End of Interest Rate Caps?, & Cytonn Weekly #42/2019

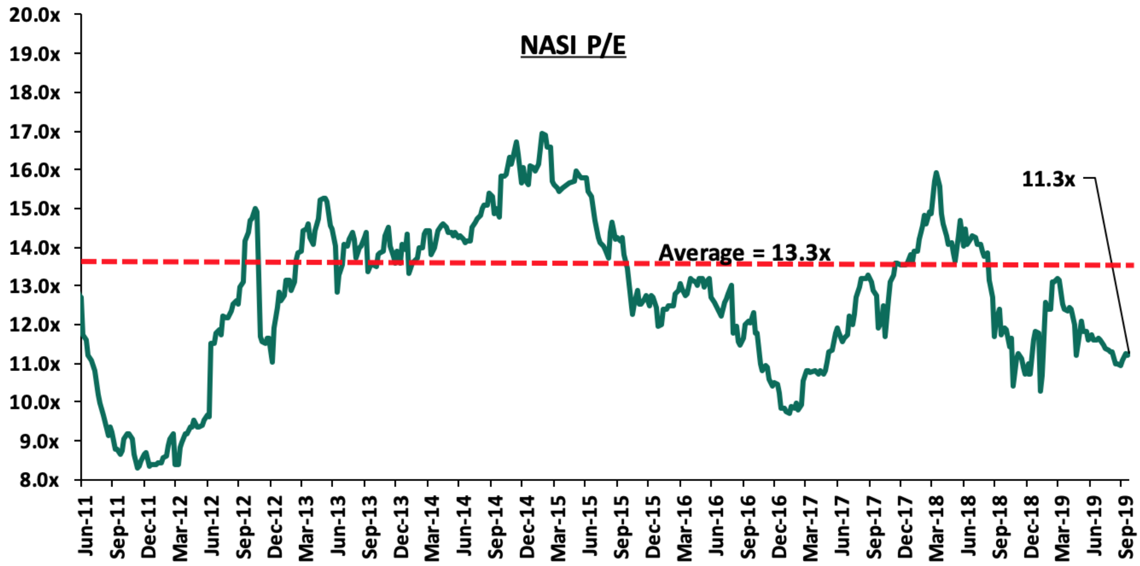
Equities

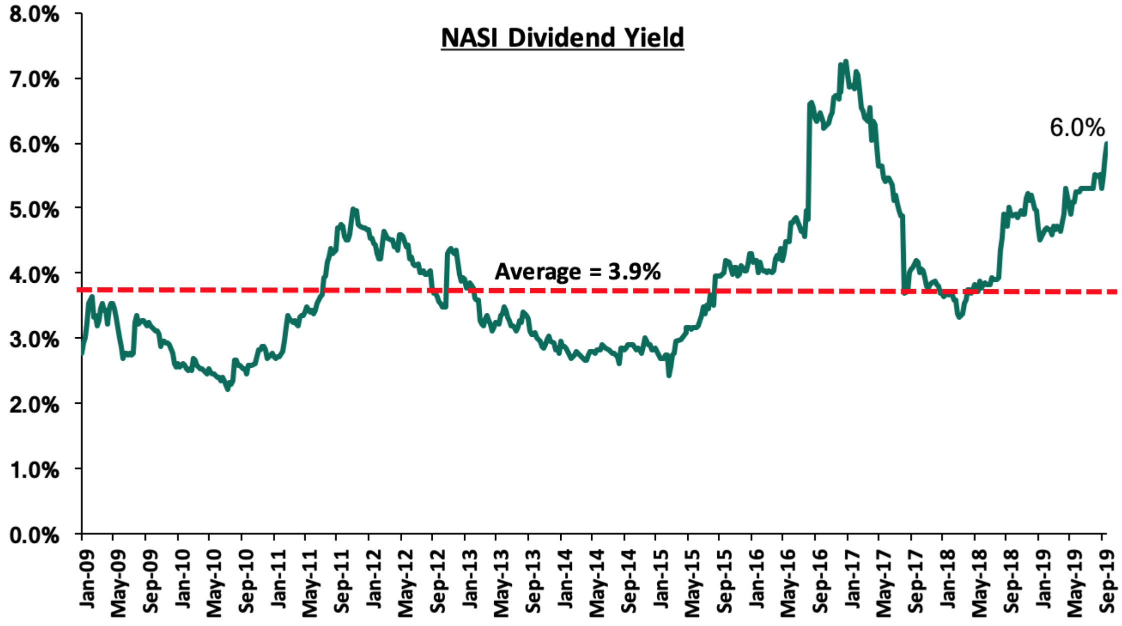
Market Performance

During the week, the equities market was on an upward trend with NASI, NSE 20 and NSE 25 gaining by 0.5%, 0.2% and 1.5%, respectively, taking their YTD performance to gains/losses of 5.6%, (13.2%) and (0.1%), for NASI, NSE 20 and NSE 25, respectively. The performance in NASI was driven by gains recorded by stocks in the Banking sector with NIC Group, I&M Holdings, Equity Group and KCB Group recording gains of 10.2%, 6.3%, 5.3% and 3.5%, respectively, as the market reacted to the news of the President's refusal to assent to the Finance Bill 2019 in an attempt to repeal the interest rate cap.

Equities turnover increased by 157.1% during the week to USD 34.4 mn, from USD 13.4 mn the previous week, taking the YTD turnover to USD 1,132.0 mn. Foreign investors remained net sellers for the week, with a net selling position of USD 8.5 mn, from a net selling position of USD 0.4 mn the previous week.

The market is currently trading at a price to earnings ratio (P/E) of 11.3x, 15.3% below the historical average of 13.3x, and a dividend yield of 6.0% above the historical average of 3.9%. With the market trading at valuations below the historical average, we believe there is value in the market. The current P/E valuation of 11.3x is 16.0% above the most recent trough valuation of 9.7x experienced in the first week of February 2017, and 35.5% 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.





Weekly Highlight

During the week, President Uhuru Kenyatta submitted a memorandum to the Speaker of the National Assembly detailing his refusal to assent to the Finance Bill 2019. The President, instead, endorsed the amendment of the Bill, by deleting clause 45 and substituting it to read, "The Banking Act is amended by repealing Section 33B". In the memorandum, the President cited that while the purpose of the capping was to address the wide concerns about affordability and availability of credit to Kenyans, the capping of interest rates instead caused unintended consequences that are significant and damaging to the economy and Micro, Small and Medium Enterprises (MSMEs). In the memo, the president highlighted that the re-introduction of Clause 45 of the Bill by the National Assembly would worsen the unintended effects brought about by the cap such as;

i. The reduction of credit to the private sector, particularly MSMEs,
ii. A decline in economic growth,
iii. The weakening of the effectiveness of a monetary policy,
iv. The reduction of loan advances by banks,
v. The growing number of shylocks and other unregulated lenders in the financial sector, and
vi. Problems such as the withdrawal of banks' lending to specific segments of the market,

The concerns of the President echoes calls by various organizations such as the IMF, the Kenya National Chamber of Commerce and Industry, the Central Bank of Kenya and the National Treasury to repeal the rate cap law. We continue to reiterate the need to urgently repeal the Banking (Amendment) Act, 2015, as it has hampered credit growth, evidenced by the continued decline of private sector credit growth, which grew by 6.3% in the 12 months to August 2019, below the 5-year average of 11.0%. A more detailed analysis is can be found in this week's focus.

During the week, HF Group announced that it retired the medium term bond issued in 2012, paying the final instalment of Kshs 3.2 bn to bondholders on Monday. HF Group received approval for listing and issuing their corporate bond of Kshs 10.0 bn with a fixed coupon rate of 13.0% in 2010. They managed to raise the bond in two tranches where in 2010 they raised Kshs 7.0 bn, and in 2012, they listed and raised the remaining Kshs 3.0 bn. This being a medium-term note of a period of 7 years, they paid off the first Kshs 7.0 bn in 2017 which was financed from a Kshs 3.0 bn in foreign currency debt and monthly cash collections from its lending and property development operations. This last instalment was paid from its internally generated cash-reserves. According to the Chairman Mr. Steve Mainda, the bond's purpose was to provide the bank with long term funding which they could use to explore financing towards the housing shortage in the middle and lower-income segments. This would be through providing mortgage financing for existing and aspiring homeowners, and the development of affordable residential housing for the middle and lower-income population in Nairobi. Additionally, this bond allowed them to offer fixed mortgages, which would cushion customers from fluctuating interest rates. Both issues recorded an oversubscription rate of 40.0%, with the initial target in 2010 being to raise Kshs 5.0 bn. Similarly, the second tranche issued in 2012 was oversubscribed by 67.0%, with HF Group raising Kshs 5.0 bn from an initial target of Kshs 3.0 bn, implying a positive interest in corporate bonds among investors. Currently, the interest in issuing new corporate bonds among firms has decreased, which is proven by HF Group's lack of intention to issue another bond, following in the steps of I&M Holdings, UAP OldMutual and CIC Group, who have also retired maturing bonds this year, and have not indicated need to come back to the market for additional funds. This is partly attributed to sour investor sentiment, on account of the corporate loan defaulters such as Nakumatt, Imperial Bank, Chase Bank, and ARM Cement, and firms such as Real People and Consolidated Bank deferring repayment on the borrowings.

Universe of Coverage

Below is a summary of our universe of coverage:

Banks	Price at 11/10/2019	Price at 18/10/2019	w/w change	YTD Change	Target Price*	Dividend Yield	Upside/ Downside**	P/TBv Multiple	Recommendation
I&M Holdings* **	46.1	49.0	6.3%	5.9%	79.8	7.2%	70.1%	**0.8x**	**Buy**
Sanlam	17.4	17.1	(2.0%)	(14.8%)	29.0	0.0%	70.1%	**0.8x**	**Buy**
Diamond Trust Bank	114.8	117.5	2.4%	(27.2%)	175.6	2.2%	51.7%	**0.6x**	**Buy**
KCB Group* **	41.8	43.3	3.5%	12.1%	61.4	8.1%	50.0%	**1.1x**	**Buy**
Equity Group* **	36.1	38.0	5.3%	7.5%	53.0	5.3%	44.7%	**1.6x**	**Buy**
CIC Group	3.0	3.0	0.0%	(20.5%)	3.8	4.3%	31.0%	**1.2x**	**Buy**
Kenya Reinsurance	3.0	3.0	(1.0%)	(17.2%)	3.8	5.0%	30.0%	**0.1x**	**Buy**
Britam	6.9	7.1	2.0%	(30.2%)	8.8	4.9%	29.2%	**0.7x**	**Buy**
Co-operative Bank	12.1	12.5	2.9%	(16.8%)	15.0	8.0%	28.5%	**1.0x**	**Buy**
Jubilee holdings	350.0	343.3	(1.9%)	(13.5%)	418.5	2.6%	24.5%	**1.0x**	**Buy**
NIC Group	29.0	32.0	10.2%	7.7%	37.9	3.1%	21.7%	**0.6x**	**Buy**
Liberty Holdings	9.8	9.7	(0.2%)	(24.7%)	11.3	5.1%	21.1%	**0.7x**	**Buy**
Barclays Bank* **	11.1	11.4	2.7%	0.0%	12.6	9.7%	20.5%	**1.4x**	**Buy**
Standard Chartered	195.5	195.8	0.1%	2.7%	208.0	6.4%	12.6%	**1.5x**	**Accumulate**
Stanbic Holdings	96.0	99.5	3.6%	5.8%	100.5	5.9%	6.9%	**1.1x**	**Hold**
HF Group	6.9	6.8	(1.7%)	27.1%	2.8	0.0%	(59.5%)	**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***

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.