

Valuation Summary

- We are of the view that National Bank is a “**BUY**” with a target price of Kshs 5.2, representing an upside of 26.8%, from the current price of Kshs 4.1 as of 31st May 2019,
- National Bank is currently trading at a P/TBV of 0.3x and a P/E of 1.8x vs an industry average of 1.2x and 6.3x, respectively.

Key Highlights Q1'2019

- KCB Group announced its intention to acquire a 100% stake in the National Bank of Kenya (NBK), with shareholders of both banks consenting to the proposal in their respective Annual General Meetings.

Income Statement

- Core earnings per share increased to Kshs 0.31, from a loss per share of Kshs 0.33 in Q1'2018, in line with our projections of an increase to Kshs 0.33. The performance was driven by a 25.8% increase in total operating income, which outpaced the 22.2% increase in total operating expenses,
- Total operating income increased by 25.8% to Kshs 2.2 bn, from Kshs 1.8 bn in Q1'2018. This was driven by a 41.7% increase in Net Interest Income (NII) to Kshs 1.7 bn, from Kshs 1.2 bn in Q1'2018, despite a 9.2% decline in Non-Funded Income (NFI) to Kshs 0.5 bn, from Kshs 0.6 bn in Q1'2018,
- Interest income increased by 18.7% to Kshs 2.4 bn, from Kshs 2.0 bn in Q1'2018. This was driven by a 24.8% growth in interest income from government securities to Kshs 1.2 bn, from Kshs 1.0 bn in Q1'2018, coupled with a 14.5% increase in interest income from loans to Kshs 1.2 bn, from Kshs 1.0 bn in Q1'2018, which more than offset the 59.7% decline in interest income from placement assets to Kshs 8.3 mn, from Kshs 20.5 mn in Q1'2018. The yield on interest-earning assets thus rose to 11.8%, from 10.5% in Q1'2018,
- Interest expense declined by 17.8% to Kshs 0.6 bn, from Kshs 0.8 bn in Q1'2018, largely due to the 11.0% decline in the interest expense on customer deposits to Kshs 0.6 bn from Kshs 0.7 bn in Q1'2018, coupled with the 69.9% decrease in interest expense on placements to Kshs 28.2 mn, from Kshs 93.4 mn in Q1'2018. The cost of funds remained flat at 3.3%. Consequently, the Net Interest Margin (NIM) rose to 8.2%, from 7.1% in Q1'2018,
- Non-Funded Income declined by 9.2% to Kshs 0.5 bn from Kshs 0.6 bn in Q1'2018. The decline was mainly driven by the 10.8% decline in total fee and commission income to Kshs 0.29 bn, from Kshs 0.32 bn in Q1'2018, coupled with the 15.5% decline in forex trading income to Kshs 0.15 bn, from Kshs 0.17 bn in Q1'2018. The decline in NFI was however mitigated by the 19.1% growth in other income to Kshs 66.6 mn, from Kshs 55.9 mn in Q1'2018,
- Total operating expenses rose by 22.2% to Kshs 2.1 bn, from Kshs 1.7 bn in Q1'2018, largely driven by an increase in Loan Loss Provisions (LLP) to Kshs 0.4 bn, from a write back of Kshs 70.8 mn in Q1'2018, coupled with a 5.3% increase in staff costs to Kshs 1.0 bn, from Kshs 0.9 bn in Q1'2018. The rise in expenses was however mitigated by the 12.1% decline in other operating expenses to Kshs 0.7 bn, from Kshs 0.8 bn in Q1'2018,
- The Cost to Income Ratio (CIR) improved to 92.9%, from 95.7% in Q1'2018. Without LLP, the cost to income ratio improved to 78.7%, from 85.0% in Q1'2018, and,
- Profit before tax increased to Kshs 0.2 bn, up from a loss before tax of Kshs 0.5 bn in Q1'2018. Profit after tax grew to Kshs 0.1 bn in Q1'2019, from a loss after tax of Kshs 0.1 bn in Q1'2018, as the effective tax rate rose to 14.1% from 3.2% in Q1'2018.

Balance Sheet

- The balance sheet contracted as total assets declined by 0.5% to Kshs 104.7 bn, from Kshs 105.2 bn in Q1’2018. The contraction was largely due to the 10.2% decline in the loan book to Kshs 45.9 bn, from Kshs 51.1 bn. The decline in assets was however mitigated by the 15.1% increase in government securities to Kshs 39.1 bn, from Kshs 33.9 bn in Q1’2018,
- Total liabilities declined by 1.3% to Kshs 97.5 bn, from Kshs 98.8 bn in Q1’2018, caused by the 55.8% decline in other liabilities to Kshs 2.9 bn, from Kshs 6.6 bn in Q1’2018, which outpaced the 2.6% increase in deposits to Kshs 89.1 bn, from Kshs 86.9 bn in Q1’2018, and the 3.8% increase in placement liabilities to Kshs 5.5 bn, from Kshs 5.3 bn in Q1’2018. Deposits per branch increased by 11.5% to Kshs 1.3 bn, from Kshs 1.2 bn in Q1’2018, as the number of branches declined to 69, from 75 in Q1’2018,
- The decline in loans coupled with the growth in deposits led to a decline in the loan to deposit ratio to 51.5%, from 58.9% in Q1’2018,
- Gross Non-Performing Loans (NPLs) increased by 8.8% to Kshs 31.5 bn in Q1’2019, from Kshs 28.9 bn in Q1’2018. The NPL ratio thus deteriorated to 48.5% in Q1’2019, from 42.9% in Q1’2018. General Loan Loss provisions rose by 16.3% to Kshs 14.5 bn, from Kshs 12.4 bn in Q1’2019, and consequently, the NPL coverage rose to 60.3%, from 56.5% in Q1’2018,
- Shareholders’ funds increased by 11.8% to Kshs 7.2 bn in Q1’2019, from Kshs 6.5 bn in Q1’2018, supported by a 21.5% increase in statutory loan loss reserves to Kshs 3.6 bn, from Kshs 3.0 bn, which outpaced the 14.3% increase in accumulated losses to Kshs 5.0 bn, from Kshs 4.4 bn in Q1’2018,
- National Bank remains undercapitalized with a core capital to risk-weighted assets ratio of 2.4%, 8.1% points below the statutory requirement. In addition, the total capital to risk-weighted assets ratio came in at 3.8%, 10.7% points below the statutory requirement of 14.5%. 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 4.7%, and,
- The bank currently has a Return on Average Assets (ROaA) of 0.7%, and a Return on Average Equity (ROaE) of 11.3%.

Key Take-Out:

1. The bank reversed the loss-making trend recorded in 2018, as it seized to incur the restructuring expense, with management highlighting that the benefits of the exercise would be felt in H1’2018. Top line interest revenue recorded an improved performance as increased allocations to government securities bore fruit. NII expansion was further supported by the decline in cost of funding.

Below is a summary of the bank’s performance:

Balance Sheet Items	Q1’2018	Q1’2019	y/y change	Q1’2019e	Projected %y/y change	Variance in Growth Actual vs. Expected
Government Securities	33.9	39.1	15.1%	48.1	41.9%	(26.8%)
Net Loans and Advances	51.1	45.9	(10.2%)	49.1	(3.9%)	(6.3%)
Total Assets	105.2	104.7	(0.5%)	118.0	12.2%	(12.6%)
Customer Deposits	86.9	89.1	2.6%	101.3	16.6%	(14.1%)
Total Liabilities	98.8	97.5	(1.3%)	110.9	12.3%	(13.6%)
Shareholders’ Funds	6.5	7.2	11.8%	7.1	9.6%	2.2%

Balance Sheet Ratios	Q1’2018	Q1’2019	y/y change
Loan to Deposit Ratio	58.9%	51.5%	(7.3%)
Return on average equity	(3.5%)	11.3%	14.7%
Return on average assets	(0.3%)	0.7%	1.8%

Income Statement	Q1'2018	Q1'2019	y/y change	Q1'2019e	Projected % y/y change	Variance in Growth Actual vs. Expected
Net Interest Income	1.2	1.7	41.7%	1.3	0.07	34.5%
Net non-Interest Income	0.6	0.5	-9.2%	0.4	(20.0%)	10.8%
Total Operating income	1.8	2.2	25.8%	1.7	(1.3%)	27.1%
Loan Loss provision	0.1	(0.4)		(0.1)		
Total Operating expenses	(1.7)	(2.1)	22.2%	(1.6)	(6.2%)	28.4%
Profit before tax	0.1	0.2	105.6%	0.2	1.07	-0.9%
Profit after tax	(0.7)	0.1		0.1	-	-
Core EPS	(0.3)	0.3		1.3	-	-

Income Statement Ratios	Q1'2018	Q1'2019	y/y change
Yield from interest-earning assets	10.5%	11.8%	1.3%
Cost of funding	3.3%	3.3%	(0.0%)
Interest Spread	7.2%	8.5%	1.3%
Net Interest Income as % of operating income	68.8%	77.5%	8.7%
Non-Funded Income as a % of operating income	31.2%	22.5%	(8.7%)
Cost to Income	95.7%	92.9%	(2.7%)
Cost to Assets	1.6%	1.6%	0.0%

Capital Adequacy Ratios	Q1'2018	Q1'2019
Core Capital/Total deposit Liabilities	3.7%	2.2%
Minimum Statutory ratio	8.0%	8.0%
Excess	-4.3%	-5.8%
Core Capital/Total Risk Weighted Assets	3.3%	2.4%
Minimum Statutory ratio	10.5%	10.5%
Excess	-7.2%	-8.1%
Total Capital/Total Risk Weighted Assets	4.8%	3.8%
Minimum Statutory ratio	14.5%	14.5%
Excess	-9.7%	-10.7%
Liquidity Ratio	29.9%	40.4%
Minimum Statutory ratio	20.0%	20.0%
Excess	9.9%	20.4%
Adjusted Core Capital/Total Risk Weighted Assets		3.1%
Adjusted Core Capital/Total Risk Weighted Assets		4.5%

Capital Adequacy Ratios	Q1'2018	Q1'2019
Core Capital/Total Liabilities	22.2%	20.8%
Minimum Statutory ratio	10.5%	10.5%
Excess	11.7%	10.3%
Core Capital/Total Risk Weighted Assets	18.7%	17.4%
Minimum Statutory ratio	10.5%	10.5%
Excess	8.2%	6.9%
Total Capital/Total Risk Weighted Assets	18.7%	19.3%

Minimum Statutory ratio	14.5%	14.5%
Excess	4.2%	4.8%
Liquidity Ratio	55.2%	57.4%
Minimum Statutory ratio	20.0%	20.0%
Excess	35.2%	37.4%