National Bank – 1H2013 Results Note

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We are **NEUTRAL** on National Bank

Operating expenses remain high

Investment Summary

We are **NEUTRAL** on National Bank.

Operating expenses remain high as evidenced by the relatively high cost/income ratio. However, we reckon that this provides some headroom for efficiency gains.

We are yet to see a clear strategic direction aimed at boosting funded income. The bank's loan/deposit ratio is relatively low compared to the industry average as alluded to in the note.

Key Results Highlights

- Interest income on loans and advances down by 18.9% to KES 2.3 billion.
- Cost of customer deposits dropped by 130 bps from 3.3% (1H2012) to 2.0% (1H2013)
- Foreign exchange trading income recorded significant gain to KES 135 million (1H2013) from KES 4 million (1H2012).
- Loans and advances to customers decreased marginally by 2.9% to KES 27.5 billion
- Operating expenses remain high

National Bank 1H2013 Earnings Update

Income statement (KES '000)	1H2012	1H2013	% Change
Interest income	4,494,099	4,027,861	-10.4%
Interest expense	2,025,561	1,253,401	-38.1%
Net Interest Income	**2,468,538**	**2,774,460**	**12.4%**
Other operating income	1,390,953	1,132,080	-18.6%
Total Income	**3,859,491**	**3,906,540**	**1.2%**
Operating expenses	2,947,716	2,962,588	0.5%
Loan loss provision	150,000	113,074	-24.6%
Profit before tax (PBT)	**911,775**	**943,952**	**3.5%**
Total comprehensive income for the year	**575,227**	**666,243**	**15.8%**
Cost/Income Ratio	**72.5%**	**72.9%**	

Bank Balance Sheet (KES '000)	FY2012	1H2013	% Change
ASSETS			
Kenya Government Securities (Held to maturity)	25,812,285	30,970,515	20.0%
Kenya Government Securities (Available for sale)	1,069,049	2,189,108	104.8%
Deposits and balances due from local banking institutions	335,595	152,234	-54.6%
Loans and advances to customers (net)	28,346,668	27,521,231	-2.9%
Total Assets	**67,108,987**	**74,668,289**	**11.3%**
LIABILITIES			
Customer deposits	55,139,858	59,985,316	8.8%
Deposits and balances due to local banks	254,694	2,049,720	704.8%
Total Liabilities	**56,637,930**	**63,887,608**	**12.8%**
Shareholders' Funds	**10,471,057**	**10,780,681**	**3.0%**
Loan/deposit ratio	**51.2%**	**44.4%**	
Liquidity ratio	**42.0%**	**30.0%**	

Source: Company Release

Interest income dropped by 10.4%

Drop in interest income: Total Interest income decreased by 10.4% to KES 4.0 billion (1H2013) from KES 4.5 billion (1H2012). The drop was attributed to decreased interest income from loans and deposits with banking institutions.

Yield on loans dropped by 210 bps

Interest income on loans and advances decreased by 18.9% to KES 2.3 billion in 1H2013 compared to a similar period last year while interest income from deposits and placements with banking institutions dropped by 45.9% to KES 103 million. Yield on loans dropped by 210 bps to 8.2% (1H2013). The drop in interest income on loans and deposits with banks is attributable to the relatively higher interest rate environment experienced during 1H2012 (Average lending rate of 20.1%) as compared to 1H2013 (Average lending rate of 17.7%).

Net non-performing loans/net loan book stood at 8.9% (1H2013) as compared to 2.3% (FY2012).

Interest income on government securities grew by 5.5%

Interest income on government securities grew by 5.5% to KES 1.6 billion on the back of increased investment in Kenya Government securities (19.8% y-o-y increase in Held to Maturity and 207.8% y-o-y increase in Available for Sale).

Yield on government securities yield rose by 100 bps to 4.9% while yield on placements with other banks rose to 10.6% (1H2013) from 8.7% (1H2012). The rise in yield on placements was on the back of reduced deposits and placements due from both local and foreign banking institutions.

Cost of customer deposits dropped by 130 bps

Lower cost of funds led to lower interest expenses: Total interest expenses dropped by 38.1% to KES 1.3 billion (1H2013) from KES 2.0 billion (1H2012). Interest expense on customer deposits dropped by 39.7% to KES 1.2 billion (1H2013) from KES 2.0 billion (1H2012) due to lower cost of funds. Cost of customer deposits dropped by 130 bps from 3.3% (1H2012) to 2.0% (1H2013). This is attributable to the bank eliminating expensive fixed term deposits and growing cheaper deposits from customers..

Interest expenses on deposits and placements from banking institutions edged up 136.8% to KES 44 million (1H2013) from KES 19 million (1H2012). This was principally due to a significant increase in deposits and balances due to local banking institutions.

Fees and commissions on loans and advances grew by 36.1%

18.6% decline in Non-interest income Total non-interest declined by 18.6% to KES 1.1 billion (1H2013) from KES 1.4 billion (1H2012). Fees and commissions on loans and advances grew by 36.1% to KES 92 million (1H2013). We attribute this to a marginal increase in the loan book (KES 427 million) in 2Q2013.

Other fees and commissions recorded a 24.8% increase to KES 646 million (1H2013).

Other income decreased by 67.7% to KES 259 million (1H2013) while foreign exchange trading income recorded significant gain to KES 135 million (1H2013) from KES 4 million (1H2012).

Staff costs rose 14.1% to KES 1.8 billion

Marginal increase in total operating expenses: Total operating expenses increased marginally by 0.5% to KES 3.0 billion (1H2013) from KES 2.9 billion (1H2012). The rise in operating expenses is attributable to a jump in staff costs that rose 14.1% to KES 1.8 billion. We note that directors' emoluments decreased by 77.2%.

Rental charges increased by 22.2% to KES 101 million while amortization charges increased by 29.4% to KES 113 million.

Other operating expenses dropped by 19.2% to KES 709 million. The cost/income ratio increased by 4 bps to 72.9% in 1H2013. The bank needs to bring this ratio down by increasing efficiency and growing the top line.

Loan loss provision decreased by 24.6% to KES 113 million (1H2013) from KES 150 million (1H2012).

11.3% increase in total assets as loans and advances drop: Kenya government securities (Available for sale) increased by 104.8% to KES 2.2 billion (1H2013) from KES 1.1 billion (FY2012). Kenya government securities (Held to maturity) increased by 20.0% to KES 31.0 billion (1H2013).

Loans and advances decreased marginally by 2.9% to KES 27.5 billion

Loans and advances to customers decreased marginally by 2.9% to KES 27.5 billion while deposits and balances due from local banking institutions decreased by 54.6% to KES 152 million.

Growth in customer deposits push up total liabilities: Total liabilities increased by 12.8% to KES 63.9 billion in 1H2013 from KES 56.6 billion in FY2012. This was mainly due to an 8.8% growth in customer deposits to KES 60.0 billion.

Deposits and balances due to local banks increased by 704.8% to KES 255 million.

Low loan/deposit ratio

Inneficient asset utilisation: The loan/deposit ratio stood at 44.4% in 1H2013 as compared to 51.2% in FY2012. We consider this to be low compared to the banking sector average of 76.1% (1Q2013 average loan/deposit ratio of listed banks). To maximise interest income, the bank may need to increase deployment of capital to high interest earning assets such as loans.

Capital adequacy: Core capital/Total risk weighted assets dropped to 26.8% (1H2013) from 27.3% (FY2012) but is still above the minimum statutory ratio of 10.5%. Core capital increased by 0.1% to KES 9.6 billion.

Total capital/Total risk weighted assets dropped to 27.9% (1H2013) from 28.4% (FY2013).

Outlook

Strategy to grow its corporate, institutional and retail business

National Bank of Kenya brought on board global consulting firm McKinsey that has led restructuring efforts in the bank. This has led to the recruitment of new management and board members that are to drive the bank's strategy in growing its corporate, institutional and retail business.

Furthermore, the bank intends to raise capital through a rights issue in order to fund expansion plans and strengthen its financial muscle in corporate lending.

Recently, the bank ventured into Islamic banking targeting the growing Muslim market.

Operating expenses remain high as evidenced by the relatively high cost/income ratio. This reflects headroom for cutting down costs that could improve the bottomline figures.

Going forward, we expect to see positive impact of the proposed strategies on the interest income on loans and advances in the mid to long-term horizon.

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