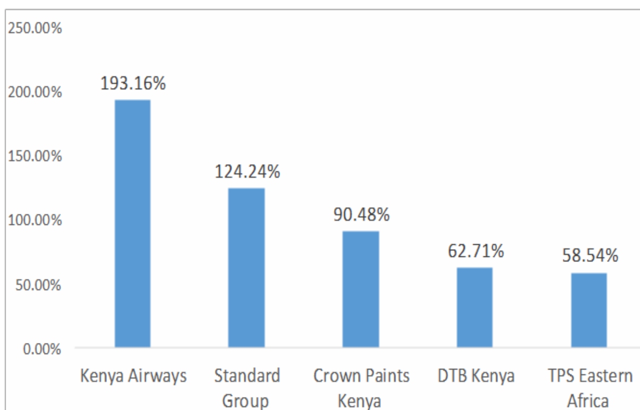
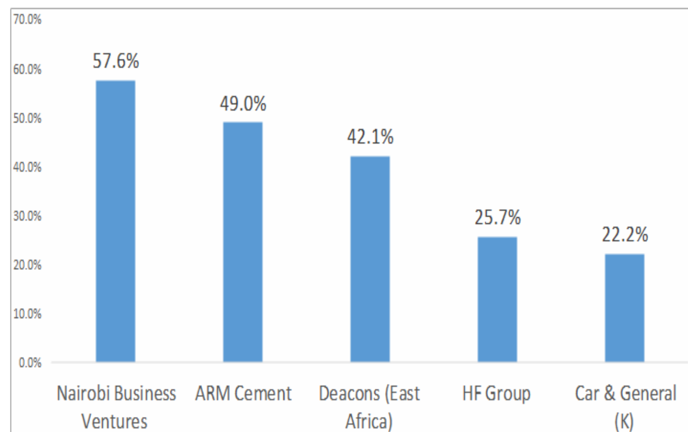
Equities: We take stock of a very good year for the market with strong gains being registered on the NASI (+28.4% to 171.2 points) and NSE-20 (+16.5% to 3711.94 points) indices. We attribute the strong performances to the solid financial results of some of the companies that were listed on the stock exchange (e.g. Safaricom) as well as market developments which led to stocks to subsequently skyrocket (e.g. Kenya Airways). In aggregate, most (63%) of the stocks gained, a few (7%) were unchanged while remainder (30%) of the stocks declined. We point out that Kenya Airways (+193.2%) and Standard Group (+124.2%) led the top gainers. We attribute KQ's sharp rise to a reverse stock split (every 4 shares were consolidated into 1 share) which induced investors to believe that the share price should quadruple as a result. Standard Group's gain was on thin volumes (0.0041% of all shares traded) thereby implying that the gain was based on a one-off or a few transactions rather than sustained demand. Nairobi Business Ventures (-57.6%) and ARM Cement (-49.0%) led the top decliners. We believe that financial headwinds facing the two businesses attributed to the value attrition over the course of the year.

KQ Set the Pace from the Front...



Source: NSE

...while Nairobi Business Ventures led from behind*



Source: NSE. *The figures above are actually negative but are positive for illustrative purposes.

Performances of our top picks in the last year: Our top picks performed considerably well over the course of 2017. We notice that 4 of our top picks gained (CIC: +47.4%, Centum: +18.2%, Bamburi: +12.5% and Kenya Power: +11.7%) while 3 (Kenya Re: -19.6%, Kenol Kobil: -6.0% and EABL: - 2.5%) of our top picks fell. Had one owned our top picks (in equal proportions) over the course of 2018, one would have earned an average return of **8.8%.** We note that Kenya-Re, Kenol Kobil and EABL could have been affected by weak investor demand in the second half of the year owing to muted investor activity occasioned by the election activity. We still believe that the investment cases are sound and would still advise investors to buy into these counters. We further discuss the key catalysts and risks for the key counters here below:

Key catalysts and risks going forward:

Government's focus on broad based economic development: We positively view the government's intention to focus on far-reaching economic development by focusing on four major areas of the economy: Manufacturing, Food Security, Affordable Housing and Universal Healthcare. We see this as the biggest catalyst to sustaining (if not improving) the economic trajectory. We believe that the economic backdrop is going to be dominated by efforts to realize the administration's four goals. If implemented correctly, there is likely to be a multiplier effect on the economy that would support consumer demand and business confidence thus providing a much needed tailwind to equities in general.

Renewed political tension: We flag that the plot by the opposition to rise to power through a swearing -in ceremony later on this month is the largest risk to economic stability in our view. Given the fact that this extra-constitutional move seems to be firmly on course, we believe this is likely to set up a political showdown with largely dire consequences. Considering that no party seems to be backing down, we believe that any stalemate is likely to throw the country back into the economic slowdown between September and November last year. Considering that we are just getting out of the politically induced economic stagnation, we believe that an uplift in the political temperatures is likely to hit both consumer and business confidence thus throwing the economy into a tailspin. We hope that dialogue may be held in order to prevent such a scenario from occurring.

Our **base case** is that some form of political resolution is likely to be ultimately reached that would enable to government to carry out its agenda as well as quell political tensions that have gripped the country over the last five months or so. This, in our view, would underpin a continued up- side in equity prices that was witnessed in 2017.

- **Foreign Exchange:** The currency was relatively well behaved (-0.58% to USD/KES 103.2) over the course of the year in part due to the CBK's intervention over the course of the year as well as a narrower current account deficit characterized by lower oil imports. We believe that a resumption of economic normalcy over the course of the year would put more pressure on the currency owing to enhanced import demand. We believe, though, that the currency is unlikely to cross USD 105 over the course of the year owing to efforts by the CBK to maintain its flexible exchange rate mechanism.

- **Inflation:** In the first half of this year, there was widespread concern about the likely trajectory of food inflation owing to the fact that the significant expansion of food inflation (Jan'17-May'17: +898 bps to 21.52%) during that interval had shown little signs of slowing. The hope of a turnaround in the inflation story was hinged on the long rains (expected to fall between March-May) which were expected to ease drought that was being experienced at the time and hence put downward pressure on both the food and headline inflation. Since June, a material difference has been witnessed with the food inflation falling (from 15.81% in June) to 5.79% in November. The fall in the food inflation coincided with the drop of headline inflation to a 54-month low of 4.73%. Going forward, we are keeping our eye on the first half of the year for any cyclical food inflationary pressures. We are also monitoring the price of crude oil that is likely to witness some upside pressure as OPEC countries

- **Fixed Income and Treasury Bills:** Over the course of the year, there was an oversubscription (110.5%), with the subscription level. We believe that strong appetite from institutional investors, government parastatals and banks led to the oversubscription. Yields on government securities were range bound (between 8% and 11%) in part due to the reluctance of the CBK to accept expensive deposits. Primary auctions in 2017 were healthily subscribed with the subscription rate (100.2%) being a reflection of the robust appetite from banks and institutional investors. We expect the above trend to be continued this year. We flag, however, that there is a risk

STOCK PICKS

Bamburi Cement: BUY at TP of KES 242, Current Price KES 178.00

- Despite Bamburi Cement issuing a profit warning for FY17F, we still rate it as a buy given it's near to medium term outlook. 2017 was always going to be a challenging year for cement companies with historical evidence showing a deceleration in cement consumption in election years due to a slower investment rate. Furthermore, a significantly slower private sector credit growth limited credit access to the construction sector. Going forward, the company is banking on growing its capacity (+1.8 million tonnes) which should be ready for commissioning in mid-2018 which will enable BMBC maintain/grow its market share thus growing its topline. We also see stable cement prices as commodity prices begin to recover.

- BCL's Kenya grinding capacity has not increased significantly in the past 10 years, only growing by 13% in that period, while all around it, new entrants and existing players (ARM Cement) ramped up. A few investors questioned BCL's ambition as its capacity utilization crept up to the 80-90% band in the past 5 years limiting sales, resulting in its volume market share contracting. This is finally being addressed with 0.9mtpa to be introduced at the Nairobi Grinding Plant (NGP) while 0.8mtpa will be introduced in Eastern Uganda, meaning Hima Cement will operate from either side of Kampala. We see this as timely given the high utilization in both Kenya and Uganda at 96% and 92% respectively as at 2016. This works out to a combined capacity utilization of 95% as intimated by management.

- We maintain our TP on a better outlook for cement prices and increased sales volumes, underpinned by a rising

utilization rate and a rebound in private sector credit growth respectively. Furthermore, the planned commissioning of new capacity is timely given BCL's current capacity constraints. We like the strategic shift to have two plants in Uganda. We see this saving freight costs and making Hima Cement more competitive in Uganda. On the flip side, both plants are purely grinding plants meaning BCL will have to use imported clinker in the interim, increasing production costs. They are however currently prospecting for additional limestone reserves to boost their clinker capacity in what they are referring to as 'phase 2' of their expansion. BCL trades at a trailing PE of 9.74x. Out TP implies the counter re-rates to 16.7x.

Centum (Unrated). Current Price: KES 44.00.

- **PBT falls by 21% on underperformance of financial services subsidiaries:** Centum Group posted a drop in its half-year PBT (-21% y/y to KES 2.2bn) largely driven by a material contraction (-35% y/y to KES 1.6bn) in income from financial services. Management attributes the dip in income to reduced fee management income and interest income witnessed in its asset management (GenAfrica and Nabo) and banking (Sidian) subsidiaries respectively. The financial services division subsequently realized a loss (KES 111.5m) thus reversing last year's profit (KES 571.3m). The company's trading business, however, was immune to the tough operating environment (between March and September) with a solid (+9.4% y/y) jump in trading profit (to KES 548.9m) being the evidence of the division's resilience. We also note than investment and other income also grew (+15.4% y/y to KES 2.2bn) which we attribute to unrealized and realized gains made in its real estate portfolio.
- **Beverages business underpins solid trading profit growth:** We note that the trading business (beverages, agribusiness, utilities and publishing) posted a stronger growth in sales (+15.8% y/y to KES 4.8bn) owing to improved performance (+8% y/y to KES 4.0bn) in the beverages business (c.86% of trading sales). The publishing business (c.11% of trading sales) also performed materially better (+41%) on a year-on- year basis. Direct and other operating costs, however, increased materially (+16.7% y/y to KES 4.2bn) predominantly driven by the beverage business.
- **Focus turns to turning around financial laggards:** As has been mentioned in the first paragraph, we note that the financial services division reversed its profit in 1H17 to post an operating loss in 1H18. Nevertheless, the group is keen on turning around the division's performance with plans afoot to improve Sidian's contribution of non-funded income to the total income (c.20% as of 1H17) of the bank (to 50% by FY18) for instance. We also believe that efforts to improve its sour loan book (NPL Ratio: c.18% as of 1H18) are underway in order to usher the bank back into profitability. We believe that the asset management divisions' turnaround is based on a resumption in risk appetite in the financial markets as a whole which the business expects to happen from the beginning of CY18.
- **Strategy ticks all the boxes; execution is key:** We are quite constructive on the group's outlook. Our view is informed by their focus on squeezing more profits from the trading business (through revenue acceleration and cost containment**)** and aggressively rolling out plans to execute their rich project pipeline (real estate, education and health sector projects in particular). Moreover, we like their efforts to deliver (Debt-to-Equity Ratio: FY17: 33% vs. 1H18: 28%) by retiring their Equity-Linked Bond (KES 4.3bn). However, we believe that execution of the projects is likely to be key risk to the group's rosy outlook. We note that failure, for instance, to aggressively sell construction ready sites as well as quickly turning around the financial services subsidiaries would taint (at least temporarily) the solid business momentum that the group has had for the last 6 years (c.26% CAGR growth in NAV). That said, we note that the company's stock is trading (KES 44.00) at a lower point than the latest NAV (KES 62.50) would suggest therefore implying that now would be a good time for investors to buy.

CIC Insurance Group (Not rated): Current Price KES 5.75

- CIC posted a solid rise (+28% y/y) in its 1H17 PBT (to KES 429.51m) primarily driven by an increase in the net earned premiums (+16.7% y/y to KES 5.88bn) and in investments and other income (+54% y/y to KES 1.98bn). The CEO is on the record as saying that the gross written premiums (+20% y/y to KES 7.59bn) which underpinned the rise in the net earned premiums, can be attributed to an increase in the distribution channels. The improvement in fortunes at the NSE is responsible for the widening of the investments and other income.

- Total expenditure also grew significantly (+25.5% y/y to KES 7.09bn) buoyed by the rise in operating and other expenses (+25% y/y to KES2.92bn) and net claims and policyholder benefits (+27.2% y/y to KES 4.07bn). Finance costs marginally slipped (-0.5% y/y to KES 323.2m) while the share of loss of associate amazingly shrank to KES 1.895m (from KES 10.77m) in the previous year.
- Going forward, CIC plans on continuing to leverage of investment in technology to make their business processes more efficient, and offer convenience to the customer. In addition, CIC hopes to tap into the micro-insurance segments (Cooperative and Mutual Micro insurance) through new micro insurance products cutting across life, medical and property insurance. This same model will be replicated across its regional offices in Malawi and Uganda which have a developing cooperative sector. Additionally, new guidelines from the government indicate that the government will disburse KES 600 for every boarding and day school student for their insurance needs. This is expected to aid schools in meeting the insurance premiums as this expense has been the biggest impediment to schools getting covers.
- Similar to other insurance companies, we expect the recovery in the stock market to be a positive for CIC. In addition, the elimination ofone-off expenses (provisions and reserves) will likely boost FY17 performance. While CIC is currently trades at a very high valuation (trailing P/E 82x), we believe that the cost efficiency and product rationalization efforts are poised to restore earnings growth and thus justify the high valuation.

Safaricom. HOLD at TP: KES 25.85; Current Price: KES 28.00.

Safaricom's reported 1H18 EPS increased by 10% to KES 0.65, marking the slowest first half growth since a 47% y/y contraction reported in 1H12A. The run-rate EPS is 3% be-hind our FY estimate of KES 1.34. The key non-voice revenue streams of MPESA and data reported slower than expected growths due to a tough macroeconomic environment and lower prices on increased competition. The second half looks set to be affected by the boycott of Safaricom services called by the main opposition party NASA over the telco's alleged dalliance with the ruling party in the nullified August 8th election.

- MPESA revenues (26% of service revenues) decelerated from 34% y/y to 16% in 1H18, the first deceleration in four years (1H14). Management allude to reducing 'bank to MPESA' transfer charges by c.33%, while person to person (P2P) transfers charges declined by 27%. These reductions are likely in response to increased competition from both Equitel and PesaLink. The former now accounts for 25% of the total value of mobile money transactions, according to the CA's latest quarterly statistics achieved in less than three years of service. Additional cuts were effected on Lipa Na MPESA (LNM) tariffs by 50% in the same period. Average transactions per user per month however increased by 13.6% to 11.

- Mobile data (15% of service revenues) continued to decelerate, growing by 31% in 1H18 versus the 46% growth reported in the corresponding period last year. This points to a likely FY18F deceleration, akin to what we have observed in the three preceding financial years (FY15A; +59%, FY16A; +43%, FY17A; +38%). Safaricom reports increased usage per user in those years (FY15A; +38%, FY16A; +77%, FY17A; +52%, 1H18A; +66% to 382MBs) implying either that a slower accretion in subscriber numbers or lower data charges are culpable for the deceleration. The former is ruled out because the absolute subscriber net-adds have risen y/y in that period. The deceleration in data revenues is therefore due to lower prices, which declined by 29% y/y in 1H18 (1H17; -16%). Data consumption is price elastic and Safaricom is responding to increased competition from its cheaper rivals especially in the youth segment.

- Voice revenues (41% of service revenues) accelerated y/y to grow at 3.6% from 1.1% the year before. With both ARPU and Minutes of Use (MoU) declining by 7.8% and 7% (NICS estimate) respectively, the acceleration can be ascribed to a more robust increase in subscriber numbers. The net-adds in the twelve months to September 2017 were 2.9m subscribers compared to 1.5m in the corresponding period last year. In that period, Safaricom reported an average tariff decline of 1%. The ability to grow subscribers by this quantum will be tested in 2H18 by the boycott call by the opposition. The churn rate is likely to rise from 24.6% reported as at 1H18.

- **Maintain HOLD at TP of KES 25.85 (Previously HOLD at KES 22.58):** Management maintained EBIT and Capex guidance for FY18F at KES 71-75bn and KES 35-38bn respectively. We however increase our EBIT estimate to KES 76.5bn from KES 73.9bn previously, largely on lower costs. But because we also moderate our service revenue growth to 9% from 16% previously, our EPS remains flat at KES 1.34. This implies Safaricom's seasonality trend of having a stronger 2H is

maintained. This is notwithstanding the impact of the boycott of Safaricom services called by the opposition coalition, which at present is difficult to quantify. Upcoming CA's quarterly statistics will help shed some light on this. Nonetheless, the reducing effects of drought should support disposable incomes of a section of subscribers. In summation, we see Safaricom facing a period of slower earnings growth (FY18F; +11%, FY19F; +10% vs. FY17A;
+27%, FY16A; +20%, FY15A; +38%). A higher exit PE derived from the average 12 month trialing PE of 22x results in a higher blended TP of KES 25.85.

BRITAM (Not rated): Current Price KES 13.70

- 1H Gross premium earned and fund management fees increased (+6.2% to KES 11.69bn) while net insurance benefits increased by KES 3.1bn (to KES 6.7bn) driven predominantly by an alteration of the valuation methodology from the net premium valuation to gross premium valuation methodology which was effected last year.
- The group's asset base rose (+8% to KES 90.6bn) as of June 2017 relative to December 2016. Assets under management have grown significantly (+14% to KES 124.5bn) relative to December 2016.
- Going forward, we expect maritime insurance to drive further growth for the industry following recent regulatory changes that requires commercial importers to take insurance exclusively with local underwriters. We believe that Britam, being a market leader with a reputable brand and significant financial capacity, will be a key beneficiary. The insurer launched a self- service online portal late last year in a bid to tap into the KES 23bn marine business. According to the Association of Kenya Insurers (AKI) 2016 industry report, Britam is currently the largest marine insurance underwriter in Kenya, with a market share of 11%.
- We also believe that the counter warrants investor confidence considering that two institutional investors (IFC and AfricInvest) have pumped in (or are planning to pump in) in KES 9.25bn in the company to acquire 10.37% and 14.3% stakes respectively.
- Currently Britam trades at a trailing P/E of 10x. The counter appreciated by 34% in 2017.

Kenya Re (Not rated): Current Price KES 19.50

- 1H17 PAT increased by 4% to KES 1.6bn. Total income grew by 7% boosted by a 9% growth in net earned premium to KES7 bn.
- Total outgo was outpaced by total income, growing at 8% to KES 6.5bn. This was due to a marginal increase in net claims and policyholder benefits of 2% to KES 3.6bn.
- Kenya Re opened its Zambia regional office in November 2016, in line with its regional expansion strategy as it seeks to in- crease reinsurance capacity for insurance companies in Africa. The regional office is expected to serve Namibia, Zambia, Zimbabwe, Botswana, Mozambique, Lesotho, Swaziland Malawi and Angola. While boosting good risk management and innovative insurance practices in the region. The reinsurer expects to benefit from the new Zambian government trade strategy for local and international investment as the country tries to diversify away from copper mining.
- With mandatory cessations by insurers to Kenya-Re still in effect till 2020, we anticipate the reinsurer to reap from under- writing maritime insurers. Experts anticipate local insurers will increase their reinsurance cover in order to increase their capacity to underwrite large shipments.
- Management are optimistic of an improvement in the insurance sector given the absence of political violence in the after- math of the August 2017 General elections. This should result in less claims, boosting earnings and the re-insurer too. We also note that Investment income declined by 3% y/y in 1H17. We expect the continued improvement in the equities market to help rebound this.
- Currently KNRE trades at a P/E 4.1x. The counter fell by -19.6% in 2017.

EABL BUY at TP of KES 328; Current Price KES 238.00

- EABL released its full year results in late July, revealing a slight 4% increase in its FY17 EPS (from continuing operations) to KES 9.71. This growth excludes the gains from the sale of Central Glass Industries (CGI) of KES 2.2bn last year hence the term 'continuing operations'. Otherwise with that sale included, EPS was down 20%. PAT was KES 8.5bn.
- Net sales grew at 9.2% to KES 70.2bn, slightly behind our 13% growth projection. We especially note that there was significant growth from the spirits (+13% y/y) segments and a flat performance (0%) being witnessed in the beer segment on a year-on-year basis. The effects of the punitive 43% excise tax levied midway through FY16A began to ease as Kenya's revenues grew at 4%. Uganda also offered some growth (+7%) while Tanzania continues to struggle with NSV declining by 12%.
- A higher than expected jump in cost of sales (COGS) impacted negatively on the earnings. While previously COGS had declined by 0.9% in FY16A and increased by 6% in FY15A, an unexpected 22% jump in FY17A impacted profitability. This was blamed on drought, a slow depreciation of KES as well as new hedges at higher prices. Selling, General and Administrative Expenses (SG&A) decreased to 16.8bn (from 18.0bn in the previous year) owing to procurement savings, a refund from Diageo, as well as an emphasis on zero based budgeting which was implemented within a framework of organizational effectiveness.
- We like EABL's balance sheet positioning. We believe that the company's favorable net debt to EBITDA ratio (1.2x) is very attractive for a manufacturing firm. We also notice that the firm is quite liquid going by the current ratio (1.01x).

KENOL KOBIL (Not rated): Current Price KES 14.00

- Kenol Kobil continues its stellar recovery under CEO David Ohana, with the share price continuing to rally underpinned by an improved performance. Kenol Kobil was the best performing counter on the NSE in 2016, gaining 67% in 2016 and continues to edge upwards in 2017. The doubling of the interim DPS to KES 0.30 is another catalyst for the recent rally, since the 1H17 results were released in early August. Revenues doubled buoyed by increased service stations and increased Open tender system (OTS) wins. Higher y/y oil prices also underpinned the 96% increase in revenues to KES 73bn. These same factors however also led to an 104% increase in COGS to KES 68bn resulting in a Gross profit growth of 17% to KES 4bn.

- PBT increased by 20% as the business continues to streamline its middle line. Finance costs, which had impacted severely on the financial performance a few years back, continues to be reined in with finance costs declining by 16% as total debt declined by 33% to KES 4.8bn. Currency losses have also being tamed with the conversion of hard currency debt to KES over the years. The business plans to add 29 service stations to its downstream business while still remaining active in the OTS. This should continue to support revenue growth. Also, the business has now fully impaired the KPRL receivable, further improving the middle line performance.

- The counter now trades at a trailing PE of 8.5x. When we annualize its 1H17 EPS of KES 0.97, its forward PE is still relatively attractive at 7.2x.

Kenya Power (Unrated :): Current Price: KES 9.10.

- Kenya Power posted a marginal drop in its FY17 profit before tax (-9.7% y/y to KES 10.912bn) mainly attributable

to an increase in trans- mission and distribution costs (+1.6% to KES 33.4bn). Total income strongly gained (+11.4% y/y to KES 120.7bn) on the back of an expansion in electricity sales (KES 87.1bn from KES 92.0bn). The increase in electricity sales was driven by domestic consumers (+13.1%) with the street lighting (+43.2%) revenue also contributing strongly to the topline growth. Total power purchase costs however declined marginally to KES 50.5bn (-KES 784m) on the back of reduced non-fuel costs.

- Total operating expenses similarly rose (+12.7% to KES 118.006bn) driven by an increase in network management (+KEs 1.7bn to 11.2bn), commercial services (+KES 0.4bn to KES 4.7bn), administration costs (+KES 2.8bn to KES 17.5bn). We do believe that the operating expenses will keep on increasing steadily owing to the company's focus on achieving universal access by FY20F.
- Going forward, Kenya Power aims to implement the Last Mile Connectivity Project aimed at achieving universal electricity access by FY20E at the same time enhancing the efficiency of the power transmission and distribution networks. We do believe the move to enhance the connectivity rate (among retail and commercial clientele) is likely to boost top-line growth and thus should catalyze profit momentum going forward. We also are very constructive about the positive effects of measures aimed at reducing power losses on the grid.
- We note that over the past few years, Kenya Power has been heavily discounted as evidenced by its very low trailing P/E ratio (2.45x). Webelieve that the current entry level is attractive for the any investor owing to the fact that the valuation is unjustified.

KCB Group: SELL at TP of KES 31.41, Current Price KES 42.75

KCB has emerged from this challenging period relatively well, judging by it posting the lowest decline in 1H17 PBT of 2.3% amongst listed banks. This was on the back of the most effective margin management and aggressive loan growth amongst peers. Capital adequacy has surprisingly improved despite a 50% increase in FY16A's dividend payout and declining profits in 2017. Buoyed by how comfortable their capital position is, they even went further to issue a surprise interim DPS as at 1H17. We however see asset growth being curtailed by IFRS 9 in 2018, with the initial hit on capital significant for KCB given an LLR of KES 12.5bn as at 1H17.

Cutting deposits and lending aggressively helps NIMs considerably

KCB's interest expenses on deposits declined by 22%, the most amongst its peers with both savings and term deposits proportionately declining by 100bps y/y. COOP had a similar strategy only that their savings accounts increased modestly, resulting in funding costs declining by 20%. The decision to ramp up lending, registering the highest growth amongst listed banks at 17% also resulted in KCB posting the lowest decline in interest income from L&A of 7%, perhaps exemplifying the notion that increased volumes actually helped compensate for the lower lending rates y/y. COOP with a similar strategy posted a decline of 9% from a loan growth of 14%. As noted earlier, KCB as a result posted the best NII performance of a 0.4% growth while all other banks posted declines. NIMs contracted by only 110bps y/y to 8.6% versus EQB's 320bps de- cline.

Asset quality improves in a difficult operating environment

KCB's NPL ratio improved by 100bps y/y to 7.9% as at 1H17, with peers reporting contrasting fortunes. Both EQB's and COOP's deteriorated by 270bps and 40bps respectively in the same period. The Cost of Risk (CoR) equally improved, declining by 40bps y/y to 1%. This is also the lowest amongst its peers with COOP's at 1.3% and EQB's at 1.4%, marking a reversal where previously KCB perennially had the higher CoR. The subsidiary book has improved with cessation of lending in South Sudan with Kenya in fact culpable for the jump in Group NPLs as is the case with its peers. But perhaps a read across from EQB which saw its Kenya's gross NPLs increase by 65% (despite not lending) compared to KCB's and COOP's 9% and 19% respectively, is that KCB's proportionately higher corporate book is faring better in the rate cap environment.

Dividend hike a pleasant surprise but further hikes unsustainable

The capital position as at 1H17 is healthy with buffers of 6.9% and 4.2% for both Tier 1 and 2 Capital ratios respectively. It was a surprise when KCB increased its FY16A DPS by 50% to KES 3.00, given that we had correctly anticipated profits would decline after the enactment of the rate cap law thus necessitating the preservation of capital. They have gone a step further to issue an uncharacteristic interim DPS of KES 1.00 as at 1H17, something they haven't done in the 12 years of data available to us. This is the same bank that had intended to conduct a rights issue last year instead settling for a USD 200m subordinate debt. With profits likely to be under more pressure on the implementation of IFRS 9, it is unlikely KCB can maintain a hike going forward.

SELL at TP of KES 31.41 (Previously HOLD at TP of KES 32.52)

KCB's loan loss reserves (LLR) are significantly higher than its peers at KES 12bn versus EQB and COOP's KES 2.3bn and 700m respectively. This implies KCB has consistently under provisioned relative to CBK guidelines. It is

to our understanding that the entire LLR must be appropriated from retained earnings. The hit on capital will force KCB to reconsider asset growth and possibly raise tier 1 capital. Additionally, its historically higher NPL ratio means it could carry higher impairment charges from the higher expected losses unless it quits lending to its riskier clientele. We estimate an RoAE of 22% in FY18F, a figure boosted by the expected hit on capital.

Equity Group: SELL at TP of KES 34.59, Current Price KES 40.25

EQB will have to reconsider its strategy in light of the relatively poor performance reported in 2017. A resumption in customer lending would be the tonic, as well as shedding expensive deposits as exemplified by peers COOP and KCB. Meanwhile, as a way to mitigate the impact of IFRS 9, EQB intends avoid the microenterprises and unsecured lending segments.

The strong margin management of yore is missing

Kenya's NIMs contracted by 440bps to 8.1% while the Group's declined by 320bps to 8.5%. The blame was put on the interest rate caps in Kenya but a look at peers KCB and COOP, shows they fared better with Group NIMs contracting by smaller quantum's of 110bps and 160bps to 8.6% and 8.1% respectively. While the increase in government securities' income was robust at 115% y/y, the fact that government papers are a proportionately smaller part of total assets vis a' vis loans, total interest income declined by the most among its peers at –12% Versus KCB's and COOP's –4% and –10% respectively. But where EQB really underperformed was in the management of their funding costs, which increased by 8%, a huge contrast to KCB and COOP who reported 22% and 20% declines respectively.

Continued deterioration of asset quality puzzling

EQB's NPL ratio has progressively worsened from 3.3% in FY15A to 7.3% as at 1H17. In that period, KCB's has only increased by 130bps to 7.9%, though this masks a 12 month improvement of 100bps y/y. COOP enjoys best in industry/coverage asset quality at 4.5%, having increased by 110bps over the same 18 month period. Every segment of EQB's loan book has deteriorated with large enterprises the most affected with an NPL ratio of 6% as at 1H17 from nil 12 months ago. Normally when lending rates (begin to) normalize, repayments improve, which could explain KCB's marginal improvement. The spike in NPLs also impacted provisions with FY16A's impairment charge increasing by 173% y/y pushing the Cost of Risk (CoR) then to an uncharacteristically sector/coverage high for EQB of 2.5%. We are aware of enhanced CBK surveil-lance in the course of 2016 on loan book management quality and reporting. The CoR has since eased to 1.4% as at 1H17.

Spot-on when it comes to non-funded income growth

Growing NIR is a focus area in EQB's strategy and they continue to set the standard. NII/Rev ratio is the lowest in the banking sector at 56.5% as at 1H17, with COOP the closest at 65.4%. This revenue diversification is built on the introduction of novel products this remains the main avenue for banks to grow fees and commission income given that hiking existing fees is precluded. Mobile banking commission grew by 337% y/y to USD 6.5m, on the back of transaction fees charged on Equitel (telco services and money transfers) and EazzyAPP, available to smartphone users to access banking services like accessing loans and paying bills.

SELL at TP of KES 34.59 (Previously HOLD at TP of KES 34.15)

EQB was the only bank to cut staff costs in 1H17, declining by 16%. We think EQB will likely resume customer lending in FY18F but shun risker cadres as intimated, which will help grow profits. The hit on capital is not too significant with KES 3.4bn (1H17; KES 2.3bn) to be appropriated from retained earnings on implementation of IFRS 9 thus not overly affecting their capital position. We model a CoR of 2% for FY18F as the bank cannot wish away their existing risky book and the now impairing of their normal book. We work out an FY18F RoAE of 22.2% based on these factors.

Co-op Bank: SELL at TP of KES 16.76, Current Price KES 16.30

COOP Bank's 1H17 PBT declined by 11.3%, the highest dip amongst its peers (EQB & KCB). Its good margin management, only second to KCB, where NIMs contracted by only 160bps was undone by a relatively weaker growth in non-funded income (NIR) and an increase in impairments vis-a-vis the contractions posted by its peers. COOP is now the bank with the best asset quality in the sector after EQB's recent rise in loan delinquencies.

Management expects only a c.15% increase in impairment charge

When announcing 1H17 results, management intimated that they were now at an advanced stage in their engagements with consultants to work out the impact of IFRS 9 on CO-OP Bank's earnings. A full report/study will be ready by the time they announce their 9M16 numbers in early November. They nonetheless stated that early tests point to only a 15% y/y increase in impairment charge for FY18F. In our view, this is too low an increase, even when we focus on normal loans only, which previously were not or were negligibly impaired under IAS 39. They will now carry a 12 month expected loss under IFRS 9. COOP's normal/performing loans were KES 214bn as at 1H17. Assuming an arbitrary charge of 1% on normal loans (as is according to CBK guidelines), 1H17's loan loss provision of KES 1.5bn would go up by 58%.

Loan growth and cutting expensive deposits helps manage margins

COOP grew its loan book by 14% as at 1H17, keeping the decline in interest income from loans low at –7% (EQB; -15%). They also managed to reduce funding costs by 20% (EQB; +8%) in what can be ascribed to cutting term deposits by 8% to KES 79bn and also decelerating the mobilization of deposits to 3% (EQB; +14%). The bank's capital position is healthy with tier 1 and 2 buffers of 540bps and 830bps respectively. This should continue to underpin loan growth in 2017 though this will likely be tempered in 2018 with the implementation of IFRS 9. This will be due to possibly lower profits (on higher impairment charges) hence the need to preserve capital or an aversion to lending to riskier sectors to manage the expected losses.

Best in sector asset quality commendable

COOP Bank's NPL ratio has remained at sub 5% throughout which is laudable considering that the likes of StanChart, EQB and BBK, which were once in the same band have since slipped. This is even after the CBK enhanced surveillance in the course of 2016 on loan book management quality and reporting, in the aftermath of the challenges at Chase Bank and Imperial Bank. The CoR was flat at a low 1.3%.

We downgrade to SELL at a new TP of KES 16.76 (prev. BUY at KES 16.78)

Even after briefly adjusting for the 1 for 5 bonus issue in July, the share price reverted to its pre ex-bonus price within a short period, gifting investors a trough to peak share price return for 2017 of 74%. The bonus issue coupled by the share price rally has improved COOP's market capitalization to USD 861m. While the size criteria for re-admission to the MSCI Frontier Market Index is not very clear (COOP was deleted from the Index in May 2016), getting close the USD 1bn mark will enhance the share's appeal. Management guides at an FY17F RoAE of 20%, a decline from the 21.7% re-ported at 1H17. We expect a higher CoR (FY18F; 1.6% vs. FY17F; 1.2%) and cautious lending, both effects of IFRS 9 to result in an RoAE of 19.5% in FY18F.