Cytonn INVESTMENTS

NCBA Group - Q1'2022

6th May 2022

Below is a summary of NCBA Group Q1'2022 performance;

Balance Sheet (Kshs bns)	Q1'2021	Q1'2022	y/y change
Net Loans and Advances	243.1	243.9	0.3%
Government Securities	158.7	194.7	22.6%
Total Assets	**542.1**	**587.4**	**8.4%**
Customer Deposits	434.2	465.5	7.2%
Total Liabilities	467.5	507.1	8.5%
Shareholders' Funds	**74.4**	**80.2**	**7.8%**

Balance sheet ratios	Q1'2021	Q1'2022	% point change
Loan to Deposit Ratio	56.0%	52.4%	(3.6%)
Return on average equity	10.1%	14.0%	3.9%
Return on average assets	1.4%	1.9%	0.5%

Income Statement(Kshs bns)	Q1'2021	Q1'2022	y/y change
Net Interest Income	6.6	7.1	7.6%
Net non-Interest Income	5.2	6.1	15.5%
Total Operating income	**11.8**	**13.1**	**11.1%**
Loan Loss provision	2.6	2.5	(4.3%)
Total Operating expenses	**7.8**	**8.1**	**4.5%**
Profit before tax	3.9	4.8	25.3%
Profit after tax	**2.8**	**3.4**	**20.3%**
Core EPS	**1.7**	**2.1**	**20.3%**

Income Statement Ratios	Q1'2021	Q1'2022	y/y change
Yield from interest-earning assets	2.5%	2.6%	0.1%
Cost of funding	1.0%	1.1%	0.1%
Net Interest Spread	1.5%	1.5%	0.0%
Net Interest Margin	6.0%	5.8%	(0.2%)
Cost of Risk	22.3%	19.2%	(3.1%)
Net Interest Income as % of operating income	55.7%	53.9%	(1.8%)
Non-Funded Income as a % of operating income	44.3%	46.1%	1.8%
Cost to Income Ratio	65.6%	61.7%	(3.9%)
Cost to Income Ratio without LLP	43.3%	42.5%	(0.8%)

Capital Adequacy Ratios	Q1'2021	Q1'2022	% points change
Core Capital/Total Liabilities	15.6%	15.4%	(0.2%)
Minimum Statutory ratio	8.0%	8.0%	0.0%
Excess	**7.6%**	**7.4%**	**(0.2%)**
Core Capital/Total Risk Weighted Assets	18.2%	17.8%	(0.4%)
Minimum Statutory ratio	10.5%	10.5%	0.0%
Excess	**7.7%**	**7.3%**	**(0.4%)**
Total Capital/Total Risk Weighted Assets	18.3%	17.9%	(0.5%)
Minimum Statutory ratio	14.5%	14.5%	0.0%
Excess	**3.8%**	**3.4%**	**(0.5%)**
Liquidity Ratio	58.7%	63.0%	4.3%
Minimum Statutory ratio	20.0%	20.0%	0.0%

Excess	**38.7%**	**43.0%**	**4.3%**
Adjusted Core Capital/Total Liabilities	16.6%	16.0%	(0.5%)
Adjusted Core Capital/Total RWA	19.3%	18.6%	(0.8%)
Adjusted Total Capital/Total RWA	19.5%	18.6%	(0.9%)

Income Statement

- Core earnings per share rose by 20.3% to Kshs 2.1, from Kshs 1.7 in Q1’2021, lower than our expectation of a 28.9% growth, driven by the 11.1% growth in total operating income to Kshs 13.1 bn, from Kshs 11.8 bn in Q1’2021. However, the performance was weighed down by the 4.5% increase in total operating expenses to Kshs 8.1 bn, from 7.8 bn in Q1’2021,
- Total operating income rose by 11.1% to Kshs 13.1 bn in Q1’2022, from Kshs 11.8 bn in Q1’2021. This was due to a 15.5% increase in Non-Funded Income (NFI) to Kshs 6.1 bn, from Kshs 5.2 bn recorded in Q1’2021 coupled with a 7.6% increase in Net Interest Income (NII) to Kshs 7.1 bn, from the Kshs 6.6 bn recorded in Q1’2021,
- Interest income rose by 10.4% to Kshs 12.2 bn, from Kshs 11.0 bn in Q1’2021 mainly driven by a 31.6% growth in interest income from government securities to Kshs 5.8 bn, from Kshs 4.4 bn in Q1’2021. However, the growth was weighed down by a 3.6% decline in interest income from loans and advances to Kshs 6.3 bn, from Kshs 6.5 bn in Q1’2021 coupled with a 14.2% increase in interest income from deposits and placements with banking institutions to Kshs 58.8 mn, from Kshs 51.5 mn in Q1’2021. Consequently, the yield on interest-earning assets increased by 0.1% points to 2.6% in Q1’2022, from 2.5% in Q1’2021, attributable to the faster 6.0% increase in average interest-earning assets to Kshs 470.8 bn, from Kshs 444.0 bn in Q1’2021, which outpaced by the 5.8% increase in trailing interest income,
- Interest expense increased by 14.9% to Kshs 5.1 bn, from Kshs 4.4 bn in Q1’2021, mainly attributable to an 11.9% increase in interest expense on customer deposits to Kshs 4.8 bn, from Kshs 4.3 bn in Q1’2021. Cost of funds increased by 0.1% points to 1.1% in Q1’2022 from 1.0% in Q1’2021 owing to the 8.9% increase in trailing interest expense that outpaced the 4.5% growth in average interest bearing liabilities, an indication that the bank was unable to mobilize cheaper deposits. The Net Interest Margin declined by 0.2% points to 5.8% in Q1’2022 from 6.0% recorded in Q1’2021, due to the slower 3.6% growth in trailing Net Interest Income, compared to the 6.0% growth seen in the average interest-earning assets,
- Non-Funded Income increased by 15.5% to Kshs 6.1 bn in Q1’2022, from Kshs 5.2 bn in Q1’2021, driven by a 39.2% increase in foreign exchange trading income to Kshs 1.6 bn, from Kshs 1.2 bn in Q1’2021, and a 3.8% increase in income from other fees and commissions to Kshs 1.0 bn, from Kshs 0.9 bn in Q1’2021. This was weighed down by a 1.3% decline in fees and commissions on loans and advances to Kshs 2.68 bn, from Kshs 2.72 bn in Q1’2021. Total fees and commissions remained relatively unchanged at Kshs 3.7 bn, similar to what was recorded in Q1’2021. Consequently, the revenue mix shifted to 54:46 in Q1’2022 from 56:44 funded to non-funded income in Q1’2021, owing to the faster growth in NFI compared to NII,
- Total operating expenses increased by 4.5% to Kshs 8.1 bn in Q1’2022, from Kshs 7.8 bn in Q1’2021, largely driven by the 10.1% increase in staff costs to Kshs 2.2 bn, from Kshs 2.0 bn recorded in Q1’2021 and an 8.4% increase in other expenses to Kshs 3.4 bn from Kshs 3.2 bn. However, the increase in interest expenses was mitigated by a 4.3% decline in loan loss provision to Kshs 2.5 bn in Q1’2022, from Kshs 2.6 bn in Q1’2021.
- The cost to income ratio improved to 61.7% from 65.6% in Q1’2021 attributable to the 11.1% growth in total operating income to Kshs 13.1 bn, from Kshs 11.8 bn in Q1’2021, which outpaced the 4.5% increase in total operating expenses to Kshs 8.1 bn, from Kshs 7.8 bn in Q1’2021. Additionally, without LLP, the cost to income ratio also improved to 42.5% from 43.3% in Q1’2021, pointing towards reduced operational costs and improved efficiency levels by the group, and,

- Profit before tax rose by 25.3% to Kshs 4.8 bn, from Kshs 3.9 bn in Q1'2021. Profit after tax also increased by 20.3% to Kshs 3.4 bn from Kshs 2.8 bn in Q1'2021 with the effective tax rate decreasing to 29.6% in Q1'2022, from 26.8% recorded in Q1'2021.

Balance Sheet

- The balance sheet recorded an expansion with total assets growing by 8.4% to Kshs 587.4 bn in Q1'2022, from Kshs 542.1 bn in Q1'2021. This growth was largely driven by a 0.3% increase in net loans and advances to Kshs 243.9 bn, from Kshs 243.1 bn in Q1'2021 coupled with a 22.6% increase in government securities to Kshs 194.7 bn, from the Kshs 158.7 bn recorded in Q1'2021. The subdued growth in the loan book is partly attributable to the bank's cautious lending owing to the relatively high non-performing loans. Key to note, the loan book, contracted by 1.8% to Kshs 243.9 bn, from Kshs 248.5 bn in FY'2020 and 0.1% from Kshs 244.0 FY'2021,
- Total liabilities rose by 8.5% to Kshs 507.1 bn in Q1'2022, from Kshs 467.5 bn in Q1'2021, driven by a 7.2% growth in customer deposits to Kshs 465.5 bn in Q1'2022, from Kshs 434.2 bn in Q1'2021, coupled with a 76.9% increase in Placements to the Kshs 9.3 bn recorded in Q1'2022, from Kshs 5.2 bn in Q1'2021. Deposits per branch declined by 8.2% to Kshs 4.5 bn, from Kshs 4.9 bn in Q1'2022, with the number of branches increasing by 15 to 104 branches in Q1'2021 from 89 branches in Q1'2021. In its continued branch expansion strategy, the group plans to open 12 more branches in Kenya,
- The faster 7.2% growth in deposits compared to the 0.3% growth in loans led to a decline in the loan to deposit ratio to 52.4%, from 56.0% in Q1'2021,
- Gross non-performing loans (NPLs) rose by 14.1% to Kshs 45.1 bn in Q1'2022, from Kshs 39.6 bn in Q1'2021 taking the NPL ratio to 16.3% in Q1'2022, from 14.7% in Q1'2021. The deterioration in the group's asset quality is mainly attributable to the faster 14.1% increase in NPLs that outpaced the 2.9% increase in gross loans. With the General loan loss provisions increasing by 29.6% to Kshs 24.2 bn, from Kshs 18.7 bn in Q1'2021, higher than the 2.9% growth in gross NPLs, the NPL coverage rose to 72.6% in Q1'2022, from 65.0% in Q1'2021,
- Shareholders' funds increased by 7.8% to Kshs 80.2 bn, from Kshs 74.4 bn in Q1'2021, mainly supported by a 14.1% increase in the retained earnings to Kshs 47.9 bn from Kshs 42.0 bn in Q1'2021,
- NCBA Group is currently sufficiently capitalized with a core capital to risk weighted assets ratio of 17.8%, 7.3% points above the statutory requirement. In addition, the total capital to risk weighted assets ratio was 17.9%, exceeding the statutory requirement by 3.4% points. Adjusting for IFRS 9, the core capital to risk weighted assets and the total capital to risk weighted assets both came in at 18.6%,
- NCBA Group currently has a return on average assets (ROaA) of 1.9% and a return on average equity (ROaE) of 14.0%.

Key Take-Outs:

i. **Asset quality**: The group's asset quality deteriorated, as evidenced by the rise in NPL ratio to 16.3%, from 14.7% in Q1'2021 driven by the 14.1% increase in NPLs to Kshs 45.1 bn from Kshs 39.6 bn. The deterioration is partly due to its loans to manufacturing and real estate sectors as well as agriculture accounting for 28.0% and 14.0% of the group's loan book, which are yet to fully recover from the pandemic, resulting to an increase in NPLs. Notably, the NPL ratio increased by 0.3% points from the 16.0% that was recorded in FY'2021. We expect NPLs to decline in the short term as the sectors recover in tandem with the economy as a whole. Risks however lie on the downside given the rising cost of living, emergence of new COVID-19 variants and the upcoming August 2022 elections,

ii. **Operating Efficiency** - The bank's operating efficiency improved as evidenced by the decline in cost to income ratio to 61.7%, from 65.6% in FY'2020, which indicates reduced operational costs and improved operational efficiency. This is despite the group's bold expansion strategy which has led to the rehiring of staff who were laid off in 2020 after 14 branches were closed in Kenya. Further, the group is planning to open 12 more branches in Kenya and this is set to increase the staff cost and consequently the operational costs. However, the bank plans to close 5 branches in close proximity which will mitigate the increase, and,

iii. **Loan Growth** - The group’s loan book expanded marginally by 0.3% to Kshs 243.9 bn, in Q1’2022 from Kshs 243.1 bn in Q1’2021, attributable to the group’s cautious lending given the increased NPLs which have seen the group’s asset quality deteriorate. Consequently, the group has focused more on government securities leading to a decline in credit growth. As such, the group is expected to redesign their operating models for loans in other sectors, as well as establish a workflow management tool to aid credit and commercial units in collaborating more effectively.

Going forward, we expect the bank’s growth to be further driven by:

i. We expect the bank to stick to its digitization plan, delivering new digital and mobile capabilities that improve customer experience and diversify the Group's revenues while also strengthening its position as a leader in corporate banking and asset finance. Notably, the groups NFI increased by 15.5% to Kshs 6.1 bn, from Kshs 5.2 bn in Q1’2021. Furthermore, the group intends to create a high-performance employee culture that will support improved financial performance and shareholder returns, and,
ii. Increased brand visibility backed by excellent customer service as it expands its retail banking operations, mainly through the expansion of its branch network to increase customer reach. So far, the group has 84 branches in Kenya, with 12 more expected by the end of 2022, for a total of 91 branches by the end of the financial year as it plans to close 5 branches that are in close proximity.

Valuation Summary

- We are of the view that NCBA Group is an “**Hold**” with a target price of Kshs 27.4, representing an upside of 9.8%, from the current price of Kshs 25.0 as of 6th May 2022,
- NCBA Group is currently trading at P/TBV of 0.5x and a P/E of 3.8x vs an industry average of 0.7x and 4.3x, respectively.