Company Research Report
14 July 2020
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CEDAR CAPITAL

Equity research | Company Research Report

FAIR VALUATION RANGE: MWK10.25 TO MWK12.98

FDH Bank

Elevating returns to shareholders, …

Commercial Bank

PARTICIPATE

Bloomberg Ticker	TBA
Reuters Ticker	TBA
IPO Price	MK10.00
Market Data	**10-Jul-20**
Current Price	MWK10.00
Forward Price[1]	MWK10.25
Fair Value	MWK12.98
Market Cap[2] (bn)	MWK69.0
Market Cap[3] (mn)	USD39.3
Listing P/E	8.80x
Listing P/B	3.04x
DPS Yield	1.50%

Important Disclaimer

Cedar Capital Limited is one of the underwriters to IPO.

MALAWI

FDH Bank Plc has opened an Initial Public Offering (IPO) with 979 175 000 ordinary shares on "Offer for Sale" and a public offer for subscription of 401 031 250 ordinary shares at MWK10.00 per share, with the shares to be listed on the Malawi Stock Exchange on 3 August 2020. The IPO opened on 29 June 2020 and closes 17 July 2020, with announcement of results on 28 July 2020.

Entrepreneurial bank…

FDH Bank, tracing its roots to just before the global financial crisis of 2008 has since grown strongly, anchored mainly on its entrepreneurial culture. It has grown to surpass other entities established much earlier and has achieved this whilst generating strong returns for shareholders as evidenced by the strong ROE of over 40% in FY19.

Stringent credit control …

Unlike most domestic and founder led banks in Africa which were/are known for bad lending practices, FDH Bank has proved itself on this front, with the lowest NPL ratio of 0.80% compared with 6.3% for the rest of the banking sector. This is really impressive especially when compared with the other two listed peers, which have double digit NPL ratios.

Strong NFI platform …

FDH Bank earns more than 75% of its total income from fees and commissions. The bank can meet its operating expenses from NFI, meaning net interest income is a bonus and the bank does not have to embark on aggressive lending to drive revenues.

Strong FY20 earnings….

The listing historic P/E of 8.80x represents a 33% discount to listed peers which are trading at 13x. We have undertaken a relative valuation for FDH Bank and got a fair value of **MWK12.98,** giving a potential 30% uplift on the IPO price of MWK10 per share. We recommend investors **PARTICIPATE** in the IPO.

[1] Based on the company's projected earnings for FY20, detailed on page 33 of the prospectus which estimates FY20 PAT at MWK7.1 billion or a forward EPS of MWK1.03. If FDH Bank is to trade at the same Forward P/E as its local peers, then its price would MWK10.25

[2] Implied market cap on listing

[3] Based on the average USD: MWK rate of 740. Most of the USD figures in this report uses an exchange rate of MWK740.

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Company Background

FDH Bank Plc (FDH), started off as FDH Merchant Bank, after its incorporation in May 2007. It has since evolved into a full-service commercial bank providing the standard services such as different types of bank accounts; custodial services, loans products, foreign currency trading and asset financing to both individuals and corporates.

The bank's distribution channels include 51 service centres, which represent the broadest reach by any banking institution in Malawi. The other customer touch points include ATMs, POS machines, agencies and the digital platforms.

At the end of December 2019, FDH Bank had a market share of 12.81% for deposits and 8.37% for loans.

Initial Public Offering Details

The pre-IPO major shareholders of the bank are FDH Financial Holdings (FDHFH) with 93.68%; Government of Malawi (GoM) with 5.04% and MSB ESOP Ltd with 1.28%.

In turn, the major shareholders of FDHFH are M Development Ltd which controls 55% of FDHFH, followed by Old Mutual Malawi and Old Mutual Life Assurance Company with 21% and 19% respectively. The balance of FDHFH is held by FDH ESOP.

The main details of the IPO of 1 380 206 250 ordinary shares which equate to a 20% stake in the bank are as follows;

Offer for sale by FDHFH	651 575 000
Offer for sale by GoM	327 600 000
Offer to subscribe by preference shareholders	311 100 000
Offer to subscribe	89 931 250
Total Shares on Offer	**1 380 206 250**

Post the IPO the shareholding of FDH Bank will be as follows;

FDHFH Limited	5 437 625 000	78,79%
MSB ESOP	83 200 000	1,21%
Public	1 380 206 250	20,00%
Total	**6 901 031 250**	**100,00%**

The proceeds from the IPO amounting to MWK13.8 billion will be split with (a) MWK6.5 billion paid to FDHFH - the selling shareholders; (b) MWK3.27 billion paid to GoM - the exiting shareholder, and (c) the balance being capital to support the bank's growth ambitions. In addition to raising capital and allowing some shareholders to sell some shares, the other major reason is to fulfil a contractual obligation with the GoM, as part of the 2015 MSB acquisition, to list FDH and allow GoM to dispose of its entire shareholding in FDH Bank.

The IPO is fully underwritten by three entities, First Discount House, Cedar Capital Ltd and Reunion Insurance Company. In the event of an undersubscription, the underwriters will pick up the outstanding shares.

The timetable for the IPO is;

Milestone	**Date**
Offer Opens	29-Jun-20
Offer Closes	17-Jul-20
Results Announcement	28-Jul-20
Securities listed on the MSE	03-Aug-20

Banking Industry Review

The banking sector has nine institutions, with only Standard Bank, Ecobank Malawi and MyBucks Banking Corporation (formerly Nedbank) being the regional players while the rest are domestic players.

According to the Reserve Bank of Malawi (RBM) Financial Stability Report 2019, two banks, namely Standard Bank (SBM) and National Bank of Malawi (NBM) dominate the sector, holding a combined 44% and 46% of total assets and total deposits respectively.

In 2019, the sector experienced growth in assets which was ahead of the core-inflation rate at 8.4% (inflation at 5%) to MWK1.9 trillion. There was a seasonality to the growth with the second half being double the first. The growth was anchored on a 10% expansion in loans and advances to MWK637 billion as well as the 13% growth in securities to MWK792 billion.

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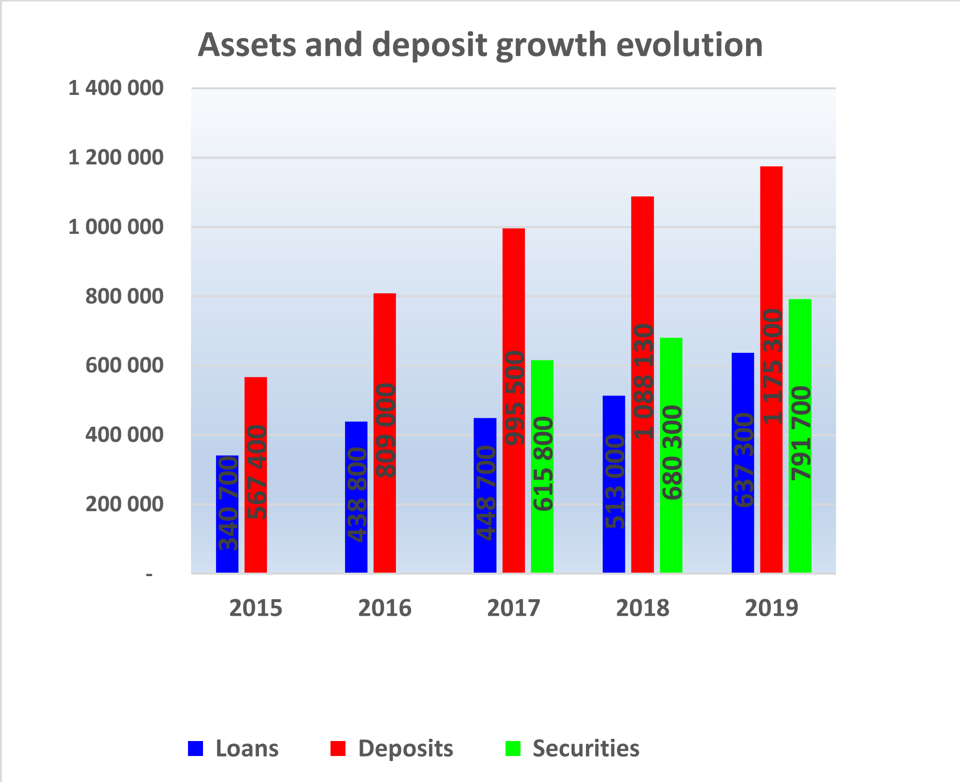

Source – Financial Stability Reports and Cedar Capital Research

This means that exposure to government through sovereign assets exceeds the stock of outstanding loans. As such, banks are now more exposed to the risk of lower interest income growth as TB yields remain soft.

The reduction in advances could also indicate the absence of a large pool of quality borrowers.

Taking a cross section of the sector asset book shows that securities comprise 42% of the total, with credit making up 34%, an unchanged position when compared with 2018.

In terms of sectoral credit concentration, three sectors dominate the share of gross loans namely, trade - wholesale and retail sector – at 23%; agriculture sector and manufacturing sector at 19% and 14% respectively.

The amount of non-performing loans rose 28% to MWK40.3 billion, which represents an NPL ratio of 6.3%, a 140bps deterioration from 4.6% in 2018. The growth was attributed to a spike in NPLs from the electricity, gas, water and energy sectors. However, the trade sector is expected to dominate new NPL formation in 2020.

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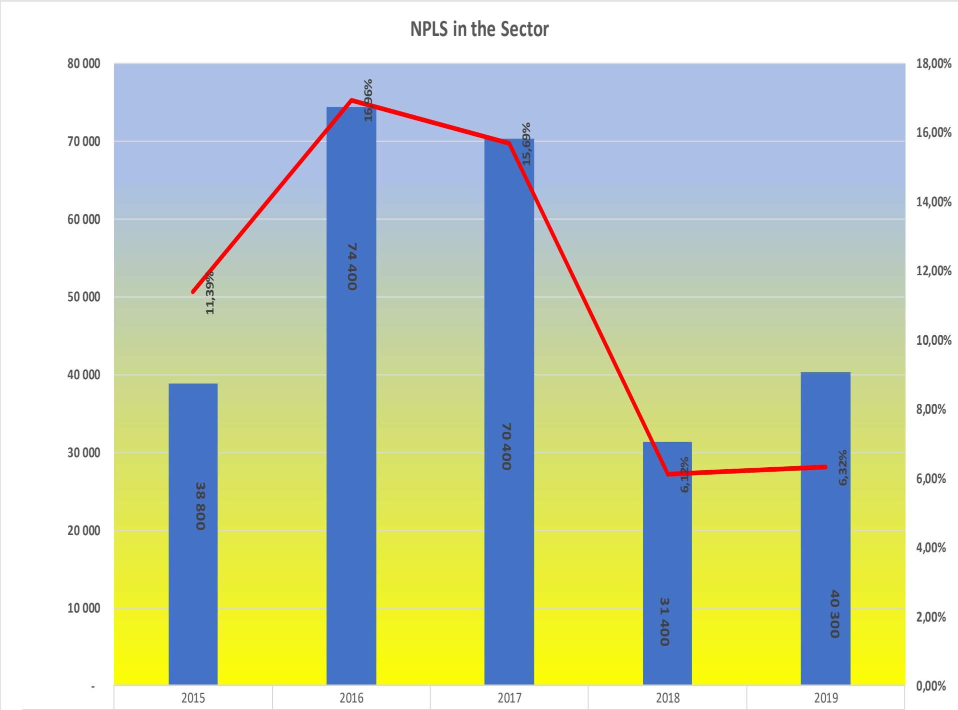

	2015	2016	2017	2018	2019
NPL Stock	38 800	74 400	70 400	31 400	40 300
NPLs Ratio	11,39%	16,96%	15,69%	6,12%	6,32%

Source – 2019 Financial Stability Report & Cedar Capital Research

The rise in NPLs, impacted negatively on the liquidity situation in the sector, with the ratio closing the year at 59% (prudential guideline is 25%), down from 63% in prior year. The ratio remains high, a scenario attributed to the continued investment in fixed income securities.

On the funding side, deposits grew 8% to MWK1.2 trillion, of which 40% were demand deposits, while savings and term deposits accounted for 18% and 23% respectively. Foreign currency deposits were almost static at MWK224 billion. Deposits remain the main source of funding, accounting for three quarters of the liabilities. Demand deposits rose strongly in the last quarter attributed to a growth in deposits of agro-companies for the financing of the 2019/20 crop planting season.

The sector is highly skewed towards short term – demand and savings – funding, which is deployed in some long-term assets. As a result, there was a liquidity gap of MKW527 billion in the less than 30 day bucket and MWK142 billion in the 30-90 day bucket.

In terms of strength, the RBM contends that the sector was adequately capitalised with surplus capital buffers exceeding 7% and 6%, above the regulatory core and total capital ratios, respectively. The regulatory minimums are 10% for core capital and 15% for total capital.

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The sector P&L shows that interest income rose 11% to MWK215 billion, on account of the growth in loans and investment securities, exceeding the negative impact of low asset yields. The sector also benefited from a 9% reduction in the interest expense to MWK55 billion. This favourable movement in income and expenses saw sector net interest income rise 22% to MWK160 billion. Treasury and transaction income grew 16% to MWK109 billion, on increased volumes and volatility of the currency.

Operating expenses on the other hand rose 12% to MWK168 billion, giving a sector cost to income ratio of around 62%, which is above the expected benchmark of 60%. Looking at it the other way, the sector is not able to meet its operating expenses from net interest income.

After debiting credit loss and taxation provisions, the bottom line grew 32% to MWK61 billion. By the end of the year, the sector ROE had improved 300bps to 21%.

Below is the collated information for the listed banks.

	Based on 31 December 2019 Results					
Growth Indicators	**NBM**	**NBS**	**SBM**	**FCB**	**FDH**	**Average**
Gross Loan	13%	136%	32%	15%	40%	47%
Asset	10%	31%	5%	28%	24%	20%
Customer Deposits	8%	21%	6%	(3%)	22%	11%
Total Operating Income	8%	39%	15%	(7%)	23%	16%
Net Income	**7%**	**162%**	**50%**	**(9%)**	**32%**	**48%**
Profitability Indicators						
Return on Average Assets	4%	1%	4%	1%	2%	2%
Return on Average Equity	18%	34%	19%	17%	41%	26%
NIM (%)	**10,99%**	**16,66%**	**11,40%**	**6,98%**	**6,01%**	**10%**
Yield on Interest Bearing Assets	14%	21%	13%	10%	12%	14%
Cost of Funds	1,61%	4,51%	1,82%	3,91%	5,83%	4%
Efficiency Indicators						
Non-Int expenses/ Assets	8,82%	14,24%	9,49%	5,84%	11,75%	10,03%
Cost to Income Ratio (%)	**61%**	**77%**	**60%**	**66%**	**65%**	**66%**
Liquidity Indicators						
Customer Deposits/Equity	3,16	7,87	2,77	4,08	6,05	4,79
Credit to Deposit Ratio (%)	**59%**	**32%**	**61%**	**53%**	**41%**	**49%**
Equity to Assets Ratio (%)	22%	10%	23%	11%	12%	16%
Credit Quality Indicators						
NPAs to GL	**12%**	**15%**	**3%**	**6%**	**1%**	**7%**
Valuation Parameters						
Share Price @10/07/20	550,00	19,50	790,00		10,00	
P/E (x)	**14,97**	**12,73**	**11,68**		**8,80**	**12,05**
P/B (x)	**2,55**	**3,70**	**2,13**		**3,04**	**2,86**

Source – Cedar Capital Research and Banks's Annual Reports.

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FDH Bank F19 Review

The discussion and table of the banking sector results, shows that fortunes were generally mixed. However, FDH Bank had a better time of it, with a balance sheet growth of 24% to MWK188.7 billion, driven in the main by a 40% growth in the loan book to MWK57 billion and 22% rise in bank placements to MWK32 billion. In total, interest earning assets were up 13% to MWK143 billion.

From this portfolio of assets, interest income rose 11% to MWK16.3 billion, benefiting from the credit book expansion which counteracted the decline in lending rates. The interest expense rose 15% to MWK7.7 billion, driven by a higher deposits base. This means that net interest income rose 7% to MWK8.5 billion.

From the above we get a net interest margin of 6.01%pa, which is way lower than peers who are sitting around 10%. The bane for FDH Bank is the high cost of funding of around 5.83% pa with peers funding their books at around 2% pa.

The funding is mostly in the form of deposits which grew 22% to MWK137 billion, attracting an average cost of 3.5%pa. The deposit structure is such that term deposits account for 26% of the total, forex deposits comprise 17% with the balance being savings and current accounts.

Positive for FDH in FY19 was the 66% decline in the provisioning charge to MWK483 million. This, as the loan book continued to perform well above the market with an NPL ratio of around 1%, which is the lowest in the Malawian banking sector.

Non funded income of MWK25 billion was recorded, up 23% on prior year. This brought total income to MWK34 billion, implying that non funded income contributes 76% to total income, three times the amount from net interest income.

Operating expenses grew in line with inflation at 14% to MWK22 billion. This works out to a cost to income ratio of 65%, which is a 500bps improvement. At the end of the year, PAT growth was a strong 32% to MWK7.8 billion.

In the outlook, in addition to the management guidance of MWK7.1 billion and MWK10.5 billion in PAT for FY20 and FY21 respectively, the bank has set ambitious targets for FY21 post the IPO which include;

- Achievement of ROE of 45%;
- Increase deposit market share by 20%;
- Achieve a minimum 15% of the total sector's PAT;.
- Maintain an NPL ratio of below 2%; and
- Reduce the Cost to Income Ratio to around 45%.

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General Comments

- **Objectives of the offer** – the bulk of the IPO is in the form of an "Offer for Sale" which will see the major shareholder FDHFH and the 'exiting shareholder; GoM being paid a combined USD13 million leaving only USD5.4 million to be reinvested in the growth of the bank.
- **Reliance on Non-Funded Income (NFI)** – the company earns 76% of its income from non-funded income, in the form of commissions and fees mostly. We would have welcomed more detail on such an important source of income, especially given that these are commissions and not necessarily transactional fees. This is also unusual for a standard commercial bank, as most of them rely mostly on net interest income. In the Malawian banking sector, NFI is roughly 40% of total income.
- **Settlement accounts** – on the balance sheet, there was a spike in receivables classified as "settlement accounts" of MWK14.7 billion in FY19, up from MWK313 million in FY18. The total receivables amounted to MWK33.5 billion, which was 18% of the total asset base. This is also highly unusual for a bank.
- **Political risk** – on January 22, 2020, it was reported that Dr Thompson Mpinganjira, then the CEO of FDHFH had been arrested on politically related matters. He was subsequently released on bail. Although it is very clear from the newspaper reports and the allegations by the Anti-Corruption Bureau, that Dr Mpinganjira is being charged in his personal capacity and the issues have nothing to do with FDHFH and FDH Bank, the possibility of collateral damage cannot be completely ruled out.

Recommendation

On page 33 of the prospectus, management gives earnings guidance for FY20 and FY21 of MWK7.1 billion and MWK10.5 billion respectively. The earnings guidance takes cognisance of the Covid-19 crisis and its effects on the country's economy, the banking sector and the bank itself.

Based on the FY20 earnings guidance, we get an EPS of 1.03. In our view, (see Malawi Banking Sector Report), the banking sector is trading at forward P/E of around 10x. Using this forward P/E we get a fair value price per share of MWK10.25.

We have also applied the relative valuation method, using listed peers; NBM; SBM and NBS Bank, which gives us a fair value for FDH Bank of MWK12.98. This gives a potential upside of 30% on the IPO price. We would recommend investors **PARTICIPATE** in the offer.

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FDH Bank	**Dec-19**	**Dec-18**	**YoY**
Net Interest Income	8 577	8 046	7%
Loan loss Charge	(483)	(1 436)	-66%
NII after credit losses	**8 094**	**6 610**	**22%**
Non-Funded Income	25 812	21 020	23%
Total Income	**33 906**	**27 630**	**23%**
Operating Expenses	(22 163)	(19 473)	14%
PBT	11 743	8 157	44%
Tax	(3 897)	(2 191)	78%
PAT	**7 846**	**5 966**	**32%**
Loans	56 814	40 689	40%
Bank Placements	31 751	26 084	22%
Investment Securities	46 955	45 048	4%
Earning Assets	142 582	126 707	13%
Total Assets	**188 700**	**152 769**	**24%**
Deposits	137 141	112 570	22%
Borrowings	8 368	8 184	2%
Capital/NAV	22 673	15 886	43%
NIM	6,01%		
NPLs	451	465	
NFI/Total Income	76%	76%	
CIR	**65%**	**70%**	
LDR	41%	36%	
ROA	2%		
ROE	**41%**		
NPLs Ratio	**0,79%**	**1,14%**	
Yield on average	12%		
Cost of Funding	**5,83%**		
Number of shares	6 901 031 250	6 901 031 250	
EPS	1,14		
NAV	3,29		
Interest Income	16 343	14 781	11%
Interest Expense	7 767	6 735	15%

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