Standard Chartered Bank Kenya Limited – Q1’2018

29th May, 2018

Valuation Summary

- We are of the view that Standard Chartered Bank is a “Lighten” with a target price of Kshs 192.6, representing an upside of 1.3%, from the current price of Kshs 202.0 as of 29th May, inclusive of a dividend yield of 6.0%,
- Standard Chartered Bank is currently trading at P/TBV of 1.6x and a P/E of 9.9x vs an industry average of 1.7x and 9.2x, respectively.

Key Highlights Q1’2018

- Standard Chartered partnered with Visa to extend loyalty points reward scheme dubbed 360° for its clients shopping using their debit cards, seen as a medium-term strategy to lower ATM operating costs by driving cashless transactions.

Income Statement

- Core earnings per share declined by 12.5% to Kshs 5.2 from Kshs 6.0 in Q1’2017. The decline in performance was driven by a 15.4% increase in total operating expenses that outpaced the 5.4% increase in total operating income,
- Total operating income increased by 5.1% to Kshs 7.1 bn in Q1’2018 from Kshs 6.8 bn in Q1’2017. Performance was driven by a 4.5% increase in Net Interest Income (NII) to Kshs 4.8 bn from Kshs 4.6 bn in Q1’2017, coupled with a 6.5% increase in Non-Funded Income (NFI) to Kshs 2.3 bn from Kshs 2.1 bn in Q1’2017,
- Interest income increased by 7.7% to Kshs 6.8 bn from Kshs 6.3 bn in Q1’2017 bn, driven by an increase in interest income on government securities that rose by 31.0% to Kshs 3.1 bn in Q1’2018 from Kshs 2.4 bn in Q1’2017. However, interest income on loans and advances declined by 6.0% to Kshs 3.4 bn from Kshs 3.6 bn in Q1’2017. The yield on interest earning assets however declined to 11.4% in Q1’2018 from 12.1% in Q1’2017, due to the relatively faster increase in the interest earning assets to Kshs 230.3 bn from Kshs 212.9 bn in Q1’2017, with the increase mainly being government securities that have a lower yield than loans,
- Interest expense increased by 16.4% to Kshs 2.0 bn from Kshs 1.7 bn in Q1’2017, following a 14.2% increase in the interest expense on customer deposits to Kshs 1.7 bn from Kshs 1.5 bn in Q1’2017. Other interest expenses also increased by 47.5% to Kshs 0.3 bn in Q1’2018 from Kshs 0.2 bn in Q1’2017. Consequently, the cost of funds increased to 3.6% from 3.3% in Q1’2017, while the Net Interest Margin declined to 8.2% from 9.0% in Q1’2017,
- Non-Funded Income increased by 6.5% to Kshs 2.3 bn from Kshs 2.1 bn in Q1’2017. The growth in NFI was driven by a 27.0% increase in Total fees and commissions to Kshs 1.5 bn from Kshs 1.2 bn in Q1’2017. Other operating expenses also increased by 26.1% to Kshs 1.2 bn from Kshs 1.0 bn in Q1’2017, largely due to the implementation of the “Digital by Design” strategy aiming to migrate over 80% of transactions to non-branch channels. Foreign exchange trading income however declined by 13.8% to Kshs 0.6 bn from Kshs 0.7 bn in Q1’2017. The current revenue mix stands at 68:32 funded to non-funded income as compared to 69:31 in Q1’2017. The proportion of non-funded income to total revenue increased slightly owing to the faster growth in NFI as compared to NII.
- Total operating expenses increased by 15.4% to Kshs 4.3 bn from Kshs 3.8 bn, largely driven by a 37.9% increase in loan loss provisions to Kshs 1.1 bn in Q1’2018 from Kshs 0.8 bn in Q1’2017, coupled with a 26.1% increase in other operating expenses to Kshs 1.2 bn in Q1’2018 from Kshs 1.0 bn in Q1’2017. Staff costs stayed flat at Kshs 1.6 bn due to the intensified investment in automated teller machines, internet and mobile banking in a cost-cutting strategy that has seen it reduce its staff costs,
- The cost to income ratio deteriorated to 61.0% from 55.6% in Q1’2017. Without LLP, the cost to income ratio also deteriorated to 46.0% from 44.1% in Q1’2017,

- Profit before tax declined by 7.7% to Kshs 2.8 bn, down from Kshs 3.0 bn in Q1’2017. Profit after tax declined by 10.5% to Kshs 1.8 bn in Q1’2018 from Kshs 2.1 bn in Q1’2017,

Balance Sheet

- The balance sheet recorded an expansion as total assets increased by 7.2% to Kshs 294.0 bn from Kshs 274.2 bn in Q1’2017. This growth was driven by a 12.4% increase in government securities to Kshs 120.6 bn from Kshs 107.3 bn in Q1’2017,
- The loan book declined by 2.6% to Kshs 113.8 bn in Q1’2018 from Kshs 116.9 bn in Q1’2017,
- Total liabilities rose by 8.8% to Kshs 247.7 bn from Kshs 227.8 bn in Q1’2017, driven by a 13.2% increase in customer deposits to Kshs 232.0 bn from Kshs 205.0 bn in Q1’2017. Deposits per branch increased by 19.4% to Kshs 6.4 bn from Kshs 5.4 bn in Q1’2017, with the branches declining to 36 from 38 as at Q1’2017. The growth in deposits coupled with the decline in loans led to a decline in the loan to deposit ratio to 49.1% from 57.0% in Q1’2017,
- Gross non-performing loans increased by 15.8% to Kshs 17.8 bn in Q1’2018 from Kshs 15.4 bn in Q1’2017. As a consequence, the NPL ratio deteriorated to 14.0% in Q1’2018 from 12.1% in Q1’2017. Loan loss provisions increased by 35.8% to Kshs 6.9 bn from Kshs 5.1 bn in Q1’2017. The NPL coverage increased to 75.2% in Q1’2018 from 65.2% in Q1’2017, due to the relatively faster increase in loan loss provisions. The increase in the non-performing loans has been attributed to major clients in the manufacturing sector, whose activities were affected by the economic slowdown occasioned by the prolonged election period coupled with the drought witnessed in 2017,
- Shareholders’ funds declined by 0.4% to Kshs 46.2 bn in Q1’2018 from Kshs 46.5 bn in Q1’2017.
- Standard Chartered Bank Kenya Limited is currently sufficiently capitalized with a core capital to risk weighted assets ratio of 15.0%, 4.5% above the statutory requirement. In addition, the total capital to risk weighted assets ratio was 17.8%, exceeding the statutory requirement by 3.3%. Adjusting for IFRS 9, the core capital to risk weighted assets stood at 15.5%, while total capital to risk weighted assets came in at 18.3%, indicating that the bank’s total capital relative to its risk-weighted assets declined by 0.5% due to implementation of IFRS 9,
- Standard Chartered Bank currently has a return on average assets of 3.1% and a return on average equity of 19.1%.

Key Take-Outs:

1. The bank experienced a deterioration in asset quality, with gross non-performing loans (NPLs) rising by 15.8% to Kshs 17.8 bn from Kshs 15.4 bn in Q1’2017. This was largely due to major clients in the manufacturing sector. This warranted increased provisioning by 35.8% to Kshs 6.9 bn from Kshs 5.1 bn in Q1’2017 and consequently an increase in the NPL coverage to 75.2% in Q1’2018 from 65.2% in Q1’2017.
2. The bank has continued to invest in technology by use of automated analysis, which has seen it continue lending in unsecured space to households and SMEs segments, despite the loan book declining by analyzing the borrowers’ transactions dating back to 10 years in the process locking out those who do not meet their credit risk threshold. This is expected to aid the bank increase its operational efficiency as well as prudent credit risk assessment, and by extension, provisioning as required by the new IFRS 9 reporting standard.

We expect the bank’s growth to be further driven by:

a. Standard Chartered Bank’s NFI is below the industry average, coming in at 31.8%. vs industry average of 33.6%. We expect NFI growth to be driven by increased adoption of alternative channels with the implementation of their "Digital by Design strategy" which is targeting to migrate over 80% of transactions to alternative non-bank channels by 2020. This will improve operational efficiency as well as increase the bank's transactional income. The bank is poised to see the commission and fee income from their mobile banking platform in the future

b. To address the deteriorating asset quality, the bank has adopted increased measures to improve its asset quality by remaining selective in their asset origination as a way to ensure that they grow their balance sheet in a safe and sustainable manner
c. The continued revenue diversification strategies, which have seen Standard Chartered partner with Sanlam Kenya Limited to distribute General insurance products (mainly Domestic and Motor Private insurance packages) to existing and potential customers under Standard Chartered Insurance Agency Limited (SCIAL).

Below is a summary of the bank's performance:

Balance Sheet Items	Q1'2017	Q1'2018	y/y change	Q1'2018e	Projected y/y change	Variance in Growth Actual vs. Expected
Government Securities	106.1	131.1	23.6%	118.8	12.0%	11.6%
Net loans	116.9	113.8	(2.6%)	131.9	12.8%	(15.4%)
Total Assets	**274.2**	**294.0**	**7.2%**	**300.7**	**9.7%**	**(2.5%)**
Customer Deposits	205.0	232.0	13.2%	229.4	11.9%	1.3%
Total Liabilities	227.8	247.7	8.8%	252.9	11.0%	(2.3%)
Shareholder's Funds	**46.5**	**46.3**	**-0.4%**	**47.8**	**3.0%**	**(3.4%)**

Balance Sheet Ratios	Q1'2017	Q1'2018	y/y change
Loan to deposit ratio	57.0%	49.1%	(7.9%)
Return on Average Equity	18.8%	19.1%	0.3%
Return on Average Assets	3.3%	3.1%	(0.1%)

Income Statement	Q1'2017	Q1'2018	y/y change	Q1'2018e	Projected y/y change	Variance in Growth Actual vs. Expected
Net Interest Income	4.6	4.8	4.5%	5.3	14.0%	(9.4%)
Net non-Interest Income	2.1	2.3	6.5%	2.3	7.9%	(1.4%)
Total Operating income	**6.8**	**7.1**	**5.1%**	**7.6**	**12.0%**	**(6.9%)**
Loan Loss provision	0.8	1.1	37.9%	1.0	25.4%	12.6%
Total Operating expenses	3.8	4.3	15.4%	4.4	16.5%	(1.1%)
Profit before tax	3.0	2.8	(7.7%)	3.2	6.4%	(14.2%)
Profit after tax	**2.1**	**1.8**	**(10.5%)**	**2.2**	**5.9%**	**(16.4%)**
Core EPS	**6.0**	**5.2**	**(12.5%)**	**6.3**	**5.9%**	**(18.4%)**

Income Statement Ratios	Q1'2017	Q1'2018	y/y change
Yield from interest-earning assets	12.1%	11.2%	(0.9%)
Cost of funding	3.3%	3.0%	(0.3%)
Net Interest Spread	8.8%	8.2%	(0.6%)
Net Interest Margin	9.0%	8.4%	(0.6%)
Cost of Risk	11.4%	15.0%	3.6%

Net Interest Income as % of operating income	68.6%	68.2%	(0.4%)
Non-Funded Income as a % of operating income	31.4%	31.8%	0.4%
Cost to Income Ratio	55.6%	61.0%	5.4%

Capital Adequacy Ratios	Q1'2017	Q1'2018
Core Capital/Total Liabilities	17.7%	14.7%
Minimum Statutory ratio	8.0%	8.0%
Excess	**9.7%**	**6.7%**
Core Capital/Total Risk Weighted Assets	17.4%	15.0%
Minimum Statutory ratio	10.5%	10.5%
Excess	**6.9%**	**4.5%**
Total Capital/Total Risk Weighted Assets	20.6%	17.8%
Minimum Statutory ratio	14.5%	14.5%
Excess	**6.1%**	**3.3%**
Liquidity Ratio	65.8%	68.8%
Minimum Statutory ratio	20.0%	20.0%
Excess	**45.8%**	**48.8%**
Adjusted core capital/ total deposit liabilities		15.1%
Adjusted core capital/ total risk weighted assets		15.5%
Adjusted total capital/ total risk weighted assets		18.3%