Kenya Listed Banks Q3'2017 Report, & Cytonn Weekly #49/2017

Focus of the Week

Following the release of the Q3'2017 results by Kenyan listed banks, Cytonn Financial Services Research team undertook an analysis on the Kenyan Banking Sector to point out any material changes from our H1'2017 Banking Report. In our Q3'2017 Banking Report, we analyze the results of the listed banks in order to determine which banks are the most attractive and stable for investment from a franchise value and from a future growth opportunity perspective.

The report is themed ***"What Next for the Kenyan Banking Sector?"*** as we assess what factors will be crucial for the sustainability of the banking sector, with the sector expected to adopt a more disciplined approach, following rising non-performing loans (NPLs) and the capping of interest rates, which has seen banks adjust their business models in an effort to manage the tough operating environment. As a result, we now ask the question, "What must banks focus their attention on going forward?" as we look forward to a relatively challenging operating environment for the banking sector, with IFRS 9 expected to come into effect as well as the continued presence of the interest rate caps. With the deteriorating asset quality, coupled with the interest rate caps, we expect prudence and efficiency will be the two key factors that will either make or break the individual banks in the sector. Below are the 6 key themes that shaped the banking sector over the first three quarters of 2017:

1. **Regulation** – The effects of the Banking (Amendment) Act 2015 have been felt over the first three quarters of 2017, with banks recording a decline in core EPS by 8.2% compared to the 5-year average of 13.0%, whereas private sector credit growth remains low at 2.0% as at October 2017, compared to 5.4% when the Banking (Amendment) Act 2015 came into play, and way below the set government target of 18.3%. The amendment stipulates a deposit and loan-pricing framework, with (i) a cap on lending rates at 4.0% above the Central Bank Rate (CBR), and (ii) a floor on the deposit rates at 70% of the CBR. The capping of interest rates, however, has seen banks prefer not to lend to consumers but rather invest in risk-free treasuries, which offer better returns on a risk adjusted basis. This can be witnessed through increased allocation by listed banks towards government securities, with allocation growing by 15.2% to Kshs 776.3 bn from Kshs 684.5 bn in Q3'2016;
2. **Consolidation –** Consolidation in the banking sector picked up towards the end of 2016 and in early 2017, but has slowed as the year has progressed. Earlier in the year, Diamond Trust Bank Kenya (DTBK) completed the acquisition of Habib Bank (K) Limited (HBL), with the deal finalized in Q3'2017. We would have expected even a lot more consolidation by now, given the year is now coming to an end, due to the attractive valuations in the banking sector, and we are surprised that some of the smaller banks have managed to stay independent this long, as we would have expected weaker banks (that don't serve a niche, or don't have a clear deposit gathering strategy), being forced to merge or be acquired. It is notable that acquisitions are also happening at much cheaper valuations, with earlier bank acquisition announcements, such as Fina Bank, K-Rep and Equatorial Commercial Bank having been at 3.2x, 1.8x and 2.3x P/B, respectively, while recent acquisitions are happening at between 0.8x to 1.7x P/B, and hence it is a great time to be an

acquirer. Below is the summary of the transaction metrics of some of the acquisitions that have happened in the banking sector, including DTBK's acquisition of Habib Bank Kenya.

Acquirer	Bank Acquired	Book Value at Acquisition (Kshs bn)	Transaction Stake	Transaction Value (Kshs bn)	P/BV Multiple	Date
Diamond Trust Bank Kenya	Habib Bank Limited Kenya	2.38	100.0%	1.82	**0.8x**	Mar-17
SBM Holdings	Fidelity Commercial Bank	1.75	100.0%	2.75	**1.6x**	Nov-16
M Bank	Oriental Commercial Bank	1.80	51.0%	1.30	**1.4x**	Jun-16
I&M Holdings	Giro Commercial Bank	2.95	100.0%	5.00	**1.7x**	Jun-16
Mwalimu SACCO	Equatorial Commercial Bank	1.15	75.0%	2.60	**2.3x**	Mar-15
Centum	K-Rep Bank	2.08	66.0%	2.50	**1.8x**	Jul-14
GT Bank	Fina Bank Group	3.86	70.0%	8.60	**3.2x**	Nov-13
Average			**80.3%**		**1.8x**	

3. **Asset Quality –** The banking sector has witnessed a deterioration in its asset quality over the past year, with the gross non-performing loans in the listed segment rising by 25.5% to Kshs 189.5 bn from Kshs 151.0 bn in Q3'2016, as the gross NPL ratio rose to 12.3% from 11.2% in Q3'2016, and this has led to an increase in provisioning levels to 52.6% from 47.7% in Q3'2016. We are seeing banks becoming more selective, prudent and conservative in terms of loan disbursement, since with the current pricing framework, it is difficult to price riskier clients within the loan limit cap in the cost of loans. This has led banks to reduce their unsecured and micro loans to small businesses, which are deemed risky, and allocating towards perceived less risky government instruments, and we expect loan growth to be subdued in 2018, as banks tighten their risk assessment framework;
4. **Efficiency –** The focus for the banking sector in 2018 will inevitably be on adjusting business models to conform to the Banking (Amendment) Act 2015. To this effect, banks have already taken proactive measures aimed at increasing operational efficiency in response to the challenging operating environment, such as laying off staff, closure of branches, reviewing operating hours for some branches, or outright sales in the case of struggling Tier III banks. Going forward, we are likely to witness banks' push for efficiency gather pace to balance off the expected reduction in absolute profitability going forward as they shy away from the physical branch model, which is very expensive compared to other alternative channels such as digital platforms;
5. **Prudence –** With the implementation of IFRS 9, from the previous IAS 39, which is expected to take effect from 1st January 2018, banks will be required to provide additionally on loans. IFRS 9 will take on a forward looking or expected impairment approach, meaning that the issuer of the loan is to calculate unrealized default on a facility, depending on the stage of the financial instrument. Some banks have estimated a 25.0% general increase in provisions as a result of the new regulation, though it is expected that most banks, those with adequate capital buffers, will pass the effect on to the balance sheet, affecting retained earnings, with a consequential reduction in Tier I capital. We believe that the new regulation will mean that banks should and will be much more prudent in loan disbursement as the impact of non-performing loans will adversely affect them, through either (i) decreased profitability, brought about by increased provisioning, or (ii) lower capital adequacy buffers, that may see some banks edge under the regulatory minimum requirements, requiring to raise more cash in order to sustain themselves.

6. **Revenue Diversification –** With banks registering compressed net interest margins following the capping of interest rates, much of the attention has shifted, with a focus to diversifying income, through non-funded income, as this section of the bank's revenue is not affected by the interest rate caps. Non-funded income (NFI) has grown by 10.4% in Q3'2016, taking its contribution to total income to 34.0%, from 27.8% registered in Q3'2016, and we expect this to continue going into 2018, as banks seek alternative sources of income to boost profitability.

Below is a summary of the branches closed and staff laid off over the last one year as the banks seek efficiency.

Kenya Banking Sector Restructuring			
	Bank	**Staff Retrenchment**	**Branches Closed**
1.	Sidian Bank	108	-
2.	Equity Group	400	7
3.	Ecobank	-	9
4.	Family Bank	Unspecified	-
5.	First Community Bank	106	-
6.	Bank of Africa	-	12
7.	National Bank	Unspecified	-
8.	NIC Bank	32	Unspecified
9.	Standard Chartered Bank Kenya	300	4
10.	KCB Group	223	Unspecified
11.	Barclays Bank	301	7
12.	I&M Holdings	-	Unspecified
	TOTAL	**1,470**	**39**

Based on the above, we believe the sector is shaping up to prudence in operations, as can be seen through the increased loan loss provisioning levels, as banks adjust their business models under the current regulatory framework.

Below is a summary of the Q3'2017 results for the eleven listed banks and key take-outs from the results:

Kenya Listed Banks Q3'2017 Earnings and Growth Metrics													
Bank	**Core EPS Growth**		**Interest Income Growth**	**Interest Expense Growth**	**Net Interest Income Growth**	**Non Funded Income (NFI) Growth**	**NFI to Total Operating Income**	**Growth in total fees and commissions**	**Loan Growth**		**Deposits Growth**		**Growth in Govt Securities**
	Q3'2017	**Q3'2016**	**Q3'2017**	**Q3'2017**	**Q3'2017**	**Q3'2017**	**Q3'2017**	**Q3'2017**	**Q3'2017**	**Q3'2016**	**Q3'2017**	**Q3'2016**	**Q3'2017**
Stanbic Bank	**19.7%**	(2.1%)	(7.3%)	(8.8%)	(6.5%)	5.1%	44.4%	45.3%	13.8%	1.9%	8.2%	22.8%	40.0%
KCB Group	**5.0%**	16.1%	(3.6%)	(10.9%)	(1.0%)	18.4%	32.9%	25.5%	15.1%	4.9%	13.6%	(7.3%)	2.8%
NIC Bank	**(1.3%)**	(6.4%)	(8.4%)	2.3%	(14.5%)	2.9%	28.2%	12.4%	7.3%	(0.7%)	21.3%	2.4%	49.7%
Equity Group	**(2.7%)**	17.7%	(11.1%)	5.9%	(15.0%)	28.3%	43.6%	24.9%	(2.2%)	3.0%	11.3%	4.8%	17.7%
DTB	**(3.5%)**	11.4%	0.8%	3.7%	(1.4%)	4.7%	21.2%	8.6%	8.1%	5.4%	16.5%	29.9%	18.2%
Co-op Bank	**(9.5%)**	22.3%	(7.7%)	(8.5%)	(7.3%)	2.7%	32.8%	5.9%	14.2%	6.9%	12.1%	1.7%	0.8%
Barclays	**(12.0%)**	(5.4%)	(4.6%)	(6.3%)	(4.2%)	(14.8%)	31.0%	(17.6%)	5.3%	14.3%	10.8%	13.4%	28.8%
I&M Bank	**(23.2%)**	16.5%	(4.0%)	(6.7%)	(2.2%)	9.3%	26.1%	24.4%	9.6%	4.5%	9.6%	9.9%	16.0%
StanChart	**(39.1%)**	24.5%	(1.4%)	19.1%	(8.0%)	(3.2%)	31.8%	(4.0%)	(5.4%)	14.1%	19.5%	19.8%	19.9%
NBK	**(73.5%)**	(76.9%)	(29.6%)	(28.0%)	(30.4%)	(3.1%)	28.3%	(5.0%)	(6.9%)	(15.5%)	1.0%	6.2%	32.1%
HF Group	**(80.9%)**	7.8%	(18.5%)	(8.7%)	(29.7%)	(4.0%)	22.8%	(21.3%)	(5.0%)	4.3%	(19.2%)	10.8%	(86.9%)
Weighted Average**	**(8.2%)**	**15.1%**	**(6.1%)**	**(1.0%)**	**(7.4%)**	**10.4%**	**34.0%**	**14.6%**	**6.3%**	**6.0%**	**12.9%**	**7.5%**	**13.2%**
*** *The weighted average is based on Market Cap as at 1st December, 2017**													

1. ***Deposit growth has remained strong at 12.9%, compared to 12.8% historically, however, the 1.0% decline in interest expense indicates banks are opening less interest earning accounts.***
2. ***Interest Income declined by 6.1%, following the capping of interest rates, depressing***

interest margins, and this saw banks issue fewer loans, as loan growth grew by 6.3%, compared to 14.6% historically, and banks earn income from fee sources and drive NFI growth.

3. ***Consequently, government securities and Non-funded income grew by 13.2% and 10.4%, respectively, as banks are unable to price risk, while also looking to diversify income.***

Key takeaways from the table above include:

- Only Stanbic Bank and KCB Group have recorded a growth in core earnings per share, with the average decline in core earnings across the banking sector at 8.2%, compared to an average growth of 15.1% in Q3'2016, owing to the tough operating environment as a result of the interest rate caps and political uncertainty in the country that affected the business environment. Key to note is that the EPS growth by Stanbic Bank and KCB Group was supported largely on account of (i) an improvement in the hyper-inflationary environment in South Sudan, that saw an adjustment in the expensing of the exceptional items for Stanbic Bank, and (ii) the restatement of the Q3'2016 earnings for KCB Group, which can be considered a one-off item,
- Average deposit growth came in at 12.9%. However, despite the average deposits having grown, the interest expense paid on deposits recorded a negative growth of 1.0% on average, indicating that banks are growing deposits but opening less interest earning accounts and possibly transferring some existing interest earning accounts to transaction accounts,
- Average loan growth came in at 6.3%. However, interest income has declined by 6.1%, highlighting the effects of the rate caps, even as private sector credit growth has remained low, currently at 2.0%, which is way below the set government target range of 18.3%,
- The Loan to Deposits ratio declined to 78.0% from 86.3% registered in Q3'2016, as banks disbursed loans less aggressively, while the Cost to Income (CIR) ratio stood at 66.6%, compared to 47.7% in Q3'2016, with the bank's net interest margins remaining compressed, following the capping of interest rates,
- Investment in government securities has grown by 15.2%, outpacing loan growth of 6.3%, as banks allocated more funds towards the government, with government securities considered risk free, depriving the private sector of credit in the process,
- The increase in the gross non-performing loan (NPL) ratio to 12.3% from 11.2% in Q3'2016 highlights increased risks around asset quality in the sector, with banks having taken a prudent approach with the adoption of IFRS 9,
- Non-funded income has however grown by 10.4%, which included a Fee and Commissions growth of 14.6%. This shows that banks are charging more fee income to improve their total yield on loans above the rate cap maximum, and,
- Listed banks recorded a decline on return on average equity to 13.4% from 15.9% in Q3'2016, as the banks' profitability was affected by the capping of interest rates, which suppressed the net interest margin (NIM coming in at 7.5% compared to 8.6% in Q3'2016.

Private sector credit growth continues to remain low, coming in at 2.0% in October 2017, way below the government set target of 18.3%, as banks channel funds more actively towards government securities, depriving the private sector of credit.

Rate cap came into effect in August 2016 when private sector credit growth was at 5.4% as highlighted above, with the decline before that as a result of a challenging operating environment

Following the challenges that the banking sector has been facing, primarily (i) the deteriorating asset quality brought about by a challenging operating environment, and (ii) the capping of interest rates, which has led to decreased profitability by banks in 2017, as private sector remains subdued, we believe the two key factors banks will consider going into 2018 are prudency and efficiency.

Banks will have to be prudent in loan disbursement, as well as in providing for loans, coupled with efficiency, in a bid to protect their profit margins. The challenging operating environment is further underpinned by the coming into effect of IFRS 9 and Basel III, which will require banks to embrace both prudence and efficiency in order to be compliant and enhance profitability, which we believe will lead to a more stable and robust sector.

As per our analysis on the banking sector, from a franchise value and from a future growth opportunity perspective, below is the comprehensive ranking of the listed banks.

The overall ranking was based on a weighted average ranking of Franchise value (accounting for 40%) and Intrinsic value (accounting for 60%). The Intrinsic Valuation is computed through a combination of valuation techniques, with a weighting of 75.0% on Discounted Cash-flow Methods and 25.0% on Relative Valuation, while the Franchise ranking is based on banks operating metrics, meant to assess the efficiency, asset quality, diversification, corporate governance and profitability, among other metrics.

CYTONN'S Q3'2017 BANKING REPORT - COMPOSITE RANKINGS					
Bank	**Franchise Value Total Score**	**Intrinsic Value Score**	**Weighted Score**	**Q3'2017 Rank**	**H1'2017 Rank**
KCB Group	49.0	2.0	20.8	**1**	**1**
Co-operative Bank	53.0	6.0	24.8	**2**	**2**
Barclays Bank	68.0	4.0	29.6	**3**	**7**
Equity Group	64.0	7.0	29.8	**4**	**5**
NIC Bank	77.0	1.0	31.4	**5**	**4**
Diamond Trust Bank	77.0	3.0	32.6	**6**	**3**
I&M Holdings	75.0	5.0	33.0	**7**	**6**
Stanbic Holdings	82.0	9.0	38.2	**8**	**8**
SCBK	87.0	10.0	40.8	**9**	**9**
NBK	110.0	11.0	50.6	**10**	**11**
HF Group	115.0	8.0	50.8	**11**	**10**

Major changes include:

- Barclays Bank climbed up 4 spots to Position 3 from Position 7 in our H1'2017 Banking Sector Report, due to impressive NIM at 9.7%, above industry average of 7.5%, and good asset quality, registering a gross NPL ratio of 6.8%, the second best among the listed banks, and below the industry average of 12.3%,
- Diamond Trust Bank dropped 3 spots to Position 6 from Position 3 in our H1'2017 Banking Sector Report, due to deteriorating asset quality, with the gross NPL ratio coming in at 8.0%, compared to 4.6% in H1'2016, as well as poor diversification, with NFI contributing only 21.2% of the total operating income, compared to an average of 31.0%.

For a comprehensive analysis on the ranking and methodology behind it, see our Cytonn Q3'2017 Banking Sector Report.