Nigerian Banks

Sector consolidation prospects

Banks

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- **The Central Bank of Nigeria has set the stage for consolidation in the sector. In this note we assess 20 of the 24 banks for corporate action. Strategic investors may view Afribank, Diamond, Sterling, Fidelity, Platinum and Wema as potentially attractive targets, based on our analysis.** Although Oceanic initially screened well in our analysis, we highlight its sensitivity to further asset quality deterioration under our stress tests; due to uncertainty over book quality generally in the sector, we exclude Oceanic from our shortlist of attractive strategic targets.
- **Based on our analysis, institutional investors may find FirstBank, Zenith, Stanbic, Unity and FCMB best placed of the local banks to consolidate the market. We would however not exclude UBA and GTBank from this list given relatively healthy capital positions.** Some of the most likely foreign banks to participate in consolidation include the SA banks in our view - we view Standard Bank, FirstRand and possibly Absa as best positioned. We expect investments in the R1-3bn range.
- **The CBN's actions result in three distinct categories in the sector:**

(i) **Government-supported banks (c.31% sector assets, 30% deposits).** Weak asset quality has led to adverse liquidity and capital levels, resulting in government support of N400bn for five banks (cN205bn required to meet the 10% regulatory minimum).

(ii) **CBN-audited banks (c.34% sector assets, 47% deposits).** An initial CBN assessment on five other banks has found them to be reasonably healthy.

(iii) **CBN-unaudited banks (c.34% sector assets, 23% deposits).** An assessment by the CBN is yet to be conducted - expected timing for all outstanding banks is mid-September 2009.

We believe each category exhibits different risk profiles, but based on our analysis, we believe strategic investors may find banks in the unaudited category most appealing. Despite government support for the five banks in the first category above, we view corporate action involving these names as risky and may prove most punitive for existing shareholders.

Nigerian banking sector data

NGN'm	2008
GDP nominal	24,048,500
Loans and advances	7,606,337
Total assets	15,882,909
Deposits	7,948,019
Capital	3,364,641
Number of banks	24
Branches	5,134
Capital adequacy ratio	22%
NPL ratio	6.3%
Bank credit / GDP	33.5%
DMB assets / GDP	66.2%
Deposits / GDP	33.0%
Average liquidity ratio	44%
Average loans/deposit ratio	83%

Source: CBN

Nigerian Banks – J.P. Morgan ratings

	Recommendation	Price (NGN)
Audited banks		
GTBank	Neutral	12.46
FirstBank	Underweight	13.33
UBA	Overweight	10.13
Government-supported banks		
Oceanic	Overweight	*4.94
Intercontinental	Neutral	*6.93
Union Bank	Underweight	*12.60
Unaudited banks		
Zenith	Overweight	10.17

Source: J.P. Morgan. Prices at COB 24 August, 2009. * Prices at COB 14 August, 2009

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Executive Summary

We review the actions of the CBN to accelerate consolidation in the Nigerian banking sector (see our note "5 bank CEOs replaced and NGN 400bn government support…", 11 Aug-09). **We expect corporate activity as early as Sep-09, when the CBN is expected to complete its assessment of all outstanding banks.** The CBN has already voiced its preference for c15 banks (versus the 24 currently) and its recent actions resulted in three distinct groups: (1) CBN-audited banks; (2) Government-supported banks; and (3) Unaudited banks - we view the banks in the unaudited category as offering the best opportunities. In this note we assess 20 of the 24 banks for corporate action.

In spite of government support for the five banks and the CBN's comments pointing to possible corporate action on these banks, we consider the risk profile for Oceanic Bank and Intercontinental Bank (in our coverage universe) to have increased. **Our analysis reveals significant additional capital required for these names, which may result in sizeable dilution to existing shareholders. We prefer Oceanic to Intercontinental as our analysis reveals Oceanic to be more attractive to strategic investors, which may underpin its share price** - see Table 4**.**

Afribank, Diamond, Sterling, Fidelity, Platinum and Wema potentially attractive targets, based on our analysis.

Oceanic initially screened well on our base case but displayed considerable sensitivity to further asset quality deterioration under our stress tests.

Strategic investors may view Afribank, Diamond, Sterling, Fidelity, Platinum and Wema as potentially attractive targets, based on our analysis. Oceanic initially screened well on our base case but displayed considerable sensitivity to further asset quality deterioration under our stress tests.

In our view, some of the most likely foreign banks to participate in consolidation include the SA banks - we consider Standard Bank, FirstRand and Absa the likely participants. We believe that suitable acquisitions at appropriate pricing would only modestly impact capital for SA banks. Select acquisitions could offer an excellent opportunity to enhance African franchises.

FirstBank, Zenith, Stanbic, Unity and FCMB best placed of the local banks to consolidate the market.

We would however not exclude UBA and GTBank from this list given relatively healthy capital positions.

Based on our analysis, institutional investors may find FirstBank, Zenith, Stanbic, Unity and FCMB best placed to consolidate the market. We would however not exclude UBA and GTBank from this list given relatively healthy capital positions.

As a result of insufficient disclosure and communication from the five banks on recent developments, the ongoing audit of the banking sector and the lack of further insight on the CBN's comments, we have not revised our earnings estimates, recommendations or PTs for the banks at this stage.

20 of the 24 banks screened in this note have a listing on the Nigerian Stock Exchange (NSE), with GTBank also trading under a GDR listed on the London Stock Exchange.

The three groups and their profiles

A distinction should be made between the audit that the CBN is undertaking on all the banks and the Special Examination (initially intended for the five banks that showed signs of stress). In his speech on 14 Aug-09 the CBN governor commented that the scope of the Special Examination has been widened to cover all the banks.

Given the CBN's previous actions and comments, we had expected the banks to be given some time (till Mar-10) to resolve issues pertaining to possible suitors and capital and fund raising initiatives - in its speech during his first MPC meeting on 7 Jul-09, the CBN guaranteed interbank placements till Mar-10 and required banks to provide full disclosure of their assets in their Dec-09 results, which have to be published by Mar-10.

Furthermore, we had expected the CBN to comment on its audit, once it had completed all 24 bank audits (vs. the 10 completed to date). The CBN has confirmed that it has completed an audit of ten banks. We consider the CBN's announcements on the progress of its audit to have resulted in three distinct groups (See Table 1 and Table 2 for a list of the banks covered in this note and selected sector data):

Table 1: Banks covered in this note

	Recommendation
Audited banks	
GTBank	Neutral
FirstBank	Underweight
UBA	Overweight
Sterling Bank	Not covered by J.P. Morgan
Diamond Bank	Not covered by J.P. Morgan
Government supported banks	
Oceanic	Overweight
Intercontinental	Neutral
Union Bank	Underweight
Afribank	Not covered by J.P. Morgan
Finbank	Not covered by J.P. Morgan
Unaudited banks	
Zenith	Overweight
Access	Not covered by J.P. Morgan
Ecobank	Not covered by J.P. Morgan
Fidelity	Not covered by J.P. Morgan
FCMB	Not covered by J.P. Morgan
Platinum	Not covered by J.P. Morgan
Skye	Not covered by J.P. Morgan
Stanbic IBTC	Not covered by J.P. Morgan
Unity	Not covered by J.P. Morgan
Wema	Not covered by J.P. Morgan

Source: J.P. Morgan, CBN

Table 2: Sector data

NGN'm	2008
GDP nominal	24,048,500
Loans and advances	7,606,337
Total assets	15,882,909
Deposits	7,948,019
Capital	3,364,641
Number of banks	24
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Capital adequacy ratio	22%
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Deposits / GDP	33.0%
Average liquidity ratio	44%
Average loans/deposit ratio	83%

Source: CBN

(1) Audited banks: We expect banks in this group to be net deposit winners as a result of certainty on their financial health. We expect the banks' funding franchises in this group to now be in a competitive position as a result of certainty on their financial health. The CBN expects to complete its audit on the sector by mid-Sep 2009. We highlight that the longer the audit takes on the banks, the stronger the funding franchise value of the audited banks becomes. This category accounts for c34% of sector assets and 47% of sector deposits.

(2) Government-supported banks: This category accounts for 31% of sector assets and 30% of sector deposits. According to the CBN these five banks demonstrated the following characteristics:

(i) Excessively high NPLs due to poor corporate governance, lax credit administration processes and the absence or non-adherence to the bank's credit risk management practices. NPL ratios ranged between 19% and 48% amongst these five banks. These banks therefore needed to make additional provisions of NGN539bn. Margin lending exposure amounted to NGN456bn (vs. sector estimate of between NGN800bn and NGN1.2tr) and exposure to the oil and gas sector was NGN487bn. Although these five banks had a disproportionate share of margin lending exposure, there is potentially a further cNGN750bn of exposure spread across the sector.

(ii) The significant provisioning requirements have led to significant capital impairment. Consequently, all five banks are undercapitalised for their current levels of operations. One of these banks has a capital adequacy ratio of 1%. The CBN has therefore calculated that a minimum capital injection of NGN205bn was required for the five banks to meet the minimum capital adequacy of 10%.

(iii) At end-July 2009, these five banks accounted for c90% of total sector CBN funding (from the CBNs discount window). Liquid asset requirements ranged between 17.65% and 24% as at end May-09 (minimum regulatory requirement 25%).

(iv) The CBN commented that at least three of these banks are systemically important (we suspect Union Bank, Intercontinental and Oceanic Bank).

(3) Unaudited banks: We expect the disclosure of very weak asset quality of the government-supported banks has resulted in a level of uncertainty for the banks that have yet to be audited by the CBN. The remaining banks account for 34% of sector assets and 23% of sector deposits. We view the immediate government support for both systemic and non-systemic banks positively.

Consolidation dynamics

We view the prospects for consolidation in the Nigerian banking sector as high. The CBN has already voiced its preference for c15 banks (versus the 24 currently). **Based on our analysis, we view the local banks in the strongest position to be acquirers in the Nigerian market as: 1) FirstBank, 2) Zenith; 3) Stanbic; 4) Unity and 5) FCMB. We would however also include UBA and GTBank in this list given that capital positions remain relatively healthy under our stress test and we view these players likely to consolidate its position.**

We view the CBN audit and the subsequent re-capitalisation process as the mechanism for this consolidation. If one excludes the current five government-supported banks, this implies that a further four banks are likely to be impacted. The audited banks have effectively been given a clean 'bill of health' and may form part of the acquirers in the current round of consolidation, in our view.

We consider three alternatives that would result in the contraction of the sector and also result in improvement in the stability of the banking system, namely:

- In-country mergers;
- Foreign acquirers; and
- Failure of banks (or nationalization as a last resort)

The third option would destroy confidence in the banking system and based on CBN comments regarding its support for the banking system support, we consider this an alternative the CBN would like to avoid. The first two alternatives are more feasible and we believe that we will see a combination of in-country mergers and foreign banks acquiring Nigerian assets.

To facilitate in-country mergers, we believe that pricing has to be attractive enough to allow local banks to participate while maintaining reasonable capital ratios on merger. We therefore consider larger, financially stable Nigerian banks to be natural acquirers of much smaller banks. That said, this process will be constrained by the ability of these banks to access funding.

If the banks are able to use existing funding, we believe that prices will have to be depressed sufficiently to allow the acquisitions to take place while preserving the integrity of the acquirers' balance sheet. Given this view, we believe that value enhancement is likely to be at the acquirer level rather than the acquiree.

If local bank consolidation is allowed at attractive pricing, we believe foreign interest in the sector would be greeted at least on similar terms. Our view is shaped by the following dynamics: i) speed of execution by the CBN is key in managing contagion risk, making the bargaining position for acquirers that much stronger; and ii) limited access to funding by local banks makes foreign participation a necessity.

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Which banks are attractive targets?

Although the focus in this note is relatively narrow, and is largely quantitative, we believe any due diligence process by potential acquirers needs to address the following: (i) Funding and liquidity; (ii) Concentration risk and asset quality; (iii) Capital structure; (iv) Efficiency; (v) IT and risk systems; (vi) quality and location of branch infrastructure; and (vi) Regulatory considerations (see discussion later).

Strategic investors may well find Afribank, Diamond, Sterling, Fidelity, Platinum and Wema potentially attractive targets based on our analysis. Oceanic initially screened well in our base case, but displayed considerable sensitivity to further deterioration in asset quality - we have removed it from our shortlist of attractive potential targets.

The central bank estimates sector margin lending exposure to be between NGN800 and NGN1.2tn (c10-15% of sector advances). Under our base case, the five government-supported banks' additional provisioning requirement is NGN552bn (NGN539bn required by the CBN). Under our analysis, additional sector provisioning required is cNGN1.7bn (base) and NGN1.9tn (stress). We have conducted a simplified exercise on 20 listed Nigerian banks to determine their attractiveness to potential acquirers.

Methodology:

The methodology applied for our screening exercise is set out below. Our assessment is based on:

i) value of its branch infrastructure (physical infrastructure and not deposit franchise - essentially replacement cost), and

ii) the potential top-up in tier 1 capital required to return the respective banks to a sound capital position (10% for government-supported banks and 20% for audited and unaudited banks).

We have adopted a broad brush approach to this exercise, applying what we consider plausible NPL provisioning assumptions to the respective books and on the assumption that the acquired banks will have to be recapitalised (tier 1) to c20% core equity capital to risk-weighted assets (10% for government-supported banks).

Thereafter, we weigh up the 'cost' to recapitalise against the replacement cost of each bank's branch infrastructure. This basic screen allows us to determine the most attractive bank targets based on their infrastructure, as well as the cost for majority stake - the key issues we believe acquirers would be interested in.

Findings:

We summarise our findings in Table 3 below. Strategic investors may well find Afribank, Diamond, Sterling, Fidelity, Platinum and Wema potentially attractive targets. Oceanic initially screened well in our base case, but displayed considerable sensitivity to further deterioration in asset quality - we have removed it from our shortlist of attractive potential targets.

Table 3: Most compelling investments (JPM base case)

	Afribank	Diamond	Sterling	Fidelity	Platinum	Wema
Category	Govt supp	Audited	Audited	Unaudited	Unaudited	Unaudited
Stressed Tier 1 capital ratio	2%	13%	8%	14%	11%	1%
Capital required - recap to 20%, R'm	977	2,039	1,665	1,356	2,688	1,162
Capital required - recap to 20% AND controlling stake, R'm	1,394	2,294	1,665	1,356	2,688	1,162
No. Branches	250	125	100	109	180	151
Deposits/branch (N'm)	872	3,360	1,769	3,473	3,969	831
Cost per branch for acquirer (USDm) - incl recap	0.46	1.92	1.96	1.46	1.76	0.91
Cost of branch (for acquirer with controlling), USDm - incl recap	0.66	2.16	1.96	1.46	1.76	0.91
Current market cap (USDm)	327	539	94	207	296	130
Discounted mkt cap, using stake to recap at 20%	229	377	66	145	207	91
Discounted mkt cap, using controlling stake and recap at 20%	164	270	47	104	148	65
Implied stake if recapped to 20%	42%	39%	75%	52%	60%	60%
Premium on branch cost to acquire (recap to 20%)	100%	234%	299%	179%	214%	138%
Premium on branch cost to acquire (recap to 20%) - controlling stake	100%	263%	299%	179%	214%	138%
Premium on branch cost to acquire (recap to 20%) - controlling stake - under stress scenario	114%	n/a	n/a	n/a	n/a	n/a

Source: J.P. Morgan estimates, Company reports. Prices cob 20 Aug-09.

Base case for potential acquisitions

Our analysis is based on determining the value of potential acquisitions from two perspectives, namely: i) value of existing branch network and ii) capital injection required to recapitalise the banks to a tier 1 ratio of 20% of core equity capital to risk-weighted assets (CBN audited and unaudited) or 10% (government-supported banks). Note that we do not attribute value explicitly to the deposit-gathering franchises in this exercise but do disclose deposits per branch as a reasonability test in our assessment.

We value the branch network as the number of branches multiplied by the value per branch. We use a higher value per branch of $820,000 per branch where the respective bank's deposits per branch is higher than the sector market share weighted average and a lower value of $660,000 per branch where this criterion is not met. We believe that the price for any potential acquisition should reflect the two issues above and we express the 'entry' price as the higher of the recapitalisation cost and our assessment of the branch infrastructure value.

We calculate two investment alternatives, namely i) cost to recapitalise bank as above (may result in only a minority shareholding); and ii) cost of a majority shareholding. We believe that foreign investors would seek a controlling stake. We also express the 'entry' price as a multiple of the branch infrastructure value to determine the relative value between banks in this exercise.

For controlling stakes in government-supported banks, we assume a 30% discount to market prices for an investment and a 50% discount to market prices for a controlling stake. For the audited and unaudited banks, we assume current market prices for both increased stakes to achieve a 20% tier 1 capital ratio as well as a controlling stake. Our analysis assumes that banks able to maintain 20% Tier 1 capital ratios post provisioning are not likely to be acquisition targets.

We make the following provisioning assumptions:

- **Government-supported banks**

- NPL assumptions consistent with disclosure from CBN. Our provisioning calculation in this exercise is consistent with CBN additional provisions for these banks;
- tier 1 capital ratios restored to 10% post provisioning;
- off balance sheet exposures weighted at 40%

- **Audited banks**
  - 25% NPLs (75% coverage, therefore 19% of book provisioned);
  - tier 1 capital ratios to 20% post provisioning

- **Unaudited banks**
  - 41% NPLs (85% coverage, therefore 35% of book provisioned) - average of the NPL levels of government-supported banks;
  - tier 1 capital ratios to 20% post provisioning;
  - off balance sheet exposures weighted at 40%

Our exchange rate assumptions are N156.40:USD1 and a ZAR8.50:USD1.

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Table 4: Government-supported banks - base case (reconciliation to CBN speech dated 14 Aug-2009)

	Afribank	Finbank	Inter	Oceanic	Union
Stressed Tier 1 capital ratio	2%	-3%	5%	1%	5%
Capital required - recap to 20%, R'm	977	2,316	2,033	3,858	1,544
Capital required - recap to 20% AND controlling stake, R'm	1,394	2,316	3,379	3,858	4,644
No. Branches	250	200	308	435	467
Deposits/branch (N'm)	872	1,600	2,903	1,920	1,461
Cost per branch for acquirer (USDm) - incl recap	0.46	1.36	0.78	1.04	0.39
Cost of branch (for acquirer with controlling), USDm - incl recap	0.66	1.36	1.29	1.04	1.17
Current market cap (USDm)	327	96	797	521	1,088
Discounted mkt cap, using stake to recap at 20%	229	67	558	365	762
Discounted mkt cap, using controlling stake and recap at 20%	164	48	399	261	544
Implied stake if recapped to 20%	42%	80%	31%	55%	29%
Premium on branch cost to acquire (recap to 20%)	100%	208%	100%	159%	100%
Premium on branch cost to acquire (recap to 20%) - controlling stake	100%	208%	157%	159%	178%

Source: J.P. Morgan estimates, company reports, Bloomberg. Prices cob 20 Aug-09

Of the government-supported banks, Afribank and Oceanic look cheap based on our screening metrics and we therefore regard them as the most compelling targets for strategic investors. However, we do not view the government-supported banks category as attractive for institutional investors. We believe that more conservatism in this category is warranted given the uncertainty - our stress test (see Table 5) reveals much higher risk with Oceanic given its sensitivity to asset quality - these banks require sizeable recapitalisation and this could result in significant dilution for existing shareholders. Although Afribank's deposit-gathering capability appears weak, we believe it is reflective in its pricing.

Table 5: Audited banks

	Diamond	FirstBank	GTBank	Sterling	UBA
Stressed Tier 1 capital ratio	13%	16%	14%	8%	11%
Capital required - recap to 20%, R'm	2,039	2,862	2,354	1,665	4,771
Capital required - recap to 20% AND controlling stake, R'm	2,294	10,086	5,754	1,665	5,919
No. Branches	125	536	154	100	694
Deposits/branch (N'm)	3,360	2,000	3,067	1,769	1,663
Cost per branch for acquirer (USDm) - incl recap	1.92	0.63	1.80	1.96	0.81
Cost of branch (for acquirer with controlling), USDm - incl recap	2.16	2.21	4.40	1.96	1.00
Current market cap (USDm)	539	2,378	1,349	94	1,393
Discounted mkt cap, using stake to recap at 20%	377	1,664	944	66	975
Discounted mkt cap, using controlling stake and recap at 20%	270	1,189	674	47	697
Implied stake if recapped to 20%	39%	17%	23%	75%	37%
Premium on branch cost to acquire (recap to 20%)	234%	100%	219%	299%	123%
Premium on branch cost to acquire (recap to 20%) - controlling stake	263%	337%	536%	299%	153%

Source: J.P. Morgan estimates, company reports, Bloomberg. Prices cob 20 Aug-09.

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Of the audited banks, strategic investors may well find Diamond and Sterling to offer the most attractive investment opportunities, according to our analysis. The branch infrastructure and entry prices in our view make these very attractive and are of a manageable size for investment (see Table 8). Diamond, in particular, could be a relatively good proposition in our opinion, with potentially less onerous restructuring required.

Table 6: Unaudited banks

	Access Bank	Ecobank	Fidelity	FCMB	Platinum	Skye	Stanbic	Unity	Wema	Zenith
Stressed Tier 1 capital ratio	6%	-4%	14%	26%	11%	2%	21%	25%	1%	23%
Capital required - recap to 20%, R'm	3,554	2,813	1,356	-	2,688	4,996	-	-	1,162	-
Capital required - recap to 20% AND controlling, R'm	3,554	6,638	1,356	-	2,688	4,996	-	-	1,162	-
No. Branches	118	200	109	250	180	224	110	216	151	355
Deposits/branch (N'm)	2,426	1,145	3,473	1,005	3,969	2,233	874	369	831	3,090
Cost per branch for acquirer (USDm) - incl recap	3.54	1.65	1.46	-	1.76	2.62	-	-	0.91	-
Cost of branch (for acquirer with controlling), USDm - incl recap	3.54	3.90	1.46	-	1.76	2.62	-	-	0.91	-
Current market cap (USDm)	545	1,561	207	588	296	205	599	101	130	1,709
Discounted mkt cap, using stake to recap at 20%	382	1,093	145	588	207	144	599	101	91	1,709
Discounted mkt cap, using controlling stake and recap at 20%	273	781	104	588	148	103	599	101	65	1,709
Implied stake if recapped to 20%	52%	23%	52%	0%	60%	80%	0%	0%	60%	0%
Premium on branch cost to acquire (recap to 20%)	432%	252%	179%	0%	214%	400%	0%	0%	138%	0%
Premium on branch cost to acquire (recap to 20%) – controlling stake	432%	595%	179%	0%	214%	400%	0%	0%	138%	0%

Source: J.P. Morgan estimates, company reports, Bloomberg. Prices cob 20 Aug-09

Strategic investors may find Wema, Fidelity and Platinum offer the most compelling entry points of the unaudited banks, based on our analysis. In addition to attractive pricing, limited injection of equity allows more flexibility around using debt in the capital structure of any potential deal. Although Wema's branch network appears cheap, this may be reflective of its weaker deposit-gathering capability.

Stress test for potential acquisitions

We have applied more punitive provisioning assumptions versus our base case scenario for the government-supported banks - we maintain our coverage ratio assumption of 85% and assume that 55% of the book is non-performing in these banks (vs. 41% in our base scenario). As can be seen from the table below, we calculate that all of these banks would be in a negative equity situation and would require material capital injection to achieve a 10% tier 1 capital ratio.

We highlight that with increased provisioning requirements, strategic investors may find that Afribank would still remain attractive on our metrics, with the premium to its branch infrastructure increasing from 100% to 114%. Under our stress scenario, Oceanic could turn out to be an extremely expensive proposition and we highlight the sensitivity to greater provisioning.

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Based on our analysis, strategic investors may find that the banks that offer a feasible compromise between price, branch infrastructure and moderate capital injection are: 1) Fidelity, 2) Platinum, 3) Sterling, 4) Wema, and 5). Afribank. Strategic investors may find that Wema and Afribank however entail more risk. Considering the limitations of this exercise however, one needs to weigh up qualitative measures to supplement this screening exercise. We do not believe we are in a position to assess any qualitative considerations for these banks at this stage.

Based on our analysis, we find that the local banks in the strongest position to be acquirers in the Nigerian market are: 1) FirstBank, 2) Zenith, 3) Stanbic, 4) Unity, and 5) FCMB. We would however include UBA and GTBank in this list given that capital positions remain relatively healthy under our stress test and we view these players as likely to consolidate positions.

Table 7: Government-supported banks - stress test (additional provisions)

	Afribank	Finbank	Inter	Oceanic	Union
Stressed Tier 1 capital ratio	-5% (2% under base case)	-6% (-3% under base case)	-6% (5% under base case)	-8% (1% under base case)	0% (5% under base case)
Capital required - recap to 20%, R'm	1,584	2,667	5,335	7,284	3,076
Capital required - recap to 20% AND controlling, R'm	1,584	2,667	5,335	7,284	4,776
No. Branches	250	200	308	435	467
Deposits/branch (N'm)	872	1,600	2,903	1,920	1,461
Cost per branch for acquirer (USDm) - incl recap	0.75	1.57	2.04	1.97	0.77
Cost of branch (for acquirer with controlling), USDm - incl recap	0.75	1.57	2.04	1.97	1.20
Current market cap (USDm)	327	96	797	521	1,088
Discounted mkt cap, using stake to recap tier 1 at 10%	229	67	558	365	762
Discounted mkt cap, using controlling stake and recap tier 1 to 10%	164	48	399	261	544
Implied stake if recapped to tier 1 at 10%	45%	82%	53%	70%	32%
Premium on branch cost to acquire (recap to tier 1 at 10%)	114%	239%	248%	300%	118%
Premium on branch cost to acquire (recap to tier 1 at 10%) - controlling stake	114%	239%	248%	300%	183%
Premium on branch cost to acquire (recap to tier 1 at 10%) - controlling stake under base case	100%	208%	157%	159%	178%

Source: J.P. Morgan estimates, Company reports, Bloomberg. Prices cob 20 Aug-09

As evidenced from the table above, the premium on branch cost to acquire Oceanic is highly sensitive to changes in the provisioning assumptions. As such, we believe the risks in Oceanic are high based on our stress test - given the high levels of uncertainty at present, we have excluded it from our shortlist.

Are South African banks well positioned as acquirers?

All the SA banks have demonstrated an interest in growing their African franchise in Nigeria and we view the consolidation phase currently underway as a significant opportunity for SA banks. Acquiring an existing Nigerian bank would give a presence and branch infrastructure (key for deposit-gathering) in a sizeable African economy with longer-term growth potential.

If transactions are concluded at attractive prices (as we suspect), the ROE and capital impact may be only moderate (see regulatory considerations section below) - we believe SA banks are likely to consider investments between R1bn – R3bn, with SBK potentially at the top end of this estimate.

Standard Bank already has a presence in Nigeria through IBTC and would likely, in our view, be interested in bolstering its branch network through a further acquisition. Given that Standard already has an operation with c110 branches, we believe that it is probably targeting a smaller acquisition to complement its existing operations, but given the strategic importance of Nigeria for Standard Bank, it may be more aggressive. Standard Bank's initial investment in IBTC was $640m and it has since invested further in this franchise through the roll-out of c40 branches.

We would view the acquisition of another asset as bolstering scale and would consolidate its existing position. This would also 'average-in' Standard Bank's total investment cost in its Nigerian franchise. Standard Bank has c$500m of surplus capital (management estimate) that could potentially be deployed and would consolidate its 'first-mover' advantage in the country significantly. Its existing IBTC franchise enjoys corporate and IB prominence and is well positioned for near-term opportunities. We also view Standard's early integration of IBTC positively, particularly the alignment of risk and IT systems and processes. Further integration may be a smoother process for Standard Bank as it has already embarked on the integration of IBTC.

FirstRand has been quite vocal recently regarding its intention to grow its African operations and we believe it would potentially be interested in pursuing mid-to-smaller size acquisitions in Nigeria. Given that FirstRand's strategy has been to pursue accelerated growth through purchasing banking platforms, we do not consider the size of the operation to be its major consideration but rather an entry point in the market at an attractive cost.

Absa has also expressed its interest in growing its operations in select African countries where the size of the economy and longer-term growth would justify the investment - we believe Nigeria offers such an opportunity. Absa Capital as well as the Bancassurance units are permitted to expand in Sub-Saharan Africa and Absa (all operations) is able to expand in African countries where Barclays does not already have a retail presence (such as Nigeria).

Absa's Batho Bonke proceeds (from lower 5.1% stake) may boost the capital position (we estimate cR2.5bn) if the BEE transaction is funded outside the Absa group. The capital impact is neutral if self-funded - the timing for funding this transaction is Sep-09.

Nedbank has a strategic alliance with Ecobank - Ecobank is part of the broader ETI group (Pan-African bank) and its Nigerian operation is one of the top 10 banks in Nigeria. Its strategic alliance with Ecobank is potentially a hurdle for Nedbank to pursue opportunities independently in Nigeria in our view. That said, this relationship is in its infancy. Based on our recent discussions with FirstBank management, discussions between FirstBank and Ecobank Nigeria on a possible merger are ongoing.

Regulatory considerations

Any investment by the SA banks offshore would require the approval of the SA regulators, which may prove to be a stumbling block. That said, we believe that the regulator would be receptive to these requests should there be comfort regarding: i) extent of future potential liability, ii) reputational risk involved, and iii) the extent of capital deployment in Nigeria and whether the SA operations would be compromised as a result.

We believe the SA regulator would allow acquisitions of Nigerian assets if a potential acquisition results in: i) modest capital deployment (should not compromise core SA operations); ii) if assets of the acquiree bank are sufficiently provided against to minimise future negative impacts; and iii) SA banks can demonstrate that any potential acquisition is handled with due care, a stringent due diligence process has been followed, and that it has the necessary skills and management capacity to execute a smooth acquisition.

The steps already taken by the CBN has arguably increased disclosure and assists the due diligence processes of acquirer banks. That said, developments coming out of Nigeria are ongoing and caution is warranted given uncertainty around the full extent of problems in the sector and other political and regulatory considerations.

With this in mind, we believe that for foreign banks to become involved in any potential transaction, then i) risk transfer to the Nigerian government (transfer of risky assets to a separate entity) is required or ii) aggressive write-downs on the loan book are required, followed by recapitalisation to levels deemed appropriate by the CBN (we use a tier ratio of 20% in our estimates). We view the latter as more likely and this forms the base case for our analysis in this note. Other considerations would be the extent of foreign ownership allowed by the CBN and ownership of systemically important banks.

Capital raising / re-deployment of capital

At the levels we consider transactions would likely take place – R1bn to R3bn - we believe the impact on existing capital levels for SA banks will be relatively muted. We consider the most attractive targets in Nigeria for consolidation above, based on branch network value, recapitalisation to 20% Tier 1 capital ratios and majority ownership.

We assume a R2bn impact on capital (i.e. deployment of capital from a SA balance sheet, we estimate the capital impact below). Note that from a consolidated group perspective, we would expect the impact on capital to be even more muted. While the possibility exists that SA banks will raise capital to fund an acquisition, we would consider this likely only for a very large purchase.

Table 8: Capital impact for R2bn acquisition

	ASA	FSR	NED	SBK
Impact on tier 1 (SA license)	-0.5%*	-0.5%	-0.6%	Nil ($500m surplus offshore could be used)
Impact on overall group	Marginal	Marginal	Marginal	Marginal

Source: J.P. Morgan estimates. *may be offset depending on how BEE transaction financed.

The purchase consideration may also be supplemented with debt in our view and therefore the appeal of businesses with relatively solid tier 1 ratios post our stress test is attractive, as the purchase consideration may be structured to use qualifying debt rather than substantial equity injection.

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Appendix I: Interest rates in Nigeria

Table 9: Interest rates

	Q108	Q208	Q308	Q408	Q109
Inter-bank call rate (weighted ave.)	10.21%	10.40%	12.83%	14.00%	15.79%
Monetary policy rate	10.00%	10.25%	9.45%	9.75%	9.75%
Savings deposit rate	2.97%	2.97%	3.06%	3.17%	2.91%
7d deposit rate	5.38%	5.55%	5.64%	7.06%	6.97%
3m deposit rate	10.71%	12.19%	12.22%	12.76%	13.85%
Prime lending rate	16.05%	15.86%	15.97%	16.03%	18.34%

Source: CBN

Table 10: Interest rates - weekly data

	07-Jul-09	14-Jul-09	21-Jul-09	28-Jul-09	03-Aug-09	10-Aug-09	17-Aug-09	24-Aug-09
Open buy back rate	8.00%	8.00%	8.00%	7.50%	7.50%	8.00%	7.00%	7.00%
Overnight rates	22.00%	22.00%	18.00%	10.00%	10.00%	13.50%	8.50%	8.00%
Interbank call rate	21.58%	21.96%	20.75%	10.17%	10.83%	13.08%	9.58%	8.08%
7d interbank rate	21.79%	21.74%	20.83%	11.92%	12.04%	13.96%	10.83%	10.88%

Source: Zenith Bank

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