Equity Group Holdings

Bloomberg: EQBNK KN Reuters: EQTY.NR

1st April 2021

We issue a **HOLD** recommendation on Equity group Holdings, with a target price of **KES 41.07** representing a **5.2%** upside from the current market price KES 39.05 (as at 1st April 2021). The stock is currently trading at a trailing P/B of 1.1x and forward P/B of 1.0x. We remain cautiously optimistic on the bank, expecting an improvement in profitability driven by both funded and non-funded income as well as improved efficiencies. However, we expect asset quality pressures to persist in the short term.

Key Highlights

a) **Transactional Revenue Continues to Drive Non-Funded Income:** We expect Equity to leverage on its SME customer base to cross sell transactional products with strategic partnerships around diaspora remittances, trade finance and merchant banking.

b) **Cost optimization through digital banking:** While we expect the overall C/I ratio to decline going forward, we note that the rise in operating expenses will be largely driven by the continued reliance on the brick and mortar model by regional subsidiaries, particularly Equity BCDC.

c) **Cautious lending:** We expect the group's loan book to continue registering growth with a conservative approach to Covid-19 high risk sectors and continued investments in liquid securities.

d) **Weakening asset quality:** We expect the cost of risk to remain elevated with i) new covid-19 regulations that will result in subdued business environment ii) bank's exposure to high risk sectors such as SMEs (51.0%), Trade (21.0%) and Real Estate (16.0%). We expect this to gradually decline going forward.

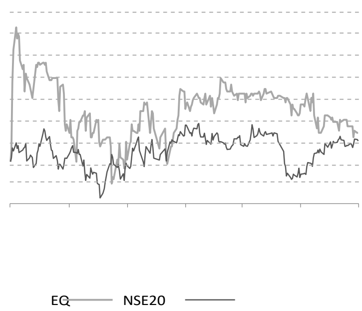
Key Metrics	2017	2018	2019F	2020F	2021F	2022F	2023F	2024F
EPS	5.00	5.25	5.93	5.24	5.52	6.74	8.35	10.18
DPS	2.00	2.00	2.00	-	2.21	2.70	3.34	4.07
BVPS	24.48	24.93	29.34	35.02	38.33	42.38	47.39	53.50
P/B	1.60	1.57	1.33	1.12	1.02	0.92	0.82	0.73
P/E	7.59	7.23	6.40	7.24	7.08	5.79	4.67	3.83
Div Yield	5.3%	5.3%	5.3%	-	5.7%	6.9%	8.6%	10.4%
ROaE	21.6%	21.1%	21.8%	15.8%	14.7%	16.7%	18.6%	20.2%
RoaA	3.8%	3.6%	3.6%	2.3%	1.9%	2.1%	2.4%	2.7%
C/I Ratio (excl. provisions)	51.9%	50.6%	50.3%	49.2%	43.8%	43.6%	43.4%	43.2%

Key data	
Target Price (KES)	**41.07**
Market price (KES)- 1/4/21	39.05
Upside	5.2%
No. of shares (mn)	3,774
Market Cap (KESmn)	143.2
Free float	93.7%
Dividend yield	0%

Major Shareholders	**% of shares**
Norfininvest	11.99
James Mwangi	3.39
Britam Limited	3.15
Equity Nominees	2.88
Fortress Highlands Limited	2.68

	NSE20	Company
1 month	-3.6%	0.1%
3 months	0.9%	8.4%
6 months	-0.2%	1.7%
12 months	-4.4%	11.6%
Min 52 weeks KES		28.00
Max 52 weeks KES		43.00

Price performance



Analyst
Ivy Barongo
+254(20) 7606026-37
Ivy.barongo@fib.co.ke

FY2020 FINANCIAL RESULTS

Equity Group recorded a 10.9% y/y decline in after tax profits to KES 20.1 billion (-11.8% y/y EPS to 5.24) mainly attributed to a surge in loan loss provisions and cushioned by deferred tax asset of KES 8.2 billion. ROE dipped to 15.3% from 21.8% in FY2019. The group's board of directors did not declare a dividend payment.

a) Declining Net Interest Margin

Net Interest Margin (NIM) declined by 110bps y/y to 7.2% driven by a 120bps y/y decline in yield from interest earning assets. This was however buoyed by cheaper cost of funds (-10bps y/y to 2.8%) supported by mobilization of transactional deposits and concessional funding.

Should the CBK permit re-pricing of loans on a risk-adjusted basis, we position Equity to benefit the most, given 51.0% loan book exposure to SMEs. Additionally, alternative channels will continue driving the mobilization of cheaper deposits. We therefore expect to see a gradual escalation of NIMs.

b) Transactional Revenue Continues to Drive Non-Funded Income

Non-funded income grew by 25.1% y/y to KES 38.5 billion boosted by forex trading income (+77.2% y/y). Diaspora remittances contributed 32.0% of the volume of forex traded. Other income grew by 58.6% y/y mainly attributed to mark to market gains of KES 4.0 billion on government securities. Transactional income now contributes 66.5% to non-funded income, mitigating the group from credit related risks.

We expect Equity to leverage on its SME customer base to cross sell transactional products with strategic partnerships around diaspora remittances, trade finance and merchant banking.

c) Improved Cost Efficiency

The group continues to reap the benefits of its digitization strategy as the C/I ratio declined to 48.5% from 51.1% in FY2019 (Kenyan subsidiary C/I ratio at 41.5% from 46.4%). As at FY2020, 98.0% of the group's volume of transactions and 60.0% of transactional value occurred on alternative channels. While we expect the overall C/I ratio to decline going forward, we note that the rise in operating expenses will be largely driven by the continued reliance on the brick and mortar model by regional subsidiaries particularly Equity BCDC

d) Asset Base Surpasses KES 1.0 trillion

Following the completion of the BCDC acquisition during the year, the group's asset base grew by 50.7% y/y to KES 1.0 trillion.

Customer deposits grew by 53.5% y/y to KES 740.8 billion while borrowed funds from development partners increased 54.1% y/y to KES 87.2 billion.

The loan book grew by 30.4% y/y to KES 477.8 billion with exposure to SMEs reducing to 51.0% (59.0% in FY2019) in favor of large corporates 19.0% (13.0% in FY2019). We see this cautious lending strategy persisting, particularly to Covid-19 high risk sectors.

e) Deteriorating Asset Quality

As at FY2020, the group had restructured KES 171.0 billion (32.0% of its loan book portfolio), warranting a significant increase in loan loss provisions, +402.2% y/y to KES 26.6 billion with the cost of risk at 6.1% from 1.3%. Gross NPLs surged 63.7% y/y to KES 59.4 billion leading to an NPL ratio of 11.0%.

Of the restructured loans, 33.0% were in real estate, 23.0% in trade, 9.0% in transport, 8.0% in tourism and 7.0% in manufacturing. As at December 2020, KES 20.0 billion of the restructured loans became paying, with KES 9.0 billion downgraded to stage 3. We expect the cost of risk to remain elevated with i) new covid-19 regulations that will result in subdued business environment in the medium term ii) bank's exposure to high risk sectors.

f) Regional Banking Subsidiaries Support Growth

The regional banking subsidiaries defied the economic challenges to post growth in profitability (except Tanzania). Rwanda and Uganda both recorded ROaE of 22.0% against a cost of capital of 19.0%. Following the acquisition of BCDC, we believe the subsidiary offers the most scaling potential (country's unbanked population of 28.4% unbanked population against 17% in Sub-Saharan Africa), now contributing 28.1% of the group's assets. Regional subsidiaries now contribute 28.0% to the group's overall profitability from 18.0% in FY2019, mitigating the group's business risk from the Kenyan subsidiary.

g) Capital Adequacy Ratios Boosted by Development Funding

The group propped its core capital by withdrawing dividend payment of KES 9.5 billion (2nd year consecutively) and raising KES 11.0 billion Tier 2 capital from development partners. Core Capital/Total Risk Weighted Assets (TRWA) stood at 16.3% (FY2019: 14.8%) while Total Capital/TRWA was at 19.8% (FY2019: 18.9%).

EQUITY GROUP HOLDINGS FINANCIALS

Income Statement (KES Mn)	2017	2018	2019	2020	2021F	2022F	2023F	2024F
Interest income	48,410	53,230	59,723	73,764	89,731	106,461	120,559	135,498
Interest expense	(10,841)	(11,808)	(14,740)	(18,616)	(22,081)	(24,778)	(27,116)	(29,420)
Net Interest income	**37,569**	**41,422**	**44,983**	**55,148**	**67,650**	**81,683**	**93,443**	**106,078**
Net fee income	16,342	15,271	17,170	22,671	28,157	32,771	37,712	43,514
Forex income	6,053	4,856	3,493	6,210	8,744	9,551	9,428	9,108
Total non-funded income	23,938	22,091	25,248	38,508	48,268	54,739	60,759	67,423
Total operating income	**61,507**	**63,513**	**70,231**	**93,656**	**115,918**	**136,422**	**154,201**	**173,501**
Credit impairment losses	(2,716)	(2,936)	(3,458)	(26,631)	(36,726)	(41,835)	(43,212)	(44,402)
Staff costs	(11,545)	(11,544)	(12,952)	(15,400)	(19,126)	(22,510)	(25,443)	(28,628)
Total operating expenses	**(34,625)**	**(35,050)**	**(38,753)**	**(72,664)**	**(86,583)**	**(100,582)**	**(109,792)**	**(119,369)**
Profit before tax	**26,882**	**28,463**	**31,478**	**21,859**	**29,335**	**35,840**	**44,409**	**54,132**
Income tax expense	(7,964)	(8,639)	(8,917)	(2,070)	(8,507)	(10,394)	(12,879)	(15,698)
Profit for the Year	**18,918**	**19,824**	**22,561**	**19,789**	**20,828**	**25,447**	**31,530**	**38,433**

Balance Sheet (KES Mn)	2017	2018	2019	2020	2021F	2022F	2023F	2024F
Assets								
Loans and advances	279,092	297,227	366,440	477,874	576,597	662,388	754,245	861,404
Investment Securities	128,002	160,952	172,208	217,407	293,045	328,863	360,290	385,906
Total Assets	**524,465**	**573,384**	**673,682**	**1,015,093**	**1,143,917**	**1,251,268**	**1,366,996**	**1,491,040**
Liabilities								
Customer deposits	373,143	422,758	482,752	740,800	874,426	955,138	1,047,563	1,138,519
Other borrowed funds	47,873	45,101	56,714	87,220	88,849	101,051	106,551	112,767
Total Liabilities	**431,323**	**478,427**	**561,905**	**876,452**	**999,247**	**1,091,330**	**1,188,139**	**1,289,124**
Shareholders Equity	**93,142**	**94,957**	**111,777**	**138,641**	**144,671**	**159,938**	**178,857**	**201,917**
Total Equity and Liabilities	**524,465**	**573,384**	**673,682**	**1,015,093**	**1,143,917**	**1,251,268**	**1,366,996**	**1,491,040**

Ratio Analysis								
Growth y/y %	**2017**	**2018**	**2019**	**2020**	**2021F**	**2022F**	**2023F**	**2024F**
Assets	10.7%	9.3%	17.5%	50.7%	12.7%	9.4%	9.2%	9.1%
Net Loans	4.9%	6.5%	23.3%	30.4%	20.7%	14.9%	13.9%	14.2%
Deposits	10.7%	13.3%	14.2%	53.5%	18.0%	9.2%	9.7%	8.7%
Non funded income	7.7%	-7.7%	14.3%	52.5%	25.3%	13.4%	11.0%	11.0%
Operating Expenses	-11.5%	1.2%	10.6%	87.5%	19.2%	16.2%	9.2%	8.7%
Net Profit	13.9%	4.8%	13.8%	-12.3%	5.2%	22.2%	23.9%	21.9%
Margins	**2017**	**2018**	**2019**	**2020**	**2021F**	**2022F**	**2023F**	**2024F**
Yield on interest earning assets	11.1%	11.1%	10.8%	10.3%	10.4%	10.5%	10.7%	10.9%
Cost of funds	2.6%	2.5%	2.7%	2.9%	2.8%	2.7%	2.7%	2.7%
Net Interest Margin (NIMs)	8.6%	8.7%	8.1%	7.4%	7.6%	7.8%	8.0%	8.2%
Balance Sheet	**2017**	**2018**	**2019**	**2020**	**2021F**	**2022F**	**2023F**	**2024F**
Gross Loans/Deposits	76.8%	74.9%	79.8%	70.0%	70.0%	73.0%	75.0%	78.0%
Net Loans/Deposits	74.8%	70.3%	75.9%	64.5%	65.9%	69.4%	72.0%	75.7%
Loans/Assets	53.2%	51.8%	54.4%	47.1%	50.4%	52.9%	55.2%	57.8%
Investment Securities/Deposits	34.3%	38.1%	35.7%	29.3%	33.5%	34.4%	34.4%	33.9%
P&L	**2017**	**2018**	**2019**	**2020**	**2021F**	**2022F**	**2023F**	**2024F**
Interest income/operating income	61.1%	65.2%	64.1%	58.9%	58.4%	59.9%	60.6%	61.1%
Non interest income/operating income	38.9%	34.8%	35.9%	41.1%	41.6%	40.1%	39.4%	38.9%
Staff costs/operating expenses	33.3%	32.9%	33.4%	21.2%	22.1%	22.4%	23.2%	24.0%
C/I ratio (provisions excluded)	51.9%	50.6%	50.3%	49.2%	43.80%	43.6%	43.4%	43.2%
C/I ratio (provisions included)	56.3%	55.2%	55.2%	77.6%	74.7%	73.7%	71.2%	68.8%
Asset Quality	**2017**	**2018**	**2019**	**2020**	**2021F**	**2022F**	**2023F**	**2024F**
Cost of risk	0.9%	0.9%	1.1%	6.1%	5.8%	5.0%	4.0%	3.0%
NPLs/Gross Loans	6.4%	7.5%	8.5%	9.0%	12.0%	12.2%	11.5%	11.0%

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Glossary of Terms

Net Interest Margin (NIM) - Net interest margin is a measure of the difference between interest paid and interest received, adjusted for the total amount of interest-generating assets held by the bank. It is calculated as: Net Interest Income/Average Interest Earning Assets
Basis points (bps) – one hundredth of a percentage i.e. 1.0%=100bps or 1bps=0.01%
Target price – Analyst estimate of the fair value or intrinsic value of the company
Cost of Funds-This is the effective average interest rate paid on interest earning liabilities. It is calculated as Total Interest Expense/Average Interest Earning Liabilities
Loan Yield- This is the effective average interest rate received on average loans and advances. It is calculated as Interest on Loans and Advances/Average Loans and Advances
Cost of Risk – This ratio measures the amount of risk involved in lending. It is calculated as: Net Impairment Provisions/Average Gross Loans in the period
Non-performing loans-These are loans that have been classified as impaired. The CBK classifies loans into five categories i.e. Normal, Watch, Substandard, Doubtful and Loss depending on performance of the loan. The last three i.e. sub-standard, doubtful and loss are referred to as non-performing loans. Under IFRS, these classified as stage 3 loans.
Non-performing loans (NPL) Ratio - This is the proportion of NPLs in the loan book. It is calculated as Gross NPLs/Gross Loans
Non-funded/Non-Interest Income– This represents the income that is not classified as interest income.
Non-Funded/Non-Interest Income Ratio. This represents the proportion of total operating income that is not classified as interest income. It is calculated as Non-Interest Income/Total Operating Income
Composite market share (Market share Index) - This is a weighted composite index comprising of assets, deposits, capital size, number of deposit and loan accounts. The composite market share is used by CBK to classify banks into three groups:

- Tier 1(Large Size Bank); Composite market share of 5.0% and above
- Tier 2(Medium Size Bank); Composite market share of between 1.0% and 5.0%
- Tier 3(Small size Bank); Composite market share of less than 1.0%

Recommendation

BUY – Minimal risks to catalysts
SELL- Risks outweigh the catalysts
NEUTRAL – This is where the positives and negatives in a company almost balance out. You can accumulate for the long term.

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Head Office: Crawford Business Park, Ground Floor, State House Road | email: Info@fib.co.ke | web: www.fib.co.ke