Equity Group Holdings – Q1’2019

9th May, 2019

Valuation Summary

- We are of the view that Equity Group is a “***BUY***” with a target price of Kshs 58.1, representing an upside of 50.3%, from the current price of Kshs 40.0 as of 9th May 2019, inclusive of a dividend yield of 5.0%,
- Equity Group is currently trading at a P/TBV of 1.7x and a P/E of 7.5x vs an industry average of 1.4x and 7.3x, respectively.

Key Highlights Q1’2019

- Equity Group entered into a binding term sheet with Atlas Mara Limited to acquire certain banking assets in 4 countries in exchange for shares in Equity Group. These include:
    a. 62.0% of the share capital of Banque Populaire du Rwanda (BPR);
    b. 100.0% of the share capital of Africa Banking Corporation Zambia (ABCZam) Ltd.;
    c. 100.0% of the share capital of Africa Banking Corporation Tanzania (ABCTz); and,
    d. 100.0% of the share capital of Africa Banking Corporation Mozambique Ltd (ABCMoz).
- Equity Group and Safaricom partnered to roll out a new joint mobile banking service that will, among others, take the M-Pesa platform beyond Kenya’s borders. The partnership will also see the two companies jointly roll-out their products and services where they both operate, a move that will likely open up significant revenue streams for both companies, if the roll out is successful in the Eastern African region.

Income Statement

- Core earnings per share increased by 4.9% to Kshs 1.64, from Kshs 1.56 in Q1’2018, faster than our projections of a 0.7% increase to Kshs 1.58. The performance was driven by a 6.6% increase in total operating income, despite a faster 7.0% increase in total operating expenses. The variance in core earnings per share growth against our expectations was largely due to a slower 7.0% rise in total operating expenses to Kshs 8.8 bn, from Kshs 8.2 bn in Q1’2018, which was not in line with our expectation of a 13.2% increase to Kshs 9.3 bn,
- Total operating income increased by 6.6% to Kshs 17.6 bn, from Kshs 16.5 bn in Q1’2018. This was driven by a 6.3% increase in Net Interest Income (NII) to Kshs 10.4 bn, from Kshs 9.8 bn in Q1’2018, coupled with a 6.9% increase in Non-Funded Income (NFI) to Kshs 7.2 bn, from Kshs 6.7 bn in Q1’2018,
- Interest income increased by 6.5% to Kshs 13.5 bn from Kshs 12.7 bn in Q1’2018. This was driven by an 11.9% growth in interest income from government securities to Kshs 4.1 bn, from Kshs 3.7 bn in Q1’2018, coupled with a 3.5% increase in interest income from loans to Kshs 9.1 bn from Kshs 8.8 bn in Q1’2018, and the 47.0% increase in interest income from placement assets to Kshs 0.3 bn from Kshs 0.2 bn in Q1’2018. The yield on interest-earning assets however declined to 11.1%, from 11.3% in Q1’2018, attributed to a decline in yields on government securities as well as a decline in lending rates due to the two Central Bank Rate (CBR) cuts in 2018,
- Interest expense rose by 7.4% to Kshs 3.1 bn, from Kshs 2.9 bn in Q1’2018, largely due to the 6.7% increase in the interest expense on customer deposits to Kshs 2.5 bn from Kshs 2.4 bn in Q1’2018, coupled with a 112.8% increase in interest expense on placements to Kshs 0.2 bn from Kshs 0.1 bn in Q1’2018. However, other interest expenses declined by 8.1% to Kshs 0.38 bn from Kshs 0.41 bn in Q1’2018. The cost of funds however declined to 2.6%, from 2.7% in Q1’2018, owing to a faster increase in interest bearing liabilities that rose by 12.0% to Kshs 483.2 bn from Kshs 431.4 bn in Q1’2018. Consequently, the Net Interest Margin (NIM) declined to 8.6%, from 8.8% in Q1’2018,
- Non-Funded Income rose by 6.9% to Kshs 7.2 bn from Kshs 6.7 bn in Q1’2018. The increase was mainly driven by the 7.9% increase in other fees and commissions to Kshs 3.4 bn, from Kshs 3.2 bn in Q1’2018, which management attributed to the monetization of the firm’s alternative transaction channels. The

improvement in NFI was also supported by the 21.7% growth in forex trading income to Kshs 0.8 bn, from Kshs 0.7 bn in Q1'2018, with management noting that this income segment benefitted from increased remittances from the diaspora, and a 12.2% growth in other income to Kshs 1.6 bn from Kshs 1.4 bn in Q1'2018. The growth in NFI was however weighed down by the 6.8% decline in fees and commissions on loans to Kshs 1.4 bn from Kshs 1.5 bn in Q1'2018, which may be attributed to 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 remained at 59:41 owing to the comparable increases in both NII and NFI,

- Total operating expenses rose by 7.0% to Kshs 8.8 bn, from Kshs 8.2 bn in Q1'2018, largely driven by a 14.3% increase in Loan Loss Provisions (LLP) to Kshs 0.41 bn from Kshs 0.36 bn in Q1'2018, coupled with a 9.6% increase in other operating expenses to Kshs 5.7 bn from Kshs 5.2 bn in Q1'2018. Staff costs rose marginally by 0.8% to Kshs 2.63 bn in Q1'2019 from Kshs 2.61 bn in Q1'2018,
- The Cost to Income Ratio (CIR) deteriorated marginally to 49.8%, from 49.6% in Q1'2018. Without LLP, the cost to income ratio remained flat at 47.5%,
- Profit before tax increased by 6.1% to Kshs 8.8 bn, up from Kshs 8.3 bn in Q1'2018. Profit after tax grew by 4.9% to Kshs 6.2 bn in Q1'2019, from Kshs 5.9 bn in Q1'2018, with the difference in growth attributable to the marginal increase in the effective tax rate to 29.4% from 29.1% in Q1'2018,

Balance Sheet

- The balance sheet recorded an expansion as total assets increased by 14.8% to Kshs 605.7 bn, from Kshs 527.8 bn in Q1'2018. Growth was supported by a 12.7% increase in the loan book to Kshs 305.5 bn, from Kshs 271.1 bn, coupled with a 13.0% increase in government securities to Kshs 169.7 bn from Kshs 150.2 bn in Q1'2018,
- Total liabilities rose by 14.5% to Kshs 510.2 bn from Kshs 445.7 bn in Q1'2018, driven by a 12.1% increase in customer deposits to Kshs 428.5 bn from Kshs 382.4 bn in Q1'2018. Deposits per branch increased by 12.1% to Kshs 1.5 bn from Kshs 1.4 bn in Q1'2018, as the number of branches remained unchanged,
- Borrowings rose by 12.5% to Kshs 51.0 bn from Kshs 45.3 bn in Q1'2018,
- The faster growth in loans as compared to the growth in deposits led to an increase in the loan to deposit ratio to 71.3% from 70.9% in Q1'2018,
- Gross Non-Performing Loans (NPLs) increased by 62.3% to Kshs 29.4 bn in Q1'2019, from Kshs 18.1 bn in Q1'2018. The NPL ratio thus deteriorated to 9.2% in Q1'2019 from 6.5% in Q1'2018. 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 10.9%, 10.8% and 5.5%, respectively. The group's Tanzania subsidiary contributed 31.6% of the NPLs, with South Sudan and Kenya contributing 12.6% and 8.5%, respectively. General Loan Loss Provisions increased by 60.6% to Kshs 10.0 bn, from Kshs 6.2 bn in Q1'2018. Thus, the NPL coverage deteriorated to 73.7% in Q1'2019 from 105.1% in Q1'2018,
- Shareholders' funds increased by 15.1% to Kshs 94.5 bn in Q1'2019 from Kshs 82.1 bn in Q1'2018, supported by a 19.7% increase in retained earnings to Kshs 83.6 bn from Kshs 69.9 bn,
- Equity Group remains sufficiently capitalized with a core capital to risk-weighted assets ratio of 17.4%, 6.9% points above the statutory requirement. In addition, the total capital to risk-weighted assets ratio came in at 19.3%, exceeding the statutory requirement by 4.8% points. Adjusting for IFRS 9, the core capital to risk weighted assets stood at 18.7%, while total capital to risk-weighted assets came in at 20.6%, and,
- The bank currently has a Return on Average Assets (ROaA) of 3.8%, and a Return on Average Equity (ROaE) of 22.8%.

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 18.0% of the bank’s total profitability and 26.0% of the group’s total asset base. Equity Group has entered into an agreement with Atlas Mara to acquire subsidiaries in Tanzania, Rwanda, Mozambique and Zambia. If successful, the transaction should see the bank significantly increase its size to a proforma asset base of Kshs 724.0 bn, placing the bank in a position to leverage on economies of scale in the rollout of its digital platforms in the region. 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 77.0% of all transactions, and agency banking contributing 12.0% of all transactions. However, in terms of value of transactions, branches contributed 50.0% of the value of all transactions, with agency banking and mobile contributing 18.0% and 16.0% 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 6.9% 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 38.5%, 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 9.2% from 6.5% in Q1’2018. The main sectors that contributed to the NPLs are large enterprises and SMEs. In terms of the regional view, the regions with the highest NPLs were Tanzania at 31.6% of their loan book, followed by South Sudan at 12.6% 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.

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

I. Channeled 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,
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 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 57.4%.

Below is a summary of the bank’s performance:

Balance Sheet Items	Q1'2018	Q1'2019	y/y change	Q1'2019e	Expected y/y change	Variance in Growth Actual vs. Expected
Government Securities	122.4	137.9	12.7%	134.69	10.1%	(2.6%)
Net Loans and Advances	271.1	305.5	12.7%	306.29	13.0%	0.3%
Total Assets	**527.8**	**605.7**	**14.8%**	**594.2**	**12.6%**	**(2.2%)**
Customer Deposits	382.4	428.5	12.1%	437.6	14.4%	2.4%

Total Liabilities	445.7	510.2	14.5%	493.3	10.7%	(3.8%)
Shareholders' Funds	**82.1**	**94.5**	**15.1%**	**100.0**	**21.8%**	**6.7%**

Balance Sheet Ratios	Q1'2018	Q1'2019	% y/y change
Loan to Deposit Ratio	70.9%	71.3%	0.4%
Return on average equity	24.7%	22.8%	(1.9%)
Return on average assets	3.9%	3.5%	(0.4%)

Income Statement	Q1'2018	Q1'2019	y/y change	Q1'2019e	Expected y/y change	Variance in Growth Actual vs. Expected
Net Interest Income	9.8	10.4	6.3%	10.4	5.5%	(0.8%)
Net non-Interest Income	6.7	7.2	6.9%	7.4	10.6%	3.6%
Total Operating income	**16.5**	**17.6**	**6.6%**	**17.8**	**7.6%**	**1.0%**
Loan Loss provision	(0.4)	(0.4)	14.3%	(0.7)	102.0%	87.7%
Total Operating expenses	(8.2)	(8.8)	7.0%	(9.3)	13.2%	6.2%
Profit before tax	8.3	8.8	6.1%	8.5	2.0%	(4.1%)
Profit after tax	**5.9**	**6.2**	**4.9%**	**5.9**	**0.7%**	**(4.2%)**
Core EPS	**1.6**	**1.6**	**4.9%**	**1.6**	**0.7%**	**(4.2%)**

Income Statement Ratios	Q1'2018	Q1'2019	y/y change
Yield from interest-earning assets	11.3%	11.1%	(0.2%)
Cost of funding	2.7%	2.6%	(0.1%)
Cost of risk	2.2%	2.3%	0.2%
Net Interest Margin	8.8%	8.6%	(0.2%)
Net Interest Income as % of operating income	59.4%	59.2%	(0.1%)
Non-Funded Income as a % of operating income	40.6%	40.8%	0.1%
Cost to Income	49.6%	49.8%	0.2%
Cost to Assets	1.5%	1.5%	(0.1%)

Capital Adequacy Ratios	Q1'2018	Q1'2019
Core Capital/Total Liabilities	22.2%	20.8%
Minimum Statutory ratio	10.5%	10.5%
Excess	**11.7%**	**10.3%**
Core Capital/Total Risk Weighted Assets	18.7%	17.4%
Minimum Statutory ratio	10.5%	10.5%
Excess	**8.2%**	**6.9%**
Total Capital/Total Risk Weighted Assets	18.7%	19.3%
Minimum Statutory ratio	14.5%	14.5%
Excess	**4.2%**	**4.8%**
Liquidity Ratio	55.2%	57.4%
Minimum Statutory ratio	20.0%	20.0%
Excess	**35.2%**	**37.4%**