NIC Group Plc Earnings Update – Q3’2018

30th November, 2018

Valuation Summary

- We are of the view that NIC Group is a “***Buy***” with a target price of Kshs 48.8, representing an upside of 118.9%, from the current price of Kshs 22.8 as of 30th November, inclusive of a dividend yield of 4.4%,
- NIC Group is currently trading at P/TBV of 0.6x and a P/E of 3.9x vs an industry average of 1.4x and 6.7x, respectively.

Key Highlights Q3’2018

- NIC Bank was crowned the Champions of Governance and the Finance and Investment Sector leader by the Institute of Certified Secretaries (ICS) during the 2018 Champions of Governance (CoG) Awards held this November.

Income Statement

- Core earnings per share declined by 3.3% to Kshs 4.56 from Kshs 4.72 in Q3’2017, which was in line with our expectation of a 2.8% decline to Kshs 4.58. Performance was driven by a 2.2% decline in total operating income to Kshs 11.0 bn from Kshs 11.2 bn in Q3’2017, which outweighed the 2.5% decline in total operating expenses to Kshs 6.6 bn from Kshs 6.8 bn.
- Total operating income declined by 2.2% to Kshs 11.0 bn in Q3’2018 from Kshs 11.2 bn in Q3’2017. This was due to a 5.9% decrease in Net Interest Income (NII) to Kshs 7.6 bn from Kshs 8.0 bn in Q3’2017, which outweighed the 7.2% increase in Non-Funded Income (NFI) to Kshs 3.4 bn from Kshs 3.2 bn in Q3’2017,
- Interest income increased by 5.5% to Kshs 14.2 bn from Kshs 13.5 bn in Q3’2017. This was largely driven by the 40.5% increase in interest income from government securites to Kshs 5.0 bn in Q3’2018 from Kshs 3.6 bn in Q3’2017, coupled with a 144.0% increase in interest income from deposits and placements with banking institutions to Kshs 133.3 mn from Kshs 46.5 mn in Q3’2017. However, interest income on loans and advances decreased by 7.9% to Kshs 9.1 bn from Kshs 9.9 bn in Q3’2017.However, the yield on interest earning assets declined to 10.8% in Q3’2018 from 10.9% in Q3’2017, due to the 2.8% increase in interest-earning assets to Kshs 180.6 bn from Kshs 175.7 bn in Q3’2017,
- Interest expense increased by 22.2% to Kshs 6.7 bn from Kshs 5.5 bn in Q3’2017, as interest expense on customer deposits increased 29.0% to Kshs 5.5 bn from Kshs 4.3 bn in Q3’2017. Interest expense on deposits from other banking institutions remained relatively flat at Kshs 0.1 bn, same as in Q3’2017. As a consequence, the cost of funds rose to 5.6% from 4.7% in Q3’2017, and the Net Interest Margin declined to 5.8% from 6.6% in Q3’2017,
- Non-Funded Income increased by 7.2% to Kshs 3.4 bn from Kshs 3.2 bn in Q3’2017. The increase in NFI was driven by a 10.7% increase in forex trading income to Kshs 1.0 bn from Kshs 0.9 bn in Q3’2017, coupled with an 11.2% increase in income from other fees and commissions to Kshs 739.6 mn from Kshs 665.3 mn in Q3’2017. Furthemore, Income from fees and commissions on loans increased by 2.2% to Kshs 1.09 bn from Kshs 1.07 bn in Q3’2017, while other income increased by 6.2% to Kshs 0.6 bn from Kshs 0.5 bn in Q3’2017. The revenue mix shifted to 69:31 funded to non-funded income in Q3’2018 from 72:28 in Q3’2017, owing to the increase in NFI, coupled with the decline in NII,
- Total operating expenses decreased by 2.5% to Kshs 6.6 bn from Kshs 6.8 bn, largely driven by a 25.4% decrease in loan loss provision (LLP) to Kshs 1.6 bn in Q3’2018 from Kshs 2.1 bn in Q3’2017. Staff costs, however, increased by 8.8% to Kshs 2.6 bn in Q3’2018 from Kshs 2.4 bn in Q3’2017. Other operating expenses rose by 7.2% to Kshs 2.4 bn from 2.3 bn in Q3’2017,
- The cost to income ratio improved marginally to 60.6% from 60.8% in Q3’2017. Without LLP, however, the cost to income ratio deteriorated to 46.0% from 41.6% in Q3’2017,

- Profit before tax decreased by 1.7% to Kshs 4.3 bn, from Kshs 4.4 bn in Q3’2017. Profit after tax decreased by 3.3% to Kshs 3.2 bn in Q3’2018 from Kshs 3.3 bn in Q3’2017.

Balance Sheet

- The balance sheet recorded an expansion with total assets growth of 3.1% to Kshs 201.8 bn from Kshs 195.7 bn in Q3’2017. This growth was largely driven by a 16.2% increase in government securities to Kshs 60.2 bn from Kshs 51.8 bn in Q3’2017, alongside a 26.9% increase in other assets to Kshs 9.6 bn from Kshs 7.6 bn in Q3’2017,
- The loan book contracted by 3.1% to Kshs 114.9 bn in Q3’2018 from Kshs 118.6 bn in Q3’2017,
- Total liabilities rose by 3.8% to Kshs 167.9 bn from Kshs 161.8 bn in Q3’2017, driven by a 10.3% increase in customer deposits to Kshs 145.0 bn from Kshs 131.4 bn in Q3’2017, alongside a 46.1% increase in other liabilities, to Kshs 4.2 bn, from Kshs 2.8 bn in Q3’2017. Deposits per branch decreased marginally by 0.5% to Kshs 3.5 bn from Kshs 3.6 bn in Q3’2017 due to the opening of 4 new branches,
- The growth in deposits coupled with the decline in loans led to a decline in the loan to deposit ratio to 79.3% from 90.2% in Q3’2017. Government securities to deposits rose to 41.5% from 39.4% in Q3’2017, due to the faster increase in government securities compared to the increase in deposits,
- Gross non-performing loans increased by 11.7% to Kshs 16.4 bn in Q3’2018 from Kshs 14.7 bn in Q3’2017. Consequently, the NPL ratio deteriorated to 13.3% in Q3’2018 from 11.7% in Q3’2017. General Loan loss provisions increased by 27.7% to Kshs 6.6 bn from Kshs 5.2 bn in Q3’2017. Consequently, the NPL coverage improved to 51.4% in Q3’2018 from 48.1% in Q3’2017. The decline in the specific provisions despite the deterioration in asset quality is due to banks being allowed to charge the provision expense on shareholders equity, on implementation of IFRS 9,
- Shareholders’ funds increased by 0.3% to Kshs 33.5 bn in Q3’2018 from Kshs 33.4 bn in Q3’2017, driven by a 0.6% increase in retained earnings to Kshs 27.6 bn from Kshs 27.4 bn in Q3’2017,
- NIC Group is currently sufficiently capitalized with a core capital to risk weighted assets ratio of 18.1%, 7.6% above the statutory requirement. In addition, the total capital to risk weighted assets ratio was 20.1%, exceeding the statutory requirement by 5.6%. Adjusting for IFRS 9, the core capital to risk weighted assets stood at 19.3%, while total capital to risk weighted assets came in at 21.2%,
- NIC Group currently has a return on average assets of 2.0% and a return on average equity of 12.1%.

Key Take-Outs:

a) NIC Group’s cost of funds increased to 5.6% in Q3’2018 from 4.7% in Q3’2017, which is way above the listed banking sector average of 3.4%, on the back of a 37.7% increase in interest expense on customer deposits brought about by a 10.5% increase in customer deposits. This highlights the bank’s inability to mobilize inexpensive deposits from its clientele base as it offers high rates to attract deposits. The bank needs to mobilize cheap deposits for it to benefit from the clause in the Finance Bill 2018, which scrapped the 70.0% floor on bank deposits,

b) The bank’s cost to income ratio (without loan loss provisions) deteriorated to 46.0% in Q3’2018, from 41.6% in Q3’2017. This was partly attributable to an 8.8% increase in staff costs to Kshs 2.6 bn in Q3’2018 from Kshs 2.4 bn in Q3’2017, coupled with the 2.2% decline in total operating income, to Kshs 11.0 bn in Q3’2018, from Kshs 11.2 bn in Q3’2017.

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

a. Increase in customer base – NIC Group should employ aggressive marketing strategies that would result in an increased customer base. This would enable the bank to mobilize inexpensive deposits from a larger pool of customers, thereby decreasing its cost of funding and, by extension, interest expenses. The ongoing expansion to East African countries such as Uganda and Tanzania will serve to increase the bank’s deposit base.

b. Non-Funded Income Growth Initiatives – NIC Bank's NFI is improving as the bank focuses on digital innovation and alternative banking channels to augment transaction volumes and increase fee income. The bank needs to increase capacity of its brokerage and advisory business, in addition to setting income targets for these entities to increase fee income from investment and advisory services.

The tables below summarize the performance:

Balance Sheet	Q3'2017	Q3'2018	y/y change	Q3'2018e	Projected y/y Change	Variance from Actual
Government Securities	51.8	60.2	16.2%	55.8	7.7%	(8.5%)
Net Loans and Advances	118.6	114.9	(3.1%)	126.8	7.0%	10.0%
Total Assets	**195.7**	**201.8**	**3.1%**	**214.7**	**9.7%**	**6.6%**
Customer Deposits	131.4	145.0	10.3%	152.8	16.3%	6.0%
Borrowings	18.9	15.8	(16.7%)	15.8	(16.7%)	0.1%
Total Liabilities	**161.8**	**167.9**	**3.8%**	**179.3**	**10.8%**	**7.0%**
Shareholders' Funds	33.4	33.5	0.3%	35.0	4.9%	4.6%

Ratios	Q3'2017	Q3'2018	y/y change
Loan to Deposit Ratio	90.2%	79.3%	(10.9%)
Return on average equity	13.7%	12.1%	(1.7%)
Return on average assets	2.4%	2.0%	(0.3%)

Income Statement	Q3'2017	Q3'2018	y/y change	Q3'2018e	Projected y/y Change	Variance from Actual
Net Interest Income	8.0	7.6	(5.9%)	7.4	(7.5%)	(1.7%)
Net non-Interest Income	3.2	3.4	7.2%	3.5	9.6%	2.4%
Total Operating income	**11.2**	**11.0**	(2.2%)	**10.9**	**(2.7%)**	**(0.5%)**
Loan Loss provision	(2.1)	(1.6)	(25.4%)	(1.3)	(37.1%)	(11.7%)
Total Operating expenses	(6.8)	(6.6)	(2.5%)	(6.3)	(7.6%)	(5.1%)
Profit before tax	**4.4**	**4.3**	(1.7%)	**4.6**	**4.9%**	**6.6%**
Profit after tax	**3.3**	**3.2**	**(3.3%)**	**3.2**	**(2.8%)**	**0.4%**
EPS	**5.2**	**5.0**	**(3.3%)**	**5.0**	**(2.8%)**	**0.4%**

Ratios	Q3'2017	Q3'2018	y/y change
Yield from interest-earning assets	10.9%	10.8%	(0.2%)
Cost of funding	4.7%	5.6%	0.8%
Net Interest Margin	6.6%	5.8%	(0.9%)
Cost to Income	60.8%	60.6%	(0.2%)
Cost to Assets	2.4%	2.5%	0.1%
Net Interest Income as % of operating income	71.8%	69.1%	(2.7%)
Non-Funded Income as a % of operating income	28.2%	30.9%	2.7%

Capital Adequacy Ratios	Q3'2017	Q3'2018
Core Capital/Total Liabilities	24.1%	21.4%
Minimum Statutory ratio	8.0%	8.0%
Excess	**16.1%**	**13.4%**
Core Capital/Total Risk Weighted Assets	18.6%	18.1%
Minimum Statutory ratio	10.5%	10.5%
Excess	**8.1%**	**7.6%**

Total Capital/Total Risk Weighted Assets	21.9%	20.1%
Minimum Statutory ratio	14.5%	14.5%
Excess	**7.4%**	**5.6%**
Liquidity Ratio	44.6%	49.3%
Minimum Statutory ratio	20.0%	20.0%
Excess	**24.6%**	**29.3%**
Adjusted Core Capital/Total Liabilities		**20.0%**
Adjusted Core Capital/Total Risk Weighted Assets		**16.7%**
Adjusted Total Capital/Total Risk Weighted Assets		**18.8%**