

Weaker Trading Income to Pressure ROE

May 28, 2018



INVESTMENT ONE

NIGERIA | EQUITIES | BANKING | ZENITH BANK PLC

Core holdings status remains despite likely decline in ROE

We resume our coverage of Zenith Bank following the release of its Q1 2018 results with a BUY recommendation on the stock given the 26.9% upside our new target price of N33.8 represents against current price levels. We point out the upside on the stock has been supported by the recent sell-off in the Nigeria Stock Exchange.

Zenith Bank remains one of our core holdings given the relatively solid capital adequacy ratio, strong asset yields and above average ROE. We believe these factors justify the bank's fair value (FV) P/B at 1.36x against peer average of 1.08x.

However, we point out the 1) possible classification of the Bank's 9Mobile exposure; 2) smaller than expected contraction in cost of funds; and 3) lacklustre loan book growth on the back of weak economic activities, pose a downside risk to our outlook.

Valuation

While we forecast ROE could fall to 20.9% in FY 2018, from 23.3% in FY 2017, due to weak non-interest income, ROE could improve to 22% levels in FY 2019, which we see as the bank's sustainable level.

The new target price of N33.8 is arrived at by applying a 1.37x FV P/B estimate to our FV 2018 Book Value Per Share (BVPS) forecast of N24.7. We derive our FV P/B estimate using a sustainable ROE of 22%, which was weighed down slightly by the forecasted FY 2018E performance. Other key assumptions include a beta of 1.2, risk free rate of 13.0% and equity risk premium of 5.0% (previously 5.5%).

Share data	
Bloomberg	ZENITHBA NL
Reuters	ZENITHB.LG
Industry	BANKING
Rating -New	BUY
Rating - Old	BUY
Price (25 May 2018)	N26.7
Price Target - New	N33.8
Price Target - Old	N22.2
Upside/Downside	26.9%
Market Cap. (N'million)	836,716.6
Avg. Daily Value Traded (N'million)	1,004.8
Shares Outstanding (Million)	31,396.5
Free Float	90.4%

Price Movement Relative to NSE-ASI



Historic performance against NSE-ASI

Performance Over	1M	3M	6M	12M	YTD
Absolute	-3.09%	-16.46%	6.64%	46.27%	3.94%
Relative to NSE-ASI	0.42%	-8.83%	1.40%	8.13%	1.11%

Source: Bloomberg, Investment One Research

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Financial and Valuation Metrics (Y/E 31 Dec)	2016A	2017A	2018E	2019E	2020E
Net interest income	240,179	257,991	278,155	319,367	355,007
Non-interest income	123,440	270,562	201,597	166,162	140,093
PBT	156,748	203,462	190,397	212,105	220,385
EPS	4.12	5.66	5.30	5.90	6.13
ROE	19.6%	23.3%	20.9%	22.5%	20.8%
EPS y/y	22.7%	37.2%	-6.4%	11.4%	3.9%
P/E (x)	6.5	4.9	5.0	4.5	4.3
P/B (x)	1.21	1.06	1.08	0.96	0.86
Div yield	7.5%	9.8%	10.0%	11.2%	11.6%

Source: Company Financials, Investment One Research



Non-interest income to weigh on top line growth

Zenith bank's non-interest performance in FY 2017 accounted for 36.3% of gross earnings, up from 24.3% in FY 2016, thereby contributing significantly to 47% year-on-year (y/y) spike in gross earnings to N745.2billion.

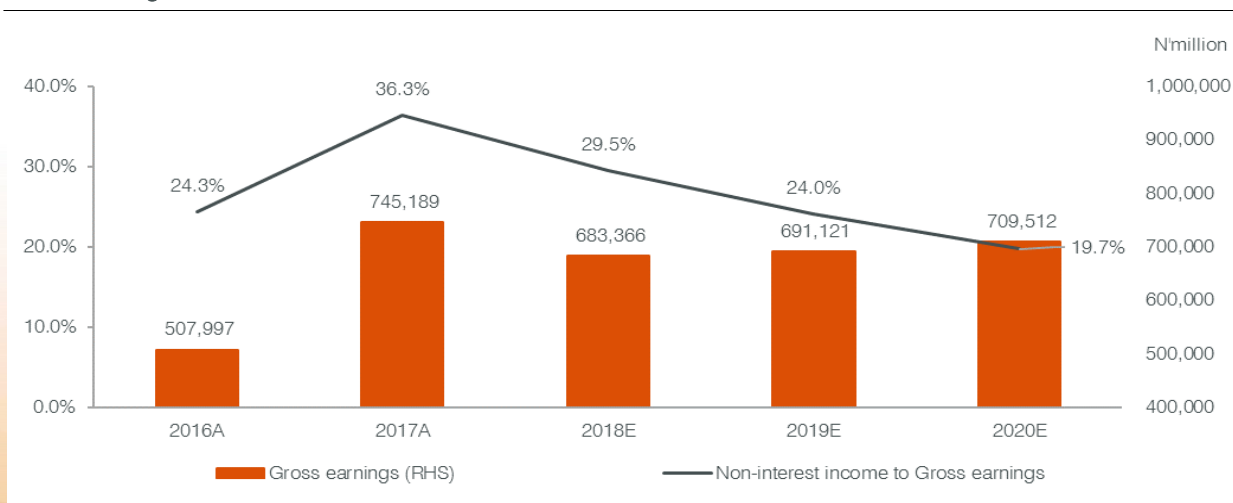
Specifically, the bank generated N158billion in trading income in FY 2017 partly due to the gains on derivative instruments, which were supported by the high yield environment in 2017.

As a result, trading income accounted for 58% of non-interest income in FY 2017, from 23% in FY 2016.

However with the spread on derivative instruments falling close to 6.5% in Q1 2018, according to management, from peaks of 11.5% in 2017, we forecast a 25.5% y/y slide in non-interest income.

However, the increasing likelihood that the banking sector may shift its translation rate for foreign currency balance positions closer to the Nigerian Autonomous Foreign Exchange rate (NAFEX), a reflection of economic realities, could be a positive for Zenith Bank given its net long foreign currency position estimated at USD 480million as at Q1 2018. As such, we see the bank recording foreign currency gains close to N14billion in FY 2018 if the rate moves to N360/USD, from N330/USD levels in Q4 2017 and N336/USD levels in Q1 2018, all else being the same.

Gross Earnings vs. Non-Interest Income Trend



Source: Company Financials, Investment One Research



Volume vs Margin

Gross earnings could also come under pressure from the continued decline in yields in the fixed income space, with the yield on the one year Treasury bill shedding more than 800basis points from the highs of 22% on 2017.

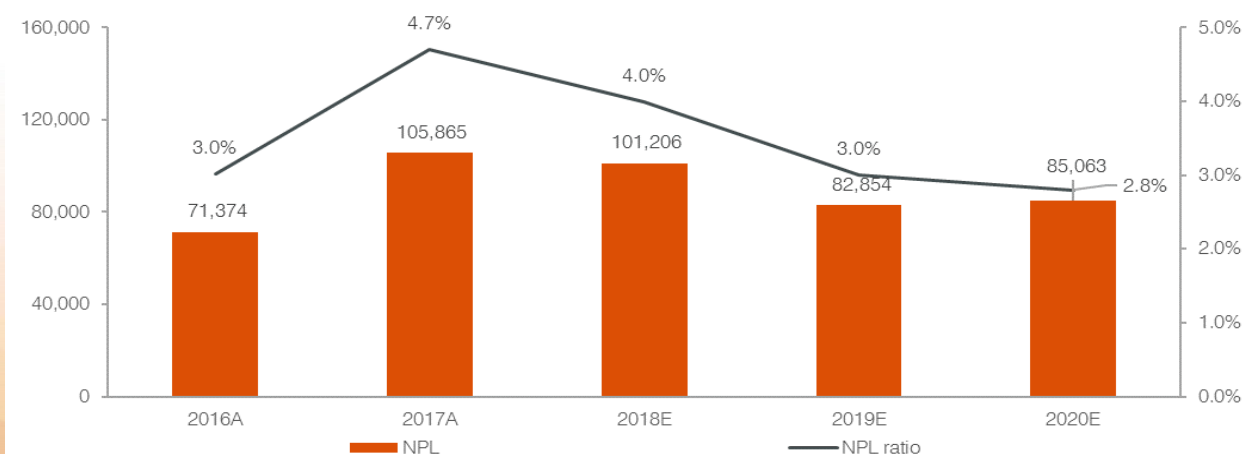
With this said, we may have potentially reached the bottom for the decline in yields in the fixed income space as the Central Bank of Nigeria continues to maintain the sale of Open Market Operation securities at 12.9% yield for a 182-day maturity.

While we expect a decline in interest income from treasury bills, which spiked by 82% y/y in FY 2017, there may also be a potential for a downward repricing of existing loans and advances.

This combined with a positive outlook for Gross Domestic Production (1.95% y/y and 2.11% y/y growth in Q1 2018 and Q4 2017 respectively) could see Zenith Bank's risk appetite increase. As such, as we see net interest margins decline, particularly in H2 2018, we expect Zenith Bank to aggressively increase loan growth.

The ability for the bank to grow its loan book should be supported by the potential improvements in asset quality and recoveries. In Q1 2018, the bank's non-performing loans (NPL) ratio fell to 4.3%, from 4.7% in Q4 2017 but higher than 3.2% recorded in Q1 2017. With this said, we could see NPL formation slow in 2018 while the possibilities for further recoveries (N310million recovered in Q1 2018) could support loan growth.

Asset Quality Trends



Source: Company Financials, Investment One Research



We point out that the slide in Zenith Bank's NPL ratio would have been more pronounced in Q1 2018 if not for the 9.5% q/q slide in gross loans to N2.04trillion on the back of loan repayments, as NPLs fell close to 17% q/q to N87.6billion. If the bank's gross loans had been relatively flat q/q in Q1 2018, Zenith Bank's NPL ratio would have stood at 3.9% as at Q1 2018.

With this said, unlike other Tier 1 bank's, Zenith has yet to classify its 9Mobile (formerly Etisalat) exposure estimated at N60-70billion as non-performing, which could have pushed the bank's NPL ratio as high as 7.7%.

Nonetheless, the bank's lending capacity should also be supported by its strong capital base with capital adequacy ratio at 24% at bank level in FY 2017. While the initial implementation of IFRS 9 reduced Zenith bank's equity position by N138billion in Q1 2018, equivalent to 18.5% of total equity in FY 2017 (at bank level), capital adequacy should be sufficient to allow the bank to grow its loan book. As such we forecast a loan book growth of 12.3% (about 9% after adjusting for the impact of the higher translation rate).

The Cost of Risk

Despite the implementation of IFRS 9, and the negative impact it had on the bank's equity position, we expect cost of risk to moderate in FY 2018 to 2.1%, from 4.4% in FY 2017, in the absence of a significant shock such as the 9Mobile scenario of 2017.

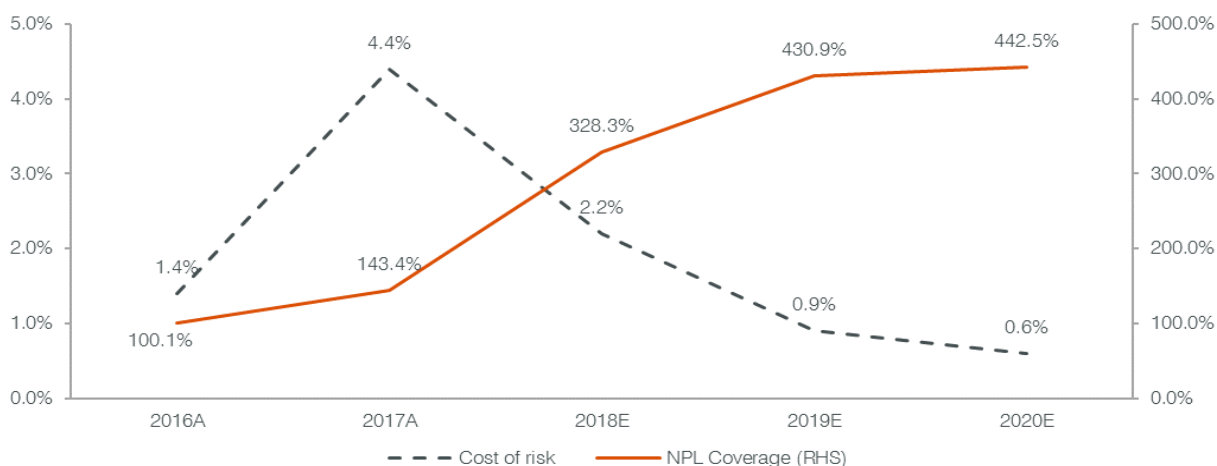
Our view is supported by the improvements in the domestic macroeconomic environment as well as the surge in oil prices to a four year high (US\$80per barrel) and the stability in the Niger Delta. These fundamentals should be a positive for the bank's asset quality in 2018 given its 31% Oil & Gas sector loan book exposure.

Furthermore, following the transfer of N138billion from equity to balance sheet provisioning, as a result of IFRS 9, the bank's NPL coverage surged to 320.7% as at Q1 2018, which should also support a lower cost of risk in FY 2018.

However, a breakdown in the pending sale of 9Mobile to Teleology and the potential classification could be a negative to our outlook. Furthermore, the high translation rate of foreign currency balances may also pressure our forecast as 27% of Zenith Bank's NPLs were in foreign currency as at Q4 2017.



Cost of Risk



Source: Company Financials, Investment One Research

Cost divergence

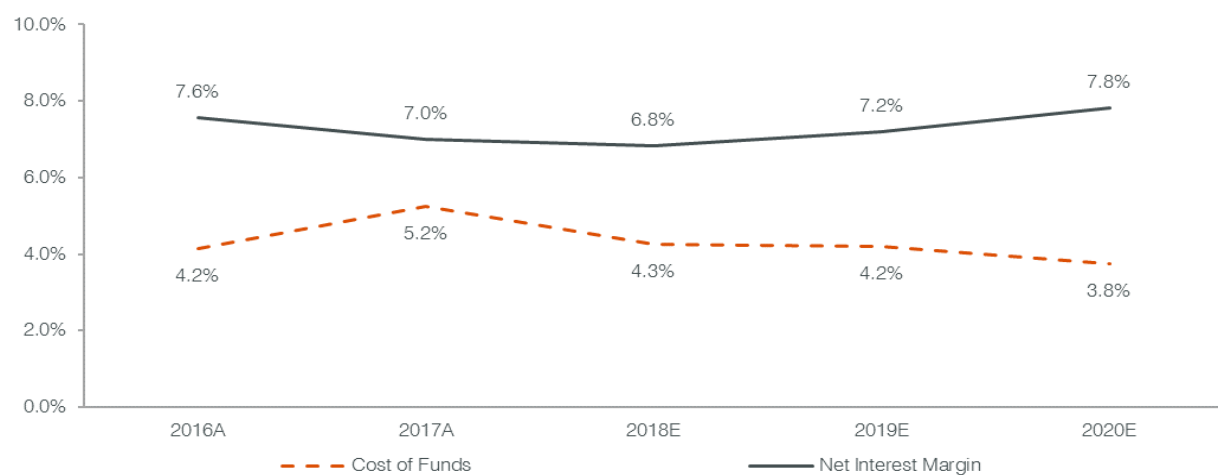
Nonetheless, weaker asset yields could pressure the bank's interest income performance given the prevailing lower yield environment currently being witnessed in 2018. As such, we see net interest margin falling by 10bps y/y to 6.9% in FY 2018 (unadjusted for Treasury bill gains in non-interest income).

We highlight that the modest decline in net interest margin is somewhat supported by our expectation for a sharp decline in cost of funds, which has decreased to 4.1% in Q1 2018, from a high of 5.2% in Q4 2017. This is also premised on lower yields on the treasury space, which should be a positive for the bank's ability to reprice term deposits in particular as well as grow low cost deposits in FY 2018, which the bank struggled to achieve in FY 2017.

On the flip side, while cost of funds should contract, we could see a modest increase in the bank's opex due to inflationary pressures in the economy although moderating. Our expectation of a marginal increase in opex appears to contrast the sharp 30.0% y/y jump witnessed in FY 2017.



Net Interest Margin Trend



Source: Company Financials, Investment One Research

However, we point out that the majority of the surge in opex, excluding AMCON charges in FY 2017, was foreign exchange driven, with about 17% of the bank's total opex excluding AMCON charges in FY 2016 exposed to foreign currency. These cost lines, mainly technology related, were negatively impacted by the sourcing of foreign currency at the Investors' & Exporters' foreign exchange (IEFX) window in FY 2017, against the interbank window previously.

With this said, given our view that the Naira is likely to remain relatively stable at the IEFX window, we do not foresee a significant jump in opex excluding AMCON charges.



Summary of Financials (N millions). Year End 31 Dec

Income statement	2016A	2017A	2018E	2019E	2020E
Gross earnings	507,997	745,189	683,366	691,121	709,514
Interest income	384,557	474,628	481,768	524,960	569,421
Interest expense	-144,378	-216,637	-203,614	-205,593	-214,414
Net interest income	240,179	257,991	278,155	319,367	355,007
Non-interest income	123,440	270,562	201,597	166,162	140,093
Profit before provisions	363,619	528,553	479,752	485,528	495,100
Loan impairment charges	-32,350	-98,227	-55,773	-24,795	-19,333
Operating expenses	-174,521	-226,864	-233,582	-248,628	-255,382
PBT before exceptional items	156,748	203,462	190,397	212,105	220,385
Profit before tax	156,748	203,462	190,397	212,105	220,385
Income tax	-27,096	-21,178	-23,800	-26,513	-27,548
Minority Interest	-218	-329	-308	-343	-357
Profit after tax	129,434	177,605	166,289	185,249	192,480
Balance sheet	2016A	2017A	2018F	2019F	2020F
T-bills	557,359	936,817	1,004,970	1,021,056	1,123,162
Due from other banks	459,457	495,803	684,691	635,991	667,790
Gross loans	2,360,809	2,252,172	2,530,145	2,761,788	3,037,967
Net loans & advances	2,289,365	2,100,362	2,197,899	2,404,747	2,661,593
Investment securities	199,478	330,951	409,164	427,416	470,158
Total assets	4,739,825	5,595,253	6,178,755	6,427,986	6,978,474
Deposits	2,983,631	3,437,915	3,878,654	4,024,113	4,426,524
Long term liabilities	263,106	356,496	389,200	391,490	411,065
Total liabilities	4,035,370	4,773,595	5,402,623	5,550,238	6,001,440
Shareholders' Funds	704,465	821,658	776,132	877,748	977,034

Source: Company Financials, Investment One Research



Summary of Financials (N millions). Year End 31 Dec

Key growth rates (y/y)	2016A	2017A	2018E	2019E	2020E
Net interest income	6.9%	7.4%	7.8%	14.8%	11.2%
Non-interest income	45.9%	119.2%	-25.5%	-17.6%	-15.7%
Profit before provisions	17.6%	45.4%	-9.2%	1.2%	2.0%
Operating expenses	4.0%	30.0%	3.0%	6.4%	2.7%
PBT	24.8%	29.8%	-6.4%	11.4%	3.9%
PAT before min. int.	22.7%	37.2%	-6.4%	11.4%	3.9%
EPS (adjusted)	22.7%	37.2%	-6.4%	11.4%	3.9%
Dividend sum	12.4%	33.7%	-0.9%	11.4%	3.9%
Net loans & advances	15.1%	-8.3%	4.6%	9.4%	10.7%
Non Performing Loans (NPL)	59.0%	48.3%	-4.4%	-18.1%	2.7%
Deposits	16.6%	15.2%	12.8%	3.8%	10.0%
Total assets	18.3%	18.0%	10.4%	4.0%	8.6%
Total liabilities	18.3%	18.3%	13.2%	2.7%	8.1%
Shareholders' Funds	18.5%	16.6%	-5.6%	13.1%	11.3%
Profitability ratios	2016A	2017A	2018E	2019E	2020E
Net interest margin	7.6%	7.0%	6.8%	7.3%	7.5%
Cost of funds	-4.2%	-5.2%	-4.3%	-4.0%	-3.8%
Cost/income ratio	52.7%	52.7%	55.1%	54.0%	53.7%
Cost/income ratio ex prov.	48.0%	42.9%	48.7%	51.2%	51.6%
Pre-tax margin	30.9%	27.3%	27.9%	30.7%	31.1%
ROA	3.0%	3.4%	2.8%	2.9%	2.9%
ROE	20.0%	23.3%	20.9%	22.5%	20.8%
Asset quality ratios	2016A	2017A	2018E	2019E	2020E
Provisions	71,444	151,810	332,246	357,041	376,374
NPL	71,374	105,865	101,206	82,854	85,063
NPL ratio	3.0%	4.7%	4.0%	3.0%	2.8%
Cost of risk	1.4%	4.4%	2.2%	0.9%	0.6%
NPL coverage	100.1%	143.4%	328.3%	430.9%	442.5%
Capital ratios	2016A	2017A	2018E	2019E	2020E
Capital adequacy	23.6%	27.4%	23.1%	23.8%	24.0%
Leverage	6.7x	6.8x	8.0x	7.3x	7.2x

Source: Company Financials, Investment One Research



Valuation

The new target price of N33.8 is arrived at by applying a 1.37x FV P/B estimate to our FV 2018 BVPS forecast of N24.7. We derive our FV P/B estimate using a sustainable ROE of 22%, which was weighed down slightly by the FY 2018 performance. Other key assumptions include a beta of 1.2, risk free rate of 13.0% and equity risk premium of 5.0% (previously 5.5%).

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Recommendations and Movements in Price Target

Date	Price (N)	Old Price Target (N)	New Price Target (N)	Old Recommendation	New Recommendation
09-Jun-15	19.8	N/A	22.9	N/A	BUY
03-Sep-15	15.3	22.9	23.1	BUY	BUY
09-Feb-16	12.7	23.1	17.9	BUY	BUY
24-May-16	15.0	17.9	17.7	BUY	BUY
14-Feb-17	15.1	17.7	19.1	BUY	BUY
07-June-17	20.2	19.1	22.2	BUY	BUY
25-May-18	26.7	22.2	33.8	BUY	BUY

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BUY

The stock is considered to be fundamentally strong with the potential to deliver returns in excess of 15% above the current price based on the analyst's target price.

HOLD

The stock is considered to be fairly priced, with potential to deliver returns between 5% and 15% above the current price based on the analyst's target price.

SELL

The stock is considered to be overvalued with weakening fundamentals, while the potential return is expected to be below 5% based on the current price and the analyst's target price.



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