Kenya Listed Banks FY’2017 Report, & Cytonn Weekly #15/2018

Focus of the Week

Following the release of the FY’2017 results by Kenyan listed banks, the Cytonn Financial Services Research Team undertook an analysis on the Kenyan Banking Sector to point out any material changes from our Q3’2017 Banking Report. In our FY’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 ***“Diversification and efficiency key to growth amidst tighter regulation”*** as we assess what factors will be crucial for the sustainability of the banking sector, with banks adjusting their business models in an effort to manage increased regulation and the tougher business environment. As a result, we seek to answer the question, “What must banks focus on going forward?”, as we look forward to a relatively challenging operating environment for the banking sector due to (i) IFRS 9 having coming into effect in 2018, and (ii) the interest rate caps. We expect more emphasis on alternative revenue streams by banks to non-funded income as they work on their efficiency.

Below are the 6 key themes that shaped the banking sector over 2017:

1. **Regulation** – The effects of the Banking (Amendment) Act 2015 have been felt over 2017, with banks recording a decline in core EPS by 1.0% compared to a growth of 4.4% in 2016, and a five-year average of 6.7%. The private sector credit growth remains low at 2.1% as at February 2018, 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 customers but rather invest in risk-free treasuries that 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 22.2% during the year to Kshs 799 bn from Kshs 654 bn in 2016;
2. **Revenue Diversification –** With banks registering compressed net interest margins following the capping of interest rates, much of the attention has shifted 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 9.1% in FY’2017, compared to the 5-year average growth of 8.1%, taking its contribution to total income to 33.6%, from 31.0% registered in FY’2016, compared to the 5-year average contribution of 33.4%. We expect this to continue going into 2018, as banks seek alternative sources of income to boost profitability. We believe revenue and product diversification is one of the core opportunities for the banking sector;
3. **Efficiency –** The focus for the banking sector in 2017 was on adjusting business models to conform to the Banking (Amendment) Act 2015. To this effect, banks took 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.

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	150	-
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	**1,620**	**39**

4. **Asset Quality –** The banking sector has witnessed a deterioration in its asset quality over the past year, with the gross non-performing loans ratio rising to 12.4% from 10.9% in FY'2016, much higher than the 5-year average of 8.4%, owing to the challenging operating environment in 2017 that saw an increase in bad loans. 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;
5. **Prudence –** With the implementation of IFRS 9 from the previous IAS 39, which took effect from 1st January 2018, banks are required to provide additionally for loans. IFRS 9 takes 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 through 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. The Central Bank of Kenya had initially published draft guidelines proposing a 5-year transition period for IFRS 9, during which a bank's incremental provisions may be added back to earnings for purposes of computing core capital. This was however revised to end of 2018, after which banks are expected to fully comply to the new standard;

6. **Consolidation –** Consolidation in the banking sector picked up at the start of 2017, but slowed as the year progressed. 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 in 2017, due to the attractive valuations in the banking sector and the effects of tighter regulation. It is notable that acquisitions are also happening at much cheaper valuations currently compared to earlier bank acquisitions. For instance, Fina Bank, K-Rep and Equatorial Commercial Bank that were acquired between 2013 and 2015, traded 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, with DTBK acquiring Habib Bank at 0.8x in 2017, and SBM Holdings acquiring Fidelity Commercial Bank at 1.6x in 2016; hence it is a great time to be an acquirer. 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. We however expect that the sustained effects of the rate cap and the reduction in the transition period for IFRS 9 adoption to have an effect on profitability and capital levels going forward and therefore still lead to more consolidation in the industry.

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	2.4	100.0%	1.8	**0.8x**	Mar-17
SBM Holdings	Fidelity Commercial Bank	1.8	100.0%	2.8	**1.6x**	Nov-16
M Bank	Oriental Commercial Bank	1.8	51.0%	1.3	**1.4x**	Jun-16
I&M Holdings	Giro Commercial Bank	3.0	100.0%	5.0	**1.7x**	Jun-16
Mwalimu SACCO	Equatorial Commercial Bank	1.2	75.0%	2.6	**2.3x**	Mar-15
Centum	K-Rep Bank	2.1	66.0%	2.5	**1.8x**	Jul-14
GT Bank	Fina Bank Group	3.9	70.0%	8.6	**3.2x**	Nov-13
Average			**80.3%**		**1.8x**	

Based on the above, we believe the sector is shaping up to a more diversified banking model and prudence in operations, as can be seen through the increase in alternative channels and restructuring in the sector, as banks adjust to the business environment and the current regulatory

framework.

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

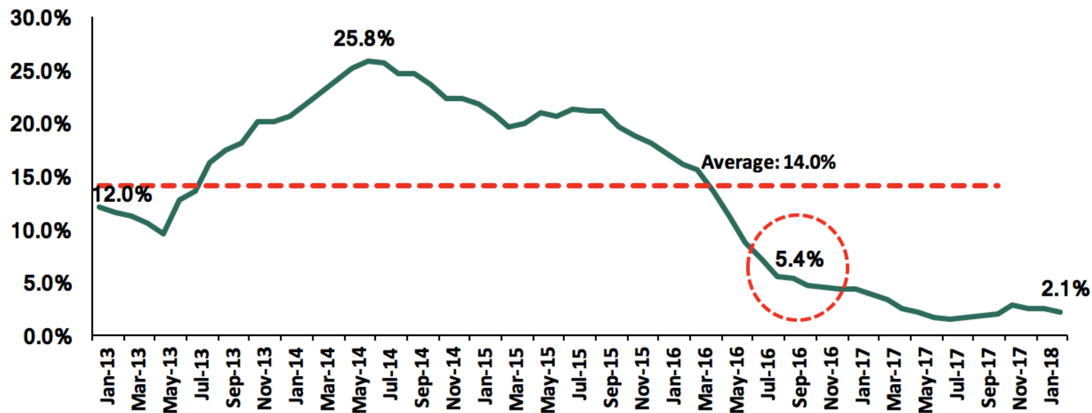
Listed Banks FY'2017 Earnings and Growth Metrics

Bank	Core EPS Growth (%)	Interest Income Growth (%)	Interest Expense Growth (%)	Net Interest Income Growth (%)	Net Interest Margin (%)	Non-Funded Income (NFI) Growth (%)	NFI to Total Operating Income (%)	Growth in Total Fees& Commissions (%)	Deposit Growth (%)	Loan Growth (%)	Growth in Govt. Securities (%)
NBK	479.0	(17.7)	(24.9)	(13.7)	7.4	(15.0)	26.5	(1.2)	0.4	0.4	(4.8)
Equity Group	14.0	(6.6)	8.1	(10.2)	9.0	24.2	42.0	22.0	10.7	4.9	27.3
KCB Group	(0.1)	1.4	(3.1)	2.9	8.7	2.5	32.2	16.4	11.5	9.6	7.4
Stanbic	(2.5)	(3.0)	(5.3)	(2.0)	5.2	10.0	44.2	38.6	24.1	8.1	42.6
NIC Group	(4.3)	(3.2)	11.5	(11.5)	6.3	3.6	27.9	14.2	24.2	4.6	77.9
Barclays Bank	(6.4)	(3.4)	(7.2)	(2.4)	9.7	(9.5)	27.9	8.6	12.5	(0.7)	20.1
I&M Holdings	(7.1)	(0.1)	0.0	0.6	7.8	15.9	27.0	22.0	15.5	13.6	10.9
Co-op Bank	(10.0)	(4.5)	(3.9)	(4.7)	9.2	5.6	32.4	0.3	9.2	7.1	19.7
DTBK	(10.3)	2.4	3.6	1.5	6.5	4.1	21.1	5.3	11.8	5.2	23.3
Stanchart	(24.0)	1.9	20.3	(4.1)	8.4	2.3	32.1	(0.4)	14.3	2.9	26.7
HF Group	(86.1)	(17.1)	(11.1)	(24.3)	5.2	78.2	31.1	(37.6)	(3.7)	(8.9)	(44.0)
Weighted Average**	**(1.0%)**	**(2.4%)**	**2.6%**	**(3.8%)**	**8.4%**	**9.1%**	**33.6%**	**13.4%**	**12.5%**	**6.1%**	**22.2%**
Weighted 2016 Average	**4.4%**	**15.5%**	**6.2%**	**20.3%**	**9.2%**	**2.4%**	**31.0%**	**12.6%**	**6.4%**	**6.3%**	**45.8%**

Key takeaways from the table above include:

- The listed banks recorded a 1.0% decline in core EPS, compared to a growth of 4.4% in 2016. Only National Bank and Equity Group recorded a growth in core EPS, registering at 479%, and 14% growth in earnings, respectively. National Bank restated their 2016 results, and benefitted from a decline in loan loss provisioning, while Equity Group gained on the back of a 24.2% growth in Non-Funded income (NFI). HF Group recorded the biggest decline at 86.1%, on the back of a 24.3% decline in Net Interest Income (NII);
- Average deposit growth came in at 12.5%. However, despite the average deposits having grown, the interest expense paid on deposits recorded a slower growth of 2.6% 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 has been recorded at 6.1%, however interest income has decreased by 2.4%, showing the effects of the rate cap;
- Investment in government securities has grown by 22.2%, outpacing loan growth of 6.1%, showing increased lending to the government by banks as they avoid the risky borrowers;
- The average Net Interest Margin in the banking sector currently stands at 8.4%, a decline from the 9.2% recorded in 2016, and,
- Non-funded income has grown by 9.1%, which included a Fee and Commissions growth of 13.4%. This shows that banks are charging more fee income to improve their income on loans above the rate cap maximum.

Private sector credit growth continues to remain low, coming in at 2.1% in February 2018, 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 key factors banks will consider going into 2018 are diversification, prudency and efficiency. Banks will have to diversify their income sources to more fee-income business, be prudent in loan disbursement, as well as enhancing their risk assessment framework, 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, we carried out a comprehensive ranking of the listed banks. For the franchise value ranking, we included the earnings and growth metrics in the table above as well as the operating metrics in the table below in order to carry out a comprehensive review of the banks.

Listed Banks FY'2017 Operating Metrics

Bank	LDR	CIR	ROACE	Deposits per Branch (bns)	Gross NPL Ratio	NPL Coverage	Tangible Common Ratio
Co-operative Bank	88.3%	60.9%	15.9%	1.9	7.2%	37.6%	17.6%
KCB Group	84.6%	59.2%	19.5%	1.9	8.4%	67.9%	15.9%
Diamond Trust Bank	73.6%	59.6%	13.9%	1.9	7.2%	67.5%	13.0%
Equity Group	74.8%	58.7%	21.6%	1.3	6.2%	50.3%	16.6%
I&M Holdings	90.4%	56.2%	17.9%	4.0	12.1%	40.0%	18.5%
NIC Group	86.2%	62.5%	12.9%	3.0	11.9%	45.7%	16.0%
Barclays Bank	90.5%	65.8%	16.0%	2.1	7.1%	70.0%	15.9%
Standard Chartered	59.2%	63.2%	16.5%	4.8	12.8%	74.4%	15.3%

Listed Banks FY'2017 Operating Metrics

Bank	LDR	CIR	ROACE	Deposits per Branch (bns)	Gross NPL Ratio	NPL Coverage	Tangible Common Ratio
Stanbic Holdings	74.1%	71.7%	10.4%	5.5	7.0%	47.4%	13.5%
HF Group	135.4%	92.3%	1.1%	1.5	15.6%	36.4%	15.6%
National Bank	55.5%	91.4%	5.8%	1.3	40.6%	57.1%	5.6%
Weighted Average	**80.0%**	**61.1%**	**17.6%**	**2.4**	**8.3%**	**56.4%**	**16.1%**

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 FY'2017 BANKING REPORT – COMPOSITE RANKINGS

Bank	Franchise Value Total Score	Intrinsic Value Score	Weighted Score	FY'2017 Rank	Q3'2017 Rank
KCB Group	53.0	3.0	23.0	**1**	**1**
Equity Group	55.0	8.0	26.8	**2**	**4**
I&M Holdings	68.0	4.0	29.6	**3**	**7**
Co-operative Bank	66.0	6.0	30.0	**4**	**2**
NIC Bank	74.0	1.0	30.2	**5**	**5**
Barclays Bank	71.0	5.0	31.4	**6**	**3**
Diamond Trust Bank	78.0	2.0	32.4	**7**	**6**
Standard Chartered Bank	77.0	11.0	37.4	**8**	**9**
Stanbic Holdings	85.0	9.0	39.4	**9**	**8**
National Bank of Kenya	111.0	11.0	48.6	**10**	**10**
HF Group	117.0	10.0	52.8	**11**	**11**

Major changes include:

- I&M Holdings climbed up 4 spots to Position 3 from Position 7 in our Q3'2017 Banking Sector Report, owing to its efficiency, with the bank having the lowest Cost to Income ratio at 56.2%, lower than industry average of 67.4%, and good deposit mobilization, with a deposit per branch of Kshs 4.0 bn, much higher than the industry at Kshs 2.7 bn,
- Barclays Bank dropped 3 spots to Position 6 from Position 3 in our Q3'2017 Banking Sector

Report, due to a high Cost to Income ratio at 65.8% and relative expensive valuation, with the bank trading at a P/TBv of 1.6x.

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

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