CARDINALSTONE

APRIL 2020

Nigeria Banking Sector Update

# SAILING THROUGH THE STORM

# Sailing through the storm

## Executive Summary

The COVID-19 pandemic and oil price shocks have led to costly global economic disruptions. With Nigeria hugely reliant on a well-functioning global economy for trade, and stable oil prices for FX earnings and budget funding, there is a strong probability that the domestic economy will plunge into another recession in 2020. Nigerian banks are hardly insulated from the impact of the shocks, given how intertwined the financial industry is with the workings of macroeconomy. In some ways, parallels are already being drawn with the most recent banking system crises, and the resilience of the sector is being called into question once again.

In our FY'20 outlook report, we highlighted that regulatory concerns, credit creation, movement in the yield environment, and NIR worries were the key issues banks were likely to grapple with in the year. Clearly, the rapid spread of COVID-19, alongside its disruptions to pre-existing economic and socio-cultural dynamics, has expanded the pressure points likely to further strain banks' performances in FY'20.

Market reaction towards risk assets have been largely overwhelming, with investors rotating towards safer havens. Nigerian equities have been beaten, with the NSE banking index losing 25.9% in the last three months. In this report, we compare valuations with those of peers across Middle East and North Africa (oil producers in particular), Sub-Saharan Africa, and Frontier Markets. Our analysis suggests not only a persistent undervaluation, but also a widening valuation discount between Nigerian banks and peers.

We note that the risks remain. Persistent weakness in oil prices could have inimical consequences for banks' exposure to oil and gas. It is unclear how long the COVID-19 pandemic will linger, but a committee of African Finance Ministers has suggested that it could take Africa between two and three years to fully recover from the current economic impact of the viral spread. What is clear, however, is that it is highly probable that Nigeria, like the rest of the world, could be set for another recession in 2020.

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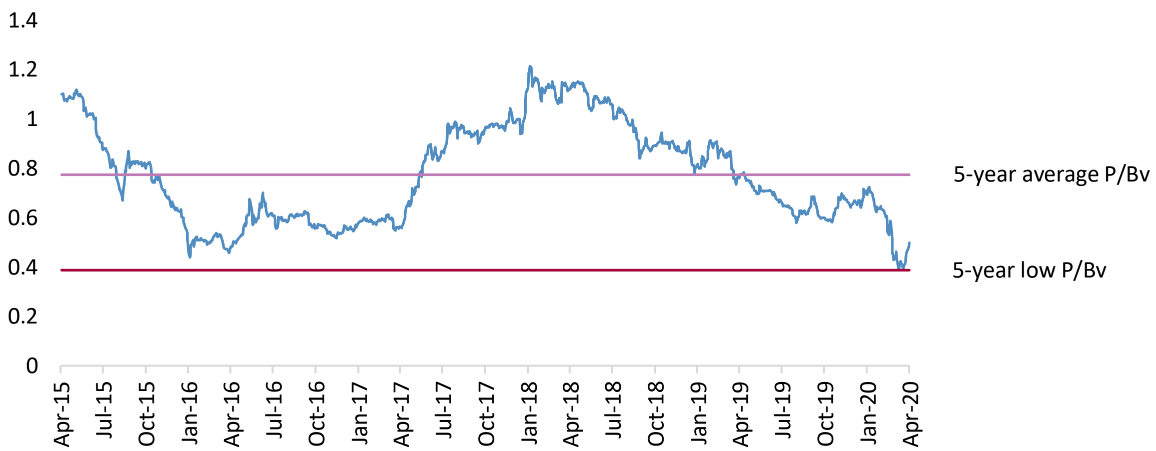
## Nigerian bank valuations have toppled

COVID-19 disruptions and oil price shocks have sent Nigerian bank valuations reeling, with our coverage trading around its 5-year low price-to-book (P/Bv) of 0.40x on average.

**Figure 1: Nigerian banks are trading near historical PB lows**

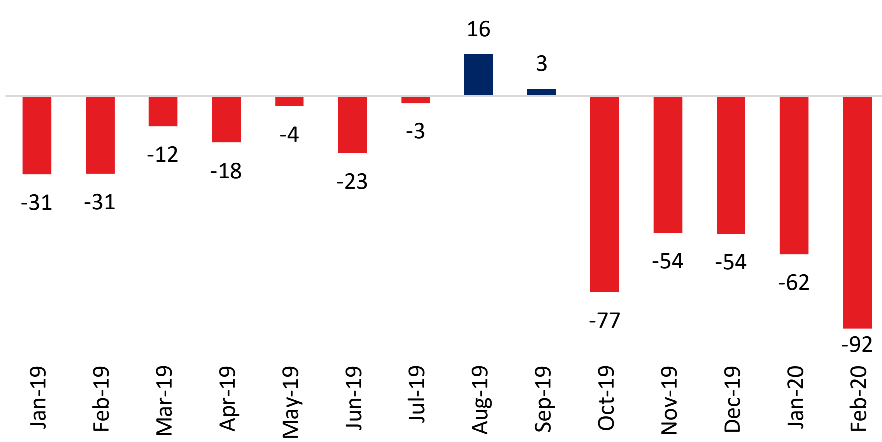



Source: Bloomberg; CardinalStone Research

We see two key drivers for the recent deterioration in valuation of banks:

1. Foreign investors (FPIs) have largely rotated out of risk assets, wary of the impact of COVID-19 and oil shocks. Notably, FPIs were mostly on the sell side before the first COVID-19 case was reported in Nigeria, with net foreign outflows from equities amounting to $154.0 million by February 2020 (vs. $102.1 million for the whole of 9M-19). Since that index COVID-19 case, investors appeared to have extended their rotation into short-dated government instruments to hedge against potential weaknesses in equities and position for possible yield reversals in coming quarters. FMDQ data suggests an 88bps contraction in average spot yields on government instruments with one-month to one-year maturities (vs. -94bps between January and February).

**Figure 2: Net foreign outflows have accelerated in the last few months ($'mn)**




Source: Nigeria Stock Exchange (NSE); CardinalStone Research

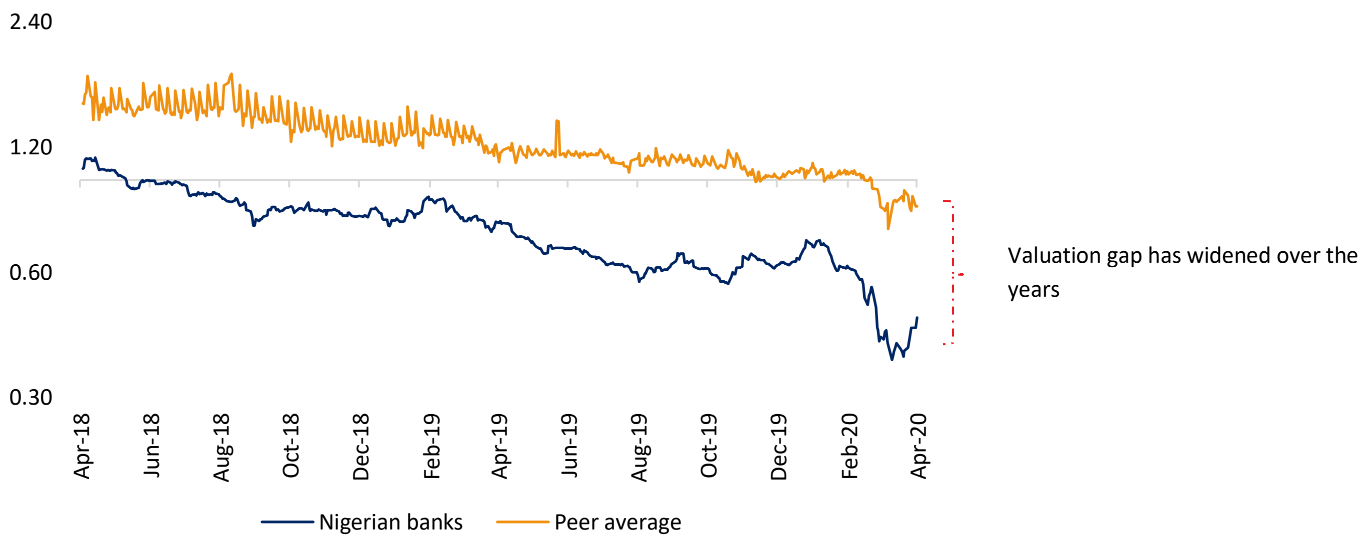
2. Parallels are being drawn between the current COVID-19-cum-oil crises and the oil price shock of 2015/2016, which caused an economic recession and left Nigerian banks stressed. This has possibly heightened aversion towards holding Nigerian risk instruments. While we realise need for caution on account of historical precedent, we note the following:

| Key variables | Commentary |
|---|---|
| **Banks' exposure to oil and Gas** | During the oil price crash of 2015-2016, banks' oil and gas exposure was as high as 22.5%. This has fallen to 19.9% as at December 2019, with restructured loans accounting for a sizeable amount.<br><br>Coordination between OPEC and non-OPEC producers supported oil price recovery from 2016 lows. COVID-19 has expanded demand deficit to c.30mbpd, and it may require more than the 9.7mbpd OPEC+ cut to stabilize the oil market in 2020 |
| **Deteriorating asset quality** | Asset quality deteriorated significantly during the 2008-2010 banking crisis and the 2015-2016 oil price crash. NPLs rose to as high as 38.6% and 15.1% respectively at the peak of the crises. Sector NPL ratio as at December 2019 was 6.0%.<br><br>While NPL ratios could increase in the near term, we view a fatal reversion to previous crises highs as unlikely due to improved risk measures and tighter regulatory framework. Also, the CBN's granting of regulatory forbearance to banks to restructure facilities could also help ease the pressure on banks |
| **Profitability, dividends and capital** | Cost of risk rose 2.7ppts on average across our coverage between 2014 and 2016. However, most banks were able to absorb the hit due to higher pre-provision earnings (average growth of 16.7% YoY).<br><br>A likely slowdown in pre-provision earnings in 2020, due to COVID-19 disruptions, poses the biggest risk to banks' ability to cushion the impact of the expected higher cost of risk.<br><br>A slow build up in reserves, due to weaker pre-provision earnings, and the devaluation implications for risk-weighted assets could stress the capital positions of banks with borderline CAR, forcing a potential decline in dividend pay-outs.<br><br>However, across our coverage, banks are 600 bps on average above the regulatory CAR minimum, increasing their likelihood to withstand shocks to their capital base. |

## Peer comparisons are suggestive of implied undervaluation

Nigerian banks have historically traded at a price-to-book (P/Bv) discount to peers across Sub-Saharan Africa (SSA), oil-producing Middle East & North Africa (MENA), and Frontier Markets (FM). However, over the last 24 months, we note that the valuation discount has widened on average to 52.9% in April 2020 from 29.4% in April 2018.

**Figure 3: Nigerian banks' price-to-book discount is increasing across comparable markets**




Source: Capital IQ; CardinalStone Research

**Figure 4: Nigerian bank peers**

| Ticker | Equity Value ($'mn) | LTM P/Tbv | LTM P/Bv | ROE |
|---|---|---|---|---|
| ACCESS | 585.65 | 0.41 | 0.37 | 17.7% |
| FBNH | 438.03 | 0.26 | 0.25 | 12.4% |
| FCMB | 87.99 | 0.18 | 0.17 | 9.0% |
| FIDELITYBK | 158.05 | 0.26 | 0.26 | 13.3% |
| GUARANTY | 1,375.68 | 0.79 | 0.77 | 31.2% |
| STANBIC | 709.74 | 0.92 | 0.90 | 27.7% |
| STERLNBANK | 103.99 | 0.34 | 0.33 | 9.8% |
| UBA | 550.98 | 0.37 | 0.35 | 16.2% |
| ZENITHBANK | 1,142.18 | 0.47 | 0.47 | 23.8% |
| | | | | |
| Mean | 572.48 | 0.45 | 0.43 | 17.9% |
| Median | 550.98 | 0.37 | 0.35 | 16.2% |
| Minimum | 87.99 | 0.18 | 0.17 | 9.0% |
| Maximum | 1,375.68 | 0.92 | 0.90 | 31.2% |

Source: Capital IQ; CardinalStone Research

## Regression valuation analysis of Nigerian banks versus peers

Using regression analysis, we compare the valuation of Nigerian banks (our coverage) against peers in Sub-Saharan Africa (SSA), oil-producing Middle East & North Africa (MENA), and Frontier Markets (FM). Our regression sample utilises daily P/Bv data and available Return on Equities (ROE) numbers over the last 24 months.

Our analysis suggests that the predictive power of the P/Bv and ROE regression is stronger for the Nigerian banking sector ($R^2$ of 83.5%) and the Frontier Market universe ($R^2$ of 52.0%) compared to MENA ($R^2$ of 1.0%) and SSA ($R^2$ of 33.0%). We, therefore, attempt a forecast of FY'20E P/Bv of the Nigerian banking sector using the regression equation from our Frontier Market analysis. *Our assessment suggests an implied average P/Bv of **0.61x** for our coverage banks vs 0.43x currently.* In arriving at this result, we applied a valuation discount of 30.0%, which represents a reversion to the valuation discount of 29.4% at the beginning of our assessment period. Our lower discount, compared to historical average of 39.3%, takes into account the recent fall in Nigerian risk-free rates (10-year bond yield - December 2018: 15.5%, June 2019: 14.2%, December 2019: 11.3%, April 2020: 12.0%) which could most likely to lead to moderation in the cost of equity of Nigerian banks.

**Figure 5: Frontier Market peers comp valuation**

| Ticker[1] | Equity Value ($'mn) | LTM P/Tbv | LTM P/Bv | ROE |
|---|---|---|---|---|
| Mean | 1,441.21 | 0.90 | 0.87 | 17.6% |
| Median | 1,445.00 | 0.95 | 0.90 | 18.9% |
| Minimum | 350.10 | 0.46 | 0.46 | 8.9% |
| Maximum | 2,844.20 | 1.25 | 1.21 | 28.2% |
| | | | | |
| Intercept: | | | | 0.40 |
| Slope: | | | | 2.63 |
| $R^2$: | | | | 0.52 |
| | | | | |
| Implied P/Bv for Nigerian banks | | | | 0.87 |
| Applicable discount | | | | 30.0% |
| **Adjusted P/Bv for Nigerian banks** | | | | **0.61** |

Source: Capital IQ; CardinalStone Research

[1] See appendix 3 for FM peer constituents

**Figure 6: Regression valuation analysis: Frontier Market peers**


Source: Capital IQ; CardinalStone Research

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### Post-COVID-19 catalysts could induce the necessary repricing

While we acknowledge that there could dire implications from the COVID-19 induced disruption and oil price shocks on banks' performance in FY'20 and, possibly, FY'21, we note critical catalysts that, in our view, could be instrumental to the repricing of banks' valuations when normalcy returns:

| Catalyst | Commentary |
| --- | --- |
| **Enhanced regulatory support** | Having learnt lessons from the last banking and oil price crises, the regulator is likely to play a more proactive role in ensuring financial system stability and preventing bank failure due to the COVID-19/oil price predicament. Granting of regulatory forbearance to banks, extension of moratorium on intervention facilities, strengthening of LDR measures to ensure banks' funding and willingness to provide liquidity backstops as required are already some measures put in place |
| **Stronger loan growth** | Revitalising the economy post-COVID-19 could require significant gross capital formation and banks are likely to play a key role on the back of little or no FDI flows in the first few years of normalcy. Manufacturing, Agriculture, Infrastructure and Healthcare are key areas for potential loan growth. We believe that efforts to de-risk critical sectors of the economy through an interplay of both fiscal and monetary reforms and initiatives will provide the needed stimulant for bank lending |
| **Financial inclusion deepening** | The COVID-19 induced restriction of movement is likely to force banks to accelerate their digital and e-Business strategies in order to render undisrupted services to customers. It is also likely to increase customers' appreciation of the use of alternative physical and digital channels for banking, thus paving the way for deeper financial inclusion |
| **Possible revaluation gains** | While 2020 threatens to be underwhelming for banks' bottom-line, we see a potential bright spot from possible revaluation gains following the recent devaluation of the naira. Our coverage banks are largely positive in their net USD positions and could potentially gain as much as N24.0 billion on average in the event of a 10.0% devaluation of the Naira from December 2019 level. |

## Appendix I: Banks' credit concentration by sectors

**Figure 7: Stanbic IBTC Holdings Plc**

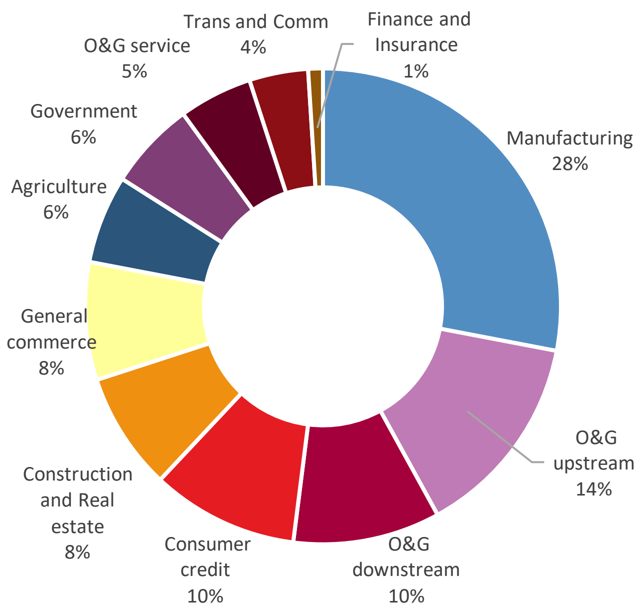



**Figure 8: FBN Holdings Plc**

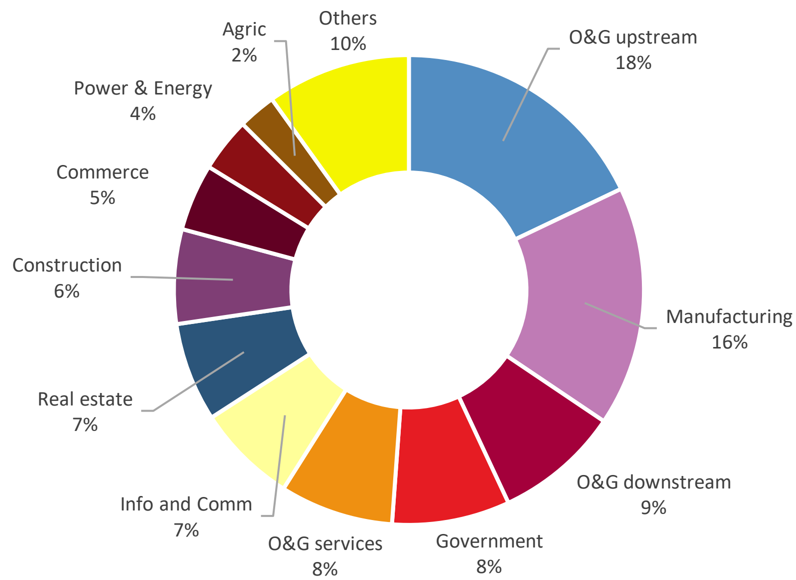



**Figure 9: Fidelity Bank Plc**

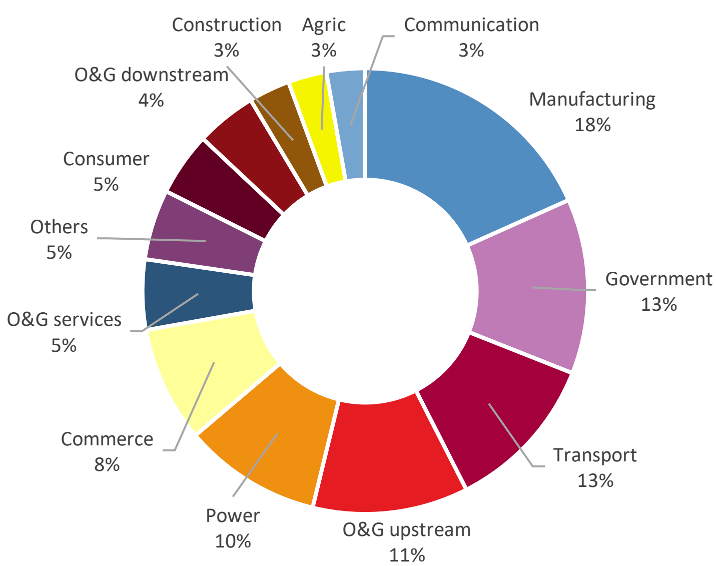
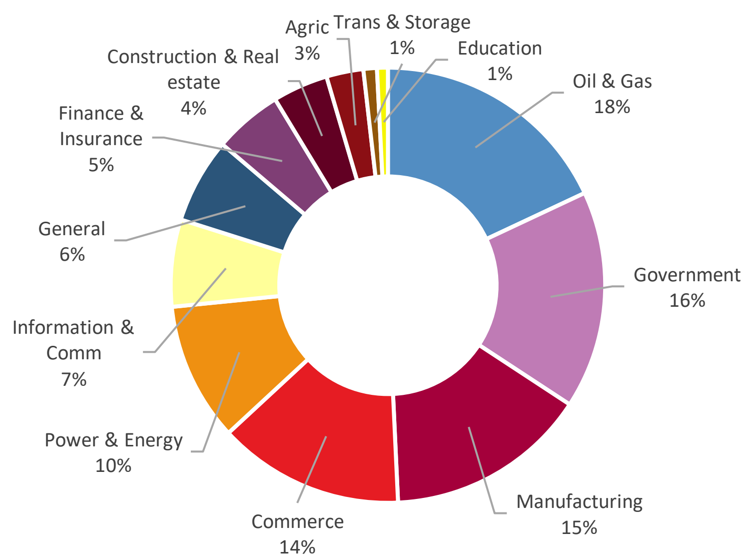



**Figure 10: United Bank for Africa Plc**




Sources: Company filings; CardinalStone Research

**Figure 11: Access Bank Plc**

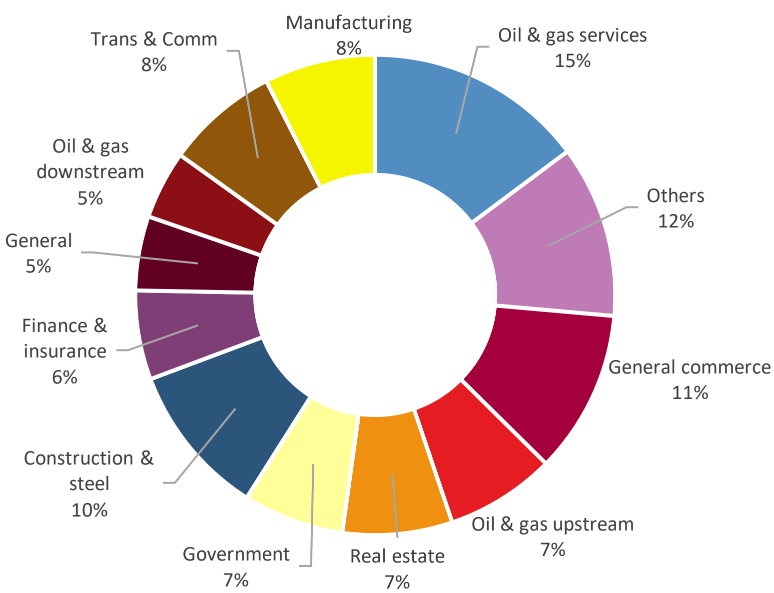



**Figure 12: FCMB Group Plc**

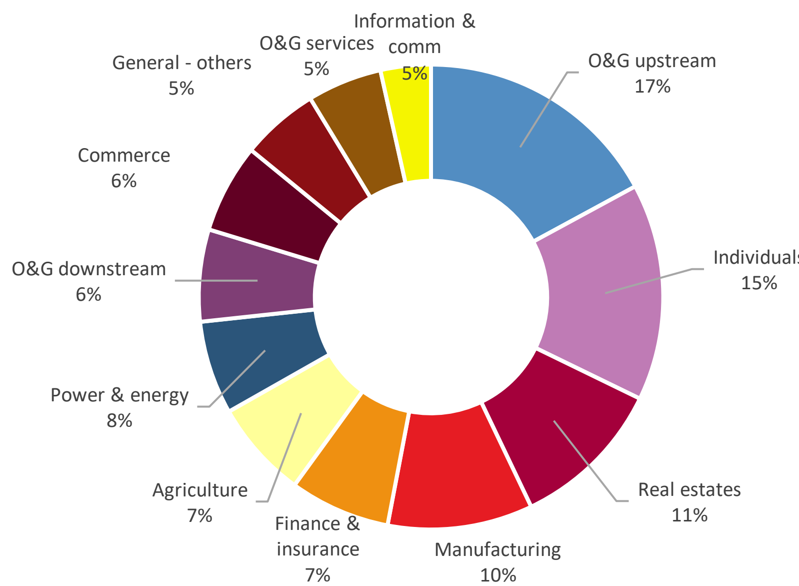



**Figure 13: Guaranty Trust Bank Plc**

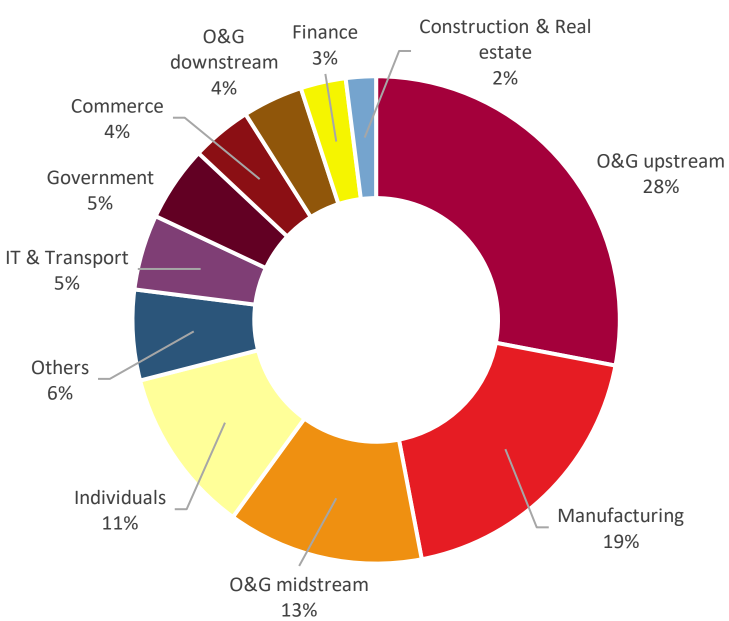
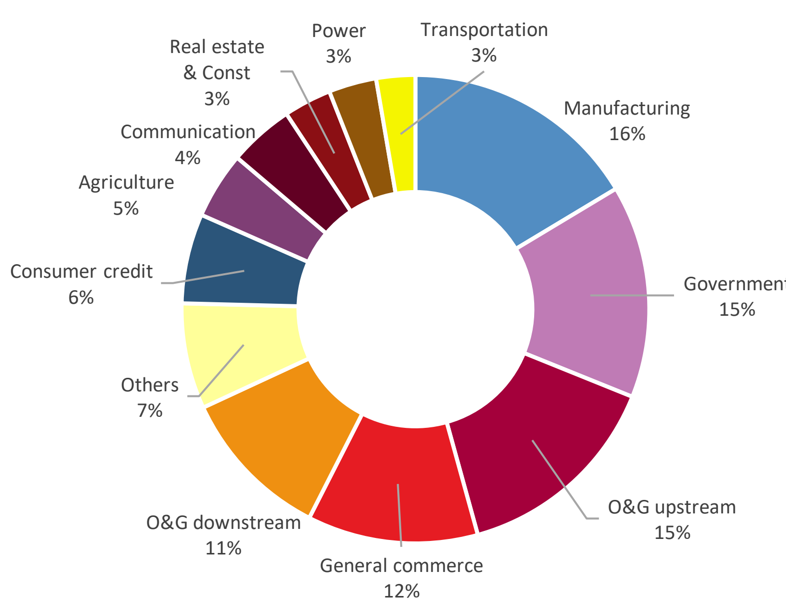



**Figure 14: Zenith Bank Plc**




Sources: Company filings; CardinalStone Research

## Appendix II: Other bank metrics

**Figure 15: Asset quality:** COVID-19 menace/oil price plunge could increase the proportion of banks' stage 3 loans

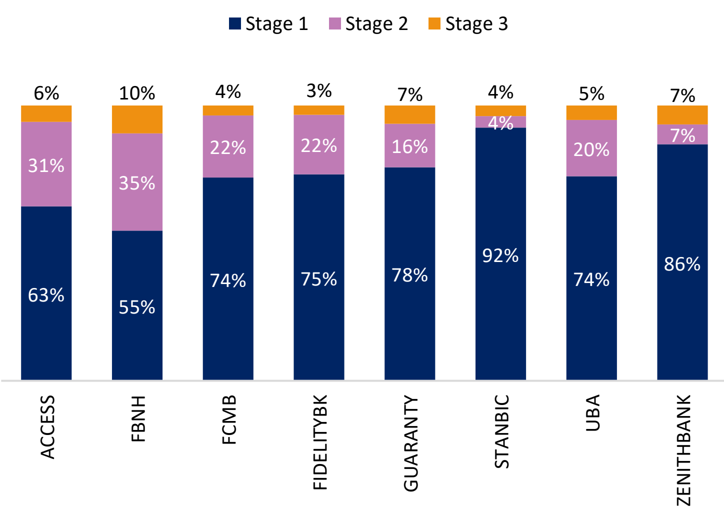



**Figure 16: Capital adequacy:** Banks have built relatively comfortable capital buffers bar a few

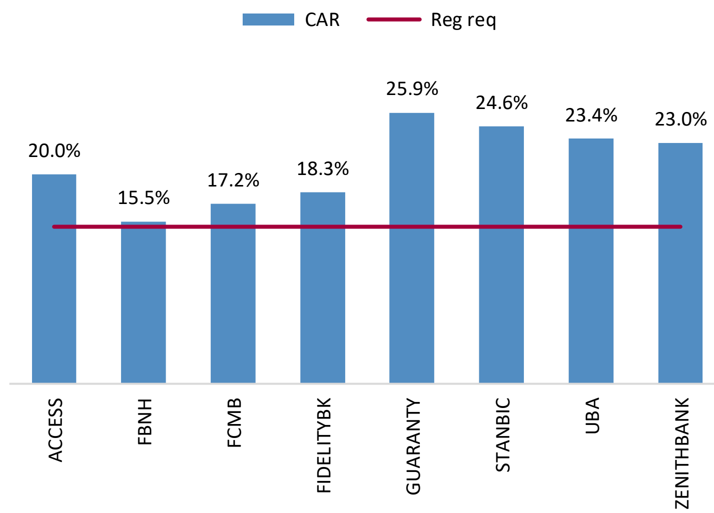



**Figure 17: Cost of risk:** Banks' provision for loan losses is likely to rise on COVID-19/oil price impact

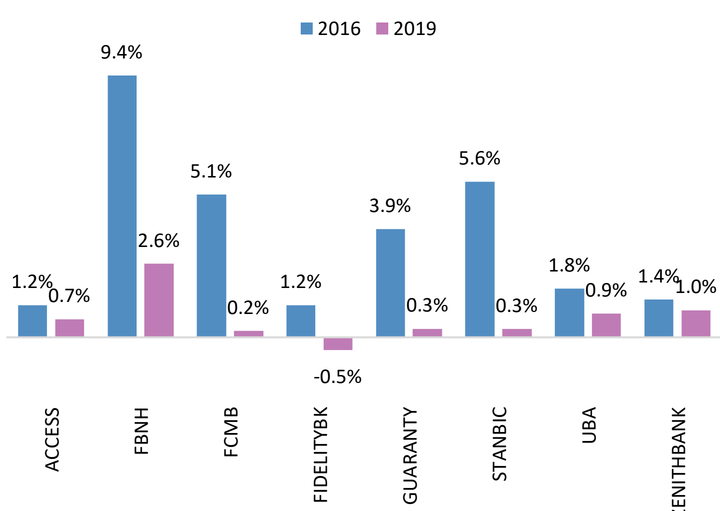
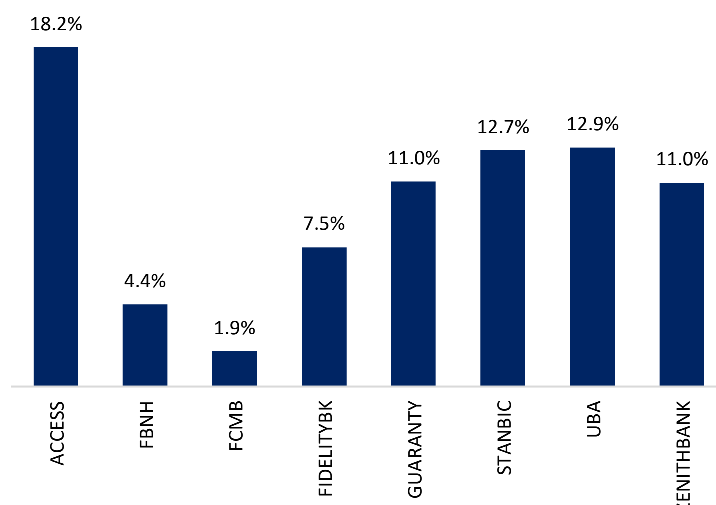



**Figure 18: 5-year pre-provision earnings (PPE) CAGR:** PPE likely to fall on COVID-19 induced slowdown in economic activities




Sources: Company filings; CardinalStone Research

## Appendix III: Peer constituents for Frontier Markets

**Frontier market peer constituents**

| Company | Ticker | Country | Equity Value ($'mn) | P/Tbv (x) | P/Bv (x) | ROE |
|---|---|---|---|---|---|---|
| BRD - Groupe Société Générale S.A. (BVB:BRD) | BVB:BRD | Romania | 1,890.00 | 1.02 | 0.99 | 18.9% |
| Equity Group Holdings Plc (NASE:EQTY) | NASE:EQTY | Kenya | 1,169.30 | 1.21 | 1.13 | 21.8% |
| Asia Commercial Joint Stock Bank (HNX:ACB) | HNX:ACB | Vietnam | 1,391.50 | 1.25 | 1.21 | 24.6% |
| Vietnam Prosperity Joint Stock Commercial Bank (HOSE:VPB) | HOSE:VPB | Vietnam | 1,924.80 | 1.11 | 1.09 | 21.5% |
| Ahli United Bank K.S.C.P. (KWSE:ALMUTAHED) | KWSE:ALMUTAHED | Kuwait | 1,498.50 | 0.91 | 0.91 | 10.9% |
| Tien Phong Commercial Joint Stock Bank (HOSE:TPB) | HOSE:TPB | Vietnam | 596.80 | 1.10 | 1.08 | 26.1% |
| Ho Chi Minh City Development Joint Stock Commercial Bank (HOSE:HDB) | HOSE:HDB | Vietnam | 837.70 | 1.08 | 1.06 | 21.6% |
| Vietnam Technological and Commercial Joint Stock Bank (HOSE:TCB) | HOSE:TCB | Vietnam | 2,484.40 | 0.99 | 0.95 | 18.0% |
| The Co-operative Bank of Kenya Limited (NASE:COOP) | NASE:COOP | Kenya | 690.10 | 0.93 | 0.90 | 18.9% |
| Military Commercial Joint Stock Bank (HOSE:MBB) | HOSE:MBB | Vietnam | 1,586.00 | 0.99 | 0.96 | 21.8% |
| Gulf Bank K.S.C.P. (KWSE:GBK) | KWSE:GBK | Kuwait | 1,790.90 | 0.89 | 0.89 | 9.8% |
| KCB Group PLC (NASE:KCB) | NASE:KCB | Kenya | 1,045.90 | 0.87 | 0.83 | 20.7% |
| Joint Stock Company Halyk Savings Bank of Kazakhstan (LSE:HSBK) | LSE:HSBK | Kazakhstan | 2,844.20 | 0.82 | 0.81 | 28.2% |
| Stanbic Holdings Plc (NASE:SBIC) | NASE:SBIC | Kenya | 350.10 | 0.97 | 0.77 | 13.6% |
| Burgan Bank K.P.S.C. (KWSE:BURG) | KWSE:BURG | Kuwait | 1,594.10 | 0.60 | 0.58 | 8.9% |
| National Bank of Oman SAOG (MSM:NBOB) | MSM:NBOB | Oman | 659.10 | 0.46 | 0.46 | 9.4% |
| Bank Muscat SAOG (MSM:BKMB) | MSM:BKMB | Oman | 2,735.40 | 0.51 | 0.51 | 9.4% |
| Nova Ljubljanska Banka d.d., Ljubljana (LJSE:NLBR) | LJSE:NLBR | Slovenia | 852.90 | 0.48 | 0.47 | 11.9% |
| | | | | | | |
| Mean | | | 1,441.21 | 0.90 | 0.87 | 17.6% |
| Median | | | 1,445.00 | 0.95 | 0.90 | 18.9% |
| Minimum | | | 350.10 | 0.46 | 0.46 | 8.9% |
| Maximum | | | 2,844.20 | 1.25 | 1.21 | 28.2% |
| Standard deviation | | | 721.08 | 0.23 | 0.22 | 6.1% |

**P/BV - Linear Regression Formula:**

| | |
|---|---|
| Intercept: | 0.40 |
| Slope: | 2.63 |
| $R^2$: | 0.52 |

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