National Bank of Kenya Earnings Update – H1'2017

28th July, 2017

Valuation Summary

- We are of the view that the NBK stock is a "Sell" with a target price of Kshs 4.0 per share, representing a downside of 59.8%, from the current price of Kshs 10.0 per share, as at 28th July, 2017,
- National Bank is currently trading at a P/B of 0.3x and a normalized P/E of 8.8x, vs an industry average of 1.5x and 7.3x, respectively.

Key Highlights During H1'2017

- NBK expects to secure a Kshs 4.4 bn shareholder loan from its top 2 shareholders, NSSF and the National Treasury, by end of September this year. The bank already received approval for a Kshs 2.9 bn shareholder loan from NSSF, with the balance expected to be obtained from the government,

- NBK shareholders approved the capitalization of the sum of Kshs 154.0 mn, through distribution amongst the existing shareholders in the proportion of one new share for every 10 shares held by existing shareholders, equivalent to 30.79 mn shares at Kshs 5.0 each.

Income Statement

- Core earnings per share declined by 42.2% to Kshs 0.6 from Kshs 1.0 in H1'2016, exceeding our expectations of a 95.7% decline to Kshs 0.04, attributed to a 29.8% decline in operating income, despite a 28.8% decrease in operating expenses,
- Total operating income declined by 29.8% to Kshs 4.1 bn from Kshs 5.8 bn in H1'2016, against our estimate of a 13.5% decline to Kshs 5.0 bn. This was attributed to a 35.5% decline in Net Interest Income coupled by an 11.3% decline in Non Funded Income,
- The 35.5% drop in Net Interest Income (NII) was attributed to a 34.6% decline in interest income to Kshs 4.6 bn from Kshs 7.0 bn in H1'2016 as a result of lower yield, following the capping of interest rates, despite a 33.0% decline in interest expense to Kshs 1.7 bn from Kshs 2.5 bn in H1'2016. The Net Interest Margin declined to 6.9% from 7.2% in H1'2016,
- Non-funded income (NFI) declined by 11.3% to Kshs 1.2 bn from Kshs 1.4 bn in H1'2016, against our expectation of a 3.0% growth to Kshs 1.4 bn. The decrease in NFI was attributed to a 10.1% decline in other fees and commissions to Kshs 0.7 bn from Kshs 0.8 bn in H1'2016 and a 54.1% decline in other income to Kshs 0.2 bn from 0.3 bn in H1'2016. The current revenue mix stands at 70:30 funded to non-funded income from 75:25 in H1'2016,
- Total operating expenses decreased by 28.8% to Kshs 3.8 bn from Kshs 5.4 bn in H1'2016 following an 85.5% decline in Loan Loss Provisions (LLP) to Kshs 0.2 bn from Kshs 1.6 bn in H1'2016, due to better lending practices, following the operationalization of the Banking (Amendment) Act 2015. However, staff costs increased by 5.5% to Kshs 1.9 bn from Kshs 1.8 bn in H1'2016. Without LLP, operating expenses declined by 4.4% to Kshs 3.6 bn from Kshs 3.8 bn registered in H1'2016,
- Cost to Income ratio worsened to 93.7% from 92.4% in H1'2016, attributable to the 29.8% decline in operating income, brought about by suppressed income, following the capping of interest rates. Without LLP, the CIR slightly deteriorated to 85.8% from 85.6% in H1'2016,
- Profit before tax decreased by 41.4% to Kshs 0.3 bn from Kshs 0.4 bn in H1'2016, against our expectations for a 95.6% decrease to Kshs 0.02 bn. The effective tax rate increased slightly to 30.0% from 29.0% in H1'2016,
- Profit after tax decreased by 42.2% to Kshs 0.2 bn from Kshs 0.3 bn in H1'2016.

Balance Sheet

- The balance sheet was almost flat, with total assets coming in at Kshs 116.6 bn from Kshs 116.5 bn in H1'2016, driven by a 823.9% growth in placements to Kshs 2.3 bn from Kshs 0.3 bn in H1'2016, which offset a 12.0% contraction in the loan book,
- The loan book contracted by 12.0% to Kshs 57.0 bn from Kshs 64.8 bn in H1'2016, slower than our expectation of a 13.2% contraction to Kshs 56.2 bn,
- Total liabilities remained flat at Kshs 105.2 bn, while shareholders' funds grew marginally by 0.6% to Kshs 11.43 bn from Kshs 11.36 bn,
- Customer deposits grew by 3.4% to Kshs 98.8 bn from Kshs 95.6 bn in H1'2016,

- The decline in loans and growth in deposits led to a decline in the loan to deposit ratio to 57.7% from 67.8% in H1'2016,
- Gross non-performing loans increased by 6.3% to Kshs 29.0 bn from Kshs 27.3 bn leading to an increase in NPL ratio to 43.6% from 41.1% in H1'2016,
- The yield on interest earning assets declined to 10.4% from 13.1% in H1'2016, while the cost of funds also decreased to 3.5% from 5.7%,
- National Bank is currently not sufficiently capitalized with a core capital to risk weighted assets ratio at 11.3%, just 0.8% above the statutory requirement of 10.5%, and total capital to total risk weighted assets falling below statutory requirement of 14.5% by 2.7% to close the period at 11.8%,
- NBK currently has a return on average assets of 0.03% and a return on average equity of 0.3%.

Key Take Outs

- NBK outperformed our expectations of a 95.7% decline in core EPS, mainly attributed to a faster decline in operating expenses of 28.8% compared to our projection of a 2.1% decrease, which resulted from a higher than expected decline in LLP of 81.2% versus our projection of a 6.8% decline,
- Another key point to note is that NBK continues to reduce its level of provisioning, despite growth in non-performing loans and contrary to the current industry trend of providing more pending adoption of IFRS 9,
- NBK's Cost to Income ratio remains high at 93.7% compared to an industry average of 64.0%, despite continued reduction in provisioning,
- NBK still remains under-capitalized with the total capital to total risk-weighted assets falling below the statutory requirement of 14.5% by 2.7%.

Moving forward, National Bank of Kenya's growth is expected to be supported by:

a) Successful revamping of its Small Enterprise banking segment and the Amanah business segment. The bank has also partnered with institutions to offer real-time collections through its Payment Gateway platform for institutions, which is expected to drive their deposits as well as reduce its cost of funding,

b) Management of expenses, which will enable the bank control its high cost-to-income ratio, currently at 93.7%.

Below is a summary of the key line items in the balance sheet and income statement

Figures in Kshs billions unless otherwise stated

Balance Sheet Items	H1'2016	H1'2017	y/y change	H1'2017e	Projected %y/y change	Variance in Growth Actual vs. Expected
Government Securities	28.2	37.6	33.4%	33.7	19.6%	13.8%
Net Loans and Advances	64.8	57.0	(12.0%)	56.2	(13.2%)	1.2%
Total Assets	**116.5**	**116.6**	**0.1%**	**116.8**	**0.2%**	**(0.1%)**
Customer Deposits	95.6	98.8	3.4%	93.7	(2.0%)	5.3%
Total Liabilities	105.2	105.2	0.0%	105.5	0.3%	(0.3%)
Shareholders' Funds	**11.4**	**11.4**	**0.6%**	**11.3**	**(0.8%)**	**1.3%**

Balance Sheet Ratios	H1'2016	H1'2017	y/y change
Loan to Deposit Ratio	67.8%	57.7%	(10.1%)
Return on average equity	(20.9%)	0.3%	21.2%
Return on average assets	(2.1%)	0.0%	2.2%
Yield from Interest-earning assets	13.1%	10.4%	(2.7%)
Cost of Funding	5.7%	3.5%	(2.2%)
Net Interest Margin	7.2%	6.8%	(0.4%)
Cost to Income	92.5%	93.7%	1.3%

Income Statement	H1'2016	H1'2017	y/y change	H1'2017e	Projected %y/y change	Variance in Growth Actual vs. Expected
Net Interest Income	4.4	2.9	(35.5%)	3.6	(18.6%)	(16.9%)

Non-Interest Income	1.4	1.2	(11.3%)	1.4	3.0%	(14.3%)
Total Operating income	**5.8**	**4.1**	**(29.8%)**	**5.0**	**(13.5%)**	**(16.3%)**
Loan Loss provision	1.6	0.2	(85.5%)	1.3	(21.4%)	(64.1%)
Total Operating expenses	**5.4**	**3.8**	**(28.8%)**	**5.0**	**(6.8%)**	**(22.0%)**
Profit before tax	0.4	0.3	(41.4%)	0.0	(95.6%)	54.2%
Profit after tax	**0.3**	**0.2**	**(42.2%)**	**0.0**	**(95.7%)**	**53.5%**
Core EPS	**1.0**	**0.6**	**(42.2%)**	**0.0**	**(95.7%)**	**53.5%**

Income Statement Ratios	H1'2016	H1'2017	y/y change
Yield from interest-earning assets	13.1%	10.4%	(2.7%)
Cost of funding	5.7%	3.5%	(2.2%)
Net Interest Margin	7.2%	6.8%	(0.4%)
Cost of Risk	27.9%	5.8%	(22.1%)
Net Interest Income as % of operating income	76.4%	70.2%	(6.2%)
Non-Funded Income as a % of operating income	23.6%	29.8%	6.2%
Cost to Income Ratio	92.4%	93.7%	1.3%
CIR without provisions	85.6%	85.8%	0.2%
Cost to Assets	6.5%	6.9%	0.3%

Capital Adequacy Ratios	H1'2016	H1'2017
Core Capital/Total Liabilities	8.8%	10.3%
Minimum Statutory ratio	8.0%	8.0%
Excess	**0.8%**	**2.3%**
Core Capital/Total Risk Weighted Assets	13.0%	11.3%
Minimum Statutory ratio	10.5%	10.5%
Excess	**2.5%**	**0.8%**
Total Capital/Total Risk Weighted Assets	14.0%	11.9%
Minimum Statutory ratio	14.5%	14.5%
Excess	**(0.5%)**	**(2.6%)**
Liquidity Ratio	30.7%	29.7%
Minimum Statutory ratio	20.0%	20.0%
Excess	**10.7%**	**9.7%**