

22nd June 2020

Equity Recommendations

Overall Overview

The adverse economic outlook as result of the COVID-19 pandemic has seen prices of most counters decline significantly, into bear market territory. The NASI, NSE20 and NSE25 are down 14.3%, 26.3%, 19.6% YTD to 142.54, 1,957.54 and 3,298.34 respectively.

In the short term, we expect significant pressure on companies' operating performance as a result of economic shocks. In our view, investors with a long-term view (ideally equity investors should have a long-term outlook anyway) and don't have short term liquidity constraints can take advantage of the attractive trading multiples for the capital gains potential.

High dividend yielding stocks are also good investing opportunities. However, with a need to conserve cash, this is a high-risk strategy due to the lower dividend safety (a number of companies have either reduced or deferred dividends or issued stock dividends instead of cash dividends).

A safer alternative for income investors is allocate funds to fixed income securities/money market fund.

Overall, the current market presents a buying opportunity for companies with strong fundamentals. We highlight some of these in the next section.

BANKING SECTOR:

Equity Group Holdings

We recommend a **LONG-TERM BUY** on Equity Group Holdings. The counter is currently trading at a trailing P/B of 1.20x (at a price of KES 35.65) compared to the banking sector P/B of 0.74x as at 22nd June 2020. Our recommendation is based on the company's i) Superior digital banking capabilities ii) Agile balance sheet- liquidity ratio of 51.6% and core capital/risk weighted asset ratio of 17.5%. iii) Growth in non-funded income. The group remains fundamentally sound hence our recommendation to investors with a long term view.

Key Drivers

Digitization Strategy

We expect the bank to continue reaping the benefits of its digitization strategy. With the current economic shock due to COVID-19, we expect the bank to leverage on its robust digital capabilities to increase its service offering on digital platforms.

With that in mind, the current waivers on mobile banking transaction fees (up to 30th June 2020) are expected to impact mobile banking fees for 2Q2020. Thereafter, we expect a pickup in fees as we expect transaction numbers on digital platforms to register growth. As at 1Q2020, 97.0% of all transactions took place on alternative channels.

With expected retail migration to alternative channels, we see potential for improved efficiency. The group has recorded a 3-year declining trend in its cost to income ratio(C/I) from 53.5% in FY2017 to 49.0% in 1Q2020.

Non-Funded Income

Prior to COVID19, during the interest rate cap regime, the group adopted a new model strategically reducing income volatility from interest income which we expect to sustain during this period.

As at 1Q2020, non-funded income growth grew by 16.0% y/y, faster than the 11.0% growth in net interest income, now contributing 42.0% of the group's total income.

While we expect decline in mobile banking commissions for 2Q2020, we foresee a boost in forex trading and merchant banking commissions to offset this decline. As at 1Q2020, forex trading income grew by 34.0% y/y to KES 1.1 billion while merchant banking grew by 11.0% to KES 582.0 million.

Treasury Income

Given the low interest rate environment and challenges in lending, we expect the group to mitigate expected reduced interest income from lending in 2Q2020, by increasing investment in government securities. As at 1Q2020, government securities portfolio was up 10.0% q/q to KES 189.9 bn (FY2019: KES 172.0 bn). Interest in government securities as at 1Q2020 accounted for 74% of Treasury income mix and treasury income accounting for 30% of total interest income. We expect the group to continue on this conservative approach for the rest of FY2020.

Regional Subsidiaries

We expect the group to focus more on regional economies, spreading its business risk. As at 1Q2020, the group was present in 7 countries, with regional subsidiaries contributing 25% to PAT with and ROaE of 18.8%. While we are positive on business diversification though regional expansion, we remain concerned around: i) high cost of running these subsidiaries (average cost to income ratio of about 61.0%) ii) economic shocks within all subsidiaries due to the pandemic has potential to drag out group's overall profitability.

Key Risks

Asset Quality

We remain concerned with the group's deteriorating asset quality which we expect to experience further pressure owing to COVID19 pandemic. As at 1Q2020, the group's gross non-performing loans increased by 21.3% q/q to KES 44.6 billion from KES 36.3 billion as at FY2019 (+51.9% y/y) as the cost of risk grew from 0.4% in 1Q2019 to 3.2% (1Q2020). NPL per sector was highest in SMEs and Large Enterprises at 12.5% and 13.2%, giving rise to an overall NPL ratio of 10.9%. From a country perspective, South Sudan and Tanzania recorded an NPL ratio of 40.8% and 40.5% respectively. The hardest hit sector is expected to

be SMEs and large enterprises (72.0% of total loan book) with large exposures within the trade (25%) and real estate sector (22.0%). We therefore expect the NPL ratio to deteriorate further for FY2020.

1Q2020 Results Commentary

- Equity Group's after-tax profits for 1Q2020 declined by 14.1% y/y to KES 5.3 bn. The group's profits were weighed down by an increase in:
 - i. Loan loss provisions which rose by 660.4% y/y to KES 3.1 bn as the group enhanced its level of provisioning to manage expected risks.
 - ii. Operating costs which increase by 16.3% y/y to KES 9.7bn.
 - iii.
- The higher provisioning was underpinned by a 51.9% y/y rise in gross non-performing loans to KES 44.6 bn – leading to an NPL ratio (gross non-performing loans/gross loans) of 10.9% (1Q2019: 9.0%)
 - The sectors that recorded the highest NPL ratios were large enterprises, SMEs and agriculture at 13.2%, 12.5% and 9.1% respectively.
 - South Sudan and Tanzania had significantly higher NPL ratios at 40.8% and 40.5% respectively compared to the rest of regional subsidiaries; DRC at 11.7%, Rwanda at 4.1% and Uganda at 3.2%.
- Operating costs were driven by:
 - i. Staff costs which increased by 23.0% y/y to KES 3.2 bn
 - ii. Other expenses which rose by 22.7% y/y to KES 4.8 bn

Consequently, the group's cost-to-income ratio edged up to 49.2% (1Q2019: 47.8%).
- Total interest income grew by 14.3% y/y growth to KES 15.4 bn supported by an 18.7% y/y rise in interest income from loans and

advances to KES 10.8 bn. The growth in interest income from loans and advances and this was due to a 24.1% y/y rise in the group's loan book (net loans) which outweighed a 50 bps dip in the yield on loans (to 11.6%).

- Total interest expenses increased by 26.7% y/y to KES 3.9 bn on the back of:
 - A 143.4% y/y increase in other interest expenses (from borrowings) to KES 926.7 mn due to a 3.2% y/y growth in borrowings to KES 52.6 bn.
 - A 12.0% y/y rise in interest expenses arising from customer deposits to KES 2.8 bn on the back of a 16.5% y/y growth in customer deposits to KES 499.3 bn. However, cost of customer deposits eased slightly by 10 bps to 2.3%.
- The group realized a net interest income of KES 11.5 bn (reflecting a growth of 10.6% y/y) and a NIM of 7.6% (1Q2019:8.2%). The lower NIM was a result of a faster growth in interest earning assets (+17.0% to KES 604.2 bn) vis-à-vis the growth posted in net interest income.
- Non-funded income grew by 15.8% y/y to KES 8.3 bn (mainly driven by a 16.8% y/y rise in other fees and commissions to KES 4.0 bn) resulting in a 110 bps increase in the proportion of non-funded income to total income to 41.9% (1Q2019: 40.8%).

KCB Group

We issue a **LONG-TERM BUY** on KCB Group. The counter is currently trading a trailing P/B multiple of 0.87x (at a price of KES 36.10), a 25.6% discount of over its 3-year P/B average of 1.17x. The company has a return on average equity (ROaE) of 20.7% (second highest among listed banks) and a dividend yield of 9.7% above the industry average of 5.9% (as at 22nd June 2020).

Our recommendation is based on the following long-term factors:

Growth Drivers

NIM Expansion on Interest Rate Cap Repeal: We expect KCB's Net Interest Margin to benefit from repeal of the rate cap. Since KCB did not materially alter its lending strategy on enactment of the rate cap, we expect the NIM expansion to be driven mainly by repricing of loans (i.e. higher loan yields) rather than loan book growth.

A portion of the loan book is still pegged on the interest rate cap regime (CBR + 4.0%). We expect these loans to be repriced downwards in line with the CBR cuts. This puts more downward pressure on NIM. However, based on management guidance, we are likely to see a much faster maturity in these loans than initially anticipated. Our model initially assumed that 50.0% of these loans would mature by the end of FY2023. However, at the FY2019 results call, management alluded to 50.0% of the loans maturing within one year. Additionally, we see the opportunity to restructure loans to the new interest rate regime. This will benefit the bank over the long term as economic prospects improve.

In light of bleak economic outlook, banks will likely be more cautious in lending. We therefore do not expect higher loan book growth to make up for the lower yields.

Due to the lower interest rate environment we expect the bank to lower its cost of deposits to mitigate the decline in NIMs.

Strategic Partnerships and Investments in Digital channels: We expect strategic partnerships and investments in digital channels (particularly the mobile channel) to play an important role in growing NFI. Notable products from these partnerships include KCB MPESA (with Safaricom) and Fuliza (with Safaricom and NCBA).

In the 1Q2020, alternative channels accounted for 97.0% of the volume of transactions with the mobile channel alone accounting for 73.0%. Through the strategic partnerships, the mobile channel has facilitated

saving and lending. By the end of FY2019, KCB had cumulatively lent KES 212.1 billion (KES 157.7 billion of this amount was lent in FY2019 after addressing capacity constraints with a revamped mobile platform). An additional KES 49.8 billion was lent in the 1Q2020. Due to the COVID 19 pandemic, management intimated that demand for credit on these platforms is likely to weaken, contrary to our previous expectations. We also anticipate that the bank will likely be more stringent to preserve the quality of borrowers, potentially leading to lower disbursements.

We expect the initiative by banks to provide free mobile transactions to lead to lower non-interest income growth. For instance, KCB expects to forego about KES 150.0 million on KCB to MPESA transfers in the 3 months. It's not clear whether banks are willing to extend the time period.

Moreover, with lower economic activity we expect lower transactions and lower credit related fees and commissions income.

Risks

Lower Loan Book Growth: For the FY2020, we expect the bank to be more cautious in lending on asset quality concerns.

Asset Quality Deterioration: We anticipate that asset quality deterioration on the adverse economic outlook brought about by the pandemic. Its highest sector exposure (36.9% as at 1Q2020) is in personal/household segment. Although the pandemic has brought about income losses following job losses, management intimated that they have a large exposure in the public sector (e.g. Teachers Service Commission) which we view as more job secure. During the 1Q2020 results call, management said that most of the restructured loans (c. KES 80.0* billion at 1Q2020) were in the corporate segment followed by mortgages. The personal segment was the best performing segment due to the aforementioned reason. We therefore expect KCB's NPL

ratio to deteriorate at a lower rate compared to some SME focused banks like Equity Group.

In sum,

In the short term, we expect a higher a cost to income ratio to lead to lower profitability for the bank. Over the long term, we see a strong investment case for a buy and hold investor driven by the aforementioned drivers which will outlive the pandemic.

*According to the Business Daily, this figure has since increased to over KES 120.0 billion as at the end of May 2020.

1Q2020 Results Commentary

- KCB Group posted an 8.5% y/y growth in after tax profits for 1Q2020 to KES 6.3 billion (1Q2019: KES 5.8 billion). The growth in profitability was predominantly attributed to a 22.4% y/y growth in total operating income to KES 23.0 billion. The performance also reflects consolidation of NBK first quarter results.
- Total interest income rose by 20.4% y/y to KES 20.2 billion. This growth was mainly driven by a 63.3% y/y increase in income from government securities to KES 5.3 billion (+20.3% q/q), due to a 52.8% y/y growth in the Group's holding of government securities to KES 203.7 billion.
- Interest income from loans and advances grew by 9.5% y/y to KES 14.7 billion as loans and advances edged up by 19.3% y/y to KES 553.9 billion (+3.5% q/q) with the yield on loans falling to 10.8% (1Q2019: 11.6%).
- Total interest expenses declined by 26.6% y/y to KES 5.2 billion owing to a 31.0% y/y dip in interest expenses from customer deposits to KES 4.7 billion. The lower interest expenses from customer deposits were owing to a marginal decrease in the

cost of customer deposits to 2.7% (1Q2019: 2.8%) as customer deposits rose by 31.4% y/y to KES 740.4 billion (+7.8% q/q).

- Despite an 18.5% y/y growth in net interest income to KES 15.1 billion, the net interest margin (NIM) fell to 7.6% from (1Q2019: 8.5%).
- Non-funded income grew by 30.5% y/y to KES 7.9 billion mainly due to a 44.8% y/y rise in other fees and commission income to KES 2.7 billion. The contribution of non-funded income to total income grew to 34.4% (1Q2019:32.3%). According to management, the growth in non-funded income was supported by additional income from National Bank.
- Despite a 22.3% y/y increase in operating expenses (excluding provisions) to KES 11.1 billion, the cost to-income ratio (excluding provisions) remained flat at 48.5% owing to the faster rise in total operating income (+22.4% y/y to KES 23.0 billion).
- Loan loss provisions surged by 149.1% y/y to KES 2.9 billion as gross nonperforming loans edged up by 70.5% y/y to KES 66.2 billion. According to the bank this was to cover for downgraded facilities, with an expected growth in defaults across key sectors of the economy attributable to the Covid-19 pandemic that has negatively affected the country's, regional and global economy.
- Cost of risk increased by to 2.1% from 1.0% in 1Q2019 owing to the rise in loan loss provisions. Asset quality deteriorated as the NPL ratio (gross NPL/ gross loan book) rose to 11.1% (1Q2019: 7.7%). This was attributed to consolidation with National Bank. We expect asset quality to be adversely impacted by the Covid-19 pandemic due to loan defaulting.
- National Bank of Kenya (NBK) posted a profit before tax of KES 233.0 million from loss of 961.0 million in the 1Q2019. Its loan book grew by 3.1% y/y to KES 47.3 billion over the same period.

NCBA

We place a **LONG-TERM BUY** recommendation on NCBA Group. The counter is currently trading at a P/B ratio of 0.60x (based on a market price of KES 27.00 as at 22nd June 2020) lower than the industry average P/B of 0.74x.

Given the economic uncertainties brought on by the pandemic, we expect the group's financial performance to come under pressure in the short-term. Our recommendation is underpinned by the following factors:

Taking into account the relatively low interest rate environment (currently CBR rate is at 7.0%) coupled with measures to ease repayment burdens on clients, we anticipate the group's NIMs to be negatively affected in FY2020.

Additionally, owing to the tough economic climate, we expect repayment challenges to affect income derived from NCBA's M-Shwari in FY2020.

NCBA's strength in digital lending is however, anticipated to support non-funded income growth in the long-term, after the COVID-19 pandemic. We opine there's some regulatory risk (in Kenya) that could potentially result in lower fees charged on M-Shwari and Fuliza.

We also have some concerns about the group's asset quality (the NPL ratio at the end of the 1Q2020 rose to 14.1% from 12.1% as at the end of FY2019 and this was attributable predominantly to legacy accounts (prior merger accounts). Given the nature of the group's asset quality (legacy accounts, whose recoveries are quite slow) coupled with the high credit risk environment (brought on by the COVID-19 pandemic), we do not expect much improvement in asset quality in the short-term. We are however optimistic that in the long-term the group's diversified loan book - consisting of corporate (62.0%) retail (30.0%) and digital banking (8.0%) - to mitigate against the asset quality issue.

Going forward, we expect NCBA group to continue to focus on investing in government & investment securities (lending to the government) as well as lending in the inter-bank market in order to mitigate against the asset quality risks brought on by the COVID-19 pandemic. Consequently, we expect to see low loan book growth in 2H2020.

The group has adopted a 5 year growth strategy based on the following key priorities:

- 1) Scaling retail banking footprint
- 2) Deepening leadership in corporate banking and asset finance
- 3) Enhancing the digital experience for their customers
- 4) Developing a strong brand and
- 5) Fostering a high performance employee culture

We expect this strategy to be implemented effectively post-pandemic since, according to management, the group is focusing on surviving the pandemic. We are optimistic about the potential success of the merger. As at the end of 1Q2020, NCBA reported witnessing the following synergies from the merger

- 1) Revenue growth and commercial organization supported by:
 - i. enhanced cross-selling
 - ii. adoption of best in class sales practices and
 - iii. improved risk management
- 2) Greater potential to scale owing to:
 - iv. an alignment towards cost effective deposit raising
 - v. shift towards improved deposit mix and current account deposits
 - vi. improved access to capital markets due to scale
- 3) Operational optimization hinged on:
 - vii. branch optimization
 - viii. it integration and consolidation

- ix. integration and optimization of support functions
- x. consolidated procurement and facility management

1Q2020 Results Commentary

- NCBA Group realized after tax profits of KES 1.6 bn in 1Q2020.
- The group's profitability was underpinned by robust operating income which stood at KES 10.9 bn and improved operational efficiencies; the group's cost-to-income ratio stood at 41.5% (lower than CBA's 53.9% and NIC's 47.6% in 1Q2019).
- According to management, the group's cost-to-income ratio largely benefitted from synergies unlocked from the merger (branch optimization, integration of support functions as well as IT integration and optimization).
- The group's customer deposits which grew by 3.2% q/q from KES 378.2 bn in FY2019 to KES 390.5 bn 1Q2020, was mostly channeled towards:
 - Lending in the Interbank market: Cash and balances with central banks and commercial banks (+16.3% q/q to KES 73.0 bn) and
 - Government and investment securities (+5.9% q/q to KES 154.7 bn)
- NCBA's loan book contracted by 1.4% q/q to KES 245.9 bn as the group adopted a cautious lending strategy amidst a slowdown in loan origination due to the COVID-19 pandemic.
- Asset quality deteriorated further in 1Q2020; NPL ratio rose to 14.1% from 12.1% as at the end of FY2019 and this was attributable predominantly to legacy accounts (prior merger accounts).

Stanbic Holdings

We assign a **LONG-TERM BUY** recommendation on Stanbic Holdings. The current market price of KES 79.75 (as at 22nd June 2020) presents a buying opportunity for investors with a long-term investment horizon.

Stanbic is currently trading at a trailing P/B of 0.64x a discount of 21.0% over its 3-year P/B average of 0.81x. The counter also has a dividend yield of 8.8%, higher than the industry average of 5.9%. Our recommendation is informed by the following factors:

In light of the challenging economic climate brought on by the COVID-19 pandemic, we expect to see some downward pressure on NIMs influenced by the effect of a low interest rate environment (CBR is currently at a 9-year low) acting on a loan book majorly pegged on the previous interest rate regime (69.1% of the loan book matures after 12 months). However, we expect the group to take advantage of restructuring opportunities to reprice the loans on the basis of the current risk environment and we opine this should provide growth momentum for NIMs in the long-term. Additionally, we expect to see Stanbic aim to lower its cost of funds to shore up NIMs.

As a result of the pandemic, loan book growth is expected to be significantly subdued in FY2020 and this may adversely affect fees and commission income.

We expect the efficiency enhancing measures adopted by Stanbic before the COVID-19 pandemic to mitigate against the expected lower net interest income, consequently supporting the bottom-line.

Our main concern regarding Stanbic continues to be its deteriorating asset quality which has generally been weakening since FY2011. Given the economic challenges arising from current pandemic, we don't expect to see any improvement in 2020. In the past, the poor asset quality was mainly attributable to the Corporate and Investment Banking (CIB) segment due to sector-wide asset quality issues and issues with few large corporate clients. However, in FY2020 we also expect asset quality challenges from the Personal and Business Banking (PBB) segment (which accounts for 54.0% of the loan book) due to job losses and a struggling SME sector.

In view of the foregoing, we expect to see improved performance in the long-term and recommend investment in the counter to investors with a long-term investment horizon.

ABSA Bank Kenya

We recommend a **LONG-TERM BUY** on ABSA Bank with the counter trading at a P/B multiple of 1.19x (at a price of KES 9.94) against an industry average of 0.74x as at 22nd June 2020. The counter has a high ROaE of 16.7%, which is above the industry average of 15.6%. Additionally, the counter has a high dividend yield at 11.1%, higher than the industry average of 5.9%. Our recommendation is based on:

Key Drivers

- We expect that if applied successfully, the new 5-year strategy would see the bank grow its non-funded income contribution to total operating income.
- We also expect the new strategy to boost operational efficiency. The Bank has been leveraging its investments in technology to improve operational efficiency. This has notably been evidenced through the reduction in the number of traditional branches and focus on alternative banking channels (mobile and internet banking).
- We note that the bank has the potential to maintain its market share as it pursues the new five-year strategy which partly focuses on increased lending.
- Following the separation from Barclays PLC we expect the bank to utilize this new 'freedom' to pursue new products more tailored towards the local market.
- We note that the two years (FY2018 and FY2019) into implementation of the new 5-year strategy the bank has recorded improvements in ROaE, cost to income ratio and non-funded income contribution.

Key Risks

- The bank's market share growth is dependent on the bank's ability to grow ahead of competition or at least not lose any more ground. Given the bank's conservative approach in the past, this is likely to be a challenge.

1Q2020 Results Commentary

- ABSA Kenya reported a 3.0% y/y growth in after tax profits to KES 2.0 billion (1Q2019: KES 1.9 billion). The performance was characterized by a 15.8% y/y increase in non-funded income to KES 3.0 billion and a 5.4% y/y decline in operating expenses (excluding provisions) to KES 4.1 billion.
- Total interest income grew by 2.8% y/y to KES 7.6 billion primarily driven by a 7.5% y/y increase in income from government securities to KES 2.1 billion (the bank's holdings of government securities edged up by 7.2% y/y to KES 125.4 billion while the yield on government securities dropped to 6.7% from 7.4% in 1Q2019).
- Income from loans and advances rose by 1.0% y/y to KES 5.5 billion on the back of a 12.4% y/y growth in the net loan book to KES 203.0 billion
- Total interest expenses declined by 1.9% y/y to KES 2.0 billion predominantly owing to a 13.2% y/y decrease in interest expenses from customer deposits to KES 1.6 billion. Although customer deposits increased by 6.6% y/y to KES 238.7 billion (1Q2019: KES 224.0 billion), the cost of deposits fell to 2.6% from 3.3% in 1Q2019.
- Consequently, net interest income edged up by 4.5% y/y to KES 5.6 billion. The net interest margin dipped to 6.9% (1Q2019: 7.5%)

due to a faster growth in interest earning assets (+10.1% y/y to KES 330.4 billion).

- Non-funded income realized a 15.8% y/y growth to KES 3.0 billion supported by a 47.4% rise in foreign exchange trading income to KES 1.1 billion. Fees and commissions on loans and advances grew by 8.8% y/y to KES 390.7 million. However, other fees and commissions declined by 3.0% y/y to KES 1.1 billion. The contribution of non-funded income to total income grew to 34.5% (1Q2019: 32.2%).
- Operating expenses (excluding provisions) fell by 5.4% y/y to KES 4.1 billion owing to: i) an 18.4% y/y dip in other expenses to KES 1.1 billion and ii) an 84.0% y/y drop in rental charges to KES 23.7 million. The cost to income ratio (excluding provisions) improved to 47.1% (1Q2019: 53.9%).
- According to management, following the separation from Barclays PLC, the bank will continue to make substantial investments in systems and rebranding over the course of the next two years; as well acquire various services from Barclays PLC.
- Loan loss provisions surged by 75.2% y/y to KES 1.1 billion as gross non-performing loans increased by 12.45 y/y to KES 17.3 billion. The NPL ratio (net gross/net loan book) grew marginally to 3.0% (1Q2019: 2.8%).
- The separation costs increased by 126.8% y/y and amounted to KES 552.1 million. According to the bank, adjusting for this non-recurring "exceptional" item (non-recurring in the long-term), the bank posted after tax profits growth of 13.0% y/y to KES 2.3 billion.

Standard Chartered

We issue a **SELL** recommendation on StanChart. The stock is currently trading at a trailing P/B ratio of 1.20x (based on a market price of KES 166.25 as at 22nd June 2020), a 11.1% discount over its 3 –year average P/B of 1.35x. Its dividend yield of 12.0% is significantly higher the industry average dividend yield of 5.9%. The stock is however, trading ex-dividend (i.e. the company has already closed the register for dividend payments).

Our recommendation is based on the following factors:

While StanChart's loan book recovered in FY2019, growing by 8.5% y/y to KES 128.7 bn, we don't expect this growth momentum to be sustained in F2020 due to the anticipated challenges relating to the COVID-19 pandemic. We opine the pandemic will compel StanChart to revert to its conservative lending approach in order to reduce their exposure to bad loans. However, given the FY2019 loan book performance, we are cautiously optimistic of renewed growth in the loan book once conditions improve.

Some of the loans are still pegged to the previous interest rate regime (CBR + 4.0%). Given the low CBR of 7.0%, we expect the yield on loans to come under pressure in FY2020. Moreover, given the introduction of repayment breaks and loan extensions, we expect interest incomes on loans to take a further hit. However, we believe StanChart will use the restructuring opportunities to reprice part of its loan book to match the current risk profile of borrowers. Already, StanChart has announced that it has restructured loans worth over KES 8.0 bn.

We expect StanChart to continue to leverage its high liquidity levels (62.6% in FY2019) to keep its cost of funds low.

StanChart's NPL ratio (as measured against net loans) reduced to 15.6% in FY2019 from 18.3% in FY2018. Despite this improvement in asset quality in FY2019, we expect asset quality to deteriorate in FY2020 – owing to the challenges occasioned by the COVID-19 pandemic. According to

company management, the sectors that have been adversely affected by the pandemic include: the hospitality and tourism sector, property market, trade and SMEs.

Housing Finance Group

We recommend a **SELL** on Housing Finance with the counter trading at a P/B multiple of 0.14x (at a price of KES 4.06) against an industry average of 0.74x as at 22nd June 2020. The counter has a high cost-to-income ratio of 93.8% (2019), higher than the listed banks' average of 53.6% (2019). Our recommendation is based on:

Key Drivers

- We expect continued growth of non-funded income in the long term as a result of the bank's digitization strategy supported by increase in fees and commissions on loans advances and fees and commissions on transactions.
 - In the short term, however, we see a possible reduction in non-funded income owing to lower fees and commissions on loans and advances as the bank exercises caution in lending. We opine that the bank will increase its holdings of government securities in lieu of lending.
- We are optimistic about the group's efforts to contain costs which have resulted in an improvement in the cost-to-income ratio (C/I) to 82.7% in 1Q2020 from 97.1% in 1Q2019. However we note that this is still above listed banks' average of 47.3% (excluding Stanbic) for the same period.
- We see potential in affordable housing that the bank can tap into. Additionally, with the establishment of the Kenya Mortgage Refinance Company (KMRC), the bank can access cheaper long-term financing.

Key Risks

- We expect that asset quality pressures are likely to increase from the real estate sector which has been experiencing a slowdown in growth.
 - The sector has been registering high non-performing loans hiking to 14.9% in 2018, ranking third after trade (25.8%) and manufacturing (16.4%). This has been due to developers being unable to service their loans because of their inability to realize projected sales revenues.
 - We opine that the Covid-19 pandemic will further impact servicing of loans which could undo the progress made by the bank in 1Q2020 on improving asset quality in the short term. The NPL ratio (net non-performing loans/net loan book) improved to 15.2% in 1Q2020 from 18.6% in 1Q2019. We expect that increased loan defaulting will worsen bottom-line performance due to higher provisioning.
 - We opine that real estate segment will still be a challenge even after the Covid-19 pandemic.
- We note that real estate has been the bank's main line of business and therefore revenue diversification (under the two-year strategy) is likely to be a challenge.

1Q2020 Results Commentary

- HF's loss reduced by 99.6% y/y to KES 633,000 from an after-tax loss of KES 158.3 million in 1Q2019. The performance was characterized by a 13.7% y/y increase in net interest income to KES 580.7 million and a 7.7% y/y decline in operating expenses (excluding provisions) to KES 689.6 million.
- Total interest income declined by 7.8% y/y to KES 1.2 billion (1Q2019: KES 1.4 billion). The decrease was mainly driven by a 10.8% y/y dip in income from loans and advances to KES 1.1 billion as the group's net loan book shrank by 8.5% y/y to KES

38.4 billion. The yield on loans fell marginally to 11.6% from 11.7% in 1Q2019.

- Income from government securities edged up by 24.6% y/y to KES 113.7 million as the group's holdings of government securities surged by 39.3% y/y to KES 5.0 billion. Yield on government securities dropped to 9.4% from 10.1% in 1Q2019
- Total interest expenses declined by 20.9% y/y to KES 664.1 million primarily owing to a 58.8% y/y decrease in other interest expenses to KES 148.0 million.
- Interest expenses from customer deposits grew by 5.9% y/y to KES 488.0 million as customer deposits edged up by 11.8% y/y to 38.0 billion. The cost of customer deposits declined to 5.2% (1Q2019: 5.4%).
- Consequently, net interest income rose by 13.7% y/y to KES 580.7 million. The net interest margin grew to 5.2% (1Q2019: 4.3%) due to a decline in interest earning assets (-5.3% y/y to KES 44.4 billion).
- Non-funded income fell by 2.0% y/y to KES 253.5 million predominantly due to a 61.9% plunge in fees and commissions on loans and advances to KES 24.4 million (1Q2019: KES 64.1 million).
 - Other fees and commissions grew by 57.4% y/y to KES 96.0 million.
 - Consequently, the contribution of non-funded income to total income dropped to 30.4% (1Q2019: 33.6%).
- Operating expenses (excluding provisions) declined by 7.7% y/y to KES 689.6 million owing to a 19.6% y/y dip in other expenses to KES 293.8 million
 - The cost to income ratio (excluding provisions) improved to 82.7% (1Q2019: 97.1%).
- Loan loss provisions fell by 23.4% y/y to KES 137.6 million as gross non-performing loans decreased by 5.8 y/y to KES 12.2 billion. The NPL ratio (net NPL/net loan book) improved to 15.2% (1Q2019: 18.6%).

- According to management, the financial statements had not been adjusted for the impact Covid-19 pandemic and measures will be taken to cushion against the impact and this may result in additional provisioning.

Safaricom

We recommend a **HOLD** on Safaricom based on the current market prices. The counter is currently trading at a P/E multiple of 16.24x (at a price of KES 30.20, as at 22nd June 2020) an 8.4% discount of over its 3-year P/E average of 18.17x. The company is a market leader in the telecommunications industry with a mobile subscription market share of 64.8% (2Q2019/20).

The key revenue drivers for the company are MPESA and mobile data, contributing 33.6% and 16.2% to service revenues respectively for the FY2020.

In FY2020 the company's after-tax profits grew by 16.2% y/y in FY2020 to KES 73.7 billion (FY2019: KES 63.4 billion) mainly driven by MPESA and mobile data. See a breakdown of the results of [here](#):

The 12.5% y/y growth in MPESA revenues to KES 84.4 billion was underpinned by 12.1% y/y growth in 30-day active MPESA customers to 24.9 million while chargeable transactions (including betting) grew to approximately 13.0 from 12.0 transactions in FY2019. MPESA's P2P (Person to Person transfer) and new business grew by 14.6% and 43.4% respectively. The company is focused on increasing P2P use cases to encourage more transactions being done within the MPESA ecosystem (which will result in fewer withdrawals). Savings and Lending (Fuliza, Mshwari, KCB MPESA) was the biggest contributor to new business growth. The company is planning to extend lending to SMEs.

Safaricom is keen to expand MPESA outside Kenya. In FY2020 the company together with Vodacom South Africa purchased MPESA intellectual property rights from Vodafone. This now gives it flexibility to

provide MPESA services within the continent in partnership with Vodacom. Proposed regulatory laws on mobile lending (agent to agent interoperability which would quickly grow competitors' agent networks) and the disruption of the betting industry are some of the challenges the company is facing with regard to MPESA. We are optimistic that the company's large M-PESA ecosystem (agent network, customers and business vendors) coupled with product innovation (e.g. MALL), better coverage and reliability will deter users from shifting to other networks.

Mobile data (+12.1% y/y to KES 40.7 billion) saw an improvement in Average Revenue per User (ARPU) in FY2020 as the company achieved strong uptake of its new "No expiry" bundle, with 30 day active customers growing by 14.0% to 22.0 million. Customer usage grew by 65.3% to 1,204.0 megabytes with data customers using over 100mbs grew by 23.7% to 9.1 million. We opine that there is room for growth in this segment. In addition, movement restriction will likely lead to increased usage of data as most people work from home.

With the current economic shock owing to the COVID-19 pandemic the company is likely to experience a slowdown in MPESA revenue growth in the short term. Although data usage is likely to increase with most people working from home, spending on bundles may be limited by job losses and pay cuts.

Bamburi

We place a **SELL** recommendation on Bamburi Cement. The company has a price of KES 31.00 as at 22nd June 2020 and is trading at a P/E ratio of 12.65x. Although the company's cost management initiatives have proven effective, we note that this is not sufficient to sustain long term growth. We note that the Group has been experiencing a contracting market in Kenya since 1H2017. In light of the COVID-19 pandemic's economic impact, suspension of operations in Rwanda

and competitive pressures within the region, we expect Bamburi to register subdued revenue growth (as compared to historical trends).

Summary

Counter	Recommendation	YTD Change	Price as at 22nd June 2020
Equity Group Holdings	Long-term Buy	-33.36%	35.65
KCB	Long-term Buy	-33.15%	36.10
NCBA	Long-term Buy	-26.73%	27.00
ABSA Bank Kenya Plc	Long-term Buy	-25.54%	9.94
Stanbic	Long-term Buy	-27.00%	79.75
Standard Chartered	Sell	-17.90%	166.25
HF	Sell	-37.15%	4.06
Safaricom	Hold	-4.13%	30.20
Bamburi	Sell	-61.25%	31.00

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. Also, the company may be facing headwinds which we view as short term.

BUY: Strong fundamentals. Minimal risks to the catalysts/growth drivers

NEUTRAL: This is where the positives and negatives in a company almost balance out. You can accumulate for the long term.

SELL: Deteriorating fundamentals. Risks outweigh the catalyst/growth drivers.

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