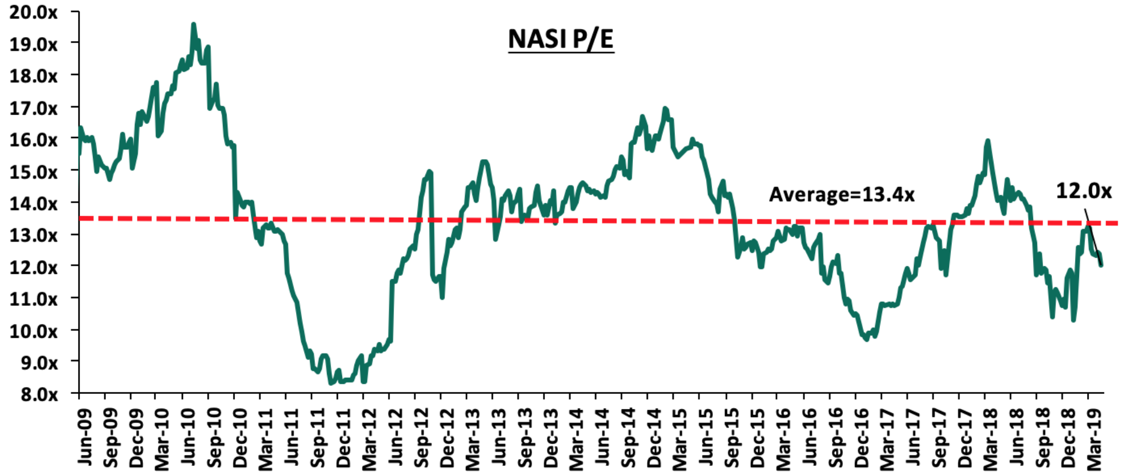
Equities

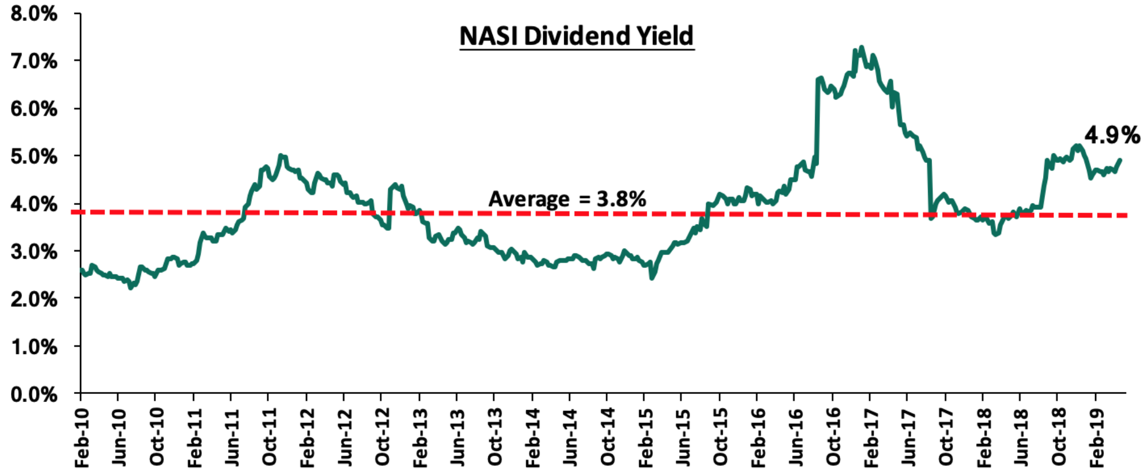
Market Performance:

During the week, the equities market was on a downward trend with NASI, NSE 20 and NSE 25 declining by 4.3%, 1.5% and 4.1%, respectively, taking their YTD performance to gains of 9.0%, (2.7%) and 6.4%, for NASI, NSE 20 and NSE 25, respectively. The performance in NASI was driven by declines in large cap stocks such as Equity Group, NIC Group, EABL and Safaricom, which declined by 6.8%, 6.7%, 4.5%, and 4.5%, respectively. The declines over the last two weeks were largely due to several counters having their book closures and thus begun trading ex-dividend.

Equities turnover declined by 18.3% during the week to USD 18.4 mn, from USD 22.5 mn the previous week, taking the YTD turnover to USD 572.3 mn. Foreign investors turned net sellers for the week, with a net selling position of USD 0.5 mn, from a net buying position of USD 1.9 mn.

The market is currently trading at a price to earnings ratio (P/E) of 12.0x, 10.3% below the historical average of 13.4x, and a dividend yield of 4.9%, 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 12.0x is 23.6% above the most recent trough valuation of 9.7x experienced in the first week of February 2017, and 44.5% 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

Equity Group released its Q1'2019 financial results:

Equity Group released its financial results with core earnings per share increasing by 4.9% to Kshs 1.64, from Kshs 1.56 in Q1'2018, faster than our projections of a 0.7% increase to Kshs 1.58. The performance was driven by a 6.6% increase in total operating income, despite a faster 7.0% increase in total operating expenses. The variance in core earnings per share growth against our expectations was largely due to a slower 7.0% rise in total operating expenses to Kshs 8.8 bn, from Kshs 8.2 bn in Q1'2018, which was not in line with our expectation of a 13.2% increase to Kshs 9.3 bn. Highlights of the performance from Q1'2018 to Q1'2019 include:

- Total operating income increased by 6.6% to Kshs 17.6 bn, from Kshs 16.5 bn in Q1'2018. This was driven by a 6.3% increase in Net Interest Income (NII) to Kshs 10.4 bn, from Kshs 9.8 bn in Q1'2018, coupled with a 6.9% increase in Non-Funded Income (NFI) to Kshs 7.2 bn, from Kshs 6.7 bn in Q1'2018,
- Interest income increased by 6.5% to Kshs 13.5 bn from Kshs 12.7 bn in Q1'2018. This was driven by an 11.9% growth in interest income from government securities to Kshs 4.1 bn, from Kshs 3.7 bn in Q1'2018, coupled with a 3.5% increase in interest income from loans to Kshs 9.1 bn from Kshs 8.8 bn in Q1'2018, and the 47.0% increase in interest income from placement assets to Kshs 0.3 bn from Kshs 0.2 bn in Q1'2018. The yield on interest-earning assets however declined to 11.1%, from 11.3% in Q1'2018, attributed to a decline in yields on government securities as well as a decline in lending rates due to the two Central Bank Rate (CBR) cuts in 2018,
- Interest expense rose by 7.4% to Kshs 3.1 bn, from Kshs 2.9 bn in Q1'2018, largely due to the 6.7% increase in the interest expense on customer deposits to Kshs 2.5 bn from Kshs 2.4 bn in Q1'2018, coupled with a 112.8% increase in interest expense on placements to Kshs 0.2 bn from Kshs 0.1 bn in Q1'2018. However, other interest expenses declined by 8.1% to Kshs 0.38 bn from Kshs 0.41 bn in Q1'2018. The cost of funds, however, declined to 2.6%, from 2.7% in Q1'2018,

owing to a faster increase in interest bearing liabilities that rose by 12.0% to Kshs 483.2 bn from Kshs 431.4 bn in Q1’2018. Consequently, the Net Interest Margin (NIM) declined to 8.6%, from 8.8% in Q1’2018,

- Non-Funded Income rose by 6.9% to Kshs 7.2 bn from Kshs 6.7 bn in Q1’2018. The increase was mainly driven by the 7.9% increase in other fees and commissions to Kshs 3.4 bn, from Kshs 3.2 bn in Q1’2018, which management attributed to the monetization of the firm’s alternative transaction channels. The improvement in NFI was also supported by the 21.7% growth in forex trading income to Kshs 0.8 bn, from Kshs 0.7 bn in Q1’2018, with management noting that this income segment benefitted from increased remittances from the diaspora and a 12.2% growth in other income to Kshs 1.6 bn from Kshs 1.4 bn in Q1’2018. The growth in NFI was however weighed down by the 6.8% decline in fees and commissions on loans to Kshs 1.4 bn from Kshs 1.5 bn in Q1’2018, which may be attributed to the implementation of the Effective Interest Rate (EIR) model under IFRS 9, which requires banks to amortize the fees and commissions on loans throughout the tenor of a loan. The revenue mix remained at 59:41 owing to the comparable increases in both NII and NFI,
- Total operating expenses rose by 7.0% to Kshs 8.8 bn, from Kshs 8.2 bn in Q1’2018, largely driven by a 14.3% increase in Loan Loss Provisions (LLP) to Kshs 0.41 bn from Kshs 0.36 bn in Q1’2018, coupled with a 9.6% increase in other operating expenses to Kshs 5.7 bn from Kshs 5.2 bn in Q1’2018. Staff costs rose marginally by 0.8% to Kshs 2.63 bn in Q1’2019 from Kshs 2.61 bn in Q1’2018,
- The Cost to Income Ratio (CIR) deteriorated marginally to 49.8%, from 49.6% in Q1’2018. Without LLP, the cost to income ratio remained flat at 47.5%,
- Profit before tax increased by 6.1% to Kshs 8.8 bn, up from Kshs 8.3 bn in Q1’2018. Profit after tax grew by 4.9% to Kshs 6.2 bn in Q1’2019, from Kshs 5.9 bn in Q1’2018, with the difference in growth attributable to the marginal increase in the effective tax rate to 29.4% from 29.1% in Q1’2018,
- The balance sheet recorded an expansion as total assets increased by 14.8% to Kshs 605.7 bn, from Kshs 527.8 bn in Q1’2018. Growth was supported by a 12.7% increase in the loan book to Kshs 305.5 bn, from Kshs 271.1 bn, coupled with a 13.0% increase in government securities to Kshs 169.7 bn from Kshs 150.2 bn in Q1’2018,
- Total liabilities rose by 14.5% to Kshs 510.2 bn from Kshs 445.7 bn in Q1’2018, driven by a 12.1% increase in customer deposits to Kshs 428.5 bn from Kshs 382.4 bn in Q1’2018. Deposits per branch increased by 12.1% to Kshs 1.5 bn from Kshs 1.4 bn in Q1’2018, as the number of branches remained unchanged,
- Borrowings rose by 12.5% to Kshs 51.0 bn from Kshs 45.3 bn in Q1’2018,
- The faster growth in loans as compared to the growth in deposits led to an increase in the loan to deposit ratio to 71.3% from 70.9% in Q1’2018,
- Gross Non-Performing Loans (NPLs) increased by 62.3% to Kshs 29.4 bn in Q1’2019, from Kshs 18.1 bn in Q1’2018. The NPL ratio thus deteriorated to 9.2% in Q1’2019 from 6.5% in Q1’2018. The deterioration in asset quality was largely attributed to various segments such as large enterprises, Small and Medium Enterprises (SMEs) and Agriculture, which had NPLs of 10.9%, 10.8% and 5.5%, respectively. The group’s Tanzania subsidiary contributed 31.6% of the NPLs, with South Sudan and Kenya contributing 12.6% and 8.5%, respectively. General Loan Loss Provisions increased by 60.6% to Kshs 10.0 bn, from Kshs 6.2 bn in Q1’2018. Thus, the NPL coverage deteriorated to 73.7% in Q1’2019 from 105.1% in Q1’2018,
- Shareholders’ funds increased by 15.1% to Kshs 94.5 bn in Q1’2019 from Kshs 82.1 bn in Q1’2018, supported by a 19.7% increase in retained earnings to Kshs 83.6 bn from Kshs 69.9 bn,
- Equity Group remains sufficiently capitalized with a core capital to risk-weighted assets ratio of 17.4%, 6.9% points above the statutory requirement. In addition, the total capital to risk-weighted assets ratio came in at 19.3%, exceeding the statutory requirement by 4.8% points. Adjusting for IFRS 9, the core capital to risk-weighted assets stood at 18.7%, while total capital to risk-weighted assets came in at 20.6%, and,

- The bank currently has a Return on Average Assets (ROaA) of 3.8%, and a Return on Average Equity (ROaE) of 22.8%.

Key Take-Outs:

1. The bank’s geographical diversification strategy has continued to emerge as a net positive, with the bank’s various subsidiaries in Uganda, DRC, Rwanda, Tanzania, and South Sudan cumulatively contributing 18.0% of the bank’s total profitability and 26.0% of the group’s total asset base. Equity Group has entered into an agreement with Atlas Mara to acquire subsidiaries in Tanzania, Rwanda, Mozambique, and Zambia. If successful, the transaction should see the bank significantly increase its size to a proforma asset base of Kshs 724.0 bn, placing the bank in a position to leverage on economies of scale in the rollout of its digital platforms in the region. This is in line with the group’s strategy to attain a Kshs 1.0 tn asset base, and a maximum contribution of 30.0% of the total profitability by a single subsidiary,
2. Increased innovation and digitization have seen 97.0% of all transactions of the bank being done on alternative channels, with mobile transactions taking up 77.0% of all transactions, and agency banking contributing 12.0% of all transactions. However, in terms of value of transactions, branches contributed 50.0% of the value of all transactions, with agency banking and mobile contributing 18.0% and 16.0% respectively. This highlights the transformation of branches to handle high value transactions. This transformation aids the bank in offering its ecosystem banking products to corporate and SME clients,
3. The bank’s Non-Funded Income bucked its declining trend, growing by 6.9% y/y, largely aided by a recovery in transactional income, as management indicated that the bank was now monetizing its transactional channels. However, fees and commissions on loans segment continued its declining trend, which may be attributed to the implementation of the EIR model under IFRS 9. With the banks’ NFI contribution to total income currently at 38.5%, it is still way above the current industry average of 33.2%, and,
4. The bank’s asset quality deteriorated, with the NPL ratio deteriorating to 9.2% from 6.5% in Q1’2018. The main sectors that contributed to the NPLs are large enterprises and SMEs. In terms of the regional view, the regions with the highest NPLs were Tanzania at 31.6% of their loan book, followed by South Sudan at 12.6% of their loan book. With the interest rate cap set to remain in place in Kenya, the bank has ramped up its loan disbursement to its customers in the region and will have to improve on its credit assessment in these markets in order to bring down the high NPL ratios in some of its regional subsidiaries.

See the Equity Group Q1'2019 Earnings note.

Stanbic Bank released its Q1’2019 financial results

Stanbic Bank released its Q1’2019 financial results with profit after tax increasing by 19.3% to Kshs 2.3 bn in Q1’2019, from Kshs 1.9 bn in Q1’2018. The performance was largely driven by an 18.5% increase in total operating income despite the 24.4% increase in the total operating expenses. Highlights of the performance from Q1’2018 to Q1’2019 include:

- Total operating income increased by 18.5% to Kshs 6.7 bn, from Kshs 5.7 bn in Q1’2018, driven by a 19.3% increase in Net Interest Income (NII) to Kshs 3.4 bn in Q1’2019, from Kshs 2.9 bn in Q1'2018, coupled with a 17.7% increase in Non-Funded Income to Kshs 3.3 bn, from Kshs 2.8 bn in Q1’2018,
- Interest income rose by 12.9% to Kshs 5.2 bn in Q1’2019, from Kshs 4.6 bn in Q1’2018. This was largely due to the 18.3% increase in interest income on loans and advances to Kshs 3.9 bn from Kshs 3.3 bn in Q1’ 2018, which outpaced the 9.1% decline in interest income on government securities to Kshs 1.1 bn from Kshs 1.2 bn in Q1’2018. The yield on interest-earning assets declined to 7.7% from 7.9% in Q1’2018, affected by the decline in yields on loans owing to the 100 bps reduction in the Central Bank Rate (CBR), and the decline in yields on government securities,

- Interest expense increased by 2.2% to Kshs 1.73 bn from Kshs 1.69 bn in Q1'2018, following a 10.9% increase in the interest expense on customer deposits to Kshs 1.2 bn from Kshs 1.1 bn in Q1'2018, as well as a 40.6% increase in other interest expense to Kshs 0.2 bn from Kshs 0.1 bn in Q1'2018. The increase in interest expenses was however mitigated by the 29.8% decline in interest expense on placement liabilities to Kshs 0.3 bn from Kshs 0.5 bn in Q1'2018. Cost of funds declined to 3.2%, from 3.3% in Q1'2018 owing to the faster 14.4% growth in an interest-bearing liabilities to Kshs 237.9 bn from Kshs 207.8 bn in Q1'2018. Consequently, the Net Interest Margin (NIM) declined to 4.9%, from 7.0% in Q1'2018,
- Non-Funded Income (NFI) increased by 17.7% to Kshs 3.3 bn from Kshs 2.8 bn in Q1'2018. The growth in NFI was driven by a 61.5% increase in total fees and commission income to Kshs 1.7 bn from Kshs 1.0 bn in Q1'2018, and an 85.2% increase in foreign exchange trading income to Kshs 1.5 bn in Q1'2019 from Kshs 0.8 bn in Q1'2018. The growth in NFI was however weighed down by the 87.0% decline in other income to Kshs 0.1 bn from Kshs 0.9 bn in Q1'2018. The revenue mix remained unchanged at 51:49 funded to non-funded income, owing to comparable increments in the bank's NII and NFI,
- Total operating expenses rose by 24.4% to Kshs 3.5 bn from Kshs 2.9 bn in Q1'2018, largely driven by an 895.5% increase in the Loan Loss Provision (LLP) to Kshs 0.6 bn from Kshs 63.4 mn in Q1'2018, as the bank increased its provisioning owing to the 61.1% increase in Non-Performing Loans (NPLs). Other interest expenses rose by 16.0% to Kshs 1.5 bn from Kshs 1.3 bn in Q1'2018. The growth in expenses was however mitigated by the 5.3% decline in staff costs to Kshs 1.4 bn from Kshs 1.5 bn in Q1'2018,
- The Cost to Income Ratio (CIR) with LLP deteriorated to 53.0% in Q1'2019 from 50.5% in Q1'2018. Without LLP, the cost to income ratio improved to 43.6% in Q1'2019 from 49.4% in Q1'2018,
- Profit before tax and exceptional items increased by 12.6% and stood at Kshs 3.1 bn, up from Kshs 2.8 bn in Q1'2018. Profit after tax increased by 19.3% to Kshs 2.3 bn in Q1'2019 from Kshs 1.9 bn in Q1'2018,
- The balance sheet recorded an expansion as total assets increased by 14.4% to Kshs 284.9 bn, from Kshs 249.0 bn in Q1'2018. This growth was largely driven by a 12.6% increase in the loan book to Kshs 144.7 bn from Kshs 128.5 bn, and balances due from the Central Bank, which increased by 130.6% to stand at Kshs 15.0 bn from Kshs 6.5 bn in Q1'2018,
- Government securities recorded an 8.8% decline to Kshs 40.3 bn from 44.2 bn in Q1'2018,
- Total liabilities rose by 14.9% to Kshs 248.0 bn from Kshs 215.9 bn in Q1'2018, largely driven by a 29.0% increase in deposits to Kshs 190.6 bn, from Kshs 147.8 bn in Q1'2018, coupled with the 13.2% increase in other liabilities to Kshs 8.2 bn, from Kshs 7.2 bn in Q1'2018. The growth in liabilities was however weighed down by the 3.3% and 43.3% decline in borrowings and placement liabilities to Kshs 11.7 bn and Kshs 13.8 bn in Q1'2019 from Kshs 12.0 bn and Kshs 24.3 bn in Q1'2018, respectively,
- The faster increase in deposits as compared to the loans lead to the decrease in the loan to deposit ratio to 75.9% in Q1'2019 from 87.0% in Q1'2018. Government securities to deposits declined to 21.2% from 29.9 % in Q1'2018, Deposits per branch grew by 29.0% to Kshs 7.3 bn from Kshs 5.7 bn in Q1'2018,
- Gross non-performing loans increased by 61.1% to Kshs 16.7 bn from Kshs 10.4 bn in Q1'2018. Consequently, the NPL ratio deteriorated to 10.9% from 7.8% in Q1'2018. General Loan Loss Provisions (LLPs) increased by 88.2% to Kshs 6.2 bn from Kshs 3.3 bn in Q1'2018, and consequently the NPL coverage increased to 56.4% from 50.3% in Q1'2018,
- Shareholders' funds increased by 11.5% to Kshs 36.8 bn in Q1'2019 from Kshs 33.0 bn in Q1'2018, largely due to the 12.7% increase in retained earnings to Kshs 28.4 bn from Kshs 25.2 bn in Q1'2018,
- Stanbic Bank is currently sufficiently capitalized with a core capital to risk weighted assets ratio of 15.5%, 5.0% points above the statutory requirement. In addition, the total capital to risk weighted assets ratio was 18.4%, exceeding the statutory requirement by 3.9% points. Adjusting

for IFRS 9, core capital to risk weighted assets ratio was at 15.5% while total capital to risk weighted assets was 19.1%, indicating that the bank's total capital relative to its risk-weighted assets declined by 0.7% points due to the implementation of IFRS 9.

Key take-outs

1. The bank continued to record an improved performance, as the bank registered improvements across all its revenue lines. NII was largely aided by the increased interest income from loans and advances, as the bank begins to reap the benefits of an aggressive lending period when most lenders were shunning lending. NFI was also largely aided by the increased lending, which rung in additional fee income, and the forex trading income. The positive performance was however impacted by the increase in expenses, largely due to the rise in impairment expenses. With increased lending the bank, however, increased its exposure to credit risk, and the bank's asset quality deteriorated. The bank may need to try and mitigate any further impairments, so as to contain the associated expenses.

See the Stanbic Bank Kenya Earnings note Q1'2019.

Weekly Highlights

During the week, Equity Group highlighted its plan to roll out lending focused especially on Micro, Small and Medium Enterprises (MSMEs), which operate in the agricultural, manufacturing and health sectors. The bank highlighted the plan to lend approximately Kshs 150.0 bn, with a majority of the funds expected to be sourced from the maturing investments in government securities. The move by Equity may be attributed to the reduction in yields on government securities, which compresses the bank's net interest margin. Thus in a bid to mitigate the re-investment risk at lower yields, the bank opts to focus on MSME lending, allowed by the relatively wider margins after the removal of the requirement to pay 70.0% of the Central Bank Rate (CBR) as interest in deposits. We expect the bank's recent partnership with Safaricom to likely aid the bank in obtaining a larger market, and consequently enable the bank in keeping a lid on costs incurred on disbursing the loans, leveraging on the digital distribution channels that have a wider reach. We, however, note that Equity Group's asset quality has been deteriorating, and as such a de-risking of the bank's loan portfolio is necessary, and therefore the adoption of robust credit scoring and assessment methods will be necessary, especially on new disbursement to avoid further deteriorations. We, however, expect the bank to benefit from increased lending by earning relatively higher interest income, and also additional fee and commission income.

Universe of Coverage

Below is a summary of our SSA universe of coverage:

Banks	Price as at 3/05/2019	Price as at 10/05/2019	w/w change	YTD Change	Target Price*	Dividend Yield	Upside/Downside**	P/TBv Multiple	Recommendation
Diamond Trust Bank	121.5	122.0	0.4%	(22.0%)	241.5	2.1%	100.1%	**0.6x**	**Buy**
Zenith Bank	21.0	20.0	(4.8%)	(13.2%)	33.3	13.5%	80.1%	**0.9x**	**Buy**
GCB Bank	4.0	4.5	12.5%	(2.2%)	7.7	8.4%	80.0%	**0.9x**	**Buy**
UBA Bank	6.7	6.5	(3.0%)	(15.6%)	10.7	13.1%	77.7%	**0.4x**	**Buy**
CRDB	130.0	125.0	(3.8%)	(16.7%)	207.7	0.0%	66.2%	**0.4x**	**Buy**
NIC Group	32.7	30.5	(6.7%)	9.7%	48.8	3.3%	63.3%	**0.9x**	**Buy**
CAL Bank	0.9	0.9	(1.1%)	(11.2%)	1.4	0.0%	60.9%	**0.7x**	**Buy**
Ecobank	6.7	6.7	0.0%	(10.4%)	10.7	0.0%	59.7%	**1.5x**	**Buy**
Co-operative Bank	12.6	12.4	(1.2%)	(13.3%)	18.5	8.1%	57.3%	**1.1x**	**Buy**
KCB Group***	41.3	40.5	(1.9%)	8.1%	60.0	8.6%	56.8%	**1.3x**	**Buy**
Equity Group	41.8	39.0	(6.8%)	11.8%	58.1	5.1%	54.3%	**1.8x**	**Buy**
I&M Holdings	123.3	119.0	(3.4%)	40.0%	167.7	2.9%	43.9%	**1.2x**	**Buy**
Access Bank	6.9	7.1	2.9%	4.4%	9.5	5.6%	39.4%	**0.4x**	**Buy**
Barclays Bank	10.6	10.7	0.9%	(2.7%)	13.1	10.3%	33.3%	**1.4x**	**Buy**
Stanbic Bank Uganda	29.0	30.0	3.4%	(3.2%)	36.3	3.9%	24.8%	**2.1x**	**Buy**
Guaranty Trust Bank	33.5	32.0	(4.3%)	(7.1%)	37.1	7.5%	23.4%	**2.1x**	**Buy**
National Bank	4.8	4.4	(9.6%)	(18.2%)	5.2	0.0%	19.5%	**0.4x**	**Accumulate**
Stanbic Holdings	101.8	103.0	1.2%	13.5%	115.6	5.7%	17.9%	**1.0x**	**Accumulate**
SBM Holdings	5.9	5.9	0.0%	(1.3%)	6.6	5.1%	16.7%	**0.8x**	**Accumulate**

Banks	Price as at 3/05/2019	Price as at 10/05/2019	w/w change	YTD Change	Target Price*	Dividend Yield	Upside/Downside**	P/TBv Multiple	Recommendation
Union Bank Plc	7.1	7.0	(1.4%)	25.0%	8.2	0.0%	16.4%	**0.7x**	**Accumulate**
Bank of Kigali	274.0	274.0	0.0%	(8.7%)	299.9	5.1%	14.5%	**1.5x**	**Accumulate**
Standard Chartered	199.0	193.0	(3.0%)	(0.8%)	203.8	6.5%	12.1%	**1.6x**	**Accumulate**
Bank of Baroda	129.0	129.0	0.0%	(7.9%)	130.6	1.9%	3.2%	**1.1x**	**Lighten**
Standard Chartered	19.0	19.0	0.0%	(9.5%)	19.5	0.0%	2.4%	**2.4x**	**Lighten**
FBN Holdings	7.4	7.3	(2.0%)	(8.8%)	6.6	3.4%	(5.1%)	**0.4x**	**Sell**
Ecobank Transnational	10.8	10.3	(4.6%)	(39.4%)	9.3	0.0%	(9.9%)	**0.4x**	**Sell**
Stanbic IBTC Holdings	43.5	46.0	5.7%	(4.1%)	37.0	1.3%	(18.3%)	**2.2x**	**Sell**
HF Group	4.0	4.4	10.0%	(20.6%)	2.9	8.0%	(26.1%)	**0.2x**	**Sell**

***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.

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