FAIDA INVESTMENT BANK

INVESTMENT RECOMMENDATIONS REPORT

27th November 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 13.9%, 32.8%, 20.9% YTD to 143.30, 1,785.05 and 3,242.80 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:

HF Group

We recommend a **SELL** on Housing Finance. The counter is trading at a P/B multiple of 0.12x (at a price of KES 3.25) against an industry average of 0.70x as at 27th November 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 mobile and legacy loans and advances and fees and commissions on transactions.
    - In the short term, however, we note the reduction in non-funded income in 1H2020 predominantly due to a 79.2%

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plunge in other income to KES 148.0 million (1H2019: KES 712.2 million) and the lower NFI contribution to total income at 22.4% (1H2019: 47.1%). We opine that the bank will continue to increase its holdings of government securities in lieu of lending in the short term and expect this to have a dampening effect on non-funded income.

- 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 85.8% in 1H2020 from 102.0% in 1H2019. However we note that this is still above listed banks' average of 48.3% (excluding Stanbic) for the same period.
- We note that HF has been lending less and investing more in government securities. We opine that his is a prudent move given the uncertainty that has been brought on by the Covid-19 pandemic and the challenges the group has faced with non-performing loans.
- We see potential in affordable housing that the bank can tap into. Additionally, with the establishment and licensing (September 2020) 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 even prior to the Covid-19 pandemic.
  - We note the real estate sector has been registering high non-performing loans. According to the CBK's September Monetary Policy Statement, the banking sector's asset quality had deteriorated to 13.6% in August 2020 from 13.1% registered in June 2020. The rise in the NPL ratio (gross non-performing loans/gross loans) was predominantly due to real estate sector as well as personal and transport and communication sectors.
  - HF has made progress in improving asset quality with the NPL ratio (net NPL/net loan book) declining to 14.3% in 1H2020 (1H2019: 18.7%). However, we note that the decline in provisions could have been driven by the bank's move to lend less and invest more in government securities.
  - According to management, the group has restructured loans worth KES 9.8 billion since the outbreak of the pandemic, which represents 25.0% of the loan book.
  - 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.
- Despite the continued improvement in operational efficiency (lower operating costs excl provisions), the group still has a very high cost to income ratio (82.7%), still above the listed bank's average of 48.3% (excl Stanbic).
- We note that customer deposit expenses have been on the rise with the cost of deposits remaining high (5.1%).

1H2020 Results Commentary

- HF's after tax loss grew by 210.8% y/y to KES 293.2 million from an after-tax loss of KES 94.3 million in 1H2019. The weaker performance was primarily due to a 68.8% y/y decline in non-funded income to KES 285.6 million.
- Total interest income fell by 12.7% y/y to KES 2.4 billion (1H2019: KES 2.7 billion). The decrease was mainly driven by a 16.5% y/y dip in income from loans and advances to KES 2.1 billion as the group's net loan book shrank by 5.8% y/y to KES 38.2 billion while the yield on loans fell to 10.8% from 11.9% in 1H2019.
- Income from government securities edged up by 26.3% y/y to KES 247.3 million as the group's holdings of government

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securities surged by 13.5% y/y to KES 4.8 billion. Yield on government securities remained flat at 10.5%.

- Total interest expenses dipped by 18.2% y/y to KES 1.4 million mainly due to a 55.2% y/y decrease in other interest expenses to KES 331.9 million.
- Interest expenses from customer deposits grew by 9.1% y/y to KES 967.5 million as customer deposits edged up by 15.8% y/y to 39.2 billion. The cost of customer deposits declined marginally to 5.1% (1H2019: 5.2%).
- Consequently, net interest income declined by 3.9% y/y to KES 987.3 million. The net interest margin grew slightly to 4.5% (1H2019: 4.4%) due to a decline in interest earning assets (-2.1% y/y to KES 44.3 billion).
- Non-funded income fell by 68.8% y/y to KES 285.6 million predominantly due to a 79.2% plunge in other income to KES 148.0 million (1H2019: KES 712.2 million).
    - Other fees and commissions decreased by 61.9% y/y to KES 61.0 million.
    - Fees and commissions on loans and advances rose by 42.1% y/y to KES 38.3 million.
    - Consequently, the contribution of non-funded income to total income fell significantly to 22.4% (1H2019: 47.1%).
- Operating expenses (excluding provisions) declined by 22.1% y/y to KES 1.3 billion (1H2019: KES 1.7 billion) owing to a 39.6% y/y dip in other expenses to KES 539.6 million
    - The cost to income ratio (excluding provisions) improved to 85.8% (1H2019: 102.0%).
- Loan loss provisions fell by 27.6% y/y to KES 267.6 million as gross non-performing loans decreased by 8.2 y/y to KES 11.9 billion. The NPL ratio (net NPL/net loan book) improved to 14.3% (1H2019: 18.7%).

INSURANCE SECTOR:

Kenya Re

We assign a **HOLD** recommendation on Kenya Re. The counter is currently trading at a trailing P/B multiple of 0.07x (at a price of KES 2.12 as at 27th November 2020) compared to the industry average of P/B ratio of 3.18x.

The company has a return on average equity (ROaE) of 13.2% (third highest amongst listed insurance companies) and a dividend yield of 4.2% -- the highest amongst listed insurance companies.

Counter	ROaE	Dividend Yield
Britam	13.3%	3.4%
CIC	4.1%	0.0%
Sanlam	6.9%	0.0%
Jubilee	13.9%	3.1%
Liberty	9.5%	0.0%
Kenya Re	13.2%	4.2%

Our recommendation is based on the following factors:

Investment Considerations

- Despite increasing competition in foreign markets, Kenya Re still maintains a leading position in its domestic market (it is the national re-insurer in Kenya) and is supported by the national government (which owns 60.0% stake through the National Treasury).
- Kenya Re has robust levels of capital and liquidity; as at 1H2020 total equity stood at KES 33.1 billion with retained earnings accounting for KES 20.2 billion. Kenya Re recently (in July 2020) received a national scale financial rating of AA+ with a stable

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outlook from Global Credit Ratings (GCR) on the back of a strong capital base and healthy liquidity. We believe the strong capital and liquidity position provides the company with the requisite financial muscle to further its diversification strategy (Kenya Re plans to venture into Egypt post-pandemic).

Risks

- We expect rising competition to continue being a major challenge to Kenya Re going forward. In the last few years, the company has persistently encountered increased competition from local and international markets occasioned by:
    - rising domestication of reinsurance in several key markets and setting up of national re-insurance companies in countries where they didn't exist before
    - price undercutting amongst re-insurers
- In 1H2020, investment income dipped by 2.1% y/y to KES 1.9 billion. This is attributable to the effect of the COVID-19 pandemic which has resulted in a depressed investment environment. We expect to continue to witness depressed earnings from the investment portfolio due to challenges in the investment climate (low yields and low equity returns).
- In 1H2020, net claims and benefits from the short-term business eased by 1.8% to KES 4.6 bn – bucking trend witnessed since FY2017 (i.e. double digit growth). This resulted in a decrease in the loss ratio to 59.2% (1H2019: 70.0%). We opine that the lower claims and benefits witnessed in the short-term business were influenced by reduced activities (transportation, business activities) due restrictions imposed to curb the spread of COVID-19. With the easing of COVID-19 restrictions, there is a high likelihood that claims and benefits in the short-term business may once again rise in 1H2020. Thus, we remain cautiously optimistic about the improvement in underwriting results.
- We also note that Kenya Re's reinsurance receivables have once again come under pressure in the 1H2020 despite the improvement witnessed in the collection of reinsurance receivables in FY2019 (which declined by 28.5% to KES 2.6 billion in FY2019). We opine that collection efforts will continue to be hampered in FY2020 owing to the economic challenges brought on by the COVID-19 pandemic, consequently resulting in higher provisions.

ENERGY SECTOR:

KenGen

We recommend a **LONG-TERM BUY** on KenGen. The counter is currently trading at a trailing P/E multiple of 3.84x (at a price of KES 3.84 as at 27th November 2020).

KenGen recently released its 1H2019/2020 results showing a 98.1% y/y growth in after tax profits to KES 8.2 bn. The jump in after tax profits was predominantly due to a tax credit of KES 1.9 billion occasioned by capital allowances following the commissioning of 165 MW Olkaria V.

Our recommendation is based on the following factors.

Investment Considerations

Capacity expansion:

KenGen is actively pursuing its Revamped Horizon III Good-to-Great (G2G) Strategy that is largely focused on geothermal capacity expansion (totaling 439 MW). KenGen benefits from plant commissions through tax credits (during the financial years in which they are commissioned), increased capacity revenues (accounting for a larger share of electricity revenues at 72.2% -- as at FY2017/2018) and the potential to increase energy revenue (through energy sales). The following is a brief description of pipeline projects according to the company;

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- 83.3MW Olkaria 1 unit 6 plant is in the advanced stages and is expected to be commissioned in 2021
- Contract processes for the 140MW Olkaria VI plant and Olkaria I Rehabilitation (from 45MW to 51MW) are at advanced stages

Direct electricity sales:

With the introduction of the Energy Act 2019 (which allows other players other than Kenya Power to sell electricity to consumers), KenGen has the ability to pursue direct energy sales. According to media reports, KenGen is currently seeking the approval of the Energy and Petroleum Regulatory Authority (EPRA) to sell electricity directly to flower firms and large industrial investors in the proposed Naivasha Industrial Park. If approved, this would enhance KenGen electricity sales and open the door for similar direct sales especially for companies in the Special Economic Zones.

Revenue diversification:

The company is also actively pursuing a revenue diversification strategy. Some of the initiatives include:

- Consultancy and drilling services; in 2019 KenGen was awarded a KES 5.2 billion tender to drill geothermal wells in Ethiopia and is reportedly currently pursuing geothermal infrastructure tenders in nine African countries
- KenGen recently entered into an agreement with Nairobi County to generate electricity from garbage
- KenGen announced plans to set up electric car charging infrastructure

Key Risks

Reduced tax credits:

With the review of tax allowances from a maximum of 150.0% to 50.0% of capital investment, going forward KenGen may not benefit as much from tax credits as it did it in the past from the commissioning of new plants as it did it in the past.

Regulatory risks:

Owing to the negative impact of the coronavirus (COVID-19) pandemic (reduced electricity demand), there has been a lot of uncertainty as to whether Kenya Power will honor existing power purchase contracts from power producers. The Ministry of Energy had earlier announced (June 2020) that it will invoke the force majeure clause in wholesale power generation contracts. The invocation of the clause indicates that Kenya Power will not be obliged to fulfill the payment of existing power purchase contracts from power producers. The nature of the contracts generally requires Kenya Power to purchase a set amount electricity while also compensating power producers for electricity availability/capacity.

The declaration of force majeure implies Kenya Power will not be obliged to pay for excess power i.e. the difference between the power consumed and the power acquired from power producers ("take or pay" model of power purchase agreement (PPA)). At present, it remains unclear as to whether the force majeure affects only the payment of unused electricity or also electricity capacity. KenGen generates electricity revenues from both sources – energy revenue and capacity revenue. If the force majeure affects electricity capacity as well this will significantly affect KenGen financial performance in FY2020/2021. However, since this is still unclear, we expect more clarifications going forward.

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Furthermore, with the easing of COVID-19 restrictions, we expect rising electricity demand to potentially reverse the invocation of the force majeure clause.

Conclusion

Whilst we expect the reduction in tax allowances to weigh down profitability in commissioning years, we believe that the capacity expansion initiatives and the revenue diversification initiatives have the potential to anchor growth for the company -- especially in the long-term thus we recommend a **LONG-TERM BUY** on KenGen.

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Summary

Counter	Recommendation	YTD Change	Price as at 27-11-2020
Housing Finance	Sell	-49.69%	3.25
KenGen	Long-term Buy	-19.41%	4.61
Kenya Re	Hold	-30.03%	2.12

For Online Share Trading (OST) via browser, 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 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.

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