FAIDA INVESTMENT BANK

INVESTMENT RECOMMENDATIONS REPORT

18th October 2019

Market Recommendations

BANKING SECTOR:

KCB Group

We recommend a **LONG TERM BUY** on KCB. The counter is currently trading at a P/B of 1.17x (at a price of KES 43.25) against an industry average of 0.86x as at 18th October 2019. Furthermore, KCB has a dividend yield of 8.1%, higher than the industry average of 5.5%. KCB has a high ROaE of 21.9% against an industry average of 13.5%. We believe the group's strategic partnerships and digital transformation will continue to deliver growth.

In a bid to grow its market presence and leadership position, the company has resulted to mergers and acquisitions (inorganic growth). The bank is currently expected to takeover certain assets and liabilities of Imperial bank and has recently concluded the takeover of National Bank of Kenya (NBK). Additionally, the bank is looking to acquire two banks; one in Rwanda and one in DRC.

In the NBK takeover, KCB Group offered 1 KCB share for every 10 shares of NBK. Our thoughts on the NBK takeover is that it was more of a bailout. NBK will benefit from better corporate governance (a key concern for us) and the capital injection (NBK's capital ratios are below the statutory minimums). KCB will benefit from the additional deposits but it will be interesting to see how KCB deals with NBK's low asset (loan book) quality. We expect aggressive recoveries, write-offs and increased provisioning (given the relatively high NPL ratio and the low quality of the financial reporting).

Equity Group Holdings

We recommend a **LONG TERM BUY** on Equity Group Holdings. Currently, Equity is trading at a P/B of 1.51x (at a price of KES 38.00) compared to the average banking sector P/B of 0.86x as at 18th October 2019. We attribute the high P/B ratio to high growth expectations by investors. Equity has a high ROaE of 21.1% (the second highest in the banking sector) which is well above the industry average of 13.5%.

The current business model, hinged on technology, innovation and business diversification affirms the group's competitive advantage in an industry adapting to the digitization strategy amidst the current regulatory challenges. Thus, we believe this business model will support growth in the long-term.

The group's business model is tailored to address the emerging challenges in the banking sector. The model is hinged on the following focus areas:

- Non funded income growth - to support net interest income

- Regional diversification - to mitigate against regulatory risk
- Strengthening liquidity and balance sheet agility
- Treasury operations - to enhance treasury income
- Asset quality (especially with tougher regulations in the horizon)
- Innovation and digitization
- Efficiencies and cost optimization

In a bid to increase their footprint across Africa, the bank announced plans to acquire four banks in Rwanda, Zambia, Tanzania and Mozambique. Equity Bank plans to acquire (currently carrying out due diligence enquiries on the banks) a 62% stake in Banque Populaire du Rwanda and full ownership of BancABC Zambia, BancABC Tanzania and BancABC Mozambique in a share- swap deal with London-listed Company Atlas Mara. This will expand the bank's operations to 8 countries within the African Continent. In addition the bank is set to acquire Banqué Commerciale du Congo (BCDC) in DRC.

Barclays Bank of Kenya

We recommend a **HOLD** on Barclays Bank with the counter trading at a P/B of 1.39x (at a price of KES 11.35) against an industry average of 0.86x as at 18th October 2019. The counter has a high ROaE of 17.1%, which is above the industry average of 13.5%. Additionally, the counter has a high dividend yield at 9.7%. The Bank has been relying on its investments in technology – leveraging it to improve operational efficiency. This has notably been evidenced through the reduction in the number of traditional branches (and consequently staff headcount) and focus on alternative banking channels (mobile and internet banking). We expect the bank to continue focusing on alternative banking channels to drive revenue growth and improve efficiencies. Moreover, following the reduction of Barclays PLC's stake in Absa Group (formerly Barclays Africa Group), we expect the bank to utilize this new 'freedom' to pursue new products more tailored towards the local market.

Diamond Trust Bank

We recommend a **HOLD** on Diamond Trust Bank. Trading at a P/B ratio of 0.61x (at a price of KES 117.50 as at 18th October 2019), makes the counter attractive when compared against the banking industry average P/B ratio of 0.86x. Additionally, the counter realized a ROaE of 13.9% in FY2018 – in line with the industry average of 13.5%. With the Aga Khan Fund for Economic Development as the top shareholder, the bank has continued to reap the benefits arising from shared ownership with organizations in other industries (Jubilee Holdings and NMG). DTB has leveraged this ecosystem to diversify its revenues. The bank has a very conservative and defensive business model. Although this model has benefited them with low NPLs, it has also lowered returns for the bank. Going forward, we expect DTB to continue to diversify its revenue streams while leveraging on technology to improve operational efficiency.

INSURANCE SECTOR:

The insurance sector in Kenya has been persistently characterized by low insurance penetration rates. Although the low penetration rates indicate a huge potential for this sector, they more accurately reflect several challenges that plague the sector. These challenges include: the affordability of insurance premiums, lack of trust (especially in regard to claim settlement) and negative perceptions informed by cultural beliefs. These factors have derailed the little product innovation coming out of this sector. For instance, micro insurance has not gained much traction. Fraud (and costs associated with reducing its prevalence) and intense competition (characterized by price undercutting) among the players are also hampering profitability of the insurance sector. In other segments such as health insurance, competition comes from government sponsored initiatives such as the National Health Insurance Fund that are tackling some the challenges faced by private players (notably affordability of premiums).

Due to these challenges, insurance companies are more dependent on investment income which tends to be volatile (particularly for players overweight in listed equities). Due to the aforementioned challenges, we recommend underweighting the insurance sector.

Jubilee Holdings

We recommend a ***LONG TERM BUY** on Jubilee Holdings. The company, through its subsidiaries, provides all classes of insurance and has a strong market presence in East Africa. Moreover, the company's associate businesses (Bujagali Energy Limited, Farmers Choice Limited, and Seacom) have strong fundamentals. Jubilee's growth strategy in the long-term business has been hinged on sustained product development, pricing efficiency and adaptability to market trends. We expect the Group to continue to focus on fraud management especially in their short-term business in order to minimize claims. With regards to medical insurance, we expect the Group to implement cost minimization measures to enable the provision of affordable premiums. In May 2019, Jubilee Financial Services Limited was licensed by the Capital Markets Authority (CMA) to operate as a fund manager (a collective investment scheme that manages a portfolio of securities). We expect the new business to enhance top-line performance. Jubilee is currently trading at a P/B of 0.95x (at a price of KES 343.25) against an industry average of 0.88x as at 18th October 2019 – higher due to its attractive fundamentals.

*The stock is relatively illiquid which means that the buyer may take a discount when exiting. Therefore, we recommend holding it for the long-term to allow for substantial capital appreciation. This will allow the investor to make a meaningful return even with the discount. Additionally, holding it for the long-term allows for the growth of the company's new business (fund management).

TELECOMMUNICATIONS SECTOR:

Safaricom

We recommend a **HOLD** on Safaricom. The counter is currently trading at a P/E multiple of 17.88x (at a price of KES 28.25, as at 18th October 2019). The company is a market leader in the telecommunications industry with a market share of 63.5% (1Q2019/20) of total mobile subscriptions. This represents a 38.9% market lead over its closest competitor Airtel Kenya. The market share gap between Safaricom and its competitors has been supported by the company's heavy CAPEX spend over the years. Mobile data and M-PESA continue to be a key revenue drivers for Safaricom. The company has continued to leverage on the success of MPESA with new initiatives being based on the money transfer platform. We also note that the company is also pursuing opportunities outside Kenya. For instance, Safaricom is in talks with the Ethiopian government to introduce M-PESA in Ethiopia. In spite of the rising competitive and regulatory pressure (anticipated regulations based on the dominance study) we remain optimistic that the company will remain competitive. Furthermore, even with the recent increase in excise taxes (on mobile money transfer services, telephone and data services), we opine that subscription numbers will not be significantly affected owing to the high costs of switching to other networks. The large M-PESA ecosystem (agent network, customers, business vendors…) coupled with better coverage and reliability will deter users from shifting to other networks. A key risk we see with the MPESA ecosystem is the proposal by CA to enhance and extend the mobile interoperability. This may see the introduction agent to agent interoperability. This coupled with the current wallet to wallet interoperability may help smaller operators grow their ecosystems much faster. Agent to agent interoperability will likely require lengthy and wide consultations to implement and thus will only be a possibility in the medium to long term.

FY2019 Results commentary:

The company's after tax profits grew by 14.7% y/y in FY2019 to KES 63.4 billion (FY2018: KES 55.3 billion). See a breakdown of the results of here: The revenue performance from the different mobile segments was a mixed bag. On one hand, MPESA delivered growth but on the other hand, the legacy business segments (Voice, SMS and mobile data) significantly slowed down.

The decline in voice and SMS is not unique to Safaricom. Globally these segments have been commoditized, which means that cheaper pricing is only way to grow usage. In the messaging segment cheaper and richer alternatives in the form of over the top applications (such as Whatsapp) are preferred by users. OTT players have also contributed to the decline of the telcos' share of international voice traffic. We expect the company to rely more on promotional activities, personal offerings and blended offers to grow usage in these segments.

We opine that margin preservation will be key in these segments. This can be achieved by leveraging more efficient technologies. For instance voice over LTE which uses LTE network for voice calls can also be used to deliver voice traffic more efficiently. Similar technologies (such as Rich Communication Services) can also be used to augment the short messaging services. We do note however that the impact of these technologies may only be in the long term due to the slow adoption rates (chicken and egg problem). Therefore in the short to medium term, we expect margin pressure on these segments.

We believe the company will still try to improve the affordability of data bundles. For instance, the company is now offering free (based on quota) YouTube access on its All in one bundle. This means the yields are likely to decline. Margin preservation for the mobile data segment can also be achieved through leveraging of more efficient technologies for instance, by shifting more traffic to the LTE network (accelerating the use of 4G through reducing cost of smartphone ownership-reduce 4G handset cost and increase affordability of data bundles), data caching and peering (this would help them lower international bandwidth costs).

Growth in MPESA revenue was supported by a bigger MPESA ecosystem (products, agents, customers). MPESA revenue profile has continued to shift reflecting a preference for more transactions that are done within the MPESA ecosystem (fewer withdrawals). In FY2019 new business and P2P accounted for 61.6% up from 52.6% in FY2016. Over the same period, withdrawals accounted for 38.4% down from 47.4% in FY2016. As a result of the higher proportion of revenue from the new business and P2P which the company does not pay commissions on, MPESA revenue contribution margin has improved from 64.6% in FY2016 to 70.3% in FY2019. We believe this shift is more sustainable (there's sustainability in revenues and margin improvement). The company's partnership with Equity bank will enable MPESA expansion to other countries. This will further boost revenues for the company. Although MPESA revenues seem resilient, the uncertain regulatory environment is a key risk. We expect the company's continuous innovation and investments in partnerships will continue delivering growth.

MPESA has also contributed significantly to cost containment through the airtime recharges done through MPESA. We believe that airtime recharges through MPESA and improvements in the revenue profile via MPESA have partly contributed to the decline in the direct cost intensity from 40.6% in FY2012 to 28.6% in FY2019. Cost containment has also been achieved through economies of scale (e.g. better rates for maintenance of the passive and active network) and shift from leased fibre network to its own fibre network. We expect even more cost savings from investments in more efficient technologies such as Tube star base stations and 500G network.

MANUFACTURING SECTOR:

EABL

We place a **HOLD** recommendation on EABL. The company is the largest branded alcohol beverage business within East Africa. Furthermore, the company is 50.03% owned by Diageo – a multinational alcoholic beverage company. We expect EABL to focus on sustaining the growth momentum of spirits and value beer, through capacity investments. The company has been redirecting its focus towards the spirits and value beer categories as opposed to the mainstream and premium beer categories due to declining beer sales occasioned by evolving consumer trends and higher excise taxes. The company is constructing a KES 14.0 billion brewery in Kisumu – which will initially produce Senator Keg (value beer). This brewery is expected to commence operations in July 2019. Moreover, the company has completed the construction of a new spirits line at its headquarters in Ruaraka at a cost of KES 600.0 million, in order to meet the rising demand for spirits (being driven by a growing middle class with higher disposable income). However, we note with concern on the implementation of the Excise Act that gives the Treasury and the Kenya Revenue Authority the power to implement inflation-based tax increases. This may hamper demand through higher retail prices. EABL has an attractive ROaE of 82.8% with a modest dividend yield of 4.4%. The company is trading at a P/E ratio of 17.10x, (at a price of KES 192.00) as at 18th October 2019.

Mumias

We recommend a **SELL** on Mumias Sugar. Despite the strong brand, we opine that Mumias Sugar cannot effectively compete in its current state and the challenges in the local sugar industry. We also note the historically weak corporate governance which have contributed lack of a clear strategy to reverse its fortunes. Mumias sugar continues to face several challenges in its operations including cane supply shortage, competition from other millers, sub optimal plant due to aging and sugar imports.

1H2019 Results commentary:

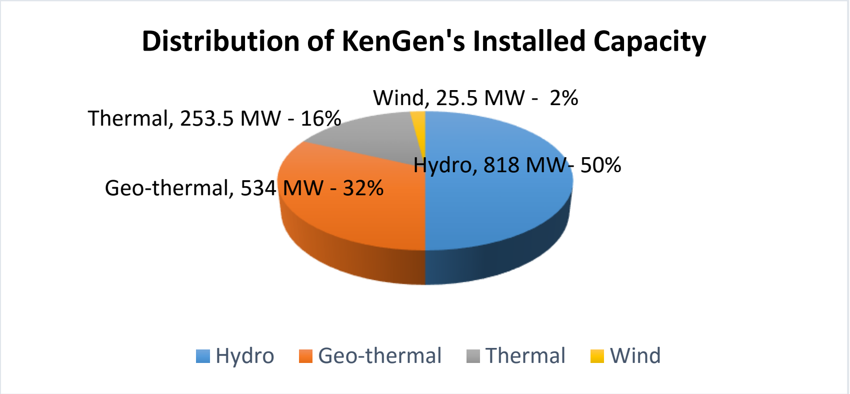
For H12019, revenues declined by 96% y/y to KES 26.0 million. Loss for the same period narrowed by 21% y/y to KES 1.5 billion from KES 2.0 billion. According to management, the loss was predominantly driven by shortage of cane which forced the company to bank on the sale of ethanol. This performance confirms that the company is not in a position to take advantage of the opportunities in the sugar industry.

The company has been placed under receivership and the share has consequently been suspended from trading.

ENERGY SECTOR:

KenGen

We recommend a **LONG-TERM BUY** on KenGen. As at the end of FY2018, the counter had a market share of 69.0% with an installed capacity of 1,631 MW distributed amongst various power sources as shown below. The company is currently trading at a P/E of 4.78x, (at a price of KES 5.74) as at 18th October 2019, lower than the industry average of 5.22x (excluding Umeme).



Source: Company Reports

The company plans to increase installed capacity by an additional 721 MW by 2020 through a geothermal led strategy. We expect these additions to enhance revenues in the long-term. The development projects lined up are shown below:

Development Projects	MW	Status
Olkaria Wellheads	25	Commissioned
Ngong Phase 3	10	Optimization Study
Olkaria I AU Uprating	30	Financing
Olkaria IV Uprating	30	Financing
Olkaria I Unit 6	70	Procurement of Contractors
Olkaria 1 Rehab	6	Financing Committed
Olkaria V	140	Construction Ongoing
Wellhead Plants	50	Procurement of Developers
Meru Wind Phase 1	80	Financing Committed
Olkaria VI	140	Project Development
Olkaria VII	140	Project Development
Total	**721**	

Source: Company Reports

KenGen also recently revealed that it is currently seeking KES 5.7 billion from multiple financiers to fund the construction of a 45 MW solar power plant. KenGen's after tax profits for FY2018 declined by 12.4% y/y to KES 7.9 billion from KES 9.0 billion recorded in FY2017. The dip in after tax profits was predominantly attributable to an 8.5% y/y rise in operating expenses to KES 23.7 billion (FY2017: KES 21.8 billion), a 57.0% y/y increase in the income tax expense to KES 3.4 billion and a 405.9% y/y decline in other net gains from KES 343.3 million to a net loss of KES 1.0 billion (impacted by revaluation losses attributable to adverse currency movements. As the next power plant is expected to be commissioned in FY2020, we do not expect KenGen to benefit from any tax allowances in FY2019. We also note that since the company has been exempted from paying compensating tax in the Finance Bill 2018, we expect their dividend policy to be much more consistent, going forward.

Summary

Counter	Recommendation	52-Week High	52-Week Low	YTD Change	Price as at 18th October 2019
KCB Group	Long-term Buy	48.00	35.50	15.49%	43.25
Equity Group Holdings	Long-term Buy	46.00	32.50	9.04%	38.00
I&M	Buy	115.25	41.75	-42.41%	48.95
Barclays Bank of Kenya	Hold	12.50	10.00	3.65%	11.35
Diamond Trust Bank	Hold	165.00	102.00	-24.92%	117.50
Jubilee Holdings	Long-term Buy	462.00	330.00	-15.19%	343.25
Bamburi Cement	Hold	159.00	92.00	-29.81%	93.00
Safaricom	Hold	29.31	20.51	27.25%	28.25
EABL	Hold	225.00	160.00	9.87%	192.00
KenGen	Long-term Buy	7.80	5.00	-18.23%	5.74

For Online Share Trading (OST) via browser, please click here:
For the Faida M-Trader Application, please click here:

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Recommendation Guide:

LONG-TERM BUY: The company has strong fundamentals (strong financial performance, clear/reasonable strategy, competent management team etc.). However, there are certain investments or strategies that would require an investor to have a long term view of the company to allow for capital appreciation.

BUY: Strong fundamentals. Target price represents an upside higher than 15%

HOLD: Stock is correctly priced. Target price represents a downside/upside within the -15% to 15% range

SELL: Deteriorating fundamentals. Target price represents a downside lower than -15%

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