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STERLING CAPITAL LIMITED

Kenya Banking Sector

HY2020 Earnings Update
Review & Outlook

October 2020

"Pandemic bites as profitability falls"

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For important disclosures refer to the disclosures section located at the end of this report.

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Executive Summary

- Our half year 2020 (HY20) banking sector earnings update and outlook report titled **"Pandemic bites as profitability falls"** reviews the financial performance of selected banks and that of the economy for the period ending June 2020.
- This was perhaps the most difficult operating environment characterized by the negative impact of the COVID-19 pandemic on both the economy and the banking sector.
- The report begins with a brief summary of the main factors affecting the banking sector, interest rates and monetary policy.
- Also reviewed is the performance of selected banks on the basis of different performance metrics including total assets, customer deposits, total interest income, asset quality and overall profitability amongst others.
- The report gives forecasted performance for the covered banks also giving a performance outlook, fair value estimates and investment recommendations.
- In the conclusion of the report, we set our expectations for the banking sector FY20 including key risks whilst mentioning the banks we see as providing the best investment value for investors on account of price appreciation and dividend payouts.

1. ECONOMIC PERFORMANCE

- The Kenyan economy performed dismally during the period under focus due to the COVID-19 (Corona virus) pandemic and the locust attack that affected the country's agricultural produce at the beginning of the year.
- First quarter GDP 2020 (Jan to March) was 4.9% lower than the same period in 2019 (5.5%) with GDP in the second quarter expected to decline further following the implementation of measures aimed at containing the spread of the pandemic including curfews and business closures.
- World Bank forecasts 2020 Gross Domestic Product (GDP) at between 1% and 1.5% a decline from 5.4% in 2019 and the 5.7% average for 2015 - 2019.
- Major risks to economic growth include a global economic recession that has affected the country's inflows from exports, diaspora remittances and tourism.
- In addition, the pandemic has disrupted economic activity with most sectors of the economy operating below full capacity leading to a decline in income from business and employment.
- On the fiscal side, declining Government revenues largely through lower tax collection and increased expenditure to contain the pandemic has resulted in a spike in public debt.
- Inflation rose slightly during the period in focus with 12-month inflation averaging 5.8% compared to 5.1% over the same period in 2019.
- The Kenya Shilling (KES) depreciated against major global currencies with the local currency trading 5.1% lower against the United States Dollar (US$) at KES.106.42.
- Overall, the recovery of the economy highly depends on the containment of the pandemic and the resumption of normal economic activity.

2. OVERALL BANKING SECTOR PERFORMANCE

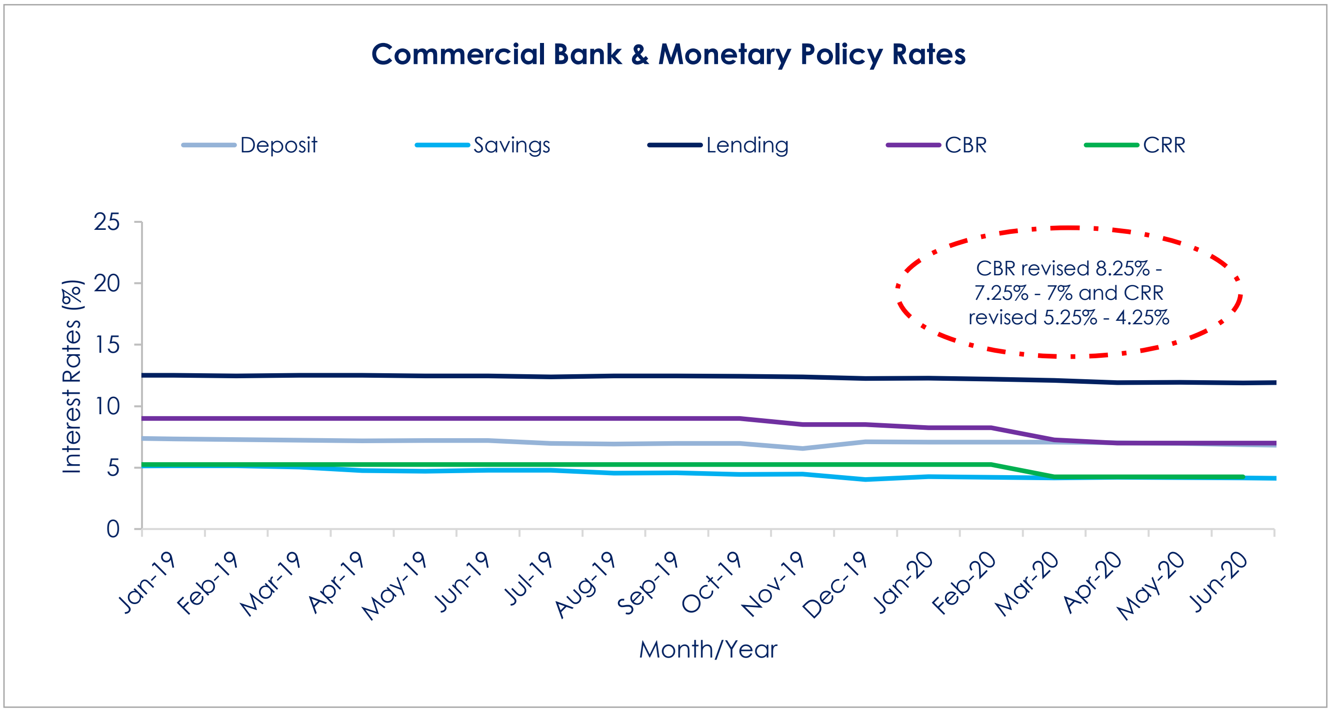
A) Interest rates

Commercial bank lending and deposit rates declined

Commercial bank interest rates declined marginally during the period in review due to downward revision of monetary policy rates.

- Commercial bank interest rates have declined marginally over the period in review with average lending, savings and deposit rates at the end of June 2020 at 12.06%, 4.19% and 7% compared to 12.49%, 4.93% and 7.23% at the end of the same period in 2019 respectively (Figure.1).
- We attribute this trend largely to revision of monetary policy rates and the resulting decline in T-Bill rates.
- The removal of caps on lending rates in October 2019 did not result in an increase in lending rates due to CBK emphasis on banks reporting their loan pricing formula.
- Average deposit and savings rates have moved in tandem with lending rates as banks looked to maintain interest rate margins in the face of falling short-term domestic debt interest rates.
- We also feel that poor economic performance worsened by the pandemic negatively impacted both demand and supply for credit due to concerns over credit risk by banks and repayment by potential borrowers thus explaining the trend in interest rates during the period under review.

Figure.1: Commercial bank deposit rates relatively stable during the period under review



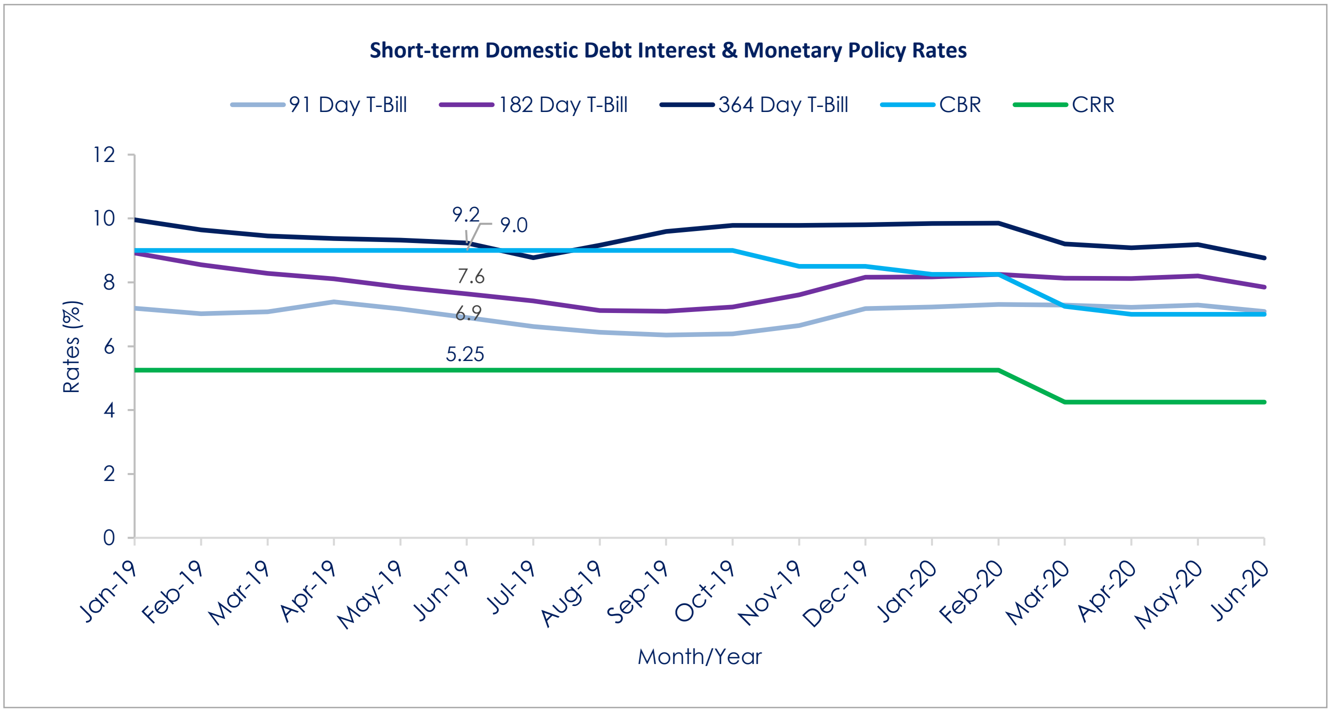
Source: Central Bank of Kenya

Domestic debt interest rates remained relatively low

Domestic debt interest rates fell sharply due high market liquidity and monetary policy

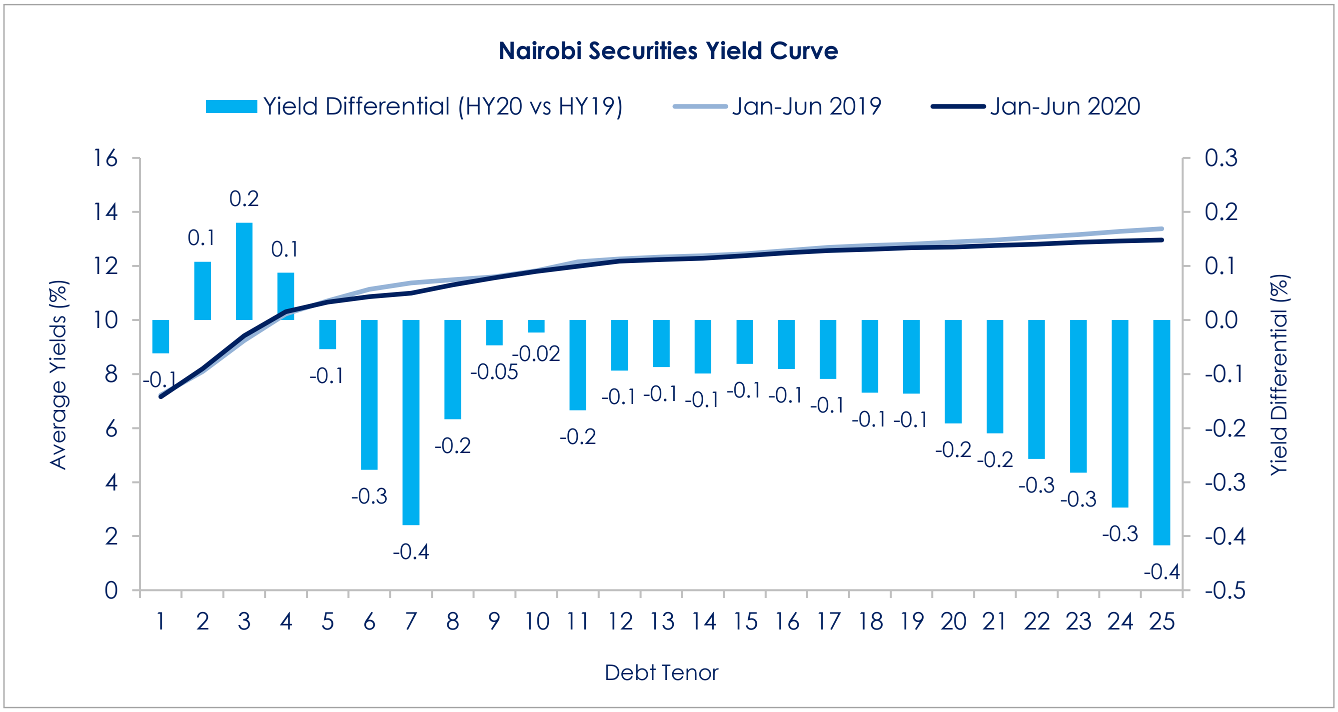
- Interest rates on domestic debt especially short-term debt - Treasury Bills (T-Bills) have declined over the last one year largely due to downward revisions of the Central Bank Rate (CBR) and the one-off cut in the Cash Reserve Ratio (CRR) (Figure.1).
- The revisions directly impacted commercial bank liquidity which in turn resulted in a sharp spike in demand for Government securities in primary T-Bill auctions with the Central Bank of Kenya (CBK) using this to push down interest rates (by rejecting high investor bids in primary debt auctions) – (Figure.2).
- The decline in interest rates is also evident in longer dated Government debt as shown by the Nairobi Securities Exchange (NSE) yield curve which shifted downwards (Figure.3).

Figure.2: Interest rates stable since caps were introduced but trending downwards in recent weeks



Source: Central Bank of Kenya

Figure.3: Yields on long-term debt have declined during the period under review



Source: Central Bank of Kenya

B) Monetary Policy

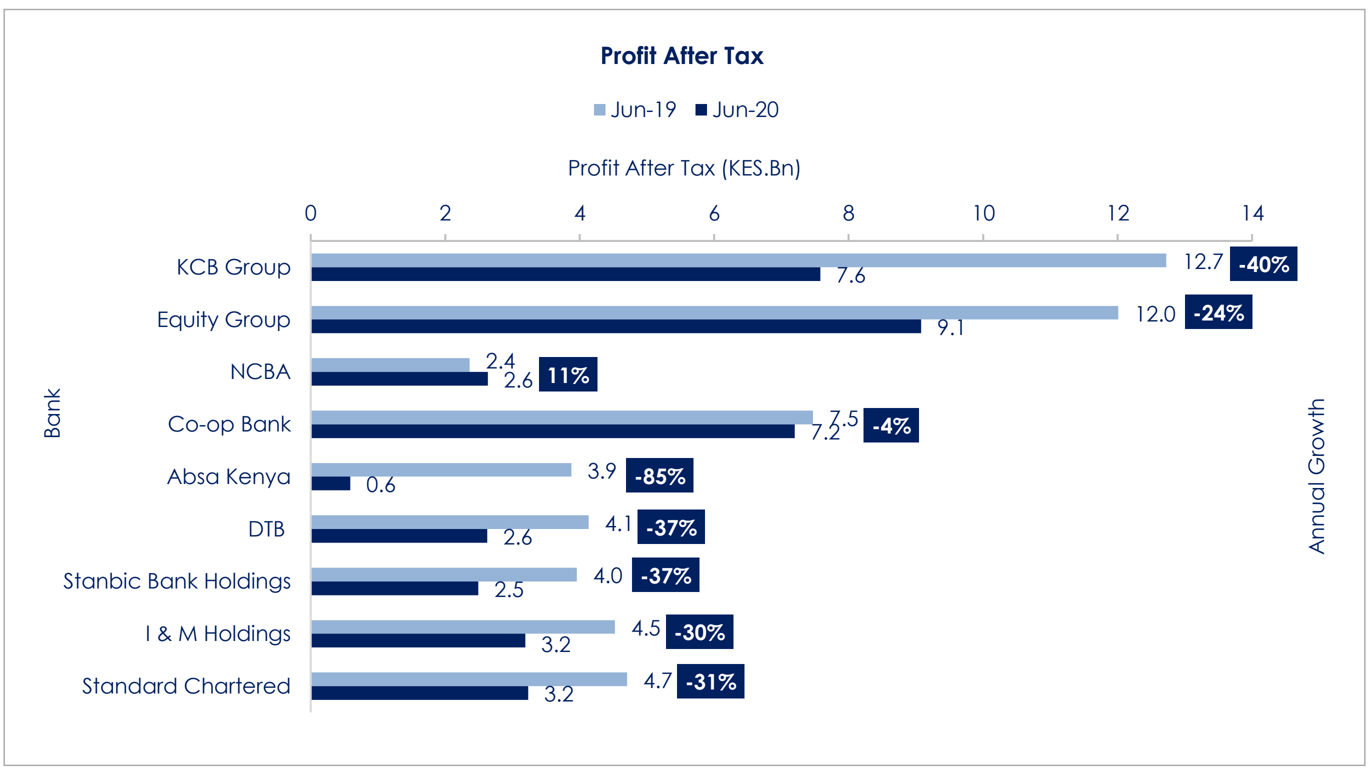
- Monetary policy changed regularly during the period under review with both the Central Bank Rate (CBR) and the Cash Reserve Ratio (CRR) revised downwards.
- The CBR was revised four times from 9% to 7% while the CRR was revised once from 5.25% to 4.25% with the main objective being to stimulate liquidity in the economy and therefore spur economic activity.

3. KENYA BANKING SECTOR HY20 FINANCIAL PERFORMANCE REVIEW

- Overall financial performance of the banking sector for the period ending June 2020 fell well below our expectations and that of the same period in 2019 with the economic impact of the COVID-19 pandemic negatively impacting business performance and particularly asset quality.

- **Profit After Tax (PAT)** - Our selected banks reported a 30.8% decline in PAT compared to a 6.9% increase over the same period in 2019. (Figure.4).
- This decline was largely due to a significant increase in loan loss provisions compared to the previous period with some banks also showing slow growth in both interest and Non-Funded Income (NFI) during the period in review.
- Absa Bank Kenya stands out amongst our banks in review reporting an 85% decline in PAT to KES.0.6Bn, largely due to a 228% increase in loan loss provisions to KES.5.4Bn (HY 2019 - KES.1.6Bn).
- KCB Group the region's largest bank reported a 40% decline in PAT to KES.7.6Bn with total operating expenses up 56% to KES.32Bn.
- Decline in profitability saw KCB, Standard Chartered, Stanbic and Absa, withhold interim dividends for the period as had been customary in recent years.

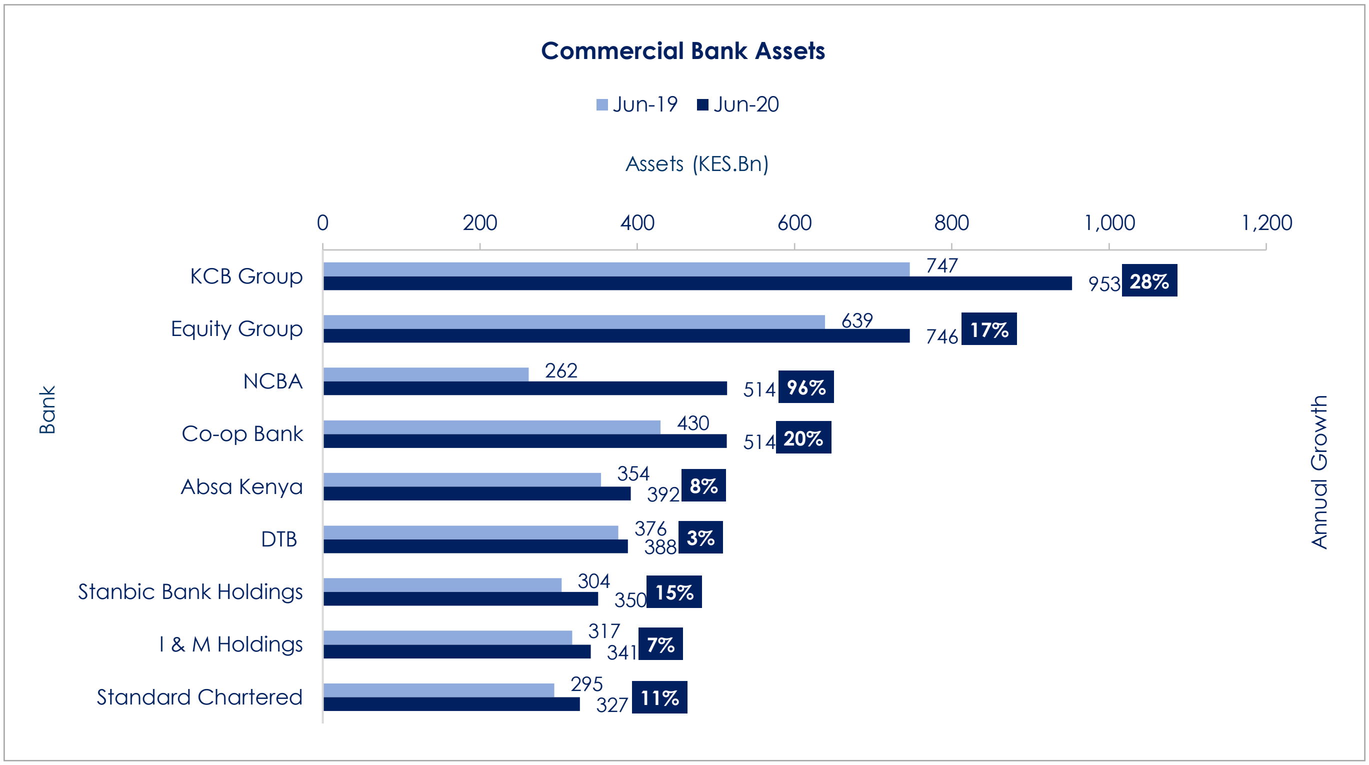
Figure.4: Overall banking sector profitability falls sharply



Source: Central Bank of Kenya

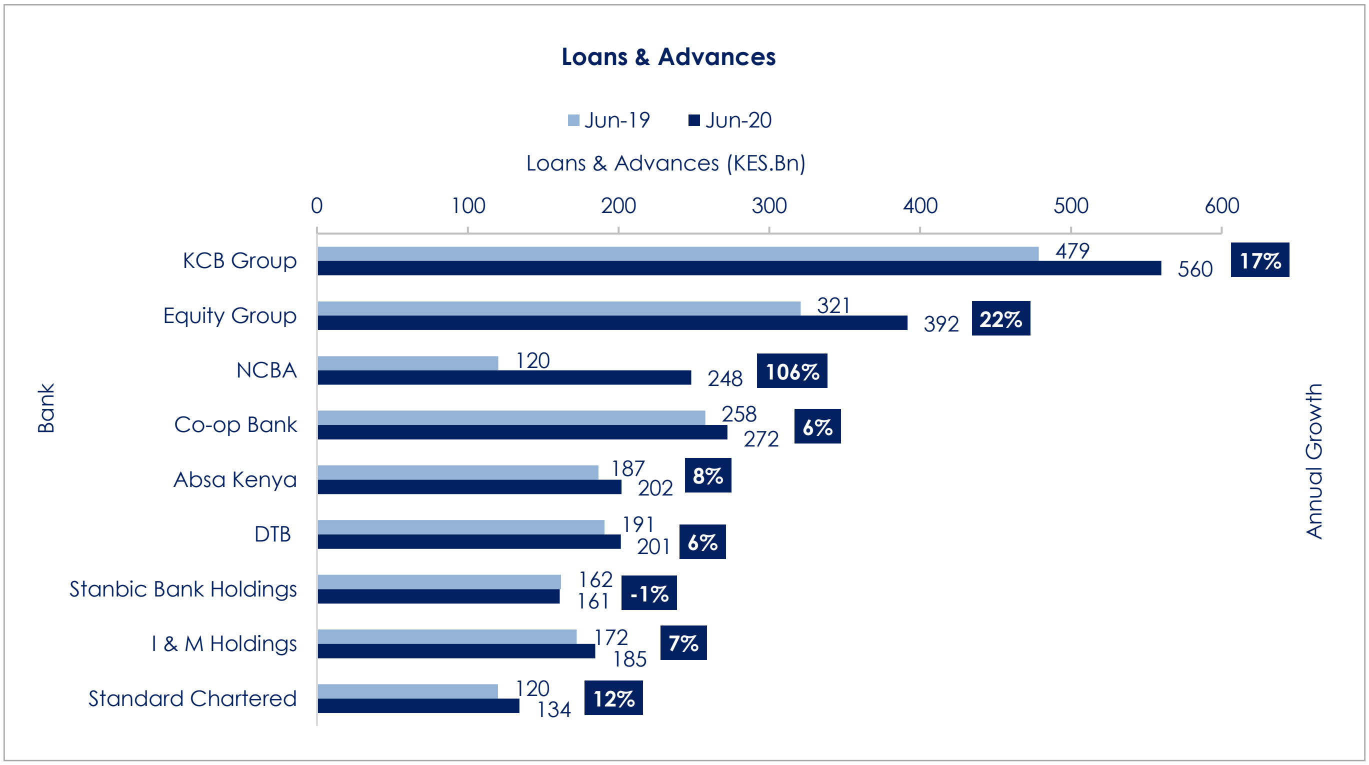
- **Asset growth** - All banks in focus reported positive growth in total assets (Figure.5).
- KCB is on its way to become the first KES.1Tn bank in assets having reported a 28% growth in total assets to KES.953Bn.
- On the other hand, DTB reported a modest 3% growth in total assets to KES.388Bn during the period under review.
- The growth in assets during this period can be linked to both growth in **loans and advances** (Figure.6) as well as **Government securities** (Figure.7).
- KCB and Co-op banks attributed the growth in loans and advances during the period to personal lending via mobile phones while Standard Chartered and I & M attributed growth to increased lending to the corporate customer segment.
- Equity's 22% loan book growth was the result of aggressive SME lending in Q1 with the bank reporting a 3.3% growth in Q2 as it directed more funds towards government securities.
- Stanbic's loan book shrunk on declining yields with the bank recording steep growth in balances with CBK and other banking institutions (+38.5% - KES.22.3Bn and +167.7% - KES.24.9Bn).
- The bank appears to prefer to invest in liquid assets as opposed to investing in other asset classes in the current economic environment.
- NCBA and DTB's loan book was driven by the corporate sector, asset finance and digital lending.
- KCB reported the biggest growth in holdings of Government securities with all investment assets recognized as held at amortized cost or fair value through other comprehensive income to minimize potential losses in interest income that would be reported in the profit and loss accounts if the investments were held for dealing purposes in this period of declining interest rates.

Figure.5: Banks continue to report asset growth



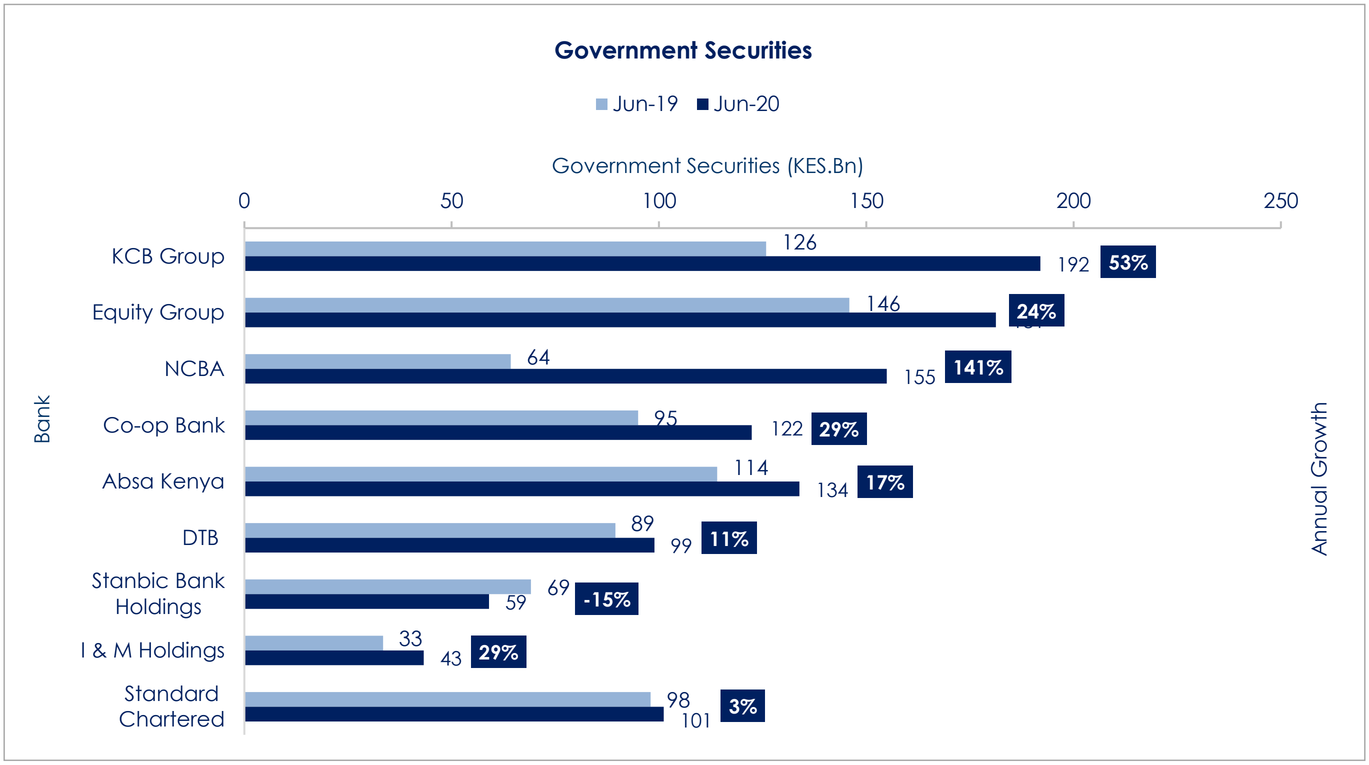
Source: Central Bank of Kenya

Figure.6: Most banks reported positive growth in loans and advances



Source: Central Bank of Kenya

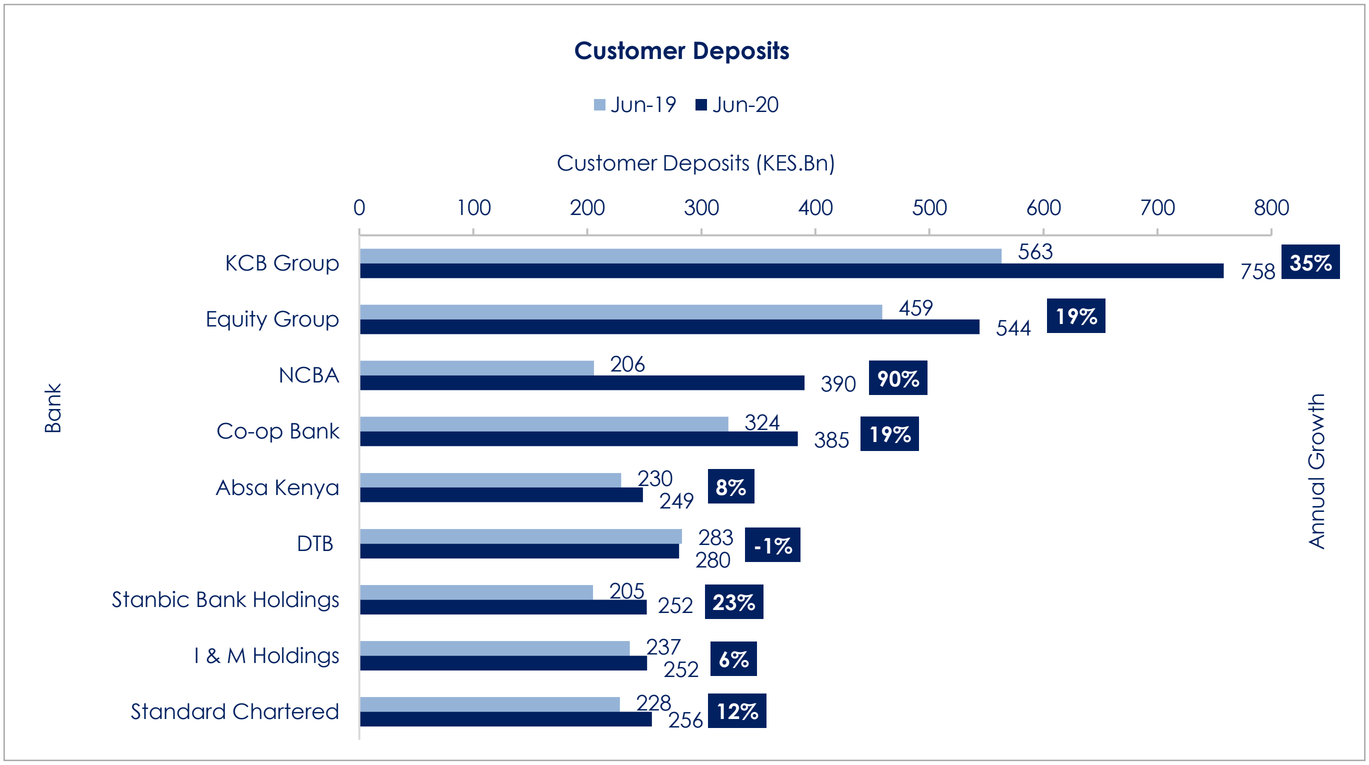
Figure.7: Commercial banks increased their holdings of Government securities



Source: Central Bank of Kenya

- **Customer Deposits** - Strong growth reported by the banks with the exception of DTB which recorded a 1% decline (Figure.8).
- DTB has not reported growth in this area in the last two half year reporting periods.
- KCB was the top pick reporting a 35% growth in customer deposits to KES.758Bn.
- We observe that banks took a conservative investment approach choosing to grow their portfolios of investment securities at the expense of lending to their customers.

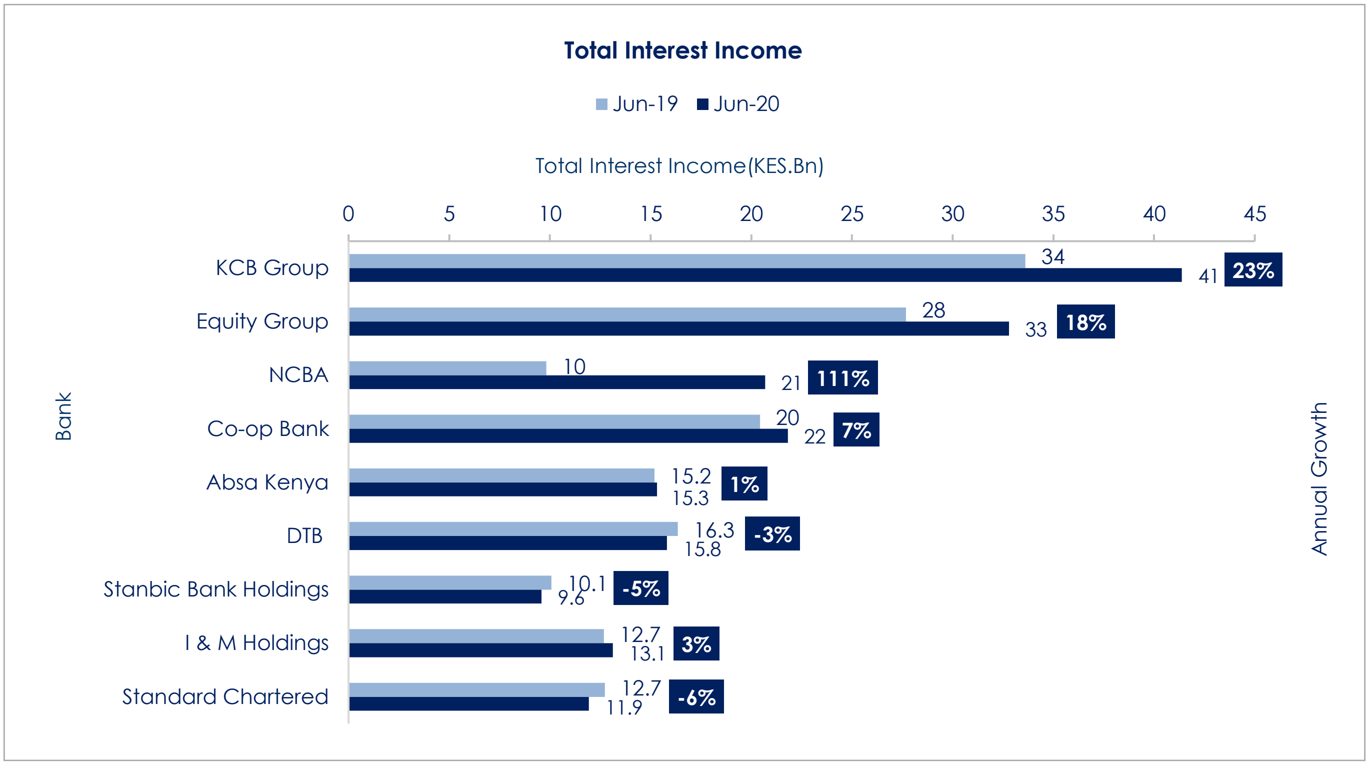
Figure.8: Banks report strong growth in customer deposits



Source: Central Bank of Kenya

- **Interest income** - Four of the nine banks we cover reported a decline in total interest income with KCB (23%) and Equity (18%) the top performers at KES.41Bn and KES.33Bn respectively (Figure.9).
- We attribute this trend to the decline in average lending and short-term domestic debt interest rates.
- Most banks taking a conservative investment approach reported modest growth in total interest income due to slow loan book, low lending rates and declining interest rates on Government securities.

Figure.9: Interest income - Mixed performance by banks



Source: Central Bank of Kenya

Figure.10: Interest income negatively impacted by slow loan book growth, debt restructuring and low interest rates

Figure.10 (a)

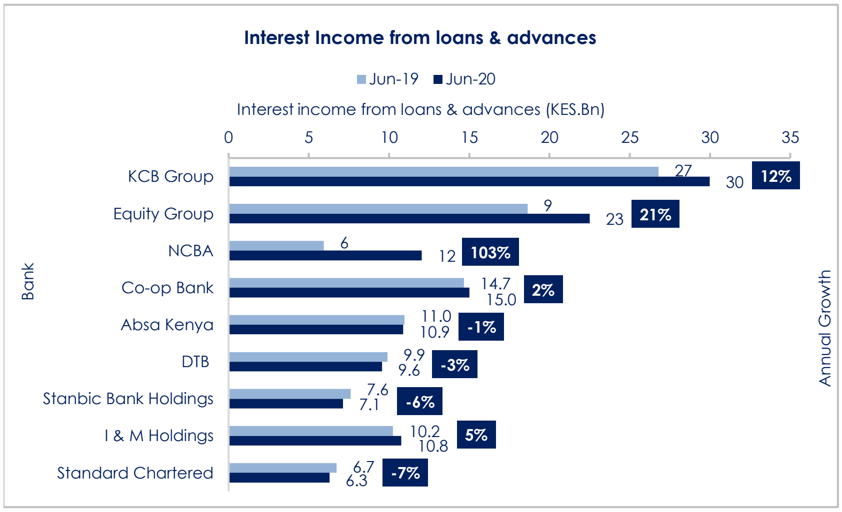
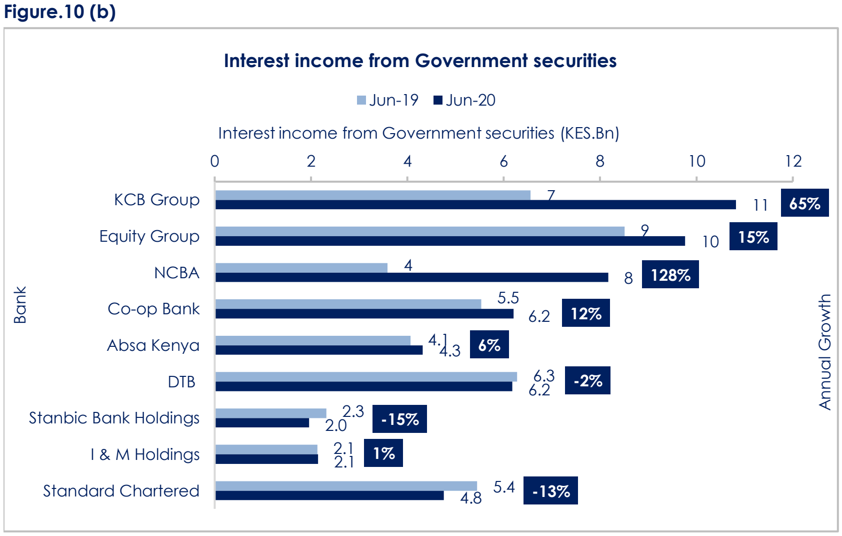


Figure.10 (b)



Interest Income

Loans & advances

- Modest growth in interest income from loans and advances due to slow loan book growth and comparatively lower lending rates (Figure.10 (a)).
- Restructuring of loans as directed by the CBK with KES.1.12Tn (38% of the banking sector loan book) reported as restructured loans as at the end of August 2020 resulted in a significant loss of interest income.
- Increased loan defaults due to poor economic performance during the reporting period.
- Equity bank recorded double digit loan book growth and interest income from loans and advances due to the bank's focus on prudential SME lending boosted by regional expansion.

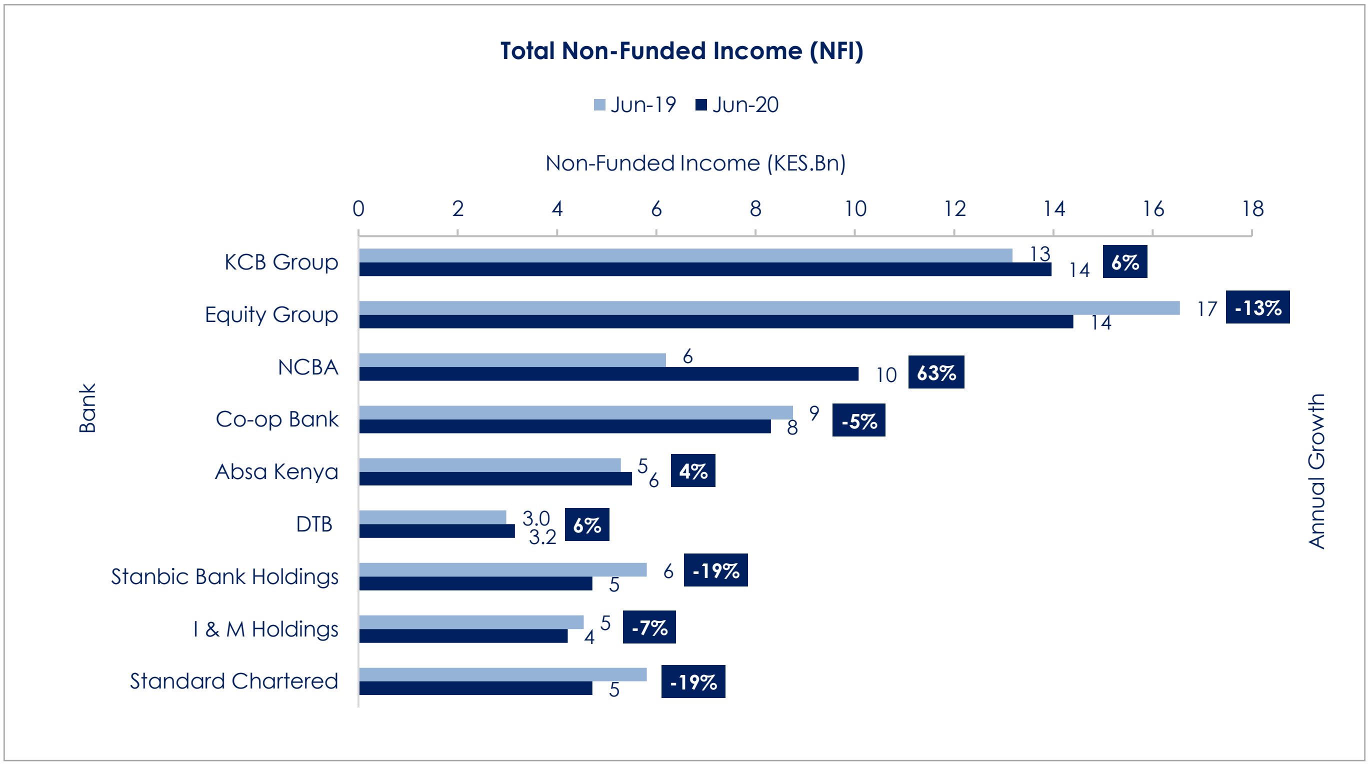
Government securities

- Combination of lower interest rates on Government securities resulted in selected banks reporting declines in interest income HY20 compared to HY19 (Figure.10 (b)).
- Stanbic Holdings reported a decline in interest income attributable to a similar decline in its portfolio of Government securities.

Source: Central Bank of Kenya

- **NFI** - Mixed performance in NFI which has been a key income growth area for banks constrained in the past by interest rate caps and current high levels of credit risk (Figure.11).
- Here we take note of the CBK directive on waiver of fees on digital transactions to ease the financial burden on customers during the pandemic as one of the reasons for the decline in fees and commissions for Stanbic together with the slowdown in trade finance activity due to lockdowns during the pandemic.
- Standard Chartered's decline attributed to a drop in fees and commissions and foreign exchange trading income while Equity related this to a decline in transactional activity due to the pandemic.
- Co-op's NFI decline attributable to decline in fees and commission from loan and advance as well as drop in other income.
- I&M's decline was mainly due to a 27% decline in foreign exchange trading income coupled with a 10.4% dip in other fees and commissions income.

Figure.11: Non-Funded Income - Mixed performance by banks

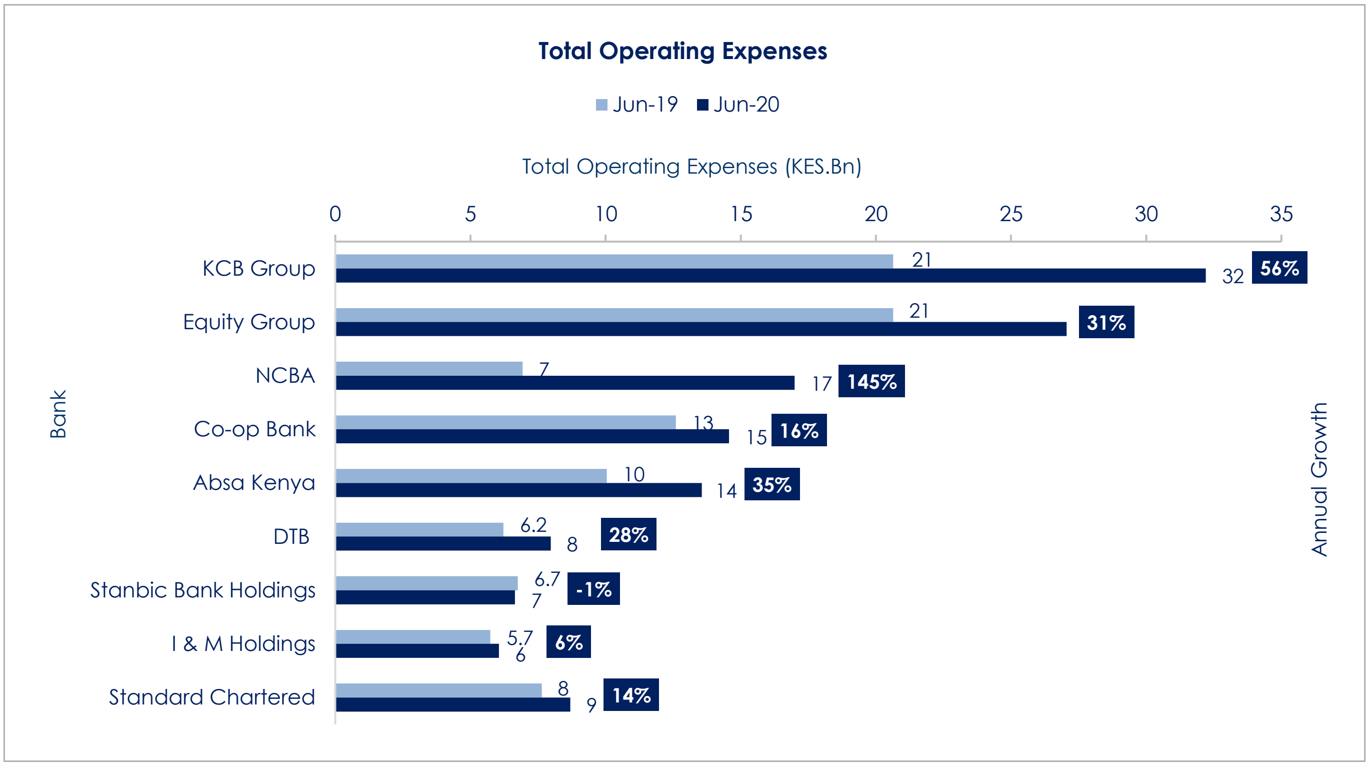


Source: Central Bank of Kenya

- **Operating Expenses** - Banks reported a marked increase in operating expenses during the period with Equity, DTB and Absa attributing it largely to increased loan loss provisioning in anticipation of loan losses due to the pandemic (Figure.12).
- The exception during the period was Stanbic Holdings which reported a decline in other expenses that had increased in 2019 due to reorganization of the business and a one-off guarantee payment estimated at KES.1.4Bn paid to geothermal development Company (GDC).
- KCB operating expenses attributable to the NBK acquisition and staff and loan loss provisions costs that rose 13.5% and 266.7%.

- I&M bank's operating expenses rose 5.5% to KES.6.1Bn, largely driven by 17.2% increase in other operating expenses. However, unlike its peers in the banking industry, the bank's loan loss provisions declined 7% during the period.

Figure.12: Total operating expenses rose largely due to higher loan loss provisioning



Source: Central Bank of Kenya

- **Non-Performing Loans (NPLs)** - Banks showing a marked increase in operating expenses during the period with the increase largely attributed to an increase in loan loss provisioning (Figure.13).
- The sharp increase reported by KCB was a direct result of its consolidation with NBK which brought on board KES.25Bn in NPLs and heightened defaults associated with the pandemic.
- Absa Kenya NPLs) increased to KES.17Bn from KES.15.7Bn HY2019, a growth of 8.4%, mainly attributable to a single client exposure in the wholesale customer segment.

Figure.13: Asset quality deterioration negatively affected banking sector's profitability bank performance

Figure.13 (a)

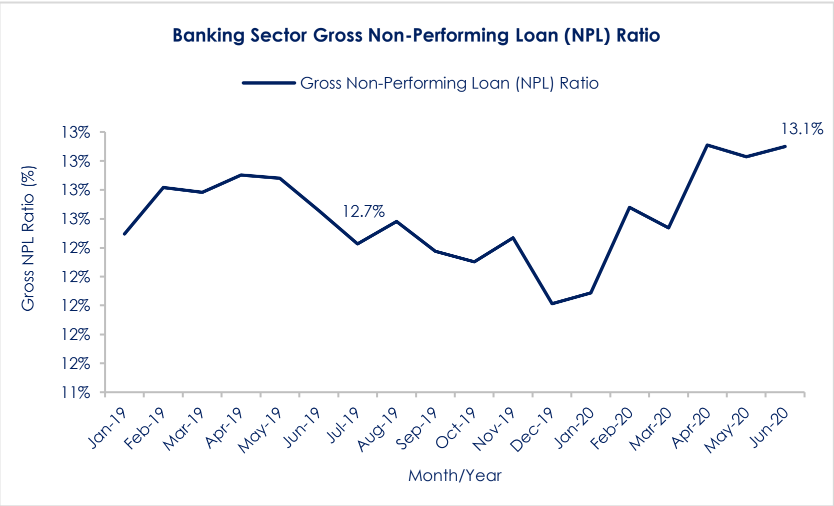


Figure.13 (b)

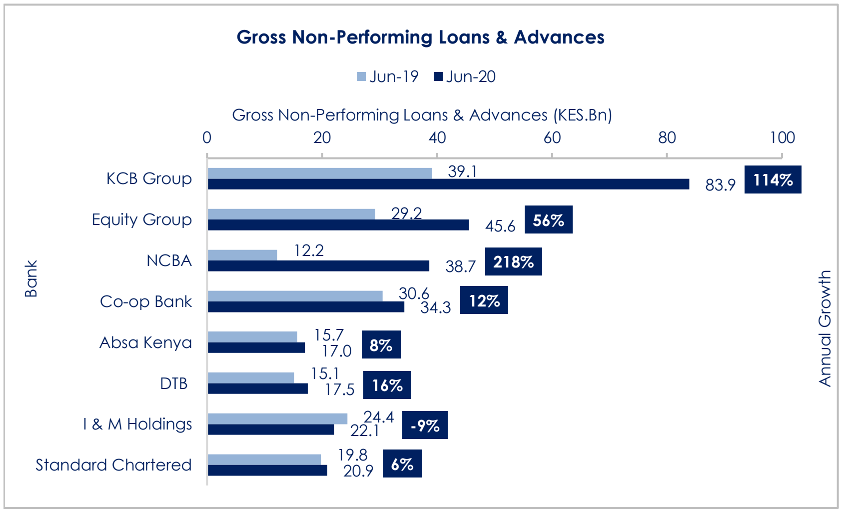
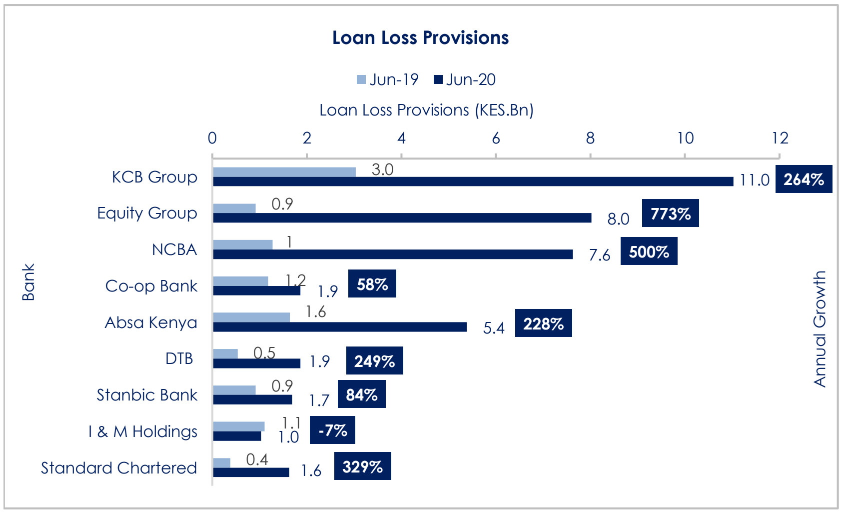


Figure.13 (c)



Source: Central Bank of Kenya

Asset Quality

- Average (Non-Performing Loan Ratio) NPL ratio during the period under consideration (January-June 2019 and 2020) remained unchanged at 12.8% although we see an uptick in the ratio in June 2020 to 13.1% (Figure.13).
- This increase was mainly attributed to the subdued business environment and the poor performance of manufacturing as well as wholesale and retail trade sectors.
- With regards to the banks we cover, KCB and Equity Group reported the biggest increases in Gross NPLs (114% and 56%) to KES.84Bn and KES.46Bn (Figure.13 (b)).
- KCB attributed this growth to a spike in NPLs in the corporate and MSME sectors
- **Loan loss provisions** - This is the main reason for the spike in operating expenses HY20 with most banks reporting a sharp rise in loan loss provisions for the period (Figure.13.c)).
- We see this as precautionary in the face of growing credit risk even with the rising number of restructured loans.
- Equity Bank, Standard Chartered and Absa Kenya reported the biggest increase in provisions during the period while I & M went against the grain being the only bank that reported a decline.

Figure.14: Overall bank liquidity increased as banks adopted a conservative investment strategy

Figure.14 (a)

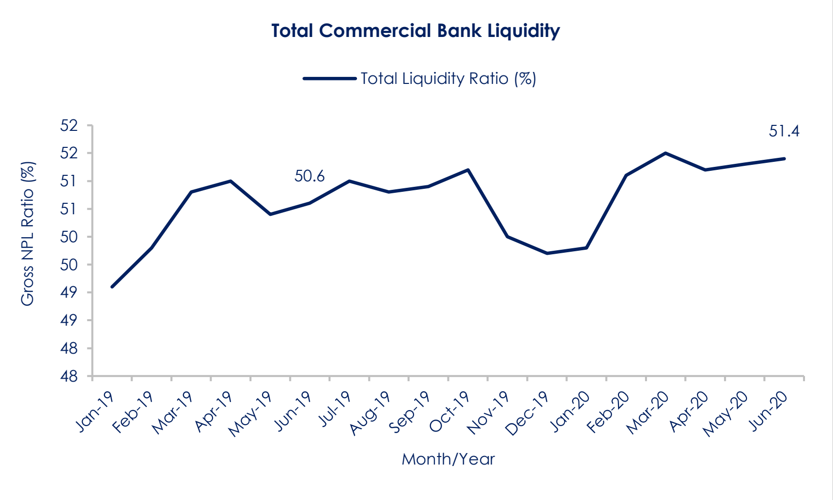
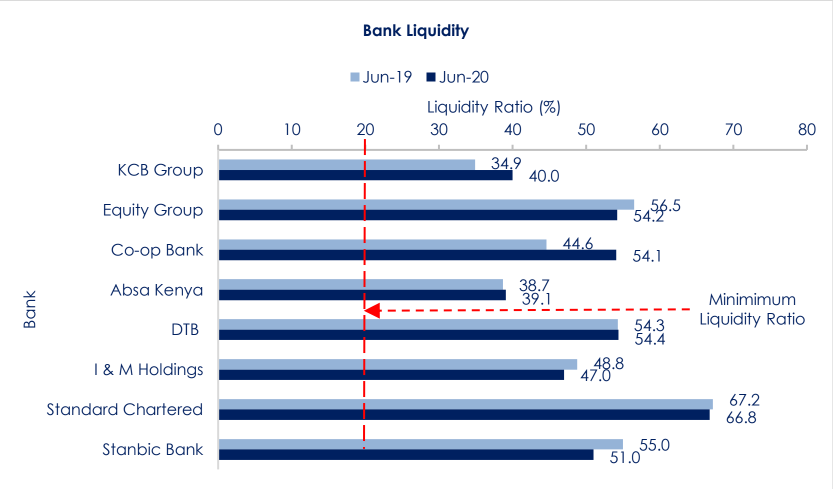


Figure.14 (b)



Source: Central Bank of Kenya

Bank Liquidity

- Commercial bank liquidity rose during the period with average liquidity in HY19 at 50.3% compared to 51.1% in HY20 (Figure.14).
- Banks appeared to prefer to increase their holdings of liquid assets rather than to grow their loans and advances portfolios or that of long-term Government securities aggressively.
- In addition, the withholding of dividends also protected banks' liquidity and capital positions.
- Other than KCB, we do not observe any significant differences in liquidity over the two periods in comparison.

4. KENYA BANKS VALUATION SUMMARY

Bank	KCB Group Plc	Equity Group	CO-OP	NCBA	Absa Kenya
NSE Code	KCB	EQTY	COOP	NCBA	ABSA
Bloomberg Code	KNCB:KN	EQBNK: KN	COOP:KN	**NCBA:KN**	ABSA:KN
Fair Value Estimate (KES)	**47.80**	**44.40**	**14.63**	**31.75**	**8.06**
Recommendation	**BUY**	**BUY**	**BUY**	**BUY**	**SE**LL
Current Price (KES)	39.10	36.70	11.85	23.00	9.82
Upside/Downside (%)	↑ 22	↑ 21.0	↑23.4	↑ **38.0**	↓ 17.9
Price Change YOY (%)	↓ 6.9	↓ 98.0	↓ 0.4	↓ 23.2	↓ 10.7
Price Change YTD (%)	↓ 27.9	↓ 32.4	↓27.5	↓ 37.6	↓ 26.4
Dividend Yield (%)	8.9	0.0	8.4%	0.0	11.2
Trailing P/Ex	4.8	6.2	4.8	2.7	7.2
Trailing P/B x	1.0	1.2	0.9	0.6	1.2
Issued Shares (Mn)	3,214	3,773.7	5,867	1,648	5,432
Free Float (%)	73.1	77.3	32.3	50.9	30.8
Market Cap (KES.Bn)	125.6	138.5	69.5	37.9	55.3

Source: Company filings, Nairobi Securities Exchange & Sterling Capital Research

Bank	DTB	Stanbic Holdings	I&M Holdings	Standard Chartered
NSE Code	DTB	SBIC	I&M	SCBK
Bloomberg Code	DTKL:KN	CFCB:KN	IMH:KN	SCBK:KN
Fair Value Estimate (KES)	**96.90**	**103.00**	**57.92**	**178.0**
Recommendation	**BUY**	**BUY**	**BUY**	**HOLD**
Current Price (KES)	60	81.50	44.25	160
Upside/Downside (%)	↑ 81.5	↑ 26.5	↑ 30.9	↑ 11.3
Price Change YOY (%)	↓ 47.4	↓ 15.1	↓ 1.7	↓ 19.9
Price Change YTD (%)	↓ 46.0	↓ 25.4	↓ 18.1	↓ 20.0
Dividend Yield (%)	4.5	8.7	5.8%	12.5
Trailing P/Ex	2.5	5.0	3.5x	6.7
Trailing P/B x	0.3	0.7	0.6x	1.2
Issued Shares (Mn)	279.6	395.3	826.8	343.5
Free Float (%)	53.4	31.0	25.7	24.3
Market Cap (KES.Bn)	**16.8**	**32.2**	**36.6**	**55**

Source: Company filings, Nairobi Securities Exchange & Sterling Capital Research

5. KENYA BANKS FINANCIAL PERFORMANCE OUTLOOK AND FORECASTS

1) KCB Group Plc

- PAT to decline 15% to KES.21.4Bn due to poor economic performance across all the operating markets.
- Positive growth in total interest income despite restructuring loan facilities (KES.101Bn-HY20)
- NFI almost flat due to a decline in transaction volume.
- Operating expenses to increase 9.8% to KES.42.5Bn driven by higher loan loss provisions.
- NPL ratio to increase from 10.9% FY2019 to 13.8%.
- We anticipate additional capital to be injected to NBK that was below total capital requirement to ensure compliance and support the turnaround strategies and this will have a negative impact on the financials.
- Final dividend to decline to KES.2 compared to KES.2.50 bringing the total dividend FY20 at KES.2.0(KES.3.5 – FY2019).
- A **BUY** recommendation is maintained guided by our **fair value estimate of KES.47.80** with **trailing P/E and P/B multiples of 4.8x and 1.0x** respectively against the industry averages of 6.2x and 1.0x.
- Our fair value estimate is an upside of 22% on the current share price of KES.39.10.

Financial Summary

	FY19	FY20E	% Change
Balance Sheet (KES.Bn)			
Loans & Advances	535.4	576.2	7.6
Government Securities	169.2	211.6	25.1
Total Assets	898.6	987.0	9.8
Customer Deposits	686.6	789.6	15.0
Income Statement (KES.Bn)			
Interest income (Loans & Advances)	58.9	63.9	8.5
Interest income (Gov't Securities)	14.1	18.1	28.4
Total Interest Income	74.4	83.9	12.8
Total Interest Expense	18.2	21.9	20.3
Net Interest Income	56.1	62.0	10.5
Non-Funded Income	28.2	28.4	0.7
Total Operating Income	84.3	90.4	7.2
Loan Loss Provisions	8.9	17.3	94.4
Total Operating Expenses	38.7	42.5	9.8
Profit After Tax	25.2	21.4	15.1
Ratios			
Cost to Income Ratio	51.3	58.2	6.9
NPL Ratio	10.9	13.8	2.9
Net Interest Margin	9.5	9.1	0.4
ROE	19.4	15.2	4.2

Source: Company filings & Sterling Capital Research

2) Equity Group Holdings Plc

- Positive growth in loan book and holdings of Government securities with the 30% growth in the latter a reflection of growing credit risk.
- We anticipate a 4% decline in PAT FY20 to KES.30.2Bn on lower interest income and higher operating expenses.
- Loan restructuring (KES.92Bn - HY2020), declining yields on loans and government securities is expected to result in a modest growth (10.7%) in total interest income.
- NFI a key driver of revenues for the bank in the recent years forecasted to grow at a slower pace (15.3%) than FY19.
- A further increase in provisions for loan losses to KES.13.3Bn is expected FY20.
- We expect the bank's NPL ratio to deteriorate to 10.7% FY20 from 9.4% FY19
- Despite the reduction in PAT, we expect the bank to issue a KES.2.00 dividend FY 2020.
- The bank had announced a dividend increase to KES.2.50 per share FY2019, but later cancelled the dividend in a bid to retain capital and maintain liquidity in the wake of the pandemic.
- We maintain a **BUY** recommendation based on a fair value estimate of **KES.44.40** an upside of 21% compared to the current market price of KES.36.70.
- The bank trades on a **trailing P/E of 6.2x and a P/B of 1.2x** against industry average **P/E of 6.2x and P/B of 1.0x.**

Financial Summary

	FY19	FY20E	% Change
Balance Sheet (KES.Bn)			
Loans & Advances	366.4	409.0	11.6
Government Securities	172.2	223.9	30.0
Total Assets	673.7	807.6	19.9
Customer Deposits	482.8	574.5	19.0
Income Statement (KES.Bn)			
Interest income (Loans & Advances)	41.5	44.4	7.2
Interest income (Gov't Securities)	16.9	20.2	20.0
Total Interest Income	59.7	66.1	10.7
Total Interest Expense	14.7	17.4	18.2
Net Interest Income	45.0	48.7	8.3
Non-Funded Income	30.8	35.5	15.3
Total Operating Income	75.8	84.2	11.2
Loan Loss Provisions	5.3	13.3	150.0
Total Operating Expenses	38.9	40.8	4.6
Profit After Tax	31.5	30.2	4.0
Ratios			
Cost to Income Ratio	51.5	48.4	3.1
NPL Ratio	9.4	10.7	1.3
Net Interest Margin	8.4	7.7	0.7
ROE	21.7	18.3	3.4

Source: Company filings & Sterling Capital Research

3) Co-op Bank Ltd

- We expect the bank's slow growth to continue in the second half of 2020 with a 5.9% decline in PAT to KES.13.5Bn.
- Digital banking continues to play a key role with 91% of the bank's transactions carried on alternative channels. However, the waiver on fees for funds transfer from bank to mobile wallets and other digital enquiries as well as the decline in transactional volumes likely to result in a 5.6% decline in NFI to KES.16.2Bn FY20.
- CO-OP has restructured a total of KES.35Bn loans which will negatively impact interest income from loans and advances.
- With rising credit risk, we anticipate the lender to further increase its loan loss provisions by 56.8% FY20.
- We do not think the recent 90% acquisition of Jamii bora will have a significant impact on its balance sheet although the strategic impact is positive in the long-term as the bank will help support business growth in the Medium and Small Enterprise segment (MSMEs).
- With the bank well capitalised and liquidity strong, we expect Co-op to match its FY19 dividend per share at **KES.1.00**.
- Our recommendation remains a **BUY** on account of our **KES.14.63** fair value estimate which represents a 23.4% upside from the current market price of KES.11.85.
- The bank trades on a **trailing P/E of 4.8x and a P/B of 0.9x** against sector average P/E of 6.2x and P/B of 1.0x.

Financial Summary

	FY19	FY20F	% Change
Balance Sheet (KES.Bn)			
Loans & Advances	266.7	282.4	5.9
Government Securities	119.6	134.2	12.3
Total Assets	457.1	541.5	18.5
Customer Deposits	332.8	396.1	19.0
Income Statement (KES.Bn)			
Interest income (Loans & Advances)	31.8	30.7	3.2
Interest income (Gov't Securities)	11.4	12.7	11.4
Total Interest Income	43.6	44.3	1.5
Total Interest Expense	12.3	11.8	4.2
Net Interest Income	31.3	32.5	3.8
Non-Funded Income	17.2	16.2	5.6
Total Operating Income	48.5	48.7	0.5
Loan Loss Provisions	2.5	4.0	56.8
Total Operating Expenses	27.8	30.8	10.8
Profit After Tax	14.3	13.5	5.9
Ratios			
Cost to Income Ratio	52.1	55.0	2.9
NPL Ratio	9.9	10.5	0.6
Net Interest Margin	8.8	7.8	1.0
ROE	19.2	16.3	2.9

Source: Company filings & Sterling Capital Research

4) NCBA Group

- Forecast a 30% decline in PAT to KES.5.5Bn (KES.7.8Bn) on account of increased loan loss provisioning.
- Slow loan book growth expected in preference for inter-bank lending and investment in Government securities.
- The bank has so far has restructured KES.58Bn, representing 23% of the loan book as at HY20 which translates to loss of interest income while NFI is expected to come under pressure due to waiver of mobile fees and commissions.
- NPL ratio stood at 13.1% HY20 and we expect a slight deterioration FY20 13.2%.
- We do not expect NCBA to issue a dividend FY20 due to the decline in profitability and as a capital preservation strategy.
- The lender cancelled its FY19 proposed dividend of KES.1.50 per share due to market uncertainty attributable to COVID-19 pandemic and replaced it with a bonus share of one for every 10 held.
- We maintain a **BUY** recommendation based on a fair value estimate of **KES.31.75** a 38% upside from the current market price of KES.23.
- The bank trades on a **trailing P/E of 2.7x and a P/B of 0.6x** against the **industry average P/E of 6.2x and P/B of 1.0x**.

Financial Summary

	FY19	FY20F	% Change
Balance Sheet (KES.Bn)			
Loans & Advances	249.4	260.2	4.4
Government Securities	145.0	180.9	24.8
Total Assets	494.8	528.4	6.8
Customer Deposits	378.2	406.6	7.5
Income Statement (KES.Bn)			
Interest income (Loans & Advances)	15.7	22.2	41.2
Interest income (Gov't Securities)	9.2	16.0	74.1
Total Interest Income	25.5	39.0	52.9
Total Interest Expense	12.2	17.8	46.5
Net Interest Income	13.3	21.2	58.8
Non-Funded Income	20.3	19.8	2.7
Total Operating Income	33.7	41.0	21.7
Loan Loss Provisions	6.3	14.6	133.2
Total Operating Expenses	20.4	33.6	65.2
Profit After Tax	7.8	5.5	30.0
Ratios			
Cost to Income Ratio	41.8	46.5	4.7
NPL Ratio	12.1	13.2	1.1
Net Interest Margin	5.0	3.4	1.6
ROE	11.7	7.9	3.8

Source: Company filings & Sterling Capital Research

5) Absa Bank Kenya

- We forecast a significant drop in PAT to KES.1.4Bn (-80.8%) resulting from a combination of lower interest income and increased operating expenses resulting from higher loan loss provisioning.
- The Bank restructured loans amounting to KES.57Bn as at HY20, representing 28.2% of the bank's loan book.
- Declining yields on loans and Government securities as well as loan restructuring (KES.57Bn HY20) will have a negative impact on total interest income.
- The bank withheld payment of an interim dividend HY20, and we expect to be the case FY20 due to the significant reduction in profitability.
- We revise our previous HOLD recommendation to **SELL** based on a fair value estimate of **KES.8.06** a downside of 18% compared to the current market price of KES.9.82.
- The bank trades on a **trailing P/E of 7.2x and a P/B of 1.2x** against industry average P/E of 6.2x and P/B of 1.0x.

Financial Summary

	FY19	FY20E	% Change
Balance Sheet (KES.Bn)			
Loans & Advances	194.9	203.9	4.6
Government Securities	123.0	147.6	20.0
Total Assets	374.0	415.9	11.2
Customer Deposits	237.7	256.8	8.0
Income Statement (KES.Bn)			
Interest income (Loans & Advances)	22.5	19.2	15.0
Interest income (Gov't Securities)	8.1	8.9	10.0
Total Interest Income	31.0	28.5	8.3
Total Interest Expense	7.8	7.7	1.5
Net Interest Income	23.2	20.7	10.6
Non-Funded Income	10.6	10.8	2.0
Total Operating Income	33.8	31.5	6.8
Loan Loss Provisions	4.2	11.8	180.0
Total Operating Expenses	17.3	17.8	3.1
Profit After Tax	7.5	1.4	80.8
Ratios			
Cost to Income Ratio	51.2	56.6	5.4
NPL Ratio	6.6	7.5	1.1
Net Interest Margin	7.8	6.1	1.7
ROE	16.5	3.1	13.4

Source: Company Filings & Sterling Capital Research

6) DTB Bank Ltd

- Relatively modest growth in total assets due to subdued growth in loans and advances as well as holdings of Government securities.
- The bank reversed the declining trend in customer deposits HY20 and we expect an increase of 1.5% to KES.284.4Bn from KES.280.2Bn FY2019.
- Significant decline in PAT expected (-36.7%) to KES.4.6Bn, mainly attributable to expected decline in interest income from loans and advances as increased operating expenses.
- The Bank restructured loans amounting to KES.64Bn as at HY20, representing 42% of DTB's loan book. We expect this to result in a further decline in the bank's interest income.
- DTB's non-branch transactions rose significantly to 87% HY202O up from 81% HY2019 on account of the increased adoption of mobile and internet banking by the Bank's customers. We expect this to remain a key focus for the bank in order to boost NFI growth FY20.
- We do not anticipate a significant deterioration in the bank's loan book as a result of selective lending that will result to a minimal growth in loan book (+2.4%).
- We expect DTB to withhold dividend payment FY20, due to the significant reduction in profitability.
- We maintain a **BUY** recommendation based on a fair value estimate of **KES.96.93** an upside of 61.5% compared to the current market price of KES.60.00.
- The bank trades on a **trailing P/E of 2.5x and a P/B of 0.3x** against **industry average P/E of 6.2x and P/B of 1.0x**.

Financial Summary

	FY19	FY20E	% Change
Balance Sheet (KES.Bn)			
Loans & Advances	199.1	203.8	2.4
Government Securities	130.3	139.5	7.0
Total Assets	386.2	399.1	3.3
Customer Deposits	280.2	284.4	1.5
Income Statement (KES.Bn)			
Interest income (Loans & Advances)	20.0	16.1	19.2
Interest income (Gov't Securities)	12.5	13.5	7.9
Total Interest Income	32.9	30.0	8.5
Total Interest Expense	141.	13.4	5.2
Net Interest Income	18.7	16.6	11.1
Non-Funded Income	5.7	5.8	1.4
Total Operating Income	24.5	22.5	8.1
Loan Loss Provisions	1.3	3.8	189.2
Total Operating Expenses	11.9	12.5	5.1
Profit After Tax	7.3	4.6	36.7
Ratios			
Cost to Income Ratio	37.0	35.7	2.7
NPL Ratio	7.7	9.0	2.0
Net Interest Margin	4.3	3.7	1.4
ROE	4.6	2.3	2.3

Source: Company Filings & Sterling Capital Research

7) Stanbic Holdings Plc

- We see a change of investment strategy with the bank choosing to remain liquid in the near term by increasing their bank balances as opposed to investing in other asset classes in the current economic environment.
- PAT to decline 31.3% to KES.4.4Bn driven by declines in both interest income and NFI.
- NFI which is usually a major income earner for the bank expected to decline 13.2% to KES.9.9Bn due to lower transactions and forex trading income.
- Operating expenses to decline as a result of lower "other expenses". Operating expenses FY19 rose due to reorganization of the business and a one-off guarantee payment estimated at KES.1.4Bn paid to geothermal development Company (GDC).
- Final Dividend expected to decline to about KES.3.50 for FY20 (KES.5.80 FY2019) for a total dividend of KES.3.50 from KES.7.05 FY19.
- We maintain a **BUY** recommendation guided by our fair value estimate of KES.103 a 27% upside on the current share price of KES.81.50.
- The bank trades on trailing **P/E and P/B multiples of 5.0x and 0.7x** respectively against **industry averages of 6.2x and 1.0x**.

Financial Summary

	FY19	FY20E	% Change
Balance Sheet (KES.Bn)			
Loans & Advances	152.8	163.6	7.1
Government Securities	69.5	73.0	5.0
Total Assets	303.6	358.5	18.1
Customer Deposits	194.2	248.6	28.0
Income Statement (KES.Bn)			
Net Interest income	13.3	12.6	5.3
Non-Funded Income	11.4	9.9	13.2
Total Operating Income	24.8	22.5	9.3
Loan Loss Provisions	3.2	3.8	18.8
Total Operating Expenses	13.9	12.9	7.2
Profit After Tax	6.4	4.4	31.3
Ratios			
Cost to Income Ratio	56.2	57.3	1.1
Net Interest Margin	5.3	4.4	0.9
ROE	13.0	8.7	4.3

Source: Bank Filings & Sterling Capital Research

8) I & M Holdings

- Increased concern over rising credit risk with increased caution on lending especially to SMEs and retail clients to result in slow loan book growth (6.2%) FY20.
- We forecast NFI FY20 to dip 12% to KES.7.3Bn on lower transactional volumes.
- We expect the bank to increase loan loss provisions by 200% to KES.1.9Bn leading to a 20.2% increase in total operating expenses to KES.12.1Bn which result in a 33.9% decline in PAT to KES.7.1Bn.
- The bank's operating efficiency is forecasted to decline due to a 20.2% increase in operating expenses to KES.12.1Bn with cost to income ratio worsening to 45.7% from 39.8% FY19.
- We do not expect the lender to issue a dividend FY20 owing to the expected 33.9% drop in profit after tax (PAT) to KES.7.1Bn from KES.10.8Bn FY19.
- We maintain a **BUY r**ecommendation based on a **fair value estimate of KES.57.92** a 30.9% upside from the current market price of KES.44.25.
- The bank trades on a **trailing P/E of 3.5x and a P/B of 0.6x** against the **industry average P/E of 6.2x and P/B of 1.0x**.

Financial Summary

	FY19	FY20F	% Change
Balance Sheet (KES.Bn)			
Loans & Advances	175.3	186.2	6.2
Government Securities	53.9	77.5	43.7
Total Assets	315.3	350.0	11.0
Customer Deposits	229.7	261.9	14.0
Income Statement (KES.Bn)			
Interest income (Loans & Advances)	22.4	22.4	0.2
Interest income (Gov't Securities)	4.1	4.2	1.9
Total Interest Income	27.2	27.4	1.0
Total Interest Expense	11.7	12.4	6.1
Net Interest Income	15.5	15.1	2.9
Non-Funded Income	8.3	7.3	12.0
Total Operating Income	23.8	22.4	6.1
Loan Loss Provisions	0.6	1.9	200.0
Total Operating Expenses	10.1	12.1	20.2
Profit After Tax	10.8	7.1	33.9
Ratios			
Cost to Income Ratio	39.8	45.7	5.9
NPL Ratio	11.4	11.0	0.4
Net Interest Margin	7.0	6.4	0.6
ROE	**19.5**	11.4	9.0

Source: Company Filings & Sterling Capital Research

9) Standard Chartered Bank Kenya Ltd

- PAT to decline 20.7% over FY19 to KES.6.5Bn attributable to 5.2% and 13.2% drop in interest income from loans and advances and government securities to KES.12.7Bn and KES.9.2Bn respectively. worsened by restructured loan facilities and declining interest rates on government securities.
- NFI projected to dip by 4.3% to KES.8.8Bn due to a decrease in transactions and foreign exchange trading income.
- Operating expenses to increase by 7.3% to KES.17.7Bn driven by higher loan loss provisions.
- FY20 NPL ratio to improve to 14.3% from 14.7% FY2019 brought by slower growth in NPLs compared to loan book. This is a positive development at a time when other banks are recording a surge in NPLs.
- Final dividend to decline to KES.10 compared to KES.15.0 bringing the total dividend FY20 at KES.10 (KES.20 – FY2019).
- We maintain a **HOLD** recommendation guided by our **fair value estimate of KES.178,** a 11.3% upside over the current market price of KES.160.
- The bank is trading on **trailing P/E and P/B multiples of 6.7x and 1.1x** respectively against **the industry averages of 6.2x and 1.0x**.

Financial Summary

	FY19	FY20E	% Change
Balance Sheet (KES.Bn)			
Loans & Advances	128.7	139.4	8.3
Government Securities	99.6	104.3	4.7
Total Assets	302.1	334.3	10.7
Customer Deposits	228.4	262.7	15.0
Income Statement (KES.Bn)			
Interest income (Loans & Advances)	13.4	12.7	5.2
Interest income (Gov't Securities)	10.6	9.7	8.5
Total Interest Income	25.3	23.6	6.7
Total Interest Expense	5.8	5.3	8.6
Net Interest Income	19.5	18.4	5.6
Non-Funded Income	9.2	8.8	4.3
Total Operating Income	28.7	27.1	5.6
Loan Loss Provisions	0.6	1.9	216.7
Total Operating Expenses	16.5	17.7	7.3
Profit After Tax	8.2	6.4	22.0
Ratios			
Cost to Income Ratio	55.6	58.0	2.4
NPL Ratio	14.7	14.3	0.4
Net Interest Margin	14.6	12.9	1.7
ROE	16.4	12.9	3.5

Source: Bank Filings & Sterling Capital Research

6. CONCLUSION

- The banking sector remains one of our preferred sectors on the NSE in spite of the forecasted poor FY20 performance on account of attractive valuations and improved economic performance in the medium term.
- The biggest risk to performance of the sector is the COVID-19 pandemic that has affected most sectors of the economy, transactional volumes and particularly asset quality.
- The recovery of the sector is highly dependent on how fast the economy can recover and revert to normal economic activity.
- We believe that it will take much longer for asset quality (sector NPL ratio to improve to around 6% to 8% from the current 13.1%.
- Loan restructures will increase in the near term due to CBK influence and this will also affect interest income.
- Most macro-economic variables including both commercial bank and domestic debt interest and foreign exchange rates will remain relatively stable for the rest of the financial year.
- With regards to investment returns, a sharp decline in profitability means that investors might have to do with lower dividends or non-payment of dividends.
- For banks, credit risk management and capital protection will be the main concern in the near to medium term.
- With regards to investment value, we see KCB and Equity Bank as our top two picks for both income (dividend yield) and price appreciation potential.
- The two banks together with Stanbic and CO-OP are also well capitalized and have strong liquidity positions, making them the best cushioned to counter the impact of the pandemic.
- Banking stocks are currently heavily discounted presenting investors with medium to long-term profit-making opportunities.
- Most of our covered banks have been fairly resilient despite the tough operating environment and we expect several including KCB, Stanbic, Standard Chartered, Equity, DTB, and CO-OP banks to issue dividends FY20.

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BUY: FV above13% of CSP
Hold: FV between 0% and 12.99% around CSP
Sell: FV less than 0% below CSP

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