Cytonn
INVESTMENTS

Cytonn Quarter 1, 2016 Report

Cytonn Weekly

Executive Summary

- Global Markets Review: The Federal Open Market Committee held rates constant and the European Central Bank increased stimulus as Central Banks globally implement policies to support economic growth;
- Regional Markets Review: Sub Saharan Africa 2016 GDP is expected to grow by 4.2% given expectations of stability in commodity prices as a result of improved economic conditions in most of its export destinations;
- Kenya Macro Economic Review: Inflation came down in Q1?2016 to 6.5% in March 2016 from a high of 8.0% in December 2015, driven by a decline in oil pump prices from the sustained low oil prices globally. The low oil prices have also helped maintain the stability of the shilling by reducing current account deficit;
- Fixed Income: Yields on treasury securities declined by over 200 basis points on account of high liquidity in the money market and confusion over the actual budget numbers as the figures from the Budget Policy Statements were different from the parliamentary budget committee;
- Kenya Equities Market: During the quarter, NASI and NSE 25 gained 1.2% and 1.6%, respectively while NSE 20 lost 1.5%. Most companies released weak earnings in the quarter with the exception of BAT, Bamburi and KCB Group, due to the tough operating environment in 2015; Majority of banks and insurance companies recorded weak earnings growth for the full year 2015;
- Private Equity: Private equity as an asset class remained robust in Q1?2016 with increased number of deals and several exits being recorded in the region, demonstrating the overall attractiveness of the Sub-Saharan Africa market;
- Real Estate: Real estate trends in Q1/2016 include diversification of funding, increased regulation, continued interest in private public partnerships, and an increase in the number of distressed real estate assets in the country.

Company Updates

- Our Investment Manager, Maurice Oduor, discussed National Bank?s corporate governance issues and Kenya Airways? plans to retrench 600 staff members. Maurice Oduor on KTN News Kenya.
- This week on Tuesday 5th April 2016, we shall be launching our FY?2015 banking report at The Sarova Stanley
- We continue to beef up the team with other ongoing hires. Careers at Cytonn

Global Markets Review

Introduction

The first quarter of 2016 was characterized by concerns over a slowdown in global economic growth due to concerns in China and the Eurozone which seem not to have recovered from the early Quantitative Easing offered last year. According to the IMF World economic outlook, 2015 is

estimated to have grown by 3.1%, and it?s projected that 2016 shall grow by 3.4%, driven by a gradual growth in the emerging and developing economies which shall grow by 4.3%, and an uneven recovery in the advanced economies projected to grow by 2.1%. The concerns in economic growth led to the financial markets volatility as evidenced by the 15.0% YTD decline of the Shanghai Composite Index.

United States

The US Fed held the federal funds rates at 0.25%-0.50% range during their much anticipated March 2016 meeting following a 25 bps increase in their December meeting. The Fed?s decision was on account of weak and uncertain global economic environment and low inflation, currently at 1.0% and below their 2% target. The Federal Open Market Committee also downgraded their expected number of rate hikes this year from 4 to 2, possibly in June and December, with a projected federal funds rate of 1.0% by the end of the year.

The US economy has remained resilient, having grown by 1.4% in Q4?2015 against a projection of 1.0% growth. Growth was driven by improved consumer confidence, increased spending due to wage growth and a robust growth in housing market. However, moving into 2016, there are concerns on the strength of consumer spending despite relatively stable income growth, owing to (i) falling labour productivity, (ii) rising labour costs, and (iii) currency volatility. This led the Federal Reserve Bank of Atlanta to revise downwards its Q1?2016 US GDP growth estimate to 0.6%, from 1.4%.

The stock market has been stable, with S&P 500 having gained 0.8% in Q1?2016, largely driven by the Fed?s decision to hold on rates and further easing measures in the Eurozone. However, company pre-tax earnings declined an average 7.8% y/y from Q1?2015, the largest decline since the first quarter of 2011. On the valuations, Cyclically Adjusted Price/Earnings (CAPE) ratio is currently at 24.1x, above the historical average of 16.0x. We expect the market to remain volatile with possibilities of declines for the remainder of 2016 unless (i) Q2?2016 earnings results show a positive surprise, which will be largely driven by increased consumer spending, (ii) China?s economy surprises growth forecast, and (iii) the Fed holds off tightening monetary policies and instead opts for further easing stimulus to support the economy.

Eurozone

The European Central Bank (ECB) met in March and delivered an additional round of quantitative easing, with the following measures; (i) increased the rate of asset purchases under their ongoing Quantitative Easing programme to Euro 80.0 bn per month from Euro 60.0 bn per month, (ii) reduced the base lending rate by 5.0 basis points to 0.00% from 0.05%, (iii) reduced the deposit lending facility rate by 10 basis points to -0.4% from -0.3%, and (iv) included investment grade euro-denominated bonds issued by non-bank corporations established in the euro area in the list of assets that are eligible for regular purchases.

These actions by the ECB came following poor economic performance of the Eurozone, with the GDP growth for the region coming in at 0.3% in Q4?2015, while manufacturing and inflation also slowed down to a reading of 51.6 at the end of Q1?2016 from 53.2 at the end of Q4?2015 on the Purchasing Managers Index%. The market expectation for Eurozone Q1?2016 GDP growth stands at 0.4% and is expected to pick up on the back of improved consumer spending.

The Euro Stoxx 300 has also been on a downward trend, losing 9.3% during the quarter. This is despite the announcements of additional stimulus by the ECB, highlighting the weak and uneven growth in the Eurozone.

Moving into 2016, inflation remains a key risk to Eurozone growth, which currently stands at -0.1% and struggling to reach a 1% level. A key factor for the weaker inflation is partly disinflationary pressures in Eurozone countries, as a result of (i) unemployment remaining well above the long-term

average, (ii) average Eurozone GDP growth rate still well below 2%, and (iii) the renewed decline in world oil prices.

China

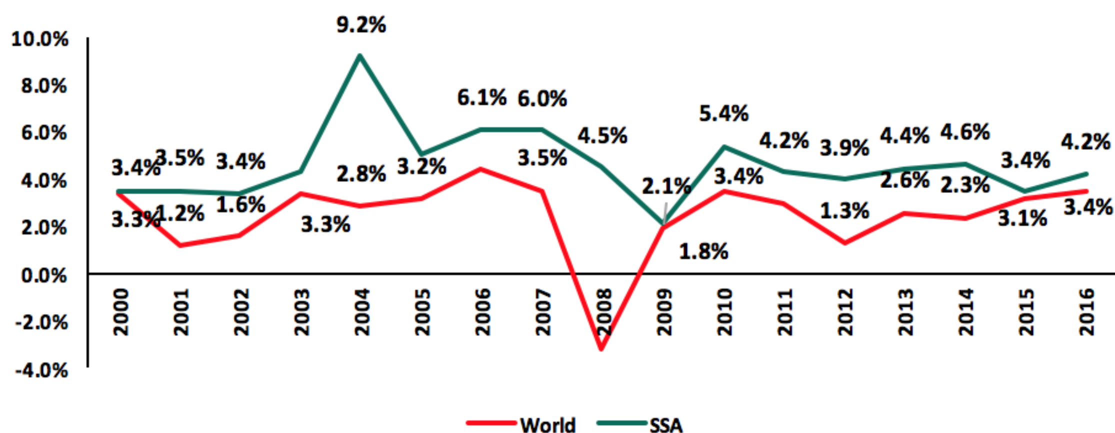
Economic growth decelerated in China to a 25-year low in 2015, coming in at 6.9% from 7.3% in 2014. This is as a result of China?s shift towards a more services led economy pegged on consumption from its export-based economy. In order to support growth, the People?s Bank of China has cut policy rates to 4.4% and bank?s reserve requirement ratio to 17.0%, amid signaling further policy easing. At the start of the year, the Chinese Government set a GDP growth target range of 6.5% - 7.0% for 2016. To achieve this, the government devalued the Yuan by 0.5%, spreading fears across the markets that (i) China's growth potential is worse than investors think, and (ii) adding questions to China on why they are still interfering artificially with the markets.

The Shanghai Composite has been one of the worst performing indices in 2016, having declined 15.0% in Q1?2016. China has also recently suffered downgrades by S&P and Moody?s, with their outlook turning negative from stable, citing the government?s reform agenda is on track but likely to proceed slower than expected.

We expect the monetary and fiscal easing to help stabilize China?s growth going into the year 2016, however, given the increased over-reliance on China by the global economy, a slowdown cannot be ignored, especially given that China has been the engine of global economic growth, contributing 10.0% since the last global financial crisis of 2008, growing at above 7.5% for the last 7 years.

Sub Saharan Africa Regional Outlook

According to the World Bank, Sub-Saharan Africa (SSA) GDP growth declined to 3.4% in 2015 from 4.6% in 2014 due to a combination of both external and domestic issues. The external factors comprised of (i) the global drop in commodity prices which affected the commodities-dependent West and Southern African nations, (ii) bilateral trade slowdown due to weak growth exhibited by major SSA?s trading partners, and (iii) tightening borrowing conditions in the global markets. Domestic factors comprise of (i) political instability and conflicts in Nigeria and several other African nations, and (ii) electricity shortages as witnessed in South Africa. However, there is much optimism for 2016, with GDP expected to grow by 4.2% driven by expectations of stability in commodity prices and the correction of supply constraints following a pickup in demand by SSA?s major trading partners. Chart below shows the SSA GDP growth rate against the World GDP growth rate



Despite a favourable Q1?2016 compared to 2015, risks still linger; (i) Political uncertainty associated with upcoming elections, (ii) insecurity and terrorism, and (iii) power shortages sum up risks that exist domestically. External risks include (i) the possibilities of a further drop in commodity prices, (ii) a faster than expected slowdown in China, and (iii) a decline in global capital flows into the region, as the United States normalizes their monetary policy which may be cushioned by a slowdown in the pace of the US rate hikes. The existing fiscal and external vulnerabilities, coupled

with domestic challenges to growth, still pose challenges for policy implementation.

African sovereign bonds have performed well in the international market with the yield coming down by an average of 1.1%. The table below shows the performance of the key African Eurobond;

Country	31-Dec-15	31-Mar-16	Change
Nigeria	8.8%	7.7%	-1.1%
Ghana	10.9%	9.1%	-1.8%
Kenya	9.4%	7.8%	-1.7%
Angola	11.1%	11.0%	-0.1%
Rwanda	7.9%	7.1%	-0.8%

Majority of the African exchanges registered negative returns in Q1?2016, as illustrated in the table below. The only gaining indices were the Johannesburg All Share Index, Uganda All Share Index and the Nairobi All Share Index, gaining 8.6%, 2.3% and 2.0%, respectively. The drops have been driven by (i) foreign capital outflow from the equities market driven by weaker market fundamentals like weaker growth in earnings, (ii) weaker operating environment in Sub-Saharan economies, and (iii) anticipation of rate hikes by the US Fed, which may result in further capital flight. However, major African currencies seem to gain traction against the US Dollar on account of a more gradual rate hike cycle expectation, than the aggressive cycle initially expected. However, the markets remain exposed to exogenous shocks from the global markets and the currencies are expected to remain under pressure in 2016.

Country	Stock Exchange Return (USD)	Currency vs US Dollar
South Africa	8.60%	4.50%
Uganda	2.30%	(0.00%)
Kenya	2.00%	0.80%
Rwanda	(0.90%)	(0.20%)
Zambia	(3.10%)	0.50%
Ghana	(4.90%)	(0.70%)
Tanzania	(8.00%)	(1.70%)
Malawi	(10.00%)	(2.40%)
Nigeria	(11.50%)	0.10%
Zimbabwe	(17.70%)	N/A
Average	(4.32%)	0.10%

Kenyan Macro-Economic Review

The Kenyan economy is expected to continue doing well and we project an economic growth of 5.5% supported by high infrastructural spending and the recovery of tourism. During Q1?2016, the IMF revised downwards Kenya?s real GDP growth forecast for 2016 by 80 bps to 6.0% from 6.8% previously. This downgrade was on the back of (i) increased volatility of capital flows from global markets indicating that in the event of another global financial instability, net capital inflows could drop by USD 5.0 bn over the next 2 years, including a USD 3.0 bn reduction in portfolio flows and USD 1.2 bn in foreign direct investment (FDI), (ii) uncertainty on the impact of weather-related effects of El-Niño on agriculture, (iii) vulnerabilities in the banking system, (iv) residual security challenges, (v) significant uncertainty about FDI in oil and gas exploration sector, and (vi) possible pressure for higher current and capital spending ahead of the August 2017 General elections on immediate benefits to voters at the expense of public investment. IMF has reviewed its precautionary credit facility to Kenya increasing it to USD 1.5 bn, more than doubling the previous allocation. The table below shows the breakdown;

Values in USD Mns	Current	Previous	% Change
Total Facility	1,484.7	688.3	116.0%
Stand-By Arrangement	989.8	497.1	99.0%
Stand-By Credit Facility	494.9	191.2	159.0%
Period (Months)	24.0	12.0	

The inflation rate has declined during the quarter to 6.5% in the month of March from a 16-month high of 8.0% in December 2015, in line with our projections of 6.5% for the month of March. Last quarter, inflation had been driven largely by (i) an increase in food prices due to the effects of the El-Niño rains, and (ii) increases in food, beverage and cigarette prices owing to the amendment to the Excise Duty Bill. This quarter, the energy prices have come down steadily, leading to a decline in prices of the various inflation basket components. We expect inflation to be within the CBK range of 2.5% to 7.5% in Q2?2016. However, we note that with the recent upward trend in oil prices, pressures abound on the local inflation as this rise in price will be effected immediately in the local markets.

During the quarter the Kenya shilling strengthened by 0.8% against the dollar closing at 101.3, compared to 102.3 as at the end of December. The current appreciation of the Kenya shilling can be attributed to (i) large forex reserves with 4.7 months of import cover, (ii) current low oil prices which have eased up the country?s current account deficit by lowering the oil import bill, (iii) growth in exports to record levels at Kshs. 581.0 bn in 2015, a 9.4% increment from Kshs. 531.2 bn in 2014 further supporting the trade balance, which improved from 10.4% of GDP in 2014 to 8.9% of GDP in 2015, (iv) the willingness of the IMF to continue supporting the country by extending the USD 1.5 bn cautionary facility, and (v) increased diaspora remittances which rose 19.9% in January to USD 137.5 mn from USD 114.6 mn and rose a further rose 11.6% in February compared to the same period last year. We expect the shilling to remain relatively stable given the above factors.

Fixed Income

The overall subscriptions for treasury bills remained high in Q1?2016, with overall subscriptions at 194.9% compared to 207.0 % as at Q4?2015. Yields on T-bills declined by 200 bps, 210 bps and 140 bps for the 91-day, 182-day, and 364-day bills closing the quarter at 9.0%, 10.7%, and 11.9%, down from 11.0%, 12.8%, and 13.3%, respectively, at the end of December,2015. On the Secondary market, the total turnover increased by 48.6% to Kshs 107.7 bn from Kshs 72.5 bn last quarter on account of the declining yields on short term securities making the longer dated papers more attractive. The recently issued bonds have been the top trading bonds in the secondary markets week on week during the period with the government issuing bonds worth Kshs 71.2 bn compared to Kshs 52.7 bn last quarter. The FTSE bond index has gained 1.2% during the quarter.

The money market has been liquid as evidenced by the interbank rate declining by 250 bps to 4.4% at the end of Q1?2016 from 6.9% in Q4?2015. This was achieved through high maturities of Government Securities of Kshs. 188.1 bn, net reverse repo purchases of Kshs. 6.7 bn and net repo maturities of Kshs. 19.8 bn during the first quarter. There was also an even distribution of liquidity in the market across the various banks and the support from Central banks for the small banks was greatly reduced.

The Monetary Policy Committee (MPC) met twice during the quarter maintaining the CBR at 11.5%. In the first meeting in January, they cited a stable macro-economic environment, with key indicators remaining stable, inflation was still high in January, largely due to one-off changes in tax and transitory El-Nino effects affecting food prices. They met again in March and maintained the CBR at 11.5% choosing not to disrupt the current macro-economic stability characterized by (i) low inflation rates currently within the CBK target of 2.5% - 7.5%, (ii) the currency which has been stable over the entire quarter, and (iii) the current low interest rate environment. For the comprehensive coverage of the March MPC meeting see our MPC Meeting Note.

By December 2015, on domestic borrowing, the government had borrowed Kshs 120.2 bn against a domestic target of Kshs 219.2 bn. On their foreign borrowing they had borrowed a further Kshs 207.0 bn against their target of Kshs. 401.6 bn. Following this, the government subsequently released a draft budgetary policy statement proposing to cut its total expenditures by Kshs 93.3 bn and cut on domestic borrowing by Kshs 53.3 bn. This had the immediate psychological effect of

lowering interest rates leading to a decline to the current level of 9.0% from 11.0% for the 91-day T-bill. On the planned reduction in expenditure where Kshs 70.0 bn was to be cut in development expenditure and Kshs 23.0 bn cut in recurrent expenditures, the parliamentary committee approved only Kshs 49.0 bn cut in the development expenditure and actually increased the initial recurrent expenditures by Kshs 8.0 bn to Kshs 953.8 bn. To date the government has already borrowed Kshs 207.1 bn of the Kshs 219.2 bn hence the reduced pressure on government domestic borrowing.

The Kenya Revenue Authority (KRA) is set to miss its full-year collection target having collected a total of Kshs 687.0 bn as of February 2016, a huge revenue deficit of Kshs 527.9 bn from the target of Kshs 1.21 bn set by the Treasury for the year to June. At the current rate, KRA will probably miss its collection target by over Kshs 100 bn and the recent budgetary cuts by Kshs 41 bn will not help to fully meet this financing deficit, implying the government has to borrow more domestically or in the foreign markets to finance the funding gap, increasing pressure on interest rates. The Treasury indicated that the shortfall mainly arose from a dip in payroll taxes and delayed application of the Excise Duty Act 2015. The huge shortfall in ordinary revenue collection were made up of a Kshs 26 bn deficit in Pay-As-You-Earn (PAYE) revenue and a Kshs 15.9 bn shortfall in Value Added Tax collection from imports. The table below shows the current funding gap;

Financing (mns)	Budget	Actual	Variance
Net Foreign Financing	401,691	*207,000	194,691
Net Domestic Financing	219,000	207,100	11,900
Revenue Collection	1,254,867	687,000	567,867
TOTAL FUNDING REDUCTION	1,875,558	1,101,100	774,458
** - As at Dec 2015*			

The government is way ahead of schedule with its domestic borrowing programme, having borrowed Kshs. 207.1 billion for the current fiscal year compared to a target of about Kshs. 164.3 billion (assuming a pro-rated borrowing throughout the financial year of Kshs. 219 billion budgeted for the full financial year). Interest rates have been on downward trend week on week since the start of February due to (i) reduced pressure on government borrowing; and (ii) high liquidity in the market. The government will continue borrowing locally to bridge the external financing deficits to date and the expected shortfall in collection by KRA. With Interest rates coming down, we advise investors to lock in their funds in short to medium-term papers, tenors of between six months and one year, as the rates are higher on a risk-adjusted basis.

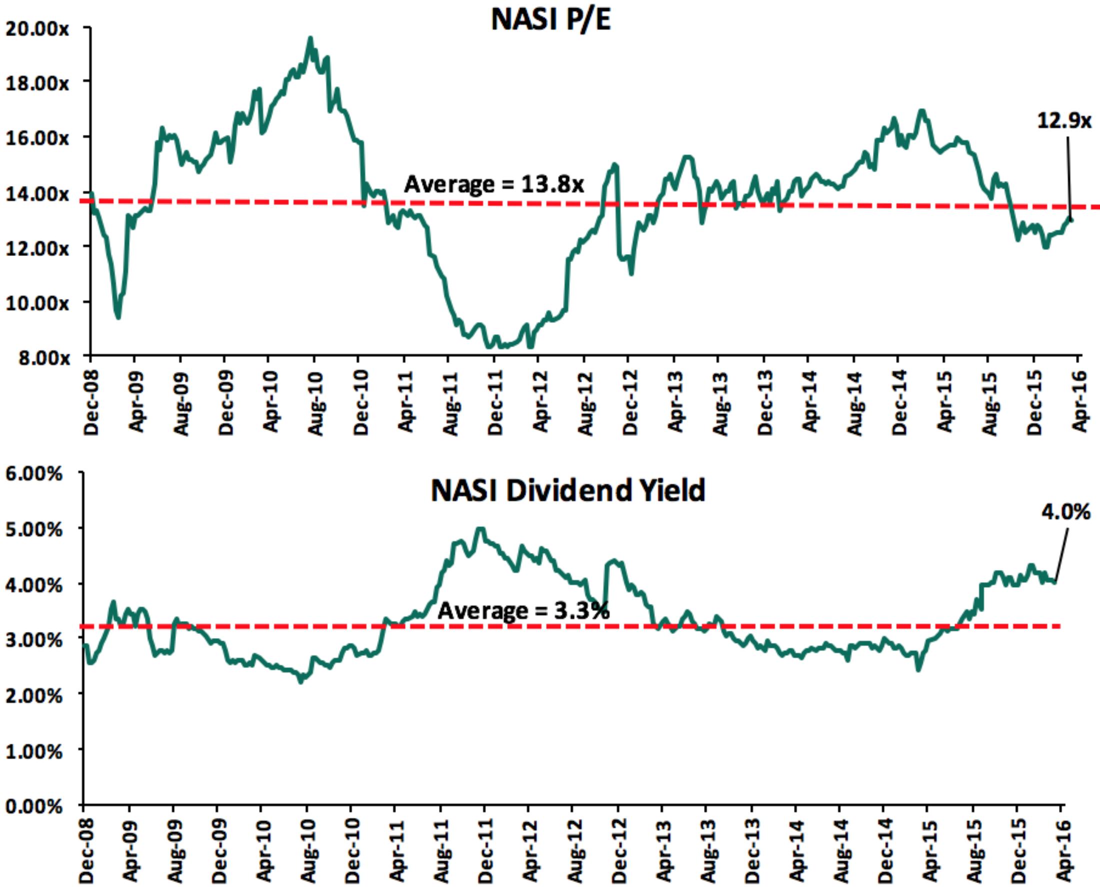
Kenya Equities Market Review

During the quarter, the Kenyan Equities market was stable with NASI and NSE 25 gaining 1.2% and 1.6%, respectively while NSE 20 lost 1.5% as a result of decline in prices of large cap stocks. Top gainers for the quarter were mainly banks led by Co-operative Bank and DTB which gained 18.2% and 16.7%, respectively on the back of strong investor sentiment after recording core EPS growths of 25.4% and 11.5%, respectively. The biggest losers among the top 20 stocks by market cap were Britam and Barclays which lost 17.7% and 17.6% with Barclays facing weak investor sentiment as a result of the impending exit of Barclays Group Plc from Africa and the expectation of a poor full year 2015 performance by Britam. Since the peak in February 2015, NASI and NSE 20 are down 16.9% and 27.6%, respectively.

Equity turnover during the quarter declined by 27.2% to Kshs 36.0 bn compared to Kshs 49.4 bn in Q4?2015 and declined 27.6% from Kshs. 49.7 bn in Q1 2015. Foreign investors were net buyers with net inflows of Kshs 498.0 mn compared to net outflows of Kshs 845.1 mn witnessed in Q4?2015. The sustained foreign investor inflows during the quarter can be attributed to improving investor sentiment, which has seen NASI recover from a 10.6% loss in 2015 to a 1.2% gain year to date. However, it is important to note that foreigners were net sellers in March of Kshs 487.0 mn driven by profit taking following the release of the full year 2015 earnings.

The market is currently trading at a price to earnings ratio of 12.9x from 12.5x at the end of Q4?2015 vs a historical average of 13.8x with a dividend yield of 4.0% versus a historical average of 3.3% driven by the increase in prices and lower earnings in 2015.

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



During the quarter, banks and insurance companies released full-year results, recording mixed performance.

Banks Results

Kenyan listed banks have released their FY?2015 results recording an average growth in core earnings per share of 2.8% compared to 9.3% in FY?2014, with the slowdown generally attributed to the tough operating environment in 2015. Based on the above growth, we can bucket the listed banks into four main buckets:

- The strong growth banks, with above 20% growth: I&M and Co-operative Bank. It is notable that the strong growth banks were mainly driven by cost containment measures.
- The stable growth banks with 10% and above growth: Diamond Trust Bank and KCB Group
- Anemic growth banks, with below 10% growth: Equity Bank
- Negative growth banks: National Bank, Standard Chartered, Housing Finance, CFC Stanbic, NIC and Barclays Bank

Bank	Core EPS Growth	Deposit Growth	Loan Growth	Interest Margin	Loan loss provision	Cost to Income**	ROaE	ROaA
Co-op Bank	25.4%	21.9%	16.2%	8.8%	71.8%	53.2%	25.1%	3.7%
I&M Bank	26.2%	16.4%	13.6%	7.2%	13.4%	35.0%	24.5%	3.7%
KCB Group	12.1%	12.5%	21.9%	7.9%	(6.8%)	50.1%	25.0%	3.7%
DTB	11.5%	20.6%	29.0%	6.5%	150.1%	41.0%	18.7%	2.9%
Equity Group	1.0%	23.1%	26.0%	6.5%	52.9%	52.9%	25.5%	4.8%

Barclays	(0.2%)	0.2%	15.9%	10.2%	25.7%	53.0%	21.6%	3.7%
NIC	(2.6%)	11.9%	13.7%	6.1%	401.4%	41.6%	18.0%	3.1%
CFC	(13.7%)	18.7%	26.6%	6.4%	24.6%	50.6%	17.1%	2.6%
HF	(18.5%)	15.4%	17.2%	6.3%	-8.6%	47.4%	16.9%	2.2%
Standard Chartered	(28.7%)	11.7%	6.2%	9.4%	274.5%	44.6%	15.5%	2.9%
NBK	(232.5%)	5.6%	3.3%	6.4%	608.0%	78.2%	(19.3%)	(1.0%)
Weighted Average*	2.8%	14.3%	14.5%	7.4%	85.4%	49.8%	17.1%	2.9%

**Averages are market cap weighted*
***Without loan loss charge*

The key highlights for the results are:

- Deposit growth: With the exception of Barclays and National Bank, listed banks recorded double digit deposit growth averaging 14.3%, however loan growth of 14.5% outpaced deposit growth
- Loan Growth: Out of the 11 listed banks, four recorded a higher deposit growth compared to loan growth indicating that the listed banks continue to struggle with deposit mobilization. The banks where deposit growth outpaced deposit growth are Coop bank, I&M Bank, Standard Chartered and NBK
- Loan loss provisions: As a result of the high interest rate environment in 2015 and increased supervision of banks as a result of exposure to Imperial Bank and Dubai Bank, banks have built up capital and other provisionary requirements with the most notable one being the increase in loan loss provisions averaging 85.4% for the 11 listed banks. The non-performing loans for the year also rose as a result of the expensive costs of financing loans. NBK and NIC Bank recorded the highest loan loss provision growths of 608.0% and 401.0%, respectively
- Cost containment: Despite the tough operating environment, banks were able to contain costs recording an average cost to income ratio of 49.8%, compared to 44.5% for the previous quarter, with NBK having a high value of 78.2% on account of its increment of loan loss provision
- Returns: Listed banks with the exception of NBK have recorded positive double digit returns on average equity averaging 17.1% while return on average assets averaged 2.9%
- Exposure to South Sudan: Due to the devaluation of the South Sudan pound, banks that operate in the country i.e. Equity Bank, KCB Group and CFC Stanbic lost significant value on their assets which are mainly held in cash hence recording lower than expected return

This week, the following banks released their FY?2015 results;

National Bank released their FY?2015 results:

National Bank reported FY?2015 results, registering a decline in core EPS by 232.5% y/y to a loss per share of Kshs 3.8 from an earnings per share of Kshs 2.8 in 2014 driven by a 608.0% y/y increase in loan loss provisions which led to a 49.2% increase in operating expenses. Key points to note are:

i. Operating revenue declined by 3.8% y/y to Kshs 9.6 bn from Kshs 9.9 bn in FY?2014 compared to operating expenses that rose by 49.2% y/y to Kshs 11.2 bn from Kshs 7.5 bn in FY?2014. This led to an increase in the cost to income ratio to 117.1% from 75.5% in 2014.
ii. Interest income grew by 14.5% to Kshs 12.2 bn from 10.7 bn in FY?2014 outpaced by interest expense which grew 50.0% to Kshs 5.9 bn from Kshs 3.9 bn in FY?2014, resulting in a decline in the net interest margin to 6.4% from 6.9% in FY?2014. Non-funded income grew marginally by 0.7% to Kshs 3.2 bn from Kshs 3.1 bn in FY?2014
iii. The bank reported a 5.6% y/y increase in customer deposits to Kshs 110.6 bn from Kshs 104.7 bn in FY?2014 while net loans increased 3.3% y/y to Kshs 67.8 bn from Kshs 65.6 bn in FY?2014. This resulted in a decline in the loan to deposit ratio to 61.3% from 62.7%
iv. Non-performing loans grew 62.5% from Kshs 11.8 bn from Kshs 7.2 bn in 2014 compared to an increase in gross loans by 8.2% which led to an increase in Non-performing loans ratio to 17.6% from 11.0% attributed to the harsh interest rate environment that characterized 2015

National Bank has issued poor results after issuing a profit warning citing increase in non-performing loans and is currently facing governance issues with the CEO and several senior executives currently suspended by the board chairman pending an internal audit. For more details on National Bank, please see our earnings note National Bank Earnings Note.

I&M Holdings released their FY?2015 results:

I&M Holdings reported FY?2015 results, registering an increase in core EPS growth of 26.3% y/y to Kshs 17.1, from Kshs 13.6 in 2014 driven by a 21.6% y/y increase in net interest income. Key points to note are:

i. Operating revenue increased by 20.9% y/y to Kshs 17.2 bn from Kshs 14.2 bn in FY?2014 outpacing operating expenses that rose by 19.5 y/y to Kshs 7.4 bn from Kshs 6.2 bn in FY?2014. This led to a slight decline in the cost to income ratio to 37.2% from 37.4% in FY?2014
ii. Interest income grew 24.3% to Kshs 21.9 bn from 17.6 bn in FY?2014 while interest expense grew 28.3% to Kshs 9.2 bn from Kshs 7.2 bn in FY?2014, resulting in a net interest margin of 7.2% from 6.6% in FY?14
iii. Customer deposits grew by 16.4% y/y to Kshs 133.0 bn from Kshs 114.2 bn in FY?2014. Deposit growth outpaced loan growth, which increased 13.6% y/y to Kshs 127.8 bn from Kshs 112.5 bn in FY?2014. This resulted in a decline in the loan to deposit ratio to 96.1% from 98.5%

For more details on I&M Bank, please see our earnings note I&M Bank Earnings Note.

For more information on the bank performance, see our Earnings Notes. We will be releasing a detailed analysis of the banking sector FY?2015 performance in our banking report on 5th April 2016.

Insurance

Of the insurance companies that have reported so far, Kenya Re, CIC Insurance and Jubilee Insurance have registered a growth in core earnings of 13.3%, 4.4%, and 0.6%, respectively while Liberty and Pan Africa have recorded declines of 35.7% and 96.8%, respectively. The declines were mainly as a result of the fair value losses on investments given the decline in the stock market and the increase in interest rates in 2015. We shall be releasing our detailed insurance report on the sector during Q2?2016. Britam is yet to announce its full year results, whose deadline for publication was on 31st March 2016.

Find below a summary of key performance metrics for the insurance sector

Insurance	Core EPS Growth	Net Premium Growth	Claims Growth	Loss Ratio	Expense Ratio	ROaA	ROaE
Kenya Re	13.30%	16.50%	18.50%	61.50%	40.20%	10.10%	16.60%
Jubilee Insurance	0.60%	(7.10%)	(27.10%)	50.20%	30.40%	4.00%	16.90%
CIC Insurance	4.40%	(12.80%)	(15.70%)	67.90%	36.50%	4.60%	15.70%
Liberty Holdings	(35.70%)	17.80%	(9.60%)	56.60%	75.90%	2.20%	11.90%
Pan Africa	(32.10%)	(3.90%)	(15.80%)	88.70%	61.10%	0.10%	0.70%
Weighted Average*	(7.1%)	(0.80%)	(23.60%)	65.00%	48.80%	4.20%	12.36%
*Average is market cap weighted							

Based on the above growth, we can bucket the listed insurance companies into 3 main buckets:

- Stable growth insurance companies: Kenya Re. It is notable that Kenya Re, being a Re-insurer has the advantage of stable inflow of premiums due to mandatory cessations
- Anemic growth insurance companies: CIC and Jubilee
- Negative growth insurance companies: Pan Africa and Liberty

Key to note is;

i. A decline in premium growth across the insurance industry sector owing to a slow uptake of new insurance products with the insurance penetration level declining slightly to 2.9% from 3.0% in 2014
ii. Decline in core EPS growth to (7.1%) across the companies. The declines in core EPS were mainly as a result of the fair value losses on investments given the decline in the value of securities held by insurance companies
iii. Increase in diversification across insurance companies with a greater allocation towards real estate investments as a general and deliberate strategy to cushion from the volatile equities market
iv. Decline in claims growth following containment of growth in fraudulent cases
v. Decline in loss ratio across the sector to 65.0% from 86.5% in FY?2014, following a faster decline in claims as compared to the decline in premiums growth
vi. Increase in the expense ratio to 48.8% from 44.5% in FY?2014, owing to increase in operating expenses despite a decline in premiums earned
vii. On average the insurance sector has delivered a ROaA and ROaE of 4.2% and 12.4%, respectively

For more information on the insurance companies? performance, see our Earnings Notes

Non - Financials

Non-financial large cap companies BAT and Bamburi recorded impressive gains for FY?2015 results, with core EPS advancing 16.9% and 47.9%, respectively aided by revenue growth and cost containment measures. NSE Limited recorded a decline in core EPS of 4.4% as a result of a decline in operating revenue by 3.9% and increase in operating expenses by 15.1%. The exchange is looking to increase the number of listings with a focus on the Real Estate Investment Trusts (REITs), Growth Enterprise Market Segment (GEMS) and the Automated Trading System (ATS) to improve investor participation in the equities market.

The relatively poor performance of the equities market for FY?2015 can be attributed to:

i. The high interest rate environment that characterized 2015 which made it unfavorable for companies to operate, especially those that rely on debt to fund their operations;
ii. A weakening Kenya Shilling which affected companies that rely on imported inputs such ARM Cement, and;
iii. Weak investor sentiment on the back of potential rate hikes in the US for the second half of 2015

Following full year results that have been released, we are updating our Equities recommendations and we will be reporting the new recommendation in the next Cytonn Weekly.

We remain neutral on equities given the significantly low earnings growth prospects for this year. The market is now purely a stock picker?s market, with few pockets of value.

Private Equity

According to East Africa Venture Capital Association (EVCA) report 2015, Kenya has attracted the majority of private equity (PE) transactions in East Africa both in number and value. This has been fostered by a favorable environment for investment with supporting regulatory regimes. Investment opportunities in the region continue to attract global PE firms, who seek to tap into the overall growth potential.

Financial Services Sector

The financial services sector attracted most deals for the quarter ending March favored by an innovative market with quick adoption of new products, services, technology and distribution

channels.

1. Fountain Enterprises Programme (FEP) plans to acquire a controlling stake of 75% in Credit Bank at a Price to Book Value (PBV) of 4.1x. The deal is valued at Kshs 4.0 bn, and with their book value at Kshs 1.3 bn and only awaits regulatory approval from the Central Bank of Kenya. Credit Bank plans to use the entire capital injection for expansion
2. Genghis Capital received regulatory approval from the Competition Authority of Kenya (CAK) to absorb Orchid Capital. Genghis Capital is Chase Bank?s investment banking arm while Orchid Capital is the bank?s investment unit. The move by Chase Bank is aimed at increasing efficiency by offering more services in a single location and reducing compliance costs
3. Chase bank secured a Kshs 5.0 bn loan to support its growth strategy. This will be used to further strengthen the bank?s venture into the SME sector. The aim of the facility is to be used to lend out to previously marginalized sectors in the credit market. The bank is committed to setting aside Kshs 60 bn towards this SME venture within the next 3 years
4. Fidelity Bank received Kshs 1.9 bn capital injection from Duet Private Equity fund to shore up the bank core capital and fund its regional expansion program. The funding will boost Fidelity core capital base to Kshs 3.8 bn as its works towards listing at the Nairobi Bourse
5. Taaleri a Finland-based NASDAQ OMX listed company in Partnership with Cytonn Investments have increased their commitment to finance additional real estate projects in Kenya by Kshs 400 mn, from the Kshs. 2.1 bn currently committed, to Kshs. 2.5 bn. Under the allocation increase, Taaleri will provide further development capital that will be deployed to the real estate sector through Cytonn Real Estate, the development affiliate of Cytonn Investments, whose deal pipeline now stands at Kshs 56 bn.

Financial services sector continues to attract private equity players driven by: (i) improved regulatory framework (ii) growth of the middle class population with increasing wallet size seeking financial services, and (iii) innovation in the sector with integration of mobile technology.

FMCG Sector

Interest in the FMCG sector continued to grow in the last quarter of 2015 into Q1?2016. According to EVCA and RISCURA report of 2015, FMCG deals attracted 40% of the deals in 2015.

Deals in the FMCG over the quarter include:

1. Indian conglomerate Godrej Consumer Products bought a 75% stake in Canon Chemicals, the makers of Valon petroleum jelly, for an undisclosed amount. Canon Chemicals is a family-run manufacturer based in Machakos County
2. The Abraaj Group acquired a minority stake in Algerian Celulose Processing (CEPRO) through their second generation North Africa Fund. CEPRO is the leading company in the baby diapers segment and has brands such as BBCool Premium, BBCool and Poupoune as well as female sanitary pads under the brand Finesse in its portfolio.

The FMCG sector is expected to continue witnessing increased activity from both local and global players with the growth of the middle class in the region.

Technology Sector

Deals in the Technology sector over the quarter include:

1. Silvertree Internet Holdings, a South African-based venture capital firm has set aside USD 10 mn to invest in Kenyan startups mainly focusing on tech firms that serve the consumer goods sector.
2. Centum Foundation has invested an undisclosed amount in Blissful.co.ke, an online start-up that connects businesses in the wedding and events industry to prospective clients. The start-up, which has grown to list over 700 businesses, is the first to benefit from Centum's commitment to invest

about USD 5 mn in start-ups in the next three years. The foundation also invested Kshs. 10.2 mn in Elimu TV, which provides online based studies for the 8-4-4 curriculum

The technology sector has been attractive due to the growing number of consumers migrating to online platforms for business transactions, supported by increased internet penetration, and the rising middle-class population that depend on technology.

Funds raisings

East Africa continued to attract global capital flows as on the back of growing political stability in the region and the ongoing major infrastructural projects

Other funding in the region include:

1. Abraaj?s Growth Markets Healthcare Fund, which is currently fundraising, landed a USD 25 million commitment from the African Development Bank for African healthcare investments. The fund, which has a hard cap of USD 1 billion, will target opportunities driven by the expanding demand for healthcare services from Africa?s growing middle class and rapidly urbanizing population, improving the quality of healthcare infrastructure and healthcare services
2. Enko Capital a West Africa based Private equity firm held a second and final close for Enko Africa Private Equity Fund at USD 83.25 million, garnering commitments from PROPARCO, the French government and high net worth investors. The fund, which is Enko?s debut private equity vehicle, held a USD 48.25 million first close in April 2014. The fund is seeking to investible equities targeting an IRR of 25% anticipating to make 7 to 8 deals averaging between USD 10mn and USD 12 mn in size. Our view is that the high expected IRR from Enko can only be obtained from real estate asset class and we expect increased investment in 2016

Outlook

Private equity investment in Africa has continued to improve, as evidenced by the increase in the number of deals and deal volumes into the region, with funds continuing to prefer financial services, energy, healthcare, education, and IT sectors although infrastructure, real estate, and natural resources are gaining ground. We remain bullish on PE as an asset class in Sub Saharan Africa given (i) the abundance of global capital looking for investment opportunities in Africa, (ii) attractive valuations in private sector, and (iii) better economic growth projections compared to global markets.

Real Estate

This quarter we witnessed four main trends for the quarter:

If these initiatives work, they will benefit the public in that there will be more housing product in the market at a subsidized cost coupled with efficient and transparent management of resources. However, we remain highly skeptical about the ability of PPPs working for the real estate sector because in order to attract private capital into a project, the respective land has to be separated and moved into a special purpose development vehicle that has title to the land. There is currently no framework to enable transfer of public land into special purpose vehicles that can attract private capital and bank debt. For example, the Kenyan University student hostels PPP between KU and Africa Integras, which was announced in July 2015 is yet to take off. The second terminal of the Mombasa port was also set to be developed through a PPP but it is being plagued by corruption allegations at the tendering stage.

1. 1) Diversified and Increased Funding: As the Kenyan real estate market becomes more institutionalized and developers undertake major projects, more financing is required for the projects. In the first quarter of 2016 there was increased funding for real estate projects that

came in form of:

i. Increased FDI?s with shelter Afrique receiving financing both debt and equity worth Kshs 3.36 billion from Islamic Development Corporation and Africa Development Bank Corporation, Cytonn Investments received additional mezzanine financing of Kshs 400mn from Finnish Investors Taaleri
ii. D-REITs - Fusion Capital was given approval by the Capital Markets Authority to issue Kenya?s first two D-REITs to fund both commercial and residential developments in Meru, Mombasa and Nakuru
iii. Government launched a project to fund up to 20% of project costs for local contractors to enable them compete with Chinese and South African Contractors who have had more financial muscle

2. Increased Regulation: Oversight bodies such as National Construction Authority (NCA) showed increased vigour in the enforcement of their regulations. This has resulted in the NCA marking various buildings in Nairobi and Kiambu Counties for demolition mainly due to the blatant non-compliance with regulations by developers and contractors. The various regulatory bodies are also automating their services, a move that is expected to result in ease of access to construction permits as well as an increase in the quality of new buildings. The land registry for instance launched an e-registry system for land registration and record keeping in a bid to reduce non-compliance in the industry. The NCA is also set to launch an online platform where details of ongoing projects will be uploaded and updated constantly afterwards. This is set to enable the body enforce its regulatory powers and thus reduce the percentage of new buildings that do not meet the set standards, currently estimated to be at 52%.
3. Public Private Partnerships: The first quarter of 2016 saw a number of PPPs being signed or are under consideration at the County level, they include:
   i. Mombasa County planned redevelopment of the 11 old estates
   ii. KCB Group placed bid to The County Government of Nairobi for the redevelopment of three estates in the City that is the Old Ngara, New Ngara and Jevanjee estates
4. Increase in distressed real estate assets and real estate bad loans: During Q3?2015, Kenya witnessed a high interest rate environment, which had a lagged effect over Q4?2015 and Q1?2016, negatively impacting developers.

Generally, the outlook remains positive across all the sectors and remains the best investment option for investors seeking for long, stable returns supported by growth of the middle class population, urbanization, and westernized lifestyle. Investments in residential sector in Nairobi?s satellite towns and retail in the counties being the most lucrative options for investors. However, the sector faces challenges which include financing, infrastructure, security and high construction costs.

Moving on into Q2 of 2016, we expect to see the results of the additional funding the sector has received through increased submissions to the NCA most especially for residential developments countrywide.

Conclusion

According to our Cytonn Annual Market Outlook ? 2016, we recommend to our investors a balanced portfolio, consisting of 40% fixed income, 30% equities, 20% alternative investments (real estate and private equity) and 10% in offshore investments. Through Q1?2016, not much has change except for the decline in yield which we believe has stabilized. We maintain our allocation and still believe that come end of 2016, this balance portfolio will outperform on a risk-adjusted basis

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