Cytonn 2020 Markets Outlook

Equities Outlook

In 2019, 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%. Since the peak in February 2015, NASI and NSE 20 are down 20.9% and 48.4%, respectively. Large-cap gainers in 2019 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, DTBK which lost (39.6%), (31.0%), and (30.4%) in 2019, respectively.

Following poor performance in the equities market in the first half of 2019, the market valuation declined to below its historical average with NASI price to earnings ratio (P/E) currently at 12.1x, 9.1% below the historical average of 13.3x, and a dividend yield of 5.5%, 1.6% points above the historical average of 3.9%. Equity turnover in 2019 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.

In 2019, 10 companies issued profit warnings to investors compared to 8 companies in 2018, attributable to the tough macro-economic environment during the year. 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. Kenya Power and Lighting Company issuing consecutive warnings over the last 2-years. The table below shows companies that have issued profit warnings in 2019 and those that issued profit warnings in 2018;

Comparison: Companies that Issued Profit Warnings 2019 vs 2018

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

Comparison: Companies that Issued Profit Warnings 2019 vs 2018

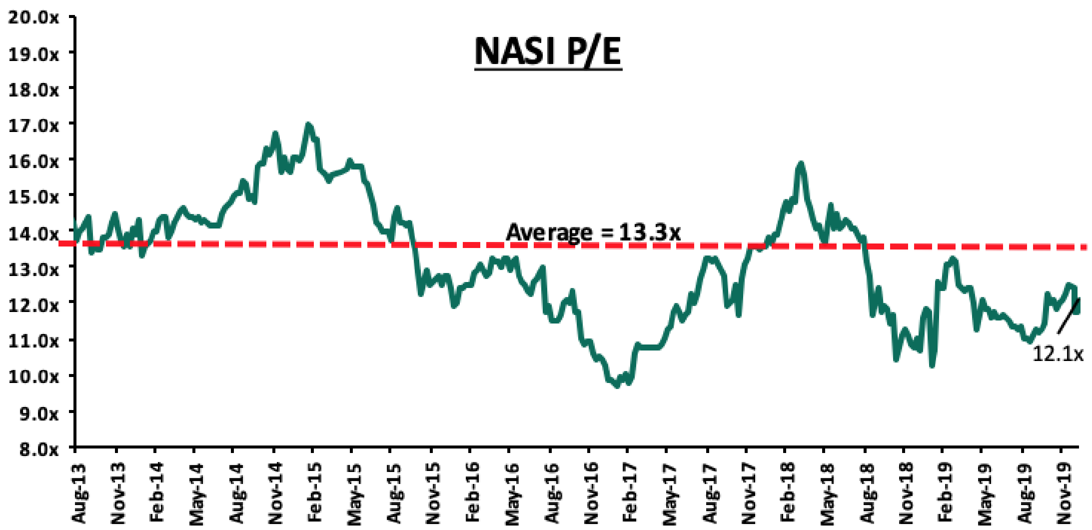
No	2019	No	2018
10	Kapchorua Tea Company		

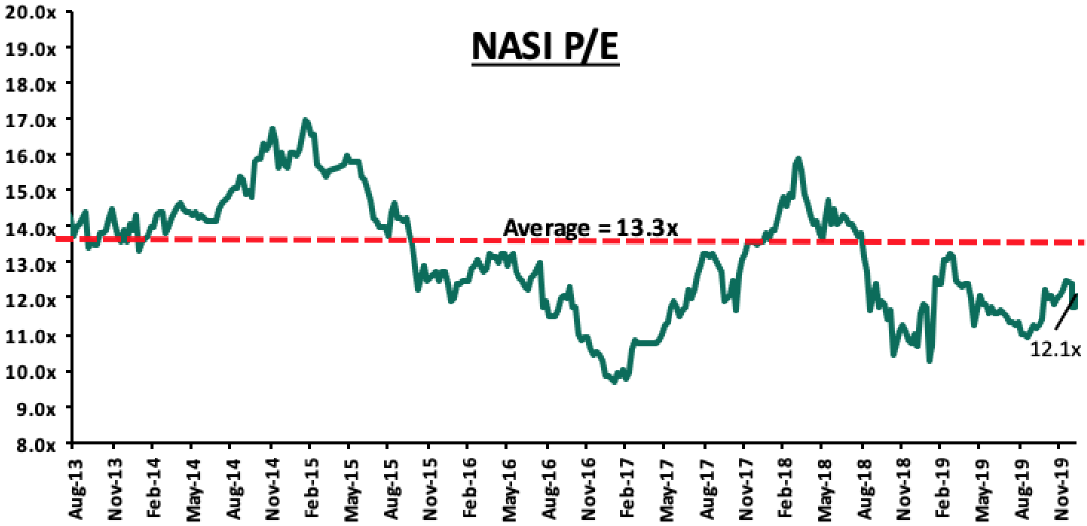
Market Performance

During the week, the equities market recorded mixed performance with NASI, and NSE 25 recording gains of 2.4% and 1.7%, respectively, and NSE 20 declining by 0.3%, taking their YTD performance to gains of 3.0%, 1.8% and 2.6%, for the NASI, NSE 20 and NSE 25, respectively. The performance in NASI was driven by gains recorded by large-cap stocks such as Diamond Trust Bank Kenya, Safaricom and EABL of 10.3%, 4.1%, and 3.3%, respectively.

Equities turnover increased by 342.1% during the week to USD 26.3 mn, from USD 6.0 mn the previous week, taking the YTD turnover to USD 28.7 mn. Foreign investors became net buyers for the week, with a net buying position of USD 0.8 mn, an improvement from a net selling position of USD 0.2 mn recorded the previous week.

The market is currently trading at a price to earnings ratio (P/E) of 12.1x, 9.1% below the historical average of 13.3x, and a dividend yield of 5.5%, 1.6% 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 12.1x is 24.6% above the most recent trough valuation of 9.7x experienced in the first week of February 2017, and 45.7% 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

Following the acquisition of National Bank of Kenya (NBK) by KCB Group in 2019, this week, KCB further injected Kshs 5.0 bn into the subsidiary, which was in breach of various capital adequacy ratios. According to NBK's Q3'2019 financial results, its core capital liabilities ratios, core capital risk-weighted assets ratio and total capital risk-weighted ratio were 6.8%, 9.0% and 11.6% below the minimum statutory requirements of 8.0%, 11.0% and 15.0%, respectively. Prior to the capital injection, with a Non-Performing Loan (NPL) ratio of 47.9% in Q3'2019, NBK's bad debts stood at Kshs 31.4 bn. Hence, before capitalization, KCB Group had indicated that it will employ aggressive strategies to recover as well as write down key NPLs and consequently, set up effective loan portfolio management measures to maintain a favorable loan portfolio quality. We expect that with the injection, NBK will be well-capitalized to continue its operations separately. KCB Group's profitability, on the hand, will be affected as it cleans up NBK's books. However, we expect the rate cap repeal will help it absorb the restructuring costs that will arise.

Kenya Equities Outlook

In 2020, the factors that will affect the direction of the Kenyan equities market include:

i. **Corporate Earnings:** On average, we expect earnings growth for the year 2020 to come in at 12.4%, higher than our 2019 expectation of 8.1%. The expectation of higher earnings growth for 2020 is mainly due to the anticipation of improved earnings from commercial banks buoyed by increased lending and asset growth, due to the repeal of the rate cap law. Going forward, banks will be able to price loans based on the credit risk of borrowers and thus, benefit from higher Net Interest Margins (NIM). Further, the repeal of the rate cap law is expected to increase credit flow that will aid the recovery of various sectors such as manufacturing and commercial;
ii. **Valuations:** The market is currently trading at a P/E of 12.1x, with an expected earnings growth of 12.4%, the market is currently trading at a Forward P/E of 10.8x, representing a potential upside of 23.0% compared to historical levels;
iii. **Capital Markets Investor Sentiment:** We expect the equities market to register increased foreign inflows in 2020, mainly supported by:
   a. Existence of value to be derived from stocks, with the market, and various counters trading at cheaper valuations relative to historical levels, which provide attractive entry opportunities for medium and long-term investors,
   b. With the uncertainty in the global economy on account of the unresolved U.S-China trade war and the recent tensions between the U.S and Iran, we expect increased capital flight to frontier and emerging economies from developed economies, and,
   c. Generally, Kenya remains more attractive compared to other frontier markets boosted by stronger economic growth compared to other economies in the region such as Nigeria.

Furthermore, Kenya's rank at position 56 globally and 4th in Sub-Saharan Africa in the 2020 Ease of Doing Business report, higher than regional peers Uganda and Tanzania, will attract investors seeking the high growth in frontier markets;

iv. **Diversification of Capital Markets and New Listings:** We expect several activities to be undertaken by NSE in 2020 including; (i) increasing the number of Single Stock Futures traded on the derivatives market. 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, and (ii) possible listing of companies currently engaged in the Ibuka program, which aims to enhance the visibility of private companies with high growth prospects, with the NSE aiming to list at least one firm from the program by the end of Q1'2020;

It is our view that these initiatives would result in; (i) increased liquidity in the market by increasing the volume of securities available for trading, and (ii) improved depth in the capital market by increasing product offerings at the exchange, consequently attracting investors. However, there are key challenges the local capital market faces; (i) reluctance to identify and implement innovative measures to attract potential issuers, (ii) increased popularity of private equity firms that provides easily accessible capital to SMEs, (iii) a capital markets infrastructure, governance and culture that favors banking products rather than capital markets is not conducive to markets growth, and (iv) low uptake of the new products introduced in the exchange attributable to increased competition from other investment vehicles that provide better short-term returns such as gambling. We maintain our view that there remains the need for increased focus towards extensive investor education and public awareness initiatives, and engagement before rolling out new products;

v. **Monetary Policy Direction:** Following the repeal of the interest rate caps in November 2019, in 2020, we expect monetary policy to remain relatively stable in the short term, and a slight upward pressure later in the year due to efforts by the Government to meet its domestic borrowing target in order to plug in the fiscal deficit. The inflation rate is expected to average 5.2% in 2020, within the government target range of 2.5% - 7.5% with inflationary pressure gradually easing off, due to improved agricultural production thus causing a decline in food prices following favorable weather conditions, while the currency is expected to remain stable supported by CBK's intervention activities, improving diaspora remittances, continued narrowing current account deficit, and foreign capital inflows with investors looking to participate in the equities market.

As can be seen in the table below, we expect equities market activity in 2020 to be driven by; (i) a stable macro-economic environment, with the GDP growth rate for the year projected to come in at 5.7%, slightly higher than our 5.6% 2019 expectations, supported by increased productivity from 2019 spillovers, following the heavy rains experienced in Q4'2019. 2019 saw the delayed onset of the traditional long rains which adversely affected the performance of the Agricultural sector, (ii) a 12.4% growth in corporate earnings, (iii) attractive valuations in a majority of the counters, with the market currently trading at P/E of 12.1x, 9.1% below the historical average of 13.3x, thereby providing attractive entry point, and possibly a higher capital appreciation gain potential, and (iv) strong foreign inflows following the repeal of the rate cap law.

Equities Market Indicators	Outlook for 2020	Current View
Macro-Economic Environment	· We expect growth to remain stable in 2020, with the GDP growth rate projected to come in at 5.7%, slightly higher than our 5.6% 2019 expectations, supported by increased productivity from 2019 spill overs, following the heavy rains experienced in Q4'2019. 2019 saw the delayed onset of the traditional long rains which adversely affected the performance of the Agricultural sector	**Positive**

Equities Market Indicators	Outlook for 2020	Current View
Corporate Earnings Growth	· We expect corporate earnings growth to average 12.4% in 2020, higher than the expected 8.1% growth for 2019 driven by the repeal of the interest rate cap law which is expected to improve credit flow that will aid the recovery of various sectors such as manufacturing and commercial. Increased lending will positively affect the performance of commercial banks	**Positive**
Valuations	· With the market currently trading at a P/E of 12.1x, and expected earnings growth of 12.4%, the market is currently trading at a Forward P/E of 10.8x, representing a potential upside of 23.0% compared to historical levels	**Positive**
Investor Sentiment and Security	· We expect 2020 to register strong foreign interest with the repeal of the interest rate cap law · We believe pockets of value still exist in the equities market, more so, following a poor performance in the first half of 2019 which saw the market valuation declining below its historical average, with NASI price to earnings ratio (P/E) currently at 12.1x, 9.1% below the historical average of 13.3x · We expect security to be maintained in 2020, especially given that the political climate in the country has eased	**Positive**

Out of the four metrics that we track, all have a positive outlook. Compared to 2019, we have maintained our positive outlook on the macroeconomic, corporate earnings growth, valuations of the market and investor sentiment and security. As such in consideration of the above, we have a "POSITIVE" outlook on Kenyan equities going into 2020.

Universe of Coverage

Banks	Price at 03/01/2020	Price at 10/01/2020	w/w change	YTD Change	Year Open	Target Price*	Dividend Yield	Upside/ Downside**	P/TBv Multiple	Recommendation
Kenya Reinsurance	3.1	3.0	(2.3%)	(1.7%)	3.0	4.8	15.1%	76.2%	**0.3x**	**Buy**
Diamond Trust Bank	110.0	120.3	9.3%	10.3%	109.0	189.0	2.2%	59.3%	**0.6x**	**Buy**
I&M Holdings* **	55.8	58.0	4.0%	7.4%	54.0	75.2	6.7%	36.4%	**1.0x**	**Buy**
Jubilee Holdings	350.0	360.0	2.9%	2.6%	351.0	453.4	2.5%	28.4%	**1.2x**	**Buy**
Sanlam	18.0	17.1	(5.3%)	(0.9%)	17.2	21.7	0.0%	27.3%	**0.7x**	**Buy**
KCB Group* **	55.0	55.0	0.0%	1.9%	54.0	64.2	6.4%	23.1%	**1.5x**	**Buy**
Co-op Bank* **	16.6	16.5	(0.3%)	0.9%	16.4	18.1	6.1%	15.8%	**1.4x**	**Accumulate**
Standard Chartered	204.3	206.0	0.9%	1.7%	202.5	211.6	9.2%	11.9%	**1.6x**	**Accumulate**
Equity Group* **	55.0	54.8	(0.5%)	2.3%	53.5	56.7	3.7%	7.2%	**2.1x**	**Hold**
Barclays Bank* **	13.4	13.3	(0.4%)	(0.4%)	13.4	13.0	8.3%	6.0%	**1.7x**	**Hold**
NCBA	37.3	36.5	(2.1%)	(0.9%)	36.9	37.0	4.1%	5.5%	**0.8x**	**Hold**
Liberty Holdings	10.5	10.5	(0.5%)	1.0%	10.4	10.1	4.8%	1.1%	**0.9x**	**Lighten**
Stanbic Holdings	103.8	107.8	3.9%	(1.4%)	109.3	103.1	4.5%	0.1%	**1.1x**	**Lighten**
CIC Group	3.0	3.0	0.3%	12.3%	2.7	2.6	4.3%	(8.0%)	**1.1x**	**Sell**

Banks	Price at 03/01/2020	Price at 10/01/2020	w/w change	YTD Change	Year Open	Target Price*	Dividend Yield	Upside/ Downside**	P/TBv Multiple	Recommendation
HF Group	6.6	5.7	(13.1%)	(11.8%)	6.5	4.2	0.0%	(26.3%)	**0.2x**	**Sell**
Britam	9.4	9.5	1.1%	5.8%	9.0	6.8	0.0%	(29.1%)	**1.0x**	**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 with a medium-term to long-term investment horizon as the sustained price declines have seen the market P/E decline below its historical average. With the repeal of the rate cap, we expect increased market activity, and increased inflows from foreign investors, as they take advantage of the attractive valuations, to support the positive performance.