Equity Group Holdings– Q3’2018

11th November, 2018

Valuation Summary

- We are of the view that Equity Group Holdings is an “***buy***” with a target price of Kshs 56.2, representing an upside of 49.2%, from the current price of Kshs 39.0 as of 9th November 2018, inclusive of a dividend yield of 5.1%,
- Equity Group Holdings is currently trading at P/TBV of 1.9x and a P/E of 7.3x vs an industry average of 1.4x and 6.7x, respectively.

Key Highlights Q3’2018

- Equity Group Holdings was ranked among the top 1000 banks globally by Banker Magazine. The Bank was placed 1st in Kenya, an improvement from last year’s 2nd position, and number 799 globally with USD 848 Million in Tier 1 capital. The Bank moved seven places up, compared with position 806 last year;
- Polycarp Igathe was confirmed and named the Managing Director of Equity Bank Kenya, marking the completion of the Group’s strategy of separating the management of its subsidiaries from that of the Holding Company. This therefore leaves Dr James Mwangi as the Group Chief Executive and Managing Director;
- Global Credit Rating (GCR) a South African credit rating firm affirmed the ratings assigned to Equity Group Holdings of AA-(KE) and A1+(KE) in the long term and short term respectively and gave an overall stable outlook.

Income Statement

- Core earnings per share increased by 8.1% to Kshs 4.2 from Kshs 3.9 in Q3’2017, below our expectation of a 23.2% increase to Kshs 4.8. The Performance was driven by a 1.1% increase in total operating income, coupled with the 4.0% decline in the total operating expenses. The variance in core earnings per share growth against our expectations was largely due to the 6.7% decline in Non-Funded Income (NFI) to Kshs 19.8 bn from Kshs 21.3 bn. We expected a 4.8% increase in NFI to Kshs 22.3 bn from Kshs 21.3 bn in Q3’2017,
- Total operating income increased by 1.1% to Kshs 49.3 bn year-to-date (YTD) Q3’2018, from Kshs 48.8 bn over the same period to Q3’2017. This was due to a 7.2% increase in Net Interest Income (NII) to Kshs 29.5 bn from Kshs 27.5 bn in Q3’2017, which outweighed the 6.7% decline in Non-Funded Income (NFI) to Kshs 19.8 bn, from Kshs 21.3 bn in Q3’2017,
- Interest income increased by 8.6% to Kshs 38.5 bn, from Kshs 35.4bn in Q3’2017. This was driven by a 24.1% growth in interest income from government securities to Kshs 12.1 bn from Kshs 9.8 bn in Q3’2017, and a 2.9% increase in interest income on loans and advances to Kshs 25.8 bn, from Kshs 25.0 bn in Q3’2017. Interest income on deposits and placements with banking institutions rose by 15.2% to Kshs 0.5 bn from Kshs 0.4 bn in Q3’2017. However, the yield on interest earning assets declined to 11.1% in Q3’2018 from 12.1% in Q3’2017, due to a faster increase at 24.1% in government securities that have relatively lower yields than loans,
- Interest expense increased by 13.5% to Kshs 9.0 bn from Kshs 7.9 bn in Q3’2017, following an 8.8% increase in the interest expense on customer deposits to Kshs 7.0 bn, from Kshs 6.5 bn in Q3’2017. Interest expense on deposits and placements from banking institutions increased by 108.7% to Kshs 0.4 bn from Kshs 0.2 bn in Q3’2017. Other interest expenses increased by 23.7% to Kshs 1.6 bn, from Kshs 1.3 bn in Q3’2017. The cost of funds thus increased to 2.7%, from 2.6% in Q3’2017. As a consequence, the Net Interest Margin (NIM) declined to 8.5%, from 9.4% in Q3’2017,
- Non-Funded Income (NFI) declined by 6.7% to Kshs 19.8 bn, from Kshs 21.3 bn in Q3’2017. The decline in NFI was realized across all NFI segments. Fees and commissions on loans declined by 1.7% to Kshs 4.28 bn from Kshs 4.35 bn in Q3’2017. Other fees and commission income declined by 2.7% to Kshs 9.4 bn, from Kshs 9.6 bn in Q3’2017. Forex trading income declined by 7.4% to Kshs 2.4 bn, from Kshs

2.6 bn in Q3’2017. Other income declined by 19.1% to Kshs 3.8 bn, from Kshs 4.7 bn in Q3’2017. As a result, the current revenue mix shifted to 60:40 funded to non-funded income as compared to 56:44 in Q3’2017. The proportion of NFI to total revenue decreased owing to the decline in NFI coupled with the increase in NII,

- Total operating expenses declined by 4.0% to Kshs 26.9 bn, from Kshs 28.0 bn, largely driven by a 54.0% decrease in Loan Loss Provisions (LLP) to Kshs 1.3 bn in Q3’2018, from Kshs 2.9 bn in Q3’2017, coupled with a marginal 0.2% decrease in other operating expenses to Kshs 17.31 bn in Q3’2018, from Kshs 17.34 bn in Q3’2017. Staff costs however rose by 6.0% to Kshs 8.3 bn from Kshs 7.8 bn in Q3’2017, attributed to heavy recruitment by the bank for several managerial positions, and the data analytics departments across its group and subsidiary offices,
- The Cost to Income Ratio (CIR) improved to 55.0%, from 57.5% in Q3’2017. Without LLP, the cost to income ratio deteriorated albeit marginally to 51.9%, from 51.6% in Q3’2017,
- Profit before tax increased by 8.1% to Kshs 22.4 bn, up from Kshs 20.7 bn in Q3’2017. Profit after tax also increased by 8.1% to Kshs 15.8 bn in Q3’2018, from Kshs 14.6 bn in Q3’2017

Balance Sheet

- The balance sheet recorded an expansion as total assets increased by 8.1% to Kshs 560.4 bn from Kshs 518.2 bn in Q3’2017. This growth was largely driven by a 24.1% increase in government securities to Kshs 158.6 bn, from Kshs 127.7 bn in Q3’2017, coupled with an 8.6% increase in their loan book to Kshs 288.4 bn from Kshs 265.5 bn in Q3’2017,
- Total liabilities rose by 9.7% to Kshs 469.7 bn from Kshs 428.1 bn in Q3’2017, driven by a 9.1% increase in total deposits to Kshs 402.3 bn from Kshs 368.8 bn in Q3’2017. Deposits per branch also increased by 9.1% to Kshs 1.4 bn from Kshs 1.3 bn in Q3’2017, with no new branches opened or closed. Placement liabilities increased by 304.3% to Kshs 9.9 bn from Kshs 2.5 bn in Q3’2017. Borrowings increased by 1.4% to Kshs 46.3 bn from Kshs 45.7 bn in Q3’2017,
- The faster growth in deposits as compared to loans led to a slight decline in the loan to deposit ratio to 71.7% from 72.0% in Q3’2017,
- Gross Non-Performing Loans (NPLs) increased by 28.1% to Kshs 26.5 bn in Q3’2018 from Kshs 20.7 bn in Q3’2017. Consequently, the NPL ratio deteriorated to 8.9% in Q3’2018 from 7.5% in Q3’2017. General Loan Loss Provisions (LLPs) increased by 3.8% to Kshs 7.6 bn from Kshs 7.3 bn in Q3’2017. With the growth in NPLs not matched with a similar increase in provisioning, the NPL coverage decreased to 38.9% in Q3’2018 from 48.2% in Q3’2017. The increase in the non-performing loans was attributed major corporate clients. Large enterprises contributed the largest proportion of NPLs at 14.7%, with Small and Medium Enterprises (SMEs) contributing 9.4% and agriculture 5.4%. In terms of regional contribution, South Sudan contributed 40.9% of total NPLs, with Tanzania and Kenya contributing 12.9% and 9.1%, respectively,
- Shareholders’ funds increased marginally by 0.6% to Kshs 90.7 bn in Q3’2018 from Kshs 90.1 bn in Q3’2017, as retained earnings grew by 6.9% y/y to Kshs 80.3 bn from Kshs 75.1 bn. The growth was however weighed down by revaluation losses, which rose 41.0% to Kshs 8.4 bn from Kshs 6.0 bn in Q3’2017,
- Equity Group Holdings is currently sufficiently capitalized with a core capital to risk weighted assets ratio of 18.0%, 7.5% above the statutory requirement. In addition, the total capital to risk weighted assets ratio was 18.0%, exceeding the statutory requirement by 3.5%. Adjusting for IFRS 9, the core capital to risk weighted assets stood at 21.9%, while total capital to risk weighted assets came in at 18.8%, indicating that the bank’s total capital relative to its risk-weighted assets declined by 0.8% due to implementation of IFRS 9,
- The bank currently has a Return On Average Assets (ROaA) of 3.9% and a Return On Average Equity (ROaE) of 22.2%.

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 14.0% in Q3’2017. The regional subsidiaries also contributed 26.0% of the bank’s loan book from 23.0% in Q3’2017, and 26.0% of the group’s assets from 23.0% in Q3’2017,
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. A key aspect to note also is that the bank’s corporate banking channel Equity EazzyBiz recorded 106.6% growth in value of transaction to Kshs 187.3 bn from Kshs 90.9 bn in Q3’2017. The platform will aid the bank in its strategy of moving the high value transactions from the branches, thereby transforming them to offer advisory services, wealth management and relationship management,
3. The bank recorded a decline in its NFI, with declines noted across all the NFI segments. According to management, the main focus at the moment is to capture market share as they deepen the ecosystem, before beginning to monetize transactions taking place on the NFI infrastructure,
4. The bank’s asset quality deteriorated, with the NPL ratio deteriorating to 8.9% from 7.5% in Q3’2017. The increase in the non-performing loans was attributed major corporate clients. Large enterprises contributed the largest proportion of NLPs at 14.7%, with Small and Medium Enterprises (SMEs) contributing 9.4% and agriculture contributing 5.4%. The NPLs arising from the corporate segment were largely due to 4 major clients, who cited delayed government payments as the causal factor. With the ongoing economic recovery, the bank’s asset quality is likely to improve, across the other segments such as SMEs and the agricultural sectors.

We expect the bank’s growth to be driven by ***Channeled diversification*** is likely to 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 NFI growth. With management indicating their strategy of capturing market share and monetize later, this will likely propel the bank’s prospects of achieving sustainable growth in the segment, as it deploys its successful business model across its various regional subsidiaries, such as DRC Congo which has 85.0% of the population that is unbanked, thereby presenting significant headroom for growth,

Below is a summary of the bank’s performance:

Balance sheet Items	Q3'2017	Q3'2018	y/y change	Q3'2018e	Expected y/y change	Variance in Actual Growth vs Expected
Government Securities	127.7	158.6	24.1%	150.4	17.7%	(6.4%)
Net Loans and Advances	265.4	288.4	8.6%	283.0	6.6%	(2.0%)
Total Assets	**518.2**	**560.4**	**8.1%**	**559.9**	**8.0%**	**(0.1%)**
Customer Deposits	368.8	402.2	9.1%	404.3	9.6%	0.6%
Total Liabilities	428.1	469.7	9.7%	466.5	9.0%	(0.7%)
Shareholders Fund's	**90.1**	**90.7**	**0.6%**	**93.3**	**3.6%**	**3.0%**

Balance sheet Ratios	Q3'2017	Q3'2018	% y/y change
Loan to Deposit Ratio	72.0%	71.7%	(0.3%)
Return on Average Equity	18.8%	22.2%	3.4%
Return on Average Assets	3.3%	3.7%	0.5%

Income Statement	Q3'2017	Q3'2018	y/y change	Q3'2018e	Expected y/y change	Variance in Actual Growth vs Expected
Net Interest Income	27.5	29.5	7.2%	30.6	11.2%	4.0%
Net non-interest Income	21.3	19.8	(6.7%)	22.3	4.8%	11.5%
Total Operating income	**48.7**	**49.3**	**1.1%**	**52.8**	**8.4%**	**7.3%**
Loan Loss Provision	(2.9)	(1.3)	(54.0%)	(1.7)	(41.4%)	12.6%
Total Operating Expenses	(28.0)	(26.9)	(4.0%)	(27.1)	(3.3%)	0.6%
Profits Before Tax	20.7	22.4	8.1%	25.8	24.3%	16.2%
Profits After Tax	**14.6**	**15.8**	**8.1%**	**18.0**	**23.2%**	**15.1%**
Core EPS	**3.9**	**4.2**	**8.1%**	**4.8**	**23.2%**	**15.1%**

Income Statement Ratios	Q3'2017	Q3'2018	y/y change
Yield from Interest Earning assets	12.1%	11.1%	(1.0%)
Cost of Funding	2.6%	2.7%	0.1%
Net Interest Spread	9.5%	8.4%	(1.1%)
Net Interest Margin	9.4%	8.5%	(0.9%)
Cost of Risk	5.9%	2.7%	(3.2%)
Net Interest Income as % of Operating Income	56.4%	59.8%	3.4%
Non-Funded Income as % of Operating income	43.6%	40.2%	(3.4%)
Cost to Income Ratio	57.5%	54.6%	(2.9%)

Capital Adequacy Ratios	Q3'2017	Q3'2018
Core Capital/Total Liabilities	23.3%	21.0%
Minimum Statutory ratio	10.5%	10.5%
Excess	**12.8%**	**10.5%**
Core Capital/Total Risk Weighted Assets	19.8%	18.0%
Minimum Statutory ratio	10.5%	10.5%
Excess	**9.3%**	**7.5%**
Total Capital/ Total Risk Weighted Assets	20.5%	18.0%
Minimum Statutory ratio	14.5%	14.5%
Excess	**6.0%**	**3.5%**
Liquidity Ratio	52.1%	55.0%
Minimum Statutory ratio	20.0%	20.0%
Excess	**32.1%**	**35.0%**
Adjusted core capital/Total deposit liabilities		21.9%
Adjusted core capital/Total risk-weighted assets		18.8%
Adjusted total capital/Total risk-weighted assets		18.8%