NCBA Group Earnings Note – FY'2021
25th March 2021

Below is a summary of NCBA Group's FY'2021 performance;

Balance Sheet	FY'2020 (Kshs bns)	FY'2021 (Kshs bns)	y/y change
Net Loans and Advances	248.5	244.0	(1.8%)
Government Securities	148.3	196.1	32.2%
Total Assets	**528.0**	**591.1**	**12.0%**
Customer Deposits	421.5	469.9	11.5%
Total Liabilities	455.4	513.1	12.7%
Shareholders' Funds	**72.3**	**77.9**	**7.6%**

Balance sheet ratios	FY'2020	FY'2021	% point change
Loan to Deposit Ratio	59.0%	51.9%	(7.0%)
Return on average equity	6.6%	13.6%	7.1%
Return on average assets	0.9%	1.8%	0.9%

Income Statement	FY'2020(Kshs bns)	FY'2021 (Kshs bns)	y/y change
Net Interest Income	25.5	27.0	6.1%
Net non-Interest Income	20.9	22.1	5.6%
Total Operating income	**46.4**	**49.2**	**5.8%**
Loan Loss provision	(20.4)	(12.7)	(37.8%)
Total Operating expenses	(40.0)	(33.4)	(16.4%)
Profit before tax	5.0	15.0	201.8%
Profit after tax	**4.6**	**10.2**	**123.7%**
Core EPS	**2.8**	**6.2**	**123.7%**

Income Statement Ratios	FY'2020	FY'2021	y/y change
Yield from interest-earning assets	10.3%	10.0%	(0.3%)
Cost of funding	4.4%	4.2%	(0.2%)
Net Interest Spread	5.9%	5.9%	0.0%
Net Interest Margin	5.9%	5.8%	(0.1%)
Cost of Risk	44.0%	25.9%	(18.1%)
Net Interest Income as % of operating income	54.9%	55.0%	0.1%
Non-Funded Income as a % of operating income	45.1%	45.0%	(0.1%)
Cost to Income Ratio	86.2%	68.1%	(18.1%)
Cost to Income Ratio without LLP	42.2%	42.2%	0.0%

Capital Adequacy Ratios	FY'2020	FY'2021
Core Capital/Total Liabilities	15.4%	16.8%
Minimum Statutory ratio	8.0%	8.0%
Excess	**7.4%**	**8.8%**
Core Capital/Total Risk Weighted Assets	17.3%	19.0%
Minimum Statutory ratio	10.5%	10.5%
Excess	**6.8%**	**8.5%**
Total Capital/Total Risk Weighted Assets	17.5%	19.1%

Minimum Statutory ratio	14.5%	14.5%
Excess	**3.0%**	**4.6%**
Liquidity Ratio	55.1%	61.7%
Minimum Statutory ratio	20.0%	20.0%
Excess	**35.1%**	**41.7%**
Adjusted Core Capital/Total Liabilities	15.6%	17.5%
Adjusted Core Capital/Total RWA	17.5%	19.8%
Adjusted Total Capital/Total RWA	17.7%	19.9%

Key Highlights FY’2021

- In H1’2021, NCBA Bank disbursed Kshs 272.0 bn in digital loans in line with its digitization agenda and in honor of the bank’s commitment towards supporting SMEs and individual customers recover from the adverse effects of the pandemic,
- In Q3’2021, Fitch Ratings, a global credit rating firm, assigned NCBA Group PLC and NCBA Bank Kenya a default rating of B+ with a negative rating outlook. The B+ rating is based on the unilateral creditworthiness of the Group due to limited probability of governmental support. The negative outlook corresponds to the rating the firm has also assigned to Kenya, owing to the country’s credit profile and being the host to the Group’s operations. The bank's viability assessment weighs the impact of an expanded franchise, high profitability and capitalization, as well as solid funding and liquidity, all achieved through the Group’s post-merger against the challenges of the operating climate and deteriorating asset quality. Further, Fitch Ratings highlighted that the group’s strengths lie within its mobile banking products,
- In August 2021, NCBA Bank in partnership with Safaricom launched a campaign dubbed “Pamoja na M-Shwari” in a bid to support M-Shwari customers in rebuilding their businesses as the country continued to recover from the effects of the Covid-19 pandemic. The campaign ran for 3 months with two main offers:
    a) An opportunity for M-Shwari customers to access up to 6.0% interest on their lock savings account to help them secure their future, and,
    b) Reinstatement of limits for customers that may have previously delayed in repaying borrowed amounts conditioned on first repaying the defaulted amount within the campaign period, after which, a new loan limit would be allocated.

Income Statement

- Core earnings per share increased by 123.7% to Kshs 6.2 from Kshs 2.8 in FY’2020 higher than our projections of a 78.6% increase to Kshs 5.0. The performance in the earnings per share was driven by the 5.8% growth in total operating income to Kshs 49.2 bn, from Kshs 46.4 bn in FY’2020 coupled with the 16.4% decline in total operating expenses to Kshs 33.4 bn from Kshs 40.0 bn. The variance in the core earnings per share growth against our expectations was due to the 16.4% decline in total operating expenses, against our expectations of an 11.0% decline,
- Total operating income rose by 5.8% to Kshs 49.2 bn in FY’2021, from Kshs 46.4 bn in FY’2020. This was due to a 6.1% increase in Net Interest Income (NII) to Kshs 27.0 bn, from Kshs 25.5 bn recorded in FY’2020, coupled with a 5.6% increase in Non-Funded Income (NFI) to Kshs 22.1 bn, from the Kshs 20.9 bn recorded in FY’2020,
- Interest income rose by 5.1% to Kshs 46.5 bn, from Kshs 44.2 bn in FY’2020 mainly driven by a 20.9% growth in interest income from government securities to Kshs 20.3 bn, from Kshs 16.8 bn in FY’2020. The growth was however weighed down by a 4.3% decline in interest income from loans and advances to Kshs

25.5 bn, from Kshs 26.7 bn in FY'2020. Consequently, the yield on interest-earning assets marginally declined by 0.3% points to 10.0% in FY'2021, from 10.3% in FY'2020, due to the faster 10.0% growth in average interest-earning assets to Kshs 485.2 bn, from Kshs 441.0 bn in FY'2020, compared to the 5.1% growth in trailing Interest Income. Trailing Interest Income refers to the performance of the interest income for the past 12 consecutive months,

- Interest expense rose by 3.9% to Kshs 19.5 bn, from Kshs 18.8 bn in FY'2020, mainly attributable to a 7.8% increase in interest expense on customer deposits to Kshs 18.5 bn, from Kshs 17.2 bn in FY'2020. The growth was mitigated by a 45.7% decline in other interest expenses to Kshs 0.7 bn in FY'2021, from Kshs 1.3 bn coupled with an 11.8% decline in expenses in deposits and placements from banking institutions to Kshs 266.8 mn, from Kshs 302.5 mn in FY'2020. Cost of funds declined to 4.2% from 4.4% in FY'2020 owing to the 16.4% decline in trailing interest expense compared to the 10.9% growth recorded on average interesting bearing liabilities. Trailing interest expense refers to the performance of the interest expense for the past 12 consecutive months. This points out that the Bank was able to mobilize cheaper deposits. The Net Interest Margin came in at 5.8%, higher than the 5.9% seen in 2020, due to the slower 6.1% growth in Net Interest Income, compared to the 10.0% growth seen in the average interest-earning assets,
- Non-Funded Income rose by 5.6% to Kshs 22.1 bn, from Kshs 20.9 bn in FY'2020, driven by a 6.8% increase in income from foreign exchange trading to Kshs 5.1 bn from Kshs 4.7 bn in FY'2020 coupled by a 12.2% increase in income from other fees to Kshs 3.8 bn, from Kshs 3.3% in FY'2020. This was however weighed down by the 0.5% decline in income from fees and other commissions to Kshs 10.79 bn, from Kshs 10.84 bn in FY'2020. Total fees and commissions increased by 2.5% to Kshs 14.5 bn from Kshs 14.2 bn. Consequently, the revenue mix remained unchanged at 55:45 in FY'2021 funded to non-funded income , similar to what was recorded in FY'2020,
- Total operating expenses declined by 16.4% to Kshs 33.4 bn, from Kshs 40.0 bn in FY'2020, largely driven by the 37.8% decline in loan loss provision to Kshs 12.7 bn, from Kshs 20.4 bn in FY'2020. The lower provisioning level was caused by declining credit risk as a result of increased business activity in 2021 on the back of the gradual economic recovery. Staff costs increased by 10.0% to Kshs 8.0 bn, from Kshs 7.2 bn recorded in FY'2020,
- The cost to income ratio significantly improved to 68.1%, from 86.2% in FY'2020 attributable to the faster 5.8% growth in total operating income to Kshs 49.2 bn, from Kshs 46.4 bn in FY'2020 coupled with the 16.4% decline in total operating expenses to Kshs 33.4 bn, from 40.0 bn in FY'2020. However, without LLP, the cost to income ratio remained unchanged at 42.2%, as was recorded in FY'2020, pointing towards similar efficiency levels by the group as in FY'2020,
- Profit before tax increased by 201.8% to Kshs 15.0 bn, from Kshs 5.0 bn in FY'2020 while Profit after tax increased by 123.7% to Kshs 10.2 bn from Kshs 4.6 bn in FY'2020. The effective tax rate increased to 32.0% from 8.3% recorded in FY'2020, and,
- The Board of Directors recommended a final Dividend per Share (DPS) of Kshs 3.0, translating to a total dividend payout of Kshs 4.9 bn. At the current price of Kshs 25.9, this translates to a dividend yield of 11.6%.

Balance Sheet

- The balance sheet recorded an expansion with total assets growth of 12.0% to Kshs 591.1 bn, from Kshs 528.0 bn in FY'2020. This growth was largely driven by a 32.2% increase in government securities to Kshs 196.1 bn, from the Kshs 148.3 bn recorded in FY'2020. The loan book on the other hand, contracted by 1.8% to Kshs 244.0 bn, from Kshs 248.5 bn in FY'2020, partly attributable to the bank's cautious lending owing to their relatively high non-performing loans,

- Total liabilities rose by 12.7% to Kshs 513.1 bn, from Kshs 455.4 bn in FY'2020, driven by an 11.5% growth in customer deposits to Kshs 469.9 bn, from Kshs 421.5 bn in FY'2020. Additionally, placements by other banking institutions increased by 134.4% to the Kshs 14.8 bn recorded in FY'2021, from Kshs 6.3 bn in FY'2020. Deposits per branch declined by 4.6% to Kshs 4.5 bn, from Kshs 4.7 bn in FY'2021, with the number of branches increasing by 15 to 104 branches in FY'2021 from 89 branches in FY'2021. In its continued branch expansion strategy, the group plans to open 11 more branches in Kenya,
- The faster 11.5% growth in deposits compared to the 1.8 decline in loans led to a decline in the loan to deposit ratio to 51.9%, from 59.0% in FY'2020,
- Gross non-performing loans (NPLs) rose by 10.7% to Kshs 44.3 bn in FY'2021, from Kshs 40.1 bn in FY'2020. Consequently, the NPL ratio rose to 16.0% in FY'2021, from 14.7% in FY'2020 attributable to the faster 10.7% increase in NPLs that outpaced the 1.4% increase in gross loans which came in at Kshs 276.7 bn in FY'2021, from the Kshs 272.1 bn in FY'2020. General loan loss provisions increased by 36.8% to Kshs 24.4 bn, from Kshs 17.8 bn in FY'2020. The NPL coverage rose to 73.6% in FY'2021, from 60.9% owing to the faster 36.8% increase in general loan loss provisions, compared to the 10.7% growth in gross NPLs,
- Shareholders' funds increased by 7.6% to Kshs 77.9 bn, from Kshs 72.3 bn in FY'2020, mainly supported by the 13.2% increase in retained earnings to Kshs 44.2 bn from Kshs 39.0 bn,
- NCBA Group is currently sufficiently capitalized with a core capital to risk weighted assets ratio of 19.0%, 8.5% above the statutory requirement. In addition, the total capital to risk weighted assets ratio was 19.1%, exceeding the statutory requirement by 4.6%. Adjusting for IFRS 9, the core capital to risk weighted assets stood at 19.8%, while total capital to risk weighted assets came in at 19.9%, and,
- NCBA Group currently has a return on average assets of 1.8% and a return on average equity of 13.6%.

<u>Key Take-Outs:</u>

i. **Asset quality**: The group's asset quality deteriorated, as evidenced by the rise in NPL ratio to 16.0%, from 14.7% in FY'2020 driven by the 10.7% increase in NPLs to Kshs 44.3 bn from Kshs 40.1 bn. The deterioration is partly due to its lending to SMEs and the construction sectors, both of which were hard hit by the pandemic and have yet to fully recover, resulting in an increase in NPLs. However, the NPL ratio declined by 1.0% point from the 17.0% that was recorded in Q3'2021 pointing towards continued recovery. We expect NPLs to continue declining as the sectors recover in tandem with the economy as a whole. Risks however lie on the downside given the emergence of new COVID-19 variants and the upcoming August 2022 elections,

ii. **Operating Efficiency** - The bank's operating efficiency improved as evidenced by the decline in cost to income ratio to 68.1%, from 86.2% in FY'2020, which indicates reduced operational costs and improved operational efficiency. This is despite the group's bold expansion strategy which has led to the rehiring of staff who were laid off in 2020 after 14 branches were closed in Kenya. Further, the group is planning to open 11 more branches in Kenya and this is set to increase the staff cost and consequently the operational costs, and,

iii. The group's loan book contracted by 1.8% to Kshs 244.0 bn, in FY'2021 from Kshs 248.5 bn in FY'2020, attributable to the group's cautious lending given the increased NPLs which have seen the group's asset quality deteriorate. Consequently, the group has focused more on government securities leading to a decline in credit growth. As such, the group is expected to redesign their operating models for loans in other sectors, as well as establish a workflow management tool to aid credit and commercial units in collaborating more effectively.

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

1. The bank is expected to continue with its strategy of undertaking digital transformation and deliver new digital and mobile capabilities that enhance customer experience and diversify the Group's revenues in addition to strengthening its position as a leader in corporate banking and asset finance. further, the group is planning on developing a high performance employee culture that supports improved financial performance and shareholder returns, and,
2. Brand visibility backed by great customer experience as it scales its retail banking primarily through expanding its branch network to enhance customer reach. So far, the group has 85 branches in Kenya with expectations of 11 more which will amount to a total of 96 branches by the end of 2021.

Valuation Summary

- We are of the view that NCBA Group is a "**Buy**" with a target price of Kshs 28.5, representing an upside of 10.0%, from the current price of Kshs 25.9 as of 25th March 2022,
- NCBA Group is currently trading at P/TBV of 0.6x and a P/E of 4.2x vs an industry average of 0.9x and 4.9x, respectively.