FBNQuest Merchant Bank Limited

2021 Final Rating Report

Agusto&Co.

Research, Credit Ratings, Credit Risk Management

FBNQuest Merchant Bank Limited

Rating Assigned:
A

Outlook: Stable
Issue Date: 26 August 2021
Expiry Date: 30 June 2022
Previous Rating: A

Industry: Banking

Analysts:
Tobi Adebuwa
tobiadebuwa@agusto.com

Ayokunle Olubunmi, CFA
kunleolubunmi@agusto.com

Agusto & Co. Limited
UBA House (5th Floor)
57, Marina
Lagos
Nigeria

www.agusto.com

This is a financial institution with a good financial condition and strong capacity to meet its obligations as and when they fall due.

Rating Rationale

The rating assigned to FBNQuest Merchant Bank Limited ('FBNQ MB' or 'the Bank') reflects its franchise upheld by the affiliation with FBN Holdings Plc, one of Nigeria's largest financial institutions with interests in commercial banking, pension assets custody, trusteeship, asset management and stockbroking. The rating also takes into consideration the Bank's strong presence in the investment banking space in Nigeria, good capitalisation, strong liquidity, acceptable asset quality and improving profitability. However, constraining these positive rating factors are the persistent concentration in the loan book, high funding and operating cost profile amidst the prevailing macroeconomic headwinds.

Gross loans and advances grew by 18.9% to ₦55.4 billion and remained concentrated by obligor and sector. As at FYE 2020, the top 20 loans accounted for 94.1% (FYE 2019: 97.7%) of gross loans and advances, reflecting the susceptibility of the Bank to the adverse changes in the financial condition of any of the top obligors. The continued focus of the Bank for asset creation remains financing of the manufacturing sector as well as obligors in the upstream segment of Oil & Gas. We believe these segments are vulnerable to the weak macroeconomic climate and some of the loans to these sectors have been restructured by the Bank. As at FYE 2020, FBNQ MB's stage 3 (impaired or non-performing) loan portfolio remained stagnant at ₦1.4 billion. The NPL ratio dipped slightly to 2.6% (FYE 2019: 3%), due to the expanded loan book, and was solely due to an impaired loan which the Bank has fully provided for. Therefore, we do not expect an adverse impact on future profits. Nonetheless, the Bank's NPL ratio was among the highest in the merchant banking segment as at FYE 2020. With the Bank strengthening its credit monitoring mechanism and the planned write off of the only large impaired loan, we expect asset quality to improve somewhat over the near term, though we note the vulnerability of its target sectors.

FBNQ MB reported strong growth of 83% in pre-tax profits to ₦5.1 billion during the FY 2020 upheld by non-interest income, particularly gains from financial instruments which grew by 107.6%. Net Interest Spread (NIS) also improved to 41.3% from a low of 23.7% on account of declining costs of deposits. The strong fee income relative to its other merchant banking peers of 4.2% of total assets is a reflection of its trading capabilities as well as the strong performance of its asset management company (the second-largest asset management company by AuM of over ₦300 billion), which will continue to lend support to the earnings of the Bank. Pre-tax return on average assets (ROA) improved to 2.8% (FY 2019: 1.9%) while pre-tax return on average equity (ROE) improved to 17% (FY 2019: 10.3%). However, subsequent to year-end, the Bank recorded a weak annualised ROA of 0.8% and ROE of 4.8% owing to the sluggish economic recovery and rising interest rates. Nevertheless, we do not anticipate a material decline in the Bank's performance although we recognise that the rising funding cost might constrain profitability. In our opinion, the Bank's good ancillary income supported by the strong investment banking division and synergy within the FBNQuest group will continue to uphold profitability. Furthermore, the anticipated expansion in the loan book amidst a rising yield climate should also support performance in FY 2021.

On the back of low yields in the market, FBNQ MB's total deposit liabilities (excluding interbank takings) grew by 31.7% to ₦100.1 billion as at FYE 2020. The weighted average cost of funds also declined to 7.6% compared to 10.5% in 2019. This WACF was higher than most of its peers. This was largely due to the deposit base being dominated by term deposits which accounted for 69.6% (FYE 2019: 68.2%). The wholesale nature of merchant banks as well as the minimum deposit allowed by the regulator continues to be a drag on the cost of funds of these players, FBNQ MB inclusive. The Bank's liquid assets to total assets were at its lowest since its inception as a merchant bank at 25.8% compared to a 5-year average of 43%. This was due to the non-discretionary cash reserve requirements by the Central Bank of Nigeria which led to a surge of 392.1% to ₦39.4 billion given the increase in the cash reserve ratio for merchant banks to 27.5% from 2% amidst arbitrary deductions. We believe the current CRR regime will continue to impact the liquidity and performance of the Bank in the near term.

We consider the Bank's capitalisation to be good with a Capital Adequacy ratio (CAR) of 25.4% (FYE 2019 17.7%) higher than the 10% prescribed minimum for merchant banks. When we stress the capital, it stood good as a percentage of total assets of 11%. We also note positively that FBNQ MB has over the years grown its shareholders' funds to ₦31 billion as at FYE 2020 through retained earnings and is 2.1 times above the regulatory requirement of ₦15 billion for merchant banks.

We hereby maintain the **"A"** rating assigned to FBN Merchant Bank Nigeria Limited, based on our expectation that the Bank's capitalisation will remain good and asset quality will remain satisfactory, upheld by the moderate risk appetite and an experienced management team.

Strengths

- Affiliation with FBN Holdings Plc
- An experienced management team
- Good capitalisation
- Good liquidity profile

Weaknesses

- Concentration in loan book and deposits
- High operating cost profile
- Relatively higher funding costs compared to peers

Challenges

- Adverse regulatory policies, especially the Cash Reserve Requirements (CRR)
- Growing quality risk assets amidst a slow economic recovery
- Maintaining good profitability in a weak economy

Table 1: Financial Data

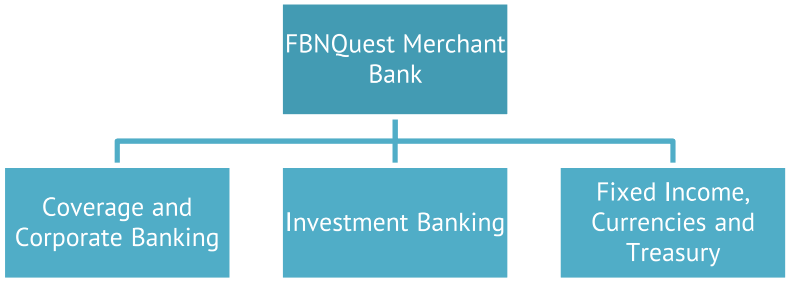
Financial Data	31 December 2018	31 December 2019	31 December 2020
Total assets and contingents	₦142.6 billion	₦155.5 billion	₦207.4 billion
Net earnings	₦9.6 billion	₦9.9 billion	₦12.8 billion
Pre-tax return on average assets and contingents (ROA)	1.6%	1.9%	2.8%
Pre-tax return on average equity (ROE)	8.7%	10.3%	17%

PROFILE

FBNQuest Merchant Bank Limited ("FBNQ MB" or "the Bank") is a wholly-owned subsidiary of FBN Holdings Plc ("the HoldCo"), one of the largest financial institution groups in Nigeria. FBNQ MB was incorporated in Nigeria as a private limited liability company on 14 February 1995 as Kakawa Discount House Limited. Subsequently, It was granted a license to carry on discount house activities on 31 October 1995 and commenced operations on 16 November 1995. In May 2015, a merchant banking licence was granted by the Central Bank of Nigeria (CBN) and related activities commenced on 02 November 2015. Subsequently, FBNQ MB acquired 100% interest in two entities (FBNQuest Securities Limited and FBNQuest Asset Management Limited) to form the FBNQuest Merchant Bank Group.

FBNQuest Merchant Bank Limited is one of the six merchant banks operating in Nigeria. The principal activities of the Bank include the provision of finance and credit facilities to non-retail customers, treasury management services, financial and advisory services and issuing house service. FBNQ MB's services also include debt and equity capital markets as well as wealth management. The Bank's liability generation strategy focuses on high net worth individuals, corporates and financial institutions while asset creation targets industrial and mid-tier corporates, public sector entities, banks and non-bank financial institutions.

Figure 1: FBNQuest Merchant Bank Limited's Business Divisions



FBNQ MB has three main business divisions: Coverage and Corporate Banking Division, Investment Banking, and the Fixed Income, Currencies and Treasury. The Bank's value proposition leverages the strength of the FBN brand and expertise developed from its discount house antecedence to provide bespoke financial solutions. Both subsidiaries, FBNQuest Asset Management Limited and FBNQuest Securities Limited provide partnerships that enhance the delivery of the Bank's overall strategy. As at 31 December 2020, FBNQuest Asset Management Limited was the second-largest asset management company in Nigeria with assets under management (AUM) of over ₦300 billion. FBNQ MB has affiliations with other subsidiaries in the Holding Company such as FBNQuest Trustees and FBNQuest Funds.

FBNQ MB presently operates from three locations in Nigeria; the head office situated at 10 Keffi Street, Off Awolowo Road, South-West Ikoyi, Lagos in addition to business offices in Abuja and Port Harcourt.

Correspondent Banks

During the year under review, FBNQ MB maintained banking relationships with the following domestic and foreign banks.

.

Local Correspondent Banks	Foreign Correspondent Banks	
First Bank of Nigeria Limited	ABSA Africa	FBN Bank, UK
Guaranty Trust Bank Plc	Access Bank UK Ltd	FCMB Bank, UK
Sterling Bank Plc	African Export-Import Bank	First Abu Dhabi Bank
	Bank of Beirut (UK) Ltd	ODDO BHF Bank
	British Arab Commercial Bank	United Bank for Africa, New York

Information, Communication & Technology (ICT)

FBNQuest Merchant Bank Limited's ICT framework supports its daily operations and enhances customer experience. FBNQ MB's Core Banking Application (CBA) is the *Finacle Core and Treasury*, which supports the banking and treasury functions. The internet banking framework is also linked to the core banking application, facilitating web-based transactions for customers. The Bank uses SalesForce which is a robust cloud-based software for customer relationship management. Furthermore, FBNQ MB's Business Continuity Plan (BCP) during the COVID-19 pandemic ensured minimal or no disruptions in the Bank's operations.

CURRENT DIRECTORS	DESIGNATIONS
Mr Bello Maccido	*Chairman*
Mr Kayode Akinkugbe	*Managing Director/CEO*
Mr Taiwo Okeowo	*Deputy Managing Director*
Dr (Mrs) Omobola Johnson	*Non-Executive Director*
Mr U. K. Eke, MFR	*Non-Executive Director*
Mr Babatunde Odunayo	*Non-Executive Director*
Mr Akin Osinbajo	*Non-Executive Director*
Mrs Oyinkan Adewale	*Non-Executive Director – Independent*
Mr Oluyele Delano	*Non-Executive Director – Independent*

SIGNIFICANT SHAREHOLDER

FBN Quest Merchant Bank Limited is a wholly-owned subsidiary of FBN Holdings Plc

MANAGEMENT TEAM

Mr Kayode Akinkugbe is the Managing Director and Chief Executive Officer of FBNQuest Merchant Bank Limited. Prior to this appointment, Mr Akinkugbe served as the Deputy Managing Director and the Managing Director/CEO of FBN Capital Limited. He has is over 25 years experience in the investment banking space garnered from both local and global financial institutions. Mr Akinkugbe served as the Head of sub-Saharan Africa (ex-SA) Coverage at Deutsche Bank and Credit Suisse. He holds a bachelor of science degree in Economics from the University of Ibadan, an MSc in International Accounting & Finance from the London School of Economics, UK and an MBA from Cranfield University, UK.

Other members of FBNQuest Merchant Bank Limited's management team include:

Mr Taiwo Okeowo	*Deputy Managing Director*
Mr Afolabi Olorode	*Head, Coverage and Corporate Banking Group*
Mr Patrick Mgbenwelu	*Head, Investment Banking*
Mr Adewale Adelokun	*Head of Operations*
Mrs Adetoun Dosunmu	*Head, Fixed Income, Currencies and Treasury Group*
Mr Tonna Ejiofor	*Head, Debt Solutions*
Mrs Olamide Adeosun	*Chief Financial Officer*
Mrs Awele Ajibola	*Chief Risk Officer*
Mrs Frances Diribe	*Chief Compliance Officer*
Mr Romeo Savage	*Chief Audit Executive*
Mrs Tolulope Adetugbo	*Company Secretary*

ANALYSTS' COMMENTS

ASSET QUALITY

As at 31 December 2020, FBNQuest Merchant Bank Limited's total assets and contingents stood at ₦207.4 billion, reflecting a 33.4% year-on-year growth propelled by larger funding and capital base. At this level, the Bank remained Nigeria's third-largest merchant bank in terms of total assets and contingents.

FBNQ MB's asset structure is dominated by the loan book and liquid assets which accounted for 26.8% (FYE 2019: 30.9%) and 25.8% (FYE 2019: 35.3%) respectively of total assets and contingents as at FYE 2020. During the year under review, sterile restricted funds with the CBN surged by 392.1% to ₦39.4 billion given the increase in the cash reserve ratio for merchant banks to 27.5% from 2% amidst arbitrary deductions. This led to liquid assets as a percentage of total assets declining to 25.8%; the lowest level since the inception of the Bank as a merchant bank. These restricted funds which accounted for 19% (FYE 2019: 5.1%) of total assets and contingents were non-earning and moderated the liquidity and financial performance of the Bank during the year under review. Given the current stance of the monetary authority, we believe the sterile restricted cash reserve will continue to grow in the near term, constraining the performance of the Bank and indeed the entire banking industry.

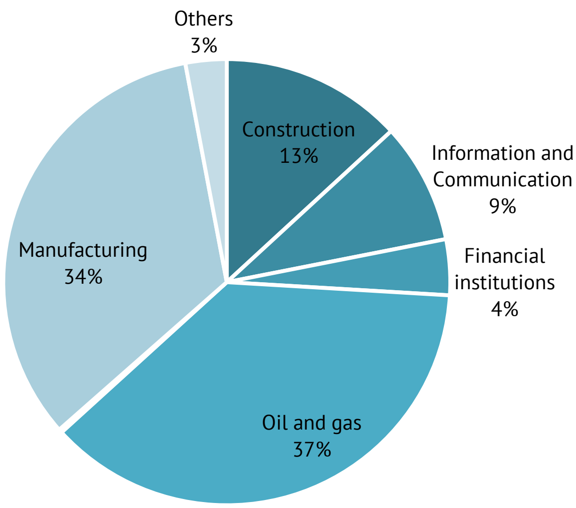
FBNQ MB's lending strategy focuses on providing financial solutions to mid-tier corporates largely in the manufacturing, oil & gas, information & communication sectors of the economy within its defined risk assets acceptance criteria. As at 31 December 2020, gross loans and advances stood at ₦55.4 billion, 18.9% higher than the prior year, but remained concentrated by obligors. As at FYE 2020, the top 20 obligors accounted for 94.1% (FYE 2019: 97.7%) of gross loans and advances, reflecting the relatively small size of the loan book. In the same vein, the top 5 obligors accounted for 44.6% of the gross loans, alluding to the concentrated loan book. In our opinion, this makes the Bank susceptible to adverse changes in the financial condition of any of these top obligors.

An assessment of the sectoral allocation of the loan book reflects the dominance of the oil and gas sector, accounting for 37% (FYE 2019: 33%) of gross loans and advances as at 31 December 2020. These credits were granted to obligors in the upstream (50.7%), downstream (28.4%) and natural gas (20.9%) segments of the oil and gas sector. While we take cognisance that the rising crude oil prices support the repayment capacity of the obligors in the upstream segment, the level of concentration in this segment exposes the Bank to the volatile crude oil prices. However, FBNQ MB uses hedging instruments to manage crude oil price volatility risks. Furthermore, the Bank maintains a Debt Service Reserve Account where the obligors are required to maintain a reserve domiciled with the Bank and can be used to offset repayments should there be a decline in the obligor's financial condition. Notwithstanding, we believe that the credits in this sector should be monitored closely to forestall future deterioration in asset quality, especially considering that the largest obligor in this sector is currently experiencing corporate governance issues which might exacerbate credit risk.

Credits to obligors in the manufacturing sector accounted for a higher 34% (FYE 2019: 20%) of gross loans. We note that these loans were largely short-tenured trade facilities predominantly to obligors in the food segment of the industry. Loans to the construction and, information and communication sector accounted for 13% (FYE

2019: 8.8%) and 9% (FYE 2019: 14.9%) of gross loans respectively. We recognise that the weak macroeconomic conditions which have resulted in the consistent devaluation of the local currency, foreign exchange illiquidity and increased inflationary pressures have decreased consumer purchasing power and margins in the manufacturing and construction sector. However, we believe that the information and communication sector has benefitted from the pandemic-induced increase in data consumption owing to the sharp switch to virtual platforms.

Figure 2: Loan Book by Sector as at 31 December 2020

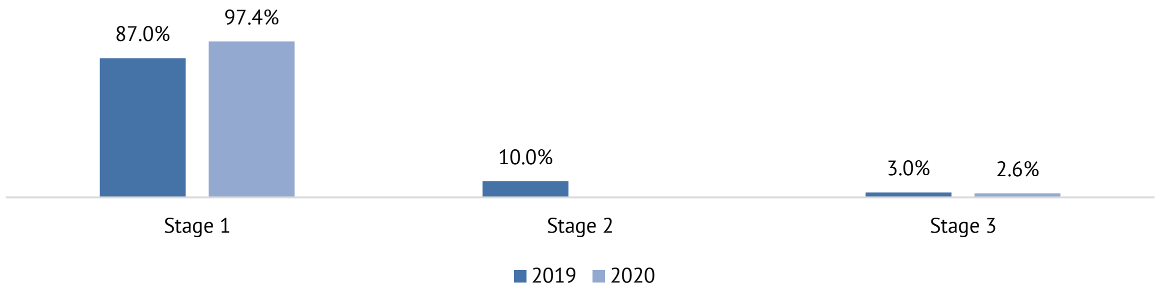


FBNQ MB's loan book is predominantly naira denominated. As at 31 December 2020, the Bank's foreign currency (FCY) loans accounted for 18.2% (FYE 2019: 28.2%) of the loan portfolio, below the 36.5% average in the merchant banking segment. We note that the FCY loans are exposures to oil and gas upstream obligors with FCY denominated receivables – providing a natural hedge. We anticipate a further decline in the FCY loan portfolio based on the conservative stance of the Bank in creating foreign currency-denominated risk assets.

During the year under review, FBNQ MB restructured approximately 19% of the loan book (including some of the largest exposures) on the back of the CBN forbearance for businesses severely impacted by the pandemic. Accordingly, 97.4% (FYE 2019: 87%) of FBNQ MB's gross loans and advances was adjudged to have a low risk of default and categorised in the stage 1 category. Following an improved performance, a ₦4.9 billion exposure to an oil and gas obligor hitherto classified as a stage 2 loan was re-categorised into the stage 1 bucket. As a result, as at FYE 2020, there was no exposure in the stage 2 category, relative to the 10% of the loan book it represented in the prior year.

As at FYE 2020, stage 3 loans remained stagnant at ₦1.4 billion. However, the stage 3 (impaired) loans accounted for a lower 2.6% (FYE 2019: 3.6%) of gross loans given the loan growth recorded during the year. Notwithstanding, the Bank's impaired loan ratio was one of the highest two in its merchant banking segment. We recognise that the impaired loans were largely dominated by one obligor which the Bank has fully provided for. Therefore, we expect no impact on future profits. The Bank plans to write off this loan in the near term, thus, we expect the impaired loan ratio to decline significantly.

Loan book by stages (FYE 2019 – 2020)



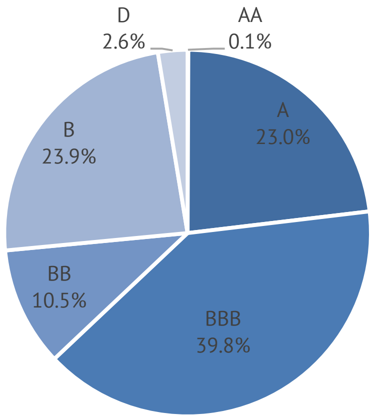
With the Bank strengthening its credit monitoring mechanism as well as plans to write off the large impaired loan in its books, we expect asset quality to improve in the near term barring any unforeseen issues. Overall, we consider FBNQ MB's asset quality to be satisfactory.

RISK MANAGEMENT

FBNQuest Merchant Bank Limited operates an Enterprise-Wide Risk Management framework that contains a robust set of policies and processes to manage different risks. The Board of Directors is responsible for determining the risk appetite and formulating the risk management strategies of the Bank. FBNQ MB also has a risk management function headed by the Chief Risk Officer (CRO) who monitors and ensures that the risk policies, control limits and risk appetites are adhered to by the operating units within the Bank. The CRO reports to the Board of Directors and the Managing Director for administrative matters.

Credit Risk: FBNQ MB's credit risk emanates largely from its loan portfolio and to a lesser extent its investment securities portfolio. The Bank has a Credit Risk Management (CRM) department responsible for managing credit risk exposures including remediation and recovery of impaired exposures. The CRM department is currently monitoring the loan book effectively as reflected in the stagnant impaired loans over the last 3 years. Furthermore, FBNQ MB has a credit policy that is reviewed periodically to guide the risk asset creation process. In managing credit risk, FBNQ MB uses an internal rating model which assesses the risk profile of obligors using quantitative and qualitative parameters.

Figure 3: Loan Book by Credit Rating (FYE2020)



The rating model has a 10-risk rating scale that ranges from AAA to D and can further be segregated into investment grade (AAA to BBB) and speculative grade (BB to D). Obligors who are in default are placed in the "D" category. According to the Bank's rating model, 62.9% of gross loans and advances was granted to investment-grade names as at FYE 2020 better than the 48% recorded in the prior year. The remaining 37.1% (FYE 2019: 52%) were to non-investment grade obligors.

Market Risk: FBNQ MB's exposure to market risk emanates from fluctuations in interest and foreign exchange rates which impacts the fair value of future cash flows from the financial instruments. The bank uses the Value at Risk (VaR) analysis, sensitivity analysis, stress tests, marking to market valuation models and expected shortfall models in measuring market risks. FBNQ MB also adopts open positions and loss limits in managing these risks. A sensitivity analysis conducted on the Bank's financial assets and liabilities as at 31 December 2020, reflects that a 10% naira devaluation would have led to ₦19.8 million profits and vice versa. Furthermore, a 100 basis points decrease in interest rates of the Bank's trading portfolio (bills and bonds) would have resulted in a ₦13.8 million loss (0.04% of shareholders' funds) and vice versa as at the same date. We consider the Bank's exposure to market risk to be within acceptable thresholds.

Operational Risk: The Bank uses the Basic Indicator Approach (BIA) as the measurement methodology for operational risks arising from people, processes and systems. As at 31 December 2020, the Bank recorded nil penalty, unlike the prior year where it paid ₦18 million for contravening the Banks and Other Financial Institutions Act (BOFIA) and the CBN AML/CFT regulations.

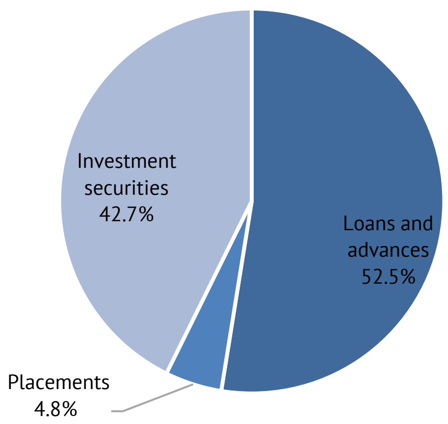
Overall, we consider FBNQ MB's risk management framework to be adequate for the level of business risks undertaken. However, we believe that given the ongoing digitalisation exercise, further fortification against cyber risk will be needed.

EARNINGS

FBNQuest Merchant Bank Limited earns income from traditional lending and core banking activities as well as other secondary activities permissible by its merchant bank license. Asides from risk assets and core banking services, FBNQ MB earns income from treasury management services, financial consultancy and advisory services, capital market services and dividends from its subsidiaries engaged in asset management and stockbroking. During the financial year ended 31 December 2020, FBNQ MB's net earnings increased by 28.8% to ₦12.8 billion.

During the financial year ended 31 December 2020, FBNQ MB's total interest income decreased by 19.7% to ₦14.2 billion owing to the low yield environment. This decline was most prominent in the yields from placements and investment securities which dipped by 52.1% and 40.5% respectively. Nevertheless, interest income from loans and advances remained the largest source of interest income, increasing by 22.6% to ₦6 billion and moderated the overall decrease in total interest income. In the near term, we expect a growth in fund-based income on the back of the rising yield environment.

Figure 6: Breakdown of Interest Income (FY 2020)

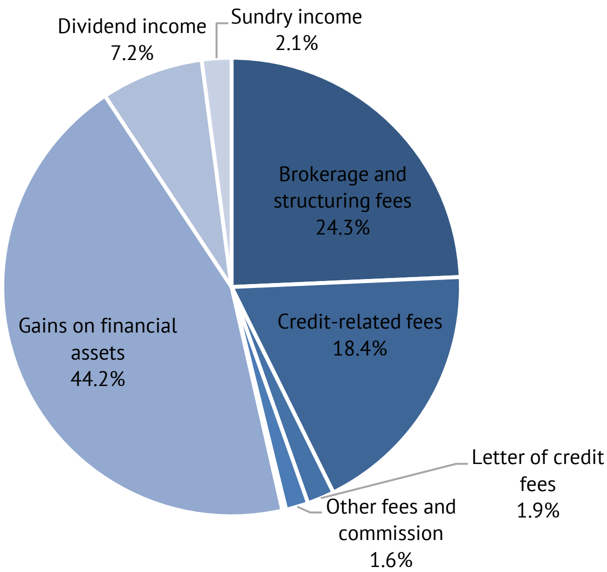


During FY 2020, the prevailing low interest rate environment also resulted in a 38.3% decline in interest expense to ₦6.7 billion. Owing to the relatively faster decline in funding cost viz-a-viz interest income, the Bank's net interest spread (NIS) surged to 41.3% (FY 2019: 23.7%) higher than the merchant banking average of 38.4%. We expect a decline in the Bank's NIS in FY 2021 underpinned by the wholesale funding nature of the merchant banking business in a period of rising interest rates and discretionary CRR debits.

During the financial year ended 31 December 2020, FBNQ MB recorded a 182.9% growth in impariment charge to ₦339 million, representing 3% (FY 2019: 0.8%) of interest income. The surge in impairment charge was largely driven by the sensitivity of the Bank's expected credit loss model to the deterioration in macroeconomic variables elicited by the pandemic. In the near term, we expect a reduction in the impairment charge due to the gradual, albeit sluggish, economic recovery.

In the financial year 2020, the Bank's ancillary income was upheld by the strength of its investment banking division as well as the strong dividend from its asset management subsidiary. Thus, non-interest income increased by 25.9% to ₦8.4 billion propelled by gains from financial assets and dividend income. The Bank's non-interest income to total assets of 4% which was higher than its peers (Coronation MB: 1.6% and FSDH: 3.2%) reflects its membership of the FBN Holdings and the synergy with subsidiaries within the FBNQuest Group. Given the low-interest rate induced favourable pricing, gains from financial assets grew by 107.6% and represented 48.8% of total non-interest income. Furthermore, FBNQ MB received dividends amounting to ₦604 million from its subsidiaries in FY 2020 after ploughing back their profits in the previous year. However, the pandemic-induced economic downturn resulted in a 17.6% decline in brokerage and structuring fees during the review year. Notwithstanding, brokerage and structuring activities from the investment banking division (a major strength of the Bank) remained a significant source representing 26.8% of non-interest income. In the near term, we do not anticipate a significant change in the structure of non-interest income. However, we believe that the rising interest rate will moderate gains from financial assets, although the Bank is optimistic about the performance of investment banking and credit-related fees

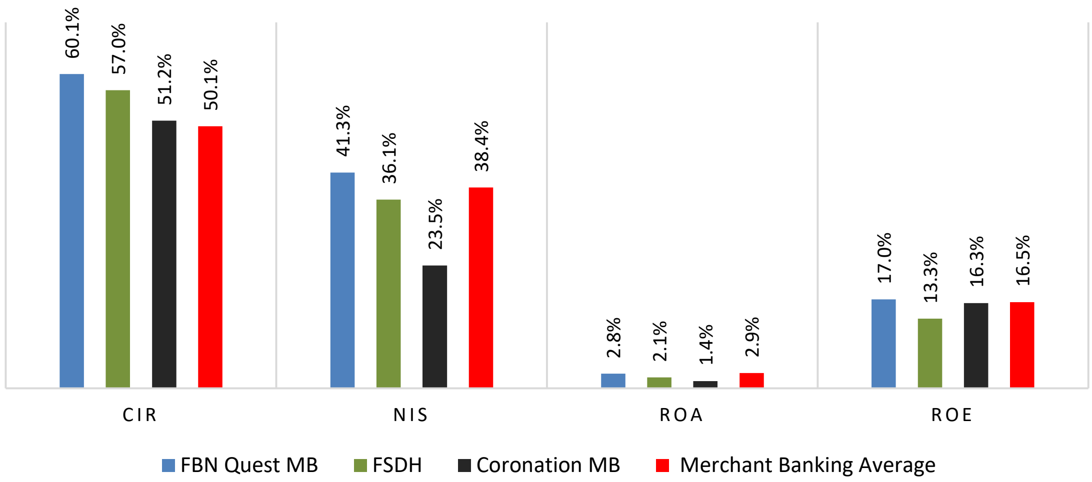
Figure 4: Breakdown of Non-Interest Income (FY 2020)



During the year under review, FBNQ MB recorded a 7.6% growth in operating expenses (OPEX) to ₦7.7 billion despite its cost containment exercise. Staff cost grew slightly to ₦3.1 billion owing to upward salary reviews accounting for 40.9% (FY 2019: 34.6%) of OPEX in FY 2020. In the same vein, administration and general expenses increased 26 times owing to reclassifications of some expense lines and inflationary pressures. Overall, FBNQ MB's cost-to-income ratio (CIR) improved to 60.1% (FY 2019: 71.9%) owing to the stronger growth in net earnings relative to operating expenses. However, this remained above 51.2% and 57% recorded by Coronation MB and FSDH MB respectively. While we expect OPEX to be largely stagnant due to the non-recurring nature of some expenses recorded in FY 2020, we believe that the Bank needs to drive down its costs in line with its peers.

Overall, FBNQ MB recorded a marked 83% growth in pre-tax profits to ₦5.1 billion, translating to a pre-tax return on average assets (ROA) of 2.8% (FY 2019: 1.9%) and a pre-tax return on average equity (ROE) of 17% (FY 2019: 10.3%). The Bank's ROA and ROE was better than peers Coronation MB and FSDH MB and the merchant banking segment (ROA: 1.4% and ROE: 16.5%).

Figure 5: Efficiency and Profitability Ratios (FY 2020)



Subsequent to year-end, in the six months ended 30 June 2021, the Bank recorded a lower annualised ROA of 0.8% and ROE of 4.8% owing to the sluggish economic recovery and rising interest rates. Nevertheless, although we believe that the rising funding cost may constrain profitability, we do not anticipate a material decline in the Bank's performance in the near term. We expect profitability to be upheld by the Bank's good ancillary income which stems from the strength of the investment banking division and synergy within the FBNQuest group. Also, the planned expansion in the loan book should support profitability in FY 2021.

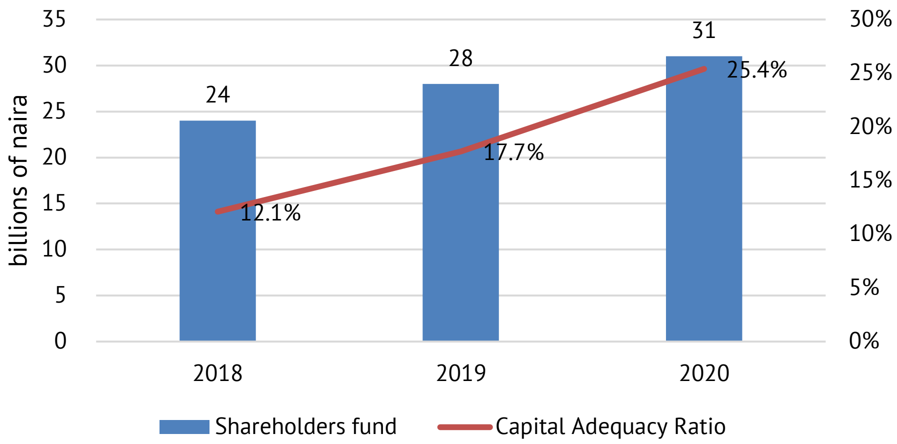
Capital Adequacy

As at 31 December 2020, FBNQ MB's core capital stood at ₦31 billion reflecting an 11.6% growth owing to accretions of undistributed profits to retained earnings and appropriations to non-distributable reserves. At this level, the Bank's core capital funded 15.3% (FYE 2019: 18.2%) of the total assets and contingents and was 2.1 times above the regulatory minimum of ₦15 billion for merchant banks. FBNQ MB has a deliberate strategy to grow the capital base through retained earnings supported by bond issuances, which we view positively.

FBNQ MB's tier-II capital stood at approximately ₦10 billion as at FYE 2020, largely due to the issued 10-year unsecured subordinated bond of ₦8 billion with a 6.5% fixed rate and the revaluation surplus ₦1.9 billion.

Given the enlarged capital base, FBNQ MB's Basel II ratio improved to 25.4% from the 17.7% recorded in the prior year and was well above the 10% CBN regulatory threshold. Also, when we stress test the Bank's capital taking full consideration of required provisioning it stood good as a percentage of total assets at 11%. Overall, we consider the Bank's capitalisation to be good considering the current level of business risk undertaken.

Figure 6: Shareholders' Funds and Capital Adequacy Ratio (FYE 2020)



LIQUIDITY AND LIABILITY GENERATION

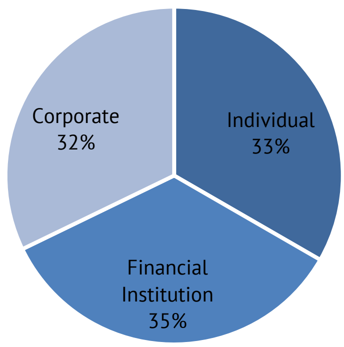
FBNQuest Merchant Bank Limited leverages its antecedence as a discount house as well as the membership of FBN Holdings Plc in generating liabilities. The Bank also provides fund management services to high net worth individuals and financial institutions while offering collection solutions to corporate and public sector clients. Also funding the Bank's activities during the year were bond issuances and confirmed stand-by lines of credit from foreign banks which funded trade transactions.

FBNQ MB customer deposits grew by 31.7% to ₦100.1 billion, owing to the low money market rates and funded 48.3% of total assets and contingents as at FYE 2020. Notwithstanding, customer deposits remained predominantly in term deposits which grew by 60.8% to ₦69.7 billion and accounted for 69.6% (FYE 2019: 68.2%) of customer deposits. The remaining 30.4% (FYE 2019: 31.8%) were in demand deposits, almost at par with peers; Coronation MB (31%) and FSDH (33%), reflecting the wholesale funding nature of the merchant banking business. Local currency (LCY) deposits accounted for 84.2% (FYE 2019: 88.8%) of customer deposits while foreign currency (FCY) deposits accounted for 15.8% (FYE 2019: 11.2%) as at FYE 2020. In addition, the Bank's FCY deposit adequately covered FCY loans 123.3% (FYE 2019: 63.1%), thereby reducing the susceptibility to foreign currency liquidity squeeze.

The Bank's deposit base is dominated by financial institutions (largely pension fund administrators) which accounted for 34.5% (FYE 2019: 28%) of total deposits as at the FYE 2020 while individuals and other corporates represented 33.3% (FYE 2019: 43%) and 32.2% (FYE 2019: 29%) respectively. Although we note that the Bank's strength in wealth management elicits deposits from individuals, we do not expect a change in this structure in FY 2021 given the wholesale nature of merchant banks.

As at FYE 2020, FBNQ MB's top 20 depositors accounted for a significant 41.6% (FYE 2019: 38.1%) of total deposits, revealing some degree of concentration akin to the merchant banking structure.

Figure 7: Customer Deposits by Source (FYE2020)



FBNQ MB's borrowings surged 39.4 times to ₦15.3 billion as at FYE 2020. The growth in borrowings was largely driven by the bond issuances during the year and the surge in liquid asset payables which are securities borrowed to take a position in the capital market. In January 2020, FBNQ MB issued a series I 3-year fixed-rate senior unsecured bond of ₦5 billion at a 10.5% coupon rate while the 6.5% fixed rate series II unsecured subordinated Bond of ₦8 billion that qualifies as tier 2 capital was issued in December 2020. Both series of bonds were from the Bank's ₦50 billion Debt Issuance Programme. Also, the Bank recorded liquid asset payables of ₦10 billion (FYE 2019: ₦388 million).

FBNQ MB's weighted average cost of funds (WACF) amounted to 7.6% in FY 2020, lower than 10.5% in the preceding year owing to the low yield environment. Notwithstanding, FBNQ MB's WACF was one of the highest in the merchant banking segment, higher than peers Coronation MB (4.8%) and FSDH (5.1%). The relatively higher WACF reflects the need to raise deposits from more stable and low-cost sources. Subsequent to the year end, in the six months ended 31 June 2021, the Bank's WACF dipped to 6.58% due to the depressed interest rate in Q1 and most of Q2 2021. With the gradually rising interest rates and the Bank's sustained play in the debt market, we expect WACF to inch upwards in 2021. However, we believe the funding costs will remain below 10% in FY 2021.

As at 31 December 2020, there were mismatches in the maturity profiles of the Bank's loan book and deposit base. Customer deposits in the "more than a year" maturity buckets were insufficient to fund corresponding loans and advances in the same maturity buckets. When we aggregate borrowings with customer deposits, the mismatch becomes restricted to exposures in the "3-5 years" maturity bucket only. While the funding disparity of ₦23.7 billion in the 3-5 years maturity bucket exposes the Bank to potential interest rate risk, we note that this maturity gap is adequately covered by the shareholders' fund and the 10-year ₦8 billion bond issuance during the review year. We also recognise that behaviourally, some of the short tenor deposits are long-term in nature.

FBNQ MB's liquid asset portfolio stood at ₦53.5 billion as at 31 December 2020, 2.4% lower than the prior year, given the arbitrary CRR debits by the CBN. Thus, the Bank's liquidity ratio (liquid assets to LCY deposit liabilities) declined slightly to 41.1% (FYE 2019: 42.6%) as at FYE 2020 and was higher than the regulatory minimum of 20% for merchant banks operating in Nigeria.

Overall, we consider FBNQ MB's liquidity profile to be satisfactory and its ability to refinance to be good, supported by its franchise as a member of the FBN Holding Group.

OWNERSHIP, MANAGEMENT & STAFF

FBNQuest Merchant Bank Limited is wholly owned by FBN Holdings Plc, one of the largest financial holding companies in Nigeria with interests in commercial banking, merchant banking, trusteeship and insurance brokerage, among others. FBN Holdings Plc is listed on the premium board of the Nigerian Stock Exchange and had 1,201,447 shareholders as at 31 December 2020. Asides from the brand franchise, FBN Group offers governance, technical and business support to the Bank.

A nine-member Board of Directors comprising seven Non-Executive Directors (two of whom are Independent Non-Executive Directors) and two Executive Directors governs FBNQ MB. The Board of Directors which is chaired by Mr Bello Maccido oversees the operations of the Bank. The oversight function of the Board is performed through four standing committees: the Board Audit Committee, the Board Credit Committee, the Board Risk Management Committee and the Board Governance/HR Committee. Mr Kayode Akinkugbe remained the Managing Director and Chief Executive Officer of FBNQuest Merchant Bank Limited and is supported by the Deputy Managing Director and a 12-member senior management team.

During the year under review, FBNQ MB had a staff strength of 150 persons lower than the 174 persons employed in the prior year. However, due to upward review in salaries and promotions employee costs increased by 27.3% to ₦3.1 billion. Thus, the average staff cost increased by 46.7% year-on-year to ₦20.8 million. However, staff productivity which is measured by net earnings per staff increased by 48.4% to ₦84.4 million and covered average staff costs 4.1 times (FY 2019: 4 times). The coverage ratio was lower than the 6.5 times recorded by Coronation MB but higher than FSDH MB's 4 times.

In our opinion, FBNQ MB's staff productivity is satisfactory and the Bank is led by an experienced management team.

Table 2: Staff Productivity Indicators (Peer Comparison)

	FBNQ MB FY 2019	FBNQ MB FY 2020	FSDH FY 2020	Coronation FY 2020
Average Number of Employees	174	151	124	142
Average Cost per Employee	₦14.2 million	₦20.7 million	₦17.2 million	₦20.8 million
Net Earnings per Staff	₦56.9 million	₦84.4 million	₦68.3 million	₦83.5 million
Net Earnings per Staff to Average Cost per Employee	4.0 times	4.1 times	4 times	6.5 times
Staff Cost/Operating Expenses	34.6%	40.9%	44.3%	30.2%

MARKET SHARE

FBN Quest Merchant Bank Limited is the third largest merchant bank, with a 16% (FYE 2019: 17%) share of the merchant banking segment's total assets and contingents. FBNQ MB's contribution to net loans and advances declined to 17% (FYE 2019: 19%) reflecting the slower growth in the loan book viz-a-viz its peers in the merchant banking segment. However, the Bank's share of pre-tax profits improved to 18% from 9% in the prior year in line with the growth in net earnings. Nonetheless, we note that unlike its peers FBNQ MB owns the second-largest asset management company in Nigeria with an AuM of over ₦300 billion and also has an investment banking division with a strong presence in the Nigerian capital market. We believe that the synergy with the subsidiary and the Bank's strong footprint in the capital market places it in a good position amidst the players in the merchant banking segment.

Table 3: Market Share Indicators of Merchant Banking Segment

	FBNQ FY 2019	FBNQ FY 2020	Coronation FY 2020	FSDH FY 2020	RMBN FY 2020	Nova FY 2020
Total Assets and Contingents	17%	16%	36%	13%	16%	19%
LCY Deposits	22%	19%	41%	14%	7%	19%
Loans & Advances (Net)	19%	17%	38%	12%	17%	16%
Net Earnings	17%	22%	21%	15%	31%	11%
Profit before Tax	9%	18%	20%	13%	38%	12%

OUTLOOK

The financial year ended 31 December 2020 was an unprecedented year for the Nigerian banking sector with the coronavirus pandemic plunging the economy into a recession in the third quarter of the year. However, the adverse effects of the pandemic have begun to dampen with increased vaccinations eliciting a sluggish economic recovery. FBNQ MB plans to increase collaboration with entities within the FBN Group and expand external partnerships to support the merchant banking and subsidiary businesses. The Bank also plans to leverage technology in mitigating costs as well as to promote growth across all business divisions.

In FY 2021, we do not anticipate a material decline in the Bank's performance although we note that the rising funding costs may constrain profitability – given the Bank's tilt to relatively expensive sources of funds. Nonetheless, we expect that the Bank's good ancillary income supported by the strong investment banking division and synergies within the FBNQuest Group will continue to uphold profitability. In addition, the anticipated expansion in the loan book amidst a rising yield climate should also support performance in FY 2021. Furthermore, despite the macroeconomic headwind, we believe FBNQ MB will harness the synergy with the FBN Group in navigating turbulent business cycles, supported by the experienced management team. Thus, we expect asset quality to remain satisfactory, hinged on the adequate monitoring of the loan book. Based on the above mentioned, Agusto & Co. hereby attaches a **'stable'** outlook to the rating of FBN Quest Merchant Bank Limited.

FINANCIAL SUMMARY

FBNQUEST MERCHANT BANK LIMITED

	BALANCE SHEET AS AT	31-Dec-2020		31-Dec-2019		31-Dec-2018	
		₦'000		₦'000		₦'000	
	ASSETS						
1	Cash & equivalents	4,320,594	2.1%	3,515	0.0%	2,249	0.0%
2	Government securities	38,184,414	18.4%	52,869,784	34.0%	52,587,640	36.9%
3	AMCON Securities	11,035,369	5.3%	2,000,466	1.3%	9,900,496	6.9%
4	Quoted investments						
5	Placements with discount houses						
6	LIQUID ASSETS	53,540,377	25.8%	54,873,765	35.3%	62,490,385	43.8%
7	BALANCES WITH NIGERIAN BANKS	9,624,947	4.6%	1,488,911	1.0%	3,678,982	2.6%
8	BALANCES WITH BANKS OUTSIDE NIGERIA	1,572,886	0.8%	1,047,043	0.7%	1,412,550	1.0%
9	Direct loans and advances - Gross	57,061,729	27.5%	48,005,509	30.9%	36,770,767	25.8%
10	Less: Cumulative loan loss provision	(1,472,002)	-0.7%	(1,615,056)	-1.0%	(1,427,942)	-1.0%
11	Direct loans & advances - net	55,589,727	26.8%	46,390,453	29.8%	35,342,825	24.8%
12	Advances under finance leases - net						
13	TOTAL LOANS & LEASES - NET	55,589,727	26.8%	46,390,453	29.8%	35,342,825	24.8%
14	INTEREST RECEIVABLE						
15	OTHER ASSETS	5,265,056	2.5%	8,517,527	5.5%	6,151,414	4.3%
16	DEFERRED LOSSES	9,113,548	4.4%	9,113,548	5.9%	9,113,548	6.4%
17	RESTRICTED FUNDS	39,370,061	19.0%	8,000,335	5.1%	3,879,865	2.7%
18	UNCONSOLIDATED SUBSIDIARIES & ASSOCIATES	1,313,329	0.6%	1,313,329	0.8%	1,381,773	1.0%
19	OTHER LONG-TERM INVESTMENTS	14,925,488	7.2%	8,445,447	5.4%	4,902,151	3.4%
20	FIXED ASSETS & INTANGIBLES	1,549,945	0.7%	2,310,991	1.5%	3,441,472	2.4%
21	**TOTAL ASSETS**	**191,865,364**	**92.5%**	**141,501,349**	**91.0%**	**131,794,965**	**92.5%**
22	TOTAL CONTINGENT ASSETS	15,556,999	7.5%	13,952,856	9.0%	10,761,510	7.5%
23	**TOTAL ASSETS & CONTINGENTS**	**207,422,363**	**100%**	**155,454,205**	**100%**	**142,556,475**	**100%**
	CAPITAL & LIABILITIES						
24	TIER 1 CAPITAL (CORE CAPITAL)	31,646,864	15.3%	28,266,254	18.2%	25,626,030	18.0%
25	TIER 2 CAPITAL	9,958,803	4.8%	(315,728)	-0.2%	(2,086,380)	-1.5%
26	LONG-TERM FOREIGN BORROWINGS	15,258,792	7.4%	387,575	0.2%		
27	Demand deposits	17,699,647	8.5%	24,143,910	15.5%	20,512,253	14.4%
28	Savings deposits						
29	Time deposits	69,656,444	33.6%	43,330,080	27.9%	54,096,141	37.9%
30	Inter-bank takings	28,475,932	13.7%	27,648,648	17.8%	8,003,945	5.6%
31	TOTAL DEPOSIT LIABILITIES - LCY	115,832,023	55.8%	95,122,638	61.2%	82,612,339	58.0%
32	Customers' foreign currency balances	12,781,734	6.2%	8,547,458	5.5%	16,368,975	11.5%
33	TOTAL DEPOSIT LIABILITIES	128,613,757	62.0%	103,670,096	66.7%	98,981,314	69.4%
34	INTEREST PAYABLE						
35	OTHER LIABILITIES	6,387,148	3.1%	9,493,152	6.1%	9,274,001	6.5%
36	**TOTAL CAPITAL & LIABILITIES**	**191,865,364**	**92.5%**	**141,501,349**	**91.0%**	**131,794,965**	**92.5%**
37	TOTAL CONTINGENT LIABILITIES	15,556,999	7.5%	13,952,856	9.0%	10,761,510	7.5%
38	**TOTAL CAPITAL, LIABILITIES & CONTINGENTS**	**207,422,363**	**100%**	**155,454,205**	**100%**	**142,556,475**	**100%**
	Proof	0					
	BREAKDOWN OF CONTINGENTS						
39	Acceptances & direct credit substitutes	11,884,579	5.7%	10,310,436	6.6%	8,172,760	5.7%
40	Guarantees, bonds etc..	3,672,420	1.8%	3,642,420	2.3%	2,588,750	1.8%
41	Short-term self liquidating contingencies						

	INCOME STATEMENT FOR THE YEAR ENDED	31-Dec-2020		31-Dec-2019		31-Dec-2018	
		₦'000		₦'000		₦'000	
42	Interest income	11,428,992	57.7%	14,232,552	68.2%	16,389,387	73.2%
43	Interest expense	(6,704,013)	-33.9%	(10,859,589)	-52.0%	(12,333,063)	-55.1%
44	Loan loss expense	(339,026)	-1.7%	(119,832)	-0.6%	(471,531)	-2.1%
45	NET REVENUE FROM FUNDS	4,385,953	22.2%	3,253,131	15.6%	3,584,793	16.0%
46	ALL OTHER INCOME	8,365,159	42.3%	6,646,222	31.8%	6,013,392	26.8%
47	**NET EARNINGS**	**12,751,112**	**64.4%**	**9,899,353**	**47.4%**	**9,598,185**	**42.8%**
48	Staff costs	(3,134,239)	-15.8%	(2,462,181)	-11.8%	(2,573,040)	-11.5%
49	Depreciation expense	(1,124,503)	-5.7%	(1,699,899)	-8.1%	(1,507,967)	-6.7%
50	Other operating expenses	(3,403,976)	-17.2%	(2,957,398)	-14.2%	(3,247,066)	-14.5%
51	TOTAL OPERATING EXPENSES	(7,662,718)	-38.7%	(7,119,478)	-34.1%	(7,328,073)	-32.7%
52	PROFIT (LOSS) BEFORE TAXATION	5,088,394	25.7%	2,779,875	13.3%	2,270,112	10.1%
53	TAX (EXPENSE) BENEFIT	(207,784)	-1.0%	(139,651)	-0.7%	(212,100)	-0.9%
54	**PROFIT (LOSS) AFTER TAXATION**	**4,880,610**	**24.7%**	**2,640,224**	**12.6%**	**2,058,012**	**9.2%**
55	NON-OPERATING INCOME (EXPENSE) - NET						
56	DIVIDEND	(1,500,000)	-7.6%			(707,000)	-3.2%
57	**GROSS EARNINGS**	**19,794,151**	**100%**	**20,878,774**	**100%**	**22,402,779**	**100%**
58	AUDITORS	PWC		PWC		PWC	
59	OPINION	CLEAN		CLEAN		CLEAN	

	KEY RATIOS	31-Dec-2020	31-Dec-2019	31-Dec-2018
	EARNINGS			
60	Net interest spread	41.3%	23.7%	24.7%
61	Loan loss expense/Interest income	3.0%	0.8%	2.9%
62	Return on average assets (Pre - tax)	2.8%	1.9%	1.6%
63	Return on average equity (Pre - tax)	17.0%	10.3%	8.7%
64	Operating Expenses/Net earnings	60.1%	71.9%	76.3%
65	Gross earnings/Total assets & contingents	10.9%	14.0%	15.9%
	EARNINGS MIX			
66	Net revenue from funds	34.4%	32.9%	37.3%
67	All other income	65.6%	67.1%	62.7%
	LIQUIDITY			
68	Total loans & leases - net/Total lcy deposits	14.3%	31.7%	26.1%
69	Liquid assets/Total lcy deposits	39.7%	42.6%	78.0%
70	Demand deposits/Total lcy deposits	15.3%	25.4%	24.8%
71	Savings deposits/Total lcy deposits			
72	Time deposits/Total lcy deposits	60.1%	45.6%	65.5%
73	Inter-bank borrowings/Total lcy deposits	24.6%	29.1%	9.7%
74	Interest expense - banks/Interest expense	24.5%	17.8%	10.3%
75	**NET FOREIGN CURRENCY ASSETS (LIABILITIES)**	(11,208,848)	(7,500,415)	(14,956,425)

	KEY RATIOS CONT'D	31-Dec-2020	31-Dec-2019	31-Dec-2018
	ASSET QUALITY			
76	Performing loans (₦'000)	55,569,159	46,545,590	35,440,779
77	Non-performing loans (₦'000)	1,492,570	1,459,919	1,329,988
78	Non-performing loans/Total loans - Gross	2.62%	3.04%	3.62%
79	Loan loss provision/Total loans - Gross	2.6%	3.4%	3.9%
80	Loan loss provision/Non-performing loans	98.6%	110.6%	
81	Risk-weighted assets/Total assets & contingents	40.9%	44.5%	39.2%
	CAPITAL ADEQUACY			
82	Adjusted capital/risk weighted assets	36.5%	24.2%	20.2%
83	Tier 1 capital/Adjusted capital	72%	110%	131%
84	Total loans - net/Adjusted capital	2.72	3.05	3.05
85	Capital unimpaired by losses (₦'000)	22,533,316	19,152,706	16,512,482
	CAPITAL ADEQUACY STRESS TEST			
86	Adjusted capital (₦'000)	30,981,291	16,713,618	11,286,094
87	Cumulative loan loss provision (actual reserves)	1,472,002	1,615,056	1,427,942
88	Equity before all provision (line 86 + line 87)	32,453,293	18,328,674	12,714,036
89	Required reserves*	8,818,674	7,524,318	6,117,053
90	Equity after required reserves (line 88 - line 89)	23,634,619	10,804,356	6,596,983
91	Equity after required reserves/risk weighted assets	27.9%	15.6%	11.8%
	STAFF INFORMATION			
92	Net earnings per staff (₦'000)	84,444	56,893	55,481
93	Staff cost per employee (₦'000)	20,757	14,150	14,873
94	Staff costs/Operating expenses	40.9%	34.6%	35.1%
95	Average number of employees	151	174	173
96	Average staff per office	50	58	58
	OTHER KEY INFORMATION			
97	Legal lending limit(₦'000)	11,266,658	9,576,353	8,256,241
98	Other unamortised losses(₦'000)	NONE	NONE	NONE
99	Unreconciled inter-branch items (₦'000) DR/(CR)	NONE	NONE	NONE
100	Number of offices	3	3	3
101	Age** (in years)	25	24	23
102	Government stake in equity (Indirect)	Nil	Nil	Nil
	MARKET SHARE OF INDUSTRY TOTAL	Actual	Actual	Actual
103	Lcy deposits (excluding interbank takings)	0.4%	0.3%	0.5%
104	Total assets & contingents	0.4%	0.4%	0.4%
105	Total loans & leases - net	0.3%	0.3%	0.3%
106	Non interest income	0.6%	0.6%	0.7%
107	Net interest income	0.3%	0.2%	0.3%

Rating Definitions

Aaa	A financial institution of impeccable financial condition and overwhelming capacity to meet obligations as and when they fall due. Adverse changes in the environment (macro-economic, political and regulatory) are unlikely to lead to deterioration in financial condition or an impairment of the ability to meet its obligations as and when they fall due. In our opinion, regulatory and/or shareholder support will be obtained, if required.
Aa	A financial institution of very good financial condition and strong capacity to meet its obligations as and when they fall due. Adverse changes in the environment (macro-economic, political and regulatory) will result in a slight increase the risk attributable to an exposure to this financial institution. However, financial condition and ability to meet obligations as and when they fall due should remain strong. Although regulatory support is not assured, shareholder support will be obtained, if required.
A	A financial institution of good financial condition and strong capacity to meet its obligations. Adverse changes in the environment (macro-economic, political and regulatory) will result in a medium increase in the risk attributable to an exposure to this financial institution. However, financial condition and ability to meet obligations as and when they fall due should remain largely unchanged. In our opinion, shareholder support should be obtainable, if required.
Bbb	A financial institution of satisfactory financial condition and adequate capacity to meet its obligations as and when they fall due. It may have one major weakness which, if addressed, should not impair its ability to meet obligations as and when due. Adverse changes in the environment (macro-economic, political and regulatory) will result in a medium increase in the risk attributable to an exposure to this financial institution.
Bb	Financial condition is satisfactory and ability to meet obligations as and when they fall due exists. May have one or more major weaknesses. Adverse changes in the environment (macro-economic, political and regulatory) will increase risk significantly.
B	Financial condition is weak but obligations are still being met as and when they fall due. Has more than one major weakness and may require external support, which, in our opinion, is not assured. Adverse changes in the environment (macro-economic, political and regulatory) will increase risk significantly.
C	Financial condition is very weak. Net worth is likely to be negative and obligations may already be in default.
D	In default.

Rating Category Modifiers

A "+" (plus) or "-" (minus) sign may be assigned to ratings from 'Aa' to 'C' to reflect comparative position within the rating category. Therefore, a rating with + (plus) attached to it is a notch higher than a rating without the + (plus) sign and two notches higher than a rating with the - (minus) sign.

www.agusto.com

UBA House (5th Floor)
57 Marina Lagos
Nigeria.
P.O Box 56136 Ikoyi
+234 (1) 2707222-4
+234 (1) 2713808
Fax: 234 (1) 2643576
Email: info@agusto.com