Standard Chartered Bank – Q3’2017

17th November, 2017

Valuation Summary

- We are of the view that Standard Chartered Bank stock is a “sell”, with a target price of Kshs 199.8 representing a downside of 3.6%, from the current price of Kshs 218.0, as at 17th November, inclusive of a dividend yield of 4.7%,
- Standard Chartered Bank is currently trading at a P/TBV of 1.8x and a P/E of 12.4x, vs an industry average of 1.4x and 8.3x, respectively.

Key highlights during Q3’2017

- Standard Chartered Bank embarked on aggressive lending to the retail segment, whose access to credit was affected by the interest rate cap law. The bank allocated Kshs 10.0 bn, from which a customer can borrow up to a maximum of Kshs 7.0 mn,
- Standard Chartered Bank has issued a profit warning for FY'2017 earnings, implying that the FY’2017 earnings will be at least 25.0% lower than FY'2016 earnings. This was attributed to 2 factors:
    - The bank's Non-Performing Loans (NPL) have increased during the year, and no turnaround on the accounts is expected before the year-end. Gross NPLs currently stand at Kshs 17.0 bn, a 15.4% growth from Kshs 14.7 bn in Q3'2016, with the gross NPL ratio increasing to 13.4% from 11.6% in Q3’2016,
    - The effects of interest rate cap coupled with a slowdown in economic activity in the country.

Income Statement

- Core earnings per share declined by 39.1% to Kshs 13.7 from Kshs 22.5 in Q3’2016, attributed to a 27.1% increase in operating expenses and a 6.5% decline in operating revenue,
- Total operating revenue declined by 6.5% y/y to Kshs 20.2 bn from Kshs 21.6 bn, attributed to an 8.0% decline in Net Interest Income (NII) to Kshs 13.8 bn from Kshs 15.0 bn, and a 3.2% decline in Non-Funded Income (NFI) to Kshs 6.4 bn from Kshs 6.6 bn in Q3'2016;
- Interest Income declined slightly by 1.4% to Kshs 19.4 bn from Kshs 19.7 bn in Q3’2016. The interest income on loans and advances alone declined by 12.1% y/y to Kshs 10.1 bn from Kshs 11.5 bn, while interest income on government securities grew by 10.0% y/y to Kshs 8.3 bn from Kshs 7.5 bn. As a result, the yield on interest-earning assets declined to 11.3% from 12.6% in Q3’2016,
- Interest expense grew by 19.1% to Kshs 5.7 bn from Kshs 4.7 bn in Q3’2016, following an 11.2% increase in interest expense on customer deposits to Kshs 4.7 bn from Kshs 4.2 bn. The growth in interest expense was also driven by a 19.5% increase in deposits. The cost of funding declined marginally to 3.3% from 3.4% in Q3’2016,
- Net Interest Income declined by 8.0% to Kshs 13.8 bn from Kshs 15.0 bn in Q3’2016, with the Net Interest Margin declining to 8.1% from 9.6% in Q3'2016,
- Non-Funded Income (NFI) recorded a decline of 3.2% to Kshs 6.4 bn from Kshs 6.6 bn in Q3'2016. The decline in NFI was attributed to a 4.0% decrease in total fees and commissions on loans to Kshs 3.2 bn from Kshs 3.3 bn in Q3’2016, and a 15.4% decrease in forex trading income to Kshs 1.9 bn from Kshs 2.2 bn in Q3’2016. The current revenue mix stands at 68:32 funded to non-funded income from 69:31 in Q3’2016,
- Total operating expenses increased by 27.1% to Kshs 13.2 bn from Kshs 10.5 bn, driven by a 104.5% increase in Loan Loss Provision (LLP) to Kshs 3.7 bn from Kshs 1.8 bn in Q3'2016. Staff costs grew by 10.0% to Kshs 5.2 bn from Kshs 4.7 bn in Q3’2016,
- The Cost to Income ratio worsened to 66.0% from 48.5% in Q3'2016 following a 27.1% increase in total operating expenses. Without LLP, the Cost to Income ratio worsened to 47.5% from 40.1% in Q3'2016,
- Profit before tax declined by 38.2% to Kshs 6.9 bn from Kshs 11.1 bn. Profit after tax declined by 39.1% to Kshs 4.7 bn from Kshs 7.7 bn in Q3’2016, following an increase in effective tax rate to 32.0% from 31.4% in Q3’2016.

Balance Sheet

- The total assets increased by 17.5% to Kshs 310.5 bn from Kshs 264.3 bn in Q3'2016. This growth was driven by a 19.9% growth in government securities to Kshs 114.1 bn from Kshs 95.1 bn in Q3’2016. The loan book contracted by 5.4% to Kshs 114.2 bn from Kshs 120.8 bn in Q3'2016,
- Total liabilities rose by 20.6% to Kshs 265.7 bn from Kshs 220.3 bn in Q3'2016, driven by a 19.5% increase in deposits to Kshs 238.5 bn from Kshs 199.6 bn in Q3'2016,
- Shareholders’ funds increased by 2.0% to Kshs 44.8 bn from Kshs 43.9 bn in Q3’2016,

- The growth in deposits coupled with a decline in loans led to a decrease in the loan to deposit ratio to 47.9% from 60.5% in Q3'2016,
- Gross non-performing loans increased by 15.4% to Kshs 17.0 bn from Kshs 14.7 bn. The NPL ratio therefore increased to 13.4% from 11.6% in Q3'2016,
- Standard Chartered Bank is currently sufficiently capitalized with a core capital to risk weighted assets ratio at 17.1%, 6.6% above the statutory requirement, with total capital to total risk weighted assets exceeding statutory requirement of 14.5% by 5.6%.
- Standard Chartered Bank currently has a return on average assets of 2.1% and a return on average equity of 13.6%.

Key Takeout:

- Standard Chartered Bank's performance as below our expectation of a 31.2% decline in core EPS, mainly due to a higher than expected increase in loan loss provision. This was as a result of increase in Non-Performing Loans during the year with the gross NPL ratio increasing from 12.1%, to 13.1% in H1'2016 and currently at 13.4%. The bank does not expect a turn-around on these accounts by end of the year, which implies that LLPs are likely to increase further. With the expected adoption of IFRS in January 2018, this is likely to affect the bank's profitability even in early 2018.

Going forward, Standard Chartered Bank's growth will be driven by:

- Continued investment in digital infrastructure through its Digital by Design strategy that aims to migrate over 80% of transactions to non-branch channels by 2020. This is expected to promote cost efficiency and enhance risk management. In 2016 the bank introduced a mobile app, a revamped online platform, fingerprint log-in technology, video banking and cash deposit machines all aimed at achieving its Digital by Design strategy target,
- Roll-out of enhanced mobile and online banking products, particularly targeting SME and retail business, which is expected to drive growth in deposits and loans.

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	95.1	114.1	19.9%	115.0	20.8%	(0.9%)
Net loans	120.8	114.2	(5.4%)	115.6	(4.2%)	(1.2%)
Total Assets	**264.3**	**310.5**	**17.5%**	**294.4**	**11.4%**	**6.1%**
Customer Deposits	199.6	238.5	19.5%	226.7	13.6%	5.9%
Total Liabilities	220.3	265.7	20.6%	248.9	13.0%	7.6%
Shareholder's Funds	**43.9**	**44.8**	**2.0%**	**45.5**	**3.5%**	**(1.6%)**

Balance Sheet Ratios	Q3'2016	Q3'2017	y/y change
Loan to deposit ratio	60.5%	47.9%	(12.6%)
Return on Average Equity	18.4%	13.6%	(4.8%)
Return on Average Assets	3.2%	2.1%	(1.1%)

Income Statement	Q3'2016	Q3'2017	y/y change	Q3'2017e	Projected y/y change	Variance in Growth Actual vs. Expected
Net Interest Income	15.0	13.8	(8.0%)	12.7	(15.0%)	7.1%
Net non-Interest Income	6.6	6.4	(3.2%)	6.7	1.0%	(4.1%)
Total Operating income	**21.6**	**20.2**	**(6.5%)**	**19.4**	**(10.1%)**	**3.6%**
Loan Loss provision	1.8	3.7	104.5%	2.4	30.8%	73.7%
Total Operating expenses	10.5	13.3	27.1%	11.6	10.6%	16.6%
Profit before tax	11.1	6.9	(38.2%)	7.8	(29.6%)	(8.6%)
Profit after tax	**7.7**	**4.7**	**(39.1%)**	**5.3**	**(31.2%)**	**(7.9%)**

Core EPS	**22.5**	**13.7**	**(39.1%)**	**15.5**	**(31.2%)**	**(7.9%)**

Income Statement Ratios	Q3'2016	Q3'2017	y/y change
Yield from interest-earning assets	12.6%	11.3%	(1.4%)
Cost of funding	3.4%	3.3%	(0.1%)
Net Interest Spread	9.3%	8.0%	(1.3%)
Net Interest Margin	9.6%	8.1%	(1.5%)
Cost of Risk	8.4%	18.5%	10.0%
Net Interest Income as % of operating income	69.3%	68.2%	(1.1%)
Non-Funded Income as a % of operating income	30.7%	31.8%	1.1%
Cost to Income Ratio	48.5%	66.0%	17.5%

Capital Adequacy Ratios	Q3'2016	Q3'2017
Core Capital/Total Liabilities	18.4%	15.1%
Minimum Statutory ratio	8.0%	8.0%
Excess	**10.4%**	**7.1%**
Core Capital/Total Risk Weighted Assets	18.2%	17.1%
Minimum Statutory ratio	10.5%	10.5%
Excess	**7.7%**	**6.6%**
Total Capital/Total Risk Weighted Assets	21.3%	20.1%
Minimum Statutory ratio	14.5%	14.5%
Excess	**6.8%**	**5.6%**
Liquidity Ratio	61.5%	69.9%
Minimum Statutory ratio	20.0%	20.0%
Excess	**41.5%**	**49.9%**