DYER & BLAIR INVESTMENT BANK
EARNINGS UPDATE

Founder Member of the Nairobi Securities Exchange

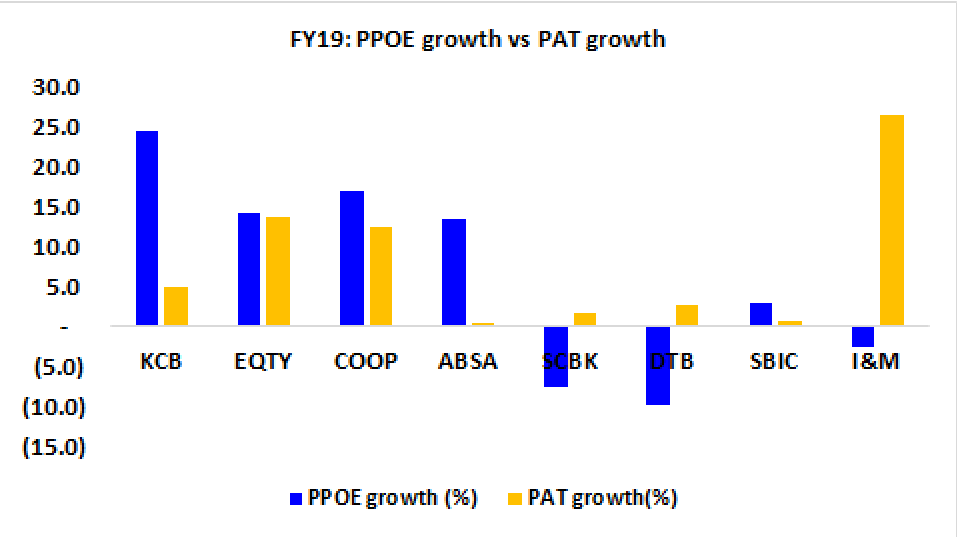
23RD APRIL 2020

DYER & BLAIR INVESTMENT BANK

WE KNOW. YOU KNOW.

KENYA: LISTED BANKS FY19 BY THE NUMBERS:

We for the sake of discussion, share our quick thoughts on listed banks following the publication of FY19 earnings. Previously thought to be a year when commercial banks begin a new phase of growth characterized by aggressive lending in a period of fiscal consolidation, banks (like all other businesses) are beset by a cloud of uncertainties about the impact of the COVID-19 crisis, the locust invasion and the uncertainties regarding the nature of post COVID-19 global economic recovery. With capital preservation in mind, we are generally drawn to foreign owned banks, which known for being conservative are less externalized from a foreign equities investor stand point, are less leveraged and have significant capital and liquidity buffers.



Source: Company, DBIB Research, *PPOE= pre provisions operating earnings*

The nature and quality of provisioning remains unclear across banks but the graph above speaks to the probable uniqueness of underlying models even though the factors behind non-performance are rather uniform across the sector. We expect that the publication of the annual reports will shed more light especially on the size and nature of stage three loans vs their respective provisions.

PAT (KES BN)	FY19	FY18
KCB	25.2	24.0
EQTY	22.6	19.8
COOP	14.3	12.7
ABSA	7.5	7.4
SCBK	8.2	8.1
DTB	7.3	7.1
SBIC	6.2	6.2
NCBA	7.8	5.0
I&M	10.8	8.5
HF	(0.1)	(0.6)

(Source: Company, DBIB Research)
PAT= profit after tax

PAT Growth	Y/Y(%)	Q/Q(%)
KCB	4.9	(6.8)
EQTY	13.8	(7.0)
COOP	12.4	0.4
ABSA	0.6	12.8
SCBK	1.7	32.3
DTB	2.6	(31.2)
SBIC	0.7	(22.6)
NCBA	56.7	44.4
I&M	26.6	96.0
HF	(81.6)	(305.4)

(Source: Company, DBIB Research)

PPOP (KES BN)	FY19	FY18
KCB	45.8	36.8
EQTY	36.8	32.2
NCBA	19.6	10.2
COOP	23.2	19.8
ABSA	16.5	14.5
I&M	14.3	14.7
SCBK	12.7	13.8
DTB	12.6	14.0
SBIC	10.9	10.5
HF	0.2	(0.3)

(Source: Company, DBIB Research)
PPOP= pre provisions operating earnings

Research Department

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LOAN BOOK GROWTH (%)

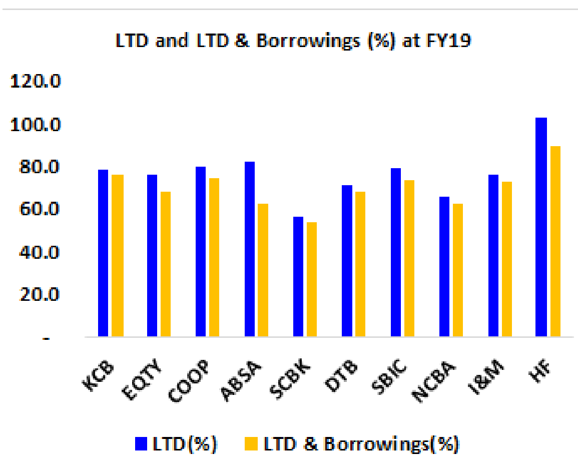
Group	Y-o-Y growth (%)
KCB	17.4
EQTY	23.3
COOP	8.7
SCBK	8.5
DTB	3.1
ABSA	9.9
SBIC	4.2
I&M	5.2
HF	(11.3)

(Source: Company, DBIB Research)

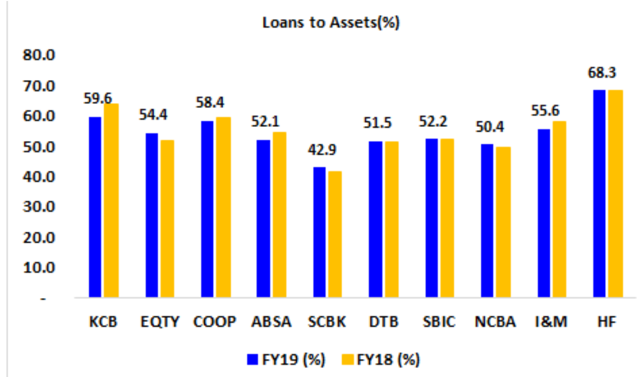
LOAN TO DEPOSITS & BORROWED FUNDS AT FY19

Group	LTD(%)	LTD &Borrowings(%)
KCB	78.0	75.6
EQTY	75.9	67.9
COOP	80.1	74.2
ABSA	82.0	62.9
SCBK	**56.3**	**53.7**
DTB	**71.1**	**68.3**
SBIC	79.0	73.7
NCBA	65.9	62.3
I&M	76.3	72.9
HF	103.1	89.2

(Source: Company, DBIB Research)

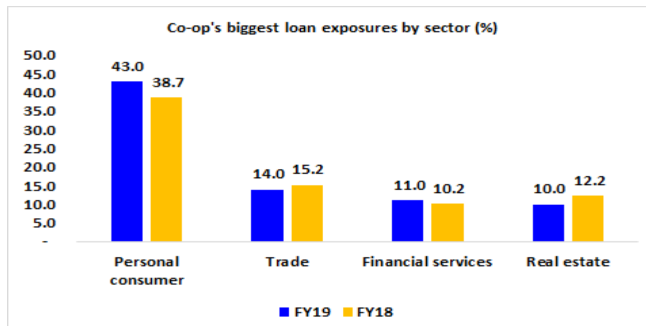


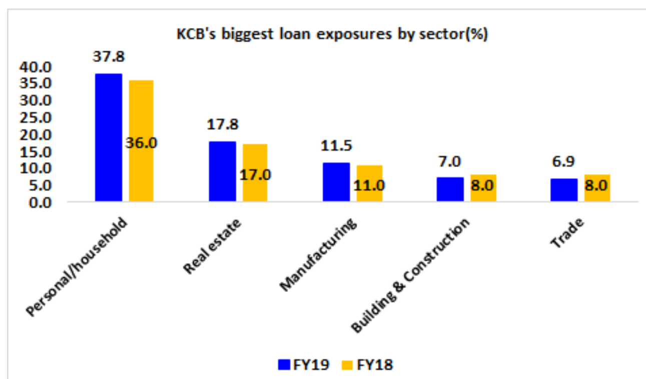
High LTDs among mass market banks exposes them to significant non-performance risk if the COVID-19 economic lock down continues for a while. Further, if cost of money rises, such banks may see cost of funds pressures in the post COVID -19 recovery phase. Conversely, foreign owned banks with relatively low LTDs stand a better chance over the crisis and post crisis period.

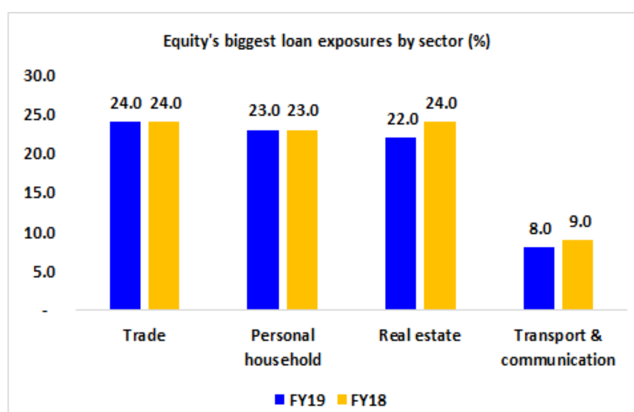


(Source: Company, DBIB Research)

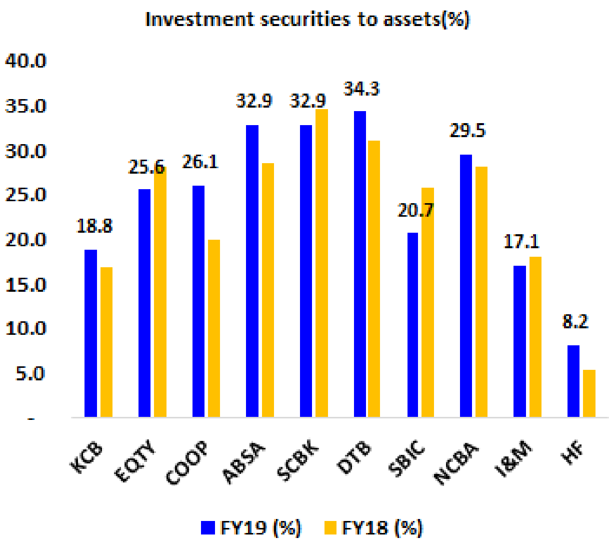
Known for a more aggressive approach, mass market banks have a higher asset exposure to loans thus face a high risk of weakening asset quality over the crisis period.



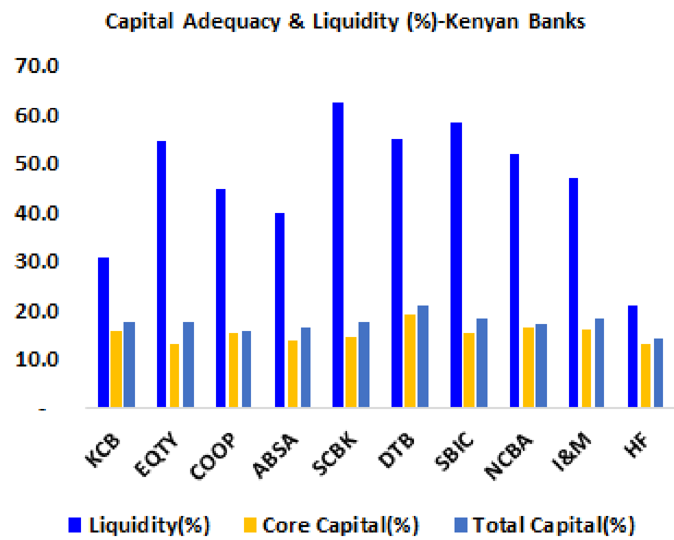




Source: Company FY19 Presentations



(Source: Company, DBIB Research)



(Source: Company, DBIB Research)

We continue to expect that yields will rise on the back of auction pressure if government continues to issue long dated papers over shorter ones. We however suspect that most of the banks' portfolios (annual reports yet to be published) are heavier on short term treasury bills than bonds as banks had planned to transition back into lending from FY20 following the repeal of the interest rate caps.

CAPITAL ADEQUACY AND LIQUIDITY AS AT FY19

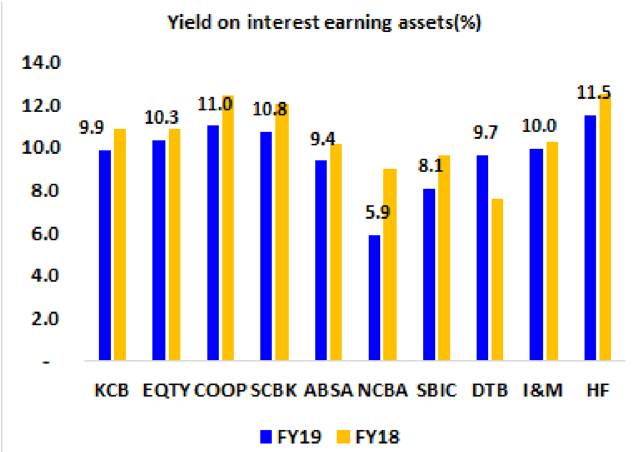
Bank	LIQUIDITY(%)	CORE CAP* (%)	TOTAL CAP* (%)
KCB	30.8	15.6	17.5
EQTY	54.7	13.1	17.4
COOP	44.8	15.3	15.8
ABSA	39.8	13.9	16.6
SCBK	62.6	14.7	17.7
DTB	54.8	19.1	20.9
SBIC	58.4	15.2	18.3
NCBA	51.8	16.6	17.3
I&M	47.0	16.1	18.2
HF	20.8	13.0	14.3
Minimum	**20.0**	**10.5**	**14.5**

*(Source: Company, DBIB Research), *Kenyan subsidiaries (bank)*

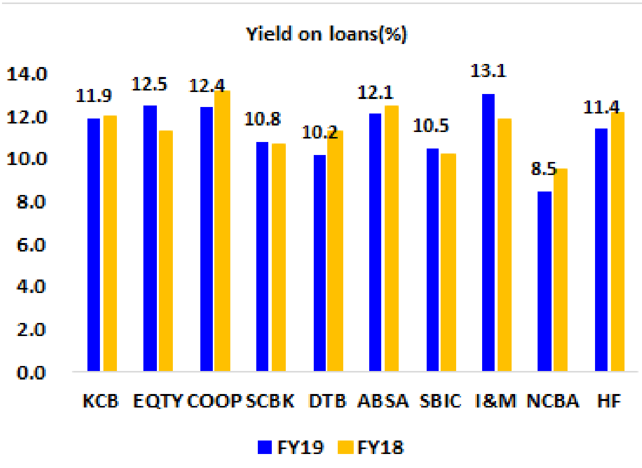
Presently, all banks are sufficiently liquid, but without liabilities growth over time such liquidity may not hold against government's borrowing needs. Will excess liquidity in the banking sector at a time when they can't lend see yields on government securities fall or will the potential rise in cost of money and a shortage of short term risk free opportunities see yields rise? We continue to think that the latter is more likely with the caveat being the tenor of new primary issues.

- KCB invested KES 5.0 BN towards recapitalizing NBK against a target of KES 7.5 BN, management anticipates that NBK will make up the KES 2.5 BN shortfall from recoveries which is expected by June 2020 but given the operating environment we expect that the group will get more time.

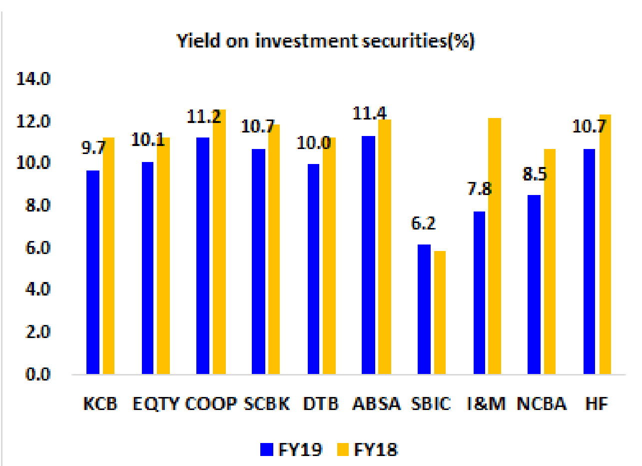
- Coop's management anticipate that they will have boosted tier II capital by 2Q20.



(Source: Company, DBIB Research)



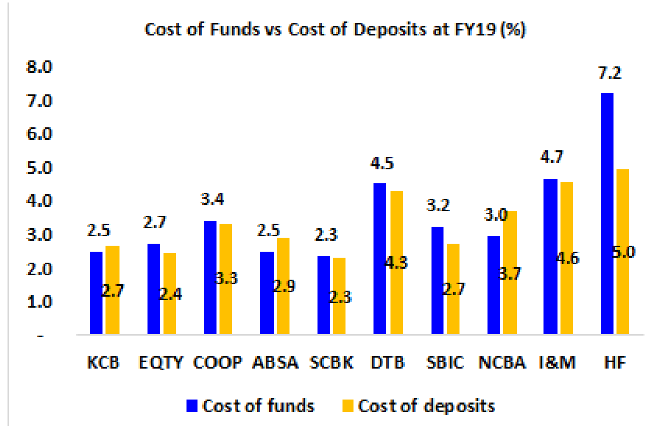
(Source: Company, DBIB Research)



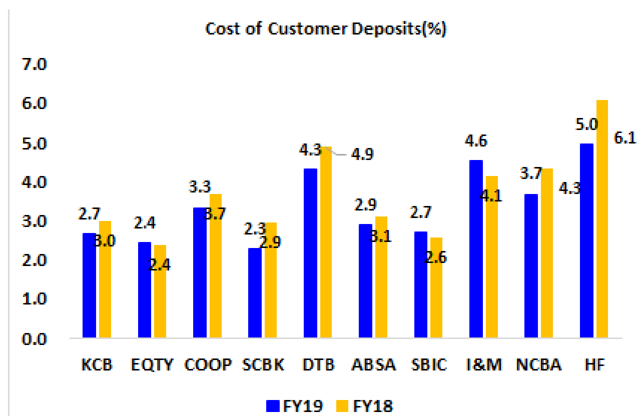
(Source: Company, DBIB Research)

Whereas the letter of the caps is now gone, the spirit has remained. Banks are expected to conclude discussing their risk based pricing methodology with the regulator by 2Q20 but given continued CBR cuts, the yield on loans is likely to fall if not remain stagnant.

Generally, we think that a significant movement in yields on assets will track yields on investment securities not loans since we expect lending to be curtailed by COVID-19 crisis and the lack of clarity on pricing of new loans while government's deficit will keep growing on account of revenue underperformance.

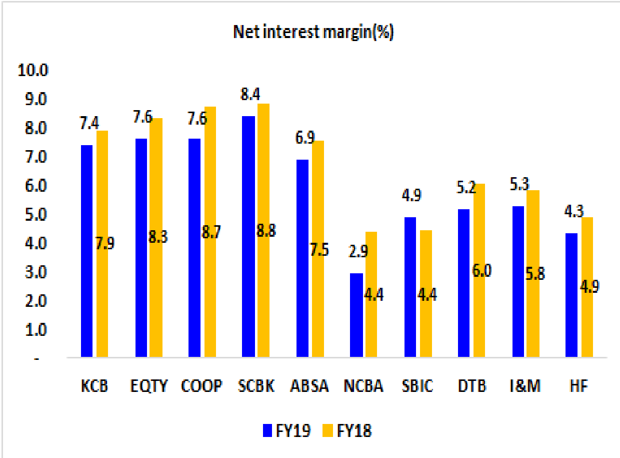


We continue to stress that all else held constant, KCB's acquisition of National Bank is growth positive due to the ease on the cost of deposits. It is notable that cost of deposits of its closest competitor rose y-o-y in FY19 unlike KCB's.

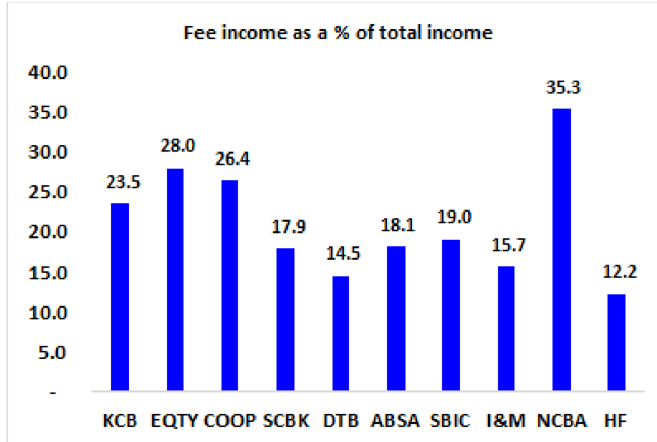


(Source: Company, DBIB Research)

We observe that low LTDs among niche and foreign owned banks (as highlighted on page 2) are reflective of their high cost of funds (as highlighted on this page) at a time when the yield on earning assets does not offer much upside. If protecting the downside is key, and in so far as fundamentals matter (we think they still do), we see these banks as suitable conservers of capital among local institutional investors (since they are not as externalized).

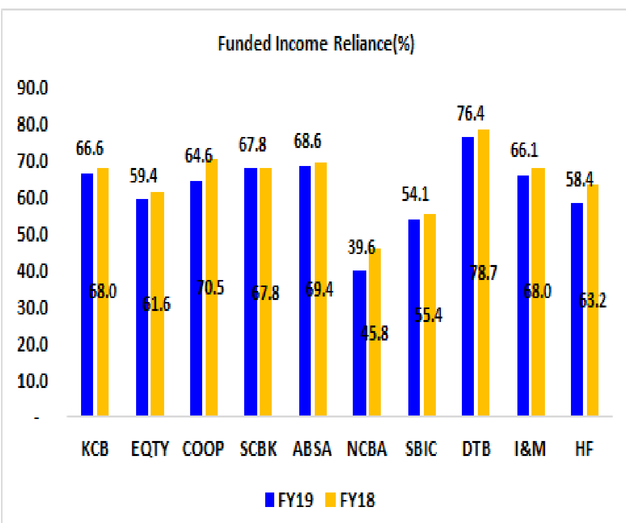


(Source: Company, DBIB Research)



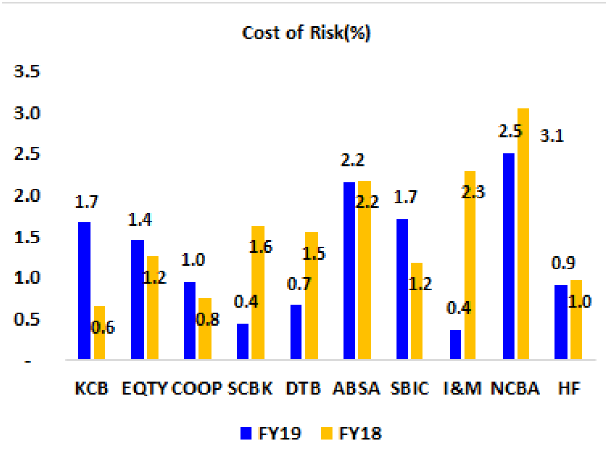
(Source: Company, DBIB Research)

To reiterate, recent Central Bank policy cuts and lack of clarity on loan pricing will keep yield on loans subdued and may be exacerbated by COVID-19 induced credit squeeze. Secondly, potential rise in the cost of money will create cost of fund pressures especially among banks that are reliant on borrowing and expensive deposits.



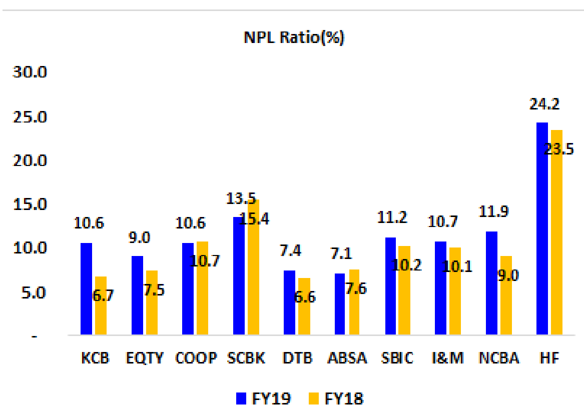
(Source: Company, DBIB Research)

- KCB's investment in a revitalized mobile platform (October 2018) has seen its fee income rise in the last 2 years and is expected to keep growing in FY20.
- KCB would expect an annual revenue loss of about KES 500.0 MN worth of fee income from the directive to have bank to Mpesa charges free over the COVID-19 crisis period.
- Co-op estimate that 5-6% (KES 640-769 MN) of Co-ops fees and commissions would be affected by the directive to have bank to Mpesa charges free over the COVID-19 crisis period.
- In the post COVID phase, we expect that banks that have mass market mobile lending platforms will benefit from the change in regulations that will moving forward hinder unregulated mobile credit providers from listing credit information in the Credit Reference Bureaus. It is however likely that there will be more regulations around the interest rates and fees charged on mobile lending facilities.



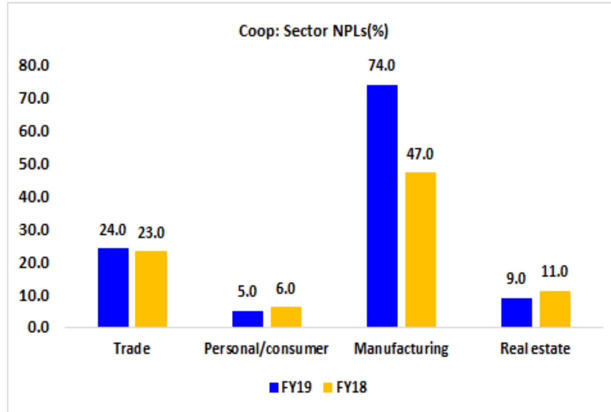
(Source: Company, DBIB Research)

Cost of risk ratios of the three biggest mass market banks worsened in FY19 despite managements' indications that the respective banks have been providing prudently prior to sector wide implementation of IFRS-9. Given that lending remained subdued, we believe that the underlying accounts are legacy loans issued in the 2015-2016 years in real estate, manufacturing, trade and construction.



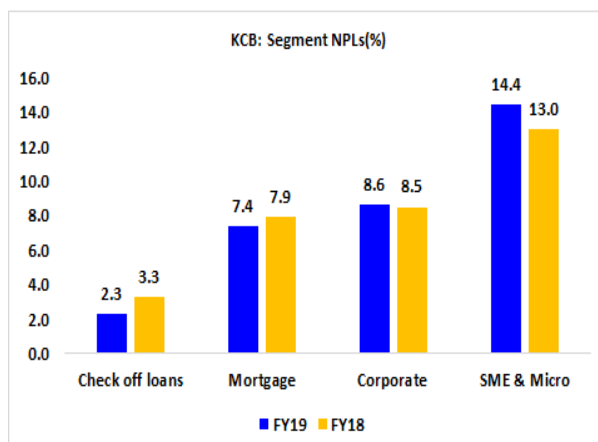
(Source: Company, DBIB Research)

Despite sector wide NPLs dropping to about 12.1% as at December 2019, most of the listed banks saw their ratios rise partly due to acquisitions as in the case of KCB and NCBA



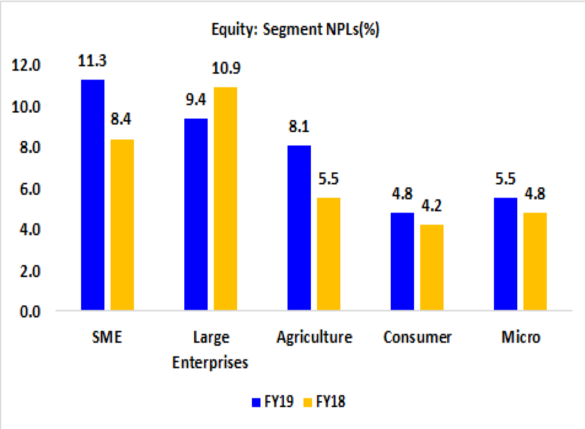
(Source: Company, DBIB Research)

- Co-op's management indicates that there is one major manufacturer who has had issues though had returned to full production in FY19.
- Co-op has minimal exposure to building and construction segment. All its real estate exposures are to already completed properties.
- Most of Co-op's personal loans are check off based to civil servants and employees of parastatals.
- Under Co-op's trade related NPLs, the issue is loans to SMEs who had supplied national and county governments and are yet to be fully paid.



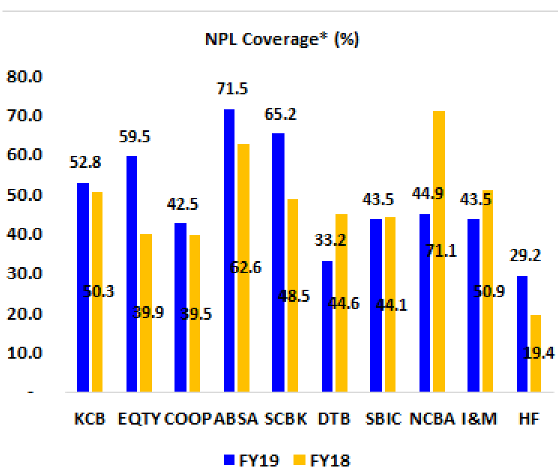
(Source: Company, DBIB Research)

- KCB wrote off KES 4.0 BN in FY19 (excluding National Bank which had no write offs).
- Other than the acquisition of NBK gross NPLs rose due to mobile loans and from manufacturing, transport and trade segments.
- KCB expects to recover about KES 10.0 BN from NBK's bad loans this year

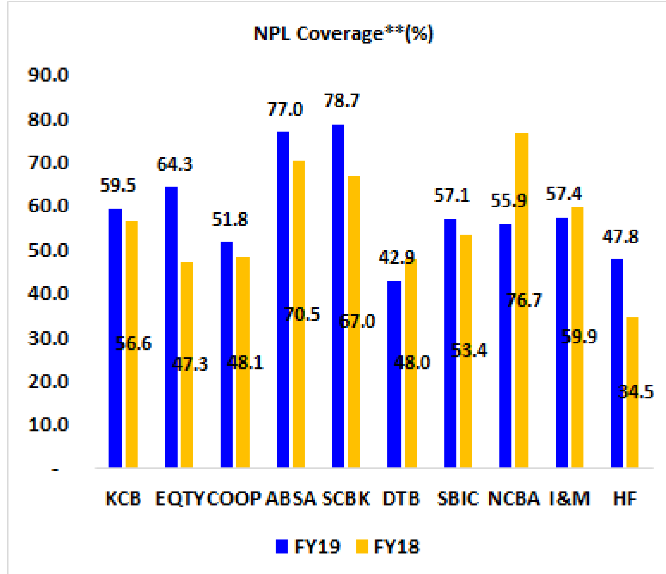


Source: Company, DBIB Research

- Equity's management indicated that most of the NPLs that came through particularly in Kenya are from loans that were originated pre-2016 in real estate and construction sectors.
- As with co-op, management indicated that around 80% of their household lending is payroll deductions with the bulk being civil servants.



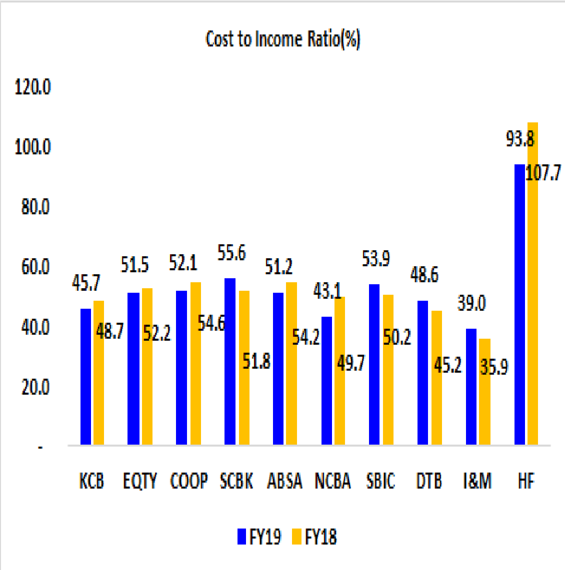
*Source: Company, DBIB Research, *loan loss provision/ total NPL where total NPL = gross NPLs less interest in suspense*



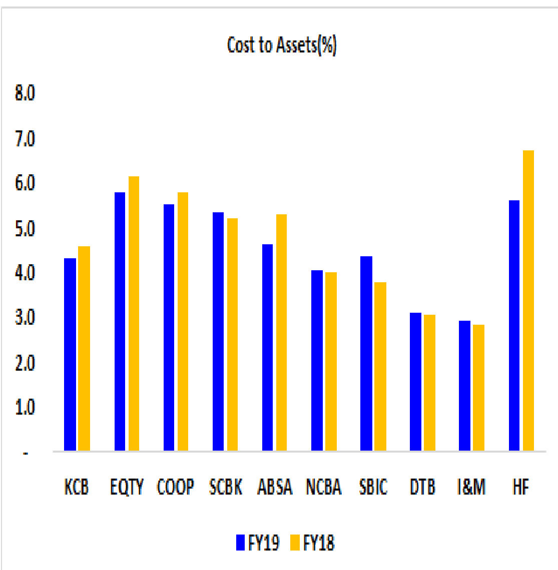
*Source: Company, DBIB Research, ** (interest in suspense+ loan loss provision)/ Gross NPL*

- It will be more insightful to see the size of stage three provisions vis-à-vis stage three loans once the annual reports are published, especially given that NPLs and cost of risk ratios have continued to grow despite subdued lending and stage one adoption of IFRS 9 in 2018. We however suspect that foreign owned banks will still be better covered as the two graphs on coverage show above.

COST TO INCOME RATIO(%)



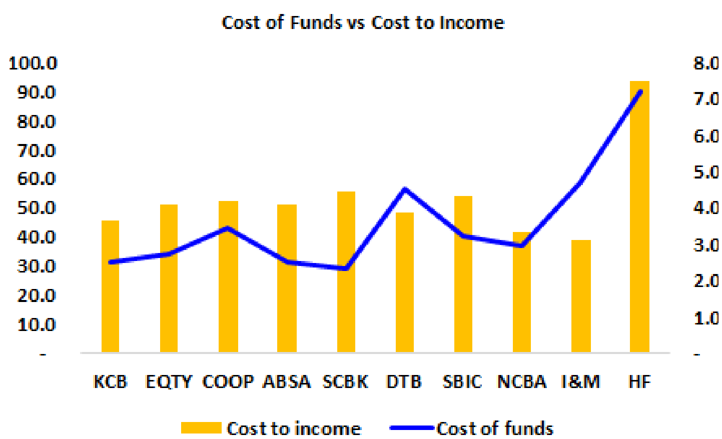
Source: Company, DBIB Research



Source: Company, DBIB Research

- Over time, KCB can improve its cost to income through efficiency gains at NBK. As part of the acquisition conditions by the Competition Authority, management can reduce the combined staff count of 8,000 by up to 20% which is above the 1,200 staff at NBK presently. Management expects NBK's cost to income ratio to drop to about 60.0% in 2020.

- On April 22nd 2020, Parliament passed the Tax Amendments Bill of 2020 which among other clauses bars employers from dismissing workers over the COVID-19 period. If signed into law, this will prevent banks from pursuing staff rationalization measures.



Source: Company, DBIB Research

- For some banks (especially mass market ones), a low cost of funds implies a high cost to income ratio because of the significant investment required for deposit mobilization. With such mobilization harder under the prevailing conditions such banks may have to compete for wholesale deposits (hence higher cost of deposits) while leaving their deposit mobilization cost structure intact (hence higher cost to income).

OPERATING EFFICIENCY

FY19	KCB	EQTY	COOP	SCBK	ABSA	NCBA	SBIC	DTB	I&M	HF
Yield on interest earning assets (%)	9.9	10.3	11.0	10.8	9.4	5.9	8.1	9.7	10.0	11.5
Cost of funds (%)	2.5	2.7	3.4	2.3	2.5	3.0	3.2	4.5	4.7	7.2
Net Interest Margin (%)	7.4	7.6	7.6	8.4	6.9	2.9	4.9	5.2	5.3	4.3
Loan-to-Deposits ratio (%)	78.0	75.9	80.1	56.3	82.0	65.9	79.0	71.1	76.3	103.1
Loan-to-Dep.& Borrowed Funds(%)	75.6	67.9	74.2	53.7	62.9	62.3	73.7	68.3	72.9	89.2
Funded Inc Generating Potential (%)	83.7	85.7	86.6	78.4	88.3	87.3	86.0	88.0	86.6	78.5
Funded Income Reliance (%)	66.6	59.4	64.6	67.8	68.6	39.6	54.1	76.4	66.1	58.4
Cost to income ratio (%)	45.7	51.5	52.1	55.6	51.2	41.9	53.9	48.6	39.0	93.8
Cost to assets ratio(%)	4.3	5.8	5.5	5.3	4.6	2.9	4.3	3.1	2.9	5.6
Pre-tax margin (%)	43.8	41.5	42.7	42.4	31.8	33.6	31.7	46.0	62.2	(4.1)
PAT margin (%)	29.9	29.8	29.5	28.7	22.1	23.3	26.4	29.7	45.9	(3.3)
NFI to OPEX ratio (%)	33.4	79.0	67.9	57.8	61.3	144.1	85.1	48.5	87.2	44.4

(Source: Company, DBIB Research)

CAPITAL ADEQUACY, LIQUIDITY & ASSET QUALITY

FY19	KCB	EQTY	COOP	SCBK	ABSA	NCBA	SBIC	DTB	I&M	HF
Core capital/TRWA (%)	15.6	13.1	15.3	14.7	13.9	16.6	15.2	19.1	16.1	13.0
Min. Statutory Ratio (%)	10.5	10.5	10.5	10.5	10.5	10.5	10.5	10.5	10.5	10.5
Total capital/TRWA (%)	17.5	17.4	15.8	17.7	16.6	17.3	18.3	20.9	18.2	14.3
Min. Statutory Ratio (%)	14.5	14.5	14.5	14.5	14.5	14.5	14.5	14.5	14.5	14.5
Liquidity Ratio (%)	30.8	54.7	44.8	62.6	39.8	51.8	58.4	54.8	47.0	20.8
Min. Statutory Ratio (%)	20.0	20.0	20.0	20.0	20.0	20.0	20.0	20.0	20.0	20.0
Leverage Ratio (%)	14.4	16.4	17.4	15.9	12.1	13.5	13.3	15.2	18.3	18.1
EQTY-to-Loans Ratio (%)	24.2	30.5	30.3	37.1	23.2	27.0	25.5	32.4	34.7	26.6
Cost of risk (%)	1.7	1.4	1.0	0.4	2.2	2.5	1.7	0.7	0.4	0.9
NPL Ratio (%)	10.6	9.0	10.6	13.5	7.1	11.9	11.2	7.4	10.7	24.2
NPL Coverage Ratio (%)	52.8	59.5	42.5	65.2	71.5	44.9	45.6	33.2	43.5	29.2
L-Term Debt to Liabilities +EQTY (%)	2.4	8.4	5.8	3.7	19.2	4.5	4.8	2.9	3.4	10.3
NTA/share (KES)	38.5	28.2	13.3	131.1	8.2	40.2	96.3	225.0	67.4	24.4
Book value/share (KES)	40.4	30.2	13.8	139.0	8.3	44.9	98.5	230.7	73.6	26.6
Payout ratio (%)	43.2	42.2	40.3	85.1	80.1	20.1	43.7	11.1	20.4	-

(Source: Company, DBIB Research)

INVESTMENT RETURN

FY19	KCB	EQTY	COOP	SCBK	ABSA	NCBA	SBIC	DTB	I&M	HF
ROA (%)	2.8	3.3	3.1	2.7	2.0	1.6	2.1	1.9	3.4	(0.2)
ROaA(%)	3.1	3.6	3.3	2.8	2.1	3.2	2.2	1.9	3.6	(0.2)
ROIC (%)	2.9	3.5	3.3	2.8	2.1	1.6	2.2	1.9	3.5	(0.2)
ROE (%)	19.4	20.2	17.7	17.2	16.5	11.7	16.0	11.3	17.7	(1.1)
ROaE(%)	20.7	21.8	18.8	17.5	16.7	23.3	16.9	11.8	19.3	(1.1)

(Source: Company, DBIB Research)

OPERATING EFFICIENCY

FY18	KCB	EQTY	COOP	SCBK	ABSA	DTB	NCBA	SBIC	I&M	HF
Yield on interest earning assets (%)	10.9	10.9	12.4	12.0	10.2	10.9	9.0	7.6	10.3	12.5
Cost of funds (%)	3.0	2.5	3.7	3.2	2.6	4.8	4.6	3.2	4.5	7.6
Net Interest Margin (%)	7.9	8.3	8.7	8.8	7.5	6.0	4.4	4.4	5.8	4.9
Loan-to-Deposits ratio (%)	84.8	70.3	80.2	52.9	85.5	68.3	61.8	74.1	78.2	125.11
Loan-to-Dep. &Borrowed Funds(%)	81.4	63.7	74.4	51.0	67.1	64.9	59.4	70.3	73.5	81.3
Funded Inc Generating Potential (%)	80.6	85.4	83.8	78.3	88.0	85.9	87.9	88.0	87.5	84.8
Funded Income Reliance (%)	68.0	61.6	70.5	67.8	69.4	78.7	45.8	55.4	68.0	63.2
Cost to income ratio (%)	48.7	52.2	54.6	51.8	54.2	45.2	52.1	50.2	35.9	107.7
Cost to assets ratio(%)	4.6	6.1	5.8	5.2	5.3	3.0	4.5	3.8	2.9	6.7
Pre-tax margin (%)	47.2	42.3	41.6	41.4	33.6	43.2	31.8	41.5	50.1	(17.9)
PAT margin (%)	33.4	29.5	29.2	28.3	23.4	27.8	23.6	29.2	37.1	(16.7)

(Source: Company, DBIB Research)

CAPITAL ADEQUACY, LIQUIDITY & ASSET QUALITY

FY18	KCB	EQTY	COOP	SCBK	ABSA	DTB	NCBA	SBIC	I&M	HF
Core capital/TRWA (%)	16.4	14.0	15.0	16.5	14.4	18.7	13.7	14.6	17.1	14.2
Min. Statutory Ratio (%)	10.5	10.5	10.5	10.5	10.5	10.5	10.5	10.5	10.5	10.5
Total capital/TRWA (%)	17.8	14.0	15.4	19.5	16.4	21.2	15.7	17.4	18.2	15.6
Min. Statutory Ratio (%)	14.5	14.5	14.5	14.5	14.5	14.5	14.5	14.5	14.5	14.5
Liquidity Ratio (%)	29.4	52.1	41.5	66.6	35.7	53.5	47.5	57.9	47.9	20.9
Min. Statutory Ratio (%)	20.0	20.0	20.0	20.0	20.0	20.0	20.0	20.0	20.0	20.0
Leverage Ratio (%)	15.9	16.4	16.9	16.3	13.6	14.2	12.5	12.3	16.6	17.1
EQTY-to-Loans Ratio (%)	24.9	31.9	29.0	39.3	24.9	30.5	25.2	23.6	30.5	23.9
Cost of risk (%)	0.6	1.2	0.8	1.6	2.2	1.5	3.1	1.2	2.3	1.0
NPL Ratio (%)	6.7	7.5	10.7	15.4	7.6	6.6	9.0	10.2	10.1	23.5
NPL Coverage Ratio (%)	50.3	39.9	39.5	48.5	62.6	44.6	71.1	44.1	50.9	19.4
L/Term Debt to Liabilities+ EQTY (%)	3.1	7.7	5.8	3.0	17.6	3.9	3.2	3.8	4.8	17.3
NTA/share (KES)	36.09	23.66	11.71	130.45	7.98	206.40	18.21	84.89	67.37	24.77
Book value/share (KES)	37.07	25.64	12.14	135.77	8.14	210.80	20.44	87.50	61.53	27.15
Payout ratio (%)	44.7	38.3	45.7	82.3	80.3	10.9	17.6	36.5	20.3	-

(Source: Company, DBIB Research)

INVESTMENT RETURN

FY18	KCB	EQTY	COOP	SCBK	ABSA	DTB	NCBA	SBIC	I&M	HF
ROA (%)*	3.4	3.5	3.1	2.8	2.3	1.9	2.0	2.2	2.9	(1.0)
ROaA(%)	3.4	3.6	3.1	2.8	2.3	1.9	2.0	2.2	2.9	(1.0)
ROIC (%)*	3.5	3.5	3.2	2.9	2.4	1.9	2.1	2.3	3.0	(1.1)
ROE (%)*	21.1	20.9	17.9	17.4	16.8	12.0	16.3	17.9	16.7	(5.7)
ROaE(%)	20.7	20.9	17.9	17.4	16.8	12.0	16.3	17.9	16.7	(5.7)

(Source: Company, DBIB Research)

APPENDIX

COMPANY INVESTMENT RATINGS

Buy: Share price may generate more than 15.0% upside over the next 12 months

Overweight: Share price may generate between 5.0% and 15.0% upside over the next 12 months

Hold: Share price may fall within the range of <+5.0/ -10.0% over the next 12 months

Take Profit: Target price has been attained. Look to accumulate at lower levels. Company fundamentals however remain strong

Underweight: Share price may generate between 10.0% and 15.0% downside over the next 12 months

Sell: Share price may generate more than 15.0% downside over the next 12 months, significant business and/or financial risks present, industry concerns

Not Rated: Counter is not within regular research coverage

SECTOR INVESTMENT RATINGS

Overweight：Industry performance better than that of the whole market

Equal weight：Industry performance about the same as that of the whole market

Underweight：Industry performance worse than that of the whole market

DISCLAIMER