NIC Bank Kenya Earnings Update – H1'2017

27th August, 2017

Valuation Summary

- We are of the view that NIC stock is a "**Buy**", with a target price of Kshs 51.2 representing an upside of 41.8%, from the current price of Kshs 37.0, as at 25th August, inclusive of a dividend yield of 3.4%
- NIC Bank is currently trading at a tangible P/B of 0.8x and a P/E of 5.4x, vs an industry average of 1.5x and 7.9x, respectively.

Key highlights during H1'2017

- In April, NIC concluded its mandate as Imperial Bank in Receivership's Asset & Liability Consultant, having made a total disbursement of Kshs 10.8 bn to more than 5,500 depositors and collected over Kshs 5.0 bn in loans while in the role,
- NIC Bank signed an asset financing partnership with General Motors East Africa that will give borrowers access to funding for their Isuzu purchases at 13.0% for up to 6 years.

Income Statement

- Core earnings per share declined by 11.9% to Kshs 3.2 from Kshs 3.6 in H1'2016, in line with our expectations of an 10.8% decline, which was a result of a 10.5% decline in total operating expenses despite a 10.0% decline in total operating revenue,
- Total operating revenue declined by 10.0% to Kshs 7.4 bn from Kshs 8.2 bn in H1'2016. This was due to an 11.1% decline in Net Interest Income (NII) to Kshs 5.4 bn from Kshs 6.1 bn, and a 6.9% decline in Non-Funded Income (NFI) to Kshs 2.0 bn from Kshs 2.2 bn in H1'2016,
- Interest Income declined by 10.6% to Kshs 8.8 bn from Kshs 9.9 bn in H1'2016, while Interest Expense declined by 9.7% to Kshs 3.4 bn from Kshs 3.8 bn in H1'2016. The Net Interest Margin thus decreased to 7.1% from 7.7% in H1'2016,
- Non-funded income declined by 6.9% to Kshs 2.0 bn from Kshs 2.2 bn in H1'2016. The decline in NFI was driven by a 43.9% decline in other income to Kshs 0.3 bn from Kshs 0.6 bn in H1'2016. Components of other income include rental income, gains/losses on disposal of motor vehicles & equipment, bad debt recoveries and trust & other fiduciary fees and it is not clear which component drove the 43.9% decline in other income. Fees and commissions however increased by 5.4% to Kshs 0.7 bn from Kshs 0.6 bn. The current revenue mix stands at 73:27 funded to non-funded income from 74:26 in H1'2016,
- Total operating expenses declined by 10.5% to Kshs 4.5 bn from Kshs 5.0 bn in H1'2016, following a 31.5% y/y decline in Loan loss provision (LLP) to Kshs 1.5 bn from Kshs 2.1 bn. Without LLP, operating expenses grew 4.8% to Kshs 3.0 bn from Kshs 2.9 bn registered in H1'2016. Staff costs grew by 12.5% to Kshs 1.6 bn from Kshs 1.4 bn in H1'2016,
- Cost to Income ratio remained relatively unchanged at 60.6% from 60.9% in H1'2016. Without LLP, cost to Income ratio deteriorated to 41.1% from 35.3% in H1'2016,
- Profit before tax declined 9.3% to Kshs 2.9 bn from Kshs 3.2 bn,
- Profit after tax declined by 11.8% to Kshs 2.0 bn from Kshs 2.3 bn in H1'2016.

Balance Sheet

- The balance sheet recorded an expansion in H1'2017, with total assets increasing by 12.1% to Kshs 189.5 bn from Kshs 169.1 bn in H1'2016, driven by a 71.9% increase in government security holdings,
- The Loan book grew by 4.1% to Kshs 116.8 bn from Kshs 112.2 bn in H1'2016, in line with our expectations of a 4.2% expansion,
- Total liabilities increased by 11.5% to Kshs 156.9 bn from Kshs 140.8 bn in H1'2016, while shareholders' funds increased by 15.4% to Kshs 32.1 bn from Kshs 27.8 bn,
- Customer deposits increased by 18.9% to Kshs 133.2 bn from Kshs 112.0 bn in H1'2016, due to the bank's efforts to strengthen its network through opening up an additional 6 new branches in 2016, 1 new branch in 2017 and 181 service outlets across the country to boost its deposit mobilisation capabilities,
- The faster growth in deposits compared to loans resulted in a decline in the loan to deposit ratio to 87.7% from 100.1% in H1'2016,
- Gross non-performing loans increased by 14.1% to Kshs 14.3 bn from Kshs 12.6 bn in H1'2016, and the NPL ratio deteriorated to 11.6% from 10.9% in H1'2016,

- The yield on interest earning assets decreased to 11.0% from 13.1% in H1'2016, and the cost of funds declined to 4.5% from 5.7%,
- NIC Bank Kenya is currently sufficiently capitalized with a core capital to risk weighted assets ratio at 17.7%, 7.2% above the statutory requirement of 10.5%, with total capital to total risk weighted assets exceeding statutory requirement by 7.1% to close the period at 21.6%,
- NIC Bank currently has a return on average assets of 2.3% and a return on average equity of 13.6%.

Key Take Outs:

a) NIC Bank has seen its yield on assets and costs of funds decline following the interest rate caps, resulting in (i) the y/y loan growth declining to 4.1% as compared to the historical average of 23.0%, (ii) the loan to deposit ratio declining to 87.7% as compared to the 2015/16 average of 103.4%, and (iii) the government securities to deposit ratio increasing to 33.3% as compared to the historical average of 17.0%,
b) NIC earnings declined in line with what we expected, as the operating environment in 2017 proves tough for the banking sector this far following the effects of the Banking Amendment Act, 2015. The bank's provisioning levels declined by 31.5%, despite the loan book growing by 4.1%, moving in the same direction as our expectation of a decrease in provisioning by 17.8%, but the NPL ratio deteriorated to 11.6% from 10.9% in H1'2016. However, we expect this to increase in 2018 as banks prepare for the implementation of IFRS 9, which requires a forward looking approach in credit risk assessment come 2018,
c) With NII and NFI both declining by 11.1% and 6.9% and the cost to income ratio at 60.6%, NIC should explore ways to increase efficiency.

Moving forward, NIC will thrive on:

a) Focusing on improving their asset quality by reducing their non-performing loans through improved credit risk management and loan recovery efforts, as we note that gross non-performing loans increased by 14.1% and the NPL ratio deteriorated to 11.6%,
b) Moving forward with their cost reduction efforts as we have seen operating expenses decline by 10.5%, as they seek to embrace efficiency and reduce their cost to income ratio down from 60.6%
c) Maximizing on the expected gains from their investments in innovation and technology to improve operating efficiency and drive fee income through their asset financing business.

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	H1'2016	H1'2017	y/y change	H1'2017e	Projected %y/y change	Variance in Growth Actual vs. Expected
Government Securities	29.1	44.3	52.5%	31.0	6.7%	45.8%
Net Loans and Advances	112.2	116.8	4.1%	116.9	4.2%	(0.1%)
Total Assets	**169.1**	**189.5**	**12.1%**	**179.2**	**6.0%**	**6.1%**
Customer Deposits	112.0	133.2	18.9%	119.3	6.5%	12.4%
Total Liabilities	140.8	156.9	11.5%	147.1	4.5%	7.0%
Shareholders' Funds	**27.8**	**32.1**	**15.4%**	**31.6**	**13.8%**	**1.6%**

Balance Sheet Ratios	H1'2016	H1'2017	y/y change
Loan to Deposit Ratio	100.1%	87.7%	(12.4%)
Return on average equity	17.7%	13.6%	(4.1%)
Return on average assets	2.8%	2.3%	(0.6%)

Income Statement	H1'2016	H1'2017	y/y change	H1'2017e	Projected %y/y change	Variance in Growth Actual vs. Expected
Net Interest Income	6.1	5.4	(11.1%)	5.4	(10.6%)	(0.5%)
Net non-Interest Income	2.2	2.0	(6.9%)	2.3	4.3%	(11.2%)

Total Operating income	**8.2**	**7.4**	**(10.0%)**	**7.7**	**(6.7%)**	**(3.3%)**
Loan Loss provision	2.1	1.4	(31.5%)	1.7	(17.8%)	(13.7%)
Total Operating expenses	**5.0**	**4.5**	**(10.5%)**	**4.7**	**(5.4%)**	**(5.1%)**
Profit before tax	3.2	2.9	(9.3%)	**2.9**	(8.8%)	(0.6%)
Profit after tax	**2.3**	**2.0**	(11.8%)	**2.1**	(10.8%)	(1.0%)

Income Statement Ratios	H1'2016	H1'2017	y/y change
Yield from interest-earning assets	13.1%	11.0%	(2.1%)
Cost of funding	5.7%	4.5%	(1.2%)
Net Interest Spread	7.4%	6.6%	(0.9%)
Net Interest Margin	7.7%	7.1%	(0.7%)
Cost of Risk	25.6%	19.5%	(6.1%)
Net Interest Income as % of operating income	73.8%	72.9%	(0.9%)
Non-Funded Income as a % of operating income	26.2%	27.1%	0.9%
Cost to Income Ratio	60.9%	60.6%	(0.3%)
Cost to Assets	3.0%	2.4%	(0.6%)

Capital Adequacy Ratios	H1'2016	H1'2017
Core Capital/Total Liabilities	22.5%	22.5%
Minimum Statutory ratio	8.0%	8.0%
Excess	**14.5%**	**14.5%**
Core Capital/Total Risk Weighted Assets	16.7%	17.7%
Minimum Statutory ratio	10.5%	10.5%
Excess	**6.2%**	**7.2%**
Total Capital/Total Risk Weighted Assets	22.8%	21.6%
Minimum Statutory ratio	14.5%	14.5%
Excess	**8.3%**	**7.1%**
Liquidity Ratio	38.6%	45.7%
Minimum Statutory ratio	20.0%	20.0%
Excess	**18.6%**	**25.7%**