August 2018

Equity Group Holdings Plc

“Fleet-footed”

Recommendation: BUY

We recommend a **BUY** on Equity Group Holdings Plc (Equity Bank) guided by our **fair value estimate of KES 55.50** with forward P/B and P/E multiples of 1.9x and 10.4x. We project an **upside potential of 14.1%** based on the current share price of KES 48.75. We expect the current dividend of KES 2.00 to be maintained for the next year.

Our fair value is guided by the bank’s position as a market leader and its regional presence that has enabled it to diversify its operations. The bank's management is proactive which will steer the lender during stormy waters in the banking and fintech industries.

The Group’s strong balance sheet positions the bank to take up any opportunistic growth and also shield itself from uncertain pressures in a continuously changing macroeconomic, regulatory and innovative environment.

Growth Drivers

- Balance sheet agility with a 59.4% liquidity ratio against an industry average of 48.0%
- Business diversity with double digit growth in profitability by non-Kenyan subsidiaries
- Fintech innovations in diaspora remittances

Risks

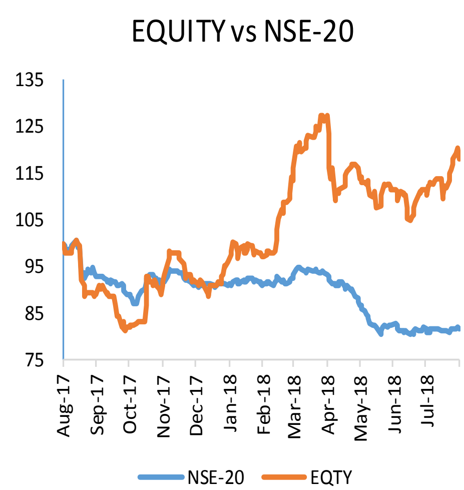
- Implementation of IFRS 9 increasing provisions
- Slow credit growth due to the impeding rate cap and tough macroeconomic conditions
- A changing macroeconomic and regulatory environment may cause unexpected pressures going forward
- Falling yields on government bonds

Summary	FY15A	FY16A	FY17A	FY18E	FY19E	FY20E
Total interest income (KES M)	43,171	54,951	48,410	49,709	54,269	60,864
% growth		27.3%	-11.9%	2.7%	9.2%	12.2%
Total interest expenses (KES M)	9,249	10,027	10,841	11,881	14,142	15,818
% growth		8.4%	8.1%	9.6%	19.0%	11.9%
Non-funded income (KES M)	22,133	16,369	23,938	26,029	28,799	31,256
% growth		-26.0%	46.2%	8.7%	10.6%	8.5%
PAT (KES M)	17,327	16,603	18,918	20,115	22,069	25,378
% growth		-4.2%	13.9%	6.3%	9.7%	15.0%
EPS (KES)	4.59	4.40	5.01	5.33	5.85	6.72

Bloomberg Ticker :	**EQBNK.KN**
Reuters Ticker:	**EQTY.NR**

Share Statistics	
Fair Value (KES)	**55.50**
Current Price (KES)	48.75
Upside(%)	**14.1**
Issued shares (M)	3773.7
Market cap (USD M)	2000
Year end	Dec
Foreign ownership (%)	46.50
Free float (%)	84.76
Av daily trading vol (USDk)	840.6

Price Trend



Source: Bloomberg

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Recapping to 2016

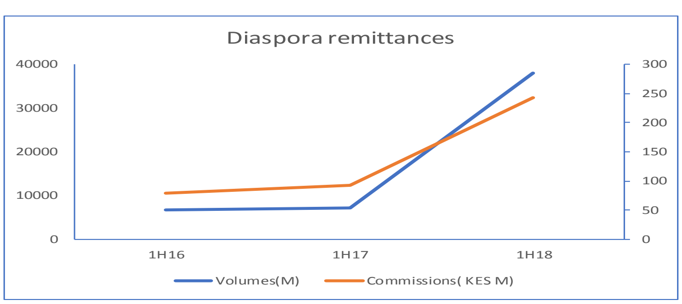
2015 & 2016 saw the collapse of 3 banks on account of corporate governance issues. Confidence in the banking sector was heavily eroded and onset of interest rate caps brought more aggravation to banking sector players. With increased investor concentration on banks' corporate governance, banking players with ethical heads at the helm were expected to carry the day.

In a few paragraphs, we will enlighten you on how Equity Group's management streamlined processes and emboldened the banks boundaries, setting the bank on an undeterred path to prosperity. Key highlights of management strategy are as follows-:

Lending– in the face of the current interest rate cap, a resolve to slow down lending was inevitable. This saw the bank's loan book decline 1.4% y/y in FY16 with a slight increase of 4.9% y/y in FY17. Despite most banking peers growing their loans books in the face of the crisis, Equity bank management held a tough decision to slow down lending in the Kenyan market. At that time, the decision could have compressed the bank's market share with peers gaining a competitive advantage and favoritism with the market.

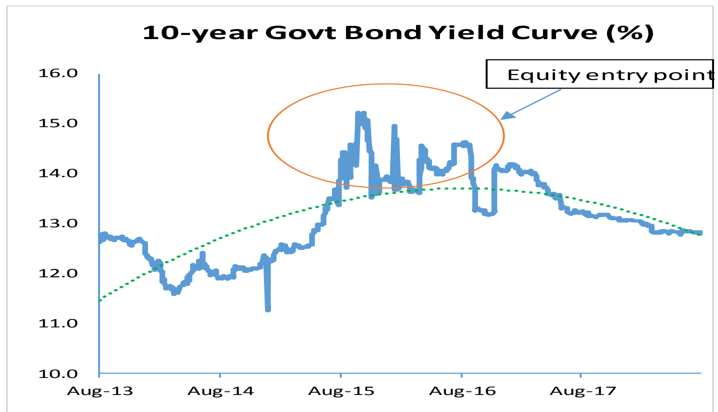
Events around the rate cap seem to have had a good turn on the bank's decision. Given that discussions around the rate cap are still ongoing, with the treasury, executive and the legislature on opposite ends, the much anticipated repeal may not happen at the end of the year. We therefore expect the bank to remain stringent on lending on the back of compressed margins and spiraling NPLs.

Non Funded Income -diversified streams of non-funded income are set to cushion the bank against a drop in revenues from fees and commission on lending. Forthcoming strategic partnerships with money transfer agents such as VISA, with an exclusive merchant acquirer deal with American express has set the bank on a path of fintech innovations in diaspora remittances.



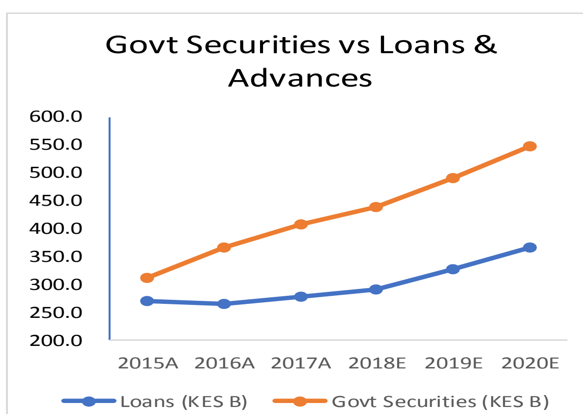
Source: Equity Group

The bank has so far experienced over 400% y/y growth to over 38M transactions. Its NFI to total income ratio grew 7.6bps y/y to 40.2% above a Tier 1 average of 33.0%. We expect that supported by the current surge in foreign inflows; a result of a prevailing tax amnesty, the group is set to gain a significant pie in diaspora remittances.



Source: Bloomberg

Investment in government securities– a decision by management to focus on lending to the government in 2016, due to low margins on loans, saw investment securities grow 135.2% y/y to KES 100.6B in 2016 giving the bank a competitive edge over its peers who just recently embraced government lending. Yields on government securities have been falling with interest rate on 10-year government bond in 2016 averaging 13.9% and declining to 12.9% in 2018 as demand continues to outweigh the government's appetite, signaling lower earnings for banks. The bank is however set to enjoy good returns given its entry point.



Source: ApexAfrica Research. Company filings

Deposits growth despite tight liquidity

We forecast a 3-year CAGR of 10.9% on customer deposits to KES 509.1B, premised on the bank's strong brand and its market share giving it the structural muscle to mobilize for deposits. In recent times, tight liquidity conditions have been brought about by the current credit crunch that has inhibited private sector credit growth causing a strain on disposable income. Illiquidity is set to be further augmented by a government resolve to cut development expenditure in 2018/19 in a bid to reduce the fiscal deficit.

If the rate cap is repealed, the tide is bound to turn as increased lending predisposes businesses to expansion spiralling growth in the private sector. Higher profits drive up disposable income resulting in increased savings.

The prevalence of the rate cap would see growth, though sublimed, of deposits riding on the bank's market share, merchant business and mobile banking. The bank's efforts to tame expenses has seen cost of funds decline 2.0bps y/y to a low of 2.3% in FY17 (Tier 1 average of 3.5%).

Revamp of economic activity to reduce non-performing loans.

As at July 2015 private sector credit growth stood at 21.2%.The prevailing rate cap has slowed down this growth (4.3% in 1H18 against a CBK target of 12.0% - 15.0%) causing a credit crunch, reining in on disposable income. This has seen banking industry average NPL ratio hit 12.0% in 1H18 (+ 2.1bps y/y).

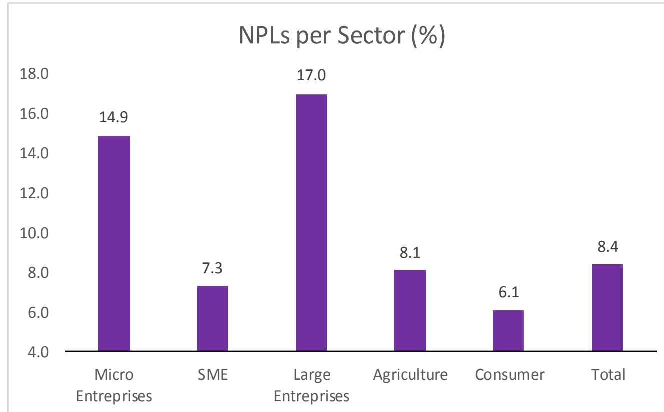
Delays by the treasury and county governments in paying suppliers and contractors has also fuelled the spike in NPLs. We expect that the business environment will improve going forward riding on-:

⇒ A strong economic growth outlook with a Central Bank projection of a GDP growth rate of 6.2% in FY18 (4.7% in FY17);

⇒ Strong investor sentiments on the country's prospects after cooling down of political temperatures;

⇒ Fast growth in the East African region, whose growth is expected to be above 6.0% on average;

In effect, we anticipate an improvement in the bank's current NPL ratio of 8.4% supported by the above factors and a possible review of the rate cap which is expected to boost lending solving the illiquidity crisis in SMEs, MSMEs and real estate sectors. Though the Government has stated its intent to settle accounts with suppliers and contractors, sluggishly growing government revenues and rallying recurrent expenditure may keep the accounts open for longer; keeping NPLs aloft.



Source: Equity Bank

Ambitious plan to have subsidiaries contribute 40.0% to PBT

The Group has enjoyed a profound regional presence with its subsidiaries growing fast to contribute 18.0% to PBT in 1H18. Equity Bank forecasts that with sustained alignment of processes, business support by the group and execution of expansion strategies, PBT contribution in the next two years could hit 40.0% of PBT.

◊ Recovery in private sector credit growth, subdued inflation, and a subdued NPL ratio of 6.0% are set to boost operations in Uganda with the bank having injected KES 1.0B more in FY17.

◊ Rwanda's GDP growth rate projection of 7.2% in tandem with positive developments in the service sector (+12.0%), agricultural sector (+8.0%) and the industrial sector (+7.2%) is expected to boost operations in the subsidiary.

◊ The rebranding of the DRC Congo to Equity Bank Congo from ProCredit Bank is anticipated to boost the bank's presence in the country by establishment of a strong brand. The vast and resource rich DRC with a population of over 85M citizens has 96% of them unbanked. Despite uncertain political temperatures and high inflation, the country's economy is on a mild recovery (GDP forecast of 3.3% in FY18), with mining on Copper and Cobalt expected to support the growth. Given the existing banking niche, we expect the bank, considering its strong brand, to aggressively acquire a significant market share in the country. Profitability in the DRC unit ranks second to Kenya as of June 2018.

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- ◊ Tanzania is also set to face rising NPLs due to stagnating credit growth and low budget implementation that has compressed business operations. However, a subdued inflation rate, increasing foreign reserves and a target GDP growth rate of 7.2% are expected to enhance business operations boosting profitability.
- ◊ The recently signed peace agreement in war-torn South Sudan may put an end to turbulence in the oil rich nation that has seen a prolonged period of hyperinflation in the last 2 years. Business has been hit hard by translation effects of hyperinflation, shortage of foreign exchange and an unstable currency. The bank maintains no expansion plans in the country and we remain positive that profitability will improve as pressure eases given that the bank is able to breakeven despite the turbulence.

What about Ethiopia?

With recent announcement by local firms on plans of expansion into Ethiopia given its Prime Ministers' resolve to open up the country's economy, it is expected that Equity with its strong regional presence will make an effort to diversify operations in Ethiopia. However, the Group has maintained a wait and watch stand with its desires to enter into the robust market on hold until all policies and measures to promote operations are put in place by the government.

Bank's strengths that will counter macroeconomic and regulatory pressures going forward

The cap on interest rates and a further reduction in the monetary policy rate to 9.0% (-100 bps h/h) has brought about a vicious cycle between banks, the government and the public.

To lend, banks need to price risk depending on a borrowers risk profile and loan loss reserves are set aside as part of Central Bank's prudential guidelines therefore affecting capital. It is therefore normal for banks be stringent in lending at an extremely low rate where they feel there is mispricing of risk.

On the other hand, with government appetite for local borrowing, banks chose to divert lending to government at a risk free rate and with no requirement to make capital reserves. As such, this cycle has aggravated the liquidity condition with banks holding onto funds.

Equity Group, with 29.3% (KES 158.9B) of its asset book composed of investment in government securities, has been able to leverage on low interest margins as a result of the rate cap. In an event where the cap is repealed, the bank is able to divert about 38% (KES 60B) into lending in a months time.

The bank has maintained an agile balance sheet with a liquidity ratio of 59.4% against an industry average of 48.0% stemming it for diversification strategies and opportunistic growth amidst anticipated changes in the regulatory and operating environment.

Looking ahead, prosperous times for the group await supported by calm political temperatures, subdued inflation rate coupled with a stable shilling that has caused a resurgence in strong capital inflows and improved investor sentiments. The Group also aims to leverage on the Big 4 agenda given its market share (over 12M customers) and its strong brand.

Tier 1 Comparable

Based on FY17 Statistics	Equity	KCB	Coop	StanChart	Barclays	DTB	Stanbic
Price (KES) (as at 17/08/18)	50.00	49.50	17.10	206.00	12.00	194.00	106.00
EPS (KES)	5.01	6.43	1.94	20.13	1.28	23.07	10.98
DPS (KES)	2.00	3.00	0.90	17.00	1.00	2.60	5.25
NAV/Share	24.7	34.6	11.9	132.9	8.1	173.0	83.6
P/Ex	10.0	7.7	8.8	10.2	9.4	8.4	9.7
P/Bx	2.0	1.4	1.4	1.5	1.5	1.1	1.3
ROE(%)	20.3	18.6	16.4	15.1	15.7	14.3	13.1
Dividend yield (%)	4.0	6.1	5.3	8.3	8.3	1.3	5.0
Cost of funds(%)	2.9	3.0	4.3	3.3	2.5	5.2	3.1
Net Interest Margin(%)	7.6	8.1	7.8	7.9	8.8	5.8	4.6
Cost/Income Ratio(%)	53.5	50.9	52.2	47.9	55.5	42.3	55.2
NPL Ratio(%)	6.3	8.5	7.2	13.2	7.3	7.3	7.7
NPL Coverage Ratio(%)	36.2	54.3	32.5	38.6	44.2	55.5	31.3
NFI/Total Income(%)	42.3	32.2	32.4	32.1	28.0	21.1	43.2
Core Capital/TRWA(%)	19.7	15.4	15.8	15.6	15.9	17.3	15.4
Total Capital/TRWA(%)	20.4	16.6	22.0	18.5	18.0	19.0	16.9

Source: ApexAfrica Research, Company Filings

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1H18 Financials Recap

	1H17	1H18	% chg y/y
Income Statement	**KES '000**	**KES '000**	
Interest Income	23,005,192	25,356,195	10.2
Interest Expense	5,062,540	5,773,202	14.0
Net Interest Income	**17,942,652**	**19,582,993**	**9.1**
Foreign Exchange Income	1,721,426	1,546,533	-10.2
Gross Fees and Commission	9,141,427	9,053,075	-1.0
Other Income	2,113,771	2,576,266	21.9
Non Interest Income	**12,976,624**	**13,175,874**	**1.5**
Total Operating Income	30,919,276	32,758,867	5.9
Total Operating Expenses	15,766,716	16,500,760	4.7
Loan Loss Provision Expense	**1,860,344**	**787,392**	**-57.7**
Operating Profit	15,152,560	16,258,107	7.3
Profit Before Tax	**13,292,216**	**15,470,715**	**16.4**
Current Tax	3,930,738	4,460,845	13.5
Profit After Tax	**9,361,478**	**11,009,870**	**17.6**
EPS (KES)	**2.47**	**2.90**	**17.4**
Balance Sheet			
Total Shareholders' Equity	85,893,664	86,311,472	0.5
Customer Deposits	**362,788,342**	**393,685,732**	**8.5**
Total Liabilities	419,050,629	455,704,771	8.7
Total Equity and Liabilities	**504,944,293**	**542,016,243**	**7.3**
Cash and CBK Balances	33,045,599	39,781,571	20.4
Balances due from Banks	44,741,638	34,542,592	-22.8
Government and Other Securities	115,595,812	158,940,490	37.5
Net Loans and Advances	**265,086,161**	**275,036,697**	**3.8**
Fixed Assets	13,004,808	10,488,727	-19.3
Total Assets	**504,944,293**	**542,016,243**	**7.3**
Key Ratios			
Gross NPL (KES M)	20,363,500	24,450,171	20.1
Interest In Suspense (KES M)	2,867,909	3,063,863	6.8
Total NPL (KES M)	17,495,591	21,386,308	22.2
Loan Loss Provision (KES M)	7,801,417	9,608,862	23.2
Net NPL	9,694,174	11,777,446	21.5
NPL Coverage Ratio	38.3%	39.3%	
NPL Ratio	7.5%	8.6%	
Cost of Risk	0.7%	0.3%	
Loan to Deposits	73.1%	69.9%	
Yield on Interest Earning Assets	10.8%	10.8%	
Cost of Funds	1.4%	1.5%	
NIM	6.8%	7.1%	
Non Funded/Total Income	42.0%	40.2%	
Cost to Income Ratio	51.0%	50.4%	
ROE	21.8%	25.5%	
ROA	3.7%	4.1%	
Core Capital/TRWA	19.6%	18.3%	
Total Capital/TRWA	20.4%	18.4%	
Liquidity Ratio	51.1%	57.1%	

Source: ApexAfrica Research, company fillings

Valuation

Assumptions

Cost of equity	16.0%	
Long term growth rate	10.0%	
No. of shares in issue (M)	3773.7	
Risk free rate	11.7%	*5-year T-Bond Yield*

P/B Valuation

Historical Average	2.0
Tier 1 Banks Average	1.5
Weighted Average	1.9
NAV/Share	29.10
Per share value	55.62
Fair Value/Share	**55.50**
Current Price	48.75
Upside	**14.1%**

Source: ApexAfrica Research Estimates

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Financial Forecasts

Income Statement	FY15A KES 000	FY16A KES 000	FY17A KES 000	FY18E KES 000	FY19E KES 000	FY20E KES 000	y/y change %	3-yr CAGR %
Interest Income	43,171	54,951	48,410	49,709	54,269	60,864	2.7	7.9
Interest Expense	9,249	10,027	10,841	11,881	14,142	15,818	9.6	13.4
Net Interest Income	**33,922**	**44,924**	**37,569**	**37,828**	**40,127**	**45,046**	**0.7**	**6.2**
Non Interest Income	**22,133**	**12,987**	**23,938**	**26,029**	**28,799**	**31,256**	**8.7**	**9.3**
Net Operating Income	53,622	55,191	58,791	60,717	65,220	72,146	3.3	7.1
Total Operating Expenses	29,664	30,264	31,909	31,981	33,692	35,892	0.2	4.0
Loan Loss Provision Expense	**2,433**	**6,102**	**2,716**	**3,140**	**3,707**	**4,155**	**15.6**	**15.2**
Operating Profit	23,958	24,927	26,882	28,736	31,528	36,254	6.9	10.5
Profit Before Tax	**23,958**	**24,927**	**26,882**	**27,493**	**28,648**	**32,987**	**2.3**	**7.1**
Current Tax	6,631	8,324	7,964	8,621	9,458	10,876	8.2	10.9
Profit After Tax	**17,327**	**16,603**	**18,918**	**20,115**	**22,069**	**25,378**	**6.3**	**10.3**
EPS (KES)	**4.59**	**4.40**	**5.01**	**5.33**	**5.85**	**6.72**	**6.3**	**10.3**
DPS (KES)	**2.00**	**2.00**	**2.00**	**2.00**	**2.00**	**2.00**	**-**	**-**
Balance Sheet								
Total Shareholders' Equity	71,492	81,275	92,392	102,570	117,035	134,799	11.0	13.4
Customer Deposits	**303,206**	**337,204**	**373,143**	**413,948**	**459,068**	**509,106**	**10.9**	**10.9**
Total Liabilities	355,926	391,737	431,323	486,061	536,304	591,847	12.7	11.1
Total Equity and Liabilities	428,062	473,713	524,465	589,380	654,089	727,396	12.4	11.5
Government and Other Securities	**42,775**	**100,589**	**128,002**	**147,779**	**163,887**	**181,751**	**15.5**	**12.4**
Net Loans and Advances	**269,893**	**266,068**	**279,092**	**291,833**	**325,938**	**366,557**	**4.6**	**9.5**
Fixed Assets	14,056	13,754	10,865	11,240	11,628	12,030	3.5	3.5
Total Assets	**428,062**	**473,713**	**524,465**	**589,380**	**654,089**	**727,396**	**12.4**	**11.5**
Key Ratios								
Cost of Risk (%)	1.0	2.3	1.0	1.1	1.2	1.2		
Loan to Deposits (%)	89.0	78.9	74.8	70.5	71.0	72.0		
Yield on Interest Earning Assets (%)	17.0	18.3	13.8	12.4	12.5	12.8		
Cost of deposits	2.5	2.5	2.3	2.3	2.4	2.4		
Net Interest Margin (%)	12.8	14.7	10.4	9.1	8.9	9.1		
Non Funded/Total Income (%)	39.5	26.7	38.9	40.8	41.8	41.0		
Cost to Income Ratio (%)	52.9	49.4	51.9	50.1	48.9	47.0		
ROaE (%)	25.5	21.5	21.6	20.6	20.1	20.2		
ROaA (%)	4.5	3.7	3.8	3.6	3.5	3.7		
P/E (x)				**10.4**				
P/B (x)				**1.9**				
Dividend Yield (%)				**3.6**				

Source: ApexAfrica Research Estimates

Appendix

Investment ratings

✦ **Strong Buy:** Issued on counters with strong fundamentals with a fair value above 20.0%. The counter is anticipated to register strong growth with and is currently undervalued.

✦ **Buy:** Issued on counters with strong fundamentals whose upside lies between 10.0% and 20.0%. The same may be issued for counters with challenged fundamentals whose upside is over 20.0%. Such a scenario is targeted for risk neutral investors.

✦ **Accumulate:** Issued on counters with an upside of between 5.0% - 10.0%. The counter may be facing contracting avenues for growth with a tepidly growing bottom-line.

✦ **Hold:** Issued on counters with an upside of between 0% and 5.0% with limited avenues for growth. Contracting bottom-line with an attractive dividend yield of about 5.0%.

✦ **Lighten:** The company is anticipated to record a moderate downside on its fair value, though it may have strong fundamentals.

✦ **Sell:** The counter currently has weak fundamentals coupled with significant potential downside.

Disclaimer

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