Valuation Summary

- We are of the view that ABSA Bank Kenya is an “**Accumulate**” with a target price of Kshs 10.8, representing an upside of 13.4%, from the current price of Kshs 9.5 as of 28th August 2020, inclusive of a dividend yield of 11.5%,
- ABSA Bank Kenya is currently trading at a P/TBV of 1.2x and a P/E of 7.6x vs an industry average of 0.9x and 5.5x, respectively.

Key Highlights H1’2020

- ABSA Bank Kenya recently restructured loans amounting to Kshs 57.0 bn equivalent to 28.2% of its net loans, which stands at Kshs 201.9 bn in H1’2020 to shield its customers and provide relief from financial distress occasioned by the COVID-19 pandemic, and,

- The bank donated Kshs 50.0 mn in support of the efforts by the government and other Kenyans of goodwill against the COVID 19 pandemic. These funds will be used for the acquisition of Personal Protective Equipment (PPEs), psychosocial support programs, business resilience training, and mentorship programs for SMEs to help them survive through this difficult time.

Income Statement

- Core earnings per share declined by 84.8% to Kshs 0.11, from Kshs 0.72 in H1’2019, not in line with our expectation of a 1.5% increase to Kshs 0.83. The performance was driven by a 34.9% increase in total operating expenses, which grew faster than the 3.0% growth in total operating income. The variance in core earnings per share growth against our expectations was largely due to the 228.1% increase in Loan Loss Provisions to Kshs 5.4 bn, from Kshs 1.6 bn in H1’2019, against our expectation of a 71.6% increase to Kshs 2.8 bn,
- Total operating income rose by 3.0% to Kshs 16.8 bn, from Kshs 16.3 bn in H1’2019. This was supported by a 4.2% rise in Non-Funded Income (NFI) to Kshs 5.5 bn, from Kshs 5.3 bn in H1’2019, coupled with a 2.5% rise in Net Interest Income (NII) to Kshs 11.3 bn, from Kshs 11.0 bn in H1’2019,
- Interest income rose marginally by 0.9% to Kshs 15.3 bn, from Kshs 15.2 bn in H1’2019. This was driven by a 6.3% growth in interest income from government securities to Kshs 4.3 bn, from Kshs 4.1 bn in H1’2019, which offset the 0.8% decline in Interest income from Loans and Advances to Kshs 10.9 bn from Kshs 11.0 bn in H1’2019, as well as the 20.8% decline in interest income from placements to Kshs 0.1 bn from Kshs 0.2 bn in H1’2019.. The yield on interest-earning assets declined to 9.7%, from 10.7% in H1’2019, attributed to the faster 14.8% y/y increase in average interest earning assets to Kshs 321.9 bn, from Kshs 280.5 bn in H1’2019, that outpaced the 3.5% growth in trailing interest income, which the management confirming it had been dropping lending rates for customers, in line with the CBR cuts.
- Interest expenses declined by 3.3% to Kshs 4.0 bn, from Kshs 4.2 bn in H1’2019, following a 7.8% decline in interest expense on customer deposits to Kshs 3.2 bn, from Kshs 3.4 bn in H1’2019. The decline was however weighed down by a 16.9% rise in placement liabilities to Kshs 0.7 bn from Kshs 0.6 bn in H1’2019. Cost of funds, on the other hand, declined to 3.1%, from 3.5% in H1’2019, owing to the faster 17.5% growth in average interest bearing liabilities, despite the 4.2% decline in trailing interest expense. Net Interest Margin (NIM) on the other hand declined to 7.3%, from 7.9% in H1’2019, owing to the faster 14.8% growth in average interest earning assets which outpaced the 2.5% growth in Net Interest Income (NII),
- Non-Funded Income (NFI) rose by 4.2% to Kshs 5.5 bn, from Kshs 5.3 bn in H1’2019. The growth was mainly driven by a 20.7% rise in forex trading income to Kshs 2.1 bn, from Kshs 1.7 bn in H1’2019, coupled with a 4.1% growth in income from fees and commissions on loans to Kshs 0.70 bn from Kshs 0.67 bn in H1’2019.

As a result, the revenue mix adjusted to 67:33 from 68:32 recorded in H1'2019, funded to non-funded income, owing to the faster 4.2% growth in NFI, that outpaced the 2.5% growth in NII,

- Total operating expenses rose by 34.9% to Kshs 13.6 bn, from Kshs 10.0 bn in H1'2019, largely driven by a 228.1% increase in Loan Loss Provisions (LLP) to Kshs 5.4 bn in H1'2020, from Kshs 1.6 bn in H1'2019, coupled with a 4.9% increase in staff costs to Kshs 5.0 bn in H1'2020, from Kshs 4.8 bn in H1'2019. The increased provisions is attributed to the bank adopting a cautious stance on the back of the expectations of increase in defaults due to the subdued operating environment. The rise in operating expenses was however mitigated by a 13.0% decline in other operating expense to Kshs 3.2 bn from Kshs 3.6 bn in H1'2019,
- The Cost to Income Ratio (CIR) deteriorated to 80.6%, from 61.6% in H1'2019, owing to the faster 34.9% rise in total operating expenses to Kshs 13.6 bn, from Kshs 10.0 bn in H1'2019, which outpaced the 3.0% rise in total operating income to Kshs 16.8 bn, from Kshs 16.3 bn in H1'2019. Without LLP, the cost to income ratio improved to 48.6%, from 51.5% in H1'2019, an indication of improved efficiency, and,
- Profit before tax declined by 72.1% to Kshs 1.6 bn, from Kshs 8.7 bn in H1'2019. Profit after tax before exceptional items declined by 49.2% to Kshs 2.3 bn in Q1'2020, from Kshs 4.4 bn in Q1'2019 attributable to the costs incurred as part of the brand transition to ABSA. Profit after tax declined by 84.8% to Kshs 0.6 bn in H1'2020, from Kshs 3.9 bn in H1'2019, with the effective tax rate increasing to 30.8% from 29.3% in H1'2019.

Balance Sheet

- The balance sheet recorded an expansion as total assets rose by 10.8% to Kshs 391.9 bn, from Kshs 353.8 bn in H1'2019. This growth was largely driven by a 17.4% increase in government securities to Kshs 133.9 bn, from Kshs 114.0 bn in H1'2019, coupled with an 8.2% growth in the loan book to Kshs 201.9 bn, from Kshs 186.7 bn in H1'2019,
- Total liabilities rose by 12.0% to Kshs 348.9 bn, from Kshs 311.4 bn in H1'2019, driven by an 8.3% increase in customer deposits to Kshs 248.7 bn, from Kshs 229.7 bn in H1'2019, coupled with a 14.2% increase in deposits and balances due to foreign banking institutions to Kshs 520.7 mn, from Kshs 456.1 mn in H1'2019. The growth in liabilities was mitigated by a 21.3% decline in placement liabilities to Kshs 6.2 bn, from Kshs 7.8 bn in H1'2019. Deposits per branch increased by 15.4% to Kshs 3.0 bn, from Kshs 2.6 bn in H1'2019, with the number of branches having reduced to 84 in H1'2020, from 88 in H1'2019,
- The faster 8.3% growth in deposits, which outpaced the 8.2% growth in loans led to a decline in the loan to deposit ratio to 81.2% from 81.3%, recorded in H1'2019,
- Gross Non-Performing Loans (NPLs) increased by 8.4% to Kshs 17.0 bn in H1'2020, from Kshs 15.7 bn in H1'2019. The NPL ratio thus deteriorated marginally to 8.0% in H1'2020, from 7.9% in H1'2019, owing to the faster 8.4% growth in gross NPLs, which outpaced the 7.4% growth in gross loans (after adding back interest suspense). General Loan Loss Provisions rose marginally by 0.2% to Kshs 8.38 bn, from Kshs 8.36 bn in H1'2019. The NPL coverage however declined to 63.6% in H1'2020, from 72.5% in H1'2019, owing to the slower 0.2% increase in General Loan Loss Provisions, which was outpaced by the 8.4% growth in gross non-performing loans,
- Shareholders' funds increased by 1.4% to Kshs 43.0 bn in H1'2020 from Kshs 42.4 bn in H1'2019, driven by a 15.5% rise in revaluation reserves to Kshs 1.2 bn, from Kshs 1.0 bn in H1'2019, coupled with a 1.1% increase in retained earnings to Kshs 38.9 bn from Kshs 38.5 bn in H1'2019,
- ABSA Bank Kenya is currently sufficiently capitalized with a core capital to risk-weighted assets ratio of 13.8%, 3.3% points above the 10.5% statutory requirement. In addition, the total capital to risk-weighted assets ratio was 16.5%, exceeding the 14.5% statutory requirement by 2.0% points. Adjusting for IFRS 9, the core capital to risk weighted assets stood at 13.9%, while total capital to risk-weighted assets came in at 16.7%, and,

- The bank currently has a Return on Average Assets (ROaA) of 1.1%, and a Return on Average Equity (ROaE) of 15.9%.

Key Take-Outs:

1. The Cost to Income Ratio (CIR), with LLP, deteriorated to 80.6%, from 61.6% in H1'2019, attributable to the 228.1% increase in Loan Loss Provisions (LLP) to Kshs 5.4 bn in H1'2020, from Kshs 1.6 bn in H1'2019, as customers struggled to keep up with loan repayments due to the economic effects of the Covid-19 pandemic. Management however disclosed that the Phase 1 repayment holiday operations had been concluded, with the daily requests for loan holidays from customers reducing by 98.0% from 1,244 requests in the period between May – June , to 23 requests,
2. The bank's asset quality deteriorated, with the NPL ratio increasing to 8.0% in H1'2020, from 7.9% in H1'2019, owing to the faster 8.4% growth in gross NPLs, which outpaced the 7.4% growth in gross loans (after adding back interest suspense). The bank attributed the 8.4% increase in gross NPLs to the increased exposure of their loan book to the retail sector and the single names in Commercial International Bank (CIB) which stood at Kshs 7.5 bn and 9.5 bn respectively, and,
3. The bank recorded a relatively strong growth in its balance sheet, as deposits grew by 8.3% y/y, and were channeled to loans and advances, which grew, by 8.2% y/y, and government securities investments, which grew by 17.4%. The growth in interest earning assets helped support increased interest income revenue, despite the decline in yields of government securities.

Going forward, we expect the bank's growth to be driven by:

I. Increased Channel diversification, which is likely to help the bank to continue improving its operational efficiency. The benefits of this are already being felt with "Timiza" already recording accelerated growth, and consequently higher Non-Interest Revenue. This coupled with the expansion of its agent-banking network and product offerings such as bancassurance and fixed income trading will see the bank expand its top-line revenue, going forward.

Below is a summary of the bank's performance:

Balance Sheet	H1'2019	H1'2020	y/y change	H1'2020e	Expected y/y change	Variance in Actual Growth vs. Expected
Government Securities	114.0	133.9	17.4%	127.8	12.1%	5.3%
Net Loans and Advances	186.7	201.9	8.2%	199.5	6.9%	1.3%
Total Assets	**353.8**	**391.9**	**10.8%**	**387.7**	**9.6%**	**1.2%**
Customer Deposits	229.7	248.7	8.3%	243.5	6.0%	2.3%
Total Liabilities	311.4	348.9	12.0%	345.2	10.8%	1.2%
Shareholders' Funds	**42.4**	**43.0**	**1.4%**	**42.5**	**0.2%**	**1.3%**

Balance sheet ratios	H1'2019	H1'2020	% y/y change
Loan to Deposit Ratio	81.3%	81.2%	(0.1%)
Return on average equity	18.1%	15.9%	(2.2%)
Return on average assets	2.5%	1.8%	(0.7%)

Income Statement	H1'2019	H1'2020	y/y change	H1'2020e	Expected y/y change	Variance in Actual Growth vs Expected

Net Interest Income	11.0	11.3	2.5%	12.4	12.3%	(9.8%)
Net non-Interest Income	5.3	5.5	4.2%	6.0	14.2%	(10.0%)
Total Operating income	**16.3**	**16.8**	**3.0%**	**18.4**	**12.9%**	**(9.9%)**
Loan Loss provision	(1.6)	(5.4)	228.1%	(2.8)	71.6%	156.5%
Total Operating expenses	(10.0)	(13.6)	34.9%	(12.0)	19.3%	15.6%
Profit before tax	**5.7**	**1.6**	(72.1%)	**6.4**	12.7%	**(84.8%)**
Profit after tax	**3.9**	**0.6**	(84.8%)	**4.5**	16.2%	**(101.0%)**
Core EPS	**0.71**	**0.11**	**(84.8%)**	**0.83**	**16.2%**	**(101.0%)**

Income statement ratios	**H1’2019**	**H1’2020**	**% y/y change**
Yield from interest-earning assets	10.7%	9.7%	(1.1%)
Cost of funding	3.5%	3.1%	(0.4%)
Net Interest Margin	7.9%	7.3%	(0.6%)
Cost to Income	61.6%	80.6%	19.1%
Cost to Assets	2.4%	2.1%	(0.3%)
Net Interest Income as % of operating income	67.6%	67.2%	(0.4%)
Non-Funded Income as a % of operating income	32.4%	32.8%	0.4%

Capital Adequacy Ratios	**H1’2019**	**H1’2020**
Core Capital/Total Liabilities	16.8%	16.2%
Minimum Statutory ratio	8.0%	8.0%
Excess	**8.8%**	**8.2%**
Core Capital/Total Risk Weighted Assets	14.1%	13.8%
Minimum Statutory ratio	10.5%	10.5%
Excess	**3.6%**	**3.3%**
Total Capital/Total Risk Weighted Assets	16.0%	16.5%
Minimum Statutory ratio	14.5%	14.5%
Excess	**1.5%**	**2.0%**
Liquidity Ratio	38.7%	39.1%
Minimum Statutory ratio	20.0%	20.0%
Excess	**18.7%**	**19.1%**
Adjusted Core Capital/Total Liabilities	**17.0%**	**16.3%**
Adjusted Core Capital/Total RWA	**14.3%**	**13.9%**
Adjusted Total Capital/Total RWA	**16.1%**	**16.7%**