Equity Group Holdings- H1’2020

21st August, 2020

Valuation Summary

- We are of the view that Equity Group is an “Accumulate” with a target price of Kshs 39.3, representing an upside of 19.2%, from the current price of Kshs 32.95 as of 21st August 2020,
- Equity Group is currently trading at a P/TBV of 1.1x and a P/E of 6.3x vs an industry average of 0.9x and 5.0x, respectively.

Key Highlights H1’2020

- Equity Group announced it had mutually agreed with Atlas Mara to call off plans to acquire banking assets in four countries in exchange for shares in Equity Group. This followed a January announcement by the board of Equity Group announcing the extension of discussions between the Group and Atlas Mara after the expiry of the transaction period before the two parties could sign a detailed transaction agreement, and,
- The Group recently completed the 66.5% stake acquisition of the Banque Commerciale Du Congo (BCDC) at a cost of USD 95.0 mn (Kshs 10.3 bn). Following the acquisition, BCDC will become Equity Groups subsidiary increasing Equity’s subsidiaries in the DRC to two.

Income Statement

- Core earnings per share declined by 24.4% to Kshs 2.4, from Kshs 3.2 in H1’2019, worse than our projections of a 15.2% decline to Kshs 2.7. The performance was driven by a 31.1% increase in total operating expenses, outpacing the 3.8% growth recorded in total operating income. The variance in core earnings per share growth against our expectations was largely due to the 773.4% rise in Loan Loss Provisions (LLPs) to Kshs 8.0 bn, from Kshs 0.9 bn in H1’2019, which was higher than our expectation of a 389.3% increase to Kshs 4.5 bn,
- Total operating income rose by 3.8% to Kshs 39.0 bn, from Kshs 37.6 bn in H1’2019. This was driven by a 16.9% rise in Net Interest Income (NII) to Kshs 24.6 bn, from Kshs 21.1 bn in H1’2019. The growth on the operating income was however weighed down by the 13.0% decline in the Non – Funded Income to Kshs 14.4 bn from Kshs 16.5 bn in H’1 2019,
- Interest income rose by 18.5% to Kshs 32.8 bn, from Kshs 27.7 bn in H1’2019. This was driven by a 20.8% increase in interest income on loans and advances to Kshs 22.5 bn, from Kshs 18.6 bn in H1’2019, coupled with a 14.8% increase in interest income on government securities to Kshs 9.8 bn, from Kshs 8.5 bn in H1’2019. 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 strategy to increase lending to the private sector, focusing on Small and Medium Enterprises. The yield on interest-earning assets declined marginally to 10.8%, from 11.0% in H1’2019, due to the faster 18.1% growth in average interest- earning assets, which outpaced the 16.7% growth in trailing interest income,
- Interest expenses rose by 23.6% to Kshs 8.2 bn from Kshs 6.6 bn in H1’2019, following the 17.7% increase in the interest expense on customer deposits to Kshs 6.1 bn, from Kshs 5.2 bn in H1’2019, coupled with a 71.4% increase in other interest expenses to Kshs 1.8 bn, from Kshs 1.0 bn in H1’2019. Cost of funds rose to 2.9%, from 2.6% in H1’2019, owing to the faster 23.6% increase in interest expense, which outpaced the 16.1% increase in average interest-bearing liabilities to Kshs 558.8 bn, from Kshs 480.4 bn in H1’2019. Net Interest Margin (NIM) on the other hand, declined to 8.1% from 8.5% in H1’2019, owing to the faster 18.1% growth in average interest earning assets which outpaced the 16.9% growth in Net Interest Income (NII),
- Non-Funded Income (NFI) declined by 13.0% to Kshs 14.4 bn, from Kshs 16.5 bn in H1’2019. The decline was mainly driven by a 10.8% decline in total fees and commissions on loans to Kshs 2.5 bn, from Kshs 2.8 bn coupled with a 36.7% decline in other income to Kshs 2.9 bn from Kshs 4.7 bn in H1’2019. The declines were however mitigated by the 20.0% increase in forex trading income to Kshs 2.3 bn, from Kshs 1.9 bn in H1’2019. As a result, the revenue mix shifted to 63:37 from 56:44 funded to non-funded income, owing to the faster 16.9% growth in NII as compared to the 13.0% decline in NFI,

- Total operating expenses rose by 31.1% to Kshs 27.1 bn, from Kshs 20.6 bn in H1'2019, largely driven by a 773.4% increase in Loan Loss Provisions (LLP) to Kshs 8.0 bn, from Kshs 0.9 bn in H1'2019, on the back of the subdued business environment, coupled with a 13.0% rise in staff costs to Kshs 6.7 bn, from Kshs 6.0 bn in H1'2019,
- As a result of the 773.4% rise in Loan Loss Provisions (LLP), Cost to Income Ratio (CIR) deteriorated by 14.5% points to 69.3%, from 54.8% in H1'2019. Without LLP, the CIR improved by 3.6% points to 48.8%, from 52.4% in H1'2019 an indication of an improvement in the Banks efficiency levels, and,
- Profit before tax declined by 29.5% to Kshs 12.0 bn, down from Kshs 17.0 bn in H1'2019. Profit after tax recorded a 24.4% decline to Kshs 9.1 bn, from Kshs 12.0 bn, with the effective tax rate declining to 24.2% from 29.3% in H1'2019.

Balance Sheet

- The balance sheet recorded an expansion as total assets increased by 16.9% to Kshs 746.5 bn, from Kshs 638.7 bn in H1'2019. The growth was supported by a 24.2% increase in the government securities to Kshs 181.2 bn, from Kshs 145.9 bn, coupled with a 22.0% increase in loan book to Kshs 391.6 bn from Kshs 320.9 bn in H1'2019. The growth was subdued by a 1.5% decrease in placements to Kshs 44.5 bn, from Kshs 45.2 bn in H1'2019,
- Total liabilities rose by 16.3% to Kshs 623.1 bn from Kshs 535.9 bn in H1'2019, driven by an 18.6% increase in customer deposits to Kshs 543.9 bn, from Kshs 458.6 bn in H1'2019. Deposits per branch increased by 9.9% to Kshs 1.8 bn, from Kshs 1.6 bn in H1'2019, with the number of branches increasing by 9 to 300 branches in H1'2020, from 291 in H1'2019. Borrowings recorded a growth of 11.3% to Kshs 57.2 bn, from Kshs 51.4 bn in H1'2019,
- The faster 22.0% growth in loans as compared to the 18.6% growth in deposits, led to a growth in the loan to deposit ratio to 72.0%, from 70.0% in H1'2019,
- Gross Non-Performing Loans (NPLs) rose by 55.8% to Kshs 45.6 bn in H1'2020, from Kshs 29.2 bn in H1'2019. Consequently, the NPL ratio deteriorated to 11.0% in H1'2020, from 8.8% in H1'2019, attributable to a faster 55.8% growth in Non-Performing Loans, which outpaced the 23.9% growth in gross loans. The main sectors that contributed to the deterioration in asset quality were large enterprises and SMEs sectors, which contributed the largest portion of the Non-Performing loans at 13.0% and 12.4%, respectively. The group's Tanzania subsidiary also recorded a high NPL levels of 42.0% in H1'2020. With general Loan Loss Provisions increasing by 72.7% to Kshs 16.3 bn, from Kshs 9.4 bn in H1'2019, higher than the 55.8% rise in Non-performing loans, the NPL coverage improved to 48.5% in H1'2020 from 45.6% in H1'2019,
- Shareholders' Funds grew by 20.1% to Kshs 122.2 bn in H1'2020 from Kshs 101.8 bn in H1'2019, supported by a 21.0% increase in retained earnings to 108.2 bn from Kshs 89.4 bn,
- Equity Group remains sufficiently capitalized with a core capital to risk-weighted assets ratio of 16.9%, 6.4% points above the statutory requirement of 10.5%. In addition, the total capital to risk-weighted assets ratio came in at 20.0%, exceeding the statutory requirement of 14.5% by 5.5% points. Adjusting for IFRS 9, the core capital to risk-weighted assets stood at 17.1%, while total capital to risk-weighted assets came in at 20.5%, and,
- The bank currently has a Return on Average Assets (ROaA) of 2.8%, and a Return on Average Equity (ROaE) of 17.5%.

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, South Sudan cumulatively contributing 14.3% of the bank's total profitability and 28.3% of the group's total asset base. However, given the high NPL levels in the group's Tanzania subsidiary of 42.0%, the group will need to improve its credit assessment in these countries to bring down the high NPL ratios. Cumulatively, the group's subsidiaries recorded a 22.7% decline in their Profit after Tax (PAT) to Kshs 1.7 bn, from Kshs 2.2 bn in H1'2019, with the Tanzanian branch recording a loss of Kshs 0.2 bn in H1'2020 from the earlier recorded PAT of

Kshs 0.2 bn in H1'2019. Total assets in the bank's regional subsidiaries grew by 20.7% to Kshs 214.6 bn in H1'2020, from Kshs 177.8 bn in H1'2019. Improved efficiencies in the subsidiaries saw their cost structure contribution to the Group, improve to 36.0%, from 41.0% in H1'2019,

2. Increased innovation and digitization have seen 98.0% of all transactions of the bank being done on alternative channels, with mobile transactions taking up 83.0% of all transactions, and agency banking contributing 9.0% of all transactions. However, in terms of the value of transactions, branches contributed 43.0% of the value of all transactions, while mobile and agency banking contributed 31.0% and 18.0%, respectively. This highlights the transformation of branches to handle high-value transactions. This transformation aids the bank by offering its ecosystem banking products to corporate and SME clients,
3. Non-Funded Income (NFI) declined by 13.0% to Kshs 14.4 bn, from Kshs 16.5 bn in H1'2019. The growth was mainly driven by a 10.8% decrease in total fees and commissions on loans to Kshs 2.5 bn, from Kshs 2.8 bn coupled with a 36.7% decline in other income to Kshs 2.9 bn from Kshs 4.7 bn in H1'2019. The declines were however mitigated by the 20.0% increase in forex trading income to Kshs 2.3 bn, from Kshs 1.9 bn in H1'2019. Given the recent waiver of banking and mobile money transactions unveiled by the Central Bank of Kenya as a measure to cushion citizens against the effects of the COVID-19 pandemic, we expect the banks NFI to continue to a downward trajectory in FY'2020, and,
4. The bank's asset quality deteriorated, with the NPL ratio deteriorating to 11.0% in H1'2020 from 8.8% in H1'2019. The main sectors that contributed to the deterioration in asset quality were large enterprises and SMEs sectors, which contributed the largest portion of the Non-Performing loans at 13.0% and 12.4%, respectively. Key to note, the groups Tanzania subsidiaries recorded high NPL ratios at 42.0%. The subsidiary contributed 3.3% of the group's loan book. With the reduction of business revenue due to the slowed down business operations, more so in the Private sector, we expect the groups asset quality to continue deteriorating.

Going forward, the factors that would drive the bank's growth would be:

I. Channelled diversification 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 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 with the repeal of the interest rate cap law. The bank's balance sheet agility is seen with a liquidity ratio of 54.2%, loan deposit ratio of 72.0% and a core capital to risk-weighted asset ratio of 16.9%.

Below is a summary of the bank's performance:

Balance Sheet Items	H1'2019	H1'2020	y/y change	H1'2020e	Expected y/y change	Variance in Growth Actual vs. Expected
Government Securities	145.9	181.2	24.2%	160.8	10.2%	(14.0%)
Net Loans and Advances	320.9	391.6	22.0%	370.5	15.5%	(6.6%)
Total Assets	**638.7**	**746.5**	**16.9%**	**711.2**	**11.4%**	**(5.5%)**
Customer Deposits	458.6	543.9	18.6%	519.3	13.2%	(5.4%)
Total Liabilities	535.9	623.1	16.3%	596.8	11.4%	(4.9%)
Shareholders' Funds	**101.8**	**122.2**	**20.1%**	**113.3**	**11.4%**	**(8.8%)**

Balance Sheet Ratios	H1'2019	H1'2020	% y/y change
Loan to Deposit Ratio	70.0%	72.0%	2.0%
Return on average equity	22.1%	17.5%	(4.6%)

Return on average assets	3.5%	2.8%	(0.7%)

Income Statement	H1'2019	H1'2020	y/y change	H1'2020e	Expected y/y change	Variance in Growth Actual vs. Expected
Net Interest Income	21.1	24.6	16.9%	24.2	14.9%	(1.9%)
Net non-Interest Income	16.5	14.4	(13.0%)	15.6	(5.6%)	7.4%
Total Operating income	**37.6**	**39.0**	**3.8%**	**39.8**	**5.9%**	**2.2%**
Loan Loss provision	(0.9)	(8.0)	773.4%	(4.5)	389.3%	(384.1%)
Total Operating expenses	(20.6)	(27.1)	31.1%	(25.3)	22.6%	(8.5%)
Profit before tax	17.0	12.0	(29.5%)	14.6	(14.4%)	15.1%
Profit after tax	**12.0**	**9.1**	(24.4%)	**10.2**	(15.2%)	9.2%
Core EPS	**3.18**	**2.41**	(24.4%)	**2.70**	(15.2%)	9.2%

Income Statement Ratios	H1'2019	H1'2020	y/y change
Yield from interest-earning assets	11.0%	10.8%	(0.1%)
Cost of funding	2.6%	2.9%	0.3%
Cost of risk	2.4%	20.6%	18.1%
Net Interest Margin	8.5%	8.1%	(0.4%)
Net Interest Income as % of operating income	56.0%	63.1%	7.1%
Non-Funded Income as a % of operating income	44.0%	36.9%	(7.1%)
Cost to Income Ratio	54.8%	69.3%	14.5%
CIR without LLP	52.4%	48.8%	(3.6%)
Cost to Assets	3.3%	2.7%	(0.6%)

Capital Adequacy Ratios	H1'2019	H1'2020
Core Capital/Total Liabilities	20.1%	20.3%
Minimum Statutory ratio	8.0%	8.0%
Excess	**12.1%**	**12.3%**
Core Capital/Total Risk Weighted Assets	17.5%	16.9%
Minimum Statutory ratio	10.5%	10.5%
Excess	**7.0%**	**6.4%**
Total Capital/Total Risk Weighted Assets	19.5%	20.2%
Minimum Statutory ratio	14.5%	14.5%
Excess	**5.0%**	**5.7%**
Liquidity Ratio	56.5%	54.2%
Minimum Statutory ratio	20.0%	20.0%
Excess	**36.5%**	**34.2%**