Equity Group Holdings – H1’2018

16th August, 2018

Valuation Summary

- We are of the view that Equity Group Holdings is an “Accumulate” with a target price of Kshs 55.5, representing an upside of 16.2%, from the current price of Kshs 49.8 as of 16th August, inclusive of a dividend yield of 4.0%,
- Equity Group Holdings is currently trading at P/TBV of 2.5x and a P/E of 9.9x vs an industry average of 1.7x and 9.2x, respectively.

Key Highlights H1’2018

- The bank received numerous accolades in the Think Business Awards 2018, which included: Overall best Bank in Kenya 2018, Best Bank in SME Banking, Retail Banking ,Agency Banking, Asset Finance 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 17.6% to Kshs 2.9 from Kshs 2.5 in H1’2017, below our expectation of a 20.7% increase to Kshs 3.0. Performance was driven by a 5.9% increase in total operating income, coupled with a 1.9% decrease in the total operating expenses. The variance in core earnings per share growth against our expectations was largely due to a slower growth in Non-Funded Income (NFI), which grew by 1.5% to Kshs 13.2 bn, against our expectation of an 8.3% growth to Kshs 14.1 bn,
- Total operating income increased by 5.9% to Kshs 32.8 bn in H1’2018 from Kshs 30.9 bn in H1’2017. This was due to a 9.1% increase in Net Interest Income (NII) to Kshs 19.6 bn from Kshs 17.9 bn in H1’2017, coupled with a 1.5% increase in Non-Funded Income (NFI) to Kshs 13.2 bn from Kshs 13.0 bn in H1’2017. The anemic NFI growth is concerning given that Equity Group has positioned itself as a transactions bank, hence we expected a stronger NFI growth,
- Interest income increased by 10.2% to Kshs 25.4 bn from Kshs 23.0 bn in H1’2017 bn. The interest income on loans and advances increased by 4.5% to Kshs 17.1 bn from Kshs 16.4 bn in H1’2017. Interest income on government securities increased by 26.8% to Kshs 7.9 bn in H1’2018 from Kshs 6.2 bn in H1’2017. The strong growth in government securities income relative to growth in loans should be a concern to policy makers as it indicates that government borrowing is crowding out the private sector. The yield on interest earning assets however declined to 11.4% in H1’2018 from 12.2% in H1’2017, due to a faster increase in government securities that have a lower yield than loans,
- Interest expense increased by 14.0% to Kshs 5.8 bn from Kshs 5.1 bn in H1’2017, following an 11.6% increase in the interest expense on customer deposits to Kshs 4.7 bn from Kshs 4.2 bn in H1’2017. Interest expense on deposits and placements from banking institutions increased by 87.7% to Kshs 0.2 bn from Kshs 0.1 bn in H1’2017. Other interest expenses increased by 17.5% to Kshs 0.9 bn in H1’2018 from Kshs 0.8 bn in H1’2017. The cost of funds thus increased to 2.7% from 2.6% in H1’2017. Net Interest Margin declined to 8.8% from 9.7% in H1’2017,
- Non-Funded Income (NFI) increased by 1.5% to Kshs 13.2 bn from Kshs 13.0 bn in H1’2017. The growth in NFI was driven by a 21.9% increase in other income to Kshs 2.6 bn from Kshs 2.1 bn in H1’2017. The growth in NFI was weighed down by a 2.5% decrease in fee and commission income on loans and advances to Kshs 2.8 bn from Kshs 2.9 bn in H1’2017, coupled with a 10.2% decline in Foreign exchange

trading income to Kshs 1.5 bn from Kshs 1.7 bn in H1’2017. The current revenue mix stands at 60:40 funded to non-funded income as compared to 58:42 in H1’2017. The proportion of non-funded income to total revenue declined owing to the faster growth in NII as compared to NFI,

- Total operating expenses declined by 1.9% to Kshs 17.3 bn from Kshs 17.6 bn, largely driven by a 57.7% decrease in loan loss provisions to Kshs 0.8 bn in H1’2018 from Kshs 1.9 bn in H1’2017, coupled with a 12.3% decrease in depreciation on property and equipment to Kshs 1.6 bn in H1’2018 from Kshs 1.9 bn in H1’2017. Staff costs however increased by 1.3% to Kshs 5.23 bn from Kshs 5.16 bn in H1’2017.
- The cost to income ratio improved to 52.8% from 57.0% in H1’2017. Without LLP, the Cost to income ratio also improved albeit marginally to 50.4% from 51.0% in H1’2017,
- Profit before tax increased by 16.4% to Kshs 15.5 bn, up from Kshs 13.3 bn in H1’2017. Profit after tax increased by 17.6% to Kshs 11.0 bn in H1’2018 from Kshs 9.4 bn in H1’2017.

Balance Sheet

- The balance sheet recorded an expansion as total assets increased by 7.3% to Kshs 542.0 bn from Kshs 504.9 bn in H1’2017. This growth was largely driven by a 37.5% increase in government securities to Kshs 158.9 bn from Kshs 115.6 bn in H1’2017.
- The loan book increased by 3.8% to Kshs 275.0 bn in H1’2018 from Kshs 265.1 bn in H1’2017,
- Total liabilities rose by 8.7% to Kshs 455.7 bn from Kshs 419.1 bn in H1’2017, driven by an 8.5% increase in total deposits to Kshs 393.7 bn from Kshs 362.8 bn in H1’2017. Deposits per branch increased by 10.8% to Kshs 1.4 bn from Kshs 1.3 bn in H1’2017, with the faster growth attributed to the bank’s closure of 6 branches in H2’2017,
- The faster growth in deposits as compared to loans led to a decline in the loan to deposit ratio to 69.9% from 73.1% in H1’2017,
- Gross non-performing loans increased by 20.1% to Kshs 24.5 bn in H1’2018 from Kshs 20.4 bn in H1’2017. Consequently, the NPL ratio deteriorated to 8.5% in H1’2018 from 7.4% in H1’2017. General Loan Loss Provisions (LLPs) increased by 23.2% to Kshs 9.6 bn from Kshs 7.8 bn in H1’2017.Thus, the NPL coverage improved to 79.9% in H1’2018 from 69.5% in H1’2017, due to the relatively faster increase in the loan loss provisions. The increase in the non-performing loans was attributed to three major corporate clients. Large enterprises contributed the largest proportion of NLPs at 17.0%, with micro enterprises and agriculture contributing 14.9% and 8.1%, respectively,
- Shareholders’ funds increased marginally by 0.5% to Kshs 86.3 bn in H1’2018 from Kshs 85.9 bn in H1’2017.
- Equity Group Holdings is currently sufficiently capitalized with a core capital to risk weighted assets ratio of 18.3%, 7.8% above the statutory requirement. In addition, the total capital to risk weighted assets ratio was 18.4%, exceeding the statutory requirement by 3.9%. Adjusting for IFRS 9, the core capital to risk weighted assets stood at 18.3%, while total capital to risk weighted assets came in at 18.4%, indicating that the bank’s total capital relative to its risk-weighted assets declined by 0.8% due to implementation of IFRS 9,
- Equity Group Holdings currently has a return on average assets of 3.9% and a return on average equity of 23.9%.

Key Take-Outs:

1. The bank’s geographical diversification strategy has continued to take effect, with the bank’s various subsidiaries in Uganda, DRC, Rwanda, Tanzania and South Sudan contributing 18.0% of the bank’s total profitability from 13.0% in H1’2017. The regional subsidiaries also contributed 25.0% of the bank’s loan book from 22.0% in H1’2017, and 26.0% of the group’s assets,

2. Increased innovation and digitization has seen 97.0% of all transactions of the bank being done on alternative channels, with mobile transactions taking up 78.0% of all transactions, and agency banking contributing 12.0% of all transactions. However, in terms of value of transactions, branches contributed 45.0% of all transactions, with mobile banking contributing 20.0% of all transactions. This shows branches have been transformed to handle high value transactions. This transformation aids the bank in offering its ecosystem banking product to corporate and SME clients,
3. The bank’s corporate internet banking platform has been gaining prominence, with 8.0% of the value of all transactions done via the platform, compared to 4.0% in H1’2017. The platforms dubbed as Eazzy Biz & Eazzy Net have gained prominence, as the value of transactions done increase exponentially. This, and other online platforms such as the Equity Eazzy app are likely to boost the bank’s transactional fee income as both the number and value of transactions continue to increase, and,
4. The bank’s asset quality deteriorated, with the NPL ratio deteriorating to 8.5% from 7.4% in H1’2017. The main sectors touted as the main contributors to the NPLs include large enterprises, micro enterprises and agriculture, which contributed 17.0%, 14.9 and 8.1%, respectively. With the ongoing economic recovery, the bank’s asset quality is likely to improve, given the strict lending policy adopted by the bank after the implementation of the Banking Act (amendment) 2015.

We expect the bank’s growth to be further propelled by

I. Channeled diversification, which 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. This will likely propel the bank’s prospects of achieving sustainable growth, as it replicates its successful business model across its various regional subsidiaries, and,
II. The bank’s operating model of enhancing balance sheet agility, which 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 57.1%.

Below is a summary of the bank’s performance:

Balance sheet Items	H1'2017	H1'2018	y/y change	H1'2018e	Expected y/y change	Variance in Actual Growth vs Expected
Government Securities	115.6	158.9	37.5%	138.1	19.5%	(18.0%)
Net Loans and Advances	265.1	275.0	3.8%	278.4	5.0%	1.3%
Total Assets	**504.9**	**542.0**	**7.3%**	**548.7**	**8.7%**	**1.3%**
Customer Deposits	362.8	393.7	8.5%	397.7	9.6%	1.1%
Total Liabilities	419.1	455.7	8.7%	461.2	10.1%	1.3%
Shareholders Fund's	**85.9**	**86.3**	**0.5%**	**87.5**	**1.9%**	**1.4%**

Balance sheet Ratios	H1'2017	H1'2018	% y/y change
Loan to Deposit Ratio	73.1%	69.9%	(3.2%)
Return on Average Equity	19.7%	23.9%	4.2%
Return on Average Assets	3.3%	3.9%	0.6%

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Income Statement	H1'2017	H1'2018	y/y change	H1'2018e	Expected y/y change	Variance in Actual Growth vs Expected
Net Interest Income	17.9	19.6	9.1%	19.0	5.8%	(3.3%)
Net non-interest Income	13.0	13.2	1.5%	14.1	8.3%	6.8%
Total Operating income	**30.9**	**32.8**	**5.9%**	**33.0**	**6.9%**	**0.9%**
Loan Loss Provision	(1.9)	(0.8)	(57.7%)	(1.7)	(10.1%)	47.6%
Total Operating Expenses	(17.6)	(17.3)	(1.9%)	(16.9)	(4.1%)	(2.2%)
Prrofits Before Tax	13.3	15.5	16.4%	16.1	21.5%	5.1%
Profits After Tax	**9.4**	**11.0**	**17.6%**	**11.3**	**20.7%**	**3.1%**
Core EPS	**2.5**	**2.9**	**17.6%**	**3.0**	**20.7%**	**3.1%**

Income Statement Ratios	H1'2017	H1'2018	y/y change
Yield from Interest Earning assets	12.2%	11.4%	(0.9%)
Cost of Funding	2.7%	2.7%	0.0%
Net Interest Spread	9.6%	8.7%	(0.9%)
Net Interest Margin	9.7%	8.8%	(0.9%)
Cost of Risk	6.0%	2.4%	(3.6%)
Net Interest Income as % of Operating Income	58.0%	59.8%	1.7%
Non-Funded Income as % of Operating income	42.0%	40.2%	(1.7%)
Cost to Income Ratio	57.0%	52.8%	(4.2%)

Capital Adequacy Ratios	H1'2017	H1'2018
Core Capital/Total Liabilities	22.2%	20.9%
Minimum Statutory ratio	10.5%	10.5%
Excess	**11.7%**	**10.4%**
Core Capital/Total Risk Weighted Assets	19.6%	18.3%
Minimum Statutory ratio	10.5%	10.5%
Excess	**9.1%**	**7.8%**
Total Capital/ Total Risk Weighted Assets	20.4%	18.4%
Minimum Statutory ratio	14.5%	14.5%
Excess	**5.9%**	**3.9%**
Liquidity Ratio	51.1%	57.1%
Minimum Statutory ratio	20.0%	20.0%
Excess	**31.1%**	**37.1%**
Adjusted core capital/Total deposit liabilities		21.8%
Adjusted core capital/Total risk-weighted assets		19.1%
Adjusted total capital/Total risk-weighted assets		19.2%