Cytonn SSA Financial Services Research Weekly Note - 12th December 2018

Executive Summary: During the week, the equities market recorded mixed performances with GGSECI gaining by 1.2% while NASI, and NGSEASI declining by 1.3%, and 2.7%, respectively. This takes their YTD performance to (20.0%), (15.2%), and (11.1%) for the NGSEASI, NASI and GGSECI, respectively.

Section I: Market Performance:

During the week, the equities market recorded mixed performances with GGSECI gaining by 1.2% while NASI, and NGSEASI declining by 1.3%, and 2.7%, respectively. This takes their YTD performance to (20.0%), (15.2%), and (11.1%) for the NGSEASI, NASI and GGSECI, respectively.

Below is a summary of top gainers and losers in our universe of coverage for last week:

Weekly Top Gainers and Losers					
Top Gainers			Top Losers		
Company	Country	Change	Company	Country	Change
NIC	Kenya	31.9%	Bank of Baroda	Uganda	(7.6%)
FBN Holdings	Nigeria	7.0%	Access Bank	Nigeria	(3.9%)
Union Bank plc	Nigeria	3.9%	Stanbic IBTC	Nigeria	(3.1%)
CAL Bank	Ghana	2.1%	Transnational	Nigeria	(2.8%)
Guaranty Trust Bank	Nigeria	1.6%	SBM Holdings	Mauritius	(2.0%)

Kenya

NASI declined by 1.3% during the week, driven by declines in large cap stocks such as British American Tobacco (BAT), Safaricom, Bamburi and Co-operative Bank, which declined by 14.8%, 3.2%, 2.2% and 2.0%, respectively. Equities turnover declined by 54.1% during the week to USD 14.2 mn from USD 31.0 mn the previous week, taking the YTD turnover to USD 1.7 bn. Foreign investors remained net sellers for the week, with a net selling position of USD 2.8 mn, a 21.9% increase from last week's net selling position of USD 2.3 mn. We expect the market to remain subdued in the near-term as international investors exit the broader emerging markets due to the expectation of rising US interest rates coupled with the strengthening of the US Dollar

Nigeria

The Nigerian All Share index declined by 2.7% during the week, largely driven by declines in the industrials, materials, and real estate segments with declines of 2.0%, 1.6% and 0.6%, respectively. For our financial services universe of coverage, FBN Holdings, Union Bank, and Guaranty Trust Bank gained by 7.0%, 3.9% and 1.6%, respectively, while the biggest decliners were Access Bank, Stanbic IBTC and Ecobank Transnational which declined by 3.9%, 3.1% and 2.8%, respectively.

Ghana

The GSE Composite Index gained by 1.2% during the week, driven mainly by gains in the financial services segment. In our universe of coverage for Ghana, CAL Bank and Standard Chartered gained by 2.1% and 0.2% respectively, while Ghana Commercial Bank (GCB) and Ecobank Ghana remained flat.

Section II: Earnings Releases

There were no earnings released during the Week

Section III: Latest Developments in the Sub Saharan Africa Banking Sector during the week:

Kenya

NIC Group and Commercial Bank of Africa (CBA) issued a joint statement indicating that the two banks will hold talks on a potential merger subject to due diligence processes and approval from shareholders, the regulators such as the Capital Markets Authority (CMA) and Central Bank of Kenya (CBK), and other stakeholders. CBA is a Tier 1 bank with an asset base of Kshs 242.6 bn while NIC is a Tier 2 Bank with an asset base of Kshs 201.8 bn as of Q3'2018.

The potential merger aims at achieving the following outcomes;

i. Enhance growth of the new entity in various aspects of banking and wealth management by consolidation of CBA's strength retail banking given that it has approximately 21.5 mn accounts, and NIC's corporate banking expertise, with the banking having approximately 116,000 accounts,
ii. Leverage on the new entity's sturdy balance sheet brought about by capital consolidation and strong liquidity, to capture strategic growth opportunities, providing the capability to undertake large transactions,

Below is an analysis of the two bank's Q3'2018 financial performance:

Bank Metrics Comparison – Q3'2018		
	CBA	**NIC Group**
Balance Sheet		
Net Loans and Advances	115.1	114.9
Government Securities	77.3	60.2
Total Assets	242.6	201.8
Customer Deposits	191.3	145.0
Borrowings	8.2	15.8
Total Liabilities	**212.0**	**167.9**
Shareholders' Equity	**31.0**	**33.5**
Income Statement		
Net Interest income	7.2	**7.6**
Non-Funded Income	8.3	3.4
Total Operating Income	**15.5**	**11.0**
Total Operating Expenses	(10.5)	(6.6)
Net Income	**3.4**	**3.2**
Key Ratios		
Yield on Interest Earning Assets	9.8%	10.8%
Cost of Funds	3.0%	5.6%
NIM	4.9%	5.8%
NFI % Total Operating Income	53.4%	29.9%
Cost to Income Ratio	67.6%	60.6%

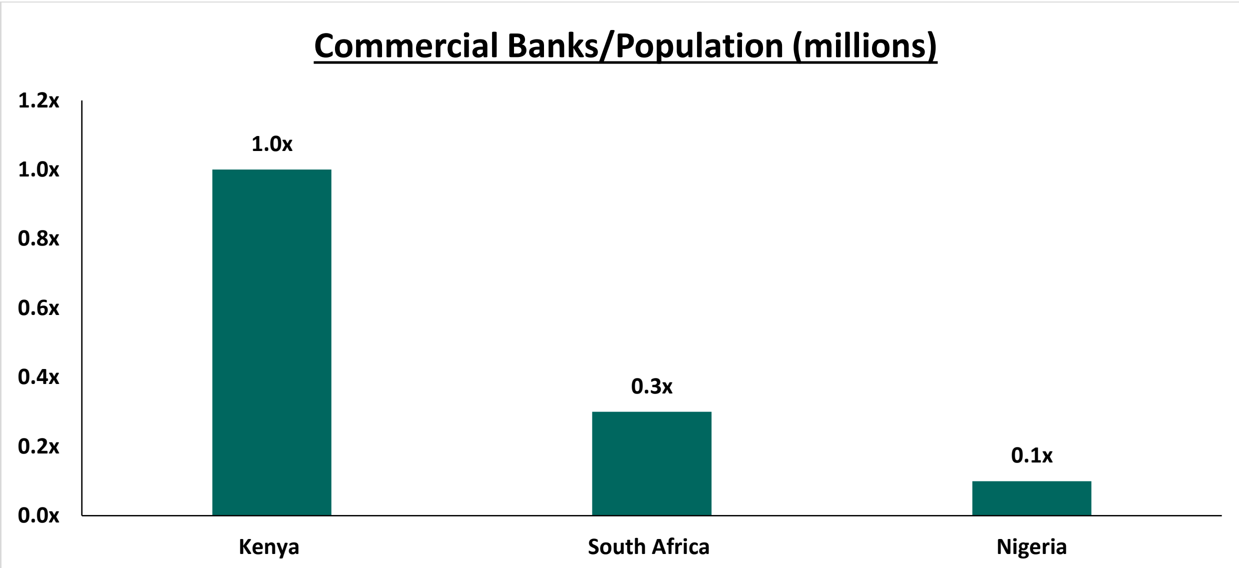
Cost of Risk	14.3%	14.6%
NPL Ratio	9.9%	13.3%
NPL Coverage	67.7%	51.4%
RoAE	26.1%	12.1%
RoAA	3.2%	2.0%

Below is the combined proforma financials;

Combined Proforma Financials – Q3’2018			
Balance Sheet	**CBA (Kshs bn)**	**NIC Group (Kshs bn)**	**Combined Metrics (Kshs bn)**
Net Loans and Advances	115.1	114.9	230
Government Securities	77.3	60.2	137.5
Total Assets	242.6	201.8	444.4
Customer Deposits	191.3	145	336.3
Borrowings	8.2	15.8	24
Total Liabilities	**212**	**167.9**	**379.9**
Shareholders’ Equity	**31**	**33.5**	**64.5**

- CBA’s total assets stood at Kshs 242.6 bn as at Q3’2018 compared to NIC’s Kshs 201.8 bn indicating that both banks have a strong asset base. Net loans and advances stood at Kshs 115.1 bn for CBA and Kshs 114.9 bn for NIC during the same period while investment in government securities was at Kshs 77.3 bn and Kshs 60.2 bn respectively. However, NIC seems to be generating higher interest income than CBA as indicated by the higher yield on its interest earning assets of 10.8% compared to CBA’s 9.8%, and consequently a higher Net Interest Margin (NIM) of 5.8% compared to CBA’s 4.9%.
- CBA has a higher deposits mobilization capacity compared to NIC, with customer deposits coming in at Kshs 191.3 bn and 145.0 bn as of Q3’2018, respectively, which is mainly attributable to CBA’s mobile application platform M-Shwari. Data from the Central Bank of Kenya (CBK) shows that CBA had about 21.5 mn deposit accounts in the period ending September 2018, compared to NIC’s 116,000 accounts during the same period. The merger is likely to lower the new entity’s cost of funds due to availability of cheaper funding and greatly benefit NIC whose cost of funds stood at 5.6% in Q3’2018 higher than the industry average of 3.1%.
- NIC had a poorer asset quality with the ratio of non-performing loans coming in at 13.3% in Q3’2018 compared to CBA’s 9.9% over the same period. NIC also had a lower NPL coverage ratio of 51.4% compared to CBA’s 67.7% indicating that the bank was less positioned to write off bad loans. The potential merger is therefore likely to improve the new entity’s asset quality by employment of better credit profiling capabilities possessed by CBA.
- CBA had a higher total operating income of Kshs 15.5 bn versus NIC’s Kshs 11.0 bn mainly driven by a higher proportion of non-funded income of Kshs 8.3 bn equivalent to 53.4% of total operating income compared to Kshs 3.4 bn generated by NIC, equivalent to 29.9% of total operating income in Q3’2018. We expect the merger to diversify and strengthen the revenue streams of the new entity backed by NIC’s strong returns from its loan book and CBA’s operational capabilities to generate non-funded income, thereby resulting in a higher bottom line.

In conclusion, we expect that the merger will provide an opportunity for the new entity to grow by tapping into both retail and corporate banking. With a potential combined market share of 10.9% by total deposits, the new entity upon merger would be the second largest by market share, second only to KCB Bank that commands approximately 14.7% market share as per the Central Bank of Kenya’s (CBK) Banking Supervision Report 2017. This would place the new entity on a strong position to play an important role in the Kenyan banking sector. We are of the view that the industry should, and will see more consolidation, as smaller banks with depleted capital positions are acquired as their performance deteriorates due to the sustained effects of the Banking (Amendment) Act 2015. We note that the industry needs fewer but stronger players to ensure the sector remains stable. We expect consolidation to continue in the near term in Kenya's banking sector, as the Kenyan market remains highly overbanked as per the chart below:



Source: Cytonn Investments

A report on African banks by global rating agency Moody's has shown that Kenyan banks have the highest proportion of bad loans among major economies in Africa. Kenya was rated fourth out of 11 countries, with the highest non-performing loans ratio being Angola's at 25.0%. Kenya ranked after Angola, Ghana and Democratic Republic of Congo (Congo) that had NPLs ratios of about 25.0%, 22.0% and 18.0%, respectively. Data from the Central Bank of Kenya shows that bad loans grew by 25.4% to Kshs 326.0 bn for the first nine months of the year from Kshs 260.0 bn in a similar period last year, and by 8.3% to Kshs 326.0 bn in the third quarter from Kshs 301.0 bn in the second quarter. The rising bad loans were mainly attributable to increased defaults by small business owners and taxi operators. The ratio of non-performing loans to total loans issued in October however reduced by 0.4% points to 12.3% in October from 12.7% in August mainly as a result of improved performance of trade and household sectors.

The number of bad loans are expected to increase in the near term, as the government continues to delay payments to contractors and sub-contractors of government projects thereby hurting their loan repayment capacity.

Nigeria

Tier two financial Institution, First City Monument Bank (FCMB) plc, has disclosed receiving USD 3.0 mn from the sale of debt-ridden 9mobile, formerly Etisalat Nigeria. The telecom firm got into trouble when it could not service the USD 1.2 bn, seven-year loan it took from a consortium of 13 Nigerian banks in 2013 to refinance a USD 650.0 mn dollar-loan, and fund expansion its network coverage. The company missed payments due to the economic downturn in Nigeria, a currency devaluation and the shortage of dollars in the country's interbank market. The Company was hit hardest among foreign firms by dollar shortages in Nigeria. Firms, which invested in the West African nation in the era of high oil prices are struggling to repay loans or keep operating as the oil producer suffers from a slump in oil revenues, hitting its currency and dollar reserves. The Company managed to repay 42.0% of the total loan, remaining with around USD 696.0 mn debt repayment, which it has failed to service since 2016. The takeover of 9mobile was completed in November by Teleology, ending a long bidding process for the debt-laden company that started a year ago. We are of the view that corporate governance needs to be strengthened by legislations in Nigeria to prevent any similar reoccurrence in future and to avoid driving foreign investors away due to fraudulent dealings. A market sensitive report released by Exotix Capital Limited indicated that local banks exposed to the USD 1.2 bn loan worsened their loan books in 2017. For Instance, Zenith Bank accounted for about NGN 80.0 bn of the total loan, which is the highest among the top eight banks that participated which is around 3.5% of its total loan book. Access bank contributed NGN 42.0 bn, which is about 2.6% of its loan book. The default of the loan by 9mobile worsened Nigerian banks asset quality in 2017 with most of the loan defaulted coming from the telecom firm hence affecting the loan book. We are of the view that the takeover will improve the performance of the banks as this will reduce the Non-performing loans and repay back the debt hence improving the asset quality of the banks.

Ghana

FBN Bank of Ghana received USD 72.5 mn from its parent bank, First Bank of Nigeria (FBN Holdings) to shore up its capital and meet the Bank of Ghana's new minimum capital requirement of GHS 400.0 mn. This capital injection will bring the total number of Commercial Banks that have already met the minimum capital requirement of GHS 400 mn to 22 out of the 30 Commercial banks in Ghana. FBN Bank Ghana Limited is a subsidiary of First Bank of Nigeria Holdings. FBN Bank Ghana currently has 19 branches and 2 agencies across the Country. The Minimum capital requirement increased by 233.3% to GHS 400.0 mn from GHS 120.0 mn and banks are supposed to meet it by December 2018 through the injection of fresh capital. Failure to do so could result in a bank losing the license or have its status reduced.

In 2003, the minimum capital requirement increased from GHS 2.5 mn to GHS 7.0 mn to enable all banks convert to universal banks. The minimum capital requirement increased to GHS 60.0 mn in 2007. In 2013, BoG again raised the minimum capital requirement to GHS 120.0 mn for new entrants and advised existing banks to take steps to increase their capital in line with their risk profiles. The recent GHS 400.0 mn minimum capital increase is necessary for a number of reasons, including solvency, macroeconomic impact on capital, credit expansion and good corporate governance.

We are of the view that increase in the minimum capital requirement is important for Banks in Ghana since it will reduce the leverage ratio and make the banking sector more safe and attractive to foreign investors. It will also lead to more mergers and acquisitions for the small banks, which are unable to meet the minimum capital requirement and this will lead to larger, stronger, and better-capitalized banks for shareholders of the merging banks.

Section IV: Equities Universe of Coverage:

The week-on-week performance, valuation and expected return of the companies in our SSA universe of coverage is highlighted in the table below:

Universe of Coverage								
Banks	Price as at 30/11/2018	Price as at 7/12/2018	w/w change	YTD Change	Target Price*	Dividend Yield	Upside/Downside**	P/TBv Multiple

Ghana Commercial Bank***	4.8	4.8	0.0%	(5.0%)	7.7	0.1	68.8%	**1.1x**
UBA Bank	7.5	7.5	0.0%	(27.2%)	10.7	0.1	54.0%	**0.5x**
Zenith Bank***	23.2	23.6	1.5%	(8.2%)	33.3	0.1	53.0%	**1.1x**
Union Bank Plc	5.2	5.4	3.9%	(31.4%)	8.2	0.0	52.3%	**0.6x**
Ecobank	7.5	7.5	0.0%	(1.3%)	10.7	0.0	43.1%	**1.6x**
CAL Bank	1.0	1.0	2.1%	(9.3%)	1.4	0.0	42.9%	**0.8x**
CRDB	150.0	150.0	0.0%	(6.3%)	207.7	0.0	38.5%	**0.5x**
Access Bank	7.8	7.5	(3.9%)	(28.7%)	9.5	0.1	32.9%	**0.5x**
Barclays	10.8	10.8	0.0%	12.0%	12.5	0.1	25.6%	**1.5x**
Stanbic Bank Uganda	31.0	30.5	(1.6%)	11.9%	36.3	0.0	22.8%	**2.2x**
SBM Holdings	6.1	6.0	(2.0%)	(20.0%)	6.6	0.1	14.3%	**0.9x**
Guaranty Trust Bank	34.4	34.9	1.6%	(14.4%)	37.1	0.1	13.2%	**2.2x**
Bank of Kigali	290.0	290.0	0.0%	(3.3%)	299.9	0.0	8.2%	**1.6x**
Standard Chartered	193.0	194.0	0.5%	(6.7%)	196.3	0.1	7.6%	**1.6x**
Bank of Baroda	139.0	128.5	(7.6%)	13.7%	130.6	0.0	3.6%	**1.1x**
FBN Holdings	7.1	7.6	7.0%	(13.6%)	6.6	0.0	(9.5%)	**0.4x**
Stanbic IBTC Holdings	48.0	46.5	(3.1%)	12.0%	37.0	0.0	(19.1%)	**2.4x**
Ecobank Transnational	16.0	15.5	(2.8%)	(8.8%)	9.3	0.0	(40.1%)	**0.6x**

**Target Price as per Cytonn Analyst estimates*
***Upside / (Downside) is adjusted for Dividend Yield*
****Banks in which Cytonn and/or its affiliates holds a stake. For full disclosure, Cytonn and/or its affiliates holds a significant stake in NIC Bank, ranking as the 5th largest shareholder*
*****Stock prices indicated in respective country currencies*
******Kenyan banks placed under review*

We are "NEUTRAL" on equities for investors with a short investment horizon. However, pockets of value exist, with a number of undervalued sectors like Financial Services, which provide an attractive entry point for medium to long-term investors, and with expectations of higher corporate earnings supported by sectors such as banking sector, we are "POSITIVE" for investors with a long-term investment horizon.