GCR GLOBAL CREDIT RATING CO.
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Equity Bank Limited

Kenya Bank Analysis **September 2012**

Security class	Rating scale	Rating	Rating outlook	Expiry date
Long term	National	AA-$_{(KE)}$	Stable	09/2013
Short term	National	A1+$_{(KE)}$		

Financial data:

(US$'m Comparative)

	31/12/10	31/12/11
KShs/US$ (avg.)	76.2	87.5
KShs/US$ (close)	78.0	82.4
Total assets	1,833.6	2,382.2
Tier I capital†	307.1	368.5
Tier II capital†	69.5	98.8
Net advances	1,003.8	1,381.4
Liquid assets	647.3	798.3
Operating income	119	142
NPAT	82	118
Market cap.*	US$1.1bn	
Market share**	8.8%	

† Refers to regulatory capital.
** Market cap as at 28 September 2012 on the*
*** Calculated as a % of total banking industry assets as at 31 December 2011.*

Rating History:

Initial Ratings (07/2005)

Long term: A$_{(KE)}$
Short term: A1-$_{(KE)}$
Rating outlook: Stable

Last Ratings (10/2011)

Long term: AA-$_{(KE)}$
Short term: A1+$_{(KE)}$
Rating outlook: Stable

Related methodologies:

Banking criteria (December 2011)
Banking Sector Bulletin (Dec. 2011)
Equity Bank reports (2005-2011)

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Rating rationale

The rating is based on the following key factors:

- The accorded ratings reflect Equity Bank Limited's ("Equity" or "the group") established domestic and regional franchise value, acceptable financial performance (yet fairly shielded given the relative insulation of the local banking market) and risk appropriate capitalisation cushioning. These are, however, partly offset by the uncertainties surrounding a stable and on-going economic recovery, as well as the coming election and/or transfer of power (the last election was marred by violence and other disruptions).
- A knowledgeable and experienced management team with a clear and consistent strategy that has positioned Equity as one of the leading financial institutions in Kenya.
- The group remains well capitalised, with a risk weighted capital adequacy ratio of 30%, against a prudential minimum of 12%.
- Despite a challenging macro-economic environment, a pre-tax profit of KShs12.8bn was recorded for F11, up 42% (F10: 71%) from the previous period. The performance was driven by net-interest income, which contributed a higher 57% (F10: 53%) of total operating income supported by strong loan growth.
- Loans in arrears declined by 9% to KShs3.2bn, on the back of write-offs amounting to KShs1.4bn. Consequently, as a percentage of the gross loan book, non-performing loans ("NPLs") amounted to a considerably reduced 2.8% as at FYE11 (FYE10: 4.5%). Total provisions covered gross NPLs by 72%, up from 51% in F10, pre-collateral. Accordingly, the NPLs ratio declined to 0.8% as at FYE11.
- A cumulative liquidity gap was displayed in the less than 1-month maturity bucket equivalent to 41% of capital as at FYE11. Liquidity risk is partly ameliorated through maintaining a liquid balance sheet and the diversified nature of the deposit base. The liquidity ratio was maintained well above the prudential minimum of 20% throughout the review period closing the year at 40%.

What could trigger a rating action

Deteriorating economic, regulatory and political environments across operating jurisdictions and the spill over effects of a weak global market, which could undermine the ability of borrowers to service debt given the bank's highly vulnerable target market encompassing the low end retail segment and SMEs. Rapid loan growth, which could lead to a spike in non-performing loans and a decline in asset quality and earnings. Conversely, a continuation of the profitability trend, while maintaining credit protection factors will be considered positively.

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Organisational profile

Business summary

Equity Bank Limited, previously known as Equity Building Society ("EBS"), commenced operations in 1984. In the 1990s, EBS changed its focus to micro-finance, targeting the under-served, low income population. The growth in business volumes and penetration necessitated the conversion to a commercial bank in 2004, and the company subsequently listed on the Nairobi Stock Exchange in August 2006 (and later the Uganda Securities Exchange). Equity Bank Limited is the holding company of the group's banking subsidiaries in Uganda, Southern Sudan and recently Rwanda (established in 2011) and Tanzania (established in February 2012).

Equity is one of the fastest growing microfinance providers across the East African region. In 2008, Equity began its regional expansion, establishing subsidiaries in both Uganda and Southern Sudan. Equity has grown its branch network from 70 in 2007 to 195 as at June 2012 across all its markets. In addition to branch growth, aimed at expanding the group's reach and retail footprint, the bank has also made substantial investments in IT infrastructure, facilitating e-based products such as internet and mobile banking to provide efficient low cost services. New initiatives include a foray into agency banking to accelerate the establishment of the bank at village level (an alternative to expensive brick and mortar branches). The roll out of the agency banking in Kenya has been successful with the number of agents growing from 875 in F10 to 3234 in F11 and 5,004 as at 1HF12.

Subsidiaries

Equity Bank Ltd serves as the holding company of the group's subsidiaries and associates. According to management, this will be reviewed once enabling legislation is put in place which will allow banks to be owned by a holding company. Equity encompasses nine wholly owned operating subsidiaries being:, Equity Bank Tanzania Ltd, Equity Bank Uganda Ltd, Equity Bank Ltd Southern Sudan, Equity Bank Rwanda Ltd, Equity Nominees Ltd, Equity Group Foundation, Equity Insurance Agency Ltd, Equity Investment Bank Ltd and Equity Investment Services Ltd. The bank also has a 24.9% stake in Housing Finance Company of Kenya Ltd, the leading mortgage service provider in Kenya. All subsidiaries, except Equity Bank Uganda, Equity Bank Rwanda, Equity Bank Tanzania and Equity Bank Southern Sudan, are incorporated in Kenya.

As at FYE11, the Kenyan operations contributed roughly 90% (FYE10: 91%) of total group assets. During F11, the group obtained licenses to operate in Rwanda and Tanzania, with the Rwandan operations commencing in the same year, enhance its presence in the East Africa region

Ownership structure

The table below provides a full breakdown of the bank's main shareholders as at end-December 2011.

Table 1: Shareholding composition	%
Helios EB Investors	24.5
British-American Investment Co. (Kenya) Ltd	10.6
Equity Bank Employee Share Ownership Plan	4.3
James Mwangi Njuguna	3.5
Fortress Highlands Limited	2.7
Andrew Mwangi Kimani	2.4
AIB Nominee A/C Solidus Holdings Ltd	2.4
Leah Wanjiku Muguku	2.0
Maewa Holdings Ltd	1.7
AIB Nominee A/C Lily Properties Ltd	1.6
Other 28,610 Shareholders	44.3
Total	**100.0**

Source: Equity.

Governance structure[1]

Equity's current directorate consists of two executive and eleven non-executive directors (after the addition of one non- executive director in F11). Equity (and all its subsidiaries) abides by the recommended rules on good corporate governance as set out by the Capital Markets Authority ("CMA") in Kenya, the Central Bank of Kenya ("CBK") as well as the principal bodies in each country of operation. A comprehensive corporate governance policy is in place. The board conducts an annual peer based evaluation of the effectiveness of its operations encompassing specific criteria such as structure of the board, effectiveness of committees, strategic leadership, corporate responsibility, attendance and participation of members and weaknesses. The results of the evaluation are submitted to the CBK annually as stipulated in the banking regulations.

Financial Reporting

The bank's accounts are in accordance with International Financial Reporting Standards ("IFRS") and the Kenyan Companies Act (periodic performance memos are also easily accessible through the bank's web platform). Ernst and Young are the group's external auditors and have issued unqualified reports. The nomination and subsequent appointment of a registered public accounting firm by an institution must be approved by CBK. To ensure independence, the prudential guidelines also require that the lead audit partner or the audit partner responsible for reviewing the audit, be rotated every five years.

Operating environment

General economic overview

Though the local economy has been out of balance for a long time, it has eventually reached breaking point; the constant barrage of shocks exposed a number of structural weaknesses, which contributed to and/or aggravated the current economic instability

[1]Given the intricacies associated with good corporate governance (and the fact that these issues fall outside the scope of this report), GCR recommends an independent assessment to test true compliance.

- that's said, economic growth remained adequate, although below potential and original expectations.

Economic shocks	Description of impact on economic growth
Higher fuel prices	The increase in international crude oil prices saw Kenya's oil import bill rise by 42.2% (26% of total) - thus, transport inflation doubled from 13 to 26%.
Higher food prices	The food shortfall was met with expensive imports of maize (77% premium per ton over global prices) - thus, food inflation rose sharply from 10 to 26%.
Drought in region	The impact of low rainfall and high temperatures on food production and power was broad based (mainly livestock mortality and hydro generation). - estimate loss of 0.2% of gross domestic product.
The European crisis	Demand (from Europe) for horticulture crops fell sharply, hurting export earnings - also contributed to the volatility/depreciation seen in the currency.

Looking forward, and the economic outlook hinges on whether the government is able to successfully manage the current crisis, maintain political stability (pre and post the elections), and address the security issues arising from the military conflict with Somalia.

Future challenges	Description and impact on economic growth
External issues	° *Recession in Europe* - this should further impact demand for horticulture exports and/or tourism (press on currency reserves/value and industry).
Internal issues	° *Political uncertainty* - historically, election years are characterised by negative growth in private investment inflows and household consumption (elections are prone to violence and new policy regimes, hence business/investor interest flat).

Basic sector overview

The table below provides a snapshot of most key performance metrics, covering the most recent year.

Industry indicators (annual change)	Percentage
Total balance sheet assets	20.4%
Gross loans and advances	31.5%
Customer deposit liabilities	20.3%
Performance ratios (outcome and trend direction)	
Total capital to risk-weighted assets	20.4% - ↑
Non-performing loans to gross loans outstanding	3.7% - ↓
Liquid assets to total balance sheet assets	28.4% - ↓
Return on total balance sheet assets	3.2% - ↓

Source: Shared industry data.

Competitive position

The following table provides an analysis of the bank relative to its peers, focusing on the key operational indicators for the period ended 31 December 2011. Equity gained significant market share in F11 ranking 2th (FYE10: 5th) in terms of total banking industry assets, with a market share of 8.8% (FYE10: 8%). The bank ranked 4th (FYE10: 5th) in terms of deposits with a market share of 8.27% (FYE10: 7.7%).

Table 2: Peer analysis (KShs'm)	Equity*	KCB	Barclays	CBK
Total assets	176,911	282,494	167,305	167,772
Market share (%)	*8.8*	*14.0*	*8.3*	*8.3*
Net customer loans	113,824	198,725	99,072	86,616
Market share (%)	*13.3*	*16.3*	*8.1*	*9.0*
Customer deposits	125,492	210,174	124,207	142,705
Market share (%)	*8.2*	*14.1*	*8.3*	*9.6*

*Refers to Equity Kenya Source: CBK/Company financials.

Financial profile

Likelihood of support

Though the government has proven its position as interventionist, this must be viewed as a systemic protection mechanism only. Therefore, shareholder backing is considered the only reasonable alternate.

Funding composition

Equity is mainly funded via customer deposits, accounting for a slightly reduced 72% (FYE10: 75%) of the group's total funding (including equity)as at FYE11, with the balance comprising equity 21%, long term debt 6.9% and interbank borrowings 0.5%. The group has made limited use of debt in growing its balance sheet and gearing remains very low. Total funding (excluding equity) grew by 41% (FYE10: 47%) to KShs157.9bn as at FYE11, supported by rollout of additional branches, electronic delivery channels and agency banking.

Table 3: Funding base	F10		F11	
By source	KShs'm	%	KShs'm	%
Interbank borrowings	499	0.4	1,023	0.6
Medium &long term debt†	7,464	6.7	13,769	8.7
Retail depositors	**69,475**	**62.1**	**111,895**	**70.8**
Term	*5,920*	*5.3*	*6,057*	*3.8*
Current	*8,271*	*7.4*	*33,209*	*21.0*
Savings	*55,284*	*49.4*	*72,629*	*46.0*
Corporate depositor	**34,956**	**31.2**	**32,270**	**20.4**
Term	*13,426*	*12.0*	*19,208*	*12.2*
Current	*15,759*	*14.1*	*10,120*	*6.4*
Savings	*5,771*	*5.2*	*2,942*	*1.9*
Total	**112394**	**100.0**	**158957**	**100.0**

*Including equity Source: AFS

†Includes borrowings qualifying as Tier II capital.

Consequently, retail deposits grew by a robust 61%, to constitute 71% of total funding as at FYE11. Meanwhile, deposits from corporates contracted 8%, reflecting reduced reliance on volatile and price sensitive wholesale funding. The deposit base is well diversified in terms of size given the nature of the group's clientele, which comprises mainly the low income mass market and Small & Medium Enterprises ("SMEs").

Borrowings

Funding is further enhanced by various medium and long-term credit facilities secured from various development partners and lenders to match long-term loans advanced to the growing SMEs sector. As at FYE11, outstanding borrowings stood at KShs14.8bn, up 98% from KShs7.5bn as at FYE10. Borrowings increased on the back of additional lines from various development institutions including China Development Bank Corporation, Deutsche Bank Microfinance Fund, KFW Germany and Microfinance Enhancement Facility.

Capital structure

Boosted by retained earnings, shareholders' funds grew by 26% to KShs34bn. Further, on the back of additional long-term borrowings, secondary capital grew by 50% toKShs8bn. However, a more than proportionate growth in risk weighted assets saw a slight decline in the total risk weighted capital adequacy ratio to 30%. Represented below is a snapshot of the bank's regulatory capital (note all ratios are well above statutory thresholds).

Table 4: Capitalisation	F10 KShs'm	F11 KShs'm
Core capital	23,956	30,361
Add: Hybrid capital	5,422	8,145
Eligible capital	**29,378**	**38,506**
Total risk weighted assets (RWA)	**90,594**	**127,880**
Key capitalisation ratios		
Core capital : RWA	**26.4**	**23.7**
Statutory requirement @ 8%		
Eligible capital : RWA	**32.4**	**30.1**
Statutory requirement @ 12%		

† Capital requirement increased to KShs1bn (comply by 2012) in 2009.
Source: AFS

Risk management

Equity's board is responsible for risk management processes and discharges its duties through board approved committees namely: the Audit Committee, Credit Committee, Risk Management & ALCO Committee Strategy & Investment Committee, Tendering & Procurement Committee, Governance, Board Nominations & Staff Remuneration Committee and Executive Committee.

Credit risk (strategic overview)

Equity's asset base (including contingencies) grew by 38% in F11 displaying an annual compound growth rate of 24.7% over the past 5 years. The bulk of the assets comprised of loans & advances, increasing further to 56% of total assets (including contingencies) as at FYE11.

Table 5: Asset mix	F10		F11	
	KShs'm	%	KShs'm	%
Cash & liquid assets	**50,491**	**34.4**	**65,784**	**32.4**
Cash	*8,500*	*6.7*	*7167*	*4.4*
Balances with central bank	*4,802*	*3.9*	*8566*	*10.6*
Balances with other banks	*2,998*	*2.0*	*4777*	*2.4*
Government securities	*31,988*	*21.8*	*30502*	*15.0*
Customer advances	78,299	53.4	113,824	56.1
Fixed assets	6971	4.8	6980	3.7
Other assets	6,371	4.3	8,207	4.0
Contingencies	4527	3.1	7753	3.6
Total	**146,676**	**100.0**	**202,764**	**100.0**

Source: AFS

A breakdown of total assets excluding contingencies (by country) is tabled below.

Table 6: Contribution to total assets	F10		F11	
	KShs'm	%	KShs'm	%
Kenya	129,410	90.5	167,587	85.4
Uganda	7,115	5.0	9,169	4.7
Southern Sudan	6,493	4.5	17,844	9.1
Rwanda	-	0.0	1,694	0.9
Total	**143,018**	**100.0**	**196,294**	**100.0**

Source: AFS

Exposure to credit risk, without taking into account any collateral held or any other credit enhancements, increased to 87% of total assets as at FYE11.

Table 7: Credit risk exposure	F10		F11	
	KShs'm	%	KShs'm	%
Interbank placements	**8,711**	**5.9**	**26,267**	**13.0**
Balances with central bank	*5,713*	*3.9*	*21,490*	*10.6*
Balances with other banks	*2,998*	*2.0*	*4,777*	*2.4*
Customer advances	**78,298**	**53.4**	**113,824**	**56.1**
Local currency	70,826	48.3	96,006	47.3
Foreign currency	7,472	5.1	17,818	8.8
Government securities	31,988	21.8	30,502	15.0
Contingencies	**6,613**	**4.5**	**5,289**	**2.6**
Guarantees & standby letters of credit	*4,272*	*2.9*	*5,016*	*2.5*
Letters of credit, acceptances & other	*2,341*	*1.6*	*273*	*0.1*
Total credit risk	**125,610**	**85.6**	**175,882**	**86.7**
Total assets	**146,676**	**100.0**	**202,764**	**100.0**

Source: AFS

Loan portfolio

Loan growth accelerated to 45% (FYE10: 24%) as at FYE11, exceeding the industry average growth of 32%. The bulk of Equity's loans and advances are to small-scale farmers, low-end salaried workers and small businesses. On average, small-scale farmers take out the smallest loans, which are usually evaluated on the basis of predicted remittances by the Kenya Tea Development Authority or other farm produce marketing companies. During the year, the bank partnered with the Ministry of Agriculture through the Cotton Development Authority, National Irrigation Board, and farmers in the Bura irrigation scheme to facilitate various agricultural projects. Although the loan portfolio remained largely skewed towards the consumer and SMEs sectors, there was a notable growth in exposures to large SMEs, which constituted a significantly higher 27% of the total loan portfolio *(See Table 8 below)*. The mortgage loan portfolio (for both residential and commercial purposes in the low income market) has grown slowly following its launch in F09. Notwithstanding this, mortgage lending still constitutes a small portion of the book at 4.5% as at FYE11. Accordingly, lending products mainly comprise secured lending to SMEs and consumer loans to salaried individuals.

Table 8: Gross loan book characteristics	F10		F11	
	KShs'm	%	KShs'm	%
By sector				
Consumer	33,401	41.7	40,298	34.7
Micro Credit	9,039	11.3	13,956	12.0
Agriculture	2,598	3.2	3,303	2.8
SMEs	20,692	25.8	27,211	23.4
Large SMEs	14,405	18.0	31,406	27.0
Total	**80,135**	**100.0**	**116,174**	**100.0**
By type				
Mortgage lending	3,946	4.9	5,189	4.5
Personal loans	41,557	51.9	56,853	48.9
SMEs secured lending	34,632	43.2	54,132	46.6
Total	**80,135**	**100.0**	**116,174**	**100.0**

Source: AFS

The maturity profile lengthened, with 47% (FYE10: 43%) of the loan portfolio, displaying a tenure of more than 5 years.

Table 9: Gross loans by maturity*	%	%
> 3 months	8.2	5.4
3-6 months	3.5	3.7
6--12 months	11.4	8.7
1-5 years	47.5	50.6
> 5 years	29.3	31.7
Total	**100.0**	**100.0**

*As a percentage of gross loans Source: AFS

Asset quality

Impaired loans contracted by 9.8% to KShs3.2bn as at FYE11 mainly due to write-offs. This, coupled with strong loan growth, led to a decline in the gross NPLs ratio to 2.8% from 4.5% in F10. Arrears coverage increased to 72% (F10: 51%) as at FYE10 contributing to a decline in the net NPLs and net NPLs/ capital ratios. Equity has adopted a conservative lending approach to advances, with security being provided in the form of land and vehicles (where the vehicle must be insured). For salaried loans, the bank requires security to the value of 200%, whilst for agricultural loans, the bank will only advance out 40% of the value of the final expected payment on a crop. However, cumbersome legal processes, mean that the realisation of collateral may be problematic and a lengthy process.

Table 10: Asset quality	F10 US$'m	F11 US$'m
Gross advances	**80,136**	**116,174**
Collectively impaired	**76,537**	**112,928**
Neither past due nor impaired	*75,165*	*111,013*
Past due but not impaired	*1,372*	*1,915*
Individually impaired	**3,599**	**3,246**
Substandard	*740*	*550*
Doubtful	*1,547*	*1,840*
Loss	*1,312*	*856*
Less : Provisions	**(1,837)**	**(2,350)**
Individually assessed	*(1,386)*	*(1,724)*
Collectively assessed	*(451)*	*(626)*
Net NPL's	**1,762**	**896**
Fair value of collateral on NPLs	5,843	629
Write-offs	2,857	1,365
Gross NPL ratio (%)	**4.5**	**2.8**
Net NPL ratio (%)	**2.3**	**0.8**
Net NPL/Total Capital (%)	**5.6**	**2.2**

Source: AFS

Financial performance

A 5-year financial synopsis is reflected at the back of this report, supplemented by the commentary below.

Gross interest income increased by 40%, with robust earnings growth attributable to loans and advances. Despite the challenging macro-economic environment characterised by high interest rates, high inflation and volatile exchange rates, Equity restrained upward interest rate adjustments on loans to customers until mid-November 2011. Consequently, the eventual re-pricing of the loan book was capped at a maximum interest rate of 25% per annum compared to an average banking industry loan interest rate of 32%. Notwithstanding decline in loan profitability, strong growth in cheaper retail deposits contributed to the slight increase in net interest margin to 12.2% (F10; 11.9%). Other income increased by 20%, despite a decline in income from foreign exchange trading impacted by volatile exchange rates, lower margins and transaction volumes. Non-interest income contributed 43% (F10: 47%) of total operating income in F11. Overall total operating income grew by 29% (F10: 41%) to 28.7bn in F11. Operating expenditure driven mainly by staff, promotion expenses, branch rollout costs and administrative expenses grew by a comparatively lower 27%. As a result, the cost ratio decreased to 50% from 51% in F10. Demonstrating the sustained improvement in the bank's asset quality, the bad debt charge represented a four-year low of 5.7% of total operating income. Profitability indicators improved with the ROaE and ROaA lifting to a review period high of 33.6% and 6.1% respectively, from 28.5% and 5.9% in F10. In terms of earnings performance, all subsidiaries contributed positively to NPBT, except the recently established operations in Rwanda.

Table 11: Contribution to before tax earnings	F10 KShs'm	F10 %	F11 KShs'm	F11 %
Kenya	9,370	104.7	12,104	95.5
Uganda	(769)	(8.6)	19	0.1
Southern Sudan	349	3.9	609	4.8
Rwanda	-	-	(59)	(0.5)
Total	**8,950**	**100.0**	**12,679**	**100.0**

Source: AFS

Future prospects

The actual unaudited results for the 6 months to June 2012, compared to the same period in F11, are shown in Table 12 below.

Table 12: Unaudited Interims (KShs'm)			
Income statement	**1HF11**	**1HF12**	**% change**
Interest income	8,310.6	14,859.4	78.8
Interest expense	(1,044.7)	(3,580.7)	242.8
Net interest income	**7,265.9**	**11,278.7**	**55.2**
Other income	5,885.2	6,284.2	6.8
Total operating income	**13,151.0**	**17,562.9**	**33.5**
Bad debt charge	(1,153.7)	(1,243.6)	7.8
Operating expenditure	(7,315.4)	(10,003.4)	36.7
NPBT	**4,683.1**	**6,317.2**	**34.9**
Selected balance sheet indicators			
Customer deposits	123,987.0	151,113.5	21.9
Bank deposits	6,092.3	5,345.4	(12.3)
Borrowings	8,441.5	22,730.9	169.3
Capital & reserves	29,083.1	35,803.1	23.1
Cash & cash equivalents	57,857	74,377	28.6
Loans & advances	97,712	124,461	27.4
Total assets	171,352.4	219,887.4	28.3

Source: Equity Bank

Equity has continued its strong performance into F12, reporting net profit after tax of KShs 4.7bn, 14% up on the corresponding period in F11. Net advances grew by a comparatively strong 27%, with more upside anticipated over the course of the year supported by growth in funding liabilities.

The group's short-to-medium term plans include: the continued expansion of its domestic franchise through investments in additional branches, agency banking and electronic delivery channels to further expand reach and grow more stable, lower cost funding liabilities.