Valuations

- We are of the view that Equity Group Holdings is a "Buy" with a target price of Kshs 53.7, representing an upside of 42.7%, from the current price of Kshs 40.3 as of 2nd August, inclusive of a dividend yield of 5.0%,
- Equity Group Holdings is currently trading at P/TBV of 1.7x and a P/E of 7.3x vs an industry average of 1.3x and 6.6x, respectively.

Key Highlights H1'2019

- Equity Group Holdings opened a commercial representative office in Addis Ababa, Ethiopia, which is expected to commence operations in July, in line with the bank's strategy to expand into 10 African countries by 2020, with Ethiopian market being the first phase of regional expansion drive to attain Pan African status.

Income Statement

- Core earnings per share increased by 9.1% to Kshs 3.2 from Kshs 2.6 in H1'2018, faster than our projections of a 7.3% increase to Kshs 3.1. The performance was driven by a 9.8% increase in total operating income, despite the 19.4% increase in total operating expenses. The variance in core earnings per share growth against our expectations was largely due to a faster 6.4% growth in total operating income to Kshs 37.6 bn, from Kshs 32.8 bn in H1'2018, which was not in line with our expectation of a 8.4% increase to Kshs 35.5 bn,
- Total operating income recorded a 14.8% growth to Kshs 37.6 bn, from Kshs 32.8 bn in H1'2018. This was driven by a 25.6% growth in Non-Funded Income (NFI) to Kshs 16.5 bn, from Kshs 13.2 bn in H1'2018, coupled with a 7.6% growth in Net Interest Income to Kshs 21.1 bn, from Kshs 19.6 bn in H1'2018,
- Interest income increased by 9.2% to Kshs 27.7 bn, from 25.4 bn in H1'2018. The interest income on loans and advances increased by 8.8% to Kshs 18.6 bn from Kshs 17.1 bn in H1'2018. Interest income on government securities increased by 7.4%, rising to Kshs 8.5 bn, from Kshs 7.9 bn in H1'2018. The slightly stronger growth in interest income on loans as compared to interest from government securities is indicative of the benefits accruing to Equity Group Holding's owing to increased lending to the private sector, with the loans extended to the private sector rising by 16.7% in H1'2019 compared to the 3.8% growth recorded in H1'2018. The yield on interest earning assets, however, declined by 0.4% points to 11.0%, from 11.4% in H1'2018, owing to declining yields on government securities,
- Interest expense rose by 14.3% to Kshs 6.6 bn, from Kshs 5.8 bn in H1'2018, following the 11.1% increase in the interest expense on customer deposits to Kshs 5.2 bn, from Kshs 4.7 bn in H1'2018, coupled with an 84.0% increase in interest expense on placements to Kshs 0.4 bn from Kshs 0.2 bn in H1'2018, and a 16.3% increase in other interest expenses to Kshs 1.0 bn from Kshs 0.9 bn in H1'2018. The cost of funds however declined to 2.6%, from 2.7% in H1'2018, owing to a faster increase in interest bearing liabilities that rose by 15.3% to Kshs 514.5 bn, from Kshs 446.3 bn in H1'2018. The Net Interest Margin (NIM) thus declined to 8.5%, from 8.8% in H1'2018,
- Non-Funded Income (NFI) recorded a 25.6% growth to Kshs 16.5 bn, from Kshs 13.2 bn in H1'2018. The growth was mainly driven by the 80.7% increase in other income to Kshs 4.7 bn, from Kshs 2.6 bn in H1'2018, which was due to the successful execution of the Equity's 3.0 innovative business strategy which is centered on digitization and virtualization. The growth was also supported by the 16.1% growth in other fees and commissions to Kshs 7.3 bn, from Kshs 6.3 bn in H1'2018, and a 20.2% growth in forex trading income to Kshs 1.8 bn, from Kshs 1.6 bn in H1'2018, with management noting that the forex income segment benefitted from

increased remittances from the diaspora. The growth in NFI was however weighed down by the 1.1% decline in fees and commissions on loans to Kshs 2.75 bn, from Kshs 2.78 bn in H1’2018, which may be attributed to continued effects of the implementation of the Effective Interest Rate (EIR) model under IFRS 9, which requires banks to amortize the fees and commissions on loans throughout the tenor of a loan,

- The revenue mix shifted to 56:44 from 60:40 funded to non-funded income, owing to the faster growth in NFI as compared to growth in NII,
- Total operating expenses rose by 19.4% to Kshs 20.6 bn, from Kshs 17.3 bn in H1’2018, largely driven by a 16.7% increase in Loan Loss Provisions (LLP) to Kshs 0.9 bn, from Kshs 0.8 bn in H1’2018, coupled with a 22.1% growth in other operating expenses to Kshs 13.8 bn, from Kshs 11.3 bn in H1’2018, and a 13.8% rise in staff costs to Kshs 5.9 bn, from Kshs 5.2 bn in H1’2018,
- As a result, the Cost to Income Ratio (CIR) deteriorated to 54.8%, from 52.8% in H1’2018. Without LLP, the cost to income ratio also deteriorated to 52.4%, from 50.4% in H1’2018,
- Profit before tax increased by 9.8% to Kshs 17.0 bn, up from Kshs 15.5 bn in H1’2018. Profit after tax recorded an 8.9% growth to Kshs 12.0 bn, from Kshs 11.0 bn, with the difference in growth attributable to the marginal increase in the effective tax rate to 29.3% from 28.8% in H1’2018.

Balance Sheet

- The balance sheet recorded an expansion as total assets grew by 17.8% to Kshs 638.6 bn, from Kshs 542.0 bn in H1’2018. Growth was supported by a 16.7% growth in loans and advances to Kshs 320.9 bn, from Kshs 275.0 bn in H1’2018, coupled with a 13.0% growth in government Securities to Kshs 179.6 bn, from Kshs 158.9 bn in H1’2018,
- Total liabilities recorded a 17.6% growth to Kshs 535.9 bn, from Kshs 455.7 bn in H1’2018, supported by a 16.5% growth in customer deposits which rose to Kshs 458.6 bn, from Kshs 393.7 bn in H1’2018, coupled with the 139.5% growth in other liabilities to Kshs 20.5 bn, from Kshs 8.5 bn in H1’2018,
- Borrowings rose by 4.6% to Kshs 51.4 bn, from Kshs 49.1 bn in H1’2018,
- The comparable growth in both loans and deposits led to a marginal increase in the loan to deposit ratio to 70.0%, from 69.9% in H1’2018,
- Gross Non-Performing Loans (NPLs) increased by 19.6% to Kshs 29.2 bn in H1’2019, from Kshs 24.5 bn in H1’2018. The NPL ratio thus deteriorated to 8.8% in H1’2019 from 8.5% in H1’2018. The deterioration in asset quality was largely attributed to various segments such as large enterprises, Small and Medium Enterprises (SMEs) and Agriculture, which had NPLs of 10.6%, 10.2% and 6.1%, respectively. The group’s Tanzania subsidiary contributed 25.7% of the NPLs, with South Sudan and Kenya contributing 12.9% and 8.7%, respectively. General Loan Loss Provisions decreased by 1.7% to Kshs 9.4 bn, from Kshs 9.6 bn in H1’2018. Thus, the NPL coverage deteriorated to 73.7% in H1’2019 from 79.9% in H1’2018,
- Shareholder’s funds recorded a 17.9% growth to Kshs 101.8 bn, from Kshs 86.3 bn in H1’2018, supported by an 18.4% increase in retained earnings to Kshs 89.4 bn, from Kshs 75.5 bn in H1’2018,
- Equity Group remains sufficiently capitalized with a core capital to risk-weighted assets ratio of 17.5%, 7.0% points above the statutory requirement of 10.5%. In addition, the total capital to risk-weighted assets ratio came in at 19.5%, exceeding the statutory requirement of 14.5% by 5.0% points. Adjusting for IFRS 9, the core capital to risk weighted assets stood at 18.4%, while total capital to risk-weighted assets came in at 20.4%, and,

- The bank currently has a Return on Average Assets (ROaA) of 3.5%, and a Return on Average Equity (ROaE) of 22.1%.

Key Take-Outs:

1. The bank’s geographical diversification strategy has continued to emerge as a net positive, with the bank’s various subsidiaries in Uganda, DRC, Rwanda, Tanzania and South Sudan cumulatively contributing 19.0% of the bank’s total profitability and 27.0% of the group’s total asset base. Equity Group Holdings opened a commercial representative office in Addis Ababa, Ethiopia, and expected to commence operations in July. This is line with the bank’s strategy to expand into 10 African countries within the year, with Ethiopian market being the first phase of regional expansion drive to attain Pan African status. The venture will affirm the bank’s position as the biggest bank in Kenya by customers. The venture will affirm the bank’s position as the biggest bank in Kenya by customers. Kenyan banks have been expanding their operations into neighbouring countries in search of growth, to diversify their earnings as competition intensifies in the local market, as margins remains compressed under the current interest rate cap regime. This is in line with the group’s strategy to attain a Kshs 1.0 tn asset base, and a maximum contribution of 30.0% of the total profitability by a single subsidiary,
2. Increased innovation and digitization have seen 97.0% of all transactions of the bank being done on alternative channels, with mobile transactions taking up 77.4% of all transactions, and agency banking contributing 12.2% of all transactions. However, in terms of value of transactions, branches contributed 48.5% of the value of all transactions, with agency banking and mobile contributing 17.7% and 16.4%, respectively. This highlights the transformation of branches to handle high value transactions. This transformation aids the bank in offering its ecosystem banking products to corporate and SME clients,
3. The bank’s Non-Funded Income bucked its declining trend, growing by 25.6% y/y, largely aided by a recovery in transactional income, as management indicated that the bank was now monetizing its transactional channels. However, fees and commissions on loans segment continued its declining trend, which may be attributed to the implementation of the EIR model under IFRS 9. With the banks’ NFI contribution to total income currently at 44.0%, it is still way above the current industry average of 33.2%, and,
4. The bank’s asset quality deteriorated, with the NPL ratio deteriorating to 8.8% in H1’2019 from 8.5% in H1’2018. The main sectors that contributed to the NPLs are large enterprises and SMEs. In terms of the regional distribution of NPLs, the regions with the highest NPLs were Tanzania at 25.7% of their loan book, followed by South Sudan at 12.9% of their loan book. With the interest rate cap set to remain in place in Kenya, the bank has ramped up its loan disbursement to its customers in the region, and will have to improve on its credit assessment in these markets in order to bring down the high NPL ratios in some of its regional subsidiaries.

We expect the bank’s growth to be further propelled by;

i. Channelled diversification, which is likely to further improve on efficiency, with emphasis on alternative channels of transactions, as the bank rides on the digital revolution wave, thereby further improving the cost to income ratio by cost rationalization and revenue expansion. This will likely propel the bank’s prospects of achieving sustainable growth, as it replicates its successful business model across its various regional subsidiaries, and,
ii. The bank’s operating model of enhancing balance sheet agility, which is likely to place the bank in a prime position to take advantage of any opportunities that may arise, such as attractive inorganic growth via acquisitions or fast lending in the event of a repeal of the

interest rate cap. The bank's balance sheet agility is seen given the bank's high liquidity ratio of 56.5%.

Below is a summary of the bank's performance:

Balance Sheet Items	H1'2018	H1'2019	y/y change	H1'2019e	Expected y/y change	Variance in Actual Growth vs Expected
Government Securities	158.8	179.6	13.0%	144.2	(9.3%)	22.3%
Net Loans and Advances	275.0	320.9	16.7%	312.0	13.4%	3.2%
Total Assets	542.0	638.7	17.8%	628.7	16.0%	1.8%
Customer Deposits	393.7	458.6	16.5%	445.6	13.2%	3.3%
Total Liabilities	455.7	535.9	17.6%	527.7	15.8%	1.8%
Shareholder's Funds	86.3	101.8	17.9%	100.0	15.9%	2.0%

Balance Sheet Ratios	H1'2018	H1'2019	y/y change
Loan to Deposit Ratio	69.9%	70.0%	0.1%
Return on Average Equity	23.9%	22.1%	(1.7%)
Return on Average Assets	3.9%	3.5%	(0.4%)

Income Statement	H1'2018	H1'2019	y/y change	H1'2019e	Expected y/y change	Variance in Actual Growth vs Expected
Net Interest Income	19.6	21.1	7.6%	21.1	7.7%	-0.1%
Net Non-Interest Income	13.2	16.5	25.6%	14.4	9.4%	16.1%
Total Operating Income	32.8	37.6	14.8%	35.5	8.4%	6.4%
Loan Loss Provision	(0.8)	(0.9)	16.7%	(1.1)	37.3%	(20.7%)
Total Operating Expenses	(17.3)	(20.6)	19.4%	(18.6)	7.8%	11.5%
Profits Before Tax	15.5	17.0	9.8%	16.9	9.0%	0.8%
Profits After Tax	11.0	12.0	9.1%	11.8	7.3%	1.8%
Core EPS	2.9	3.2	9.1%	3.1	7.3%	1.8%

Income Statement Ratios	H1'2018	H1'2019	y/y change
Yield on Interest Earning Assets	11.4%	11.0%	(0.4%)
Cost of Funding	2.7%	2.6%	(0.1%)
Net Interest Margin	8.8%	8.5%	(0.3%)
Cost of Risk	2.4%	2.4%	0.0%
Net Interest Income as a % of Operating Income	59.8%	56.0%	(3.8%)
Non-Funded Income as a % of Operating Income	40.2%	44.0%	3.8%
Cost to Income Ratio	52.8%	54.8%	2.1%

Capital Adequacy Ratios	H1'2018	H1'2019
Core Capital/ Total Liabilities	20.9%	20.1%
Minimum Statutory Ratio	10.5%	10.5%
Excess/Deficit	**10.4%**	**9.6%**
Core Capital risk weighted assets ratio	18.3%	17.5%
Minimum Statutory requirement	10.5%	10.5%
Excess/Deficit	**7.8%**	**7.0%**
Total Capital risk weighted ratio	18.4%	19.5%
Minimum Statutory requirement	14.5%	14.5%

Excess/Deficit	**3.9%**	**5.0%**
Adjusted Core Capital/ Total Liabilities		21.1%
Adjusted Core Capital/ Total risk weighted assets ratio		18.4%
Adjusted Total Capital/ Total risk weighted ratio		20.4%