National Bank of Kenya – FY'2018
29th March, 2019

Valuation Summary

- We are of the view that National Bank of Kenya is a "***SELL***" with a target price of Kshs 4.9, representing a downside of 2.0%, from the current price of Kshs 5.0 as of 29th March 2019, inclusive of a dividend yield of 0.0%,
- National Bank of Kenya is currently trading at a P/TBV of 0.3x and a P/E of 241.7x vs an industry average of 1.5x and 7.0x, respectively.

Key Highlights FY'2018

- In October 2018, National Bank of Kenya launched its deposit mobilization plan, aimed at enticing new deposits, by offering customers relatively higher rates, depending on the deposit amount, with rates ranging between 1.0% p.a. and 7.0% p.a. Savers with deposits of more than Kshs 2.0 mn will earn 7.0% interest while those with between Kshs 50,001 and Kshs 2.0 mn will earn 5.0% interest. Those with between Kshs 5,001 and Kshs 50,000 will be paid 1.0% interest on their deposits. The plan highlights the bank's plan to grow deposits that have been on a declining trend.

Income Statement

- Core EPS increased by 33.5% to Kshs 1.6, from Kshs 1.2 in FY'2017, exceeding our expectation of an 11.3% increase to Kshs 1.4. However, this was due to the stripping out of a one-off restructuring exceptional expense of Kshs 0.5 bn. The bank registered a 98.3% decline in the profit after tax to Kshs 7.0 mn from Kshs 0.4 bn in FY'2017. The performance was as a result of a 12.4% decline in total operating income to Kshs 8.0 bn, from Kshs 9.2 bn in FY'2017, which outpaced the 9.6% decline in the total operating expenses to Kshs 7.6 bn from Kshs 8.4 bn in FY'2017. The variance in core earnings per share growth against our expectations was largely due to the faster 9.6% decline in total operating expenses to Kshs 7.6 bn from Kshs 8.4 bn, exceeding our expectation of a 0.6% decline,
- Total operating income declined by 12.4% to Kshs 8.0 bn from Kshs 9.2 bn in FY'2017, driven by the 10.4% decline in Net Interest Income (NII) to Kshs 6.0 bn, from Kshs 6.7 bn in FY'2017, coupled with the 18.0% decline in Non-Funded Income (NFI) to Kshs 2.0 bn, from Kshs 2.4 bn in FY'2017,
- Interest income declined by 10.5% to Kshs 8.9 bn, from Kshs 10.0 bn in FY'2017. This was as a result of a 22.3% decline in interest income from loans and advances to Kshs 4.4 bn, from Kshs 5.7 bn in FY'2017, coupled with a 45.8% decline in interest income from placement assets to Kshs 0.05 bn from Kshs 0.1 bn in FY'2017. The decline in interest income from loans and advances was however mitigated by the 6.4% increase in interest income from government securities to Kshs 4.4 bn from Kshs 4.2 bn in FY'2017. Consequently, the yield on interest-earning assets declined to 9.5% from 11.0% in FY'2017,
- Interest expense declined by 10.9% to Kshs 2.9 bn, from Kshs 3.2 bn in FY'2017, following a 12.3% decrease in the interest expense on customer deposits to Kshs 2.6 bn from Kshs 2.9 bn in FY'2017. The deposit mobilization plan was launched in Q4'2018, and consequently did not significantly affect the expenses. The decrease in interest expense was countered by the 2.1% increase in interest expense on placement liabilities to Kshs 0.32 bn, from Kshs 0.31 bn in FY'2017. Consequently, the cost of funds declined to 2.8% from 3.3% in FY'2017. Thus, the Net Interest Margin (NIM) declined to 6.2% from 7.4% in FY'2017,
- Non-Funded Income (NFI) declined by 18.0% to Kshs 2.0 bn, from Kshs 2.4 bn in FY'2017. The increase was mainly driven by the 14.4% decline in the total fees and commissions to Kshs 1.4 bn from Kshs 1.2 bn in FY'2017. The decline in NFI was however mitigated by the 14.1% growth in forex trading income to Kshs 0.6 bn from Kshs 0.5 bn in FY'2017. Owing to the faster decline in NFI, the revenue mix shifted to 75:25, funded to non-funded income from 73:27 in FY'2017,

- Total operating expenses declined by 9.6% to Kshs 7.6 bn from Kshs 8.4 bn in FY'2017, largely driven by the 75.5% decline in Loan Loss Provisions (LLP) to Kshs 0.2 bn from Kshs 0.8 bn in FY'2017. The provisions declined despite the increase in Non-Performing Loans (NPLs) as the bank incurred charged the impairments on its equity, as allowed in the initial year of implementation of IFRS 9. In addition, other operating expenses declined by 4.9% to Kshs 3.5 bn from Kshs 3.7 bn in FY'2017, while staff costs decreased by 1.3% to Kshs 3.86 bn from Kshs 3.92 bn in FY'2017,
- The Cost to Income Ratio (CIR) deteriorated to 94.3%, from 91.4% in FY'2017 owing to the faster decline in total operating income. Without LLP, the cost to income ratio deteriorated by a wider margin to 92.0%, from 83.2% in FY'2017, highlighting the significant decline in the cost of risk to 2.3% from 8.3% in FY'2017,
- Profit before tax declined to a loss before tax of Kshs 0.1 bn, down from a profit before tax of Kshs 0.8 bn in FY'2017. Profit after tax declined by 98.3% to Kshs 7.0 mn in FY'2018, from Kshs 0.4 bn in FY'2017, with the difference attributable to a tax credit of Kshs 145.5 mn in FY'2018,
- The bank does not recommend a dividend.

Balance Sheet

- The balance sheet recorded an expansion as total assets increased by 4.5% to Kshs 114.8 bn, from Kshs 109.9 bn in FY'2017. This growth was largely driven by a 29.7% growth in government securities to Kshs 46.3 bn, from Kshs 35.7 bn in FY'2017, coupled with a 5.2% increase in other assets to Kshs 8.5 bn from Kshs 8.1 bn in FY'2017,
- However, the loan book contracted by 8.8% to Kshs 47.8 bn from Kshs 52.4 bn in FY'2017, as the bank increased allocations to government securities, as the bank is constricted in lending given the severe undercapitalization, with the total capital to risk-weighted assets ratio currently at 3.7%, 10.8% points below regulatory requirement,
- Total liabilities rose by 5.1% to Kshs 107.9 bn, from Kshs 102.6 bn in FY'2017, driven by a 4.9% increase in customer deposits to Kshs 98.9 bn from Kshs 94.3 bn in FY'2017, coupled with the 7.1% growth in placement liabilities to Kshs 6.0 bn from Kshs 5.6 bn in FY'2017. Deposits per branch rose by 10.8% to Kshs 1.4 bn from Kshs 1.3 bn in FY'2017, as the number of branches decreased by 4 to 71 in 2018, from 75 in FY'2017,
- The faster growth in deposits coupled with the decline in loans led to a decline in the loan to deposit ratio to 48.3% from 55.5% in FY'2017,
- Gross Non-Performing Loans (NPLs) rose by 13.8% to Kshs 31.5 bn in FY'2018 from Kshs 27.7 bn in FY'2017. As a consequence, the NPL ratio deteriorated to 47.6% in FY'2018 from 40.6% in FY'2017. General Loan Loss Provisions rose by 16.2% to Kshs 18.3 bn, from Kshs 15.8 bn in FY'2017. Thus, the NPL coverage improved to 58.3% in FY'2018 from 57.1% in FY'2017, owing to the faster growth in provisions,
- Shareholders' funds declined by 3.6% to Kshs 7.0 bn in FY'2018 from Kshs 7.2 bn in FY'2017, largely due to the 37.7% increase in the accumulated losses to Kshs 4.9 bn, from Kshs 3.5 bn in FY'2017,
- National Bank is currently undercapitalized with a core capital to risk-weighted assets ratio of 2.3%, 8.2% points below the statutory requirement. In addition, the total capital to risk-weighted assets ratio was 3.7%, below the statutory requirement by 10.8% points. Adjusting for IFRS 9, the core capital to risk weighted assets stood at 3.1%, while total capital to risk-weighted assets came in at 4.5%,
- The bank currently has a Return on Average Assets (ROaA) of 0.01%, and a Return on Average Equity (ROaE) of 0.1%.

Key Take-Outs:

1. National Bank remains severely undercapitalized with the total capital to risk-weighted assets ratio coming in at 3.7%, 10.8% points 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. With such depleted capital reserves, the bank becomes increasingly vulnerable to any future external shocks that may affect its continuity in the future, in addition to rendering the bank unable to issue new loans,

2. The bank experienced a deterioration in its asset quality, with the NPL ratio rising to 47.6% from 40.6% in FY’2017, and is still the highest in the listed banking space, above the industry average of 11.9%, thus requiring the bank to adopt a raft of corrective measures to improve on the overall asset quality. The bank’s lending activities have continued to be hampered by the poor asset quality, as corrective and recovery efforts seem not to be bearing fruit, leading to a decline in its interest income, as well as the associated fees and commission income, and,
3. The bank recorded declines in all of its revenue lines, as the bank has failed to adapt to a tough operating environment. This consequently led to the overall decline in the operating profit, as they were not matched by proportionate declines in the operating expenses. Furthermore, the bank incurred an exceptional items expense of Kshs 0.5 bn that was utilized in covering restructuring costs such as the voluntary early retirement program, which consequently negatively affected the bank’s profitability.

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

1. We are of the view that the bank may need to be privatized as the core step to address its underperformance. With the bank’s efforts of a rights issue being delayed, the bank is in a precarious position, with privatization offering the bank an easier capital raising route, other than the planned rights issue or the issuance of subordinated debt. Another initiative would be the sale of non-core assets such as land owned, and,
2. National bank has the worst asset quality in the listed banking space. 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. A restructuring would enable the bank to resume its core activities such as lending, which would aid in improving the Net Interest Income, and consequently the associated fee and commission income, and in the process instill confidence in the public thereby aiding in improving its deposit mobilization capacity.

Below is a summary of the bank’s performance:

	FY'2017	FY'2018	y/y change	FY'2018e	Projected %y/y change	Variance in Growth Actual vs. Expected
Government Securities	35.7	46.3	29.7%	41.8	17.2%	12.6%
Net Loans and Advances	52.4	47.8	(8.8%)	46.5	(11.2%)	2.4%
Total Assets	**109.9**	**114.8**	**4.5%**	**112.9**	**2.7%**	**1.8%**
Customer Deposits	94.3	98.9	4.9%	93.0	(1.4%)	6.2%
Total Liabilities	**102.6**	**107.9**	**5.1%**	**106.0**	**3.3%**	**1.8%**
Shareholders’ Funds	7.2	7.0	(3.6%)	6.9	(4.9%)	1.2%

Balance Sheet Ratios	FY'2017	FY'2018	y/y change
Loan to Deposit Ratio	55.5%	48.3%	(7.2%)
Return on Average Equity	5.8%	0.1%	(5.7%)
Return on Average Assets	0.4%	0.0%	1.8%

Income Statement	FY'2017	FY'2018	y/y change	FY'2018e	Projected % y/y change	Variance in Growth Actual vs. Expected
Net Interest Income	6.7	6.0	(10.4%)	9.5	0.42	(52.2%)
Non Funded Income	2.4	2.0	(18.0%)	2.2	(8.4%)	(9.7%)

Total Operating Income	9.2	8.0	(12.4%)	8.7	(4.5%)	(7.9%)
Loan Loss Provision	(0.8)	(0.2)	(75.5%)	(0.5)	(34.7%)	(40.9%)
Total Operating Expenses	(8.4)	(7.6)	(9.6%)	(8.3)	(0.6%)	(9.0%)
Profit Before Tax	0.8	0.5	(41.9%)	0.4	(46.0%)	4.2%
Profit After Tax	**0.4**	**0.0**	**(98.3%)**	**(0.1)**	**-**	**-**
Core EPS	**1.2**	**1.6**	**33.5%**	**1.3**	**11.3%**	**11.3%**

Income Statement Ratios	FY'2017	FY'2018	y/y change
Yield from interest-earning assets	11.0%	9.5%	(1.4%)
Cost of funding	3.3%	2.8%	(0.5%)
Net Interest Spread	7.7%	6.7%	(1.0%)
Net Interest Income as % of operating income	73.5%	75.2%	1.7%
Non-Funded Income as a % of operating income	26.5%	24.8%	(1.7%)
Cost to Income	91.4%	94.3%	2.9%
Cost to Assets	6.9%	6.6%	(0.3%)

Capital Adequacy Ratios	FY'2017	FY'2018
Core Capital/Total deposit Liabilities	3.7%	2.1%
Minimum Statutory ratio	8.0%	8.0%
Excess	**(4.3%)**	**(5.9%)**
Core Capital/Total Risk Weighted Assets	4.0%	2.3%
Minimum Statutory ratio	10.5%	10.5%
Excess	**(6.5%)**	**(8.2%)**
Total Capital/Total Risk Weighted Assets	5.4%	3.7%
Minimum Statutory ratio	14.5%	14.5%
Excess	**(9.1%)**	**(10.8%)**
Liquidity Ratio	36.3%	43.1%
Minimum Statutory ratio	20.0%	20.0%
Excess	**16.3%**	**23.1%**
Adjusted Core Capital/Total Risk Weighted Assets		3.1%
Adjusted Core Capital/Total Risk Weighted Assets		4.5%