Diamond Trust Bank Kenya – FY'2018

21st March, 2019

Valuation Summary

- We are of the view that Diamond Trust Bank Kenya is a "***buy***" with a target price of Kshs 283.7, representing an upside of 112.1%, from the current price of Kshs 135.0 as of 21st March 2019, inclusive of a dividend yield of 1.9%,
- Diamond Trust Bank Kenya is currently trading at a P/TBV of 0.7x and a P/E of 5.3x vs an industry average of 1.5x and 7.0x, respectively.

Key Highlights FY'2018

- DTB partnered with the Postal Corporation of Kenya (PCK) to increase its agency banking outlets, where all Posta branches are signed up as agents of DTB. The partnership was aimed at bringing DTB's banking services closer to customers who are now able to perform various banking services at over 500 Posta locations across the country;
- Diamond Trust Bank and the African Development Bank signed two agreements worth Kshs 7.6 bn for financing of Small and Medium Enterprises (SMEs) as well as corporates in the country. The financing from AfDB was split into a line of credit and a debt facility to DTB.

Income Statement

- Diamond Trust Bank Kenya released their FY'2018 financial results, with core earnings per share increasing by 2.3% to Kshs 25.3, from Kshs 24.8 in FY'2017, slower than our expectation of a 6.3% increase to Kshs 26.3 per share. The performance was driven by a 2.0% increase in total operating income, coupled with the 2.5% decline in total operating expenses. The variance in core earnings per share growth against our expectations was largely due to the slower than expected growth in total operating income, that expanded by 2.0%, against the expected 2.9%, coupled with the 4.2% points increase in the effective tax rate to 35.6% from 31.4% in FY'2017,
- Total operating income increased by 2.0% to Kshs 25.5 bn from Kshs 25.0 bn in FY'2017. This was due to a 1.8% increase in Net Interest Income (NII) to Kshs 20.0 bn, from Kshs 19.7 bn in FY'2017, coupled with the 3.0% increase in Non-Funded Income (NFI) to Kshs 5.4 bn, from Kshs 5.3 bn in FY'2017,
- Interest income increased by 1.8% to Kshs 35.3 bn from Kshs 34.6 bn in FY'2017. This was driven by a 10.8% growth in interest income from government securities to Kshs 13.0 bn, from Kshs 11.7 bn in FY'2017, coupled with a 29.8% increase in interest income from placement assets to Kshs 0.3 bn from Kshs 0.2 bn in FY'2017. The growth in interest income was however weighed down by the 3.1% decline in interest income from loans to Kshs 22.0 bn from Kshs 22.7 bn in FY'2017. However, the yield on interest-earning assets declined to 10.9% from 11.4% in FY'2017, largely due to the decline in yields on government securities, and the decline in yields on loans owing to the 100 bps cut in the Central Bank Rate (CBR),
- Interest expense rose by 2.0% to Kshs 15.3 bn from Kshs 15.0 bn in FY'2017, following a 62.1% increase in the interest expense on placement liabilities to Kshs 0.8 bn from Kshs 0.5 bn in FY'2017, coupled with the 2.4% increase in other interest expenses to Kshs 0.99 bn from Kshs 0.97 bn in FY'2017. The increase in interest expense was mitigated by the 0.3% decline in interest expense on customer deposits to Kshs 13.46 bn, from Kshs 13.50 bn in FY'2017. However, the cost of funds declined to 4.9% from 5.1% in FY'2017, due to the faster 3.5% increase in interest bearing liabilities to Kshs 314.7 bn from Kshs 303.9 bn in FY'2017. The Net Interest Margin (NIM) declined to 6.2%, from 6.5% in FY'2017,
- Non-Funded Income (NFI) rose by 3.0% to Kshs 5.4 bn, from Kshs 5.3 bn in FY'2017. The increase was mainly driven by the 5.7% growth in the total fees and commissions to Kshs 3.4 bn from Kshs 3.2 bn in FY'2017. The growth in NFI was however weighed down by the 1.6% decline in forex trading income, to

Kshs 1.57 bn from Kshs 1.6 bn in FY'2017. Owing to the comparable movement in both NII and NFI, the revenue mix remained 79:21, funded to non-funded income,

- Total operating expenses declined by 2.5% to Kshs 14.5 bn from Kshs 14.9 bn in FY'2017, largely driven by the 30.7% decline in Loan Loss Provisions (LLP) to Kshs 3.0 bn from Kshs 4.3 bn in FY'2017. Other operating expenses rose, with staff costs rising by 5.5% to Kshs 4.2 bn from Kshs 4.0 bn in FY'2017, coupled with an 11.0% increase in other operating expenses to Kshs 7.3 bn from Kshs 6.6 bn in FY'2017,
- The Cost to Income Ratio (CIR) improved to 56.9%, from 59.6% in FY'2017. However, without LLP, the cost to income ratio deteriorated to 45.2%, from 42.3% in FY'2017, highlighting the significant decline in the cost of risk to 11.7% from 17.2% in FY'2017,
- Profit before tax increased by 8.9% to Kshs 11.0 bn, up from Kshs 10.1 bn in FY'2017. Profit after tax grew by 2.3% to Kshs 7.1 bn in FY'2018, from Kshs 6.9 bn in FY'2017, with the effective tax rate rising to 35.6% from 31.4% in FY'2017,
- The bank recommends a first and final dividend of Kshs 2.6 per share, similar to that paid in FY'2017, which translates to a dividend yield of 1.9%, and a payout ratio of 10.9%.

Balance Sheet

- The balance sheet recorded an expansion as total assets increased by 4.0% to Kshs 377.7 bn from Kshs 363.3 bn in FY'2017. This growth was largely driven by a 2.6% increase in government securities to Kshs 117.3 bn from Kshs 114.4 bn in FY'2017, coupled with a 4.2% increase in other assets to Kshs 9.0 bn from Kshs 8.7 bn in FY'2017,
- However, the loan book contracted by 1.5% to Kshs 193.1 bn from Kshs 196.1 bn in FY'2017,
- Total liabilities rose by 2.9% to Kshs 318.8 bn from Kshs 309.7 bn in FY'2017, driven by a 6.2% increase in customer deposits to Kshs 282.9 bn from Kshs 266.3 bn in FY'2017. The growth was however weighed down by the 16.4% decline in placement liabilities to Kshs 17.1 bn from Kshs 20.5 bn in FY'2017, coupled with the 14.4% decline in borrowings to Kshs 14.7 bn from Kshs 17.2 bn in FY'2017. Deposits per branch increased by 4.0% to Kshs 2.0 bn from Kshs 1.9 bn in FY'2017, as the number of branches increased by 3 to 140 in 2018, from 137 in FY'2017,
- The faster growth in deposits as compared to loans led to a decline in the loan to deposit ratio to 68.3% from 73.6% in FY'2017,
- Gross Non-Performing Loans (NPLs) declined by 8.2% to Kshs 13.6 bn in FY'2018 from Kshs 14.8 bn in FY'2017. As a consequence, the NPL ratio improved to 6.7% in FY'2018 from 7.1% in FY'2017. General Loan Loss Provisions declined by 34.2% to Kshs 5.4 bn from Kshs 8.2 bn in FY'2017. Thus, the NPL coverage declined to 50.6% in FY'2018 from 67.5% in FY'2017,
- Shareholders' funds increased by 10.9% to Kshs 53.7 bn in FY'2018 from Kshs 48.4 bn in FY'2017, largely due to the 17.1% increase in the retained earnings to Kshs 42.1 bn, from Kshs 35.9 bn in FY'2017,
- Diamond Trust Bank is currently sufficiently capitalized with a core capital to risk-weighted assets ratio of 18.7%, 8.2% points above the statutory requirement. In addition, the total capital to risk-weighted assets ratio was 21.1%, exceeding the statutory requirement by 6.6% points. Adjusting for IFRS 9, the core capital to risk weighted assets stood at 19.6%, while total capital to risk-weighted assets came in at 22.0%,
- The bank currently has a Return on Average Assets (ROaA) of 1.8%, and a Return on Average Equity (ROaE) of 13.1%.

Key Take-Outs:

1. The bank's asset quality improved, with the NPL ratio improving to 6.7% from 7.1% in FY'2017, as the gross NPLs declined by 8.2%. This, coupled with the implementation of IFRS 9, which allowed the bank to charge a one-off provision on the equity, lead to an improved cost of risk to 11.7% from 17.2%, which was the key

contributing factor to a decline in the bank's total operating expenses, and consequently an improved bottom line,

2. The bank's Non-Funded Income expanded by 3.0% y/y, with the growth being derived largely from fees and commissions. However, the bank's revenue remains skewed towards funded income, with NFI accounting for only 21.0% of total revenue, way below the industry average of 31.4% as at FY'2018, indicating there's more room for the bank to exploit this income stream, and,
3. The bank's loan book shrunk by 1.5%, as the bank tightened its credit standards, opting to invest in government securities instead, which increased by 2.6%. Declining yields on government securities coupled with the 100 bps cut of the CBR have seen interest income remain compressed, as it grew by only 1.8%. This was further exacerbated by the 2.0% rise in interest expenses. Thus the bank growth may be hindered by continued preference to funded income, especially if the rate cap remains in place.

Going forward, the factors that would drive the bank's growth would be:

1. **Geographical diversification*:*** The bank's forays into other markets such as Tanzania, Uganda and Burundi, may aid the bank's growth, given the lack of loan pricing controls in those markets. Continued focus on those markets would aid in alleviating the compressed interest income regime in the Kenyan market.

Below is a summary of the bank's performance:

Balance Sheet Items	FY'2017	FY'2018	y/y change	FY'2018e	Projected %y/y change	Variance in Growth Actual vs. Expected
Government Securities	114.4	117.3	2.6%	125.4	9.6%	(7.0%)
Net Loans and Advances	196.0	193.1	(1.5%)	200.4	2.2%	(3.8%)
Total Assets	**363.3**	**377.7**	**4.0%**	**385.1**	**6.0%**	**(2.0%)**
Customer Deposits	266.2	282.9	6.2%	286.4	7.6%	(1.3%)
Total Liabilities	309.7	318.8	2.9%	327.2	5.6%	(2.7%)
Shareholders' Funds	**48.4**	**53.7**	**10.9%**	**52.9**	**9.3%**	**1.6%**

Balance Sheet Ratios	FY'2017	FY'2018	y/y change
Loan to Deposit Ratio	73.6%	68.3%	(5.4%)
Return on average equity	14.4%	13.1%	(1.3%)
Return on average assets	2.0%	1.8%	(0.2%)

Income Statement	FY'2017	FY'2018	y/y change	FY'2018e	Projected %y/y change	Variance in Growth Actual vs. Expected
Net Interest Income	19.7	20.0	1.8%	20.4	3.6%	(1.9%)
Net non-Interest Income	5.3	5.4	3.0%	5.3	0.3%	2.7%
Total Operating income	**24.95**	**25.46**	**2.0%**	**25.7**	**2.9%**	**(0.9%)**
Loan Loss provision	4.3	3.0	(30.7%)	4.0	(7.8%)	(22.8%)
Total Operating expenses	14.9	14.5	(2.5%)	15.2	2.1%	(4.6%)
Profit before tax	**10.1**	**11.0**	**8.9%**	**10.5**	**4.2%**	**4.8%**
Profit after tax	**6.9**	**7.1**	**2.3%**	**7.4**	**6.3%**	**(4.1%)**

Income Statement Ratios	FY'2017	FY'2018	y/y change
Yield from interest-earning assets	11.4%	10.9%	(0.5%)
Cost of funding	5.1%	4.9%	(0.2%)
Net Interest Spread	6.2%	6.0%	(0.3%)
Net Interest Income as % of operating income	78.9%	78.7%	(0.2%)
Non-Funded Income as a % of operating income	21.1%	21.3%	0.2%
Cost to Income Ratio (CIR)	59.6%	56.9%	(2.7%)
CIR without provisions	42.3%	45.2%	2.9%
Cost to Assets	4.3%	3.9%	(0.4%)
Net Interest Margin	6.5%	6.2%	(0.3%)

Capital Adequacy Ratios	FY'2018	FY'2017
Core Capital/Total Liabilities	19.4%	18.5%
Minimum Statutory ratio	8.0%	8.0%
Excess	**11.4%**	**10.5%**
Core Capital/Total Risk Weighted Assets	18.7%	17.3%
Minimum Statutory ratio	10.5%	10.5%
Excess	**8.2%**	**6.8%**
Total Capital/Total Risk Weighted Assets	21.1%	19.0%
Minimum Statutory ratio	14.5%	14.5%
Excess	**6.6%**	**4.5%**
Liquidity Ratio	53.5%	49.9%
Minimum Statutory ratio	20.0%	20.0%
Excess	**33.5%**	**29.9%**
Adjusted core capital/ Total deposit liabilities	20.3%	
Adjusted core capital/ Total Risk Weighted Assets	20.0%	
Adjusted total capital/ Total Risk Weighted Assets	17.2%	