Kenya Strategy Outlook 2018—A Post Election Revival?

Following on from the prolonged election cycle of 2017, the political and economic outlook for Kenya in FY18 looks considerably improved. However, issues such as bank lending interest rate caps and IFRS9's impact on the banking sector continue to concern investors. We believe the interest rate caps, whilst not being retracted completely, will be modified in 2H18 resulting in a widening of the rate capping bands. Following the implementation of IFRS9 in FY18, although we expect some banks in the Kenyan banking sector to seek additional Tier 1 and Tier 2 capital in order to boost capital ratios, we understand the Central Bank of Kenya is currently seeking industry comments on its proposal to give banks upto five years to build capital buffers.

Summary

Political Outlook: We have a positive outlook on the political environment in Kenya in FY18. We do not however rule out the likelihood of some constitutional changes that may help accommodate demands from both sides of the political divide

Macro-economic Outlook:

- **Gross Domestic Product:** We anticipate stronger headline GDP growth in FY18 c. 5.3% - 5.7%, driven by a recovery of private sector confidence (post elections) and the agricultural sector (resumption of normal rainfall patterns). Expected headwinds for 2018 include the interest rate caps and slightly slower Government spending on account of fiscal concerns.
- **Inflation:** We expect inflation to be within the 3.5%-6.5% range. Trend in headline inflation is expected downward. We do not however discount short term volatility on account of the removal of food subsidies. Inflation in FY18—largely cost push.
- **Exchange Rate Outlook:** We expect the KES to weaken between 3.0%-5.0% against the USD in FY18. We do not anticipate any short term balance of payments shocks. A higher fuel import bill is expected to offset the decline in food imports.
- **Interest Rate Outlook:** We expect Government borrowing costs to increase in line with the expected relaxation of the rate caps in 2H18. We believe Government borrowing costs at present are artificially suppressed. Private sector borrowing rates are expected to be correlated with the Central Bank Rate. We believe private sector borrowing rates will increase following the expected relaxation of rate caps in 2H18.

Stock Recommendations

From a valuation perspective, we like stocks such as **KenolKobil (earnings growth, TP KES 17.85, 25.2% upside)** and **NIC bank (significant discount to NAV, TP KES 40.00, 17.7% upside)**. **KCB is of interest** to us due to management guidance of a 9.3% dividend yield in FY18F, although concerns surrounding loan loss provisioning continue to weigh on the stock (**TP KES 42.88, 0.9% upside**) . In our opinion **Kenya Airways is significantly overvalued** by the market. With an **FY17e net asset value per share of between KES 0.80 to 1.00**, we think the **current valuation of KES 18.50 per share places the stock in irrational territory. Among the larger market cap stocks,** we rate **Safaricom** as a **HOLD (under review), Equity Group Holdings** as a **HOLD (TP: 35.36, 11.6% downside), Cooperative Bank** as a **HOLD (TP KES 13.84 23.7% downside)**, **EABL** as a **HOLD (under review),** and **BAT** as a **HOLD (TP: 796.00, 4.7% upside)**. Our banking estimates do not assume a relaxation of the interest rate caps. Any relaxation will likely be positive for valuations across the sector.

Bloomberg Ticker :	**NSEASI**
Reuters Ticker:	**.NSEK**

Country Statistics

Nominal GDP—2017f (USD bn)	78.4
Nominal GDP per cap. (USD)—2017f	1,677.70
Population (m)	46.7
Total debt to GDP (%)*	56.2%

Real GDP Growth

	y/y (%)	q/q (%)**
4Q16	6.10%	1.31%
1Q17	4.70%	1.82%
2Q17	5.00%	1.23%
3Q17	4.40%	0.42%

Inflation

	y/y (%)	m/m (%)***
Mar-17	10.28%	1.67%
Jun-17	9.21%	-1.20%
Sep-17	7.06%	-0.57%
Dec-17	4.50%	0.54%

Interest Rates

	Dec 2017	Dec 2016
91d T-Bill	8.01%	8.60%
182d T-Bill	10.58%	10.49%
5Y Yields	12.40%	13.20%
Deposit Rates	7.67%	7.33%
Savings Rates	5.94%	6.37%
Lending Rates	13.65%	13.66%
CBR	10.00%	10.00%

Balance of Payments

% of GDP	3Q17	2Q17	3Q16
Curr. Acc.	-6.97%	-6.21%	-6.10%
Capital Acc.	0.07%	0.19%	0.07%
Overall BOPs	3.36%	-1.07%	0.35%

NSE Statistics

	Dec 2017	Dec 2016	% chg
NSE 20	3,711.94	3,186.21	16.5%
NASI****	171.2	133.3	28.4%

*IMF Estimates
**Seasonally adjusted. Non annualized.
*** Non-annualized. Deposit, Savings and Lending Rates are as at June 2017
****Difference being driven by Safaricom's impact on the market weighted NASI index.
TP = Target Price

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Political and Macroeconomic Outlook

Political Outlook

We have a positive outlook on the political situation in Kenya in FY18. Opposition party options remain limited after the new government was sworn in. We however do not rule out the likelihood of some constitutional changes that may help accommodate demands from both sides of the political divide following the highly contested elections.

Macro-economic Outlook

Gross Domestic Product

We anticipate stronger headline GDP growth in Kenya through FY18 (5.3% - 5.7%) driven primarily by a recovery of the agricultural sector following a resumption of normal rainfall patterns in 2H17 and further aided by a recovery in business confidence following the prolonged presidential elections of 2017. Domestic credit growth is however expected to remain constrained in 1H18 due to the implementation of IFRS9, further compounded by the interest rate capping regime, with a resulting headwind to private sector performance. We believe we will see a relaxation of the interest rate caps, with a widening of the interest rate bands in 2H18, which should be beneficial for private sector credit growth (mid-high single digit growth). The timing and magnitude of any such reversal however remains uncertain.

While public sector infrastructure spending has been a key contributor to headline GDP growth (an average of 0.7% contribution per annum between 2011 and 2016 according to the World Bank), we expect to see a slight slowdown in Government infrastructure spending as the Government becomes more selective in its infrastructure investments, driven by concerns surrounding its fiscal position.

Inflation

Kenya experienced a drought between 2H16 and 1H17, driven by the La-Nina phenomenon which resulted in double digit headline inflation mainly due to food price volatility. For FY18, headline inflation is expected to trend downwards, on account of a recovery in food production although we do expect short term volatility driven by the removal of food related subsidies. The recent increase in global crude prices will erode some of the benefits of lower food prices. We anticipate inflation to be within the 3.5% - 6.5% range through FY18 i.e. within the Central Bank's targets. Inflationary pressures are largely expected to be 'cost-push'.

Exchange Rate Outlook

The KES remained stable against the USD through 2017 (-0.7%), despite the prolonged presidential elections although it weakened by double digit percentage points against the GBP (-10.5%) and the EUR (-14.7%), driven by the strengthening of those currencies against the USD. That said, the TZS (-1.8%)and RWF (-1.9%) weakened against the KES, with UGX largely ending the year unchanged (+0.1%), making Kenyan exports more expensive relative to key domestic trading partners.

Kenya's current account deficit increased in 1H17 to 6.4% driven largely by higher food imports and lower exports, although capital flows to both the government and private sector (including remittances) continued to offer notable balance of payments support. We believe the KES will weaken by 3.0% -5.0% against the USD in FY18, in line with fundamentals. At present we do not foresee any short term balance of payments shocks, with an anticipated increase in fuel import costs being offset by lower food import costs. In addition, we are not excessively concerned by the current trade spat with Tanzania.

Interest Rate Outlook
We remain concerned with the rate of borrowing by the national government. As we had highlighted in our report on Kenya's Debt Sustainability (02-Oct-2017), we believe the Government needs to reduce its aggressive deficit spending sooner rather than later, noting that at present, recurrent expenditures (including interest payments and county transfers) are running above revenue collection. Domestic government borrowing costs continue to be suppressed (due to a perceived 'risk-free' nature) as a result of the interest rate caps. We expect domestic government borrowing costs to increase in line with the relaxation of the caps in 2H18.

Private sector borrowing rates are expected to be correlated with the Central Bank Rate, which we expect will remain unchanged despite a tempering of inflation expectations. A relaxation of the interest rate caps is expected to push average private sector borrowing costs higher, but this will be offset by an increase in private sector lending.

Investment Recommendations and Sector Outlook

Telecommunications Sector: Safaricom—Dominance Report:
The Communications Authority of Kenya, in its revised dominance study, has dropped the proposal of splitting Safaricom's business units. The study was updated after consultations with industry stakeholders. The splitting of Safaricom's business units had reportedly been one of the proposed action points if the Company was found to be abusing dominance. We view this positively, as it would maintain the synergies of the businesses. Upon completion of the study, we expect Safaricom to be found to be dominant but not to have abused that dominance.
SAFARICOM: HOLD (UNDER REVIEW)

Breweries (EABL) and Tobacco (BAT Kenya) - Inflation adjustment to Excise Taxes
We anticipate high single digit / low double digit inflationary adjustments to excise taxes on beers to be implemented on 01-Jan-2018. EABL has been working towards reducing costs and improving asset utilisation as a means of absorbing the cost of the excise tax changes in January 2018, rather than passing on the excise tax increase onto consumers. Retail checks suggest EABL has not revised product prices upward (02-Jan-2018). We do not anticipate any significant changes to EABL's bottom line as a result. Spirits' excise taxes had already been revised upwards as at April 2017. BAT Kenya management indicated they had expected excise inflation adjustments to take place in June 2018 as opposed to January 2018, with all increases in excise taxes passed onto the consumer in the form of price increases.
BAT Kenya: HOLD (TP: KES 796.00, 4.7% UPSIDE.)
EABL: HOLD (UNDER REVIEW)

The Kenyan Banking Sector: A key sector to look at in FY18
Following on from sharp increases in NPLs, further compounded by the introduction of interest rate caps in Kenya and a tepid business environment, 2017 has been a year of significant volatility for the Kenyan banking sector. For 2018 we expect the following:

- Interest rate caps to be relaxed mid-2018 onwards, allowing banks more flexibility in pricing loans.
- IFRS 9 impact – for the most part we believe certain smaller (Tier 3 and Tier 4) banks with lower capital buffers may need to raise capital in the face of higher loan loss provisioning under IFRS9. While larger banks such as KCB and Cooperative Bank may seek to raise additional core capital in

FY18 in order to ensure stronger capital buffers, local press has recently suggested the Central Bank of Kenya is seeking comments on its proposal to give banks five years to build up capital buffers in light of IFRS9. A final recommendation by the CBK is expected in the coming months.

- Profitability is expected to be marginally lower in 2018 as the implementation of IFRS9 results in an increase in cost of risk, although a modification of interest rate caps may largely offset this increase in the cost of provisions.
- NPLs to rise marginally further in 1H18 with a more positive economic environment being offset by slower loan book growth and thus a higher weighted average life of loans.
- Excluding the impact of wider interest rate bands, we think the larger banks are fairly valued, with smaller banks such as NIC offering investors a buying opportunity. Barclays offers investors a substantive dividend yield (>10.0%), although this is primarily driven by a high pay-out ratio, which we understand management is seeking to maintain. KCB is of interest to us as management guidance points to a 9.3% FY18f dividend yield, with a 50.0% payout ratio, although concerns surrounding provisioning continue to weigh on the stock in the short term.

BUY

- **NIC (TP KES 40.00, 17.7% UPSIDE)**

ACCUMULATE

- **KCB (TP KES 42.88, 0.9% UPSIDE)**

HOLD:

- **EQUITY GROUP (TP KES 35.36, 11.6% DOWNSIDE)**
- **COOPERATIVE BANK (TP KES 13.84, 23.7% DOWNSIDE)**
- **DTB (TP: 147.00, 23.4% DOWNSIDE)**
- **BARCLAYS (TP: KES 9.79, 1.9% UPSIDE),**
- **STANDARD CHARTERED (possible buying opportunity following FY17 numbers— StanChart has issued a profit warning for FY17 results, TP: KES 206.44, 1.7% DOWNSIDE)**
- **STANBIC (UNDER REVIEW)**

Our price targets above do not assume a modification or reversal of the interest rate caps. We expect price targets to improve on account of any modification or reversal of the rate caps.

The Kenyan Cement Sector—Low cost housing and productive infrastructure investments

While there has been a slowdown in the construction industry due to the interest rate cap and the recent economic stresses, we anticipate a pickup in 2018 buoyed by a modification in the rate cap and increased business confidence. In addition, the Jubilee government continues to focus on productive infrastructure investments, and is notably encouraging private sector driven low cost housing construction. We believe this will be positive for cement demand. We believe local cement players such as Bamburi and ARM Cement will remain major beneficiaries of these efforts.

- **BAMBURI CEMENT: HOLD (UNDER REVIEW),**
- **ARM Cement: (UNDER REVIEW)**

P.T.O.

KenolKobil—Strong outlook

Our price target is KES 17.85 per share (28% upside from the current price of KES 14.00) and we maintain our BUY recommendation. KenolKobil is on track for strong results in FY17E and FY18E and we believe the current valuation is attractive (4.8x FY18E EPS and 3.1x FY18E EBITDA) given the strong growth outlook - an EBITDA CAGR of 29.1% 2017-2018 and EPS CAGR of 32.9% 2017-2018, underpinned by strong volume growth, an efficient operating cost base and superior inventory management. The company is expected to deliver strong ROAEs of 25.7% in FY17E and 29.7% in FY18E.

- **KENOLKOBIL: BUY(TP: KES 17.85%, 25.2% UPSIDE)**

Kenya Airways—Irrational exuberance strikes again

With a FY17e net asset value of KES 0.8-1.0 per share, we believe that Kenya Airways is an irrationally valued stock.

- **KENYA AIRWAYS: SELL (NAV: KES 0.80—1.00, 94.1% - 95.3% DOWNSIDE)**

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