Barclays Bank of Kenya Ltd– Q3’2018

23rd November, 2018

Valuation Summary

- We are of the view that Barclays Bank of Kenya Ltd is an “***buy***” with a target price of Kshs 12.5, representing an upside of 26.8%, from the current price of Kshs 10.7 as of 23rd November 2018, inclusive of a dividend yield of 9.4%,
- Barclays Bank of Kenya Ltd is currently trading at P/TBV of 1.5x and a P/E of 8.2x vs an industry average of 1.4x and 6.7x, respectively.

Key Highlights Q3’2018

- The bank launched increased its Enterprise Supply Development (ESD) funding, a fund which targets small and medium sized enterprises (SMEs) to Kshs 500 mn from Kshs 150 mn successfully piloting the programme for 1 year, having disbursed Kshs 131.0 mn.

Income Statement

- Core earnings per share increased by 2.0% to Kshs 1.0 from Kshs 0.98 in Q3’2017, exceeding our expectation of a 1.5% decline to Kshs 0.97. The Performance was driven by a 5.5% increase in total operating income, despite being weighed down by the 8.3% increase in the total operating expenses. The variance in core earnings per share growth against our expectations was largely due to the 14.0% growth in Non-Funded Income (NFI) to Kshs 7.4 bn from Kshs 6.5 bn in Q3’2017. We expected a 0.6% decline in NFI to Kshs 6.4 bn from Kshs 6.5 bn in Q3’2017,
- Total operating income increased by 5.5% to Kshs 23.9 bn in Q3’2018, from Kshs 22.6 bn over the same period to Q3’2017. This was due to a 2.1% increase in Net Interest Income (NII) to Kshs 16.5 bn, from Kshs 16.2 bn in Q3’2017, coupled with the 14.0% increase in Non-Funded Income (NFI) to Kshs 7.4 bn, from Kshs 6.5 bn in Q3’2017,
- Interest income increased by 7.7% to Kshs 21.7 bn, from Kshs 20.1 bn in Q3’2017. This was largely driven by the 34.8% growth in interest income from government securities to Kshs 5.6 bn from Kshs 4.1 bn in Q3’2017, and a 0.7% increase in interest income on loans and advances to Kshs 16.0 bn, from Kshs 15.9 bn in Q3’2017. Interest income on deposits and placements with banking institutions rose by 26.8% to Kshs 0.1 bn from Kshs 0.08 bn in Q3’2017. However, the yield on interest earning assets declined to 11.8% in Q3’2018, from 12.1% in Q3’2017, due to a faster increase of 29.5% in government securities that have relatively lower yields than loans,
- Interest expense increased by 30.1% to Kshs 5.2 bn, from Kshs 4.0 bn in Q3’2017, following a 26.9% increase in the interest expense on customer deposits to Kshs 4.5 bn, from Kshs 3.6 bn in Q3’2017. Interest expense on deposits and placements from banking institutions increased by 57.1% to Kshs 0.7 bn from Kshs 0.4 bn in Q3’2017. The cost of funds thus increased to 3.1%, from 2.8% in Q3’2017. As a consequence, the Net Interest Margin (NIM) declined to 6.8%, from 7.2% in Q3’2017,
- Non-Funded Income (NFI) increased by 14.0% to Kshs 7.4 bn, from Kshs 6.5 bn in Q3’2017. The growth in NFI was largely driven by the 16.6% growth in foreign exchange trading income to Kshs 2.5 bn from Kshs 2.2 bn in Q3’2017, coupled with a 52.2% growth in Fees and commissions on loans to Kshs 0.8 bn from Kshs 0.5 bn in Q3’2017. Furthermore, other income grew by 114.9% to Kshs 0.6 bn, from Kshs 0.3 bn in Q3’2017. However, the other fees and commission income declined by 1.7% to Kshs 3.4 bn from Kshs 3.5 bn in Q3’2017. As a result of the above performance, the current revenue mix shifted to 69:31 funded to non-funded income as compared to 71:29 in Q3’2017. The proportion of NFI to total revenue increased owing to the faster growth in NFI than in NII,
- Total operating expenses increased by 8.3% to Kshs 16.1 bn, from Kshs 14.9 bn, largely driven by a 31.0% increase in other operating expenses to Kshs 5.9 bn in Q3’2018, from Kshs 4.5 bn in Q3’2017, coupled with a 21.3% increase in Loan Loss Provisions (LLP) to Kshs 2.8 bn in Q3’2018, from Kshs 2.3 bn in Q3’2017. Staff costs however declined by 7.9% to Kshs 7.5 bn from Kshs 8.1 bn in Q3’2017,

- As a result, Cost to Income Ratio (CIR) deteriorated to 67.6%, from 65.9% in Q3’2017. Without LLP, the cost to income ratio also deteriorated, albeit marginally, to 55.8%, from 55.6% in Q3’2017,
- Profit before tax increased by 0.1% to Kshs 7.72 bn, up from Kshs 7.71 bn in Q3’2017. Profit after tax however increased by 2.0% to Kshs 5.4 bn in Q3’2018, from Kshs 5.3 bn in Q3’2017, due to the Kshs 0.5 bn deferred tax in Q3’2018.

Balance Sheet

- The balance sheet recorded an expansion as total assets increased by 15.9% to Kshs 322.2 bn, from Kshs 278 bn in Q3’2017. This growth was largely driven by a 29.5% increase in government securities to Kshs 74.6 bn, from Kshs 57.6 bn in Q3’2017, coupled with a 6.7% increase in the loan book to Kshs 178.4 bn, from Kshs 167.3 bn in Q3’2017,
- Total liabilities rose by 18.7% to Kshs 279.5 bn, from Kshs 235.4 bn in Q3’2017, driven by a 9.9% increase in total deposits to Kshs 220.3 bn, from Kshs 200.4 bn in Q3’2017. Deposits per branch increased by 34.6% to Kshs 2.5 bn, from Kshs 1.8 bn in Q3’2017, with 2 branches closed in H1’2018 bringing the total number of branches to 89. Placement liabilities increased by 37.3% to Kshs 2.4 bn from Kshs 1.7 bn in Q3’2017. The bank did not have any borrowed funds,
- The faster growth in deposits as compared to loans led to a decline in the loan to deposit ratio to 81.0% from 83.5% in Q3’2017. However, the proportion of government securities to deposits increased to 33.9% from 28.8% in Q3’2017,
- Gross Non-Performing Loans (NPLs) increased by 22.3% to Kshs 14.6 bn in Q3’2018 from Kshs 11.9 bn in Q3’2017. Consequently, the NPL ratio deteriorated to 7.7% in Q3’2018 from 6.8% in Q3’2017. General Loan Loss Provisions (LLPs) increased by 34.5% to Kshs 7.2 bn from Kshs 5.4 bn in Q3’2017. With the growth in NPLs outpaced by the increase in provisioning, the NPL coverage improved to 70.5% in Q3’2018, from 70.3% in Q3’2017,
- Shareholders’ funds increased marginally by 0.3% to Kshs 42.7 bn in Q3’2018 from Kshs 42.5 bn in Q3’2017, as the 231.7% increase in the revaluation reserve to Kshs 0.6 bn from Kshs 0.2 bn, was outweighed by the 0.7% decline in retained earnings to Kshs 39.2 bn from Kshs 39.4 bn, and the 8.9% decline in the other reserves to Kshs 0.19 bn from Kshs 0.21 bn in Q3’2017,
- Barclays Bank of Kenya Ltd is currently sufficiently capitalized with a core capital to risk weighted assets ratio of 14.8%, 4.3% points above the statutory requirement. In addition, the total capital to risk weighted assets ratio was 16.7%, exceeding the statutory requirement by 2.2% points. Adjusting for IFRS 9, the core capital to risk weighted assets stood at 15.1%, while total capital to risk weighted assets came in at 17.1%, indicating that the bank’s total capital relative to its risk-weighted assets declined by 0.4% pointsdue to implementation of IFRS 9,
- The bank currently has a Return on Average Assets (ROaA) of 2.5%, and a Return on Average Equity (ROaE) of 16.5%.

Key Take-Outs:

a) The bank had a steep increase in its interest expense, coming in at a 30.1%, an indication that the bank mobilized deposits at higher costs, as deposits grew only by 9.9%, while interest expense on deposits grew by 26.9%. Furthermore, the bank increased its placement liabilities, which grew 37.2%, while the interest expenses on placements increased by 57.1%, an indication of expensive mobilization of funding, which compressed the bank’s top line revenue,
b) The bank’s other operating expenses increased by 31.0% y/y, with the bank indicating that the ongoing rebranding efforts to Absa Group, coupled with the upgrade and installation of IT infrastructure have increased the bank’s other operating expenses. However, staff costs

declined by 7.9% y/y indicating the bank benefited from its strategy of lowering its staff number, from its retirement programs, with 323 staff leaving in H2'2017, and,

c) The bank's asset quality deteriorated, with the NPL Ratio deteriorating to 7.7%, from 6.8% in Q3'2017. The deterioration in asset quality is likely being experienced with the trade sector clients facing delayed payments from governments, affecting their debt servicing. This, coupled with the relatively tighter macroeconomic environment, led to a deterioration in asset quality. However, with the bank employing prudence in provisioning, the coverage improved to 70.5% in Q3'2018.

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

a. **Non-Funded Income Growth Initiatives** - Barclays' NFI is improving as the bank focuses on digital innovation and alternative banking channels in the wake of the rebranding move. These will go a long way to grow the bank's fee income, and,
b. **Cost Control** – Barclays' cost to income ratio currently stands at 67.6%. The bank needs to manage any rising costs, such as those that may arise from poor asset qualities, leading to increasing provisioning, and other operational expenses, which arise from the bank's rebranding activities, strain its revenue expansion.

Below is a summary of the bank's performance:

Balance Sheet	Q3'2017	Q3'2018	y/y change	Q3'2018e	Expected y/y change	Variance in Actual Growth vs. Expected
Government Securities	57.6	74.6	29.5%	70.8	22.8%	6.6%
Net Loans and Advances	167.2	178.4	6.7%	179.1	7.1%	(0.4%)
Total Assets	**278.0**	**322.2**	**15.9%**	**323.3**	**16.3%**	**(0.4%)**
Customer Deposits	200.4	220.2	9.9%	221.1	10.4%	(0.4%)
Total Liabilities	235.4	279.5	18.7%	281.0	19.3%	(0.6%)
Shareholders Funds	**42.5**	**42.7**	**0.3%**	**42.3**	**(0.6%)**	**0.9%**

Balance sheet ratios	Q3'2017	Q3'2018	% y/y change
Loan to Deposit Ratio	83.5%	81.0%	(2.5%)
Return on average equity	15.9%	16.5%	0.6%
Return on average assets	2.6%	2.5%	(0.1%)

Income Statement	Q3'2017	Q3'2018	y/y change	Q3'2018e	Expected y/y change	Variance in Actual Growth vs Expected
Net Interest Income	16.1	16.5	2.1%	16.8	3.9%	(1.7%)
Net non-Interest Income	6.5	7.4	14.0%	6.4	(0.6%)	14.6%
Total Operating income	**22.6**	**23.9**	**5.5%**	**23.2**	**2.6%**	**2.9%**
Loan Loss provision	(2.3)	(2.8)	21.3%	(2.5)	8.0%	13.3%
Total Operating expenses	(14.9)	(16.1)	8.3%	(15.7)	5.4%	3.0%
Profit before tax	7.7	7.7	0.1%	7.5	(2.8%)	2.9%
Profit after tax	5.3	5.4	2.0%	5.2	(1.5%)	3.5%
Core EPS	**0.98**	**1.00**	**2.0%**	**1.0**	**(1.5%)**	**3.5%**

Income statement ratios	H1'2017	H1'2018	% y/y change
Yield from interest-earning assets	12.1%	11.7%	(0.5%)
Cost of funding	2.8%	2.9%	0.0%

Net Interest Margin	7.2%	4.5%	(2.7%)
Cost to Income	65.9%	66.3%	0.4%
Cost to Assets	4.5%	2.7%	(1.8%)
Net Interest Income as % of operating income	71.4%	69.2%	(2.3%)
Non-Funded Income as a % of operating income	28.6%	30.8%	2.3%

Capital Adequacy Ratios	Q3'2017	Q3'2018
Core Capital/Total Liabilities	19.4%	17.5%
Minimum Statutory ratio	8.0%	8.0%
Excess	**11.4%**	**9.5%**
Core Capital/Total Risk Weighted Assets	15.9%	14.8%
Minimum Statutory ratio	10.5%	10.5%
Excess	**5.4%**	**4.3%**
Total Capital/Total Risk Weighted Assets	18.0%	16.7%
Minimum Statutory ratio	14.5%	14.5%
Excess	**3.5%**	**2.2%**
Liquidity Ratio	38.0%	39.9%
Minimum Statutory ratio	20.0%	20.0%
Excess	**18.0%**	**19.9%**
Adjusted Core Capital/Total Liabilities*		**17.9%**
Adjusted Core Capital/Total RWA*		**15.1%**
Adjusted Total Capital/Total RWA*		**17.1%**

Adjusted ratios in line with CBK’s guidance note, with provisions added back for capital computation purposes