Cytonn SSA Financial Services Research: CAFF Weekly Note #10/2019

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Executive Summary

During the week, KCB Group announced plans to venture into Ethiopia as it released its FY'2018 financial results, with core EPS growth of 21.8% to Kshs 7.8, from Kshs 6.4 in FY'2017. In Nigeria, shareholders of Access Bank and Diamond Bank Plc consented to the ongoing merger process, which is set to be completed on 31st March 2019, and commence operations as a joint entity on 1st April 2019. In Ghana, Omnibank Ghana Limited and Sahel Sahara Bank, Ghana Limited (BSIC) announced the completion of a merger process between the two lenders, commencing operations on 4th March 2019 under the name OmniBSIC Bank Ghana Limited.

Section I: Market Performance:

During the week, the equities markets had mixed performances with the NASI and NGSEASI gaining by 1.9% and 1.0%, respectively, while GGSECI declined by 0.6%. This takes the YTD performance of NASI, NGSEASI and GGSECI to 13.8%, 2.8%, and (13.6%), respectively.

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

Weekly Top Gainers and Losers					
Top Gainers			Top Losers		
Company	Country	Change	Company	Country	Change
GCB Bank	Ghana	8.5%	National Bank of Kenya	Kenya	(6.6%)
KCB Group	Kenya	6.5%	Diamond Trust Bank	Kenya	(5.4%)
Access Bank	Nigeria	5.3%	I&M Holdings	Kenya	(2.2%)
Guaranty Trust	Nigeria	5.1%	Stanbic Holdings	Kenya	(2.1%)
Union Bank Plc	Nigeria	4.5%	Bank of Baroda	Uganda	(0.7%)

Kenya

During the week, the equities market was on an upward trend, with NASI gaining 1.9%, taking its YTD performance to a gain of 13.8%. The performance in NASI was driven by gains in large cap stocks such as EABL, KCB Group and Safaricom, which gained by 10.7%, 6.5% and 3.6%, respectively. In our universe of coverage, National Bank of Kenya (NBK), Diamond Trust Bank (DTB), I&M Holdings and Stanbic Holdings posted declines of 6.6%, 5.4%, 2.2% and 2.1% during the week, respectively. Equities turnover rose by 123.6% during the week to USD 55.8 mn, from USD 24.7 mn the previous week, taking the YTD turnover to USD 350.6 mn. Foreign investors turned net buyers for the week, with a net buying position of USD 4.6 mn, a positive shift from last week's net selling position of USD 1.1 mn.

Nigeria

The Nigerian All Share Index (NGSEASI) advanced by 1.0% during the week, driven by recoveries in the performance of the banking and insurance market segments, with the largest gainers in our universe of coverage being Access Bank, Guaranty Trust and Union Bank Plc, with gains of 5.3%, 5.1% and 4.5%, respectively. The NGSEASI has gained 2.8%. YTD.

Ghana

The GSE Composite Index marginally declined by 0.6% during the week, driving YTD gains to (13.6%). In our universe of coverage, Ghana Commercial Bank (GCB) was the biggest gainer during the week with 8.5% gains, with a majority of other counters remaining flat during the week on minimal trading activity.

Section II: Earnings Releases:

Nigeria Banks' Performance:

There were no earnings releases during the week.

Kenya Banks' Performance:

KCB Group released their FY'2018 financial results with core earnings per share increasing by 21.8% to Kshs 7.8, from Kshs 6.4 in FY'2017, above our expectation of a 19.4% increase to Kshs 7.7. The performance was driven by a 0.6% increase in total operating income, coupled with a 10.2% decline in total operating expenses. The variance in core earnings per share growth against our expectations was largely due to the 10.2% decline in total operating expenses to Kshs 37.9 bn, from Kshs 42.3 bn in FY'2017 largely driven by the 50.2% decline in Loan Loss Provisions (LLP) to Kshs 2.9 bn from Kshs 5.9 bn, which exceeded our expectation of a 4.2% decline. Highlights of the performance from FY'2017 to FY'2018 include:

- Total operating income increased marginally by 0.6% to Kshs 71.8 bn from Kshs 71.4 bn in FY'2017. This was due to a 0.9% increase in Net Interest Income (NII) to Kshs 48.8 bn, from Kshs 48.4 bn in FY'2017, while Non-Funded Income (NFI) declined marginally by 0.1% to Kshs 22.97 bn, from Kshs 23.0 bn in FY'2017,
- Interest income rose by 4.1% to Kshs 66.3 bn, from Kshs 63.7 bn in FY'2017. This was driven by a 5.0% growth in interest income from government securities to Kshs 13.0 bn, from Kshs 12.4 bn in FY'2017, and a 3.7% increase in interest income on loans and advances to Kshs 52.7 bn, from Kshs 50.8 bn in FY'2017. The yield on interest-earning assets however declined to 11.2%, from 11.5% in FY'2017, attributed to a decline in yields on government securities as well as a decline in lending rates due to the two Central Bank Rate (CBR) cuts in 2018. Furthermore, interest earning assets grew at a faster rate as compared to interest income, rising by 5.5% to Kshs 608.0 bn from Kshs 576.0 bn in FY'2017,
- Interest expense increased by 14.1% to Kshs 17.5 bn from Kshs 15.3 bn in FY'2017, following a 13.6% increase in the interest expense on customer deposits to Kshs 15.5 bn from Kshs 13.6 bn in FY'2017. Interest expense on deposits and placements from banking institutions increased by 18.7% to Kshs 2.0 bn, from Kshs 1.7 bn in FY'2017. The cost of funds thus rose to 3.2% from 3.0% in FY'2017, as the bank sought to support deposit growth amidst tight liquidity in the money market. As a consequence, the Net Interest Margin (NIM) declined to 8.2%, from 8.5% in FY'2017,
- Non-Funded Income (NFI) declined marginally by 0.1% to Kshs 22.97 bn, from Kshs 23.0 bn in FY'2017. The decline was mainly driven by a 25.3% reduction in other fees and commissions to Kshs 6.8 bn, from Kshs 9.1 bn in FY'2017, largely due to a slowdown in NFI growth from the bank's regional subsidiaries, coupled with the implementation of the Effective Interest Rate (EIR) under IFRS 9, which saw the bank amortize fees charged on loans over future period of a loan's tenor. As a result, the revenue mix remained unchanged at 68:32 funded to non-funded income,
- Total operating expenses declined by 10.2% to Kshs 37.9 bn, from Kshs 42.3 bn, largely driven by a 50.2% decline in Loan Loss Provisions (LLP) to Kshs 2.9 bn in FY'2018, from Kshs 5.9 bn in FY'2017, coupled with an 11.2% decline in staff costs to Kshs 17.0 bn in FY'2018, from Kshs 19.1 bn in FY'2017. The decline in staff

costs was due to the reduction in the number of staff to 6,220 staff in FY'2018 from 6,483 staff in FY'2017, following the staff rationalization programme, that cost the bank Kshs 2.0 bn, and resulted in the layoff of 709 staff,

- Consequently, the Cost to Income Ratio (CIR) improved to 52.8%, from 59.2% in FY'2017. Without LLP, the cost to income ratio also improved to 48.7%, from 50.9% in FY'2017,
- Profit before tax increased by 16.3% to Kshs 33.9 bn, up from Kshs 29.1 bn in FY'2017. Profit after tax grew by 21.8% to Kshs 24.0 bn in FY'2018, from Kshs 19.7 bn in FY'2017, as the effective tax rate declined to 33.3% from 34.8% in FY'2017,
- The bank recommends a final dividend of Kshs 2.5 per share, having already paid an interim dividend of Kshs 1.0 per share, translating to a total dividend payout of Kshs 3.5 per share, a 16.7% rise from the Kshs 3.0 paid in FY'2017, and translates to a dividend yield of 8.0%,
- The balance sheet recorded an expansion as total assets increased by 10.5% to Kshs 714.3 bn from Kshs 646.7 bn in FY'2017. This growth was largely driven by a 9.1% increase in government securities to Kshs 120.1 bn, from Kshs 110.0 bn in FY'2017, coupled with a 7.9% increase in their loan book to Kshs 455.9 bn from Kshs 422.7 bn in FY'2017, which management attributed to a growth in the corporate loan book,
- Total liabilities rose by 11.1% to Kshs 600.7 bn from Kshs 540.7 bn in FY'2017, driven by an 82.1% increase in Placement Liabilities to Kshs 20.1 bn from Kshs 11.0 bn in FY'2017, coupled with a 50.7% increase in Borrowings to Kshs 22.5 bn from Kshs 14.9 bn in FY'2017. The increase in borrowings is attributed to the receipt of the first tranche of the USD 80.0 mn of the USD 100 mn line of credit advanced by the African Development Bank (AfDB) following a deal signed by the two institutions in 2017,
- Customer deposits increased by 7.6% to Kshs 537.5 bn from Kshs 499.6 bn in FY'2017. Deposits per branch increased by 10.0% to Kshs 2.1 bn from Kshs 1.9 bn in FY'2017, owing to a reduction in the number of branches to 258 from 263 in FY'2017,
- The faster growth in loans as compared to deposits led to a marginal rise in the loan to deposit ratio to 84.8% from 84.6% in FY'2017,
- Gross Non-Performing Loans (NPLs) declined by 12.8% to Kshs 32.7 bn in FY'2018 from Kshs 37.5 bn in FY'2017. As a consequence, the NPL ratio improved to 6.9% in FY'2018 from 8.4% in FY'2017. The NPL coverage declined to 56.6% in FY'2018 from 67.9% in FY'2017, as provisions declined at a faster rate than the NPLs,
- Shareholders' funds increased by 7.3% to Kshs 113.7 bn in FY'2018 from Kshs 106.0 bn in FY'2017, as retained earnings grew by 23.5% y/y to Kshs 85.2 bn from Kshs 69.0 bn in FY'2017,
- KCB Group is currently sufficiently capitalized with a core capital to risk-weighted assets ratio of 18.1%, 7.6% above the statutory requirement of 10.5%. In addition, the total capital to risk-weighted assets ratio was 19.5%, exceeding the statutory requirement of 14.5% by 5.0%. Adjusting for IFRS 9, the core capital to risk weighted assets stood at 21.3%, while total capital to risk-weighted assets came in at 18.8%,
- The bank currently has a Return on Average Assets (ROaA) of 3.6%, and a Return on Average Equity (ROaE) of 21.9%.

Key Take-Outs:

1. The bank's asset quality improved, with the NPL ratio improving to 6.9% from 8.4% in FY'2017. The improved NPL ratio was mainly attributed to an improvement in the corporate loan book's NPL ratio to 8.5% in FY'2018 from in 11.0% in '2017, as well as the SME and Micro loan book, which improved to 13.0% in FY'2018, down from 16.4% in FY'2017. With the ongoing economic recovery, the bank's asset quality is likely to continue improving, across the other segments such as SMEs and the agricultural segments,
2. There was subdued Non-Funded Income growth. The decline in NFI's was largely due to a slowdown in NFI growth from the bank's regional subsidiaries, coupled with the implementation of the Effective Interest

Rate (EIR) under IFRS 9, which saw the bank amortize fees charged on loans over future period of a loan's tenor. KCB Group's NFI contribution to revenue stands at 32.0%, which is 3.0% lower than its peer average of 35.0%. Going forward however, the Bank expects improved growth in NFI's since the effects of the rebasing of fees due to the Effective Interest Rate (EIR) application under IFRS 9 is one-off, and,

3. Increased innovation and digitization has seen 88.0% of all transactions of the bank being done on alternative channels, with mobile transactions taking up 45.0% of all transactions, while agency and internet banking contributing 32.0% of all transactions. Increased usage of these channels should aid the bank in expanding its NFI revenue.

For more information, plaease see our KCB Group FY'2018 Earnings Note

Ghana Banks' Performance:

There were no earnings releases during the week.

Section III: Weekly Highlights:

Kenya

KCB Group highlighted its intention to venture into Ethiopia as the country promotes foreign investment in its financial services sector. With the government pledging a speedy resolution of the reform and liberalization process of the banking and telecommunication sectors, the bank is set to strategically position itself to take advantage of the vast market, which is currently being serviced by 16 private and 3 government owned banks. With a population of more than 105.0 mn, the Ethiopian market presents a vast market for KCB to tap into, and grow its business, by leveraging on its strong capital position and extensive experience on regional expansion, with the bank currently operating in Kenya, Tanzania, Uganda, Rwanda, Burundi and South Sudan. With their representative office in operation for 4-years in the market, the bank should have a good understanding of the demands and operational structure of the Ethiopian market, which should enable the bank to smoothly deploy its operations in the market. We are thus of the view that with Ethiopia's economy witnessing increased infrastructure development, and being the fastest growing economy in Africa, with GDP expanding by an average of 10.3% over the last 10-years, this gives the bank a huge market to expand its loan book. Furthermore, given the lack of price controls on loan pricing, this should see the bank expand it topline interest revenue, whose growth has slowed down owing to the implementation of the interest rate cap in Kenya, which is the bank's largest market. In addition, a successful implementation of the bank's mobile and alternative transaction channels in the Ethiopian market should result in a gradual and rapid expansion of the Non-Interest Revenue, which would be supported by the vastly untapped market. This should consequently boost the bank's growth and profitability in the long run.

Nigeria

Shareholders of Diamond Bank Plc and Access Bank Plc gave their consent to the ongoing merger process between the two entities at a court ordered meeting held in Lagos. The merger process is set to be completed on 31st March 2019, with the combined entity to begin operations on 1st April 2019. The combined entity is set to become Africa's largest retail bank by number of customers, with 29 million customers and 13 million mobile customers. The merger has been carried out at a consideration of NGN 1.0 per every share of Diamond Bank for a total of NGN 23.1 bn, in addition to a share swap of 6.6 bn Access Bank shares in the ratio of 2:7 between Access and Diamond shareholders, respectively. The merger is voluntary and not induced by regulatory authorities. In our view, the merger will create a robust company with a stronger value proposition for customers, taking into account Diamond Bank's market leadership in mobile and digital banking. The merged entity will also boost financial inclusion in Nigeria, which was previously Diamond Bank's digital banking strategy.

Diamond Bank Plc has introduced PayDay loan to ease the financial burden of customers. PayDay Loan is an instant salary advance service available to all customers with salary accounts at Diamond Bank. The new loan service will cater for customers in a quick, convenient manner and does not require any paperwork, collateral or guarantor. PayDay Loan was originally part of Access Bank's Salary Advance Scheme that provides instant credit to its salaried customers and individuals whose salaries are processed through the electronic payment platform, Remita. The instant loan service has now been extended to Diamond Bank salary account holders as a result of the ongoing merger between the two lenders.

Ghana

OmniBank Ghana Limited and Sahel Sahara Bank, Ghana Limited (BSIC) announced the completion of the merger process between the two lenders. The combined entity commenced operations on 4th March 2019, under the name OmniBSIC Bank Ghana Limited. The merger was necessitated by the need to increase capital to meet the new Bank of Ghana's Minimum Capital Requirement (MCR) of GHS 400.0 mn. The merger has been concluded without any immediate job losses due to ongoing efforts to achieve seamless cultural integration and capacity building to ensure all staff are carried along as part of the merger process. The merger will bring numerous benefits including a wider branch network, a stronger balance sheet, enhanced product offerings and integration of electronic banking platforms. The merged entity's product offering will span various segments including corporate banking, commercial and retail banking, digital banking and trade finance, delivered to over 160,000 customers in Nigeria and millions more across the continent. In our view, the just concluded merger will create a stronger bank, which will contribute to a robust financial sector in Ghana given that the Bank of Ghana continues to clean up the banking sector through new regulatory requirements.

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:

Banks	Price as at 1/03/2019	Price as at 8/03/2019	w/w change	YTD Change	Target Price*	Dividend Yield	Upside/Downside**	P/TBv Multiple
GCB Bank	3.5	3.8	8.5%	(17.2%)	7.7	10.0%	112.6%	**0.9x**
Diamond Trust Bank	148.0	140.0	(5.4%)	(10.5%)	283.7	1.9%	104.5%	**0.8x**
Access Bank	5.7	6.0	5.3%	(11.8%)	9.5	6.7%	65.0%	**0.4x**
I&M Holdings	92.0	90.0	(2.2%)	5.9%	138.6	3.9%	57.9%	**0.9x**
CRDB	135.0	135.0	0.0%	(10.0%)	207.7	0.0%	53.9%	**0.5x**
UBA Bank	7.6	7.7	0.7%	(0.6%)	10.7	11.1%	51.0%	**0.5x**
KCB Group***	41.3	44.0	6.5%	17.5%	61.3	8.0%	47.3%	**1.4x**
Zenith Bank	23.9	25.0	4.4%	8.2%	33.3	10.8%	44.4%	**1.1x**
CAL Bank	1.0	1.0	0.0%	0.0%	1.4	0.0%	42.9%	**0.8x**
Equity Group	40.8	41.0	0.5%	17.6%	56.2	4.9%	42.0%	**2.0x**
Co-operative Bank	14.5	14.6	0.7%	2.1%	19.9	5.5%	41.8%	**1.3x**
Ecobank	7.8	7.8	0.0%	3.3%	10.7	0.0%	38.5%	**1.7x**
NIC Group	36.0	37.0	2.8%	33.1%	48.8	2.7%	34.6%	**1.0x**
Stanbic Bank Uganda	29.0	29.0	0.0%	(6.5%)	36.3	4.0%	29.1%	**2.1x**
Barclays Bank	11.3	11.4	1.3%	4.1%	12.5	8.8%	18.4%	**1.6x**
Union Bank Plc	6.7	7.0	4.5%	25.0%	8.2	0.0%	16.4%	**0.7x**
HF Group	6.0	6.0	0.0%	8.3%	6.6	5.8%	15.8%	**0.2x**
Bank of Kigali	275.0	275.0	0.0%	(8.3%)	299.9	5.0%	14.1%	**1.5x**
SBM Holdings	6.0	6.1	1.0%	2.0%	6.6	4.9%	12.8%	**0.9x**

Guaranty Trust Bank	35.5	37.3	5.1%	8.3%	37.1	6.4%	5.9%	**2.3x**
Stanbic Holdings	95.0	93.0	(2.1%)	2.5%	92.6	6.3%	5.9%	**0.9x**
Standard Chartered	199.0	199.0	0.0%	2.3%	196.3	6.3%	4.9%	**1.6x**
Bank of Baroda	135.0	134.0	(0.7%)	(4.3%)	130.6	1.9%	(0.7%)	**1.2x**
Standard Chartered	21.0	21.0	0.0%	0.0%	19.5	0.0%	(7.3%)	**2.6x**
National Bank	6.1	5.7	(6.6%)	7.1%	4.9	0.0%	(14.0%)	**0.4x**
FBN Holdings	7.8	8.1	4.5%	1.9%	6.6	3.1%	(15.1%)	**0.4x**
Stanbic IBTC Holdings	46.5	48.0	3.2%	0.1%	37.0	1.2%	(21.7%)	**2.5x**
Ecobank Transnational	14.0	14.0	0.0%	(17.6%)	9.3	0.0%	(33.7%)	**0.5x**

**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.*

*****Stock prices indicated in respective country currencies*

We are "NEUTRAL" on equities since the markets are currently trading below historical P/E averages. However, pockets of value continue to exist, with a number of undervalued sectors like Financial Services, which provide an attractive entry point for medium and long-term investors, and with expectations of higher corporate earnings this year, we are "POSITIVE" for investors with a long-term investment horizon.