DYER & BLAIR INVESTMENT BANK

EARNINGS UPDATE

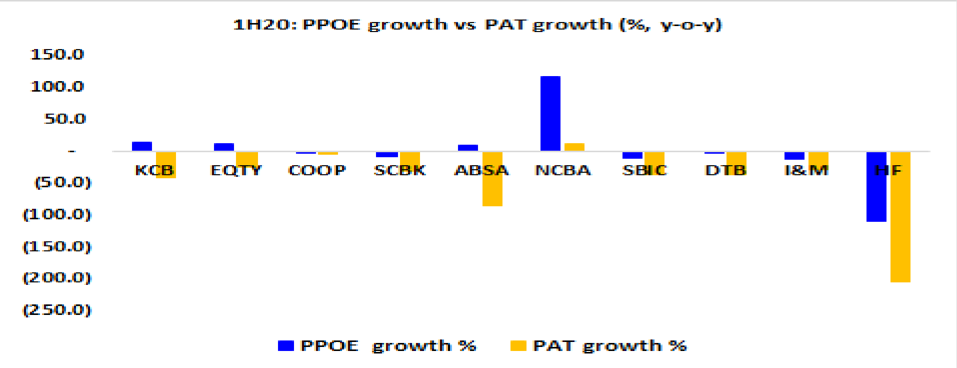
Founder Member of the Nairobi Securities Exchange

11TH SEPTEMBER 2020

DYER & BLAIR
INVESTMENT BANK
WE KNOW. YOU KNOW.

KENYA: LISTED BANKS 1H20 BY THE NUMBERS:

Listed banks saw a decline in profitability across the board mainly due to increased loan loss provisioning. In the graph below, we compare and contrast the growth of pre-provision operating earnings and profit after tax across listed banks. We observe that whereas there appears to be an inconsistency with respect to how various banks have responded to COVID-19 related uncertainties, the general expectation is that all banks should see their cost of risk rise materially in FY20 to see profit after tax decline significantly.



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

For banks like Equity, NCBA and KCB, an increase in gross NPLs alongside cost of risk has created the impression that there remains legacy issues to be dealt with in the sector. In the case of Equity, to what extent the increase in gross NPLs follows management's prudence in light of COVID-19 uncertainties remains unclear whereas in the case of NCBA and KCB, investors might consider that the impact of COVID-19 has exacerbated asset quality issues associated with recent acquisitions (NIC, NBK). Absa's punctiliousness might explain their high cost of risk despite relatively flat NPLs more so because it squares with their other decisions on re-pricing of "CBR+4" loans.

Given the rising cynicism around asset quality, we believe that Absa, Stanchart and Stanbic offer more predictability but expect that technical indicators will continue to see the more liquid stocks such as KCB and Equity receive more attention from investors, even though that is likely to remain muted by the general COVID-19 related overhang.

PAT (KES BN)	1H20	1H19
KCB	7.6	12.7
EQTY	9.1	12.0
COOP	7.2	7.5
SCBK	3.2	4.7
ABSA	0.6	3.9
NCBA	2.6	2.4
SBIC	2.5	4.0
DTB	2.6	4.1
I&M	3.2	4.5
HF	(0.3)	(0.1)

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

PAT Growth	Y/Y(%)	Q/Q(%)
KCB	(40.4)	(79.0)
EQTY	(24.4)	(29.5)
COOP	(3.6)	0.6
SCBK	(31.3)	(39.2)
ABSA	(84.8)	(169.9)
NCBA	11.3	(38.6)
SBIC	(37.0)	(37.0)
DTB	(36.5)	(71.6)
I&M	(29.5)	(8.1)

(Source: Company, DBIB Research)

PPOP (KES BN)	1H20	1H19
KCB	23.9	21.0
EQTY	20.0	17.9
COOP	11.5	11.6
SCBK	6.7	7.3
ABSA	5.5	5.3
NCBA	11.9	5.5
SBIC	5.7	6.3
DTB	6.3	6.5
I&M	6.1	6.9

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

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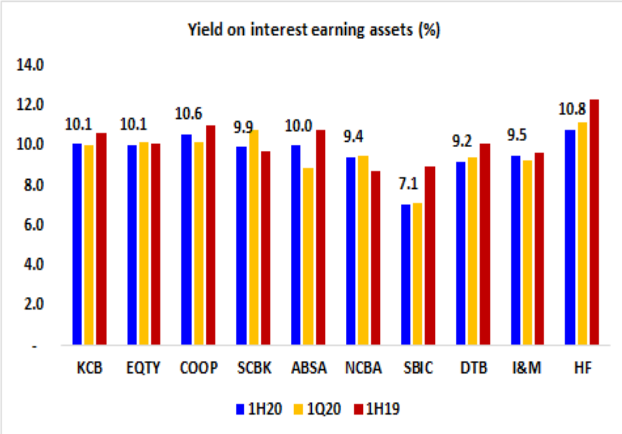
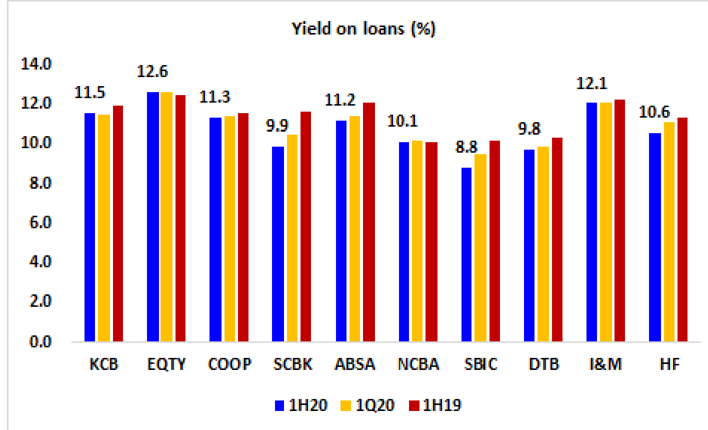


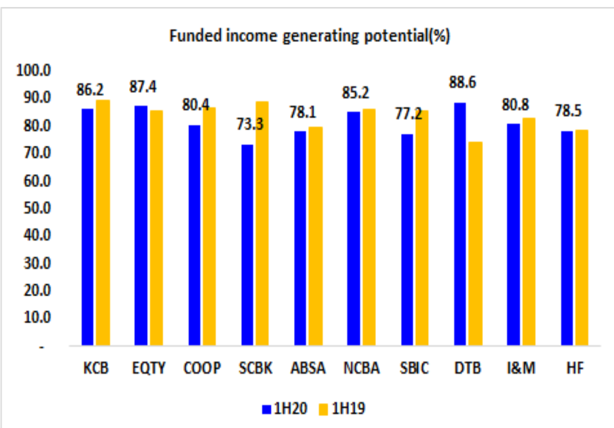
(Source: Company, DBIB Research)



(Source: Company, DBIB Research)

Yields on interest earning assets have generally declined in 1H20 on the back of a drop in government yields and a reduction of the Central Bank Rate (CBR). We expect that yields will remain subdued in FY20 as banks eschew lending and as yields on government securities remained subdued by liquid market conditions.

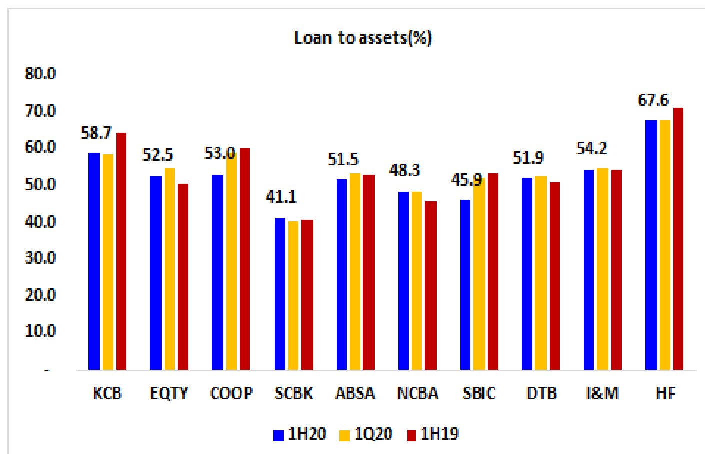
Most banks have repriced old loans downwards to about 12.5% in line with the initial CBR cut and appear unlikely to cut further. Absa Kenya however appears to have repriced old loans all the way to 11.0% in line with all the post repeal CBR cuts. The relative lack of clarity on how banks should treat loans issued under the rate cap regime, and the delay in transitioning to a new risk based pricing framework affirms that the expected margin enhancement will take a while and when it happens, will mainly be on the back of a rising government securities yield curve.



(Source: Company, DBIB Research)

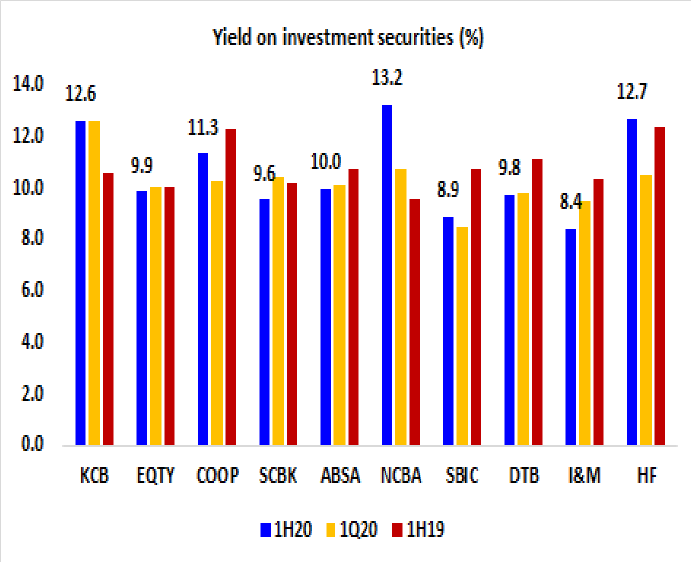
The funded-income generating potential ratio measures the contribution of interest earning assets to total assets. While the specifics of how each bank has structured its asset book matters (maturity profile etc.), this ratio can show how a repricing of interest earning assets can impact the yields.

We observe that local mass market banks (Equity, KCB, Co-op) have high funded income generating potential relative to foreign owned banks like Stanbic, Stanchart and Absa, in part because they do not run held for trading books. DTB which tends to conservatively pack a significant investment in held to maturity securities has the highest funded income generating potential.

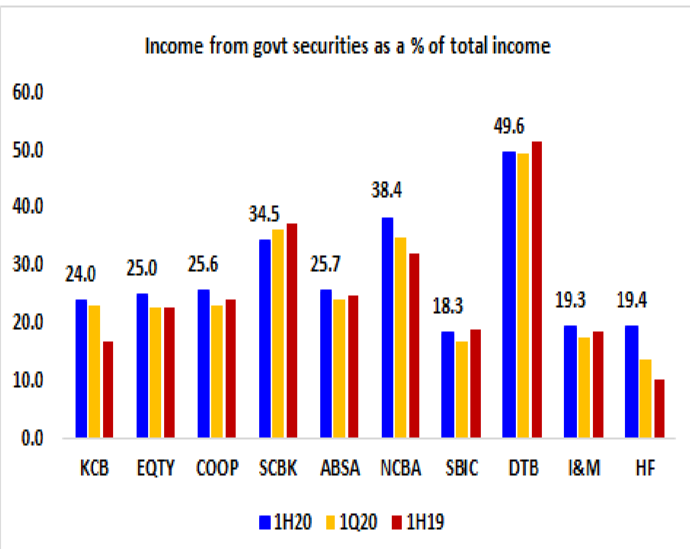


(Source: Company, DBIB Research)

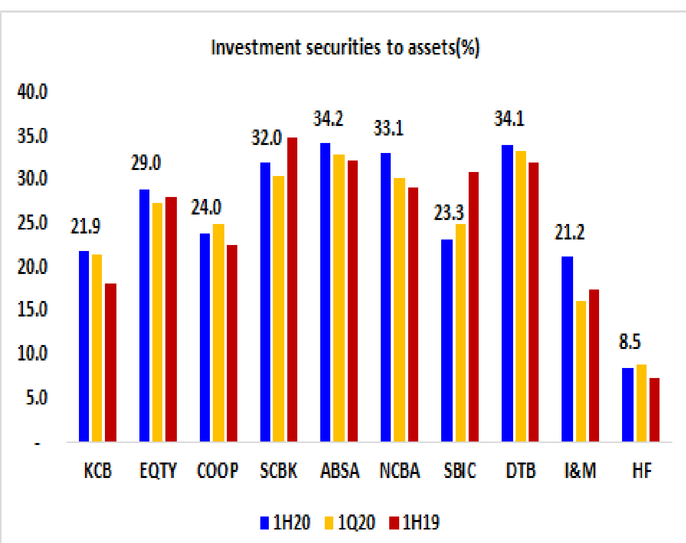
If all banks were to be as punctilious as Absa has been with respect to repricing of “CBR+4%” loans, and general cost of risk enhancement (general provisioning), the speed and efficacy to which they can issue high quality loans is paramount. While these are subject to the operating environment, the contribution of loans to assets might show how a bank stands to balance the need for asset book agility and earnings resilience. In this regard, we find that Stanchart Stanbic, NCBA and Absa appear well positioned.



(Source: Company, DBIB Research)



(Source: Company, DBIB Research)



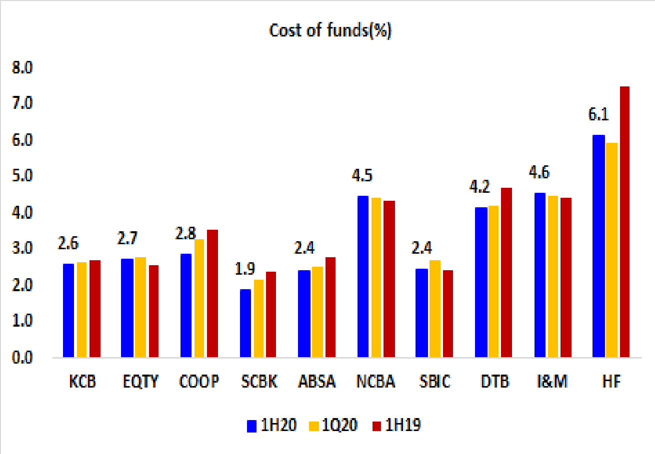
(Source: Company, DBIB Research)

In the course of the rate caps era, we frequently argued that even if the letter of the caps was eventually changed in someway, its spirit would remain. Moreover, we argued that while caps were an inappropriate response, they were aimed at an actual problem; that is the unwillingness of banks to lend in an environment where risk pricing proved difficult and where high risk free rates offered a competitive alternative. Fast forward to June 2020, and the implications of the caps repeal remain unclear even as credit risk markets have deteriorated.

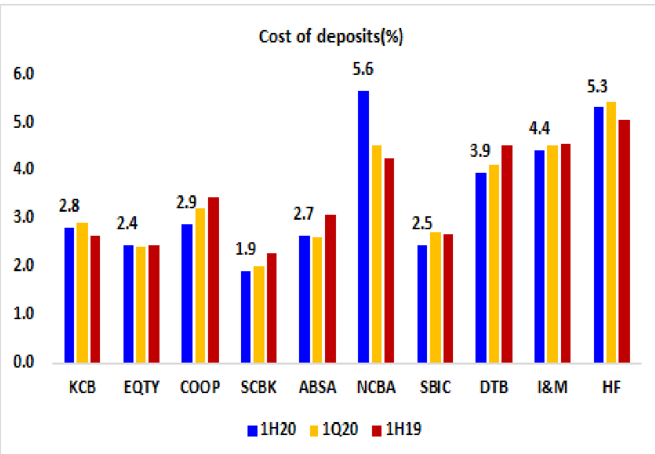
We rehash these arguments because we believe that despite the repeal, risk free markets will continue to reign. We believe that whereas excess liquidity has kept yields low YTD, the impact of COVID-19 on government revenue amidst an escalation to complete legacy development projects etc. will see the government's deficit rise which will in turn see government yields rise. If the disjointedness between the private sector credit market and the government credit market continues, perhaps due to a delayed transition to a new risk based lending framework, then we can expect banks to double down on their focus on government securities.

For the sake of discussion, we argue that this doubling down will affect the earnings of banks differently depending on their policies around investment securities. For example, some banks may have to balance potential mark to market losses with reinvestments at higher yields. Other banks like **DTB** that hold a majority of their government securities in the HTM book might see a relatively higher growth of income, which given the high contribution of income from government securities to total income **(49.6%)** could see its earnings grow significantly.

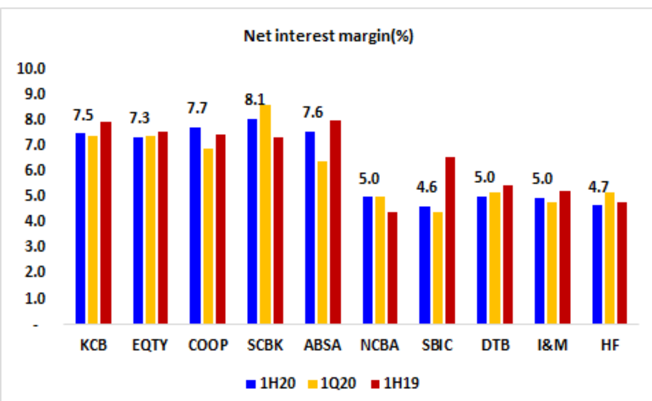
We anticipate that fiscal year 2020/21 and 2021/22 might see better absorption of government's development budget ahead of the 2022 elections. With private credit and equities markets likely to remain subdued, this can be expected to either keep yields flat or drive a gradual decline. However, we on balance believe that an extended recovery will at some point see the government's borrowing appetite force an upward adjustment of interest rates.



(Source: Company, DBIB Research)



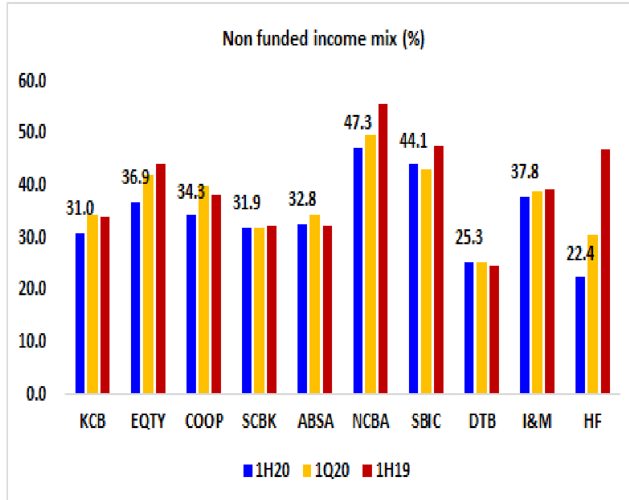
(Source: Company, DBIB Research)



(Source: Company, DBIB Research)

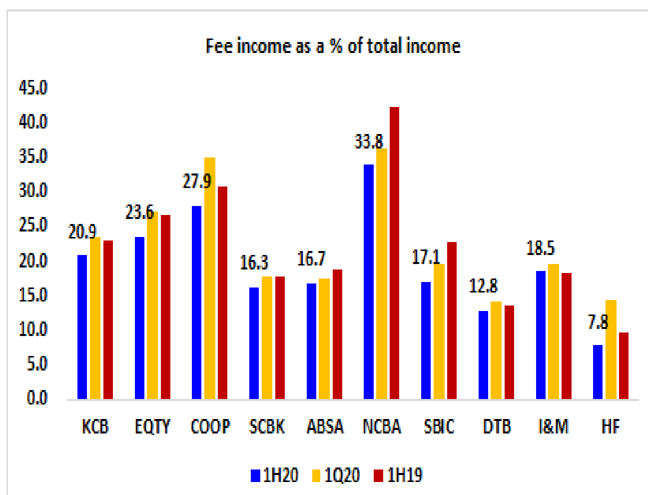
Given the uncertainties around yields on assets, we expect that margins will remain liabilities driven keeping cost of funds as a key source of competitive advantage. A protracted economic recovery might see pressure on CASA deposits putting pressure on cost of deposits. That said, low interest rate environment globally will see banks with LIBOR based funding benefit.

At an industry level, subdued lending, the waiver of both fees on restructured loans and fees on mobile money transfers has seen the non funded income mix fall. Banks are however observing that the waiver of fees on mobile transfers has heightened the adoption of alternative channels creating opportunities for more efficiency gains after the crisis.

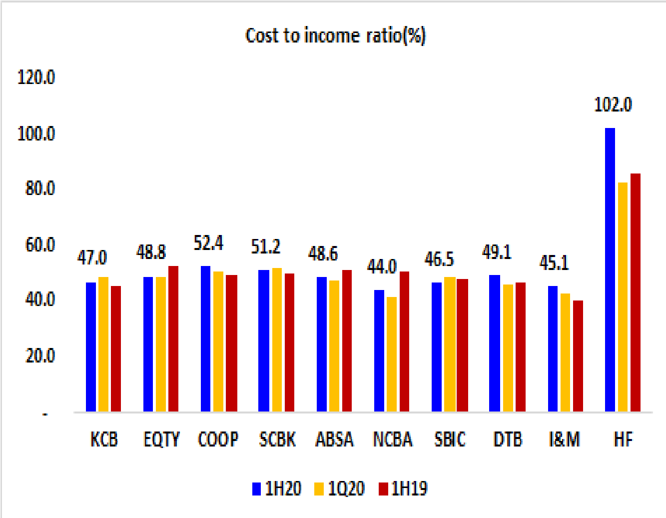


(Source: Company, DBIB Research)

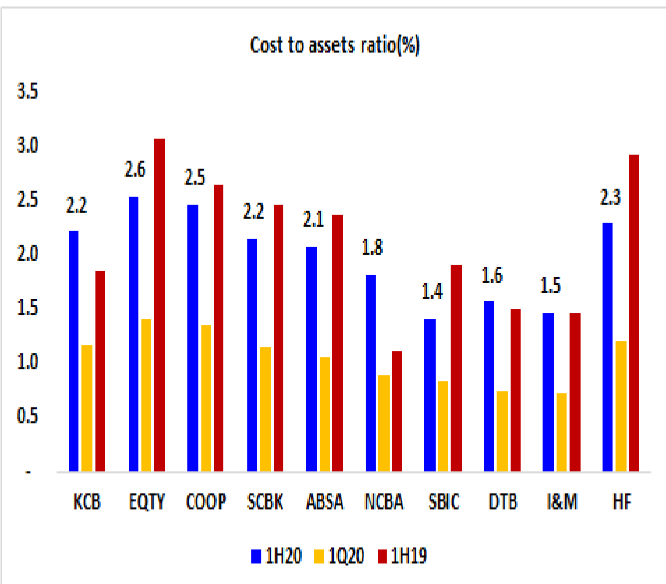
It follows, that locally owned banks have fee income accounting for a significant portion of their total income in light of their mass market mobile lending platforms and a higher size of personal and SME loans. With a view that concessions on fees will lapse before sector wide yield enhancement occurs, these banks are better positioned to augment their income performance in the short term. Further, potential regulations on unlicensed digital lenders might see more room for such banks to grow their mobile lending.



(Source: Company, DBIB Research)



(Source: Company, DBIB Research)



(Source: Company, DBIB Research)

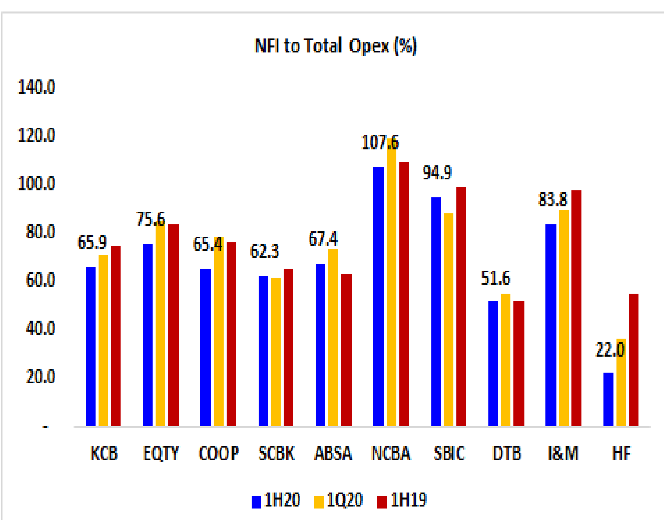
We expect cost to income ratios to look even better as the economy recovers and incomes improve. Perhaps Covid-19 has sensitized management of unproductive cost elements and maybe the shift away from cash by customers will stick even post Covid-19. In spite of these, we doubt any meaningful consolidation of costs can happen in the medium term as optics are likely to stand in the way of deep cuts especially ahead of 2022's election.

In our view, the narrative of a shift to alternative channels especially among market banks remains challenged by the banks high cost to asset ratios. We think that these ratios should and can get to below 2.0%.

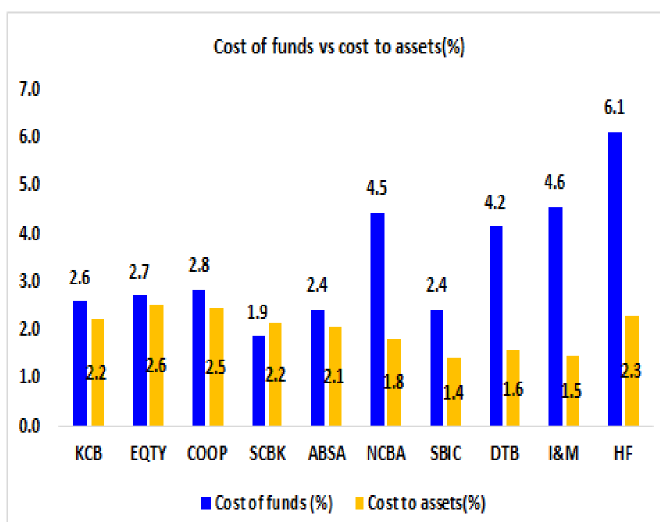
In 1H20, KCB, Co-op, DTB, NCBA, and I&M saw an increase in operating expenses which led to a deterioration of their cost to income ratio as most of the banks saw a flat or lower performance of total income.

We think that one way of assessing a bank's cost efficiency is on how much of total expenses are covered by non funded income, an income line whose improvement should follow significant investment in cost saving alternative channels. In this regard, Stanbic shows the biggest promise.

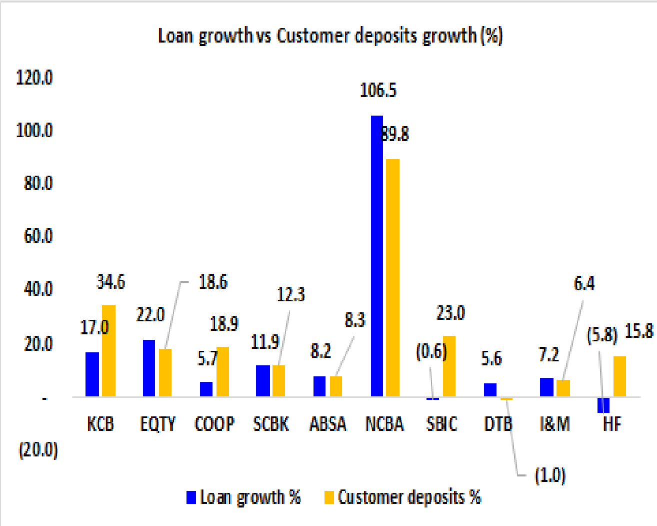
We believe that a truly cost efficient bank will show both a low cost to assets and a low cost of funds relative to the industry. In this regard, we like Stanchart, Absa and Stanbic



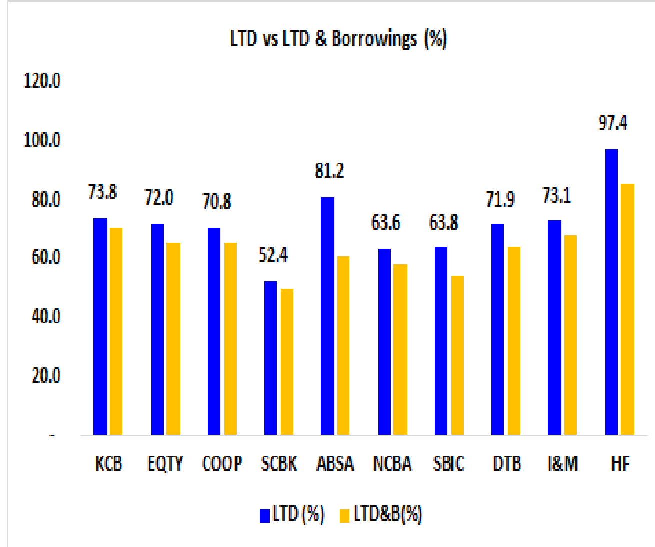
(Source: Company, DBIB Research)



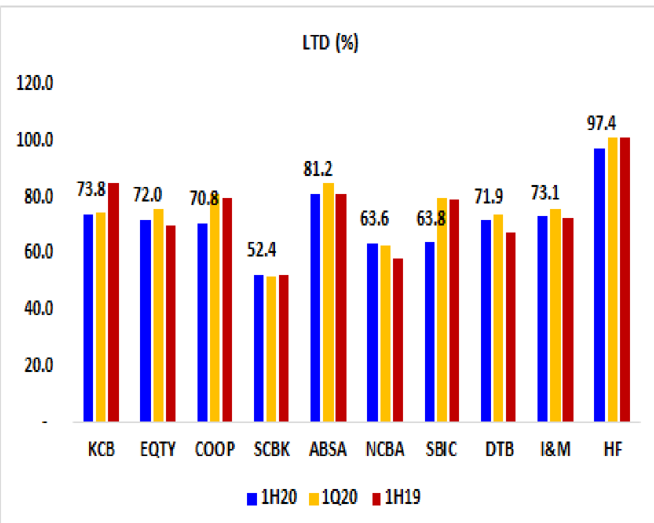
(Source: Company, DBIB Research)



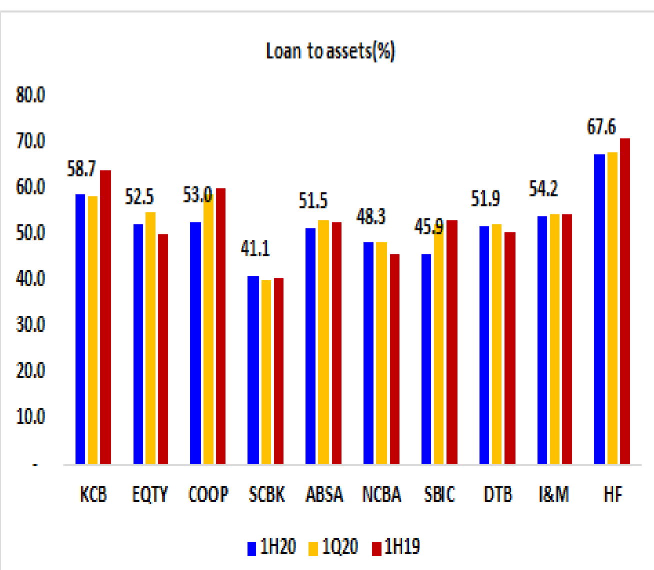
(Source: Company, DBIB Research)



(Source: Company, DBIB Research)



(Source: Company, DBIB Research)



(Source: Company, DBIB Research)

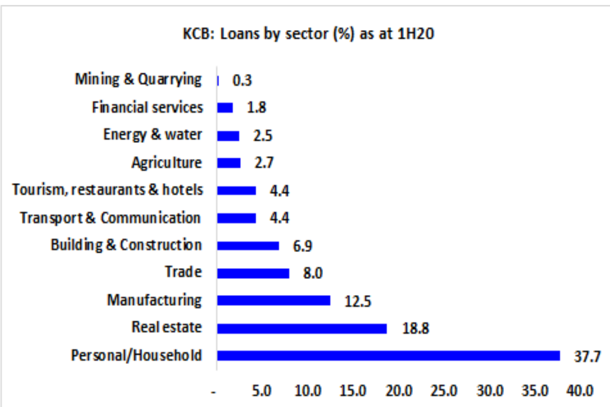
We expect LTDs to remain fairly stable through FY20 as banks eschew lending as they continue to assess the impact of the COVID-19 crisis and as they await clarity on new risk pricing models.

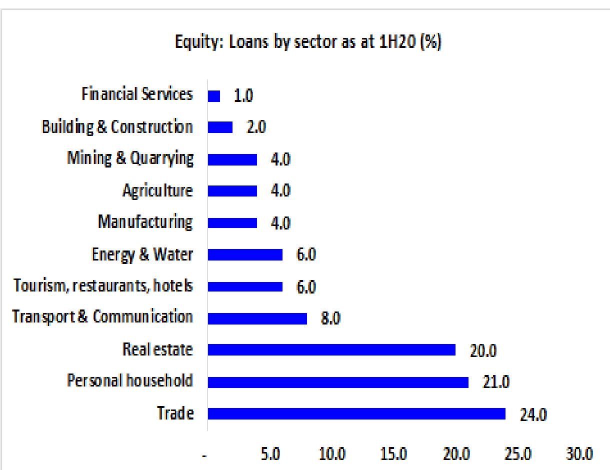
We observe that various banks indicate that they continue to see and exploit pockets of opportunity in agriculture, manufacturing and mobile lending and as such expect loan book growth to average about 10.0% across listed banks in the full year.

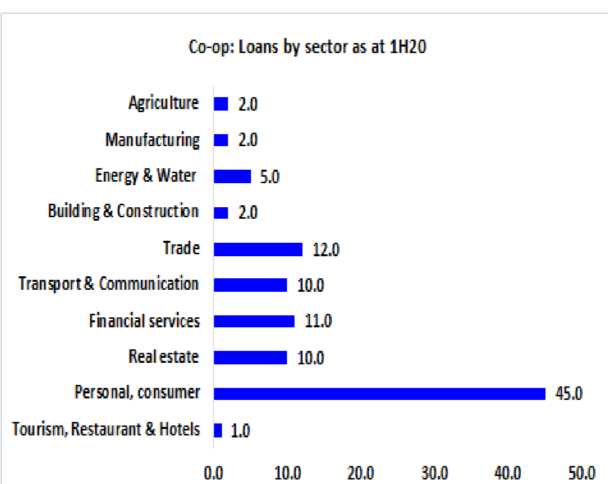
For long term buy and hold investors, we remain bullish on **Stanchart** in this case because its low loans to deposits and loans to assets ratios alongside high capital adequacy ratios can support margin accretive growth in the long term. Whereas, Equity and KCB's loans to assets and loans to deposits ratios are historically also low, we acknowledge that uncertainty over their asset quality outlook, in part due to recent acquisitions as well as their capital adequacy ratios might dampen investor appetite until clarity begins to develop, perhaps in FY21.

If the COVID-19 crisis becomes further protracted, perhaps through additional waves, then we continue to believe that banks with low LTDs are more attractive investment options.

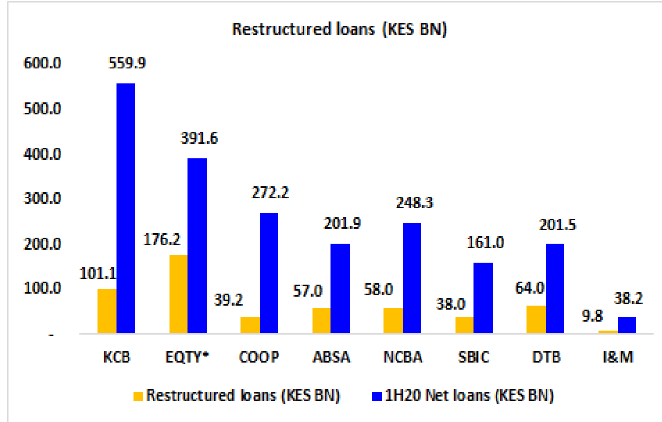
Assessing the level and nature of restructuring among banks is complicated by the sector wide inconsistencies with some banks restructuring more and longer than others. While investors are likely to continue in a wait and see posture, we think that local banks have been more transparent about the composition of their loan books including that of restructured loans.





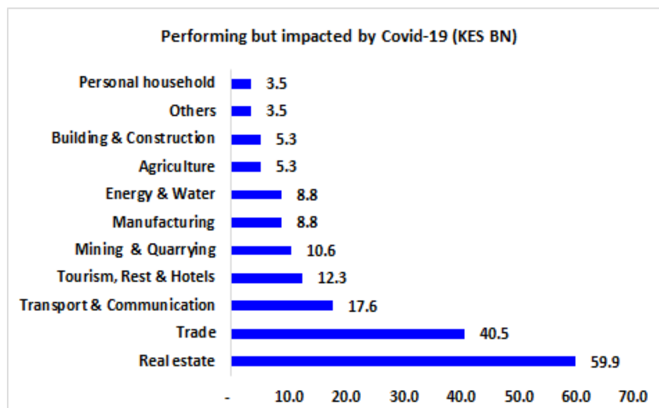


(Source: Company, DBIB Research)



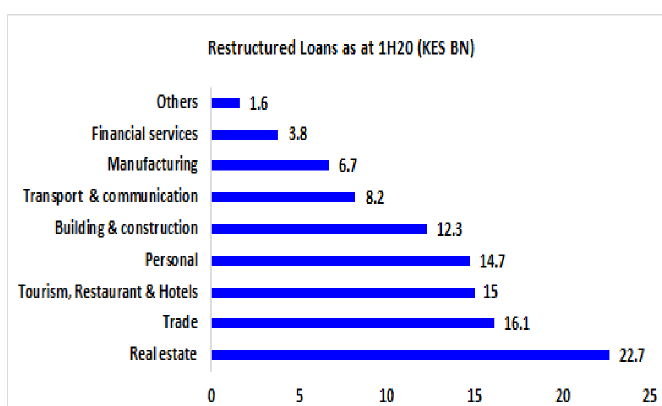
*(Source: Company, DBIB Research), * management's max estimate*

Equity reported that they have identified 45.0% of the book, about KES 176.2 BN, that though currently performing stands to be affected by COVID-19 pandemic. Although the restructured book as at 1H20 was lower, they highlighted the 45.0% to be the likely maximum size that could be affected by COVID-19 and hence what investors should focus on. The breakdown of that book by sector is as shown below:

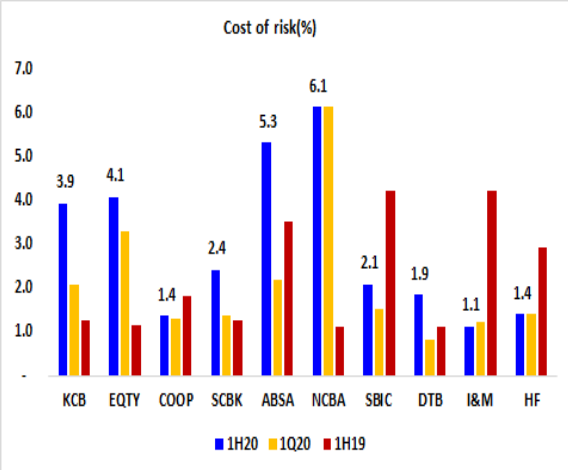


(Source: Company, DBIB Research)

KCB announced that it had restructured about KES 101.1 BN due to Covid-19 related issues. The distribution of the restructured book is as follows:

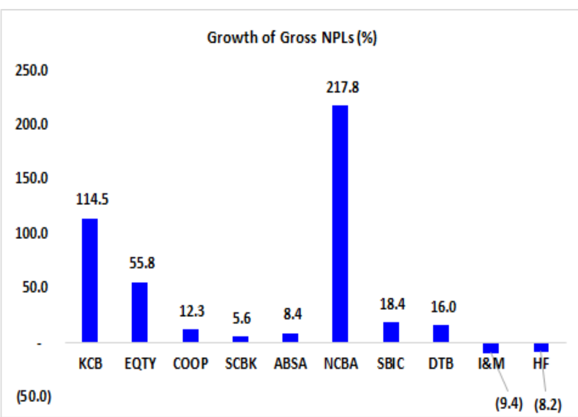


(Source: Company, DBIB Research)



(Source: Company, DBIB Research)

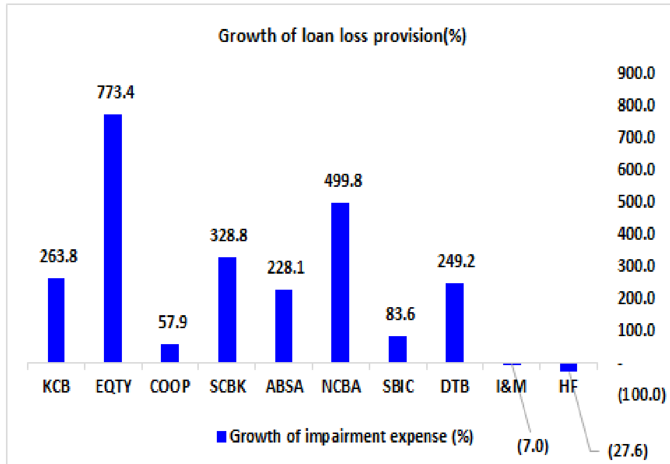
The general argument is that the regulators and the accounting bodies have given banks flexibility to restructure credit facilities. Thus assuming that banks had already made adequate provisions prior to COVID-19, we should see marginal movement of loans into NPL category despite significant increases in cost of risk (impairment expense as a percentage of loans). However, as the graph below shows, most of the banks have reported a rise of gross NPLs as at 1H20.



(Source: Company, DBIB Research)

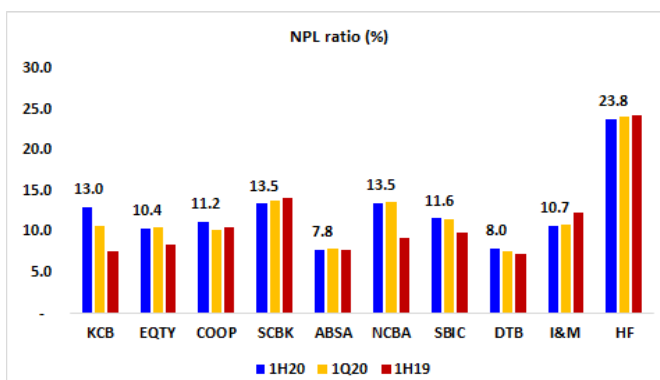
It follows that banks that have done acquisitions recently like KCB and NCBA would see an uptick in NPLs given the asset quality of the acquired banks (NBK and NIC respectively). It is however plausible that despite the recent adoption of IFRS 9, banks had not made adequate provisions for loans that were borderline non-performing, and have thus seen the COVID-19 period as an opportunity to fully de-risk their books.

If the above general argument holds, then investors can count on I&M which has seen a decline in NPLs over the period, and banks like ABSA and Stanchart that have seen a single digit increase in NPLs despite significant jumps in loan loss provision expenses.



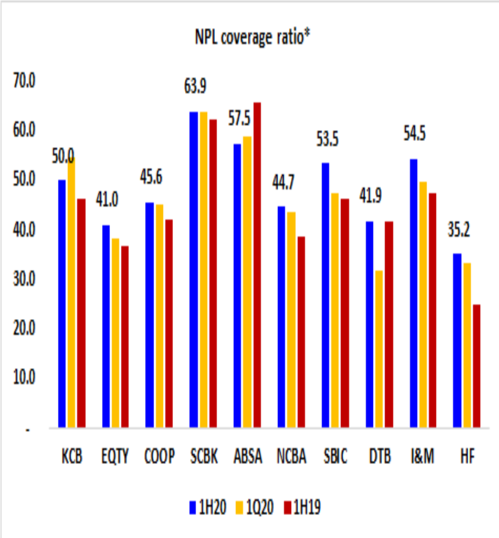
(Source: Company, DBIB Research)

Whether the de-risking is complete is hard to see given the inconsistency of cost of risk changes across the sector and the unclear messaging by various managements. Equity for instance has taken the view of increasing provisions against sectors that are likely to be affected by the COVID-19 crisis and its aftermath, while Co-op has chosen to increase provisions on specific accounts that have sought some form of restructuring. In effect, we have ended up with a relatively marginal growth of cost of risk to Co-op than to Equity.

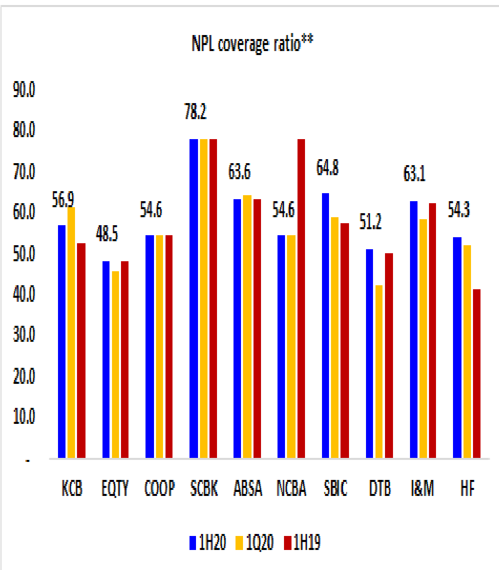


(Source: Company, DBIB Research)

As the concerns are macro based and industry wide, we would anticipate that any bank that has not de-risked its book significantly will have to do it in 3Q20 or in FY20.



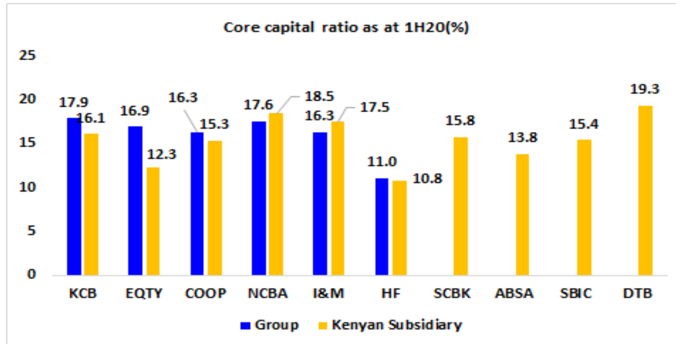
(Source: Company, DBIB Research)



(Source: Company, DBIB Research)

Given the negative outlook on real estate, with most of the collateral in form of land and property, we are concerned that additional haircuts on collateral values will require additional coverage. Thus for locally owned mass market banks, that also have manifested asset quality uncertainties, low coverage ratios are another factor that might dampen investor appetite until clarity around the end of the Covid-19 crisis materializes. Still, most management teams expect a small haircut on the upcoming revaluations of up to 10.0%.

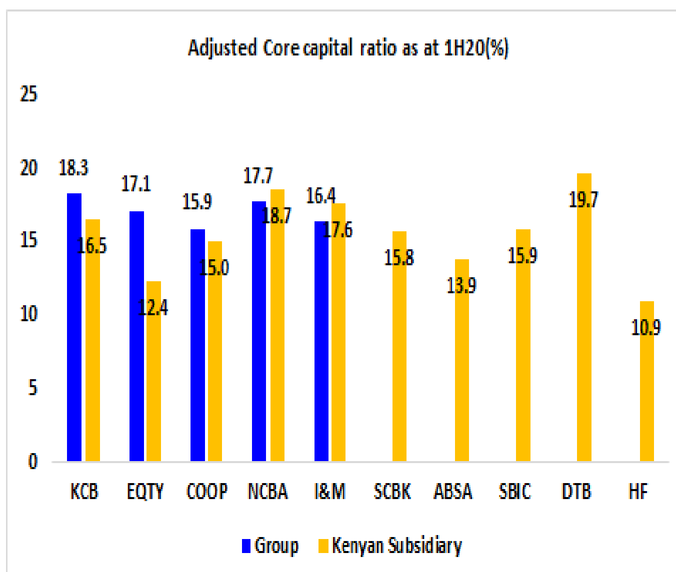
With a view that resilience is key over the short term, we compare and contrast core capital adequacy ratios of various banks as at 1H20. For banks with a holdco structure, we also compare the core ratio at the group level versus at the Kenya subsidiary's level.



(Source: Company, DBIB Research)

Against a statutory minimum of 10.5%, both Equity and Absa appear undercapitalized. However, Equity holds excess capital at the group level.

Comparing these ratios against the adjusted ones (adjusted ratios include ECL provisions in line with the CBK guidance note on deferred impact of IFRS 9 on regulatory capital), we observe that Stanchart and Absa ratios are largely equal affirming their prudence in asset provisioning.



(Source: Company, DBIB Research)

OPERATING EFFICIENCY

	KCB	EQTY	COOP	SCBK	ABSA	NCBA	SBIC	DTB	I&M	HF
Yield on interest earning assets (%)*	10.1	10.1	10.6	9.9	10.0	9.4	7.1	9.2	9.5	10.8
Cost of funds (%)*	2.6	2.7	2.8	1.9	2.4	4.5	2.4	4.2	4.6	6.1
Net Interest Margin (%)*	7.5	7.3	7.7	8.1	7.6	5.0	4.6	5.0	5.0	4.7
Loan-to-Deposits ratio (%)	73.8	72.0	70.8	52.4	81.2	63.6	63.8	71.9	73.1	97.4
Loan-to-Dep.& Borrowings(%)	70.6	65.2	65.6	49.8	61.1	58.4	54.5	64.3	67.9	85.8
Funded Income Gen Potential (%)	86.2	87.4	80.4	73.3	78.1	85.2	77.2	88.6	80.8	78.5
Funded Income Reliance (%)	69.0	63.1	65.7	68.1	67.2	52.7	55.9	74.7	62.2	77.6
Cost to income ratio (%)	47.0	48.8	52.4	51.2	48.6	44.0	46.5	49.1	45.1	102.0
Cost to assets ratio(%)	2.2	2.6	2.5	2.2	2.1	1.8	1.4	1.6	1.5	2.3
NFI to Opex ratio (%)	65.9	75.6	65.4	62.3	67.4	107.6	94.9	51.6	83.8	22.0
Cost of risk (%)*	3.9	4.1	1.4	2.4	5.3	6.1	2.1	1.9	1.1	1.4
Pre-tax margin (%)	28.5	30.7	39.6	37.0	9.5	18.4	37.8	36.0	40.4	(23.1)
PAT margin (%)	16.8	23.3	29.7	23.4	3.5	12.4	23.3	21.1	28.7	(23.2)

(Source: Company, DBIB Research)

CAPITAL ADEQUACY, LIQUIDITY & ASSET QUALITY

	KCB	EQTY	COOP	SCBK	ABSA	NCBA	SBIC	DTB	I&M	HF
Core capital/TRWA (%)	16.1	12.3	15.3	15.8	13.8	17.6	15.4	19.3	17.5	11.0
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 (%)	17.4	16.3	15.8	18.4	16.5	18.5	17.9	21.0	21.6	12.3
Min. Statutory Ratio (%)	12.5	12.5	12.5	12.5	12.5	12.5	12.5	12.5	12.5	12.5
Liquidity Ratio (%)	34.7	59.4	52.8	66.8	39.1	54.9	51.1	54.4	48.6	22.0
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 (%)	13.9	16.4	15.6	15.8	11.0	13.6	11.2	15.7	17.2	17.6
EQTY-to-Loans Ratio (%)	23.6	31.5	30.0	38.5	21.3	28.3	24.5	33.3	33.6	26.0
NPL Ratio (%)	13.0	10.4	11.2	13.5	7.8	13.5	11.6	8.0	10.7	23.8
NPL Coverage Ratio (%)	50.0	41.0	45.6	63.9	57.5	44.7	53.5	41.9	54.5	35.2
L/Term Debt to Liabilities & EQTY (%)	2.2	7.7	5.0	3.4	19.3	4.2	3.6	4.4	2.9	9.4
NTA/share (KES)	34.82	30.00	12.11	128.38	7.32	41.52	90.47	196.68	57.94	24.62
Book value/share (KES)	41.12	33.01	13.65	136.88	7.92	42.52	99.60	218.28	71.01	25.62

(Source: Company, DBIB Research)

INVESTMENT RETURN

	KCB	EQTY	COOP	SCBK	ABSA	NCBA	SBIC	DTB	I&M	HF
ROA (%)*	1.6	2.4	2.8	2.0	0.3	1.2	1.4	1.2	1.8	(1.0)
ROaA(%)	1.8	2.6	3.1	2.1	0.3	1.6	1.5	1.3	1.9	(1.0)
ROIC (%)*	1.6	2.5	2.9	2.0	0.3	1.2	1.5	1.3	1.8	(1.1)
ROE (%)*	11.5	14.6	17.6	12.5	2.7	8.7	12.7	7.2	9.8	(6.0)
ROaE(%)	12.1	16.0	18.7	13.1	2.8	11.9	13.1	7.4	10.4	(5.9)

(Source: Company, DBIB Research)

OPERATING EFFICIENCY

1H19	KCB	EQTY	COOP	SCBK	ABSA	NCBA	SBIC	DTB	I&M	HF
Yield on interest earning assets (%)*	10.7	10.1	11.0	9.7	10.8	8.8	9.0	10.1	9.7	12.3
Cost of funds (%)*	2.7	2.6	3.6	2.4	2.8	4.3	2.4	4.7	4.4	7.5
Net Interest Margin (%)*	7.9	7.6	7.4	7.3	8.0	4.4	6.5	5.4	5.2	4.8
Loan-to-Deposits ratio (%)	85.0	70.0	79.6	52.5	81.3	58.5	79.0	67.4	72.6	101.10
Loan-to-Dep.& Borrowings ratio (%)	81.7	62.9	74.6	50.5	64.3	54.5	74.2	64.4	69.6	87.6
Funded Income Gen Potential (%)	89.4	85.4	86.4	88.9	79.5	85.6	73.9	85.9	82.8	78.4
Funded Income Reliance (%)	65.9	56.0	62.0	67.6	67.6	44.5	52.2	75.5	60.7	52.9
Cost to income ratio (%)	45.7	52.4	49.6	49.9	51.5	50.7	48.0	46.8	40.1	85.8
Cost to assets ratio(%)	1.9	3.1	2.7	2.5	2.4	1.1	1.9	1.5	1.5	2.9
Cost of risk (%)*	1.3	1.1	1.8	1.3	3.5	4.2	2.3	1.1	2.6	3.8
Pre-tax margin (%)	46.5	45.2	45.4	47.5	35.0	36.1	44.5	48.9	53.8	(4.9)
PAT margin (%)	33.0	31.9	32.5	32.3	23.8	21.2	32.6	34.0	39.2	(5.0)

(Source: Company, DBIB Research)

CAPITAL ADEQUACY, LIQUIDITY & ASSET QUALITY

1H19	**KCB**	**EQTY**	**COOP**	**SCBK**	**ABSA**	**NCBA**	**SBIC**	**DTB**	**I&M**	**HF**
Core capital/TRWA (%)	16.1	14.3	15.1	15.6	14.1	13.9	14.2	18.9	17.1	14.5
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	16.8	15.4	18.6	16.0	15.4	17.5	21.1	18.2	15.8
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 (%)	32.2	61.6	43.5	67.2	38.7	55.7	55.3	54.3	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 (%)	15.7	15.9	16.5	15.9	12.0	12.2	12.1	15.1	16.5	18.2
EQTY-to-Loans Ratio (%)	24.5	32.0	28.1	39.0	22.7	26.6	22.7	32.8	32.2	25.6
NPL Ratio (%)	7.6	8.4	10.6	14.1	7.8	9.2	10.0	7.3	12.4	24.2
NPL Coverage Ratio (%)	46.5	36.8	42.2	62.2	66.0	38.9	46.2	41.6	47.6	25.1
L/Term Debt to Liabilities & EQTY (%)	3.0	8.1	5.0	3.2	17.2	5.7	4.4	3.5	3.2	18.7
NTA/share (KES)	33.91	25.57	11.68	114.26	7.67	17.60	90.55	199.58	64.43	24.39
Book value/share (KES)	38.33	27.48	12.10	124.05	7.80	19.43	93.06	203.65	63.35	26.77
Payout ratio (%) (interim)	12.05	-	-	37.15	28.17	-	9.69	-	-	-

(Source: Company, DBIB Research)

INVESTMENT RETURN

1H19	**KCB**	**EQTY**	**COOP**	**SCBK**	**ABSA**	**NCBA**	**SBIC**	**DTB**	**I&M**	**HF**
ROA (%)*	3.4	3.7	3.5	3.2	2.2	1.8	2.6	2.1	2.7	(0.3)
ROaA(%)	3.1	3.1	3.6	3.2	2.3	1.9	2.8	2.2	2.9	(0.3)
ROIC (%)*	3.5	3.9	3.6	3.3	2.3	1.9	2.7	2.1	2.8	(0.4)
ROE (%)*	21.7	23.4	21.0	20.1	18.3	14.8	21.5	13.6	16.4	(1.9)
ROaE(%)	23.5	25.5	21.5	20.6	18.6	15.1	23.0	14.5	17.6	(1.8)

(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

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