

KINGDOM SECURITIES

Nairobi Securities Exchange - Investment Note

We open the coverage of Nairobi Securities Exchange (NSE) with a SELL recommendation on a valuation of KES 7.36, a 35.4% downside compared to current price of KES 11.40. On overall, we project a 6% decline in FY'19 revenues driven by a 9% drop in transaction levy occasioned by a 12.4% 2019 drop in equity turnover to KES 307.63Bn from KES 351.31Bn in 2018. We forecast an EPS of 0.48 compared to a five-year EPS average of 1.12 and a KES 0.30 per share in FY'19.

NES Ltd saw a 82.4% decline in HY'19 PAT to KES 24.0Mn from 134.0Mn in HY18. This was driven by a 18% decline in revenues caused by a 28% drop in equity turnover in the period. The poor HY performance was made worse by a KES 54Mn, one off restructuring cost, which pushed expenses 22.4% higher, compared to HY'18.

We forecast a 6% decline in transaction revenue as H2'2019 performed better after a Banking Sector rally in Q4'19 following the repeal of the interest caps. Full year 2019, NSE saw a 12.4% decline in equities turnover. The poor revenue performance will be cushioned by bonds turnover, which edged up to KES 1,303.36Bn, a 15.8% jump from 1,125.43Bn in 2018 as foreign investors improved their appetite on Infrastructure bonds. Interest income dropped by 19.8%. We expect this to translate to FY'19 on effect of suppressed yields on government papers.

We forecast FY'19 PBT margins to deteriorate to 30% against 38.5% in FY'18 occasioned by a one off staff restructuring cost of KES 52Mn in first half of 2019.

A 5.2% increase in total assets in 2018 and an 11.8% declining PAT led to ROaA easing to 8.8% against 10.8% in 2017. This was due to a 6.2% increase in current assets in 2018. Shareholders' equity saw a 4.2% growth in FY'18 from 8.0% FY'17. The growth suppressed by special dividend of KES 0.29/share for a final total dividend of KES 0.49. This saw ROaE dip to 9.3% from 11.2% over the period.

In spite of a downward slide in equity turnover, foreign participation improved to 68.5% compared to 63.2% seen in 2018. Foreign companies contributed 67.8% from 62.7% in 2018 while local companies continued to shy away from the market with their contribution shrinking to 22.5% from 27.2% over the same period.

Introduction of Derivative products in July 2019 did not manage to spur the market as anticipated. There is need for additional stakeholder's education, regulatory amendments to allow funds managers, insurance firms, government entities and individuals participate in the product.

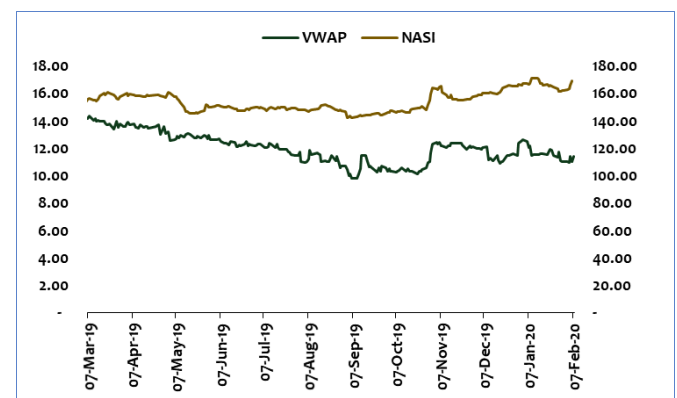
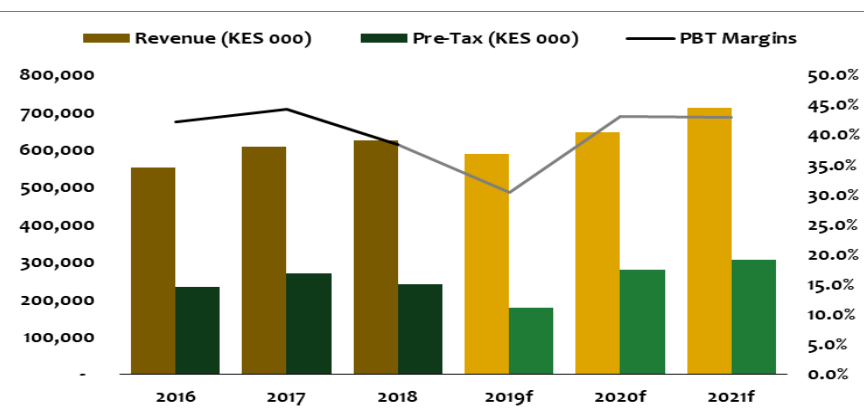
As of February 7th, 2020, the counter has lost 23.7% value y/y and 9.2% y-t-d basis. On the contrary, NASI is up 5.1% y/y and 1.6% y-t-d. In the last 52 weeks, the counter has touched KES 15.45 high and KES 9.82 low. With the expected 2019 and project performance, we anticipate a further deterioration of value.

Recommendation	SELL
Current Price	11.4
Valuation Price	7.36
Upside/Downside	-35.4%
No Of Shares (,000)	259,501
Market Cap (Mn)	2,958.31
Free Float	93.3%
Dividend Yield	1.20%
Forward PE	0.48

	2016	2017	2018
Revenue (KES 000)	552,164	607,438	626,191
Pre-Tax (KES 000)	233,115	269,186	240,849
PBT Margins	42.2%	44.3%	38.5%
EPS	0.71	0.83	0.73
PE	20.63	23.73	19.93
PEG	(51.80)	140.43	(165.43)
EPS Growth	-39.83%	16.9%	-12.0%
Dividend	0.27	0.30	0.29
Dividend Growth	-44.90%	11.1%	-3.3%
Dividend Cover	2.63	2.77	2.52
Dividend Yield	1.8%	1.5%	2.0%
Stock Price	14.65	19.70	14.55
ROaE	10.1%	11.2%	9.3%
ROaA	9.4%	10.5%	8.8%

	Profit and Loss		
KES ,000	2016A	2017A	2018A
Revenue	552,164	607,438	626,191
Interest Income	94,766	98,569	116,341
Other Income	70,255	46,711	39,605
Total Income	717,185	752,718	782,137
Admin Expenses	(487,291)	(495,856)	(560,300)
Operating Profit	229,894	256,862	221,837
PBT	233,115	269,186	240,849
Tax	(49,159)	(52,936)	(50,171)
PAT	183,956	216,250	190,678
EPS	0.71	0.83	0.73

	Balance Sheet		
KES ,000	2016A	2017A	2018A
Total Assets	2,013,745	2,108,220	2,218,388
Shareholders' Equity	1,863,145	2,011,886	2,095,748
Total Liabilities	288,296	185,342	242,569



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Forecast

- With the repeal of the interest caps, we forecast a 10% increase in revenues in 2020 on improved volumes and market value recovery. Interest income is bound to better on better government higher government paper yields and better term deposit returns. With the reduced staff cost and system efficiency, we project PBT to grow by 56.5%, which will push PBT margins to near long-term average of 43.1%.
- Foreign activity will dominating trades. This will help improve on volumes while containing price levels shouldering transaction revenue contribution.
- Efficiency created from technology deployment to improve trading and lower staff cost will aid PBT margins to revert back 43.1% in 2020.
- We foresee management and board issue a KES 0.30/share dividend for FY 2019. With our cash flow projection, we forecast the company will have adequate cash on reserve pay a special dividend in 2021.
- Economic performance – economic performance has a related impact on stock exchange counters, as company profitability and divided payment will influence investor's interest in a counter.
- Global growth will continue to play a major role as Fund Managers continue to seek returns in the emerging markets. The IMF projects a 3.3% Global Growth in 2020 from 2.9% expected in 2019. World Bank Projects a 2.5% in Global growth from 2.4% in 2019.
- With calm returning from international trade wars between US and trading partners and military standoff in the Middle East, we expect an improved in manufacturing and trade.
- Stakeholders education – there is additional need to train stakeholders on the new product, derivatives and stock
- Potential listing from the Ibuka Program will aid in bringing back market confidence after a five-year IPO draught.

Valuation

- Our intrinsic value of KES 7.36 was arrived on use of Discounted Cash Flow Method (DCM) on Free Cash Flow to Equity (FCFE). Our assumptions include risk free rate of 11.5055% pegged on a 5 year government bond as we only focused on three years, Adjusted Beta of 1.129 from Bloomberg, for market risk, we used the Damodaran Country Risk of 5.43% and a terminal growth rate of 6% equivalent to Kenya's projected GDP growth rate.

Assumptions		
Risk Free Rate	11.51%	5 Year Government Bond
Beta	1.13	Bloomberg 1 Year
Market Risk	5.43%	Damodaran (Jan 2020)
Cost of Equity	17.6%	
Terminal Growth	6.0%	Government Projection
Tax Rate	30%	
Number of Shares	259,501	
Valuation Date	08-02-20	
Current Share Price	11.40	February 7th 2020
Days in the Year	365	

FCFF	31-Dec-16	31-Dec-17	31-Dec-18	31-Dec-19	31-Dec-20	31-Dec-21
Net Income	183,956	216,250	190,678	124,964	195,509	214,187
Dep & Am	39,948	26,208	43,780	49,874	53,797	58,032
CAPEX	70,811	42,518	65,199	55,210	59,559	64,253
W.CAPITAL	51,369	(86,658)	(25,708)	(3,149)	(17,771)	(18,633)
Sum	101,724	286,598	194,967	122,777	207,518	226,599
Terminal Growth						1,949,216
Time				(0.10)	0.88	1.87
				1.02	0.87	0.74
Discounting Factor						
Discounted Value				124,814	179,750	167,238
						1,438,593
Intrinsic Value (KES)						1,910,395
Intrinsic Value per Share (KES)						7.36
Upside/Downside						-35.4%

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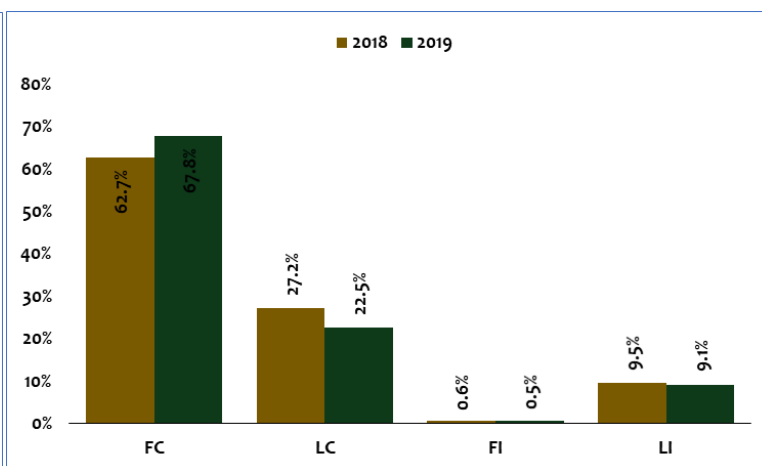
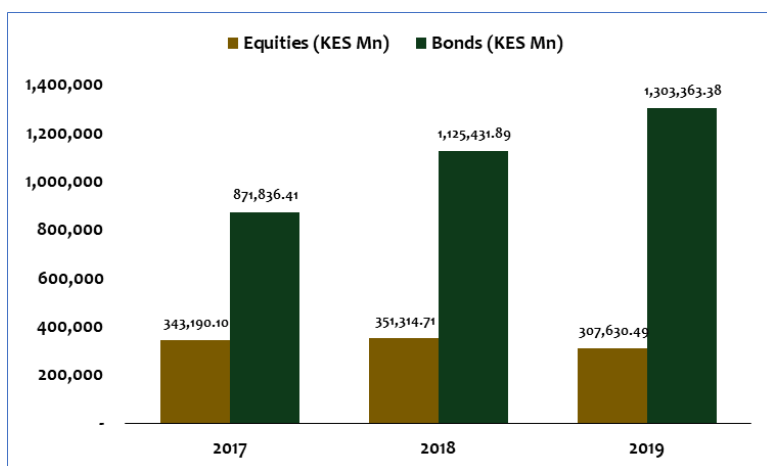
Forecast Books of Accounts

Profit and Loss KES ,000	2016A	2017A	2018A	2019F	2020F	2021F
Transaction Revenues	552,164	607,438	626,191	588,620	647,481	712,230
Interest Income	94,766	98,569	116,341	97,593	110,590	121,649
Other Income	70,255	46,711	39,605	41,570	45,473	49,766
Total Income	717,185	752,718	782,137	727,783	803,544	883,644
Administrative expenses	(487,291)	(495,856)	(560,300)	(559,189)	(534,172)	(587,589)
Operating Profits	229,894	256,862	221,837	168,595	269,372	296,055
PBT	233,115	269,186	240,849	178,521	279,298	305,981
Tax	(49,159)	(52,936)	(50,171)	(53,556)	(83,789)	(91,794)
PAT	183,956	216,250	190,678	124,964	195,509	214,187
EPS	0.71	0.83	0.73	0.48	0.75	0.83
Final Dividend	0.27	0.30	0.29	0.30	0.30	0.35
Special Dividend			0.20			

Balance Sheet KES ,000	2016A	2017A	2018A	2019F	2020F	2021F
Current Assets	1,004,550	1,035,836	1,079,514	1,075,501	1,125,768	1,140,200
Non-Current Assets	1,009,195	1,072,384	1,138,874	1,186,615	1,258,909	1,372,980
Total Assets	2,013,745	2,108,220	2,218,388	2,262,117	2,384,678	2,513,179
Shareholders' Equity	1,863,145	2,011,886	2,095,748	2,142,862	2,260,521	2,383,882
Current Liabilities	12,904	7,326	2,711	2,711	2,711	2,711
Non-Current Liabilities	137,696	89,008	119,929	116,544	121,446	126,586
Total Shareholders' Equity and Liabilities	2,013,745	2,108,220	2,218,388	2,262,117	2,384,678	2,513,179

Cash Flow KES ,000	2016A	2017A	2018A	2019F	2020F	2021F
Net cash from operating activities	195,931	70,180	67,151	24,222	67,148	73,905
Net cash from/(used in) investing activities	347,091	(327,035)	79,987	145,205	130,094	123,105
Net cash used in financing activities	(92,375)	(66,474)	(73,860)	(77,850)	(77,850)	(90,825)
Increase/(decrease) in cash and cash equivalents	450,647	(323,329)	73,278	91,577	119,391	106,185

NSE Securities Turnover Performance



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Analysts' stock ratings are defined as follows:

- **Buy** – A buy rating reflects 1) An analyst has a bullish conviction on a stock 2) A 30% or greater expected return.
- **Accumulate** – An accumulate rating reflects 1) An analyst has a lesser bullish conviction on a stock 2) Expected return falls between 10% and 30%.
- **Hold** – A hold rating reflects 1) An analyst has a neutral conviction (lack of bullish or bearish conviction) on a stock 2) Expected return falls within the range of 5% to 10%.
- **Speculative Buy** – A speculative buy rating reflects 1) An analyst has a bullish conviction accompanied by a substantially higher than normal risk 2) Expected return falls above 10%.
- **Sell** – A sell rating reflects 1) An analyst has a bearish conviction on a stock 2) Expected return falls below 5%.

*Expected Return (ER) represents the sum total of both capital appreciation and the dividend yield.

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