Cytonn INVESTMENTS

Investing in Unit Trust Funds, & Cytonn Weekly #20/2019

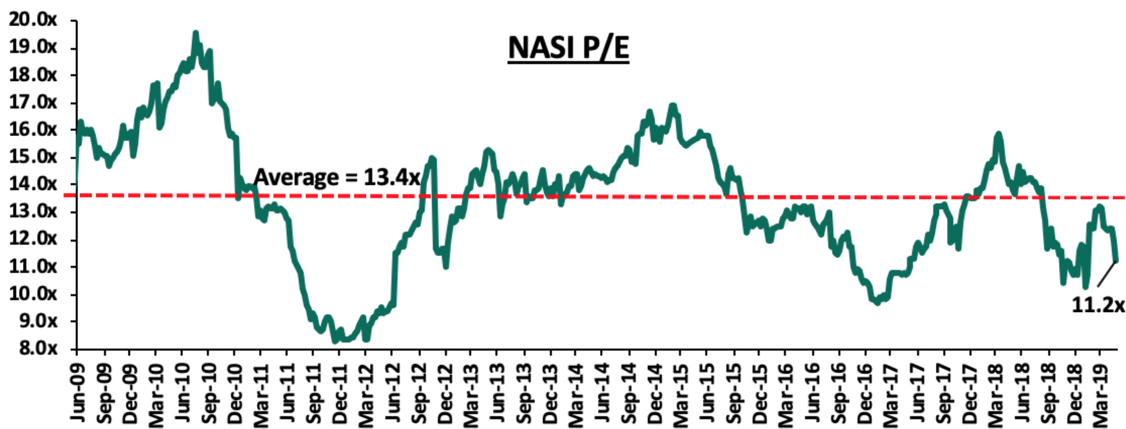
Equities

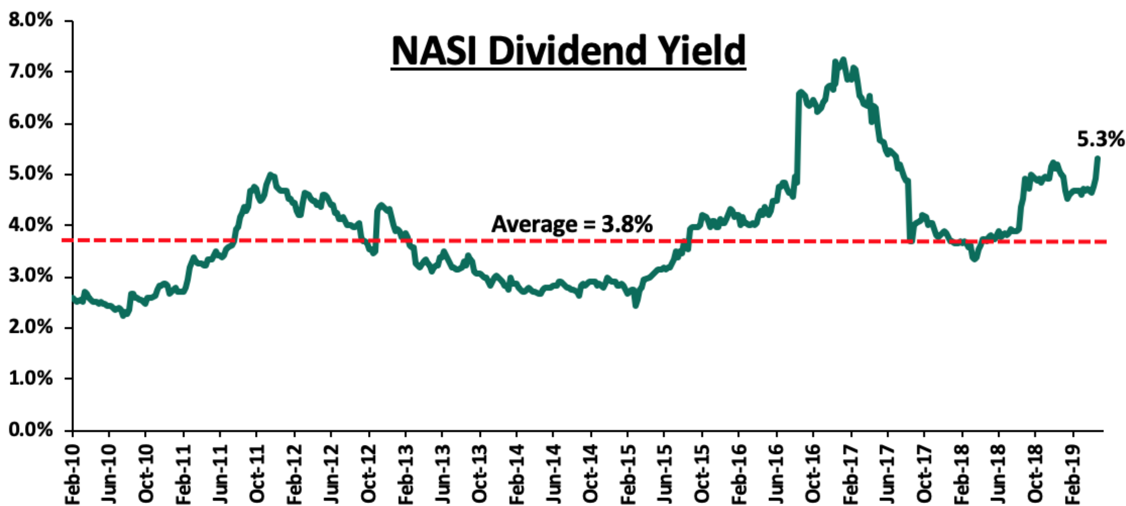
Market Performance

During the week, the equities market was on a downward trend with NASI, NSE 20 and NSE 25 declining by 6.5%, 3.3% and 6.6%, respectively, taking their YTD performance to gains / (losses) of 2.0%, (5.9%) and (0.7%), for NASI, NSE 20 and NSE 25, respectively. The performance of NASI was driven by declines in large cap stocks such as KCB Group, Equity Group, Standard Chartered Bank Kenya (SCBK), Safaricom and Co-operative Bank, which declined by 10.4%, 6.5%, 6.1%, 5.6% and 4.0%, respectively.

Equities turnover rose by 75.7% during the week to USD 32.3 mn, from USD 18.4 mn the previous week, taking the YTD turnover to USD 604.6 mn. Foreign investors turned net buyers for the week, with a net buying position of USD 3.8 mn, from a net selling position of USD 0.5 mn last week.

The market is currently trading at a price to earnings ratio (P/E) of 11.2x, 16.0% below the historical average of 13.4x, and a dividend yield of 5.3%, 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 11.2x is 15.7% above the most recent trough valuation of 9.7x experienced in the first week of February 2017, and 35.2% 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.





Earnings Releases

NIC Group released their Q1'2019 financial results:

NIC Group released their financial results with core earnings per share declining by 4.3% to Kshs 1.3, from Kshs 1.4 in Q1'2018, contrary to our projections of a 1.2% increase to Kshs 1.4. The performance was driven by an 8.8% increase in total operating income to Kshs 3.8 bn, from Kshs 3.5 bn in Q1'2018, which was outpaced by the 16.8% increase in total operating expenses to Kshs 2.5 bn, from Kshs 2.1 bn in Q1'2018. The variance in core earnings per share growth against our expectations was largely due to the faster 16.8% rise in total operating expenses to Kshs 2.5 bn, from Kshs 2.1 bn in Q1'2018, which was not in line with our expectation of a 11.2% increase to Kshs 2.4 bn.

- Total operating income rose by 8.8% to Kshs 3.8 bn, from Kshs 3.5 bn in Q1'2018. This was driven by a 9.4% increase in Net Interest Income (NII) to Kshs 2.7 bn, from Kshs 2.5 bn in Q1'2018, coupled with a 7.2% increase in Non-Funded Income (NFI) to Kshs 1.1 bn, from Kshs 1.0 bn in Q1'2018,
- Interest income rose by 1.3% to Kshs 4.73 bn, from Kshs 4.66 bn in Q1'2018. This was driven by a 7.6% growth in interest income from government securities to Kshs 1.7 bn, from Kshs 1.6 bn in Q1'2018. The increase in interest income was however weighed down by the 40.3% decline in interest income from placement assets to Kshs 16.7 mn from Kshs 27.9 mn in Q1'2018, and the 1.6% decline in interest income from loans to Kshs 2.99 bn from Kshs 3.04 bn in Q1'2018. The yield on interest-earning assets however declined to 10.6%, from 11.2% in Q1'2018, attributed to a decline in yields on government securities as well as a decline in lending rates due to the 100 bps Central Bank Rate (CBR) cut in 2018,
- Interest expense declined by 7.9% to Kshs 2.0 bn, from Kshs 2.2 bn in Q1'2018, largely due to the 8.1% decline in the interest expense on customer deposits to Kshs 1.6 bn, from Kshs 1.8 bn in

Q1’2018, coupled with a 37.8% decline in interest expense on placement liabilities to Kshs 53.3 mn bn from Kshs 85.7 mn in Q1’2018. However, other interest expenses rose by 1.4% to Kshs 0.324 bn from Kshs 0.320 bn in Q1’2018. The cost of funds thus declined to 5.1%, from 5.4% in Q1’2018. The Net Interest Margin (NIM) declined to 5.9%, from 6.3% in Q1’2018,

- Non-Funded Income rose by 7.2% to Kshs 1.1 bn from Kshs 1.0 bn in Q1’2018. The increase was mainly driven by the 6.2% increase in total fees and commissions to Kshs 0.60 bn, from Kshs 0.56 bn in Q1’2018, with fees and commissions on loans income improving as a result of increased lending activity by the bank during the period under review. The improvement in NFI was also supported by the 17.5% growth in other income to Kshs 0.21 bn, from Kshs 0.18 bn in Q1’2018, and a 2.8% growth in forex trading income to Kshs 0.31 bn, from Kshs 0.30 bn in Q1’2018. The revenue mix shifted to 71:29 from 70:30 funded to non-funded income owing to the slightly faster increase in NII,
- Total operating expenses rose by 16.8% to Kshs 2.5 bn, from Kshs 2.1 bn in Q1’2018, largely driven by a 21.4% increase in Loan Loss Provisions (LLP) to Kshs 0.7 bn from Kshs 0.6 bn in Q1’2018, coupled with an 11.5% increase in staff costs to Kshs 0.9 bn, from Kshs 0.8 bn in Q1’2018, and a 19.1% increase in other operating expenses to Kshs 0.9 bn, from Kshs 0.8 bn in Q1’2018,
- The Cost to Income Ratio (CIR) deteriorated to 65.2%, from 60.7% in Q1’2018. Without LLP, the cost to income ratio deteriorated to 47.6%, from 45.0% in Q1’2018,
- Profit before tax decreased by 3.7% to Kshs 1.3 bn, up from Kshs 1.4 bn in Q1’2018. Profit after tax declined by 4.3% to Kshs 0.9 bn in Q1’2019, from Kshs 1.0 bn in Q1’2018, with the difference in growth attributable to the marginal increase in the effective tax rate to 30.3%, from 29.8% in Q1’2018,
- The balance sheet recorded an expansion as total assets increased by 6.9% to Kshs 213.6 bn, from Kshs 199.8 bn in Q1’2018. Growth was supported by a 2.1% increase in the loan book to Kshs 118.3 bn, from Kshs 115.9 bn, coupled with a 10.3% increase in government securities to Kshs 60.4 bn, from Kshs 54.8 bn in Q1’2018,
- Total liabilities rose by 5.1% to Kshs 176.3 bn from Kshs 167.8 bn in Q1’2018, driven by a 5.0% increase in customer deposits to Kshs 151.1 bn from Kshs 143.9 bn in Q1’2018. Deposits per branch increased by 25.4% to Kshs 3.7 bn from Kshs 2.9 bn in Q1’2018, as the number of branches declined to 41, from 49 as at Q1’2018,
- Borrowings declined by 10.9% to Kshs 14.9 bn, from Kshs 16.8 bn in Q1’2018,
- The faster growth in deposits compared to the loan growth led to a decline in the loan to deposit ratio to 78.3%, from 80.5% in Q1’2018,
- Gross Non-Performing Loans (NPLs) increased by 9.4% to Kshs 17.4 bn in Q1’2019, from Kshs 15.4 bn in Q1’2018. The NPL ratio thus deteriorated to 13.9% in Q1’2019 from 11.9% in Q1’2018. General Loan Loss Provisions decreased by 26.7% to Kshs 4.5 bn, from Kshs 6.1 bn in Q1’2018, and consequently the NPL coverage deteriorated to 40.8% in Q1’2019, from 48.0% in Q1’2018,
- Shareholders’ funds increased by 17.2% to Kshs 37.0 bn in Q1’2019 from Kshs 31.6 bn in Q1’2018, supported by a 15.7% increase in retained earnings to Kshs 29.9 bn, from Kshs 25.9 bn in Q1’2018,
- NIC Group remains sufficiently capitalized with a core capital to risk-weighted assets ratio of 19.7%, 9.2% points above the statutory requirement. In addition, the total capital to risk-weighted assets ratio came in at 21.3%, exceeding the statutory requirement by 6.8% points. Adjusting for IFRS 9, the core capital to risk weighted assets stood at 20.9%, while total capital to risk-weighted assets came in at 22.5%, and,
- The bank currently has a Return on Average Assets (ROaA) of 2.0%, and a Return on Average Equity (ROaE) of 12.2%.

Key Take-Outs:

1. The bank’s performance was largely weighed down by rising operational inefficiencies, as the rise

in total operating expenses outpaced the rise in total operating income. The bank recorded significant increments in provisioning expenses, as the asset quality deteriorated with NPL ratio rising to 13.9% from 11.9% in Q1’2018, and,

2. The bank’s cost of funds declined to 5.1% from 5.4% in Q1’2018. This may largely be due to the removal of the 70.0% of the Central Bank Rate (CBR) floor on interest paid to deposits, in the Finance Act 2018. However, the cost of funds remains way above the market average of 3.7%, implying that funding for NIC Group still remains relatively expensive compared to the market. We however expect this to improve going forward, as the merger with CBA is likely to make it easier for NIC to mobilize cheaper funding, aided by CBA’s large customer base, increased scale and market reach with a combined entity, and digital banking platforms, which will likely improve Net Interest Margins and consequently generating higher Net Interest Income.

For more information, please see our NIC Group Q1’2019 Earnings Note

The table below highlights the performance of the banks that have released so far, showing the performance using several metrics, and 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 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 Bank	N/A	12.9%	2.2%	19.3%	4.9%	17.7%	49.0%	61.5%	29.0%	(8.8%)	53.0%	75.9%	12.6%	3.2%	14.3%
Equity	4.9%	6.5%	7.4%	6.3%	8.6%	6.9%	40.8%	3.2%	12.1%	13.0%	49.8%	71.3%	12.7%	2.6%	22.8%
NIC Group	(4.3%)	1.3%	(7.9%)	9.4%	5.9%	7.2%	29.1%	6.2%	5.0%	10.3%	65.2%	78.3%	2.1%	5.1%	12.2%
Q1’2019 Mkt cap Weighted Average	**0.5%**	**5.0%**	**0.3%**	**9.1%**	**7.1%**	**8.2%**	**36.7%**	**11.0%**	**10.9%**	**9.4%**	**56.7%**	**74.8%**	**8.2%**	**3.7%**	**17.4%**
Q1’2018 Mkt cap Weighted Average	**14.4%**	**9.3%**	**11.4%**	**8.1%**	**8.1%**	**9.5%**	**37.1%**	**12.2%**	**9.4%**	**25.0%**	**56.6%**	**76.8%**	**6.1%**	**3.6%**	**17.6%**

Key takeaways from the table above include:

i. Three banks have released their Q1’2019 financial results, recording a 0.5% average increase in core Earnings Per Share (EPS), compared to a growth of 14.4% in Q1’2018 for the entire banking sector, and consequently, the Return on Average Equity (RoAE) has declined to 17.4%, from 17.6% in Q1’2018,

ii. The banks that have released results have recorded better deposit growth, which came in at 10.9%, faster than the 9.4% growth recorded in Q1’2018. Despite the faster deposit growth, interest expenses rose marginally by 0.3%, indicating that banks have been mobilizing relatively cheaper deposits. Furthermore, in September 2018, an implementation of the Finance Act 2018 saw the removal of the minimum interest rate payable on deposits, which stood at 70.0% of the Central Bank Rate (CBR). This helped mitigate high increments in interest expense, despite the relatively faster deposit growth,

iii. Average loan growth came in at 8.2%, which was faster than the 6.1% recorded in Q1’2018, indicating that there was an improvement in credit extension, with banks targeting select segments such as corporate entities and Small and Medium Enterprises (SMEs). Government securities on the other hand recorded a growth of 9.4% y/y, which was faster compared to the loans, albeit slower than 25.0% recorded in Q1’2018. This highlights banks’ continued preference towards investing in government securities, which offer better risk-adjusted returns. Interest income increased by 5.0%, compared to a growth of 9.3% recorded in Q1’2018. The slower growth in interest income despite the increased allocations to both loans and government securities may be attributable to the decline in yields on loans owing to the 100-bps decline in the CBR, and the decline in yields on government securities, and consequently, the Net Interest Margin (NIM) has thus declined to 7.1% from 8.1% in Q1’2018, and,

iv. Non-Funded Income grew by 8.2% y/y, slower than 9.5% recorded in Q1’2018. The growth in NFI

was weighed down as total fee and commission income grew by 11.0%, slower than the 12.2% growth recorded in Q1'2018. The fee and commission income were also subdued by the implementation of the Effective Interest Rate (EIR) model under IFRS 9 in 2018, which requires banks to amortize the fees and commissions on loans, over the tenor of the loan. A faster growth in Net Interest Income (NII) led to a decline in the contribution of NFI to total operating income, to 36.7% from 37.1% in Q1'2018.

Weekly Highlights

During the week, NIC Group and Commercial Bank of Africa (CBA) announced the leadership of the combined entity, upon the completion of the proposed merger between the two banks. Mr. John Gachora, who is currently the Group Managing Director of NIC Group will become the Group Managing Director and Chief Executive Officer of the combined entity, while Isaac Awuondo who is currently the Group Managing Director of CBA will become Chairman of the Kenyan banking subsidiary, and will maintain direct oversight over the Digital Business. The appointments are in line with our expectations, which we highlighted in our Cytonn January 2019 Monthly Report. The merger proposal has already been ratified by the shareholders of both companies, with the Competition Authority of Kenya (CAK) also approving the transaction during the week, highlighting that it was unlikely to lessen the competition in the relevant product market for retail and corporate banking services in Kenya. With digital banking being a core aspect in the merger, a separate digital banking unit will be created, and it will be overseen by its own distinct board. We note that the transaction has been progressing with some of the requisite approvals being granted. Pending approvals include that of the Central Bank of Kenya (CBK). Both banks are preparing for a merger on the day to day operations, with an Integration Management Office having been set up and a detailed integration work plan developed. We expect the merger to be completed with the set-out timelines, with the merged entity set to commence operations in August 2019.

During the week, KCB Group released a circular to its shareholders detailing the merger guidelines and expected timelines. The transaction details were as we had highlighted in our Kenya Listed Banks FY'2018 Report & Cytonn Weekly #16/2019. If successful, the transaction will see KCB Group significantly increase its balance sheet, with management highlighting that they expected to reach the Kshs 1.0 tn mark by the end of 2022. The circular also highlighted that in a bid to streamline the operations of the group, there may be job cuts, as the bank removes overlapping roles, reduce the associated expenses and consequently improve the overall efficiency. A successful completion of the merger is however contingent on the granting of the approvals from various regulatory bodies, with only The Capital Markets Authority (CMA) granting approval so far, and the acceptance of the offer by the Board of Directors of National Bank of Kenya (NBK). KCB Group expects to complete the transaction by 8th October 2019, with NBK expected to be de-listed, and remain as a separate subsidiary of KCB. We continue to expect activity on the consolidation front as the larger players look to consolidate their market positions, while smaller players that are struggling to operate under the current operating environment will also likely move to form strategic partnerships through mergers or outright sale. We thus maintain our view that the sector would be more stable with fewer, well capitalized players able to withstand any systemic shocks.

Universe of Coverage

Below is a summary of our SSA universe of coverage:

Banks	Price as at 10/05/2019	Price as at 17/05/2019	w/w change	YTD Change	Target Price*	Dividend Yield	Upside/Downside**	P/TBv Multiple	Recommendation
Diamond Trust Bank	122.0	121.0	(0.8%)	(22.7%)	241.5	2.1%	101.7%	**0.6x**	**Buy**
UBA Bank	6.5	6.0	(7.7%)	(22.1%)	10.7	14.2%	92.5%	**0.4x**	**Buy**
Zenith Bank	20.0	19.6	(2.0%)	(15.0%)	33.3	13.8%	83.8%	**0.9x**	**Buy**
KCB Group***	40.5	36.3	(10.4%)	(3.1%)	60.0	9.6%	74.9%	**1.2x**	**Buy**
CRDB	125.0	120.0	(4.0%)	(20.0%)	207.7	0.0%	73.1%	**0.4x**	**Buy**

Banks	Price as at 10/05/2019	Price as at 17/05/2019	w/w change	YTD Change	Target Price*	Dividend Yield	Upside/Downside**	P/TBv Multiple	Recommendation
CAL Bank	0.9	0.8	(5.7%)	(16.3%)	1.4	0.0%	70.7%	**0.7x**	**Buy**
Equity Group	39.0	36.4	(6.5%)	4.4%	58.1	5.5%	65.1%	**1.6x**	**Buy**
Co-operative Bank	12.4	11.9	(4.0%)	(16.8%)	18.5	8.4%	63.9%	**1.0x**	**Buy**
GCB Bank	4.5	5.0	11.3%	8.9%	7.7	7.6%	61.7%	**1.2x**	**Buy**
Ecobank	6.7	6.8	1.2%	(9.3%)	10.7	0.0%	57.8%	**1.5x**	**Buy**
NIC Group	30.5	31.6	3.6%	13.7%	48.8	3.2%	57.6%	**0.8x**	**Buy**
Access Bank	7.1	6.5	(9.2%)	(5.1%)	9.5	6.2%	53.5%	**0.4x**	**Buy**
I&M Holdings	119.0	60.0	(49.6%)	(29.4%)	83.9	5.8%	45.6%	**0.6x**	**Buy**
Barclays Bank	10.7	10.5	(1.4%)	(4.1%)	13.1	10.5%	35.2%	**1.4x**	**Buy**
National Bank	4.4	3.9	(9.4%)	(25.9%)	5.2	0.0%	32.0%	**0.3x**	**Buy**
Guaranty Trust Bank	32.0	30.6	(4.4%)	(11.2%)	37.1	7.8%	29.1%	**1.9x**	**Buy**
Stanbic Bank Uganda	30.0	30.0	0.0%	(3.2%)	36.3	3.9%	24.8%	**2.1x**	**Buy**
Stanbic Holdings	103.0	97.5	(5.3%)	7.4%	115.6	6.0%	24.6%	**0.9x**	**Buy**
Standard Chartered	193.0	181.3	(6.1%)	(6.8%)	203.8	6.9%	19.3%	**1.5x**	**Accumulate**
SBM Holdings	5.9	5.9	0.0%	(1.3%)	6.6	5.1%	16.7%	**0.8x**	**Accumulate**
Union Bank Plc	7.0	7.0	0.0%	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**
Bank of Baroda	129.0	129.0	0.0%	(7.9%)	130.6	1.9%	3.2%	**1.1x**	**Lighten**
FBN Holdings	7.3	7.0	(3.4%)	(11.9%)	6.6	3.6%	(1.7%)	**0.4x**	**Sell**
Ecobank Transnational	10.3	10.0	(2.9%)	(41.2%)	9.3	0.0%	(7.2%)	**0.4x**	**Sell**
Standard Chartered	19.0	21.8	14.7%	3.8%	19.5	0.0%	(10.7%)	**2.7x**	**Sell**
Stanbic IBTC Holdings	46.0	44.1	(4.2%)	(8.1%)	37.0	1.4%	(14.6%)	**2.3x**	**Sell**
HF Group	4.4	4.4	0.0%	(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 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.