VM Wealth Management Limited

APO Analysis: NCB Financial Group (NCBFG)

VMWM Research | May 06, 2024

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NCB FINANCIAL GROUP

- APO Recommendation: **CONDITIONAL PARTICIPATION**
- Stock Recommendation: **OVERWEIGHT**
- Offer Price: $65.00
- Price Target: **$79.76**
- Current Price: $61.17[1]

- Shares on Offer: 780,000 units.
- Shares Outstanding: 2,545,325,512 units.
- Financial Year End: September 30
- Selling Agent: VM Wealth Management Limited

ABOUT THE COMPANY

NCB Financial Group Ltd. is a financial holding company incorporated and domiciled in Jamaica. The Head office, the Atrium, is located at 32 Trafalgar Road, Kingston 10. It is the largest financial group in Jamaica with an asset base of more than $2 Trillion. Its subsidiaries include National Commercial Bank Jamaica (NCBJ), Clarien Group Limited, NCB Global Holdings and TFOB (2021) Limited.

The Group's primary objective is to deliver faster services and efficiently strengthen its position in both the local and regional market. It offers Consumer & SME and Corporate & Commercial Banking, Payment services, Asset Management & Investment Banking and Insurance and Pension Fund Management.

AIC (Barbados) Ltd is the parent company of NCB, which has majority shareholdings of 52.46%. The ultimate parent company is Portland Holdings Inc. which is controlled by the Hon. Michael Lee-Chin O.J. NCBFG trades on the Jamaica and Trinidad and Tobago Stock Exchanges.

FINANCIAL PERFORMANCE

J$'000	FY 2021/22	FY 2022/23	Q1 2022/23	Q1 2023/24
Net Interest Income	59,198,862	62,801,040	18,875,000	21,657,000
Operating Profit	39,617,077	19,585,267	3,880,000	8,353,0000
Net Profit to Parent	23,889,103	7,592,226	1,378,000	3,077,000
Total Assets	2,078,186,259	2,222,801,512	2,082,966,000	2,221,324,000
Shareholder Equity to parent	146,098,191	170,022,090	1532,553,000	159,662,000
Total Liabilities	1,884,977,273	1,999,404,540	1,925,831,000	2,025,272,000
Book value per share ($)	63.54	73.94	52.08	62.73
Earnings per share ($)	10.39	3.30	(1.83)	1.32

Dividend Policy

NCBFG's dividend policy is in alignment with its Capital Management Plan which is reviewed annually or as the Board of Directors sees fit. As it stands, the Board of Directors declares dividends at its discretion and intends to pay out subjected to maximum of 50% of annual earnings which will be paid from the Group's retained earnings.

Use of Proceeds

The company intends to use the proceeds from the sale of the shares as outlined below:

- Pay its APO transaction costs
- Reallocate capital with the focus on reducing indebtedness

Outlook

Over the last year the global economy has been plagued with mounting financial stress caused by stubbornly high inflation. In response, local and international central banks have adopted the mechanism of hiking interest rates to strengthen the momentum of economic recovery, revive growth and improve consumer sentiment. NCBFG remains resilient and steadfast implementing a restructuring exercise aimed to recalibrate strategies and institute measures to contain operational costs, improve margins and increase shareholder value.

Projections and Valuations

We used a combination of market comparable and an absolute based approach to determine the value for the stock. For the absolute approach, a cost of equity of 11.07% was used to determine the appropriate equity charge and discount the expected residual income. For the comparative approach, a forward BVPS and EPS of $74.37 and $8.99 respectively were used. An applied P/B and P/E of 1.00x and 10.00x were deemed appropriate and were used to determine a relative value. By averaging all three approaches, we obtained a consensus target price of **$79.76**.

Risks to Price Target

NCBFG continues to grapple with the persistently high interest rate environment against the backdrop of the higher for longer sentiment. BOJ is projecting that inflation will likely maintain this upward trend underscored by the outlook on the agriculture sector along with higher-than-projected wage adjustments, given the tight labor market. The risks associated with this includes but not limited to lower interest income due to margin compression as well as adjustment to insurance assumptions which may elevate insurance expense resulting in lower reported earnings.

[1] As at May 05, 2024

ABRIDGE OFFER DETAILS

ISSUER	NCB Financial Group Limited
ARRANGER	NCB Capital Markets Limited
LEAD BROKER	NCB Capital Markets Limited
ISSUE	Total of 78,500,000 Ordinary Shares: • Employee Reservation Pool – 785,000 The Company reserves the full, unqualified, and absolute right to increase the number of Shares in the APO by up to a further 39,250,000.
OFFER PRICE	$58.00 per share – Employee Reservation Members. $65.00 per share – All other applicants.
MINIMUM APPLICATION	100 shares with excess in multiples of 10
TARGET AMOUNT	$5,030,679,045 after $66,718,454.30 approximately is used to cover transaction costs. (subject to the right of the Company to upsize the offer on oversubscription)
KEY DATES	Opens May 06, 2024, at 9:00 am Closes May 27, 2024, at 4:00 pm
USE OF PROCEEDS	• Pay its APO Expenses • Reallocate capital and reduce debt

Table 1. Offer Details

CORPORATE GOVERNANCE

The Board of Directors of NCB Financial Group comprises seven (7) individuals, three (3) of whom are directly involved in the business operations.

NAME	POSITION
Hon. Michael Lee-Chin	Chairman of the Board, Non-Executive Director
Robert Almeida	Director & Group CEO, Non-Executive Director
Gary Brown	Lead Independent Non-Executive Director
Bruce Bowen	CEO NCBJ, Non-Executive Independent Director
Thalia Lyn	Non-Executive Independent Director
Sanya M. Goffe	Non-Executive Independent Director
Howard L. Shearer	Non-Executive Independent Director

Table 2. Corporate Governance

CAPITAL STRUCTURE AND SHAREHOLDING

The group will be offering 78,500,000 shares divided amongst the reserved pool for NCBFG employees and general applicants. The shares being offered will represent approximately 2.99% of the post-APO total shares outstanding, while existing shareholders will own 97.01%. A further breakdown shows that of the 2.99%, reserved share applicants will be offered 0.029% of the group, while 2.96% will be available to public applicants. NCBFG reserves the right to upsize the APO by 39,250,000 shares.

SHAREHOLDERS	SHAREHOLDING (PRE-APO)	ISSUED CAPITAL (%)	SHAREHOLDING (POST-APO)	ISSUED CAPITAL (%)
Existing Ordinary Shares	2,545,325,512	100%	2,545,325,512	97.01%
Reserved Shares – NCB Employees	-	-	785,000	0.029%
Non-Reserved Shares- General Public	-	-	77,715,000	2.96%
Total	**2,545,325,512**	**100%**	**2,623,825,512**	**100%**

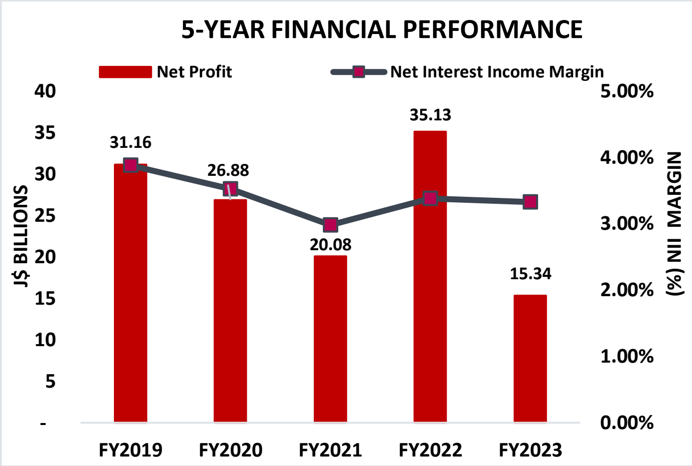
Table 3. Capital Structure and Shareholding Pre and Post APO Breakdown

FINANCIAL PERFORMACE

J$'000	FY 2018/19	FY 2019/20	FY 2020/21	FY 2021/22	FY 2022/23	Q1 2022/23	Q1 2023/24
Net Interest Income	44,595,084	52,489,709	48,626,967	59,198,862	62,801,040	18,875,000	21,657,000
Operating Profit	26,444,072	27,261,085	26,255,244	39,617,077	19,585,267	3,880,000	8,353,0000
Net Profit to Parent	29,869,398	19,090,378	14,226,671	23,889,103	7,592,226	1,378,000	3,077,000
Total Assets	1,616,299,602	1,800,260,275	1,921,368,172	2,078,186,259	2,222,801,512	2,082,966,000	2,221,324,000
Shareholder Equity to parent	147,590,179	156,114,678	161,456,191	146,098,191	170,022,090	1532,553,000	159,662,000
Total Liabilities	1,432,428,984	1,600,055,352	1,714,703,146	1,884,977,273	1,999,404,540	1,925,831,000	2,025,272,000
Book value per share ($)	57.98	67.90	70.22	63.54	73.94	52.08	62.73
Earnings per share ($)	12.30	8.30	6.19	10.39	3.30	(1.83)	1.32

Table 4. Financial Performance

FIVE YEAR HISTORICAL PERFORMANCE (FY2018/19 – FY2022/23)



NCBFG over the last five years produced mixed earnings results where most of the earnings can be accounted for by its core operations, the banking and investment segment. In 2019 the Group acquired a majority stake in Guardian Holdings Limited, a leading insurance and financial services company in the Caribbean. This acquisition gave NCBFG a strong presence in the insurance market while expanding its regional reach. The Group operates in a mature financial services market and is generally regarded as one of two dominant players in the local sphere.

NCBFG recorded a gradual increase in interest income at a CAGR of 9.26% against dwindling market conditions, consumer sentiment and heightened volatility during the period, but was tempered by inflated interest expense (CAGR 13.46%). This resulted in a drag in interest income which only performed at a CAGR of 7.09% over the same period but in the last year surpassed the $60 billion mark. Similarly, Fees and Commission income grew steadily as did its expense counterpart posting an annualized growth of 7.92%. Over the five-year period, NCBFG's banking and investment segment reported an annualized net improvement of 8.05%. Notable increases in foreign currency and investment activities, up 6.89% owing to unrealized gains on equity investments along with higher dividend income and other operating income. It should be noted that against the severe market disruptions caused by the pandemic, the segment remained resilient and continued to outperform its prior year's results.

On the other hand, net results from insurance activities annualized growth rate tipped higher at 10.92%, underscored by Guardian Holdings Limited dominance in the market. In particular, the net result for 2022 showed a significant jump when compared to 2021 which could be explained by the health crisis set on by the pandemic. However, net results plummeted to $24.23 billion in the following year which was chiefly attributable to the negative impacts of elevated interest rate and inflation environment along with higher claims on insurance benefits. For context, the financial statements for NCBFG for the years 2022 and 2023 were prepared in accordance with IFRS4, which calls for calculating reserve movements by taking the present value of future changes in variables like interest rates, inflation rates, expenses, etc. This resulted in elevated charges caused higher reserves coupled with an increase in net claims, particularly in the health, property, and casualty areas. Furthermore, there was an increase in elective procedures during the pandemic; however, the jump in health claims is anticipated to return to pre-pandemic levels over the long-term.

Operating Expenses grew in tandem with group operations and expansions, supported by an upward trend shown over the last five years at a CAGR of 12.70%. Higher expenses were mainly attributable to elevated staff costs, which grew at an annualized average rate of 13.54%. For context, between 2021 and 2022 staff costs went from $44.50 billion to $50.34 billion, a sharp increase following the launch of TFOB in 2021 introducing Lynk, an industry-leading digital payment system, to the market. Additionally, when comparing 2023 results with 2022, the staff complement experienced an uptick of 20.24% to $60.62 billion underscored by non-recurring expenses associated with the restructuring exercise that occurred in the September 2023 quarter. Provisions were allotted to account for separation benefits due to the executive directors of the Company, which resulted in the cost to income ratio growing from 71.40% in 2022 to 82.54% for the 2023 year-end. Other operating expenses and finance costs associated with operational losses and property, vehicle, ABM maintenance and utilities also aided in higher reported operating expenses.

Over the five-year period, NCBFG's consolidated net profit reported mixed results as the Group navigates internal and macroeconomic challenges. For the financial year 2023 net earnings totaled $15.34 billion, a steep drop of 56.35% below $35.13 billion reported in the previous year. Earnings attributable to the parent company amounted to $7.59 billion, when compared to $29.86 billion in 2019 represents a 23.96% decline and translates to an EPS of $3.30 (2019: EPS $12.30).

NCBFG's total asset base was higher by a CAGR of 6.58%, an increase from $1.62 trillion to close 2023 at $2.22 trillion, reflecting a sharp decline in return on assets (ROA) to 0.7%. The main contributors to the increase were investments securities and reverse repurchase agreements which when combined grew to $1.11 trillion underscored by improvements in macroeconomic metrics resulting in higher asset prices and portfolio growth.

On the other hand, total liabilities grew from $1.43 trillion to $1.99 trillion, representing a CAGR of 6.90%. This was mainly attributable to repurchase agreements, other borrowed funds and obligations under securitization arrangements which grew at 9.88%, 7.53% and 15.24% respectively. Similarly, customer deposits grew by 8.18% and continue to be the largest source of funding for the Group.

For the period in review, equity attributable to the parent company rose to $170.02 billion in 2023 from $147.59 billion in 2019 or by an equivalent CAGR of 2.87%. The lion share was chiefly associated with year over year improvements in retained earnings and retained earnings reserves which collectively grew by 16.86% to close the 2023 financial year at $185.99 billion. Net Interest Margin (NIM) over the period in review remained above the 3% mark, except in 2021 where it fell marginally to 2.98%. While return on equity (ROE) showed mixed results but contracted significantly in 2023 to 9.70% when compared to 22.85% in the prior year.

FIRST QUARTER ENDED DECEMBER 2023:

For the first quarter ending December 31, 2023, revenue from Banking and Investment activities amounted to $19.51 billion, an improvement of $720 million over the prior year of $18.79 billion or by an equivalent increase of 3.83%. The marginal increase was mainly associated with growth of 14.74% in interest income to close at $21.66 billion and fee and commission income of 12.52% to close at $9.48 billion for the period. This was however tempered by higher interest and fee & commission expenses, while both dividend income and other operating income tripled to $280 million and $143 million respectively. The current quarter's unrealized fair losses contributed significantly to the $607 million reduction in gain on foreign currency and investment operations, although partially offset by an increase in foreign exchange revenue.

The Group adopted IFRS 17 on October 1, 2023, which significantly adjusted how insurance contracts are recognized and measured, particularly in the Life, Health, and Pension segment. During the period net revenue from insurance activities amounted to $15.01 billion, outperforming the prior year's results of $8.10 billion and representing an equivalent uptick of 85.34%. Insurance revenue for the period outstripped insurance service expense while net expenses from reinsurance contracts experienced a decline posting insurance service results at $6.20 billion which was particularly due to the outperformance of the property & casualty general insurance segment.

Finance expenses from insurance contracts held climbed to $6.09 billion and was compounded by a finance loss in reinsurance contracts held of $28 million owing to fair value movements and changes in interest rate assumptions against the backdrop of higher for longer sentiment. Investment income and other income insurance improved over the prior year for a similar period by 57.37% to close at $14.92 billion, underpinned by a non-recurring adjustment of $3 billion and net gains from equity securities. As a result, Operating Income ended the period at $34.52 billion, 28.28% higher than the previous year.

Operating Expenses pivoted higher over a corresponding period in 2022 by 13.72% at $26.17 billion, predominately associated with significantly higher depreciation and amortization expense coupled with other operating expenses which totaled $2.44 billion and $9.62 billion respectively. The former was supported by prior year's downward adjustment for depreciation and amortization charges underscored by policy changes that prolonged the useful lives of different asset classes as well as expenses associated with audit fees, management fees and operational losses. Staff costs climbed marginally by 3.55% to $13.58 billion driven by an annual staff increase which was countered by the restructuring exercise which took place in the last quarter of the prior fiscal year.

Notwithstanding, Operating Profit more than doubled to $8.35 billion, a $4.47 billion gain above the comparable period of $3.88 billion. This coupled with the share of profit of associates amounting to $46 million resulted in Profit before tax of $8.40 billion. Accounting for tax charges, net earnings for the first quarter ended December 2023 totaled $5.97 billion which translated to an earnings per share of $1.32 while earnings attributable to the parent company amounted to $3.08 billion.

During the first quarter of the fiscal year NCBFG’s total asset base at $2.22 trillion increased by 7%, or $138.4 billion, over the previous year. Increased investment securities and net loans and advances—which were mostly financed by repurchase agreements, deposits, and other borrowed funds—were the primary cause of the asset base uptick. This reflects a rebound in return on assets (ROA) to 0.27% comparable to 0.11% for the previous year. The primary drivers of this increase were reverse repurchase agreements, investment securities, and pledged assets which together surpassed $1.11 trillion. Increases in asset prices and portfolio growth were caused by improvements in macroeconomic sentiments while loans and advances net of provision for credit losses, increased by 4.92% to $621.22 billion over the previous quarter.

Total liabilities also experienced an increase to $2.03 trillion, representing an equivalent increase of 5.16% over $1.93 trillion reported in the previous year. This was predominantly associated with higher customer deposits of 5.53% to $756.59 billion, repurchase agreements of 16.55% to $297.43 billion and other borrowed fund which grew by 12.30% to $175.85 billion; customer deposits remain the largest source of funding for the Group.

Equity attributable to the parent company climbed to $159.66 billion when compared to $132.55 billion, representing an equivalent uptick of 20.45%. Share capital experienced a marginal increase of 3.18% to 158.73 billion, accompanied by increases in banking reserve fund of 19.68% to $8.25 billion and retained earnings of 25.38% to $78.44 billion along with significant improvements in fair value and capital reserves. Return on equity (ROE) ballooned to 3.74% when compared to 1.67% in the prior year over a corresponding period.

OUTLOOK

Due to persistently high inflation, the global economy has been beset with increasing financial hardship over the past year. As a result, both domestic and foreign central banks have implemented the mechanism of hiking interest rates in an effort to quicken the momentum of economic recovery, revive growth and improve consumer sentiment. Though local inflation abated from its peak rate of 11.8% in April 2022, for most of 2023 it remained well above BOJ’s target range of 4%-6%. However, in recent times annual headline inflation seems to have cooled where the 12-month point-to-point inflation (March 2023 to March 2024) was 5.6%, within the bank’s target range and represents the second consecutive decline. The BOJ is projecting that inflation will likely maintain an upward trend underscored by the outlook on the agriculture sector along with higher-than-projected wage adjustments, given the tight labor market. This is expected to dampen earning potential as net interest income is reduced owing to margin contraction. NCBFG remains resilient and steadfast implementing a restructuring exercise and recently an APO, just two of many initiatives aimed at recalibrating strategies and institute measures to contain operational costs, improve margins, and increase shareholder value.

Despite looming macroeconomic metrics and tighter capital requirements, NCBFG is expected to experience improvements across its banking & investments and insurance segments underpinned by a rebound in market activities.

During the September 2023 quarter NCBFG entered an arrangement with TFOB 2021 Limited to take over the management of the Lynk mobile wallet effective October 1, 2023. This move will capitalize on synergies anchoring NCBJ's ecosystem and broadening its customer base while deepening its interaction between individuals and businesses. The implementation of Basel III, whose core function is to ensure that banks hold enough capital reserve to protect the financial system, is well underway. To better reflect the risk exposures of financial institutions and increase their shock resistance, the Basel III framework now includes new capital charges for credit risk, market risk, and operational risk. NCBFG continues to maintain its strong capital and liquidity position given proactive management and strategic practices.

INVESTMENTS POSITIVES

- **Implementation of IFRS-17,** NCBFG's insurance subsidiary, Guardian Holdings Limited (GHL) adopted the IFRS 17 standard effective January 2023 which is more forward looking and improves comparability and increases transparency. The Group will adopt the standard effective October 01, 2023.
- **Diversified Portfolio,** the Group maintains a well-diversified income stream, namely through its banking, insurance, and investment businesses.
- **Geographical Diversification** across the Caribbean region with operations in Bermuda, Cayman, Trinidad & Tobago, Jamaica among other Dutch & English-speaking Caribbean countries, mitigate the concentration of risk in any one jurisdiction.
- **Strong balance sheet** provides NCBFG with a high degree of financial flexibility well positioned for investment opportunities.
- **Improving macroeconomic conditions** is expected to translate to improved performance and asset quality.

INVESTMENTS NEGATIVES:

- **Geopolitical conflicts**, the on-going Russia-Ukraine war and recently the Hamas-Israel dispute may exacerbate global supply chain challenges. In response, the central bank may implement policies that increase policy rates to quell elevated inflation which would negatively impact the Group's operations.
- **Adoption of Basel III framework,** the implementation of Basel III will result in higher risk weighted assets, higher capital standards and additional capital buffers which will require greater capital efficiency.
- **Rising Cost of Funding**, local and international central banks have adopted the mechanism of hiking interest rates as a bid to subdue high inflationary trends which may compress interest margins.
- **Higher reinsurance costs**, underscored by increasing market uncertainty.

CONCLUSION

Over the last year the global economy has been plagued with mounting financial stress caused by stubbornly high inflation. In response, local and international central banks have adopted the mechanism of hiking interest rates to strengthen the momentum of economic recovery, revive growth and improve consumer sentiment. NCBFG remains resilient and steadfast implementing a restructuring exercise aimed to recalibrate strategies and institute measures to contain operational costs, improve margins and increase shareholder value.

Using a residual income model and the market-based method, we have determined a price target of **$79.76** based on our evaluation of NCBFG's current state. Institutional investors looking to profit from a substantial block of the stock that has been sharply discounted to its intrinsic value are better suited for this APO offer. Given that purchasing the stock on the open market could result in significant capital gains for retail/small investors, an **OVERWEIGHT** recommendation is put forward. Employees will have the option to buy stock at a significant discount to the offer price. Although some would use this as an opportunity to average down, others might profit from the arbitrage opportunity (5.50% discount to the current price **$61.17**).

SOURCES

NCBFG Limited Annual & Quarterly Reports, Investor Briefing Jamaica Stock Exchange (JSE), The Gleaner Company, Loop News Jamaica, The Jamaica Observer, and the Financial Services Commission (FSC).

DISCLAIMER

DEFINITIONS

- **OVERWEIGHT** - Security is deemed to be undervalued and is expected to outperform compared to the average market return and/or return of comparable securities in the same sector or industry.
- **MARKETWEIGHT** – Security is expected to provide similar returns compared to the market in general or at the same pace as comparable companies; neither strongly positive nor negative.
- **UNDERWEIGHT** – Security is deemed to be overvalued and is expected to underperform compared to the average market return and/or return of comparable securities in the same sector or industry.

- **ZEROWEIGHT** – This security is substantially distressed or at risk of a shock which may significantly impair its value.