Diamond Trust Bank Group – Q1'2018

25th May, 2018

Valuation Summary

- We are of the view that Diamond Trust Bank is a "Buy" with a target price of Kshs 272.9, representing an upside of 42.9%, from the current price of Kshs 191.0 as of 25th May, inclusive of a dividend yield of 1.3%,
- Diamond Trust Bank is currently trading at P/TBV of 1.1x and a P/E of 8.2x vs an industry average of 1.7x and 10.3x, respectively.

Key Highlights Q1'2018

- Diamond Trust Bank (DTB) has suspended all transactions on Nakumatt Global cards. The bank, which has been the lead issuer of Nakumatt Global Prepaid cards since 2013, stated that it has halted all transactions carried out on point of sale machines, ATMs or online. DTB, which is Nakumatt's single-largest creditor, supports the revival of the retailer rather than liquidation.
- Diamond Trust Bank secured a USD 75.0 mn (Kshs 7.6 bn) loan deal with the African Development Bank (AfDB) at undisclosed interest rates for onward lending to SMEs and boost its capital. The seven-year credit deal comprises USD 50.0 mn (Kshs 5.0 bn) line of credit for onward lending to small and medium-sized enterprises and USD 25 mn (Kshs 2.5 bn) subordinated loan to boost its tier-two capital. The credit line largely targets firms in trade, transport, construction and manufacturing sectors in Kenya, Tanzania, Uganda and Burundi where it operates more than 130 outlets

Income Statement

- Core earnings per share increased by 3.0% to Kshs 6.0 from Kshs 5.9 in Q1'2017, which was slightly below our expectation of a 4.3% increase to Kshs 6.5. Performance was driven by a 5.2% increase in total operating income, despite a 6.3% increase in the total operating expenses,
- Total operating income increased by 5.2% to Kshs 6.2 bn in Q1'2018 from Kshs 5.9 bn in Q1'2017. This was due to a 5.4% increase in Net Interest Income (NII) to Kshs 4.9 bn from Kshs 4.6 bn in Q1'2017, coupled with a 4.4% increase in Non-Funded Income (NFI) to Kshs 1.4 bn from Kshs 1.3 bn in Q1'2017,
- Interest income increased by 4.9% to Kshs 8.6 bn from Kshs 8.2 bn in Q1'2017. The interest income on loans and advances increased by 8.8% to Kshs 8.4 bn from Kshs 7.7 bn in Q1'2017. Interest income on government securities declined, albeit marginally, by 0.3% to Kshs 5.5 bn in Q1'2018. The yield on interest earning assets however declined to 11.3% in Q1'2018 from 12.5% in Q1'2017, due to the relatively faster increase in the interest earning assets by 12.0% to Kshs 327.0 bn from Kshs 292.0 bn in Q1'2017,
- Interest expense increased by 4.2% to Kshs 3.7 bn from Kshs 3.6 bn in Q1'2017, as interest expense on customer deposits increased 2.7% to Kshs 3.3 bn from Kshs 3.2 bn in Q1'2017. Interest expense on deposits from other banking institutions rose 117.2% to Kshs 0.2 bn from Kshs 0.1 bn in Q1'2017. Other interest expenses declined by 18.0% to Kshs 0.2 bn in Q1'2018 from Kshs 0.3 bn in Q1'2017. The cost of funds declined to 5.1% from 5.5% in Q1'2017. The Net Interest Margin declined to 6.4% from 7.2% in Q1'2017,
- Non-Funded Income increased by 4.4% to Kshs 1.4 bn from Kshs 1.3 bn in Q1'2017. The growth in NFI was driven by a 5.0% increase in other fees and commissions income to Kshs 0.51 bn from Kshs 0.48 bn in Q1'2017, and a 131.0% increase in other income to Kshs 93.8 mn from Kshs 40.6 mn in Q1'2017. Forex trading income however declined by 14.7% to Kshs 365.8 mn from Kshs 429.1 mn in Q1'2017. The revenue mix remained unchanged at 78:22 funded to non-funded income, similar to Q1'2017.
- Total operating expenses increased by 6.3% to Kshs 3.5 bn from Kshs 3.3 bn, largely driven by a 28.7% increase in rental charges to Kshs 238.3 mn in Q1'2018 from Kshs 185.2 mn in Q1'2017, coupled with an 11.3% increase in other operating expenses to Kshs 1.2 bn in Q1'2018 from Kshs 1.1 bn in Q1'2017. The Loan Loss Provisions (LLP) increased by 10.0% to Kshs 0.70 bn from Kshs 0.63 bn in Q1'2017, largely

due to an increase in the non-performing loans by 82.4%, coupled with increased provisioning levels due to implementation of IFRS 9. Staff costs reduced marginally by 0.6% to Kshs 1.027 bn from Kshs 1.033 bn in Q1'2017.

- The cost to income ratio deteriorated to 56.3% from 55.7% in Q1'2017. Without LLP, the Cost to income ratio also worsened marginally to 45.0% from 44.9% in Q1'2017,
- Profit before tax increased by 3.9% to Kshs 2.7 bn, up from Kshs 2.6 bn in Q1'2017. Profit after tax increased 3.0% to Kshs 1.80 bn in Q1'2018 from Kshs 1.75 bn in Q1'2017,

Balance Sheet

- The balance sheet recorded an expansion with total assets increasing by 9.6% to Kshs 367.7 bn from Kshs 335.3 bn in Q1'2017. This growth was largely driven by a 16.0% increase in government securities to Kshs 89.4 bn from Kshs 77.2 bn in Q1'2017.
- The loan book increased by 3.0% to Kshs 194.1 bn in Q1'2018 from Kshs 188.4 bn in Q1'2017,
- Total liabilities rose by 8.7% to Kshs 312.8 bn from Kshs 287.8 bn in Q1'2017, driven by an 11.6% increase in total deposits to Kshs 290.9 bn from Kshs 260.8 bn in Q1'2017. Deposits per branch increased by 11.6% to Kshs 2.1 bn from Kshs 1.9 bn in Q1'2017
- The faster growth in deposits as compared to loans led to a decline in the loan to deposit ratio to 71.4% from 76.5% in Q1'2017,
- Gross non-performing loans increased by 82.4% to Kshs 15.4 bn in Q1'2018 from Kshs 8.4 bn in Q1'2017. Consequently, the NPL ratio deteriorated to 7.1% in Q1'2018 from 4.1% in Q1'2017. Loan loss provisions increased by 52.0% to Kshs 8.3 bn from Kshs 5.5 bn in Q1'2017.Consequently, the NPL coverage decreased to 68.0% in Q1'2018 from 87.0% in Q1'2017, due to the relatively faster increase in the gross non-performing loans. The increase in the non-performing loans could be attributed to loan defaults by Nakumatt to which DTB had extended a credit line of Kshs 3.7 bn.
- Shareholders' funds increased by 16.7% to Kshs 49.7 bn in Q1'2018 from Kshs 42.6 bn in Q1'2017.
- Diamond Trust Bank is currently sufficiently capitalized with a core capital to risk weighted assets ratio of 17.5%, 7.0% above the statutory requirement. In addition, the total capital to risk weighted assets ratio was 19.1%, exceeding the statutory requirement by 4.6%. Adjusting for IFRS 9, the core capital to risk weighted assets stood at 19.1%, while total capital to risk weighted assets came in at 20.7%, indicating that the bank's total capital relative to its risk-weighted assets declined by 1.6% due to implementation of IFRS 9,
- Diamond Trust Bank currently has a return on average assets of 1.8% and a return on average equity of 13.8%.

Key Take-Outs:

1. Diamond Trust Bank's NFI currently stands at 22.0%, which is way below the industry average of 33.6%. The low NFI contribution to total income is an indication of lack of diversity in generating revenue from alternative sources other than interest income. DTB should find avenues to increase its NFI so as to compete favorably with its peers in the wake of the rate cap legislation. DTB is currently venturing into bancassurance with Defender insurance policy which targets motorists, in addition to alternative distribution channels such as point of sales (P.O.S) and agency banking, which are in line with the bank's Vision 2020 of being an omnichannel bank offering multiple services to customers.
2. The bank saw a deterioration in its Cost-to-income ratio to 56.3% from 55.8% in Q1'2017. This is a pointer to inefficiencies in the company's operations resulting in higher expense growth as opposed to income growth.
3. The bank experienced a deterioration in asset quality, with gross non-performing loans (NPLs) rising by 82.4%, to Kshs 15.4 bn from Kshs 8.4 bn in Q1'2017. This was largely due to major clients such as Nakumatt defaulting on a kshs 3.7 bn loan issued to the retailer by the bank. However, provisioning

levels failed to rise in tandem, increasing by 10.0%, leading to a decline in the NPL coverage to 68.0% in Q1’2018 from 87.0% in Q1’2017

We expect the bank’s growth to be further driven by:

a. Non-Funded Income Growth Initiatives - DTB’s NFI is way below with the industry average, coming in at 22.0%, while the industry average is at 33.6%. The bank needs to put more focus on growing its agency banking network and expansion of its digital channels to improve efficiencies while increasing transactions. This will enable DTB acquire higher transactional income, thereby increasing its NFI growth and contribution to total income. In addition, DTB is currently venturing into bancassurance with Defender insurance policy that targets motorists, with the aim to increase the bank’s fee income businesses,
b. DTB experienced a deterioration in asset quality, with gross non-performing loans (NPLs) rising by 82.4%, to Kshs 15.4 bn from Kshs 8.4 bn in Q1’2017. This was largely due to major clients such as Nakumatt defaulting on a Kshs 3.7 bn loan issued to the retailer by the bank. However, provisioning levels failed to rise in tandem, increasing by 9.7%, leading to a decline in the NPL coverage to 68.0% in Q1’2018 from 87.0% in Q1’2017. The bank needs to adopt initiatives that will aid to improve the asset quality of the bank, and consequently reduce the loan-loss provision expense.

Balance Sheet Items	Q1'2017	Q1'2018	y/y change	Q1'2018e	Projected %y/y change	Variance in Growth Actual vs. Expected
Government Securities	98.3	119.4	21.5%	110.7	12.7%	8.8%
Net Loans and Advances	188.4	194.1	3.0%	205.6	9.1%	(6.1%)
Total Assets	**335.3**	**367.7**	**9.6%**	**372.4**	**11.0%**	**(1.4%)**
Customer Deposits	251.4	271.9	8.1%	281.6	12.0%	(3.9%)
Total Liabilities	287.8	312.8	8.7%	323.1	12.2%	(3.6%)
Shareholders’ Funds	**42.6**	**49.7**	**16.7%**	**44.4**	**4.3%**	**12.4%**

Balance Sheet Ratios	Q1'2017	Q1'2018	y/y change
Loan to Deposit Ratio	74.9%	71.4%	(3.5%)
Return on average equity	20.2%	13.8%	(6.4%)
Return on average assets	2.5%	1.8%	(0.7%)

Income Statement	Q1'2017	Q1'2018	y/y change	Q1'2018e	Projected %y/y change	Variance in Growth Actual vs. Expected
Net Interest Income	4.6	4.9	5.4%	5.1	10.1%	(4.6%)
Net non-Interest Income	1.3	1.3	4.4%	1.4	8.1%	(3.7%)
Total Operating income	5.89	6.20	5.2%	6.5	9.6%	(4.4%)
Loan Loss provision	0.6	0.7	9.7%	1.0	55.1%	(45.4%)
Total Operating expenses	3.3	3.5	6.3%	3.9	17.5%	(11.3%)
Profit before tax	2.6	2.7	3.9%	2.6	(0.3%)	4.2%
Profit after tax	**1.8**	**1.8**	**3.0%**	**1.8**	**4.3%**	**(1.3%)**

Income Statement Ratios	Q1'2017	Q1'2018	y/y change
Yield from interest-earning assets	12.5%	11.3%	(1.1%)
Cost of funding	5.5%	5.1%	(0.4%)
Net Interest Spread	6.9%	6.2%	(0.8%)

Net Interest Income as % of operating income	78.3%	78.5%	0.2%
Non-Funded Income as a % of operating income	21.7%	21.5%	(0.2%)
Cost to Income Ratio (CIR)	55.7%	56.3%	0.5%
CIR without provisions	44.9%	45.0%	0.1%
Cost to Assets	4.3%	4.3%	(0.0%)
Net Interest Margin	7.2%	6.4%	(0.7%)

Capital Adequacy Ratios	Q1'2017	Q1'2018
Core Capital/Total Liabilities	16.8%	18.2%
Minimum Statutory ratio	8.0%	8.0%
Excess	**8.8%**	**10.2%**
Core Capital/Total Risk Weighted Assets	15.9%	17.5%
Minimum Statutory ratio	10.5%	10.5%
Excess	**5.4%**	**7.0%**
Total Capital/Total Risk Weighted Assets	18.1%	19.1%
Minimum Statutory ratio	14.5%	14.5%
Excess	**3.6%**	**4.6%**
Liquidity Ratio	52.0%	51.5%
Minimum Statutory ratio	20.0%	20.0%
Excess	**32.0%**	**31.5%**
Adjusted Core Capital/Total Liabilities	**19.9%**	
Adjusted Core Capital/Total Risk Weighted Assets	**19.1%**	
Adjusted Total Capital/Total Risk Weighted Assets	**20.7%**	