Nairobi Securities Exchange (NSE) IPO – Research Note

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Investment Summary

We place a **NEUTRAL** recommendation on the Nairobi Securities Exchange (NSE) with a target price of KES 14.13 that represents a 48.8% upside potential from the offer price (KES 9.50). The recommendation is informed by our adjusted earnings that revealed a declining trend in the ROE.

Key Highlights

- **Majority of income derived from transaction levies**: Transaction levies accounted for 65.2% of total income in FY2013 and 83.0% of operating income the same financial year.
- **Increased efforts to increase alternative revenue streams**: The company books additional revenue from listing fees, interest income, data vending, rental income and others.
- **New market initiatives that are expected to boost trading activity**: The company plans to launch key initiatives such as a derivatives exchange, asset backed securities and exchange traded funds.
- **Declining trend on return metrics**: The company has posted a declinign trend on both Return on Equity (ROE) and Return on Assets (ROA) when earnings are adjusted for recurring income.

Key Initial Public Offer (IPO) details

Selected Offer Data	
Par value of NSE shares	KES 4.00
Offer Price (KES)	9.50
Issued and fully paid up share capital of NSE (KES)	514,500,000
Unissued and fully paid up share capital of NSE (KES)	335,500,000
Number of issued and fully paid up shares of NSE	128,625,000
Offer shares	66,000,000
Gross Proceeds of Offer	627,000,000
No. of issued and fully paid up shares of NSE post-offer assuming full subscription	194,625,000
Trailing price-earnings ratio using the diluted earnings per share above (KES)	**4.66**
Trailing price-earnings ratio using the earnings per share above post offer assuming full subscription (KES)	**7.05**

Source: NSE, FIB estimates

Timetable

Event	**Time**	**Date**
Offer Opens	9:00 a.m.	24-Jul-14
Offer Closes (Closure Date)	4:00 p.m.	12-Aug-14
Public announcement of the results of the offer	by 5:00 p.m.	3-Sep-14
Electronic crediting of CDS accounts and processing of refunds (if applicable) (Refund Date)	by 5:00 p.m.	4-Sep-14
Self-Listing and commencement and trading of fully paid NSE shares on the Exchange (Self-Listing Date)	9:00 a.m.	9-Sep-14

Source: NSE

Brief Introduction

The Nairobi Stock Exchange (NSE) was set up in 1954 as a voluntary association of stockbrokers registered under the Societies Act and was first incorporated as a private company on 29 November 1990. The company's principle activity is providing securities exchange services.

On the 6 July 2011, members of the NSE resolved to change the name from Nairobi Stock Exchange to Nairobi Securities Exchange. Following ammendments to the Capital Markets Legislation, the NSE was re-registered as a company limited by shares on 21 September 2011.

Use of Proceeds

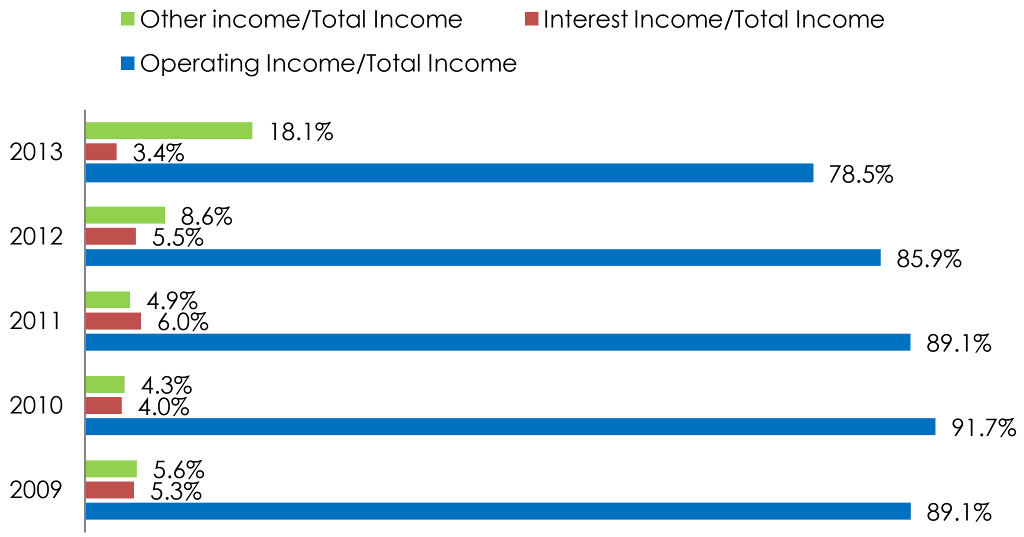
The NSE plans to deploy the the net proceeds of the IPO in the following manner:

- Investing in new infrastructure needed to support various expansion initiatives: These include the Automated Trading System upgrade and Bonds Trade Reporting System (Software implementation fees, licenses, hardware costs, training and other project expenses). Investment is also considered for the Futures License Fees, Hardware Servers for capacity enhancement, service desk system, additional trading floor computers, network management software and screen and an administration system.
- Mortgage debt reduction: The KES 300 million mortgage from Kenya Commercial Bank (KCB) is repayable in equal monthly installments of KES 4.84 million over a 5 year period. The loan is secured by a legal charge of KES 300 million over the property purchased and a debenture of the same amount over the assets of the company. KES 140 million (KES 120 million paid during FY2013 and KES 20 million paid in January 2014) has since been made.
- Provide seed capital towards the settlement guarantee fund for futures.

We view the above planned initiatives as positive revenue-generating actions characterized by improved service delivery, increased product offering and cost efficiency. However, our going concern will be delays that may arise in the implementation of these projects.

Revenue Analysis

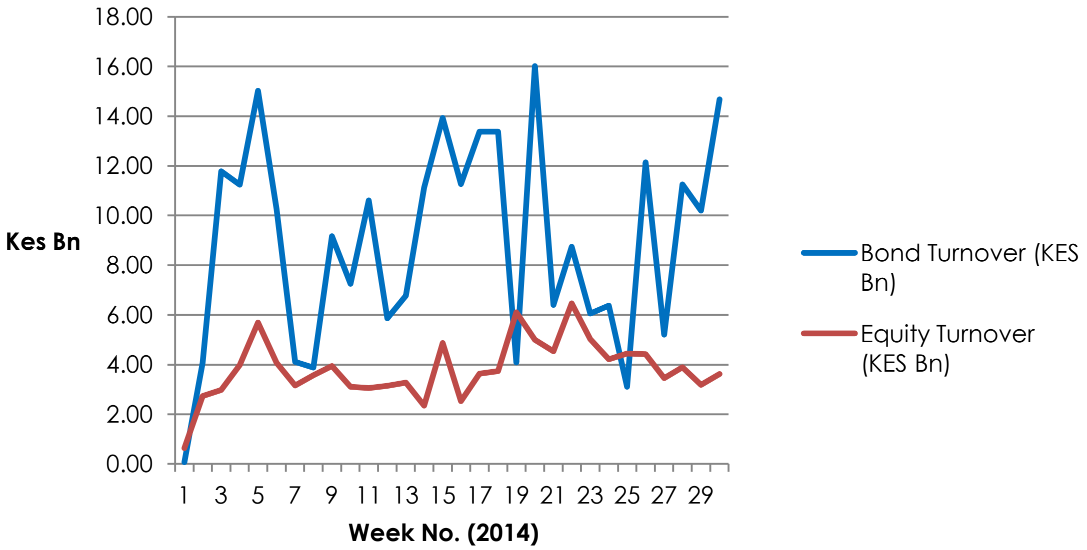
The company's income is segmented into operating income, interest income and other income. Operating income stood at 78.5% of total income in FY2013 followed by other income and interest income at 18.1% and 3.4% respectively.



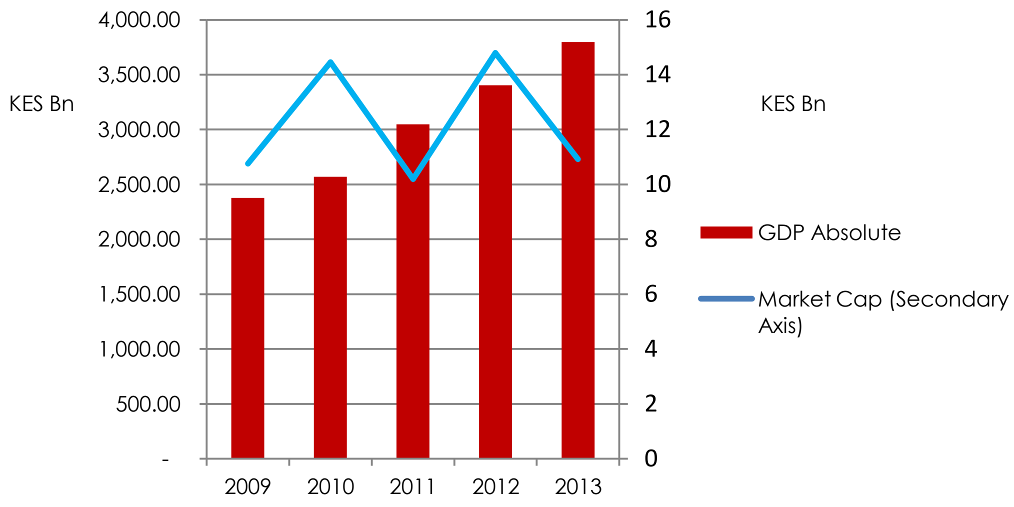
Transaction Levies: The NSE primarily derives its revenue from transaction levies on both equity and bond transactions. Transaction levies accounted for 65.2% of total income in FY2013 and 83.0% of operating income the same financial year.

The company currently charges a 0.12% levy on the value of an equity transaction and a 0.0035% levy on the value of a bond transaction. As a result, revenue growth from transaction levies is dependent on both equity and bond turnovers.

The chart below depicts the equity and bond turnovers from the beginning of the year.



Going forward, we believe that equity turnovers are bound to increase albeit at a rate dependent on the macroeconomic environment. Key macroeconomic indicators we considered imperative in our opinion include the GDP, interest rates, inflation, exchange rates and the debt management strategy.

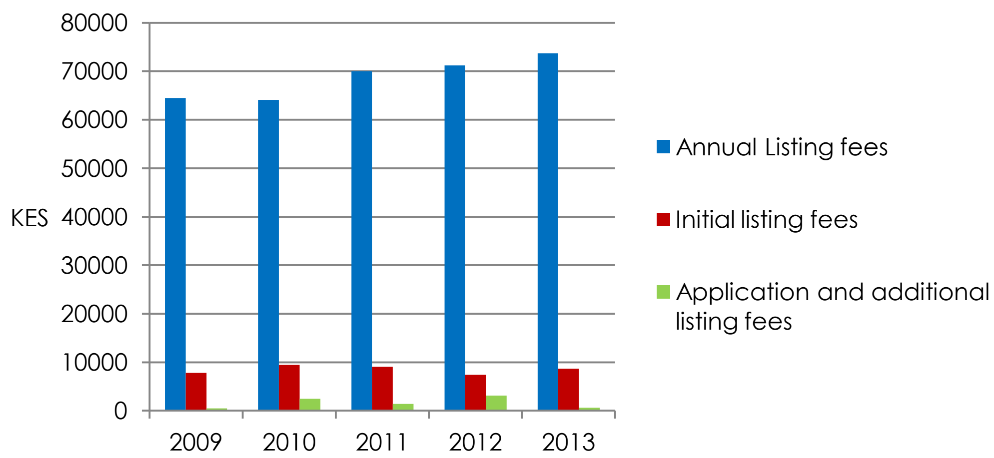


Although the Government and the financial sector at large have expressed willingness to lower interest rates, inflation may pose a significant threat towards their endeavor. We therefore do not expect a significant drop in the interest rates in the short-term but rather a stable or slow reduction in the medium term.

As a result, we believe that bond turnover may post marginal growth in the medium term driven by the current stable macroeconomic environment. Investors may seek higher returns in the equity market that may benefit from lower interest rates and general economic growth across the board.

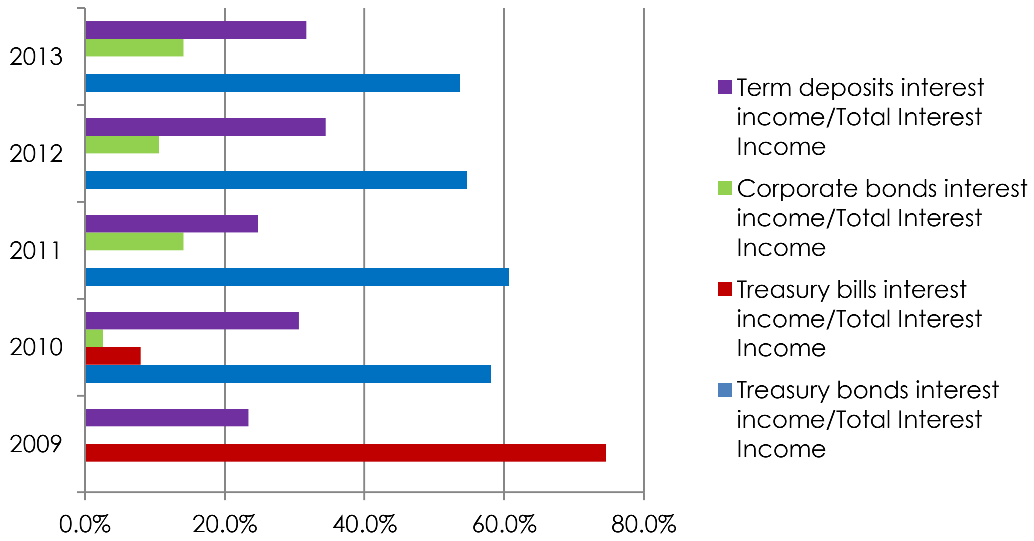
Going forward, we believe that equity turnover can be spurred by the planned equity capital market initiatives the NSE plans to undertake (reduced settlement cycle, introduction of margin account, short selling and securities lending etc). We are however not convinced if the initiatives will be implemented in good time.

Annual, Initial, Application and Additional listing fees: The NSE books additional revenue from annual, initial, application and additional listing fees. Annual listing fees grew at a 5 year CAGR of 3.4% to KES 73 million (FY2013) from KES 64 million (FY2009) while initial listing fees grew at a CAGR of 2.5% to KES 8.6 million from KES 7.8 million during the same period. Application and additional listing fees recorded an average growth of 97.3% during the period under review but a lower CAGR of 5.7% to KES 623,000 (FY2013) from KES 500,000 (FY2009).



In an effort to diversify its revenue streams, the NSE has diversified into the following: -

Interest Income: The NSE's interest income grew at a 5 year Compounded Average Growth Rate (CAGR) of 21.6% from KES 9.8 million in FY2009 to KES 21.4 million in FY2013. Interest income is driven by interest on held to maturity treasury bonds and corporate bonds and interest on term deposits. Interest on treasury bonds, term deposits and corporate bonds accounted for 53.5%, 31.7% and 14.1% respectively of the total interest income in FY2013.



	2009	2010	2011	2012	2013
Treasury Bonds yield	0.0%	4.7%	7.9%	7.4%	7.3%
Corporate Bonds yield	0.0%	0.9%	8.1%	6.3%	8.5%
Term deposits yield	3.3%	4.8%	8.3%	20.8%	5.0%

Source: FIB Estimates

Given a stable macroeconomic outlook, we expect the NSE to steadily reduce its holdings in government securities and increase the corporate bond book and term deposits as they may offer higher returns.

Data Vending: The NSE sells a broad spectrum of data on market performance and investor participation (both local and foreign). Income from data vending grew at a 5 year CAGR of 24.1% from KES 6.7 million in FY2009 to KES 15.8 million in FY2013. We expect income from data vending to maintain its growth trajectory in the medium term as the company adds more products to its current portfolio.

Broker back office subscription: Income from broker back office subscription grew signifcantly by 71.8% to KES 21.2 million (FY2013) from KES 12.4 million (FY2012). The growth was propelled by increased subscription and product offering that includes Clear Vision and Trader Work Station softwares. We expect income from broker back office subscrition to post moderate growth in the medium term driven by a stable subscription base and increased product offering.

Market Access: The market access fee is the fee charged to a new company on admission as a trading participant on the NSE. The company recorded a non-recurring income of KES 40 million in FY2013 following the admission of CBA Capital. Given the non-recurring nature of this income stream, we do not expect frequent revenue from it in the short term.

Rental Income: The company acquired investment property worth KES 242 million in FY2012 partly financed by a loan of KES 300 million from Kenya

Commercial Bank. Rental income for FY2013 was KES 25 million and stood at 4.1% of total income. Going forward, our short term expectations are that the rental yield will be higher than the 8.7% recorded in FY2013. This is informed by the increasing demand for commercial space within the capital.

Investment in CDSC: The NSE held a 22.5% stake in the Central Depository and Settlement Corporation (CDSC) Limited as at the end of FY2013. The CDSC provides services relating to clearing, settlement and depository services. The share of profits from the CDSC increased by 309.6% in FY2013 to KES 14 million.

New Market Initiatives

The table below highlights the new market initiatives that the company expects to increase listings and trading activity.

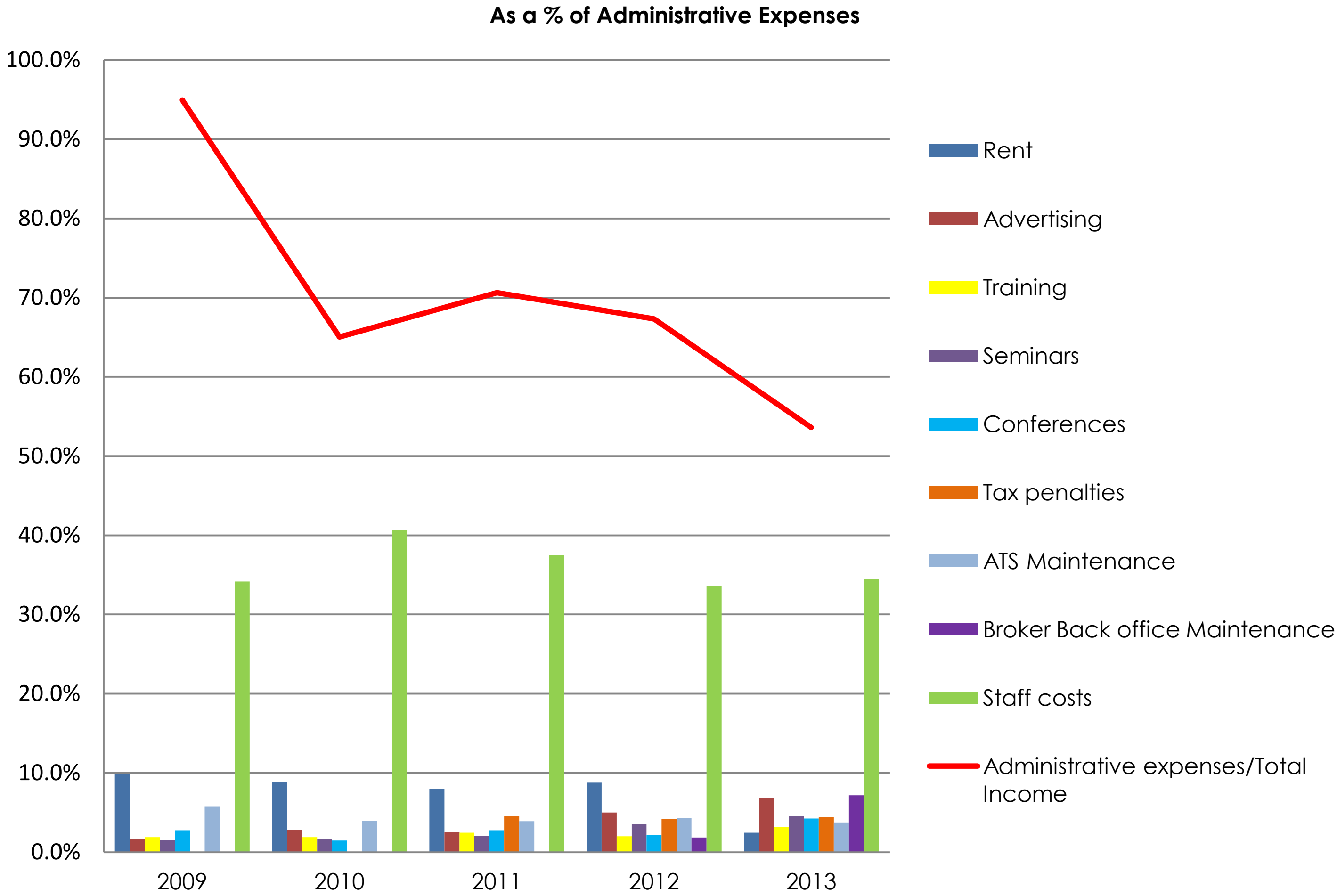
New Market Initiatives	Definition	FIB Comment
Real Estate Investment Trusts (REITs)	Regulated investment vehicle that enables persons to collectively contribute funds for the acquisition of rights in a trust with the intention of earning income from real estate as the underlying assets of the trust.	Given the high level of interest from both listed and unlisted companies, we believe that the listing of REITs would be a catalyst for both transaction and listing revenues.
Asset Backed Securities	A security whose value and income payments are derived and collateralized by a specific pool of underlying securities	We do not expect listing of any asset backed securities in the short term given the limited number of assets that could be collateralized (e.g. Mortgages, Credit card repayments)
Listed Unit Trusts/Exchange Traded Funds	Investment funds that can hold different types of securities and can be traded on the exchange.	We expect the introduction of Exchange Traded Funds to occur in the medium term given the stage of growth and development of the capital markets.
Derivatives Exchange	Central financial exchange where people can trade standardized futures and options contracts; trade specific quantities of a commodity or other underlying assets at a specific price with delivery set at a specific time in the future.	The formation of the derivatives exchange is dependent on the speed at which the relevant authorities approve the company's application. Should the application be successful and the response timely, we believe the futures exchange would be a significant driver of income going forward.
Mining sector	Ministry of Mining appointed the NSE to chair the taskforce that has been appointed to establish a mining and minerals exchange to serve the region.	The establishment of the mining and minerals exchange is also highly dependent on the approval and response of the relevant authorities. We therefore believe that this would be a viable revenue stream in the long term.

Source: NSE, FIB

We will be keen to see how fast these initiatives are implemented.

Cost Analysis

Administrative Expenses: Administrative expenses grew at a 5 year CAGR of 17.5% to KES 333 million in FY2013 from KES 175 million in FY2009. Key constituents of administrative expenses during this period include rent, advertising, training, seminars, conferences, tax penalties, ATS maintenance, Broker Back Office maintenance and staff costs.



Going forward, we expect upward pressure on advertising, seminar and conference costs given the company's planned initiatives to market itself (both domestically and internationally) and increase investor participation. Increases in costs are also expected in training, ATS maintenance, Broker Back Office Maintenance and staff costs as the company upgrades its sytems and infrastructure and trains its personnel.

Rental costs have since been replaced with interest expenses following the acquistion of investment property in FY2012.

Finance Costs: Interest expense on borrowings rose significantly in FY2013 to KES 39.4 million from KES 1.5 million in FY2012. The company plans to use the proceeds of the IPO to accelerate repayment of the KES 300 million loan from KCB. FY2013 effective interest rate was 15.0% with an accelerated repayment of KES 120 million in FY2013 and KES 20 million in January 2014.

The statement of cash flows for the four months period ended 30 April 2014 indicates KES 32 million for loan repayment and KES 7 million for loan interest payment. This indicates the company's continuing intentions to accelerate loan repayment.

We view this as a positive action to increase the company's bottom line in the short term. Should the IPO be succesful, interest expense is expected to be lower in the FY2014 income statement and cleared thereafter.

Key Investment Risks

Exposure to macroeconomic shocks: The company's revenues are vulnerable to adverse macroeconomic shocks that may affect both equity and bond turnovers. A stable macroeconomic outlook is expected with inflation currently in the Monetary Policy Committee's range and stable interest rates. However, currency depreciation may be expected given the persistent current account deficit which stood at 9.8% of GDP in April 2014.

Legislation implementation: The business and operations of the NSE are closely monitored and regulated by the Government through the Capital Markets Authority (market regulator). The regulatory framework within which the NSE operates may have adverse effects either through lag to implementation or through new laws and regulations.

Liquidity: We expect the NSE shares to be relatively illiquid in the short term given the nature of majority of the incumbent shareholders. The Demutualization of the Nairobi Securities Exchange Limited Regulation (2012) requires the trading participants to reduce their cumulative shareholding in the NSE to not more than 40.0% within three years. We therefore expect gradual sale of shares by the trading participants towards the stipulated three year deadline. This could lead to periods of extremes of supply of demand that may affect price discovery.

Financial Statements

Income Statement (KES '000)	**FY2009**	**FY2010**	**FY2011**	**FY2012**	**FY2013**	**FY2014**
Operating Income	164,387	292,797	301,946	329,961	488,767	520,554
Interest Income	9,802	12,680	20,497	21,184	21,420	19,730
Other Income	10,340	13,656	16,542	33,185	112,528	80,271
TOTAL INCOME	**184,529**	**319,133**	**338,985**	**384,330**	**622,715**	**620,555**
Administrative Expenses	(175,246)	(207,566)	(239,466)	(258,801)	(333,839)	(382,406)
Finance Costs	-	-	-	(1,521)	(39,360)	(12,283)
Share of Profit of Associate	1,639	3,019	6,190	3,479	14,252	17,102
Recovery of/(Provision for) Doubtful Debts	(42,623)	(300)	(675)	(100)	115,574	-
Profit /(Loss) before Tax	**(31,701)**	**114,286**	**105,034**	**127,387**	**379,342**	**242,968**
Taxation Charge	(4,050)	(35,081)	(19,401)	(42,606)	(117,077)	(72,890)
Profit/(Loss) for the Year	**(35,751)**	**79,205**	**85,633**	**84,781**	**262,265**	**170,078**

FY2013 recorded a non-recurring recovery of KES 115 million (amounts recievable from Francis Thuo & Partners Ltd.). No significant recoveries are expected going forward.

Condensed Balance Sheet (KES '000)	FY2009	FY2010	FY2011	FY2012	FY2013	FY2014
ASSETS						
Equipment	32,911	18,210	26,597	161,054	194,162	184,454
Investment Property	-	-	-	242,485	294,628	294,628
Intangible Assets	41,549	26,118	61,783	79,947	106,904	110,111
Corporate Bonds	-	35,276	35,507	35,509	35,509	35,154
Government securities	34,554	157,208	157,537	157,445	156,889	156,261
Term deposits	69,064	-	60,994	35,026	135,744	122,170
Bank and cash balances	42,002	80,813	12,483	44,546	34,304	519,914
Total Assets	**302,971**	**403,053**	**475,319**	**882,690**	**1,149,137**	**1,630,543**
LIABILITIES						
Non-current Borrowings	-	-	-	285,982	128,060	-
Current Borrowings	-	-	-	15,539	36,568	-
Trade and other payables	37,332	37,345	45,582	66,658	170,976	192,646
Tax payable	-	21,596	-	-	69,460	20,843
Dividends payable	-	-	-	22,000	5,050	-
Total Liabilities	**38,064**	**58,941**	**45,582**	**390,179**	**418,334**	**221,709**
Shareholders' Funds	**264,907**	**344,112**	**429,737**	**492,518**	**730,810**	**1,408,833**

Return Metrics	2010	2011	2012	2013	2014
ROaE	26.0%	22.1%	18.4%	42.9%	4.0%
ROE	23.0%	19.9%	17.2%	35.9%	12.1%
ROaA	22.4%	19.5%	12.5%	25.8%	3.1%
ROA	19.7%	18.0%	9.6%	22.8%	10.4%
FY2013 ROE (Using earnings less non-recurring income)				14.6%	
FY2013 ROA (Using earnings less non-recurring income)				9.3%	

*Non-recurring income = Market access fee, Recovery of doubtful debts

Comparative Analysis	JSE	MAL	NSE*
P/E	15.4	26.26	7.05
P/B	3.87	5.4	1.67
FY2013 ROE	24.96%	20.50%	35.9%
FY2013 ROA	2.63%	8.50%	22.80%
FY2013 Sustainable Growth Rate	7.82%	10.40%	29.2%
FY2013 Net Profit Margin	32.10%	39.40%	53.7%
EV/EBITDA	9.41	12.77	

*Calculated using 194,625,000 shares

P/E Analysis	
FY2013 Earnings (KES)	262,265,000
Number of shares post-offer (Assuming full subscription)	194,625,000
Earnings Per Share (EPS) post offer	1.35
Offer Price	9.50
Trailing P/E ratio	**7.05**
FY2013 Earnings less non-recurring income	106,691,000
EPS using FY2013 earnings less non-recurring income	0.55
P/E ratio using EPS above (earnings less non-recurring income)	**17.33**

Outlook

We applaud the company's initiatives to spur trading activity, increase turnover and increase investor participation. The initiatives may boost the company's revenues and increase efficiency in trade executions. However, we remain concerned about the implementation lag, free float of the shares once listed and the declining trend of the ROE.

Recommendation

We place a **NEUTRAL** recommendation on the NSE. We used the EV/EBITDA Multiple approach to value the company.

EV/EBITDA Valuation	
Forecasted EBITDA	**259,746**
Average Comparables EV/EBITDA Multiple	11.09
Enterprise Value	**2,881,224**
Add cash and cash equivalents	34,304
Less Total Debt	164,628
Market Capitalization	2,750,900
Number of Shares	194,625
Target Price	**14.13**
Upside Potential	**48.8%**