Macroeconomic outlook and Equities recommendations

Resonating with our 'Macroeconomic and Equity Market Analysis and Outlook report—July 2015', the Kenyan economy experienced significant volatility in the second half of the year, with a tightening of credit conditions—driven by the unexpected closure of Imperial Bank (a Tier 2 bank); higher government yields; an inaccurate forecasting of government expenditures and revenues by the National Treasury; significantly weaker corporate earnings (16 companies issued profit warnings in the last year); higher cost push inflation (which was driven by higher food and alcohol prices); and a weakened KES / USD exchange rate. For 2016, we expect there to be an improvement in economic conditions, relative to that seen in 2H15, and we provide our outlook in the following pages. Of particular note is the upcoming general elections which are scheduled for 08th August 2017. While we expect increased political posturing as we get closer to the elections, we expect the election process to be better managed as a result of strengthened governance structures. We estimate GDP growth for 2015 come in at 5.5-5.8% and we predict growth for 2016 at similar levels, reaching 6.0% in the medium term, mainly driven by the construction, agriculture, telecommunication sectors and a recovery in the tourism sector.

Monetary policy outlook

* Central Bank Rate (CBR) may be reviewed downwards by 50bps during 2016 to 11.0% (from a current high of 11.50%) to spur growth, but is dependent on the perceived stability of the KES against the USD.
* The Kenya Banker's Reference Rate (KBRR) was not revised upwards during the Monetary Policy Committee (MPC) meet on 20-Jan-2016. This is despite higher 91-day T-Bill rates in September and October. We believe there is an increased likelihood of a revision to the KBRR methodology this year, in order to make it more reflective of current market conditions.

Inflation

* We project inflation to lie within the range of 5.0-7.5%, supported by lower oil prices, however 16.0% VAT levy on petroleum products in September 2016 and higher food prices could result in higher than estimated cost push inflation during 2016.
* The election cycle and private sector credit growth may lead to demand driven inflation.

Interest rates

* T-Bill yields to stay high in 1H16 at 13.0%-16.0% but comparably lower to yields seen in 3Q15 and 4Q15 (11.5% - 22.1%), driven by the Government's fiscal deficit and further driven by scheduled maturities.
* Commercial bank lending rates to remain high in the short term (currently at 17.2%) but normalize at about 14.0-17.0%.

Exchange rate

* KES to remain under pressure on the back of volatility in global markets and the persistent current account deficit, although completion of infrastructure projects could reduce the deficit.

Company	Recommendation	Target price	Current price	Upside/(downside)	Div. yield	Total return
KCB Bank	BUY	58.25	41.50	40.4%	5.0%	45.4%
BAT Kenya	BUY	870.00	800.00	8.7%	5.3%	14.1%
Co-op Bank	BUY	26.37	17.15	53.8%	3.0%	56.8%
DTB Bank	BUY	246.00	190.00	29.5%	1.3%	30.8%
KenolKobil	BUY	14.20	8.90	59.6%	3.2%	62.8%
Safaricom*	ACCUMULATE	Under Review	16.40	N/A	4.0%	N/A
Equity	HOLD	Under Review	38.50	N/A	4.5%	N/A
EABL	HOLD	274.04	255.00	7.5%	2.8%	10.3%

Bloomberg Ticker :	KNSMIDX
Reuters Ticker:	.NSEK

Country Statistics

Nominal GDP (USD bn)	63.1
Real GDP (USD)	40.8
Nominal GDP per capita (USD)	1,432
Real GDP per capita (USD)	926
Population (m)	44.1
Overall Inflation (%)	6.3
Total Debt to GDP %	56.2
Current Account Deficit to GDP (%)	9.6

GDP Growth

	y/y
1Q15	5.0%
2Q15	5.6%
3Q15	5.8%

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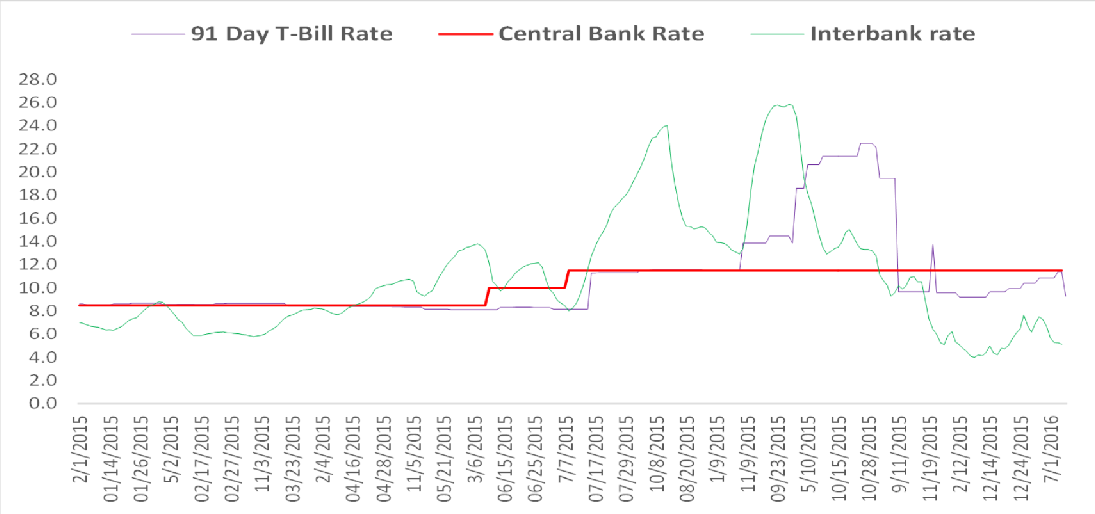
Macroeconomic outlook

A monetary policy stance that will balance GDP growth and risks to inflation

We expect the MPC to review the CBR to 11.0%

In 2015, the Monetary Policy Committee (MPC) appeared more concerned with inflationary pressures arising from the depreciating KES, and responded by hiking the Central Bank Rate (CBR) by 300bps to 11.50% from 8.50%. Since then, the KES/USD exchange rate has stabilized and we opine that the MPC will lower the CBR to 11.0% over the course of this year, dependent on the perceived stability of the KES against the USD. The CBK has already hinted no further hikes at least in the near term. The MPC met on 20th January 2016 to review its monetary policy decisions and adjust the Kenya Banker's Reference Rate (KBRR). No changes were made to either the CBR or the KBRR. Given the lack of revision to the KBRR and keeping in the evolution of the 91 day T-Bill rate (which forms a key input to the KBRR), especially in September and October 2015, we believe the methodology to the KBRR may see an update during 2016, in an attempt to make it more reflective of current market conditions.



Source: CBK

KES to remain under pressure

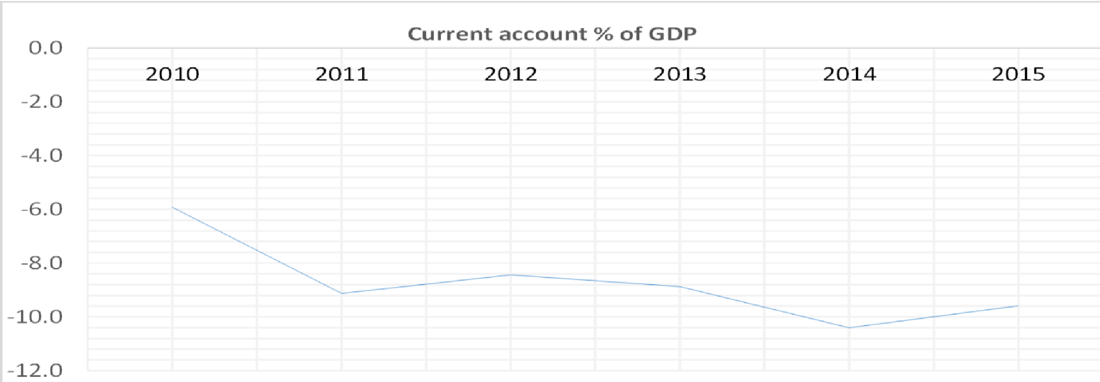
While we expect the KES to remain under pressure on the back of volatility in the global markets and the persistent current account deficit, we forecast the current account deficit % of GDP to reduce to ~8.0% in the medium term, from 10.4%, as major investment projects come to completion, combined with a recovery in the tourism sector. We also anticipate the lower oil prices to continue driving down the oil import bill.

The current account % of GDP at 10.4% to reduce to 8.0% in the medium term

We do however remain wary of the short term capital flows sustaining the current account deficit—any reversal of which could increase the downward pressure on the KES, although the completion of large infrastructure projects could encourage investment in the export sector over the medium-long term.

Macroeconomic outlook

The current account has been widening over increased machinery and equipment imports

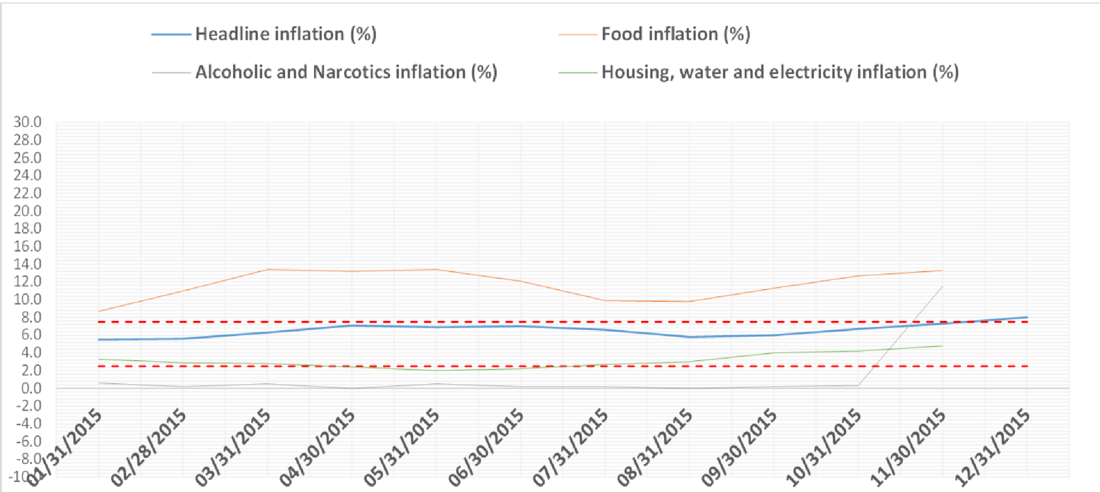


Source: Bloomberg

Headline inflation to remain within the range of 5.0-7.5%

Risks to food inflation from the El Nino phenomenon and the implementation of the 16.0% VAT levy on petroleum products

Inflation rate in 2015 broadly lay within the target band of 2.5-7.5%, with an exception in December, where it reached a high of 8.0% driven by food prices and as a result of the implementation of the new Excise Duty Act which mostly pushed prices of alcoholic drinks and cigarettes upwards. For 2016, we expect to see cost push inflation over the implementation of the 16.0% VAT levy on petroleum products (partly offset by lower global oil prices) in September 2016 and higher food prices owing to risks from irregular weather arising from the El Nino / La Nina phenomenon through the year. We also expect growth in money supply as we enter the election cycle (though limited vs. the previous cycles), as well as growth in the private sector credit (in the 8 months to August 2015, private credit growth was at 21.7%, above the Central Bank of Kenya (CBK) target of 19.7%), to pose upward risk to demand inflation. We do however remain wary of weakening business confidence as we move closer to the August 2017 elections.



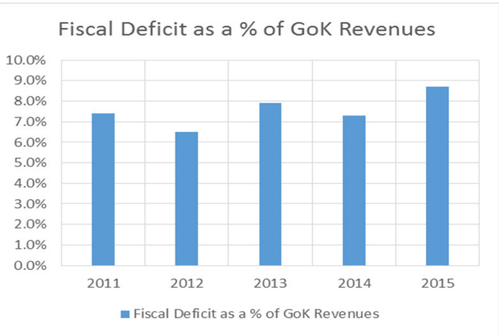
Source: Bloomberg

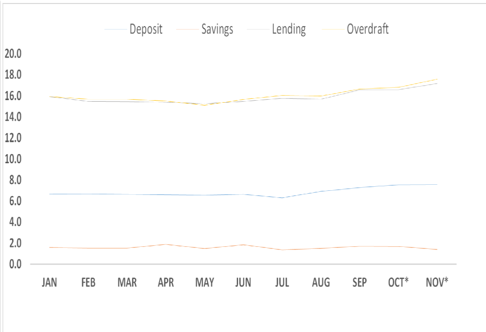
Macroeconomic outlook

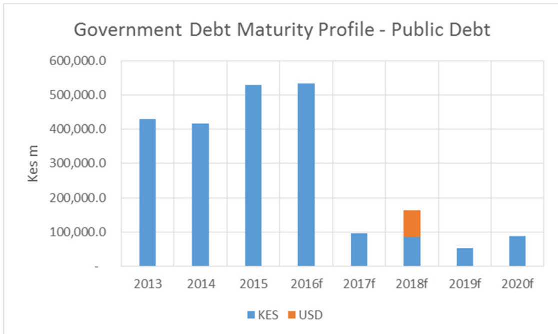
Interest rates to remain high in 1H16 due to government borrowing pressure amid scheduled debt maturities

We estimate the 91-Day T-Bill rate to range at 13-16.0% in 1H16

Given that the government is 20.0% behind schedule on its borrowing plans for the 1H of its fiscal year FY 15/16 (domestic net borrowing of KES 93.0bn), we see upward pressure on Government yields in 1H16—although we forecast it to be comparably lower to 2015 where the 91-Day T-Bill rate peaked at 22.5% during the interest rate hiking cycle in October—as the Government 'catches up' to its target. We place a 13.0-16.0% range for the 91 Day T-Bill rates in 1H16 vs. a 4 year median of ~9.3%. We do however note the intention of the government to externalize a key portion of its debt, through international borrowing, which may help in keeping interest rates down as it attempts to reduce borrowing from the domestic debt market. The Government is expected to announce a supplementary budget shortly, which is expected to cut-costs by 1% of GDP. Given that we expect Government revenue targets to be lower than forecasted, we believe the cost cuts (if they are fully implemented) will only seek to re-calibrate the budget to lower revenues. As for the bank rates, we posit them to remain high in the short term (currently at ~17.2%) but normalize to about 14.0-17.0% over the course of the year.





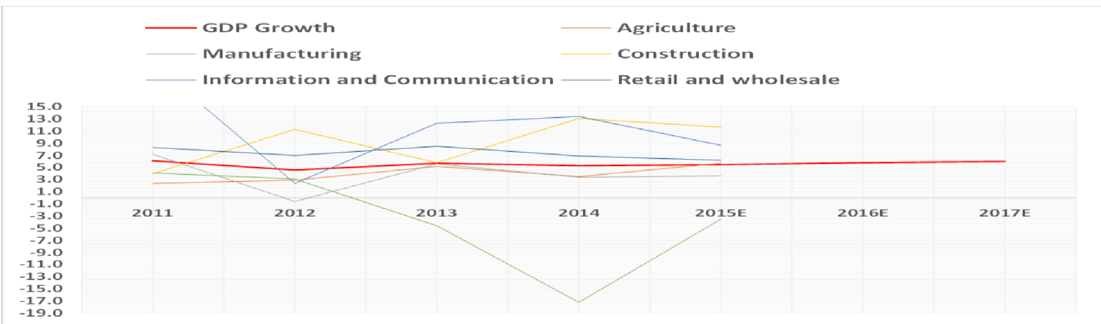


Source: CBK. Note: Government debt maturity profile counts only publicly traded debt. Does not include debt owed to MDBs (e.g. IMF, World Bank) or to syndicated loan holders. Note (2): Debt maturities past 2020 are not shown here.

GDP growth

We estimate GDP growth for 2015 at 5.5-5.8% and predict growth for 2016 at similar levels of approximately 6.0% in the medium term, above the Sub-Saharan forecasted GDP growth average of 4.2% in 2016. The National Treasury's growth estimate for 2016 lies at 6.1% compared to World Bank's estimate of 5.7%. Infrastructure has been forecasted to be the likely major driver of growth, alongside growth in tourism and farming.

2016 GDP growth likely to be approximately 6.0% in the medium term, mostly driven by infrastructure developments



Source: KNBS, Kestrel Estimates

Equities recommendations

KCB Bank: Buy

Improved NIMs in 2H15 to reflect positively in FY 15, though weighed down by reduced non-funded income.

* We expect improved NIMs in the second half of 2015 following the rise in average domestic interest rates to support growth in net interest income in FY15. In 3Q15, NIMs rose approximately 200bps y/y to 10%.
* There is a possibility of interest rates moving up in 2016 driven by heightened Government borrowing that could continue to support higher NIMs for KCB and the overall banking sector.
* The bank is expected to have continued recording strong loan book growth in the fourth quarter of 2015, amidst stable economic growth in 2015. We expect the loan book to grow approximately 21% y/y in FY15.
* Non-interest income growth was subdued (+2% y/y in 3Q15) and we remain concerned about the devaluation of the South Sudanese Pound (SSP) in mid-Dec, which we believe will have a significant impact on KCB's forex income performance for the full year (FY15). We further expect subdued performance through FY16.

BAT Kenya: Buy

Margins improvement over the implementation of the new Excise Taxes and foreign currency gain related to export sales.

* Following the gazetting of the Excise Duty Act 2016, BAT has increased cigarette prices on most of its brands to a greater extent than necessary to pass on the excise taxes to consumers. The price increases are expected to lead to margin improvement in 2016.
* BAT's export sales are USD denominated and account for roughly 30% of gross revenues, meaning there will be a positive foreign currency gain on export sales in FY15 that will support results.
* Domestic sales are expected to have continued to record stable growth in 2015 amidst relatively stable economic growth in the period; we expect them to grow 8% y/y in FY 15.
* The alleged bribery scandal involving BAT Kenya could lead to litigation in the future as reports have indicated that the Serious Fraud Office and the KRA are investigating the allegations.
* BAT will continue to face pressure for the implementation of the Tobacco Control Regulations 2014 which will be negative for the company especially due to the graphic warning labels to be introduced on all cigarette packaging. We believe the implementation of the regulations would negatively affect domestic cigarette demand going forward. BAT's lobbying capabilities may have also been hampered following the emergence of the alleged bribery scandal.

Co-op Bank: Buy

Real Estate and trade investments by Sacco's who account for ~11.0% to drive loan book expansion.

* Impressive deposits structure with SMEs contribution increasing quite fast (from 4% in 3Q14 to 14% in 3Q15) and corporates declining (from 31% to 29%), easing pressure on cost of funds. Government banking still remains a strong contributor to Co-op Banks deposit growth, accounting for 23% of the same.
* Sacco's will continue to be a significant driver for loan book growth. Currently accounting for 11% of the loan book, we feel that as Saccos get into more real estate and trade ventures, Co-op Bank will continue to benefit. This coupled with growing its SME, Mortgage and Asset Finance portfolios informs our optimism in sustained loan book growth. (25.5% y/y in FY15E and 25.3% y/y in FY16F).

Equities recommendations

* Non-funded income growth remains on course as use of alternative channels grows significantly (currently at 72% from less than 10% three years ago). This coupled with strong loan book growth will be key in driving growth in fees and commissions. Alternative channels (Agents, M-Coop Cash, ATMs and Internet Banking) account for 72% of transactions implying more room for increased utilization while delivering efficiencies. Non funded income currently accounts for 33% of total income and we estimate it to grow to 35% in FY16F. NPLs at a decent 4.0% to be maintained in the medium term.

DTB Bank: Buy

Subsidiaries to drive growth with a possible benefit from the Imperial Bank issue.

* Performance to be driven by growth in subsidiaries, with its contribution to the group revenues and assets (at 33.0% Vs. 10.0%-15.0% ten years ago. We anticipate entry into a new market in the next 12 months.
* Expected to be a major beneficiary from the Imperial Bank collapse.
* Strong growth in loan book and deposits as well as a superior loan book quality.
* Key risks remain the high reliance on the interest based income (NIMs contracting) but appears to be growing non-interest income payments
* While there is political crisis in Burundi, it only accounts for ~1.0% of the group PAT.

KenolKobil: Buy

EPS to grow on the back of higher sales volumes and income from non-fuel business segments.

* EPS to be driven by increased sales volumes and increased income from the niche and non-fuel business segments.
* Increased profitability from the consolidation and exit from loss making segments and subsidiaries.
* Continued operational efficiencies-may be a competitive advantage in the long run.
* Continued deleveraging as the main focus will drive EPS in the short term further accelerated by lower oil prices.

Safaricom: Accumulate

Data and M-Pesa segments to be key drivers of growth going forward.

* Safaricom announced excellent growth across most of their business lines in 1H16, a handful of which were above our expectations.
* We believe that while voice will continue to contribute to the lion's share of the Group's revenues, data and M-Pesa will continue to grow substantially over the coming years. This will be driven by innovations within the M-Pesa segment, such as Lipa-na-Mpesa; and through increased data usage – keeping in mind that 99% of Kenya's internet subscribers do so using their phones.
* Key risks include the potential takeover of Orange Kenya by Helios – we believe Helios is targeting a 'Helios Towers' like business in Kenya, which would ease the cost of doing business for the other players; and regulatory risk in relation to market dominance and potentially on M-Pesa.
* We are in the process of revising our price target (to be revised upwards) and hence we continue to have our 'Accumulate' rating.

Equities recommendations

E.A Breweries: Hold

Reversal of the Excise duty on Senator to positively impact on senator volumes but the new Excise Duty Act likely to negatively impact on the beer portfolio.

* While we expect EABL's 1H16 results to be better Y-o-Y, driven by the fair value gain on the sale of Central Glass Industries and increased sales of EABL's value offerings – given the reversal of the excise duty on Senator and as a result of the crack-down on illicit brews – we do remained concerned about the Group's exposure to the recently devalued South Sudanese Pound.
* We also remain concerned as to the potential impact of any settlement with the Fair Competition Commission of Tanzania, in relation to Serengeti Breweries' performance, including the likelihood of any goodwill write-down, however we believe that talks between EABL and the FCC were still ongoing as at the end of 1H16.
* In terms of the impact of the new Excise Duty Act, we expect there to be a negative impact on the Group's beer portfolio (in the short term), but do see some positive in the Group's spirits portfolio (especially the higher end brands) for whom excise taxes have been estimated to go down. The impact of this change in excise taxes are expected to be largely felt in the second half of this year.

Equity Bank: Hold

Equity continues to have a strong business proposition, with the highest NIMs, subsidiaries which are expected to more strongly contribute to the bottom line and lower expected operating costs going forward. We however assign a 'Hold' rating to Equity given that the shares trade a significant premium to its peers.

* Despite the massive sell off, Equity Bank is still trading at a significant premium to its peers at 2.1x book value compared to KCB Bank's 1.5x and Co-op Bank's 1.7x, albeit with a much higher ROE (26.4%) than the rest (KCB Bank:22.1%, Co-op Bank:20.8%) which sort of justifies the premium.
* Strong branch and biggest agency network: Equity Bank has 20,000 agents, double the size of KCB Bank (10,000+) and Co-op Bank (7,000+). Owing to this, the bank has been able to mobilise cheap deposits whose growth was registered at 30% in 3Q15. The bank still maintains the highest NIMs in the industry recorded at 10.0% despite declining over the last years owing to their ability to contain cost of funds. We therefore expect net interest income to grow at the levels of 10-15% going forward.
* Equity Bank has partnered with various global cards including Visa and Mastercard, and introduced Equity Money, its money transfer service for its diaspora clients. Additionally, the bank reduced its money transfer charges to 1.0% compared to an average of 10% charged by its competitors. As such, Equity Bank has managed to attract strong diaspora remittances which boosted its foreign trading income growth by 64.0% y/y in 3Q15. We view this as a very calculated strategy which should continue to boost non-funded income growth.
* Subsidiaries will contribute more strongly to bottom line growth owing to the reorganisation of the operating structure which now allows Equity group to invest as much as it pleases to subsidiaries which look promising (under the previous structure, Equity Bank was restricted to investing 25% of its capital across all subsidiaries.)
* Operating costs will be contained going forward as investment in the business and human capital is now complete. We expect a further boost to the bottom line as the cost to income ratio eases from 51.0% to 47% in FY16

Equities recommendations

Recommendation guide

STRONG BUY: Highly undervalued/ strong fundamentals
BUY: Good value/ strong fundamentals
ACCUMULATE: Buy on price dips
HOLD: Correctly valued with little pricing upside or downside
LIGHTEN: Overvalued by the market/ Reduce exposure/Declining fundamentals/industry concerns
SELL: Weak fundamentals and challenging operating environment/Highly overpriced