Equity Group – FY'2018
29th March, 2019

Valuation Summary

- We are of the view that Equity Group is a "***BUY***" with a target price of Kshs 56.2, representing an upside of 43.9%, from the current price of Kshs 42.5 as of 29th March 2019, inclusive of a dividend yield of 4.9%,
- Equity Group is currently trading at a P/TBV of 1.8x and a P/E of 7.7x vs an industry average of 1.5x and 7.0x, respectively.

Key Highlights FY'2018

- The bank received numerous accolades in the Think Business Awards 2018, which include: Overall best Bank in Kenya 2018, Best Bank in SME Banking, Most Customer Centric Bank, Best Commercial Bank in Microfinance and Best Bank in Asset Finance;
- The bank was given a global rating of B2 by Moody's and rated as stable. Global Credit Rating (GCR) rated the bank as A+ with a rating outlook of stable;
- The bank was feted at the Euromoney Awards for excellence as Kenya's Best Bank. The bank was also awarded as the Top Banking Superbrand in Kenya and East Africa.

Income Statement

- Core earnings per share increased by 4.8% to Kshs 5.25, from Kshs 5.0 in FY'2017, slower than our projections of an 11.3% increase to Kshs 5.6. The performance was driven by a 3.3% increase in total operating income, which outpaced the 1.4% increase in total operating expenses. The variance in core earnings per share growth against our expectations was largely due to the 1.4% rise in total operating expenses to Kshs 38.8 bn, from Kshs 38.3 bn in FY'2017, which was not in line with our expectation of a 3.9% decline,
- Total operating income increased by 3.3% to Kshs 67.3 bn, from Kshs 65.2 bn in FY'2017. This was driven by a 10.3% increase in Net Interest Income (NII) to Kshs 41.4 bn from Kshs 37.6 bn in FY'2017, which outpaced the 6.3% decline in Non-Funded Income (NFI) to Kshs 25.9 bn, from Kshs 27.6 bn in FY'2017,
- Interest income increased by 10.0% to Kshs 53.2 bn from Kshs 48.4 bn in FY'2017. This was driven by a 21.7% growth in interest income from government securities to Kshs 16.3 bn, from Kshs 13.4 bn in FY'2017, coupled with a 7.5% increase in interest income from loans to Kshs 36.4 bn from Kshs 33.9 bn in FY'2017. The yield on interest-earning assets however declined to 11.0%, 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,
- Interest expense increased by 8.9% to Kshs 11.8 bn from Kshs 10.8 bn in FY'2017, following a 16.7% increase in the interest expense on customer deposits to Kshs 9.4 bn from Kshs 8.1 bn in FY'2017, coupled with a 53.4% increase in interest expense on placements to Kshs 0.5 bn from Kshs 0.3 bn in FY'2017. However, other interest expenses declined by 23.5% to Kshs 1.8 bn from Kshs 2.4 bn in FY'2017. Despite the higher interest expenses, the cost of funds remained unchanged at 2.7%, owing to a faster increase in interest bearing liabilities that rose by 11.1% to Kshs 467.9 bn from Kshs 421.0 bn in FY'2017. Consequently, the Net Interest Margin (NIM) declined to 8.5%, from 8.9% in FY'2017,
- Non-Funded Income declined by 6.3% to Kshs 25.9 bn from Kshs 27.6 bn in FY'2017. The decline was mainly due to a 16.6% decline in fees and commissions on loans to Kshs 4.9 bn, from Kshs 5.9 bn in FY'2017, which management attributed to the implementation of the Effective Interest Rate (EIR) model under IFRS 9, which requires banks to amortize the fees and commissions on loans, throughout the tenor of a loan. In addition, the FX trading income declined by 19.5% to Kshs 3.3 bn, from Kshs 4.1 bn in FY'2017. The revenue mix shifted to 62:38 funded to non-funded income, from 58:42, owing to the decline in NFI coupled with the growth in NII,

- Total operating expenses rose by 1.4% to Kshs 38.8 bn, from Kshs 38.3 bn in FY'2017, largely driven by an 8.2% increase in Loan Loss Provisions (LLP) to Kshs 3.7 bn from Kshs 3.4 bn in FY'2017, coupled with a 3.4% increase in other operating expenses to Kshs 16.9 bn from Kshs 16.3 bn in FY'2017. Staff costs declined marginally by 0.2% to Kshs 11.4 bn in FY'2018 from Kshs 11.5 bn in FY'2017,
- The Cost to Income Ratio (CIR) improved to 57.7%, from 58.7% in FY'2017. Without LLP, the cost to income ratio improved by a wider margin to 52.2% from 53.5% in FY'2017, highlighting the increase in cost of risk to 5.5% from 5.3% in FY'2017,
- Profit before tax increased by 5.9% to Kshs 28.5 bn, up from Kshs 26.9 bn in FY'2017. Profit after tax grew by 4.8% to Kshs 19.8 bn in FY'2018, from Kshs 18.9 bn in FY'2017, with the difference in growth attributable to the increase in the effective tax rate to 30.4% from 29.6% in FY'2017,
- The bank recommends a first and final dividend of Kshs 2.0 per share, similar to the Kshs 2.0 paid in FY'2017, which translates to a dividend yield of 4.9%, and a payout ratio of 38.1%.

Balance Sheet

- The balance sheet recorded an expansion as total assets increased by 9.3% to Kshs 573.4 bn, from Kshs 524.5 bn in FY'2017. Growth was supported by a 6.5% increase in the loan book to Kshs 297.2 bn, from Kshs 279.1 bn, coupled with a 1.9% increase in government securities to Kshs 130.4 bn from Kshs 128.0 bn in FY'2017,
- Total liabilities rose by 10.9% to Kshs 478.4 bn from Kshs 431.3 bn in FY'2017, driven by a 13.3% increase in customer deposits to Kshs 422.8 bn from Kshs 373.1 bn in FY'2017. Deposits per branch increased by 13.7% to Kshs 1.5 bn from Kshs 1.3 bn in FY'2017, as the number of branches declined by 1 to 283 branches,
- Borrowings declined by 4.2% to Kshs 44.2 bn from Kshs 46.1 bn in FY'2017,
- The faster growth in deposits as compared to the growth in loans led to a decline in the loan to deposit ratio to 70.3% from 74.8% in FY'2017,
- Gross Non-Performing Loans (NPLs) increased by 33.6% to Kshs 24.0 bn in FY'2018 from Kshs 18.0 bn in FY'2017. The NPL ratio thus deteriorated to 7.8% in FY'2018 from 6.2% in FY'2017. General Loan Loss Provisions increased by 29.4% to Kshs 8.4 bn, from Kshs 6.5 bn in FY'2017. Thus, the NPL coverage deteriorated to 47.3% in FY'2018 from 50.3% in FY'2017,
- Shareholders' funds increased marginally by 1.0% to Kshs 94.1 bn in FY'2018 from Kshs 93.1 bn in FY'2017, supported by an 8.3% increase in retained earnings to Kshs 77.5 bn from Kshs 71.5 bn,
- Equity Group remains sufficiently capitalized with a core capital to risk-weighted assets ratio of 15.9%, 5.4% points above the statutory requirement. In addition, the total capital to risk-weighted assets ratio came in at 15.9%, exceeding the statutory requirement by 1.4% points. Adjusting for IFRS 9, the core capital to risk weighted assets stood at 17.3%, while total capital to risk-weighted assets came in at 17.3%. However, total capital to risk-weighted assets ratio for Equity Bank Kenya came in at 14.0%, indicating a deficiency of 0.5% for the Kenyan banking unit.
- The bank currently has a Return on Average Assets (ROaA) of 3.8%, and a Return on Average Equity (ROaE) of 22.5%.

Key Take-Outs:

1. The bank's geographical diversification strategy has continued to emerge a net positive, with the bank's various subsidiaries in Uganda, DRC, Rwanda, Tanzania and South Sudan cumulatively contributing 15.0% of the bank's total profitability from 14.0% in FY'2017. The regional subsidiaries also outpaced Equity Bank Kenya (EBKL) in deposit, asset and loan growth, growing by 19%, 14%, and 16%, as compared to EBKL's 14%, 4%, and 8%, respectively.

2. Increased innovation and digitization have seen 96.0% of all transactions of the bank being done on alternative channels, with mobile transactions taking up 77.0% of all transactions, and agency banking contributing 12.0% of all transactions. However, in terms of value of transactions, branches contributed 52% of the value of all transactions, with mobile and agency banking contributing 16.0% each. This highlights the transformation of branches to handle high value transactions. This transformation aids the bank in offering its ecosystem banking products to corporate and SME clients,
3. The bank's Non-Funded Income shrunk by 6.3% y/y, with the decline attributed to the 16.6% decline in fees and commissions on loans. This was largely due to the implementation of the EIR model under IFRS 9, which requires the amortization of the fees over the tenor of the loan. However, with the bank's alternative channels gaining prominence in frequency of transactions, we expect this to contribute positively towards the NFI revenue stream. With the banks' NFI contribution to total income currently at 38.4%, it is still way above the current industry average of 33.8%,
4. The bank's asset quality deteriorated, with the NPL ratio deteriorating to 7.8% from 6.2% in FY'2017. The main sectors that contributed to the NPLs are large enterprises and SMEs. In terms of the regional view, the regions with the highest NPLs were Tanzania at 25.7% of their loan book, followed by South Sudan at 14.3% of their loan book. With the interest rate cap set to remain in place in Kenya, the bank has ramped up its loan disbursement to its customers in the region, and will have to improve on its credit assessment in these markets in order to bring down the high NPL ratios in some of its regional subsidiaries.

Going forward, the factors that would drive the bank's growth would be:

I. Channeled diversification is likely to further improve on efficiency with emphasis on alternative channels of transactions, as the bank rides on the digital revolution wave, thereby further improving the cost to income ratio by cost rationalization and revenue expansion,
II. The bank's operating model of enhancing balance sheet agility is likely to place the bank in a prime position to take advantage of any opportunities that may arise, such as attractive inorganic growth via acquisitions or fast lending in the event of a repeal of the interest rate cap. The bank's balance sheet agility is seen given the bank's high liquidity ratio of 54.1%.

Below is a summary of the bank's performance:

Balance Sheet Items	FY'2017	FY'2018	y/y change	FY'2018e	Projected %y/y change	Variance in Growth Actual vs. Expected
Government Securities	128.0	130.4	1.9%	135.82	6.1%	4.2%
Net Loans and Advances	279.1	297.2	6.5%	292.27	4.7%	(1.8%)
Total Assets	**524.5**	**573.4**	**9.3%**	**585.4**	**11.6%**	**2.3%**
Customer Deposits	373.1	422.8	13.3%	413.1	10.7%	(2.6%)
Total Liabilities	**431.3**	**478.4**	**10.9%**	**481.2**	**11.6%**	**0.6%**
Shareholders Funds	**93.1**	**94.1**	**1.0%**	**103.3**	**10.9%**	**9.9%**

Balance Sheet Ratios	FY'2017	FY'2018	y/y change
Loan to Deposit Ratio	74.8%	70.3%	(4.5%)
Return on average equity	21.6%	22.5%	0.9%
Return on average assets	3.8%	3.8%	(0.0%)

Income Statement	FY'2017	FY'2018	y/y change	FY'2018e	Projected %y/y change	Variance in Growth Actual vs. Expected
Net Interest Income	37.6	41.4	10.3%	41.1	9.5%	(0.8%)
Non-Interest Income	27.6	25.9	(6.3%)	25.7	(6.7%)	(0.5%)
Total Operating income	**65.2**	**67.3**	**3.3%**	**66.9**	**2.6%**	**(0.6%)**
Loan Loss provision	(3.4)	(3.7)	8.2%	(2.0)	(41.7%)	(49.9%)
Total Operating expenses	(38.3)	(38.8)	1.4%	(36.8)	(3.9%)	(5.3%)
Profit before tax	26.9	28.5	5.9%	30.1	11.9%	6.0%
Profit after tax	**18.9**	**19.8**	**4.8%**	**21.1**	**11.3%**	**6.5%**
Earnings per share	**5.0**	**5.25**	**4.8%**	**5.58**	**11.3%**	**6.5%**

Income Statement Ratios	FY'2017	FY'2018
Yield from interest-earning assets	10.6%	10.9%
Cost of funding	2.6%	2.5%
Cost of Risk	5.3%	5.5%
Net Interest Spread	8.9%	8.5%
Net Interest Income as % of operating income	57.7%	61.6%
Non-Funded Income as a % of operating income	42.3%	38.4%
Cost to Income	58.7%	57.7%
Cost to Assets	7.0%	6.7%

Capital Adequacy Ratios	FY'2017	FY'2018
Core Capital/Total deposit Liabilities	23.5%	18.6%
Minimum Statutory ratio	10.5%	10.5%
Excess	**13.0%**	**8.1%**
Core Capital/Total Risk Weighted Assets	19.7%	15.9%
Minimum Statutory ratio	10.5%	10.5%
Excess	**9.2%**	**5.4%**
Total Capital/Total Risk Weighted Assets	20.4%	15.9%
Minimum Statutory ratio	14.5%	14.5%
Excess	**5.9%**	**1.4%**
Liquidity Ratio	54.2%	54.1%
Minimum Statutory ratio	20.0%	20.0%
Excess	**34.2%**	**34.1%**
Adjusted Core Capital/Total Risk Weighted Assets		17.3%
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