Financial Statement Reporting & Analysis

Cytonn Foundation – Media Training

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I. Introduction to Financial Reporting & Statements

Financial statements allow analysis of a company's operating results and financial status

The primary financial statements answer basic questions including:

- What is the company's current financial status?
- What is the financial position of a company at that point in time?
- What was the company's operating results for the period?
- How did the company obtain and use cash during the period?

Primary Financial statements:

- Balance Sheet
- Income Statement
- Statement of Cash Flows
- Statement of Changes in Equity

II. Specifics of Financial Statements

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Balance Sheet

Balance Sheet shows the financial position of a company at a particular date

- **Assets:** Cash, accounts receivable, inventory, land, buildings, equipment and intangible items
- **Liabilities:** Accounts payable, notes payable and mortgages payable
- **Owners' Equity:** Net assets after all obligations have been satisfied

Resources to use to generate revenue	=	Creditor's claim against Resources	+	Owner's claims against resources

Balance Sheet:

- Provides the reader with information about the financial position of the firm with regard to its ability to pay current debts. By comparing the current assets to the current liabilities, the reader can assess whether the company is in a position to meet to meet its short-term financial obligations
- Gives the reader a view of the firm's financial position to carry on its business operations. The fixed-asset section indicates how many resources the company has working for it to assist in revenue generation
- Reveals the strength of the owner's claim against the assets. Remember, however, that this claim is residual, or the remaining claim after the creditors

Balance Sheet, continued…

Balance Sheets record assets at historical value, and does not report the market value of a firm

Balance Sheet Limitations:

- Assets recorded at historical value
- Only recognizes assets that can be expressed in monetary terms
- Owners' equity is usually less than the company's market value

What a Balance Sheet Doesn't Say:

- A Balance Sheet does not show the claims of the creditors and the owner(s) against a specific asset. The claims are against the assets in general
- The word 'Capital' under owner's equity must not be interpreted as cash. The investment can come in many forms – cash being just one of them. The owner's original cash investment may have gone primarily to purchase fixed assets in order to assist revenue generation. Capital means investment not cash.
- A Balance Sheet does not report the market value, current value, or worth of a business. Many readers believe the total assets represent a bundle of future cash reserves. This is not true because fixed assets are reported at historical cost, and their purpose is to assist revenue

Sample Balance Sheet – Non-Financial

Below is a sample balance sheet showing Safaricom financial position

Balance Sheet Items	2014A	2015A
Non-current assets		
Property, plant and equipment	97.7	107.8
Intangible-licenses & Goodwill	0.9	10.1
Indefeasible rights of use	4.9	4.8
Non current assets-depreciable	103.3	122.5
Deferred income tax asset	2.8	1.7
Current assets		
Inventories	3.0	8.3
Receivables and prepayments	7.7	10.3
Cash and cash equivalents	17.6	14.0
Total Assets	**134.6**	**157.0**
CAPITAL & RESERVES		
Share capital	2.0	2.0
Share premium	2.2	2.2
Retained earnings	68.2	74.4
Proposed dividend	18.8	25.6
Attributable to company equity holders	91	104
Total equity	**91.2**	**104.3**
Non-current liabilities		
Borrowings	5.1	0.5
Current liabilities		
Payables and accrued expenses	29.5	41.4
Current income tax payable	1.3	0.6
Borrowings	7.5	10.1
Total Equity & Liabilities	**134.6**	**157.0**

Sample Balance Sheet - Bank

Below is a sample balance sheet showing a Standard Chartered's financial position

Balance Sheet Items	FY2014	FY2015
Assets:		
Excess cash	3.74	3.79
Net Loans	122.75	115.13
Placements	4.80	3.19
Govt sec-HTM	55.68	67.91
Govt sec- AFS	3.08	5.71
Investment Securities	0.10	0.69
Cash and Bank Balances	11.64	10.45
P&E	3.67	3.27
Others	17.04	23.83
Total Assets	**222.50**	**233.97**
Liabilities		
Balancing debt	5.45	-
Deposits	154.07	172.04
Placements	3.65	4.29
Borrowings	-	-
Others	18.66	16.38
Total liabilities	**181.84**	**192.71**
S/Funds	40.7	41.25
Minority Interest	-	-
Total Equity & liabilities	**222.50**	**233.97**

Income Statement

Income statements shows the results of a company's operations over a period of time

- What goods were sold or services performed that provided revenue for the company?
- What costs were incurred in normal operations to generate these revenues?
- What are the earnings or company profit?

- **Revenues: Assets created through business operations**
- **Expenses: Consumption through business operations**
- **Net Income or (Net Loss) : Revenues – Expenses - Tax**

What an Income Statement Doesn't Say:

- An Income Statement does not predict the future net income for any accounting period
- An Income Statement, no matter how well prepared, does not provide an exact measurement of net cash income for the accounting period
- Net Income does not mean cash! Always keep in mind that net income is the excess revenue over related expenses for a specific accounting period

Sample Income Statement - Bank

Below is a sample income statements showing the results of a Standard Chartereds operations

Income Statement Items	FY'2014	FY'2015
Net interest Income	17.90	18.12
Fees & commissions on loans	0.37	0.34
Other fees	3.50	3.81
FX trading income	2.02	2.33
Other Income	2.28	0.77
Net non-interest income	8.17	7.25
Total Operating income	26.07	25.37
Loan loss provision	(1.31)	(4.90)
Total Operating expenses	(11.73)	(16.21)
Profit before tax	14.35	9.16
Tax	(3.91)	(2.82)
Profit after tax	**10.44**	**6.34**

Sample Income Statement – Non-Financial

Below is a sample income statements showing the results of Bamburi's operations during a period

Income Statement Item	FY'2014	FY'2015
Revenue	36,029.0	39,200.0
Direct costs	(26,683.0)	(26,670.0)
Gross profit	9,346.0	12,530.0
Investment Income	349.0	374.0
Other gains and losses	253.0	997.0
Distribution costs	(223.0)	
Marketing costs	(190.0)	
Staff costs	(1,721.0)	(192.0)
Other operraating costs	(1,937.0)	(5,251.0)
Finance costs	(76.0)	-
Insuarance Claims	-	-
Profit before tax	5,801.0	8,458.0
Taxation Charge	(1,898.0)	(2,586.0)
Profit for the year	**3,903.0**	**5,872.0**

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Earnings Quality

Earnings quality are an assessment of how repeatable, controllable and bankable a firms earnings are

Earnings Quality:

- Criteria for earnings to be considered high-quality differs between authors, sustainability of earnings may be the underlying concept
- A correlation between reported earnings and underlying economic activity
- The permanence and sustainability of reported earnings
- The transparency and completeness of disclosures
- The degree to which earnings are good estimates of cash flows

Ways to Lower Earnings Quality:

- Investors not being confident that a firm's reported earnings are free from mistake or manipulation
- Recording revenue too soon or of questionable quality
- Boosting income with one-time gains
- Shifting current expense to a different period
- Failing to record or improperly reducing liabilities

Issues in Looking at Earnings Quality

Issues in Calculating Earnings per Share (EPS) are EPS dilution and underlying earnings

EPS Dilution

The analyst's job is made easier here because firms are required to report basic EPS and diluted EPS. Basic EPS utilizes the actual number of shares outstanding during the period. Diluted EPS utilizes the number of shares that would be outstanding and the accompanying earnings if all executive stock options, equity warrants, and convertible bonds were exercised

The P/E from diluted EPS is typically higher than that from basic EPS. Analysts generally prefer diluted EPS P/Es because they make comparisons across firms more relevant

Underlying Earnings

When calculating a P/E, the analyst should focus on the earnings that are expected to continue into the future. These earnings are referred to as the underlying earnings (also referred to as the persistent earnings, continuing earnings, or core earnings). See the next slide for an example of their calculation

Normalized Earnings

Due to earnings volatility from business or industry cycles, the most recent four quarters of earnings for a firm may not reflect the long-term earning potential of a firm

This is particularly true for cyclical firms, such as auto and steel companies. In this case, the P/E may be inflated based on deflated earnings at the bottom of the business cycle and deflated based on inflated earnings at the top of the business cycle. This effect is known as the Molodovsky effect and is corrected by calculating an EPS under mid-cycle conditions, known as the normalized or normal EPS

Differences in Accounting Methods

When comparing firms, the analyst should adjust for differences in EPS calculation so that the P/Es are comparable. For example, an analyst may be comparing one company using LIFO (last in, first out) inventory accounting (permitted by U.S. GAAP but not the IFRS) with another using FIFO (first in, first out) accounting

III. Fundamental Concepts and Assumptions

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Financial Ratios

Tools and techniques to convert financial statements to formats that facilitate analysis and comparison

What are Ratios?

These are useful tools used to express relationships between various data components of the financial statements.

Key to Note:

- Ratios are not useful when used in isolation
- It's important to understand what firm characteristic each ratio is measuring and therefore which one is suitable for a certain situation
- Calculation of ratios is often subjective, with different analyst calculating different ratios differently. What matters is an understanding of what each ratio represents and what may likely change in any scenario. An analyst should also be consistent in the way they calculate certain ratios

Uses of Ratios:

1. Assessment of Management Performance
2. Projection of future earnings and cash flows
3. Evaluation of a firm's flexibility and ability to adapt to any changes that may arise
4. Comparison of a firm with its peers, industry and performance over a certain period of time

Financial Ratios

Tools and techniques to convert financial statements to formats that facilitate analysis and comparison

Profitability

- Indicate how well a firm generates operating income and net income
- **Include**: gross margins, net margins, operating profit margin, pretax margin, return on assets, return on total capital, return on total equity, return on common equity

Solvency

- Indicate a firm's ability to meet its long term obligations. Measures the level of risk associated with a company
- **Include:** debt-to-equity ratio, debt–to-assets, debt–to-capital, financial leverage and interest coverage

Liquidity

- Indicate a firm's ability to meet its short term obligations. Generally the higher the ratio, the higher the margin of safety for a firm
- **Include**: Current Ratio, Quick Ratio and Cash Ratio

Activity

- Indicate how well a firm uses its assets. They are used to measure the relative efficiency of a firm based on the use of its assets
- **Include**: Inventory turnover, Receivables Turnover, Payables Turnover, Inventory Days Outstanding, Receivables Days Outstanding, Payables Days Outstanding, Operating Cycle

Valuation

- Used to measure the relative value of different firms
- **Include**: Earnings per share, price-to-earnings, price-to-sales, price-to-book value, price-to- cashflow etc.

Financial Ratios

Comparable vs forecasted fundamentals

Comparables Analysis

- The Comparable Company Analysis is one of several techniques used to determine value for a "target" company
- The method of Comparables compares the price and enterprise value multiples of the subject firm with those of similar assets, and similar operating models and environments. The analysis seeks to identify a group / universe of public companies which are deemed fundamentally comparable to the target
- For example, we could compare the P/E multiple of a subject firm with that of firms that are comparable in terms of risk, profitability, and growth. The comps could be a similar firm or a group of firms in the same industry e.g. Visa and MasterCard, Bamburi and ARM etc.
- If a firm had a higher P/E than the Comparables, it would be deemed overvalued. Note that this assumes that the Comparable companies themselves are correctly valued
- The economic rationale for the method of Comps is the law of one price—i.e., identical assets should sell for the same price

Forecasted Multiples

- The method based on forecasted fundamentals compares the firm's actual valuation with one determined using the firm's fundamentals
- A very good example of this is when the Gordon growth model is used to derive a justified Price to Earnings Ratio (P/E Ratio) of a Company, given its fundamentals.
- The firm's actual price multiple is compared with that derived from its fundamentals, which reflect the firm's future cash flows
- If, for example, the actual price multiple is more than that justified by the firm's fundamentals, the stock is deemed overvalued

Rationale For / Drawbacks Against using Price Multiples

Rationales

Earning power is a chief driver of investment value. Earnings per share (EPS), the denominator of the price–earnings ratio, is perhaps the chief focus of security analysts' attention

The price–earnings ratio is widely recognized and used by investors

Differences in price–earnings ratios may be related to differences in long-run average returns, according to empirical research

Drawbacks

Zero or very small earnings. Earnings Per Share can also be negative. The P/E ratio does not make economic sense with a negative denominator

The components of earnings that are on-going or recurrent are most important in determining intrinsic value. However, earnings often have volatile, transient components, making the analyst's task difficult

Management can exercise its discretion within allowable accounting practices to distort earnings per share as an accurate reflection of economic performance. Distortions can affect the comparability of P/E ratios across companies

Calculating the Price multiples

Trailing Price Multiples e.g. P/E, P/CF

Uses last year's earnings i.e. the Earnings from the previous period which have not been forecasted by the Analyst

This is preferred when forecasted earnings are not available, and also included in analysis to allow for measurements across time periods

Forward Price Multiples e.g. P/E, P/CF

Uses next year's earnings, and are in majority of cases the first years Analyst projections on Earnings

Preferred when trailing earnings are not reflective of future earnings, and to test the Analyst assumptions on Earnings growth

Calculating the Price multiples, continued…

Price / Earnings multiple is the most commonly used price multiple

The Price / Earnings Multiple

- When calculating the P/E multiple, the stock price numerator is unambiguous for publicly traded companies
- The earnings denominator, however, can generally be characterized in two different ways:

  A) the time horizon over which it was measured and,

  B) the adjustments to accounting earnings (required so that P/E's are comparable across firms)

The Time Horizon for Earnings results in two broad definitions of the P/E:

- The trailing P/E (also referred to as the current P/E), which uses the past four quarters of earnings, referred to as the trailing 12 month (TTM) Earnings per Share (EPS)
- The forward P/E (also referred to as the leading or prospective P/E), which uses next year's expected earnings (based on analyst or database estimates), i.e. the NTM Earnings per Share (EPS)
- The forward P/E is preferred over the trailing P/E when trailing earnings are not representative of the firm's future. The trailing P/E is preferred when forecasted earnings are not available, which is often the case for small firms that are not widely followed
- If earnings are zero or negative, the analyst may use a longer-term or future (positive) earnings figure. Regardless, the analyst should use the same definition of earnings when making comparisons across firms

Calculating the Price Multiples, continued…

Example below in calculating forward Price/Earnings

Stock price	$20.00
2011:Q1 EPS	$0.18
2011:Q2 EPS	$0.25
2011:Q3 EPS	$0.32
2011:Q4 EPS	$0.35
2011 Fiscal year forecast	*$1.10*
2012:Q1 EPS	$0.43
2012:Q2 EPS	$0.48
2012:Q3 EPS	$0.50
2012:Q4 EPS	$0.59
2012 Fiscal year forecast	*$2.00*

Forward Looking Notes

Forward P/Es are often favored over trailing P/Es because they are forward looking. There are many different interpretations, however, of the forward earnings figure. Forward earnings could be:

1) EPS for the next four quarters;
2) EPS for the next 12 months (NTM); or
3) EPS for the future fiscal year. The future fiscal year itself may be defined in different ways:
    a) If the time of prediction is between fiscal year-ends, the fiscal year used can be the current one, for which some time has already elapsed
    b) The fiscal year used can be the next fiscal year

The example here illustrates the various calculations of the forward P/E. We will assume that the P/E is calculated and the stock price is recorded in November 2011. We also assume that the fiscal year-end is the calendar year-end (December)

Calculating the Price Multiples, continued…

Different ways of calculating forward Price/Earnings

- Forward P/E based on EPS for the next 4 quarters:
  - EPS for the next 4 quarters = $ 0.35 + $ 0.43 + $0.48 + $0.50 = $1.76
  - Forward P/E based on EPS for the next 4 quarters = $20/ $1.76 = 11.4x
- Forward P/E based on EPS for the NTM (next twelve months)
  - EPS for the NTM = (1/12)* $1.10 + (11/12)*$2.00 = $1.925
  - Forward P/E based on EPS for the NTM = $2.0/$1.925 = 10.4x
- Forward P/E based on the current fiscal year's EPS
  - EPS for the current fiscal year = $1.10
  - Forward P/E based on EPS for the current fiscal year = $20/ $1.10 = 18.2x
- Forward P/E based on EPS for the next fiscal year's EPS
  - EPS for the next fiscal year = $2.00
  - Forward P/E based on EPS for the next fiscal year = $20/$2.00 = 10.0x

Underlying Earnings

Description of underlying earnings are those expected to persist in the future

- The analyst should focus on the earnings that are expected to persist into the future, which are referred to as underlying earnings
- Some firms will report adjusted earnings, pro forma earnings, or core earnings. These reported figures, however, are not always equal to the underlying earnings desired for P/E calculation. In these cases, the analyst will need to adjust the firm's figures

Example:

Reported EPS from previous four quarters	$4.00	P/E Based on Reported Earnings	$50/$4 = 12.5x
Restructuring charges	$0.10	Core Earnings	$4+$0.45 = $4.45
Amortization of intangibles	$0.15	P/E Based on Core Earnings	$50/$4.45 = 11.2x
Impairment charge	$0.20	Underlying Earnings	$4+$0.2 = $4.20
Stock price	$50.00	P/E Based on Underlying Earnings	$50/$4.20 = 11.9x

Underlying Earnings

Adjusting financial statements to show underlying earnings

- The P/E based on reported earnings is 12.5x
- We then calculate the core earnings that a firm may report. Core earnings are a non-IFRS and non-GAAP concept, so there are no prescribed rules for their calculation
- In the example shown, the firm adds the restructuring charge ($0.10), the amortization of intangibles ($0.15), and the impairment charge ($0.20) to the reported EPS to obtain core earnings of $4.45. The resulting P/E is 11.2x
- The analyst then scrutinizes the firm's accounting statements and determines that the firm has consistently reported charges from restructuring and amortization. If, in the example, we consider the only nonrecurring charge to be the impairment charge, then only it is added to the EPS to arrive at underlying earnings of $4.20
- The resulting P/E is 11.9. Note that this P/E is more likely to indicate that the stock is overvalued, relative to the P/E calculated from the firm's reported core earnings

Your Job as an Analyst:

- This example illustrates that an analyst will need to adjust firm figures to arrive at underlying earnings
- This may require an examination of the footnotes and management discussion sections in the accounting statements. Earnings can also be decomposed into accrual and cash flow components, giving greater weight to the cash flow component because it may be more persistent
- Regardless, the analyst should use a consistent adjustment process so that P/Es are comparable across firms

Normalized Earnings

It is important to calculate price multiples with a normalized earnings set

In order to adjust for earnings volatility from business or industry cycles by, it is important to calculate Price Multiples using a normalized EPS

There are two different methods for calculating a normalized EPS:

1) Method of historical average EPS: Normalized EPS = Average EPS over the most recent full cycle

2) Method of average return on equity (ROE): Normalized EPS = Average ROE over the most recent full cycle × Current BVPS

The first method does not account for changes in a business's size, whereas the second method does. For this reason, the second method is often preferred

Example:

Year	EPS	BVPS	ROE
2010	$0.66	$4.11	16.1%
2009	$0.55	$3.67	15.0%
2008	$0.81	$2.98	27.2%
2007	$0.73	$2.12	34.4%
2006	$0.34	$1.61	21.1%

2011 stock price = $24.00

Normalized Earnings, continued…

1) Method of historical average EPS

$$\text{Average (normalized) EPS} = \frac{(\$0.66 + \$0.55 + \$0.81 + \$0.73 + \$0.34)}{5} = \$0.618$$

$$\text{P/E} = \$24.00 / \$0.618 = 38.8$$

2) Method of average ROE

$$\text{Average ROE} = \frac{(16.1\% + 15.0\% + 27.2\% + 34.4\% + 21.1\%)}{5} = 22.8\%$$

$$\text{Average (normalized) EPS} = \text{Average ROE} \times \text{Current equity book value per share}$$
$$\text{Average (normalized) EPS} = 22.8\% \times \$4.11 = \$0.937$$

$$\text{P / E} = \$24.00 / \$0.937 = 25.6$$

Normalized Earnings, continued…

Interpreting average Return on Equity

- Under the second method of average return on equity (ROE), the average ROE over five years is first determined, which is 22.8%
- The average ROE is then multiplied by the current equity book value per share, which results in a normalized EPS of $0.937. The resulting P/E is 25.6X
- Note that the EPS under this method is larger than under the first method because this method reflects the larger current scale of the firm
- Note that the book value from 2006 to 2010 grew by 155%($4.11/$1.61 – 1). The EPS under this method better reflects the current size of the firm
- The corresponding P/E under this method reflects a lower market valuation (lower P/E) for the firm (a 25.6X P/E under this method versus a 38.8X P/E under the first method)

Dividend Yield & Earnings Yield

Normalized Earnings Results Explained

Dividend Yield

- Dividend Yield is a financial ratio that shows how much a company pays out in dividends each year relative to its share price
- In the absence of any capital gains in the stock you are holding, the dividend yield is the return on investment for a stock
- Dividend yield is calculated as follows

$$= \frac{\text{Annual Dividends Per Share}}{\text{Price Per Share}}$$

Earnings Yield

- The earnings per share for the most recent 12-month period divided by the current market price per share. The earnings yield (which is the inverse of the P/E ratio) shows the percentage of each dollar invested in the stock that was earned by the company

Role of Earnings Yield

- The earnings yield is used by many investment managers to determine optimal asset allocations
- Money managers often compare the earnings yield of a broad market index (such as the S&P 500) to prevailing interest rates, such as the current 10-year Treasury yield
- If the earnings yield is less than the rate of the 10-year Treasury yield, stocks as a whole may be considered overvalued. If the earnings yield is higher, stocks may considered undervalued relative to bonds

IV. Tools for Analysis

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Core Performance

Core performance measures a company's true earnings without one-off items

- Companies have different activities through which they realize profits and improve their bottom line performance
- **Core performance** is the measure of a company's profitability based on its main business activities
- It entails stripping out non-recurrent items that will skew the profitability positively or negatively for a particular period
- Core performance gives investors a glimpse of what truly **"clean"** earnings look like
- Core performance takes care of the following items from the income statement:

Core Performance Inclusions	Core Performance Exclusions
Main business operation income and costs	One off gains/losses from sale of assets
Restructuring charges from ongoing operations	Goodwill charges on new premises or business lines
Pension fund costs	Litigation costs
Research and development expenses	Merger and acquisition related expenses
Depreciation on operating assets	Unrealized gains from hedging activities
Employee stock option expenses	Pension fund gains

Core performance enables consistency and credibility of earnings based on a company's main operational activities

Core Performance: Case of Standard Chartered

The sale of land in 2014 overstated true profits made by Standard Chartered

Stripping off the sale of land during 2014, performance actually dipped in comparison to 2013 by 3.6%

Income Statement	FY'2013	FY'2014	y/y change
Net interest Income	**16.76**	**17.90**	
Fees & commissions on loans	0.90	0.37	
Other fees	2.94	3.50	
FX trading income	2.28	2.02	
Other Income	**0.95**	**2.28**	**140.0%**
Net non-interest income	**7.07**	**8.17**	
Total Operating income	**23.83**	**26.07**	
Loan loss provision	(0.99)	(1.31)	
Total Operating expenses	**(10.47)**	**(11.73)**	
Profit before tax	**13.35**	**14.35**	
Tax	(4.06)	(3.91)	
Profit after tax	**9.27**	**10.44**	
Reported EPS	**26.67**	**33.19**	**24.4%**
Land sale	-	1.5	
Actual Profit after tax	9.27	8.94	
Core EPS	**26.67**	**28.30**	**(3.6%)**

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Core Performance: Case of Standard Chartered

Stripping off the one off gain in 2014, 2015 performance dipped less than reported

Stripping off the sale of land during 2014, Standard Chartered's performance in 2015 declined by 28.7%, lower than the reported decline of 39.2%

Income Statement	FY'2014	FY'2015	y/y change
Net interest Income	**17.90**	**18.12**	
Fees & commissions on loans	0.37	0.34	
Other fees	3.50	3.81	
FX trading income	2.02	2.33	
Other Income	**2.28**	**0.77**	**(66.3%)**
Net non-interest income	**8.17**	**7.25**	
Total Operating income	**26.07**	**25.37**	
Loan loss provision	(1.31)	(4.90)	**274.2%**
Total Operating expenses	**(11.73)**	**(16.21)**	
Profit before tax	**14.35**	**9.16**	
Tax	(3.91)	(2.82)	
Profit after tax	**10.44**	**6.34**	
Reported EPS	**33.19**	**19.9**	**(39.2%)**
Land sale	1.5	-	
Actual Profit after tax	8.94	6.34	
Core EPS	**28.30**	**20.16**	**(28.7%)**

Earnings Quality – The Case of National Bank

A gain of Kshs 600 mn from sale of 12 branches in NBK drove up HY'15 EPS by 102.9%

Income Statement	HY'2014	HY'2015	y/y change
Net interest Income	**3.2**	**3.8**	
Fees & commissions on loans	0.38	0.22	
Other fees	0.70	0.83	
FX trading income	0.18	0.75	
Other Income	**0.32**	**1.06**	**226.8%**
Non-interest income	**1.58**	**2.36**	
Total Operating income	**4.78**	**6.16**	
Loan loss provision	(0.13)	(0.33)	
Total Operating expenses	**(3.53)**	**(3.67)**	
Profit before tax	**1.25**	**2.48**	
Tax	(0.34)	(0.75)	
Profit after tax	**0.78**	**1.73**	
Reported EPS	**2.77**	**5.62**	**102.9%**
Branch sale	-	0.6	
Actual Profit after tax	0.78	1.13	
Core EPS	**3.24**	**3.67**	**13.5%**

Sources: NBK Financials HY'2015

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Earnings Quality – The Case of National Bank, continued…

Apart from boosting profitability the sale was essential to meet statutory capital requirements

- NBK'S net profits for the 6 months ending June 2015 jumped to 1.7 bn aided by the sale of 12 of their branches for Kshs 1.2 bn during the year, a realized gain of Kshs 600 mn
- NBK had frozen dividend payments and the sale of their low earning buildings helped the company raise its core capital ahead of their much anticipated rights issue on which they hope to raise Kshs 13.5 bn to fund its expansion plan
- The sale helped the company raise its total capital to risk weighted assets ratio to 15.4% from 12.9% above the statutory minimum of 14.5%. The company's liquidity ratio subsequently rose to 25.8% in June from 21.0% above the statutory minimum of 20.0%
- The one off sale now sees the company holding leases on all its branches except the headquarters building on Harambee Avenue

Sources: NBK Financials HY'2015

Analysis Tools – Revenue, Expense & Profit

It is important to understand whether profit is being driven by revenue growth or expense reduction

KenGen

Metrics	2014	2015	y/y change
Operating Revenue	12.2	18.5	51.9%
Operating Expenses	7.0	8.7	23.9%
PAT	4.9	5.7	15.0%

Uchumi Supermarkets

Metrics	2014	2015	y/y change
Operating Revenue	6.8	4.3	(37.6%)
Operating Expenses	1.8	2.0	11.7%
PAT	(0.26)	(1.02)	

Revenue, Expenses and their Impact on Profit

- KenGen registered an increase in operating revenue by 51.9%, faster than the increase in operating expenses which rose by 23.9%. This led to an increase in profit for the company by 15%. This is a good example of how admirable revenue growth, accompanied by cost containment, directly leads to an increase in company profit

- Uchumi Supermarket on the other hand registered a decline in operating revenue by 37.6%, while the operating expenses rose 11.7%. This led to an increase in loss for the company to Kshs 1 bn from Kshs 0.26 bn in 2014. This shows how a decline in revenue for the business, accompanied by increasing expenses is a recipe for additional company losses

Source – Company Results

Analysis Tools – Loan Growth vs. Deposit Growth

Kenya's banking sector core EPS growth was 2.8% for FY'2015

FY'2015 Listed Banking Sector Metrics								
Bank	Core EPS Growth	Deposit Growth	Loan Growth	Net Interest Margin	Loan Loss Provision	Cost to Income**	ROaE	ROaA
I&M Bank	26.2%	16.4%	13.6%	7.2%	13.4%	35.0%	24.5%	3.7%
Co-op Bank	25.4%	21.9%	16.2%	8.8%	71.8%	53.2%	25.1%	3.7%
KCB Group	12.1%	12.5%	21.9%	7.9%	(6.8%)	50.1%	25.0%	3.7%
DTB	11.5%	20.6%	29.0%	6.5%	150.1%	41.0%	18.7%	2.9%
Equity Group	1.0%	23.1%	26.0%	6.5%	52.9%	52.9%	25.5%	4.8%
Barclays	(0.2%)	0.2%	15.9%	10.2%	25.7%	53.0%	21.6%	3.7%
NIC	(2.6%)	11.9%	13.7%	6.1%	401.4%	41.6%	18.0%	3.1%
CFC	(13.7%)	18.7%	26.6%	6.4%	24.6%	50.6%	17.1%	2.6%
HF Group	(18.5%)	15.4%	17.2%	6.3%	(8.6%)	47.4%	16.9%	2.2%
Stanchart	(28.7%)	11.7%	6.2%	9.4%	274.5%	44.6%	15.5%	2.9%
NBK	(232.5%)	5.6%	3.3%	6.4%	608.0%	78.2%	(19.3%)	(1.0%)
Weighted Average	**2.8%***	**14.3%**	**14.5%**	**7.4%**	**85.4%**	**49.8%**	**17.1%**	**2.9%**

**Averages are market cap weighted*

***Without loan loss charge*

Source: NSE, Cytonn Banking Sector Report

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Analysis Tools – Loan Growth vs. Deposit Growth, continued…

Relating Deposits and Loans growth in Banks

- For banks, it is always a positive for their deposits to be growing at a high rate, especially if a bank can gather both deposits and give out loans at a high rate, as this highlights continued stability for the bank. For the full year ending 2015, Co-operative Bank grew its deposit base by 21.9%, faster than the rate of loan growth, at 16.2%, against industry averages of 14.3% and 14.6%, respectively. The bank further reported a core EPS growth of 25.1%

- Barclays bank on the other hand grew their deposits at a mere 0.2%, compared to an industry average of 14.6%, while their loans grew at a faster rate at 15.9%, against the industry average of 14.3%. This shows the bank has become more aggressive in giving out loans, despite not being able to grow their deposit base. Their EPS further declined by 0.2%

Source – Company Results

Analysis Tools – Core & Non-core Revenue

Relating Non-core Revenue and diversification in Banks

- In addition to their core interest revenue, banks also diversify their sources of income. This has the advantage of reducing overreliance on interest income, which is quite dependent on the interest rate environment in the country. However, non funded income should not increase to the point where the bank loses sight of its core business, as earnings from this source of income are quite volatile

- An ideal revenue mix of funded to non funded income is exhibited by CfC Stanbic bank, which stands at 56.1%:43.9%, and Co-operative bank, which stands at 36.2%: 63.8%, against a target of 60%:40%,

Source – Company Results

Dilutive Effects of a Rights Issue

Case Study –HF Group

Figures in '000'

Year	2014	2015
PAT	975,336	1,196,969
Number of Shares	211,827	211,827
Rights Issue (new Shares)		137,070
Number of Shares		348,897
EPS	4.60	3.43
PAT Growth		23%
Core EPS Growth		(0.25)

- In the above case, it would be a misleading to praise an impressive 23% growth in PAT at FY 2015 as indeed shareholders suffered a decline in their earning by 25% for the period
- This is as a result of increase in the number of shares following a rights issue . The Right issue lead to dilutive effects on the shareholders earnings
- Therefore EPS growth is the recommended metric measuring a firms performance over a given period as opposed to PAT growth

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Equity Bank's Pro Credit Acquiscition

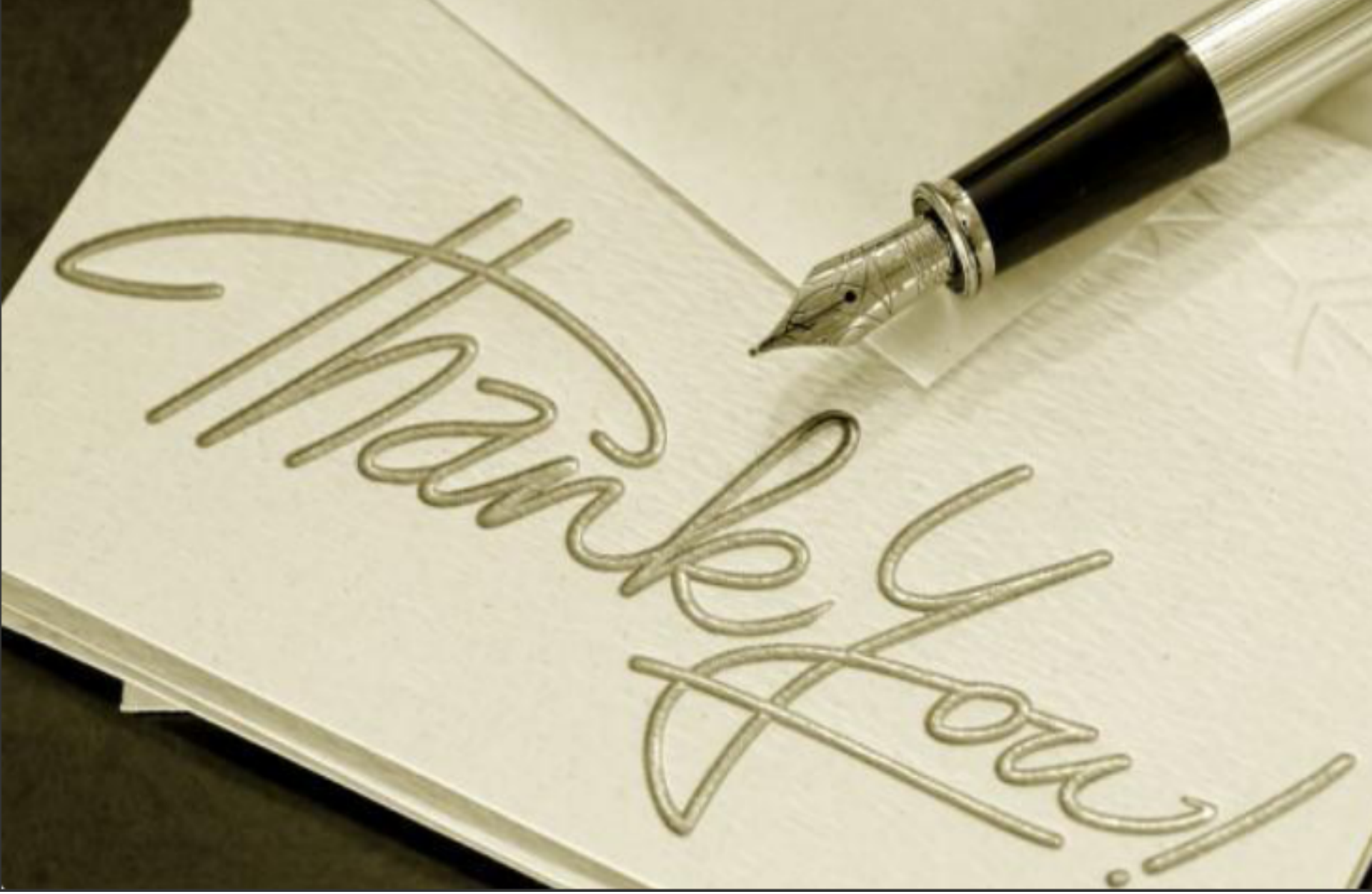
The acquisition of Pro Credit was dilutive it led to a decline in EPS by 0.9%

All values in bn Kshs unless stated otherwise

	2014 (Pre acquisition)	2015 (Post acquisition)
Earnings	17.2	17.3
Shares	3.7	3.8
EPS	4.6	4.6
Earnings Growth		**1.0%**
EPS Growth		**(0.9%)**

- **A dilutive acquisition** is a transaction that will lead to a decline in the acquirer's earnings per share (EPS) if additional shares are issued to pay for the acquisition. These acquisitions should be avoided as they decrease shareholder value but if the strategic value of the acquisition is expected to cause a sufficient increase in EPS in later years, the acquisition can be pursued
- **An accretive acquisition** is an acquisition that will lead to an increase in the acquiring company's earnings per share (EPS). These acquisitions are favored because the price paid by the acquiring firm is lower than the boost the new acquisition will provide for its EPS

- For Equity Bank the acquisition of Pro Credit Bank by issuing 70,897,782 new shares is dilutive as the EPS declined by 0.9% as compared to the earnings growth of 1.0%. However, the strategic placement in Congo will lead to an increase in EPS for Equity Bank in the coming years thus making the acquisition attractive



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