BPI Capital Africa

EQUITY RESEARCH

# Kenyan Banks

23rd February 2016

Kenya

# Much To Gain

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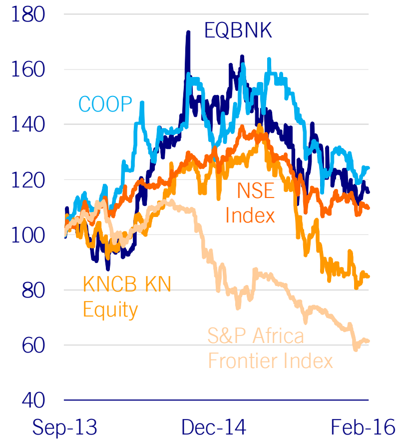
# Much To Gain

Cape Town, 23rd February 2016

**Our Kenyan banks stocks are 30% off their 12M high (vs SAFCOM and EABL, which were 15% down).** The weakness is largely attributed to: (1) KES vs USD depreciation, (2) high volatility of bond yields, (3) negative investor sentiment on emerging and frontier markets, (4) concerns over risk asset quality and NPL coverage, (5) an increased regulatory tone and (6) potential recapitalisation issues, which are specific to KCB. **In our opinion, however, the stock derating makes valuations attractive in the ST and MT. This is because Kenyan banks continue to exhibit high profitability (4-yr historic avg. ROE: 27%), while earnings visibility (strong management execution, good governance and disclosure) carries lower risk vs SSA peers (especially Nigeria). Moreover, the Kenyan macro environment is among the best performing in the region (on supply-led growth initiatives), despite the negative impact of certain risks (such as currency volatility, high government debt and a trade deficit).**

**We update coverage of our Kenyan banks universe setting new YE16 Price Targets for Coop Bank (maintain Buy, upside 28%), Equity Bank (upgrade from Hold to Buy, upside 25%) and KCB (maintain Hold, upside 22%) and. Significantly, we have cut our 15-18F earnings estimates by an avg. 8%, owing to:** (1) potentially higher COF, and (2) increased volatility of CoR due to higher lending rates in the Kenyan banks sector. As such, our estimates are below consensus, and we do not foresee further downside risk in the ST and MT. Nevertheless, due to substantial price action, we believe that current risk reward is largely positive.

**Price Performance**




*Source: Bloomberg.*

**Valuation and Recommendation Table**

| Bank | Rating New | Rating Old | Mkt Cap (USDmn) | ADV(1) (USDmn) | Price | New YE16PT | Old YE16PT | Upside | Risk rating |
|---|---|---|---|---|---|---|---|---|---|
| **Coop** | **BUY** | **BUY** | **828** | **0.2** | **18.30** | **22.15** | **23.50** | **28%** | **High** |
| Equity | BUY | HOLD | 1 474 | 2.0 | 39.75 | 49.75 | 52.50 | 25% | High |
| KCB | HOLD | HOLD | 1 174 | 1.3 | 39.75 | 48.60 | 57.85 | 22% | High |
| | | | **1 159** | **1.2** | | | | **25%** | |

*Ranked by upside to Price Target (PT). Share prices as at 19 February 2016.*
*(1) ADV is daily average value traded for 12M.*
*Source: BPI Capital Africa, Bloomberg.*

**Earnings Revision**

| PAT | 2015F | 2016F | 2017F | 2018F |
|---|---|---|---|---|
| Coop | -5% | -6% | -6% | -6% |
| Equity | -8% | -8% | -9% | -9% |
| KCB | -3% | -9% | -11% | -9% |
| **Average** | **-5%** | **-8%** | **-9%** | **-8%** |

*Source: BPI Capital Africa.*

**Coop Bank:** Despite relatively low stock liquidity (ADV: USD194k), the stock remains our preferred pick in Kenya as it combines an attractive valuation (12M fw PER and PBV multiples discounted by 20% and 25% on a historic perspective), superior earnings growth (25% EPS CAGR15-18[F]) and high earnings visibility (strong management execution and successful turnaround initiative). We believe that Coop Bank will continue to improve its competitiveness vs peers as it drives an aggressive customer-focused strategy while driving a strong share of loans and deposits in the retail and corporate segments. **We set a YE16 PT of KES22.15/share and reinforce our BUY recommendation.**

**Equity Bank:** We remain positive on Equity Bank as a strong MT and LT exposure to Kenya, and highlight that its higher stock liquidity offers an alternative to Coop Bank. Management's ambitious initiative to gain presence in 15 countries in SSA is ambitious, but potentially provides access to a vast market of retail and SME customers. Thus far, Kenya remains its most significant earnings driver (90% of PBT), while S. Sudan is noteworthy among its 5 subsidiaries. Though we have cut our earnings estimates by an avg. 8% (implied 16% EPS CAGR15-18[F]), Equity Bank is the most profitable on a historical perspective vs peers (4-yr historic avg. ROE: 31%), and we continue to see higher profitability in the ST and MT. Further, its multiples are currently undemanding (12M fw PER and P/BV of 6.7x and 1.6x) vs peers. **We have revised our YE16 PT to KES49.75 and update our recommendation from HOLD to BUY.**

**KCB Bank:** We believe that KCB's earnings have higher forecast risk relative to peers, owing to lower asset quality (NPL ratio: 7% vs sector avg. 4.9%) and NPL coverage of < 50% (IFRS).Moreover, high exposure to corporate deposits (45% of total) increases sensitivity to COF in a high interest rate environment. As such, we conservatively adjusted our CoR- and COF15-18[F] estimates to 2.0% and 3.5%, and reduced earnings by an avg. 8%. Despite concerns over asset quality, management has grown alternative distribution, via the KCB-MPESA partnership and a larger agency network of 22 000 (similar in size to Equity Bank). In addition, strong regional supports revenue and PBT contribution of 20% and 12% respectively, while subsidiary assets and loans are 30% of group. However, we cannot rule out the potential for a capital call in the MT to drive growth opportunities as well as to stem a persistent slide in tier 1 CAR (currently lowest vs peers). Nevertheless, the stock underperformed its peers (40% off its 12M high vs sector avg. 30%), making its valuation relatively attractive (12M fw PER and P/BV multiples are discounting 30% respectively to 5-yr avg. multiples). **On balance, we remain neutral on risk vs reward and set a revised YE16 PT of KES48.60/share. We maintain our HOLD recommendation.**

# KEY THEMES

## Attractive price multiples

**We reiterate our view that Kenyan banks price multiples are currently attractive (absolute and relative) vs a historical perspective. A discount of 22% and 25% to historic avg. 12M fw PER and P/BV multiples, underscores significant upside to stock rerating, because: (1) Kenyan banks achieve high profitability vs SSA peers (avg. ROE: 24%), (2) earnings visibility is high vs peers; and (3) the Kenyan macro outlook is positive and growth estimates remain ahead of regional avg.**

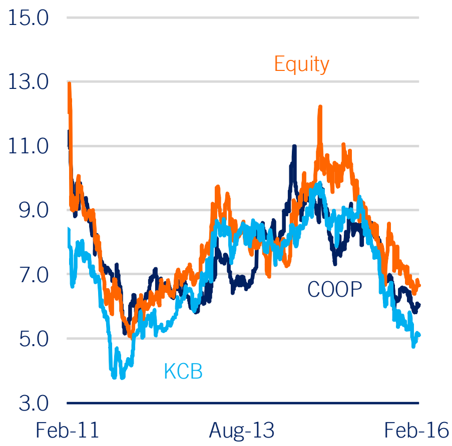
**ROE forecast**

| | 2013 | 2014 | 2015F | 2016F | 2017F | 2018F |
|---|---|---|---|---|---|---|
| Coop | 28% | 20% | 24% | 24% | 23% | 23% |
| Equity | 29% | 30% | 24% | 25% | 25% | 25% |
| KCB | 25% | 24% | 24% | 24% | 23% | 23% |
| **Avg.** | **27%** | **25%** | **24%** | **24%** | **24%** | **24%** |

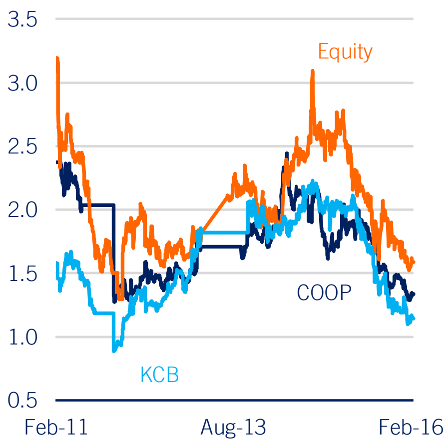
*Source: BPI Capital Africa.*

Nevertheless, the sustainability of previously high valuations was dependent on several factors, namely: (1) a strong operating environment-limited regulation, strong management execution and improving efficiencies; (2) a stable KES combined with consistent inflows from portfolio investors; (3) low interest rates-rendering fixed income yields unattractive; (4) an improvement of asset quality and limited downside risk to capital adequacy; and (5) positive investor sentiment over growth in emerging/frontier economies. Few of these triggers, however, remained constant over the last 12M period, driving lower stock valuations.

**12M fw P/E (x)**




**12M fw P/BV (x)**




*Source: Bloomberg.*

**12M fw PER multiples**

| | Coop | Equity | KCB | Avg. |
|---|---|---|---|---|
| Current rating | 6.1 | 6.7 | 5.1 | 5.9 |
| 5-yr avg. | 7.5 | 8.0 | 7.1 | 7.6 |
| Premium/(discount) | -20% | -17% | -28% | -22% |
| YTD16 lowest | 5.8 | 6.4 | 4.7 | 5.7 |
| Premium/(discount) | 4.2% | 4.0% | 7.5% | 5% |

*Source: Bloomberg, BPI Capital Africa.*

**12M fw P/BV multiples**

| | Coop | Equity | KCB | Avg. |
|---|---|---|---|---|
| Current rating | 1.3 | 1.6 | 1.1 | 1.4 |
| 5-yr avg. | 1.8 | 2.0 | 1.6 | 1.8 |
| Premium/(discount) | -24% | -22% | -29% | -25% |
| YTD16 lowest | 1.3 | 1.5 | 1.1 | 1.3 |
| Premium/(discount) | 4.2% | 4.0% | 7.5% | 5% |

*Source: Bloomberg, BPI Capital Africa.*

## Kenya 1 vs Nigeria 0

**Broadly, we prefer Kenyan banks over Nigeria from a fundamentals perspective**, which include the following: (1) well-positioned for structurally higher profitability in the MT and LT, (2) operating efficiency is stronger due to effective distribution in the retail segment; (3) unfunded income is mostly supported by growth in transactions vs Nigerian banks' FX gains; (4) management execution is stronger, and corporate governance and disclosure are among the best vs SSA peers; and (5) higher visibility of earnings/lower forecast risk in the ST and MT.

However, risks include the impact of rising interest rates on asset quality and cost of funding. In addition, there may be some concerns over recapitalisation in the MT and LT. **We have provided a comparative assessment of Kenyan vs Nigerian banks, below:**

### 1. MARGINS

**Kenyan banks are strongly positioned for higher profitability in the MT and LT due to structurally high margins (avg. NIM: 10.7%) vs Nigerian banks (avg. 7.8%).** Impressively, Equity Bank has historic avg. margins of 12%, although currently lower as a result of increased competition and pressure on COF. In Nigeria, Diamond Bank and GT Bank continue to drive a profit models, which are geared to achieve above sector avg. margins.

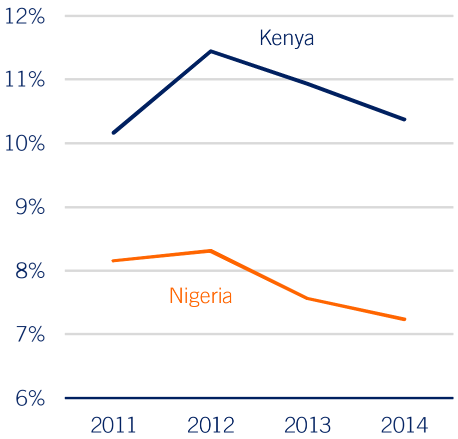
**NIM**

| | Coop | Equity | KCB | **Avg.** | Access | Diamond | FBNH | GTB | UBA | Zenith | **Avg.** |
|---|---|---|---|---|---|---|---|---|---|---|---|
| 2011 | 8.9% | 11.6% | 10.0% | **10.2%** | 7.0% | 12.2% | 9.3% | 8.2% | 4.5% | 7.8% | **8.2%** |
| 2012 | 10.4% | 13.0% | 10.9% | **11.4%** | 7.7% | 9.9% | 8.8% | 9.5% | 5.8% | 8.2% | **8.3%** |
| 2013 | 10.7% | 12.0% | 10.1% | **10.9%** | 5.8% | 8.1% | 8.0% | 8.9% | 5.9% | 8.7% | **7.6%** |
| 2014 | 10.0% | 11.4% | 9.7% | **10.4%** | 6.8% | 6.6% | 7.6% | 8.1% | 5.9% | 8.4% | **7.2%** |
| **Avg.** | **10.0%** | **12.0%** | **10.2%** | | **6.8%** | **9.2%** | **8.4%** | **8.7%** | **5.5%** | **8.3%** | |

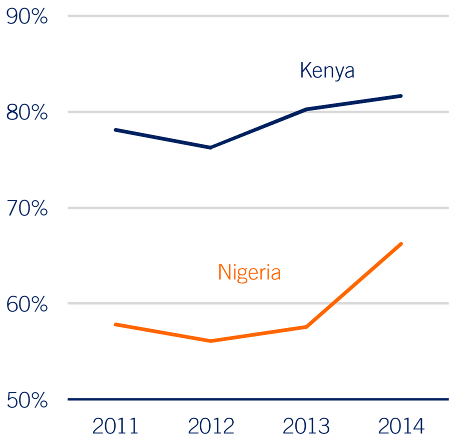
*Source: Company report.*

**In our view, Kenyan banks achieve strong margins largely as a result of higher asset yields** - which reflect significant pricing power over well-diversified risk asset portfolios (retail, SME and corporate loans). Nigerian banks, on the other hand, have considerably higher exposure to the corporate segment (especially to oil & gas), and therefore exhibit lower pricing power. Moreover, Nigerian banks (in particular UBA) have larger exposures to lower yielding fixed income (government stock) owing to a persistently high risk perception in the credit market. As such, Nigerian banks have lower loans gearing (avg. LDR: 60% vs Kenya: 80%), implying a structural deficiency in driving interest income growth.

**NIM evolution**




**LDR evolution**




*Source: Company report.*

**LDR**

| | Coop | Equity | KCB | **Avg.** | Access | Diamond | FBNH | GTB | UBA | Zenith | **Avg.** |
|---|---|---|---|---|---|---|---|---|---|---|---|
| 2011 | 77% | 81% | 77% | **78%** | 52% | 64% | 64% | 69% | 42% | 55% | **58%** |
| 2012 | 73% | 82% | 73% | **76%** | 50% | 64% | 64% | 68% | 38% | 51% | **56%** |
| 2013 | 78% | 88% | 75% | **80%** | 59% | 57% | 60% | 70% | 43% | 55% | **58%** |
| 2014 | 82% | 87% | 75% | **82%** | 76% | 53% | 71% | 79% | 49% | 68% | **66%** |
| **Avg.** | **78%** | **85%** | **75%** | | **59%** | **60%** | **65%** | **71%** | **43%** | **57%** | |

*Source: Company report.*

**Next to that, Kenyan banks have a substantially stronger presence in the retail segment, mostly via the positive impact of alternative distribution (for example, agency banking and mobile money). This drives stronger efficiencies in the low cost deposits segment (avg. COF: 3.1% vs Nigeria: 3.3%).** Nevertheless, there is limited upside for improved COF in Kenya due to: (1) persistent conditions of low liquidity in the banking sector, (2) rising interest rates, and (3) significant competition for retail deposits (banking penetration approximately: 50% vs Nigeria: 30%). Despite challenges experienced by Kenyan banks, their Nigerian peers largely rely on price-sensitive corporate deposits, although high exposure to lower yielding FX deposits have helped to improve overall COF from a historic perspective.

**COF**

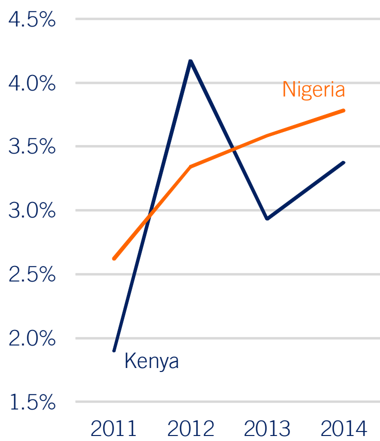
| | Coop | Equity | KCB | **Avg.** | Access | Diamond | FBNH | GTB | UBA | Zenith | **Avg.** |
|---|---|---|---|---|---|---|---|---|---|---|---|
| 2011 | 1.9% | 1.9% | 1.9% | **1.9%** | 3.9% | 2.2% | 1.9% | 2.6% | 2.9% | 2.2% | **2.6%** |
| 2012 | 4.0% | 4.2% | 4.2% | **4.2%** | 4.9% | 2.7% | 2.9% | 3.0% | 3.2% | 3.4% | **3.3%** |
| 2013 | 3.3% | 2.8% | 2.8% | **2.9%** | 4.7% | 3.3% | 3.3% | 3.2% | 3.9% | 3.2% | **3.6%** |
| 2014 | 3.8% | 3.2% | 3.2% | **3.4%** | 4.6% | 3.4% | 3.5% | 3.2% | 3.8% | 4.0% | **3.8%** |
| **Avg.** | **3.3%** | **3.0%** | **3.0%** | | **4.5%** | **2.9%** | **2.9%** | **3.0%** | **3.4%** | **3.2%** | |

*Source: Company report.*

## 2. COST EFFICIENCY

**As a result of a considerable investment in alternative distribution, Kenyan banks currently drive stronger cost efficiencies (avg. CIR: 55% vs Nigeria: 60%).** Ahead of the pack is Equity Bank, which pioneered agency banking and substantially levered its B/S without the additional cost of an expanded branch network and larger headcount. Among Nigerian banks, cost efficiencies are much more difficult to achieve (excepting GT Bank), due to a structurally high cost of operating. This includes: (1) limited access to on-grid electricity supply and substantial usage of off-grid power generators to run extensive branch networks; (2) costly salary packages and top-heavy structures; and (3) a very large headcount vs Kenyan banks.

**COF evolution**




*Source: Company report.*

**CIR**

| | Coop | Equity | KCB | **Avg.** | Access | Diamond | FBNH | GTB | UBA | Zenith | **Avg.** |
|---|---|---|---|---|---|---|---|---|---|---|---|
| 2011 | 62% | 50% | 59% | **57%** | 66% | 60% | 68% | 46% | 91% | 59% | **65%** |
| 2012 | 56% | 49% | 54% | **53%** | 60% | 61% | 64% | 43% | 64% | 53% | **57%** |
| 2013 | 60% | 49% | 56% | **55%** | 73% | 60% | 63% | 43% | 61% | 56% | **59%** |
| 2014 | 59% | 52% | 50% | **54%** | 62% | 65% | 67% | 43% | 67% | 55% | **60%** |
| **Avg.** | **59%** | **50%** | **55%** | | **65%** | **61%** | **65%** | **44%** | **71%** | **56%** | |

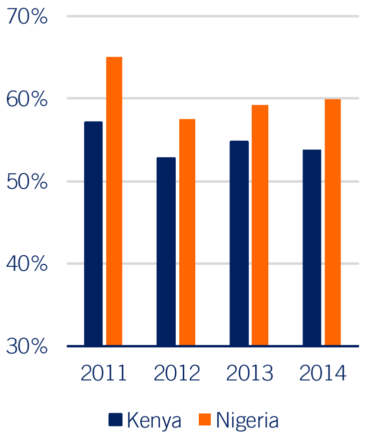
*Source: Company report.*

## 3. UNFUNDED INCOME

**Due to extensive distribution, Kenyan banks drive stronger unfunded income (transaction fees) vs Nigerian banks.** The contribution of agency and mobile banking (which account for the bulk of banking transactions) has largely overtaken revenue from traditional branch and ATM networks. Overall, avg. NIR contribution of 36% for Kenyan banks outperforms Nigerian banks (avg. 32%). Equity Bank remains a leader in this segment, although recent initiatives by its competitors (such as the KCB-MPESA partnership) are a considerable threat to its dominance.

**Nigerian banks unfunded income was traditionally driven by COT, which unfortunately has been gradually reduced due to regulation.** Trade finance and credit handling fees remain key drivers of unfunded income, although lower oil prices will yet have a negative impact in the ST and MT. Further, recent NGN devaluation resulted in a notable increase in FX income (revaluation gains and trading income); but in our opinion, this is difficult to repeat and therefore not sustainable in the MT.

**CIR evolution**



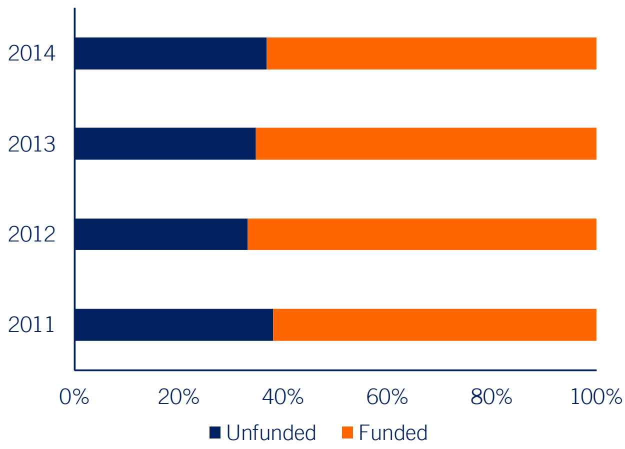

*Source: Company report.*

**NIR contribution**

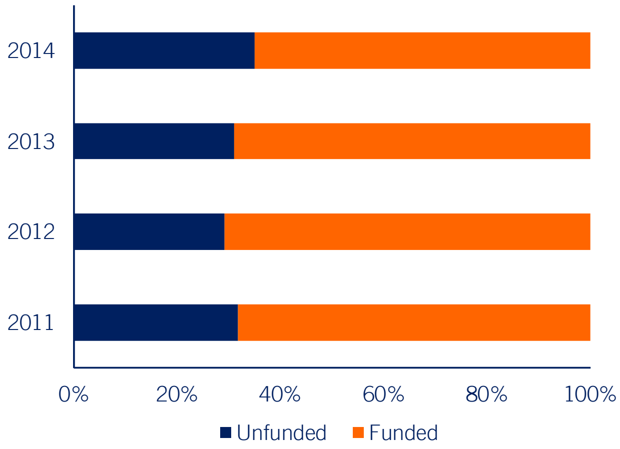
| | Coop | Equity | KCB | Avg. | Access | Diamond | FBNH | GTB | UBA | Zenith | Avg. |
|---|---|---|---|---|---|---|---|---|---|---|---|
| 2011 | 35% | 43% | 36% | **38%** | 30% | 25% | 26% | 35% | 42% | 34% | **32%** |
| 2012 | 34% | 35% | 30% | **33%** | 29% | 21% | 25% | 28% | 42% | 31% | **29%** |
| 2013 | 33% | 37% | 34% | **35%** | 44% | 25% | 22% | 29% | 42% | 24% | **31%** |
| 2014 | 34% | 39% | 38% | **37%** | 41% | 29% | 31% | 35% | 45% | 30% | **35%** |
| **Avg.** | **34%** | **38%** | **35%** | | **36%** | **25%** | **26%** | **32%** | **43%** | **30%** | |

*Source: Company report.*

**Kenya NIR contribution**




**Nigeria NIR contribution**

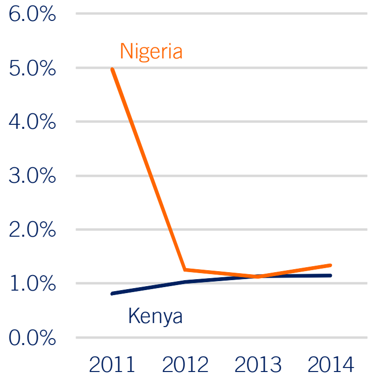



*Source: Company report.*

## 4. COST OF RISK

**Kenyan banks have relatively lower volatility of cost of risk (avg. 1.0%) vs Nigerian banks (avg. 2.2%).** In a sense, lower provisioning was a key driver of Kenyan banks profitability. However, due to current high lending rates and concerns over relatively low NPL coverage ratios, we believe that Kenyan banks reporting is aggressive vs Nigerian banks. As such, as the Kenyan operating environment continues to face cyclical challenges (low liquidity, higher interest rates, asset quality deterioration), we expect that banks will be compelled to increase cost of risk in the ST. **We have therefore taken a conservative approach, by making significant adjustments to cost of risk assumptions.** Nevertheless, given the potential impact of lower oil prices, we believe that Nigerian banks will likely experience higher volatility of provisioning vs Kenyan banks.

**COR evolution**




*Source: Company report.*

**CoR**

| | Coop | Equity | KCB | **Avg.** | Access | Diamond | FBNH | GTB | UBA | Zenith | **Avg.** |
|---|---|---|---|---|---|---|---|---|---|---|---|
| 2011 | 0.7% | 1.7% | 0.1% | **0.8%** | 1.6% | 14% | 3.0% | 2.8% | 6.0% | 1.9% | **5.0%** |
| 2012 | 0.8% | 1.3% | 1.0% | **1.0%** | 1.6% | 3.3% | 0.9% | 0.1% | 0.7% | 0.9% | **1.2%** |
| 2013 | 0.6% | 1.5% | 1.3% | **1.1%** | -0.9% | 3.5% | 1.2% | 0.3% | 1.6% | 1.0% | **1.1%** |
| 2014 | 0.7% | 0.8% | 1.9% | **1.1%** | 1.2% | 3.4% | 1.3% | 0.6% | 0.6% | 0.9% | **1.3%** |
| **Avg.** | **0.7%** | **1.3%** | **1.1%** | | **0.9%** | **6.1%** | **1.6%** | **1.0%** | **2.2%** | **1.2%** | |

*Source: Company report.*

## 5. PROFITABILITY AND CAPITALISATION

**Despite our concerns over cost of risk, Kenyan banks have consistently achieved higher and stable profitability (historic avg. ROE: 27% vs Nigeria: 18%).** Significantly, post the Nigerian banking crisis, profitability declined to an avg. 5.1% in YE11 before recovering to 25% in YE12. Nevertheless, both sectors have experienced significant pressure on capital adequacy, owing to: (1) the transition to Basel II, (2) deteriorating asset quality, and (3) opportunities for growth in the large ticket credit market. These factors have necessitated capital calls for banks such as UBA, Diamond Bank and Access Bank. In addition, most banks have (in recent times) increased their tier 2 funding (from multilaterals) to meet capital adequacy thresholds as well as finance FX-driven demand for credit.

**ROE**

| | Coop | Equity | KCB | **Avg.** | Access | Diamond | FBNH | GTB | UBA | Zenith | **Avg.** |
|---|---|---|---|---|---|---|---|---|---|---|---|
| 2011 | 27% | 34% | 26% | **29%** | 8.9% | -14% | 5.1% | 23% | -5.1% | 13% | **5.1%** |
| 2012 | 31% | 31% | 25% | **29%** | 20% | 23% | 19% | 34% | 32% | 23% | **25%** |
| 2013 | 28% | 29% | 25% | **27%** | 15% | 23% | 15% | 29% | 22% | 19% | **21%** |
| 2014 | 20% | 30% | 24% | **25%** | 17% | 15% | 17% | 28% | 20% | 20% | **19%** |
| **Avg.** | **26%** | **31%** | **25%** | | **15%** | **12%** | **14%** | **29%** | **17%** | **19%** | |

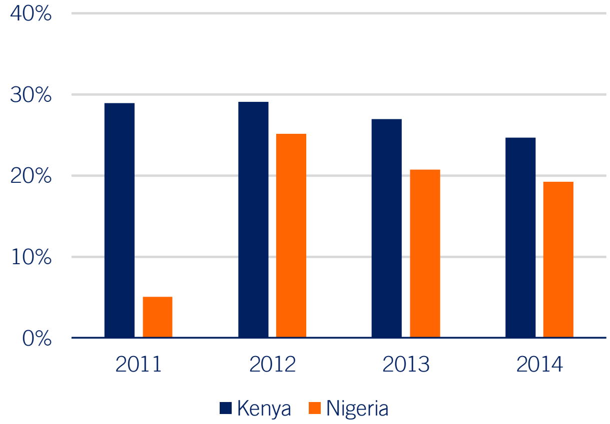
*Source: Company report.*

## TIER 1 CAR

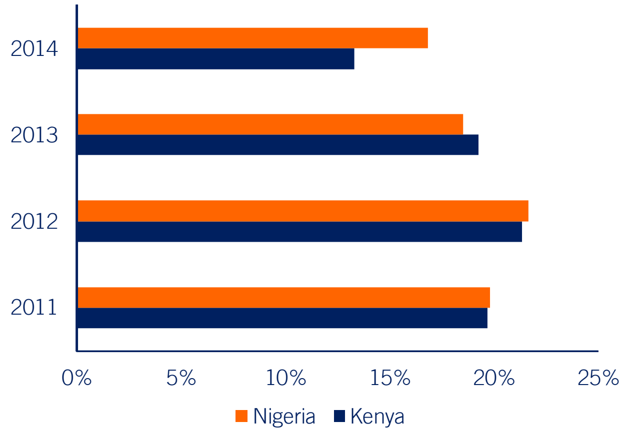
| | Coop | Equity | KCB | Avg. | Access | Diamond | FBNH | GTB | UBA | Zenith | Avg. |
|---|---|---|---|---|---|---|---|---|---|---|---|
| 2011 | 16% | 23% | 20% | **20%** | 19% | 15% | 21% | 20% | 15% | 29% | **20%** |
| 2012 | 20% | 23% | 21% | **21%** | 23% | 12% | 18% | 24% | 24% | 30% | **22%** |
| 2013 | 16% | 19% | 19% | **18%** | 20% | 13% | 13% | 24% | 15% | 26% | **19%** |
| 2014 | 15% | 15% | 17% | **15%** | 16% | 14% | 12% | 21% | 18% | 20% | **17%** |
| **Avg.** | **17%** | **20%** | **19%** | | **19%** | **14%** | **16%** | **22%** | **18%** | **26%** | |

*Source: Company report;*

**ROE evolution**




**Tier 1 evolution**

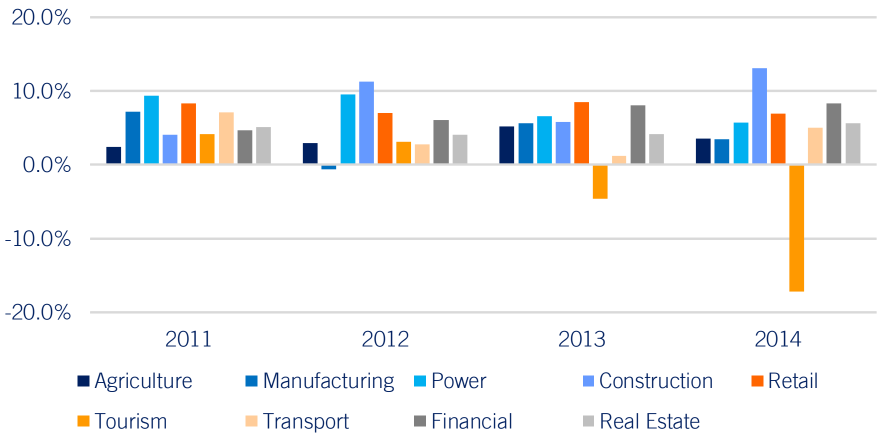



*Source: Company report.*

## SNAPSHOT OF KENYAN MACRO

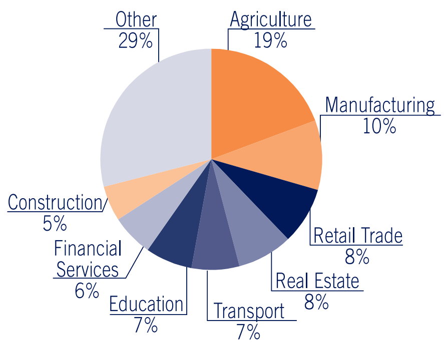
**The Kenyan economy continues to reflect strong supply-led growth**, driven by the construction sector (+14.1% y/y), mining (+12.5%), power generation (+11.0%), financial services (+10.1%) and ICT (+8.9%). In addition, transport and storage, agriculture and retail trade have also made a significant contribution to growth (+8.7%, +7.1% and +6.5%) on the back of rising consumer demand. Nevertheless, real estate sector growth was less impressive at 5.4% y/y, despite support from a vibrant mortgages market. Further, manufacturing declined by 2.3% highlighting the persistent challenge of increasing production efficiency vs cheaper imports. Notably, however, Kenya is a net importer of oil and current low prices have positively impacted local production costs, while driving higher consumption. **Overall, 9M15 Kenyan GDP reflected some gains via an increase of 5.8% y/y (vs 9M14: 5.2%), while YE15 growth is estimated at about 6.0%.**

**GDP Growth (Key Sectors)**




*Source: National statistics.*

**GDP composition (3Q15)**




*Source: National statistics.*

**Significantly, Kenyan GDP growth remains strong vs peers, underscoring the high impact of current infrastructure financing and investment in the country (construction and transport sectors).** The IMF predicts Kenya's GDP growth (16-20$^{F}$: 7.0%) to outperform the regional avg. (6.7%) and importantly, will be ahead of Nigeria (4.7% growth). Nevertheless, Ethiopia, Tanzania and Rwanda appear to be achieving relatively higher growth rates in the ST and MT, although this may yet benefit Kenyan banks-via substantial presence (except Ethiopia) and strong trade finance links. Burundi, on the other hand, is likely to achieve negative growth of over 7.0% on the back of a sustained political crisis and slower economic productivity.

**Regional GDP Growth (%)**

| | Burundi | Ethiopia | Kenya | Rwanda | Uganda | Tanzania | Avg. | Nigeria |
|---|---|---|---|---|---|---|---|---|
| 2008 | 4.9 | 11.2 | 0.2 | 11.2 | 10.4 | 5.6 | 7.3 | 8.0 |
| 2009 | 3.8 | 10.0 | 3.3 | 6.2 | 8.1 | 5.4 | 6.1 | 9.0 |
| 2010 | 5.1 | 10.6 | 8.4 | 6.3 | 7.7 | 6.4 | 7.4 | 10.0 |
| 2011 | 4.2 | 11.4 | 6.1 | 7.5 | 6.8 | 7.9 | 7.3 | 4.9 |
| 2012 | 4.0 | 8.7 | 4.6 | 8.8 | 2.6 | 5.1 | 5.6 | 4.3 |
| 2013 | 4.5 | 9.8 | 5.7 | 4.7 | 3.9 | 7.3 | 6.0 | 5.4 |
| 2014 | 4.7 | 10.3 | 5.3 | 6.9 | 4.8 | 7.0 | 6.5 | 6.3 |
| 2015F | -7.2 | 8.7 | 6.5 | 6.5 | 5.2 | 6.9 | 4.4 | 4.0 |
| **2016F** | **5.2** | **8.1** | **6.8** | **7.0** | **5.5** | **7.0** | **6.6** | **4.3** |
| 2017F | 4.5 | 7.6 | 7.0 | 7.5 | 5.8 | 7.0 | 6.6 | 4.5 |
| 2018F | 5.0 | 7.5 | 7.0 | 7.5 | 6.1 | 6.9 | 6.7 | 4.7 |
| 2019F | 5.1 | 7.5 | 7.0 | 7.5 | 6.2 | 6.9 | 6.7 | 4.9 |
| 2020F | 5.2 | 7.5 | 6.9 | 7.5 | 6.4 | 6.9 | 6.7 | 5.1 |

*Source: IMF.*

## Economic Performance Triggers

The Kenyan economy-which is among the strongest in the East African region-is predicted to sustain additional growth in the MT and LT, on the back: (1) increasing activity in agriculture (although risk of droughts/flooding is persistent), (2) FDI-led construction and real estate development, (3) expansion of the transport sector (driven by positive developments in the LAPSSET corridor), (4) a wider tax net linked to growth of the SME sector, (5) growth of organised retailers tapping into both the mass market and a growing middle, importantly (continued growth and development of financial services).

In addition, we have identified ST triggers, which could support further growth as follows: (1) an increase in tea export value, (2) recovery of the tourism sector, (3) a reduction in government debt levels, (4) lower oil prices, and (5) further investment in infrastructure.

### 1. Stronger tea exports

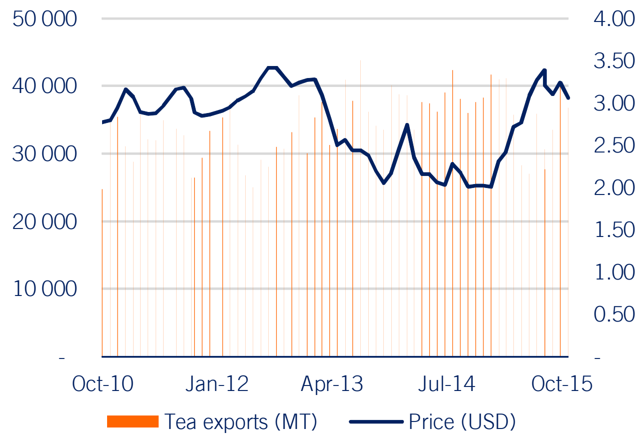
Tea export revenue remains Kenya's main FX driver (YE15 avg. monthly volumes: 34 341MT vs 3-yr monthly historic avg. 34 294MT); while an avg. price of USD2.96/kg was 7% higher than the historic avg. **In our opinion, an increase in tea production and exports is a significant trigger for sustained economic performance from both a FX-perspective and job creation.** Higher tea prices (in USD) will unsurprisingly drive stronger FX income, but more importantly sustain profitability in the tea sector.

### 2. Increase in tourist arrivals

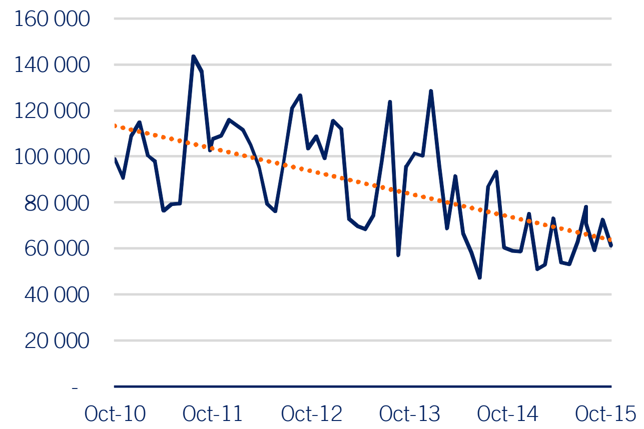
A recovery in tourism driven largely by an increase in tourist arrivals, would help to sustain FX income, while creating additional jobs in the sector. In addition, an increase in air passengers is positive for the aviation sub-sector, while adjacent sectors (banking services, high-income retail trade and real estate) potentially benefit from increased FX-related income. **However, Kenya has**

**continued to face significant challenges in driving a recovery in tourism, mostly as a result of persistent national security concerns.** YE15 avg. tourist arrivals (62 693) were 29% below the 3-yr historic avg., and recovery appears to be elusive in the ST, owing to regional instability (Burundi, Somalia and South Sudan).

**Tea export volumes (MT) and Price (USD/kg)**




**Tourist arrivals**

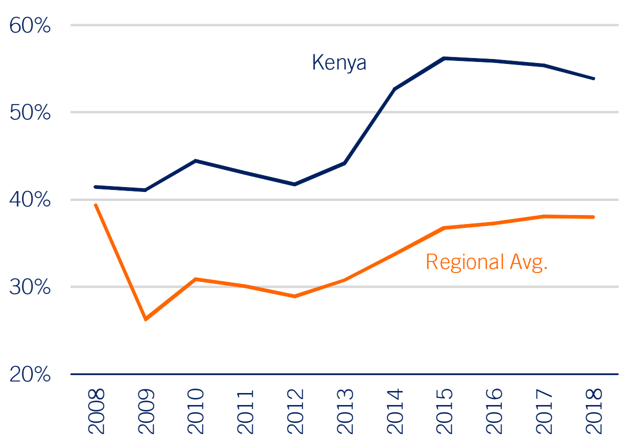



*Source: National statistics.*

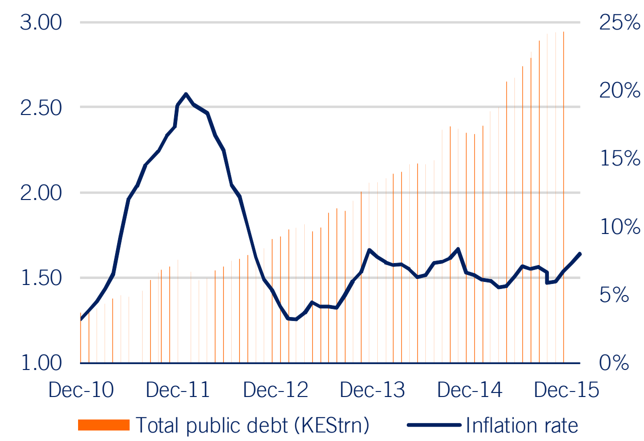
## 3. Fiscal prudence

Kenya has a relatively higher debt burden vs regional peers, owing to: (1) a large civil service (financing of recurrent expenditure) and (2) the impact of financing initiatives undertaken in infrastructure development. **Current debt to GDP is about 45% vs a regional avg. of 30% (and Nigeria (12%).** We believe that government should enhance efforts to reduce debt levels to regional avg. levels. This would also alleviate pressure on taxation, KES exchange rate and inflation (YE15 avg. 6.6%). Further, implementing significant fiscal prudence will likely ease private sector crowding-out, for which the impact is higher volatility of ST interest rates. Notably, total government debt is about KES2.94trn, an increase of 26% y/y.

**Government debt (% of GDP)**




**Government debt vs inflation**



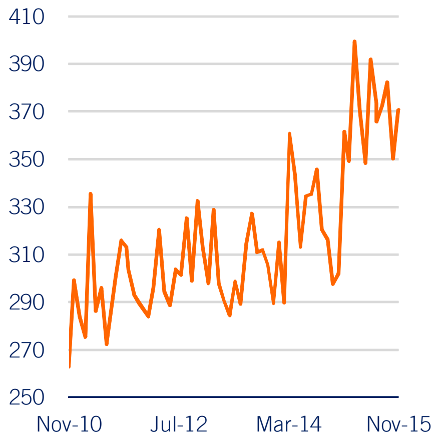

*Source: IMF, National statistics.*

## 4. Additional cheap oil

**Current low oil prices continue to have a positive impact on Kenyan GDP growth**, via: (1) low energy costs for the industrial and power generation sectors, and (2) a marginal increase in discretionary income for consumers. Overall, the impact of additional cheaper oil in the MT should continue to ease pressure on demand for FX, while stimulating a reduction in the rate of increase of the import bill vs exports (increase in import cover). However, this may be offset by a sharp rise in total fuel consumption.

**Oil price trend (USD/bbl.)**


**Total fuel consumption (MT)**

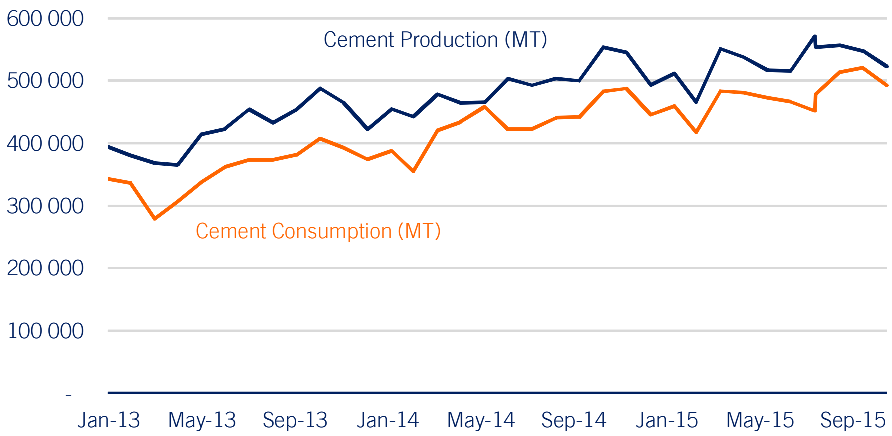



*Source: OPEC, National statistics.*

## 5. Infrastructure spend

Private sector investment in infrastructure is critical for sustained economic performance via increased capacity for production. In turn, this can drive stronger efficiencies in the MT and LT, while supporting a relatively underperforming manufacturing sector vs cheaper imports.

**Cement production vs consumption (MT)**




*Source: National statistics.*

## Implications

**Overall, an increase in the performance of exports, a concerted effort to reduce government debt as well as sustainably lower energy costs, should be positive ST triggers for economic performance in Kenya.** Kenya would therefore benefit from: (1) lower volatility of the KES exchange rate, (2) an increase in the import cover, and (3) reduced upward pressure on private sector lending rates.

### 1. Currency volatility

The KES was largely volatile in YE15, depreciating by 17% vs USD from its 12M high (KES90.50/USD) to its lowest level (KES106.10). This was due to a combination of factors, namely: (1) a rising import bill vs exports, (2) lower tea export volumes (despite higher tea prices) and declining tourist arrivals, (3) higher government borrowings and (4) speculative behaviour in the FX market. Nevertheless, the KES vs USD exchange rate stabilised in late YE15 (4Q15 avg.: KES102.35/USD).

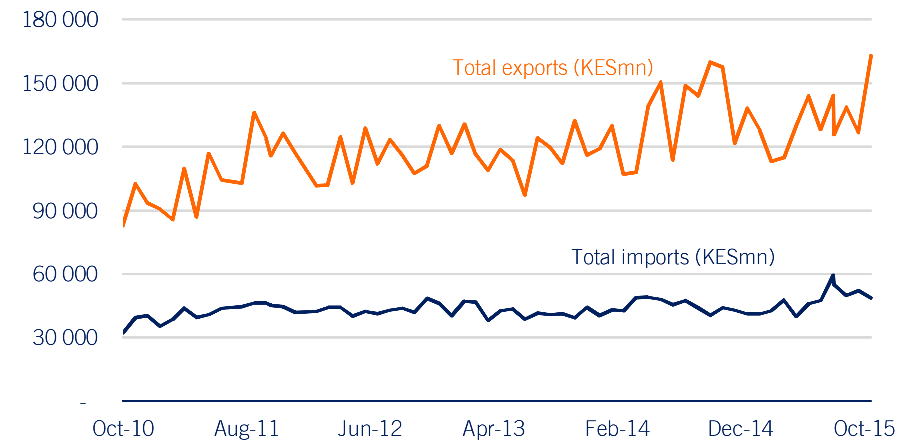
**KES/USD trend**


*Source: Bloomberg.*

### 2. Import cover

Kenya has continued to experience a higher rate of increase in imports vs exports, largely due to a weaker KES vs USD in YE15 as well as additional infrastructure expenditure. Nevertheless, lower energy prices have had a positive impact on the import bill, despite a sharp increase in total fuel consumption (YE15 monthly avg. 370MT vs 3-yr avg. 318MT). Import cover in Kenya is currently 4 months.

**Total exports vs total imports**




*Source: National statistics.*

### 3. Interest rates

Due to a significant increase in ST government borrowing in YE15, monthly avg. 91-day T-Bill yields increased from a low of 8.3% to a high of 22%. Due to a 'crowding-out' effect, the Kenyan banking sector experienced low liquidity, driving higher volatility of interbank rates (12M high: 26% vs low.

**91d T-Bill yield**


**Interbank rates**


*Source: Central bank.*

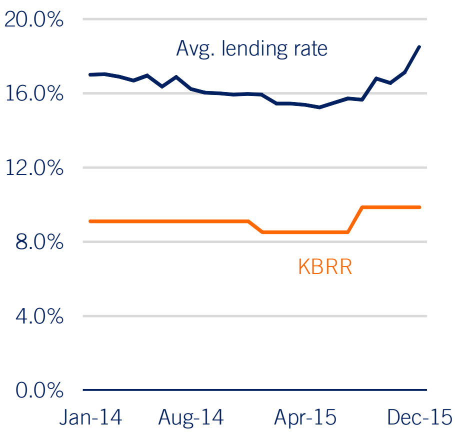
## SNAPSHOT OF THE KENYAN BANKING SECTOR

**The Kenyan banking sector is one of the most profitable vs SSA banks. In addition, the sector delivers strong shareholder returns, supported by an extensive presence (mobilisation of low cost deposits), high margins and strong operating efficiencies.** Corporate governance and disclosure is strong, while management execution is considerably more reliable vs SSA banks. However, there remain some concerns over deteriorating asset quality and capitalisation, mostly due to the impact of rising interest rates, current low NPL coverage ratios, as well as a substantial increase in loan growth over the past few years. The recent failure of two banks in the sector (Dubai Bank and Imperial Bank) has also added to concerns of sustainability of high performance and capitalisation; while suggestions of consolidation cannot be ruled out. Kenya has c. 40 banks vs 22 in Nigeria.

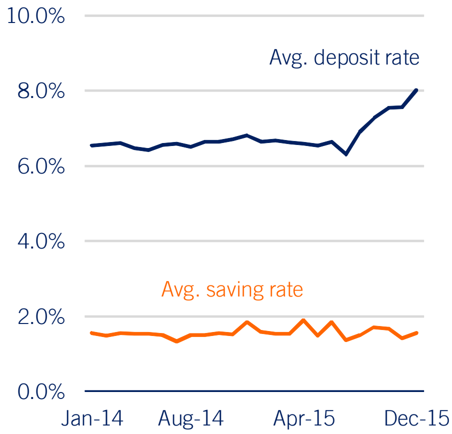
### Lending and Deposit Rates

**Private sector lending rates remained relatively high in YE15, as they mostly responded to conditions of low liquidity conditions and monetary tightening.** The CBR increased by 300bp to 11.5% (Nigeria: 11%), while the avg. lending rate was 16.1% (YE14 avg.: 16.5%). Likewise, deposit rates also increased on the back of a tightening stance by the regulator. The YE15 avg. deposit rate was 7.0% vs 6.6% in YE14.

**Lending rates**




**Cost of funding**

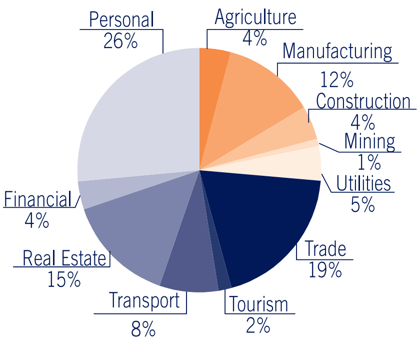



*Source: Central bank.*

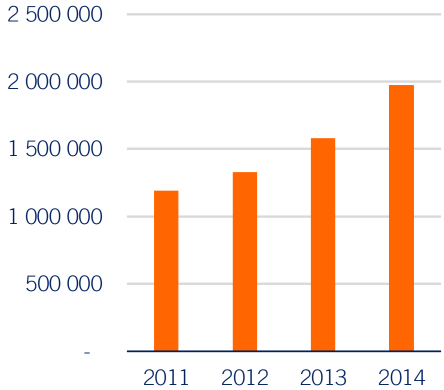
### Private sector credit

**A vibrant lending sector (YE11-14 CAGR of 18%) highlights effectiveness of fiscal and monetary policy to stimulate investment in the economy as well as improved access to financial services in the mass market.** Contribution from the industrials sector (manufacturing, construction, energy & water/utilities, transport) as well as real estate increased from 40% at YE11 to 45% at YE14. The increase in share of loans highlights substantial investments in improving capacity in the economy via increased power output, road and rail development as well as increased access to mortgages. Personal loans achieved 18% 3-yr CAGR driven by a significant uptake of microloans linked to mobile money platforms as well as the adoption of non-conventional risk management criteria. Trade finance loans also grew by a compounded avg. of 18%, owing to strong regional trade opportunities. However, tourism and mining underperformed with avg. growth of just 8% and 6%. This was due to a slump in tourist arrivals and some net loan repayments in the mining sector.

**Aggregate gross loans by sector**




**Aggregate gross loans (KES 000)**



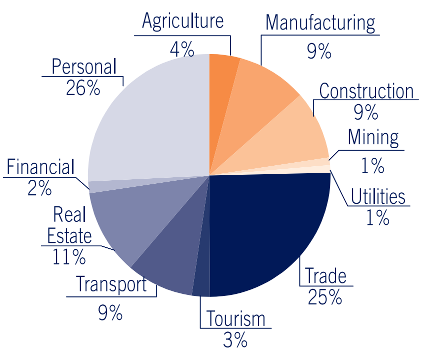

*Source: Central bank.*

## Asset quality

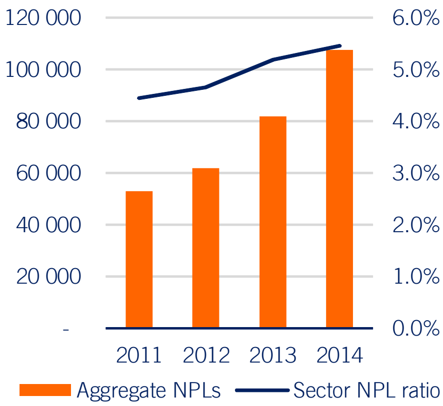
**Although Kenyan banks averted a NPL crisis in YE11, following a spike in inflation and interest rates (which worsened the operating environment), the sector remains under significant pressure to improve asset quality.** This is largely due to the fact that sector NPL coverage ratios are historically low at c. 50%, while rising lending rates have added pressure to collections. Sectors with the highest share of NPLs are personal loans (25.8%), trade finance (25.3%), real estate (11.4%), manufacturing (9.3%), construction (9.1%) and transport (9.0%).

**Notably, the most significant deterioration was experienced in the mining sector, where the NPL ratio increased from 0.6% at YE11 to 52% at YE14. Construction NPLs deteriorated from 4.2% to 11%, trade finance NPLs from 4.2% to 7.2% and real estate from 3.3% to 6.2%.** On the other hand, personal loans NPLs improved from 6.0% to 5.3%, despite significant concerns over significant growth of microloans linked to mobile money. Tourism NPLs remained relatively flat at 7.5% and utilities at 1.2%. Overall, banking sector NPLs increased from 4.4% to 5.5%.

**NPL share by sector**




**Sector NPLs (KES000) and NPL ratio**




*Source: Central bank.*

## REVISING OUR ESTIMATES

**Broadly, we have cut our 15-18$^F$ earnings estimates by an avg. of 7%, which we mainly attribute to: (1) increased cost of funding, due to low liquidity conditions in the sector, and (2) higher volatility of provisioning, on the back of rising interest rates.** We have taken a more conservative approach to Equity Bank and KCB, which we believe face more significant risk to asset quality in the ST and MT. Equity Bank's substantial SME portfolio will likely to experience increased stress, while KCB continues to face similar SME challenges, as well as an underperforming legacy portfolio.

**PAT**

| | 2015$^F$ | 2016$^F$ | 2017$^F$ | 2018$^F$ |
|---|---|---|---|---|
| Coop | -5% | -6% | -6% | -6% |
| Equity | -8% | -8% | -9% | -9% |
| KCB | -2% | -8% | -10% | -8% |
| **Average** | **-5%** | **-7%** | **-8%** | **-8%** |

*Source: BPI Capital Africa.*

### Cooperative Bank

**We have revised our earnings estimates by an avg. of 6%, after adjusting for higher cost of funding and cost of risk**. However, we have also made positive changes to our interest income on the back of rising asset yields. Significantly our YE15$^F$ EPS of KES2.26 is 3% lower than consensus, but largely matched in YE16. As such, Coop Bank currently represents the lowest forecast risk among our Kenyan banks sector, and we remain positive on management execution, the impact of the turnaround initiative as well as the earnings growth outlook in the St and MT.

**Coop**

| | Adjustment | | | | |
|---|---|---|---|---|---|
| | 2015$^F$ | 2016$^F$ | 2017$^F$ | 2018$^F$ | Avg. |
| Interest income | 4% | 3% | 3% | 3% | 3% |
| Interest expense | 14% | 12% | 12% | 12% | 12% |
| Net interest income | 0% | 0% | 0% | 0% | 0% |
| Non-interest income | 0% | 0% | 0% | 0% | 0% |
| Total operating income | 0% | 0% | 0% | 0% | 0% |
| Operating expenses | 2% | 4% | 4% | 4% | 3% |
| PBT before provisioning | -2% | -4% | -4% | -4% | -4% |
| Impairment loss | 10% | 1% | 1% | 1% | 3% |
| Profit before tax | -4% | -5% | -5% | -5% | -4% |
| Taxation | 0% | -1% | -2% | -2% | -1% |
| **Profit after tax** | **-5%** | **-6%** | **-6%** | **-6%** | **-6%** |

*Source: BPI Capital Africa.*

**Coop**

| | BPI 2015$^F$ | Consensus 2015$^F$ | +/- | BPI 2016$^F$ | Consensus 2016$^F$ | +/- |
|---|---|---|---|---|---|---|
| PBT before provisioning | 18 059 | 17 073 | 6% | 22 014 | 19 578 | 12% |
| Impairment loss | 2 289 | 1 285 | 78% | 2 540 | 1 284 | 98% |
| PBT | 15 770 | 15 788 | 0% | 19 474 | 18 294 | 6% |
| PAT | 11 039 | 11 339 | -3% | 13 632 | 13 354 | 2% |
| **EPS** | **2.26** | **2.33** | **-3%** | **2.79** | **2.77** | **1%** |

*Source: BPI Capital Africa, Bloomberg.*

## Equity Bank

**We have taken a conservative stance on Equity Bank by cutting our 15-18F earnings by an avg. of 9%**. The reduction highlights increased pressure on cost of funding, and more importantly, on cost of risk. Firstly, we believe that Equity Bank's pioneering approach to its funding model is under significant threat from competition and will plateau in the MT, driving increased pressure on cost of funding. Second, Equity Bank's key market of SMEs is under substantial threat from rising lending rates in the ST and MT, which may impact asset quality. As such, we highlight potentially higher cost of risk. Importantly, our YE15F EPS is below the consensus estimate by 3%, and we therefore do not anticipate any further downside risk to earnings in the ST.

### Equity

| | Adjustment | | | | |
|---|---|---|---|---|---|
| | 2015F | 2016F | 2017F | 2018F | Avg. |
| Interest income | 1% | 3% | 2% | 2% | 2% |
| Interest expense | 16% | 20% | 20% | 20% | 19% |
| Net interest income | -2% | -1% | -2% | -2% | -2% |
| Non-interest income | -6% | -5% | -6% | -6% | -6% |
| Total operating income | -4% | -3% | -4% | -4% | -4% |
| Operating expenses | -2% | -1% | -2% | -2% | -2% |
| PBT before provisioning | -5% | -5% | -6% | -6% | -6% |
| Impairment loss | 24% | 26% | 24% | 24% | 25% |
| Profit before tax | -8% | -8% | -9% | -9% | -8% |
| Taxation | -8% | -8% | -9% | -9% | -8% |
| **Profit after tax** | **-8%** | **-8%** | **-9%** | **-9%** | **-8%** |

*Source: BPI Capital Africa.*

### Equity

| | BPI 2015F | Consensus 2015F | +/- | BPI 2016F | Consensus 2016F | +/- |
|---|---|---|---|---|---|---|
| PBT before provisioning | 27 401 | 27 068 | 1% | 34 148 | 35 353 | -3% |
| Impairment loss | 2 994 | 1 521 | 97% | 3 706 | 3 415 | 9% |
| PBT | 24 407 | 25 547 | -4% | 30 441 | 31 938 | -5% |
| PAT | 17 329 | 18 212 | -5% | 21 309 | 21 998 | -3% |
| **EPS** | **4.68** | **4.82** | **-3%** | **5.75** | **5.83** | **-1%** |

*Source: BPI Capital Africa, Bloomberg.*

## KCB

**Our 15-18F avg. cost of risk assumption for KCB of 2.0% (vs sector avg.: 1.4%) underscores our conservative view of asset quality**. This includes KCB's legacy bad loans and a stressed SME portfolio, which are negatively impacted by rising interest rates. As such we have made a significant increase to our YE15F cost of risk assumption in order to align it with our MT estimates. We have also increased our cost of funding assumption, driving an increase in interest expense by an avg. of c. 10%. **Overall, the impact of higher cost of risk and cost of funding, resulted in an avg. earnings reduction 15-18F of 8%.**

### Cost of risk

| | 2013 | 2014 | 2015F | 2016F | 2017F | 2018F |
|---|---|---|---|---|---|---|
| Coop | 0.6% | 0.7% | 1.1% | 1.0% | 1.0% | 1.0% |
| Equity | 1.5% | 0.8% | 1.2% | 1.2% | 1.2% | 1.2% |
| KCB | 1.3% | 1.9% | 2.0% | 2.0% | 2.0% | 2.0% |
| Average | 1.1% | 1.1% | 1.4% | 1.4% | 1.4% | 1.4% |

*Source: Company report, BPI Capital Africa.*

### KCB

| | Adjustment | | | | |
|---|---|---|---|---|---|
| | 2015F | 2016F | 2017F | 2018F | Avg. |
| Interest income | 0% | -6% | -6% | -6% | -4% |
| Interest expense | 10% | 7% | 10% | 10% | 10% |
| Net interest income | -4% | -10% | -11% | -11% | -9% |
| Non-interest income | 0% | -6% | -8% | -8% | -5% |
| Total operating income | -2% | -9% | -10% | -10% | -8% |
| Operating expenses | -4% | -11% | -12% | -12% | -10% |
| PBT before provisioning | 0% | -7% | -8% | -8% | -6% |
| Impairment loss | 19% | 6% | 6% | 6% | 9% |
| Profit before tax | -3% | -9% | -11% | -11% | -9% |
| Taxation | -3% | -9% | -11% | -14% | -9% |
| **Profit after tax** | **-3%** | **-9%** | **-11%** | **-9%** | **-8%** |

*Source: BPI Capital Africa.*

### KCB

| | BPI 2015F | Consensus 2015F | +/- | BPI 2016F | Consensus 2016F | +/- |
|---|---|---|---|---|---|---|
| PBT before provisioning | 32 399 | 28 764 | 13% | 35 746 | 34 538 | 3% |
| Impairment loss | 5 669 | 1 732 | 227% | 6 022 | 1 576 | 282% |
| PBT | 26 730 | 27 032 | -1% | 29 724 | 32 962 | -10% |
| PAT | 18 979 | 19 116 | -1% | 21 104 | 23 088 | -9% |
| **EPS** | **6.24** | **6.30** | **-1%** | **6.94** | **7.57** | **-8%** |

*Source: BPI Capital Africa, Bloomberg.*

## VALUATION

**We continue to set our valuation on Kenyan banks using an equal-weighted dividend discount model and a P/BV approach**. Following a cut to our ST and MT estimates (avg. 8%), we have reduced our YE16 PT by an avg. of 9%. However, due to significant price action, we currently have a BUY 2 of 3 of our Kenyan banks.

**Valuation summary - Coop**

| | KES/share |
|---|---|
| DDM valuation | 20.05 |
| P/BV valuation | 24.25 |
| **YE16 PT (KES)** | **22.15** |
| Current value (KES) | 17.30 |
| Upside | 28% |

*Source: BPI Capital Africa.*

**Valuation summary - Equity**

| | KES/share |
|---|---|
| DDM valuation | 48.90 |
| P/BV valuation | 50.65 |
| **YE16 PT (KES)** | **49.75** |
| Current value (KES) | 39.75 |
| Upside | 25% |

*Source: BPI Capital Africa.*

**Valuation summary - KCB**

| | KES/share |
|---|---|
| DDM valuation | 48.85 |
| P/BV valuation | 48.40 |
| **YE16 PT (KES)** | **48.60** |
| Current value (KES) | 39.75 |
| Upside | 22% |

*Source: BPI Capital Africa.*

**Price Target**

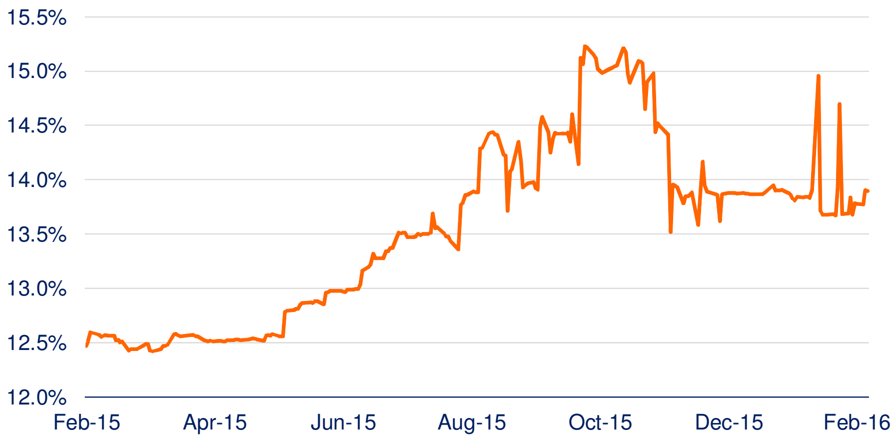
| | Old | New | Change |
|---|---|---|---|
| Coop | 23.50 | 22.15 | -6% |
| Equity | 52.50 | 49.75 | -5% |
| KCB | 57.85 | 48.60 | -16% |
| **Avg.** | | | **-9%** |

*Source: BPI Capital Africa.*

### VALUATION 1: DIVIDEND DISCOUNT MODEL

**We have maintained our risk free rate at 12%, although we highlight high volatility of bond yields in YE15. Overall, our calculated COE for Kenyan banks remains 18%**.

**10-yr Bond yield**




*Source: Bloomberg.*

**Valuation Parameters**

| | |
|---|---|
| Risk-free rate | 12.0% |
| Risk premium | 6.0% |
| Beta | 1 |
| Cost of equity | 18.0% |
| Terminal growth | 5% |

*Source: BPI Capital Africa.*

### DDM sensitivity table - Coop

| | | Discount rate | | | | |
|---|---|---|---|---|---|---|
| | | 16.0% | 17.0% | 18.0% | 19.0% | 20.0% |
| | 3.0% | 22.26 | 20.25 | 18.53 | 17.05 | 15.76 |
| | 4.0% | 23.35 | 21.13 | 19.24 | 17.64 | 16.25 |
| Growth | 5.0% | 24.64 | 22.15 | **20.05** | 18.30 | 16.80 |
| | 6.0% | 26.18 | 23.35 | 21.02 | 19.07 | 17.42 |
| | 7.0% | 28.07 | 24.80 | 22.15 | 19.97 | 18.15 |

*Source: BPI Capital Africa.*

### Coop

| | YE16 |
|---|---|
| Total dividends (KESmn) | 98 105 |
| Shares in issue (mn) | 4 889 |
| **YE16 PT (KES)** | **20.05** |
| Current value (KES) | 17.30 |
| Upside | 16% |

*Source: BPI Capital Africa.*

### DM sensitivity table - Equity

| | | Discount rate | | | | |
|---|---|---|---|---|---|---|
| | | 16.0% | 17.0% | 18.0% | 19.0% | 20.0% |
| | 3.0% | 54.07 | 49.25 | 45.15 | 41.62 | 38.56 |
| | 4.0% | 56.72 | 51.38 | 46.88 | 43.04 | 39.74 |
| Growth | 5.0% | 59.84 | 53.86 | **48.90** | 44.67 | 41.07 |
| | 6.0% | 63.60 | 56.80 | 51.21 | 46.54 | 42.60 |
| | 7.0% | 68.19 | 60.32 | 53.96 | 48.72 | 44.36 |

*Source: BPI Capital Africa.*

### Equity

| | YE16 |
|---|---|
| Total dividends (KESmn) | 184 683 |
| Shares in issue (mn) | 3 703 |
| **YE16 PT (KES)** | **48.90** |
| Current value (KES) | 39.75 |
| Upside | 23% |

*Source: BPI Capital Africa.*

### DM sensitivity table - KCB

| | | Discount rate | | | | |
|---|---|---|---|---|---|---|
| | | 16.0% | 17.0% | 18.0% | 19.0% | 20.0% |
| | 3.0% | 53.93 | 49.39 | 45.50 | 42.13 | 39.20 |
| | 4.0% | 56.33 | 51.32 | 47.06 | 43.42 | 40.26 |
| Growth | 5.0% | 59.16 | 53.56 | **48.85** | 44.89 | 41.47 |
| | 6.0% | 62.55 | 56.22 | 50.98 | 46.58 | 42.85 |
| | 7.0% | 66.70 | 59.40 | 53.47 | 48.56 | 44.44 |

*Source: BPI Capital Africa.*

### KCB

| | YE16 |
|---|---|
| Total dividends (KESmn) | 148 599 |
| Shares in issue (mn) | 3 041 |
| **YE16 PT (KES)** | **48.85** |
| Current value (KES) | 39.75 |
| Upside | 23% |

*Source: BPI Capital Africa.*

## VALUATION 2: P/BV COMPARATIVE VALUATION

**We derived our P/BV valuation model using a revised sector YE16 P/BV of 2.0x, which we believe to represent a fair exit multiple for Kenyan banks that are highly profitable(avg. ROE 15-18^F: 24% vs SSA peers). Next to that, we calculated an exit multiple for each bank, by applying a premium or discount to the sector multiple. We then applied each bank's exit multiple to its YE16^F tangible NAV to derive a PT.**

### ROE

| | 2013 | 2014 | 2015^F | 2016^F | 2017^F | 2018^F |
|---|---|---|---|---|---|---|
| Coop | 28% | 20% | 24% | 24% | 23% | 23% |
| Equity | 29% | 30% | 24% | 25% | 25% | 25% |
| KCB | 25% | 24% | 24% | 24% | 24% | 24% |
| **Avg.** | **27%** | **25%** | **24%** | **24%** | **24%** | **24%** |

*Source: BPI Capital Africa.*



BPI

## P/BV Comparative model

| | Sector exit(x) | Premium/ discount | Exit multiple(x) | T. NAV | YE16 PT | Current value | +/- |
|---|---|---|---|---|---|---|---|
| Coop | 2.0 | -5% | 1.9 | 12.77 | 24.26 | 17.25 | 41% |
| Equity | 2.0 | 5% | 2.1 | 24.12 | 50.65 | 39.75 | 27% |
| KCB | 2.0 | -20% | 1.6 | 30.24 | 48.40 | 39.75 | 22% |
| **Avg.** | **2.0** | | **2.0** | | | | **30%** |

**market cap weighted avg. Source: BPI Capital Africa.*

## Valuation Sanity Check

| | YE15F | YE16F | YE17F | YE18F |
|---|---|---|---|---|
| **Coop** | | | | |
| PT/EPS (x) | 7.7 | 6.2 | 5.1 | 4.3 |
| PT/BV (x) | 1.7 | 1.4 | 1.1 | 0.9 |
| Div./PT (%) | 3.1% | 3.8% | 4.6% | 5.5% |
| **Equity** | | | | |
| PT/EPS (x) | 10.6 | 8.6 | 7.2 | 6.0 |
| PT/BV (x) | 2.0 | 1.6 | 1.4 | 1.1 |
| Div./PT (%) | 3.8% | 4.6% | 5.6% | 6.7% |
| **KCB** | | | | |
| PT/EPS (x) | 7.8 | 7.0 | 5.9 | 4.9 |
| PT/BV (x) | 1.9 | 1.6 | 1.3 | 1.1 |
| Div./PT (%) | 4.5% | 5.7% | 6.7% | 8.1% |

*Source: BPI Capital Africa.*



BPI

## Valuation Triggers

1. **Margin expansion**
   Due to rising interest rates and volatility in the interbank market, we expect top tier banks to expand NIMs in the ST. Banks with stronger pricing power (retail and SME focus) will achieve a faster increase in asset repricing vs corporate focused banks.

2. **FX gains**
   KES volatility increased opportunities for FX gains (trading and asset revaluation) in the ST. We believe that this is positive for banks, which are long FX as well as strong trade finance links.

3. **Stronger cost efficiency**
   Declining energy costs and moderate inflation will drive slower opex growth and improve operating efficiency. In addition, strong management execution in turnaround strategies as well as continued expansion of alternative distribution channels will positively realign cost structures.

4. **Growing contribution from subsidiaries**
   Kenyan banks continue to invest in the East African region via additional capital flows (for lending) and strong trade finance links with their subsidiaries. Exposure to high growth countries such as Rwanda and Tanzania is positive for earnings momentum. South Sudan may yet prove to be the largest contributor to earnings, despite substantial macro risks in the economy.

5. **Strong and sustainable profitability**
   Kenyan banks have continued to outperform regional peers through the cycle (ROE: +/-25%). We believe that by sustaining this high level of sector profitability in the ST and MT justifies a premium rating vs SSA banks.

## Valuation Risks

1. **Low NPL coverage ratios as lending rates increase**
   Kenyan banks have 'notoriously' low NPL coverage ratios vs Nigerian banks. Higher interest rates therefore imply potentially high downside risk to earnings via deteriorating asset quality and a subsequent increase in the volatility of cost of risk.

2. **Personal loans 'bubble'**
   Substantial exposure to the personal loans category (+25% of aggregate loans) can be singled out as a threat to overall sustainability of lending in Kenya. Much of the growth in personal loans is driven by loans originated on mobile platforms, where the effectiveness of risk assessment is uncertain. We believe that this segment is potentially a 'bubble'...

3. **Increased regulation**
   In our view, the central bank has extensively applied moral suasion on the banks, to reduce 'speculative' FX trading, increase cost of risk (re: NPL coverage ratios), and to lower lending rates. We find the regulatory tone to be relatively restrictive, which would imply that the sector is increasingly facing higher regulation. This will likely have a direct impact on lending rates, capitalisation, sector exposure and ultimately profitability.

# Company Notes

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# EQUITY RESEARCH

# Co-operative Bank

SSA Banks

**Buy**

High-Risk

23rd February 2016

Kenya

## Still Rising

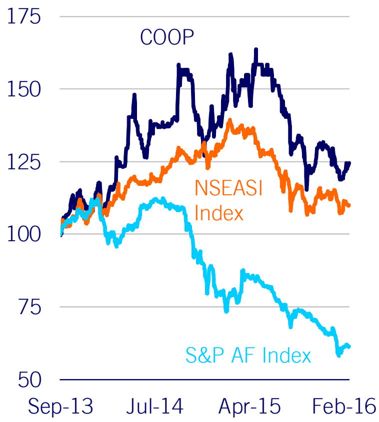
(YE16 PT cut from KES23.50 to KES22.15; Buy Recommendation maintained)

- **Still positive on outlook but fine-tuning estimates.** We continue to call out Coop a rising star on the back of substantial efforts to reposition the business via improved efficiency and scalability. However, in view of increased risk in the sector (higher interest rates, KES volatility and deteriorating asset quality), we have fine-tuned our estimates. Importantly, we have conservatively increased our COF assumption from 3.5% to 4.0% to reflect the impact of higher deposit rates. In addition, we have fine-tuned CoR to highlight increased pressure on asset quality and low NPL coverage. As such, we have cut our earnings by an avg. 6%; although it maintains the fastest growth (25% EPS CAGR15-18$^F$ vs sector avg. 19%). Significantly, there is limited downside risk to our ST and MT earnings estimates. We also highlight that our estimates are below consensus.

- **A strategy that works.** We reiterate our view that Coop Bank's aggressive shift from a product- to a customer-focused business will boost market share of loans and deposits in the retail and corporate segments. In addition, management effort to streamline and modernise the business will continue to boost efficiency in the ST and MT. In addition, a strong franchise in the cooperative societies sector gives Coop an advantage vs peers (access to low cost deposits and distribution).

- **Top pick but low stock liquidity.** Coop Bank remains our top pick Kenya owing to a combination of: (1) management execution-successful turnaround initiative, (2) high visibility of earnings, (3) above sector avg. earnings growth and (4) undemanding valuation-the stock declined 25% from a 12M high and 12M fw PER and P/BV multiples are currently discounting 20% and 25% to historic avg. multiples. However, stock liquidity is low vs peers (10% of Equity Bank's ADV). Further, risks to call include a negative impact of high interest rates on asset quality and current low NPL coverage ratios. **We revise our YE16 PT to KES22.15 (28% upside) and we reinforce our BUY.**

### COOP KN vs. NSEASI vs. S&P Africa Frontier Index




*Source: Bloomberg.*

### Stock data

| | | | |
|---|---|---|---|
| Price (KES): | 17.30 | Price Target (KES): | 22.15 |
| N° of shares (mn): | 4 889 | Reuters / Bloomberg: | COOP KN / COOP.NR |
| Market Cap (KESmn): | 84 341 | Market Cap (USDmn): | 828 |
| Avg. Daily Vol. (KES '000): | 19 120 | Avg.Daily Vol. (USD '000): | 194 |
| EPS growth (14-18$^F$): | 25% | Free-float: | 30% |
| ROE/ROA '15$^F$: | 4.7 | ROE'15$^F$: | 24% |
| Major shareholders: | | | Coop Holdings 65% |

### Valuation Summary

| | KES |
|---|---|
| YE16 DDM fair value | 20.05 |
| YE16 P/B fair value | 24.25 |
| **YE16 Price Target** | **22.15** |

*Source: BPI Capital Africa.*

| Estimates | 2013 | 2014 | 2015$^F$ | 2016$^F$ | 2017$^F$ | 2018$^F$ |
|---|---|---|---|---|---|---|
| Diluted EPS (KES) | 2.2 | 1.6 | 2.3 | 2.8 | 3.4 | 4.1 |
| P/E (x) | 8.0 | 10.6 | 7.7 | 6.2 | 5.1 | 4.3 |
| Dividend yield | 2.9% | 2.9% | 3.9% | 4.8% | 5.9% | 7.0% |
| Adjusted P/BV (x) | 2.1 | 2.0 | 1.7 | 1.4 | 1.1 | 0.9 |

### Historical Recommendation

| Date | Recommendation |
|---|---|
| 08-Jun-15(1) | Hold |
| 01-Oct-15 | Buy |

*(1) Initiating Coverage.*
*Source: BPI Capital Africa.*

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### Valuation triggers

1. Positive impact of turnaround initiative on cost efficiency
2. Improved efficiencies and scalability from alternative distribution
3. FX trading gains from KES volatility
4. Stronger contribution from subsidiaries

### Valuation risks

1. Asset quality concerns in a rising interest rate environment
2. Relatively low NPL coverage ratios
3. Pressure on CoR
4. Increased regulation may impact profitability

### Earnings revision

| | Adjustment | | | | |
|---|---|---|---|---|---|
| | 2015F | 2016F | 2017F | 2018F | Avg. |
| Interest income | 4% | 3% | 3% | 3% | 3% |
| Interest expense | 14% | 12% | 12% | 12% | 12% |
| Net interest income | 0% | 0% | 0% | 0% | 0% |
| Non-interest income | 0% | 0% | 0% | 0% | 0% |
| Total operating income | 0% | 0% | 0% | 0% | 0% |
| Operating expenses | 2% | 4% | 4% | 4% | 3% |
| PBT before provisioning | -2% | -4% | -4% | -4% | -4% |
| Impairment loss | 10% | 1% | 1% | 1% | 3% |
| Profit before tax | -4% | -5% | -5% | -5% | -4% |
| Taxation | 0% | -1% | -2% | -2% | -1% |
| **Profit after tax** | **-5%** | **-6%** | **-6%** | **-6%** | **-6%** |

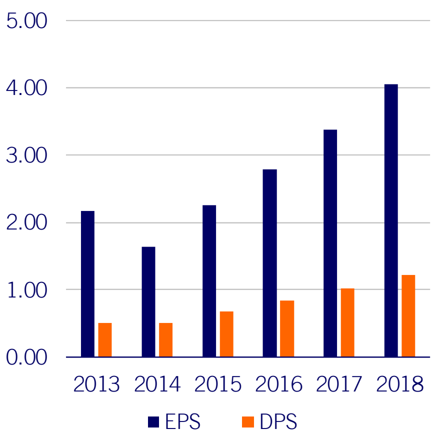
*Source: BPI Capital Africa.*

### Comparing estimates

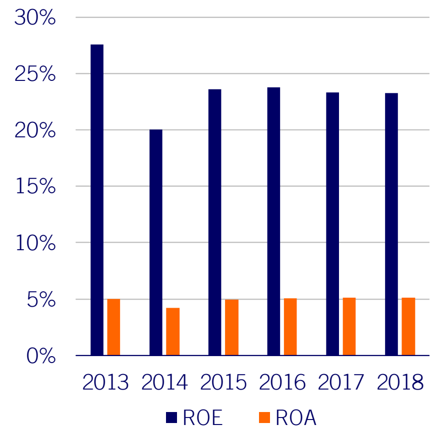
| | BPI | Consensus | | BPI | Consensus | |
|---|---|---|---|---|---|---|
| | 2015F | 2015F | +/- | 2016F | 2016F | +/- |
| PBT before provisioning | 18 059 | 17 073 | 6% | 22 014 | 19 578 | 12% |
| Impairment loss | 2 289 | 1 285 | 78% | 2 540 | 1 284 | 98% |
| PBT | 15 770 | 15 788 | 0% | 19 474 | 18 294 | 6% |
| PAT | 11 039 | 11 339 | -3% | 13 632 | 13 354 | 2% |
| **EPS** | **2.26** | **2.33** | **-3%** | **2.79** | **2.77** | **1%** |

*Source: BPI Capital Africa, Bloomberg.*

**EPS and DPS (KES)**

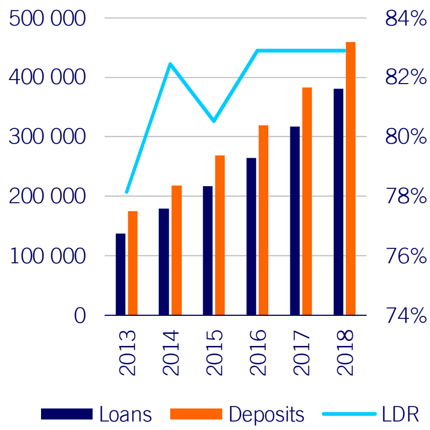



**ROE and ROA**

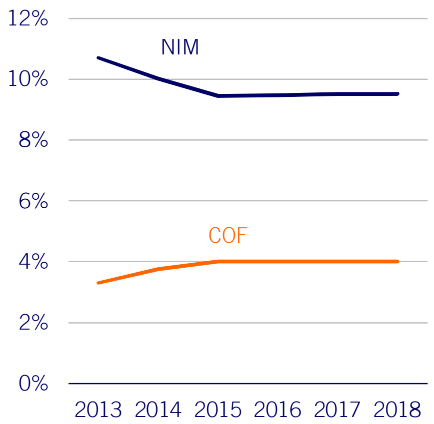



*Source: Company report.*

**Loans and Deposits (KESmn)**

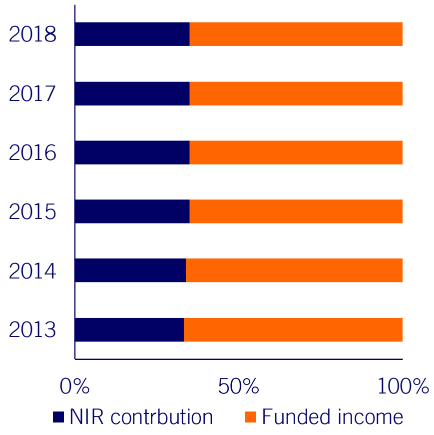



**NIM and COF**

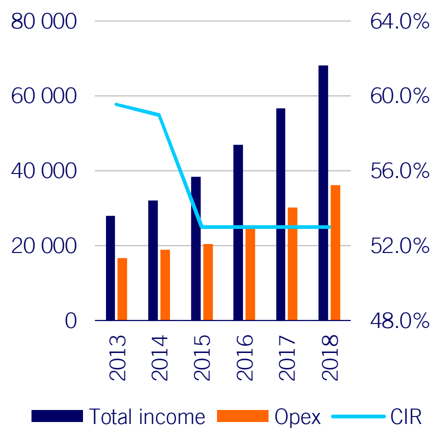



*Source: Company report.*

**NIR Contribution**

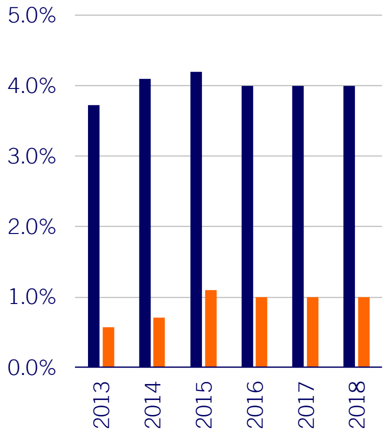



**Cost efficiency (Opex KESmn; CIR %)**




*Source: Company report.*

**NPL ratio and CoR**




*Source: Company report.*

## Income Statement

| (KES mn) | 2013 | 2014 | 2015F | 2016F | 2017F | 2018F | CAGR 14-18F |
|---|---|---|---|---|---|---|---|
| **Net interest income** | **18 626** | **21 276** | **24 976** | **30 444** | **36 900** | **44 280** | **20%** |
| Dividends | 54 | 6 | 13 | 16 | 20 | 24 | 41% |
| Commissions | 7 161 | 8 714 | 10 759 | 13 115 | 15 896 | 19 075 | 22% |
| FX and trading | 1 472 | 1 418 | 1 748 | 2 131 | 2 583 | 3 100 | 22% |
| Other | 577 | 672 | 928 | 1 131 | 1 371 | 1 645 | 25% |
| **Net operating revenue** | **27 890** | **32 086** | **38 424** | **46 838** | **56 770** | **68 124** | **21%** |
| Personnel expenses | 8 014 | 8 438 | 9 164 | 11 171 | 13 540 | 16 248 | 18% |
| Other admin exp | 6 883 | 8 188 | 9 164 | 11 171 | 13 540 | 16 248 | 19% |
| Operating cash flow | 12 993 | 15 459 | 20 096 | 24 496 | 29 691 | 35 629 | 23% |
| Depreciation | 1 708 | 2 296 | 2 036 | 2 482 | 3 009 | 3 611 | 12% |
| Cost-to-income (incl. dep.) | 59.5% | 59.0% | 53.0% | 53.0% | 53.0% | 53.0% | |
| **Operating profit** | **11 285** | **13 163** | **18 059** | **22 014** | **26 682** | **32 018** | **25%** |
| Loan loss impairments | 778 | 1 176 | 2 289 | 2 540 | 3 069 | 3 683 | 33% |
| Extraordinaries | 365 | -1 072 | 0 | 0 | 0 | 0 | |
| **Profit before taxes** | **10 872** | **10 916** | **15 770** | **19 474** | **23 613** | **28 336** | **27%** |
| Taxes | 1 764 | 2 901 | 4 731 | 5 842 | 7 084 | 8 501 | 31% |
| Minorities | 0 | 0 | 0 | 0 | 0 | 0 | |
| **Net profit** | **9 108** | **8 015** | **11 039** | **13 632** | **16 529** | **19 835** | **25%** |

## Balance sheet

| (KES mn) | 2013 | 2014 | 2015F | 2016F | 2017F | 2018F | CAGR 14-18F |
|---|---|---|---|---|---|---|---|
| Cash and deposits with C. Banks | 20 713 | 24 335 | 29 717 | 35 660 | 42 792 | 51 351 | 21% |
| Trading, AFS & HTM | 39 366 | 45 815 | 55 938 | 67 125 | 80 550 | 96 660 | 21% |
| Loans to credit institutions | 10 041 | 13 018 | 17 481 | 20 977 | 25 172 | 30 206 | 23% |
| Loans to customers | 137 087 | 179 486 | 216 758 | 264 305 | 317 166 | 380 600 | 21% |
| Participations | 0 | 0 | 0 | 0 | 0 | 0 | |
| Tangible & intangible | 13 102 | 11 829 | 13 984 | 16 781 | 20 138 | 24 165 | 20% |
| Other assets | 10 906 | 10 912 | 15 732 | 14 684 | 17 620 | 21 144 | 18% |
| **Total assets** | **231215** | **285396** | **349610** | **419532** | **503439** | **604126** | **21%** |
| Deposits | 175 425 | 217 698 | 269 200 | 318 844 | 382 613 | 459 136 | 21% |
| Trading portfolio | 0 | 0 | 0 | 0 | 0 | 0 | |
| Debt to credit institutions | 15 715 | 21 429 | 26 570 | 31 884 | 38 261 | 45 914 | 21% |
| Debt backed by securities | 0 | 0 | 0 | 0 | 0 | 0 | |
| Subordinated debt | 0 | 0 | 0 | 0 | 0 | 0 | |
| Other liabilities | 2 937 | 2 856 | 3 496 | 4 195 | 5 034 | 6 041 | 21% |
| Provisions | 0 | 0 | 0 | 0 | 0 | 0 | |
| Minorities (B/S) | 365 | 82 | 82 | 82 | 82 | 82 | |
| Preferred stock | 0 | 0 | 0 | 0 | 0 | 0 | |
| Shareholder's equity | 36 774 | 43 331 | 50 262 | 64 526 | 77 447 | 92 953 | 21% |
| **Total liabilities & sh. Equity** | **231215** | **285396** | **349610** | **419532** | **503439** | **604126** | **21%** |

*Source: Company report, BPI Capital Africa.*

# EQUITY RESEARCH

# Equity Bank

SSA Banks

**Buy**

High-Risk

23rd February 2016

Kenya

## Ambitious

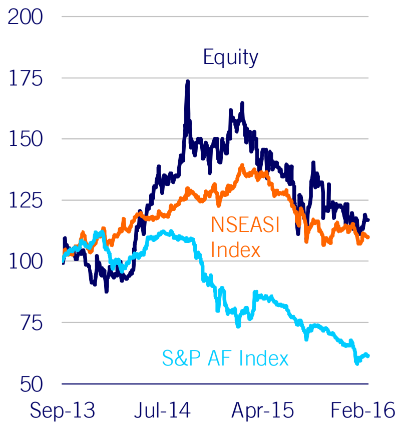
(YE16 PT cut from KES52.50 to KES49.75; Rec. increased from Hold to Buy)

- **Increasing CoR due to high SME exposure.** We continue to be broadly positive on Equity Bank, but revise our estimates in light of risks in the sector. We increased CoR15-18F from 1.0% to 1.2% (BPI: KES3.0bn vs consensus: KES2.4bn), but highlight that through the cycle, Equity Bank has surprised on the upside with relatively stable asset quality and low volatility of provisioning vs peers. Next to that, we increased COF15-18F from 2.5% to 2.8% reflecting increased competition for deposits and relatively low banking sector liquidity. Overall, we cut our earnings estimates by an avg. of 8%, which implies 16% EPS CAGR15-18F (previously 18%). Our estimated avg. ROE15-18F is therefore 24%, which in our opinion is largely conservative (vs 4-yr historic avg: 31%).

- **Ambitious SSA growth strategy.** Management is in the early stages of transforming Equity Bank to a continental behemoth present in 15 countries. At a time when some global banks may exit the SSA market (citing increased risk), this could be an opportunity for Equity to further test its model in a vast market of potential retail and SME customers. Will this work? So far, its 5 subsidiaries contribute about 10% of PBT vs KCB 12%; and for both banks S. Sudan has a lion's share (despite substantial economic challenges). Other countries are yet to prove their significance; but what difference would 10 other countries do to the bottom-line?

- **Alternative to our top pick.** Current valuations are undemanding (12M fw PER and P/BV multiples of 6.7x and 1.6x) and at a considerable discount to 5-yr historic avg. multiples. Triggers for a stock re-rating include NIM expansion, effective management execution and improved contribution from subsidiaries. In addition, the stock is an alternative top pick to investors with concerns of low trading liquidity on Coop Bank. **On balance, we see the current risk reward as positive despite cutting our YE16 PT to KES49.75. Upgrade to BUY.**

**EQBNK KN vs. NSEASI vs. S&P Africa Frontier Index**




*Source: Bloomberg.*

**Stock data**

| | | | |
|---|---|---|---|
| Price (KES): | 39.75 | Price Target (KES): | 49.75 |
| No. of shares (mn): | 3 703 | Bloomberg/Reuters: | EQBNK KN/EQTR.NR |
| Market Cap (KESmn): | 150 004 | Market Cap (USDmn): | 1 474 |
| Avg. Daily Val. (KES '000): | 200 624 | Avg. Daily Val. (USD '000): | 2 005 |
| EPS growth (14-18F): | 16% | Free float: | 55% |
| ROE/ROA '15F: | 4.0x | ROE '15F: | 24% |
| Major shareholders: | Helios (12%); Norfund (12%); Britam (8%); ESOP (4%) | | |

| **Estimates** | 2013 | 2014 | 2015F | 2016F | 2017F | 2018F |
|---|---|---|---|---|---|---|
| Diluted EPS (KES) | 3.7 | 4.6 | 4.7 | 5.8 | 6.9 | 8.3 |
| P/E (x) | 10.8 | 8.6 | 8.5 | 6.9 | 5.8 | 4.8 |
| Dividend yield (x) | 3.8% | 4.5% | 4.7% | 5.8% | 6.9% | 8.3% |
| Adjusted P/BV (x) | 3.0 | 2.4 | 2.0 | 1.6 | 1.4 | 1.1 |

**Valuation Summary**

| | KES |
|---|---|
| YE16 DDM fair value | 48.90 |
| YE16 P/B fair value | 50.65 |
| **YE16 Price Target** | **49.75** |

*Source: BPI Capital Africa.*

**Historical Recommendation**

| Date | Recommendation |
|---|---|
| 09-Jun-14 | Sell |
| 08-Jun-15 | Hold |

*Source: BPI Capital Africa.*

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## Valuation triggers

1. Margin expansion due to strong retail and SME exposure
2. Improved efficiencies and scalability from alternative distribution
3. FX trading gains from KES volatility
4. Strong management execution on growing concerns over sustainability of asset quality
5. Stronger contribution from subsidiaries

## Valuation risks

1. High exposure to SMEs in a rising rate environment
2. Increased volatility of CoR
3. Threat to dominance of agency banking
4. Increased regulation may impact profitability

## Earnings revision

| | Adjustment | | | | |
|---|---|---|---|---|---|
| | 2015F | 2016F | 2017F | 2018F | Avg. |
| Interest income | 1% | 3% | 2% | 2% | 2% |
| Interest expense | 16% | 20% | 20% | 20% | 19% |
| Net interest income | -2% | -1% | -2% | -2% | -2% |
| Non-interest income | -6% | -5% | -6% | -6% | -6% |
| Total operating income | -4% | -3% | -4% | -4% | -4% |
| Operating expenses | -2% | -1% | -2% | -2% | -2% |
| PBT before provisioning | -5% | -5% | -6% | -6% | -6% |
| Impairment loss | 24% | 26% | 24% | 24% | 25% |
| Profit before tax | -8% | -8% | -9% | -9% | -8% |
| Taxation | -8% | -8% | -9% | -9% | -8% |
| **Profit after tax** | **-8%** | **-8%** | **-9%** | **-9%** | **-8%** |

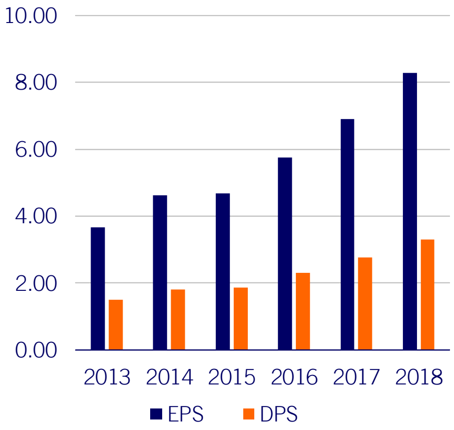
*Source: BPI Capital Africa.*

## Comparing estimates

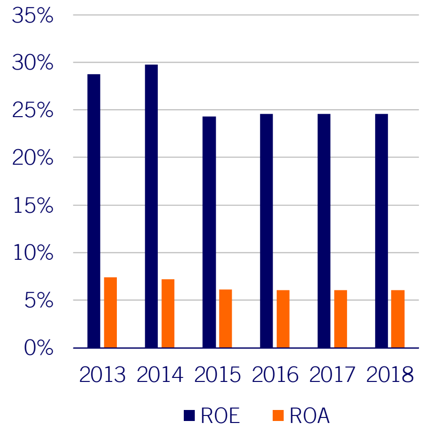
| | BPI | Consensus | | BPI | Consensus | |
|---|---|---|---|---|---|---|
| | 2015F | 2015F | +/- | 2016F | 2016F | +/- |
| PBT before provisioning | 27 401 | 27 068 | 1% | 34 148 | 35 353 | -3% |
| Impairment loss | 2 994 | 1 521 | 97% | 3 706 | 3 415 | 9% |
| PBT | 24 407 | 25 547 | -4% | 30 441 | 31 938 | -5% |
| PAT | 17 329 | 18 212 | -5% | 21 309 | 21 998 | -3% |
| **EPS** | **4.68** | **4.82** | **-3%** | **5.75** | **5.83** | **-1%** |

*Source: BPI Capital Africa., Bloomberg.*

**EPS and DPS (KES)**

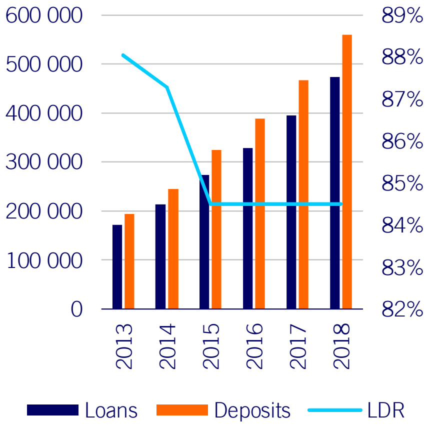



**ROE and ROA**

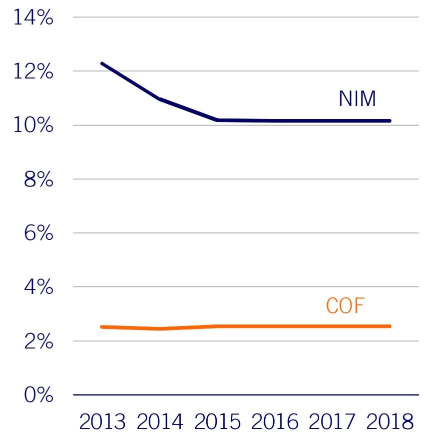



*Source: Company report.*

**Loans and Deposits (KESmn)**

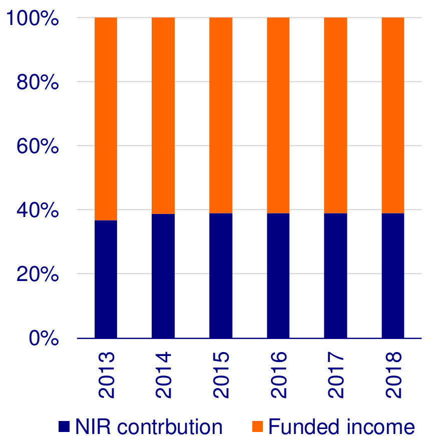



**NIM and COF**

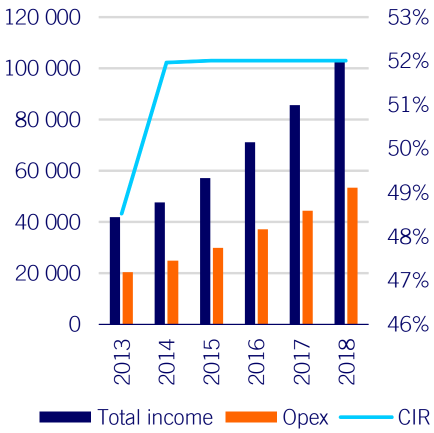



*Source: Company report.*

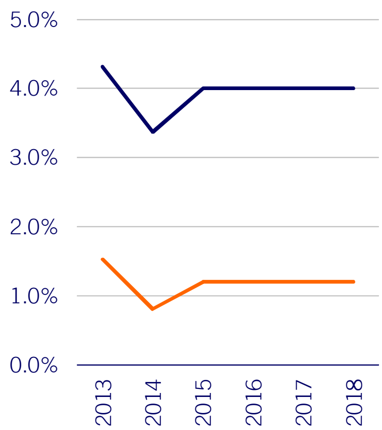
**NIR Contribution**




**Cost efficiency (Opex KESmn; CIR %)**




**NPL ratio and CoR**




*Source: Company report.*

*Source: Company report.*

## Income Statement

| (KES mn) | 2013 | 2014 | 2015F | 2016F | 2017F | 2018F | CAGR 14-18F |
|---|---|---|---|---|---|---|---|
| **Net interest income** | **26 491** | **29 175** | **34 822** | **43 396** | **52 075** | **62 490** | **21%** |
| Dividends | 7 | 104 | 111 | 139 | 166 | 200 | |
| Commissions | 11 190 | 14 056 | 16 697 | 20 809 | 24 971 | 29 965 | 21% |
| FX and trading | 1 866 | 2 345 | 2 672 | 3 329 | 3 995 | 4 794 | 20% |
| Other | 2 307 | 1 969 | 2 783 | 3 468 | 4 162 | 4 994 | 26% |
| **Net operating revenue** | **41 861** | **47 649** | **57 085** | **71 141** | **85 369** | **102 443** | **21%** |
| Personnel expenses | 9 024 | 10 776 | 13 358 | 16 647 | 19 976 | 23 972 | 22% |
| Other admin exp | 7 182 | 11 343 | 13 358 | 16 647 | 19 976 | 23 972 | 21% |
| Operating cash flow | 25 655 | 25 529 | 30 369 | 37 847 | 45 416 | 54 500 | 21% |
| Depreciation | 2 526 | 2 638 | 2 968 | 3 699 | 4 439 | 5 327 | 19% |
| Cost-to-income (incl. dep.) | 44.7% | 52.0% | 52.0% | 52.0% | 52.0% | 52.0% | |
| **Operating profit** | **23 129** | **22 892** | **27 401** | **34 148** | **40 977** | **49 173** | **21%** |
| Loan loss impairments | 2 402 | 1 591 | 2 994 | 3 706 | 4 448 | 5 337 | 35% |
| Other provisions | 0 | 0 | 0 | 0 | 0 | 0 | |
| Extraordinaries | -146 | 1 064 | 0 | 0 | 0 | 0 | |
| Profit before taxes | 19 296 | 22 364 | 24 407 | 30 441 | 36 530 | 43 836 | 18% |
| Taxes | 5 727 | 5 213 | 7 078 | 9 132 | 10 959 | 13 151 | 26% |
| Minorities | 0 | 0 | 0 | 0 | 0 | 0 | |
| **Net profit** | **13 570** | **17 151** | **17 329** | **21 309** | **25 571** | **30 685** | **16%** |

## Balance sheet

| (KES mn) | 2013 | 2014 | 2015F | 2016F | 2017F | 2018F | CAGR 14-18F |
|---|---|---|---|---|---|---|---|
| Cash and deposits with C. Banks | 14 194 | 14 544 | 20 545 | 24 654 | 29 585 | 35 502 | 25% |
| Trading, AFS & HTM | 44 572 | 48 369 | 68 484 | 82 180 | 98 616 | 118 340 | 25% |
| Loans to credit institutions | 20 333 | 33 674 | 45 656 | 54 787 | 65 744 | 78 893 | 24% |
| Loans to customers | 171 364 | 214 170 | 273 934 | 328 721 | 394 466 | 473 359 | 22% |
| Participations | 0 | 0 | 0 | 0 | 0 | 0 | |
| Tangible & intangible | 12 931 | 14 059 | 20 545 | 24 654 | 29 585 | 35 502 | 26% |
| Other assets | 14 334 | 19 754 | 27 393 | 32 872 | 39 447 | 47 336 | 24% |
| **Total assets** | **277 729** | **344 572** | **456 557** | **547 869** | **657 443** | **788 931** | **23%** |
| | | | | | | | |
| Deposits | 194 621 | 245 383 | 324 156 | 388 987 | 466 784 | 560 141 | 23% |
| Trading portfolio | 0 | 0 | 0 | 0 | 0 | 0 | |
| Debt to credit institutions | 27 267 | 30 441 | 46 569 | 55 883 | 67 059 | 80 471 | 28% |
| Debt backed by securities | 0 | 0 | 0 | 0 | 0 | 0 | |
| Subordinated debt | 0 | 0 | 0 | 0 | 0 | 0 | |
| Other liabilities | 4 285 | 4 972 | 6 848 | 8 218 | 9 862 | 11 834 | 24% |
| Provisions | 0 | 0 | 0 | 0 | 0 | 0 | |
| Minorities (B/S) | 0 | 0 | 0 | 0 | 0 | 0 | |
| Preferred stock | 0 | 0 | 0 | 0 | 0 | 0 | |
| Shareholders' equity | 51 556 | 63 776 | 78 984 | 94 781 | 113 738 | 136 485 | 21% |
| **Total liabilities & sh. Equity** | **277729** | **344572** | **456557** | **547869** | **657443** | **788931** | **23%** |

*Source: Company report, BPI Capital Africa.*

EQUITY RESEARCH

# KCB Bank

SSA Banks

**Hold**

High-Risk

23rd February 2016

Kenya

## Price action vs Risks

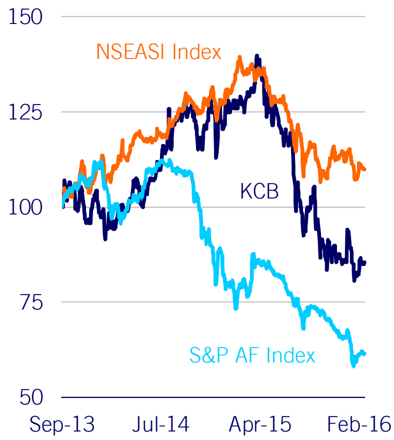
(YE16 PT cut from KES57.85 to KES48.60; Hold Recommendation maintained)

- **Conservatively adjusting estimates.** In our opinion, KCB's NPL ratio (7%) vs sector avg. (4.9%), and NPL coverage 48% continues to increase forecast risk to our estimates in the ST and MT. As such, we conservatively increased 15-18F CoR by 50bp to 2.0%, highlighting the impact of rising rates and 'legacy' bad loans on provisioning. We also increased our COF assumption from 3.1% to 3.5% on concerns over low B/S liquidity, as well as price sensitivity of corporate deposits (45% of total deposits). Nevertheless, there are some positives. Cost efficiency will continue to improve on scalability of the KCB-MPESA partnership (4.3mn subscribers' vs Equity: 1.3mn), and growth of agency banking, 2x y/y to 21 973 vs Equity 22 017. Significantly, alternative channels comprise 65% of total transactions vs branches 35%; (Equity Bank: 77% of total transactions). Nevertheless, we estimate lower CIR 15-18$^F$ of 49% vs 50% previously. **Overall, we have cut our EPS 15-18$^F$ by an avg. 8% (implied 15% EPS CAGR14-18$^F$).**

- **Strong regional presence**. KCB remains most widely represented in East Africa with total assets of KES607bn (Equity: KES446bn). Its subsidiaries comprise 30% of total loans and deposits, while revenue and PBT contribute 20% and 12% respectively. Entry to Ethiopia will likely boost regional earnings, as KCB gains access to a population of 80mn people. Nevertheless, potential growth opportunities and persistent tier 1 CAR reduction may spur recapitalisation in the MT.

- **Price action increases upside**. The stock underperformed peers (40% off 12M vs Equity: 30% and Coop: 25%), while 12M fw PER and P/BV multiples are currently attractive on a historic perspective-30% discount to 5-yr avg. multiples. Though we are conservative on our estimates, we continue to see lower asset quality as a key risk in the ST. **We therefore remain risk reward neutral and revise our YE16 PT to KES48.60 (22% upside). Maintain HOLD**.

### KNCB KN vs. NSEASI vs. S&P Africa Frontier Index




*Source: Bloomberg.*

### Stock data

| | | | |
|---|---|---|---|
| Price (KES): | 39.75 | Price Target (KES): | 48.60 |
| No. of shares (mn): | 3 041 | Bloomberg: | KNCB KN/KCB.NR |
| Market Cap (KESmn): | 119 496 | Market Cap (USDmn): | 1 174 |
| Avg. Daily Val. (KES '000): | 132 078 | Avg. Daily Val. (USD '000): | 1 335 |
| EPS growth (14-18$^F$): | 15% | Free float: | 70% |
| ROE/ROA '15: | 5.0x | ROE '15: | 24% |
| Major shareholders: | | | Government (18%); NSSF (8%) |

### Valuation Summary

| | KES |
|---|---|
| YE16 DDM fair value | 48.85 |
| YE16 P/B fair value | 48.40 |
| **YE16 Price Target** | **48.60** |

*Source: BPI Capital Africa.*

| Estimates | 2013 | 2014 | 2015$^F$ | 2016$^F$ | 2017$^F$ | 2018$^F$ |
|---|---|---|---|---|---|---|
| Diluted EPS (KES) | 4.8 | 5.6 | 6.2 | 6.9 | 8.2 | 9.8 |
| P/E | 10.1 | 8.7 | 7.8 | 7.0 | 5.9 | 4.9 |
| Dividend yield | 4.1% | 4.1% | 4.5% | 5.7% | 6.7% | 8.1% |
| Adjusted P/BV | 2.3 | 2.0 | 1.9 | 1.6 | 1.3 | 1.1 |

### Historical Recommendation

| Date | Recommendation |
|---|---|
| 20-Aug-14 | Sell |
| 01-Oct-15 | Hold |

*Source: BPI Capital Africa.*


Analyst
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Available on our website: **www.bpiequity.bpi.pt**, **BPI Online**, and Bloomberg at **BPAF.**

### Valuation triggers

1. Margin expansion driven by rising lending rates
2. Improved liquidity to reduce volatility of COF
3. FX trading gains from KES volatility
4. Stronger cost efficiency due to scalability of KCB M-PESA partnership
5. Stronger contribution from subsidiaries

### Valuation risks

1. Persistent asset quality concerns
2. High volatility of CoR
3. High exposure to price sensitive corporate deposits may increase pressure on COF
4. Increased regulation may impact profitability
5. Potentially earnings dilutive capital call

### Earnings revision

| | 2015F | 2016F | 2017F | 2018F | Avg. |
|---|---|---|---|---|---|
| Interest income | 0% | -6% | -6% | -6% | -4% |
| Interest expense | 10% | 7% | 10% | 10% | 10% |
| Net interest income | -4% | -10% | -11% | -11% | -9% |
| Non-interest income | 0% | -6% | -8% | -8% | -5% |
| Total operating income | -2% | -9% | -10% | -10% | -8% |
| Operating expenses | -4% | -11% | -12% | -12% | -10% |
| PBT before provisioning | 0% | -7% | -8% | -8% | -6% |
| Impairment loss | 19% | 6% | 6% | 6% | 9% |
| Profit before tax | -3% | -9% | -11% | -11% | -9% |
| Taxation | -3% | -9% | -11% | -14% | -9% |
| Profit after tax | -3% | -9% | -11% | -9% | -8% |

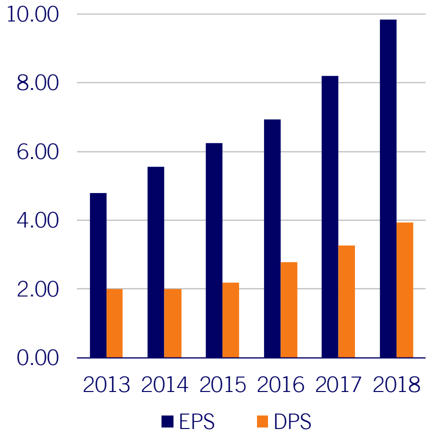
*Source: BPI Capital Africa.*

### Comparing estimates

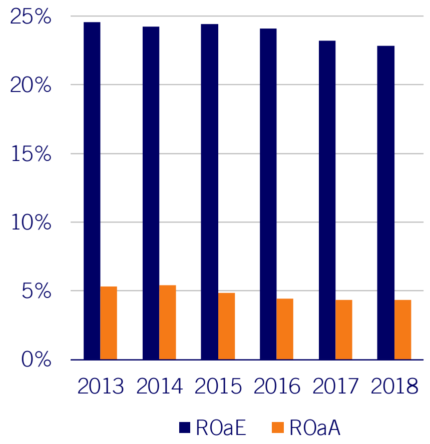
| | BPI | Consensus | | BPI | Consensus | |
|---|---|---|---|---|---|---|
| | 2015F | 2015F | +/- | 2016F | 2016F | +/- |
| PBT before provisioning | 32 399 | 28 764 | 13% | 35 746 | 34 538 | 3% |
| Impairment loss | 5 669 | 1 732 | 227% | 6 022 | 1 576 | 282% |
| PBT | 26 730 | 27 032 | -1% | 29 724 | 32 962 | -10% |
| PAT | 18 979 | 19 116 | -1% | 21 104 | 23 088 | -9% |
| **EPS** | **6.24** | **6.30** | **-1%** | **6.94** | **7.57** | **-8%** |

*Source: BPI Capital Africa, Bloomberg.*

**EPS and DPS (KES)**

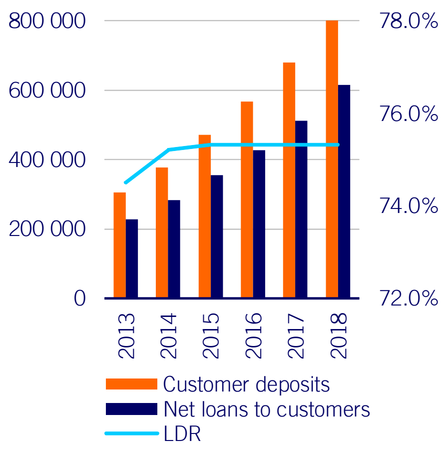



**ROE and ROA**

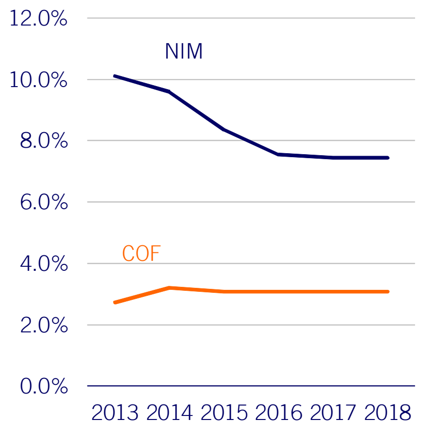



*Source: Company report.*

**Loans and Deposits (KESmn)**

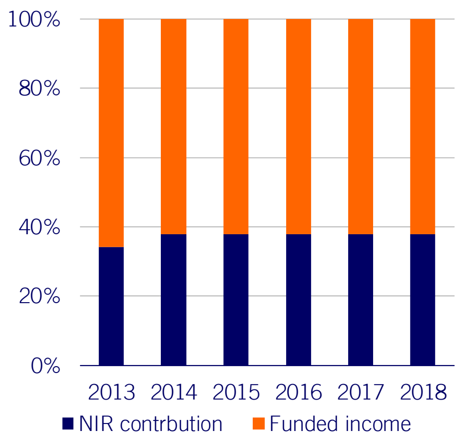



**NIM and COF (%)**

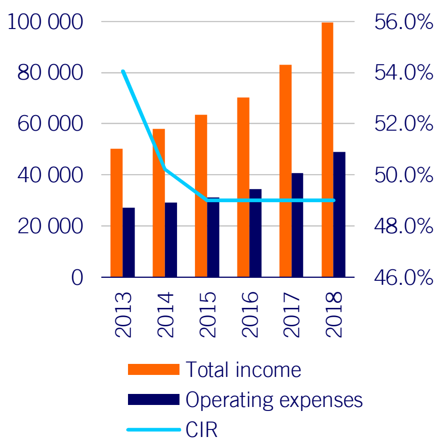



*Source: Company report.*

**NIR Contribution**

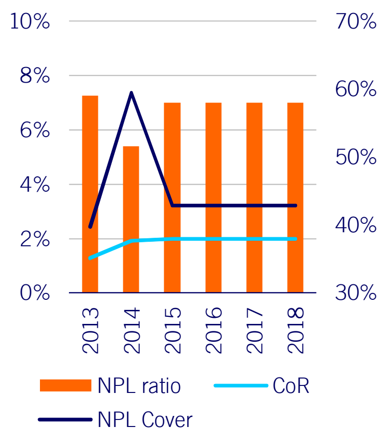



**Cost efficiency (Opex KESmn; CIR %)**




*Source: Company report.*

**NPL ratio and CoR (LHS); NPL Cover (RHS)**




*Source: Company report.*

## Income Statement

| (KES mn) | 2013 | 2014 | 2015F | 2016F | 2017F | 2018F | CAGR 14-18F |
|---|---|---|---|---|---|---|---|
| **Net interest income** | **32 984** | **35 949** | **39 387** | **43 456** | **51 464** | **61 757** | **14%** |
| Dividends | 12 | 0 | 24 | 27 | 32 | 38 | 338% |
| Commissions | 10 501 | 12 739 | 14 484 | 15 981 | 18 925 | 22 711 | 16% |
| FX and trading | 3 710 | 4 150 | 4 828 | 5 327 | 6 308 | 7 570 | 16% |
| Other | 2 903 | 5 112 | 4 804 | 5 300 | 6 277 | 7 532 | 10% |
| **Net operating revenue** | **50 110** | **57 950** | **63 528** | **70 091** | **83 007** | **99 608** | **15%** |
| Personnel expenses | 13 470 | 13 993 | 14 008 | 15 455 | 18 303 | 21 964 | 12% |
| Other admin exp | 10 931 | 13 226 | 14 008 | 15 455 | 18 303 | 21 964 | 14% |
| Operating cash flow | 25 709 | 30 731 | 35 512 | 39 181 | 46 401 | 55 681 | 16% |
| Depreciation | 2 679 | 1 885 | 3 113 | 3 434 | 4 067 | 4 881 | 27% |
| Cost-to-income (incl. dep.) | 54.0% | 50.2% | 49.0% | 49.0% | 49.0% | 49.0% | -1% |
| **Operating profit** | **23 030** | **28 846** | **32 399** | **35 746** | **42 333** | **50 800** | **15%** |
| Loan loss impairments | 2 906 | 5 058 | 5 669 | 6 022 | 7 227 | 8 672 | 14% |
| Other provisions | 0 | 0 | 0 | 0 | 0 | 0 | |
| **Profit before taxes** | **20 124** | **23 787** | **26 730** | **29 724** | **35 107** | **42 128** | **15%** |
| Taxes | 5 782 | 6 939 | 7 752 | 8 620 | 10 181 | 12 217 | 15% |
| Minorities | 0 | 0 | 0 | 0 | 0 | 0 | |
| **Net profit** | **14 341** | **16 849** | **18 979** | **21 104** | **24 926** | **29 911** | **15%** |

## Balance sheet

| (KES mn) | 2013 | 2014 | 2015F | 2016F | 2017F | 2018F | CAGR 14-18F |
|---|---|---|---|---|---|---|---|
| Cash and deposits with C. Banks | 34 730 | 47 064 | 58 228 | 69 873 | 83 848 | 100 617 | 21% |
| Trading, AFS & HTM | 92 996 | 97 198 | 122 585 | 147 101 | 176 522 | 211 826 | 22% |
| Loans to credit institutions | 10 402 | 37 572 | 45 969 | 55 163 | 66 196 | 79 435 | 21% |
| Loans to customers | 227 722 | 283 732 | 355 495 | 426 594 | 511 913 | 614 296 | 21% |
| Participations | 0 | 0 | 0 | 0 | 0 | 0 | |
| Tangible & intangible | 9 888 | 10 351 | 14 097 | 16 917 | 20 300 | 24 360 | 24% |
| Other assets | 15 114 | 14 420 | 16 549 | 19 859 | 23 830 | 28 597 | 19% |
| **Total assets** | **390 852** | **490 338** | **612 923** | **735 507** | **882 609** | **1 059 131** | **21%** |
| Deposits | 305 659 | 377 272 | 471 951 | 566 341 | 679 609 | 815 531 | 21% |
| Trading portfolio | 0 | 0 | 0 | 0 | 0 | 0 | |
| Debt to credit institutions | 14 371 | 27 030 | 45 969 | 55 163 | 66 196 | 79 435 | 31% |
| Debt backed by securities | 0 | 0 | 0 | 0 | 0 | 0 | |
| Subordinated debt | 0 | 0 | 0 | 0 | 0 | 0 | |
| Other liabilities | 7 467 | 10 402 | 15 323 | 18 388 | 22 065 | 26 478 | 26% |
| Provisions | 0 | 0 | 0 | 0 | 0 | 0 | |
| Minorities (B/S) | 0 | 0 | 0 | 0 | 0 | 0 | |
| Preferred stock | 0 | 0 | 0 | 0 | 0 | 0 | |
| Shareholders' equity | 63 355 | 75 634 | 79 680 | 95 616 | 114 739 | 137 687 | 16% |
| **Total liabilities & sh. Equity** | **390 852** | **490 338** | **612 923** | **735 507** | **882 609** | **1 059 131** | **21%** |

*Source: Company report, BPI Capital Africa.*

# BPI Capital Africa

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(TOTAL RETURN IN 12-18 MONTHS):

| | Low Risk | Medium Risk | High Risk |
|---|---|---|---|
| Buy | >15% | >20% | >25% |
| Hold | >0% and < 15% | >0% and < 20% | >0% and < 25% |
| Sell | < 0% | < 0% | < 0% |

These investment ratings are not strict and should be taken as a general rule.

INVESTMENT RATINGS STATISTICS

As of 29th January BPI Capital Africa Equity Research's investment ratings were distributed as follows:

| | |
|---|---|
| Buy | 41% |
| Hold | 39% |
| Sell | 20% |
| Total | 100% |


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**BPI is also present in Africa through:**

BFA in Angola (50.1% stake)

BCI in Mozambique (30% stake)