# National Bank of Kenya – FY'2017

**29th March, 2018**

**Valuation Summary**

- We are of the view that National Bank of Kenya is a "sell" with a target price of Ksh 5.6, representing a downside of 38.8%, from the current price of Kshs 9.15 as of 29th March,
- National Bank is currently trading at P/TBV of 0.5x and a P/E of 7.6x vs an industry average of 1.6x and 9.2x, respectively.

**Key highlights FY'2017**

- The general macroeconomic environment proved difficult for operations in the country. This was largely occasioned by the prolonged electioneering period thus impacting profitability. The tough operating conditions were further exacerbated by the interest rate cap on lending rates,
- A lot of banks adopted a raft of cost rationalizing measures with most resorting to reduction in staff numbers, in a bid to rationalize costs as interest income was subdued by the interest rate cap regime

**Income Statement**

- Core earnings per share increased by 479% to Kshs 1.2 per share from Kshs 0.2, much higher than our expectations of a 63.7% increase The improvement in performance was driven by a 20.8% decline in operating expenses, despite operating income also declining by 14.0%.
- Total operating income declined by 14.0% to Kshs 9.2 bn from Kshs 10.6 bn, caused by a decrease in both the Net Interest Income (NII) and the Non-Funded Income (NFI). NII decreased by 13.7% to Kshs 6.7 bn from Kshs 7.8 bn. NFI decreased by 15% from Kshs 2.9 bn to Kshs 2.4 bn.
- Interest income declined by 17.7% to Kshs 10 bn from Kshs 12.1 bn in FY'2016. The interest income on loans and advances declined by 35.2% to Kshs 5.7 bn from Kshs 8.8 bn, while interest income on government securities increased by 27.9% to Kshs 4.2 bn from Kshs 3.3 bn. As a result, the yield on interest-earning assets declined to 11% in FY' 2017 from 12.7 % in FY'2016,
- Interest expense declined by 24.9% to Kshs 3.2 bn from Kshs 4.3 bn in FY'2016, following a 16.9% decline in the interest expense on customer deposits to Kshs 2.9 bn from Kshs 3.5 bn in FY'2016. Interest expense from deposits and placements with banking institutions declined by 60.2% to Kshs 0.3 bn from Kshs 0.8 bn in FY'2016, thus consequently reducing the cost of funds to 3.3% from 4.1% in FY'2016. The net interest income declined by 13.7% to Ksh 6.7 bn from 7.8 bn, and as a consequence the Net Interest Margin declined from 8% in FY' 2016 to 7% in FY' 2017,
- Non-Funded Income (NFI) decreased by 15% to Kshs 2.4 bn from Kshs 2.9 bn in FY'2016. The decline in NFI was driven by an 8.5% increase in other fees and commissions on loans to Kshs 1.3 bn from Kshs 1.4 bn in FY'2016, and a 44.7% decrease in other income to Kshs 0.5 bn from Kshs 1.04 bn. The revenue mix currently stands at about 74:26 funded to non-funded income. This is a marginal increase from the 73:27 ratio in FY'2016 owing to a corresponding 27.9% increase in the interest income from government securities to Kshs 4.2 bn from Kshs 3.3 bn in 2016,
- The increase in the fees and commissions on loans could be attributed to the bank's attempts at squeezing as much income as it can from the loan portfolio, to compensate for the declines in the interest income caused by both the interest rate cap and the overall challenging macroeconomic conditions,
- Total operating expenses decreased by 20.8% to Kshs 8.4 bn from Kshs 10.6 bn, largely driven by a 68.7% decrease in the loan loss provision to Kshs 0.8 bn in FY 2017 from Kshs 2.4 bn in FY'2016. Staff costs rose 7.5% largely due to the company's early retirement plan to lay off workers in a bid to lower the long term staff costs,

- The cost to income ratio improved to 91.4% in FY'2017 from 99.2% in FY'2016, due to the 68.7% decline in loan loss provisions. Without LLP, the Cost to income ratio worsened to 83.2% from 76.6% in FY 2016, largely driven by a 7.5% increase in staff costs to Kshs 3.9 bn in FY' 2017 from Kshs 3.6 bn FY'2016,
- Profit before tax increased by 882.7% and stood at Ksh 0.8 bn up from Kshs 0.1 bn. Profit after tax increased by 479% to Kshs 0.4 bn from Kshs 0.1 bn in FY'2016.

**Balance Sheet**

- Total assets decreased by 2.0% to Kshs 109.9 bn in FY'2017 from Kshs 112.1 bn in FY'2016. This decline was driven by a 4.8% decrease in the loan book to Kshs 52.4 bn in FY'2017 from Kshs 55 bn in FY 2016. Also, investment in government securities Held to Maturity (HTM) decreased by 24.9% to Kshs 20.8 bn in FY' 2017 from Kshs 27.7 bn in FY' 2016,
- Total liabilities decreased by 2.4% to Kshs 102.6 bn from Kshs 105.2 bn in FY'2016, largely due to a 31.5% decrease in other liabilities from Kshs 4 bn to Kshs 2.7 bn in FY' 2017,
- Total customer deposits increased marginally by 0.4% to Kshs 94.3 bn in FY'2017 from Kshs 93.9 bn in FY'2016. Deposits per branch closed the year at Kshs 3.6 bn, unchanged from FY'2016.
- Shareholders' funds increased by 4.7% to Kshs 7.2 bn in FY'2017 from Kshs 6.9 bn in FY'2016. This is largely due to the 566% increase in statutory loan loss reserve to Kshs 2.9 bn in FY'2017 from Kshs 0.4 bn FY'2016,
- The marginal 0.4% increase in the deposits coupled with the 4.8% decrease in the net loans and advances led to the decrease in the loan to deposit ratio (LDR) to 55.5% in FY 2017 from 58.6% in FY'2016,
- Gross non-performing loans decreased by 7.8% to Kshs 27.7 bn from Kshs 30 bn. The NPL ratio as a consequence improved to 40.6% in FY'2017 from 44.6% in FY'2016,
- National bank is currently undercapitalized with a core capital to risk weighted assets ratio of 4.0%, 6.5% below the statutory requirement of 10.5%. In addition, the total capital to risk weighted assets ratio was 5.4%, which is 9.1% below the statutory requirement of 14.5%. The expected Kshs 4.2bn shareholder loan from the NSSF and The National treasury is expected to be used to shore up the company's capital,
- The bank did not recommend any dividend, same as in 2016.

**Key Take out:**

a) The relatively challenging macroeconomic environment coupled with the effects of the interest rate cap compressed the bank's interest income. The bank's main drivers for efficiency are the increased adoption of alternative channels by the customers with transactions done via alternative channels such as internet banking and reduction in operating costs by aligning the staff counts with the needs of the bank by laying off staff via the voluntary retirement program,

b) The bank's profitability was derived from a decline in the Bank's operating expenses, mainly the loan loss provisions that reduced to 0.8bn in FY'2017, from 2.4 bn in FY'2016.Overall, asset quality improved but extremely poor, and in fact the worst in comparison with the other industry players, with gross NPL ratio at 40.6%,

c) The bank has remained undercapitalized for 24 months, since March 2016, with the total capital to total risk weighted assets ratio currently at 5.4%, which is 9.1% below the minimum statutory ratio of 14.5%. The bank expects to shore up its capital reserves by a Kshs 4.2 bn shareholder loan from its top two shareholder, NSSF and the National treasury.

**Below is a summary of the key line items in the line items in the balance sheet and income statement Figures in Kshs billions except the EPS**

| Balance Sheet Items | FY'2016 | FY'2017 | y/y change | FY''2017e | Projected %y/y change | Variance in Growth Actual vs. Expected |
|---|---|---|---|---|---|---|
| Government Securities | 34.5 | 35.7 | 3.4% | 40.6 | 17.6% | (14.2%) |
| Net Loans and Advances | 55.0 | 52.4 | (4.8%) | 60.2 | 9.4% | (14.3%) |
| **Total Assets** | **112.1** | **109.9** | **(2.0%)** | **119.0** | **6.2%** | **(8.1%)** |
| Customer Deposits | 93.9 | 94.3 | 0.4% | 100.3 | 6.9% | (6.5%) |
| Total Liabilities | 112.1 | 102.6 | (8.4%) | 107.8 | (3.8%) | (4.6%) |
| **Shareholders’ Funds** | **6.9** | **7.2** | **4.7%** | **11.2** | **61.5%** | **(56.9%)** |

| Balance Sheet Ratios | FY'2016 | FY'2017 | y/y change |
|---|---|---|---|
| Loan to Deposit Ratio | 58.61% | 55.54% | (3.1%) |
| Return on average equity | 0.79% | 5.81% | 5.0% |
| Return on average assets | 0.06% | 0.37% | 0.3% |
| Yield from Interest-earning assets | 12.72% | 10.98% | (1.7%) |
| Cost of Funding | 4.10% | 3.28% | (0.8%) |
| Net Interest Margin | 8.19% | 7.41% | (0.8%) |
| Cost to Income | 99.25% | 91.42% | (7.8%) |

| Income Statement | FY'2016 | FY'2017 | y/y change | FY'2017e | Projected %y/y change | Variance in Growth Actual vs. Expected |
|---|---|---|---|---|---|---|
| Net Interest Income | 7.8 | 6.7 | -13.7% | 6.1 | -21.6% | 7.9% |
| Non-Interest Income | 2.9 | 2.4 | -15.0% | 2.8 | -3.1% | -11.9% |
| **Total Operating income** | **10.6** | **9.2** | **-14.0%** | **8.9** | **-16.6%** | **2.6%** |
| Loan Loss provision | 2.4 | 0.8 | -68.7% | 1.4 | -40.4% | -28.3% |
| **Total Operating expenses** | **10.6** | **8.4** | **-20.8%** | **8.7** | **-17.6%** | **-3.2%** |
| Profit before tax | 0.1 | 0.8 | 882.7% | 0.2 | 107.7% | 775.0% |
| **Profit after tax** | **0.1** | **0.3** | **355.9%** | **0.1** | **63.7%** | 292.1% |
| **Core EPS** | **0.2** | **1.2** | **479.0%** | **0.3** | **63.7%** | **415.2%** |