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## LOCAL EQUITY REPORT

# NCB FINANCIAL GROUP LIMITED

**Barita Investments Limited**
**15 St. Lucia Way, Kingston**
**Tel #: 1-888-429-5333**

## Company Overview

NCB Financial Group Limited (NCBFG) is a Jamaican-based holding company that holds the largest commercial bank in Jamaica by assets and profits, NCB Bank Jamaica. The primary business of the group and its subsidiaries comprise commercial banking, life & general insurance, and wealth & investment management activities. Its major subsidiaries include National Commercial Bank Jamaica Limited, NCB Capital Markets Limited, NCB Insurance Company Limited, Guardian Life Holdings, and Clarien Bank Limited. Some of NCBFG's associate companies include RGM Limited with 33.3% and Elite Diagnostic with 18.7% among others. Currently, NCBFG is 52.68% owned by AIC (Barbados) Limited with the ultimate parent being Portland Holdings Inc which is incorporated in Canada and controlled by the chairman of NCBFG, Michael Lee-Chin.

| Stock | NCBFG |
|---|---|
| Last Closing | J$71.44 |
| 52 Week High | J$99.00 |
| 52 Week Low | J$55.00 |
| YTD Return | -10.61% |
| Trailing P/B | 0.96X |
| Trailing P/E | 16.43X |
| Forward P/E | 9.62X |
| Target Price | J$86.43 |
| Upside Potential | 21.0% |
| Recommendation | OVERWEIGHT |
| Date | August 25, 2023 |

## Investment Summary and Rationale

NCBFG has been challenged due to the macroeconomic environment in recent quarters, namely the shift to a more restrictive monetary policy that has challenged its capital position. This has necessitated management's focus on liquidity and thus the decision to forego dividends for an extended period. We do **not** expect that dividends will be paid out for the remainder of the current financial year ending September 30th, 2023. Despite this, management has pointed out an immediate focus on improving the group's cost-to-income ratio, while also pointing to Efficiency, Governance and Customer Experience as key internal points of focus to improve the group's bottom line, and as a result, the possibility of dividend payments. As mentioned earlier, measures that have been implemented since the shuffling of the NCBFG Board in late July are already expected to save $6-$8 billion annually. We anticipate that NCBFG will be in a better position to resume dividend payments at some point during the September 2023 to September 2024 financial year. **At the end of the Q3 Investor Briefing, the Group Chairman suggested that NCBFG will resume dividend distributions by the end of the year, not specifying whether he was referring to the calendar year or the financial year. Given a comment earlier in the briefing suggesting that a dividend would not be paid in FY 2023 ending September, we see the possibility of a dividend distribution in Q1 of FY 2024. Nonetheless, This will likely be within the context of the progression of the cost-to-income-related initiatives.**

A challenging macroeconomic environment in conjunction with the general decline in the overall market and a specific weakening sentiment for financial sector stocks in general have negatively impacted the price performance of the group. We believe that there will be continued headwinds as it relates to its insurance segment, we do expect that the general macroeconomic environment will improve, particularly as we head towards the peak of the current hiking cycle.

Given the above, we expect to see a continued recovery in the group's capital and liquidity position over the coming year, even as we expect earnings growth to continue to be subdued relative to prior years. We still believe that due in part to the current negative sentiment, the stock is priced attractively as we enter the new macroeconomic cycle. Hence, we believe the investor with a long-run focus and a want for a relatively more liquid blue chip holding might consider being **OVERWEIGHT** in NCBFG with a price target of $86.43. The prospect of a return to dividend payment within the next 6 months, may materially contribute to the recovery of market sentiment in the stock.



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**Therefore, the stock is most suitable for investors looking for a beaten down "blue chip" trading relatively cheap compared to fundamentals with no immediate need for dividends income and an outlook long enough to weather continued short-term negative sentiment.**

## Industry Overview and Outlook

Currently, the two (2) most pertinent developments in the sector are the implementation of IFRS (International Financial Reporting Standards) 17 and the implementation of Basel 3, which the regulators are tentatively about to implement. Basel III is a set of global regulatory standards developed by the Basel Committee on Banking Supervision, an international committee of banking supervisors, to strengthen the banking sector's resilience. The main objective of Basel III is to improve the quality and quantity of capital held by banks, increase the level of liquidity buffers, and introduce new measures to manage risks such as credit risk, market risk, and operational risk. Therefore, it is expected that the full implementation of Basel III might lead to higher capital requirements for some institutions in the industry. This is particularly true as the Basel III framework includes additional capital charges for credit risk, market risk, and operational risk, and as such riskier loans for example will require greater capital reserve requirements. **It was noted during NCBFG's latest investor briefing that the Group expects to execute full implementation of Basel III in 2024.**

IFRS 17 is a global accounting standard that specifies how insurance contracts should be accounted for and reported in financial statements. This standard was developed to replace the existing IFRS4 standard, which contained too many inconsistencies in accounting practices among insurers. IFRS 17 applies to all insurance contracts, including reinsurance contracts, that an insurer issues and to all types of insurance entities, including mutual insurers and cooperative insurers. It is effective for annual periods beginning on or after January 1, 2023, with earlier adoption permitted. The expected impact is that there are going to be increased costs associated with adhering to the standard which includes staff training and updating systems to aid the transition. **In this quarter's investor briefing it was noted that NCBFG at the Group level has not yet begun to report under the IFRS 17 standard, CFO Mr. Malcolm Sadler stated that the group is still assessing the full impact of IFRS 17 on the performance at the Group level and indicated that in the Q4 audited accounts, details on the impact of IFRS 17 on NCBFG's financials moving forward will be shared. Profitability is anticipated to be lower under the new measure.**

## Historical Financial Performance

| Income Statement Extract ('000) | FY2019 | FY2020 | FY2021 | FY2022 | TTM | 9M 2022 | 9M 2023 |
|---|---|---|---|---|---|---|---|
| Interest Income | 65,068,228 | 74,421,878 | 74,574,816 | 84,923,549 | 96,743,310 | 67,582,436 | 79,402,197 |
| Interest Expense | -20,473,144 | -21,932,169 | -25,947,849 | -25,724,687 | -34,240,386 | -19,016,000 | -27,531,699 |
| Net Interest Income | 44,595,084 | 52,489,709 | 48,626,967 | 59,198,862 | 62,502,924 | 48,566,436 | 51,870,498 |
| Net Fee and Commission | 19,179,833 | 21,369,407 | 22,488,994 | 26,132,751 | 28,264,857 | 19,145,491 | 21,277,597 |
| Investments & Other Income | 12,974,543 | 2,511,782 | 27,037,702 | 21,961,010 | 21,272,530 | 12,428,320 | 11,739,840 |
| Net result from insurance activities | 14,431,515 | 32,455,991 | 22,951,692 | 42,303,994 | 28,746,357 | 25,478,508 | 11,920,871 |
| Operating Expense | -64,736,903 | -81,565,804 | -94,850,111 | -104,460,096 | -106,116,210 | -77,247,839 | -78,903,953 |
| EBT | 37,588,396 | 27,573,476 | 26,595,533 | 45,869,034 | 34,993,039 | 29,013,657 | 18,137,662 |
| **Net Profit to Shareholders** | **29,869,398** | **19,090,378** | **14,226,671** | **27,318,907** | **10,725,171** | **26,302,730** | **9,708,994** |

## Financial Year 2022

Full coverage of The Group's FY 2022 Performance can be found in our Half Year Analysis, as of March 31, 2023.



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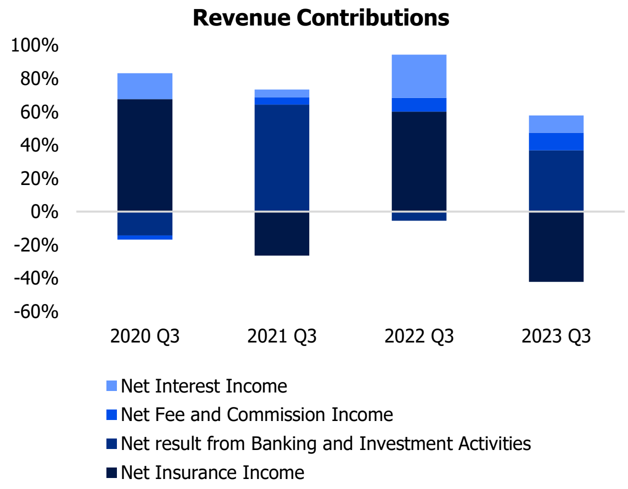
## First Nine Months of FY 2023

NCBFG produced a total income of $96.8 billion for the first nine months of FY 2023 (9M 2023), compared to $105.6 billion for the comparable period last year representing a decline of approximately 8.3%. Looking at the Group's operating segments, the banking and investment activities increased by 5.9%, while the insurance arm saw a fairly large decline, producing net results of $11.9 billion, compared to $25.5 billion in the comparable period of the prior year, representing a decline of 53.2%, by extension acting as the primary driver of the overall decline in operating income year-to-date (YTD).

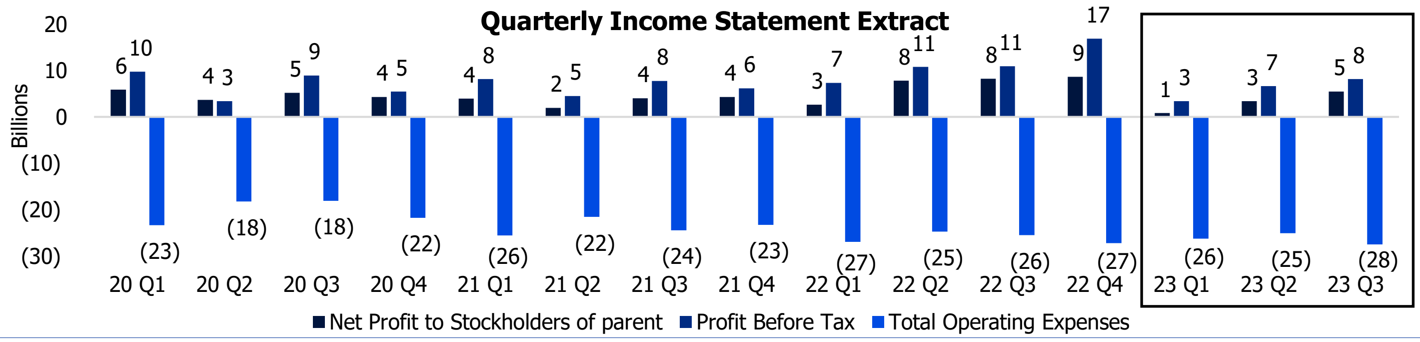
## Revenue Streams

The Group primarily reports on four (4) revenue streams, namely, net interest income, net fee and commission income, net investment activities, and lastly net insurance activities. Total operating income from these streams equated to $96.8 billion YTD, representing a decline of 8.3%. The $35.6 billion outturn for the quarter represents, its worst Q3 performance since the onset of the pandemic and the first Q3 that did not represent a YoY increase in the period. Across the streams of income reported, the result from insurance activities stood out as it was solely responsible for the decline in operating income year-over-year (YoY) with a decline of -53.2%. This large decline was only partially offset by improved income in every other business segment.




## Continued Poor Insurance Performance?

Revenue from insurance activities was the main culprit for the subdued 9M 2023 performance, however, there are some signs of recovery in the business compared to the first half of FY 2023. Breaking from the declines noted through the first half of FY 2023, top-line gross premiums written increased YoY by 3.4% to $125.1 billion. However, the Group ceded a greater portion of the premium to reinsurers at $42.5 billion or 33.9% of premium income, compared to 32.8% for the 9M 2022, with reinsurance commission coming in virtually flat. The net result was a 1.4% increase in net underwriting income to $91.7 billion. Despite this, benefits and claims paid out as well as commissions and other expenses grew significantly YoY, rising 25.5% to $65.7 billion and 11.8% to $14.1 billion respectively. Management attributed this increase to higher net claims mainly from the Life, Health and Pensions segment. The increased claims were primarily in relation to health and some additional general insurance claims.



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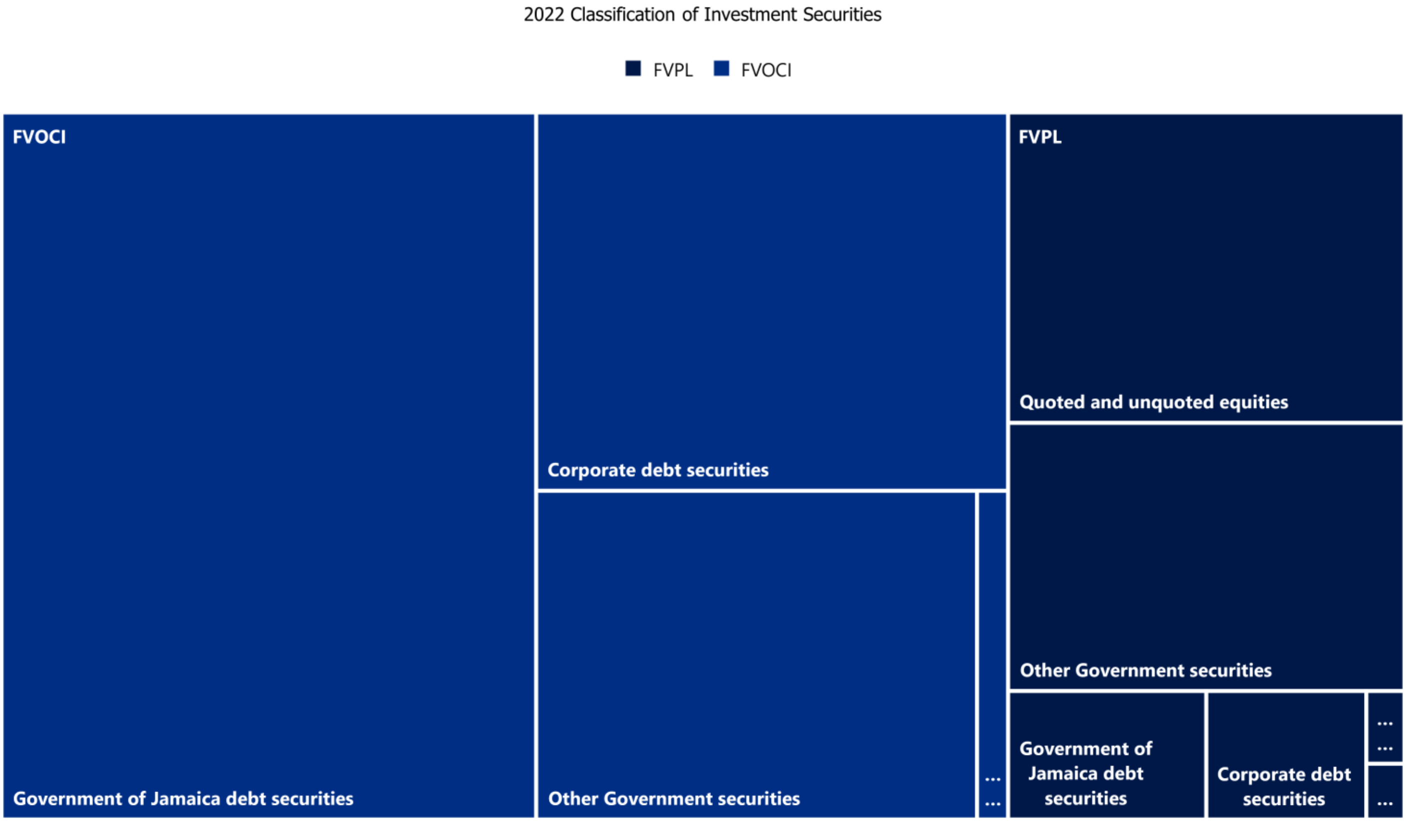
## Moderate Performance from Other Segments

### Interest Margin

The Group's net interest income contributed positively to revenue growth, increasing by 6.8% to $51.9 billion, compared to $48.6 billion in the 9M 2022. This improvement comes in line with the Group's net interest margin increasing to 3.37%, relative to the outturn for the comparable period last year of 2.66%. Therefore, the improvement in net interest income for the period was a result of both the Group enhancing the profitability of its banking and investing activities as well as from the Group increasing the volume of interest-earning assets on their balance sheet (increase in both loans and their investment portfolio).

### Investment Income

Despite the significant improvement in gains in foreign currency and investment activity of 54.7% to $10.9 billion for the 9M 2023, net investment income declined 5.5% to $11.7 billion due to a 30.9% decline in other operating income to $3.6 billion. The chart below illustrates the approximate classification of NCBFG's classification of investment securities as of September 2022. As such, from this, we can see that most of the securities carried at fair value through profit and loss were quoted and unquoted equity securities and government securities. Despite the double-digit percentage loss observed on the JSE Combined market during the 9M 2023, when coupled with a rebounding bond market due to Central Banks appearing to be nearing terminal rates, the Group managed to book increased FX and investment gains during the period.



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**Fees and Commission**

Overall net fees and commission income totalled $21.3 billion compared to $19.1 billion in the previous year, representing an increase of 11.1% YoY. Management attributed the improvement to the growth in the Group's loan portfolio coupled with increased card transaction volume.

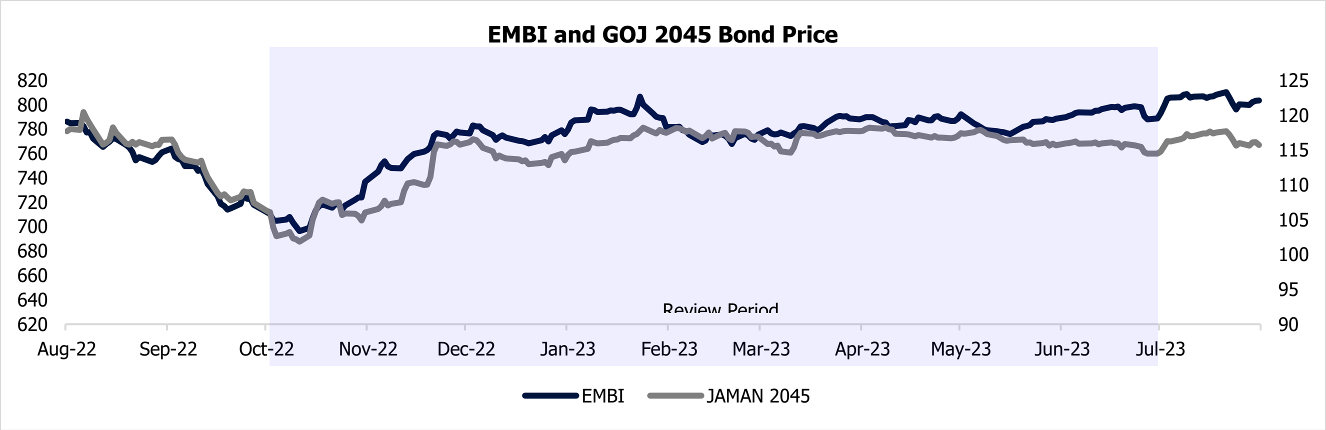
## Operating Expenses

Operating expenses grew by 2.1% to $78.9 billion for the 9M 2023. Management has attributed this growth to lower credit card rebates, higher professional fees, and lower consultancy charges throughout the period. Notably, however, management indicated that the Group saw lower staff costs in Q3 because of the inclusion of additional incentive payment schemes introduced during the March 2023 quarter. Given the reduction of revenues for the group and an ultimate increase in operating expenses, expense ratios were higher for the quarter. The operating expenses to operating income ratio for the period was 81.5%, compared to 73.1% last year. **Management has stated that the continued increase in the Group's cost-to-income ratio is "unacceptable" and that steps will be taken to materially reduce the ratio in the next fiscal year. Previously, management highlighted that it is their goal to reach a target efficiency ratio of 55% but acknowledged that they were a long way off from this goal; in the investor briefing following the release of the financial report for the June 2023 quarter, Mr. Robert Almeida suggested a near-term target of a low 60% cost to income ratio, which would ultimately add $15 billion annually to NCBFG's bottom line. He also stated that cost savings measures already actioned are expected to save $6-$8 billion currently on an annualized basis.** At the very least the growth rate in operating expenses has decelerated in the previous quarter.

Ultimately, the decline in overall operating income coupled with an increase in operating expenses contributed to profit and profit attributable to shareholders for NCBFG declining YTD. Profit before tax declined to $18.1 billion compared to $29.0 billion last year. Taxation expense for the quarter was also much higher (1257.4% growth to $4.4 billion) which led to a much higher effective tax rate, further subduing earnings. This culminated in net profit after tax declining by over 52.2% to $13.7 billion, while net profit after tax attributable to shareholders of the parent came in at $9.7 billion, a 63.1% decline YoY.

## Other Comprehensive Income

Given the prevailing broader economic backdrop, special attention was paid to the other comprehensive income statement. While there was a return to increased profitability in FY 2022, the Group recorded significant other comprehensive losses to the tune of approximately $47.6 billion, compared to the OCI profit of $271 million in 2021 (OCI for 2020 and 2019 -$523 million and $7.7 billion respectively). As can be seen in the chart above the majority of the Group's investment securities are carried at FVOCI and overwhelmingly includes debt securities (corporate and government of Jamaica securities).



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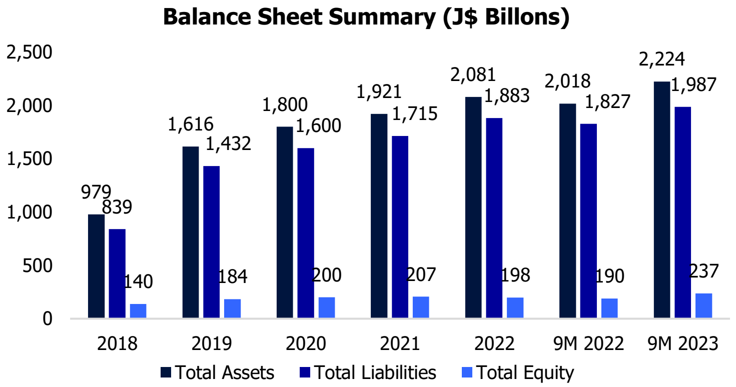
In a shift from the prior financial year, NCBFG generated other comprehensive income of $26.0 billion for the 9M 2023, compared to a loss of $37.5 billion recorded in the prior year. This was driven by unrealized gains on securities of $25.9 billion. The Group's holdings are dominated by GOJ securities and corporate debt. As can be seen in the chart above there was some price recovery in GOJ bonds (proxied by the 2045s) during the 9M 2023, with the bond's price increasing by 6.9%, while the Emerging Market Bond Index increased by 11.8%. It is within this context that the Group generated gains in other comprehensive income.

## Balance Sheet

**Total Assets:** As of June 2023, the Group had **total assets** of $2.2 trillion, compared to $2.0 trillion at the end of June 2022. This represented an increase of $206.0 billion. The bulk of this increase was contributed by investment securities and pledged assets, which together was higher by $182.5 billion. The increase in the value of investment securities was partially driven by fair value gains in other comprehensive income during the quarter. Other prominent contributors included loans and advances (up $45.9 billion or 8.21% to $302 billion) and other assets (up $16.1 billion or 26.45% to $77.1 billion).




As it relates to asset composition there was a noticeable shift from cash due from banks which was down 3.05 percentage points to 6.01% of total assets, while pledged assets increased by 3.43 percentage points to 13.61% of total assets. Loans, investment securities and pledged assets remained the bulk of total assets, which together accounted for 77.23% of total assets. Historically, NCBFG's main assets have primarily been loans and advances as shown by its year-end 2018 balance sheet assets primarily consisting of 38% loans and advances. As of June 2023, the largest asset group was investment securities, which comprised 36.4% of total assets, up from 35.9% in June 2022, while loans and advances declined to 27.2% of total assets from 27.7% in June 2022. A part of the reason for the change in the composition of the Company's balance sheet is a result of the diversification of the Group's business, primarily the expansion of the life insurance line (i.e., Guardian Life). However, year-over-year (YoY), there have not been any major changes in the composition of the Group's balance sheet.

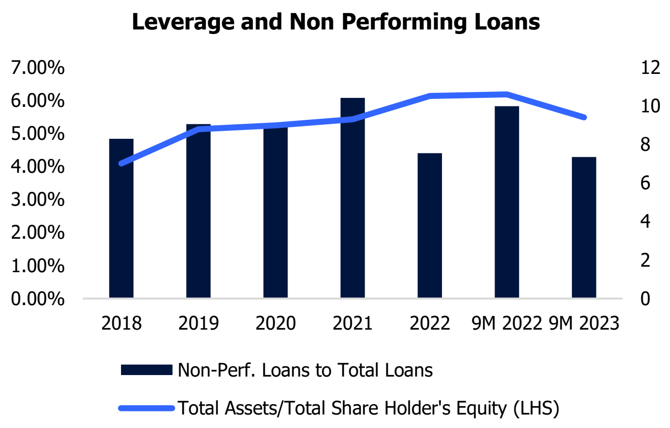
**Total Liabilities:** As it relates to the funding base, the increase in total assets was primarily funded by a $159.8 billion increase in liabilities (77.2% of the increase in total assets), while the remaining portion was funded by a $46.3 billion increase in equity ($37.3 billion increase in equity attributable to shareholders of the parent). The increase in liabilities comprised a $42.1 billion increase in obligations under securitization agreements, a $36.9 billion increase in repo liabilities, a $26.9 billion increase in customer deposits and a $21.3 billion increase in liabilities under annuity and insurance contracts. As such, these were the primary driving factors for the increase in the group's total asset base.

These changes reflect the Group prioritizing raising liquidity through the debt market and securitizing assets. Given the growth in the significance of the Group's insurance segment, liabilities under annuity contracts represented 23.4% of total liabilities as of June 2023, compared to 4% for FY 2018. Invariably, the share of customer deposits in the funding base declined, moving from 50% in FY 2018 to 37.2% as of June 2023. The group's funding base remains low cost, particularly the banking division, which better positions them for the current high-rate environment relative to other financial institutions (particularly security dealers).

**Total Equity:** The group's equity balance increased over the last year by 24.3% to $236.7 billion. This increase was primarily a result of the recovery of losses in the fair value and capital reserve of $14.9 billion and increases in retained earnings and the retained earnings reserve of $14.0 billion and $8.1 billion respectively.

**Capital**

At the end of June 2023, NCBFG had a Leverage ratio of 9.4x. This compares to the industry average for DTIs as of March 2023 of 7.7x. For a more direct comparison, NCBFG's leverage ratio was 9.3x at the end of March 2023. In terms of asset quality, there has been continued improvement, non-performing loans represented 4.3% of total loans, down from 6.1% in 2021. For reference, this compares to the NPL ratio of 2.7% for the industry as of February 2023.




Unfortunately, the Group did not provide the details of their current regulatory capital ratios in their latest financial filings. Beyond this, management has confirmed that all subsidiaries did meet regulatory capital requirements as at June 30th, 2023. We would anticipate that capital adequacy ratios would have improved for the most current period due to the recovery in bond prices across the board in 2023 and the resulting modest increases that would be expected to pass through to equity.

**Outlook**

The current macroeconomic outlook is for continued domestic growth, above the historical long-run growth rate in the short to medium term. This is coupled with a quicker-than-expected fall in the rate of inflation back to the BOJ's target band of 4-6%. This has therefore made the current policy stance even more restrictive assuming a commensurate fall in inflation expectations and therefore means that a continuation of the short-term pause and a medium-term cut (mid to late 2024) has become more likely. This is owing to the expectation that inflation will return firmly to target by the end of 2023, which means interest rates will likely go further into positive real rate territory (more restrictive) if the policy rate stance remains unchanged in 2024 despite a drop in inflation. While it is possible that the BOJ may choose to maintain positive real rates given the stronger-than-expected growth in recent quarters domestically, we nonetheless surmise that the possibility for less restrictive policy will increase going into mid-2024. In the case of the global economy, while the projections are for slowing global growth in the short term, this is coupled with the expectations that global central banks are likely to pivot to more accommodative policy or at the least pause the pace of rate hikes.

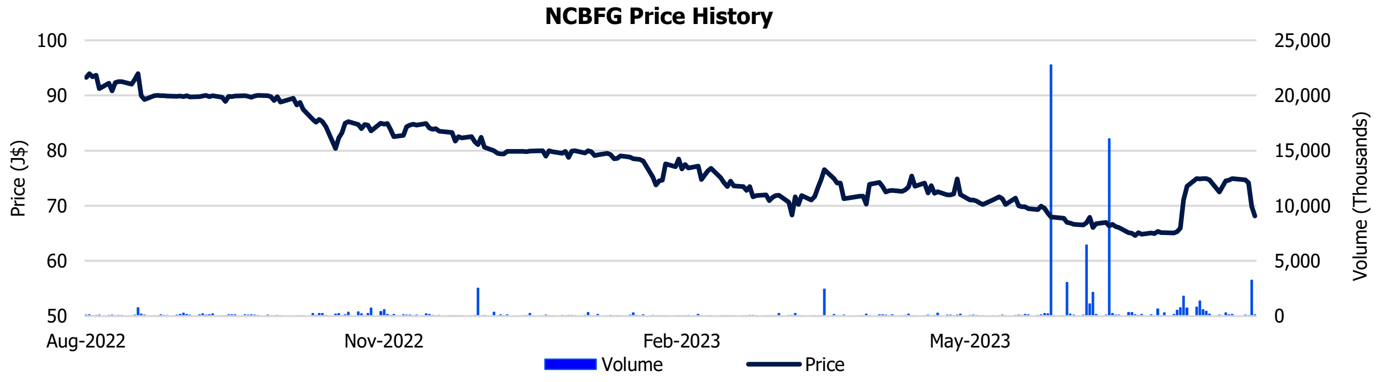
The implication of the above is that fixed-income securities have become more attractive. This comes as the inflation pulse has weakened, with further weakening expected, which, when coupled with the expectation of slower growth ahead has moderated the prospects of a much longer hiking cycle. This therefore bodes well for financial institutions such as NCB which derive a generous portion of their trading gains from investment in fixed-income securities. While the global outlook is for slowing growth, the apparent strength in the domestic economy also bodes well for the credit quality of the Group's loan book which reduces the probability of outsized impairment provisions such as the ones we saw at the start of the pandemic going forward. Further to this, we expect that the buoyancy seen in the Jamaican economy will continue in the short term and help to ensure economic activity remains robust enough to bolster fees and commission income.

Despite the positives outlined above a substantial portion of the Group's earnings is derived from their insurance business, which faces several headwinds in the short to medium term. This is inclusive of a weakening in capacity for reinsurance globally which has led to greater reinsurance costs for both general and life insurers. This, therefore, is likely to lead to higher costs for consumers as these higher reinsurance costs are passed on, which may lead to a weaker take-up of insurance products. There is also the possibility of continued normalization of actuarial reserve adjustments in later quarters, particularly if interest rates have indeed plateaued and begin to level off in the coming months. These risk factors only slightly offset the expected normalization of Covid-related life insurance claims going forward, which might mean continued improvement in this business segment as we have seen for the 6M 2023.

## Trading and Ownership Summary

**NCBFG ownership (as at June 30, 2023)**

| Name | Shares Held | Percentage |
|---|---|---|
| AIC (Barbados) Limited | 1,261,730,942 | 51.15% |
| MF&G Asset Management Limited - NCB Share Scheme | 101,406,205 | 4.11% |
| Sagicor PIF Equity Fund | 73,795,464 | 2.99% |
| NCB Insurance Agency & Fund Managers Limited WT 109 | 57,715,172 | 2.34% |
| Harprop Limited | 46,434,102 | 1.88% |
| AIC Global Holdings Inc. | 45,499,690 | 1.84% |
| National Insurance Fund | 33,139,232 | 1.34% |
| Ideal Portfolio Services Company Limited | 32,843,465 | 1.33% |
| SJIML A/C 3119 | 31,883,479 | 1.29% |
| Guardian Life of the Caribbean | 30,206,368 | 1.22% |
| **Total** | **1,714,654,119** | **69.51%** |



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The top ten shareholders of NCBFG held 1.7 billion shares as at June 30th, 2023, which equates to 69.5% of the total shares outstanding with 44,094 total shareholders. This makes NCBFG one of the more broadly held stocks on the Main Market of the Jamaica Stock Exchange.

NCBFG stock has declined 14.98% YTD with a closing price high approaching $100 seen in August of 2022. The average daily volume amounted to 352,104 units over the past year, coupled with a weighted average price of $71.21, resulting in an average daily value traded of $25.1 million. This is generallu sufficient volume for trading by both retail and high-net-worth investors as well as for institutions.

## Valuation

| Stock | NCBFG |
|---|---|
| Last Closing | J$71.44 |
| 52 Week High | J$99.00 |
| 52 Week Low | J$55.00 |
| YTD Return | -10.61% |
| Trailing P/B | 0.96X |
| Trailing P/E | 16.43X |
| Forward P/E | 9.62X |
| Target Price | J$86.43 |
| Upside Potential | 21.0% |
| Recommendation | OVERWEIGHT |
| Date | August 25, 2023 |

To value NCBFG we utilized two different valuation approaches. These included a market-based approach comparing the Price-to-book ratio and a residual income model. Under the market-based approach, we forecasted a 1-year forward book value attributable to shareholders for the Group and compared it to the current P/B multiple of its peer group. We opted to use only other DTIs operating as fairly large financial conglomerates and made minor adjustments to book values given the impact of the new IFRS 17 regulations. An average P/B ratio of 1.08x was observed from this peer group sample. Therefore, given our forecasted BVPS of $81.99, we arrived at a price target of $89.33. Note that NCBFG currently trades at a P/B ratio of 0.96x, which is below the peer group average. As such, this forecast is contingent on an improvement in sentiment towards NCBFG, as well as a recovery in its profitability metrics, which might allow for the stock to trade closer to the peer group average.

In our second valuation approach, the residual income model, we incorporated adjustments to include comprehensive income in our return on equity calculations (hence utilising total comprehensive income as opposed to just net income). Additionally, we projected earnings for the next 5 years for the Group and subsequently subtracted an equity charge to the tune of 12.58%, our estimated cost of equity. Another key assumption of this model is an average return on equity which falls to the cost of capital in the long run (no excess returns). Based on these assumptions, we arrived at a 1-year price target of $83.52. To arrive at our final estimate of fair value we used a simple average of our two model outputs. The ultimate 1-year price target came in at $86.43, which represents an upside of approximately 21.0% compared to the closing price of $71.44 as of August 25th, 2023. We, therefore, assigned an **OVERWEIGHT** rating to NCBFG as we believe the stock provides an opportunity for an attractive upside. **We however caution that downside risks continue to be embedded in the relative lack of positive sentiment around financial sector stocks which may impede the opportunity for price appreciation in the short term.**



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**OVERWEiGHT/BUY = EXPOSURE TO THiS ASSET SHOULD BE BETWEEN 5% AND 10% OF YOUR TOTAL PORTFOLiO**