

Valuation Summary

- We are of the view that NIC Group stock is a “buy”, with a target price of Kshs 58.2 representing an upside of 61.7%, from the current price of Kshs 36.8, as at 24th November, inclusive of a dividend yield of 3.3%,
- NIC Bank is currently trading at a P/TBv of 0.9x and a P/E of 5.5x, vs an industry average of 1.5x and 8.5x, respectively.

Key highlights during Q3'2017

- NIC Bank Limited completed its restructuring on 1st September 2017, into a Non-Operating Holding Company known as NIC Group Plc, following regulator, shareholder and bondholder approvals. The restructuring exercise involved the creation of a new wholly owned subsidiary, NIC Bank Kenya Plc, to which assets and liabilities of the Kenyan banking business were transferred.

Income Statement

- Core earnings per share (EPS) declined by 2.5% to Kshs 3.3 from Kshs 3.4 in Q3'2016, driven by an 18.8% decline in total operating income, despite a 24.8% decrease in operating expenses, attributable to the one-off deferred tax of Kshs 0.8 bn recorded in Q3'2017,
- Total operating income declined by 18.8% to Kshs 10.1 bn from Kshs 12.5 bn in Q3'2016, driven by a 21.8% decline in Net Interest Income (NII) to Kshs 7.4 bn from Kshs 9.4 bn in Q3'2016, and a 9.6% decline in Non-Funded income to Kshs 2.8 bn from Kshs 3.1 bn in Q3'2016,
- Interest Income decreased by 15.7% to Kshs 12.4 bn from Kshs 14.7 bn in Q3'2016. Interest income on loans & advances declined by 17.7% to Kshs 9.2 bn to Kshs 11.1 bn and interest income on government securities increased by 34.0% to Kshs 3.2 bn from Kshs 2.4 bn in Q3'2016,
- Interest expense declined by 4.9% to Kshs 5.1 bn from Kshs 5.3 bn in Q3'2016, leading to a 21.8% decline in the Net Interest Income to Kshs 7.4 bn from Kshs 9.4 bn. The Net Interest Margin thus declined to 6.4% from 8.3% in Q3'2016,
- Non-Funded Income (NFI) recorded a decline of 9.6% to Kshs 2.8 bn from Kshs 3.1 bn in Q3'2016. The decline in NFI was driven by a decrease in other income that shed 47.0% to Kshs 0.4 bn from Kshs 0.7 bn in Q3'2016 despite the 2.4% increase in fees & commissions on loans to Kshs 0.97 bn from Kshs 0.95 bn in Q3'2016,
- The current revenue mix came in at 73:27 funded to non-funded income from 75:25 in Q3'2016,
- Total operating expenses decreased by 24.8% to Kshs 5.8 bn from Kshs 7.7 bn, driven by a 34.6% decrease in Loan Loss Provisions (LLP) to Kshs 2.1 bn from Kshs 3.2 bn, coupled with a 15.0% decline in staff costs to Kshs 1.9 bn from Kshs 2.3 bn in Q3'2016. Staff costs account for 32.9% of operating expenses while LLPs account for 36.0% of operating expenses,
- The Cost to Income ratio improved to 57.4% from 62.0% in Q3'2016, following the 24.8% decrease in total operating expenses that outpaced the 18.8% decline in total operating income. Without LLP, the Cost to Income ratio deteriorated to 36.7% from 36.4% in Q3'2016,
- Profit before tax decreased by 8.9% to Kshs 4.3 bn from Kshs 4.7 bn, while profit after tax decreased by 2.5% to Kshs 3.3 bn from Kshs 3.4 bn in Q3'2016, due to the one-off deferred tax of Kshs 0.8 bn recorded in Q3'2017.

Balance Sheet

- The balance sheet recorded an expansion in Q3'2017, with total assets increasing by 10.0% to Kshs 181.9 bn from Kshs 165.3 bn in Q3'2016. This growth was driven by a 42.4% increase in investment in government securities to Kshs 49.3 bn from Kshs 34.6 bn in Q3'2016, despite a 0.2% decrease in the loan book, which is 60.6% of the bank's total assets, to Kshs 110.3 bn from Kshs 110.5 bn in Q3'2016,
- Total liabilities rose by 13.3% to Kshs 153.8 bn from Kshs 135.7 bn in Q3'2016, driven by a 13.6% increase in deposits to Kshs 123.1 bn from Kshs 108.4 bn in Q3'2016. Shareholders' funds decreased by 3.3% to Kshs 28.1 bn from Kshs 29.1 bn in Q3'2016,
- The increase in deposits and decline in loans led to a decline in the loan to deposit ratio to 89.6% from 101.9% in Q3'2016,
- Gross non-performing loans declined slightly by 2.5% to Kshs 13.9 bn from Kshs 14.3 bn, despite being on a gradual upward trend over the previous two quarters. This, coupled with a decline in loan book, led to a decrease in the

NPL ratio to 11.8% from 12.5% in Q3'2016, indicating that the decline in NPLs was probably due to the shrinking of the loan book,

- The yield on interest earning assets declined to 10.6% from 13.4% in Q3'2016, while the cost of funds also declined to 4.6% from 5.8% in Q3'2016,
- NIC Group is currently sufficiently capitalized with a core capital to risk weighted assets ratio at 16.3%, 5.8% above the statutory requirement, with total capital to total risk weighted assets exceeding statutory requirement by 5.1%,
- NIC Group currently has a return on average assets of 2.4% and a return on average equity of 14.9%, compared to 2.6% and 16.0%, respectively, in Q3'2016.

Key Take outs:

- Resilience through improved efficiency and coverage.** NIC Group's cost to income ratio improved by 4.6 percentage points to 57.4% from 62.0% in Q3'2016, due to a faster decline in operating expenses by 24.8%, compared to the 18.8% decline in operating income. This was driven by a 15.0% decline in staff costs to Kshs 1.9 bn from Kshs 2.3 bn in Q3'2015, with staff costs constituting 32.9% of operating expenses,
- Prudence through improved coverage.** The lender's largest component, LLPs at 36.0%, declined by 34.6% to Kshs 2.1 bn from Kshs 3.2 bn, as NPLs and loans declined by 2.5% and 0.2%, respectively. With the declining gross NPL ratio due to this, we notice that the NPL coverage ratio improved to 50.9% from 22.4% in Q3'2016,
- Going forward, we expect NIC Group to reap the benefits expected from the newly concluded restructuring, which include improved capital use, strategic and risk management, and subsidiary governance. This is expected to result in further gradual improvement of efficiency and asset quality, observed through improving cost to income and gross NPL ratios, respectively.

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 | Q3'2016 | Q3'2017 | y/y change | Q3'2017e | Projected %y/y change | Variance in Growth Actual vs. Expected |
|----------------------------|--------------|--------------|---------------|--------------|-----------------------|--|
| Government Securities | 34.6 | 49.3 | 42.4% | 44.5 | 28.7% | 13.7% |
| Net Loans and Advances | 110.5 | 110.3 | (0.2%) | 117.4 | 6.2% | (6.4%) |
| Total Assets | 165.3 | 181.9 | 10.0% | 195.2 | 18.1% | (8.0%) |
| Customer Deposits | 108.4 | 123.1 | 13.6% | 134.9 | 24.5% | (10.9%) |
| Total Liabilities | 135.7 | 153.8 | 13.3% | 161.6 | 19.0% | (5.7%) |
| Shareholders' Funds | 29.1 | 28.1 | (3.3%) | 33.1 | 13.9% | (17.3%) |

| Balance Sheet Ratios | Q3'2016 | Q3'2017 | y/y change |
|--------------------------|---------|---------|------------|
| Loan to Deposit Ratio | 101.9% | 89.6% | (12.3%) |
| Return on average equity | 16.0% | 14.9% | (1.2%) |
| Return on average assets | 2.6% | 2.4% | (0.2%) |

| Income Statement | Q3'2016 | Q3'2017 | y/y change | Q3'2017e | Projected %y/y change | Variance in Growth Actual vs. Expected |
|---------------------------------|-------------|-------------|----------------|-------------|-----------------------|--|
| Net Interest Income | 9.4 | 7.4 | (21.8%) | 8.8 | (6.5%) | (15.2%) |
| Net non-Interest Income | 3.1 | 2.8 | (9.6%) | 3.1 | 1.9% | (11.5%) |
| Total Operating income | 12.5 | 10.1 | (18.8%) | 11.9 | (4.5%) | (14.3%) |
| Loan Loss provision | 3.2 | 2.1 | (34.6%) | 2.8 | (12.9%) | (21.6%) |
| Total Operating expenses | 7.7 | 5.8 | (24.8%) | 7.5 | (2.7%) | (22.1%) |
| Profit before tax | 4.7 | 4.3 | (8.9%) | 4.4 | (7.4%) | (1.6%) |
| Profit after tax | 3.4 | 3.3 | (2.5%) | 3.1 | (8.7%) | 6.1% |

| Income Statement Ratios | Q3'2016 | Q3'2017 | y/y change |
|--|---------|---------|------------|
| Yield from interest-earning assets | 13.4% | 10.6% | (2.8%) |
| Cost of funding | 5.8% | 4.6% | (1.2%) |
| Net Interest Spread | 7.6% | 6.0% | (1.6%) |
| Net Interest Margin | 8.3% | 6.4% | (1.8%) |
| Cost of Risk | 25.6% | 20.6% | (5.0%) |
| Net Interest Income as % of operating income | 75.4% | 72.6% | (2.8%) |
| Non-Funded Income as a % of operating income | 24.6% | 27.4% | 2.8% |
| Cost to Income Ratio | 62.0% | 57.4% | (4.6%) |
| Cost to Income Ratio (less LLP) | 36.4% | 36.7% | 0.4% |
| Cost to Assets | 4.7% | 3.2% | (1.5%) |

| Capital Adequacy Ratios | Q3'2016 | Q3'2017 |
|--|--------------|--------------|
| Core Capital/Total Liabilities | 22.5% | 21.4% |
| Minimum Statutory ratio | 8.0% | 8.0% |
| Excess | 14.5% | 13.4% |
| Core Capital/Total Risk Weighted Assets | 15.9% | 16.3% |
| Minimum Statutory ratio | 10.5% | 10.5% |
| Excess | 5.4% | 5.8% |
| Total Capital/Total Risk Weighted Assets | 21.9% | 19.6% |
| Minimum Statutory ratio | 14.5% | 14.5% |
| Excess | 7.4% | 5.1% |
| Liquidity Ratio | 33.1% | 45.8% |
| Minimum Statutory ratio | 20.0% | 20.0% |
| Excess | 13.1% | 25.8% |