

Valuation Summary

- We are of the view that NCBA Group is a “Buy” with a target price of Kshs 39.4, representing an upside of 46.0%, from the current price of Kshs 27.2 as of 22nd May 2020, inclusive of a dividend yield of 0.9%.
- NIC Group is currently trading at P/TBV of 0.7x and a P/E of 24.9x vs an industry average of 1.0x and 5.4x, respectively.

Key Highlights Q1'2020

- NIC Group and Commercial Bank of Africa (CBA) finalized their merger and are currently operating as NCBA Group with NIC Group's Group Managing Director (MD) Mr. John Gachora as the Group Managing Director and Chief Executive Officer.

Notably, the financial statements of the bank have been prepared on a prospective basis (assuming a continuation of CBA), representing Q1'2020 results of NCBA bank (merged bank) with prior year comparatives (Q1'2019) being those of CBA bank. Hence, the results are not comparable on a like for like basis. As such, we have used proforma-combined financials for the two entities.

Income Statement

- Core earnings per share declined by 26.8% to Kshs 2.3 from Kshs 3.2 in Q1'2019, which was not in line with our projections of Kshs 1.6. The performance can be attributed to a 23.6% increase in total operating income to Kshs 10.9 bn from Kshs 8.8 bn in Q1'2019, coupled with the 49.8% increase in total operating expenses from Kshs 5.5 bn in Q1'2019 to Kshs 8.3 bn in Q1'2020,
- Total operating income increased by 23.6% to Kshs 10.9 bn in Q1'2020 from Kshs 8.8 bn in Q1'2019. This was due to a 49.7% increase in Non-Funded Income (NFI) to Kshs 5.4 bn in Q1'2020 from Kshs 3.6 bn recorded the previous year, coupled with a 5.5% increase in Net Interest Income (NII) to Kshs 5.5 bn from the Kshs 5.2 bn recorded in Q1'2019,
- Interest income rose by 6.8% to Kshs 10.2 bn from Kshs 9.5 bn in Q1'2019. This was mainly driven by a 39.1% rise in interest from loans and advances to Kshs 6.2 bn from Kshs 6.0 bn in 2019 coupled with an 11.8% rise in interest income on government securities to Kshs 3.8 bn in Q1'2020 from Kshs 3.4 bn in Q1'2019. Despite this, the yield on interest-earning assets declined to 6.3% in Q1'2020 from 9.8% in Q1'2019 due to the 32.6% decline in trailing interest income compared to 3.8% growth in average interest-earning assets to Kshs 412.4 bn from Kshs 397.3 bn in Q1'2019,
- Interest expense increased by 8.3% to Kshs 4.7 bn from Kshs 4.3 bn in Q1'2019, mainly attributable to an increase in interest expense on customer deposits by 14.1% to Kshs 4.2 bn from Kshs 3.6 bn in Q1'2019. The cost of funds fell to 3.1% from 4.8% in Q1'2019 owing to the 30.9% decline in trailing interest expense compared to the faster 6.7% growth in average interesting bearing liabilities. The Net Interest Margin came in at 3.3%, lower than the 5.2% seen in Q1'2019, due to the 34.1% decline in trailing NII compared to the faster 3.8% growth seen in the average interest-earning assets,
- Non-Funded Income rose by 49.7% to Kshs 5.4 bn from Kshs 3.6 bn in Q1'2019. The increase in NFI was driven by a 125.8% increase in fees and other commissions to Kshs 3.2 bn from Kshs 1.4 bn in Q1'2019, coupled with a 17.0% increase in forex trading income to Kshs 1.0 bn from Kshs 0.8 bn in Q1'2019. The revenue mix shifted to 50:50 funded to non-funded income in Q1'2020 from 59:41 in Q1'2019, owing to the faster increase in NFI compared to NII,

- Total operating expenses increased by 49.8% to Kshs 8.3 bn from Kshs 5.6 bn in Q1'2019, largely driven by a 404.3% increase in loan loss provision to Kshs 3.8 bn in Q1'2020 from Kshs 0.7 bn in Q1'2019, coupled with a 4.3% increase in other operating expenses to Kshs 2.9 bn in Q1'2020 from Kshs 2.7 bn in Q1'2019. The high increase in Loan loss provision is driven by the expectations of a significant increase in NPLs due to the economic fallouts caused by Coronavirus. However, the growth in total operating expenses was weighed down by an 18.4% decline in staff costs to Kshs 1.7 bn from Kshs 2.1 bn recorded in Q1'2019,
- The cost to income ratio deteriorated to 76.1% from 62.8% in Q1'2019. However, without LLP, the cost to income ratio improved to 41.5% from 54.3% in Q1'2019, highlighting improved efficiency
- Profit before tax declined by 26.5% to Kshs 2.4 bn from Kshs 3.3 bn in Q1'2019. Profit after tax declined by 26.8% to Kshs 1.6 bn in Q1'2020 from Kshs 2.2 bn in Q1'2019, with part of the variance being attributed to an exceptional item of Kshs 195.6 mn. The effective tax rate increased to 32.5% from 32.3% recorded in Q1'2019,
- The board of directors announced that it was changing its earlier recommendation to pay a cash dividend and instead recommend a bonus share issue where shareholders will receive one (1) share for every ten (10) shares held. This decision was made considering the need to preserve capital for the stakeholders, in light of the challenges posed by the COVID-19 pandemic

Balance Sheet

- The balance sheet recorded an expansion with a total assets growth of 9.2% to Kshs 509.6 bn from Kshs 466.8 bn in Q1'2019. This growth was largely driven by a 21.1% increase in government securities to Kshs 153.5 bn from the Kshs 126.8 bn recorded in Q1'2019. The loan book expanded by 3.9% to Kshs 245.9 bn in Q1'2020 from Kshs 240.6 bn in Q1'2019,
- Total liabilities rose by 10.4% to Kshs 440.8 bn from Kshs 399.1 bn in Q1'2019, driven by a 9.9% increase in customer deposits to Kshs 390.5 bn from Kshs 355.3 bn in Q1'2019. Placements decreased by 3.8% from the Kshs 9.2 bn recorded in Q1'2019 to Kshs 8.9 bn in Q1'2020. Deposits per branch stood at Kshs. 9.1 bn with the bank operating 43 branches,
- The faster 9.9% growth in deposits compared to the 2.2% growth in loans led to a decline in the loan to deposit ratio to 63.0% from 67.7% in Q1'2019,
- Gross non-performing loans increased by 31.8% to Kshs 38.8 bn in Q1'2020 from Kshs 29.5 bn in Q1'2019. Consequently, the NPL ratio deteriorated to 14.5% in Q1'2020 from 11.4% in Q1'2019.
- Shareholders' funds increased by 1.9% to Kshs 68.6 bn in Q1'2020 from Kshs 67.0 bn in Q1'2019, as share premium grew by 199.3% to Kshs 22.2 bn from Kshs 7.4 bn recorded in Q1'2019, the growth was however weighed down by a 27.4% decline in retained earnings to Kshs 38.6 bn, from Kshs 53.5 bn in Q1'2019,
- NCBA Group is currently sufficiently capitalized with a core capital to risk-weighted assets ratio of 17.9%, 7.4% above the statutory requirement. In addition, the total capital to risk-weighted assets ratio was 18.5%, exceeding the statutory requirement by 4.0%. Adjusting for IFRS 9, the core capital to risk-weighted assets stood at 18.2%, while total capital to risk-weighted assets came in at 18.8%,
- NCBA Group currently has a return on average assets of 1.5% and a return on average equity of 10.7%.

Key Take-Outs:

- I. PAT and exceptional items decreased by 26.8% to Kshs 1.6 bn in Q1'2020, from the Kshs 2.2 bn recorded in Q1'2019, attributable to a 49.8% increase in Total operating expenses to Kshs 8.3 bn from Kshs 5.6 bn in Q1'2019, largely driven by a 404.3% increase in loan loss provision to Kshs 3.8 bn in Q1'2020 from Kshs 0.7 bn in Q1'2019. This was mitigated by the 23.6% increase in Total operating income to Kshs 10.9 bn in

- Q1'2020 from Kshs 8.8 bn in Q1'2019. This was due to a 49.7% increase in Non-Funded Income (NFI) to Kshs 5.4 bn in Q1'2020 from Kshs 3.6 bn recorded the previous year,
- II. NCBA's Non-funded income (NFI) growth came in at 49.7%, higher than the industry average of 21.6%. As a result, the revenue mix shifted to 50:50 funded to non-funded income in Q1'2020 from 59:41 in Q1'2019, owing to the faster increase in NFI compared to NII,
 - III. There was an improvement in efficiency levels as the cost to income ratio without LLP improved to 41.5% from 54.3% in Q1'2019. This was mainly attributable to the 18.4% decline in Staff costs to Kshs 1.7 bn from Kshs 2.1 bn recorded in Q1'2019.

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

- a. The Bank is expected to continue increasing its synergy by capitalizing on the strengths of the previous entities. This can be seen through the use of their LOOP digital platform, which has allowed the bank to diversify its revenue streams.

Balance Sheet Items	Q1'2019	Q1'2020	y/y change
Net Loans and Advances	240.6	245.9	2.2%
Total Assets	466.7	509.6	9.2%
Customer Deposits	355.3	390.5	9.9%
Total Liabilities	399.1	440.8	10.4%
Shareholders' Funds	67.3	68.6	1.9%

Balance Sheet Ratios	Q1'2019	Q1'2020	y/y change
Loan to Deposit Ratio	67.7%	63.0%	(4.8%)
Return on average equity	14.8%	10.7%	(4.1%)
Return on average assets	2.1%	1.5%	(0.6%)

Income Statement	Q1'2019	Q1'2020	y/y change
Net Interest Income	5.2	5.5	5.5%
Net non-Interest Income	3.6	5.4	49.7%
Total Operating income	8.8	10.9	23.6%
Loan Loss provision	0.7	3.8	404.3%
Total Operating expenses	5.5	8.3	49.8%
Profit before tax	3.3	2.4	(26.5%)
Profit after tax	2.2	1.6	(26.8%)
Core EPS	3.2	2.3	(26.8%)

Income Statement Ratios	Q1'2019	Q1'2020	y/y change
Yield from interest-earning assets	9.8%	6.3%	(3.4%)
Cost of funding	4.8%	3.1%	(1.7%)
Net Interest Spread	5.0%	3.2%	(1.7%)
Net Interest Margin	5.2%	3.3%	(1.9%)
Cost of Risk	8.5%	34.6%	26.1%
Net Interest Income as % of operating income	59.0%	50.3%	(8.6%)
Non-Funded Income as a % of operating income	41.0%	49.7%	8.6%
Cost to Income Ratio	62.8%	76.1%	13.3%

Capital Adequacy Ratios	Q1'2019	Q1'2020
Core Capital/Total Liabilities	17.5%	17.4%
Minimum Statutory ratio	8.0%	8.0%
Excess	9.5%	9.4%
Core Capital/Total Risk Weighted Assets	16.7%	17.9%
Minimum Statutory ratio	10.5%	10.5%
Excess	6.2%	7.4%
Total Capital/Total Risk Weighted Assets	18.1%	18.5%
Minimum Statutory ratio	14.5%	14.5%
Excess	3.6%	4.0%
Liquidity Ratio	50.8%	55.5%
Minimum Statutory ratio	20.0%	20.0%
Excess	30.8%	35.5%
Adjusted core capital/ total deposit liabilities		17.7%
Adjusted core capital/ total risk weighted assets		18.2%
Adjusted total capital/ total risk weighted assets		18.8%

**Note that the figures for Q1'2019 are combined from CBA's and NIC's Q1'2019 releases.*