NIC Group Plc Earnings Update – Q1’2018

17th May, 2018

Valuation Summary

- We are of the view that NIC Group is a “Buy”, with a target price of Kshs 56.0 per share representing an upside of 54.1% from the current price of Kshs 37.0 per share, as at 16th May, inclusive of a dividend yield of 2.7%.
- NIC Bank is currently trading at a P/TBv of 0.9x and a P/E of 6.3x, vs an industry average of 1.7x and 9.2x, respectively.

Key highlights during Q1’2018

- NIC Bank expanded its footprint across Kenya with the opening of 4 new branches at the Coast in Malindi, Watamu, Kilifi and Diani in a bid to increase its customer base in the coastal region.

Income Statement

- Core earnings per share increased by 2.2% to Kshs 1.38 from Kshs 1.35 in Q1’2017, compared to our expectations of a 3.4% increase to Kshs 1.43. Performance was driven by a faster decline in total operating expenses of 8.1% outpacing the decline in total operating revenue, which declined by 4.6%. The variance in core earnings per share growth against our expectations was largely due to a 36.6% decline in NIC’S provisioning levels despite the compliance with IFRS 9 that adopts a forward-looking approach to credit risk assessment. We expected provisioning levels of Kshs 0.9bn, that came in at Kshs 0.6 bn,
- Total operating revenue declined by 4.6% to Kshs 3.5 bn from Kshs 3.7 bn in Q1’2017. This was due to an 8.3% decline in Net Interest Income (NII) to Kshs 2.5 bn from Kshs 2.7 bn, despite a 5.5% increase in Non - Funded Income (NFI) to Kshs 1.0 bn from Kshs 988.9 mn in Q1’2017,
- Interest Income increased by 8.2% to Kshs 4.7 bn from Kshs 4.3 bn in Q1’2017, driven by a 66.1% increase in interest income on government securities to Kshs 1.6 bn from Kshs 962.8 mn in Q1’2017. Interest income on loans and advances alone declined by 8.9% to Kshs 3.0 bn from Kshs 3.3 bn in Q1’2017. The yield on interest earning assets decreased to 11.2% from 12.2% in Q1’2017,
- Interest expense increased by 35.9% to Kshs 2.2 bn from Kshs 1.6 bn in Q1’2017, driven by a 43.7% increase in interest expense on customer deposits to Kshs 1.8 bn from Kshs 1.2 bn in Q1’2017. The cost of funds came in at 5.2% from 4.8% in Q1’2017. The Net Interest Margin thus declined to 6.3% from 7.9% in Q1’2017, as a result of a faster increase in interest expense as compared to the increase in interest income,
- Non-funded income recorded a growth of 5.5% to Kshs 1.0 bn from Kshs 988.9 mn in Q1’2017. The increase in NFI was driven by a 33.1% increase in other income to Kshs 0.2 bn from Kshs 0.1 bn in Q1’2017. Components of other income include rental income, gains/losses on disposal of motor vehicles & equipment, bad debt recoveries and trust & other fiduciary fees, and it is not clear which component drove the 33.1% increase in other income, and it appears a one-time increase as opposed to a sustainable fundamental increase. Total fees and commissions also increased by 1.8% to Kshs 564.0 mn from Kshs 554.0 mn in Q1’2017,
- Owing to the increase in NFI coupled with the decline in NII, the proportion of non-funded income to revenue increased, with the current revenue mix at 70:30 funded to non-funded income from 73:27 in Q1’2017,
- Total operating expenses declined by 8.1% to Kshs 2.1 bn from Kshs 2.3 bn in Q1’2017, following a 36.6% y/y decline in Loan loss provisions (LLP) to Kshs 0.6 bn from Kshs 0.9 bn in Q1’2017. Without LLP, operating expenses grew by 9.2% to Kshs 1.6 bn from Kshs 1.5 bn registered in Q1’2017. Staff costs grew by 12.0% to Kshs 0.8 bn from Kshs 0.7 bn in Q1’2017,
- The Cost to Income ratio improved to 60.7% from 63.0% in Q1’2017. Without LLP, cost to Income ratio deteriorated to 45.0% from 39.3% in Q1’2017,
- Profit before tax increased by 1.3% to Kshs 1.39 bn from Kshs 1.37 bn, while profit after tax also increased by 2.2% to Kshs 972.7 mn from Kshs 952.0 mn in Q1’2017.

Balance Sheet

- The balance sheet recorded an expansion in Q1’2018, with total assets increasing by 14.9% to Kshs 199.8 bn from Kshs 173.8 bn in Q1’2017. This expansion was driven by an 81.2% increase in government security holdings to Kshs 54.7 bn from Kshs 30.2 bn in Q1’2017,
- The Loan book declined by 0.4% to Kshs 115.9 bn from Kshs 116.3 bn in Q1’2017,
- Total liabilities increased by 17.5% to Kshs 167.8 bn from Kshs 142.8 bn in Q1’2017, driven by a 22.1% increase in customer deposits to Kshs 143.9 bn from Kshs 117.8 bn in Q1’2017,

- Deposits per branch increased by 14.8% to Kshs 2.9 bn from Kshs 2.5 bn in Q1'2017, with the bank's branch network increasing by four branches that opened in 2018. The bank's efforts to strengthen its network channels through 4 new branches at the Coast in 2018 are aimed at boosting its deposit mobilization capabilities,
- The faster growth in deposits compared to loans resulted in a decline in the loan to deposit ratio to 80.5% from 98.7% in Q1'2017,
- Gross non-performing loans (NPLs) increased by 15.5% to Kshs 15.9 bn from Kshs 13.8 bn in Q1'2017. The faster growth in NPLs coupled with a contraction in the loan book resulted in the NPL ratio deteriorating to 12.9% from 11.3% in Q1'2017. Gross NPL coverage ratio increased to 48.0% from 43.3% in Q1'2017,
- Shareholders' funds increased by 3.4% to Kshs 31.6 bn from Kshs 30.5 bn in Q1'2017,
- NIC Group is currently sufficiently capitalized with a core capital to risk weighted assets ratio at 18.2%, 7.7% above the statutory requirement of 10.5%, with total capital to total risk weighted assets exceeding statutory requirement by 6.3% to close the period at 20.8%. Adjusting for IFRS 9, the core capital to risk weighted assets stood at 19.0%, while total capital to risk weighted assets came in at 21.6%, indicating the bank's total capital relative to its risk-weighted assets declined by 0.8% owing to IFRS 9 compliance,
- NIC Group currently has a return on average assets of 2.2% and a return on average equity of 13.4%. The ROAE of 13.4% is way below industry average of 17.6%, an indicator that the franchise is underperforming.

Key Take-Outs:

a) The implementation of IFRS 9 took effect-starting 2018, with banks mostly opting to pass the effect through their balance sheet. NIC Group also took this approach, with their statutory loan reserves in their shareholder's funds declining by 81.0% to Kshs 196.4 mn from Kshs 1.0 bn in FY'2017. In addition, the adjusted capital ratios have also been disclosed in the statements, assuming the effect of the IFRS 9 compliance is added back to the bank's capital,
b) Despite the 15.5% increase in NPLs and the requirement to comply with the forward-looking IFRS 9 accounting standard, NIC Group recorded a 36.6% decline in Loan Loss Provisions to Kshs 0.6 bn from Kshs 0.9 bn in Q1'2017. We find this trend worrying and highlights a possible increase in risk for the bank.

Going forward NIC Group has an opportunity to address its poor performance by targeting the following areas**:**

a) NIC Group's NFI is still below industry average, coming in at 30.0% while the industry is at 33.6%; yet it has fee income businesses such as NIC Securities and NIC Capital. NIC Group is really performing below its potential on fee income businesses, with total fees rising a mere 1.8%, and this should be a key area of focus to improve profitability,
b) Better deployment of deposits, which grew strongly by 22.1%, leading to a 35.9% growth in interest expense, but the bank was not able to deploy the strong deposit growth into yielding assets, leading to an 8.3% drop in Net Interest Income,
c) Bring down the cost of funds: It is not clear why the bank is aggressive in mobilizing expensive deposits that it is not able to deploy, as the loan book actually declined even as deposits grew aggressively at 2.1%, leading to cost of money at 5.2%, which is too high above Tier 1 and 2 averages of 3.1%, and almost double the cost of other players such as equity bank at 2.7%. The bank needs to urgently address its cost of funding, and,
d) Focusing on improving their asset quality, with the establishment of the Credit Risk Advisory Group (CRAG) division expected to improve the credit appraisal process and loan recovery efforts. This in turn should reduce NIC Group's NPLs. NIC Group's Gross Non-Performing Loans ratio came in at 12.9%, which is way above industry average of 8.3%,
e) NIC should strive to manage its rising staff costs, which increased by 12.0%, which is way higher than the average increase of 3.6%. Increased adoption of alternative distribution channels such as mobile and internet banking will aid in increasing the bank's operation efficiency, by cost reduction, as well as increase the bank's transaction income, thereby achieving sustainable growth

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	Q1'2017	Q1'2018	y/y change	Q1'2018e	Projected %y/y change	Variance in Growth Actual vs. Expected
Government Securities	30.2	54.7	81.2%	47.3	56.6%	24.6%
Net Loans and Advances	116.3	115.9	(0.4%)	114.1	(1.9%)	1.6%

Total Assets	**173.8**	**199.8**	**14.9%**	**191.4**	**10.1%**	**4.8%**
Customer Deposits	117.8	143.9	22.1%	129.6	10.0%	12.1%
Total Liabilities	142.8	167.8	17.5%	155.7	9.1%	8.4%
Shareholders’ Funds	**30.5**	**31.6**	**3.4%**	**35.2**	**15.4%**	**(12.0%)**

Balance Sheet Ratios	Q1'2017	Q1'2018	y/y change
Loan to Deposit Ratio	98.7%	80.5%	(18.2%)
Return on average equity	15.0%	13.4%	(1.6%)
Return on average assets	2.6%	2.2%	(0.3%)

Income Statement	Q1’2017	Q1’2018	y/y change	Q1’2018e	Projected %y/y change	Variance in Growth Actual vs. Expected
Net Interest Income	2.7	2.5	(8.3%)	2.8	4.3%	(12.5%)
Net non-Interest Income	1.0	1.0	5.5%	1.1	8.0%	(2.5%)
Total Operating income	**3.7**	**3.5**	**(4.6%)**	**3.9**	**5.3%**	**(9.9%)**
Loan Loss provision	0.9	0.6	(36.6%)	0.9	5.3%	(41.9%)
Total Operating expenses	2.3	2.1	(8.1%)	2.5	6.7%	(14.8%)
Profit before tax	1.4	1.4	1.3%	1.4	2.8%	(1.4%)
Profit after tax	**1.0**	**1.0**	**2.2%**	**1.0**	**3.4%**	**(1.2%)**

Income Statement Ratios	Q1’2017	Q1'2018	y/y change
Yield from interest-earning assets	12.2%	11.2%	(1.0%)
Cost of funding	4.8%	5.2%	0.4%
Net Interest Spread	7.4%	6.0%	(1.4%)
Net Interest Margin	7.9%	6.3%	(1.7%)
Cost of Risk	23.7%	15.7%	(8.0%)
Net Interest Income as % of operating income	73.2%	70.4%	(2.8%)
Non-Funded Income as a % of operating income	26.8%	29.6%	2.8%
Cost to Income Ratio	63.0%	60.7%	(2.3%)
Cost to Assets	39.3%	45.0%	5.7%

Capital Adequacy Ratios	Q1’2017	Q1'2018
Core Capital/Total Liabilities	25.0%	21.6%
Minimum Statutory ratio	8.0%	8.0%
Excess	**17.0%**	**13.6%**
Core Capital/Total Risk Weighted Assets	17.9%	18.2%
Minimum Statutory ratio	10.5%	10.5%
Excess	**7.4%**	**7.7%**
Total Capital/Total Risk Weighted Assets	21.9%	20.8%
Minimum Statutory ratio	14.5%	14.5%
Excess	**7.4%**	**6.3%**
Liquidity Ratio	39.0%	48.2%
Minimum Statutory ratio	20.0%	20.0%
Excess	**19.0%**	**28.2%**
Adjusted Core Capital/Total Liabilities		**22.7%**
Adjusted Core Capital/Total Risk Weighted Assets		**19.0%**

Adjusted Total Capital/Total Risk Weighted Assets	**21.6%**