STERLING CAPITAL LIMITED
Members of the Nairobi Stock Exchange

Barclays Bank of Kenya (BBK)

Q3 Earnings Update

[November 03, 2011]

We recommend a HOLD for BBK based on its strong fundamentals. Our projected EPS of Ksh 2.05 yields a P/E of 6.9x a 24% discount to the sector at 8.2x. The bank is also known for a generous dividend payout. Currently, the dividend yield stands at 10%. ROE grew to 21% above KCB's at 17% but slightly below Equity's at 23%. As the operating environment becomes more challenging, we expect its focus on the corporate market as well as cost management to enhance stability and minimize pressure on the bottom line.

However, in view of the massive increase in the Central bank rate, we expect an upward adjustment in the lending rates of most banks. Barclays last month raised its base lending rate to 17.5% up from 14.7%. Further adjustment is anticipated next month following CBK's move to raise CBR by another 550 bps. This will result in a slowdown in credit flow to the public as well as increased default rate and thus the asset quality. Overall, we are pessimistic on the short term outlook of the bank, particularly on the income line (funded and non-funded). Our pessimism is also supported by the weak performance of the bank relative to the other listed banks which have so far released their Q3 results. We attribute this to the lack of new initiatives such as branch expansion and new product development (unlike other banks, notably KCB and Equity) in growing the income line and overconcentration in cutting costs. This is a signal of slowdown in earnings in an industry that remains promising despite the stiff competition.

BBK announced improved Q3 results backed by prudent cost management. Pretax profit jumped 26% to Ksh 8.87 Bn y/y. Q3/Q2, pretax profit rose by 20% to Ksh 8.87 Bn. Net profit grew by 11% and 17% y/y and q/q respectively. Operating income dropped marginally owing to a corresponding 0.7% drop in net interest income. This was also due to a 20% decline in income from government securities occasioned by the reduction in the volume of the government papers. Year-to-date, the investment in government securities has declined by 20.78% to Kshs 46.36 billion. Part of the reason is to improve liquidity in line with the increase in the cash reserve ratio by the Central bank. However, mobilization of cheaper deposits saw the interest expense decline by 40% to Ksh 0.73 Bn. Interest on deposits more than halved during the period. Total operating expenses declined by 16% to Ksh 10.69. Asset quality improved significantly in view of the 10% decline in non-performing loans.

Income Statement

Kshs (Billion)	30-Sept-10	30-Sept-11	1H 11	Q3 11	Q2 11	y/y%	q/q%
Interest from Loans & Advances	10.36	10.08	6.25	3.84	3.08	-2.65%	24.46%
Interest from Government securities	2.56	2.04	1.30	0.74	0.70	-20.00%	6.01%
Total Interest Income	13.27	12.70	7.81	4.89	3.95	-4.32%	23.98%
Total interest Expenses	1.22	0.73	0.41	0.32	0.23	-40.05%	36.48%
Net Interest income	12.05	11.97	7.39	4.57	3.71	-0.71%	23.20%
Fees & Commissions	5.56	5.16	3.42	1.73	1.68	-7.21%	2.91%
Foreign exchange income	1.80	2.09	1.34	0.76	0.82	16.15%	-8.04%
Other income	0.33	0.34	0.33	0.01	0.07	2.76%	-85.51%
Total Non-Funded Income	7.69	7.59	5.09	2.50	2.58	-1.30%	-3.10%
Total Operating Income	19.74	19.55	12.48	7.07	6.29	-0.94%	12.40%
Loan loss Provision	1.17	0.52	0.39	0.13	0.04	-55.67%	225.64%
Operating Expenses	12.72	10.69	7.14	3.55	3.35	-16.02%	6.03%
Profit before tax	7.01	8.87	5.35	3.52	2.94	26.40%	19.74%
Profit after tax	5.49	6.11	3.64	2.47	2.11	11.14%	16.82%
EPS	1.01	1.12	0.67	0.45	0.39	11.14%	16.82%
cost-provision/Income	64.5%	54.6%	57.2%	50.2%	53.2%	-15.22%	-5.66%

Source: BBK presentation

Net Interest Income – Dropped by 0.7% y/y to Ksh 11.97 Bn attributable to a 2.7% decline in the interest from loans and advances despite the marginal growth in lending. The decline was mainly reported in the 1st and 2nd quarter as the bank registered a 24% increase in income from loans in Q3 compared to Q2. Interest from Government securities dropped 20% owing to the sharp rise in interest securities which occasioned a significant devaluation of the bonds' portfolio. However, interest from the government securities increased by 6% in Q3 as the bank reclassified most of its bonds held for trading to hold to Maturity (HTM).

Notably, interest expense dropped 40% to Ksh 1.22 Bn y/y despite a wider deposit base and tighter market liquidity in the period. However, q/q interest expenses jumped 36% to Ksh 0.32 Bn as a result of tapping expensive corporate deposits following a sharp rise in T-bill rates. The rise in the T-Bills' rates was attributed to the tight liquidity that saw interbank rates peak at 31.4%.

Non–Interest Income – Dropped marginally to Ksh 7.59 Bn in the 9-months from Ksh 7.6 Bn in the previous period. This was on the back of reduced transaction volumes. Foreign exchange income rose by 16% to Ksh 2.1 Bn compared to Ksh 1.8 Bn in the previous period. However, in the Q3, the income dropped by 8% to Ksh 0.89 Bn. Q3 was characterized by high dollar demand that saw the shilling lose about 25% to the dollar after falling to a low of Ksh 107 per dollar. This prompted CBK to reduce banks' foreign reserve ratio to 10% from an initial ratio of 20%.

Assuming that, current currency trading strategies by the bank will be favoured by the operating environment as was the case in Q3, we foresee at least 50% reduction in foreign exchange income. This will negatively impact on the non-funded income.

Total operating income – Dropped 0.94% to Ksh 19.5 from Ksh 19.74 Bn in Q3 2010 owing to a corresponding drop in net interest income. Net interest income represented 61% while non-funded income accounted for 39% of the income.

Loan loss Provision – In line with the improving quality of the assets, the bank's loan loss expense dropped by 55.7% to Ksh 0.52 Bn. This was on the back of lesser impairment on its corporate book which represents most of the loan book portfolio. Nonperforming loans declined by 9.8% to Ksh 5.7 Bn representing 5.8% of the loan book. However, loan loss expense increased substantially in Q3 from Ksh 0.04 Bn in Q2 to Ksh 0.13 Bn.

Operating Expenses – Effective cost management saw operating expenses decline by 16% to Ksh 10.69 Bn. This was mainly attributed to improved efficiency due to improved technology as well as staff rationalization which saw the bank trim down its top and middle management teams. Costs were also minimized by improved credit management which saw NPL reduce significantly in the 9 months.

Cost/Income Ratio (Less provisions) – In line with the decline in operating expenses as well as the income, cost/income ration dropped by 15% to 54% in the period.

Balance sheet Items

Kshs (Billion)	Q3 10	Q3 11	1H 11	Q1	y/y%	q/q%
Balances due from CBK	4.06	4.73	3.75	4.17	16.42%	26.01%
Government securities (HTM)	54.09	46.36	56.83	59.29	-14.29%	-18.42%
Loans & Advances to Customers	91.69	98.90	91.83	90.76	7.87%	7.70%
Total Assets	177.14	180.92	176.82	178.89	2.13%	2.32%
Customer deposits	127.73	135.81	128.43	129.14	6.33%	5.75%
Total Liabilities	148.55	151.69	150.02	146.17	2.11%	1.11%
Equity	28.59	29.23	26.80	32.73	2.24%	9.07%
Loans/Deposit	71.8%	72.8%	71.5%	70.3%	1.45%	1.85%
ROE	19.2%	20.9%	13.6%	7.5%	8.71%	53.76%
ROA	3.1%	3.4%	2.1%	1.4%	8.82%	63.90%

Source: BBK presentation

Government securities – Investments in government papers declined by 14% to Ksh 46 Bn in the 9-months. This follows the devaluation of bonds; mark-to-market, in line with the upturn in yields. The uncertainty in rates has also attracted caution on new investments in the government papers. Yields are set to rise further following CBK's move to raise the CBR by another 550 bps, a month after it raised the rate by 400 bps. The new rule by CBK for banks to liquidate their bonds to boost liquidity has also discouraged purchase of government papers by the commercial banks.

Loans & Advances – The bank grew its loan book by a marginal 7.9% to Ksh 98.90 Bn supported by a slight growth in deposits. Barclays has been known for its conservative lending with a keen eye on the corporate segment. The upturn in rates has discouraged aggressive lending in fear of weakening the asset quality.

Customer deposits – Customer deposits grew by 6.3% to Ksh 135.6 Bn on the back of increased customer numbers.

Return on Equity – ROE increased to 21% from 19% in the previous period attributable to more than proportionate increase in earnings relative to the shareholders' funds.