Barclays Bank Kenya Earnings Note–Q3'2019

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Valuation Summary

- We are of the view that Barclays Bank Kenya is a "buy" with a target price of Kshs 12.8, representing an upside of 16.0%, from the current price of Kshs 12.0 as of 22nd November 2019, inclusive of a dividend yield of 9.2%,
- Barclays Bank Kenya is currently trading at a P/TBV of 1.5x and a P/E of 11.7x vs an industry average of 1.5x and 7.9x, respectively.

Key Highlights Q3'2019

- Barclays Bank Kenya (BBK) continued its rebranding exercise to Absa Group, as the bank continued to invest in technology and brand modernization, in line with the strategy to transition fully to Absa by June 2020.

Income Statement

- Core earnings per share increased by 19.0% to Kshs 1.2 from Kshs 1.0 in Q3'2018, driven by a 3.9% growth in total operating income to Kshs 24.8 bn from Kshs 23.9 bn in Q3'2018. The core earnings per share grew faster than our expectations of 12.7%, with the variance being attributable to the 2.7% decrease in total expenses to Kshs 15.7 bn from Kshs 16.1 bn in Q3'2018, which fell short of our expectations of a 2.0% increase.
- Total operating income increased by 3.9% to Kshs 24.8 bn from Kshs 23.9 bn in Q3'2018. This was due to a 8.1% increase in Non-Funded Income (NFI) to Kshs 8.0 bn, from Kshs 7.4 bn in Q3'2018, coupled with a 2.0% increase in Net Interest Income (NII) to Kshs 16.8 bn from Kshs 16.5 bn in Q3'2018,
- Interest income increased by 5.6% to Kshs 22.9 bn, from Kshs 21.7 bn in Q3'2018. This was driven by a 10.0% increase in interest income from government securities to Kshs 6.1 bn, from Kshs 5.6 bn in Q3'2018, coupled with a 3.0% increase in interest income on loans and advances to Kshs 16.5 bn from Kshs 16.0 bn in Q3'2018. The yield on interest-earning assets however declined to 11.5% from 11.8% in Q3'2018 attributed to the decline in yields on government securities,
- Interest expenses increased by 17.1% to Kshs 6.1 bn, from Kshs 5.2 bn in Q3'2018, following an 41.1% increase in interest expense on deposits and placements from banking institutions to Kshs 0.9 bn from Kshs 0.7 bn in Q3'2018, coupled with a 11.3% rise in interest expense on customer deposits to Kshs 5.0 bn from Kshs 4.5 bn in Q3'2018. The cost of funds thus increased to 3.4% from 3.1% in Q3'2018. The Net Interest Margin (NIM) declined to 6.4%, from 6.8% in Q3'2018,
- Non-Funded Income (NFI) increased by 8.1% to Kshs 8.0 bn, from Kshs 7.4 bn in Q3'2018. The increase was mainly driven by a 30.9% rise in fees and commissions on loans to Kshs 1.1 bn, from Kshs 0.8 bn in Q3'2018, coupled with a 4.1% and 7.5% increase in other fees and forex trading income to Kshs 3.6 bn and Kshs 2.7 bn from Kshs 3.4 bn and Kshs 2.5 bn, respectively. As a result, the revenue mix shifted to 68:32 from 69:31 funded to non-funded income, due to the faster

growth in NFI compared to NII,

- Total operating expenses decreased by 2.7% to Kshs 15.7 bn, from Kshs 16.1 bn, largely driven by a 9.7% decrease in other expenses to Kshs 5.3 bn in Q3’2019, from Kshs 5.9 bn in Q3’2018, coupled with a 1.6% decrease in staff costs to Kshs 7.3 bn in Q3’2019, from Kshs 7.5 bn in Q3’2018,
- Due to the faster growth of operating income that outpaced the decline in total operating expenses, Cost to Income Ratio (CIR) improved to 63.3%, from 67.6% in Q3’2018. Also without LLP, the cost to income ratio improved, to 50.9%, from 55.8% in Q3’2018, and,
- Profit before tax increased by 17.8% to Kshs 9.1 bn, up from Kshs 7.7 bn in Q3’2018. Profit after tax grew by 19.0% to Kshs 6.5 bn in Q3’2019, from Kshs 5.4 bn in Q3’2018 with the effective tax rate remaining unchanged at 32.1%

Balance Sheet

- The balance sheet recorded an expansion as total assets increased by 11.7% to Kshs 359.8 bn, from Kshs 322.2 bn in Q3’2018. This growth was largely driven by an 8.8% increase in the loan book to Kshs 194.2 bn from Kshs 178.4 bn in Q3’2018. Investment in government and other securities also recorded a 3.0% growth to Kshs 76.8 bn, from Kshs 74.6 bn in Q3’2018,
- Total liabilities rose by 13.0% to Kshs 315.8 bn, from Kshs 279.5 bn in Q3’2018, driven by a 6.9% increase in deposits to Kshs 235.4 bn, from Kshs 220.2 bn in Q3’2018. Deposits per branch increased by 8.0% to Kshs 2.7 bn from Kshs 2.5 bn in Q3’2018, with the number of branches having reduced to 88 from 89 in Q3’2018,
- The marginal growth in loans as compared to deposits led to a rise in the loan to deposit ratio to 82.5% from 81.0% in Q3’2018,
- Gross Non-Performing Loans (NPLs) decreased by 4.8% to Kshs 13.9 bn in Q3’2019 from Kshs 14.6 bn in Q3’2018. The NPL ratio thus improved to 6.8% from 7.7% in Q3’2018 due to the slower growth in Gross Non-Performing Loans (NPLs) which was slower than the growth in loans. General Loan Loss Provisions increased by 8.8% to Kshs 3.1 bn, from Kshs 2.8 bn in Q3’2018. The NPL coverage however increased to 78.6% from 70.5% in Q3’2018 due to the decline in Gross Non-Performing Loans (NPLs) relative to the 11.1% growth in General Loan Loss Provisions to Kshs 8.0 bn from Kshs 7.2 bn recorded in Q3’2018,
- Shareholders’ funds increased by 3.1% to Kshs 44.0 bn in Q3’2019, from Kshs 42.7 bn in Q3’2018, as retained earnings grew by 3.7% y/y to Kshs 5.6 bn, from Kshs 5.4 bn recorded in Q3’2018,
- Barclays Bank Group is currently sufficiently capitalized with a core capital to risk-weighted assets ratio of 14.2%, 3.7% above the statutory requirement. In addition, the total capital to risk-weighted assets ratio was 16.1%, exceeding the statutory requirement by 1.6%. Adjusting for IFRS 9, the core capital to risk weighted assets stood at 14.7%, while total capital to risk-weighted assets came in at 16.7 %, and,
- The bank currently has a Return on Average Assets (ROaA) of 2.4%, and a Return on Average Equity (ROaE) of 17.4%.

Key Take-Outs:

1. The bank’s asset quality improved, with the NPL ratio decreasing to 6.8% from 7.7% in Q3’2018 due to a 4.8% decrease in Gross Non-Performing Loans (NPLs) to Kshs 13.9 bn from Kshs 14.6 bn which was slower than the growth in loans,
2. Barclays Bank benefited from the restructuring exercise it conducted in 2017, as it continues to record a decline in staff costs y/y, which reduced by 1.6% y/y, and, NFI supported the improvement in the top line revenue, as it expanded by 8.1% y/y, largely supported by other fees and commissions, as well as the forex trading income segments, which recorded growths of 4.1% and 7.5%, respectively. Recovery in the fees and commissions on loans is presumably due to the low base of 2018, on the initial implementation of the Effective Interest Model (EIR) under IFRS 9, which required banks to amortize fees and commissions on loans over the tenor of the loan. As a

result of the performance, the revenue mix shifted to 68:32 from 69:31 funded to non-funded income, due to the faster growth in NFI compared to NII and,

3. There was an improvement in operational efficiency as evidenced by the decline in the Cost to Income Ratio (CIR) without LLP to 50.9% in Q3'2019, from 55.8% in Q3'2018.

We expect the bank's growth to be driven by:

1. 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 banc assurance 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	**Q3'2018**	**Q3'2019**	**y/y change**	**Q3'2019e**	**Expected y/y change**	**Variance in Actual Growth vs. Expected**
Government Securities	74.6	76.8	3.0%	81.6	9.4%	(6.4%)
Net Loans and Advances	178.4	194.2	8.8%	191.6	7.4%	1.4%
Total Assets	**322.2**	**359.8**	**11.6%**	**360.5**	**11.9%**	**(0.2%)**
Customer Deposits	220.2	235.4	6.9%	236.6	7.4%	(0.5%)
Total Liabilities	279.5	315.8	13.0%	316.4	13.2%	(0.2%)
Shareholders' Funds	**42.7**	**44.0**	**3.1%**	**48.0**	**12.4%**	**(9.3%)**

Balance sheet ratios	**Q3'2018**	**Q3'2019**	**% y/y change**
Loan to Deposit Ratio	81.0%	82.5%	1.5%
Return on average equity	16.5%	17.4%	0.9%
Return on average assets	2.5%	2.4%	(0.1%)

Income Statement	**Q3'2018**	**Q3'2019**	**y/y change**	**Q3'2019e**	**Expected y/y change**	**Variance in Actual Growth vs Expected**
Net Interest Income	16.5	16.8	2.0%	16.8	2.1%	(0.1%)
Net non-Interest Income	7.4	8.0	8.1%	8.1	10.5%	(2.4%)
Total Operating income	**23.9**	**24.8**	**3.9%**	**25.0**	**4.7%**	**(0.8%)**
Loan Loss provision	(2.8)	(3.1)	8.8%	(3.0)	7.3%	1.6%

Income Statement	**Q3'2018**	**Q3'2019**	**y/y change**	**Q3'2019e**	**Expected y/y change**	**Variance in Actual Growth vs Expected**
Total Operating expenses	(16.1)	(15.7)	(2.7%)	(16.5)	2.0%	(4.8%)
Profit before tax	**7.7**	**9.1**	17.8%	**8.5**	10.2%	**7.6%**
Profit after tax	**5.4**	**6.5**	19.0%	**6.1**	12.7%	**6.3%**
Core EPS	**1.00**	**1.19**	**19.0%**	**1.13**	**12.7%**	**6.3%**

Income statement ratios	**Q3'2018**	**Q3'2019**	**% y/y change**
Yield from interest-earning assets	11.8%	11.5%	(0.3%)
Cost of funding	3.1%	3.4%	0.4%
Net Interest Margin	9.1%	8.5%	(0.6%)
Cost to Income	67.6%	63.3%	(4.3%)
Cost to Assets	4.1%	3.5%	(0.6%)
Net Interest Income as % of operating income	69.2%	67.9%	(1.2%)
Non-Funded Income as a % of operating income	30.8%	32.1%	1.2%

Capital Adequacy Ratios	**Q3'2018**	**Q3'2019**
Core Capital/Total Liabilities	17.5%	16.7%
Minimum Statutory ratio	8.0%	8.0%
Excess	**9.5%**	**8.7%**
Core Capital/Total Risk-Weighted Assets	14.8%	14.2%
Minimum Statutory ratio	10.5%	10.5%
Excess	**4.3%**	**3.7%**
Total Capital/Total Risk Weighted Assets	16.7%	16.1%
Minimum Statutory ratio	14.5%	14.5%
Excess	**2.2%**	**1.6%**
Liquidity Ratio	39.9%	39.6%
Minimum Statutory ratio	20.0%	20.0%
Excess	**19.9%**	**19.6%**
Adjusted Core Capital/Total Liabilities	17.9%	17.2%
Adjusted Core Capital/Total RWA	15.1%	14.7%
Adjusted Total Capital/Total RWA	17.1%	16.7%