FNB NAMIBIA HOLDINGS
1H18 Results Review
May 2018

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FNB Namibia Holdings

1H18 Results Review

Target Price (c)	***4529***
Current Price (c)	4611

Year End 30 June	2016	2017	F2018	F2019	F2020
Net Interest Income (N$m)	1,654	1,765	1,883	2,082	2,323
Non-Interest Income (N$m)	1,507	1,554	1,657	1,823	1,996
Profit (N$m)	1,218	1,113	1,099	1,256	1,441
HEPS (c)	460	419	415	474	544
DPS (c)	213	204	204	228	265
DY (%)	4.5	4.3	4.4	4.9	5.7
P/E (x)	10.3	11.3	11.1	9.7	8.5
P/BV (x)	3.1	2.7	2.4	2.1	2.1

Recommendation	HOLD
NSX Code	FNB
Market Cap (N$m)	12,339
Shares in Issue (m)	267.6
Free float (%)	24
52 week high	4721
52 week low	4611
Expected Total Return (%)	0.7

Source: FNB, IJG, Bloomberg

1H18 Initial Impression

FNB Namibia released its results for the six months ending 31 December 2017. A trading statement from the company dated 31 January 2018 advised shareholders that the group's unaudited earnings for the half year would be down 10% to 15%. Earnings per share for the period fell by 12.5% to 198cps (1H17: 226.3cps), resulting in a drop in the return on average equity to 25.6%. Half year EPS decreased by 0.1% in 1H17, making this the second decrease in half year EPS from a 1H16 peak of 226.5cps. Profit before tax decreased by 11.9% due to an increase in impairments, a tightening net interest margin, and increased costs associated with the funding and integration of Pointbreak and EBank. Profit before tax, normalised for Pointbreak and EBank, decreased by 9%. These results are below our expectations, reflecting a further squeeze in the net interest margin as well as continued cost increases related to risk and compliance staff and IT infrastructure.

Advances grew by 5.8% to N$28.55 billion from N$26.99 billion. Annual PSCE growth came in at 5.1% in December meaning FNB grew market-share over the period. The growth in advances was largely driven by homeloans which grew by 6.3% over the period. Growth in overdrafts (12%) and term loans (9.8%) underpinned advances growth, while instalment credit was reduced by 5.2%. Increased use if investment securities and cash and equivalents was largely due to a combination of decreased demand for credit and more stringent internal practices.

Interest income grew by 12% to N$1.791 billion, while interest expense grew by 24.2% to N$884.7 million. The net interest margin contracted further as a result. The increase in interest expense stems from a large increase in the utilisation of term deposits, as well as the increased use of fixed and floating rate notes as a source of funding. Interest paid on term deposits increased by 42.8%, while interest expense on fixed and floating rate notes was recorded for the full period for the first time in 1H18.

Non-performing loans increased by almost 80% y/y to N$489 million. While this is a rapid rate of increase the ratio of non-performing loans to gross advances ended at 1.7%, which is within management's risk appetite and below the industry average of 2.2%. Impairment losses increased to N$76.1 million or 0.26% of gross advances, well within acceptable levels. Particularly low impairments through the income statement in 1H17 does skew the EPS comparison with that period somewhat.

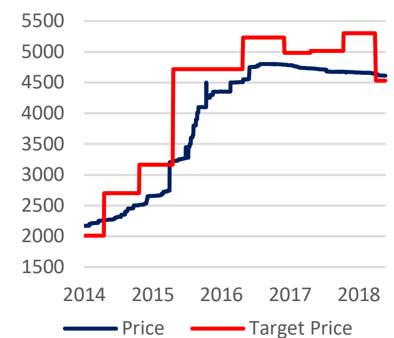
Total operating income was split 51.4% to 48.6% between non-interest income and net-interest income (after impairments). This is a reversal of the prior period results where interest income made up the bulk of total operating income. Non-interest income grew by 12.8% while net interest income (after impairments) fell by 5%. The number of active accounts increased by 6.3% and transactional volumes grew by 8%. Banking non-interest income reflected strong growth in consumer segments but stagnation in the business and corporate consumer segment.

Operating expenses grew by 20.5% as a result of investment in risk and compliance staff and systems as well as the integration of the investment and wealth entities. Excluding the acquired entities would have seen operating expenses grow by 11%. Overall staff costs increased by 20.7% which includes the Pointbreak and EBank related costs for the first time. Much of these cost increases are likely to be once-off step ups with a continued push toward self-service channels which should enable a reduction in overheads over the medium-term.

FNB remains well capitalized with a total capital adequacy of 17.3% (tier 1 capital of 13.8%), up from 17.2 % in 1H17, and well above the regulatory requirement of 10%.

We value FNB on a justified P/B multiple of 2.3x, derived from a sustainable ROE of 24%, a growth rate of 8% (reduced from 9%), and a cost of equity of 14.9%. Our target price, accounting for the performance over the last year and a reduction in the long-term growth rate, has been revised down to **N$c4529** per share. As such we have downgraded our recommendation to a **HOLD**.

FNB Share Price vs Target Price



Dividends

Dividend (interim): 91c/share

Declaration date: 30 January 2018

Ex-date: 26 February 2018

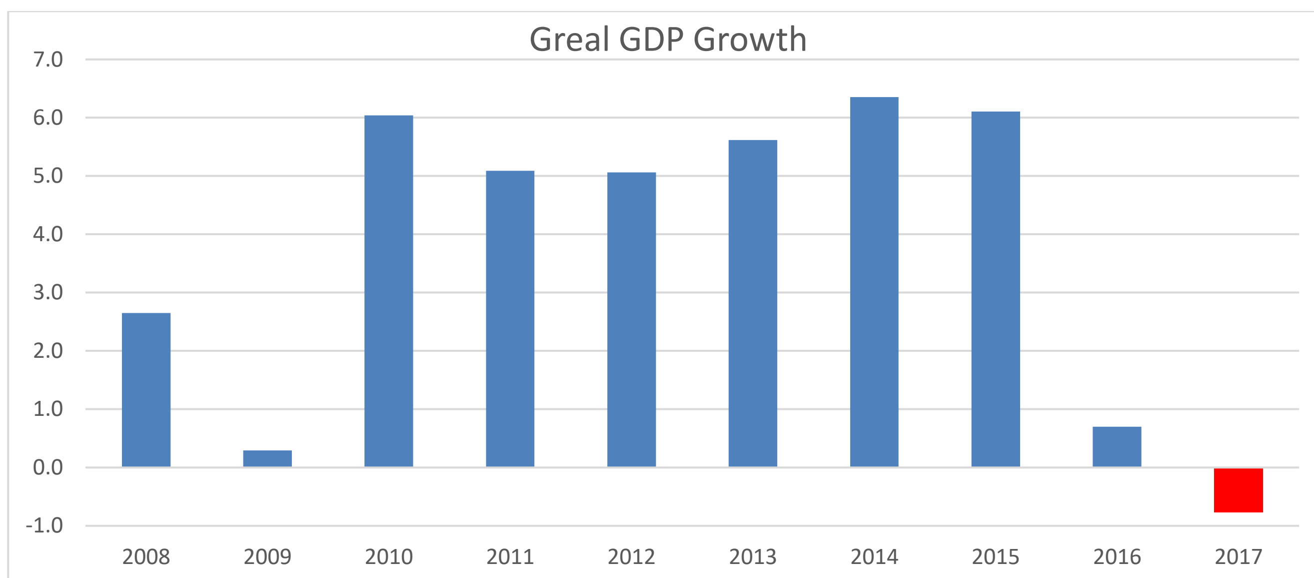
Record date: 2 March 2018

Payment date: 16 March 2018

Banking Macro

Growth environment

The preliminary national accounts for 2017 have confirmed our forecasts for a recession in 2017. Our 2017 Outlook mid-year revision forecasted a contraction of 0.6% for 2017. We revised this figure down to a contraction of 1.3% in our 2018 Outlook released earlier this year. The preliminary national accounts, released in March, show that real GDP contracted by 0.7% last year. Growth for 2016 was revised down from the final national accounts figure of 1.1% to 0.7%.



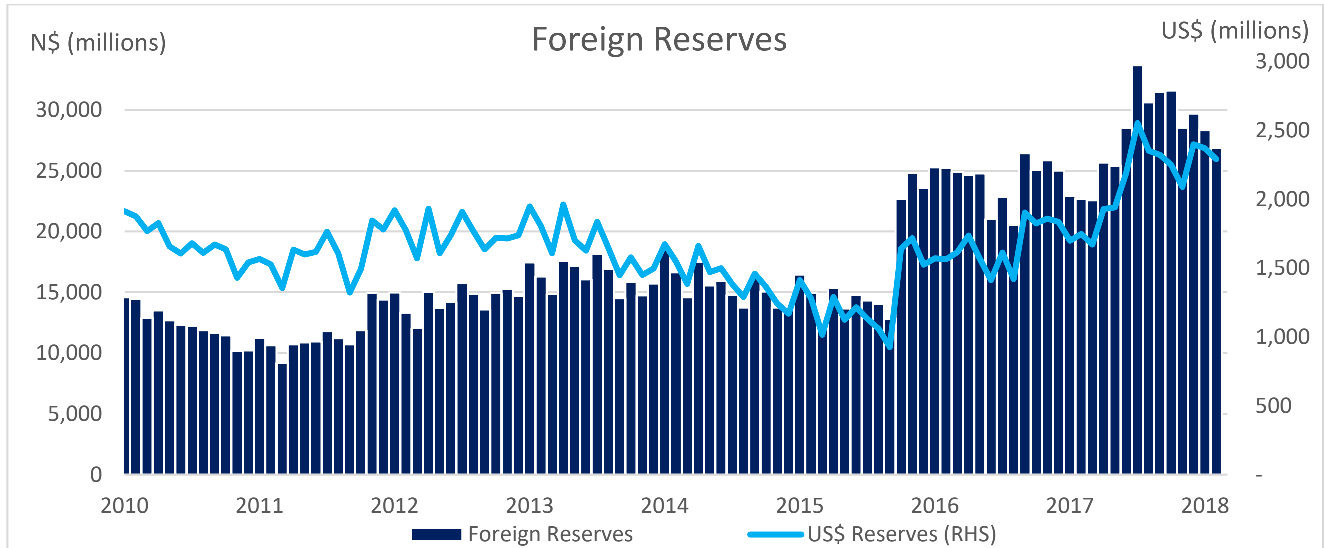
Source: NSA

As banks are leveraged plays on the economy, restricted somewhat by regulation, the macro environment does have a particularly strong bearing on bank profitability. This is evidenced in the recent results from both listed banks in Namibia. This is concerning given our outlook for Namibian growth is muted, due in part to the lack of fiscal space stemming from pro-cyclical policy and continued large fiscal deficits funding government's consumption machine. Private sector growth is expected to slowly gain momentum as policy clarity surrounding NEEEF may free up some investment. However, the growth rates experienced between 2010 and 2015 are unlikely to materialise within the next five years due to the lack of the factors which contributed to that growth previously.

Over the short- and medium-term we expect Namibian growth to remain subdued. This has been factored into our models as it will have an impact on the profitability of the banks in our view. We thus model the medium term on these expectations with surprises in growth largely skewed to the upside.

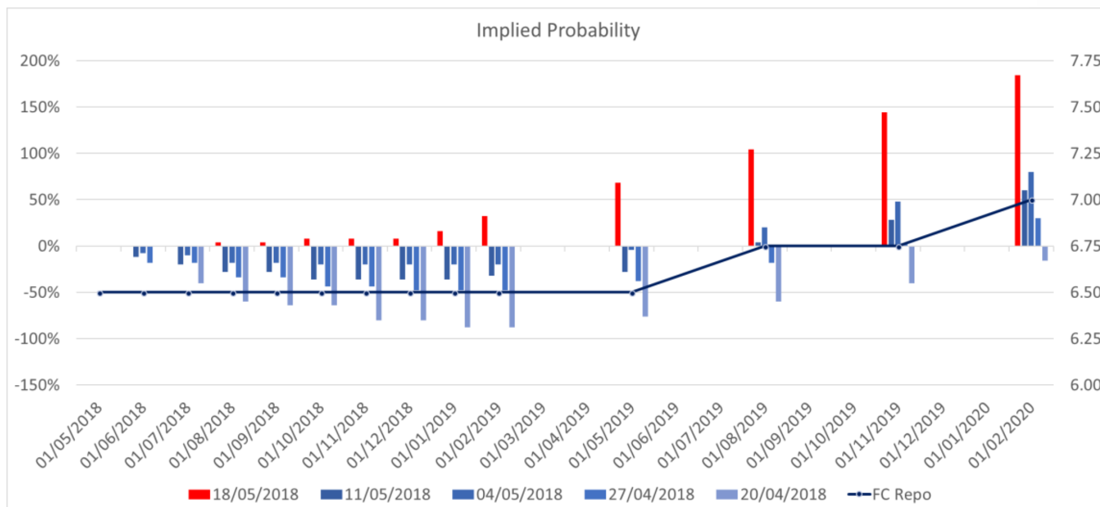
Interest Rates

The interest rate environment has turned from a hiking cycle to a cutting cycle. Both the SARB and BoN cut interest rates by 25bps in the second half of 2017 (1H18 review period). Subsequently the SARB cut rates further by 25bps in March this year. BoN didn't follow this action due to deterioration in the international reserve position over the last few months. We still feel that should the reserve position stabilise BoN would ideally like to cut rates to provide some stimulus to the economy. That said we also feel that a buffer between Namibian and South African repo rates is prudent given the lack of fiscal space and exposure to possible external shocks. We believe the banks would agree with this view.



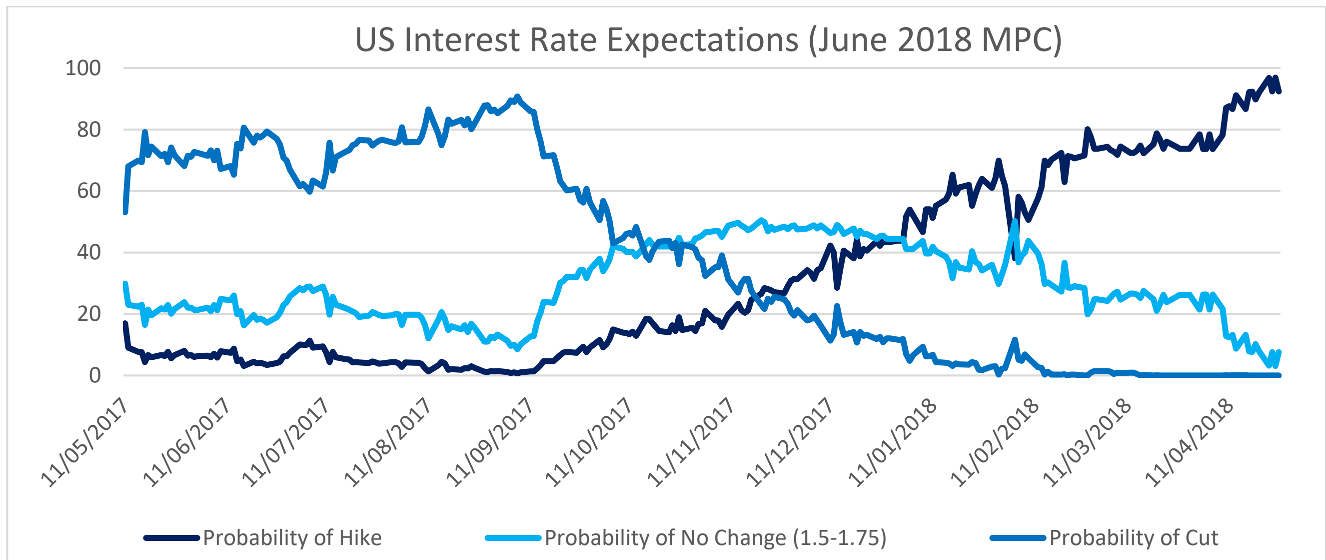
Source: BoN, IJG Securities

Much uncertainty has returned to the South African interest rate outlook. After December's ANC conference and the subsequent resignation of Jacob Zuma as president, expectations were for two interest rate cuts during 2018. Inflation was supportive of this, as it still seems pending the April data release. Additionally, growth in South Africa has been depressed for a prolonged period and thus stimulus was expected. Subsequent to the SARB's March decision the outlook has shifted with increased expectations for no further cuts during the year. The FRA curve is currently pointing to rate hikes in 2019 and a flat 2018 although some experts have called for a hike in 2018. This in stark contrast to the outlook a few short weeks ago where the FRA curve was pointing to a cut later in 2018.



Source: Bloomberg

Much of the uncertainty in the interest rate environment at present stems from expectations for tightening in developed markets, the US in particular. Expectations are for the Fed to hike rates again in June this year with one further hike probable towards the latter quarter of the year.



Source: Bloomberg

United States	Instrument	Futures: Fed Funds - Midpoint	Fed Effective Rate 1.70
1) Overview	2) Future Implied Probability		
Current Implied Probabilities		3) Add/Remove Rates	
Dates: Meeting / Calculation		Calculated 05/22/2018	Based on rate 1.50-1.75

Meeting	Hike Prob	Cut Prob	1.75-2	2-2.25	2.25-2.5	2.5-2.75	2.75-3	3-3.25	3.25-3.5	Fwd Rate
06/13/2018	100.0%	0.0%	72.0%	28.0%	0.0%	0.0%	0.0%	0.0%	0.0%	1.95
08/01/2018	100.0%	0.0%	67.5%	30.7%	1.7%	0.0%	0.0%	0.0%	0.0%	1.96
09/26/2018	100.0%	0.0%	16.3%	58.6%	23.7%	1.3%	0.0%	0.0%	0.0%	2.15
11/08/2018	100.0%	0.0%	14.6%	54.0%	27.5%	3.8%	0.1%	0.0%	0.0%	2.18
12/19/2018	100.0%	0.0%	7.4%	34.6%	40.5%	15.4%	1.9%	0.1%	0.0%	2.30
01/30/2019	100.0%	0.0%	6.7%	31.9%	39.9%	17.9%	3.3%	0.3%	0.0%	2.33

Source: Bloomberg

The UK is also leaning towards tightening, although with less certainty as to the timing of rate increases.

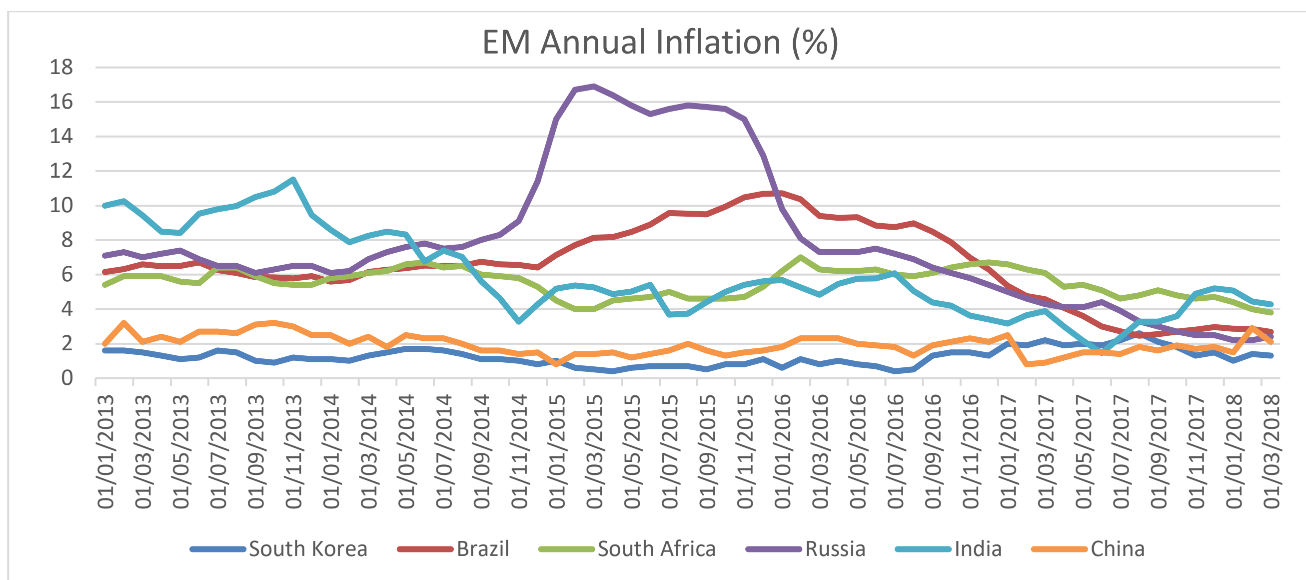
United Kingdom	Instrument	OIS: United Kingdom OIS	Current Rate 0.50
1) Overview	2) Future Implied Probability		
Current Implied Probabilities		3) Add/Remove Rates	
Dates: Meeting / Calculation		Calculated 05/22/2018	Based on rate 0.50

Meeting	Hike Prob	Cut Prob	0.5	0.75	1	1.25	1.5	Fwd Rate
06/21/2018	6.3%	0.0%	93.7%	6.3%	0.0%	0.0%	0.0%	0.47
08/02/2018	45.9%	0.0%	54.1%	43.2%	2.7%	0.0%	0.0%	0.58
09/13/2018	48.8%	0.0%	51.2%	43.8%	4.9%	0.1%	0.0%	0.59
11/01/2018	63.0%	0.0%	37.0%	45.8%	15.7%	1.5%	0.0%	0.66
12/20/2018	65.5%	0.0%	34.5%	45.2%	17.7%	2.4%	0.1%	0.68

Source: Bloomberg

The Euro Zone and Japan are unlikely to be hiking rates in 2018. They are however moving toward tighter policy (normalisation) as well.

The tightening in developed markets (DM) will theoretically impact emerging markets (EM) negatively as the spread between DM yields and EM yields narrow and funds are attracted back into DMs. However Bloomberg data shows that both carry-trades and equities may shrug off Fed tightening. This scenario is more likely in our view in a world where the Trumpian trade policies and tax cuts may offset some of the dollar strength which could be expected from Fed rate hikes. In fact, a weakening dollar and subdued commodities prices such as that of oil have supported low inflation in EM in general, leading to widening real yields which continue to attract DM flows despite the days of easy money drawing to an end.



Source: Bloomberg

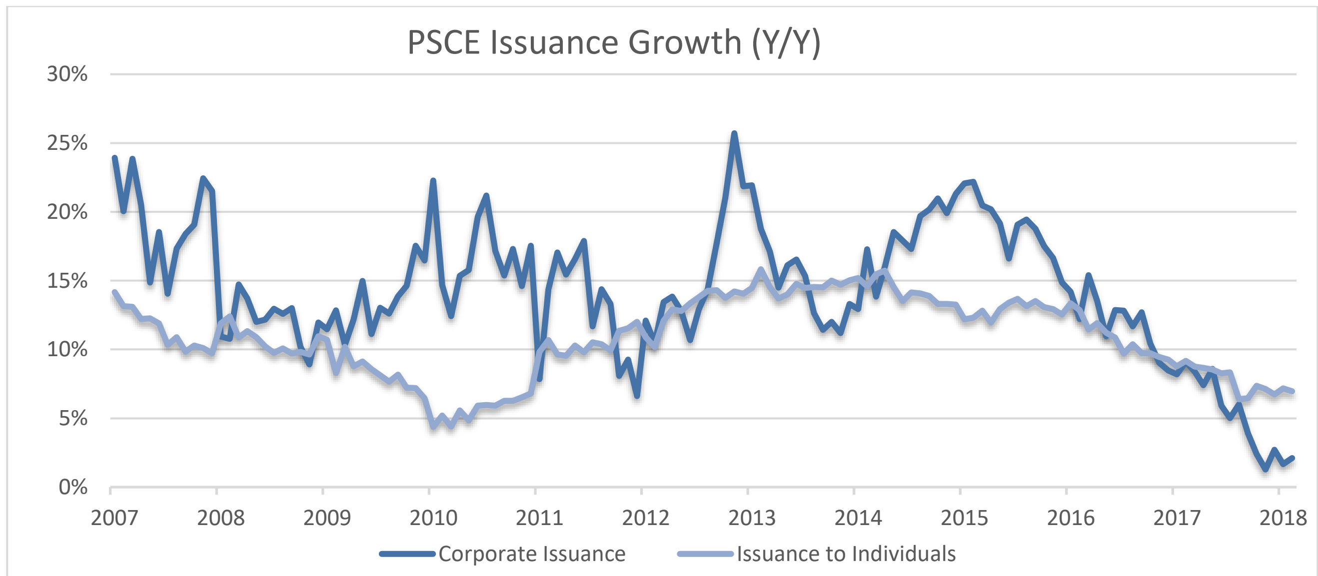
The prior paragraph does make an argument for further monetary easing in South Africa. March annual inflation surprised at 3.8% after the SARB noted that the February post of 4.0% was likely to be a low point. The political environment in South Africa remains a risk however (although materially less so over the short term we believe), possibly still deterring flows and further rand strength. Recent swings in expectations from a cutting cycle to a heightened probability of a rate hike illustrate the amount of uncertainty in the current environment. Some of the initial shocks of US trade policy seem to have been overplayed and the continued strengthening of the US dollar in the last weeks has tempered our expectations for a further interest rate cut from the SARB.

Our expectations are now based on flat interest rates for the remainder of 2018 in both SA and Namibia. The 25bp buffer does provide some incentive for funds to flow back to Namibia, although this has not been very evident thus far. The rate cut in SA means that JIBAR based funding should remain slightly cheaper for the rest of the year.

The increase in liquidity in Namibia post the crunch experienced late 2016/early 2017 has resulted in lower market (TB and NCD) rates which should lead to a marginal improvement in interest margin as the banks roll into cheaper deposit and NCD funding. Stable administered rates for the rest of 2018 mean that there is no further downward pressure expected on the interest margin from a macro perspective.

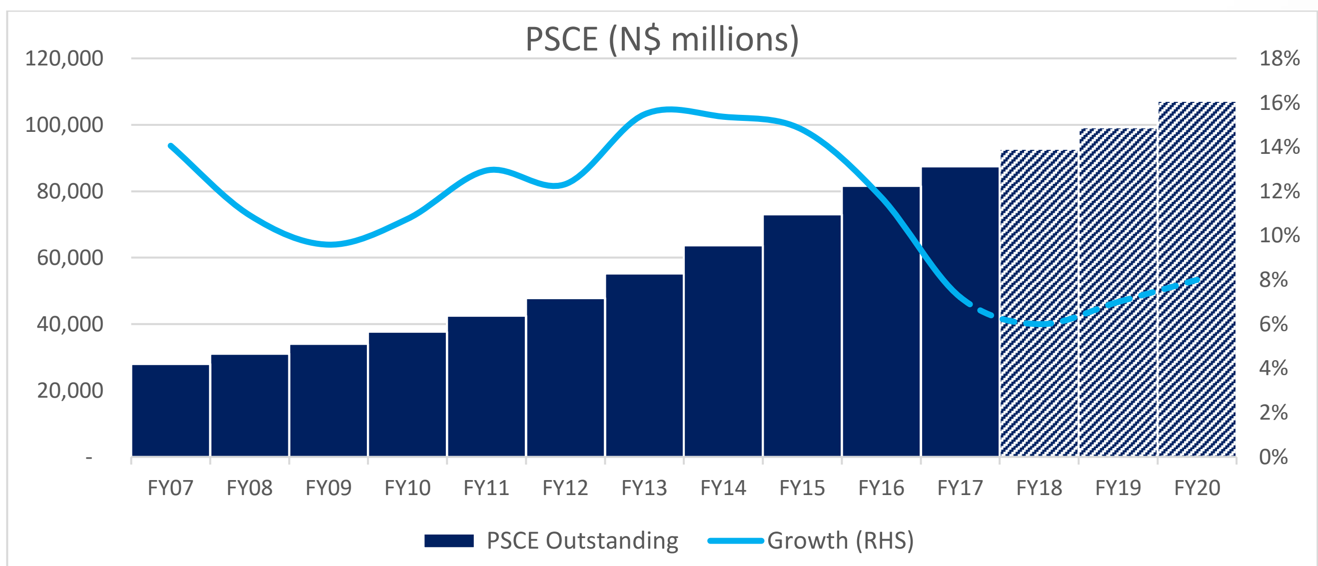
PSCE

Private sector credit extension has slowed considerably over the last year and a half. Credit extension to corporates has come under particular pressure, dropping to low single digit growth. Overall credit extension for the year ended 31 December 2017 grew by 5.2% with corporate credit extension posting growth of 2.7% and credit extension to individuals growing by 6.7%. In general, there were net repayments of instalment credit outstanding with 'other loans and advances' growing at the most rapid rate of the categories. Mortgage loans extended grew by 8.0% y/y.



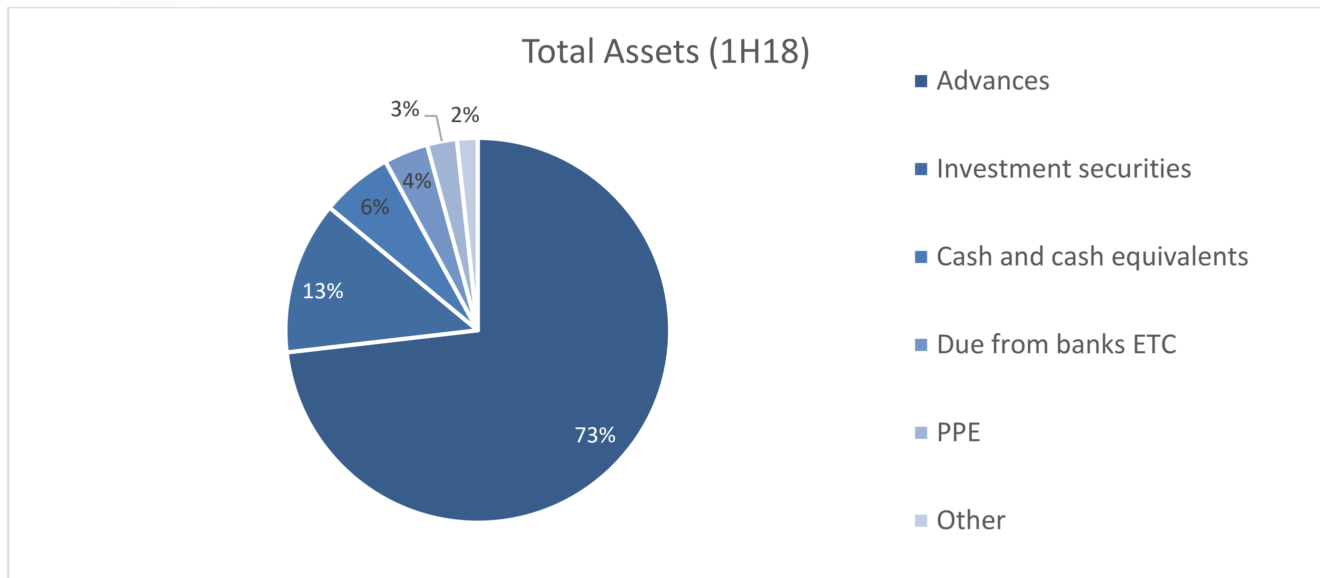
Source: BoN

Our last round of full year results reviews for the banks expected PSCE growth of 8.5% in 2018, 10% in 2019 and 11.5% in 2020 (bank year-end). We have revised this view due to the continued downward trajectory of PSCE over the last six months as well as the subdued economic environment at present. We expect growth to remain subdued over the medium term which should contain PSCE growth somewhat. This will in turn provide some resistance to top line growth in the banking sector in our view.



Source: BoN

Asset Base



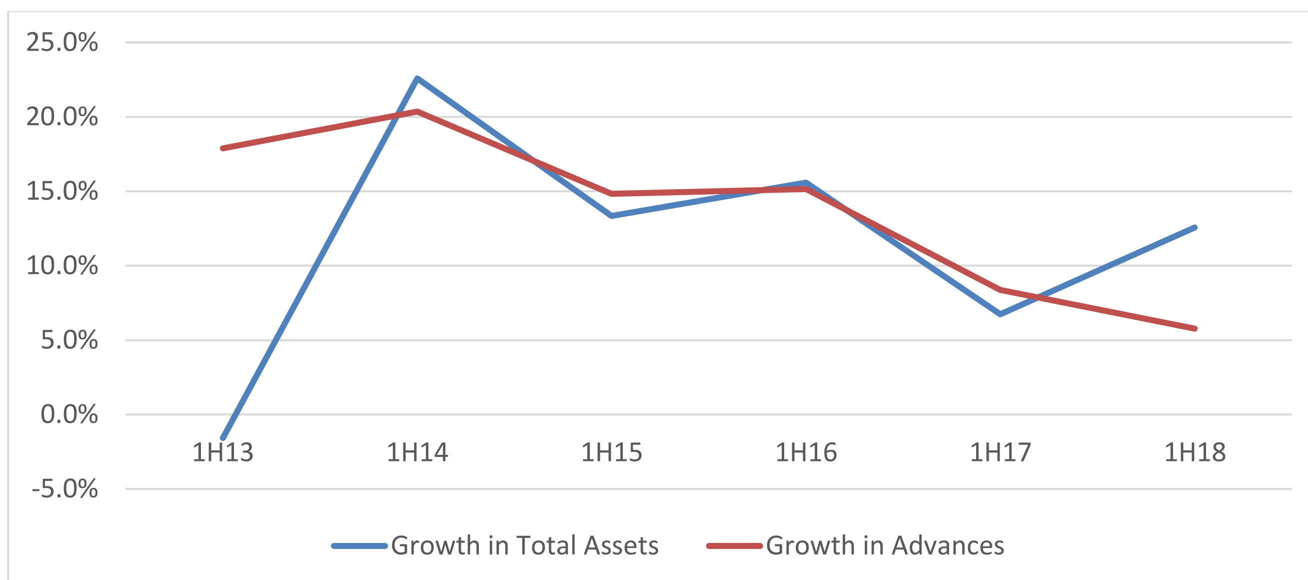
Source: FNB Namibia

Total assets grew by 12.6% y/y in 1H18, while advances grew by 5.8%. Advances growth exceeded PSCE growth of 5.2%, increasing FNB Namibia's share of the market during tough economic conditions. FNB grew their homeloan book by 6.3% y/y, increasing the share of home loans as a component of total advances. Mortgage credit extended by FNB grew at a less rapid rate than the overall market which grew at 7.5% y/y (to individuals and businesses) for the year ended December 2017. FNB has thus not kept pace with the rest of the market in the mortgage/home loans space. This has been a strategic move from management due to the concentration of private sector credit in the mortgage market and the risks that come with such a large exposure. FNB has been much more selective in extending home loans over the last 18 months, focussing on diversifying exposure geographically and into segments where risk is expected to be lower.

Advances Breakdown	***1H17***	***1H18***	***Change***
Notional value of advances	**27,223,500**	**28,880,636**	**6.1%**
Contractual interest suspended	(38,262)	(58,030)	51.7%
Gross advances	**27,185,238**	**28,822,606**	**6.0%**
Category analysis			
Overdrafts and cash management accounts	2,875,644	3,224,383	12.1%
Card loans	266,319	354,413	33.1%
Instalment sales and hire purchase agreements	3,358,320	3,184,947	-5.2%
Lease payments receivable	351,223	298,504	-15.0%
Home loans	12,232,989	13,004,595	6.3%
Term loans	7,368,004	8,086,462	9.8%
Investment bank term loans	478,732	447,309	-6.6%
Preference share advance			
Assets under agreement to resell	43,796	15,511	-64.6%
Other	210,211	206,482	-1.8%
Gross advances	**27,185,238**	**28,822,606**	**6.0%**
Impairment of advances	(190,445)	(270,230)	41.9%
Net advances	**26,994,793**	**28,552,376**	**5.8%**
Impairment of advances	-0.70%	-0.94%	

IJG

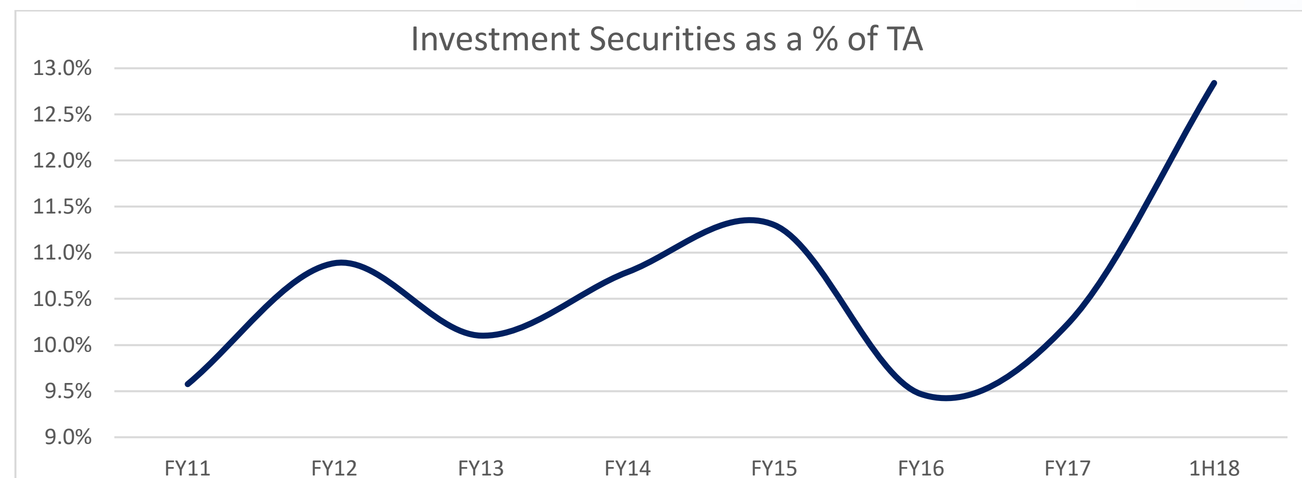
Term loans, the second largest component of advances, grew by 9.8% making up an increased share of total advances (28.1% in 1H18 vs 27.1% in 1H17). Overdrafts and cash management accounts grew by 12.1% making up larger chunk of total advances than instalment sales and hire purchase agreements which contracted by 5.2%. The contraction, and previously, slowdown, in instalment sales is attributed to the heavy contraction in new vehicles sales, down almost 45% from the early 2015 peak. This too is a sign of low consumer and business confidence. Regulatory changes reducing the term of vehicle financing and requiring deposits has added fuel to the fire.



Source: FNB Namibia, IJG Securities

Growth in total assets and advances growth is highly correlated as advances make up the vast majority of assets. The divergence in 1H18 (as seen above) stems from strong growth in other BS line-items such as “amounts due from banks and other financial institutions”, investment securities, and cash and equivalents.

The increase in investment securities as a proportion of the total book is a prudent measure given the current economic environment and the uptick in non-performing loans. Investment securities now make up 12.8% of total assets which should help to reduce the duration of the overall book somewhat as well. The increase in cash and equivalents will aid this further.

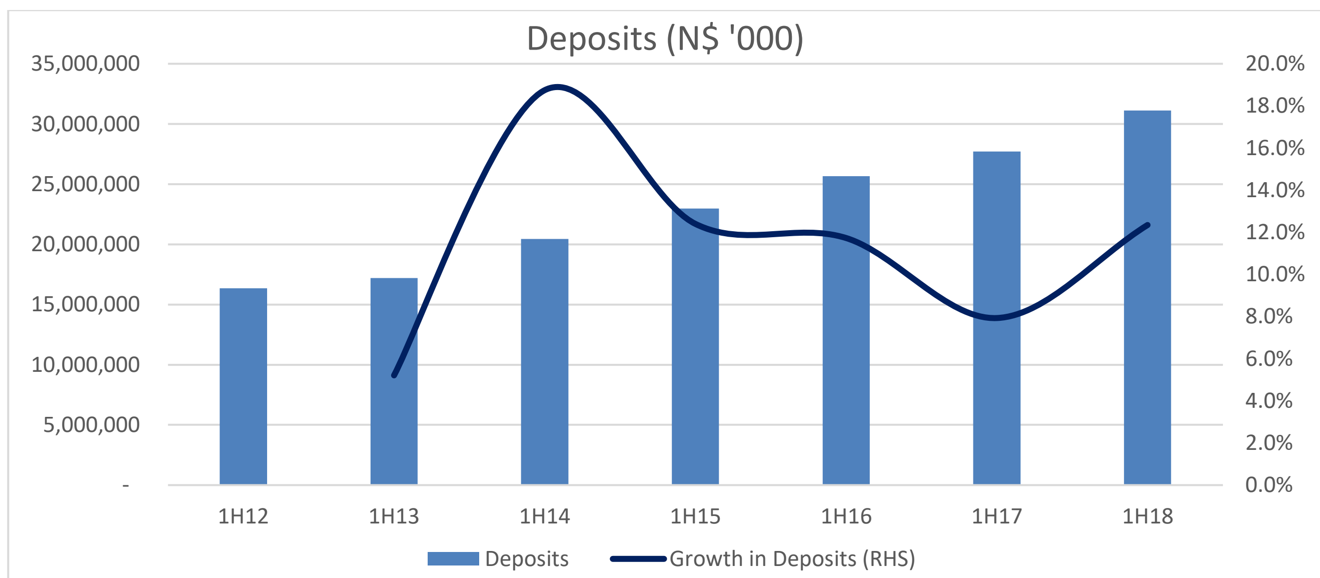


Source: FNB Namibia, IJG Securities

Funding

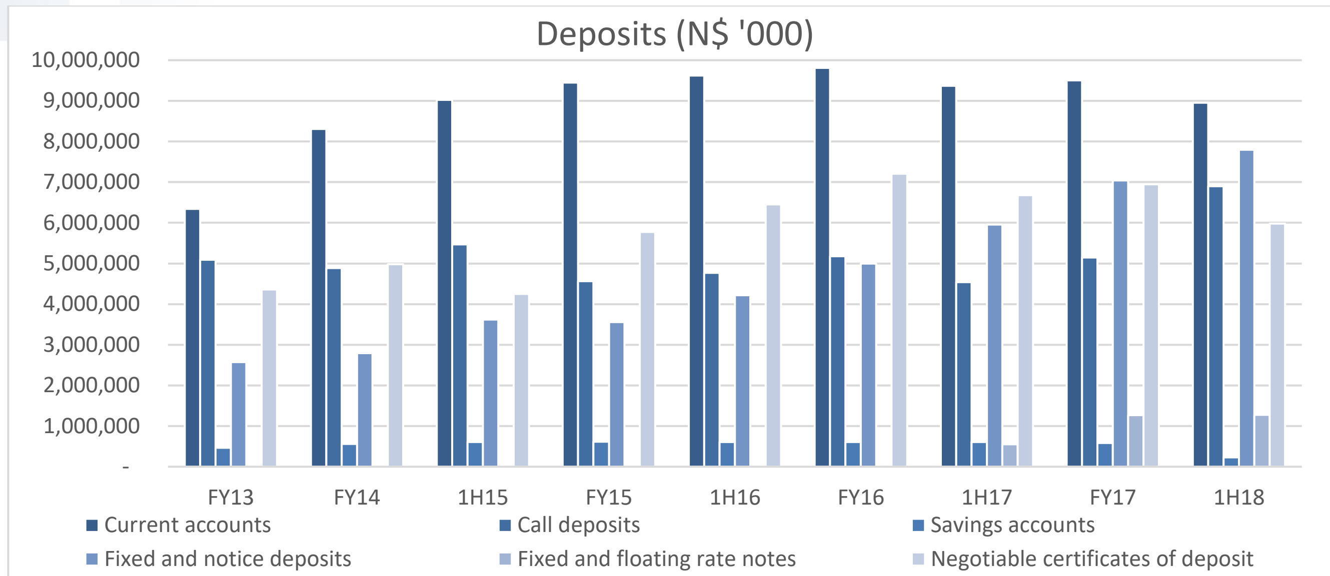
Deposits	1H17	1H18	Change
Current accounts	9,367,179	8,952,950	-4.4%
Call deposits	4,542,742	6,897,210	51.8%
Savings accounts	606,634	225,771	-62.8%
Fixed and notice deposits	5,955,831	7,794,097	30.9%
Fixed and floating rate notes	548,853	1,273,283	132.0%
Negotiable certificates of deposit	6,678,450	5,976,225	-10.5%
Total deposits and current accounts	27,699,689	31,119,536	12.3%
To banks and financial institutions	1,117,884	1,258,244	12.6%
Total	**28,817,573**	**32,377,780**	12.4%

FNB Namibia grew its deposit book by 12.3% y/y for the period under review. This is an elevated rate given the current economic climate and goes some way in showing how effective the bank has been at growing its funding base. The liabilities in this funding mix have been shifting from largely current account based to a more even mix of liabilities. The demand for fixed and notice deposits has increased to become the second largest source of funding over the last year or so. This is a relatively more expensive source of funding (as depicted below) and has had an impact on the net interest margin. The growth in NCD funding has reversed somewhat after peaking in FY16.



Source: FNB Namibia, IJG Securities

Over 80% of the growth in deposits took place during the first half of CY17, which was largely a result of the raising of debt in the domestic and South African markets. This was strategic according to management, with a positive asset/liability impact.



Source: FNB Namibia, IJG Securities

Interest Income and Expenses

Interest and similar income grew by 12.0% to N$1.79bn in 1H17, slower than asset growth but quicker than advances growth, reflecting the shift to lower yielding assets. Interest expense and similar charges grew by 24.2%, resulting in a 40bp contraction in the net interest margin from a high base in 1H17. Net interest income (before impairments) grew by 2.2% y/y, a far cry from the 15.5%, 27.7%, 13.8% growth seen in FY14, FY15, and FY16 respectively. This is however to be expected in an environment where the economic climate has deteriorated significantly, and the use of more expensive funding instruments has increased rapidly.

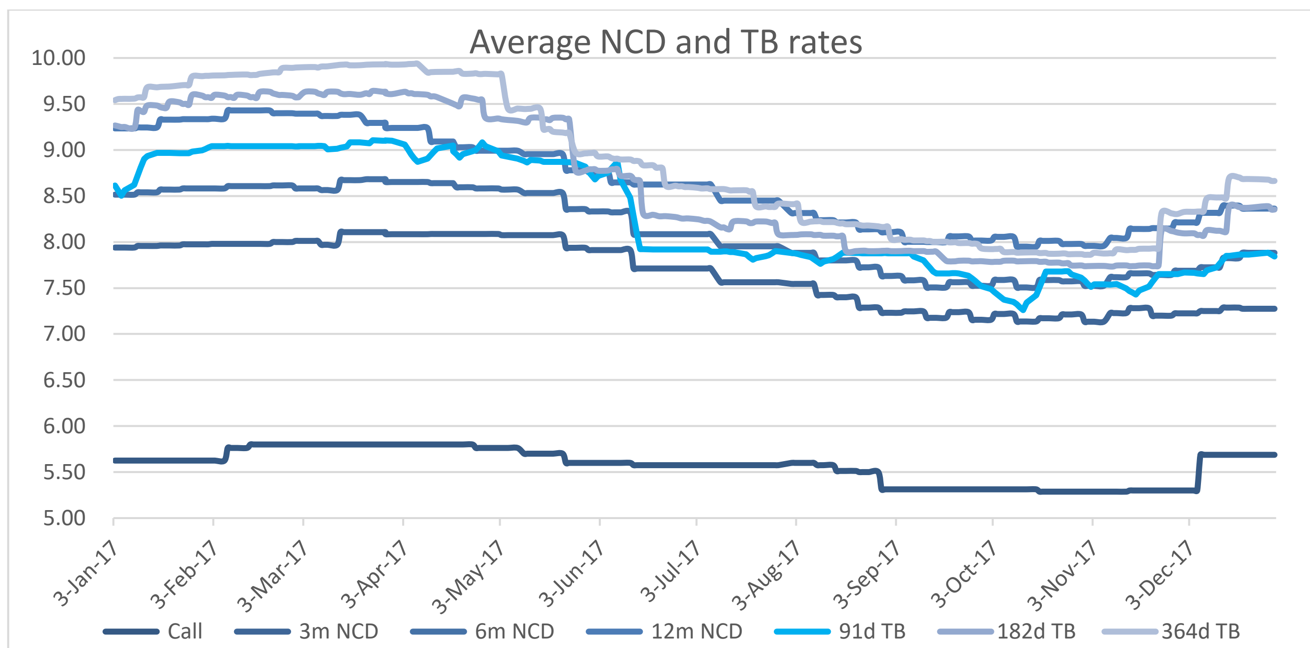
Interest and similar income ('000)	**1H17**	**1H18**	**Change**
Advances	1,412,466	1,522,247	7.8%
Cash and cash equivalents	40,583	51,464	26.8%
Investment securities	131,952	207,372	57.2%
Unwinding of discounted present value on non-performing loans	9,413	9,620	2.2%
Unwinding of discounted present value on off-market advances	1,479	1,317	-11.0%
On impaired advances	(8,122)	(9,302)	14.5%
Net release of deferred fee and expenses	10,345	6,001	-42.0%
Other	649	2,164	233.4%
	1,598,765	**1,790,883**	**12.0%**

Interest expense and similar charges ('000)			
Deposits from banks and financial institutions	(26,056)	(17,858)	-31.5%
Current accounts	(50,147)	(66,909)	33.4%
Savings deposits	(6,886)	(3,388)	-50.8%
Call deposits	(123,410)	(142,405)	15.4%
Term deposits	(191,799)	(273,830)	42.8%
Negotiable certificates of deposit	(286,677)	(297,380)	3.7%
Tier two liabilities	(17,582)	(19,830)	12.8%
Fixed and floating rate notes	(8,855)	(62,959)	611.0%
Other	(655)	(135)	-79.4%
	(712,067)	**(884,694)**	**24.2%**

Interest income from investment securities has grown rapidly, with half year income from this source amounting to N$207.4m, an increase of 57% on 1H17. As these assets have been growing (up 31%), the interest derived from investment securities has become a more important source of interest income. The Interest rate on these securities has also been improving. A simple calculation of the income generated from these sources over the total investment securities portfolio shows a 98bp increase in the rate since FY17, and a 138bp increase since 1H17.

Interest income from cash and equivalents also posted strong growth of 26.8%, consistent with the 25.4% increase in cash and equivalents on the balance sheet. The slightly faster growth in income generated by cash and equivalent assets is likely due to higher rates prior to the 25bp rate cut in August 2017.

Interest rates over the second half of 2017 were generally much lower (over a variety of instruments ranging from TB's to NCDs) than during the first half of 2017 due to the liquidity crunch experienced between October 2016 and April 2017. This decrease in market rates should remove some pressure on the net interest margin although the investment securities and cash investments would give back some yield. The results should be net positive on the net interest margin as term and deposit liabilities exceed the investment assets.



(Graph shows the decrease in interest rates post the rate cut in August. Note rates increasing toward year end with uncertainty surrounding ANC elective conference)
Source: IJG Securities

The major drag on the net interest margin over the period was the increased interest expense recorded from term (fixed and notice) deposits and fixed and floating rate notes. Term deposits increased by 30.9% and the interest expense on these accounts rose by 42.8%. Thus, the use of more expensive funding as well as increased costs on this funding have contributed to the lacklustre growth in net interest income. The costs of funding would have been influenced by the lack of liquidity towards the end of 2016 and early 2017 as much of this funding would have matured in the review period. This means that we have likely seen somewhat of a highwater-mark for funding costs on term deposits in terms of absolute rates, which should contribute to slightly higher growth in the net interest income in FY18 (above the 2.2% recorded in 1H18). This growth is more than offset by the expected increase in impairments though.

The use of fixed and floating rate notes, previously not a factor in the FNB funding mix, has also contributed to the increased interest expenses in a notable manner. As this funding source was not present for much of the prior period the growth in interest expense is not comparable. The inclusion of this funding source for a full year will still impact the net interest margin in the FY18 results, although a proportionally smaller impact than in the 1H18 results.

Impairments

Non-performing loans as a percentage of gross advances has been rising steadily. Our FY17 report noted that this ratio increased from 0.26% to 1.00%. The ratio has risen further to 1.7% in 1H17. Management pointed out that this is still below the industry average of 2.2%. The value of non-performing loans increased from N$272m to N$489m over the year, up almost 80%. Considering the economic slowdown experienced in Namibia over the last 18-months or so the non-performing book is less concerning than expected.

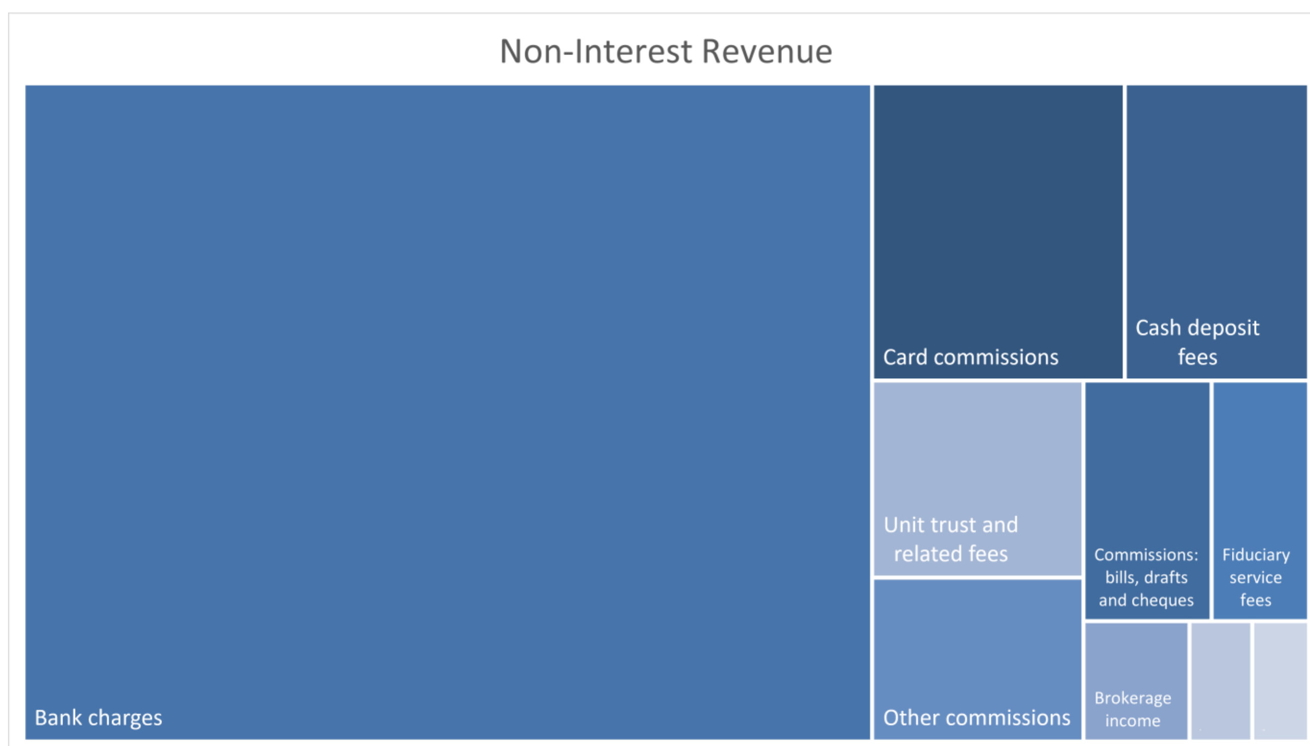
The impairment charge for the period under review was N$76.1m or 0.26% of gross advances which remains well below expectations in our view. Impairments and non-performing loans are within tolerance ranges according to management. There is still very little guidance on IFRS 9 and the impact that this will have on impairments. We do expect an increase, but the magnitude thereof is unclear. Management did mention that there is no threat of recapitalization due to the increase in impairments as a result of IFRS 9.

Our expectations are for a further increase in impairments in the FY18 results. Management indicated that contrary to expectations, NPLs have continued to tick up in 2018, although expected to remain well below the industry average of 2.2%. Our expectations are for impairments to increase to 0.4% of gross advances in FY18. The impact of a potential impairments spike to 1% in our models is N$0.65 off the target price, all else equal. We see this as unlikely during the current period and continue to expect an improvement in the economy contributing to impairments below 0.5% of gross advances over the next three years.

Non-Interest Revenue

Non-interest revenue (NIR) increased by 12.8% to N$878.9m. Included in this figure is an amount of N$37.4m attributable to Ashburton and Pointbreak. Stripping this amount out gives a growth rate of just over 8%, well in excess of the 4.7% growth experienced in 1H17. The results document states that this growth was driven by the consumer segment while NIR from the corporate consumer segment remained flat. Thus, all of the overall NIR growth of 8% was extracted from the consumer segment, further confirming the tough business environment.

Overall fee and commission income benefitted from strong volume growth of 8% according to the results. Electronic channels continued to gain favour as a means of transacting which the group deems a success of their migration strategy to these channels. NIR from consumer segments has been a stable and growing source of revenue for FNB and the early adoption of e-channels are starting to pay off. The reduction in manual branch volumes further affirms the decision to migrate to e-channels. The results note that there may be an opportunity to reduce legacy infrastructure costs, although this is likely to still be some way off in our view. Management are actively looking at reducing legacy cost, covered in the subsequent section.



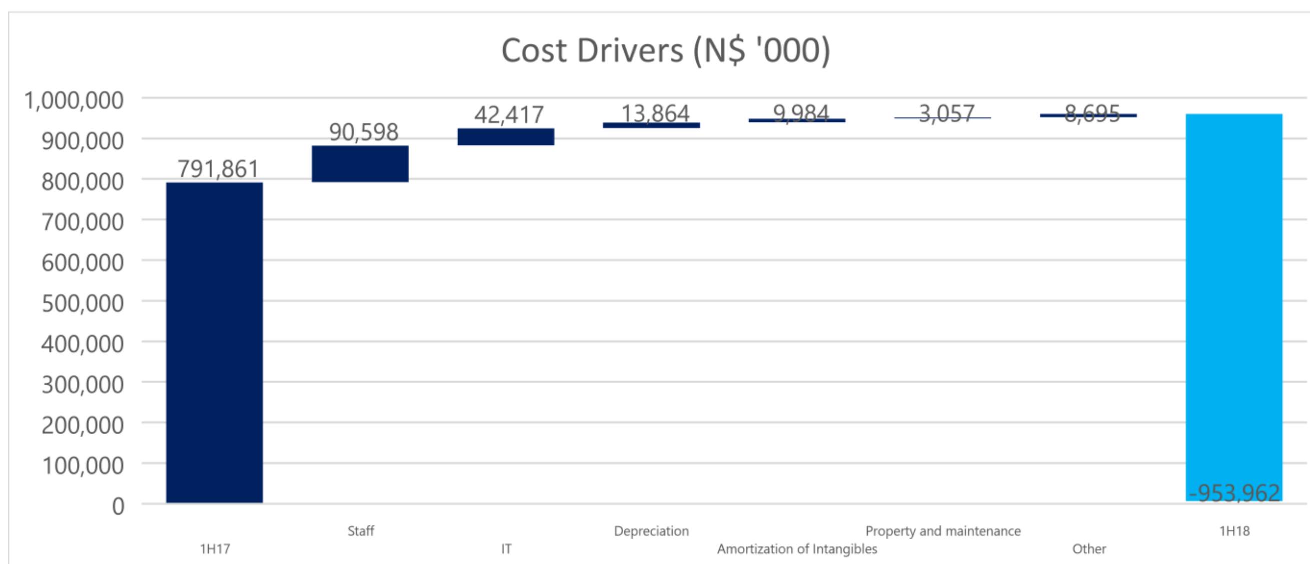
Source: FNB Namibia, IJG Securities

The number of active accounts increased by 6.3% according to the results which means that transactions per active account increased marginally leading to the 8% increase in transactional volume growth. The BoN Banking Fees and Charges report points to FNB accounts not being as expensive as some of the competitors, depending on account type. This suggests that FNB is not pushing the boundaries in terms of fees charged or pricing themselves out of the market. The bank remains competitive on this front as a result.

Operating Costs

Total operating expenses increased by 20.5% in 1H18 versus 1H17. The results point out that cost growth in the existing operations (excluding the acquired entities) increased by 11%. Thus much of the growth in opex is related to the integration and acquisition of the Ashburton and Pointbreak operations and should be a once-off step up as a result.

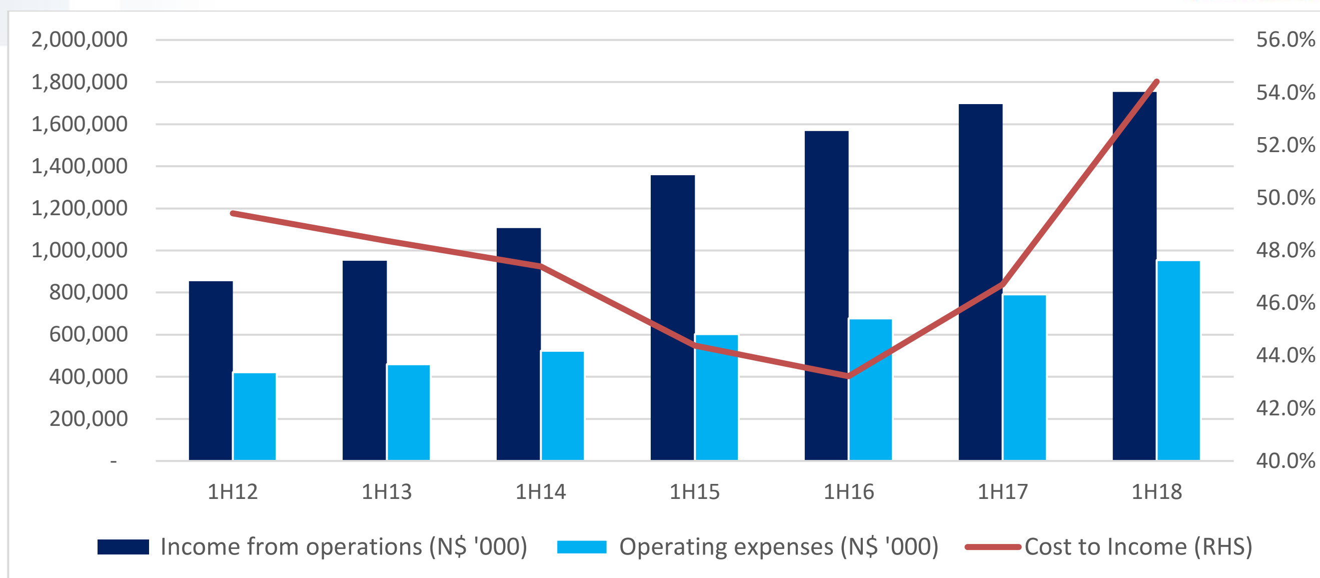
Staff related costs increased by 15%, excluding Pointbreak and EBank. Including these entities total staff related costs increased by 20.7%. The increase in risk and compliance staff was responsible for most of the 15% increase in staff related costs. Average non-managerial salary increases of 7.3% added to the increased staff costs. According to management the step-up in risk and compliance costs have more or less filtered through into the financials and further increases will be related to organic growth. Staff related costs make up more than 50% of total opex and the increases seen over the last year have weighed on results that have been under pressure due to general economic conditions. Staff costs in general are expected to return to organic single digit growth rates going forward.



Source: FNB Namibia, IJG Securities

Computer and processing related costs increased by 38.3%, constituting the second largest driver in opex growth. Most of these costs are step-up increases (unlikely to decrease again) such as the investment in bandwidth and data lines. Management indicated that FNB will continue to invest in expanding capacity related to their electronic banking channels. These channels will facilitate a shrinking physical footprint and a reduction in related costs. An added benefit of growing the use of these channels is to provide cheaper services to customers. This investment should help to reduce cost-to-income in the long run.

The rising cost to income ratio is a function of costs increasing at a rapid rate in conjunction with a slowdown in net income growth. The squeeze has come from both sides and it is our view that this is unlikely to be a long-term trend. FNB has benefitted from a superior cost-to-income ratio in the past and we expect some improvement in this ratio going forward, particularly from FY18 to FY19 (thus still high in FY18). Management pointed to a slow return to 50%, and below, as their target. This does not seem unreasonable. A challenge we do foresee would be an increase in competition from smaller banks with less legacy infrastructure, who may be able to provide similar services for less. These challenges are still some way off however, and FNB is very focussed on remaining competitive.



Source: FNB Namibia, IJG Securities

Capital Adequacy

Capital adequacy remains sufficient at 17.7% for the consolidated group and 17.3% for the banking operations. Banking operations Tier 1 capital improved to 13.8% in 1H18 from 13.4% in 1H17, although down from 14.7% in FY17. Tier 2 capital for the banking operations was 3.5% versus 3.8% in 1H17. Tier 1 capital for the consolidated group improved to 14.4% from 14.2% in 1H17. Total capital adequacy for the banking operations at 17.3% was well above the internal board approved target of 14.2%.

Outlook

The outlook for FNB Namibia remains challenging given the recessionary environment currently plaguing Namibia. Management has also indicated that optimism for a quick recovery has dissipated somewhat. That said, we do expect improvement in economic conditions in Namibia in the latter half of the year, with consumer sentiment leading to some uptick in credit extension. The IJG Business Climate Monitor has returned to flat growth levels indicating that the economy may have bottomed out. While this does not mean that rapid growth is on the near-term horizon, some positive sentiment should come from this.

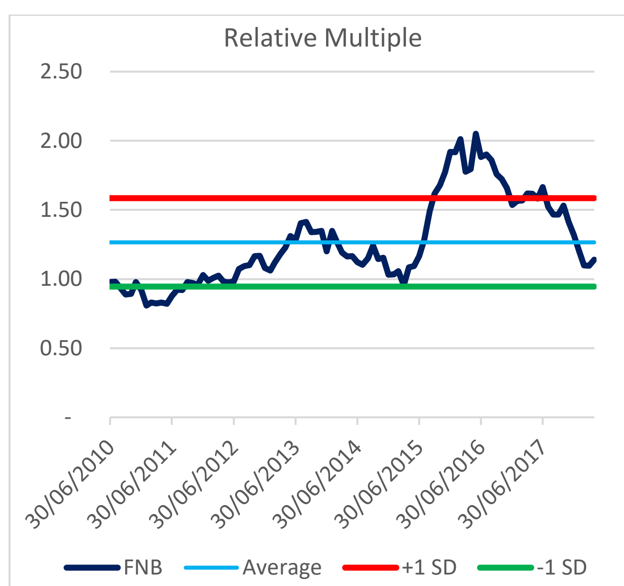
Net interest income growth is likely to remain subdued for FY18 and we see impairment charges offsetting what little growth we do expect. A continued increase in operating costs in order to pursue capacity growth is likely to result in negative bottom line growth and a lower ROE. We expect ROE to bottom out in FY18 at 22.3% Management continue to target an ROE in the 23% to 25% range which we feel is still achievable over the medium term.

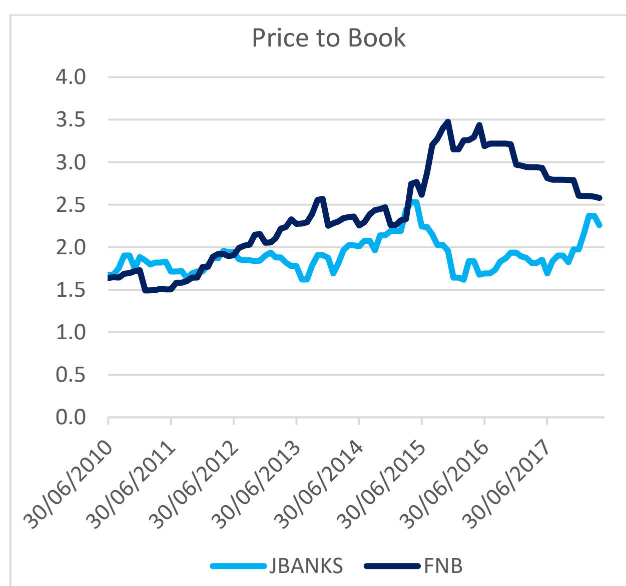
Containing costs and bringing the cost-to-income ratio down to 50% will be critical in maintaining ROE's at 24% (we use the mid-point from management's range). Management have noted that market-share growth will not be pursued at the expense of returns and that liquidity is more important than profitability. Thus, sustainable returns are the objective.

We expect slower advances growth for the FY18 period with an increase in investment securities held on the balance sheet. This is down to lower consumer and business demand for credit as well as prudent measures implemented by the bank in this trying economic environment. Going into FY19 we do expect to see an uptick in PSCE growth and advances extended by FNB. We have moderated our expectations regarding the PSCE growth rate which has impacted the target price. Households have been deleveraging somewhat as per the BoN data, although household debt to disposable income remains well above that seen in South Africa.

Valuation

For the purpose of valuing the company we establish a **cost of equity of 14.9%**, which consist of a risk-free rate of 10.3% (based on the IJG Generic 10-year bond yield), and an equity risk premium of 4.6%. Based on this cost of equity, a highly conservative **long-term growth rate for the company of 8.0% (reduced from 9% previously)**, and a long term sustainable **Return on Equity of 24.0%**, we believe a **Price to Book multiple of 2.3x** can be justified. Given an expected book value per share of 1,943cps in FY18 (revised down from 1,979cps previously), we derive a **target price of N$c4529 per share**. Coupled with an expected 2H18 dividend of 113 cps, we expect a **total return of 0.7%.** As such we downgrade our recommendation to **HOLD**.





Source: Bloomberg, FNB Namibia, IJG Securities

FNB Namibia's price to book multiple has normalised relative to JBANKS from a difference of +1 standard deviation in 1H17. Currently the relative price to book is below the long-term average which is what could be expected given the economic climate in the country. FNB Namibia has historically benefitted from a superior ROA and ROE which justified the relative multiple. This has normalised somewhat although we believe that the long-term ROE target of 24% remains relevant. We adjusted the long-term growth rate down to 8% as we believe this is a better reflection of the maturity of bank and the opportunities available in the Namibian market. This has had a material effect on our target price.

We have adjusted our PSCE growth expectations down to reflect our conservative economic growth expectations. We have taken a similarly conservative approach to our expectations for longer term growth and impairments growth. Overall our expectations are more conservative than before, reflective of the economic climate. As such our target price has been significantly revised and we change our recommendation on FNB Namibia to **HOLD**. The company remains well managed and well capitalised. Should the Namibian economy recover more rapidly than our conservative estimates suggest we see more upside potential to downside risks for FNB.

Target Price		ROE						
		22.5%	23.0%	23.5%	24.0%	24.5%	25.0%	25.5%
Growth	6.5%	3,721	3,837	3,953	4,069	4,186	4,302	4,418
	7.0%	3,833	3,956	4,080	4,203	4,327	4,451	4,574
	7.5%	3,959	4,091	4,223	4,355	4,487	4,619	4,751
	8.0%	4,105	4,246	4,388	**4,529**	4,671	4,813	4,954
	8.5%	4,273	4,426	4,578	4,731	4,883	5,036	5,189
	9.0%	4,470	4,635	4,801	4,966	5,132	5,297	5,463
	9.5%	4,703	4,883	5,064	5,245	5,426	5,607	5,788

Expected Return		ROE						
		22.5%	23.0%	23.5%	24.0%	24.5%	25.0%	25.5%
Growth	6.5%	-16.9%	-14.3%	-11.8%	-9.3%	-6.8%	-4.3%	-1.7%
	7.0%	-14.4%	-11.8%	-9.1%	-6.4%	-3.7%	-1.0%	1.7%
	7.5%	-11.7%	-8.8%	-6.0%	-3.1%	-0.2%	2.6%	5.5%
	8.0%	-8.5%	-5.5%	-2.4%	**0.7%**	3.8%	6.8%	9.9%
	8.5%	-4.9%	-1.6%	1.7%	5.0%	8.4%	11.7%	15.0%
	9.0%	-0.6%	3.0%	6.6%	10.2%	13.7%	17.3%	20.9%
	9.5%	4.4%	8.4%	12.3%	16.2%	20.1%	24.0%	28.0%

Price to Book		ROE						
		22.5%	23.0%	23.5%	24.0%	24.5%	25.0%	25.5%
Growth	6.5%	1.90	1.96	2.02	2.08	2.14	2.20	2.26
	7.0%	1.96	2.03	2.09	2.15	2.22	2.28	2.34
	7.5%	2.03	2.09	2.16	2.23	2.30	2.36	2.43
	8.0%	2.10	2.17	2.25	**2.32**	2.39	2.46	2.54
	8.5%	2.19	2.27	2.34	2.42	2.50	2.58	2.66
	9.0%	2.29	2.37	2.46	2.54	2.63	2.71	2.80
	9.5%	2.41	2.50	2.59	2.69	2.78	2.87	2.96

Summary Income Statement

Year End June (N$ 000)	*FY16*	*FY17*	*FY18*	*FY19*	*FY20*
Interest and similar income	2,869,473	3,285,633	3,430,168	3,652,918	4,131,858
Interest expense and similar charges	(1,215,842)	(1,521,032)	(1,547,383)	(1,570,900)	(1,809,206)
Net interest income before impairment of advances	1,653,631	1,764,601	1,882,786	2,082,018	2,322,652
% Growth	*13.8%*	*6.7%*	*6.7%*	*10.6%*	*11.6%*
Impairment of advances	(47,852)	(59,251)	(120,599)	(129,041)	(139,364)
Net interest income after impairment of advances	1,605,779	1,705,350	1,762,187	1,952,977	2,183,288
Non-interest revenue	1,506,656	1,553,954	1,656,526	1,823,409	1,995,699
Net insurance premium income	189,253	182,902	201,192	221,311	243,443
Net claims and benefits paid	(102,777)	(103,678)	(100,596)	(110,656)	(121,721)
Income from operations	3,198,911	3,338,528	3,519,309	3,887,042	4,300,708
% Growth	*17.0%*	*4.4%*	*5.4%*	*10.4%*	*10.6%*
Operating expenses	(1,417,647)	(1,663,061)	(1,883,197)	(2,018,852)	(2,157,542)
Net income from operations	1,781,264	1,675,467	1,636,112	1,868,190	2,143,166
Share of profit from associate after tax	1,328	2,515	2,515	2,515	2,515
Income before tax	1,782,592	1,677,982	1,638,627	1,870,705	2,145,681
Indirect tax	(31,974)	(40,767)	(45,659)	(51,138)	(57,275)
Profit before tax	1,750,618	1,637,215	1,592,968	1,819,567	2,088,406
Direct tax	(532,985)	(523,984)	(493,820)	(564,066)	(647,406)
Profit for the period	1,217,633	1,113,231	1,099,148	1,255,501	1,441,000
% Growth	*21.9%*	*-8.6%*	*-1.3%*	*14.2%*	*14.8%*

Summary Balance Sheet

Year End June (N$ 000)	FY16	FY17	FY18	FY19	FY20
Cash and cash equivalents	2,119,861	1,466,113	1,460,400	1,682,125	1,536,212
Due from banks and other financial institutions	1,772,267	2,667,981	2,008,426	2,149,558	2,275,322
Derivative financial instruments	209,497	95,221	154,454	153,057	134,244
Advances	25,776,087	28,258,413	30,149,770	32,260,254	34,841,074
Investment securities	3,236,883	3,866,395	5,007,755	5,491,393	6,384,567
Accounts receivable	136,592	197,444	173,217	169,084	179,915
Investments in associate	5,054	36,025	36,025	36,025	36,025
Property and equipment	924,997	953,290	1,029,553	1,111,917	1,200,871
Intangible assets	104	232,665	232,665	232,665	232,665
Deferred income tax asset	2,868	34,634	13,800	17,101	21,845
Reinsurance assets	598	99	296	331	242
Tax asset	695	1,226	862	928	1,005
Total assets	34,185,503	37,809,506	40,267,221	43,304,437	46,843,987
Deposits	27,793,798	30,488,360	32,317,662	34,579,898	37,346,290
Due to banks and other financial institutions	800,973	1,192,537	1,276,015	1,378,096	1,378,096
Derivative financial instruments	209,497	95,221	154,454	153,057	134,244
Short trading positions	36,927	39,330	39,330	39,330	39,330
Creditors and accruals	396,958	452,815	427,185	425,653	435,217
Tax liability	54,920	56,233	53,642	54,932	54,936
Employee liabilities	191,350	211,340	211,340	211,340	211,340
Deferred income tax liability	190,209	257,240	257,240	257,240	257,240
Policyholders liabilities under insurance contracts	67,778	52,642	57,906	63,697	70,067
Finance lease obligation	-	-	-	-	-
Tier two liabilities	392,654	402,830	402,830	402,830	402,830
Other Debt Securities	-	-	-	-	-
Total liabilities	30,145,022	33,268,889	35,168,099	37,553,383	40,353,035
Capital and reserves attributable to ordinary equity holders of parent	3,989,699	4,478,919	5,029,047	5,671,199	6,399,999
Non-controlling interests	50,782	61,698	70,076	79,855	90,953
Total equity	4,040,481	4,540,617	5,099,122	5,751,054	6,490,952
Total equity and liabilities	34,185,503	37,809,506	40,267,221	43,304,437	46,843,987

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