Standard Chartered Bank of Kenya Plc – Q3’2019

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Valuation Summary

- We are of the view that Standard Chartered is an “Accumulate” with a target price of Kshs 208.0, representing an upside of 14.6%, from the current price of Kshs 198.0 as of 22nd November 2019, inclusive of a dividend yield of 9.6%,
- Standard Chartered Bank is currently trading at a P/TBV of 1.5x and a P/E of 8.5x vs an industry average of 5x and 7.9x, respectively.

Income Statement

- Core earnings per share declined by 1.3% to Kshs 18.1 from Kshs 18.4 in Q3’2018, which was not in line with our expectation of a 4.0% increase to Kshs 19.1. The performance was driven by a 0.9% increase in total operating expenses to Kshs 12.5 bn from Kshs 12.4 bn, despite total operating income remaining flat at Kshs 21.6 bn. The variance in core earnings per share growth was largely due to the 0.9% increase in total operating expenses which was not in line with our expectations of a 4.5% decline,
- Total operating income remained flat at Kshs 21.6 bn, unchanged from Q3’2018. This was due to a 1.1% decline in Non-Funded Income (NFI) to Kshs 6.96 bn from Kshs 7.04 bn in Q3’2018, which offset the 0.6% increase in Net Interest Income (NII) to Kshs 14.7 bn from Kshs 14.6 bn in Q3’2018,
- Interest income declined by 6.3% to Kshs 19.1 bn, from Kshs 20.3 bn in Q3’2018. This was driven by a 15.4% decline in interest income on government securities to Kshs 8.1 bn from Kshs 9.5 bn in Q3’2018. Interest on loans and advances however increased marginally by 1.5% to Kshs 10.1 bn from Kshs 9.9 bn in Q3’2018. Consequently, the yield on interest-earning assets declined to 9.9%, from 10.6% in Q3’2018,
- Interest expense declined by 23.7% to Kshs 4.4 bn from Kshs 5.8 bn in Q3’2018, following a 42.7% decline in other interest expenses to Kshs 442.2 mn from Kshs 771.5 mn in Q3’2018, coupled with a 20.4% decline in interest expense on customer deposits to Kshs 3.9 bn, from Kshs 4.9 bn in Q3’2018. Consequently, cost of funds declined to 3.0%, from 3.4% in Q3’2018, with the Net Interest Margin (NIM) also declining to 7.5%, from 7.8 in Q3’2018, owing to the faster 5.9% growth in average total interest earning assets that outpaced the 0.6% growth in the trailing net interest income,
- Non-Funded Income (NFI) declined by 1.1% to Kshs 6.96 bn, from Kshs 7.04 bn in Q3’2018. The decline was mainly driven by a 9.3% decline in other fees to Kshs 3.6 bn from Kshs 4.0 bn in Q3’2018. The decline in NFI was however mitigated by a 12.6% growth in foreign exchange trading income to Kshs 2.4 bn from Kshs 2.1 bn and a 7.0% rise in fees and commissions on loans and advances to Kshs 207.4 mn, from Kshs 193.9 mn in Q3’2018. The revenue mix shifted to 68:32 funded to non-funded income, from 67:33 in Q3’2018, largely due to the 1.1% decline in NFI despite net interest income (NII) increasing by 0.6%,

- Total operating expenses increased by 0.9% to Kshs 12.5 bn from Kshs 12.4 bn in Q3’2018, largely driven by a 9.8% increase in staff costs to Kshs 5.6 bn from Kshs 5.1 bn in Q3’2018 and a 16.8% increase in other operating expenses to Kshs 4.9 bn from Kshs 4.2 bn in Q3’2018. The increases were however mitigated by a 61.2% decline in in loan loss provisions to Kshs 728.2 mn, from Kshs 1.9 bn in Q3’2018. Consequently, the Cost to Income Ratio (CIR) deteriorated to 57.7%, from 57.2% in Q3’2018. Without LLP, the cost to income ratio also deteriorated to 54.4%, from 48.5% in Q3’2018, and,
- Profit before tax declined by 1.2% to Kshs 9.1 bn from Kshs 9.2 bn in Q3’2018. Profit after tax declined by 1.3% to Kshs 6.2 bn in Q3’2019, from Kshs 6.3 bn in Q3’2018, as the effective tax rate rose marginally to 31.9% from 31.8% in Q3’2018.

Balance Sheet

- The balance sheet recorded an expansion as total assets increased by 0.7% to Kshs 290.6 bn, from Kshs 288.6 bn in Q3’2018. The increase was driven by a 6.8% expansion of the loan book to Kshs 118.5 bn from Kshs 111.0 bn in Q3’2018, and a 27.4% increase in cash and balances due from Central Bank of Kenya to Kshs 19.4 bn from Kshs 15.2 bn in Q3’2018. The increases were however mitigated by the 7.9% decline in Government securities to Kshs 98.7 bn from Kshs 107.2 bn in Q3’2018.
- Total liabilities increased marginally by 0.3% to Kshs 242.7 bn from Kshs 241.8 bn in Q3’2018, mainly driven by a 2.4% increase in customer deposits to Kshs 224.8 bn from Kshs 219.5 bn in Q3’2018. Deposits per branch increased by 8.4% to Kshs 6.6 bn from Kshs 6.1 bn in Q3’2018, as the number of branches declined by 2 to 34 from 36 in Q3’2018,
- The faster growth in loans which outpaced the growth in deposits led to a rise in the loan to deposit ratio to 52.7% from 50.6% in Q3’2018,
- Gross Non-Performing Loans (NPLs) increased by 12.0% to Kshs 19.9 bn in Q3’2019, from Kshs 17.8 bn in Q3’2018. The NPL ratio deteriorated to 14.9% in Q3’2019, from 14.2% in Q3’2018, due to the faster growth in gross Non-performing Loans (NPLs), which outpaced the growth in gross loans. General Loan Loss Provisions increased by 10.9% to Kshs 7.9 bn, from Kshs 7.2 bn in Q3’2018. The NPL coverage however deteriorated to 77.0% , from 81.4% in Q3’2018, due to the faster growth in gross Non-performing Loans (NPLs) that outpaced the growth in General Loan Loss Provisions,
- Shareholders’ funds increased by 2.4% to Kshs 47.9 bn in Q3’2019, from Kshs 46.8 bn in Q3’2018, supported by a 1.3% increase in retained earnings to Kshs 31.4 bn, from Kshs 31.0 bn in Q3’2018, coupled with an inclusion of Kshs 1.1 bn in Q3’2019 Statutory loan loss reserve, as the CBK provisions were higher than IFRS 9 provisions. As per the CBK guidance on the implementation of IFRS 9, where the CBK provisions are higher than IFRS 9, the excess provisions shall be treated as an appropriation of retained earnings and not expenses in determining profit and loss and thus the excess provision shall be credited to the statutory loan loss reserve,
- Standard Chartered Bank Kenya remains sufficiently capitalized with a core capital to risk-weighted assets ratio of 15.7%, 5.2% points above the statutory requirement of 10.5%. In addition, the total capital to risk-weighted assets ratio came in at 18.9%, exceeding the statutory requirement by 4.4% points. Adjusting for IFRS 9, the core capital to risk weighted assets stood at 15.8%, while total capital to risk-weighted assets came in at 18.9%, and,
- The bank currently has a Return on Average Assets (ROaA) of 2.8%, and a Return on Average Equity (ROaE) of 16.9%.

Key Take-Outs:

1. The bank registered a weak deposit growth, following the 2.4% increase in customer deposits to Kshs 224.8 bn from Kshs 219.5 bn in Q3’2018. The deposit growth rate at 2.4% is lower than the industrial average of 11.7%,
2. The bank registered a decline in operating revenue, following the 1.1% decline in NFI to Kshs

6.96 bn, from Kshs 7.04 bn in Q3’2018. This has bucked the trend of similar Tier I banks that have generally reported an expansion in NFI, with Standard Chartered bank’s NFI contribution to total revenue at 32%, lower than the industry average of 37.0%

3. The bank’s asset quality deteriorated, with the NPL ratio increasing to 14.9% from 14.2% in Q3’2018. This was due to the faster 12.0% growth in gross Non-performing Loans (NPLs) that outpaced the 6.6% growth in gross loans.

Going forward, we expect the bank’s growth to be driven by:

1. Continued focus on promoting the usage of the bank’s alternative channels is likely to boost the company’s Non-Funded Income (NFI) as well as aiding in improving operational efficiency levels, which deteriorated in Q3’2019 as evidenced by the worsening of the cost to income ratio to 57.7% from 57.2% in Q3’2018. Revenue expansion coupled with cost containment will be key in boosting the bank’s bottom line.

Below is a summary of the bank’s performance:

Balance Sheet Items	**Q3'2018**	**Q3'2019**	**y/y change**	**Q3'2019e**	**Projected y/y change**	**Variance in Growth Actual vs. Expected**
Net loans	111.0	118.5	6.8%	121.2	9.2%	(2.4%)
Total Assets	**288.6**	**290.6**	**0.7%**	**300.3**	**4.1%**	**(3.4%)**
Customer Deposits	219.5	224.8	2.4%	230.8	5.2%	(2.7%)
Total Liabilities	241.8	242.7	0.3%	251.6	4.0%	(3.7%)
Shareholder's Funds	**46.8**	**47.9**	**2.4%**	**48.7**	**4.2%**	**(1.8%)**

Balance Sheet Ratios	**Q3'2018**	**Q3'2019**	**y/y change**
Loan to deposit ratio	50.6%	52.7%	2.1%
Return on Average Equity	18.6%	16.9%	(1.6%)
Return on Average Assets	2.8%	2.8%	(0.1%)

Income Statement	**Q3'2018**	**Q3'2019**	**y/y change**	**Q3'2019e**	**Projected y/y change**	**Variance in Growth Actual vs. Expected**
Net Interest Income	14.6	14.7	0.6%	14.4	(1.2%)	1.8%
Net non-Interest Income	7.0	7.0	(1.1%)	7.1	0.3%	(1.4%)
Total Operating income	**21.6**	**21.6**	**0.0%**	**21.5**	**(0.7%)**	**0.8%**
Loan Loss provision	1.9	0.7	(61.2%)	1.3	(32.0%)	(29.2%)

Income Statement	Q3'2018	Q3'2019	y/y change	Q3'2019e	Projected y/y change	Variance in Growth Actual vs. Expected
Total Operating expenses	12.4	12.5	0.9%	11.8	(4.5%)	5.4%
Profit before tax	9.2	9.1	(1.2%)	9.6	4.3%	(5.5%)
Profit after tax	**6.3**	**6.2**	**(1.3%)**	**6.6**	**4.0%**	**(5.2%)**
Core EPS	**18.4**	**18.1**	**(1.3%)**	**19.1**	**4.0%**	**(5.2%)**

Income Statement Ratios	Q3'2018	Q3'2019	y/y change
Yield from interest-earning assets	11.2%	9.9%	(1.2%)
Cost of funding	3.4%	3.0%	(0.4%)
Net Interest Spread	7.8%	7.0%	(0.8%)
Net Interest Margin	7.9%	7.5%	(0.4%)
Cost of Risk	8.7%	3.4%	(5.3%)
Net Interest Income as % of operating income	67.4%	67.8%	0.4%
Non-Funded Income as a % of operating income	32.6%	32.2%	(0.4%)
Cost to Income Ratio	57.2%	57.7%	0.5%

Capital Adequacy Ratios kuku	Q3'2018	Q3'2019
Core Capital/Total Liabilities	16.4%	15.8%
Minimum Statutory ratio	8.0%	8.0%
Excess	**8.4%**	**7.8%**
Core Capital/Total Risk Weighted Assets	16.9%	15.7%
Minimum Statutory ratio	10.5%	10.5%
Excess	**6.4%**	**5.2%**
Total Capital/Total Risk Weighted Assets	19.8%	18.9%
Minimum Statutory ratio	14.5%	14.5%
Excess	**5.3%**	**4.4%**
Liquidity Ratio	69.9%	67.5%
Minimum Statutory ratio	20.0%	20.0%
Excess	**49.9%**	**47.5%**
Adjusted core capital/ total deposit liabilities	16.5%	15.9%
Adjusted core capital/ total risk weighted assets	17.1%	15.8%
Adjusted total capital/ total risk weighted liabilities	20.1%	18.9%