Equity Bank – 3Q2013 Results Note

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RECOMMNEDATION: BUY

Current market price (9.12.13)	33.50
Trailing BVPS: 2012	11.59
Trailing P/B	3.04
Forecasted BVPS	14.01
Target Price	**40.49**
Upside Potential	**20.9%**

Share Statistics

Issued shares (Mn)	3,703
Market Cap (KES Mn)	130,523
Market Cap (USD Mn)	1,512

Investment Summary

We maintain our **BUY recommendation** on Equity Bank. However, we downgrade our price target from KES 43.82 to KES 40.49, providing a 20.9% upside potential from the current share price of KES 33.50. This is driven by a downgrade in our forecast of key metrics as alluded to in this report. The forecasted BVPS drops by 7.6% to KES 14.01 as a result.

Key 3Q2013 Results Highlights

- ✓ **Slower loan book growth in 3Q2013:** The loan book grew by 5.4% in 3Q2013 to KES 158.6 billion as compared to a 7.8% growth recorded the previous quarter. We forecast a 2.8% growth q/q (4Q2013) compared to an earlier forecast of 7.4%.
- ✓ **Sustained growth in customer deposits albeit at a slower pace:** Equity managed to mobilise KES 6.1 billion during 3Q2013 representing a 3.3% q-o-q growth as compared to a 27.1% q-o-q growth recorded the previous quarter. We forecast a q/q growth of 3.3% (4Q2013) down from an earlier forecast of 5.1%.
- ✓ **Investments in systems infrasturcture push up operating expenses:** Operating expenses rose 15.1% to KES 15.4 billion on account of increased investments in systems. This is a significant step considering our view of the direction of the industry.
- ✓ **Deterioration in asset quality:** Of concern is the spike in growth of gross non-performing loans to KES 9.0 billion (3Q2013) from KES 7.8 billion (2H2013) representing a 16.1% increase. We continue ot monitor the loan book.

Year to 31 Dec	2012A	2013F
Net Income (KES Mn)	12,080	12,657
EPS	3.26	3.42
BVPS	11.59	14.01
P/E x	10.81	9.80
P/B x	3.04	2.39
ROE	28.1%	24.4%
ROA	5.0%	4.5%
C/I Ratio	48.8%	49.7%

Equity Bank 3Q2013 Earnings Update

Income statement (KES '000)	3Q2012	3Q2013	% Change
Interest income	22,670,644	23,560,306	3.9%
Interest expense	5,438,022	3,848,214	-29.2%
Net Interest Income	**17,232,622**	**19,712,092**	**14.4%**
Non-interest income	9,420,487	10,554,097	12.0%
Total Income	**26,653,109**	**30,266,189**	**13.6%**
Operating expenses	13,391,334	15,409,262	15.1%
Loan loss provision	1,566,221	2,370,609	51.4%
Profit before tax	**11,695,554**	**12,486,318**	**6.8%**
Profit after tax	**8,300,635**	**8,904,223**	**7.3%**
Yield on loans	**15.4%**	**12.9%**	
Cost of customer deposits	**2.5%**	**1.5%**	
Cost/Income Ratio	**50.2%**	**50.9%**	
EPS	**2.24**	**2.40**	

Source: Company Release, FIB Analysis

Bank Balance Sheet (KES '000)	1H2013	3Q2013	% Change
ASSETS			
Loans and advances to customers (net)	150,477,390	158,577,454	5.4%
Kenya Government Securities (Held to maturity)	21,877,011	21,760,382	-0.5%
Total Assets	**261,577,670**	**267,668,399**	**2.3%**
LIABILITIES			
Customer deposits	184,024,528	190,141,876	3.3%
Borrowed funds	25,613,851	24,544,662	-4.2%
Total Liabilities	**216,912,569**	**220,709,410**	**1.8%**
Shareholders' Funds	**44,665,101**	**46,958,989**	**5.1%**
Loan/deposit ratio	**81.8%**	**83.4%**	
Liquidity ratio	**41.0%**	**38.0%**	
Core capital/Total risk weighted assets	**15.0%**	**15.0%**	
Total capital/Total risk weighted assets	**22.0%**	**23.0%**	

Source: Company Release, FIB Analysis

Equity Bank announced a 6.8% rise in profit before tax to KES 12.5 billion (3Q2013) from KES 11.7 billion (3Q2012).

Interest income grew 3.9% y-o-y to KES 23.6 billion

Interest Income growth on the back of increased volumes of government securities: Interest income recorded a growth of 3.9% y-o-y to KES 23.6 billion (3Q2013) from KES 22.7 billion (3Q2012). The growth was principally due to a 21.2% increase in Interest income on government securities to KES 2.7 billion from KES 2.2 billion the prior year. A combination of growth in volume of holdings and a rise in interest rate on the securities resulted in this growth.

Kenya Government securities holdings increased by KES 1.7 billion

Notably, the bank increased its holdings of Kenya government securities by KES 1.7 billion during the period under review. The benchmark 91-day Treasury bill increased by 134 bps from 7.8% in 3Q2012 to 9.1% at the end of 3Q2013.

Going forward, we are keen on how the bank will boost the pace of interest income growth especially on loans. Our expectation is that the single-digit growth is becoming the new norm in terms of the bank's growth.

Slower loan book growth in 3Q2013: The loan book grew by 5.4% in 3Q2013 to KES 158.6 billion as compared to a 7.8% growth recorded the previous quarter. Loan book growth was driven by loans advanced to SMEs during the quarter.

Yield on loans dropped by 250 bps to 12.9%

Yield on loans dropped by 250 bps to 12.9% from 15.4% during the prior comparable period. This is in line with declining interest rates that saw the Central Bank Rate (CBR) decline by 450 bps to 8.5% (Sept. 2013) from 13.0% (Sept. 2012). Interest income on loans and advances recorded a marginal 1.1% increase to KES 20.5 billion (3Q2013) from KES 20.3 billion (3Q2012) due to a 20.7% y-o-y growth in net loans and advances.

KES 6.1 billion mobilized during 3Q2013

Sustained growth in customer deposits albeit at a slower pace: Equity managed to mobilise KES 6.1 billion during 3Q2013 representing a 3.3% q-o-q growth as compared to a 27.1% q-o-q growth recorded the previous quarter. Deposits consisted of 15.0% term deposits, 29.0% demand accounts and 56.0% savings accounts. With demand and savings depostis having a dominant share of total deposits, Equity enjoys a cheap source of funding for loan deployment.

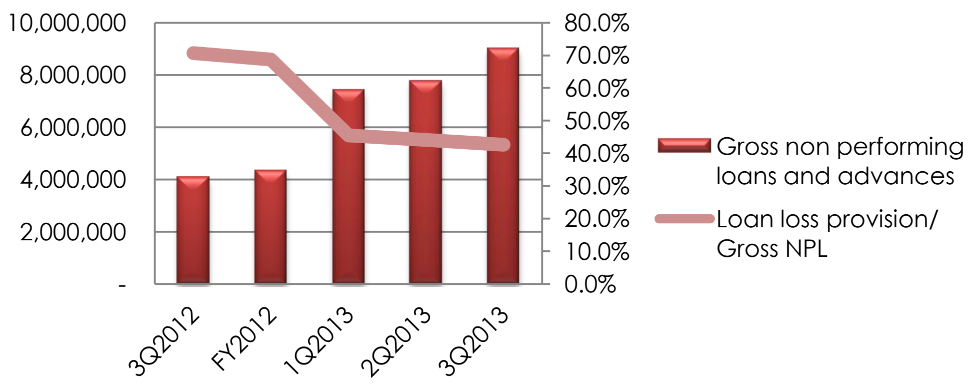
Cost of customer deposits dropped by 100 bps

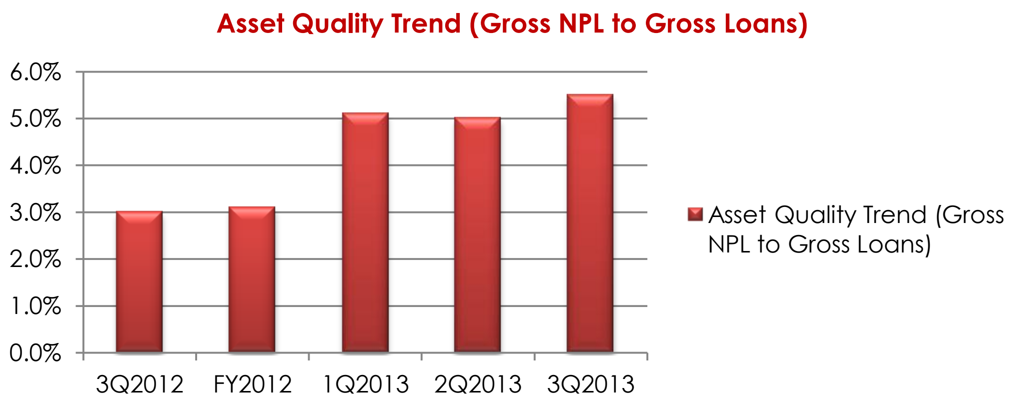
Continued decline in cost of funds: The 29.2% decrease in interest expenses is primarily attributable to a 31.1% decrease in interest expense on customer deposits to KES 2.8 billion (3Q2013) from KES 4.0 billion (3Q2012). Cost of customer deposits dropped by 100 bps to 1.5% during the period under review in line with the drop in the CBR rate.

Investments in ICT infrasturcture push up operating expenses: Operating expenses rose 15.1% to KES 15.4 billion on account of increased investments in ICT, payment systems and physical upgrades on some of the branches. We expect the cost to income ratio to trend downwards in the medium term as the benefits from the investments in ICT come into effect.

16.1% increase in non-performing loans during 3Q2013

Deterioration in asset quality in 3Q2013: Of concern is the spike in growth of gross non-performing loans to KES 9.0 billion (3Q2013) from KES 7.8 billion (2H2013) representing a 16.1% increase. This implies a slight deterioration of asset quality in our view. Equity attributed this to delayed government payments to SMEs and new prudential guidelines requiring longer observation period.

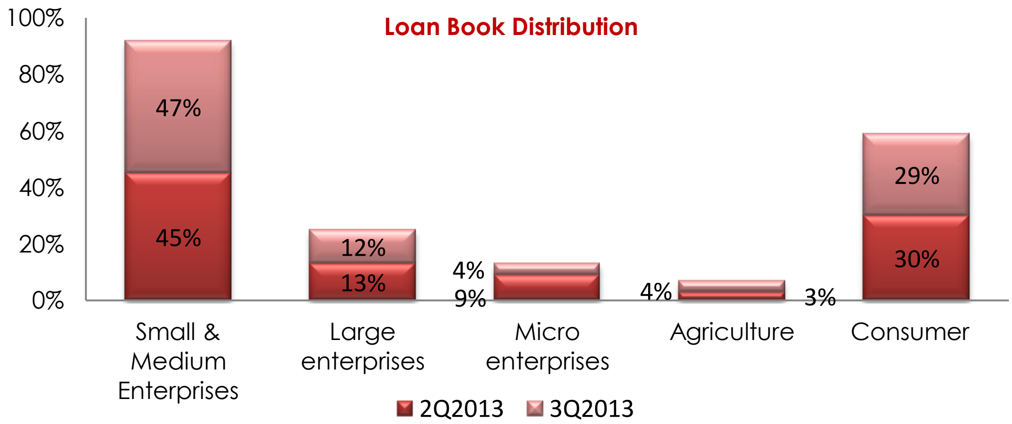




Source: Company presentation, FIB Analysis

Majority of loans advanced towards SMEs

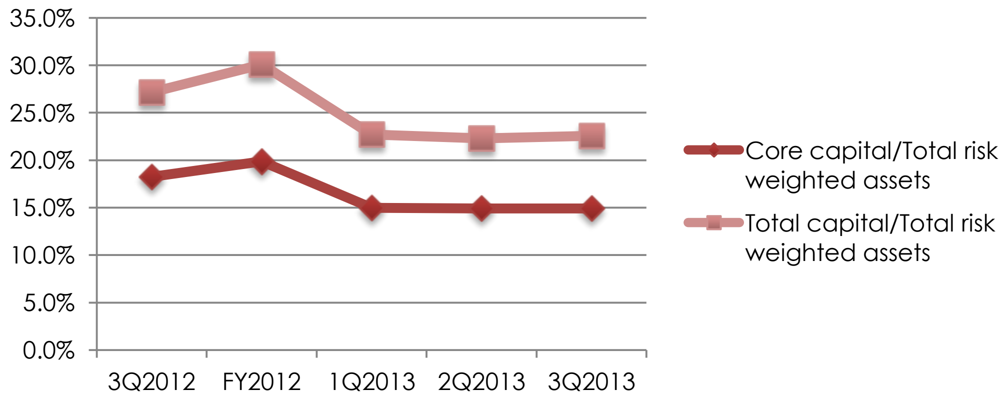
We continue to expect increased volatility in terms of asset quality as the bank shows strong bias towards SMEs that have dependance on government operations or activities.



Source: Company presentation

Key capital adequacy ratios remained unchanged from previous quarter

Capital adequacy relatively stable: Key capital adequacy ratios remained relatively stable during 3Q2013 with the core capital/total risk weighted assets remaining unchanged at 14.9% and the total capital/total risk weighted assets rising 30 bps to 22.6%.



Source: FIB Analysis

As we alluded to in our last update, if the declining trend was to persist, the need to raise capital will become inevitable. The core capital/total risk-weighted assets was only 4.4% above the minimum required ratio while the total capital/total risk-weighted assets was 8.1% above the minimum required ratio.

OUTLOOK

Considerable amounts of deposits expected to be mobilized

Aggressive deposit mobilization to continue despite slowdown in 3Q2013: Despite the slowdown in customer deposit growth in 3Q2013, we still expect Equity to marshall considerable amounts of deposits under the devolved government system coupled with its formidable branch network.

Growth of 980 agents in 3Q2013

There's no stopping agency growth: The number of agents increased by 980 to 8,612 by 3Q2013 as opposed to a growth of 740 in 2Q2013. The agency network provides a good source of cheap deposits for the bank. Furthermore, the bank lowers its costs by leveraging on the expansive agency network.

As at 3Q2013, agency transactions had surpassed branch transactions to stand at 2,496 transactions as compared to branch transactions of 2,336.

The value of deposit transactions handled by agents amounted to KES 11.0 billion (KES 10.9 billion as at end of 2Q2013) compared to withdrawals of KES 4.7 billion (KES 4.9 billion as at end of 2Q2013) as at September 2013.

Market share of monthly diaspora remittances stood at 16.0%

Increasing market share in monthly diaspora remittances: Equity Bank managed to grow its market share of monthly diaspora remittances to 16.0% in September 2013 from 14.0% in May 2013. As at September 2013, Equity had handled USD 132 million in diaspora remittances. We expect continued growth in this segment based on product and service offering.

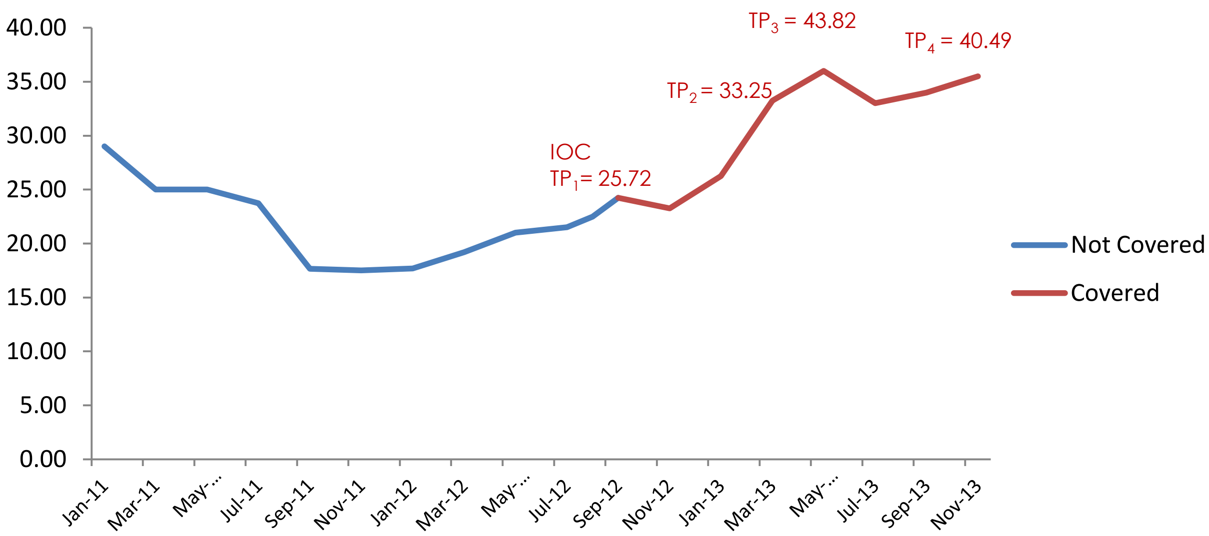
We laud management's decision to consolidate growth: We view the management's decision to go slow on regional expansion and to focus on its existing businesses as a positive one that aims to boost the contibution of subsidiaries to group revenue. As at 3Q2013, Kenya contributed 86.0% to roup PBT, followed by South Sudan (7.0%), Uganda (4.0%), Rwanda (2.0%) and Tanzania (1.0%).

RECOMMENDATION

We maintain our **BUY RECOMMENDATION**

We maintain our **BUY recommendation** on Equity Bank. However, we downgrade our price target from KES 43.82 to KES 40.49, providing a 20.9% upside potential from the current share price of KES 33.50. This is driven by a downgrade in our forecast of key metrics as alluded to in this report. The forecasted BVPS drops by 7.6% to KES 14.01 as a result.

Target Price History



NB: IOC = Initiation of Coverage