GRAYISSUE

The sentiment pendulum

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Investor sentiment is a delicate thing, which changes with surprising rapidity.

Kenyan banks…

Three years ago Kenya and the Kenyan banks were very out of favour. The largest bank, Kenya Commercial Bank (KCB), was trading at KES15 equal to tangible book value. It now seems the sector can do no wrong, growing advances and generating strong returns.

We were keen buyers of KCB at KES15, but unfortunately very early sellers. We valued the company at KES25 in late 2011 and had sold our holding by the time it reached KES35 in early 2013. KCB currently trades at KES60, 2.5 times book value. We believe it is a high-quality business that deserves to trade at a premium to book value.

In our opinion the risks are beginning to creep into Kenya, with growing dollar lending in both the private and the public sector and a current account deficit sitting at 9% of GDP. (This makes South Africa's 5% current account deficit look relatively modest, but a caveat is that Kenya is investing much more than SA.)

…versus Nigerian banks

On the other hand, sentiment towards Nigerian banks has gone from positive to outright fear. The fear is not without reason given the falling oil price, likely spike in bad debts, political uncertainty and Boko Haram insurgency.

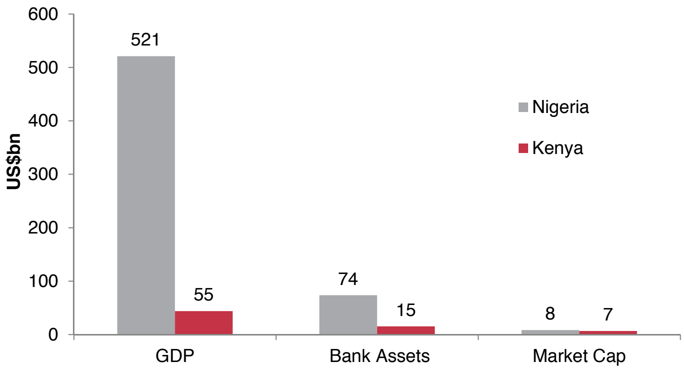
Graph 1 gives an indication of the market capitalisation of the largest five banks in Kenya and Nigeria relative to their assets and the GDP of the respective countries.

It is indeed likely that there will be a lot of distress in the next year, but it is important to remember that what a company earns in a particular year generally has little bearing on the intrinsic value of the business; what counts is the level of normal earnings through the cycle and the ability to grow those earnings. Financial companies are a little different in this regard as they may go bankrupt before achieving normal earnings. A few Nigerian banks may go bust or raise capital, but luckily the share prices are discounting this probability.

Over the long term, there is no reason why the Kenyan banking sector should be any more or less profitable than the Nigerian banking sector and over the past 10 years the return on equity (ROE) for each of these sectors has been similar. With a similar ROE, the price-to-book value for these two countries' banks should be fairly close. However, the largest five listed banks in Kenya are trading at 2.6 times book value, discounting a long-term ROE of about 26%, while the Nigerian banks trade below book value, indicating a long-term ROE of around 10%. The market cap of the companies relative to the assets on the balance sheet tells a similar story, with Kenyan banks pricing in a return on assets 3.5 times that of Nigerian banks (see **Graph 2**).

In the Allan Gray Africa ex-SA Equity Fund we have a significant investment in Nigerian banks and very little in Kenyan banks. We think the terrible sentiment and clear risks are giving us the opportunity to buy decent businesses, with favourable long-term prospects, at very attractive prices.

Graph 1 | Nigerian & Kenyan banks: contrasting numbers



Source: Allan Gray research, Bloomberg and country data

Graph 2 | Kenya banks are pricing in a lot

Source: Allan Gray research, Bloomberg and country data

Definitions

Return on equity (ROE): Return on equity measures a company's profitability by revealing how much profit a company generates with the money shareholders have invested.

Price to book value (P/B): A financial ratio used to compare a company's current market share price to its book value, i.e. the value of a company's net assets expressed on the balance sheet.

Sources: Investopedia.com, Wikipedia.org

Commentary by Andrew Lapping, portfolio manager, Allan Gray