NIC Group Earnings Note– H1’2019
23rd August, 2019

Valuation Summary

- We are of the view that NIC Group is a “Buy” with a target price of Kshs 42.5, representing an upside of 42.4%, from the current price of Kshs 28.4 as of 23rd August, inclusive of a dividend yield of 3.5%,
- NIC Group is currently trading at P/TBV of 0.6x and a P/E of 5.5x vs an industry average of 1.6x and 7.1x, respectively.

Key Highlights H1’2018

- 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 increasing by 8.6% to Kshs 3.1 bn from Kshs 2.8 in H1’2018. Performance was driven by an 18.0% increase in operating expenses to Kshs 5.2 bn from Kshs 4.4 bn in H1’2018, this was mitigated by the 12.5% increase in operating income to Kshs 8.2 bn from Kshs 7.3 bn,
- Total operating income increased by 12.5% to Kshs 8.2 bn in H1’2019 from Kshs 7.3 bn in H1’2018. This was driven by a 7.7% increase in Net Interest Income (NII) to Kshs 5.5 bn from Kshs 5.1 bn in H1’2018, coupled with a 23.9% increase in Non-Funded Income (NFI) to Kshs 2.7 bn from Kshs 2.1 bn in H1’2018,
- Interest income increased marginally to Kshs 9.7 bn from Kshs 9.6 bn in H1’2018. Interest income on government securities increased by 3.8% to Kshs 3.4 bn in H1’2019 from Kshs 3.3 bn in H1’2018. The yield on interest earning assets however declined to 10.8% in H1’2019 from 10.9% in H1’2018, due to declining yields on government securities, and lower interest on loans due to a relatively lower Central Bank Rate (CBR) currently at 9.0%, ,
- Interest expense decreased by 7.0% to Kshs 4.1 bn from Kshs 4.4 bn in H1’2018, as interest expense on customer deposits decreased by 8.7% to Kshs 3.3 bn from Kshs 3.7 bn in H1’2018. The cost of funds fell to 5.1% from 5.4% in H1’2018. The Net Interest Margin remained at 6.0%,
- Non-Funded Income increased by 23.9% to Kshs 2.7 bn from Kshs 2.1 bn in H1’2018. The increase in NFI was driven by a 29.3% increase in Fees and commissions to Kshs 0.8 bn from Kshs 0.6 bn in H1’2018, coupled with a 67.8% increase in other income to Kshs 0.6 bn from Kshs 0.4 bn in H1’2018. Forex trading income also rose by 7.6% to Kshs 735.0 mn from Kshs 683.0 mn in H1’2018. The revenue mix shifted to 67:33 funded to non-funded income from 70:30 in H1’2018, owing to the increase in NFI coupled with the decline in NII,
- Total operating expenses increased by 18.0% to Kshs 5.2 bn from Kshs 4.4 bn, largely driven by a 29.6% increase in loan loss provision (LLP) to Kshs 1.4 bn in H1’2019 from Kshs 1.1 bn in H1’2018. Staff costs also increased by 9.1% to Kshs 1.9 bn in H1’2019 from Kshs 1.7 bn in H1’2018,

- The cost to income ratio deteriorated to 63.9% from 60.9% in H1’2018. Without LLP, the cost to income ratio also deteriorated to 46.3% from 45.6% in H1’2018,
- NIC Group incurred an exceptional item of Kshs 255.2 mn following the integration, advisory and legal expenses related to the merger with CBA,
- Profit before tax and exceptional items increased by 4.0% to Kshs 3.0 bn from Kshs 2.8 bn in H1’2018. Profit after tax declined by 4.2% to Kshs 1.9 bn in H1’2019 from Kshs 2.0 bn in H1’2018,
- The bank declared an Interim dividend of Kshs. 0.25 per share, which will be paid in October 2019. Assuming a final dividend payout of Kshs 1.25, the dividend yield translates to 4.4% at the current price of Kshs 28.4.

Balance Sheet

- The balance sheet recorded an expansion with total assets growth of 6.6% to Kshs 214.1 bn from Kshs 201.0 bn in H1’2018. This growth was largely driven by an 8.1% increase in government securities to Kshs. 60.3 bn from Kshs. 55.7 bn in H1’2018,
- The loan book expanded by 3.1% to Kshs 118.5 bn in H1’2019 from Kshs 115.0 bn in H1’2018,
- Total liabilities rose by 4.6% to Kshs 176.4 bn from Kshs 168.7 bn in H1’2018, driven by a 3.5% increase in customer deposits to Kshs 152.3 bn from Kshs 147.1 bn in H1’2018. Deposits per branch increased by 6.1% to Kshs 3.7 bn from Kshs 3.6 bn in H1’2018, with the branches decreasing to 41 in H1’2019 from 42 in H1’2018,
- The faster growth in deposits compared to the growth in loans led to a slight decline in the loan to deposit ratio to 77.8% from 78.2% in H1’2018,
- Gross non-performing loans increased by 12.3% to Kshs 18.1 bn in H1’2019 from Kshs 16.2 bn in H1’2018. Consequently, the NPL ratio deteriorated to 14.3% in H1’2019 from 13.1% in H1’2018. General Loan loss provisions decreased by 25.0% to Kshs 5.1 bn from Kshs 6.8 bn in H1’2018. Consequently, the NPL coverage deteriorated to 44.5% in H1’2018 from 52.2% in H1’2018,
- Shareholders’ funds increased significantly by 17.7% to Kshs 37.4 bn in H1’2019 from Kshs 31.8 bn in H1’2018, mainly driven by a 17.1% increase in retained earnings to Kshs 30.9 bn from Kshs 26.4 bn reported in H1’2018,
- NIC Group is currently sufficiently capitalized with a core capital to risk weighted assets ratio of 20.4%, 9.9% above the statutory requirement. In addition, the total capital to risk weighted assets ratio was 21.9%, exceeding the statutory requirement by 7.4%. Adjusting for IFRS 9, the core capital to risk weighted assets stood at 19.4%, while total capital to risk weighted assets came in at 20.8%,
- NIC Group currently has a return on average assets of 2.1% and a return on average equity of 12.0%.

Key Take-Outs:

a. NIC Group’s non-funded income increased by 23.9% for the period ending 30th June 2019. This shows improved diversification with the bank improving its alternative sources of income, but assuming the change is sustainable, which is too early to tell. This led to an increment in the bank’s NFI contribution to total income to 32.5%, which is still lower than the industry average of 36.8%,

b. The bank’s NPL Ratio declined to 14.3% as the gross non-performing loans increased by 12.3%, outpacing loan growth of 3.1%. Despite this, the bank’s provisions also decreased by 25.0%. This performance in NPL’s shows the continued deterioration in the quality of loans that local banks hold and consequently, the increasing level of risk that that comes with high NPLs,
c. The Bank has a relatively low ROA of 2.1% and an ROE of 12.0% in H1’2019 compared to the market average of 17.5%. This was mainly driven by the decline in profits during the period under review.

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

a. 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 increase NIC’s interest margins, thereby helping grow the interest income segment. Furthermore, alternative channel synergy would aid in NFI expansion, which should aid in generating higher profitability.

Balance Sheet Items	H1'2018	H1'2019	y/y change
Net Loans and Advances	115.0	118.5	3.1%
Total Assets	**201.0**	**214.1**	**6.6%**
Customer Deposits	147.1	152.3	3.5%
Total Liabilities	168.7	176.4	4.6%
Shareholders’ Funds	**31.8**	**37.4**	**17.7%**

Balance Sheet Ratios	H1'2018	H1'2019	% y/y change
Loan to Deposit Ratio	78.2%	77.8%	(0.4%)
Return on average equity	12.7%	12.0%	(0.7%)
Return on average assets	2.2%	2.1%	(0.1%)

Income Statement	H1'2018	H1'2019	y/y change
Net Interest Income	5.1	5.5	7.7%
Net non-Interest Income	2.1	2.7	23.9%
Total Operating income	**7.3**	**8.2**	**12.5%**
Loan Loss provision	1.1	1.4	29.6%
Total Operating expenses	4.4	5.2	18.0%
Profit before tax	2.8	3.0	4.0%
Profit after tax	**2.0**	**1.9**	**(4.2%)**
Core EPS	**2.8**	**3.1**	**8.6%**

Income Statement Ratios	H1'2018	H1'2019	y/y change
Yield from interest-earning assets	10.9%	10.8%	(0.1%)
Cost of funding	5.4%	5.1%	(0.3%)
Net Interest Spread	5.5%	5.8%	0.3%
Net Interest Margin	6.0%	6.0%	(0.0%)
Cost of Risk	15.3%	17.6%	2.3%
Net Interest Income as % of operating income	70%	67%	(3.0%)
Non-Funded Income as a % of operating income	30%	33%	3.0%
Cost to Income Ratio	60.9%	63.9%	3.0%
Cost to Income Ratio without LLP	45.6%	46.3%	0.7%

Capital Adequacy Ratios	H1'2018	H1'2019
Core Capital/Total Liabilities	21.1%	23.0%
Minimum Statutory ratio	8.0%	8.0%
Excess	**13.1%**	**15.0%**
Core Capital/Total Risk Weighted Assets	18.1%	19.4%
Minimum Statutory ratio	10.5%	10.5%
Excess	**7.6%**	**8.9%**
Total Capital/Total Risk Weighted Assets	20.7%	20.8%
Minimum Statutory ratio	14.5%	14.5%
Excess	**6.2%**	**6.3%**
Liquidity Ratio	48.8%	50.9%
Minimum Statutory ratio	20.0%	20.0%
Excess	**28.8%**	**30.9%**
Adjusted core capital/ total deposit liabilities	21.1%	24.5%
Adjusted core capital/ total risk weighted assets	17.8%	20.4%
Adjusted total capital/ total risk weighted assets	20.4%	21.9%