National Bank – Q1’2018
30th May, 2018

Valuation Summary

- We are of the view that National Bank is an “buy” with a target price of Kshs 8.6, representing an upside of 24.6%, from the current price of Kshs 6.9 as of 30th May,
- National Bank Holdings is currently trading at P/TBV of 0.4x and a P/E of 8.4x vs an industry average of 1.7x and 9.2x, respectively.

Key Highlights Q1’2018

- 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,

Income Statement

- Core earnings per share increased by 348.0% to Kshs 0.8 from Kshs 0.2 in Q1’2017, compared to our expectation of a 13.2% increase to Kshs 0.20. However, this growth in core EPS was realized after stripping out of an exceptional expense of Kshs 0.5 bn, which the bank incurred in Q1’2018. The bank registered a loss after tax of Kshs 0.3 bn in Q1’2018 from a profit of Kshs 0.1 bn in Q1’2017. Performance was driven by a 14.7% decrease in total operating income, despite a 14.9% decrease in the total operating expenses.
- The variance in core earnings per share growth against our expectations was largely due to (i) the exceptional expense item of Kshs 0.5 bn that the bank incurred during the quarter, (ii) the write back of the loan loss provisions despite compliance with IFRS 9 that adopts a prospective approach to credit risk assessment. We expected provisioning levels of Kshs 0.2 bn, that came in as a write back of Kshs 0.1 bn, and (iii) the one-off deferred tax item of Kshs 0.2 bn,
- Total operating income decreased by 14.7% to Kshs 1.8 bn in Q1’2018 from Kshs 2.1 bn in Q1’2017. This was due to a 15.8% decrease in Net Interest Income (NII) to Kshs 1.2 bn in Q1’2018 from Kshs 1.4 bn in Q1’2017. Non Funded Income (NFI) decreased by 12.3% to Kshs 552.5 mn from Kshs 630.3 mn in in Q1’2017,
- Interest income decreased by 14.2% to Kshs 2.0 bn from Kshs 2.3 bn in Q1’2017, largely due to the decline in interest income on loans and advances that declined by 18.9% to Kshs 1.0 bn from Kshs 1.3 bn in Q1’2017. Interest income on government securities also decreased by 9.8% to Kshs 0.9 bn in Q1’2018 from Kshs 1.0 bn in Q1’2017. As a result, the yield on interest earning assets declined to 10.5% in Q1’2018 from 11.5% in Q1’2017,
- Interest expense decreased by 11.7% to Kshs 0.8 bn from Kshs 0.9 bn in Q1’2017, following a 41.5% decrease in the interest expense on deposits and placements from banking institutions to Kshs 93.4 mn from Kshs 0.2 bn in Q1’2017. Interest expense on customer deposits also declined by 4.6% to Kshs 676.1 mn from Kshs 711.8 mn in Q1’2017. Consequently, the cost of funds declined to 3.3% from 4.0% in Q1’2017. Net Interest Margin declined to 7.1% from 7.3% in Q1’2017, due to the faster decline in the net interest income,
- Non-Funded Income declined by 12.3% to Kshs 552.5 mn from Kshs 630.3 mn in Q1’2017. The decline in NFI was driven by a 39.5% decrease in other fees and commissions to Kshs 0.2 bn from Kshs 0.3 bn in Q1’2017, coupled with a 42.1% decline in other income to Kshs 55.9 mn from Kshs 96.6 mn in Q1’2017. However, the fees and commission income on loans and advances increased by 91.3% to Kshs 141.6 mn from Kshs 74.0 mn in Q1’2017. The current revenue mix stands at 69:31 funded to non-funded income as compared to 70:30 in Q1’2017. The proportion of funded income to total revenue declined slightly owing to the faster decline in NII as compared to NFI,

- Total operating expenses decreased by 14.9% to Kshs 1.7 bn from Kshs 2.0 bn, largely driven by the write back in provisions of Kshs 70.8 mn in Q1’2018, from the Kshs 131.2 mn loan loss provision expense incurred in Q1’2017. The decline in the operating expenses was also attributed to the 22.9% decline in other operating expenses to Kshs 0.5 bn from Kshs 0.6 bn in Q1’2017, coupled with a 2.1% decrease in staff costs to Kshs 924.8 mn in Q1’2018 from Kshs 944.3 mn in Q1’2017. The decline in staff costs is mainly due to the voluntary releasing of 120 staff during the year 2017,
- The cost to income ratio improved albeit marginally to 95.7% from 95.9% in Q1’2017. Without LLP, the Cost to income ratio deteriorated to 85.0% from 84.2% in Q1’2017,
- Profit before tax decreased by 9.8% to Kshs 76.6 mn, down from Kshs 84.9 mn in Q1’2017,
- The bank recorded an exceptional item expense of Kshs 544.9 mn in Q1’2018. The details of the exceptional item have not been disclosed. Consequently, the bank recorded a loss of Kshs 278.5 mn in Q1’2018, compared to the profit of Kshs 59.5 mn in Q1’2017.

Balance Sheet

- The balance sheet experienced a contraction, as total assets declined by 9.0% to Kshs 105.2 bn from Kshs 115.7 bn in Q1’2017. This contraction was due to a 12.0% decline in the loan book to Kshs 51.1 bn from Kshs 58.1 bn in Q1’2017,
- Government securities also declined by 9.8% to Kshs 0.9 bn from Kshs 1.0 bn in Q1’2017,
- Total liabilities declined by 5.5% to Kshs 98.8 bn from Kshs 104.5 bn in Q1’2017, driven by a 6.3% decrease in total deposits to Kshs 86.9 bn from Kshs 92.8 bn in Q1’2017. Deposits per branch also decreased by 6.3% to Kshs 1.16 bn from Kshs 1.24 bn in Q1’2017,
- The faster decline in loans as compared to deposits led to a decline in the loan to deposit ratio to 58.9% from 62.7% in Q1’2017,
- Gross non-performing loans decreased by 0.3% to Kshs 28.9 bn in Q1’2018 from Kshs 29.0 bn in Q1’2017. The NPL ratio was unchanged at 42.9%, as the decline in NPL was minimal. The NPL coverage thus increased to 56.5% in Q1’2018 from 32.9% in Q1’2017. The bank had a write back in provisions of Kshs 70.8 mn in Q1’2018. However, the total loan loss provisions increased by 101.9% to Kshs 12.4 bn from Kshs 6.2 bn in Q1’2017. This increase contributed to the increase in the NPL coverage,
- Shareholders’ funds decreased by 42.2% to Kshs 6.5 bn in Q1’2018 from Kshs 11.2 bn in Q1’2017, mainly due to a decline in the retained earnings to a retained loss of Kshs 4.4 bn from retained earnings of Kshs 3.0 bn in Q1’2017,
- National Bank is currently severely undercapitalized with a core capital to risk weighted assets ratio of 3.3%, 4.8% below the statutory requirement. In addition, the total capital to risk weighted assets ratio was 4.8%, below the statutory requirement by 9.7%. Adjusting for IFRS 9, the core capital to risk weighted assets stood at 3.9%, while total capital to risk weighted assets came in at 5.4%, indicating that the bank’s total capital relative to its risk-weighted assets declined by 0.6% due to implementation of IFRS 9,
- National Bank currently has a return on average assets of 0.1% and a return on average equity of 0.8%.

Key Take-Outs:

1. National Bank is currently undercapitalized with the total capital to risk-weighted assets ratio coming in at 4.8%, 9.7% below 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.
2. The bank experienced a slight improvement in asset quality, with gross non-performing loans (NPLs) declining by 0.3%, to Kshs 28.9 bn from Kshs 29.0 bn in Q1’2017. However, the NPL ratio of 42.9% 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. This consequently led to the overall decline in the operating profit.
4. The bank’s profitability was negatively impacted by an undefined exceptional expense item of Kshs 0.5 bn, which resulted in a loss after tax for the bank.

The bank underperformed and needs to focus on the following, to improve:

a. **Improve the asset quality**: National bank has the worst asset quality, with an NPL ratio of 42.9%. The bank can improve this by (i) helping collapsed businesses to regain operation, which would enable them to service their obligations and eventually improve the asset quality, (ii) the bank could securitize the bad debt, and sell to third parties. This would enable the bank to recoup some of the funds locked in the non-performing loans, thereby gradually improving the asset quality, (iii) adoption of big data technology for accurate credit pre-scoring and rating. This would enable the bank to accurately price loans and identify loan defaults in advance by deep analysis of implicit factors that lead to defaults.

b. **Focus on NFI growth:** The bank should focus on growing its non-funded income. The bank can ride on the digital banking revolution by providing mobile and internet banking services such as mobile lending, deposit as well as withdrawal services to its clientele, which would both increase its transactional income and increase its operational efficiency by operation cost reduction, thus enabling the bank to achieve sustainable growth. Furthermore, the bank should also leverage on its strength in sharia banking, which currently contributes to about 13.0% of its total book. Increased focus on this banking segment would help the bank create a niche for itself in the segment, which would gradually increase the NFI.

c. **Focus on interest income:** National bank registered a decline in the interest income, largely due to a decline in the interest income on loans and government securities. The bank can mitigate the effects of the interest rate cap by increasing its allocation to government securities, which would in turn help in increasing interest income.

d. **Improve the capital position:** The bank is currently undercapitalized and needs to improve its capital position so as 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. Other capital raising initiatives would be the sale of non-core assets.

Below is a summary of the bank’s performance:

Balance Sheet Items	Q1'2017	Q1'2018	y/y change	Q1'2018e	Projected % y/y change	Variance in Growth Actual vs. Expected
Government Securities	35.5	33.9	(4.3%)	35.0	(1.3%)	(3.0%)
Net Loans and Advances	**58.1**	**51.1**	**(12.0%)**	**52.7**	**(9.3%)**	**(2.7%)**
Total Assets	115.7	105.2	(9.0%)	109.6	(5.3%)	(3.7%)
Customer Deposits	**92.8**	**86.9**	**(6.3%)**	**93.3**	**(0.6%)**	**(7.0%)**
Total Liabilities	104.5	98.8	(5.5%)	102.3	(2.1%)	(3.3%)
Shareholders’ Funds	**11.2**	**6.5**	**(42.2%)**	**7.3**	**(34.7%)**	**(7.5%)**

Income Statement	Q1'2017	Q1'2018	y/y change	Q1'2018e	Projected % y/y change	Variance in Growth Actual vs. Expected
Net Interest Income	1.4	1.2	(15.8%)	1.5	5.2%	(20.9%)
Net non-Interest Income	0.6	0.6	(12.3%)	0.6	(1.4%)	(11.0%)
Total Operating income	**2.1**	**1.8**	**(14.7%)**	**2.1**	**3.2%**	**(17.9%)**
Loan Loss provision	(0.1)	0.1	(154.0%)	(0.2)	36.2%	(190.2%)
Total Operating expenses	(2.0)	(1.7)	(14.9%)	(2.0)	2.8%	(17.7%)
Profit before tax	0.1	(0.5)	(9.8%)	0.1	13.2%	(3.4%)
Profit after tax	**0.1**	**(0.3)**		**0.1**	**13.2%**	

Capital Adequacy Ratios	Q1'17	Q1'18
Core Capital/Total deposit Liabilities	10.70%	3.20%
Minimum Statutory ratio	8.00%	8.00%
Excess	**2.70%**	**(4.80%)**
Core Capital/Total Risk Weighted Assets	11.10%	3.30%
Minimum Statutory ratio	10.50%	10.50%
Excess	**0.60%**	**(7.20%)**
Total Capital/Total Risk Weighted Assets	11.60%	4.80%
Minimum Statutory ratio	14.50%	14.50%
Excess	**(2.90%)**	**(9.70%)**
Liquidity Ratio	26.50%	29.90%
Minimum Statutory ratio	20.00%	20.00%
Excess	**6.50%**	**9.90%**
Adjusted Core Capital/Total Deposit Liabilities		**3.70%**
Adjusted Core Capital/Total Risk Weighted Assets		**3.90%**
Adjusted Core Capital/Total Risk Weighted Assets		**5.40%**

Balance Sheet Ratios	Q1'2017	Q1'2018	y/y change
Loan to Deposit Ratio	62.7%	58.9%	(3.8%)
Return on average equity	0.5%	0.8%	0.3%
Return on average assets	(0.2%)	0.1%	1.8%

Income Statement Ratios	Q1'2017	Q1'2018	y/y change
Yield from interest-earning assets	11.5%	10.5%	(1.0%)

Cost of funding	4.0%	3.3%	(0.6%)
Net Interest Spread	7.5%	7.2%	(0.4%)
Net Interest Income as % of operating income	69.6%	68.8%	(0.8%)
Non-Funded Income as a % of operating income	30.4%	31.2%	0.8%
Cost to Income	**95.9%**	**95.7%**	**(0.2%)**
Cost to Assets	1.6%	1.6%	0.0%