BANKING SECTOR RESULTS REVIEW

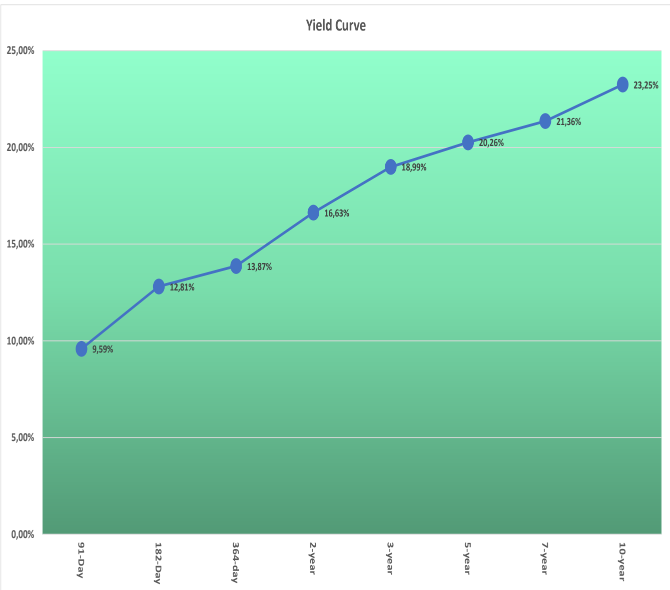
Armstrong Kamphoni 17 OCTOBER 2021 Equity Research

NB: In this coverage report, we excluded FMBCH as it more of a regional bank and comparisons with purely Malawian banks would be misleading.

ASSETS & LIABILITIES			
	Jun-21	Dec-20	Jun-20
Gross Loans	809,30	724,60	653,50
Growth	12%	11%	
Securities	1 169,50	891,90	868,10
Growth	31%	3%	
Deposits	1 550,60	1 417,80	1 248,20
Growth	9%	14%	
LDR	52%	51%	52%

ASSET QUALITY			
	Jun-21	Dec-20	Jun-20
Gross Loans	809,30	724,60	653,50
NPLs	53,20	44,70	43,00
NPL Ratio	6,57%	6,17%	6,58%

PROFITABILITY			
	Jun-21	Dec-20	Jun-20
PAT	48,50	81,00	38,40
Growth (Y-o-Y)	26%		
ROA	3,40%	3,10%	3,20%
ROE	26%	23%	24%



Introduction

The Reserve Bank of Malawi (RBM) Financial Stability Report as of 30 June 2021, highlighted that the financial sector remained safe and sound, based on capital adequacy, liquidity, and growth in profitability. However, asset quality deteriorated marginally to 6.6% from 6.2% at December 2020.

In the six months, total assets rose 16% to MWK2,6trn. The growth was driven by a 31% increase in fixed income investments to MWK1.2trn while gross loans were up 12% to MWK809bln.

The growth in assets was funded by a 9% increase in deposits to MWK1.6trn and a surge in "repurchase assets" to MWK166bln. Customer deposits remained the largest source of funding, accounting for 70% of total liabilities, followed by repurchase agreements at 8%. This was at a time when broad money supply (M2) had grown 11% year-on-year.

Asset allocation remains skewed towards investments and securities, which accounted for 45% of total assets, followed by gross loans at 32%. Deployment in investment securities has grown faster than loans as the shortage of quality and low risk borrowers continues to affect the industry.

NPLs remain a concern, increasing 19% to MWK53bln, resulting in an NPL ratio of 6.6%. Credit concentration by economic sectors remained high, as the top three sectors accounted for 65% of gross loans and leases, which was an increase from 56% reported in FY20. The problem sectors, with regards to NPLs were the wholesale and retail trade sector with 36% and the manufacturing sector with 17% of NPLs.

Profitability growth was 26% to MWK49bln attributed to a 30% surge in interest income to MWK152bln, while non-interest income experienced a proportionately lower growth rate of 8% to MWK67bln. Average ROE closed the half at 26%.

In November 2020, the RBM reduced the Policy Rate from 13.50%pa to 12.00%pa. The rate cut prompted the banks to reduce the base lending rates to 12.20%pa, down marginally from 12.30%pa in FY20. Mortgage lending rates remained high at more than 20%pa.

The average yield for the 91-day tenor TBs decreased by 36bps, while the average yields for the 182-day and 364-day tenors recorded increases of 132bps and 34bps to close at 9.6%pa, 12.8%pa, and 13.9%pa respectively.

Over the reporting period, average yields for Treasury Notes (TN) stood at 16.6%pa for the 2-year paper, 18.9%pa for the 3-year note, 20.1%pa for the 5-year paper, 21.4%pa for the 7-year bond, and 23.0%pa for the 10-year bond.

TREASURY BILL YIELDS			
	Jun-21	Dec-20	Jun-20
All Type	12,09%	11,99%	10,75%
91 - day	9,59%	9,95%	7,54%
182 - day	12,81%	12,49%	11,60%
364 - day	13,87%	13,53%	13,10%

EXCHANGE RATES			
	Jun-21	Dec-20	Dep
USD	811,95	773,11	4,78%
ZAR	61,66	56,91	7,70%

	Jun-21
Base Lending Rates	12,20%
Mortgage Lending Rate	21%
All Type TB yield	12,09%
Deposit Rates	4,09%

ASSETS & LIABILITIES				
	FDH	NBM	NBS	SBM
Loans	97 113	226 366	57 472	185 330
Growth	22%	13%	(3%)	12%
Securities	138 065	317 377	187 958	185 526
Growth	28%	19%	61%	19%
Deposits	178 919	477 536	174 245	364 903
Growth	0%	18%	13%	16%
Bank Dep	41 787		71 322	37 048
Growth	0%		136%	22%

Although asset allocation has been skewed towards treasury securities, RBM's treasury bill auctions have been persistently undersubscribed which strongly suggests that either liquidity conditions could be tight, or banks are anticipating a pricing risk with regards to the inflation outlook.

In terms of liquidity gap analysis, the banking sector continued to fund long term assets using short-term transitory deposits. This was evident in the presence of negative liquidity gaps within the bucket period of up to one month and between one and three months at MWK645bln and K165bln at the end of June 2021.

As of the end of June 2021, two banks (NBM and SBM) out of the eight players accounted for 45% and 49% of the sector's total assets and total deposits, respectively.

The forex situation remains precarious. As a result of the forex pressures, the MWK has depreciated 6% YTD to around MWK822:US$. As of 31 August 2021, total forex reserves stood at US$993.97 million equating to 3.98 months of import cover, having benefitted from the IMF SDR disbursements. The RBM responded to the forex shortages by re-introducing the 2015 mandatory conversion of US$ in Foreign Currency Denominated Accounts (FCDAs). Starting in August, exporters are required to sell a minimum of 30.00% of their export proceeds to commercial banks while retaining, at most, 70.00% of the proceeds in their FCDAs.

Banking Model …

Commercial banking in Malawi is an X<4: Y>9: Z>12 model. X is the maximum interest rate of 4%pa paid by the banks for deposits, with Y being the minimum of 9%pa earned by the banks on TBs, and Z is the 12%pa base lending rate on loans. Simply put, get deposits at less than 4%pa and lend out for at least 9%pa.

As such, the most important income variables in the sector are (a) the growth and yield of loans; (b) the growth of deposits and the cost of the deposits, and (c) the growth and yield on fixed income securities.

Asset and liability growth rates...

The listed banks, except for NBS recorded double-digit growth in loans. FDH was more aggressive in loan disbursements, expanding 22% and 32% respectively, possibly to compensate for the 10bps softening in base lending rates. The bigger players NBM and SBM grew loan books by 12%, off a higher base.

Investment securities and bank placements continued to be the preferred assets, growing at a much faster pace, more so for NBS, which was up 61%.

All the players had more investments in securities than in loans. As a result, NBS had the lowest LDR of 23%, while SBM had the highest of 51%. These levels are very low by international standards.

Quality of the loan book…

NPLs				
	FDH	NBM	NBS	SBM
NPLs	1,2%	12,4%	3,3%	2,1%

NBM had a relatively poor credit book as evidenced by the higher NPL ratio of 12% which is way above the sector average of 6.57%. The NPL ratio for the bank remained at December 2020 levels, whilst other institutions had relatively low NPL ratios of less than 3.5%.

NIMs…

NIM				
	FDH	NBM	NBS	SBM
N I I	11 017	32 739	14 560	23 862
Growth	70%	36%	10%	21%
Book Yield	9%	10%	13%	9%
COF	5%	2%	8%	2%
NIM	**9%**	**10%**	**13%**	**9%**

The balance sheet movements in loans and deposits influence the growth of net interest income (NII) and the level of net interest margins (NIM). In the half, FDH had the fastest growth of NII of 70% to MWK11bln. This was driven by a 22% and a 28% growth in the loan book and securities portfolio respectively. In second and third place were NBM and SBM which grew NII by 36% and 21% respectively. In absolute numbers, NBM recorded the largest amount of NII of MWK33bln.

In terms of funding, NBS experienced a deterioration in cost of funding (COF) from 6%pa at year end to the current 8%pa. NBS increased its reliance on volatile and costly wholesale deposits. However, it continues to have the highest NIM of 13%pa. SBM, and NBM because of their strong retail franchises have access to the cheapest deposits, with a COF of around 2%pa.

Operational Efficiency…

	FDH	NBM	NBS	SBM
N I I	11 017	32 739	14 560	23 862
NFI	7 274	19 414	6 133	18 567
Expenses	(11 407)	(28 037)	(12 945)	(22 713)
NFI/Total	40%	37%	30%	44%
CIR	62%	54%	63%	54%

Noninterest or non-funded income (NFI) is any income that banks earn from activities other than their core intermediation business (taking deposits and making loans and/or buying TBs). Banks that increase noninterest income can reduce risks associated with credit. Furthermore, NFI is steadier or more stable than interest income and is an important source of predictable revenues.

We note that not a single bank is able to cover operating expenses from NFI only. However, except for FDH, the banks can meet operating expenses from NII. This means that NFI is playing largely a supporting role. In most cases, NFI is around 40% of total banking income. NBS is the laggard in this case with NFI contributing 30% to total income.

SBM and NBM with cost to income ratios (CIR) of 54% appear to have higher productivity than peers. The CIR shows how many Kwachas were needed to generate one MWK in revenue. FDH and NBS with CIRs greater than 60% either have too high costs or are not generating optimal revenues.

PAT				
	FDH	NBM	NBS	SBM
PAT	4 550	13 469	4 395	11 578
Growth	41%	49%	54%	(8%)

	FDH	NBM	NBS	SBM
Leverage (x)	**10,22**	**5,23**	**12,11**	**5,03**
ROA	3,86%	4,32%	3,49%	4,50%
ROE	39,4%	22,6%	42,3%	22,6%
ROD	4,1%	5,9%	4,0%	6,8%
PC	(9 556)	43 159	807	65 578

The bottom line ….

The PAT picture shows remarkable growth rates of a minimum of 40% attributed to the robust NII performances, which outpaced the rise in operating expenses and the effect of lower provisioning charges across the board. NBS and FDH recorded single-digit increases in operating expenses while NBM and SBM saw operating costs surge by 41% and 13% respectively. The former was affected by the consolidation of Akiba Commercial Bank. SBM's bottom line was also impacted by the MWK5bln non-recurring loan loss provision writeback in HY20 as opposed to the MWK2bln provision charge in HY21. The result was the 8% decline in PAT for SBM to MWK12bln. NBM had the highest amount of profits of MWK13bln.

ROE Decomposition …

Both NBS and FDH have what appear to be superlative ROEs of 39% and 42% respectively. However, these returns were achieved on the basis of a thin capital base as evidenced by the leverage ratios or equity multipliers (EM) which are way above the benchmark of 6x. This would suggest that the two banks are overtrading. EM measures financial leverage and indicates whether a bank funds its assets through debt or equity. A decrease in the leverage ratio will decrease the ROE while an increase in EM increases ROE.

The EMs of 10.2x and 12.1x for FDH and NBS respectively suggests that the institutions should consider raising additional capital from shareholders, reducing dividends, and retaining more profits to shore up the capital bases. EM might improve results in the upswing – in the way it functions as a multiplier but, conversely, it can also make it more likely for a bank to fail, due to rare unexpected losses.

On the other hand, the ROEs of NBM and SBM of circa 22% were primarily anchored on the ROA and less on EM. This is a more conservative and less risky strategy to achieve returns.

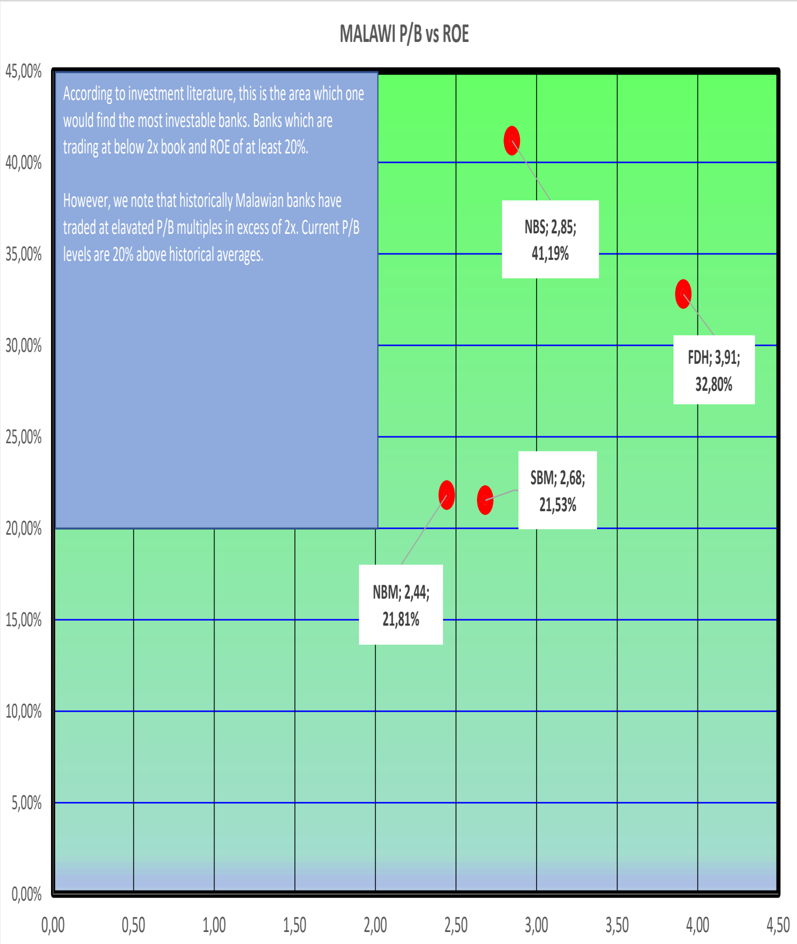
The ROA measures how efficiently a bank uses its assets to generate revenue. As a rule, the higher the ratio the better the bank is performing. In this regard, SBM and NBM have higher ROAs of over 4%pa. Comparing with other countries, Malawian banks have higher ROAs of over 3%pa as opposed to the general standard of 2%pa.

We have also considered a lesser used ratio; Return on Deposits (ROD) which is a ratio of net earnings to total deposits. It shows the percentage return on each unit of customers' deposits, thus, indicating the effectiveness of a bank in converting deposits into profits. Once again, SBM and NBM came out tops with 6.8% and 5.9% respectively.

Using the ROE decomposition and the ROD measures, NBM and SBM have superior return profiles.

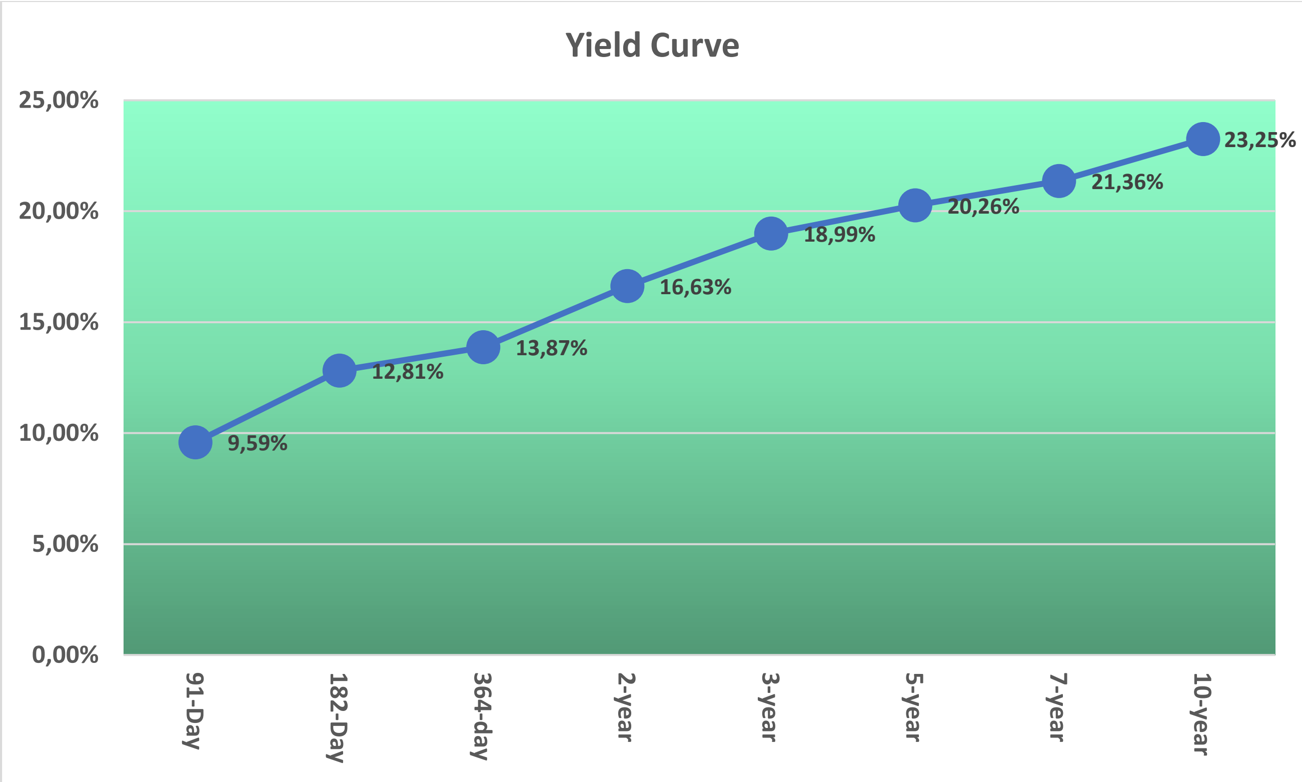
Valuation…

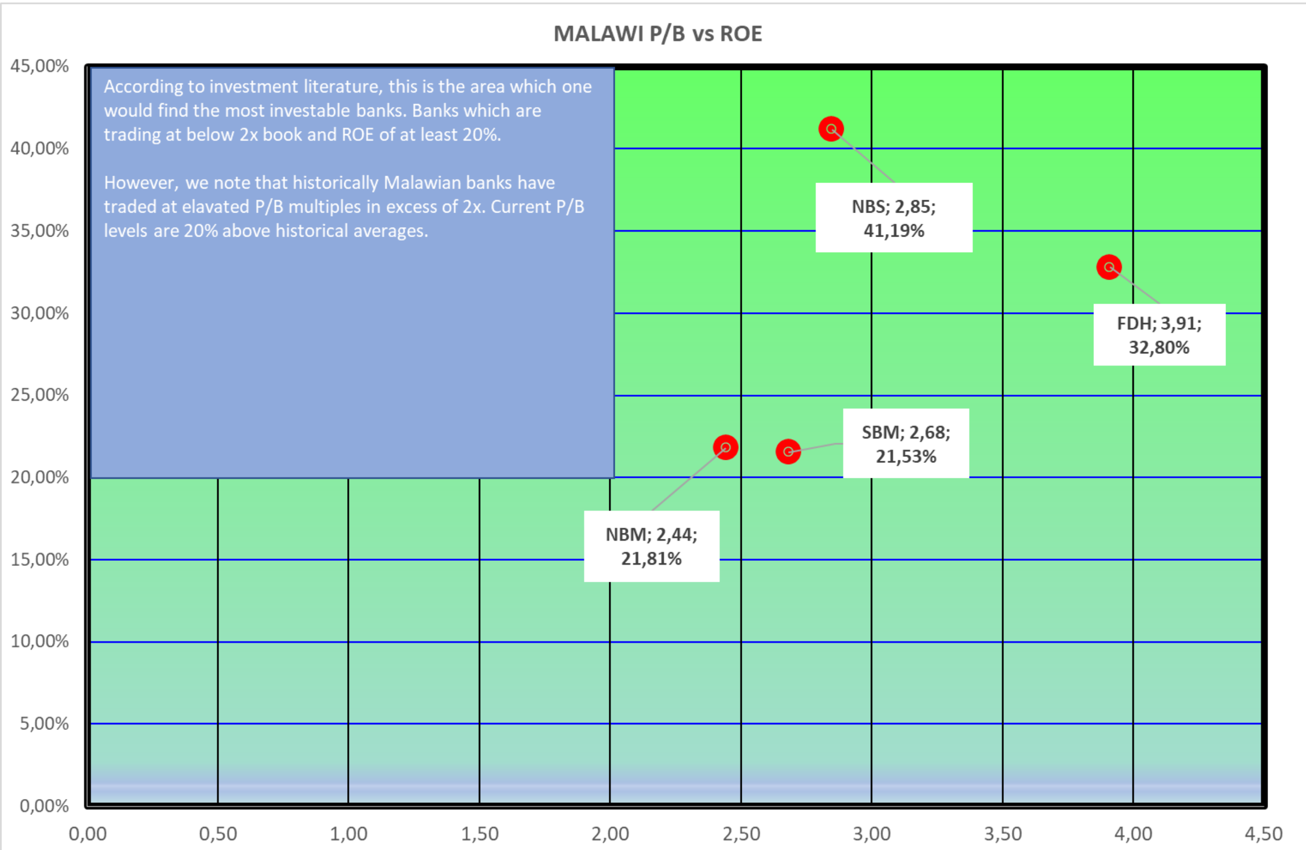
	FDH	NBM	NBS	SBM
Price	16	700	23	1 250
YTD	**12%**	**8%**	**6%**	**19%**
P/E (x)	7,28	12.18	7,78	12,93
P/B (x)	3,91	2,53	2,85	2,68
TP	**18**	**872**	**27**	**1 499**
Uplift	13%	25%	18%	20%



We have updated our valuation models, and NBM, notwithstanding its somewhat elevated NPL ratio accounting for more than 50% of the NPLs in the sector, still offers the highest possible return of 25%. This is attributed to the fact that the share price has barely moved YTD. SBM, although up 19% YTD and being the best performing banking stock, still has some headroom. We rate SBM and NBM as **BUYs.**

Although NBS and FDH still offer some potentially attractive returns, we are concerned about the high leverage. We are also concerned with NBS's increased reliance on unstable deposits from other banks, which now account for 30% of deposit-based funding. Additionally, FDH is trading at an unjustifiable premium to the sector in terms of its P/B multiple of 3.91x. We attach a **HOLD** rating to NBS and FDH.


Yield Curve
25,00%
20,00%
15,00%
10,00%
5,00%
0,00%
9,59%
12,81%
13,87%
16,63%
18,99%
20,26%
21,36%
23,25%
91-Day
182-Day
364-day
2-year
3-year
5-year
7-year
10-year


MALAWI P/B vs ROE
According to investment literature, this is the area which one would find the most investable banks. Banks which are trading at below 2x book and ROE of at least 20%.
However, we note that historically Malawian banks have traded at elavated P/B multiples in excess of 2x. Current P/B levels are 20% above historical averages.
NBS; 2,85; 41,19%
FDH; 3,91; 32,80%
SBM; 2,68; 21,53%
NBM; 2,44; 21,81%
45,00%
40,00%
35,00%
30,00%
25,00%
20,00%
15,00%
10,00%
5,00%
0,00%
0,00
0,50
1,00
1,50
2,00
2,50
3,00
3,50
4,00
4,50

	FDH	NBM	NBS Bank	SBM
	Jun-21	**Jun-21**	**Jun-21**	**Jun-21**
Interest Income	16 425	36 634	22 869	27 580
Interest Expense	(5 408)	(3 895)	(8 309)	(3 718)
Net Interest Income	**11 017**	**32 739**	**14 560**	**23 862**
Loan loss Charge	(375)	(4 784)	(1 280)	(2 419)
NII after credit losses	**10 642**	**27 955**	**13 280**	**21 443**
Non-Funded Income	7 274	19 414	6 133	18 567
Total Income	**17 916**	**47 369**	**19 413**	**40 010**
Operating Expenses	(11 407)	(28 037)	(12 945)	(22 713)
PBT	**6 509**	**19 332**	**6 468**	**17 297**
Tax	(1 959)	(6 578)	(2 073)	(5 719)
Minorities		715		
PAT	**4 550**	**13 469**	**4 395**	**11 578**
Loans	97 113	226 366	57 472	185 330
Bank Placements	44 667	41 253		106 918
Investment Securities	93 398	276 124	187 958	185 526
Earning Assets	253 461	589 706	262 092	514 713
Total Assets	**291 533**	**675 760**	**284 796**	**550 164**
Deposits	178 919	477 536	174 245	364 903
Deposits from Banks	41 787		71 322	
Borrowings	9 071	12 325	6 274	
Capital/NAV	**28 516**	**129 213**	**23 511**	**109 390**
NIM	9,40%	10,27%	12,61%	9,01%
NPLs	1 193	28 165	1 901	3 909
NFI/Total Income	41%	41%	32%	46%
CIR	64%	59%	67%	57%
LDR	54%	47%	33%	51%
ROA	3,9%	4,3%	3,5%	4,5%
ROE	**33%**	**22%**	**41%**	**22%**
NPLs Ratio	1,23%	12,44%	3,31%	2,11%
Yield on Loans	0%	0%	0%	0%
Yield on Securities	0%	0%	0%	0%
Yield on Book	9%	10%	13%	9%
Cost of deposits	3%	1%	5%	1%
Cost of Funding	5%	2%	8%	2%
Leverage (x)	10,22	5,23	12,11	5,03