Standard Chartered Bank Kenya Limited – H1’2018

23rd August, 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 3.6%, from the current price of Kshs 207.0 as of 23rd August, inclusive of a dividend yield of 10.6%,
- Standard Chartered Bank is currently trading at P/TBV of 1.7x and a P/E of 15.9x vs an industry average of 1.7x and 9.2x, respectively.

Key Highlights H1’2018

- 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 increased by 30.3% to Kshs 13.0 from Kshs 10.0 in H1’2017, vs our expectations of 12.6. The improvement in performance was driven by a 9.0% rise in total operating income coupled with a 4.5% decline in total operating expenses,
- Total operating income increased by 9.0% to Kshs 14.7 bn in H1’2018 from Kshs 13.5 bn in H1’2017. Performance was driven by a 7.5% increase in Net Interest Income (NII) to Kshs 9.8 bn from Kshs 9.2 bn in H1’2017, coupled with a 12.2% increase in Non-Funded Income (NFI) to Kshs 4.8 bn from Kshs 4.3 bn in H1’2017,
- Interest income increased by 7.9% to Kshs 13.7 bn from Kshs 12.7 bn in H1’2017 bn, driven by an increase in interest income on government securities that rose by 23.2% to Kshs 6.4 bn in H1’2018 from Kshs 5.2 bn in H1’2017. However, interest income on loans and advances declined by 2.0% to Kshs 6.7 bn from Kshs 6.9 bn in H1’2017. The yield on interest earning assets increased to 11.3% in H1’2018 from 11.2% in H1’2017, due to the relatively faster increase in the interest income by 7.9% compared to the 3.1% rise in interest earning assets to Kshs 241.8 bn from Kshs 234.6 bn in H1’2017,
- Interest expense increased by 8.8% to Kshs 3.9 bn from Kshs 3.6 bn in H1’2017, following an 11.0% increase in the interest expense on customer deposits to Kshs 3.4 bn from Kshs 3.0 bn in H1’2017. Other interest expenses also increased by 11.3% to Kshs 0.51 bn in H1’2018 from Kshs 0.46 bn in H1’2017, while interest expense on bank placements declined by 68.5% to Kshs 0.03 bn from Kshs 0.1 bn. Consequently, the cost of funds increased to 3.6% from 3.5% in H1’2017, while the Net Interest Margin declined to 8.0% from 8.2% in H1’2017,
- Non-Funded Income increased by 12.2% to Kshs 4.8 bn from Kshs 4.3 bn in H1’2017. The growth in NFI was driven by a 35.6% increase in other fees and commissions to Kshs 2.8 bn from Kshs 2.1 bn in H1’2017, and an 11.6% rise in foreign exchange trading income to Kshs 1.4 bn from 1.2 bn in H1’2018. The current revenue mix stands at 67:33 funded to non-funded income as compared to 68:32 in H1’2017. 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 declined by 4.5% to Kshs 8.1 bn from Kshs 8.5 bn in H1’2018, largely driven by a 45.2% decline in loan loss provisions to Kshs 1.3 bn in H1’2018 from Kshs 2.3 bn in H1’2017. However, other operating expenses increased by 27.5% to Kshs 2.6 bn from Kshs 2.1 bn in H1’2017. Staff costs increased marginally by 1.9% to Kshs 3.33 bn from Kshs 3.23 bn in H1’2018,
- The cost to income ratio improved to 55.2% from 63.0% in H1’2017. Without LLP, the cost to income ratio deteriorated to 46.6% from 45.8% in H1’2017,
- Profit before tax increased by 32.0% to Kshs 6.6 bn, down from Kshs 5.0 bn in H1’2017. Profit after tax rose by 30.3% to Kshs 4.5 bn in H1’2018 from Kshs 3.4 bn in H1’2017,

- Standard Chartered Bank declared an interim dividend of Kshs 5.0 per share. We expect a final dividend per share of Kshs 17.0, taking the total dividend for 2018 to Kshs 22.0 per share, translating to a dividend yield of 10.6%.

Balance Sheet

- The balance sheet recorded an expansion as total assets increased by 2.4% to Kshs 296.0 bn from Kshs 289.1 bn in H1'2017. This growth was driven by a 3.5% increase in government securities to Kshs 120.9 bn from Kshs 116.8 bn in H1'2017,
- The loan book declined by 1.1% to Kshs 111.7 bn in H1'2018 from Kshs 113.0 bn in H1'2017,
- Total liabilities rose by 2.4% to Kshs 251.3.7 bn from Kshs 245.5 bn in H1'2017, driven by a 2.8% increase in customer deposits to Kshs 230.8 bn from Kshs 224.5 bn in H1'2017. Deposits per branch increased by 2.8% to Kshs 6.4 bn from Kshs 6.2 bn in H1'2017.
- The growth in deposits coupled with the decline in loans led to a decline in the loan to deposit ratio to 48.4% from 50.4% in H1'2017,
- Gross non-performing loans increased by 9.7% to Kshs 18.5 bn in H1'2018 from Kshs 16.9 bn in H1'2017. As a consequence, the NPL ratio deteriorated to 15.5% in H1'2018 from 13.5% in H1'2017. Loan loss provisions increased by 4.4% to Kshs 7.1 bn from Kshs 6.8 bn in H1'2017. The NPL coverage increased to 75.0 % in H1'2018 from 71.9% in H1'2017, driven by 4.4% increase in loan loss provisions to Kshs 7.1 bn from Kshs 6.8 bn in H1'2017 coupled with a 26.9% rise in interest in suspense to Kshs 6.8 bn from Kshs 5.4 bn in H1'2017.
- Shareholders' funds increased by 2.4% to Kshs 44.6 bn in H1'2018 from Kshs 43.6 bn in H1'2017.
- Standard Chartered Bank Kenya Limited is currently sufficiently capitalized with a core capital to risk weighted assets ratio of 15.8%, 5.3% above the statutory requirement. In addition, the total capital to risk weighted assets ratio was 18.6%, exceeding the statutory requirement by 4.1%. Adjusting for IFRS 9, the core capital to risk weighted assets stood at 16.1%, while total capital to risk weighted assets came in at 19.0%, indicating that the bank's total capital relative to its risk-weighted assets declined by 0.3% due to implementation of IFRS 9,
- Standard Chartered Bank currently has a return on average assets of 2.7% and a return on average equity of 18.0%.

Key Take-Outs:

1. The bank experienced a deterioration in asset quality, with gross non-performing loans (NPLs) rising by 9.7%, to Kshs 18.5 bn from Kshs 16.9 bn in H1'2017. This warranted increased provisioning by 4.4% to Kshs 7.1 bn from Kshs 6.8 bn in H1'2017 and consequently an increase in the NPL coverage to 75.0% in H1'2018 from 71.9% in H1'2017.
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 continue aiding 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. Growth in NFI which increased by 12.2% in H1'2018. We expect the growth in NFI 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, and

b. Better loan underwriting to improve non-performing loans; as the bank's NPL ratio is currently at 15.5% compared to tier 1 average of 11.6%,

Below is a summary of the bank's performance:

Balance Sheet Items	H1'2017	H1'2018	y/y change	H1'2018e	Projected y/y change	Variance in Growth Actual vs. Expected
Government Securities	116.8	120.9	3.5%	116.4	-0.3%	3.9%
Net loans	113.0	111.7	(1.1%)	113.6	0.5%	(1.6%)
Total Assets	**289.1**	**296.0**	**2.4%**	**300.7**	**4.0%**	**(1.7%)**
Customer Deposits	224.5	230.8	2.8%	236.6	5.4%	(2.6%)
Total Liabilities	245.5	251.3	2.4%	252.1	2.7%	(0.3%)
Shareholder's Funds	**43.6**	**44.6**	**2.4%**	**48.6**	**11.6%**	**(9.2%)**

Balance Sheet Ratios	H1'2017	H1'2018	y/y change
Loan to deposit ratio	50.4%	48.4%	(1.9%)
Return on Average Equity	16.6%	18.0%	1.4%
Return on Average Assets	2.7%	2.7%	0.1%

Income Statement	H1'2017	H1'2018	y/y change	H1'2018e	Projected y/y change	Variance in Growth Actual vs. Expected
Net Interest Income	9.2	9.8	7.5%	9.7	5.5%	2.0%
Net non-Interest Income	4.3	4.8	12.2%	4.6	7.2%	5.0%
Total Operating income	**13.5**	**14.7**	**9.0%**	**14.3**	**6.0%**	**3.0%**
Loan Loss provision	2.3	1.3	(45.2%)	1.2	(48.1%)	2.9%
Total Operating expenses	8.5	8.1	(4.5%)	7.8	(7.7%)	3.2%
Profit before tax	5.0	6.6	32.0%	6.4	28.3%	3.7%
Profit after tax	**3.4**	**4.5**	**30.3%**	**4.3**	**26.7%**	**3.7%**
Core EPS	**10.0**	**13.0**	**30.3%**	**12.6**	**26.7%**	**3.7%**

Income Statement Ratios	H1'2017	H1'2018	y/y change
Yield from interest-earning assets	11.2%	11.3%	0.1%
Cost of funding	3.2%	3.5%	0.3%
Net Interest Spread	7.9%	7.8%	(0.2%)
Net Interest Margin	8.2%	8.0%	(0.2%)
Cost of Risk	17.2%	8.6%	(8.5%)
Net Interest Income as % of operating income	68.1%	67.1%	(0.9%)
Non-Funded Income as a % of operating income	31.9%	32.9%	0.9%
Cost to Income Ratio	63.0%	55.2%	(7.8%)

Capital Adequacy Ratios	H1'2017	H1'2018
Core Capital/Total Liabilities	15.7%	15.1%
Minimum Statutory ratio	8.0%	8.0%

Excess	**7.7%**	**7.1%**
Core Capital/Total Risk Weighted Assets	16.7%	15.8%
Minimum Statutory ratio	10.5%	10.5%
Excess	**6.2%**	**5.3%**
Total Capital/Total Risk Weighted Assets	20.1%	18.6%
Minimum Statutory ratio	14.5%	14.5%
Excess	**5.6%**	**4.1%**
Liquidity Ratio	69.1%	71.3%
Minimum Statutory ratio	20.0%	20.0%
Excess	**49.1%**	**51.3%**
Adjusted core capital/ total deposit liabilities		15.3%
Adjusted core capital/ total risk weighted assets		16.1%
Adjusted total capital/ total risk weighted liabilities		19.0%