Equity Group Holdings – Q1’2018

17th May, 2018

Valuation Summary

- We are of the view that Equity Group Holdings is an “Accumulate” with a target price of Kshs 54.3, representing an upside of 14.3%, from the current price of Kshs 50.5 as of 17th May, inclusive of a dividend yield of 3.9%,
- Equity Group Holdings is currently trading at P/TBV of 2.2x and a P/E of 9.5x vs an industry average of 1.7x and 9.2x, respectively.

Key Highlights Q1’2018

- 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.

Income Statement

- Core earnings per share increased by 21.7% to Kshs 5.9 from Kshs 4.9 in Q1’2017, compared to our expectation of a 17.5% increase to Kshs 5.7. Performance was driven by an 8.6% increase in total operating income, coupled with a 1.2% decrease in the total operating expenses. The variance in core earnings per share growth against our expectations was largely due to a 55.0% decline in Equity’s provisioning levels despite the compliance with IFRS 9 that adopts a prospective approach to credit risk assessment. We expected provisioning levels of Kshs 0.9 bn, that came in at Kshs 0.4 bn. Total operating income increased by 8.6% to Kshs 16.5 bn in Q1’2018 from Kshs 15.2 bn in Q1’2017. This was due to a 10.5% increase in Net Interest Income (NII) to Kshs 9.8 bn in Q1’2018 from Kshs 8.9 bn in Q1’2017, coupled with a 6.3% increase in Non-Funded Income (NFI) to Kshs 6.7 bn in Q1’2018 from Kshs 6.3 bn in Q1’2017,
- Interest income increased by 10.5% to Kshs 12.7 bn in Q1’2018 from Kshs 11.5 bn in Q1’2017 bn. The interest income on loans and advances increased by 7.0% to Kshs 8.8 bn in Q1’2018 from Kshs 8.2 bn in Q1’2017. Interest income on government securities increased by 21.9% to Kshs 3.9 bn in Q1’2018 from Kshs 3.2 bn in Q1’2017. The yield on interest earning assets however declined to 11.3% in Q1’2018 from 13.0% in Q1’2017, due to the relatively faster increase in the interest earning assets to Kshs 458.3 bn from Kshs 407.1 bn in Q1’2017,
- Interest expense increased by 10.5% to Kshs 2.9 bn in Q1’2018 from Kshs 2.6 bn in Q1’2017, following a 16.8% increase in the interest expense on customer deposits to Kshs 2.4 bn in Q1’2018 from Kshs 2.0 bn in Q1’2017. Other interest expenses declined by 18.7% to Kshs 0.4 bn in Q1’2018 from Kshs 0.5 bn in Q1’2017. The cost of funds remained unchanged at 2.7%. Net Interest Margin declined to 8.4% from 8.5% in Q1’2017,
- Non-Funded Income increased by 6.3% to Kshs 6.7 bn from Kshs 6.3 bn in Q1’2017. The growth in NFI was driven by a 7.2% increase in Fees and commissions on loans to Kshs 1.5 bn from Kshs 1.4 bn in Q1’2017, and a 3.2% increase in other fees and commission income to Kshs 3.2 bn from Kshs 3.1 bn in Q1’2017. Foreign exchange income however declined by 26.9% to Kshs 0.7 bn from Kshs 0.9 bn in Q1’2017. The current revenue mix stands at 59:41 funded to non-funded income as compared to 58:42 in Q1’2017. The proportion of non-funded income to total revenue declined slightly owing to the faster growth in NII as compared to NFI,
- Total operating expenses declined by 1.2% to Kshs 8.2 bn from Kshs 8.3 bn, largely driven by a 55% decrease in the loan loss provision to Kshs 0.4 bn in Q1’2018 from Kshs 0.8 bn in Q1’2017, coupled with a 9.5% decline in the depreciation charge on property and equipment to Kshs 0.8 bn in Q1’2018 from Kshs 0.9 bn in Q1’2017. Staff costs however rose by 6.0% to Kshs 2.6 bn in Q1’2018 from Kshs 2.5 bn in Q1’2017, owing to increased staff reorganization costs as 400 employees were laid off,
- The cost to income ratio improved to 49.6% from 54.7% in Q1’2017. Without LLP, the Cost to income ratio also improved to 47.5% from 49.4% in Q1’2017,

- Profit before tax increased by 21.0% to Kshs 8.3 bn, up from Kshs 6.9 bn in Q1'2017. Profit after tax increased 21.7% to Kshs 5.9 bn in Q1'2018 from Kshs 4.9 bn in Q1'2017,

Balance Sheet

- The balance sheet recorded an expansion as total assets increased by 2.0% to Kshs 402.2 bn from Kshs 393.9 bn in Q1'2017. This growth was largely driven by a 32.9% increase in the government securities to Kshs 150.2 bn from Kshs 113.0 bn. Net loans and advances increased by 3.5% to Kshs 271.1 bn in Q1'2018 from Kshs 261.9 bn in Q1'2017,
- Total liabilities rose by 8.0% to Kshs 445.7 bn from Kshs 412.7 bn in Q1'2017, driven by a 10.0% increase in total deposits to Kshs 382.4 bn in Q1'2018 from Kshs 349.3 bn in Q1'2017. Deposits per branch increased by 9.5% to Kshs 1.4 bn from Kshs 1.2 bn in Q1'2017
- The faster growth in deposits as compared to loans led to the decline in the loan to deposit ratio to 70.9% from 75.0% in Q1'2017,
- Gross non-performing loans decreased by 7.2% to Kshs 18.1 bn in Q1'2018 from Kshs 19.5 bn in Q1'2017. As a consequence, the NPL ratio improved to 6.3% in Q1'2018 from 7.1% in Q1'2017. The NPL coverage increased to 105.1% in Q1'2018 from 64.9% in Q1'2017, as the group implemented provisioning under the IFRS 9 reporting standard,
- Shareholders' funds increased by 3.0% to Kshs 82.1 bn in Q1'2018 from Kshs 79.4 bn in Q1'2017.
- Equity Group Holdings is currently sufficiently capitalized with a core capital to risk weighted assets ratio of 19.3%, 8.8% above the statutory requirement. In addition, the total capital to risk weighted assets ratio was 20.2%, exceeding the statutory requirement by 5.7%. Adjusting for IFRS 9, the core capital to risk weighted assets stood at 20.2%, while total capital to risk weighted assets came in at 20.3%, indicating that the bank's total capital relative to its risk-weighted assets declined by 0.5% due to implementation of IFRS 9,
- Equity Group currently has a return on average assets of 3.9% and a return on average equity of 24.7%.

Key Take-Outs:

a) The Group's adjustment of its strategy under the interest rate capping regime is bearing fruit as the bank mitigated the effects of the interest rate cap that compressed the bank's interest income. The bank increased focus on non-funded income growth, mainly trade finance, gross merchant commission and mobile banking commission, all which recorded growths of 32%, 23% and 75%, respectively, to record incomes of Kshs 374 mn, Kshs 343 mn and Kshs 230.8 mn, respectively. The bank's main drivers for efficiency are the increased adoption of alternative channels by the customers with transactions done via alternative channels such as internet banking (EazzyNet) and mobile banking via Equity Eazzy Banking app, Equitel and EazzyBiz. The bank leverages on these channels to both boost its efficiency and find new sources of income. Currently, 97% of the number of all transactions are done through these alternative channels with branches only accounting 3% of the number of all transactions. However, branches still contribute to 46% of the value of all transactions, with Equitel contributing 17% of the value of all transactions. Branches have therefore been transformed to handle high value transactions for SMEs and corporates, and provide wealth management and advisory services,

b) Equity Group is also aggressively increasing its regional presence with the entry into markets such as DRC Congo, with the regional banks in Uganda, DRC, Rwanda, Tanzania and S.Sudan contributing 19% of the Group's earnings

c) The Group's asset quality improved, as gross NPL declined by 7.2% to record an NPL ratio of 6.3%. The biggest contributors to the NPL were the Micro enterprises at 14.9%, followed by the agriculture at 9.4%. Therefore, due to the decline in NPLs the provisions set aside declined even as the Group implemented the IFRS 9 standard after making a one-off provisioning of Kshs 9.8 bn for the existing loan portfolio, that was passed on the balance sheet, affecting the retained earnings. Provisions for newly issued loans shall be passed through the income statement in line with CBK guidance note,

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

I. Increased focus on alternative distribution channels, as the bank rides on the digital revolution wave, as evidenced by the increase in the number of transactions done via the Equity Eazzy Banking app, which had the number of transactions increase by 239.0% to 48.7 mn transactions from 14.4 mn transactions in Q1’2017. This consequently saw the value of transactions done via the channel increase by 146.0% to Kshs 26.7 bn from Kshs 10.9 bn in Q1’2017. Equitel on the other hand had the number of transactions decline by 16.0% to 60.1 mn transactions from 71.4 mn transactions in Q1’2017. However, the value of transactions done via Equitel increased by 17.0% to Kshs 138.5 bn from 118.0 bn in Q1’2017. Thus, the adoption of these alternative channels will help in improving the cost to income ratio by cost rationalization and revenue expansion, thereby aiding the group in achieving a sustainable growth,
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 opportunities via acquisitions or fast lending in the event of a repeal of the interest rate cap, and,
III. Increased focus on regional expansion as the bank focuses increasing its footprint in regions it has established itself as it aims to diversify across geographies

Balance sheet Items	Q1'2017	Q1'2018	y/y change	Q1'2018e	Expected y/y change	Variance in Actual Growth vs Expected
Government Securities	103.2	150.2	45.5%	114.1	10.6%	(35.0%)
Net Loans and Advances	261.9	271.1	3.5%	288.3	10.1%	6.6%
Total Assets	**492.2**	**527.8**	**7.2%**	**541.4**	**10.0%**	**2.8%**
Customer Deposits	347.5	382.4	10.0%	384.3	10.6%	0.5%
Total Liabilities	412.7	445.7	8.0%	442.6	7.2%	(0.7%)
Shareholders Fund's	**79.4**	**82.1**	**3.4%**	**98.8**	**24.4%**	**21.0%**

Balance sheet Ratios	Q1'2017	Q1'2018	% y/y change
Loan to Deposit Ratio	75.0%	70.9%	(4.1%)
Return on Average Equity	24.0%	27.0%	3.0%
Return on Average Assets	3.7%	4.0%	0.3%

Income Statement	Q1'2017	Q1'2018	y/y change	Q1'2018e	Expected y/y change	Variance in Actual Growth vs Expected
Net Interest Income	8.9	9.8	10.1%	10.5	18.0%	7.9%
Net non-interest Income	6.3	6.7	6.3%	7.1	12.7%	6.3%
Total Operating income	**15.2**	**16.5**	**8.6%**	**17.6**	**15.8%**	**7.2%**
Loan Loss Provision	0.8	0.4	(50.0%)	0.9	12.5%	62.5%
Total Operating Expenses	(8.3)	(8.2)	(1.2%)	(9.5)	14.2%	15.6%
Profits Before Tax	6.9	8.3	20.3%	8.1	17.4%	(2.9%)
Profits After Tax	**4.9**	**5.9**	**21.7%**	**5.7**	**17.5%**	**(4.2%)**
Core EPS	**1.3**	**1.6**	**21.7%**	**1.5**	**17.5%**	**(4.2%)**

Income Statement Ratios	Q1'2017	Q1'2018	y/y change
Yield from Interest Earning assets	11.1%	11.0%	(0.1%)
Cost of Funding	2.7%	2.7%	0.0%
Net Interest Spread	8.4%	8.3%	(0.1%)
Net Interest Margin	8.5%	8.4%	(0.1%)
Cost of Risk	5.2%	2.2%	(3.1%)
Net Interest Income as % of Operating Income	58.0%	59.0%	1.0%
Non-Funded Income as % of Operating income	42.0%	41.0%	(1.0%)
Cost to Income Ratio	54.7%	49.6%	(5.1%)

Capital Adequacy Ratios	Q1'2017	Q1'2018
Core Capital/Total Liabilities	23.2%	22.2%
Minimum Statutory ratio	10.5%	10.5%
Excess	**12.7%**	**11.7%**
Core Capital/Total Risk Weighted Assets	19.3%	18.7%
Minimum Statutory ratio	10.5%	10.5%
Excess	**8.8%**	**8.2%**
Total Capital/ Total Risk Weighted Assets	20.2%	18.7%
Minimum Statutory ratio	14.5%	14.5%
Excess	**5.7%**	**4.2%**
Liquidity Ratio	50.6%	55.2%
Minimum Statutory ratio	20.0%	20.0%
Excess	**30.6%**	**35.2%**
Adjusted core capital/Total deposit liabilities		24.0%
Adjusted core capital/Total risk-weighted assets		20.2%
Adjusted total capital/Total risk-weighted assets		20.3%