EXOTIX PARTNERS
In collaboration with EQUITY Investment Bank

# KENYA BANKS UPDATE

15 January 2016

**Recommendation: BUY**

## Place your orders for a perfect "Banks Dawa"

- In this note we update our earnings forecasts and investment recommendations for our Kenya banks' universe of CFC Stanbic, Co-op Bank, Diamond Trust Bank, Equity Group, KCB and NIC Bank.
- Dawa is a popular Kenyan cocktail comprised of vodka, lime juice and honey. **We think the Kenyan banks may provide a perfect "Dawa" as they offer a relatively clear and resilient earnings outlook on the back of stable macro.**
- After years of scepticism **this note is not a dramatic shift to "the dark-side" in our view on Kenyan banks,** but rather a pragmatic assessment of the value proposition. Since the end of the Moi-era (12 years ago), Kenyan banks have recorded a gravity-defying average loan growth rate of 18.6% per annum. Despite the super-normal growth, banks' asset quality ratios have improved consistently and in the past few years have remained robust in the face of some very significant economic challenges (post-election chaos in 2008, severe drought and massive interest rate spike in 2011, among others). We think generous interpretation of IFRS accounting rules, inter alia, may be understating the true scale of the underlying asset quality issues. However, these issues are unlikely to come to the fore unless there is a dramatic change in the regulatory environment (eg Nigeria in 2008). While one cannot ignore this possibility (especially since there is a new governor at the Central Bank), we think it is a low probability event.
- Therefore, taking a pragmatic view, **we think the Kenyan banks represent a perfect top-down cocktail of strong macro, improving profitability and multi-year-low valuations.**
- **On the macro front, we believe that Kenya will be a visible out-performer in 2016, growing at 5.5% compared to SSA average under 4.0%.** After a difficult year in 2015, when the country seemed to lurch from one small crisis to the next, the conditions are now coming together for a return of confidence. The interest rates cycle is at a peak (in our view); the shilling has been stabilised; inter-bank rates are normalising; and lower oil prices will keep easing pressure on the external accounts. Moreover, Kenya is one of the few economies in Africa whose growth model does not (and has not) relied on an improving terms of trade and/or an unsustainable rise in government leverage, recycled into public sector wages.
- **Turnaround in profitability and accelerating earnings.** We forecast the Kenyan banks to sustain their trend of declining profitability and earnings growth in FY15, with the former declining by 210bp to an average of 21.0% and the latter decelerating to 9.8% from 13.5% the year before. We forecast these trends to reverse sharply in FY16 on the back of expanding margins. As in the past, we expect banks' net-of-risk interest margins to expand in a higher interest rate environment – we estimate the increase in asset yields will more than offset the higher funding costs and risk charge. We also expect loan growth to moderate but still remain robust at 14.2% per annum given the strong aforementioned macroeconomic fundamentals, therefore translating into strong top- and bottom-line growth.
- **Multi-year low valuations.** Due to poor performance in 2015, our bank universe is trading at FY16f P/BVPS of 1.2x, 50% below its historical average of 1.8x. We believe the sector is undervalued at this valuation given that our average ROE forecast of 22.5% is not significantly lower than the historical average of 23.4%.
- **Our top picks: KCB, Co-op and DTB.** KCB (BUY, TP KES72.7, ETR 82.8%) is our top pick given its bellwether status for the sector and its consistent profitability profile. We also like Co-op (BUY, TP KES26.7, ETR 60.4%) given its turnaround story and DTB (BUY, TP KES295.9, ETR 59.7%) given its consistently high quality of assets and diversified earnings base. We also upgrade NIC to BUY (TP KES72.4, ETR 71.4% and CFC Stanbic to HOLD (TP KES81.4, ETR 6.2%).
- We continue to have **no recommendation on EQUITY Bank** due to our joint venture with the group. We do, however, present our updated earnings estimates.


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# Investment summary table

**Table 1: Kenya banks' investment summary table**

| | Price (KES) | Rec. | Target price (KES) | Dividend yield (%) | ETR (%) | FY16f EPS (KES) | FY16f NAV (KES) | FY16f P/BVPS | FY16f P/EPS |
|---|---|---|---|---|---|---|---|---|---|
| **CFC Stanbic** | 80 | HOLD | 81.4 | 4.4 | 6.2 | 13.6 | 107.28 | 1.0 | 5.9 |
| **Co-op** | 17.1 | BUY | 26.7 | 4.1 | 60.4 | 2.9 | 12.79 | 1.3 | 8.8 |
| **Diamond Trust** | 187 | BUY | 295.9 | 1.5 | 59.7 | 36.0 | 176.08 | 1.1 | 5.2 |
| **Equity** | 39.25 | N/R | - | 5.0 | - | 6.7 | 25.43 | 1.5 | 8.5 |
| **KCB** | 41 | BUY | 72.7 | 5.4 | 82.8 | 8.6 | 34.23 | 1.2 | 7.4 |
| **NIC** | 43 | BUY | 72.4 | 2.9 | 71.4 | 8.6 | 46.76 | 0.9 | 5.0 |
| **Average** | | | | **3.9** | **56.1** | | | **1.2** | **6.8** |

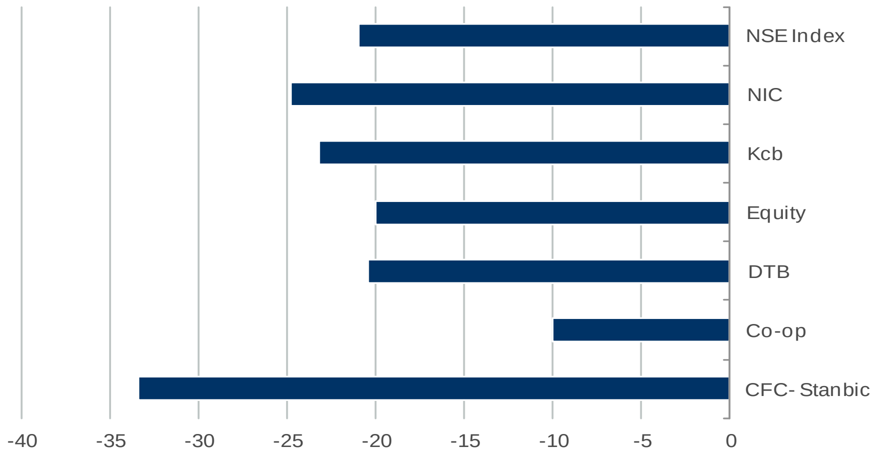
*Source: Bloomberg, Banks annual reports, Exotix estimates*

# Investment theme

## 2015, a year to forget for Kenyan banks (and the Kenyan stock market in general)

Like the wider Kenyan stock market, our Kenyan banks universe recorded poor share price performance in 2015, down an average of 22.0% (in local currency terms).

**Figure 1: Kenya banks' share price performance (%)**




*Source: Bloomberg, Exotix estimates*

The sell off can be attributed to a number of factors. Firstly, we think the banks were "priced to perfection" at the beginning of 2015; the banks were trading at a forward P/BVPS of 2.1x, which implied an estimated ROE of 26.5% (based on our terminal growth rate of 8% and cost of equity 16.5%) compared to banks' FY14 and three-year average of 23.1% and 25.1%, respectively. Thus the poor performance could be attributed partly to below-consensus earnings estimates (see table below).

**Table 2: Kenya banks' consensus vs 9M15 earnings and profitability**

| | Consensus EPS (KES) | Annualised 9M15 EPS (KES) | Var (%) | Consensus ROE (KES) | Annualised 9M15 ROE (KES) | Var (bp) |
|---|---|---|---|---|---|---|
| **CFC Stanbic** | 11.0 | 9.3 | -15.6% | 15.1 | 13.7 | (136.7) |
| **Co-op** | 2.3 | 2.3 | 2.3% | 23.6 | 24.8 | 120.0 |
| **DTB** | 26.8 | 23.3 | -12.9% | 20.7 | 18.4 | (230.0) |
| **KCB** | 6.8 | 6.1 | -10.4% | 23.6 | 23.3 | (30.0) |
| **Equity bank** | 4.7 | 4.6 | -1.9% | 25.7 | 25.1 | (64.4) |
| **NIC** | 7.8 | 7.5 | -3.9% | 19.1 | 20.8 | (170.0) |
| **Average** | | | **-7.1%** | | | **(28.5)** |

*Source: Banks annual report, Exotix estimates*

As observed above, we do not think the primary driver of the underperformance was below par earnings expectations, as the difference in profitability was moderate (especially amongst the Tier 1 banks). Moreover, a similar drop in the NSE Index indicates a market wide problem.

We think the bigger issue for the banks (and Kenyan stocks in particular) was a series of macro concerns which resulted in a significant negative shift in investor sentiment. The year began with concerns about a drought and ended with worries about flooding (weather always has a big impact on the macro as agriculture contributes almost 25% of GDP). In between, investors were besieged by a depreciating currency (although the KES still remained one the best performing free floating exchange rates in the frontier and emerging market universe), a pickup in inflation (although it remained within the Central Bank's target range), a significant and volatile interest rate environment (interest rate levels ended the year at similar levels to those at the beginning of the year), increased awareness of "teething issues" under the new constitution, a series of profit warnings from listed companies (mainly from small caps), two-mid tier banks being placed under statutory management and lastly, an uncertain regulatory environment under a new CBK governor.

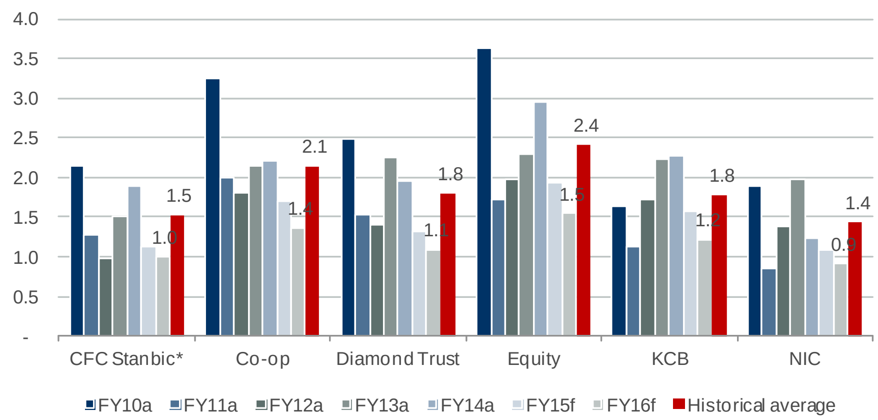
All these events took place under an increasingly negative global macro-environment due to expectations of a Fed Rate hike, slowdown in China, prolonged Eurozone crisis, significant decline in commodity prices and increasing geopolitical risks.

Therefore, despite continued strong macro (9M15 GDP growth of 5.8%) and resilient earnings announcements (annualised 9M15 ROE of 21.0%) the banks' share prices declined by 22.0% on average, underperforming the 18.6% and 16.9% drop in the MSCI frontier and MCSI Emerging market indices respectively.

That is the bad news!

The good news is that the Kenyan banks are now trading multi-year low valuations:

**Figure 2: Kenya banks' P/BVPS**

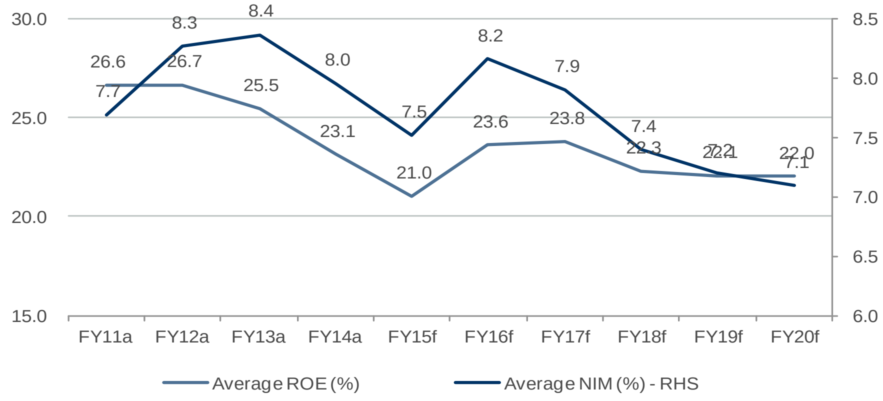



*Source: Banks annual report, Exotix estimates*

The average FY16 P/BVPS of 1.2x is 50% lower than its historical average of 1.8x.

From a profitability perspective, our medium-term profitability forecasts are little changed with estimated FY19 average ROE of 22.1% (vs our previous average of 22.4%). However, we increase our FY16 and FY17 average ROE estimates to 23.6% and 23.8% from our previous estimates of 22.8% and 22.5%, respectively. We believe the short-term profitability improvement will be driven by expanding margins as banks' asset yields increase by more than their funding costs in a higher interest rate environment; after three years of persistent decline, we forecast banks average net interest margin to increase by 70bp yoy to 8.2% in FY16. Naturally, higher interest rates should lead to a higher risk cost. However, as in the past we expect the increase will be moderate (we estimate cost of risk to increase by 40bp to 1.3%), thus resulting in higher net-of-risk margins.

**Figure 3: Kenya banks' NIM vs ROE estimates (%)**




*Source: Banks annual reports, Exotix, estimates*

Based on our five-year average ROE estimate, risk-free rate and terminal growth rate of 22.8%, 16.5% and 8% respectively, we estimate a justified P/BVPS for our Kenyan banks universe of 1.74x, further validating our bullish stance on the sector.

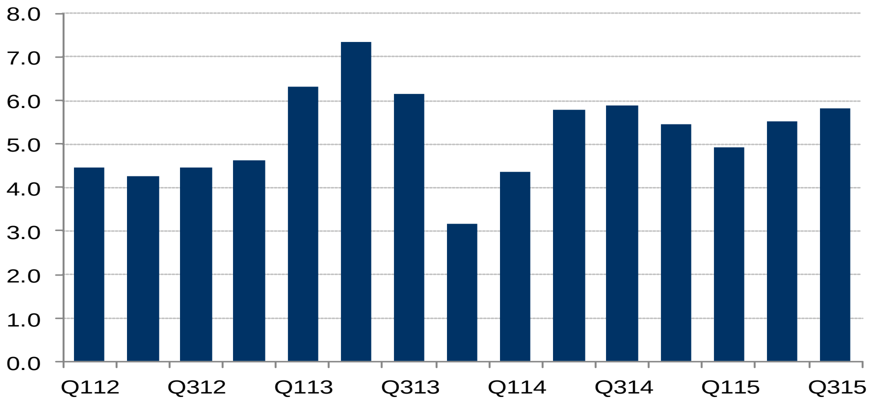
In the following sections, we discuss in greater detail our top-down view on the Kenyan banks.

## Kenya macro: a regional outperformer

From a fundamental perspective, we continue to believe that Kenya is one of the stronger economies in Africa. In contrast to the commodity-producing nations elsewhere on the continent, growth in Kenya is driven by investment more than consumption or net exports. In a world where commodity prices are expected to remain low, and government spending is coming under greater scrutiny from investors, we think that investment-led models such as Kenya's are the most likely to continue delivering high rates of growth.

On that note, recently-released data for Q3 2015 show that the economy is still expanding well above the Sub-Saharan African average of 3.8% (according to the IMF), growing at 5.8% yoy in the quarter and an average of 5.4% over the year. From a sectoral perspective, the four "pillars" of the economy – agriculture, manufacturing, trade, and transport – each put in a decent performance, growing at 7.1%, 2.8%, 6.5% and 8.7% respectively. Interestingly, these results were achieved against the backdrop of fairly volatile market conditions: the NSE 20 fell 15% in Q3; the shilling sold off by over 7%; and inter-bank rates spiked to over 25%.

**Figure 4: Real GDP growth, % yoy**




*Source: KNBS*

Looking to the year ahead, we think that market conditions – which matter more to banks than to the wider economy – are likely to be calmer than in 2015. The gyrations in inter-bank rates, caused by insufficient coordination between the CBK and the National Treasury, are unlikely to be repeated in 2016, in our view. Critically, the Treasury was able to take some pressure off the domestic issuance schedule by raising a US$750mn syndicated loan in Q4 2015, and is looking at other similar financing options for the year ahead. Although there are large domestic debt redemptions in H1 2016, the key to avoiding interest rate volatility is coordinated forward planning by the CBK and Treasury – of which we have seen concrete evidence in the past several months.

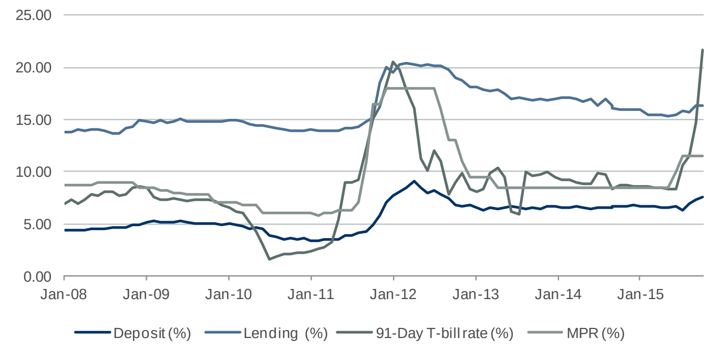
Elsewhere on the market front, we expect 2016 to be a year of greater FX rate stability. Our interpretation of the sharp sell-off in 2015 is that it was more a market phenomenon than a fundamental one. Specifically, banks and households built up large long US$ positions (to the tune of over US$1bn), on the expectation of further KES weakness. Thanks to a combination of outright restrictions (banks' open positions were capped at 10% of paid-up capital) and moral suasion (we understand the CBK told them to de-dollarise), this process has now begun to move in reverse, resulting in FX rate stability and modestly rising reserves. With this in mind, we expect the shilling to remain in the KES102-103 range over the next several months, and to resume its gentle depreciation thereafter.

# Kenya banks: turnaround in prospect

## Increasing interest rates should reverse margin contraction

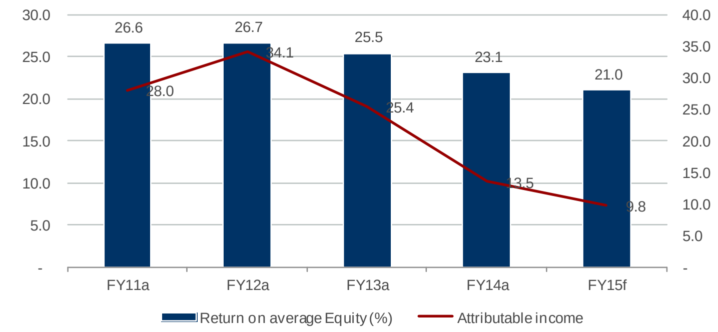
The earnings growth momentum and profitability of Kenyan banks have been declining gradually over the past four years; we forecast average net interest income growth of 9.8% in FY15 (down from 28.0% in FY11) and average ROE of 21.0% (down from 26.6% in FY11). We attribute the slowdown primarily to a drop in margins due to declining asset yields (on the back of a low interest rate environment) and increasing funding costs (due to increasing competition from Tier 2 banks).

**Figure 5: Kenya key interest rates**




*Source: Central Bank of Kenya, Exotix estimates*

**Figure 6: Banks' average earnings growth and ROE (%)**

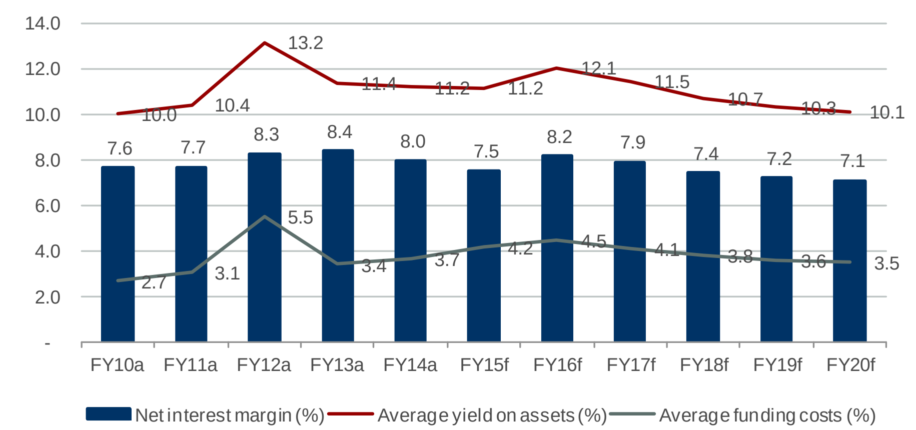



*Source: Banks annual reports, Exotix estimates*

As illustrated in figure 1, all key interest rates increased significantly at the beginning of 3Q15 driven by a number of factors discussed earlier. Although the key money markets moderated towards the end of the year, our discussions with banks indicate that lending rates were on average 100-300bp higher than the beginning of the year. As in previous interest rate cycles, we believe banks' lending rates will be stickier during a declining interest rate environment and we therefore forecast the average asset yield for banks within our universe to increase by 90bp yoy in FY16 to 12.1%.

As in the past, we expect the increase in funding costs for banks in our universe will be more moderate due to their superior deposit-taking franchises as a result of a wider branch network and more recently due to their investments in agency and mobile banking. We also think banks funding costs will be lowered from a "flight to quality" of deposits following the collapse of two mid-tier banks (Imperial and Dubai) in 2015. We therefore forecast banks' average funding costs to increase by a moderate 30bp yoy in FY16 to 4.3%.

**Figure 7: Kenya banks' average NIM**

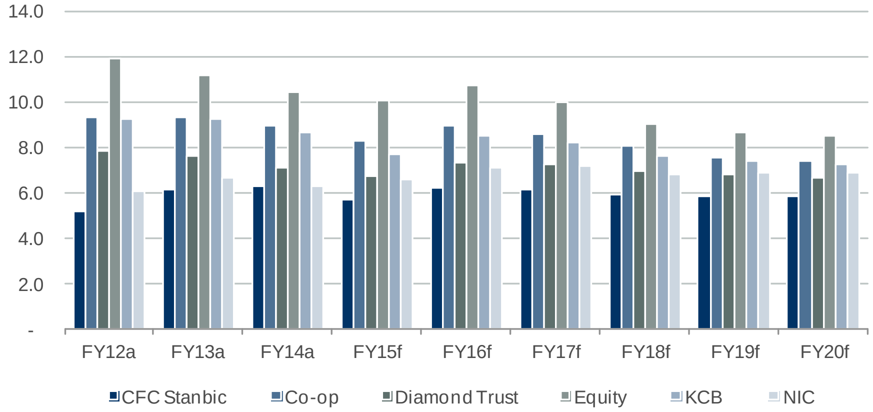



*Source: Banks annual reports, Exotix estimates*

Based on our assumptions, we estimate the average NIM could increase by 70bp yoy in FY16. We would like to point out that we think the increase in margins is temporary and we believe margins will sustain their medium-term downward trajectory due to: 1) increasing penetration rates (we estimate the deposits-to-GDP ratio will increase to 48% by FY20 from 43.5% in FY14) and subsequent increase in competition within the sector; and 2) a decline in the long-term average inflation rate and reduced volatility (relative to historical levels) should reduce long-term average interest rates in the economy and thus result in lower margins. Despite the decline, we estimate banks' margins will still remain relatively healthy at 7.1% at the end of our forecast period.

Within the banks, we estimate the bigger Tier 1 banks will continue to sustain higher margins due to higher yielding retail loans and stronger low-cost retail deposit penetration (by virtue of a larger branch network and higher investment in mobile and agency banking); we forecast Co-op, Equity and KCB will sustain an average NIM of 8.4% vs 6.7% for CFC Stanbic, Diamond Trust and NIC.

**Figure 8: Kenya banks' NIM breakdown**




*Source: Bank annual report, Exotix estimates*

## Balance sheet growth momentum should moderate (from historical levels), but remain relatively strong

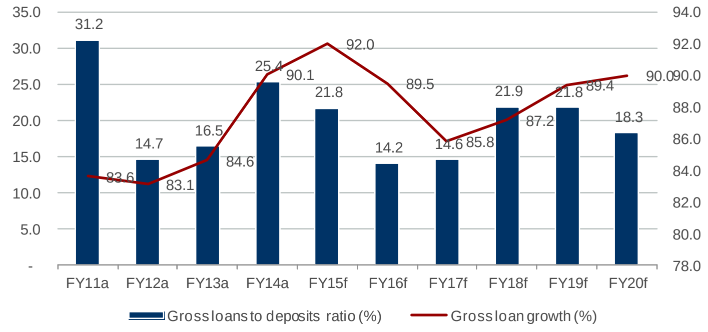
Despite the macro and interest rate volatility, loan growth for the entire sector has increased at a cumulative rate of 17.8% per annum over the past 10 years, driven primarily by increasing penetration within the consumer and SME sector. 9M15 date released by the Central Bank indicates the growth momentum was sustained with gross loans increasing by 21.5% yoy during the period. Within our universe, we forecast average loan growth of 21.8% in FY15.

We believe loan growth will moderate in FY16 given the aforementioned increase in lending rates. We note that after the 2011 interest rate hike, average loan growth for the sector declined to 11.7% in 2012 from 35.9% in 2011. Within our universe, growth decelerated to 14.7% in 2012 from 31.2% in the previous year.

We believe the decline in growth momentum is unlikely to be as significant this time because: 1) the pace and magnitude of increase in monetary policy rate is more moderate (in 2011 the MPR increased by 1225bp over a 10-month period vs +300bp in 2015); 2) GDP growth is expected to remain at c5% (above the SSA average); 3) the government continues to sustain its intensive capex programme which creates value-chain lending opportunity for the banks; and 4) continued strong regional growth is likely to boost growth for banks with strong regional operations (especially Equity Bank which expanded into Democratic Republic of Congo last year and is starting to report impressive growth figures from its other regional subsidiaries).

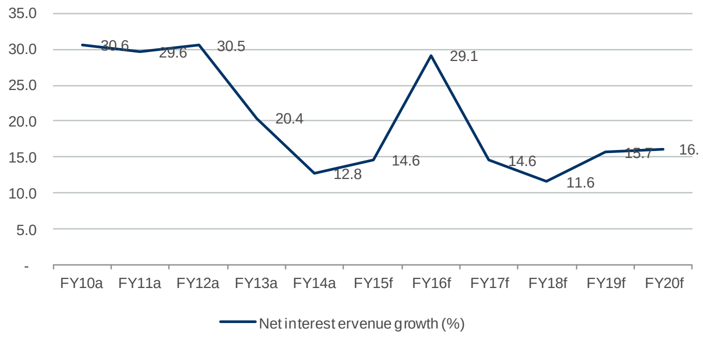
We therefore assume loan growth will decline, but still grow at an impressive 14.2% yoy in FY16, while total asset growth will decline to 16.6% (from FY15f of 20.4%). Given the presidential elections scheduled for 2017, we believe banks will become more risk averse and thus loan growth is likely to remain below trend at 14.6%. Assuming a peaceful outcome, we expect loan growth to pick up thereafter and thus estimate average growth of 20.7% per annum between FY18 and FY20.

**Figure 9: Banks' loan growth assumptions**




*Source: Banks annual reports, Exotix estimates*

**Figure 10: Banks' net interest income growth estimates**



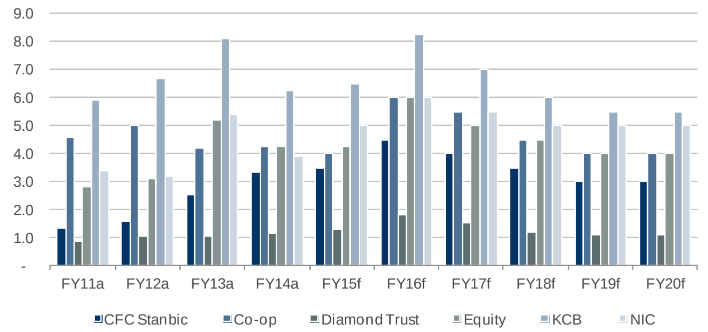

*Source: Banks annual reports, Exotix estimates*

Based on our loan growth and margin expansion assumptions, we estimate banks' net interest income growth – after steadily declining over the past three years – will accelerate to 29.1% in FY16.

## Asset quality to deteriorate but from a low base

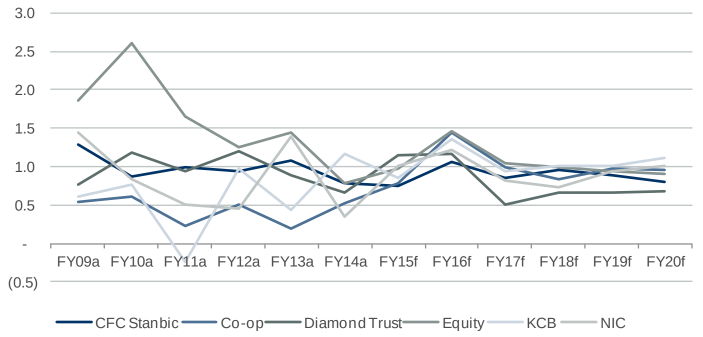
We expect banks' asset quality to come under pressure given the environment of increasing interest rates. However, given the strong macroeconomic outlook and relatively good asset quality (sector-wide gross NPL ratio of 5.7%), we expect banks' cost of risk to remain moderate even after factoring in a deterioration. Within our universe, we assume the average NPL ratio will increase from an estimated 4.1% in FY15 to 5.4% in FY16. As in the past, we believe banks provisioning for these additional bad debts will be gradual and therefore assume the NPL cover will drop to 51% from 55% in FY15, translating into a 40bp increase in risk charge to 1.1%.

**Figure 11: Kenya banks' NPL ratio assumptions (%)**




*Source: Banks annual reports, Exotix estimates*

**Figure 12: Kenya banks' cost of risk assumptions (%)**




*Source: Banks annual reports, Exotix estimates*

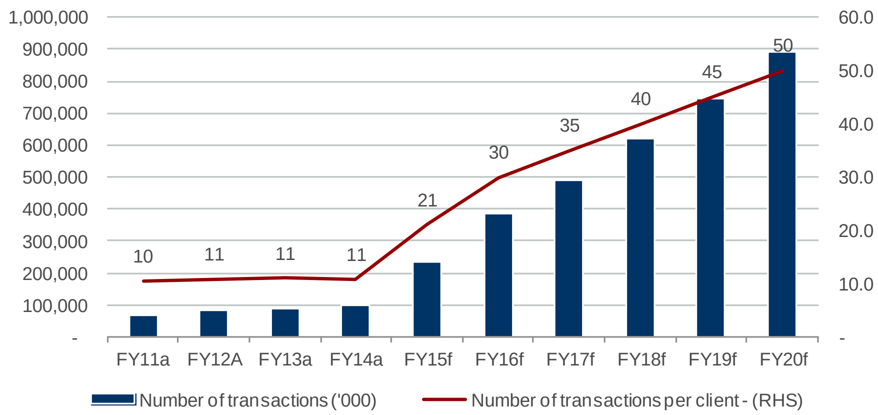
We note that in the past the Kenyan banks have had the flexibility to restructure distressed loans and thus mitigate significant crystallisation of bad debts. For instance in 2012, despite a substantial increase in interest rates in 2011, the sector wide NPL ratio increased by only 20bp to 4.6% and the cost of risk increased by only 10bp to 1.0%. Within our banks universe, the average NPL ratio increased by a modest 30bp and cost of risk actually declined by 10bp to 0.9%. It would be interesting to see if banks are allowed to continued restructuring their loans under the new regulatory regime (a new governor was appointed at the Central bank in June 2015), especially after the collapse of two Tier 2 banks last year. The continued ability to restructure distressed loans would therefore be an upside risk to our estimates.

## Continued strong non-interest revenue should support strong top-line growth

With the exception of CFC Stanbic (whose NIR declined because of a decline in its South Sudan operations) and KCB (whose NIR is increasing off a high 2014 base) we forecast strong double-digit NIR growth for the rest of the banks (average of 19.4% yoy) driven by a combination of new products and increased volumes as banks' alternative banking channels continue to gain traction.

Although detailed sector-wide information on transaction volume is unavailable, zooming in on the figures released by Equity Bank (which admittedly is ahead of the sector in terms of adopting and implementing alternative banking channels) indicates that banks could sustain fairly strong medium-term volume growth from this channel: data released by the bank indicates their transaction volumes could potentially double in FY15 driven by continued strong growth in Agency banking volumes (we estimate 22% volume growth from this channel) and Mobile banking volumes could potentially contribute more than half the total transaction volumes (in the first full year of Equitel's operations). Although the bank does not disclose transaction volumes by type, we believe a significant proportion of the higher volumes are low value transactions (such as account statement balance, etc) and this reduces the bank's average revenue per transaction. Nonetheless, we think the impact from the higher volumes more than offsets the decline in transaction value and is thus value accretive. We estimate transaction volumes will quadruple over the next five years as customers become more comfortable using alternative channels and the bank continues to roll out new products. Based on our transaction volume and revenue per transaction assumptions, we estimate Equity's fees and commission income will increase at a cumulative rate of 20% per annum over the next five years.

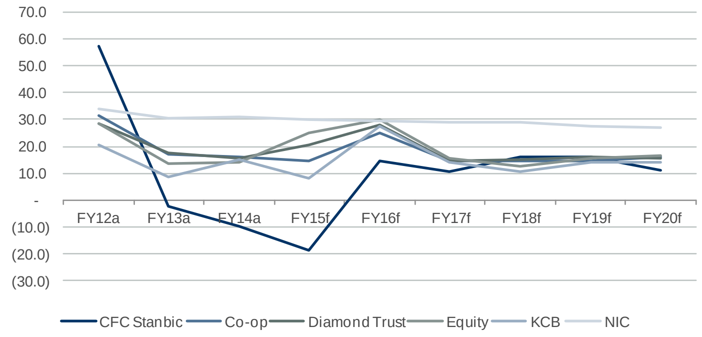
**Figure 13: Equity Bank transaction volume assumptions**




*Source: Bank annual reports, Exotix estimates*

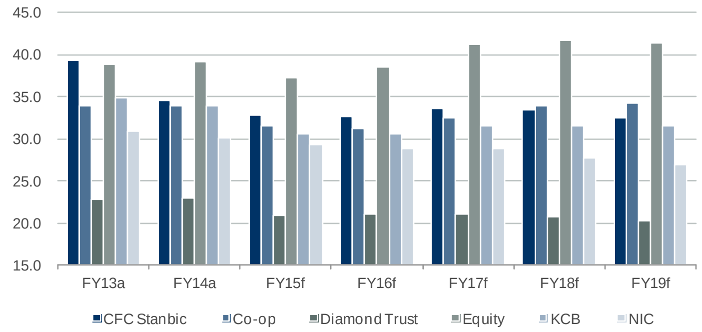
Although detailed information on transaction volumes is unavailable, we believe other Kenyan banks will record similar growth in non-interest revenue as they build up their own agency and mobile banking platforms and introduce more products. Indeed both Co-op and KCB have invested significantly in building their agency network and all the other banks in our universe have partnered with telcos (primarily Safricom) to provide some form of mobile banking. We therefore estimate NIR to increase on average by 15.7% per annum throughout our forecast period.

**Figure 14: Banks' NIR growth estimates (%)**




*Source: Banks annual reports, Exotix estimates*

**Figure 15: Banks' NIR to total revenue estimates**




*Source: Banks annual reports, Exotix estimates*

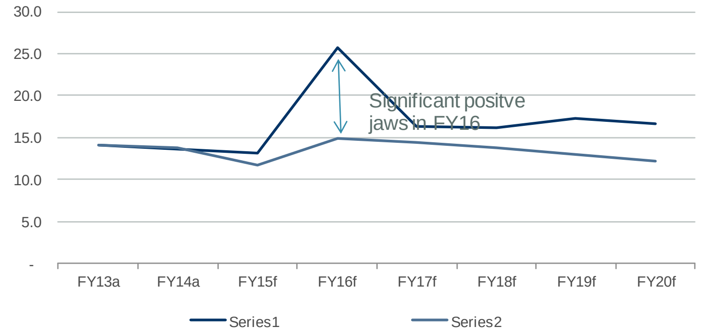
Despite our strong NIR growth assumptions, we estimate the NIR to total revenue ratio will decline to 30.4% in FY16 from an estimated 32.4% in FY15, as we estimate the contribution from net interest income will increase due to potential margin expansion and continued strong asset growth.

## Operating efficiency should benefit from strong positive jaws

The opex intensity of banks has gradually declined over the past three years as banks have adopted cheaper alternative banking channels to continue increasing their penetration rates; the average operating expenses growth has declined from 19.2% in FY12 to an estimated 11.8% in FY15. Despite the cost growth moderation, the improvement in cost-to-income ratio (CIR) has been minimal (FY15f of 50% vs 51.5% in FY12) due to margin contraction and subsequent moderation in top-line growth.

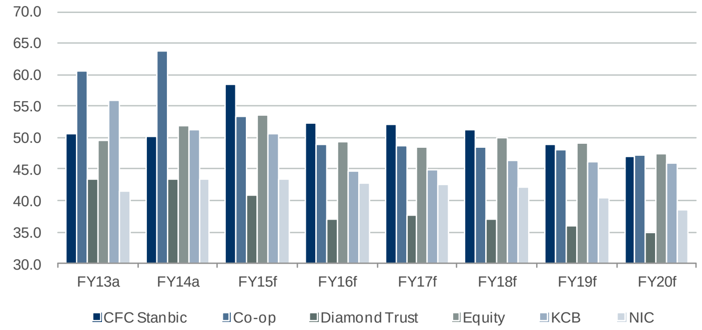
We estimate banks' CIRs could drop significantly in FY16 as operating expenses continue to increase at a moderate pace and, as discussed previously, margin expansion and healthy balance sheet growth translates to very strong top-line growth. We estimate the positive jaws (the difference between average operating revenue growth and average operating expense growth) could be as high as 14.4ppt vs an average of 0.4ppt over the past three years, resulting in CIR dropping to 45.9%. We estimate the magnitude of the positive jaws will decline thereafter (we estimate an average of 3.3ppt through the rest of the forecast period) resulting in a modest improvement in CIR by the end of our forecast period (FY20f of 43.5%).

**Figure 16: Banks' average income and expense growth (%)**




*Source: Banks annual reports, Exotix estimates*

**Figure 1: Banks' CIR estimates**




*Source: Banks annual reports, Exotix estimates*

# INDIVIDUAL BANKS' SECTION

# CFC Stanbic: earnings growth to resume (from a low base)

| | |
|---|---|
| Price | 80.0 |
| Target price | **81.42** |
| Expected share price return | 1.8% |
| Expected dividend yield | 4.4% |
| **Expected total return** | **6.2%** |
| Market cap (mn) | 32,219 |
| Market cap (US$mn) | 315 |
| Avg. daily volume (US$k) | 186 |

- **We upgrade our recommendation on the stock to HOLD (**from BUY) based on a target price of KES81.4 (previously KES82.2), giving an ETR of 6.2% at the current market price of KES80.0. Our target price is 0.8x forward FY16f BVPS of KES107.3 and 6.0x forward EPS.
- **9M15 earnings review:** attributable earnings for the bank (which contributes more than 90% of the listed Group Holding Company) declined by 33.6% yoy to KES2.8bn due primarily to a 22%yoy drop in non-interest revenue. We attribute the drop in NIR to a decline in their South Sudan business due to continued political disruption in the country.
- **New vs old:** following the lower than expected 9M15 earnings, we reduce our FY15, FY16 and FY19 estimates by 22.2%, 12.5% and 13.6% respectively. Nevertheless, we still forecast the bank's earnings to grow at 36.2% yoy in FY16 (and at a cumulative rate of 21.3% over the next five years). We attribute the potential turnaround in earnings growth to 1) low base effect of FY15, 2) normalisation of South Sudan subsidiary whose contribution to the group should be less than 10% after the steep drop in FY15, and 3) strong loan growth recorded by the bank in 9M15 (up 33.9% yoy) which should translate to strong top-line growth in FY16.
- **Investment recommendation explained:** based on our assumptions, we estimate an average ROE of 14.8% throughout our forecast period vs an average of 23.6% for the other Kenyan banks and our cost of equity estimate of 16.5%. Even after excluding intangibles (as the bank has significantly more intangibles than other Kenyan banks), the bank's average tangible ROE of 18.5% remains significantly lower than the sector average. We attribute the bank's below average profitability to its strategy of focusing on corporate and investment banking and "high-end" personal and retail banking resulting in almost 50% of its loan book being US$ denominated and therefore lower yielding. Since the merger with CFC Bank in 2008, the bank's profitability has managed to exceed its cost of capital only twice (FY13 and FY14), and that was driven by strong performance in its South Sudan subsidiary. With a short-term recovery in South Sudan seeming unlikely, we believe the bank's profitability will continue to remain below its cost of capital and thus a below book value and sector average valuation is justified.

**Table 3: CFC Stanbic investment summary table**

| Year to 31 Dec | 2013 | 2014 | 2015f | 2016f | 2017f |
|---|---|---|---|---|---|
| Net Income (mn) | 5,127 | 5,687 | 3,950 | 5,380 | 6,191 |
| EPS | 12.97 | 14.38 | 9.99 | 13.61 | 15.66 |
| EPS (Old) | 12.97 | 14.38 | 20.15 | 22.89 | 23.89 |
| P/E (x) | 3.2 | 6.0 | 8.2 | 6.0 | 5.2 |
| P/TBVPS (x) | 1.5 | 1.9 | 1.1 | 1.0 | 0.9 |
| DPS | 2.15 | 6.15 | 3.50 | 4.50 | 5.50 |
| Dividend yield (%) | 5.1% | 4.7% | 4.4% | 5.5% | 6.7% |
| TROE (%) | 26.2% | 23.0% | 14.2% | 17.6% | 17.8% |
| ROA (%) | 3.2% | 3.1% | 2.0% | 2.4% | 2.5% |

*Source: Company reports and Exotix estimates*

## CFC Stanbic profit model

In the table below, we provide a summary of CFC Stanbic's profit model. Based on the analysis provided below, we forecast ROE to decline to 10.5% in FY15 before gradually increasing to 16.9% by the end of our forecast period.

**Table 4: CFC Stanbic profit model**

| (%) | FY13 | FY14 | FY15f | FY16f | FY17f | FY18f | FY19f | FY20f |
|---|---|---|---|---|---|---|---|---|
| Net interest income/ average assets [1] | 5.5 | 5.7 | 5.2 | 5.7 | 5.7 | 5.5 | 5.5 | 5.5 |
| Non-interest income/ average assets [2] | 4.6 | 3.7 | 2.7 | 2.8 | 2.7 | 2.8 | 2.8 | 2.7 |
| Operating expenses/ average assets [3] | (5.1) | (4.7) | (4.6) | (4.4) | (4.4) | (4.2) | (4.0) | (3.9) |
| Net provisioning/ average assets [4] | (0.5) | (0.4) | (0.4) | (0.6) | (0.5) | (0.6) | (0.5) | (0.5) |
| Tax/average assets [5] | (1.3) | (1.1) | (0.9) | (1.0) | (1.1) | (1.0) | (1.1) | (1.2) |
| **ROA = [1+2+3+4+5]** | **3.2** | **3.1** | **2.0** | **2.4** | **2.5** | **2.4** | **2.6** | **2.7** |
| Average assets / average equity [6] | 5.4 | 5.2 | 5.2 | 5.5 | 5.6 | 5.8 | 6.1 | 6.2 |
| **ROE = [ROA * 6]** | **17.2** | **16.4** | **10.5** | **13.3** | **13.9** | **14.1** | **15.7** | **16.9** |

*Source: Company annual reports, Exotix estimates*

**We note that the bank includes income from its available-for-sale investment securities as part of its non-interest income. In FY13 and FY14 we have adjusted the bank's net interest income by including the interest income from investment securities.*

We make the following observations regarding the above:

- **Non-interest revenue yield likely to remain depressed:** we forecast the bank's non-interest revenue yield to drop to 2.7% in FY15 from 3.7% due primarily to a drop in transaction income from its South Sudan subsidiary because of a drop in oil prices as well as continued geopolitical disruptions. We believe a recovery in NIR yield is unlikely in short term due to the continued political disruptions in South Sudan. A medium-term recovery in the NIR yield is also unlikely to materialise if the group follows through with its intention to spin-off the South Sudan business to its parent company (Standard Bank Group) and sustains its strategy in Kenya of focusing on Corporate and Investment Banking and "high-end" personal and retail banking.
- **Below sector average NIM dictated by business model**: like its NIR yields, we forecast the bank's net interest margin to decline by 60bp yoy in FY15 to 5.7%. We attribute the margin contraction to a drop in the bank's yield on investment securities, which in turn is driven by losses on its mark to market investment portfolio (we believe the bank lumps together trading profits or losses with interest income from government securities). We therefore expect the NIM to bounce back to 6.2% in FY16 due to higher yields on customer loans and the investment securities portfolio. Despite the rebound, we forecast the bank's five-year average margin of 6.0% to be significantly lower than 7.9% for the other banks due to its focus on corporate and "high-end" retail banking where margins are lower. This is because 1) a significant proportion of the loans are US$ denominated and have lower yields than KES denominated loans, and 2) the more sophisticated nature of the end-user makes the segment more competitive.
- **Strong, albeit inconsistent, growth combined with higher dividend payout should increase balance sheet leverage:** the bank's FY15f equity to assets ratio of 18.1% is much higher than the sector average of 15.1% due to 1) inconsistent loan (and asset) growth rates over the years resulting in below average cumulative growth rates, and 2) a very low average dividend payout ratio of only 8.8%. We think the bank's asset growth is likely to remain inconsistent as we think the group remains highly sensitive to macro and political developments; we therefore estimate cumulative growth of 16.2% over the next five years. The group also increased its dividend payout ratio to 42.8% in FY14 and we forecast it to remain elevated (estimated average of 34.7% over the next five years) due to the bank's low balance sheet leverage and high capital adequacy ratio (9M15 CAR of 19.0%). Based on our assumptions, we forecast the bank's leverage to increase to 6.2x by FY20 from 5.2x currently.

## CFC Stanbic Bank: Key financials

### Table 5: Income statement (new vs old)

| Income statement (KESmn) | 2013 | 2014 | FY15f (old) | FY15f (new) | FY16f (old) | FY16f (new) | FY17f (old) | FY17f (new) |
|---|---|---|---|---|---|---|---|---|
| Interest income | 11,627 | 13,416 | 15,653 | 15,249 | 18,875 | 18,857 | 19,938 | 20,275 |
| Interest expense | (2,792) | (3,181) | (4,718) | (5,087) | (5,977) | (6,193) | (5,789) | (6,198) |
| **Net interest income** | **8,835** | **10,236** | **10,935** | **10,162** | **12,897** | **12,663** | **14,149** | **14,077** |
| Non-interest income | 7,368 | 6,635 | 5,858 | 5,377 | 5,682 | 6,173 | 6,380 | 6,820 |
| Operating revenue | 16,203 | 16,870 | 16,793 | 15,539 | 18,580 | 18,836 | 20,529 | 20,897 |
| Operating expenses | (8,212) | (8,467) | (8,692) | (9,092) | (8,632) | (9,844) | (9,352) | (10,881) |
| **Net operating profit** | **7,991** | **8,403** | **8,101** | **6,446** | **9,948** | **8,992** | **11,177** | **10,017** |
| Total provisions | (767) | (703) | (852) | (804) | (1,167) | (1,306) | (1,053) | (1,172) |
| **Pre-tax income** | **7,224** | **7,700** | **7,249** | **5,642** | **8,781** | **7,686** | **10,124** | **8,845** |
| Income taxes | (2,097) | (2,014) | (2,175) | (1,693) | (2,634) | (2,306) | (3,037) | (2,653) |
| **Attributable income** | **5,127** | **5,687** | **5,075** | **3,950** | **6,147** | **5,380** | **7,087** | **6,191** |
| **EPS** | **13.0** | **14.4** | **12.8** | **10.0** | **15.5** | **13.6** | **17.9** | **15.7** |
| **DPS** | **2.2** | **6.15** | **2.50** | **3.50** | **3.25** | **4.50** | **3.50** | **5.50** |
| **BVPS** | **82.0** | **93.3** | **97.5** | **97.2** | **110.5** | **107.3** | **125.2** | **118.4** |

*Source: Company annual reports, Exotix estimates*

### Table 6: Balance sheet (new vs old)

| Balance sheet (KESmn) | 2013 | 2014 | FY15f (old) | FY15f (new) | FY16f (old) | FY16f (new) | FY17f (old) | FY17f (new) |
|---|---|---|---|---|---|---|---|---|
| **Total assets** | | | | | | | | |
| Cash and cash equivalents | 9,467 | 9,556 | 12,188 | 11,319 | 13,638 | 12,706 | 15,566 | 14,497 |
| Money market & interbank assets | 34,714 | 12,863 | 13,297 | 18,110 | 17,358 | 17,788 | 16,981 | 20,295 |
| Investment securities | 48,545 | 52,168 | 53,186 | 58,857 | 58,273 | 63,528 | 63,677 | 74,658 |
| **Gross loans** | **71,034** | **90,339** | **109,696** | **107,528** | **123,985** | **123,880** | **141,505** | **137,719** |
| Reserves | (1,900) | (1,992) | (2,402) | (2,355) | (3,031) | (3,134) | (3,347) | (3,526) |
| **Net loans** | **69,133** | **88,347** | **107,294** | **105,173** | **120,953** | **120,745** | **138,158** | **134,194** |
| Property and equipment | 2,175 | 2,348 | 2,398 | 2,398 | 2,398 | 2,448 | 2,448 | 2,498 |
| Other assets | 16,477 | 15,717 | 16,111 | 16,111 | 16,541 | 16,541 | 17,009 | 17,009 |
| **Total assets** | **180,512** | **180,999** | **204,474** | **211,969** | **229,162** | **233,756** | **253,839** | **263,152** |
| **Total liabilities & equity** | | | | | | | | |
| **Total shareholders' equity** | **32,426** | **36,895** | **38,539** | **38,414** | **43,697** | **42,410** | **49,499** | **46,824** |
| Borrowed funds | 5,848 | 6,513 | 7,760 | 6,503 | 9,065 | 4,448 | 3,837 | 3,902 |
| Amounts due to other banks | 35,558 | 33,570 | 38,781 | 45,275 | 43,395 | 50,822 | 49,527 | 57,987 |
| **Customer deposits** | **94,728** | **95,839** | **110,804** | **113,187** | **123,985** | **127,056** | **141,505** | **144,968** |
| Other liabilities | 11,952 | 8,181 | 8,590 | 8,590 | 9,020 | 9,020 | 9,471 | 9,471 |
| **Total equity and liabilities** | **180,512** | **180,999** | **204,474** | **211,969** | **229,162** | **233,756** | **253,839** | **263,152** |

*Source: Company annual reports, Exotix estimates*

### Table 7: Income statement (yoy trends)

| Income statement (KESmn) | 2013 | 2014 | % ch | FY15f | % ch | FY16f | % ch | FY17f | % ch |
|---|---|---|---|---|---|---|---|---|---|
| Interest income | 11,627 | 13,416 | 15.4% | 15,249 | 13.7% | 18,857 | 23.7% | 20,275 | 7.5% |
| Interest expense | (2,792) | (3,181) | 13.9% | (5,087) | 59.9% | (6,193) | 21.7% | (6,198) | 0.1% |
| **Net interest income** | **8,835** | **10,236** | **15.8%** | **10,162** | **-0.7%** | **12,663** | **24.6%** | **14,077** | **11.2%** |
| Non-interest income | 7,368 | 6,635 | -9.9% | 5,377 | -19.0% | 6,173 | 14.8% | 6,820 | 10.5% |
| Operating revenue | 16,203 | 16,870 | 4.1% | 15,539 | -7.9% | 18,836 | 21.2% | 20,897 | 10.9% |
| Operating expenses | (8,212) | (8,467) | 3.1% | (9,092) | 7.4% | (9,844) | 8.3% | (10,881) | 10.5% |
| **Net operating profit** | **7,991** | **8,403** | **5.2%** | **6,446** | **-23.3%** | **8,992** | **39.5%** | **10,017** | **11.4%** |
| Total provisions | (767) | (703) | -8.3% | (804) | 14.4% | (1,306) | 62.4% | (1,172) | -10.3% |
| **Pre-tax income** | **7,224** | **7,700** | **6.6%** | **5,642** | **-26.7%** | **7,686** | **36.2%** | **8,845** | **15.1%** |
| Income taxes | (2,097) | (2,014) | -4.0% | (1,693) | -15.9% | (2,306) | 36.2% | (2,653) | 15.1% |
| **Attributable income** | **5,127** | **5,687** | **10.9%** | **3,950** | **-30.5%** | **5,380** | **36.2%** | **6,191** | **15.1%** |
| **EPS** | **12.97** | **14.38** | **10.9%** | **9.99** | **-30.5%** | **13.61** | **36.2%** | **15.66** | **15.1%** |
| **DPS** | **2.15** | **6.15** | **186.0%** | **3.50** | **-43.1%** | **4.50** | **28.5%** | **5.50** | **22.3%** |
| **BVPS** | **82.0** | **93.3** | **13.8%** | **97.2** | **4.1%** | **107.3** | **10.4%** | **118.4** | **10.4%** |

*Source: Company annual reports, Exotix estimates*

### Table 8: Balance sheet (yoy trends)

| Balance sheet (KESmn) | 2013 | 2014 | % ch | FY15f | % ch | FY16f | %ch | FY17f | %ch |
|---|---|---|---|---|---|---|---|---|---|
| **Total assets** | | | | | | | | | |
| Cash and cash equivalents | 9,467 | 9,556 | 0.9% | 11,319 | 18.5% | 12,706 | 12.3% | 14,497 | 14.1% |
| Interbank assets | 34,714 | 12,863 | -62.9% | 18,110 | 40.8% | 17,788 | -1.8% | 20,295 | 14.1% |
| Investment securities | 48,545 | 52,168 | 7.5% | 58,857 | 12.8% | 63,528 | 7.9% | 74,658 | 17.5% |
| **Gross loans** | **71,034** | **90,339** | **27.2%** | **107,528** | **19.0%** | **123,880** | **15.2%** | **137,719** | **11.2%** |
| Reserves | (1,900) | (1,992) | 4.8% | (2,355) | 18.2% | (3,134) | 33.1% | (3,526) | 12.5% |
| **Net loans** | **69,133** | **88,347** | **27.8%** | **105,173** | **19.0%** | **120,745** | **14.8%** | **134,194** | **11.1%** |
| Property and equipment | 2,175 | 2,348 | 8.0% | 2,398 | 2.1% | 2,448 | 2.1% | 2,498 | 2.0% |
| Other assets | 16,477 | 15,717 | -4.6% | 16,111 | 2.5% | 16,541 | 2.7% | 17,009 | 2.8% |
| **Total assets** | **180,512** | **180,999** | **0.3%** | **211,969** | **17.1%** | **233,756** | **10.3%** | **263,152** | **12.6%** |
| **Total liabilities & equity** | | | | | | | | | |
| **Total shareholders' equity** | **32,426** | **36,895** | **13.8%** | **38,414** | **4.1%** | **42,410** | **10.4%** | **46,824** | **10.4%** |
| Borrowed funds | - | - | | 0 | | - | | - | |
| Amounts due to other banks | 5,848 | 6,513 | 11.4% | 6,503 | -0.2% | 4,448 | -31.6% | 3,902 | -12.3% |
| **Customer deposits** | **35,558** | **33,570** | **-5.6%** | **45,275** | **34.9%** | **50,822** | **12.3%** | **57,987** | **14.1%** |
| Other liabilities | 94,728 | 95,839 | 1.2% | 113,187 | 18.1% | 127,056 | 12.3% | 144,968 | 14.1% |
| **Total equity and liabilities** | **11,952** | **8,181** | **-31.6%** | **8,590** | **5.0%** | **9,020** | **5.0%** | **9,471** | **5.0%** |

*Source: Company annual reports, Exotix estimates*

**Table 9: CFC Stanbic financial ratios**

| | 2013 | 2014 | FY15f | FY16f | FY17f |
|---|---|---|---|---|---|
| **Margins (%)** | | | | | |
| Net interest margin | 6.1 | 6.3 | 5.7 | 6.2 | 6.1 |
| Yield on average earning assets | 8.1 | 8.3 | 8.6 | 9.2 | 8.8 |
| Cost of interest bearing liabilities | 2.3 | 2.3 | 3.4 | 3.6 | 3.2 |
| Cost/income | 50.7 | 50.2 | 58.5 | 52.3 | 52.1 |
| Cost of risk | 1.1 | 0.8 | 0.7 | 1.1 | 0.9 |
| **Growth (%)** | | | | | |
| Gross loans (%) | 4.9 | 27.2 | 19.0 | 15.2 | 11.2 |
| Deposits (%) | 26.5 | 1.2 | 18.1 | 12.3 | 14.1 |
| Total assets (%) | 26.0 | 0.3 | 17.1 | 10.3 | 12.6 |
| **Returns (%)** | | | | | |
| Return on average equity | 17.2 | 16.4 | 10.5 | 13.3 | 13.9 |
| Return on average assets | 3.2 | 3.1 | 2.0 | 2.4 | 2.5 |
| **Asset quality (%)** | | | | | |
| NPL ratio | 2.5 | 3.3 | 3.5 | 4.5 | 4.0 |
| NPL cover | 53.6 | 36.5 | 35.0 | 35.0 | 40.0 |
| **Asset mix (%)** | | | | | |
| Gross loans to deposit | 75.0 | 94.3 | 95.0 | 97.5 | 95.0 |
| Net loans to assets | 38.3 | 48.8 | 49.6 | 51.7 | 51.0 |
| Investment securities to total assets | 26.9 | 28.8 | 27.8 | 27.2 | 28.4 |
| Interbank lending to total assets | 19.2 | 7.1 | 8.5 | 7.6 | 7.7 |
| Cash to total assets | 5.2 | 5.3 | 5.3 | 5.4 | 5.5 |
| **Funding mix (%)** | | | | | |
| Deposits to total funding | 52.5 | 52.9 | 53.4 | 54.4 | 55.1 |
| Interbank borrowing to total funding | 19.7 | 18.5 | 21.4 | 21.7 | 22.0 |
| Other borrowing to total funding | 3.2 | 3.6 | 3.1 | 1.9 | 1.5 |
| Equity to total funding | 18.0 | 20.4 | 18.1 | 18.1 | 17.8 |
| Capital adequacy ratio | 20.5 | 19.2 | 17.9 | 18.2 | 18.0 |

*Source: Company annual reports, Exotix estimates*

## Valuation

Our fair value estimate and target price for CFC Stanbic is KES81.4 per share.

### Methodology

To calculate our fair value estimate for CFC Stanbic, we applied a two-stage dividend discount model:

Stage 1 – between FY16 and FY20 we estimated the present value of dividends using the profitability drivers we discuss above.

Stage 2 – we determine the terminal value as the perpetual growth rate in the bank's book value based on its average ROE between FY16f and FY20f and a terminal growth rate assumption of 8.0%.

We have assumed a cost of equity (CoE) of 16.5% using a risk-free rate of 11.5%, an equity risk premium of 5% and a beta of 1.0x. As our valuation is Kenya shilling-based, we have applied an 8% terminal growth rate.

In the table below, we provide our assumptions used to calculate our fair value estimate of the bank.

**Table 10: CFC Stanbic valuation summary**

| (KESmn) | 2016f | 2017f | 2018f | 2019f | 2020f |
|---|---|---|---|---|---|
| Aggregate Dividend | 1,777 | 2,174 | 2,473 | 2,965 | 3,646 |
| PV | 1,526 | 1,602 | 1,564 | 1,610 | 1,699 |
| Total PV | 8,000 | | | | |
| **Terminal Value** | | | | | |
| RoAE | | | | | 14.8% |
| CoE | | | | | 16.5% |
| Growth | | | | | 8.0% |
| Book value in 2020 | | | | | 65,101 |
| Terminal value | | | | | 51,905 |
| PV of Terminal Value | 24,187 | | | | |
| **Total PV** | **32,187** | | | | |
| Shares in issue (mn) | 395 | | | | |
| **Per share value** | **81.4** | | | | |

*Source: Bank annual reports, Exotix estimates*

### Risks

In our opinion, the following are key risks to our forecasts and target price:

- **South Sudan:** As discussed above, we do not expect South Sudan to be a key contributor to group profits due to the continued disruptions in the country and potential future spin-off of the subsidiary to Standard Bank PLC. A turnaround in the performance of the subsidiary is therefore an upside risk to our estimates.
- **Margins:** As discussed previously, we forecast the bank's margins to expand in FY16 due to the higher interest rate environment. A lower than expected increase in margins (or even a decrease) is therefore a key downside risk to our estimates.
- **Balance sheet leverage:** we forecast the bank's balance sheet leverage to gradually increase on the back of reasonably strong loans growth (higher than its historical average) and a higher than historical average dividend payout ratio (in line with the FY14 payout ratio). Potentially lower balance sheet growth or lower dividends could therefore lead to lower balance sheet leverage.

# Co-op Bank: efficiency gains

| | |
|---|---|
| Price | 17.1 |
| Target price | **26.72** |
| Expected share price return | 56.3% |
| Expected dividend yield | 4.1% |
| **Expected total return** | **60.4%** |
| Market cap (mn) | 83,363 |
| Market cap (US$mn) | 814 |
| Avg. daily volume (US$k) | 145 |

- **We upgrade our recommendation on the stock to BUY** (previously Hold) based on a target price of KES26.7 (previously KES23.1), giving an ETR of 60.4% at the current market price of KES17.1. Our target price is 2.1x estimated forward BVPS of KES12.8 and 9.1x forward EPS.
- **9M15 review:** EPS for the nine-month period increased by 36.6% yoy and ROE improved by 30bp yoy to 24.8% driven primarily by a 4.5% yoy drop in operating expenses resulting in the cost to income ratio improving by 9.2ppt to 49.0%. The efficiency gains are attributable to non-recurrence of redundancy costs incurred in FY14 as well as improvement in transaction processing efficiency as the bank adopted the McKinsey recommendations. In addition, loan growth remained robust at 20.7% yoy.
- **New vs old**: the 9M results were largely in line with our estimates and we have subsequently increased our FY15 EPS estimate by a moderate 5% to KES2.3. Our FY16 (+1.8%) and FY19 (+2.3%) estimates are also little changed as higher margin forecasts are offset by moderately lower asset growth assumptions.
- **Our recommendation explained:** despite announcing relatively strong results (see 9M15 review above), the bank's stock price declined by 10% in 2015. Subsequently, the bank ended the year trading at 1.7x FY15f BVPS, significantly lower than its historical average of 2.3x. As stated above, we forecast the bank's ROE to improve to 23.6% in FY15 (due to the efficiency gains) and 25.2% in FY17 (due to margin expansion) before gradually declining to 22.9% by FY20. Our average ROE estimate of 24.1% over the next five years is higher than the bank's historical normalised average ROE of 22.3% (once we normalise the tax rate at 30% between FY09 and FY13 compared to the subsidised tax rate of 23.9% that the bank was paying during that period). Our estimates therefore indicate that the bank is now operating on a higher profitability plane following the efficiency improvements implemented over the last 18 months. We therefore think the bank is undervalued at 1.3x forward BVPS. A justified P/BVPS estimate of 1.9x (using an average ROE of 24.1%, COE of 16.5% and terminal growth of 8%) further supports our recommendation.

**Table 11: Co-op Bank investment summary table**

| Year to 31 Dec | 2013 | 2014 | 2015f | 2016f | 2017f |
|---|---|---|---|---|---|
| Net Income (mn) | 9,490 | 8,265 | 11,223 | 14,362 | 17,376 |
| EPS | 2.26 | 1.69 | 2.30 | 2.94 | 3.55 |
| EPS (Old) | 2.24 | 1.69 | 2.19 | 2.88 | 3.37 |
| P/E (x) | 8.5 | 11.5 | 7.4 | 5.8 | 4.8 |
| P/TBVPS (x) | 2.1 | 2.0 | 1.7 | 1.4 | 1.2 |
| DPS | 0.61 | 0.50 | 0.70 | 0.90 | 1.10 |
| Dividend yield (%) | 2.7% | 2.6% | 4.1% | 5.3% | 6.4% |
| TROE (%) | 30.5% | 21.5% | 24.6% | 26.3% | 26.3% |
| ROA (%) | 4.3% | 3.1% | 3.6% | 3.8% | 3.9% |

*Source: Company reports and Exotix estimates*

## Co-op Bank profit model

In the table below we provide a summary of Co-op's profit model. Based on the analysis provided below, we are forecasting ROE to improve to 25.2% in FY16 and to decline to 22.9% by the end of our forecast period.

**Table 12: Co-op Bank profit model**

| (%) | FY13 | FY14 | FY15f | FY16f | FY17f | FY18f | FY19f | FY20f |
|---|---|---|---|---|---|---|---|---|
| Net interest income/ average assets [1] | 8.5 | 8.1 | 7.7 | 8.4 | 8.0 | 7.6 | 7.1 | 7.0 |
| Non-interest income/ average assets [2] | 4.2 | 4.2 | 4.0 | 3.8 | 3.7 | 3.7 | 3.7 | 3.6 |
| Operating expenses/ average assets [3] | (7.7) | (7.8) | (6.2) | (6.0) | (5.7) | (5.4) | (5.2) | (5.0) |
| Net provisioning/ average assets [4] | (0.1) | (0.3) | (0.5) | (0.9) | (0.6) | (0.5) | (0.6) | (0.6) |
| Tax/average assets [5] | (0.8) | (1.1) | (1.5) | (1.6) | (1.6) | (1.6) | (1.5) | (1.5) |
| Associate profits/ average assets [6] | 0.2 | 0.1 | 0.1 | 0.1 | 0.1 | 0.1 | 0.1 | 0.1 |
| Minority interest / average assets [7] | 0.1 | 0.1 | 0.1 | 0.1 | 0.1 | 0.1 | 0.1 | 0.0 |
| Average assets / average equity [8] | 6.5 | 6.4 | 6.6 | 6.5 | 6.5 | 6.4 | 6.4 | 6.4 |
| ROA = [1+2+3+4+5+6+7] | 4.3 | 3.2 | 3.6 | 3.8 | 3.9 | 3.8 | 3.6 | 3.6 |
| **ROE = [ROA * 8]** | **28.0** | **20.6** | **23.6** | **25.2** | **25.2** | **24.4** | **23.0** | **22.9** |

*Source: Company annual reports, Exotix estimates*

We make the following observations regarding the above:

- **Efficiency improvement:** we forecast the bank's cost to income ratio to improve by 10.4ppt to 53.3% in FY15 due to a 4.5% yoy decline in operating expenses. The drop in operating expenses was due to non-recurrence of c.KES1.4bn of redundancy expenses incurred in FY14 and implementation of reforms by McKinsey resulting in more efficient transaction processing. We estimate the CIR could further drop to 48.9% in FY16 as opex growth remains moderate (estimate +14.8% yoy), and a combination of expanding margins and strong asset and non-interest revenue growth translates to strong top-line growth (estimate +31.5% yoy). We expect a moderate improvement in CIR from FY16 onwards (estimate FY20 CIR of 47.3%) as moderate opex growth (estimate CAGR of 13.9% per annum) is offset by declining margins and thus decelerating top-line growth (estimate CAGR of 14.9% per annum).
- **Margins rebound, albeit temporarily:** we forecast the bank's NIM to expand by 70bp to 9.0% in FY16 due to the high inters rate environment. Management indicated that they had increased their lending rates by 200-300bp towards the end of 3Q15, the impact of which will be felt in 4Q15 and FY16. We therefore forecast the average lending rate to increase to 17.0% in FY16 (+175bp yoy) and the investment securities yield to increase to 12.5% (+80bp yoy). The higher yields will be partially offset by a 70bp increase in average deposit costs to 5.3%. We forecast margins to resume their long-term downward trajectory from FY17 onwards (estimated FY20 NIM of 7.4%) due to increased competition.
- **Moderation of loan growth:** we forecast net loan growth to moderate to 13.7% in FY16 as loan uptake eases as banks become risk averse ahead of the Presidential election. Assuming a successful conclusion to the election, growth should revert back to historical levels from FY18f onwards. Overall, despite the slowdown over the next two years, we forecast loan growth to remain relatively robust at 15.6% over the next five years.
- **Risk charge should normalise at a higher rate:** based on management guidance of gradually increasing the NPL cover to 60%, we estimate the FY15 cost of risk increases by 30bp to 0.8% (vs historical average of 0.5%). In FY18, we forecast the cost of risk could further increase to 1.4% to cover for potentially higher defaults (estimate NPL ratio to increase by 200bp yoy to 6.0% due to the high interest rate environment). Although we expect the NPL ratio to gradually drop back to 4% by FY20, we expect the bank's cost of risk will remain elevated as it tries to increase its NPL cover to the targeted 60%. Thus our average cost of risk estimate of 1.0% over the next five years is double its historical average.

## Co-op Bank: Key financials

### Table 13: Income statement (new vs old)

| | 2013 | 2014 | FY15f (old) | FY15f (new) | FY16f (old) | FY16f (new) | FY17f (old) | FY17f (new) |
|---|---|---|---|---|---|---|---|---|
| Interest income | 24,194 | 29,109 | 36,301 | 36,423 | 45,825 | 47,995 | 51,561 | 53,129 |
| Interest expense | (5,916) | (8,076) | (10,625) | (12,389) | (14,030) | (16,794) | (15,624) | (17,255) |
| **Net interest income** | **18,278** | **21,032** | **25,676** | **24,035** | **31,795** | **31,201** | **35,937** | **35,873** |
| Non-interest income | 9,104 | 10,759 | 11,691 | 12,359 | 13,662 | 14,370 | 16,632 | 16,293 |
| Operating revenue | 27,382 | 31,791 | 37,367 | 36,393 | 45,457 | 45,570 | 52,570 | 52,166 |
| Operating expenses | (16,605) | (20,265) | (20,909) | (19,415) | (23,835) | (22,284) | (26,928) | (25,375) |
| **Net operating profit** | **10,778** | **11,526** | **16,458** | **16,978** | **21,622** | **23,286** | **25,642** | **26,791** |
| Total provisions | (270) | (881) | (1,857) | (1,620) | (2,198) | (3,491) | (2,857) | (2,743) |
| **Pre-tax income** | 10,872 | 10,916 | 14,899 | 15,657 | 19,752 | 20,123 | 23,146 | 24,409 |
| Income taxes | (1,764) | (2,901) | (4,470) | (4,697) | (5,925) | (6,037) | (6,944) | (7,323) |
| **Minority interest** | 125 | 250 | 263 | 263 | 276 | 276 | 290 | 290 |
| **Attributable income** | **9,233** | **8,265** | **10,692** | **11,223** | **14,102** | **14,362** | **16,492** | **17,376** |
| **EPS** | **2.20** | **1.69** | **2.19** | **2.30** | **2.88** | **2.94** | **3.37** | **3.55** |
| **DPS** | **0.50** | **0.50** | **0.65** | **0.70** | **0.80** | **0.90** | **1.00** | **1.10** |
| **BVPS** | **8.8** | **8.9** | **10.3** | **10.6** | **12.6** | **12.8** | **15.2** | **15.4** |

*Source: Company annual reports, Exotix estimates*

### Table 14: Balance sheet (new vs old)

| | 2013 | 2014 | FY15f (old) | FY15f (new) | FY16f (old) | FY16f (new) | FY17f (old) | FY17f (new) |
|---|---|---|---|---|---|---|---|---|
| **Total assets** | | | | | | | | |
| Cash and cash equivalents | 20,713 | 24,335 | 32,001 | 31,087 | 37,530 | 37,302 | 45,961 | 44,914 |
| Money market & interbank assets | 10,041 | 13,018 | 16,001 | 15,544 | 18,765 | 21,760 | 19,150 | 26,200 |
| Investment securities | 39,366 | 45,815 | 53,335 | 51,812 | 68,805 | 74,604 | 84,262 | 101,057 |
| **Gross loans** | **145,662** | **187,172** | **229,342** | **225,382** | **262,712** | **258,007** | **325,557** | **295,687** |
| Reserves | (8,574) | (7,685) | (9,267) | (8,970) | (11,283) | (12,049) | (14,163) | (13,964) |
| **Net loans** | **137,087** | **179,486** | **220,075** | **216,412** | **251,428** | **245,958** | **311,394** | **281,723** |
| Property and equipment | 10,041 | 13,018 | 16,001 | 15,544 | 18,765 | 21,760 | 19,150 | 26,200 |
| Other assets | 13,967 | 9,723 | 8,975 | 9,432 | 8,770 | 5,776 | 11,329 | 4,279 |
| **Total assets** | **231,215** | **285,396** | **346,388** | **339,830** | **404,064** | **407,160** | **491,246** | **484,374** |
| **Total liabilities & equity** | | | | | | | | |
| **Total shareholders' equity** | **36,774** | **43,331** | **50,578** | **51,609** | **61,502** | **62,543** | **74,086** | **75,518** |
| Minority interest | 365 | 82 | 82 | 82 | 82 | 82 | 82 | 82 |
| Borrowed funds | 10,252 | 18,269 | 20,647 | 22,124 | 20,173 | 25,720 | 22,861 | 25,325 |
| Amounts due to other banks | 5,462 | 3,159 | 5,334 | 3,886 | 6,255 | 4,663 | 7,660 | 5,614 |
| **Customer deposits** | **175,425** | **217,698** | **266,677** | **259,060** | **312,752** | **310,851** | **383,008** | **374,287** |
| Other liabilities | 2,937 | 2,856 | 3,070 | 3,070 | 3,300 | 3,300 | 3,548 | 3,548 |
| **Total equity and liabilities** | **231,215** | **285,396** | **346,388** | **339,830** | **404,064** | **407,160** | **491,246** | **484,374** |

*Source: Company annual reports, Exotix estimates*

**Table 15: Income statement (yoy trends)**

| | 2013 | 2014 | % ch | FY15f | % ch | FY16f | %ch | FY17f | %ch |
|---|---|---|---|---|---|---|---|---|---|
| Interest income | 24,194 | 29,109 | 20.3% | 36,423 | 25.1% | 47,995 | 31.8% | 53,129 | 10.7% |
| Interest expense | (5,916) | (8,076) | 36.5% | (12,389) | 53.4% | (16,794) | 35.6% | (17,255) | 2.7% |
| **Net interest income** | **18,278** | **21,032** | **15.1%** | **24,035** | **14.3%** | **31,201** | **29.8%** | **35,873** | **15.0%** |
| Non-interest income | 9,104 | 10,759 | 18.2% | 12,359 | 14.9% | 14,370 | 16.3% | 16,293 | 13.4% |
| Operating revenue | 27,382 | 31,791 | 16.1% | 36,393 | 14.5% | 45,570 | 25.2% | 52,166 | 14.5% |
| Operating expenses | (16,605) | (20,265) | 22.0% | (19,415) | -4.2% | (22,284) | 14.8% | (25,375) | 13.9% |
| **Net operating profit** | **10,778** | **11,526** | **6.9%** | **16,978** | **47.3%** | **23,286** | **37.2%** | **26,791** | **15.1%** |
| Total provisions | (270) | (881) | 225.8% | (1,620) | 83.8% | (3,491) | 115.5% | (2,743) | -21.4% |
| **Pre-tax income** | **10,872** | **10,916** | **0.4%** | **15,657** | **43.4%** | **20,123** | **28.5%** | **24,409** | **21.3%** |
| Income taxes | (1,764) | (2,901) | 64.4% | (4,697) | 61.9% | (6,037) | 28.5% | (7,323) | 21.3% |
| Minority interest | 125 | 250 | 100.1% | 263 | 5.0% | 276 | 5.0% | 290 | 5.0% |
| **Attributable income** | **9,233** | **8,265** | **-10.5%** | **11,223** | **35.8%** | **14,362** | **28.0%** | **17,376** | **21.0%** |
| **EPS** | **2.20** | **1.69** | **-23.3%** | **2.30** | **35.8%** | **2.94** | **28.0%** | **3.55** | **21.0%** |
| **DPS** | **0.50** | **0.50** | **0.0%** | **0.70** | **40.2%** | **0.90** | **28.4%** | **1.10** | **22.1%** |
| **BVPS** | **8.8** | **8.9** | **1.0%** | **10.6** | **19.1%** | **12.8** | **21.2%** | **15.4** | **20.7%** |

*Source: Company annual reports, Exotix estimates*

**Table 16: Balance sheet (yoy trends)**

| | 2013 | 2014 | % ch | FY15f | % ch | FY16f | %ch | FY17f | %ch |
|---|---|---|---|---|---|---|---|---|---|
| **Total assets** | | | | | | | | | |
| Cash and cash equivalents | 20,713 | 24,335 | 17.5% | 31,087 | 27.7% | 37,302 | 20.0% | 44,914 | 20.4% |
| Interbank assets | 10,041 | 13,018 | 29.7% | 15,544 | 19.4% | 21,760 | 40.0% | 26,200 | 20.4% |
| Investment securities | 39,366 | 45,815 | 16.4% | 51,812 | 13.1% | 74,604 | 44.0% | 101,057 | 35.5% |
| **Gross loans** | **145,662** | **187,172** | **28.5%** | **225,382** | **20.4%** | **258,007** | **14.5%** | **295,687** | **14.6%** |
| Reserves | (8,574) | (7,685) | -10.4% | (8,970) | 16.7% | (12,049) | 34.3% | (13,964) | 15.9% |
| **Net loans** | **137,087** | **179,486** | **30.9%** | **216,412** | **20.6%** | **245,958** | **13.7%** | **281,723** | **14.5%** |
| Property and equipment | 10,041 | 13,018 | 29.7% | 15,544 | 19.4% | 21,760 | 40.0% | 26,200 | 20.4% |
| Other assets | 13,967 | 9,723 | -30.4% | 9,432 | -3.0% | 5,776 | -38.8% | 4,279 | -25.9% |
| **Total assets** | **231,215** | **285,396** | **23.4%** | **339,830** | **19.1%** | **407,160** | **19.8%** | **484,374** | **19.0%** |
| **Total liabilities & equity** | | | | | | | | | |
| **Total shareholders' equity** | **36,774** | **43,331** | **17.8%** | **51,609** | **19.1%** | **62,543** | **21.2%** | **75,518** | **20.7%** |
| Minority interest | 365 | 82 | -77.5% | 82 | 0.0% | 82 | 0.0% | 82 | 0.0% |
| Borrowed funds | 10,252 | 18,269 | 78.2% | 22,124 | 21.1% | 25,720 | 16.3% | 25,325 | -1.5% |
| Amounts due to other banks | 5,462 | 3,159 | -42.2% | 3,886 | 23.0% | 4,663 | 20.0% | 5,614 | 20.4% |
| **Customer deposits** | **175,425** | **217,698** | **24.1%** | **259,060** | **19.0%** | **310,851** | **20.0%** | **374,287** | **20.4%** |
| Other liabilities | 2,937 | 2,856 | -2.8% | 3,070 | 7.5% | 3,300 | 7.5% | 3,548 | 7.5% |
| **Total equity and liabilities** | **231,215** | **285,396** | **23.4%** | **339,830** | **19.1%** | **407,160** | **19.8%** | **484,374** | **19.0%** |

*Source: Company annual reports, Exotix estimates*

**Table 17: Co-op Bank financial ratios**

| | 2013 | 2014 | 2015f | FY16f | FY17f |
|---|---|---|---|---|---|
| **Margins (%)** | | | | | |
| Net interest margin | 9.4 | 9.0 | 8.3 | 9.0 | 8.6 |
| Yield on average earning assets | 12.4 | 12.4 | 12.6 | 13.8 | 12.7 |
| Cost of interest bearing liabilities | 9.4 | 9.0 | 8.3 | 9.0 | 8.6 |
| Cost/income | 60.6 | 63.7 | 53.3 | 48.9 | 48.6 |
| Cost of risk | 0.2 | 0.5 | 0.8 | 1.4 | 1.0 |
| **Growth (%)** | | | | | |
| Gross loans (%) | 17.6 | 28.5 | 20.4 | 14.5 | 14.6 |
| Deposits (%) | 8.2 | 24.1 | 19.0 | 20.0 | 20.4 |
| Total assets (%) | 15.1 | 23.4 | 19.1 | 19.8 | 19.0 |
| **Returns (%)** | | | | | |
| Return on average assets | 28.0 | 20.6 | 23.6 | 25.2 | 25.2 |
| Return on average equity | 4.3 | 3.2 | 3.6 | 3.8 | 3.9 |
| **Asset quality (%)** | | | | | |
| NPL ratio | 4.2 | 4.3 | 4.0 | 6.0 | 5.5 |
| NPL cover | 48.7 | 30.5 | 50.0 | 45.0 | 50.0 |
| **Asset mix (%)** | | | | | |
| Gross loans to deposit | 83.0 | 86.0 | 87.0 | 83.0 | 79.0 |
| Net loans to assets | 59.3 | 62.9 | 63.7 | 60.4 | 58.2 |
| Investment securities to total assets | 17.0 | 16.1 | 15.2 | 18.3 | 20.9 |
| Interbank lending to total assets | 4.3 | 4.6 | 4.6 | 5.3 | 5.4 |
| Cash to total assets | 9.0 | 8.5 | 9.1 | 9.2 | 9.3 |
| **Funding mix (%)** | | | | | |
| Deposits to total funding | 75.9 | 76.3 | 76.2 | 76.3 | 77.3 |
| Interbank borrowing to total funding | 2.4 | 1.1 | 1.1 | 1.1 | 1.2 |
| Other borrowing to total funding | 4.4 | 6.4 | 6.5 | 6.3 | 5.2 |
| Equity to total funding | 15.9 | 15.2 | 15.2 | 15.4 | 15.6 |
| Capital adequacy ratio | 21.1 | 21.6 | 22.0 | 22.1 | 21.2 |

*Source: Company annual reports, Exotix estimates*

## Valuation

Our fair value estimate and target price for Co-op Bank is KES26.72/share.

### Methodology

To calculate our fair value estimate for Co-op we applied a two-stage dividend discount model:

Stage 1 - between FY16 and FY20 we estimated the present value of dividends using the profitability drivers we discuss above.

Stage 2 – we determine the terminal value as the perpetual growth rate in the bank's book value based on its average ROE between FY16 and FY20 and a terminal growth rate assumption of 8.0%.

We assume a cost of equity (CoE) of 16.5%, using a risk-free rate of 11.5%, an equity risk premium of 5% and a beta of 1.0x. As our valuation is Kenya shilling-based, we have applied an 8% terminal growth rate.

In the table below, we provide our assumptions used to calculate our fair value estimate of the bank.

**Table 18: Co-op Bank valuation summary**

| (KESbn) | 2016f | 2017f | 2018f | 2019f | 2020f |
|---|---|---|---|---|---|
| Aggregate dividend | 4,402 | 5,372 | 6,356 | 6,849 | 8,312 |
| PV | 3,778 | 3,958 | 4,020 | 3,718 | 3,873 |
| Total PV | 19,348 | | | | |
| **Terminal Value** | | | | | |
| RoAE | | | | | 24.0% |
| CoE | | | | | 16.5% |
| Growth | | | | | 8.0% |
| Book value in 2019 | | | | | 126,606 |
| Terminal value | | | | | 238,884 |
| PV of Terminal Value | 111,316 | | | | |
| **Total PV** | **130,664** | | | | |
| Shares in issue (mn) | 4,889 | | | | |
| **Per share value** | **26.7** | | | | |

*Source: Exotix estimates*

### Risks

In our opinion, the following are key risks to our forecasts and target price:

- **Margins –** as in 2011, we forecast the bank's margins to expand in 2016 due to the high interest rate environment. A lower than expected increase in margins (or even a decrease) is therefore a key downside risk to our estimates.
- **Improvement in operating efficiency –** we forecast the bank's opex growth to moderate to 13.9% per annum over the next five years (vs a historical average of 22%) on the back of the cost-cutting measures implemented in FY14. Opex growth in line with historical trends is therefore a downside risk to our estimates.
- **Asset quality:** like in the past, we do not expect a significant deterioration in the bank's asset quality due to the high interest rate environment. We therefore forecast a modest 60bp yoy increase in cost of risk in FY16. Stronger than expected deterioration in asset quality is therefore a downside risk to our estimates.

# Diamond Trust Bank: Imperial shine

| | |
|---|---|
| Price | 187 |
| Target price | **295.89** |
| Expected share price return | 58.2% |
| Expected dividend yield | 1.5% |
| **Expected total return** | **59.7%** |
| Market cap (mn) | 46,001 |
| Market cap (US$mn) | 449 |
| Avg. daily volume (US$) | 18,488 |

- **We upgrade our recommendation to BUY:** (from HOLD) based on a target price of KES295.9 (previously KES226), giving an ETR of 59.7% at the current market price of KES187. Our target price is 1.7x FY16f BVPS and 8.2x forward EPS.
- **9M15 review:** EPS for the nine-month period increased by 15.9% yoy to KES17.5 and annualised ROE declined by 240bp yoy to 18.4%. The drop in ROE is attributable primarily to a higher base effect following the bank's rights issue last year. Like its peers, the bank's margins continued to contract (-40bp yoy to 7.4%). The bank's cost of risk also increased (from a low base) by 40bp to 1.1%. On the positive side, loan growth remains strong (+36.5% yoy), opex growth remains contained (+12.2% yoy) and non-interest revenue growth is starting to accelerate (+17.5% yoy).
- **New vs old:** we have increased our FY15 EPS estimate by 7.2% to KES25.6 primarily because of higher loan growth estimates (FY15f of KES177.6bn vs KES165.4bn previously). We increase our FY16 and FY17 estimates by a much larger proportion (+21.8% and 19.5%) due to expectations of higher margins (+80bp in each year to 7.4% and 7.2% respectively). Like other banks, we expect DTB's asset yields will increase in FY16 due to the higher rate environment. We also think the bank may benefit from an influx of low cost funds due to a "flight to quality" of deposits following the collapse of Imperial and Dubai Bank; in particular from the former, as DTB has been picked by the Central Bank of Kenya to handle deposit refunds and we believe most of these deposits will remain captive at the bank and thus enable the bank to improve its funding profile. We therefore estimate DTB's deposit cost will increase by a modest 30bp in FY16, thus resulting in margin expansion of 70bp.
- **Investment recommendation explained**: DTB has been among the most consistent and highest quality performers within our Kenya banks universe over the past six years. During that period the bank's loan book and earnings have increased at a cumulative rate of 26% and 30% respectively, while its NPL ratio has averaged 1.1%. Given its strategic connection with the influential and wealthy Aga Khan community, we believe the bank can sustain this performance; we therefore forecast EPS growth of 21.8% per annum and average ROE of 21.4% over the next five years. We therefore believe the stock is undervalued at 1.1x FY16f BVPS compared to its historical average of1.9x.

**Table 19: DTB Investment summary table**

| Year to 31 Dec | 2013 | 2014 | 2015f | 2016f | 2017f |
|---|---|---|---|---|---|
| Net Income (mn) | 4,757 | 5,084 | 6,207 | 8,707 | 10,800 |
| EPS | 21.61 | 21.00 | 25.64 | 35.96 | 44.61 |
| EPS (Old) | 21.61 | 21.00 | 23.92 | 29.52 | 37.34 |
| P/E (x) | 9.9 | 11.2 | 7.4 | 5.3 | 4.3 |
| P/TBVPS (x) | 2.3 | 2.0 | 1.4 | 1.1 | 0.9 |
| DPS | 2.40 | 2.75 | 4.26 | 6.07 | 7.11 |
| Dividend yield (%) | 1.0% | 1.0% | 1.4% | 2.2% | 3.2% |
| TROE (%) | 26.2% | 21.0% | 18.8% | 19.5% | 20.6% |
| ROA (%) | 2.7% | 2.6% | 3.1% | 3.3% | 3.1% |

*Source: Company reports and Exotix estimates*

## Diamond Trust Bank profit model

In the table below, we provide a summary of DTB's profit model. Based on our analysis, we forecast ROE to increase to 22.5% in FY16 and to average 21.4% throughout our forecast period.

**Table 20: DTB profit model**

| (%) | FY13 | FY14 | FY15f | FY16f | FY17f | FY18f | FY19f | FY20f |
|---|---|---|---|---|---|---|---|---|
| Net interest income/average assets [1] | 7.3 | 6.8 | 6.4 | 7.1 | 7.0 | 6.8 | 6.6 | 6.5 |
| Non-interest income/average assets [2] | 2.2 | 2.0 | 1.9 | 1.9 | 1.9 | 1.8 | 1.7 | 1.7 |
| Operating expenses/average assets [3] | (4.1) | (3.8) | (3.4) | (3.3) | (3.3) | (3.2) | (3.0) | (2.8) |
| Net provisioning/average assets [4] | (0.6) | (0.5) | (0.8) | (0.8) | (0.3) | (0.4) | (0.5) | (0.5) |
| Tax/average assets [5] | (1.3) | (1.5) | (1.3) | (1.5) | (1.6) | (1.5) | (1.5) | (1.4) |
| Minority interest/average assets [6] | (0.3) | (0.3) | (0.3) | (0.3) | (0.4) | (0.4) | (0.4) | (0.4) |
| **ROA = [1+2+3+4+5+6]** | **3.1** | **2.7** | **2.6** | **3.1** | **3.3** | **3.1** | **3.1** | **3.0** |
| Average assets/average equity [7] | 8.1 | 7.6 | 7.5 | 7.4 | 7.0 | 6.8 | 6.7 | 6.7 |
| **ROE = [ROA * 7]** | **25.4** | **20.4** | **19.5** | **22.5** | **22.7** | **21.1** | **20.6** | **20.1** |

*Source: Company annual reports, Exotix estimates*

We make the following observations regarding the above:

- **Margin rebound:** The bank's NIM has consistently shrunk over the past three years, declining from an all-time high of 7.8% in FY12 to 6.6% in FY15. Like its peers, the decline is partly attributed to a decline in asset yields from the highs of 2011. The bank was initially able to mitigate the lower asset yields by reducing its funding costs (in FY13 NIM declined by only 10bp as average deposit cost declined by 250bp yoy). However, increasing competition from more aggressive Tier 2 banks has increased the pressure on the bank's funding costs (increasing to 5.5% by 1H15). We think the pressure on the bank's funding costs should improve as the bank benefits from a "flight to quality" of deposits as following the collapse of two mid Tier banks (Imperial and Dubai) in 2015. Indeed, DTB was picked by the Central Bank as one of the banks (along with KCB) to process refunds for Imperial deposits. We believe a significant proportion of the deposit refunds could remain captive at DTB, thus accelerating the bank's deposit growth and reducing the pressure on deposit costs. This trend was visible in the bank's 9M15 results with margins expanding by 40bp qoq in 3Q15. We therefore expect a 70bp yoy increase in margins in FY16 to 7.4%.
- **Balance sheet leverage declining despite strong loan growth:** historically, the bank's loan growth increased at a cumulative rate of 29% per annum and we forecast a similar growth rate in FY15. Like all its peers, we forecast loan growth to moderate to 13.2% in FY16 and 13.1% in FY17 due to high interest rates and the presidential election. We forecast cumulative loan growth of 21.7% from FY18 onwards translating to overall loan growth of 18.2% per annum over the next five years. Despite a relatively strong loan growth forecast, we estimate the bank's balance sheet leverage to decline from 7.6x to 6.7x due to its persistently low dividend payout ratio (five-year average of 11.3%). Our discussions with management indicate that they are unlikely to increase the payout significantly from current levels. We have therefore estimated an average payout ratio of 13.8% over the next five years, thus resulting in a build-up in shareholder equity. A potential higher dividend payout ratio is therefore an upside risk to our estimate. Likewise we note that in the past, the bank's loan growth has not decelerated in a high interest rate environment or prior to a presidential election. Thus the expected slowdown in loan growth may not materialise.
- **Risk charge to remain elevated in the short term:** given the rising interest rate environment, we forecast the bank's cost of risk to increase to 1.1% in FY15 and 1.2% in FY16 (vs a historical average of 0.9%) as the NPL ratio increases to 1.8% (from a historical average of 1.1%). Given the bank's strong track record of sustaining a very high quality of assets, we forecast the asset quality deterioration to be temporary; we therefore forecast the NPL ratio to decline to 1.1% by FY20 and the average cost of risk to moderate to 0.6% from FY17 onwards.

## Diamond Trust Bank: Key financials

### Table 21: Income statement (new vs old)

| | 2013 | 2014 | FY15f (old) | FY15f (new) | FY16f (old) | FY16f (new) | FY17f (old) | FY17f (new) |
|---|---|---|---|---|---|---|---|---|
| Interest income | 17,179 | 20,808 | 24,774 | 25,690 | 30,887 | 33,097 | 36,358 | 37,313 |
| Interest expense | (6,176) | (8,020) | (10,532) | (10,315) | (13,217) | (12,908) | (15,364) | (14,229) |
| **Net interest income** | **11,003** | **12,788** | **14,243** | **15,376** | **17,669** | **20,190** | **20,994** | **23,084** |
| Non-interest income | 3,350 | 3,777 | 4,598 | 4,574 | 5,365 | 5,319 | 6,388 | 6,145 |
| Operating revenue | 14,353 | 16,564 | 18,840 | 19,950 | 23,034 | 25,508 | 27,381 | 29,229 |
| Operating expenses | (6,223) | (7,197) | (8,217) | (8,159) | (9,560) | (9,464) | (10,815) | (10,996) |
| **Net operating profit** | **6,223** | **7,197** | **8,217** | **8,159** | **9,560** | **9,464** | **10,815** | **10,996** |
| Total provisions | (899) | (851) | (1,193) | (1,858) | (1,706) | (2,274) | (1,701) | (1,138) |
| **Pre-tax income** | **7,231** | **8,517** | **9,430** | **9,932** | **11,769** | **13,771** | **14,866** | **17,095** |
| Income taxes | (2,004) | (2,813) | (2,831) | (2,981) | (3,533) | (4,133) | (4,462) | (5,131) |
| Minority interest | 474 | 625 | 812 | 750 | 1,097 | 937 | 1,371 | 1,172 |
| **Attributable income** | **4,757** | **5,084** | **5,792** | **6,207** | **7,146** | **8,707** | **9,040** | **10,800** |
| **EPS** | **21.6** | **21.0** | **23.9** | **25.6** | **29.5** | **36.0** | **37.3** | **44.6** |
| **DPS** | **2.10** | **2.40** | **2.75** | **2.75** | **3.50** | **4.26** | **5.50** | **6.07** |
| **BVPS** | **95.2** | **119.6** | **141.2** | **142.9** | **167.9** | **176.1** | **201.8** | **216.4** |

*Source: Company annual reports, Exotix estimates*

### Table 22: Balance sheet (new vs old)

| | 2013 | 2014 | FY15f (old) | FY15f (new) | FY16f (old) | FY16f (new) | FY17f (old) | FY17f (new) |
|---|---|---|---|---|---|---|---|---|
| **Total assets** | | | | | | | | |
| Cash and cash equivalents | 12,709 | 15,910 | 19,537 | 19,446 | 23,595 | 22,383 | 28,748 | 26,703 |
| Money market & interbank assets | 8,786 | 13,701 | 17,584 | 15,557 | 21,235 | 20,144 | 25,873 | 24,033 |
| Investment securities | 25,446 | 35,101 | 42,982 | 42,781 | 54,268 | 49,242 | 66,121 | 66,759 |
| **Gross loans** | 114,086 | 141,292 | 169,974 | 182,792 | 200,554 | 208,158 | 247,235 | 234,990 |
| Reserves | (3,140) | (3,638) | (4,546) | (5,211) | (5,915) | (7,057) | (7,147) | (7,520) |
| **Net loans** | **110,945** | **137,655** | **165,428** | **177,581** | **194,639** | **201,101** | **240,088** | **227,470** |
| Property and equipment | 4,879 | 5,272 | 5,772 | 5,772 | 6,272 | 6,272 | 6,522 | 6,772 |
| Other assets | 3,755 | 3,900 | 4,230 | 4,230 | 4,612 | 4,592 | 5,030 | 5,013 |
| **Total assets** | **166,520** | **211,539** | **255,533** | **265,367** | **304,621** | **303,734** | **372,383** | **356,750** |
| **Total liabilities & equity** | | | | | | | | |
| **Total shareholders' equity** | 20,951 | 28,963 | 34,174 | 34,589 | 40,655 | 42,630 | 48,848 | 52,397 |
| Minority interest | 2,793 | 3,300 | 4,113 | 4,050 | 5,209 | 4,988 | 6,580 | 6,159 |
| Borrowed funds | 5,760 | 12,287 | 14,951 | 25,360 | 14,893 | 24,556 | 20,358 | 22,352 |
| Amounts due to other banks | 4,718 | 2,393 | 2,931 | 2,917 | 3,539 | 3,357 | 4,312 | 4,006 |
| **Customer deposits** | **128,788** | **160,956** | **195,372** | **194,460** | **235,946** | **223,826** | **287,482** | **267,035** |
| Other liabilities | 3,509 | 3,640 | 3,991 | 3,991 | 4,378 | 4,378 | 4,802 | 4,802 |
| **Total equity and liabilities** | **166,520** | **211,539** | **255,533** | **265,367** | **304,621** | **303,734** | **372,383** | **356,750** |

*Source: Company annual reports, Exotix estimates*

**Table 23: Income statement (yoy trends)**

| | 2013 | 2014 | % ch | FY15f | % ch | FY16f | %ch | FY17f | % ch |
|---|---|---|---|---|---|---|---|---|---|
| Interest income | 17,179 | 20,808 | 21.1% | 25,690 | 23.5% | 33,097 | 28.8% | 37,313 | 12.7% |
| Interest expense | (6,176) | (8,020) | 29.9% | (10,315) | 28.6% | (12,908) | 25.1% | (14,229) | 10.2% |
| **Net interest income** | **11,003** | **12,788** | **16.2%** | **15,376** | **20.2%** | **20,190** | **31.3%** | **23,084** | **14.3%** |
| Non-interest income | 3,350 | 3,777 | 12.7% | 4,574 | 21.1% | 5,319 | 16.3% | 6,145 | 15.5% |
| Operating revenue | 14,353 | 16,564 | 15.4% | 19,950 | 20.4% | 25,508 | 27.9% | 29,229 | 14.6% |
| Operating expenses | (6,223) | (7,197) | 15.6% | (8,159) | 13.4% | (9,464) | 16.0% | (10,996) | 16.2% |
| **Net operating profit** | **8,130** | **9,368** | **15.2%** | **11,791** | **25.9%** | **16,045** | **36.1%** | **18,233** | **13.6%** |
| Total provisions | (899) | (851) | -5.3% | (1,858) | 118.3% | (2,274) | 22.4% | (1,138) | -50.0% |
| **Pre-tax income** | 7,231 | 8,517 | 17.8% | 9,932 | 16.6% | 13,771 | 38.6% | 17,095 | 24.1% |
| Income taxes | (2,004) | (2,813) | 40.3% | (2,981) | 6.0% | (4,133) | 38.6% | (5,131) | 24.1% |
| Minority interest | (474) | (625) | 31.8% | (750) | 20.0% | (937) | 25.0% | (1,172) | 25.0% |
| **Attributable income** | **4,757** | **5,084** | **6.9%** | **6,207** | **22.1%** | **8,707** | **40.3%** | **10,800** | **24.0%** |
| **EPS** | **21.6** | **21.0** | **-2.8%** | **25.6** | **22.1%** | **36.0** | **40.3%** | **44.6** | **24.0%** |
| **DPS** | **2.10** | **2.40** | **14.3%** | **2.75** | **14.6%** | **4.26** | **55.1%** | **6.07** | **42.3%** |
| **BVPS** | **95.2** | **119.6** | **25.7%** | **142.9** | **19.4%** | **176.1** | **23.2%** | **216.4** | **22.9%** |

*Source: Company annual reports, Exotix estimates*

**Table 24: Balance sheet (yoy trends)**

| | 2013 | 2014 | % ch | FY15f | % ch | FY16f | %ch | FY17f | % ch |
|---|---|---|---|---|---|---|---|---|---|
| **Total assets** | | | | | | | | | |
| Cash and cash equivalents | 12,709 | 15,910 | 25.2% | 19,446 | 22.2% | 22,383 | 15.1% | 26,703 | 19.3% |
| Interbank assets | 8,786 | 13,701 | 55.9% | 15,557 | 13.5% | 20,144 | 29.5% | 24,033 | 19.3% |
| Investment securities | 25,446 | 35,101 | 37.9% | 42,781 | 21.9% | 49,242 | 15.1% | 66,759 | 35.6% |
| **Gross loans** | 114,086 | 141,292 | 23.8% | 182,792 | 29.4% | 208,158 | 13.9% | 234,990 | 12.9% |
| Reserves | (3,140) | (3,638) | 15.8% | (5,211) | 43.3% | (7,057) | 35.4% | (7,520) | 6.6% |
| **Net loans** | **110,945** | **137,655** | **24.1%** | **177,581** | **29.0%** | **201,101** | **13.2%** | **227,470** | **13.1%** |
| Property and equipment | 4,879 | 5,272 | 8.1% | 5,772 | 9.5% | 6,272 | 8.7% | 6,772 | 8.0% |
| Other assets | 3,755 | 3,900 | 3.9% | 4,230 | 8.4% | 4,592 | 8.6% | 5,013 | 9.2% |
| **Total assets** | **166,520** | **211,539** | **27.0%** | **265,367** | **25.4%** | **303,734** | **14.5%** | **356,750** | **17.5%** |
| **Total liabilities & equity** | | | | | | | | | |
| **Total shareholders' equity** | **20,951** | **28,963** | **38.2%** | **34,589** | **19.4%** | **42,630** | **23.2%** | **52,397** | **22.9%** |
| Minority interest | 2,793 | 3,300 | 18.1% | 4,050 | 22.7% | 4,988 | 23.1% | 6,159 | 23.5% |
| Borrowed funds | 5,760 | 12,287 | 113.3% | 25,360 | 106.4% | 24,556 | -3.2% | 22,352 | -9.0% |
| Amounts due to other banks | 4,718 | 2,393 | -49.3% | 2,917 | 21.9% | 3,357 | 15.1% | 4,006 | 19.3% |
| **Customer deposits** | **128,788** | **160,956** | **25.0%** | **194,460** | **20.8%** | **223,826** | **15.1%** | **267,035** | **19.3%** |
| Other liabilities | 3,509 | 3,640 | 3.7% | 3,991 | 9.6% | 4,378 | 9.7% | 4,802 | 9.7% |
| **Total equity and liabilities** | **166,520** | **211,539** | **27.0%** | **265,367** | **25.4%** | **303,734** | **14.5%** | **356,750** | **17.5%** |

*Source: Company annual reports, Exotix estimates*

**Table 25: DTB financial ratios**

| | 2013 | 2014 | FY15f | FY16f | FY17f |
|---|---|---|---|---|---|
| **Margins (%)** | | | | | |
| Net interest margin | 7.7 | 7.1 | 6.7 | 7.4 | 7.2 |
| Yield on average earning assets | 11.9 | 11.6 | 11.2 | 12.1 | 11.7 |
| Cost of interest bearing liabilities | 4.9 | 5.1 | 5.2 | 5.4 | 5.2 |
| Cost/income | 43.4 | 43.4 | 40.9 | 37.1 | 37.6 |
| Cost of risk | 0.9 | 0.7 | 1.1 | 1.2 | 0.5 |
| **Growth (%)** | | | | | |
| Gross loans (%) | 26.6 | 23.8 | 29.4 | 13.9 | 12.9 |
| Deposits (%) | 20.4 | 25.0 | 20.8 | 15.1 | 19.3 |
| Total assets (%) | 22.9 | 27.0 | 25.4 | 14.5 | 17.5 |
| **Returns (%)** | | | | | |
| Return on average equity | 25.4 | 20.4 | 19.5 | 22.5 | 22.7 |
| Return on average assets | 3.1 | 2.7 | 2.6 | 3.1 | 3.3 |
| **Asset quality (%)** | | | | | |
| NPL ratio | 1.1 | 1.1 | 1.3 | 1.8 | 1.5 |
| NPL cover | 98.5 | 90.5 | 90.0 | 90.0 | 95.0 |
| **Asset mix (%)** | | | | | |
| Gross loans to deposit | 88.6 | 87.8 | 94.0 | 93.0 | 88.0 |
| Net loans to assets | 66.6 | 65.1 | 66.9 | 66.2 | 63.8 |
| Investment securities to total assets | 15.3 | 16.6 | 16.1 | 16.2 | 18.7 |
| Interbank lending to total assets | 15.3 | 16.6 | 16.1 | 16.2 | 18.7 |
| Cash to total assets | 7.6 | 7.5 | 7.3 | 7.4 | 7.5 |
| **Funding mix (%)** | | | | | |
| Deposits to total funding | 77.3 | 76.1 | 73.3 | 73.7 | 74.9 |
| Interbank borrowing to total funding | 2.8 | 1.1 | 1.1 | 1.1 | 1.1 |
| Other borrowing to total funding | 3.5 | 5.8 | 9.6 | 8.1 | 6.3 |
| Equity to total funding | 12.6 | 13.7 | 13.0 | 14.0 | 14.7 |
| Capital adequacy ratio | 19.3 | 19.4 | 17.3 | 17.9 | 18.2 |

*Source: Banks annual reports, Exotix estimates*

## Valuation

Our fair value estimate and target price for DTK is KES295.89/share.

### Methodology

To calculate our fair value estimate for DTK we applied a two-stage dividend discount model:

Stage 1 - between FY16 and FY20 we estimated the present value of dividends using the profitability drivers we discuss above.

Stage 2 – we determine the terminal value as the perpetual growth rate in the bank's book value based on its average ROE between FY16 and FY20 and a terminal growth rate assumption of 8.0%.

We assume a cost of equity (CoE) of 16.5%, using a risk-free rate of 11.5%, an equity risk premium of 5% and a beta of 1.0x. As our valuation is Kenyan shilling-based, we have applied an 8% terminal growth rate.

In the table below, we provide our assumptions used to calculate our fair value estimate of the bank.

**Table 26: DTK valuation summary**

| (KESbn) | 2015f | 2016f | 2017f | 2018f | 2019f |
|---|---|---|---|---|---|
| Aggregate Dividend | 1,032 | 1,469 | 1,721 | 2,092 | 2,466 |
| PV | 886 | 1,082 | 1,089 | 1,136 | 1,149 |
| Total PV | 5,342 | | | | |
| **Terminal Value** | | | | | |
| Average RoAE | | | | | 21.4% |
| CoE | | | | | 16.5% |
| Growth | | | | | 8.0% |
| Book value in 2020 | | | | | 90,260 |
| Terminal value | | | | | 142,272 |
| PV of Terminal Value | 66,296.4 | | | | |
| **Total PV** | **71,63** | | | | |
| Shares in issue (mn) | 242 | | | | |
| **Per share value** | **295.9** | | | | |

*Source: Bank annual reports, Exotix estimates*

### Risks

- **Margin risk**: As discussed above, we expect the bank's margins to improve in FY16 due to the high interest rate environment and "flight to quality" of deposits. A lower than expected increase in margins (or even a decrease) is therefore a key downside risk to our estimates.
- **Expansion into other countries**: In the past, management have indicated their desire to expand into other East and Central African countries in the medium term. Due to a lack of information, we do not include any further expansion in our forecasts.
- **Asset quality:** although we forecast the bank's asset quality to deteriorate in FY16 due to the high interest rate environment, we expect it to converge back towards its long-term average of 1% in the medium term. A prolonged deterioration in asset quality is therefore a key downside risk to our estimates.

# Equity Bank Group: bank morphing into group

| Price | 39 |
|---|---|
| Target price | **N/R** |
| Expected share price return | - |
| Expected dividend yield | - |
| **Expected total return** | **-** |
| Market cap (mn) | 147,173 |
| Market cap (US$mn) | 1,437 |
| Avg. daily volume (US$) | 2,405 |

- **Earnings update.** We continue to have no recommendation on the group due to our joint venture with the institution in Kenya. However, we roll forward our earnings estimates to take into consideration recent developments. Based on our estimates, the group is trading at a FY16 P/BVPS of 1.5x (vs average of 1.1x for the other banks) and P/EPS of 8.5x (vs an average of 6.5x).
- **9M15 review**. EPS for the nine-month period increased by 14.2% yoy to KES3.5 and ROE declined by 200bp to 25.1%. Customer loans during the period increased by 27.4% driven by strong growth across most of the subsidiaries as well as the acquisition of ProCredit DRC. The NPL ratio remained steady at 4.3%. Like all banks, Equity's margins were under pressure in the first six months of 2015 (down 130bp yoy to 9.4%), but unlike other banks it expanded sharply in 3Q15 (up 130bp qoq) as the bank adjusted its lending rates in a higher interest rate environment. Continued strong opex growth (as the bank sustained the roll out of its alternative banking channels) resulted in the cost to income ratio edging up 110bp to 53.0%.
- **New vs old.** Based on the 9M15 results, we reduce our FY15 earnings estimates by 3.2% mainly as our higher asset and margin estimates are offset by stronger opex growth. The sharp reversal in margins in 3Q15 makes us optimistic for strong top-line growth in FY16 and FY17 and we therefore increase our EPS estimates by 7.5% and 11.1% respectively for the next two years. Our long-term estimates are little changed (FY19 EPS estimate up 2.9%) as moderately higher asset and margin forecasts will be partially offset by higher operating costs.
- **Kenya dominating, but group becoming more relevant.** Historically, the investment narrative for Equity has been dominated by its performance in Kenya as the contribution from other subsidiaries was too small (less than 10%). We think that view will continue to dominate in the short term as asset growth in Kenya remains strong and RoA for the subsidiary is far higher than the group average. However, in the medium term, we believe the group will come into more focus as it continues to expand into new territories or businesses (like DRC in 2015 and Bancassurance in 2014) and gains traction from its existing subsidiaries (Rwanda and Tanzania have recorded strong growth over the past two years and have turned around their loss-making positions). As at 9M15, non-Kenya subsidiaries contributed 14% of PBT and 29% of assets. We would note that the group's performance outside Kenya is now better than KCB's; although KCB's non-Kenya subsidiaries' contribution to the group is similar (28%), the PBT contribution is lower (12%) and most of that comes from South Sudan. We therefore believe that the increasing contribution from outside Kenya (both from a growth and profitability perspective) should enable the group to sustain its strong growth momentum and profitability profile: we forecast cumulative loan growth of 20% per annum and average ROE of 27.3% over the next five years.

**Table 27: Equity Bank investment summary table**

| Year to 31 Dec | 2013 | 2014 | 2015f | 2016f | 2017f |
|---|---|---|---|---|---|
| Net Income (mn) | 13,278 | 17,151 | 18,385 | 25,336 | 30,888 |
| EPS | 3.59 | 4.63 | 4.87 | 6.71 | 8.19 |
| EPS (Old) | 3.59 | 4.63 | 5.03 | 6.24 | 7.36 |
| P/E (x) | 8.9 | 11.0 | 8.0 | 5.8 | 4.8 |
| P/TBVPS (x) | 2.3 | 3.1 | 1.9 | 1.6 | 1.3 |
| DPS | 1.50 | 1.80 | 1.95 | 2.50 | 3.25 |
| Dividend yield (%) | 4.9% | 3.6% | 5.0% | 6.4% | 8.3% |
| TROE (%) | 29.5% | 31.5% | 27.4% | 30.6% | 30.2% |
| ROA (%) | 5.1% | 5.5% | 4.6% | 5.1% | 5.1% |

*Source: Company reports and Exotix estimates*

## Equity Bank: Profit model

In the table below we provide a summary of Equity's profit model. Based on the analysis provided below, we are forecasting ROE to increase to 29.1% in FY16 before gradually declining to 26.2% by FY20.

**Table 28: Equity Bank profit model**

| (%) | FY13 | FY14 | FY15f | FY16f | FY17f | FY18f | FY19f | FY20f |
|---|---|---|---|---|---|---|---|---|
| Net interest income/ average assets [1] | 10.1 | 9.4 | 9.1 | 9.7 | 9.1 | 8.2 | 7.9 | 7.8 |
| Non-interest income/ average assets [2] | 5.9 | 5.9 | 5.9 | 5.8 | 5.7 | 5.8 | 5.7 | 5.5 |
| Operating expenses/ average assets [3] | (7.9) | (8.0) | (8.0) | (7.7) | (7.2) | (7.0) | (6.7) | (6.3) |
| Net provisioning/ average assets [4] | (0.9) | (0.5) | (0.6) | (0.9) | (0.6) | (0.6) | (0.6) | (0.6) |
| Associate income/ average assets [5] | 0.1 | 0.3 | - | - | - | - | - | - |
| tax/average assets [6] | (2.2) | (1.7) | (1.7) | (1.9) | (1.9) | (1.7) | (1.7) | (1.7) |
| Average assets / average equity [7] | 5.5 | 5.4 | 5.6 | 5.7 | 5.6 | 5.6 | 5.6 | 5.6 |
| ROA = [1+2+3+4+5+6] | **5.1** | **5.5** | **4.6** | **5.1** | **5.1** | **4.7** | **4.6** | **4.7** |
| **ROE = [ROA * 7]** | **28.1** | **29.7** | **25.9** | **29.1** | **28.9** | **26.3** | **25.9** | **26.2** |

*Source: Company annual reports, Exotix estimates*

We make the following observations regarding the above:

- **Margins to rebound in the short term:** Equity's margins have been under sustained pressure over the last three years, declining from a high of 11.9% in FY12 to 9.4% in 1H15 due to a low interest rate environment. The group's margins however rebounded in 3Q15 following the 300bp increase in Monetary Policy Rate at the beginning of the quarter; the bank managed to increase its effective lending rate by 270bp to 17.7% whereas its cost of deposits remained flat on a qoq basis at 2.3%. We believe the bank can carry through the margin expansion into next year and therefore forecast a 60bp yoy increase in NIMs in FY16. We forecast margins to gradually decline thereafter to 8.6% by FY20 as interest rates continue to normalise at a lower level.
- **Top line growth should be supported by strong NIR growth:** as discussed previously, the bank has been the pioneer in rolling out alternative banking channels such as Agency and Mobile banking. We believe the bank's investments into these segments should enable it to sustain non-interest revenue growth momentum driven by increased penetration and introduction of new products. We therefore estimate non-interest revenue should continue growing at 19.1% per annum over the next five years, contributing on average 40% of total operating income.
- **Operating efficiency to improve as investment intensity moderates:** despite a reduction in branch roll-out, the group's opex growth has remained fairly strong over the past three years (cumulative average growth of 21% per annum). We forecast opex growth to moderate from FY16 onwards as the bank has reached critical mass in its roll out of alternative channels. We therefore estimate opex growth of 19.7% in FY16 and a cumulative increase of 15% over the next five years. Moderation in opex growth combined with continued strong top-line growth should result in the cost to income ratio improving to 47.5% by FY20 from an estimated 53.5% in FY15.
- **Increasing contribution from subsidiaries should sustain balance sheet growth:** we estimate group subsidiaries will contribute c.26.3% of total deposits in FY15. Continued strong growth of non-Kenyan subsidiaries (albeit from a low base) should increase their total contribution of group deposits to 35.9% by FY20, thus translating to growth in group deposits of 20.3% per annum. As in the past, we expect Equity to utilise the funding primarily for lending opportunities and thus assume an average loan to deposit ratio of 81.5%, translating to gross loan growth of 20% per annum. Based on our assumptions, we estimate the group's loan portfolio will triple between FY14 and FY20.

# Equity Bank: Key financials

## Table 29: Income statement (new vs old)

| | 2013 | 2014 | FY15f (old) | FY15f (new) | FY16f (old) | FY16f (new) | FY17f (old) | FY17f (new) |
|---|---|---|---|---|---|---|---|---|
| Interest income | 31,890 | 35,367 | 41,465 | 44,697 | 51,757 | 59,947 | 58,056 | 67,589 |
| Interest expense | (5,499) | (6,192) | (8,172) | (8,499) | (10,945) | (11,438) | (11,920) | (12,679) |
| **Net interest income** | **26,391** | **29,175** | **33,293** | **36,198** | **40,812** | **48,509** | **46,137** | **54,910** |
| Non-interest income | 15,371 | 18,474 | 21,853 | 23,309 | 26,395 | 28,771 | 32,952 | 34,332 |
| Operating revenue | 41,761 | 47,649 | 55,146 | 59,507 | 67,207 | 77,280 | 79,089 | 89,242 |
| Operating expenses | (20,656) | (24,758) | (27,572) | (31,862) | (31,925) | (38,138) | (37,662) | (43,300) |
| **Net operating profit** | **21,105** | **22,891** | **27,573** | **27,645** | **35,282** | **39,142** | **41,427** | **45,942** |
| Total provisions | 2,302 | 1,591 | 2,035 | 2,460 | 3,616 | 4,435 | 4,071 | 3,629 |
| **Pre-tax income** | **18,803** | **21,300** | **25,538** | **25,186** | **31,666** | **34,707** | **37,356** | **42,313** |
| Income taxes | (5,726) | (5,213) | (6,895) | (6,800) | (8,550) | (9,371) | (10,086) | (11,424) |
| **Attributable income** | **13,278** | **17,151** | **18,643** | **18,385** | **23,116** | **25,336** | **27,270** | **30,888** |
| **EPS** | **3.59** | **4.63** | **5.03** | **4.87** | **6.24** | **6.71** | **7.36** | **8.19** |
| **DPS** | **1.50** | **1.80** | **2.00** | **1.95** | **2.30** | **2.50** | **3.00** | **3.25** |
| **BVPS** | **13.9** | **17.2** | **20.3** | **20.7** | **24.6** | **25.4** | **29.6** | **31.1** |

*Source: Company annual reports, Exotix estimates*

## Table 30: Balance sheet (new vs old)

| | 2013 | 2014 | FY15f (old) | FY15f (new) | FY16f (old) | FY16f (new) | FY17f (old) | FY17f (new) |
|---|---|---|---|---|---|---|---|---|
| **Total assets** | | | | | | | | |
| Cash and cash equivalents | 25,332 | 33,071 | 24,169 | 42,547 | 28,338 | 51,764 | 34,595 | 62,916 |
| Money market & interbank assets | 9,196 | 13,968 | 36,253 | 32,729 | 42,506 | 43,800 | 47,568 | 58,076 |
| Investment securities | 44,572 | 48,369 | 54,380 | 58,912 | 70,844 | 87,600 | 90,812 | 116,152 |
| **Gross loans** | **178,630** | **224,491** | **268,880** | **281,468** | **309,943** | **324,518** | **378,385** | **372,656** |
| Reserves | (7,267) | (10,321) | (8,429) | (8,854) | (9,903) | (10,956) | (11,533) | (11,664) |
| **Net loans** | **171,363** | **214,170** | **260,450** | **272,614** | **300,040** | **313,562** | **366,851** | **360,992** |
| Property and equipment | 9,796 | 10,528 | 11,528 | 14,528 | 12,778 | 15,778 | 14,278 | 17,278 |
| Other assets | 17,470 | 23,285 | 28,019 | 28,019 | 33,742 | 33,742 | 40,731 | 40,731 |
| **Total assets** | **277,729** | **343,392** | **414,801** | **449,350** | **488,249** | **546,247** | **594,836** | **656,146** |
| **Total liabilities & equity** | | | | | | | | |
| **Total shareholders' equity** | **51,556** | **63,776** | **75,253** | **77,996** | **90,958** | **95,978** | **109,689** | **117,430** |
| Borrowed funds | 26,731 | 30,242 | 31,270 | 32,110 | 35,693 | 41,613 | 43,838 | 42,118 |
| Amounts due to other banks | 536 | 535 | 755 | 6,546 | 886 | 3,982 | 1,081 | 4,840 |
| **Customer deposits** | **194,621** | **245,383** | **302,112** | **327,288** | **354,220** | **398,182** | **432,439** | **483,969** |
| Other liabilities | 4,285 | 4,636 | 5,410 | 5,410 | 6,492 | 6,492 | 7,790 | 7,790 |
| **Total equity and liabilities** | **277,729** | **344,572** | **414,801** | **449,350** | **488,249** | **546,247** | **594,836** | **656,146** |

*Source: Company annual reports, Exotix estimates*

**Table 31: Income statement (yoy trends)**

| | 2013 | 2014 | % ch | FY15f | % ch | FY16f | %ch | FY17f | % ch |
|---|---|---|---|---|---|---|---|---|---|
| Interest income | 31,890 | 35,367 | 10.9% | 44,697 | 26.4% | 59,947 | 34.1% | 67,589 | 12.7% |
| Interest expense | (5,499) | (6,192) | 12.6% | (8,499) | 37.2% | (11,438) | 34.6% | (12,679) | 10.9% |
| **Net interest income** | **26,391** | **29,175** | **10.5%** | **36,198** | **24.1%** | **48,509** | **34.0%** | **54,910** | **13.2%** |
| Non-interest income | 15,371 | 18,474 | 20.2% | 23,309 | 26.2% | 28,771 | 23.4% | 34,332 | 19.3% |
| Operating revenue | 41,761 | 47,649 | 14.1% | 59,507 | 24.9% | 77,280 | 29.9% | 89,242 | 15.5% |
| Operating expenses | (20,656) | (24,758) | 19.9% | (31,862) | 28.7% | (38,138) | 19.7% | (43,300) | 13.5% |
| **Net operating profit** | **21,105** | **22,891** | **8.5%** | **27,645** | **20.8%** | **39,142** | **41.6%** | **45,942** | **17.4%** |
| Total provisions | 2,302 | 1,591 | -30.9% | 2,460 | 54.6% | 4,435 | 80.3% | 3,629 | -18.2% |
| **Pre-tax income** | 18,803 | 21,300 | 13.3% | 25,186 | 18.2% | 34,707 | 37.8% | 42,313 | 21.9% |
| Income taxes | (5,726) | (5,213) | -9.0% | (6,800) | 30.5% | (9,371) | 37.8% | (11,424) | 21.9% |
| **Attributable income** | **13,278** | **17,151** | **29.2%** | **18,385** | **7.2%** | **25,336** | **37.8%** | **30,888** | **21.9%** |
| **EPS** | **3.59** | **4.63** | **29.2%** | **4.87** | **5.2%** | **6.71** | **37.8%** | **8.19** | **21.9%** |
| **DPS** | **1.50** | **1.80** | **20.0%** | **1.95** | **8.3%** | **2.50** | **28.3%** | **3.25** | **30.0%** |
| **BVPS** | **13.9** | **17.2** | **23.7%** | **20.7** | **20.0%** | **25.4** | **23.1%** | **31.1** | **22.4%** |

*Source: Company annual reports, Exotix estimates*

**Table 32: Balance sheet (yoy trends)**

| | 2013 | 2014 | % ch | FY15f | % ch | FY16f | %ch | FY17f | % ch |
|---|---|---|---|---|---|---|---|---|---|
| **Total assets** | | | | | | | | | |
| Cash and cash equivalents | 25,332 | 33,071 | 30.6% | 42,547 | 28.7% | 51,764 | 21.7% | 62,916 | 21.5% |
| Interbank assets | 9,196 | 13,968 | 51.9% | 32,729 | 134.3% | 43,800 | 33.8% | 58,076 | 32.6% |
| Investment securities | 44,572 | 48,369 | 8.5% | 58,912 | 21.8% | 87,600 | 48.7% | 116,152 | 32.6% |
| **Gross loans** | **178,630** | **224,491** | **25.7%** | **281,468** | **25.4%** | **324,518** | **15.3%** | **372,656** | **14.8%** |
| Reserves | (7,267) | (10,321) | 42.0% | (8,854) | -14.2% | (10,956) | 23.7% | (11,664) | 6.5% |
| **Net loans** | **171,363** | **214,170** | **25.0%** | **272,614** | **27.3%** | **313,562** | **15.0%** | **360,992** | **15.1%** |
| Property and equipment | 9,796 | 10,528 | 7.5% | 14,528 | 38.0% | 15,778 | 8.6% | 17,278 | 9.5% |
| Other assets | 17,470 | 23,285 | 33.3% | 28,019 | 20.3% | 33,742 | 20.4% | 40,731 | 20.7% |
| **Total assets** | **277,729** | **343,392** | **23.6%** | **449,350** | **30.9%** | **546,247** | **21.6%** | **656,146** | **20.1%** |
| **Total liabilities & equity** | | | | | | | | | |
| **Total shareholders' equity** | **51,556** | **63,776** | **23.7%** | **77,996** | **22.3%** | **95,978** | **23.1%** | **117,430** | **22.4%** |
| Borrowed funds | 26,731 | 30,242 | 13.1% | 32,110 | 6.2% | 41,613 | 29.6% | 42,118 | 1.2% |
| Amounts due to other banks | 536 | 535 | -0.2% | 6,546 | 1122.8% | 3,982 | -39.2% | 4,840 | 21.5% |
| **Customer deposits** | **194,621** | **245,383** | **26.1%** | **327,288** | **33.4%** | **398,182** | **21.7%** | **483,969** | **21.5%** |
| Other liabilities | 4,285 | 4,636 | 8.2% | 5,410 | 16.7% | 6,492 | 20.0% | 7,790 | 20.0% |
| **Total equity and liabilities** | **277,729** | **344,572** | **24.1%** | **449,350** | **30.4%** | **546,247** | **21.6%** | **656,146** | **20.1%** |

*Source: Company annual reports, Exotix estimates*

**Table 33: Key ratios**

| | 2013 | 2014f | FY15f | FY16f | FY17f |
|---|---|---|---|---|---|
| **Margins (%)** | | | | | |
| Net interest margin | 11.2 | 10.4 | 10.1 | 10.7 | 10.0 |
| Yield on average earning assets | 13.5 | 12.6 | 12.5 | 13.3 | 12.3 |
| Cost of interest bearing liabilities | 2.6 | 2.5 | 2.6 | 2.8 | 2.6 |
| Cost/income | 49.5 | 52.0 | 53.5 | 49.4 | 48.5 |
| Cost of risk | 1.4 | 0.8 | 1.0 | 1.5 | 1.0 |
| **Growth (%)** | | | | | |
| Gross loans (%) | 27.6 | 25.7 | 25.4 | 15.3 | 14.8 |
| Deposits (%) | 15.9 | 26.1 | 33.4 | 21.7 | 21.5 |
| Total assets (%) | 14.2 | 23.6 | 30.9 | 21.6 | 20.1 |
| **Returns (%)** | | | | | |
| Return on average equity | 28.1 | 29.7 | 25.9 | 29.1 | 28.9 |
| Return on average assets | 5.1 | 5.5 | 4.6 | 5.1 | 5.1 |
| **Asset quality (%)** | | | | | |
| NPL ratio | 5.2 | 4.3 | 4.3 | 6.0 | 5.0 |
| NPL cover | 51 | 69.3 | 65 | 50 | 55 |
| **Asset mix (%)** | | | | | |
| Gross loans to deposit | 91.8 | 91.5 | 86.0 | 81.5 | 77.0 |
| Net loans to assets | 61.7 | 62.4 | 60.7 | 57.4 | 55.0 |
| Investment securities to total assets | 16.0 | 14.1 | 13.1 | 16.0 | 17.7 |
| Interbank lending to total assets | 3.3 | 4.1 | 7.3 | 8.0 | 8.9 |
| Cash to total assets | 9.1 | 9.6 | 9.5 | 9.5 | 9.6 |
| **Funding mix (%)** | | | | | |
| Deposits to total funding | 70.1 | 71.2 | 72.8 | 72.9 | 73.8 |
| Interbank borrowing to total funding | 0.2 | 0.2 | 1.5 | 0.7 | 0.7 |
| Other borrowing to total funding | 9.6 | 8.8 | 7.1 | 7.6 | 6.4 |
| Equity to total funding | 18.6 | 18.6 | 17.4 | 17.6 | 17.9 |
| Capital adequacy ratio | 23.6 | 17.0 | 16.5 | 17.2 | 17.5 |

*Source: Company annual reports, Exotix estimates*

## Risks

In our opinion, the following are key risks to our forecasts and target price:

- **Execution risk:** as discussed earlier, we think the group's operations outside Kenya will come into focus as those operations increase in size and the bank expands into new countries. Our medium-term forecasts implicitly assume management can achieve reasonably high returns from these operations. Thus potentially poor execution outside Kenya is a key risk for our estimates.
- **Margin risk:** As discussed above, we expect the bank's margins to improve in FY16 due to the high interest rate environment and "flight to quality" of deposits. A lower than expected increase in margins (or even a decrease) is therefore a key downside risk to our estimates.
- **Non-interest revenue growth:** a key driver for our earnings estimate for the bank is continued strong growth in non-interest revenue on the back of increasing use of alternative banking channels. Potentially lower than expected pick-up in transaction volumes and/ or revenue per transaction is a key downside risk to our earnings estimates.

# KCB: breaking through the glass ceiling (temporarily)

| | |
|---|---|
| Price | 41.0 |
| Target price | **72.74** |
| Expected share price return | 77.4% |
| Expected dividend yield | 5.4% |
| **Expected total return** | **82.8%** |
| Market cap (mn) | 125,547 |
| Market cap (US$mn) | 1,226 |
| Avg. daily volume (US$k) | 1,146 |

- **We upgrade our recommendation to BUY** (previously HOLD) based on a target price of KES72.7, giving an ETR of 82.8% at the current market price. Our target price is 2.1x FY16f BVPS and 8.5x EPS.
- **9M15 review.** EPS growth for the nine-month period decelerated to 10.0% yoy to KES4.5 and annualised ROE reduced by 140bp yoy to 23.3%. The decline in profitability is attributable to shrinking margins (NIM declined by 150bp yoy to 7.2% - the lowest in the bank's corporate history) and a decline in non-interest revenue contribution (NIR to total income declined by 170bp yoy to 37.9%) due to non-recurrence of c.KES1.4bn worth of one-off revenue earned in FY14. On the flip side, opex growth remained in the single digits for the third year running (although CIR increased by 90bp yoy to 49.1% due to moderation in top-line growth) and loan growth of 31.5% yoy is very impressive, in our view (given it is the largest bank in East Africa).
- **New vs old.** The 9M15 results were largely in line with our estimates and we therefore increase our FY15 EPS forecast by a meagre 0.8% to KES6.19. We increase our FY16 and FY17 forecast by 9.3% and 12.2% to KES8.6 and KES10.2 due to our expectation of higher margins; management guidance during the 9M15 conference call indicated that they had increased their lending rates by 200-300bp towards the end of the quarter to compensate for the higher funding costs (deposit costs increased by 60bp qoq to 3.6%). Apart from the increase in lending rates, we expect the bank's funding costs to moderate as the bank benefits from a "flight to quality" of deposits following the collapse of Imperial and Dubai bank. Consequently, we expect the bank's margin to increase to 8.5%. We reduce our FY19 EPS forecast by 10.0% due to a lower medium-term margin estimate (7.3% vs 7.8%).
- **Our recommendation explained:** Despite announcing very strong earnings growth (CAGR of 14.3% per annum), KCB's profitability has consistently been below management guidance of +25%. The below guidance profitability is attributable to several factors including shrinking margins (throughout the four years), low loan growth (in FY12 and FY13) or spiking cost of risk (FY12 and FY14). We estimate a combination of strong asset growth momentum, expanding margins, contained opex growth and improvement in non-interest revenue growth should enable the bank to finally break through the 25% ceiling and record an ROE of 27.6%. We believe profitability will remain high next year (FY17f ROE of 27.0%) before gradually declining to 22.2% by FY20 as margins resume their long-term downward trajectory. We estimate an average ROE of 24.8% throughout our forecast period vs its historical average of 23.6%. On that basis, we believe the bank is undervalued at 1.2x BVPS vs its historical average of 1.9x.

**Table 34: KCB investment summary table**

| Year to 31 Dec | 2013 | 2014 | 2015f | 2016f | 2017f |
|---|---|---|---|---|---|
| Net Income (mn) | 14,341 | 16,849 | 18,740 | 25,893 | 30,859 |
| EPS | 4.83 | 5.57 | 6.19 | 8.56 | 10.20 |
| EPS (Old) | 4.83 | 5.57 | 6.15 | 7.83 | 9.09 |
| P/E (x) | 9.9 | 10.2 | 6.7 | 4.8 | 4.1 |
| P/TBVPS (x) | 2.3 | 2.3 | 1.5 | 1.2 | 1.0 |
| DPS | 2.00 | 2.00 | 2.20 | 3.00 | 3.50 |
| Dividend yield (%) | 4.2% | 3.5% | 5.4% | 7.2% | 8.4% |
| TROE (%) | 25.0% | 24.6% | 23.9% | 28.2% | 27.6% |
| ROA (%) | 3.8% | 3.8% | 3.5% | 4.0% | 4.0% |

*Source: Company reports and Exotix estimates*

## KCB profit model

In the table below we provide a summary of KCB's profit model. Based on the analysis provided below, we are forecasting ROE to increase to 27.6% in FY16 and to average 24.8% throughout our forecast period.

**Table 35: KCB profit model**

| (%) | FY13 | FY14 | FY15f | FY16f | FY17f | FY18f | FY19f | FY20f |
|---|---|---|---|---|---|---|---|---|
| Net interest income/ average assets [1] | 8.7 | 8.2 | 7.3 | 8.2 | 7.9 | 7.3 | 7.1 | 7.0 |
| Non-interest income/ average assets [2] | 3.9 | 4.4 | 3.7 | 3.6 | 3.5 | 3.4 | 3.3 | 3.2 |
| Operating expenses/ average assets [3] | (7.0) | (6.4) | (5.6) | (5.3) | (5.1) | (4.9) | (4.8) | (4.7) |
| Net provisioning/ average assets [4] | (0.3) | (0.7) | (0.5) | (0.8) | (0.5) | (0.6) | (0.6) | (0.7) |
| tax/average assets [5] | (1.5) | (1.6) | (1.5) | (1.7) | (1.7) | (1.5) | (1.5) | (1.5) |
| Average assets / average equity [6] | 6.5 | 6.3 | 6.8 | 6.9 | 6.7 | 6.6 | 6.6 | 6.6 |
| ROA = [1+2+3+4+5] | **3.8** | **3.8** | **3.5** | **4.0** | **4.0** | **3.6** | **3.5** | **3.4** |
| **ROE = [ROA * 6]** | **24.4** | **24.1** | **23.4** | **27.6** | **27.0** | **23.9** | **23.3** | **22.2** |

*Source: Company annual reports, Exotix estimates*

We make the following observations regarding the above:

- **Margins to rebound in the short term:** like its peers, the bank's net interest margin has shrunk significantly over the past three years, dropping from a high of 9.3% in FY12 to a low of 7.2% in 9M15. The drop in margin is partially attributable to a drop in asset yields in a declining interest rate environment. In KCB's case the drop is also attributable to significant growth in assets at its South Sudan subsidiary. Total assets in SS has doubled over the past 18 months and we believe more than 90% of these deposits are held as cash at the Central Bank of South Sudan earning very low (if any) yields. The increase in lending rates in Kenya (which still accounts for 90% of group loans) by 200-300bp at the end of 3Q15 should increase the effective asset yield by 90bp yoy to 11.9% in FY16. At the same time, we estimate the increase in the bank's deposit costs should be moderate (forecast +20bp yoy to 3.5%), thus resulting in a 70bp yoy increase in net interest margin to 8.5%. We believe margins will sustain their medium-term downward trajectory and thus forecast them to decline gradually to 7.3% by FY20.
- **Operating efficiency to improve from positive jaws:** a shift in expansion strategy towards low-cost alternative banking channels combined with cost-cutting initiatives implemented since 2012 has resulted in single digit opex growth in each of the past three years. While we forecast opex growth to accelerate from FY16 onwards, as the impact of cost-cutting measures begins to wear off, we believe it should remain relatively contained and thus estimate cumulative growth of 13.8% over the next five years. Moderate cost growth combined with continued strong top-line growth should result in the cost to income ratio improving to 45.9% by FY20 from an estimated 50.5% in FY15. The effect should be more pronounced in FY16 due to the margin expansion, resulting in the CIR dropping to 44.8% in FY16f.
- **Magnitude and volatility of asset quality is concerning:** despite a significant "clean-up" of its legacy bad debts, the bank's asset quality continues to remain significantly below the sector average; KCB's average NPL ratio over the past four years is 6.7% vs the sector average of 4.9%. Efforts to improve the bank's asset quality have consistently been hampered by a sharp increase in NPLs in one or two quarters which has been attributed by management to either special circumstances (like the 2013 elections) or "one or two" bad corporates. The regularity of the spike in NPLs makes us pessimistic about the bank's asset quality improving to the sector average. We therefore forecast the NPL ratio to increase to 8.25% in FY16 before gradually declining to 5.5% by FY20. Apart from the high NPLs, the bank's estimated NPL cover of 50% as at FY15 is amongst the lowest in the sector and we assume it will gradually increase to 60% by FY20. Based on our assumptions, we estimate the bank's average cost of risk will increase to 1.1% over the next five years compared to the recent historical average of 0.7%

## KCB: Key financials and ratios

### Table 36: Income statement (new vs old)

| | 2013 | 2014 | FY15f (old) | FY15f (new) | FY16f (old) | FY16f (new) | FY17f (old) | FY17f (new) |
|---|---|---|---|---|---|---|---|---|
| Interest income | 41,613 | 47,476 | 54,904 | 55,362 | 69,613 | 73,870 | 77,374 | 83,877 |
| Interest expense | (8,629) | (11,527) | (13,685) | (15,843) | (18,046) | (20,828) | (19,485) | (23,287) |
| **Net interest income** | **32,984** | **35,949** | **41,220** | **39,519** | **51,567** | **53,042** | **57,889** | **60,590** |
| Non-interest income | 14,878 | 19,235 | 20,700 | 20,247 | 24,060 | 23,295 | 28,208 | 26,615 |
| Operating revenue | 47,862 | 55,184 | 61,920 | 59,765 | 75,627 | 76,337 | 86,097 | 87,205 |
| Operating expenses | (26,743) | (28,308) | (31,428) | (30,190) | (36,018) | (34,163) | (41,196) | (39,085) |
| **Net operating profit** | **21,119** | **26,876** | **30,492** | **29,576** | **39,609** | **42,174** | **44,902** | **48,119** |
| Total provisions | 996 | 3,089 | 3,927 | 2,805 | 5,764 | 5,184 | 5,621 | 4,035 |
| **Pre-tax income** | **20,124** | **23,787** | **26,565** | **26,771** | **33,846** | **36,990** | **39,281** | **44,084** |
| Income taxes | (5,782) | (6,939) | (7,969) | (8,031) | (10,154) | (11,097) | (11,784) | (13,225) |
| **Attributable income** | **14,341** | **16,849** | **18,595** | **18,740** | **23,692** | **25,893** | **27,496** | **30,859** |
| **EPS** | **4.81** | **5.57** | **6.15** | **6.19** | **7.83** | **8.56** | **9.09** | **10.20** |
| **DPS** | **2.00** | **2.00** | **2.10** | **2.20** | **2.75** | **3.00** | **3.15** | **3.50** |
| **BVPS** | **21.4** | **25.0** | **28.8** | **27.9** | **34.6** | **34.2** | **40.9** | **41.4** |

*Source: Company annual reports, Exotix estimates*

### Table 37: Balance sheet (new vs old)

| | 2013 | 2014 | FY15f (old) | FY15f (new) | FY16f (old) | FY16f (new) | FY17f (old) | FY17f (new) |
|---|---|---|---|---|---|---|---|---|
| **Total assets** | | | | | | | | |
| Cash and cash equivalents | 33,941 | 71,459 | 86,079 | 99,027 | 100,004 | 118,739 | 113,983 | 140,456 |
| Money market & interbank assets | 10,402 | 13,178 | 20,387 | 18,005 | 23,685 | 24,287 | 25,330 | 28,730 |
| Investment securities | 92,996 | 97,198 | 126,853 | 99,027 | 152,638 | 145,725 | 177,307 | 191,530 |
| **Gross loans** | **236,610** | **294,117** | **348,846** | **360,097** | **400,017** | **404,791** | **481,262** | **453,289** |
| Reserves | (8,888) | (10,385) | (12,883) | (12,713) | (16,861) | (16,142) | (20,119) | (17,923) |
| **Net loans** | **227,722** | **283,732** | **335,963** | **347,383** | **383,157** | **388,649** | **461,143** | **435,366** |
| Property and equipment | 8,485 | 8,838 | 9,838 | 9,838 | 10,838 | 10,838 | 11,838 | 11,838 |
| Other assets | 17,934 | 15,933 | 18,097 | 18,097 | 20,647 | 20,647 | 23,660 | 23,660 |
| **Total assets** | **391,479** | **490,338** | **597,217** | **591,377** | **690,969** | **708,884** | **813,260** | **831,579** |
| **Total liabilities & equity** | | | | | | | | |
| **Total shareholders' equity** | **63,983** | **75,634** | **87,179** | **84,323** | **104,525** | **103,560** | **123,709** | **125,353** |
| Borrowed funds | 7,720 | 12,735 | 37,015 | 28,012 | 38,124 | 37,957 | 31,626 | 36,617 |
| Amounts due to other banks | 6,651 | 14,296 | 9,061 | 18,005 | 10,527 | 16,192 | 12,665 | 19,153 |
| **Customer deposits** | **305,659** | **377,272** | **453,047** | **450,121** | **526,339** | **539,721** | **633,239** | **638,435** |
| Other liabilities | 7,467 | 10,402 | 10,916 | 10,916 | 11,455 | 11,455 | 12,021 | 12,021 |
| **Total equity and liabilities** | **391,479** | **490,338** | **597,217** | **591,377** | **690,969** | **708,884** | **813,260** | **831,579** |

*Source: Company annual reports, Exotix estimates*

**Table 38: Income statement (yoy trends)**

| | 2013 | 2014 | % ch | FY15f | % ch | FY16f | %ch | FY17f | % ch |
|---|---|---|---|---|---|---|---|---|---|
| Interest income | 41,613 | 47,476 | 14.1% | 55,362 | 16.6% | 73,870 | 33.4% | 83,877 | 13.5% |
| Interest expense | (8,629) | (11,527) | 33.6% | (15,843) | 37.4% | (20,828) | 31.5% | (23,287) | 11.8% |
| **Net interest income** | **32,984** | **35,949** | **9.0%** | **39,519** | **9.9%** | **53,042** | **34.2%** | **60,590** | **14.2%** |
| Non-interest income | 14,878 | 19,235 | 29.3% | 20,247 | 5.3% | 23,295 | 15.1% | 26,615 | 14.3% |
| Operating revenue | 47,862 | 55,184 | 15.3% | 59,765 | 8.3% | 76,337 | 27.7% | 87,205 | 14.2% |
| Operating expenses | (26,743) | (28,308) | 5.9% | (30,190) | 6.6% | (34,163) | 13.2% | (39,085) | 14.4% |
| **Net operating profit** | **21,119** | **26,876** | **27.3%** | **29,576** | **10.0%** | **42,174** | **42.6%** | **48,119** | **14.1%** |
| Total provisions | 996 | 3,089 | 210.2% | 2,805 | -9.2% | 5,184 | 84.8% | 4,035 | -22.2% |
| **Pre-tax income** | **20,124** | **23,787** | **18.2%** | **26,771** | **12.5%** | **36,990** | **38.2%** | **44,084** | **19.2%** |
| Income taxes | (5,782) | (6,939) | 20.0% | (8,031) | 15.7% | (11,097) | 38.2% | (13,225) | 19.2% |
| **Attributable income** | **14,341** | **16,849** | **17.5%** | **18,740** | **11.2%** | **25,893** | **38.2%** | **30,859** | **19.2%** |
| **EPS** | **4.81** | **5.57** | **15.9%** | **6.19** | **11.2%** | **8.56** | **38.2%** | **10.20** | **19.2%** |
| **DPS** | **2.00** | **2.00** | **0.0%** | **2.20** | **10.0%** | **3.00** | **36.2%** | **3.50** | **16.8%** |
| **BVPS** | **21.4** | **25.0** | **16.6%** | **27.9** | **11.5%** | **34.2** | **22.8%** | **41.4** | **21.0%** |

*Source: Company annual reports, Exotix estimates*

**Table 39: Balance sheet (yoy trends)**

| | 2013 | 2014 | % ch | FY15f | % ch | FY16f | %ch | FY17f | % ch |
|---|---|---|---|---|---|---|---|---|---|
| **Total assets** | | | | | | | | | |
| Cash and cash equivalents | 33,941 | 71,459 | 110.5% | 99,027 | 38.6% | 118,739 | 19.9% | 140,456 | 18.3% |
| Money market & interbank assets | 10,402 | 13,178 | 26.7% | 18,005 | 36.6% | 24,287 | 34.9% | 28,730 | 18.3% |
| Investment securities | 92,996 | 97,198 | 4.5% | 99,027 | 1.9% | 145,725 | 47.2% | 191,530 | 31.4% |
| **Gross loans** | **236,610** | **294,117** | **24.3%** | **360,097** | **22.4%** | **404,791** | **12.4%** | **453,289** | **12.0%** |
| Reserves | (8,888) | (10,385) | 16.8% | (12,713) | 22.4% | (16,142) | 27.0% | (17,923) | 11.0% |
| **Net loans** | **227,722** | **283,732** | **24.6%** | **347,383** | **22.4%** | **388,649** | **11.9%** | **435,366** | **12.0%** |
| Property and equipment | 8,485 | 8,838 | 4.2% | 9,838 | 11.3% | 10,838 | 10.2% | 11,838 | 9.2% |
| Other assets | 17,934 | 15,933 | -11.2% | 18,097 | 13.6% | 20,647 | 14.1% | 23,660 | 14.6% |
| **Total assets** | **391,479** | **490,338** | **25.3%** | **591,377** | **20.6%** | **708,884** | **19.9%** | **831,579** | **17.3%** |
| **Total liabilities & equity** | | | | | | | | | |
| **Total shareholders' equity** | **63,983** | **75,634** | **18.2%** | **84,323** | **11.5%** | **103,560** | **22.8%** | **125,353** | **21.0%** |
| Borrowed funds | 7,720 | 12,735 | 65.0% | 28,012 | 120.0% | 37,957 | 35.5% | 36,617 | -3.5% |
| Amounts due to other banks | 6,651 | 14,296 | 114.9% | 18,005 | 25.9% | 16,192 | -10.1% | 19,153 | 18.3% |
| **Customer deposits** | **305,659** | **377,272** | **23.4%** | **450,121** | **19.3%** | **539,721** | **19.9%** | **638,435** | **18.3%** |
| Other liabilities | 7,467 | 10,402 | 39.3% | 10,916 | 4.9% | 11,455 | 4.9% | 12,021 | 4.9% |
| **Total equity and liabilities** | **391,479** | **490,338** | **25.3%** | **591,377** | **20.6%** | **708,884** | **19.9%** | **831,579** | **17.3%** |

*Source: Company annual reports, Exotix estimates*

**Table 40: KCB key financial ratios**

| | 2013 | 2014 | FY15f | FY16f | FY17f |
|---|---|---|---|---|---|
| **Margins (%)** | | | | | |
| Net interest margin | 9.3 | 8.7 | 7.7 | 8.5 | 8.2 |
| Yield on average earning assets | 11.7 | 11.4 | 10.8 | 11.9 | 11.4 |
| Cost of interest bearing liabilities | 2.8 | 3.2 | 3.5 | 3.8 | 3.6 |
| Cost/income | 55.9 | 51.3 | 50.5 | 44.8 | 44.8 |
| Cost of risk | 0.4 | 1.2 | 0.9 | 1.4 | 0.9 |
| **Growth (%)** | | | | | |
| Gross loans (%) | 7.3 | 24.3 | 22.4 | 12.4 | 12.0 |
| Deposits (%) | 6.1 | 23.4 | 19.3 | 19.9 | 18.3 |
| Total assets (%) | 6.6 | 25.3 | 20.6 | 19.9 | 17.3 |
| **Returns (%)** | | | | | |
| Return on average equity | 24.4 | 24.1 | 23.4 | 27.6 | 27.0 |
| Return on average assets | 3.8 | 3.8 | 3.5 | 4.0 | 4.0 |
| Asset quality (%) | | | | | |
| NPL ratio | 8.1 | 6.3 | 6.5 | 8.3 | 7.0 |
| NPL cover | 33.9 | 51.8 | 50.0 | 45.0 | 52.5 |
| **Asset mix (%)** | | | | | |
| Gross loans to deposit | 77.4 | 78.0 | 80.0 | 75.0 | 71.0 |
| Net loans to assets | 58.2 | 57.9 | 58.7 | 54.8 | 52.4 |
| Investment securities to total assets | 23.8 | 19.8 | 16.7 | 20.6 | 23.0 |
| Interbank lending to total assets | 2.7 | 2.7 | 3.0 | 3.4 | 3.5 |
| Cash to total assets | 8.7 | 14.6 | 16.7 | 16.8 | 16.9 |
| **Funding mix (%)** | | | | | |
| Deposits to total funding | 78.1 | 76.9 | 76.1 | 76.1 | 76.8 |
| Interbank borrowing to total funding | 1.7 | 2.9 | 3.0 | 2.3 | 2.3 |
| Other borrowing to total funding | 2.0 | 2.6 | 4.7 | 5.4 | 4.4 |
| Equity to total funding | 16.3 | 15.4 | 14.3 | 14.6 | 15.1 |
| Capital adequacy ratio | 22.5 | 21.0 | 19.9 | 21.6 | 22.2 |

*Source: Company annual reports, Exotix estimates*

## Valuation

Our fair value estimate and target price for KCB is KES72.7/share.

### Methodology

To calculate our fair value estimate for KCB we applied a two-stage dividend discount model:

Stage 1 - between FY16 and FY20 we estimated the present value of dividends using the profitability drivers we discuss above.

Stage 2 – we determine the terminal value as the perpetual growth rate in the bank's book value based on its average ROE between FY16 and FY20 and a terminal growth rate assumption of 8.0%.

We assume a cost of equity (CoE) of 16.5%, using a risk-free rate of 11.5%, an equity risk premium of 5% and a beta of 1.0x. As our valuation is Kenya shilling-based, we have applied an 8% terminal growth rate.

In the table below, we provide our assumptions used to calculate our fair value estimate of the bank.

**Table 41: KCB valuation summary**

| (KESbn) | 2016f | 2017f | 2018f | 2019f | 2020f |
|---|---|---|---|---|---|
| Aggregate Dividend | 9,066 | 10,585 | 11,345 | 12,857 | 14,370 |
| PV | 7,782 | 7,799 | 7,175 | 6,980 | 6,696 |
| Total PV | 36,432 | | | | |
| **Terminal Value** | | | | | |
| Average RoAE | | | | | 24.6% |
| CoE | | | | | 16.5% |
| Growth | | | | | 8.0% |
| Book value in 2019 | | | | | 202,201 |
| Terminal value | | | | | 394,035 |
| PV of Terminal Value | 183,614 | | | | |
| **Total PV** | **220,045** | | | | |
| Shares in issue (mn) | 3,025.2 | | | | |
| **Per share value** | **72.74** | | | | |

*Source: Exotix estimates*

### Risks

- **Margin risk:** As discussed above, we expect the bank's margins to improve in FY16 due to the high interest rate environment and "flight to quality" of deposits. A lower than expected increase in margins (or even a decrease) is therefore a key downside risk to our estimates.
- **Improvement in subsidiaries:** the group's poor performance outside Kenya (except South Sudan) has been a big drag on overall group return on assets. A successful and significant turnaround in the operations of these subsidiaries is therefore an upside risk to our estimates.
- **Asset quality risk:** in our forecasts we assume the bank's asset quality continues to remain lower than sector average. A sustained improvement in the bank's asset quality is therefore an upside risk to our estimates.

| | |
|---|---|
| Price | 43 |
| Target price | **72.4** |
| Expected share price return | 68.4% |
| Expected dividend yield | 2.9% |
| **Expected total return** | **71.4%** |
| Market cap (mn) | 27,518 |
| Market cap (US$mn) | 269 |
| Avg. daily volume (US$) | 25,989 |

# NIC: returns to improve as excess capital is deployed

- **We upgrade our recommendation on the stock to BUY** (from HOLD) based on a target price of KES72.4 (previously KES56.6), giving an ETR of 71.4% at the current market price of KES43. Our target price is 1.5x estimated FY16 BVPS of KES56.2 and 8.5x forward EPS.
- **9M15 earnings review:** attributable earnings for the nine-month period increased by 8.0% yoy to KES5.6 and annualised ROE declined by 300bp to 20.8%. The drop in ROE is attributable to a high base effect as the bank raised additional capital in FY15. Loan growth remained robust at 14.9% per annum and contrary to all its peers the bank's margins improved on a yoy basis (up 10bp to 6.5%). The bank was able to deploy the significant amount of capital it raised in 2015 to mitigate a significant increase in funding costs (up 20bp) and thus improve its margins. On the flip side, opex growth remains high (+19.8%) as the bank continues to roll out its branch network, although the 9M cost to income ratio remains within its historical range. A 200bp yoy increase in NPL ratio to 5.0% is also disappointing and high relative to the bank's historical average of 4.0%. We do think that the decline in NPL ratio from a peak of 5.7% in 1H15 seems to indicate that the asset quality deterioration is isolated to a couple of bigger exposures rather than a wider deterioration in asset quality.
- **New vs old.** Based on the 9M15 results, we increase our FY15 EPS estimate to KES7.3 driven by a moderate upward adjustment in NIM (+20bp to 6.6%) and non-interest revenue (+3.0% to KES4.1bn). We also reduce our cost of risk estimate by 20bp to 1.0%. We reduce our FY16 EPS estimate by 3.4% as a lower loan growth estimate (-8%) is partially offset by a higher margin outlook (+20bp). We raise our medium-term EPS estimates by 8.1% on average due to a higher margin outlook on the back of the bank's increasingly retail-driven strategy.
- **Investment recommendation explained.** We forecast the bank's ROE to drop to 19.6% in FY15 primarily due to an increase in equity following the bank's rights issue in 2015. We forecast the bank's ROE to gradually improve to 21.2% by FY17 and average 20.5% throughout our forecast period (vs a historical average of 22.1% and our cost of equity estimate of 16.5%) as the bank deploys the excess capital and return on assets improve on the back of the bank's retail-oriented strategy. We therefore believe the bank is undervalued at 0.9x BVPS and an upward re-rating is justified.

**Table 42: NIC Bank investment summary table**

| Year to 31 Dec | 2013 | 2014 | 2015f | 2016f | 2017f |
|---|---|---|---|---|---|
| Net Income (mn) | 3,323 | 4,121 | 4,642 | 5,465 | 6,969 |
| EPS | 6.12 | 6.43 | 7.27 | 8.56 | 10.91 |
| EPS (Old) | 6.12 | 6.43 | 6.57 | 8.86 | 10.28 |
| P/E (x) | 10.2 | 8.9 | 5.9 | 5.0 | 3.9 |
| P/TBVPS (x) | 2.1 | 1.7 | 1.1 | 1.0 | 0.8 |
| DPS | 1.00 | 1.00 | 1.25 | 1.50 | 2.00 |
| Dividend yield (%) | 1.6% | 1.7% | 2.9% | 3.5% | 4.7% |
| TROE (%) | 22.2% | 22.1% | 20.5% | 20.6% | 21.9% |
| ROA (%) | 2.9% | 3.1% | 3.0% | 3.2% | 3.5% |

*Source: Company reports and Exotix estimates*

## NIC Bank profit model

In the table below we provide a summary of NIC's profit model. Based on the analysis provided below, we are forecasting ROE to improve to decline to 19.6% in FY15 and to average 20.5% throughout our forecast period.

**Table 43: Profit model**

| (%) | FY13 | FY14 | FY15f | FY16f | FY17f | FY18f | FY19f | FY20f |
|---|---|---|---|---|---|---|---|---|
| Net interest income/ average assets [1] | 6.3 | 6.0 | 6.3 | 6.8 | 6.9 | 6.5 | 6.6 | 6.6 |
| Non-interest income/ average assets [2] | 2.8 | 2.7 | 2.7 | 2.8 | 2.8 | 2.6 | 2.5 | 2.5 |
| Operating expenses/ average assets [3] | (3.8) | (3.8) | (3.9) | (4.1) | (4.1) | (3.9) | (3.7) | (3.5) |
| Net provisioning/ average assets [4] | (1.0) | (0.2) | (0.7) | (0.9) | (0.6) | (0.5) | (0.7) | (0.7) |
| Tax/average assets [5] | (1.5) | (1.6) | (1.3) | (1.4) | (1.5) | (1.4) | (1.4) | (1.5) |
| Minority interest / average assets [6] | 0.1 | 0.0 | (0.0) | (0.0) | (0.0) | (0.0) | (0.0) | (0.0) |
| **ROA = [1+2+3+4+5+6]** | **2.9** | **3.1** | **3.0** | **3.2** | **3.5** | **3.3** | **3.3** | **3.4** |
| Average assets / average equity [7] | 7.1 | 6.8 | 6.4 | 6.2 | 6.1 | 6.2 | 6.2 | 6.1 |
| **ROE = [ROA * 7]** | **20.7** | **20.9** | **19.6** | **19.8** | **21.2** | **20.6** | **20.5** | **20.7** |

*Source: Company annual reports, Exotix estimates*

We make the following observations regarding the above:

- **Margin expansion:** as we noted earlier, we estimate NIC will be the only Kenyan bank within our universe whose NIM will expand in FY15 (+30bp yoy to 6.6%). The margin expansion is attributable to deposit costs remaining flat at 5.3% as the bank deploys the significant long-term capital it raised during the year (thereby increasing the loan to deposit ratio to 107% from 100% in FY14). We also forecast the bank's lending rates to increase by 20bp yoy due to the higher interest rate environment. Going forward, we believe the bank can sustain higher margins: in the short term we think, like all the other banks, margins should benefit from higher interest rate environment while in the medium term we think the bank's increasing push into retail banking should enable the bank to mitigate a significant decline in its lending rate (we forecast FY20 lending rate will be at the same level as the FY14 lending rate of 12.5%) and reduce the bank's long-term deposit cost (we estimate FY20 deposit cost of 4.8% will be 50bp cheaper than the FY14 deposit cost).
- **Measured expansion should prevent CIR from escalating:** the bank is in the process of increasing its network from 32 branches in FY14 to more than 50 branches in FY18. We believe management's measured approach to expansion should prevent opex growth from spiralling up and the cost to income ratio should remain range bound: we forecast the CIR to peak at 43.4% in FY15 and average 42.5% over the next three years before easing to 38.5% by FY20 as the opex intensity reduces.
- **Retail expansion could push up risk charge:** historically, the bank has recorded a fairly low average NPL ratio and cost of risk of 4.0% and 0.8% respectively. An increase in the NPL ratio in FY15 (which we believe is concentrated to a few exposures rather than a general deterioration in asset quality) should push up the cost of risk up to 1.0% during the year. Moreover, going forward, we believe the bank's push into retail banking should lead to moderately lower asset quality: we therefore estimate an average NPL ratio and cost of risk of 5.3% and 1.0% respectively through our forecast period.

## NIC Bank: Key financials

### Table 44: Income statement (new vs old)

| | 2013 | 2014 | FY15f (old) | FY15f (new) | FY16f (old) | FY16f (new) | FY17f (old) | FY17f (new) |
|---|---|---|---|---|---|---|---|---|
| Interest income | 11,642 | 13,711 | 16,144 | 16,535 | 19,638 | 19,584 | 22,504 | 22,723 |
| Interest expense | (4,374) | (5,713) | (6,722) | (6,934) | (8,059) | (8,010) | (8,939) | (8,869) |
| **Net interest income** | **7,268** | **7,998** | **9,421** | **9,601** | **11,578** | **11,574** | **13,564** | **13,855** |
| Non-interest income | 3,155 | 3,573 | 4,002 | 4,124 | 4,575 | 4,784 | 5,298 | 5,603 |
| Operating revenue | 10,423 | 11,571 | 13,423 | 13,725 | 16,153 | 16,358 | 18,862 | 19,457 |
| Operating expenses | (4,321) | (5,012) | (6,006) | (5,959) | (7,082) | (7,003) | (8,362) | (8,261) |
| **Net operating profit** | **6,102** | **6,560** | **7,417** | **7,766** | **9,071** | **9,355** | **10,500** | **11,196** |
| Total provisions | (1,093) | (329) | (1,414) | (1,120) | (971) | (1,532) | (1,100) | (1,222) |
| **Pre-tax income** | **5,010** | **6,231** | **6,004** | **6,646** | **8,100** | **7,823** | **9,401** | **9,975** |
| Income taxes | (1,772) | (2,114) | (1,801) | (1,994) | (2,430) | (2,347) | (2,820) | (2,992) |
| Minority interest | 86 | 4 | (42) | (10) | (57) | (12) | (66) | (13) |
| **Attributable income** | **3,323** | **4,121** | **4,161** | **4,642** | **5,613** | **5,465** | **6,515** | **6,969** |
| **EPS** | **6.12** | **6.4** | **6.6** | **7.3** | **8.9** | **8.6** | **10.3** | **10.9** |
| **DPS** | **1.00** | **1.0** | **1.0** | **1.2** | **1.5** | **1.5** | **1.7** | **2.0** |
| **BVPS** | **31.7** | **34.7** | **39.5** | **39.4** | **47.4** | **46.8** | **56.2** | **56.2** |

*Source: Company annual reports, Exotix estimates*

### Table 45: Balance sheet (new vs old)

| | 2013 | 2014 | FY15f (old) | FY15f (new) | FY16f (old) | FY16f (new) | FY17f (old) | FY17f (new) |
|---|---|---|---|---|---|---|---|---|
| **Total assets** | | | | | | | | |
| Cash and cash equivalents | 8,744 | 10,539 | 9,024 | 7,500 | 11,819 | 8,766 | 14,236 | 10,930 |
| Money market & interbank assets | 5,920 | 8,754 | 5,640 | 7,500 | 5,253 | 7,514 | 6,327 | 9,369 |
| Investment securities | 18,093 | 19,224 | 20,303 | 21,428 | 23,637 | 26,299 | 28,472 | 32,791 |
| **Gross loans** | **84,180** | **103,321** | **124,075** | **117,856** | **145,764** | **133,998** | **173,993** | **163,956** |
| Reserves | (2,762) | (2,745) | (3,958) | (2,525) | (4,650) | (3,468) | (5,422) | (4,368) |
| **Net loans** | **81,418** | **100,575** | **120,117** | **115,331** | **141,114** | **130,531** | **168,571** | **159,588** |
| Property and equipment | 1,119 | 1,079 | 1,229 | 1,229 | 1,379 | 1,379 | 1,529 | 1,529 |
| Other assets | 5,768 | 5,609 | 6,159 | 6,180 | 6,794 | 6,811 | 7,528 | 7,541 |
| **Total assets** | **121,063** | **145,781** | **162,472** | **159,169** | **189,997** | **181,300** | **226,663** | **221,749** |
| **Total liabilities & equity** | | | | | | | | |
| **Total shareholders' equity** | **17,191** | **22,233** | **25,296** | **25,246** | **30,326** | **29,925** | **35,946** | **35,947** |
| Minority interest | 378 | 478 | 520 | 488 | 576 | 499 | 642 | 512 |
| Borrowed funds | 3,628 | 14,358 | 14,507 | 16,715 | 17,746 | 15,919 | 20,182 | 17,525 |
| Amounts due to other banks | 5,896 | 5,412 | 6,204 | 6,429 | 6,566 | 6,262 | 7,909 | 7,807 |
| **Customer deposits** | **91,565** | **100,435** | **112,796** | **107,142** | **131,319** | **125,232** | **158,175** | **156,148** |
| Other liabilities | 2,404 | 2,865 | 3,150 | 3,150 | 3,464 | 3,464 | 3,809 | 3,809 |
| **Total equity and liabilities** | **121,063** | **145,781** | **162,472** | **159,169** | **189,997** | **181,300** | **226,663** | **221,749** |

*Source: Company annual reports, Exotix estimates*

**Table 46: Income statement (yoy trends)**

| | 2013 | 2014 | % ch | FY15f | % ch | FY16f | %ch | FY17f | %ch |
|---|---|---|---|---|---|---|---|---|---|
| Interest income | 11,642 | 13,711 | 17.8% | 16,535 | 20.6% | 19,584 | 18.4% | 22,723 | 16.0% |
| Interest expense | (4,374) | (5,713) | 30.6% | (6,934) | 21.4% | (8,010) | 15.5% | (8,869) | 10.7% |
| **Net interest income** | **7,268** | **7,998** | **10.0%** | **9,601** | **20.0%** | **11,574** | **20.6%** | **13,855** | **19.7%** |
| Non-interest income | 3,155 | 3,573 | 13.2% | 4,124 | 15.4% | 4,784 | 16.0% | 5,603 | 17.1% |
| Operating revenue | 10,423 | 11,571 | 11.0% | 13,725 | 18.6% | 16,358 | 19.2% | 19,457 | 18.9% |
| Operating expenses | (4,321) | (5,012) | 16.0% | (5,959) | 18.9% | (7,003) | 17.5% | (8,261) | 18.0% |
| **Net operating profit** | **6,102** | **6,560** | **7.5%** | **7,766** | **18.4%** | **9,355** | **20.5%** | **11,196** | **19.7%** |
| Total provisions | (1,093) | (329) | -69.9% | (1,120) | 240.2% | (1,532) | 36.8% | (1,222) | -20.3% |
| **Pre-tax income** | **5,010** | **6,231** | **24.4%** | **6,646** | **6.7%** | **7,823** | **17.7%** | **9,975** | **27.5%** |
| Income taxes | (1,772) | (2,114) | 19.3% | (1,994) | -5.7% | (2,347) | 17.7% | (2,992) | 27.5% |
| Minority interest | 86 | 4 | -95.1% | (10) | -339.2% | (12) | 15.0% | (13) | 15.0% |
| **Attributable income** | **3,323** | **4,121** | **24.0%** | **4,642** | **12.7%** | **5,465** | **17.7%** | **6,969** | **27.5%** |
| **EPS** | **6.12** | **6.43** | **5.1%** | **7.27** | **13.0%** | **8.56** | **17.7%** | **10.91** | **27.5%** |
| **DPS** | **1.00** | **1.00** | **0.0%** | **1.25** | **24.6%** | **1.50** | **20.4%** | **2.00** | **33.3%** |
| **BVPS** | **32** | **34.7** | **9.7%** | **39.4** | **13.5%** | **46.8** | **18.5%** | **56.2** | **20.1%** |

*Source: Company annual reports, Exotix estimates*

**Table 47: Balance sheet (yoy trends)**

| | 2013 | 2014 | % ch | FY15f | % ch | FY16f | %ch | FY17f | %ch |
|---|---|---|---|---|---|---|---|---|---|
| **Total assets** | | | | | | | | | |
| Cash and cash equivalents | 8,744 | 10,539 | 20.5% | 7,500 | -28.8% | 8,766 | 16.9% | 10,930 | 24.7% |
| Money market & interbank assets | 5,920 | 8,754 | 47.9% | 7,500 | -14.3% | 7,514 | 0.2% | 9,369 | 24.7% |
| Investment securities | 18,093 | 19,224 | 6.2% | 21,428 | 11.5% | 26,299 | 22.7% | 32,791 | 24.7% |
| **Gross loans** | **84,180** | **103,321** | **22.7%** | **117,856** | **14.1%** | **133,998** | **13.7%** | **163,956** | **22.4%** |
| Reserves | (2,762) | (2,745) | -0.6% | (2,525) | -8.0% | (3,468) | 37.3% | (4,368) | 25.9% |
| **Net loans** | **81,418** | **100,575** | **23.5%** | **115,331** | **14.7%** | **130,531** | **13.2%** | **159,588** | **22.3%** |
| Property and equipment | 1,119 | 1,079 | -3.6% | 1,229 | 13.9% | 1,379 | 12.2% | 1,529 | 10.9% |
| Other assets | 5,768 | 5,609 | -2.8% | 6,180 | 10.2% | 6,811 | 10.2% | 7,541 | 10.7% |
| **Total assets** | **121,063** | **145,781** | **20.4%** | **159,169** | **9.2%** | **181,300** | **13.9%** | **221,749** | **22.3%** |
| **Total liabilities & equity** | | | | | | | | | |
| **Total shareholders' equity** | **17,191** | **22,233** | **29.3%** | **25,246** | **13.5%** | **29,925** | **18.5%** | **35,947** | **20.1%** |
| **Minority interest** | 378 | 478 | 26.5% | 488 | 2.1% | 499 | 2.4% | 512 | 2.6% |
| Borrowed funds | 3,628 | 14,358 | 295.8% | 16,715 | 16.4% | 15,919 | -4.8% | 17,525 | 10.1% |
| Amounts due to other banks | 5,896 | 5,412 | -8.2% | 6,429 | 18.8% | 6,262 | -2.6% | 7,807 | 24.7% |
| **Customer deposits** | **91,565** | **100,435** | **9.7%** | **107,142** | **6.7%** | **125,232** | **16.9%** | **156,148** | **24.7%** |
| Other liabilities | 2,404 | 2,865 | 19.1% | 3,150 | 10.0% | 3,464 | 10.0% | 3,809 | 10.0% |
| **Total equity and liabilities** | **121,063** | **145,781** | **20.4%** | **159,169** | **9.2%** | **181,300** | **13.9%** | **221,749** | **22.3%** |

*Source: Company annual reports, Exotix estimates*

**Table 48: Key financial ratios**

| | 2013 | 2014 | 2015f | FY16f | FY17f |
|---|---|---|---|---|---|
| **Margins (%)** | | | | | |
| Net interest margin | 6.7 | 6.3 | 6.6 | 7.1 | 7.2 |
| Yield on average earning assets | 10.7 | 10.8 | 11.4 | 12.1 | 11.8 |
| Cost of interest bearing liabilities | 4.6 | 5.2 | 5.5 | 5.8 | 5.4 |
| Cost/income | 41.5 | 43.3 | 43.4 | 42.8 | 42.5 |
| Cost of risk | 1.4 | 0.4 | 1.0 | 1.2 | 0.8 |
| **Growth (%)** | | | | | |
| Gross loans (%) | 14.8 | 22.7 | 14.1 | 13.7 | 22.4 |
| Deposits (%) | 9.8 | 9.7 | 6.7 | 16.9 | 24.7 |
| Total assets (%) | 11.7 | 20.4 | 9.2 | 13.9 | 22.3 |
| **Returns (%)** | | | | | |
| Return on average equity | 20.7 | 20.9 | 19.6 | 19.8 | 21.2 |
| Return on average assets | 2.9 | 3.1 | 3.0 | 3.2 | 3.5 |
| **Asset quality (%)** | | | | | |
| NPL ratio | 5.4 | 3.9 | 5.0 | 6.0 | 5.5 |
| NPL cover | 57.3 | 66.5 | 40.0 | 40.0 | 45.0 |
| **Asset mix (%)** | | | | | |
| Gross loans to deposit | 91.9 | 102.9 | 110.0 | 107.0 | 105.0 |
| Net loans to assets | 67.3 | 69.0 | 72.5 | 72.0 | 72.0 |
| Investment securities to total assets | 14.9 | 13.2 | 13.5 | 14.5 | 14.8 |
| Interbank lending to total assets | 4.9 | 6.0 | 4.7 | 4.1 | 4.2 |
| Cash to total assets | 7.2 | 7.2 | 4.7 | 4.8 | 4.9 |
| **Funding mix (%)** | | | | | |
| Deposits to total funding | 75.6 | 68.9 | 67.3 | 69.1 | 70.4 |
| Interbank borrowing to total funding | 4.9 | 3.7 | 4.0 | 3.5 | 3.5 |
| Other borrowing to total funding | 3.0 | 9.8 | 10.5 | 8.8 | 7.9 |
| Equity to total funding | 14.2 | 15.3 | 15.9 | 16.5 | 16.2 |
| Capital adequacy ratio | 16.4 | 21.0 | 22.0 | 21.9 | 20.6 |

*Source: Company annual reports, Exotix estimates*

## Valuation

Our fair value estimate and target price for NIC is KES72.4/share.

### Methodology

To calculate our fair value estimate for NIC we applied a two-stage dividend discount model:

Stage 1 - between FY16 and FY20 we estimated the present value of dividends using the profitability drivers we discuss above.

Stage 2 – we determine the terminal value as the perpetual growth rate in the bank's book value based on its average ROE between FY16 and FY20 and a terminal growth rate assumption of 8.0%.

We assume a cost of equity (CoE) of 16.5%, using a risk-free rate of 11.5%, an equity risk premium of 5% and a beta of 1.0x. As our valuation is Kenya shilling-based, we have applied an 8% terminal growth rate.

In the table below, we provide our assumptions used to calculate our fair value estimate of the bank.

**Table 49: Valuation summary**

| (KESmn) | 2016f | 2017f | 2018f | 2019f | 2020f |
|---|---|---|---|---|---|
| Aggregate Dividend | 960 | 1,280 | 1,600 | 1,920 | 2,240 |
| PV | 824 | 943 | 1,012 | 1,042 | 1,044 |
| Total PV | 4,865 | | | | |
| **Terminal Value** | | | | | |
| RoAE | | | | | 20.5% |
| CoE | | | | | 16.5% |
| Growth | | | | | 8.0% |
| Book value in 2020 | | | | | 60,363 |
| Terminal value | | | | | 89,039 |
| PV of Terminal Value | 41,491 | | | | |
| **Total PV** | **46,355** | | | | |
| Shares in issue (mn) | 640 | | | | |
| **Per share value** | **72.4** | | | | |

*Source: Bank annual reports, Exotix estimates*

### Risks

In our opinion, the following are key risks to our forecasts and target price:

- **Margin risk:** As discussed above, we expect the bank's margins to improve in FY16 due to the high interest rate environment and "flight to quality" of deposits. In the medium term, we believe the bank's margins will be higher due to an increasing push in the retail segment. A lower than expected increase in margins (or even a decrease) is therefore a key downside risk to our estimates.
- **Asset quality:** as noted above, we expect the bank's cost of risk to spike in FY15 due to asset quality deterioration in 1Q15. In the long run, we expect asset quality to improve to its historical levels. A sustained period of high NPL ratios and cost of risk is therefore a downside risk to our estimates.
- **Execution risk:** as discussed above, management are in the process of executing an aggressive network expansion strategy. We believe strong top line growth should offset the strong operating expense growth and thus sustain the bank's CIR within the historical range. Poor execution of the strategy could therefore result in worse than expected cost efficiency estimates and thus reduce our earnings estimates.

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| | | | | | |
|---|---|---|---|---|---|
| Buy | 33 | Sell | 34 | Hold | 43 |

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