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FNB First National Bank

RESEARCH NOTE: JUNE FY 2016

When the going gets tough, the tougher gets going…

FNBB year-end results reflected the rugged operating environment characterized by lower interest rate, central bank moratorium on interest rate which was eventually lifted beginning this year and increased competition. The bank showed its aggressiveness by defying odds as it grew its interest income by 2%. This is despite the current ultra-low interest rate environment in the history of the country. Much of the growth of this line came from the treasury and retail business as the bank stamped its authority in this space. Impairments were within range, growing by 14%, while operating expenses and employee benefits costs appeared to have gone beyond our expectations, jumping 31% and 19% respectively. Reflecting these developments PAT came down 15%, with EPS also dropping by the same margin to 19.81thebe.

Using the relevant valuation techniques, we still maintain our **HOLD** recommendation on FNBB as it is fairly valued at the current price, with a P/E of 15.4x against market P/E of 12.1x and a Price/Book value of 3.1x. The bank has proven itself to focus on efficiency (through innovating products, reliable and convenient service networks) and maintaining a cleaner loan book without compromising its aggressive high yielding advances. We remain positive about the long term view of the bank despite the lower interest rates and the run for market share.

Trading & Liquidity	
Market Cap	BWP7.8bn
Market Cap	US$710mn
Shares in Issue	2,563,700,00
Year End	June
Free Float	26.7%
Current Price	P3.05
12 month high	P3.97
12 month low	P3.04
Target Price	P3.20
Reuters Code	FNBB.BT
Bloomberg Code	FNBB.BG
ISIN No.	BW 000 000 0066
BSE Code	FNBB
RECOMMENDATION: HOLD	

Key Investment themes

- **Stable growth in interest income**

  FNBB has defied odds by growing its interest income at a time when interest rates are at historical lows.

- **Big and quality loan book**

  With a loan book of P14.3bn, FNBB has the biggest loan book in the country. The loan book is also very quality as shown by the lower non-performing loans which sits at around 5.26% of gross advances.

Interest income growing

- **Strong growth in non-interest income**

  FNBB is the only back which is able to cover its non-interest expenses with non-interest income. This is important in this current low interest environment. The bank's wider product offerings as well as the introduction of exciting products in the market has been key in the growth of this line.

- **Strong Leadership**

  FNBB has a strong leadership team with strong banking credentials. The bank has proven to have a successful succession policy with the current CEO being a former CFO at the bank. This allows policy consistency and it's not surprising that FNBB has been the market leader for some time now.

Summary of Income Statement and Balance Sheet

Interest Income

FNBB interest income grew by 2% to P1.3bn (FY15: P1.28bn) at a time when interest rates are at historical lows. On the 12th of August the Bank of Botswana reduced the bank rate from 6% to 5.5%. The last interest rate cut was made on the 6th of August 2015. The cut in the bank rate was always expected given the slow growth of the domestic economy. We expect the Bank of Botswana to remain accommodative through to 2017 by keeping rates at current levels, with little room for further easing.

Bank rate reduced to 5.5%

Although Treasury contributed the most towards interest income 47%, its contribution dropped from 55% the previous year. This is partly due to the lower interest rate environment as well as intensifying competition. Contribution from the retail business increased to 28% from 19% previously, while the business sector contribution came in at 12% from 9% the previous year. Wesbank appears to be struggling as interest income fell to P141.3mn (FY15: P179.2mn). Interest expense was well contained and declined by 12% to P363.6mn (FY15: P415.3mn) as management were more proactive in ensuring that interest cost are well contained.

Treasury the biggest contributor to interest income

Non-Interest Income

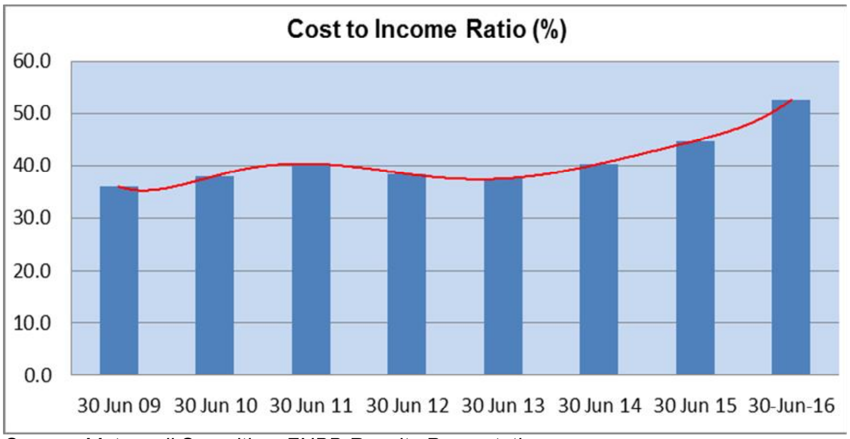
Non-interest income went up by 7% and this was made possible by an increase in transactional volumes with significant growth being recorded on FNBB Connect (94%), Online Banking (16%) and other new product offerings. This growth was complimented by the banks wider customer base of around 480,000, wider product offerings and improved cross selling of a wider product range. Over the years FNBB has been placing more emphasis towards the diversification of its income streams through the growth of non-interest income and this is bearing fruits as seen by the exciting growth in this product line. Already the bank is able to cover all its operating expenses with non-interest income which we believe is a very sustainable business model during this low interest rate environment.

Strong growth in non-interest income

Jump in Operating Expenses

The sudden jump in operating expenses wasn't in line with our expectations. FNBB is known for having the lowest cost to income ratio in the industry. Operating expenses jumped by 31% to P520.3mn, while employee benefit costs came in 19% higher at P439.9mn. This pushed the cost to income ratio to 52.6% from 44.8%. Management attributes the increase in cost to the upgrading of the banks branch network, investments in operating systems, improvements of existing point of sale machines and the rolling out of deposit taking ATM's across the country.

Jump in cost to income



Source: Motswedi Securities, FNBB Results Presentation

It is our view that although this investments and refurbishment exercise comes at a cost, it is important going forward as it will ensure that the bank provides world class services and maintains its competitive advantage. The cost to income is expected to normalise to levels just under 45% once the refurbishment exercise is completed.

Loan Book

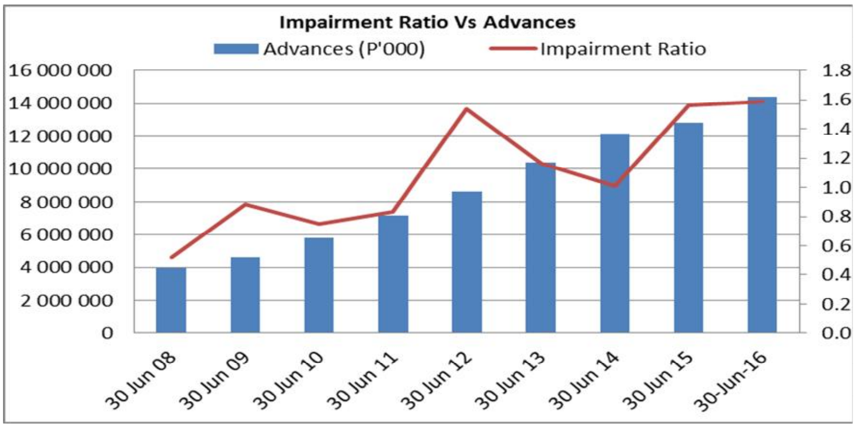
FNBB has the biggest book in the country with a market share of around 28%. During FY16, the loan book grew by 12% to P14.4bn with 65% of that being secured. Advances to the consumer segment constitutes 47% of the total loan book and grew by 33% during FY16. We note an increase in the banks appetite to extend more credit to the retail segment and this might pose a challenge to the bank when interest rates start to increase as this might exert pressure on households incomes which in turn might result in arrears rising if the bulk of the loans are not secured. With a loan to deposit ratio of 84% (FY15: 75%), we expect FNBB loan book to expand at a smaller pace going forward as we don't expect deposits to rise much faster than the loan book. Depositors are likely to the discouraged by the low interest rate environment which discourages saving. Moreover, 67% of FNBB total deposits are from 'Commercial' and RMB space and these are mostly demand deposits.

Strong loan book growth

Impairment and NPL's

Impairments grew by 14% to P228mn. (FY15: P201.1mn). This is not surprising given the operating environment and comes from specific business closures. Further a more conservative approach to portfolio provisioning was introduced as a prudent precaution.

Impairments up but still within range



Source: Motswedi Securities, FNBB Results Presentation

The good news is the impairment charge is still lower and sits at a respectable 1.59% (FY15: 1.56%). The ratio of NPL/ Gross advances however, increased to 5.26% from 4.28% previously.

Profitability

Decline in profitability ratios

FNBB profitability ratios such as RoAA and RoE came out lower at 2.4% and 20.2% respectively from 3.1% and 25% the previous year. This doesn't come to us a surprise given the increasing competitive landscape and decline in profitability due to the low interest rate environment. Although these numbers came out lower, they remain one of the highest in the industry.

Conclusion

There is no doubt that the year 2016 will be another tough year for the local banking sector due to the low interest rate environment, low deposit levels and rising impairments levels. We are however, of the view that opportunities for growth still exist in selective markets ie the SME's, central government and parastatals.

Ratio Analysis

	30 June 2016	30 June 2015	30 June 2014
Cost to Income (%)	52.6	44.8	40.3
RoE (%)	20.2	25.0	34
RoA (%)	2.4	3.1	4.3
Dividend Per Share (thebe)	11	16	16
Dividend cover (times)	1.5	1.4	1.8
EPS (thebe)	19.81	23.25	28.29
Capital adequacy (%)	16.38	18.99	18.27

Source: Motswedi Securities, FNBB Results Presentation

Credit growth slowing

Already we are witnessing a slower growth in credit growth, while arrears in the business and non-financial institutions are increasing. Some of the mines are struggling, while others have closed, exposing some banks to NPL's. More companies are reportedly facing some viability challenges and this is of serious concern to us as it impacts negatively on the growth of the banking sector and the economy at large. Going forward, banks that are more innovative, able to defend and grow their market share, command a healthy loan book with low impairments and have the ability to harness deposits will be able to survive and give acceptable returns to investors. We are confident that FNBB business model is strong although we cannot rule out another dip in earnings during the next financial year.

FNBB SWOT Analysis

STRENGTH	WEAKNESS
• Quality loan book (65% secured) • Strong growth in Non-Interest Income (NII) • Lowest NPL's in the industry	• More exposure to the household sector
OPPORTUNITIES	**THREATS**
• More scope of growth in NII due to a larger customer base and wider product offering. • More opportunities in the SME's sector. • Lowest CIR in the industry	• Pressure on interest margins • Rising impairments • Rising cost to income • Low interest rate environment • Increased competition

Source: Motswedi Securities

Valuation

We maintain our Hold recommendation on FNBB. FNBB P/BV of 3.1 is the highest compared to the industry average of 3. The PE of 15.4x is also on the upside compared to the market weighted average of 12.1x. On the positive side, FNBB still offers above-average returns ie ROE above 20%, which is firmly above competitors. In addition, we like the banks innovation and its wider product range which will continue to support the growth of non-interest income and ultimately profitability.

Maintain a HOLD recommendation

RECOMMENDATION SCALE

Buy	Hold	Reduce	Sell
Sustainable Fundamentals	Balanced	Trading at a Premium	Weak Fundamentals
Strong Opportunities and Growth	Stable Growth	Growth in the long term	Threatened Outlook
Undervalued	Par Valued	Overvalued at current levels	Over Valued

Research
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