KESTREL CAPITAL

1Q22 Market Commentary & Outlook for 2Q22

April 2022

1Q22 Market Commentary & Investment Outlook for 2Q22

Key highlights:

Macro:
No major shocks expected, but inflation is a key headwind. Twin deficits remain a concern.

On average, beers, wines and cigarettes will see a 10.0% hike in excise duty. And Spirits by 20%. Notably, nicotine pouches will see a 108.3% increment if the Finance Bill 2022 is approved.

Elections:
Tight elections expected. Running mate deadline has been extended to May 16. The choice of the running mate by each of the competing parties may alter the current political dynamics.

Equities:

a. **Top sector picks**: Banking, Brewing and Cement.
b. **Banks** – PB re-rating on strong ROE recovery driven by NIM expansion and lower cost of risk. Resumption of dividends a key plus for investors' returns.
c. **Brewing** - EABL to benefit from volume growth, price increments across its markets & products and margin enhancement from sale of premium brands. Escalation in input costs to weigh on margins.
d. **Tobacco** – BAT top line boost from LYFT (nicotine pouches) sales, improved pricing & growth in export volumes. Rising costs to negatively impact margins.
e. **Cement** - Bamburi to benefit from better product mix, sustained cement demand-retail & infrastructure and margin enhancement upon completion of new clinker plant. A rise in input costs to weigh on margins.

Safaricom – Neutral, +0.7% above FV. Kenya operations remain strong however, delayed launch of telecom services in Ethiopia to result in negative investor sentiment.

Marco Economic Environment & Outlook for 2Q22

INFLATION

- In 1Q22, headline inflation averaged 5.3%, peaking at 5.6% as at March, mainly on account of higher food prices. During the period, consumers were cushioned from rising global oil prices through the Government fuel subsidy program. As a result, Fuel inflation averaged 6.8% in 1Q22, versus 10.2% in 4Q21. Core inflation averaged 2.1% - stable on a q/q basis, reflecting muted consumer demand.

- We expect 2Q22 headline inflation to be within 6.0% - 7.0% range, largely driven by higher fuel prices given the upward adjustment on retail pump prices in April. In addition, the below than average rainfall experienced in March 2022 and wheat supply shocks (Russia -Ukraine war) will result in an uptick in Food inflation.

EXCHANGE RATE

- In 1Q22, against the USD the KES depreciated by 1.9% driven by higher oil imports, industrial supplies and the general strengthening of the USD (+2.7% q/q against major currencies). Against our SSA peer universe, the KES was the 3rd best performing currency. For 2Q22, we expect the KES to gradually decline, fluctuating within the range of KES 115-116.

- In our view, FX reserves (5.04 months of import cover – April 2022) remain adequate to cover any potential short-term balance of payments shocks. Strong diaspora inflows (+21.6% y/y – March 2022) and CBK intervention should also support the shilling from significant volatility.

INTEREST RATES

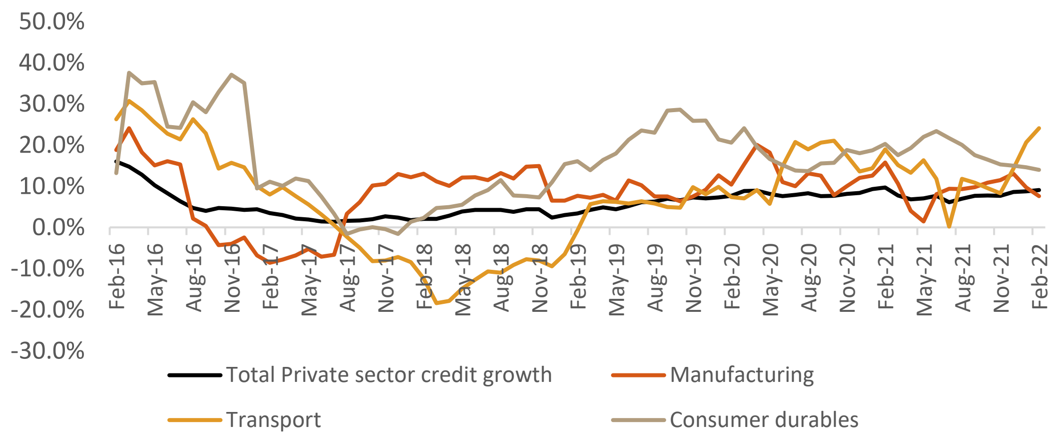
- The policy rate was stable at 7.0% in 1Q22, as the Central Bank maintained an accommodative policy to stimulate the economy. For 2Q22, we don’t foresee a change in the policy stance. We therefore do not expect a change on the Central Bank Rate as private sector growth at 8.8%, remains below monetary policy target.

- In 1Q22, domestic yields continued to exhibit an upward shift. The short-end of the curve rose by an average of 66bps versus 48bps on the long-end.

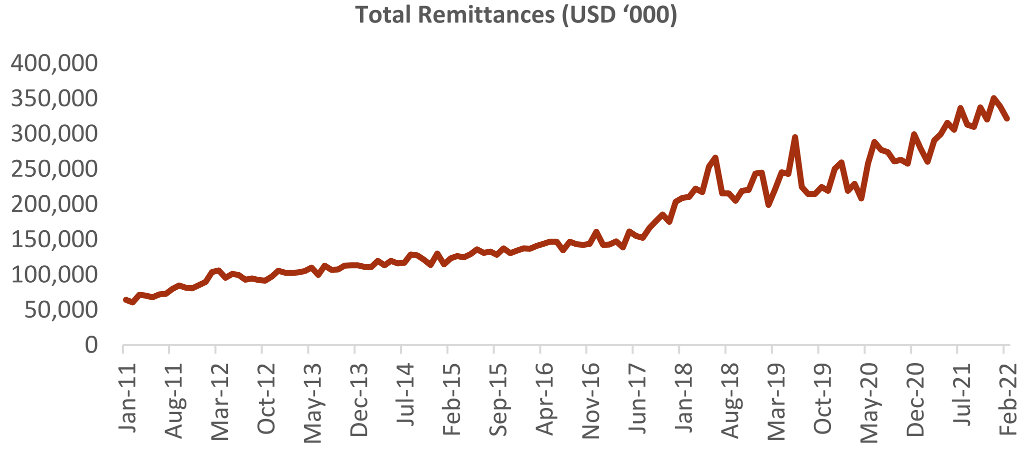
- We maintain our view on yields i.e., to gradually increase on account of government borrowing pressure to fund the completion of projects before the end of the election term and political risks to fuel offshore fire sales.

Macro Positives

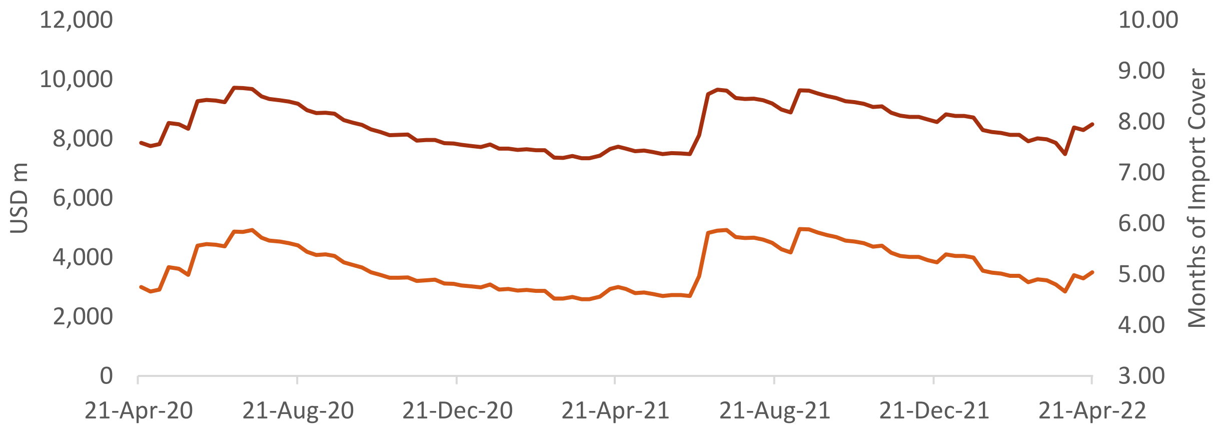
Gradual recovery in private sector credit growth as loans are properly priced for risk



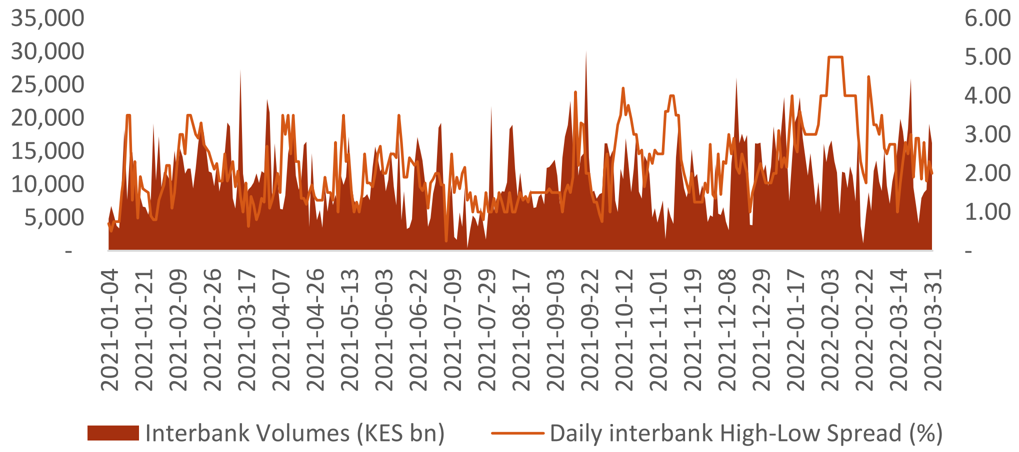
Continued growth in diaspora remittances to support KES



CBK reserves remain above recommended levels, sufficient buffer to absorb shocks

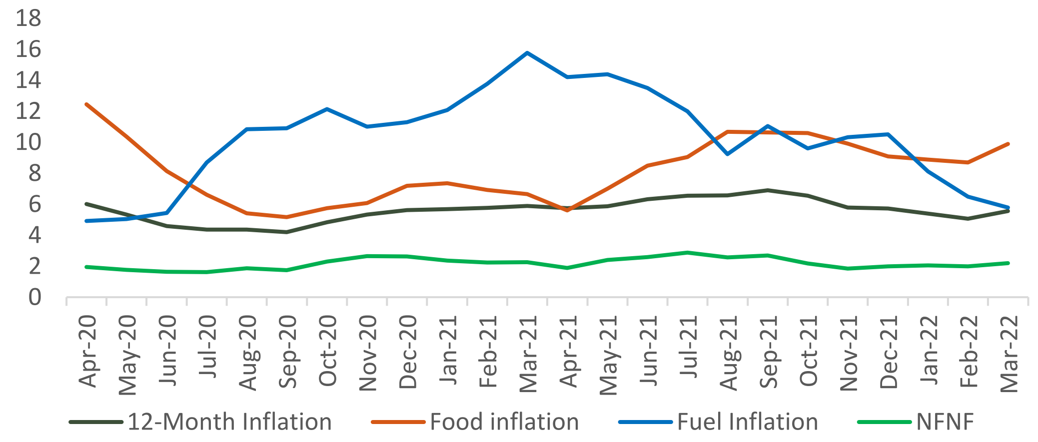


Market liquidity slightly improved as the average interbank rate declined 39bps q/q in 1Q22

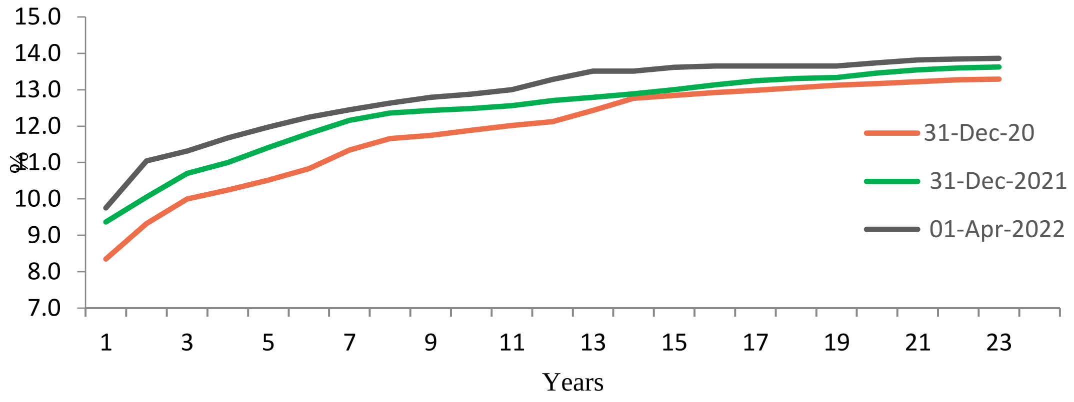


Macro areas of concern

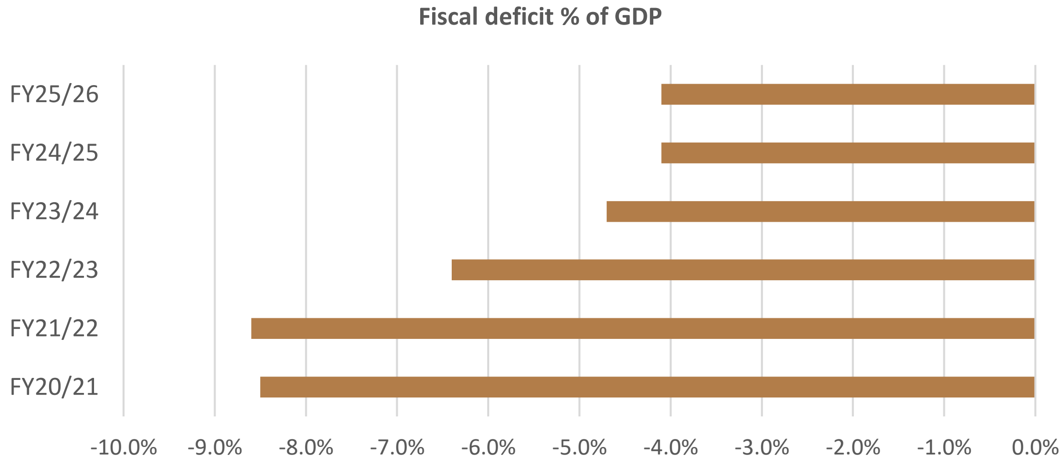
Negative outlook on inflation, driven by higher food and fuel prices



Yields to gradually rise on government borrowing pressure

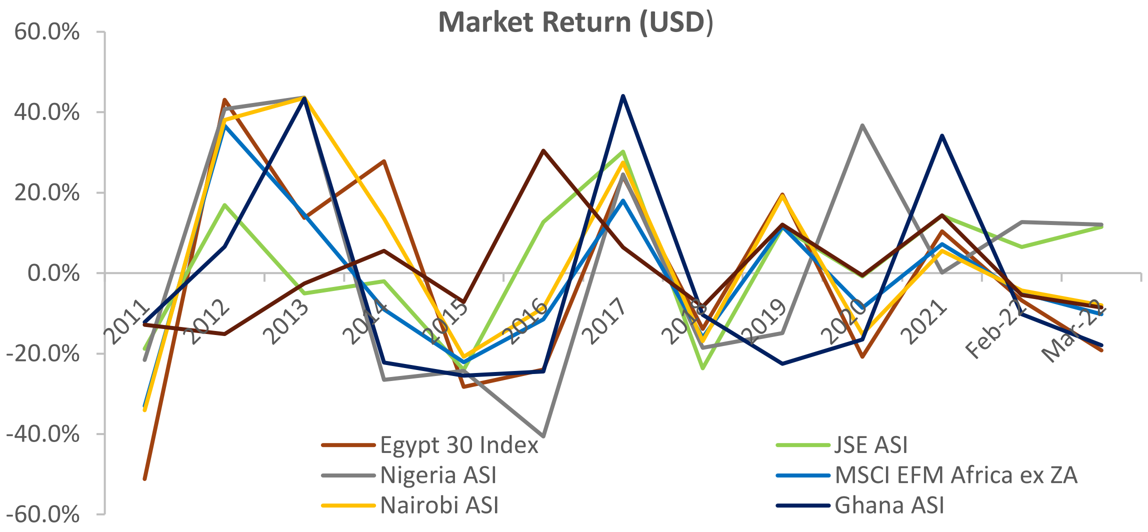


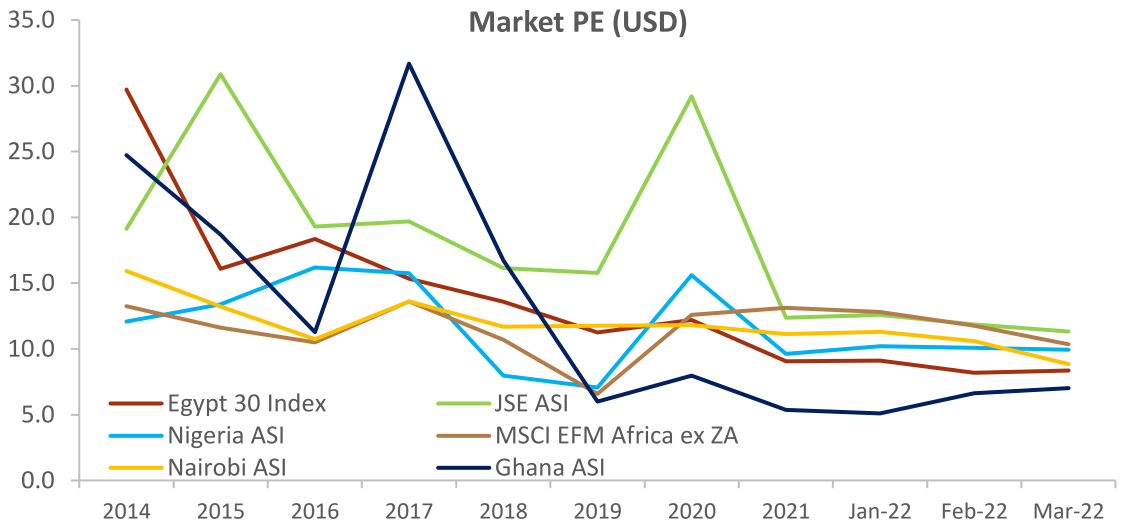
Fiscal deficit remains a concern

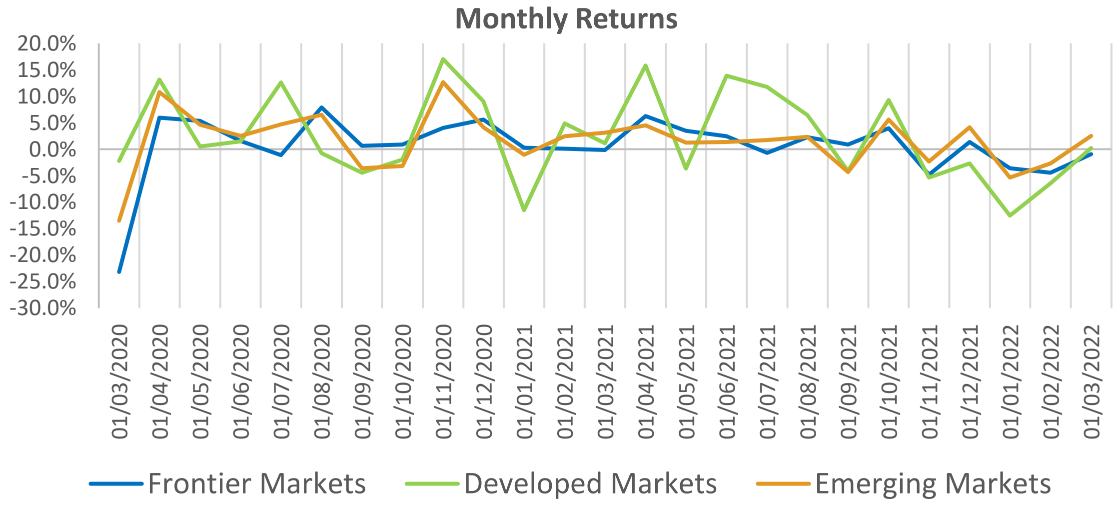


- By the end of 1Q22, we estimate net domestic borrowing stood at KES 485bn, indicating that the government had raised 73% of their budget target.
- For 2Q22, we expect a gradual increase in interest rates as the government is likely to accept more aggressive bids to meet domestic borrowing target for FY21/22.
- We remain concerned with the Kenyan Government’s fiscal position. As per the Budget speech, fiscal deficit is set to close at 8.1% of GDP – above the initial estimate of 7.5% in FY21/22.

Equities Market Commentary & Outlook - SSA Markets trading at deep discounts

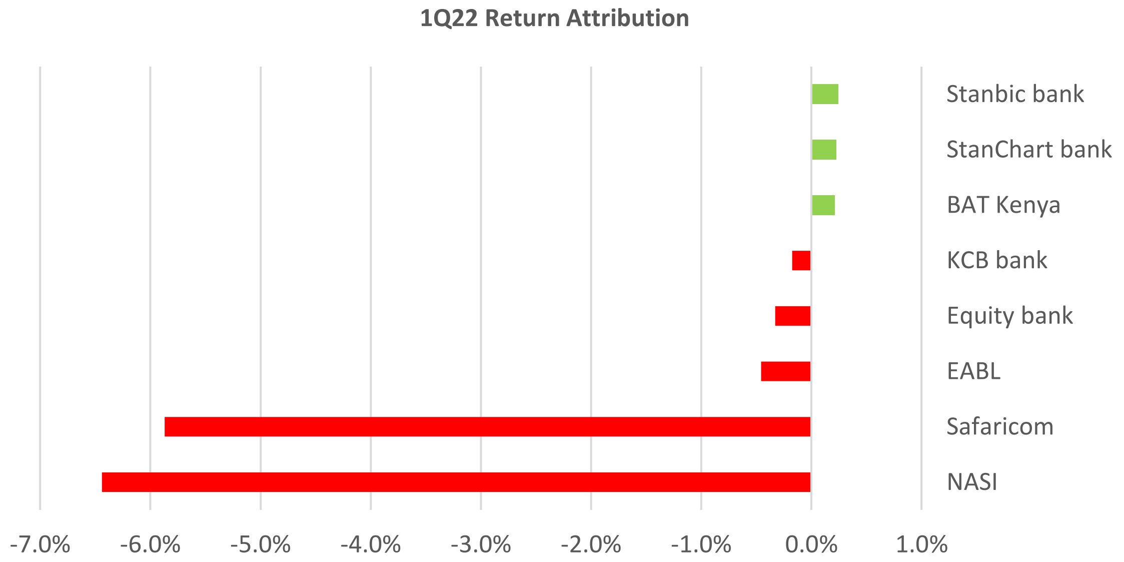




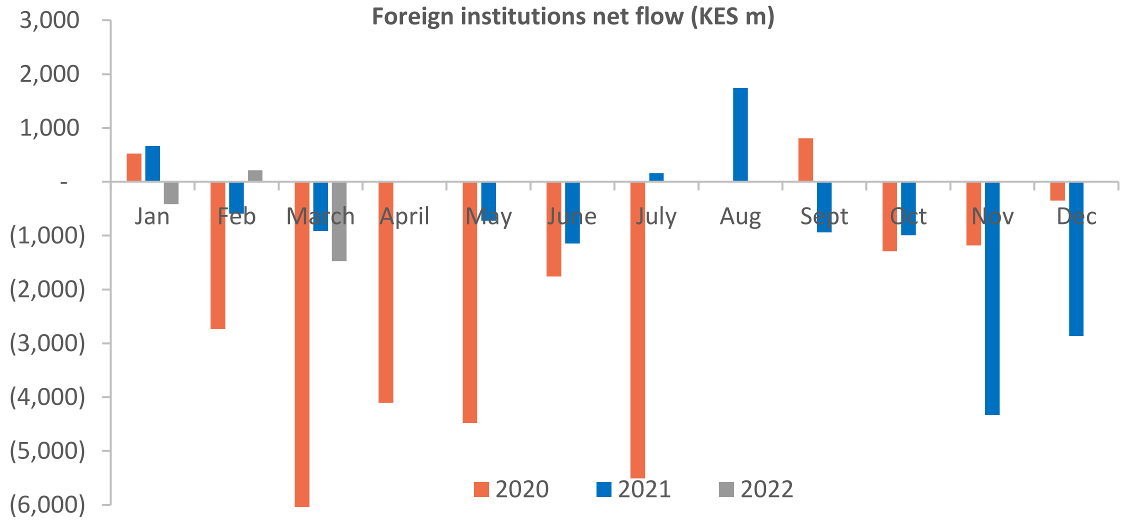


- In 1Q22, equity markets globally started off poorly. Developed markets lagged emerging & frontier markets.
- In SSA, only Nigeria & SA equities posted positive USD returns in 1Q22. All other peers saw negative returns – weak local returns & currencies weakness.
- In 1Q22, except for Ghana and Nigeria, there was broad-based PE multiple contraction among SSA peers.
- Compared to their 8-year average PE multiples, key SSA markets are trading at significant discounts, with Ghana leading the pack (54% discount)
- We expect, the prevailing SSA FX accessibility constraints & weakness and reduced market liquidity to continue weighing on prices in 2Q22. Resilience in corporate earnings will continue to favour a strong re-bound in equity prices.

Kenya Equities Market Commentary & Outlook



1Q22 PERFORMANCE			
TOP GAINERS	% Chg	TOP LOSERS	% Chg
Stanbic bank	18.1	Jubilee Insurance	-14.1
BAT Kenya	12.4	Britam Insurance	-11.5
StanChart bank	12.1	Safaricom	-10.0



- In 1Q22, Kenyan equities returned -8.0%, weighed by the telco and financial services sectors – all insurance stocks ended in red.
- Since Sept 21, foreign investors have consistently sold out, except in Feb 22. March 22 posted the highest foreign investors' net out flow in 3 months.
- In 1Q22, Equity recorded the highest foreign investors' net inflows, while Safaricom recorded the highest net outflows.
- In 1Q22, foreign investors' participation declined to a 6-year low of 47.9%. We attribute the low participation levels and continued sell-off to the global risk-off sentiment. Across key SSA markets, in 2022, foreign investors have been net buyers in S. Africa and net sellers in Egypt, Kenya and Nigeria.
- **Going forward, we expect investors' sentiment to remain weak. We maintain that 2022 equity returns will be driven by earnings growth and dividend returns.**

Banking Sector FY21 Variance Analysis & Outlook

Parameter	Summary	FY22 outlook
Net Interest Margins	❑ **Industry NIMs came in 20bps above forecast** ○ Co-op (8.0%) outperformed on margins while DTB (4.6%) underperformed	❑ Industry NIMs of 7.1%, 100bps above FY21 levels ○ KCB, highest NIMs; DTB lowest NIMs
NFI Mix	❑ **NFI mix came in a modest 10bps lower than forecasts** ○ NCBA (44.9%) excelled in NFI mix while DTB (24.0%) lagged the industry	❑ Industry NFI of 30.6%, 360bps lower than FY21 levels ○ Stanbic , highest ; DTB lowest
Cost to Income Ratio	❑ **CTI ratio was 160bps lower compared to our estimates** ○ NCBA (42.2%) reported the lowest CTI ratio while Stanbic (51.8%) recorded the highest CTI ratio on account of higher staff costs	❑ Industry CTI of 45.0%, 220bps lower than FY21 levels ○ Co-op, highest ; NCBA lowest
Cost of Risk	❑ **Industry cost of risk came in 10bps below forecast** ○ Equity (0.9%) saw the lowest cost of risk while NCBA (4.8%) marked the highest cost of risk	❑ Industry cost of risk of 1.8%, 40bps lower than FY21 numbers ○ NCBA, highest CoR; ABSA lowest CoR
NPL ratio	❑ **Industry NPL ratio came in 40bps below estimates** ○ StanChart (17.0%) posted the highest NPL ratio while ABSA (7.8%) registered the lowest NPL ratio	❑ Industry NPL ratio of 12.5%, 10bps lower than FY21 levels ○ StanChart, highest ; ABSA lowest
EPS Growth	❑ **Industry EPS growth came in 10.5% above our projections – average EPS growth was 74.3% y/y in FY21** ○ ABSA (+161.0% y/y) recorded the fastest EPS growth while DTB (+20.5% y/y) saw the slowest growth	❑ Industry EPS growth of 24.1% y/y, slower than the 74.3% growth in FY21 ○ I&M, fastest ; Stanbic, slowest
Net Loan growth	❑ **Net loan growth came in just a modest 0.4% above estimates** ○ Equity (+23.0% y/y) boosted the fastest net loan growth while NCBA (-1.8% y/y) marked a decline in net loan growth	❑ Industry net loan growth of 8.1%, 230bps lower than FY21 levels ○ Equity, highest ; Stanbic lowest
Return on Equity	❑ **Return on Equity came in 80bps above our forecasts** ○ Equity (23.2%) outperformed on ROE while DTB (5.8%) underperformed	❑ Industry loan growth of 16.4%, 60bps above FY21 levels ○ Equity, highest ; DTB lowest

Industry Outlook

Sector	Key Developments	View relative to FY22 Outlook
Telecommunication	○ Safaricom delays commercial launch of telco services in Ethiopia ○ Mobile money merchant payment interoperability launch ○ Airtel and Telkom Kenya mobile subscribers decline in 1Q22	○ NEUTRAL
Banking	○ Approvals of risk-based pricing models for select banks to benefit NIMs & loan growth ○ Expected rise in yields to benefit NIMs & investment in GOK securities ○ CBK lobbying for competitive pricing within the digital lending and mobile money transfer front ○ Regulatory costs – increased need for disclosures on fees and other charges	○ OPTIMISTIC
Breweries	○ Continued sound volume performance across key markets ○ An introduction of a 15% excise duty rate on fees charged on advertisements on alcoholic activities to increase marketing costs ○ Escalation in input costs; fuel inflation to constrain margins ○ On average, an excise duty increment of 10.0% is expected on beers and wines. A 20% increase is expected on spirits	○ OPTIMISTIC
Tobacco	○ Management expects growth in domestic volumes in FY22 (+1% y/y in FY21) ○ Uganda & Somalia sales expected to rebound ○ Escalation in input costs: fuel inflation to weigh on margins ○ Excise duty on cigarettes to rise by 10.0%; Nicotine pouches by 108.3%	○ OPTIMISTIC
Cement	○ Infrastructure spend and pent-up demand to drive cement consumption ○ Escalation in input costs; fuel inflation to squeeze margins ○ Higher construction costs to dampen supply of new housing units ○ Banking credit expansion to support demand & construction activity	○ OPTIMISTIC

Recommendation summary

COMPANY	FAIR VALUE (KES)	Upside/Downside	CURRENT RATING	PRICE COMPARED TO 50- DAY MOVING AVERAGE
Safaricom	33.95*	-0.7%	HOLD	-4.8%
Equity Bank	60.84	22.3%	BUY	-2.5%
KCB Bank	59.61	38.6%	BUY	-3.3%
Co-op Bank	16.15	27.7%	BUY	-2.1%
ABSA Bank	12.47	-1.0%	HOLD	3.4%
StanChart Bank	134.08	-7.5%	HOLD	4.5%
NCBA Bank	33.44	27.6%	BUY	3.4%
I&M Bank	21.43	7.1%	HOLD	-4.0%
Stanbic Bank	94.83	-5.2%	HOLD	0.2%
DTB Bank	106.48	86.8%	BUY	0.0%
EABL	256.11	76.9%	BUY	-5.7%
Bamburi Cement	89.84	149.6%	BUY	-2.0%
BAT Kenya	521.50	6.9%	HOLD	0.3%

FV includes Ethiopia operations representing KES 1.17 per share

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