Zenith Bank Plc

Nigeria | Equities | Financial Services | October 26, 2018 — PAC RESEARCH

Impairment Charge Management Buoys Profitability

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INVESTMENT SUMMARY

The unaudited nine-month to September 2018 result released by Zenith Bank Plc shows an improvement in the bottom line as the bank benefited from lower impairment charges during the period. However, we are worried about the unsatisfactory performance in the top line as gross earnings decline by 10.66% to ₦474.61 billion in CQ3'18 (vs. ₦531.27 billion in CQ3'17). The drop in gross earnings is attributed to the poor performance across board as both interest income and non-interest income suffer during the period. As a result of decline in interest income from loans and advances and lower interest income from government securities, interest income fell by 6.28% to ₦339.06 billion in CQ3'18 (vs. ₦361.79 billion reported CQ3'17). Non-interest income diminished by 20.02% to ₦135.54 billion (vs. ₦169.48 billion in CQ3'17), due to lower trading income and other operating income. However, interest expenses fell by 31.41% to ₦110.55 billion in CQ3'18 (vs. ₦160.30 billion in CQ3'17) while non-interest expenses rose by 6.45% to ₦182.42 billion (vs. ₦171.36 billion in CQ3'17). As a result, net interest income increased by 13.41% to ₦228.52 billion in CQ3'18 (vs. ₦201.49 billion in CQ3'17).

Due to improved net interest income and significant reduction in provision for impairment loss on financial assets, profit before tax increased by 9.67% to ₦167.31 billion in CQ3'18 (vs. ₦152.55 billion recorded in CQ3'17). The bank made a tax provision of ₦23.13 billion during the period and as a result, profit after tax increased by 11.56% to ₦144.18 billion in CQ3'18 (vs. ₦129.24 billion in CQ3'17). Impressively, 12-month trailing EPS improved by 8.76% to ₦6.14, from ₦5.21 achieved in the previous corresponding period. Based on the recent figures released by the bank, we upgrade our target price per share to ₦32.06 (Previous target price: ₦31.27) and as a result, we maintain **BUY** rating on the stock.

Fig. 1: Quarterly results highlights

	3Q2018	2Q2018	3Q2017	Q/q Δ	Y/y Δ
Gross Earnings (₦'mn)	152,402	151,719	150,826	+0.45%	+1.04%
Net Int. Income (₦'mn)	74,556	56,773	62,530	+31.32%	+19.23%
Net profit (₦'mn)	62,438	34,658	53,918	+80.15%	+15.80%

Source: NSE, Bloomberg, PAC Research

Price:

- Current	₦24.00
- Target	₦32.06
Recommendation:	**STRONG BUY**

** As at Friday October 26, 2018*

Fig. 2: Stock data

FYE	December
Price Mov't: YtD / 52wk	-10.91%/-25.1%
52-week range	₦34.20- ₦19.60
30-day Average vol.	20,147,860
Shares Outstanding ('mn)	31,396.49
Market Cap. (₦bn)	753,515.85
EPS (₦) - 12months trailing	6.14
DPS (₦) - FY2017	2.70

Source: NSE, Bloomberg, PAC Research

Fig. 3: Key ratios

	CQ3'18	CQ3'17
Net Interest Margin	9.60%	8.40%
Net profit margin	30.38%	24.33%
Equity multiplier	7.22	6.68
Cash/ total Assets	16.10%	14.95%

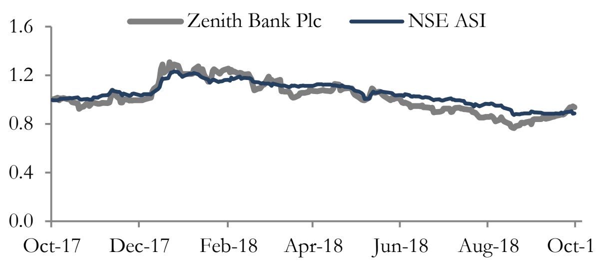
Source: NSE, Bloomberg, PAC Research

Fig. 4: Valuations

	FY2016	FY2017	FY2018E	FY2019E
P/E (x)	5.81	4.06	3.92	3.65
P/B (x)	1.07	0.92	1.00	1.04
Div Yield	8.42%	11.25%	11.46%	11.88%
Payout Ratio	48.92%	47.64%	46.54%	46.34%
Ev/Revenue	2.03	1.44	1.74	1.60
Rev per share	16.18	23.73	20.98	23.29
ROE	18.40%	21.66%	24.71%	26.43%
ROA	2.74%	3.18%	3.33%	3.27%

Source: NSE, Bloomberg, PAC Research

Fig. 5: 52-Week Price Movement of ZENITH vs NSE ASI



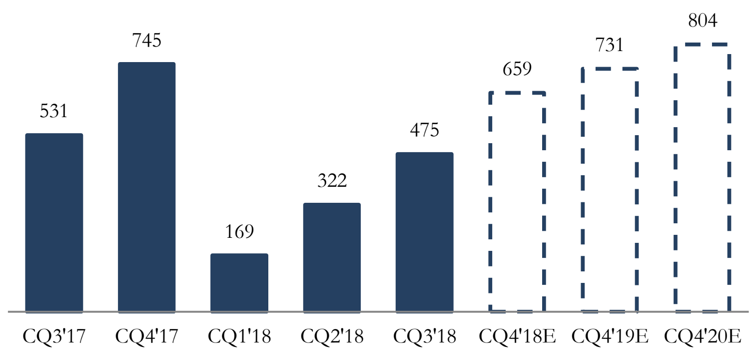
Source: Bloomberg, PAC Research

Gross earnings continues to fall due to lower interest income and non-interest income

During the period under review, the bank reported another disappointing figure in its top-line as gross earnings in nine-month to September 2018 fell by 10.66% to ₦474.61 billion (vs ₦531.27 billion in nine-month to September 2017). The reduction in the gross earnings is attributed to poor performance across board as both interest income and non-interest income declined in the period. Interest income declined by 6.28% to ₦339.06 billion in CQ3'18 (vs. ₦361.79 billion published in CQ3'17) while non-interest income fell by 20.02% to ₦182.42 billion in CQ3'18 (vs. ₦171.36 billion published in CQ3'17). The reduction in interest income came as a result of lower interest income from loans and advances to customers and government securities. However, reduction in non-interest income can be ascribed to lower fees and commission income, lower trading income, particularly loss of ₦20.77 billion from derivative instruments during the period.

The reduction in the gross earnings is attributed to poor performance across board as both interest income and non-interest income declined in the period

Fig. 6: Grosss Earnings – Cummulative Quarters CQ3'17-CQ4'20E (Billion NGN)



Source: NSE, Bloomberg, PAC Research

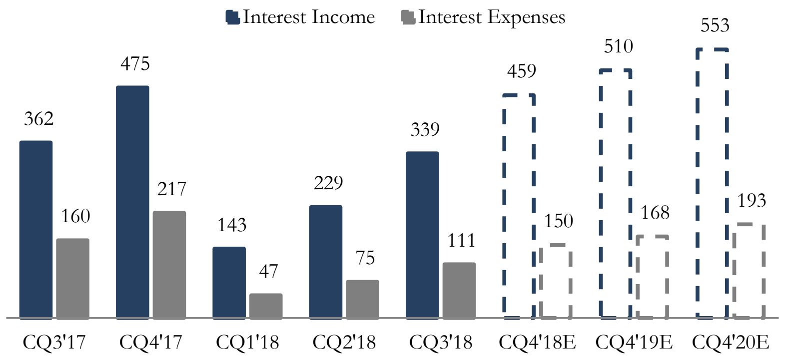
Total interest income falls by 6.28% YoY, due to declining yields on assets and a reduction in the loan book

Zenith Bank Plc reported a drop in interest income as it declined by 6.28% to ₦339.06 billion in CQ3'18 (vs. ₦361.79 billion in CQ3'17), due to declining yields on assets and a reduction in the loan book. This reflected on lower interest income from loans and advances to customers and lower treasury bills during the period. Interest income from loans and advances to customers declined by 11.18% to ₦214.06 billion (vs. ₦241.00 billion in CQ3'17) while interest income from treasury bills fell by 10.46% to ₦75.51 billion in CQ3'18 (vs. ₦84.33 billion reported in CQ3'17). Meanwhile, interest income from bonds rose by 25.84% to ₦40.58 billion in CQ3'18 (vs. ₦32.25 billion in CQ3'17) as the bank continues to benefit from high interest rate position previously taken in the long term investment.

…Interest income from loans and advances to customers declined by 11.18% to ₦214.06 billion (vs. ₦241.00 billion in CQ3'18'17) while interest income from treasury bills fell by 10.46%....

However, total interest expenses declined by 31.04% to ₦110.55billion in CQ3'18 (vs. ₦160.30 billion published in CQ3'17), due to a significant reduction in interest payment on time deposit. Total interest expenses on timed deposit declined by 69.46% to ₦32.98 billion in CQ3'18 (vs. ₦32.98 billion recorded in CQ3'17). The significant drop in total interest expenses offset the reduction in interest income and as a result, net interest income increased by 13.41% to ₦228.52 billion in nine-month to September 2018 (vs. ₦201.49 billion in nine-month to September 2017).

Fig. 7: Interest Income and Interest Expenses: CQ3'17-CQ4'20E (Billion NGN)



Source: NSE, Bloomberg, PAC Research,

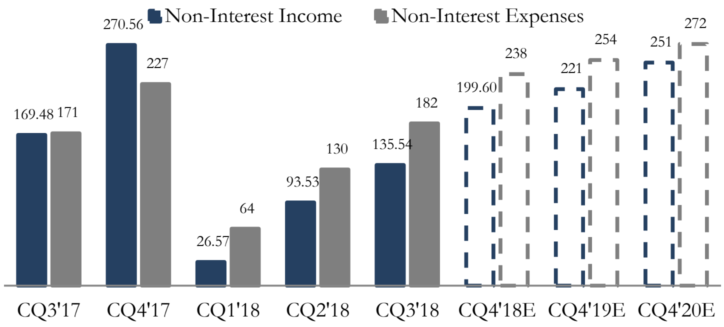
Moderate growth in non-interest expenses as non-interest income disappoints

During the nine-month to September 2018, there was a significant drop in non-interest income as it declined by 20.02% to ₦135.54 billion in CQ3'18, from ₦169.48 billion reported in CQ3'17. Reduction in trading income, fees and commission income and other operating income are responsible for the lower non-interest income. Trading income declined by 35.30% to ₦52.93 billion in CQ3'18 (vs. ₦81.81 billion reported in CQ3'17), due to a loss of ₦20.77 billion in derivatives income (vs. a gain of ₦28.79 billion in CQ3'17). Fees and commission income decline by 1.48% to ₦69.97 billion in CQ3'18 (vs. ₦71.02 billion in CQ3'17) while other operating income fell by 24.05% to ₦12.64 billion in CQ3'18 (vs. ₦16.65 billion achieved in CQ3'17).

Trading income declined by 35.30% to ₦52.93 billion in CQ3'18 (vs. ₦81.81 billion reported in CQ3'17), due to a loss of ₦20.77 billion in derivatives income…

However, the bank recorded a moderate growth non-interest expenses as it increased by 6.45% to ₦182.42 billion in CQ3'18 (vs. ₦171.36 billion recorded in CQ3'17), mainly as a result of increase in personnel expenses and operating expenses. Personnel expenses increased by 12.53% to ₦51.69 billion (vs. ₦45.93 billion in CQ3'17) while operating expenses increased by 0.98% to ₦116.74 billion in CQ3'18 (vs. ₦115.61 billion in recorded in CQ3'17).

Fig. 8: Non-Int. Income and Non-Int. Expense: CQ3'17-CQ4'20E (Billion NGN)



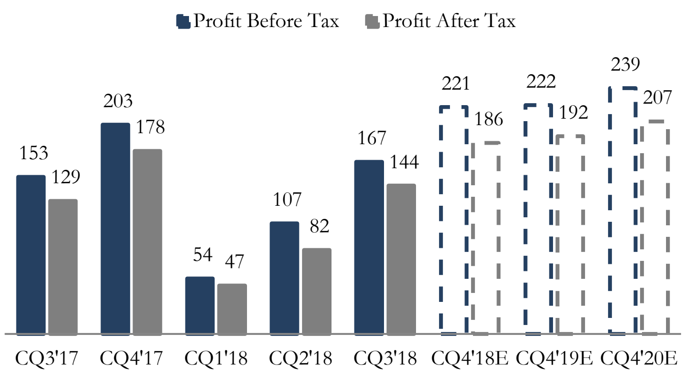
Source: NSE, Bloomberg, PAC Research

Improved net interest income and lower provision for impairment charge boost bottom line

The bank continue to release impressive figures in the bottom line as profit before tax increased by 9.67% to ₦167.31 in CQ3'18 (vs. ₦152.55 billion reported in CQ3'17). The expansion in profit before tax can be credited to improvement in the core operating activities of the bank and lower provision for impairment charges during the period. Net interest income improved by 13.41% to ₦228.52 billion in CQ3'18 (vs. ₦201.49 billion in CQ3'17) while a provision of ₦14.34 billion was made in CQ3'18 (CQ3'17: ₦47.05 billion) for impairment charge for credit loss, representing a decline of 69.53%. However, the bank made a provision of ₦23.13 billion for income tax in CQ3'18 (vs. ₦23.32 billion in CQ3'17), representing a marginal decrease of 0.81%. Consequently, profit after tax increased by 11.56% to ₦144.18 billion in CQ3'18 (vs. ₦129.24 billion reported in CQ3'17). Impressively, 12-month trailing EPS improved by 8.76% to ₦6.14, from ₦5.21 achieved in the previous corresponding period.

The expansion in profit before tax can be credited to improvement in the core operating activities of the bank and lower provision for impairment charges during the period.

Fig. 9: Profit before Tax and Profit after Tax (CQ3'17-CQ4'20E) (Billion NGN)



Source: NSE, Bloomberg, PAC Research

Assurance of impressive final dividend as balance sheet remains solid

The balance sheet of the company remains strong and liquid as total assets increased by 9.47% to ₦5.62 trillion in Q3'18 (vs. ₦5.13 trillion in Q3'17) while total liabilities rose by 10.90% to ₦4.84 trillion in Q3'18 from ₦4.36 trillion reported in Q3'17. Consequently, net asset increased by 1.33% to ₦777.90 billion in Q3'18 (vs. ₦767.69 billion reported in Q3'17). However, the bank continues to watch its loans and advances closely due to high non-performing loans experienced in the banking sector in the recent years. As a result, loans and advances declined by 15.36% to ₦1.82 trillion in Q3'18 (vs. ₦2.16 trillion reported in Q3'17). However, non-performing loan ratio increased to 4.9% in Q3'18 (vs. 4.2% recorded in Q3'17). Liquidity and capital adequacy ratio of the bank remain strong at 72.0% (Q3'17: 61.1%) and 21.0% (CQ'17: 22.2%) respectively. However, these figures are well above industry requirements of 30% for liquidity and 15% for capital adequacy ratio.

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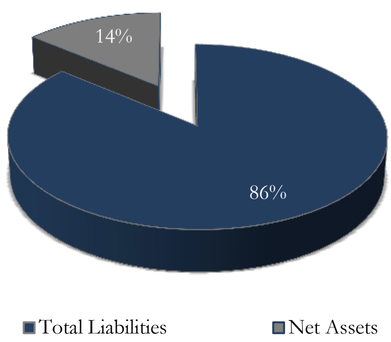
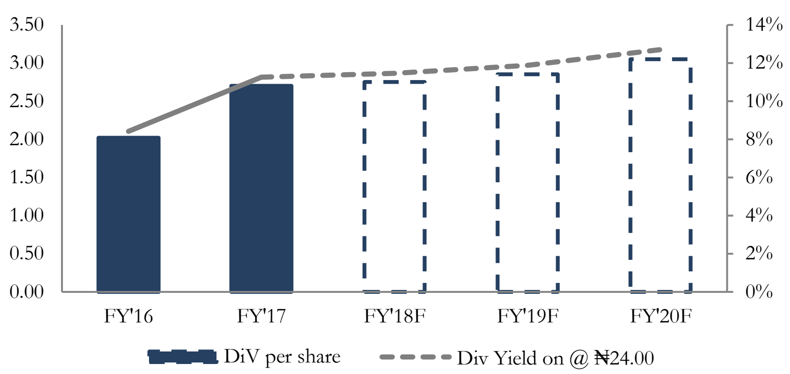
Fig. 10: Total Liabilities Vs Net Asset in Q3'18



Source: NSE, PAC Research

Fig. 11: Dividend Per Share and Dividend Yield (FY'16-FY'20F)



Source: NSE, PAC Research

Valuation

Our valuation puts the target price of the stock at ₦32.06, representing an increase of 33.58% from the current price of ₦24.00. In arriving at the target price, we employed Dividend Discount Model and Residual Income Valuation Model. Consequently, we maintain a **BUY** recommendation on the stock of the company.

Our valuation and forecasts considered several factors (both quantitative and qualitative) among which are; the previous financial reports of the company, the current figures released by the company, the performance of the bank in the banking industry, and outlook from the management.

Our valuation puts the target price of the stock at N32.06, representing an increase of 33.58% from the current price of N24.00

Fig. 12: Share Price History

Source: NSE, PAC Research

Fig. 13: Statement of Profit or Loss, N'mn

	2016	2017	2018E	2019F
Gross Earnings	507,997	745,189	658,747	731,209
Change		46.69%	-11.60%	11.00%
Interest and Similar Income	384,557	474,628	459,147	510,384
Change		23.42%	-3.26%	11.16%
Interest and Similar Expenses	-144,378	-216,637	-150,194	-168,178
Change		50.05%	-30.67%	11.97%
Net Interest Income	240,179	257,991	308,952	342,206
Change		7.42%	19.75%	10.76%
Impairment Charge for credit losses	-32,350	-98,227	-20,421	-29,248
Change		203.64%	-79.21%	43.23%
Fees and Commission Income	68,444	90,143	89,590	93,595
Change		31.70%	-0.61%	4.47%
Trade gains	28,398	157,974	65,875	47,529
Change		456.29%	-58.30%	-27.85%
Personnel expenses	-59,326	-64,459	-69,168	-76,046
Change		8.65%	7.31%	9.94%
Profit Before Taxation	156,748	203,461	220,549	222,288
Change		29.80%	8.40%	0.79%
Taxation	-27,096	-25,528	-34,847	-30,009
Change		-5.79%	36.50%	-13.88%
Profit After Taxation	129,652	177,933	185,702	192,279
Change		37.24%	4.37%	3.54%

Fig. 14: Statement of Financial Position, N'mn

	2016	2017	2018E	2019F
Cash and balances	669,058	957,663	922,246	987,132
Treasury bills	557,359	936,817	895,896	921,324
Assets pledged as collateral	328,343	468,010	513,823	526,471
Due from other banks	459,457	495,803	507,235	497,222
Derivative assets	82,860	57,219	98,812	109,681
Loans and advances	2,289,365	2,100,362	1,844,492	2,047,386
Investment securities	199,478	330,951	526,998	511,846
Deffered tax assets	6,440	9,561	10,540	11,699
Other assets	37,536	92,494	98,812	99,444
Property and equipment	105,284	133,384	144,924	157,210
Total Assets	4,739,825	5,595,253	5,578,929	5,884,772
Customer deposits	2,983,621	3,437,915	3,458,422	3,692,607
Derivative Liabilities	66,834	20,805	18,379	20,401
Other liabilities	208,680	233,481	263,499	292,484
On lending facilities	350,657	383,034	395,248	416,789
Borrowings	263,106	356,496	322,786	318,076
Debt securities issued	153,464	332,931	362,311	409,477
Total Liabilities	4,035,360	4,773,595	4,827,299	5,157,219
Net Assets	704,465	821,658	751,630	727,553
Total equity and liabilities	4,739,825	5,595,253	5,578,929	5,884,772

Fig. 15: Profitability Ratio

	2016	2017	2018E	2019F
Return on Equity	18.40%	21.66%	24.71%	26.43%
Return on Assets	2.74%	3.18%	3.33%	3.27%
Net int. income to Rev.	47.28%	34.62%	46.90%	46.80%
PBT margin	30.86%	27.30%	33.48%	30.40%
Net Profit Margin	25.52%	23.88%	28.19%	26.30%
ROCE	4.71%	5.15%	5.41%	5.02%

Fig. 16: Asset Utilisation

	2016	2017	2018E	2019F
Cash/Revenue	131.71%	128.51%	140.00%	135.00%
Revenue to total assets (x)	10.72%	13.32%	11.81%	12.43%
Interest Inc. / Total Assets	8.11%	8.48%	8.23%	8.67%
Other Income/ Total Assets	0.56%	0.40%	0.26%	0.37%
Rev. to total fixed assets	482.50%	558.68%	454.55%	465.12%
fixed asset turnover	20.73%	17.90%	22.00%	21.50%

Fig. 17: Liquidity Ratios

	2016E	2017E	2018E	2019F
Current ratio	1.17	1.17	1.16	1.14
Cash ratio	0.17	0.20	0.19	0.19
Interest Coverage ratio	1.09	0.94	1.47	1.32
Liquid Assets/Total Deposit	0.48	0.65	0.68	0.66
Loans & Adv./Total Deposit	0.77	0.61	0.53	0.55
Liquid Assets/Total Assets	0.30	0.40	0.42	0.41
Debt/net income	3.21	3.87	3.69	3.78
Debt to asset	0.09	0.12	0.12	0.12
Debt to equity	0.59	0.84	0.91	1.00
Total Liabilities / Total Asset	0.85	0.85	0.87	0.88
Cost to income ratio	0.53	0.53	0.52	0.53
net interest margin AVERAGED	0.08	0.08	0.08	0.08
Total liabilities/equities	5.73	5.81	6.42	7.09

Fig. 18: Shareholders' Investment Ratios

	2016E	2017E	2018E	2019E
Earnings per share	4.13	5.67	5.91	6.12
DiV per share	2.02	2.70	2.75	2.85
NAVPS	22.44	26.17	23.94	23.17
Earnings yield	17.21%	23.61%	24.64%	25.52%

Fig. 19: Capital Adequacy Ratios

	2016E	2017E	2018E	2019E
Loans and Advances/Equity	3.25	2.56	2.45	2.81
Equity/Total Assets	0.15	0.15	0.13	0.12
Loan Loss Expense/ Equity	0.05	0.12	0.03	0.04

Source: Company's Annual Reports, PAC Research

Equity research methodology employed in this report

Views documented in this equity research report stem from conclusions reached through the use of multiple valuation methodologies, industry-wide knowledge, company specific information and our near to medium term expectations of industry and company performance, as well as market outlook. Our forecasts are based on a combination of top down and bottom up analysis, alongside historical trends in industry and company financials. Where appropriate, we factored in available forecasts and business direction provided by company management.

Our recommendation tends towards value investing. Therefore, our investment rank gauge—a customized scale we use to judge how well a firm under coverage has performed—is determined using major value parameters as well as relevant ratios and multiples computed with figures from the company's most recent financials.

The variables used to arrive at the company's investment rank cover a wide range of measures which characterize liquidity, operational efficiency, profitability, profit margins, growth, economic viability, gearing, relative valuation ratios, capital structure and management performance. Our investment recommendation is underpinned by the upside or downside potential of a stock under coverage. This potential is estimated by comparing the stock's current market price to its price target and fair value, on a percentage increase or decrease basis as summarized below:

Deviation from current price	Recommendation
>30%	STRONG BUY
10% to < 30%	BUY
-10% to < 10%	HOLD
<-10%	SELL

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