Cytonn Monthly November 2019

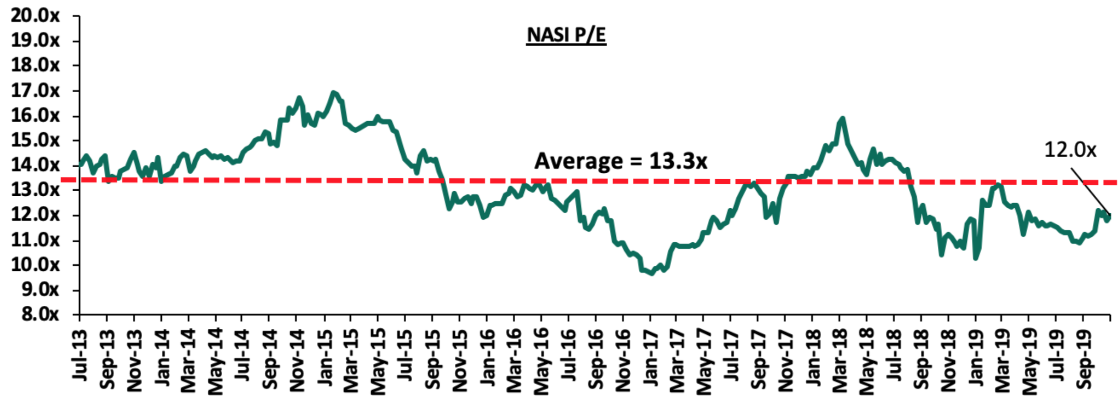
Equities

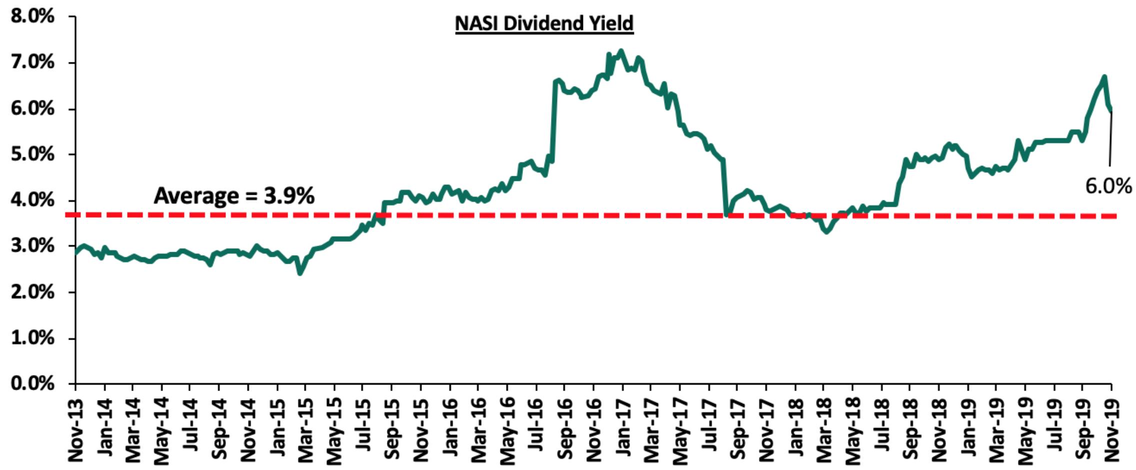
Markets Performance

During the month of November, the equities market was on a downward trend, with NASI, NSE 20 and NSE 25 decreasing by 1.0%, 1.0%, and 0.2%, respectively. The decline was driven by losses in large-cap bank stocks such as NCBA Group, Barclays Bank of Kenya, Standard Chartered Bank of Kenya and KCB Group, which recorded losses of 10.7%, 6.4%, 5.8% and 3.4%, respectively, owing to the market re-adjusting after the bullish trend in October owing to expectations of the repeal of the interest rate cap. During the week, the market was on an upward trend, with NASI and NSE 25 both increasing by 2.0%, whereas NSE 20 declined slightly by 0.005%, taking their YTD performance to gains/ (losses) of 12.5%, 10.3%, and (7.6%) for NASI, NSE 25 and NSE 20, respectively.

Equities turnover increased by 5.1% during the month to USD 165.8 mn, from USD 157.8 mn in October 2019. Foreign investors remained net sellers for the month, with a net selling position of USD 4.7 mn, compared to October's net selling position of USD 14.8 mn. During the week, equities turnover increased by 29.6% to USD 32.2 mn, from USD 24.9 mn the previous week, bringing the year to date (YTD) turnover to USD 1,383.9 mn. Foreign investors became net buyers for the week, with a net buying position of USD 0.7 mn, from last week's net selling position of USD 1.4 mn.

The market is currently trading at a price to earnings ratio (P/E) of 12.0x, 9.9% below the historical average of 13.3x, and a dividend yield of 6.0%, 2.1% points 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 12.0x is 23.5% above the most recent trough valuation of 9.7x experienced in the first week of February 2017, and 44.3% above the previous trough valuation of 8.3x experienced in December 2011. The charts below indicate the historical P/E and dividend yield of the market.





Weekly Highlights

During the week, Moody's Investors released a peer comparison report rating some of Kenya's and Nigeria's biggest banks. Particularly, they compared Kenya's Equity Bank limited, Co-operative Bank of Kenya Limited and KCB Bank Kenya Limited with Nigeria's Access Bank Plc, Zenith Bank Plc and United Bank of Africa Plc. Their findings showed Kenyan banks to be superior in profitability compared to the Nigerian banks. Some of the metrics used included;

- **Cost to Income** - Kenyan banks have lower cost to income ratios despite their higher retail overhead costs,
- **Net Interest Margin** - Kenyan banks have higher net interest margins owing to the greater exposure to retail clients, whereas, Nigerian banks have lower net interest margins which are attributable to their focus on lower margin corporate clients, and,
- **Cost of Funds** - Kenyan banks cost of funding was 100 bps lower owing to their wider access to retail deposits.

Moody's outlook for the banks was positive with an expectation that;

- Kenyan banks will have higher net interest margins going forward supported by the recent interest rate cap repeal,
- Kenyan banks overall profitability will increase owing to stronger cost to income ratios mostly associated with lower loan loss provision costs,
- Nigerian banks will increase their net interest margins as they target to increase exposure to retail clients, and,
- Nigerian banks will improve their cost to income ratios owing to digitization of their operations and the limit in branch and staff expansion.

Therefore, Kenyan banks can be expected to benefit from the recent interest rate cap removal leading to increased profitability and much lower cost to income ratios.

Monthly Highlights

During the month, Equity Bank Group ('Equity'), in line with its regional expansion strategy, announced that it is set to pay Kshs 10.7 bn to acquire a 66.5% stake in Banque Commerciale du Congo (BCDC), a top bank in the Democratic Republic of Congo owned by the George Arthur Forrest family. Equity is expected to acquire 625,354 shares in a deal that is inclusive of dividends that the bank will declare early next year.

For more information, see our Equities Highlight #47

Earnings Releases

During the week, I&M Holdings released their Q3'2019 financial results

Income Statement:

- I&M Holdings released their Q3'2019 results, registering core earnings per share growth of 13.4% to Kshs 16.0, from Kshs 14.2 in Q3'2018. Performance was driven by a 6.8% increase in operating income to Kshs 16.9 bn, from Kshs 15.8 bn in Q3'2018, which outpaced the marginal increase in operating expenses by 0.5% to Kshs 8.23 bn from Kshs 8.18 bn recorded in Q3'2018,
- Total operating income increased by 6.8% to Kshs 16.9 bn, from Kshs 15.8 bn in Q3'2018. This was due to a 14.0% increase in Non-Funded Income (NFI) to Kshs 6.3 bn, from Kshs 5.6 bn in Q3'2018, coupled with a 2.9% growth in Net Interest Income (NII) to Kshs 10.6 bn, from Kshs 10.3 bn recorded in Q3'2018,
- Interest income increased by 7.2% to Kshs 19.2 bn, from Kshs 17.9 bn in Q3'2018. This was mainly driven by the 13.5% increase in interest income on loans and advances to Kshs 15.5 bn, from Kshs 13.7 bn in Q3'2018. The growth was however mitigated by the 21.2% decline in interest income on government securities to Kshs 3.1 bn in Q3'2019, from Kshs 4.0 bn. The yields on interest earning assets stood at 10.1% in Q3'2019, a decline from 10.9% recorded in Q3'2018, due to a 17.2% increase in average interest earning assets to Kshs 269.5 bn from Kshs 230.0 bn, which outpaced the 7.2% increase in interest income,
- Interest expense increased by 12.9% to Kshs 8.6 bn from Kshs 7.6 bn in Q3'2018, as interest expense on customer deposits increased by 21.3% to Kshs 7.8 bn from Kshs 6.4 bn in Q3'2018. Interest expense on deposits from other banking institutions however declined by 65.5% to Kshs 161.0 mn from Kshs 467.2 mn in Q3'2018. The cost of funds decreased marginally to 4.6% from 4.8% in Q3'2018, driven by a 27.3% increase in interest bearing liabilities to Kshs 239.2 bn from Kshs 176.3 bn which grew faster than interest expense which grew by 12.9%,
- Non-Funded Income increased by 14.0% to Kshs 6.3 bn from Kshs 5.6 bn in Q3'2018. The increase in NFI was driven by a 111.8% increase in other income to Kshs 1.2 bn from Kshs 558.8 mn in Q3'2018 coupled with an 11.1% increase in fees and commission income on loans to Kshs 1.4 bn from Kshs 1.2 bn in Q3'2018. Other fees and commissions increased by 1.1% to Kshs 1.9 bn from Kshs 1.8 bn in Q3'2018. The revenue mix shifted to 63:37 funded to non-funded income from 65:35 in Q3'2018, owing to the faster increase in NFI compared to NII,
- Total operating expenses posted a marginal growth of 0.5% to Kshs 8.23 bn from Kshs 8.18 bn, largely driven by a 13.6% increase in staff costs to Kshs 3.5 bn in Q3'2019 from Kshs 3.1 bn in Q3'2018, coupled with a 31.6% decline in Loan loss provisions (LLP) to Kshs 1.3 bn in Q3'2019 from Kshs 1.9 bn in Q3'2018,
- The cost to income ratio improved by 3.1% points to 48.6% from 51.7% in Q3'2018, driven by the faster increase of operating income compared to operating expenses. Without LLP, however, the cost to income ratio deteriorated to 40.9% from 39.9% in Q3'2018,
- Profit before tax recorded a 12.2% growth to Kshs 9.3 bn from Kshs 8.3 bn in Q3'2018. Profit after tax increased by 13.4% Kshs 6.3 bn in Q3'2019 from Kshs 5.5 bn recorded in a similar period in 2018, with the effective tax rate declining to 28.7% from 29.4%.

Balance Sheet:

- The balance sheet recorded an expansion with total assets growth of 12.0% to Kshs 324.3 bn, from Kshs 289.6 bn recorded in Q3'2018. This growth was driven by a 6.6% increase in net loans and advances to Kshs 174.1 bn in Q3'2019, from Kshs 163.3 bn in Q3'2018, and a 9.2% growth in deposits and balances due from banking institutions abroad to Kshs 52.0 bn from Kshs 33.1 bn in Q3'2018. Government securities decreased by 0.7% to Kshs 53.5 bn from Kshs 53.9 bn in Q3'2018,
- Total liabilities recorded a growth of 11.2% to Kshs 266.7 bn from Kshs 239.8 bn recorded in Q3'2018, driven by a 13.0% increase in customer deposits to Kshs 236.2 bn from Kshs 209.0 bn in Q3'2018. Deposits per branch increased by 13.0% to Kshs 5.6 bn from Kshs 5.0 bn in Q3'2018 as the bank has not increased its branch network from the current 42 branches,
- The loan to deposit ratio decreased to 73.7% from 78.1% in Q3'2018, driven by the 13.0% growth

in deposits to Kshs 236.2 bn from Kshs 209.0 bn in Q3'2018, which outpaced the 6.6% increase in net loans to Kshs 174.1 from Kshs 163.3 bn in Q3'2018,

- Gross non-performing loans increased by 8.9% to Kshs 24.1 bn in Q3'2019 from Kshs 22.1 bn in Q3'2018. However, the NPL ratio remained unchanged at 12.7% in Q3'2019. General loan loss provisions increased by 40.3% to Kshs 8.3 bn from Kshs 5.9 bn in Q3'2018, hence an improvement in NPL coverage to 62.5% in Q3'2019 from 49.2% in Q3'2018,
- Shareholders' funds increased by 16.0% to Kshs 54.5 bn from Kshs 47.0 bn recorded in Q3'2018 attributable to a 19.2% increase in retained earnings to Kshs 31.7 bn from Kshs 26.6 bn,
- I&M Holdings is currently sufficiently capitalized with a core capital to risk weighted assets ratio of 15.9%, 5.4% above the statutory requirement. In addition, the total capital to risk weighted assets ratio was 19.4%, exceeding the statutory requirement by 4.9%. Adjusting for IFRS 9, the core capital to risk weighted assets stood at 16.0%, while total capital to risk weighted assets came in at 19.5%, indicating that the bank's total capital relative to its risk-weighted assets decreased by 0.1% due to the impact of IFRS 9,
- I&M Holdings currently has a return on average assets of 2.8% and a return on average equity of 17.2%.

Key Take-Outs:

a. The bank maintained its continual rise in NFI recording a 14.0% growth to Kshs 6.3 bn from Kshs 5.6 bn in Q3'2018. This resulted in the revenue contribution mix shifting to 63:37 funded to non-funded income, from 65:35, owing to the high growth in NFI that outpaced growth in NII. The acquisition of Youjays Insurance Brokers in 2018 provides the bank with an avenue to grow its bancassurance business, thereby putting the firm's NFI on a positive growth trajectory, and,
b. The bank's asset quality remained steady, with the NPL ratio flat-lining at 12.7% while NPL coverage improved to 62.5% in Q3'2019 from 49.2% in Q3'2018. Further, the 40.3% rise in general provisions to Kshs 8.3 bn from Kshs 5.9 bn in Q3'2018, outpaced the 8.9% growth in gross NPL to Kshs 24.1 bn in Q3'2019 from Kshs 22.1 bn in Q3'2018 thus leading to an improvement in the NPL coverage to 62.5% from 49.2% in Q3'2018.

Going forward, the factors that would drive the bank's growth would be:

i. Non-Funded Income Growth Initiatives – I&M Holdings' NFI growth is improving as the bank focuses on digital innovation to augment transaction volumes and increase fee income. The bank needs to increase capacity of its brokerage and advisory businesses so as to increase income contribution from investment and advisory services, and,
ii. Diversification – The bank has been aggressively expanding into other regions, namely Tanzania, Rwanda and Uganda. This is expected to drive growth in the near future.

For more analysis, see the I&M Holdings Q3'2019 Earnings Note

During the week, Stanbic Bank released their Q3'2019 financial results

Income Statement:

- Profit after tax increased by 7.9% to Kshs 5.1 bn in Q3'2019, from Kshs 4.7 bn in Q3'2018. The performance was driven by a 15.2% increase in total operating income,
- Total operating income increased by 15.2% to Kshs 18.4 bn, from Kshs 15.9 bn in Q3'2018, driven by a 12.6% increase in Net Interest Income to Kshs 9.6 bn in Q3'2019, from Kshs 8.5 bn in Q3' 2018, coupled with a 18.3% increase in Non-Funded Income to Kshs 8.8 bn, from Kshs 7.4 bn in Q3'2018,
- Interest income increased by 11.3% to Kshs 15.4 bn in Q3'2019, from Kshs 13.8 bn in Q3'2018. This was largely due to the interest income on loans and advances, which increased by 13.6% to Kshs 11.7 bn in Q3'2019, from Kshs 10.3 bn in Q3'2018. The yield on interest-earning assets increased to 8.1% from 6.7% in Q3'2018 following the 11.6 % increase in interest income to Kshs

15.4 bn from Kshs 13.8 bn in Q3’2018,

- Interest expense increased by 9.3% to Kshs 5.8 bn from Kshs 5.3 bn in Q3’2018, following a 19.7% increase in the interest expense on customer deposits to Kshs 4.0 bn from Kshs 3.3 bn in Q3’2018. The increase was however mitigated by the 20.8% decline in Interest expense on deposits and placements from banking institutions, to Kshs 1.2 bn from Kshs 1.5 bn in Q3’2018. The cost of funds thus rose to 2.6%, from 2.5% in Q3’2018. Net Interest Margin increased to 6.9%, from 6.2% in Q3’2018 on the back of the rapidly increasing Net Interest Income by 55.3% to Kshs 13.2 bn from Kshs 8.5 bn in Q3’ 2018,
- Non-Funded Income (NFI) increased by 18.3% to Kshs 8.8 bn in Q3’2019 from Kshs 7.4 bn in Q3’2018. The growth in NFI was driven by a 44.6% increase in foreign exchange trading income to Kshs 3.4 bn from Kshs 2.3 bn in Q3’2018, and a 22.6% increase in other fees and commissions to Kshs 3.4 bn from Kshs 2.8 bn. Fees and commissions on loans and advances increased by 30.9% to Kshs 0.3 bn from Kshs 0.2 bn in Q3’2019. The current revenue mix stands at 52:48 funded to non-funded income in Q3’2018 from the 53:47 ratio recorded in Q3’2018, owing to a faster increase in NFI,
- Total operating expenses increased by 26.3% to Kshs 11.7 bn in Q3’2019 from Kshs 9.2 bn in Q3’2018, largely driven by a 31.2% increase in the loan loss provision to Kshs 1.7 bn from Kshs 1.2 bn in Q3’2018. Staff costs also recorded a 0.1% increase to Kshs 4.3 bn from Kshs 4.2 bn in Q3’2018. Consequentially, Cost to income ratio with LLP deteriorated to 63.5% in Q3’2019 from 57.9% in Q3’2018. Without LLP, the Cost to income ratio also deteriorated to 54.4% in Q3’2019, from 50.1% in Q3’2018,
- Profit before tax remained unchanged at Kshs 6.7 bn in Q3’2019. Profit after tax increased by 24.0% to Kshs 5.9 bn in Q3’2019 from Kshs 4.7 bn in Q3’2018 after adding back the exceptional items.

Balance Sheet:

- The balance sheet recorded an expansion as total assets increased by 2.8% to Kshs 294.3 bn from Kshs 286.3 bn in Q3’2018. This growth was largely driven by a 14.6% increase in the loan book to Kshs 161.7 bn from Kshs 141.1 bn, and balances due from the Central Bank, which increased by 88.0% to stand at Kshs 36.0 bn from Kshs 19.2 bn in Q3’2018. The growth was however slowed down by a sharp decline in placements by 51.6% % to Kshs 4.5 bn from Kshs 6.8 bn in Q3’2018,
- Total liabilities rose by 1.3% to Kshs 256.5 bn from Kshs 253.2 bn in Q3’2018, largely driven by a 5.4% increase in customer deposits to Kshs 191.2 bn in Q3’2019 from Kshs 181.5 bn in Q3’ 2018, and borrowings that grew by 0.8% to Kshs 12.4 bn from Kshs 12.3 bn in Q3’2018. Other liabilities however decreased by 17.4% to Kshs 10.8 bn in Q3’2019 from Kshs 13.1 bn in Q3’2018,
- The faster increase in loans as compared to the deposits lead to the increase in the loan to deposit ratio to 84.6% in Q3’2019 from 77.8% in Q3’2018,
- Gross non-performing loans increased by 78.3% to Kshs 18.9 bn from Kshs 10.6 bn in Q3’2018. The NPL ratio thus increased to 10.9% in Q3’2019 from 7.5% in Q3’2018, owing to the faster growth in non-performing loans that outpaced growth in the net loans. General Loan Loss Provisions (LLPs) increased by 73.6% to Kshs 6.8 bn from Kshs 3.9 bn in Q3’2018. The NPL coverage declined to 58.9% in Q3’2019 from 60.6% in Q3’2018 mainly due to the 78.3% growth in Non-performing loans to Kshs 18.9 bn from Kshs 10.6 bn in Q3’2018 which outpaced the growth in loan loss provision,
- Shareholders’ funds increased by 2.8% to Kshs 37.8 bn in Q3’2019 from Kshs 33.1 bn in Q3’2018, largely due to the 17.3% increase in the retained earnings to Kshs 30.8 bn from Kshs 26.3 bn in Q3’2018,
- Stanbic Bank is currently sufficiently capitalized with a core capital to risk weighted assets ratio of 13.9%, 3.4% points above the statutory requirement. In addition, the total capital to risk weighted assets ratio was 17.2%, exceeding the statutory requirement by 2.7% points. Adjusting for IFRS 9, core capital to risk weighted assets ratio was at 15.1% while total capital to risk

weighted assets was 18.7%, indicating that the bank's total capital relative to its risk-weighted assets declined by 1.5% points due to the implementation of IFRS 9,
- Stanbic Holdings currently has a return on average assets of 2.5% and a return on average equity of 20.7%.

Key Take-Out:

The bank recorded a relatively strong performance in both funded and NFI segments. The bank's aggressive lending has led to increased interest income, as well as the associated fees and commissions. The increased lending has however came at a cost as asset quality deteriorated, as shown by the rise in the NPL ratio to 10.9%, from 7.5% in Q3'2018. Consequently, the cost of risk rose to 9.1% from 7.8% in Q3'2018.

For more analysis, see the Stanbic Bank Q3'2019 Earnings Note

During the week, HF Group released their Q3'2019 financial results

Income Statement

- HF Group released their Q3'2019 financial results, recording a 74.5% decline in loss per share to Kshs 0.2 in Q3'2019, from a loss per share of Kshs 0.9 recorded in Q3'2018. The performance was driven by a 16.5% increase in total operating income, which was offset by a 5.6% increase in total operating expenses,
- Total operating income increased by 16.5% to Kshs 2.8 bn, from Kshs 2.4 bn in Q3'2018. This was mainly driven by a 78.9% increase in Non-Funded Income (NFI) to Kshs 1.1 bn, from Kshs 0.6 bn in Q3'2018. This was however weighed down by a 4.3% decline in Net Interest Income (NII) to Kshs 1.7 bn from Kshs 1.8 bn in Q3'2018,
- Interest income declined by 11.9% to Kshs 4.1 bn, from Kshs 4.7 bn in Q3'2018. This was driven by a 13.9% decline in interest income from loans and advances to Kshs 3.8 bn, from Kshs 4.4 bn in Q3'2018. Interest income on government securities, however, recorded a 31.5% rise to Kshs 0.3 bn, from Kshs 0.2 bn in Q3'2018. The yield on interest-earning assets declined to 11.3%, from 11.8% in Q3'2018, due to the faster 11.9% decline in interest income compared to the 11.5% decline in the average interest-earning assets. Consequently, the Net Interest Margin (NIM) declined to 4.5%, from 4.8% in Q3'2018,
- Interest expense declined by 16.6% to Kshs 2.4 bn, from Kshs 2.9 bn in Q3'2018, following a 42.3% decline in interest on other interest expenses to Kshs 0.7 bn, from Kshs 1.1 bn in Q3'2018. Despite the decline, the cost of funds remained flat at 7.0%,
- Non-Funded Income increased by 78.9% to Kshs 1.1 bn, from Kshs 0.6 bn in Q3'2018. The increase was mainly due to a 144.2% increase in other fees & commissions to Kshs 0.3 bn, from Kshs 0.1 bn, coupled with a 68.5% increase in fees and commissions on loans and advances to Kshs 46.6 mn from Kshs 27.7 mn, and a further 68.6% increase in other income from Kshs 0.4 bn in Q3'2018 to Kshs 0.7 bn in Q3'2019. The revenue mix shifted to 62:38 funded to non-funded income, from 75:25, owing to the decline in NII coupled with the growth in NFI,
- Total operating expenses increased by 5.6% to Kshs 2.9 bn from Kshs 2.7 bn in Q3'2018, largely driven by a 64.5% increase in loan loss provisions to Kshs 0.6 bn from Kshs 0.4 bn in Q3'2018. This was however offset by a 17.2% decline in Staff costs to Kshs 0.7 bn from Kshs 0.9 bn, in Q3'2018,
- The Cost to Income Ratio (CIR) improved to 102.9%, from 113.5% in Q3'2018. Without LLP, the cost to income ratio improved, to 81.8% from 98.6% in Q3'2018, and,
- HF Group recorded a 75.0% decline in loss before tax to Kshs 81.4 mn from a loss before tax of Kshs 325.6 mn in Q3'2018. The Group also recorded a 74.5% decline in loss after tax of Kshs 84.6 mn from a loss after tax of Kshs 332.0 mn in Q3'2018.

Balance Sheet

- The balance sheet recorded a contraction as total assets declined by 9.4% to Kshs 57.4 bn, from Kshs 63.4 bn in Q3'2018. The contraction was mainly driven by a 13.7% decline in the loan book to Kshs 39.2 bn from Kshs 45.4 bn in Q3'2018, coupled with a 41.6% decline in property & equipment to Kshs 1.2 bn from Kshs 2.1 bn recorded in Q3'2018,
- Government securities recorded a 7.0% decline to Kshs 3.6 bn, from Kshs 3.9 bn in Q3'2018,
- Total liabilities declined by 10.6% to Kshs 47.0 bn, from Kshs 52.6 bn in Q3'2018, driven by a 35.3% decline in borrowings to Kshs 9.9 bn, from Kshs 15.3 bn in Q3'2018. Customer deposits declined marginally by 0.1% to Kshs 34.6 bn from Kshs 34.7 bn in Q3'2018. Deposits per branch remained flat at Kshs 1.6 bn,
- The faster decline in loans as compared to deposits led to a decline in the loan to deposit ratio to 113.3% from 131.1% in Q3'2018,
- Gross Non-Performing Loans (NPLs) increased by 41.4% to Kshs 12.6 bn in Q3'2019 from Kshs 8.9 bn in Q3'2018. The NPL ratio thus deteriorated to 28.2%, from 18.2% in Q3'2018. General Loan Loss Provisions increased by 17.1% to Kshs 2.7 bn, from Kshs 2.3 bn in Q3'2018. Consequently, NPL coverage increased to 44.4%, from 42.4% in Q3'2018,
- Shareholders' funds declined by 3.4% to Kshs 10.4 bn in Q3'2019, from Kshs 10.8 bn in Q3'2018,
- HF Group remains sufficiently capitalized with a core capital to risk-weighted assets ratio of 15.1%, 4.6% points above the statutory requirement of 10.5%. In addition, the total capital to risk-weighted assets ratio came in at 16.4%, exceeding the statutory requirement by 1.9% points. Adjusting for IFRS 9, the core capital to risk-weighted assets stood at 14.4%, while total capital to risk-weighted assets came in at 15.7% indicating that the bank's total capital relative to its risk-weighted assets decreased by 0.7% due to the impact of IFRS 9, and,
- The bank currently has a Return on Average Assets (ROaA) of (0.6%), and a Return on Average Equity (ROaE) of (3.3%).

Key Take-Outs:

1. The balance sheet declined by 9.4% to Kshs 57.4 bn, from Kshs 63.4 bn in Q3'2018. The contraction was mainly driven by a 13.7% decline in the loan book to Kshs 39.2 bn from Kshs 45.4 bn in Q3'2018, coupled with a 41.6% decline in Property & equipment to Kshs 1.2 bn from Kshs 2.1 bn recorded in Q3'2018. The bank faces issues of asset-liability mismatch - with a high cost of funds and declining average interest-earning assets,
2. The bank experienced a deterioration in asset quality as gross non-performing loans (NPLs) increased by 41.4% to Kshs 12.6 bn in Q3'2019, from Kshs 8.9 bn in Q3'2018. This warranted increased provisioning by 17.1% to Kshs 2.7 bn, from Kshs 2.3 bn in Q3'2018. The deteriorating asset quality, coupled with the tough operating environment occasioned by the interest rate cap, has continued to hamper the bank's lending activities, leading to a decline in its interest income,

Going forward, the factors that would drive the bank's growth would be:

1. Continued investment in digital channels to enhance accessibility as well as reduce operating expenses mainly through aligning staff costs to the bank's operational needs: On this end, the Bank undertook a redundancy exercise in 2018 in a cost-cutting drive, which saw the merging of some staff positions. This is expected to improve efficiencies in subsequent periods by providing clarity on operational accountabilities and curb the high operational costs, and,
2. We maintain our view that HF Group as a conventional bank has a long way to go, given its inability to mobilize deposits evidenced by the slow deposit growth. Furthermore, the removal of the Interest rate cap will ultimately increase competition among banks in terms of credit offerings. The bank will ultimately have to adjust its business model, or couple up with a strong bank with a sizeable asset base, and a strong deposit gathering capability, in an effort to capitalize on HF's strength in mortgages and real estate development.

For more analysis, see the HF Q3'2019 Earnings Note

During the week, Diamond Trust Bank Kenya Ltd released their Q3'2019 financial results

Income Statement:

Diamond Trust Bank released its Q3'2019 results during the week, with core earnings per share growing by 7.5% to Kshs 20.2 from Kshs 18.8 in Q3'2018, lower than our expectation of a 13.3% increase to Kshs 21.3. Performance was driven by cost-cutting measures and efficiency evidenced by a 12.5% decrease in total operating expenses to Kshs 9.5 bn from Kshs 10.8 bn, which outpaced the decline in total operating that fell by 4.6% to Kshs 18.2 bn from Kshs 19.0 bn. The variance in core earnings per share growth relative to our expectations, was as a result of a faster growth in Non-Funded Income (NFI) of 5.7% to Kshs 4.37 bn, from Kshs 4.1 bn in Q3'2018 against our expectation of a 6.2% increase to Kshs 4.39 bn. Highlights of the performance from Q3'2018 to Q3'2019 include:

- Total operating income decreased by 4.6% to Kshs 18.2 bn, from Kshs 19.0 bn in Q3'2018. This was due to a 7.5% decrease in Net Interest Income (NII) to Kshs 13.8 bn from Kshs 14.9 bn in Q3'2018, that outpaced the 5.7% growth in Non-Funded Income (NFI) to Kshs 4.4 bn, from Kshs 4.1 bn in Q3'2018,
- Interest income decreased by 7.3% to Kshs 24.5 bn from Kshs 26.5 bn in Q3'2018. The interest income on loans and advances decreased by 10.2% to Kshs 14.8 bn from Kshs 16.5 bn in Q3'2018. Interest income on government securities decreased by 3.9% to Kshs 9.3 bn in Q3'2019, from Kshs 9.7 bn in Q3'2018. The yield on interest earning assets declined to 9.9% in Q3'2019, from 10.8% in Q3'2018, due to the decline recorded in total interest earning assets by 2.3%, to Kshs 333.8 bn from Kshs 341.7 coupled with the decline in interest income sustained from a low interest rate environment,
- Interest expense decreased by 7.0% to Kshs 10.7 bn from Kshs 11.6 bn in Q3'2018, as interest expense on customer deposits decreased by 10.7% to Kshs 9.2 bn, from Kshs 10.3 bn in Q3'2018. Other interest expense increased by 54.9% to Kshs 1.0 bn, from Kshs 664.4 mn in Q3'2018. Consequently, cost of funds decreased to 4.6%, from 4.9% in Q3'2018 due to the decline recorded in total interest bearing liabilities by 4.4% to Kshs 309.9 bn from Kshs 324.7 bn recorded in Q3'2018. The Net Interest Margin, resultantly, declined to 5.6%, from 6.1% in Q3'2018,
- Non-Funded Income increased by 5.7% to Kshs 4.4 bn, from Kshs 4.1 bn in Q3'2018. The increase in NFI was driven by a 41.2% increase in forex trading income to Kshs 1.4 bn from Kshs 1.2 bn in Q3'2018, coupled with a 25.1% increase in other income to Kshs 0.44 bn from Kshs 0.35 bn in Q3'2018. Fees and commissions on loans however decreased by 4.6% to Kshs 0.96 bn from Kshs 1.0 bn in Q3'2018, while other fees fell marginally by 1.2% to Kshs 1.57 bn from Kshs 1.58 bn in Q3'2018. The revenue mix shifted to 76:24 funded to non-funded income in Q3'2019, from 78:22 in Q3'2018, owing to the increase in NFI coupled with the decrease in NII,
- Total operating expenses decreased by 12.5% to Kshs 9.5 bn from Kshs 10.8 bn, largely driven by a 63.7% decrease in loan loss provision (LLP) to Kshs 870.3 mn in Q3'2019, from Kshs 2.4 bn in Q3'2018. The decline was however mitigated by the 8.5% increase in staff costs to Kshs 3.4 bn in Q3'2019, from Kshs 3.1 bn in Q3'2018,
- Due to the faster 12.5% decline in total operating expenses that outpaced the 4.6% decline in total operating income, the cost to income ratio improved to 52.2%, from 56.9% in Q3'2018. Without LLP, however, the cost to income ratio deteriorated to 47.4% from 44.4% in Q3'2018,
- Profit before tax increased by 5.8% to Kshs 8.7 bn, up from Kshs 8.2 bn in Q3'2018. Profit after tax increased by 6.5% to Kshs 6.0 bn in Q3'2019, from Kshs 5.6 bn in Q3'2018, as the effective tax rate declined to 31.0%, from 31.3% in Q3'2018.

Balance Sheet:

- The balance sheet recorded a contraction as total assets declined by 0.6% to Kshs 382.5 bn from Kshs 385.0 bn in Q3'2018. This decrease was largely driven by a 1.2% decrease in government securities to Kshs 97.5 bn in Q3'2019, from Kshs 98.7 bn in Q3'2018, coupled with a 2.9% contraction of the loan book to Kshs 192.0 bn in Q3'2019, from Kshs 197.7 bn in Q3'2018. The decline was however mitigated by the 55.8% growth in other assets to Kshs 14.4 bn, from Kshs 9.3 bn in Q3’2018,

- Total liabilities declined by 3.1% to Kshs 317.8 bn, from Kshs 328.0 bn in Q3’2018, driven by a 47.1% decrease in placements to Kshs 14.3 bn, from Kshs 27.0 bn in Q3’2018, coupled with a 15.8% decrease in borrowings to Kshs 12.6 bn, from Kshs 14.9 bn in Q3’2018,
- Deposits however increased by 0.3% to Kshs 283.1 bn from Kshs 282.2 in Q3’2018. Deposit per branch increased marginally by 0.3% to Kshs 2.07 bn from Kshs 2.06 bn in Q3’2018, with the branch network remaining unchanged at 137 in Q3’2019,
- The faster growth in deposits compared to the decline recorded in loans led to a decline in the loan to deposit ratio to 67.8% from 70.0% in Q3’2018,
- Gross non-performing loans increased by 9.6% to Kshs 17.9 bn in Q3’2019, from Kshs 16.3 bn in Q3’2018. The NPL ratio thus deteriorated to 8.9% in Q3’2019, from 7.8% in Q3’2018. General loan loss provisions recorded a 38.4% decline to Kshs 5.7 bn, from Kshs 9.3 bn in Q3’2018. The NPL coverage, thus, decreased to 48.0% in Q3’2019, from 72.5% in Q3’2018 due to the decrease in general loan loss provisions,
- Shareholders’ funds increased by 13.6% to Kshs 58.9 bn in Q3’2019, from Kshs 51.9 bn in Q3’2018, due to earnings retained since DTBK did not declare any interim dividends
- DTB Kenya Limited is currently sufficiently capitalized with a core capital to risk weighted assets ratio of 19.1%, 8.6% above the statutory requirement. In addition, the total capital to risk weighted assets ratio was 21.2%, exceeding the statutory requirement by 6.7%. Adjusting for IFRS 9, the core capital to risk weighted assets stood at 19.8%, while total capital to risk weighted assets came in at 21.8%, indicating that the bank’s total capital relative to its risk-weighted assets decreased by 0.6% due to the impact of IFRS 9,
- DTB Kenya currently has a return on average assets of 1.9% and a return on average equity of 13.4%.

Key Take-Outs:

a. The bank recorded a relatively weaker earnings performance with total operating income declining by 4.6%. This was largely due to the depressed performance of funded income, with the bank recording declining interest income on loans and advances and government securities. The expansion from the bottom line was largely due to a faster decline in total operating expenses, which was largely derived from the steep 63.7% decline in Loan Loss Provisions (LLP),
b. The bank recorded an improved performance on the NFI income segment, which recorded a 5.7% growth y/y, largely supported by the 41.2% increase in forex trading income, coupled with a 25.1% growth in other income. Consequently, NFI contribution to total income rose to 24.1% from 21.7% in Q3’2019. This however remains below the current industry average of 36.0%.

Going forward, we expect the bank’s growth to be further driven by:

a. **Regional Diversification**: We continue to expect DTBK’s increased regional presence to aid in enhancing growth. We expect DTBK’s increased focus on other regions to boost the growth in the bottom line, largely supported by the expansion of funded income which has remained subdued largely due to the pricing restriction existent in Kenya. Diversification into other regions would aid the bank in mitigating the sustained effects of compressed margins,
b. **Operational Efficiency**: DTBK continues to be one of the most efficient banks, and as at Q3’2019, had a cost to income ratio of 52.2%, which was below the market average of 56.7%. Thus, DTBK’s continued focus on maintaining high operational margins coupled with an expanding top line revenue growth will likely lead to consistent growth in the long run.

For more analysis, see the Diamond Trust Bank Kenya Ltd Q3’2019 Earnings Note

Other listed bank releases for Q3’2019 are:

- Equity Group Holdings Plc released their Q3’2019 results, recording a 10.4% increase in core earnings per share to Kshs 4.6, from Kshs 4.2 in Q3’2018, attributed to an 11.2% increase in total operating income to Kshs 54.8 bn from Kshs 49.3 bn in Q3’2018. For more information, Equity Group Holdings Q3'2019 Earnings Note
- KCB Group released their Q3’2019 results, recording a 6.2% increase in core earnings per share to Kshs 6.3, from Kshs 5.9 in Q3’2018, attributed to a 10.0% increase in total operating income to Kshs 59.7 bn, from Kshs 54.2 bn in Q3’2018. For more information, see our KCB Group Q3'2019 Earnings Note
- Co-operative Bank released their Q3’2019 results, recording a 5.5% increase in core earnings per share to Kshs 1.6, from Kshs 1.5 in Q3’2018, attributed to a 10.0% increase in total operating income to Kshs 35.2 bn, from Kshs 32.3 bn in Q3’2018. For more information, see our Co-operative Bank Q3'2019 Earnings Note
- Standard Chartered Bank released their Q3’2019 results, recording a 1.3% decrease in core earnings per share to Kshs 18.1, from Kshs 18.4 in Q3’2018, attributed to a 0.9% increase in total operating expenses to Kshs 12.5 bn, from Kshs 12.4 bn in Q3’2018, with total operating income remaining flat at Kshs 21.6 bn. For more information, see our Standard Chartered Bank of Kenya Plc – Q3’2019 Earnings Note
- NIC Group released their Q3’2019 results, recording a 3.3% decrease in core earnings per share to Kshs 4.4, from Kshs 4.6 in Q3’2018, attributed to a 22.9% increase in total operating expenses to Kshs 8.2 bn, from Kshs 6.6 bn in Q3’2018, which was offset by an increase in total operating income by 15.2% to Kshs 12.6 bn, from Kshs 11.0 bn in Q3’2018. For more information, see our NIC Group Q3'2019 Earnings Note
- Barclays Bank released their Q3’2019 results, recording a 19.0% increase in core earnings per share to Kshs 1.2, from Kshs 1.0 in Q3’2018, attributed to a 3.9% increase in total operating income to Kshs 24.8 bn, from Kshs 23.9 bn in Q3’2018. For more information, see our Barclays Bank of Kenya Plc-Q3'2019 Earnings Note

The table below summarizes the performance of listed banks that have released their Q3’2019 results:

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 Fees & Commissions	Deposit Growth	Growth in Government Securities	Loan to Deposit Ratio	Loan Growth	Return on Average Equity
HF Group	74.5%	(11.9%)	(16.6%)	(4.3%)	4.5%	78.9%	38.4%	129.3%	(0.1%)	(7.0%)	113.3%	(13.7%)	(3.3%)
BBK	19.0%	5.6%	17.1%	2.0%	6.4%	8.1%	32.1%	30.9%	6.9%	3.0%	81.0%	8.8%	17.4%
I&M Holdings	13.4%	7.2%	12.9%	2.9%	5.9%	14.0%	37.5%	5.1%	13.0%	(0.7%)	73.7%	6.6%	17.2%
Equity Group	10.4%	11.2%	16.8%	9.5%	8.4%	13.7%	41.1%	15.0%	18.9%	7.8%	73.0%	21.0%	22.8%
DTBK	7.5%	(7.3%)	(7.0%)	(7.5%)	5.6%	5.7%	22.3%	(2.5%)	0.3%	(1.2%)	67.8%	(2.9%)	14.6%
KCB Group	6.2%	4.6%	(0.8%)	6.5%	8.2%	16.9%	35.2%	28.5%	11.4%	7.5%	82.9%	11.7%	22.2%
Co-operative Bank	5.5%	(1.6%)	0.9%	(2.7%)	8.3%	33.3%	40.0%	46.6%	8.9%	13.6%	83.4%	5.8%	18.4%
SCBK	(1.3%)	(6.3%)	(23.7%)	0.6%	7.5%	(1.1%)	32.2%	7.0%	2.4%	(7.9%)	52.7%	6.8%	16.9%
NIC Group	(3.3%)	3.4%	(4.7%)	10.6%	6.1%	25.6%	34.0%	19.4%	9.2%	9.4%	75.8%	4.3%	5.4%
NBK	(4.7%)	4.7%	(8.2%)	11.6%	7.2%	(4.6%)	23.8%	4.5%	(11.1%)	(17.1%)	58.0%	(0.3%)	5.5%
Stanbic Bank	N/A	11.3%	9.3%	12.6%	6.9%	18.3%	47.7%	23.3%	5.4%	(33.2%)	84.6%	14.6%	20.9%
Q3'2019 Mkt Weighted Average*	**7.7%**	**4.6%**	**4.6%**	**4.8%**	**7.6%**	**15.6%**	**37.1%**	**22.5%**	**10.9%**	**3.2%**	**76.1%**	**11.6%**	**19.6%**
Q3'2018 Mkt Weighted Average**	**16.2%**	**6.1%**	**12.5%**	**3.8%**	**8.0%**	**5.9%**	**34.5%**	**0.6%**	**7.4%**	**17.8%**	**75.3%**	**4.2%**	**18.8%**

Market cap weighted as at 29/11/2019
*****Market cap weighted as at 30/11/2018***
• HF recorded a 74.5% core EPS growth, however key to note, this is a decline in loss per share and the bank is not yet profitable

Key takeaways from the table above include:

1. The eleven listed Kenyan banks recorded a 7.7% average increase in core Earnings per Share (EPS), compared to an increase of 16.2% in Q3’2018 for all listed banks. Return on Average

Equity (ROaE) increased to 19.6%, from 18.8% in Q3’2018,

2. The banks recorded stronger deposit growth, which came in at 10.9%, faster than the 7.4% growth recorded in the sector in Q3’2018. Interest expenses increased at a slower pace of 4.6%, compared to 12.5% in Q3’2018, indicating the banks have been able to mobilize relatively cheaper deposits,
3. Average loan growth came in at 11.6%, which was faster than the 4.2% recorded in the sector in Q3’2018, indicating that there was an improvement in credit extension by the banks. Government securities recorded a growth of 3.2% y/y, which was slower compared to the loans, and a decline from the 17.8% recorded in the sector in Q3’2018. This highlights that banks are beginning to adjust their business models back to private sector lending as opposed to investing in government securities, as the yields on government securities declined during the year. Interest income increased by 4.6%, lower than the 6.1% growth recorded in the sector in Q3’2018. Consequently, the Net Interest Income (NII) grew by 4.8% compared to a growth of 3.8% in the sector in Q3’2018,
4. The banks recorded a Net Interest Margin of 7.6%, 37 bps lower than 8.0% the sector recorded in Q3’2018, and,
5. Non-Funded Income grew by 15.6% y/y, faster than the 5.9% recorded in the sector in Q3’2018. The growth in NFI was boosted by the total fee and commission income which improved by 22.5%, compared to the 0.6% growth recorded in the sector Q3’2018, owing to the faster loan growth.

Universe of Coverage

Banks	Price at 22/11/2019	Price at 29/11/2019	m/m change	w/w change	YTD Change	Target Price*	Dividend Yield	Upside/ Downside**	TBV/Share	P/TBv Multiple	Recommendation
Kenya Reinsurance	3.07	3.03	(4.4%)	(1.3%)	(17.2%)	4.8	14.9%	73.3%	9.1	**0.3x**	**Buy**
I&M Holdings* **	50.00	48.95	(3.1%)	(2.1%)	5.9%	79.8	8.0%	70.9%	48.8	**1.0x**	**Buy**
Diamond Trust Bank	114.25	115.00	(2.3%)	0.7%	(27.2%)	175.6	2.3%	55.0%	199.6	**0.6x**	**Buy**
Jubilee Holdings	355.00	350.00	4.2%	(1.4%)	(13.5%)	453.4	2.6%	32.1%	306.3	**1.1x**	**Buy**
Sanlam	16.50	16.50	(3.8%)	0.0%	(14.8%)	21.7	0.0%	31.5%	25.0	**0.7x**	**Buy**
KCB Group* **	49.05	50.00	(3.4%)	1.9%	12.1%	61.4	7.0%	29.7%	37.5	**1.3x**	**Buy**
Standard Chartered	198.00	193.25	(5.8%)	(2.4%)	2.7%	208.0	9.8%	17.5%	124.4	**1.6x**	**Accumulate**
Barclays Bank* **	12.00	12.45	(6.4%)	3.7%	0.0%	12.6	8.8%	9.9%	7.7	**1.6x**	**Hold**
NCBA	34.45	34.95	(10.7%)	1.5%	7.7%	37.9	0.7%	9.2%	91.7	**0.4x**	**Hold**
Equity Group* **	48.65	51.00	9.7%	4.8%	7.5%	53.0	3.9%	7.8%	25.4	**2.0x**	**Hold**
Liberty Holdings	9.60	9.96	2.7%	3.8%	(24.7%)	10.1	5.0%	6.1%	11.8	**0.8x**	**Hold**
Co-op Bank* **	14.95	16.05	10.3%	7.4%	(16.8%)	15.0	6.2%	(0.3%)	11.7	**1.4x**	**Sell**
Stanbic Holdings	109.25	112.00	5.2%	2.5%	5.8%	100.5	4.3%	(6.0%)	94.8	**1.2x**	**Sell**
CIC Group	3.12	3.07	1.0%	(1.6%)	(20.5%)	2.6	4.2%	(9.8%)	2.8	**1.1x**	**Sell**
Britam	7.66	8.30	18.2%	8.4%	(30.2%)	6.8	0.0%	(18.6%)	9.9	**0.8x**	**Sell**
HF Group	6.40	6.00	(9.4%)	(6.3%)	27.1%	2.8	0.0%	(54.0%)	24.4	**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 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.