Zenith Bank Plc

PAC Holdings
RC254413
| A PROPRIETARY INVESTMENT COMPANY |

Nigeria | Equities | Financial Services | February 27, 2019 — PAC RESEARCH

Lower Impairment Charges and Optimisation of Cost of Funds Boost Profitability

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INVESTMENT SUMMARY

The 2018 full year audited report released by Zenith Bank Plc showed an impressive performance as figure for bottom line beat our forecast by 4.16%. However, due to challenging macro-environment which affected interest income and non-interest income during the period, gross earnings depressed by 15.41% to ₦630.34 billion (vs. ₦745.19 billion in FY'17). Interest and similar income declined by 7.28% to ₦440.05 billion in FY'18 (vs. ₦474.63 billion recorded FY'17), mainly owing to compressed yields on assets and a reduction of 10.00% in the loan book. As a result of lower trading income and other operating income, non-interest income diminished by 29.67% to ₦190.29 billion in FY'18 (vs. ₦270.56 billion in FY'17). However, the bank recorded an impressive figure in interest expenses as it declined by 33.32% to ₦144.46 billion in FY'18 (vs. ₦216.64 billion in FY'17). A lower provision of ₦18.37 billion was made for impairment charges in FY'18, compared with ₦98.23 billion provided for in FY'17.

Despite the decline in gross earnings, the Group mitigated these knock-on effects through growth of its net interest income and lower provision for impairment charges during the period. This resulted in improved profit before tax of ₦231.69 billion in FY'18 (vs. ₦199.32 billion in FY'17). The bank made provision of ₦38.26 billion for tax during the period and as a result, profit after tax rose by 11.30% to ₦193.42 billion in FY'18 (vs. ₦173.79 billion in FY'17). Impressively, 12-month trailing EPS improved by 8.64% to ₦6.16. The bank proposed a final dividend of ₦2.50 per share (2017 Final dividend: ₦2.45) after the payment of ₦0.30 as interim dividend per share in 2018 (2017 interim dividend: ₦0.25), totalling ₦2.80 in FY'18 (FY'17: ₦2.70). Based on the recent figures released by the bank, we upgrade our target price per share to ₦34.23 (Previous target price: ₦32.06) and as a result, we maintain **BUY** rating on the stock.

Fig. 1: Quarterly results highlights

	4Q2018	3Q2018	4Q2017	Q/q Δ	Y/y Δ
Gross Earnings (₦'mn)	155,737	152,402	152,402	+2.19%	- 27.20%
Net Int. Income (₦'mn)	67,077	74,556	74,556	-10.03%	+18.72%
Net profit (₦'mn)	49,245	62,442	62,438	-21.13%	+1.12%

Source: NSE, Bloomberg, PAC Research

Price:

- Current	₦25.80
- Target	₦34.23
Recommendation:	STRONG BUY

** As at Tuesday February 26, 2019*

Fig. 2: Stock data

FYE	December
Price Mov't: YtD / 52wk	+11.93%/-19.12%
52-week range	₦32.15- ₦19.60
30-day Average vol.	33,437,110
Shares Outstanding ('mn)	31,396.49
Market Cap. (₦bn)	810.03
EPS (₦) - 12months trailing	6.16
DPS (₦) - FY2018	2.80

Source: NSE, Bloomberg, PAC Research

Fig. 3: Key ratios

	FY'18	FY'17
Net Interest Margin	8.90%	8.94%
Net profit margin	30.69%	23.32%
Equity multiplier	7.30	6.89
Cash/ total Assets	16.03%	17.12%

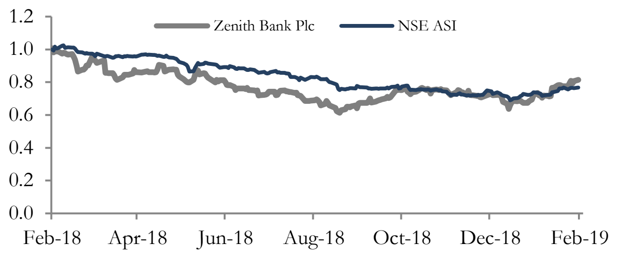
Source: NSE, Bloomberg, PAC Research

Fig. 4: Valuations

	FY2017	FY2018	FY2019F	FY2020F
P/E (x)	4.55	4.19	3.89	3.38
P/B (x)	1.00	0.99	0.91	0.85
Div Yield	10.47%	10.85%	11.24%	11.63%
Payout Ratio	47.64%	45.45%	43.70%	39.33%
EV/Revenue	1.58	2.04	1.97	1.89
Rev per share	23.73	20.08	21.08	22.56
ROE	21.91%	23.71%	23.38%	25.12%
ROA	3.18%	3.25%	3.40%	3.65%

Source: NSE, Bloomberg, PAC Research

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



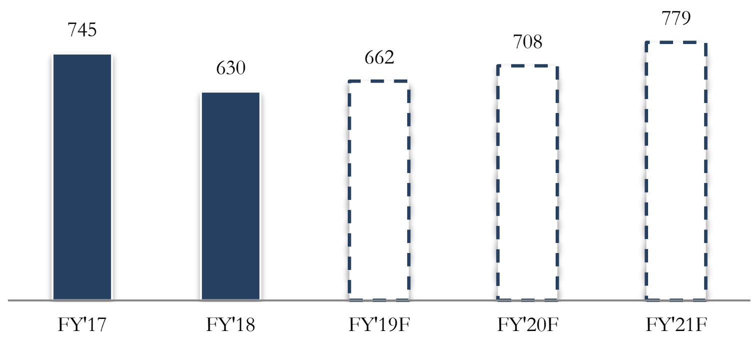
Source: Bloomberg, PAC Research

Due to lower interest income and non-interest income, gross earnings falls by 15.41% YoY

In the full year of 2018, Zenith Bank Plc reported lower figure in its top-line as gross earnings fell by 15.41% to ₦630.34 billion (vs ₦745.19 billion in full year of 2017). The drop in the gross earnings is attributed to the poor performance across board as both interest income and non-interest income declined in the period. The bank recorded a reduction of 7.28% and 29.67% in interest income and non-interest income respectively. Interest income declined to ₦440.05 billion (vs. ₦474.63 billion FY'17) while non-interest income fell to ₦190.29 billion in FY'18 (vs. ₦270.56 billion reported in FY'17). The reduction in interest income can be mainly attributed to the compressed yields on assets and a reduction of 10% in the loan book. However, lower non-interest income can be mainly ascribed to a dip of 49.23% and 20.04% in trading income and other operating income respectively during the period.

The bank recorded a reduction of 7.28% and 29.67% in interest income and non-interest income respectively

Fig. 6: Grosss Earnings – FY'17 –FY'21F (Billion NGN)



Source: NSE, Bloomberg, PAC Research

Interest income declined by 7.28% as a result of reduction in total loans to customers and a lower yield environment

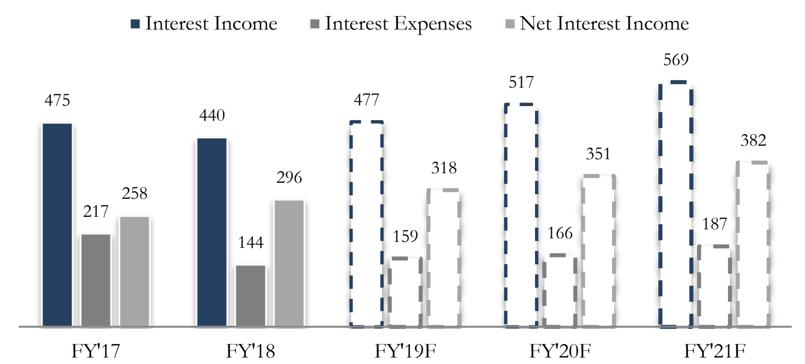
The bank reported a drop in interest income as it declined by 7.28% to ₦440.05 billion in FY'18 (vs. ₦474.63 billion in FY'17), due to the lower average yields and reduced total loans to customers in 2018. The average one year treasury bills yield is 15% in 2018, compared to average yield of 21% in 2017. Also, loans and advances declined by 13.20% to ₦1.82 trillion in FY'18 (vs. ₦2.10 trillion in FY'17). The dip in the loans to customers and lower average yield 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 decreased by 13.19% to ₦273.18 billion (vs. ₦314.68 billion in FY'17) while interest income from treasury bills fell by 8.39% to ₦100.54 billion in FY'18 (vs. ₦109.74 billion in FY'17).

The average one year treasury bills yield is 15% in 2018, compared to average yield of 21% in 2017.

Impressively, the bank continues to benefit from high interest rate position previously taken in the long term investment as the interest income from bonds increased by 20.65% to ₦52.45 billion in FY'18 (vs. ₦43.47 billion in FY'17).

However, total interest expenses fell by 33.32% to ₦144.46 billion in FY'18 (vs. ₦216.64 billion in FY'17), due to a significant reduction in interest payment on time deposit. Total interest expenses on timed deposit declined by 61.10% to ₦42.30 billion (vs. ₦108.74 billion reported in FY'17). The substantial drop in total interest expenses outweighed the decline in interest income and as a result, net interest income increased by 14.58% to ₦295.59 billion in 2018 (vs. ₦257.99 billion in 2017).

Fig. 7: Interest Income and Interest Expenses: FY'17-FY'21F (Billion NGN)



Source: NSE, Bloomberg, PAC Research,

Improved operating income with marginal growth in operating expenses

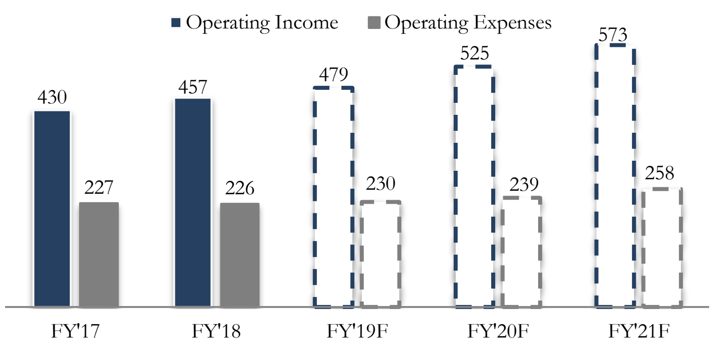
During the year 2018, the bank reported a significant improvement in operating income as it increased by 8.15% to ₦457.19 billion, from ₦422.73 billion reported in the year 2017. The significant improvement in operating income can be mainly attributed to improved net interest income after impairment loss on financial and non-financial instruments. However, trading income reduced by 49.23% to ₦80.20 billion in FY'18 (vs. ₦157.97 billion reported in FY'17). The decline in trading income is due to a loss of ₦16.78 billion in derivatives income (vs. a gain of ₦68.71 billion in FY'17). Net fees and commission income decreased marginally by 0.89% to ₦81.81 billion in (vs. ₦82.55 billion in FY'17) while other operating income fell by 20.04% to ₦17.95 billion in FY'18 (vs. ₦22.44 billion in FY'17).

The decline in trading income is due to a loss of ₦16.78 billion in derivatives income (vs. a gain of ₦68.71 billion in FY'17)

The bank recorded a moderate growth in operating expenses as it increased by 0.94% to ₦225.50 billion in FY'18 (vs. ₦223.41 billion in FY'17). During the period, higher personnel expenses, higher amortisation and depreciation of assets contributed to the increase in operating expenses.

Depreciation of property and equipment increased by 33.96% to ₦16.65 billion (vs. ₦12.43 billion in FY'17) while personnel expenses rose by 6.36% to ₦68.56 billion in FY'18 (vs. ₦64.46 billion in FY'17).

Fig. 8: Operating Income and Non-Int. Expense: FY'17-FY'21F (Billion NGN)



Source: NSE, Company's Results, PAC Research

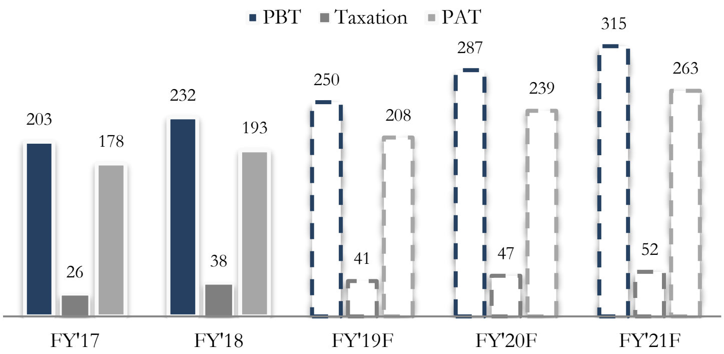
Improved net interest income and lower provision for impairment charges boost profitability

Over the past few years, the bank has been consistently reporting improved performance in the bottom lines. In the 2018 audited report released last week, the bank reported a significant improvement in the profit before tax as it increased by 16.24% to ₦231.69 billion in FY'18 (vs. ₦199.2 billion reported in FY'17). The improvement in profit before tax was achieved through the bank's optimisation of its cost of funds, cost-to-income ratio and cost of risk. The optimisation of cost of funds reflected on net interest income as it rose by 14.58% to ₦295.59 billion in FY'18 (vs. ₦257.991 billion in FY'17). The cost-to-income ratio of the bank also reduced to 49.32% in FY'18, from 52.85% recorded in FY'17. In Addition, the risk-centric approach of the bank also ensured that cost of risk reduced significantly from 4.3% in the prior year to 0.9% in 2018. This was reflected through the drop-off in impairment charges by 81.30% to ₦18.37 billion in FY'18 (vs. ₦98.23 billion in FY'17), re-affirming the bank's enhanced asset quality.

The improvement in profit before tax was achieved through the bank's optimisation of its cost of funds, cost-to-income ratio and cost of risk.

The bank made a provision of ₦38.26 billion for tax during the period (FY'17: ₦25.53 billion), representing an increase of 49.88%. As a result, profit after tax increased by 11.30% to ₦193.42 billion in FY'18 (vs. ₦173.79 billion achieved in FY'17). Impressively, earnings per share (EPS) strengthened by 8.64% to ₦6.16 in FY'18, from ₦5.67 the bank achieved in FY'17.

Fig. 9: Profit before Tax, Taxation and Profit after Tax - FY'17-FY'21F (Billion NGN)



Source: NSE, Bloomberg, PAC Research

With Solid and high quality capital position, the bank declares improved total dividend of ₦2.80 per share

The balance sheet of the bank remains solid and liquid in the full year of 2018. This is mirrored in the liquidity ratio, capital adequacy ratio non-performing loans ratio. The liquidity ratio of the bank improved to 72.0% (2017: 69.7%) while capital adequacy ratio declined to 25.0% in 2018 (2017: 27.0%). Liquidity and Capital Adequacy Ratio of the bank are well above industry requirements of 30% for liquidity ratio and 15% for capital adequacy ratio. The bank also continue to monitor its loans portfolio and this can be seen in loan-to-deposit ratio as it declined to 44.2% in 2018 (2017: 54.5%). However, non-performing loan ratio increased to 4.98% in 2018 (2017: 4.70%) and this is below the industry requirement of 5%. Oil and Gas sector still remains the major contributor to non-performing loan (38.23%), followed by manufacturing sector (31.05%). Again, upstream oil & gas sector, government and other manufacturing have the highest share of the loans given out in 2018 as the contributed 15.70%, 15.40% and 14.10% respectively to loans by sector.

Oil and Gas sector still remains the major contributor to non-performing loan (38.23%), followed by manufacturing sector (31.05%)

The total assets increased by 6.44% to ₦5.96 trillion in FY'18 (vs. ₦5.60 trillion in FY'17) while total liabilities rose by 7.46% to ₦5.14 trillion in FY'18 (vs. ₦4.78 trillion in FY'17). Consequently, net asset increased by 0.45% to ₦815.75 billion in FY'18 (vs. ₦812.12 billion in FY'17) while net asset per share increased marginally by 0.45% ₦25.98 in 2018, from ₦25.87 reported in 2017. The bank proposed a final dividend of ₦2.50 per share (2017 Final dividend: ₦2.45) after the payment of ₦0.30 as interim dividend per share in 2018 (2017 interim dividend: ₦0.25), totalling ₦2.80 in FY'18 (FY'17: ₦2.70).

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

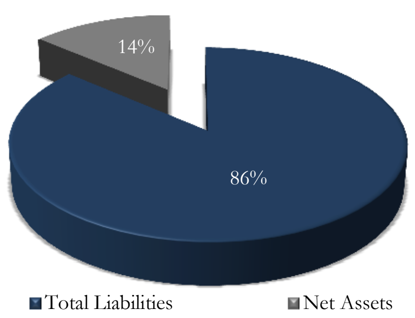


Fig. 11: Dividend Per Share and Dividend Yield (FY'17-FY'21F)

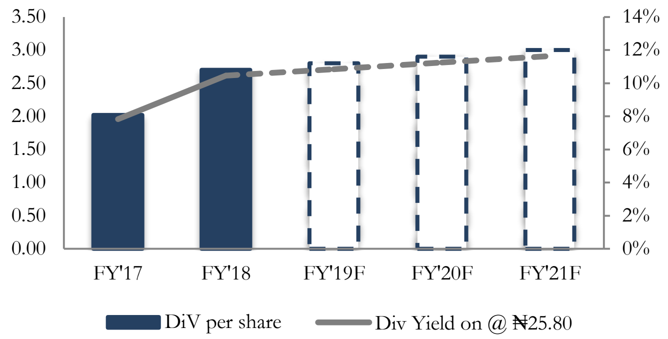


Fig. 12: Loans by Sector – FY'18 (Gross Loans – ₦2.02 trillion)

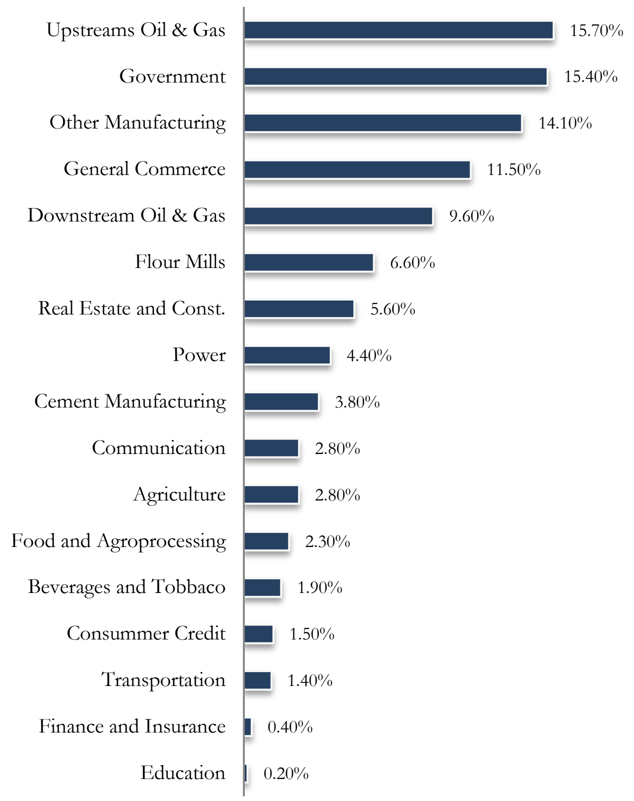
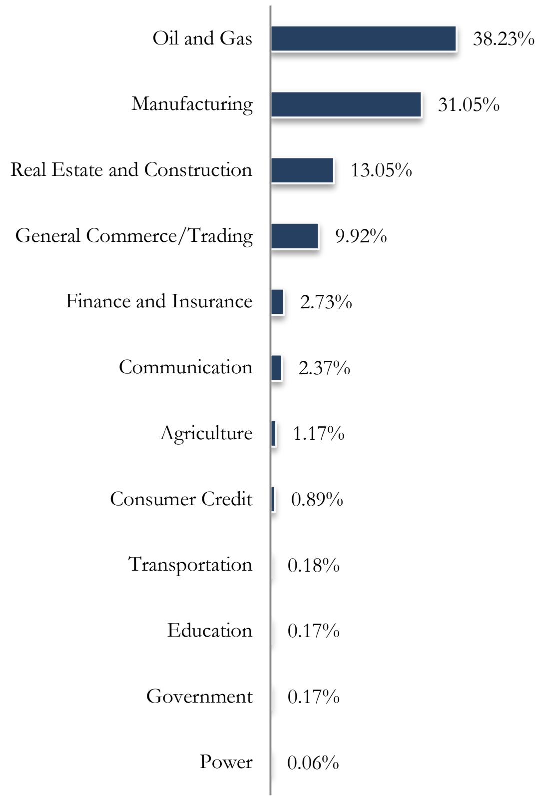


Fig. 13: NPL by Sector – FY'18 (Gross Loans – ₦100.50 billion)



Source: Company's Presentation, PAC Research

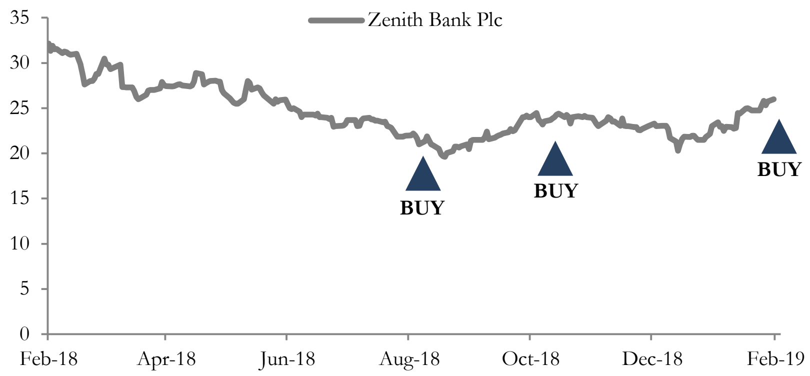
Valuation

Our valuation puts the target price of the stock at ₦34.23, representing an increase of 32.69% from the current price of ₦25.80. 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 N34.23, representing an increase of 32.69% from the current price of N25.80.

Fig. 14: Share Price History (Naira)



Source: NSE, PAC Research

Fig. 15: Statement of Profit or Loss, N'mn

	2017	2018	2019F	2020F
Gross Earnings	745,189	630,344	661,861	708,191
Change		-15.41%	5.00%	7.00%
Interest and Similar Income	474,628	440,052	476,540	516,980
Change		-7.28%	8.29%	8.49%
Interest and Similar Expenses	-216,637	-144,458	-158,847	-166,425
Change		-33.32%	9.96%	4.77%
Net Interest Income	257,991	295,594	317,693	350,555
Change		14.58%	7.48%	10.34%
Impairment Charge for credit losses	-98,227	-18,372	-20,518	-24,787
Change		-81.30%	11.68%	20.81%
Fees and Commission Income	90,143	81,814	86,042	93,481
Change		-9.24%	5.17%	8.65%
Trade gains	157,974	80,202	76,114	81,442
Change		-49.23%	-5.10%	7.00%
Personnel expenses	-64,459	-68,556	-68,834	-72,236
Change		6.36%	0.40%	4.94%
Profit Before Taxation	203,461	231,685	249,522	286,818
Change		13.87%	7.70%	14.95%
Taxation	-25,528	-38,261	-41,171	-47,325
Change		49.88%	7.61%	14.95%
Profit After Taxation	177,933	193,424	208,351	239,493
Change		8.71%	7.72%	14.95%

Fig. 16: Statement of Financial Position, N'mn

	2017	2018	2019F	2020F
Cash and balances	957,663	954,416	1,010,993	1,081,762
Treasury bills	936,817	1,000,560	1,092,071	1,168,516
Assets pledged as collateral	468,010	592,935	529,489	601,963
Due from other banks	495,803	674,274	540,741	578,592
Derivative assets	57,219	88,826	99,279	106,229
Loans and advances	2,100,362	1,823,111	2,018,677	2,124,574
Investment securities	330,951	565,312	562,582	601,963
Deffered tax assets	9,561	9,513	10,590	11,331
Other assets	92,494	80,948	90,013	96,314
Property and equipment	133,384	149,137	158,847	169,966
Total Assets	5,595,253	5,955,710	6,127,180	6,556,083
Customer deposits	3,437,915	3,690,295	3,706,423	3,965,872
Derivative Liabilities	20,805	16,995	18,532	19,829
Other liabilities	243,023	231,716	248,198	265,572
On lending facilities	383,034	393,295	412,273	441,132
Borrowings	356,496	437,260	410,354	439,079
Debt securities issued	332,931	361,177	430,210	460,324
Total Liabilities	4,783,137	5,139,959	5,235,984	5,602,503
Net Assets	812,116	815,751	891,196	953,580
Total equity and liabilities	5,595,253	5,955,710	6,127,180	6,556,083

Fig. 17: Profitability Ratio

	2017	2018	2019F	2020F
Return on Equity	21.91%	23.71%	23.38%	25.12%
Return on Assets	3.18%	3.25%	3.40%	3.65%
Net int. income to Rev.	34.62%	46.89%	48.00%	49.50%
PBT margin	27.30%	36.76%	37.70%	40.50%
Net Profit Margin	23.88%	30.69%	31.48%	33.82%
ROCE	5.12%	5.36%	5.74%	6.17%

Fig. 18: Asset Utilisation

	2017	2018	2019F	2020F
Cash/Revenue	128.51%	151.41%	152.75%	152.75%
Revenue to total assets (x)	13.32%	10.58%	10.80%	10.80%
Interest Inc. / Total Assets	8.48%	7.39%	7.78%	7.89%
Other Income/ Total Assets	0.40%	0.30%	0.32%	0.38%
Rev. to total fixed assets	558.68%	422.66%	416.67%	416.67%
fixed asset turnover	17.90%	23.66%	24.00%	24.00%

Fig. 19: Liquidity Ratios

	2017	2018	2019F	2020F
Current ratio	1.17	1.16	1.17	1.17
Cash ratio	0.20	0.19	0.19	0.19
Interest Coverage ratio	0.94	1.60	1.57	1.72
Liquid Assets/Total Deposit	0.65	0.68	0.72	0.72
Loans & Adv./Total Deposit	0.61	0.49	0.54	0.54
Liquid Assets/Total Assets	0.40	0.42	0.44	0.44
Debt/net income	3.87	4.13	4.03	3.76
Debt to asset	0.12	0.13	0.14	0.14
Debt to equity	0.85	0.98	0.94	0.94
Total Liabilities / Total Asset	0.85	0.86	0.85	0.85
Cost to income ratio	0.53	0.49	0.48	0.45
net interest margin AVERAGED	0.08	0.08	0.08	0.07
Total liabilities/equities	5.89	6.30	5.88	5.88

Fig. 20: Shareholders' Investment Ratios

	2017	2018	2019F	2020F
Earnings per share	5.67	6.16	6.64	7.63
DiV per share	2.70	2.80	2.90	3.00
NAVPS	25.87	25.98	28.39	30.37
Earnings yield	21.97%	23.88%	25.72%	29.57%

Fig. 21: Capital Adequacy Ratios

	2017	2018	2019F	2020F
Loans and Advances/Equity	2.59	2.23	2.27	2.23
Equity/Total Assets	0.15	0.14	0.15	0.15
Loan Loss Expense/ Equity	0.12	0.02	0.02	0.03

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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