

## **MERISTEM EQUITY RESEARCH**

### **PUBLIC OFFER REPORT**

**REPORT DATE: NOVEMBER 2, 2007**

### **EXECUTIVE SUMMARY & INVESTMENT RATIONALE**

- Fidelity Bank is currently in the primary market seeking to raise N50bn to enable it expand its branch network, retool its processes and take its profound expertise to the international stage via a hybrid Offer of 5, 501, 100, 421 Ordinary Shares of 50k each at N8 per share and Rights Issue of 498, 899, 579 Ordinary Shares of 50k each at N8 per share.
- Fidelity Bank ranks as a middle tier Bank as revealed by metrics of size determinant such as Gross Revenue, Total Assets and Deposits. Nevertheless, it is rapidly growing like most other Banks especially its “new-generation peers”.
- The Bank has grown tremendously in size and value in the last couple of years post consolidation and resolute about evolving as a big contender among peers and in the ‘financial supermarket’. Fidelity Bank has special biases in the emerging opportunities in oil and gas, telecoms, power, e.t.c.
- Economic reforms in Nigeria paved way for the much acclaimed unprecedented growth in the financial services sector, most especially, in the banking industry. Sustainability of the present momentum in the financial services sector and consolidation on current feat are hinged on the continuity of the Federal Government reforms among other macro economic and political factors.
- Instability in the Niger Delta poses serious threats not only to the country’s fortunes but also to Fidelity Bank’s earnings and largely growth strategy. The Bank’s current operations and future prospects are largely skewed towards corporate and project financing in oil and gas, among others. This social unrest and youth restiveness may militate against achieving set targets both in the short and long term horizons.
- The Bank’s forecast growth in after-tax profit of 60 per cent CAGR over the next 3 years (2008-2010) seems moderate and easily achievable having recorded about 55 per cent CAGR in the previous 5 years. Our conservative profit forecast over same period is 63 per cent. We believe the Bank will achieve the set targets and probably surpass on successful completion of its integration processes.

- **The Bank's Offer price of N8 suggests a marginal discount of 3.5 per cent to our fair value of N8.29. However, we maintain a BUY recommendation on the Offered shares as the Bank has strong potentials for further growth and increased returns to investors as it begins to fully integrate its processes and operations.**

### **Nigeria Banking sector: Ahead of economic reforms**

The Nigeria Financial sector has been adjudged the fastest growing in Africa and one of the fastest in the world, according to recent surveys by the World Bank and its development arm, the International Finance Corporation (IFC). The banking consolidation exercise has made Nigeria banks far better prepared to face the challenges of financing big projects that may come their way. This has also spawned growing foreign interest which is subsequently making the nation's apex bank- Central Bank of Nigeria (CBN) to focus attention on devising a framework that will restrict foreign ownership of banks in the country. The top ten banks in Nigeria collectively account for 71 per cent of the country's banking system (CBN), and yet, the trend seems beginning to inch up. Nigeria currently accounts for five of the top ten banks in Africa and according to the CBN, the Nigerian Market represents 75 per cent of the entire market of the West African sub-region. In view of this, there are ample opportunities for Nigerian banks to provide greater intermediation function in the West African Sub region. Nigerian banks are expected to leverage on the nation's current position in the sub region to achieve the set goals of financial services sector 2020.

### **Nexus between Banks' performance and economic growth in Nigeria:**

Nigeria is positioning itself as the financial hub of Africa by 2020 with a growth projection of 12 per cent annually in GDP. It is crystal clear that achieving this seemingly lofty but attainable status requires concerted efforts towards a robust diversification of the economy base from oil to the next phase, i.e service and real sectors. Given the postulation of experts that a strong correlation exists between economic growth and corporate earnings, the current triumph in the nation's financial services sector in terms of growth and profitability should be indicative of a proportionate rise in activity level in other facets of the economic system. Conversely, at present, the reverse seems be the case and experts have expressed worries about the impact of the rapidly growing financial services sector, especially banking industry on other sectors. It is therefore hoped that the status quo will be reversed as banks are currently going through the second stage of fund raising christened as 'market induced' by market experts.

### **Fidelity Bank Plc: Transformation/Growth History**

Fidelity Bank Plc was incorporated on November 19, 1987 as Fidelity Union Merchant Bank Limited, a niche provider of merchant banking services. After more than a decade in the merchant banking business, the bank was successfully converted into a commercial bank on July 16, 1999 and changed its name to Fidelity Bank Plc. Barely six years after, the bank was quoted on the Nigerian Stock Exchange on May 17, 2005. The Bank raised a colossal sum of N22bn (US\$176m) through its IPO and private placement prior to banking consolidation exercise in the subsequent year. In January 2006, Fidelity Bank effectively scaled the hurdle of N25bn recapitalisation benchmark set by the nation's apex bank, the Central Bank of Nigeria (CBN). This exercise was facilitated when Fidelity Bank Plc seamlessly consummated a merger with two other commercial banks- FSB International Bank Plc and Manny Bank Plc.

The enlarged Fidelity Bank Plc has recorded appreciable growth in the modern Nigeria banking industry and can be described as a strong emerging player in the banking industry. Gross earnings grew at 37.5 per cent CAGR to N11.57bn (US\$92.58m) (2002-2006) while Total Assets soared by 66.4 per cent CAGR to N119.99bn (US\$959.88m) over same period. Its aggregate liabilities rose to N110.89bn from N15.64bn in 2002. The bank has grown its branch network substantially from 23 before merger exercise in 2005/06 to 90 at present with significant investments in the deployment of electronic banking services. Its shareholders' base is currently approximated to 121,000. Fidelity Bank's has a huge number of shares in issue relative to peers. Its issued number of shares currently stands at 16.463billion which is expected to jump to 23.839billion post offer. The bank's shares are held by mainly Nigerians. 10 per cent is held by Fidelity Staff Trust while the remaining 90 per cent is held by other Nigerians

### **Business Model:**

Fidelity Bank Group is made up of Fidelity Bank Plc and its three subsidiaries; Fidelity Union Securities Limited (51%), Fidelity Pension Managers Limited (51%) and Eastline Investment Limited (99%). Fidelity Bank plays dominant role in Public sector intermediation. Fidelity Bank is among the 15 Primary Dealers/Market Makers (PPMM) appointed by the Debt Management Office (DMO), dealing directly in the FGN bonds. It is also amongst the settlement banks to the Nigerian Stock Exchange and participates in the wholesale currency dealing, Wholesale Dutch Auction System (WDAS). Fidelity Bank has the mandate from the CBN to manage the nation's foreign reserves in partnership with Investec Group of South Africa alongside 13 other banks.

Fidelity Bank leverages on the core competence of one of its legacy banks, FSB International Plc (which has strong footprints in the oil and gas and power sectors) to navigate and propel its corporate lending in the energy sector and emerging telecoms, power and real estate/mortgage sectors. The bank has successfully closed deals worth over US\$100 for oil majors and prominent upcoming firms in the downstream segment of the oil and gas sector. On wholesale and commercial banking, the bank rides on the hitherto strongholds of its other two legacy banks- Fidelity and Manny Banks in the Eastern part of Nigeria and Lagos region. The enlarged Fidelity Bank has since embarked on media launch to propagate its new brand image with a view to increasing its market share and play dominant roles both within and outside confines of the Nigerian financial system.

### **Future Strategic Growth Focus:**

Fidelity Bank has identified three (3) major strategic growth focuses which are; play dominant roles in retail banking via branch expansion and brand propagation; increased participation in emerging sector to harness opportunities and fortification of its investment banking business to play more active and bigger roles in the financial markets, locally and internationally. These strategic growth focuses have been mapped into three (3) distinct growth phases: Short term strategy; Mid-term strategy and Long term strategy. The Bank's current outing is, without doubt, in line with its Short-term strategies of aggressive branch expansion and total integration of operational processes and products across regions and markets and subsequently followed by a shift to growth and product differentiation. The Bank intends to leverage on its enlarged balance sheet and retained earnings to nourish its investment banking business as well as harness opportunities abound in the corporate financing and project financing in oil and gas, Telecoms and Power sectors.

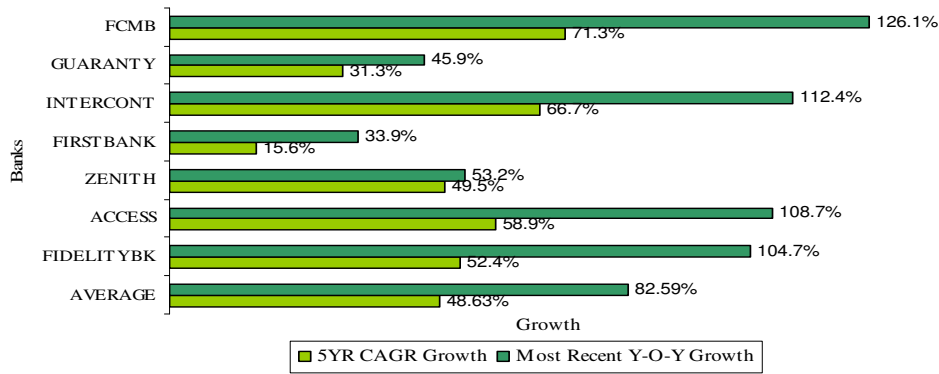
### **Performance Overview:**

#### **Gross Revenue and Profit After Tax**

The total income from all sources including interest income, fees and commissions etc for Fidelity Bank has grown at an average annual rate of 37.5 per cent (CAGR), increasing from N3.2 billion (FY 2002) to N11.6 billion (FY 2006). Most recent gross revenue figure for the bank stands at N17.8 billion for the Q3 – 2007. Annualised gross revenue figure stands at N23.7 billion implying a forecast gross revenue growth rate of 104.7 per cent for the full year. Fidelity Bank has had an impressive gross revenue growth rate comparable to that of the high flyers in the industry.

#### **Chart 1:**

### Industry Growth Trend - Gross Revenue



### Total Assets and Total Deposits

Fidelity Bank’s Total Assets and Total Deposits growth averaged 69.7 per cent and 66.0 per cent annually over the past 5 year (CAGR). These growth figures represent median growth figures for the industry over the 5 years. The most recent year-on-year growth for the bank stands at 55.5 per cent and 63.2 per cent for the Total Assets and Total deposits (Industry averages stand at 63.8 per and 70.0 per cent for Total Assets and Total Deposits respectively). Current Q3-2007 Total Assets and Total Deposits for the Bank stand at N139.9 bn and N96.2 bn. The asset mix shows that loans and advances constitute 40 per cent of the Bank’s total assets while liquid assets 45.8 per of the total assets. Total Deposits for the Bank finances 68.8 per cent of its total assets.

Chart 2:

### Industry Growth Trend - Total Assets

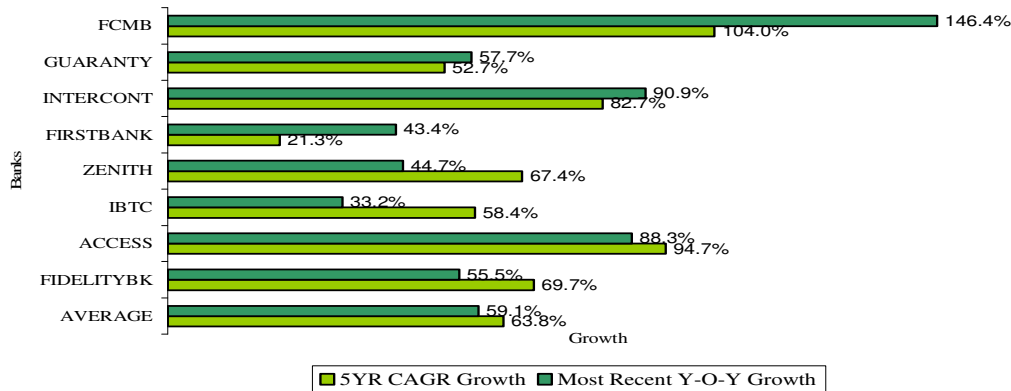
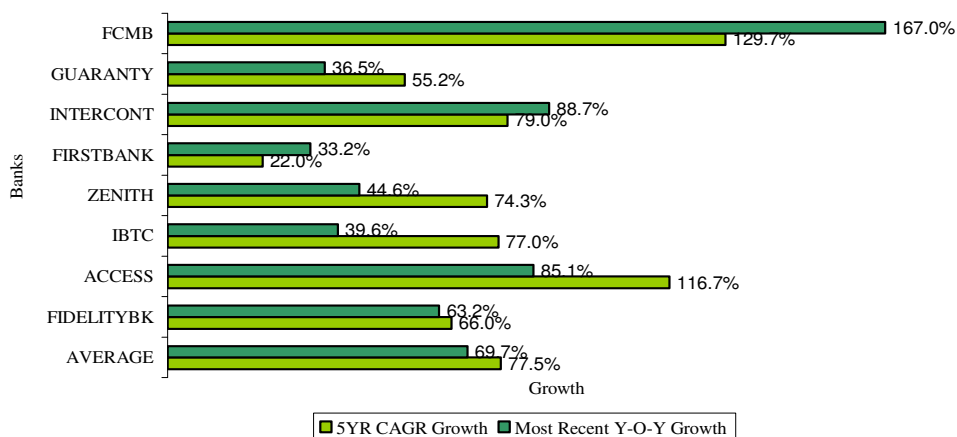


Chart 3:

### Industry Growth Trend - Total Deposits

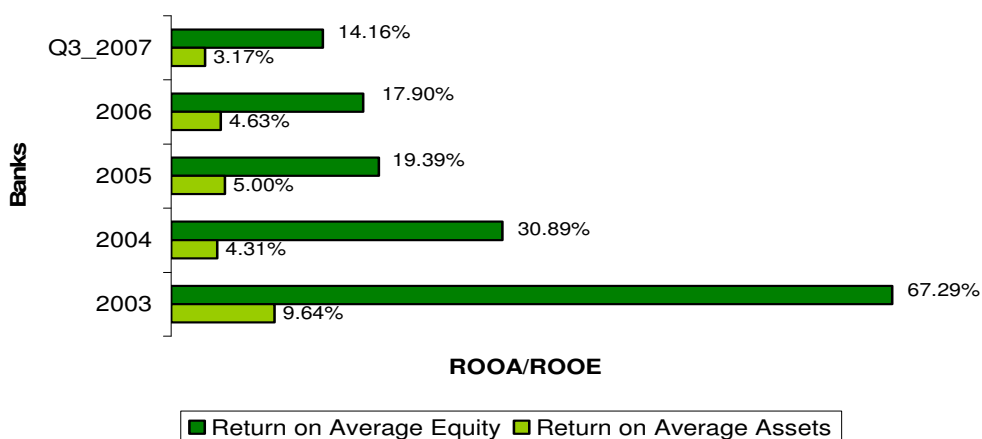


### Earnings Performance

Fidelity like other banks, has reported an increasing After Tax Profits over the years. However, the bank’s Return on Average Assets and Average Equity has followed a downward trend. This is peculiar to the industry and can be attributable to reducing interest rates, increasing competition, more stringent regulations and increasing operating costs. This trend is likely to abate in not too distant future as banks shore up their capital base, embrace state-of-the-art information technology equipment and venture into new businesses both within and outside Nigeria.

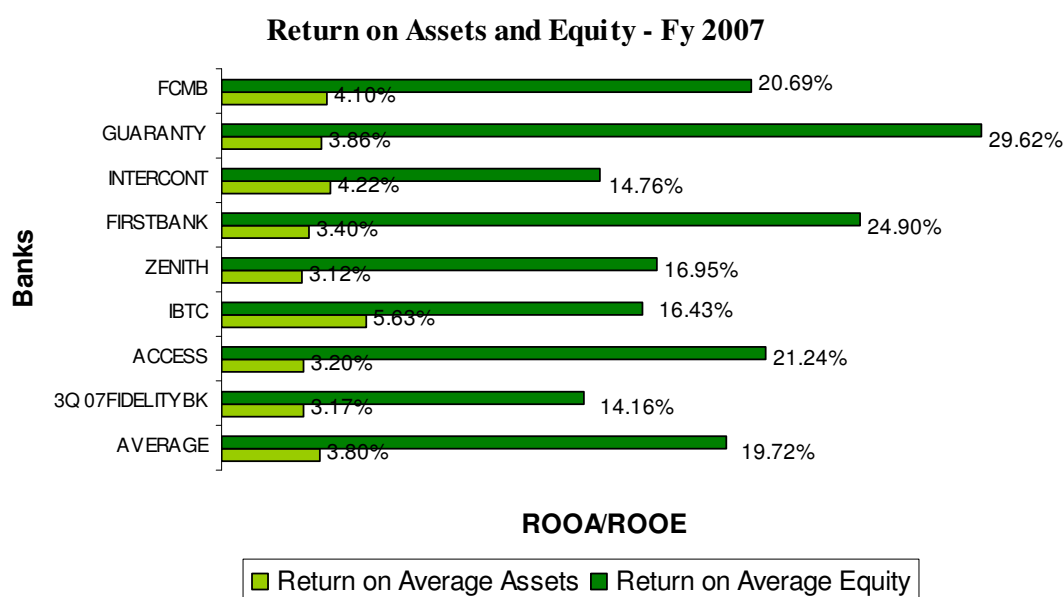
Chart 4:

### Return on Assets and Equity - FIDELITY BANK



In line with the peer rating of Fidelity on gross revenue, total assets and deposit growth, the Bank remains competitive in terms of returns relative to total asset and equity employed in their operations. Fidelity bank outperforms much bigger banks in terms of the Return on Average Assets and Equity (making use of its annualized Q3 FY07 results).

**Chart 5:**



A breakdown of the Bank's Return on Average Equity and Return on Average Assets shows dwindling asset utilization ratio as the proportion of both interest and non interest income to average assets declined over the years down from 23 per cent in 2002 to 14 per cent in 2007. Similarly, the Bank's yield which measures the difference between the interest income as a proportion of the average interest earning assets and the interest expenses as a proportion of the average interest bearing liabilities showed a consistently declining trend, moving down from 9.54 per cent in 2002 to 0.80 per cent in 2006 and -3 per cent for annualized figures for 2007. Though the Bank's expense ratio followed a similar pattern, declining from 17.3 per cent in FY 2002 to 12.2 per cent in FY 2007, this did not reverse the effects of these measures on the Return on Asset and Equity figures.

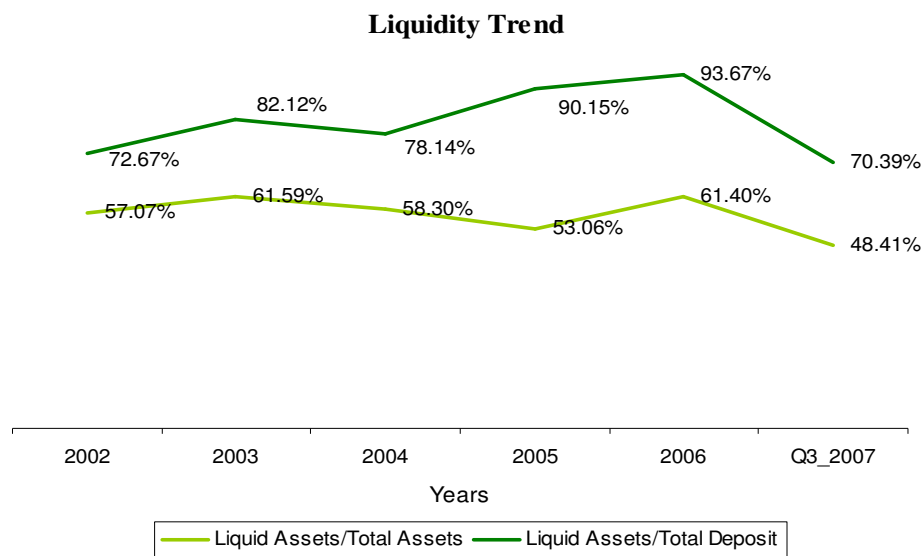
Further analyses of the expense ratio show declining interest expenses, operating expenses and loan loss expenses as percentages of average total assets suggesting improve cost management in the face of declining income relative to assets employed in operations. Similarly, for Return on Average Equity, declining Equity Multiplier ratio contributed to its downward trend. As a result of the series of rights issues, public offers carried out by the bank to meet regulatory requirements both pre and post consolidation exercise, the equity base of the bank, like most other banks in the industry has grown in relation to its total assets. The bank's equity multiplier reduced from 875 per cent in 2002 to 477 per cent in 2007.

### **Asset Quality, Liquidity and Capital Adequacy**

Fidelity has had an improving asset quality over the years as shown by the various asset quality indicators. For Q3 2007, 85 per cent of its total loan portfolio is made up of performing loans and over the past years, over 80 per cent of its total loan portfolio is classified as performing. Also, the bank's ratio of loan loss expense to net interest income had declined progressively over the years from 23 per cent in 2004 to 5.2 per cent in 2006 and 4.7 per cent in Q3-2007. Other asset quality ratios such as Loan Loss Provision/ Total Non Performing, Loan Loss Expenses to After Tax Profit, affirms proper control and management of the bank's loan portfolio.

In respect of liquidity, the bank has had an upward trending liquidity position over the years except for the most recent Q3 period end. More of the company's assets, deposits are maintained in liquid assets – cash and short term funds, treasury bills and other short term assets until recently (Q3 2007) when loans and advances surged. The composition of loan in the total asset mix has increased to 40 per cent (Q3 2007) compared to 32 per cent for full year 2006.

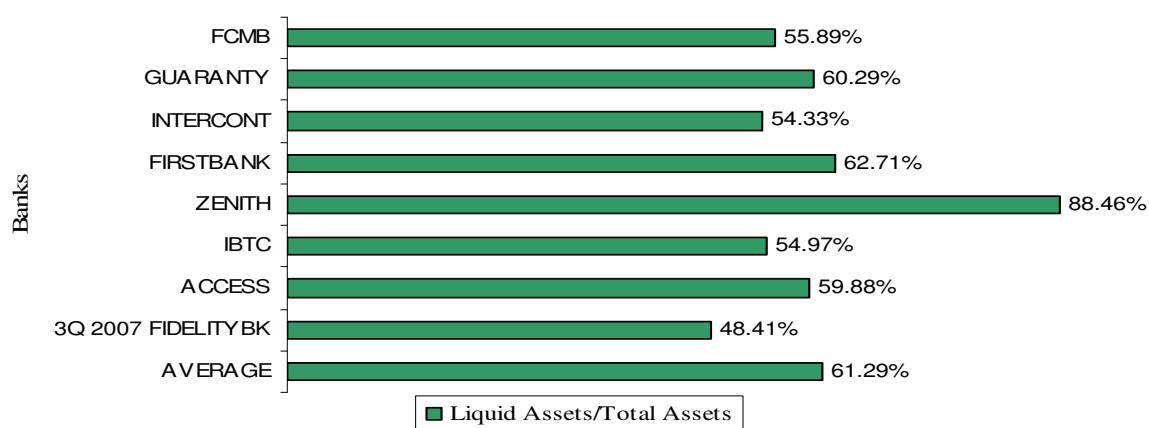
**Chart 6:**



In terms of liquidity as measured by the ratio of Liquid Assets/Total Assets from 2002 - 2006, Fidelity Bank's performance has not deviated so drastically from that of the Industry in the past. The ratio of Liquid Assets to Total Assets for Q3 2007 however, fall shorts of the mean of the ratio for the Industry.

**Chart 7:**

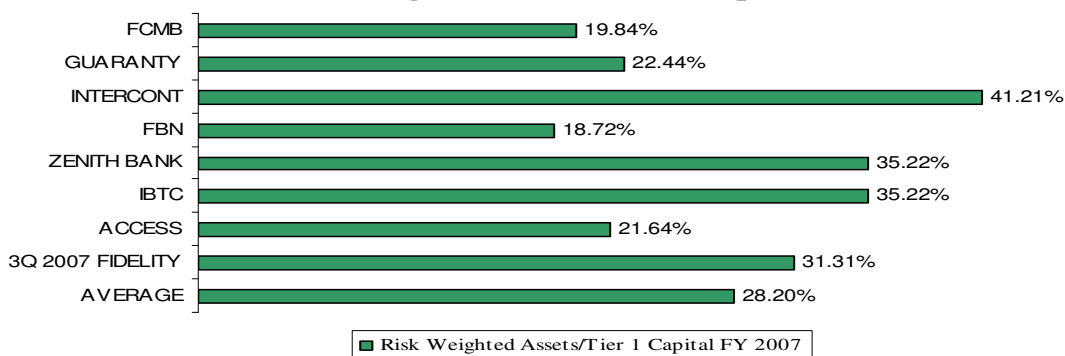
### Liquid Assets/Total Assets - FY 2007



Fidelity bank has sufficient capital to back its risks assets as shown by its Capital Adequacy ratios. The ratio of the bank's Tier 1 Capital/Total Risk Weighted Assets stands at 31.31 per cent for Q3 2007. This compares favourably with those of its peers and the industry average of (28.2 per cent), though the figure dropped from 41.99 per cent in 2005 to 37.5 per cent in 2006.

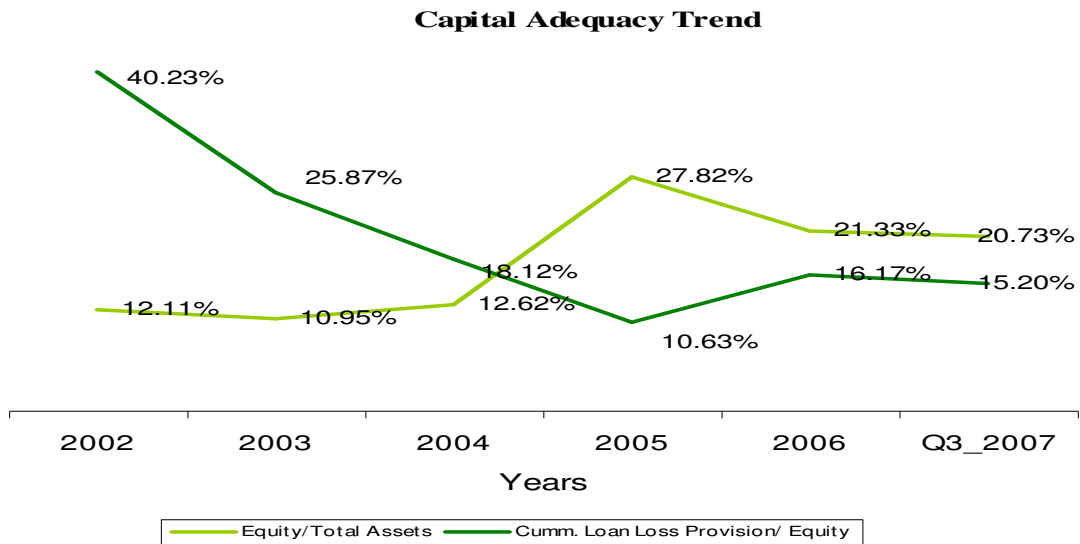
**Chart 8:**

### Risk Weighted Assets/Tier 1 Capital FY 2007



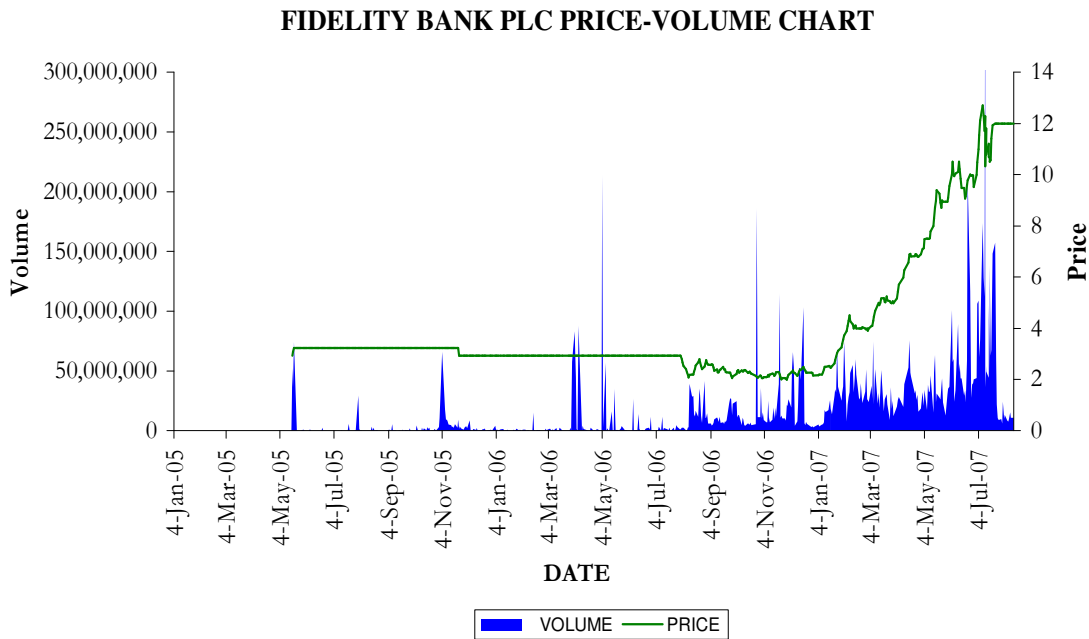
A further analysis of the capital adequacy level of Fidelity reveals that less equity is used to finance the Bank's total assets as the ratio of equity to total assets has dropped from 27.8 per cent in 2005 to 20.73 per cent in 2007 (Q3). Similarly, the proportion of Non-performing loan to equity has increased from 18.7 per cent in 2005 to 34.9 per cent (Q3 2007). The ratio of loan loss provision to equity has also risen in the past two years. While the very strong capital adequacy figures reported for 2005 can be attributed to the company's rights issue and private placement carried out in the year, the rapidly expanding business of the firm calls for more equity cushion. The proposed Public Offer will no doubt improve the capital adequacy outlook of the Bank.

Chart 9:



### Stock Market Performance Analysis:

Chart 10:



Fidelity Bank was listed on the floor of the Nigerian Stock Exchange on the May 17, 2005. The stock was placed on a technical suspension from May 20, 2005 to Aug. 1, 2006 following its merger exercise with a view to meeting the CBN consolidation deadline of December 31, 2005. Fidelity stock opened

the year 2006 at N2.93 and closed the year at N2.15, losing 15.02 per cent in value. Traded volume for fidelity remained relatively low in 2005 and 2006 with average traded daily volume standing at 1.8 million and 10.9 million respectively. In 2007, however, the stock experienced a strong rally, moving from N2.17 from the 1st trading day of the year to an all time High of N12.71. In 2007, average daily traded volume surged to 43.8 million units. The stock was placed on technical suspension on the July 23, 2007 at a price of N11.99 returning a capital appreciation of 380 per cent as at that date.

### Stock Market Data over Last 5 Years

Table 1:

NAIRA (NGN)	2007	2006	2005	2004	2003	2002
On December 31 (closing price)	11.99**	2.15	2.93			
Annual change in share price*	+380.0% **	-15.02%	-0.34%			
Annual change in All-Share Index*	+53.9% **	+37.7%	+1.0%			
► High	12.71	2.93	3.23			
► Low	2.19	1.99	2.93			
*Change btw 31/12/N-1 and 31/12/N						
** Price /change as at time of technical suspension 4 Jan. - 23 July 2007						

### Valuation of Fidelity Bank Plc

We used two different classes of valuation methods in arriving at a fair value for Fidelity Bank Plc. The first class of methods is based on trading multiples relative to prices of other comparable banks in the industry. The second valuation method was based on the present value of Fidelity Bank's projected dividend payments.

Table 2: Trading Multiples for Comparable Banks

		FIDELITY	ACCESS	IBTC	FCMB	AVERAGE
Gross Earnings *	(N 'm)	23,690	27,881	21,124	24,973	24,417.00
Profit After Tax *	(N 'm)	4,549	6,083	5,762	5,949	5,585.83
Share Outstanding	(m Units)	16,464	3,489	6,250	4,751	
Share Price (29 Oct. 07)	(N)	11.99	18.85	16.95	17.45	
Market Capitalisation	(N 'm)	197,403	65,768	105,938	82,905	113,003.37
Book Value	(N 'm)	29,008	28,385	37,445	31,104	31,485.50
Price/Earnings		35.22	10.81	18.39	13.94	19.59
Price/Gross Earnings		11.07	2.36	5.02	3.32	5.44
Price/Book Value		5.10	2.32	2.83	2.67	3.23

\* Fidelity Figures are 3Q 2007 Annualised

Table 3: Valuation Metrics:

P/E Valuation		
Average P/E		19.59
Projected EPS		0.49
Valuation		9.59
P/BV Valuation		
Average P/BV		3.23
Projected BVPS		1.47
Valuation		4.75
P/GE Valuation		
Average P/GE		5.44
Projected GEPS		1.88
Valuation		10.28
Valuation Summary- Per share basis		
VALUATION BASES	ATTACHED WEIGHTS	VALUATION
Price to Earnings	25 %	9.60
Price to Book value	10 %	4.75
Price to Gross Earnings	25 %	10.28
DCF Valuation	<u>40 %</u>	7.14
<b>Average</b>	<b><u>100%</u></b>	<b>8.29</b>

### Valuation Summary

The Discounted Cash flow (DCF) valuation is based on a cost of equity of 17.05 % and a terminal growth rate of 7.5%. Our proxy for risk free rate is 5-yr FG Treasury bond rate of 10.75 %, while risk premium is set at 9.0%. We attached the greatest weight to discounted cash flow (DCF) Valuation because dividend is a main driver of value. Similarly, the other drivers of value, Earnings and Gross Earnings are taken into consideration in attaching higher weights to Price to Earnings and Price to Gross Earnings.

**•Our valuation for Fidelity Bank shows the stock's offer price is at a slight discount of 3.5 per cent to fair value. At the current market price N11.99, the stock is trading at a marked premium of 44.6 per cent. We recommend the stock a BUY for medium to long term investment decisions.**

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