I&M Holdings– Q3'2018

30th November, 2018

Valuation Summary

- We are of the view that I&M Holdings is a "***buy***" with a target price of Kshs 138.6, representing an upside of 59.7%, from the current price of Kshs 85.0 as of 30th November 2018, inclusive of a dividend yield of 3.9%,
- I&M Holdings is currently trading at P/TBV of 0.9x and a P/E of 6.4x vs an industry average of 1.4x and 6.7x, respectively.

Key Highlights Q3'2018

- Dutch Development Bank FMO granted a loan of USD 40.0 mn to I&M Bank Kenya, to boost lending to small and medium-sized enterprises in the country. The facility will support the expansion of I&M Bank's strategy to increase its SME loan book, boosting the local economy in the process.

Income Statement

- Core earnings per share increased by 21.4% to Kshs 13.4 from Kshs 11.0 in Q3'2017, in line with our projections of a 22.6% growth to Kshs 13.5. The performance was driven by a 6.8% increase in total operating income to Kshs 15.8 bn from 14.8 bn in Q3'2017, despite being weighed down by the 5.4% increase in the total operating expenses to Kshs 8.2 bn from Kshs 7.8 bn in Q3'2017,
- Total operating income increased by 6.8% to Kshs 15.8 bn from Kshs 14.8 bn in Q3'2017. This was due to a 38.4% increase in Non-Funded Income (NFI) to Kshs 5.6 bn, from Kshs 4.0 bn in Q3'2017, which outpaced the 4.9% decrease in Net Interest Income (NII) to Kshs 10.3 bn, from Kshs 10.8 bn in Q3'2017,
- Interest income increased by 3.3% to Kshs 17.9 bn, from Kshs 17.3 bn in Q3'2017, largely driven by the 4.0% growth in interest income on loans and advances to Kshs 13.7 bn from Kshs 13.1 bn in Q3'2017. Interest income on government securities remained flat at Kshs 4.0 bn. Interest income on deposits and placements with banking institutions rose by 74.6% to Kshs 0.2 bn from Kshs 0.1 bn in Q3'2017. However, the yield on interest earning assets declined to 8.0% in Q3'2018, from 8.7% in Q3'2017, due to a relatively faster growth in the interest earning assets by 15.3% to of 240.8bn from 208.7 bn in Q3'2017,
- Interest expense increased by 16.8% to Kshs 7.6 bn, from Kshs 6.5 bn in Q3'2017, following a 14.5% increase in the interest expense on customer deposits to Kshs 6.4 bn, from Kshs 5.8 bn in Q3'2017. Interest expense on deposits and placements from banking institutions increased by 114.8% to Kshs 0.5 bn from Kshs 0.2 bn in Q3'2017. Thus, the cost of funds increased to 4.8%, from 3.8% in Q3'2017. As a consequence, the Net Interest Margin (NIM) declined to 6.7%, from 7.7% in Q3'2017,
- Non-Funded Income (NFI) increased by 38.4% to Kshs 5.6 bn, from Kshs 4.0 bn in Q3'2017. The growth in NFI was largely driven by the 48.0% growth in Fees and commission income on loans to Kshs 1.2 bn from Kshs 0.8 bn in Q3'2017, coupled with a 42.6% growth in foreign exchange trading income to Kshs 1.9 bn from Kshs 1.3 bn in Q3'2017. Furthermore, other fees and commission income grew by 20.3% to Kshs 1.8 bn, from Kshs 1.5 bn in Q3'2017. As a result of the above performance, the current revenue mix shifted to 65:35 funded to non-funded income as compared to 73:27 in Q3'2017.
- Total operating expenses increased by 5.4% to Kshs 8.2 bn, from Kshs 7.8 bn in Q3'2017, largely driven by a 8.3% increase in staff cost to Kshs 3.1 bn in Q3'2018, from Kshs 2.9 bn in Q3'2017, coupled with a 6.7% increase in other expenses to Kshs 3.2 bn in Q3'2018, from Kshs 3.0 bn in Q3'2017. Loan Loss provision (LLP) however declined marginally by 1.1% to Kshs 1.91 bn from Kshs 1.90 bn in Q3'2017,
- As a result, Cost to Income Ratio (CIR) improved to 51.7%, from 52.4% in Q3'2017. Without LLP, the cost to income ratio deteriorated, albeit marginally, to 39.7%, from 39.5% in Q3'2017,
- Profit before tax increased by 11.9% to Kshs 8.3 bn from Kshs 7.4 bn in Q3'2017. Profit after tax increased by 18.3% to Kshs 5.9 bn in Q3'2018, from Kshs 4.9 bn in Q3'2017.

Balance Sheet

- The balance sheet recorded an expansion as total assets increased by 22.4% to Kshs 289.6 bn, from Kshs 236.6 bn in Q3’2017. This growth was largely driven by a 304.0% increase in deposits and placements with banking institutions to Kshs 34.1 bn from Kshs 8.4 bn in Q3’2017, coupled with a 8.6% increase in the loan book to Kshs 163.3 bn, from Kshs 150.5 bn in Q3’2017, despite a 13.0% decline in government securities to Kshs 43.4 bn from Kshs 49.9 bn in Q3’2017,
- Total liabilities rose by 25.7% to Kshs 239.8 bn, from Kshs 190.8 bn in Q3’2017, driven by a 27.6% increase in total deposits to Kshs 209.0 bn, from Kshs 163.8 bn in Q3’2017. Placement liabilities increased by 86.8% to Kshs 12.4 bn from Kshs 6.6 bn in Q3’2017. Borrowed funds however decreased by 2.2% to Kshs 12.0 bn from Kshs 12.3 bn in Q3’2017,
- The faster growth in deposits as compared to loans led to a decline in the loan to deposit ratio to 78.1% from 91.8% in Q3’2017. The proportion of government securities to deposits decreased to 20.8% from 30.5% in Q3’2017,
- Gross Non-Performing Loans (NPLs) increased by 94.2% to Kshs 22.1 bn in Q3’2018 from Kshs 11.4 bn in Q3’2017. Consequently, the NPL ratio deteriorated to 12.7% in Q3’2018 from 7.2% in Q3’2017. General Loan Loss Provisions (LLPs) increased by 59.0% to Kshs 5.9 bn from Kshs 3.7 bn in Q3’2017. The NPL coverage declined to 49.2% in Q3’2018 from 62.2% in Q3’2017, despite a 48.1% increase in interest in suspense to Kshs 5.0 bn, from Kshs 3.4 bn in Q3’2017. The decline in the specific provisions by 1.1% to Kshs 1.91 bn from Kshs 1.90 bn in Q3’2017 despite a deterioration in asset quality, is due to banks being allowed to charge provisions on equity, on the initial implementation of IFRS 9,
- Shareholders’ funds increased by 8.7% to Kshs 47.0 bn in Q3’2018 from Kshs 43.2 bn in Q3’2017. The growth was mainly driven by a 19.4% increase in the statutory loan loss reserves to Kshs 1.4 bn from Kshs 1.2 bn in Q3’2017, coupled with a 9.8% increase in the revaluation reserve to Kshs 0.8 bn from Kshs 0.7 bn in Q3’2017,
- I&M Holdings is currently sufficiently capitalized with a core capital to risk weighted assets ratio of 15.3%, 4.8% points above the statutory requirement. In addition, the total capital to risk weighted assets ratio was 16.9%, exceeding the statutory requirement by 2.4% points. Adjusting for IFRS 9, the core capital to risk weighted assets stood at 15.3%, while total capital to risk weighted assets came in at 17.3%, indicating that the bank’s total capital relative to its risk-weighted assets increased by 0.4% points due to implementation of IFRS 9,
- The bank currently has a Return on Average Assets (ROaA) of 2.9%, and a Return on Average Equity (ROaE) of 17.2%.

Key Take-Outs:

a) The bank had a deterioration in its asset quality, with the gross NPLs rising by 94.2% y/y, as the industry wide asset quality continues to deteriorate, sighting delayed government payments coupled with the relatively tighter macroeconomic environment, affecting borrowers’ credit servicing ability,
b) The bank managed to improve the Non- Funded Income by 38.4%. This shows the bank’s improved focus on digital innovation and alternative banking channels, which enhanced the increase in the fee income hence increasing the total operating income.

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 and alternative banking channels to increase fee income. The bank needs to increase capacity of its brokerage and advisory services and these will go a long way to grow the bank’s fee income, and,
b. **Geographical Diversification** – The bank has been aggressively expanding into other regions, namely Tanzania, Rwanda and Uganda. This is expected to drive growth in the near future.

Below is a summary of the bank’s performance:

Balance Sheet	Q3'2017	Q3'2018	y/y change	Q3'2018e	Expected y/y change	Variance in Actual Growth vs. Expected
Government Securities	49,891.3	43,389.4	(13.0%)	66,032.1	32.4%	(45.4%)
Net Loans and Advances	150,460.2	163,327.4	8.6%	170,405.4	13.3%	(4.7%)
Total Assets	**236,634.7**	**289,595.3**	**22.4%**	**291,423.8**	**23.2%**	**(0.8%)**
Customer Deposits	163,846.7	209,040.9	27.6%	213,006.8	30.0%	(2.4%)
Total Liabilities	**190,823.8**	**239,815.1**	**25.7%**	**241,097.7**	**26.3%**	**(0.7%)**
Shareholders’ Funds	**43,232.0**	**47,009.1**	**8.7%**	**47,596.4**	**10.1%**	**(1.4%)**

Balance sheet ratios	Q3'2017	Q3'2018	% y/y change
Loan to Deposit Ratio	91.8%	78.1%	(13.7%)
Return on average equity	14.9%	17.2%	2.2%
Return on average assets	2.6%	2.9%	0.3%

Income Statement	Q3'2017	Q3'2018	y/y change	Q3'2018e	Expected y/y change	Variance in Actual Growth vs. Expected
Net Interest Income	10,813.7	10,284.6	(4.9%)	10,008.3	(7.4%)	2.6%
Net non-Interest Income	4,017.6	5,560.3	38.4%	5,095.6	26.8%	11.6%
Total Operating income	**14,831.3**	**15,844.9**	**6.8%**	**15,103.9**	**1.8%**	**5.0%**
Loan Loss provision	(1,919.0)	(1,898.3)	(1.1%)	(2,211.9)	15.3%	(16.3%)
Total Operating expenses	(7,772.5)	(8,188.7)	5.4%	(7,130.6)	(8.3%)	13.6%
Profit before tax	**7,410.1**	**8,290.7**	**11.9%**	**7,973.4**	**7.6%**	**4.3%**
Profit after tax	4,947.6	5,850.8	18.3%	5,581.3	12.8%	5.4%
Core EPS	**11.0**	**13.4**	**21.4%**	**13.5**	**22.6%**	**(1.2%)**

Income statement ratios	Q3'2017	Q3'2018	% y/y change
Yield from interest-earning assets	8.7%	8.0%	(0.7%)
Cost of funding	3.8%	4.8%	1.0%
Net Interest Margin	7.7%	6.7%	(1.1%)
Cost to Income	52.4%	51.7%	(0.7%)
Cost to Assets	3.3%	2.8%	(0.5%)
Net Interest Income as % of operating income	72.9%	64.9%	(8.0%)
Non-Funded Income as a % of operating income	27.1%	35.1%	8.0%

Capital Adequacy Ratios	Q3'2017	Q3'2018
Core Capital/Total Liabilities	23.4%	20.2%
Minimum Statutory ratio	8.0%	8.0%
Excess	**15.4%**	**12.2%**
Core Capital/Total Risk Weighted Assets	22.7%	15.3%
Minimum Statutory ratio	10.5%	10.5%
Excess	**12.2%**	**4.8%**
Total Capital/Total Risk Weighted Assets	24.8%	16.9%
Minimum Statutory ratio	14.5%	14.5%

Excess	**10.3%**	**2.4%**
Liquidity Ratio	39.5%	47.8%
Minimum Statutory ratio	20.0%	20.0%
Excess	**19.5%**	**27.8%**
Adjusted Core Capital/Total Liabilities		**20.3%**
Adjusted Core Capital/Total RWA		**15.3%**
Adjusted Total Capital/Total RWA		**17.3%**

**Adjusted ratios in line with CBK’s guidance note, with provisions added back for capital computation purposes*