Cytonn INVESTMENTS

National Bank of Kenya Q3'2019 Earnings Note

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Key Highlights Q3'2019

- KCB Group finalized the take-over of 100.0% of all the ordinary shares of the National Bank of Kenya (NBK) on 6th September 2019 after the Capital Markets Authority approved the acquisition. The transaction will enable the two banks to increase its customer base and product offerings, which should result in a steady growth in profitability, after addressing the current challenges facing NBK of inadequate capitalization and high levels of Non-Performing Loans.

Income Statement

- Profit before tax increased to Kshs. 0.7 bn, from a loss of Kshs 0.1 bn Q3'2018. The bank recorded a 1,753.4% increase in profit after tax of Kshs 0.4 bn compared to a profit after tax of Kshs. 22.0 mn in Q3'2018. The performance was driven by a 7.3% increase in total operating income, and was weighed down by the 3.9% increase in the total operating expenses,
- Total operating income increased by 7.3% to Kshs. 6.0 bn from Kshs. 5.6 bn in Q3'2018. This was driven by an 11.6 % increase in Net Interest Income (NII) to Kshs. 4.6 bn from Kshs. 4.1 bn in Q3'2018, despite the 4.6% decline in Non-Funded Income (NFI) to Kshs. 1.4 bn from Kshs. 1.5 bn in Q3'2018,
- Interest income increased by 4.7% to Kshs. 6.6 bn, from Kshs. 6.3 bn in Q3'2018, driven by the increase in interest income on Loans & Advances that increased by 6.0% to Kshs. 3.3 bn, from Kshs. 3.1 bn in Q3'2018. Interest income on Government Securities increased by 4.2% to Kshs. 3.3 bn, from Kshs. 3.2 bn in Q3'2018. As a result, the yield on interest-earning assets increased to 10.6% in Q3'2019 from 10.1% in Q3'2018,
- Interest expense declined by 8.2% to Kshs. 2.0 bn, from Kshs. 2.2 bn in Q3'2018, following a 16.8% decline in the interest expense on Customer Deposits to Kshs. 1.6 bn, from Kshs. 2.0 bn in Q3'2018. Interest expense on Deposits & Placements from Banking Institutions increased by 38.8% to Kshs. 0.3 bn, from Kshs. 0.2 bn in Q3'2018. The cost of funds declined marginally to 2.9%, from 3.0% in Q3'2018, while Net Interest Margin increased to 7.2%, from 6.6% in Q3'2018,
- Non-Funded Income (NFI) declined by 4.6% to Kshs. 1.4 bn, from Kshs. 1.5 bn in Q3'2018. The decline in NFI was driven by a 39.1% decrease in Other Income to Kshs. 0.1 bn, from Kshs. 0.2 bn in Q3'2018, coupled with a 10.3% decline in foreign exchange income to Kshs. 363.4 mn, from Kshs. 404.9 mn in Q3'2018. Fees and commissions on loans and advances also declined by 6.4% to Kshs. 90.0 mn, from Kshs. 96.2 mn in Q3'2018. Other Fees however increased by 5.8% to Kshs 0.9 bn from Kshs 0.8 bn recorded in Q3'2018. The current revenue mix stands at 86:14 funded to non-funded income as compared to 80:20 in Q3'2018. The proportion of funded income to total revenue increased owing to the decline in NFI coupled with the increase in NII,
- Total Operating Expenses increased by 3.9% to Kshs. 5.4 bn, from Kshs. 5.2 bn, largely driven by the 3.7% increase in Staff Costs to Kshs. 3.0 bn in Q3'2019, as compared to Kshs 2.9 bn in Q3'2018. The lower write-back in Loan Loss Provisions of Kshs 30.8 mn, compared to Kshs 0.2 bn

in Q3’2018, also contributed to the increase in Total Operating Expenses. Other Expenses declined by 4.5% to Kshs. 2.4 bn in Q3’2019, from Kshs. 2.5 bn in Q3’2018,
- The cost to income ratio improved to 88.8% from 91.8% in Q3’2018. Without LLP, the cost to income ratio deteriorated to 87.5%, from 86.7% in Q3’2018, as a result of the lower write-back in Loan Loss Provisions,

Balance Sheet

- The balance sheet experienced a contraction, as total assets decreased by 4.7% to Kshs. 107.2 bn from Kshs. 112.5 bn in Q3’2018. This decrease was largely caused by a 24.8% decline in cash and bank balances to Kshs 6.9 bn, from Kshs 9.2 bn in Q3’2018, coupled with the 17.5% decline in Government Securities to Kshs 34.1 bn, from Kshs 41.3 bn in Q3’2018,
- The loan book declined marginally by 0.3% to Kshs 47.9 bn, from Kshs 48.0 bn in Q3’2018.
- Total liabilities decreased by 5.3% to Kshs. 99.9 bn, from Kshs. 105.5 bn in Q3’2018, driven by an 11.1% decline in Customer Deposits to Kshs. 82.5 bn, from Kshs 92.8 bn in Q3’2018. However, there was a 24.5% increase in Deposits and Balances due to other banking Institutions to Kshs 7.3 bn, from Kshs 5.8 bn in Q3’2018, and the 48.0% increase in Other Liabilities to Kshs. 10.0 bn, from Kshs. 6.8 bn in Q3’2018,
- Deposits per branch decreased by 9.8% to Kshs. 1.2 bn, from Kshs. 1.3 bn in Q3’2018, as the bank closed the third quarter with 69 branches,
- The slower decline in loans as compared to deposits led to an increase in the loan to deposit ratio to 58.0%, from 51.7% in Q3’2018,
- Gross non-performing loans increased by 6.7% to Kshs. 33.0 bn in Q3’2019, from Kshs. 30.9 bn in Q3’2018. Consequently, the NPL ratio increased marginally to 47.9%, from 47.1% in Q3’2018. General provisions increased by 17.5%, to Kshs. 15.6 bn from Kshs. 13.3 bn in Q3’2018. The NPL coverage thus increased to 63.4% in Q3’2019, from 57.1% in Q3’2018.
- Shareholders’ funds increased by 4.5% to Kshs. 7.3 bn in Q3’2019, from Kshs. 7.0 bn in Q3’2018, aided by the 19.3% increase in the statutory loan loss reserves to Kshs 4.5 bn, from Kshs 3.8 bn in Q3’2018,
- National Bank is currently severely undercapitalized with a core capital to risk-weighted assets ratio of 1.5%, 9.0% below the statutory requirement. In addition, the total capital to risk-weighted assets ratio was 2.9%, below the statutory requirement by 11.6%. Adjusting for IFRS 9, the core capital to risk-weighted assets stood at 1.8%, while total capital to risk-weighted assets came in at 3.5%, indicating that the bank’s total capital relative to its risk-weighted assets declined by 0.6% due to implementation of IFRS 9, and,
- National Bank currently has a return on average assets of 0.4% and a return on average equity of 5.5%.

Key Take-Outs:

1. National Bank is currently severely undercapitalized with the total capital to risk-weighted assets ratio coming in at 2.9%, 11.6% below the 14.5%, as required by regulation. The bank has been granted an exemption to operate below the regulatory requirement but the current acquisition by KCB Group should see the bank become recapitalized as they operate as a separate subsidiary for two years, and,
2. The bank experienced a deterioration in asset quality, with gross non-performing loans (NPLs) increasing by 6.7% to Kshs. 33.0 bn, from Kshs. 30.9 bn in Q3’2018. The NPL ratio of 47.9% is still above the banking sector average of 10.0% and thus the bank needs to adopt a raft of measures to improve on the overall asset quality.

The bank could improve its poor performance, and needs to focus on the following to improve:

a. Improve the asset quality: National bank has a poor asset quality, with an NPL ratio of 47.9% which is above the baking sector average. KCB Group have highlighted their intentions to focus on

the recovery of NBK's outstanding loans which mainly comprises of private sector debt in the real-estate sector, manufacturing, infrastructure and agriculture,

Balance Sheet Items	Q3'2018	Q3'2019	y/y Change	Q3'2019f	Projected %y/y change	Variance in Growth Actual vs. Expected
Government Securities	41.0	34.0	(17.1%)	37.9	11.5%	(28.5%)
Net Loans and Advances	48.0	47.9	(0.3%)	45.4	(5.1%)	4.8%
Total Assets	**112.5**	**107.2**	**(4.7%)**	**117.2**	**9.4%**	**(14.1%)**
Customer Deposits	92.8	82.5	(11.1%)	93.6	13.5%	(24.6%)
Total Liabilities	**105.5**	**99.9**	**(5.3%)**	**110.1**	**10.2%**	**(15.5%)**
Shareholders' Funds	7.0	7.3	4.5%	7.1	(2.0%)	6.5%

Balance Sheet Ratios	Q3'2018	Q3'2019	y/y change
Loan to Deposit Ratio	51.7%	58.0%	6.3%
Return on average equity	3.2%	5.5%	2.3%
Return on average assets	0.3%	0.4%	0.1%

Income Statement	Q3'2018	Q3'2019	y/y change	Q3'2019f	Projected % y/y change	Variance in Growth Actual vs. Expected
Net Interest Income	4.1	4.6	11.6%	4.1	(11.9%)	23.6%
Net non-Interest Income	1.5	1.4	(4.6%)	1.4	(0.7%)	(3.9%)
Total Operating income	5.6	6.0	7.3%	5.5	(9.2%)	16.5%
Loan Loss provision	0.2	0.0	(86.8%)	(0.4)	1,306.1%	(1,392.9%)
Total Operating expenses	(5.2)	(5.4)	3.9%	(5.5)	2.8%	1.0%
Profit before tax	(0.1)	0.7	0.0%	(0.0)	(105.3%)	105.3%
Profit after tax	**0.0**	**0.4**	**1,753.4%**	**(0.0)**	**(106.2%)**	**1,859.6%**

Capital Adequacy Ratios	Q3'2018	Q3'2019
Core Capital/Total deposit Liabilities	2.5%	2.2%
Minimum Statutory ratio	8.0%	8.0%

Capital Adequacy Ratios	Q3'2018	Q3'2019
Excess	**(5.5%)**	**(5.8%)**
Core Capital/Total Risk-Weighted Assets	2.6%	2.4%
Minimum Statutory ratio	10.5%	10.5%
Excess	**(7.9%)**	**(8.1%)**
Total Capital/Total Risk-Weighted Assets	4.1%	3.8%
Minimum Statutory ratio	14.5%	14.5%
Excess	**(10.4%)**	**(10.7%)**
Liquidity Ratio	38.8%	40.4%
Minimum Statutory ratio	20.0%	20.0%
Excess	**18.8%**	**20.4%**
Adjusted Core Capital/Total Risk-Weighted Assets	3.1%	1.8%
Adjusted Total Capital/Total Risk-Weighted Assets	4.5%	3.5%