Cytonn INVESTMENTS

National Bank of Kenya Earnings Update – Q1'2016

26th May 2016

Valuation Summary

- We recommend a SELL for the National Bank of Kenya stock with a target price of Kshs 8.5 representing a downside of 15.0%, from the current price of Kshs 10.0, as at Thursday, 26th May 2016
- Standard Chartered Bank is currently trading at a P/B of 0.3x, versus an industry average of 1.6x

Key highlights during the quarter

- National Bank of Kenya sent its CEO and 5 top managers on forced leave ahead of an internal audit that hinted at corporate governance issues within the lender who were finally dismissed in April.
- The delayed rights issue which had been scheduled for 2013 has come to the forefront with disagreements between the owners of the preference shares, NSSF and The Treasury, on how to convert them to ordinary shares. The impact of this will be a 93.7% ownership of the company by the two leading to significant dilution for the other shareholders who will have 6.3% of shareholding once the 1.14 bn preference shares are converted.

Income Statement

- Core earnings per share declined by 38.4% to Kshs 1.09 per share in Q1'2016 from Kshs 1.77 per share in Q1'2015, driven by a 31.8% growth in operating expenses in Q1'2016 outpacing the 14.5% growth in operating income in Q1'2016
- Operating revenue grew by 14.5% to Kshs 3.0 bn in Q1'2016 from Kshs 2.6 bn in Q1'2015 driven by a 22.4% growth in net interest income, which was supported by a 20.7% growth in interest from loans and advances as a result of the high interest rate environment in Q4'2015 and a marginal 2.1% growth in total interest expense to Kshs 1.2 bn in Q1'2016. Net interest margin decreased to 6.8% in Q1'2016 from 7.8% in Q1'2015
- Non-funded income recorded a decrease of 4.5% to Kshs 0.7 bn from Kshs 0.8 bn in Q1'2015. This decline was as a result of a 33.1% and a 14.5% decline in fees and commissions and other fees and commissions, respectively as well as a 27.8% decline in forex income. The current revenue mix stands at 76:24 funded to non-funded income
- Operating expenses grew greatly by 31.8% to Kshs 2.5 bn in Q1'2016 from Kshs 1.9 bn in Q1'2015 driven by a 347.7% rise in loan loss provision despite the decline in staff costs by 3.5%. The high growth in expenses resulted in a significant increase in cost to income ratio to 84.1% from 73.1% in Q1'2015
- The faster growth in operating expenses led to a decline in PAT y/y by 32.4% to Kshs 0.3 bn from Kshs 0.5 bn in Q1'2015 compared to our expectations of an 11.2% growth

Balance Sheet

- The balance sheet recorded a contraction with total assets decreasing by 1.2% to Kshs 115.6 bn from Kshs 116.9 bn in Q1'2015 driven by 5.3% decrease in loan book. The bank's loan book stood at Kshs 66.3 bn from Kshs 70.1 bn in Q1'2015, showing a conservative approach to lending as the bank continued with the process of cleaning its existing loan book
- Customer deposits increased by 16.6% to Kshs 99.4 bn from Kshs 85.3 bn in Q1'2015 showing the prevailing positive sentiment customers have towards the bank despite the recent headwinds on the leadership of the bank. The decline in loan book led to a decrease in the loan to deposit ratio to 66.7% from 82.2% in Q1'2015, lower than the industry average of 82.5%.
- Gross non-performing loans grew by 143.7% to Kshs 17.0 bn from Kshs 7.0 bn in Q1'2015 compared to a decrease in gross loans of 4.5% which led to an increase in NPL ratio to 24.6% from 9.7% in Q1'2015. This is a trend that has been witnessed across the banking sector in FY'2015 results on account of high interest on loans in Q4'2015
- The yield on interest earning assets remained flat at 12.7% with the cost of funds increasing to 5.9% from 4.9%

- National Bank of Kenya is currently not sufficiently capitalized with a core capital to risk weighted assets ratio at 12.4%, only 1.9% above the statutory requirement with total capital to total risk weighted assets below the statutory requirement by 1.4%

National Bank's growth going forward will be propelled by:

i. The ability to raise funds to shore up their capital requirements which are below Central Bank minimum statutory requirements in order to meet the required threshold and be able to grow the loan book
ii. Management of expenses which will enable the bank to control the run-away cost to income, which currently stands at 84.1%, the highest in the industry
iii. Removing the overhand associated with the conversion of the preferred shares. Investors need clarity around the conversion terms
iv. Improving sentiment towards the bank by clearing out on issues of corporate governance that had resulted in ballooning of Non-performing loans within the lender

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	Q1'2015	Q1'2016	y/y change	Q1'2016e	% y/y change	Variance in Growth Actual vs. Expected
Government Securities	27.3	32.0	28.6	(10.6%)	29.9	(6.6%)	(4.0%)
Net Loans and Advances	67.8	70.1	66.3	(5.3%)	69.0	(1.5%)	(3.9%)
Total Assets	125.4	116.9	115.6	(1.2%)	132.8	13.5%	(14.7%)
Customer Deposits	110.6	85.3	99.4	16.6%	115.0	34.9%	(18.3%)
Total Liabilities	114.4	104.2	104.2	(0.0%)	121.1	16.2%	(16.3%)
Shareholders' Funds	11.1	12.7	11.4	(10.6%)	11.6	(8.9%)	(1.7%)

Balance Sheet Ratios	FY'2015	Q1'2015	Q1'2016	y/y change
Loan to Deposit Ratio	61.3%	82.2%	66.7%	(15.5%)
Return on average equity	-9.9%	7.6%	-10.9%	(18.5%)
Return on average assets	-0.9%	0.9%	-1.1%	(2.0%)

Income Statement	FY'2015	Q1'2015	Q1'2016	y/y change	FY'2016e	% y/y change	Variance in Growth Actual vs. Expected
Net Interest Income	6.4	1.9	2.3	22.4%	2.1	12.5%	9.9%
Net non-Interest Income	3.2	0.8	0.7	(4.5%)	1.0	29.8%	(34.3%)
Total Operating income	**9.6**	**2.6**	**3.0**	**14.5%**	**3.1**	**17.6%**	**(3.0%)**
Loan Loss provision	(3.7)	(0.2)	(0.7)	347.7%	(0.2)	31.9%	315.9%
Total Operating expenses	(11.2)	(1.9)	(2.5)	31.8%	(2.3)	19.9%	11.9%
Profit before tax	**(1.6)**	**0.7**	**0.5**	**(32.4%)**	**0.8**	**11.2%**	**(43.6%)**
Profit after tax	**(1.2)**	**0.5**	**0.3**	**(32.4%)**	**0.6**	**11.2%**	**(43.7%)**
Core EPS	**(3.9)**	**1.8**	**1.1**	**(38.4%)**	**1.8**	**1.1%**	**(39.5%)**

Income Statement Ratios	FY'2015	Q1'2015	Q1'2016	y/y change
Yield from interest-earning assets	12.4%	12.7%	12.7%	0.0%
Cost of funding	5.3%	4.9%	5.9%	1.1%
Net Interest Margin	6.5%	7.8%	6.8%	(1.0%)
Cost to Income	117.1%	73.1%	84.1%	11.0%
Net Interest Income as % of operating income	67.0%	70.7%	75.5%	4.9%
Non-Funded Income as a % of operating income	33.0%	29.3%	24.5%	(4.9%)

Capital Adequacy Ratios	Q1'15	Q1'16
Core Capital/Total Liabilities	12.0%	10.1%
Minimum Statutory ratio	10.5%	10.5%
Excess	**1.5%**	**-0.4%**
Core Capital/Total Risk Weighted Assets	12.0%	12.4%
Minimum Statutory ratio	10.5%	10.5%
Excess	**1.5%**	**1.9%**
Total Capital/Total Risk Weighted Assets	13.0%	13.1%
Minimum Statutory ratio	14.5%	14.5%
Excess	**-1.5%**	**-1.4%**
Liquidity Ratio	21.0%	26.9%
Minimum Statutory ratio	20.0%	20.0%
Excess	**1.0%**	**6.9%**