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Victoria Commercial Bank Limited

Kenya Bank Analysis **July 2016**

Rating class	Rating scale	Rating	Rating outlook	Expiry date
Long-term	National	$BBB_{(KE)}$	Stable	July 2017
Short-term	National	$A2_{(KE)}$		

Financial data:

(USDm comparative)

	31/12/14	31/12/15
KES/USD (avg.)	90.47	98.24
KES/USD (close)	89.05	102.33
Total assets†	228.2	240.6
Tier 1 capital‡	29.4	32.7
Tier 2 capital‡	1.6	1.3
Net advances	123.3	128.3
Liquid assets	59.3	60.2
Operating income	11.7	15.2
Profit after tax	5.1	7.3
Market cap.		n.a
Market share*		0.6%

† Including off-balance sheet items.
‡ Refers to the calculation of regulatory capital as per banking regulations.
* Based on the Central Bank of Kenya calculation of total banking industry assets at 31 December 2015.

Rating history:

Initial rating (October 2012)
Long-term rating: $BBB_{(KE)}$
Short-term rating: $A3_{(KE)}$
Rating outlook: Positive

Last rating (August 2015)
Long-term: $BBB_{(KE)}$
Short-term: $A2_{(KE)}$
Rating outlook: Stable

Related methodologies/research:

Global Criteria for Rating Banks and Other Financial Institutions, updated March 2016
Kenyan Bank Statistical Bulletin (December 2015)
Kenya Operating Environment Overview (May 2016)
VCB rating reports (2012-15)

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Summary rating rationale

- The ratings of Victoria Commercial Bank Limited ("VCB" or "the bank") reflect its successful relationship-based niche private banking model and broadly stable credit profile, supported by robust asset quality, comfortable capitalisation, strong liquidity and sound profitability. The bank's ratings are, however, constrained by its relatively small size, which implies low systemic importance relative to the larger local banks.
- VCB maintained healthy capitalisation ratios during F15, recording Tier 1 and total capital adequacy ratios of 18.6% and 19.3% respectively at FYE15 (FYE14: 18.2% and 19.2%). This was supported by the bank's high profit retention (with balance sheet retained earnings growing by 40.8%) and an additional capital injection of KES56m.
- The bank has consistently maintained robust asset quality, recording zero non-performing loans ("NPLs") for over a decade. The bank's exceptional asset quality reflects its stringent credit origination standards and proactive post disbursement monitoring. Given VCB's client selectivity, credit concentrations within its lending portfolio are high. However, GCR takes comfort from the bank's disciplined underwriting approach.
- Pre-tax earnings grew by a four year high of 44.8% to KES919.1m in F15, mainly driven by a 35.6% increase in interest income (due to growth in loans), and a review period high 113.9% increase in non-interest income (supported by a once-off gain from the sale of an associate which contributed 55.3% to non-funded income, and improved fee and commission income). The combined rise of the aforementioned factors more than offset the 46.8% increase in funding costs and 35% increase in operating expenditure (driven by increased staff costs, branch expansion costs and IT related expenses). The bank's ROaA and ROaE increased to 3.8% and 22.4% respectively in F15 (F14: 3.0% and 17.2%).
- In spite of negative contractual gaps in the bank's short-term maturity buckets (a structural industry feature), VCB preserves adequate liquidity buffers and maintains its liquidity ratio well above the minimum regulatory requirement of 20%.

Factors that could trigger a rating action may include

Positive changes: GCR considers the broader context of market position as one of its rating factors. Market position is based on the bank's market share and core competences, and the advantages and vulnerabilities arising from its market position are examined. As such, VCB's ratings could be positively impacted by substantial gains in market share, while maintaining stable profitability, asset quality and capitalisation. Furthermore, the bank's ratings would benefit from increased diversification of both earnings and funding.

Negative changes: Downward pressure on VCB's ratings could stem from a deterioration in macroeconomic conditions, which could adversely affect its asset quality, capital base and earnings power and/or negative changes in the bank's financial profile.

Corporate profile

Business summary[1]

VCB commenced operations in 1987 as a private finance company specialising in leasing finance, mainly targeting the small and medium sized enterprises ("SME") sector in Kisumu, Kenya. In March 1996, the private finance company converted to a commercial bank, now known as VCB. To pave the way for rights issues and funding private placements, the bank changed its status from private to unlisted public company by way of a special resolution passed in March 2012. The bank offers relationship-based niche private banking services, focusing on corporate and high net worth clients.

Ownership structure

Table 1 provides a breakdown of the bank's main shareholders as at 31 December 2015.

Table 1: Shareholding composition	Country of residence	%
Kanji Damji Pattni	Kenya	13.0
Kingsway Investments Ltd	Kenya	9.0
Orchid Holdings Ltd	Kenya	8.3
Asif E A Sheikh	Kenya	7.7
Rochester Holdings Limited	Kenya	7.1
Rajan Jani & Yadav Rajan Jani	Kenya	4.8
Premchand Hemraj Gudka & Avani Jayeshkumar Devraj -Joint Executors Of Estate of late H Gudka	Kenya	4.3
Premchand H Gudka	Kenya	4.3
Godfrey C.Omondi	Kenya	4.0
Occidental Insurance Company Limited	Kenya	3.3
Others (< 3% individual shareholdings)	Kenya	34.2
Total		**100.0**

Source: VCB.

Strategy and operations

VCB operates as a small niche private bank with three branches in Nairobi. The bank's success has been built on personal associations with clients and designing financial solutions to suit different client needs. Given the bank's limited focus on broad based retail banking, there are no plans for extensive branch expansion, although the bank aims to build a new branch by 2018 and grow its reach into other high income locations around Nairobi. Due to the limited branch network, the bank offers free courier services for banking instruments such as cheques and mail, to its clients.

Although mainly targeting high net worth individuals and mid-to-large sized corporates, the bank also offers personal banking services to the employees of its corporate clients. Following the roll out of credit cards, introduction of M-Pesa[2] mobile banking and continuous upgrade of its internet banking platform in the prior review period, the bank has placed more emphasis on technological innovation going forward.

[1] Refer to GCR's previous rating reports for additional background information.

[2] M-Pesa is a mobile-phone based money transfer and micro-financing service through Safaricom in Kenya.

Governance structure[3]

Table 2 summarises the composition of the board of directors ("board") and adherence to selected aspects of good corporate governance. The bank is committed to complying with the Central Bank of Kenya's ("CBK") Corporate Governance Guidelines.

Table 2: Corporate governance	
Description	**Findings**
Current number of directors	6
Directors - *executives*	1 of 6
- *non-executives*	5 of 6
- *independent*	3 of 6
Separation of the chairman	Chairman is separate from the Managing Director.
Frequency of meetings	At least bi-monthly.
Insider lending	Loans granted to insiders/related parties are approved by the entire board and fully secured in line with CBK prudential guidelines and Banking Act provisions.
Board committees	The bank has four main functional board committees (Audit, Credit, Risk Management, and Nominations and Remuneration committees). To further entrench good corporate governance practices, the board has established various management committees.
External auditor's rotation policy	PricewaterhouseCoopers, 5 years.

Source: VCB.

Financial Reporting

VCB's financial statements are prepared in accordance with International Financial Reporting Standards ("IFRS"). The content also complies with the Banking Act and the Kenyan Companies Act. The bank's external auditors, PricewaterhouseCoopers, issued an unqualified audit opinion on the F15 financial statements.

Operating environment

Economic overview[4]

Real gross domestic product ("GDP") growth remains robust, but was lower in 2015 than the initial forecast by the IMF and National Treasury of 6.5%, due mainly to delays in planned road infrastructure spending, weaker tourism receipts in the wake of the April 2015 terrorist attack, and the tapering of capital inflows amid heightened volatility in global markets.

Table 3: Macroeconomic Indicators (%)	2013	2014	2015	2016f
Real GDP growth	5.7	5.3	5.6	6.0
Inflation (annual avg. % change)	5.7	6.9	6.6	6.3
Government gross debt % GDP	41.6	47.0	52.7	55.2
Current account % GDP	(8.9)	(10.4)	(8.2)	(8.3)

f – forecast. Source: IMF Economic outlook, April 2016.

[3] Given the intricacies associated with good corporate governance, GCR recommends an independent assessment to test compliance.

[4] CBK Weekly Report, 6 May 2016; IMF Country Report, March 2016; CBK Monthly Economic Review, December 2015.

The economy expanded by 5.6% in 2015 (2014: 5.3%), supported by public infrastructure spending, construction, mining, lower energy prices, improved agricultural productivity and strong consumer demand. The heightened volatility in global markets and a major terrorist attack adversely affected foreign exchange inflows and more than offset the improvement in the current account balance (mainly due to a decline in oil related imports), contributing to pressure on the exchange rate, reserves, domestic fiscal financing and economic growth.

Inflation trended above the CBK's target range (5±2.5%), increasing from 5.5% in January 2015 to 8.0% in December 2015, mainly reflecting increased food prices and pass-through effects of exchange rate depreciation (which were largely driven by adverse weather conditions associated with the *El Nino* rains which disrupted food supply chains, and revised excise taxes that took effect from 1 December 2015). Following this, inflation decreased to 6.8% in February 2016 and 6.5% in March 2016, reflecting lower food prices and a significant decline in energy prices. Table 4 shows the trend for selected monetary and financial indicators over the review period.

Table 4: Inflation, interest rates and other financial indicators (in %)

	Mar-15	Jun-15	Sept-15	Dec-15
Inflation (YoY)	6.3	7.0	6.0	8.0
Central Bank Rate ("CBR")	8.5	10.0	11.5	11.5
Repo rate	8.1	9.7	11.5	9.8
Interbank rate	6.9	11.8	19.8	7.3
Treasury bill rate (91-days)	8.5	8.3	14.6	9.8
Avg. deposit rate (3-month)	9.9	9.7	10.1	11.4
Avg. lending rate	15.5	16.1	16.8	18.3
Exchange rate (USD/KES)	91.7	97.7	105.3	102.2

Source: CBK Monthly Economic Review December 2015, CBK Weekly Statistical Bulletin, 6 May 2016.

The CBK tightened monetary policy sharply during the period April-September 2015. The Monetary Policy Committee ("MPC") raised the CBR by 150bps from 8.5% to 10.0% in June 2015, and by a further 150bps in July 2015 to 11.5%. In addition, the CBK sold foreign exchange, mopped up liquidity through other operations, and restricted banks' access to the overnight discount window. The resulting liquidity squeeze curbed the exchange rate depreciation, but at the expense of a significant increase in the level (up to 26%) and volatility of interbank interest rates. The period October 2015-February 2016 witnessed easing foreign exchange market pressures and emerging financial stability concerns (following pressures on the government borrowing programme and the placement of the second bank (Imperial Bank Limited) into receivership). Liquidity conditions tightened further and exerted upward pressure on short-term interest rates partly due to the skewed distribution of liquidity. The temporary pressure on the government borrowing programme coupled with the policy measures adopted to anchor inflation expectations contributed to a significant rise in treasury bill ("TB") rates in 4Q 2015. Against this backdrop, the CBK loosened its *de facto* monetary policy stance (as measured by the interbank interest rate), purchased foreign exchange, reopened the discount window, and engaged in reverse repo operations to support banks experiencing liquidity pressures. Improved liquidity led to a decline in the interbank rate to 7.3% at December 2015 from a high of 19.9% in September 2015. The 91-day TB rate declined to 9.8% in December 2015 from 21.7% in October 2015. In March 2016, the MPC maintained the CBR at 11.5%.

Real GDP growth of 6.0% is forecast for 2016, mainly on account of higher growth in agriculture from better rains, and an expected recovery in tourism following the recent removal of travel warnings by several key tourism source markets. The economy remains vulnerable to shocks which include volatility in global financial markets and capital flows; slower global and regional growth; falling commodity prices; adverse weather conditions; significant uncertainty about FDI in oil and gas exploration; and heightened volatility in global markets, which could be amplified by further increases in US policy interest rates; and possible pressures for higher current and capital spending as the 2017 presidential elections approach.

Industry overview[5]

As at 30 April 2016, Kenya's banking sector ("the sector") comprised 42 commercial banks[6], one mortgage finance company, eight representative offices of foreign banks and 12 microfinance banks.

Table 5: Key industry indicators (%)	31 December 2014	31 December 2015
Capital adequacy		
Capital adequacy ratio	19.2	18.6
Tier I ratio	15.9	15.6
Asset quality		
Gross NPLs/Gross loans	5.4	6.1
Provisions/NPLs	65.0	61.6
Profitability		
ROaA	3.4	3.1
ROaE	26.5	25.2
Liquidity		
Liquid assets/total deposits	45.2	44.0
Liquid assets/total assets	32.7	31.4

^ Commercial banks.
Source: CBK.

[5] Refer to GCR Kenya Operating Overview Report, May 2016.

[6] Including:

i. Chase Bank Kenya Limited – Placed in receivership on 7 April 2016, Kenya Deposit Insurance Corporation ("KDIC") appointed as receiver for a period of twelve months, pursuant to provisions of the Kenya Deposit Insurance Act, 2012 ("KDIA").
ii. Imperial Bank Limited – Placed in receivership on 13 October 2015, KDIC appointed as receiver for a period of twelve months, pursuant to the provisions of the KDIA.

Excluding:

iii. Dubai Bank Kenya Limited – Placed in liquidation on 24 August 2015, CBK appointed the KDIC as liquidator of Dubai Bank in terms of the KDIA.

At 31 December 2015, financial indicators remained sound on an aggregate basis, notwithstanding pockets of vulnerabilities in the sector due to mounting asset quality pressure, rapid credit growth in the last three years, the recent regulatory intervention in relation to three banks and liquidity stress, particularly in smaller banks (partly due to declining depositor confidence and a flight to quality). The sector recorded an average capital adequacy ratio ("CAR") of 18.6% at 31 December 2015 (19.2% at 31 December 2014). The CBK issued revised prudential guidelines in January 2013 that require banks to maintain an additional capital conservation buffer of 2.5% from January 2015. This effectively increased the minimum regulatory CAR to 14.5% from 12%. A new proposal to raise the minimum capital level for commercial banks from KES1bn to KES5bn (with compliance by December 2018) has been drafted and is awaiting approval by Parliament. Average liquidity ratios remained satisfactory at a stable 44% at 31 December 2015, against a prudential minimum of 20%. However, a flight to quality in recent months has resulted in liquidity risk being differentiated within segments of the banking sector.

The gross NPL ratio continued its upward trend increasing from 5.4% in December 2014 to 6.1% in December 2015, mainly attributable to unfavourable weather conditions, security concerns, a delayed regulatory framework for the mining sector, and a challenging business environment during 2015. Loan loss provisions remained broadly adequate relative to NPLs, although declining from 65% of NPLs at 31 December 2014 to 61.6% at 31 December 2015 (but relative to a notably higher 80.9% at the end of 2012). Furthermore, NPLs not covered by provisions have risen to 9.5% of capital at 31 December 2015 (2014: 7.4%; 2012: 3.5%) indicating a three-fold increase in the exposure of banks' capital to credit risk over a relatively short time period. This trend is reflective of strong credit growth (which outstripped growth in bank capital), together with some negative developments within sectors of the economy. GCR would expect to see increasing provisions during 2016 to accommodate the sharp rise in uncovered NPLs.

Total banking industry assets increased 13.6% (2014: 18.4%), while gross loans and advances registered growth of 16.6% (2014: 22.8%) in 2015, with increased lending in all sectors except mining and quarrying. Deposits grew by 12.2% (2014: 18.4%) to KES2.6tn at 31 December 2015. The banking sector registered a 2.8% (2014: 16.6%) growth in pre-tax profit to KES144.9bn during 2015, although ROaA and ROaE decreased to 3.1% (2014: 3.4%) and 25.2% (2014: 26.5%) mainly as a result of falling interest margins and higher impairment charges.

On the regulatory front, the CBK has strengthened the legal and regulatory framework by implementing capital conservation buffers, ensuring adequate provisioning for NPLs, establishing supervisory colleges for significant regional banking groups, and conducting host country legal and regulatory assessments among other measures.

Competitive position[7]

The Kenyan banking sector is highly fragmented and competitive, with the Tier 1 and Tier 2 banks accounting for approximately 91% of total industry assets, and the rest split amongst 21 Tier 3 players at 31 December 2015. According to the weighted market share index ("WMSI")[8], the bank ranked 24th at 31 December 2015, remaining in the Tier 3 banks category. That said, VCB has demonstrated its ability to adapt to the increasingly competitive environment by leveraging on its relationship-based niche private bank model, and posting sound financial fundamentals over the years.

Table 6: Peer analysis (KESm)‡	ABC	K-REP	GTB	VCB
Market shares (%)				
WMSI	0.6	0.6	0.9	0.6
Total assets	0.6	0.5	0.8	0.6
Loans and advances	0.7	0.6	0.6	0.6
Customer deposits	0.6	0.5	0.6	0.5
Selected ratios (%)				
Capital adequacy	16.5	24.7	27.7	19.3
Gross NPL ratio	12.7	10.5	3.1	0.0
Coverage ratio	9.1	44.8	57.6	n.a
Advance to deposits ratio	94.0	93.6	80.2	93.6
Cost ratio	95.1	67.9	69.7	37.1
ROE	9.5	11.4	6.0	22.4
ROA	1.2	2.0	1.6	3.8

‡ Refers to Kenyan operations.
Source: CBK.

GCR considers the broader context of market position as one of its rating factors. Market position is based on the bank's market share and core competences, and the advantages and vulnerabilities arising from its market position are examined. VCB's market share has remained relatively constant (0.4% - 0.6% range) over the past 5 years.

Financial profile

Likelihood of support

Although the Kenyan government has demonstrated its position as an interventionist, this must be viewed as a systemic protection mechanism only (no history of providing bailouts to distressed banks). Furthermore, GCR feels that the relatively small size of VCB's deposit base places it at a lower systemic importance than the larger local banks. However, the bank has demonstrated ability to access shareholder

[7] Banking sector comparatives based on Kenyan operations (excluding regional subsidiaries).

[8] The WMSI is a composite of the respective banks' market share of net assets, deposits, total shareholders' funds, number of loan accounts and number of deposits accounts.

funds, evidenced by successful capital raising initiatives.

Funding composition

VCB's 'high-touch' relationship based business model has enabled it to attract substantial deposits from its clients, despite its small branch network. As such, the bank has managed to grow its deposit base through customised targeting of its existing client base. Customer deposits grew by 16.0% in 1Q F16 and 14.1% in F15 (F14: 35.9%), remaining above the industry average growth rate of ±1% and 12.2% respectively. During F15, long-term offshore borrowings (earmarked for foreign currency lending) declined by 5.9% due to repayments, while interbank borrowings rose by 69.1% (F14: 20.2%), owing to currency swaps. That said, the bank reduced its interbank borrowings in 1Q F16, remaining as a net lender in the interbank market. Owing to its narrow target market for deposit generation (high net worth clients and corporates), and high proportion of term deposits, the bank has been incurring relatively high funding costs. To address this, the bank aims to mobilise retail deposits in the future.

Table 7: Funding profile	F14		F15	
	KESm	%	KESm	%
Customer deposits	12 289	85.9	14 024	85.5
Corporates	*5 147*	*36.0*	*5 804*	*35.4*
Individuals	*7 142*	*49.9*	*8 220*	*50.1*
Interbank borrowings	637	4.4	1 077	6.6
Domestic banks	*100*	*0.7*	*666*	*4.1*
Foreign banks	*537*	*3.7*	*411*	*2.5*
Long-term borrowings+	1 387	9.7	1 305	7.9
Total	**14 313**	**100.0**	**16 406**	**100.0**

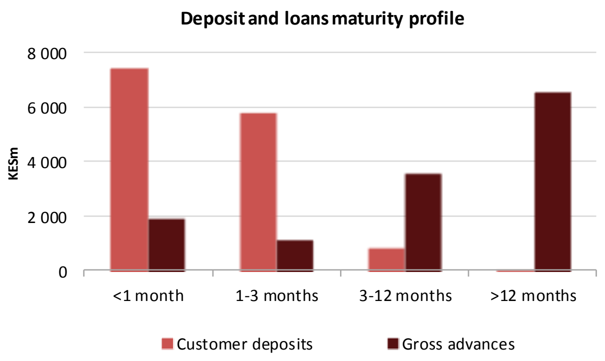
+ Comprises a 6 year USD15m line of credit from Symnex Limited and 10 year USD18m line of credit from Cistenique Investment Fund. Both facilities are at an interest rate of 6% per annum. Facilities availed to support lending in foreign currency.

Source: VCB.

In terms of size, the top 20 depositors constituted 19.9% of customer deposits at FYE15, while the top exposure accounted for 3.0% of the book.

Liquidity risk

Local lending institutions are structurally exposed to liquidity risk due to the maturity mismatches between assets and liabilities, where the average duration of liabilities is shorter than that of assets. This is as a result of an underdeveloped bond market, volatile interest rates and low levels of financial intermediation. In this regard, the bank's deposit and loans maturity profile analysis reflects net maturity gaps in the short-term (less than 1 month and 1-3 months) maturity buckets. VCB's liquidity risk is further exacerbated by the wholesale nature of its deposits (rendering it susceptible to external shocks).



Nonetheless, management indicated that over 90% of wholesale deposits are typically rolled-over year-on-year and to manage the resultant mismatches, the bank retains sufficient liquidity buffers, maintaining its average liquidity ratio well above the minimum statutory requirement of 20%

Table 8: Net liquid assets to customer deposits (%)	F13	F14	F15
At close of the year	30.8	32.6	27.1
Average for the year	35.4	29.8	29.5
Maximum for the year	42.2	35.2	33.5
Minimum for the year	25.5	24.3	23.7

Source: VCB.

Capital structure

VCB's capital position improved in F15, with its regulatory capital increasing 26.1% to KES3.5bn. This was supported by high profit retention (with balance sheet retained earnings growing by 40.8%) and additional capital of KES56m. Consequently, the bank maintained healthy capitalisation ratios, recording Tier 1 and total capital adequacy ratios of 18.6% and 19.3% respectively at FYE15 (FYE14: 18.2% and 19.2%). In light of the potential increase in the minimum capital requirement to KES5bn, management indicated that the bank is considering seeking additional capital and that part of the increase will mainly be addressed through organic growth and earnings retention.

Table 9: Capitalisation	F14	F15	1Q F16
	KESm	KESm	KESm
Tier 1 capital	2 615	3 343	3 401
Ordinary share capital	*589*	*608*	*608*
Share premium	*383*	*420*	*420*
Retained earnings	*1 644*	*2 314*	*2 373*
Other reserves	*(1)*	*(1)*	*-*
Tier 2 capital	141	132	132
Total regulatory capital	**2 756**	**3 475**	**3 533**
Total risk weighted assets ("RWA")	**14 376**	**18 004**	**18 932**
Tier 1 capital: RWA	**18.2**	**18.6**	**18.0**
Statutory requirement @ 10.5%			
Regulatory capital: RWA	**19.2**	**19.3**	**18.7**
Statutory requirement @ 14.5%			

Source: VCB.

Operational profile

Risk management

VCB has a strong risk management framework, which is based on risk principles approved by the board, and underpinned by numerous reporting lines. The existing framework embodies all aspects of credit, operational, market and liquidity risk among other risks. In addition, the framework includes setting key control standards, compliance monitoring and continuous education of staff on all risks faced by the bank.

Credit Risk

Asset composition

Supported by increased funding (albeit at a lower growth rate), VCB grew its balance sheet by 16.1% in F15 (F14: 26.4%). The bank's risk appetite framework remained largely unchanged during F15, with the bank maintaining an ample liquid asset base and credit risk typically manifesting through lending transactions. That said, VCB adopted a more conservative investment approach during 1Q F16, deploying a greater proportion of funding towards liquid assets, as the sector faced liquidity challenges.

Table 10: Asset composition	F14		F15	
	KESm	%	KESm	%
Cash and liquid assets	5 278	30.6	6 160	30.8
Cash	*48*	*0.3*	*82*	*0.4*
Balances with CBK	*1 036*	*6.0*	*1 238*	*6.2*
CBK - REPO	*450*	*2.6*	*-*	*-*
*Marketable securities**	*2 704*	*15.7*	*3 348*	*16.7*
Balances with banks	*1 040*	*6.0*	*1 492*	*7.5*
Customer loans	10 979	63.7	13 124	65.5
Investment in associates†	597	3.4	253	1.3
Fixed assets #	185	1.1	235	1.2
Other assets	205	1.2	248	1.2
Total	**17 244**	**100.0**	**20 020**	**100.0**

*Mainly comprise Government securities.

† During F15, the bank sold its 20% stake in Brookhouse Schools Limited.

At FYE15, fixed assets consisted of property and equipment held for sale worth KES40m.

Source: VCB.

The bank has significant off-balance sheet exposures constituting 18.7% of total assets (including contingencies) at FYE15 (FYE14: 15.1%), which management does not consider to exhibit legal credit exposure. These are mainly in the form of guarantees, letters of credit and committed facilities, extended to strong and reputable clients. The majority of the guarantees and letters of credit ("LCs") are self-liquidating or cash covered. Management indicated that the bank intends to maintain its portfolio of contingent assets below 25% of total balance sheet assets.

Table 11: Contingencies	F14		F15	
	KESm	%	KESm	%
Acceptances and LCs	933	30.4	1 869	40.6
Guarantees	825	26.8	963	20.9
Other commitments	1 317	42.8	1 771	38.5
Total	**3 075**	**100.0**	**4 603**	**100.0**

Source: VCB.

Loan portfolio

Gross loans and advances grew by a lower 19.7% during F15 (F14: 31.3%). The bank's selectivity criteria and the high value of transactions associated with lending to its niche corporate clientele has resulted in some credit concentrations within the loan portfolio, with the top 20 exposures accounting for 68.0% of total loans and advances at FYE15 (FYE14: 68.3%). The largest borrower amounted to 5.4% (FYE14: 5.0%) of the credit book and 20.5% (FYE14: 23.3%) of capital at FYE15. Nonetheless, comfort is derived from the bank's robust credit risk management practices and it is noted that the single largest exposure to capital was within the CBK prudential guideline, which limit exposures to a single borrower/ group to 25% of capital. GCR notes that transactions with related parties form an insignificant portion of VCB's loan book, and controls of the granting of such loans are adequate.

Table 12: Gross loans and advances	F14		F15	
	KESm	%	KESm	%
By sector				
Agriculture	432	3.9	556	4.2
Construction	339	3.1	574	4.4
Individuals	461	4.2	660	5.0
Manufacturing	3 253	29.5	3 955	30.0
IT and telecommunication	87	0.8	84	0.6
Wholesale and retail trade	2 693	24.5	2 995	22.8
Related parties	222	2.0	152	1.2
Other	3 517	32.0	4 193	31.8
Total	**11 004**	**100.0**	**13 169**	**100.0**
By borrower				
Corporates	10 543	95.8	12 509	95.0
Large corporates	*1 481*	*13.5*	*2 075*	*15.8*
SMEs	*9 062*	*82.3*	*10 434*	*79.2*
Individuals	461	4.2	660	5.0
Overdrafts	*10*	*0.1*	*49*	*0.4*
Mortgages	*145*	*1.3*	*207*	*1.6*
Term loans	*306*	*2.8*	*404*	*3.0*
Total	**11 004**	**100.0**	**13 169**	**100.0**

Source: VCB.

The bank has sectorial limits in place, guided by the performance of each sector, as well as associated risks. VCB's portfolio mix continues to reflect high exposures to the manufacturing, wholesale trade and real estate sectors, given that it strategically targets mid-to large size corporates.

Asset quality

VCB's selective picking of clients at the pre-loan application process stage and strong risk management capabilities at the post loan disbursement stage has enabled it to maintain robust asset quality. In this respect, the bank has not registered any non-performing loans for at least the past decade. Furthermore, it is positively noted that the bank avoids any exposure to unsecured lending. GCR considers that asset quality pressures emanating from the increasing challenging operating environment are mitigated by the bank's disciplined underwriting approach.

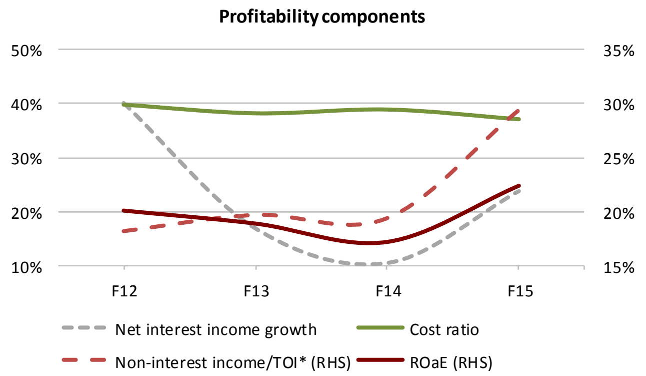
Table 13: Asset quality	F14 KESm	F15 KESm	1Q F16 KESm
Gross advances	**11 004**	**13 169**	**13 777**
Neither past due nor impaired	*11 004*	*12 999*	*13 599*
Past due but not impaired	-	*170*	*178*
Impaired	-	-	-
Less: Provisions	**(25)**	**(45)**	**(45)**
Individually assessed	-	-	-
Collectively assessed	*(25)*	*(45)*	*(45)*
Net loans and advances	**10 979**	**13 124**	**13 732**
Loan write-offs	1	26	32
Loan recoveries	3	-	-
Gross NPL ratio (%)	-	-	-
Total provisions/Gross loans (%)	0.2	0.3	0.3

Source: VCB.

Financial performance and prospects

A five year financial profile is included at the back of this report, supplemented by the commentary below.

Pre-tax earnings grew by a four year high of 44.8% to KES919.1m in F15, mainly driven by a 35.6% increase in interest income (due to growth in loans), and a review period high 113.9% increase in non-interest income, which more than offset the 46.8% increase in funding costs and 35% increase in operating expenditure. The bank's ROaA and ROaE increased to 3.8% and 22.4% respectively in F15 (F14: 3.0% and 17.2%).



* Total operating income.

Net interest income: Net interest income increased by a higher 23.8% in F15 (F14: 10.5%), supported by increased lending at relatively higher yields. The bank's net interest margin remained fairly flat at 6.4% in F15 (F14: 6.3%), as the effect of higher funding costs was counterbalanced by higher yields.

Non-interest income: Benefiting mainly from an increase in fee and commission income and a once off gain from the sale of an associate, non-interest income rose by a review period high of 113.9% in F15 (F14: 8.1%; F13: 29.4%). Excluding the sale and profit contribution of the associate company, non-funded income grew by 15.4% in F15, compared to a prior growth of 12.4%.

Operating expenses: The bank's cost base rose by 34.7% to KES553.5m in F15 (F14: 12.0%), driven by increased staff costs, branch expansion costs and IT related expenses. Despite the high increase in operating expenditure, VCB's operations remained efficient as highlighted by a relatively low cost ratio which declined to 37.1% in F15 (F14: 38.9%).

The bank's results for 1Q F16 and 1Q F15 are shown in Table 14. Pre-tax earnings increased 19.2% in 1Q F16, compared to the corresponding prior year period. Notable growth was experienced in all asset categories at 1Q F16, supported by increased customer deposits. Overall, year-to-date results point towards a solid full year result.

Table 14: Actual interim results (KESm)	Actual 1Q F15	Actual 1Q F16	Growth (%)
Income statement			
Interest income	489	626	28.0
Interest expense	(280)	(368)	31.4
Net interest income	**209**	**258**	**23.4**
Other income	45	53	17.8
Total operating income	**254**	**311**	**22.4**
Operating expenditure	(108)	(137)	26.9
Loan loss provision	-	(<0.1)	n.a
Profit before tax	**146**	**174**	**19.2**
Balance sheet			
Cash and liquid assets	5 009	5 699	13.8
Net loans and advances	11 382	13 732	20.6
Customer deposits	13 748	15 646	13.8
Total capital and reserves	2 964	3 652	23.2
Total assets*	18 420	21 159	14.9

*Excluding contingencies.
Source: VCB.

Looking ahead, the bank aims to enhance/deepen its relationship based banking model, focus on the corporate segment and improve its delivery channels. Potential challenges could emanate from increased competition, in particular, in the high net worth segment.

Victoria Commercial Bank Limited

(Kenya Shillings in millions except as noted)

Year end: 31 December	2011	2012	2013	2014	2015
Income Statement Analysis					
Interest income	740.1	1 352.8	1 375.4	1 754.7	2 379.9
Interest expense	(269.2)	(693.0)	(604.3)	(902.9)	(1 325.4)
Net interest income	**470.9**	**659.8**	**771.1**	**851.8**	**1 054.5**
Fee and commission income	66.4	92.8	119.4	124.7	164.5
Trading income	34.9	16.5	24.3	23.4	27.7
Other income	7.2	37.1	45.8	56.8	246.0
Total operating income	**579.3**	**806.3**	**960.7**	**1 056.7**	**1 492.7**
Impairment charge	15.3	5.7	(7.5)	(11.0)	(20.0)
Operating expenditure	(265.0)	(321.1)	(366.8)	(410.9)	(553.5)
Net profit before tax	**329.7**	**490.9**	**586.4**	**634.9**	**919.1**
Tax	(99.4)	(140.4)	(154.5)	(170.5)	(205.3)
Profit after tax	**230.3**	**350.5**	**431.9**	**464.3**	**713.8**
Balance Sheet Analysis					
Subscribed capital	399.1	953.6	953.6	971.6	1 027.9
Reserves (incl. net income for the year)	853.3	1 082.5	1 574.6	1 904.0	2 483.6
Total capital and reserves	**1 252.5**	**2 036.0**	**2 528.1**	**2 875.5**	**3 511.5**
Bank borrowings (incl. deposits, placements and REPOs)	453.0	342.1	530.0	636.6	1 076.9
Customer deposits	5 906.5	7 560.9	8 985.8	12 288.3	14 022.8
Other borrowings	-	312.8	1 482.7	1 387.4	1 305.4
Short-term funding (< 1 year)	**6 359.5**	**8 215.8**	**10 998.5**	**14 312.3**	**16 405.1**
Customer deposits	-	-	57.9	0.4	1.6
Other funding (> 1 year)	**-**	**-**	**57.9**	**0.4**	**1.6**
Payables/Deferred liabilities	33.2	71.0	59.8	55.9	101.8
Other liabilities	**33.2**	**71.0**	**59.8**	**55.9**	**101.8**
Total capital and liabilities	**7 645.2**	**10 322.8**	**13 644.2**	**17 244.1**	**20 020.1**
Cash in hand	32.7	38.0	42.0	47.9	82.1
Balances with central bank	242.8	447.6	427.1	1 485.5	1 237.5
Fixed assets	145.4	142.5	137.4	185.4	235.5
Receivables/Deferred assets	123.1	244.5	198.8	205.2	247.9
Non-earnings assets	**543.9**	**872.6**	**805.3**	**1 924.0**	**1 803.0**
Loans and advances (net of provisions)	4 110.4	5 291.2	8 363.5	10 979.2	13 124.4
Bank placements	1 072.9	1 011.7	1 912.2	1 040.5	1 491.7
Marketable/Trading securities	1 531.2	2 817.3	2 005.7	2 703.8	3 347.9
Total investments	81.4	-	-	-	-
Investments in subsidiaries/associates	305.4	330.0	557.6	596.6	253.1
Total earning assets	**7 101.3**	**9 450.2**	**12 838.9**	**15 320.1**	**18 217.1**
Total assets	**7 645.2**	**10 322.8**	**13 644.2**	**17 244.1**	**20 020.1**
Contingencies	**2 050.4**	**2 629.1**	**3 127.8**	**3 074.7**	**4 603.3**
Ratio Analysis (%)					
Capitalisation					
Internal capital generation	16.7	16.3	17.1	16.1	20.3
Total capital / Net advances + net equity invest. + guarantees	24.9	29.7	25.6	22.6	22.0
Total capital / Total assets	16.4	19.7	18.5	16.7	17.5
Liquidity					
Net advances / Customer deposits	69.6	70.0	92.5	89.3	93.6
Net advances / Customer deposits + other short-term funding	64.6	64.4	75.6	76.7	80.0
Net advances / Total funding (excl. equity portion)	64.6	64.4	75.6	76.7	80.0
Liquid and trading assets / Total assets	37.7	41.8	32.2	30.6	30.8
Liquid and trading assets / Total short-term funding	45.3	52.5	39.9	36.9	37.5
Liquid and trading assets / Total funding (excl. equity portion)	45.3	52.5	39.7	36.9	37.5
Asset quality					
Impaired loans / Gross advances	0.0	0.0	0.0	0.0	0.0
Total loan loss reserves / Gross advances	0.5	0.5	0.2	0.1	(0.1)
Bad debt charge (income statement) / Gross advances (avg.)	(0.4)	(0.1)	0.1	0.1	0.2
Bad debt charge (income statement) / Total operating income	(2.6)	(0.7)	0.8	1.0	1.3
Profitability					
Net interest margin	8.1	8.3	7.2	6.3	6.4
Interest income + com. fees / Earning assets + guarantees (a/avg.)	6.8	7.0	6.1	5.3	5.3
Non-interest income / Total operating income	18.7	18.2	19.7	19.4	29.4
Non-interest income / Total operating expenses (or burden ratio)	40.9	45.6	51.7	49.9	79.2
Cost ratio	45.7	39.8	38.2	38.9	37.1
ROaE	17.8	20.1	18.9	17.2	22.4
ROaA	3.0	3.7	3.6	3.0	3.8
Nominal growth indicators					
Total assets	23.0	35.0	32.2	26.4	16.1
Net advances	17.9	28.7	58.1	31.3	19.5
Total capital and reserves	13.6	62.6	24.2	13.7	22.1
Customer deposits	19.7	28.0	19.6	35.9	14.1
Net income	7.2	52.2	23.2	32.5	65.3

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GLOSSARY OF TERMS/ACRONYMS USED IN THIS DOCUMENT AS PER GCR'S FINANCIAL INSTITUTIONS

Asset	A resource with economic value that a company owns or controls with the expectation that it will provide future benefit.
Asset Quality	Refers primarily to the credit quality of a bank's earning assets, the bulk of which comprises its loan portfolio, but will also include its investment portfolio as well as off balance sheet items. Quality in this context means the degree to which the loans that the bank has extended are performing (ie, being paid back in accordance with their terms) and the likelihood that they will continue to perform.
Balance Sheet	Also known as a Statement of Financial Position. A statement of a company's assets and liabilities provided for the benefit of shareholders and regulators. It gives a snapshot at a specific point in time of the assets the company holds and how they have been financed.
Bond	A long term debt instrument issued by either: a company, institution or the government to raise funds.
Capital	The sum of money that is invested to generate proceeds.
Capital Adequacy	A measure of the adequacy of an entity's capital resources in relation to its current liabilities and also in relation to the risks associated with its assets. An appropriate level of capital adequacy ensures that the entity has sufficient capital to support its activities and that its net worth is sufficient to absorb adverse changes in the value of its assets without becoming insolvent.
Cash	Funds that can be readily spent or used to meet current obligations.
Contingent Assets	Assets not recorded in an entity's financial reports, but which may be realised.
Corporate Governance	Refers to the mechanisms, processes and relations by which corporations are controlled and directed, and is used to ensure the effectiveness, accountability and transparency of an entity to its stakeholders.
Cost Ratio	The ratio of operating expenses to operating income. Used to measures a bank's efficiency.
Credit Risk	The possibility that a bond issuer or any other borrowers (including debtors/creditors) will default and fail to pay the principal and/or interest when due.
Customer Deposit	Cash received in exchange for a service, including safekeeping, savings, investment, etc. Customer deposits are a liability in a bank's books.
Debt	An obligation to repay a sum of money. More specifically, it is funds passed from a creditor to a debtor in exchange for interest and a commitment to repay the principal in full on a specified date or over a specified period.
Exchange Rate	The value of one country's currency expressed in terms of another.
Exposure	Exposure is the amount of risk the holder of an asset or security is faced with as a consequence of holding the security or asset. For a company, its exposure may relate to a particular product class or customer grouping. Exposure may also arise from an overreliance on one source of funding.
Financial Institution	An entity that focuses on dealing with financial transactions, such as investments, loans and deposits.
Financial Statements	Presentation of financial data including balance sheets, income statements and statements of cash flow, or any supporting statement that is intended to communicate an entity's financial position at a point in time.
Fixed Assets	Assets of a company that will be used or held for longer than a year. They include tangible assets, such as land and equipment, stake in subsidiaries and other investments, as well as intangible assets such as goodwill, information technology or a company's logo and brand.
Forecast	A calculation or estimate of future financial events.
Guarantee	An undertaking in writing by one person (the guarantor) given to another, usually a bank (the creditor) to be answerable for the debt of a third person (the debtor) to the creditor, upon default of the debtor.
Impairment	Reduction in the value of an asset because the asset is no longer expected to generate the same benefits, as determined by the company through periodic assessments.
Interest	Scheduled payments made to a creditor in return for the use of borrowed money. The size of the payments will be determined by the interest rate, the amount borrowed or principal and the duration of the loan.
Interest Rate	The charge or the return on an asset or debt expressed as a percentage of the price or size of the asset or debt. It is usually expressed on an annual basis.
International Financial Reporting Standards	IFRS is designed as a common global language for business affairs so that company accounts are understandable and comparable across international boundaries.
International Scale Rating LC	International local currency (International LC) ratings measure the likelihood of repayment in the currency of the jurisdiction in which the issuer is domiciled. Therefore, the rating does not take into account the possibility that it will not be able to convert local currency into foreign currency or make transfers between sovereign jurisdictions.
Liabilities	All financial claims, debts or potential losses incurred by an individual or an organisation.
Liquid Assets	Assets, generally of a short term, that can be converted into cash.
Liquidity	The speed at which assets can be converted to cash. It can also refer to the ability of a company to service its debt obligations due to the presence of liquid assets such as cash and its equivalents. Market liquidity refers to the ease with which a security can be bought or sold quickly and in large volumes without substantially affecting the market price.
Liquidity Risk	The risk that a company may not be able to meet its financial obligations or other operational cash requirements due to an inability to timeously realise cash from its assets. Regarding securities, the risk that a financial instrument cannot be traded at its market price due to the size, structure or efficiency of the market.
Long-Term	Not current; ordinarily more than one year.
Long-Term Rating	Reflects an issuer's ability to meet its financial obligations over the following three to five year period,

	including interest payments and debt redemptions. This encompasses an evaluation of the organisation's current financial position, as well as how the position may change in the future with regard to meeting longer term financial obligations.
Margin	The rate taken by the lender over the cost of funds, which effectively represents the entity's profit and remuneration for taking the risk of the loan; also known as spread.
Maturity	The length of time between the issue of a bond or other security and the date on which it becomes payable in full.
Monetary Policy	Measures taken by the central bank to influence the quantity of money or the rate of interest with a view to achieving stable prices, full employment and economic growth.
Net Interest Margin	Net interest income divided by average interest earning assets. Measures a bank's margin after paying funding sources and how successful a bank's interest-related operations are.
Off Balance Sheet	Off balance sheet items are assets or liabilities that are not shown on a company's balance sheet. They are usually referred to in the notes to a company's accounts.
Past Due	Any note or other time instrument of indebtedness that has not been paid on the due date.
Performing Loan	A loan is said to be performing if the borrower is paying the interest on it on a timely basis.
Portfolio	A collection of investments held by an individual investor or financial institution. They may include stocks, bonds, futures contracts, options, real estate investments or any item that the holder believes will retain its value.
Private Placement	The sale of securities to a small number of institutional investors such as large banks, insurance companies and pension funds. Such issuances do not require a formal prospectus and are often not listed on an exchange.
Provision	The amount set aside or deducted from operating income to cover expected or identified loan losses.
Rating Outlook	Indicates the potential direction of a rated entity's rating over the medium term, typically one to two years. An outlook may be defined as: 'Stable' (nothing to suggest that the rating will change), 'Positive' (the rating symbol may be raised), 'Negative' (the rating symbol may be lowered) or 'Evolving' (the rating symbol may be raised or lowered).
Regulatory Capital	The total of primary, secondary and tertiary capital.
Retained Earnings	Earnings not paid out as dividends by a company. Retained earnings are typically reinvested back into the business and are an important component of shareholders' equity.
Rights Issue	One of the ways that a company can raise additional funds is to issue new shares. These must be first offered to current shareholders and a rights issue allows a shareholder to buy shares in proportion to the number already held.
Risk Management	Process of identifying and monitoring business risks in a manner that offers a risk/return relationship that is acceptable to an entity's operating philosophy.
Security	An asset deposited or pledged as a guarantee of the fulfilment of an undertaking or the repayment of a loan, to be forfeited in case of default.
Shareholder	An individual, entity or financial institution that holds shares or stock in an organisation or company.
Short-Term	Current; ordinarily less than one year.
Short-Term Rating	An opinion of an issuer's ability to meet all financial obligations over the upcoming 12 month period, including interest payments and debt redemptions.
Swap	An exchange of payment streams between two parties for their mutual benefit. Swaps can involve an exchange of debt obligations, interest payments or currencies, with a commitment to re-exchange them at a specified time.
Term Deposit	A savings account held for a fixed term. Also called a time deposit. Generally, there are penalties for early withdrawal.
Tier 1 Capital	Primary capital consists of issued ordinary share capital, hybrid debt capital, perpetual preference share capital, retained earnings and reserves. This amount is then reduced by the portion of capital that is allocated to trading activities and other regulatory deductions.
Tier 2 Capital	Secondary capital is mainly made up of subordinated debt, portfolio impairment and 50% of any revaluation reserves and other specified regulatory deductions.
Tier I Capital	Primary capital consists of issued ordinary share capital, hybrid debt capital, perpetual preference share capital, retained earnings and reserves. This amount is then reduced by the portion of capital that is allocated to trading activities and other regulatory deductions.
Yield	Percentage return on an investment or security, usually calculated at an annual rate.

For a detailed glossary of terms utilised in this report please click here

SALIENT FEATURES OF ACCORDED RATINGS

GCR affirms that a.) no part of the rating was influenced by any other business activities of the credit rating agency; b.) the rating was based solely on the merits of the rated entity, security or financial instrument being rated; and c.) such rating was an independent evaluation of the risks and merits of the rated entity, security or financial instrument.

Victoria Commercial Bank Limited participated in the rating process via face-to-face management meetings and other written correspondence. Furthermore, the quality of information received was considered adequate and has been independently verified where possible.

The credit ratings have been disclosed to Victoria Commercial Bank Limited with no contestation of the ratings.

Information received from Victoria Commercial Bank Limited and other reliable third parties to accord the credit ratings included:

- Audited financial results as at 31 December 2015 (and four years comparative numbers)
- Unaudited interim results at 31 March 2016
- Budgeted financial statements for 2016
- Latest internal and/or external audit report to management
- A breakdown of facilities available and related counterparties
- Corporate governance and enterprise risk framework

The ratings above were solicited by, or on behalf of, Victoria Commercial Bank Limited, and therefore, GCR has been compensated for the provision of the ratings.