National Bank of Kenya Ltd– Q3'2018
30th November, 2018

Valuation Summary

- We are of the view that National Bank of Kenya Ltd is an "***sell***" with a target price of Kshs 4.9, representing a downside of 14.3%, from the current price of Kshs 5.7 as of 30th November 2018, inclusive of a dividend yield of 0.0%,
- National Bank of Kenya Ltd is currently trading at P/TBV of 0.4x and a P/E of 6.5x vs an industry average of 1.4x and 6.7x, respectively.

Key Highlights Q3'2018

- National Bank of Kenya launched its deposit mobilization plan, by offering customers relatively higher rates, depending on the deposit amount, with rates ranging between 1.0% and 7.0%. Savers with deposits of more than Kshs 2.0 mn will earn 7.0% interest while those with between Kshs 50,001 and Kshs 2.0 mn will earn 5.0% interest. Those with between Kshs 5,001 and Kshs 50,000 will be paid 1.0% interest on their deposits.

Income Statement

- Core EPS increased by 303.2% to Kshs 1.7, from Kshs 0.4 in Q3'2017, exceeding our expectation a decrease to a loss per share of Kshs 0.3. However, this was due to the stripping out of an exceptional expense of Kshs 0.5 bn. The bank registered an 84.1% decline in the profit after tax to Kshs 22.0 mn from Kshs 138.1 mn in Q3'2017. The performance was driven by an 11.8% decline in total operating income to Kshs 5.6 bn from Kshs 6.4 bn, which outweighed the 16.5% decline in the total operating expenses to Kshs 5.2 bn from Kshs 6.2 bn in Q3'2017. The variance in core earnings per share growth against our expectations was largely due to the 16.5% decline in total operating expenses to Kshs 5.2 bn from Kshs 6.2 bn, largely due to the write back in Loan Loss Provisions (LLP) of Kshs 0.2 bn, from an expense of Kshs 0.5 bn in Q3'2017. We had anticipated a provisioning expense of Kshs 0.5 bn in Q3'2018,
- Total operating income declined by 11.8% to Kshs 5.6 bn from Kshs 6.4 bn in Q3'2017. This was due to a 10.0% decline in Net Interest Income (NII) to Kshs 4.1 bn from Kshs 4.6 bn, coupled with the 16.3% decline in Non-Funded Income (NFI) to Kshs 1.5 bn, from Kshs 1.8 bn,
- Interest income declined by 10.5% to Kshs 6.3 bn, from Kshs 7.1 bn in Q3'2017. This was caused by an 18.0% decline in interest income from loans and advances to Kshs 3.1 bn, from Kshs 3.8 bn in Q3'2017, a 0.8% decline in interest income from government securities to Kshs 3.18 bn, from Kshs 3.21 bn in Q3'2017, and a 44.9% decline in interest income on deposits and placements with other banking institutions, to Kshs 0.05 bn from Kshs 0.09 bn in Q3'2017. The yield on interest earning assets remained at 9.6%,
- Interest expense declined by 11.5% to Kshs 2.2 bn, from Kshs 2.5 bn, following an 11.8% decline in the interest expense on customer deposits to Kshs 2.0 bn, from Kshs 2.3 bn in Q3'2017, coupled with an 8.5% decline in Interest expense on deposits and placements from banking institutions to Kshs 0.21 bn from Kshs 0.23 bn in Q3'2017. As a result, of the decrease in interest expenses, the cost of funds declined to 3.0%, from 3.4% in Q3'2017. The Net Interest Margin (NIM) thus rose to 6.6%, from 6.1% in Q3'2017,
- Non-Funded Income (NFI) declined by 16.3% to Kshs 1.5 bn, from Kshs 1.8 bn in Q3'2017. This was largely due to the 32.1% decline in fees and commissions on loans to Kshs 96.2 mn, from Kshs 141.6 mn in Q3'2017, coupled with the 16.8% decline in other fees and commission income to Kshs 0.8 bn, from Kshs 1.0 bn in Q3'2017.Futhermore, other income declined by 28.3% to Kshs 0.2 bn, from Kshs 0.3 bn in Q3'2017 while foreign exchange trading income declined by 2.4% to Kshs 0.40 bn from Kshs 0.42 bn in Q3'2017. As a result of the above performance, the current revenue mix shifted to 73:27 funded to non-funded income as compared to 72:28 in Q3'2017, with the NFI as proportion of total operating income decreasing owing to its faster decline than NII,

- Total operating expenses declined by 16.5% to Kshs 5.2 bn, from Kshs 6.2 bn, largely driven by a write back in Loan Loss Provisions (LLP) of Kshs 0.2 bn in Q3’2018, from a Loan Loss Provision expense of Kshs 0.5 bn in Q3’2017, coupled with a 10.5% decline in other operating expenses to Kshs 2.5 bn in Q3’2018, from Kshs 2.8 bn in Q3’2017. However, staff costs rose marginally by 0.7% to Kshs 2.92 bn from Kshs 2.90 bn in Q3’2017,
- Consequently, the Cost to Income Ratio (CIR) improved to 91.8%, from 96.9% in Q3’2017. However, without LLP, the cost to income ratio deteriorated to 95.9%, from 88.8% in Q3’2017,
- Profit before tax and exceptional items increased by 135.3% to Kshs 0.5 bn, up from Kshs 0.2 bn in Q3’2017. Profit after tax and exceptional items declined by 84.1% to Kshs 0.02 bn in Q3’2018, from Kshs 0.1 bn in Q3’2017, owing to the exceptional items expense of Kshs 0.5 bn incurred in Q3’2018.

Balance Sheet

- The balance sheet recorded a contraction as total assets decreased by 3.3% to Kshs 112.5 bn from Kshs 116.3 bn in Q3’2017. This decline was largely driven by a 17.1% decline in the net loans and advances to Kshs 48.0 bn, from Kshs 57.9 bn in Q3’2017, which outweighed the 3.2% increase in the government securities to Kshs 41.0 bn, from Kshs 39.7 bn in Q3’2017, and the 22.3% increase in other assets to Kshs 9.1 bn from Kshs 7.4 bn in Q3’2017,
- Total liabilities rose marginally by 0.4% to Kshs 105.5 bn from Kshs 105.1 bn in Q3’2017, driven by a 168.8% increase in placement liabilities to Kshs 5.8 bn from Kshs 2.2 bn in Q3’2017, coupled with a 24.0% rise in other liabilities to Kshs 6.8 bn from Kshs 5.5 bn in Q3’2017. These were however weighed down by a 4.7% decline in customer deposits to Kshs 92.8 bn from Kshs 97.4 bn in Q3’2017. Deposits per branch rose by 2.1% to Kshs 1.33 bn, from Kshs 1.30 bn in Q3’2017, with 5 branches closed during the period to bring the total number of branches to 70,
- The faster decline in loans as compared to deposits led to an decrease in the loan to deposit ratio to 51.7%, from 59.4% in Q3’2017.The proportion of government securities to deposits increased, to 44.2% from 38.1% in Q3’2017, owing to an increase in government securities coupled with a decline in deposits,
- Gross Non-Performing Loans (NPLs) increased by 4.3% to Kshs 30.9 bn in Q3’2018, from Kshs 29.6 bn in Q3’2017. Consequently, the NPL ratio deteriorated to 47.1% in Q3’2018, from 43.8% in Q3’2017. General Loan Loss Provisions (LLPs) increased by 113.3% to Kshs 13.3 bn from Kshs 6.2 bn in Q3’2017. Thus, as a consequence, the NPL coverage improved to 57.1% in Q3’2018 from 33.0% in Q3’2017. The write back in specific provisions despite a deterioration in asset quality, is due banks being allowed to charge provisions on equity, on the initial implementation of IFRS 9,
- Shareholders’ funds declined by 37.6% to Kshs 7.0 bn in Q3’2018 from Kshs 11.2 bn in Q3’2017, as retained earnings of Kshs 2.1 bn in Q3’2017 were depleted, to accumulated losses of Kshs 5.0 bn in Q3’2018, outweighing the 203.3% increase in statutory loan loss reserves to Kshs 3.8 bn from Kshs 1.3 bn in Q3’2017,
- National Bank of Kenya Ltd remains severely undercapitalized with a core capital to risk weighted assets ratio of 2.6%, 7.9% points below the statutory requirement. In addition, the total capital to risk weighted assets ratio was 4.1%, below the statutory requirement by 10.4% points. Adjusting for IFRS 9, the core capital to risk weighted assets stood at 3.1%, while total capital to risk weighted assets came in at 4.5%, indicating that the bank’s total capital relative to its risk-weighted assets declined by 0.4% points on implementation of IFRS 9,
- The bank currently has a Return on Average Assets (ROaA) of 0.3% and a Return on Average Equity (ROaE) of 3.2%.

Key Take-Outs:

a) National Bank remains severely undercapitalized with the total capital to risk-weighted assets ratio coming in at 4.1%, 10.4% points below the 14.5%, as required by regulation. The bank has been granted exemption to operate below the regulatory requirement, with the promise of mobilizing capital to meet the requirements, by both debt and a rights issue. With such depleted capital reserves, the bank becomes increasingly vulnerable to any future external shocks that may affect its continuity in the future, in addition to rendering the bank unable to issue new loans.
b) The bank experienced a deterioration in its asset quality, with the NPL ratio rising to 47.1% from 43.8% in Q3’2017, and is still the highest in the listed banking space, thus requiring the bank needs to adopt a raft of corrective measures to improve on the overall asset quality. The bank’s lending activities have continued to be hampered by the poor asset quality, as corrective and recovery efforts seem not to be bearing fruit, leading to a decline in its interest income, as well as the associated fees and commission income.
c) The bank recorded declines in all of its revenue lines, as the bank has failed to adapt to a tough operating environment occasioned by the interest rate cap, and a severe drought that affected the country, and whose effects spilled over to the current year. This consequently led to the overall decline in the operating profit as they were not matched proportionate declines in the operating expenses. Furthermore, the bank incurred an exceptional items expense of Kshs 0.5 bn, which negatively affected the bank’s profitability.

The bank could improve its poor performance, and could focus on the following to improve:

i. We are of the view that the bank may need to be privatized as the core step to address its underperformance. With the bank’s efforts of a rights issue being delayed, the bank is in a precarious position, with privatization offering the bank an easier capital raising route, other than the planned rights issue or the issuance of subordinated debt. Another initiative would be the sale of non-core assets such as land owned, and,
ii. National bank has the worst asset quality in the listed banking space. At this level of NPL, a restructuring to separate the “good bank” from the “bad bank” is necessary to resolve the bad portfolio. It will be difficult for the bank to focus on growth with such a bad portfolio. A restructuring would enable the bank to resume its core activities such as lending, which would aid in improving the Net Interest Income, and consequently the associated fee and commission income, and in the process instill confidence in the public thereby aiding in improving its deposit mobilization capacity.

Below is a summary of the bank’s performance:

Balance Sheet Items	Q3'2017	Q3'2018	y/y change	Q3'2018e	Projected %y/y change	Variance in Growth Actual vs. Expected
Government Securities	39.7	41.0	3.2%	39.9	0.5%	2.8%
Net Loans and Advances	57.9	48.0	(17.1%)	47.5	(17.9%)	0.8%
Total Assets	**116.3**	**112.5**	**(3.3%)**	**112.5**	**(3.3%)**	**(0.0%)**
Customer Deposits	97.4	92.8	(4.7%)	95.0	(2.5%)	(2.3%)
Total Liabilities	**105.1**	**105.5**	**0.4%**	**106.9**	**1.8%**	**(1.4%)**
Shareholders’ Funds	11.2	7.0	(37.6%)	5.5	(50.7%)	13.1%

Balance Sheet Ratios	Q3'2017	Q3'2018	y/y change
Loan to Deposit Ratio	59.4%	51.7%	(7.7%)
Return on average equity	(2.8%)	3.2%	6.0%
Return on average assets	(0.3%)	0.3%	1.8%

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Income Statement	Q3'2017	Q3'2018	y/y change	Q3'2018e	Projected % y/y change	Variance in Growth Actual vs. Expected
Net Interest Income	4.6	4.1	(10.0%)	4.4	(4.7%)	(5.3%)
Net non-Interest Income	1.8	1.1	(41.6%)	1.7	(8.1%)	(33.5%)
Total Operating income	6.4	5.6	(11.8%)	6.0	(5.7%)	(6.1%)
Loan Loss provision	(0.52)	0.2	-	(0.50)	(3.4%)	(141.6%)
Total Operating expenses	(6.2)	(5.2)	(16.5%)	(6.1)	(0.8%)	(15.6%)
Profit before tax	0.2	0.5	135.3%	(0.6)	-	-
Profit after tax	**0.1**	**0.0**	**(84.1%)**	**(0.6)**	**-**	**-**
Core EPS	**0.4**	**1.6**	**303.2%**	**(0.3)**	**-**	**-**

Income Statement Ratios	Q3'2017	Q3'2018	y/y change
Yield from interest-earning assets	9.6%	9.6%	0.1%
Cost of funding	3.4%	3.0%	(0.4%)
Net Interest Spread	6.2%	6.7%	0.5%
Net Interest Income as % of operating income	71.7%	73.2%	1.4%
Non-Funded Income as a % of operating income	28.3%	26.8%	(1.4%)
Cost to Income	96.9%	91.8%	(5.2%)
Cost to Assets	4.9%	4.7%	(0.2%)

Capital Adequacy Ratios	Q3'2017	Q3'2018
Core Capital/Total deposit Liabilities	9.1%	2.5%
Minimum Statutory ratio	8.0%	8.0%
Excess	**1.1%**	**(5.5%)**
Core Capital/Total Risk Weighted Assets	9.8%	2.6%
Minimum Statutory ratio	10.5%	10.5%
Excess	**(0.7%)**	**(7.9%)**
Total Capital/Total Risk Weighted Assets	11.3%	4.1%
Minimum Statutory ratio	14.5%	14.5%
Excess	**(3.2%)**	**(10.4%)**
Liquidity Ratio	34.0%	38.8%
Minimum Statutory ratio	20.0%	20.0%
Excess	**14.0%**	**18.8%**
Adjusted Core Capital/Total Deposit Liabilities		2.0%
Adjusted Core Capital/Total Risk Weighted Assets		3.1%
Adjusted Total Capital/Total Risk Weighted Assets		4.5%

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