Cytonn INVESTMENTS

Diamond Trust Bank Kenya Earnings Update – Q3'2017

17th November, 2017

Valuation Summary

- We are of the view that Diamond Trust Bank Kenya (DTBK) stock is a "buy", with a target price of Kshs 234.1 representing an upside of 26.5%, from the current price of Kshs 187.0, as at 17th November, inclusive of a dividend yield of 1.3%,
- DTBK is currently trading at a P/TBV of 1.0x and a P/E of 6.6x, vs an industry average of 1.4x and 8.3x, respectively.

Key highlights during Q3'2017

- 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.

Income Statement

- Core earnings per share (EPS) declined by 3.5% to Kshs 18.3 from Kshs 19.0 in Q3'2016, driven by a 0.2% decline in total operating income, and a 2.5% increase in operating expenses. This was in line with our expectations of a 5.1% core EPS decline,
- Total operating income declined marginally by 0.2% to Kshs 18.37 bn from Kshs 18.40 bn in Q3'2016. The stable performance was supported by a 4.7% growth in Non-Funded income to Kshs 3.9 bn from Kshs 3.7 bn in Q3'2016, despite a 1.4% decline in Net Interest Income(NII),
- Interest Income increased slightly by 0.8% to Kshs 25.7 bn from Kshs 25.5 bn in Q3'2016, outpaced by the 3.7% growth in interest expense to Kshs 11.2 bn from Kshs 10.8 bn in Q3'2016, leading to a 1.4% decline in the Net Interest Income to Kshs 14.5 bn from Kshs 14.7 bn. The Net Interest Margin thus declined to 6.4% from 7.6% in Q3'2016,
- Non-Funded Income (NFI) recorded a growth of 4.7% to Kshs 3.9 bn from Kshs 3.7 bn in Q3'2016. The growth in NFI was driven by an increase in total fees and commissions on loans that rose by 22.0% to Kshs 933.6 mn from Kshs 765.3 mn in Q3'2016 despite the 9.7% decline in foreign exchange trading income to Kshs 1.2 bn from Kshs 1.3 bn in Q3'2016,
- The current revenue mix remained relatively the same at 79:21 funded to non-funded income from 80:20 in Q3'2016,
- Total operating expenses increased by 2.5% to Kshs 10.9 bn from Kshs 10.6 bn, driven by an 8.3% increase in staff costs to Kshs 3.0 bn from Kshs 2.8 bn as DTBK had to take on 41 HBLK staff members as a condition for the authorization of the acquisition transaction by the CAK. This was despite a decline in Loan Loss Provisions (LLP) by 19.6% to Kshs 3.0 bn from Kshs 3.6 bn in Q3'2016. Staff costs accounts for 27.4% of operating expenses while LLPs account for 26.7% of operating expenses,
- The Cost to Income ratio worsened to 59.1% from 57.6% in Q3'2016 following a 2.5% increase in total operating expenses coupled with a 0.2% decline total operating income. Without LLP, the Cost to Income ratio deteriorated by a bigger margin to 43.3% from 38.0% in Q3'2016,
- Profit before tax decreased by 3.6% to Kshs 7.5 bn from Kshs 7.8 bn, while profit after tax decreased by 3.5% to Kshs 5.1 bn from Kshs 5.3 bn in Q3'2016.

Balance Sheet

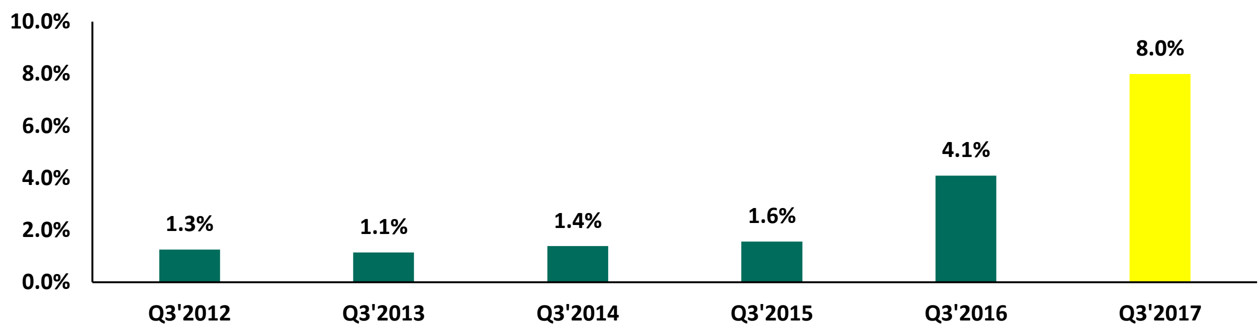
- The balance sheet recorded an expansion in Q3'2017, with total assets increasing by 13.8% to Kshs 357.2 bn from Kshs 313.8 bn in Q3'2016. This growth was driven by an 18.2% increase in investment in government securities to Kshs 109.0 bn from Kshs 92.2 bn in Q3'2016, and an 8.1% increase in the loan book, which is 55.0% of the bank's total assets, to Kshs 196.3 bn from Kshs 181.6 bn in Q3'2016. The value of property & equipment also increased by 21.8% y/y to Kshs 6.7 bn from Kshs 5.5 bn in Q3'2016, attributed to the completion of acquisition of 5 HBLK branches in Kenya,
- Total liabilities rose by 12.6% to Kshs 305.3 bn from Kshs 271.2 bn in Q3'2016, driven by a 16.5% increase in deposits to Kshs 265.0 bn from Kshs 227.4 bn in Q3'2016. Shareholders' funds increased by 23.6% to Kshs 46.7 bn from Kshs 37.8 bn in Q3'2016,

- The faster increase in deposits than in the loan book led to a decline in the loan to deposit ratio to 74.1% from 79.8% in Q3'2016,
- Gross non-performing loans increased by a whopping 113.8% to Kshs 16.6 bn from Kshs 7.8 bn, validating our expectations that DTBK’s asset quality was fast deteriorating. It cannot be fully attributed to the acquisition of HBLK because as at H1’2017, HBLK’s gross NPLs were at just Kshs 851.0 mn compared to DTBK’s at Kshs 9.2 bn; a mere 9.2% of DTBK’s book. HBLK’s loan book was worth Kshs 3.1 bn as at H1’2017; even if most of it was classified as bad loans upon consolidation, it would still not be enough to account for the Kshs 8.8 bn y/y and Kshs 7.4 bn q/q increase in gross NPLs. This coupled with a decline in loan book led to an increase in the NPL ratio to 8.0% from 4.1% in Q3’2016 highlighting concerns around asset quality,
- The yield on interest earning assets declined to 8.6% from 10.2% in Q3’2016, while the cost of funds also declined to 4.0% from 4.6% in Q3’2016,
- DTBK is currently sufficiently capitalized with a core capital to risk weighted assets ratio at 16.5%, 6.0% above the statutory requirement, with total capital to total risk weighted assets exceeding statutory requirement by 3.9%.
- DTBK currently has a return on average assets of 2.2% and a return on average equity of 17.8%.

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 Q3’2014 to 1.6% in Q3’2015 to 4.1% in Q3’2016 and now drastically worsen to 8.0% in Q3’2017 as shown in the chart below. Given DTBK got around just Kshs 851.0 mn of gross NPLs from the acquisition of HBLK, compared to its H1’2017 gross NPLs of Kshs 7.8 bn and current NPLs of Kshs 16.6 bn, we cannot fully attribute the increase in NPL ratio to this. 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,

Gross NPL Ratio



ii. **Branch Expansion**. Despite most banks holding off on branch expansion plans or even reducing their brick and mortar branch network in countries present to increase efficiency by reducing operating expenses associated with running a full branch and staff costs, DTBK has added two branches during the first quarter of the year, one in Two Rivers Mall and the other in Rivaan Center. This, coupled with the acquisition of 5 branches of HBLK through a transaction completed in July 2017 has seen the lender’s total branch network increase to 66 branches. DTB also had to retain 41 HBLK employees as part of the transaction. This has led to a deterioration of the cost to income ratio (without LLPs) to 43.3% from 38.0% in Q3’2016. Deposits however, have exhibited double digit growth of 16.5%. We expect DTB to find a balance between efficiency and deposit mobilization in their branch expansion plan going forward,

iii. 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.

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	Q3'2016	Q3'2017	y/y change	Q3'2017e	Projected %y/y change	Variance in Growth Actual vs. Expected
Government Securities	92.2	109.0	18.2%	91.9	(0.3%)	18.5%
Net Loans and Advances	181.6	196.3	8.1%	195.6	7.7%	0.4%
Total Assets	**313.8**	**357.2**	**13.8%**	**350.8**	**11.8%**	**2.0%**
Customer Deposits	227.4	265.0	16.5%	261.5	15.0%	1.6%
Total Liabilities	271.2	305.3	12.6%	300.7	10.9%	1.7%
Shareholders' Funds	**37.8**	**46.7**	**23.6%**	**45.1**	**19.4%**	**4.2%**

Balance Sheet Ratios	Q3'2016	Q3'2017	y/y change
Loan to Deposit Ratio	79.8%	74.1%	(5.8%)
Return on average equity	20.4%	17.8%	(2.6%)
Return on average assets	2.6%	2.2%	(0.3%)

Income Statement	Q3'2016	Q3'2017	y/y change	Q3'2017e	Projected %y/y change	Variance in Growth Actual vs. Expected
Net Interest Income	14.7	14.5	(1.4%)	14.5	(1.3%)	(0.1%)
Net non-Interest Income	3.7	3.9	4.7%	3.8	2.3%	2.4%
Total Operating income	18.40	18.37	(0.2%)	18.3	(0.5%)	0.4%
Loan Loss provision	3.6	2.9	(19.6%)	2.9	(20.5%)	0.8%
Total Operating expenses	10.6	10.9	2.5%	11.1	4.8%	(2.4%)
Profit before tax	7.8	7.5	(3.6%)	7.2	(7.7%)	4.1%
Profit after tax	**5.3**	**5.1**	**(3.5%)**	**5.0**	**(5.1%)**	1.6%

Income Statement Ratios	Q3'2016	Q3'2017	y/y change
Yield from interest-earning assets	10.2%	8.6%	(1.6%)
Cost of funding	4.6%	4.0%	(0.6%)
Net Interest Spread	5.6%	4.7%	(1.0%)
Net Interest Income as % of operating income	79.8%	78.8%	(1.0%)
Non-Funded Income as a % of operating income	20.2%	21.2%	1.0%
Cost to Income Ratio (CIR)	57.6%	59.1%	1.5%
CIR without provisions	38.0%	43.3%	5.3%
Cost to Assets	3.3%	3.0%	(0.2%)
Net Interest Margin	7.6%	6.4%	(1.2%)

Capital Adequacy Ratios	Q3'2016	Q3'2017
Core Capital/Total Liabilities	16.5%	17.5%
Minimum Statutory ratio	8.0%	8.0%
Excess	**8.5%**	**9.5%**
Core Capital/Total Risk Weighted Assets	14.9%	16.5%
Minimum Statutory ratio	10.5%	10.5%
Excess	**4.4%**	**6.0%**
Total Capital/Total Risk Weighted Assets	17.3%	18.4%
Minimum Statutory ratio	14.5%	14.5%
Excess	**2.8%**	**3.9%**
Liquidity Ratio	48.5%	51.2%
Minimum Statutory ratio	20.0%	20.0%
Excess	**28.5%**	**31.2%**