Diamond Trust Bank Kenya Earnings Update – FY'2017

26th March, 2018

Valuation Summary

- We are of the view that Diamond Trust Bank Kenya (DTBK) stock is a "Buy", with a target price of Kshs 281.7 representing an upside of 30.4%, from the current price of Kshs 218.0, as at 26th March, inclusive of a dividend yield of 1.2%,
- DTBK is currently trading at a P/TBV of 1.2x and a P/E of 6.6x, vs an industry average of 1.4x and 8.8x, respectively.

Key highlights during FY'2017

- DTBK completed the acquisition of Habib Bank Limited Kenya (HBLK) at the end of July 2017 after obtaining approvals from relevant regulators, in a transaction that took place through issuance of 13.3 mn new DTB ordinary shares at a price per share of Kshs 137.4 and resulted in an increase in Habib Bank Limited's shareholding in DTBK by 16.1% from 12.0% previously. The Competition Authority of Kenya (CAK) authorised the transaction on condition that DTBK kept 41 HBLK employees
- Diamond Trust Bank increased its branch network during the year with the opening of 6 new branches, with some of these branches opened by its Tanzanian subsidiary in order to target SMEs with loans and key financial services

Income Statement

- Core earnings per share (EPS) declined by 10.3% to Kshs 24.8 from Kshs 27.6 in FY'2016, lower than our expectations for an EPS of Kshs 26.8. The decline in performance was driven by a 10.4% increase in operating expenses, despite operating income increasing by 2.0%,
- Total operating income increased by 2.0% to Kshs 25.0 bn from Kshs 24.5 bn in FY'2016. The increase was driven by a 1.5% growth in Net Interest Income (NII) to Kshs 19.7 bn from Kshs 19.4 bn, coupled with a 4.1% growth in Non-Funded income to Kshs 5.3 bn from Kshs 5.1 bn in FY'2016,
- Interest Income increased by 2.4% to Kshs 34.6 bn from Kshs 33.8 bn in FY'2016, driven by a 22.4% increase in interest income on government securities to Kshs 11.7 bn from Kshs 9.6 bn. However, interest income on loans and advances declined 5.3% to Kshs 22.7 bn from Kshs 23.9 bn. As a result, the yield on interest-earning assets declined to 11.4% from 13.0% in FY'2016,
- Interest expense increased by 3.6% to Kshs 15.0 bn from Kshs 14.4 bn in FY'2016, following a 4.3% increase in interest expense on customer deposits to Kshs 13.5 bn from Kshs 12.9 bn in FY'2016. Cost of funds came in at 5.1%, a decline from 5.7% recorded in FY'2016. The Net Interest Margin declined to 6.5% from 7.4% in 2016,
- Non-Funded Income (NFI) recorded a growth of 4.1% to Kshs 5.3 bn from Kshs 5.1 bn in FY'2016. The growth in NFI was driven by an increase in fees and commissions on loans that rose by 15.0% to Kshs 1.3 bn from Kshs 1.1 bn in FY'2016, despite an 8.5% decline in foreign exchange trading income to Kshs 1.6 bn from Kshs 1.7 bn in FY'2016. The revenue mix currently stands at 79:21 Funded to Non-Funded Income, similar to FY'2016, owing to an increase in both NFI and NII,
- Total operating expenses increased by 10.4% to Kshs 14.9 bn from Kshs 13.5 bn, driven by an 18.5% increase in staff costs to Kshs 4.0 bn from Kshs 3.4 bn. Following the acquisition of Habib Bank Kenya Ltd. DTBK had to take on 41 HBLK staff members as a condition for the authorization of the acquisition transaction by the CAK. Loan Loss Provisions (LLP) increased marginally by 0.7% to Kshs 4.3 bn from Kshs 4.27 bn in FY'2016. Staff costs accounts for 26.8% of operating expenses while LLPs account for 28.9% of operating expenses,
- The Cost to Income ratio worsened to 59.6% from 55.1% in FY'2016, following the 10.4% increase in total operating expenses that outpaced the 2.0% increase in total operating income. Without LLP, the Cost to Income ratio also deteriorated to 42.3% from 37.6% in FY'2016,
- Profit before tax decreased by 8.1% to Kshs 10.1 bn from Kshs 11.0 bn, while profit after tax decreased by 10.3% to Kshs 6.9 bn from Kshs 7.7 bn in FY'2016. The effective tax rate increased to 31.4% from 29.7% in FY'2016,
- The group recommended a first and final dividend of Kshs 2.6 per share, same as 2016, translating to a dividend yield of 1.2%.

Balance Sheet

- The balance sheet recorded an expansion in FY'2017, with total assets increasing by 10.7% to Kshs 363.3 bn from Kshs 328.0 bn in FY'2016. This growth was driven by a 23.3% increase in investment in government securities to

Kshs 114.4 bn from Kshs 92.8 bn in FY'2016, and a 5.2% increase in the loan book to Kshs 196.1 bn from Kshs 186.3 bn in FY'2016,

- Total liabilities rose by 9.8% to Kshs 309.7 bn from Kshs 282.2 bn in FY'2016, driven by an 11.8% increase in deposits to Kshs 266.3 bn from Kshs 238.1 bn in FY'2016. Deposits per branch increased by 6.8% to Kshs 2.0 bn from Kshs 1.9 bn in FY`2016,
- The faster increase in deposits as compared to the loan book led to a decline in the loan to deposit ratio to 73.6% from 78.2% in FY'2016,
- Gross non-performing loans increased by 97.2% to Kshs 14.8 bn from Kshs 7.5 bn, validating our expectations that DTBK's asset quality has been fast deteriorating. It has emerged that DTBK was the major bank lender to Nakumatt Holdings, with an exposure of Kshs 3.6 bn, which has become in default following the retailer being placed under administration. The NPL ratio deteriorated to 7.1% in FY'2017 from 3.9% in FY'2016 as NPLs increased at a higher rate than the loan book,
- Shareholders' funds increased by 17.9% to Kshs 48.4 bn from Kshs 41.0 bn in FY'2016. This is largely due to a 17.1% increase in retained earnings to Kshs 28.0 bn from 26.8 bn.
- DTBK is currently sufficiently capitalized with a core capital to risk weighted assets ratio at 17.3%, 6.8% above the statutory requirement, with total capital to total risk weighted assets exceeding statutory requirement by 4.5%.
- DTBK currently has a return on average assets of 2.0% and a return on average equity of 14.4%.

Key Take outs:

i. Drastic Deterioration in Asset Quality. DTBK has for a long time maintained the best asset quality in the listed Banking space, being able to maintain its gross NPL ratio at lows of 1.2% (2010-2014 average). We have seen this gradually deteriorate from 1.4% in FY'2014 to 1.6% in FY'2015 to 4.1% in FY'2016 and now drastically worsen to 7.1% in FY'2017 as shown in the chart below. Going forward, DTBK will have to be more prudent in its credit risk analysis, to avoid such high NPLs that will only lead to more provisioning and affect its bottom line profits negatively,
ii. Going forward, the bank plans to increase its tech-savvy branch count to increase efficiency in running its brick-and-mortar branch network while still growing its client base and mobilizing more in deposits. We expect the lender to be very prudent in exploring measures towards maintaining efficiency.

Going forward, we expect DTBK's growth to be propelled by looking at the following areas;

(i) DTBK's NFI is way below industry average, with the bank's NFI contribution to total revenue at 21%, compared to the banking sector average of 35%,
(ii) Improvements in asset quality, with the DTBK's NPL's rising drastically over the year, bringing the bank's NPL ratio to 7.1%, which is much closer to industry average at 7.9%,

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'2016	FY'2017	y/y change	FY'2017e	Projected %y/y change	Variance in Growth Actual vs. Expected
Government Securities	92.8	114.4	23.3%	108.9	17.4%	5.9%
Net Loans and Advances	186.3	196.0	5.2%	203.9	9.5%	(4.2%)
Total Assets	**328.0**	**363.3**	**10.7%**	**368.1**	**12.2%**	**(1.5%)**
Customer Deposits	238.1	266.2	11.8%	275.6	15.8%	(3.9%)
Total Liabilities	282.2	309.7	9.8%	314.6	11.5%	(1.7%)
Shareholders' Funds	**41.0**	**48.4**	**17.9%**	**48.4**	**17.9%**	**0.0%**

Balance Sheet Ratios	FY'2016	FY'2017	y/y change
Loan to Deposit Ratio	78.2%	73.6%	(4.6%)
Return on average equity	20.5%	13.9%	(6.6%)
Return on average assets	2.6%	2.0%	(0.6%)

Income Statement	FY'2016	FY'2017	y/y change	FY'2017e	Projected %y/y change	Variance in Growth Actual vs. Expected
Net Interest Income	19.4	19.7	1.5%	19.6	1.2%	0.3%
Net non-Interest Income	5.1	5.3	4.1%	5.3	4.2%	(0.1%)
Total Operating income	24.45	24.95	2.0%	24.9	1.8%	0.2%
Loan Loss provision	4.3	4.3	0.7%	3.6	(15.9%)	16.6%
Total Operating expenses	13.5	14.9	10.4%	14.2	5.5%	4.9%
Profit before tax	11.0	10.1	(8.1%)	10.7	(2.6%)	(5.5%)
Profit after tax	**7.7**	**6.9**	**(10.3%)**	**7.5**	**(2.9%)**	(7.4%)

Income Statement Ratios	FY'2016	FY'2017	y/y change
Yield from interest-earning assets	13.0%	11.4%	(1.6%)
Cost of funding	5.7%	5.1%	(0.6%)
Net Interest Spread	7.3%	6.2%	(1.1%)
Net Interest Income as % of operating income	79.3%	78.9%	(0.4%)
Non-Funded Income as a % of operating income	20.7%	21.1%	0.4%
Cost to Income Ratio (CIR)	55.1%	59.6%	4.5%
CIR without provisions	37.6%	42.3%	4.7%
Cost to Assets	3.1%	3.1%	(0.0%)
Net Interest Margin	7.4%	6.5%	(1.0%)

Capital Adequacy Ratios	FY'2016	FY'2017
Core Capital/Total Liabilities	17.4%	18.5%
Minimum Statutory ratio	8.0%	8.0%
Excess	**9.4%**	**10.5%**
Core Capital/Total Risk Weighted Assets	16.2%	17.3%
Minimum Statutory ratio	10.5%	10.5%
Excess	**5.7%**	**6.8%**
Total Capital/Total Risk Weighted Assets	18.5%	19.0%
Minimum Statutory ratio	14.5%	14.5%
Excess	**4.0%**	**4.5%**
Liquidity Ratio	50.2%	49.9%
Minimum Statutory ratio	20.0%	20.0%