Diamond Trust Bank Kenya Limited Acquires Habib Bank Limited Kenya

Diamond Trust Bank Kenya Limited (DTBK) this week expressed their intention to acquire Habib Bank Limited Kenya (HBLK). The Tier I bank announced that it had already entered into a definitive agreement with the latter and that conclusion of the transaction was likely to take place within H1'2017, subject to approvals from DTBK shareholders and regulatory approvals from authorities in both Kenya and Pakistan. This will be the first bank acquisition in 2017 should it go through, and will be in line with our expectation of consolidation in the Kenya banking sector following the enactment of the Banking (Amendment) Act, 2015 and the fact that Kenya is overbanked, as highlighted in our note on the acquisition of Fidelity Bank by SBM Holdings of Mauritius.

Habib Bank Limited (HBL) is at present the largest private bank in Pakistan with over 1,600 branches in Pakistan alone, over 1,700 ATMs globally and branches in 25 other countries. It is listed on the Pakistan Stock Exchange and is already the second largest DTB shareholder with 11.97% shareholding. HBLK has 5 branches in total, with 3 in Nairobi, and 1 in Mombasa and Malindi; and a market share of 0.4% by total deposits, ranking 32nd out of 40 banks according to the CBK's Annual Supervisory Report, 2015. DTBK is a listed Tier I bank with presence in Kenya, Tanzania, Uganda and Burundi.

The transaction details are as below:

1. DTBK is to acquire the business, assets and liabilities of HBLK as a going concern,
2. The transaction is to take place through the issuance of 13.3 mn new DTB ordinary shares at a price per share of Kshs 137.4, amounting to Kshs 1.8 bn, and will result into a dilutive effect of 4.8% to current shareholders. The price as at the announcement date (21st March, 2017) was Kshs 103.0, indicating a 33.4% premium on share price,
3. As at HBLK's last reporting in Q3'2016, the bank had a book value of Kshs 2.4 bn,
4. As such, the transaction is being carried out at a price-to-book value (P/Bv) of 0.8x, which is an 11.1% discount to the market's current trading valuation of 0.9x P/Bv.

The table below indicates previous banking acquisition deals and their transaction multiples in the Kenyan banking industry;

Acquirer	Bank Acquired	Book Value at Acquisition (bns)	Transaction Details (stake)	Transaction Value (bns)	P/Bv Multiple	Date
DTBK	Habib Bank Limited Kenya	2.38	100%	1.82	**0.8x**	Mar-17
SBM Holdings	Fidelity Commercial Bank	1.75	100%	2.75	**1.6x**	Nov-16
M Bank	Oriental Commercial Bank	1.80	51%	1.30	**1.4x**	Jun-16
I&M Holdings	Giro Commercial Bank	2.95	100%	5.00	**1.7x**	Jun-16
Mwalimu SACCO	Equatorial Commercial Bank	1.15	75%	2.60	**2.3x**	Mar-15
Centum	K-Rep Bank	2.08	66%	2.50	**1.8x**	Jul-14
GT Bank	Fina Bank Group	3.86	70%	8.60	**3.2x**	Nov-13
Average			**80.3%**		**1.8x**	

From this, we can see that our local bank acquisition price-to-book average is at 1.8x, down from 2.0x due to the DTB deal which has the lowest multiple at 0.8x, and the average stake acquired is at 80.3%, up from 77.0%. Previously, transactions have taken place at a premium, (i) SMB and Fidelity at 57.0% above market, (ii) I&M and Giro at 30.8% above market, and (iii) M Bank and Oriental at 9.0% above market as stated in our earlier note on Fidelity Bank's Acquisition and its Effect on the Kenyan Banking Sector.

Key to note is that HBL is an existing DTBK shareholder with 11.97% shareholding at present, second only to the Aga Khan Fund for Economic Development at 17.3%. The transaction will dilute Aga Khan Foundation's shareholding to 16.5% and increase HBL's shareholding to 16.1%.

In our last note on Fidelity Bank's acquisition and its effect on the Kenyan Banking Sector, we were of the view that larger banks would be looking for acquisition targets to grow their client and deposit base. We laid out 5 criteria that would be used by these larger banks in their selection, and in this note, we seek to look at whether the transaction considered the criteria.

The table below looks at the criteria for consideration in relation to the current transaction between DTB and HBLK:

No.	Criteria	Explanation	Relation To The Current Transaction	Does it fit the criteria?
i.	Poorly capitalized banks	This includes challenges in meeting the statutory requirements, including capital adequacy and liquidity. With the injection of fresh capital, the acquiring entity can bolster the capital position of the bank, thereby meeting all statutory requirements	HBLK had a liquidity position of 71.1%, 51.1% above the statutory requirement as at Q3'2016. HBL was well capitalized as at their last reporting, with all capital adequacy ratios well above statutory requirements	**No**
ii.	Locally owned Tier III banks	Since the banks are locally owned, the banks most likely have a particular niche or market segment that they serve in Kenya's banking space. In addition, their market share is below 1.0% of the total market, indicating that they are largely non-competitive but there is lots of market share to potentially grow into and merge with existing business	HBLK is not locally owned but is actually owned by the larger HBL which is a bank based in Pakistan. However, its market share is at 0.4% and it is a Tier III bank	**No**
iii.	Banks with a low return on equity	This will favour the acquiring foreign entity as shareholders would be more willing to sell their stake and cash out, as opposed to banks that deliver a high return on equity	As at their last reporting in Q3'2016, HBLK recorded a return on average equity of 2.2%, way below market which was at 21.0% on average	**Yes**
iv.	Banks with high NPLs	This is an area where the acquiring foreign entity can improve with their expertise and move with speed to rectify, and also restructure their loan book and debt	In Q3'2016, HBLK was being weighed down by its high NPL ratio which was at 16.3%, again above market which was at 7.0% on average	**Yes**
v.	Banks with shared common significant shareholding	Local stable banks will also seek to acquire banks aligned with their strategies and with a large common shareholding	DTBK and HBLK share this in terms of HBL, which is the 2nd largest shareholder in DTBK with a current holding of 11.8%	**Yes**

With the transaction fitting 3 out of 5 criteria items, we can conclude that the transaction was a strategic move. Key take-aways from this transaction are:

i. Kenya's banking sector consolidation will continue to happen and it will lead to a more stable, safer banking sector,

ii. Kenyan banking sector stocks are generally undervalued as can be seen from the fact that (i) HBL, an existing DTB shareholder and hence an insider, will get new DTB shares at a 33.4% premium from market as at the announcement date, and (ii) the transaction will take place at the lowest P/Bv multiple in the history of Kenya banking sector acquisitions, at 0.8x.

This is a further case of consolidation in the banking sector with banks such as Habib Bank Limited Kenya, who are uncompetitive in the market, being bought out. It continues to echo our sentiments on the attractive investment opportunity in financial services in Kenya.