INVESTMENT RECOMMENDATIONS REPORT

25th September 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 15.6%, 30.4%, 20.9% YTD to 140.37, 1,847.63 and 3,242.38 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 1.22x (at a price of KES 36.10) compared to the banking sector P/B of 0.73x as at 25th September 2020. It is also trading at a 24.2% discount to its 3-year average P/B multiple of 1.61.x. The group remains fundamentally sound hence our recommendation is to investors with a long term view.

FY2020 Outlook

Funded Income

Management guidance is towards a loan book growth of 8.0%-9.0% with deposit growth maintaining the same momentum as 1H2020. We expect cautious lending towards high COVID-19 impacted sectors with increased focus on health, agriculture and manufacturing.

With the repeal of the interest rate caps, we expect interest income growth to be driven by loan book growth with management expecting loan yields to remain static for 2H2020 (to manage asset quality pressures).

With focus on mobilizing more current and transactional deposits, particularly through digital channels, and with subsequent repricing of borrowed funds (due to LIBOR declining), we expect funding costs to remain relatively stable.

We expect the group to maintain its conservative approach with the growth in government securities expected to be higher than that of the loan book for FY2020. As at 1H2020, treasury income accounted for 31.0% of total interest income, with the government securities portfolio increasing by 20.0 % y/y.

Non Funded Income

Non-funded income has been a key growth driver for the group, managing income volatility from interest income. With the extension of the mobile money fee waivers, we expect continued impact to mobile banking commissions. Management expects to focus on treasury and trade finance to mitigate the loss of mobile commissions.

Digitization Strategy

With 98.0% of the bank's transactions now outside branches, the group has leveraged on its robust digital capabilities to increase its service offering on digital platforms. In 1H2020, the Eazzy Platform recorded strong double-digit growth in transaction numbers (EazzyApp +37%, EazzyFX +550%, EazyBiz +11%, EazzyPay +49% and EazzyNet +33%). We expect this momentum to sustain for 2H2020.

We expect the bank to continue reaping cost optimization benefits of its digitization strategy through its variable cost structure. With continued retail migration to alternative channels, we see further potential for improved efficiency. The group has recorded a 3-year declining trend in its cost to income ratio (excluding provisions) from 53.5% in FY2017 to 51.0% as at FY209 (48.8% in 1H2020).

Asset Quality

11.0% of the loan book is non-performing with 48.9% of the performing loans impacted by Covid-19. Out of these 65% are in SME and 26% in large corporates. From a sector perspective, 34% are in real estate, 23% in trade, 10% in transport and communication, 7% in tourism and hospitality and the rest across different sectors. The restructuring on the covid impacted loans allows for a moratorium of upto 3 years. With exposure to highly impacted customer categories and sectors, we expect continued pressure on the asset quality. The cost of risk is expected to remain elevated within the same levels of 1H2020. The bank's high liquidity ratio (54.2% as at 1H2020) will help mitigate the asset quality pressures.

Regional Diversification

We expect the group to focus more on regional economies, spreading its business risk. In 1H2020, Rwanda and Uganda subsidiaries reported a 7.0% and 6.0% increase in profitability despite the prevailing economic uncertainties. 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 64.1%) ii) economic shocks within all subsidiaries due to the pandemic has potential to drag out group's overall profitability.

With completion of the BCDC acquisition (amalgamating it with the Equity DRC subsidiary), we see potential for a high growth business. We believe DRC has scaling potential given more than 25 million people are excluded from the financial system. Equity is armed with superior digital capabilities of which we expect them to replicate the Kenyan subsidiary digitization strategy. Management expects the subsidiary to generate returns above cost of capital in the medium-term.

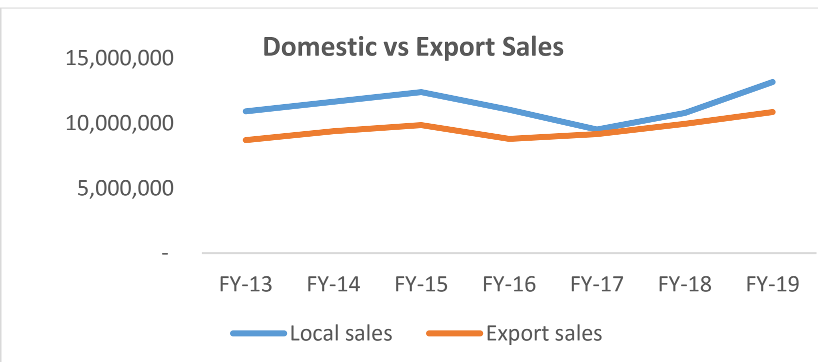
BAT

We recommend a **BUY** on BAT, most suitable to dividend investors as the dividend yield currently stands at 9.4% (compared to the 364 T-Bill at 7.690%) trading at a price of KES 355.00. The stock is currently trading at a trailing P/E of 9.14x and a 5 year average ROE of 40.8%. Based on the company's new strategy to diversify to new categories in line with the global trends, we believe it is well positioned to meet growing demand given its market leadership position and pricing power. We however remain concerned around the regulatory challenges, impacting the core business performance.

Growth Drivers

Product Innovation to Drive Growth in Line with Shifting Business Strategy

- Combustible tobacco continues to drive business growth, with BAT Kenya distributing to 16 markets across Africa. As at FY2019, local sales comprised 54.8% of revenue, with exports at 45.2%. As the domestic market continues to face regulatory challenges, export markets have witnessed continued growth due to incremental pricing and an improved mix on the back of distribution initiatives and slight foreign exchange gains.



Source: Company annual report

- Since FY2017, the company has continued to innovate its products and transform its product portfolio. Key initiatives have been:
    - 2017 launch of Dunhill flavored capsule products (now approximately 25% of Dunhill volume contribution)
    - 2017 launch of Sportsman Switch and Sportsman Full Flow
    - 2018 introduction of BAT's global highest selling Value for Money brand, Pall Mall and the consequent brand migration of Safari into Pall Mall
    - 2019 Migration of local brand Embassy to Dunhill to drive strategic growth of Dunhill
    - 2019 capsule offerings for Rothmans Switch and Rothmans Purple- an innovative product for Value for Money category
    - 2019 migration of SM into Rothmans.
    - 2019 launch of lyft oral nicotine pouch

- While combustible tobacco continues to be the core of the business, the company is looking towards growing its product portfolio by aligning itself with global shifting trends (towards health and wellness). Total global tobacco consumption (by volume) has seen a decline over the years, recently declining by 2% from 2018 to 2019. Towards the end of FY2019, BAT Group embarked on a corporate transformation strategy aimed at reducing the business' health impact by introducing innovative and less risky products.
- In 2H2019, the company launched Lyft – a tobacco free oral nicotine pouch that was received well and contributed to the 15.9% y/y growth in net revenue. For FY2020, the company is investing KES 2.5 billion in building a factory in Nairobi to manufacture oral nicotine products to meet growing demand.
- In line with product innovation, we are likely to see new categories of products including and beyond tobacco and nicotine.

Continued Productivity Initiatives

- The group continues on its productivity savings resulting from the Integrated Works Systems (IWS) introduced in 2015 to improve factory efficiencies, increase productivity and deliver savings.
- At the Kenyan manufacturing hub, 64% of machinery is now on IWS resulting in improved efficiencies by an average of 11.0%, capex avoidance of average KES 120 million annually and reduction in manufacturing cost by an average of 11%. As a result, the Gross Margin has averaged at 46.8% between FY2013 and FY2018, dipping to 39.3% as a result of regulatory costs that increased cost of operations (28.9% y/y to KES 14.5bn as at FY2019 from 11.3% in FY2018).
- We believe despite this, the company has made sustainable efforts in operational efficiencies to mitigate unforeseen economic uncertainty going forward.

Sustained Dividend Payment

- BAT has maintained a dividend payout of 86.0% (among the highest in the listed companies on the NSE). Interim dividend annually stands at KES 3.50 with the final dividend dependent on business performance (FY2019: KES 33.50). The current dividend yield stands at 10.5%, presenting a good opportunity for dividend investors.
- The advent of CoVID-19, its impacts on the local as well as global economy and its potential to disrupt local and international supply chains, remains a concern to the bottom-line for FY2020. This could impact the dividend payout for this year.

Risks
Regulation

- BAT continues to grapple with regulatory challenges focused on tax, packaging and graphic health warnings. In the domestic market, excise tax implementations over the years have had an impact on cigarette volumes sold. Recent regulatory enactments have been:
    - 20% increase in excise duty as at October 2019. Tax per mile (thousand sticks) on filtered cigarettes rose to KES 3,157 from KES 2,765 while tax on unfiltered cigarettes jumped to KES 2,272 from KES 1,990.
    - 2% Solatium Levy introduced in November 2019 requiring the company to remit 2% of the value of manufactured products (used by the government to fund tobacco research and rehabilitation programmes)

- Implementation of some of these tax measures (particularly the solatium levy) contributed significantly to the higher operating costs. The higher operating costs saw profit after tax for FY2019 decline by 4.9% y/y to KES 3.8 billion despite net revenue growing by 15.9% y/y to KES 24.0 billion within the same period. We expect continued tobacco regulation to impact tobacco sales volume, especially low tier products that are sensitive to price changes, with consumers in this category shifting to illicit products.
- However, in the wake of a smokeless society, and as mentioned earlier, management has put down plans to venture into alternative tobacco products in an effort to grow its revenue base. Globally, BAT Plc is already the world's largest e-cigarettes maker, with a quick adoption rate in developed countries whose population is seeking products with reduced health risks. As the new categories (oral nicotine pouches) are nascent, the company still has leeway to roll out new products before stringent regulation on the products are enacted.

Summary

Counter	Recommendation	YTD Change	Price as at 25th September 2020
Equity	Long-term Buy	-32.52%	36.10
BAT	Buy	-29.00%	355.00

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

E-mail: research@fib.co.ke

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 head wings 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.

HEAD OFFICE:

Crawford Business Park,
Ground Floor
State House Road
Tel: 0207606026-37
P.O Box 45236-00100
Nairobi