STERLING CAPITAL LIMITED

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Kenya Banks

FY2018 Earnings Update

April 2019

“Listed Banks post mixed performance, upbeat about 2019”

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Executive Summary

- Our 2018 banking sector review and 2019 outlook report provides a detailed review of the main factors that affected the banking sector in 2018 and gives our expectations for 2019.
- The key themes for 2018 were interest rate caps, asset allocation, asset quality, financial reporting and consolidation.
- On interest rates, the Kenya parliament voted to remove the floors on deposits, a move we have noted as insignificant in increasing private sector credit.
- In terms of the outlook, we expect the interest rate debate to continue especially following a proposed Bill to amend lending rates and following court action to declare the current caps as unconstitutional.
- Asset quality deteriorated in 2018 and this we expect to further reduce credit to the private sector as well as increase banks' focus on credit risk.
- Banks generally showed preference for government securities over private sector lending but there were a few exceptions mentioned in the report.
- 2018 was the year that International Financial Reporting Standards (IFRS 9) was implemented and this had an impact mainly on loan loss provisioning and income recognition.
- Consolidation was another key theme of the banking sector with the main highlight being the proposed merger between Commercial Bank of Africa (CBA) and NIC.
- The report delves into the financial performance of the main listed banks highlighting key performance metrics.
- Our top picks amongst the covered banks were Stanbic Bank and KCB Group with Profit After Tax (PAT) growth rates of 46.5% and 21.8% respectively.
- We are impressed particularly by the performance of Stanbic that recorded double digit growth in both interest income and Non-Funded income.
- The bank took what appears to be a contrarian strategy by growing its loan book while reducing its holdings of government securities.
- On the bottom end of our performance chart was Commercial Bank of Africa that recorded a 9.7% decline in PAT during the period.
- Finally in conclusion, we maintain our positive view on the banking sector and believe that it presents good investment value in spite of the challenges it faces today and in the near and medium term.

A) Interest rates - The interest Rate cap debate just won't go away

Interest rate caps continue to impact the banking business.

Possible revision of interest rate in 2019 after high court ruling.

- The impact of interest rate caps on the financial performance of the banking sector was clearly evident as bank's posted modest growth FY2018.
- Private sector credit remained low but stable, a marked increase in government credit and a further deterioration in as asset quality (Fig.1).
- The debate on interest rate caps continued with a "compromise" arrived at with the removal of interest rate caps on deposits in October 2018 (a move we see as insignificant in relation to private sector credit).

Interest rate floors on deposits removed - October 2018

- **October 2018** - Interest rate floors on bank deposits removed through legislation on the presumption that it will increase private sector credit.
- **Potential impact** - Wider interest margin for banks that had already implemented strategies to reduce interest expense including account reclassifications and drive for short term deposit and current accounts.
- **Full impact on industry interest margins will be noticeable in 2019**.

Regulation will remain a key theme in 2019 with the interest rate cap a key agenda item

Removal of floors on bank deposits will be largely ineffective

We do not expect the removal of interest rate caps to impact private sector credit.

Upward revision of interest rate cap likely to result in increased bank appetite for private sector credit.

We do not expect the removal of floors on deposits to increase credit to the private sector for the following reasons:

1) **Credit risk remains high** - Higher interest rate margins are unlikely to alter banks' asset allocation strategy until there is a significant improvement in asset quality.
2) **Government appetite for domestic debt remains high** - Government continues to borrow heavily from the domestic debt market to fund its fiscal deficit.

Proposed amendment to law capping lending rates

- **January 2019** - A member of parliament affiliated to the ruling party plans to introduce an amendment to the existing law that regulates lending rates.

1) Maintaining the lending cap at 4% above the CBR for low risk clients
2) Introduction of a risk negotiation window of up to 6% above the lending rate for SMEs and unsecured individual customers to negotiate pricing based on their risk profile.

2019 Outlook

- Implementation of the proposal could potentially be more impactful in increasing private sector credit for the following reasons:

1) A lending rate of 19% (assuming a 13% maximum lending rate) is above the average lending rates prior to the introduction of the interest rate caps in September 2016 (Fig.1).

Low to medium probability of the implementation of proposal on interest rate caps.

High chance of the adoption of the risk based loan pricing model.

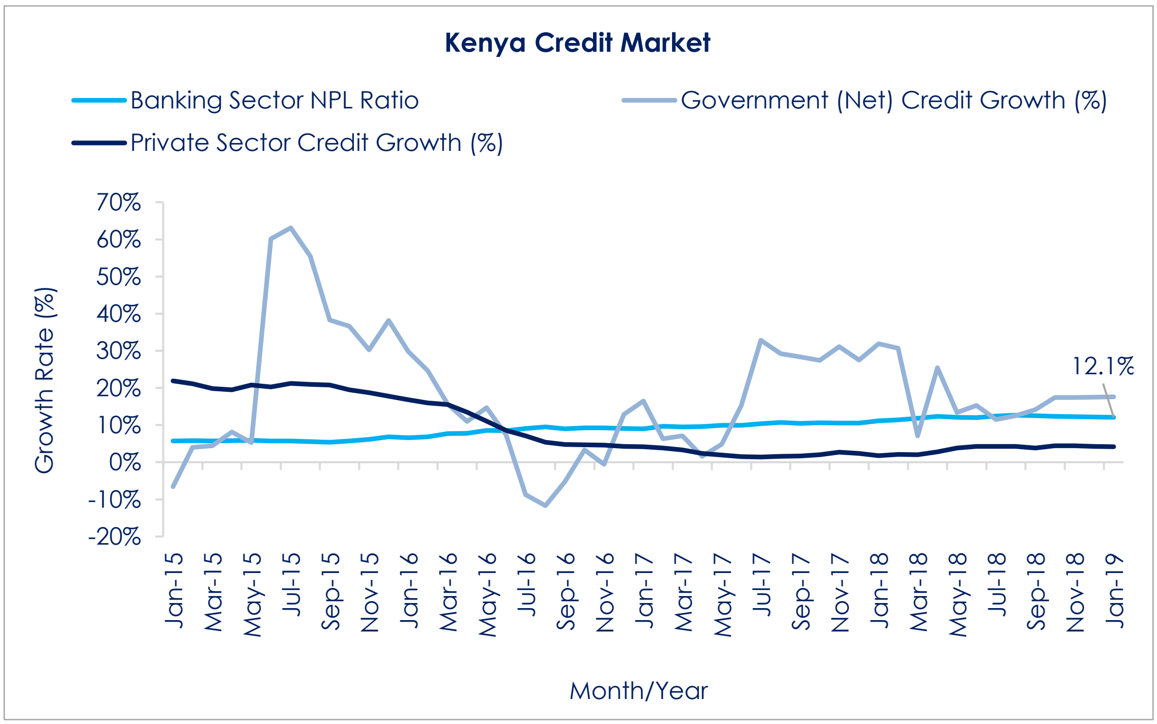
2) It is also significantly higher than the current risk free rate (9.4%) for a one year (364 day Treasury Bill) government security.

- We give the proposal a low to medium probability of implementation for the following reasons:

1) Increase in the cost of domestic debt as government competes for bank credit with the private sector this at a time government is looking to meet a growing fiscal deficit.
2) High lending rates, a problem legislators were trying to solve in the first place with interest rate caps.
3) Implementation challenges specifically how banks will determine the risk level of different customers.

- We see a comparatively higher chance of the implementation of the **Risk Based Loan-Pricing.**
- This would involve banks developing a loan pricing model that takes into consideration all historical data and risks associated with a borrower in determining credit risk and loan pricing.

Fig.1: Private sector credit low and credit quality still a concern



Source: Central Bank of Kenya, Kenya National Bureau of Statistics & World Bank

B) Asset allocation - In favour of risk free securities

Banks' preference for government securities over private sector credit remains.

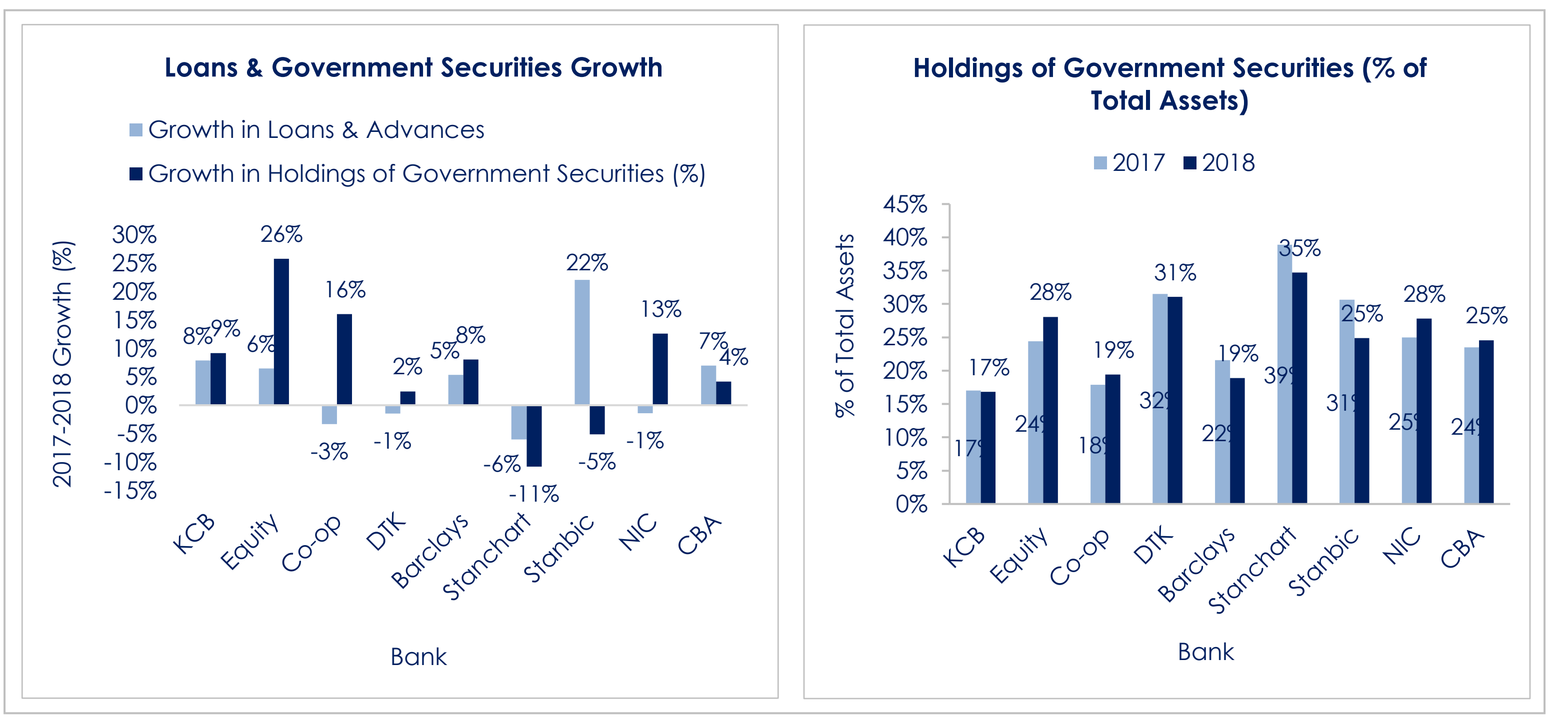
Stanbic Bank an exception growing loan book and reducing holdings of government securities.

- In the face of heightened credit risk, banks generally maintained a conservative approach to lending in favour of investment in government securities (Fig.2)
- Equity Bank and Co-op Bank recorded the highest growth rate in holdings of government securities (25.8% and 16%) to KES.161Bn and KES.80.3Bn.
- Stanbic Bank defied this trend as the bank grew its loan book by 22.1% to KES.174.9Bn while reducing its investment in government in government securities by 5.1% to KES.72.3Bn.
- Notable were Standard Chartered, Co-op, Diamond Trust Bank and NIC Bank whose loan books shrunk 6%, 3.3%, 1.5% and 1.4% during the period in consideration.
- Standard Chartered took a deviant approach with a 6% and 10.8% decline in their loan and government securities portfolio to KES.118.7Bn and KES.99.1Bn respectively.

Contrasting strategies in Holdings of Government securities

- Equity bank showed the biggest growth in an increase in the holdings of government securities as a proportion of total assets between 2017 and 2018 (24.4% to 28.1%).
- On the other hand Stanbic Bank's holdings of government securities as a proportion of total assets declined from 30.6% to 24.9% only emphasizing the bank's growing appetite for customer lending.

Fig.2: Banking interest earning asset growth analysis 2017-2018



Source: Sterling Capital Research

2019 Outlook

- We do not see a major deviation from banks' strategies with regards to lending and investment in government securities unless there is a major disruption in the operating environment.
- The major influencer would be interest rate caps and a lot would depend on the action taken be legislators in terms of the review of the existing law.
- An upward review would result in an increase in lending rates and a growing appetite of private sector credit.
- We expect banks to maintain their hold of government securities and with it a "wait and see approach" to legislation on interest rates.

C) Asset quality deterioration - A rise in sector NPLs

NPLs rose across the banking industry with trade, agriculture, real estate and retail sectors had the highest NPLs.

- The average banking sector Non-Performing Loans (NPLs ratio rose to 12.0% compared to 10.6% in 2017 (Fig.1).
- This was largely due to the impact of the challenging business environment which spilled over from 2017.
- The manufacturing, trade, agriculture, real estate and retail sectors had the highest NPLs.
- Banks have adopted stringent lending criteria and intensified debt recovery efforts aimed at improving overall asset quality.

2019 outlook

- We expect the NPL ratios for most banks to decline marginally in the short to medium term as banks strive to lend to clients with high credit scores.
- The amount of non-performing loans is expected to go up as the banks grow their loan books.

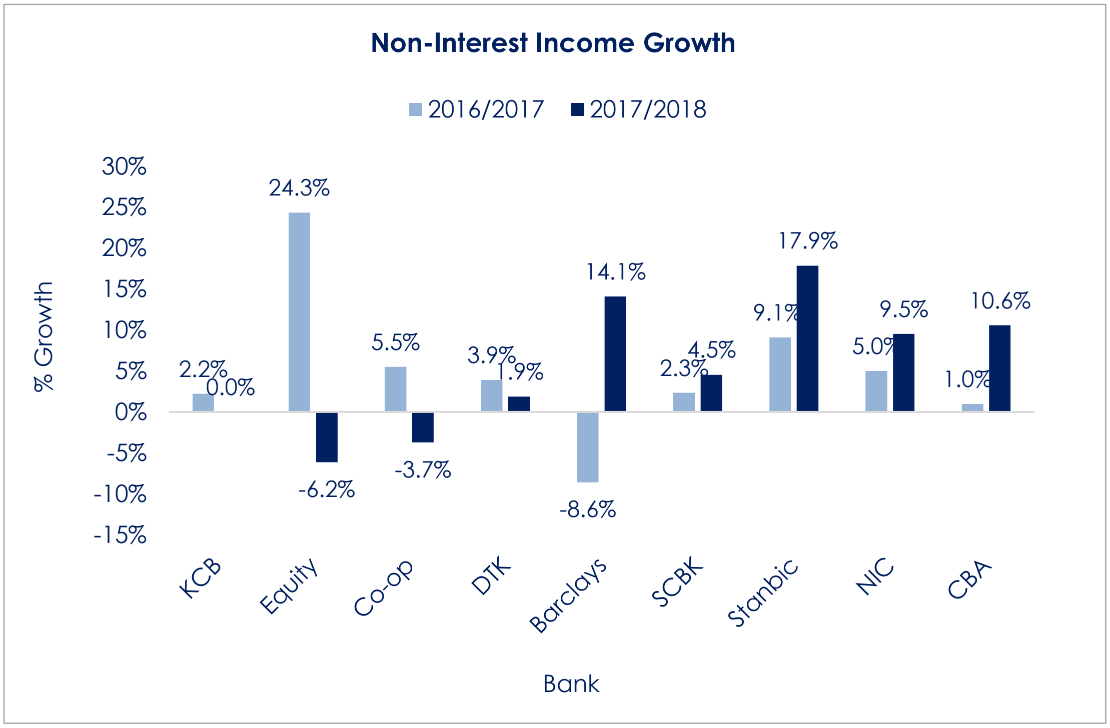
D) Mixed performance of Non-Funded Income (NFI)

NFI a key focus for banks following the introduction of interest rate caps.

Stanbic Bank and Barclays Banks were the top performers in NFI.

- The introduction of interest rate caps in 2016 had an adverse impact on interest margins and overall banking sector profitability.
- Banks diversified their income sources through Non Funded Income (NFI) (Forex trading income, fees and commissions from alternative channels such as agency banking, mobile banking and internet banking).
- For this reason we saw a sharp spike in Non-Funded Income (NFI) between 2016 and 2017 for most banks (exception being Barclays Bank).
- We saw this continued focus FY2018 with Stanbic Bank and Barclays Bank the top performers recording growth rates of 17.9% and 14.1% respectively (Fig.3).
- We draw attention to the 6.3% and 4.4% decline in NFI for Equity and Co-op to KES.25.9Bn and KES.12.9Bn respectively.
- This is attributed to IFRS 9 effective interest rate (EIR) model, which requires the amortization of the fees over the tenor of the loan.

Fig.3: Banking interest earning asset growth analysis 2017-2018



Source: Company Filings

E) Financial reporting - IFRS9

IFRS9 impacted both income recognition & reporting.

Equity Bank and CO-OP negatively affected in recognition of fees & commissions on loans and advances.

- The International Financial Reporting Standard (IFRS) 9 on Financial Instruments became effective from 1st January 2018.
- The implementation of IFRS 9 had an impact on the banking sector including;

1) Banks attempted to reduce credit risk exposure through stringent credit issuance criteria.
2) Increased focus on non-performing loans recovery.
3) Most banks reduced their provisions because the allowance for expected credit losses at the balance sheet date is calculated by considering possible defaults only for the next 12 months ("12 month ECLs"), and not the entire remaining life of the asset ("Lifetime ECLs")
4) Decline in appetite for private sector lending and increased investment in government securities.
5) Equity and Co-op bank fees and commission on loans and advances declined significantly owing to the implementation of the effective interest rate (EIR) model under IFRS, which requires the amortization of the fees over the tenor of the loan.

F) Consolidation in the Banking Sector

The proposed merger of NIC and CBA in Q3 2019 will create the 3rd largest bank in the country.

We expect further mergers & acquisitions in the near future.

- The banking sector experienced consolidation following the increased capital requirements and thinner margins after the introduction of interest rate caps in September, 2016.
- Interest rate caps compressed banks interest margins making it difficult for tier 1and tier 3 banks to operate due to declining revenue.
- Some of the mergers and acquisitions that have taken place in the industry in the last three years include;

  1) Diamond Trust Bank (DTB) acquired Habib Bank in a share swap deal in 2017.
  2) I&M Holdings buyout of Giro Commercial Bank in 2017 in a cash and stock deal.
  3) State Bank of Mauritius (SBM) acquired selected assets and matching liabilities of Chase Bank in 2018.

2019 outlook

- We expect more consolidation in the banking industry to take advantage of strategic business benefits, and to mitigate the impact of falling incomes and capital constraints.

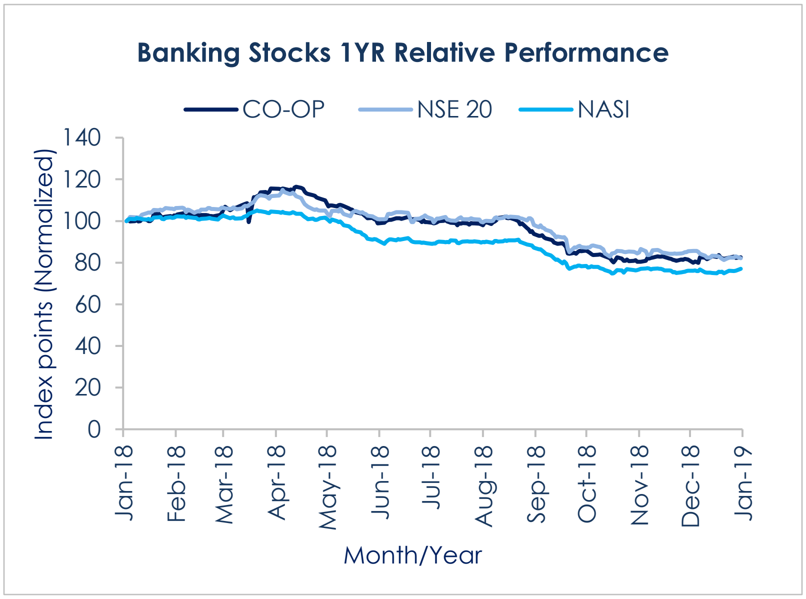
  1) Proposed merger between NIC and CBA in Q3 2019.
  2) KCB expected to acquire Imperial Bank which was placed under receivership in 2016.

- From an industry perspective, consolidation will boost financial sector stability and banks financial capacity to compete effectively.

Benchmark indices outperformed our banking index in 2018

- Kenyan banks underperformed the NASI share index over the periods under consideration.
- Our banking index, NSE-20 and NASI shed 22.9%, 17.9% and 17.5% respectively.

Fig 1: Kenyan banks underperformed the benchmark indices in 2018



Source: Nairobi Securities Exchange & Sterling Capital Research

Table 1: 2018 indices performance

Index	2018
SCL Banking Index	-22.9%
NSE-20	-17.9%
NASI	-17.5%

Source: Nairobi Securities Exchange & Sterling Capital Research

Kenya Banks FY 2018 Financial Performance Highlights

1. KCB Group Ltd

Key Financial Performance highlights

- **Profitability** - PAT up 21.8% mainly attributable to a 50.9% decline in loan loss provisions to KES.2.9Bn and 4.1% growth in interest income.
- **NFI** - remained flat at KES.23.0Bn with the 32.2% increase in fees and commissions on loans and advances to KES.7.4Bn offset by a 25.3% decline in other fees and commissions to KES.6.8Bn.
- Regional subsidiaries reported an aggregate 64% growth in PBT mainly driven by KCB Bank Tanzania (PBT from KES.19Mn to KES.777Mn) and KCB Bank Burundi up 102% to KES.220Mn. KCB Bank Rwanda however report a 25% decline to KES.424.Mn.
- **Asset Book** – Total Assets growth 10.5% to KES.714.3Bn with holdings of government securities increasing 9.2% to KES.120.1Bn and loans and advances up 7.9% to KES.455.9Bn.
- **Customer deposits** - Up 7.6% to KES.537.5Bn which led to a 14.4% increase in interest expense to KES.17.5Bn.
- **Operating Expenses** - 3.9% decline to KES.35Bn partially attributed to the decline in loan loss provisions to KES.2.9Bn and a decline in staff costs from KES.19.1Bn to KES.17.0Bn.
- **CIR** - Improvement to 48.3% from 51.0% in FY 2017.
- **Asset Quality** - 12.8% reduction in NPLs resulting in a NPL ratio of 6.9% compared to 8.5% FY 2017. This also lower than the 12% sector average.
- **Dividend** - Final dividend KES.2.50 per share, total FY2018 dividend up to KES.3.50 from KES.3.00 in FY2017.

Financial Performance

Financial Summary	FY2017	FY2018	% Change
Balance Sheet (KES.Bn)			
Loans & Advances	422.7	455.9	7.9
Government Securities	110.0	120.1	9.2
Total Assets	646.7	714.3	10.5
Customer Deposits	499.5	537.5	7.6
Shareholders' Funds	106.0	113.7	7.3
Total Liabilities	540.7	600.7	11.1
Income Statement (KES.Bn)			
Total Interest Income	63.7	66.3	4.1
Interest income from loans & advances	50.82	52.71	3.7
Interest income from Gov't Securities	12.37	12.98	4.9
Non-Funded Income	23.0	23.0	0.0
Total Operating Income	71.4	71.8	0.6
Total Interest expense	15.3	17.5	14.4
Gross NPLs	37.5	32.7	12.8
Loan Loss Provisions	5.9	2.9	50.9
Total Operating Expenses	36.4	35.0	3.9
Profit After Tax	19.7	24.0	21.8
Ratios			
Cost to Income Ratio	51.0	48.3	2.7
Loan to Deposit Ratio	85.1	84.8	0.3
NFI/Total Income	32.2	32.0	0.2
Gross NPL to Gross Loans	8.5	6.9	1.6
Government securities/Total Assets	17.0	16.8	0.2

Source: Company Filings

FY2019 Outlook

- KCB Bank has exhibited strong and consistent earnings growth averaging 11% over the last five years, this attributable to growth in key income drivers, subsidiary performance and sound business strategies during the period.
- Increased investment in digital banking business and growing presence in the fintech space and strategic partnerships (Fuliza – Safaricom and CBA) will continue to boost business growth and reduce operational costs.
- We project FY2019 PAT at around KES.26Bn on the back of growth in interest income and increased efficiency resulting in lower operating costs.
- We maintain a **BUY** recommendation on KCB with a **fair value estimate of KES.50.29** which is a 12.4% upside from the current trading price on the NSE.

2. Equity Group Holdings Ltd

Key Financial Performance highlights

- **Profitability** - PAT up 5% to KES.19.8Bn, mainly driven by a 10% increase in net interest income to KES.41.4Bn
- **Interest income from government securities** - Up 21.7% to KES.16.3Bn was the biggest driver of interest income for the period while interest income from loans and advance rose 7.5% to KES.36.2Bn.
- **NFI** - Declined by 6.3%, driven by a 16.6% decline in fees and commissions income after the bank waived the fees on its online platforms, aiming to grow its number of customers and transactions.
- **Asset Book Growth** - Holdings of government securities increased 25.7% to KES.161.0Bn while loan book grew by a relatively modest 6% to KES.297.2Bn.
- **Asset Quality** - Total Non-Performing Loans (NPLs) rose 36.6% to KES.21.1Bn resulting in a deterioration of the NPL ratio to 7.6% compared to 6.3% FY2017. This was however below the industry average of 12%.
- **Geographical diversification** - Non- Kenyan subsidiaries all posted double digit growth in profitability. Subsidiary contribution to Group PAT improved to 15% compared to14% in 2017, driven by 173% growth in DRC.
- **CIR** - Declined from 53.5% to 52.2% as a result of cost optimization which resulted in a 1% growth in total costs against a total income growth rate of 3%.
- **Dividend** – Final dividend remains KES.2 unchanged from FY 2017.

Financial Performance

Financial Summary	FY2017	FY2018	% Change
Balance Sheet (KES.Bn)			
Loans & Advances	279.1	297.2	6.4
Government Securities	128.0	161.0	25.7
Total Assets	524.5	573.4	9.3
Customer Deposits	373.1	422.8	13.2
Shareholders' Funds	93.1	95.0	1.9
Total Liabilities	431.3	478.4	10.9
Income Statement (KES.Bn)			
Total Interest Income	48.4	53.2	10.0
Interest income from loans & advances	33.9	36.4	7.5
Interest income from Gov't Securities	13.4	16.3	21.7
Non-Funded Income	27.6	25.9	6.3
Total Income	65.2	67.3	3.3
Total Interest expense	10.8	11.8	8.9
Total NPLs	15.4	21.1	36.6
Total Operating Expenses	38.3	38.8	1.4
Loan Loss Provision	3.4	3.7	8.2
Profit After Tax	18.9	19.7	4.8
Ratios			
Cost to Income Ratio	53.5	52.2	1.3
Loan to Deposit Ratio	74.8	70.3	4.5
NFI/Total Income	42.3	38.5	3.8
NPL Ratio	6.3	7.6	1.3
Liquidity Ratio	54.2	54.1	0.1

Source: Company Filings

FY2019 Outlook

- Fees and commissions on loans and advances expected to increase as the bank plans to introduce fees on its digital platforms, which will have positive impact on the banks fees and commissions leading to a reversal in the drop in non-interest income.
- We expect subsidiaries to increase their contribution to overall Group performance as a result of improved macroeconomic conditions in DRC and South Sudan.
- The bank will continue to derive the benefits of digitization and its cost and operational efficiency advantages and for this reason we expect the CIR to decline further.
- We maintain our **BUY** position on Equity Bank with a **fair value estimate of KES.45.20** on account improved earnings and diversification

3. Co-op Bank Ltd

Key Financial Performance highlights

- **Profitability** - PAT up 11.6% to KES.12.7Bn driven by a 6.6% growth in interest income to KES.43.0Bn and a 48.9% decline in loan loss provisions to KES.1.8Bn.
- **Interest income** from government securities increased by 19.2% to KES.9.8Bn while interest income from loans & advances grew 3.1% to KES.32.9Bn.
- **Interest expense** - Down 0.2% to KES.12.2Bn despite a 6.5% growth in customer deposits to KES.306.6Bn.
- **Non-funded income (NFI)** - Down 4.4% to KES.12.9Bn mainly attributable to a 77.8% decrease in fees and commissions on loans and advances to KES.0.6Bn which offset a 23.9% gain in other fees and commissions to KES.8.9Bn. The decrease in fees and commission on loans and advances was due to the implementation of the effective interest rate model under IFRS, which requires the amortization of the fees over the tenor of the loan.
- **Asset Book Growth -** Holdings of Government securities up 15.9% to KES.80.3Bn compared to loans and advances which declined 3.3% to KES.245.4Bn. Loan book decline was attributed to a repayment of KES.8.0Bn by a single client in the real estate sector.
- **Asset quality** - NPLs ratio deteriorated to 11.2% compared to 7.0% in FY2017 as a result of an increase in NPLs in manufacturing and agriculture sectors from 1.0% and 4.0% to 47.0% and 21.0% respectively the previous year.
- **Subsidiary Performance** - South Sudan unit Profit before Tax (PBT) loss of KES.30.8Mn compared to a KES.605.9Mn loss in FY2017.
- **Efficiency** - Total operating expenses increased 1.4% to KES.25.7Bn due to a 13.4% and 6.7% increase in staff costs and other operating expenses respectively. This resulted in a rise in the bank's CIR to 54.6% compared to 52.2% the previous year.
- **Dividend** - KES1.00 per share from KES.0.80 FY2017 an increase in the dividend payout ratio to 46% from 40% during the period.

Financial Performance

Financial Summary	FY2017	FY2018	% Change
Balance Sheet (KES.Bn)			
Loans & Advances	253.9	245.4	3.3
Government Securities	69.2	80.3	15.9
Total Assets	386.9	413.4	6.9
Customer Deposits	287.7	306.6	6.5
Shareholders' Funds	69.6	69.9	0.4
Total Liabilities	316.6	342.2	8.1
Income Statement (KES.Bn)			
Total Interest Income	40.4	43.0	6.6
Interest income from loans & advances	31.9	32.9	3.1
Interest income from Gov't Securities	8.2	9.8	19.2
Non-Funded Income	13.4	12.9	4.4
Total Income	41.6	43.7	5.0
Total Interest expense	12.3	12.2	0.2
Total NPLs	17.8	25.2	41.5
Loan Loss Provision	3.6	1.8	48.9
Total Operating Expenses	25.3	25.7	1.4
Profit After Tax	11.4	12.7	11.6
Ratios			
Cost to Income Ratio	52.2%	54.6%	2.4
Loan to Deposit Ratio	88.2%	80.1%	8.1
NFI/Total Income	32.4%	28.2%	4.2
NPL Ratio	7.0%	11.2%	4.2
Liquidity Ratio	33.5%	41.1%	7.3

Source: Company Filings

FY2019 Outlook

- Co-op bank wants to focus on e-credit lending as one of its revenue drivers FY2019. KES.2.0Bn was disbursed in February 2019 via e-credit, up from KES.1.0Bn in January 2019. The bank expects to lend out KES.10.0Bn per month by end of the year.
- Improvement in asset quality with a decline in non-performing loans (NPLs) in trade, manufacturing and real estate sectors.
- New IT investments and focus on digitization to drive non-funded income (NFI) growth and reduce cost to income ratio (CIR) FY2019.
- We maintain a **BUY** on **Co-op Bank** with a fair value of **KES.16.92** per share which represents a 13.2% upside from the current price (KES.14.95).

4. Diamond Trust Bank Ltd

Key Financial Performance highlights

- **Profitability** - PAT up 2.3% to KES.7.0Bn mainly driven by 3% growth in NFI to KES.5.4Bn.
- **Interest income** – Up 1.8% supported by 10.8% growth in interest income from government securities to KES.
- Interest income from loans and advances recorded a 3.1% decline to KES.22.0Bn as a result of a 1.5% shrink on the loan book.
- **NFI** – Up 3.0% driven by 1.8% increase in fees and commissions from loans and advances and 8.1% growth in other fees and commissions
- **Asset Book Growth** – 4.0% growth in total asset book to KES.377.7Bn largely driven by a 2.4% increase in holdings of Government securities to KES.117.3Bn.
- **Loan Book** – Down 1.5% to KES.193.1Bn
- **Customer Deposits** - Up 6.2% to KES.282.9Bn supported by the Group's continuing branch and network expansion.
- **Asset quality –** Total NPLS down 8.2% to KES.13.6Bn from KES.14.8Bn indicating prudence in selection of client screening.
- **Dividend -** The bank maintained its dividend payout at KES.2.60 per share.

Financial Performance

Financial Summary	FY2017	FY2018	% Change
Balance Sheet (KES.Bn)			
Loans & Advances	196.0	193.1	1.5
Government Securities	114.5	117.3	2.4
Total Assets	363.3	377.7	4.0
Customer Deposits	266.2	282.9	6.2
Shareholders' Funds	53.6	58.9	10.9
Total Liabilities	309.7	318.8	2.9
Income Statement (KES.Bn)			
Total Interest Income	34.6	35.3	1.8
Non-Funded Income	5.3	5.4	3.0
Total Income	25.0	25.5	2.0
Total Interest expense	15.0	15.2	2.0
Interest income from loans & advances	22.7	22.0	3.1
Interest income from Gov't Securities	11.7	13.0	10.8
Total NPLs	14..8	13.6	8.2
Loan Loss Provision	4.3	3.0	30.7
Total Operating Expenses	14.9	14.5	2.5
Profit After Tax	6.9	7.1	2.3
Dividend (KES.Unit)	2.6	2.6	0.0
Ratios			
Cost to Income Ratio	59.5	56.9	2.6
Loan to Deposit Ratio	73.6	68.3	5.3
NFI/Total Income	21.1	21.3	0.2
Gross NPL to Gross Loans	7.6	7.0	0.6
Liquidity Ratio	49.9	53.5	3.6

Source: Company Filings

FY2019 Outlook

- NPL ratio expected to remain relatively unchanged as the bank extends its loan book to SMEs.
- DTB received KES.7.6Bn from the African Development Bank (AFDB) to lend to SMEs and this will increase the bank's loan book.
- We maintain a **BUY** recommendation on DTB with a fair value of **KES 168.30**, an upside of 29% from the current price of KES.130.

5. Barclays Bank of Kenya Limited

Key Financial Performance highlights

- **Profitability** - Up 7% to KES.7.4Bn below our projection of KES.8.2B, attributable to a 15% growth in Non-Funded income to KES.9.7Bn, and 1% growth in interest income to KES. 22.0Bn.
- **Interest income** - Edged up by 7.0% to KES.29.1Bn from KES.27.2Bn on the back of 27.8% growth in income expense from government securities.
- **Interest Expense** - up 31.6% mainly driven by interest expense on customer deposits (+26.7%) resulting from a significant growth in customer deposits from KES186.0Bn to KES207.4Bn (+11.5%)
- **NFI -** Up 14.7% to KES.9.7Bn mainly attributable to a 65.5% increase in fees and commissions on loans and advances to KES.9.7Bn and 14.5% increase in foreign exchange trading income to KES.3.3Bn.
- **Loan book** - 5.3% growth to KES.177.4Bn, with approximately KES.10Bn disbursed through the bank's digital platform "Timiza".
- **Operating Expenses** - Up 5.8% to KES.21Bn attributable to a 24.3% increase in loan loss provisions to KES.3.9Bn. The bank however posted a cost to income ratio of 56.9% the lowest since 2016.
- **Asset Quality** - NPL ratio increased to 6.1% from 5.6% as result of default by some corporate clients.
- **Dividend** - The lender increased the final dividend per share to KES.0.90 from KES.0.80 in FY2017, resulting in a 5% increase in total dividend to KES.1.10

Financial Performance

Financial Summary	FY2017	FY2018	% Change
Balance Sheet (KES.Bn)			
Loans & Advances	168.4	177.4	5.3
Government Securities	58.5	63.2	8.1
Total Assets	271.2	334.8	19.8
Customer Deposits	186.0	207.4	11.5
Shareholders' Funds	44.1	44.2	0.2
Total Liabilities	227.1	280.6	23.6
Income Statement (KES.Bn)			
Total Interest Income	27.2	29.1	7.0
Interest income from loans & advances	21.3	21.5	1.3
Interest income from Gov't Securities	5.8	7.4	27.8
Non-Funded Income	8.5	9.7	14.7
Total Income	30.0	31.7	4.7
Total Interest expense	5.4	7.1	31.6
Total NPLs	9.4	10.8	15.7
Loan Loss Provision	3.1	3.9	24.3
Total Operating Expenses	19.9	21.0	5.8
Profit After Tax	6.8	7.4	7.1
Ratios			
Cost to Income Ratio	55.0	51.4	3.6
Loan to Deposit Ratio	91.0	86.0	5.0
NFI/Total Income	28.0	30.6	2.6
NPL Ratio	5.6	6.1	0.5
Liquidity Ratio	33.4	35.4	2.0

Source: Company Filings

FY2019 Outlook

- The retail banking business will be a key focus with products such as Timiza the bank's mobile phone based lending platform) and other digital products expected to drive business growth.
- We however expect stiff competition from other digital platforms that offer lower lending rates such as KCB M-Pesa to result in slower uptake of the product by the market.
- Focus on digitization with the bank intent on increasing non-branch transactions and this expected to be a key driver of NFI through fees and commissions.
- Increase in operating expenses expected until 2021 as a result of a rise in branding and other expenses associated with the separation from Barclays PLC.
- The bank operates on a P/E of 8.7X and P/B of 1.5X, both of which are above the industry average of 7.05X and 1.3X respectively.
- We maintain a **HOLD** recommendation guided by our fair value estimate of **KES 10.52**, a downside of 12.6% from the current price of KES.11.85.

6. Stanbic Bank Ltd

Financial Performance Highlights

- **Profitability** - PAT up 46.5% to KES.6.3Bn driven by a 15.7% growth in total income to KES.22.1Bn.
- **Interest income -** Up 14.2% boosted by 22.1% growth in loans and advances to KES.174.9Bn.
- **NFI** - Up 17.9% to KES.9.9Bn driven by increase in trading income from mark to market gains on money market and fixed income by 22% and foreign exchange gains by 13%.
- **Total operating expenses** - Up 1.8% to KES.11.1Bn with loan loss provisions recording a decline of 25% to KES.2.1Bn.
- **Asset Growth** – Contrary to the banks under review, holdings of government securities declined 5.1% to KES.72.3Bn while loans and advances increased 22.1% to KES.174.9Bn.
- **Customer deposits** - 13.5% growth to KES.219.5Bn.
- **CIR** – Cost to income ratio declined by 7% as a result of revenue (16%) growing at a higher rate than costs (2%).
- **Dividend** - Interim dividend of KES.5.80 (FY2017 KES.5.25).

Financial Performance

Financial Summary	FY2017	FY2018	% Change
Balance Sheet			
Loans & Advances	143.3	174.9	22.1
Government Securities	76.2	72.3	5.1
Total Assets	248.7	290.6	16.8
Customer Deposits	193.4	219.5	13.5
Shareholders' Funds	42.9	44.6	3.9
Total Liabilities	205.8	245.9	19.5
Income Statement			
Net Interest Income	10.6	12.1	14.2
Non-Funded Income	8.4	9.9	17.9
Total Income	19.1	22.1	15.7
Loan Loss Provision	2.8	2.1	25.0
Total Operating Expenses	10.9	11.1	1.8
Profit Before Tax	5.4	8.9	64.8
Profit After Tax	4.3	6.3	46.5
Ratios			
Cost to Income Ratio	57.2	50.2	7.0
Loan to Deposit Ratio	74.1	79.7	5.6
NFI/Total Income	43.9	44.8	0.9
NPL Coverage Ratio	36.7	31.3	5.4
Liquidity Ratio	52.4	58.0	5.6
Government Securities/ Total Assets	30.6	24.9	5.7

Source: Company Filings

FY2019 Outlook

- We forecast 19.1% growth in Profit after Tax (PAT) in FY2019 to KES.7.5Bn driven by non-funded income.
- We expect the well-diversified business to accelerate Non-Funded Income (NFI) growth particularly the Investment banking business and foreign exchange income.
- NFI contributed 45% of total income in FY2018 compared to 44% in FY2017.
- Focus on cost management initiatives and Investment in technology based distribution platforms are amongst other reasons for expected improvement in earnings.
- We maintain a **BUY** on Stanbic Bank on the back of its relatively low P/E and P/B multiple 5.9x and 0.9x below the industry averages of 7.3x and 1.3x respectively and a fair value estimate of **KES.104**.

7. Standard Chartered Bank Ltd

Key Financial Performance highlights

- **Profitability** – PAT Up 17.4% supported by a 10.6% increase in interest income from government securities to KES.12.5Bn and 4.5% growth in NFI to KES.9.2Bn.
- **Interest income** - Interest income from loans and advances declined 3.7% to KES.13.1Bn a trend we observed in their half year results.
- **NFI** - Up 4.5% to KES.9.2Bn driven by other fees and commissions up 15.9% to KES.5.1Bn and foreign exchange trading income up 6.7% to KES.2.8Bn.
- **Total operating expenses** - Declined 2.9% to KES.16.8Bn on the back of a 54.8% decline in loan loss provisioning to KES.1.9Bn from KES.4.2Bn.
- **Asset Growth** - We observe a marginal decline in assets by 0.1% due to loans and government securities recording a decline of 6.0% to KES.118.7Bn and 10.8% to KES.99.1Bn respectively.
- **Asset Quality** - Gross NPLs rose 22.9% to KES.21.7Bn.
- **Customer deposits** – 5.2% jump to KES.224.3Bn resulting in an improved liquidity position.
- **Dividend** - Final Dividend of KES.14.0 to be paid on 23rd May, 2019 contributing to a total dividend of KES.19.0 for FY2018 (FY2017 - KES.17).

Financial Performance

Financial Summary	FY2017	FY2018	% Change
Balance Sheet			
Loans & Advances	126.3	118.7	6.0
Government Securities	111.1	99.1	10.8
Total Assets	285.7	285.4	0.1
Customer Deposits	213.3	224.3	5.2
Shareholders' Funds	45.7	46.6	1.9
Total Liabilities	240.1	238.8	0.5
Income Statement			
Total Interest Income	26.3	26.9	2.3
Interest income from loans & advances	13.6	13.1	3.7
Interest income from Gov't Securities	11.3	12.5	10.6
Non-Interest Income	8.8	9.2	4.5
Total Income	27.3	28.6	4.8
Total Interest expense	7.7	7.5	2.6
Total NPLs	11.3	13.9	23.0
Loan Loss Provision	4.2	1.9	54.8
Total Operating Expenses	17.3	16.8	2.9
Profit After Tax	6.9	8.1	17.4
Ratios			
Cost to Income Ratio	63.4	58.7	4.7
Loan to Deposit Ratio	59.2	52.9	6.3
NFI/Total Income	32.2	32.2	0.0
Liquidity Ratio	58.7	66.6	7.9
Government Securities/ Total Assets	38.9	34.7	4.2

Source: Company Filings

FY2019 Outlook

- FY2019 PAT forecasted at KES.10.0Bn (FY2018 KES.8.1Bn) supported by improved operational efficiency and interest income from government securities.
- Operating expenses to decline in FY2019 resulting in a lower cost to income ratio due to the bank's "organizational transformation journey" aimed at management of operational cost and also due to a reduced loan loss provision.
- We maintain our fair value estimate of **KES.192 which is 6.7% above the current share price** and recommend a **HOLD** on the stock.

8. NIC Bank Ltd

Key Financial Performance Highlights

- **Profitability** - 2.4% increase in Profit after Tax (PAT) to KES.4.2Bn mainly attributable to a 30.8% increase in interest income from government securities to KES.6.8Bn and 9.5% growth in non-interest income to KES.4.6Bn.
- **Interest income** - Up 4.9% driven by a 30.8% growth in income from government securities which offset a 6.1% decline in interest income from loans and advances to KES.12.3Bn.
- **Interest expense** - Up 14.5% to KES.8.7Bn, following a 20.6% (KES.7.2Bn) increase in interest expense in customer deposits which grew by 4.0% to KES.144.5Bn.
- **NFI** - Up 9.5% to KES.4.6Bn mainly driven by 10.2% (KES.1.3Bn) growth in foreign exchange trading income and 8.0% (KES.1.5Bn) increase in fees and commission on loans.
- NFI to total income stood at 30.5% FY2018 compared to 27.9% in 2017.
- **Total assets** - Expanded marginally by 1.1% to KES.208.5Bn driven by 12.6% growth in holdings of government securities to KES.58.0Bn. The loan book contracted by 1.4% to KES.118.1Bn.
- **Operating Expenses** – Rose marginally by 1.1% to KES.9.4Bn largely driven by 13.6% increase in staff costs to KES.3.6Bn which offset the 21.0% decline in loan loss provisions to KES.2.4Bn.
- **CIR** – Declined to 46.3% from 42.6% FY2017 owing to 14.5% and 1.1% increase in interest expense and operating expenses respectively.
- **Asset Quality** - Gross Non-Performing Loans (NPLs) grew 17.5% to KES.16.8Bn. The NPL ratio deteriorated to 13.4% compared to 11.3% FY2017. This is one of the highest amongst our comparable banks and above the industry average (12.0%).
- **Dividend** - The bank announced a dividend of KES.1.25 per share same as FY2017.

Financial Performance

Financial Summary	FY2017	FY2018	% Change
Balance Sheet (KES.Bn)			
Loans & Advances	119.8	118.1	1.4
Government Securities	51.5	58.0	12.6
Total Assets	206.2	208.5	1.1
Customer Deposits	138.9	144.5	4.0
Shareholders' Funds	34.7	35.8	3.2
Total Liabilities	171.5	172.7	0.7
Income Statement (KES.Bn)			
Interest Income	18.4	19.3	4.9
Interest income from loans & advances	13.1	12.3	6.1
Interest income from Gov't Securities	5.2	6.8	30.8
Non-Interest Income	4.2	4.6	9.5
Total Income	14.9	15.2	2.0
Total Interest Expense	7.6	8.7	14.5
Total NPLs	13.0	16.8	17.5
Loan Loss Provision	3.0	2.4	20.0
Total Operating Expenses	9.3	9.4	1.1
Profit After Tax	4.1	4.2	2.4
Ratios			
Cost to Income Ratio	42.6	46.3	3.7
Loan to Deposit Ratio	86.2	81.7	4.5
NFI/Total Income	27.9	30.5	2.6
NPL Ratio	11.1	13.4	2.3
Liquidity Ratio	48.2	48.7	0.5

Source: Company Filings

FY2019 Outlook

- We expect the bank to increase its focus on improving its asset quality through an enhanced credit appraisal process and loan recovery efforts.
- The proposed merger between NIC and Commercial Bank of Africa (CBA) will create the third largest asset book with increased interest income expected in the medium and long term.
- However, we are cautious about the short term impact of the merger in terms of merger related costs and the ability of the merged entity to derive immediate advantage of the business and operational benefits of the merger.
- The bank trades on a forward P/E of 6.1x and a P/B of 0.7x against sector average P/E of 7.1x and P/B of 1.3x.
- We recommend a **BUY** on **NIC Group Plc** based on a fair value estimate of **KES.43.46** a 19.6% upside from the current market price of KES.36.35.

9. Commercial Bank of Africa

Key Financial Performance Highlights

- **Total Assets** - The balance sheet contracted 0.3% to KES.245.1Bn due to a 29% (KES.12.0Bn) decline in balances due from CBK which offset a 7.2% and 4.2% growth in loan and advances and government securities to KES.121.5Bn and KES.60.2Bn respectively.
- **Profitability** - PAT down 9.7% to KES.5.0Bn mainly attributable to a 2.5% (KES.11.6Bn) decrease in interest income from loans and advances and 11.3% rise in operating expenses.
- **Interest income** – Went up marginally by 0.2% driven by a 7.2% (KES.7.4Bn) growth in interest income from government securities which offset a 2.5% decline in interest income from loans and advances (KES.11.6Bn).
- **NFI** - Up 10.6% to KES.11.5Bn mainly driven by 15.4% (KES.6.7Bn) growth in fees and commission from loans and advances and 3.9% (KES.2.4Bn) increase in foreign exchange trading income. NFI to total income increased to 54.2% FY2018 from 51.9% in 2017.
- **Operating Expenses** - Rose by 11.3% to KES.14.8Bn owing to 44.5% and 21.7% increase in other operating expenses and loan loss provisions to KES.5.0Bn and KES.3.7Bn respectively.

Financial Performance

Financial Summary	FY2017	FY2018	% Change
Balance Sheet (KES.Bn)			
Loans & Advances	113.6	121.5	7.0
Government Securities	57.8	60.2	4.2
Total Assets	245.8	245.1	0.3
Customer Deposits	193.8	196.5	1.4
Shareholders' Funds	30.1	30.6	1.7
Total Liabilities	215.7	214.5	0.6
Income Statement (KES.Bn)			
Interest Income	19.4	19.4	0.2
Interest income from loans & advances	11.9	11.6	2.5
Interest income from Gov't Securities	6.9	7.4	7.2
Non-Interest Income	10.4	11.5	10.6
Total Income	20.1	21.2	5.5
Total Interest Expense	9.8	9.7	1.0
Total NPLs	11.9	12.0	0.8
Loan Loss Provision	3.1	3.7	19.4
Total Operating Expenses	13.3	14.8	11.3
Profit After Tax	5.5	5.0	9.7
Ratios			
Cost to Income Ratio	51.2	52.1	0.9
Loan to Deposit Ratio	58.6	61.8	3.1
NFI/Total Income	51.9	54.2	2.3
NPL Ratio	8.5	8.0	0.5
Liquidity Ratio	50.4	47.5	2.9

Source: Company Filings

FY2019 Outlook

- The proposed merger of NIC and CBA is likely to define its long term prospects but this merger is expected in Q3 2019 and unlikely to have a major impact on the CBA's financial performance FY2019.
- We expect significant growth in commission Income FY2019 from the bank's mobile lending product, "M-Shwari" and the mobile advance product "Fuliza".
- Income earned is classified under **"Fees and commissions on loans and advances."**
- Focus will also be directed to Improving asset quality that is similar to the industry' average.

FY2019 Bank Financial Performance Summary

Bank	KCB	Equity	Co-op	DTB	Barclays	Stanbic	Stanchart	CBA	NIC
Balance Sheet									
Loans & Advances	455.9	297.2	245.4	193.1	177.4	174.9	118.7	121.5	118.1
Government Securities	120.1	161.0	80.3	117.3	63.2	72.3	99.1	60.2	58.0
Total Assets	714.3	573.4	413.4	377.7	334.8	290.6	285.4	245.1	208.5
Customer Deposits	537.5	422.8	306.6	282.9	207.4	219.5	224.3	196.5	144.5
Shareholders' Funds	113.7	95.0	69.9	58.9	44.2	44.6	46.6	30.6	35.8
Total Liabilities	600.7	478.4	342.2	318.8	280.6	245.9	238.8	214.5	172.7
Income Statement									
Total Interest Income	66.3	53.2	43.0	35.3	29.1	-	26.9	19.4	19.3
Interest income from loans & advances	52.7	36.4	32.9	22.0	21.5	-	13.1	11.6	12.3
Interest income from Government Securities	12.9	16.3	9.8	13.0	7.4	-	12.5	7.4	6.8
Net Interest Income	48.8	41.4	30.8	20.0	21.9	12.1	19.4	9.7	10.6
Non-Interest Income	23.0	25.9	12.9	5.4	9.7	9.9	9.2	11.5	4.6
Total Income	71.8	67.3	43.7	25.5	31.7	22.1	28.6	21.2	15.2
Total NPLs	32.7	21.1	25.2	13.6	10.8		13.9	12.0	16.8
Loan Loss Provision	2.9	3.7	1.8	3.0	3.9	2.1	1.9	3.7	2.4
Total Operating Expenses	35.0	38.8	25.7	14.5	21.0	11.1	16.8	14.8	9.4
Profit After Tax	24.0	19.7	12.7	7.1	7.4	6.3	8.1	5.0	4.2
Ratios									
Cost to Income Ratio	48.3	52.2	54.6	56.9	51.4	50.2	58.7	52.1	46.3
Loan to Deposit Ratio	84.8	70.3	80.1	68.3	86.0	79.7	52.9	61.8	81.7
NFI/Total Income	32.0	38.5	28.2	21.3	30.6	44.8	32.2	54.2	30.5
NPL Ratio	6.9	7.6	11.2	7.0	6.1		18.3	8.0	13.4
Liquidity Ratio	29.4	54.1	41.1	53.5	35.4	58.0	66.6	47.5	48.7
Valuation Ratios									
Share Price	44.25	42.50	14.95	130.00	11.85	97.00	205.75	-	36.35
P/E Ratio	5.7	7.9	7.1	5.13	8.7	6.1	8.9	-	6.1
P/B Ratio (X)	1.2	1.7	1.3	0.7	1.5	0.9	1.5	-	0.7
Dividend Yield (%)	7.9	4.7	6.7	2.0	9.3	6.0	9.2	-	3.4
ROA (%)	3.5	3.6	3.2	1.9	2.3	2.3	2.8	2.04	2.0
ROE (%)	21.9	21.1	18.3	12.0	16.8	14.3	17.6	16.3	12.1

Source: Company Filings

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