Cytonn INVESTMENTS

Cytonn Annual Markets Review – 2019

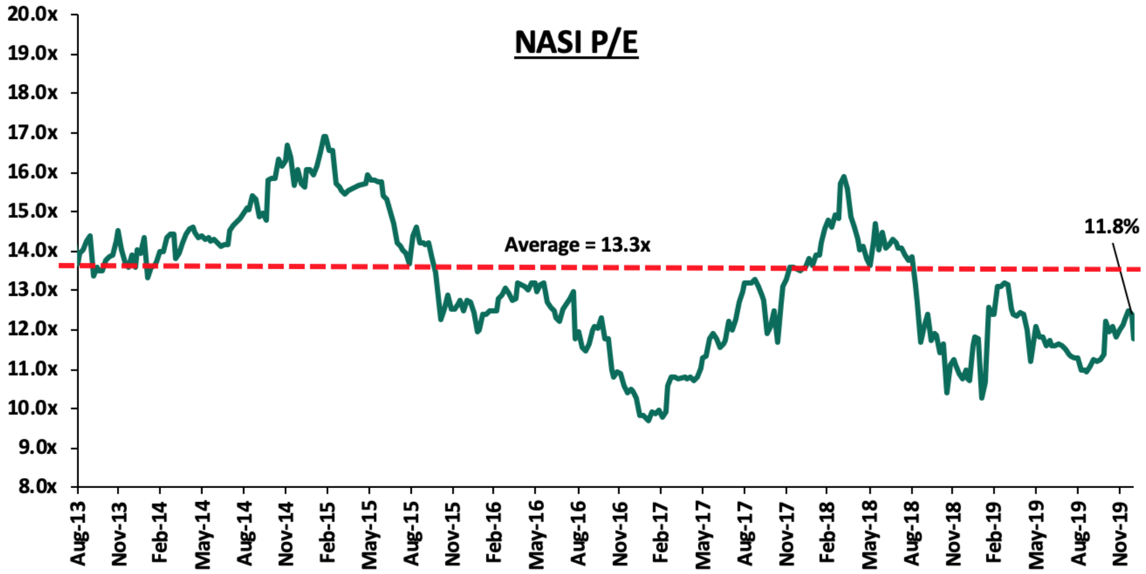
Equities

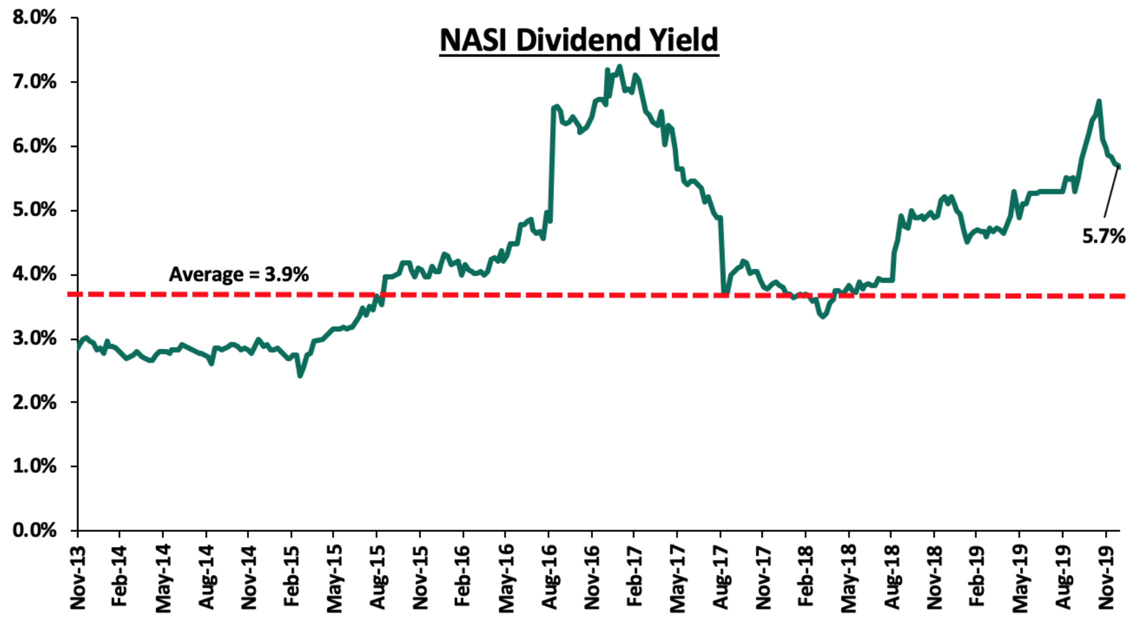
Market Performance

During the year, the Kenyan equities market recorded mixed performance, with NASI and NSE 25 gaining by 18.5% and 15.5%, respectively, while NSE 20 declined by 6.3%. Large cap gainers during the year included Equity Group, KCB Group, Safaricom, NCBA, Barclays, Co-operative Bank and EABL which gained by 53.5%, 44.2%, 41.9%, 32.6%, 21.9%, 14.3% and 13.6%, respectively, while the largest losers were Bamburi, BAT and, DTB which lost (39.6%), (31.0%), and (30.4%) during the year, respectively. Safaricom continues to be a key part of Kenyan equities portfolios, accounting for 50.9% of Nairobi Stock Exchange (NSE's) market capitalization, and has dominated on both the market turnover and in determining the direction of the market given its weight and liquidity in the Nairobi Securities Exchange.

Equity turnover during the year declined by 12.9% to USD 1.5 bn, from USD 1.7 bn in FY'2018. Foreign investors turned net buyers, with a net inflow of USD 18.5 mn, compared to net outflows of USD 425.6 mn recorded in FY'2018. The foreign investor inflows during the year can be attributed mainly to the improved financial performance of listed commercial banks in the country, coupled with the repeal of the rate cap law in the last quarter of the year, which led to increased foreign activity in the local bourse.

The market is currently trading at a price to earnings ratio (P/E) of 11.8x, 11.2% below the historical average of 13.3x, and a dividend yield of 5.7%, 1.8% points above the historical average of 3.9%. The current P/E valuation of 11.8x is 21.3% above the most recent trough valuation of 9.7x experienced in the first week of February 2017, and 41.6% 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.





Banking Sector Earnings

During the year, Kenyan listed banks released their Q3'2019 results recording an average increase in core earnings per share of 8.7%, slower compared to an average growth of 16.2% in Q3'2018. The table below highlights the performance of the banking sector using several metrics, and the key take-outs of the performance;

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%	8.5%	8.1%	32.1%	30.9%	6.9%	3.0%	82.5%	8.8%	17.4%
NCBA	16.3%	2.7%	(3.7%)	8.8%	5.3%	23.3%	47.2%	21.7%	10.7%	7.4%	66.8%	8.2%	14.9%
I&M Holdings	13.4%	7.2%	12.9%	2.9%	6.0%	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%	21.7%
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%
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%	18.5%
Q3'2019 Mkt Weighted Average*	**8.7%**	**4.5%**	**4.3%**	**4.9%**	**7.7%**	**15.8%**	**37.9%**	**22.6%**	**11.0%**	**3.3%**	**75.7%**	**11.6%**	**19.3%**
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**

Key highlights from the table above include:

1. The banks recorded stronger deposit growth, which came in at 11.0%, faster than the 7.4% growth recorded in the sector in Q3'2018. Interest expenses increased at a slower pace of 4.3%, compared to 12.5% in Q3'2018, indicating the banks have been able to mobilize relatively cheaper deposits,
2. 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 3.3% y/y, which was slower compared to 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 quarter. Interest income

increased by 4.5%, slower than the 6.1% growth recorded in the sector in Q3’2018. Consequently, the Net Interest Income (NII) grew by 4.9% compared to a growth of 3.8% in the sector in Q3’2018,

3. The banks recorded a Net Interest Margin of 7.7%, 30 bps lower than the 8.0% recorded in the sector in Q3’2018. The decline was mainly due to a decline in yields recorded in interest earnings assets following the decline in government securities yields, coupled with the decline in yields on loans due to the 50-bps decline in the Central Bank Rate since the end of Q3’2018, and,
4. Non-Funded Income grew by 15.8% 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 22.6%, compared to the 0.6% growth recorded in the sector Q3’2018, owing to the faster loan growth.

For a comprehensive analysis of the Kenya Listed Banks performance, see our Cytonn Q3'2019 Kenya Listed Commercial Banks Review.

Insurance Sector Earnings

During the year, Kenyan listed insurers released their H1’2019 results recording an average increase in core earnings per share of 3.2%, an improvement compared to an average decline of 0.6% in H1’2018. The table below highlights the performance of the listed insurance sector, showing the performance using several metrics, and the key take-outs of the performance;

Listed Insurance Companies H1'2019 Earnings and Growth Metrics

Insurance Company	Core EPS Growth	Net Premium Growth	Claims Growth	Loss Ratio	Expense Ratio	Combined Ratio	ROaA	ROaE
Britam Holdings	**50.0%**	(0.4%)	(12.1%)	59.3%	70.5%	129.8%	(1.4%)	(6.1%)
Liberty Holdings	**45.8%**	3.4%	(0.5%)	80.3%	71.7%	152.0%	1.8%	8.3%
Jubilee Holdings	**(1.6%)**	7.7%	(8.5%)	94.1%	31.4%	125.5%	3.5%	14.4%
Kenya Re	**(12.5%)**	16.6%	48.8%	67.3%	41.0%	108.3%	2.4%	3.7%
CIC Group	**(95.2%)**	0.4%	7.9%	70.9%	49.9%	184.8%	(0.9%)	(3.8%)
Sanlam Kenya*	**N/A**	10.8%	(18.8%)	72.1%	63.4%	135.5%	0.6%	9.9%
H1'2019 Weighted Average**	**3.2%**	**5.7%**	**0.0%**	**77.2%**	**49.1%**	**133.7%**	**1.4%**	**5.1%**
H1'2018 Weighted Average**	**(0.6%)**	**(8.2%)**	**(1.8%)**	**84.2%**	**60.2%**	**144.4%**	**0.9%**	**3.9%**

***Sanlam's EPS cannot be calculated since it has registered losses in H1'2018**

****The weighted average is based on Market Cap as at 22nd October 2019**

The key take-outs from the above table include;

1. The premiums grew by 5.7% in H1’2019, compared to a decline of 8.2% in H1’2018, while claims remained flat on a weighted average basis,
2. The loss ratio across the sector decreased to 77.2% in H1’2019, from 84.2% in H1’2018, owing to the introduction of tough measures by market players to reduce fraudulent claims,
3. The expense ratio decreased to 49.1% in H1’2019, from 60.2% in H1’2018, owing to a decrease in operating expenses through cost rationalization and awareness,
4. The insurance core business still remains unprofitable, with a combined ratio of 133.7% as at H1’2019, compared to 144.4% in H1’2018, and,
5. On average, the insurance sector has delivered a Return on Average Equity of 5.7%, an increase from 3.9% in H1’2018.

For a comprehensive analysis of the Kenya Listed Insurers performance, see our Kenya Listed Insurance Companies Analysis Cytonn H1'2019 report.

Other Key Results

Safaricom Limited released H1’2020 results, recording core earnings per share growth of 14.1% to Kshs 0.9 from Kshs 0.8 in H1’2019. The earnings growth was supported by a 5.3% growth in service revenue (M-PESA, messaging, voice, mobile data and fixed service) to Kshs 124.3 bn, from Kshs 118.1 bn recorded in H1’2019 due to increased usage of non-voice services, particularly M-PESA services, coupled with an 8.0% decline in operating costs to Kshs 23.8 bn, from Kshs 25.8 bn in H1’2019.

This year, 10 companies issued profit warnings to investors compared to 8 companies in 2018, attributable to the tough macro-economic environment in 2019. Companies are required to issue profit warnings if they project a more than 25% decline in profits year-on-year. They include Nairobi Stock Exchange (NSE), BOC Kenya, UAP Holdings Limited, KPLC, Eaagads, Williamson Tea, Standard Group, CIC Insurance, Kenya Airways, and Kapchorua Tea as shown in the table below;

Companies that issued profit warnings Comparison

No	2019	2018
1	Nairobi Stock Exchange	Bamburi Cement
2	BOC Kenya Plc	Britam Holdings
3	UAP Holdings Limited	HF Group
4	Kenya Power and Lightning Company	Deacons East Africa Plc
5	Eaagads	Kenya Power and Lightning Company
6	Williamson Tea Kenya	Sanlam
7	Standard Group Plc	UAP-Old Mutual
8	CIC Insurance	Sameer Africa
9	Kenya Airways	
10	Kapchorua Tea Company	

The key take-outs from the table above include;

i. NSE attributed the shortfall in profits to a challenging economic environment and reduced inflow of capital from global frontier market investors,
ii. BOC Kenya issued a profit warning statement attributing dismal performance to depressed demand for gases from the industrial sector due to the prevailing economic environment coupled with high local energy costs amid soaring debts,
iii. UAP Holdings also issued a profit warning citing that the weakening performance of the property market in Kenya and the uncertain political environment in South Sudan will likely lead to further impairments in the carrying value of certain group investment properties,
iv. KPLC continues to face operating challenges stemming from an increase in non-fuel costs as the company implements its long-term strategy of growing cheaper and cleaner renewable energy to cut cost of energy to consumers,
v. In Eaagads’ case, anticipated slide in earnings is attributed to the depressive global coffee prices, which have reduced significantly this year in the face of market oversupply coupled with a rise in coffee production costs, notably increased labour costs which have been on an upward trend year over year,
vi. Williamson Tea cited uneven and unpredictable weather patterns and the inability to control rising labour costs,

vii. Standard Group's expected decline is attributable to increased newsprint costs during the year, coupled with reduced subscriptions for newspapers, with existing clients spending less due to subdued economic growth and limited access to credit. The media company further cited that increase in costs due to investments in new products whose revenues will be realized in subsequent years led to reduced profitability, amid regulatory changes the betting, gaming and alcoholic sectors that affected advertising income,
viii. CIC Insurance has witnessed a declining trend in profitability attributed to adverse claims in lines of key businesses. Further, the capping of interest rates in 2016 resulted in a ripple effect on business owing to the fact that lending to insurable investment projects and assets remained constrained. Also, diminishing disposable income on account of tough economic times has slowed down the uptake of insurance products,
ix. Kenya Airways attributes the expected decline in profits to competition in areas of operation, amid significant adjustments to both the profit and loss statements and balance sheets as the airline adopts new guidelines as provided by IFRS 16, and,
x. Kapchorua Tea issued a profit warning statement this year citing uneven and unprecedented weather patterns coupled with rising labour costs, amid depressed prices for tea.

De-listings and Suspensions

During the year, we witnessed the Nairobi Securities Exchange (NSE) take actions towards the delisting, suspending and placing in receivership listed companies as highlighted below;

i. In May 2019, the Nairobi Securities Exchange (NSE) delisted KenolKobil Plc from trading on the bourse following a takeover by Rubis Energie SAS, and,
ii. In April 2019, Atlas Development and Support Services was delisted from the NSE following the closing down of the company's operations, the deregistration of the company in its country of incorporation under the Gurnesey laws and failure by the company to adhere to regulatory requirements from the year 2017 when the security of the company was suspended from trading on the NSE, and
iii. In September 2019, Mumias Sugar was suspended from trading on the securities exchange after the company was placed under receivership.

Legislations and other Developments

The year 2019 saw a number of legislative changes and other developments that affected the equities market and investor sentiment, namely:

i. **Repeal of the Interest Rate Cap (Banking (Amendment) Act, 2019):** President Uhuru Kenyatta submitted a memorandum to the Speaker of the National Assembly detailing his refusal to assent to the Finance Bill 2019, and 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). Thus, during the last parliamentary sitting on November 5th, the law capping interest rates was repealed.

    Our view has always been that the interest rate cap regime would have an adverse effect on the economy and by extension to Kenyans, and as popular as the regulation was, it needed to be repealed as highlighted in our previous reports as outlined below:

    a. In our focus note Review of the Interest Rate Cap, dated 23rd June 2019, we revisited the interest rate cap topic following the proposal by the then, National Treasury Cabinet Secretary, Mr. Henry Rotich, in the Budget reading for the 2019/20 fiscal year, to repeal Section 33B of the Banking Act, which was included in the Finance Bill, 2019. In this focus, we discussed policy measures that can protect borrowers from excessive interest rates, including consumer education and protection measures, as well as promoting capital markets infrastructure to spur competition in the credit market through non-bank funding,

b. In End of Interest Rate Caps?, dated 20th October 2019, we revisited the interest rate cap following the recommendation by President Uhuru Kenyatta to repeal the Interest Rate Cap, in a memorandum to Parliament in which he declined to assent the Finance Bill, 2019 into law, where we gave our views on how the economy would be impacted by the repeal of the cap. We highlighted that we expect to see a growth in private sector credit, higher GDP growth and increased monetary policy effectiveness, and

c. In Market Post Interest Rate Cap, dated 15th December 2019, we revisited the interest rate cap following the repeal of the interest cap law by the Parliament where we reiterate that the decision to repeal the rate cap law will be a boost to the economy because a free market, where interest rates are set by the forces of demand and supply coupled with increased competition from non-bank financial institutions for funding, will see a competitive environment with increased access to credit by borrowers and higher economic growth prospects, given that monetary policy tools will be more effective in response to the changing conditions.

Going forward, we do not expect banks to reprice loans taken during the rate cap era. According to the Kenyan Bankers Association, most banks will not readjust their new pricing on commercial loans since banks have accepted their risk profile as an industry, with the cost of credit being at 13.0%, offered before the law was overhauled. However, we still recommend that we deal with two key outstanding issues of;

a. **Consumer Protection against Abuse by Banks**, since the removal of the cap may set stage for the return of expensive loans that had risen to more than 25.0% before the rate cap. The Banking Sector Charter, a commitment from banks to practice responsible and disciplined banking cognizant of customer needs, is a good but insufficient step. We need statutory consumer protection laws and a strong consumer protection agency,

b. **Promoting Competing Alternative Funding Channels**, which will further increase access to credit for borrowers who are unable to access formal loans from banks, due to the expected increase in banks' loan books at the detriment of other loan providers post the rate cap era.

ii. **Banking Sector Charter:** The Banking Sector Charter, introduced by the Central Bank of Kenya in 2018, came into effect in March 2019 with an aim to instill discipline in the banking sector in order to make it responsive to the needs of the banked population. The charter is largely centered on consumer protection, by requiring banks to make full disclosure on the terms of the issuance of credit. In a bid to improve credit extension to Micro, Small and Medium Enterprises (MSMEs), the Banking Sector Charter prescribes that banks should have at least 20.0% of the loans extended to MSMEs. The Central Bank of Kenya requires strict compliance with the charter, as banks may be imposed with administrative sanctions should they fail to comply with the charter,

iii. **Demonetization:** In an effort to track illicit financial flows, the Central Bank of Kenya, on 31st May 2019, announced the introduction of new generation notes of denominations Kshs 1,000, Kshs 500, Kshs 200, Kshs 100 and Kshs 50. Further to this, they highlighted that the old Kshs 1,000 notes will cease to be a legal tender and will be withdrawn from the market by 1st October 2019. In some cases, this exercise has brought cash shortages in the market that prompts people to seek alternatives on digital platforms. Aside from tracking illegal financial flows, demonetization is expected to enhance financial inclusion of the informal sector, in addition to helping the country transition to a more cash-less economy. For more information on demonetization, kindly see our topical on the Effects of the Issuance of the New Generation Banknotes,

iv. **Nairobi Securities Exchange Derivatives Market (NEXT):** The Nairobi Securities Exchange (NSE) launched the Nairobi derivatives market on Thursday 4th July 2019 to facilitate the trading of futures contracts on the NSE 25 Share Index and a variety of stocks in the Kenyan market, regulated by the Capital Markets Authority (CMA). NEXT was established on account of;

i. Increased integration of the Kenyan financial markets with international markets,
ii. Increased volatility in asset prices in local and international financial markets,
iii. The need for more sophisticated risk management tools and strategies, and
iv. The need to broaden and deepen Kenyan financial markets.

Currently, the Derivatives market offers investors Equity Single Stock Futures (SSF) and Equity Index Futures, and will later introduce other financial and commodities derivatives. Currently, the bourse offers 6 Single Stock Futures namely Safaricom Plc, Kenya Commercial Bank Group Plc, Equity Group Holdings Plc, East African Breweries Ltd, Barclays Bank of Kenya and British American Tobacco Plc. According to the Capital Market Soundness Report Q3'2019, 349 contracts, worth Kshs 12.8 mn, were traded during the quarter under review with a majority of liquidity concentrated around Safaricom and banking counters, mainly KCB Group and Equity Bank. Safaricom accounted for 55.0% of the market's turnover while KCB accounted for 18.0%, followed by NSE 25 index at 17.0% while Equity Bank stood at 8.0%, during the quarter. In Q4'2019, 148 contracts, worth Kshs 7.1 mn, have been traded so far in the derivatives market, a 57.6% decline from the 349 recorded in Q3'2019 taking the total number of contracts traded in the derivatives market since inception to 497, with a total value of Kshs 19.9 mn. The NEXT derivatives market is expected to provide new opportunities to investors enabling them to diversify, manage risk and allocate capital efficiently. However, it still remains extremely small.

v. **Consolidation:** Consolidation remained a key highlight in 2019 with the following being the major M&A's activities witnessed during the year by the top three banks in the industry:
   a. On 27th September 2019, the Central Bank of Kenya approved the merger and name changes of NIC Group and Commercial Bank of Africa (CBA), which paved the way for the merged institution to officially start operating as NCBA Group PLC. Read more information on the same here, and,
   b. KCB Group also received the approval from the regulator to acquire 100% stake in National Bank which increased its shares from 3.07 bn units to 3.21 bn units, lifting the lenders market capitalization to Kshs. 135.6 bn from Kshs. 129.3 bn. Read more information on the same here.

Other mergers and acquisitions that happened or were announced during the year include;

a. Equity Group Holdings, in its expansion strategy had various ongoing acquisitions in the region inclusive of a 62.0% of the share capital of Rwanda's Banque Populaire du Rwanda, and 100.0% of African Banking Corporation Mozambique, African Banking Corporation of Zambia, and African Banking Corporation of Tanzania. These acquisitions will allow Equity Group Holdings an easy penetration into these four African countries. Further, the lender is set 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. For more information see here,
b. Commercial International Bank sent an application to Competition Authority of Kenya propositioning to acquire controlling interest in Mayfair Bank, a Tier III Kenyan bank. Mayfair is the fourth smallest lender in Kenya and it recorded a loss of Kshs. 250.0 mn in Q3'2019, and,
c. Access Bank Nigeria is set to acquire Transnational Bank following the approval by Competition Authority of Kenya and Central Bank of Kenya. Access Bank is expected to acquire a controlling stake equivalent to 93.57% in the troubled lender who reported a full-year pre-tax loss of Kshs 98.5 mn in 2018.

Below is a summary of the deals in the last 5-years that have either happened, been announced or expected to be concluded:

Acquirer	Bank Acquired	Book Value at Acquisition (Kshs. Bn)	Transaction Stake	Transaction Value (Kshs. Bn)	P/Bv Multiple	Date
Access Bank (Nigeria)	Transnational Bank Ltd.	1.9	93.6%	Undisclosed	N/A	Oct-2019*
Oiko Credit	Credit Bank	3.0	22.8%	1.0	1.5x	Aug-19
KCB Group	National Bank of Kenya	7.0	100.0%	6.6	0.9x	Sep-19
CBA Group	NIC Group	33.5	53%:47%	23.0	0.7x	Sep-19
CBA Group	Jamii Bora Bank	3.4	100.0%	1.4	0.4x	Jan-19
AfricInvest Azure	Prime Bank	21.2	24.2%	5.1	1.0x	Jan-19
KCB Group	Imperial Bank	Unknown	Undisclosed	Undisclosed	N/A	Dec-18
SBM Bank Kenya	Chase Bank Ltd	Unknown	75.0%	Undisclosed	N/A	Aug-18
DTBK	Habib Bank Kenya	2.4	100.0%	1.8	0.8x	Mar-17
SBM Holdings	Fidelity Commercial Bank	1.8	100.0%	2.8	1.6x	Nov-16
M Bank	Oriental Commercial Bank	1.8	51.0%	1.3	1.4x	Jun-16
I&M Holdings	Giro Commercial Bank	3.0	100.0%	5.0	1.7x	Jun-16
Mwalimu SACCO	Equatorial Commercial Bank	1.2	75.0%	2.6	2.3x	Mar-15
Centum	K-Rep Bank	2.1	66.0%	2.5	1.8x	Jul-14
GT Bank	Fina Bank Group	3.9	70.0%	8.6	3.2x	Nov-13
Average			75.2%		1.4x	

*** Announcement date**

In 2019, Kenya's operating environment was characterized by challenging macro-economic conditions owing to delayed long rains that led to decline in agricultural production and consequently, slowed manufacturing activity. However, with the repeal of the rate cap law in November 2019, the financial performance of banks is expected to further improve and consequently spark investor confidence. In 2019, the market remained slumped with P/E below its' historical average of 13.3x to 11.8x, below the most recent peak of 15.9x in April 2018, showing that pockets of value still exist. We remain neutral on equities for investors with short-term investment horizon, but are positive for investors with a long-term investment horizon.