Cytonn INVESTMENTS

NIC Group Plc Earnings Update – H1’2018

23th August, 2018

Valuation Summary

- We are of the view that NIC Group is a “Buy” with a target price of Kshs 54.1, representing an upside of 59.7%, from the current price of Kshs 33.0 as of 23th August, inclusive of a dividend yield of 2.9%,
- NIC Group is currently trading at P/TBV of 0.8x and a P/E of 13.2x vs an industry average of 1.6x and 9.7x, respectively.

Key Highlights H1’2018

- NIC Bank opened 4 new branches on the Coast as part of expansion under the its strategic plan to increase its foothold in the country. New branches were in Malindi, Watamu, Kilifi and Diani, increasing the bank’s branch count across the country to 41.

Income Statement

- Core earnings per share declined by 2.1% to Kshs 2.8 from Kshs 2.9 in H1’2017, which was lower than our expectation of a 7.5% increase to Kshs 3.1. Performance was driven by a 1.7% decline in operating income to Kshs 7.3 bn from Kshs 7.4 bn in H1’2017, which outpaced the 1.2% decline in operating expenses to Kshs 4.4 bn from Kshs 4.5 bn. The variance was as a result of a 4.9% decrease in net interest income (NII) against a projected 11.1% increase to Kshs 6.0 bn,
- Total operating income decreased by 1.7% to Kshs 7.3 bn in H1’2018 from Kshs 7.4 bn in H1’2017. This was due to a 4.9% decrease in Net Interest Income (NII) to Kshs 5.1 bn from Kshs 5.4 bn in H1’2017, despite a 7.0% increase in Non-Funded Income (NFI) to Kshs 2.2 bn from Kshs 2.0 bn in H1’2017,
- Interest income increased by 8.6% to Kshs 9.6 bn from Kshs 8.8 bn in H1’2017. The interest income on loans and advances decreased by 6.5% to Kshs 6.2 bn from Kshs 6.6 bn in H1’2017. Interest income on government securities increased by 52.8% to Kshs 3.3 bn in H1’2018 from Kshs 2.1 bn in H1’2017. The yield on interest earning assets however declined to 10.9% in H1’2018 from 11.0% in H1’2017, due to the relatively faster increase in low-yielding government securities by 25.7% to Kshs 55.7 bn from Kshs 44.3 bn in H1’2017,
- Interest expense increased by 30.0% to Kshs 4.4 bn from Kshs 3.4 bn in H1’2017, as interest expense on customer deposits increased 37.7% to Kshs 3.7 bn from Kshs 2.7 bn in H1’2017. Interest expense on deposits from other banking institutions rose by 70.4% to Kshs 104.8 mn from Kshs 61.5 mn in H1’2017. The cost of funds rose to 5.4% from 4.5% in H1’2017. The Net Interest Margin declined to 6.0% from 7.1% in H1’2017,
- Non-Funded Income increased by 7.0% to Kshs 2.2 bn from Kshs 2.0 bn in H1’2017. The increase in NFI was driven by a 16.9% increase in forex trading income to Kshs 0.7 bn from Kshs 0.6 bn in H1’2017, coupled with a 24.1% increase in other income to Kshs 0.4 bn from Kshs 0.3 bn in H1’2017. Other fees and commissions increased by 13.5% to Kshs 0.5 bn from Kshs 0.4 bn in H1’2017. However, fees and commissions on loans declined by 13.6% to Kshs 0.6 bn from Kshs 0.7 bn in H1’2017. The revenue mix shifted to 70:30 funded to non-funded income in H1’2018 from 73:27 in H1’2017, owing to the increase in NFI, coupled with the decline in NII,
- Total operating expenses decreased by 1.2% to Kshs 4.4 bn from Kshs 4.5 bn, largely driven by a 23.0% decrease in loan loss provision (LLP) to Kshs 1.1 bn in H1’2018 from Kshs 1.4 bn in H1’2017. Staff costs, however, increased by 7.7% to Kshs 1.7 bn in H1’2018 from Kshs 1.6 bn in H1’2017,
- The cost to income ratio deteriorated marginally to 60.9% from 60.6% in H1’2017. Without LLP, the cost to income ratio deteriorated to 45.6% from 41.1% in H1’2017,
- Profit before tax decreased by 2.4% to Kshs 2.8 bn, up from Kshs 2.9 bn in H1’2017. Profit after tax decreased 2.1% to Kshs 1.99 bn in H1’2018 from Kshs 2.03 bn in H1’2017,

Balance Sheet

- The balance sheet recorded an expansion with total assets growth of 6.0% to Kshs 201.0 bn from Kshs 189.5 bn in H1’2017. This growth was largely driven by a 25.7% increase in government securities to Kshs 55.7 bn from Kshs 44.3 bn in H1’2017,
- The loan book contracted by 1.5% to Kshs 115.0 bn in H1’2018 from Kshs 116.8 bn in H1’2017,
- Total liabilities rose by 7.5% to Kshs 168.7 bn from Kshs 156.9 bn in H1’2017, driven by a 10.5% increase in customer deposits to Kshs 147.1 bn from Kshs 133.2 bn in H1’2017. Deposits per branch increased by 2.2% to Kshs 3.6 bn from Kshs 3.5 bn in H1’2017, as bank branches increased to 42 from 38; while deposit growth was strong, the cost of deposits is very costly given one of the highest cost of funds at 5.4%, compared to tier 1 and 2 average of 3.2%,
- The growth in deposits coupled with the decline in loans led to a decline in the loan to deposit ratio to 78.2% from 88.7% in H1’2017,
- Gross non-performing loans increased by 12.7% to Kshs 16.2 bn in H1’2018 from Kshs 14.3 bn in H1’2017. Consequently, the NPL ratio deteriorated to 13.1% in H1’2018 from 11.7% in H1’2017.General Loan loss provisions increased by 33.0% to Kshs 6.8 bn from Kshs 5.1 bn in H1’2017. Consequently, the NPL coverage improved to 52.2% in H1’2018 from 48.1% in H1’2017,
- Shareholders’ funds decreased marginally to Kshs 31.8 bn in H1’2018 from Kshs 32.1 bn in H1’2017,
- NIC Group is currently sufficiently capitalized with a core capital to risk weighted assets ratio of 17.8%, 7.3% above the statutory requirement. In addition, the total capital to risk weighted assets ratio was 20.4%, exceeding the statutory requirement by 5.9%. Adjusting for IFRS 9, the core capital to risk weighted assets stood at 18.1%, while total capital to risk weighted assets came in at 20.7%, indicating that the bank’s total capital relative to its risk-weighted assets decreased by 0.3% due to the impact of IFRS 9,
- NIC Group currently has a return on average assets of 2.1% and a return on average equity of 12.8%. This compares to a tier 1 and 2 average of 21.0% in H1’2017, with the bank’s RoE falling below its peers due to the low trailing PAT.

Key Take-Outs:

a. NIC Group’s cost of funds increased to 5.4% in H1’2018 from 4.5% in H1’2017, which is way above the listed banking sector average of 3.4%, on the back of a 37.7% increase in interest expense on customer deposits brought about by a 10.5% increase in customer deposits. This implies that the bulk of deposits consist of term deposits and not current and/or savings accounts (CASA) deposits, hence the high cost of funds. The bank should mobilize more CASA deposits by reaching out to a wider clientele base with the potential of increasing the number of current and savings accounts held with NIC Bank, hence increasing capacity to mobilize inexpensive deposits from customers.

b. The bank experienced a contraction in the loan book by 1.5% YoY, which contributed to the 6.5% decrease in interest income on loans and advances from H1’2017. This, in turn, drove the 4.9% decrease in Net Interest Income (NII), thereby reducing operating income for the bank by 1.7%. The result was a 2.1% decline in overall profitability despite a 1.2% decrease in operating expenses.

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

a. **Non-Funded Income Growth Initiatives** – NIC Bank’s NFI is improving as the bank focuses on digital innovation and alternative banking channels to augment transaction volumes and increase fee income. The bank needs to increase capacity of its brokerage and advisory business, in addition to setting income targets for these entities so as to increase fee income from investment and advisory services,
b. **Loan growth** – The bank needs to grow its loan book aggressively so as to increase interest income on loans and advances. The bank is shying away from lending to the SME segment, which forms much of its clientele base. With the rate capping legislation expected to be repealed, the bank should grow its market reach to include retail and corporate clients in order to increase loans and maximize interest income,
c. **Better underwriting** in order to reduce the proportion of non-performing loans and improve the bank’s asset quality as the bank’s NPL ratio currently stands at 13.1% compared to the Tier 1 and 2 banks’ average of 11.6%.
d. **Funding Structure:** The bank needs to relook at its funding structure as it is not clear why the bank was accumulating expensive deposit only to invest in low yielding assets,
e. **Operational efficiency**: Recording a staff cost growth of 7.7% with such a poor bottom line performance in the era of bank processes automation and digitisation is worrying and not in the best interest of shareholders.

Balance Sheet Items	H1`2017	H1`2018	y/y change	H1`2018e	Projected %y/y change	Variance in Growth Actual vs. Expected
Government Securities	44.3	55.7	25.7%	53.5	20.6%	5.1%
Net Loans and Advances	116.8	115.0	(1.5%)	120.1	2.9%	(4.4%)
Total Assets	**189.5**	**201.0**	**6.0%**	**210.0**	**10.8%**	**(4.8%)**
Customer Deposits	133.2	147.1	10.5%	146.5	10.0%	0.5%
Total Liabilities	156.9	168.7	7.5%	175.8	12.0%	(4.5%)
Shareholders’ Funds	**32.1**	**31.8**	**(0.9%)**	**33.8**	**5.3%**	**(6.2%)**

Balance Sheet Ratios	H1'2017	H1'2018	y/y change
Loan to Deposit Ratio	87.7%	78.2%	(9.5%)
Return on average equity	13.6%	12.8%	(0.7%)
Return on average assets	2.3%	2.1%	(0.2%)

Income Statement	H1`2017	H1`2018	y/y change	H1`2018e	Projected %y/y change	Variance in Growth Actual vs. Expected
Net Interest Income	5.4	5.1	(4.9%)	6.0	11.1%	(16.1%)
Net non-Interest Income	2.01	2.15	7.0%	2.2	11.0%	(4.0%)
Total Operating income	**7.4**	**7.3**	**(1.7%)**	**8.2**	**11.1%**	**(12.8%)**
Loan Loss provision	1.4	1.1	(23.0%)	1.6	9.3%	(32.3%)
Total Operating expenses	**4.5**	**4.4**	**(1.2%)**	**5.1**	**13.8%**	**(15.0%)**
Profit before tax	2.9	2.8	(2.4%)	3.1	6.9%	(9.3%)
Profit after tax	**2.0**	**2.0**	(2.2%)	**2.2**	7.3%	(9.5%)

Income Statement Ratios	H1'2017	H1`2018	y/y change

Yield from interest-earning assets	11.0%	10.9%	(0.1%)
Cost of funding	4.5%	5.4%	0.9%
Net Interest Spread	6.6%	5.5%	(1.0%)
Net Interest Margin	7.1%	6.0%	(1.1%)
Cost of Risk	19.5%	15.3%	(4.2%)
Net Interest Income as % of operating income	72.9%	70.5%	(2.4%)
Non-Funded Income as a % of operating income	27.1%	29.5%	2.4%
Cost to Income Ratio	60.6%	60.9%	0.3%
Cost to Income Ratio (less LLP)	41.1%	45.6%	4.5%
Cost to Assets	1.6%	1.7%	0.0%

Capital Adequacy Ratios	H1'2017	H1'2018
Core Capital/Total Liabilities	22.5%	21.1%
Minimum Statutory ratio	8.0%	8.0%
Excess	**14.5%**	**13.1%**
Core Capital/Total Risk Weighted Assets	17.7%	18.1%
Minimum Statutory ratio	10.5%	10.5%
Excess	**7.2%**	**7.6%**
Total Capital/Total Risk Weighted Assets	21.6%	20.7%
Minimum Statutory ratio	14.5%	14.5%
Excess	**7.1%**	**6.2%**
Liquidity Ratio	45.7%	48.8%
Minimum Statutory ratio	20.0%	20.0%
Excess	**25.7%**	**28.8%**