Equity Group Holdings Plc – Q3'2017

1st November, 2017

Valuation Summary

- We are of the view that Equity Group Holdings Plc stock is an "accumulate", with a target price of Kshs 42.5 representing an upside of 16.8%, from the current price of Kshs 38.0, as at 31st October, inclusive of a dividend yield of 4.9%,
- Equity Group is currently trading at a P/TBv of 1.7x and a P/E of 8.9x, vs an industry average of 1.4x and 7.7x, respectively.

Key highlights during Q3'2017

- GCR affirmed Equity Group Holding's National Scale Rating of AA- in the long term and A1+ in the short term, with a stable outlook, citing the group's competitive position in Kenya's Banking Industry driven by a favourable market reputation as well as a resilient and innovative financial services business,
- Equity Group will be cutting down unsecured and micro loans to small businesses, which are deemed riskier, ahead of the new accounting guidelines, IFRS 9, which is coming into effect in January, 2018,
- Following the closure of 8 of 13 branches and the layoff of 200 of its 300 employees in South Sudan in Q2'2017, the group's South Sudan subsidiary posted a positive earnings, with the contribution to overall group at 0.8% of the PBT against a (0.6%) PBT performance in the same period in 2016,

Income Statement

- Core earnings per share declined by 2.7% to Kshs 3.87 from Kshs 3.98 in Q3'2016, driven by a 0.3% decline in total operating revenue, and a 2.2% increase in operating expenses,
- Total operating revenue dipped slightly by 0.3% to Kshs 48.7 bn from Kshs 48.9 bn in Q3'2016. The stable performance was supported by a 28.3% growth in Non-Funded income to Kshs 21.3 bn from Kshs 16.6 bn in Q3'2016, despite a 15.0% decline in Net Interest Income(NII),
- Interest Income declined by 11.1% to Kshs 34.4 bn from Kshs 39.8 bn in Q3'2016 while interest expense increased by 5.9% to Kshs 7.9 bn from Kshs 7.5 bn in Q3'2016, leading to a 15.0% drop in the Net Interest Income to Kshs 27.5 bn from Kshs 32.3 bn. The Net Interest Margin thus declined to 9.4% from 11.0% in Q3'2016,
- Non-Funded Income (NFI) recorded a growth of 28.3% to Kshs 21.3 bn from Kshs 16.6 bn in Q3'2016. The growth in NFI was driven by an increase in total fees and commissions on loans that rose by 47.8% to Kshs 4.3 bn from Kshs 2.9 bn in Q3'2016, a 16.7% increase in other fees and commissions to Kshs 9.6 bn from Kshs 8.3 bn, and a 5.3% increase in foreign exchange trading income,
- The 47.8% increase in total fees and commissions on loans, despite a 2.2% contraction in the value of total loans issued, is attributed to increase in fees charged on loans by banks following the operationalisation of Banking Act Amendment 2016, which resulted into compressed Net Interest Margin. This increase in fees charged on loans, does not entirely cushion the bank from the effect of interest rate caps. Assuming the increased amount in fees charged on loans was to be added to the bank's Net Interest income, the Net Interest Margin would only improve slightly to 9.5% from the current 9.4%,
- The 16.7% increase in other fees and commissions was driven by a growth in commissions from alternative banking channels including digital platforms and agency banking. The value of transactions made through these alternative channels increased by 50.0% to Kshs 934.0 bn from Kshs 622.6 bn in Q3'2016,
- The current revenue mix stands at 56:44 funded to non-funded income from 66:34 in Q3'2016,
- Total operating expenses increased by 2.2% to Kshs 28.0 bn from Kshs 27.4 bn, driven by other expenses, which increased 16.3% to Kshs 11.9 bn from Kshs 10.3 bn in Q3'2016 owing to costs incurred in staff compensation following the layoff of 200 of its 300 employees in South Sudan. This was despite a decline in staff costs, which declined by 10.7% to Kshs 7.8 bn from Kshs 8.7 bn in Q3'2016 attributed to a shift in channels of delivery, to automated options. Loan Loss Provisions (LLP), also declined by 13.2% to Kshs 2.8 bn from Kshs 3.3 bn,
- The Cost to Income ratio deteriorated to 57.5% from 56.0% in Q3'2016 following a 2.2% increase in total operating expenses coupled with a 0.3% decline total operating income. Without LLP, the Cost to Income ratio worsened to 51.6% from 49.2% in Q3'2016
- Profit before tax decreased by 3.6% to Kshs 20.7 bn from Kshs 21.5 bn, while profit after tax decreased by 2.7% to Kshs 14.6 bn from Kshs 15.0 bn in Q3'2016.

Balance Sheet

- The balance sheet recorded an expansion in Q3’2017, with total assets increasing by 10.7% to Kshs 518.3 bn from Kshs 468.0 bn in Q3'2016. This growth was driven by a 37.2% increase in investment in government and other securities to Kshs 127.5 bn from Kshs 93.1 bn in Q3'2016. Loan book, which is 51.2% of the total assets book, contracted by 2.2% to Kshs 265.4 bn from Kshs 271.4 bn in Q3’2016 leading to the 10.7% growth despite the significant growth in investment in government securities. The value of property and equipment declined by 7.2%, attributed to the closure of 8 of its 13 branches in South Sudan,
- Total liabilities rose by 10.9% to Kshs 428.1 bn from Kshs 386.4 bn in Q3'2016, driven by an 11.3% increase in deposits to Kshs 368.8 bn from Kshs 331.3 bn in Q3'2016. Shareholders’ funds increased by 10.5% to Kshs 90.1 bn from Kshs 81.6 bn in Q3’2016,
- The increase in deposits coupled with a decline in the loan book led to a decline in the loan to deposit ratio to 72.8% from 81.9% in Q3'2016, indicating shift in funds allocation from loans to other less risky assets like government securities following the enactment of the law on loan pricing framework,
- Gross non-performing loans increased by 25.4% to Kshs 20.7 bn from Kshs 16.5 bn. This coupled with a decline in loan book led to an increase in NPL ratio to 9.1% from 5.9% in Q3’2016 highlighting concerns around asset quality,
- The yield on interest earning assets declined to 12.1% from 13.9% in Q3’2016, while the cost of funds declined to 2.6% from 3.0% in Q3’2016
- Equity Group is currently sufficiently capitalized with a core capital to risk weighted assets ratio at 19.8%, 9.3% above the statutory requirement, with total capital to total risk weighted assets exceeding statutory requirement by 6.0%.
- Equity Group currently has a return on average assets of 3.3% and a return on average equity of 18.8%.

Key Take outs:

i. **Change in business model**. In response to the tough operating environment Equity Group has adopted a new business model with key focus on, (i) growing non-funded income, (ii) regional diversification, (iii) strengthening liquidity and balance sheet agility, (iv) treasury operations, (v) improving asset quality, (vi) innovation and digitization, and (vii) enhancing efficiencies and cost optimization. The Bank’s strategy to increase allocation in non-funded income is expected to be a major growth driver going forward. Loan growth was down 2.1% with investment in government securities up 33.1% Y/Y as the bank adjusts its business model in the interest rate cap era,

ii. **Growth in its Non-Funded income**, which currently accounts for 43.7% of total revenue, against 33.9% in Q3'2016. With the introduction of the interest rate caps, Equity Group has diversified its revenue sources. Fees and commissions from these avenues have contributed to the growth of the Bank’s non-funded income, with commissions from mobile banking, American Express transactions and trade finance, registering y/y growths of 135.5%, 61.5% and 39.2% respectively. Going forward, and given the trends in net interest income revenue stream, the profitability of the bank is going to be mainly supported by the growth in non- funded income,

iii. **Regional Performance**. All the bank’s subsidiaries are also performing well, having a total aggregate growth of 53.2% in PBT, and contributing 13.9% of the Group’s PBT, an increase from a 9.4% contribution in Q3'2016.The performance of Non Kenyan business is going to be key is supporting the revenue growth of Equity Group Holdings,

iv. Going forward, the Equity Group is leveraging on its heavy investment in technology to boost its growth and increase its profitability by reducing its operating costs. By Q3'2017, 91.1% of the bank's transaction were handled through alternative channels such as mobile, internet, merchant and agency banking with the remaining 8.9% being ATMs and Branch transactions. In our view, the investment on digital platforms made by the bank over the last 5 years should enable the bank achieve the much needed efficiency in this era of compressed NIMs and hence supporting the profitability going forward.

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	Expected y/y change	Variance in Growth Actual vs. Expected
Government Securities	82.4	109.6	33.1%	117.13	42.2%	9.1%
Net Loans and Advances	271.4	265.4	(2.2%)	269.77	(0.6%)	1.6%
Total Assets	**468.0**	**518.2**	**10.7%**	**524.0**	**12.0%**	**1.2%**
Customer Deposits	331.3	368.8	11.3%	377.3	13.9%	2.6%
Total Liabilities	386.4	428.1	10.8%	433.6	12.2%	1.4%
Shareholders’ Funds	**81.6**	**90.1**	**10.5%**	**90.4**	**10.8%**	**0.3%**

Balance Sheet Ratios	Q3'2016	Q3'2017	% y/y change
Loan to Deposit Ratio	81.9%	72.0%	(9.9%)
Return on average equity	25.7%	18.8%	(6.9%)
Return on average assets	4.3%	3.3%	(1.0%)

Income Statement	Q3'2016	Q3'2017	y/y change	Q3'2017e	Expected y/y change	Variance in Growth Actual vs. Expected
Net Interest Income	32.3	27.5	(15.0%)	27.4	(15.4%)	(0.4%)
Net non-Interest Income	16.6	21.3	28.3%	18.9	14.0%	(14.3%)
Total Operating income	**48.9**	**48.7**	**(0.3%)**	**46.2**	**(5.4%)**	**(5.1%)**
Loan Loss provision	(3.3)	(2.9)	(13.2%)	(3.3)	0.3%	13.5%
Total Operating expenses	(27.4)	(28.0)	2.2%	(26.4)	(3.5%)	(5.8%)
Profit before tax	21.5	20.7	(3.6%)	19.8	(7.9%)	(4.3%)
Profit after tax	**15.0**	**14.6**	**(2.7%)**	**13.9**	**(7.6%)**	**(4.9%)**
Core EPS	**3.98**	**3.87**	**(2.7%)**	**3.68**	**(7.6%)**	**(4.9%)**

Income Statement Ratios	Q3'2016	Q3'2017	y/y change
Yield from interest-earning assets	10.3%	8.2%	(2.1%)
Cost of funding	3.0%	2.6%	(0.4%)
Cost of risk	6.8%	5.9%	(0.9%)
Net Interest Margin	11.0%	9.4%	(1.5%)
Net Interest Income as % of operating income	66.1%	56.4%	(9.7%)
Non-Funded Income as a % of operating income	33.9%	43.6%	9.7%
Cost to Income	56.0%	57.5%	1.5%
Cost to Assets	5.3%	5.1%	(0.2%)

Capital Adequacy Ratios	Q3'2016	Q3'2017
Core Capital/Total Liabilities	22.5%	23.3%
Minimum Statutory ratio	10.5%	10.5%
Excess	**12.0%**	**12.8%**
Core Capital/Total Risk Weighted Assets	18.0%	19.8%
Minimum Statutory ratio	10.5%	10.5%
Excess	**7.5%**	**9.3%**
Total Capital/Total Risk Weighted Assets	19.0%	20.5%
Minimum Statutory ratio	14.5%	14.5%
Excess	**4.5%**	**6.0%**
Liquidity Ratio	42.7%	52.1%
Minimum Statutory ratio	20.0%	20.0%
Excess	**22.7%**	**32.1%**