FSDH Merchant Bank Limited

Final Rating Report

Agusto&Co.

Research, Credit Ratings, Credit Risk Management

FSDH Merchant Bank Limited

Ratings Assigned:

National Rating: **A**
Foreign Currency (FCY): **B-**

Outlook: Stable
Issue Date: 27 May 2021
Expiry Date: 30 June 2022
Previous National Rating: A
Previous FCY Rating: N/A

Industry: Banking

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A financial institution of good financial condition and strong capacity to meet its obligations as and when they fall due.

Rating Rationale

Agusto & Co. affirms FSDH Merchant Bank Limited's ('FSDH' or 'the Bank) national rating of '**A**' and assigns a '**B-**' foreign currency rating. The ratings assigned reflects the Bank's good capitalisation, good liquidity profile and the conservative and experienced management team. However, constraining these positives is the lingering concentration (sectorial and obligor) in the loan book. The ratings are also constrained by FSDH's comparably low profitability, the adverse implications of the regulatory environment and the fragile economic recovery on the Bank's performance. FSDH's assigned FCY rating is reflective of the risk rating of the Federal Republic of Nigeria with a sovereign rating of '**B**' assigned by Agusto & Co.

Owing to the COVID-19 pandemic, FSDH maintained a cautious approach to risk asset creation, with gross loans and advances declining by 13.8% (year-on-year) to stand at ₦40.3 billion as at 31 December 2020. However, concentration in the loan book has persisted, with the top three sectors accounting for 75% of the portfolio while the top five obligors accounted for a marked 68% of the loan book as at FYE 2020. FSDH proactively classified a syndicated restructured facility in the stage 3 category, in contrast to other banks in the syndicate. The loan which represents the only stage 3 exposure represented 5.6% (FYE 2019: 4.8%) of gross loans and advances, higher than the regulatory guidance of 5%. The Bank anticipates a repayment of 17% of the exposure, which we believe should reduce the non-performing loan ratio as the Bank renews its appetite for lending in FY 2021.

Reflective of the cautious approach to lending and the prevailing low interest rate environment during the year under review, FSDH's fund-based income declined by a marked 52.6% to ₦2.8 billion, accounting for a lower 33% (FY 2019: 57.6%) of net earnings. However, the Bank sustained its strong treasury competence, with ancillary income growing by 31.3% to ₦5.7 billion. Due to the dip in core earnings, pre-tax profits fell by 29.7% to

₦3.6 billion, translating to a lower pre-tax return on average assets and contingents (ROA) of 2.1% (FY 2019: 3.3%) and a pre-tax return on average equity (ROE) of 13.3% (FY 2019: 18.5%). The Bank's ROE was almost at par with the average inflation rate of 13.2% during the year under review. We find this level of profitability to be subpar relative to its peers in the merchant banking segment with an average ROE of 16.5% in the same year.

Supported by the ₦12.1 billion combined bond issuance in January 2021, FSDH seeks to grow its loan book by 60% in FY 2020, which we believe should drive better profitability (albeit moderate) in the near-term. Considering that the Bank's playing field is characterised by pricing rigidity, FSDH seeks to penetrate the commercial and top-tier MSME segments to improve core earnings. However, this will require additional risk control measures considering the relatively high risk associated with the proposed segments.

During the year under review, FSDH fully repaid its stock of foreign currency borrowings provided by African Development Bank (AfDB) and now seeks to raise a foreign currency (FCY) commercial paper to improve funding diversity. With successful series of commercial papers issued in the Nigerian capital market, we believe that the Bank's domestic brand equity should provide support for the maiden FCY commercial paper issuance.

FSDH Merchant Bank Limited is well capitalised for the current level of business risk undertaken, with shareholders' equity of ₦28 billion as at FYE 2020. As at the same date, the Basel II computed capital adequacy ratio stood at 42.7% (FYE 2019: 31.2%), adequate enough to absorb moderate shocks from the difficult regulatory and macroeconomic environment. With a liquidity ratio of 36.8% as at FYE 2020, which is above the required 20% for merchant banks, we consider the Bank's liquidity profile to be good.

Based on the aforementioned, we attach a **stable** outlook to the rating of FSDH Merchant Bank Limited.

Strengths

- Good capitalisation
- Good liquidity profile
- Experienced management team

Weaknesses

- Sector and obligor concentration in the loan book
- Subpar profitability

Challenges

- The impact of the fragile economic recovery on creating quality risk assets
- Unfavourable regulations
- Maintaining good asset quality as the Bank expands its loan book

Table 1: Background Information

	31 December 2019	31 December 2020
Total Assets & Contingents	₦172.8 billion	₦175.2 billion
Net Earnings	₦10.2 billion	₦8.5 billion
Pre-tax Return on Average Assets & Contingents (ROA)	3.3%	2.1%
Pre-tax Return on Average Equity (ROE)	18.5%	13.3%

PROFILE

FSDH Merchant Bank Limited ('FSDH' or the 'Bank') was incorporated in June 1992 as First Securities Discount House Limited and commenced operations in July 1992. Following the review of the banking regulatory framework and the re-introduction of the merchant banking business model, FSDH converted to a merchant bank in November 2012, the first financial institution to receive licensing under the new framework. Thereafter, the Bank's name was changed to FSDH Merchant Bank Limited, with merchant banking operations commencing in January 2013.

During the 2019 financial year, a comprehensive review of the activities of FSDH and its subsidiaries was conducted with a view to further optimise available resources. Thus, FSDH Holding Company Limited (the HoldCo) a non-operating legal entity domiciled in Nigeria and regulated by the Central Bank of Nigeria (CBN) was established. FSDH Merchant Bank Limited transferred its ownership stake in its hitherto subsidiaries to the HoldCo and became a wholly-owned subsidiary. Other subsidiaries under FSDH Holding Company Limited are FSDH Asset Management Limited, Pensions Alliance Limited and FSDH Capital Limited. The investment banking business was also transferred to the HoldCo. It is expected that the transition will enhance the performance of the FSDH Group by maximising synergies from sister financial institutions under the new operating structure.

FSDH Merchant Bank Limited is one of the six merchant banks operating in Nigeria. The services offered by the Bank include transactional and structured finance services, money market activities including trading and holding of marketable securities such as treasury bills, government bonds, commercial bills and other eligible instruments. FSDH's activities are organised into two business divisions:

- Global Markets and Prestige Banking
- Corporate Banking

FSDH's head office is situated at UAC House (5^{th} - 8^{th} Floor), 1/5 Odunlami Street, Marina, Lagos. The Bank has two other offices located in Abuja and Port Harcourt. During the year under review, FSDH employed an average of 124 persons.

Technology

FSDH uses a variety of hardware and software applications to integrate various functions deployed to facilitate business transactions and support risk management activities. The Bank maintains over 50 applications for business processes, however, Flexcube software is the core banking application. Ethernet Local Area Network (ELANs) and Virtual Local Area Networks (VLAN) are maintained to ensure seamless communication and access to business data at the head office, branches and other remote locations. A Wide Area Network (WAN) Link is deployed by FSDH to facilitate uninterrupted communication between the offices in Lagos, Abuja and Port Harcourt, while a telecommunication system with audio and video conferencing capabilities is also maintained.

Correspondent Banks

FSDH maintained corresponding banking relationships with the following banks in 2020

1.	Commerzbank	7.	Standard Chartered Bank London, New York & Frankfurt
2.	Deutsche Bank London & Frankfurt	8.	Access Bank, UK
3.	Bank of Beirut London	9.	Zenith Bank, UK
4.	Standard Bank of South Africa	10.	United Bank for Africa (UBA) Plc
5.	FCMB Bank UK	11.	Union Bank UK
6.	FBN Bank UK	12.	Byblos Bank Europe SA

Track Record of Financial Performance

As at 31 December 2020, FSDH Merchant Bank Limited had an asset base (including contingents) of ₦175.2 billion, representing a marginal growth of 1.4% compared to the prior year. Gross loans and advances declined year-on-year by 13.8% to stand at ₦40.3 billion as at the same date.

As at 31 December 2020, FSDH's deposit liabilities, excluding inter-bank takings, accounted for a significant 34.8% of the asset base. As at the same date, outstanding borrowings stood at ₦23.1 billion and funded 13.2% of the Bank's activities while the core (tier 1) capital) of ₦28 billion represented 16% of the asset base. The Basel II computed adequacy ratio improved to 42.7% as at FYE 2020 from 31.2% in the prior year, a reflection of the reduction in the risk-weighted assets.

FSDH's net earnings in the period ended 31 December 2020 declined by 17% to ₦8.5 billion due to lower fund-based income. As a result, the cost-to-income ratio increased to 57% from 49.3% in the prior year. Pre-tax return on average assets (ROA) and pre-tax return on average equity (ROE) were lower at 2.1% (FY 2019: 3.3%) and 13.3% (FY 2019: 18.5%) respectively in FY 2020.

Current Directors	Designation	Representative
Mr Olufemi Agbaje	Chairman	KMC Investments Limited
Mrs Bukola Smith*	Managing Director	Nil
Mr Taiwo Otiti	Executive Director	Nil
Alhaji Bello Garba	Non-Executive Director	KMC Investments Limited
Mr Tosayee Ogbomo	Non-Executive Director	KMC Investments Limited
Mr Patrice Backer	Non-Executive Director	Atlantic Coast Regional Fund
Mr Godwin Ize-Iyamu	Independent Director	Nil
Mr Kelechi Okoro**	Non-Executive Director	Atlantic Coast Regional Fund

**Appointed April 2021*
***Appointed March 2020*

Major Shareholder

FSDH Holding Company Limited	99.99%

MANAGEMENT TEAM

Mrs Bukola Smith is the Managing Director, FSDH Merchant Bank Limited. She was appointed in April 2021 following the retirement of the erstwhile Managing Director, Mrs Hamda Ambah after 28 years of service at the Bank. Mrs Smith has almost three decades of experience in commercial banking in various roles including treasury, capital markets, structured finance, internal audit and business development. Prior to her appointment as Managing Director, she was the Executive Director, Business Development at First City Monument Bank (FCMB) Limited, where she spent about two decades. Mrs Smith also worked at Fidelity Bank Plc where she commenced her career in 1992. She holds a B.Sc. in Economics from the University of Lagos and a Master's in Business Administration (MBA) from Alliance Manchester Business School, Manchester, UK. Mrs Smith is a Fellow, Institute of Chartered Accountants of Nigeria (ICAN) and an Associate Member, Certified Institute of Pensions (Nigeria).

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

Mr Taiwo Otiti	Executive Director, Operations, Information Technology and Compliance
Mr Richard Osuagwu	Chief Risk Officer
Ms. Stella-Marie Omogbai	Group Head, Corporate Banking and Branch Offices
Mr Hakeem Muhammed	Head, Global Markets and Prestige Banking
Mr Babatunde Obidare	Group Head, Operations
Mr Kunle Osunkunle	Head, Corporates
Ms. Tolulope Obadagbonyi	Treasurer
Mr Toyin Owolabi	Head, Prestige Banking
Mr Taiwo Sanusi	Chief Compliance Officer
Mr Adediran Oni	Head, Energy
Mr Oluwaseun Omole	Chief Financial Officer
Ms Bolanle Meshida	Head, Legal and Company Secretary

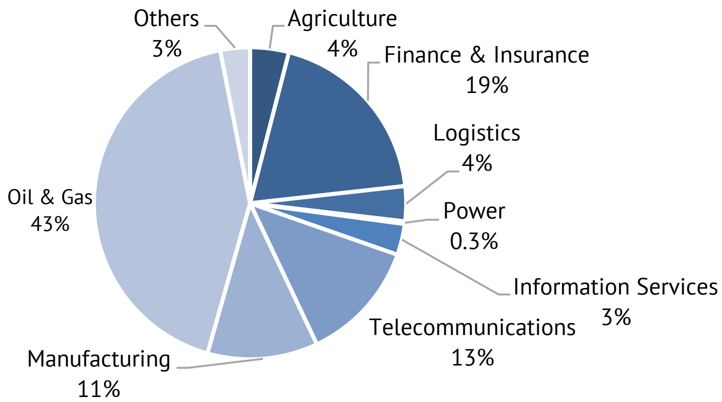
ANALYSTS' COMMENTS

ASSET QUALITY

As at 31 December 2020, FSDH Merchant Bank Limited's total assets and contingents stood at ₦175.2 billion, a marginal growth of 1.4% compared to the prior year. The muted growth reflects the economic impact of the COVID-19 outbreak, adverse regulations and management's stance not to grow the risk assets in a period of economic weakness. Owing to the revision of the cash reserve ratio for merchant banks to 27.5% from 2% in January 2020 amid arbitrary deductions, FSDH's restricted cash reserves jumped by approximately 4 times to stand at ₦27.1 billion as at FYE 2020. The non-earning reserves accounted for 15.4% (FYE 2019: 4.6%) of total assets, higher than a selected merchant banking peer: Coronation Merchant Bank Limited's (Coronation MB) 15.2% but lower than the other selected peer: FBNQuest Merchant Bank Limited's (FBNQuest) 19%. As a result, FSDH's performance in FY 2020 was adversely impacted by the significant level of non-earning assets and management's stance of being cautious in a period of adverse macroeconomic climate exacerbated by the pandemic. Overall, the loan book remained the predominant asset base, accounting for 23% (FYE 2019: 27.1%) as at FYE 2020.

FSDH's lending strategy selectively targets top-tier corporates and value chain operators to some extent. The Bank provides a range of services including trade finance and working capital financing support. With the impact of regulatory measures targeted at lowering borrowing costs, the interest rate sensitivity of FSDH's focus customer segment (top-tier corporates) increased and spurred the need to harness opportunities within the segment's value chain. To ensure the predominant low risk appetite does not surpass a moderate level, FSDH plans to introduce risk-sharing facilities. While this provides room for growth given stringent loan pricing in the corporate segment, we are concerned about the high risk peculiar to the targeted MSME segments.

Figure 1: Breakdown of the Loan Book by Sector as at 31 December 2020

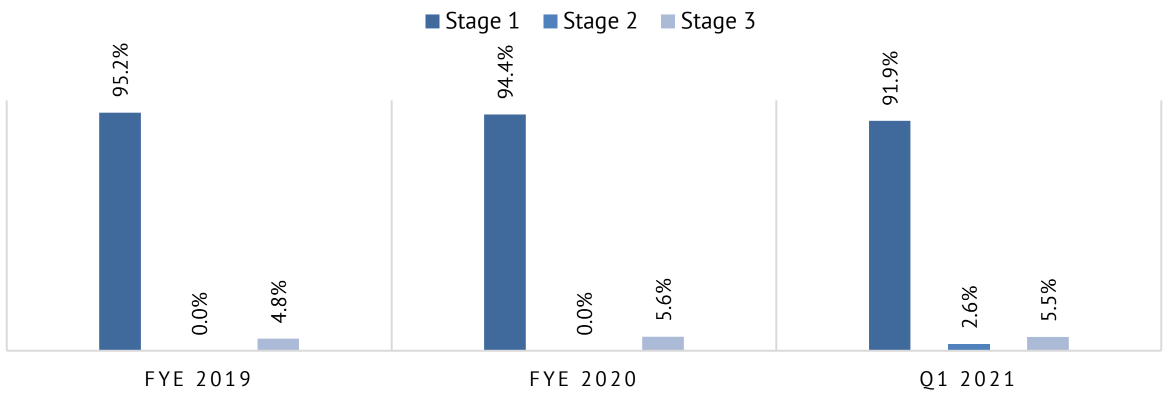


Given the uncertainties in the global economy created by the outbreak of the COVID-19 pandemic, FSDH adopted a conservative approach to risk asset creation during the year under review. As a result, gross loans and advances declined by 13.8% year-on-year to stand at ₦40.3 billion as at 31 December 2020. The Bank's largest sectorial exposure, oil and gas, which accounted for 43% of the loan portfolio comprised oil and gas upstream (97%) and oil and gas servicing (3%). The upstream exposure is largely to one obligor which accounted for 36% of the loan portfolio and 47.3% of shareholders' fund as at FYE 2020. Given that the exposure is FCY denominated, we are concerned that a further naira devaluation could result in a breach of the CBN's single obligor threshold of 50%. The exposure to the oil and gas upstream segment is also of concern given that the obligor commenced production and exports in October 2020. Management has disclosed that repayment commenced in April 2021 and this should provide some respite regarding the breach of the single obligor limit should the domestic currency devalue further.

While exposure to the finance and insurance sector was significant at 19% of the loan book, our concerns are moderated by the liquid government securities used to secure most of these loans. FSDH plans to improve sectorial diversification by seeking lending opportunities in the agriculture, healthcare and telecommunications sectors.

The obligor concentration in the loan book persisted in the year under review with FSDH's top five obligors accounted for 68% (FYE 2019: 57%) of the loan book. Thus, making the Bank vulnerable to any deterioration in the financial condition of these obligors. Agusto & Co. notes that concentration in loan book by obligors is a norm in the merchant banking segment given their wholesale focus and conservative obligor numbers.

Figure 2: Loan Book by Stages (FYE 2019 – Q1 2021)



Owing to prevailing economic headwinds and in line with the CBN's forbearance policy, the Bank restructured loans granted to three customers, which amounted to about 43% of average loans. Notwithstanding, stage 1 loans accounted for 94.4% of the gross loans (FYE 2019: 95.2%), with no loans classified under the stage 2 category as at FYE 2020. The Bank proactively classified exposure to a challenged obligor in the telecommunications sector in the stage 3 category. Although the loan which was granted in syndication with other banks has been restructured with the consent of the CBN, the Bank categorised the exposure in the impaired category as a proactive measure, compared to other banks in the syndicate. The loan which is the only stage 3 exposure accounted for 5.6% of the loan book as at FYE 2020 (FYE 2019: 4.8%), higher than the 5% regulatory guidance. As at the same date, cumulative loan loss provision covered the loan by 98.5% which we consider very good. Nonetheless, the Bank expects a repayment of 17% of the impaired loan to be paid in

2021, which reflects some resolution. Subsequent to the year end, while no additional exposure was included in the stage 3 category as at 31 March 2021, a loan granted to an information service provider (restructured in line with the CBN forbearance) was classified under the stage 2 category, accounting for 2.6% of gross loans. The Bank expects the resolution of the facility before FYE 2021.

In our opinion, FSDH's asset quality is acceptable. The Bank has disclosed plans to grow the loan book by 60% in the near term, leveraging the gradual reopening of the economy. Backed by the ₦12.1 billion bond issued in January 2021, priority will be given to longer-tenured facilities. We believe the loan growth is achievable given the relatively low size of the loan book. However, we expect that with the anticipated expansion in lending, particularly to customer segments with comparably high risk, the credit risk management framework will need to be fortified to curtail credit losses.

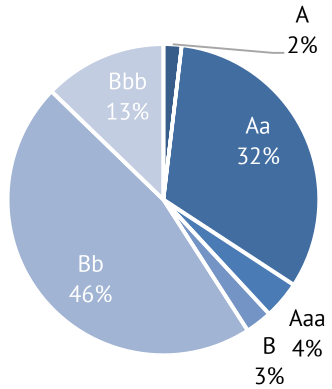
Risk Management

FSDH Merchant Bank Limited runs an Enterprise-wise Risk Management (ERM) framework backed by a risk appetite that is defined as conservative. The Board Risk Management Committee oversees the Bank's risk management activities while the Chief Risk Officer (CRO), supported by the Deputy Chief Risk Officer (DCRO) are responsible for the implementation of the various risk policies.

Credit Risk

In assessing credit risk, FSDH adopts an internal risk rating model which considers qualitative and quantitative factors. The assessment methodology provides nine rating categories (Aaa to C). As at 31 December 2020, 51% of the loan book was classified as investment-grade (Aaa to Bbb), lower than 66% in the prior year. The proportion of speculative-grade obligors increased to 49% (FYE 2019: 34%), largely due to the reclassification of an oil and gas upstream obligor impacted by the pandemic. Nevertheless, management expects the obligor's risk rating to improve in the near term given the easing of COVID-19 induced restrictions and the commencement of crude oil production at the obligor's oil field.

Figure 3: Breakdown of the Loan Book by Credit Rating as at 31 December 2020



In line with the standardised risk management practice, FSDH's loans are secured by cash, liquid securities, fixed and floating assets and domiciliation of contract proceeds. As at FYE 2019, approximately 72% of the loan book was secured with a collateral coverage of 1.4 times. We consider the Bank's credit risk management framework to be satisfactory.

Market Risk

FSDH applies value-at-risk measures in the assessment and management of market risk. These measures include position limits, trading limits and mark-to-market valuations. The Bank also carries out monthly stress tests to ascertain potential losses that could occur in extreme market conditions. An interest rate sensitivity analysis on floating rate borrowings as at 31 December 2020 showed a maximum loss position of ₦9.4 million should there be a 100 basis points increase in interest rates. This level of loss is minimal compared to the Bank's core capital of ₦28 billion. In the event of a 20% naira devaluation, the Bank's sensitivity analysis of the foreign currency statement of financial position showed a ₦567.3 million gain.

Operational Risk

Operational risk is measured, monitored and managed using the Basic Indicator Approach (BIA) and supported by a policy manual which is updated at least once in three years. Similar to the prior year, FSDH did not report any cases of fraud and forgery. In addition, there were no reports of penalties incurred for contravening the CBN's regulations and directives.

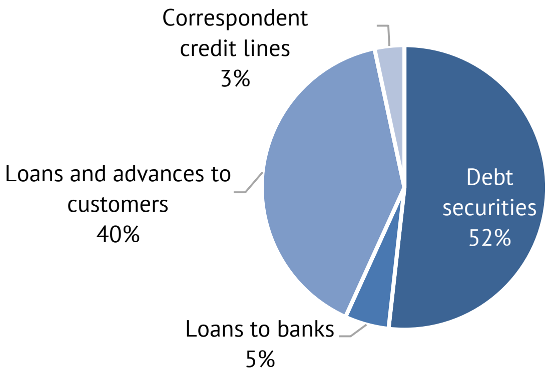
We consider FSDH's risk management framework to be adequate for the current level of business risks undertaken. Given the plan to expand the loan book to relatively high-risk segments, the Bank intends to fortify risk management with the appropriate tools to preserve asset quality. However, with plans to adopt digitalisation in customer onboarding, loan disbursement and other customer services, we expect additional risk measures to curtail operational losses.

EARNINGS

During the financial year ended 31 December 2020, FSDH Merchant Bank Limited recorded gross earnings of ₦16.3 billion, a 21.7% decline from the prior year due to the COVID-19 pandemic and the CBN's heterodox policies. Dividends from the hitherto subsidiaries and earnings from other business activities of the Bank that were divested to the HoldCo that did not reflect in the Bank's figures also contributed to lower gross earnings in the year under review. Fund-based income represented 32.3% (FY 2019: 57.6%) of gross earnings while non-interest income accounted for the remaining 67.7% (FY 2019: 42.4%) in FY 2020.

The Bank's interest income decreased by 36% to ₦10.6 billion in FY 2020, the lowest since 2015, largely due to the prevailing low interest rate environment. The decline was most prominent in the interest income from investment securities which dipped by 40% to ₦5.5 billion and accounted for 52% (FY 2019: 54.7%) of total interest income. The decision of the Bank to suspend loan disbursements in response to uncertainties created by the pandemic also contributed to the lower interest income. As a result, interest income from loans and advances dipped by 30.4% to ₦4.2 billion. Notwithstanding, loans and advances remained one of the primary sources of interest income for the Bank and contributed 39.8% (FY 2019: 36.7%) to total interest income for the year. We anticipate higher interest income in the near term based on the gradual increase in prevailing interest rates and the planned 60% loan growth by the Bank in FY 2021.

Figure 4: Breakdown of Interest Income for FY 2020



During FY 2020, FSDH leveraged the low interest rate environment to moderate interest expense while expanding the funding base. As a result, the Bank's interest expense declined by 38.1% to ₦6.8 billion despite the sustained growth in customer deposits and the larger size of commercial papers issuance. We believe interest expense will increase in FY 2021 based on the expected increase in prevailing interest rates. The coupon on the ₦12 billion fixed-rate bond issued in January 2021, the discount expected from the Bank's maiden foreign currency and local currency commercial papers will also contribute to higher interest expense in the near term.

Overall, FSDH's net interest spread (NIS) improved to 35.6% from the prior year's 33.3% and was the highest since it obtained a merchant banking license in 2012, as the interest expense dipped faster than interest income. FSDH's NIS was higher compared to Coronation MB's 23.5% but lower than FBNQuest's 41.3%. Subsequent to the year-end, in the first quarter of 2021, the Bank's NIS further increased to 53.8%. We expect the growth trajectory in FSDH's NIS to be sustained in FY 2021 as the impact of the anticipated increase in interest income is expected to dampen the higher interest expense expected in the year.

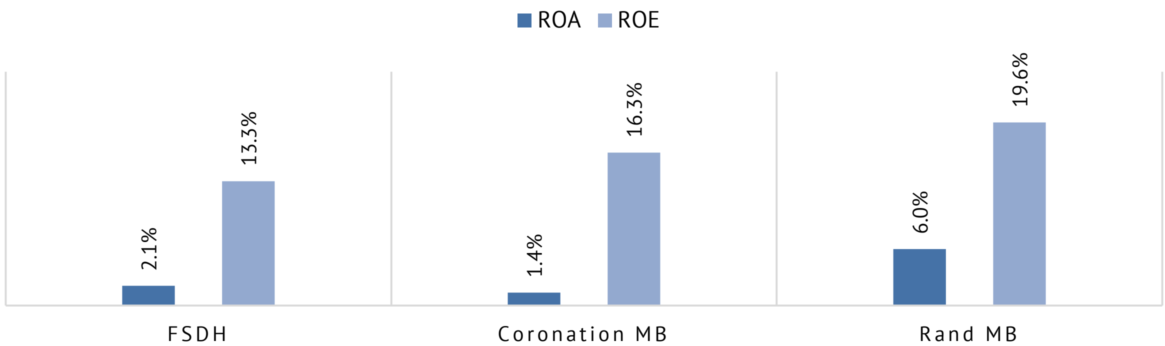
During the year under review, FSDH expensed ₦1 billion as impairment charge, a deterioration from a write-back of ₦400 million recorded in the prior year. In addition to the weak macroeconomic environment, accentuated by the pandemic, the Bank proactively increased provision on the exposure to the challenged obligor in the telecommunication industry. The impairment charge for the year represented 9.7% of interest income while the cost of risk was 2.5%, higher than Coronation MB's 0.2% and FBNQuest's 0.6%. We anticipate a decline in the impairment charge for FY 2021, based on the expected cash inflow from the challenged obligor and barring any unforeseen deterioration in the Bank's largest obligors.

FSDH's non-interest income grew by 32.7% during the year to ₦5.7 billion largely due to volatilities in the fixed income market which propped trading gains from financial instruments significantly by 125.1% to ₦5 billion. The Bank's strong treasury competence also accounted for the 86.6% contribution of trading income to non-interest income, the highest among all sources. However, the CBN's downward review of bank charges, the contraction of the loan book, and the transfer of some businesses and subsidiaries to the HoldCo reduced fees and commission income by 30.3% to ₦484.5 million. Considering the impact of rising interest rates on fixed income pricing, we do not expect substantial growth in ancillary earnings in the near term. To support transactional activities and income, FSDH plans to scale up its digital banking capabilities through the deployment of POS terminals and debit cards. The Bank also expects to launch new investment products in efforts to boost fees.

FSDH's cost-to-income ratio increased to 57% from the prior year's 49.3% as a result of declined earnings during the year. FSDH's CIR was higher than Coronation MB's 51.2% but lower than FBNQuest's 60.1% and the merchant banking average of 50.1%. FSDH's operating expenses to total assets of 3% was also higher than Coronation's 1.5% and lower than FBNQuest's 4%. While we anticipate a marked increase in earnings in the near term, we believe the expected growth in OPEX on digitisation initiatives, anticipated increase in staff numbers and inflationary pressures will keep the Bank's CIR stagnant in FY 2021.

In the financial year ended 31 December 2020, FSDH posted a pre-tax profit of ₦3.6 billion, a 29.7% decline from the prior year. Similarly, profitability ratios were lower with a pre-tax return on average assets (ROA) of 2.1% (FY 2019: 3.3%) and a pre-tax return on average equity (ROE) of 13.3% (FY 2019: 18.5%). FSDH's ROA was better when compared to Coronation MB's 1.4%, but less than FBNQuest's ROA of 2.8%. In terms of ROE, both Coronation MB (16.3%) and FBNQuest (17%) performed better than the Bank. Subsequent to the year-end, in the first three months of 2021, the Bank's profitability indicators declined further with annualised ROA and annualised ROE of 1% and 6.4% respectively. Overall, we believe that the anticipated growth in lending in FY 2021 as well as a foray into the mid-tier companies will translate to higher margins for the Bank in the near term. However, given that the Bank's playing field is largely characterised by loan pricing rigidity, we expect the increase in profitability to be moderate.

Figure 5: Peer Comparison: Profitability Ratios in FY 2020



CAPITAL ADEQUACY

As at 31 December 2020, FSDH's core (tier 1) capital stood at ₦28.1 billion, a moderate 4.8% higher than the prior year and well above the ₦15 billion required for merchant banks. The increase in core capital was backed by the appropriation to non-distributable reserves and the accretion to retained earnings. The core capital funded 16% of the Bank's activities as at FYE 2020. Due to gains on financial assets classified as fair value through other comprehensive income, the Bank's tier 2 capital spiked to ₦2.8 billion from ₦1.6 million in the prior year.

As at FYE 2020, FSDH's capital adequacy ratio (CAR), considering the IFRS 9 transitional arrangement, stood at 31% (FYE 2019: 31.2%). Notwithstanding the increase in tier 2 capital, the Bank's CAR was largely unchanged due to a higher weighting assigned to credit risk (year-on-year). Nevertheless, FSDH's capital adequacy ratio higher than the regulatory minimum of 10% for merchant banks, Coronation MB's 19.9% and FBNQuest's 25.4%.

Subsequent to year-end, in January 2021, FSDH issued a ₦12.1 billion combined bond, in which the first tranche of ₦7.1 billion qualifies as tier 2 capital. In our opinion, FSDH's capitalisation is good for the current level of business risks undertaken.

LIQUIDITY AND LIABILITY GENERATION

FSDH leverages its good brand name developed all through its almost three decades of existence in generating liabilities. In the last two years, the Bank has provided fund collection solutions to corporates and public sector clients. Similarly, FSDH's client investment fund deposit product has provided relatively higher yields to financial institutions and high net worth individuals.

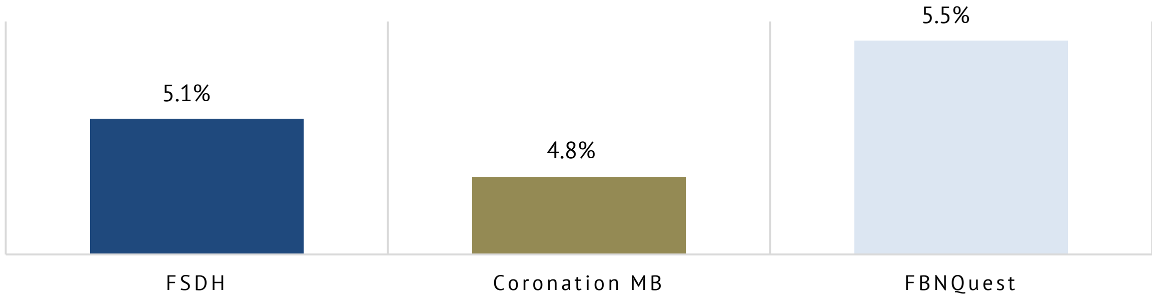
As at 31 December 2020, FSDH's deposit liabilities (excluding interbank takings) stood at ₦80.2 billion, reflecting an 18.8% year-on-year increase. This was backed by a 35.2% marked increase in local currency (LCY) deposits. Notwithstanding prevailing low interest rates during the year, the Bank's low-cost LCY demand deposits grew by 2.3 times to ₦20.2 billion as at FYE 2020, reflecting the success of the fund collection strategy for the year. As a result, the funding mix improved with low-cost LCY deposits accounting for 33% (FY 2019: 14%) of total LCY deposits, higher than 31% posted by Coronation MB. We anticipate an improvement in FSDH's deposit base in the near term as the Bank increases its investment in the digitisation of processes aimed at improving collections and service quality.

During the year under review, FSDH's foreign currency (FCY) deposits rose by 71% to ₦19.2 billion and accounted for 24% of total deposits as at 31 December 2020. The growth in FCY deposits was buoyed by improved products and the offering of competitive rates by the Bank on domiciliary account balances. As at FYE 2020, FSDH's FCY deposits were sufficient to fund the FCY loans 1.2 times; which we consider satisfactory. We expect FCY deposits to grow in the near term, hinged on the Bank's focus on attracting customers with foreign currency earnings.

In addition to deposit liabilities and shareholders' funds, FSDH activities are funded by interbank takings, commercial papers, bonds and borrowings from multilateral financial institutions. During the year under review, interbank takings (comprising secured borrowings from Nigerian banks and trade-related obligations to foreign banks) declined by 29.1% to ₦19.6 billion. Though the associated interest expense also declined by 5.8%, it accounted for a higher 17% of total interest expense (FY 2019: 11.1%), which is below our threshold. The low interest rate environment coupled with the aggressive implementation of the CRR policy by the CBN prompted a 63.6% year-on-year growth in commercial papers with an outstanding balance of ₦23 billion as at FYE 2020. During the year, FSDH paid back its US$50 million line of credit due to African Development Bank (AfDB)) and largely relied on growing FCY deposits to finance the creation of FCY assets. Subsequent to the year end, in January 2021, FSDH raised a ₦12 billion fixed rate 5-year bond in two tranches to further diversity the funding base, lengthen the average maturity profile of available funding and support capitalisation. The Bank also intends to launch its maiden foreign currency commercial papers in FY 2021 to increase the pool of foreign currency funding.

In view of the prevailing low interest rates and the improvement in the deposit mix, FSDH's weighted average cost of fund (WACF) declined to 5.1% in FY 2020, an improvement from 8.1% recorded in the previous year. This was higher than 4.8% recorded by Coronation MB but better than FBNQuest's estimated 5.5%. Subsequent to the year end, in Q1 2021, the Bank's WACF further dipped to 3.6%. We anticipate a gradual increase in the WACF for FY 2021 as prevailing interest rates inflect upwards and the impact of the issued bonds.

Figure 6: Peer Comparison - WACF (FY 2020)



As at 31 December 2020, FSDH's deposits liabilities were not sufficient to fund the loans in most of the maturity buckets. Only deposit liabilities in the 1-3 months maturity bucket were sufficient to fund loans in the corresponding maturity bucket. While the funding mismatch exposes the Bank to potential interest rate risk, especially in a rising interest rate environment, FSDH's large pool of treasury securities and access to the money market, serve as mitigants. The ₦12 billion medium term bond, issued subsequent to the year-end will also improve the maturity profile of funding, albeit to an extent.

During the year under review, FSDH's liquidity ratio increased to 136.3% (FYE 2019: 110%) and remained comfortably above the regulatory minimum of 20% for merchant banks.

Overall, we consider FSDH's ability to refinance to be good upheld by its good brand name and its antecedents of being a conservative institution.

OWNERSHIP, MANAGEMENT & STAFF

FSDH Merchant Bank Limited is a wholly-owned subsidiary of FSDH Holding Company Limited, a non-operating legal entity regulated by the CBN. As at 31 December 2020, shareholders listed in the table below held over 5% equity stake in the HoldCo.

Table 2: Significant Shareholders of FSDH Holding Company Limited as at FYE 2020

Shareholder	Holding
KMC Investments Limited	32.04%
Atlantic Coast Regional Fund	23.25%
United Capital Asset Management Limited	10.8%
FSDH Staff Co-operative	10.4%
International Finance Corporation	6.26%

FSDH was governed by a ten-member Board of Directors as at FYE 2020, chaired by Mr Olufemi Agbaje. The Board comprised three Executive Directors, six Non-Executive Directors and one Independent Non-Executive Director. There were some changes in the Board during the year under review as Mr Vincent Omoike, an Independent Non-Executive Director, resigned in March 2020 while Mr Kelechi Okoro was appointed as a Non-Executive Director in the same month.

Mr Kelechi Okoro is currently a Partner at AFIG Funds, where he leads transaction execution and value-creation teams. Prior to joining AFIG Funds in 2013, Mr Okoro worked at Argentil Capital Partners, the Infrastructure and Natural Resources Group of the International Finance Corporation (IFC) and ARM Investment Managers. He holds a BSc in Human Physiology from the University of Ibadan and a Master's in Business Administration (MBA) from the Lagos Business School.

Subsequent to year-end, in April 2021, Mrs Hamda Ambah – the erstwhile Managing Director – retired after 28 years of service. Thereafter, Mrs Bukola Smith was appointed as Managing Director of the Bank. Mrs Smith was formerly Executive Director, Business Development at First City Monument Bank (FCMB) Limited, where she spent about two decades. She holds a B.Sc. in Economics from the University of Lagos and a Master's in Business Administration (MBA) from Alliance Manchester Business School, Manchester, UK. Mrs Smith is a Fellow, Institute of Chartered Accountants of Nigeria (ICAN) and an Associate Member, Certified Institute of Pensions (Nigeria). Ms Funsho Olusanya, Executive Director, Treasury and International Banking, also resigned from the Bank in April 2021. Agusto & Co. notes the changes in executive management but we do not expect a material aberration from the traditional stance of the Bank in the near term.

During the 2020 financial year, the Bank employed an average of 124 persons (FY 2019: 126 persons), with 78% of the workforce in non-managerial roles, 19% in managerial roles and the remaining 3% in executive management. Due to lower earnings, net earnings per staff declined by 15.7% to ₦68.3 million and covered average covered staff costs 4 times (FY 2019: 4.4 times). This was lower than its peers' FBNQuest's 4.1 times and Coronation MB's 6.5 times. In our opinion, FSDH's staff productivity can be improved upon in tandem with its peers.

MARKET SHARE

As at FYE 2020, FSDH stands as the merchant bank with the least balance sheet footing, with total assets and contingents of ₦175.2 billion, representing a significant decline from the second position in the prior year. This was due to the Bank's conservative stance as a response to the raging pandemic, with resulted in a decline in lending activities. Consequently, this impacted FSDH's share of the merchant banking segment's key indicators. The share of net earnings declined to 15% (FY 2019: 18%) and the market share of profit before tax reduced to 13% (FY 2019: 17%). We believe that with concerted efforts to grow the loan book (a projected 60% growth) and plans to develop structured products and improve digital capabilities, FSDH should be able to recapture market share in the near term.

Figure 7: Market Share of the Merchant Banking Segment as at FYE 2020

	FSDH	Coronation	FBNQuest	Nova	Rand MB
Total Assets & Contingents	13%	36%	16%	19%	16%
LCY deposits	14%	38%	20%	20%	7%
Loans & Advances (Net)	12%	38%	17%	16%	17%
Net Earnings	15%	21%	22%	11%	31%
Profit Before Tax	13%	20%	18%	12%	38%

OUTLOOK

The 2020 financial year was unprecedented, with the COVID-19 pandemic significantly constraining economic activities. This drove the Bank to take a cautious lending approach which resulted in a subpar performance in terms of profitability. However, with economic activities gradually picking up as the pandemic-induced restrictions are eased, the Bank intends to grow its business significantly in the near term. The growth in lending will be focused on Mid-tier companies in agriculture, health care, telecommunications and oil and gas, with considerations for risk-sharing facilities. To support these aspirations, the Bank plans to invest in additional risk management and digital banking capabilities. With the anticipated growth in the customer base, transaction income is expected to improve and also drive cheaper deposits to keep funding costs low.

Overall, Agusto & Co. expects profitability to improve fairly in the near term, upheld by the strong treasury function and the anticipated renewed appetite for lending. We also expect that asset quality should remain acceptable barring any significant impairment from its top obligors. Liquidity and capitalisation should also remain well above expectations. Based on this, we hereby attach a ***stable*** outlook to the rating of FSDH Merchant Bank Limited.

FINANCIAL SUMMARY

FSDH MERCHANT BANK LIMITED

	STATEMENT OF FINANCIAL POSITION AS AT	31-Dec-2020		31-Dec-2019		31-Dec-2018	
		₦'000		₦'000		₦'000	
	ASSETS						
1	Cash & equivalents	2,001,264	1.1%	3,907,089	2.3%	1,324,953	0.9%
2	Government securities	16,018,775	9.1%	61,983,584	35.9%	38,782,026	27.5%
3	Money market placements	4,003,401	2.3%	9,817,413	5.7%	17,057,637	12.1%
4	Quoted investments						
5	Placements with discount houses						
6	LIQUID ASSETS	22,023,440	12.6%	75,708,086	43.8%	57,164,616	40.6%
7	BALANCES WITH NIGERIAN BANKS	397,368	0.2%	263,277	0.2%	657,634	0.5%
8	BALANCES WITH BANKS OUTSIDE NIGERIA	20,484,753	11.7%	4,779,983	2.8%	5,008,095	3.6%
9	Direct loans and advances - Gross	40,314,083	23.0%	46,753,615	27.1%	41,835,627	29.7%
10	Less: Cumulative loan loss provision	(2,241,681)	-1.3%	(1,257,275)	-0.7%	(1,298,769)	-0.9%
11	Direct loans & advances - net	38,072,402	21.7%	45,496,340	26.3%	40,536,858	28.8%
12	Advances under finance leases - net						
13	TOTAL LOANS & LEASES - NET	38,072,402	21.7%	45,496,340	26.3%	40,536,858	28.8%
14	INTEREST RECEIVABLE						
15	OTHER ASSETS	1,167,708	0.7%	776,778	0.4%	852,999	0.6%
16	DEFERRED LOSSES	2,599,335	1.5%	2,888,150	1.7%	3,223,982	2.3%
17	RESTRICTED FUNDS	27,061,559	15.4%	7,210,940	4.2%	4,196,302	3.0%
18	UNCONSOLIDATED SUBSIDIARIES & ASSOCIATES					961,377	0.7%
19	OTHER LONG-TERM INVESTMENTS	46,562,057	26.6%	17,688,428	10.2%	6,219,410	4.4%
20	FIXED ASSETS & INTANGIBLES	1,080,108	0.6%	1,182,087	0.7%	816,632	0.6%
21	**TOTAL ASSETS**	**159,448,730**	**91.0%**	**155,994,069**	**90.3%**	**119,637,905**	**85.0%**
22	TOTAL CONTINGENT ASSETS	15,766,004	9.0%	16,800,880	9.7%	21,177,188	15.0%
23	**TOTAL ASSETS & CONTINGENTS**	**175,214,734**	**100%**	**172,794,949**	**100%**	**140,815,093**	**100%**
	CAPITAL & LIABILITIES						
24	TIER 1 CAPITAL (CORE CAPITAL)	28,045,401	16.0%	26,768,352	15.5%	29,335,557	20.8%
25	TIER 2 CAPITAL	2,768,729	1.6%	1,610	0.0%		
26	Medium to long-term borrowings	23,050,499	13.2%	32,823,321	19.0%	33,250,660	23.6%
27	Demand deposits	20,184,519	11.5%	6,143,173	3.6%	9,269,590	6.6%
28	Savings deposits						
29	Time deposits	40,806,222	23.3%	38,953,042	22.5%	37,449,771	26.6%
30	Inter-bank takings	19,621,072	11.2%	27,684,828	16.0%	4,744,992	3.4%
31	TOTAL DEPOSIT LIABILITIES - LCY	80,611,813	46.0%	72,781,043	42.1%	51,464,353	36.5%
32	Customers' foreign currency balances	19,223,248	11.0%	11,244,221	6.5%		
33	TOTAL DEPOSIT LIABILITIES	99,835,061	57.0%	84,025,264	48.6%	51,464,353	36.5%
34	INTEREST PAYABLE						
35	OTHER LIABILITIES	5,749,040	3.3%	12,375,522	7.2%	5,587,335	4.0%
36	**TOTAL CAPITAL & LIABILITIES**	**159,448,730**	**91.0%**	**155,994,069**	**90.3%**	**119,637,905**	**85.0%**
37	TOTAL CONTINGENT LIABILITIES	15,766,004	9.0%	16,800,880	9.7%	21,177,188	15.0%
38	**TOTAL CAPITAL, LIABILITIES & CONTINGENTS**	**175,214,734**	**100%**	**172,794,949**	**100%**	**140,815,093**	**100%**
	BREAKDOWN OF CONTINGENTS						
39	Acceptances & direct credit substitutes	11,516,711	6.6%	11,060,498	6.4%	21,044,590	14.9%
40	Guarantees, bonds etc..	4,249,293	2.4%	5,740,382	3.3%	132,598	0.1%
41	Short-term self liquidating contingencies						

FSDH MERCHANT BANK LIMITED

	STATEMENT OF COMPREHENSIVE INCOME	31-Dec-2020 N'000		31-Dec-2019 N'000		31-Dec-2018 N'000	
42	Interest income	10,574,103	64.8%	16,495,503	79.2%	15,086,916	81.4%
43	Interest expense	(6,814,365)	-41.8%	(11,009,079)	-52.9%	(10,320,248)	-55.7%
44	Loan loss expense	(1,026,940)	-6.3%	400,568	1.9%	1,396,641	7.5%
45	NET REVENUE FROM FUNDS	2,732,798	16.8%	5,886,992	28.3%	6,163,309	33.3%
46	ALL OTHER INCOME	5,739,632	35.2%	4,326,839	20.8%	3,438,674	18.6%
47	**NET EARNINGS**	**8,472,430**	**51.9%**	**10,213,831**	**49.1%**	**9,601,983**	**51.8%**
48	Staff costs	(2,137,172)	-13.1%	(2,296,859)	-11.0%	(2,193,606)	-11.8%
49	Depreciation expense	(525,159)	-3.2%	(457,990)	-2.2%	(350,696)	-1.9%
50	Other operating expenses	(2,165,035)	-13.3%	(2,276,153)	-10.9%	(1,871,236)	-10.1%
51	TOTAL OPERATING EXPENSES	(4,827,366)	-29.6%	(5,031,002)	-24.2%	(4,415,538)	-23.8%
52	PROFIT (LOSS) BEFORE TAXATION	3,645,064	22.3%	5,182,829	24.9%	5,186,445	28.0%
53	TAX (EXPENSE) BENEFIT	(367,229)	-2.3%	(1,572,426)	-7.6%	(775,053)	-4.2%
54	**PROFIT (LOSS) AFTER TAXATION**	**3,277,835**	**20.1%**	**3,610,403**	**17.3%**	**4,411,392**	**23.8%**
55	NON-RECURRING INCOME (EXPENSE) - NET						
56	PROPOSED DIVIDEND	(2,000,787)	-12.3%	(4,614,343)	-22.2%	(2,207,887)	-11.9%
57	**GROSS EARNINGS**	**16,313,735**	**100%**	**20,822,342**	**100%**	**18,525,590**	**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 margin	35.6%	33.3%	31.6%
61	Loan loss expense/Interest income	9.7%		
62	Return on average assets (Pre - tax)	2.1%	3.3%	3.5%
63	Return on average equity (Pre - tax)	13.3%	18.5%	17.8%
64	Operating Expenses/Net earnings	57.0%	49.3%	46.0%
65	Gross earnings/Total assets & contingents	9.4%	13.3%	12.6%
	EARNINGS MIX			
66	Net revenue from funds	32.3%	57.6%	64.2%
67	All other income	67.7%	42.4%	35.8%
	LIQUIDITY			
68	Total loans & leases - net/Total lcy deposits	68.1%	51.7%	37.3%
69	Liquid assets/Total lcy deposits*	36.8%	168.5%	123.8%
70	Demand deposits/Total lcy deposits	25.0%	8.4%	18.0%
71	Savings deposits/Total lcy deposits			
72	Time deposits/Total lcy deposits	50.6%	53.5%	72.8%
73	Inter-bank borrowings/Total lcy deposits	24.3%	38.0%	9.2%
74	Interest expense - banks/Interest expense	16.9%	11.1%	12.1%
75	**NET FOREIGN CURRENCY ASSETS (LIABILITIES)**	1,261,505	(6,464,238)	5,008,095

**Liquid assets adjusted for inter-bank takings*

FSDH MERCHANT BANK LIMITED

	KEY RATIOS CONT'D	31-Dec-2020	31-Dec-2019	31-Dec-2018
	ASSET QUALITY			
76	Performing loans (N'000)	38,038,545	44,512,784	39,601,393
77	Non-performing loans (N'000)	2,275,538	2,240,831	2,234,234
78	Non-performing loans/Total loans - Gross	5.6%	4.8%	5.3%
79	Loan loss provision/Total loans - Gross	5.6%	2.7%	3.1%
80	Loan loss provision/Non-performing loans	2137.6%		
81	Risk-weighted assets/Total assets & contingents	32.4%	35.0%	46.0%
	CAPITAL ADEQUACY			
82	Adjusted capital/risk weighted assets	49.0%	38.8%	38.5%
83	Tier 1 capital/Adjusted capital	90%	100%	104%
84	Total loans - net/Adjusted capital	1.37	1.94	1.63
85	Capital unimpaired by losses (N'000)	25,446,066	23,880,202	26,111,575
	CAPITAL ADEQUACY STRESS TEST			
86	Total shareholders' funds (N'000)	27,790,842	23,456,183	24,937,610
87	Cumulative loan loss provision (actual reserves)	2,241,681	1,257,275	1,298,769
88	Equity before all provision (line 86 + line 87)	30,032,523	24,713,458	26,236,379
89	Required reserves*	8,036,504	8,229,524	8,648,136
90	Equity after required reserves (line 88 - line 89)	23,071,736	17,559,651	18,663,960
86	Equity after required reserves/risk weighted assets	40.6%	29.0%	28.8%
	STAFF INFORMATION			
87	Net earnings per staff (N'000)	68,326	81,062	71,657
88	Staff cost per employee (N'000)	17,235	18,229	16,370
89	Staff costs/Operating expenses	44.3%	45.7%	49.7%
90	Average number of employees	124	126	134
91	Average staff per branch	41	42	45
	OTHER KEY INFORMATION			
92	Legal lending limit(N'000)	12,723,033	11,940,101	13,055,788
93	Number of branches	3	3	3
94	Age (in years)	28	27	26
95	Government stake in equity (Indirect)	Nil	Nil	Nil
		Estimate	**Actual**	**Actual**
	MARKET SHARE OF INDUSTRY TOTAL	2020	2019	2018
96	Lcy deposits (excluding interbank takings)	0.28%	0.23%	0.29%
97	Total assets & contingents	0.34%	0.39%	0.37%
98	Total loans & leases - net	0.22%	0.29%	0.32%
99	Net earnings	0.32%	0.38%	0.42%
100	Profit before tax	0.47%	0.56%	0.67%
101	Cash dividend	0.92%	2.42%	0.79%

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.

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.

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