

15 August 2016

Zenith Bank Plc. | Earnings Report

6 months ended 30th June, 2016

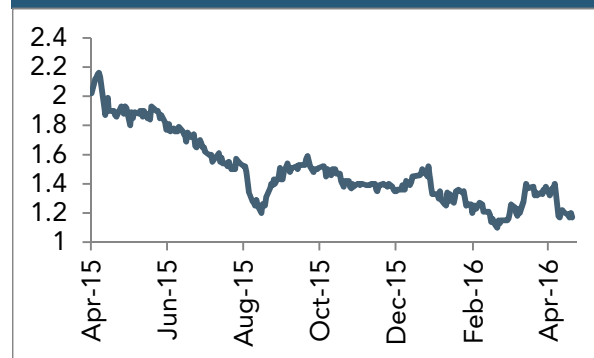
Higher loan loss charges dampen earnings (NEUTRAL: ₦16.54)

- Zenith Bank Plc. (Zenith) released audited H1 2016 results wherein gross earnings declined 6% YoY to ₦214 billion with PBT and PAT sliding 12% and 16% YoY to ₦63.3 billion and ₦44.8 billion respectively. Relative to our estimates, PBT was largely in line while a higher effective tax relative to our forecasts drives PAT underperformance.
- In addition, Zenith declared a dividend of ₦0.25 per share as in 2015, which translates to a **dividend yield of 1.6%** using price as at last close.

Macro pressures drive higher provisioning on loan book

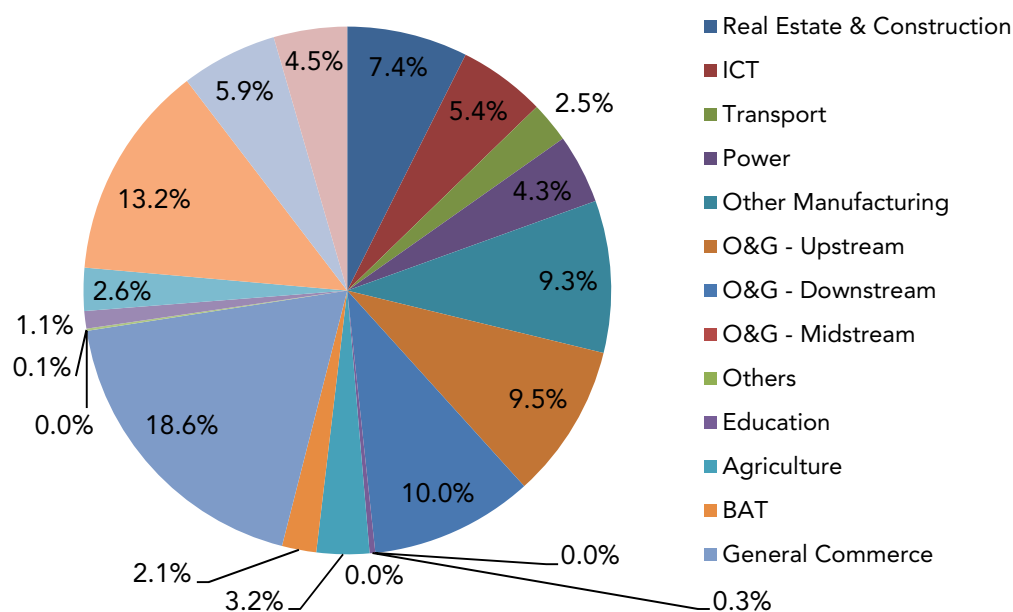
- Largely reflecting the softening economic landscape, which has resulted in worsening loan quality across the banking industry, Zenith recorded a three-fold QoQ increase in loan loss charges in Q2 16 to ₦11.7 billion. The upsurge in Q2 provisions translates to 150bps QoQ rise in annualized cost of risk to 2% (H1 16: 1.2%). Parsing through breakdowns provided the deterioration in loan quality likely stems from O&G where Zenith reports that sector NPL rose six-fold to ₦7.8 billion. Given the largely FX denominated nature of O&G loans, we believe NGN depreciation supported faster expansion in NPLs for the sector. In a similar vein, Zenith also increased provisioning on NPLs in Power and General Commerce loans.

Income Statement Data			
	2016 – 6M'm	2015 – 6M'm	%chg
Gross Earnings	214,812	229,082	-6%
PBT	63,281	72,201	-12%
Tax	(18,438)	(19,021)	-3%
PAT	44,843	53,180	-16%
Balance Sheet Data			
	2016-Jun 'm	2015 -Dec 'm	%chg
Cash	627,156	761,561	-18%
Loans	2,279,655	1,989,313	15%
Deposits	2,685,477	2,557,884	5%
Fixed Asset	94,090	87,022	8%
Net Assets	620,739	594,353	4%
Stock Data			
Price	₦15.30		
52 week range	₦8.83 – ₦18.85		
Market Cap. (N'm)	489,785		
1-month Avg. Vol	6,488,135		
Curr. PE	5.03x		
Bloomberg Ticker	ZENITHBA:NL		
Zenith Bank Plc- Share Price Trend			


Analyst(s)
Wale Okunrinboye
adewale.okunrinboye@arm.com.ng

- Assisted by higher effective tax rates (Q2 16: +24pps QoQ to 41%)¹ the elevated loan loss charge underpinned compression in PAT margins and largely accounts for 200bps QoQ compression in ROAE to 15.1%.

Figure 1: Zenith Bank Loan book by sector



Source: Company financials, ARM Research

Cutback in net long FCY positions drives subdued NIR growth

- Surprisingly despite having a sizable net long FCY position as at FY 15 (33% of net assets), Zenith reported small gains of ₦1.5 billion in other income post the 43% NGN depreciation in June. The tame gains reflect a contraction in net long positions (-50% to \$487million from FY 15) and some accounting classification which saw Zenith book ₦26 billion in FX translation gains on foreign operations in OCI. Discussion with management reveals that the adverse impact of NGN depreciation on CAR ratio informed the decision to reduce Zenith's net long FCY position which muted the scope of NIR gains.
- The tamer reading combined with lower fee income largely accounts for NIR underperformance relative to our forecasts.

¹ The higher tax rates reflect statutory requirements for advance tax payments for interim dividends.

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- Given Zenith's FCY share of loans (FY 15: 43%), the naira weakness also largely accounts for the 18% QoQ expansion in net loans during the period. However, Zenith also cut-back on FCY share of loans (H1 16: -7pps to 36%). The faster rise in risk assets post the depreciation largely underpinned moderation in CAR which dipped 240bps QoQ to 18.6%. In contrast, exchange rate depreciation did not elicit a similar expansion in deposit growth, which rose 4% QoQ.

Weaker macro environment points to higher impairment charges

- Going forward, we adjust our models to incorporate the FX translation impact on balance sheet items and CBN switch to a hawkish monetary policy stance. First, the difficult economic conditions imply that as in H1 16, when actual loan growth was flat (adjusted for FX effects), organic loan creations should remain weak. This leaves currency weakness as the source of loan book expansion in H2 16. Given Zenith's FCY share of loans, we now estimate net loans 22% higher YoY at ₦2.4 trillion (vs. our prior expectations for only 5% YoY growth). Following CBN's move to a tight monetary policy stance, we see upside to asset yields for Zenith and raise our forecasts (2016E: +70bps to 10%). Tying our expectations for asset yield and loan growth results in 2016E interest income ₦396 billion (+14% YoY).
 - Elsewhere, the weaker H1 16 NIR reading and management guidance about remaining neutral to currency movements, which reduce scale of any FX translation gains, inform our position on 2016E (-22% YoY to ₦66 billion).
 - On asset quality, the increased prospect for a recession, extended naira weakness and current run rate of loan loss charges lead to upward revisions in our annualized cost of risk assumptions to 1.8% (vs. 1.3% previously and Zenith's revised 1.5% 2016E guidance). Our more aggressive stance on provisioning reflects concerns about impact on renewed militancy in the Niger Delta and tempered oil prices on upstream O&G (H1 16: 9.5% of total loans). Furthermore, extended naira depreciation stokes pessimism on General Commerce loans (H1 16: 18.6% of loans). Our raised cost of risk estimate translates to FY 16E impairment charges of ₦44 billion. Largely reflecting the higher provisions, we forecast a drop in FY 16E
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earnings (PBT: -10% YoY to ₦112 billion, PAT: -15% YoY to ₦90 billion). In addition, management commentary during the H1 16 earnings call about increased focus on capital retention to bolster CAR inform downward adjustment to payout ratios (-10pps from prior to 45%, FY 15: 54%).

- On current pricing, both P/E and P/B of 4.9x and 0.8x are in line with Bloomberg Nigerian banking sector averages at 4.9x and 0.8x respectively. Upside implied in our **FVE (₦16.54)** relative to last trading price of ₦15.3, translates to a **NEUTRAL** rating on Zenith.

Summary of Results and Forecasts - Naira (₦)

QUARTERLY					
Income Statement (₦'000)*					
	Q1 2016A	Q2 2016A	Q3 2016E	Q4 2016E	
Gross earnings	99,435	115,377	112,583	135,485	
Interest Income	84,177	97,231	97,094	118,194	
Interest Expense	(26,020)	(28,365)	(30,144)	(42,025)	
Net interest income	58,157	68,866	66,950	76,169	
Non-Interest Revenue	15,258	18,146	16,028	16,752	
OPEX	(38,765)	(44,149)	(45,290)	(51,902)	
Provisions	(2,577)	(11,655)	(7,349)	(22,064)	
PBT	32,121	31,160	30,339	18,955	
Tax	(5,548)	(12,890)	(6,068)	1,991	
PAT	26,573	18,270	24,271	20,946	
ANNUAL					
Income Statement (₦'000)*					
	FY 2014A	FY 2015A	FY 2016F	FY 2017F	FY 2018F
Gross earnings	403,343	432,535	462,880	492,932	520,859
Interest Income	313,422	348,179	396,696	420,014	440,364
Interest Expense	(106,919)	(123,597)	(126,554)	(108,184)	(122,868)
Net interest income	206,503	224,582	270,142	311,830	317,496
Non-Interest Revenue	89,921	84,356	66,184	72,918	80,494
OPEX	(163,702)	(167,877)	(180,107)	(199,945)	(215,715)
Provisions	(13,064)	(15,673)	(43,644)	(34,051)	(31,492)
PBT	119,658	125,616	112,575	150,753	150,784
Tax	(20,341)	(19,953)	(22,515)	(30,151)	(30,157)
PAT	99,317	105,663	90,060	120,602	120,627
Balance Sheet (₦ '000)*					
Assets					
Cash & Short term funds	752,580	761,561	595,127	729,825	871,132
Net Loans	1,729,507	1,989,313	2,424,685	2,619,287	2,862,894
Fixed Assets	71,571	87,022	87,892	89,215	91,008
LT investment	351,825	478,192	410,380	416,223	422,359
Total Assets	3,755,264	4,006,842	4,206,329	4,575,600	5,025,110
Liabilities					
Deposits	2,537,311	2,557,884	2,675,411	2,942,800	3,272,589
Taxation	359,342	645,561	677,839	725,288	790,564
Borrowings	3,202,626	3,412,489	3,562,295	3,877,132	4,272,197
Total liabilities	552,638	594,353	644,034	698,468	752,913
Shareholders' fund	752,580	761,561	595,127	729,825	871,132
Key Ratios					
EPS	3.16	3.37	2.87	3.84	3.84
DPS	1.75	1.80	1.29	2.12	2.12
BVPS	17.60	18.93	20.51	22.25	23.98
ROE	18.7%	18.1%	14.5%	18.0%	16.6%
ROA	2.9%	2.7%	2.2%	2.7%	2.5%
Financial Leverage	6.80	6.74	6.53	6.55	6.67
Loan to Deposit	68.2%	77.8%	90.6%	89.0%	87.5%
Cost to income	55.2%	54.3%	53.6%	52.0%	54.2%
Cost of risk	0.8%	0.8%	1.8%	1.3%	1.1%
WACF	4.0%	4.1%	3.9%	3.1%	3.2%
Asset yields	9.4%	9.3%	10.0%	9.9%	9.4%
PE	5.82	4.94	5.33	3.98	3.98
PB	1.05	0.77	0.75	0.69	0.64
CAR	20.2%	21.3%	18.2%	18.3%	18.1%

Source: ARM Research *unless otherwise stated

ARM ratings and recommendations

ARM now employs a two-tier rating system which is based on systemic importance of the security under review and the deviation of our target price for the stock from current market price. We characterize systemic importance as a function of a stock's ranking among the group of top 20 stocks by NSE market capitalization over a trailing 6 month period (minimum) to the review date. We adopt a 5 point rating system for this category of stocks and a 3 point rating system for stocks outside this group. The choice of top 20 stocks arises from the consideration that this group of stocks constitutes >75% of overall market capitalization and stocks outside this group are generally less liquid and individually account for <<1% of market capitalization. For stocks in both categories, the basis for ratings subject to target price deviation is outlined below:

TOP 20		NON-TOP 20	
Rating	Deviation	Rating	Deviation
STRONG BUY	>20%	BUY	>20%
OVERWEIGHT	10% — 20 %	NEUTRAL	5% — 20 %
NEUTRAL	0% — 10 %	SELL	<5%
UNDERWEIGHT	-5% — 0%		
SELL	<-5%		

RECOMMENDATION KEY	
Rating	Recommendation
BUY	Accumulate security to a substantial extent constrained only by portfolio diversification considerations
OVERWEIGHT	Accumulate security to an extent moderated by cognizance of its benchmark weight
NEUTRAL	Maintain status quo for security with respect to current holding—i.e. keep if already holding and don't buy otherwise—subject reasonable portfolio constraints
UNDERWEIGHT	Minimise exposure to security taking cognizance of its index weighting
SELL	Sell-off security completely from portfolio

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