AIB Capital Ltd.
Your Vision... Our Mission

Recommendation:

BUY

Target Price: KES 57.27

Price on 23rd May 2018:
KES 35.00

Potential Upside/Downside:
63.00%

52-week Trading Range:
KES 40.75 to KES 26.36

EPS:
KES 6.45

P/E
5.4x

ROaE
11.7%

ROaA
1.9%

Dividend Yield:
3.8%

Market cap:
KES 25,341.8Bn

Estimated free float:
56.5%

Shares Outstanding:
639.95 Million

Latest Full Year Results:
Quarter 1 2018

Analyst

Victor Koech

+254711047133

koechv@aibcapital.com

NIC GROUP PLC

Bank holds value for the patient & contrarian investor

We have upgraded our investment recommendation on NIC Bank from a **HOLD** to a **BUY** based on a better than expected **Q1** results and our expectations of a better outlook for the group in the medium term. The market is mispricing the fundamental value of the bank partly due to the current loss aversion that plague Tier II bank stocks and also partly due to a receding ROE. NIC Bank ROE has been declining since 2015 driven mainly driven downwards by a flight to quality and exacerbated by the introduction of interest rate caps in 2016, all we expect to reverse gradually in the medium term. We advise long-term investors to consider positioning themselves in the stock to benefit from the decline of flight to quality in the medium term and possible repeal of the interest rate caps that will propel the recovery of ROE that will eventually drive the price upwards towards fair value.

NIC Bank released their Quarter 1 2018 **(Q1-18)** results posting a marginal increase of **1.31%** in Profit Before Tax (**PBT)** from **KES 1.37Bn** in **Q1-17** to **KES 1.39Bn** in **Q1-18.** Likewise, Profit After Tax **(PAT)** improved by **2.17%** from **KES 952.04Mn** to **KES 972.66Mn** over the same period. The twelve-month trailing Earnings Per Share (EPS), on the other hand, declined by **5.56%** from **KES 6.83** in Q1-17 to a twelve-month trailing EPS of **KES 6.45** Q1-18**.**

Key Metrics: The group's Total interest income grew by **8.16%** to **KES 4.66Bn** in Q1-18 compared to **KES 4.31Bn** in Q1-17. The Q1-18 Total interest income was pushed upwards by an increase in interest income from Government securities; that firmed up **66%** in the quarter to **KES 1.60Bn** from **KES 0.96Bn** driven by the **87.0%** growth in investments in government securities. The rise of interest income was, however, diluted by a slight **0.35%** decline in Loans and advanced that forced Interest income down **8.9%** to **KES 3.04Bn** from **KES 3.33Bn.**

Total Non-Funding Income (NFI) grew to **KES 1.04Bn (+5.45%)** in Q1-18 from **KES 0.99Bn** in Q1-17 driven by a **12.1%** improvement in other fees and commissions. Fees and commissions on loans and advances and Foreign exchange income shrunk **4.8%** and **0.2%** respectively. NFI contribution to total income advanced to **29.57%** in Q1-18 from **26.76%** in Q1-17.

A **36.6%** decline in loan loss provision contributed to an **8.1%** dip in operating expenditure to **KES 2.14Bn** from **KES 2.33Bn.** The cost to income (CTI) ration with provisions in Q1-18 improved to **60.7%** from **63.0%** in Q1-17**.** CTI without provisions in the first quarter of 2018, in divergence with CTI, worsened to **45.0%** from **39.3%** driven by the increase in staff expenses**.** The staff cost in Q1-18 rose by **KES 86.1 Mn** from **KES 717.2Mn** penned in Q1-17 to **KES 803.3 Mn** in Q1-18. The upswing in staff-related costs pushed the ratio of Staff cost to operating income to **22.8%** in Q1-2018 up from **19.4%** in Q1-2016**.**

NIC Bank's Total Assets increased by **14.94%** from **KES 173.82Bn** to **KES 199.89Bn.** Its uptake of government securities amplified by **KES 18.1Bn** from **KES 28.0Bn** registered in Q1-17 to hit **KES 52.4Bn** in Q1-18. The group's loan book shrunk down by **0.4%,** from **KES 116.32Bn** in Q1-17 to **KES 115.91Bn** in Q1-18. Customer deposits surged upwards by **22.14%** to **KES 143.93Bn** from **KES 117.84Bn**.

The group witnessed a **15.48%** increase in Non-Performing Loans (NPL) from **KES 13.80Bn** registered in Q1-17 to **KES 15.94Bn** in Q1-18; representing **7.98%** of Total Assets and **13.75%** of Total Loans. Consequently, loan loss provisions increased by **31.57%** to **KES 6.11Bn** in Q1-18 to **KES 4.64Bn.**

Return On average Equity (ROaE) decelerated in Q1-18 to **11.70%** from **12.40%** in Q1-17 on the expansion of shareholders' equity from **KES 31.02Bn** to **KES 32.02Bn**. A **14.9%** growth in total assets pushed Return On average Assets (ROaA) down to **2.01%** from **2.2%** over the same period. The Q1-18 Price to Book value (P/B) accelerated to **1.8x** from Q1-17 P/B ratio of **1.75x.**

CERTIFICATIONS AND REQUIRED DISCLOSURES BEGIN ON PAGE 2

Expected Credit Loss Model:

This quarter marks the implementation of IFRS 9's much eagerly awaited IFRS 9's Expected Credit Loss (ECL) model, the successor of Incurred Credit Loss (ICL) model, by Banks in line with Central Bank of Kenya's Guidance note on the implementation of IFRS 9 released in April. Banking institutions have five years since to implement IFRS 9 in the calculation of regulatory capital but CBK through its guidance note is seeking to have adjusted ratios disclosed in their published financial results to help clarify the impact of additional ECL provisions on the Banks' capital ratios.

The implementation of ECL by NIC Bank had a marginal one time impact on its Total Shareholder's Equity. NIC group's lost a combined **KES 2.8Bn (or 9.6%)** from both retained earnings and statutory reserves in **Q1-18** compared to the figures reported in the Full Year 2017. As a direct result of the implementation of the ECL model, NIC's retained earnings in the three months of 2018 fell by **6.9%** or **KES 1.9Bn** from **KES 27.8Bn** reported on the group's balance sheet on 31st of December of 2017 to the current **KES 25.9 Bn** reflected on its balance sheet as of 31st of March this year. Statutory loan reserves also shrunk by a massive **81.2%** or **KES 0.8Bn** to **KES 196.39Mn** from **KES 1.03Bn** mainly as a result of higher provisioning from IFRS 9 compared to the CBK's provisioning.

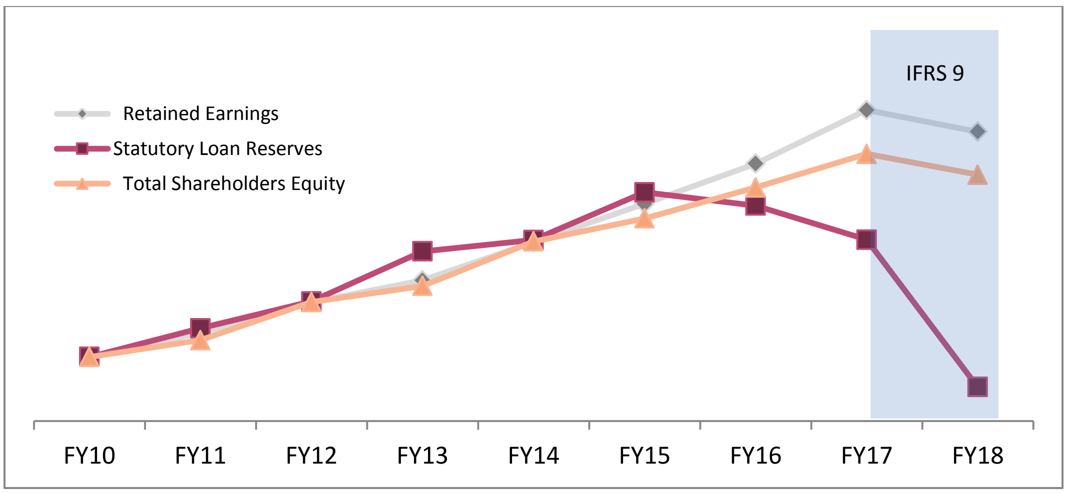

Figure 1: 7-yr Shareholders Equity Trend

Outlook 2018:

We expect NIC's Earnings Per Share (EPS) and Book Value Per Share to increase by **5%** over the next four quarters from a trailing four quarters of **KES 6.45** and per share to **KES 6.77** per share. Our projections are based on the recovery of the Kenyan economy and a possible increased pricing ability from a possible repeal of the interest caps in June. Better macroeconomic conditions in the short to medium term will not only mean lower NPLs for the NIC Group but also mean lower probability of default that will drive ECL provisioning lower. Increased pricing ability from a possible repeal of interest caps will improve income for NIC from loans and asset financing to the corporate and SME sectors, who are currently priced out by the 400 basis point interest rate cap. We see book value growing by **4%** to **KES 46.60** per share in the next twelve months from the latest BVPS of **KES 44.85**, pushed upwards by the recovery of retained earnings.

Valuation: We upgrade the group's investment recommendation from a **HOLD** to a **BUY** because NIC is currently trading at what we consider enticing multiples of a P/E of **5.4x** compared to the Sub-Saharan median of **9.3x**. It is also relatively undervalued if P/B is considered, with the current market valuing it at a P/B of **0.78x** below the Sub-Saharan industry P/B of **1.20x**. We currently have a twelve months target of **KES 57.27** for the counter, giving a long-term investor a potential **63%**upside to the current price of **KES 35.00.**

AIB Capital Research

Research Analysts,
AIB Capital Research

Willis Nalwenge
nalwengew@aibcapital.com
(+254) 711047105

Victor Koech
koechv@aibcapital.com
(+254) 711047133

Equity Dealing Desk

Chief Dealer,
AIB Capital Equities

Bernard Kung'u
kungub@aibcapital.com
(+254) 711047108

Head of Institutional Trading,
AIB Capital Equities

Bernard Gichuru
gichurub@aibcapital.com
(+254) 711047111

Equities and Derivatives trader,
AIB Capital Equities

Brian Tanui
tanuib@aibcapital.com
(+254) 711047124

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