

Valuation Summary

- We are of the view that National Bank is a “*lighten*” with a target price of Kshs. 3.9, representing a downside of 2.6%, from the current price of Kshs. 3.8 as of 23rd August 2019,
- National Bank Holdings is currently trading at P/TBV of 0.2x and a P/E of 2.3x vs an industry average of 1.3x and 6.3x, respectively.

Key Highlights H1'2019

- The bank made high profile hires in information systems security and forensic investigation, after a spate of high profile theft and cyber security incidents at the bank, and,
- Shareholders of the bank accepted the KCB offer for the acquisition 100% of the issued ordinary shares. The closing date of the offer changed to 30th August 2019. The announcement of the results of the offer will be 13th September with the settlement date set for 27th September 2019, and the listing of the additional KCB shared will be on 30th September 2019.

Income Statement

Core earnings per share declined by 40.1% to Kshs. 0.4 bn, from Kshs. 0.7 in H1'2018. Performance was driven by a 6.0% increase in total operating income, coupled with the 5.8% increase in the total operating expenses, National Bank of Kenya released their financial results with core earnings per share declining by 40.1% to Kshs. 0.4, from Kshs. 0.7 in H1'2018. However, this was after stripping out the exceptional items expense of Kshs 0.5 bn in H1'2018. Performance was driven by a 6.0% increase in total operating income, and was weighed down by the 5.8% increase in the total operating expenses.

- Total operating income increased by 6.0% to Kshs. 3.9 bn from Kshs. 3.7 bn in H1'2018. This was due to an 20.0 % increase in Net Interest Income (NII) to Kshs. 3.1 bn from Kshs. 2.6 bn in H1'2018, coupled with a 28.7% decline in Non-Funded Income (NFI) to Kshs. 0.8 bn from Kshs. 1.1 bn in in H1'2018,
- Interest income increased by 7.3% to Kshs. 4.4 bn, from Kshs. 4.1 bn in H1'2018, driven by the increase in interest income on government securities that increased by 11.5% to Kshs. 2.2 bn, from Kshs. 2.0 bn in H1'2018. Interest income on loans and advances increased by 4.7% to Kshs. 2.2 bn, from Kshs. 2.1 bn in H1'2018. As a result, the yield on interest earning assets increased to 11.6% in H1'2019 from 10.1% in H1'2018,
- Interest expense declined by 14.4% to Kshs. 1.3 bn, from Kshs. 1.5 bn in H1'2018, following a 34.2% decline in the interest expense on deposits and placements from banking institutions to Kshs. 101.3 mn, from Kshs. 153.9 mn in H1'2018. Interest expense on customer deposits declined by 12.2% to Kshs. 1.2 bn, from Kshs. 1.4 bn in H1'2018. The cost of funds remained flat at 3.0% in H1'2019, while Net Interest Margin increased to 8.2%, from 6.9% in H1'2018,
- Non-Funded Income (NFI) declined by 28.7% to Kshs. 0.8 bn, from Kshs. 1.1 bn in H1'2018. The decline in NFI was driven by an 8.9% decrease in other fees and commissions to Kshs 564.8 mn, from Kshs 620.0 mn in H1'2018, coupled with a 15.3% decline in foreign exchange to Kshs 241.5 mn, from Kshs. 285.0 mn in H1'2018. However, fees and commissions on loans and advances increased by 67.1% to Kshs. 62.8 mn, from Kshs. 37.6 mn in H1'2018. The current revenue mix stands at 81:19 funded to non-funded income as compared to 71:29 in H1'2018. The proportion of funded income to total revenue increased owing to the decline in NFI coupled with the increase in NII,
- Total operating expenses increased by 5.8% to Kshs. 3.7 bn, from Kshs. 3.5 bn, largely driven by the increase in provisions of Kshs. 0.1 bn in H1'2019, as compared to the write back in provisions of Kshs. 47.9 mn in H1'2018. The increase in the operating expenses could also be attributed to the 9.6%

increase in staff costs to Kshs. 2.1 bn, from Kshs. 1.9bn in H1'2018. Other expenses declined by 7.5% to Kshs. 1.5 bn in H1'2019, from Kshs. 1.7 bn in H1'2018,

- The cost to income ratio improved slightly to 95.5% from 95.6% in H1'2018. Without LLP, the Cost to income ratio also improved to 81.8%, from 86.7% in H1'2018,
- Profit before tax increased by 10.0% to Kshs. 175.4 mn, up from Kshs. 159.4 mn in H1'2018. The bank recorded a profit after tax of Kshs. 150.1 mn compared to a loss after tax of Kshs. 282.7 mn in H1'2018.

Balance Sheet

- The balance sheet experienced marginal expansion, as total assets increased by 1.1% to Kshs. 114.6 bn from Kshs. 113.3 bn in H1'2018. This increase was largely caused by an 89.1% increase in cash and bank balances to Kshs 17.0 bn, from Kshs 9.0 bn in H1'2018, which outweighed the 17.5% decline in government securities to Kshs 34.1 bn, from Kshs 41.3 bn in H1'2018,
- The loan book declined by 1.0% to Kshs 44.3 bn, from Kshs 47.3 bn in H1'2018.
- Total liabilities decreased by 0.2% to Kshs. 107.3 bn, from Kshs. 107.5 bn in H1'2018, driven by a 25.0% decline in placements by other institutions to Kshs. 5.1 bn, from Kshs.6.8 bn in H1'2018, coupled with a 4.9% decline in customer deposits to Kshs 91.3 bn, from Kshs 96.0 bn in H1'2018, which outweighed the 131.9% increase in other liabilities to Kshs. 10.8 bn, from Kshs. 4.7 bn in H1'2018,
- Deposits per branch increased by 4.1% to Kshs. 1.4 bn, from Kshs. 1.3 bn in H1'2018, as the bank closed 5 branches, to close the half year at 69 branches,
- The slower decline in loans as compared to deposits led to an increase in the loan to deposit ratio to 51.8%, from 49.8% in H1'2018,
- Gross non-performing loans increased by 7.5% to Kshs. 32.4 bn in H1'2019, from Kshs. 30.1 bn in H1'2018. Consequently, the NPL ratio increased to 48.1%, from 46.5% in H1'2018. General provisions increased by 17.5%, to Kshs. 15.1 bn from Kshs. 12.9 bn in H1'2018. The NPL coverage thus increased to 61.8% in H1'2018, from 56.5% in H1'2018.
- Shareholders' funds increased by 25.2% to Kshs. 7.3 bn in H1'2019, from Kshs. 5.9 bn in H1'2018, aided by the 29.2% increase in the statutory loan loss reserves to Kshs 4.5 bn, from Kshs 3.5 bn in H1'2018,
- National Bank is currently severely undercapitalized with a core capital to risk weighted assets ratio of 1.5%, 9.0% below the statutory requirement. In addition, the total capital to risk weighted assets ratio was 2.9%, below the statutory requirement by 11.6%. Adjusting for IFRS 9, the core capital to risk weighted assets stood at 2.0%, while total capital to risk weighted assets came in at 3.4%, indicating that the bank's total capital relative to its risk-weighted assets declined by 0.5% due to implementation of IFRS 9, and,
- National Bank currently has a return on average assets of 0.4% and a return on average equity of 6.7%.

Key Take-Outs:

1. National Bank is currently severely undercapitalized with the total capital to risk-weighted assets ratio coming in at 2.9%, 11.6% below the 14.5%, as required by regulation. The bank has been granted exemption to operate below the regulatory requirement, with the promise of mobilizing capital to meet the requirements, by both debt and a rights issue. The current acquisition by KCB Group will see the bank become recapitalized as they operate as a separate subsidiary for two years, and,
2. The bank experienced a deterioration in asset quality, with gross non-performing loans (NPLs) increasing by 7.5% to Kshs. 32.4 bn, from Kshs. 30.1 bn in H1'2018. The NPL ratio of 48.1% is still the

highest in the sector and thus the bank needs to adopt a raft of measures to improve on the overall asset quality.

The bank could improve its performance, and needs to focus on the following to improve:

- a. Improve the asset quality: National bank has the worst asset quality in the listed banking space, with an NPL ratio of 48.1%. At this level of NPL, a restructuring to separate the “good bank” from the “bad bank” is necessary to resolve the bad portfolio. It will be difficult for the bank to focus on growth with such a bad portfolio.

Below is a summary of the bank's performance:

Balance Sheet Items	H1'2018	H1'2019	y/y change	H1'2019e	Projected %y/y change	Variance in Growth Actual vs. Expected
Government Securities	41.3	34.1	(17.5%)	43.4	5.0%	(22.5%)
Net loans and advances	47.8	47.3	(1.0%)	44.3	(7.4%)	6.4%
Total Assets	113.3	114.6	1.1%	107.0	(5.6%)	6.7%
Customer Deposits	96.0	91.3	(4.9%)	91.3	(4.9%)	0.0%
Total Liabilities	107.5	107.3	(0.2%)	110.9	3.2%	(3.4%)
Shareholders' Funds	5.8	7.3	25.2%	6.7	15.3%	9.9%

Balance Sheet Ratios	H1'2018	H1'2019	y/y change
Loan to Deposit Ratio	49.8%	51.8%	2.0%
Return on average equity	(0.6%)	6.7%	7.3%
Return on average assets	(0.0%)	0.4%	1.8%

Income Statement	H1'2018	H1'2019	y/y change	H1'2019e	Projected % y/y change	Variance in Growth Actual vs. Expected
Net Interest Income	2.6	3.1	20.0%	2.3	(10.0%)	29.9%
Net non-Interest Income	1.1	0.8	(28.7%)	1.0	(3.5%)	(25.1%)
Total Operating income	3.7	3.9	6.0%	3.4	(8.1%)	14.1%
Loan Loss provision	0.0	(0.1)		(0.4)		

Total Operating expenses	(3.5)	(3.7)	5.8%	(3.7)	4.7%	1.1%
Profit before tax	0.2	0.2	10.0%	(0.3)		
Profit after tax	(0.3)	0.2		(0.2)	-	-
Core EPS	0.7	0.4	(40.1%)	(0.6)	-	-

Capital Adequacy Ratios	H1'2018	H1'2019
Core Capital/Total deposit Liabilities	1.8%	1.3%
Minimum Statutory ratio	8.0%	8.0%
Excess	(6.2%)	(6.7%)
Core Capital/Total Risk Weighted Assets	2.0%	1.5%
Minimum Statutory ratio	10.5%	10.5%
Excess	(8.5%)	(9.0%)
Total Capital/Total Risk Weighted Assets	3.4%	2.9%
Minimum Statutory ratio	14.5%	14.5%
Excess	(11.1%)	(11.6%)
Liquidity Ratio	39.9%	40.7%
Minimum Statutory ratio	20.0%	20.0%
Excess	19.9%	20.7%
Adjusted Core Capital/Total Risk Weighted Assets	2.4%	2.0%
Adjusted Core Capital/Total Risk Weighted Assets	3.9%	3.4%