NCBA Group Earnings Note – H1'2020
28th August 2020

Valuation Summary

- We are of the view that NIC Group is a "Buy" with a target price of Kshs 39.4, representing an upside of 56.6%, from the current price of Kshs 23.5 as of 28th August 2020,
- NIC Group is currently trading at P/TBV of 0.6x and a P/E of 21.5x vs an industry average of 0.9x and 5.5x, respectively.

Key Highlights H1'2020

- Since the advent of COVID-19 the bank has so far restructured loans amounting to Kshs 58.0 bn (23.0% of the bank's loan book), to help struggling businesses stay afloat during the current period of uncertainty.

Notably, the financial statements of the bank have been prepared on a prospective basis (assuming a continuation of CBA), representing H1'2020 results of NCBA bank (merged bank) with prior year comparatives (H1'2019) being those of CBA bank. Hence, the results are not comparable on a like for like basis. As such we have used proforma combined financials for the two entities.

Income Statement

- Core earnings per share declined by 38.3% to Kshs 3.7 from Kshs 6.1 in H1'2019 which was not in line with our projections of Kshs 1.9. The variance can be attributed to our expectations of a slower growth in both total operating income, where we expected an 18.4% decline, compared to the actual growth of 10.0%. The performance can be attributed to the 180.9% increase in loan loss provisions, which lead to a 39.6% increase in total operating expenses, coupled with the 10.0% growth in total operating income,
- Total operating income increased by 10.0% to Kshs 21.3 bn in H1'2020 from Kshs 19.4 bn in H1'2019. This was due to a 13.7% increase in Non-Funded Income (NFI) to Kshs 10.1 bn in H1'2020, from Kshs 8.9 bn recorded the previous year, coupled with an 6.8% increase in Net Interest Income (NII) to Kshs 11.2 bn from the Kshs 10.5 bn recorded in H1'2019,
- Interest income rose by 6.2% to Kshs 20.7 bn, from Kshs 19.5 bn in H1'2019. This was mainly driven by a 33.5% rise in interest income from deposits to Kshs 0.4 bn from Kshs 0.3 bn in H1'2019 coupled with a 16.8% rise in interest income on government securities to Kshs 8.2 bn in H1'2020, from Kshs 7.0 bn in H1'2019. This was weighed down by a 0.5% decline in interest income from loans and advances to Kshs 12.0 bn, from Kshs 12.1 bn, and a 20.8% decline in other interest income to Kshs 51.1 mn in H1'2020, from Kshs 64.5 mn. Despite this, the yield on interest-earning assets declined to 6.4% in H1'2020 from 9.7% in H1'2019, due to the faster 6.7% growth in average interest-earning assets to Kshs 436.8 bn from Kshs 411.0 bn in H1'2019, compared to the 6.2% growth in Interest Income,
- Interest expense increased by 5.5% to Kshs 9.5 bn from Kshs 9.0 bn in H1'2019, mainly attributable to an 11.6% increase in interest expense on customer deposits to Kshs 8.4 bn from Kshs 7.5 bn in H1'2019. The cost of funds fell to 3.1% from 4.7% in H1'2019 owing to the slower growth of 5.5% in interest expense compared to the growth of 7.6% in average interesting bearing liabilities to Kshs 425.0 bn in H1'2020, from Kshs 395.0 bn in H1'2019. The Net Interest Margin came in at 3.4%, lower than the 5.2% seen in 2019, due to the 29.4% decline in NII compared to the 6.7% growth seen in the average interest earning assets,

- Non-Funded Income rose by 13.7% to Kshs 10.1 bn from Kshs 8.9 bn in H1’2019. The increase in NFI was driven by a 20.4% increase in fees and other commissions to Kshs 4.7 bn from Kshs 3.9 bn in H1’2019, coupled with a 19.1% increase in other fees to Kshs 2.5 bn from Kshs 2.1 bn in H1’2019. Consequently, the revenue mix shifted to 53:47 funded to non-funded income in H1’2020 from 54:46 in H1’2019, owing to the faster increase in NFI compared to NII,
- Total operating expenses increased by 39.6% to Kshs 17.0 bn, from Kshs 12.2 bn in H1’2019, largely driven by a 180.9% increase in loan loss provision to Kshs 7.6 bn in H1’2020 from Kshs 2.7 bn in H1’2019, coupled with other operating expenses which increased by 6.4% to Kshs 5.9 bn in H1’2020 from Kshs 5.5 bn in H1’2019. The high increase in Loan loss provision was driven by the expectations of a significant increase in NPLs due to the economic fallouts of the Coronavirus. Staff costs, on the other hand, decreased by 11.2% to Kshs 3.5 bn, from Kshs 3.9 bn recorded in H1’2019,
- The cost to income ratio deteriorated to 79.8% from 62.9% in H1’2019. However, without LLP, the cost to income ratio improved to 44.0% from 48.8% in H1’2019, pointing towards improved efficiency,
- Profit before tax declined by 42.0% to Kshs 3.9 bn from Kshs 6.7 bn in H1’2019. Profit after tax declined by 38.3% to Kshs 2.6 bn in H1’2020 from Kshs 4.3 bn in H1’2019. The effective tax rate decreased to 29.8% from 32.2% recorded in H1’2019.

Balance Sheet

- The balance sheet recorded an expansion with a total assets growth of 8.0% to Kshs 514.0 bn from Kshs 476.1 bn in H1’2019. This growth was largely driven by a 24.0% increase in government securities to Kshs 169.0 bn from the Kshs 136.2 bn recorded in H1’2019. The loan book on the other hand expanded by 4.0% to Kshs 248.3 bn in H1’2020 from Kshs 238.8 bn in H1’2019,
- Total liabilities rose by 9.1% to Kshs 443.7 bn from Kshs 406.6 bn in H1’2019, driven by a 9.1% increase in customer deposits to Kshs 390.5 bn from Kshs 358.0 bn in H1’2019. Placements increased by 58.6% from the Kshs 8.3 bn recorded in H1’2019 to Kshs 13.1 bn in H1’2020. Deposits per branch increased by 9.1% from Kshs 4.4 bn, to Kshs 4.8 bn in H1’2020, with the number of branches remaining unchanged at 82 branches,
- The faster growth in deposits compared to the growth in loans led to a decline in the loan to deposit ratio to 63.6% from 66.7% in H1’2019,
- Gross non-performing loans (NPLs) increased by 15.3% to Kshs 34.9 bn in H1’2020 from Kshs 30.3 bn in H1’2019. Consequently, the NPL ratio deteriorated to 13.1% in H1’2020 from 11.8% in H1’2019 attributable to the faster 15.3% increase in NPLs that outpaced the 4.3% increase in gross loans which came in at Kshs 34.9 bn in H1’2020, from the Kshs 30.3 bn in H1’2019. General loan loss provisions increased by 2.6% from Kshs 11.9 bn, to Kshs 12.2 bn in H1’2020. The NPL coverage fell to 53.2% in H1’2020, from 58.1% owing to the slower 2.6% increase in general loan loss provisions, compared to the 15.3% growth in gross NPLs,
- Shareholders’ funds increased marginally by 1.3% to Kshs 70.1 bn in H1’2020 from Kshs 69.2bn in H1’2019,
- NCBA Group is currently sufficiently capitalized with a core capital to risk weighted assets ratio of 18.5%, 8.0% above the statutory requirement. In addition, the total capital to risk weighted assets ratio was 19.4%, exceeding the statutory requirement by 4.9%. Adjusting for IFRS 9, the core capital to risk weighted assets stood at 18.7%, while total capital to risk weighted assets came in at 19.6%,
- NCBA Group currently has a return on average assets of 1.3% and a return on average equity of 8.9%.

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Key Take-Outs:

a. The bank's gross non-performing loans (NPLs) increased by 15.3% to Kshs 34.9 bn in H1'2020 from Kshs 30.3 bn in H1'2019. Consequently, the NPL ratio deteriorated to 13.1% in H1'2020 from 11.8% in H1'2019 attributable to the faster 15.3% increase in NPLs that outpaced the 4.3% increase in gross loans which came in at Kshs 34.9 bn in H1'2020, from the Kshs 30.3 bn in H1'2019. As a result of the significant increase in NPLs, the NPL coverage fell to 53.2% in H1'2020, from 58.1% owing to the slower 2.6% increase in general loan loss provisions, compared to the 15.3% growth in gross NPLs,

b. The Bank recorded an expansion with a total assets growth of 8.0% to Kshs 514.0 bn from Kshs 476.1 bn in H1'2019. This growth was largely driven by a 24.0% increase in government securities to Kshs 169.0 bn from the Kshs 136.2 bn recorded in H1'2019, despite the decline in yields of government securities. The loan book on the other hand expanded by 4.0% to Kshs 248.3 bn in H1'2020 from Kshs 238.8 bn in H1'2019,

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

a. The Bank is expected to continue increasing it synergy by capitalizing on the strengths of the previous entities where the use of their LOOP digital platform will allow the bank diversify its revenue streams and support the bank's operation given the current situation surrounding the spread of the Novel Coronavirus

Balance Sheet Items	H1'2019	H1'2020	y/y change	H1'2020f	Expected y/y change	Variance in Actual Growth vs Expected
Net Loans and Advances	238.8	248.3	4.0%	251.0	5.1%	(1.1%)
Total Assets	**476.1**	**514.0**	**8.0%**	**506.8**	**6.4%**	**1.5%**
Customer Deposits	358.0	390.5	9.1%	393.5	9.9%	(0.8%)
Total Liabilities	406.6	443.7	9.1%	443.4	9.0%	0.1%
Shareholders' Funds	**69.2**	**70.1**	**1.3%**	**63.2**	**(8.7%)**	**9.9%**

Balance Sheet Ratios	H1'2019	H1'2020	y/y change
Loan to Deposit Ratio	66.7%	63.6%	(3.1%)
Return on average equity	13.7%	8.9%	(4.8%)
Return on average assets	2.0%	1.3%	(0.7%)

Income Statement	H1'2019	H1'2020	y/y change	H1'2020f	Expected y/y change	Variance in Actual Growth vs Expected
Net Interest Income	10.5	11.2	6.8%	7.5	(28.5%)	35.3%
Net non-Interest Income	8.9	10.1	13.7%	8.3	(6.4%)	20.2%
Total Operating income	**19.4**	**21.3**	**10.0%**	**15.8**	**(18.4%)**	**28.4%**
Loan Loss provision	2.7	7.6	180.9%	3.7	35.3%	145.6%
Total Operating expenses	12.2	17.0	39.6%	11.6	(4.3%)	43.9%
Profit before tax	6.7	3.9	(42.0%)	4.1	(38.4%)	(3.6%)
Profit after tax	**4.3**	**2.6**	**(38.3%)**	**2.9**	**(32.0%)**	**(6.3%)**
Core EPS	**6.1**	**3.7**	**(38.3%)**	**1.9**	**(68.0%)**	**29.7%**

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Income Statement Ratios	H1'2019	H1'2020	y/y change
Yield from interest-earning assets	9.8%	6.3%	(3.5%)
Cost of funding	4.7%	3.1%	(1.6%)
Net Interest Spread	5.1%	3.2%	(1.9%)
Net Interest Margin	5.3%	3.3%	(1.9%)
Cost of Risk	14.0%	35.8%	21.8%
Net Interest Income as % of operating income	54.2%	52.7%	(1.6%)
Non-Funded Income as a % of operating income	45.8%	47.3%	1.6%
Cost to Income Ratio	62.9%	79.8%	17.0%

Capital Adequacy Ratios	H1'2019	H1'2020
Core Capital/Total Liabilities	17.6%	17.8%
Minimum Statutory ratio	8.0%	8.0%
Excess	**9.6%**	**9.8%**
Core Capital/Total Risk Weighted Assets	16.6%	18.5%
Minimum Statutory ratio	10.5%	10.5%
Excess	**6.1%**	**8.0%**
Total Capital/Total Risk Weighted Assets	18.1%	19.4%
Minimum Statutory ratio	14.5%	14.5%
Excess	**3.6%**	**4.9%**
Liquidity Ratio	50.8%	54.7%
Minimum Statutory ratio	20.0%	20.0%
Excess	**30.8%**	**34.7%**
Adjusted core capital/ total deposit liabilities		17.9%
Adjusted core capital/ total risk weighted assets		18.7%
Adjusted total capital/ total risk weighted assets		19.6%

Note that the figures for H1'2019 are combined from CBA's and NIC's H1'2019 releases.