Barclays Bank Kenya Earnings Note– H1’2019

30th August, 2019

Valuation Summary

- We are of the view that Barclays Bank Kenya is a “***buy***” with a target price of Kshs 12.8, representing an upside of 26.4%, from the current price of Kshs 11.0 as of 30th August 2019, inclusive of a dividend yield of 10.0%,
- Barclays Bank Kenya is currently trading at a P/TBV of 1.4x and a P/E of 8.0x vs an industry average of 1.3x and 6.3x, respectively.

Key Highlights H1’2019

- Barclays Bank Kenya (BBK) continued its rebranding exercise to Absa Group, as the bank continued to replace its existing Information Technology (IT) equipment, in line with the strategy to transition fully to Absa by June 2020.

Income Statement

- Barclays Bank Kenya released their financial results with core earnings per share increasing by 18.0% to Kshs 0.8 from Kshs 0.69 in H1’2018, faster than our expectation of a 6.9% increase to Kshs 0.71. The performance was driven by the 4.2% growth in total operating income to Kshs 16.3 bn, from Kshs 15.7 bn in H1’2018, coupled with the 3.2% decline in total operating expenses to Kshs 10.1 bn, from Kshs 10.4 bn in H1’2018. However, the growth in core EPS was after stripping the exceptional items expense of Kshs 0.6 bn. The variance in core EPS growth against our expectation was due to the 3.2% decline in total operating expenses to Kshs 10.0 bn, from Kshs 10.4 bn, contrary to our expectation of a 6.6% increase in total operating expenses to Kshs 11.1 bn,
- Total operating income rose by 4.2% to Kshs 16.3 bn, from Kshs 15.7 bn in H1’2018, driven by the 12.6% growth in Non-Funded Income (NFI) to Kshs 5.3 bn, from Kshs 4.7 bn in H1’2018, coupled with the marginal 0.6% increase in Net Interest Income (NII) to Kshs 11.0 bn, from Kshs 10.97 bn in H1’2018,
- Interest income rose by 7.4% to Kshs 15.2 bn, from Kshs 14.1 bn in H1’2018, driven by the 15.4% increase in interest income from government securities to Kshs 4.1 bn, from Kshs 3.5 bn in H1’2018, the 3.9% increase in interest income from loans to Kshs 11.0 bn, from Kshs 10.5 bn in H1’2018, and the 131.0% increase in interest income from placement assets to Kshs 0.2 bn, from Kshs 0.1 bn in H1’2018. The yield on interest-earning assets however declined to 11.4%, from 11.7% in H1’2018, due to the 100 bps decline in the Central Bank Rate (CBR) which consequently reduced the yields on loans, and the decline in yields on government securities,
- Interest expenses rose by 30.8% to Kshs 4.2 bn, from Kshs 3.2 bn in H1’2018, following a 24.8% increase in the interest expense on customer deposits to Kshs 3.4bn, from Kshs 2.8 bn in H1’2018, coupled with the 53.9% rise in interest expense on placement liabilities to Kshs 0.6 bn, from Kshs 0.4 bn in H1’2018. The cost of funds thus rose to 3.5% from 2.9% in H1’2018. The Net Interest Margin (NIM) declined to 8.4%, from 9.2% in H1’2018,
- Non-Funded Income (NFI) increased by 12.6% to Kshs 5.3 bn, from Kshs 4.7 bn in H1’2018. The increase was mainly driven by a 41.0% rise in total fees and commission income to Kshs 0.7 bn, from Kshs 0.5 bn in H1’2018 coupled with the 74.4% growth in other income to Kshs 0.5 bn, from Kshs 0.3 bn in H1’2018, and the 4.0% rise in forex trading income to Kshs 1.7 bn, from Kshs 1.6 bn in H1’2018. As a result of the performance, the revenue mix shifted to 68:32 Funded to Non-Funded Income from 70:30, due to the faster growth in NFI compared to NII,
- Total operating expenses declined by 3.2% to Kshs 10.1 bn, from Kshs 10.4 bn, largely driven by the 6.3% decline in staff costs to Kshs 4.8 bn in H1’2019, from Kshs 5.1 bn in H1’2018, coupled with the 4.4% decline in Loan Loss Provisions (LLP) to Kshs 1.6 bn, from Kshs 1.7 bn in H1’2018, which outweighed the 1.8% rise in other operating expenses to Kshs 3.62 bn, from Kshs 3.56 bn in H1’2018,

- Due to the decline in total operating expenses coupled with the increase in total operating income, the Cost to Income Ratio (CIR) improved to 61.6%, from 66.3% in H1’2018. Without LLP, the cost to income ratio improved to 51.5%, from 55.3% in H1’2018,
- Profit before tax increased by 8.1% to Kshs 5.7 bn, up from Kshs 5.3 bn in H1’2018. Profit after tax grew by 3.1% to Kshs 3.9 bn in H1’2019, from Kshs 3.8 bn in H1’2018 as the effective tax rate increased to 32.1% from 28.8% in H1’2018, and,
- The bank declared an interim dividend of Kshs 0.2 per share. Assuming a final payout of Kshs 0.9 similar to 2018, this translates to a dividend yield of 10.0%.

Balance Sheet

- The balance sheet recorded an expansion as total assets increased by 11.8% to Kshs 353.8 bn, from Kshs 316.6 bn in H1’2018. This growth was largely driven by a 15.4% increase in investments in securities to Kshs 81.2 bn, from Kshs 70.3 bn in H1’2018, coupled with a 27.6% increase in other assets to Kshs 53.6 bn, from Kshs 42.0 bn in H1’2018,
- The loan book rose by 6.0% to Kshs 186.7 bn, from Kshs 176.1 bn in H1’2018, attributed to an increase in the corporate loan book segment, increased SME lending, and increased lending via the bank’s Timiza mobile lending platform,
- Total liabilities rose by 12.9% to Kshs 311.5 bn, from Kshs 275.8 bn in H1’2018, driven by a 5.9% increase in deposits to Kshs 229.7 bn, from Kshs 216.8 bn in H1’2018, coupled with a 44.0% increase in placement liabilities to Kshs 7.8 bn, from Kshs 5.4 bn in H1’2018. Deposits per branch increased by 7.1% to Kshs 2.6 bn, from Kshs 2.4 bn in H1’2018, with the number of branches having reduced to 88 from 89 in H1’2018,
- The marginal faster growth in loans compared to deposits led to a marginal rise in the loan to deposit ratio to 81.3%, from 81.2% in H1’2018,
- Gross Non-Performing Loans (NPLs) rose by 9.3% to Kshs 15.7 bn in H1’2019, from Kshs 14.4 bn in H1’2018. The NPL ratio thus deteriorated to 7.9%, from 7.7% in H1’2018. General Loan Loss Provisions rose by 31.3% to Kshs 8.4 bn, from Kshs 6.4 bn in H1’2018. Consequently, the NPL coverage rose to 72.5%, from 68.2% in H1’2018,
- Shareholders’ funds increased by 3.9% to Kshs 42.4 bn in H1’2019, from Kshs 40.8 bn in H1’2018, as retained earnings grew by 2.6% to Kshs 38.5 bn, from Kshs 37.5 bn in H1’2018, and revaluation reserves rose by 148.1% to Kshs 1.0 bn, from Kshs 0.4 bn in H1’2018,
- Barclays Bank Kenya is currently sufficiently capitalized with a core capital to risk-weighted assets ratio of 14.1%, 3.6% points above the statutory requirement. In addition, the total capital to risk-weighted assets ratio was 16.0%, exceeding the statutory requirement by 1.5% points. Adjusting for IFRS 9, the core capital to risk weighted assets stood at 14.3%, while total capital to risk-weighted assets came in at 16.1%, and,
- The bank currently has a Return on Average Assets (ROaA) of 2.5%, and a Return on Average Equity (ROaE) of 18.1%.

Key Take-Outs:

1. The bank’s improved performance was weighed down by the separation costs as the bank transitions its systems to that of ABSA. The bank’s management highlighted that the spending should continue to affect the bank’s earnings, with expenditure expected to be focused on advertising, rebranding ATMs, cards and branches to Absa brand, the purchase of new IT hardware, and software upgrades,

2. Asset quality continued to experience a deterioration, as highlighted by the rise in the NPL ratio to 7.9% from 7.7% in H1’2018. Main sectors that continue to experience challenges include trade, manufacturing and retail,

3. Barclays Bank benefited from the restructuring exercise it conducted in 2017, as it continues to record a decline in staff costs y/y, which reduced by 6.3% y/y, and,

- NFI supported the improvement in the top line revenue, as it expanded by 12.6% y/y, largely supported by the fee and commissions on loans, as well as the other income segments, which recorded growths of 41.0% and 74.4%, respectively. Recovery in the fees and commissions on loans is presumably due to the low base of 2018, on the initial implementation of the Effective Interest Model (EIR) under IFRS 9, which required banks to amortize fees and commissions on loans over the tenor of the loan. As a result of the performance, the revenue mix shifted to 68:32 Funded to Non-Funded Income from 70:30, due to the faster growth in NFI compared to NII, with NFI contribution remaining below the market contribution of 37.3%

4.

We expect the bank's growth to be driven by:

1. 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 an accelerated growth, and consequently higher Non-Interest Revenue. This, coupled with the expansion of its agent banking network and product offerings such as banc assurance and fixed income trading will see the bank expand its topline revenue, going forward.

Below is a summary of the bank's performance:

Balance Sheet	H1'2018	H1'2019	y/y change	H1'2019e	Expected y/y change	Variance in Actual Growth vs. Expected
Government Securities	70.3	81.2	15.4%	78.8	12.1%	3.4%
Net Loans and Advances	176.1	186.7	6.0%	185.1	5.1%	0.9%
Total Assets	**316.6**	**353.8**	**11.8%**	**350.3**	**10.6%**	**1.1%**
Customer Deposits	216.8	229.7	5.9%	228.5	5.4%	0.6%
Total Liabilities	275.8	311.4	12.9%	302.3	9.6%	3.3%
Shareholders Funds	**40.8**	**42.4**	**3.9%**	**48.0**	**17.6%**	**(13.7%)**

Balance sheet ratios	H1'2018	H1'2019	% y/y change
Loan to Deposit Ratio	81.2%	81.3%	0.0%
Return on average equity	17.5%	18.1%	0.6%
Return on average assets	2.6%	2.5%	(0.1%)

Income Statement	H1'2018	H1'2019	y/y change	H1'2019e	Expected y/y change	Variance in Actual Growth vs Expected
Net Interest Income	11.0	11.0	0.6%	11.5	5.3%	(4.7%)
Net non-Interest Income	4.7	5.3	12.6%	5.1	9.6%	2.9%
Total Operating income	**15.7**	**16.3**	**4.2%**	**16.7**	**6.6%**	**(2.4%)**
Loan Loss provision	(1.7)	(1.6)	(4.4%)	(1.9)	10.4%	(14.8%)
Total Operating expenses	(10.4)	(10.0)	(3.2%)	(11.1)	6.6%	(9.8%)
Profit before tax	**5.3**	**5.7**	8.1%	**5.6**	6.7%	**1.4%**
Profit after tax	**3.8**	**3.9**	3.1%	**4.0**	6.9%	**(3.8%)**
Core EPS	**0.69**	**0.82**	**18.0%**	**0.74**	**6.9%**	**11.1%**

Income statement ratios	H1'2018	H1'2019	% y/y change
Yield from interest-earning assets	11.7%	11.4%	(0.3%)
Cost of funding	2.9%	3.5%	0.6%
Net Interest Margin	9.2%	8.4%	(0.9%)
Cost to Income	66.3%	61.6%	(4.7%)

Cost to Assets	2.7%	2.4%	(0.4%)
Net Interest Income as % of operating income	70.0%	67.6%	(2.4%)
Non-Funded Income as a % of operating income	30.0%	32.4%	2.4%

Capital Adequacy Ratios	H1'2018	H1'2019
Core Capital/Total Liabilities	17.6%	16.8%
Minimum Statutory ratio	8.0%	8.0%
Excess	**9.6%**	**8.8%**
Core Capital/Total Risk Weighted Assets	14.7%	14.1%
Minimum Statutory ratio	10.5%	10.5%
Excess	**4.2%**	**3.6%**
Total Capital/Total Risk Weighted Assets	16.7%	16.0%
Minimum Statutory ratio	14.5%	14.5%
Excess	**2.2%**	**1.5%**
Liquidity Ratio	38.3%	38.7%
Minimum Statutory ratio	20.0%	20.0%
Excess	**18.3%**	**18.7%**
Adjusted Core Capital/Total Liabilities		**17.0%**
Adjusted Core Capital/Total RWA		**14.3%**
Adjusted Total Capital/Total RWA		**18.7%**