National Bank of Kenya Limited – Q3'2017

1st December, 2017

Valuation Summary

- We are of the view that National Bank of Kenya stock is a "sell", with a target price of Kshs 5.2 representing a downside of 48.7%, from the current price of Kshs 10.1, as at 1st December 2017,
- National Bank of Kenya is currently trading at a P/TBV of 0.4x and a P/E of 8.7x, vs an industry average of 1.4x and 8.5x, respectively.

Key Highlights during Q3'2017

- National Bank upgraded its core banking system to Fusion Banking Essence [FBE], aimed at enhancing the technology platform in line with the bank's focus to improve customer experience and to provide a wider range of product offering,
- National Bank collaborated with WorldRemit to enable Kenyans living abroad to make instant transfers home. WorldRemit users can now make instant bank deposits to NBK accounts held in both Kenyan Shillings and US Dollars, as well as send funds for cash pickup in KES across NBK's branch network.

Income Statement

- Core earnings per share declined by 73.5% to Kshs 0.4 from Kshs 1.5 in Q3'2016, worse than our expectation of a 61.7% decline in core EPS to Kshs 0.5 per share. The decline was attributed to a 24.4% decline in operating revenue, which outpaced a 19.6% decline in operating expenses
- Total operating revenue declined by 24.4% y/y to Kshs 6.4 bn from Kshs 8.4 bn, attributed to a 30.4% decline in Net Interest Income (NII) to Kshs 4.6 bn from Kshs 6.6 bn, and a 3.1% decline in Non-Funded Income (NFI) to Kshs 1.8 bn from Kshs 1.9 bn in Q3'2016,
- Interest Income declined by 29.6% to Kshs 7.1 bn from Kshs 10.0 bn in Q3'2016, attributable to a decline in the yield on interest-earning assets to 9.8% from 12.9% in Q3'2016. Interest income on loans and advances declined by 50.7% y/y to Kshs 3.8 bn from Kshs 7.6 bn, while interest on government securities increased by 36.7% y/y to Kshs 3.2 bn from Kshs 2.3 bn,
- Interest expense decreased by 28.0% to Kshs 2.5 bn from Kshs 3.5 bn in Q3'2016, following a decline in cost of funds to 3.4% from 5.4% in Q3'2016. Interest expense on placements declined by 65.4% y/y to Kshs 0.2 bn from Kshs 0.7 bn, while interest expense on customer deposits declined by 18.7% y/y to Kshs 2.3 bn from Kshs 2.8 bn in Q3'2016. Owing to the faster decline in interest income, the Net Interest Income declined by 30.4% to Kshs 4.6 bn from Kshs 6.6 bn in Q3'2016. The Net Interest Margin thus declined to 6.3% from 7.5% in Q3'2016,
- Non-Funded Income (NFI) recorded a drop of 3.1% to Kshs 1.8 bn from Kshs 1.9 bn in Q3'2016. The decline in NFI is attributable to a 5.0% drop in total fees and commissions to Kshs 1.1 bn from Kshs 1.2 bn in Q3'2016. Given the slower decline in NFI compared to decline in NII, the proportion of NFI to total revenue increased, with the current revenue mix at 72:28 funded to non-funded income from 78:22 in Q3'2016,
- Total operating expenses decreased by 19.6% to Kshs 6.2 bn from Kshs 7.7 bn, attributable to a 72.9% decrease in loan loss provisions (LLP) to Kshs 0.5 bn from Kshs 1.9 bn in Q3'2016. However, staff costs increased by 7.6% to Kshs 2.9 bn from Kshs 2.7 bn in Q3'2016,
- The Cost to Income ratio worsened to 96.9% from 91.2% in Q3'2016, following a 24.4% decline in operating revenue, which outpaced a 19.6% decrease in operating expenses. Without LLP, the Cost to Income ratio worsened to 88.8% from 68.6% in Q3'2016,
- Profit before tax declined by 73.5% to Kshs 0.2 bn from Kshs 0.7 bn, while profit after tax declined by 73.5% to Kshs 0.1 bn from Kshs 0.5 bn in Q3'2016.

Balance Sheet

- The total assets increased by 2.4% to Kshs 116.3 bn from Kshs 113.6 bn in Q3'2016. This growth was driven by a 42.1% growth in government securities to Kshs 39.7 bn from Kshs 28.0 bn in Q3'2016. The loan book contracted by 6.9% to Kshs 57.9 bn from Kshs 62.1 bn in Q3'2016,
- Total liabilities rose by 2.9% to Kshs 105.1 bn from Kshs 102.1 bn in Q3'2016, driven by an increase in placements that grew 86.8% to Kshs 2.2 bn from Kshs 1.2 bn in Q3'2016. Deposits also increased by 1.8% to Kshs 97.4 bn from Kshs 95.7 bn in Q3'2016,
- The growth in deposits coupled with a decline in loans led to a decrease in the loan to deposit ratio to 59.4% from 64.9% in Q3'2016,

- Shareholders’ funds decreased by 2.4% to Kshs 11.2 bn from Kshs 11.5 bn in Q3’2016, due to a 38.3% y/y decrease retained earnings to Kshs 2.1 bn from Kshs 3.3 bn in Q3’2016.
- Gross non-performing loans increased by 0.7% y/y to Kshs 29.6 bn from Kshs 29.3 bn. The NPL ratio also increased to 47.8% from 45.7% in Q3’2016,
- National Bank is currently under capitalized with a core capital to risk weighted assets ratio at 9.8%, 0.7% below the statutory requirement, with total capital to total risk weighted assets below the statutory requirement of 14.5% by 3.2%,
- National Bank currently has a return on average assets of -0.2% and a return on average equity of -1.9%

Key Take Out:

- Key point to note is that NBK continues to reduce its level of provisioning, despite growth in non-performing loans and contrary to the current industry trend of providing more pending adoption of IFRS 9,
- NBK still remains under-capitalized with the total capital to total risk-weighted assets falling below the statutory requirement of 14.5% by 3.2%.

Moving forward, National Bank of Kenya’s growth is expected to be supported by:

a) Revamping of its Small Enterprise banking segment and the Amanah business segment. The bank has also partnered with institutions to offer real-time collections through its Payment Gateway platform for institutions, which is expected to drive their deposits as well as further reduce its cost of funding,
b) Management of expenses, which will enable the bank control its high cost-to-income ratio, currently at 96.9%.

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	Projected %y/y change	Variance in Growth Actual vs. Expected
Government Securities	28.0	39.7	42.1%	36.9	32.1%	10.1%
Net Loans and Advances	62.1	57.9	(6.9%)	59.9	(3.7%)	(3.2%)
Total Assets	**113.6**	**116.3**	**2.4%**	**118.0**	**3.9%**	**(1.5%)**
Customer Deposits	95.7	97.4	1.8%	99.8	4.3%	(2.5%)
Total Liabilities	102.1	105.1	2.9%	106.5	4.3%	(1.4%)
Shareholders’ Funds	**11.5**	**11.2**	**(2.4%)**	**11.5**	**0.0%**	**(2.3%)**

Balance Sheet Ratios	Q3'2016	Q3'2017	y/y change
Loan to Deposit Ratio	64.9%	59.4%	(5.5%)
Return on average equity	(23.1%)	(2.0%)	21.2%
Return on average assets	(2.5%)	(0.2%)	2.3%

Income Statement	Q3'2016	Q3'2017	y/y change	Q3'2017e	Projected %y/y change	Variance in Growth Actual vs. Expected
Net Interest Income	6.6	4.6	(30.4%)	5.7	(13.5%)	(16.9%)
Non-Interest Income	1.9	1.8	(3.1%)	1.8	(0.9%)	(2.2%)
Total Operating income	**8.4**	**6.4**	**(24.4%)**	**7.5**	**(10.7%)**	**(13.6%)**
Loan Loss provision	1.9	0.5	(72.9%)	(1.4)	(174.9%)	102.0%
Total Operating expenses	**7.7**	**6.2**	**(19.6%)**	**(7.2)**	**(194.1%)**	**174.5%**
Profit before tax	0.7	0.2	(73.5%)	0.3	(60.9%)	(12.5%)
Profit after tax	**0.5**	**0.1**	**(73.5%)**	**0.2**	**(60.9%)**	(12.5%)
Core EPS	**1.5**	**0.4**	**(73.5%)**	**0.0**	**(97.2%)**	**23.7%**

Income Statement Ratios	Q3'2016	Q3'2017	y/y change

Yield from interest-earning assets	12.9%	9.8%	(3.1%)
Cost of funding	5.4%	3.4%	(2.0%)
Net Interest Margin	7.5%	6.3%	(1.2%)
Cost of Risk	22.6%	8.1%	(14.5%)
Net Interest Income as % of operating income	77.9%	71.7%	(6.2%)
Non-Funded Income as a % of operating income	22.1%	28.3%	6.2%
Cost to Income Ratio	91.2%	96.9%	5.7%
CIR without provisions	89.9%	89.5%	(0.3%)
Cost to Assets	7.1%	7.0%	(0.1%)

Capital Adequacy Ratios	Q3'2016	Q3'2017
Core Capital/Total Liabilities	10.5%	9.1%
Minimum Statutory ratio	8.0%	8.0%
Excess	**2.5%**	**1.1%**
Core Capital/Total Risk Weighted Assets	12.1%	9.8%
Minimum Statutory ratio	10.5%	10.5%
Excess	**1.6%**	**(0.7%)**
Total Capital/Total Risk Weighted Assets	12.6%	11.3%
Minimum Statutory ratio	14.5%	14.5%
Excess	**(1.9%)**	**(3.2%)**
Liquidity Ratio	25.2%	34.0%
Minimum Statutory ratio	20.0%	20.0%
Excess	**5.2%**	**14.0%**