

CFC Bank: A changing of guard

Price	Sh.243.00
Market Cap	Sh.37.9bn
KES/USD	72.00
Av wkly vol.	118,687
Free Float	13.9%
P/E	62.7
Dividend yield	0.4%
Price to book	8.5

RATING **SELL**

Date 7 Feb 2007

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- Standard Bank of South Africa's takeover and merger proposal has triggered the imagination of the market.
- Following the announcement the share price rallied strongly stretching valuation ratings.
- We have a value determined a valuation estimate of Ksh.34.80 using a dividend discount methodology.
- The main investment risks are related to the ongoing merger negotiations which will change the strategic direction of the company.
- Unless addressed by the current deal a narrow free float will mean the share will continue to be peripheral at the exchange

Stanbic's takeover

On 24 Jan 07, the board of CFC Bank through a cautionary announcement revealed it had entered into negotiations with Standard Bank of South Africa that would see control of the company shift to Standard Bank. The deal as described would involve two steps, the first being a sale of shares by current leading shareholders to Standard Bank. The second would involve a merger of Stanbic Bank (K) Ltd and CFC Bank.

The resulting merged entity would have banking assets totalling Ksh.48bn as at 30 Sep 06 and would probably rank as the fifth largest bank in Kenya with a 6.6% market share. The combined entity's loan book would total Ksh.25bn (6.7% market share) and a deposit base of Ksh.35bn (5.4% market share).

The cautionary statement did not give any indication about the future of CFC's considerable insurance interests. In our view a third related transaction involving the sale of these insurance interests to an unidentified third party would be likely. While Standard Bank controls Liberty Life in South Africa, the bank has not articulated an insurance strategy for its interests in Africa.

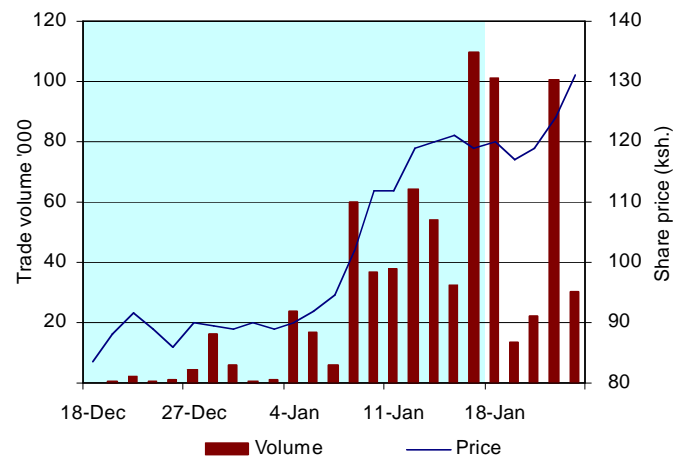
The merged banks would pose a greater competitive threat to the more established large banks in Kenya. Interestingly the entity would remain a potential acquirer as its market share would remain small enough not to raise anti-competition objections. It is no secret Stanbic has been actively looking around for suitable candidates to acquire but more surprising is the proposed sale by CFC's major shareholders.

We speculate the apparent turnaround has its genesis in the passing away of CFC's immediate past chairman, Mr PK Jani. It is probable his heirs would have preferred to liquidate the estate's position in the bank avoiding bearing commercial risks and responsibilities associated with running such a large financial group.

While the cautionary statement was not categorical on the specifics of the merger and takeover, it did reveal that pricing would be partially based on the average trading price of CFC shares on the Nairobi Stock Exchange (NSE). The trading period would cover 30 days up to 18 Jan 07. We calculate a simple average price of Ksh.99.38 and a weighted average of Ksh.112.57.

At these prices a price to book value ratio of 3.5 – 4.0 and a price to earnings ratio of 20.3 – 22.9 would obtain. In Standard Bank's view CFC would be worth Ksh.15.5bn (\$215mn) or Ksh.17.5bn (\$245mn). However, the market on hearing the news rallied pushing the share price to an intra-day high of Ksh.900 and closed the day at Ksh.368, well above the pre announcement share price of Ksh.131.

Chart 1: CFC Bank's share price



Source: NSE

The proposed transaction is not a done deal at this stage and we'd assume that the parties are undertaking various due diligence exercises. To gain control of CFC Bank Standard bank would have to acquire 78mn shares plus one, assuming a purchase of existing shares. The 2005 annual account reveal the top three leading shareholders control 86.1% of the issued shares.

Table 1: Shareholder profile

Shareholder	Holding	Share
Gambit Holdings	71,243,617	45.7%
African Liason & Consultants Services	43,063,683	27.6%
Sovereign Trust	19,967,592	12.8%
Free float	21,725,108	13.9%

Source: 2005 CFC Bank annual accounts

Probably of greater interest to investors is if the proposed merger will lead to greater liquidity on the exchange. With a free float of less than 14% and closely held by current shareholders the stock has proven to be difficult to get a hold of.

Business overview

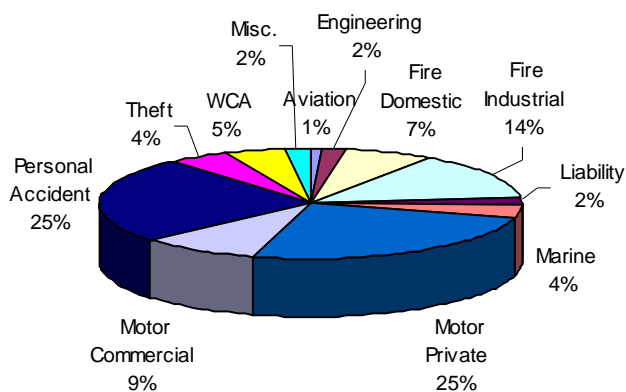
CFC Bank has been in existence from 1955 and was originally an asset finance company. Over the years particularly under the stewardship of its late chairman, Mr PK Jani, has grown tremendously. Notable developments have been its expansion into insurance services and its conversion from an asset finance company into a commercial bank in Kenya.

The group today comprises of 3 major operating units, CFC Bank, Heritage All Insurance and CFC Life. The group can be best described as a financial services conglomerate with its insurance business contributing the larger share of income to the group. The insurance interests also include significant minority interests in two Tanzanian insurance companies that together account for 10% of the group's income.

CFC Life was formed following the acquisition of American Life Insurance Company's (ALICO) life fund in Kenya in 2004. The acquisition catapulted the group's ranking in the life insurance segment to third place with a 11.85% share of gross premiums earned in 2005. The group hopes to continue growing its life insurance interests organically as it digests the acquisition of ALICO.

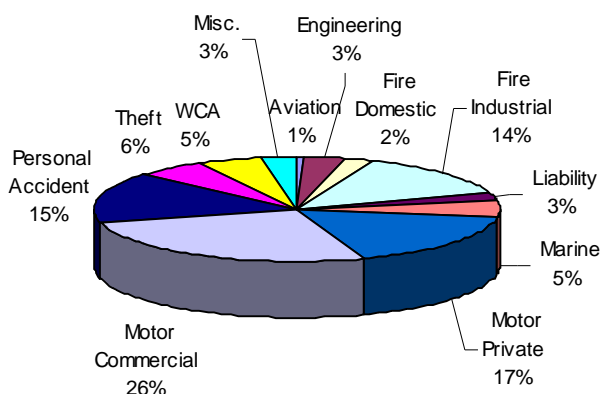
General insurance lines of business within the group are handled by Heritage (All) Insurance. The main lines in 2005 were private motor and personal accident insurance making up 50% of premiums earned. This is higher than the industry average, where the two total 32% of premiums earned. Industry experience on these lines of business has been poor over the six years from 2000 to 2005, with loss ratios consistently exceeding 50%. Due to group accounting presentation in the annual accounts we are unable to assess the performance of Heritage on this front.

Chart 2: Heritage All general insurance premiums



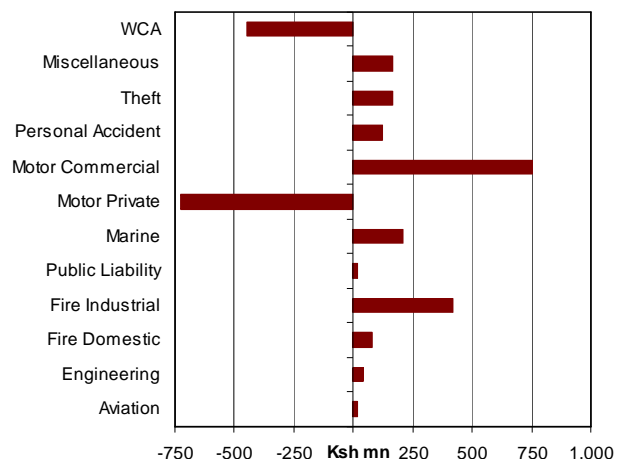
Source: Association of Kenya Insurers

Chart 3: Total industry general insurance premiums



Source: Association of Kenya Insurers

Chart 4: 2005 Industry underwriting losses/profits



Source: Association of Kenya Insurers

The banking operations are based in Kenya with a market share of about 3% competing in a crowded field of 43 banks. The banking industry has by and large resisted consolidation over the years. CFC also has a stock broking operation, CFC Financial Services, in Kenya that is ranked number one by trading volume.

Financial performance

In recent years the group has grown steadily its assets and deposits with faster growth exhibited in its insurance businesses following a number of acquisitions in Kenya and Tanzania. Financial performance has been mixed with some improvement in the early part of this decade but a regression in return on equity and assets has occurred in recent years.

Table 2: Ratio analysis

	2001	2002	2003	2004	2005	2006e
ROA	2.6%	2.9%	3.5%	3.2%	2.8%	3.2%
ROE	7.7%	9.1%	14.9%	19.5%	18.3%	16.5%
Int. earned	14.9%	11.1%	9.9%	8.4%	10.6%	10.5%
Int exp	8.3%	5.3%	3.4%	2.6%	5.4%	5.3%
Net int inc	8.3%	6.9%	7.1%	6.5%	6.7%	6.6%

Source: CFC annual accounts, SIB estimates

The changing structure of the balance sheet may point to the cause as the banking business accounted for a shrinking proportion of the company. Lower returns in insurance interests particularly following the acquisition of ALICO have contributed to the lower group level returns.

Table 3: Balance sheet structure (liability side)

	2000	2001	2002	2003	2004	2005
Banking	67.4	65.6	70.6	73.0	52.0	54.6
Insurance	11.2	13.0	8.9	10.5	35.3	28.7
Equity	21.4	21.4	20.0	16.2	10.2	13.2
Debt	0.0	0.0	0.0	0.0	2.1	2.9
Other	0.0	0.0	0.5	0.3	0.4	0.6

Source: CFC annual accounts, SIB estimates

The ALICO acquisition

The acquisition of ALICO required a 3 year loan from Barclays Bank to partly offset the total acquisition cost of Ksh.1.9bn. The term loan has progressively been replaced by an unlisted floating rate note issued to local institutional investors. Following the acquisition the group raised additional capital through a rights issue raising Ksh.729mn and additional borrowings of Ksh.329mn. We believe these amounts were utilised to finance the acquisition.

Somewhat surprisingly the group did not opt to merge its existing interests housed in Heritage All with the newly acquired ALICO. We assume in the view of management any potential synergies were immaterial compared to the benefit of keeping the companies focussed on respective market segments.

The business has since been re-branded as CFC Life and some investment made in information technology. It would appear the strategy is to improve overall efficiencies in the business while continually releasing new products into market segments not serviced at the moment.

Valuation

Following the rise immediately after the announcement of merger discussions, the share price has retreated somewhat to Ksh.243. It is difficult to explain the price rise despite the pricing guidance provided in the cautionary announcement. At current levels the share is trading at 62.7 our estimate of 2006 earnings (or 76.7 times 2005 earnings) and 8.5 times book value.

Table 4: Comparables

NSE Company	PE
Barclays Bank	21.8
CFC Bank	76.7
Diamond Trust	31.3
Equity Bank	52.9
Housing Finance	74.0
Jubilee Holdings	29.0
K.C.B Bank	37.7
National Bank	43.4
National Industrial Credit	32.3
Pan Africa Insurance Holdings	31.0
Standard Chartered Bank	25.0
Financial sector averages	
Kenya	35.5
Ghana	12.7
Nigeria	27.5
Botswana	19.4

Source: IBTC, Databank, Stockbrokers Botswana, NSE, SIB est

From table 4 it can be seen the share is the highest rated in the NSE and amongst peer markets in sub-Sahara Africa the Kenyan financial sector is also the highest rated. In our view this reflects an overvaluation of Kenyan equities. We are thus reluctant to apply comparable valuation on CFC Bank.

We used a discounted dividend valuation approach to value CFC Bank as opposed to comparables in the local market which we feel would produce a more realistic valuation estimate. We started out with a medium term financial forecast to 2010 in which our key assumptions were the banking business would not grow market share but grow in line with money supply. The insurance businesses would continue to see industry level growth and no further acquisitions are possible as the group digests the ALICO purchase.

Our required rate of return was arrived at through a build up methodology by adding the yield on the 10 year t-bond of 13.7% to an equity premium of 5.5%. We felt given the banking operation's market position and limited growth opportunities to achieve significant scale advantages a suitably high premium was warranted.

For the terminal value after 2010 we settled on the fundamental price to book value ratio¹, which we applied to our estimate of adjusted book value in 2010. We used 20% as our long term return on equity estimate, growth 10% and a required return of 16.5% comprising of a 10 year t-bond yield of 12% and an equity premium of 4.5%.

Our valuation estimate for CFC Bank is thus Ksh.34.80, 14.3% of the current market price. The pricing guidance for the proposed takeover suggests Standard Bank will pay Ksh.99.00 assuming a simple average or Ksh.112.00 assuming a weighted average price. This would reflect a 200% premium to our valuation. Given Stanbic Kenya's long stated desire to acquire a sizeable bank in Kenya but the lack of realistic opportunities, the Bank is left with few options but to pay a market related price at this stage.

As an alternative valuation measure we note the group one year ago paid Ksh.1.9bn for ALICO. After applying inflation related appreciation of 10% gives a current valuation estimate of Ksh.2.09bn. We then write off the goodwill on the company's books against this value reducing it to Ksh.1.01bn. In addition to this, applying a price to book value ratio of 1.54 to net assets of the banking business as at end September 2006 yields a value of Ksh.4.37bn. We then add a value estimate for Heritage of Ksh.500mn and another Ksh.150mn for CFC Financial Services. This yields a group value of Ksh.6.03bn or Ksh.38.65 per share.

From the foregoing we feel a fair valuation for CFC Bank would be Ksh.40.00 per share. Given the share price of Ksh.243.00 the share in our view is highly overvalued and our investment rating would be sell.

$$^1 \frac{P}{B_0} = \frac{ROE - g}{r - g}$$

Investment risks

In our view the main investment risks in the share revolve around the proposed transaction. It is important to understand Stanbic's strategy in Kenya as this will become the new focus of management going forward. Until this is clearly outlined to the market the uncertainties surrounding this will cloud any forward looking analysis.

For the banking business to achieve higher performance a significant increase in size will be required. Assuming the proposed deal with Stanbic falls through, CFC Bank will have to go into an acquisition mode or itself remain a target for potential acquires. By entering takeover negotiations the controlling shareholders have indicated an unwillingness to remain the anchor shareholders of the company. Which implies the strategic direction is subject to change.

Finally the assumptions we have applied in our valuation estimate may be erroneous leading to an incorrect valuation opinion. As a result any investment action taken as a result of this is potentially incorrect. We are however comfortable with our estimates at this stage.

Table 5: Financial forecasts

Kenya shillings million	2003	2004	2005	2006e	2007f	2008f	2009f	2010f
Profit and Loss								
Loans and advances	816	937	1,457	1,682	2,008	2,287	2,607	2,985
Government securities	222	442	821	982	1,161	1,313	1,464	1,607
Banking institutions	67	52	77	140	147	158	178	185
Other	0	20	47	9	9	9	9	9
Interest income	1,104	1,450	2,402	2,812	3,325	3,766	4,257	4,785
Customer deposits	293	295	702	804	979	1,158	1,369	1,590
Deposits and placements	19	35	87	164	209	198	207	192
Interest on borrowed funds	0	7	93	64	64	61	67	60
Interest expense	312	337	882	1,032	1,253	1,417	1,643	1,841
Net interest income	792	1,113	1,520	1,780	2,073	2,349	2,615	2,944
Fees and commissions	251	351	516	774	1,123	1,600	2,240	3,080
FX trading income	27	90	125	156	211	280	364	464
Insurance premiums	1,038	1,718	2,468	2,962	3,554	4,265	5,118	6,039
Other operating income	323	268	235	481	298	301	323	352
Operating income	2,432	3,540	4,863	6,153	7,258	8,794	10,658	12,878
Bad debt charge	115	75	91	164	205	226	260	299
Insurance claims incurred	758	1,105	1,989	2,238	2,573	3,024	3,629	4,264
Staff costs	505	701	805	990	1,188	1,414	1,711	2,019
Depreciation	83	79	111	127	150	166	194	233
Other operating costs	466	860	1,031	1,484	1,855	2,319	2,783	3,409
Operating expense	1,928	2,820	4,027	5,003	5,973	7,149	8,577	10,224
Operating profit	505	720	836	1,150	1,286	1,645	2,081	2,654
Profit/(loss) in associates	(8)	18	30	12	14	18	25	35
Profit before tax	497	738	866	1,162	1,300	1,663	2,106	2,689
Tax	(115)	(215)	(313)	(407)	(416)	(499)	(590)	(807)
Profit after tax	382	523	552	755	884	1,164	1,516	1,882
Minority interest	(83)	(90)	(88)	(150)	(225)	(315)	(410)	(492)
Net profit	299	433	464	605	659	849	1,107	1,390
EPS (Ksh.)	1.92	2.78	2.98	3.88	4.22	5.44	7.09	8.91
DPS (Ksh.)	0.65	0.77	0.84	1.00	1.30	1.60	1.90	2.40

Source: CFC annual reports, SIB est.

Table 5: Financial Forecasts (contd.)

Kenya shillings million	2003	2004	2005	2006e	2007f	2008f	2009f	2010f
Balance Sheet								
Cash with CBK	769	967	1,389	1,788	2,062	2,107	2,354	2,749
Government securities	4,517	9,124	9,548	13,033	14,292	16,240	18,203	19,609
Banking institutions	780	1,265	2,709	2,384	2,546	2,984	3,119	3,926
Customer loans	7,831	10,969	11,662	14,212	16,684	18,904	21,986	25,394
Interest in associates	10	107	110	107	109	127	131	135
Taxation recoverable	21	5	48	51	53	56	58	61
Investment properties	138	152	294	235	259	272	283	291
Other investments	1,068	1,776	2,163	2,379	2,795	3,159	3,538	4,033
Property and equipment	486	823	958	1,152	1,251	1,404	1,701	2,028
Operating lease prepayment	32	36	32	34	33	32	31	30
Goodwill	0	1,085	1,085	1,085	1,085	1,085	1,085	1,085
Other assets	776	3,518	3,115	3,275	3,474	3,767	4,091	4,497
Total assets	16,430	29,829	33,112	39,735	44,643	50,137	56,580	63,837
Customer deposits	9,868	12,673	14,794	17,383	20,286	23,423	26,347	30,431
Banking institutions	1,222	1,464	1,399	2,702	2,345	2,361	2,518	2,819
Borrowed funds	0	1,016	1,396	1,260	1,341	1,212	1,300	1,037
Retirement benefits contracts	0	3,259	4,299	5,051	5,723	6,378	7,061	7,765
Insurance contract liabilities	479	3,182	3,247	3,490	3,776	4,142	4,474	4,667
Other insurance liabilities	1,249	4,076	1,972	2,416	2,874	3,363	3,945	4,492
Other liabilities	953	1,121	1,628	2,025	2,127	2,227	2,719	3,105
Total liabilities	13,771	26,792	28,734	34,326	38,472	43,105	48,364	54,315
Shareholder's funds	2,216	2,536	3,665	4,452	4,936	5,564	6,405	7,468
Minority interest	444	501	714	956	1,235	1,468	1,811	2,053
Total capital and liabilities	16,430	29,829	33,112	39,735	44,643	50,137	56,580	63,837
Ratio analysis								
Return on assets	3.5%	3.2%	2.8%	3.2%	3.1%	3.5%	3.9%	4.5%
Return on equity	14.9%	19.5%	18.3%	16.5%	14.8%	17.2%	19.9%	21.7%
Interest yield	9.9%	8.4%	10.6%	10.5%	10.5%	10.5%	10.5%	10.4%
Cost of funds	3.4%	2.6%	5.4%	5.3%	5.5%	5.6%	5.7%	5.7%
Net interest margin	7.1%	6.5%	6.7%	6.6%	6.6%	6.6%	6.4%	6.4%
Growth in earnings	72.4%	44.7%	7.2%	30.3%	8.9%	28.9%	30.4%	25.6%
Growth in dividends	26.1%	18.5%	9.1%	19.0%	30.0%	23.1%	18.8%	26.3%
Adjustment to net assets (BV)								
Shareholder's funds (2010)	7,468							
less: goodwill	1,085							
less: proposed dividend	187							
Adjusted BV	6,197							
Issued shares (million)	156							
Adjusted BV per share (Ksh.)	39.72							

Source: CFC annual reports, SIB est.

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