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Barclays Bank of Kenya (BBK): Update Note

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3-Year Strategy: Will it deliver sustainable growth?

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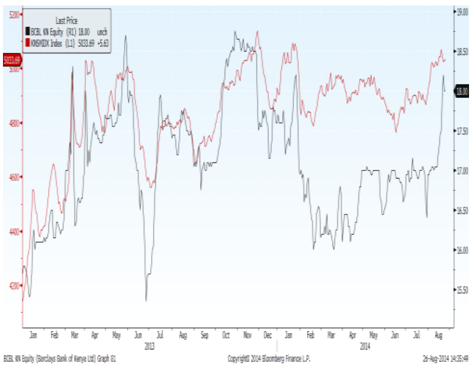
RECOMMENDATION:	BUY
Market Price (25.08.14)	18.00
Trailing BVPS: FY2013	5.96
Trailing P/B	3.02
3 yr Historical Average P/B	2.76
Forecasted BVPS: FY2014	8.19
Target Price	**22.59**
Upside Potential	**25.5%**

Share Statistics

Current Price (25.08.14)	18.00
Issued Shares (Mn)	5,432
Market Cap (KES Mn)	97,776
Market Cap (USD)	1,104

Source: NSE



Summary

Based on the recent results and the 3-year strategy in place, we upgrade our recommendation from **NEUTRAL** to **BUY** in the short term. We arrive at a **target price of KES 22.59** which provides an upside potential of 25.5% from the current market price of KES 18.00 (as at 25.08.14). The stock is trading at a trailing P/B of 3.02x and a forward P/B multiple of 2.2x.

We believe the bank will deliver growth within its 3-year strategy. Beyond that, we are cautiously optimistic. We remain concerned about the bank's ability to mobilize cheap deposits from the domestic market. We also expect to see stiff competition in the business segments that BBK is targeting.

Key indicators of short term growth include:

- **1H2014 results:** Interest income grew by 6.1% from KES 10.5 billion (1H2013) to KES 11.1 billion (1H2014).
- **Increasing risk-appetite on lending:** In the first 6 months of 2014, the bank recorded an 8.5% growth in the loan book to KES 128.4 billion. Quarter-on-quarter (q/q), the bank recorded a growth of 10.0% (2Q2014) compared to a growth of -1.3% (1Q2014)

Key Risks

- **Declining headroom on capitalization:** The capital adequacy ratio declined to 15.7% (1H2014) (against the statutory requirement of 14.5%), reducing the headroom to only 1.2%.
- **Ability to grow customer deposits:** In our view, the bank will continue to find it challenging growing customer deposits in the domestic market.
- **Competitive advantage in new business segments:** These include SMEs, insurance agency, mortgages. We believe that this might take awhile to gain traction and contribute significantly to the bank's profitability due to the competitive enviroment.

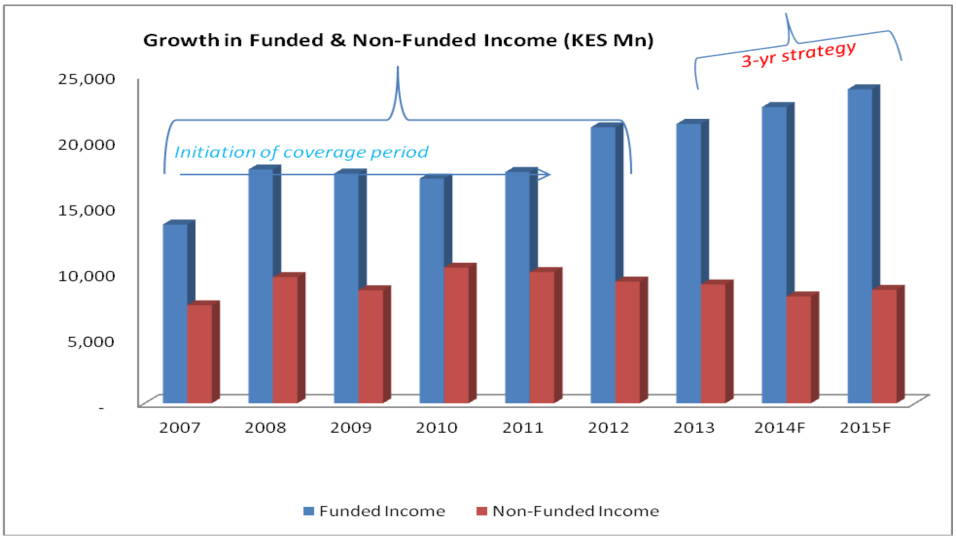
Year to 31 Dec	2010A	2011A	2012A	2013A	2014F
Net Income (Kshs Mn)	10,599	8,073	8,741	7,623	8,474
EPS (Kshs)	7.80	1.49	1.61	1.40	1.56
BVPS (Kshs)	27.87	6.68	6.15	6.46	8.19
P/E x	8.01	8.78	9.79	12.54	11.54
P/B x	2.7	2.4	2.9	3.0	2.2
ROaE	38.1%	26.6%	29.7%	24.6%	23.3%
ROaA	6.3%	4.8%	5.0%	3.9%	4.0%
C/I Ratio	54.0%	51.6%	52.0%	52.9%	50.6%

Source: Company reports, FIB analysis

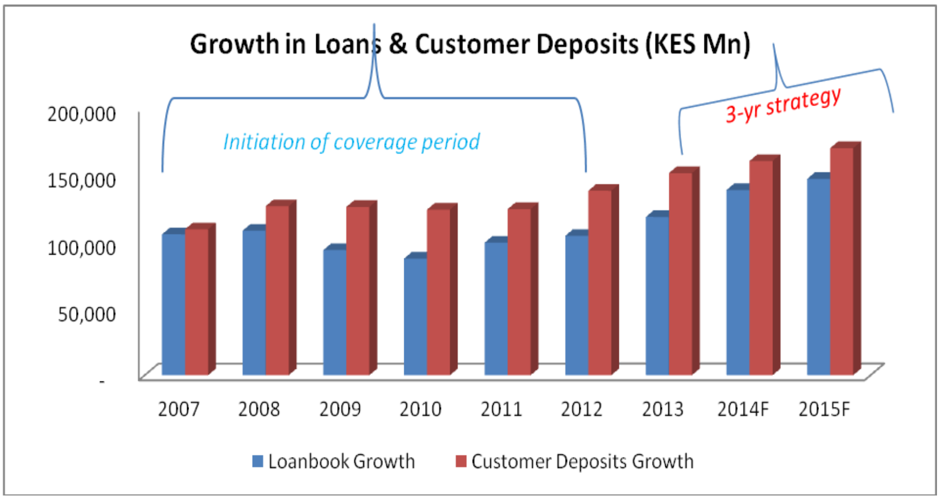
Building up the context

Historically: During our Kenya Banking Sector initiation of coverage report dubbed "The Innovation Imperative (covering the period from FY2007-FY2011), we arrived at a **SELL recommendation** on BBK's stock premised on the following key concerns:

- **Flat top line growth:** The bank's top line growth of both funded and non-funded income was flat from FY2007-FY2010. It picked up from FY2012.



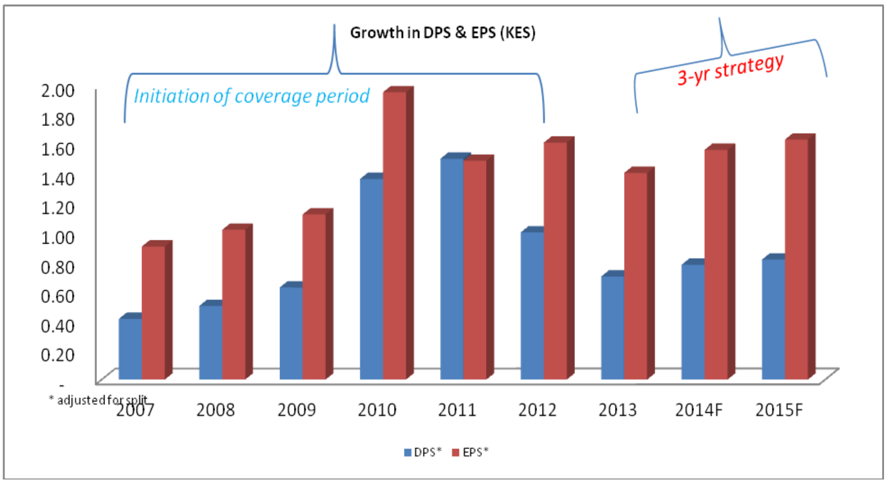
- **Shrinking loan book and marginal growth in customer deposits:** With a fairly flat growth in customer deposits, BBK was unable to grow the loan book, contributing to the flat top line growth in funded income.



- **Bottom line being boosted by cost containment strategies and a potentially unsustainable high dividend yield:** Earnings per share (EPS) and dividend per share (DPS) were on the increase from 2007,up until 2010, before beginning to decline, therefore informing our dividend payout outlook.

  The growth in bottom line was mainly due to cost-containment initiatives that the bank has been implementing over the years. Although staff count declined by 39.1% (FY2007-FY2011), staff-related costs showed very minimal changes due to upward inflationary adjustments.

We therefore believe that the improvement in the bottom-line was due to increasingly lower interest expense.



The Current Situation: By the end of FY2013, The bank was not able to achieve the 2010 performance levels again. In our view, the bank has had challenges communicating the strategy or lack of it thereof.

In FY2013, the management, headed by a new Managing Director (Mr. Jeremy Awori) formulated a 3-year strategy. The strategy envisages delivering on a number of initiatives including:

- Harnessing growth opportunities in retail, corporate and treasury banking
- Tapping into the small and medium sized enterprises

This strategy is expected to leverage on the Bank's local, regional and global networks. Management expects to deliver growth on the foundation of strong human resource, risk management, cost effective operational capabilities, innovation of products and services.

Latest Results (1H2014), and what they mean: BBK released its 1H2014 results, recording a 2.4% drop in profit before tax (PBT) and a 13.4% increase in profit after tax (PAT) to KES 4.2 billion compared to KES 3.7 billion in 1H2013. Below we outline the key drivers of these results:

Income Statement (KES '000)	1H2013	1H2014	% Change
Interest income	10,457,145	**11,097,427**	6.1%
Interest expense	1,225,780	1,407,108	14.8%
Net Interest Income	**9,231,365**	9,690,319	5.0%
Non-interest income	4,491,906	4,260,241	-5.2%
Total Income	**13,723,271**	**13,950,560**	1.7%
Operating expenses	6,879,108	7,118,691	3.5%
Loan loss provision	581,154	720,031	23.9%
PBT	**6,263,009**	6,111,838	-2.4%
PAT	**3,732,269**	**4,233,294**	13.4%
EPS	***0.69***	**0.78**	13.4%
DPS	***0.20***	**0**	
Cost/Income Ratio	***50.1%***	**51.0%**	

Source: Company reports, FIB database

Balance Sheet (KES '000)	FY2013	1H2014	% Change
ASSETS			
Kenya government securities	47,558,631	45,466,977	**-4.4%**
Loans & advances to customers	118,361,911	128,446,955	**8.5%**
Total Assets	**206,736,932**	**213,166,989**	**3.1%**
LIABILITIES			
Customer deposits	151,121,844	148,177,399	**-1.9%**
Deposits from local & foreign institutions	4,738,316	7,335,947	-
Other liabilities	9,466,381	10,611,123	**12.1%**
Total Liabilities	**174,366,046**	**179,219,872**	**2.8%**
Shareholders' Funds	**32,370,886**	**33,947,117**	**4.9%**
Loan /deposit Ratio	***75.9%***	***82.6%***	
Total Capital/Total Risk-Weighted Assets	***17.3%***	***15.7%***	
Liquidity Ratio	**42.0%**	**34.0%**	

Source: Company reports, FIB database

Interest income grew by 6.1% from KES 10.5 billion (1H2013) to KES 11.1 billion (1H2014). This was driven mainly by an 8.5% growth in loan book (to KES 128.4 billion

Increasing risk-appetite on lending: In the first 6 months of 2014, the bank recorded an 8.5% growth in loan book to KES 128.4 billion. Q/q, the bank recorded a growth of 10.0% (2Q2014) compared to a growth of -1.3% (1Q2014).

Over the last 5 years, average loan book growth stood at 2.4%. In the last 3 years, BBK registered double-digit growth, of 13.7% (FY2011) and 13.6% (FY2013).

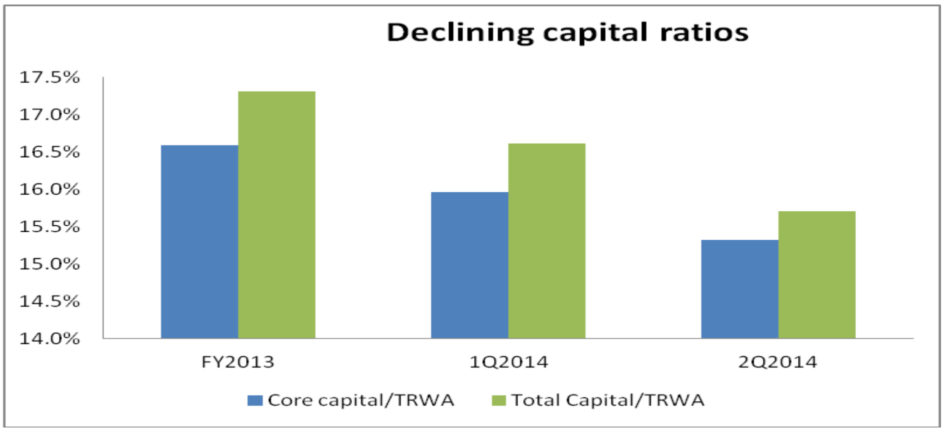
In our view, the bank seems to be getting relatively aggressive in lending. The loan/deposit (L/D) ratio steadily increased from 75.9% (FY2013) to 82.6 %(1H2014). We expect this momentum to be maintained within the strategic period.

Minimal growth in customer deposits: Although the loan book grew by 10.0% (2Q2014), customer deposits grew by 2.7%. In absolute terms, KES 3.8 billion was mobilized in 2Q2014, but KES 11.7 billion was lent out. Most of the lendable funds came from group companies (KES 4.0 billion) and disposal of government securities (KES 3.9 billion). Going forward, we expect to see active trading on government securities, as well assistance from group companies in terms of funding of the loan book growth.

Key Risks

In our view, we see the following as some of the key risks:

Declining headroom on capitalization: Capital ratios have continued to be on the decline. By 1H2014, the capital adequacy ratio declined to 15.7% (against the statutory requirement of 14.5%), reducing the headroom to only 1.2%.



However, management indicated that Tier I (95.0% of total capital) is sufficient, but that they will need to raise Tier II capital. This will be sourced from the local market, which might be referenced to the T-bill.

Ability to grow customer deposits: In our view, the bank will continue to find it challenging to grow cheap customer deposits in the domestic market. We expect the fight for cheap deposits to heighten. As a result, we expect the bank to continue relying heavily on the group companies in their funding structure.

New business segments: In the 3-year strategy, the bank identified new business segments that they plan to get into or increase their presence. These include SMEs, insurance agency, mortgages. We believe that this might take awhile to gain traction and contribute significantly to the bank's profitability due to the competitive enviroment.

Valuation & Recommendation

In our valuation, we have used a benchmark multiple for the average P/B over the last 3 years.

P/B Multiple Valuation	
Market Price (265.08.14)	18.00
Trailing BVPS: FY2013	5.96
Trailing P/B (X)	3.02
3 yr Historical Average P/B (X)	2.76
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Based on the foregoing, we upgrade our recommendation from **NEUTRAL** to **BUY** in the short term. We arrive at a **target price of KES 22.59** which provides an upside potential of 25.5% from the current market price of KES 18.00 (as at 25.08.14). The stock is trading at a trailing P/B 3.02x and a forward P/B multiple of 2.2x.