Zenith Bank Plc

Non-interest Income Drives Earnings

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INVESTMENT SUMMARY

In the banking industry, Zenith Bank is notable for improved financial results and the unaudited report for the first quarter of 2020 is not exempted as gross earnings increased by 5.50% to ₦166.81 billion (vs. ₦158.11 billion in the first quarter of 2019), due to higher non-interest income. Mainly as a result of foreign currency revaluation gain and derivative income, non-interest income rose significantly by 42.82% to ₦46.64 billion in Q1'20 (vs. ₦32.66 billion in Q1'19). However, the interest income line of the bank suffered a setback as it fell by 6.65% to ₦114.33 billion in the first quarter of 2020 (vs. ₦122.48 billion in the first quarter of 2019). The setback in the interest income line can be mainly attributed to the lower interest income from treasury bills, as a result of lower yield and contraction in T-bills portfolio during the period. Impressively, the bank benefited from the lower rates in Q1'20 as interest expense fell by 9.67% to ₦32.83 billion (vs. ₦36.34 billion in Q1'19). Meanwhile, operating expenses increased by 10.10% to ₦65.40 billion (vs. ₦59.40 billion in Q1'19) while loan impairment charge rose significantly by 88.50% to ₦3.95 billion in Q1'20 (vs. ₦2.10 billion in Q1'19).

The benefit derived from the non-interest income line reflected on the profitability of the bank as profit before tax increased by 2.61% to ₦58.79 billion in Q1'20 (vs. ₦57.29 billion in Q1'19). The bank made a higher provision of ₦8.26 billion for tax (vs. ₦7.06 billion in Q1'19) and as a result, profit after tax increased marginally by 0.58% to ₦50.53 billion in Q1'20 (vs. ₦50.23 billion in Q1'19). Impressively, the 12-month trailing EPS improved by 6.39% to ₦6.66, from ₦6.26 recorded in the previous period. Based on the figures released by the bank, we maintain a **BUY** rating on the stock at the current price of ₦15.85 as present forward estimate places the company share price at ₦25.67 (Previous target price: ₦25.48).

Fig. 1: Quarterly results highlights

	1Q2020	4Q2019	1Q2019	Q/q Δ	Y/y Δ
Gross Earnings (₦'mn)	166,814	170,983	158,111	-2.44%	+5.50%
Net Int. Income (₦'mn)	81,501	52,404	86,137	+5.52%	-5.38%
Net profit (₦'mn)	50,526	58,120	50,234	-13.07%	+0.58%

Source: NSE, Bloomberg, PAC Research

Price:	
- Current	₦15.85
- Target	₦25.67
Recommendation:	**STRONG BUY**

** As at Tuesday May 19, 2020*

Fig. 2: Stock data

FYE	December
Price Mov't: YtD / 52wk	-14.78%/-19.13%
52-week range	₦23.00 - ₦10.70
30-day Average vol.	32,541,340
Shares Outstanding ('mn)	31,396.49
Market Cap. (₦bn)	497.63
EPS (₦) – 12 Months Trailing	6.66
DPS (₦) - FY2019	2.80

Source: NSE, Bloomberg, PAC Research

Fig. 3: Key ratios

	Q1'20	Q1'19
Net Interest Margin	7.70%	8.90%
Net profit margin	30.29%	31.77%
Equity multiplier	7.70	7.53
Cash/ total Assets	17.94%	16.43%

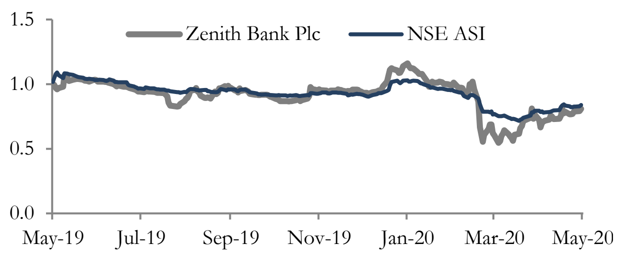
Source: NSE, Bloomberg, PAC Research

Fig. 4: Valuations

	FY2018	FY2019	FY2020E	FY2021F
P/E (x)	2.57	2.38	2.61	2.58
P/B (x)	0.61	0.53	0.55	0.54
Div Yield	17.67%	17.67%	17.35%	17.67%
Payout Ratio	45.45%	42.09%	45.25%	45.55%
EV/Revenue	1.53	1.03	1.48	1.50
Rev per share	20.08	21.09	20.67	21.39
ROE	23.71%	22.17%	21.18%	21.00%
ROA	3.25%	3.29%	2.70%	2.70%

Source: NSE, Bloomberg, PAC Research

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

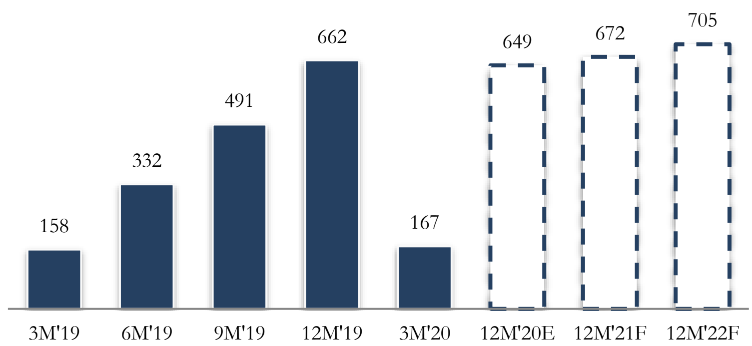


Source: Bloomberg, PAC Research

Gross earnings rises by 5.50% year-on-year, due to higher non-interest income: In the first quarter of 2020, the figure released by the Zenith Bank for the gross earnings improved by 5.50% to ₦166.81 billion (vs ₦158.11 billion in the first quarter of 2019), mainly as a result of significant rise in the non-interest income. The bank's non-interest income improved by 42.82% to ₦46.64 billion in three-month to March 2020 (vs. ₦32.66 billion in three-month to March 2019). The rise in non-interest income can be attributed to the significant improvement in derivatives income and higher foreign currency revaluation gain during the period. However, the bank reported a lower figure for interest and similar income as it fell by 6.65% to ₦114.33 billion in three-month to March 2020 (vs. ₦122.48 billion reported in three-month to March 2019). The setback in the interest income line of the bank can be mainly attributed to the lower interest income from treasury bills as a result of lower yield and contraction in T-bills portfolio of the bank during the period.

The rise in non-interest income can be attributed to the significant improvement in derivatives income and higher foreign currency revaluation gain during the period

Fig. 6: Grosss Earnings – 3M'19 –12M'22F (Billion NGN)



Source: NSE, Bloomberg, PAC Research

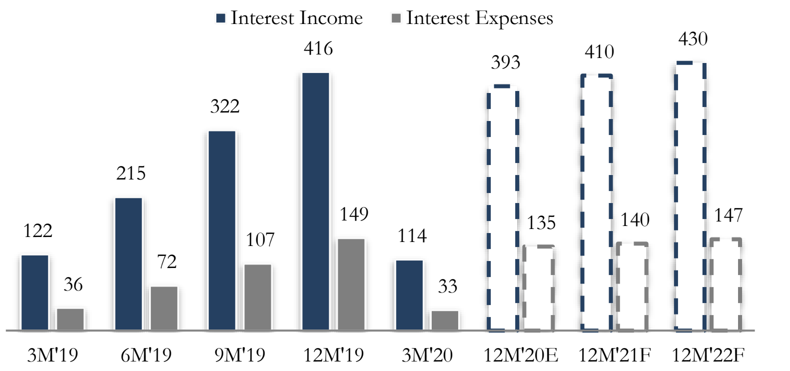
Even with higher interest income from loans and advances to customers, total interest income falls by 6.65% year-on-year: In three-month to March 2020, the bank benefited from higher loan-to-deposit ratio, as instructed by the Central Bank of Nigeria. In line with our projection, interest income from loans and advances to customers increased by 15.85% to ₦67.54 billion in Q1'20 (vs. ₦58.30 billion in Q1'19). In addition, interest income from government & other bonds increased by 22.70% to ₦20.43 billion in Q1'20 (vs. ₦16.65 billion in Q1'19) as the bank continue to enjoy long term position taken in the bond market when rates were high. However, the bank's interest income from treasury bills fell significantly by 63.91% to ₦15.31 billion in Q1'20 (vs. ₦42.41 billion in Q1'19) due to the lower yield in the money market and contraction in T-bills portfolio during the period. The lower interest income from the treasury bills outweighed the increase in interest income from government bond, loans and advances in the first quarter of 2020.

…the bank reported improved figures for interest income from treasury bills, government & other bonds and placement with banks and discount houses…

Consequently, total interest income fell by 6.65% to ₦114.33 billion in Q1'20 (vs. ₦122.48 billion in Q1'19).

With significant drop in interest expenses on borrowed funds and current accounts, total interest expenses fell by 9.67% to ₦32.83 billion in Q1'20 (vs. ₦36.43 billion in Q1'19). Total interest expenses on borrowed funds declined by 38.98% to ₦10.96 billion (vs. ₦17.97 billion reported in Q1'19) while interest expenses on current accounts declined by 25.61% to ₦2.24 billion in Q1'20 (vs. ₦3.01 billion reported in Q1'19). However, interest expenses on savings accounts and time deposits rose by 22.34% and 29.97% to ₦5.59 billion (vs. ₦4.57 billion in Q1'19) and ₦14.04 billion in Q1'20 (vs. ₦10.81 billion in Q1'19) respectively.

Fig. 7: Interest Income and Interest Expenses: 3M'19-12M'22F (Billion NGN)



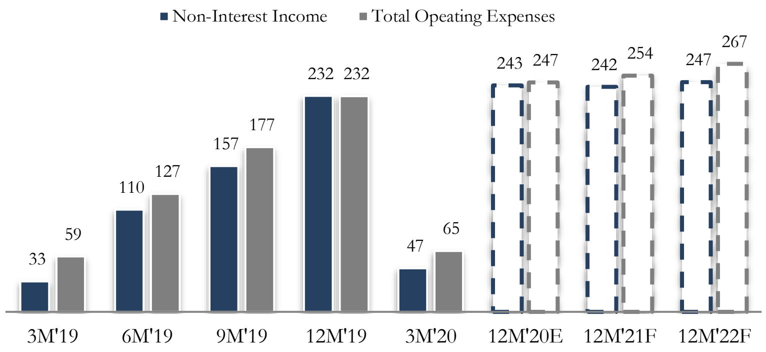
Source: NSE, Bloomberg, PAC Research,

Foreign curency revalution gain outweighs the lower income from fee and commission as non-interest income rises by 42.82% year-on-year: The Central Bank of Nigeria reduced the bank charges across board in the beginning of 2020 and this impacted the net fee and commission income of Zenith Bank as it fell by 27.57% to ₦15.44 billion in the first quarter of 2020 (vs. ₦21.32 billion reported in the first quarter of 2019). The decline in fee and commission income lines can be mainly ascribed to the lower fees on electronic products, which fell by 37.72% to ₦5.44 billion in Q1'20 (Q1'19: ₦8.74 billion). However, the bank reported significant improved figures for trading income and foreign currency revaluation gain. Mainly as a result of derivative income of ₦0.83 billion in Q1'20 (Q1'19: derivative loss of ₦6.09 billion), total trading income increased by 98.02% to ₦15.48 billion (vs. ₦7.81 billion in Q1'19). In addition, the bank recorded a foreign currency revaluation gain of ₦14.68 billion in Q1'20 (vs. ₦3.34 billion in Q1'19). The gain from derivatives and foreign currency revaluation outweighed the setback recorded in fee and commission income line of the bank and as a result, non-interest income increased by 42.82% to ₦46.64 billion in Q1'20 (vs. ₦32.66 billion in Q1'19).

The decline in fee and commission income lines can be mainly ascribed to the lower fees on electronic products, which fell by 37.72% to ₦5.44 billion in Q1'20…

However, the operating expenses of the bank increased by 10.10% to ₦65.40 billion in Q1'20 (vs. ₦59.40 billion in Q1'19), due to higher expenses on deposit insurance premium, information technology, fuel and maintenance, among others. Although, operating expenses increased by 10.10% in the first quarter of 2020, this is lower than the inflation rate of 12.26% for the month of March 2020.

Fig. 8: Non-Int. Income & Total Op. Expense: 3M'19-12M'22F (Billion NGN)

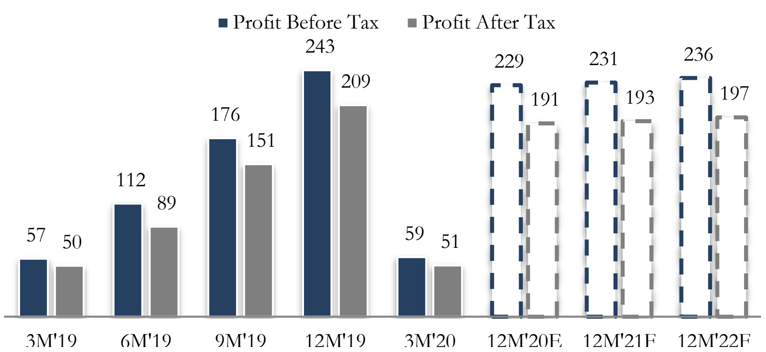


Source: NSE, Company's Results, PAC Research

PBT increases by 2.61% year-on-year, driven by non-interest income: In addition to the lower interest income recorded in the first quarter of 2020, the bank reported an unimpressive figure for impairment charges as it increased by 88.50% to ₦3.95 billion (vs. ₦2.10 billion in the first quarter of 2019), due to the higher expected credit losses on loans and advances. This is in line we our projection as we expect the new minimum loan-to-deposit ratio requirement by the CBN to have adverse effects on the non-performing loans of the banks. However, the benefit derived from the non-interest income lines outweighed the lower interest income and higher impairment charge during the period. As a result, profit before tax increased by 2.61% to ₦58.79 billion in Q1'20 (vs. ₦57.29 billion reported in Q1'19). However, the bank made a lower provision of ₦8.26 billion for tax during the period (Q1'19: ₦7.06 billion) and as a result, profit after tax rose marginally by 0.58% to ₦50.53 billion in Q1'20 (vs. ₦50.23 billion in Q1'19).

…the benefit derived from the non-interest income lines outweighed the lower interest income and higher impairment charge during the period. As a result, profit before tax increased by 2.61%...

Fig. 9: Profit before Tax and Profit after Tax – 3M'19-12M'22F (Billion NGN)



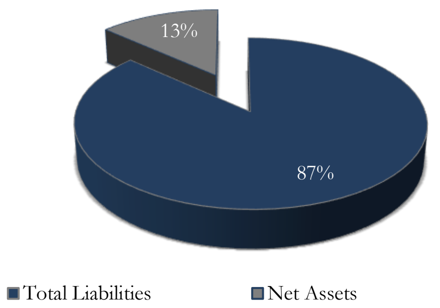
Source: NSE, Bloomberg, PAC Research

Balance sheet remains healthy and solid; Expectation of interim dividends in half year of 2020: The bank's consistency in solid and improved balance sheet continued in the first quarter of 2020, as mirrored in the strong liquidity ratio, capital adequacy ratio and non-performing loans ratio. Liquidity (41.8%) and Capital Adequacy Ratio (19.6%) of the bank in the first quarter of 2020 are well above the industry requirements of 30% for liquidity ratio and 15% for capital adequacy ratio. In addition, the non-performing loan ratio of the bank remained healthy at 4.3%, even with loan-to-deposit ratio (bank) of 71.7% in the first quarter of 2020. About 25% of the bank's total loan is accounted for the oil sector, followed by other manufacturing sector.

…the non-performing loan ratio of the bank remained healthy at 4.3%, even with loan-to-deposit ratio (bank) of 71.7% in the first quarter of 2020.

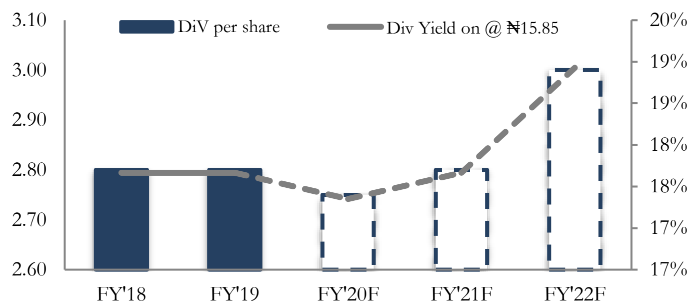
Total assets of the bank rose by 21.24% to ₦7.13 trillion in Q1'20 (vs. ₦5.88 trillion in Q1'19), due to the significant increase in total loans and advances to customers. In line with the CBN directive on LDR, the bank increased its total loans and advances by 43.99% to ₦2.58 trillion in Q1'20 (vs. ₦1.79 trillion in Q1'19). However, total liabilities of the bank rose by 21.65% to ₦6.20 trillion in Q1'20 (vs. ₦5.10 trillion in Q1'19), mainly as a result of higher deposit during the period. Consequently, net asset increased by 18.58% to ₦925.94 billion in Q1'20 (vs. ₦780.89 billion in Q1'19) and this translated to a net asset per share of ₦29.49 (Q1'18: ₦24.87). With the robust balance sheet and improved EPS, we expect the bank to pay interim dividend in the half year of 2020.

Fig. 10: Total Liabilities Vs Net Asset - Q1'20



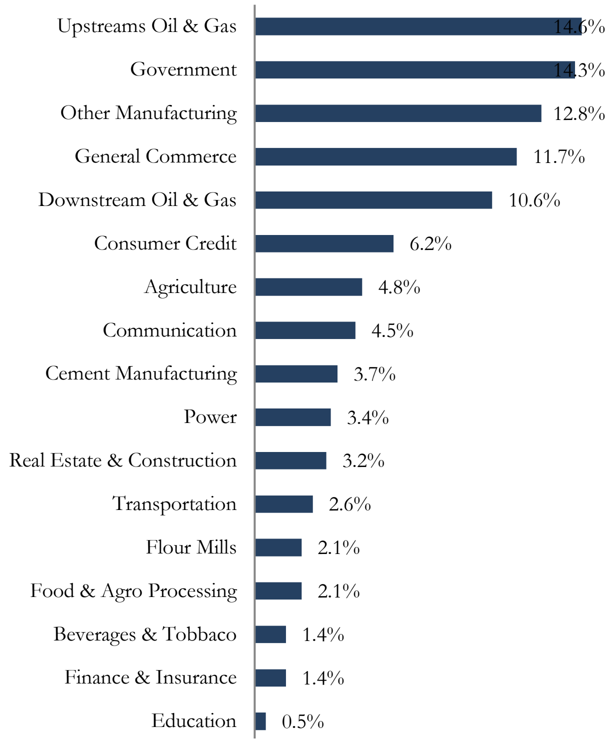
Source: NSE, PAC Research

Fig. 11: Dividend Per Share and Dividend Yield (FY'18-FY'22F)



Source: NSE, Zenith Bank, PAC Research

Fig. 12: Loans by Sector - Q1'20



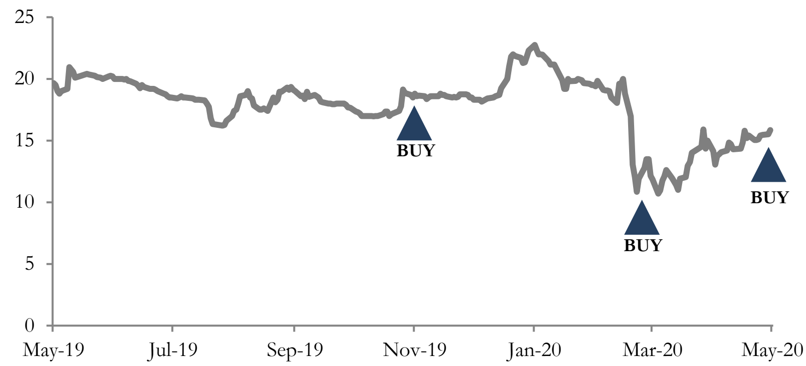
Valuation

Our valuation puts the target price of the stock at ₦25.67, representing an increase of 61.98% from the current price of ₦15.85. 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 bank.

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, the impacts of COVID-19 on businesses and outlook from the management.

Our valuation puts the target price of the stock at N25.67, representing an increase of 61.98% from the current price of N15.85.

Fig. 13: Share Price History (Naira)



Source: NSE, PAC Research

Fig. 14: Statement of Profit or Loss, N'mn

	2018	2019	2020E	2021F
Gross Earnings	630,344	662,251	649,006	671,721
Change		5.06%	-2.00%	3.50%
Interest and Similar Income	440,052	415,563	392,649	409,750
Change		-5.57%	-5.51%	4.36%
Interest and Similar Expenses	-144,458	-148,532	-134,993	-139,718
Change		2.82%	-9.12%	3.50%
Net Interest Income	295,594	267,031	257,655	270,032
Change		-9.66%	-3.51%	4.80%
Impairment Charge for credit losses	-18,372	-24,032	-25,960	-26,869
Change		30.81%	8.02%	3.50%
Net Fees and Comm. Income	81,814	100,106	84,371	100,758
Change		22.36%	-15.72%	19.42%
Trade gains	80,202	117,798	120,066	117,551
Change		46.88%	1.93%	-2.09%
Personnel expenses	-68,556	-77,858	-77,167	-79,868
Change		13.57%	-0.89%	3.50%
Profit Before Taxation	231,685	243,294	228,515	231,139
Change		5.01%	-6.07%	1.15%
Taxation	-38,261	-34,451	-37,705	-38,138
Change		-9.96%	9.45%	1.15%
Profit After Taxation	193,424	208,843	190,810	193,001
Change		7.97%	-8.63%	1.15%

Fig. 15: Statement of Financial Position, N'mn

	2018	2019	2020E	2021F
Cash and balances	954,416	936,278	1,135,760	1,074,754
Treasury bills	1,000,560	991,393	908,608	926,975
Assets pledged as collateral	592,935	431,728	421,854	436,619
Due from other banks	674,274	707,103	843,708	839,651
Derivative assets	88,826	92,722	94,106	97,400
Loans and advances	1,823,111	2,305,565	2,725,825	2,821,229
Investment securities	565,312	591,097	579,562	599,847
Deffered tax assets	9,513	11,885	11,885	12,980
Other assets	80,948	77,395	77,395	129,801
Property and equipment	149,137	185,216	185,216	188,212
Total Assets	5,955,710	6,346,879	7,056,642	7,155,846
Customer deposits	3,690,295	4,262,289	4,510,592	4,601,290
Derivative Liabilities	16,995	14,762	38,940	40,303
Other liabilities	231,716	363,764	843,708	806,065
On lending facilities	393,295	392,871	389,404	403,033
Borrowings	437,260	322,479	311,523	322,426
Debt securities issued	361,177	39,092	51,920	53,738
Total Liabilities	5,139,959	5,404,993	6,155,887	6,236,998
Net Assets	815,751	941,886	900,755	918,847
Total equity and liabilities	5,955,710	6,346,879	7,056,642	7,155,846

Fig. 16: Profitability Ratio

	2018	2019	2020E	2021F
Return on Equity	23.71%	22.17%	21.18%	21.00%
Return on Assets	3.25%	3.29%	2.70%	2.70%
Net int. income to Rev.	46.89%	40.32%	39.70%	40.20%
PBT margin	36.76%	36.74%	35.21%	34.41%
Net Profit Margin	30.69%	31.54%	29.40%	28.73%
ROCE	5.36%	5.45%	4.35%	4.35%

Fig. 17: Asset Utilisation

	2018	2019	2020E	2021F
Cash/Revenue	151.41%	141.38%	175.00%	160.00%
Revenue to total assets (x)	10.58%	10.43%	9.20%	9.39%
Interest Inc. / Total Assets	7.39%	6.55%	5.56%	5.73%
Other Income/ Total Assets	0.30%	0.22%	0.55%	0.33%
Rev. to total fixed assets	422.66%	357.56%	344.83%	344.83%
fixed asset turnover	23.66%	27.97%	29.00%	29.00%

Fig. 18: Liquidity Ratios

	2018	2019	2020E	2021F
Current ratio	1.16	1.17	1.15	1.15
Cash ratio	0.19	0.17	0.18	0.17
Interest Coverage ratio	1.60	1.64	1.69	1.65
Liquid Assets/Total Deposit	0.68	0.59	0.58	0.57
Loans & Adv./Total Deposit	0.49	0.54	0.60	0.61
Liquid Assets/Total Assets	0.42	0.40	0.37	0.36
Debt/net income	4.13	1.73	1.90	1.95
Debt to asset	0.13	0.06	0.05	0.05
Debt to equity	0.98	0.38	0.40	0.41
Total Liabilities / Total Asset	0.86	0.85	0.87	0.87
Cost to income ratio	0.49	0.49	0.52	0.52
net interest margin AVERAGED	0.08	0.09	0.09	0.09
Total liabilities/equities	6.30	5.74	6.83	6.79

Fig. 19: Shareholders' Investment Ratios

	2018	2019	2020E	2021F
Earnings per share	6.16	6.65	6.08	6.15
DiV per share	2.80	2.80	2.75	2.80
NAVPS	25.98	30.00	28.69	29.27
Earnings yield	38.87%	41.97%	38.34%	38.78%

Fig. 20: Capital Adequacy Ratios

	2018	2019	2020E	2021F
Loans and Advances/Equity	2.23	2.45	3.03	3.07
Equity/Total Assets	0.14	0.15	0.13	0.13
Loan Loss Expense/ Equity	0.02	0.03	0.03	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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