NIC Group – Q1’2019 Earnings Note

17th May, 2019

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 58.4%, from the current price of Kshs 31.6 as of 17th May 2019, inclusive of a dividend yield of 4.0%,
- NIC Group is currently trading at a P/TBV of 0.8x and a P/E of 4.5x vs an industry average of 1.3x and 6.7x, respectively.

Key Highlights Q1’2019

- NIC Group shareholders agreed the proposal to merge with Commercial Bank of Africa (CBA), with the Competition Authority of Kenya (CAK) also ratifying the merger proposal. The leadership of the combined entity has been revealed, with NIC Group’s Group Managing Director (MD) Mr. John Gachora expected to be the Group Managing Director and Chief Executive Officer, with CBA Group MD Mr Isaac Awuondo set to become the Chairman of the Kenyan Banking subsidiary.

Income Statement

- Core earnings per share declined by 4.3% to Kshs 1.3, from Kshs 1.4 in Q1’2018, contrary to our projections of a 1.2% increase to Kshs 1.41. The performance was driven by an 8.8% increase in total operating income to Kshs 3.8 bn from Kshs 3.5 bn in Q1’2018, which was outpaced by the 16.8% increase in total operating expenses to Kshs 2.5 bn from Kshs 2.1 bn in Q1’2018. The variance in core earnings per share growth against our expectations was largely due to the faster 16.8% rise in total operating expenses to Kshs 2.5 bn, from Kshs 2.1 bn in Q1’2018, which was not in line with our expectation of a 11.2% increase to Kshs 2.4 bn,
- Total operating income rose by 8.8% to Kshs 3.8 bn, from Kshs 3.5 bn in Q1’2018. This was driven by a 9.4% increase in Net Interest Income (NII) to Kshs 2.7 bn, from Kshs 2.5 bn in Q1’2018, coupled with a 7.2% increase in Non-Funded Income (NFI) to Kshs 1.1 bn, from Kshs 1.0 bn in Q1’2018,
- Interest income rose by 1.3% to Kshs 4.73 bn, from Kshs 4.66 bn in Q1’2018. This was driven by a 7.6% growth in interest income from government securities to Kshs 1.7 bn, from Kshs 1.6 bn in Q1’2018. The increase in interest income was however weighed down by the 40.3% decline in interest income from placement assets to Kshs 16.7 mn from Kshs 27.9 mn in Q1’2018, and the 1.6% decline in interest income from loans to Kshs 2.99 bn from Kshs 3.04 bn in Q1’2018. The yield on interest-earning assets however declined to 10.6%, from 11.2% in Q1’2018, attributed to a decline in yields on government securities as well as a decline in lending rates due to the 100 bps Central Bank Rate (CBR) cut in 2018,
- Interest expense declined by 7.9% to Kshs 2.0 bn, from Kshs 2.2 bn in Q1’2018, largely due to the 8.1% decline in the interest expense on customer deposits to Kshs 1.6 bn, from Kshs 1.8 bn in Q1’2018, coupled with a 37.8% decline in interest expense on placement liabilities to Kshs 53.3 mn bn from Kshs 85.7 mn in Q1’2018. However, other interest expenses rose by 1.4% to Kshs 0.324 bn from Kshs 0.320 bn in Q1’2018. The cost of funds thus declined to 5.1%, from 5.4% in Q1’2018. The Net Interest Margin (NIM) declined to 5.9%, from 6.3% in Q1’2018,
- Non-Funded Income rose by 7.2% to Kshs 1.1 bn from Kshs 1.0 bn in Q1’2018. The increase was mainly driven by the 6.2% increase in total fees and commissions to Kshs 0.60 bn, from Kshs 0.56 bn in Q1’2018, with fees and commissions on loans income improving as a result of increased lending activity by the bank during the period under review. The improvement in NFI was also supported by the 17.5% growth in other income to Kshs 0.21 bn, from Kshs 0.18 bn in Q1’2018, and a 2.8% growth in forex trading income to Kshs 0.31 bn, from Kshs 0.30 bn in Q1’2018. The revenue mix shifted to 71:29 from 70:30 funded to non-funded income owing to the slightly faster increase in NII,

- Total operating expenses rose by 16.8% to Kshs 2.5 bn, from Kshs 2.1 bn in Q1’2018, largely driven by a 21.4% increase in Loan Loss Provisions (LLP) to Kshs 0.7 bn from Kshs 0.6 bn in Q1’2018, coupled with an 11.5% increase in staff costs to Kshs 0.9 bn, from Kshs 0.8 bn in Q1’2018, and a 19.1% increase in other operating expenses to Kshs 0.9 bn, from Kshs 0.8 bn in Q1’2018,
- The Cost to Income Ratio (CIR) deteriorated to 65.2%, from 60.7% in Q1’2018. Without LLP, the cost to income ratio deteriorated to 47.6%, from 45.0% in Q1’2018,
- Profit before tax decreased by 3.7% to Kshs 1.3 bn, up from Kshs 1.4 bn in Q1’2018. Profit after tax declined by 4.3% to Kshs 0.9 bn in Q1’2019, from Kshs 1.0 bn in Q1’2018, with the difference in growth attributable to the marginal increase in the effective tax rate to 30.3%, from 29.8% in Q1’2018.

Balance Sheet

- The balance sheet recorded an expansion as total assets increased by 6.9% to Kshs 213.6 bn, from Kshs 199.8 bn in Q1’2018. Growth was supported by a 2.1% increase in the loan book to Kshs 118.3 bn, from Kshs 115.9 bn, coupled with a 10.3% increase in government securities to Kshs 60.4 bn, from Kshs 54.8 bn in Q1’2018,
- Total liabilities rose by 5.1% to Kshs 176.3 bn from Kshs 167.8 bn in Q1’2018, driven by a 5.0% increase in customer deposits to Kshs 151.1 bn from Kshs 143.9 bn in Q1’2018. Deposits per branch increased by 25.4% to Kshs 3.7 bn from Kshs 2.9 bn in Q1’2018, as the number of branches declined to 41, from 49 as at Q1’2018,
- Borrowings declined by 10.9% to Kshs 14.9 bn, from Kshs 16.8 bn in Q1’2018,
- The faster growth in deposits compared to the loan growth led to a decline in the loan to deposit ratio to 78.3%, from 80.5% in Q1’2018,
- Gross Non-Performing Loans (NPLs) increased by 9.4% to Kshs 17.4 bn in Q1’2019, from Kshs 15.4 bn in Q1’2018. The NPL ratio thus deteriorated to 13.9% in Q1’2019 from 11.9% in Q1’2018. General Loan Loss Provisions decreased by 26.7% to Kshs 4.5 bn, from Kshs 6.1 bn in Q1’2018, and consequently the NPL coverage deteriorated to 40.8% in Q1’2019, from 48.0% in Q1’2018,
- Shareholders’ funds increased by 17.2% to Kshs 37.0 bn in Q1’2019 from Kshs 31.6 bn in Q1’2018, supported by a 15.7% increase in retained earnings to Kshs 29.9 bn, from Kshs 25.9 bn in Q1’2018,
- NIC Group remains sufficiently capitalized with a core capital to risk-weighted assets ratio of 19.7%, 9.2% points above the statutory requirement. In addition, the total capital to risk-weighted assets ratio came in at 21.3%, exceeding the statutory requirement by 6.8% points. Adjusting for IFRS 9, the core capital to risk weighted assets stood at 20.9%, while total capital to risk-weighted assets came in at 22.5%, and,
- The bank currently has a Return on Average Assets (ROaA) of 2.0%, and a Return on Average Equity (ROaE) of 12.2%.

Key Take-Outs:

1. The bank’s performance was largely weighed down by rising operational inefficiencies, as the rise in total operating expenses outpaced the rise in total operating income. The bank recorded significant increments in provisioning expenses, as the asset quality deteriorated with NPL ratio rising to 13.9% from 11.9% in Q1’2018, and,
2. The bank’s cost of funds declined to 5.1% from 5.4% in Q1’2018. This may largely be due to the removal of the 70.0% of the Central Bank Rate (CBR) floor on interest paid to deposits, in the Finance Act 2018. However, the cost of funds remains way above the market average of 3.7%, implying that funding for NIC Group still remains relatively expensive compared to the market. We however expect this to improve going forward, as the merger with CBA is likely to make it easier for NIC to mobilize cheaper funding, aided by CBA’s large customer base, increased scale and market reach with a combined entity, and digital

banking platforms, which will likely improve Net Interest Margins and consequently generating higher Net Interest Income.

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

i. The merger with CBA will likely enable NIC mobilize cheaper funding, leveraging on the scale and market reach of the combined entity as well as the digital channels. We expect this to help widen NIC's increase NIC's interest margins, thereby helping grow the interest income segment. Furthermore, alternative channels would aid in NFI expansion, which should aid in generating higher profitability.

Below is a summary of the bank's performance:

Balance Sheet Items	Q1'2018	Q1'2019	y/y change	Q1'2019e	Projected %y/y change	Variance in Growth Actual vs. Expected
Government Securities	54.7	60.4	10.3%	56.8	3.8%	6.6%
Net Loans and Advances	115.9	118.3	2.1%	120.1	3.6%	(1.5%)
Total Assets	**199.8**	**213.6**	**6.9%**	**210.0**	**5.1%**	**1.8%**
Customer Deposits	143.9	151.1	5.0%	146.5	1.8%	3.2%
Total Liabilities	167.8	176.3	5.1%	175.8	4.8%	0.3%
Shareholders' Funds	**31.6**	**37.0**	**17.2%**	**36.0**	**14.1%**	**3.1%**

Balance Sheet Ratios	Q1'2018	Q1'2019	y/y change
Loan to Deposit Ratio	80.5%	78.3%	(2.2%)
Return on average equity	13.4%	12.2%	(1.2%)
Return on average assets	2.2%	2.0%	(0.2%)

Income Statement	Q1'2018	Q1'2019	y/y change	Q1'2019e	Projected %y/y change	Variance in Growth Actual vs. Expected
Net Interest Income	2.5	2.7	9.4%	2.8	12.7%	(3.3%)
Net non-Interest Income	1.04	1.12	7.2%	1.0	(4.1%)	11.3%
Total Operating income	**3.5**	**3.8**	**8.8%**	**3.7**	**4.9%**	**3.8%**
Loan Loss provision	0.6	0.7	21.4%	0.6	6.4%	15.0%
Total Operating expenses	**2.1**	**2.5**	**16.8%**	**2.4**	**11.2%**	**5.6%**
Profit before tax	1.4	1.3	(3.7%)	1.4	1.2%	(4.9%)
Profit after tax	**1.0**	**0.9**	**(4.3%)**	**1.0**	**1.2%**	**(5.5%)**

Income Statement Ratios	Q1'2018	Q1'2019	y/y change
Yield from interest-earning assets	11.2%	10.6%	(0.5%)
Cost of funding	5.4%	5.1%	(0.3%)
Net Interest Spread	5.8%	5.6%	(0.2%)
Net Interest Margin	6.3%	5.9%	(0.3%)
Cost of Risk	15.7%	17.6%	1.8%
Net Interest Income as % of operating income	70.4%	70.9%	0.4%
Non-Funded Income as a % of operating income	29.6%	29.1%	(0.4%)
Cost to Income Ratio	60.7%	65.2%	4.5%
Cost to Income Ratio (less LLP)	45.0%	47.6%	2.7%

Cost to Assets	0.8%	0.9%	0.1%

Capital Adequacy Ratios	Q1'2018	Q1'2019
Core Capital/Total Liabilities	21.6%	22.9%
Minimum Statutory ratio	8.0%	8.0%
Excess	**13.6%**	**14.9%**
Core Capital/Total Risk Weighted Assets	18.2%	19.7%
Minimum Statutory ratio	10.5%	10.5%
Excess	**7.7%**	**9.2%**
Total Capital/Total Risk Weighted Assets	20.8%	21.3%
Minimum Statutory ratio	14.5%	14.5%
Excess	6.3%	6.8%
Liquidity Ratio	48.2%	50.4%
Minimum Statutory ratio	20.0%	20.0%
Excess	**28.2%**	**30.4%**