Standard Chartered Bank Kenya Ltd– Q3’2018

23rd November, 2018

Valuation Summary

- We are of the view that Standard Chartered Bank Kenya Ltd is an “***Hold***” with a target price of Kshs 196.0, representing an upside of 9.9%, from the current price of Kshs 190.0 as of 23rd November 2018, inclusive of a dividend yield of 3.3%,
- Standard Chartered Bank Kenya Ltd is currently trading at P/TBV of 1.5x and a P/E of 7.7x vs an industry average of 1.4x and 6.7x, respectively.

Key Highlights Q3’2018

- On 29thSeptember 2018, Standard Chartered introduced launched a mobile app, whose main aim is to facilitate fees payment, for students in private schools. Schools will directly invoice parents and guardians through the app to make payments on the platform.

Income Statement

- Core EPS increased by 33.9% to Kshs 18.4, from Kshs 13.7 in Q3’2017, exceeding our expectation of an 18.9% increase to Kshs 16.3. The performance was driven by a 7.1% increase in total operating income, coupled with a 7.1% decline in the total operating expenses. The variance in core earnings per share growth against our expectations was largely due to the faster 9.7% growth in Non-Funded Income (NFI) to Kshs 7.0 bn from Kshs 6.4 bn, coupled with a faster 49.6% decline in Loan Loss Provisions (LLP) to Kshs 1.9 bn, from Kshs 3.7 bn in Q3’2017. Important to note for Standard Chartered Bank is that the decline in the specific provisions, that came despite a deterioration in asset quality, is due to banks being allowed to charge provisions through the balance sheet during the first year of the implementation of IFRS 9. We expected a slower 3.4% growth in NFI to Kshs 6.6 bn, from Kshs 6.4 bn in Q3’2017, and a slower 36.5% decline in LLP to Kshs 2.4 bn,
- Total operating income increased by 7.1% to Kshs 21.6 bn year-to-date (YTD) Q3’2018, from Kshs 20.2 bn over the same period to Q3’2017. This was due to a 5.9% increase in Net Interest Income (NII) to Kshs 14.6 bn from Kshs 13.8 bn in Q3’2017, coupled with the 9.7% increase in Non-Funded Income (NFI) to Kshs 7.0 bn, from Kshs 6.4 bn in Q3’2017,
- Interest income increased by 4.8% to Kshs 20.3 bn, from Kshs 19.4 bn in Q3’2017. This was driven by a 15.2% growth in interest income from government securities to Kshs 9.5 bn, from Kshs 8.3 bn in Q3’2017, which outpaced the 1.7% decline in interest income on loans and advances to Kshs 9.9 bn, from Kshs 10.1 bn in Q3’2017, and a 2.5% decline in interest income on deposits and placements with banking institutions, to Kshs 0.39 bn from Kshs 0.4 bn in Q3’2017. As a result of the increase in interest income, the yield on interest earning assets rose to 11.9% in Q3’2018, from 11.3% in Q3’2017,
- Interest expense increased by 2.1% to Kshs 5.8 bn, from Kshs 5.7 bn in Q3’2017, following a 5.4% increase in the interest expense on customer deposits to Kshs 4.9 bn, from Kshs 4.7 bn in Q3’2017. However, Interest expense on deposits and placements from banking institutions declined by 69.0% to Kshs 0.1 bn from Kshs 0.2 bn in Q3’2017. Furthermore, other interest expenses declined by 2.9% to Kshs 0.77 bn, from Kshs 0.79 bn in Q3’2017. As a result of the increase in interest expenses, the cost of funds increased to 3.4%, from 3.3% in Q3’2017. The Net Interest Margin (NIM) rose to 8.5%, from 8.1% in Q3’2017,
- Non-Funded Income (NFI) increased by 9.7% to Kshs 7.0 bn, from Kshs 6.4 bn in Q3’2017. Fees and commissions on loans rose by 66.7% to Kshs 0.2 bn, from Kshs 0.1 bn in Q3’2017. Other fees and commission income rose by 29.9% to Kshs 4.0 bn, from Kshs 3.1 bn in Q3’2017. Forex trading income increased by 10.9% to Kshs 2.1 bn, from Kshs 1.9 bn in Q3’2017. However, other income declined by 43.6% to Kshs 0.7 bn, from Kshs 1.3 bn in Q3’2017. As a result of the above performance, the current revenue mix shifted to 67:33 funded to non-funded income as compared to 68:32 in Q3’2017, with the NFI as proportion of total operating income slightly lower than the 34.8% industry average. The proportion of NII to total revenue decreased owing to the faster growth in NFI,

- Total operating expenses declined by 7.1% to Kshs 12.4 bn, from Kshs 13.3 bn, largely driven by a 49.6% decrease in Loan Loss Provisions (LLP) to Kshs 1.9 bn in Q3’2018, from Kshs 3.7 bn in Q3’2017, coupled with a 1.9% decline in staff costs to Kshs 5.1 bn in Q3’2018, from Kshs 5.2 bn in Q3’2017. However, other operating expenses rose by 22.7% to Kshs 5.4 bn from Kshs 4.4 bn in Q3’2017,
- As a consequence, the Cost to Income Ratio (CIR) improved to 57.2%, from 66.0% in Q3’2017. However, without LLP, the cost to income ratio deteriorated to 48.5%, from 47.5% in Q3’2017,
- Profit before tax increased by 34.6% to Kshs 9.2 bn, up from Kshs 6.9 bn in Q3’2017. Profit after tax increased by 33.9% to Kshs 6.3 bn in Q3’2018, from Kshs 4.7 bn in Q3’2017.

Balance Sheet

- The balance sheet recorded a contraction as total assets decreased by 7.1% to Kshs 288.6 bn from Kshs 310.5 bn in Q3’2017. This decline was largely driven by a 6.1% decline in government securities to Kshs 107.2 bn, from Kshs 114.1 bn in Q3’2017, coupled with a 2.8% decline in the loan book to Kshs 111.0 bn, from Kshs 114.2 bn in Q3’2017,
- Total liabilities declined by 9.0% to Kshs 241.8 bn from Kshs 265.7 bn in Q3’2017, driven by an 8.0% decrease in total deposits to Kshs 219.5 bn from Kshs 238.5 bn in Q3’2017. Deposits per branch also decreased by 9.0% to Kshs 6.1 bn, from Kshs 6.6 bn in Q3’2017, with no new branches opened or closed. Placement liabilities increased by 9.8% to Kshs 4.1 bn from Kshs 3.7 bn in Q3’2017. The bank does not have any borrowed funds,
- The faster decline in deposits as compared to loans led to an increase in the loan to deposit ratio to 50.6%, from 47.9% in Q3’2017.The proportion of government securities to deposits also increased, to 48.8% from 47.8% in Q3’2017
- Gross Non-Performing Loans (NPLs) increased by 14.9% to Kshs 19.5 bn in Q3’2018, from Kshs 17.0 bn in Q3’2017. Consequently, the NPL ratio deteriorated to 15.6% in Q3’2018, from 13.4% in Q3’2017. General Loan Loss Provisions (LLPs) increased by 5.7% to Kshs 7.2 bn from Kshs 6.8 bn in Q3’2017. The NPL coverage declined marginally to 74.2% in Q3’2018 from 74.3% in Q3’2017, supported by the 25.5% increase in interest in suspense to Kshs 7.3 bn, from Kshs 5.8 bn in Q3’2017. The decline in the specific provisions despite a deterioration in asset quality, is due banks being allowed to charge provisions on equity, on the initial implementation of IFRS 9,
- Shareholders’ funds increased by 4.4% to Kshs 46.8 bn in Q3’2018 from Kshs 44.8 bn in Q3’2017, as retained earnings grew by 1.7% y/y to Kshs 31.0 bn from Kshs 30.4 bn, coupled with a 76.9% increase in the revaluation reserve to Kshs 0.7 bn from Kshs 0.4 bn in Q3’2017,
- Standard Chartered Bank Kenya Ltd remains sufficiently capitalized with a core capital to risk weighted assets ratio of 16.9%, 6.4% points above the statutory requirement. In addition, the total capital to risk weighted assets ratio was 19.0%, exceeding the statutory requirement by 5.3% points. Adjusting for IFRS 9, the core capital to risk weighted assets stood at 17.1%, while total capital to risk weighted assets came in at 20.1%, indicating that the bank’s total capital relative to its risk-weighted assets declined by 0.3% points due to implementation of IFRS 9,
- The bank currently has a Return on Average Assets (ROaA) of 2.8% and a Return on Average Equity (ROaE) of 18.6%.

Key Take-Outs:

a) The bank had a deterioration in its quality, with the gross NPLs rising by 14.9% y/y, as the industry wide asset quality continues to deteriorate, sighting delayed government payments coupled with the relatively tighter macroeconomic environment, affecting borrowers’ credit servicing ability,
b) The bank had a contraction in its balance sheet as the net loans and advances declined by 2.8%, and its customer deposits declined by 8.0% y/y. The decline in the bank’s core funding base, coupled with

the bank’s stringent lending policies on asset quality concerns led to a decline in the bank’s lending activities, and,

c) The bank managed to improve on its operational efficiency as the CIR improved to 57.2% from 66.0% in Q3’2017. However, this seems to have stemmed from a lower cost of risk on reduced provisioning, as the CIR without LLP deteriorated to 48.5%. This was due to a 22.7% increase in other operating expenses.

We expect the bank’s growth to be driven by

a) Continued focus on promoting the usage of the bank’s alternative channels is likely to continue boosting the company’s Non-Funded Income (NFI) as well as aiding in improving operational efficiency. Revenue expansion coupled with cost containment will boost the bank’s bottom line, and
b) The bank could diversify on its funding base to aid the bank in matching its issued loans tenor to its funding by e.g taking up long term borrowings for use lending activities, hence improve on the interest income, that is likely to experience compression on reduced lending.

Below is a summary of the bank’s performance:

Balance Sheet Items	Q3'2017	Q3'2018	y/y change	Q3'2018e	Projected y/y change	Variance in Growth Actual vs. Expected
Government Securities	114.1	107.1	(6.1%)	126.8	11.1%	(17.2%)
Net loans	114.2	111.0	(2.8%)	110.4	(3.3%)	0.5%
Total Assets	**310.5**	**288.6**	**(7.1%)**	**306.2**	**(1.4%)**	**(5.7%)**
Customer Deposits	238.5	219.5	(8.0%)	240.1	0.7%	(8.6%)
Total Liabilities	265.7	241.8	(9.0%)	260.4	(2.0%)	(7.0%)
Shareholder's Funds	**44.8**	**46.8**	**4.4%**	**45.8**	**2.2%**	**2.2%**

Balance Sheet Ratios	H1'2017	H1'2018	y/y change
Loan to deposit ratio	47.9%	50.6%	2.7%
Return on Average Equity	13.6%	18.6%	5.0%
Return on Average Assets	2.1%	2.8%	0.7%

Income Statement	Q3'2017	Q3'2018	y/y change	Q3'2018e	Projected y/y change	Variance in Growth Actual vs. Expected
Net Interest Income	13.8	14.6	5.9%	14.0	1.6%	4.3%
Net non-Interest Income	6.4	7.0	9.7%	6.6	3.4%	6.3%
Total Operating income	**20.2**	**21.6**	**7.1%**	**20.6**	**2.2%**	**4.9%**
Loan Loss provision	3.7	1.9	(49.6%)	2.4	(36.5%)	(13.1%)
Total Operating expenses	13.3	12.4	(7.1%)	12.6	(5.2%)	(1.9%)
Profit before tax	6.9	9.2	34.6%	8.0	16.5%	18.2%
Profit after tax	**4.7**	**6.3**	**33.9%**	**5.6**	**18.9%**	**15.0%**
Core EPS	**13.7**	**18.4**	**33.9%**	**16.3**	**18.9%**	**15.0%**

Income Statement Ratios	Q3'2017	Q3'2018	y/y change
Yield from interest-earning assets	11.3%	11.9%	0.6%
Cost of funding	3.3%	3.4%	0.1%
Net Interest Spread	8.0%	8.6%	0.6%
Net Interest Margin	8.1%	8.5%	0.4%

Cost of Risk	18.5%	8.7%	(9.8%)
Net Interest Income as % of operating income	68.2%	67.4%	(0.8%)
Non-Funded Income as a % of operating income	31.8%	32.6%	0.8%
Cost to Income Ratio	66.0%	57.2%	(8.7%)

Capital Adequacy Ratios	Q3'2017	Q3'2018
Core Capital/Total Liabilities	15.1%	16.4%
Minimum Statutory ratio	8.0%	8.0%
Excess	**7.1%**	**8.4%**
Core Capital/Total Risk Weighted Assets	17.1%	16.9%
Minimum Statutory ratio	10.5%	10.5%
Excess	**6.6%**	**6.4%**
Total Capital/Total Risk Weighted Assets	20.1%	19.8%
Minimum Statutory ratio	14.5%	14.5%
Excess	**5.6%**	**5.3%**
Liquidity Ratio	69.9%	69.9%
Minimum Statutory ratio	20.0%	20.0%
Excess	**49.9%**	**49.9%**
Adjusted core capital/ total deposit liabilities*		15.3%
Adjusted core capital/ total risk weighted assets*		16.1%
Adjusted total capital/ total risk weighted liabilities*		19.0%

**Adjusted ratios in line with CBK’s guidance note, with provisions added back for capital computation purposes*