KENYA BANKING SECTOR

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SUMMARY

Prior to 2015, Kenya's banking sector was observed as a vibrant, highly profitable sector, with industry ROE's averaging north of 20%. Sector loan book grew at an impressive CAGR of 16% between 2011 to 2015 on the back of high economic growth and low financial inclusion. As at 2015, Kenya's private sector credit to GDP was 35%, lower than Sub-Saharan Africa's average of 46% and the global average of 129%. The sector was also characterized by increased adoption of technology and usage of alternative channels which enabled aggressive banks to tap into the unbanked population efficiently, thereby boosting margins and overall profitability.

Considering low rates of financial inclusion, the sector's potential to grow remains high. However, following various developments in the banking sector over the past two years, expectations on the future outlook of the sector have also changed much. Following the changes In Central Bank leadership mid-2015, the sector has seen 3 banks collapse which resulted to low consumer confidence in the sector and overall strength of the sector. This deteriorated further after the introduction of the interest rate cap in August 2016, which is expected to lower interest margins and result in slower credit growth. Non-performing loans have also increased across the sector from an industry average of 5.2% before 2015 to an average of 7.9% as at September 2016, mainly attributed to a challenging business environment and enhanced supervision by the Central Bank.

Consequently, banking sector valuations have gone down significantly, with industry P/B declining from 1.9x as at the end of 2014 to 0.8x as at the end of January 2017.

In this report, we start by highlight the key trends that are expected to shape the banking sector in 2017 and beyond. We then discuss the expected performance of the individual listed banks based on the new outlook and present our updated financial projections and valuations.

Below is a summary of the sector valuation. Specific bank discussions start from page 6.

	Price (17/2/2017)	Target Price	Upside/ downside	Recommendation
KCB Group	24.75	30.95	25%	BUY
Equity Group	27.00	31.09	15%	BUY
Co-operative Bank	12.35	16.64	35%	BUY
Stanbic Bank	66.5	78.71	18%	BUY
Diamond Trust Bank	107	157.74	47%	BUY
NIC Bank	25.75	27.59	7%	HOLD
Barclays Bank Kenya	8.4	12.88	53%	BUY
I&M Holdings	79.5	90.56	14%	BUY
Standard Chartered Kenya	182	132.25	-27%	SELL

Trends in the Banking Industry

We look at the trends that we believe are going to shape the banking industry in 2017 and beyond.

Adoption of the New IFRS 9

During the financial crisis of 2008/2009, the delayed recognition of credit losses on loans (and other financial instruments) was identified as a weakness in existing accounting standards for banks. In response to this, the International Accounting Standards Board (IASB) issued the final version of IFRS 9 Financial Instruments that replaces IAS 39. IFRS 9 brings together all three aspects of the accounting for financial instruments project: classification and measurement, impairment and hedge accounting. Guidelines on impairment are expected to have the biggest impact on the financial statement of Kenyan banks. A new, expected-loss impairment model which requires more timely recognition of expected credit losses will be adopted. Specifically, the new Standard requires entities to account for expected credit losses from when financial instruments are first recognized and to recognize full lifetime expected losses on a timelier basis.

The new model shifts from today's model of incurred losses model to a forward looking expected losses model. When a Bank originates a loan facility it will now be required to recognize an impairment loss equivalent to the expected losses assuming the facility defaults in the next 12 months. Banks will thereafter be required to assess whether the credit risk of the facility has changed significantly. Based on the Banks judgement on changes in the credit risk, the impairment of that loss should step up from 12 month loss to a full time loss. The new Standard will come into effect on 1 January 2018 with early application permitted.

Implications: From a risk management perspective, the new standard is viewed as a positive move that will see banks increase their level of provisioning. Both IMF and treasury have in the past raised concerns over the relatively slow growth of loan provisions, compared to credit growth. This will thereby give suppliers of capital to the banks much needed confidence in the operations of the banks.

This will however come at the expense of lower and more volatile earnings in the future. To classify an expected loss into either 12 month loss or a full time loss will see increase earnings volatility. We expect banks with a longer tenure loans to be most affected. From our listed banks Barclays has the biggest composition of loans with maturities of less than 1 year. Stanbic and DTB have the highest composition of more than 1 year. We have factored in increased levels of provisioning in our valuations based on the maturity profile of the loans. Below is a table summary of the percentage of loans classified according to maturity as at Dec 2015.

	< 1year	1year - 5years	> 5years
KCB	32%	32%	36%
EQUITY	18%	47%	35%
COOP	27%	44%	29%
Stanchart	34%	31%	35%
Barclays	67%	33%	0%
Stanbic	42%	31%	27%
I&M	92%	6%	2%
NIC	32%	68%	0%
DTB	51%	36%	13%

Source: Company filings, AIB Research

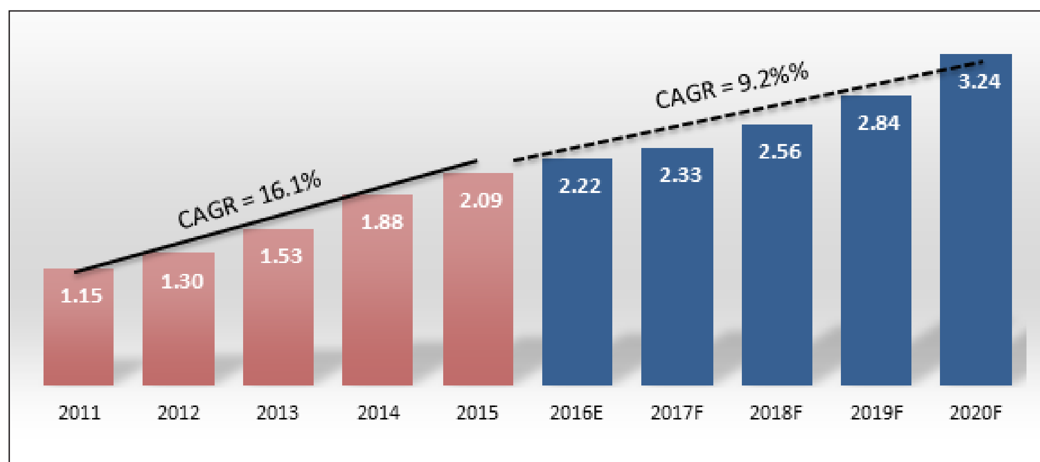
Focus on Risk mitigation

Kenyan Banks have historically been able to grow their loan books at tremendous growth rates. Between 2011 and 2015, the banking sector loan book grew at a CAGR of 16%. While this may be justifiable given the low banking penetration in the country, it also points out to an aggressive stance that the banks had taken with less regard to risk mitigation.

Risk management is now emerging as a key priority area for the industry. The inability of banks to properly price risk emphasizes the need for banks to enhance their risk management capabilities. The past one year has seen banks take a conservative approach to conducting their business. Asset allocation is seen to be shifting in favour of less risky assets like cash and government securities. Government securities as at September 2016 contributed 24% of the sectors balance sheet compared to an 18% average between 2011-2015.

Implications: loan books are expected to grow at a much slower pace than in the past. We project that the sector loan book will grow at a CAGR of 9% between 2016-2020. Secondly, we expect additional technological and infrastructural spending that prioritizes on risk management. This will be largely to enhance compliance as well as improve on the quality of their assets.

Industry loan book growth (KES Trillion)



Source: Central Bank of Kenya, AIB Research

Universal adoption of Remote Banking Solutions

Banks have continued to move their business outside the traditional banking halls to channels like Mobile internet banking, Agency and internet self-service banking. The need to increase banking penetration at the lowest cost possible led the regulator to allow use of alternative channels by banks and telecommunication companies.

While traditionally these channels were thought as competitive edges for a few large banks, they are now being widely used across the sector. They have moved from being "good to have" to being "must have" functionality for banks. Some of the benefits that banks derive from use of remote banking solutions include; improved customer satisfactions, source of Intelligence data, improved operational efficiency, income from transaction fees just to mention a few. We continue to see convergence in the use of these channels across the sector. Agency banking for instance is now being offered by 17 commercial banks up from 8 in 2011.

Implications: We expect banking products to converge as far as features and capabilities is concerned. Clients will be able to get similar services and products across the industry. The only point of differentiation will now be on Pricing and security.

Industry Consolidation

We believe the Kenyan banking sector is now ripe for consolidation through mergers and acquisitions. The following are the key drivers

• Banking business today is proving to be more difficult for small players in the industry. Consumer confidence in the sector is skewed in favour of the large banks following the closure of 3 Banks in 2015/2016 period.

• The National Treasury has been pushing for increased capitalization of the banks by proposing twice that the minimum core capital be increased from the current Kes 1Bn to 5 Bn. It should be noted that both attempts have been unsuccessful but we expect the push to continue.

• Lastly the newly enacted law that seeks to control interest rates that banks charge for credit is expected to negatively impact the small players more than the big players. Based on Q3 2016 results, (pre rate cap) Tier 3 banks enjoyed an average yield on loans (Interest income divided by Net loans) of 15.4% compared to 14.38% average for tier 1 Banks and 15.69% for tier 2 banks. By putting a ceiling on the interest charged, it is clear that tier 2 and tier 3 banks have the most to lose.

On the back of these factors, Mergers and acquisitions activities are expected in tier 2 and tier 3 banks. Well capitalized banks with strong anchor shareholders have better consumer confidence, are competitive and are less likely to get into headwinds with regulators. The stage has already been set with a couple of deals having happened in the last 12 months. Mid 2016 saw M bank of Tanzania complete a majority takeover in local tier 3 bank Oriental commercial. In June 2016 I&M Holdings completed 100% acquisition of Giro bank. The latest was the acquisition of Fina Bank by Mauritian firm SBM holdings.

The expected acquisition of Chase Bank and the proposed consolidation of all state-owned banks (National Bank of Kenya, Consolidated Bank and Development Bank of Kenya) could set the stage for more mergers and acquisition in the near future.
It is expected that with more consolidation in the industry, Banks are going to be more competitive and the product offering may evolve in favour of clients.

Cost Management

The banking sector is now expected to shift focus to being more efficient in service delivery. The main driver to this are

• Lower expected margins from their mainstream business following the interest rate cap.

• Private sector Credit growth was low in 2016 (4.6% as at September 2016) and we further expected to remain low throughout 2017.

Banks are expected to enter into defense mode - reduce costs. Staff cost are usually the first target when corporates want to reduce costs. Central bank reported in the 2015 supervisory reports that the total number of staff in the banking sector declined by 721 (2%) in 2015 to stand at 36,212 thousand. A keen look at the breakdown reveals that Clerical and secretarial level positions declined by 2,036 (11%) to stand at 16,503 positions. This may have been largely contributed to by the increased use of remote banking solutions. In 2016, several banks came out to report that they were looking to downsize their workforce while others alluded to freezing of new hiring. We also expect banks to slow down their branch expansion as they push their operations to the alternative channels.

Individual Banks commentary
Valuation Summary

Residual income method: Rationale- Traditional discounted cash flow methods (DCFs) have proved inappropriate for banking valuations because of two main reasons. The first is that the cash flows to a bank cannot be easily estimated, since items like capital expenditures, working capital and debt are not clearly defined. The second is that banks operate under a regulatory framework that governs how they are capitalized, where they can invest and how fast they grow. Changes in the regulatory environment can create large shifts in value. Case in point the interest rate cap law that came into effect in August 2016 saw market capitalization of banks decline significantly. In this note we argue that banks are best valued using equity valuation models, rather than enterprise valuation models.

Drivers of value: The two key numbers that will drive value are the cost of equity, which will be a function of the risk that emanates from a bank's investments, and the return on equity, which is determined both by the company's business choices as well as regulatory restrictions. We believe that ROE will be driven by how fast the sector loan book grows and the ability of a bank to acquire/defend/seed market share in the industry.

Down side risks: We believe that Kenyan banks have entered in a phase of structurally low ROEs. The new interest rate capping law is the key risk to our valuation, given that no data is yet to be released that indicates how banks have reacted to it. Some regulatory changes and enhancements are further expected to have further downward pressure on ROE.

Lower valuation multiples: Going forward, we expect banks to trade at lower P/B's compared to historical. Our exit P/Bs for the banks are estimated by looking at the historical 5 year average for each bank and adjusting downwards/upwards based on where we believe the equilibrium will be.

Below we summarize the 5 year historical vs expected earnings growth, ROEs and price to book for the banks under review. We later discuss the individual banks and what we expect in the next 5 years.

Historical vs forward EPS growth, ROE and P/B

	Earnings growth (cagr)		ROE		P/B	
	2011-2015	2016-2020	2011-2015	2016-2020	2011-2015	2016-2020
KCB	22.3%	7.0%	23.3%	19.0%	1.86	1.16
Equity	19.7%	6.6%	27.0%	20.3%	2.47	1.67
Coop	20.6%	6.6%	24.0%	20.3%	1.95	1.55
Standard chartered	1.7%	7.2%	24.2%	18.0%	2.27	1.47
Barclays	0.7%	14.7%	22.2%	18.9%	2.37	1.57
Stanbic bank	25.0%	13.5%	18.8%	16.6%	1.25	1.25
DTB	22.1%	13.5%	22.8%	17.4%	1.78	1.1
I&M	20.1%	7.7%	22.6%	17.4%	1.77	1.06
NIC	13.5%	11.7%	20.3%	15.9%	1.46	0.95

KCB Group

Following the new regulations to Cap interest rates, we expect KCB's net interest margin to decline from 10.9% to 10.0%. Management has indicated that they intend to compensate the margin loss with increased credit volumes, cost containment and improving fees and commission income. Management has guided 11% growth in loan book.

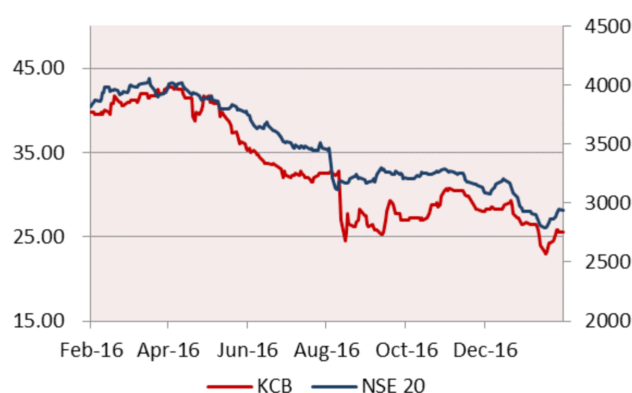
The SME segment which was expected to drive loan book growth for the bank is no longer an area of focus for the bank. Credit appetite for the corporate sector which is KCB's main lending segment is also expected to be low given low investment needs. We are of the view that these responsive strategies are difficult to execute for KCB in the current environment. We however expect KCB's deposit growth to remain strong in 2017 driven the bank's investment in remote Banking solutions and its strong brand appeal. It is expected that with the strong deposit growth and slower loan book growth, KCB will increase its allocation to government securities, thereby boosting its tier 1 capital ratios. The quality of its assets is also expected to improve in 2017 and beyond.

As at December 2015, KCB had a market share (loan book) of 15% which we expect it to defend in the coming years.

We further expect KCB to enhance its provisioning as early as 2017 in response to the new IFRS 9 standards.

As a result of the lower margins, enhanced provisioning and slow loan book growth, we expect KCB's ROE will decline to 18.4% in 2017 from 23% estimate for 2016. We forecast a 5 year average ROE of 19% and earnings growth of 7% over the same period.

Recommendation	BUY
Target Price (KES)	30.95
Current Price (KES)	24.75
Upside/downside potential	25%
52 week range	22.50 -43.50
Market cap (KES b)	77.90
Dividend yield	7.77%
Beta	1.04
Exit PB	1.16



Financial Summary (KES m)	2015A	2016E	2017F	2018F	2019F	2020F	CAGR
Loan Book	345,969	367,158	402,973	443,271	493,545	556,253	10%
Deposits	424,391	464,757	559,685	615,654	685,479	772,574	13%
Net Interest Income	39,297	45,230	41,434	46,333	51,654	58,869	8%
Non Funded Income	20,834	19,092	24,178	26,596	29,613	33,375	10%
Earnings	19,623	20,467	18,230	19,281	22,853	26,792	7%
Cost to Income	52%	48%	54%	56%	54%	53%	
ROE	24%	22%	18%	17%	18%	19%	

Valuation Summary (KES m)	2016E	2017F	2018F	2019F	2020F
Earnings	20,467	18,230	19,281	22,853	26,792
Shareholders' Equity	91,487	100,602	110,243	125,554	143,505
Cost of Equity	(16,148)	(17,757)	(19,458)	(22,161)	(25,329)
Residual Income	**4,319**	**473**	**(177)**	**692**	**1,463**
Terminal Value					166,544
Total	5,281	4,319	473	(177)	168,007
Present Value	94,881				
No of shares	3,066				
Value per share	30.95				

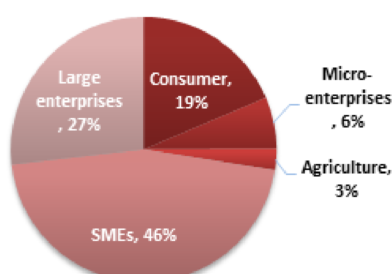
Equity Group

Of all the banks in our valuation universe, we see Equity bank as taking the biggest hit as far as margins are concerned. Equity bank enjoyed a net interest margin of 11% in 2015 (12% in 2014). We are projecting this to go to 8% in 2017. We also expect loan book growth to decline to 4% in 2017. From our discussions with industry players, SME's are currently observed as the most risky segment to lend to. As at 2015, Equity's loan book comprised of 46% SME's, 27% Corporates and 27% Retail (consumer and micro enterprises). The inability to price risk means that Equity will have to slow lending to the SME sector and focus on corporates and consumer. Since SME's was the bank's biggest growth frontiers we expect loan book to decline significantly. Further to that the bank's management had previously alluded to preference of government securities to onward lending.

We however believe that the bank is best positioned to increase its non-funded income through its robust and innovative product offering and alternative banking solutions. Through its Mobile, Internet and Agency banking models (the best in the industry in our opinion), we believe the bank will be able to increase its transactional income as more users move into these platforms.

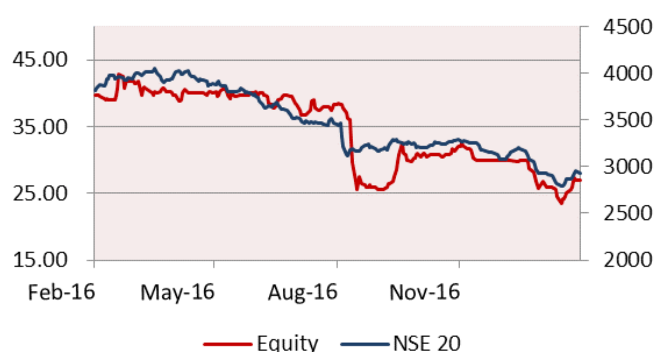
Management had guided a flat loan book growth both for 2016 and 2017 and instead insinuated its preference to government securities. As at September 2016, investments in government securities had grown 155% year on year to constitute 17% of the asset base up from 7% in 2015. As at Dec 2015, 82% of Equity bank's loans had a maturity of more than 1 year. This is the highest composition in the sector. Given the forward looking nature of the new IFRS 9 standards, we expect this bank to be affected significantly as far as increase in the level and volatility of provisioning is concerned. We expect Equity's ROE will decline to 19.7% in 2017 from 23% estimate for 2016. We forecast a 5 year ROE of 20.4%. Earnings are expected to grow 7% between 2016-2020.

Equity's loan composition (2015)



Source: Equity Group Annual Report 2015

Recommendation	BUY
Target Price (KES)	30.39
Current Price (KES)	27.00
Upside Potential	13%
52 week range	23.5 - 43.00
Market cap (KES b)	103.80
Dividend yield	7.29%
Beta	1.10
Exit PB	1.67
Cost of Equity	18.36%



Financial Summary (KES m)	2015A	2016E	2017F	2018F	2019F	2020F	CAGR
Loan Book	269,893	284,292	296,139	335,101	377,580	433,505	10%
Deposits	303,206	337,615	355,583	396,713	442,871	504,706	11%
Net Interest Income	34,124	42,583	30,849	35,265	39,764	45,355	6%
Non Funded Income	22,133	21,322	28,296	28,719	32,058	36,689	11%
Earnings	17,557	19,201	17,894	19,908	22,118	24,825	7%
Cost to Income	53%	51%	50%	50%	50%	50%	
ROE	24%	23%	19%	19%	20%	20%	

Valuation Summary (KES m)	2016E	2017F	2018F	2019F	2020F
Earnings	19,201	17,894	19,908	22,118	24,825
Shareholders' Equity	83,083	93,285	103,239	113,192	123,122
Cost of Equity	(14,957)	(16,794)	(18,586)	(20,378)	(22,166)
Residual Income	**4,244**	**1,100**	**1,322**	**1,740**	**2,660**
Terminal Value					205,595
Total	4,244	1,100	1,322	1,740	208,255
Present Value	117,324				
No of shares	3,774				
Value per share	31.09				

Cooperative Bank

We view Coop bank as the best placed bank to acquire market share from competition at least in 2017. This will be driven by their diverse exposure in Corporate and Retail banking segments. Management expects a growth of 15% in their loan book and we largely expect this to be achieved because of two reasons; one is their improved efficiencies around product delivery which may improve corporate client engagement and thereby increase probability of mining more business from existing clients. Two is their high exposure to consumer lending related to civil servant check off loans. Management indicates that of the 22% of its loan book which is lent to personal unsecured loans, majority of them are civil servants in various government institutions. Post rate cap demand in this segment is poised to increase significantly and given its low risk profile, we believe that it's going to be a key driver for Coop's loan book growth. Management further expects to improve on non-funded income as they seek to increase their cross sell ratio on the corporate segment. Off balance sheet products like Letters of credit (LOC's) and guarantees will boost their non-funded income.

Market share acquisition will be largely offset by a significant reduction in interest margins hence lower revenues. As at FY 2015 58% of Coop's operating income was derived from the retail segment. This is despite its holding only 26% of the bank's Asset base. (This represents a 24% yield on assets). This indicates how the retail segment was delivering healthy margins to the Bank. Going forward we expect this to decline significantly both on the funded and non-funded income.

We further expect the benefits of the restructuring exercise on cost reduction to diminish in the coming years.

The other downside with the bank is its relatively low presence in the remote banking solutions compared to its main competitors KCB and Equity. This may limit growth in their non-funded income going forward. We expect Equity's ROE will decline to 19.2% in 2017 from 23% estimate for 2016. We forecast a 5 year ROE of 20.3%. Earnings are projected to grow at an average of 9.3% between 2016 and 2020.

Recommendation	BUY
Target Price (KES)	16.64
Current Price (KES)	12.35
Upside Potential	35%
52 week range	9.75 - 23.00
Market cap (KES b)	61.12
Dividend yield	6.40%
Beta	1.00
Exit PB	1.55
Cost of Equity	17.39%

Financial Summary (KES m)	2015A	2016E	2017F	2018F	2019F	2020F	CAGR
Loan Book	208,572	220,179	250,009	274,900	305,200	347,893	11%
Deposits	265,399	292,276	327,350	355,649	394,420	446,375	11%
Net Interest Income	11,706	13,714	12,670	13,939	15,586	17,969	9%
Non Funded Income	23,274	28,962	22,712	24,385	26,537	30,160	5%
Earnings	11,706	13,714	12,670	13,939	15,586	17,969	9%
Cost to Income	53%	50%	49%	48%	47%	46%	
ROE	23%	23%	19%	19%	19%	20%	

Valuation Summary (KES m)	2016E	2017F	2018F	2019F	2020F
Earnings	13,714	12,670	13,939	15,586	17,969
Shareholders' Equity	58,653	65,822	73,012	80,272	87,744
Cost of Equity	(10,194)	(11,439)	(12,689)	(13,951)	(15,250)
Residual Income	**3,520**	**1,230**	**1,250**	**1,635**	**2,719**
Terminal Value					131,617
Total	**3,520**	**1,230**	**1,250**	**1,635**	138,638
Present Value	81,354				
No of shares	4,889				
Value per share	16.64				

Barclays Bank Kenya

In a bid to recapture lost market share, Barclays began lending to SMEs in 2015 through its business banking segment. This was in line with their new strategy that focused on de-risking the loan book through diversification. The Bank was to focus on signing in new SME's & Local Large Corporations (LLC), reducing dependency on the Scheme Book (consumer loans) and improving the balance between corporate and retail customers.

SME sector is a key segment that the bank is seeking to grow. By increasing their risk appetite for the sector, the bank has been able grow the segment which was previously on decline. Specifically, the bank reviewed its unsecured lending cap upwards for SME customers. The bank no longer requires SME customers to produce financial statements. The bank was able to acquire market share in 2016 as implementation of the strategy continued. As at Q32016, Barclays bank was the only listed bank that recorded a double digit loan book growth of 14.3%. This however came with a significant deterioration of the loan book quality. Net NPLs grew 37% to Kes 7.8 Bn representing 5% of the loan book. Provisioning subsequently increased by 218% to Kes 3.2 Bn.

The bank is also observed increasing focus on increasing its non-funded income through bank assurance, investment banking services and transactional banking. The newly acquired First Assurance by Barclays Africa is expected to boost Banc assurance business for the Kenya unit.

We are therefore bullish on the banks earnings growth for the next 5 years. We project an average earnings growth of 14% between 2017 and 2020. We expect ROE to average at 19% over the same period. We however believe that the bank will have to increase their retention ratio going forward, so as to retain more capital for this aggressive growth.

Recommendation	BUY
Target Price (KES)	12.88
Current Price (KES)	8.4
Upside Potential	53%
52 week range	7.05 - 13.30
Market cap (KES b)	48.07
Dividend yield	11.30%
Beta	0.85
Exit PB	1.57
Cost of Equity	16.9%

Financial Summary (KES m)	2015A	2016E	2017F	2018F	2019F	2020F	CAGR
Loan Book	145,379	160,309	174,842	199,495	229,398	270,585	13%
Deposits	165,083	182,169	218,552	249,369	286,747	338,232	15%
Net Interest Income	20,411	23,378	22,988	27,017	30,483	35,827	12%
Non Funded Income	10,010	11,504	12,614	14,148	16,427	19,363	14%
Earnings	8,401	8,318	9,629	10,881	12,188	14,381	11%
Cost to Income	51%	54%	52%	52%	52%	52%	
ROE	21%	19%	19%	19%	18%	19%	

Valuation Summary (KES m)	2016E	2017F	2018F	2019F	2020F
Earnings	8,318	9,629	10,881	12,188	14,381
Shareholders' Equity	43,501	50,219	57,729	66,108	76,223
Cost of Equity	(7,350)	(8,485)	(9,754)	(11,170)	(12,879)
Residual Income	**967**	**1,144**	**1,126**	**1,018**	**1,502**
Terminal Value					119,847
Total	**967**	**1,144**	**1,126**	**1,018**	121,349
Present Value	69,933				
No of shares	5,432				
Value per share	12.88				

Standard Chartered Kenya

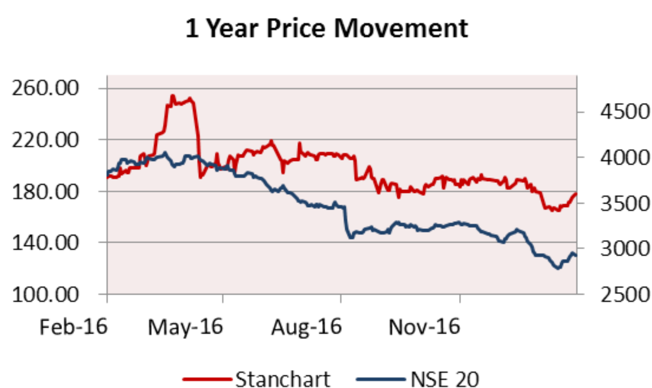
In November 2015, the Standard Chartered announced a new strategy which was aimed at prioritizing returns and allocation of capital and investment in areas in which the bank has long term competitive advantage. Key outcomes expected from the new strategy were strong and quality balance sheet, cost efficiency and a new ethical organization culture. To achieve this, Standard Chartered Kenya executives have been given more flexibility and autonomy as far as decision making is concerned. The local chief executive will be making decisions, in accordance with the local climate without consulting with the mother company in London. Management guidance on strategy is limited for Standard Charted and it is therefore not clear on how this strategy will change following the new law to cap lending rates. We however expect the bank to maintain its focus on Corporate and institutional banking which constitutes 62% of their asset base as at Dec 2015.

We do not expect the bank's net interest margins to be affected following the interest rate cap. In 2015 the weighted average interest for loans was at 13.15% compared to 16.2% recorded for the industry over the same period. We however expect the bank's costs to remain fairly flat in line with the global strategy of cost efficiency. Standard chartered PLC initiated a cost cutting drive in 2016 mainly targeting staff related costs. Investments in technology are expected to drive cost efficiencies across the banks operations.

Management access has been strenuous for minority shareholders and this remains a key risk to our valuation because of lack of clarity on how management is responding to changes in its operating environment. The banks market share (measured by asset base) has declined from 8.1% in 2011 to 6.7% as at 2015. This is largely attributed to the slow response to changing market dynamics. Going forward we expect the bank to cede further market share as it tries to play catch up with the peers.

We expect Equity's ROE will decline to 16.4 % in 2017 from 18.2% estimate for 2016. We forecast a 5 year ROE of 18% and 11% earnings growth for the next 5 years.

Recommendation	SELL
Target Price (KES)	132.25
Current Price (KES)	182.00
Upside Potential	-27%
52 week range	165 - 270
Market cap (KES b)	53.79
Dividend yield	9.91%
Beta	0.81
Exit PB	1.47
Cost of Equity	16.7%



Financial Summary (KES m)	2015A	2016E	2017F	2018F	2019F	2020F	CAGR
Loan Book	115,125	120,818	126,859	134,424	142,105	153,900	6%
Deposits	172,036	201,363	204,611	210,037	215,311	219,857	5%
Net Interest Income	18,116	18,482	16,836	18,066	19,157	20,692	3%
Non Funded Income	7,249	8,457	8,375	8,914	9,623	10,250	7%
Earnings	6,343	7,945	7,355	8,318	9,324	10,488	11%
Cost to Income	45%	45%	46%	46%	46%	46%	
ROE	15%	18%	16%	18%	19%	19%	

Valuation Summary (KES m)	2016E	2017F	2018F	2019F	2020F
Earnings	7,945	7,355	8,318	9,324	10,488
Shareholders' Equity	43,635	44,739	46,818	50,081	54,801
Cost of Equity	(7,306)	(7,490)	(7,838)	(8,385)	(9,175)
Residual Income	**640**	**(135)**	**479**	**939**	**1,313**
Terminal Value					80,349
Total	640	(135)	479	939	81,662
Present Value	45,430				
No of shares	344				
Value per share	132.25				

Stanbic Bank

Stanbic bank has over the past 3 years been able to acquire market share (loan book) in Kenya, albeit marginally. This has mainly been attributed to the high growth in the Corporate and investment banking segment. Stanbic bank has over the past 5 years been able to maintain fairly diversified streams of incomes both across segments, non-credit related revenues and across currencies. As at 2015 Corporate and investment banking segment contributed 55% of Net interest income while Personal and business banking contributed 45%. As at September 2016, non-interest income contributed 43% of total income. Similar to Barclays Bank, Stanbic bank mirrors the Mother companies group strategy closely. The group's strategic focus has always been on client relationship management, customer growth and acquisition, efficiency improvement & cost reduction initiatives and Investment in new age distribution platforms.

We observe Stanbic's operations as uniquely hedged against the effects of the interest rate cap due to three main reasons.

a. As at Dec 2015 Stanbic's loan book comprised of 58% foreign denominated currency loans which are not covered under the interest rate cap law.

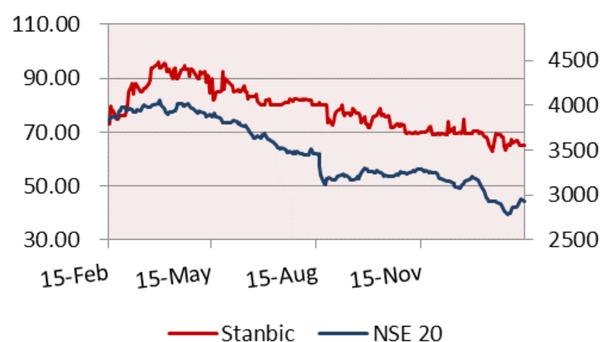
b. Stanbic's net interest margins have historically been low, meaning not much will change going forward.

c. It's well diversified income streams means low dependence on interest income compared to its peers.

We however expect Stanbic's earnings to be affected by increased provisioning. At 27.44% (September 2016) Stanbic Bank has the lowest level of coverage ratio (provisioning/NPLs ratio) among the listed banks. With the adoption of the New IFRS 9 standard we expect this to improve towards peer average which is currently at 49.6%.

We expect Stanbic's tangible ROE will decline to 16% in 2017 from 17% estimate for 2016. We forecast a 5 year tangible ROE of 17% and 10% earnings growth for the next 5 years.

Recommendation	BUY
Target Price (KES)	78.71
Current Price (KES)	66.50
Upside Potential	18.0%
52 week range	63 - 98
Market cap (KES b)	25.70
Dividend yield	11.03%
Beta	0.81
Exit PB	1.25
Cost of Equity	16.73%



Financial Summary (KES m)	2015A	2016E	2017F	2018F	2019F	2020F	CAGR
Loan Book	104,982	109,064	114,517	125,969	139,825	159,401	9%
Deposits	106,246	143,371	134,708	143,115	147,184	161,011	9%
Net Interest Income	9,307	10,396	9,750	11,021	11,717	13,107	7%
Non Funded Income	7,962	7,180	10,289	11,317	11,723	12,918	10%
Earnings	4,906	4,703	5,556	6,721	7,101	7,802	10%
Cost to Income	52%	55%	52%	51%	50%	49%	
ROE (tangible)	17%	15%	16%	18%	17%	17%	

Valuation Summary (KES m)	2016E	2017F	2018F	2019F	2020F
Earnings	4,906	4,703	5,556	6,721	7,101
Shareholders' Equity	29,015	31,387	34,245	37,736	41,478
Cost of Equity	(4,854)	(5,251)	(5,729)	(6,313)	(6,939)
Residual Income	51	(549)	(173)	408	161
Terminal Value					56,895
Total	51	(549)	(173)	408	57,062
Present Value	31,116				
No of shares	395				
Value per share	78.71				

I&M Holdings

I&M's market share is set to increase slightly after the expected completion of the acquisition of Giro Commercial Bank, in a deal worth KES 5 billion that will see the owners of Giro getting a 5.1 per cent stake of I&M Bank. The move is seen by management as strategic in terms of maintaining the quality of their loan book. Both Giro and I&M had an NPL ratio of 1.9 per cent of the loan book in 2015.

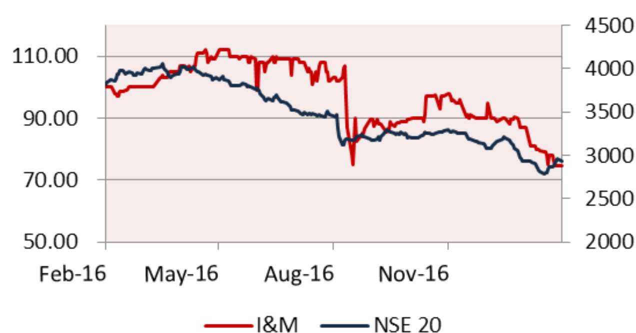
We expect the bank to maintain its focus on Corporate and institutional banking. However, we expect I&M to find it difficult to grow market share in this space due to increased competition as the larger banks will try to reduce exposure in the retail and SME space and shift to the less risky corporates and institutions.

Management indicates that the bank will focus on transactional banking by introducing new product offerings to improve non-funded income growth. In line with this strategy, I&M acquired Burbidge Capital in October 2015 in order to diversify their income by including fees from financial advisory services. Based on Q3 figures for 2016, we expect the contribution of NFI to total income to reduce from 27% in 2015. We however expect this to recover and increase towards 32% over the next 5 years.

At 37.2%, the bank had one of the lowest cost to income ratio in 2015. This is however expected to increase towards levels of 38%, mainly due to expected decrease in interest income, despite investments in low-cost alternative channels. I&M introduced the agency model in 2015, not only to reach areas where they have no presence, but also for the convenience of customers who move around.

Over the last 3 years, I&M has achieved an average ROE of 23% with at a constant dividend payout of around 20%. We expect the bank to increase dividend payout in order to maintain average ROE levels of 19%. Under current environment, we expect single-digit growth in earnings for the next two years, mainly due to an expected decrease in interest margins as a result of the capping of lending rates.

Recommendation	BUY
Target Price (KES)	92.31
Current Price (KES)	79.50
Upside Potential	16%
52 week range	74 - 113
Market cap (KES b)	29.23
Dividend yield	4.70%
Beta	0.96
Exit PB	1.06
Cost of Equity	17.33%



Financial Summary (KES m)	2015A	2016E	2017F	2018F	2019F	2020F	CAGR
Loan Book	127,824	144,578	167,628	186,521	209,515	240,831	14%
Deposits	132,981	151,992	178,096	200,297	227,432	264,295	15%
Net Interest Income	12,647	13,831	14,899	15,726	17,864	20,561	10%
Non Funded Income	2,365	2,458	3,149	3,877	4,774	5,970	20%
Earnings	7,144	7,668	8,013	7,817	8,929	10,375	8%
Cost to Income	37%	37%	38%	38%	38%	38%	
ROE	23%	20%	18%	16%	16%	16%	

Valuation Summary (KES m)	2016E	2017F	2018F	2019F	2020F
Earnings	7,668	8,013	7,817	8,929	10,375
Shareholders' Equity	37,583	43,993	49,465	55,716	62,978
Cost of Equity	(6,310)	(7,420)	(8,369)	(9,452)	(10,711)
Residual Income	1,359	593	(552)	(523)	(336)
Terminal Value					65,512
Total	1,359	593	(552)	(523)	65,176
Present Value	36,219				
No of shares	392				
Value per share	92.31				

Diamond Trust Bank Kenya

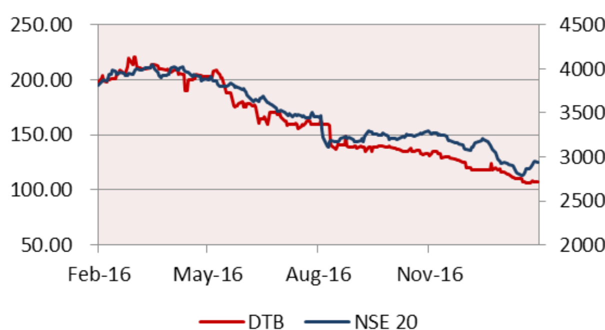
DTB's market share grew to 5.32 per cent to rank seventh, up from position nine, and surpassed the 5 per cent mark used by the CBK to classify banks as Tier 1. The bank moved to the large peer group mainly due to increased deposit bases, after DTB, together with KCB, were given access to deposits of Imperial Bank.

Over the last 3 years, the bank has boasted an average cost to income ratio of 43%. This is expected to reduce to 39% for 2016 and average 40% over the next 5 years. This will come as a result of increased use of alternative channels. DTB has tapped into Postal Corporation of Kenya (PCK)'s network to bolster its agency banking network to a 1000, up from the current 600.

DTB's balance sheet as of September 2016 shows that the bank has shifted significant amounts towards government securities. Our estimated ratio of government securities to total assets for 2016 is 30%, up from 17% as at the end of 2015. We expect income from this segment to increase by at least 80% year-on-year for the year ended 2016.
We expect the bank's ROE to drop in 2017 to 17.1% from an estimate of 18.9% in 2016. We forecast a 5-yr ROE of around 17%. We also expect DTB's provisioning to be least affected by the introduction of IFRS 9, since they have the highest NPL coverage of 82%.

A key risk to our valuation is a low strategy visibility for the bank. Given their high exposure to the SME sector, it is not clear if the bank will continue to pursue this sector following the rate cap law. As at December 2015, 26% of DTB's Profit before tax came from regional subsidiaries (highest in the sector), and this may help mitigate any slowdowns in Kenya.

Recommendation	BUY
Target Price (KES)	157.74
Current Price (KES)	107.00
Upside Potential	47%
52 week range	106.00 - 226.00
Market cap (KES b)	30.89
Dividend yield	0.98%
Beta	0.98
Exit PB	1.10
Cost of Equity	17.41%



Financial Summary (KES m)	2015A	2016E	2017F	2018F	2019F	2020F	CAGR
Loan Book	177,545	185,611	196,459	216,105	240,497	274,167	9%
Deposits	194,052	232,014	245,574	254,241	282,938	322,549	11%
Net Interest Income	15,190	18,874	18,938	19,815	22,122	25,274	11%
Non Funded Income	4,698	5,531	6,391	7,411	8,630	10,054	16%
Earnings	6,600	7,615	7,986	9,166	10,643	12,439	14%
Cost to Income	41%	39%	41%	40%	40%	40%	
ROE	19%	19%	17%	17%	17%	17%	

Valuation Summary (KES m)	2016E	2017F	2018F	2019F	2020F
Earnings	7,615	7,986	9,166	10,643	12,439
Shareholders' Equity	40,382	46,771	54,103	62,618	72,569
Cost of Equity	(7,031)	(8,143)	(9,419)	(10,902)	(12,634)
Residual Income	584	(157)	(254)	(259)	(196)
Terminal Value					79826
Total	584	(157)	(254)	(259)	79,630
Present Value	42,011				
No of shares	266				
Value per share	157.74				

NIC Bank

As larger banks shift strategy away from the SME segment following the capping of interest rates, management of NIC has maintained that they will focus on SMEs as they attempt to grow market share. The bank also expects to slightly increase their market share after taking over some of the operations of the collapsed Imperial Bank. NIC opened a window for former Imperial Bank depositors to access their money through new accounts opened at NIC. NIC also expects to take over the assets of the bank after completion of a due diligence.

In August 2016, Global Credit Ratings assigned NIC Bank Limited A+ and A1 in the long-term and short-term respectively, based on strong capitalization and resilient financial performance with the outlook accorded as Negative, due to deteriorating asset quality. The group's NPL ratio soared to 11.5% in 2015 from 4.0% in 2014 and loan loss provisions increased 5x to KES 1.6 billion.

Based on Q3 results for 2016, we expect a slight increase in the NPL ratio for the full year ended 2016. As at September, the group reported an NPL ratio of 12.3% and a year-on-year increase in provisioning of almost 5x to KES 3.1 billion. We view the past two years to be abnormal for NIC with regards to NPLs and we therefore expect the NPL ratio to reduce to single digit figures. We expect NIC's ROE to reduce from 17% in 2015 to 15% in 2016, and thereafter to average 16% over the next 5 years as NPLs normalize.

The lender's investment in government securities rose by 45% to KES 27.9 billion in 2015 to counter the effect of reduced loan growth. With loans expected to shrink slightly for the year ended 2016, we expect at least a 30% growth in government securities, with income from securities accounting for at least 20% of total interest income, up from 16% in 2016.

The bank has averaged a cost to income ratio of 42% over the last 5 years and this is expected to reduce to an average of 40% over the next 5 years through increased use of cheaper alternative channels and reduced staff count. In November 2016, the bank announced plans to retrench 32 senior level employees in order to contain operating costs.

Recommendation	HOLD
Target Price (KES)	27.59
Current Price (KES)	27.00
Upside Potential	2%
52 week range	20.00 - 43.00
Market cap (KES b)	13.44
Dividend yield	5.95%
Beta	0.95
Exit PB	0.95
Cost of Equity	19.01%

Financial Summary (KES m)	2015A	2016E	2017F	2018F	2019F	2020F	CAGR
Loan Book	114,658	112,414	122,443	139,221	153,931	174,673	9%
Deposits	112,365	110,209	121,231	139,221	155,486	178,237	10%
Net Interest Income	9,743	11,170	11,560	12,895	14,522	16,848	12%
Non Funded Income	3,956	4,942	5,884	6,844	8,086	9,869	20%
Earnings	4,485	4,239	5,045	5,562	6,478	7,798	12%
Cost to Income	41%	38%	41%	40%	40%	40%	
ROE	17.3%	15.0%	15.9%	15.6%	16.1%	17.1%	

Valuation Summary (KES m)	2016E	2017F	2018F	2019F	2020F
Earnings	4,239	5,045	5,562	6,478	7,798
Shareholders' Equity	28,289	31,820	35,713	40,248	45,706
Cost of Equity	(5,378)	(6,049)	(6,789)	(7,651)	(8,689)
Residual Income	(1,139)	(1,004)	(1,228)	(1,173)	(891)
Terminal Value					43,421
Total	(1,139)	(1,004)	(1,228)	(1,173)	42,530
Present Value	17,656				
No of shares	640				
Value per share	27.59				

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