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DLM RESEARCH

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The Nigerian Banking Industry Report

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BACKGROUND

This report was commissioned by the Nigerian Sovereign Investment Authority ("NSIA") and prepared by Dunn Loren Merrifield Asset Management & Research Co. Ltd. ("DLM AMR"). The report focuses on the credit analysis of eight publicly traded Nigerian banks, namely:

- Access Bank Plc.
- Diamond Bank Plc.
- Ecobank Group Plc.
- Fidelity Bank Plc.
- First Bank of Nigeria Holdings Plc.
- Guaranty Trust Bank Plc.
- United Bank for Africa Plc.
- Zenith Bank Plc.

In this report, the key areas of consideration include:

- The creditworthiness of the banks;
- Performance Evaluation of the banks;
- Understanding refinancing risk and market view of the Banks' credit;
- Identify the key factors that drive the Banks' future performance and evaluate the likely impact on credit standing;
- Ascertain the Banks' ability to service/refinance their respective obligations as they come due, and;
- Review of the debt structures to assess the extent to which they meet the commercial needs of the borrower and protect the lender's interests.

EXECUTIVE SUMMARY

INTEREST AND EXCHANGE RATE EXPECTATIONS

- **We anticipate that monetary authorities will continue to sustain the current contractionary monetary policy stance in the current year as risks remain elevated.** While we note that the disposition of the CBN governor is to gradually lower interest rate in order to stimulate growth of the real sector, we are persuaded however that the CBN is likely to continue its contractionary monetary policy stance in the current year to rein in the effects of the currency depreciation and or possible devaluation of the naira including upward inflationary pressures. Consequently, we project that the MPR will remain at current levels for the rest of the year. In our view, a blend of tighter liquidity in the banks, rising costs of funding, continued pressure on the naira among others will keep lending rates relatively high in 2015.

- **It is expected that the decline in oil prices will continue to exert pressure on the exchange rate due to the outflow of foreign funds as investors express concern on macro-economic stability due to the economy's over-reliance on oil.** We see the possibility of a further devaluation of the currency in the current year to ease the rapid depletion of Nigeria's foreign reserves if current economic realities persist. That is, a further adjustment of the mid-point of the official exchange rate to reduce the need for CBN to aggressively fund the foreign exchange market in a bid to maintain exchange rate stability. Based on the possibility of a further devaluation, we also anticipate a slight increase in NPLs across the industry. In addition, the impact of the lower oil price on government revenues will result in reduction in capital expenditure spending, thus adversely affecting the construction sector, contractors, agricultural sector among others which increases the possibility of default on these loans.

- **Overall, a protracted economic downturn driven by lower oil prices remain a risk as the economic implications for Nigeria will invariably affect the banks' performance by exerting pressure on profitability.** Although prices are expected to average $65-$70 in 2015, we also do not discount the possibility that global oil prices could continue to decline beyond these levels. The impact will be transmitted through austerity measures likely to be put in place which would reduce household savings and consequently deposits, constricted liquidity, policy inconsistencies, tighter rules by the CBN e.g. commencement of the treasury single account scheme among others.

ACCESS BANK PLC.

- **Healthy debt service coverage…** In our evaluation, Access Bank's debt service coverage ratio is relatively strong despite decreasing to 2.42x from 3.32x in the preceding year. This indicates that the bank's operating income is enough to cover 242% of its annual debt payments which in our view signifies a healthy credit quality of the bank.

- **… and interest coverage...** The bank's interest coverage ratio is equally comparatively healthy, as it increased to 2.19x in FY 2014 from 2.03x in the preceding year. The higher interest coverage ratio indicates lower possibility of default.

- **… supported by strong operating profit.** For the FY to December 2014, Access Bank's interest payment on debt issued and other borrowed funds stood at ₦17.20billion. This is 10.22% of the bank's operating income and 27.01% of operating profit. This is relatively strong in our view and indicates sufficient cash flow to service interest pay on the debt.

- **However, significant increase in Dollar debts raises concerns…** The significant increase in Access Bank's Eurobond in FY 2014 by ~148.10% to ₦138.49billion ($750mn) from ₦55.83billion ($350mn) in the preceding year is a major concern. In our view, this has significantly increased the bank's vulnerability to foreign exchange risk. Our view is underpinned by the possibility of a further devaluation of the naira, which will place considerable pressure on the bank's ability to service its debts.

- **… as highlighted in the increase in the bank's break-even ratio (BER).** In order to ascertain the refinancing strength of the bank, we estimate the bank's BER, which matches cash outflow to inflow i.e. interest on debt payment, operating expenses and operating income. Based on our evaluation, the bank has a comparatively stable BER at 52.77%. While this implies that the bank has strong operating income to refinance its debt obligations, nevertheless, we are inclined to highlight the increase in BER from 35.44% recorded in FYE 2013 to the current level.

- **Outlook.** We reckon that the main operating strength of the bank lies in improving profit margins on the back of improved interest earnings assets. There is bound to be tighter cost controls in response to regulatory induced revenue growth constraints. Improved operating stability can therefore be expected as regulatory pressure is expected to ease and banks devote more time to the corporate purpose of building wealth for shareholders. A drive towards improvement interest earning assets and the tendency to carry bad loans on the balance sheet will determine the future growth prospect of the bank.

  Meanwhile, we are equally of the opinion that Access Bank's exposure to the downstream sector of the oil & gas industry remains a major cause for concern in view of the non-payment of subsidies by the federal government thus far in 2015. While the bank has reduced its exposure to this sector over the years, its exposure of c.12% is still the second largest sectoral exposure in its portfolio of risk assets. Therefore, we believe the required provisioning that will occur as a result of these developments will restrain the bank's profitability in the current financial year.

DIAMOND BANK PLC.

- **In our view, Diamond Bank's solvency indicates lower risk to both debt and equity holders…** The bank's liquidity ratio of 41.70% in FY 2014, signals adequacy of funds to grow its balance sheet. We note that though the capital adequacy ratio of 17.48% lies above the 15% benchmark stipulated by the CBN, there is a need to further strengthen its capital base to support future growth. Consequently, we are positive on the bank's leverage, especially as it strengthens our position on the overall growth in shareholders' wealth.

- **… despite a comparatively high break-even ratio.** In addition, we highlight that the bank's interest coverage ratio at 2.41x reflects the availability of earnings to meet interest payments. In order to ascertain the refinancing strength of the bank, we established the bank's break-even ratio which matches percentage of cash outflows to cash inflows. This measures how much room we think the bank has to refinance the debt obligations. Based on our evaluation, the bank's break-even ratio of 85.19% is above our acceptable limit of 80%. This means that operating income only exceeds cost by 14.81%. Consequently, we recommend a lower ratio as we note that the current level is a pointer to medium term sustainable cash flow challenges and risk.

- **Diamond Bank is characterized by organic growth in terms of business expansion.** The performance of the bank has been based on its retail franchise, aggressive loan strategy - particularly loans channelled to over 30,000 MSMEs in Nigeria in the last six years, innovation in e-banking and the rollout of new products geared towards the "banking the un-banked" strategy. Diamond Bank is arguably the largest tier 2 bank in Nigeria with total assets of ₦1.93trillion and shareholders fund of ₦209.02billion in FYE'14. Gross earnings increased by 94.24% from ₦107.29billion in FY2011 to ₦208.40billion in FY2014, while profit after tax increased significantly to ₦25.49billion from a loss of ₦13.94billion posted in FY2011 - driven by the significant loan loss provisions and exceptional loss recorded. While we note the bank's strong recovery post-FY-2011, we are inclined to highlight that its profitability came under some pressure in FY2014 on the back of regulatory headwinds, higher loan impairment charges and increased operating expenses. This is further reflected in the reduced ability to deliver results to shareholders as return on average equity and return on average assets stood at 14.65% and 1.48% in FY2014 down from 23.05% and 2.12% respectively in the preceding year. The high cost of funding and lower net interest spread depressed net interest margin to 6.6% from 7.2% in the previous year. Operating efficiency is still a source of concern as cost/income ratio remains elevated at 64.57% due to high operating expenses. In view of intense competition in the sector, we anticipate the bank will look to implement some cost reduction strategies to improve efficiency.

- **Operating income, albeit weak, is sufficient to offset interest payment on existing debts.** Based on FY 2014 results, interest payment on debt issued and other borrowed funds was ₦4.88billion i.e. 3.1% of operating income of ₦156.85billion. In addition, with current debt of ₦106.50billion, the banks also have adequate liquid assets including cash and tradable securities (₦301.39bn) to cover maturing obligations. Furthermore, the bank's debt service coverage ratio rose to 1.27x from 0.11x in the preceding year which indicates that the bank's operating income is enough to cover 127% of its annual debt payments. However, we are inclined to highlight any significant pressure on operating income could result in the bank's inability to cover annual debt payments.

- **In our opinion, market perception of the bank's credit has lowered in recent times underpinned by the bank's weaker asset quality and refinancing risk.** The Bank's plan to raise additional capital of US$750 million approved in 2012 was largely unsuccessful, as only US$200 million was raised. In May 2014, the Bank issued a debut 5 year $200 unsubordinated

unsecured Eurobonds with a coupon of 8.75% with the yield at inception being 9.0% (issue price of 99.0). The yield spread offered by the bank reflects the fact that global fixed income investors were reluctant to buy into it. In addition, while other Nigerian corporate Eurobonds have similar ratings, Diamond Bank's Eurobond has the widest spread (385bps) compared with FGN bond maturing in 2021. Those for others are GTB, 267bps (2018); Fidelity Bank, 25bps (2018); Zenith Bank, 239bps (2019) and; FBNH, 43bps (2020) Overall, we believe this reflects investors' demand for a higher premium given the refinancing risk.

- **The bank is vulnerable to regulatory headwinds in its operating environment, albeit to a minimal degree.** Going forward, we are of the view that Diamond Bank has potential to boost its earnings through an introduction of cost reduction strategies, efforts to significantly reduce impairment charges and a sustained retail strategy aimed at attracting cheaper deposits given the huge retail opportunities in Nigeria. In addition, greater management efficiency and creation of high quality risk assets is fundamental to the bank's ability to sustain earnings growth in the face of regulatory headwinds in the banking sector. In our view, the bank currently has a poor credit risk structure which poses some concerns as it could be a drag on profitability if not properly managed. We are also inclined to highlight that loan concentration risks are inherent a significant number of huge MSMEs defaults could negatively impact on the bank's capital base. While we acknowledge the bank's recent capital raising exercises in the previous year ($200mn Eurobond in June 2014 and ₦50.4bn rights issue offering in August 2014), we are of the opinion that the recent capital injection is not fully sufficient to sustain a similar pace of risk asset growth. Consequently, we believe this would hamper the bank's income generating capacity in the current year. Our position is further supported by the need for the bank to significantly improve the quality of its risk asset portfolio while embarking on an aggressive loan recovery programme given the increase in its NPL ratio rose to 5.1% due of the exposure to the retail space and the attendant drag on asset quality due to defaults. The increase in non-performing loans was principally driven by the real estate and general commerce sectors, which accounted for 54%. Among its peers, Diamond Bank recorded the highest loan-loss provisions with ₦26.4billion. Out of the eight tier-two banks, Diamond Bank accounted for 35.87% of the combined total loan-loss provisions of ₦73.6billion.

- **Whilst we understand the rationale behind the bank's dollar debt funding, we highlight that it increases the bank's vulnerability to foreign exchange risks, particularly given the near term outlook.** We observed that the increase of 55.71% in debts in FY 2014 to ₦106.5billion from ₦68.4billion in the preceding year is a major concern as further growth could weaken debt servicing ability. We note the bank's Eurobond and other dollar denominated debt accounted for 65.41% of overall debt, which is a key risk in our view. Hence, a further devaluation of the local currency especially when repayment is due will make settling the foreign currency denominated debt more expensive. In addition, the bank's loan book also appears to be highly concentrated with three sectors accounting for 70% of gross loans to customers at the end of FY 2014.

ECOBANK GROUP

- **Ecobank: Is there a take-over in the horizon?** Having decided to pursue an inorganic growth strategy in Nigeria, Ecobank acquired 100% stake in Oceanic Bank Plc from AMCON in Q4 2011. This propelled the bank to the top tier within the domestic banking space especially with respect to revenues, branch network, total assets, deposits and shareholders' funds. Subsequently, the bank expanded this strategy into its Africa operations by acquiring 96% stake in Banco ProCredit Mozambique, through a share purchase agreement. The bank appears to be positioning for growth strategy that will offer excellent prospects in the near future. This growth prospects explain the rationale behind Qatar National Bank's acquisition of 12.5% stake of the bank from AMCON; this was subsequently increased to 23.5% to become the dominant shareholder in the bank. This is in addition to Nedbank's 20% stake in Ecobank. All together, these have raised concerns of a possible takeover of the bank by these two much larger financial institutions that are seeking to foray into sub-Saharan Africa and Nigeria.

- In 2014, Ecobank raised $200 million subordinated notes maturing in 2020, with a yield of 9% and a coupon of 8.75%. Obviously, this has increased that bank's exchange rate risk while the yield spread offered by the bank reflects investors pricing of risk inherent in the bond. Among other Nigerian corporate Eurobonds with similar ratings, Ecobank's Eurobond has the second widest spread (410bps) compared with FGN bond maturing in 2021. Those for others are FBNH, 70bps (2020); Diamond Bank, 30bps (2019) and; FBNH, 50bps (2021). Overall, we believe this reflects investors' demand for a higher premium given the refinancing risk.
- **Business expansion supports current profitability.** In the FY to December 2014, Ecobank reported a 19% increase in gross earnings to ₦489.25billion from ₦411.18billion in FY2013. Similarly, profit after tax increased by 179% y/y to

₦65.68billion from ₦23.57billion in FY2013; this significant growth was driven by treasury income, fees and commissions and strong growth in customer loans especially in Nigeria despite the impact of FX translation. However, we observed that net interest income was restrained by spread compression due to an increase in cost of funds. The high cost of funding and lower net interest spread depressed net interest margin to 6.8% from 7.1% in the previous year. Operating efficiency is still a source of concern despite cost/income ratio declining to 65.4% from 70.1% in the prior year. In view of intense competition in the sector, we anticipate the bank will look to implement some cost reduction strategies to improve efficiency. It has already executed staff redundancies in Q1 2015. The current efficiency gain was due to benefits of business synergy and ICT investments across its platform. Overall, the strong performance for the year was spurred by strong performance from treasury, which benefited from currency volatility and higher transaction volumes.

- **Asset quality and CAR remain strong.** We are inclined to say that the bank is well capitalised based on its current risk weighted assets, recording tier 1 risk-based capital ratio of 18.30% and risk weighted capital adequacy ratio of 20.40%, (FY13: 16.30%), which is at premium to the CBN regulatory limit of 15%. We note that the bank also maintained good tangible common equity ratio of 8.56%, (FY13: 6.53%). Hence, the bank's capital management policies support its business expansion strategy and ensure sufficient capitalisation to withstand unexpected macroeconomic shocks. We are inclined to state that the key drivers of growth in the bank's CAR were IFC's convertible loan of US$75.2million which was converted to838.3million new shares and 4.5billion shares issued to Nedbank (20% stake) following its loan conversion and top-up investment. While the current CAR appears strong enough to support the bank's business risk, there is a need to further strengthen its capital base to support future growth. Therefore, the plan to raise additional tier 1 capital in Q3 2015 will augur well for the bank as it will help to strengthen overall capital base and support long term growth. The bank's non-performing loan ratio of 4.4% decreased from 6.2% in FY13 largely due to aggressive loan recoveries by its Early Warning and Remedial Recovery (EWRR) teams. The banks' non-performing loans ratio is below the Central Bank of Nigeria's (CBN) informal cap of 5%. Regardless, we believe the current position is relatively high and signals accumulation of bad loans. Overall, the coverage ratio for the entire portfolio of loans decreased to 68.7% from 79% in the preceding year. The relative decline in the coverage ratio is due to the decrease in NPL, however, going forward, we are of the opinion that the bank should be better provisioned to deal with future loan losses as this could be an additional drag on the bank's earnings. In our assessment, it was observed that the highest proportion of NPL was recorded in east Africa (6.9%) and southern Africa (6.4%), while the Nigeria operation recorded the lowest NPL of 3.2%. Hence, exposure to these other African countries is a key risk and reflects high credit concentrations as well as emerging risks. While the bank maintains strong capital adequacy levels, we believe the current asset-liability ratio of 0.89 is high which in our view indicates near-to-medium term challenges in meeting debt obligations. We therefore highlight that a rise in interest bearing liabilities burden without a corresponding increase in cash flow could trigger default risk.

- **The bank is exposed to liquidity risk despite having liquid balance sheet position.** By our assessment, the bank's balance sheet is highly liquid, with earning assets constituting ~80.40% of its total assets as at FY14. This indicates the bank's ability to fund itself under stressed conditions with minimum level of support from regulatory authorities. This is particularly an important factor for the bank that operates in an environment where conditions can change rapidly. As such, the prime risk to the bank to renew or replace maturing funding liabilities appears low. However, based on FY14 results, the bank is exposed to liquidity risk for maturities of up to one month due to overnight contractual maturity of current and savings deposits which accounted for over 70% of total deposits. Although, liquidity ratio increased from 25.6% to 26.5%, it is still below the regulatory limit of 30% while loan-to-deposit ratio was flat at 72.8% as at the end of 2014.

- **Acceptable credit concentration.** Whilst we observe an increase in loans to key sectors which reflects increasing credit concentration as well as emerging risks, particularly the oil & gas and trade finance sectors, no single loan to a sector was above 20% of total loans. Hence, we highlight that the strategic and reduced loan concentration across selected industries indicates the limit of credit exposures the bank is willing to assume – which also reflects its credit risk appetite. Thus, reducing loans to the sectors for which there may be an increased risk of loss or default - particularly the manufacturing sector where the bank recorded the highest NPL ratio of 4.3% - will help to boost the asset quality of the bank.

- **Interest coverage needs to improve further...** Ecobank's interest coverage ratio is relatively healthy, increasing to 1.27x from 0.43x in the preceding year. This implies that operating profit is sufficient to offset interest payment on existing debt and other borrowed funds. However, we note a further growth in the bank's debt burden will put pressure on its operating profits.
- **…along with the break-even ratio…** In order to ascertain the refinancing strength of the bank, we established the bank's break-even ratio which matches percentage of cash outflows to cash inflows – a measures of how much headroom we believe

the bank has to refinance its debt obligations. Based on our estimates, the bank's break-even ratio of 81.96% is above our acceptable limit of 80%. This means that operating income is more than cost by 18.04%. Given the bank's offshore exposure, we therefore recommend a lower ratio as we note that the current level is a pointer to medium term sustainable cash flow challenges and risk.

- **… as the debt service coverage ratio reveals the true situation…** We pay more attention to this ratio in view of its relative importance in evaluating the bank's credit condition. In our evaluation, the bank's debt service coverage ratio weakened to 0.91x in FY14 from 2.81x in the preceding year, indicating a decreasing and weak capacity to service its debts.

- **In our outlook** we reckon that the main operating strength of the bank is predicated on the need to support Africa's trade and infrastructure development through private-public partnerships and regional integration. This offers the opportunity to finance projects of larger scale at lower unit costs. The bank will need to leverage on its diversified business model to drive revenues, particularly in non-funded income and focus on LOBs to play to their strengths in each of their respective markets.

FIDELITY BANK PLC.

- Despite maintaining an insignificant share of the industry in terms of asset, loans and deposits, Fidelity Bank is well capitalised at ₦173.111billion based on its current risk weighted assets of ₦821.527, recording a risk weighted capital adequacy ratio of 24.21%, (FYE13: 21.77%), which is at premium to the CBN regulatory limit of 15%. The bank's tier 2 capital is 33.33% of its tier1-which is also in line with the CBN regulatory limit. In our view, the current CAR is sufficient to support the bank's business risk. The additional ₦30billion debt raised through local currency may augur well for the bank to further boost its CAR; however, its ability to service debts remains a key risk particularly in view of the current asset liability mismatch. The bank's non-performing loan ratio of 4.4% increased from 3.7% in FY13 (FY12: 3.9%). We note that the increase in NPL for the period was caused by newly classified loans in the communication, manufacturing, and consumer sectors. In our view, the fact that the current NPL inches towards the CBN limit of 5% poses significant concern as a further increase in NPL particularly from the 'high risk' sectors will push the ratio above 5% in the current year.

- **Exposure to exchange rate risk is high in our view.** Fidelity Bank has a relatively high exposure to the effects of fluctuations in exchange rates on its financial assets and liability. This is the risk that the fair value or future cash flows of its financial instrument will be adversely affected by changes in exchange rate. While the bank's cash flow is in local currency, persistent decline in naira against the issued currency ($) will increase the debt burden of the bank and further pressure its profitability.

- **Oil & Gas exposure reveals a higher degree of credit risk.** We observe an increase loans to key sectors which reflects increasing credit concentration as well as emerging risks particularly in the oil & gas sector. For the bank, oil & gas lending is the most expansionary segment of the bank's risk assets portfolio. We believe the weakening asset quality in the preceding years prompted the management to review its strategy and hence significantly reduced its exposure to selected sectors. The trend towards stabilizing diminution in asset quality is definitely a reflection of a much changed risk appetite and risk discipline of the bank. However, given the increased lending to the oil & gas sector, an upward trend in NPL is most probable in the short-to-medium term.

- **Operating profit appears sufficient to offset interest payment on existing debt, at present.** Based on FY 2014 results, we note that interest payment on debt issued and other borrowed funds stands at ₦3.71billion. This currently stands at 5.11% of the bank's operating income of ₦72.62billion and 23.90% of operating profit of ₦15.52billion. However, with the newly issued ₦30bn local currency bond which was fully underwritten, we note a further pressure on the bank's operating profit. To this end, we expect the overall debt outstanding of the bank in a region of ₦150billion, while we also anticipate interest payment on debt and other borrowed funds to grow to ₦8.65billion–which is 11.91% and 55.72% of expected operating income and operating profit respectively.

- **Interest coverage ratio appears strong...** Fidelity Bank's interest coverage ratio is relatively healthy, increasing to 4.18x from 2.84x in the preceding year.

- **… however, debt service coverage reveals the true situation…** We pay more attention to this ratio in view of its relative importance in evaluating the bank's credit condition. In our evaluation, the bank's debt service coverage ratio weakened to 2.25x from 5.78x, indicating a decreased capacity to service its debts

- **… supported by a comparatively high break-even ratio.** Based on our evaluation, the bank's break-even ratio of 83.73% is above our acceptable limit of 80%. This means that operating income only exceeds cost by 16.30%.

- **Outlook.** We reckon that the main operating strength for the bank lies in improving profit margins a possible strengthening of the naira and lower exposure to the downstream oil & gas sector. There is bound to be tighter cost controls in response to regulatory induced revenue growth constraints. Improved operating stability can therefore be expected as regulatory pressure is expected to ease and banks devote more time to the corporate purpose of building wealth for shareholders. The tendency to carry distressed risk assets on balance sheet is an impediment to the future growth prospects of the bank.

FIRST BANK OF NIGERIA HOLDINGS PLC.

- **Significant increase in dollar debt is worrisome.** The significant increase in dollar debt in FY 2014 by 192.72% to ₦369.71billion from ₦126.3billion in the preceding year is a major concern as a further devaluation will weaken debt servicing ability and invariably increase the bank's asset quality risk. We note the bank's Eurobond accounts for 38.36% of overall debt. Hence, a further devaluation of the local currency especially when repayment is due will make settling the foreign currency denominated debt more expensive. This is a key risk in our view.

- **Interest payment on debt almost at par with operating profit.** The bank's ability to pay interest and principal borrowing depends largely on its operating income/operating profit and cash flow generation potential. Based on it FY 2014 results, we note that interest payment on debt issued and other borrowed funds stands at ₦83.16billion. This is 25.35% of the bank's operating income and 90.11% of operating profit. This appears weak in our view and signals default probability. Hence, this and capital adequacy ratio explained the rationale behind the low dividend pay-out in FY 2014.

- **High break-even ratio implies refinancing risk.** This measures how much room we think the bank has to refinance the debt obligations. Based on our evaluation, the bank's break-even ratio of 131.77% is relatively high and above our acceptable limit of 80%. This means that operating income is less than cost by 31.77%.

- **Increasing loan concentration signal asset deterioration.** FBNH's loan book appears to be concentrated with the 8-largest loans accounting for 90.11% of gross loans to customers at the end of FY 2014. Oil & gas lending is the most expansionary segment. However, given the increased lending to the oil & gas sector, an upward trend in NPL seems likely in the short-to-medium term. In the light of declining oil prices and exchange rate, pressure on the asset quality side cannot be ruled out for 2015. Macroeconomic weakness and exchange rate pressure should add to the growing NPL ratio. Therefore, the bank's NPL ratio may increase to c.3%-3.2%, depending on total loan extensions in 2015. Adding to this is the significantly lower provision for fuel subsidies by the Federal government in 2015 appropriation act, indicating a likely situation of extended non-performing risk assets in the bank's books.

- **Weak interest coverage ratio…** The bank's interest coverage ratio declined to 0.78x in FY 2014 from 0.96x in the preceding year. The lower ICR indicates lower earnings are available to service interest obligation on the bank's debts.

- **… and weaker debt service coverage.** We note that the bank's debt service coverage ratio is relatively weak despite increasing to 0.64x from 0.40x in the preceding year which indicates that the bank's operating income is enough to cover only 64% of its annual debt payments which in our view may signifies a potential risk of default on payment.

- **Default probability is present albeit minimum.** The bank appear to be stable but with uncertainty of financial position and future cash flow in view of the challenging operating environment. Hence, default risk appear to be inherent but at a reduced rate in comparison to its peers in the industry given its relative systemic importance. We note that many things can influence default risk on the bank debt instruments such as falling cash flow from operations which is often needed to make the interest and principal payments, rising interest rates since the bonds are floating-rate bonds as rising interest rates would increase the required interest payments.

- **Outlook.** We reckon that the main operating strength for the bank lies on its low cost deposit mobilization. There is bound to be tighter cost controls in response to regulatory induced revenue growth constraints. In addition, we expect the First Bank Group to leverage on its leading position in the investment banking and investment management space of the domestic market to drive income going forward. Our view is underpinned by the fact that the Group's investment banking group (corporate finance, M&A, asset management, securities trading) was recently licensed by the CBN to operate as a merchant bank.

GUARANTY TRUST BANK PLC.

- **In our view, the bank's solvency signals lower risk to both debt and equity holders and invariably support its credit worthiness.** In view of GTB's capital adequacy ratio and liquidity ratio at 21.40% and 40.00% respectively in FY2014, we are of the opinion that the bank has adequate funds to grow its balance sheets. We are positive on the bank's leverage, especially as it strengthens our position on the overall growth in shareholders' wealth by further driving its momentum of higher return on equity. In addition, we highlight that the bank's interest coverage ratio at 3.75x reflects earnings are available to a reasonable degree to meet interest payments.

- **Guaranty Trust Bank has been characterized by strong profitability, low cost business model, healthy asset quality driven by sound underwriting, and an aggressive growth strategy implemented by its management team.** The bank has consistently enhanced its performance with gross earnings growing by 46.34% from ₦190.32billion in FY2010 to ₦278.52billion in FY2014, while profit after tax (PAT) increased significantly by 149.20% to ₦98.69billion from ₦39.60billion posted in FY2010. The bank also has a strong aggressive expansion strategy and has largely delivered on its targets by improved service offerings and leveraging on its status as the pioneer of 'Social Banking' in Nigeria which led to the introduction of additional channels for banking transactions. This has driven performance in recent years with the bank emerging as a clear leader in terms of delivering results to shareholders as return on average equity and return on average assets stood at 27.93% and 4.43% in FY2014 respectively. The bank's impressive performance is also supported by the strong management efficiency buttressed by the cost/income ratio of 44.79% as at FY2014 which is the lowest in the sector.

- **Whilst we understand the rationale behind the increase in the bank's dollar debt funding, we highlight that it increases the bank's vulnerability to foreign exchange risks, particularly given the near term outlook of the naira and the possibility of a further devaluation.** The increased dollar loan exposure in FY2014 by 61.16% to ₦648.91billion from ₦402.64billion in the previous year also raises some concerns as a further devaluation could impact debt servicing ability of the loan beneficiaries and increase the bank's asset quality risk. Consequently, the possibility of a negative impact of a further devaluation on the banks' credit risks is elevated to a reasonable degree.

- **We are of the view that the market view of the bank's credit standing is been largely positive underpinned by the bank's track record, robust performance and positive outlook for future growth.** The $350 million Regulation S Eurobond issue in January 2007 which was oversubscribed by 148.86% made GTB the first Nigerian company to issue Eurobonds and also, the first Nigerian institution to venture into the international capital markets without a sovereign guarantee or credit enhancement from any international financial institution. This in our view set a positive precedence for subsequent issuances undertaken by the bank.

- **Whilst the bank has demonstrated its ability to withstand headwinds in its operating environment; we believe that macroeconomic stability, strong management team, policies that support banking sector growth and favourable competition would drive the bank's future performance in the medium to long term.** Going forward, we are of the view that the performance of the retail banking segment reflects growing customer base driven by the massive investment in telephone contact centre to ensure real time responses to customers' enquiries. However, further expansion of the bank's retail market can be achieved via an increase in its branch network as it lags behind the number of branches of its major competitors. We are also inclined to highlight that the bank has a concentrated customer base which increases vulnerability to weakening industry specific conditions. As a result, loan concentration risks are inherent as a significant number of huge corporate defaults could negatively impact on the bank's capital base.

- **Overall, we note that a probability of default remains largely minimal as the bank appears to be stable with relatively healthy fundamentals.** The low probability of default is further supported by the bank's high debt service cover ratio which shows that the bank's operating income is enough to cover 205% of its annual debt payments. We remain optimistic that the bank will continue to leverage on its strong track record and improved capital base to support growth in the medium term.

Hence, we are of the view that adverse changes in the macro-economic and regulatory environment will not significantly affect the bank's ability to meet payment obligations as at when due.

- The bank's debt structure consists of debt securities estimated at ₦167.32billion as at FY2014. We highlight that 99.76% of total debt securities issued consists of Eurobonds which include the $500m, 5yr, 7.5% note due 2016 and the $400m, 5yr, 6% note due 2018 whilst 0.24% account for corporate bonds. In the event of a further devaluation, the current debt structure can result in volatile earnings as a result of the additional interest expense which increase the chances of a default.

UNITED BANK FOR AFRICA PLC.

- **In our view, UBA's solvency indicates negligible risk to both debt and equity holders…** The bank's liquidity ratio of 48.90% in FY 2014, signals adequacy of funds to grow its balance sheet. We note that though the capital adequacy ratio of 17.00% lies above the 15.00% benchmark stipulated by the CBN and appears strong enough to support the bank's business risk, we believe there is a need to further strengthen its capital base to support future growth. In addition, we highlight that the bank's interest coverage ratio at 2.13x reflects the availability of earnings to meet interest payments. In order to ascertain the refinancing strength of the bank, we established the bank's break-even ratio which matches percentage of cash outflows to cash inflows. Based on our evaluation, the bank's break-even ratio stood at 72.13% as at FY2014 which implies that operating income exceeds cost by 27.87%. Given that this ratio still lies below our acceptable limit of 80%, we are of the opinion that current position still supports the sustainability of the bank's cash flow in the short to medium term. Consequently, we are positive that the bank's strong liquidity position would enhance its aggressive lending drive whilst supporting profitability and overall growth in shareholders' wealth.

- **Over the years, the bank's performance has been supported by its strong domestic franchise, relatively strong international presence, good funding profile, strong liquidity position, good asset quality and strong management team with a proven track record.** UBA is the fourth largest bank in Nigeria by balance sheet size, with total assets worth ₦2.76trillion as at December 31, 2014. Gross earnings increased by 56.91% from ₦184.83billion in FY2011 to ₦290.02billion in FY2014, while profit after tax increased significantly to ₦47.91billion from a loss of ₦10.47billion posted in FY2011 - driven principally by a one-off write-off against earnings, including those arising from the transfer of loans to the Asset Management Company of Nigeria (AMCON). While we note the bank's strong recovery in FY2012, we are inclined to highlight that its profitability came under some pressure in the last two years on the back of tax effects and increased operating expenses. The bank's return on average equity (ROAE) remained competitive in FY2014 at 19.15% though we note the steady decline from 30.22% and 21.80% in the two preceding years. Return on average assets also declined to 1.77% in FY2014. The higher cost of funding was insufficient to negatively impact net interest margin as it improved marginally to 6.00% from 5.90% in the previous year. Operating efficiency is still a source of concern as cost/income ratio remains elevated at 67.40% higher than 60.90% recorded in the previous year. In view of intense competition in the sector, we anticipate the bank will look to implement some cost reduction strategies to improve efficiency.

- **Operating income is sufficient to offset interest payment on existing debts.** Based on FY2014 results, interest payment on borrowed funds was ₦9.13billion i.e. 4.74% of operating income of ₦192.46billion. Furthermore, the bank's debt service coverage ratio rose to 2.23x from 1.06x in the preceding year which indicates that the bank's operating income is enough to cover 223% of its annual debt payments. Consequently, we note that a probability of default remains largely minimal as the bank appears to be stable with relatively healthy fundamentals. We remain optimistic that the bank will continue to leverage on its strong track record to support growth in the medium term. Hence, we are of the view that adverse changes in the macro-economic and regulatory environment will not significantly affect the bank's ability to meet payment obligations as at when due.

- **In our opinion, market perception of the bank's credit has been largely positive supported by its strategic positioning and continued leverage on the existing strength of the franchise.** UBA's plan to raise capital has been largely successful supported by bonds issued by the bank over the years. In 2010, UBA raised ₦20billion fixed rate subordinated unsecured notes, maturing in 2017 with a coupon of 13%. This was followed by a ₦35-billion fixed rate subordinated unsecured notes, maturing in 2018 with a coupon of 14% issued the following year. In December 2014, the bank raised ₦30.5billion fixed rate unsecured notes maturing in 2021. We also note the recent increase in Tier-1 capital via an ₦11.5 billion rights issue, which was concluded in Q1 2015. Meanwhile, we are inclined to highlight that the extension of the offer period and discount of 12.5% in the offer price to ₦3.50 which reduced gross proceeds to ₦11.5 billion from the expected

₦13.2billion was predominantly driven by the lull observed in the domestic equity market at the time of issue rather than negative investor sentiments.

- **Whilst the bank has demonstrated its ability to withstand headwinds in its operating environment, we believe that macroeconomic stability, strong management team, and favourable competition would drive the bank's future performance in the medium-to-long term.** Going forward, we are of the view that UBA has potential to boost its earnings through an introduction of cost reduction strategies and retail expansion aimed at attracting cheaper deposits given the huge retail opportunities in Nigeria. In addition, we believe greater management efficiency and sustained creation of high quality risk assets is fundamental to the bank's resilience in the face of regulatory headwinds in the banking sector. In our view, the bank currently has a strong credit risk structure which buttresses its ability to significantly grow its loan book at moderate risk supported by a low NPL ratio of 1.55% - the lowest among our coverage banks. However, we are also inclined to highlight that the bank has a concentrated customer base (loan portfolios and deposit base) which increases vulnerability to weakening industry specific conditions. Loans to corporate entities and other organisations accounted for 89.20% of total loans whilst deposit from corporate entities accounted for 67.03% of total deposits in FY2014. As a result, loan concentration risks are inherent as a significant number of huge corporate defaults could negatively impact on the bank's capital base whilst putting pressure on asset quality and margins. Overall, we expect that UBA will continue to leverage on the strength of its management team, large branch network, improved technology and business initiatives to compete effectively as banks increasingly focus on the same space invariably leading to a more intense competitive environment and the proliferation of financial products.

- **Whilst we understand the rationale behind the increase in the bank's dollar denominated debt in FY2014, we highlight that it increases the bank's vulnerability to foreign exchange risks, albeit to a minimal degree.** UBA's debt structure consists of borrowings estimated at ₦113.80billion as at FY2014, representing a significant increase of 132.86% from ₦48.87billion in the preceding year. We highlight that 77.64% of total borrowings are dollar-denominated whilst 22.36% account for domestic borrowing. In the event of a further devaluation, the current debt structure can result in additional interest expense which could weaken debt servicing ability and increase the chances of a default. Subordinated liabilities which represent medium-term bonds issued by the bank also increased by 53.32% to ₦85.32billion from ₦55.65billion in the previous year. However, we note that this is naira denominated and as such poses no foreign exchange risk.

ZENITH BANK PLC.

- **In our view, the bank's solvency signal lower risks to both debt and equity holders and invariably support the bank's credit worthiness.** With the bank's capital adequacy ratio and liquidity ratio at 20.00% and 47.00% respectively in FY2014 – well above the regulatory benchmarks of 10% and 30% respectively, we are of the opinion that the improved capital and liquidity positions support loan growth and invariably improved profitability. We are also positive on the bank's leverage, especially as it strengthens our position on the sustainability of the bank's funding. In addition, we highlight that the bank's lower interest coverage ratio at 2.65x in FY2014 from 3.58x in the preceding year- though sufficient reflects that lower earnings are available to meet interest payments and that increases the bank's vulnerability to increases in interest rates.

- **We remain optimistic that the bank will continue to leverage on its strong balance sheet and improved capital base to support growth in the medium term.** Over the years, Zenith Bank has been characterized by aggressive growth; primarily driven by focus on quality service delivery, leveraging on information and communication technology and the conservative business model through an expansion of branch network to generate deposits from the retail end of the market. Zenith has recorded consistent profitability as it maintains a strong competitive edge through focus on high quality assets, strong liquidity position, brand leverage and corporate and retail strategy. Hence, we are of the view that adverse changes in the macro-economic and regulatory environment will not significantly affect the bank's ability to meet payment obligations as at when due. Our view is firmly supported by the bank's earnings, strong asset quality, and robust capital base, which are sufficient to cushion business risks.

- **In our opinion, the recent increase in the bank's dollar debt funding increases the bank's vulnerability to foreign exchange risks.** In addition, we are inclined to highlight that 43.45 per cent of Zenith Bank's lending is in foreign currency with dollar lending accounting for 39.38% with a relatively significant net on-balance sheet position to foreign exchange. The increased dollar loan exposure in FY 2014 to ₦692.35billion from ₦296.44billion in the previous year also raises some concerns as a further devaluation could impact debt servicing ability and increase Zenith Bank's asset quality risk. Consequently, the possibility of a negative impact of a further devaluation on the banks' credit risks is elevated to a reasonable

degree. We are of the view that investors' perception of Zenith Bank is fundamentally positive underpinned by its strong balance sheet, liquidity and healthy asset quality.

- **Whilst the bank has demonstrated its ability to withstand headwinds in its operating environment; we believe that macroeconomic stability, sustenance of strategies to de-risk its loan book, and favourable competition would drive the bank's future performance in the medium-to-long term**. We are of the view that Zenith Bank's earnings appear to be largely revenue-driven as opposed to cost-reduction. Consequently, we expect the bank to maintain strong levels of profitability through its strategy to continually grow market share, widen its distribution networks and the continued creation of quality risk assets. The expectation of continued creation of quality risk assets is against the backdrop of the bank's non-performing loans ratio of 1.80% recorded in FY 2014. However, in view of intense competition in the sector, we anticipate the bank will look to implement some cost reduction strategies to improve efficiency.

- **Overall, we note that a probability of default remains significantly low as the bank appears to be stable with relatively robust fundamentals.** The low probability of default is further supported by the bank's high debt service cover ratio which shows that the bank's operating income is enough to cover 6.40x of its annual debt payments. As a result, the probability of default on payment is unlikely. Overall, we are of the view that adverse changes in the macro-economic and regulatory environment will not significantly affect the bank's ability to meet payment obligations as at when due.

- **In the event of a further devaluation, the current debt structure can result in volatile earnings as a result of the additional interest expense which increase the chances of a default.** The bank's debt structure consists of debt securities estimated at ₦167.32billion as at FY2014 which wholly consists of Eurobonds $500m, 5yr, 6.25% note due 2019. In addition, we note the 229.29% increase in dollar-denominated debt to ₦198.07billion in FY2014 from ₦60.15billion in the previous year.

GUARANTY TRUST BANK

GUARANTY TRUST BANK

Background

Guaranty Trust Bank plc. ("Guaranty Trust Bank" or "the bank") is a Nigerian financial institution with vast business outlays spanning Anglophone/Francophone, West Africa, East Africa and the United Kingdom. Guaranty Trust Bank currently has an asset base of ₦2.36trillion thereby ranking as the fifth largest bank in Nigeria. The bank was incorporated as a limited liability company licensed to provide commercial and other banking services to the Nigerian public in 1990 and commenced operations in February 1991. In September 1996, it became a publicly quoted company and was granted a universal banking license in 2002. Its second share offering was done in 2004 with over ₦11 billion raised from Nigerian Investors to expand its operations and support favourable competition.

"Guaranty Trust Bank currently has an asset base of ₦2.36trillion thereby making it the fifth largest bank in Nigeria."

Post-consolidation, Guaranty Trust Bank made a strategic decision to actively pursue retail banking. In 2007, the bank became the first Nigerian financial Institution to undertake a $350 million regulation S Eurobond issue and a $750 million Global Depositary Receipts (GDR) Offer. In December 2009, Guaranty Trust Bank successfully completed the first tranche of its $200 million corporate bond targeted at increasing the depth of its operations in West Africa and Europe. In May 2011, the Bank successfully launched a US$500 million bond - the first non-sovereign benchmark bond offering from sub-Saharan Africa (outside South Africa), to the international community. In 2013, the Bank issued a USD 400,000,000 Euro bond at a coupon rate of 6%; the least obtained by a Nigerian company in the international capital market. The Eurobond was issued under the USD 2,000,000 Global Medium Term Note Programme, which is registered under both Regulation in the United State of America and Rule 144A in the United Kingdom and sold to investors across Africa, America, Asia and Europe

Credit Rating

In view of the lowered ratings on Nigeria to 'B+' due to the effect of the recent decline in oil prices on the country's external position by Standard and Poor's, the long-term ratings on Guaranty Trust Bank was lowered to 'B+' from 'BB-'. However, the outlook remains stable as the bank ranks among the top tiers in the Nigerian banking sector and expectations of its ability to absorb economic shocks to a significant extent, despite the assumption of growing pressure on banks' credit quality and profitability.

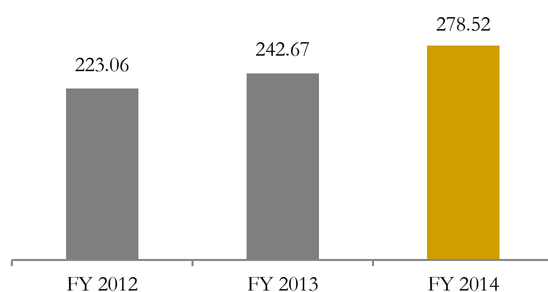
Rating Agency	Rating	Outlook	Outlook
Fitch Ratings	B+/B	Stable	April 2015
Standard and Poor's	B+/B	Stable	March 2015

Source: DLM Research

Performance Evaluation

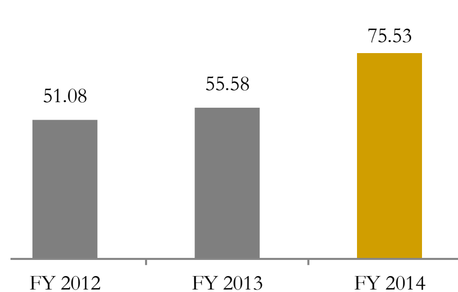
Guaranty Trust Bank has a strong aggressive expansion strategy and has largely delivered on its targets by improved service offerings and leveraging on its status as the pioneer of 'Social Banking' in Nigeria which led to the introduction of additional channels for banking transactions. The bank reported gross earnings of ₦278.52billion in FY2014, up by 14.78% from ₦242.67billion in FY2013 supported by increased financial intermediation activities. We observed that earnings growth is significantly higher than the earnings growth of 8.97% recorded in FY2013. Whilst we note the growth recorded in earnings and overall profitability, we observed the steady decline in margins in the last two years as it declined to 41.79% and 35.44% in FY2014 from 44.13% and 37.10% respectively in the previous years.

Gross Earnings, ₦'billion



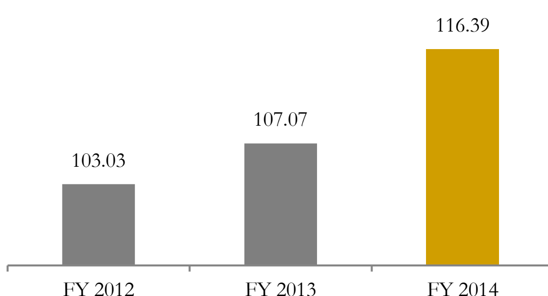
Source: NSE, Company Financials, DLM Research

Operating Income, ₦'billion



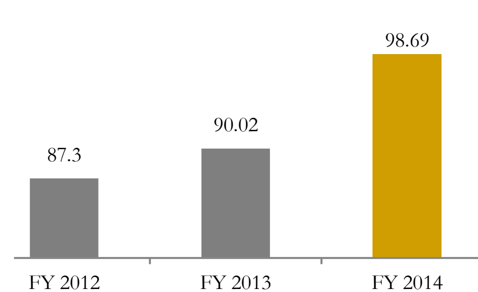
Source: NSE, Company Financials, DLM Research

Profit Before Tax, ₦'billion



Source: NSE, Company Financials, DLM Research

Profit After Tax, ₦'billion



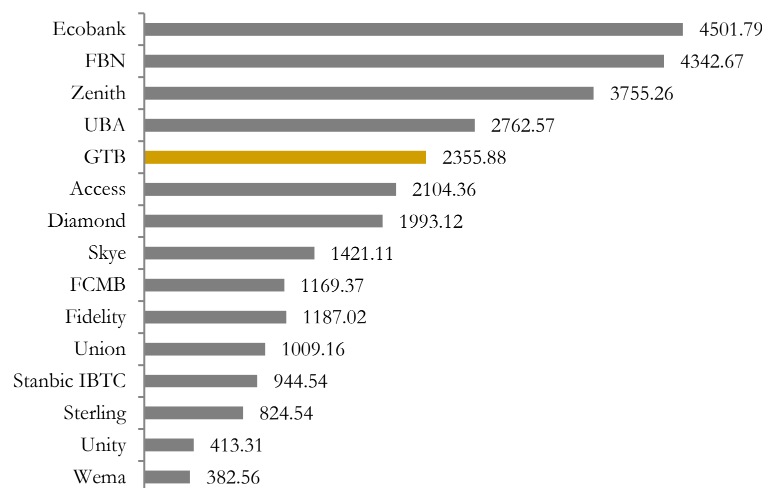
Source: NSE, Company Financials, DLM Research

Growth in total assets recorded in FY2014 was firmly supported by loans and advances to customers. Loans and advances to customers rose by 27.12% to ₦1.28trillion in FY2014 from ₦1.01trillion in the previous year. The growth in loan book recorded in FY2014 was largely

driven by increased exposure to oil & gas and construction sectors. Oil and gas recorded the highest sectoral contribution to total loans with 33.00% followed by manufacturing accounting for 17.00%. However, Guaranty Trust Bank reported that loan exposure to the oil & gas sector was spread across the various sub-sectors – upstream (21%), mid-stream (6%) and downstream (6%). We also share the view that oil & gas exposures, particularly upstream will be the most susceptible to low oil prices and this poses some concerns. In the event that oil prices trend lower, we expect to see a diversion from risk assets channelled to sectors with huge exposure and possible restructuring some of the portfolios by extending tenors to better match new cash flow projections.

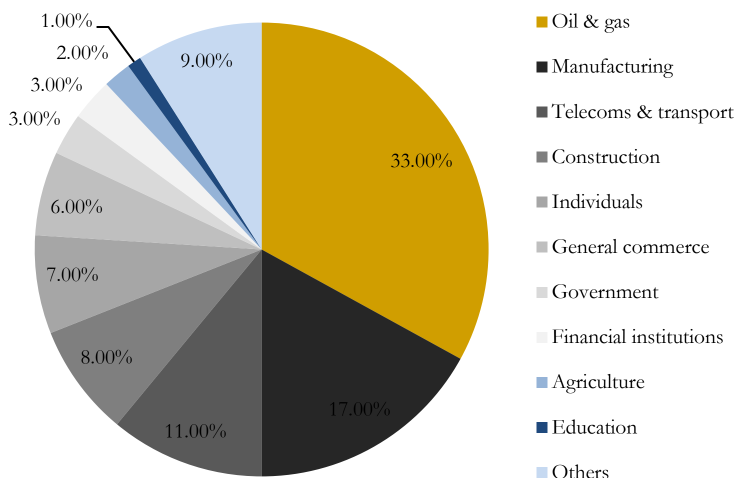
"In the event that oil prices trend lower, we expect to see a diversion from risk assets channelled to sectors with huge exposure and possible restructuring some of the portfolios by extending tenors to better match new cash flow projections."

Total assets, ₦'billion



Source: NSE, Company Financials, DLM Research

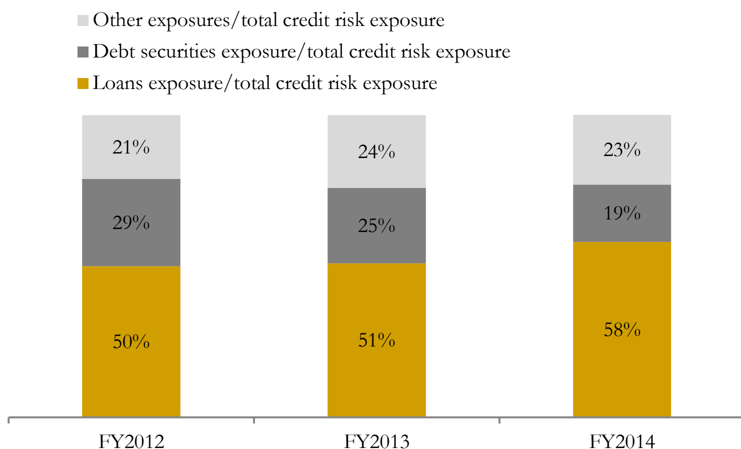
Sectoral contribution to gross loans, %



Source: NSE, Company Financials, DLM Research

Our analysis show that 58.09% of the total maximum exposures to credit risk is derived from loans and advances to banks and customers higher than 51.38% in the previous year while exposure to investments in debt securities and 'other securities' account for 19.26% and 22.65% respectively

Composition of total maximum exposure



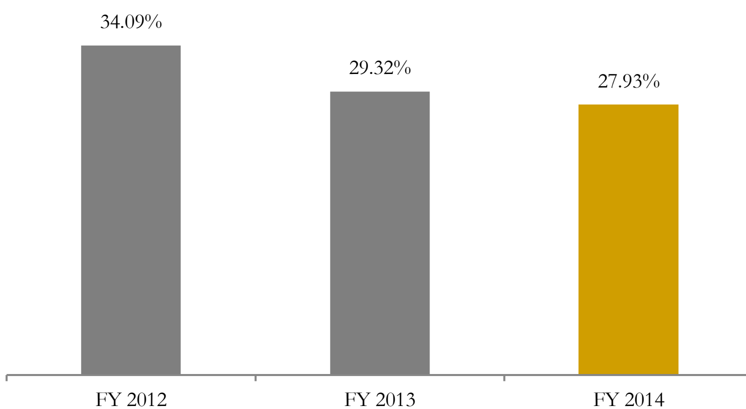
Source: NSE, Company Financials, DLM Research

Efficiency

The bank's return on average equity (ROAE) remained competitive in FY2014 at 27.93% though we note the steady decline from 34.09% and 29.32% in the two preceding years. Return on average assets also declined to 4.43% in FY2014. Whilst we note the decline in efficiency as cost/income ratio increased to 44.79% during the period, we highlight that the bank currently has the lowest cost/income ratio across the industry which signals strong management efficiency.

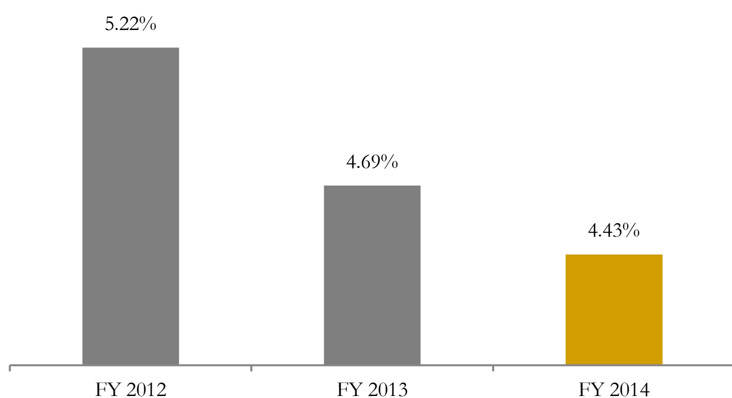
"Whilst we note the decline in efficiency as cost/income ratio increased to 44.79% during the period, we highlight that the bank currently has the lowest cost/income ratio across the industry which signals strong management efficiency."

Return on average equity



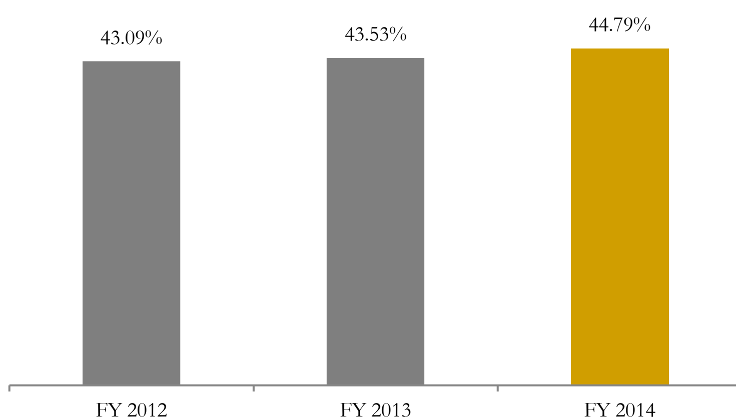
Source: NSE, Company Financials, DLM Research

Return on average assets



Source: NSE, Company Financials, DLM Research

Cost to income ratio



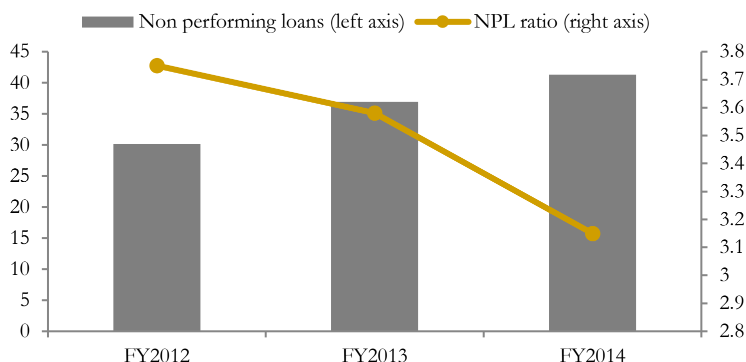
Source: NSE, Company Financials, DLM Research

"In our view, this shows that the bank has a relatively healthy asset quality as it lies below the 5% stipulated by the CBN guideline. Whilst we note that the NPL ratio can be further reduced, we highlight the bank's effort at risk management."

Asset quality

Total non-performing loans as a percentage of gross loans declined from 3.58% in FY2013 to 3.15% in FY2014 despite the increase in non-performing loans to ₦41.33billion from ₦36.94billion during the previous year. In our view, this shows that the bank has a relatively healthy asset quality as it lies below the 5% stipulated by the CBN guideline. Whilst we note that the NPL ratio can be further reduced, we highlight the bank's effort at risk management. We however highlight the marked increase in the exposure to the manufacturing sector in FY2014 from a contribution of 31.40% in the previous year to 39.00% in FY2014.

Non-performing loans vs. NPL ratio

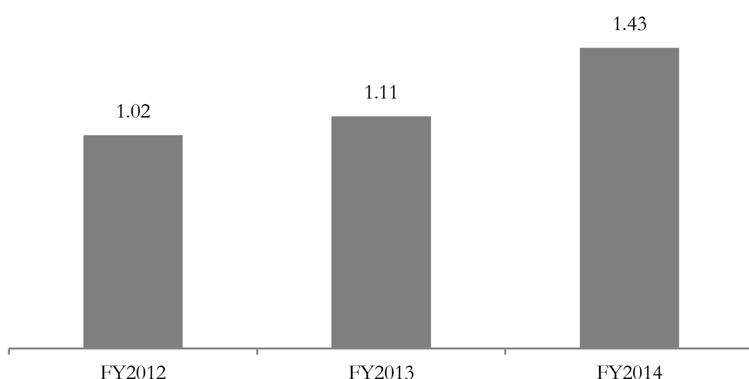


Source: NSE, Company Financials, DLM Research

The coverage ratio which measures the provision made for non-performing loans was 1.43x in FY2014 and has averaged 1.06x over the five-year historical period. This shows that the bank's ability to absorb potential losses has steadily increased over the years.

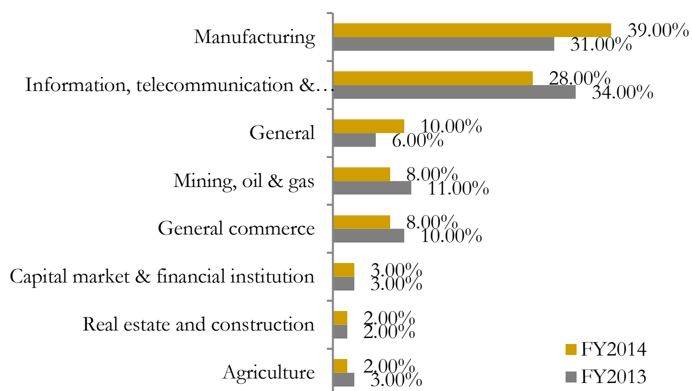
"The coverage ratio which measures the provision made for non-performing loans was 1.43x in FY2014 and has averaged 1.06x over the five-year historical period."

NPL coverage ratio



Source: NSE, Company Financials, DLM Research

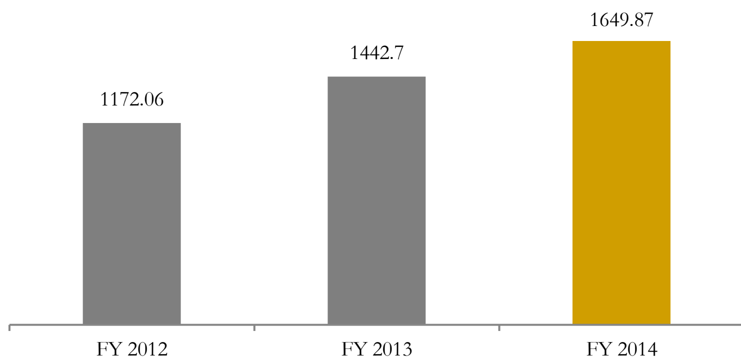
Non-performing loans by segment



Source: NSE, Company Financials, DLM Research

In FY2014, the bank's total liabilities increased to ₦1981.54billion from ₦1770.49billion in the previous year. During the same period, the bank equally recorded 14.36% growth in deposits to ₦1649.87billion from ₦1442.7billion in FY2013. We commend the slight moderation in the bank's average cost of funds to 3.12% from 3.33% in the previous year

Deposits, ₦'billion

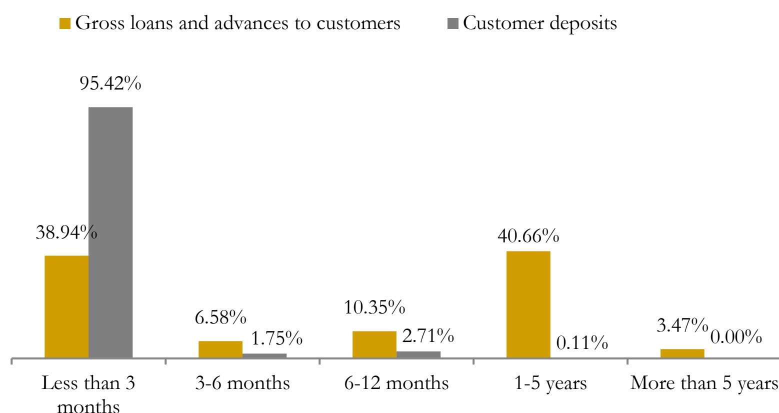


Source: NSE, Company Financials, DLM Research

An analysis of the bank's loan portfolio maturity profile shows that 40.66% of gross loans accounted for '1-5 years' loans in FY2014, which supports that the bank has the largest proportion of its loans concentrated in longer tenor term loans. However, the funding side of the balance sheet showed a concentration of 'deposits' in the maturity profile of 'less than 3 months' which represents 95.42% of total deposits respectively. Given that the negative cumulative gap appears in the 0-6 months range, we assume a roll-over exists and as a result there appears to be no significant mismatch, in the utilization of deposit liabilities in creation of 'loans & advances'.

"Given that the negative cumulative gap appears in the 0-6 months range, we assume a roll-over exists and as a result there appears to be no significant mismatch."

Maturity profile of Loans & advances vs Deposits: FY2014



Source: Company Financials, DLM Research

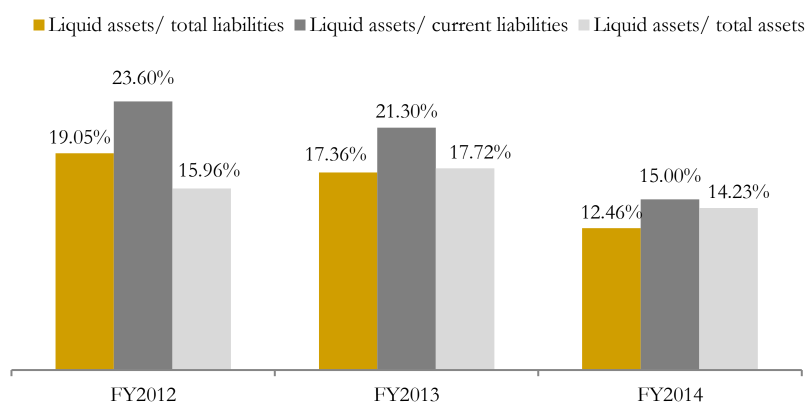
	Less than 3 months	3-6 months	6-12 months	1-5 years	More than 5 years
Financial assets					
Cash and cash equivalents	239,155	11,139	96	-	-
Loans and advances to banks	5,685	8	-	-	-
Loans and advances to customers	554,036	94,595	148,821	584,393	49,869
Financial assets held for trading	5,487	3,390	711	25	129
Derivative financial asset	328	202	-	-	-
Investment securities:					
– Available for sale	162,307	175,785	5,205	3,155	10,698
– Held to maturity	12,363	7,848	3,672	9,671	3,038
Assets pledged as collateral	40,150	-	-	5,558	-
Restricted deposits and other assets	284,633	431	643	5,737	55
	1,304,144	293,399	159,147	608,539	63,790
Financial liabilities					
Deposits from banks	15,683	12808	3563	-	-
Deposits from customers	1,560,313	16,176	41,155	1,973	53,251
Derivative financial liabilities	253	-	-	-	-
Debt securities issued	3	6	29	167,375	-
Other borrowed funds	10,076	10,308	14,860	67,093	24,446
Other liabilities	16,783	2,627	3,715	30,758	2,061
	1,603,112	41,925	63,322	267,199	79,758
Gap (asset - liabilities)	**(298,968.0)**	**251,473**	**95,826**	**341,340**	**(15,968.3)**
Cumulative liquidity gap	**(298,968.0)**	**(47,496.0)**	**48,330**	**384,218**	**421,447**

Liquidity

The bank's liquidity position declined during the period under review as its liquid assets to current liabilities ratio declined from 21.30% in the prior year to 15.00% in FY2014. The bank's liquid assets as a percentage of total assets also declined from 17.72% in FY2013 to 14.23% in FY2014. However, loans to deposits ratio increased from 69.87% to 77.67% during the review year. We are inclined to highlight that the bank is close to its 80% limit in loan to deposit ratio as mandated in the CBN's prudential guidelines for deposit money banks. Consequently, we expect the bank to aggressively grow its deposit base to accommodate for growth in loans.

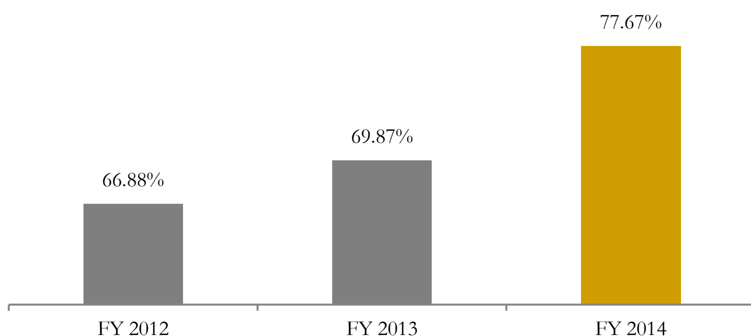
"We are inclined to highlight that the bank is close to its 80% limit in loan to deposit ratio as mandated in the CBN's prudential guidelines for deposit money banks."

Liquidity ratios



Source: Company Financials, DLM Research

Loan/deposit ratio

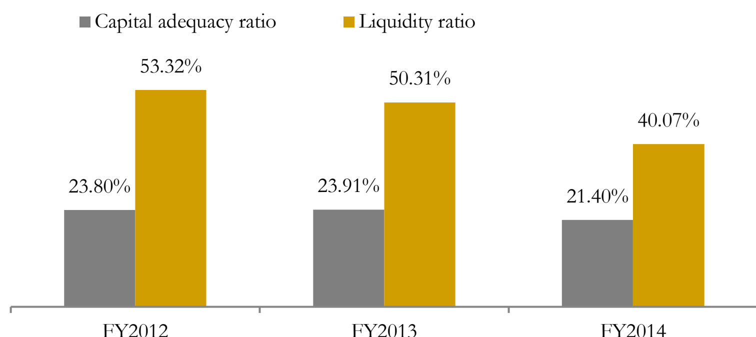


Source: Company Financials, DLM Research

Capital adequacy and liquidity ratios for FY2014 stood at 21.40% and 40.07% respectively – well above the regulatory benchmarks of 10% and 30% respectively. The shareholders' funds of the Bank increased to ₦374.33billion as at FY2014 from ₦332.35billion in the previous year. Tier 1 capital to risk weighted assets ratio was 21.40% in FY2014 while the risk weighted assets to total assets ratio increased from 53.77% in FY2013 to 59.24% in FY2014.

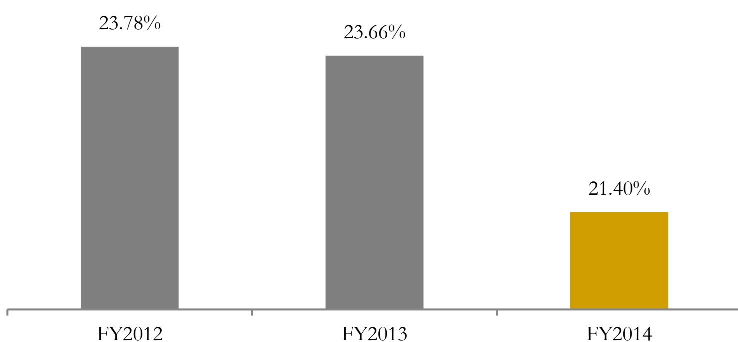
"Capital adequacy and liquidity ratios for FY2014 stood at 21.40% and 40.07% respectively – well above the regulatory benchmarks of 10% and 30% respectively."

Liquidity and capital adequacy ratio



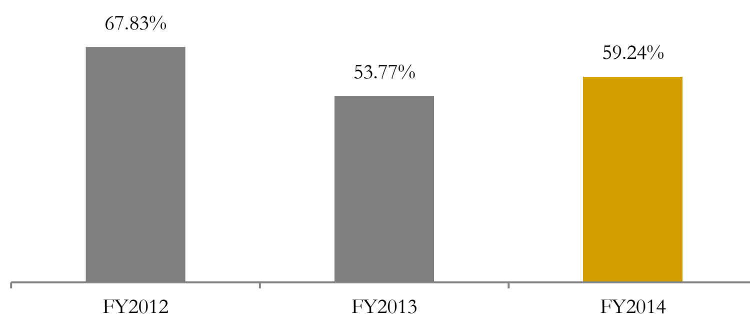
Source: Company Financials, DLM Research

Tier 1 capital to risk weighted assets



Source: Company Financials, DLM Research

Risk weighted assets to total assets



Source: Company Financials, DLM Research

Debt analysis

As at FY2014, the bank's borrowings stood at ₦91.30billion, down by 0.91% from the level recorded in the preceding year. In addition, the Eurobond debt securities recorded during the period was ₦166.92billion ($897.66million) which represented the amortised cost of dollar guaranteed note issued by GTB B.V., Netherlands. The 500 million Eurobond was issued in May 2011 for a period of 5 years at 7.5% per annum payable semi-annually. This was three years after the $350 million Regulation S Eurobond issue in January 2007, which made GTBank the first Nigerian company to issue Eurobonds and also, the first Nigerian institution to venture into the international capital markets without a sovereign guarantee or credit enhancement from any international financial institution. We are also inclined to highlight that the second tranche of 400,000,000 (principal) was issued in November 2013 for a period of 5 years at 6%. Whilst we understand the rationale behind the increase in the bank's dollar debt funding, we highlight that it increases the bank's vulnerability to foreign exchange risks, particularly given the near term outlook of the naira and the possibility of a further devaluation.

"Whilst we understand the rationale behind the increase in the bank's dollar debt funding, we highlight that it increases the bank's vulnerability to foreign exchange risks, particularly given the near term outlook of the naira and the possibility of a further devaluation."

On the corporate bond side, we note the decline to ₦401.89million from ₦13.60billion in the preceding year. The amount of ₦13.23billion (current) in the prior year represents the amortised cost of fixed rate (13.5%) senior unsecured non-convertible bonds issued by the Bank in December 2009 - the first tranche of a ₦200 billion debt issuance programme. The debt security matured and was redeemed by the Bank in December 2014.

Borrowings, ₦'million

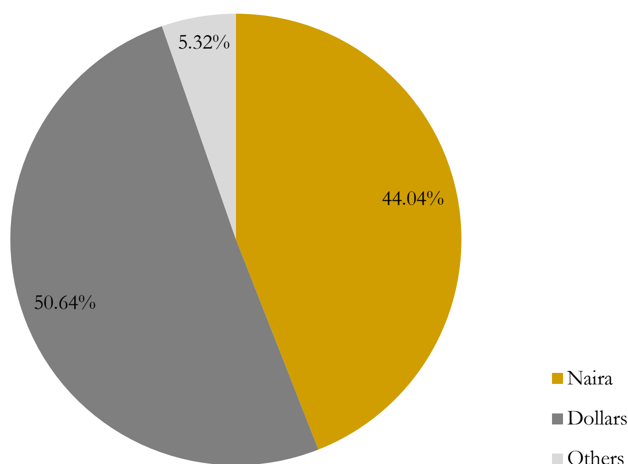
	FY2012	FY2013	FY2014
Due to IFC	29633	26988	26690
Due to ADB	14640	12969	11657
Due to FMO	985.39	207.54	5231
Due to PROPARCO	6149	4448	3110
Due to BOI	35654	40236	40916
Due to GBTV	-	-	-
Due to CAC	5500	5500	3694
Due to KFW	-	-	128.17
Due to EDIF	-	-	458.03
Due to SCHT	-	-	1200
Total	**92565**	**92135**	**91299**

Source: Company Financials, DLM Research

In addition, we are inclined to highlight that 55.96% of Guaranty Trust Bank's lending is in foreign currency with dollar lending accounting for the largest percentage at 50.64% with a relatively significant net on-balance sheet position to foreign exchange. The increased dollar loan exposure in FY2014 by 61.16% to ₦648.91billion from ₦402.64billion in the previous year also raises some concerns as a further devaluation could impact debt servicing ability of the loan beneficiaries and increase the bank's asset quality risk. Consequently, the possibility of a negative impact of a further devaluation on the banks' credit risks is elevated to a reasonable degree.

"The increased dollar loan exposure in FY2014 by 61.16% to ₦648.91billion from ₦402.64billion in the previous year also raises some concerns as a further devaluation could impact debt servicing ability of the loan beneficiaries and increase the bank's asset quality risk."

Loan: Foreign exchange exposure



Source: Company Financials, DLM Research

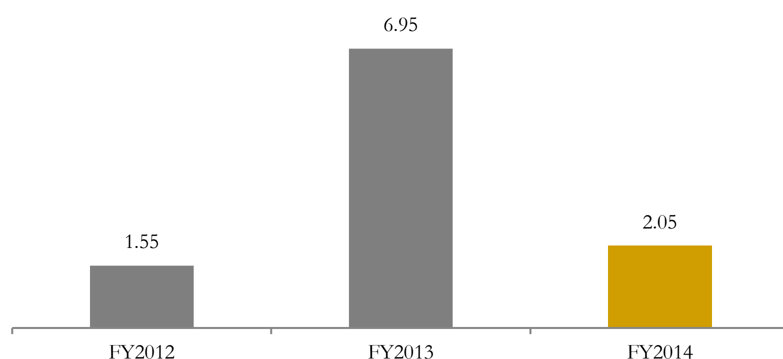
	Naira	USD	GBP	Euro	Others
Cash and cash equivalents	59,314	114,201	27,071	6,698	39,656
Loans and advances to banks	31	5,665	-	-	-
Loans and advances to customers	564,328	643,247	12,076	927	55,102
Financial assets held for trading	5,676	-	-	-	3,740
Derivative financial asset	530	-	-	-	-
Investment securities:					
– Available for sale	317,750	4,439	2,018	221	20,274
– Held to maturity	4,511	1,311	1,205	1,988	26,146
Assets pledged as collateral	39,174	-	-	-	6
Restricted deposits and other assets	257,787	30,089	75	2,046	1,502
Total	**1,249,100**	**798,952**	**42,445**	**11,881**	**146,426**
Deposits from banks	144	15149	5468	3,181	7,720
Deposits from customers	1,046,323	430,201	37,131	12,535	92,019
Derivative financial liabilities	-	253	-	-	-
Debt securities issued	-	166,919	-	-	402
Other borrowed funds	47,608	36,574	1,730	-	5,387
Other liabilities	(103,697.0)	146,390	2,302	5,660	6,451
Total	**990,378**	**795,486**	**46,631**	**21,376**	**111,979**

Leverage ratios

The debt service coverage ratio is a benchmark used to measure the cash producing ability of a business entity to cover its debt payments. We note that the debt service coverage ratio of the bank declined significantly during the period to 2.05x from 6.95x in the preceding year. However, this still indicates that the bank's cash flow from operations is enough to cover annual debt payments (principal and interest). This shows that the bank's operating income is enough to cover 205% of its annual debt payments which in our view signifies a healthy credit quality. This decline was primarily driven by the significant increase in principal repayments to ₦50.96billion from ₦5.48billion in the previous year.

"This shows that the bank's operating income is enough to cover 205% of its annual debt payments which in our view signifies a healthy credit quality."

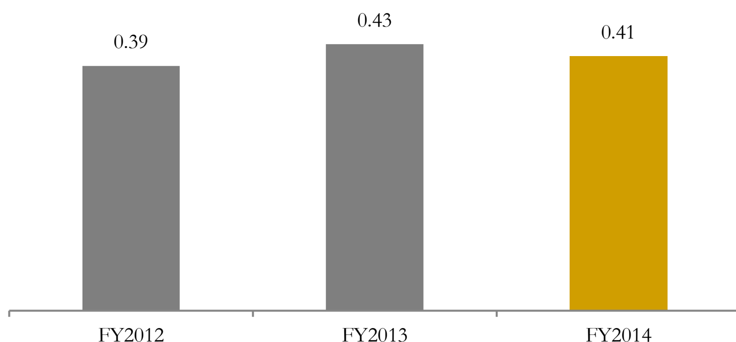
Debt service cover ratio



Source: Company Financials, DLM Research

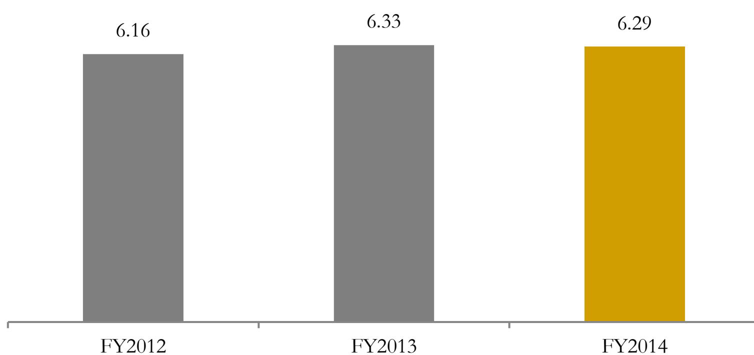
The bank's capitalization ratio which measures the debt component of the bank's capital structure reduced to 0.41x from 0.43x which still remains within acceptable limit. In addition, the bank's equity multiplier declined marginally to 6.29x.

Capitalization ratio



Source: Company Financials, DLM Research

Equity Multiplier

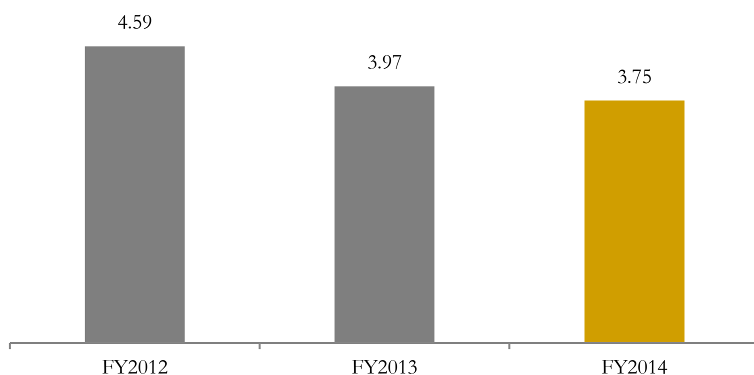


Source: Company Financials, DLM Research

The bank's interest coverage ratio (ICR) declined to 3.75x from 3.97x in the preceding year. The lower ICR reflects that lower earnings are available to meet interest payments and that increases the bank's vulnerability to increases in interest rates.

"The lower ICR reflects that lower earnings are available to meet interest payments and that increases the bank's vulnerability to increases in interest rates."

Interest coverage ratio

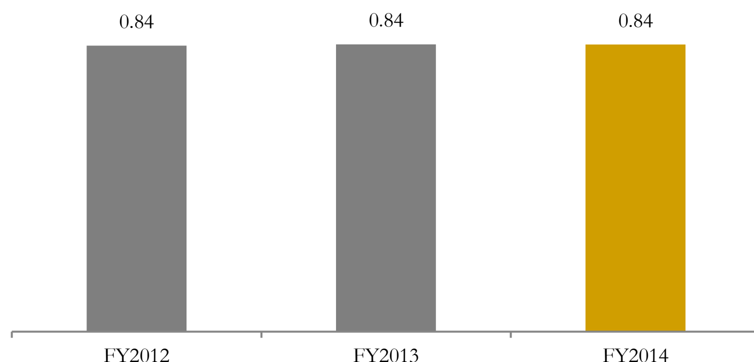


Source: Company Financials, DLM Research

The bank's debt to assets ratio has remained flat at 0.84x which indicates the proportion of the bank's assets being financed with debt, rather than

equity. This shows that the financial risk remains low as it stands below 1.00x.

Debt to assets ratio



Source: Company Financials, DLM Research

Credit risk outlook

Overall, we note that a probability of default remains largely minimal as the bank appears to be stable with relatively healthy fundamentals. We remain optimistic that the bank will continue to leverage on its strong track record and improved capital base to support growth in the medium term. Hence, we are of the view that adverse changes in the macro-economic and regulatory environment will not significantly affect the bank's ability to meet payment obligations as at when due.

"We are also inclined to highlight that the bank has a concentrated customer base which increases vulnerability to weakening industry specific conditions."

Key factors for future performance

Over the years, Guaranty Trust bank has been characterized by adequate capital base, strong profitability, low cost business model, healthy asset quality driven by sound underwriting, and an aggressive growth strategy implemented by its management team. The bank has high corporate lending expertise and reputation founded upon quality service delivery and huge leverage of social media. This is further buttressed by the 49.49% of total revenue is generated from corporate banking followed by retail and commercial banking with 24.05% and 14.43% respectively. We are of the view that the performance of the retail banking segment reflects growing customer base driven by the massive investment in telephone contact centre to ensure real time responses to customers' enquiries.

We are also inclined to highlight that the bank has a concentrated customer base which increases vulnerability to weakening industry specific conditions. As a result, loan concentration risks are inherent as a

significant number of huge corporate defaults could negatively impact on the bank's capital base.

We also observed that bank's major competitors have more extensive branch networks. In our view, the bank would needs to further improve service delivery by expanding its retail market and increasing its branch network which currently stands at about 217.

"A protracted economic downturn driven by lower oil prices remains a risk as the economic implications for Nigeria will invariably affect the bank's performance."

A protracted economic downturn driven by lower oil prices remains a risk as the economic implications for Nigeria will invariably affect the bank's performance. The impact will be transmitted through austerity measures likely to be put in place which would reduce household savings and consequently deposits, tighter rules by the CBN- commencement of the treasury single account scheme among others.
In conclusion, the bank has demonstrated its ability to withstand headwinds in its operating environment. However, we believe that these factors would drive the bank's future performance in the medium to long term: macroeconomic stability, a stable political environment, the sustenance of policies that have so far driven the growth of the banking sector in recent time, ability to ensure that the bank's risk management structures and processes are continually reviewed to ensure risks are tightly managed, ability to compete favourably due to proliferation of financial products in the Nigerian banking space and conditions within the international financial markets.

Zenith Bank

ZENITH BANK

Background

Zenith Bank Plc. ("Zenith Bank" or "the bank") was incorporated in Nigeria as a private limited liability company on May 30, 1990. It was granted a banking license in June 1990 to carry on the business of commercial banking, and commenced business on June 16, 1990. Zenith Bank was converted to a public limited liability company on May 20, 2004, and consequently had its shares listed on the floor of the Nigerian Stock Exchange on October 21 2004 following a highly successful Initial Public Offering (IPO). Zenith Bank currently has a shareholder base of about one million and is Nigeria's biggest bank by tier-1 capital. In 2013, the Bank listed $850 million worth of its shares at $6.80 each on the London Stock Exchange (LSE). Zenith Bank's core businesses include: Corporate and Investment Banking, Commercial and Consumer Banking, Personal and Private Banking, Trade Services and Foreign Exchange, Treasury and Cash Management Services and Other Non-Bank Financial Services mainly through subsidiaries

As at FY2014, the bank has over 377 branches and business offices in all states of the federation and the Federal Capital Territory (FCT). In March 2007, Zenith Bank was licensed by the Financial Services Authority (FSA) of the United Kingdom to establish Zenith Bank (UK) Limited as the United Kingdom subsidiary of Zenith Bank Plc. Zenith Bank also has subsidiaries in: Ghana, Zenith Bank (Ghana) Limited; Sierra Leone, Zenith Bank (Sierra Leone) Limited; Gambia, Zenith Bank (Gambia) Limited. The bank also has representative offices in South Africa and The People's Republic of China. The Bank plans to take the Zenith brand to other African countries as well as the European and Asian markets.

"In view of the lowered ratings on Nigeria to 'B+' from 'BB-' due to the effect of the recent decline in oil prices on the country's external position by Standard and Poor's, the long-term ratings on Zenith Bank was lowered to 'B+' from 'BB-'."

Credit Rating

In view of the lowered ratings on Nigeria to 'B+' from 'BB-' due to the effect of the recent decline in oil prices on the country's external position by Standard and Poor's, the long-term ratings on Zenith Bank was lowered to 'B+' from 'BB-'. However, the bank's outlook remains stable reflecting its position in the Nigerian banking sector and expectations of its ability to absorb economic shocks to a significant extent, despite the assumption of growing pressure on banks' credit quality and profitability..

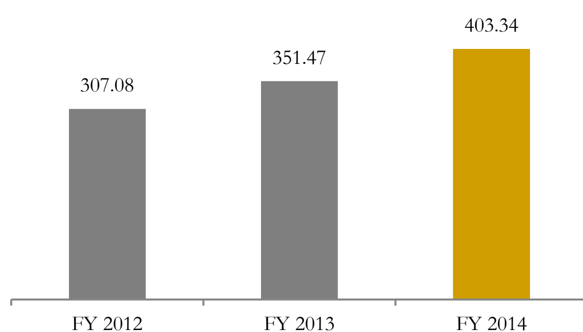
Rating Agency	Rating	Outlook	Outlook
Fitch Ratings	B+/B	Stable	April 2015
Standard and Poor's	B+/B	Stable	March 2015

Source: DLM Researc

Performance Evaluation

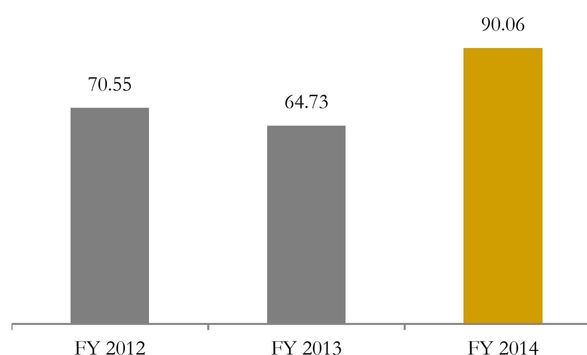
Over the years, Zenith Bank has been characterized by aggressive growth; primarily driven by focus on quality service delivery, leveraging on information and communication technology and the conservative business model through an expansion of branch network to generate deposits from the retail end of the market. In addition, the bank uses its strong balance sheet and liquidity position to continuously support growth. Zenith Bank reported gross earnings of ₦403.34billion in FY2014, up by 14.76% from ₦351.47billion in FY2013 supported by increased transaction volumes and lending activities. We observed that earnings growth still hovers around the double digit range in line with the bank's medium term strategic objectives and slightly higher from growth levels of 14.45% recorded in FY2013.

Gross Earnings, ₦'billion



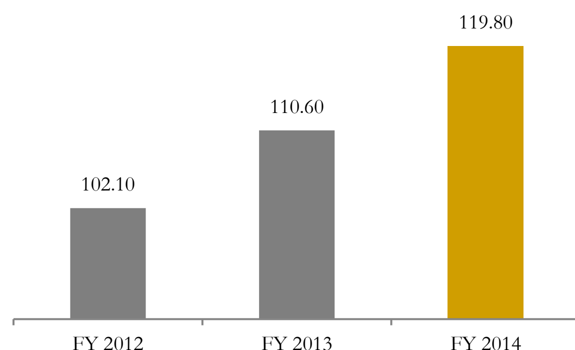
Source: NSE, Company Financials, DLM Research

Operating Income, ₦'billion



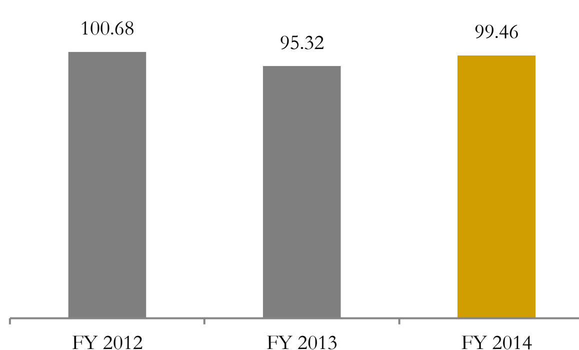
Source: NSE, Company Financials, DLM Research

Profit Before Tax, ₦'billion



Source: NSE, Company Financials, DLM Research

Profit After Tax, ₦'billion



Source: NSE, Company Financials, DLM Research

Whilst we note the growth recorded in earnings and overall profitability, we observed the steady decline in margins in the last two years. In our view, this can be attributed to challenges faced by the Nigerian Banking Sector arising from tighter regulatory responses particularly from the Central Bank of Nigeria (increase in cash reserve ratio "CRR" among others) in reaction to the impact of global decline oil in prices on macro-economic indicators. In 2014, the CRR

on private and public sector funds was increased to 20% and 75% from 15% and 50% respectively while MPR was moved from 12% to 13% with attendant implications on banking sector earnings.

Revenue & Margins	FY2012 ₦'bn	FY2013 ₦'bn	FY2014 ₦'bn	y/y growth	
				FY2013	FY2014
Interest Income	221.32	270.54	313.42	22.24%	15.85%
Interest Expense	64.56	70.80	106.92	9.66%	51.02%
Net Interest Income	156.76	199.74	206.50	27.42%	3.38%
Non-Interest Income	70.55	64.73	90.06	-8.52%	39.13%
Net Interest Margin	15.84%	15.96%	11.94%		
Pre-Tax Margin	33.25%	31.47%	29.70%		
Post-Tax Margin	32.79%	27.12%	24.66%		

Zenith Bank is the third largest bank in Nigeria by balance sheet size, with total assets worth ₦3.76trillion as at December 31, 2014. The growth in total assets recorded in FY2014 was firmly supported by loans and advances to customers, and cash & balances with the Central Bank of Nigeria amongst others.

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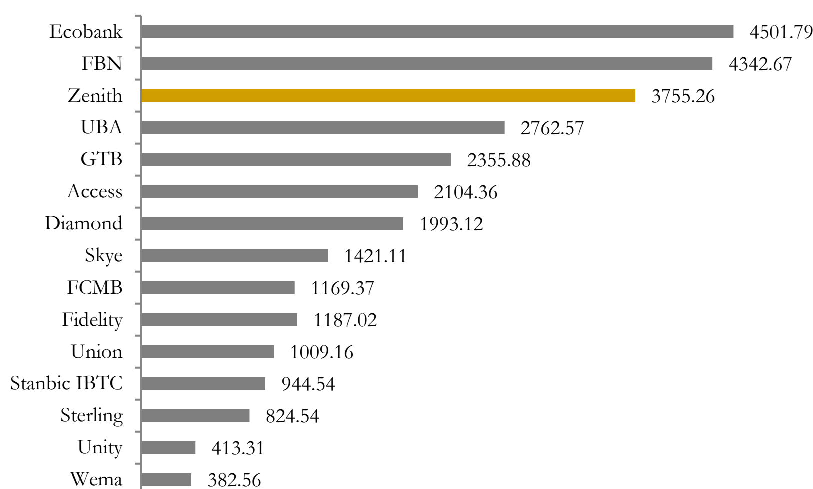
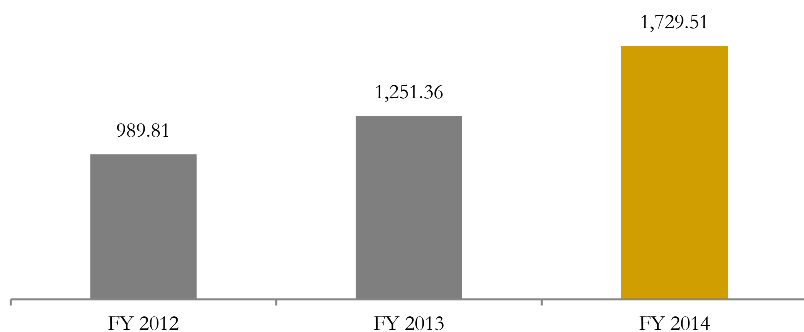
Total assets, ₦'billion



Source: NSE, Company Financials, DLM Research

Improved capital and liquidity positions support loan growth. Loans and advances to customers rose by 38.21% to ₦1.73trillion in FY2014 from ₦1.25trillion in the previous year. Loans to corporate and commercial entities accounted for 81.70% of total loans, lower than 89.00% in FY2013 whilst the contribution of institutional, public sector and retail loans stood at 3.60%, 6.60% and 8.20% respectively.

Loans and Advances to Customers, ₦'billion

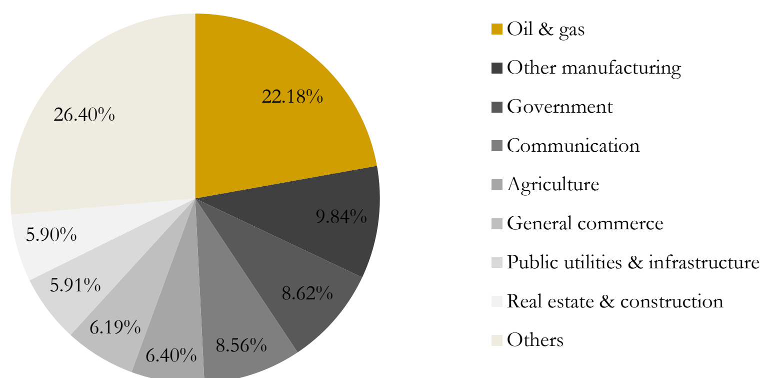


Source: NSE, Company Financials, DLM Research

The growth in loan book recorded in FY2014 was driven by increased exposure to oil & gas, agriculture, general commerce, and public utilities & infrastructure among others. Oil and gas recorded the highest sectoral contribution to total loans with 22.18% followed by 'other manufacturing' accounting for 9.84%. However, Zenith reported that loan exposure to the oil & gas sector was spread across the various sub-sectors – upstream (8.43%) and downstream (13.75%).

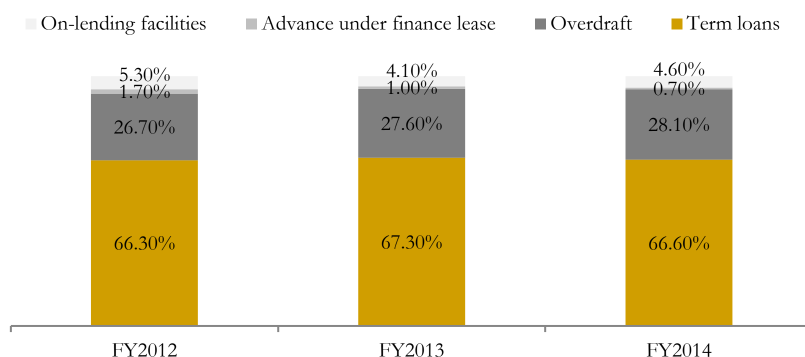
"Oil and gas recorded the highest sectoral contribution to total loans with 22.18% followed by 'other manufacturing' accounting for 9.84%."

Sectoral contribution to gross loans, %



Source: NSE, Company Financials, DLM Research

Loan mix

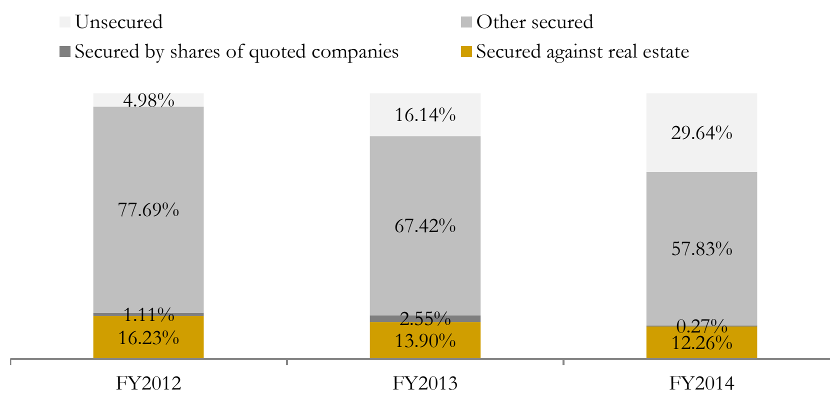


Source: NSE, Company Financials, DLM Research

As at FY2014, Zenith Bank had 70.36% of its loans secured, while 29.64% were unsecured. The percentage of unsecured loans poses some concerns as the bank

had significantly reduced unsecured loans from 41% in FY2007 to 4.98% in FY2012. However, in the last two years, the percentage spiked to 16% and 30% respectively. Loans secured by 'real estate' made up 12.26% of total loans, while 'other secured' loans and those 'secured by shares of quoted companies' made up 57.83% and 0.27% of total loans respectively.

Security of total exposure



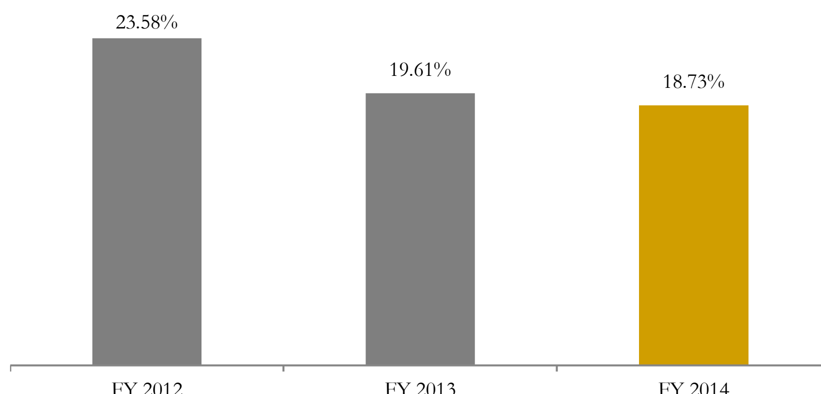
Source: NSE, Company Financials, DLM Research

> "The percentage of unsecured loans poses some concerns as the bank had significantly reduced unsecured loans from 41% in FY2007 to 4.98% in FY2012."

Efficiency

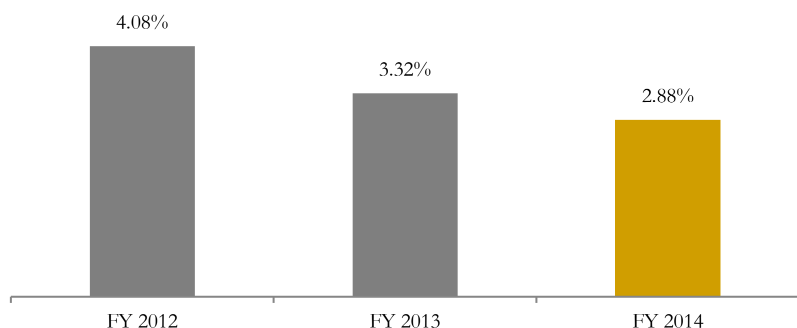
The bank's return on average equity (ROAE) declined to 18.73% in FY2014 from 19.61% and 23.58% in the two preceding years. Return on average assets also declined to 2.88% in FY2014. We also note the steady decline in efficiency in the last two years as the cost/income ratio further rose, albeit slightly to 57.74% in FY2014. With the increase seen in operating expenses, we anticipate the bank will look to implement some cost reduction strategies to improve efficiency.

Return on average equity



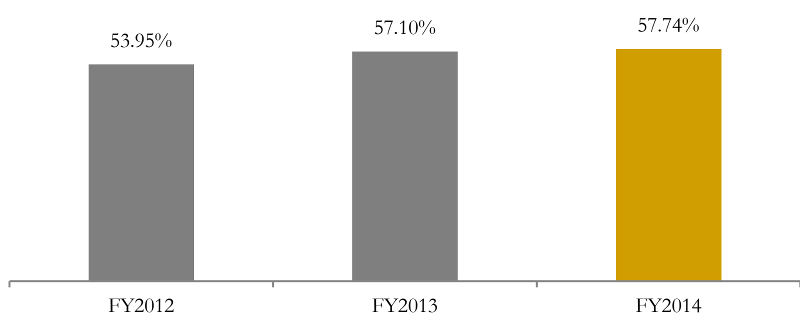
Source: NSE, Company Financials, DLM Research

Return on average assets



Source: NSE, Company Financials, DLM Research

Cost to income ratio



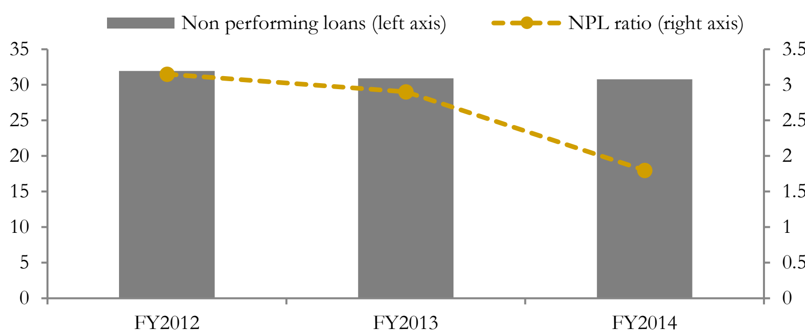
Source: NSE, Company Financials, DLM Research

Asset quality

Historically, Zenith Bank has kept its NPL ratio relatively low. Despite the growth in gross loans and advances recorded during the year, total non-performing loans as a percentage of gross loans declined significantly from 2.90% in FY2013 to 1.80% in FY2014 as non-performing loans declined to ₦30.77billion. This is particularly commendable as it lies significantly below the minimum NPL regulatory threshold of 5% for Nigerian banks. In our view, the healthy asset quality is supported by the bank's well-diversified loan portfolio and we expect that the bank will maintain strategies to de-risk its loan book.

> *"In our view, the healthy asset quality is supported by the bank's well-diversified loan portfolio and we expect that the bank will maintain strategies to de-risk its loan book."*

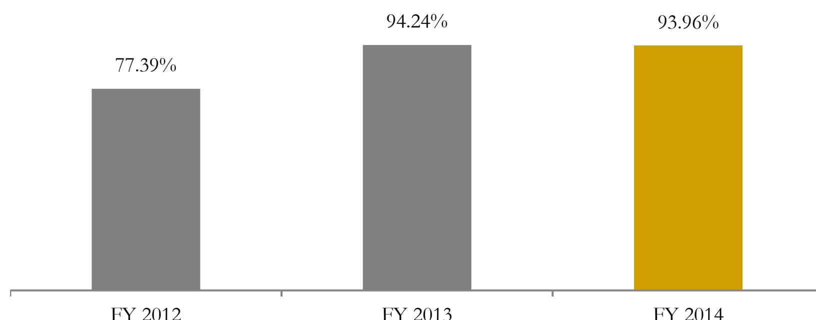
Non-performing loans vs. NPL ratio



Source: NSE, Company Financials, DLM Research

The coverage ratio which measures the provision made for non-performing loans was 0.94x in FY2014 and has averaged 0.89x over the five-year historical period. Zenith Bank's coverage ratio remained largely flat from levels in FY2013.

NPL coverage ratio

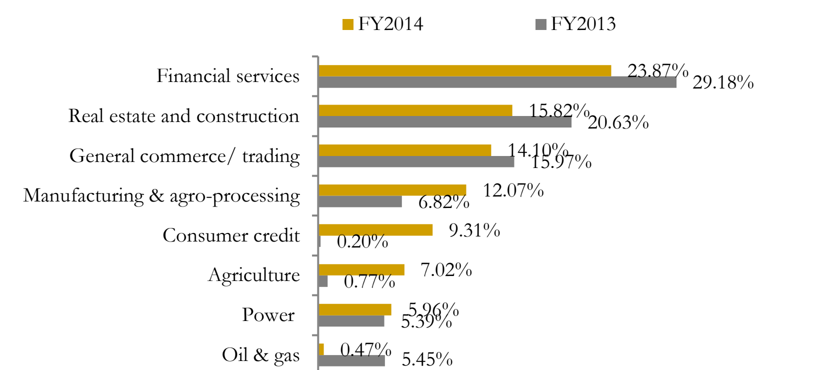


Source: NSE, Company Financials, DLM Research

We are also inclined to highlight that despite the marked increase in the exposure to the oil and gas sector in FY2014 from a contribution of 15.20% in the previous year, the percentage contribution to non-performing loans remain significantly low. However, we note the increase in non-performing loans from agriculture, manufacturing & agro-processing and consumer credit.

> *"We are also inclined to highlight that despite the marked increase in the exposure to the oil and gas sector in FY2014 from a contribution of 15.20% in the previous year, the percentage contribution to non-performing loans remain significantly low."*

Non-performing loans by segment

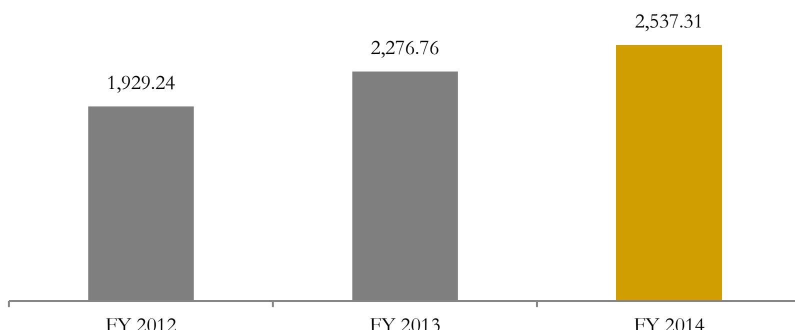


Source: NSE, Company Financials, DLM Research

In FY2014, Zenith bank's total liabilities increased by 21.59% to ₦3202.62billion from ₦2633.88billion in the previous year. During the same period, the bank equally recorded 11.44% growth in deposits to ₦2537.31billion from ₦2276.76billion in FY2013. Growth was driven by demand deposits which accounted for 50.9% of total deposits (2013: 56.8%). We note the steady decline in contribution of demand deposits to total deposits in the last three years. Term deposits also declined to 18.20% during the period whilst we note the improvement in domiciliary deposit to 22.50% from 12.60% in the previous year. We observed the moderation in the bank's average cost of funds to 4.00%

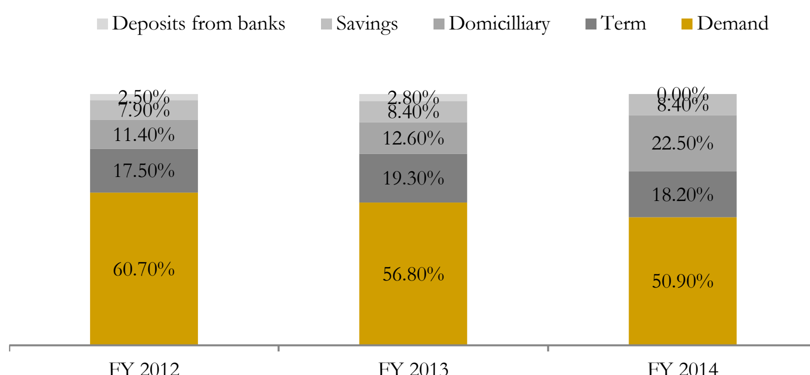
amidst liquidity pressures in the banking system and the resulting spike in interest rates.

Deposits, ₦'billion



Source: NSE, Company Financials, DLM Research

Percentage contribution to deposits



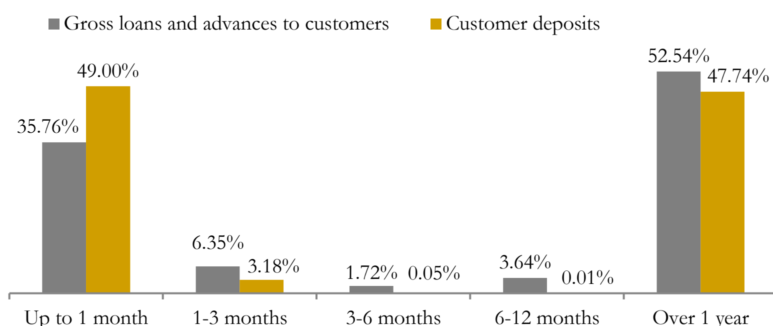
Source: NSE, Company Financials, DLM Research

"Zenith Bank has displayed funding stability over time predominantly through its strong deposit base even though a higher percentage of total deposits (52.26%) have short-term contractual maturity."

Zenith has displayed funding stability over time predominantly through its strong deposit base even though a higher percentage of total deposits (52.26%) have short-term contractual maturity. An analysis of the bank's loan portfolio maturity profile shows that 52.54% of gross loans accounted for 'over 1 year' loans in FY2014, which supports that the bank has the largest proportion of its loans concentrated in longer tenor term loans.

However, the funding side of the balance sheet showed a concentration of 'deposits' in the maturity profile of 'under 1-month' and 'over 12- months', which represents 49.00% and 47.74% of total deposits respectively. Given that the gross value of deposits is 18.44% higher than gross loans, there appears to be no significant mismatch, in the utilization of deposit liabilities in creation of 'loans & advances'

Maturity profile of Loans & advances vs Deposits: FY2014



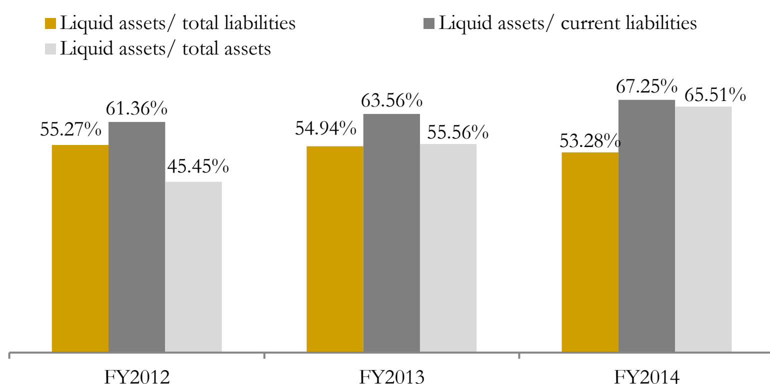
Source: Company Financials, DLM Research

Liquidity

Zenith Bank's liquidity position improved during the period under review. Its liquid assets to current liabilities ratio increased from 63.56% in prior year to 67.25% in FY2014. The bank's liquid assets as a percentage of total assets grew from 55.56% in FY2013 to 65.51% in FY2014 while loans to deposits ratio increased to 68.16% from 54.96% during the review year - below the 80% limit for loan to deposit ratio as mandated in the CBN's prudential guidelines for deposit money banks.

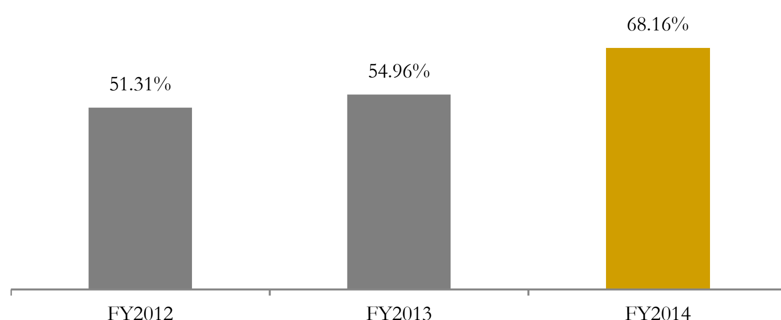
"The bank's liquid assets as a percentage of total assets grew from 55.56% in FY2013 to 65.51% in FY2014 while loans to deposits ratio increased to 68.16% from 54.96% during the review year."

Liquidity ratios



Source: Company Financials, DLM Research

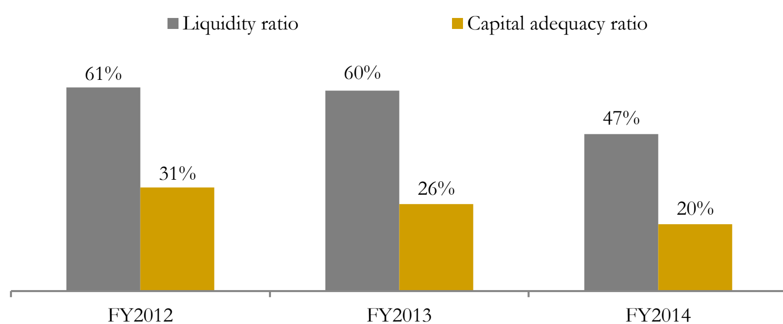
Loan/deposit ratio



Source: Company Financials, DLM Research

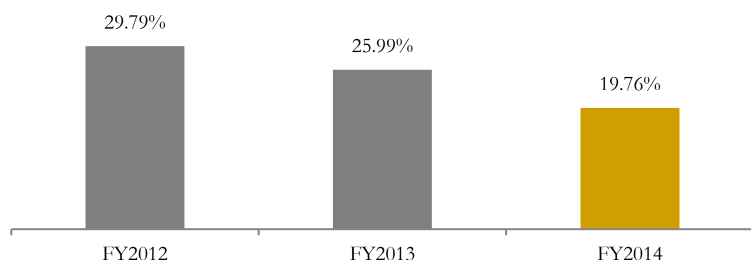
Capital adequacy and liquidity ratios for FY2014 stood at 20% and 47% respectively – well above the regulatory benchmarks of 10% and 30% respectively. The shareholders' funds of the Bank increased to ₦552.64billion as at FY2014 from ₦509.25billion in the previous year. Tier 1 capital to risk weighted assets ratio was 19.76% in FY2014 while the risk weighted assets to total assets ratio increased from 62.04% in FY2013 to 71.37% in FY2014. Overall, these ratios show that the bank has the ability to absorb losses or defaults on its risky assets.

Liquidity and capital adequacy ratio



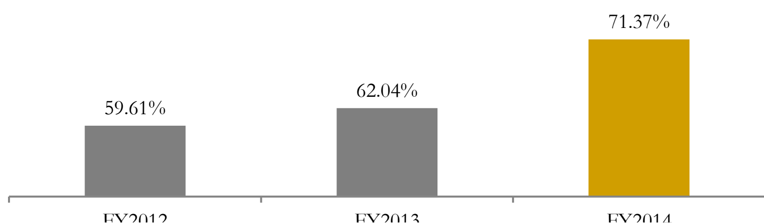
Source: Company Financials, DLM Research

Tier 1 capital to risk weighted assets



Source: Company Financials, DLM Research

Risk weighted assets to total assets



Source: Company Financials, DLM Research

"Capital adequacy and liquidity ratios for FY2014 stood at 20% and 47% respectively – well above the regulatory benchmarks of 10% and 30% respectively."

Debt analysis

As at FY2014, the bank's borrowings stood at ₦198.07billion, significantly higher by 229.29% from the level recorded in the preceding year. Zenith Bank also accessed funds of ₦92.9billion ($500million) in April 2014 from the

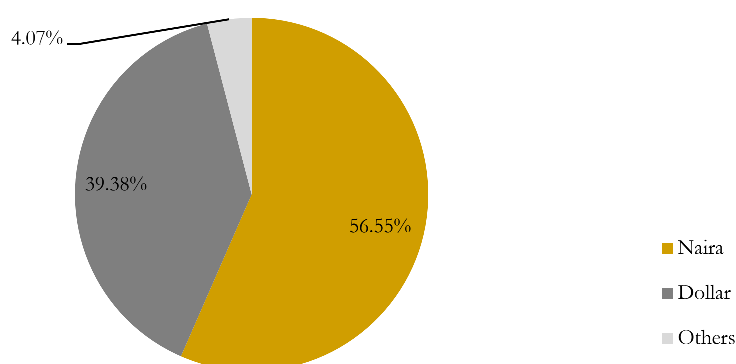
Eurobond market with a maturity of April 22, 2019 (senior unsecured debt) and a yield of 6.50% which were channelled to financing power, oil and gas and other project loans. In our opinion, the recent increase in the bank's dollar debt funding increases the bank's vulnerability to foreign exchange risks. In addition, we are inclined to highlight that 43.45 per cent of Zenith Bank's lending is in foreign currency with dollar lending accounting for 39.38% with a relatively significant net on-balance sheet position to foreign exchange. The increased dollar loan exposure in FY2014 to ₦692.35billion from ₦296.44billion in the previous year also raises some concerns as a further devaluation could impact debt servicing ability and increase Zenith Bank's asset quality risk. Consequently, the possibility of a negative impact of a further devaluation on the banks' credit risks is elevated to a reasonable degree.

Borrowings, ₦'million

	FY2012	FY2013	FY2014
Due to ADB	11957	7445	25672
Due to KEXIM	313	3440	5632
Due to EIB	-	4331	5111
Due to PROPARCO	2183	13264	14053
Due to SCB	-	15876	4166
Due to CITIBANK	-	15794	18710
Due to ABSA Bank	-	-	18637
Due to JP Morgan Chase Bank	-	-	27955
Due to SCB	-	-	13977
Due to First Rand Bank	-	-	8981
Due to Commerz Bank	-	-	55172
Others*	685		
Total	**60150**	**60150**	**198066**

Source: Company Financials, DLM Research

Loan: Foreign exchange exposure



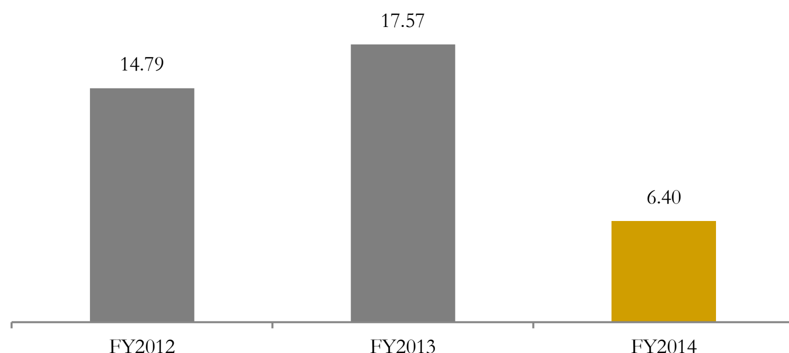
Source: Company Financials, DLM Research

Leverage ratios

We note that the debt service coverage ratio of the bank declined significantly to 6.40x from 17.57x in the preceding year. However, the ratio indicates that the bank's cash flow from operations is enough to cover annual debt payments (principal and interest). This shows that the bank's operating income is enough

to cover 640% of its annual debt payments which in our view signifies a healthy credit quality. As a result, the probability of default on payment is unlikely.

Debt service coverage ratio

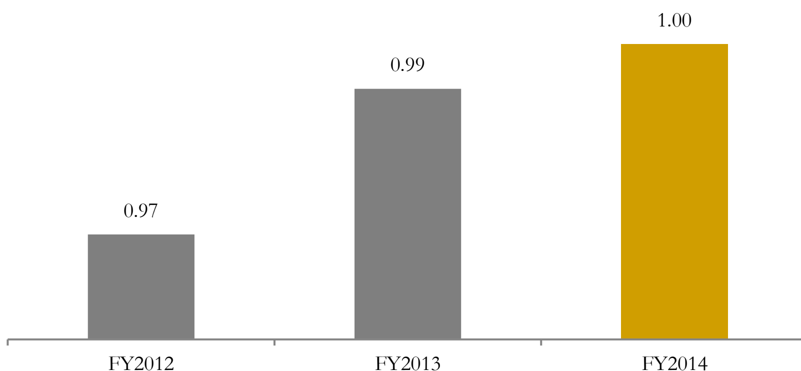


Source: Company Financials, DLM Research

> *"This shows that the bank's operating income is enough to cover 640% of its annual debt payments which in our view signifies a healthy credit quality."*

The bank's capitalization ratio which measures the extent to which the bank operates on its equity increase to 1.00x from 0.99x which remains within acceptable limit.

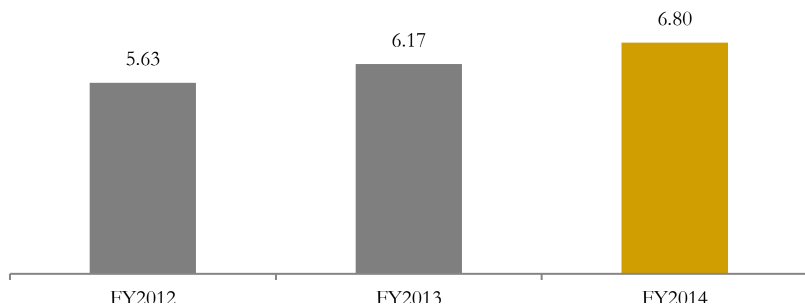
Capitalization ratio



Source: Company Financials, DLM Research

Zenith bank's equity multiplier increased marginally to 6.80x from 6.17x in the preceding year which signals increasing financial leverage due to the bank's recent debt financing.

Equity Multiplier

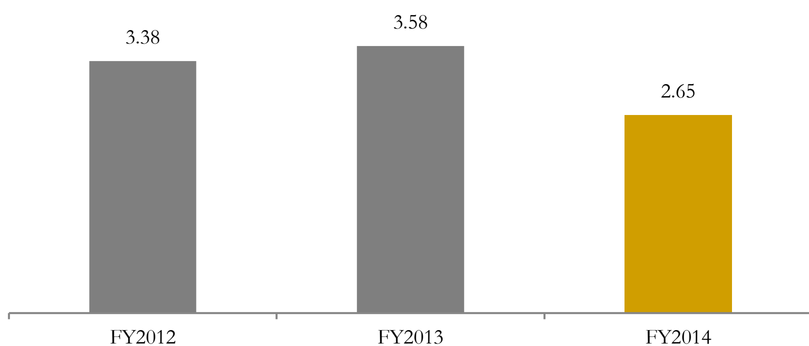


Source: Company Financials, DLM Research

The bank's interest coverage ratio declined to 2.65x from 3.58x in the preceding year. The lower ICR reflects that lower earnings are available to meet interest payments and that increases the bank's vulnerability to increases in interest rates. However, this is still within acceptable limit.

"The lower ICR reflects that lower earnings are available to meet interest payments and that increases the bank's vulnerability to increases in interest rates. However, this is still within acceptable limit."

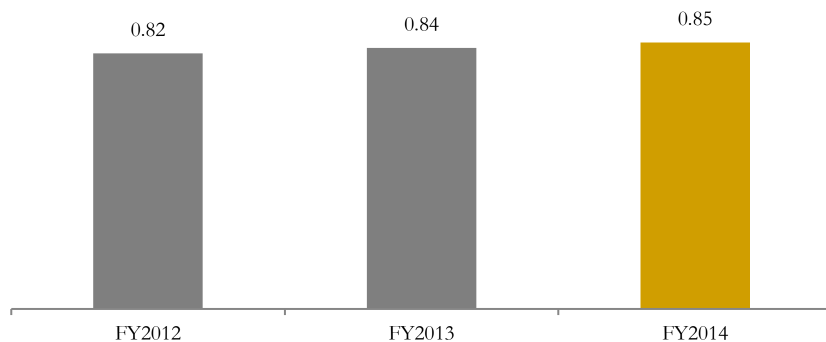
Interest Coverage Ratio



Source: Company Financials, DLM Research

Zenith bank's debt to assets ratio increased marginally to 0.85x. This in our view indicates conservative financing with an opportunity to borrow in the future.

Debt to Assets Ratio



Source: Company Financials, DLM Research

Credit risk outlook

We remain optimistic that the bank will continue to leverage on its strong balance sheet and improved capital base to support growth in the medium term. Zenith has recorded consistent profitability as it maintains a strong competitive edge through focus on high quality assets, strong liquidity position, brand leverage and retail strategy. Hence, we are of the view that adverse changes in the macro-economic and regulatory environment will not significantly affect the bank's ability to meet payment obligations as at when due. Our view is firmly supported by the bank's earnings, strong asset quality, and robust capital base which are sufficient to cushion business risks.

Key factors for future performance

Overall, Zenith bank's earnings appear to be largely revenue-driven earnings as opposed to cost-reduction. This is further buttressed by the 15.85% in interest income from ₦313.42billion in FY2014 from ₦270.54 in the preceding year. Also worthy of note is the 28.17% in Fees and commission income recorded during the year despite expected pressure as a result of the downward review of bank charges implemented in 2013 to ₦3 per mille from ₦5 per mille with further decreases expected till it is phased out by 2016. We highlight that the impact of the decrease in bank charges was buffered to a large extent by the increased transaction volume recorded during the period.

"Hence, we are of the view that adverse changes in the macro-economic and regulatory environment will not significantly affect the bank's ability to meet payment obligations as at when due."

Historically, the bank has demonstrated its ability to withstand headwinds in its operating environment. However, these factors would drive the bank's future performance in the medium to long term: macroeconomic stability, a stable political environment, the sustenance of policies that have so far driven the growth of the banking sector in recent time, ability to ensure that the bank's risk management structures and processes are continually reviewed to ensure risks are tightly managed, ability to compete favourably due to proliferation of financial products in the Nigerian banking space and conditions within the international financial markets.

The impact of lower oil prices on the sector is negative as the economic implications for Nigeria will invariably affect bank performance. The impact will be transmitted through austerity measures likely to be put in place which would reduce household savings and consequently deposits, tighter rules by the CBN- commencement of the treasury single account scheme among others.

FIDELITY BANK PLC.

FIDELITY BANK PLC.

Background

Fidelity Bank Plc. ranks amongst the mid-tier banks in Nigeria by key balance sheet metrics and geographic presence. The bank controls ~4%, of the total industry's assets. The bank is engaged in commercial banking, investment banking and asset management activities through a network of 219 branches, with 685 ATM and over 2.8 million accounts across the country. We note that though the bank appears small based on assets size, it is well capitalised at ₦173,111 based on its current risk level, recording a risk weighted capital adequacy ratio of 24.21% at FYE15 after adjustment and implementation of Basel 11, relative to the 15% regulatory limit.

Investment summary

In 2013, Fidelity Bank issued a $300 million 5-year Eurobond paying annual coupon of 6.875% and a yield of 7%, priced at 99.48% and gave a spread of 635bps over U.S. Treasuries. The bond was issued to fund its long term financial activities and also to provide USD-denominated loans to companies looking to expand in the oil, power, gas and infrastructure sectors. The bank has also commenced plans to raise an additional ₦30 billion, seven-year bond at an interest rate of 16.48%. This provided a spread of 128bps over risk free federal government bond. With an average lending rate to customers at 21.56%, the bank's borrowing rate on the bond is calculated to be a discount of 5.08% to lending rate to customers. Hence, while we note the riskiness of the bond, we are of the view that investors are well compensated for the risk. While the new issue would increase the bank's debt burden, we highlight that it will also increase the bank's Tier II capital, overall capital adequacy and ultimately increase the bank's lending activities. The ability of the bank to pay interest and principal when due otherwise called default probability has become a major concern to many investors in view of the challenging operating environment. Given that the first issue was Eurobond, therefore concerns regarding exposure to exchange rate risk remain paramount. While the bank's cash flow is in local currency, persistent decline in naira against the issued currency ($) will increase the debt burden of the bank. Given that the bank's cash flow or earnings is largely driven by interest income from loans and advances to customers, we maintain that the new issue is a concerted effort at improving its operating liabilities in order to support earnings assets. The bank's ability to pay interest and principal borrowing depends largely on its operating income/operating profit and cash flow generation potential. While operating income is vital, however, we consider operating profit more important in view of the embedded operating expenses in operating income. Based on it FYE'14 results, we note

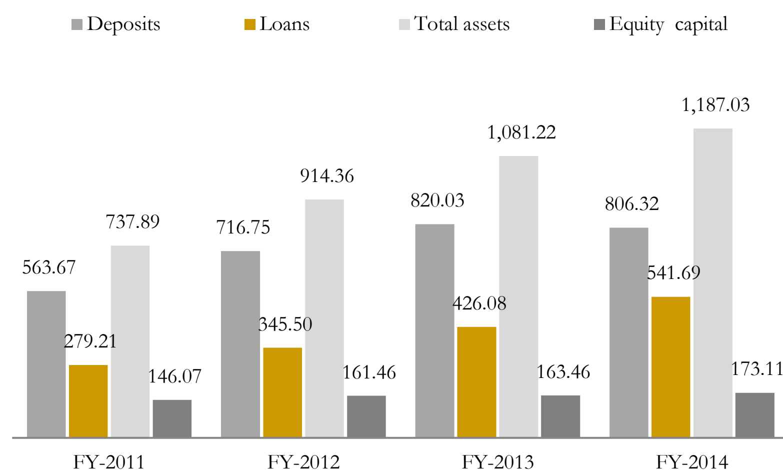
that interest payment on debt issued and other borrowed funds stands at ₦3.71billion. This currently stands at 5.11% of the bank's operating income and 23.90% of operating profit. with likely increase expected in the current year following the impact of the new issue. Despite the fairly stable investment ratings accord the bank by global rating agency (Fitch ratings), we note that a number of factors can trigger the bank's default on payment despite maintaining a healthy financial position. On this note, we investigate the bank's ability to make payment on this debt instrument when due. Our investigation is centred on key ratios.

Rating Reviews Fitch Ratings assigned Fidelity Bank Plc Long-term Issuer Default Rating (IDR) of 'B', Viability Rating (VR) of 'b-', Support Rating of '4' and Support Rating Floor of 'B'. It also assigned the a Short-term IDR of 'B' and affirmed its National Long-term Rating at 'BBB+(nga)' and Short-term Rating at 'F2(nga)'. While the outlook on the bank's Long-term IDR is Stable, IDRs, National and Support Ratings appears to be driven by the limited probability of support from the Nigerian authorities given the bank's perceived systemic importance. The bank's VR ratings reflects a challenging operating environment, weak earnings through Nigeria's financial crisis and asset quality that was vulnerable to market conditions.

Business growth, 2011- 2014

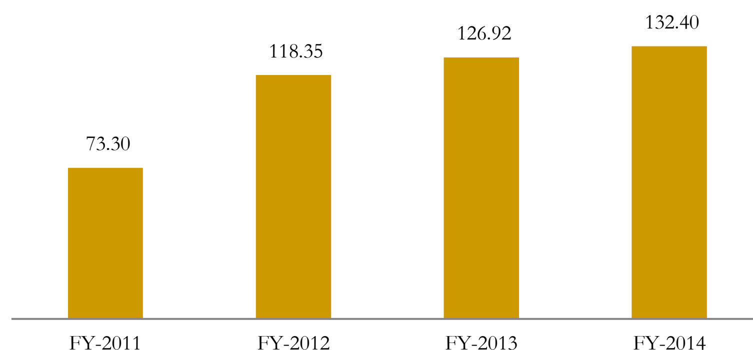
Business growth (₦bn)	2011	2012	2013	2014	CAGR
Deposits from customers	563.67	716.75	820.03	806.32	12.67%
Loans and advances to customers	279.21	345.50	426.08	541.69	24.72%
Total assets	737.89	914.36	1,081.22	1,187.03	17.17%
Equity capital	146.07	161.46	163.46	173.11	5.82%
Gross earnings	73.30	118.35	126.92	132.40	21.79%

Deposits, loans, equity capital and assets growth (₦'bn) -2011-2014



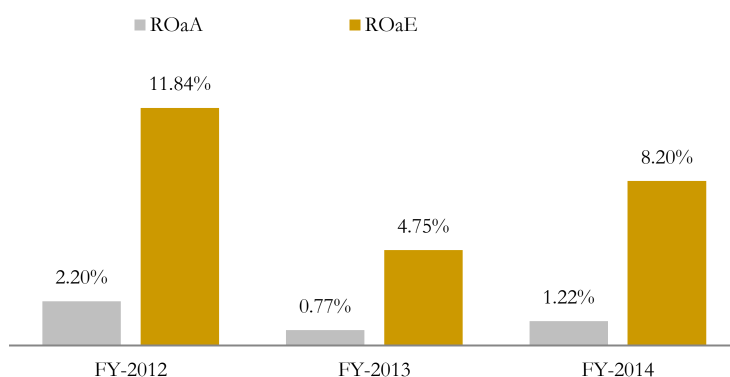
Source: Company annual report, DLM Research

Revenues growth (₦'bn) -2011 -2014



Source: Company annual report, DLM Research

Returns on average asset and equity (%) -2012 -2014



Source: Company annual report, DLM Research

Performance Summary

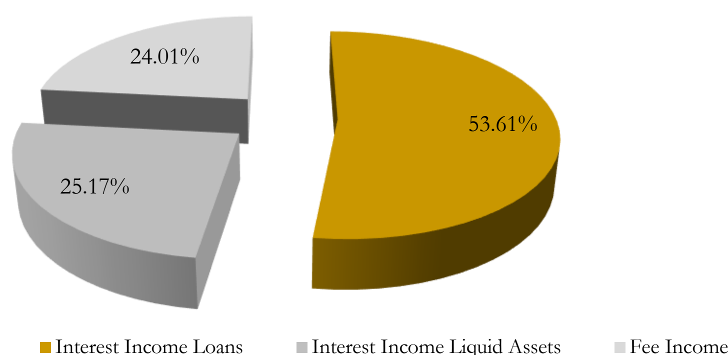
Moderate growth in gross earnings. Gross earnings of ₦132.40billion was up 4.32% y/y, (CAGR: 21.78%, 2011- 2014) largely driven by growth in interest income on loans and advances –stimulated by strong growth in customer loans.

We note however that the slow growth in revenue was impacted by growth in interest bearing liabilities and net loss on financial instruments. While interest income on loans rose by 40% to ₦70.98billion, income from other liquid assets and FX transactions declined by 5.4% and 4.4% respectively. We are of the view that this may be attributable to spread compression in yields on these assets and the devaluation of the naira.

"We note however that the slow growth in revenue was impacted by growth in interest bearing liabilities and net loss on financial instruments."

Income Statement (₦'m)	FY'11	FY'12	FY'13	FY'14	y/y %	CAGR
Gross earnings	73,302	118,354	126,918	132,401	4.32%	21.8%
Interest income	49,534	78,996	86,257	104,307	20.93%	28.2%
Interest expense	18,979	42,186	55,445	55,481	0.06%	43.0%
Impairment charge for credit losses	16,726	4,610	8,140	4,306	-47.10%	-36.4%
Net interest income after impairment charges	13,829	32,200	22,672	44,520	96.37%	47.7%
Operating profit	161	20,844	6,590	17,962	172.56%	381.4%
Profit before tax	161	21,625	9,028	15,515	71.85%	358.5%
Tax	2,426	3,425	1,307	1,719	31.52%	-189.2%
Profit after tax	**2,587**	**18,200**	**7,721**	**13,796**	78.68%	74.7%

Business contributions to gross earnings (%)

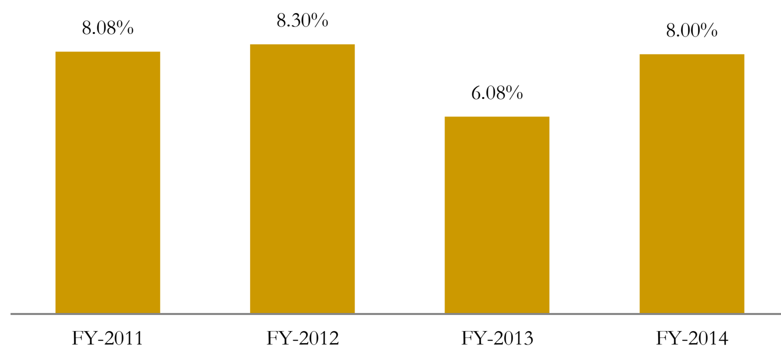


Source: Company annual report, DLM Research

Operating efficiency improved on the back of effective cost management. Interest expense rose marginally by 0.06% y/y to ₦55.48billion during the review year(FYE'13:₦55.48bn). We note that the moderate growth was impacted by decrease in term deposits (-1.43%) and current account. This is despite the increase in savings account rate from 3.6% to 3.9%. Although we note that the bank maintained an insignificant proportion of 11.95% of deposit in savings account. Hence the bank's average cost of fund declined to 6.82% with a corresponding decrease in interest spread. This invariably led to an increase in the bank's NIM.

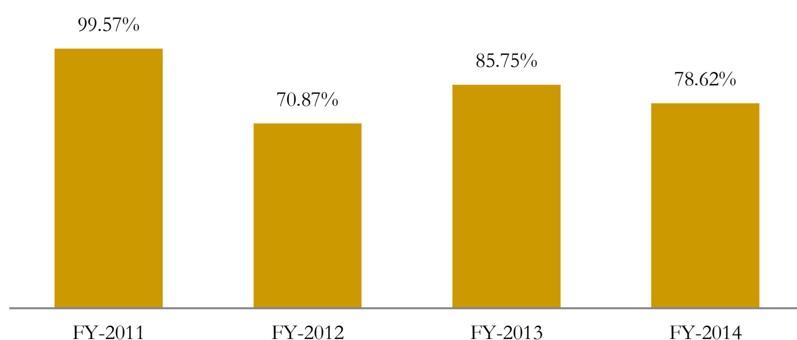
Operating expenses rose 5.15% y/y to ₦57.10billion, (FYE'13: N54.31bn) driven primarily by staff cost, depreciation and regulatory charges accounting for ~70% of total expenses. Regardless, operating income grew by 14.67% y/y to ₦72.62billion, (FYE'13:₦63.33bn). Hence, cost-to-income ratio declined to 78.62%, (FYE'13:85.75%). Whilst the decline is impressive in our view, we are inclined to highlight that current level remains high in comparison to tier 1 banks in the industry.

Net interest margins (%) 2011-2014



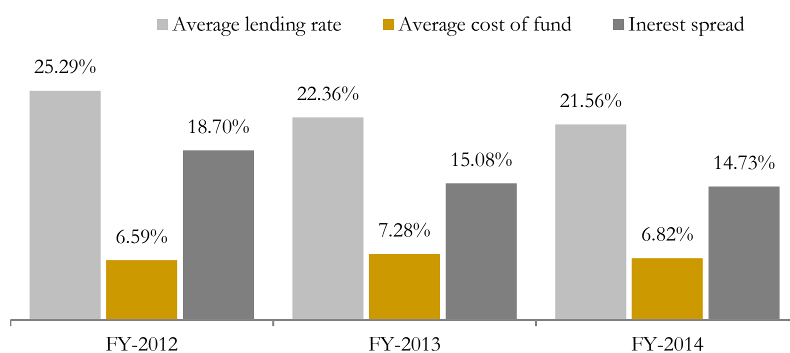
Source: Company annual report, DLM Research

Cost to income ratio (%) 2011-2014



Source: Company annual report, DLM Research

Average lending rate, cost of fund and interest spread (%) 2012-2014

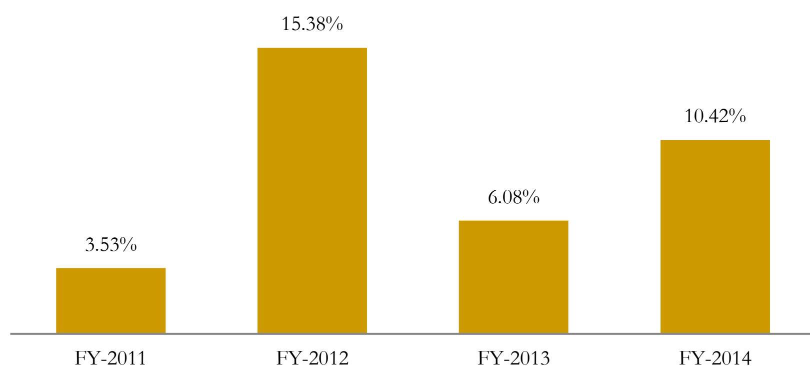


Source: Company annual report, DLM Research

Profitability margins remain impressive. - Profitability and earnings are a significant determinant of the bank's ability to survive in the long run. They also reflect the quality of the bank's asset base, funding sources, costs management; and a reflection of the bank's management and strategy. Regardless of the challenging business environment, the bank's profitability and earnings prospects remains positive however regulatory challenges remain a major risk. . With post tax profit increasing significantly by 78.68% y/y to ₦13.80billion from ₦7.72billion in the previous year, the bank's net profit margin rose to 10.42%. Although, we are inclined to highlight that the bank's net profit margins has been oscillating in the last four years. Specifically, net profit margins hovered around 3.53% – 15.38% (2011 -2014), with the highest net profit margin (15.38%) recorded in FYE'12 on the back of strong growth in revenue and post-tax profit. Despite the growth in the current year, we note that the bank's net profit margin is one of the lowest in the industry. Hence, in FYE'14, ROaE and ROaA improved to 8.20% (FYE13: 4.75%) and 1.22% (FYE'13: 0.77%) respectively, which is less than half of returns being recorded by banks within the tier1 space.

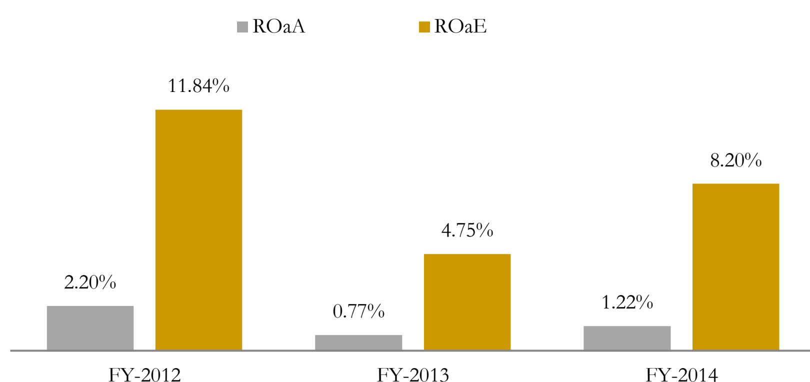
"Although, we highlight that the bank's net profit margins has been oscillating in the past four years."

Post tax profit margins (%) 2011-2014



Source: Company annual report, DLM Research

Returns on average equity and asset (%) 2012-2014



Source: Company annual report, DLM Research

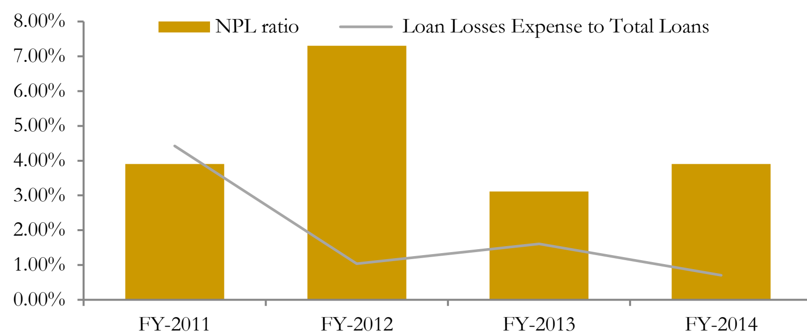
Asset Quality/Credit Risk – With the growing market risk, credit risk remains the principal risk for the banks. Our methodology to credit risk entails analysis of the entire balance sheet, looking at different asset categories. Although, we note that it is a common feature for banks to have off-balance sheet commitments apart from guarantees and letters of credit. These include derivatives, such as exchange rate et.al. We analyse the make-up of the balance sheet to ascertain the asset mix and concentration. We note that loan portfolio represents the most important asset category of the bank. Where the major risk is not connected to loan assets, we focused on the investment assets such as tradable securities and the associated credit and market risk such as fluctuation in yield as a result of changes in interest rate. More importantly is the exposure to exchange rates as persistent devaluation of the local currency especially when repayment is due, will make settling the foreign currency denominated debt more expensive.

Asset quality and CAR remain strong. Despite maintaining an insignificant share of the industry in terms of asset, loans and deposits, the bank is well capitalised at ₦173.111billion based on its current risk weighted assets of ₦821.527 , recording a risk weighted capital adequacy ratio of 24.21%, (FYE13: 21.77%), which is at premium to the CBN regulatory limit of 15%. The bank's tier 2 capital is 33.33% of its tier1-which is also in line with the CBN regulatory limit. The current CAR appears strong enough to support the bank's business risk. The additional ₦30billion debt issued through local currency will augur well for the bank to further boost its CAR but ability to pay interest remains a key risk particularly in view of the current asset liability mismatch. The bank's non-performing loan ratio of 4.4% increased from 3.7% in FYE'13, (FYE12: 3.9%, FYE11: 7.3%), though just 0.6% away from the CBN's 5% limit. We note that the increased in NPL for the period was caused by newly classified loans in the Communication, Manufacturing, and Consumer Sectors. The banks' non-performing loans ratio is below the Central Bank of Nigeria's (CBN) informal cap of 5%.

"The current CAR appears strong enough to support the bank's business risk."

The current low level of NPL was due to a clean-up of the loan book, with write-offs (including the claw-back of loans previously sold to Asset Management Corporation of Nigeria amounting to ₦7.6billionn in FYE'13. The highest proportion of NPL was observed in manufacturing 30%, communication 15% andoil & gas 2.5% sectors. However, we expect NPL in the oil & gas sector to increase further in FYE'15 in view of the declining crude oil price. Hence, exposure to these sectors is a key risk and reflects high credit concentrations. Oil & gas lending is sensitive to low oil prices and if low oil prices persist, the bank would need to restructure part of its loan portfolio in order to limit exposure.

NPL ratio, loan loss exp to total loan ratio (%) -2011-2014



Source: Company annual report, DLM Research

Capital adequacy ratio (%) -2011-2014

Source: Company annual report, DLM Research

	2011	2012	2013	2014
Tier 1 capital	145,773	161,742	140,470	149,168
Tier 2 capital	300	-289	46,818	49,718
Total regulatory capital	146,073	161,453	187,288	198,886
On balance sheet	118,335	904,337		
Off balance sheet	430,361	132,223		
Total risk-weighted assets	430,361	561,325	860,352	821,527
Capital adequacy ratio	33.94%	28.76%	21.77%	24.21%
Tier 1 capital ratio	33.87%	28.81%	16.33%	18.16%

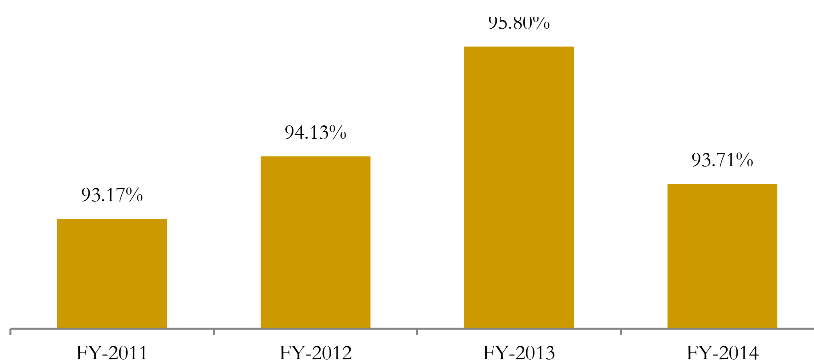
"By our assessment, the bank's balance sheet is highly liquid, with cash and liquid assets constituting 93% of its total assets as at FYE14, while liquid and trading assets to short-term funds ratio remain at an acceptable level."

Liquid balance sheet position. We note that weak liquidity is often the main cause of a bank's failure to operation and meet financial obligations. The bank's liquidity ratio declined to 38% from 45.7% in 2013 but above CBN regulatory limit of 30% which is sound in our view. By our assessment, the bank's balance sheet is highly liquid, with cash and liquid assets constituting 93% of its total assets as at FYE14, while liquid and trading assets to short-term funds ratio remain at an acceptable level. This indicates the bank's ability to fund itself under stress conditions with minimum level of support from regulatory authorities. This is particularly an important factor for the bank that operates in an environment where conditions can change rapidly. As such, the prime risk to the bank to renew or

replace maturing funding liabilities appears low. Although we note that there is a mismatch in maturity of the bank's assets and liabilities, which is a major concern in our view- though this appear to be a common feature in Nigerian banks' balance sheets. Hence, we are of the view that the bank's liquidity could decline in the near term due to higher central bank reserve requirements.

Liquid assets	2014	2013	%
Bank placements	42,049	13,000	223.5%
Treasury Bills	184,342	239,885	-23.2%
Bonds	50,917	72,787	-30.0%
Customer Loans (Naira)	314,941	310,906	1.3%
Customer Loans (FCY)	226,744	115,170	96.9%
Cash	33,659	31,889	5.6%
Balances with CBN/Settlement Acct.	224,472	175,945	27.6%
Balances with other Banks	26,686	67,875	-60.7%
Total	**1,103,810**	**1,027,457**	**7.4%**

% of liquid assets in total assets -2011-2014



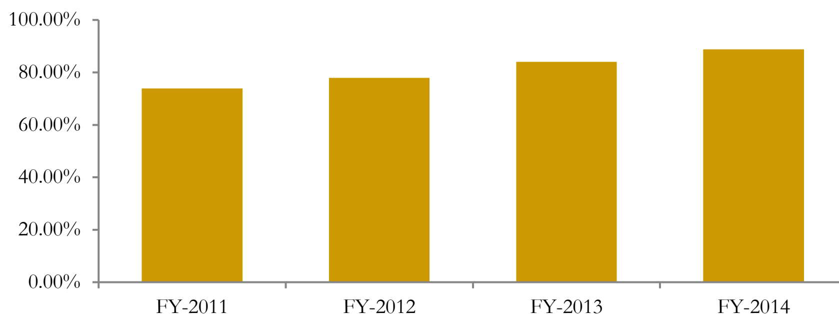
Source: Company annual report, DLM Research

Acceptable credit concentration. Although we note an increase loans to key sectors which reflects increasing credit concentrations as well as emerging risks, particularly in the oil and gas, transportation, and agricultural sectors. However, the strategic reduction of loan portfolio concentration across selected industry indicates the limit of credit exposures the bank is willing to assume – which also reflect the bank's credit risk appetite. We note that the bank has high exposure to exchange rate fluctuations. Hence, reducing loan to the sectors for which there may be an increased risk of loss or default particularly oil & gas in view of declining oil price and exchange rate devaluation will help to boost the asset quality of the bank. The strategic loan portfolio concentration across the industry indicates the limit of credit exposures the bank is willing to assume – which also reflect the Bank's credit risk appetite.

"Hence, reducing loan to the sectors for which there may be an increased risk of loss or default particularly oil & gas in view of declining oil price and exchange rate devaluation will help to boost the asset quality of the bank."

While the bank maintains strong capital adequacy level, we think the negative cumulative asset liability gap is worrisome which in our view indicates near to medium term challenges in meeting debt obligations. We therefore highlight that a rise in interest bearing liabilities burden without a corresponding increase in cash flow could trigger default risk.

Loan concentration risk -2011-2014



Source: Company annual report, DLM Research

Credit concentration

Sectors	2013	2014	%
Agriculture	9,390	14,456	54%
Oil and gas	77,215	134,750	75%
Consumer credit	34,340	41,735	22%
Manufacturing	30,480	51,323	68%
Mortgage	893	427	-52%
Government	33,046	12,328	-63%
Real estate	8,093	12,146	50%
Construction	18,303	18,444	1%
Finance and insurance	388	836	115%
Transportation	21,315	48,826	129%
Power	50,017	57,626	15%
Others	66,722	86,955	30%
Communication	88,171	76,480	-13%
Other public utilities	311	186	-40%
Education	3,966	2,553	-36%
Capital market		65	#DIV/0!
Total	**442,650**	**559,136**	**26%**

Credit exposures by class and value of collaterals

	2014		2013	
	Exposure	Fair Value of Collateral	Exposure	Fair Value of Collateral
Secured against Real Estate	85,378	156,967	46,648	167,636
Secured by shares	452	870	643	1,469
Secured - others	459,629	1,002,435	380,941	2,481,443
Unsecured	13,677			

Financial Assets	2014	2013	%
Cash and balances with Central Ban	258,131	207,834	24.20%
Due from banks	68,735	80,875	-15.01%
Loans and advances to customers	541,686	426,076	27.13%
Held for trading (Fair value through profit or loss)	83,335	254,881	-67.30%
Available for sale	90,864	12,685	616.31%
Held to maturity	69,526	45,104	54.15%
Other assets	36,256	1,445	2409.07%
Performance bonds and guarantees	104,910	143,269	-26.77%
Total	**1,253,443**	**1,172,169**	**6.93%**
Fair value of Collateral held	1,160,272	2,650,548	-56.23%
Surplus collateral	618,586	2,224,472	

Asset- Liability mismatch a concern. We highlight the financial assets and liabilities of the bank into relevant maturity period based on the remaining period at reporting date to the contractual maturity date for FYE'14. While we note the negative cumulative liquidity gap within some periods of maturity, we are of the view that this may not reflect the actual liquidity position of the bank as some term deposits maturing within one year might be rolled over as historically being observed in the banks.

Asset and Liabilities Analysis

Financial assets	Up to 1 month	1-3 months	3-12 months	1-5 years	Over 5 years	Total
Cash & balances with CBN	258,131					258,131
Due from banks	68,735					68,735
Loans and advances to customers	128,964	19,211	17,365	268,034	108,111	541,685
Held for trading	83,363					83,363
Available for sale	48,185	24,063	-	8,887	9,729	90,864
Held to maturity	20,944	36,478	1,447	3,165	7,492	69,526
Total financial assets	608,322	79,752	18,812	280,086	125,332	1,112,304
Financial liabilities						
Customer deposits	502,988	209,465	107,580			820,033
Other liabilities	14,350	15,106	36,774			66,230
Debt issued and borrowed funds				117,541		117,541
Performance bonds & guarantees	6,314	13,584	21,419	63,593		104,910
Letters of credit	9,830	11,915	8,515			30,260
On-lending facilities	41					41
Total financial liabilities	533,523	250,070	174,288	181,134	-	1,139,015
(Assets-liabilities)	***74,799***	***(170,318)***	***(155,476)***	***98,952***	***125,332***	***(26,711)***
Cumulative liquidity gap	***74,799***	***(95,519)***	***(250,995)***	***(152,043)***	***(26,711)***	

Earnings assets	**2014**	**2013**	**%**
Bank placements	42,049	13,000	223.5%
Treasury Bills	184,342	239,885	-23.2%
Bonds	50,917	72,787	-30.0%
Customer Loans (Naira)	314,941	310,906	1.3%
Customer Loans (FCY)	226,744	115,170	96.9%
Total Earnings Assets	818,993	751,748	8.9%
Demand	424,397	453,845	-6.5%
Savings	97,996	83,325	17.6%
Time Deposits	297,641	269,150	10.6%
Borrowings	62,547	22,484	178.2%
Eurobond	54,994	47,844	14.9%
Total Interest Bearing Liabilities	937,575	876,648	6.9%
Cumulative Gap	***(118,582)***	***(124,900)***	***-5.1%***

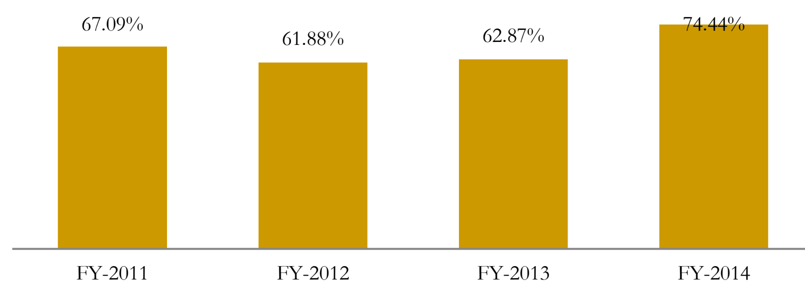
Exposure to exchange rate risk is high in our view. The Bank is highly exposed to the effects of fluctuations in foreign currency exchange rates on its financial assets and liability. This is the risk that the fair value or future cash flows of a financial instrument will be adversely affected by changes in foreign exchange rates. Although we note that gains of the local currency (Naira) against these currencies will boost the operating cash flow of the bank. The table below summarises the bank's exposure to foreign currency exchange risk as at 31 December 2014.

Financial assets	USD (m'n)	GBP (m'n)	Euro (m'n)	Naira (m'n)	Total
Cash and balances with Central Bank	10,834	935	2,395	243,967	258,131
Due from banks	15,106	1,109	2,099	50,421	68,735
Loans and advances to customers	226,224	520		314,941	541,685
Financial assets held for trading	12,083			71,280	83,363
Available for sale	1,599			89,265	90,864
Held to maturity				69,526	69,526
Other financial assets				29,167	29,167
Total	**265,846**	**2,564**	**4,494**	**868,567**	**1,141,471**
Financial liabilities					
Customer deposits	131,676	1,988	1,664	684,706	820,034
Other liabilities				66,230	66,230
Debt issued & other borrowed fund	117,541				117,541
Total	**249,217**	**1,988**	**1,664**	**750,936**	**1,003,805**

Loan-to-deposit ratios improved on the back of growth in loans. Adjustment to a new macroeconomic and market environment, the tightened liquidity, capitalization requirements and the need to boost earnings are factors that have pushed the bank towards a strong focus on liquid assets. The banks loans to customers grew 27.13% y/y, (CAGR: 24.72%, (2011-2014), primarily driven by loans to oil & gas, communication, transportation, consumer lending, manufacturing et.al. This in addition to an increased contribution from FCY loan book led by an average return on loan 14.73%, a decline from 15.05% in FYE13. As a result and on an annual basis, the customer Loan-to-Deposit (L/D) ratio improved to74.44% which is a fairly balanced ratio. This trend shows that the bank has internal resources that could be transferred to fund growth in earnings. This was supported by a 1.70% increase in deposits.

"This trend shows that the bank has internal resources that could be transferred to fund growth in earnings."

Loan to deposits ratio (%) -2011-2014



Source: Company annual report, DLM Research

Default probability exists but remains at a minimum level. The bank appear to be stable but with uncertainty of financial position and future cash flow in view of challenging operating environment. Hence, default risk appear to be inherent but at a reduced rate. We note that many things can influence default risk on the bank debt instruments such as falling cash flow from operations which is often needed to make the interest and principal payments, rising interest rates and changes in the nature of the marketplace.

"Hence, default risk appear to be inherent but at a reduced rate."

Hence, to measure the bank's ability to meet its financial obligations when due, the following metrics were deployed.

Asset coverage ratio. This measures the ability of the bank to cover its debt obligations with its assets. While the bank's asset cover ratio declined from 3.46x in 2013 to 2.54x, regardless, we highlight therefore that chances of its insolvency remain low given its cash flow generation potentials.

Capitalization ratio. The ratio reflects the extent to which the bank is operating on its equity–in other word, it reflect the debt component of the bank's capital structure. The bank's capitalization ratio increase to 0.40x from 0.30x but remain relatively low in our view, indicating investment quality.

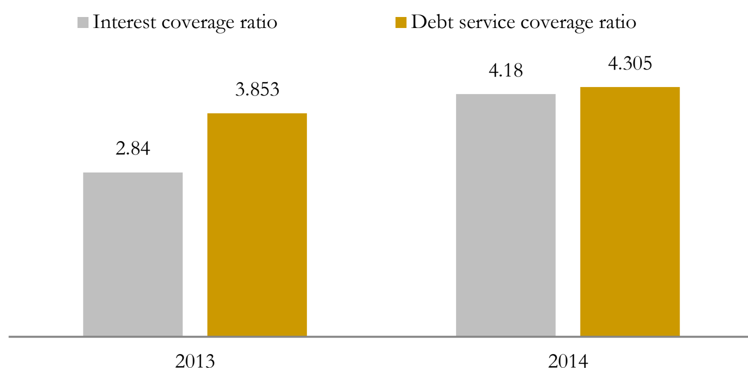
Debt service coverage ratio. We pay more attention to this ratio in view of its relative importance in evaluating the bank's credit condition. Given our evaluation, it is worthy to state therefore that the bank's debt service coverage ratio is relatively strong increasing to 4.31x from 3.85x in the preceding year which indicates that the bank's operating income is enough to cover 431% of its annual debt payments which in our view signifies a healthy credit quality of the bank.

Equity multiplier. This measure the financial leverage of the bank. The bank's equity multiplier increased fractionally to 6.86x from 6.61x in the preceding year. The higher equity multiplier indicates growing financial leverage, which also indicates that the bank's reliance on debt financing has increased.

Interest coverage ratio. The bank's interest coverage ratio is relatively healthy, increasing to 4.18x from 2.84x in the preceding year. The higher interest coverage ratio indicates lower possibility of default. The high ICR indicates the bank has much cash available to meet interest.

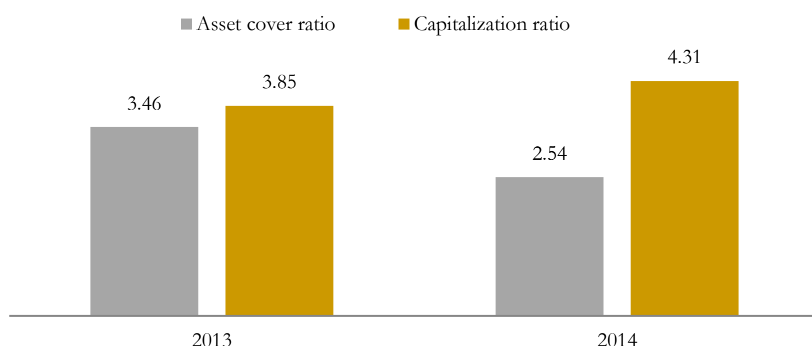
Debt-to-asset ratio. The ratio has remained flat at 0.85. This in our view indicates conservative financing with an opportunity to borrow in the future.

Interest and debt service coverage ratio



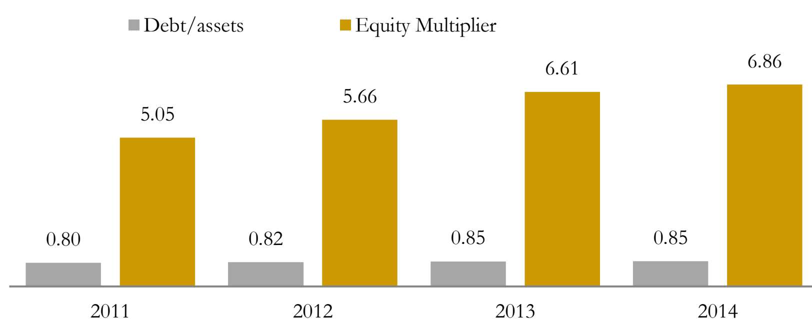
Source: Company annual report, DLM Research

Asset cover and capitalization ratios (x)



Source: Company annual report, DLM Research

Debt to asset ratio and equity multiplier (x) -2011-2014



Source: Company annual report, DLM Research

Outlook. We reckon that the main operating strength for the bank lies in improving profit margin. There is bound to be tighter cost controls in response to regulatory induced revenue growth constraints. Improved operating stability can therefore be expected as regulatory pressure is expected to ease and banks devote more time to the corporate purpose of building wealth for shareholders.

First Bank of Nigeria Holdings Plc.

FIRST BANK OF NIGERIA HOLDINGS PLC.

Background

First Bank Nigeria Holdings Plc. is a leading diversified financial services group with a market share of ~30% in terms of tier1 banks assets in Nigeria. The bank is engaged in commercial banking, investment banking and asset management, insurance and other financial services activity through a network of 892 branches, with 2,597 ATM and over 9.7 million customers across the continent. The bank operates in 8 African countries and offices in London, Paris, Beijing and Abu Dhabi and employed 10,464 employees based on FY'14 annual report. The bank in 2013 acquired Kakawa Discount House Limited with the view to securing a merchant banking license. The bank has a sizable market share of system loans and deposits but its current capital adequacy ratio does not reflect the bank position in the industry.

Investment summary

In 2014, the bank issued a $450 million tier-2, 7-year Eurobond with 8.25% yield to maturity callable after five years. The bank had in 2013, issued a $300-million Eurobond. The bond was issued to fund its long term growth, and increased financial activities by providing loans to companies in key sectors of the economy. The ability of the bank to pay interest and principal when due otherwise called default probability has become a major concern to many investors in view of the challenging operating environment. Given that the bond was dollar denominated, concerns surrounding exposure to exchange rate risk remain paramount. While the bank's cash flow is in local currency, the persistent decline in naira against the issued currency ($) will increase the debt burden of the bank especially given the weak outlook for the naira. While the bank's cash flow or earnings is largely driven by interest income from loans and advances to customers, we maintain that concerted effort should be made to improve its operating liabilities in order to support its earnings assets. The bank's ability to pay interest and principal on its borrowings depends largely on its operating income/operating profit and cash flow generation potential. While operating income is vital, however, we consider operating profit more important in view of the embedded operating expenses in operating income. Based on it FYE'14 results, we note that interest payment on debt issued and other borrowed funds stands at ₦83.16billion. This is 25.35% of the bank's operating income and 90.11% of operating profit. Despite the fairly stable investment ratings accord the bank by Fitch ratings, we note that a number of factors can trigger the bank's default on payment despite maintaining a healthy financial position.

On this note, our approach is to look at the four main areas of the bank's financials: asset quality, capital, liquidity, and profitability in a bid to determine

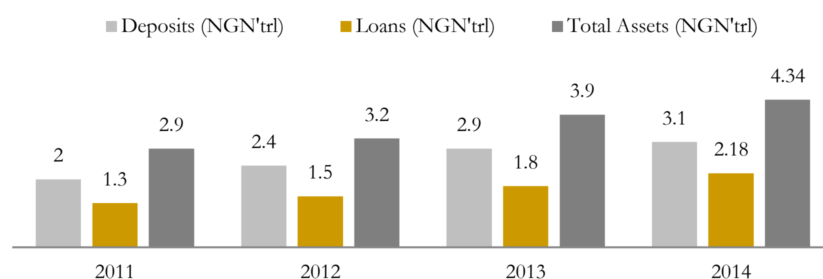
likelihood of default on debt instruments. We note that asset quality is acceptable but the group has a strong oil & gas exposure which is a key risk. We note that the implementation of Basel II reporting reduced the bank's capital adequacy ratios to 15.78%, some fraction above the minimum regulatory capital adequacy ratio– which signalled the need to boost its tier1 CAR given the 33.33% regulatory limit of Tier 2 CAR on tier1. Hence, we note that the current level of CAR inspired the bank to reduce its dividend pay-out ratio for the FY'14. While the bank is heavy on marketable securities, we highlight that changes to interest rates and exchange rate fluctuation are strong determinant of credit risk because it influences the debt burden of the bank. In addition, we note that the significant asset-liabilities mismatch may be a cause for concern if a liquidity event occurs. To analyse the probability of default, we highlight the financial strength of the bank

Business growth, 2011- 2014

Business growth

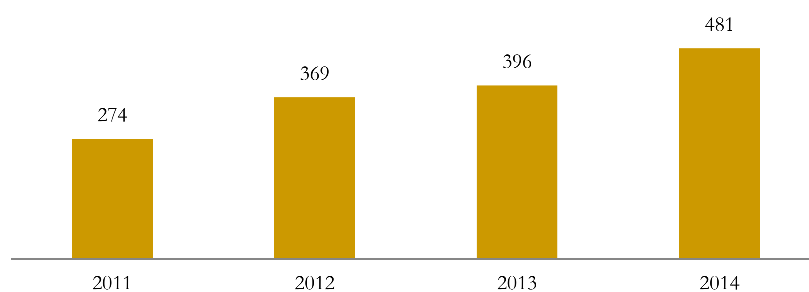
	2011	2012	2013	2014	CAGR
Deposits (₦'trl)	2	2.4	2.9	3.1	11.58%
Loans (₦'trl)	1.3	1.5	1.8	2.18	13.80%
Total Assets (₦'trl)	2.9	3.2	3.9	4.34	10.60%
Gross Earnings (₦'bn)	274	369	396	481	15.11%

Deposits, loans and assets growth (₦'trl) -2011-2014



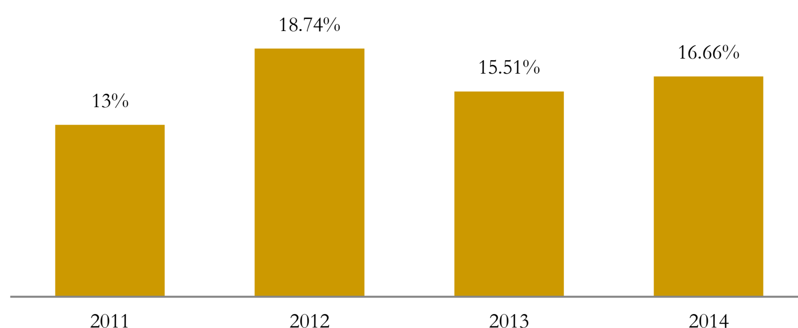
Source: Company annual report, DLM Research

Revenues growth (₦'bn) -2011 -2014



Source: Company annual report, DLM Research

Returns on average asset (%) -2011 -2014



Source: Company annual report, DLM Research

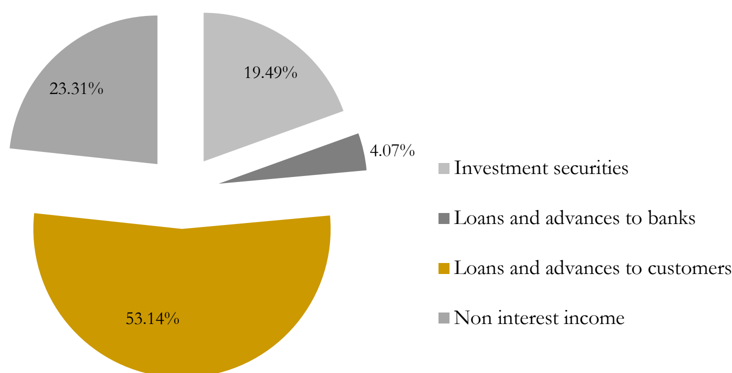
Performance Summary

Gross earnings rose on the back of growth in earnings assets. Gross earnings of ₦472.75billion was up by 21.40% y/y largely driven by growth in interest income on the back of growth in interest income from loans and advances to customers (+14.17%), banks (+10.30%) and investment securities (+6.94%). This was supported by strong performance in treasury income as a result of enhanced treasury activities, and fee & commission income which was inspired by commission on turnover, financial advisory fee, increased electronic banking activities, as well as funds transfer and intermediation fees. Hence, NIR grew 67.38% to ₦110.18bn (FY 2013: ₦65.82bn). Although loan yields declined due to increase in FCY loans but tradable securities yield increased driven by tight monetary policy despite 10.3% y/y decline in investment securities which was due to matured bonds and increased reserves funded from liquidated bonds. Hence, we note that the bank's focus is on aggressively driving transaction & value chain banking from electronic banking, increasing contribution from the non-banking subsidiaries as well as leveraging cross selling opportunities.

"We note that the bank's focus is on aggressively driving transaction & value chain banking from electronic banking, increasing contribution from the nonbanking subsidiaries as well as leveraging cross selling opportunities."

	2012	2013	2014	CAGR
Gross earnings	359,847	389,445	472,754	14.62%
Interest income	287,274	323,621	362,579	12.34%
Interest expense	62,082	93,506	118,725	38.29%
Impairment charge	12,299	20,903	25,942	45.23%
Net interest income after impairment charges	212,893	209,212	217,912	1.17%
Profit before tax	92,701	91,337	92,884	0.10%
Profit after tax	75,670	70,631	82,839	4.63%

Business contributions to gross earnings (%)

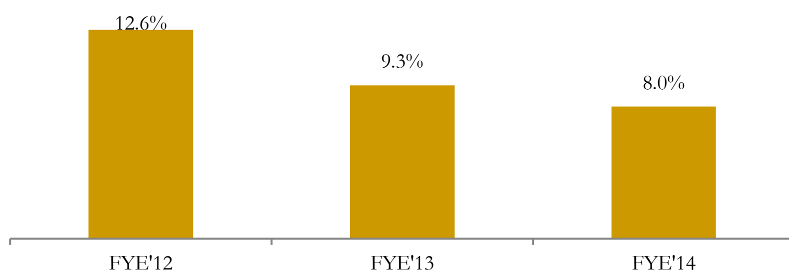


Source: Company annual report, DLM Research

Operating efficiency declined on the back of growth in operating expenses. Interest expense rose 26.97 % y/y to ₦118.7bn largely driven by growth in term deposits (+46.4%) and the increase in the savings account rate from 3.6% to 3.9%, this is as the bank maintained 24% of deposit book in savings account.. Despite the growth in interest income, we highlight that increase in cost of funds was much faster than growth in overall asset yields which invariably led to depression in the bank's NIMs. While treasury bills were discounted to fund rising CRR, the bank's NIM appears to be pressured, declining to 8.0%, (FYE'13: 9.30%). Specifically, while interest on savings deposits rose to 3.9% from 3.6% for the industry, this impacted the bank's cost of funds as it rose to 3.5% due to the increase in term deposits as well as the impact of a 0.3% hike in the savings deposits rate as savings account constitute ~24% of total deposit. Operating expenses rose 27.5% y/y to ₦236.8billion, (FYE'13: N185.8bn) driven primarily by staff cost, resulting from the integration of the West African Subsidiaries, acquisitions during the year such as Oasis, ICB Senegal & Kakawa, AMCON charges, and other regulatory cost. Regardless, operating income grew by 19.8% y/y to ₦355.1billion inspired by growth in non-interest revenue. Hence, cost-to-income ratio rose to 66.7%, (FYE'13:62.70%). This impacted on overall operating efficiency of the bank.

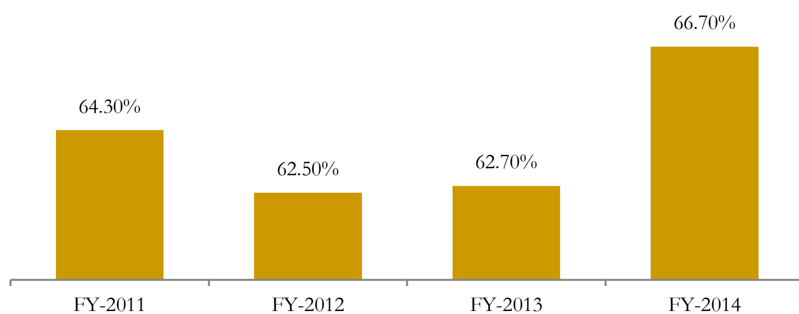
"While treasury bills were discounted to fund rising CRR, the bank's NIM appears to be pressured, declining to 7.6%, (FYE'13: 8.0%)."

Interest margins (%) 2012-2014



Source: Company annual report, DLM Research

Cost –to-income (%) 2011-2014

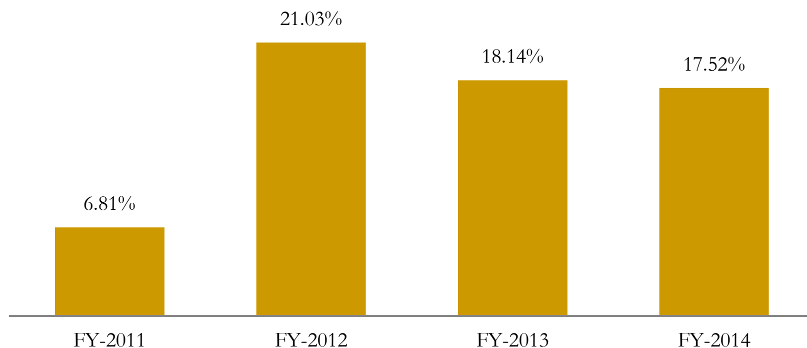


Source: Company annual report, DLM Research

Profitability margins remain impressive. - Profitability and earnings are a significant determinant of a bank's ability to survive in the long run. Profitability and earnings also reflect the quality of the asset base, funding sources and costs, franchise value and a reflection of the bank's management and strategy. Regardless of the challenging business environment, the bank's profitability and earnings prospects remains positive however regulatory challenges remain a major risk . With post tax profit increasing by 17.28% y/y to ₦82.84billion from ₦70.63billion in the previous year, the bank's net profit margins remain strong in the past three years despite a fractional decline in FYE'14. Specifically, net profit margins hovered around 17.52% – 21.03% (2012 -2014), with the highest net profit margin (21.03%) recorded in FYE'12 on the back of strong growth in revenue. Hence, in FYE'14, ROaE and ROaA improved to 16.16% (FYE13: 15.51%) and 2.02% (FYE'13: 2.00%) respectively.

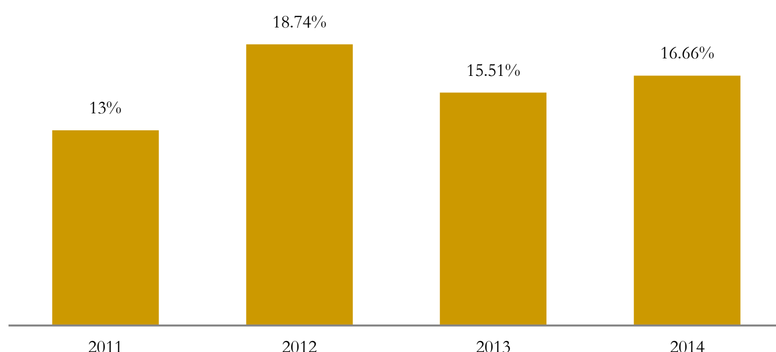
"Regardless of the challenging business environment, the bank's profitability and earnings prospects remain positive but a major risk to this is regulatory challenges."

Net profit margins (%) 2011-2014



Source: Company annual report, DLM Research

Returns on average equity (%) 2011-2014



Source: Company annual report, DLM Research

"FBNH loan book appear to be concentrated above it peers in tier1 category with the 8-largest loans accounting for 90.11% of gross loans loan to customers at the end of FYE'14."

Asset quality is acceptable. We highlight that current capital of the bank provides it with protection to absorb unexpected losses and allows it to operate in a solvent manner as the bank's capital also provides leverage to the balance sheet. Its tier 1 capital gives the bank opportunity to expand the asset base and, in turn, increase earnings. As a result, the level of capital and risk weighted capital adequacy are fundamental factors in the bank's creditworthiness. First Bank has the largest exposure to oil and gas with ₦853 billion credit to the sector, (FY13: ₦621bn). This is a high credit concentration risk in our view. In the event of persistent decline in oil price, the banks faces the risk of a significant portion of its loans going bad as majority of the oil & gas companies will likely be faced with difficulties in repaying their loan obligation just as observed in the 2008/2009 crises that rocked the sector. Neverthe less, we are inclined to draw attention to the fact that amongst all the sectors the bank has exposure, the oil & gas sector remains the most profitable and has the highest capacity for repayment. Meanwhile, we equally highlight that loan to the oil & gas sector has different risk profiles. Lending to the different segments is sensitive to low oil prices and if low oil prices persist, the bank would need to restructure part of its loan portfolios and tenors to match cash flow projections.

First Bank's involvement in the oil and gas sector spreads across the three segments i.e. downstream, mid-stream and upstream. The bank's exposure to the downstream sector is 20%. Although, the bank highlighted that the risk in the segment is limited and involves trade finance risk. However contrary to the management's view, we are inclined to say that the risk is relatively high. We think having ₦853billion of its ₦2.17trillion total loans to customers concentrated in a single industry (energy and related companies) is a substantial risk even though the bank has improved its risk management process to prevent a repeat of 2008/2009 crisis. Supportive of our view is that most of the notable defaulters

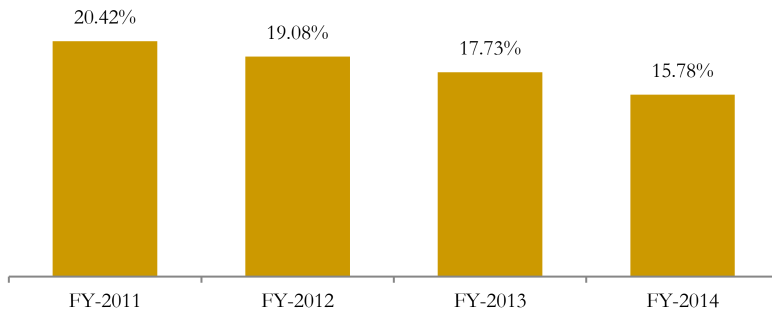
during the 2008/2009 crises were downstream operators. Given current realities, we believe that the current exposure to the sector can potentially produce losses large enough to negatively impact its balance sheet. We highlight that the clean-up of the sector, resolution of the outstanding fuel subsidies coupled with regulatory and policy changes by the new administration, are some of the factors that could drive the bank's non-performing loans (NPLs) in the sector in the near term.

In addition, the bank's exposure to the upstream segment of the market is 15% and the repayment cash flows are derived from the operations of the obligor's oil wells. We note that the financing of the upstream segment is done through hedge contracts put in place to provide secondary protection. The bank has made provision to elongate the tenure of the facility by a year or less than two years for those with repayment challenges with the view that, as long as the oil wells still exist and are producing, there will always be cash flows. In general, loans to the segment have different default probabilities, which can be correlated to each other. The growth in non-performing loans ratio to 2.90%, though below CBN's cap of 5%, reflects high credit concentrations as well as emerging risks, particularly to oil & gas and manufacturing sectors. The shift to Basel II and CBN's revised regulatory capital computation rules is likely to add more pressure on the bank's CAR, which may see Tier 1 capital ratio fall below 15%.

The bank's capital position was enhanced through increased profit retention. The bank's loan loss coverage ratio is significantly high at 137.9% in FYE'14, an increase from 97.7% in the preceding year. We consider that the higher ~23.20% credit growth (loan to customers) during FYE'14 increases the risk of deterioration in NPLs especially those in key sectors of the economy. FBNH loan book appear to be concentrated above it peers in tier1 category with the 8-largest loans accounting for 90.11% of gross loans loan to customers at the end of FYE'14. Although we note that credit concentration is a key feature among Nigeria banks which adds volatility to earnings and asset quality. Hence, we anticipate the bank's extension of loan tenors in key sectors to align with expected reduced cash flow.

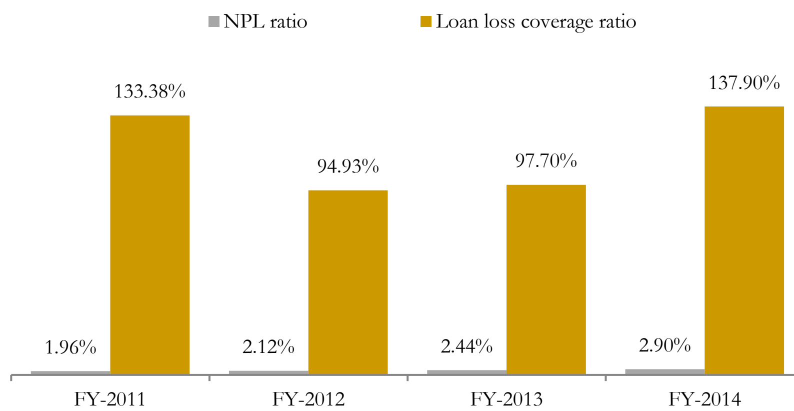
Capital Type, ₦'mn	2011	2012	2013	2014
Tier 1 capital	357,925	356,772	352,011	316,687
Tier 2 capital	46,297	32,517	65,206	91,195
Total regulatory capital	404,222	389,289	417,217	407,882
On balance sheet		1,825,116	2,059,077	2,585,213
Off balance sheet	1,979,660	215,245	293,644	
Total risk-weighted assets	1,979,660	2,040,361	2,352,721	2,585,213
Capital adequacy ratio	***20.42%***	***19.08%***	***17.73%***	***15.78%***
Tier 1 capital ratio	***18.08%***	***17.49%***	***14.96%***	***12.25%***

Capital adequacy ratio (%) -2011-2014



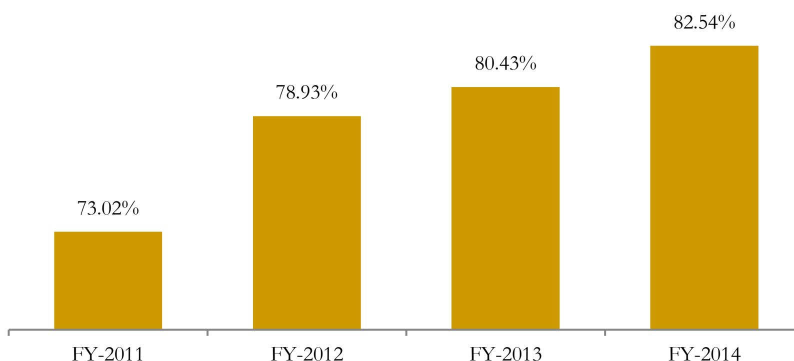
Source: Company annual report, DLM Research

NPL ratio, loan loss coverage ratio (%) -2011-2014



Source: Company annual report, DLM Research

Loan concentration risk (%) -2011-2014



Source: Company annual report, DLM Research

Breakdown of loans by sector-2011-2014, ₦'mn

Sectors	2011	2012	2013	2014	2014 %
Agriculture	21,057	54,006	65,057	57,916	2.66%
Oil and gas	356,595	559,343	621,430	853,104	39.15%
Consumer credit	224,245	152,316	143,371	174,672	8.02%
Manufacturing	137,468	233,445	271,219	375,215	17.22%
Real estate	49,622	106,672	131,600	144,721	6.64%
Construction	9,079	35,631	47,986	90,289	4.14%
Finance and insurance	579,140	466,942	11,623	20,452	0.94%
Transportation	5,288	11,505	8,592	12,409	0.57%
Communication	67,711	81,117	95,559	66,634	3.06%
General commerce	92,239	81,120	94,017	94,874	4.35%
Utilities		6,369	33,293	58,089	2.67%
Retail services	129,074	90,683	102,995	110,015	5.05%
Public sector	813,783	801,782	142,389	120,590	5.53%
Total	**2,485,301**	**2,680,931**	**1,769,131**	**2,178,980**	

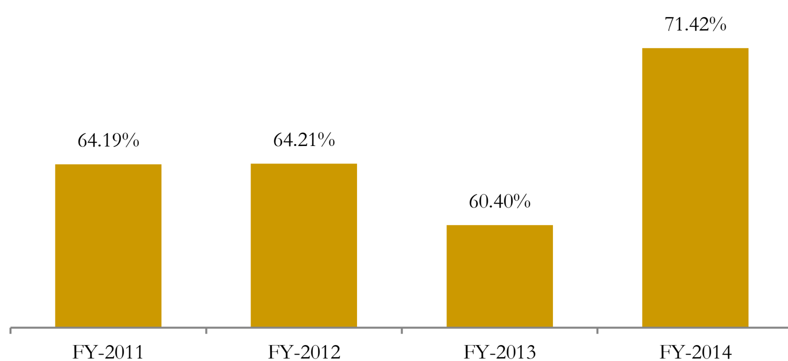
Asset Quality/Credit Risk – With the growing market risk, credit risk remains the principal risk for the banks. Our methodology to credit risk entails analysis of the entire balance sheet, looking at different asset categories. We note that it is a common feature for banks to have off-balance sheet commitments apart from guarantees and letters of credit. These include derivatives, such as exchange rate et.al. We analyse the make-up of the balance sheet to ascertain the asset mix and concentration. We note that loan portfolio represents the most important asset category of the bank. But where the major risk is not connected to loan assets, we focuses on the investment assets such as tradable securities and the associated credit and market risk such as fluctuation in yield as a result of changes in interest rate. More importantly is the exposure to exchange rates as persistent devaluation of the local currency especially when repayment is due, will make settling the foreign currency denominated debt more expensive.

"We note that loan portfolio represents the most important asset category of the bank."

Liquidity is adequate. We not that weak liquidity is often the main cause of a bank's failure to operation and meet financial obligations. The bank maintains 93.89% of liquid asset in total asset, which is relatively liquid in our view. Hence, given that the bank's liquidity is sound coupled with the structure of its funding position, we are optimistic of the bank's ability to fund itself under stress conditions. This is particularly an important factor for the bank that operates in an environment where conditions can change rapidly. As such, the prime risk to the bank to renew or replace maturing funding liabilities appears low. We anticipate that the bank's liquidity could decline in the near term due to higher central bank reserve requirements. The regulatory limit on foreign currency borrowing and net open positions are likely to reduce US dollar debt issuance.

Loan-to-deposit ratio: Adjustment to a new macroeconomic and market environment, cautious business strategies and the digestion of tightened liquidity and capitalization requirements and the need to boost earnings are all factors that have pushed the bank towards a strong focus on liquid assets. As a result and on an annual basis, the customer Loan-to-Deposit (L/D) ratio improved to 71.42% which is a fairly balanced ratio. Hence, a broad-based increase in balance sheet flexibility has taken place. Its retail franchise allows it to source low-cost deposits. FY2014 recorded quite a strong loan growth, which has also bolstered the L/D ratio improvement supported by fairly modest inflation readings. This trend shows that the bank has internal resources that could be transferred to fund growth in earnings. Supportive of this is the moderate growth in deposits which can hopefully be transformed into a new wave of lending. Despite increasing competition for low-cost deposits, customer deposit growth remains healthy and helped loans-to-deposit ratios remain below the regulatory limit of 80%. To this end, we evaluate the funding mix and structure to ascertain the degree of funds derived from more stable sources, such as core customer deposits, and the 'stickiness' of such funding which is relatively high in our view.

Loan to deposits ratio (%) -2011-2014



Source: Company annual report, DLM Research

"We highlight that the only reason the bond sells lower than risk free government bond is the inherent default probability"

Default probability is there but remains at a minimum level. The bank appear to be stable but with uncertainty of financial position and future cash flow in view of challenging operating environment. Hence, default risk appear to be inherent but at a reduced rate in comparison to its peers in the industry given its relative systemic importance. We note that many things can influence default risk on the bank debt instruments such as falling cash flow from operations which is often needed to make the interest and principal payments, rising interest rates since the bonds are floating-rate bonds as rising interest rates would increase the required interest payments. In addition, we observed that default could be triggered by country specific business risk, and industry specific challenges. We

highlight that the only reason the bond is trading lower than government bonds is the higher credit risk. Hence, in estimating default probability using this method, we assumed a recovery rate of 40% in the event of default which is in line with historical global trends for corporate bonds. Consequently, we arrived at default probability of 7.02%, which is low in our view.

Hence, to measure the bank's ability to meet its financial obligations when due, the following metrics were deployed.

Asset coverage ratio. This measures the ability of the bank to cover its debt obligations with its assets. We note deterioration in the bank's asset cover ratio declining from 7.19x in 2011 to 3.76x, regardless, we note therefore that chances of its insolvency are less given its cash flow generation potentials.

Capitalization ratio. The ratio reflects the extent to which the bank is operating on its equity. The bank's capitalization ratio increase to 0.41x from 0.21x but still relatively low indicating investment quality.

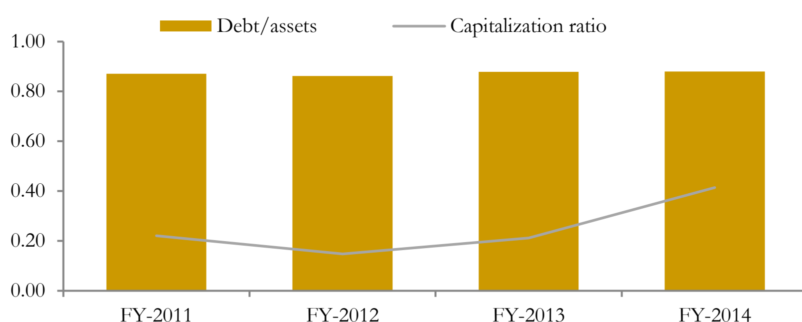
Debt service coverage ratio. We note that the bank's debt service coverage ratio is relatively weak despite increasing to 0.64x from 0.40x in the preceding year which indicates that the bank's operating income is enough to cover only 64% of its annual debt payments which in our view may signifies a potential risk of default on payment.

Equity multiplier. This measure the financial leverage of the bank. The bank's equity multiplier increased fractionally to 8.31x from 8.20x in the preceding year. The higher equity multiplier indicates growing financial leverage, which also indicates that the bank's reliance on debt financing has increased.

Interest coverage ratio. The bank's interest coverage ratio declined to 0.78 from 0.96 in the preceding year. The lower ICR means less earnings are available to meet interest payments and that the business is more vulnerable to increases in interest rates.

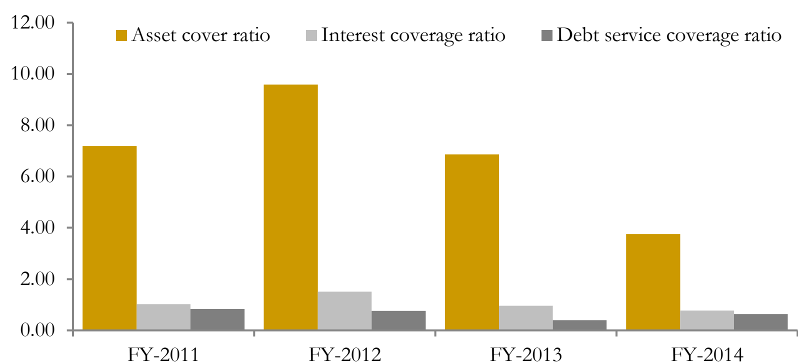
Debt-to-asset ratio. The ratio has remained flat at 0.88. This in our view indicates conservative financing with an opportunity to borrow in the future.

Debt/asset and capitalization ratios (x) -2011-2014



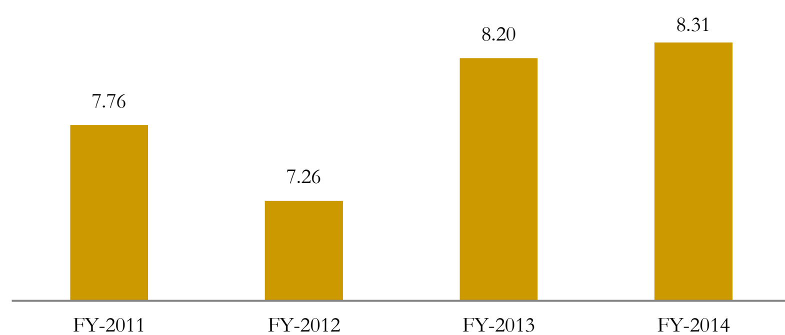
Source: Company annual report, DLM Research

Asset cover, interest cover and debt service cover ratios (x) -2011-2014



Source: Company annual report, DLM Research

Equity multiplier (x) -2011-2014



Source: Company annual report, DLM Research

Debt ratios (x)				
Asset cover ratio	7.19x	9.59x	6.87x	3.76x
Interest coverage ratio	1.02x	1.50x	0.96x	0.78x
Debt service coverage ratio	0.84x	0.76x	0.40x	0.64x
Capitalization ratio	0.22x	0.15x	0.21x	0.41x
Debt/assets	0.87x	0.86x	0.88x	0.88x
Equity Multiplier	7.76x	7.26x	8.20x	8.31x

Outlook. We reckon that the main operating strength for the bank lies in improving profit margin. There is bound to be tighter cost controls in response to regulatory induced revenue growth constraints. Improved operating stability can therefore be expected as regulatory pressure is expected to ease and banks devote more time to the corporate purpose of building wealth for shareholders.

Access Bank Plc.

ACCESS BANK PLC.

Background:

Access Bank Plc is a full service commercial bank operating through a network of about 366 branches and service outlets located in major centres across Nigeria, Sub Saharan Africa and the United Kingdom. Listed on the Nigerian Stock Exchange in 1998, the Bank serves its various markets through four (4) major business segments: Personal, Business, Commercial and Corporate & Investment banking. The Bank has over 830,000 shareholders including several Nigerian and International Institutional Investors and has enjoyed what is arguably Africa's most successful banking growth trajectory in the last ten years ranking amongst Africa's top 20 banks by total assets and capital in 2011.

In 2012, the bank through a Special Purpose Vehicle ("SPV") - Access Finance B.V, issued a US$350 million Senior Unsecured Eurobond paying 7.25%, maturing in 2017 but callable at the end of five years– with ratings of B+ and B assigned by Standard & Poor's and Fitch Rating respectively. The bond was issued with the view to enhance its trade finance business, and loan to key sector of the economy such as oil, power et.al. In addition, in 2014, the bank issued an additional $400 million seven-year bond, which is callable at the end of five years. Hence, we note therefore that the bond issued is long-term foreign currency borrowing, which make the bank vulnerable to foreign exchange risk over the life span of the bond. This therefore increases the debt burden of the bank. Although we highlight that the bond provides the bank with additional capacity to fund future growth.

In this note however, we investigate the bank's financial health to ascertain probability of default on interest payment on the instrument.

Rating Reviews

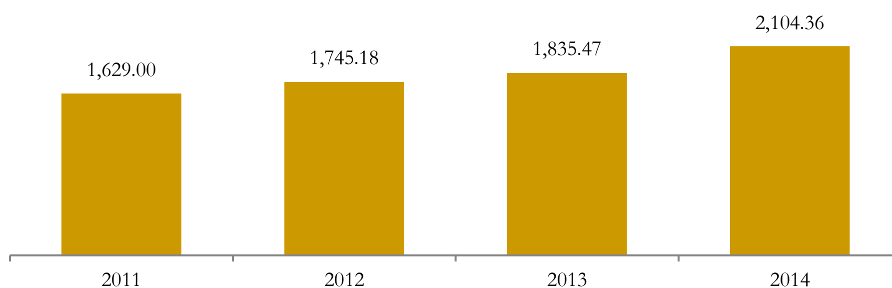
In April 2015, Fitch Ratings affirmed the long-term Issuer Default Ratings (IDRs) of Access Bank Plc to stable albeit Fitch's revision of the Outlook on Nigeria's Long-term Issuer Default Ratings (IDRs) to Negative from Stable in March 2015. Access' Viability Ratings (VRs) reflects the bank's adequate capitalisation, which will improve should the planned rights issue complete successfully. The VR also considers the bank's stronger company profile since the Intercontinental Bank acquisition. This has benefitted Access' financial metrics, including improved earnings and asset quality. The rating is in the 'B' range, indicating highly speculative fundamental credit quality, and Fitch's expectation of increasingly challenging economic conditions and market volatility in Nigeria.

Business Growth: 2011- 2014

Balance Sheet Size

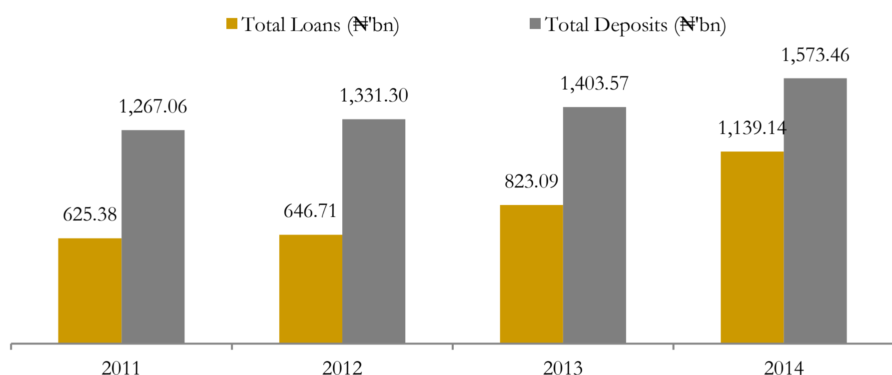
	2011	2012	2013	2014	CAGR
Total Assets (₦'bn)	1,629.00	1,745.18	1,835.47	2,104.36	8.91%
Total Loans (₦'bn)	625.38	646.71	823.09	1,139.14	22.13%
Total Deposits (₦'bn)	1,267.06	1,331.30	1,403.57	1,573.46	7.49%
Shareholders' Fund (₦'bn)	192.06	240.99	244.48	277.41	13.04%

Asset Growth (₦'bn) -2011-2014



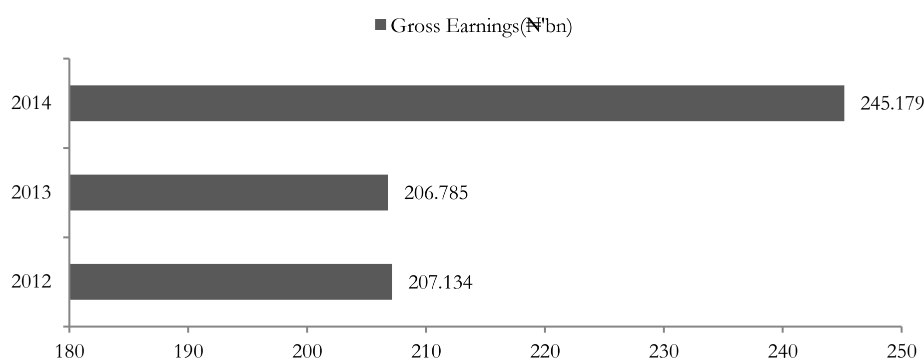
Source: Company annual report, DLM Research

Loans & Deposits Trend (₦'bn) -2011 -2014



Source: Company annual report, DLM Research

Revenue (₦'bn):2012 -2014



Source: Company annual report, DLM Research

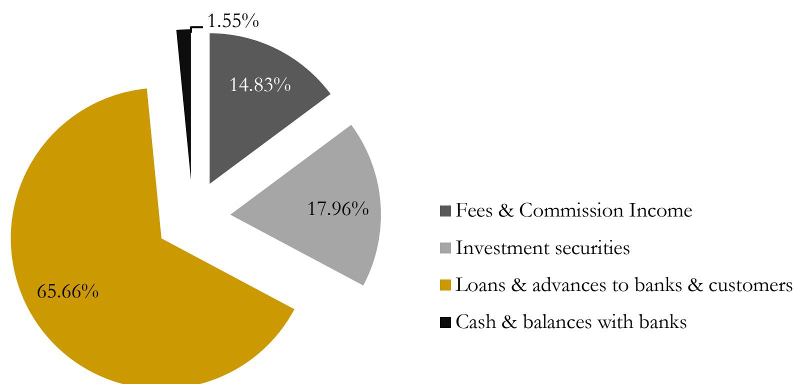
Performance Summary

Gross earnings rose on the back of growth in interest income. Gross earnings of ₦245.18billion were up 18.57% y/y largely driven by growth in interest income which grew by 21.21% to ₦176.92billion as a result of increased loans to customers. Income from loans & advances accounted for 66% of interest income. This was supported by strong performance in treasury income and fee & commission income. Specifically non-interest income grew 12.23% to ₦68.26billion on the back of increased net gains in financial investment securities.

"Gross earnings of ₦245.18billion were up 18.57% y/y largely driven by growth in interest income"

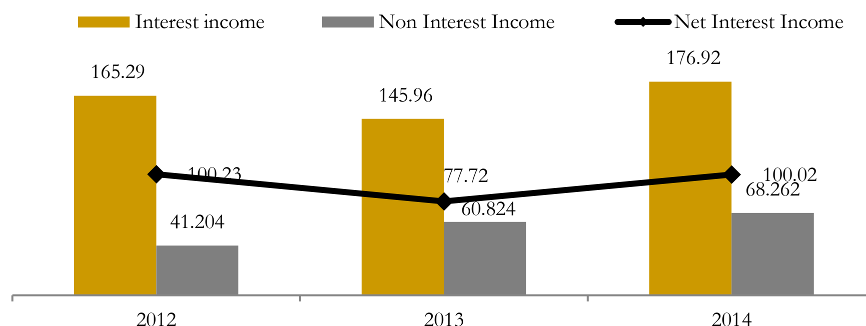
Revenue (₦'bn)	2012	2013	2014	YoY(%)	CAGR(%)
Gross earnings	207.13	206.79	245.18	18.57	8.80
Interest income	165.29	145.96	176.92	21.21	3.46
Interest expense	65.06	68.24	76.90	12.70	8.72
Net Interest Income	**100.23**	**77.72**	**100.02**	**28.68**	**-0.11**
Non-interest Income	41.20	60.82	68.26	12.23	28.71
Operating Income	**141.44**	**138.55**	**168.28**	**21.46**	**9.08**
Operating Expense	84.75	101.18	104.60	3.38	11.10
Profit before tax	44.88	43.53	52.02	19.51	33.01
Profit after tax	42.86	36.03	43.06	19.52	41.88

Business Contributions to Gross Earnings (%) 2014



Source: Company annual report, DLM Research

Interest & Non-Interest Income

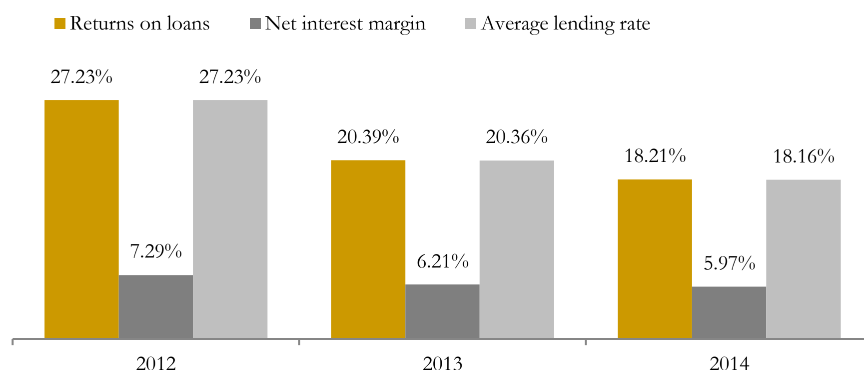


Source: Company annual report, DLM Research

Operating efficiency improved despite increase in operating expense. For the FYE'14, the bank's interest expense rose by 12.70 % y/y to ₦76.90billion (FYYE'13: ₦68.24bn). This was driven largely by growth in time deposits from financial institutions, interest bearing debt, which may be due to the impact of the subordinated tier II note on the banks' funding cost, and growth in term deposit (+25.43%). In our view, we think the bank may have been paying more on term deposits. Specifically, while interest on savings deposits rose to 3.6% from 3.9% for the industry, this may have impacted the bank's interest expenses due to the increase in term deposits as well as the impact of a 0.3% hike in the savings deposits rate. Although, we note the increase in the savings deposits accounts for insignificant proportion of total deposits (8%). Low cost deposits contributing 57% of the total customer deposits. Hence the bank's average cost of risk increased to 5.6%, while returns on average loans declined to 18.20% with a corresponding decrease in interest spread. This invariably led to a decrease in the bank's NIM. Operating expenses rose by 3.38% y/y to ₦104.6billion, (FYE'13: ₦101.18bn). Regardless, operating income grew by 21.46% y/y to ₦168.30billion, (FYE'13:₦138.55bn). Hence, cost-to-income ratio declined to 62.20%, (FYE'13:73.00%).

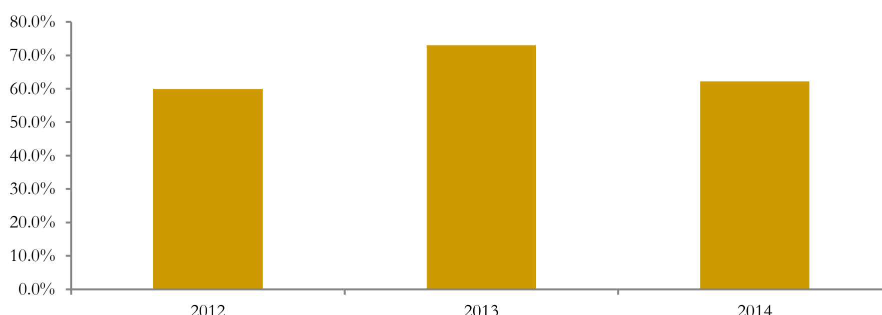
"Although, we note the increase in the savings deposits accounts for insignificant proportion of savings deposits (8%)."

Average returns on loans, NIM, average lending rate (%)



Source: Company annual report, DLM Research

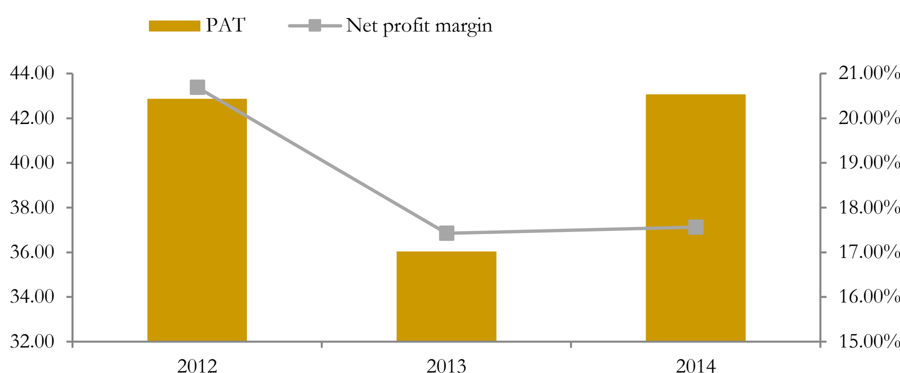
Cost to income (%)



Source: Company annual report, DLM Research

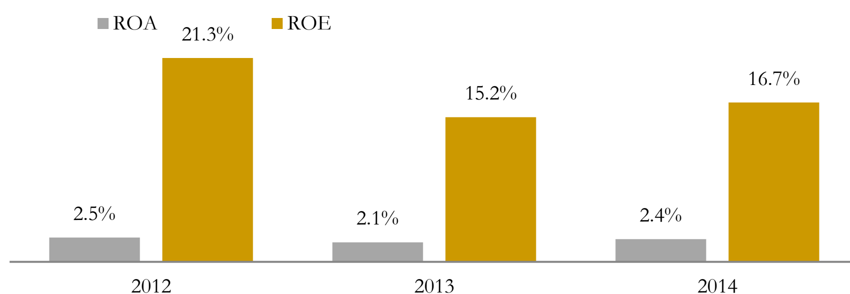
Profitability margins are fairly stable. - The bank's profitability and earnings prospects remains positive regardless of the challenging business environment, however regulatory challenges remain a key risk. With post tax profit increasing by 19% y/y to ₦43.06billion from ₦36.03billion in the previous year, net profit margin rose marginally to 17.56%. Although, we highlight that the bank's net profit margins has been oscillating in the past three years. Specifically, net profit margins flit around 17.42% – 20.69% (2012 -2014), with the highest net profit margin (20.69%) recorded in FYE'12 on the back of strong growth in post-tax profit. Hence, in FYE'14, ROaE and ROaA improved to 16.70% (FYE13: 15.2%) and 2.40% (FYE'13: 2.1%) respectively.

Post tax profit and margins (%)



Source: Company annual report, DLM Research

Return on asset and equity (%)



Source: Company annual report, DLM Research

"Where the major risk is not connected to loan assets, we focused on the investment assets such as debt securities and the associated credit and market risk"

Asset Quality/Credit Risk – With the growing market risk, credit risk remains the principal risk for the banks. Our methodology to credit risk entails analysis of the entire balance sheet, looking at different asset categories. We analyse the make-up of the balance sheet to ascertain the asset mix and concentration. We note that loan portfolio represents the most important asset category of the bank. Although, we note that the bank's debt securities grew by 148% due to the $400million subordinated

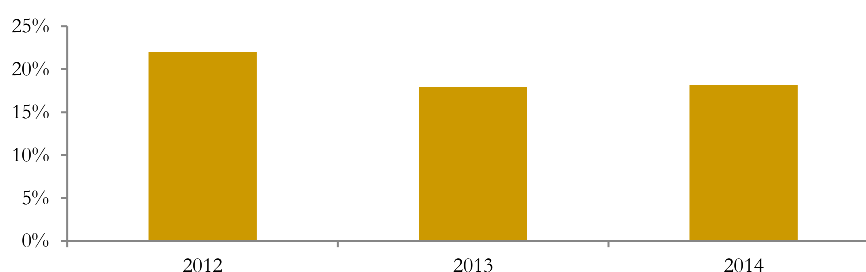
bond issued in 2014. Where the major risk is not connected to loan assets, we focused on the investment assets such as debt securities and the associated credit and market risk such as fluctuation in yield as a result of changes in interest rate. More importantly is the exposure to exchange rates as persistent devaluation of the local currency especially when repayment is due, will make settling the foreign currency denominated debt more expensive.

Asset quality and CAR remain strong. The bank appear to be capitalised at ₦306.60billion based on its current risk weighted assets of ₦1.69trillion, recording a risk weighted capital adequacy ratio of 18.20%, (FYE13: 17.95%), which is at premium to the CBN regulatory limit of 15%. The growth in risk weighted assets reflects the bank's effort to optimize balance sheet. The bank's tier 2 capital is 31.43% of its tier1- which is below CBN regulatory limit. This leaves room for the bank to raise an additional tier 2 capital to fund growth. The current CAR appears strong enough to support the bank's business risk. Reduction in Non-Performing Loan ratio to 2.2% indicates improved risk management as a result of loan screening strategy to quality obligors and improved monitoring of loan performance. The NPL coverage ratio which measures the provision made for non-performing loans and the bank's ability to absorb potential losses from non-performing loans increased to 134% in 2014 as adequate provisions were made on classified assets. Oil & gas sector recorded the highest NPL and we expect NPL in the sector to increase further in FYE'15 in view of lower crude oil price. Hence, exposure to the sector is a key risk and reflects high credit concentrations as well as emerging risks, particularly in the oil and gas, and general commerce. Oil & gas lending is sensitive to low oil prices and if low oil prices persist, the bank would need to restructure part of its loan portfolio in order to limit exposure.

"The current CAR appears strong enough to support the bank's business risk"

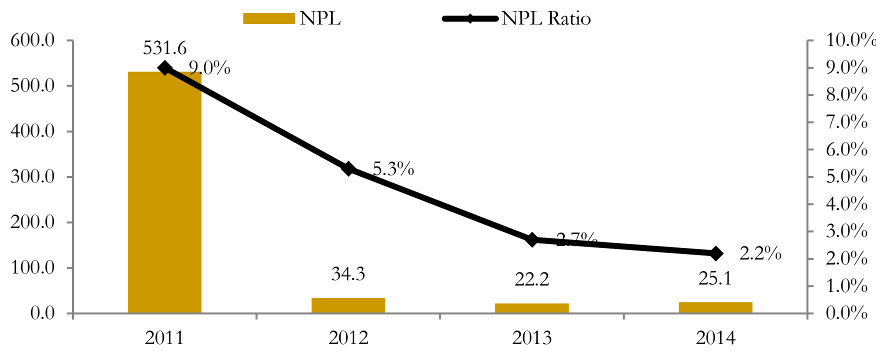
	2012	2013	2014
Tier 1 capital	218,175	215,525	233,265
Tier 2 capital	11,590	1,535	73,320
Total regulatory capital	229,765	217,060	306,585
On balance sheet			
Off balance sheet			
Total risk-weighted assets	1,043,455	1,209,463	1,686,979
Capital adequacy ratio	22%	18%	18%
Tier 1 capital ratio	21%	18%	14%

Capital adequacy ratio (%)



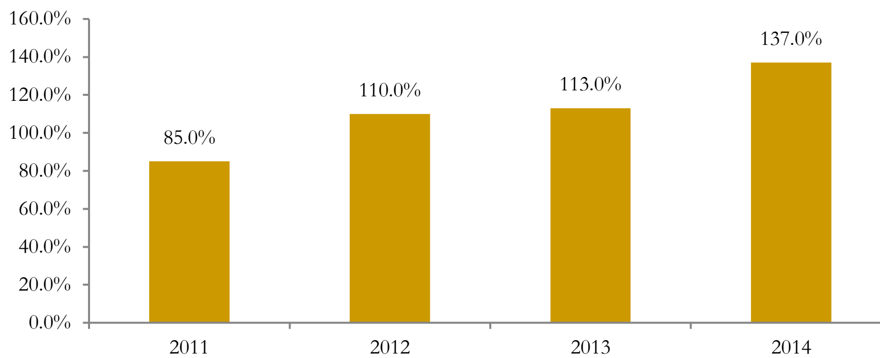
Source: Company annual report, DLM Research

Non-performing loan (₦'bn) and ratios (%)



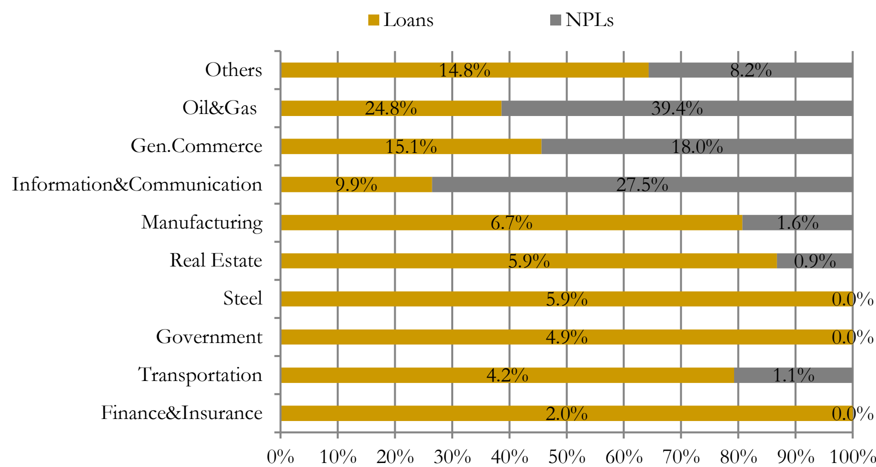
Source: Company annual report, DLM Research

Non-performing loan coverage ratios (%)



Source: Company annual report, DLM Research

Industry loans and NPL ratios (%)

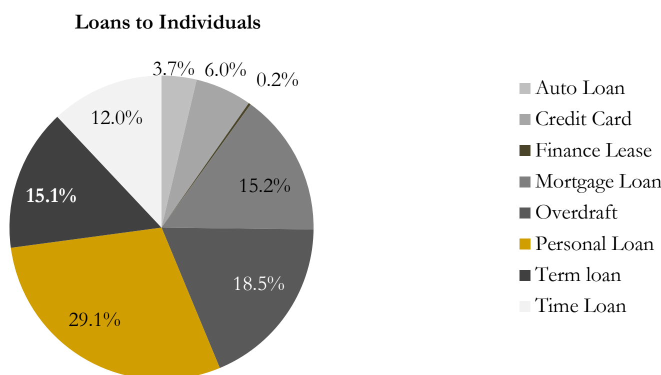


Source: Company annual report, DLM Research

Increasing credit concentration. The low concentration across selected industry indicates the limit of credit exposures which the bank is willing to assume– which also reflect the bank's credit risk appetite. Hence, reducing loan to the sectors for which there may be an increased risk of loss or default particularly oil & gas in view of declining oil price and exchange rate devaluation will help to boost the asset quality of the bank. Loan book rose by 39% y/y to ₦1.1trillion in 2014 as Construction, General Commerce and Oil & Gas upstream were the key sectors accounting for the growth. The growth in loan book recorded in FY2014 was driven by personal loans to individuals and term loans to corporates which recorded contribution to total loans by 29% and 49% respectively. Overdraft and mortgage loans contributed 19% and 15% respectively to individual loans whilst time loans and overdraft accounted for 27% and 23% respectively to total corporate loan.

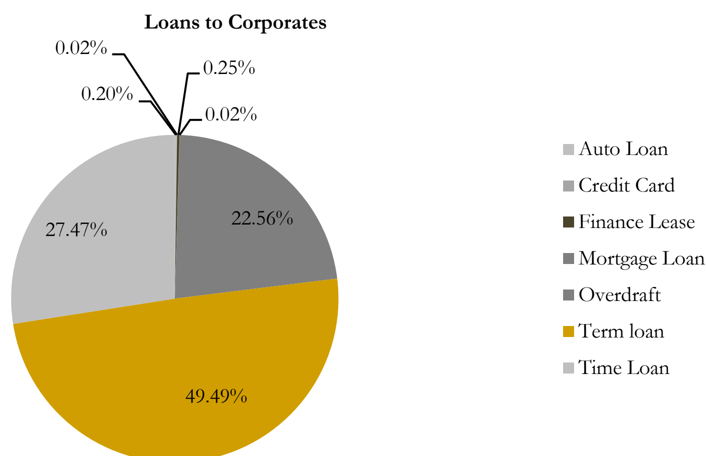
"The low concentration across selected industry indicates the limit of credit exposures the bank is willing to assume on these sectors"

Loan composition (%)



Source: Company annual report, DLM Research

Loan composition (%)

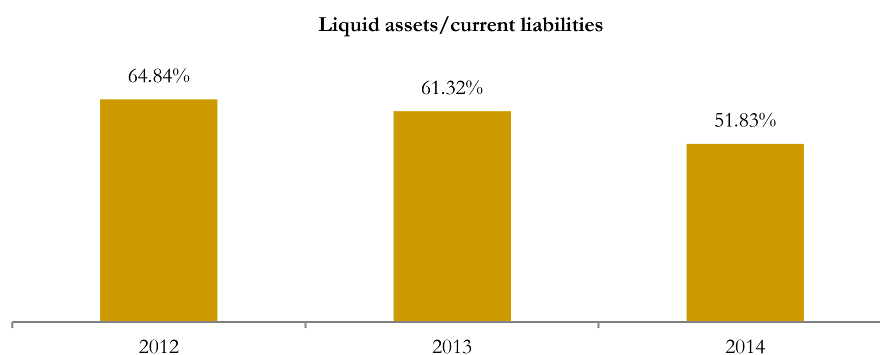


Source: Company annual report, DLM Research

Overall liquidity ratio weakens on CBN tight regulation. The bank's liquidity ratio declined to 36% in 2014 (FYE'13: 41%) due to hike in CRR on public and private sector deposits but above CBN regulatory limit of 30%. Given its size, we would expect the bank to improve its liquidity status going forward. By our assessment, liquid assets such as cash and cash equivalent, treasury bills and government bonds account for 74%, 7% and 12% of total assets as at FYE14. However, the bank's ability to fund itself under stress conditions with minimum level of support still remain largely doubtful. As such, the risk for the bank to renew or replace maturing funding liabilities appears high. Hence, we are of the view that the bank's liquidity could decline in the near term due to higher central bank reserve requirements.

"The bank's liquidity ratio declined to 36% in 2014 (FYE'13: 41%) due to hike in CRR on public and private sector deposits but above CBN regulatory limit of 30%."

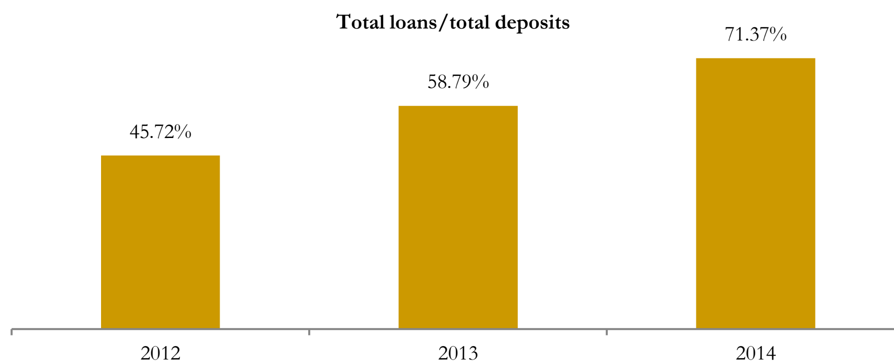
Liquid asset/current liability (%)



Source: Company annual report, DLM Research

Loan-to-deposit ratios improved on the back of growth in loans. Adjustment to the tightened liquidity and capitalization requirements and the need to boost earnings are all factors that have pushed the bank towards a strong focus on liquid assets. The banks loans to customers grew 41.25% y/y to ₦1.1trillion primarily driven by loans to oil & gas. As a result and on an annual basis, Loan-to-Deposit (L/D) ratio improved to 71.40% which is a fairly balanced ratio. This trend shows that the bank has internal resources that could be transferred to fund growth in earnings. This was supported by growth in deposits particularly deposits contribution from subsidiaries and 24% increase in FCY deposits largely driven by exchange rate devaluation.

Loans/deposits (%)



Source: Company annual report, DLM Research

"Default risk appear to be inherent but at a reduced rate."

Default probability is there but remains at a minimum level. The bank appear to be stable but with uncertainty of financial position and future cash flow in view of challenging operating environment. Hence, default risk appear to be inherent but at a reduced rate given it systemic importance. We note that many things can influence default risk on payment of interest on the bank debt instruments such as falling cash flow from operations which is often needed to make the interest and principal payments, rising interest rates and changes in the nature of the marketplace.

Hence, to measure the bank's ability to meet its financial obligations when due, the following metrics were deployed.

Capitalization ratio. The ratio reflects the debt component of the bank's capital structure. The bank's capitalization ratio increase to 0.44x from 0.33x but remain relatively low in our view, indicating investment quality.

Debt service coverage ratio. We pay more attention to this ratio in view of its relative in importance in evaluating the bank's credit condition. Given our evaluation, it is worthy to state therefore that the bank's debt service coverage ratio is relatively strong despite decreasing to 2.42x from 3.32x in the preceding year which indicates that the bank's operating income is enough to cover 242% of its annual debt payments which in our view signifies a healthy credit quality of the bank.

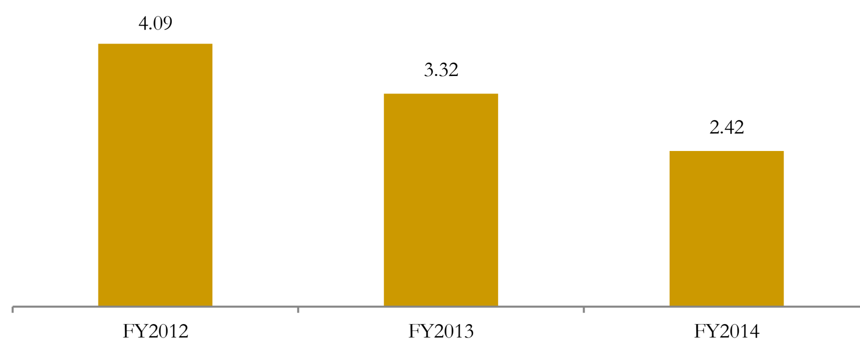
Equity multiplier. This measure the financial leverage of the bank. The bank's equity multiplier increased fractionally to 7.59x from 7.51x in the preceding year. The higher equity multiplier indicates growing financial leverage, which also indicates that the bank's reliance on debt financing has increased.

Interest coverage ratio. The bank's interest coverage ratio is relatively healthy, increasing to 2.19x from 2.03x in the preceding year. The higher interest coverage

ratio indicates lower possibility of default. The high ICR indicates the bank has much cash available to meet interest payment.

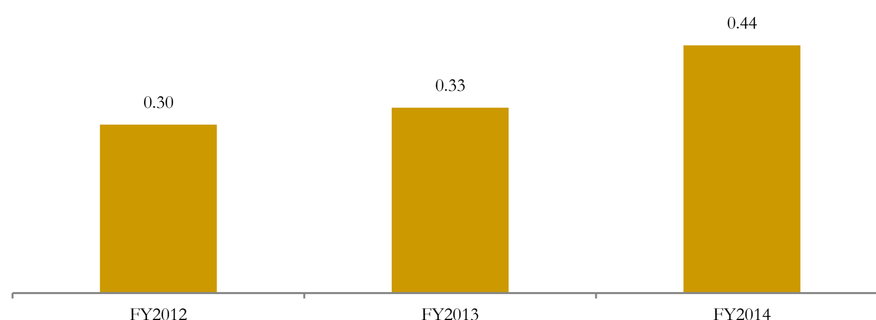
Debt-to-asset ratio. The ratio has remained flat at 0.87. This in our view indicates conservative financing with an opportunity to borrow in the future.

Debt cover ratio (x)



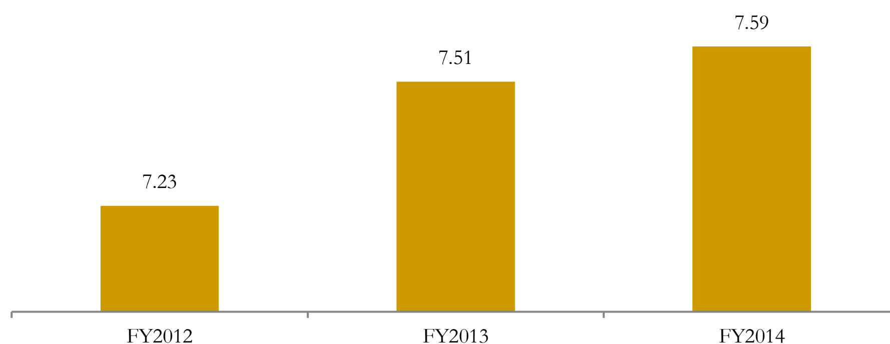
Source: Company annual report, DLM Research

Capitalization ratio (x)



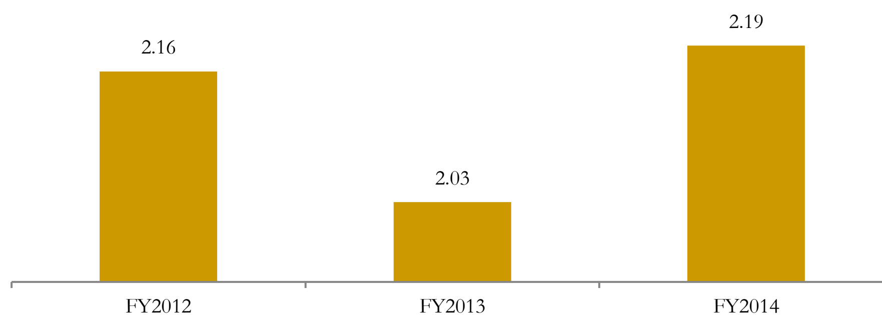
Source: Company annual report, DLM Research

Equity multiplier (%)



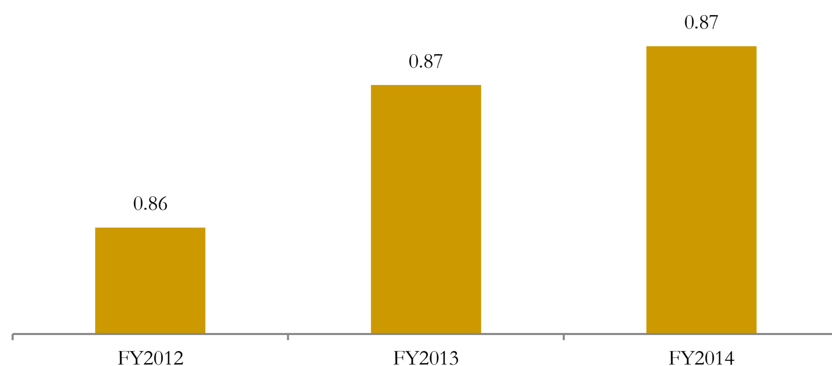
Source: Company annual report, DLM Research

Interest cover ratio (x)



Source: Company annual report, DLM Research

Debt-to-asset ratio (%)



Source: Company annual report, DLM Research

Outlook. We reckon that the main operating strength for the bank lies in improving profit margin. There is bound to be tighter cost controls in response to regulatory induced revenue growth constraints. Improved operating stability can therefore be expected as regulatory pressure is expected to ease and banks devote more time to the corporate purpose of building wealth for shareholders.

United bank for Africa Plc.

UNITED BANK FOR AFRICA PLC.

Background

United Bank for Africa plc. ("UBA" or "the bank") emerged from the merger of Standard Trust Bank, incorporated in 1990 and UBA, one of the biggest and oldest banks in Nigeria on August 1, 2005. Following the merger, UBA acquired Continental Trust Bank in the same year, in a bid to further expand the UBA brand. UBA subsequently acquired Trade Bank in 2006 which was under liquidation by the Central Bank of Nigeria (CBN). UBA had another successful combined public offering and rights issue in 2007 and made further banking acquisitions of three liquidated banks namely: City Express Bank, Metropolitan bank, and African Express Bank. The bank also acquired Afrinvest UK, rebranding it UBA Capital, UK.

In 2008, UBA made further acquisitions of two liquidated banks, Gulf Bank and Liberty Bank while at the same time intensifying its African footprint with the establishment of UBA Cameroon, UBA Cote d Ivoire, UBA Uganda, UBA Sierra Leone, and UBA Liberia as well as the acquisition of a 51% interest in Banque Internationale du Burkina Faso, which was the largest bank in the country with 40% market share. Currently, UBA has 18 African subsidiaries contributing about 20% of the Group's balance sheet with a target of contributing 50%. On 13 December 2012, the shareholders of UBA Plc unanimously voted for the bank to restructure into a Monoline Commercial Banking Model to fully comply with the new CBN guidelines for commercial banks in Nigeria, which repealed the erstwhile universal banking regime.

Now fully positioned as a pan-African bank, the UBA Group is firmly in the forefront of driving the renaissance of the African economy and is well positioned as a one-stop financial services institution, with growing reputation as the face of banking on the continent. Today, UBA ranks as one of Africa's leading financial institution with an asset base of ₦2.76trillion offering a range of banking, 'other financial' and pension fund custody services to over eight million customers across 605 business offices, 1,738 ATMs and 13,452 POS machines.

"Today, UBA ranks as one of Africa's leading financial institution with an asset base of ₦2.76trillion offering a range of banking, 'other financial' and pension fund custody services to over eight million customers across 605 business offices, 1,738 ATMs and 13,452 POS machines."

Credit Rating

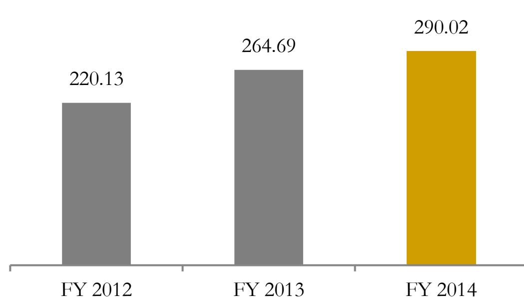
As at April 2015, the long-term Issuer Default Rating on UBA was 'B+' with a stable outlook affirmed by Fitch Ratings.

Performance Evaluation

Over the years, the bank's performance has been supported by its strong domestic franchise, strong international presence, good funding profile, strong liquidity position, good asset quality and strong management team with a proven track record. The bank's gross earnings increased by 56.91% from ₦184.83billion in FY2011 to ₦290.02billion in FY2014 supported by increased financial intermediation activities, while profit after tax increased significantly to

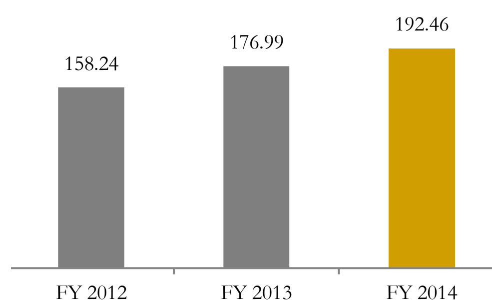
₦47.91billion from a loss of ₦10.47billion posted in FY2011 - driven principally by one-off writes against earnings, including those arising from the transfer of loans to the Asset Management Company of Nigeria (AMCON). While we note the bank's strong recovery in FY2012, we are inclined to highlight that its profitability came under some pressure in the last two years on the back of tax effects and increased operating expenses. In addition, we observed that earnings growth in FY2014 (9.57%) is significantly lower than the earnings growth of 20.24% recorded in the preceding year. Overall, in line with its peers we observed the steady decline in post-tax margin in the last two years as it declined to 16.52% in FY2014 from 17.61% and 24.88% respectively in the previous years.

Gross Earnings, ₦'billion



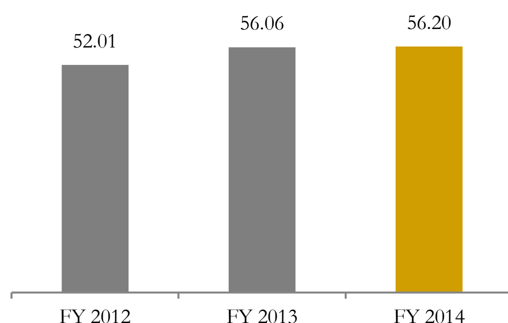
Source: NSE, Company Financials, DLM Research

Operating Income, ₦'billion



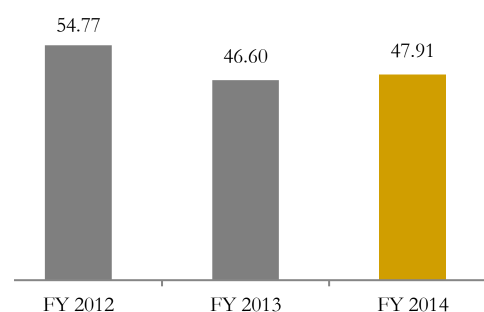
Source: NSE, Company Financials, DLM Research

Profit Before Tax, ₦'billion



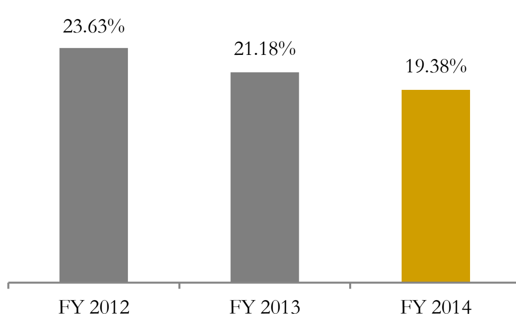
Source: NSE, Company Financials, DLM Research

Profit After Tax, ₦'billion



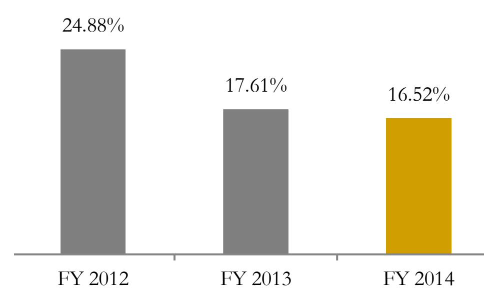
Source: NSE, Company Financials, DLM Research

Pre-Tax Margin



Source: NSE, Company Financials, DLM Research

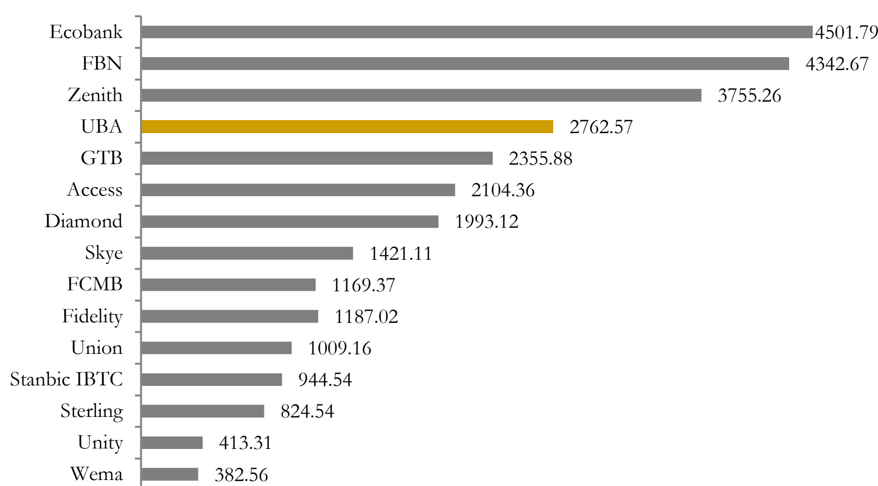
Post-Tax Margin



Source: NSE, Company Financials, DLM Research

Growth in total assets recorded in FY2014 was firmly supported by loans and advances to customers. Total loans and advances rose by 16.19% to ₦1.12trillion in FY2014 from ₦963.87billion in the previous year. The growth in loan book was largely driven by exposure to the oil & gas and manufacturing sectors with a contribution of 19.00% and 14.00% respectively. We also share the view that oil & gas exposures will be the most susceptible to low oil prices and this poses some concerns. In the event that oil prices trend lower, we expect to see a diversion from risk assets channelled to sectors with huge exposure and possible restructuring some of the portfolios by extending tenors to better match new cash flow projections. Notwithstanding the growth in loan book, credit impairment charges reduced significantly to ₦6.58billion from ₦13.08billion in the preceding year. In addition, we note the reduction in cost of risk to 0.70% from 1.40% in FY2013.

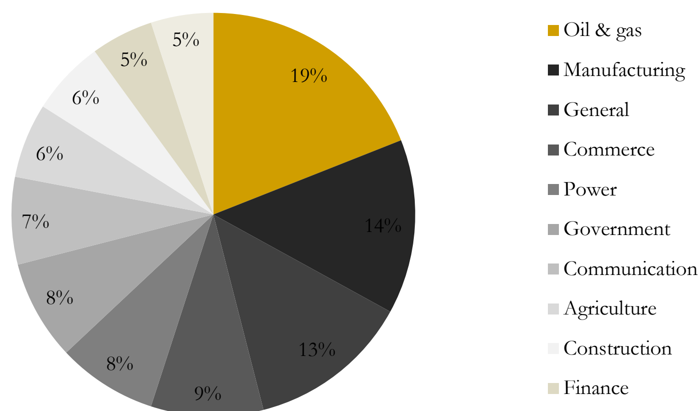
Total assets, ₦'billion



Source: NSE, Company Financials, DLM Research

"Notwithstanding the growth in loan book, credit impairment charges reduced significantly to ₦6.58billion from ₦13.08billion in the preceding year."

Sectoral contribution to gross loans, %



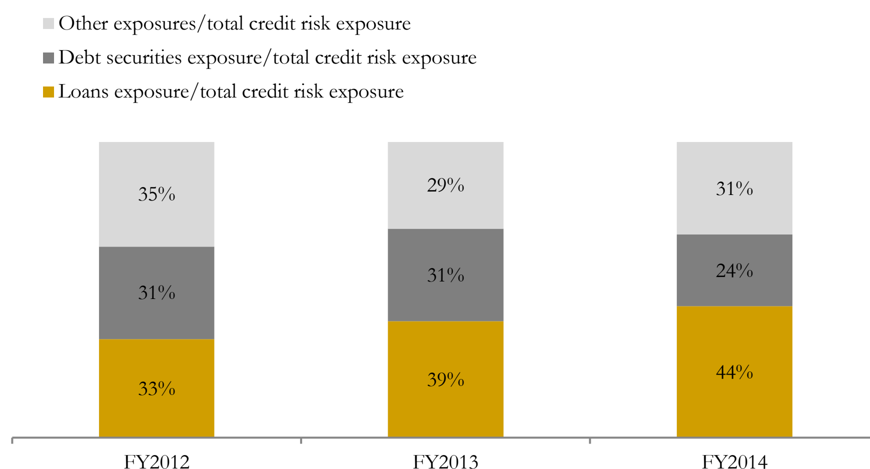
Source: NSE, Company Financials, DLM Research

However, we are also inclined to highlight that the bank has a concentrated customer base (loan portfolios and deposit base) which increases vulnerability to weakening

industry specific conditions. Loans to corporate entities and other organisations accounted for 89.20% of total loans whilst deposit from corporate entities accounted for 67.03% of total deposits in FY2014. As a result, loan concentration risks are inherent as a significant number of huge corporate defaults could negatively impact on the bank's capital base whilst putting pressure on asset quality and margins.

Our analysis show that 44% of the total maximum exposures to credit risk is derived from loans and advances to banks and customers higher than 39% in the previous year while exposure to investments in debt securities and 'other securities' account for 24% and 31% respectively.

Composition of total maximum exposure



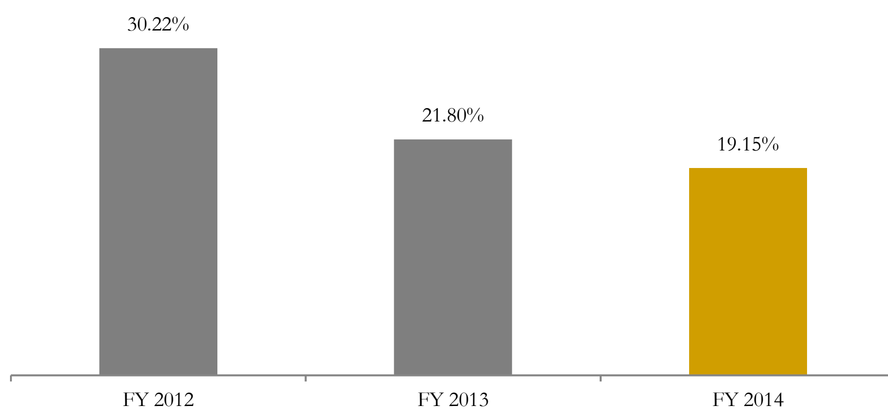
Source: NSE, Company Financials, DLM Research

"As a result, loan concentration risks are inherent as a significant number of huge corporate defaults could negatively impact on the bank's capital base whilst putting pressure on asset quality and margins."

Efficiency

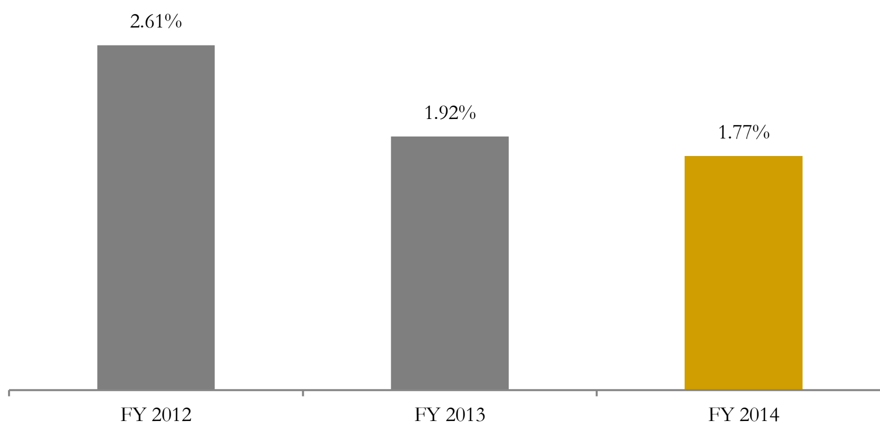
The bank's return on average equity (ROAE) remained competitive in FY2014 at 19.15% though we note the steady decline from 30.22% and 21.80% in the two preceding years. Return on average assets also declined to 1.77% in FY2014. The higher cost of funding was insufficient to negatively impact net interest margin as it improved marginally to 6.00% from 5.90% in the previous year. Operating efficiency is still a source of concern as cost/income ratio remains elevated at 67.40% higher than 60.90% recorded in the previous year. In view of intense competition in the sector, we anticipate the bank will look to implement some cost reduction strategies to improve efficiency.

Return on average equity



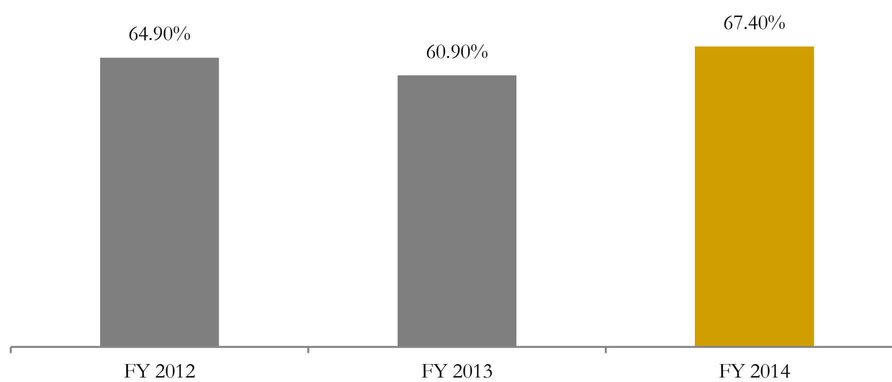
Source: NSE, Company Financials, DLM Research

Return on average assets



Source: NSE, Company Financials, DLM Research

Cost to income ratio

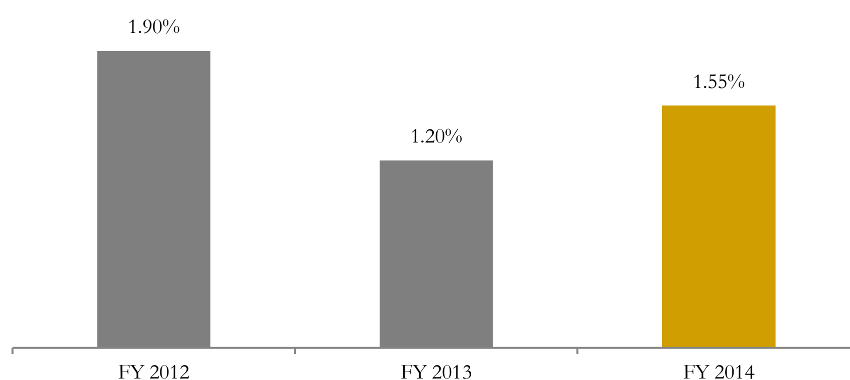


Source: NSE, Company Financials, DLM Research

Asset quality

Total non-performing loans as a percentage of gross loans rose marginally to 1.55% in FY2014 from 1.20% in the previous year. In our view, the bank currently has a strong credit risk structure which buttresses its ability to significantly grow the loan book at moderate risk supported by its low non-performing loans ratio of 1.55% - the lowest among our coverage banks. In addition, this shows that the bank has a relatively healthy asset quality as it lies below the 5% stipulated by the CBN. Whilst we commend the bank's effort at risk management, we state that sustained creation of high quality risk assets is fundamental to the bank's resilience in the face of regulatory headwinds in the banking sector.

Non-Performing Loan ratio

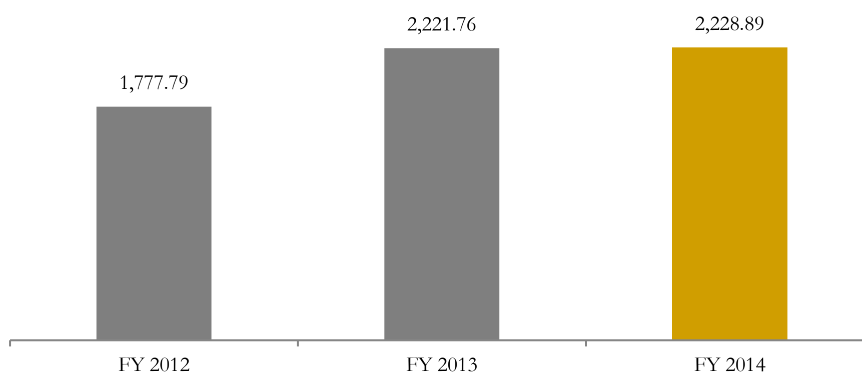


Source: NSE, Company Financials, DLM Research

"In our view, the bank currently has a strong credit risk structure which buttresses the bank's ability to significantly grow its loan book at moderate risk supported by its low non-performing loans ratio of 1.55% - the lowest among our coverage banks."

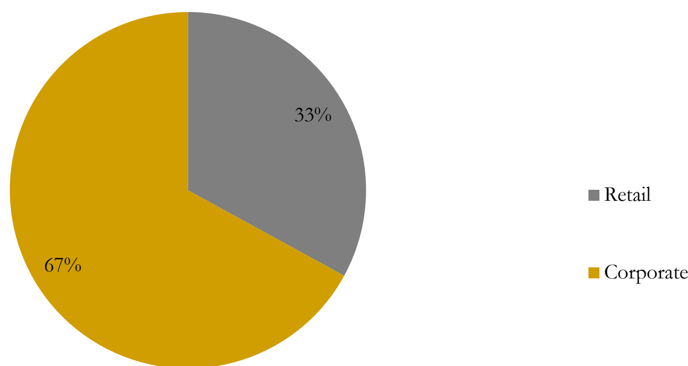
In FY2014, UBA's total liabilities increased to ₦2.50trillion from ₦2.41trillion in the previous year. During the same period, the bank equally recorded 0.32% growth in deposits to ₦2.23trillion from ₦2.22trillion in FY2013. Growth was driven by deposits from corporate entities as it accounted for 67.03% of total deposits while retail deposits contributing 32.97%. However, we are inclined to highlight the steady rise in retail deposits in the last two years considered which in our view reflects increasing focus on the bank's retail business.

Deposits, ₦'billion



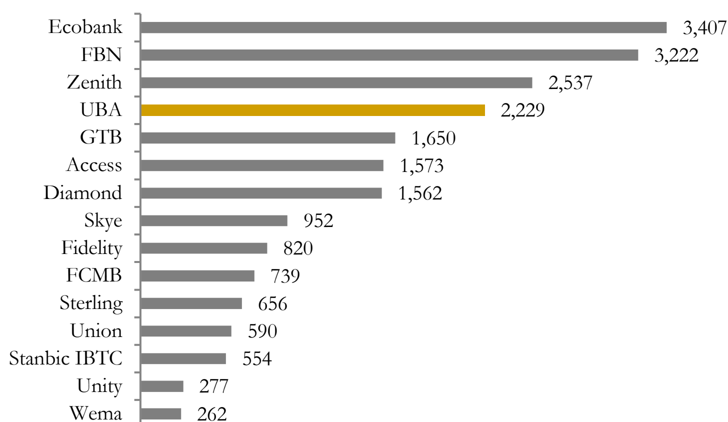
Source: NSE, Company Financials, DLM Research

Deposits by type



Source: NSE, Company Financials, DLM Research

Comparison across the sector – Total deposits, ₦'billion

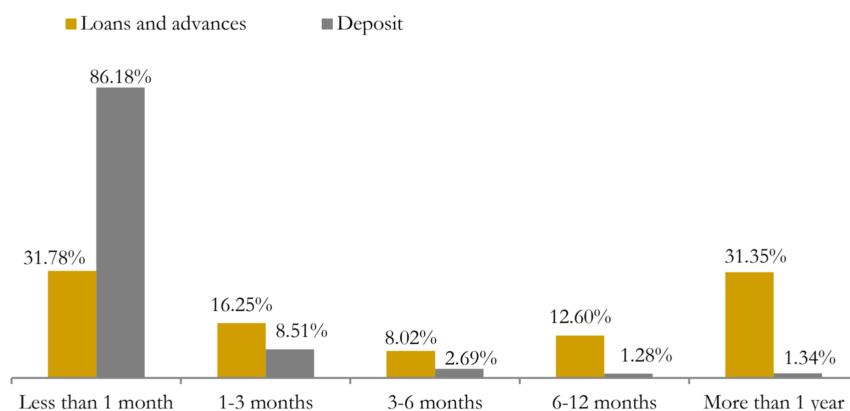


Source: NSE, Company Financials, DLM Research

"The funding side of the balance sheet showed a concentration of 'deposits' in the maturity profile of 'less than 1 month' which represents 86.18% of total deposits."

An analysis of the bank's loan portfolio maturity profile shows that 31.78% of gross loans accounted for 'less than 1 month' loans in FY2014, which reflects that the bank has the largest proportion of its loans concentrated in shorter tenor term loans. However, this is closely followed by the 'more than 1 year' loans with 31.35%. The funding side of the balance sheet showed a concentration of 'deposits' in the maturity profile of 'less than 1 month' which represents 86.18% of total deposits. Given that the negative cumulative gap appears in the 'less than 1 month' range, we assume a roll-over exists and as a result there appears to be no significant mismatch, in the utilization of deposit liabilities in creation of 'loans & advances'.

Maturity profile of Loans & advances vs Deposits: FY2014



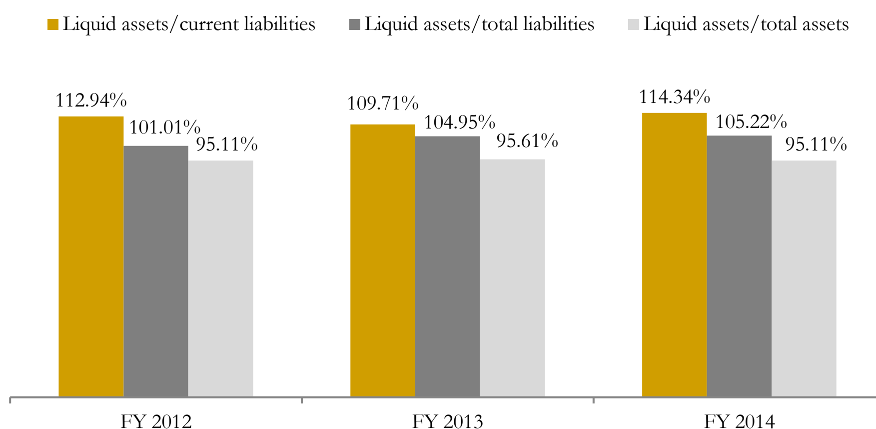
Source: Company Financials, DLM Research

Liquidity

Our analyses show that the bank's balance sheet is highly liquid, with cash and liquid assets constituting 95.11% of its total assets as at FY14. This highlights the bank's ability to fund itself under stress conditions with minimum level of support from external sources. This is particularly an important factor for the bank that operates in an environment where conditions can change rapidly. The bank's liquidity position improved during the period under review as its liquid assets to current liabilities ratio increased from 109.71% in the preceding year to 114.34% in FY2014. However we note that the bank's liquid assets as a percentage of total assets declined to 95.11% from 95.61% in FY2013. However, loans to deposits ratio increased from 43.38% to 50.25% during the review year – which still hovers considerably lower than 80% limit mandated in the CBN's prudential guidelines for deposit money banks. Consequently, we are of the view that the bank has additional room to accommodate for future growth in loans as the ratio supports the existence of internal resources that could be channelled to the creation of risk assets.

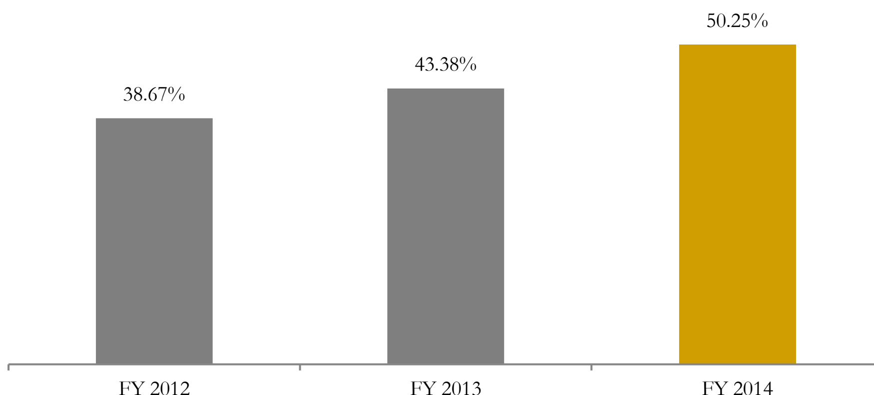
"Consequently, we are of the view that the bank has additional room to accommodate for future growth in loans as the ratio supports the existence of internal resources that could be channelled to the creation of risk assets."

Liquidity ratios



Source: Company Financials, DLM Research

Loan/deposit ratio

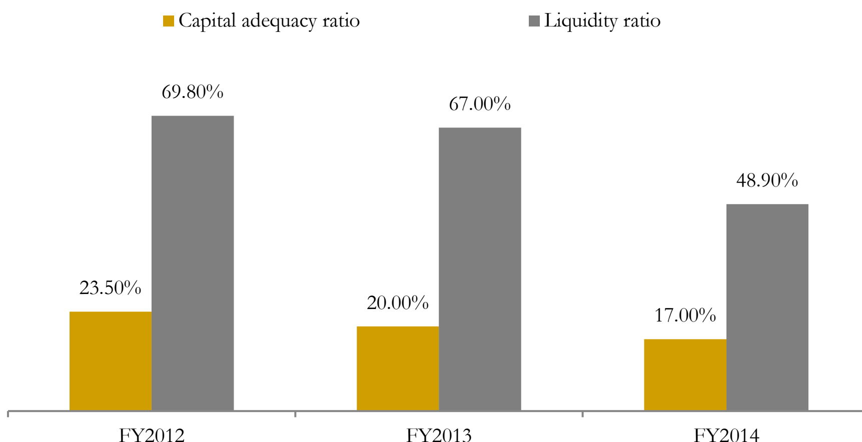


Source: Company Financials, DLM Research

The bank's liquidity ratio of 48.90% in FY 2014 signals adequacy of funds to grow its balance sheet. Capital adequacy and liquidity ratios for FY2014 stood at 17.00% and 48.90% respectively – well above the regulatory benchmarks of 10% and 30% respectively. The shareholders' funds of the Bank increased to ₦265.41billion as at FY2014 from ₦235.04billion in the previous year. Tier 1 capital to risk weighted assets ratio was 14.00% in FY2014 down from 16.00% in the previous year while the risk weighted assets to total assets ratio increased from 46.30% in FY2013 to 57.23% in FY2014. We note that though the capital adequacy ratio of 17.00% lies above the 15.00% benchmark stipulated by the CBN and appears strong enough to support the bank's business risk, we believe there is a need to further strengthen its capital base to support future growth.

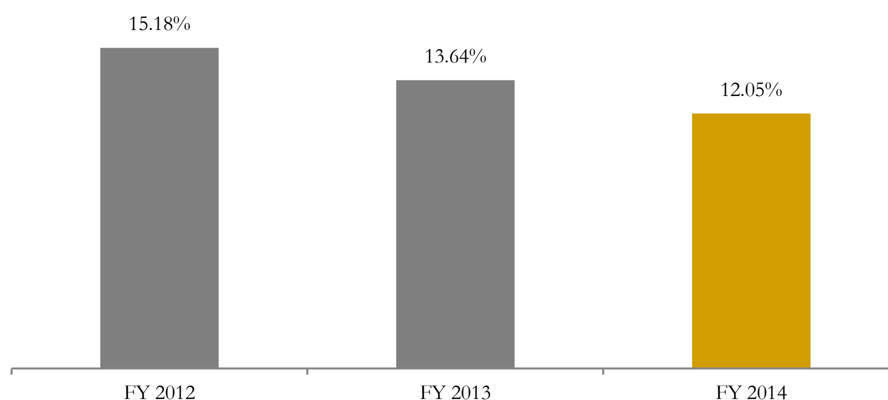
"We note that though the capital adequacy ratio of 17.00% lies above the 15.00% benchmark stipulated by the CBN and appears strong enough to support the bank's business risk, we believe there is a need to further strengthen its capital base to support future growth."

Liquidity and capital adequacy ratio



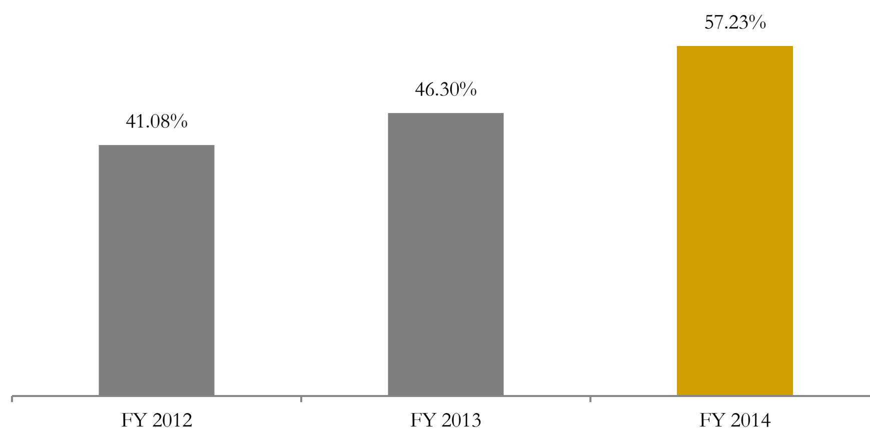
Source: Company Financials, DLM Research

Tier 1 capital to risk weighted assets



Source: Company Financials, DLM Research

Risk weighted assets to total assets



Source: Company Financials, DLM Research

Debt analysis

The Bank's plan to raise capital has been largely successful supported by medium-term bonds issued by the Bank over the years. In 2010, UBA raised ₦20billion fixed rate subordinated unsecured notes, maturing in 2017 with a coupon of 13%. This was followed by a ₦35-billion fixed rate subordinated unsecured notes, maturing in 2018 with a coupon of 14% issued the following year. In December 2014, the bank raised ₦30.5billion fixed rate unsecured notes maturing in 2021. We also note the recent increase in Tier-1 capital via an ₦11.5 billion rights issue, which was concluded in Q1 2015. Meanwhile, we are inclined to highlight that the extension of the offer period and discount of 12.5% in the offer price to ₦3.50 which reduced gross proceeds to ₦11.5 billion from the expected ₦13.2billion was predominantly driven by the lull observed in the domestic equity market at the time of issue rather than negative investor sentiments.

Whilst we understand the rationale behind the increase in the bank's dollar denominated debt in FY2014, we highlight that it increases the bank's vulnerability to foreign exchange risks, albeit to a minimal degree. UBA's debt structure consists of borrowings estimated at ₦113.80billion as at FY2014, representing a significant increase of 132.86% from ₦48.87billion in the preceding year. We highlight that 77.64% of total borrowings are dollar denominated whilst 22.36% account for domestic borrowing. In the event of a further devaluation, the current debt structure can result in additional interest expense which could weaken debt servicing ability and increase the chances of a default.

Subordinated liabilities which represent medium-term bonds issued by the Bank also increased by 53.32% to ₦85.32billion from ₦55.65billion in the previous year. However, we note that this is naira denominated and as such poses no foreign exchange risk.

Borrowings, ₦'million

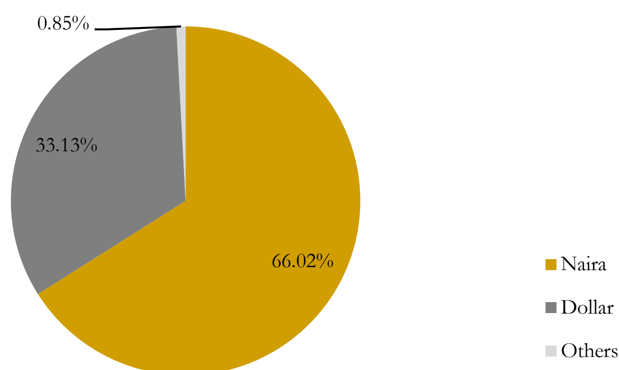
	FY2012	FY2013	FY2014
Central Bank of Nigeria	36,612	31,812	9,958
Bank of Industry (BoI)	13,869	13,175	15,493
Standard Chartered Bank	25,093	1,432	37,192
European Investment Bank (EIB)	-	2,447	1,466
Syndicated facility	-	-	49,688
African Development Bank (AfDB)	23,707	-	-
Afrexim	14,452	-	-
HSBC	787	-	-
Total	**114,520**	**48,866**	**113,797**

Source: Company Financials, DLM Research

"In the event of a further devaluation, the current debt structure can result in additional interest expense which could weaken debt servicing ability and increase the chances of a default."

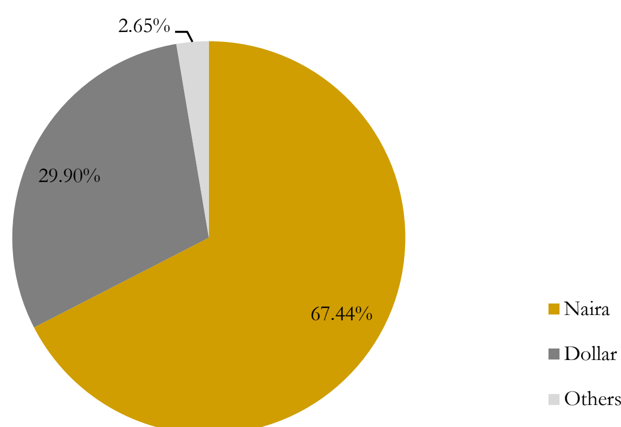
In addition, we are inclined to highlight that 33.98% of UBA's lending is in foreign currency with naira lending accounting for the largest percentage at 66.02%. Consequently, the possibility of a negative impact of a further devaluation on the banks' credit remains minimal to a reasonable degree.

Loan: Foreign exchange exposure



Source: Company Financials, DLM Research

Deposit: Foreign exchange exposure



Source: Company Financials, DLM Research

Exchange rate exposure, ₦'million

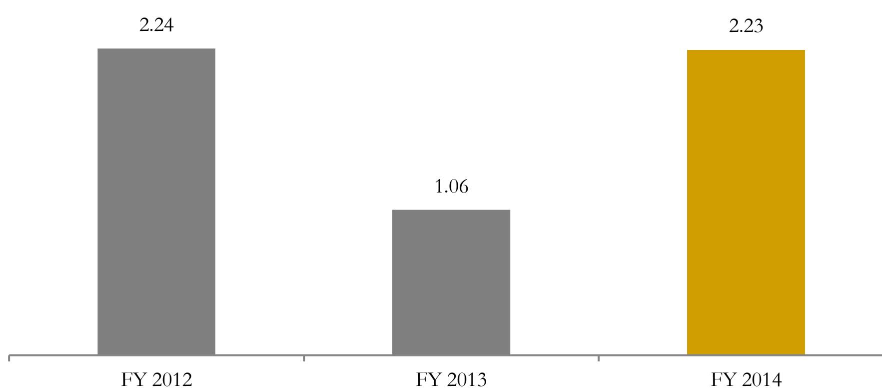
	USD	GBP	Euro	Others
Cash and bank balances	286,600	6,897	8,078	1,270
Loans and advances to banks	48,093	-	-	-
Loans and advances to customers	322,951	36	9,472	-
Financial assets held for trading	-	-	-	-
Derivative financial asset	6,534	-	-	-
Investment securities:	59,177	-	-	-
Account receivables	50,236	-	-	-
Total	**773,591**	**6,933**	**17,550**	**1,270**
Deposits from banks	15,581	729	-	43,648
Deposits from customers	650,899	6,357	8,413	1
Derivative financial liabilities	943	-	-	-
Other borrowed funds	88,346	-	-	-
Other liabilities	19,705	1,187	12,224	1,818
Total	**775,474**	**8,273**	**20,637**	**45,467**

"Consequently, we note that a probability of default remains largely minimal as the bank appears to be stable with relatively healthy fundamentals."

Leverage ratios

Operating income is sufficient to offset interest payment on existing debts. Based on FY2014 results, interest payment on borrowed funds was ₦9.13billion i.e. 4.74% of operating income of ₦192.46billion. The debt service coverage ratio is a benchmark used to measure the cash producing ability of a business entity to cover its debt payments. Furthermore, the bank's debt service coverage ratio rose to 2.23x from 1.06x in the preceding year which indicates that the bank's operating income is enough to cover 223% of its annual debt payments. Consequently, we note that a probability of default remains largely minimal as the bank appears to be stable with relatively healthy fundamentals.

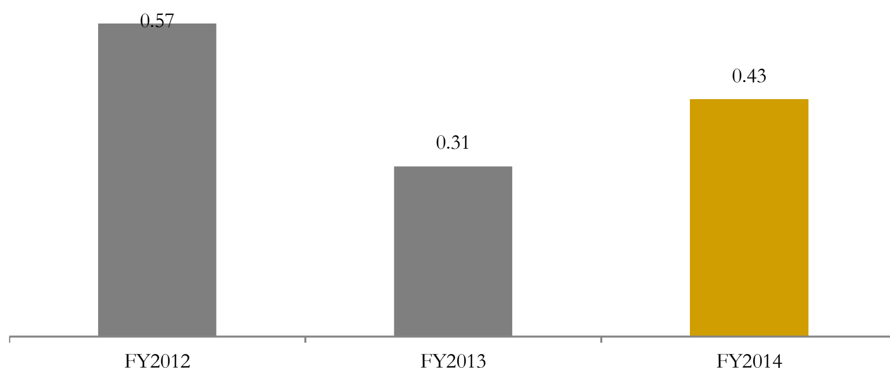
Debt service cover ratio



Source: Company Financials, DLM Research

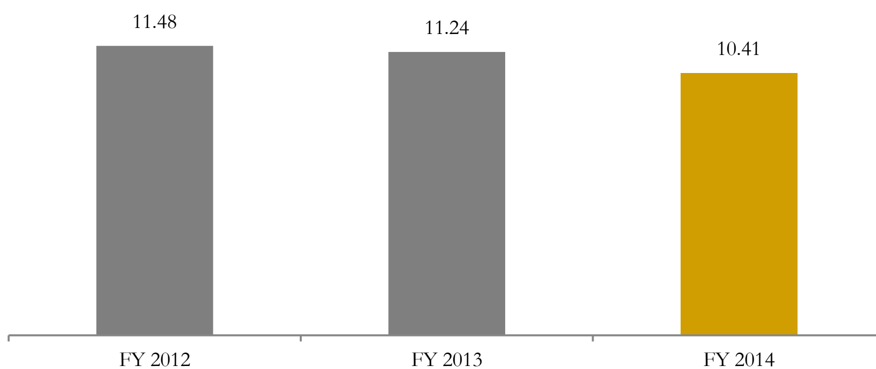
The bank's capitalization ratio which measures the debt component of the bank's capital structure improved to 0.43x from 0.31x which still remains within acceptable limit. In addition, the bank's equity multiplier declined marginally to 10.41x.

Capitalization ratio



Source: Company Financials, DLM Research

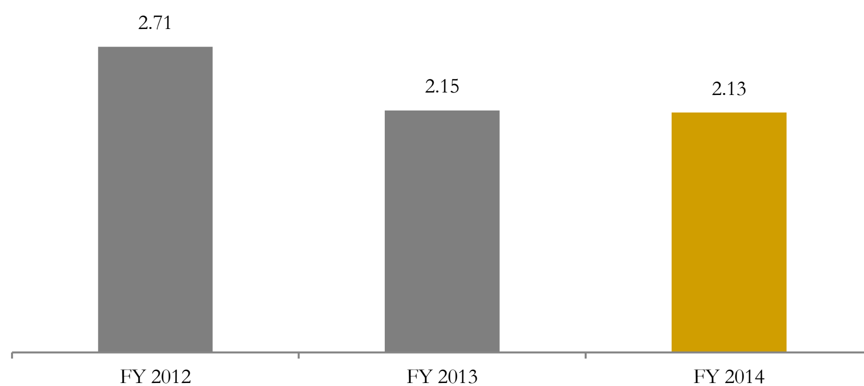
Equity Multiplier



Source: Company Financials, DLM Research

In addition, we highlight that the bank's interest coverage ratio at 2.13x reflects the availability of earnings to meet interest payments. In order to ascertain the refinancing strength of the bank, we established the bank's break-even ratio which matches percentage of cash outflows to cash inflows. Based on our evaluation, the bank's break-even ratio stood at 72.13% as at FY2014 which implies that operating income exceeds cost by 27.87%. Given that the break even ratio still lies below our acceptable limit of 80%, we are of the opinion that current position still supports the sustainability of the bank's cash flow in the short to medium term.

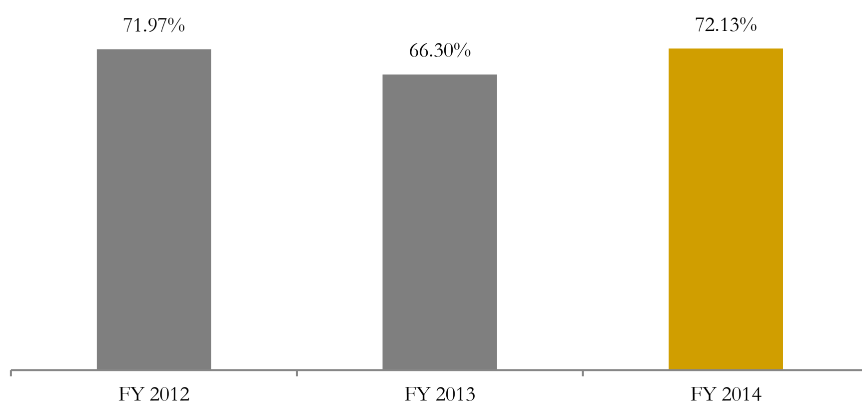
Interest coverage ratio



Source: Company Financials, DLM Research

"Given that the break even ratio still lies below our acceptable limit of 80%, we are of the opinion that current position still supports the sustainability of the bank's cash flow in the short to medium term."

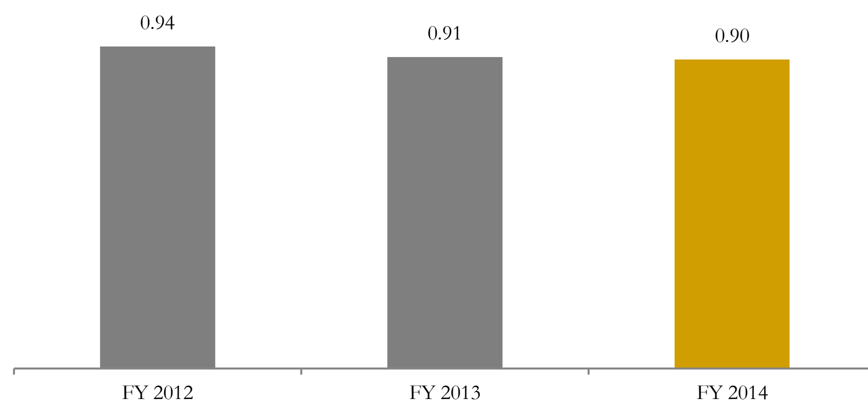
Break even ratio



Source: Company Financials, DLM Research

The bank's debt to assets ratio declined marginally to 0.90x which indicates the proportion of the bank's assets being financed with debt, rather than equity. This shows that the financial risk remains low as it stands below 1.00x.

Debt to assets ratio



Source: Company Financials, DLM Research

We remain optimistic that the bank will continue to leverage on its strong track record to support growth in the medium term. Hence, we are of the view that adverse changes in the macro-economic and regulatory environment will not significantly affect the bank's ability to meet payment obligations as at when due.

"Hence, we are of the view that adverse changes in the macro-economic and regulatory environment will not significantly affect the bank's ability to meet payment obligations as at when due."

Credit risk outlook

Operating income is sufficient to offset interest payment on existing debts. Based on FY2014 results, interest payment on borrowed funds was ₦9.13billion i.e. 4.74% of operating income of ₦192.46billion. Furthermore, the bank's debt service coverage ratio rose to 2.23x from 1.06x in the preceding year which indicates that the bank's operating income is enough to cover 223% of its annual debt payments. Consequently, we note that a probability of default remains largely minimal as the bank appears to be stable with relatively healthy fundamentals. We remain optimistic that the bank will

continue to leverage on its strong track record to support growth in the medium term. Hence, we are of the view that adverse changes in the macro-economic and regulatory environment will not significantly affect the bank's ability to meet payment obligations as at when due.

Key factors for future performance

Whilst the bank has demonstrated its ability to withstand headwinds in its operating environment; we believe that macroeconomic stability, strong management team, and favourable competition would drive the bank's future performance in the medium to long term. Going forward, we are of the view that UBA has potential to boost its earnings through an introduction of cost reduction strategies and retail expansion aimed at attracting cheaper deposits given the huge retail opportunities in Nigeria. Overall, we expect that UBA will continue to leverage on the strength of its management team, large branch network, improved technology and business initiatives to compete effectively as banks increasingly focus on the same space invariably leading to a more intense competitive environment and the proliferation of financial products.

A protracted economic downturn driven by lower oil prices remains a risk as the economic implications for Nigeria will invariably affect the bank's performance. This support our earlier assertion that greater management efficiency and sustained creation of high quality risk assets is fundamental to the bank's resilience in the face of regulatory headwinds in the banking sector.

Ecobank group

ECOBANK GROUP

Background

Ecobank is a leading pan-African banking group, with presence in 40 countries worldwide with total asset and shareholder funds of ₦4.5trillion and ₦493.02billion respectively. The bank's Nigeria operations remain its major income driver.

Investment summary

After acquiring 96% stake in Banco ProCredit Mozambique, Ecobank appears to be positioning to pursue its aggressive growth strategy that offers interesting prospects in the near future–which explains the rationale behind the Qatar National Bank's acquisition of 12.5% stake in Ecobank from the Asset Management Corporation of Nigeria (AMCON). Presently, the majority shareholders of the bank include Nedbank (20.7%); Qatar National Bank (QNB) (17.4% ord. shares & 68.7% pref. shares); IFC (14.5%); Public Investment Corporation (PIC) of South Africa (13.8%); the Social Security and National Insurance Trust (SSNIT) of Ghana (4%) and free float of 29.6%. While we see QNB and Nedbank's investment in Ecobank as a long term investment, we believe the current shareholding structure raises concerns of a hostile takeover. On the other hand, we highlight that the structure will not allow any single investor to control more than 30% of the bank's shares –a plan which was made clear to both QNB and Nedbank.

"The bank's capital position was boosted in 2014 by Nedbank's US$493 million investment and IFC's US$75 million loan conversion into equity–which was great for the bank as it offers stability."

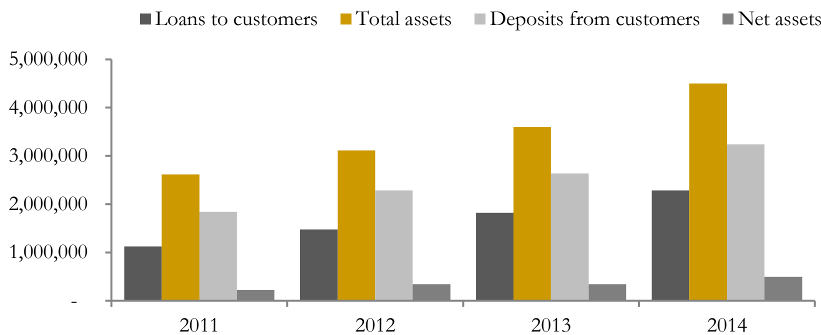
In 2014, the bank sold $200 million subordinated notes maturing in 2021, with a yield of 9.9% and a coupon of 8.75%. Naturally, currency depreciation and devaluation in Nigeria is putting the bank's Eurobonds under pressure. The debt repayment is hinged on strong cash flow from operation, operating income, asset quality and management operating efficiency. The yield spread offered by the bank reflects investors pricing of risk inherent on the bond.

The bank's capital position was boosted in 2014 by Nedbank's US$493 million investment and IFC's US$75 million loan conversion into equity–which was a good development given the stabilising effect of the transaction. Hence, its Tier I capital increased to ₦563.04billion (US$3.03bn) in FY2014, while the total regulatory capital also increased to ₦629.10billion (US$3.39bn). Hence, we are optimistic the current capital level of the bank can support its growth and business risk.

Business growth, 2011- 2014 (₦'m)

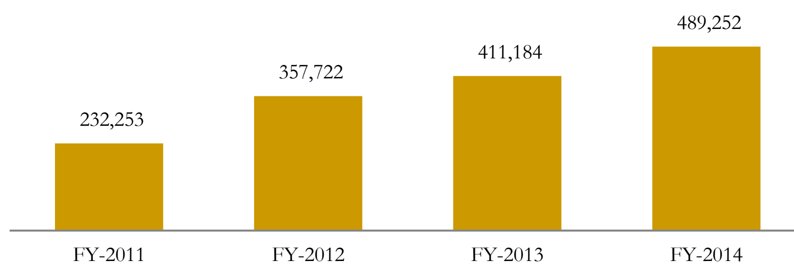
	2011	2012	2013	2014
Loans to customers	1,122,906	1,474,487	1,824,602	2,286,149
Total assets	2,618,393	3,115,843	3,599,560	4,501,787
Deposits from customers	1,842,511	2,283,426	2,634,262	3,237,871
Net assets	222,651	339,921	341,010	493,023

Loans, Assets, Deposits and Net assets growth (₦'bn) -2011-2014



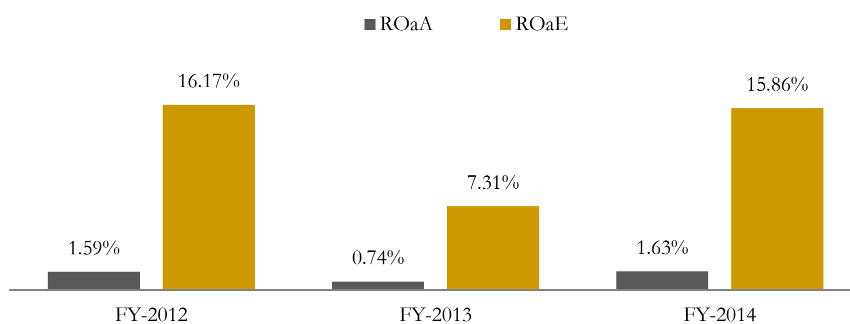
Source: Company annual report, DLM Research

Revenues growth (₦'bn) -2011 -2014



Source: Company annual report, DLM Research

Returns on average asset and equity (%) -2012 -2014



Source: Company annual report, DLM Research

"The bank's business diversification along geography, appears to be paying off given the underlying performance thus far –which underpin its pan-African strategy."

Performance Summary

Business expansion support current profitability. The bank's business diversification along geography appears to be paying off given the underlying performance thus far –which underpin its pan-African strategy. Gross earnings increased by 19% from ₦411.18billion ($2.58bn) in FY2013 to ₦489.25billion ($2.94bn) in FY2014, reflecting the strength and stability of the bank's diversified business model.

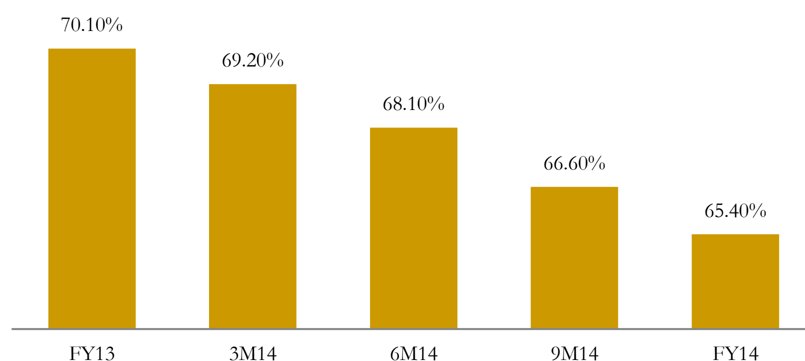
We highlight that the strong performance in earnings was largely driven by trading income, fee and commission on loans on the back of strong growth in customer loans especially in Nigeria despite FX translation impact. We note that growth in interest income was impacted by spread compression due to an increase in cost of funds. The bank made an attributable profit of ₦56.21billion (FY'13; ₦15.24bn) for the 2014 financial year end. Overall, the performance for the year was spurred by strong performance from treasury activities, which benefited from currency volatility and higher transaction volumes.

Highlight of income statement (₦'bn)

	FY2011	FY2012	FY2013	FY2014
Gross earnings	232,253	357,722	411,184	489,252
Interest income	136,860	215,265	255,171	288,105
Interest expense	45,974	79,628	87,568	103,524
Impairment charges	13,359	22,358	60,091	44,416
Operating profit	43,237	55,676	35,372	86,814
Profit before tax	43,220	55,209	35,375	86,442
Tax	10,996	9,723	10,484	20,302
Profit after tax	32,224	45,486	24,891	66,139

Operating efficiency. We note remarkable improvement on the bank's operating efficiency despite moderate growth in cost. Interest expense rose by 18.22% y/y to ₦103.52billion ($622.22m), (FY13:₦87.57bn; $549m). Hence, the bank's average cost of fund was 3.53% with a decrease in interest spread to 10.49%. This invariably led to a decrease in the bank's net interest margin to 6.8%. Meanwhile, operating expenses rose 54.5% y/y to ₦129.07billion ($775.78m), (FY13: ₦123.51bn; $774.36m) driven primarily by staff cost, and other operating expenses. Regardless, operating income grew by 28.157% y/y to ₦194.74billion ($1.17bn), (FY13:₦151.96bn; $952.70m). Hence, cost-to-income ratio declined to 65.4%, (FYE'13: 70.1%). Whilst the decline is impressive in our view, we highlight that current efficiency gain was due to benefit of business synergy and ICT investments across its platform.

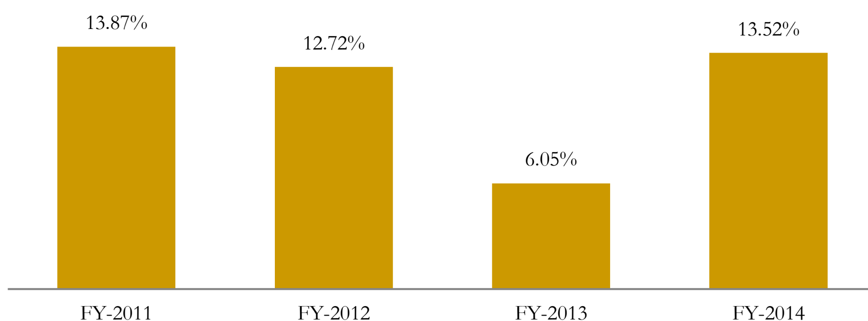
Cost to income ratio (%) 2013-2014



Source: Company annual report, DLM Research

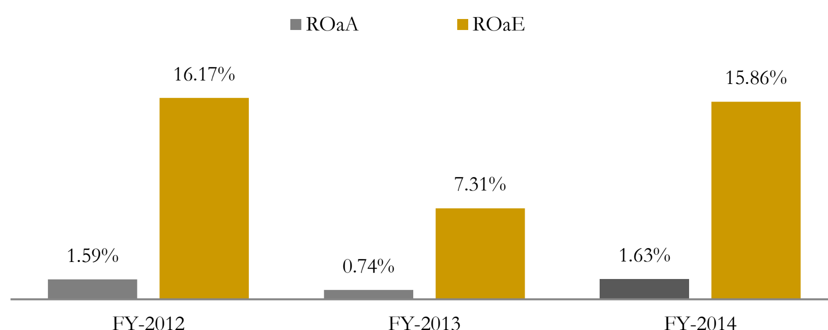
Profitability margins. Regardless of the challenging business environment, in terms of relative profitability by return metrics, remarkable improvement was noted. With post tax profit increasing significantly by 166% y/y, Ecobank's net profit margin rose to 13.52% from 6.05% in the preceding year. Although, we are inclined to stress that the bank's net profit margins has volatile in the last four years. Specifically, net profit margins hovered between 6.05% – 13.87% (2011-2014).In FY14, ROaE and ROaA improved to 15.86% (FY13: 7.31%) and 1.63% (FY13: 0.74%) respectively.

Post tax profit margins (%) 2011-2014



Source: Company annual report, DLM Research

Returns on average equity and asset (%) 2012-2014



Source: Company annual report, DLM Research

"The current debt level puts the bank's debt/equity ratio at 51.78% which is relatively high despite declining from 63.56% in the preceding year."

Debt analysis. As at FY14, Ecobank's total borrowings stood at ₦286.01billion ($1,54bn) up by 37.36% from the level recorded in the preceding year. In addition, the Eurobond debt securities issued in 2014 represents Subordinated Tier 2 Note of $250 million Fixed Rate Limited Recourse Participation Notes maturing in 2021. The Note has a tenure of 7 years while interest of 8.5% on the notes is payable semi-annually in arrears commencing 14 August 2014. The capital injection significantly improved Ecobank's capacity to fund large ticket transactions in major sectors of the economy e.g. energy, agriculture, telecoms, engage in intra-regional trade opportunities and boost its capital adequacy. We note that the bank's senior unsecured loan facility of $200 million from Deutsche Bank AG, interest rate is based on 6-month LIBOR rate is a, one year, plus margin of 5.5% payable annually. The current debt level put the bank's

debt/equity ratio at 51.78% which is relatively high despite declining from 63.56% in the preceding year.

Borrowed funds ($,m)	2013	2014	%
Nedbank	285,000		-100.00%
Bank of Industry of Nigeria (BOI)	282,263	307,267	8.86%
Eurobond Nigeria		244,655	
Deutsche Bank		198,683	
Standard Chartered Bank, Nigeria		151,176	
4% Convertible preference shares	109,794	115,973	5.63%
African Development Bank (AfDB)		70,103	
Societe de Promotion et Participation pour la Coopération Economique	82,320	79,266	-3.71%
Opec Fund for International Development (OFID)	35,077	30,546	-12.92%
International Finance Corporation	203,336	85,669	-57.87%
European Investment Bank	114,716	91,614	-20.14%
Standard Chartered Bank, Nigeria to Bewcastle	45,000	40,000	-11.11%
Keystone Bank, Nigeria	20,000	25,000	25.00%
Central Bank of Nigeria	11,393	1,999	-82.45%
Nederlandse Financierings-Maatschappij voor Ontwikkelingslanden N.V	17,678	7,656	-56.69%
Caisse Régionale de Refinancement Hypothécaire	19,332	14,588	-24.54%
Atlantic Coast Regional Fund (ACRF)	11,297	13,875	22.82%
Social Security and National Insurance Trust	2,016	1,404	-30.36%
Banque Ouest-Africaine de Dévelopment (BOAD)	3,893	1,349	-65.35%
Export Development Investment Fund (EDIF) Ghana	6,383	5,010	-21.51%
East African Development Bank (EADB) Kenya	2,900	5,513	90.10%
Other loans	51,006	48,919	-4.09%
	1,303,404	1,540,265	18.17%

"We are inclined to say that the bank is well capitalized based on its current risk weighted assets of ₦3.1trillion."

Fig.10: Eurobond debt component

	($'bn)	(N'bn)
Face value of debt	250.00	41,000
Semi-annual coupon rate	8.50%	8.50%
Semi-annual coupon payment	21.25	3,485
Annual coupon payment	42.50	6,970.00
Years to maturity from issue date	8	8
Total expected interest payment	298	48,790
Principal and interest on maturity	**548**	**89,790**

Capital adequacy. We are inclined to say that the bank is well capitalised based on its current risk weighted assets of ₦3.1trillion, recording Tier1 risk-based capital ratio of 18.30% and risk-weighted capital adequacy ratio of 20.40%, (FY13: 16.30%), which is at premium to the CBN regulatory limit of 15%. We note that the bank also maintained good tangible common equity ratio of 8.56%, (FY13: 6.53%). Hence, the bank's capital management policies support its business expansion strategy and ensure sufficient capitalisation to withstand unexpected macroeconomic shocks. We are inclined to state that the key drivers of growth in the bank's CAR were; the conversion of IFC's convertible loan of US$75.2m to 838.3 million new shares and 4.5 billion shares issued to Nedbank (for a 20% stake) following its loan conversion and top-up investment. While the current CAR appears strong enough to support the

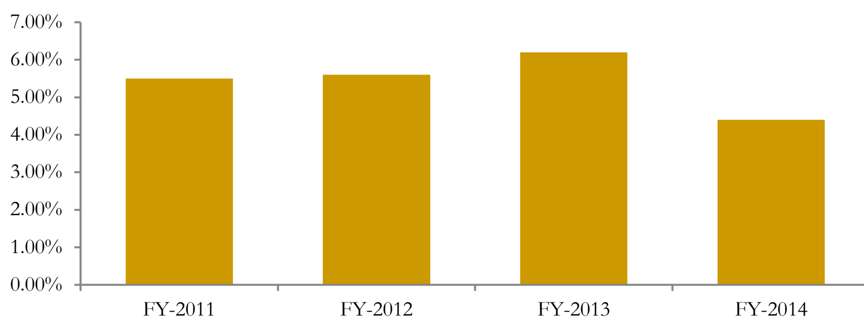
bank's business risk, there is a need to further strengthen its capital base to support future growth. Therefore, tThe plan to raise an additional Tier1 capital in 3Q 2015 will augur well for the bank as it will help to strengthen overall capital base and support long term growth.

Asset quality. Ecobank's non-performing loan ratio of 4.4% decreased from 6.2% in FY13 due largely to aggressive loan recoveries by its Early Warning and Remedial Recovery (EWRR) teams. The banks' non-performing loans ratio is below the CBN's cap of 5%. Regardless, we are of the opinion that the current position is relatively high and signals accumulation of bad loans. Historically, the bank's NPL has remained relatively high, above 5%, which in our view implies inefficient management of risk assets on the bank's balance sheet–which is a major concern. Overall, the coverage ratio for the entire portfolio of loans decreased to 68.7% from 79% in the preceding year– which basically means the bank provisioned less for it bad debt, which is fine since there isn't an increase in non-performing loans. The relatively decline in the coverage ratio is due to the decrease in NPL but going forward, we think the bank should be better provisioned to deal with future loan losses but this could be an additional drag on the bank's earnings. Highest proportion of NPL (6.9%) was noted in east Africa and southern Africa 6.4%, while the Nigeria operation recorded the lowest NPL of 3.2%. Hence, exposure to these other African countries is a key risk and reflects high credit concentrations as well as emerging risks. While the bank maintains strong capital adequacy level, we think the current asset- liability ratio of 0.89 is high which in our view indicates near to medium challenges in meeting debt obligations. We therefore highlight that a rise in interest bearing liabilities burden without a corresponding increase in cash flow could trigger default risk.

"While the bank maintains strong capital adequacy level, we believe the current asset- liability ratio of 0.89 is high which in our view indicates near to medium challenges in meeting debt obligations."

Capital adequacy composition	2011	2012	2013	2014
Tier 1 capital	196,652	311,875	320,401	563,043
Tier 2 capital	94,977	88,994	84,697	69,169
Regulatory capital	291,628	400,869	405,098	632,212
Less investments in associates	524	3,292	3,435	3,115
Total regulatory capital	291,104	397,577	401,663	629,098
On balance sheet	1,467,256	1,943,535	2,309,145	2,898,097
Off balance sheet	101,215	111,296	151,490	181,033
Total risk-weighted assets	1,568,471	2,054,831	2,460,635	3,079,130
Capital adequacy ratio	18.56%	19.35%	16.32%	20.43%
Tier 1 capital ratio	12.54%	15.18%	13.02%	18.29%
Minimum Regulatory Capital Adequacy Ratio			15.00%	15.00%

Non-performing loan ratios (%) 2011-2014

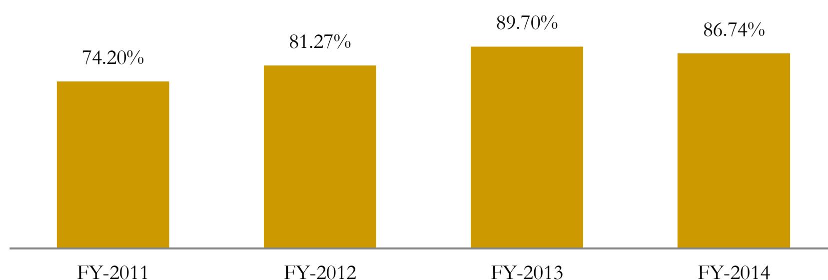


Source: Company annual report, DLM Research

Credit concentration. The overall credit growth was primarily driven by Nigeria operations. We observed an increased credit concentration risk in key sectors which reflects emerging risks, particularly the oil & gas, and trade finance sectors. Hence, we draw attention to the fact that the strategic and reduced loan concentration across selected industry indicates the limit of credit exposures the bank is willing to assume in these industries– which also reflect the bank's credit risk appetite. Hence, reducing loan to the sectors for which there may be an increased risk of loss or default particularly the manufacturing sector where the bank recorded the highest NPL ratio of 4.3% will help to boost asset quality. For all the sectors the bank has exposure, we believe the oil & gas sector remains the most profitable and has the highest capacity for loan repayment. We highlight that loan to the oil & gas sector (upstream, downstream, and mid-stream) has different risk profiles. Lending to the different segments is sensitive to low oil prices and if low oil prices persist, the bank would need to restructure part of its loan portfolios/book to match cash flow projections. Although, we note that prices of crude oil has remained relatively stable at $60pb which put repayment of the loan at a minimum risk. We highlight that the clean-up of the sector and how the outstanding fuel subsidies are resolved, as well as regulatory/policy changes by the new administration, are some of the factors that could drive the bank's non-performing loans (NPLs) in the medium term.

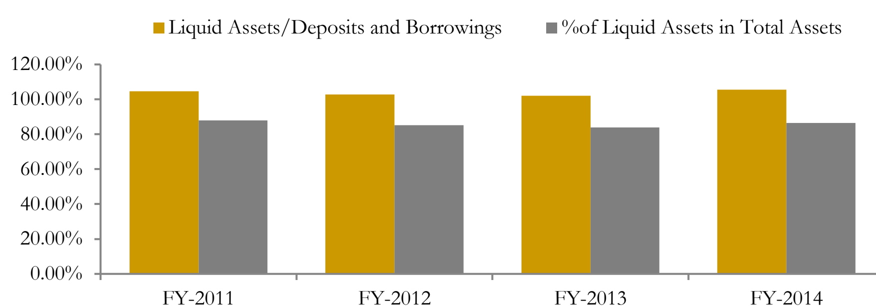
"We highlight that the clean-up of the sector and how the outstanding fuel subsidies is resolved, as well as regulatory/policy changes by the new administration, are some of the factors that could drive the bank's non-performing loans (NPLs) in the medium term."

Loan concentration risk ratios (%) 2011-2014



Liquidity position. By our assessment, the bank's balance sheet is highly liquid, with liquid assets constituting ~86% of its total assets as at FY14. This indicates the bank's ability to fund itself under stress conditions with minimum level of support from regulatory authorities. This is particularly an important factor for the bank that operates in an environment where conditions can change rapidly. As such, the prime risk to the bank to renew or replace maturing funding liabilities appears low. In addition, the bank also has strong liquid assets to deposits ratio. However, based on FY14, the bank is exposed to liquidity risk for maturities of up to one month due to overnight contractual maturity of current and savings deposits which accounted for over 70% of total deposits. Liquidity ratio (LR) increased from 25.6% to 26.5% but below the CBN regulatory limit of 30% which in our view suggest weak liquidity position, while the loans-to-deposits ratio (LDR) was flat at 72.8% as at the end of 2014. Hence, the bank has a relatively funding ability through its strong deposit base even though a higher proportion of total deposits have short-term maturity profile of 1-month. However, with gross deposits for FY14 higher than gross loans by 29.3%, we think there is a mismatch, in the utilization of operating liabilities particularly in the creation of loans. Of major concern is the fact that 39.23% of the bank's financial assets have short-term maturity profile, while 68.61% of financial liabilities has maturity of within one month– this therefore create short term assets-liability mismatch, although, larger proportion of the bank's loans has longer term maturity.

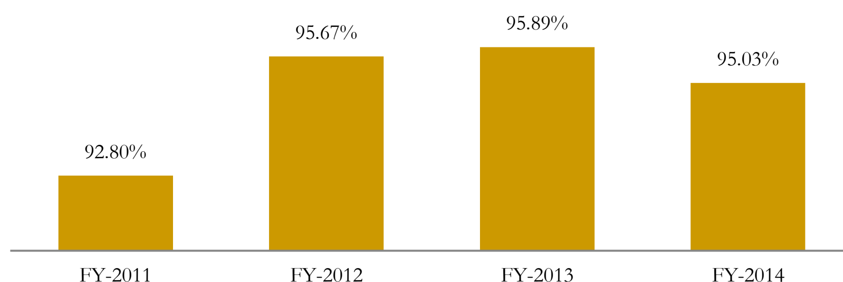
Liquidity ratios (%) 2011-2014



Source: Company annual report, DLM Research

" Liquidity ratio (LR) increased from 25.6% to 26.5% but below the CBN regulatory limit of 30% which in our view suggest weak liquidity position. "

Volatile deposits ratios (%) 2011-2014



Source: Company annual report, DLM Research

Cash payable by the bank	Up to 1 month	1 -3 months	3–12 months	1–5 years	Over 5 years	Total
Assets						
Cash and balances with central banks	3,523,876	18,573	4,094			3,546,543
Loans and advances to banks	1,955,901	142,605	425,401	88,691		2,612,598
Loans and advances to customers	3,572,844	1,810,569	1,642,406	4,955,004	1,472,710	13,453,533
Derivative financial instruments	131,170	58,554	57,941			247,665
Financial Asset held for trading	3,209	283,507	289	540		287,545
Treasury bills and other eligible bills	240,723	542,403	544,096	56,281		1,383,503
Investment securities–available-for-sale	100,671	94,667	109,347	825,710	574,883	1,705,278
Pledged assets	76,210	625,629	22,479	207,268	111,730	1,043,316
Other assets	137,147	46,963	278,724	86,418	609	549,862
Total financial assets	9,741,751	3,623,470	3,084,777	6,219,912	2,159,932	24,829,843
Liabilities						
Deposits from banks	551,082	95,470	389,205	1,526		1,037,283
Due to customers	13,629,138	1,435,534	1,503,616	940,488		17,508,776
Other deposits	737,747		881	1,928		740,556
Other borrowed funds	46,296	28,975	55,353	1,216,895	581,870	1,929,389
Other liabilities	299,699	302,409	192,196	237,160	8,000	1,039,464
Derivative financial instruments	20,234	344				20,578
Total financial liabilities	15,284,196	1,862,732	2,141,251	2,397,997	589,870	22,276,046
Cumulative Gap	5,542,445	1,760,738	943,526	3,821,915	1,570,062	2,553,797

Exposure to exchange and interest rates risk. We note that the bank is exposed to the effects of fluctuations in foreign currency exchange rates in 20 currencies on its financial assets and liability. This is the risk that the fair value or future cash flows of a financial instrument will be affected by changes in foreign exchange rates. This is because the bank reports its financials in US$ and at each reporting period the functional currencies (CFA, Naira, Ghana cedi) are converted into US$. Based on FY14 results, 40% of the bank's net loans are in CFA franc, 29% in US$, 21% in Naira and others in Ghana cedis, Euros. Of the bank's currencies exposure, the Nigeria Naira and the CFA franc continued to be the currencies to which the Group has significant exposure; accounting for 22% and 34% of the Group's credit portfolio respectively. Thus, the CFA franc is a common currency for 14 out of the 40 countries in which the bank operates. The table below summarises the bank's exposure to foreign currency exchange rate risk based on FY14. From our analysis, Ecobank's average VaR for 2014 was US$5.4 million (2013: US$7.3m), of which US$2.8 million is attributable to foreign exchange risk and US$2.6 million to interest rate risk.

"The bank's average VaR for 2014 was US$5.4 million (2013: US$7.3 million), of which US$2.8 million is attributable to foreign exchange risk and US$2.6 million to interest rate risk."

Exposure to foreign currency exchange rate risk	Dollar	Euro	CFA	Naira	Cedis	Others	Total
Assets							
Cash and balances with central banks	175,516	357,264	1,160,862	1,326,125	168,209	358,567	3,546,543
Loans and advances to banks	1,074,911	259,866	169,361	234,773	50,272	93,318	1,882,501
Loans and advances to customers	3,511,750	139,957	4,879,316	2,609,479	536,002	635,138	12,311,642
Financial assets held for trading				279,077		357	279,434
Derivative financial instruments	126,802			120,862			247,664
Treasury bills and other eligible bills			487,242	457,805	123,022	208,051	1,276,120
Investment securities–available-for-sale	231,085	764	877,848	90,928	96,843	138,112	1,435,580
Pledged assets				1,032,146			1,032,146
Other assets	185,123	2,248	52,621	20,640	26,504	26,111	313,248
Total financial assets	5,305,187	760,099	7,627,250	6,171,835	1,000,852	1,459,654	22,324,878
Liabilities							
Deposits from banks	253,212	167,516	106,488	323,869	2,865	58,891	912,841
Due to customers	3,767,540	261,655	6,640,749	4,985,421	618,648	1,081,873	17,355,886
Other deposits	1,526	19,186	550,124			2,464	573,300
Derivative financial instruments	20,478						20,478
Other borrowed funds	1,062,253	1,656	11,409	407,610	10,416	46,920	1,540,264
Other liabilities	195,249	18,936	245,368	197,306	55,951	30,901	743,711
Total financial liabilities	5,300,258	468,949	7,554,138	5,914,206	687,880	1,221,049	21,146,480

Interest Rate Sensitivity Analysis	Up to 1 month	1-3 months	3-12 months	1-5 years	Over 5 years	Non-interest bearing	Total
Assets							
Cash and balances with central banks	398,038	-	-	-	-	3,148,505	3,546,543
Loans and advances to banks	1,362,652	103,055	115,667	32,849	1,313	266,965	1,882,501
Loans and advances to customers	3,068,888	1,679,930	1,518,104	4,544,131	1,500,589	-	12,311,642
Financial assets held for trading		279,077	288	69	-	-	279,434
Derivative financial instruments	10,307	58,554	57,941	-	-	120,862	247,664
Treasury bills and other eligible bills	177,151	552,246	501,374	43,548	1,801	-	1,276,120
Investment securities–available-for-sale	206,570	99,285	154,537	449,587	525,601	-	1,435,580
Pledged assets	75,394	618,930	22,239	205,049	110,534	-	1,032,146
Other assets	6,097	25,088	166,048	1,262	2,469	112,283	313,248
Total financial assets	**5,305,097**	**3,416,165**	**2,536,198**	**5,276,495**	**2,142,307**	**3,648,615**	**22,324,878**
Liabilities							
Deposits from banks	94,371	113,479	451,043	29,266	-	224,682	912,841
Due to customers	5,482,432	1,333,590	1,387,890	730,643	24,103	8,478,312	17,436,970
Other deposits	569,310			1,769		2,221	573,300
Derivative financial instruments	20,234	244	-	-	-	-	20,478
Other borrowed funds	43,358	60,328	37,254	216,431	1,113,732	69,161	1,540,264
Other liabilities	2,041	290,342	142,575	18,276	25,831	264,646	743,711
Total financial liabilities	6211746	1797983	2018762	996385	1163666	9039022	21227564
Total interest repricing gap	-906,649	1,618,182	517,436	4,280,110	978,641	-5,390,407	

Strong cash-flow –to- interest on debt reaffirms healthy financing ability. In our evaluation, we take cash flow from operation adequacy as the primary measure of cash sufficiency. We assume all the cash flow from operation would be used to pay off interest on, which is not realistically possible for the bank to devote all of its cash flow from operation in this way. However, this ratio is used as a "what-if" scenario as a basis for debt finances ability of the bank. We summarize the bank's cash flows to interest on borrowed fund and discovered that higher cash flow is evidenced on the financial positions of the bank. The bank's interest on debt of ₦26.15billion ($158.56m) is lower than it operating cash flows of ₦86.44billion ($519.55m), and a ratio of 3.3:1 is considered relatively strong. In this instance, the bank has strong capacity to cover its debt expenses with its operating cash flow. The increasing ratio is a positive sign, showing the bank is in a healthy financial position and will not default on its debt obligation. The current level indicates that the bank is capable of taking on additional debt.

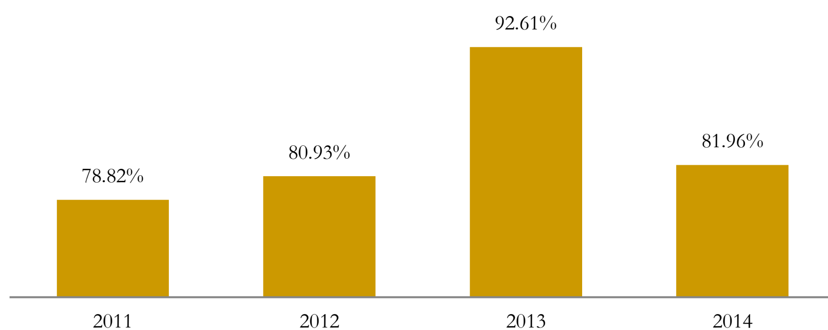
"We summarize the bank's cash flows to interest on borrowed fund and discovered that higher cash flow is evidenced on the financial positions of the bank."

Default probability is present albeit minimal. We note that many things can influence default risk on the bank debt instruments such as falling cash flow from operations which is often needed to make the interest and principal payments and rising interest rates. In addition, we note that default could be trigger by country specific business cycle, management reactiveness and industry specific challenges. In estimating default probability using this method, we assumed a recovery rate of 40% in the event of default which is in line with historical global trends for corporate bonds. Hence, we arrived at default probability of 7.15%, which is low in our view. The bank is sensitive to declines in investor confidence, just like other banks in the industry, which can result in a relatively fast descent into default in the event of insufficient stable cash flow from operation despite maintaining relatively strong liquid assets which necessary will not be selloff.

To measure the bank's ability to meet its financial obligations when due, the following metrics were deployed

Break-even ratio. In order to ascertain the refinancing strength of the bank, we established the bank's break-even ratio which matches percentage of cash outflows to cash inflows–a measures of how much room we think the bank has to refinance the debt obligations. Based on our evaluation, the bank's break-even ratio of 81.96% appear stable though above our acceptable limit of 80%. This means that operating income is more than cost by 18.04%. Given the bank's offshore exposure, we therefore recommend a lower ratio as we note that the current level is a pointer to medium term sustainable cash flow challenges and risk.

Break even ratios (%) 2011-2014

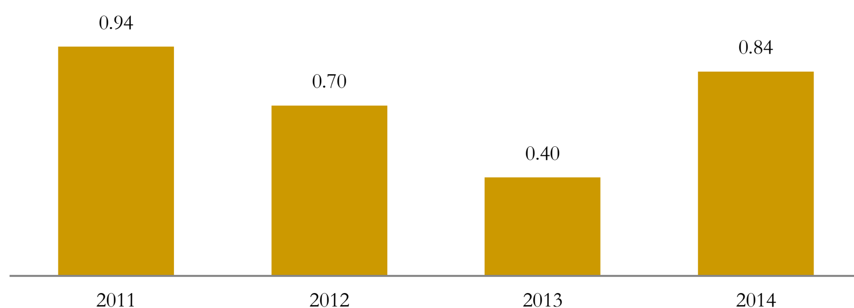


Source: Company annual report, DLM Research

Interest coverage ratio. Ecobank's interest coverage ratio, though increased to 0.84x from 0.40x in the preceding year, is not strong enough in our view. The current level implies that operating profit is sufficient to offset interest payment on existing debt and other borrowed funds. However, we note that a further growth in debt will exert further pressure operating profit and dampen ability to meet debt obligations.

"In our evaluation, the bank's debt service coverage ratio remained weak at 0.91x, declining from 2.8x in the preceding year, indicating a decreasing and weak capacity to service its debts."

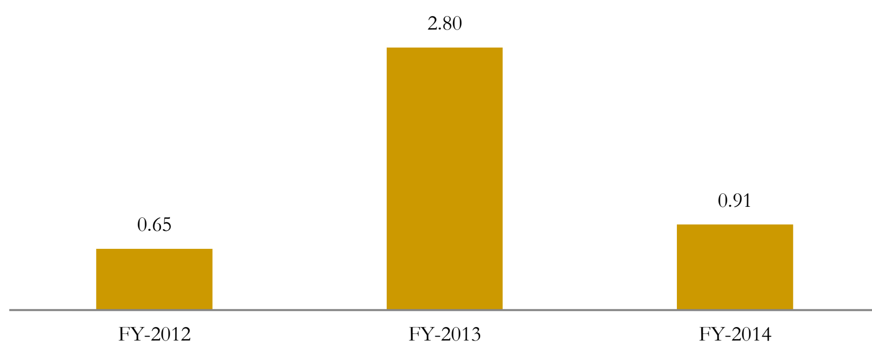
Interests cover ratios (x) 2011-2014



Source: Company annual report, DLM Research

Debt service coverage ratio. We pay more attention to this ratio in view of its relative importance in evaluating the bank's credit condition. In our evaluation, the bank's debt service coverage ratio remained weak at 0.91x, declining from 2.8x in the preceding year, indicating a decreasing and weak capacity to service its debts.

Debt services cover ratios (x) 2012-2014



Source: Company annual report, DLM Research

Outlook. We reckon that the main operating strength of the bank is predicated on the need to support Africa's trade and infrastructure development through private-public partnership and regional integration. This offers the bank opportunity to finance projects of larger scale at lower unit costs. The bank will need to leverage on its diversified business model to drive revenues, particularly in non-funded income and focus on low cost borrowings to play their strengths in each of their markets. Overall, we maintain that the bank can withstand the unexpected economic shock.For now, we perceive that low oil prices and pressure on the Nigerian currency suggest a difficult year ahead.

Diamond Bank Plc.

DIAMOND BANK PLC.

Background:

Diamond Bank commenced operations in March 1991. It assumed the universal banking status in February 2001, and was listed on the Nigerian Stock Exchange in May 2005. In October 2005, it acquired Lion Bank Plc. In January 2008, Its GDRs were listed on the Professional Securities Market of the London Stock Exchange. The Group has 302 business locations across Nigeria, Benin Republic, Cote d'Ivoire, Senegal, Togo and the United Kingdom. In compliance with the new CBN banking model, Diamond divested from its non-banking subsidiaries and was licensed to operate as a commercial bank with international authorization.

Diamond bank has retained excellent banking relationships with a number of well-known international banks, allowing the bank to provide a bouquet of world class banking services to suit the business needs of clients. These international banking partners include Citibank; HSBC Bank; ANZ Banking Group; ING BHF Bank AG; Standard Chartered Bank; Belgolaise Bank S.A; Deutsche Bank; Commerzbank; and Nordea Bank Plc.

In 2008, Diamond bank streamlined its operations into three distinct strategic business segments: Retail banking, Corporate Banking, and Public sector.

Diamond bank issued $200 million Eurobond in June 2014 an also raised N50.3bn via a rights issue offering of 3 for 5 in August 2014. Actis, a significant shareholder, divested from the bank in 2014 and the conclusion of the rights issue led to the emergence of Carlyle Group as a significant shareholder.

"Diamond Bank currently has an asset base of ₦1.93trillion as at FYE 2014"

Rating Reviews

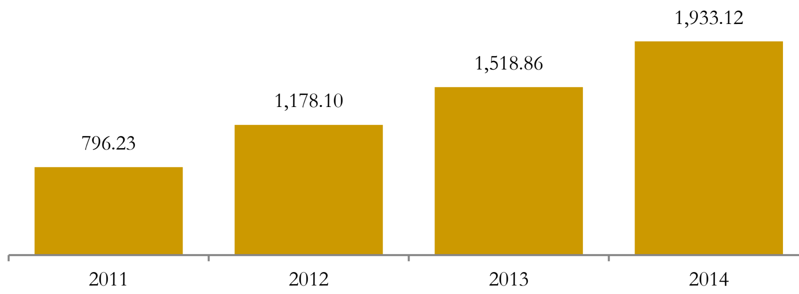
In April 2015, Fitch Ratings affirmed the long-term Issuer Default Ratings (IDRs) of Diamond Bank Plc to stable albeit Fitch's revision of the Outlook on Nigeria's Long-term Issuer Default Ratings (IDRs) to Negative from Stable in March 2015. Diamond Bank's BBB+ rating by Fitch Ratings, Agusto & Co., and A- rating by GCR, reflects the bank's sustainable liquidity, sound and professional practices and good standing as a high investment grade institution.

Business Growth: 2011- 2014

Balance Sheet Size

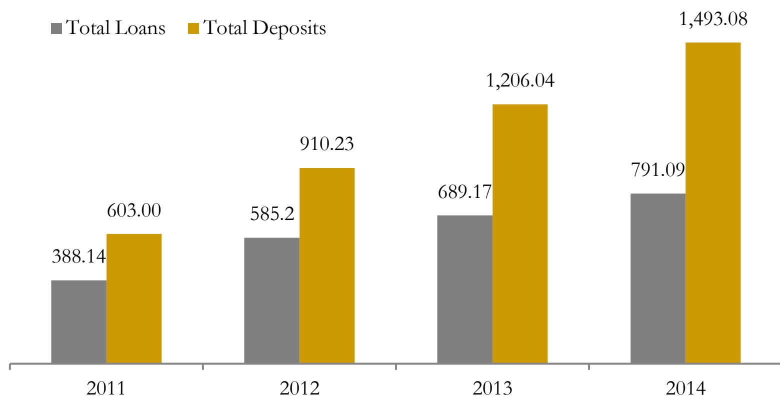
	2011	2012	2013	2014	CAGR
Total Assets (₦'bn)	796.23	1,178.10	1,518.86	1,933.12	34.40%
Total Loans (₦'bn)	388.14	585.20	689.17	791.09	26.79%
Total Deposits (₦'bn)	603.00	910.23	1,206.04	1,493.08	35.29%
Shareholders' Fund (₦'bn)	85.91	108.86	138.85	209.02	34.50%

Asset Growth (₦'bn) -2011-2014



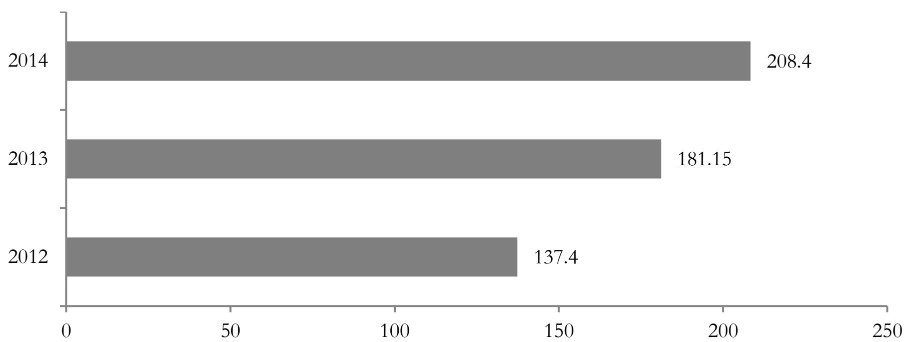
Source: Company annual report, DLM Research

Loans & Deposits Trend (₦'bn) -2011 -2014



Source: Company annual report, DLM Research

Revenue (₦'bn):2012 -2014



Source: Company annual report, DLM Research

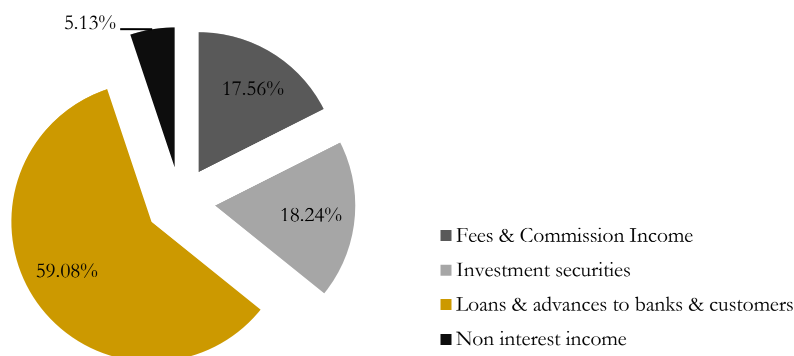
Performance Summary

Gross earnings rose on the back of growth in interest income and fees and commission. Gross earnings of ₦208.40billion were up 15.0% y/y largely driven by growth in interest income which grew by 12.6% to ₦161.13billion as a result of increased loans to customers. Income from loans & advances accounted for 62.3% of interest income. This was supported by strong performance in treasury income and fee & commission income. Specifically non-interest income grew 26.5% to ₦44.18billion on the back of increased net gains in investment securities.

"Gross earnings of ₦208.4billion were up 15.0% y/y largely driven by growth in interest income and fees & commission income"

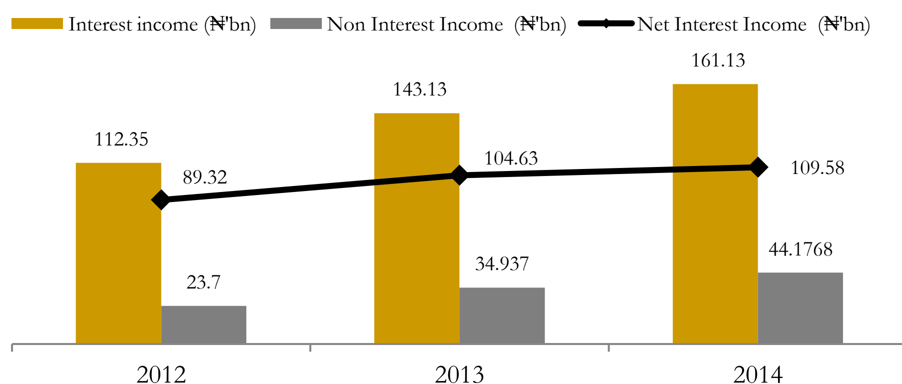
Revenue (₦'bn)	2012	2013	2014	YoY(%)	CAGR(%)
Gross earnings	137.4	181.15	208.4	15.04	23.16
Interest income	112.35	143.13	161.13	12.58	19.76
Interest expense	23.03	38.50	51.55	33.90	49.62
Net Interest Income	89.32	104.63	109.58	4.73	10.76
Non-interest Income	23.7	34.937	44.1768	26.45	36.53
Operating Income	113.02	139.56	153.75	10.17	16.64
Operating Expense	68.50	84.20	99.30	17.93	20.40
Profit before tax	27.48	32.08	28.10	-12.40	1.12
Profit after tax	22.11	28.54	25.49	-10.72	7.37

Business Contributions to Gross Earnings (%) 2014



Source: Company annual report, DLM Research

Interest & Non-Interest Income



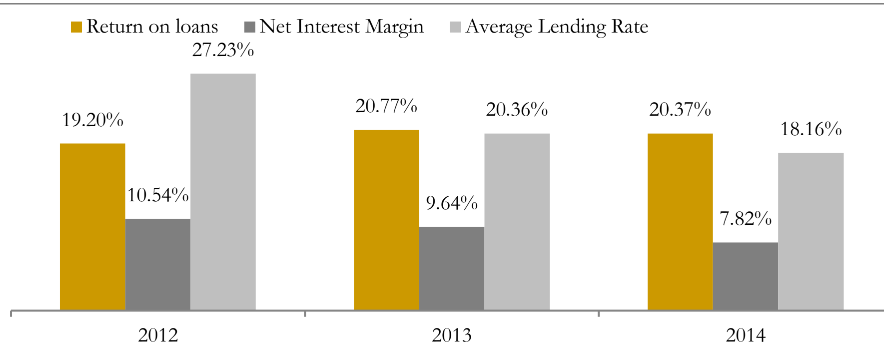
Source: Company annual report, DLM Research

Increased interest expense impacted net interest income. For the FYE'14, the bank's interest expense rose by 33.9 % y/y to ₦51.55billion (FYE'13: ₦38.50bn). This was driven largely by growth in deposits from customers, borrowing cost and interest bearing debt, which may be due to the impact of the subordinated tier II note on the banks' funding cost, and growth in term deposit (+55.98%). In our view, the bank may have been paying more on term deposits. Specifically, while interest on borrowings and customers' deposits rose by 607.70% and 34.95% y/y respectively, this may have impacted the bank's interest expenses due to the increase in term deposits as well as the subordinated tier II note. We note the bank's average cost of funds increased to 3.6% (FYE'13: 3.4%), while returns on average loans declined to 20.37% with a corresponding decrease in interest spread to 6.24% (FYE'13 6.24%). This invariably led to a decrease in the bank's NIM to 7.82%. (FYE'13: 9.64%), in addition to the impact of CRR. on deposits.

"Specifically, while interest on borrowings and customers' deposits rose by 607.70% and 34.95% y/y respectively, this may have impacted the bank's interest expenses due to the increase in term deposits as well as the subordinated tier II note"

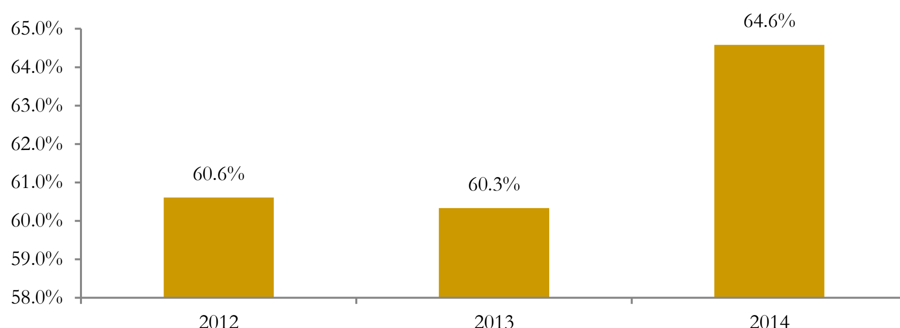
Growth in operating expenses weakened overall operating efficiency: Regardless of growth in operating income by 10.17% y/y to ₦153.75billion, (FYE'13:₦139.56bn), operating expenses rose by 17.93% y/y to ₦99.30billion, (FYE'13: ₦84.20bn.) and consequently, cost-to-income ratio rose to 64.6%, (FYE'13:60.30%).

Average Returns On Loans, NIM, Average Lending Rate (%)



Source: Company annual report, DLM Research

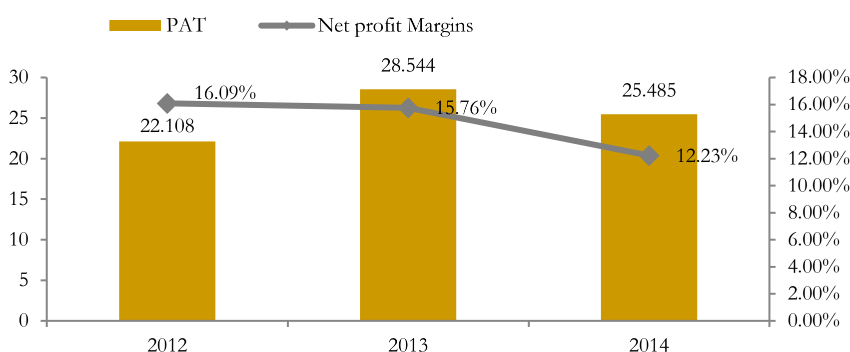
Cost to income (%)



Source: Company annual report, DLM Research

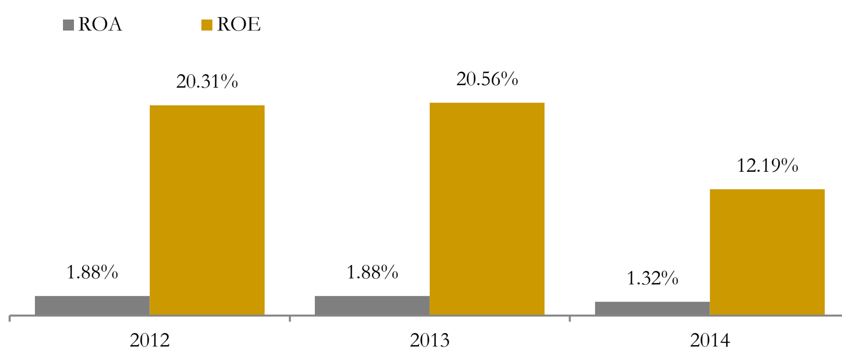
Diminishing profitability margins.- The bank's profitability and earnings decreased on the back of growth in interest expense which rose by 33.9% in FYE'14 to ₦51.55billion (FYE'13: ₦38.50billion), owing to rise in interest paid on deposits and other long-term borrowings. We also note a 17.9% and 13.3% increase in operating expenses and impairment in FYE'14 to ₦99.30billion (FYE'13: ₦84.20billion) and ₦26.40billion (FYE'13: ₦23.30billion) respectively. With post tax profit decreasing by 10.7% y/y to ₦25.49billion from ₦28.54billion in the previous year, net profit margin declined considerably to 12.23%. Hence, in FYE'14, ROaE and ROaA declined to 12.19% (FYE13: 20.56%) and 1.32% (FYE'13: 1.88%) respectively.

Post tax profit and margins (%)



Source: Company annual report, DLM Research

Return on Asset and Equity (%)



Source: Company annual report, DLM Research

"Growth in balance sheet was driven by deposits, alongside long term borrowings"

Asset Quality/Credit Risk – As market risk continue to grow, credit risk remains the dominant risk for the banks. Our approach to credit risk entails examination of the entire balance sheet, looking at different asset classes. We analyse the make-up of the balance sheet to ascertain the asset mix and concentration. However, we note that loan portfolio represents the most important asset category of the bank. Although, we observed that the bank's debt securities grew by 608% due to the $200million subordinated bond issued in 2014. Where the major risk is not connected to loan assets,

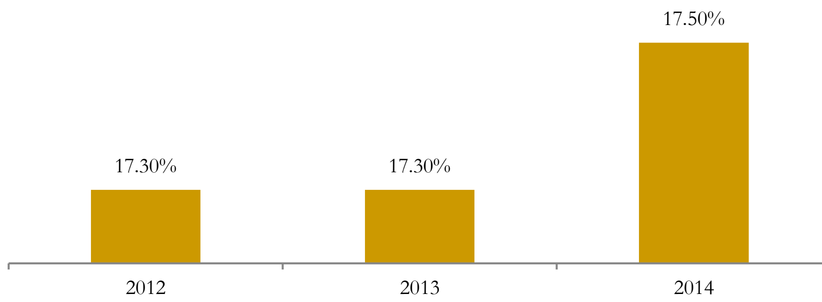
we focused on the investment assets such as debt securities and the associated credit and market risk such as fluctuation in yield due to changes in interest rate. More importantly is the exposure to exchange rates as persistent devaluation of the local currency especially when repayment is due, will make settling the foreign currency denominated debt more expensive.

Asset quality and CAR appeared strong. The bank appear to be capitalised at ₦244.75billion based on its current risk weighted assets of ₦1.40trillion, recording a risk weighted capital adequacy ratio of 17.50%, (FYE13: 17.30%), which is at premium to the CBN regulatory limit of 15%. The growth in risk weighted assets reflects the bank's effort to optimize balance sheet. The improvement in the bank's capitalisation was predominantly due to the impact of its rights issue concluded in the last quarter of 2014, as well as the capitalisation of profits in 2014. Shareholders' funds increased from ₦138.7billion to ₦208.8billion in 2014. The bank's tier 2 capital is 22.70% of its tier1- which is below CBN regulatory limit. This leaves adequate room for the bank to raise an additional tier 2 capital to fund growth. The current CAR appears strong enough to support the bank's business risk. However, increase in Non-Performing Loan ratio to 5.12% indicates weak risk management and weak monitoring of loan performance. The NPL coverage ratio which measures the provision made for non-performing loans and the bank's ability to absorb potential losses from non-performing loans decreased to 93.3% in 2014 due to inadequate provisions for classified assets. Real Estate & Construction sector recorded the highest NPL of 42.0% in FYE'14. Hence, exposure to the sector is a key risk and reflects high credit concentrations as well as emerging risks, particularly in general commerce and as such the bank is expected to restructure part of its loan portfolio in order to limit exposure.

"The current CAR appears strong enough to support the bank's business risk"

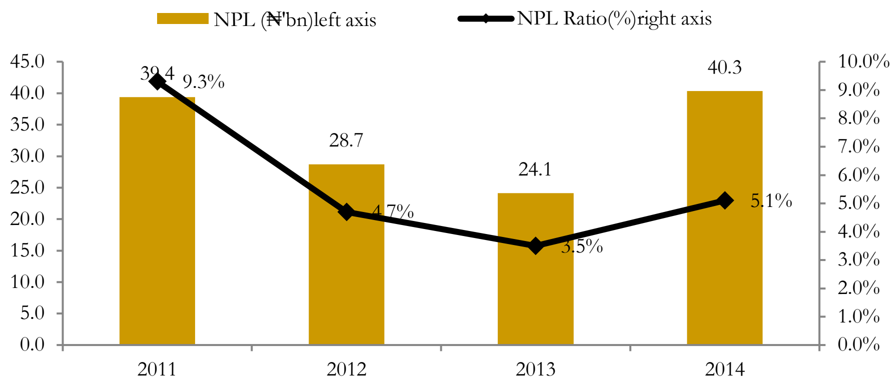
	2012	2013	2014
Tier 1 capital (₦bn)	109.10	128.09	199.47
Tier 2 capital (₦bn)	35.08	37.69	45.28
Total regulatory capital (₦bn)	**144.18**	**165.784**	**244.75**
On balance sheet	696.80	817.24	1,025.60
Off balance sheet	135.78	141.71	114.81
Total risk-weighted assets (₦bn)	**832.58**	**958.95**	**1,399.87**
Capital adequacy ratio	17.3%	17.3%	17.5%
Tier 1 capital ratio	13.1%	13.4%	14.3%

Capital Adequacy Ratio (%)



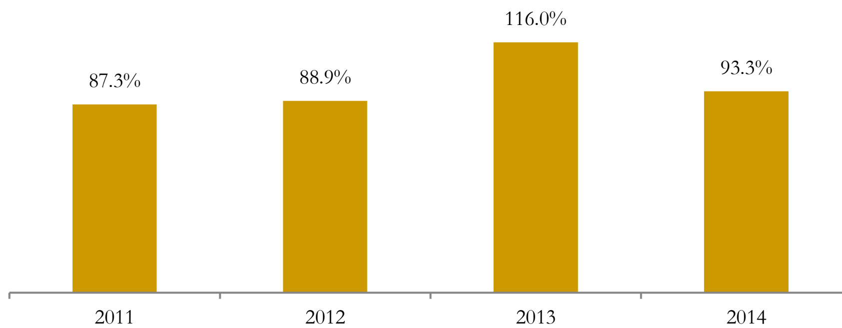
Source: Company annual report, DLM Research

Non-Performing Loan (₦bn) and Ratios (%)



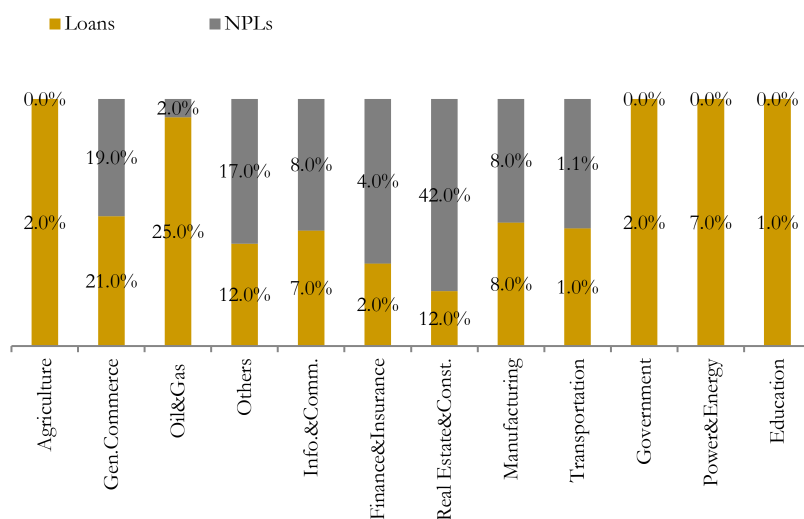
Source: Company annual report, DLM Research

Non-Performing Loan Coverage Ratios (%)



Source: Company annual report, DLM Research

Loans and NPL ratios by Industry (%)

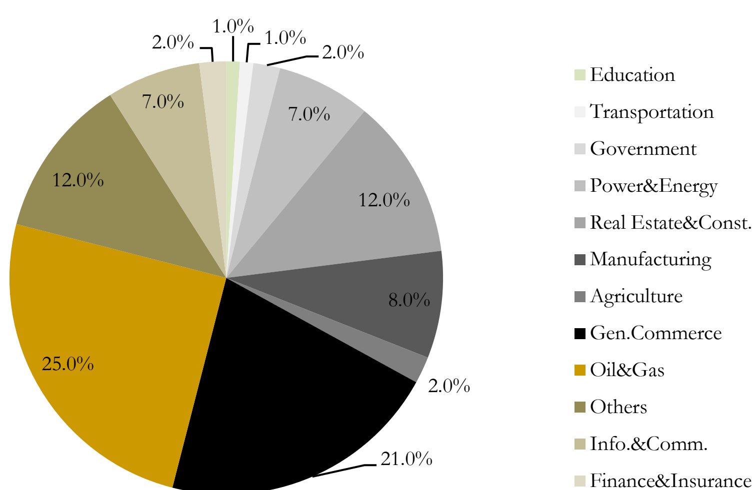


Source: Company annual report, DLM Research

Increasing Credit Concentration. The low concentration across selected industry reflects the bank's credit risk appetite which indicates the limit of credit exposures which the bank is willing to assume. Hence, reducing loan to the sectors for which there may be an increased risk of loss or default particularly oil & gas in view of declining oil price and exchange rate devaluation will help to boost the asset quality of the bank. Loan book rose by 14.8% y/y to ₦791.09billion in 2014 (FYE'13: ₦689.17billion) as Oil & Gas, General Commerce and Real Estate & Construction were the key sectors accounting for the growth.

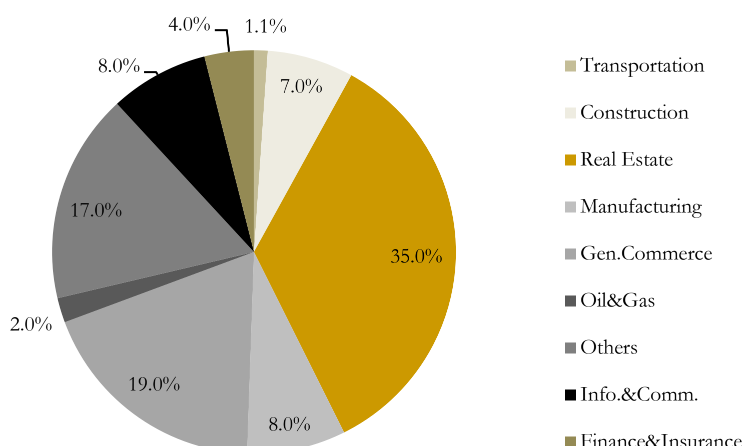
"The growth in loan book in FYE'14 was driven by Oil & Gas, General Commerce and Real Estate & Construction"

Loan composition (%)



Source: Company annual report, DLM Research

Non-Performing Loan composition (%)



Source: Company annual report, DLM Research

Debt Analysis. As at FY14, the bank's total borrowings stood at ₦106.50billion up by 55.71% from the preceding year. The bank's Eurobond debt securities issued in 2014 represents subordinated unsecured tier 2 note of $200 million five-year fixed rate. Interest (coupon) of 8.5% on the notes is payable semi-annually. The yield at inception was 9.0% (issue price of 99.0), at the top of the high 8-9% guidance initially, and the equivalent z-spread over UST around 744 bps.

We note that the bank's loan facility of $7.15 million from Kunnouch holdings has an interest rate that is based on 5% plus 6-month LIBOR for duration of seven years. This may be risky for the bank given that an increase in LIBOR will in turns increase the debt body of the bank. A major relief for the bank in this regards is the embedded derivative option on the loan whereby the Kunnouch holdings has the right to convert all or part of the outstanding principal amount to the bank's share. The current debt level put the bank's debt/equity ratio at 1.96x which is relatively high despite declining from 2.03x from the preceding year.

Strong cash-flow –to- interest on debt reaffirms healthy financing ability. In our evaluation, we take cash flow from operation adequacy as the primary measure of cash sufficiency. We assume all the cash flow from operation would be used to pay off interest on debt, which is not realistically possible for the bank to devote all of its cash flow from operation in this way. However, this ratio is used as a "what-if" scenario as a basis for debt finances ability of the bank. We summarize the bank's cash flows to interest on borrowed fund and discovered that higher cash flow is evidenced on the financial positions of the bank. The bank's interest on debt of ₦4.88billion is lower than it operating cash flows of ₦131.87billion with cash-flow –to- interest ratio of 27.03:1. We considered this to be relatively strong and hence maintain that the bank has strong capacity to cover its debt expenses with its operating cash flow. This showed that the

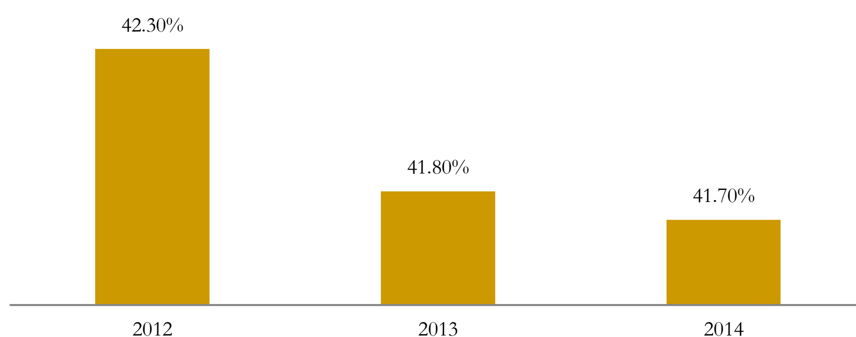
"With cash-flow –to- interest ratio of 27.03:1, we considered this to be relatively strong and hence maintain that the bank has strong capacity to cover its debt expenses with its operating cash flow."

bank is in a healthy financial position and will not default on its debt obligation. The current level indicates that the bank is capable of taking on additional debt.

Liquidity position remains strong despite tight regulation. The bank maintained liquidity ratio of 41.7% in 2014, (FYE'13: 41.8%), although down marginally despite hike in CRR on public and private sector deposits–which is well above CBN regulatory limit of 30%. Hence, we note that the current liquidity level was supported by growth in customer deposits which closed at ₦1.5trillion as at December 2014. Consequently, the bank's ability to fund itself under stress conditions with minimum level of support remains strong. As such, the risk for the bank to renew or replace maturing funding liabilities appears minimal.

"The bank's liquidity ratio declined to 41.7% in 2014 (FYE'13: 41.8%) due to hike in CRR on public and private sector deposits but above CBN regulatory limit of 30%."

Liquidity Ratio (%) 2012-2014



Source: Company annual report, DLM Research

Loan-to-deposit ratios improved on the back of growth in loans. Adjustment to the tightened liquidity and capitalization requirements and the need to boost earnings are all factors that have pushed the bank towards a strong focus on liquid assets. We note that the bank's loan book (loans to banks and customers) has crossed the ₦1 trillion marks compared to its Tier-2 peers. The banks loans to customers grew ~14.80% y/y to ₦791.09billion primarily driven by loans to oil & gas and general commerce. As a result and, loan-to-deposit (L/D) ratio improved to ~70% from 65% in the preceding year–which is a fairly balanced ratio. This remained broadly in line with trend across the banking space despite the CBN's contractionary stance and in the face of weakening macroeconomic indicators. This trend shows that the bank has internal resources that could be transferred to fund growth in earnings. The growth was partly supported by growth in deposits from customers.

Default probability is there but remains at a minimum level. The bank appear to be stable but with uncertainty of financial position and future cash flow in view of challenging operating environment. Hence, default risk appear to be inherent but at a reduced rate given it systemic importance. We note that many things can influence default risk on payment of interest on the bank debt instruments such as falling cash flow from operations which is often needed to make the interest and principal payments, rising interest rates and changes in the nature of the marketplace.

"Default risk appear to be inherent but at a reduced rate."

Hence, to measure the bank's ability to meet its financial obligations when due, the following metrics were deployed.

- **Capitalization Ratio.** The ratio reflects the debt component of the bank's capital structure. The bank's capitalization ratio increased to 0.05x from 0.04x but remain relatively low in our view, indicating investment quality.
- **Debt Service Coverage Ratio.** We pay more attention to this ratio in view of its relative in importance in evaluating the bank's credit condition. Given our evaluation, it is worthy to state therefore that the bank's debt service coverage ratio is relatively strong, increasing to 1.27x from 0.11x in the preceding year which indicates that the bank's operating income is enough to cover 127% of its annual debt payments which in our view signifies a healthy credit quality of the bank.
- **Equity Multiplier.** This measure the financial leverage of the bank. Despite the observed increased in the bank's borrowings, equity multiplier decreased fractionally to 9.25x from 10.94x in the preceding year. The decreasing equity multiplier indicates low financial leverage, which also indicates that the bank's reliance on debt financing is minimal.
- **Interest Coverage Ratio.** The bank's interest coverage ratio is relatively weak, decreasing to 0.55x from 0.83x in the preceding year. The low ICR indicates the bank has less cash available to meet interest payment.

Outlook. We expect the bank to focus on fee earning opportunities and leverage on existing value chain management schemes and deepen penetration of its retail banking offerings to boost earnings. For continued growth and profitability, the bank may continue to drive the implementation of its alternative banking channels such as digital banking which may help to drive down operating costs. We reckon that the main operating strength for the bank lies in improving profit margin. As a matter of fact, the bank needs to implement strategies that will increase the efficiency of its assets to improve its net margin which eased in 2014. Improved operating stability can therefore be expected, as regulatory pressure may ease and banks devote more time to the corporate purpose of building wealth for shareholders.

COMPARATIVE ANALYSIS

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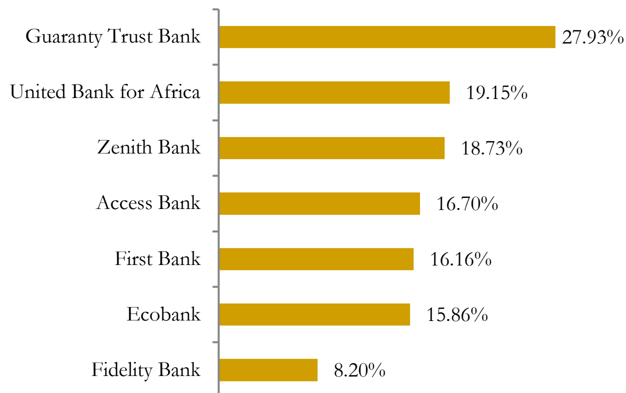
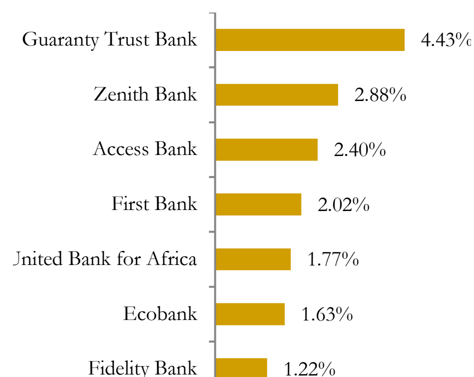
Return on average equity



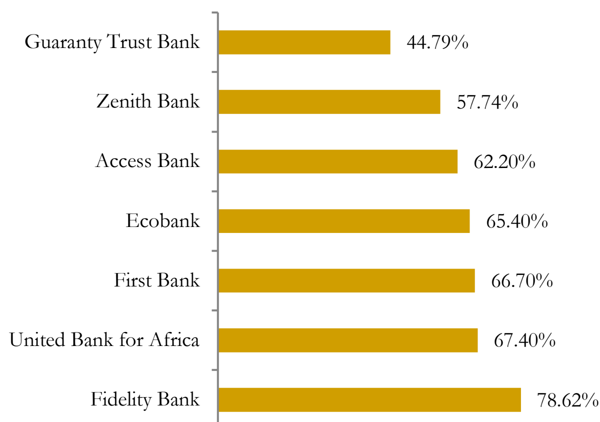
Source: NSE, Company Financials, DLM Research

Return on average assets



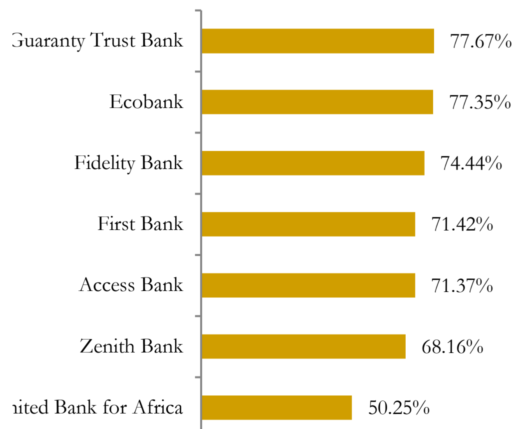
Source: NSE, Company Financials, DLM Research

Cost/income ratio



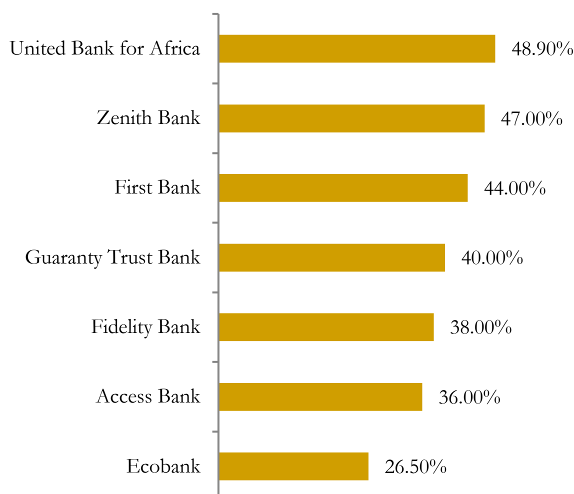
Source: NSE, Company Financials, DLM Research

Loan/deposit



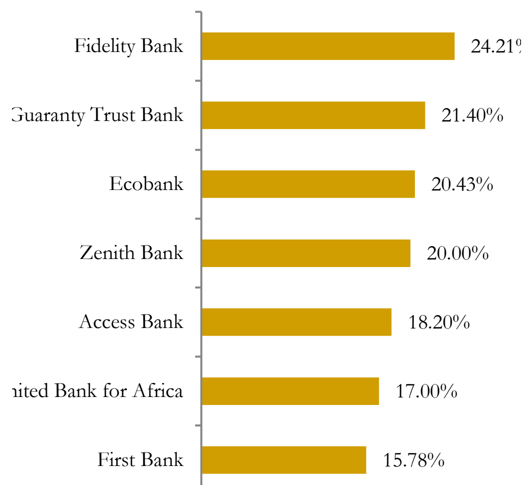
Source: NSE, Company Financials, DLM Research

Liquidity ratio



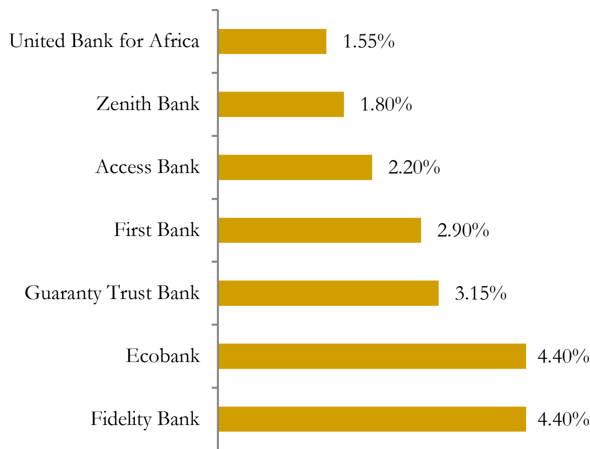
Source: NSE, Company Financials, DLM Research

Capital adequacy ratio



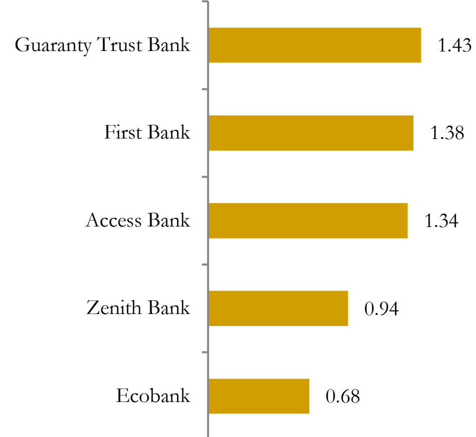
Source: NSE, Company Financials, DLM Research

NPL ratio



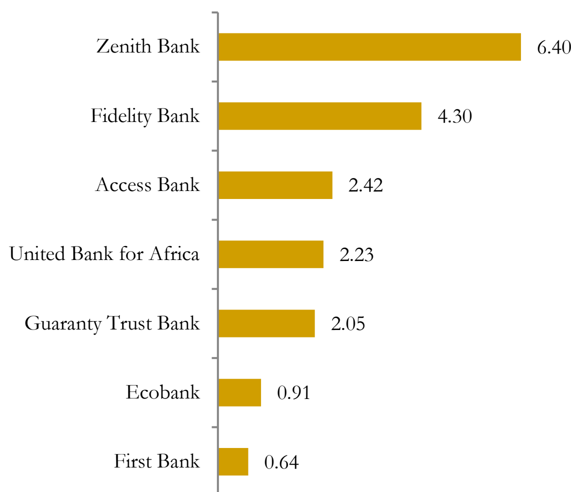
Source: NSE, Company Financials, DLM Research

NPL Coverage ratio



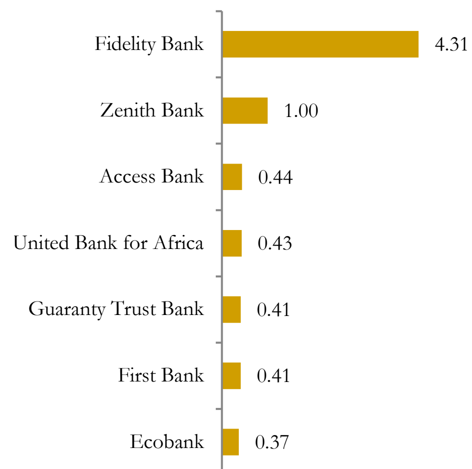
Source: NSE, Company Financials, DLM Research

Debt service cover ratio



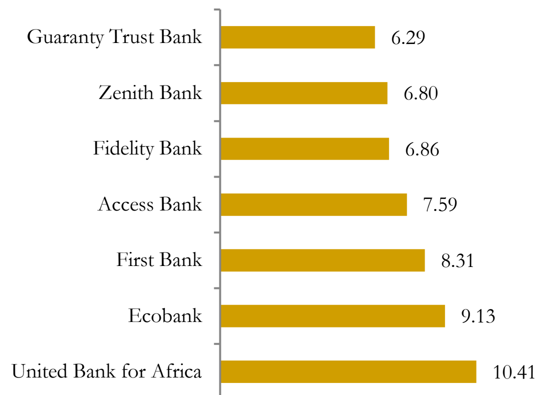
Source: NSE, Company Financials, DLM Research

Capitalisation ratio



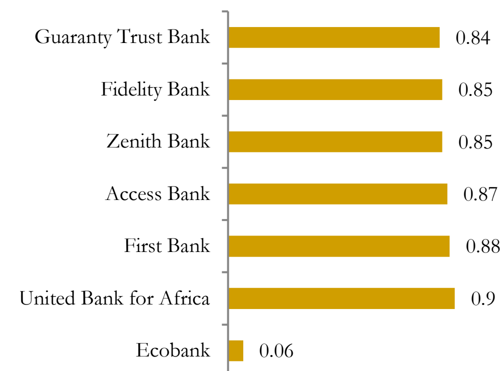
Source: NSE, Company Financials, DLM Research

Equity Multiplier



Source: NSE, Company Financials, DLM Research

Debt/asset ratio



Source: NSE, Company Financials, DLM Research

OVERALL RATING

	Access	Fidelity	FBNH	GTB	Zenith	UBA	ECOBANK
Profitability	Average	Average	Average	Good	Good	Good	Good
Efficiency	Average	Poor	Average	Good	Good	Average	Average
Asset quality	Average	Average	Average	Good	Good	Good	Good
Liquidity	Good	Good	Good	Good	Good	Good	Poor
Debt payment ability	Good	Good	Poor	Good	Good	Good	Good
Capital adequacy	Good	Good	Average	Good	Good	Good	Good

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