Diamond Trust Bank Limited Earnings Update – H1'2018

31st August, 2018

Valuation Summary

- We are of the view that Diamond Trust Bank is a "Buy" with a target price of Kshs 280.1, representing an upside of 48.8%, from the current price of Kshs 190 as of 31st August, inclusive of a dividend yield of 1.4%,
- DTB is currently trading at P/TBV of 1.1x and a P/E of 8.2x vs an industry average of 1.6x and 9.5x, respectively.

Key Highlights H1'2018

- 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 as well as corporates in the country. The financing from AfDB was split into a line of credit and a debt facility to DTB. The partnership is expected to bolster DTB's reach into the SME sector.

Income Statement

Diamond Trust Bank released their H1'2018 results during the week, with core earnings per share growing by 2.5% to Kshs 12.5 from Kshs 12.2 in H1'2017, lower than our expectation of a 16.6% increase to Kshs 13.8. Performance was driven by a 5.3% increase in total operating income to Kshs 12.7 bn from Kshs 12.0 bn in H1'2017, which outpaced a 4.0% increase in total operating expenses to Kshs 7.3 bn from Kshs 7.0 bn. The variance in core earnings per share growth, relative to our expectations, was as a result of a slower growth in Net Interest Income (NII) of 4.6% against our expectation of an 11.7% increase to Kshs 10.6 bn. Highlights of the performance from H1'2017 to H1'2018 include:

- Total operating income increased by 5.3% to Kshs 12.7 bn from Kshs 12.0 bn in H1'2017. This was due to an increase of 8.0% increase in Non-Funded Income (NFI) to Kshs 2.7 bn from Kshs 2.5 bn in H1'2017, coupled with a 4.6% increase in Net Interest Income (NII) to Kshs 9.9 bn from Kshs 9.5 bn in H1'2017,
- Interest income increased by 3.9% to Kshs 17.5 bn from Kshs 16.9 bn in H1'2017. The interest income on loans and advances decreased by 0.9% to Kshs 11.1 bn from Kshs 11.2 bn in H1'2017. Interest income on government securities increased by 13.5% to Kshs 6.3 bn in H1'2018 from Kshs 5.6 bn in H1'2017. The yield on interest earning assets declined to 11.0% in H1'2018 from 12.0% in H1'2017, due to the relatively faster growth in interest-earning assets by 12.1% to Kshs 338.6 bn from Kshs 302.2 bn in H1'2017, with the increase mainly being government securities that have a lower yield than loans,
- Interest expense increased by 3.0% to Kshs 7.6 bn from Kshs 7.4 bn in H1'2017, as interest expense on customer deposits increased by 1.6% to Kshs 6.8 bn from Kshs 6.7 bn in H1'2017. Interest expense on deposits from other banking institutions increased by 68.3% to Kshs 371.9 mn from Kshs 221.1 mn in H1'2017. The cost of funds decreased to 5.0% from 5.3% in H1'2017. The Net Interest Margin declined to 6.5% from 6.8% in H1'2017,
- Non-Funded Income increased by 8.0% to Kshs 2.7 bn from Kshs 2.5 bn in H1'2017. The increase in NFI was driven by a 70.4% increase in other income to Kshs 0.2 bn from Kshs 0.1 bn in H1'2017, coupled with an 11.7% increase in other fees and commission income to Kshs 1.0 bn from Kshs 989.9 mn in H1'2017. Fees and commissions on loans increased by 4.3% to Kshs 0.7 bn from Kshs 0.6 bn in H1'2017, while forex trading income rose marginally by 0.3% to Kshs 795.9 mn from Kshs 793.8 mn in H1'2017. The revenue mix shifted to 78:22 funded to non-funded income in H1'2018 from 79:21 in H1'2017, owing to the faster increase in NFI compared to NII,

- Total operating expenses increased by 4.0% to Kshs 7.3 bn from Kshs 7.0 bn, largely driven by a 7.3% increase in other operating expenses to Kshs 3.5 bn in H1'2018 from Kshs 3.3 bn in H1'2017. Staff costs increased by 3.8% to Kshs 2.1 bn in H1'2018 from Kshs 2.0 bn in H1'2017. Loan loss provision expense (LLP) declined by 2.2% to Kshs 1.68 bn from Kshs 1.72 bn in H1'2017,
- The cost to income ratio improved to 57.4% from 58.1% in H1'2017. Without LLP, however, the cost to income ratio deteriorated to 44.2% from 43.9% in H1'2017,
- Profit before tax increased by 7.0% to Kshs 5.4 bn, up from Kshs 5.0 bn in H1'2017. Profit after tax increased by 2.5% to Kshs 3.5 bn in H1'2018 from Kshs 3.4 bn in H1'2017,

Balance Sheet

- The balance sheet recorded an expansion with total assets growth of 9.4% to Kshs 376.1 bn from Kshs 343.7 bn in H1'2017. This growth was largely driven by a 22.5% increase in government securities to Kshs 129.2 bn in H1'2018 from Kshs 105.4 bn in H1'2017. The loan book expanded by 3.5% to Kshs 198.2 bn in H1'2018 from 191.5 bn in H1'2017,
- Total liabilities rose by 8.8% to Kshs 321.1 bn from Kshs 295.2 bn in H1'2017, driven by a 9.9% increase in customer deposits to Kshs 281.8 bn from Kshs 256.3 bn in H1'2017. Deposit per branch increased by 3.5% to Kshs 4.1 bn from Kshs 3.9 bn in H1'2017, with the branches increasing from 65 in H1'2017 to 69 in H1'2018,
- The faster growth in deposits compared with loan growth led to a decline in the loan to deposit ratio to 70.4% from 74.7% in H1'2017,
- Gross non-performing loans increased by 65.6% to Kshs 15.3 bn in H1'2018 from Kshs 9.2 bn in H1'2017. Consequently, the NPL ratio deteriorated to 7.1% in H1'2018 from 4.5% in H1'2017. General Loan loss provisions increased by 40.4% to Kshs 8.5 bn from Kshs 6.0 bn in H1'2017. However, the NPL coverage decreased to 70.7% in H1'2018 from 86.8% in H1'2017 due to the faster increase in NPLs,
- Shareholders' funds increased by 14.9% to Kshs 50.0 bn in H1'2018 from Kshs 43.5 bn in H1'2017,
- DTB Kenya Limited is currently sufficiently capitalized with a core capital to risk weighted assets ratio of 17.4%, 6.9% above the statutory requirement. In addition, the total capital to risk weighted assets ratio was 18.7%, exceeding the statutory requirement by 4.2%. Adjusting for IFRS 9, the core capital to risk weighted assets stood at 18.5%, while total capital to risk weighted assets came in at 19.8%, indicating that the bank's total capital relative to its risk-weighted assets decreased by 1.1% due to the impact of IFRS 9,
- DTB currently has a return on average assets of 1.8% and a return on average equity of 14.0%.

Key Take-Outs:

a. The asset quality of DTB deteriorated significantly, with gross NPLs increasing by 65.6% to Kshs 15.3 bn from Kshs 9.2 bn in the period under review, with the NPL ratio rising to 7.1% from 4.5% a year earlier. Despite the bank raising its loan loss provisions by 40.4% in order to mitigate the effect of the rising bad loans, the NPL coverage decreased to 70.7% as the non-performing loans increased faster than the general loan-loss provisions.

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

a. Non-Funded Income Growth Initiatives – DTB's partnership with the Postal Corporation of Kenya has expanded its agency banking reach across the country. This is expected to increase transactional volumes, which will in turn contribute to NFI generation through fees and commissions. DTB should also increase the capacity of its bancassurance business to acquire more customers through cross-selling insurance products to existing customers.

b. Better underwriting of loans to ascertain and minimize risks associated with every market segment in which it operates, in order to mitigate the bank’s deteriorating asset quality. The bank obtained a credit facility from Africa Development Bank (AfDB), which it will use to extend credit to SME businesses. It is important for the bank to adopt appropriate risk management policies in order to reduce its bad loan portfolio.

Balance Sheet Items	H1'2017	H1'2018	y/y change	H1'2018e	Projected %y/y change	Variance in Growth Actual vs. Expected
Government Securities	105.4	129.2	22.5%	110.9	5.2%	17.3%
Net Loans and Advances	191.5	198.2	3.5%	197.0	2.9%	0.7%
Total Assets	**343.7**	**376.1**	**9.4%**	**371.8**	**8.2%**	**1.2%**
Customer Deposits	256.3	281.7	9.9%	278.1	8.5%	1.4%
Total Liabilities	295.2	321.1	8.8%	314.8	6.6%	2.1%
Shareholders’ Funds	**43.5**	**50.0**	**14.9%**	**51.9**	**19.1%**	**(4.2%)**

Balance Sheet Ratios	H1'2017	H1'2018	y/y change
Loan to Deposit Ratio	74.7%	70.4%	(4.3%)
Return on average equity	18.8%	14.0%	(4.8%)
Return on average assets	2.3%	1.8%	(0.5%)

Income Statement	H1'2017	H1'2018	y/y change	H1'2018e	Projected %y/y change	Variance in Growth Actual vs. Expected
Net Interest Income	9.5	9.9	4.6%	10.6	11.7%	(7.1%)
Net non-Interest Income	2.5	2.7	8.0%	2.7	6.8%	1.2%
Total Operating income	12.03	12.67	5.3%	13.3	10.7%	(5.4%)
Loan Loss provision	1.7	1.7	(2.2%)	1.9	13.2%	(15.4%)
Total Operating expenses	7.0	7.3	4.0%	7.6	9.2%	(5.2%)
Profit before tax	5.0	5.4	7.0%	5.7	12.7%	(5.6%)
Profit after tax	**3.4**	**3.5**	**2.5%**	**4.0**	**16.6%**	(14.1%)

Income Statement Ratios	H1'2017	H1'2018	y/y change
Yield from interest-earning assets	12.0%	11.0%	(1.0%)
Cost of funding	5.3%	5.0%	(0.4%)
Net Interest Spread	6.6%	6.0%	(0.6%)
Net Interest Income as % of operating income	78.9%	78.4%	(0.5%)
Non-Funded Income as a % of operating income	21.1%	21.6%	0.5%
Cost to Income Ratio (CIR)	58.1%	57.4%	(0.7%)
CIR without provisions	43.9%	44.2%	0.3%
Cost to Assets	4.2%	4.2%	(0.0%)
Net Interest Margin	6.8%	6.5%	(0.3%)

Capital Adequacy Ratios	H1'2017	H1'2018
Core Capital/Total Liabilities	16.8%	17.5%
Minimum Statutory ratio	8.0%	8.0%
Excess	**9.5%**	**8.8%**
Core Capital/Total Risk Weighted Assets	17.4%	16.0%
Minimum Statutory ratio	10.5%	10.5%
Excess	**6.9%**	**5.5%**
Total Capital/Total Risk Weighted Assets	18.7%	18.0%
Minimum Statutory ratio	14.5%	14.5%
Excess	**4.2%**	**3.5%**
Adjusted Core Capital/Total Liabilities		18.9%
Adjusted Core Capital/Total Risk Weighted Assets		18.5%
Adjusted Total Capital/Total Risk Weighted Assets		19.8%
Liquidity Ratio	51.1%	51.3%
Minimum Statutory ratio	20.0%	20.0%
Excess	**31.1%**	**31.3%**