Zenith Bank Plc

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Earnings Below Expectation: Lower Provision for Loan Loss Saves the Day

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INVESTMENT SUMMARY

The recently released H1'18 audited result by Zenith Bank Plc shows a decline of 15.31% in its gross earnings as it reduced to ₦322.20 billion (vs. ₦380.44 billion in H1'17). The decline in top-line is attributed to the poor performance across board as both interest income and non-interest income declined in the period under review. In the first quarter of 2018, interest income of the bank fell by 12.81% to ₦228.67 billion (vs. ₦262.26 billion recorded in first half of 2017) while non-interest income reduced by 20.86% to ₦93.53 billion (vs. ₦118.18 billion in the first half of 2017). However, interest expenses reduced by 39.41% to ₦74.71 billion in H1'18 (vs. ₦123.30 billion in H1'17) while non-interest expenses increased by 6.40% to ₦130.41 billion (vs. ₦122.56 billion in H1'17). Consequently, net interest income increased by 10.79% to ₦153.96 billion in H1'18 (vs. ₦138.96 billion in H1'17) while net non-interest expense increased by 741.89% to ₦36.88 billion in H1'18 (vs. ₦4.38 billion in H1'17). The bank made a provision of ₦9.72 billion in H1'18 (H1'17: ₦42.40 billion) for impairment charge for credit loss.

On the back of tremendous reduction in provision for impairment loss on financial assets, profit before tax increased by 16.46% to ₦107.36 billion in H1'18 (vs. ₦92.18 billion recorded in H1'17) while profit after tax increased to ₦81.74 billion in H1'18, from ₦75.32 billion in H1'17, representing an increase of 8.52%. The improvement in the bottom-line shows in 12-month trailing EPS as it increased by 8.76% to ₦5.87, from ₦5.40 recorded in the previous period. Impressively, the bank rewarded shareholders as it declared an interim dividend of ₦0.30 in H1'18 (vs ₦0.25 in H1'17).

Though, the current performance of the company is slightly below our expectation, we reiterate a **BUY** position on the company shares at current price as present forward estimates places the company share price at ₦31.27 (Previous target price: ₦33.43).

Price:

- Current	**₦23.00**
- Target	**₦31.27**
Recommendation:	**BUY**

** As at Wednesday August 15, 2018*

Fig. 2: Stock data

FYE	December
Price Mov't: YtD / 52wk	-10.30%/-2.64%
52-week range	₦34.20- ₦22.00
30-day Average vol.	22,552,930
Shares Outstanding ('mn)	31,396.49
Market Cap. (₦bn)	722,119.36
EPS (₦) - 12months trailing	5.87
DPS (₦) - FY2017	2.70

Source: NSE, Bloomberg, PAC Research

Fig. 3: Key ratios

	H1'18	H1'17
Net Interest Margin	10.10%	8.60%
Net profit margin	25.37%	19.80%
Equity multiplier	7.31	6.85
Cash/ total Assets	16.05%	13.80%

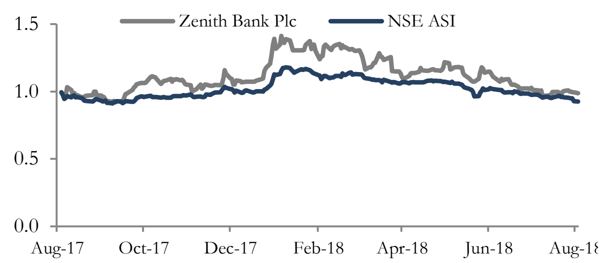
Source: NSE, Bloomberg, PAC Research

Fig. 4: Valuations

	FY2016	FY2017	FY2018E	FY2019E
P/E (x)	5.57	4.06	3.93	3.67
P/B (x)	1.03	0.88	0.99	0.91
Div Yield	8.78%	11.74%	11.74%	12.39%
Payout Ratio	48.92%	47.64%	46.15%	45.46%
Ev/Revenue	2.03	1.44	1.68	1.54
Rev per share	16.18	23.73	21.48	23.84
ROE	18.40%	21.66%	25.09%	24.73%
ROA	2.74%	3.18%	3.46%	3.43%

Source: NSE, Bloomberg, PAC Research

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



Source: Bloomberg, PAC Research

Fig. 1: Quarterly results highlights

	2Q2018	1Q2018	2Q2017	Q/q Δ	Y/y Δ
Gross Earnings (₦'mn)	151,719	169,192	232,704	-10.33%	-34.80%
Net Int. Income (₦'mn)	56,773	95,898	68,358	-40.80%	-16.95%
Net profit (₦'mn)	34,658	47,079	47,818	-26.38%	-27.52%

Source: NSE, Bloomberg, PAC Research

Gross earnings declines by 15.31% YoY as both interest income and non-interest income drop

Zenith bank recorded a lower than expected performance in the top-line as gross earnings in H1'18 fell by 15.31% to ₦322.20 billion (vs ₦380.44 billion in H1'17) and this was as a result of reduction in both interest income and non-interest income. Interest income declined by 12.81% to ₦228.67 billion in H1'18 (vs. ₦262.26 billion published in H1'17) while non-interest income declined by 20.86% to ₦93.53 billion in H1'18 (vs. ₦118.18 billion published in H1'17). The reduction in interest income was triggered by interest income from loans and advances to customers and treasury bills. Lower trading gain, particularly from treasury bill trading income, is the main reason behind the decline in non-interest income in the half year of 2018. During the period, interest income contributed more to the gross earnings as it stands at 70.97% in H1'18 (vs. 68.94% in H1'17) while non-interest income contributed 29.03% to gross earnings in H1'18 (vs. 31.06% in H1'17).

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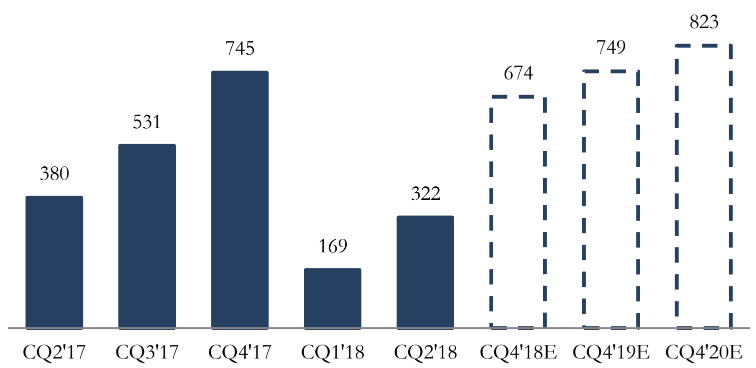
Fig. 6: Grosss Earnings – Cummulative Quarters CQ2'17-CQ4'20E (Billion NGN)



Source: NSE, Bloomberg, PAC Research

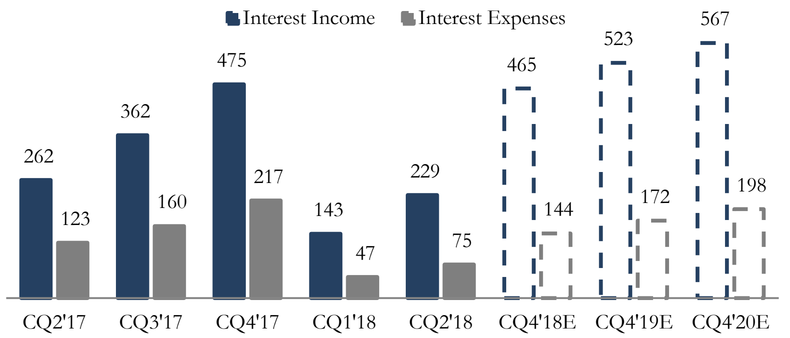
Interest income declines as a result of reduction in total loans to customers and lower interest regime

During the six months to June 2018, the bank recorded a drop in interest income as it declined by 12.81% to ₦228.67 billion in H1'18 (vs. ₦262.257billion in H1'17). The growth in interest income can be credited to declining yields on assets and a reduction in the loan book. Interest income from loans and advances to customers declined by 18.00% to ₦146.43 billion in H1'18 (vs. ₦178.59 billion in H1'17) while interest income from treasury bills fell by 13.34% to ₦51.41 billion in H1'18 (vs. ₦59.33 billion in H1'17). However, interest income from government and other bonds rose by 17.42% to ₦25.88 billion in H1'18 from ₦22.42 billion in H1'17. Interest income from loans and advances to customers remains the highest contributor to total interest income as it contributed 64.04% in H1'18 (H1'17: 68.10%).

Interest income from loans and advances to customers declined by 18.00% to ₦146.43 billion in H1'18 (vs. ₦178.59 billion in H1'17) while interest income from treasury bills fell by 13.34%...

Due to a significant reduction of 75.38% in interest payment on time deposit, total interest expenses declined by 39.41% to ₦74.71 billion in H1’18 (vs. ₦123.30 billion recorded in H1’17). The knock-on effect of interest income was mitigated by a significant reduction in interest expenses and as a result, net interest income rose by 10.79% to ₦153.96 billion in first half of 2018 (vs. ₦138.96 billion reported in first half of 2017) while net interest margin stood at 10.10% (H1’17: 8.6%).

Fig. 7: Interest Income and Interest Expenses: CQ2’17-CQ4’20E (Billion NGN)



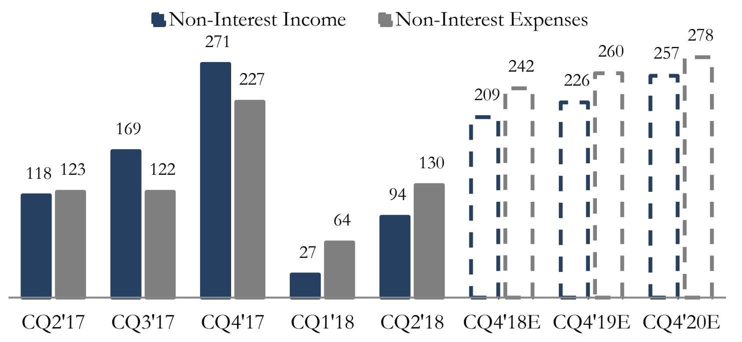
Source: NSE, Bloomberg, PAC Research,

Unimpressive performance from non-interest income and non-interest expenses

Trading income reduced by 40.06% to ₦36.81 billion in H1’18 (vs. ₦65.14 billion reported in H1’17), due to a loss of ₦18.59 billion in derivatives trading (vs. a gain of ₦46.42 billion in H’17)

The bank reported an unimpressive performance in non-interest income as it abridged by 20.86% to ₦93.53 billion in H1’18, from ₦118.18 billion reported in H1’17. This can be ascribed to a significant reduction in trading income. Trading income reduced by 40.06% to ₦36.81 billion in H1’18 (vs. ₦65.14 billion reported in H1’17), due to a loss of ₦18.59 billion in derivatives trading (vs. a gain of ₦46.42 billion in H1’17). The loss in trading income trivialised the impressive performance of treasury bill trading income and bond trading income. Treasury bill trading income increased by 192.59% to ₦55.09 billion in H1’18 (vs. ₦18.28 billion achieved in H1’17) while bond trading income rose by 357.97% to ₦316 million (from ₦69 million in H1’17) Another concern lies with non-interest expenses as it increased by 6.40% to ₦130.41 billion in H1’18 (vs. ₦122.56 billion recorded in H1’17), mainly as a result of increase in personnel expenses and operating expenses. Personnel expenses increased by 12.16% while operating expenses increased by 1.50% to ₦34.81 billion (vs. ₦31.03 billion in H1’17) and ₦86.52 billion in H1’18 (vs. ₦85.25 billion in H1’17) respectively.

Fig. 8: Non-Int. Income and Non-Int. Expense: CQ2'17-CQ4'20E (Billion NGN)



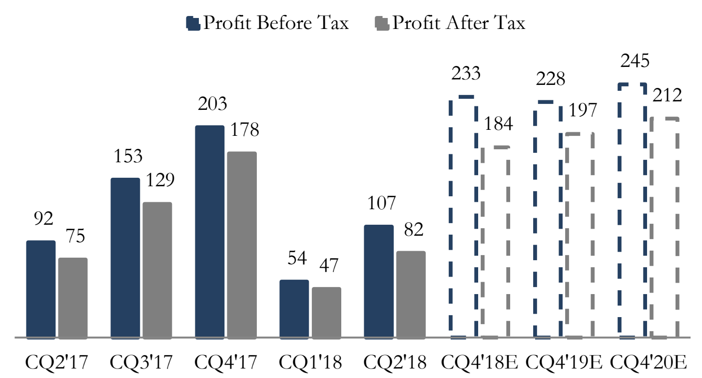
Source: NSE, Bloomberg, PAC Research

Lower provision for impairment charge for credit loss saves bottom line as it grew by 25.55% YoY

The unimpressive performance of the bank, particularly in the area of non-interest activities, almost put the profitability of the company in jeopardy but lower provision for impairment charge for credit loss in the first half of 2018 saves the day. A provision of ₦9.72 billion was made in H1'18 (H1'17: ₦42.40 billion) for impairment charge for credit loss and this represents a decline of 77.07%. With a significant progress in retail banking, evidenced by a remarkable increase in the volume of transactions on various electronic platforms as well as increase in customer acquisitions, fees on electronic products grew by 87.30% to ₦10.01 billion in H1'18 (vs. ₦5.38 billion in H1'17). As a result, fee and commission income rose by 23.72% to ₦46.71 billion in the H1'18 (vs. ₦37.75 billion in H1'17). On the back of the significant improvement in fee and commission income, enhanced net interest income and lower provision for impairment loss on financial assets , profit before tax grew by 16.46% to ₦107.36 billion in H1'18 (vs. ₦92.18 billion in H1'17). However, adequate provision was made for tax in H1'18 as it increased by 51.91% to ₦25.62 billion, from ₦16.87 billion in H1'18. As a result, profit after tax increased by 8.52% to ₦81.74 billion in H1'18 (vs. ₦75.32 billion reported in H1'17).

On the back of the significant improvement in fee and commission income, enhanced net interest income and lower provision for impairment loss on financial assets , profit before tax grew by 16.46% to ₦107.36 billion in H1'18 (vs. ₦92.18 billion in H1'17).

Fig. 9: Profit before Tax and Profit after Tax (CQ2'17-CQ4'20E) (Billion NGN)



Source: NSE, Bloomberg, PAC Research

The bank rewarded shareholders with improved interim dividend: Balance sheet remains strong and liquid

During the period under review, the bank rewarded shareholders with improved interim dividend as it increased by 20.00% to ₦0.30 in the first half of 2018, from ₦0.25 in the first half of 2017. On August 24 2018, dividends will be paid electronically to shareholders whose names appear on the Register of Members as at August 17, 2018.

The balance sheet of the company remains strong as total assets improved by 6.68% to ₦5.26 trillion in H1'18 (vs. ₦4.93 trillion in H1'17) while total liabilities increased by 7.82% to ₦4.54 trillion in H1'18 from ₦4.21 trillion reported in H1'17. Consequently, net asset remained relatively flat at ₦719.51billion in H1'18 (vs. ₦719.33 billion published in H1'17). As a result of high non-performing loans experienced in the banking sector in the recent years, the bank continue to monitor its loans and advances as it declined by 14.36% to ₦1.87 trillion in H1'18 (vs. ₦2.19 trillion reported in H1'17). Consequently, non-performing loan ratio remains at 4.90% in H1'18 (vs. 4.3% recorded in H1'17). Liquidity and capital adequacy ratio of the bank in H1'18 are strong at 77.0% (H1'17: 61.1%) and 21.0% (H1'17: 21.0%) respectively. Impressively, these are well above industry requirements of 30% for liquidity and 15% for capital adequacy ratio.

…the bank rewarded shareholders with improved interim dividend as it increased by 20.00% to ₦0.30 in the first half of 2018, from ₦0.25 in the first half of 2018

Fig. 10: Loan by Sectors – H1'18

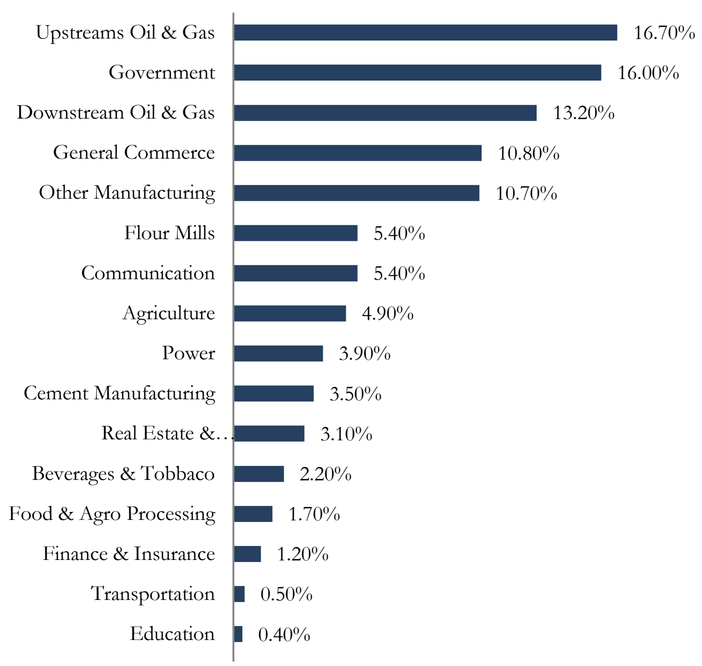
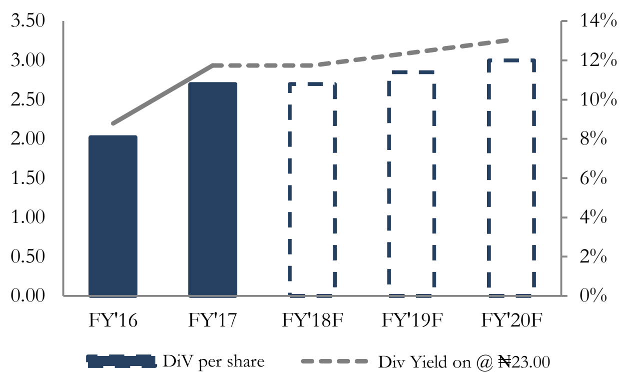


Fig. 11: Dividend Per Share and Dividend Yield (FY'16-FY'20F)



Source: NSE, PAC Research

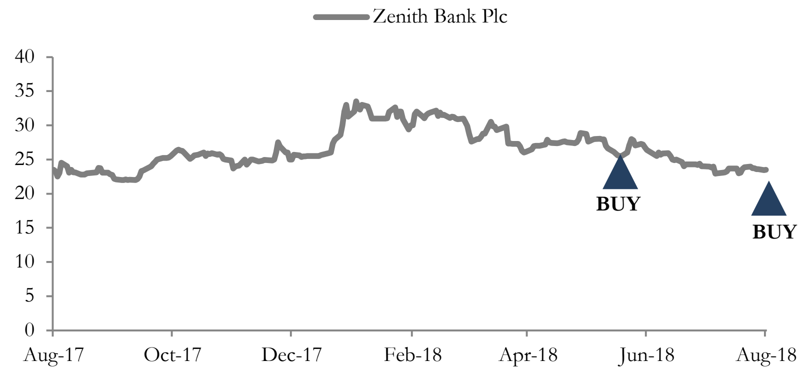
Valuation

Our valuation puts the target price of the stock of the bank at ₦31.27, representing an increase of 35.95% from the current price of ₦23.00. In arriving at the target price, we employed Dividend Discount 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 bright outlook from the management.

Our valuation puts the target price of the stock of the bank at N31.27, representing an increase of 35.95% from the current price of N23.00

Fig. 12: Share Price History



Source: NSE, PAC Research

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

	2016	2017	2018E	2019E
Gross Earnings	507,997	745,189	674,396	748,580
Change		46.69%	-9.50%	11.00%
Interest and Similar Income	384,557	474,628	465,333	522,509
Change		23.42%	-1.96%	12.29%
Interest and Similar Expenses	-144,378	-216,637	-143,646	-172,173
Change		50.05%	-33.69%	19.86%
Net Interest Income	240,179	257,991	321,687	350,335
Change		7.42%	24.69%	8.91%
Impairment Charge for credit losses	-32,350	-98,227	-25,627	-29,943
Change		203.64%	-73.91%	16.84%
Fees and Commission Income	68,444	90,143	91,043	95,818
Change		31.70%	1.00%	5.24%
Trade gains	28,398	157,974	70,812	48,658
Change		456.29%	-55.18%	-31.29%
Personnel expenses	-59,326	-64,459	-69,463	-77,852
Change		8.65%	7.76%	12.08%
Profit Before Taxation	156,748	203,461	232,532	227,568
Change		29.80%	14.29%	-2.13%
Taxation	-27,096	-25,528	-48,832	-30,722
Change		-5.79%	91.29%	-37.09%
Profit After Taxation	129,652	177,933	183,700	196,846
Change		37.24%	3.24%	7.16%

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

	2016	2017	2018E	2019E
Cash and balances	669,058	957,663	910,435	1,003,097
Treasury bills	557,359	936,817	917,179	943,210
Assets pledged as collateral	328,343	468,010	492,309	509,034
Due from other banks	459,457	495,803	438,357	486,577
Derivative assets	82,860	57,219	35,069	38,926
Loans and advances	2,289,365	2,100,362	1,888,309	2,096,023
Investment securities	199,478	330,951	370,918	374,290
Deffered tax assets	6,440	9,561	9,104	10,106
Other assets	37,536	92,494	91,043	101,058
Property and equipment	105,284	133,384	148,367	160,945
Total Assets	4,739,825	5,595,253	5,316,601	5,738,986
Customer deposits	2,983,621	3,437,915	3,237,101	3,480,895
Derivative Liabilities	66,834	20,805	18,816	20,885
Other liabilities	208,680	233,481	215,807	239,545
On lending facilities	350,657	383,034	404,638	426,690
Borrowings	263,106	356,496	330,454	325,632
Debt securities issued	153,464	332,931	370,918	441,662
Total Liabilities	4,035,360	4,773,595	4,584,544	4,942,871
Net Assets	704,465	821,658	732,057	796,114
Total equity and liabilities	4,739,825	5,595,253	5,316,601	5,738,986

Fig. 15: Profitability Ratio

	2016	2017	2018E	2019E
Return on Equity	18.40%	21.66%	25.09%	24.73%
Return on Assets	2.74%	3.18%	3.46%	3.43%
Net int. income to Rev.	47.28%	34.62%	47.70%	46.80%
PBT margin	30.86%	27.30%	34.48%	30.40%
Net Profit Margin	25.52%	23.88%	27.24%	26.30%
ROCE	4.71%	5.15%	6.04%	5.49%

Fig. 16: Asset Utilisation

	2016	2017	2018E	2019E
Cash/Revenue	131.71%	128.51%	135.00%	134.00%
Revenue to total assets (x)	10.72%	13.32%	12.68%	13.04%
Interest Inc. / Total Assets	8.11%	8.48%	8.75%	9.10%
Other Inc./ Total Assets	0.56%	0.40%	0.32%	0.39%
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	2019E
Current ratio	1.17	1.17	1.16	1.16
Cash ratio	0.17	0.20	0.20	0.20
Interest Coverage ratio	1.09	0.94	1.62	1.32
Liquid Assets/Total Deposit	0.48	0.65	0.68	0.67
Loans & Adv./Total Deposit	0.77	0.61	0.58	0.60
Liquid Assets/Total Assets	0.30	0.40	0.41	0.40
Debt/net income	3.21	3.87	3.82	3.90
Debt to asset	0.09	0.12	0.13	0.13
Debt to equity	0.59	0.84	0.96	0.96
Total Liabilities / Total Asset	0.85	0.85	0.86	0.86
Cost to income ratio	0.53	0.53	0.51	0.53
Net int. margin	0.10	0.09	0.08	0.08
Total liabilities/equities	5.73	5.81	6.26	6.21

Fig. 18: Shareholders' Investment Ratios

	2016E	2017E	2018E	2019E
Earnings per share	4.13	5.67	5.85	6.27
DiV per share	2.02	2.70	2.70	2.85
NAVPS	22.44	26.17	23.32	25.36
Earnings yield	17.95%	24.64%	25.44%	27.26%

Fig. 19: Capital Adequacy Ratios

	2016E	2017E	2018E	2019E
Loans and Advances/Equity	3.25	2.56	2.58	2.63
Equity/Total Assets	0.15	0.15	0.14	0.14
Loan Loss Expense/ Equity	0.05	0.12	0.04	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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