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This is an abridged version of the banking report. To get the full report with analysis across the 12 analysis metrics and how the 11 listed banks compare across the respective metrics, kindly email cmugendi@cytonn.com or bdteam@cytonn.com
I. Kenya Banking Sector
Kenya’s Banking Sector Overview

Kenya currently has 43 commercial banks, all regulated by the Central Bank of Kenya

• In Kenya there are a total of 43 commercial banks, 10 microfinance banks and 1 mortgage finance institution

• All banks are regulated by the Central Bank of Kenya. The Capital Markets Authority has additional oversight over the listed banks. All banks are required to adhere to certain prudential regulations such as minimum liquidity ratios and cash reserve ratios with the Central Bank

• Kenya has a high relative ratio of banks to the total population, with the 43 commercial banks serving a country of 44 million people, compared with Nigeria's 22 for 180 million inhabitants and South Africa's 19 for 55 million

• The share of non regulated financial institutions reduced from 39% to 25% in 2013, indicating a rise in financial knowledge among the general population and also a reduction of fraudulent institutions

• Credit Information Sharing systems (CIS), agency banking, revised prudential guidelines and mobile banking are some of the new developments in banking that have spurred increased efficiency in the sector, as well as enhanced competition
Growth in the Banking Sector

Growth in the banking sector has been underpinned by alternative banking offerings

- Over the last few years, the Banking sector in Kenya has continued to grow in assets, deposits, profitability and products offering

- The banking sector’s aggregate balance sheet grew by 3.4% from Kshs 3.26 tn in December 2014 to Kshs 3.37 tn in March 2015

- The growth has mainly been underpinned by:
  - Banks responding to the needs of the Kenyan market for convenience and efficiency through alternative banking channels such as mobile, internet and agency banking
  - Industry wide branch network expansion strategy both in Kenya and in the East African community region
  - A resilience by banks to reduce their rates following the introduction of the KBRR. Kenyan banks have been fairly good at protecting their margins regardless of the rate environment
Consolidation in the Banking Sector

Banks will have to consolidate to meet the new minimum core capital requirements by 2018

• In a bid to improve the financial soundness of financial sector, the minimum core capital requirement for banks is set to increase from Kshs 1 billion to Kshs 5 billion by 2018

• The changes were proposed in a bid to ensure that banks and insurance companies are well capitalized and can absorb financial shocks

• Concentration is fairly high in Kenyan banks, with the country's top eight banks holding about 60% of the market

• Roughly half of Kenyan banks have less than Kshs 5 bn of equity and will need to increase their core capital

• M&A activity will be heightened in such a period as small banks seek to survive, while market leaders consolidate to boost their franchise value, market reach and distribution
Banking Sector Growth Drivers

We anticipate banks to remain profitable in 2015 driven by cost containment and regional expansion

There are a number of factors which will drive growth in Kenya’s banking sector:

1) **Cost containment initiatives**: In the event that NIMs decrease due to the increase of the CBR, as well as the effects of the KBRR, banks will have to undertake comprehensive cost cutting measures which ensure operational efficiency.

2) **Increased use of alternative service delivery channels**: With the growth of mobile and agency banking, penetration in the market has increased and this will lead to a greater number of transactions as well as offer loan products to the mass market e.g. M-Kesho which was launched by KCB and Safaricom.

3) **Growth of the retail segment**: As the middle-class grows rapidly in Kenya, faster than majority of the countries in the region, there is an inherent increase in consumption expenditure and an increase in the numbers in the population which will require banking services.

4) **Expansion both regionally and domestically**: With devolution in Kenya, we will see banks become more aggressive in trying to capture the opportunities that exist at county levels, which will increase their customer base. In addition, banks looking to expand in the less penetrated markets of Tanzania, Uganda, Rwanda and South Sudan are opening themselves up to new revenue channels.
Banking Sector Metrics

Robust growth in the banking sector as evidenced by constant increase in loans and amount of deposits in the banking system.

### Loans and Advances (Kshs Bn)

- **CAGR:** 21%
- **2010:** 876
- **2011:** 1,152
- **2012:** 1,296
- **2013:** 1,532
- **2014:** 1,881
- **Q1'2015:** 2,040

### Deposits (Kshs Bn)

- **CAGR:** 16.6%
- **2010:** 1,237
- **2011:** 1,488
- **2012:** 1,708
- **2013:** 1,936
- **2014:** 2,292
- **Q1'2015:** 2,410

### Shareholders Equity (Kshs Bn)

- **CAGR:** 16.6%
- **2010:** 266
- **2011:** 291
- **2012:** 362
- **2013:** 432
- **2014:** 502
- **Q1'2015:** 534

### Bank Branches

- **2010:** 1,063
- **2011:** 1,161
- **2012:** 1,272
- **2013:** 1,342
- **2014:** 1,443

*Source: Central Bank of Kenya*
Improvement in efficiency still a bright spot for the sector, despite tighter profit margins and uptick in non performing loans.

**Cost to income (%)**

<table>
<thead>
<tr>
<th>Year</th>
<th>2010</th>
<th>2011</th>
<th>2012</th>
<th>2013</th>
<th>2014</th>
</tr>
</thead>
<tbody>
<tr>
<td>%</td>
<td>50.0</td>
<td>47.4</td>
<td>40.1</td>
<td>43.7</td>
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**Loans to deposits (%)**

<table>
<thead>
<tr>
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<th>2011</th>
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<th>2014</th>
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<tr>
<td>%</td>
<td>70.9</td>
<td>77.4</td>
<td>75.9</td>
<td>79.2</td>
<td>82.1</td>
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</table>

**NPLs to total loans ratio(%)**

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<th>2012</th>
<th>2013</th>
<th>2014</th>
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</thead>
<tbody>
<tr>
<td>%</td>
<td>6.6</td>
<td>4.6</td>
<td>4.8</td>
<td>5.3</td>
<td>5.8</td>
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</table>

**Net interest margin (%)**

<table>
<thead>
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<th>2011</th>
<th>2012</th>
<th>2013</th>
<th>2014</th>
</tr>
</thead>
<tbody>
<tr>
<td>%</td>
<td>8.6</td>
<td>8.7</td>
<td>9.5</td>
<td>9.4</td>
<td>8.6</td>
</tr>
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</table>

Source: Central Bank of Kenya
# Banking Sector Multiples

Kenya’s banking sector is trading at an average P/TBV of 1.92x with a dividend yield of 3.5%

All values in Kshs unless stated

<table>
<thead>
<tr>
<th>Bank</th>
<th>Share Price</th>
<th>Shares issued (bn)</th>
<th>Mkt Cap (bn)</th>
<th>Price/TBV P/E FY14</th>
<th>P/E FY15e</th>
<th>Dividend Yield</th>
</tr>
</thead>
<tbody>
<tr>
<td>Barclays Bank of Kenya Ltd</td>
<td>15.55</td>
<td>5.43</td>
<td>84.46</td>
<td>2.23x</td>
<td>10.10x</td>
<td>8.50x</td>
</tr>
<tr>
<td>CFC Stanbic bank</td>
<td>104.00</td>
<td>0.40</td>
<td>41.11</td>
<td>1.59x</td>
<td>7.23x</td>
<td>6.61x</td>
</tr>
<tr>
<td>Diamond Trust Bank Kenya</td>
<td>225.00</td>
<td>0.24</td>
<td>54.47</td>
<td>1.84x</td>
<td>10.26x</td>
<td>8.32x</td>
</tr>
<tr>
<td>Equity Group Holdings</td>
<td>45.75</td>
<td>3.70</td>
<td>169.40</td>
<td>2.99x</td>
<td>9.88x</td>
<td>10.61x</td>
</tr>
<tr>
<td>Housing Finance Co.Kenya Ltd</td>
<td>27.50</td>
<td>0.35</td>
<td>9.69</td>
<td>1.02x</td>
<td>6.53x</td>
<td>7.96x</td>
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<tr>
<td>I&amp;M Holdings Ltd</td>
<td>116.00</td>
<td>0.39</td>
<td>45.51</td>
<td>2.16x</td>
<td>8.55x</td>
<td>8.33x</td>
</tr>
<tr>
<td>Kenya Commercial Bank Ltd</td>
<td>56.50</td>
<td>2.98</td>
<td>168.61</td>
<td>2.16x</td>
<td>10.04x</td>
<td>9.69x</td>
</tr>
<tr>
<td>National Bank of Kenya Ltd</td>
<td>21.50</td>
<td>0.31</td>
<td>6.62</td>
<td>1.05x</td>
<td>6.91x</td>
<td>6.16x</td>
</tr>
<tr>
<td>NIC Bank Ltd</td>
<td>51.50</td>
<td>0.64</td>
<td>32.96</td>
<td>1.46x</td>
<td>7.28x</td>
<td>7.32x</td>
</tr>
<tr>
<td>Standard Chartered Bank Kenya Ltd</td>
<td>300.00</td>
<td>0.31</td>
<td>92.75</td>
<td>2.36x</td>
<td>9.03x</td>
<td>10.21x</td>
</tr>
<tr>
<td>The Co-operative Bank of Kenya Ltd</td>
<td>21.50</td>
<td>4.89</td>
<td>105.12</td>
<td>2.29x</td>
<td>13.11x</td>
<td>8.97x</td>
</tr>
</tbody>
</table>

| Median | 54.47 | 2.16x | 9.03x | 8.33x | 3.54% |
| Average| 73.70 | 1.92x | 8.99x | 8.42x | 3.52% |

Source: NSE, Cytonn Banking Sector Report
II. Cytonn Banking Sector Report
Banking Sector Report Overview

Cytonn has undertaken this report to offer our investors a comprehensive view of the listed banks

• All listed banks in the Kenyan market were analysed by the Cytonn Investment Team

• The analysis was brought about by a need to be able to recommend to our investors which banks are the most stable from a capital markets trading metrics perspective

• The analysis covers the health of the financial institution, by highlighting their relative performance using metrics to measure profitability, efficiency, growth, asset quality, liquidity, revenue diversification, capitalization, relative valuation and soundness

• All analysis was undertaken using Q1’2015 results

• For banks which are part of a group structure, the financials of the group were utilised to take into consideration the listed counter which an investor will purchase
Banking Sector Report – Metrics Used

Cytonn has undertaken analysis of the listed banks in Kenya using 11 key metrics

• **Net Interest Margin** - A bank’s net interest margin (NIM), is the difference between the interest paid on deposits and the interest earned on loans, relative to the amount of interest-earning assets with higher net interest margins translating into higher profits

  **Output:**
  Majority of Bank’s funding is towards the issuing of loans rather than the purchase of government securities. Even with the introduction of the KBRR and the raising of the CBR to 10%, we expect the banks to maintain their NIMs in 2015. Barclays had the highest NIM at 11.73%, with the lowest for CfC Stanbic at 5.63%

• **Return on Average Common Equity** - A bank’s return on average common equity (ROACE), is the amount of profit the bank earns as a percentage of average common shareholders’ equity. It’s a profitability measure that shows how much a company generates with the money shareholders have invested

  **Output:**
  Banks with higher ROACEs are better at utilizing capital to generate profits. Equity bank has the highest ROACE at 31.65%, which was much above the industry average, while Housing Finance had the lowest at 12.03%
Cytonn has undertaken analysis of the listed banks in Kenya using 11 key metrics

- **Price/Earnings to Growth Ratio** - The price/earnings to growth (PEG) ratio is the stock’s market price to earnings ratio divided by its growth in earnings for a specified period of time. The PEG ratio is used to determine the value of a stock while taking into account its growth rate, with lower PEG ratios showing the stock is undervalued given the growth in its earnings.

**Output:**
To obtain this ratio, we estimated each bank’s 5-year growth rate based on previous growth rates, as well as our analysts’ views on the growth potential of each listed counter. KCB had the lowest PEG ratio at 0.65x, while HF was the most overvalued at 1.59x.

- **Deposits per Branch** - A bank’s deposits per branch shows the amount of deposits a bank receives from each of its branches, hence a measure of efficiency. Banks with higher deposits per branch are preferred, as it shows for each unit cost of capital expenditure required to open new branches and their subsequent operating costs, a bank receives more in deposits.

**Output:**
Standard Chartered and CFC Stanbic have the highest deposits per branch at 4.58 bn and 4.42 bn, respectively, while National Bank and Equity Bank have the lowest deposits per branch at 1.14 bn and 1.21 bn, respectively. However, this could be because of the high number of branches which Equity Bank has, as well as the large corporate book of Standard Chartered.
Cytonn has undertaken analysis of the listed banks in Kenya using 11 key metrics

• **Loans to Deposits Ratio** - A bank’s loans to deposit ratio (LTD) is a measure of liquidity as it shows how much of a bank’s loans are being funded by its deposits. Low LTD ratios indicate that the bank may not be earning a lot of interest. Very high LTD ratios indicate that the bank might not have enough liquidity to cover any unforeseen funding requirements, and ratios above 1 show that the bank supplemented their loan issues with outside borrowings

**Output:**
Our analysis showed us that in Kenya, the loan to deposit ratio has been steadily increasing, showing increased uptake of loans and more aggressive use of deposits by banks. Taking a preferred loans to deposit ratio of 85%, we found that CfC Stanbic was closest to the target at 85.71%, while Housing Finance was the farthest at 144.21%

• **Cost to Income Ratio** - The cost to income ratio is a measure of a bank’s efficiency, showing its costs in relation to its income. A lower ratio is preferred, as it indicates a bank is more profitable. An increase in the ratio often highlights potential problems as it shows a bank’s costs rose faster than its income; while a fall in the ratio could be brought by management’s cost cutting measures

**Output:**
We see many Kenyan banks making an effort to be more efficient. Many Kenyan banks have opted to restructure in a bid to bring down costs and subsequently this ratio, most recently being Co-operative and National Bank. I&M had the lowest cost to income ratio of 32.25%, while NBK had the highest ratio at 67.16%
Cytonn has undertaken analysis of the listed banks in Kenya using 11 key metrics

- **Price to Tangible Book Value** - This is a valuation ratio that expresses the bank’s market price to its tangible book value. It shows the amount that an investor would receive in the event of a liquidation. A ratio of less than one indicates that the bank’s assets are undervalued in the market while a ratio greater than one signifies overvaluation.

**Output:**
We find Housing Finance to be the most undervalued bank as per this metric, while Equity bank is the most overvalued.

- **Tangible Common Equity Ratio** - This is the ratio of a bank’s common equity less intangible assets to its tangible assets. It is a common indicator of a bank’s risk and capitalization and measures how much losses a bank can take before shareholder’s equity is wiped out, hence solvency.

**Output:**
Standard Chartered was the most solvent with a tangible common ratio of 17.11%, while National Bank was the least solvent at 5.40%.

- **Non-Performing Loans to Total Loans Ratio** - This is a measure of the percentage of a bank’s issued loans that are non-performing that is, in default, or close to being in default.

**Output:**
Diamond Trust bank had the highest quality loan book with a non-performing loans to total loans ratio of 1.43%, while National Bank had the highest non-performing loans at 9.95%.
Cytonn has undertaken analysis of the listed banks in Kenya using 11 key metrics

- **Reserves to Non-Performing Loans (NPLs)** - This is a credit quality metric that measures the credit risks for banks. It shows the extent to which the NPLs are already covered by provisions hence the degree of stability of the bank’s lending base, with higher ratios preferred

**Output:**
I&M has the highest statutory loan loss reserves to non-performing loans at 25.83%, while Diamond Trust bank and Housing Finance have the lowest at 0%. In the case of Diamond Trust bank, its high quality loan book provides a basis for not providing for non performing loans given its low rate on loan defaults

- **Non-Interest Income to Revenue** - The non interest income is the income earned from sources other than loans and investments. The non-interest income to revenue therefore shows the extent of diversification of a bank’s operations. High levels are preferred, not exceeding the point where the bank loses focus of its primary business

**Output:**
We see that Kenyan banks’ non-interest income is set to benefit from new initiatives such as banc-assurance and mobile banking. CfC Stanbic has the highest non-interest income as a percentage of revenue at 45.13%, while Standard Chartered has the lowest at 24.34%

- **Camel Rating** - This is a ranking system that assesses the overall condition of a bank, that is, Capital Adequacy, Asset Quality, Management Quality, Earnings Quality and Liquidity
We analyzed the health of the listed banks in the Kenyan market

<table>
<thead>
<tr>
<th>Bank</th>
<th>Loans/Deposits</th>
<th>Cost to Income Ratio</th>
<th>ROACE</th>
<th>NIM/PEG ratio</th>
<th>Price/Tangible Book Value</th>
<th>Deposits per branch billions</th>
<th>NPLs/Reserve NPLs</th>
<th>Tangible Common Ratio</th>
<th>Non Interest Income / Revenue</th>
<th>Camel Rating</th>
<th>Total</th>
<th>Rank</th>
</tr>
</thead>
<tbody>
<tr>
<td>CFC Stanbic</td>
<td>1</td>
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<td>6</td>
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</tr>
</tbody>
</table>

- The bank ranking assigns a value of 1 for the best performing bank, and a value of 11 for the worst
- All metrics had equal weighting in the cumulative total
- The metrics highlighted a bank’s profitability, efficiency, growth, asset quality, liquidity, revenue diversification, capitalization, relative valuation and soundness

Source: Cytonn Banking Sector Report
Banking Sector Report Results

CfC Stanbic ranks highest overall in the banking sector analysis

- CfC Stanbic ranked the highest overall, ranking high in revenue diversification and mobilisation despite being weighed down by its lower than industry average net interest margin.

- I&M Bank was a close second, ranking high in efficiency, with the lowest cost to income ratio at 32.5%. I&M additionally benefited from being a less risky bank, as can be seen with the low NPLs / Total Loans, as well as maintaining the highest levels of Reserves for their NPLs.

- Equity Bank, as expected, was among the highest in Net Interest Margin due to their significant exposure to the retail sector who do not possess the bargaining power of corporates, who push for higher deposit rates and cheaper loans.

- National Bank of Kenya, despite having a high loan to deposit ratio, was the second lowest rated bank. They are the most inefficient bank in terms of cost containment, operating at cost to income ratios of 67.2%. In addition, they have the lowest quality of assets in their loan portfolio, as can be seen by their NPLs which are 10% of their total loan book.

- Housing Finance ranked the lowest overall. It registered poor profitability, with the ROACE at 12% and their NIM at 6.1%, second lowest in the market. In addition, they are hampered by liquidity issues, with a loan to deposit ratio of 144%.

Source: Cytonn Banking Sector report
Future of the Banking Sector

The future is bright for the banking sector given the resilience to maintain margins and the likelihood of increased consolidation

- There has been a lot of question as to whether banks will be able to maintain their profitability margins with the increase of the CBR to 10%. With the exception of minimal increases in non-performing loans, we do not think the banking businesses will be impacted significantly by the increases and historically, Kenyan banks have been fairly good at protecting their margins regardless of the rate environment.

- In terms of acquisitions, the small size of some of the banks will also be an obstacle to attracting new investors, however there are those investors with a high risk appetite that will look to purchase a small commercial bank and provide them with much needed core capital, or to transform a microfinance bank to a fully licensed commercial bank.

However, risks exist in the banking sector:

- **NPL Increases:** Due to the potential increase in rates across the market, there exists a likelihood that more borrowers will default on their obligations.

- **Consolidation:** As banks merge and are bought out to meet the new core capital requirement by 2018, there is a risk that cultures and operating values do not mix, which will ultimately effect the end user, as well as see banks who had a niche in the market lose their unique position.
Q&A