ABSA Bank Kenya-FY2019 Earnings Note

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Valuation Summary

- We are of the view that ABSA Bank Kenya is a "Buy" with a target price of Kshs 13.0, representing an upside of 43.6%, from the current price of Kshs 9.8 as of 27th March 2020, inclusive of a dividend yield of 11.2%,
- ABSA Bank Kenya is currently trading at a P/TBV of 1.2x and a P/E of 7.1x vs an industry average of 1.2x and 6.1x, respectively.

Key Highlights FY

- Barclays Bank Kenya (BBK) completed its rebranding exercise to Absa Group, as the bank continued to invest in Information Technology (IT) equipment and brand modernization. The transition was completed well ahead of the bank's strategy to transition fully to Absa by June 2020.

Income Statement

- Core earnings per share (excluding exceptional items), increased by 21.2% to Kshs 1.65, from Kshs 1.37 in FY'2018, above our expectation of a 5.1% increase to Kshs 1.44. Earnings per share inclusive of exceptional items remained flat at Kshs 1.37, following a one-off exceptional item of Kshs 1.5 bn that the bank incurred in rebranding expenses from Barclays to Absa. The performance was driven by a 6.5% increase in total operating income, despite the 2.1% increase in total operating expenses. The variance in core earnings per share growth against our expectations was largely due to the 8.5% increase in Loan Loss Provisions (LLP) to Kshs 4.2 bn, from Kshs 3.9 bn in FY'2018, against our expectation of a 31.4% increase in LLP to Kshs 5.1 bn,
- Total operating income rose by 6.5% to Kshs 33.8 bn, from Kshs 31.7 bn in FY'2018. This was due to a 9.1% rise in Non-Funded Income (NFI) to Kshs 10.6 bn, from Kshs 9.7 bn in FY'2018, coupled with a 5.4% rise in Net Interest Income (NII) to Kshs 23.2 bn, from Kshs 22.0 bn in FY'2018,
- Interest income rose by 6.8% to Kshs 31.0 bn, from Kshs 29.1 bn in FY'2018. This was driven by a 9.7% growth in interest income from government securities to Kshs 8.1 bn, from Kshs 7.4 bn in FY'2018, and a 4.7% increase in interest income on loans and advances to Kshs 22.5 bn, from Kshs 21.5 bn in FY'2018. The yield on interest-earning assets, however, declined to 10.4%, from 11.4% in FY'2018, attributed to the faster 17.6% y/y increase in average interest earning assets to Kshs 299.3 bn, from Kshs 254.5 bn in FY'2018, that outpaced the 6.8% growth in interest income,
- Interest expenses rose by 11.0% to Kshs 9 bn, from Kshs 7.1 bn in FY'2018, following a 32.8% increase in the interest expense on placement liabilities to Kshs 1.3 bn from Kshs 0.9 bn in FY'2018, coupled with the 5.4% rise in interest expense on customer deposits to Kshs 6.5 bn from Kshs 6.1 bn in FY'2018, on the back of the strong 14.6% y/y deposit growth recorded in 2019. Cost of funds, on the other hand, declined marginally to 3.45%, from 3.52% in FY'2018, owing to the faster 13.1% growth in average interest-bearing liabilities, which outpaced the 11.0% growth in interest expense. The Net Interest Margin (NIM) however declined to 7.7%, from 8.6% in FY'2018, owing to the faster 17.6% growth in average interest-earning assets which outpaced the

5.4% growth in Net Interest Income (NII),

- Non-Funded Income (NFI) rose by 9.1% to Kshs 10.6 bn, from Kshs 9.7 bn in FY'2018. The growth was mainly driven by an 11.0% rise in forex trading income to Kshs 3.6 bn, from Kshs 3.3 bn in FY'2018, coupled with an 8.8% growth in total fees and commissions on loans to Kshs 6.1 bn from Kshs 5.6 bn in FY'2018. As a result, the revenue mix adjusted marginally to 68.6:31.4 from 69.4:30.6 recorded in FY'2018, funded to non-funded income, owing to the faster 9.1% growth in NFI, that outpaced the 5.4% growth in NII,
- Total operating expenses rose by 2.1% to Kshs 21.5 bn from Kshs 21.1 bn, largely driven by an 8.5% increase in Loan Loss Provisions (LLP) to Kshs 4.2 bn in FY'2019, from Kshs 3.9 bn in FY'2018, coupled with a 4.0% increase in staff costs to Kshs 10.2 bn in FY'2019, from Kshs 9.8 bn in FY'2018, with the bank has hired an additional 463 staff as it undertook rebranding in 2019. The rise in operating expenses was however mitigated by a 91.9% decline in rental charges to Kshs 0.1 bn from Kshs 1.2 bn in FY'2018, owing to the bank closing some of its branches across the country and opting to rent smaller spaces in some areas,
- The Cost to Income Ratio (CIR) improved to 63.6%, from 66.4% in FY'2018, owing to the faster 6.5% rise in total operating income to Kshs 33.8 bn, from Kshs 31.7 bn in FY'2018, which outpaced the 2.1% rise in total operating expenses to Kshs 21.5 bn, from Kshs 21.1 bn in FY'2018. Without LLP, the cost to income ratio also improved to 51.2%, from 54.2% in FY'2018, an indication of improved efficiency,
- Profit before tax rose by 15.4% to Kshs 12.3 bn, from Kshs 10.6 bn in FY'2018. Profit after tax before exceptional items grew by 21.2% to Kshs 9.0 bn in FY'2019, from Kshs 7.4 bn in FY'2018, while profit after tax and exceptional items, which relates to a one-off transition expense of Kshs 1.5 bn, grew by a marginal 0.5% to Kshs 7.5 bn in FY'2019, from Kshs 7.4 bn in FY'2018, with the effective tax rate increasing to 30.7% from 30.0% in FY'2018, and,
- The bank recommends a final dividend of Kshs 0.9 per share, inclusive of a Kshs 0.2 per share interim dividend paid in October, translating to a total Dividend per Share (DPS) of Kshs 1.1 for the year, unchanged from the Kshs 1.1 per share paid in FY'2018. This translates to a dividend yield of 11.2% at the current price of Kshs 9.8, and a payout ratio of 80.1%.

Balance Sheet

- The balance sheet recorded an expansion as total assets increased by 15.1% to Kshs 374.0 bn, from Kshs 324.8 bn in FY'2018. This growth was largely driven by a 32.3% increase in government securities to Kshs 123.0 bn, from Kshs 92.9 bn in FY'2018, coupled with a 9.9% increase in their loan book to Kshs 194.9 bn, from Kshs 177.4 bn in FY'2018,
- Total liabilities rose by 17.2% to Kshs 328.8 bn, from Kshs 280.6 bn in FY'2018, driven by a 14.6% increase in customer deposits to Kshs 237.7 bn, from Kshs 207.4 bn in FY'2018, coupled with a 26.2% increase in balances due to banking institutions in the group to Kshs 72.0 bn, from Kshs 57.0 bn in FY'2018. The growth in liabilities was mitigated by a 23.1% decline in placement liabilities to Kshs 4.1 bn, from Kshs 5.3 bn in FY'2018. Deposits per branch increased by 12.5% to Kshs 2.7 bn, from Kshs 2.4 bn in FY'2018, with the number of branches has increased by 4 to 88 from 84 in FY'2018,
- The faster 14.6% growth in deposits, which outpaced the 9.9% growth in loans led to a decline in the loan to deposit ratio to 82.0% from 85.5%, recorded in FY'2018,
- Gross Non-Performing Loans (NPLs) declined by 2.8% to Kshs 13.5 bn in FY'2019, from Kshs 13.9 bn in FY'2018. The NPL ratio thus improved to 6.6% in FY'2019, from 7.4% in FY'2018, owing to the faster 9.8% growth in gross loans (after adding back interest suspense), coupled with a 2.8% decline in non-performing loans. General Loan Loss Provisions rose by 19.3% to Kshs 7.8 bn, from Kshs 6.5 bn in FY'2018. Consequently, the NPL coverage increased to 77.0% in FY'2019, from 69.2% in FY'2018, owing to the 19.3% increase in general loan loss provisions, coupled with a 2.8% decline in gross non-performing loans,
- Shareholders' funds increased by 2.2% to Kshs 45.2 bn in FY'2019 from Kshs 44.2 bn in FY'2018,

driven by a 3.4% increase in retained earnings to Kshs 37.1 bn, from Kshs 35.9 bn in FY'2018. However, the growth was weighed down by a 46.9% decline in revaluation reserve to Kshs 0.3 bn from Kshs 0.5 bn in FY'2018,

- ABSA Bank Kenya is currently sufficiently capitalized with a core capital to risk-weighted assets ratio of 13.9%, 3.4% points above the 10.5% statutory requirement. In addition, the total capital to risk-weighted assets ratio was 16.6%, exceeding the 14.5% statutory requirement by 2.1% points. Adjusting for IFRS 9, the core capital to risk weighted assets stood at 14.3%, while total capital to risk-weighted assets came in at 17.0%, and,
- The bank currently has a Return on Average Assets (ROaA) of 2.3%, and a Return on Average Equity (ROaE) of 16.7%.

Key Take-Outs:

1. There was an improvement in efficiency levels as the cost to income ratio without LLP improved to 51.2% from 54.2% in FY'2018. The improvement was largely attributable to a 91.9% decrease in rental charges to Kshs 0.1 bn from Kshs 1.2 bn in FY'2018, owing to the bank closing some of its branches across the country and opting to rent smaller spaces in some areas, which in turn boosted the bottom line,
2. The bank's asset quality improved, with the NPL ratio improving to 6.6% from 7.4% in FY'2018. The improving NPL ratio is attributable to a 2.8% decline in gross non-performing loans to Kshs 13.5 bn, from Kshs 13.9 bn in FY'2018 compared to the 9.8% growth in gross loans to Kshs 205.3 bn, from Kshs 187.0 bn in FY'2018. The bank continued to demonstrate prudence, as the coverage remained relatively high, at 77.0%, higher than the 69.2% in FY'2018,
3. The banks' reported earnings per share remained flat at Kshs 1.37, weighed down by the Kshs 1.5 bn one-off exceptional item that the bank incurred in rebranding expenses. However, core earnings per share recorded a 21.2% growth to Kshs 1.65, from Kshs 1.37 in FY'2018, and,
4. The bank recorded relatively strong growth in its balance sheet, as deposits grew by 14.6% y/y, and were channeled to Government Securities investments, which grew by 32.3%, and loans and advances, which grew, by 9.9% y/y. The growth in interest-earning assets helped support increased interest income revenue, despite the decline in yields of government securities.

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

i. Increased Channel diversification, which is likely to help the bank to continue improving its operational efficiency. The benefits of this are already being felt with "Timiza" already recording accelerated growth, and consequently higher Non-Interest This coupled with the expansion of its agent-banking network and product offerings such as bancassurance and fixed income trading will see the bank expand its topline revenue, going forward.

Below is a summary of the bank's performance:

Balance Sheet	FY'2018	FY'2019	y/y change	FY'2019e	Expected y/y change	Variance in Actual Growth vs. Expected
Government Securities	92.9	123.0	32.3%	80.0	(13.9%)	46.2%
Net Loans and Advances	177.4	194.9	9.9%	213.9	20.6%	(10.7%)
Total Assets	**324.8**	**374.0**	**15.1%**	**380.5**	**17.1%**	**(2.0%)**
Customer Deposits	207.4	237.7	14.6%	251.7	21.3%	(6.7%)
Total Liabilities	280.6	328.8	17.2%	334.9	19.3%	(2.2%)
Shareholders' Funds	**44.2**	**45.2**	**2.2%**	**45.8**	**3.5%**	**(1.3%)**

Balance sheet ratios	**FY'2018**	**FY'2019**	**% y/y change**
Loan to Deposit Ratio	85.5%	82.0%	(3.5%)
Return on average equity	16.8%	16.7%	(0.1%)
Return on average assets	2.7%	2.3%	(0.4%)

Income Statement	**FY'2018**	**FY'2019**	**y/y change**	**FY'2019e**	**Expected y/y change**	**Variance in Actual Growth vs Expected**
Net Interest Income	22.0	23.2	5.4%	23.8	8.3%	(2.9%)
Net non-Interest Income	9.7	10.6	9.1%	10.8	11.3%	(2.1%)
Total Operating income	**31.7**	**33.8**	**6.5%**	**34.6**	**9.2%**	**(2.7%)**
Loan Loss provision	(3.9)	(4.2)	8.5%	(5.1)	31.4%	(22.9%)
Total Operating expenses	(21.0)	(21.5)	2.1%	(23.5)	11.5%	(9.5%)
Profit before tax	**10.6**	**12.3**	15.4%	**11.1**	4.6%	**10.7%**
Profit after tax	**7.4**	**9.0**	21.2%	**7.8**	5.1%	**16.0%**
Core EPS	**1.37**	**1.65**	**21.2%**	**1.44**	**5.1%**	**16.0%**

Income statement ratios	**FY'2018**	**FY'2019**	**% y/y change**
Yield from interest-earning assets	11.4%	10.4%	(1.1%)
Cost of funding	3.5%	3.5%	(0.1%)
Net Interest Margin	8.6%	7.7%	(0.9%)
Cost to Income	66.4%	63.6%	(2.8%)
Cost to Assets	5.3%	4.6%	(0.7%)
Net Interest Income as % of operating income	69.4%	68.6%	(0.7%)
Non-Funded Income as a % of operating income	30.6%	31.4%	0.7%

Capital Adequacy Ratios	**FY'2018**	**FY'2019**
Core Capital/Total Liabilities	18.2%	16.3%
Minimum Statutory ratio	8.0%	8.0%
Excess	**10.2%**	**8.3%**
Core Capital/Total Risk Weighted Assets	14.4%	13.9%
Minimum Statutory ratio	10.5%	10.5%
Excess	**3.9%**	**3.4%**
Total Capital/Total Risk Weighted Assets	16.4%	16.6%
Minimum Statutory ratio	14.5%	14.5%

Capital Adequacy Ratios	FY'2018	FY'2019
Excess	**1.9%**	**2.1%**
Liquidity Ratio	35.7%	39.8%
Minimum Statutory ratio	20.0%	20.0%
Excess	**15.7%**	**19.8%**
Adjusted Core Capital/Total Liabilities	**18.6%**	**16.8%**
Adjusted Core Capital/Total RWA	**14.7%**	**14.3%**
Adjusted Total Capital/Total RWA	**16.7%**	**17.0%**