ABSA Bank Kenya Plc – Q3’2020

20th November 2020

Valuation Summary

- We are of the view that ABSA Bank Kenya is an “**Accumulate**” with a target price of Kshs 10.7, representing an upside of 12.0%, from the current price of Kshs 9.6 as of 20th November 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 13.6x vs an industry average of 0.9x and 6.4x, respectively.

Key Highlights Q3’2020

- ABSA disclosed that it would be offering unsecured loans to Micro, Small and Medium Enterprises (MSMEs) in a bid to support businesses recover from the effects emanating from the COVID-19 pandemic. The bank, through the recently launched ‘ABSA One Account’ will offer unsecured loans of up-to Kshs 10.0 mn to businesses and a maximum of Kshs 5.0 mn to individuals.

Income Statement

- Core earnings per share declined by 65.4% to Kshs 0.4, from Kshs 1.0 in Q3’2019, not in line with our expectation of a 32.8% decline to Kshs 0.7. The performance was driven by a 27.9% increase in total operating expenses, which grew faster than the 2.5% growth in total operating income. The variance in core earnings per share growth against our expectations was largely due to the 146.7% increase in Loan Loss Provisions to Kshs 7.6 bn, from Kshs 3.1 bn in Q3’2019, against our expectation of a 111.3% increase to Kshs 6.5 bn,
- Total operating income rose by 2.5% to Kshs 25.4 bn, from Kshs 24.8 bn in Q3’2019. This was supported by a 4.5% rise in Non-Funded Income (NFI) to Kshs 8.3 bn, from Kshs 8.0 bn in Q3’2019, coupled with a 1.6% rise in Net Interest Income (NII) to Kshs 17.1 bn, from Kshs 16.8 bn in Q3’2019,
- Interest income rose by 1.4% to Kshs 23.2 bn, from Kshs 22.9 bn in Q3’2019. This was driven by a 9.6% growth in interest income from government securities to Kshs 6.7 bn, from Kshs 6.1 bn in Q3’2019. The increased was however weighed down by a 0.8% decline in Interest income from Loans and Advances to Kshs 16.4 bn from Kshs 16.5 bn in Q3’2019, as well as a 46.7% decline in interest income from placements to Kshs 0.2 bn from Kshs 0.3 bn in Q3’2019. The yield on interest-earning assets declined to 9.5%, from 10.7% in Q3’2019, attributed to the faster 16.6% y/y increase in average interest earning assets to Kshs 331.4 bn, from Kshs 284.2 bn in Q3’2019, that outpaced the slower 3.5% growth in trailing interest income,
- Interest expenses increased by 0.8% to Kshs 6.11 bn, from Kshs 6.06 bn in Q3’2019, following a 25.6% rise in placement liabilities to Kshs 1.2 bn from Kshs 0.9 bn in Q3’2019. The rise was however mitigated by a 4.4% decline in interest expense on customer deposits to Kshs 4.8 bn, from Kshs 5.0 bn in Q3’2019. Cost of funds, on the other hand, declined marginally by 0.2% points to 3.2%, from 3.4% in Q3’2019, owing to the faster 7.6% growth in average interest bearing liabilities, despite a 0.8% decline in trailing interest expense. Net Interest Margin (NIM) on the other hand declined to 7.1%, from 7.9% in Q3’2019, owing to the faster 16.6% growth in average interest earning assets which outpaced the 1.6% growth in Net Interest Income (NII),
- Non-Funded Income (NFI) rose by 4.5% to Kshs 8.3 bn, from Kshs 8.0 bn in Q3’2019. The growth was mainly driven by an 18.8% rise in forex trading income to Kshs 3.2 bn, from Kshs 2.7 bn in Q3’2019. The growth was however weighed down a 10.7% decline in total fees and commission income to Kshs 4.1 bn from Kshs 4.6 bn in Q2’2019, attributable to the waiver on fees on mobile banking fees. As a result, the revenue mix adjusted to 67:33 from 68:32 recorded in Q3’2019, funded to non-funded income, owing to the faster 4.5% growth in NFI, that outpaced the 1.6% growth in NII,

- Total operating expenses rose by 27.9% to Kshs 20.1 bn, from Kshs 15.7 bn in Q3’2019, largely driven by a 146.7% increase in Loan Loss Provisions (LLP) to Kshs 7.6 bn in Q3’2020, from Kshs 3.1 bn in Q3’2019, coupled with a 1.9% increase in staff costs to Kshs 7.5 bn in Q3’2020, from Kshs 7.3 bn in Q3’2019. 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 5.2% decline in other operating expense to Kshs 5.0 bn from Kshs 5.3 bn in Q3’2019,
- The Cost to Income Ratio (CIR) deteriorated to 79.0%, from 63.3% in Q3’2019, owing to the faster 27.9% rise in total operating expenses to Kshs 20.1 bn, from Kshs 15.7 bn in Q3’2019, which outpaced the 2.5% rise in total operating income to Kshs 25.4 bn, from Kshs 24.8 bn in Q3’2019. Without LLP, the cost to income ratio however improved to 49.1%, from 50.9% in Q3’2019, an indication of improved efficiency, and,
- Profit before tax declined by 58.6% to Kshs 3.4 bn, from Kshs 8.2 bn in Q3’2019. Profit after tax before exceptional items declined by 40.2% to Kshs 3.9 bn in Q3’2020, from Kshs 6.5 bn in Q3’2019. Profit after tax and exceptional items declined by 65.4% to Kshs 1.9 bn in Q3’2020, from Kshs 5.6 bn in Q3’2019, attributable to the costs incurred as part of the brand transition to ABSA. The effective tax rate declined to 27.5% from 28.9% in Q3’2019.

Balance Sheet

- The balance sheet recorded an expansion as total assets rose by 7.8% to Kshs 387.9 bn, from Kshs 359.8 bn in Q3’2019. This growth was largely driven by a 13.1% increase in government securities to Kshs 134.0 bn, from Kshs 118.5 bn in Q3’2019, coupled with an 7.8% growth in the loan book to Kshs 209.2 bn, from Kshs 194.2 bn in Q3’2019,
- Total liabilities rose by 8.7% to Kshs 343.2 bn, from Kshs 315.8 bn in Q3’2019, driven by a 4.7% increase in customer deposits to Kshs 246.6 bn, from Kshs 235.4 bn in Q3’2019, coupled with an 11.3% increase in other liabilities Kshs 85.6 mn, from Kshs 77.0 mn in Q3’2019. The growth in liabilities was weighted down by a 225.8% growth in placement liabilities to Kshs 11.1 bn, from Kshs 3.4 bn in Q3’2019. Deposits per branch increased by 9.7% to Kshs 2.9 bn, from Kshs 2.7 bn in Q3’2019, with the number of branches having reduced to 84 in Q3’2020, from 88 in Q3’2019,
- The faster 7.8% growth in loans, which outpaced the 4.7% growth in deposits led to an increase in the loan to deposit ratio to 84.9% from 82.5%, recorded in Q3’2019,
- Gross Non-Performing Loans (NPLs) increased by 20.8% to Kshs 16.8 bn in Q3’2020, from Kshs 13.9 bn in Q3’2019. The NPL ratio thus deteriorated to 7.6% in Q3’2020, from 6.8% in Q3’2019, owing to the faster 20.8% growth in gross NPLs, which outpaced the 7.3% growth in gross loans (after adding back interest suspense). General Loan Loss Provisions rose by 5.2% to Kshs 8.4 bn, from Kshs 8.0 bn in Q3’2019. The NPL coverage however declined to 64.9% in Q3’2020, from 78.6% in Q3’2019, owing to the slower 5.2% increase in General Loan Loss Provisions, which was outpaced by the 7.3% growth in gross non-performing loans,
- NPL Coverage ratio dropped to 64.9% in Q3’2020, from 78.6% recorded in Q3’2019 which could suggest an under-provisioning. Had NPL Coverage remained at the 78.6%% level recorded in Q3’2019, we would have had an additional provisioning of Kshs 2.3 bn, which would have reduced Earnings per Share (EPS) from the reported Kshs 0.4 to Kshs (0.1),
- Shareholders’ funds increased by 1.4% to Kshs 44.6 bn in Q3’2020 from Kshs 44.0 bn in Q3’2019, driven by a 63.5% rise in revaluation reserves to Kshs 1.5 bn, from Kshs 0.9 bn in Q3’2019, coupled with a 0.2% increase in retained earnings to Kshs 40.23 bn from Kshs 40.15 bn in Q3’2019. The growth was weighed down by a 23.0% decline in other reserves to Kshs 0.15 bn from Kshs 0.20 bn in Q3’2019,
- ABSA Bank Kenya is currently sufficiently capitalized with a core capital to risk-weighted assets ratio of 13.7%, 3.2% 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 13.8%, while total capital to risk-weighted assets came in at 16.6%, and,

- The bank currently has a Return on Average Assets (ROaA) of 1.0%, and a Return on Average Equity (ROaE) of 15.2%.

Key Take-Outs:

1. The Cost to Income Ratio (CIR) deteriorated to 79.0%, from 63.3% in Q3'2019, attributable to the 146.7% increase in Loan Loss Provisions (LLP) to Kshs 7.6 bn in Q3'2020, from Kshs 3.1 bn in Q3'2019, as customers struggled to keep up with loan repayments due to the economic effects of the Covid-19 pandemic,
2. The bank's asset quality deteriorated, with the NPL ratio increasing to 7.6% in Q3'2020, from 6.8% in Q3'2019, owing to the faster 20.8% growth in gross NPLs, which outpaced the 7.3% growth in gross loans (after adding back interest suspense). Notably, on a y/y basis, the bank's asset quality deteriorated however on a quarter on quarter basis, the bank recorded an improvement on its asset quality with the NPL ratio improving to 7.6% from 8.0% recorded in H1'2020, and,
3. The bank recorded a relatively strong growth in its balance sheet, as deposits grew by 4.7% y/y, and were channeled to loans and advances, which grew, by 7.8% y/y, and government securities investments, which grew by 13.1%. 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:

ABSA Bank Q3'2020 Key Highlights						
Balance Sheet						
Balance Sheet	**Q3'2019**	**Q3'2020**	**y/y change**	**Q3'2020e**	**Expected y/y change**	**Variance in Actual Growth vs. Expected**
Government Securities	118.5	134.0	13.1%	135.7	14.5%	(1.4%)
Net Loans and Advances	194.2	209.2	7.8%	204.9	5.5%	2.3%
Total Assets	**359.8**	**387.9**	**7.8%**	**395.4**	**9.9%**	**(2.1%)**
Customer Deposits	235.4	246.6	4.7%	251.2	6.7%	(2.0%)
Total Liabilities	315.8	343.2	8.7%	351.5	11.3%	(2.6%)
Shareholder's Funds	**44.0**	**44.6**	**1.4%**	**44.5**	**1.0%**	**0.4%**

Balance sheet ratios	Q3'2019	Q3'2020	% y/y change
Loan to Deposit Ratio	82.5%	84.9%	2.4%
Return on average equity	17.4%	15.2%	(2.2%)
Return on average assets	2.4%	1.0%	(1.4%)

Income Statement

Income Statement Items	Q3’2019	Q3’2020	y/y change	Q3’2020e	Expected y/y change	Variance in Actual Growth vs Expected
Net Interest Income	16.8	17.1	1.6%	18.3	8.4%	(6.8%)
Net non-Interest Income	8.0	8.3	4.5%	8.8	11.1%	(6.6%)
Total Operating income	**24.8**	**25.4**	**2.5%**	**27.1**	**9.3%**	**(6.7%)**
Loan Loss provision	(3.1)	(7.6)	146.7%	(6.5)	111.3%	35.4%
Total Operating expenses	(15.7)	(20.1)	27.9%	(20.0)	27.6%	0.3%
Profit before tax	**8.2**	**3.4**	(58.6%)	**7.1**	(13.7%)	**(44.9%)**
Profit after tax	**5.6**	**1.9**	(65.4%)	**3.7**	(32.8%)	**(32.6%)**
Core EPS	**1.0**	**0.4**	**(65.4%)**	**0.7**	**(32.8%)**	**(32.6%)**

Income statement ratios	Q3’2019	Q3’2020	% y/y change
Yield from interest-earning assets	10.7%	9.5%	(1.2%)
Cost of funding	3.4%	3.2%	(0.2%)
Net Interest Margin	7.9%	7.1%	(0.8%)
Cost to Income	63.3%	79.0%	15.7%
Cost to Assets	3.5%	3.2%	(0.3%)
Net Interest Income as % of operating income	67.9%	67.3%	(0.6%)
Non-Funded Income as a % of operating income	32.1%	32.7%	0.6%

Capital Adequacy Ratios	Q3’2019	Q3’2020
Core Capital/Total Liabilities	16.7%	16.6%
Minimum Statutory ratio	8.0%	8.0%
Excess	**8.7%**	**8.6%**
Core Capital/Total Risk Weighted Assets	14.2%	13.7%
Minimum Statutory ratio	10.5%	10.5%
Excess	**3.7%**	**3.2%**
Total Capital/Total Risk Weighted Assets	16.1%	16.5%
Minimum Statutory ratio	14.5%	14.5%
Excess	**1.6%**	**2.0%**
Liquidity Ratio	39.6%	36.4%
Minimum Statutory ratio	20.0%	20.0%
Excess	**19.6%**	**16.4%**
Adjusted Core Capital/Total Liabilities	**17.2%**	**16.7%**
Adjusted Core Capital/Total RWA	**14.7%**	**13.8%**
Adjusted Total Capital/Total RWA	**16.7%**	**16.6%**