National Bank of Kenya Ltd – H1'2018

22th August, 2018

Valuation Summary

- We are of the view that National Bank is a "sell" with a target price of Kshs 2.8, representing a downside of 55.6%, from the current price of Kshs 6.3 as of 22th August 2018, inclusive of a dividend yield of 0.0%,
- National Bank Holdings is currently trading at P/TBV of 0.4x and a P/E of 8.5x vs an industry average of 1.7x and 9.2x, respectively.

Key Highlights H1'2018

- The bank made high profile hires in information systems security and forensic investigation, after a spate of high profile theft and cyber security incidents at the bank,
- The bank issued a voluntary retirement program for employees aged over 35 years, in its strategy to realign staff headcount with the bank's needs.

Income Statement

- Core earnings per share increased by 39.3% to Kshs 0.7 from Kshs 0.5 in H1'2017, compared to our expectation of a 54.9% increase to Kshs 0.8. However, this was due to the stripping out of an exceptional expense of Kshs 0.5 bn. The bank registered a loss after tax of Kshs 0.3 bn in H1'2018 from a profit of Kshs 0.2 bn in H1'2017. Performance was driven by a 10.1% decrease in total operating income, which outpaced the 8.3% decrease in the total operating expenses. The variance in core earnings per share performance is due to a faster than expected 10.1% decline in total operating income. We had expected a 4.7% decline in total operating income,
- Total operating income declined by 10.1% to Kshs 3.7 bn from Kshs 4.1 bn in H1'2017. This was due to an 8.9% decrease in Net Interest Income (NII) to Kshs 2.6 bn from Kshs 2.9 bn in H1'2017, coupled with a 13.1% decline in Non-Funded Income (NFI) to Kshs 1.1 bn from Kshs 1.2 bn in in H1'2017,
- Interest income declined by 9.6% to Kshs 4.1 bn from Kshs 4.6 bn in H1'2017, driven by the decline in interest income on loans and advances that declined by 14.4% to Kshs 2.1 bn from Kshs 2.4 bn in H1'2017. Interest income on government securities also declined by 3.7% to Kshs 2.0 bn from Kshs 2.1 bn in H1'2017. As a result, the yield on interest earning assets declined to 10.1% in H1'2018 from 10.3% in H1'2017,
- Interest expense declined by 10.1% to Kshs 1.5 bn from Kshs 1.7 bn in H1'2017, following a 27.1% decline in the interest expense on deposits and placements from banking institutions to Kshs 153.9 mn from Kshs 211.0 mn in H1'2017. Interest expense on customer deposits declined by 8.6% to Kshs 1.4 bn from Kshs 1.5 bn in H1'2017. Consequently, the cost of funds declined to 3.0% from 3.5% in H1'2017. Net Interest Margin increased to 6.9% from 6.5% in H1'2017, due to the faster decline in the interest expense, coupled with a 0.7% decline in interest earning assets to Kshs 94.4 bn from Kshs 95.1 bn,
- Non-Funded Income declined by 13.1% to Kshs 1.1 bn from Kshs 1.2 bn in H1'2017. The decline in NFI was driven by a 59.4% decrease in fees and commissions on loans and advances to Kshs 37.6 mn from Kshs 92.7 mn in H1'2017, coupled with a 9.8% decline in other fees and commissions to Kshs 0.6 bn from Kshs 0.7 bn in H1'2017. However, foreign exchange trading income increased by 1.3% to Kshs 285.0 mn from Kshs 281.3 mn in H1'2017. The current revenue mix stands at 71:29 funded to non-funded income as compared to 70:30 in H1'2017. The proportion of funded income to total revenue increased slightly owing to the faster decline in NFI as compared to NII,
- Total operating expenses decreased by 8.3% to Kshs 3.5 bn from Kshs 3.8 bn, largely driven by the write back in provisions of Kshs 47.9 mn in H1'2018, as compared to the Kshs 235.3 mn loan loss

provision expense incurred in H1’2017. The decline in the operating expenses could also be attributed to the 17.4% decline in other operating expenses to Kshs 1.0 bn from Kshs 1.2 bn in H1’2017. Staff costs rose marginally by 0.5% to Kshs 1.89 bn in H1’2018 from Kshs 1.88 bn in H1’2017,

- The cost to income ratio deteriorated to 95.6% from 93.7% in H1’2017. Without LLP, the Cost to income ratio also deteriorated to 97.0% from 87.9% in H1’2017,
- Profit before tax decreased by 37.9% to Kshs 0.2 bn, down from Kshs 0.3 bn in H1’2017. The bank incurred an undefined exceptional item of Kshs 0.5 bn in H1’2018, and as a result, the bank recorded a loss after tax of Kshs 282.7 mn in H1’2018, compared to the profit of Kshs 59.5 mn in H1’2017. Stripping off the exceptional item, the profit before tax decreased by 37.9% to Kshs 159.4 mn from Kshs 256.9 mn in H1’2017

Balance Sheet

- The balance sheet experienced a contraction, as total assets declined by 2.8% to Kshs 113.3 bn from Kshs 116.6 bn in H1’2017. This decline was largely caused by a 16.1% decrease in loans and advances to Kshs 47.8 bn from Kshs 57.0 bn in H1’2017,
- Government securities increased by 9.8% to Kshs 41.3 bn from Kshs 37.6 bn in H1’2017,
- Total liabilities increased by 2.2% to Kshs 107.5 bn from Kshs 105.2 bn in H1’2017, driven by a 170.4% increase in placements by other institutions to Kshs 6.8 bn from Kshs 2.5 bn in H1’2017, coupled with a 20.1% increase in other liabilities to Kshs 4.7 bn from Kshs 3.9 bn in H1’2017,
- Customer deposits declined 2.8% to Kshs 96.0 bn from Kshs 98.8 bn in H1’2017. Deposits per branch increased by 4.1% to Kshs 1.4 bn from Kshs 1.3 bn in H1’2017, as the bank closed 5 branches,
- The faster decline in loans as compared to deposits led to a decline in the loan to deposit ratio to 49.8% from 57.7% in H1’2017,
- Gross non-performing loans increased by 2.5% to Kshs 30.1 bn in H1’2018 from Kshs 29.4 bn in H1’2017. Consequently, the NPL ratio increased to 46.5% from 44.2% in H1’2017. General provisions increased by 109.5% to Kshs 13.1 bn from Kshs 6.3 bn in H1’2017. The NPL coverage thus increased to 56.5% in H1’2018 from 32.5% in H1’2017. The bank had a write back in provisions of Kshs 47.9 mn in H1’2018,
- Shareholders’ funds decreased by 48.8% to Kshs 5.9 bn in H1’2018 from Kshs 11.4 bn in H1’2017, mainly due to a decline in the retained earnings owing to an accumulated loss of Kshs 4.9 bn from a retained earnings position of Kshs 3.3 bn in H1’2017,
- National Bank is currently severely undercapitalized with a core capital to risk weighted assets ratio of 2.0%, 8.5% below the statutory requirement. In addition, the total capital to risk weighted assets ratio was 3.4%, below the statutory requirement by 11.1%. Adjusting for IFRS 9, the core capital to risk weighted assets stood at 2.4%, while total capital to risk weighted assets came in at 3.9%, indicating that the bank’s total capital relative to its risk-weighted assets declined by 0.5% due to implementation of IFRS 9,
- National Bank currently has a return on average assets of 0.0% and a return on average equity of (0.6%).

Key Take-Outs:

1. National Bank is currently severely undercapitalized with the total capital to risk-weighted assets ratio coming in at 3.4%, 11.1% below the 14.5%, as required by regulation. The bank has been granted exemption to operate below the regulatory requirement, with the promise of mobilizing capital to meet the requirements, by both debt and a rights issue.
2. The bank experienced a deterioration in asset quality, with gross non-performing loans (NPLs) increasing by 2.5% to Kshs 30.1 bn from Kshs 29.0 bn in H1’2017. However, the NPL ratio of 46.5% is

still the highest in the sector and thus the bank needs to adopt a raft of measures to improve on the overall asset quality.

3. Both funded and non-funded income declined, as the bank has failed to adapt to a tough operating environment occasioned by the interest rate cap, prolonged electioneering period and a severe drought that affected the country, and whose effects spilled over to the current year. This consequently led to the overall decline in the operating profit. Furthermore, undefined exceptional items of Kshs 0.5 bn negatively affected the bank’s profitability.

The bank could improve its poor performance, and needs to focus on the following to improve:

a. **Privatization:** We are of the strong view that the bank needs to be privatized as the core step to address its underperformance
b. **Improve the asset quality**: National bank has the worst asset quality in the listed banking space, with an NPL ratio of 46.5%. At this level of NPL, a restructuring to separate the “good bank” from the “bad bank” is necessary to resolve the bad portfolio. It will be difficult for the bank to focus on growth with such a bad portfolio,
c. **Improve the capital position:** The bank is currently undercapitalized and needs to improve its capital position, to meet the regulatory requirements. The bank has stated its efforts to raise both Tier I and Tier II capital in the form of subordinated debt, and a rights issue. Other capital raising initiatives would be the sale of non-core assets such as land. However, we believe the fastest way to raise capital would be a privatization of the bank.

Below is a summary of the bank’s performance:

Balance Sheet Items	H1'2017	H1'2018	y/y change	H1'2018e	Projected %y/y change	Variance in Growth Actual vs. Expected
Government Securities	37.6	41.3	9.8%	36.0	(4.4%)	14.2%
Net Loans and Advances	57.0	47.8	(16.1%)	49.3	(13.6%)	(2.5%)
Total Assets	**116.6**	**113.3**	**(2.8%)**	**104.3**	**(10.5%)**	**7.7%**
Customer Deposits	98.8	96.0	(2.8%)	85.7	(13.3%)	10.5%
Total Liabilities	**105.2**	**107.5**	**2.2%**	**97.9**	**(7.0%)**	**9.1%**
Shareholders’ Funds	11.4	5.8	(48.8%)	6.5	(43.4%)	(5.5%)

Balance Sheet Ratios	H1'2017	H1'2018	y/y change
Loan to Deposit Ratio	57.7%	49.8%	(7.9%)
Return on average equity	(0.5%)	(0.6%)	(0.1%)
Return on average assets	(0.1%)	0.0%	1.8%

Income Statement	H1'2017	H1'2018	y/y change	H1'2018e	Projected % y/y change	Variance in Growth Actual vs. Expected
Net Interest Income	2.9	2.6	(8.9%)	2.7	(4.1%)	(4.8%)

Net non-Interest Income	1.2	1.1	(13.1%)	1.1	(6.1%)	(7.0%)
Total Operating income	4.1	3.7	(10.1%)	3.9	(4.7%)	(5.4%)
Loan Loss provision	(0.2)	0.0	(120.3%)	(0.3)	38.2%	(158.6%)
Total Operating expenses	(3.8)	(3.5)	(8.3%)	(3.7)	(2.6%)	(5.7%)
Profit before tax	0.3	0.2	(37.9%)	0.2	(36.0%)	(1.9%)
Profit after tax	**0.2**	**(0.3)**	**-**	**0.3**	**54.9%**	**-**
Core EPS	**0.5**	**0.7**	**39.3%**	**0.8**	**54.9%**	**(15.5%)**

Income Statement Ratios	H1'2017	H1'2018	y/y change
Yield from interest-earning assets	10.3%	10.1%	(0.3%)
Cost of funding	3.5%	3.0%	(0.5%)
Net Interest Spread	6.8%	7.1%	0.3%
Net Interest Income as % of operating income	70.2%	71.2%	1.0%
Non-Funded Income as a % of operating income	29.8%	28.8%	(1.0%)
Cost to Income	93.7%	95.6%	2.0%
Cost to Assets	3.1%	3.1%	0.0%

Capital Adequacy Ratios	H1'2017	H1'2018
Core Capital/Total deposit Liabilities	10.2%	1.8%
Minimum Statutory ratio	8.0%	8.0%
Excess	**2.2%**	**(6.2%)**
Core Capital/Total Risk Weighted Assets	11.3%	2.0%
Minimum Statutory ratio	10.5%	10.5%
Excess	**0.8%**	**(8.5%)**
Total Capital/Total Risk Weighted Assets	11.7%	3.4%
Minimum Statutory ratio	14.5%	14.5%
Excess	**(2.8%)**	**(11.1%)**
Liquidity Ratio	35.2%	39.9%
Minimum Statutory ratio	20.0%	20.0%
Excess	**15.2%**	**19.9%**
Adjusted Core Capital/Total Risk Weighted Assets		2.4%
Adjusted Core Capital/Total Risk Weighted Assets		3.9%