BANKING SECTOR: Sailing Through Uncharted Waters

Deteriorating Asset Quality

NPLs in the Kenyan banking sector are expected to increase as economic conditions in the country deteriorate due to disruptions to trade and supply chains and collapse of global travel as countries try to contain the COVID-19 pandemic. Consequently, we project an upsurge in cost of risk as banks increase provisioning.

We expect Equity, Absa, and DTB to record the highest growth in NPLs. However, DTB's NPL ratio, however, is likely to remain relatively lower than that of its peers.

Recommendations

We issue a BUY recommendation on Equity, KCB, COOP, Stanbic, ABSA Bank and DTB. Our view on Equity is that despite subdued top line growth we see the bank taking advantage of the credit guarantee scheme in lending to SMEs. KCB is likely to maintain its payout policy. We also anticipate that personal loans will shield the lender asset book growth.

Cooperative Bank's diverse asset book is anticipated to shield it from expected growth in bad loans even as diversity supports loan book growth. We foresee stability in personal banking business informing our buy recommendation on Stanbic

Our view on Absa is informed by the bank's improved efficiency ratio, increased usage of technology, and support from the parent company. Although capital ratios remain relatively low, access to capital support from its parent company mitigates capital risk thus the bank is unlikely to reduce dividends in order to conserve capital.

DTB is likely to maintain its dividend policy as its adequate capital ratios reduces the need for capital conservation. However, earnings growth is likely to be muted due to an increase in provisioning as NPL ratios increases. Interest income growth is likely to be subdued due to a depressed balance sheet growth as DTB management tends to be conservative on lending.

We issue a SELL recommendation on Standard Chartered with a target price of KES 167.57, representing a 0.3% upside. The growth prospects for the bank remain dim, asset quality is expected to deteriorate, and the dividend yield has declined.

DATE: 8TH JULY 2020

Equity	
Target Price	**41.82**
Recommendation	**BUY**
KCB	
Target Price	**46.02**
Recommendation	**BUY**
COOP	
Target Price	**16.82**
Recommendation	**BUY**
Stanbic	
Target Price	**102.28**
Recommendation	**BUY**
ABSA	
Target Price	**12.99**
Recommendation	**BUY**
DTB	
Target Price	**97.2**
Recommendation	**BUY**
Standard Chartered	
Target Price	**167.57**
Recommendation	**SELL**

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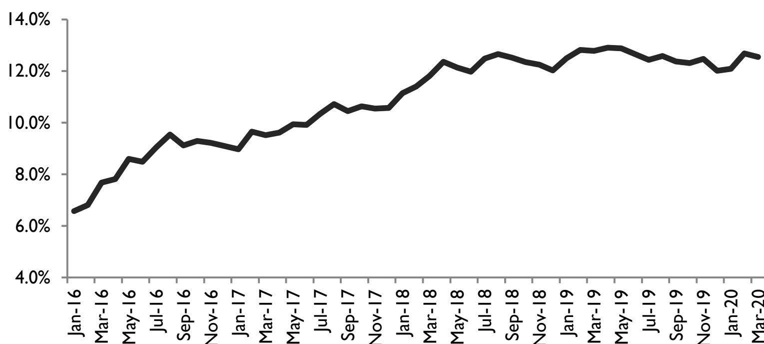
Asset Quality

NPLs in the Kenyan banking sector are expected to increase as economic conditions in the country deteriorate due to disruptions to trade and supply chains and collapse of global travel as countries try to contain the COVID-19 pandemic. Consequently, we project an upsurge in cost of risk as banks increase provisioning.

According to data from CBK, the NPL ratio has trended upwards in 2020 from 12.0% in December 2019 to 13.0% in May 2020.

Graph1: Banking Sector's NPL Ratio

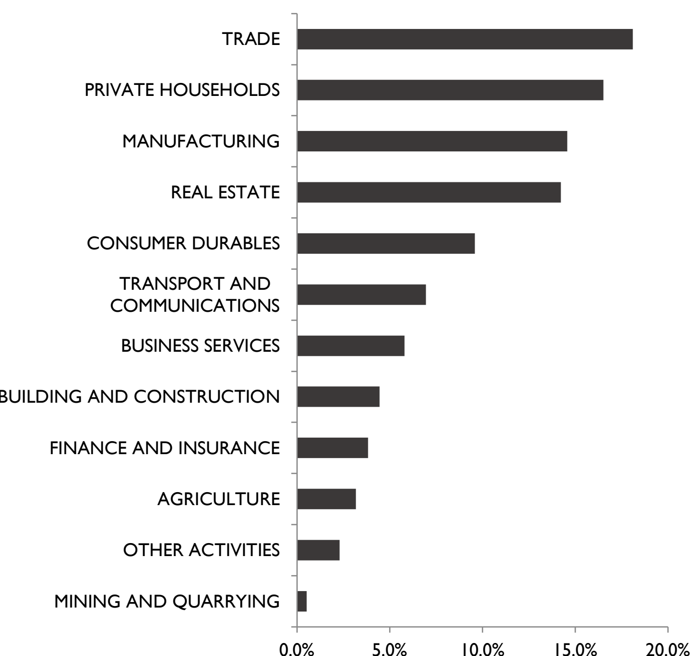


Source: AIB-AXYS Research. CBK

While the full effect of the pandemic is yet to be felt, reduced economic demand is likely to persist in the short to medium term which will see a deterioration in the quality of commercial banks' loan books with those heavily exposed to the SME space more likely to feel the pinch, given the high risk profile of the sector.

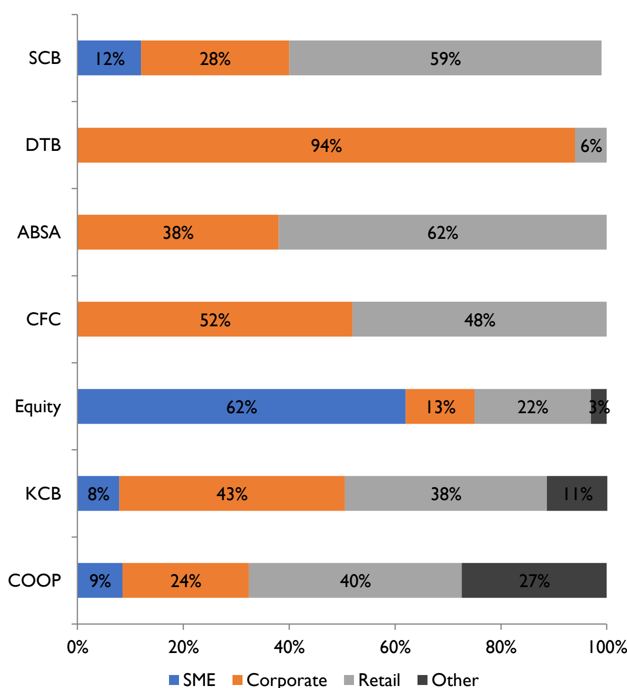
Over the past six months, the real estate, trade, energy, manufacturing, and personal/household sectors have experiences an increase in NPLs. Unfortunately, banks' loan books are heavily exposure to four of these sectors.

Graph 2: Banking Sector Loan book composition



Source: AIB-AXYS Research. CBK

Graph 3: Loan book composition

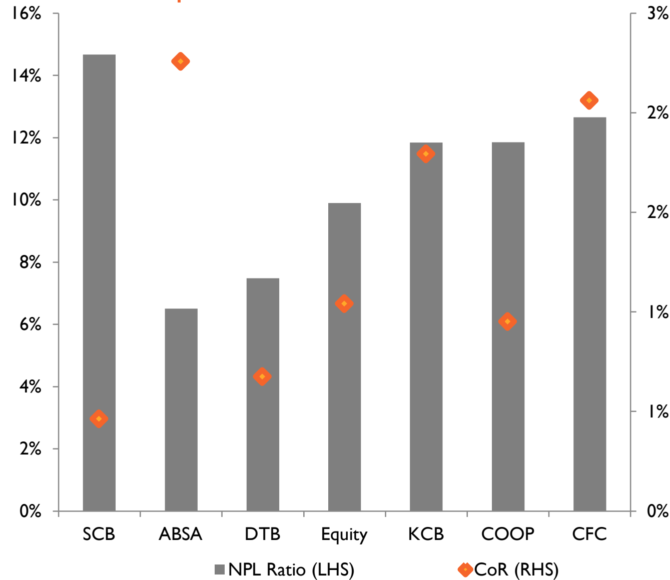


Source: AIB-AXYS Research. CBK

AIB AXYS AFRICA

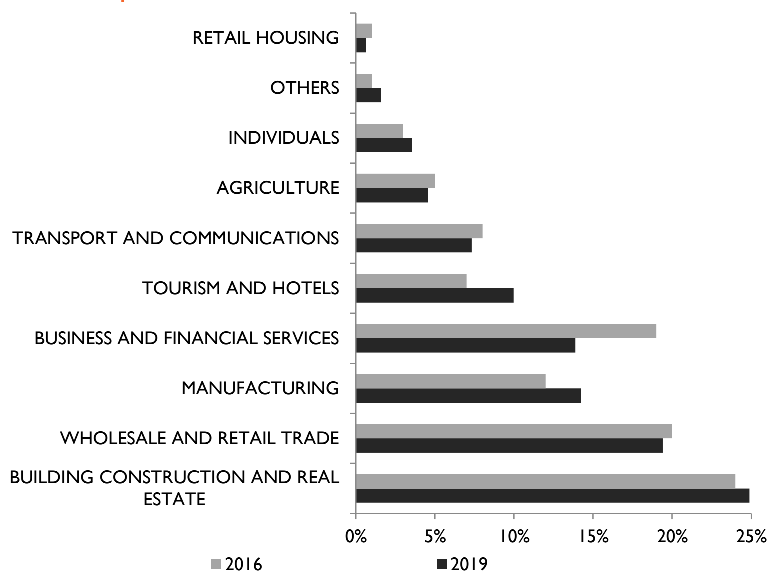
We expect Equity Group to take the largest hit given its strong foot print in the SME sector.
Absa is also likely to be greatly affected due to its high exposure to the retail sector, in particular unsecured retail loans.
We expect a spike in DTB's NPL ratio mainly due to the composition of the bank's loan book which is mainly exposed to the sectors that have been greatly affected in the current environment. Since the acquisition of Habib bank in 2017, DTB's NPL ratio has remained elevated mainly on account of the banks increased exposure to the manufacturing and tourism sectors.

Graph 4: NPL Ratios



Source: AIB-AXYS Research. Company fillings

Graph 5: DTB's loan book



Source: AIB-AXYS Research. Company fillings

We expect StanChart's NPL ratio to continue to deteriorate which is likely to lead to an increase in the bank's cost of risk. COOP's diverse asset book may offer some saving grace though the group remains quite exposed in the SME and real estate sectors. CFC has gradually seen its NPL ratio come up y/y with the trend proving worrisome as we expect this to persist. KCB Group saw a recent spike in NPL ratio with its exposure due to NBK likely to see the numbers worsen going forward given the projected 50% decline in recoveries

Overall, Equity, Absa, and DTB are likely to record the highest growth in NPLs. However, DTB's NPL ratio, however, is likely to remain relatively lower than that of its peers.

The Central Bank has allowed banks to restructure loans thus banks have offered customers leeway to make interest payments with principal payment to be made later. While this may protect the books for now, there still remains a risk in the possible recovery of these individual businesses. Loan restructuring provides a short-term reprieve for the banks as restructured loans represent potential asset quality weakness in the future.

Capital Conservation

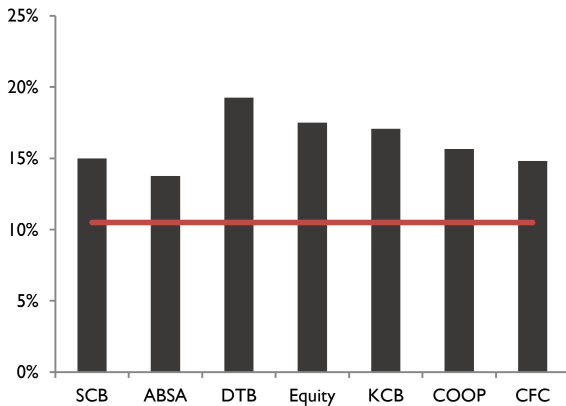
In this tough operating environment, capital adequacy ratios are likely to decline. In order to conserve capital, a number of banks may be forced to reduce or altogether forego dividend payment.

Banks that are less likely to be affected are:

- Those with sufficient capital
- Those likely to have a minimal increase in NPL ratios
- Increased profitability

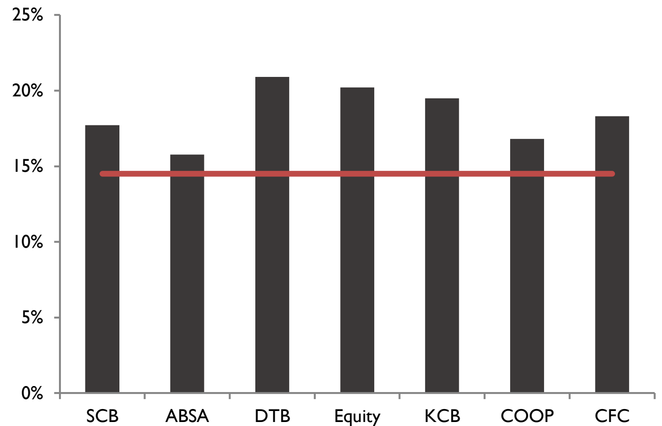
DTB has sufficient capital and is likely to maintain its dividend policy. The Group's capital ratios have remained stable. ABSA's capital ratios have declined over the past two years but we believe the bank is likely to maintain it dividend policy as it continues to receive support from ABSA Group. Absa Kenya's parent company, ABSA Group, waived its right to FY19 dividend, a trend that is likely to be repeated in FY20, as the group caters for the separation costs. In order to preserve capital, StanChart is unlikely to increase its final dividend from the Ksh7.50 paid for FY2019.

Graph 6: Core capital/TRWA



Source: AIB-AXYS Research, Company Fillings

Graph 7: Total Capital/TRWA



Source: AIB-AXYS Research, Company Fillings

Equity's capital ratios has been coming off probably necessitating the bank to halt FY19 dividend payment given the uncertainty brought about by the pandemic. This coupled with the Group's cancellation of the proposed acquisition of AtlasMara is also expected to see some capital conservation. Anticipated surge in provisions may have caused the Group's capital conservation measures even as the bank preserves capital to take up any opportunities that may arise.

COOP bank is expected to maintain its dividend policy even as it boosts its capital base through the conversion of the tranche two of the USD 150M IFC loan (initially drawn USD 75M for each tranche) from a senior loan to Tier 2 debt. KCB's ratios have also remained stable despite the NBK buyout with the Group expected to maintain its dividend policy. However, we may see the Group postpone payment of the interim dividend as it accesses the full impact of the pandemic on its books. CFC may need additional capital buffers given expected increase in provisions. We however expect the Group to maintain its dividend policy.

NIM Compression

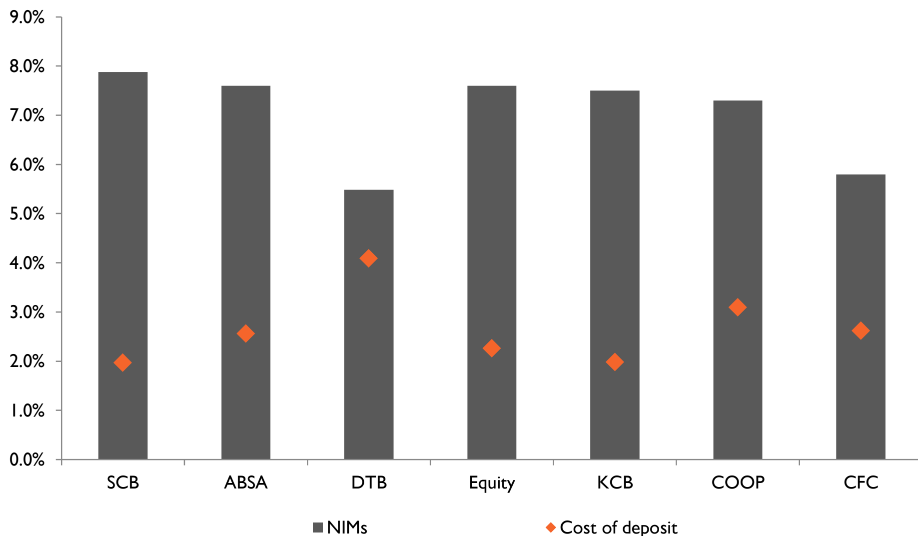
In the current environment, CBK is likely to maintain an accommodative monetary policy stance. Majority of loans in the banking sector are linked to the CBR thus recent rate cuts have led to a decline in yield on loans. Furthermore, a steepening of the yield curve is reducing interest income on government securities (but could increase the income from bond sales).

Meanwhile, the opportunity to reduce deposit rates is limited for KCB and Equity bank which have. We, therefore, expect a decline in net interest margins.

Banks can increase yield on loans by growing their loan book as following the removal of interest rate caps, new loans aren't linked to the CBR. Given that banks can now price risk, we expect that any new loans to the SME sector are likely to be at a higher interest rate. We expect DTB to adopt a conservative approach in the current environment.

In order to buoy interest income, we expect KCB, Coop, and Equity to increase lending to the SME sector. These banks are likely to secure funding from development institutions that will be channeled towards these sectors.

Graph 8: Net Interest Margin



Source: AIB-AXYS Research, Company Fillings

Valuation Summary

We use P/B multiples to value the Tier1 banks. To calculate the cost of equity, we make the following assumptions:

- Risk free rate (5 year government bond): 11.10%
- Equity risk premium: 5%
- Beta: 1

We issue a **BUY** recommendation of Equity, KCB, Coop, Stanbic, Absa, and DTB, and a **SELL** recommendation on Standard Chartered Bank.

Table 1:Valuation Summary

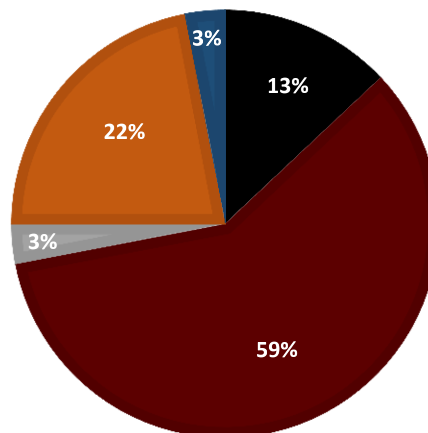
	Equity	KCB	COOP	Stanbic	Absa	DTB	SCB
CoE	16.1%	16.1%	16.1%	16.1%	16.1%	16.1%	16.1%
Risk free rate	11.1%	11.1%	11.1%	11.1%	11.1%	11.1%	11.1%
ERP	5.0%	5.0%	5.0%	5.0%	5.0%	5.0%	5.0%
Beta	1.0	1.0	1.0	1.0	1.0	1.0	1.0
Growth	6.0%	6.0%	6.0%	6.0%	6.0%	6.0%	6.0%
Exit P/B	1.43	1.2	1.25	0.99	1.58	0.5	1.05
Target Price	**41.82**	**46.2**	**16.82**	**102.28**	**12.99**	**97.2**	**167.57**
Current Price	32.85	34.60	12.40	79.50	9.94	70	167
Upside	**27.3%**	**33.5%**	**35.6%**	**28.7%**	**30.7%**	**12.2%**	**0.3%**
Recommendation	**BUY**	**BUY**	**BUY**	**BUY**	**BUY**	**BUY**	**SELL**

EQUITY GROUP

We recommend a **BUY** on Equity Group with a target Price of **KES 41.82**, offering a potential upside of 27.3%. Our views are informed by the expectation of government support in recovery of the SME sector despite the pandemic which is also expected to fuel deposit growth.

» Government push for SME lending to support loan book growth: In the wake of the current pandemic, it is expected that the Group will slow down lending as it remains cautious in an uncertain and ever-changing business environment. The Group has so far restructured over KES 92B worth of loans (about 25% of its loan book) as it seeks to cushion its customers whose businesses have been adversely affected by the tough business environment. Micro and SMEs businesses (about 62% of the Group's loan book) have been crippled due to pandemic related difficulties. However, the government has laid down guidelines to support these sectors through a credit guarantee scheme and Treasury-backed cash plan under which banks will be offered additional funding for onward lending to SMEs at subsidized interest rate. Further, the credit guarantee will cushion lenders in the case of default. Taking into account this perspective, we project a 4.3% y/y loan book growth to KES 383.3B in FY20. We anticipate that though the lender may actively take up lending to SMEs, there exists a limitation in terms of the specific segment to lend to with the main focus being the hospitality, agriculture and health services segments. Notwithstanding government support, we expect that the Group will remain cautious given the high-risk profile of the sector with this expected to subdue loan book growth.

Chat 1: Loan Segmentation By sector



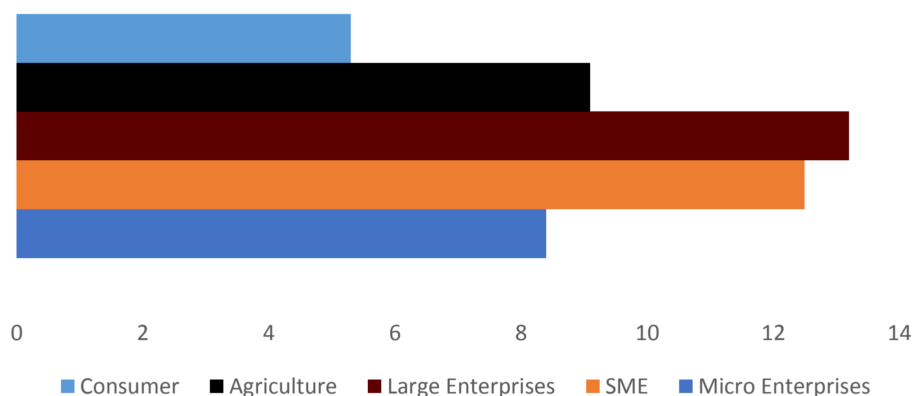
Source: AIB-AXYS Research, Company Fillings

»Deposit growth fueled by SME stimulus program We project a 10.0% y/y growth in deposit growth on the back of the aforementioned efforts by Treasury to boost SMEs business in a tough operating environment. The governments' resolve on payment of pending bills and VAT refunds is also expected to support growth. However, deposit growth may be curtailed by constrained consumer spending with the straining liquidity in the economy coupled with the persistent drop in diaspora remittances as the global economy is hit hard by the pandemic.

» Wary on provisioning

We project a 220bps y/y surge in cost of risk to 3.2% in FY20 following the foreseen gush in loan loss provisions. Gross NPLs rose 51.9% y/y to KES 44.6B in 1Q20 signaling an already struggling asset book even before the onset of the pandemic. We therefore project that the asset book quality may further deteriorate after taking into account the effects of the pandemic on the operating environment. While we project a rise in the NPL ratio (current ratio of 10.9%) we anticipate that this number will fall behind the industry ratio (current ratio of 12.7%). Provisions ae set to hold as the key risk factor in the anticipated shedding of the bottom-line.

Graph 9: NPL Ratio per Sector in 1Q20 (%)



Source: AIB-AXYs research, company fillings

» Pandemic to hit subsidiary performance

Overall performance of the subsidiaries is expected to come down following a challenging business environment riding on effects of the pandemic. The East African GDP is expected to slow down due to disruption of agricultural production and exports cuts.

The Bank of Tanzania lowered the statutory minimum reserve requirement from 7% to 6% to safeguard the economy from pandemic effects through enhanced lending by banks. Following witnessed lackluster performance in FY19, we may fail to see the subsidiary breakeven in FY20 further compressing the Groups bottom-line. The NPL ratio of 40.5% (1Q20) may further worsen in the prevailing business environment.

The lock down in Uganda, DRC and Rwanda has seen a significant drop in economic growth with this expected to trickle down to the subsidiaries' top-line in FY20. However, the governments for the respective countries have set up guidelines to boost economic recovery through business funding and tax waivers. This has also been the case in DRC and with the expectation that the economy will take time to recover. Following the prevailing conditions, we presume that the Group will continue to delay negotiations in the proposed acquisition of AtlasMara. We expect dismal performance in South Sudan with the pandemic expected to challenge the country's efforts in economic recovery.

Table 2: Financial Statements (Equity)

Income Statement (KES M)	2017	2018	2019	2020F	2021F	2022F
Interest income	48,410	53,230	59,723	63,217	70,921	80,389
Interest expense	-10,841	-11,808	-14,740	-15,209	-16,909	-19,151
Net interest income	37,569	41,422	44,983	48,008	54,011	61,238
Net interest income y/y	**-16%**	**10%**	**9%**	**7%**	**13%**	**13%**
Non-funded income	23,938	22,091	25,248	30,026	31,183	34,605
Non-funded income y/y	**46%**	**-8%**	**14%**	**19%**	**4%**	**11%**
Total operating income	61,507	63,513	70,231	78,033	85,195	95,843
Total operating income y/y	**0%**	**3%**	**11%**	**11%**	**9%**	**12%**
Provision for impairment	2,716	2,936	3,458	12,130	9,365	10,739
Operating expenses	31,909	32,114	35,295	38,112	42,920	48,356
OpEx y/y	**5%**	**1%**	**10%**	**8%**	**13%**	**13%**
Profit before tax	26,882	28,463	31,478	27,792	32,909	36,748
PBT y/y	**8%**	**6%**	**11%**	**-12%**	**18%**	**12%**
Taxation	7,964	8,639	8,917	6,948	9,873	11,025
Effective tax rate	**30%**	**30%**	**30%**	**25%**	**30%**	**30%**
Profit After tax	26,882	28,463	31,478	27,792	32,909	36,748
PAT y/y	**8%**	**6%**	**11%**	**-12%**	**18%**	**12%**
Proposed dividend	**7,547**	**7,547**		**9,434**	**9,434**	**9,434**

Balance sheet	2017	2018	2019	2020F	2021F	2022F
Cash & balance with CBK	39,914	47,881	64,890	64,213	72,127	83,320
Government securities	128,002	160,952	172,208	202,756	214,424	241,964
Loans and advances to customers	279,092	297,227	366,440	382,340	432,044	501,771
Loans and advances y/y	**5%**	**6%**	**23%**	**4%**	**13%**	**16%**
Property and equipment	10,865	10,276	11,031	11,583	12,162	12,770
Total assets	524,465	573,384	673,682	746,242	819,955	924,042
Total assets y/y	**11%**	**9%**	**17%**	**11%**	**10%**	**13%**
Customer deposits	373,143	422,758	482,752	531,027	600,061	678,069
Customer deposits y/y	**11%**	**13%**	**14%**	**10%**	**13%**	**13%**
Borrowings	47,873	45,101	56,714	59,553	64,406	74,313
Other Liabilities	9,832	10,343	12,865	25,648	22,804	24,585
Total liabilities	431,323	478,427	561,905	617,720	688,763	778,519
Total Liabilities y/y	**10%**	**11%**	**17%**	**10%**	**12%**	**13%**
Shareholders' funds	93,142	94,957	111,777	119,875	131,975	146,337

Source: AIB-AXYS Research

KCB Group

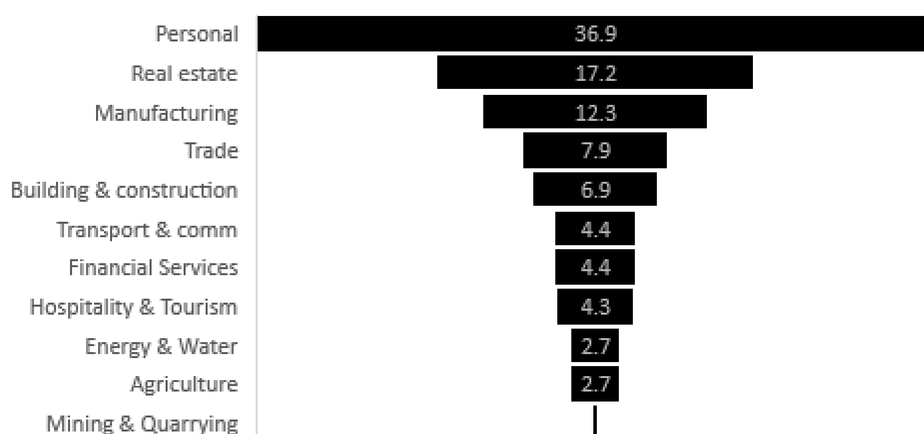
We recommend a **BUY** on KCB Group with a target price of KES 46.17, offering a potential upside of 33.5% on the current market price. Our view is informed by the banks heavy foot print in the personal loans space with expected savings following the closure of some branches after the acquisition of NBK.

» Personal loans to shield loan book growth

We project a 5% y/y growth in loans and advances on the back of lower lending in the wake of the current pandemic. We anticipate that personal loans will remain least affected by effects of the pandemic shielding the shedding of the loan book in other sectors. The Group has restructured KES 115B (about 15% of the loan book) worth of loans mainly from the tourism, hospitality, transport, agriculture and real estate sectors. However, we expect improved performance in the health and agriculture sectors in the short to medium term as export business opens up following the lifting of lockdowns in the European market. Despite witnessed job losses, we expect little effect on loans via the check off system. 79.3% of restructures stem from the corporate loans segment, we presume that this will drive the subdued loan growth even as we expect that the bank may take up lending to SMEs following the National Treasury cash back up plan and credit guarantee scheme in lending to SMEs.

We anticipate a strain in the interest income given the decline in CBR with 25% of the loan book being linked to the CBR .

Graph 10: Loan concentration by sectors (%)



Source: AIB-AXYS Research, Company Fillings

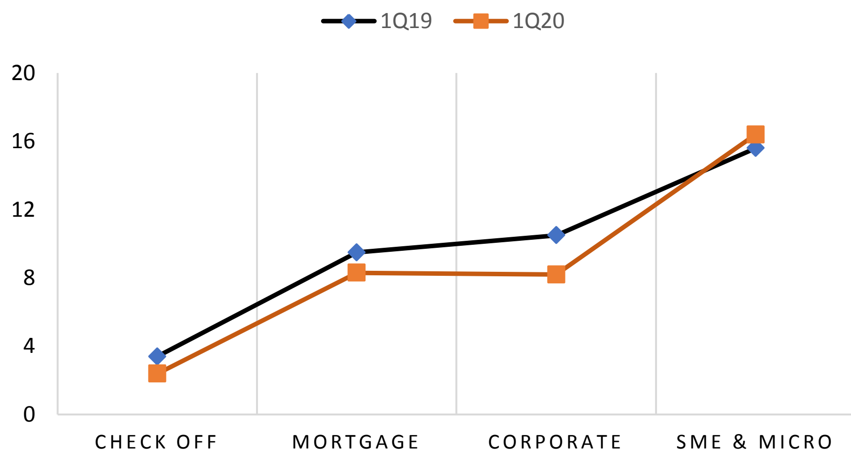
» Less transaction volume on mobile banking to weigh down NFI

On the back of declining transactions volume in mobile lending, suspension of fees and commissions on transactions coupled with increasing cost of risk due to difficulties in repayments, we expect subdued growth in non-funded income. In 1Q20, mobile loans stood at KES 49.8B. We project a 40% - 50% decline in mobile loans fueled by the aforementioned challenges with majority of customers affected by the current liquidity crunch. Declining NFI is expected to contribute largely in the weighing down on bottom-line.

» Higher provisioning to distress the bottom-line

We project a 70bps y/y incline in cost of risk to 2.5% on the back of higher provision necessitated by an expectation of rising NPLs in an operating environment characterized by uncertainty and worsening business conditions. We project that increase in cost of risk will be further fueled by a 50% decline in recoveries hence higher provisions. We anticipate that asset book quality will deteriorate pushed by loans in the SME and mortgage segments. While the NPL ratio is bound to increase we presume that it rally behind the industry average NPL ratio.

Graph 11: NPL Breakdown (%)



Source: AIB-AXYS Research, Company Fillings

» Cost savings from merger with NBK yet to be realized

The Group has so far pushed for a KES 6.3B shed in the bad book in NBK as it continues to effect a clean up of the lenders bad book with NBK's NPL ratio above industry average. Given the tough business environment in this pandemic and an expected 50% cut in total recoveries, we may see the Group take longer in the clean up which may also fuel provisions. We expect that the Group will continue to effect restructures in operations with an aim to boost cost efficiency while optimizing value of NBK. In the short term however, cost savings will be derived from traditional sources in the parent company's operations as opposed to investment in NBK.

Table 3: Financial Statements (KCB)

Income Statement (KES M)	2017	2018	2019	2020F	2021F	2022F
Interest income	63,673	66,280	74,350	82,479	94,410	104,623
Interest expense	-15,288	-17,450	-18,220	-19,581	-22,225	-24,447
Net interest income	48,385	48,830	56,130	62,898	72,185	80,176
Net interest income y/y	**3%**	**1%**	**15%**	**12%**	**15%**	**11%**
Non-funded income	23,000	22,973	28,171	27,209	31,148	35,962
Non-funded income y/y	**2%**	**0%**	**23%**	**-3%**	**14%**	**15%**
Total operating income	71,385	71,803	84,301	90,107	103,333	116,137
Total operating income y/y	**3%**	**1%**	**17%**	**7%**	**15%**	**12%**
Provision for impairment	-5,914	-2,944	-8,889	-13,517	-14,536	-15,649
Operating expenses	-34,996	-34,698	-38,679	-42,180	-46,303	-50,696
OpEx y/y	**6%**	**-1%**	**11%**	**9%**	**10%**	**9%**
Profit before tax	30,475	34,161	36,733	34,410	42,494	49,792
PBT y/y	**-6%**	**12%**	**8%**	**-6%**	**23%**	**17%**
Taxation	-9,410	-9,864	-11,732	-8,603	-12,748	-14,938
Effective tax rate	**-31%**	**-29%**	**-30%**	**-25%**	**-30%**	**-30%**
Profit After tax	19,704	23,995	25,165	25,808	29,746	34,855
PAT y/y	**0%**	**22%**	**5%**	**3%**	**15%**	**17%**
Proposed dividend	6,132	7,665	8,033	8,033	8,033	8,033

Balance sheet	2017	2018	2019	2020F	2021F	2022F
Cash & balance with CBK	50,714	50,101	83,235	79,910	91,713	100,884
Government securities	110,007	120,979	169,242	236,759	260,373	286,343
Loans and advances to customers	422,685	455,880	535,371	540,684	618,543	680,397
Loans and advances y/y	**10%**	**8%**	**17%**	**5%**	**14%**	**10%**
Property and equipment	10,454	11,007	13,132	14,887	15,336	16,769
Total assets	646,668	714,313	898,572	972,408	1,078,265	1,183,837
Total assets y/y	**9%**	**10%**	**26%**	**8%**	**11%**	**10%**
Deposits due to other banks	11,039	20,105	20,371	20,785	22,857	25,146
Customer deposits	499,549	537,460	686,583	720,912	793,003	872,304
Customer deposits y/y	**11%**	**8%**	**28%**	**5%**	**10%**	**10%**
Borrowings	14,895	22,447	21,485	24,705	26,573	29,230
Other Liabilities	8,653	14,817	29,701	45,002	54,675	55,528
Total liabilities	540,703	600,652	768,831	828,376	919,419	1,003,400
Total Liabilities y/y	**8%**	**11%**	**28%**	**8%**	**11%**	**9%**
Shareholders' funds	105,966	113,661	129,741	144,033	158,846	180,437

Source: AIB-AXYS Research

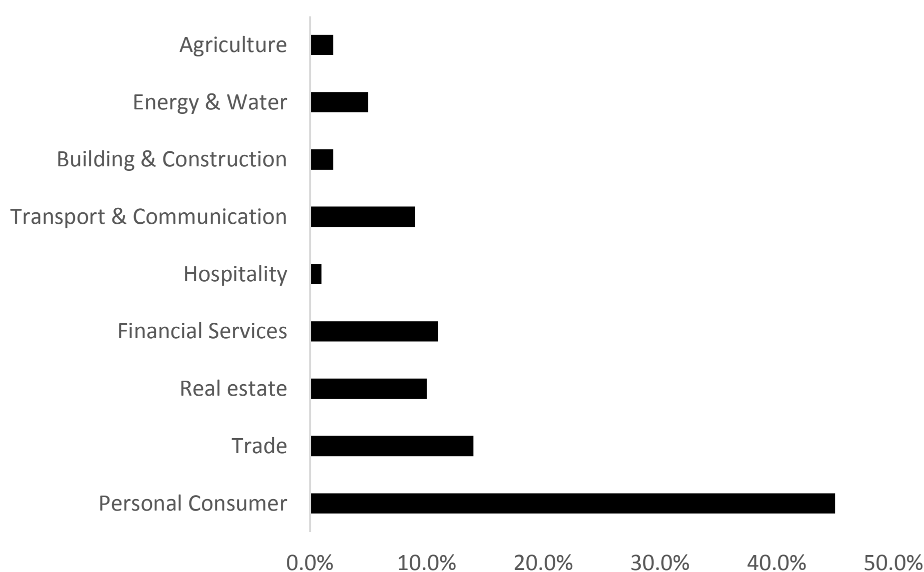
Co-operative Bank of Kenya

We recommend a **BUY** on Co-operative Bank with a target price of **KES 16.82**, offering a potential upside of **35.6%**. Our view is informed by the Groups diverse loan book that is anticipated to shield its asset growth even as we expect that asset book quality may be least affected by effects of the pandemic.

» Diverse loan book to shield growth amidst the pandemic

We forecast a 4.5% y/y growth in loans and advances premised on the Group's diverse loan book. We project that despite a slowdown in lending in the general economy, some sectors will recover faster than others with the cumulative recovery in these sectors expected to drive the banks asset book. We project that personal consumer lending will continue to drive loan book growth, with some expected recovery expected in the trade and agricultural sectors while anticipating minimal expansion in manufacturing and the building and construction sectors. While e-credit is also expected to drive loan book growth, we may see a 10% -15% reduction in demand on mobile loans as customers face challenges in payment driving up the cost of risk.

Graph 12: Loan Concentration by Sectors



Source: AIB-AXYS Research, Company Fillings

» Higher cost of risk as the asset book quality deteriorates further

We forecast a slight increase in both NPLs and provisions with the asset book quality further deteriorating in the wake of a tough business environment. The Bank has already restructured about KES 30B of loans across all sectors to shield its customers from the tough business environment. The manufacturing sector will continue to be hit hard by the pandemic with so far over 77% of bad loans in the sector. The real estate slowdown in wake of the pandemic is expected to worsen the already struggling real estate sector (about 47% of bad loans in building and construction book). We therefore forecast a 60bps y/y rise in cost of risk to 1.8%.

» Lower subsidiary performance

We anticipate lower profit contribution from the subsidiaries premised on lower topline performance following the continued bear run at the NSE. The Equities market sustained a downward trend since the onset of the pandemic marred by foreign exits and investors sceptic of poor performance across all sectors. This has further been fueled by some counters halting dividend payment, issues of profit warnings with expected dismal performance in uncertainty and an ever-changing business environment.

» Value in Jamii Bora?

We continue to closely monitor the proposed acquisition of 100% shareholding in Jamii Bora Bank Ltd. While we see value in Jamii Bora in deepening the Group's footprint in the SME segment we feel that the Group pegged the acquisition on repeal of the rate cap with the expectation of enhanced lending in a robust environment. In the current market, the SME segment is expected to be most hit by effects of the pandemic which may worsen Jamii Bora's NPL book before the takeover materializes. The full effect of COVID-19 on the market is yet to realized or fully planned for in uncertainty which may see the Group take longer to realize value in the already cash-strapped bank. We therefore remain worried that this deal may turn out problematic for Co-operative Bank in such an operating environment. We would expect the lender to delay the proposed acquisition until the full effect of the pandemic has been felt on its books and consider taking up Jamii Bora at even lower multiples.

Table 4: Financial Statements (Co-op)

Income Statement (KES M)	2017	2018	2019	2020F	2021F	2022F
Interest income	36,273	43,541	43,639	46,559	52,940	56,053
Interest expense	12,269	12,240	12,336	13,361	14,393	15,547
Net interest income	48,542	55,781	55,976	59,920	67,333	71,599
Net interest income y/y	**-2%**	**30%**	**0%**	**6%**	**16%**	**5%**
Non-funded income	17,592	12,259	17,157	19,235	19,656	20,554
Non-funded income y/y	**-1%**	**-30%**	**40%**	**12%**	**2%**	**5%**
Total operating income	41,596	43,560	48,460	52,432	58,203	61,061
Total operating income y/y	**-2%**	**5%**	**11%**	**8%**	**11%**	**5%**
Provision for impairment	3,601	1,722	2,539	4,772	4,983	4,765
Operating expenses	21,726	23,852	25,255	27,659	30,177	31,697
OpEx y/y	**-1%**	**10%**	**6%**	**10%**	**9%**	**5%**
Profit before tax	16,398	18,157	20,706	20,173	23,215	24,770
PBT y/y	**-7%**	**11%**	**14%**	**-3%**	**15%**	**7%**
Taxation	4,994	5,425	6,395	5,110	6,508	7,198
Effective tax rate	**30%**	**30%**	**30%**	**25%**	**30%**	**30%**
Profit After tax	11,405	12,732	14,311	15,063	16,707	17,572
PAT y/y	**-10%**	**12%**	**12%**	**5%**	**11%**	**5%**
Proposed dividend	**4,694**	**5,867**	**5,867**	**5,867**	**5,867**	**5,867**

Balance sheet	2017	2018	2019	2020F	2021F	2022F
Cash & balance with CBK	23,797	31,203	28,892	30,824	33,175	33,606
Government securities	73,322	82,829	119,188	138,455	145,908	159,149
Loans and advances to customers	253,862	245,410	266,713	278,640	307,544	327,765
Loans and advances y/y	**9%**	**-3%**	**9%**	**4%**	**10%**	**7%**
Property and equipment	7,494	6,614	11,421	12,792	13,431	15,245
Total assets	386,858	413,671	457,009	498,568	544,606	584,811
Total assets y/y	**10%**	**7%**	**10%**	**9%**	**9%**	**7%**
Deposits due to other banks	373	443	177	488	522	565
Customer deposits	287,372	306,117	332,824	359,450	390,722	416,119
Customer deposits y/y	**10%**	**7%**	**9%**	**8%**	**9%**	**7%**
Borrowings	25,156	23,950	26,424	28,287	29,926	32,395
Other Liabilities	3,476	11,214	4,716	9,513	11,813	14,605
Total liabilities	317,045	342,915	376,595	408,854	443,305	471,780
Total Liabilities y/y	**9%**	**8%**	**10%**	**9%**	**8%**	**6%**
Shareholders' funds	69,085	69,402	78,892	88,193	99,779	111,509

Source: AIB-AXYS Research

Stanbic Holdings

We recommend a **BUY** on Stanbic Holdings with a target Price of **KES 102.28**, offering a potential upside of **28.7%.** Our view is informed by the banks an expectation of stability in personal lending even as the banks expands footprint in the SME sector.

» Constrained loan book growth

We project a 3.6% y/y increase in loans and advances to KES 158.3B premised on the banks conservative lending policy with an expectation that the current economic environment will greatly affect its focus areas. While we expect that the bank may seek to attract SME customers under the Treasury's cash back up plan and credit guarantee scheme, we recognize that the bank is yet to solidify its presence in the SME space and may therefore take a conservative approach in such a business environment. With the current liquidity strain expected to sustain in a somewhat closed economy, we are not optimistic of opportunities in asset financing. We forecast that the aforementioned growth rate will be steered by an increase in corporate banking as well as secured personal lending segments as the lender takes advantage of improved margins to expand its asset book.

» NIM to remain below expectation

We anticipate that the Groups' NIM may continue to further contract despite the cumulative cut in the Central Bank Rate. We however remain optimistic that yield on interest earning assets will improve following the repeal of the rate cap and delinking of loans from CBR as the Bank shifts to more KES nominated interest earning assets.

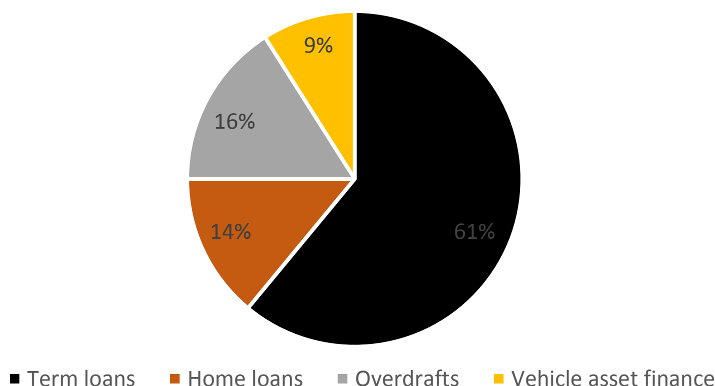
» Lower transaction fees to weigh in on NFI

The cut on transaction fees is expected to cut fees and commissions income slowing NFI growth. Lower foreign exchange margins as exchange rates stabilize and lower investment banking advisory deals due to the current pandemic are further expected to exacerbate the expected slow down in NFI growth.

» Cost of risk to rise

We project a 40bps y/y rise in cost of risk to 2.5% as in anticipation of a deterioration of asset book quality as a result of the current pandemic. The bank in line with its competitors has effected loan restores to shield its customers from the tough operating environment.

Chat 2: NPLs by Product in FY19



Source: AIB-AXYS Research, Company Fillings

Table 5: Financial Statements (Stanbic)

Income Statement (KES M)	2017	2018	2019	2020F	2021F	2022F
Interest income	16,608	19,248	20,961	22,440	23,863	26,382
Interest expense	-5,964	-7,118	-7,613	-7,279	-8,166	-9,001
Net interest income	10,644	12,130	13,348	15,161	15,697	17,381
Net interest income y/y	***-2%***	***14%***	***10%***	***14%***	***4%***	***11%***
Non-funded income	8,420	9,965	11,433	12,699	13,919	14,789
Non-funded income y/y	***10%***	***18%***	***15%***	***11%***	***10%***	***6%***
Total operating income	19,064	22,094	24,781	27,861	29,616	32,170
Total operating income y/y %	***3%***	***16%***	***12%***	***12%***	***6%***	***9%***
Provision for impairment	-2,761	-2,064	-3,151	-3,956	-4,060	-4,077
Operating expenses	-10,902	-11,082	-13,920	-14,641	-15,353	-16,795
OpEx y/y	***2%***	***2%***	***26%***	***5%***	***5%***	***9%***
Profit before tax	5,401	8,948	7,710	9,263	10,204	11,298
PBT y/y	***-11%***	***66%***	***-14%***	***20%***	***10%***	***11%***
Taxation	-1,092	-2,671	-1,329	-2,316	-3,061	-3,389
Effective tax rate	***-20%***	***-30%***	***-30%***	***-25%***	***-30%***	***-30%***
Profit After tax	4,309	6,277	6,381	6,947	7,143	7,908
PAT y/y	***-2%***	***22%***	***5%***	***3%***	***15%***	***17%***
Proposed dividend	**21,647**	**21,647**	**27,690**	**27,690**	**27,690**	**27,690**

Balance sheet	2017	2018	2019	2020F	2021F	2022F
Cash & balance with CBK	8,045	22,062	17,251	21,158	21,204	24,681
Government securities	71,330	72,260	70,078	81,518	85,073	93,750
Loans and advances to customers	130,536	146,604	152,817	158,256	176,503	194,153
Loans and advances y/y	***13%***	***12%***	***4%***	***4%***	***12%***	***10%***
Property and equipment	2,256	2,186	2,302	2,683	2,763	2,910
Total assets	248,739	290,570	303,625	320,712	350,159	388,125
Total assets y/y	***16%***	***17%***	***4%***	***6%***	***9%***	***11%***
Deposits due to other banks	38,707	27,909	30,451	37,573	36,393	41,395
Customer deposits	154,661	191,585	194,222	203,933	224,327	246,759
Customer deposits y/y	***30%***	***24%***	***1%***	***5%***	***10%***	***10%***
Borrowings	3,989	7,064	9,127	9,583	9,785	11,318
Other Liabilities	5,597	6,427	14,725	11,725	15,178	17,725
Total liabilities	205,783	245,947	254,590	267,517	292,609	325,453
Total Liabilities y/y	***18%***	***20%***	***4%***	***5%***	***9%***	***11%***
Shareholders' funds	42,956	44,623	49,035	53,195	57,551	62,672

Source: AIB-AXYS Research

Absa Bank Kenya

We issue a **BUY** recommendation on Absa bank with a target price of **KES 12.99**, representing a 30.7% upside. Our view is informed by the bank's improved efficiency ratio, increased usage of technology, and support from the parent company. Although capital ratios remain relatively low, access to capital support from its parent company mitigates capital risk thus the bank is unlikely to reduce dividends in order to conserve capital. The above-industry average dividend pay-out makes the bank relatively attractive.

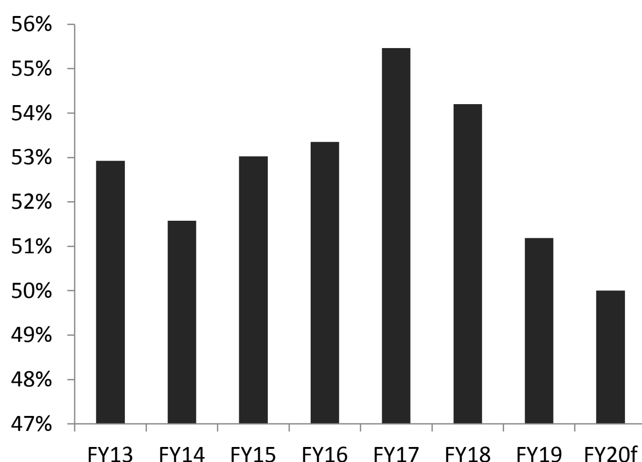
We are, however, concerned about a possible increase in its cost of risk on account of it exposure to the retail sector and unsecured loans.

» Investment in technology helps improving efficiency

Absa's cost to income ratio has been declining as the bank income grows at a faster rate than its cost. It has been able to contain costs by investing in technology and reducing its reliance on branches.

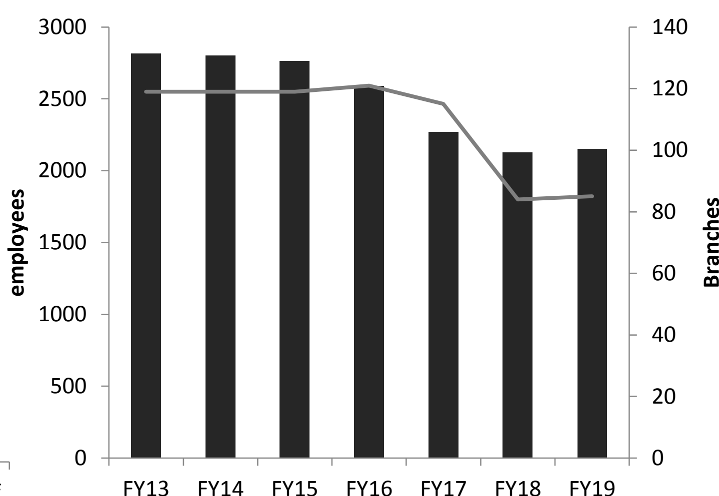
The launch of products such as Timiza (a mobile app) has also helped reduce reliance on the branch. As at the end of 2019 there were 4.5million customers on the platform which now supports lending to retail and SME clients.

Graph 13: Cost to Income Ratio



Source: AIB-AXYS Research, Company Fillings

Graph 14: Efficiency Indicators



Source: AIB-AXYS Research, Company Fillings

The recent investment in technology as Absa separates from Barclays has enabled the bank to acquire new technology which will greatly improve efficiency.

» Reduced reliance on branches

Currently over 70% of their transactions are processed outside the bank. This is an improvement but it's still below other Tier 1 banks where over 90% of transactions are carried out outside the branch. This means that there is still room for improvement which is likely to lead to a further decrease in the cost to income ratio.

Table 6: Financial Statements (Absa)

Income Statement	2017	2018	2019	2020F	2021F	2022F
Interest income	27,171	29,061	31,024	34,934	41,305	45,481
interest expense	-5,370	-7,069	-7,845	-7,740	-9,141	-10,146
Net interest income	21,801	21,992	23,179	27,195	32,164	35,334
Net interest income Y/Y %	-2%	1%	5%	24%	18%	10%
Non-funded income	8,457	9,702	10,588	12,781	15,117	16,607
Non-funded income Y/Y %	-10%	15%	9%	32%	18%	10%
Total operating income	30,259	31,694	33,767	39,976	47,281	51,942
Total operating income y/y %	-4%	5%	7%	26%	18%	10%
Provision for impairment	-3,115	-3,871	-4,201	-6,630	-7,229	-7,915
Operating expenses	-16,782	-17,178	-17,284	-19,988	-23,522	-25,711
OpEx Y/Y%	-1%	2%	1%	16%	18%	9%
Profit before tax	10,361	10,646	10,753	13,358	16,530	18,315
PBT Y/Y%	-5%	3%	1%	25%	24%	11%
Taxation	-3,435	-3,230	-3,296	-3,339	-4,959	-6,410
Effective tax rate (%)	-33%	-30%	-31%	-25%	-30%	-35%
Profit After tax	6,926	7,416	7,457	10,018	11,571	11,905
PAT Y/Y%	-6%	7%	1%	35%	15%	3%
Proposed dividend	5432	5975.2	5975.2	7012.9	8099.8	8333.4

Balance sheet	2017	2018	2019	2020F	2021F	2022F
Cash & balance with CBK	16,354	23,531	28,807	31,952	35,307	39,191
Government securities	68,084	92,939	122,996	141,122	154,468	169,827
Loans and advances to customers	168,397	177,354	194,895	221,002	244,207	271,070
Loans and advances Y/Y%	0%	5%	10%	25%	11%	11%
Property and equipment	2,744	2,337	2,889	2,663	2,942	3,266
Total assets	271,177	324,840	373,982	427,359	470,761	520,911
Total assets Y/Y %	4%	20%	15%	32%	10%	11%
Deposits due to other banks	3,059	5,308	4,083	3,994	4,413	4,899
Customer deposits	185,977	207,408	237,739	266,267	294,225	326,590
Customer deposits Y/Y%	4%	12%	15%	28%	11%	11%
Borrowings	0	0	0	0	0	0
Other Liabilities	9,210	10,883	14,993	13,313	14,711	16,330
Total liabilities	227,078	280,633	328,792	377,080	416,819	462,508
Total Liabilities Y/Y %	4%	24%	17%	34%	11%	11%
Shareholders' funds	44,099	44,207	45,189	50,279	53,942	58,403

Source: AIB-AXYS Research

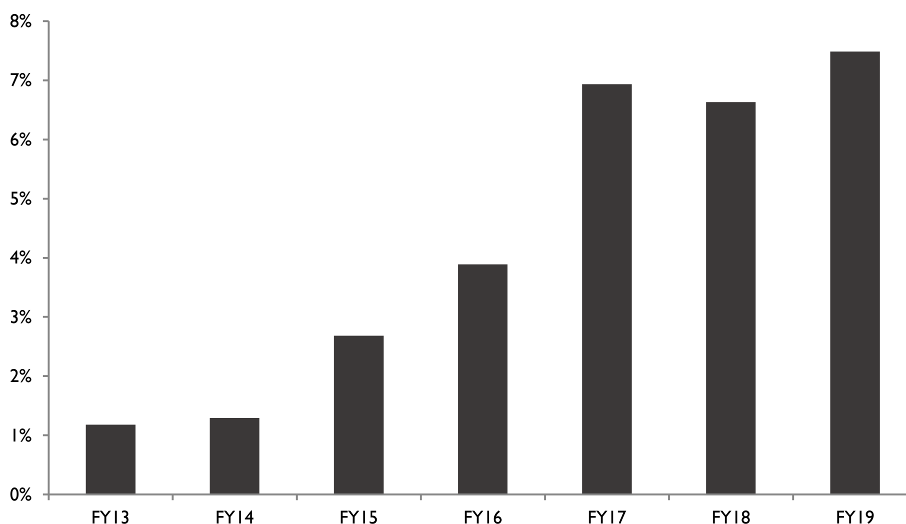
Diamond Trust Bank (DTB)

We issue a **BUY** recommendation on DTB bank with a target Price of **KES 97.2**, representing a 38.9% upside. The bank is likely to maintain its dividend policy as its adequate capital ratios reduces the need for capital conservation.
However, earnings growth is likely to be muted due to an increase in provisioning as NPL ratios increases. Interest income growth is likely to be subdued due to a depressed balance sheet growth as DTB management tends to be conservative on lending.

» High NPLs

Since the acquisition of Habib Bank in 2017, DTB's NPL ratio has remained relatively high.

Graph 15: NPL Ratio

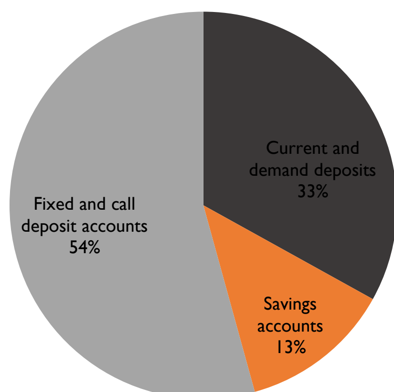


Source: AIB-AXYS Research, Company Fillings

» High cost of deposits

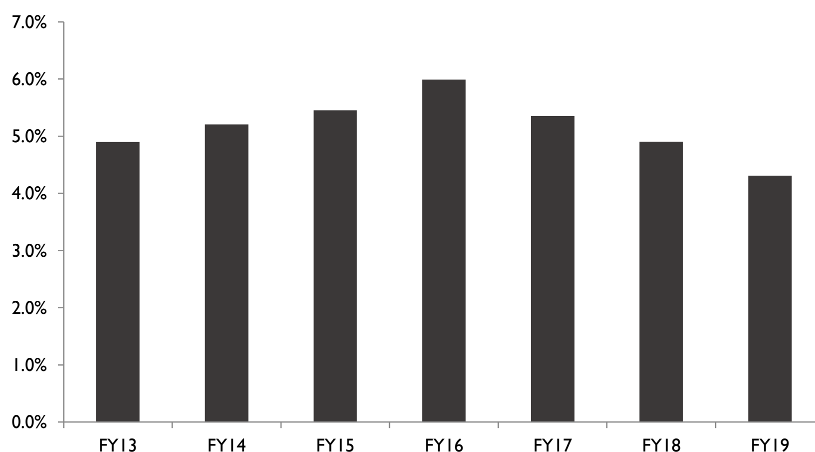
DTB has had to offer relatively high deposit rates in order to attract deposits.
Most of the funds are from fixed and call deposits.

Chat 3: Deposit Book



Source: AIB-AXYS Research, Company Fillings

Graph 16: Cost of Deposits

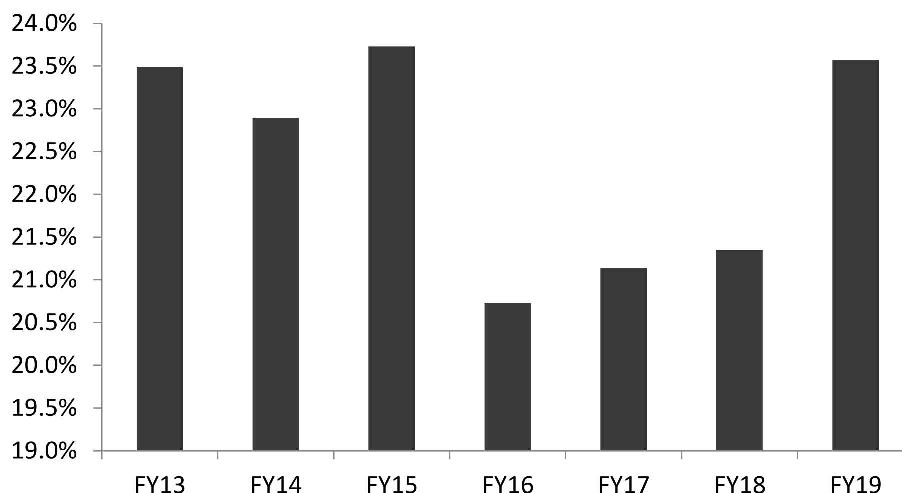


Source: AIB-AXYS Research, Company Fillings

» Non funded income expected to drive growth

The bank has a potential to grow its non-funded income.

Graph 17: Non-funded to total income

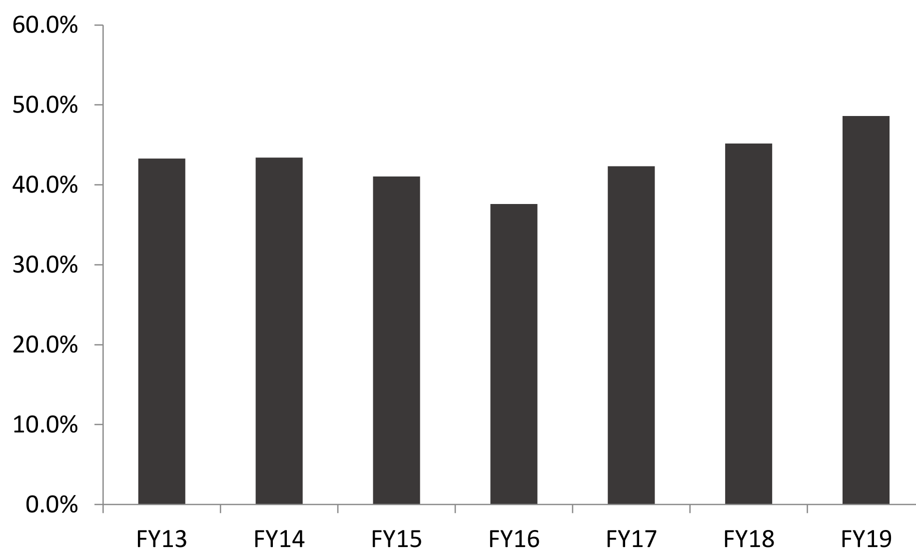


Source: AIB-AXYS Research, Company Fillings

» Cost to income ratio likely to decrease to historical levels

DTB's cost to income (CTI) ratio touched a low of 38% in 2016; it then increased in the subsequent years following the acquisition of Habib bank. We believe that there's room for DTB to return to its relatively low CTI ratios.
Lowering staff cost is one area that the bank could adopt to reduce its CTI ratio as before the acquisition, 50% of Habib's banks costs were staff costs versus 37% for DTB. In 1Q20, CTI ratio declined 336bps q/q to 45.3% mainly due to a 7.9% decrease in staff costs.

Graph 18: Cost to Income Ratio



Source: AIB-AXYS Research, Company Fillings

Table 7: Financial Statements (DTB)

Income Statement	2017	2018	2019	2020F	2021F	2022F
Interest income	19,676	20,022	18,711	19,338	20,627	22,441
interest expense	-14,954	-15,247	-14,140	-14,233	-15,097	-16,297
Net interest income	19,676	20,022	18,711	19,338	20,627	22,441
Net interest income Y/Y %	2%	2%	-7%	-3%	7%	9%
Non-funded income	5,274	5,435	5,770	5,995	6,394	6,957
Non-funded income Y/Y %	4%	3%	6%	10%	7%	9%
Total operating income	24,950	25,456	24,481	25,333	27,022	29,398
Total operating income y/y %	2%	2%	-4%	0%	7%	9%
Provision for impairment	-4,301	-2,982	-1,323	-2,079	-3,361	-2,582
Operating expenses	-10,560	-11,503	-11,902	-12,160	-12,862	-13,817
OpEx Y/Y%	15%	9%	3%	6%	6%	7%
Profit before tax	10,098	11,000	11,263	11,094	10,799	12,998
PBT Y/Y%	-8%	9%	2%	1%	-3%	20%
Taxation	-3,173	-3,918	-3,994	-2,773	-3,240	-4,549
Effective tax rate (%)	-31%	-36%	-35%	-25%	-30%	-35%
Profit After tax	6,925	7,082	7,269	8,320	7,559	8,449
PAT Y/Y%	-10%	2%	3%	17%	-9%	12%
Proposed dividend	706.823	706.823	754.9254	832.04955	755.91363	844.90036

Balance sheet	2017	2018	2019	2020F	2021F	2022F
Cash & balance with CBK	25,009	37,717	27,219	29,700	28,601	31,175
Government securities	112,538	115,028	130,328	133,649	141,416	152,411
Loans and advances to customers	196,048	193,074	199,089	207,899	224,041	245,936
Loans and advances Y/Y%	5%	-2%	3%	8%	8%	10%
Property and equipment	3,351	3,071	3,894	3,911	3,593	3,809
Total assets	363,303	377,719	386,230	405,403	435,370	469,357
Total assets Y/Y %	11%	4%	2%	7%	7%	8%
Deposits due to other banks	20,504	17,143	22,454	17,820	20,656	19,051
Customer deposits	266,247	282,860	280,187	296,998	317,788	346,389
Customer deposits Y/Y%	12%	6%	-1%	5%	7%	9%
Borrowings	17,175	14,694	11,357	14,850	16,525	16,973
Other Liabilities	5,758	9,365	7,717	10,395	11,123	12,124
Total liabilities	309,684	324,062	321,715	340,063	366,092	394,537
Total Liabilities Y/Y %	10%	5%	-1%	5%	8%	8%
Shareholders' funds	53,620	53,657	64,515	65,340	69,278	74,820

Source: AIB-AXYS Research

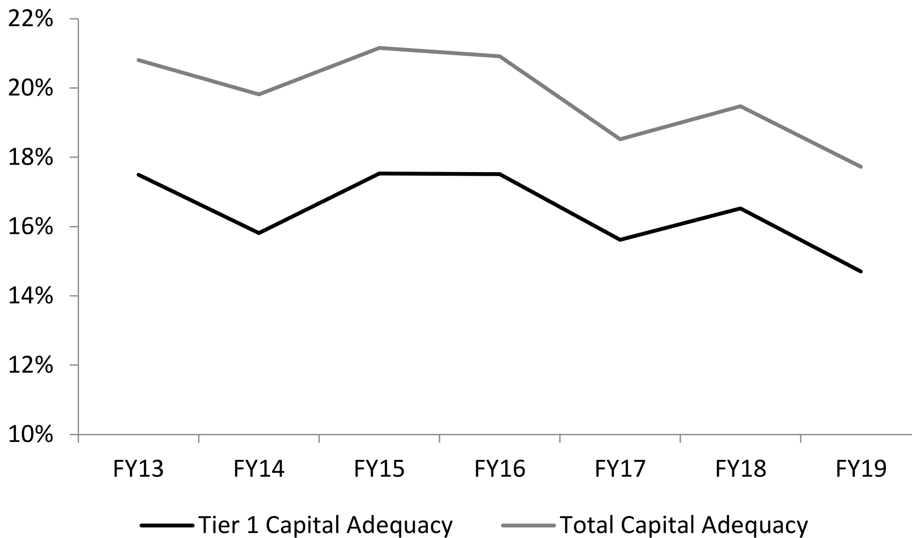
Standard Chartered

We issue a **SELL** recommendation on Standard Chartered with a target Price of **KES 167.57**, representing an 0.3% upside. The growth prospects for the bank remain dim, asset quality is expected to deteriorate and the dividend yield has declined.

» Deteriorating capital ratios

The increased provisions has led to a decrease in provisions

Chat 18: Capital Ratios



Source: AIB-AXYS Research, Company Fillings

» NPL likely to increase: The bank has had a problem with rising NPL ratios. This started to improve last year. However, the situation is likely to reverse this year.

»Reduced efficiency: The bank has been investing in technology as it tries to improve the customer experience and reduce its reliance on branches. The effect of this has been an increased acceptance by clients as 85% of our customer transactions are done on non-branch channels.

»Opportunities to grow non-funded income: The investment in technology has enabled the bank to offer additional products in its platform. This is likely to help drive growth of the non-funded income. In particular, we expect growth to come from the new products introduced under wealth management.

Under weather management, the bank has rolled out home, motor, travel and farewell insurance, off-shore mutual funds, fixed income and foreign exchange. This has enabled the sectors contribution to Retail Banking revenue to increase from 18% two years ago to 20% while assets under management grew 34% year-on-year.

» Reduced 2019 dividends: In June, StanChart decided to change its recommendation for the final dividend for FY19 from Ksh15.00 to Ksh7.50. This reduces dividend yield.

Table 8: Financial Statements (StanChart)

Income Statement (KES Mn)	2017	2018	2019	2020F	2021F	2022F
Interest income	26,274	26,871	25,272	26,499	27,445	29,674
interest expense	-7,708	-7,475	-5,800	-5,212	-5,209	-5,505
Net interest income	18,566	19,396	19,472	21,287	22,236	24,169
Net interest income Y/Y %	-4%	4%	0%	10%	4%	9%
Non-funded income	8,772	9,201	9,227	10,537	11,563	12,809
Non-funded income Y/Y %	2%	5%	0%	15%	10%	11%
Total operating income	27,338	28,598	28,700	31,824	33,799	36,978
Total operating income y/y %	-2%	5%	0%	11%	6%	9%
Provision for impairment	-4,186	-1,931	-572.592	-2,307	-2,926	-2,399
Operating expenses	-13,081	-14,820	-15,953	-17,822	-18,927	-20,486
OpEx Y/Y%	5%	13%	8%	20%	6%	8%
Profit before tax	10,722	12,245	12,174	11,695	11,946	14,093
PBT Y/Y%	-22%	14%	-1%	-4%	2%	18%
Taxation	-3,157	-3,747	-3,937	-2,924	-3,584	-4,932
Effective tax rate (%)	-29%	-31%	-32%	-25%	-30%	-35%
Profit After tax	7,565	8,498	8,237	8,772	8,362	9,160
PAT Y/Y%	-20%	12%	-3%	3%	-5%	10%
Proposed dividend	5840	6527	3440	3684	5435	6412

Balance sheet	2017	2018	2019	2020F	2021F	2022F
Cash & balance with CBK	13,342	20,284	20,621	21,998	21,815	23,124
Government securities	103,486	94,749	97,672	103,257	107,137	112,205
Loans and advances to customers	126,294	118,652	128,690	144,210	153,987	171,388
Loans and advances Y/Y%	3%	-6%	8%	22%	7%	11%
Property and equipment	3,351	3,071	3,894	3,911	3,593	3,809
Total assets	285,724	285,404	302,139	328,043	338,029	363,480
Total assets Y/Y %	14%	0%	6%	15%	3%	8%
Deposits due to other banks	12,701	155.959	8,028	5,044	2,730	2,893
Customer deposits	213,349	224,284	228,434	244,424	256,645	272,044
Customer deposits Y/Y%	14%	5%	2%	9%	5%	6%
Borrowings	0	0	0	10,280	8,269	10,280
Other Liabilities	5,561	5,778	6,795	7,333	7,699	8,161
Total liabilities	240,060	238,765	254,379	278,080	286,892	305,621
Total Liabilities Y/Y %	17%	-1%	7%	16%	3%	7%
Shareholders' funds	45,665	46,639	47,761	49,963	51,137	57,859

Source: AIB-AXYS Research

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Investment ratings

- **Strong Buy:** Issued on counters with strong fundamentals with a fair value above 20.0%. The counter is anticipated to register strong growth with and is currently undervalued.
- **Buy:** Issued on counters with strong fundamentals whose upside lies between 10.0% and 20.0%. The same may be issued for counters with challenged fundamentals whose upside is over 20.0%. Such a scenario is targeted for risk neutral investors.
- **Accumulate:** Issued on counters with an upside of between 5.0% - 10.0%. The counter may be facing contracting avenues for growth with a tepidly growing bottom-line.
- **Hold:** Issued on counters with an upside of between 1% and 5.0% with limited avenues for growth. Contracting bottom-line with an attractive dividend yield of about 5.0%.
- **Sell:** The counter currently has weak fundamentals coupled with potential downside.

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