

Valuation Summary

- We are of the view that I&M Holdings is a “Buy” with a target price of Kshs 169.5, representing an upside of 64.9%, from the current price of Kshs 100.0 as of 31st August, inclusive of a dividend yield of 3.5%,
- I&M Holdings is currently trading at P/TBV of 1.1x and a P/E of 8.1x vs an industry average of 1.6x and 9.5x, respectively.

Key Highlights H1'2018

- I&M Bank Limited, through its wholly owned subsidiary, I&M Insurance Agency Limited (IMIAL) completed the acquisition of Youjays Insurance Brokers Limited (YIB). The bank acquired 100.0% of the shareholding of the insurance broking firm, simultaneously merging its operations with the Group’s Bancassurance division. The acquisition underpins the Group’s efforts in expanding revenue streams for its non-funded income portfolio in line with its iMara corporate strategy. The bank’s insurance is expected to benefit from additional capacity and expertise to grow the Bancassurance business, which provides brokerage services for personal and commercial lines.

Income Statement

I&M Holdings released their H1'2018 results, registering core earnings per share growth of 11.7% to Kshs 8.8 from Kshs 7.9 in H1'2017, lower than our expectation of a 14.7% increase to Kshs 9.0. Performance was driven by a 9.9% increase in operating income to Kshs 10.6 bn from Kshs 9.6 bn in H1'2017, despite a 15.8% increase in operating expenses to Kshs 5.7 bn from Kshs 4.9 bn. Highlights of the performance from H1'2017 to H1'2018 include:

- Total operating income increased by 9.9% to Kshs 10.6 bn from Kshs 9.6 bn in H1'2017. This was due to a 34.4% increase in Non-Funded Income (NFI) to Kshs 3.7 bn from Kshs 2.8 bn in H1'2017, while Net Interest Income (NII) remained flat at Kshs 6.9 bn,
- Interest income increased by 5.1% to Kshs 11.7 bn from Kshs 11.1 bn in H1'2017. The interest income on loans and advances increased by 7.3% to Kshs 9.0 bn from Kshs 8.4 bn in H1'2017. Interest income on government securities remained flat at Kshs 2.6 bn in H1'2018. The yields on interest earning assets stood at 11.3% in H1'2018, a decline from 12.0% recorded in H1'2017,
- Interest expense increased by 13.2% to Kshs 4.8 bn from Kshs 4.2 bn in H1'2017, as interest expense on customer deposits increased by 16.6% to Kshs 4.2 bn from Kshs 3.6 bn in H1'2017. Interest expense on deposits from other banking institutions declined by 30.4% to Kshs 112.5 mn from Kshs 161.6 mn in H1'2017. The cost of funds decreased to 4.6% from 4.9% in H1'2017, indicating that cheaper non-interest bearing accounts were opened as deposits grew by 30.6%. The Net Interest Margin declined marginally to 7.1% from 7.2% in H1'2017,
- Non-Funded Income increased by an impressive 34.4% to Kshs 3.7 bn from Kshs 2.8 bn in H1'2017. The increase in NFI was driven by a 64.2% increase in fees and commission income on loans to Kshs 0.8 bn from Kshs 0.5 bn in H1'2017, coupled with a 39.2% increase in other income to Kshs 0.5 bn from Kshs 0.4 bn in H1'2017. Other fees and commissions increased by 27.0% to Kshs 1.2 bn from Kshs 1.0 bn in H1'2017, while forex trading income rose by 25.5% to Kshs 1.2 bn from Kshs 1.0 bn in H1'2017. The revenue mix shifted to 65:35 funded to non-funded income from 71:29 in H1'2017, owing to the faster increase in NFI compared to NII,

- Total operating expenses increased by 15.8% to Kshs 5.7 bn from Kshs 4.9 bn, largely driven by a 26.2% increase in loan loss provisions (LLP) to Kshs 1.4 bn in H1'2018 from Kshs 1.0 bn in H1'2017. Staff costs increased by 10.2% to Kshs 2.0 bn in H1'2018 from Kshs 1.9 bn in H1'2017,
- The cost to income ratio deteriorated marginally to 53.7% from 51.0% in H1'2017. Without LLP, however, the cost to income ratio improved to 40.4% from 41.0% in H1'2017, implying a higher cost of risk due to the increase in LLP,
- Profit before tax increased by 3.8% to Kshs 4.9 bn, up from Kshs 4.7 bn in H1'2017. Profit after tax increased by 12.8% to Kshs 3.9 bn in H1'2018 from Kshs 3.4 bn in H1'2017,

Balance Sheet

- The balance sheet recorded an expansion with total assets growth of 23.5% to Kshs 283.1 bn from Kshs 229.2 bn in H1'2017. This growth was largely driven by a 12.6% increase in net loans and advances to Kshs 162.8 bn in H1'2018 from Kshs 144.5 bn in H1'2017, and a 502.4% growth in deposits and balances due from banking institutions abroad to Kshs 38.6 bn from Kshs 6.4 bn in H1'2017. Government securities decreased by 28.3% to Kshs 36.1 bn from Kshs 50.4 bn in H1'2017,
- Total liabilities rose by 27.2% to Kshs 235.3 bn from Kshs 184.9 bn in H1'2017, driven by a strong 30.6% increase in customer deposits to Kshs 210.9 bn from Kshs 161.5 bn in H1'2017. Deposits per branch increased by 30.6% to Kshs 5.2 bn from Kshs 4.0 bn in H1'2017 as the bank has not increased its branch network from the current 42 branches,
- The faster growth in deposits compared to loan growth led to a decline in the loan to deposit ratio to 77.2% from 89.5% in H1'2017,
- Gross non-performing loans increased by 118.1% to Kshs 22.4 bn in H1'2018 from Kshs 10.3 bn in H1'2017. Consequently, the NPL ratio deteriorated to 13.0% in H1'2018 from 6.0% in H1'2017. General Loan loss provisions increased by 64.1% to Kshs 5.9 bn from Kshs 3.4 bn in H1'2017, hence an improvement in NPL coverage to 43.4% in H1'2018 from 33.6% in H1'2017,
- Shareholders' funds increased by 7.5% to Kshs 45.1 bn in H1'2018 from Kshs 41.9 bn in H1'2017,
- I&M Holdings is currently sufficiently capitalized with a core capital to risk weighted assets ratio of 16.5%, 6.0% above the statutory requirement. In addition, the total capital to risk weighted assets ratio was 18.2%, exceeding the statutory requirement by 3.7%. Adjusting for IFRS 9, the core capital to risk weighted assets stood at 16.5%, while total capital to risk weighted assets came in at 18.6%, indicating that the bank's total capital relative to its risk-weighted assets decreased by 0.4% due to the impact of IFRS 9,
- I&M Holdings currently has a return on average assets of 3.0% and a return on average equity of 17.2%.

Key Take-Outs:

- a. The asset quality of I&M Holdings deteriorated significantly, with gross NPLs increasing by 118.1% to Kshs 22.4 bn from Kshs 10.3 bn in the period under review, with the NPL ratio rising to 13.0% from 6.0% a year earlier. The bank had to raise its loan loss provisions by 26.2% in order to mitigate the effect of the rising bad loans to its asset quality.

Going forward, we expect the bank's growth to be further driven by:

- a. Non-Funded Income Growth Initiatives – I&M Holdings' NFI growth is improving as the bank focuses on digital innovation to augment transaction volumes and increase fee income. The bank needs to increase capacity of its brokerage and advisory businesses so as to increase income contribution from

investment and advisory services. The acquisition of Youjays Insurance Brokers provides the bank with an avenue to grow its bancassurance business, thereby putting the firm's NFI on a positive growth trajectory.

Balance Sheet	H1'2017	H1'2018	y/y change	H1'2018e	Expected y/y change	Variance in Actual Growth vs. Expected
Government Securities	50,371.6	36,131.3	(28.3%)	56,285.6	11.7%	(40.0%)
Net Loans and Advances	144,546.8	162,823.3	12.6%	165,165.8	14.3%	(1.6%)
Total Assets	229,223.8	283,070.1	23.5%	261,878.1	14.2%	9.2%
Customer Deposits	161,526.9	210,897.8	30.6%	184,542.8	14.2%	16.3%
Total Liabilities	184,856.1	235,255.7	27.3%	211,900.0	14.6%	12.6%
Shareholders Funds	41,929.8	45,084.9	7.5%	47,124.1	12.4%	(4.9%)

Balance sheet ratios	H1'2017	H1'2018	% y/y change
Loan to Deposit Ratio	89.5%	77.2%	(12.3%)
Return on average equity	17.2%	17.2%	(0.0%)
Return on average assets	3.0%	2.9%	(0.1%)

Income Statement	H1'2017	H1'2018	y/y change	H1'2018e	Expected y/y change	Variance in Actual Growth vs. Expected
Net Interest Income	6,861.3	6,865.8	0.1%	6,789.2	(1.1%)	1.1%
Net non-Interest Income	2,767.2	3,720.1	34.4%	3,658.3	32.2%	2.2%
Total Operating income	9,628.5	10,585.8	9.9%	10,447.5	8.5%	1.4%
Loan Loss provision	(965.6)	(1,411.9)	46.2%	(954.6)	(1.1%)	47.4%
Total Operating expenses	(4,909.8)	(5,687.3)	15.8%	(4,826.9)	(1.7%)	17.5%
Profit before tax	4,964.2	5,398.0	8.7%	5,620.6	13.2%	(4.5%)
Profit after tax	3,430.1	3,868.1	12.8%	3,934.4	14.7%	(1.9%)
Core EPS	7.9	8.8	11.7%	9.0	14.7%	(3.0%)

Income statement ratios	H1'2017	H1'2018	% y/y change
Yield from interest-earning assets	12.0%	11.3%	(0.7%)
Cost of funding	4.9%	4.6%	(0.3%)
Net Interest Margin	7.7%	7.1%	(0.6%)
Cost to Income	51.0%	53.7%	2.7%
Cost to Assets	2.1%	2.0%	(0.1%)
Net Interest Income as % of operating income	71.3%	64.9%	(6.4%)
Non-Funded Income as a % of operating income	28.7%	35.1%	6.4%

Capital Adequacy Ratios	H1'2017	H1'2018
Core Capital/Total Liabilities	23.9%	20.3%
Minimum Statutory ratio	8.0%	8.0%
Excess	15.9%	12.3%
Core Capital/Total Risk Weighted Assets	21.2%	16.5%
Minimum Statutory ratio	10.5%	10.5%
Excess	10.7%	6.0%
Total Capital/Total Risk Weighted Assets	23.1%	18.2%
Minimum Statutory ratio	14.5%	14.5%
Excess	8.6%	3.7%

Adjusted Core Capital/Total Liabilities		20.4%
Adjusted Core Capital/Total Risk Weighted Assets		16.5%
Adjusted Total Capital/Total Risk Weighted Assets		18.6%
Liquidity Ratio	39.3%	45.5%
Minimum Statutory ratio	20.0%	20.0%
Excess	19.3%	25.5%