Cytonn Monthly October 2019

Equities

Markets Performance

During the month of October, the equities market was on an upward trend, with NASI, NSE 20, and NSE 25 increasing by 9.7%, 8.8%, and 13.0%, respectively. The increase recorded in NASI was driven by gains in large-cap bank stocks such as NCBA Group, Equity Group, KCB Group and Co-operative Bank, which recorded gains of 30.7%, 24.2%, 23.2% and 22.3%, respectively, owing to expectations of the repeal of the interest rate cap. For this week, the market was on an upward trend, with NASI, NSE 20, and NSE 25 increasing by 9.5 %, 9.8%, and 13.2%, respectively, taking their YTD performance to gains/(losses) of 17.0%, (3.5%) and 14.9%, respectively. The improvement in NASI was largely due to gains recorded in large-cap counters such as Co-operative Bank, KCB Group, and NCBA, which recorded gains of 26.4% and 20.8%, and 17.4%, respectively.

Equities turnover increased by 55.3% during the month to USD 157.8 mn, from USD 101.6 mn in September 2019. Foreign investors became net sellers for the month, with a net selling position of USD 14.8 mn, compared to September's net buying position of USD 6.6 mn. For this week, equities turnover increased by 82.2% to USD 71.1 mn, from USD 39.0 mn the previous week, bringing the year to date (YTD) turnover to USD 1,242.1 mn. Foreign investors remained net sellers for the week, with a net selling position of USD 4.7 mn, a 65.6% increase from last week's net selling position of USD 2.8 mn.

The market is currently trading at a price to earnings ratio (P/E) of 12.2x, 8.3% below the historical average of 13.3x, and a dividend yield of 6.4%, 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 12.2x is 25.9% above the most recent trough valuation of 9.7x experienced in the first week of February 2017, and 47.1% 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.

Monthly Highlights

During the week, Capital Markets Authority (CMA) released the Capital Markets Soundness Report (CMSR) for Q3' 2019. This report analyses the Kenyan Capital Markets industry focusing on the various policy issues that may be a promoter or threat to its growth. For the equities section, they discuss elements such as NSE 20 and NASI indexes volatility, turnover ratio, foreign investor turnover, net foreign portfolio flow, and market concentration. These components were used to assess the equity market depth in Kenya.

?. **Indices Volatility**: For the indexes volatility, NSE 20's index volatility stood at an average of 0.45% in Q3'2019, which is an increase from an average of 0.43% in Q3'2018. On the other hand, NASI's volatility stood at an average of 0.5% in Q3'2019, a decrease from 0.7% in Q3'2018. While this level of volatility is considered low, as it is less than 10.0%, the CMA still expects it to reduce further with the commencement of trading of financial derivatives such as index futures on NEXT. This is a key accomplishment on the part of CMA as in their soundness report last year they expected to lower the indexes volatility by introducing market makers, derivatives, direct market access and securities lending and borrowing,

i. **Turnover:** In the turnover ratio, the Kenyan equities market stood at 1.4% in Q3'2019, which was an improvement from 0.5% in Q3 2018, showing an increase in trading activity. To improve this further, CMA is developing an operational framework that will support securities lending and borrowing. Correspondingly, the authority intends to engage market stakeholders on formalization of the margin of lending in future. In comparison, the foreign investor turnover as a percentage of total turnover stood at an average of 64.9% in Q3'2019, which shows a slight improvement from the 64.8% as at Q3'2018. While this indicates a medium penetration of foreign investors, CMA intends to reduce this ratio by working on a strategy to on-board more local investors. As well, net foreign portfolio flows showed an inflow of Kshs 262.0 mn in Q3'2019 compared to an outflow of Kshs 6,705.0 mn in Q3'2018. This performance can be attributed to the proposed foreign income tax amnesty allowing individuals to repatriate income, thus attracting diaspora inflows, and
ii. **Market Concentration:** During Q3 2019, the top companies by market capitalization proved their dominance in the market as they accounted for an average of 70.8%, which is an increase from 68.0% in Q3'2018. This shows a high concentration which has been maintained both times at above 50.0%. These top companies include Safaricom, Equity Group, KCB Group, EABL and Co-op Bank. This presents limited diversification at the bourse, which poses a risk to the market. To address this, CMA is actively promoting market depth through innovation and product development. As well, if they continue working on the privatization program we can expect an increase in new listings, which could increase liquidity and promote diversification.

In our view, efforts by the government and the CMA to improve the soundness of the capital markets will improve market depth, access to foreign exchange, market transparency and capacity of local investors as assessed in the Absa 2019 Africa Financial Markets Index .

During the month, 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, recommended a repeal of the interest rate cap. 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;

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

For a more detailed analysis, please see Cytonn Weekly #42/2019

Universe of Coverage

Banks	Price at 30/9/2019	Price at 31/10/2019	Price at 25/10/2019	Price at 1/11/2019	m/m change	w/w change	Target Price	Upside/ Downside	P/TBv Multiple	Recommendation
Sanlam	18.8	17.2	17.1	16.0	(8.5%)	(6.2%)	29.0	81.3%	**0.8x**	**Buy**

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I&M Holdings	45.0	50.5	45.2	47.0	12.2%	4.1%	79.8	77.5%	**0.8x**	**Buy**
Diamond Trust Bank	114	117.75	115.0	116.0	3.3%	0.9%	175.6	53.7%	**0.6x**	**Buy**
Britam	7.1	7.0	6.9	7.0	(0.8%)	1.2%	8.8	30.7%	**0.7x**	**Buy**
CIC Group	3.1	3.0	3.0	3.0	(1.0%)	2.4%	3.8	29.2%	**1.2x**	**Buy**
KCB Group	42.0	51.8	44.1	53.3	23.2%	20.7%	61.4	23.6%	**1.4x**	**Buy**
Kenya Reinsurance	2.9	3.2	3.0	3.2	9.7%	4.6%	3.8	23.5%	**0.1x**	**Buy**
Liberty Holdings	9.7	9.7	10.4	9.7	(0.2%)	(6.7%)	11.3	21.6%	**0.7x**	**Buy**
Equity Group	37.5	46.5	40.0	46.5	24.2%	16.4%	53.0	19.3%	**1.9x**	**Accumulate**
Jubilee holdings	350.0	336.0	350.0	360.0	(4.0%)	2.9%	418.5	18.8%	**1.0x**	**Accumulate**
Co-operative Bank	11.9	14.6	12.5	15.8	22.3%	26.4%	15.0	3.3%	**1.4x**	**Lighten**
Barclays Bank	11.0	13.3	11.5	13.5	21.5%	17.4%	12.6	3.2%	**1.8x**	**Lighten**
Standard Chartered	199.8	205.3	198.5	214.8	2.8%	8.2%	208.0	3.1%	**1.7x**	**Lighten**
NCBA Group	30.0	39.2	33.6	39.5	30.7%	17.4%	37.9	(0.6%)	**0.8x**	**Sell**
Stanbic Holdings	96.0	106.5	101.8	110.5	10.9%	8.6%	100.5	(2.9%)	**1.2x**	**Sell**
HF Group	7.0	6.6	6.7	7.2	(6.0%)	7.8%	2.8	(61.7%)	**0.3x**	**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 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.

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