Company Research Report
12 June 2018
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CEDAR CAPITAL

Equity research | Company Research Report

MALAWI

National Bank of Malawi

Top drawer quality at reasonable price

Commercial Banking

Bloomberg Ticker	NBM.MV
Reuters Ticker	NBM.MV
Target Price	MK396.20
Market Data	**10 June 18**
Closing Price	MK300.00
52 Week High	MK300.00
52 Week Low	MK262.00
Market Cap (b)	MK140.03
Market Cap (m)	USD193.2
P/E	7.32x
P/B	1.71x
DPS Yield	6.43%

Price performance

	NBM	MSE Index
YTD	11.08%	25,44%
2017	13.87%	62,14%
2016	(8.09%)	(8,53%)
2013 -Date	25.58%	350,37%

Conservatively managed

Management is everything in a bank. Poor management can turn a well-capitalised good bank into a poor one, whilst the reverse is true. In our view NBM is one of the astutely and diligently managed institutions in Malawi. The new team is currently bedding down the Indebank acquisition whilst actively scouring the market for other attractively priced banking assets.

Well capitalised and underleveraged

Capitalisation comes in in close second to quality of management. With total capital of MK82bn, NBM has excess capital which is advantageous and provides; (a) a buffer and last line of defence against potential asset quality deterioration; (b) scope to participate in highly profitable, big ticket transactions; (c) capacity to fund acquisitions and organic growth and; (d) scope to return cash to shareholders through sustainable dividend policies.

Low cost deposits and healthy net interest margins

The net interest margin hovers around 14% p.a, a level which has been maintained in the last five years giving NBM the extraordinary ability to ride economic cycles. This characteristic is attributed to the stable cost of funding of around 2,5% p.a which is one of the lowest in the industry enabling the bank to absorb fluctuations in lending rates and treasury bill yields.

Positive GDP growth augurs well for NBM

The Malawian economy is expected to grow by at least 3.5% in 2018 and 5.5% in 2019, which gives NBM a strong earnings impetus. Empirical studies have shown that GDP growth has a positive correlation with bank profitability growth as it is normally accompanied by buoyant demand for credit.

Credit quality concerns

On the negative, is the fact that NBM was exposed to the now infamous fraud, resulting in an elevated NPL ratio. However, the bank has more than enough capital to withstand this shock.

Valuations still compelling

Our valuation method, anchored on the P/B yields an intrinsic value for NMB of MK396.20 per share, representing a potential 42% upside. We also note that NBM is trading at a forward P/B of 1.71x, which is less that the standard 2x**. Long term BUY**.

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Investment Thesis

We initiate coverage of National Bank of Malawi (NBM) with a **Long-term BUY** recommendation. Our valuation, based on the P/B metric gives us an intrinsic value of NBM of MK396.20, which is an upside of 32% on the current price.

NBM is the pre-eminent bank in Malawi, with the biggest market share in deposits and loans. It is well capitalised and the recent acquisition of Indebank allows the bank access into a niche previously served by the acquired institution. The purchase also came with a prime property portfolio, which is now classified as investment property.

The NPL ratio, at nearly 11% is obviously above the international benchmark of around 5%, but is showing a positive trend, having peaked at around 20% in FY16 following exposure to the now infamous; Cotton Ginners Africa Limited. Going forward, having learnt a lesson, NBM is targeting a single digit NPL ratio, through aggressive collections and a more thorough credit vetting and monitoring system. On the positive, the bank is well capitalised and thus, able to absorb such shocks, unlike some of the competition. A lower NPL going forward will mean that the growth in net interest income and non-funded income will filter, undiluted to the bottom line.

The solidity of NBM is further revealed by the Du Point decomposition of returns as shown in the table below.

	31-Dec-13	12-Dec-14	31-Dec-15	31-Dec-16	31-Dec-17
Jaws	0,15	(0,03)	(0,16)	(0,09)	0,04
Participating Capital	(5 620,00)	(10 914,00)	5 249,00	9 092,00	20 166,00
Equity Multiplier	5,77	5,17	5,37	4,86	4,78
ROE (EM*ROA)	46,47	36,25	27,77	26,09	25,38
Non- Interest cost of Intermediation	7,78	6,51	8,42	10,31	8,75

Source: Company Financials & Cedar Capital Research

Since 2014, the jaws have been negative, reflecting the fact that expenses were growing at a fast pace than income. However, the situation was rectified in FY17, with jaws starting to widen again as income growth outpaced expenses growth by four percentage points. FY16 is obviously distorted by the incorporation of the staff costs of Indebank, which were subsequently rationalised and higher provisioning.

Presenting a lot of headroom is the fact that the bank is underleveraged with an equity multiplier of 4.78x, when the international benchmark is 6x. This means that NMB can underwrite more business and grow its asset base without necessarily needing to raise more capital. This is a sweet spot to be in for any management team.

Company Overview

National Bank of Malawi (NBM) as we know it now arose from the merger of Barclays Bank DCO (Dominion Colonial Overseas) and Standard Chartered Bank in 1971. With its head office in Blantyre, the banking group is 52% owned by Press Corporation. In May 2016, NBM completed the acquisition and merger with Indebank for roughly MK6,6 billion, of which MK4 billion was goodwill. The bank distributes its products and services through different channels which include 31 service centres and various electronic and mobile channels.

Because of its strong roots and entrenchment into the Malawian financial services landscape, NBM has the commanding market share of deposits and loans, circa 28% and 31% respectively.

The business model is essentially that of traditional intermediation, accessing relatively low-cost deposits and on-lending to mostly corporates which comprise at least 80% of the loan book. Additionally, the advances to corporates are mostly large tickets. The biggest exposures are to wholesale & retail; agriculture and manufacturing sectors. Contrary to market perception, NBM exposure to government through both deposits and loans is very minimal.

In terms of business segments, corporate banking contributes 54% to the bottom line, followed by treasury operations, mainly in the form of foreign currency trading income with the retail division contributing the least, mainly because its loan book is much smaller when compared with the corporate banking loan book.

Economic, Market & Industry Overview

Malawi’s banking sector is largely centred on commercial banking which has 7 players comprising NBM, Standard Bank, FMB Bank, Nedbank, NBS Bank, Ecobank, and FDH Bank. There is one merchant bank, CDH Investment Bank. Standard Bank and Nedbank are South African owned while Ecobank is a subsidiary of Togolese Ecobank ETI. These players offer standard commercial banking products and services to individuals, small to medium enterprises and big corporates.

There has been a series of mergers and acquisitions, with FDH having acquired Malawi Savings Bank; FMB acquiring Opportunity International Bank and NBM swallowing Indebank.

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The banks compete with a large microfinance sector, comprising 57 registered entities which play an integral part of providing credit in the lower end of the market, together with co-operatives and village banks.

The banking sector is usually referred as the “oil” that lubricates the economy, and as such the prospects of the economy are inexorably tied to that of the sector. The banking system provides five key services: (a) savings facilities, (b) credit allocation and monitoring of borrowers, (c) facilitate payments, (d) risk mitigation, and (e) liquidity services.

	2013	2014	2015	2016	2017
Country GDP	1 924 110,08	2 534 656,29	3 212 683,76	3 818 492,51	4 659 488,21
Total Banking Assets	653 000,00	796 100,00	907 000,00	1 239 900,00	1 572 300,00
Total Deposits		481 600,00	629 400,00	809 000,00	995 500,00
Total Loans	256 600,00	304 900,00	370 800,00	438 800,00	448 700,00
Banking Assets/GDP	33,94	31,41	28,23	32,47	33,74
Deposits/GDP	-	19,00	19,59	21,19	21,37
Loans/GDP (%)	13,34	12,03	11,54	11,49	9,63
NBM Deposit Market Share (%)		30,10	34,16	28,59	27,98
NBM Loans Market Share (%)	24,52	26,02	30,74	30,38	30,66
NBM Assets to GDP (%)	9,63	9,01	8,99	8,63	8,42
Sector NPLs Ratio (%)	15,40	14,90	11,60	16,96	15,69

Source: RBM Reports, Company Financials & Cedar Capital Research

The table above shows that, NBM plays a very important role in the Malawian economy with its balance sheet almost a tenth of the GDP. At the same time, the deposit/GDP ratio at around 20%, shows that access to financial services in Malawi is very low. In a 2014 survey, FinScope found out that 51% of the adult population in the country were not using any formal, or even informal, financial products, while only 27% were formally banked and a further 15% relied on mostly microfinance products. The same survey found out that 25% of the adult population had an informal product, such as borrowing from employers, getting credit from shops or receiving inputs as credit.

This is mainly because the Malawian banking sector is structurally geared towards providing services to the narrow corporate sector and the formally employed people. *This presents a possible “mining” opportunity for banks to go lower and milk the lower income segments.*

According to the December 2017 Financial Stability Report produced by the Reserve Bank of Malawi (RBM), interest rates, another key variable for the banking sector, have been weakening, especially in the period between April 2017 and April 2018, with the Policy Rate declining from 33,6% to

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16% p.a. In tandem, the banking sector reduced their lending rates by 600 basis points (bps) to 27,5%p.a.

In terms of growth, total assets in the sector grew 29% to MK1,6 trillion, driven mostly by investments in short term securities, as lending was largely constrained. In summary, deposits expanded by 23% to MK966 billion, while credit growth was a minimal 5% to MK449 billion. This gives a sector loan to deposit ratio of 45% as at December 2017.

Credit quality was under pressure, though, with the NPLs ratio deteriorating to 15,6%. However, the sector remained profitable with an average ROE and ROA of 15,7% and 2,3% respectively.

With regards to franchise, two big banks dominate the sector with combined total deposits for the two in excess of 51%. The sector remains exposed to high concentration risk due to the limited number of large creditworthy borrowers.

On the macro-economic front, performance largely depends on weather conditions, which in the face of climatic changes are expected to be more variable. Thus, the economic outlook is greatly influenced by agriculture output, government management programs, commodity prices and donor support levels.

In terms of economic growth, according to the Reserve Bank of Malawi, economic growth rebounded to 4,5% in FY17 from the 2,7% recorded in 2016. The positive outturn was attributed to the recovery in agricultural output following good rains.

Elections in 2019 are expected to increase pressure on fiscal spending as the current administration strengthens its efforts to win a re-election. The 'empty coffers" hymn which usually accompanies an election, especially if there is a change in administration, presents elevated risks going forward.

NBM 5-year Operational and Financial Review

NBM's business model is anchored on the profitable deployment of deposits, either to the corporate sector as normal advances and/or government securities. Thus, lending rates and yields on the advances are key to performance.

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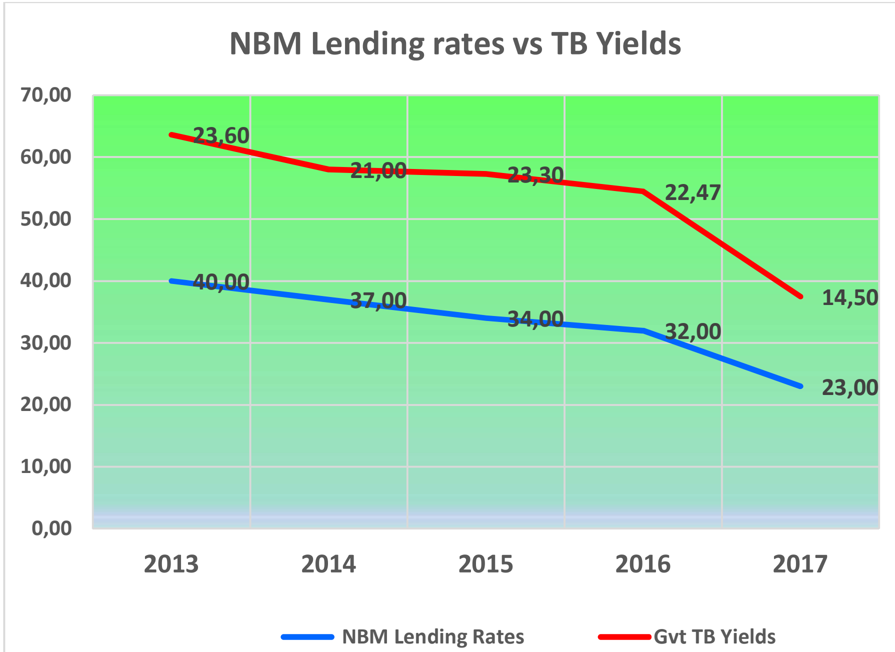
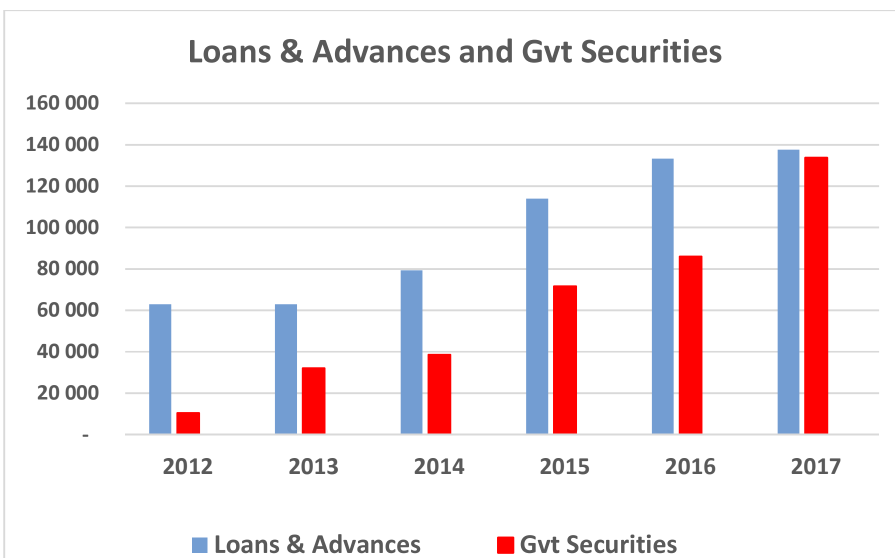


Source: Company financials

NBM's lending rates have halved from 40% p.a in 2013 to 23% p.a in FY17 and hence the endowment effect on earnings of high interests started contracting. At the same time, TB yields were weakening, closing FY17 at 14.5% p.a. However, with a reduction of good credits, NBM shifted the investment strategies from loans to TBs. This response saw the share of TBs to total interest earning assets increasing from 10% in FY13 to 40% in FY17. As such, securities are now almost equal to loans and advances as the chart below shows;



Source: Company financials

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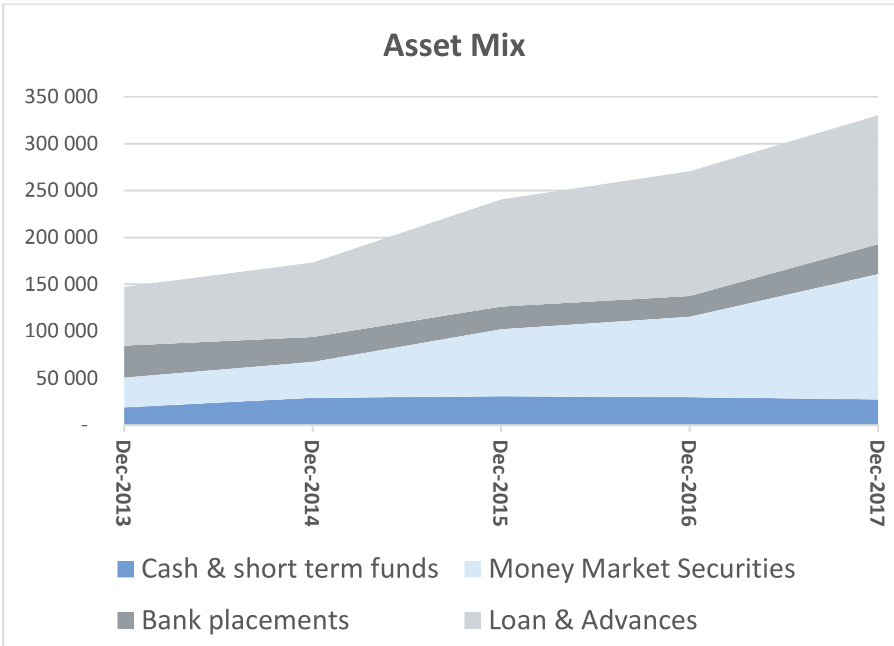
The response by the bank was informed by the fact that the economy was under pressure and risk was no longer being adequately compensated by the interest rates and TBs are attractive for three reasons: (a) their relatively high yield (around 14.5% per annum on 91-day TBs, versus an average inflation of 7.7% as at December FY17), which is tax exempt; (b) the ease with which these securities can be refinanced at the RBM's discount window; and (c) "zero weighting" of government sovereign risk in the computation of bank solvency, thus requiring no capital provision and providing a high leverage effect on profitability.

The evolution of the funding mix since 2013, informed by this shift is strategies is depicted below;



Source: Company financials & Cedar Capital Research

In terms of growth rates, the loan book expanded at a compounded annual growth rate of 17% since 2013 to MK137.6bn. The shift in strategies mentioned earlier is more illustrated by the insipid 3% increase in the loan book between FY16 and FY17. At the same time, in the last 12 months, securities grew by 76% to MK104.2bn. As such the Loan to Deposit ratio (LDR) trended down from 57% in FY16 to 50% in FY17. In total, interest earning assets of the bank grew by 5-year CAGR of 27% to MK330.4bn.

As a result of the above balance sheet movements, net interest income grew by a 34% 5-year CAGR to MK42.3bn, with most of the growth occurring in FY15 and FY16, while FY17 was an insipid 5%, reflecting the soft lending rates.

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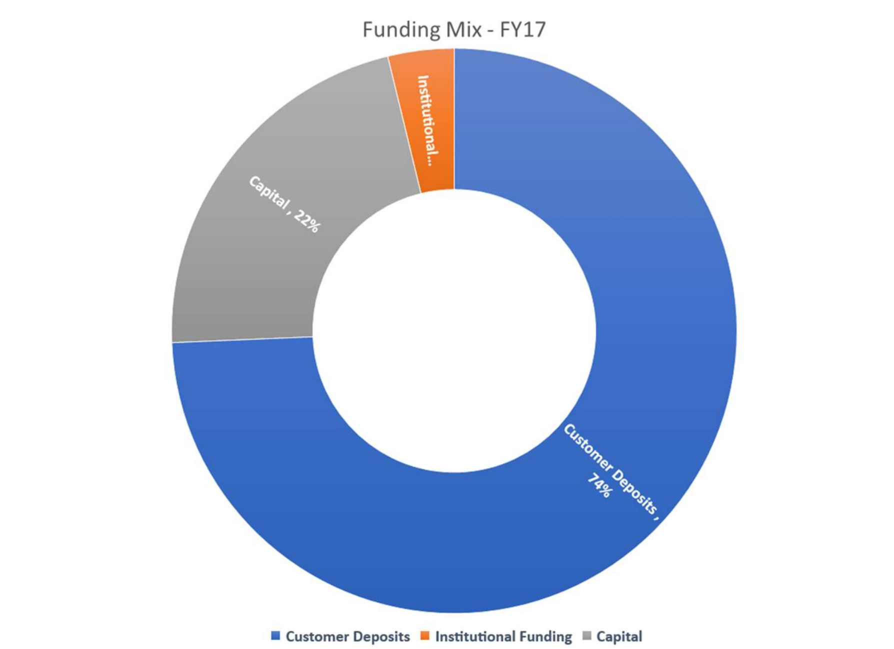
The corresponding net interest margins hovered around 14% per annum, reflecting the astute management of the asset mix by the management of the bank.

The quality of the book has, in some instances, been a cause for concern, with evolution of the NPLs ratio and provisions reflecting the quality of the book. Provisions rose steeply in FY17 to MK4.2bn following a spike in the NPLs ratio to nearly 20% in FY16. NBM was exposed to the now infamous; Cotton Ginners Africa Limited.

Non- funded income contribution to total income has in the last 5 years been maintained at nearly 40% driven by commissions and foreign currency trading income, while fair value adjustments on investment properties and equities occasionally drag the figures down.

The funding side of the balance sheet, has in the five years, remained anchored of relatively low-cost deposits. Total customer deposit mobilisation grew annually by 26% to MK278.5bn, with the most phenomenal growth occurring in FY15. The cost of funding for the bank has remained roughly at 2.5% per annum, which benefitted the net interest margins.



Source: Company financials & Cedar Capital Research

The funding structure of NBM places it in good stead to weather the storms, scarred but not killed. A 74% base of customer deposits and 22% capital buffer contributes to the low cost of funding as recourse to the interest rates sensitive institutional funding is limited to just 4%.

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Expenses have been growing in line with the inflation rate, with the exception of FY16, which is unique in that the cost figures include the integration of Indebank staff as well as the retrenchments that were effected. The absence of these costs in FY17, saw the expenses growth being flat. Stripping out the non-recurring items, expenses actually grew at the same pace with the inflation rate. The overall impact, over the years has been a marked in the cost to income ratio from a low of 46% in FY13 to the current level of 55%. What NBM has going for it, is that net interest income fully covers its operating expenses, meaning that non-funded income is a bonus and its growth fully filters to the bottom line.

The bottom line has in the past five years grown at a steady pace of 20% per annum to MK19.1bn.

In terms of returns, NBM has a ROE of 25%, which is reflecting a downward trend as the pace of profitability has not kept pace with the growth in the capital levels. This is a negative is our books.

NBM could rectify the declining ROEs by either aggressively growing earnings or shrinking the capital base by returning capital to shareholders through an enhanced dividend pay-out.

Outlook

While we do not invest much currency in 5-year strategy plans, we think the 2018 to 2022 plan by the company is not just management speak. NBM has a new C-suite team and they are keen to consolidate the bank's position in the market. The acquisition of Indebank is said to have contributed some strategic and niche assets, which the management team is now sweating and the contribution should start to be felt this financial year.

According to available data, Malawi's bank assets to GDP is lower than its peers and as the economy is expected to grow by 3.5% and 5.5% in 2018 and 2019 respectively, citizens should have more resources at their disposal which should see deposits growing as well as enhance the economy's appetite for credit. This bodes well for the aspirations of NBM of growing at least above inflation. The plan is to grow both organically and through acquisitions, whilst at the same time taking out costs from the business. As such, margins will be defended, while efficiency ratios should start to improve.

Valuation and Recommendation

We have applied equity valuation method summarised below which yield a fair value price for NBM of MK396.20, giving potential uplift 32% in the short term. **Long term BUY**

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CALCULATION OF P/B MULTIPLE

Average ROE in next 3 years	27,00%
Cost of equity	30,96%
- Risk free rate	14,00%
- Beta	2,12
-Equity Risk Premium	8%
Multinational bank adjustment	0,000
Growth	20%
Exit P/B multiple	2

VALUATION	**MK millions**	**Per Share**
NAV in FY+3	136 996.75	293,40
x exit P/B multiple	2,00	
Terminal value at Dec FY+3	273 993.51	
x Discount factor	0,51	
Present Value of terminal value	139 602.63	298.98
+ PV Dividends (2017-18e)	8 656,91	18,54
Today's fair value	148 259.54	317.52
Roll forward by cost of equity less dividend yield	24,78%	
One year forward valuation	**184 998.26**	**396.20**
Current price		300,00
Capital return		32%
Dividend yield		5%
Total return in next 12 months		**37%**

Our recommendation is supported by the ROE vs P/B which has NMB is the quadrant that we have normally regarded as good buys. Ideally, these are banks with a high ROE, above 20% and a P/B less than 2x.

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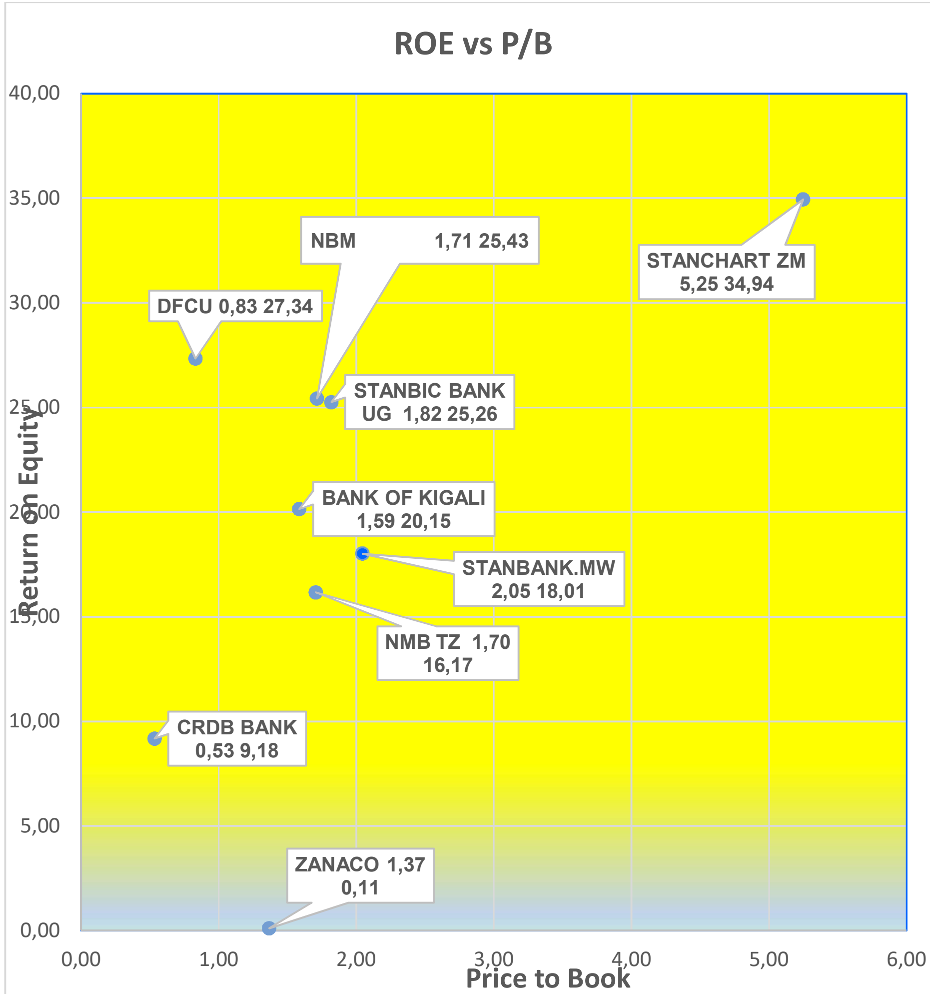

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CEDAR CAPITAL

MK millions	31-Dec-12	31-Dec-13	12-Dec-14	31-Dec-15	31-Dec-16	31-Dec-17
Interest Income	12 270	25 008	25 473	32 758	46 211	48 804
Interest Expense	(2 407)	(5 290)	(3 773)	(4 660)	(6 148)	(6 558)
Net Interest Income	**9 863**	**19 718**	**21 700**	**28 098**	**40 063**	**42 246**
Y-o-Y Growth		*99,92%*	*10,05%*	*29,48%*	*42,58%*	*5,45%*
Provision for Loan Losses	(607)	(216)	(670)	(1 816)	(783)	(4 230)
Total Interest Based Income	**9 256**	**19 502**	**21 030**	**26 282**	**39 280**	**38 016**
Total Non Funded Income	13 196	14 322	17 587	15 826	19 329	22 895
Y-o-Y Growth		*8,53%*	*22,80%*	*-10,01%*	*22,13%*	*18,45%*
Total Banking Income	**22 452**	**33 824**	**38 617**	**42 108**	**58 609**	**60 911**
Total Expenditure	(11 321)	(15 378)	(17 956)	(22 493)	(33 362)	(33 361)
Y-o-Y Growth		*35,84%*	*16,76%*	*25,27%*	*48,32%*	*0,00%*
Profit/Losses Before Taxes	**11 131**	**18 446**	**20 661**	**19 615**	**25 247**	**27 550**
Taxation	(3 418)	(5 740)	(6 132)	(6 246)	(8 642)	(8 403)
Minority Interests		(27)	(24)	(40)	(214)	
Net Profit/loss	**7 713**	**12 679**	**14 505**	**13 369**	**16 605**	**19 147**
Y-o-Y Growth		*64,38%*	*14,40%*	*-7,83%*	*24,21%*	*15,31%*
Shares ('millions)	467	467	467	467	467	467
EPS	16,52	27,15	31,06	28,63	35,56	41,01
DPS		10,49	11,55	13,22	13,29	18,54
Price	235,00	235,00	237,00	258,00	238,00	297,00
P/E	1,38	8,65	7,63	9,01	6,69	7,24
Price/NAV	0,49	0,33	2,50	2,24	1,64	1,69
DPS Yield	0%	46%	5%	5%	6%	6%
NAV/Share	46,15	68,78	94,62	115,17	145,27	175,59
Profitability Metrics						
Interest Margin (%)	11,37	15,84	13,53	13,58	15,68	14,05
Interest Spread (%)	11,16	15,36	13,26	13,37	15,45	13,80
Net Interest Income/ Average Total Assets (%)	8,90	12,53	10,49	10,86	12,96	11,71
Cost of Funding (%)	2,99	4,73	2,62	2,47	2,63	2,43
Cost of deposits (%)	2,16	3,58	2,56	2,44	2,55	2,57
Cost to Income Ratio (%)	50,42	45,46	46,50	53,42	56,92	54,77
Yield on Advances (%)	18,40	26,93	23,86	18,87	23,00	
Liquidity Ratio (%)	41,51	57,80	59,04	40,18	33,90	31,84
Impairments/Average Advances (%)	0,96	0,34	0,84	1,59	0,59	3,07
NPLS		4 155,00	7 764,00	7 040,00	26 444,00	14 002,00
NPLS/Advances (%)	-	6,60	9,79	6,18	19,84	10,18
Return on Equity (%)	41,42	47,25	38,02	27,29	27,31	25,56
Return on Assets (%)	6,96	8,06	7,01	5,17	5,37	5,31
Loans/Deposits Ratio (%)	72,02	50,80	54,72	53,01	57,63	49,40
Debt/Equity Ratio (%)	15,76	25,99	12,63	6,60	0,31	17,30
NBM Lending Rates (%)		40,00	37,00	34,00	32,00	23,00
Gvt TB Yields (%)		23,60	21,00	23,30	22,47	

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BALANCE SHEETS

	31-Dec-12	31-Dec-13	12-Dec-14	31-Dec-15	31-Dec-16	31-Dec-17
Cash & short term funds	8 797	18 830	28 992	30 550	29 774	27 098
Gvt Securities	8 173	18 974	30 075	31 694	26 943	29 526
Placements with other banks	19 347	33 784	26 516	24 129	21 683	32 052
Loan & Advances	63 001	62 918	79 322	113 975	133 287	137 575
Y-o-Y Growth		***-0,13%***	***26,07%***	***43,69%***	***16,94%***	***3,22%***
Investment Securities	2 104	13 039	8 412	40 023	59 077	104 195
Y-o-Y Growth		***519,72%***	***-35,49%***	***375,78%***	***47,61%***	***76,37%***
Total Interest Earning (Operating) Assets	**101 422**	**147 545**	**173 317**	**240 371**	**270 764**	**330 446**
Y-o-Y Growth		*45,48%*	*17,47%*	*38,69%*	*12,64%*	*22,04%*
Equity Investments	732	1 557	2 483	2 761	1 969	3 698
Associates	214	380	454	527	398	487
Held for Sale Assets				133	711	330
Intangible Assets	2 082	2 912	3 819	9 014	10 057	12 284
Tax	1 134	2 500	3 422	4 590	6 846	6 379
Other Assets	8 539	12 738	24 934	5 985	10 545	7 673
PPE	15 366	17 650	19 984	25 519	28 211	30 970
Total Non Operating (Fixed Assets)	**28 067**	**37 737**	**55 096**	**48 529**	**58 737**	**61 821**
Total Assets	**129 489**	**185 282**	**228 413**	**288 900**	**329 501**	**392 267**
Customer Deposits	87 480	123 855	144 967	214 989	231 282	278 492
Y-o-Y Growth		*41,58%*	*17,05%*	*48,30%*	*7,58%*	*20,41%*
Bank Deposits	583	212	5 228	3 347	14 570	
Borrowings	3 395	8 348	5 582	3 551	209	14 185
Total Interest Bearing Liabilities	**91 458**	**132 415**	**155 777**	**221 887**	**246 061**	**292 677**
Total Non Interest Bearing Liabilities	**16 464**	**20 724**	**28 395**	**12 192**	**14 488**	**17 377**
Shareholders Equity	21 548	32 117	44 182	53 778	67 829	81 987
Minority Interest	19	46	59	1 043	1 123	1 306
Total Equity and Liabilities	**129 489**	**185 282**	**228 413**	**288 900**	**329 501**	**393 347**

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