ABSA Bank Kenya-Q1'2020 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 12.6, representing an upside of 26.9%, from the current price of Kshs 10.8 as of 29th May 2020, inclusive of a dividend yield of 10.2%,
- ABSA Bank Kenya is currently trading at a P/TBV of 1.4x and a P/E of 7.8x vs an industry average of 1.0x and 5.4x, respectively.

Key Highlights Q1’2020

- ABSA Bank Kenya recently restructured loans amounting to Kshs 8.3 bn equivalent to 4.3% of its net loans, which stood at Kshs 194.9 bn in FY’2019 to shield its customers and provide relief from financial distress occasioned by the COVID-19 pandemic.
- The bank donated Kshs 50.0 mn in support of the efforts by the government and other Kenyans of goodwill against the COVID 19 pandemic. These funds will be used for the acquisition of Personal Protective Equipment (PPEs), psychosocial support programs, business resilience training, and mentorship programs for SMEs to help them survive through this difficult time.

Income Statement

- Core earnings per share (excluding exceptional items), increased by 17.0% to Kshs 0.46, from Kshs 0.39 in Q1’2019, above our expectation of a 2.6% increase to Kshs 0.40. Earnings per share inclusive of exceptional items increased by 3.0% to Kshs 0.36, from Kshs 0.35 in Q1’2019. The one-off exceptional item of Kshs 0.6 bn relates to separation costs incurred by the bank following the separation of ABSA Group from Barclays PLC. The performance was driven by an 8.1% increase in total operating income, which grew faster than the 5.0% growth in total operating expenses. The variance in core earnings per share growth against our expectations was largely due to the 8.1% increase in the total operating income to Kshs 8.6 bn, from Kshs 8.0 bn in Q1’2019, against our expectation of a 6.4% increase to Kshs 8.5 bn,
- Total operating income rose by 8.1% to Kshs 8.6 bn, from Kshs 8.0 bn in Q1’2019. This was due to a 15.8% rise in Non-Funded Income (NFI) to Kshs 3.0 bn, from Kshs 2.6 bn in Q1’2019, coupled with a 4.5% rise in Net Interest Income (NII) to Kshs 5.6 bn, from Kshs 5.4 bn in Q1’2019,
- Interest income rose by 2.8% to Kshs 7.6 bn, from Kshs 7.4 bn in Q1’2019. This was driven by a 7.5% growth in interest income from government securities to Kshs 2.1 bn, from Kshs 1.9 bn in Q1’2019, and a 1.0% increase in interest income on loans and advances to Kshs 5.5 bn, from Kshs 5.4 bn in Q1’2018. The yield on interest-earning assets, however, declined to 9.9%, from 11.0% in Q1’2019, attributed to the faster 17.4% y/y increase in average interest earning assets to Kshs 315.2 bn, from Kshs 268.5 bn in Q1’2019, that outpaced the 2.8% growth in interest income,
- Interest expenses declined by 1.9% to Kshs 1.99 bn, from Kshs 03 bn in Q1’2019, following a 13.2% decline in interest expense on customer deposits to Kshs 1.5 bn, from Kshs 1.8 bn in

Q1’2019. The decline was however weighed down by a 54.6% increase in placement liabilities to Kshs 0.4 bn from Kshs 0.3 bn in Q1’2019. Cost of funds, on the other hand, declined to 3.3%, from 3.6% in Q1’2019, owing to the faster 13.8% growth in average interest bearing liabilities, which outpaced the 1.9% decline in interest expense. Net Interest Margin (NIM) on the other hand declined to 7.4%, from 8.2% in Q1’2019, owing to the faster 17.4% growth in average interest earning assets which outpaced the 4.5% growth in Net Interest Income (NII),

- Non-Funded Income (NFI) rose by 15.8% to Kshs 3.0 bn, from Kshs 2.6 bn in Q1’2019. The growth was mainly driven by a 47.4% rise in forex trading income to Kshs 1.1 bn, from Kshs 0.8 bn in Q1’2019. Total fees and commissions remained unchanged at Kshs 1.5 bn. As a result, the revenue mix adjusted to 66:35 from 68:32 recorded in Q1’2019, funded to non-funded income, owing to the faster 15.8% growth in NFI, that outpaced the 4.5% growth in NII,
- Total operating expenses rose by 5.0% to Kshs 5.2 bn, from Kshs 4.9 bn in Q1’2019, largely driven by a 75.2% increase in Loan Loss Provisions (LLP) to Kshs 1.1 bn in Q1’2020, from Kshs 0.6 bn in Q1’2019, coupled with a 6.6% increase in staff costs to Kshs 2.5 bn in Q1’2020, from Kshs 2.3 bn in Q1’2019. The increased provisions is attributed to the bank adopting a cautious stance on the back of the expected increase in defaults across sectors caused by the COVID-19 pandemic. The rise in operating expenses was however mitigated by a 19.9% decline in other operating expense to Kshs 1.6 bn from Kshs 2.0 bn in Q1’2019,
- The Cost to Income Ratio (CIR) improved to 60.1%, from 61.9% in Q1’2019, owing to the faster 8.1% rise in total operating income to Kshs 8.6 bn, from Kshs 8.0 bn in Q1’2019, which outpaced the 5.0% rise in total operating expenses to Kshs 5.2 bn, from Kshs 4.9 bn in Q1’2019. Without LLP, the cost to income ratio also improved to 47.1%, from 53.9% in Q1’2019, an indication of improved efficiency, and,
- Profit before tax rose by 13.3% to Kshs 3.4 bn, from Kshs 3.0 bn in Q1’2019. Profit after tax before exceptional items grew by 17.0% to Kshs 2.5 bn in Q1’2020, from Kshs 2.1 bn in Q1’2019, while profit after tax and exceptional items, which relates to one-off separation cost of Kshs 0.6 bn, grew by 3.0% to Kshs 1.96 bn in Q1’2020, from Kshs 1.9 bn in Q1’2019, with the effective tax rate increasing to 32.0% from 31.8% in Q1’2019.

Balance Sheet

- The balance sheet recorded an expansion as total assets increased by 10.4% to Kshs 381.5 bn, from Kshs 345.4 bn in Q1’2019. This growth was largely driven by a 12.4% increase in their loan book to Kshs 203.0 bn, from Kshs 180.5 bn in Q1’2019, coupled with a 7.2% increase in government securities to Kshs 125.4 bn, from Kshs 117.0 bn in Q1’2019,
- Total liabilities rose by 13.3% to Kshs 339.2 bn, from Kshs 299.4 bn in Q1’2019, driven by a 6.6% increase in customer deposits to Kshs 238.7 bn, from Kshs 224.0 bn in Q1’2019, coupled with a 32.7% increase in deposits and balances due to foreign banking institutions to Kshs 2.1 bn, from Kshs 0.9 bn in Q1’2019. The growth in liabilities was mitigated by a 32.4% decline in placement liabilities to Kshs 4.9 bn, from Kshs 7.2 bn in Q1’2019. Deposits per branch increased by 11.7% to Kshs 2.8 bn, from Kshs 2.5 bn in Q1’2019, with the number of branches has reduced to 84 in Q1’2020, from 88 in Q1’2019,
- The faster 12.4% growth in loans, which outpaced the 6.6% growth in deposits led to an increase in the loan to deposit ratio to 85.0% from 80.6%, recorded in Q1’2019,
- Gross Non-Performing Loans (NPLs) increased by 12.4% to Kshs 17.3 bn in Q1’2020, from Kshs 15.4 bn in Q1’2019. The NPL ratio thus deteriorated marginally to 8.10% in Q1’2020, from 8.07% in Q1’2019, owing to the faster 12.4% growth in gross NPLs, which marginally outpaced the 12.1% growth in gross loans (after adding back interest suspense). General Loan Loss Provisions rose by 18.0% to Kshs 8.8 bn, from Kshs 7.5 bn in Q1’2019. Consequently, the NPL coverage declined to 64.5% in Q1’2020, from 67.8% in Q1’2019, owing to the 18.0% increase in general loan loss provisions, which was outpaced by the 12.1% growth in gross non-performing loans,
- Shareholders’ funds declined by 8.2% to Kshs 42.3 bn in Q1’2020 from Kshs 46.1 bn in Q1’2019,

driven by a 54.5% decline in revaluation reserves to Kshs 0.3 bn, from Kshs 0.7 bn in Q1'2019. However, the decline was mitigated by a 3.9% increase in retained earnings to Kshs 39.1 bn from Kshs 37.6 bn in Q1'2019, coupled with a 9.7% increase in other reserves to Kshs 0.21 bn, from Kshs 0.19 bn in Q1'2019,

- ABSA Bank Kenya is currently sufficiently capitalized with a core capital to risk-weighted assets ratio of 13.8%, 3.3% points above the 10.5% statutory requirement. In addition, the total capital to risk-weighted assets ratio was 16.5%, exceeding the 14.5% statutory requirement by 2.0% points. Adjusting for IFRS 9, the core capital to risk-weighted assets stood at 14.0%, while total capital to risk-weighted assets came in at 16.7%, and,
- The bank currently has a Return on Average Assets (ROaA) of 2.1%, and a Return on Average Equity (ROaE) of 17.0%.

Key Take-Outs:

1. There was an improvement in efficiency levels as the cost to income ratio without LLP improved to 47.1% from 53.9% in Q1'2019. The improvement was largely attributable to an 84.0% decline in the bank's rental charges to Kshs 23.7 mn in Q1'2020, from Kshs 148.5 mn in Q1'2019 with the number of branches reducing to 84 in Q1'2020, from 88 in Q1'2019,
2. The bank's asset quality was maintained at the same level, with the NPL ratio remaining at 8.10%. The bank embraced prudent risk assessment with secured lending targeted on key sectors, as well as focus on big-ticket recoveries, which has seen the bank maintain its NPL ratio, which in comparison to the other banks has performed well. The bank continued to demonstrate prudence, as the coverage remained relatively high, at 64.5%, despite being lower than the 67.8% recorded in Q1'2019,
3. The banks' reported earnings per share increased by 3.0% to Kshs 0.36, from Kshs 0.35 in Q1'2019, despite being weighed down by the Kshs 0.6 bn one-off exceptional item that the bank incurred in separation costs. However, core earnings per share recorded a 17.0% growth to Kshs 0.46, from Kshs 0.39 in Q1'2019, and,
4. The bank recorded relatively strong growth in its balance sheet, as deposits grew by 6.6% y/y, and were channeled to loans and advances, which grew, by 12.4% y/y, and government securities investments, which grew by 7.2%. 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 Revenue. 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 top-line revenue, going forward.

Below is a summary of the bank's performance:

Balance Sheet	Q1'2019	Q1'2020	y/y change	Q1'2020e	Expected y/y change	Variance in Actual Growth vs. Expected
Government Securities	117.0	125.4	7.2%	113.1	(3.3%)	10.5%
Net Loans and Advances	180.5	203.0	12.4%	185.5	2.8%	9.7%
Total Assets	345.4	381.5	10.4%	368.0	6.5%	3.9%
Customer Deposits	224.0	238.7	6.6%	226.2	1.0%	5.6%
Total Liabilities	299.4	339.2	13.3%	320.7	7.1%	6.2%
Shareholders' Funds	46.1	42.3	(8.2%)	47.4	2.9%	(11.1%)

Balance sheet ratios	Q1'2019	Q1'2020	% y/y change
Loan to Deposit Ratio	80.6%	85.0%	4.4%
Return on average equity	16.5%	17.0%	0.5%
Return on average assets	2.5%	2.1%	(0.5%)

Income Statement	Q1'2019	Q1'2020	y/y change	Q1'2020e	Expected y/y change	Variance in Actual Growth vs Expected
Net Interest Income	5.4	5.6	4.5%	5.9	10.0%	(5.5%)
Net non-Interest Income	2.6	3.0	15.8%	2.5	(1.0%)	16.8%
Total Operating income	8.0	8.6	8.1%	8.5	6.4%	1.7%
Loan Loss provision	(0.6)	(1.1)	75.2%	(0.9)	40.4%	34.8%
Total Operating expenses	(4.9)	(5.2)	5.0%	(5.3)	8.1%	(3.1%)
Profit before tax	3.0	3.4	13.3%	3.1	3.7%	9.6%
Profit after tax	2.1	2.5	17.0%	2.2	2.6%	14.5%
Core EPS	0.39	0.46	17.0%	0.40	2.6%	14.5%

Income statement ratios	Q1'2019	Q1'2020	% y/y change
Yield from interest-earning assets	11.0%	9.9%	(1.1%)
Cost of funding	3.6%	3.3%	(0.3%)
Net Interest Margin	8.2%	7.4%	(0.7%)
Cost to Income	61.9%	60.1%	(1.8%)
Cost to Assets	1.2%	1.1%	(0.2%)
Net Interest Income as % of operating income	67.8%	65.5%	(2.3%)
Non-Funded Income as a % of operating income	32.2%	34.5%	2.3%

Capital Adequacy Ratios	Q1'2019	Q1'2020
Core Capital/Total Liabilities	17.3%	16.6%
Minimum Statutory ratio	8.0%	8.0%
Excess	9.3%	8.6%
Core Capital/Total Risk-Weighted Assets	14.6%	13.8%
Minimum Statutory ratio	10.5%	10.5%
Excess	4.1%	3.3%
Total Capital/Total Risk Weighted Assets	16.5%	16.5%
Minimum Statutory ratio	14.5%	14.5%
Excess	2.0%	2.0%
Liquidity Ratio	41.1%	37.9%

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