

Valuation Summary

- We recommend an ACCUMULATE for the NIC Bank stock with a target price of Kshs 30.8 representing an upside of 11.6%, from the current price of Kshs 28.5, as at 25th November, 2016 inclusive of a dividend yield of 3.5%
- NIC is currently trading at a P/B of 0.7x and a P/E of 4.6x, vs an industry average of 0.9x and 5.8x, respectively.

Key highlights during Q3'2016

- The High Court ruled that Imperial Bank (IR) former depositors could access their deposits over the previously accessible Kshs 1.0 mn from NIC Bank
- Global Credit Ratings (GCR), a South Africa-based rating company, accorded NIC's outlook as "negative" due to the increasing Non-Performing Loans (NPLs) and rising bad debts.

Income Statement

- Core earnings per share declined by 6.4% to Kshs 5.3 from Kshs 5.6 in Q3'2015, driven by a 56.6% growth in total operating expenses that exceeded the 23.7% increase in total operating revenue
- Total operating revenue grew by 23.7% to Kshs 12.5 bn from Kshs 10.1 bn in Q3'2015, faster than our estimate of a 14.2% growth. This was supported by a 34.1% growth in Net Interest Income (NII) despite Non-Funded Income remaining flat
- Interest Income grew by 21.8% to Kshs 14.7 bn from Kshs 12.1 bn in Q3'2015, faster than the 4.8% growth in Interest expense to Kshs 5.3 bn from Kshs 5.1 bn in Q3'2015. Owing to a faster growth in Interest income, the Net Interest Margin (NIM) rose to 8.3% from 7.0% in Q3'2015
- Non-Funded Income (NFI) remained relatively flat at Kshs 3.1 bn, below our expectation of a 21.5% increase. Other fees and commissions grew by a 28.8% to Kshs 0.6 bn from Kshs 0.5 bn in Q3'2015 while foreign exchange trading income declined by 22.9% to Kshs 0.9 bn from Kshs 1.1 bn in Q3'2015. The current revenue mix stands at 75:25, Funded to Non-Funded Income from 69:31 in Q3'2015
- Total operating expenses grew by 56.6% to Kshs 7.7 bn from Kshs 4.9 bn in Q3'2015 driven by a 363.7% rise in Loan Loss Provision (LLP) to Kshs 3.2 bn from Kshs 0.7 bn in Q3'2015 and a 2.4% y/y growth in staff costs to Kshs 2.3 bn from Kshs 2.2 bn. Without LLP, operating expenses grew by 6.8% to Kshs 4.5 bn from Kshs 4.3 bn in Q3'2015
- The faster growth in operating expenses compared to operating revenue resulted in the cost to income ratio increasing to 62.0% from 49.0% in Q3'2015. Excluding LLP, cost to income ratio stood at 36.4% from 42.1% in the same period last year
- Profit after tax decreased by 6.4% to Kshs 3.4 bn from Kshs 3.6 bn in Q3'2015.

Balance Sheet

- The balance sheet recorded an expansion in Q3'2016, with total assets increasing by 6.2% to Kshs 165.3 bn from Kshs 155.6 bn in Q3'2015, driven by a 46.2% growth in allocation to government securities which stood at Kshs 34.6 bn from Kshs 23.7 bn
- The loan book recorded a 0.7% growth to Kshs 110.5 bn from Kshs 111.2 bn in Q3'2015, as compared to our expectation of a 5.8% increase. Loan growth was supported by NIC's focus on increasing SME lending in their new business strategy
- Total liabilities increased by 3.5% to Kshs 135.7 bn from Kshs 131.2 bn in Q3'2015 compared to our projections of a 9.4% increase, driven by a 2.4% rise in customer deposits by other banks to Kshs 108.4 bn from Kshs 105.8 bn in Q3'2015. Shareholder funds increased by 21.4% to Kshs 29.1 bn
- Customer deposits grew by 2.4% to Kshs 108.4 bn from Kshs 105.8 bn in Q3'2015 as compared to our expectation of a 9.4% increase. The faster growth in customer deposits resulted in the loan to deposit ratio declining to 101.9% from 103.2% in Q3'2015, which is quite high compared to the industry average of 86.1%, and our preferred range of 80%-90%
- Gross non-performing loans grew by 107.2% to Kshs 14.3 bn from Kshs 6.9 bn in Q3'2016, which led to an increase in the NPL ratio to 12.5% from 6.0% in Q3'2015
- The yield on interest earning assets increased to 13.4% from 12.0% in Q3'2015, while cost of funds decreased to 4.5% from 5.5% in Q3'2015

- NIC currently operates at a Return on average Assets (ROaA) and Return on average Equity (ROaE) of 2.6% and 12.6%, down from 3.0% and 19.8% in Q3'2015, respectively
- NIC is currently sufficiently capitalized with core capital to risk weighted assets ratio at 17.2%, 6.7% above the statutory requirement, with the total capital to total risk weighted assets exceeding statutory requirement by 8.5%.

Key Take Outs:

- NIC Bank's cost to income ratio has risen significantly to 62.0% from 49.0% in Q3'2015, on account of the bank increasing LLPs by quite a large margin as compared to a similar period last year, where LLP increased by 235.3%. The Loan loss provision continues to remain high for NIC as it is for the industry, thus resulting in a cut-back on earnings growth for the bank.

Moving forward, NIC will thrive on:

- Increased efficiency through cutting down of costs by: (i) reducing redundant roles across all branches thus cutting down on staff costs, and (ii) exploring technology as a more cost effective measure in deposit collection and loan disbursement
- Reducing on the non-performing loans through improved credit risk management and loan recovery efforts
- Revenue diversification with new business lines such as bancassurance through NIC Insurance.

Below is a summary of the key line items in the balance sheet and income statement

Figures in Kshs billions unless otherwise stated

Balance Sheet Items	FY'2015	Q3'2015	Q3'2016	y/y change	Q3'2016e	Projected %y/y change	Variance in Growth Actual vs. Expected
Government Securities	27.8	23.7	34.6	46.2%	28.3	19.5%	26.7%
Net Loans and Advances	116.0	111.2	110.5	-0.7%	117.7	5.8%	-6.5%
Total Assets	165.8	155.6	165.3	6.2%	173.2	11.3%	-5.1%
Customer Deposits	112.4	105.8	108.4	2.4%	115.4	9.1%	-6.6%
Total Liabilities	139.4	131.2	135.7	3.5%	143.5	9.4%	-5.9%
Shareholders' Funds	25.9	23.9	29.1	21.4%	29.2	21.9%	-0.5%

Balance Sheet Ratios	Q3'2015	Q3'2016	y/y change
Loan to Deposit Ratio	103.2%	101.9%	-1.3%
Return on average equity	19.8%	12.6%	-7.2%
Return on average assets	3.0%	2.6%	-0.4%

Income Statement	FY'2015	Q3'2015	Q3'2016	y/y change	Q3'2016e	Projected %y/y change	Variance in Growth Actual vs. Expected
Net Interest Income	9.7	7.0	9.4	34.1%	7.8	11.0%	23.1%
Net non-Interest Income	4.0	3.1	3.1	-0.1%	3.7	21.5%	-21.6%
Total Operating income	13.8	10.1	12.5	23.7%	11.5	14.2%	9.5%
Loan Loss provision	1.7	0.7	3.2	363.7%	1.8	154.3%	209.4%
Total Operating expenses	7.4	4.9	7.7	56.6%	6.2	26.2%	30.4%
Profit before tax	6.4	5.1	4.7	-7.9%	5.3	2.7%	-10.6%
Profit after tax	4.5	3.6	3.4	-6.4%	3.7	3.0%	-9.4%

Income Statement Ratios	Q3'2015	Q3'2016	y/y change
Yield from interest-earning assets	12.0%	13.4%	1.4%
Cost of funding	5.5%	4.5%	-1.0%
Net Interest Spread	6.5%	8.9%	2.4%
Net Interest Margin	7.0%	8.3%	1.3%
Net Interest Income as % of operating income	69.5%	75.4%	5.9%
Non-Funded Income as a % of operating income	30.5%	24.6%	-5.9%

Cost to Income Ratio	49.0%	62.0%	13.0%
Cost to Assets	3.2%	4.7%	1.5%

Capital Adequacy Ratios	Q3'2015	Q3'2016
Core Capital/Total Liabilities	21.1%	23.7%
Minimum Statutory ratio	8.0%	8.0%
Excess	13.1%	15.7%
Core Capital/Total Risk Weighted Assets	14.4%	17.2%
Minimum Statutory ratio	10.5%	10.5%
Excess	3.9%	6.7%
Total Capital/Total Risk Weighted Assets	20.1%	23.0%
Minimum Statutory ratio	14.5%	14.5%
Excess	5.6%	8.5%
Liquidity Ratio	31.6%	34.0%
Minimum Statutory ratio	20.0%	20.0%
Excess	11.6%	14.0%