FAIDA INVESTMENT BANK

INVESTMENT RECOMMENDATIONS REPORT

9th April 2021

Equity Recommendations

Overall Overview

In 2020, the COVID-19 pandemic saw prices on most counters decline significantly into bear market territory. The NASI, NSE20 and NSE25 declined by 8.6%, 29.6%, 16.7% to 152.11, 1,868.39 and 3,415.24 respectively at 31st December 2020.

The gradual easing of restrictions in the second half of year created expectations of economic recovery in 2021. This created some optimism in the NSE. As at 26th March 2021(the day of the announcement of the new containment measures), the NASI, NSE 20 Share NSE 25 Share were up by 9.4%, 1.9% and 4.2% to 166.48, 1,903.06 and 3,666.29 YTD respectively.

The third wave of the pandemic has seen resumption in movement restrictions and limitations on business activities. We expect the new measures to derail the economic recovery if maintained for an extended period of time.

We expect a lot more caution in the equities market and reallocation to safe havens (e.g. government securities). With this, we also expect opportunities to emerge for investors with a long term outlook and those who do not have liquidity constraints.

We highlight some of these opportunities in the next section.

Equity Group

We issue a **HOLD** recommendation on Equity group Holdings, with a target price of **KES 41.07** representing an **8.9%** upside from the current market price KES 37.70 (as at 9th April 2021). The stock is currently trading at a trailing P/B of 1.03x and forward P/B of 1.0x. We remain cautiously optimistic on the bank, expecting an improvement in profitability driven by both funded and non-funded income as well as improved efficiencies. However, we expect asset quality pressures to persist in the short term.

Key Highlights

a) **Transactional Revenue Continues to Drive Non-Funded Income:** We expect Equity to leverage on its SME customer base to cross sell transactional products with strategic partnerships around diaspora remittances, trade finance and merchant banking.

b) **Cost optimization through digital banking:** While we expect the overall C/I ratio to decline going forward, we note that the rise in operating expenses will be largely driven by the continued reliance on the brick and mortar model by regional subsidiaries, particularly Equity BCDC.

c) **Cautious lending:** We expect the group's loan book to continue registering growth with a conservative approach to Covid-19 high risk sectors and continued investments in liquid securities.

d) **Weakening asset quality:** We expect the cost of risk to remain elevated with i) new covid-19 regulations that will result in subdued business environment ii) bank's exposure to high risk sectors such as SMEs (51.0%), Trade (21.0%) and Real Estate (16.0%). We expect this to gradually decline going forward.

FY2020 FINANCIAL RESULTS

Equity Group recorded a 10.9% y/y decline in after tax profits to KES 20.1 billion (-11.8% y/y EPS to 5.24) mainly attributed to a surge in loan loss provisions and cushioned by deferred tax asset of KES 8.2 billion. ROE dipped to 15.3% from 21.8% in FY2019. The group's board of directors did not declare a dividend payment.

a) Declining Net Interest Margin

Net Interest Margin (NIM) declined by 110bps y/y to 7.2% driven by a 120bps y/y decline in yield from interest earning assets. This was however buoyed by cheaper cost of funds (-10bps y/y to 2.8%) supported by mobilization of transactional deposits and concessional funding.

Should the CBK permit re-pricing of loans on a risk-adjusted basis, we position Equity to benefit the most, given 51.0% loan book exposure to SMEs. Additionally, alternative channels will continue driving the mobilization of cheaper deposits. We therefore expect to see a gradual escalation of NIMs.

b) Transactional Revenue Continues to Drive Non-Funded Income

Non-funded income grew by 25.1% y/y to KES 38.5 billion boosted by forex trading income (+77.2% y/y). Diaspora remittances contributed 32.0% of the volume of forex traded. Other income grew by 58.6% y/y mainly attributed to mark to market gains of KES 4.0 billion on government securities. Transactional income now contributes 66.5% to non-funded income, mitigating the group from credit related risks.

We expect Equity to leverage on its SME customer base to cross sell transactional products with strategic partnerships around diaspora remittances, trade finance and merchant banking.

c) Improved Cost Efficiency

The group continues to reap the benefits of its digitization strategy as the C/I ratio declined to 48.5% from 51.1% in FY2019 (Kenyan subsidiary C/I ratio at 41.5% from 46.4%). As at FY2020, 98.0% of the group's volume of transactions and 60.0% of transactional value occurred on alternative channels. While we expect the overall C/I ratio to decline going forward, we note that the rise in operating expenses will be largely driven by the continued reliance on the brick and mortar model by regional subsidiaries particularly Equity BCDC

d) Asset Base Surpasses KES 1.0 trillion

Following the completion of the BCDC acquisition during the year, the group's asset base grew by 50.7% y/y to KES 1.0 trillion. Customer deposits grew by 53.5% y/y to KES 740.8 billion while borrowed funds from development partners increased 54.1% y/y to KES 87.2 billion. The loan book grew by 30.4% y/y to KES 477.8 billion with exposure to SMEs reducing to 51.0% (59.0% in FY2019) in favor of large corporates 19.0% (13.0% in FY2019). We see this cautious lending strategy persisting, particularly to Covid-19 high risk sectors.

e) Deteriorating Asset Quality

As at FY2020, the group had restructured KES 171.0 billion (32.0% of its loan book portfolio), warranting a significant increase in loan loss provisions, +402.2% y/y to KES 26.6 billion with the cost of risk at 6.1% from 1.3%. Gross NPLs surged 63.7% y/y to KES 59.4 billion leading to an NPL ratio of 11.0%.

Of the restructured loans, 33.0% were in real estate, 23.0% in trade, 9.0% in transport, 8.0% in tourism and 7.0% in manufacturing. As at December 2020, KES 20.0 billion of the restructured loans became paying, with KES 9.0 billion downgraded to stage 3. We expect the cost of risk to remain elevated with i) new covid-19 regulations that will result in subdued business environment in the medium term ii) bank's exposure to high risk sectors.

f) Regional Banking Subsidiaries Support Growth

The regional banking subsidiaries defied the economic challenges to post growth in profitability (except Tanzania). Rwanda and Uganda both recorded ROaE of 22.0% against a cost of capital of 19.0%. Following the acquisition of BCDC, we believe the subsidiary offers the most scaling potential (country's unbanked population of 28.4% unbanked population against 17% in Sub-Saharan Africa), now contributing 28.1% of the group's assets. Regional subsidiaries now contribute 28.0% to the group's overall profitability from 18.0% in FY2019, mitigating the group's business risk from the Kenyan subsidiary.

g) Capital Adequacy Ratios Boosted by Development Funding

The group propped its core capital by withdrawing dividend payment of KES 9.5 billion (2nd year consecutively) and raising KES 11.0 billion Tier 2 capital from development partners. Core Capital/Total Risk Weighted Assets (TRWA) stood at 16.3% (FY2019: 14.8%) while Total Capital/TRWA was at 19.8% (FY2019: 18.9%).

EABL

We recommend a **LONG TERM BUY** on EABL. The counter is trading at a KES 163.75 at a P/E multiple of 31.7x, with a dividend yield of 1.8% and

ROE of 46.6%. **We recommend investors with a long term view to take buying positions in the counter**.

Given the business trajectory over the years and the group's agile adaptability to the current challenging operating environment, we are confident in the group's robust business strategy to return to strong growth in the medium term. We therefore expect a bounce back in performance, albeit gradually, towards pre-Covid levels. We remain confident in performance going forward given improved performance in 1H2021 compared to 2H2020 (following the ease of restrictions). Comparing the two periods:

- Volume grew by 45.0%
- Gross sales grew by 52.0% to KES 78.2 billion
- Gross profit grew by 73.0% to KES 19.3 billion
- Profit after tax grew by 55.5% to KES 3.8 billion

Growth Drivers

- **Changing business model** - In line with economic and consumer shifts, the group managed to shift its business model, adapting to e-commerce channels and growth in the off-trade business (increased product portfolio in supermarkets and retail outlets). We expect the company to continue delivering insight driven innovations to capture evolving consumer preferences.
    - In particular, we expect continued sustainable growth in the spirits category, particularly the premium segment. Spirits have consistently outperformed beers over the years, registering double digit growth (12.0% growth y/y in 1H2021)
    - The group expects continued growth in mainstream beer across East Africa given continued investment -- expected capacity expansion CAPEX of KES 1.6 billion.
- **Operational efficiencies** - We expect the group to continue reaping the benefits of its productivity and sustainability initiatives, cushioning the bottom line. This includes investments in renewable energy to improve production processes in water, energy and waste management. Additionally, in light of Covid-19, EABL has managed to optimize its selling and distribution costs (selling costs and administrative expenses declined by 43.0% and 6.0% y/y as at 1H2021).
- **Sustained growth in Tanzania** - Tanzania presents opportunity for growth in both the short and long term driven by the Serengeti brand (double digit growth the past 3 years -- +21.0% in FY2019, +19.0% in FY2020 and 16.0% in 1H2021.
- **Portfolio diversification** - The diversified product portfolio has insulated the firm from excessive losses during periods of uncertainty. Going forward, management expects premium brands and mainstream beers to drive growth. In particular, the group expects innovation around their gin portfolio (across different price points), that has gained traction the past 2 years.
- **Strong parent company** - Leveraging on Diageo's financial support and in particular the recovery fund to support pubs and bars post lockdown, we expect a quicker turnaround for the firm.

Risks

- With the new Covid-19 measures in place that have resulted in cessation of movement and closure of bars and restaurants in high risk zones country-wide, we expect depressed sales volumes in 2H2020 particularly in the on-trade business that remains the core revenue driver.
- We expect the pandemic's aftermath to have short term risk particularly on consumer purchasing power that has led to down trading of product portfolio consumption.
- Foreign currency fluctuations remain a risk given the group's operations across the East African region exacerbated by the Shilling depreciation, resulting in translational losses.

Summary

Counter	Recommendation	52-week High	52-week Low	Price as at 9th April 2021	Target Price	Upside/(Downside)	Expected DPS	YTD Change
Equity Group	Hold	43.00	28.00	37.70	41.07	8.9%	2.21	3.1%
EABL	Long term Buy	185.00	143.25	163.75	*N/A	N/A	*N/A	6.2%

****Not rated**

For Online Share Trading (OST) via browser, please click here:
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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