



Fidelity Bank Acquisition and What it Means to Kenya's Banking Sector

The Central Bank of Kenya announced this week the proposed acquisition of Fidelity Commercial Bank by SBM Holdings Limited, subject to regulatory approvals in both Kenya and Mauritius. If this deal goes through, this would be the 3rd successful local bank acquisition in Kenya's banking sector this year, following Giro Commercial Bank's acquisition by I&M Holdings, and Oriental Commercial Bank's acquisition by M Bank.

As highlighted in our Cytonn H1'2016 Banking Report, we are of the view that Kenya is over-banked with a relatively high ratio of banks to total population, with 42 commercial banks serving 44 mn people. This overbanked environment, coupled with the enactment of the Banking Act (Amendment) 2015 that sought to cap interest rates charged on loans, will inevitably lead to consolidation in the banking sector. This consolidation is going to happen in the near-term to acquire the weaker banks. The strong banks will be able to protect their margins by simply limiting any interest paying accounts in favor of transaction accounts, and limiting loans to prime clients and investing balance of deposits in government, which has already been happening and leading to a crowding-out of the private sector. Subprime clients will need to find non-bank financial solutions.

This consolidation in the banking sector will lead to larger banks, which are more stable and can withstand shocks in the economy. In addition, banks will have to be innovative to find their niche in the market to remain competitive and gather deposits.

Fidelity Bank Acquisition Details:

SBM Holdings Ltd, is the second largest bank in Mauritius, with a market share of about 25%, and an asset base of Kshs 417.0 bn. SBM Group has an international footprint in India, Madagascar, and a representative office in Myanmar, and is looking to expand into East Africa. Fidelity bank started as a commercial bank 20-years ago, has 14 branches in Kenya and is ranked 31 out of 41 Kenyan lenders with a market share of 0.4%.

The transaction details are as below:

1. SBM Holdings is acquiring the entire share capital of Fidelity Commercial Bank for Kshs 1.3 bn,
2. SBM Holdings will additionally inject a further Kshs 1.5 bn as growth capital into the bank,
3. Hence the total consideration is Kshs. 2.8 bn, comprising both payments to shareholders of Fidelity and the new capital injection,
4. As at Fidelity Bank's last reporting, Q1'2016, the bank had a book value of Kshs 1.8 bn,
5. As such, the transaction is being carried out at a 1.6x price-to-book valuation, a 57.0% premium book, representing the premium SBM Holdings had to pay to enter the Kenyan banking space.

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

Acquirer	Bank Acquired	Book Value at Acquisition (bn)	Transaction Stake	Transaction Value (bn)	P/Bv Multiple	Date
SBM Holdings	Fidelity Commercial Bank	1.75	100.0%	2.75	1.6x	Nov-16
M Bank	Oriental Commercial Bank	1.80	51.0%	1.30	1.4x	Jun-16
I&M Holdings	Giro Commercial Bank	2.95	100.0%	5.00	1.7x	Jun-16
Mwalimu SACCO	Equatorial Commercial Bank	1.15	75.0%	2.60	2.3x	Mar-15
Centum	K-Rep Bank	2.08	66.0%	2.50	1.8x	Jul-14
GT Bank	Fina Bank Group	3.86	70.0%	8.60	3.2x	Nov-13
Average			77.0%		2.0x	

We note that for local bank acquisitions, the average price-to-book multiple is at 2.0x, with an average acquisition stake of 77%. Given that SBM Holdings is going for a 100% stake at a 1.6x price-to-book valuation, we feel that the 57% premium above the market is an attractive price, given that (i) the listed market is at a historic low valuation of 1.0x book value, against a historical average of 1.9x, and (ii) the acquisition is at a time when CBK has placed a moratorium on the licensing of new banks, thus operating banks have additional negotiating power, and purchasers of private banks have to pay premiums over the listed market valuations.

From the recent acquisitions this year, M Bank acquired Oriental Commercial Bank at a 9.0% premium above market, while I&M Holdings acquired Giro Commercial Bank at a 30.8% premium above market.

With the moratorium on licensing new banks still in play, all international banks and investors looking for exposure to the Kenyan banking sector will have to enter via way of acquisition. This will be in addition to the larger banks in Kenya also looking for acquisition targets to grow their client and deposit base. The criteria for consideration will be:

- 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 foreign entity can bolster the capital position of the bank, thereby meeting all statutory requirements. Fidelity Commercial Bank had a liquidity position of 11.0% as at Q1'2016, 9.0% lower than the minimum statutory ratio of 20.0%, and was looking to sell a stake to a strategic investor to bolster its liquidity and capital position. Other banks that are poorly capitalized, and may not meet the proposed minimum capital of Kshs 5 bn, should it ever be enacted, will be prime targets for acquisition, especially by the larger local banks.
- 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% 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.
- iii. **Banks with a low Return on Equity (ROaE)** - This will favor 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. Before acquisition, Fidelity Commercial Bank and Oriental had a ROaE of 0.6% and 0.2%, respectively,
- iv. **Banks with High NPL's** - 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 structure. Both Fidelity Commercial Bank and Oriental Bank were being weighed down by this, with their NPLs to total loans ratio at 16.4% and 14.9%, respectively.

Key take-aways from this transaction:

- i. Consolidation in the banking sector will only gather pace going forward. There are many limping players that need to merger or be acquired. Consolidation will lead to a more stable and safe banking sector,
- ii. There is value in the banking sector. Sophisticated players like SBM are willing to pay 1.6x book for a sector trading at 1.0x book value,
- iii. We shall see more foreign entries into the market, following M Bank and SBM Holdings

This is a further case of consolidation in the banking industry, with banks such as Fidelity Commercial Bank, who are uncompetitive in the market, being bought out, and highlights the attractive investment opportunity in financial services in Kenya.