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Market Update
Sector: Banking

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NIC-CBA Planned Merger

“Size, then scalability”

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Executive Summary

- NIC Group Plc (NIC) and Commercial Bank of Africa Ltd (CBA) announced a merger on 31st January, 2019 and this report gives our analysis of the probable motivation and impact of the proposed merger.
- In addition, we do a peer comparison, analyze potential risks and conclude the report with a valuation of the merged entity and our investment recommendation.
- We hold the view that the bank will enjoy several benefits including leveraging on the strengths of a bigger bank to explore growth opportunities for the bank, economies of scale, financial and operational efficiency, business diversification and synergies among other benefits.
- The merger will create the third largest bank by measure of assets and customer deposits using FY2018 industry results with the merged entity listing on the NSE as NIC Group Holdings.
- The merger poses some risks that could affect business operation such as potential employee layoffs and differences in organization cultures, strategies and decision making processes.
- We believe this is the first of many mergers and consolidations to be witnessed in the banking industry Kenya, as the population appears to be "over banked". Customers have also shown preference for larger banks following the collapse of Imperial Bank and Chase Bank.
- Our fair value estimate for the merged entity is **KES.52.60**, a value we consider relatively modest as it does not take the takeover premium, synergies and costs into consideration.
- We believe the merger offers great value for holders of NIC shares due to synergies that will result from the merged entity, given the management track record, potential scalability and the companies' financial capabilities.
- **We therefore advice potential investors to BUY and existing investors to HOLD the stock for the long-run.**

NIC-CBA merger will create Kenya's third largest bank in assets

NIC and CBA announce proposed merger that we estimate to take place in Q3 2019.

CBA/NIC - 53%/47% share swap

- NIC Group Plc (NIC) and Commercial Bank of Africa Ltd (CBA) announced a proposed merger on 31st January, 2019.
- The proposed merger that is subject to shareholder and regulatory approval will have the following attributes:

  1) Shareholders of CBA (34 investors) owning a 53% majority stake with existing NIC shareholders holding 47% in the merged entity.
  2) CBA will become a publicly traded entity under NIC Group Holdings (on the Nairobi Securities Exchange).
  3) Settlement to be done through a share swap with CBA shareholders exchanging shares in CBA for shares in NIC.

- It is reported that 29 of the 34 CBA shareholders approved the proposed merger in March 2019, paving the way for the approval of NIC shareholders in their Annual General Meeting (AGM) on 17th April 2019.

1) Also on the agenda of the NIC AGM is the creation of 793 million shares to be issued to the CBA shareholders.

Fig.1: Timeline of the merger

Source: Sterling Capital Research

Financial, scale and strategic business opportunities amongst the main motivations for the merger

- We believe that both NIC and CBA stand to gain from the merger:

1) Financial and operational efficiency

Operational efficiency, economies of scale are some of the benefits to be derived by the merged entity

- Larger bank likely to benefit from access to cost-saving technologies or spread both fixed and variable costs, thus reducing average operational costs.
- The bank will enjoy economies of scope (efficiencies formed through offering a wider variety of products). The merger deal will allow the two banks to combine their various specialty products and simultaneously widen their customer base.
- The two banks have in the past catered to different clientele, and possess valuable customer needs and preferences data that will be of great value when shared between the banks.

- Improved human capacity – Improved staff quality and managerial efficiency through a superior talent pool resulting from the merger.
- Following the collapse of Chase Bank and Imperial Banks, customers have shown a preference for Tier 1 banks, a situation that will see the merged entity benefit.

2) Business Synergies

Achieved through product cross-selling, higher yields on interest-earning assets and lower cost of funds as a result of economies of scale.

- Lowering the cost of funds and greater focus on optimal utilization of interest earning assets to increase yields.
- New entity puts greater emphasis improve asset quality improvement.

3) Strategic Business Growth Opportunities

Diversification, business growth opportunities, leveraging on business strengths beneficial to the bigger bank

- **Scale for growth** - A larger balance sheet, a shift towards improved customer deposit mix and capital markets access will position the merged entity for growth and expansion into other markets.
- **Business diversification** - Management of NIC and CBA banks have shown intent to venture actively into segments such as Small and Medium Enterprise (SME) lending to compete with banks like KCB and Equity.
- This is a benefit that will come with the banks holding a bigger balance sheet (3rd largest in customer deposits).

4) Leveraging on unique capabilities

- NIC's strength lies in asset financing, and has a strong base of mid-size corporate clients, while CBA's strength lies in corporate banking.
- CBA also has a large retail client base of "digital customers" through its partnership with Safaricom for M-Shwari.
- Combining the two businesses will increase capacity through capital consolidation and strong liquidity to capture strategic growth opportunities.

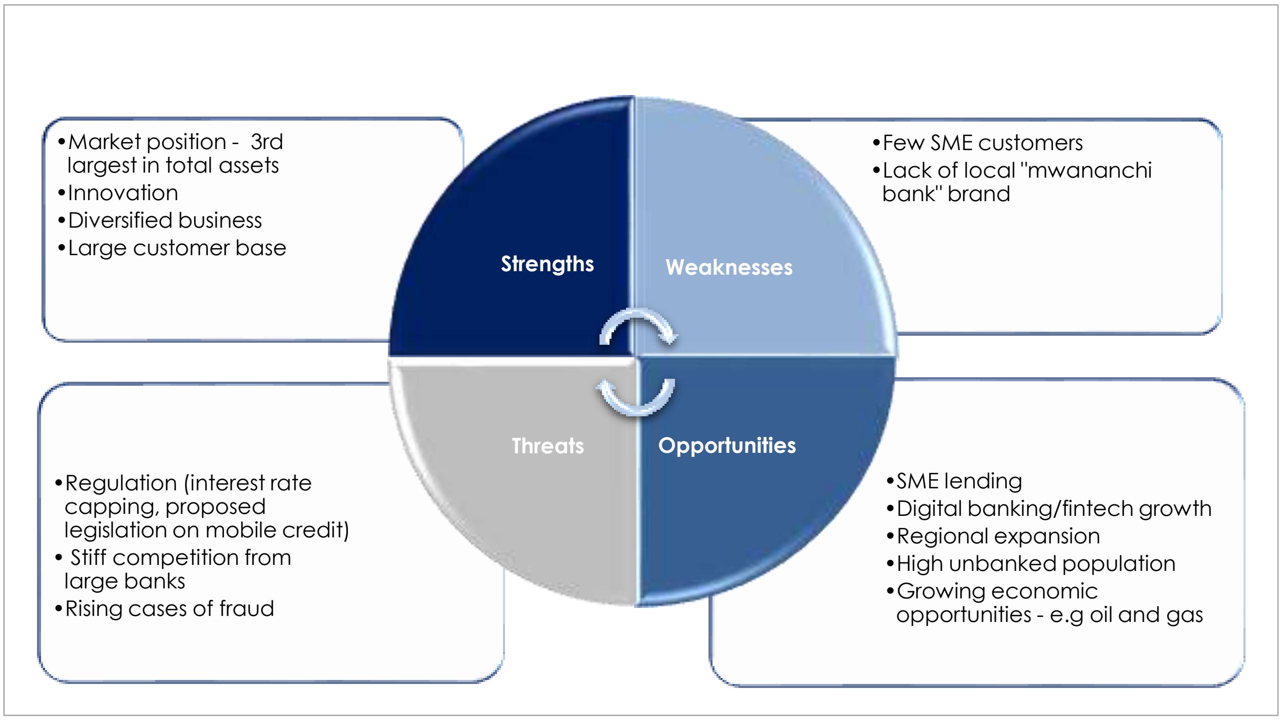
Merged entity finds space in the capital markets

- In addition to the main benefits of the merger mentioned, we also take note of the following reasons as secondary motivations for CBA entering into the merger agreement with NIC.

1) CBA shares will be traded on the NSE, thus increasing share liquidity. In addition, we expect more shares to be floated on the exchange for CBA shares, which is a Secondary stock offering.

2) Listing on the exchange through a reverse merger will save CBA from the complexities, cost and lengthy process of listing through an Initial Public Offering (IPO) or listing by introduction.

Fig.2: SWOT Analysis of the merged entity



Source: Sterling Capital Research

Post - Merger Industry Structure

The HHI concentration for the banking industry is low, (703.26 points) indicating a highly competitive operating environment.

1) Competitive intensity

- The merger is significant as it will increase the competitive intensity of the banking sector and primarily the Tier 1 banks.
- We use the Herfindahl-Hirschman Index (HHI) to determine market concentration levels for the entire banking industry.
- **Here we use the market share for customer deposits as reported by the Central Bank of Kenya (CBK) at the end of 2017 financial year in the banking sector annual supervision report.**
- High HHI scores (1,801-10,000 points) indicate few market players and low competition while lower HHI scores (<1,800 points) indicate the industry has many players and operates in a highly competitive environment.
- The HHI concentration for the banking industry is low, (703.26 points) indicating a highly competitive operating environment. This suggests the following:

  1) As a result of a larger market share, NIC-CBA will enjoy increased market power. This will however not have a significant impact on the market concentration for the banking industry as indicated by the pre-merger and post-merger HHI comparison.

  2) A larger balance sheet bank will effectively position the bank to compete with the top banks in the market through access to a bigger customer base and diversified loan products and this will give the firm a competitive advantage over other banks.

Table.1: Merger will increase sector market concentration and competitive intensity

Data as at end of 2017

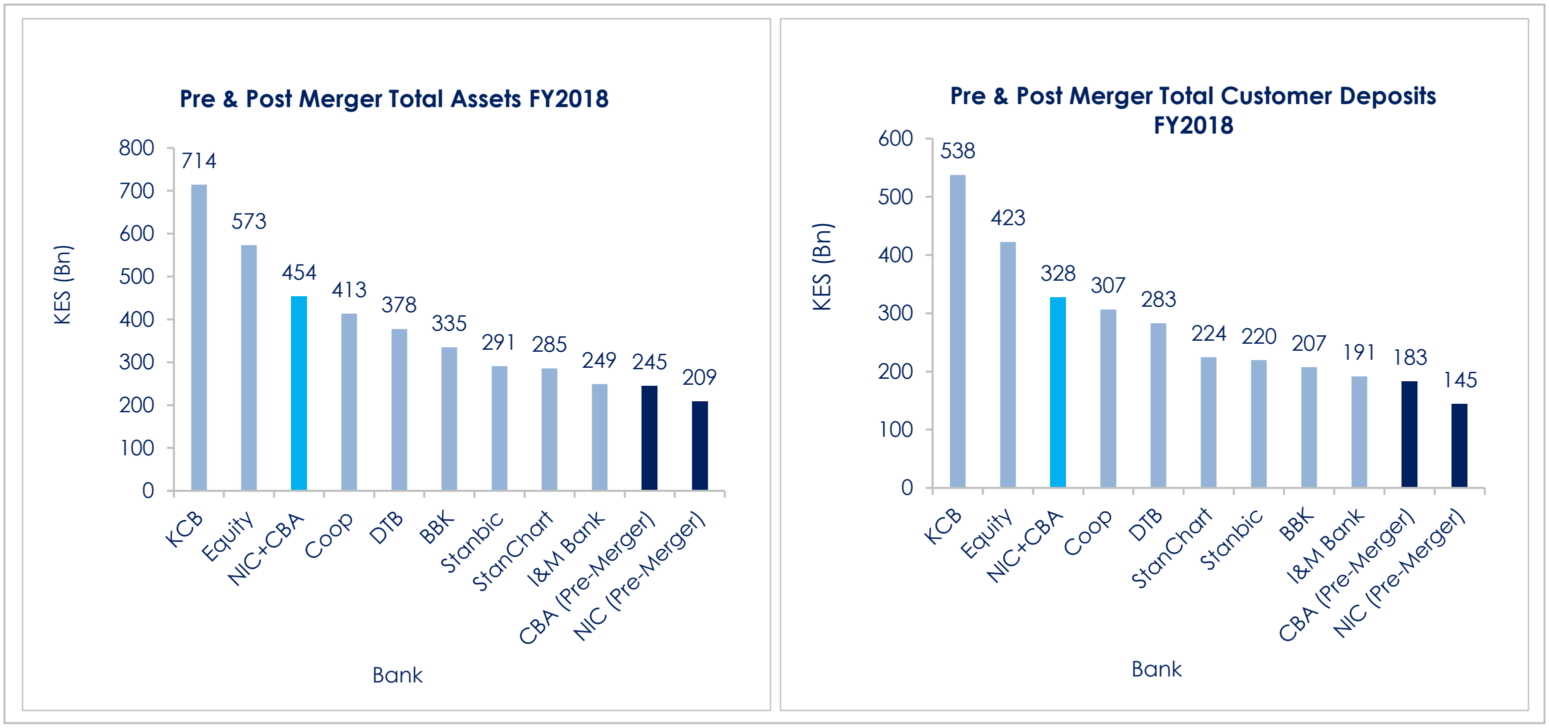
Bank	Pre-merger size (Total Customer Deposits)	Bank	Post-merger size (Total Customer Deposits)
KCB	14.7%	KCB	14.7%
Equity Bank	9.9%	**NIC - CBA**	**10.9%**
CO-OP	9.5%	Equity Bank Kenya Ltd	9.9%
Standard Chartered	7.5%	CO-OP	9.5%
Diamond Trust Bank	6.9%	Standard Chartered	7.5%
Barclays	6.3%	Diamond Trust Bank	6.9%
CBA	**6.2%**	Barclays	6.3%
Stanbic Bank	5.9%	Stanbic Bank	5.9%
NIC Bank PLC	**4.7%**	I&M Bank	4.4%
I&M Bank	4.7%	Bank of Baroda	2.6%

Source: Sterling Capital Research

Merger will create third largest bank in Kenya

- The merged bank will be the third largest in the country by measure of assets and customer deposits using FY2018 financials (Fig.3)
- The bank will have 26 million and 41 million customers in Kenya and at a group level regionally respectively

Fig.3: Merger will create the third largest bank in Kenya in both assets and customer deposits



Source: Sterling Capital Research

Could the NIC-CBA merger trigger a wave of mergers in the Kenyan banking sector?

NIC-CBA merger could trigger a new wave of mergers and acquisitions with Tier 3 banks primary targets

- We see a moderate chance of consolidation in the Kenyan banking sector.
- However, potential mergers would most likely be between the Tier 1 or Tier 2 with the smaller Tier 3 banks rather than banking players of almost the same size.
- Small banks have suffered from the interest rate controls, customer deposits flight following the collapse of imperial and chase banks as well as erosion of shareholders' capital.
- This has made it unprofitable to operate, difficult to compete effectively and meet capital guidelines.
- Reports of CBA's KES.1.4Bn acquisition of Jamii Bora Bank a largely SME customer oriented bank shows the existence of these opportunities.
- For this reason we see them as attractive merger potentials.

Are there any risks of the merger?

- Like all merger and acquisitions, the NIC-CBA merger is likely to face some challenges and we do not expect an entirely flawless merger process.
- These challenges could reduce the speed at which the merged entity will derive the benefits of the merger.
- Some of the challenges we expect include:

Financial, technology, and strategic mismatches are some of the potential risks that NIC-CBA could face after the merger.

1) CBA lacks experience in managing and operating a public company and failure to comply with securities rules or regulations could subject the lender to fines or regulatory action, which may materially affect the business financial performance, business operations and market reputation.
2) Mismatches in financial performance by one entity could adversely affect the performance of the merged bank.

   For instance, NIC appears to be experiencing challenges in asset quality as illustrated by the high growth in NPLs and this could potentially have a negative impact on the merged bank's overall financial performance.
3) Both companies have different organization cultures, strategies and decision making processes and it will take time before they are aligned.
4) Differences in core banking and other banking systems could cause integration delays or compromise quality of services provided by customers.
5) The merger may result in an employee layoff due to the need to reduce duplication of roles which will result in an increase in staff costs in the short term.

- We are fairly confident about the merged entities' ability to manage these challenges with minimal impact on the financial and operational performance.

Table.2: Financial Analysis

All figures in KES.Bn unless stated

	CBA Group	NIC Group	NIC-CBA	KCB	Equity
Balance Sheet					
Loans and Advances	121.5	118.1	**239.6**	455.9	297.2
Customer Deposits	196.5	144.5	**341.0**	537.5	422.8
Government Securities	60.2	58.0	**118.2**	120.1	161.0
Total Assets	245.1	208.5	**453.6**	714.3	573.4
Total Shareholder Equity	30.6	35.8	**66.4**	113.7	95.0
Income Statement					
Total Interest Income	19.4	19.3	**38.7**	66.3	53.2
Interest Expense	9.7	8.7	**18.4**	17.5	11.8
Net Interest Income	9.7	10.6	**20.3**	48.8	41.4
Non-Interest Income	11.5	4.6	**16.1**	23.0	25.9
Operating Expenses	14.8	9.4	**24.2**	35.0	38.8
Profit After Tax	5.0	4.2	**9.2**	24.0	19.7
EPS (KES)	17.4	6.01	**11.7**	7.83	5.25
DPS (KES)		1.25	**N/A**	3.50	2.00
Ratios					
Cost of Funds	5%	6%	**5.5%**	3.2%	2.7%
Net Interest Margin	5%	6%	**5.5%**	8.1%	8.5%
Loan to Deposit	61.8%	81.7%	**70.3%**	84.8%	70.3%
NFI to Total Income	54.2%	30.5%	**44.2%**	32.0%	38.5%
Cost of Risk	3%	2%	**2.5%**	0.7%	1.2%
Cost to Income	35.9%	46.3%	**41.0%**	48.3%	52.2%
ROA	2.1%	2.0%	**2.0%**	3.5%	3.6%
ROE	15.6%	11.8%	**13.9%**	21.9%	21.1%

Source: FY-2018 Company filings & Sterling Capital Research

What is the potential investment value in the merged entity?

- We attempt to give a fair value estimate for the NIC-CBA merged entity based on several assumptions and financial data.
- Total NIC-CBA shares = 1,433,750,468 (639,945,603 NIC shares and CBA shareholders will get a maximum of 793,804,865)

Fig.4: Valuation metrics

	NIC	CBA	NIC-CBA
BV (KES)	35,425,327,000	30,607,811,000	66,033,138,000
Earnings (KES)	4,228,370,000	5,003,319,000	9,231,689,000
Issued Shares	639,945,603	287,775,000	1,433,750,468*
BVPS (KES)	55.36	106.36	46.05
EPS (KES)	6.61	17.39	6.44
Dividends (KES)	1.00	4.94 (FY2017)	

Source: FY-2018 Company filings & Sterling Capital Research

***Includes New Shares**

B/V (Book value), P/B (Price to book ratio), P/E (Price Earnings ratio), BVPS (Book Value Per Share), EPS (Earnings Per Share)

- Based on the current NIC and maximum CBA shares to be issued we estimate the value at **KES.52.60** using P/B and P/E valuation methods. (Without consideration of the takeover premium, synergies and costs).
- Given equal weighting for both models our fair value estimate for the merged entity using trailing EPS & trailing BVPS:

Fig.5: Fair valuation estimate

	NIC-CBA	Industry P/B	Industry P/E	Valuation
		1.3x	7.05x	
BVPS (KES)	46.05	46.05*1.3	6.44*7.05	KES.59.87
EPS (KES)	6.44	**59.87**	**45.40**	KES.45.40
50% Weighting (KES)		**29.94**	**22.70**	**52.60**

Source: Sterling Capital Research

NIC - CBA presents a good value investing opportunity

- We believe that there is great value in investing in NIC Bank ahead of the merger given synergies that will culminate from the merged entity backed by the track record of management of both the companies, the potential, scalability and the companies' financial capabilities.
- **We therefore advice potential investors to BUY and existing investors to HOLD the stock for the long-run.**

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