Cytonn Monthly - July 2019

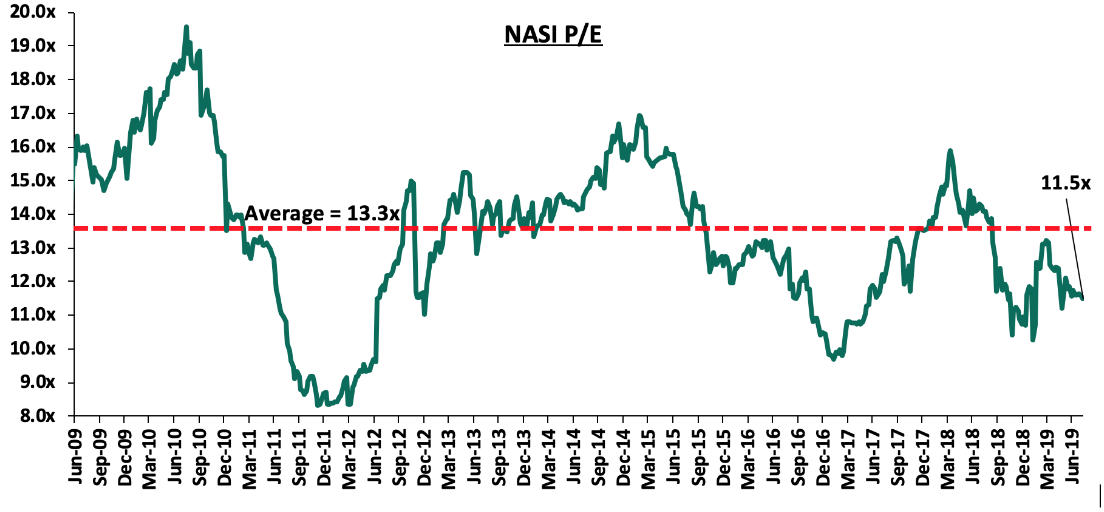
Equities

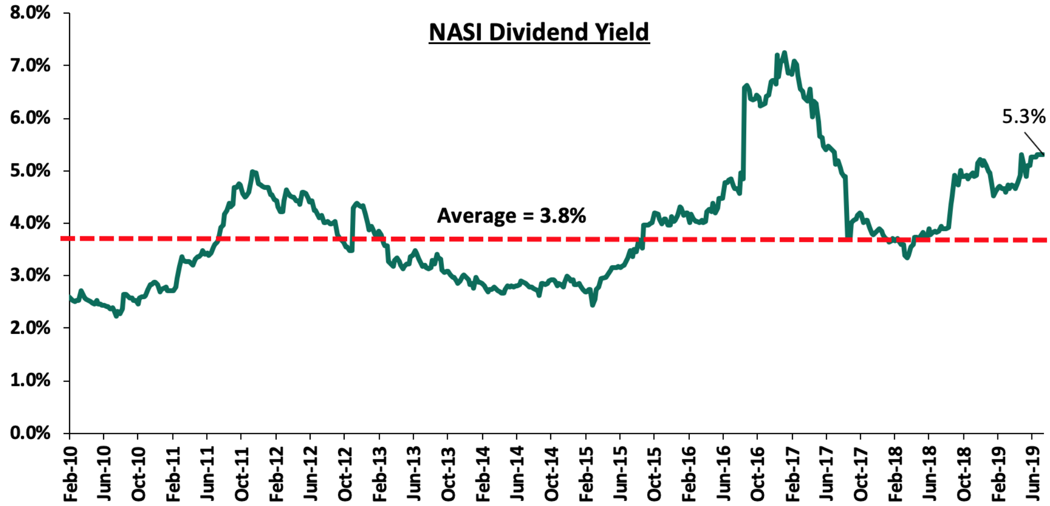
Markets

During the month of July, the equities market was on a downward trend, with NASI, NSE 20 and NSE 25 declining by 0.9%, 0.2%, and 0.1%, respectively. The decline recorded in NASI was driven by declines in large-cap stocks such as NIC Group, Diamond Trust Bank, and Safaricom, whose declines of 5.7%, 2.6%, and 2.1%, respectively, outweighed the gains made by KCB Group, BAT, Equity Group Holdings and EABL of 4.6%, 3.0%, 2.7%, and 2.5%, respectively. For this week, the market was on a downward trend, with NASI, NSE 20 and NSE 25 declining by 0.4%, 2.5%, and 0.7%, respectively, taking their YTD performance to gains/(losses) of 5.6%, (8.7%) and 0.9%, respectively. The decline in NASI was largely due to losses recorded in large-cap counters such as Bamburi and NIC Group, which recorded losses of 7.2% and 1.7%, respectively.

Equities turnover increased by 4.6% during the month to USD 108.3 mn, from USD 103.6 mn in June 2019. Foreign investors remained net sellers for the month, with a net selling position of USD 20.6 mn, a 133.3% increase from June's net selling position of USD 8.8 mn. For this week, equities turnover decreased by 8.9% to USD 21.3 mn, from USD 23.4 mn the previous week, bringing the year to date (YTD) turnover to USD 882.8 mn. Foreign investors were net buyers for the week, with a net buying position of USD 2.1 mn, as compared to last week's net selling position of USD 4.3 mn.

The market is currently trading at a price to earnings ratio (P/E) of 11.5x, 13.5% below the historical average of 13.3x, 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 11.5x is 18.6% above the most recent trough valuation of 9.7x experienced in the first week of February 2017, and 38.6% 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.





Earnings Releases

Equity Group Holdings released their H1'2019 financial results, recording a 9.1% increase in core earnings per share to Kshs 3.2 from Kshs 2.6 in H1'2018, faster than our projections of a 7.3% increase to Kshs 3.1. The performance was driven by a 14.8% increase in total operating income, despite the 19.4% increase in total operating expenses. The variance in core earnings per share growth against our expectations was largely due to the faster 14.8% growth in total operating income to Kshs 37.6 bn from Kshs 32.8 bn in H1'2018, which outpaced our expectation of an 8.4% increase to Kshs 35.5 bn. Highlights of the performance from H1'2018 to H1'2019 include:

- Total operating income recorded a 14.8% increase to Kshs 37.6 bn, from Kshs 32.8 bn in H1'2018. This was driven by a 25.6% growth in Non-Funded Income (NFI) to Kshs 16.5 bn, from Kshs 13.2 bn in H1'2018, coupled with a 7.6% growth in Net Interest Income to Kshs 21.1 bn, from Kshs 19.6 bn in H1'2018,
- Interest income increased by 9.2% to Kshs 27.7 bn, from 25.4 bn in H1'2018. The interest income on loans and advances increased by 8.8% to Kshs 18.6 bn from Kshs 17.1 bn in H1'2018. Interest income on government securities also increased by 7.4%, rising to Kshs 8.5 bn from Kshs 7.9 bn in H1'2018. The slightly stronger growth in interest income on loans as compared to interest from government securities is indicative of the benefits accruing to Equity Group Holding's owing to increased lending to the private sector, with the loans extended to the private sector rising by 16.7% in H1'2019 compared to the 3.8% growth recorded in H1'2018. The yield on interest earning assets, however, declined by 0.4% points to 11.0%, from 11.4% in H1'2018, owing to declining yields on government securities,
- Interest expense rose by 14.3% to Kshs 6.6 bn from Kshs 5.8 bn in H1'2018, following the 11.1% increase in the interest expense on customer deposits to Kshs 5.2 bn from Kshs 4.7 bn in H1'2018, coupled with an 84.0% increase in interest expense on placements to Kshs 0.4 bn from Kshs 0.2

bn in H1’2018. In addition, other interest expenses increased by 16.3% to Kshs 1.0 bn from Kshs 0.9 bn in H1’2018. The cost of funds however declined to 2.6%, from 2.7% in H1’2018, owing to a faster increase in interest bearing liabilities that rose by 15.3% to Kshs 514.5 bn, from Kshs 446.3 bn in H1’2018. The Net Interest Margin (NIM) thus declined to 8.5%, from 8.8% in H1’2018,

- Non-Funded Income (NFI) recorded a 25.6% increase to Kshs 16.5 bn from Kshs 13.2 bn in H1’2018. The growth was mainly driven by the 80.7% increase in other income to Kshs 4.7 bn from Kshs 2.6 bn in H1’2018 given the successful execution of the Equity’s 3.0 innovative business strategy, which is centered on digitization and virtualization. The growth was also supported by the 16.1% growth in other fees and commissions to Kshs 7.3 bn, from Kshs 6.3 bn in H1’2018, and a 20.2% growth in forex trading income to Kshs 1.8 bn, from Kshs 1.6 bn in H1’2018, with management noting that the forex income segment benefitted from increased remittances from the diaspora. The growth in NFI was however weighed down by the 1.1% decline in fees and commissions on loans to Kshs 2.75 bn, from Kshs 2.78 bn in H1’2018, which may be attributed to continued effects of 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 shifted to 56:44 from 60:40 funded to non-funded income, owing to the faster growth in NFI as compared to growth in NII,
- Total operating expenses rose by 19.4% to Kshs 20.6 bn, from Kshs 17.3 bn in H1’2018, largely driven by a 16.7% increase in Loan Loss Provisions (LLP) to Kshs 0.9 bn from Kshs 0.8 bn in H1’2018, coupled with a 22.1% growth in other operating expenses to Kshs 13.8 bn from Kshs 11.3 bn in H1’2018. Staff costs also increased by 13.8% to Kshs 5.9 bn, from Kshs 5.2 bn in H1’2018,
- The Cost to Income Ratio (CIR) deteriorated to 54.8%, from 52.8% in H1’2018. Without LLP, the cost to income ratio also deteriorated to 52.4%, from 50.4% in H1’2018,
- Profit before tax increased by 9.8% to Kshs 17.0 bn, up from Kshs 15.5 bn in H1’2018. Profit after tax recorded an 8.9% growth to Kshs 12.0 bn, from Kshs 11.0 bn, with the difference in growth attributable to the marginal increase in the effective tax rate to 29.3% from 28.8% in H1’2018,
- The balance sheet recorded an expansion as total assets grew by 17.8% to Kshs 638.6 bn, from Kshs 542.0 bn in H1’2018. Growth was supported by a 16.7% growth in loans and advances to Kshs 320.9 bn, from Kshs 275.0 bn in H1’2018, coupled with a 13.0% growth in government Securities to Kshs 179.6 bn, from Kshs 158.9 bn in H1’2018,
- Total liabilities recorded a 17.6% growth to Kshs 535.9 bn, from Kshs 455.7 bn in H1’2018, supported by a 16.5% growth in customer deposits which rose to Kshs 458.6 bn, from Kshs 393.7 bn in H1’2018, coupled with the 139.5% growth in other liabilities to Kshs 20.5 bn, from Kshs 8.5 bn in H1’2018,
- The comparable growth in both loans and deposits led to a marginal increase in the loan to deposit ratio to 70.0%, from 69.9% in H1’2018,
- Gross Non-Performing Loans (NPLs) increased by 19.6% to Kshs 29.2 bn in H1’2019, from Kshs 24.5 bn in H1’2018. The NPL ratio thus deteriorated to 8.8% in H1’2019 from 8.5% in H1’2018. 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 10.6%, 10.2% and 6.1%, respectively. The group’s Tanzania subsidiary contributed 25.7% of the NPLs, with South Sudan and Kenya contributing 12.9% and 8.7%, respectively. General Loan Loss Provisions decreased by 1.7% to Kshs 9.4 bn, from Kshs 9.6 bn in H1’2018. Thus, the NPL coverage deteriorated to 73.7% in H1’2019 from 79.9% in H1’2018,
- Shareholder’s funds recorded a 17.9% growth to Kshs 101.8 bn, from Kshs 86.3 bn in H1’2018, supported by an 18.4% increase in retained earnings to Kshs 89.4 bn, from Kshs 75.5 bn in H1’2018,
- Equity Group remains sufficiently capitalized with a core capital to risk-weighted assets ratio of 17.5%, 7.0% points above the statutory requirement of 10.5%. In addition, the total capital to risk-weighted assets ratio came in at 19.5%, exceeding the statutory requirement of 14.5% by 5.0%

points. Adjusting for IFRS 9, the core capital to risk weighted assets stood at 18.4%, while total capital to risk-weighted assets came in at 20.4%, and,
- The bank currently has a Return on Average Assets (ROaA) of 3.5%, and a Return on Average Equity (ROaE) of 22.1%.

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 19.0% of the bank's total profitability and 27.0% of the group's total asset base. Equity Group Holdings opened a commercial representative office in Addis Ababa, Ethiopia, and expected to commence operations in July.
2. The bank's Non-Funded Income bucked its declining trend, growing by 25.6% y/y, largely aided by a recovery in transactional income, as management indicated that the bank was now monetizing its transactional channels. With the banks' NFI contribution to total income currently at 44.0%, it is way above the current industry average of 33.2%, and,
3. The bank's asset quality deteriorated, with the NPL ratio deteriorating to 8.8% in H1'2019, from 8.5% in H1'2018. The main sectors that contributed to the NPLs are large enterprises and SMEs. In terms of the regional distribution of NPLs, the regions with the highest NPLs were Tanzania at 25.7% of their loan book, followed by South Sudan at 12.9% 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.

For more information, please see our Equity Group Holdings Earnings Note.

Monthly Highlights

Barclays Bank of Kenya announced that three of its branches namely, Bamburi, Maragua and Supplies, were up for sale, valued at Kshs 65.0 mn. This is in line with the lender's strategy of deepening digital channels to accommodate the changing pattern of customer preferences towards alternate channels. Previously, in FY'2017, the lender closed 13 branches as part of its consolidation strategy and drive to achieve operational efficiencies. For a more detailed analysis, please see our Cytonn Weekly #27/2019.

The Kenya Bankers Association (KBA) released the State of Banking Industry Report 2019. The report gives the various factors that shaped the banking sector's performance in 2018, the emerging trends, and the outlook for the sector going forward. For more information please see more detailed analysis here Cytonn Weekly #28/2019

KCB Group released the offer document for the intended 100% acquisition of the National Bank of Kenya (NBK), and timelines for the acquisition. The expected timelines are as follows:

i. Both the Central Bank of Kenya (CBK) and the Competition Authority of Kenya (CAK) are expected to grant their approvals by 30th July 2019,
ii. The offer has a closing date of 30th August 2019,
iii. The settlement of the swap transaction, where the swap ratio will be 1 KCB share for 10 NBK shares, will be done on the 12th September 2019 with the listing of additional KCB shares set for 16th September 2019.

For more details, please see our Cytonn Weekly #28/2019

The Banking Amendment Bill was tabled in the National Assembly. The Bill seeks to seal the loopholes in the wordings of the Banking (Amendment) Act 2015. In March 2019, the High Court suspended the Banking (Amendment) Act 2015 in a ruling that declared Section 33B (1) and (2) of the Banking Act unconstitutional, and gave the National Assembly one year to amend the anomalies, failure to which will mean a reversion to a free-floating interest rates regime. For more details, please see our Cytonn Weekly #30/2019

Universe of Coverage

Banks	Price as at 26/07/2019	Price as at 02/08/2019	m/m change	w/w change	YTD Change	Target Price*	Upside/ Downside**	P/TBv Multiple	Recommendation
Diamond Trust Bank	114	114	(3.2%)	0.0%	(27.2%)	228.4	96.2%	**0.6x**	**Buy**
CRDB	105.0	100.0	(9.1%)	(4.8%)	(33.3%)	207.7	88.8%	**0.3x**	**Buy**
UBA Bank	5.5	5.9	(3.2%)	7.3%	(23.4%)	10.7	87.0%	**0.4x**	**Buy**
Zenith Bank	18.5	18.4	(7.6%)	(0.5%)	(20.4%)	33.3	83.0%	**0.8x**	**Buy**
KCB Group***	39.8	40.0	4.6%	0.6%	6.8%	60.4	66.7%	**1.1x**	**Buy**
GCB Bank	5.0	5.0	1.0%	1.0%	8.7%	7.7	64.2%	**1.2x**	**Buy**
I&M Holdings	53.0	52.0	(5.9%)	(1.9%)	22.4%	81.5	54.9%	**1.0x**	**Buy**
Access Bank	6.5	6.2	0.8%	(4.6%)	(8.8%)	9.5	52.6%	**0.4x**	**Buy**
Co-operative Bank	12.1	12.0	(3.6%)	(1.2%)	(16.4%)	17.1	50.5%	**1.0x**	**Buy**
Equity Group	40.3	40.3	3.2%	0.0%	15.5%	53.7	42.7%	**1.7x**	**Buy**
NIC Group	29.8	29.3	(3.3%)	(1.7%)	5.2%	42.5	42.3%	**0.6x**	**Buy**
CAL Bank	1.0	1.0	1.0%	1.0%	1.0%	1.4	40.0%	**0.8x**	**Buy**
Barclays Bank	10.5	10.7	1.9%	2.4%	(2.3%)	12.8	32.7%	**1.3x**	**Buy**
Stanbic Bank Uganda	29.0	29.0	0.0%	0.0%	(6.5%)	36.3	29.1%	**2.1x**	**Buy**
SBM Holdings	5.5	5.5	(2.2%)	0.7%	(7.7%)	6.6	23.0%	**0.8x**	**Buy**
Guaranty Trust Bank	28.7	27.9	(13.7%)	(2.6%)	(19.0%)	37.1	21.4%	**1.7x**	**Buy**
Stanbic Holdings	98.5	98.5	(0.5%)	0.0%	8.5%	113.6	20.6%	**1.1x**	**Buy**
Ecobank	8.5	8.5	0.0%	0.0%	13.3%	10.7	19.2%	**1.9x**	**Accumulate**
Union Bank Plc	6.4	7.0	0.0%	9.4%	25.0%	8.2	16.4%	**0.7x**	**Accumulate**
Standard Chartered	196.0	197.0	0.6%	0.5%	1.3%	200.6	9.5%	**1.4x**	**Hold**
Bank of Kigali	274.0	275.0	0.0%	0.4%	(8.3%)	299.9	8.5%	**1.5x**	**Hold**
FBN Holdings	5.6	5.6	(13.0%)	0.0%	(29.6%)	6.6	5.7%	**0.3x**	**Hold**
Bank of Baroda	128.0	128.0	(0.6%)	0.0%	(8.6%)	130.6	3.4%	**1.1x**	**Lighten**
Standard Chartered	19.0	19.0	0.0%	0.0%	(9.5%)	19.5	2.3%	**2.4x**	**Lighten**
National Bank	3.9	3.9	(7.0%)	0.0%	(27.6%)	3.9	(4.8%)	**0.2x**	**Sell**
Stanbic IBTC Holdings	38.1	38.1	(5.1%)	0.0%	(20.5%)	37.0	(6.5%)	**2.0x**	**Sell**
Ecobank Transnational	8.5	7.6	(25.5%)	(10.6%)	(55.3%)	9.3	(15.6%)	**0.3x**	**Sell**
HF Group	4.0	4.1	2.2%	1.3%	(26.9%)	2.9	(27.7%)	**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 are invested in***
*******Stock prices indicated in respective country currencies***

Below is a summary of our SSA universe of coverage:

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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