Valuation Summary

- We are of the view that NIC Group is a "buy" with a target price of Kshs 48.8, representing an upside of 31.5%, from the current price of Kshs 37.1 as of 21st March 2019, inclusive of a dividend yield of 3.4%,
- NIC Group is currently trading at a P/TBV of 0.8x and a P/E of 6.2x vs an industry average of 1.5x and 7.0x, respectively.

Key Highlights FY'2018

- During the year, the respective Boards of Directors have agreed to a merger of NIC and CBA. The proposed merger will be executed through a share swap, and it is proposed that the 34 shareholders of CBA will exchange their shares in CBA for new shares in NIC Group, which will be the holding company of the merged businesses and remain a publicly listed company quoted on the Nairobi Securities Exchange. It is envisioned that the share exchange ratio will be based on a 47:53 relative valuation of NIC and CBA, respectively. As such, it is expected that the CBA shareholders will in aggregate own 53% of the then issued shares in NIC, whilst existing NIC shareholders will own 47% of the then issued shares in NIC.

Income Statement

- NIC Group released their financial results, with core earnings per share increasing by 2.0% to Kshs 6.0 from Kshs 5.9 in FY'2017, below our expectation of a 3.9% increase to Kshs 6.1 per share. The performance was driven by a 1.9% increase in total operating income, which outweighed the 0.6% increase in total operating expenses. The variance in core earnings per share growth against our expectations was largely due to the 0.6% rise in total operating expenses to Kshs 9.4 bn, from Kshs 9.3 bn in FY'2017, which was not in line with our expectation of a 2.1% decline,
- Total operating income increased by 1.9% to Kshs 15.2 bn from Kshs 14.9 bn in FY'2017. The marginal rise was due to an 11.4% increase in Non-Funded Income (NFI), coupled with a 1.8% decline in Net Interest Income (NII) to Kshs 10.6 bn, from Kshs 10.8 bn in FY'2017,
- Interest income rose by 4.8% to Kshs 19.3 bn, from Kshs 18.4 bn in FY'2017. This was driven by a 31.2% growth in interest income from government securities to Kshs 6.8 bn, from Kshs 5.2 bn in FY'2017. The growth however was subdued by the 6.1% decline in interest income on loans and advances to Kshs 12.3 bn, from Kshs 13.1 bn in FY'2017. The yield on interest-earning assets however declined to 10.4%, from 10.8% in FY'2017, attributed to a decline in yields on government securities as well as a decline in lending rates due to the two Central Bank Rate (CBR) cuts in 2018,
- Interest expense increased by 14.1% to Kshs 17.5 bn, from Kshs 15.3 bn in FY'2017, following a 20.6% increase in the interest expense on customer deposits to Kshs 7.2 bn from Kshs 6.0 bn in FY'2017, significantly faster than the 4.0% increase in customer deposits, indicating that the bank may be paying relatively higher interest on deposits, as a strategy to attract deposits. Interest expense on deposits and placements from banking institutions however declined by 31.8% to Kshs 217.8 mn, from Kshs 319.1 mn in FY'2017. Consequently, cost of funds rose to 5.2% from 4.7% in FY'2017, with the Net Interest Margin (NIM) declining to 5.7%, from 6.3% in FY'2017,
- Non-Funded Income (NFI) increased by 11.4% to Kshs 4.6 bn, from Kshs 4.2 bn in FY'2017. The rise was mainly driven by a 10.2% rise in forex trading income to Kshs 1.3 bn from Kshs 1.2 bn, coupled with an 8.0% increase in fees and commissions on loans. Other incomes also rose by 20.2% to Kshs 853.9 mn from Kshs 710.3 mn in FY'2017. The revenue mix shifted to 70:30 funded to non-funded income, from 72:28 in FY'2017, owing to the faster growth in NFI, coupled with the decline in NII,
- Total operating expenses increased by 0.6% to Kshs 9.4 bn, from Kshs 9.3 bn, largely driven by a 13.6% rise in staff costs to Kshs 3.6 bn from Kshs 3.2 bn in FY'2017, and a 7.9% rise in other operating expenses to

Kshs 3.4 bn from Kshs 3.2 bn. This offset the 21.0% decline in Loan Loss Provisions (LLP) to Kshs 2.4 bn in FY'2018, from Kshs 3.0 bn in FY'2017,
- Consequently, the Cost to Income Ratio (CIR) improved to 61.7%, from 62.5% in FY'2017. Without LLP, the cost to income however deteriorated to 46.3%, from 42.6% in FY'2017,
- Profit before tax increased by 4.0% to Kshs 5.8 bn, from Kshs 5.6 bn in FY'2017. Profit after tax grew by 2.0% to Kshs 4.2 bn in FY'2018, from Kshs 4.1 bn in FY'2017, as the effective tax rate increased to 27.4% from 26.0% in FY'2017,
- The bank recommends a first and final dividend of Kshs 1.25 per share; similar to that paid in FY'2017, which translates to a dividend yield of 3.4%, and a payout ratio of 20.8%,

Balance Sheet

- The balance sheet recorded an expansion as total assets increased by 1.1% to Kshs 208.5 bn from Kshs 206.2 bn in FY'2017. This growth was largely driven by a 12.9% increase in government securities to Kshs 61.2 bn, from Kshs 54.2 bn in FY'2017, coupled with a 25.8% increase in cash and cash balances to Kshs 12.0 bn from Kshs 9.5 bn in FY'2017. This growth was however offset by the 57.7% decline in placements to Kshs 5.3 bn from Kshs 12.4 bn in FY'2017 and a 1.4% decline in the loan book to Kshs 118.1 bn from Kshs 119.8 bn in FY'2017,
- Total liabilities rose marginally by 0.7% to Kshs 172.7 bn from Kshs 171.5 bn in FY'2017. This was driven by a 4.0% increase in deposits to Kshs 144.5 bn from Kshs 138.9 bn in FY'2017, coupled with an 18.4% decline in placements and a 12.7% decline in borrowings to Kshs 9.9 bn, and Kshs 14.9 bn from Kshs 12.1 bn, and Kshs 17.0 bn in FY'2017, respectively. Deposits per branch increased by 6.4% to Kshs 3.4 bn from Kshs 3.2bn with the number of branches as at the close of 2018 at 43 from 44 at the close of FY'2017,
- The rise in deposits coupled with the decline in loans led to a decline in the loan to deposit ratio to 81.7% from 86.2% in FY'2017,
- Gross Non-Performing Loans (NPLs) increased by 17.6% to Kshs 16.8 bn in FY'2018 from Kshs 14.3 bn in FY'2017. Consequently, the NPL ratio deteriorated to 13.4% in FY'2018 from 11.3% in FY'2017. The NPL coverage declined to 43.5% in FY'2018 from 45.7% in FY'2017, as provisions declined despite the rise in NPLs,
- Shareholders' funds increased by 3.4% to Kshs 35.4 bn in FY'2018 from Kshs 34.3 bn in FY'2017, as retained earnings grew by 3.9% to Kshs 28.9 bn from Kshs 27.8 bn in FY'2017,
- NIC Group is currently sufficiently capitalized with a core capital to risk-weighted assets ratio of 19.5%, 9.0% points above the statutory requirement of 10.5%. In addition, the total capital to risk-weighted assets ratio was 21.2%, exceeding the statutory requirement of 14.5% by 6.7% points. Adjusting for IFRS 9, the core capital to risk weighted assets stood at 19.3%, while total capital to risk-weighted assets came in at 20.9%,
- The bank currently has a Return on Average Assets (ROaA) of 2.0%, and a Return on Average Equity (ROaE) of 12.1%.

Key Take-Outs:

1. There was an 11.4% rise in NFI's, which is way ahead of most banks that have reported so far. This was despite the implementation of the Effective Interest Rate (EIR) under IFRS 9, which has seen the bank amortize fees charged on loans over future period of a loan's tenor leading to a decline in NFI's in FY'2018. NFI contribution to total operating income is slightly below the industrial average of 31.4% indicating room for growth of the income segment exists,
2. The bank's asset quality deteriorated, with the NPL ratio rising to 13.4% from 11.3% in FY'2017. The deteriorating NPL ratio is attributable to a 17.6% rise in gross non-performing loans to Kshs 16.8 bn from Kshs 14.3 bn in FY'2017, and,

3. The Bank's cost of funds continued to rise coming in at 5.2% from 4.7% in FY'2017, while the Net Interest Margin (NIM) declined to 5.7%, from 6.3% in FY'2017. This is mainly attributable to the bank accepting costly customer deposits, which saw interest in customer deposits increasing by 20.6% to Kshs 7.2 bn from Kshs 6.0% in FY'2017. It remains unclear why the bank continues to pay high cost on deposits – now at 5.2% compared to industry average of 3.7% - and even with paying the highest cost of deposits NIC Group is still registering the weakest deposit growth of 4.0% relative to industry average of 7.7%.

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

1. Synergies arising from the merger between the Bank and CBA group. Some of the potential growth synergies expected to enhance profitability and shareholder value include:
    - Better and competitive Market positioning underpinned by the two strong brands, which will result in the second largest bank in Kenya by customer deposits, and third largest by total assets leading to enhanced capital adequacy as well. The combined entity is expected to have a total asset vase of Kshs 415.3 bn,
    - The Integration and optimization of support functions provides an opportunity to leverage strong digital platform to reach a wider customer base across the region,
    - The strategy going forward on alignment towards cost effective deposit raising is expected to Increase the banks yields and reduced cost of funds driven by scale,
    - The merger will also enhance the franchise value of the new entity by complimenting NIC Group's asset finance mainstay with CBA Group's leadership position in digital banking. In addition, both banks engage in corporate banking, therefore the merger holds the potential of becoming a market leader in the corporate segment as well. The process will also create a top-tier bank by regulatory standards, augmented by a robust capital position that will enable it take advantage of big-ticket projects.

Below is a summary of the bank's performance:

Balance Sheet Items	FY'2017	FY'2018	y/y change	FY'2018e	Expected y/y change	Variance in Actual Growth vs Expected
Net Loans and Advances	119.8	118.1	(1.4%)	118.3	(1.3%)	(0.2%)
Total Assets	**206.2**	**208.5**	**1.1%**	**209.4**	**1.6%**	**(0.4%)**
Customer Deposits	138.9	144.5	4.0%	145.1	4.5%	(0.4%)
Total Liabilities	171.5	172.7	0.7%	171.9	0.2%	0.5%
Shareholders' Funds	**34.3**	**35.4**	**3.4%**	**37.1**	**8.1%**	**(4.8%)**

Balance Sheet Ratios	FY'2017	FY'2018	% y/y change
Loan to Deposit Ratio	86.2%	81.7%	(4.5%)
Return on average equity	12.9%	12.1%	(0.8%)
Return on average assets	2.2%	2.0%	(0.2%)

Income Statement	FY'2017	FY'2018	y/y change	FY'2018e	Expected y/y change	Variance in Actual Growth vs Expected
Net Interest Income	10.8	10.6	(1.8%)	10.6	(1.3%)	(0.5%)
Net non-Interest Income	4.2	4.6	11.4%	4.7	11.7%	(0.3%)
Total Operating income	**14.9**	**15.2**	**1.9%**	**15.3**	**2.4%**	**(0.5%)**
Loan Loss provision	3.0	2.4	(21.0%)	2.4	(20.1%)	(0.9%)
Total Operating expenses	9.3	9.4	0.6%	9.1	(2.1%)	2.7%
Profit before tax	5.6	5.8	4.0%	6.1	9.8%	(5.8%)

Profit after tax	**4.1**	**4.2**	**2.0%**	**4.3**	**3.9%**	**(1.8%)**
Core EPS	**5.9**	**6.0**	**2.0%**	**6.1**	**3.9%**	**(1.8%)**

Income Statement Ratios	FY'2017	FY'2018	y/y change
Yield from interest-earning assets	10.8%	10.4%	(0.4%)
Cost of funding	4.7%	5.2%	0.4%
Net Interest Spread	6.1%	5.2%	(0.8%)
Net Interest Margin	6.3%	5.7%	(0.6%)
Cost of Risk	19.9%	15.5%	(4.5%)
Net Interest Income as % of operating income	72%	70%	(2.6%)
Non-Funded Income as a % of operating income	28%	30%	2.6%
Cost to Income Ratio	62.5%	61.7%	(0.8%)

Capital Adequacy Ratios	FY'2017	FY'2018
Core Capital/Total Liabilities	24.1%	23.5%
Minimum Statutory ratio	8.0%	8.0%
Excess	**16.1%**	**15.5%**
Core Capital/Total Risk Weighted Assets	19.2%	19.5%
Minimum Statutory ratio	10.5%	10.5%
Excess	**8.7%**	**9.0%**
Total Capital/Total Risk Weighted Assets	22.3%	21.2%
Minimum Statutory ratio	14.5%	14.5%
Excess	**7.8%**	**6.7%**
Liquidity Ratio	48.2%	48.7%
Minimum Statutory ratio	20.0%	20.0%
Excess	**28.2%**	**28.7%**
Adjusted core capital/ total deposit liabilities		23.4%
Adjusted core capital/ total risk weighted assets		19.3%
Adjusted total capital/ total risk weighted assets		20.9%