Cytonn INVESTMENTS

NCBA Group – Q3'2021
26th November 2021

Below is a summary of NCBA Group Q3'2021 performance;

Balance Sheet (bns)	Q3'2020	Q3'2021	y/y change
Net Loans and Advances	249.7	238.2	(4.6%)
Total Assets	**519.2**	**562.6**	**8.4%**
Customer Deposits	402.6	447.6	11.2%
Total Liabilities	448.5	487.7	8.7%
Shareholders' Funds	**70.4**	**74.8**	**6.3%**

Balance sheet ratios	Q3'2020	Q3'2021	% point change
Loan to Deposit Ratio	62.0%	53.2%	(8.8%)
Return on average equity	3.9%	11.8%	8.0%
Return on average assets	0.5%	1.6%	1.1%

Income Statement(mns)	Q3'2020	Q3'2021	y/y change
Net Interest Income	17.0	20.2	19.1%
Net non-Interest Income	16.1	16.1	(0.2%)
Total Operating income	**33.1**	**36.3**	**9.7%**
Loan Loss provision	13.4	9.2	(31.3%)
Total Operating expenses	28.6	24.7	(13.8%)
Profit before tax	3.8	11.1	192.0%
Profit after tax	**2.5**	**6.5**	**159.0%**
Core EPS	**1.5**	**4.0**	**159.0%**

Income Statement Ratios	Q3'2020	Q3'2021	y/y change
Yield from interest-earning assets	6.1%	10.2%	4.1%
Cost of funding	3.1%	4.1%	1.1%
Net Interest Spread	3.1%	6.1%	3.0%
Net Interest Margin	3.2%	6.2%	3.0%
Cost of Risk	40.4%	25.3%	(15.1%)
Net Interest Income as % of operating income	51.3%	55.7%	4.4%
Non-Funded Income as a % of operating income	48.7%	44.3%	(4.4%)
Cost to Income Ratio	86.5%	68.0%	(18.5%)

Capital Adequacy Ratios	Q3'2020	Q3'2021
Core Capital/Total Liabilities	16.9%	16.8%
Minimum Statutory ratio	8.0%	8.0%
Excess	**8.9%**	**8.8%**
Core Capital/Total Risk Weighted Assets	18.1%	19.0%
Minimum Statutory ratio	10.5%	10.5%
Excess	**7.6%**	**8.5%**
Total Capital/Total Risk Weighted Assets	18.6%	19.1%
Minimum Statutory ratio	14.5%	14.5%
Excess	**4.1%**	**4.6%**
Liquidity Ratio	53.2%	61.7%
Minimum Statutory ratio	20.0%	20.0%
Excess	**33.2%**	**41.7%**
Adjusted Core Capital/Total Liabilities	16.1%	17.5%

Adjusted Core Capital/Total RWA	17.0%	19.8%
Adjusted Total Capital/Total RWA	17.6%	19.9%

Key Highlights Q3’2021

- 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.

Income Statement

- Core earnings per share rose by 159.0% to Kshs 4.0, from Kshs 1.5 in Q3’2020, higher than our expectations of a 100.3% increase to Kshs 3.1. The performance was driven by the 9.7% growth in total operating income to Kshs 36.3 bn, from Kshs 33.1 bn in Q3’2020, coupled with the 13.8% decline in total operating expenses to Kshs 24.7 bn, from 28.6 bn in Q3’2020. The variance in the core earnings per share increase against our expectation was mainly attributable to the 13.8% decline in total operating expenses to Kshs 24.7 bn, from Kshs 28.6 bn recorded in Q3’2020, against our expectations of a 5.3% increase to Kshs 30.1 bn in Q3’2021,
- Total operating income rose by 9.7% to Kshs 36.3 bn, from Kshs 33.1 bn in Q3’2020 driven by a 19.1% increase in Net Interest Income (NII) to Kshs 20.2 bn, from Kshs 17.0 bn recorded in Q3’2020. The growth was however weighed down by a marginal decline of 0.2% in the Non-Funded Income (NFI) to Kshs 16.08 bn, from the Kshs 16.11 bn recorded in Q3’2020,
- Interest income rose by 9.3 to Kshs 34.2 bn, from Kshs 31.3 bn in Q3’2020 mainly driven by a 15.4% growth in interest income from government securities to Kshs 14.7 bn, from Kshs 12.8 bn in Q3’2020, coupled with a 6.5% rise in interest income from loans and advances to Kshs 19.1 bn, from Kshs 17.9 bn in Q3’2020. However, the growth was weighed down by a 42.1% decline in interest income from deposits and placements with banking institutions to Kshs 0.3 bn, from Kshs 0.6 bn in Q3’2020. Consequently, the Yield on Interest-Earning Assets (YIEA) increased by 4.0% points to 10.2% in Q3’2021, from 6.2% in Q3’2020, attributable to the faster 74.1% growth in trailing interest income which outpaced the 5.1% growth in average interest-earning assets. Trailing Interest Income refers to the performance of the interest income for the past 12 consecutive months,
- Interest expense declined by 2.4% to Kshs 14.0 bn, from Kshs 14.4 bn in Q3’2020, mainly attributable to a 49.9% decline in interest expense on placements from banking institutions to Kshs 0.2 bn, from Kshs 0.3 bn in Q3’2020. The decline was weighed down by a 5.8% growth in interest expense on customer deposits to Kshs 13.6 bn, from Kshs 12.9 bn in Q3’2020. Cost of funds on the other hand increased by 1.0% points to 4.1%, from 3.1% in Q3’2020 owing to the 45.8% increase in trailing interest expense that outpaced the 6.3% growth in average interest bearing liabilities, an indication that the Bank was not able to mobilize cheaper deposits. The Net Interest Margin increased by 3.0% points to 6.2%, from 3.2% recorded in Q3’2020, due to the faster 74.1% growth in trailing Net Interest Income, compared to the 5.1% growth seen in the average interest-earning assets,
- Non-Funded Income declined marginally by 0.2% to Kshs 16.08 bn, from Kshs 16.11 bn in Q3’2020, driven by a 13.2% decrease in fees and commissions on loans and advances to Kshs 8.2 bn, from Kshs 9.4 bn in Q3’2020. The decline in NFI was however mitigated by a 14.8% increase in income from foreign exchange trading to Kshs 3.5 bn, from Kshs 3.1 bn coupled with a 38.8% increase in income from other fees and commissions to Kshs 2.7 mn, from Kshs 2.0 mn in Q3’2020. Total fees and commissions declined by 4.3% to Kshs 10.9 bn, from Kshs 11.4 bn in Q3’2020. Consequently, the

revenue mix shifted to 56:44 from 51:49 funded to non-funded income, owing to the faster 19.1% growth in NII compared to the 0.2% decline in NFI,

- Total operating expenses declined by 13.8% to Kshs 24.7 bn, from Kshs 28.6 bn in Q3’2020, largely driven by the 31.3% decrease in loan loss provision to Kshs 9.2 bn, from Kshs 13.4 bn in Q3’2020. The decline in the provisioning levels by the lender can be partly attributable to improved business environment as the economy gradually rebounds. However, the decline in total operating expenses was weighed down by a 10.8% increase in staff costs to Kshs 5.9 bn, from Kshs 5.3 bn recorded in Q3’2020 as the bank rehired some of their staff who were laid off in 2020 to fill in the reopened branches,
- The Cost to Income ratio improved to 68.0%, from 86.5% in Q3’2020 attributable to the 9.7% growth in total operating income to Kshs 36.3 bn, from Kshs 33.1 bn in Q3’2020 coupled with the 13.8% decline in total operating expenses to Kshs 24.7 bn, from 28.0 bn in Q3’2020. Similarly, without LLP, the cost to income ratio also improved to 42.7%, from 46.2% in Q3’2020, pointing towards reduced operational costs and improved efficiency levels by the group, and,
- Profit before tax rose by 192.0% to Kshs 11.1 bn, from Kshs 3.8 bn in Q3’2020. Profit after tax also increased by 159.0% to Kshs 6.5 bn, from Kshs 2.5 bn in Q3’2020 with the effective tax rate increasing to 41.0%, from 33.5% recorded in Q3’2020.

Balance Sheet

- The balance sheet recorded an expansion with total assets growing by 8.4% to Kshs 562.6 bn, from Kshs 519.2 bn in Q3’2020. This growth was largely driven by a 25.2% increase in government securities to Kshs 189.6 bn, from Kshs 151.4 bn in Q3’2020 coupled with a 12.1% increase in bank placements to Kshs 42.1 bn, from Kshs 37.6 bn in Q3’2020. On the other hand, the loan book contracted by 4.6% to Kshs 238.2 bn, from Kshs 249.7 bn in Q3’2020, partly attributable to the bank’s cautious lending due to elevated credit risk as new variants of the COVID-19 virus continue to emerge posing a threat to the economy,
- Total liabilities rose by 8.7% to Kshs 487.7 bn, from Kshs 448.5 bn in Q3’2020, driven by an 11.2% growth in customer deposits to Kshs 447.6 bn, from Kshs 402.6 bn in Q3’2020, coupled with a 7.7% increase in placements liabilities to Kshs 12.6 bn recorded in Q3’2021, from Kshs 11.7 bn in Q3’2020. Deposits per branch declined by 1.0% to Kshs 4.6 bn, from Kshs 4.5 bn in Q3’2021, with the number of branches increasing by 9 to 98 branches, from 89 branches in Q3’2020. The group intends to open 4 more branches in Kenya in Q4’2021, as the bank deploys its growth strategy,
- The faster 11.2% growth in deposits compared to the 4.6% decline in loans led to a decline in the loan to deposit ratio to 53.2%, from 62.0% in Q3’2020,
- Gross non-performing loans (NPLs) rose by 19.7% to Kshs 46.0 bn in Q3’2021, from Kshs 38.4 bn in Q3’2020 taking the NPL ratio to 17.0% in Q3’2021, from 14.1% in Q3’2020, the highest it has ever been. The deterioration in the group’s asset quality is mainly attributable to the faster 19.7% increase in NPLs that outpaced the 0.6% decrease in gross loans. The bank lends to SMEs and provides construction loans, both of which were heavily hit by the pandemic, resulting in an increase in NPLs as the sectors are yet to fully recover. With the General loan loss provisions increasing by 52.3% to Kshs 24.2 bn, from Kshs 15.9 bn in Q3’2020, higher than the 19.7% growth in gross NPLs, the NPL coverage rose to 70.2% in Q3’2021, from 58.3% in Q3’2020,
- Shareholders’ funds increased by 6.3% to Kshs 74.8 bn, from Kshs 70.4 bn in Q3’2020, mainly supported by a 12.9% increase in the retained earnings to Kshs 44.4 bn, from Kshs 39.4 bn in Q3’2020,
- 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%,
- NCBA Group currently has a return on average assets (ROaA) of 1.6% and a return on average equity (ROaE) of 11.8%.

Key Take-Outs:

i. **Asset quality**: The group’s asset quality deteriorated, with the NPL ratio increasing to 17.0%, from 14.1% in Q3’2020. The deterioration is as a result of its lending to SMEs and the construction sectors, both of which were hard hit by the pandemic and are yet to fully recover, leading to an increase in NPLs. We expect the NPLs to decline in the near term as the sectors recover in tandem with the economy at large. This is the highest it has been in over a decade owing to the faster 19.7% increase in NPLs that outpaced the 0.6% decrease in gross loans. The bank will have 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, and,

ii. **Operating Efficiency** - The bank’s operating efficiency improved as evidenced by the decline in cost to income ratio to 68.0% from 86.5% in Q3’2020. Additionally, cost to income without LLP, also improved to 42.7% from 46.2% in Q3’2020, which indicates reduced operational costs. However, the bank is investing more in additional branches and is rehiring their staff who were laid off in 2020 to fill in the new branches. We expect the move to increase the operational cost as staff cost will continue to increase.

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

i. NCBA Bank intends to leverage on risk diversification, economies of scale, diversified earnings, and access to cheaper funding to continue building a strong and resilient business that is delivering on its strategic objectives. Further, the bank is expected to perform better as the economy gradually recovers and the results of the group's focus on strategic initiatives centred on customer experience continue to emerge. The bank has also embarked on a bold branch expansion and digital transformation in its quest to increase the reach of its product and services in a bid to structurally improve efficiency and agility.

Valuation Summary

- We are of the view that NCBA Group is a “**Accumulate**” with a target price of Kshs 29.1, representing an upside of 24.0%, from the current price of Kshs 23.5 as of 26th November 2021,
- NCBA Group is currently trading at P/TBV of 0.5x and a P/E of 5.3x vs an industry average of 0.9x and 5.3x, respectively.