DYER & BLAIR INVESTMENT BANK
EARNINGS UPDATE

Founder Member of the Nairobi Securities Exchange

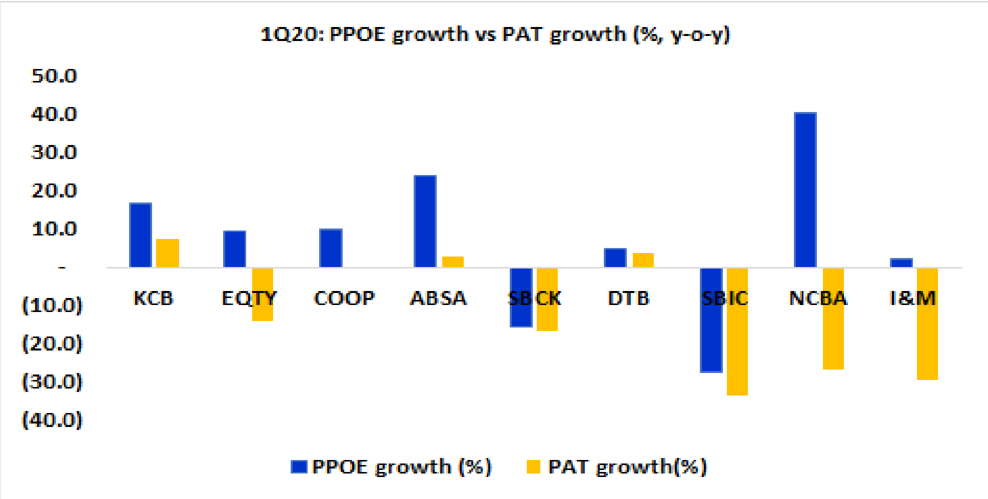
16TH JUNE 2020

DYER & BLAIR INVESTMENT BANK

WE KNOW. YOU KNOW.

KENYA: LISTED BANKS 1Q20 BY THE NUMBERS:

1Q20 saw an underperformance across the sector as only 4 out of 10 listed banks saw an improvement in profitability on the back of a weaker top line growth and a higher cost of risk. Top line growth was impeded by Central Bank Policy rate cuts as despite the 4Q19 repeal of the interest rate caps, loans issued until then remain under the CBR plus 4.0% pricing framework. The elevation of cost of risk across the sector is a big concern as COVID-19 related economic shut down was only applicable in the last month of the quarter (March).



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

Looking ahead, we expect top line to further underperform as banks eschew lending and as the impact of concessions given on digital transactions continue to eat into non-interest income revenue streams. Secondly, cost of risk will remain elevated as the secondary order effects of the COVID-19 crisis continue to reflect in form of SME shut downs, layoffs and subdued trade. For public markets investors, we think that clarity of one's investment horizon is key to crafting a portfolio that reflects the near trade-off between liquid and illiquid banking stocks. For long term investors, we like the more illiquid but valuable stocks like Stanchart and DTB while for more short term oriented investors we think that the more externalized mass market banks offer better value due to their ease of exit.

PAT (KES BN)	1Q20	1Q19
KCB**	6.3	5.8
EQTY	5.3	6.2
COOP	3.6	3.6
ABSA	2.0	1.9
SBCK	2.0	2.4
DTB	2.0	2.0
SBIC	1.5	2.3
NCBA**	2.2	2.2
I&M	1.7	2.4
HF	(0.0)	(0.2)

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

PAT Growth	Y/Y(%)	Q/Q(%)
KCB**	7.2	4.3
EQTY	(14.1)	4.7
COOP	(0.3)	4.7
ABSA	3.0	3.1
SBCK	(16.6)	0.0
DTB	3.7	59.8
SBIC	(33.5)	37.0
NCBA**	(26.8)	(49.6)
I&M	(29.7)	(59.8)
HF	99.6	97.5

(Source: Company, DBIB Research)

PPOP (KES BN)	1Q20	1Q19
KCB**	11.8	10.1
EQTY	10.1	9.2
NCBA**	6.4	4.5
COOP	6.1	5.6
ABSA	4.5	3.7
I&M	3.2	3.2
SBCK	3.3	4.0
DTB	3.4	3.2
SBIC	2.7	3.8
HF	0.1	0.0

(Source: Company, DBIB Research)
PPOP= pre provisions operating earnings
***For our variance analysis we have combined the two banks numbers in 1Q19 and 1Q20*

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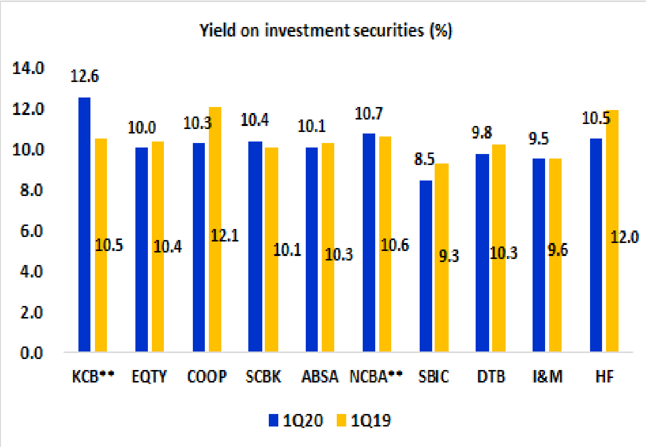
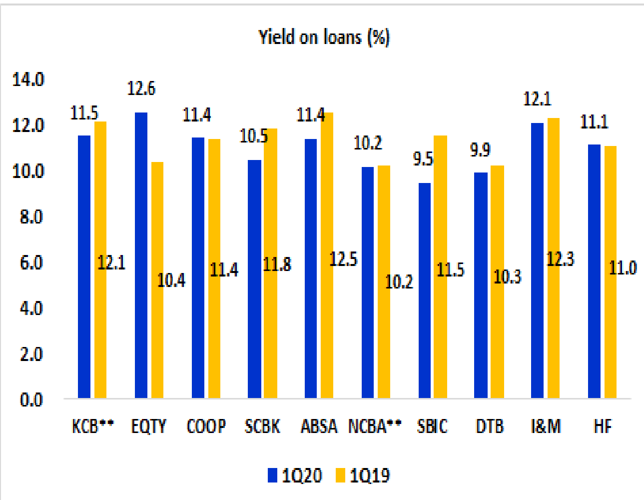
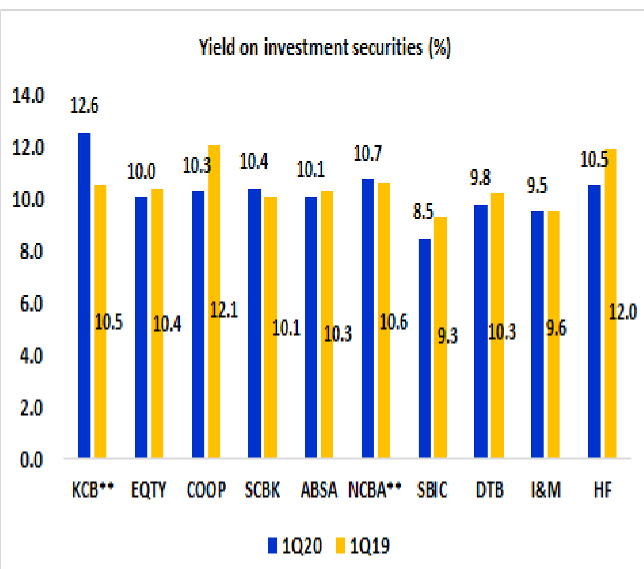


(Source: Company, DBIB Research)



(Source: Company, DBIB Research)



(Source: Company, DBIB Research)

We observe that the decision to keep loans that were issued before 4Q20 capped slowed the expected credit release that was to follow the repeal of the interest caps.

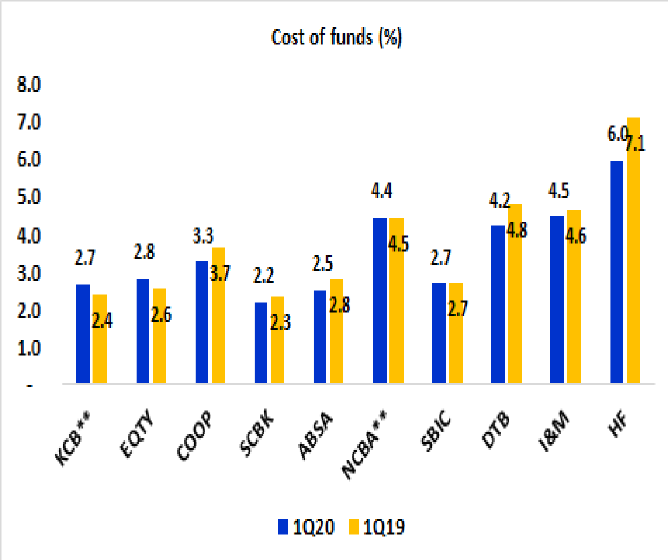
For all banks except KCB and DTB, the yield on interest earning assets declined mainly on the back of Central Bank Policy rate cuts as existing loan books had to be repriced downwards in response.

Despite the emerging consensus of a yield curve elevation over time, we do not expect yields to improve in 2020 as banks are likely to spend more time fine-tuning their risk pricing models. That is, individual banks may have to revisit all their risk pricing assumptions as the nature of credit related risk continues to evolve. Further, although the government's fiscal deficit is set to continue widening, the re-allocation of liquidity from institutional investors towards risk free assets is likely to keep the yields on investment securities fairly stagnant.

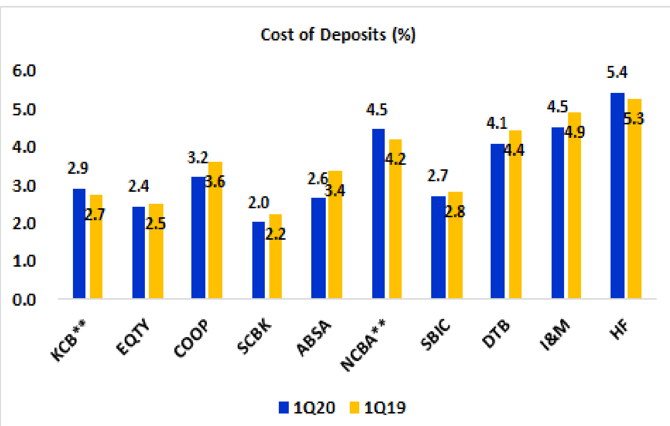
Equity stands out as the only bank that significantly improved its yield on loans from 1Q19 with a 220 bps rise to 12.6% in line with our past arguments that its balance sheet was best prepared to take advantage of the post rate cap environment through an agile conversion of maturing treasury bills into loans. Of course, this strategy is now in flux given COVID-19. While we can't speculate on how and when the post-crisis will be, we are confident that this agility, partly born of a decisive management will come in handy then.

KCB's balance sheet size and an ever growing digital lending offering allow it room to enhance its yields through asset re-allocation and the monthly compounding nature of mobile loans.

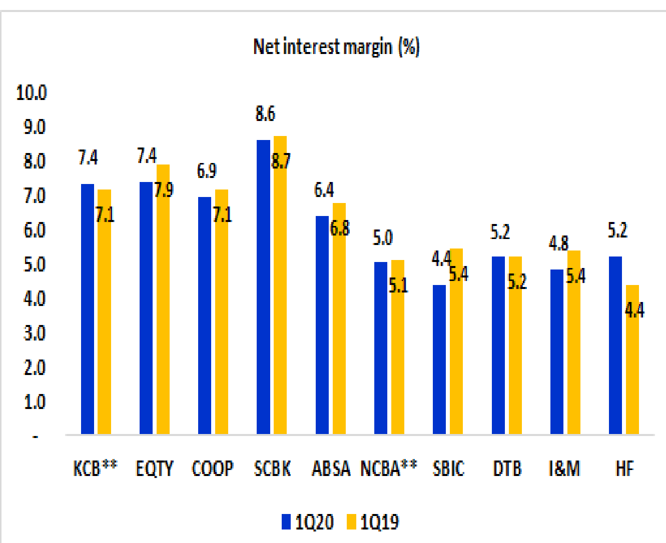
Thus, with a long term perspective, a 50/50 weighted portfolio between these two banks will allow an investor to balance the benefits of agility to the former and scale to the latter.



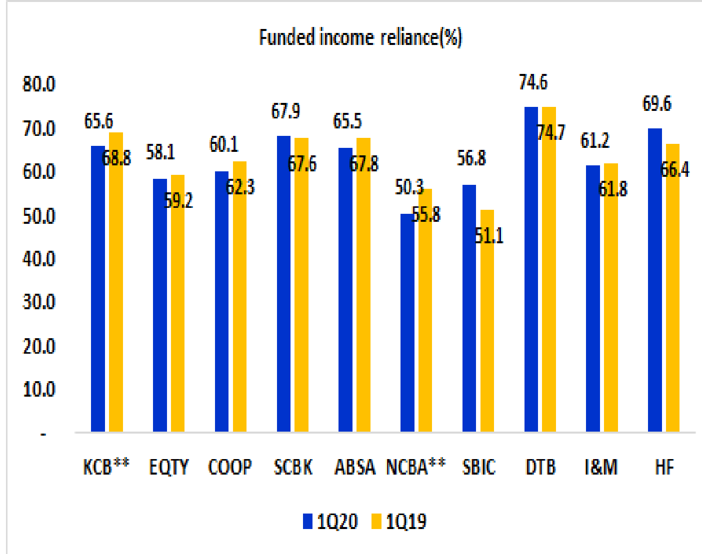
(Source: Company, DBIB Research)



(Source: Company, DBIB Research)



(Source: Company, DBIB Research)

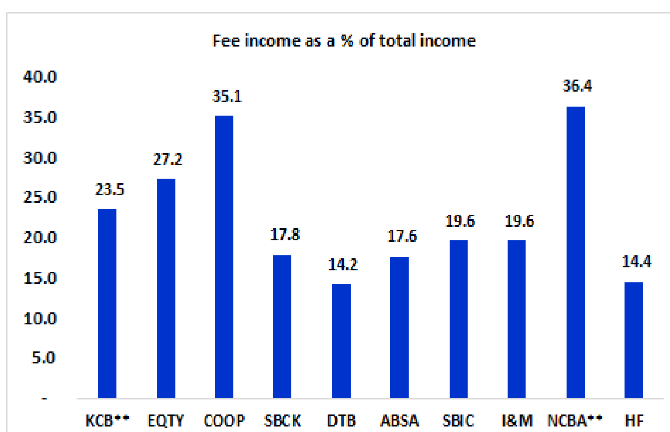


(Source: Company, DBIB Research)

With yields generally subdued, we expect that margins will continue to be largely liability driven. As job losses and SME closures eat into cheap sources of liabilities (CASA accounts), cost of funds will ultimately rise even though such upward pressure will in the short term remain muted by lack of aggressive lending by banks.

A bank like KCB, whose current account deposits are arguably fairly sticky in part due to the acquisition of National Bank will undoubtedly remain competitive margins wise regardless of how the current crisis evolves. Equity and Coop's heavy SME focus may lead to funding pressures if the crisis continues.

With concessions on fees and commissions as well as reduced transactions, we can expect that funded income reliance will rise y-o-y.



(Source: Company, DBIB Research)

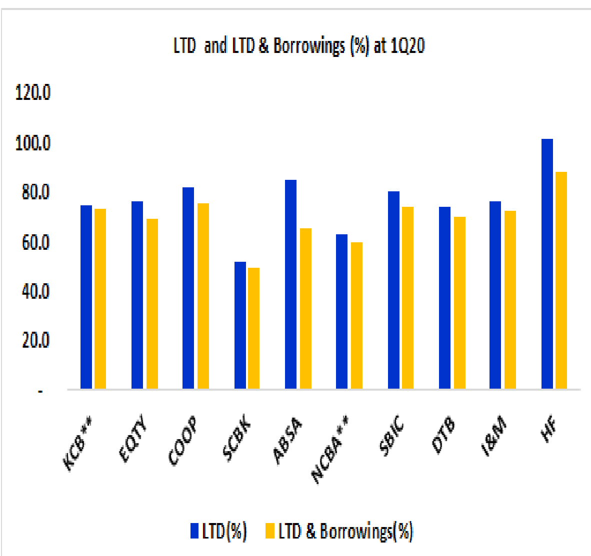
LOAN BOOK GROWTH (%)

Group	Y-o-Y growth (%)
KCB**	8.6
EQTY	24.1
COOP	9.8
SBCK	6.8
DTB	6.7
ABSA	12.4
SBIC	11.8
I&M	8.3
NCBA**	2.2
HF	(8.5)

(Source: Company, DBIB Research)

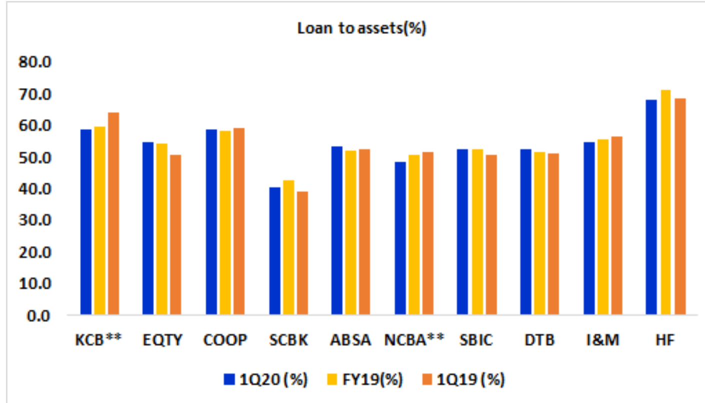
LOAN TO DEPOSITS & BORROWED FUNDS AT FY19

Group	LTD(%)	LTD & Borrowings(%)
KCB	74.8	72.6
EQTY	75.9	68.7
COOP	81.3	75.3
SCBK	51.5	49.3
ABSA	85.0	64.9
NCBA	63.0	59.6
SBIC	79.8	73.6
DTB	73.8	69.9
I&M	76.0	72.4
HF	101.1	87.6



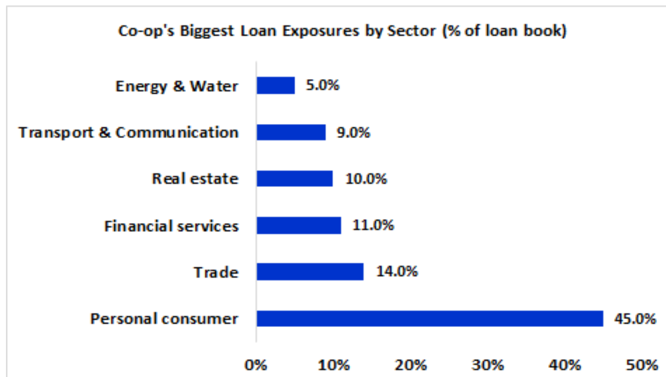
(Source: Company, DBIB Research)

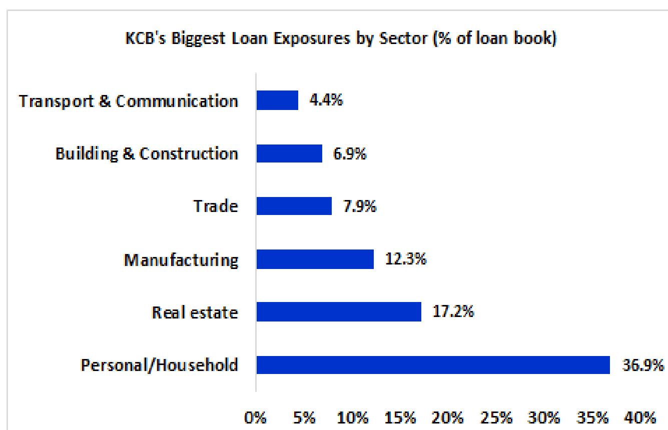
High LTDs among mass market banks exposes them to significant non-performance risk if the COVID-19 economic lock down continues for a while. Conversely, foreign owned banks with relatively low LTDs stand a better chance over the crisis and post crisis period.

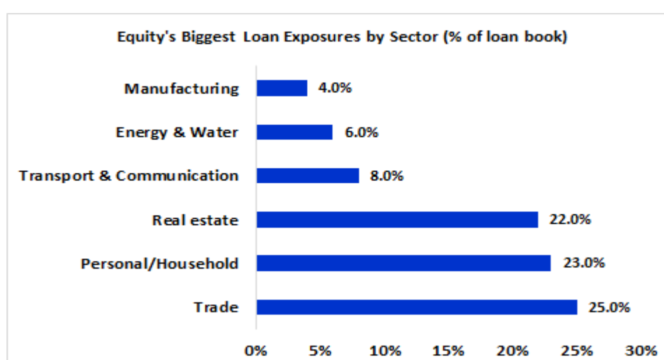


(Source: Company, DBIB Research)

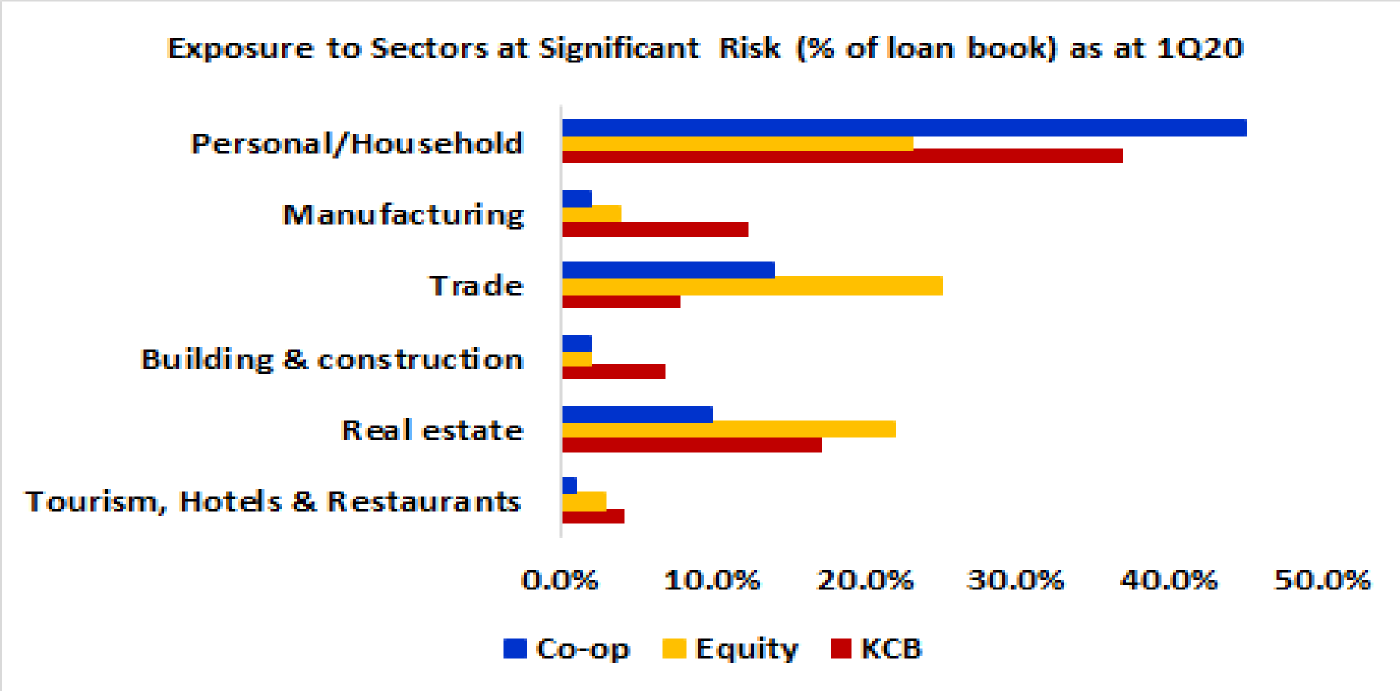
Known for a more aggressive approach, mass market banks have a higher asset exposure to loans thus face a high risk of weakening asset quality over the crisis period.







(Source: Company 1Q20 Presentations)



(Source: Company, DBIB Research)

We believe that the above sectors (personal loans, manufacturing, trade, real estate, construction and tourism), will carry the brunt of the negative impact of the COVID-19 crisis as well as its aftermath. In aggregate, KCB is most affected with a combined exposure of 85.5%, with Equity's and Co-op's exposure at 79.0% and 74.0% respectively.

Potential deterioration of personal loans due to job losses and SME shutdowns is a risk that could crystallize rather insidiously in part since almost every management claims that the underlying loans are check-off based to public related entities (where retrenchments are unlikely) and because the underlying sector exposure is unknown.

Despite management's assurance that these loans are check off based to public related entities, Co-op's exposure of 45.0% is too high relative to Equity's and KCB's which stand at 23.0% and 36.9% respectively. That said, if you make the assumption that personal loans track SME loans with respect to performance, then Equity's SME focus balances this risk leaving KCB as a safer bet.

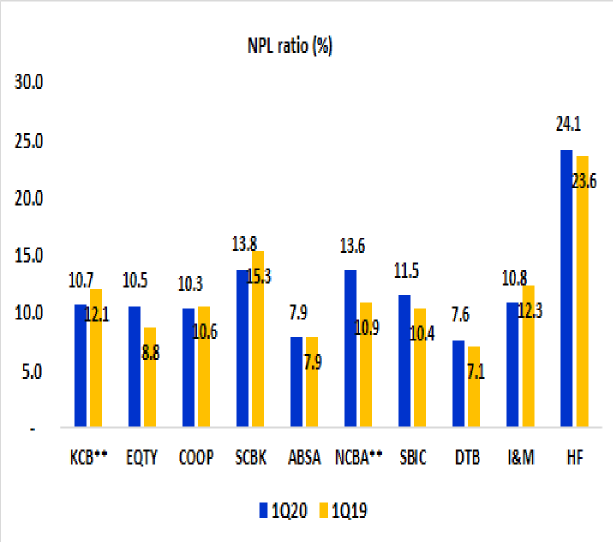
With the outlook on real estate looking grim by the day, the stage is set for further increases in cost of risk and heightened difficulty of recoveries given that most of the secured loans have property or land as collateral.

If you make the assumption that most of personal loans are exposed to real estate, then the combined exposure to real estate is significantly higher than the numbers above show with Co-op leading with a combined exposure of 55.0% to real estate and personal loans while KCB and Equity follow at 54.1% and 45.0% respectively.

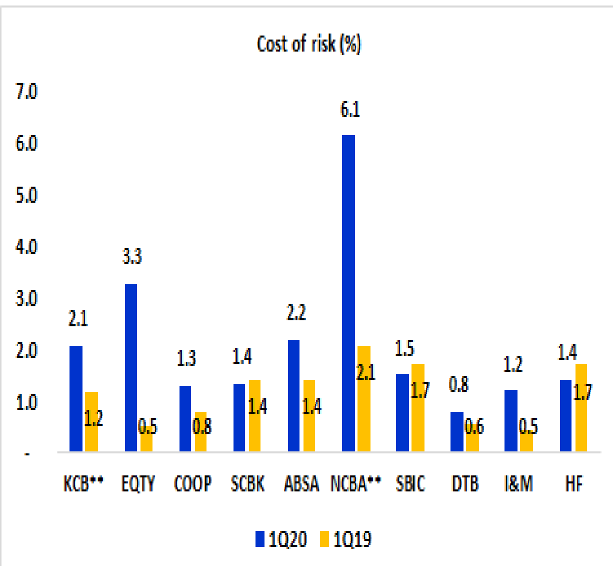
We think it is fair to expect that exposures to building and construction will remain at risk of a total write off until all the pending bills to contractors are paid. KCB's 6.9% exposure leads the pack with Equity's and Coop's at 2.0% respectively.

Exposures to tourism, hotels and restaurants are likely to remain at risk until global travel normalizes which may not happen until we have a mass distributed vaccine.

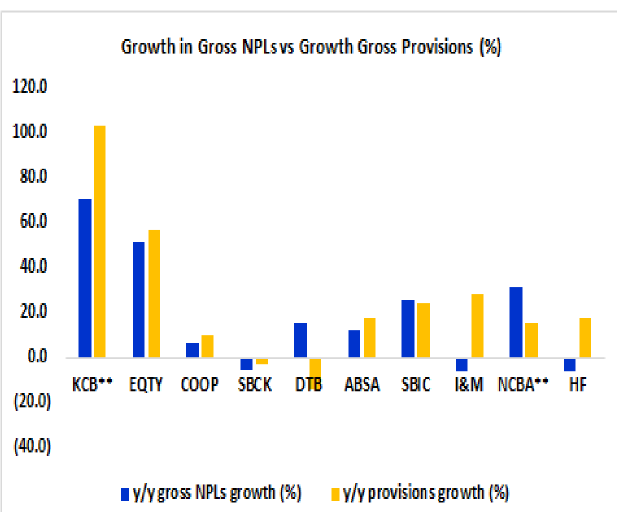
Regular readers will observe that whereas we acknowledge the liquidity discount on these mass market banking stocks, we believe that in times of systemic risk, the more illiquid foreign owned banks are safer for capital preservation.



(Source: Company, DBIB Research)



(Source: Company, DBIB Research)



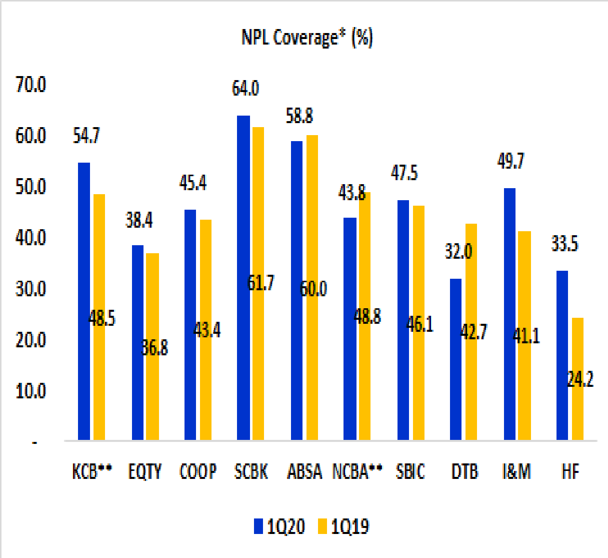
(Source: Company, DBIB Research)

At a base-line, we expect NPL ratios to remain elevated as banks are unlikely to grow their loan book aggressively. While this tepid growth is easily explained by the destruction of credit by the COVID crisis, we also see uncertainty of pricing as a key impediment to lending. Following the repeal of the interest rate caps, banks have been discussing their new risk based pricing models with the regulator with the goal of establishing a new base rate for their loans. We think that these discussions will be stalled by the uncertainty over the short term outlook of risk free rates (that banks are probably using in their risk pricing models) as recent government pronouncements suggest a continuity of an expansionary fiscal framework.

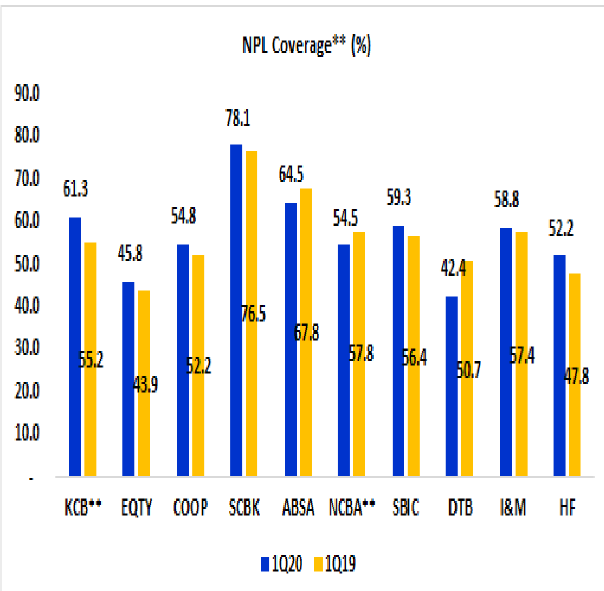
Although banks have flexibility on mechanical application of accounting treatment of COVID-19 related non performance, we expect them to take advantage of the current environment to significantly de-risk their books as Equity did in 1Q20. Unfortunately, though welcome, these efforts will also work to weaken management's credibility in the short term given their past insistence of prudent provisioning levels. As a result, valuations are likely to remain subdued in the short to medium term as investors subject management's assurances to an extended wait and see approach.

The sharp uptick in cost of risk across the sector appears insufficient given that economic shut down only applied to the last month of 1Q20. Thus we can expect the bad debt impairment expense to significantly rise in 2Q20 and beyond as the secondary effects of the shut downs will have a long lag.

With respect to asset quality, we emphasize our belief that foreign owned banks like Stanchart, Absa and Stanbic will show more earnings resilience than locally owned banks in the short term.



*(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*

Coverage ratios underline the resilience of foreign owned banks like **Stanchart** and **Absa** which is key if one is to work with the assumption that the aftermath of the COVID-19 crisis is unpredictably risky to asset quality. In the case of Stanchart, the thin foreign ownership of its free float makes its share price a better investment for those optimizing for capital preservation. That said, the share's illiquidity makes it fairly unattractive to institutional investors.

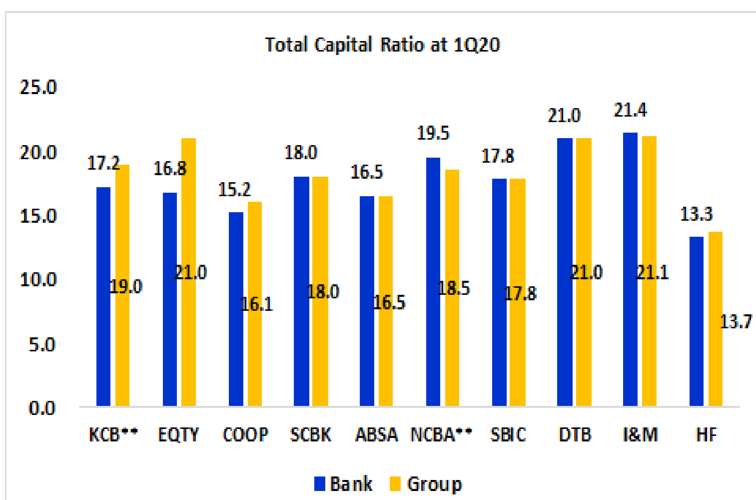
We are uncertain on whether the level of provisions will outgrow the gross NPLs among local mass market banks. Thus though management of the various firms expect the respective coverage ratios to improve, it is a tough bet to choose them over foreign owned banks that are generally seen to be prudent with their provisioning standards.

CAPITAL ADEQUACY AND LIQUIDITY AS AT 1Q20

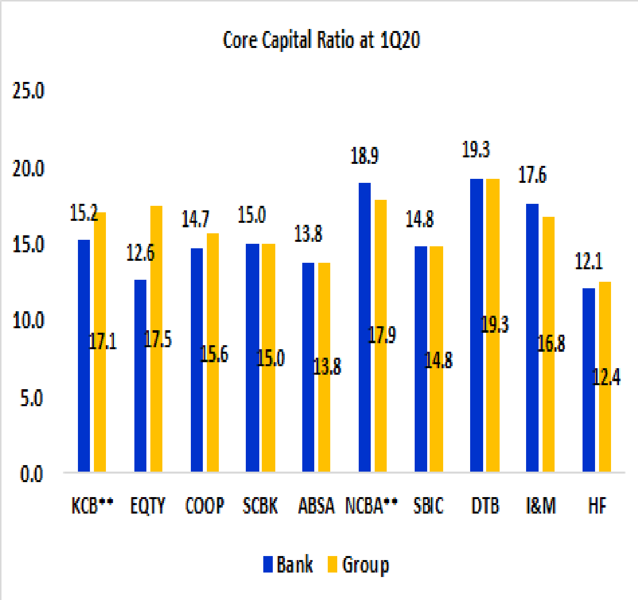
Bank*	LIQUIDITY(%)	CORE CAP* (%)	TOTAL CAP* (%)
KCB	35.4	15.2	17.2
EQTY	54.9	12.6	16.8
COOP	47.5	14.7	15.2
SCBK	67.6	15.0	18.0
ABSA	37.9	13.8	16.5
NCBA	54.6	18.9	19.5
SBIC	54.4	14.8	17.8
DTB	54.7	19.3	21.0
I&M	47.8	17.6	21.4
HF	21.3	12.1	13.3
Minimum	**20.0**	**10.5**	**14.5**

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

At what point does capital become a material factor for public markets investors? For banks with a holding company structure like Equity, how much of surplus capital should they hold at the Holdco level given that the crisis is systemic not just from a Kenyan standpoint but regional as well. For banks without a holding structure such as DTB, where international subsidiaries are held under the Kenyan bank, how much buffer should the Kenyan bank hold?

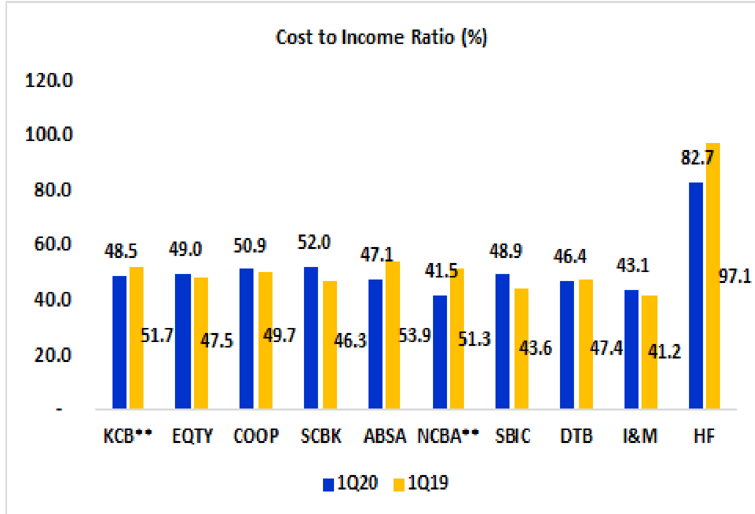


(Source: Company, DBIB Research)



(Source: Company, DBIB Research)

COST EFFICIENCY



(Source: Company, DBIB Research)

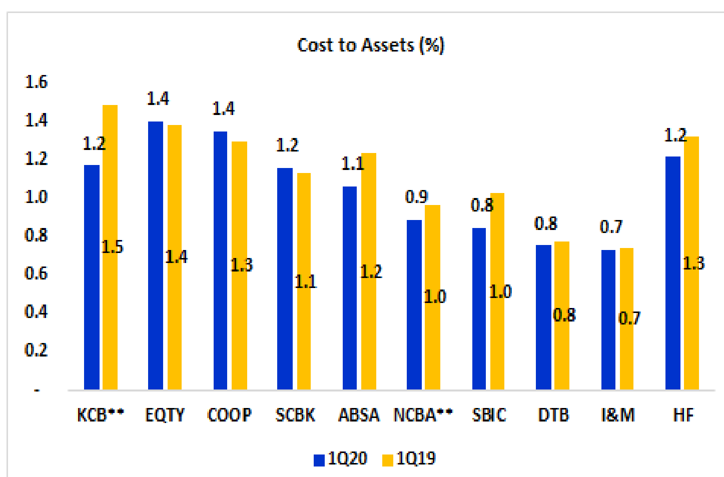
The Central Bank circular on compliance with regulatory capital following the implementation of IFRS 9, gives banks a transition period of 5 years beginning January 2018. Further, the short to medium term outlook suggests that banks are likely to remain lending averse in light of the uncertainties around the impact of the COVID-19 crisis on credit risk not to forget upcoming political season in Tanzania (2020), Kenya (2022) and Uganda (2021). As a result, banks could avoid having to recapitalize in the short term.

However, that banks such as NCBA and Equity Group chose to withdraw their FY19 dividend recommendations, cements the thinking that the annual impairment provisions are going to be quite significant which at a base line means that banks are likely to pare or refrain from recommending dividends in 2020.

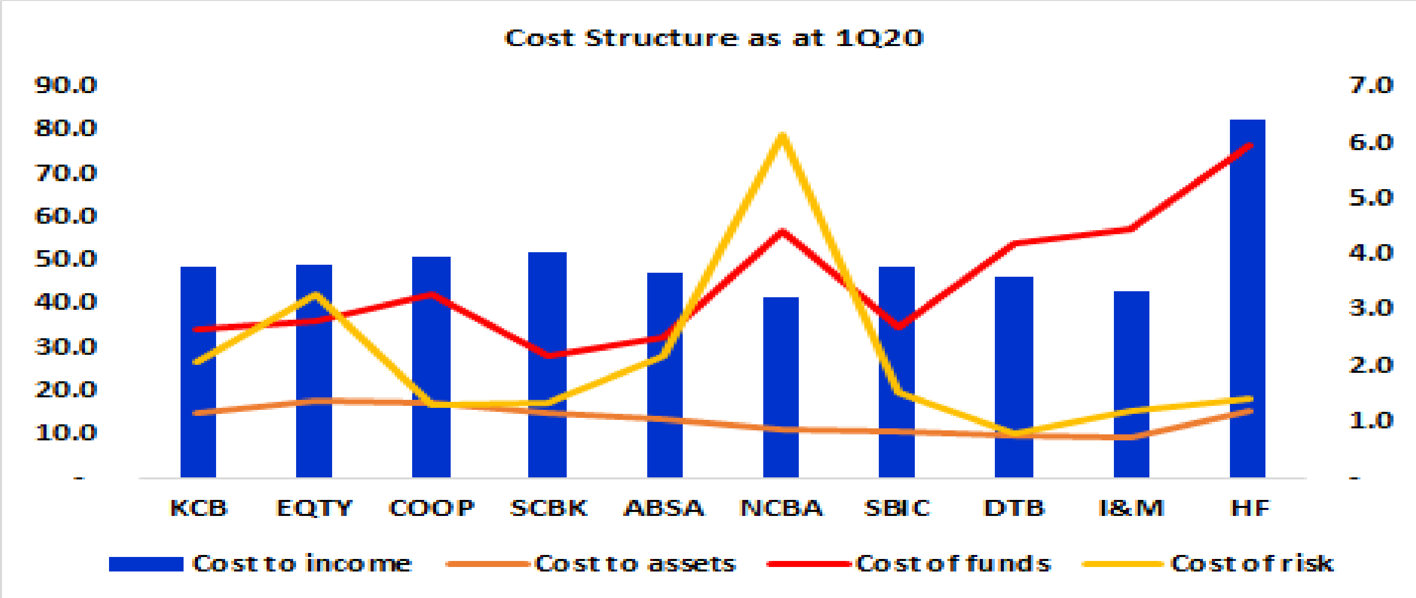
As they have done in the last 3 years, banks are likely to opt for raising subordinated debt for tier II capital over straight up equity raises. For example, Co-op management is undertaking a conversion of senior debt to subordinated debt to boost its tier II capital.

Predictably, 1Q20 show higher cost to income ratios due to the underperformance of the income lines on the back of Central Bank Policy rate cuts and fee concessions on digital transactions that banks have given the customers to minimize the transmission of coronavirus through use of cash.

We believe that COVID-19 will change customer behavior to further deepen the adoption of digital banking. Even if banks are unable to immediately roll back the fees on digital transactions, the efficiency gains should translate to better cost to income ratios in the medium term. In this regard, we like Equity and KCB banks as their mass market nature means that the marginal productivity of every unit of efficiency gains will be much higher.



(Source: Company, DBIB Research)



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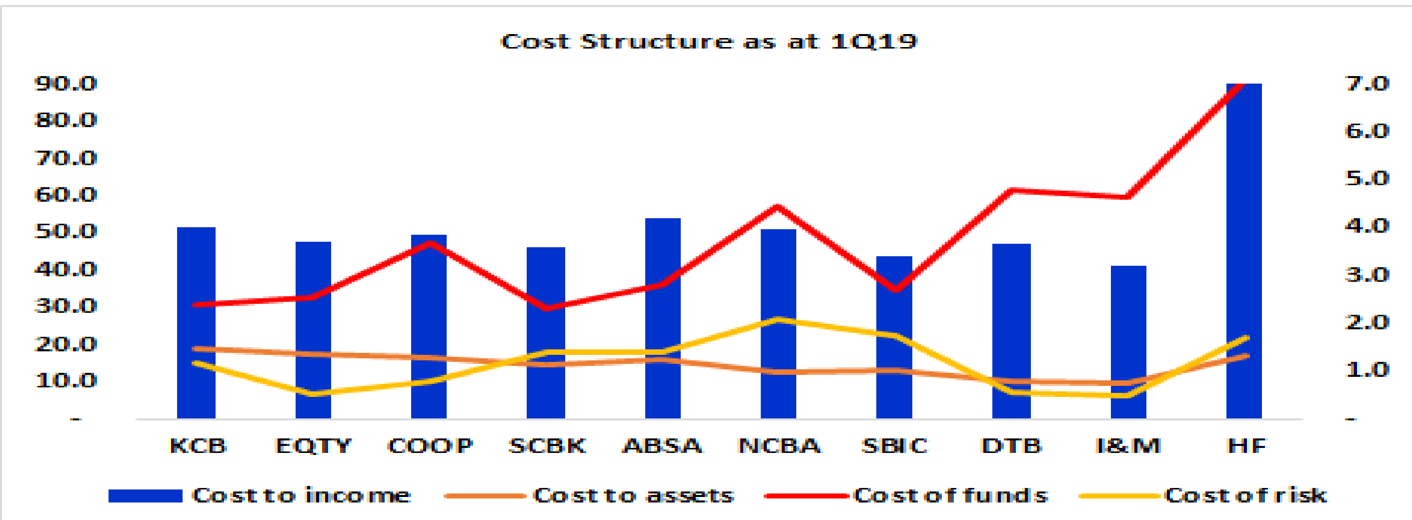

(Source: Company, DBIB Research)

We think that the current environment makes it even more difficult for KCB to derive the efficiency gains that management expected from consolidating National Bank of Kenya across all cost elements other than cost of funds. As yields on assets are likely to remain subdued in the short term, this difficulty may negate the impact of a lower cost of funds in the short term.

We think that cost efficiencies in NCBA are very much likely following the onset of branch consolidations last month. With the market continuing to only price NIC, we believe that NCBA offers better value over time from efficiency gains.

On balance, if the goal is to protect the downside, with respect to the entire cost structure, foreign owned banks like Stanchart, Stanbic and DTB hold more promise.

OPERATING EFFICIENCY

1Q20	KCB**	EQTY	COOP	SCBK	ABSA	NCBA**	SBIC	DTB	I&M	HF
Yield on interest earning assets (%)*	10.0	10.2	10.2	10.8	8.9	9.5	7.1	9.4	9.3	11.2
Cost of funds (%)*	2.7	2.8	3.3	2.2	2.5	4.4	2.7	4.2	4.5	6.0
Net Interest Margin (%)*	7.4	7.4	6.9	8.6	6.4	5.0	4.4	5.2	4.8	5.2
Loan-to-Deposits ratio (%)	74.8	75.9	81.3	51.5	85.0	63.0	79.8	73.8	76.0	101.1
Loan-to-Dep.& Borrowings(%)	72.6	68.7	75.3	49.3	64.9	59.6	73.6	69.9	72.4	87.6
Funded Income Gen Potential (%)	85.3	87.2	87.7	72.7	89.9	84.4	87.3	87.8	82.8	78.4
Funded Income Reliance (%)	65.6	58.1	60.1	67.9	65.5	50.3	56.8	74.6	61.2	69.6
Cost to income ratio (%)	48.5	49.0	50.9	52.0	47.1	41.5	48.9	46.4	43.1	82.7
Cost to assets ratio(%)	1.2	1.4	1.4	1.2	1.1	0.9	0.8	0.8	0.7	1.2
Pre-tax margin (%)	38.9	35.3	40.9	41.9	33.5	22.1	39.6	47.1	43.5	0.8
PAT margin (%)	27.3	26.8	28.7	28.9	22.7	14.9	28.5	32.6	29.1	(0.1)
NFI to OPEX ratio (%)	70.9	85.4	78.3	61.8	73.2	119.6	88.3	54.7	89.9	36.8

(Source: Company, DBIB Research)

CAPITAL ADEQUACY, LIQUIDITY & ASSET QUALITY

1Q20	KCB**	EQTY	COOP	SCBK	ABSA	NCBA**	SBIC	DTB	I&M	HF
Core capital/TRWA (%)	15.2	12.6	14.7	15.0	13.8	18.9	14.8	19.3	17.6	12.1
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 (%)	17.2	16.8	15.2	18.0	16.5	19.5	17.8	21.0	21.4	13.3
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 (%)	35.4	54.9	47.5	67.6	37.9	54.6	54.4	54.7	47.8	21.3
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 (%)	14.3	16.6	17.4	16.0	11.1	13.5	13.1	15.9	17.7	18.0
EQTY-to-Loans Ratio (%)	24.5	30.7	30.3	39.7	20.8	28.0	25.1	33.2	34.3	26.6
Cost of risk (%)*	2.1	3.3	1.3	1.4	2.2	6.1	1.5	0.8	1.2	1.4
NPL Ratio (%)	10.7	10.5	10.3	13.8	7.9	13.6	11.5	7.6	10.8	24.1
NPL Coverage Ratio (%)	54.7	38.4	45.4	64.0	58.8	43.8	47.5	32.0	49.7	33.5
L/T Debt to Liabilities and EQTY (%)	2.3	7.6	5.8	3.6	19.4	4.4	5.5	3.9	3.5	10.3
NTA/share (KES)	40.27	29.35	13.69	135.90	7.69	41.48	100.59	233.76	69.29	24.41
Book value/share (KES)	42.24	31.43	14.24	145.07	7.79	45.95	102.60	239.24	75.77	26.56

(Source: Company, DBIB Research)

INVESTMENT RETURN

1Q20	KCB**	EQTY	COOP	SCBK	ABSA	NCBA**	SBIC	DTB	I&M	HF
ROA (%)*	2.6	3.1	3.1	2.6	2.1	1.3	2.0	2.1	2.0	(0.004)
ROaA(%)	2.8	3.3	3.2	2.6	2.2	1.3	2.1	2.2	2.1	(0.004)
ROIC (%)*	2.7	3.2	3.2	2.6	2.2	1.3	2.1	2.2	2.0	(0.005)
ROE (%)*	18.5	18.3	17.2	16.1	18.5	9.5	15.1	12.2	10.6	(0.025)
ROaE(%)	19.1	20.1	18.2	16.3	17.7	9.6	15.8	12.8	11.5	(0.025)

*(Source: Company, DBIB Research) **For our variance analysis we have combined the two banks numbers in 1Q19 and 1Q20*

OPERATING EFFICIENCY

1Q19	KCB**	EQTY	COOP	SCBK	ABSA	NCBA**	SBIC	DTB	I&M	HF
Yield on interest earning assets (%)*	9.5	10.5	10.8	11.1	9.6	9.5	8.1	10.0	10.0	11.5
Cost of funds (%)*	2.4	2.6	3.7	2.3	2.8	4.5	2.7	4.8	4.6	7.1
Net Interest Margin (%)*	7.1	7.9	7.1	8.7	6.8	5.1	5.4	5.2	5.4	4.4
Loan-to-Deposits ratio (%)	79.5	71.3	79.2	50.5	80.6	67.7	75.9	68.5	76.4	123.51
Loan-to-Dep.& Borrowings(%)	76.9	63.7	73.7	48.8	64.6	63.6	71.6	65.5	72.9	89.3
Funded Income Gen Potential (%)	82.2	85.3	87.6	76.7	89.5	85.5	89.1	87.9	81.5	79.4
Funded Income Reliance (%)	68.8	59.2	62.3	67.6	67.8	55.8	51.1	74.7	61.8	66.4
Cost to income ratio (%)	51.7	47.5	49.7	46.3	53.9	51.3	43.6	47.4	41.2	97.1
Cost to assets ratio(%)	1.5	1.4	1.3	1.1	1.2	1.0	1.0	0.8	0.7	1.3
Pre-tax margin (%)	41.0	50.2	46.0	48.1	35.0	35.2	47.0	48.3	60.4	(20.5)
PAT margin (%)	27.9	35.2	32.4	32.7	23.9	23.8	34.3	32.4	43.7	(20.6)

(Source: Company, DBIB Research)

CAPITAL ADEQUACY, LIQUIDITY & ASSET QUALITY

1Q19	KCB**	EQTY	COOP	SCBK	ABSA	NCBA**	SBIC	DTB	I&M	HF
Core capital/TRWA (%)	16.4	14.4	14.7	16.1	14.6	18.0	14.9	18.5	17.3	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 (%)	17.7	14.5	15.0	18.8	16.5	19.1	18.4	20.7	18.0	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 (%)	32.3	56.0	44.7	71.7	41.1	53.2	55.9	53.4	45.6	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 (%)	15.2	15.6	17.1	16.3	13.3	14.4	12.9	15.0	16.7	17.4
EQTY-to-Loans Ratio (%)	24.8	31.2	29.5	41.8	25.5	28.1	25.5	32.2	31.5	24.4
Cost of risk (%)*	1.2	0.5	0.8	1.4	1.4	2.1	1.7	0.6	0.5	1.7
NPL Ratio (%)	12.1	8.8	10.6	15.3	7.9	10.9	10.4	7.1	12.3	23.6
NPL Coverage Ratio (%)	48.5	36.8	43.4	61.7	60.0	48.8	46.1	42.7	41.1	24.2
L/T Debt to Liabilities and EQTY (%)	2.6	8.4	5.6	2.7	16.1	5.0	4.1	3.4	3.5	22.0
NTA/share (KES)	37.84	23.85	12.24	137.93	8.33	41.77	90.62	214.06	69.29	24.19
Book value/share (KES)	39.45	25.77	12.64	143.03	8.48	45.14	93.18	217.39	64.31	26.69

(Source: Company, DBIB Research)

INVESTMENT RETURN

1Q19	KCB**	EQTY	COOP	SCBK	ABSA	NCBA**	SBIC	DTB	I&M	HF
ROA (%)*	2.8	4.1	3.4	3.2	2.2	1.9	3.2	2.1	3.2	(1.1)
ROaA(%)	2.6	3.8	3.5	3.2	2.4	1.8	3.4	2.1	3.5	(1.0)
ROIC (%)*	2.9	4.3	3.4	3.3	2.3	2.0	3.3	2.2	3.2	(1.1)
ROE (%)*	18.5	26.0	19.4	19.6	16.5	13.2	25.0	13.0	17.8	(6.2)
ROaE(%)	19.6	27.9	20.2	20.2	16.8	13.1	26.3	13.6	18.7	(5.9)

*(Source: Company, DBIB Research) **For our variance analysis we have combined the two banks numbers in 1Q19 and 1Q20*

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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