Edition: December 2019
Region: Africa, Kenya
Issued by: Imara Asset Management Limited
Author: Rainer Orth

Equity Bank is quality, value and growth

This article has several objectives:

- Firstly, it highlights the positive growth story of Equity Bank, one of our top 5 allocations.
- Secondly, it explains how the value opportunity of Equity Bank emerged.
- Lastly, it reflects on two principles that underpin value which are:
  - Principle 1: Value emerges from negative events as markets over-react and good companies respond.
  - Principle 2: Value managers require discipline and experience to target high and stable ROIC/ROE's.

Latest news extremely positive, +46% YTD, we maintain as a high conviction allocation

Equity Bank is up 46% YTD on positive news flow for lending rates in Kenya. President Kenyatta brought finance policy to its senses by removing lending rate caps. The policy limited banks to charge 13% on loans (policy rate of 9% + 4% cap limit). Strengthened by his second term and no need for re-election, Kenyatta refused to sign the Finance Bill if it included continued interest rate caps. MPs could not gather the two thirds majority to oppose him. Kenyatta signed a compromise where existing loans remain capped till maturity. However, new loans will be uncapped. We think the story has far to run as the next three years should see margin and ROE upgrades coupled with earnings momentum.

Positive for Kenya Inc. – consumer vibrancy expected in 2020

The rate caps policy was highly popular amongst voters in 2016 on the promise of cheap credit but it was always doomed. It made banks less eager to lend, especially to SMEs. Low bank credit growth followed in 2017 and 2018 – only 3% growth in both years. SMEs starved for credit were forced to take credit from the unregulated microfinance sector at 70% per annum versus the 18-23% they got before rate caps. We expect new life to breathe into the SME sector. Our trip to Nairobi in September this year highlighted many positives in Kenya: quality earnings from top corporates, low inflation, GDP growth, better road network, available power from geo-thermal, and a new tech-based digital efficiency. However, we noticed a missing link. The consumer is not as strong. The smaller SMEs, the trader at the corner of streets, are not as vibrant as before. The credit crunch and new reliance on micro-finance (including fintech based ones) are just too small and expensive for their needs. The rate cap removal will inject new life into the SME sector and we expect consumer demand to come back strongly at the end of 2020. This bodes well for Kenya Inc. Our allocations to Safaricom and East African Breweries will also benefit from consumer vibrancy.

Strong boost to earnings and ROE for each of the next three years

Equity Bank's earnings and ROE will be boosted by higher volume and margin in each of the next three years. On the volume side, we expect guidance revision from 10 to 15% as credit growth and money supply speeds up. On the margin side, we expect 10% higher each year till 2022 as new loans get priced higher and the old book unwinds. The total margin impact will be 30% but it will be staggered over three years as roughly a third of Equity Bank's loan book matures each year. We outline the formula for margin impact below. After adjusting for maturity roll-over, we only apply it to the SME book which is likely to be priced up. We estimate SME is about half of Equity's current book. We add a top-up of about 5% from bringing back several clients that did not qualify after rate caps. Management noted that it stopped lending to half its 1.2m SME loan customer base after the rate cap policy came in 2016. As the formula shows below, we expect an 83bps increase in yield each year until 2022. This will shift the current net interest margin from its current 7.6% to 8.4% in 2020, 9.2% in 2021, levelling out at 10% in 2022. We expect ROE back at 26% from its 23% low in 2018. As medium-term ROE assumption is up, we also adjusted our fair value forward multiple to 2.4x book which implies a fair value of about KES 75/share (previous: 58). That represents 50% upside from current levels of KES 50/share.

Formula for annual yield pick up

Key assumptions:

- Average rate **increase 5%.**
- Book duration 3.5yrs = **30% of book** repriced per year.
- Kenya SME % of total book 50%, plus new clients re-introduce 5% of book per year = **55% of book.**

Annual Asset yield pick-up: = rate hike x 1/duration x SME book
= 5% x 30% x 55%
= 83bps

A case study of a market over-reaction - How did the value opportunity emerge?

While the latest news is strongly positive, our investment case is not built on near-term momentum. In line with our QVG research process we had to be sure that Equity Bank is a quality company that could maintain its ROE level despite a negative macro backdrop in 2016-2018. Below we narrate what happened and how we responded through our allocation.

In September 2016, President Kenyatta in pre-election mode agreed to MPs capping rates at 4% above the central bank reference rate - effectively 13% maximum loan rate. Quite a shock to the system as the top loan rate would be just above the sovereign long bond. Before the decision, SME loans priced between 18 and 23%. When the news hit, the market as expected went into meltdown. Sell-side reports expected a calamitous drop in Equity Bank's net interest margin that would translate to a ROE between 8 and 16%. Compare that to the 27-30% level in the previous 5 years.

We had a different perspective. Yes, SME loans would be impacted, and average loan yields would come down but like good corporates everywhere management would find a solution. After reviewing our numbers and speaking to management we felt a 23% ROE would be more realistic. In the next year, the company actually managed an ROE of 23.5%. Why the over-reaction by the sell-side and market? Often we find the devil is in the detail:

- **Wrong data used for rate cap analysis of loan book** – The correct approach was to exclude parts of the book that were not affected by Kenya shilling (KES) based rate caps. Several analysts did not exclude loan assets outside Kenya (e.g. Uganda), lowly priced KES corporate loans or USD loans. These loans were not subject to the new cap regulation. Equity Bank had 60% in Kenya based, higher priced SME loans. Many analysts over-estimated the book affected at between 70-100%.
- **Bond yields provide a low risk pick up** – Equity Bank had good liquidity and could easily re-allocate which they did aggressively to higher yielding, longer duration bonds. At that point bonds were a default option and therefore short-term and low yielding. Long bond yields on par with the best loan yields meant re-allocation was the logical and right thing to do.
- **Mobile money fees growth** - Operational leverage from mobile fees growing faster than costs did not feature significantly in sell-side forecasts. Cost growth from Equity's investment in its MVNO-driven transaction platform was a feature of the preceding years. But in 2016, that investment was largely done. We expected revenue to grow much faster than cost going forward which was the case.

Case study: FY17 P&L scenarios after rate cap event in September 2016					
		Sell-side reports			
Profit drivers		Worst case	Best case	Our view	FY17 actual
1. Loan book cap	Loan book capped %	100%	75%	60%	
	Caps applied to KES book (bn)	220	165	132	
	Yield impact (%)	-6%	-6%	-6%	
	Cap profit impact (KES bn)	**-13.2**	**-9.9**	**-7.9**	**-9**
2. Bond book	Bond book increase (KES bn)	0	50	50	
	Book yield shift (%)	0	4%	8%	
	Bond profit pick-up (KES bn)	**0**	**2**	**4**	**5**
3. Fees operating leverage	Fee growth (%)	15%	15%	25%	
	Opex growth (%)	10%	10%	10%	
	FY16 Opex (KES bn)	32	32	32	
	FY 16 Fee (KES bn)	22	22	22	
	Positive jaws (KES bn)	**0.1**	**0.1**	**2.3**	**3**
Total of drivers (KES bn)		**-13.1**	**-7.8**	**-1.6**	**-1.0**
ROE (%)		**8%**	**16%**	**23.5%**	**23.8%**

Source: IAM, Equity Bank 2017 annual report, Sell-side reports

Two lessons for us from this case study:

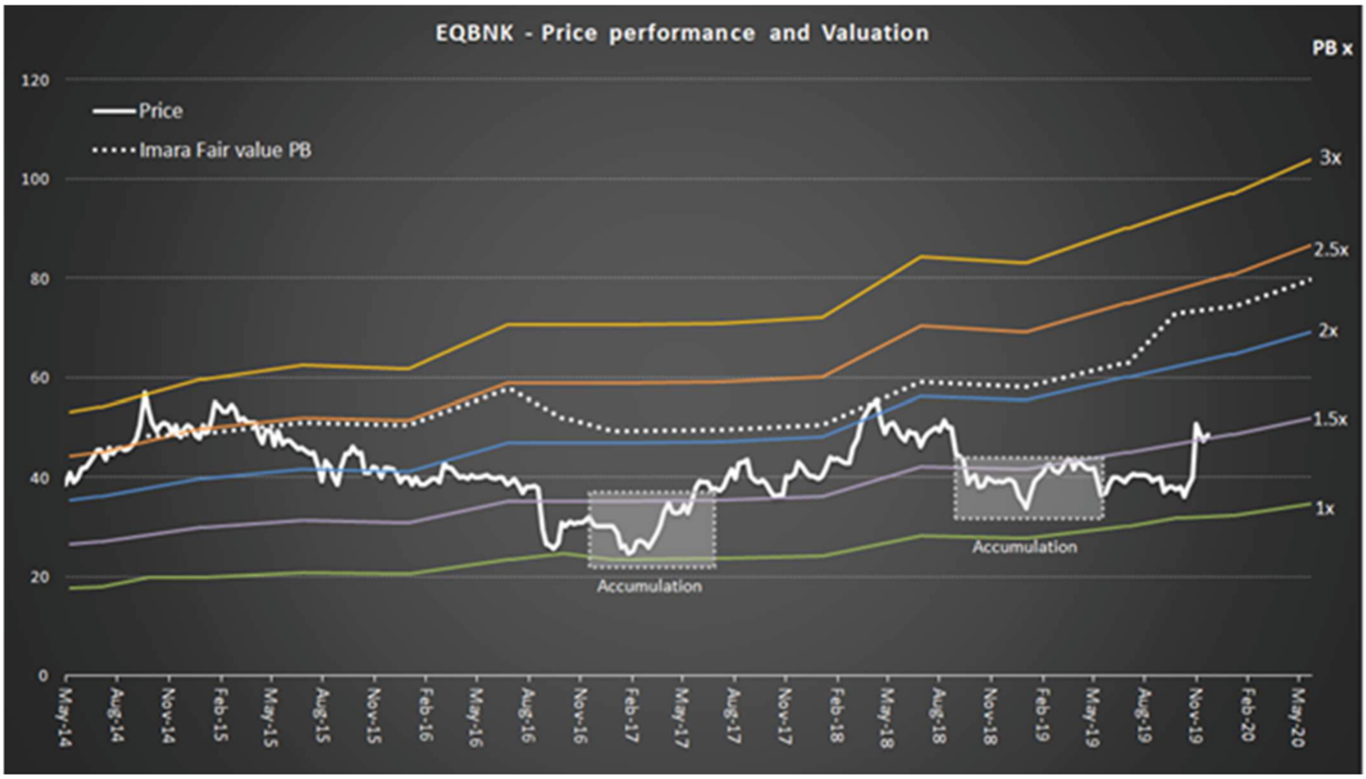
1. **Markets behaviour: It over-reacts to bad news.** It often over-reacts and discounts negative events. Whether driven by the wrong information or lack of positive factors many analysts and market participants over-estimate negative events. Experience is necessary to pick up the nuances of how earnings actually develop. This is what creates the value opportunity in the first place. From a fund manager perspective, the important take-away is that experience counts. As a result we were able to build a good average entry price at much discounted levels.
2. **Good companies find a way** – The second learning is that good management teams are typically guided by defending profitability. Good companies find a way. And so did Equity Bank. This learning supports our overall view of African listed equity space that there are excellent corporates that build shareholder value addressing the key consumer themes.

Principle 1: Value emerges from negative events as markets over-react and good companies respond.

Portfolio allocation and QVG illustrated

How did we allocate? Our experience and understanding of the Equity Bank business model gave us the confidence to invest when the market went into meltdown in 2017 and were simply pessimistic in late 2018. Where previously Equity Bank was in our portfolio as fairly priced growth at a 4-5% weighting, as the market sold off more, the greater the value opportunity became. In the chart below, downside volatility from 2017 to 2019 offered us great entry prices. Notice, the level it was trading at, between 1x and 1.5x book – far below our fair value of 2.1x and previous multiples. By adding value to the existing growth and quality metrics of Equity Bank meant it moved into our top 5 opportunities. We positioned it with a 8% weighting.

Going forward, despite a recent rally, its only trading just above 1.5x book. We believe earnings upgrades in 2020 and 2021 will shift consensus fair value expectations up. We upgraded our fair value to 2.35x – note the dotted line shift in October 2019.



Source: IAM, Bloomberg

Also visible in the chart is the constant gradient or growth of Equity's book value. Its dividend policy of 40% pay-out means 60% retention of a mid-20s ROE. That translates to approximately 15% growth in book value annually.

Key lessons for us – value investing with an ROE underpin is very important

In the film classic Shawshank Redemption one of the main characters reflect that "Hope is a dangerous thing. Hope can drive a man insane". And so it is with value investing. Hope has no place.

We often get asked if there is a holy grail to picking winners in African equities? We think there is one. Companies that maintain a return on investment capital substantially above the cost of capital will outperform. The answer is simple. But simple is not the same as easy. We had to learn to distinguish between the simple objective and the "not easy" parts of our jobs.

Step 1: The simple part: My objective is simple: find these winners. Find the ones that will maintain that all important RoIC, ROE in the case of banks. This is the part of my job that requires discipline. I am not interested in a more complex answer. If a company tells me they are momentarily relinquishing RoIC for the shiny new factory line and a better future in 3 years' time, best to move along to something else. When we deal with objectives, hope is a dangerous thing in investing. It can drive anyone insane. So step 1: Keep it simple. Stick with and stay focused on high RoIC.

Step 2: is the interesting and not easy part. My day to day goals are not easy but can be honed like a well-oiled machine or a Federer backhand…only over time. Repeat, repeat and repeat. Experience of seeing something before helps the next time you need to see the nuance of events and its impact. In our case, 13 years of traipsing around the continent helps build the nuance matrix.

So put together, the value manager principle:

Principle 2: Value managers require discipline and experience to target high and stable ROIC/ROE's.

Back to the future – what are we investing for?

Where to from here? It is important to remember the basics. In Africa we target growth – certainly higher than developed markets and higher than many frontier or emerging market peers. Equity Bank is an exceptional growth company that profitably converts an important theme of African financial inclusion. Using its investment in new distribution methods such as mobile money applications and its agency (retail store) network it has built a dominant banking platform in East Africa. It has a large footprint in Kenya where it banks approximately half of the 25m banked clients. And it is an emerging challenger in other regional markets – we expect dominance to follow there. The key driver for the business is converting cash especially in informal economy trade to bank services.

It managed to achieve that conversion by first rolling out low-cost branch and ATMs across an underpenetrated market from 1995-2010. It then introduced new distribution methods in 2012/13, using 40,000 retail (mom and pop) stores and mobile applications via its MVNO license to lower cost and increase the reach of its services. The result was rapid growth.

The 10yr statistics in USD terms:

- Deposit CAGR of 19% to current book of USD4.1bn,
- loans CAGR of 18% to USD2.9bn,
- earnings CAGR of 15%,
- that is a cumulative profit of USD1.4bn and USD550m of dividends.
- In terms of the share performance, growth translated to a total USD CAGR return of 14.2%.

IMARA
Asset Management

Equity Bank 10yr performance

Operational performance (USD million)

	2008	2018	CAGR
Deposits	715	4,100	19.1%
Loans	555	2,900	18.0%
Earnings	45	200	16.1%
Dividend	18	80	16.1%
10 yr cumulative profits		1,400	
10 yr cumulative dividends		550	

10 yr investment return (USD)

	2008	2018	Nominal	CAGR
Price (US c)	21.3	49.8	**134%**	8.9%
Cumulative dividend (US c)		16	**75%**	5.8%
Total return			**209%**	**14.6%**

Rainer Orth, Portfolio Manager
December 2019