Corporate Governance and Stock Performance, & Cytonn Weekly #34/2017

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Executive Summary

Fixed Income: T-bills were undersubscribed during the week, with the overall subscription rate at 94.7%, compared to an oversubscription of 144.8% recorded the previous week. The yield on the 91-day T-bill declined by 10 bps to 8.1% from 8.2% the previous week, while yields on the 182 and 364-day papers remained unchanged at 10.3% and 10.9%, respectively. According to Standard & Poor (S&P), a global credit ratings agency, Kenya's biggest economic risk is its rising public debt level, which hit 54.4% of GDP in Q1'2017;

Equities: During the week, the equities market was on an upward trend with NASI, NSE 25 and NSE 20 gaining 4.3%, 2.8% and 1.9%, respectively, taking their YTD performance to 29.2%, 28.6% and 27.7%, respectively. The impact of the rate capping can be seen in the results of most banks as NIC Bank Group, Equity Group, and Diamond Trust Bank Group released H1'2017 results, where they all recorded declines in their core earnings per share by 11.9%, 7.8% and 5.8%, respectively;

Private Equity: We continue to witness increased investment in the Sub-Saharan Africa private equity space with (i) Kansai Plascon Africa Limited, a subsidiary of Japanese paint maker Kansai Paint Co. Ltd, completing the acquisition of a 90.0% stake in Kenyan paint and coating manufacturer Sadolin Group, and (ii) South African Based Sanlam Investments committing to acquire a 30.0% stake in EasyEquities, a South African based fintech company that provides low cost investment solutions, for USD 7.6 mn, subject to regulatory approvals in South Africa;

Real Estate: The education sector is set to be the next frontier for real estate development as ADvTECH Ltd, an education, training and placement company based in South Africa, announced the purchase of a land parcel in Tatu City to be used to set up a THRASS (Teaching Handwriting Reading and Spelling Skills) education system - Crawford schools brand, in line with their expansion strategy to various countries in Africa. Real estate developer Acorn Group and Helios, a London-based private equity fund, announced plans to build 3,800 university hostel units in Nairobi;

Focus of the Week: This week, we discuss the relationship between corporate governance and stock performance, drawing lessons from the US market, where corporate governance has led to the recovery and vibrancy of the financial market.

Company Updates

- We shall be hosting the Cytonn Corporate Governance Workshop on Monday, 28th August 2017, an event aimed at raising awareness on the need for better corporate governance, explaining the methodology of the Cytonn Corporate Governance Report (CGR) and getting feedback from the industry. The CGR, which is released annually, is a Cytonn initiative geared towards informing investors on the state of governance in listed entities. Through the workshop, we also seek to explore how to transition ownership of CGR from a Cytonn initiative to an industrywide initiative, since corporate governance is a collaborative effort,
- Our Real Estate Project Procurement team launched the Cytonn's Supplier Code of Conduct, highlighting the principles that we expect our suppliers to uphold and giving guidance on the standards that they are expected to meet. See Event Note
- Our Investment Manager, Maurice Oduor, discussed new developments in the equities market. Watch Maurice on CNBC here
- Our Head of Private Equity, Shiv Arora, discussed Equity Holding's H1'2017 financial results and Kenya's import cover trend. Watch Shiv on CNBC here

- Our Investment Analyst, Caleb Mugendi, talked about what investors need to know before investing. Watch Caleb on Ebru Africa here
- We continue to showcase real estate developments by our real estate development affiliate, Cytonn Real Estate, through weekly site visits. Watch progress videos and pictures on The Alma, Amara, The Ridge and Taraji Heights. The site visits target both investors looking to invest in real estate directly, and also those interested in high yield investment products to familiarize themselves with how we support the high yield returns. To deliver high yield returns, our cost of capital is priced off the loan markets where all-in pricing ranges from 16% to 21% and our yield on real estate developments ranges from 23% to 25%, hence our top-line gross spread is about 6%. If interested in attending the site visits, kindly register here
- We continue to see very strong interest in our Private Wealth Management training, which is at no cost, and is held bi-weekly, but is open only to pre-screened participants. The training can also be offered to institutions that would like their employees trained on Financial Planning. To get further details contact our Client Services team at clientservices@cytonn.com
- For recent news about the company, see our news section here
- We have 10 investment-ready projects, offering attractive development and buyer targeted returns of around 23.0% to 25.0% p.a. See further details here: Summary of investment-ready projects
- To invest in any of our current or upcoming real estate projects, please visit Cytonn Real Estate
    - The Alma, which is over 55.0% sold, has delivered an annualized return of 55.0% p.a. for investors who bought off-plan. See The Alma
    - Amara Ridge is currently 100.0% sold and has delivered over 20.0% p.a. returns to investors. See Amara Ridge
    - Situ Village is currently 15.0% sold. See Situ Village
    - The Ridge (Phase One) is currently 31.0% sold. See The Ridge
    - Taraji Heights is currently 10.0% sold. See Taraji Heights
    - RiverRun Estates (Phase One) is currently 8.7% sold after the recent launch. See RiverRun Estates
- We are currently looking for 5-10 acres in Kikuyu, Lower Kabete, Upper Kabete, Loresho or Mountain View, Garden Estate and Langáta for development. Contact us at rdo@cytonn.com if you have any land for sale or joint ventures in the above areas.
- We continue to beef up the team with ongoing hires: Careers at Cytonn

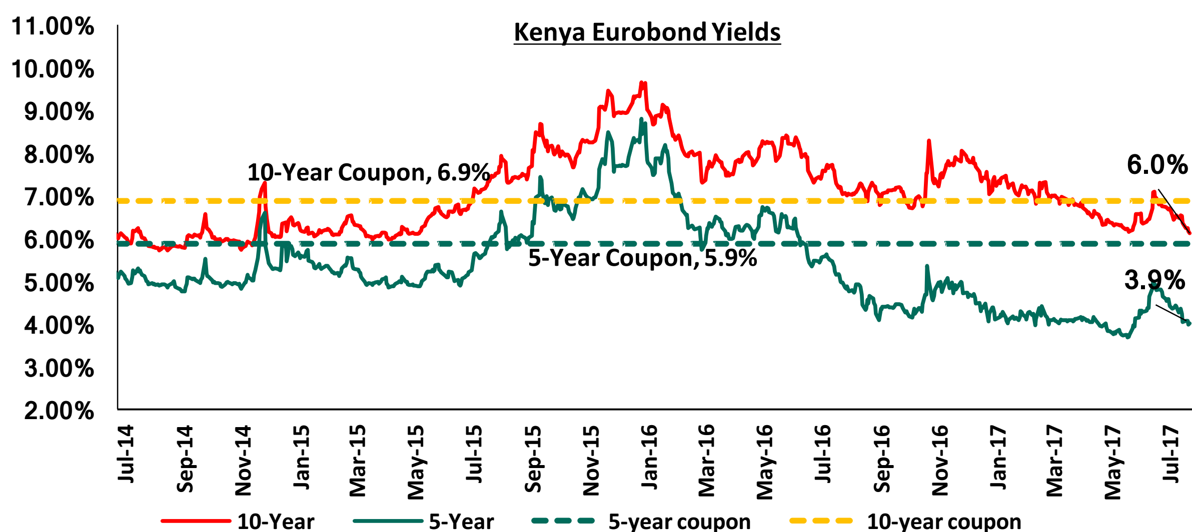
Fixed Income

During the week, T-bills were undersubscribed, with the overall subscription rate at 94.7%, compared to an oversubscription of 144.8% recorded the previous week. The subscription rates for the 91, 182 and 364-day papers came in at 105.0%, 59.8% and 125.3% compared to 94.5%, 188.9% and 120.9% the previous week, respectively. The 91 and 364-day papers recorded oversubscriptions, while the 182-day paper recorded an undersubscription during the week despite yielding the highest return on a risk-adjusted basis. Yields on the 182 and 364-day papers remained unchanged at 10.3% and 10.9%, respectively, while the yield on the 91-day declined by 10 basis points to 8.1% from 8.2% the previous week. The overall acceptance rate came in at 98.0% compared to 97.2% the previous week, with the government accepting a total of Kshs 22.3 bn of the Kshs 22.7 bn worth of bids received, against the Kshs 24.0 bn on offer in this auction.

The Kenyan Government issued a new 5-year bond (FXD 1/2017/5) and re-opened a 10-year fixed-coupon bond (FXD 1/2017/10) with an effective tenor to maturity of 9.9 years and a coupon rate of 13.0%, in a bid to raise Kshs 30.0 bn for budgetary support. The bonds were undersubscribed with the overall subscription rate at 88.9%, with Kshs 26.7 bn worth of bids received compared to Kshs 30.0 bn on offer. The average market bid rates came in at 12.5% and 13.2%, while the average yields of the accepted bids came in at 12.5% and 13.1%, for the 5-year and 10-year bonds, respectively. The acceptance rate for the bids received came in at 66.0%, which was higher than the average acceptance rate from previous auctions during the

year of 59.5%, with the government accepting Kshs 17.6 bn out of the Kshs 26.7 bn worth of bids received. Despite this, the government is behind its net domestic borrowing target for the current fiscal year, having borrowed Kshs (0.2) bn, against a target of Kshs 48.9 bn (assuming a pro-rated borrowing target throughout the financial year of Kshs 317.7 bn budgeted for the full financial year), as redemptions of Kshs 167.6 bn exceed its current borrowings of Kshs 167.4 bn. The expected T-bill redemptions of approximately Kshs 27.9 bn next week will further pile pressure on the government's borrowing plans.

According to Bloomberg, yields on the 5-year Eurobond, with 1.6-years to maturity remained relatively unchanged at 3.9%, while yields for the 10-year Eurobond, with 6.9-years to maturity, declined by 10 bps to close at 6.0% from 6.1% the previous week. Since the mid-January 2016 peak, yields on the Kenya Eurobonds have declined by 4.9% points and 3.6% points for the 5-year and 10-year Eurobonds, respectively, due to stable macroeconomic conditions in the country. The declining Eurobond yields and stable rating (Fitch Ratings having affirmed Kenya's long-term foreign and local currency issuer default ratings (IDRs) at "B+"), are indications that Kenya's macro-economic environment remains stable and hence an attractive investment destination.



The Kenya Shilling appreciated against the USD by 0.1% during the week to close at Kshs 103.3 from 103.4 the previous week, as investors who had bought dollars for speculative purposes in the run up to elections continue to sell dollars in the market and buy back the shilling. In coming weeks, the outcome of the election petition will play a role in determining the performance of the shilling in the short term. On a year to date basis, the shilling has depreciated against the dollar by 0.7%. Against the Euro, Yen and the Pound, the shilling has lost 12.1%, 7.6% and 5.2% YTD, respectively. The significant depreciation against the Euro, Yen and Pound is as a result of stronger economic fundamentals in the Eurozone, UK and Japan as compared to the US, that have pushed further the expected path for the US interest rate hike cycle. In our view, the shilling should remain relatively stable to the dollar in the short term supported by the forex reserves, which currently is at USD 7.4 bn (equivalent to 4.9 months of import cover). In months leading up to August, we have seen forex reserves decline significantly from USD 8.3 bn at the peak in April this year, but we expect this level to be maintained as the shilling regains stability, supported by expected inflows from tourism, tea and horticulture exports and diaspora remittances.

We are projecting the inflation rate in the month of August to decline to between 7.0% - 7.4%, from 7.5% in July, mainly driven by a decline in food prices following the resumption of food supplies to the urban centres after the general election. Going forward to the end of 2017, we expect inflationary pressures to be subdued given (i) food prices are expected to continue to decline because of the rainfall witnessed during the long rains period, albeit depressed, and (ii) low global oil prices due to rising US oil production, which has suppressed the global recovery of oil prices, countering OPEC's decision to extend the deal to cut down on oil production. We expect inflationary pressures to ease in the second half of 2017, but average 8.2% in 2017, which is above the upper bound of the government target range of 2.5% - 7.5%.

According to Standard & Poor (S&P), a global credit ratings agency, Kenya's biggest economic risk is its rising public debt level, which hit 54.4% of GDP in Q1'2017, 4.4% above the IMF's recommended threshold of 50.0% for frontier markets. S&P's concern is that (i) the cost of debt service is high, and (ii) in the event of a shock to Kenya's economy, the government could experience difficulties in repayment. S&P recommend that the government should work towards reducing the budget deficit (8.9% in FY 2016/17 and expected to decline to 6.3% in FY 2017/18), and maintain the economic growth rate to reduce the growing public debt burden. In our view, as mentioned in detail in our topical; the Post-Election Areas of Focus and Kenyan Debt Sustainability, the government should (i) enhance tax collection growth, (ii) adopt Public-Private Partnerships (PPP) to involve the private sector in economic development, and (iii) reduce recurrent expenditure, allocating more towards development. This should ensure that the country's debt levels, with good public financial management, remains sustainable, below the 50.0% threshold.

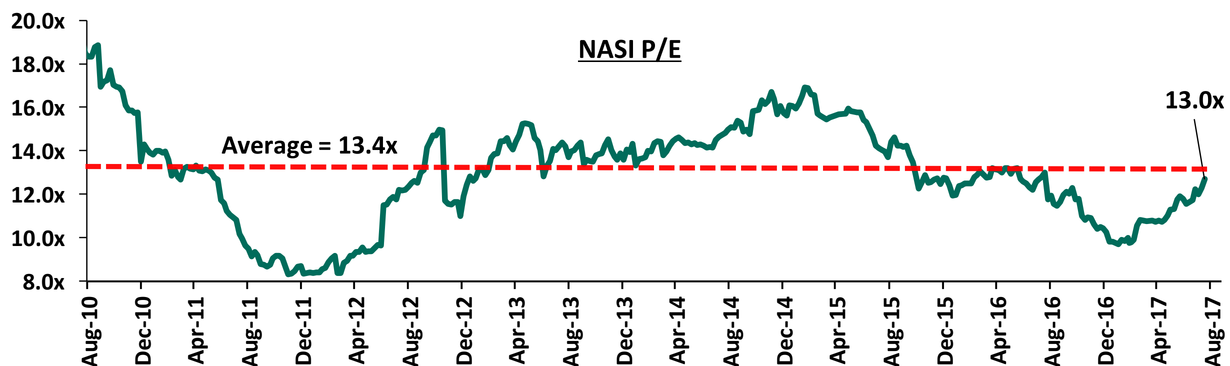
Rates in the fixed income market have remained stable, and we expect this to continue in the short-term. However, a budget deficit that is likely to result from depressed revenue collection creates uncertainty in the interest rates environment as any additional borrowing in the domestic market to plug the deficit could lead to upward pressures on interest rates. Our view is that investors should be biased towards short-to medium term fixed income instruments to reduce duration risk.

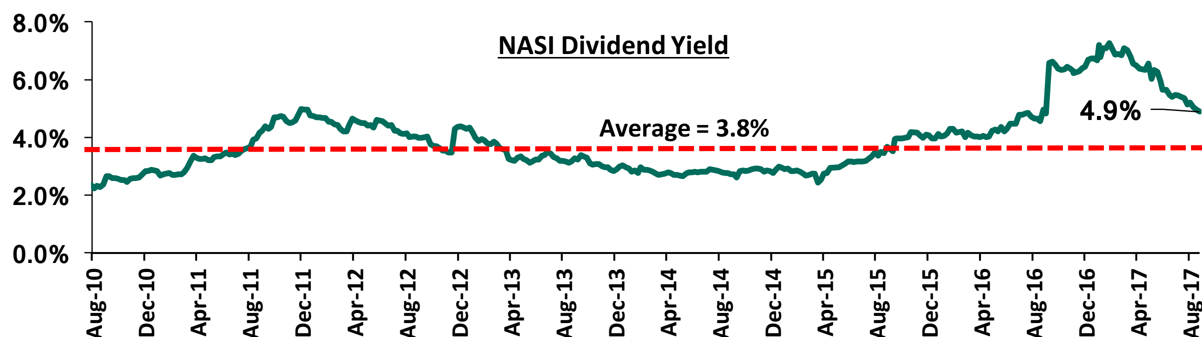
Equities

During the week, the equities market was on an upward trend with NASI, NSE 25 and NSE 20 gaining 4.3%, 2.8% and 1.9%, respectively, taking their YTD performance to 29.2%, 28.6% and 27.7%, respectively. This week's performance was driven by gains in select large cap stocks such as Safaricom, Co-operative Bank and KCB Group, which gained 9.3%, 4.6% and 3.4%, respectively. Since the February 2015 peak, the market has lost 2.9% and 26.0% for NASI and NSE 20, respectively.

Equities turnover decreased by 23.9% to close the week at USD 29.7 mn from USD 39.0 mn the previous week. Foreign investors remained net sellers with a net outflow of USD 21.9 mn compared to a net outflow of USD 1.3 mn recorded the previous week. Foreign investor participation increased to 73.8% from 56.9% recorded the previous week. We expect the market to remain supported by improving investor sentiment and attractive stock valuations.

The market is currently trading at a price to earnings ratio (P/E) of 13.0x, versus a historical average of 13.4x, and a dividend yield of 4.9%, compared to a historical average of 3.8%. The current P/E valuation of 13.0x is 33.5% above the most recent trough valuation of 9.7x experienced in the first week of February 2017, and 55.8% 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.





Equity Group Holdings Plc released H1'2017 results:

Equity Group Holdings Plc released H1'2017 results, recording a 7.8% decline in core earnings per share to Kshs 2.5 from Kshs 2.7 in H1'2016, attributed to a 3.6% decline in operating revenue, which outpaced a 1.3% decline in operating expenses. Key highlights for the performance from H1'2016 to H1'2017 include:

- Total operating income declined by 3.6% to Kshs 30.9 bn from Kshs 32.1 bn in H1'2016. This was due to a 15.6% decline in Net Interest Income (NII), despite a 19.6% growth in Non-Funded Income (NFI),
- NII declined by 15.6% to Kshs 17.9 bn from Kshs 21.2 bn in H1'2016, following an 11.8% decline in interest income to Kshs 23.0 bn from Kshs 26.1 bn in H1'2016, and a 4.1% increase in interest expense to Kshs 5.1 bn from Kshs 4.8 bn in H1'2017. This led to a reduction in the Net Interest Margin to 9.7% from 10.8% in H1'2016,
- NFI grew by 19.6% to Kshs 13.0 bn from Kshs 10.8 bn in H1'2016, driven by a 41.9% increase in total fees and commissions to Kshs 2.9 bn from Kshs 2.0 bn. Commission from alternative banking channels including digital and agency banking supported this increase in fees and commissions, despite a contraction in the value of total loans issued. The current revenue mix stands at 58:42 funded to non-funded income from 66:34 in H1'2016,
- Total operating expenses declined by 1.2% to Kshs 17.6 bn from Kshs 17.8 bn in H1'2016, following a 3.5% y/y decline in Loan Loss Provision (LLP) to Kshs 1.8 bn from Kshs 1.9 bn. Staff costs declined by 15.7% to Kshs 5.2 bn from Kshs 6.1 bn in H1'2016. Other expenses increased by 6.1% to Kshs 7.0 bn from Kshs 6.4 bn in H1'2016,
- Cost to Income ratio worsened to 57.0% from 55.6% in H1'2016. Without LLP, the Cost to Income ratio worsened to 51.1% from 49.6% in H1'2016,
- Profit before tax (PBT) declined by 6.6% to Kshs 13.3 bn from Kshs 14.2 bn, while profit after tax (PAT) declined by 7.4% to Kshs 9.4 bn from Kshs 10.1 bn in H1'2016,
- The loan book contracted marginally by 1.5% to Kshs 265.1 bn from Kshs 269.0 bn in H1'2016,
- Customer deposits grew by 13.6% to Kshs 362.8 bn from Kshs 319.2 bn in H1'2016. Consequently, the faster growth in deposits compared to loans resulted in the loan to deposit ratio decreasing to 73.1% from 84.3% in H1'2016,
- The board of directors did not recommend payment of an interim dividend.

Going forward, we expect Equity Group's growth to be driven by;

i. Change in business model. The tough operating environment experienced by the bank has forced it to adopt a new business model, that will focus on (i) growing non-funded income, (ii) strengthening liquidity and balance sheet agility, (iii) treasury operations, (iv) improving asset quality, (v) innovation and digitization, and (vi) enhancing efficiencies and cost optimization,

ii. Growth in its Non-Funded income, which currently accounts for 42.0% of its total operating income. This was mainly driven by (i) mobile banking transactions fees and commissions which grew by 337% y/y to Kshs 0.6 bn from Kshs 0.2 bn, (ii) trade finance grew by 25% y/y to hit Kshs 0.5 bn from Kshs 0.4 bn, (iii) Merchant commissions which grew by 12% y/y to Kshs 0.6 bn from Kshs 0.5 bn, and (iv) Agency revenue grew by 27% to Kshs 0.4 bn up from Kshs 0.3 bn in H1'2016, and,

iii. Regional Performance - all the bank's subsidiaries had positive growth in y/y pre-tax earnings, with the exception of Kenya and South Sudan. The subsidiaries contributed 10% of PBT from 5% in H1'2016. The bank plans to continue with its regional diversification plan, by opening up more subsidiaries as all their current subsidiaries are self-sustainable. However, the Group continues to be affected by the ongoing political instability in South Sudan, coupled with the devaluation of the South Sudanese Pound (SSP) and hyper-inflationary effects, with the bank announcing that it had shut down 7 of the 12 branches in the country earlier in the year.

For a more comprehensive analysis, see our Equity Group H1'2017 Earnings Note.

NIC Bank Group released H1'2017 results:

NIC Bank Group released H1'2017 results, recording an 11.9% decline in core earnings per share to Kshs 3.2 from Kshs 3.6 in H1'2016, despite the 10.5% decline in total operating expenses slightly outpacing the 10.0% decline in total operating revenue. Key highlights for the performance from H1'2016 to H1'2017 include:

- Total operating income declined by 10.0% to Kshs 7.4 bn from Kshs 8.2 bn in H1'2016. This was due to an 11.1% decline in Net Interest Income (NII), and a 6.9% decline in Non - Funded Income (NFI),
- NII declined by 11.1% to Kshs 5.4 bn from Kshs 6.1 bn in H1'2016, following a 10.6% decline in Interest Income to Kshs 8.8 bn from Kshs 9.9 bn, which outpaced a 9.7% decline in Interest Expense to Kshs 3.4 bn from Kshs 3.8 bn in H1'2016. The Net Interest Margin thus decreased to 7.1% from 7.7% in H1'2016,
- NFI declined by 6.9% to Kshs 2.0 bn from Kshs 2.2 bn in H1'2016. The decline in NFI was attributed to a 43.9% decline in other income to Kshs 0.3 bn from Kshs 0.6 bn in H1'2016. Fees and commissions however grew by 5.4% to Kshs 0.7 bn from Kshs 0.6 bn in H1'2016. The current revenue mix stands at 73:27 funded to non-funded income from 74:26 in H1'2016,
- Total operating expenses declined by 10.5% to Kshs 4.5 bn from Kshs 5.0 bn in H1'2016, following a 31.5% y/y decline in Loan Loss Provision (LLP) to Kshs 1.5 bn from Kshs 2.1 bn. Without LLP, operating expenses grew 4.8% to Kshs 3.0 bn from Kshs 2.9 bn registered in H1'2016. Staff costs grew by 12.5% to Kshs 1.6 bn from Kshs 1.4 bn in H1'2016,
- Cost to Income ratio remained relatively unchanged at 60.6% from 60.9% in H1'2016. Without LLP, the Cost to Income ratio deteriorated to 41.1% from 35.3% in H1'2016,
- Profit before tax declined 9.3% to Kshs 2.9 bn from Kshs 3.2 bn, while profit after tax declined by 11.8% to Kshs 2.0 bn from Kshs 2.3 bn in H1'2016,
- The Loan book grew by 4.1% to Kshs 116.8 bn from Kshs 112.2 bn in H1'2016, in line with our expectations of a 4.2% expansion,
- Customer deposits increased by 18.9% to Kshs 133.2 bn from Kshs 112.0 bn in H1'2016, due to the bank's efforts to strengthen its network channels through opening up additional 6 new branches in 2016, 1 new branch in 2017 and 181 service outlets across the country to boost its deposit mobilization capabilities. In addition, the bank had collected Kshs 5.0 bn from borrowers on behalf of KDIC, in its mandate as an asset and liability consultant for Imperial Bank, which spurred the significant deposit growth. The faster growth in deposits compared to loans resulted in a decline in the loan to deposit ratio to 87.7% from 100.1% in H1'2016,
- The board of directors did not recommend payment of an interim dividend.

Going forward, we expect NIC Bank Group's growth to be driven by;

i. Focus on improving their asset quality by reducing their non-performing loans through improved credit risk management and loan recovery efforts, as we note that gross non-performing loans increased by 14.1% and the NPL ratio deteriorated to 11.6%,

ii. Adoption of cost-efficient methods of servicing clients by use of digital platforms and other alternative channels that eliminate need for physical branches. The reduction in operating expenses has resulted from reduced provisioning, which is not sustainable for the bank, and

iii. Maximizing on the expected gains from their investments in innovation and technology to improve operating efficiency and drive fee income.

For a more comprehensive analysis, see our NIC Bank H1’2017 Earnings Note.

Diamond Trust Bank Group released H1’2017 results:

Diamond Trust Bank Group (DTB) released H1’2017 results, recording a 5.8% decline in core earnings per share to Kshs 12.2 from Kshs 13.0 in H1’2016, attributed to a 2.6% increase in operating expenses. Key highlights for the performance from H1’2016 to H1’2017 include:

- Total operating income declined slightly by 0.4% to Kshs 12.0 bn from Kshs 12.1 bn in H1’2016, following a 0.8% decline in Net Interest Income (NII), despite a 1.2% increase in Non - Funded Income (NFI),
- NII declined marginally by 0.8% to Kshs 9.5 bn from Kshs 9.6 bn in H1’2016, following a 2.7% increase in Interest Expense to Kshs 7.4 bn from Kshs 7.2 bn, that outpaced the 0.7% increase in Interest Income to Kshs 16.9 bn from Kshs 16.7 bn in H1'2016. The Net Interest Margin thus declined to 6.8% from 7.6% in H1'2016,
- NFI grew by 1.2% to Kshs 2.54 bn from Kshs 2.51 bn in H1'2016, driven by an 18.1% increase in fees & commissions income to Kshs 0.6 bn from Kshs 0.5 bn in H1'2016. The revenue mix remained unchanged at 79:21 funded to non-funded income,
- Total operating expenses increased by 2.6% to Kshs 7.0 bn from Kshs 6.8 bn, attributed to a 13.2% rise in staff costs to Kshs 2.0 bn from Kshs 1.8 bn in H1’2016, and 14.6% increase in other expenses to Kshs 3.3 bn from Kshs 2.9 bn in H1’2016. Loan Loss Provision (LLP) declined by 21.7% to Kshs 1.7 bn from Kshs 2.2 bn in H1'2016.
- The Cost to Income ratio deteriorated marginally to 58.1% from 56.5% in H1'2016. Without LLP, the Cost to Income ratio worsened to 43.9% from 38.3% in H1'2016,
- Profit before tax declined 4.1% to Kshs 5.0 bn from Kshs 5.3 bn, while profit after tax declined by 5.8% to Kshs 3.4 bn from Kshs 3.6 bn in H1’2016,
- The Loan book grew by 7.2% to Kshs 191.5 bn from Kshs 178.5 bn in H1’2016,
- Customer deposits increased by 18.6% to Kshs 256.3 bn from Kshs 216.1 bn in H1'2016, due to (i) the bank’s efforts to strengthen its network through opening up an additional branches in Eldoret during H1’2017, (ii) partnering with the Postal Corporation of Kenya (PCK) to increase its agency network, and (iii) it’s gain from Imperial Bank Ltd (IR) clients, whereby Imperial Bank depositors were allowed access to their funds under the management of DTB and KCB Group,
- The faster growth in deposits compared to loans led to the decline in Loan to Deposit ratio to 74.7% from 82.6% in H1'2016,
- The board of directors did not recommend payment of an interim dividend.

Cytonn INVESTMENTS

Going forward, we expect DTB’s growth to be driven by (i) increased efficiency through cutting down of costs by opening more digital branches offering 24/7 customer service, and (ii) leveraging on new innovative products to increase non-funded income.

For a more comprehensive analysis, see our DTB H1’2017 Earnings Note.

Of the 9 listed banks that have released their H1’2017 results, none has recorded a growth in core earnings per share, with the average decline in core earnings across the listed banking sector at 11.3%. This is a significant decrease compared to the average growth of 12.7% registered for H1’2016. The sector has experienced slower loan growth, which in turn led to reduction of their Net Interest Margins. Despite the growth in the loan book the private sector credit growth remains low, and was at 2.1% in May 2017, which is an 8-year low. The loan to deposit ratio remained relatively unchanged at 80.7% compared to 80.8% in H1’2016.

Listed Banks H1'2017 Earnings and Growth Metrics												
3ank	Core EPS Growth		Deposit Growth		Loan Growth		Net Interest Margin		Loan to Deposit Ratio		Exposure to Government Securitie	
	H1'2017	H1'2016	H1'2017	H1'2016	H1'2017	H1'2016	H1'2017	H1'2016	H1'2017	H1'2016	H1'2017	H1'2016
(CB Group	(3.6%)	13.6%	1.3%	(2.2%)	16.7%	8.4%	8.7%	8.1%	84.3%	73.2%	24.0%	21.1%
)TB Kenya	(5.8%)	11.3%	18.6%	24.7%	7.2%	10.2%	6.8%	7.6%	74.7%	82.6%	41.1%	36.4%
:quity Group	(7.8%)	18.0%	13.6%	6.5%	(1.5%)	13.6%	9.7%	10.8%	73.1%	84.3%	37.2%	24.6%
NIC Bank	(11.9%)	2.9%	18.9%	6.5%	4.1%	3.6%	7.1%	7.7%	87.7%	100.1%	33.3%	25.9%
;tanbic	(12.1%)	22.2%	12.5%	(2.7%)	8.0%	0.3%	5.3%	5.6%	75.1%	78.2%	38.6%	36.3%
3arclays	(13.3%)	(10.2%)	3.2%	11.9%	6.8%	14.8%	10.1%	10.7%	86.8%	83.8%	27.9%	26.0%
:o-op Bank	(25.4%)	18.7%	2.7%	12.0%	14.2%	8.0%	8.8%	8.9%	88.4%	79.5%	26.0%	29.2%
NBK	(42.2%)	(70.0%)	3.4%	(1.6%)	(12.0%)	(9.3%)	6.9%	7.2%	57.7%	67.8%	38.1%	29.5%
HF Group	(74.0%)	26.3%	(6.0%)	6.2%	(1.3%)	7.0%	5.7%	6.7%	89.3%**	92.1%**	9.2%	9.3%
Neighted Average*	**(11.3%)**	**12.7%**	**8.1%**	**7.0%**	**7.9%**	**9.8%**	**8.7%**	**9.1%**	**80.7%**	**80.8%**	**31.2%**	**26.4%**

' The weighted average is based on Market Cap as at 25th August, 2017

*'*The Loans to Loanable funds ratio. The Loan to Deposit ratio is at 141.3%*

Britam Holdings released H1’2017 results:

Britam Holdings released their H1’2017 results, reporting a decline in earnings per share of 44.1% to Kshs 0.5 from Kshs 0.9 in H1’2016. This was attributed to a 33.3% growth in total expenses to Kshs 13.5 bn from Kshs 10.1 bn in H1’2016, despite a 15.8% increase in total revenue to Kshs 14.7 bn from Kshs 12.7 bn in H1’2016. Additionally, there was a change in the methodology used to account for long-term insurance liabilities to the Gross Premium Valuation from the Net Premium Valuation as per the IRA requirements, which had a one-off effect of reducing the claims in H1’2016, due to the decline in Long-Term Insurance Liabilities by Kshs 2.2 bn in the period brought about by the change, and hence the normalisation in net insurance benefits and claims in H1’2017. Britam, however, did not disclose the full impact of the valuation change on their Income Statement. Key highlights for the performance from H1’2016 to H1’2017 include:

- Total revenue grew by 15.8% to Kshs 14.7 bn from Kshs 12.7 bn supported by an 8.8% growth in net earned premiums to Kshs 10.2 bn and a 1.7% growth in investment income to Kshs 2.8 bn from Kshs. 2.7 bn,
- Gross written premiums rose by 6.2% to Kshs 11.7 bn from Kshs 11.0 bn. Retention ratio increased to 87.2% from 85.1%,
- Investment income grew marginally by 1.7% to Kshs 2.8 bn, from Kshs 2.7 bn in H1’2016, driven by more proactive portfolio allocation taking advantage of the high yields in the fixed income market. Investment in equities fair value gains amounted to Kshs 2.1 bn compared to a loss of Kshs 0.3 mn in H1’2016. Investment income currently accounts for 18.9% of the total income, a decrease from 21.5%,
- Total expenses increased by 33.3% to Kshs 13.5 bn from Kshs 10.1 bn, primarily brought about by an 84.8% rise in net insurance benefits and claims to Kshs 6.7 bn from Kshs 3.6 bn in H1’2016. The significant rise in expenses was due to the change in the accounting method for long-term insurance liabilities to the Gross Premium Valuation from the Net Premium Valuation, which had the one-off impact of reducing the long-term business liabilities for 2016, necessitated by the Insurance Act (Cap. 487) and amendments by the Finance Act 2015. As a result, the loss ratio increased to 54.7% from 48.0% in H1’2016,
- Profit before tax (PBT) declined by 53.1% to Kshs 1.2 bn, from Kshs 2.6 bn in H1’2016, while profit after tax (PAT) declined by 44.1% to Kshs 1.0 bn from Kshs 1.8 bn in H1’2016,
- The board of directors did not recommend payment of an interim dividend.

Going forward, Britam’s growth will be driven by:

i. Solid regional presence to drive growth as evidenced by operations in Uganda, Rwanda and the subsequent acquisition of Real Insurance Company Ltd in 2014 that led to expansion into Tanzania, Malawi and Mozambique,
ii. A strong distribution channel, coupled with the roll out of the first phase of its financial advisor portal,
iii. A diversified business strategy as evidenced in the Holdings' interests in insurance, asset management, real estate and strategic holdings in banks enabling the group to respond effectively to shifting market dynamics.

The key risk for Britam remains the overexposure to equities, particularly banking stocks, which tends to adversely affect the performance of the group when they dip. Britam has 48.8% holding in HF Group and 8.2% in Equity Group Holdings Plc.

For a more comprehensive analysis, see our Britam Holdings Earnings Note H1'2017.

In an effort to keep our rankings of companies on the Cytonn Corporate Governance Ranking ("Cytonn CGR"" Report up-to-date, we continually update the rankings whenever there are changes on any of the 24 metrics that we track, and how this affects the company ranking. Below are the changes during the week:

- Mr Francis Muthaura stepped down as the chairman of Britam Holdings having attained the CMA recommended retirement age of 70-years of age. He will be replaced by Walter Andrew Hollas, who is part of the board. Britam's score has improved to 62.5% from 60.4% due to reduction in board size from an even number 8 to an odd number 7. It's ranking has however remained at position 33,
- The board of directors of KenGen appointed Mrs Rebecca Miano as the acting Managing Director & CEO, following the retirement of Eng. Albert Mugo. KenGen's score has improved to 77.1% from 75.0% due to increase in gender diversity score to 36.4% from 27.3%. It's ranking has therefore improved to position 14 from position 16.

Below is our Equities Universe of Coverage:

all prices in Kshs unless stated otherwise								
No.	**Company**	**Price as at 18/08/17**	**Price as at 25/08/17**	**w/w Change**	**YTD Change**	**Target Price***	**Dividend Yield**	**Upside/ (Downside)****
1.	NIC***	36.3	37.0	2.1%	42.3%	51.2	3.4%	41.8%
2.	DTBK	190.0	188.0	(1.1%)	59.3%	241.1	1.7%	29.9%
3.	KCB Group***	44.0	45.5	3.4%	58.3%	54.0	6.6%	25.3%
4.	Barclays	10.5	10.6	1.4%	25.0%	12.1	9.4%	23.6%
5.	HF Group	11.5	11.7	1.7%	(16.8%)	13.9	3.2%	22.5%
6.	I&M Holdings	124.0	125.0	0.8%	38.9%	147.5	2.9%	20.9%
7.	Co-op Bank	16.2	17.0	4.6%	28.4%	18.5	4.5%	13.7%
8.	Jubilee Insurance	464.0	464.0	0.0%	(5.3%)	490.5	1.8%	7.5%
9.	Stanbic Holdings	81.5	81.5	0.0%	15.6%	77.0	5.8%	0.2%
10.	Kenya Re	22.0	21.8	(1.1%)	(3.3%)	20.5	4.4%	(1.3%)
11.	Liberty	14.0	13.7	(1.8%)	3.8%	13.0	0.0%	(5.3%)
12.	StanChart	233.0	233.0	0.0%	23.3%	209.3	4.4%	(5.8%)
13.	Equity Group	43.0	43.5	1.2%	45.0%	38.4	4.6%	(7.1%)
14.	Britam	15.2	15.1	(0.3%)	51.0%	13.2	1.8%	(10.8%)
15.	Safaricom	24.3	26.5	9.3%	38.4%	19.8	4.7%	(20.7%)
16.	Sanlam Kenya	29.8	30.0	0.8%	9.1%	21.1	0.0%	(29.8%)
17.	CIC Group	6.3	6.2	(0.8%)	63.2%	3.7	3.2%	(37.0%)
18.	NBK	11.5	11.9	3.5%	65.3%	4.0	0.0%	(66.2%)

**Target Price as per Cytonn Analyst estimates*
***Upside / (Downside) is adjusted for Dividend Yield*
****Banks in which Cytonn and/or its affiliates holds a stake*
For full disclosure, Cytonn and/or its affiliates holds a significant stake in KCB Group, ranking as the 5th largest local institutional investor

We remain "neutral with a bias to positive" for investors with short to medium-term investments horizon and are "positive" for investors with a long-term investment horizon.

Private Equity

Kansai Plascon Africa Limited, a subsidiary of Japanese paint maker Kansai Paint Co. Ltd, has completed the acquisition of a 90.0% stake in Kenyan paint and coating manufacturer, Sadolin Group. The transaction is valued at USD 100.0 mn hence valuing the company at USD 111.1 mn (Kshs 14.5 bn). The remaining 10.0% stake is held by undisclosed local investors. This transaction will see Kansai Plascon Africa Limited take up the operations of Sadolin Paint in Kenya, Uganda, Tanzania and Rwanda. The acquisition will (i) drive innovation in Sadolin Paints as Plascon has invested heavily in research and development facilities, catering for development across all products, with these facilities located in Japan, India and South Africa, and (ii) assist Plascon implement its expansion strategy in Africa by increasing their presence in Africa through the acquisition of local African paint brands, as Sadolin Group is amongst the largest producer of paint in East Africa. The demand for paint is being driven by rapidly growing middle class population, increased disposable income and growing urbanisation hence presenting an investment opportunity. The manufacturing sector is however facing challenges including (i) counterfeit goods, and (ii) poor transport connectivity and high energy costs. Despite these challenges, the manufacturing sector can make significant growth by (i) adopting technological innovations, and (ii) increasing their distribution networks to untapped demand from the rural population, which is not easily accessed.

South African based Sanlam Investments has committed to acquire a 30.0% stake at USD 7.6 mn in South African based EasyEquities, a subsidiary of Purple Group, a South African based financial services provider, subject to regulatory approval in South Africa. This effectively values EasyEquities at USD 25.3 mn (Kshs 2.6 bn). EasyEquities is a fintech company that offers a platform for low cost investment solutions, by offering users an opportunity to invest in securities which include whole shares and fractional share rights. The acquisition will see (i) addition of more capital in EasyEquities. This will assist the company to implement its aggressive growth and development plan over the next two to three years by expanding in the South African market and other jurisdictions through the development of new products, (ii) EasyEquities benefit from Sanlam's investment skills, insights and access to other markets outside the South Africa market, and (iii) Sanlam implement its expansion plan by diversifying into different varieties of investment products. Investment in fintech is gaining momentum in Sub-Saharan Africa as witnessed through various transactions, such as (i) Kenyan digital currency payments platform BitPesa recently closed a USD 2.5 mn funding round that brought BitPesa's total amount of funding raised to nearly USD 6.0 mn (for more information click here), and (ii) Kenyan Mobile credit firm Tala, formerly known as Mkopo Rahisi, raised more than USD 30.0 mn in series B financing from IVP, Rabbit Capital and existing investors including Lowercase Capital, Data Collective, Collaborative Fund, and Female Founders Fund (F3) (for more information click here). The investments in fintech have been driven by: (i) Broad range of reforms across Sub Saharan Africa in recent years in the process of transitioning economies to a digital age, (ii) infrastructure initiatives in Sub-Sahara Africa that are opening new avenues of commerce, and (iii) new efforts towards regional integration.

Private equity investments in Africa remain robust as evidenced by the increased deals. The increasing investor interest is attributed to (i) rapid urbanization, a resilient and adapting middle class and increased consumerism, (ii) the attractive valuations in Sub Saharan Africa's private markets compared to its public markets, (iii) the attractive valuations in Sub Saharan Africa's markets compared to global markets, and (iv) better economic projections in Sub Sahara Africa compared to global markets. We remain bullish on PE as an asset class in Sub-Sahara Africa. Going forward, the increasing investor interest and stable macro-economic environment will continue to boost deal flow into African markets.

Real Estate

The master planned community concept in Kenya continues to take shape with key masterplans attracting international players in the various precincts such as residential, industrial parks, commercial office and education zones, among others. This was witnessed this week with Johannesburg Stock Exchange (JSE)-listed ADvTECH Ltd, an education, training and placement company based in South Africa, announcing the

purchase of a land parcel in Tatu City. The parcel will be used to set up a THRASS education system Crawford schools brand, in line with the company's expansion strategy to various countries in Africa. ADvTECH Ltd becomes the second education institution to invest in Tatu City's education precinct after Nova Academies took up land and set up Nova Pioneer Tatu City. These institutions are attracted to the city by (i) the live – work – play lifestyle, (ii) quality infrastructure provided, and (iii) the over 4,500 residents expected to occupy the residential zone in Tatu City creating a steady supply. Tatu City has attracted several multinationals in the master plan, including: Dorman's Coffee, Bidco oil Refinery Limited, Unilever and Kim Fay, all of whom have taken up space in the industrial park, which is currently 65.6% occupied. Lifestyle Properties and Karibu Homes developers have taken up land parcels in the residential precinct, and Tatu's self-build plots zone dubbed Kijani Ridge is over 60.0% sold.

Master planned communities have various advantages to the country including: (i) de-congesting the central business districts, (ii) communal lifestyle and increasing the standards of living, (iii) decentralization of industries, and (iv) provision of trunk infrastructure in remote areas, hence opening up such areas for development. Ruiru, area where Tatu City is located in Kiambu County, has recorded a capital appreciation of 23.9% p.a. over the last 5 years. Master plans have however previously failed to kick off due to (i) tedious land acquisition processes, (ii) inadequate infrastructure as most master plans are located some distance from the main cities, (iii) high financing costs, and iv) inadequate skills to organize and bring it all together, with Tatu City finally kicking off and recording high uptake levels. We are likely to witness a change of mindset among developers, financiers and buyers, hence development of more master planned communities in addition to current cities under development such as Konza City by the Kenyan Government, Newtown by Cytonn Real Estate and Northland City by the Triad Architects, among others.

In November 2015, the real estate developer Acorn Group and Helios, a London-based private equity fund, signed a memorandum of understanding (MOU) on a 50:50 partnership, with Helios acting as the fund-raising arm for Acorn's real estate developments, owing to the capital-intensive nature of the industry. This partnership was primarily focused on the youth housing segment in Nairobi. In light of that, during the week, the two partners announced their first deal to build a 3,800-university hostel unit in Nairobi at a project cost Kshs 7.4 bn financed by International Finance Corporation (IFC) through a jointly owned investment vehicle.

The first set of the hostels will be set up in areas near Strathmore University, United States International University Africa (USIU-Africa) and Daystar University. The development is targeting the growing student population in institutions of higher learning in the country, which has grown by a CAGR of 18.0% in the last 5-years, from 251,200 in 2012 to 564,500 in 2016, according to Economic Survey 2017. This growth has not been commensurate with the growth in accommodation resulting in a deficit, with the Jumia House Real Estate Research report estimating that most universities in Kenya can only accommodate 20% – 30% of the students admitted, with the rest being forced to seek housing outside campus, hence student housing shortage accounting for 40.0% of the over 200,000 national housing units p.a.

Therefore, these developments, in our view, are a step in the right direction towards curbing the student housing deficit and we expect to see more private companies enter the sector to tap into the demand gap and reap investment returns supported by (i) steady income from solid rental growth and resilience from tough economic times, (ii) high occupancy backed by a strong demand from the student population growing at a 5-year CAGR of 18.0%, and (iii) relatively low risk profile given the multi-tenant nature of student housing.

During the week, Java House, a coffee chain retailer owned by Dubai-based private equity firm Abraaj Group, announced that it will take up 2,800 sqft of space in Crystal Rivers Mall in Athi River. The mall, developed by Safaricom Investments Pension Scheme, is scheduled to start operations in early 2018 with retailers such as Naivas Supermarket pre-booking the space. These retailers are seeking to tap into the opportunity presented by the rising middle class in satellite towns in the Nairobi Metropolitan Area, who are attracted to the locations by improved infrastructure and relatively affordable land and house prices. Real estate developers are also seeking to cater for the growing population and to tap into the high returns being earned in satellite towns with average retail rental yields of 9.3% at occupancy rates of 88.3% according to Cytonn Retail Report 2016. We expect increased development of malls in satellite towns and

county headquarters driven by the increased supply of mall space in Nairobi at an average space growth of 17.0% p.a. and population growth in the satellite towns and county headquarters mainly driven by devolution and affordability.

The market outlook points to increased housing supply as the local and international firms and finance institutions support housing projects with focus on student housing. In addition, there is increase in the supply and demand of retail space outside Nairobi County due to heavy population influx in Nairobi satellite towns and county headquarters.

Corporate Governance and Stock Performance

Corporate governance is the application of best management practices, compliance with laws and regulations and adherence to ethical standards for effective management and distribution of wealth and discharge of social responsibility for sustainable development of stakeholders. Good corporate governance is essential for the vibrancy and efficiency of any financial market. Over the years, we have seen vast financial losses, both globally and locally, partly attributable to poor corporate governance structures and oversight.

This focus note aims to first highlight the need for good and sound corporate governance, and point out examples of firms where poor corporate governance has led to investor losses. We then aim to conclude by demonstrating that proper corporate governance structures do have a correlation to stock market performance, but requires the input of all market participants and stakeholders, drawing lessons from the US market, where proper corporate governance has led to the recovery from the global financial crisis in 2008, and vibrancy of the financial market.

Following the global financial crisis in 2008, more emphasis has been placed on good corporate governance and consequently, the redefinition of corporate value has become increasingly imperative. The financial crisis of 2008 led to the review of global principles regarding corporate governance after it was determined that poor governance contributed largely to institutional failures in the crisis. Bringing this home, we are all too familiar with the recent bank failures and operational crisis in firms such as:

- Imperial Bank, which was placed under receivership by the CBK following unsound business conditions in the bank;
- Chase Bank, which was also placed under receivership following cases of unsound banking practices such as large unsecured loans to directors;
- Uchumi Supermarket and Nakumatt, which have experienced cash-flow problems due to mismanagement at the retailer level; and
- Kenya Airways, whose issues around governance came into light following four consecutive years of massive losses resulting from high debt levels after a botched expansion plan, and reduction in passengers.

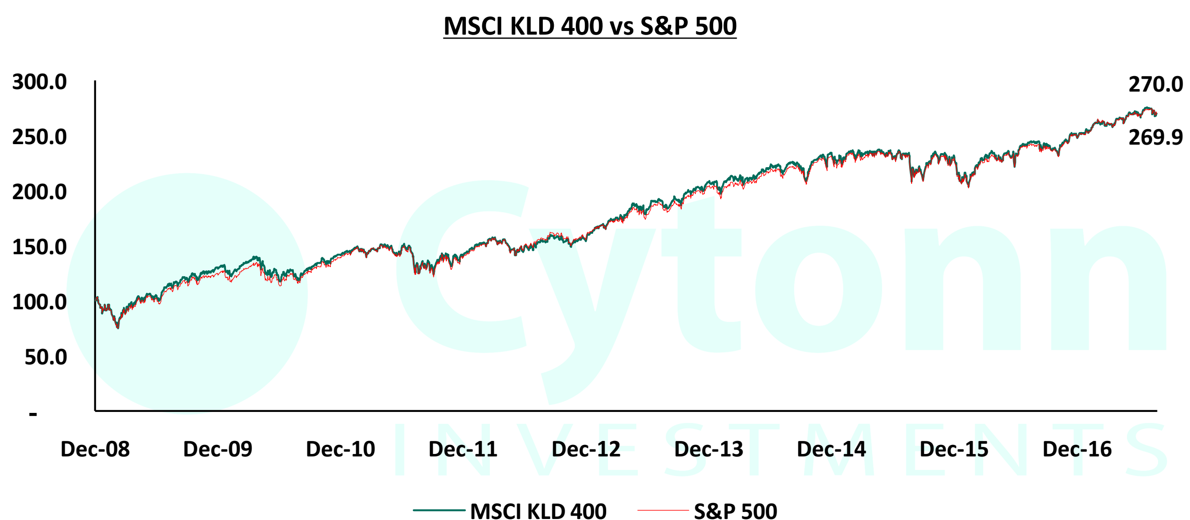
Taking the United States as an example, corporate governance is strong given that it is embraced as an industrywide practice. The following are the stakeholders involved in enforcing corporate governance:

- **Regulatory Bodies** - Bodies such as the Senate, Stock Exchanges such as NASDAQ & NYSE and the Securities & Exchange Commission (SEC) are entrusted with (i) setting up laws and guidelines on corporate governance such as the Sarbanes-Oxley Act of 2002 (SOX), and (ii) regulating the securities industry;
- **Fund Managers** – Fund managers in the US, post-2008, have been increasingly considering the importance of governance factors in investing. This is further supported by the fact that, as per a research done by John Hancock Investments, portfolios with a balanced Environmental, Social and Governance (ESG) holding delivered an annualised return of 9.0% since 2012, compared to 7.8% for portfolios with traditional holding;
- **Professional Organisations** – Professional bodies such as the American Institute of Certified Public Accountants (AICA) and the Finance Accreditation Agency (FAA), continue to play a critical role in

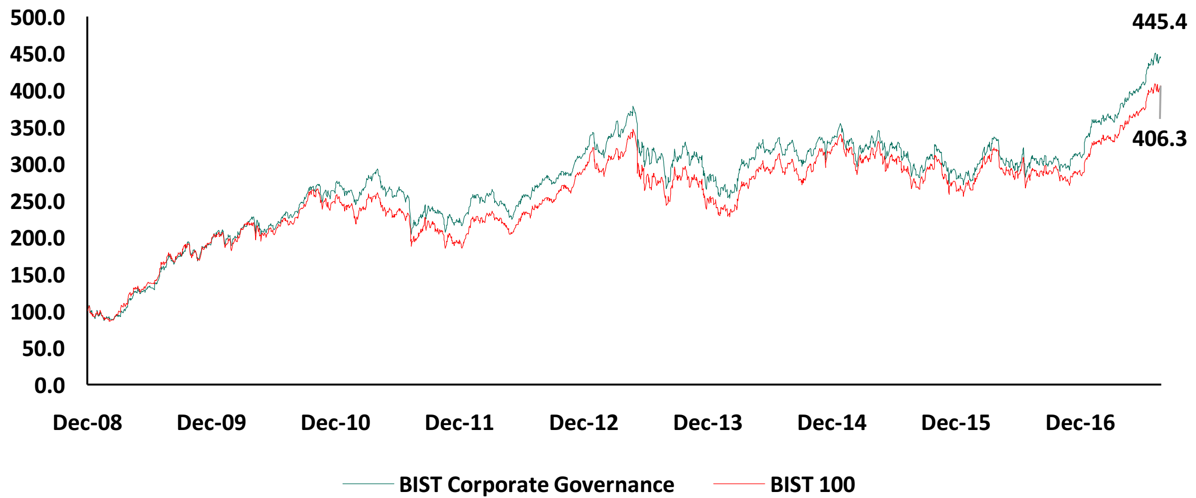
enhancing corporate governance in the US as they uphold their members to the highest standards of ethics and professionalism; and

- **NGOs** - The Organisation for Economic Co-operation and Development (OECD), the Financial Stability Board (FSB), and the Society of Corporate Governance are one of the major bodies entrusted with formulating corporate governance principles that help policy makers evaluate and improve the legal, regulatory, and institutional framework for corporate governance.

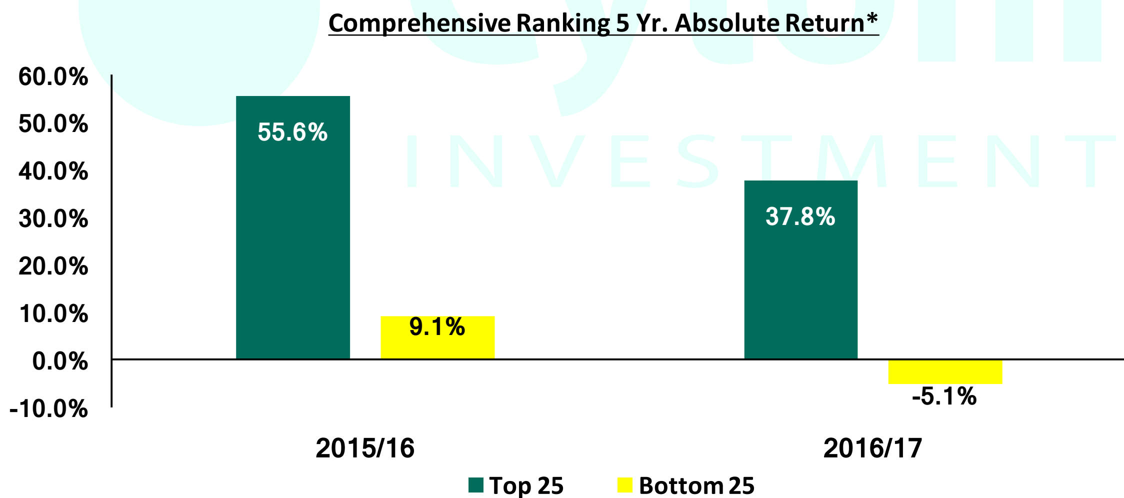
The regulation around corporate governance in the US has been so strong post-2008, that there is a clear correlation between stock market returns and corporate governance. Previously, investing in companies with great corporate governance was considered a niche market, but post 2008, with tighter regulations around corporate governance, picking any stock from the market is almost a guarantee that they have the right governance structures in place. The chart below of, the MSCI KLD 400 Social Index, a market cap weighted index of 400 U.S. securities that provides exposure to companies with outstanding governance ratings, against the S&P 500, clearly indicate that the market and the social index deliver generally similar returns over the years. Since both indices are market cap weighted, and deliver similar returns, it is an indication that the largest companies by market cap in US, are also the ones that rank highest in terms of corporate governance.



However, in markets where corporate governance structures have not been as tightly enforced, stocks with great corporate governance structures outperform the market. In Turkey, comparing the BIST Corporate Governance Index (a market cap weighted index comprising of 50 of the highest-ranking companies as per their corporate governance ratings) and the BIST 100 Index, the BIST Corporate Governance Index has outperformed the BIST 100 Index, having grown by a CAGR of 18.8% and 17.6% since 2009, respectively.



The correlation between corporate governance and stock performance can also be observed in the Nairobi Securities Exchange (NSE). The recently released Cytonn Corporate Governance Ranking Report 2017, (CGR), highlighted the strong correlation between corporate governance and returns on stocks of the listed entities. The top 25 companies in the Cytonn CGR delivered an absolute return of approximately 37.8% over the last 5-years compared to the bottom 25 companies, which delivered an absolute return of (5.1%) per annum over the last 5-years. The chart below illustrates this:



From the above examples, it is clear that corporate governance has a direct relationship with stock markets returns. However, for the Kenyan case, it is imperative that corporate governance be emphasised to a level where an investor does not necessarily have to dig deep to gauge whether a company has put in place the right corporate governance structures. This can be achieved by both companies and regulators taking an initiative in educating both the corporate world and the public on the importance and impact of corporate governance on returns and sustainability for the future. Assessing the corporate governance regulation in the Kenyan market, we have to applaud the Kenyan listed entities in their mission to firm up to sound corporate governance practices. We cannot also fail to recognise the support from increased regulation from various bodies and organizations responsible for corporate governance oversight, with (i) the CMA publishing the Code of Governance Practices, and (ii) the Government of Kenya forming Mwongozo, an independent body tasked with management, governance and oversight of state corporations, which is essential for stability of the companies and the general market. However, despite a general improvement

in terms of market participants embracing global best practices in terms of corporate governance, there still lacks a significant level of goodwill in adopting said practices.

Sound corporate governance structures are essential to well-functioning and vibrant financial markets. However, structures do not mean anything if there lacks goodwill and participation from all stakeholders. It is therefore imperative that all participants ensure that they are adhering to the corporate governance structures set out by the various regulators.

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