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SBN Holdings Limited

Initiation Report

Target Price (N$) **10.02**

Year End 31 December	2017	2018	1H19	F2019	F2020
Net Interest Income (N$ m)	1,236	1,220	659	1,373	1,459
Non-Interest Income (N$ m)	957	1,126	608	1,237	1,338
Profit (N$ m)	546	552	282	605	676
HEPS (c)	109	109	57	120	129
DPS (c)	53	48	24	24	54
DY (%)	4.6	4.6	2.3	2.3	5.6
P/E (x)	10.9	9.5	9.3	8.7	7.8
P/BV (x)	1.7	1.5	1.4	1.4	1.3

Source: SNO, IJG, Bloomberg
HEPS and DPS adjusted for share split

Recommendation	HOLD
NSX Code	SNO
Market Cap (N$ m)	4,650
Shares in Issue (m)	522.5
Free float (%)	25.1
52 week high	
52 week low	
Expected Total Return (%)	15.2%

We initiate coverage on Standard Bank Namibia Holdings Limited (SNO) prior to listing on the Namibian Stock Exchange. We base this coverage on SNO historic financials as well as the IPO prospectus forecasts. We explicitly forecast out a further three years off this base.

In the most recent results release (1H19) net interest income grew by 10.5% to N$658.7 million. Non-interest income grew by 14.4% to N$608.5 million in 1H19. Total income before impairment charges grew by 12.3% in 1H19. Profit after tax for the period increased by 10.9% to N$283.1 million as operating costs decreased by 2.1% y/y. The main drag on the bottom line for the period was a 267.1% increase in impairments to N$178.5 million. SNO's credit loss ratio for the period was 155bps, up from 45bps in 1H18.

Total group assets grew by 12.7% y/y in 1H19, to N$33.876 billion. Most of this growth came from an increase of 23.1% y/y in investment securities as well as 13.5% y/y expansion in loans and advances extended. Growth in the asset base was largely funded by deposit growth of 9.5% y/y as well as a 75.7% y/y increase in liabilities to group companies (funding sourced from the South African parent company).

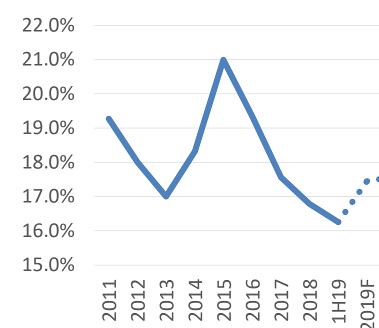
SNO's total loans and advances after impairments grew by 16.3% y/y in 1H19 after growing by just 0.4% y/y in FY18 (due partly to higher impairments in FY18 due to IFRS 9, but mostly due to a decrease in loans to other banks). SNO's loans and advances growth of 9.9% between FY18 and 1H19 is well ahead of PSCE growth of 6.2% y/y recorded in September and has been a driver of interest income for the period.

Total deposits grew by 9.5% y/y in 1H19 to N$26.566 billion. Much of this increase came in the latter half of the period. Deposits grew by just 2.3% in FY18, driven primarily by an increase in term deposits of 29.2% to N$2.362 billion, and an increase in call deposits of 5.7% to N$7.128 billion. SNO's funding has shifted toward more expensive wholesale funding over the last three financial years ending FY18, as with the two listed banks. Much of the slowdown in retail deposits can be attributed to the lacklustre economic growth experienced over the last few years.

Net interest income is forecast to grow 12.5% in FY19, and stems from expected loans and advances growth of over 10%, thereafter net interest income is forecast to grow by 6.3% y/y in FY20. This flows through to forecasts of growth in profit after tax of 9.4% in FY19 and 11.8% in FY20. The profit growth forecast for FY20 hinges on SNO's ability to maintain operating expense growth below that of revenue growth and to curb impairment charges to below 100bps. The forecasts for FY19 and FY20 are reasonable in our view, although we have implemented more conservative forecasts in years FY21, FY22 and FY23 due to the underlying economic headwinds which we do not expect to reverse meaningfully over the forecast period.

Our valuation for SNO incorporates two discounted cash flow methodologies and two justified multiple approaches. We calculate a cost of equity of 14.44% and a sustainable growth rate of 9.69% which leads us to derive a target price of N$10.02 per share. Coupled with expected dividends of 23cps over the next 12 months, we expect a total return of 15.2%. While our expected total return exceeds our cost of equity, mounting economic headwinds pose a risk to the SNO prospectus forecasts as well as our own, and as such we place a HOLD recommendation on the counter. The dissipation of some of the headwinds facing the banking sector is likely to result in an upgrade to this recommendation, all else equal.

SNO Historic and Expected ROE



Dividends

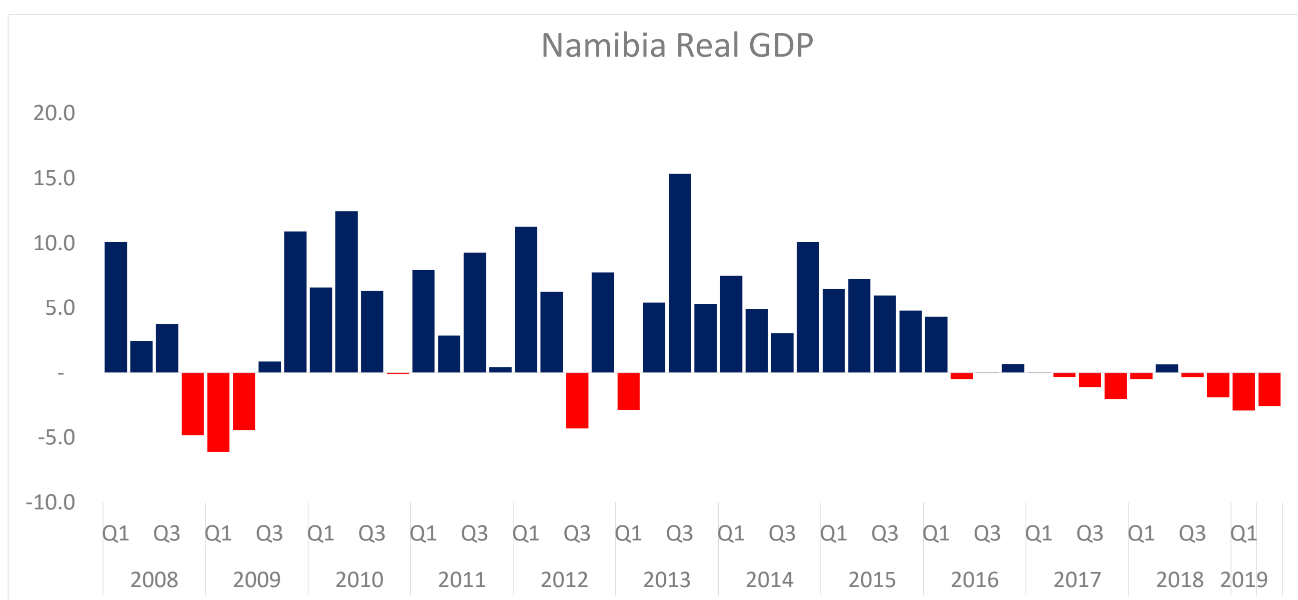
SNO aims for a pay-out ratio of 43% of earnings, or dividend cover of 2.3x. This will be applicable from 1H20 as the board have decided to not pay a dividend during the second half of FY19.

Macro Environment

Growth environment

Economic growth in Namibia has been stagnant since the start of 2016. Q2 GDP figures released by the Namibia Statistics Agency (NSA) indicates that nine of the last thirteen quarters have posted contractions in real GDP while the positive quarters were marginally positive at best. The Q2 numbers pointed to a contraction of 2.6% y/y making it the fourth consecutive quarter of contraction the country has experienced.

In their July 2019 economic outlook, the Bank of Namibia projected the domestic economy to contract by 1.7% in 2019, revised down from a 0.3% contraction expected for 2019 in their April 2019 outlook. The revision was largely due to the effect of the prolonged drought as well as the effect of lower diamond output following regular maintenance of diamond mining vessels.



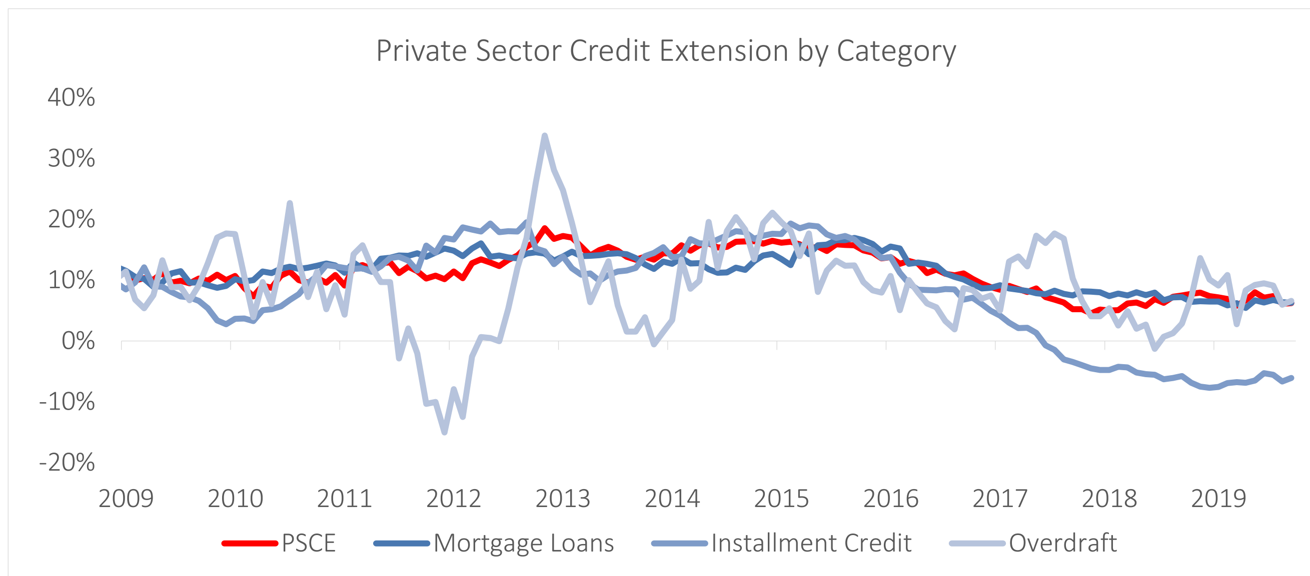
Source: NSA, IJG

Although earlier expectations were for a swifter recovery, reality has set in that the next few years will continue to be trying for the domestic economy. The last three and a half years have posted dismal growth, but of much greater concern is the outlook for the Namibian economy which still shows little signs of turning. The downgrade of Namibia's sovereign credit rating from BB+ to BB by Fitch in October 2019 was largely due to this deteriorating growth outlook. Fitch indicated that they expect Namibia to stagnate over the 2019 – 2021 period and that Namibia is expected to achieve the third-weakest economic performance among all Fitch-rated sovereigns during that period.

It is this low growth environment that poses the greatest challenge to banking sector growth in Namibia. It means higher impairments as customers come under pressure, lower ROE's as advances growth slows and it becomes more difficult for banks to reinvest funds, and ultimately low earnings growth. Such low earnings growth has already been visible in the Namibian banks' financial results over the last three years. The risk is that the stagnant economic environment persists for longer than expected and that this weighs on earnings in the sector.

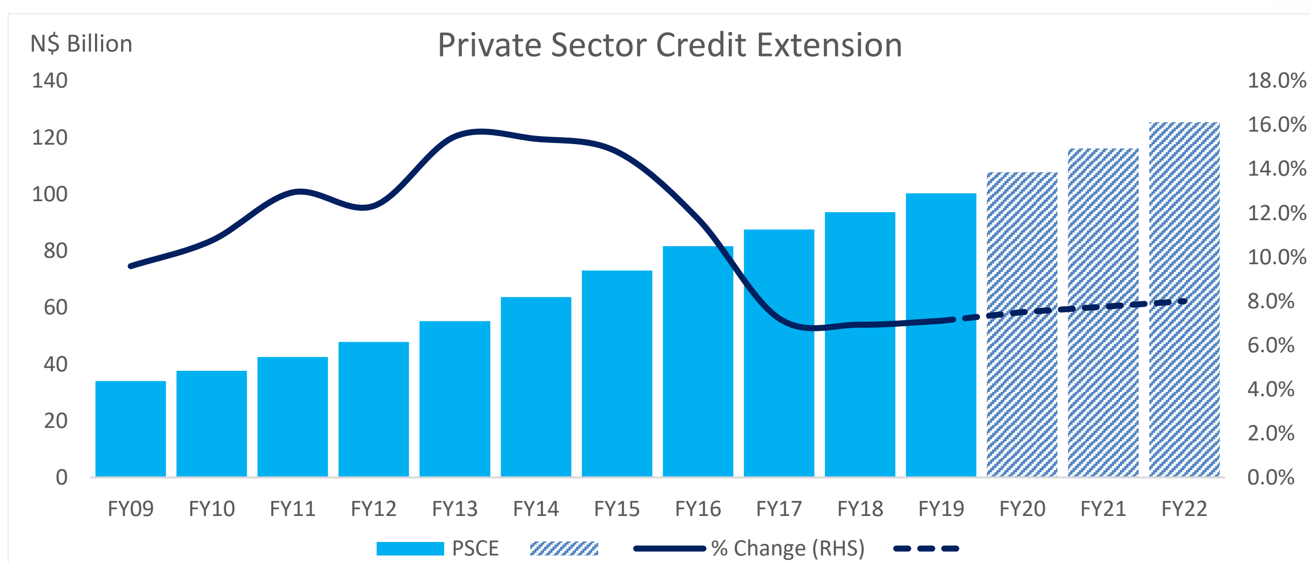
PSCE

Despite economic headwinds, private sector credit has continued to deliver nominal growth. PSCE growth stood at 6.1% y/y by the end of September. Much of the year-on-year growth has been driven by the short term, high interest rate, 'Other Loans and Advances' category, including credit card debt and term loans, which grew by 19.7% y/y. Mortgage growth has been steady at 6.3% y/y while leasing and instalment credit have contracted by 23.7% y/y and 6.1% y/y respectively.



Source: BoN, IJG

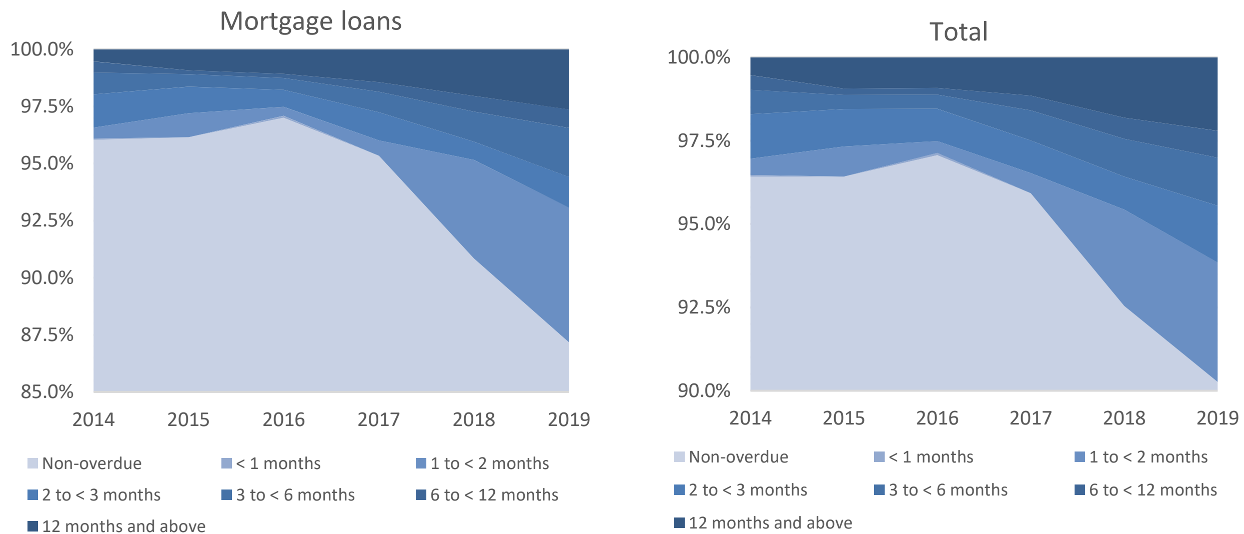
Given the current economic environment we do not expect private sector credit extension to exhibit a rapid recovery. We expect marginal growth in the mortgage market seeing as the Bank of Namibia has relaxed some of its loan to value directives which will allow individuals to purchase second and third properties without increasing deposit requirements. Nevertheless, we expect PSCE to remain around current levels for the medium-term future and have pencilled in PSCE growth of 7.5% for FY20, 7.8% in FY21 and 8.0% in FY22.



Source: BoN, IJG

Banking Sector Credit Quality

The quality of banking assets has been impacted negatively by the economic slowdown, as is clearly visible in the rising proportion of arrears. This has been observed right across the industry as lower disposable incomes and higher unemployment have resulted in increased non-payments and an ageing arrears book.



Source: Bank of Namibia, IJG

Mortgage loans have been one of the worst hit categories with 12.8% of loans in arrears in the country. This is especially worrying as this makes up 51.7% of the total banking sector credit outstating in the country at present. Personal loans have seen a rapid deterioration in arrears as 10.4% of these loans are now one or more payments behind, from 2.8% a year ago.

Higher non-performing loans will translate into higher impairments for the sector as banks make provisions for expected credit losses. The transition to IFRS 9 has also come at an unfortunate time from a financial performance perspective, as many of the loans currently classified as stage 2 would previously not have been provided for.

Additionally, the poor economic outlook and sector specific default exposures will further increase portfolio impairment charges. Namibian banks historically had very low credit loss ratios and the implementation of the new standard will likely be a more accurate reflection of reality. It also provides for impairments before they happen which should reduce the chances of large single year write-offs. On the other hand, in the unlikely event that the outlook for the Namibian economy rapidly turns positive, a portion of these provisions may be released.

Interest Rates

The prolonged global expansion is running out of steam, with the IMF downgrading their global growth forecast for 2019 to 3.0%, the lowest level since 2008/09. The latest manufacturing data indicates American factories are operating at their lowest rate in 10 years, while Chinese plants are also suffering, posting decade low results in August. Much of this is directly attributable to the increased tariffs imposed by the US on China. Trade wars aside, Eurozone growth, which has been tenuous since the global financial crisis, seems to be against the ropes again with consumer demand waning. Thus, it may seem as though the stage is thus set for further monetary easing. However, the Eurozone already has negative interest rates while the US Federal Reserve has cut interest rates three times since July.

United States | Instrument: Futures: Fed Funds - Effective | Fed Effective Rate 1.55

1) Overview | 2) Future Implied Probability

Current Implied Probabilities | 3) Add/Remove Rates

Dates: Meeting / Calculation | Calculated 11/12/2019 | Based on rate 1.50-1.75

Meeting	Hike Prob	Cut Prob	0.5-0.75	0.75-1	1-1.25	1.25-1.5	1.5-1.75	Fwd Rate
12/11/2019	0.0%	5.8%	0.0%	0.0%	0.0%	5.8%	94.2%	1.55
01/29/2020	0.0%	19.6%	0.0%	0.0%	0.9%	18.8%	80.4%	1.52
03/18/2020	0.0%	28.2%	0.0%	0.1%	2.8%	25.4%	71.8%	1.49
04/29/2020	0.0%	33.5%	0.0%	0.3%	4.4%	28.8%	66.5%	1.47
06/10/2020	0.0%	38.7%	0.0%	0.6%	6.3%	31.7%	61.3%	1.45
07/29/2020	0.0%	42.5%	0.1%	1.0%	7.9%	33.6%	57.5%	1.44
09/16/2020	0.0%	47.8%	0.1%	1.6%	10.3%	35.8%	52.2%	1.41
11/05/2020	0.0%	50.3%	0.2%	2.0%	11.5%	36.5%	49.7%	1.40
12/16/2020	0.0%	55.3%	0.4%	3.0%	14.0%	37.9%	44.7%	1.37

Source: Bloomberg

Current expectations are for benchmark rates to be held steady in the US at present levels. This follows October's interest rate cut which now sees the top of the Fed Funds band at 1.75%, last seen in June 2018. Despite muted inflation and slowing global growth the Fed seems to be comfortable with rates at present levels given the pace of US expansion and the "strong" labour market.

Euro Zone | Instrument: OIS: Eurozone OIS | Current Rate -0.50

1) Overview | 2) Future Implied Probability

Current Implied Probabilities | 3) Add/Remove Rates

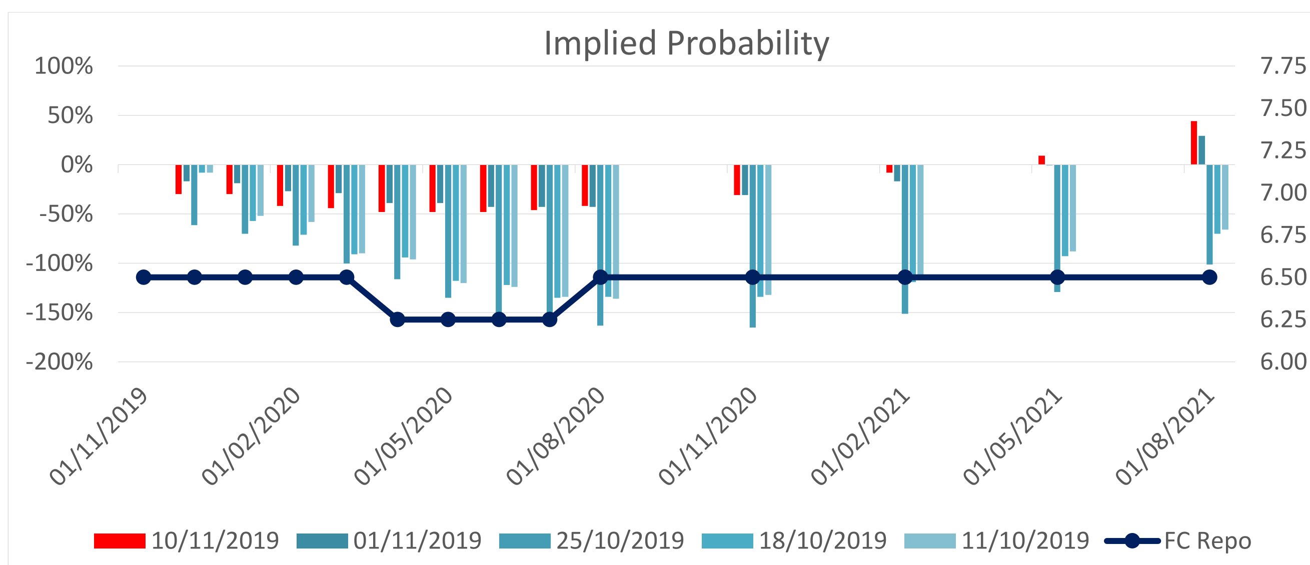
Dates: Meeting / Calculation | Calculated 11/12/2019 | Based on rate -0.50

Meeting	Hike Prob	Cut Prob	-0.7	-0.6	-0.5	-0.4	-0.3	Fwd Rate
12/12/2019	0.3%	0.0%	0.0%	0.0%	99.7%	0.3%	0.0%	-0.45
01/23/2020	0.3%	2.3%	0.0%	2.3%	97.4%	0.3%	0.0%	-0.46
03/12/2020	0.2%	16.1%	0.3%	15.7%	83.7%	0.2%	0.0%	-0.47
04/30/2020	1.6%	15.8%	0.3%	15.5%	82.6%	1.6%	0.0%	-0.47
06/04/2020	1.3%	32.2%	3.3%	28.8%	66.5%	1.3%	0.0%	-0.49
07/16/2020	1.2%	34.3%	4.1%	30.0%	64.4%	1.2%	0.0%	-0.49
09/10/2020	1.1%	44.5%	8.2%	35.4%	54.5%	1.0%	0.0%	-0.51
10/29/2020	7.7%	40.1%	7.3%	32.1%	52.1%	7.6%	0.1%	-0.49

Source: Bloomberg

The increased trade barriers and general anti-trade rhetoric continue to weigh on European sentiment. Expectations are for the ECB to follow the global trend of easing although this will not necessarily take the form of further rate cuts. Given the fact that rates are already in negative territory and that the ECB has restarted their quantitative easing programme, it is probable that future easing will be in the form of QE rather than rate cuts which may not have much impact on stimulating demand.

South Africa currently faces low growth and low inflation. Minutes of the September 2019 Monetary Policy Committee meeting indicates that the South African Reserve Bank expects real GDP growth for 2019 to be around 0.6% and inflation is expected to average 4.2%. The combination of low growth and low inflation provides room for monetary easing, but with the increased likelihood of a loss of the country's last investment grade credit rating a possible risk to such easing over the short-term. The SA mid-term budget painted a gloomy picture as the fiscal slide continued with debt-to-GDP expectations revised higher and budget deficits expected to be larger than estimates from February. At present our FRA curve model is pricing in one interest rate cut followed shortly thereafter by a hike of the same magnitude. Our expectations therefore are for no changes in benchmark rates over the short-term. We view an interest rate cut of 25bps as the second most likely scenario.



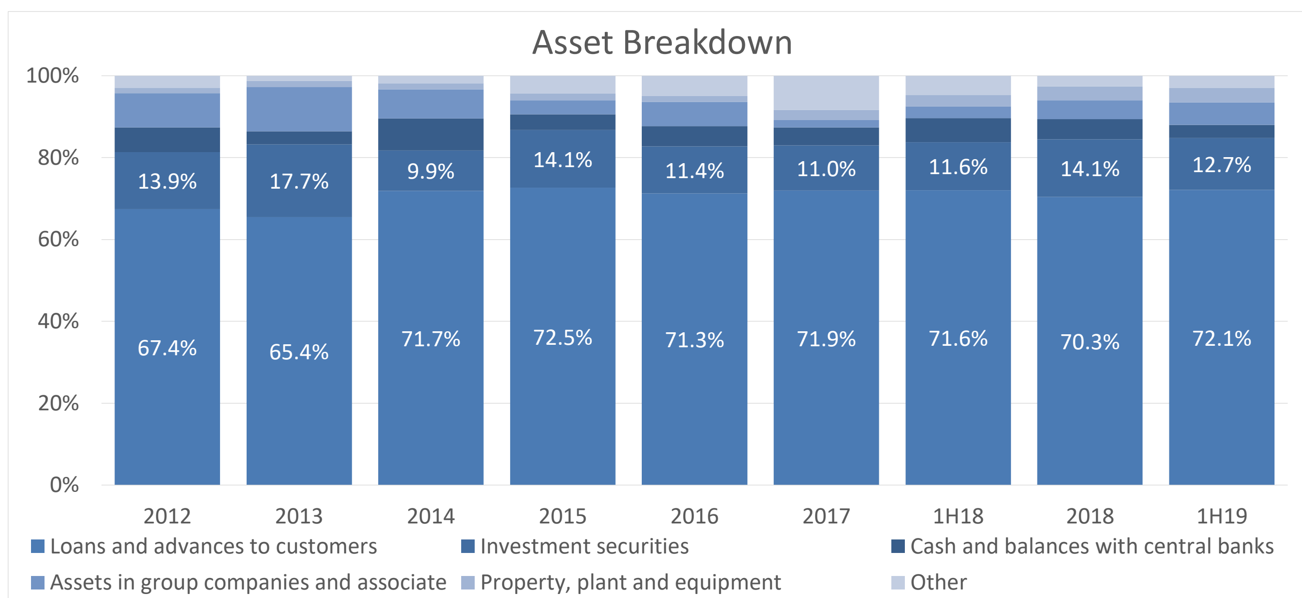
Source: Bloomberg, IJG

As has usually been the case, we expect Bank of Namibia to follow the South African Reserve Bank's monetary policy stance. Given the low level of growth in Namibia, the central bank will likely jump on the opportunity to provide some monetary stimulus to the domestic economy, albeit only in the event that the SARB moves first.

Net Interest Income

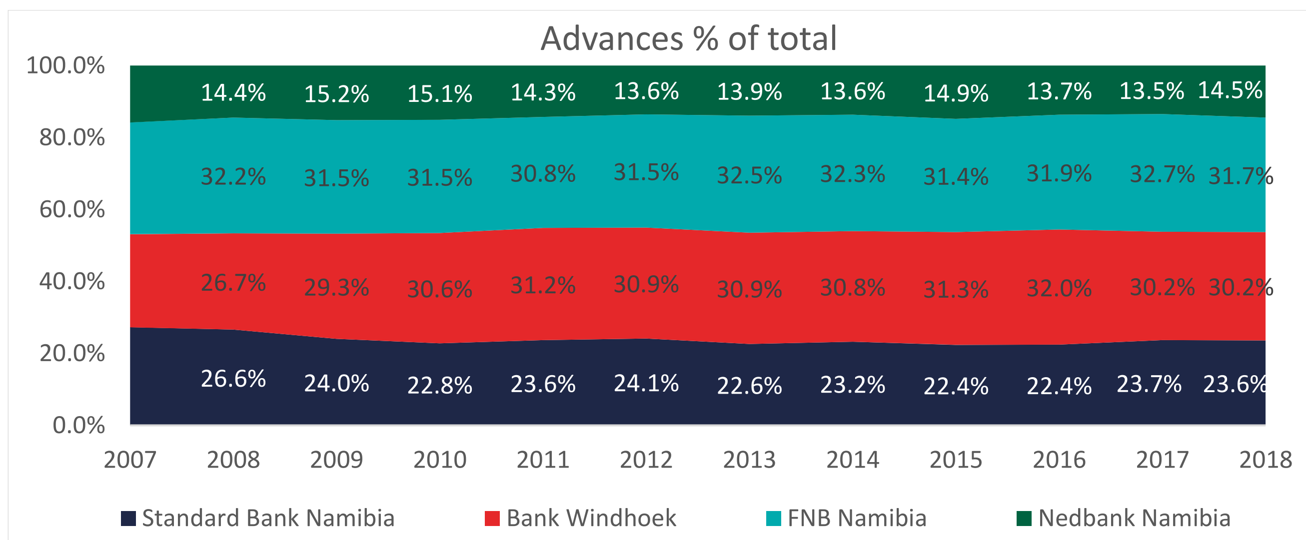
Asset Base

Total group assets grew by 12.7% y/y in 1H19, to N$33.876 billion. Most of this growth came from an increase of 23.1% y/y in investment securities as well as 13.5% y/y expansion in loans and advances extended. Growth in the asset base was largely funded by deposit growth of 9.5% y/y as well as a 75.7% y/y increase in liabilities to group companies (funding sourced from the South African parent company).



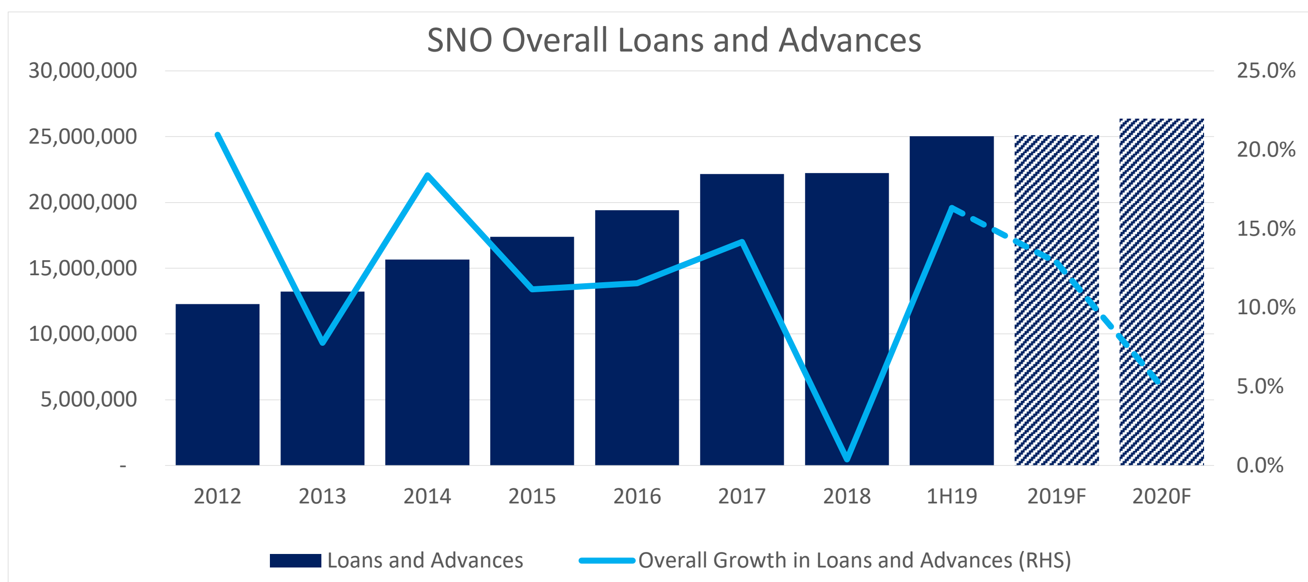
Source: SNO, IJG

Loans and advances



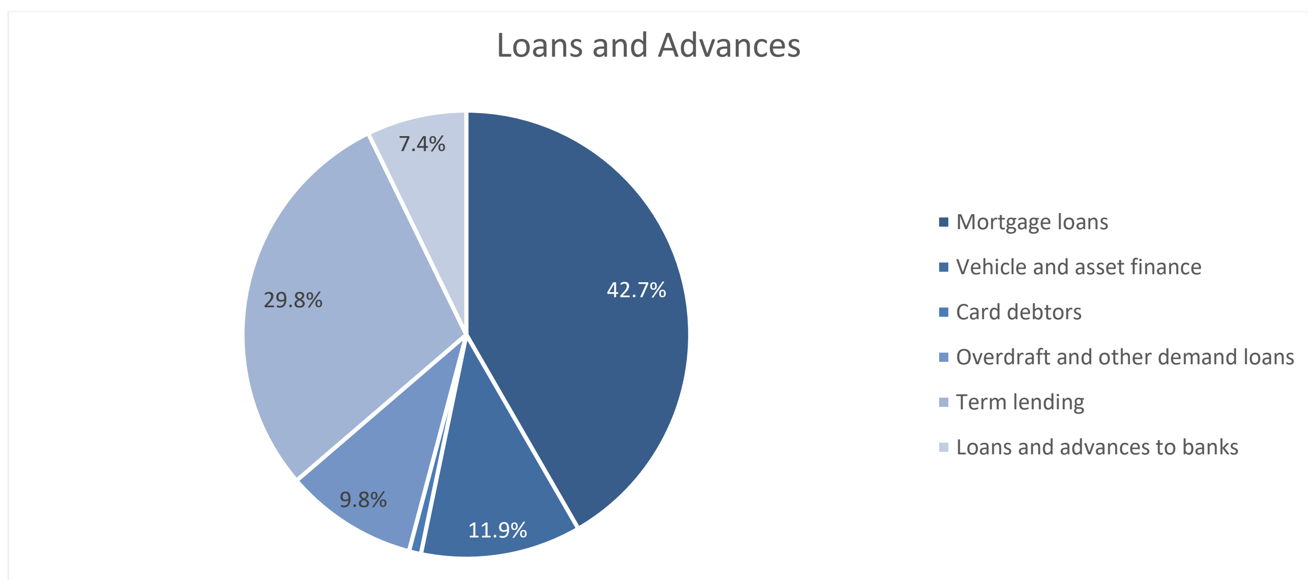
The above figure refers to the four big banks.
Source: BoN, IJG

SNO's total loans and advances after impairments grew by 16.3% y/y in 1H19 after growing by just 0.4% y/y in FY18 (due partly to higher impairments in FY18 due to IFRS 9, but mostly due to a decrease in loans to other banks). SNO's loans and advances growth of 9.9% between FY18 and 1H19 is well ahead of PSCE growth of 6.2% y/y recorded in September and has been a driver of interest income for the period. We expect PSCE growth of 6.5% in 2019 and 7.5% for the 2020 calendar year. It is worth noting that, assuming the breakdown of loans and advances in the prospectus is correct, it would seem as if the 1H19 breakdown double counted impairments (differences also between pages 22, 23, and 187 in the prospectus).



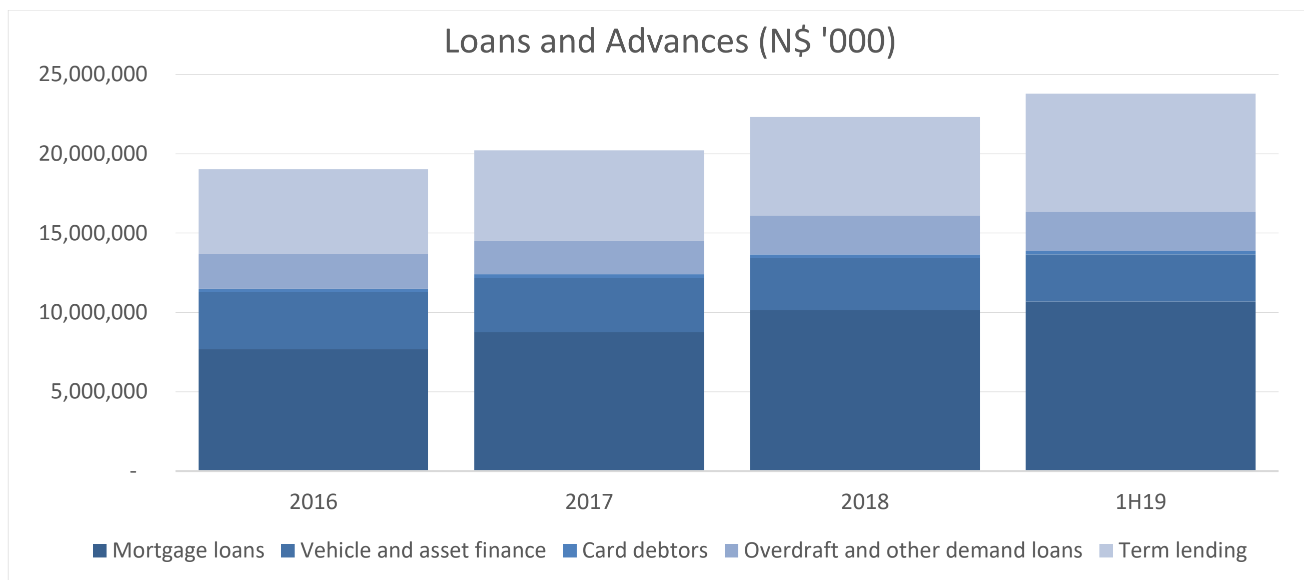
Source: SNO, IJG

Very strong growth of 16.2% y/y in mortgage loans was recorded in FY18, with 1H19 growth in the segment at 6.8% y/y. SNO's growth outperformed the rest of the market for this segment which recorded growth of 6.5% y/y and 6.3% y/y for the respective corresponding periods. SNO secured over half of the mortgage credit extended in FY18, growing market-share by 2% according to the prospectus.



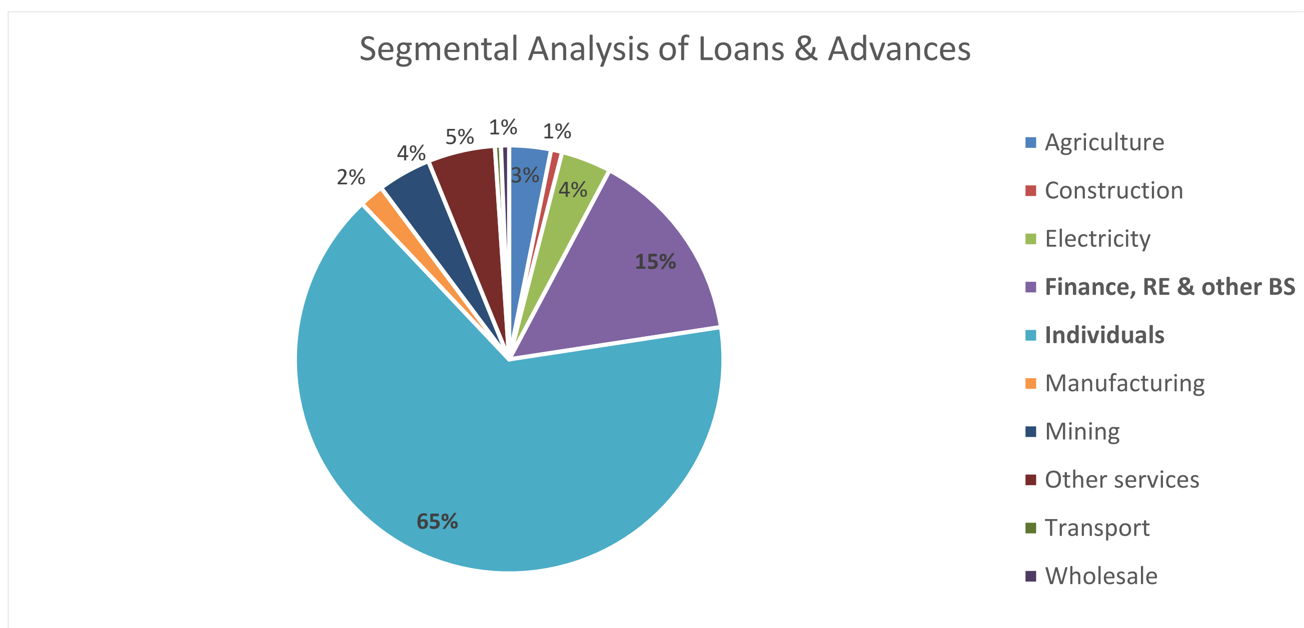
Source: SNO, IJG

Mortgage loans make up 42.7% of the loans and advances book as at 1H19. In FY16 the mortgage book made up 39.7% of the overall book. By FY18 this figure had grown to 45.7%, before dipping again. It is positive to see this exposure coming down again in 1H19 as the property market continues to rebase. SNO does have marginally less proportional exposure to the property market than banking sector on average. Mortgages made up 43.7% of FNB's total book, and 46% of CGP's. The property market and the banks' exposure to this market is a concern given the current economic outlook for Namibia. Affordability in the residential property market, despite price decreases over the last three years, remains an issue in our view and there could be a further rebasing in house prices in the coming year.



Source: SNO, IJG

Term lending makes up the second largest portion of the book at 29.8%. This is not out of line with industry averages with FNB recording slightly less and CGP slightly more. Term loans have grown by 8.8% y/y in FY18 and 6.6% y/y in FY17, slightly quicker than average PSCE growth but decreasing as a proportion of the total book. Vehicle and asset finance contribute around 12% of the book as at 1H19.



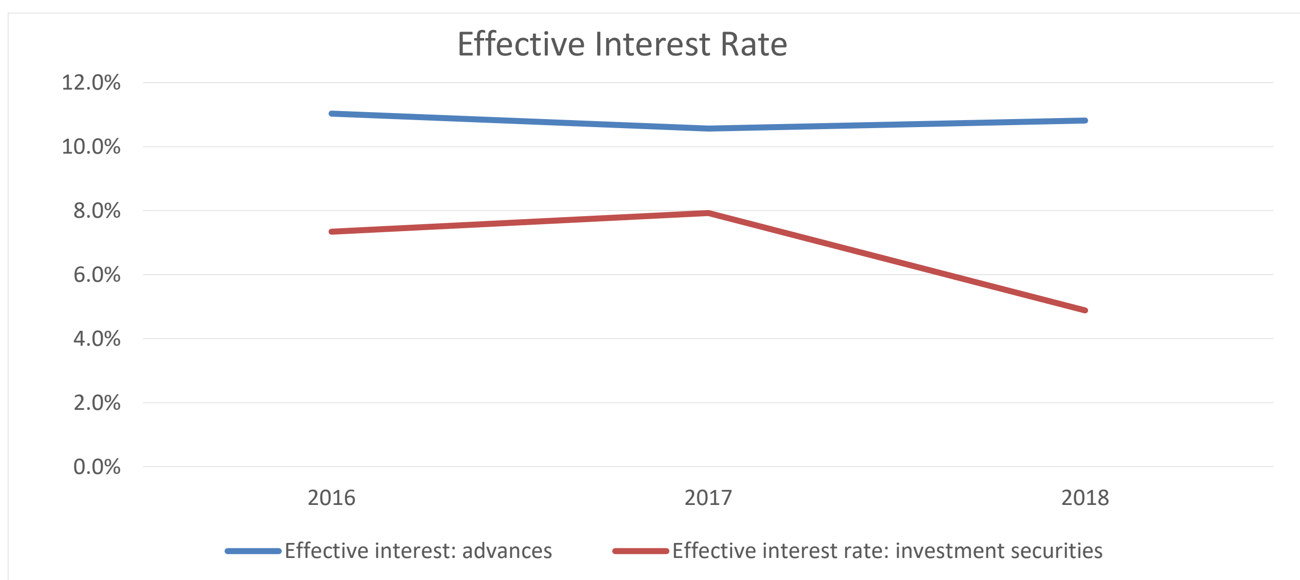
Source: SNO, IJG

With regards to the segmental analysis of the book, loans and advances to individuals makes up around 65% of the book which suggests a relatively high level of diversification among clients. Finance, Real Estate and Other Business Services make up a further 15% of the book on a segmental basis with only Other Services making up more than 5% of the book of the remaining segments. Thus, in terms of concentration risk the book seems reasonably well diversified. It is encouraging to see a low exposure to the construction and wholesale and retail trade sectors as these have been performing particularly poorly over the last three years. SNO has only a 3% exposure to agriculture which is relatively low and favourable given the pressure that the sector is under this year due to drought.

The 12.9% growth in loans and advances pencilled in for FY19 was almost completely achieved by 1H19 and driven largely by loans and advances to banks. This line-item fluctuates greatly and is generally much more fluid than loans and advances to customers. Due to the shorter-term nature of loans and advances to banks it draws a lower interest rate than loans and advances to customers. We expect to see a shift from loans and advances to banks towards customers in the FY19 numbers, with a positive marginal impact on the net interest margin. The FY20 forecast growth in loans and advances is in-line with our own expectations which err on the side of caution. The expected slow growth in loans and advances due to persistent economic headwinds over the medium-term will weigh on interest income over the period.

Investment Securities

As at 1H19 investment securities made up 12.7% of the asset base, slightly below the average over the last seven years. SNO has generally held a higher percentage of investment securities than FNB and CGP, but these other banks have ramped up their holdings in recent periods while SNO has maintained a relatively stable proportion of these assets on the balance sheet. As at 1H19 SNO held a marginally lower proportion of investment securities than the two listed banks. While this might be viewed as positive given that interest rates on these securities have come down more than the repo rate, SNO has recorded a significant decrease in the effective interest rate to 4.9% received on the securities it does hold, as is visible below.

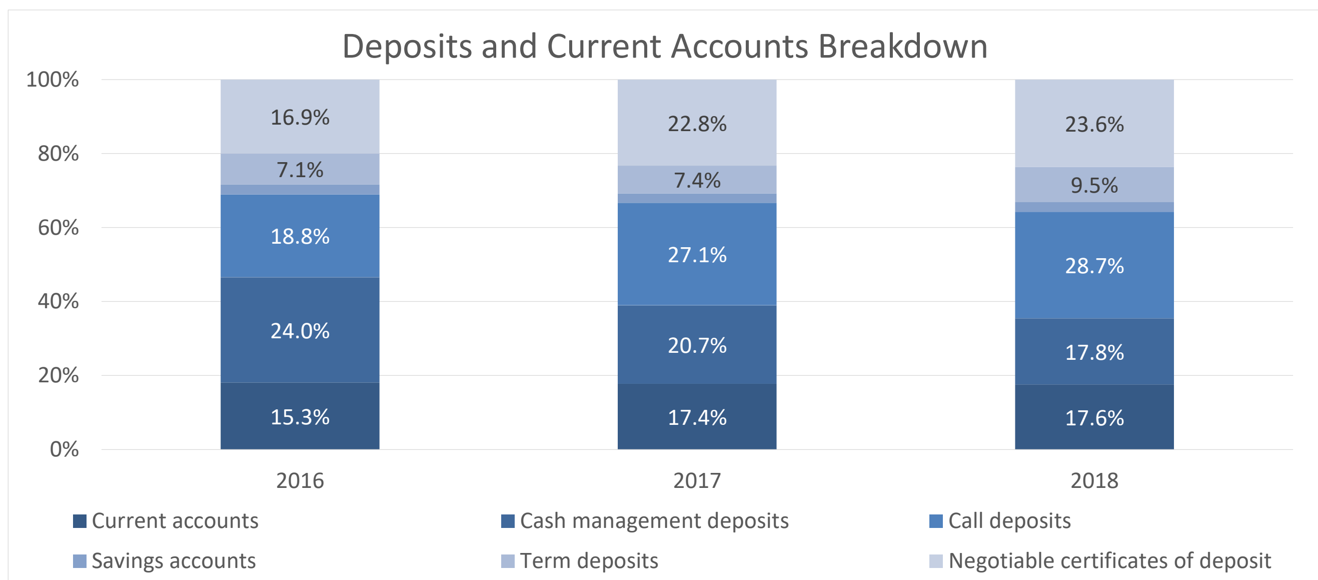


Source: SNO, IJG

The drop in effective interest rate on investment securities is likely due to timing of deposit flows and the purchase of securities towards the end of the measurement period. Nevertheless, rates on investment securities are lower than interest earned on loans and advances and the slow expected growth in the advances book suggests that SNO will likely be forced to park more money in these instruments in the future as appetite for credit remains low.

Funding

Total deposits grew by 9.5% y/y in 1H19 to N$26.566 billion. Much of this increase came in the latter half of the period. Deposits grew by just 2.3% in FY18, driven primarily by an increase in term deposits of 29.2% to N$2.362 billion, and an increase in call deposits of 5.7% to N$7.128 billion. A decrease in cash management deposits of 14.0% in FY18 posed a drag on overall deposit growth.



Source: SNO, IJG

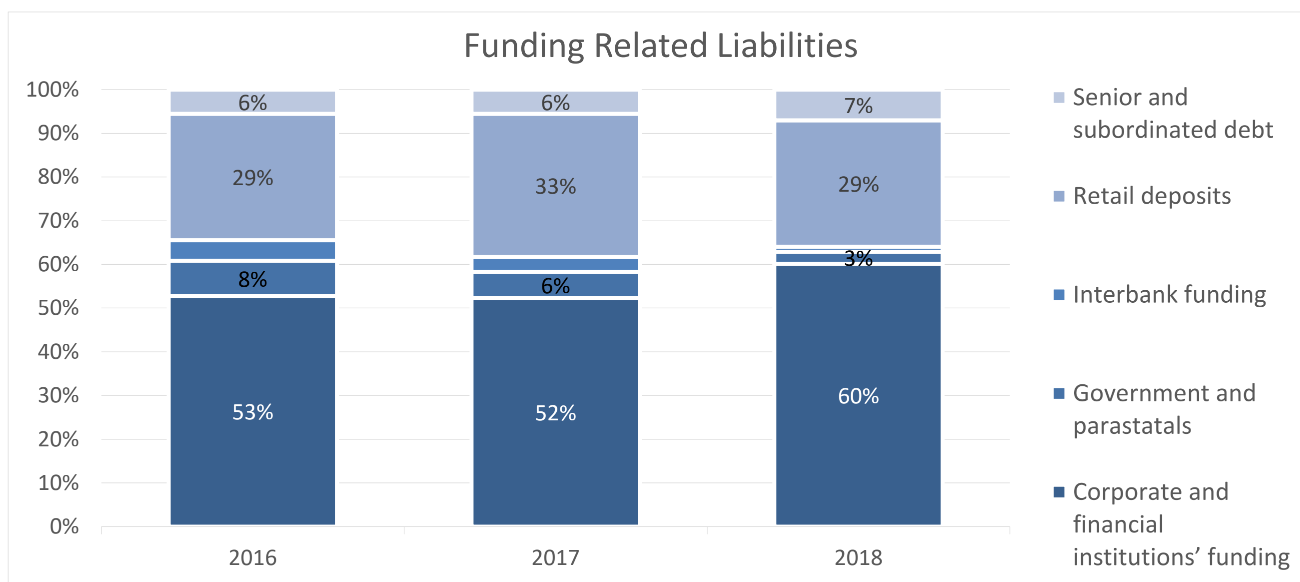
While current accounts have grown to 17.6% of the deposit book, the figure above illustrates the same shift as we have seen in the other banks to costlier deposit funding such as NCDs, now 23.6% of SNO the book, and call deposits, now 28.7% of the book. Current accounts carry the lowest interest cost and provide the base for the net interest margin. A lower proportion of SNO's funding coming from current accounts, 17.6% in FY18, versus 27.8% for FNB and 17% for CGP. FNB thus has a superior funding base to CGP and SNO from a current accounts perspective.

	2017	***2018***	***% Change***	***N$ Change***
Current accounts	4,333,232	4,382,643	1.1%	49,411
Cash management deposits	5,156,111	4,432,141	-14.0%	(723,970)
Card creditors	30,936	29,840	-3.5%	(1,096)
Call deposits	6,743,534	7,127,703	5.7%	384,169
Savings accounts	611,395	649,111	6.2%	37,716
Term deposits	1,827,927	2,361,599	29.2%	533,672
Negotiable certificates of deposit	5,680,701	5,878,589	3.5%	197,888
	24,385,853	**24,863,644**	2.0%	**477,791**

Source: SNO, IJG

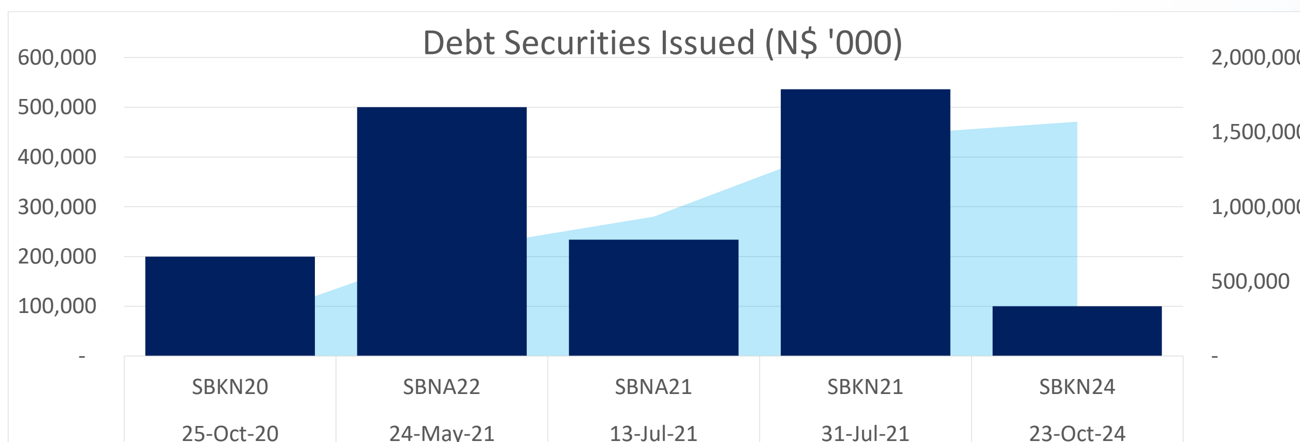
The last three years have seen the funding mix remain relatively stable with regards to wholesale to retail funding as less funding has been sourced from government and parastatals and more from corporates. The mix is skewed towards wholesale funding and has been throughout the last three years. SNO's wholesale to retail funding mix was approximately 62:38 as at FY18 (when including senior and subordinated debt). Both FNB and CGP are closer to or below 60:40. SNO does however benefit from the large cash management deposits portion which is relatively cheap funding. These balances have allowed SNO to be more selective when it comes to wholesale funding and the price paid for it which has been positive for the net interest margin.

Depositor concentration has been improving, with the single largest depositor contributing 3.2% of total deposits in FY18, down from 4.1% in FY17. The top ten depositors contributed 16.2% of total deposits, down from 19.5% in FY16.



Source: SNO, IJG

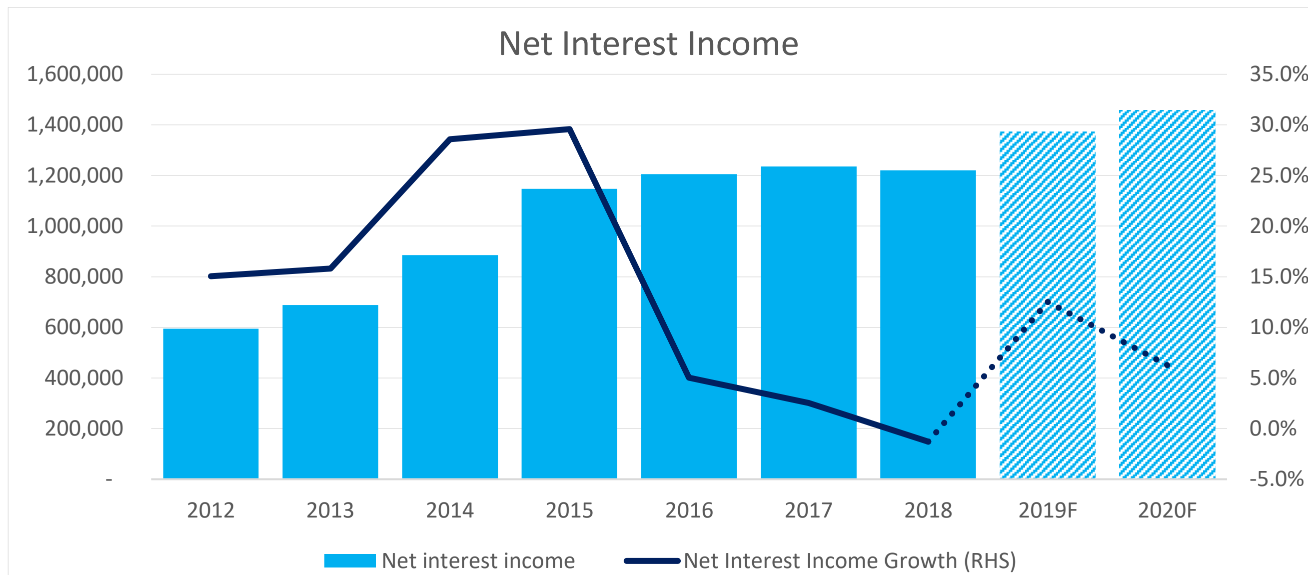
Liabilities to group companies increased by 75.7% y/y to N$1.709 billion in 1H19. This is a relatively large increase which is likely due to timing and liquidity management rather than utilisation of a strategic source of funding. Debt securities issued increased by 30.6% at 1H19 to N$1.591 billion, although down from N$1.690 billion as at FY18. The maturity profile of this debt is reasonably well spaced over the next five years and should not be difficult to roll.



Source: SNO, IJG

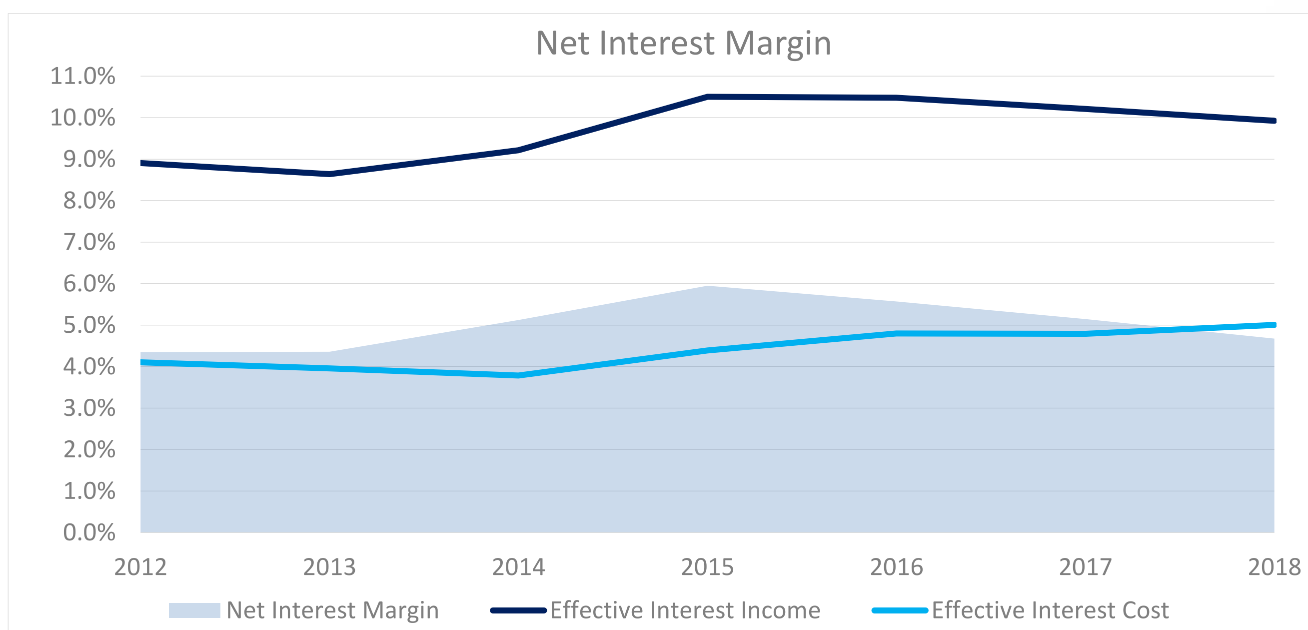
As noted in our reviews of the other banks, we expect deposit growth to remain relatively low, as retail deposit growth has been declining in the market and wholesale funding, which remains relatively abundant, will be raised as required to fund advances.

Interest Income and Expenses



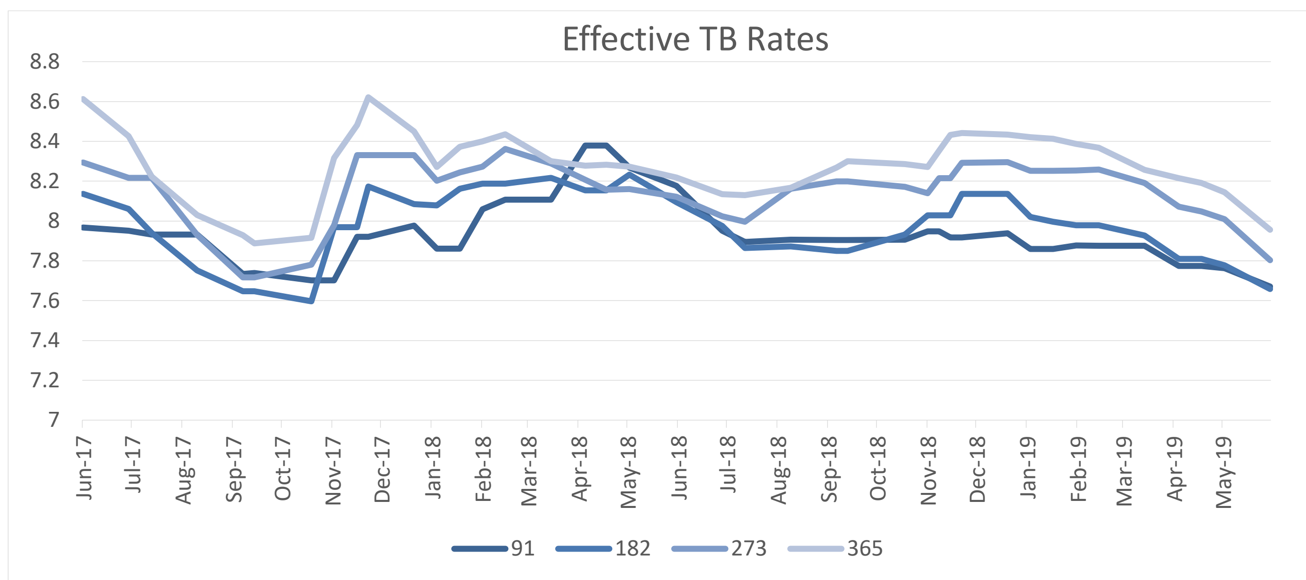
Source: SNO, IJG

As with the two listed banks, SNO's funding has shifted toward more expensive wholesale funding over the last three financial years ending FY18. Much of the slowdown in retail deposits can be attributed to the lacklustre economic growth experienced over the last few years. Current account balances have been relatively stable and the cheap cash management account funding has decreased by around N$700 million per year between FY16 and FY18. As noted in our reviews of FNB and CGP, wholesale funding has however recently become cheaper as liquidity has improved in the market. How long this excess liquidity environment lasts will impact these funding costs.



Source: SNO, IJG

SNO's net interest margin has been compressing since FY15 as a result of the funding split tilting towards wholesale funding. This is despite the decrease in wholesale funding costs towards the end of the 1H19 period. The split influences the net interest margin more than the fluctuations in cost of wholesale funding. The amount of excess liquidity currently in the market suggests that wholesale funding will remain at cheaper average rates in FY19 than those seen in FY18, but the main benefits of this cheaper funding are likely to only be visible in net interest income in FY20.



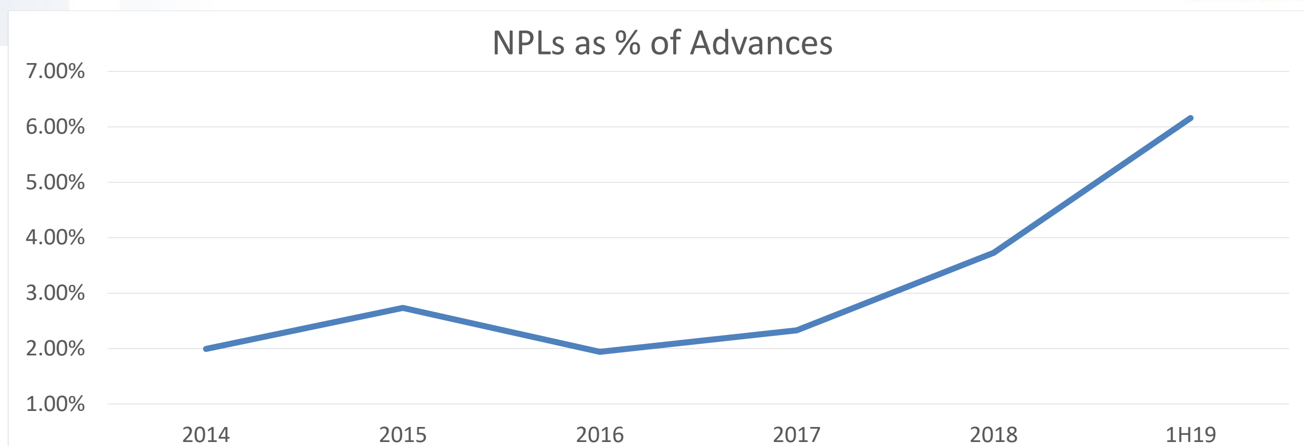
Source: SNO, IJG

The driver of the forecast 12.5% growth in net interest income for SNO in FY19 stems from expected loans and advances growth of over 10% (9.9% between FY18 and 1H19 already) coupled with a slight opening up of the net interest margin. Thereafter net interest income is forecast to grow by 6.3% y/y in FY20. Our analysis suggests that this may be conservative given a 7.5% expected growth in total PSCE, slightly cheaper wholesale funding still being on the books and the general tend toward extension of term loans with higher interest rates. We do however model SNO's financial performance based on this conservative growth in net interest margin given the multitude of uncertainties surrounding the economic climate and interest rate environment.

Impairments

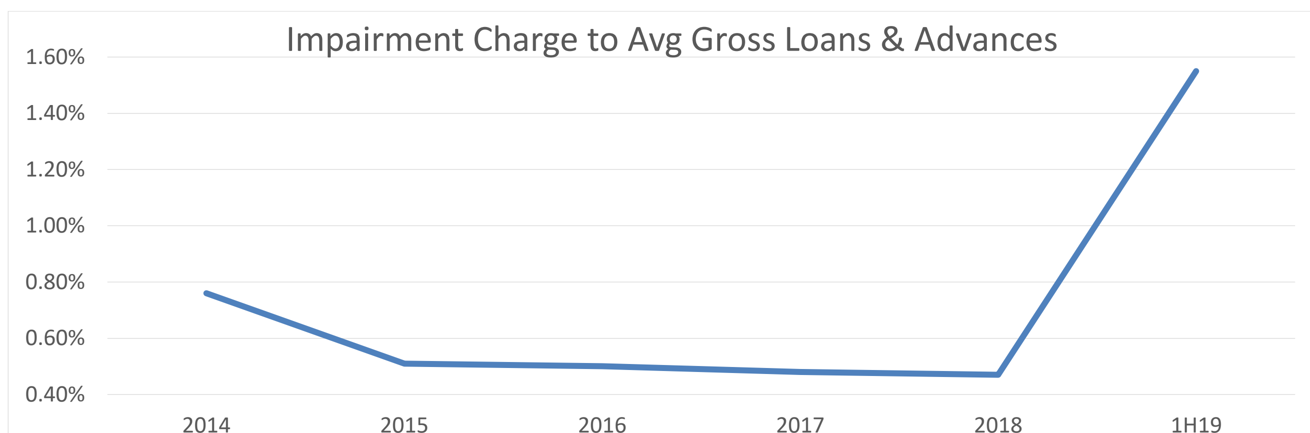
The Namibian banking sector has experienced an increase in arrears as a whole. This is to be expected given the recessionary economic climate and large increase in the unemployment rate. Wholesale and retail customers are under financial stress which is translating to an increase in arrears. The reclassification of how the quality of financial assets are measured and how impairments are modelled under the IFRS 9 framework has placed a more forward-looking criteria on how banks measure, and report on, the quality of their loan books.

While this may have an impact on earnings in the short term and has been costly to implement, it comes as a timely change in the Namibian context which should result in a more accurate and prudent reflection of the quality of the loans and advances in the banking sector. Thus, while IFRS 9 may impact financial performance negatively it adds some reassurance in terms of the forward-looking quality of the assets held by the banks. IFRS 9 does rely on internal/management judgements, assumptions and estimates in order to achieve this more accurate reflection of credit risk and the provision thereof. This subjectivity reduces comparability between banks.



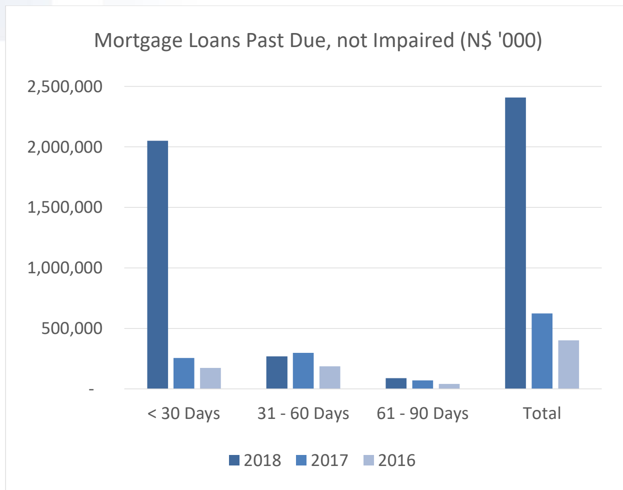
Source: SNO, IJG

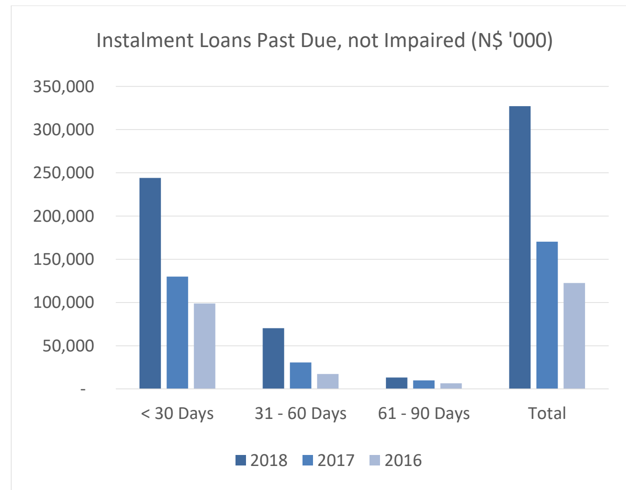
SNO's NPL's have been increasing over the last two and a half financial years, reaching 6.2% of gross advances or N$1.505 billion as at 1H19. There has been an acceleration in the rate of deterioration in the quality of the loans and advances book. This has been slow to translate into impairment charges however as these have remained below 0.5% as at FY18, only jumping to 1.55% in 1H19. This is still a very low figure given the present economic climate. The credit impairment charge for 1H19 amounted to N$178.5 million, an increase of 276% y/y and up 86.7% on the FY18 charge. We would expect higher impairment charges going forward as more of the arrears book move into the NPL classification.

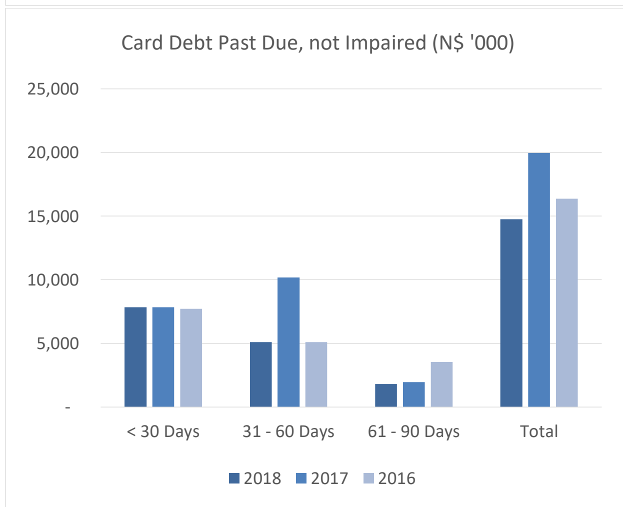


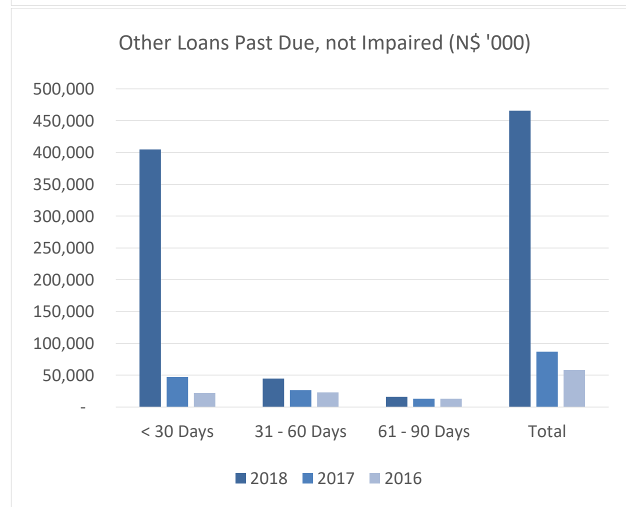
Source: SNO, IJG

Expected credit losses for loans and advances increased to N$605.8 million in 1H19 from N$466.7 million in FY18. The below figures give an indication of the extent of the acceleration of deterioration in the various segments of the loans and advances book. As at FY18 roughly 23% of the mortgage book was past due but not impaired, which is of particular concern as this figure is higher than the industry average. As pointed out in the earlier banking sector credit quality section of this report, 12.8% of mortgage loans countrywide are in arears.







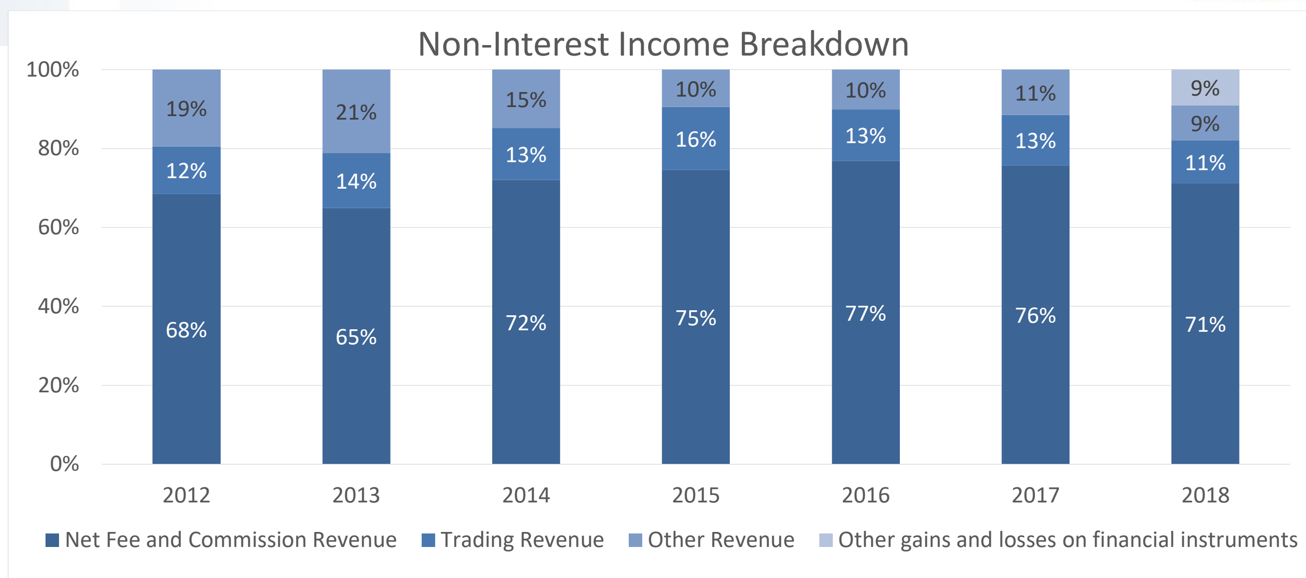


Source: SNO, IJG

SNO's impairment charge at 1.55% is higher than both FNB and CGP's at 0.71% and 0.30% respectively. SNO does forecast that this figure will decrease to roughly 1.1% by FY19 after which it is expected to increase to around 1H19 levels again in FY20. The higher than banking-sector-average impairment charge may be due to more prudent IFRS 9 modelling or a more stressed loans and advances book. The subjectivity of the assumptions involved in IFRS 9 modelling makes comparison difficult, as previously mentioned, but the size of the difference between SNO's impairment charge and those of the other banks leads us to believe that there is a higher level of prudence in the SNO assumptions.

Non-Interest Revenue

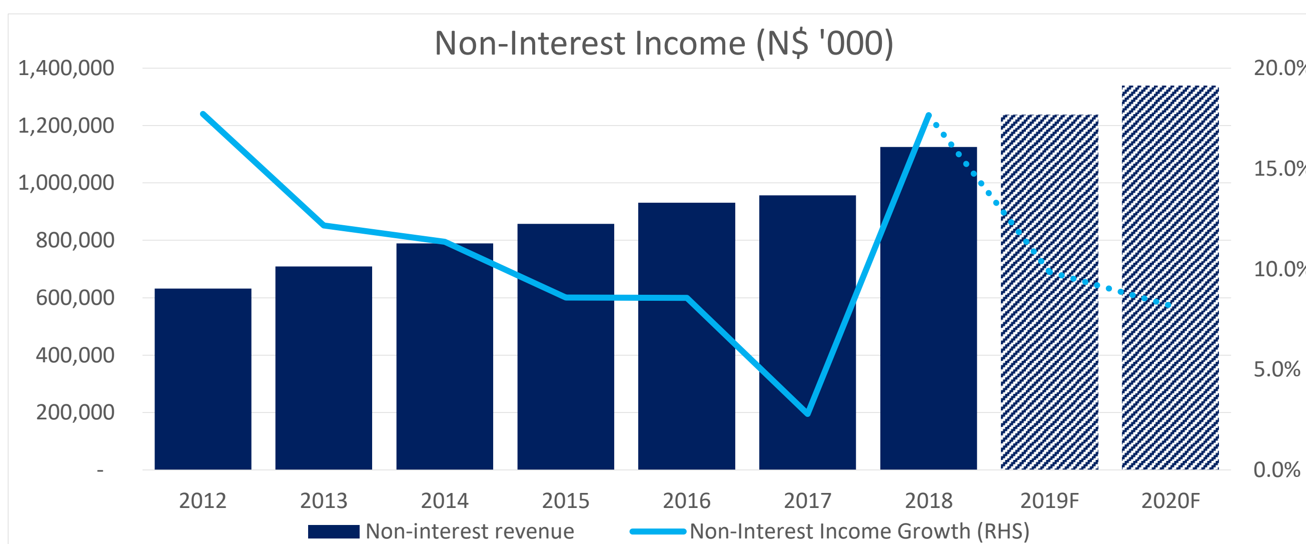
Non-interest income grew by 17.7% y/y or N$169.0 million to N$1.126 billion in FY18. The main component of non-interest income was net fee and commission income which made up 71%. Net fee and commission income grew by 10.6% in FY18 as a result of a decrease in fee and commission expenses, notably card-based commissions which decreased by N$15.4 million or 21.7%, as well as 6.7% growth in gross fee and commission income.



Source: SNO, IJG

Trading revenue has contributed a relatively stable proportion of non-interest income in the past. However this source of revenue contracted by 0.5% in FY18. Other revenues also contracted in FY18, by 8.3% or N$9.1 million. Overall non-interest income growth was bolstered by "other gains and losses on financial instruments" which contributed N$101.9 million to non-interest income. Stripping this shows non-interest income growing by 7.0% instead of 17.7%.

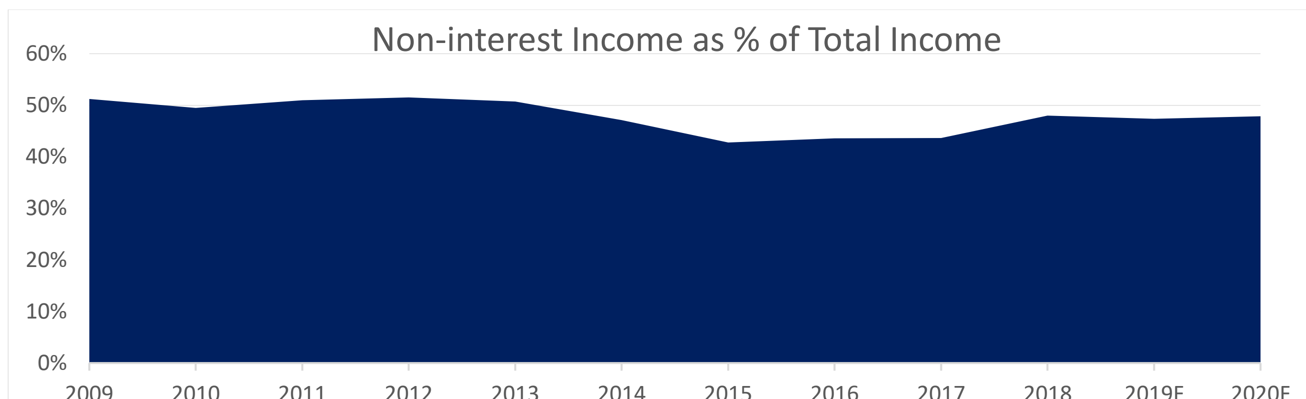
This is the first time other gains and losses has featured in the results and has to do with the reclassification of financial instruments under IFRS 9. According to the prospectus, "When a debt financial asset is disposed of, the cumulative fair value adjustments, previously recognised in OCI, are reclassified to the other gains and losses on financial instruments within non-interest revenue." We thus expect this line-item to remain on the profit and loss statement but to fluctuate more than the other components of non-interest income.



Source: SNO, IJG

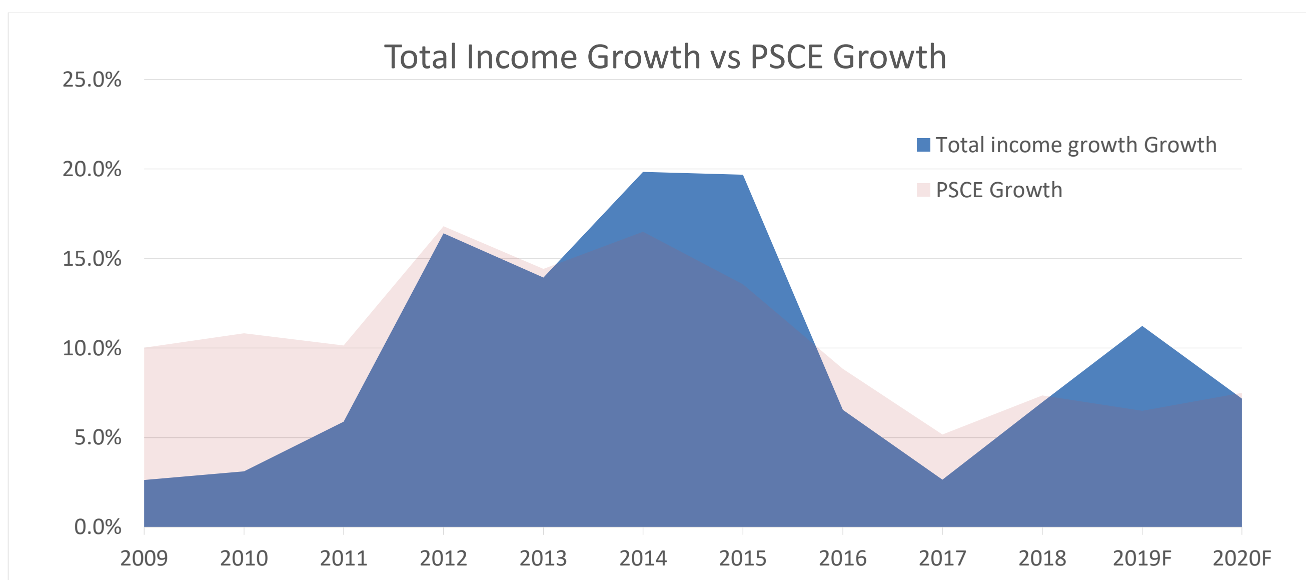
Growth in non-interest income has been slowing over the period between FY12 and FY18, with growth of only 2.8% recorded in FY17. Account transaction fees have been decreasing while card-based commission and electronic banking fees are becoming larger components of non-interest income, along with documentation and administration fees.

SNO forecast non-interest income growth of 9.9% in FY19 and 8.2% in FY20. We se this as a reasonable forecast due to further growth expected in card-based commissions and electronic banking fees. While non-interest income has traditionally made up around 50% of revenues, this contribution has decreased over the last five periods and SNO's forecast does not expect non-interest income's contribution to revenue to increase above 48% in the short-term.



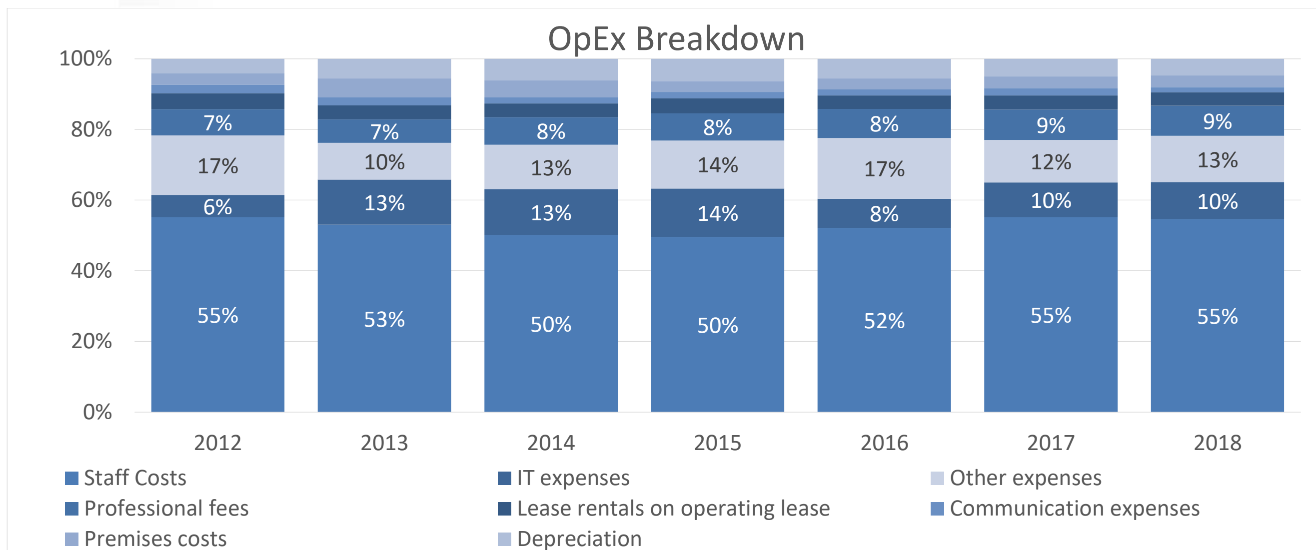
Source: SNO, IJG

The below figure illustrates the correlation between SNO's total income growth and overall PSCE growth. This correlation does not hold perfectly but does suggest that for SNO's total income growth forecast of 11.2% in FY19 and 7.2% in FY20 to materialise, SNO will have to continue to gain market-share if our expectation for PSCE growth of around 6.5% and 7.5% are vaguely accurate. We know that FY19 is likely to show exactly that due to growth of 12.9% in loans and advances. This suggests realistic forecasts on the total income side and we have used this as the basis for our valuations.



Source: SNO, IJG

Operating Costs



Source: SNO, IJG

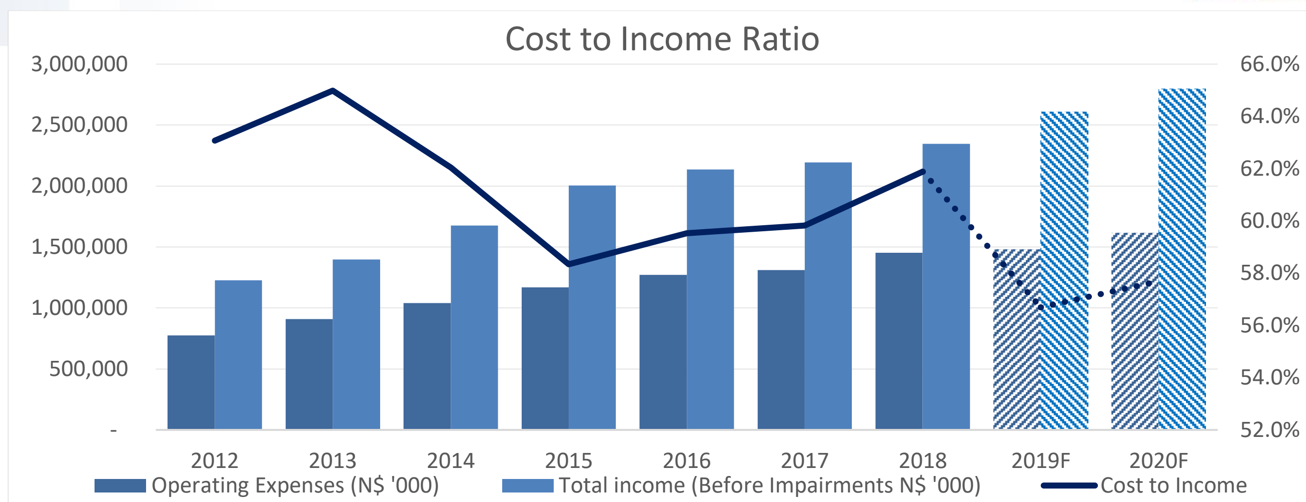
Operating expenses increased by 10.7% in FY18 to N$1.452 billion, versus growth in total income (revenue) of 2.6%. The vast majority of operating expenses are related to staff costs. Staff costs have made up approximately 55% of operating expenses over the last two financial years and grew by 9.0% and 9.5% if FY17 and FY18 respectively. Staff costs are arguably the most sticky operating costs and the main driver in operating expenses growth as the below table shows. The increase in staff costs drove 49% of the increase in operating expenses in FY18.

Contribution to OpEx Increases	***2013***	***2014***	***2015***	***2016***	***2017***	***2018***
Staff Costs	41%	29%	45%	82%	150%	49%
Communication expenses	2%	-1%	2%	1%	13%	-4%
Depreciation	14%	10%	9%	-4%	-13%	3%
IT expenses	50%	15%	20%	-55%	60%	17%
Lease rentals on operating lease	1%	3%	8%	-3%	9%	3%
Professional fees	2%	17%	6%	15%	22%	7%
Premises costs	0%	-5%	4%	-3%	6%	-2%
Other expenses	-27%	31%	17%	48%	-181%	24%

Source: SNO, IJG

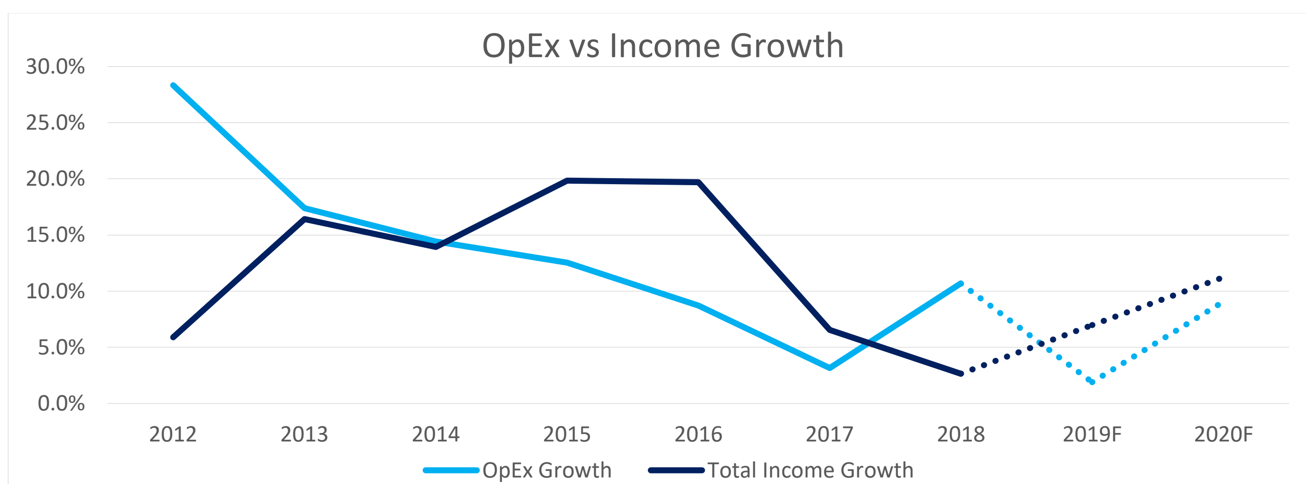
SNO has traditionally had a higher cost to income ratio than the two listed banks, averaging over 61% between FY12 and FY18. In FY18 SNO's cost to income ratio rose to 61.9% from 59.8% in FY17, largely as a result of increases in staff costs and IT expenses. SNO's relatively high cost base is the main reason why the bank has lower ROE's than FNB. Recent increases in CGP's cost to income ratio to over 60% lead to more comparable ROE's with SNO.

SNO expects its cost to income ratio to decrease to 56.7% in FY19 and 57.7% in FY20. Considering 1H19's 54.4% cost to income ratio this may be achievable. SNO's extensive investment into IT and network infrastructure is the basis for this expected decrease in cost to income. SNO suggests that the increased use of cheaper digital channels will drive non-interest revenues while reducing overheads. SNO has also added a completely new core banking system over the last few years which enables a wider range of digital offerings and manoeuvrability within the digital banking space.



Source: SNO, IJG

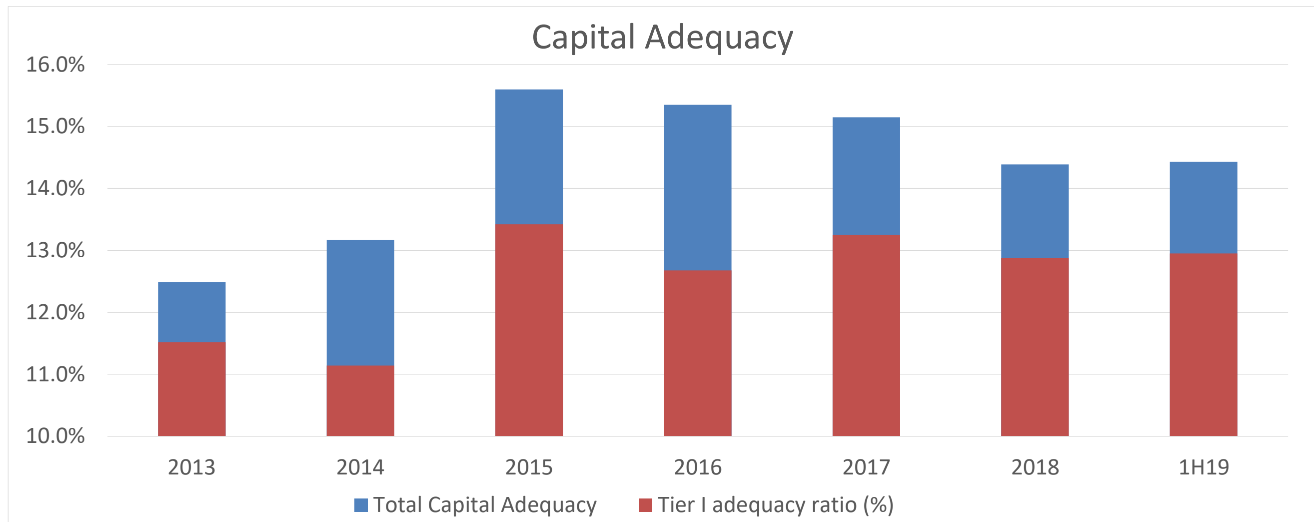
Operating expenses growth has been more or less contained below that of total income growth for the period between FY13 and FY17, with some divergence in FY18. The forecasts included in the prospectus expect this to reverse however as income growth accelerates and growth in operating expenses slows. We base our valuation off the forecasts for the FY19 and FY20 periods which means that a deviation from the forecast cost to income ratio will have an impact on valuation.



Source: SNO, IJG

Capital Adequacy

SNO remained well capitalised with a total capital adequacy ratio of 14.4% in 1H19. Tier 1 capital adequacy stood at 13.0% for SNO at 1H19, and at 11.6% for the bank as at FY18.



Source: SNO, IJG

Namibian banks are subject to the Basel III framework, as implemented on 1 September 2018 in Namibia. However, Namibia is following a five-year phase in to be completed by 2022. The tier 1 capital ratio is set to incrementally increase to 9.5%, while the total capital ratio will increase to 12.5%. Two additional aspects of Basel III, namely the Liquidity Coverage Ratio (LCR) and the Net Stable Funding Ratio (NSFR) will also be phased in over this period but should not materially affect any of the operations of the bank.

Outlook

The Bank of Namibia made large revisions to its growth expectations for Namibia in its July 2019 Economic Outlook. The regulator expects a contraction in real GDP of 1.7% in 2019, followed by low growth of 0.8% and 1.2% in 2020 and 2021 respectively. Given that banks leverage off of economic growth the outlook for the sector is thus for medium term stagnation rather than expansion.

Headwinds surrounding the outlook continue to build with global growth slowing and global manufacturing already in a recession. The mounting possibility of external shocks is untimely as the Namibian government's fiscal position continues to deteriorate with 2020 and beyond at risk of tax revenue underperformance and larger than expected budget deficits.

We attempt to look through the cycle with regards to our valuation of SNO, but this leaves the valuation at risk of large surprises given the abnormal nature of the recessionary environment in Namibia. The IMF's recently concluded Article IV consultations provide a more positive perspective:

"Despite the economic slowdown, the financial sector remains sound. The authorities are taking steps to curb possible risks arising from structural vulnerabilities in the sector and advance key reforms, such as strengthening banks' asset classification, tightening concentration risk regulations, and improving the macroprudential policy framework." -IMF

We do not expect SNO to be immune to the headwinds facing the banking sector. It is evident in the mortgage arrears book for the sector, and SNO in particular, that major challenges lie ahead. We believe that SNO is adequately capitalised to deal with these challenges, but performance may disappoint over the medium term if realised economic growth aligns with BoN's forecast. SNO expects positive growth of 1.14% over the next 12 months and 1.12% growth in 2020, slightly above BoN's expectations.

SNO's expectations for loans and advances growth of 12.9% in FY19 and 5.0% in FY20 are reasonable in our view and should drive the forecast growth of 12.5% and 6.3% in net interest income for the respective periods as the full impact of cheaper wholesale funding flows through. A risk is that operating expenses growth cannot be contained to the forecast 1.9% and 9.1% in FY19 and FY20 respectively. However 1H19 operating expenses growth declined by 2.1% lending credibility to the FY19 forecast in the prospectus.

The risks surrounding the outlook are numerous but we believe that SNO's forecasts for FY19 and FY20 are reasonable. We base our valuation off these forecasts but warn that the potential for surprises is large given the economic climate and deteriorating global outlook.

Valuation

Our valuation for SNO incorporates several valuation methods to reduce the overreliance on a single methodology. These methods include two discounted cash flow methodologies and two justified multiple approaches. The outputs of the different methodologies were equally weighed.

Two of the main valuation input assumptions are the cost of equity and long-term sustainable growth rate. The cost of equity was calculated using the capital asset pricing model (CAPM). The resultant cost of equity amounted to 14.44% based on a 9.42% 10-year average yield on the IJG generic 10-year bond, an equity risk premium of 4.05%, a beta of 1.0, a country risk premium of 1.0%. The sustainable growth rate was estimated to be 9.69% based on a long tern sustainable return on equity of 17.0% (we explicitly model five years forward and use the average ROE over this period) and the stated pay-out ratio of 43%. Seeing as the valuation is very sensitive to these inputs, a sensitivity analysis can be found in the annexures to illustrate the effect of changes in these assumptions.

The output of our valuation model is presented below.

	Value (NS'000)	Price per Share (N$)	Price to Earnings	Forward PE	Price to Book	Forward PB	Dividend Yield	Forward DY	Weight
Residual Income	5,302,265	10.15	9.60	8.77	1.53	1.38	4.53%	2.26%	25%
Dividend Discount	4,826,322	9.24	8.74	7.98	1.39	1.26	4.97%	2.49%	25%
Justified Price to Earnings	5,485,482	10.50	**9.93**	9.07	1.58	1.43	4.38%	2.19%	25%
Justified Price to Book	5,331,542	10.20	9.65	8.82	**1.54**	1.39	4.50%	2.25%	25%
Weighted Average	**5,236,402**	**10.02**	**9.48**	**8.66**	**1.51**	**1.36**	**4.59%**	**2.30%**	**100%**

Source: IJG

Based on the table above, we derive a **target price of N$10.02** per share. Coupled with expected dividends of 23cps over the next 12 months, we expect a **total return of 15.2%.** While our expected total return exceeds our cost of equity, mounting economic headwinds pose a risk to the SNO prospectus forecasts as well as our own, and as such we place a **HOLD** recommendation on the counter. The dissipation of some of the headwinds facing the banking sector is likely to result in an upgrade to this recommendation, all else equal.

Summary of Financial Statements

	Actual		Forecast		
in N$ 000s	**2017**	**2018**	**2019**	**2020**	**2021**
Interest and similar income	2,452,824	2,591,903	2,850,180	2,951,755	3,142,346
Interest and similar expense	(1,216,853)	(1,371,881)	(1,477,511)	(1,493,066)	(1,640,007)
Net interest income	**1,235,971**	**1,220,022**	**1,372,669**	**1,458,689**	**1,502,340**
% Growth	2.5%	-1.3%	12.5%	6.3%	3.0%
Impairment losses	(97,047)	(95,617)	(269,674)	(178,765)	(231,312)
Non-Interest Income	**956,756**	**1,125,710**	**1,236,602**	**1,337,763**	**1,458,162**
Operating expenses	1,311,612	1,451,709	1,479,209	1,613,278	1,742,340
Operating profit	**784,068**	**798,406**	**860,388**	**1,004,409**	**986,850**
% Growth	1.4%	1.8%	7.8%	16.7%	-1.7%
Share of profit from associates	1,370	3,410	1,746	1,834	2,017
Profit before tax	**785,438**	**801,816**	**862,134**	**1,006,243**	**988,867**
Income tax expense	239,511	249,392	257,592	330,623	301,802
Profit for the year	**545,927**	**552,424**	**604,542**	**675,620**	**687,065**
%Growth	1.2%	1.2%	9.4%	11.8%	1.7%
Other comprehensive income for the year	10,726	8,348	-	-	-
Total comprehensive income	**545,927**	**552,424**	**604,542**	**675,620**	**687,065**
Headline Earnings	544,134	548,245	604,542	675,620	687,065
%Growth	1.2%	0.8%	10.3%	11.8%	1.7%
EPS (c)	**546**	**552**	**116**	**129**	**132**
HEPS (c)	**544**	**548**	**116**	**129**	**132**
Dividends declared per share (c)	**240**	**240**	**23**	**56**	**57**

Dividends and earnings per share in prior periods not adjusted for per IPO share-split. 2019 forecasts and forward-looking figures calculated on 522,471,910 shares.

in N$ 000s	Actual		Forecast		
	2018	**2019**	**2020**	**2021**	**2022**
ASSETS					
Cash and balances with central bank	1,357,937	1,546,357	1,212,911	1,222,020	1,222,020
Financial assets designated at fair value	494,384	163,038	396,198	396,198	396,198
Investment securities	3,395,582	4,452,053	5,472,729	5,472,729	5,472,729
Loans and advances to customers	22,146,338	22,231,755	25,091,103	26,972,936	29,130,771
Investment in associates	562,369	1,464,132	2,391,949	2,542,072	1,868,450
Other assets	2,829,279	1,748,045	2,222,442	2,242,545	2,008,608
Total assets	**30,785,889**	**31,605,380**	**36,787,332**	**38,848,500**	**40,098,775**
LIABILITIES					
Other borrowings	1,285,685	922,680	2,031,093	2,338,233	2,031,093
Debt securities in issue	1,218,731	1,690,299	1,661,058	1,661,058	1,661,058
Deposits	24,567,292	25,141,868	28,419,295	29,581,240	31,060,302
Other liabilities	605,309	559,395	1,211,514	1,425,414	1,112,140
Total liabilities	**27,677,017**	**28,314,242**	**33,322,960**	**35,005,945**	**35,864,593**
EQUITY					
Share capital and premium	443,234	443,234	643,234	643,234	643,234
Reserves	2,665,638	2,847,904	2,821,174	3,199,321	3,590,948
Total shareholders' equity	**3,108,872**	**3,291,138**	**3,464,408**	**3,842,555**	**4,234,182**

Sensitivity Analysis

Sensitivity Analysis - Price

N$16.00
N$15.00
N$14.00
N$13.00
N$12.00
N$11.00
N$10.00
N$9.00
N$8.00
N$7.00

13.44% 13.69% 13.94% 14.19% 14.44% 14.69% 14.94% 15.19% 15.44%

Cost of Equity

SGR @ 8.69%
SGR @ 8.94%
SGR @ 9.19%
SGR @ 9.44%
SGR @ 9.69%
SGR @ 9.94%
SGR @ 10.19%
SGR @ 10.44%
SGR @ 10.69%

Source: IJG

Sustainable Growth Rate \ Cost of Equity	13.44%	13.69%	13.94%	14.19%	**14.44%**	14.69%	14.94%	15.19%	15.44%
8.69%	N$10.79	N$10.26	N$9.77	N$9.33	N$8.93	N$8.56	N$8.22	N$7.91	N$7.62
8.94%	N$11.18	N$10.60	N$10.07	N$9.60	N$9.17	N$8.77	N$8.41	N$8.08	N$7.77
9.19%	N$11.61	N$10.98	N$10.40	N$9.89	N$9.42	N$9.00	N$8.62	N$8.26	N$7.94
9.44%	N$12.10	N$11.40	N$10.77	N$10.21	N$9.71	N$9.25	N$8.84	N$8.46	N$8.11
9.69%	N$12.65	N$11.87	N$11.18	N$10.57	**N$10.02**	N$9.53	N$9.08	N$8.68	N$8.31
9.94%	N$13.28	N$12.41	N$11.65	N$10.97	N$10.37	N$9.83	N$9.35	N$8.91	N$8.52
10.19%	N$14.01	N$13.02	N$12.17	N$11.42	N$10.76	N$10.17	N$9.65	N$9.18	N$8.75
10.44%	N$14.86	N$13.73	N$12.77	N$11.93	N$11.20	N$10.55	N$9.98	N$9.46	N$9.00
10.69%	N$15.86	N$14.56	N$13.46	N$12.51	N$11.70	N$10.98	N$10.35	N$9.78	N$9.28

Source: IJG

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