Valuations

- We are of the view that Equity Group Holdings is a "Buy" with a target price of Kshs 55.5, representing an upside of 21.2%, from the current price of Kshs 47.5 as of 15th November, inclusive of a dividend yield of 4.2%,
- Equity Group Holdings is currently trading at P/TBV of 1.8x and a P/E of 8.3x vs an industry average of 1.2x and 6.0x, respectively.

Key Highlights Q3'2019

- Equity Group Holdings' board of directors entered into a non-binding agreement with shareholders of Democratic Republic Bank of Congo to acquire a majority stake for, a move which will see it increase its market share in Congo, having expanded into the region through its subsidiary, Equity Bank Congo. The proposed transaction together with the binding term sheet signed with Atlas Mara Ltd to acquire certain banking assets in Rwanda, Zambia, Tanzania and Mozambique, are in line with Equity Group's expansion strategy. This highlights Kenyan banks' continued pursuit for inorganic growth strategies.

Income Statement

- Core earnings per share increased by 10.4% to Kshs 4.6 from Kshs 4.2 in Q3'2018, slower than our projections of a 13.3% increase to Kshs 4.8. The performance was driven by an 11.2% increase in total operating income. The variance in core earnings per share growth against our expectations was largely due to a slower growth in total operating income by 11.2% to Kshs 54.8 bn, from Kshs 49.3 bn in Q3'2018, which was not in line with our expectation of a 12.3% increase to Kshs 55.4 bn,
- Total operating income recorded an 11.2% growth to Kshs 54.8 bn, from Kshs 49.3 bn in Q3'2018. This was driven by a 13.7% growth in Non-Funded Income (NFI) to Kshs 22.6 bn, from Kshs 19.8 bn in Q3'2018, coupled with a 9.5% growth in Net Interest Income to Kshs 32.3 bn, from Kshs 29.5 bn in Q3'2018,
- Interest income increased by 11.2% to Kshs 42.8 bn, from 38.5 bn in Q3'2018. This was driven by a 12.5% increase in interest income on loans and advances to Kshs 29.0 bn from Kshs 25.8 bn in Q3'2018. Interest income on government securities, on the other hand, increased by 4.1% to Kshs 12.6 bn, from Kshs 12.1 bn in Q3'2018. The slightly stronger growth in interest income on loans as compared to interest from government securities is indicative of the benefits accruing to Equity Group Holding's strategy to increase lending to the private sector, focusing on Small and Medium Enterprises. The yield on interest earning assets, however, declined by 0.2% points to 10.9%, from 11.1% in Q3'2018, owing to declining yields on government securities, which saw the 13.7% growth in average interest earning assets outpacing the 11.2% growth in interest income
- Interest expense rose by 16.8% to Kshs 10.5 bn, from Kshs 9.0 bn in Q3'2018, following the 15.4% increase in the interest expense on customer deposits to Kshs 8.1 bn, from Kshs 7.0 bn in Q3'2018, coupled with an 42.2% increase in interest expense on placements to Kshs 0.5 bn from Kshs 0.4 bn in Q3'2018, and a 17.5% increase in other interest expenses to Kshs 1.9 bn from Kshs 1.6 bn in Q3'2018. The cost of funds, however, declined to 2.6%, from 2.7% in Q3'2018, owing to a faster increase in interest bearing liabilities that rose by 18.7% to Kshs 544.4 bn, from Kshs 458.5 bn in Q3'2018. The Net Interest Margin (NIM), thus, declined to 8.4%, from 8.5% in Q3'2018, owing to a faster growth of 13.7% in average interest earning assets, compared to a 9.5% growth in Net Interest Income,
- Non-Funded Income (NFI) recorded a 13.7% growth to Kshs 22.6 bn, from Kshs 19.8 bn in Q3'2018. The growth was mainly driven by the 21.7% increase in other fees to Kshs 11.4 bn,

from Kshs 9.4 bn in Q3'2018. The growth was also supported by the 19.9% growth in forex trading income to Kshs 2.8 bn, from Kshs 2.4 bn in Q3'2018, and a 5.3% growth in other income to Kshs 4.0 bn, from Kshs 3.8 bn in Q3'2018, with management noting that the forex income segment benefitted from increased flows from the diaspora. Fees and commissions on loans, on the other hand, increased marginally by 0.4% points to Kshs 4.29 bn, from Kshs 4.28 bn in Q3'2018,

- The revenue mix shifted to 59:41 from 60:40 funded to non-funded income, owing to the faster growth in NFI as compared to growth in NII,
- Total operating expenses rose by 11.7% to Kshs 30.0 bn, from Kshs 26.9 bn in Q3'2018, largely driven by a 41.8% increase in Loan Loss Provisions (LLP) to Kshs 1.9 bn, from Kshs 1.3 bn in Q3'2018, coupled with a 12.8% rise in staff costs to Kshs 9.3 bn from Kshs 8.3 bn in Q3'2018, and a 8.9% growth in other operating expenses to Kshs 18.9 bn, from Kshs 17.3 bn in Q3'2018
- As a result, the Cost to Income Ratio (CIR) deteriorated to 54.8%, from 54.6% in Q3'2018 However, without LLP, the cost to income ratio improved to 51.4%, from 51.9% in Q3'2018,
- Profit before tax increased by 10.6% to Kshs 24.8 bn, up from Kshs 22.4 bn in Q3'2018. Profit after tax recorded a 10.4% growth to Kshs 17.5 bn, from Kshs 15.8 bn, with the difference in growth attributable to the marginal increase in the effective tax rate to 29.5% from 29.4% in Q3'2018,

Balance Sheet

- The balance sheet recorded an expansion as total assets grew by 20.8% to Kshs 677.1 bn, from Kshs 560.4 bn in Q3'2018. The growth was supported by a 21.0% growth in loans and advances to Kshs 348.9 bn, from Kshs 288.4 bn in Q3'2018, coupled with a 7.7% growth in government Securities to Kshs 135.1 bn, from Kshs 125.3 bn in Q3'2018,
- Total liabilities recorded a 21.0% growth to Kshs 568.4 bn, from Kshs 469.7 bn in Q3'2018, supported by a 18.9% growth in customer deposits which rose to Kshs 478.1 bn, from Kshs 402.2 bn in Q3'2018, coupled with the 114.0% growth in other liabilities to Kshs 24.0 bn, from Kshs 11.2 bn in Q3'2018,
- The comparable growth in both loans and deposits led to a marginal increase in the loan to deposit ratio to 73.0%, from 71.7% in Q3'2018, attributable to the faster growth in loans compared to deposits,
- Gross Non-Performing Loans (NPLs) increased by 15.4% to Kshs 30.5 bn in Q3'2019, from Kshs 26.5 bn in Q3'2018. The NPL ratio, however, improved to 8.4% in Q3'2019 from 8.9% in Q3'2018, attributable to a 21.5% growth in gross loans which outpaced the 15.4% growth in NPLs. The slight improvement in asset quality was largely attributed to a drop in the Large Enterprise sector's contribution to total NPL, from 14.7% to 9.2% in Q3'2019. The group's Tanzania subsidiary contributed 27.5% of the NPLs, with South Sudan and Kenya contributing 23.5% and 8.0%, respectively. General Loan Loss Provisions increased by 31.9% to Kshs 10.0 bn, from Kshs 7.6 bn in Q3'2018, thus, the NPL coverage improved to 45.8% in Q3'2019 from 38.9% in Q3'2018,
- Shareholder's funds recorded a 19.9% growth to Kshs 107.7 bn, from Kshs 89.8 bn in Q3'2018, supported by an 18.1% increase in retained earnings to Kshs 94.8 bn, from Kshs 80.3 bn in Q3'2018,
- Equity Group remains sufficiently capitalized with a core capital to risk-weighted assets ratio of 16.7%, 6.2% points above the statutory requirement of 10.5%. In addition, the total capital to risk-weighted assets ratio came in at 20.5%, exceeding the statutory requirement of 14.5%

by 6.0% points. Adjusting for IFRS 9, the core capital to risk weighted assets stood at 17.5%, while total capital to risk-weighted assets came in at 21.2%, and,

- The bank currently has a Return on Average Assets (ROaA) of 3.9%, and a Return on Average Equity (ROaE) of 21.3%.

Key Take-Outs:

1. The bank’s geographical diversification strategy has continued to emerge as a net positive, with the bank’s various subsidiaries in Uganda, DRC, Rwanda, Tanzania and South Sudan cumulatively contributing 18.0% of the bank’s total profitability and 27.0% of the group’s total asset base. Equity Group Holdings opened a commercial representative office in Addis Ababa, Ethiopia, and expected to commence operations in July. This is line with the bank’s strategy to expand into 9 African countries within the year, with Ethiopian market being the first phase of regional expansion drive to attain Pan African status. The venture will affirm the bank’s position as the biggest bank in Kenya by customers. The venture will affirm the bank’s position as the biggest bank in Kenya by customers. Kenyan banks have been expanding their operations into neighbouring countries in search of growth, to diversify their earnings as competition intensifies in the local market, as margins remains compressed under the current interest rate cap regime. This is in line with the group’s strategy to attain a Kshs 1.0 tn asset base, and a maximum contribution of 30.0% of the total profitability by a single subsidiary,
2. Increased innovation and digitization have seen 97.0% 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 50.0% of the value of all transactions, with agency banking and mobile contributing 16.0% and 16.0%, respectively. 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 asset quality improved, with the NPL ratio improving to 8.4% in Q3’2019, from 8.9% in Q3’2018. The main sectors that contributed to the NPLs are large enterprises and SMEs. In terms of the regional distribution of NPLs, the regions with the highest NPLs were Tanzania at 27.5% of their loan book, followed by South Sudan at 23.5% of their loan book. With the repeal of interest rate cap in Kenya, due to the Group’s focus on lending to the Small and Medium Enterprises (SMEs), we expect a slight deterioration of the loan book quality as the Group is set to lend more towards trade and real estate sectors.

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

i. Channelled 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 54.2%.

Below is a summary of the bank’s performance:

Balance Sheet Items	Q3'2018	Q3'2019	y/y change	Q3'2019e	Expected y/y change	Variance in Growth Actual vs. Expected
Government Securities	125.3	135.1	7.8%	154.9	23.6%	15.8%
Net Loans and Advances	288.4	348.9	21.0%	330.6	14.7%	(6.3%)
Total Assets	**560.4**	**677.1**	**20.8%**	**658.9**	**17.6%**	**(3.3%)**
Customer Deposits	402.2	478.1	18.9%	472.4	17.4%	(1.4%)
Total Liabilities	469.7	568.4	21.0%	550.1	17.1%	(3.9%)
Shareholders' Funds	**89.8**	**107.7**	**19.9%**	**107.8**	**20.0%**	**0.1%**

Balance Sheet Ratios	Q3'2018	Q3'2019	% y/y change
Loan to Deposit Ratio	71.7%	73.0%	1.3%
Return on average equity	24.7%	22.8%	(1.9%)
Return on average assets	3.9%	3.5%	(0.4%)

Income Statement	Q3'2018	Q3'2019	y/y change	Q3'2019e	Expected y/y change	Variance in Growth Actual vs. Expected
Net Interest Income	29.5	32.3	9.5%	32.0	8.5%	(1.0%)
Net non-Interest Income	19.8	22.5	13.7%	23.4	17.8%	4.1%
Total Operating income	**49.3**	**54.8**	11.2%	**55.4**	12.3%	1.1%
Loan Loss provision	(1.3)	(1.9)	41.8%	(1.8)	33.2%	(8.6%)
Total Operating expenses	(26.9)	(30.0)	11.7%	(29.7)	10.6%	(1.1%)
Profit before tax	22.4	24.8	10.6%	25.6	14.3%	3.7%
Profit after tax	**15.8**	**17.5**	10.4%	**17.9**	13.3%	2.9%
Core EPS	**4.2**	**4.6**	10.4%	**4.8**	13.3%	2.9%

Income Statement Ratios	Q3'2018	Q3'2019	y/y change
Yield from interest-earning assets	11.1%	10.9%	(0.2%)
Cost of funding	2.7%	2.6%	(0.1%)
Cost of risk	2.7%	3.4%	0.7%
Net Interest Margin	8.5%	8.4%	(0.1%)
Net Interest Income as % of operating income	59.8%	58.9%	(0.9%)
Non-Funded Income as a % of operating income	40.2%	41.1%	0.9%
Cost to Income	54.6%	54.8%	0.2%
Cost to Assets	4.7%	4.5%	(0.2%)

Capital Adequacy Ratios	Q3'2018	Q3'2019
Core Capital/Total Liabilities	21.0%	19.8%
Minimum Statutory ratio	10.5%	10.5%
Excess	**10.5%**	**9.3%**
Core Capital/Total Risk Weighted Assets	18.0%	16.7%
Minimum Statutory ratio	10.5%	10.5%
Excess	**7.5%**	**6.2%**
Total Capital/Total Risk Weighted Assets	18.0%	20.5%
Minimum Statutory ratio	14.5%	14.5%
Excess	**3.5%**	**6.0%**
Liquidity Ratio	55.0%	54.2%
Minimum Statutory ratio	20.0%	20.0%

Excess	**35.0%**	**34.2%**