

FSDH Funding SPV Plc

Series I up to ₦20 billion combined 5-year fixed rate subordinated unsecured bond (Tranche A) and 5-year fixed rate senior unsecured bond (Tranche B) under the ₦30 billion Debt Issuance Programme

Final Rating Report

 **Agusto&Co.**

Research, Credit Ratings, Credit Risk Management

Series I up to ₦20 billion combined 5-year Fixed rate subordinated unsecured bond (Tranche A) and 5-year Fixed rate senior unsecured bond (Tranche B).

FSDH Funding SPV Plc

Series I up to ₦20 billion combined 5-year fixed rate subordinated unsecured bond (Tranche A) and 5-year fixed rate senior unsecured bond (Tranche B) under the ₦30 billion Debt Issuance Programme

Tranche 'A' Rating: **A-**

Tranche 'B' Rating: **A**

Outlook: Stable

Issue Date: 4 December 2020

Expiry Date: 4 December 2021

Bond Tenors: Tranche A: 5 years
Tranche B: 5 years

Previous Ratings: N/A

The rating is valid throughout the life of the instruments but will be subject to periodic monitoring and annual review.

Industry: Banking

Analysts:

Ada Ufomadu

adaufomadu@agusto.com

Ayokunle Olubunmi, CFA

ayokunleolubunmi@agusto.com

Agusto & Co. Limited

UBA House (5th Floor)

57, Marina

Lagos

Nigeria

www.agusto.com

RATING RATIONALE

Agusto & Co. assigns a 'A-' rating to the Series I 5-year subordinated bond ('Tranche A') and a 'A' rating to the Series I 5-year senior unsecured bond ('Tranche B') of FSDH Funding SPV Plc ('the Issuer' or 'the SPV'). The combined issue of ₦20 billion ('the Issue') is the first series of a ₦30 billion debt issuance programme ('the Programme') registered with the Securities and Exchange Commission (SEC) in 2020. The Issue is backed by FSDH Merchant Bank Limited ('FSDH' or 'the Sponsor' or 'the Bank') which guarantees all obligations of the Issuer under the Programme. The rating assigned to Tranche A is a notch lower than the Sponsor's stand-alone rating of 'A' by Agusto & Co., given its subordinated status, while the rating assigned to Tranche B reflects its seniority ranking to other unsecured obligations of the Bank. The Sponsor's rating is hinged on its position as the second-largest merchant bank in Nigeria by asset size, a strong liquidity profile and good capitalisation ratios. However, the rating is constrained by concentration risk in the loan book and funding base that threaten asset quality and funding costs respectively. The COVID-19 pandemic has also accentuated credit risks in the lending landscape and this is a rating concern.

The Sponsor's loan portfolio contracted by 17.9% to ₦38.4 billion as at 30 September 2020 and an impaired loan ratio of 5.8% was recorded at the same date, up from 4.8% as at FYE2019. At this level, FSDH's NPL ratio was above the regulatory threshold of 5%. Nonetheless, we note positively the Sponsor's proactive classification of a major syndicated loan in the telecommunications industry (which accounted for 99% of impaired loans), given that most banks in the syndicate have not done so. While we do not envisage a significant increase in impaired loans in the short term on account of the regulatory forbearance, which propelled the restructuring of approximately 43% of the loan book as at 30 September 2020, we believe that the Sponsor's asset quality remains vulnerable to the weak macroeconomic climate and the concentration in the loan book.

FSDH's Basel II capital adequacy ratio (CAR) declined to 21% as at 30 September 2020 (FYE2019: 30%) despite the contraction in risk assets, because of a reduction in cash backed loans. Nonetheless, the Sponsor's CAR remained well above the regulatory minimum of 10% for a merchant bank and is expected to further strengthen subsequent to a successful proposed bond issue in the short term.

In the 2019 financial year, FSDH's profit before tax amounted to ₦5.2 billion, at par with the prior year. This translated to a pre-tax return on average assets (ROA) and pre-tax return on equity (ROE) of 3.3% (FY 2018: 3.5%) and 18.5% (FY 2018: 17.8%) respectively. Subsequent to year end, the Sponsor's pre-tax profits declined to ₦2.5 billion in Q3, 2020 (Q3, 2019: ₦3.9 billion) due to lower asset yields, aggressive cash reserves (CRR) debits and increased impairment charges. Thus, annualised pre-tax return on average assets (ROA) and annualised pre-tax return on average equity (ROE) both weakened to 1.8% (Q3, 2019: 3.6%) and 12% (Q3, 2019: 18.6%) respectively. We consider the Sponsor's profitability to be satisfactory.

FSDH continues to maintain a strong liquidity profile despite the aggressive CRR debits by the CBN. As at 30 September 2020, liquid assets as a percentage of total LCY deposits stood at 84.2%, well above the regulatory liquidity ratio of 20% prescribed by the CBN for merchant banks.

In the short term, we expect the FSDH's asset quality to be preserved by the regulatory forbearance. However, we believe the Bank's performance will be adversely impacted by regulatory costs and the lingering pandemic. Based on the aforementioned, we attach a '*stable*' outlook to the ratings assigned to Tranche A and Tranche B of the Issue.

2020 Series I up to ₦20 billion combined 5-year Fixed rate subordinated unsecured bond (Tranche A) and 5-year Fixed rate senior unsecured bond (Tranche B).

Strengths

- Good capitalisation ratios
- Membership of the FSDH Holding Company which strengthens synergies with other subsidiaries
- Strong liquidity profile despite increased regulatory CRR debits
- An experienced management team

Weaknesses

- Sector and obligor concentration in the loan book
- Concentration in the funding base

Challenges

- COVID-19 and the impact on the Nigerian economy and businesses
- Regulatory constraints
- Dependence on rate sensitive deposits

Table 1: Background Information

	31 December 2018 (12 Months)	31 December 2019 (12 Months)	30 September 2020** (9 Months)
Total Assets & Contingents	₦140.8 billion	₦172.8 billion	₦197.1 billion
Local Currency Deposits (excluding interbank takings)	₦46.7 billion	₦56.3 billion	₦87.8 billion
Net Earnings	₦9.6 billion	₦10.2 billion	₦6.1 billion
Pre-tax Return on Average Assets & Contingents (ROA)	3.5%	3.3%	1.8%*
Pre-tax Return on Average Equity (ROE)	17.8%	18.5%	12.0%*

*Annualised.

**Unaudited

THE NIGERIAN BANKING INDUSTRY

The Nigerian banking industry is a ₦46 trillion¹ asset-based (including contingent) industry. The Industry is controlled by the top five banks which held approximately 60% of the Industry's total assets and contingents, 62% of local currency deposits and 67% of pre-tax profits as at 31 December 2019. As at the same date, the banking industry comprised 29 deposit money banks (DMBs), 22 of which were commercial banks, five merchant banks and two non-interest banks. Subsequent to the end of the 2019 financial year, the Central Bank of Nigeria (CBN) granted a merchant banking license to a new operator in September 2020, bringing the total number of merchant banks in Nigeria to six and further expanding the entire banking industry operator base to thirty deposit money banks as at 30 November 2020.

The 2020 financial year has been characterised by the impact of the novel coronavirus outbreak on the global macroeconomic environment and subsequent regulatory and policy responses. The COVID-19 pandemic has had far-reaching effects on the Nigerian economy given the country's reliance on crude oil and its import-dependent status. In the third quarter of 2020, Nigeria's economy contracted by 3.6% year-on-year, following a 6.1% contraction in the prior quarter (Q2, 2020). This implies that the economy is technically in a recession. To manage the impact of the pandemic, the CBN implemented various heterodox monetary policies to increase access to cheap credits, while ensuring price and foreign exchange stability. Thus, the banking industry's prime lending rate declined to 11.3% in October 2020 from 15% in January 2020. In addition, yields on government securities also fell to an average of 0.9% in October 2020 from 3.5% in January 2020 as part of measures to channel banks' lending to the private sector. With an increase in money supply, the CBN adopts an aggressive stance on cash reserve requirements (CRR), with discretionary random debits on Industry operators which impacts negatively on liquidity and lending capacity. The Industry's non-performing loans ratio has remained relatively stable despite the weak macroeconomic environment because of the regulatory forbearance extended by CBN to businesses that were worst hit by the pandemic. However, impairment charges continue to rise to reflect the weak operating environment.

In 2020, the merchant banking space has been particularly affected by an increase in CRR to 27.5% from 2% effected in January 2020 and the discretionary debits. Given their relatively small size, the ability of merchant banks to lend is further stifled by the CRR debits. However, the flexibility of the merchant banking license continues to support its operators' income through other income-generating activities in the debt capital market, advisory services and investment management. In addition, the lower interest rate environment favours the Industry's cost of funding and securities trading income. Operators are also taking advantage of the low interest rate environment to raise medium to long term bonds to refinance costly liabilities and provide additional capital buffer. Being a soft currency zone, a devaluation of the domestic currency would typically translate to revaluation gains for banks that are well-positioned in terms of their foreign currency balance sheet.

¹ Approximately \$122 billion @ ₦380/\$

2020 Series I up to ¥20 billion combined 5-year Fixed rate subordinated unsecured bond (Tranche A) and 5-year Fixed rate senior unsecured bond (Tranche B).

The merchant bank segment and the banking industry as a whole remain resilient, supported by improved risk management oversight, digital banking channels and a growing balance sheet. We expect this tenacity to persist in the short term.

PROFILE

The Issuer

FSDH Funding SPV Plc (“the Issuer”) was incorporated in Nigeria on 13 June 2013 as a public limited company under the name of FSDH Funding SPV Plc. The Issuer which has no subsidiaries or affiliates has been established as a Special Purpose Vehicle (SPV) to issue securities to fund working capital, enhance the liquidity profile and capital base of FSDH Merchant Bank Limited (“the Sponsor” or “FSDH” or “the Bank”). The principal objective of the Issuer is amongst other things, to raise money for the Sponsor and other companies within the FSDH group of companies through the issuance of bonds, debenture, debenture stock, other securities or perpetual annuities and to purchase Notes from FSDH Merchant Bank Limited. Neither the Sponsor nor any company within the FSDH Group holds directly or indirectly any equity stake in the Issuer.

In 2013, the Issuer established a ₦100 Billion Bond Issuance Programme on behalf of the Sponsor, following which ₦5.53 billion was raised through a Series 1 Bond Issue. The Bond Issuance Programme expired on October 25, 2015 (two years from the signing of the shelf prospectus) and the ₦5.53 billion Series 1 Bond was paid subsequently.

The Sponsor

FSDH Merchant Bank Limited was incorporated in June 1992 as First Securities Discount House Limited and commenced operations in July 1992. The Central Bank of Nigeria (CBN) approved the conversion from a discount house to a merchant bank in November 2012, following a review of the structure of the banking industry in 2010. FSDH became the first merchant bank to be licensed under the new banking industry structure. Consequently, the entity’s name was changed to FSDH Merchant Bank Limited and the Bank commenced operations as a merchant bank in January 2013.

In 2019, there was a business restructuring within the FSDH Group which resulted in the adoption of a holding company model. FSDH Holding Company Limited was set up as a non-operating legal entity domiciled in Nigeria and regulated by the Central Bank of Nigeria (CBN). FSDH Merchant Bank Limited transferred its ownership stake in its subsidiaries to the Holding Company and became a wholly-owned subsidiary of FSDH Holding Company Limited. Other subsidiaries under FSDH Holding Company Limited are FSDH Asset Management Limited, Pensions Alliance Limited and FSDH Capital Limited.

FSDH Merchant Bank Limited is currently one of the six merchant banks operating in Nigeria. The Bank’s services involve 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 has three offices in Lagos, Abuja and Port Harcourt with the Head office situated at UAC House (5th -8th Floors), 1/5 Odunlami Street, Lagos Island, Lagos.

THE ISSUE

The Issue (or ‘the Bond’) represents the first series of a ₦30 billion Debt Issuance Programme registered with the Securities and Exchange Commission (SEC) in 2020 and it is split into two tranches (A and B). The aggregate principal amount of the Issue is “up to ₦20 billion” while the offer received from investors will determine the ultimate size of each tranche. Tranche A of the Bond is a direct, unsecured and subordinated obligation of the Issuer and the net proceeds will, if certified by the Central Bank of Nigeria (CBN), form part of the Issuer’s tier II capital. Tranche A will rank *pari passu* and without any preference among themselves and at least *pari passu* with the claims of all holders of both present and future unsecured subordinated obligations of the Issuer. Tranche B of the Issue represents an unsecured senior obligation of the Issuer and ranks *pari passu* and without any preference among themselves, and at least *pari passu* with all other unsecured senior obligations of the Issuer, present and future.

The principal amount of the Issue shall be repaid at par together with any outstanding interest accrued thereon as a single and complete repayment on the maturity date or the declaration and subsistence of an event of default, or on such earlier date as the Trustees declare the Bond to have become immediately payable. The tranches of the Issue are repayable in full in 2025, five years from the issue date. Interest on the Bond shall accrue from day to day on the principal amount at the rate (to be determined) per annum payable semi-annually in arrears until the Issue has been fully redeemed by the Issuer under the terms of the Trust Deed.

Purpose of the Issue

The net proceeds of the Issue will be used to fund growth in the Issuer’s credit risk assets and shore up capital in line with the Bank’s Internal Capital Adequacy Assessment Process (ICAAP) strategy to raise capital in response to certain macroeconomic triggers. In addition, the net proceeds of the Issue will be used to close long term funding gaps in the Sponsor’s balance sheet.

Source of Repayment

Repayments comprising coupon (in arrears) and principal relating to the Issue will be redeemed from the Issuer’s operating cash flows. FSDH Merchant Bank Limited has been assigned an “A” rating by Agusto & Co. Limited which expires in June 2021, subject to annual reviews. The rating assigned to the Issuer is reflective of a financial institution with a good financial condition and strong capacity to meet its obligations as and when they fall due.

Trustees to the Issue

ARM Trustees Limited has been appointed as the Trustee for the holders of the Issue. The Trustee will maintain the bond payment account and ensure that compliance with terms of the Trust Deed and debt service obligations are met. ARM Trustees Limited is a wholly-owned subsidiary of ARM Traditional Asset Management Company Limited and registered with SEC. ARM Trustees Limited in almost two decades of existence offers a bouquet of services including private trust, estate planning and commercial trust services. The registered office is located at 1, Mekunwen Road, Off Onikan Abayomi Drive, Ikoyi, Lagos.

In line with the Trustee Investment Act of 1962, trust assets held are duly separated from the accounts of the Trustees

2020 Series I up to ₹20 billion combined 5-year Fixed rate subordinated unsecured bond (Tranche A) and 5-year Fixed rate senior unsecured bond (Tranche B).

such that trust continues to exist if the Trustee goes into liquidation. The Securities and Exchange Commission is also empowered to periodically monitor the activities of ARM Trustees Limited, hence providing an independent check on these entities.

AN OVERVIEW OF SPONSOR'S FINANCIAL CONDITION

Growing asset base and acceptable asset quality

As at 30 September 2020, FSDH's total assets and contingents stood at ₦197.1 billion, 14.1% higher than FYE2019's position, reflecting a larger customer deposit base and an enlarged capital base. However, the Sponsor's loan portfolio contracted to ₦38.4 billion (FYE2019: ₦46.8 billion) on account of the weak operating environment elicited by the COVID-19 pandemic and an associated waned appetite for loan growth. Thus, a significant portion of the recorded growth in total assets as at 30 September 2020 was reflected in restricted funds with the Central Bank of Nigeria which spiked to ₦42.3 billion as at Q3, 2020 from ₦7.2 billion as at 31 December 2019. Contributing to this spike was an upward review of the mandatory cash reserve requirements for merchant banks from 2% to 27.5% in January 2020 and additional discretionary CRR debits, targeted at withdrawing excess liquidity from the financial system. Thus, mandatory cash reserves accounted for 21.5% of FSDH's total assets and contingents as at 30 September 2020, compared to 4.2% as at 31 December 2019. These mandatory cash reserves are largely non-earning assets further impeding the performance of the Bank in the period.

The shrinkage in FSDH's gross loans and advances intensified sector and obligor concentration, evidenced by a 43% allocation to the oil and gas sector as at 30 September 2020, up from 38.8% as at FYE2019 and higher than the Industry average of 30%. The Sponsor's single largest obligor (in the oil and gas sector) accounted for 37.8% of shareholders' funds unimpaired by losses as at the same date. While FSDH's single obligor limit (SOL) is lower than the regulatory maximum of 50% for merchant banks, we believe that the existing concentration increases the Sponsor's susceptibility to the performance of the obligor. Our concerns are justified by the non-investment grade rating of the obligor, foreign currency denomination of the exposure and volatilities in the oil and gas market. Nonetheless, we note positively, that the obligor recently commenced the extraction of crude oil from its mining field and this is expected to improve its repayment capacity in the near term.

Figure 1: Loan book as at 31 December 2019

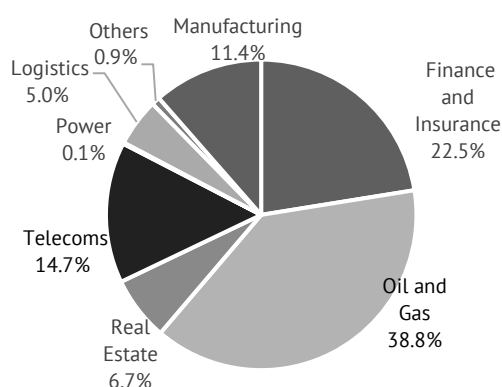
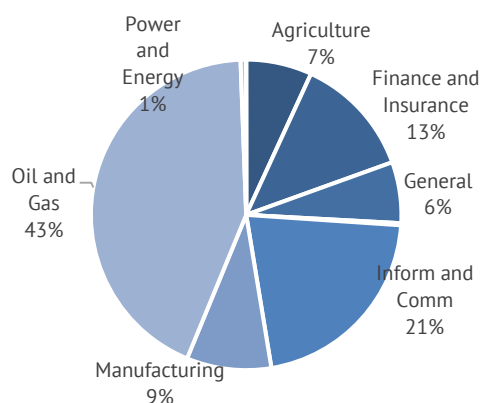


Figure 2: Loan book as at 30 September 2020



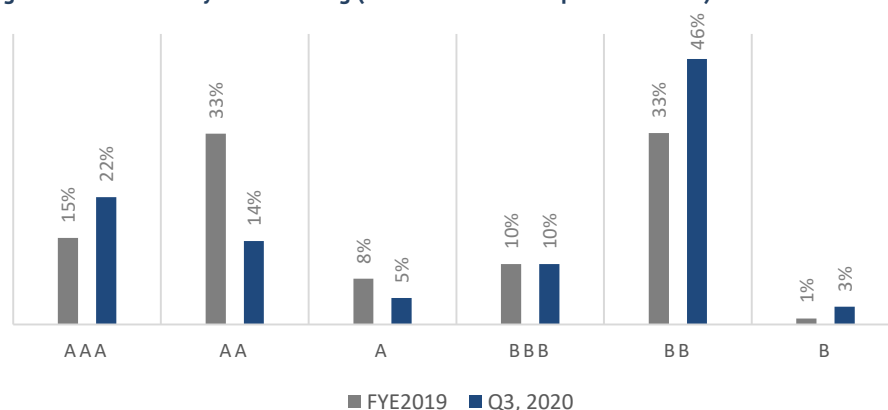
Approximately 46% of the Bank’s gross loans was foreign currency denominated as at 30 September 2020, lower than 58% as at 31 December 2019, despite the 6.5% currency devaluation that occurred during the year between March and October 2020. This was largely due to repayments and a waned appetite for foreign currency loan growth.

As at 30 September 2020, FSDH Merchant Bank Limited had restructured 43% of its loans in line with the CBN’s forbearance policy due to the impact of the COVID-19 pandemic on businesses and households. Stage 1 loans accounted for 94.2% of total loans as at Q3, 2020 (FYE2019: 95.2%), while stage 3 loans as a percentage of total loans rose to 5.8% from 4.8% as at FYE 2019. The Bank had no stage 2 loans. We recognise that the increase in the Sponsor’s impaired loan ratio was driven by the decline in the loan book as the absolute value of delinquent loans declined marginally compared to FYE2019. The Sponsor’s NPL ratio was higher than its merchant banking peer, Coronation Merchant Bank Limited (CoronationMB) which reported a nil impaired loan ratio as at 30 September 2020 and the regulatory threshold of 5% as prescribed by the CBN. We recognise that FSDH has been proactive in classifying a loan that accounts for 99% of its stage 3 loans, as most banks in the syndication did not do so.

During the period under review, FSDH fully provided for its major stage 3 loan - a syndicated credit to a telecommunication company which the Sponsor had proactively classified. Thus, cumulative loan loss provisions increased by 88.2% and translated to a coverage ratio of 106.4% (FYE2019: 56.1%) excluding regulatory risk reserves as at 30 September 2020.

Rating migrations of obligors in the Sponsor’s loan portfolio as at 30 September 2020 reflect the weak macroeconomic environment. According to FSDH’s internal scoring model, non-investment grade names accounted for a higher 49% of gross loans and advances as at 30 September 2020 compared to 34% as at 31 December 2019. Although the CBN permits banks to restructure loans that have been negatively impacted by the pandemic, we envisage more strain on asset quality in the medium term, particularly with the lingering pandemic.

Figure 3: Loan Book by Credit Rating (FYE2019 and 30 September 2020)



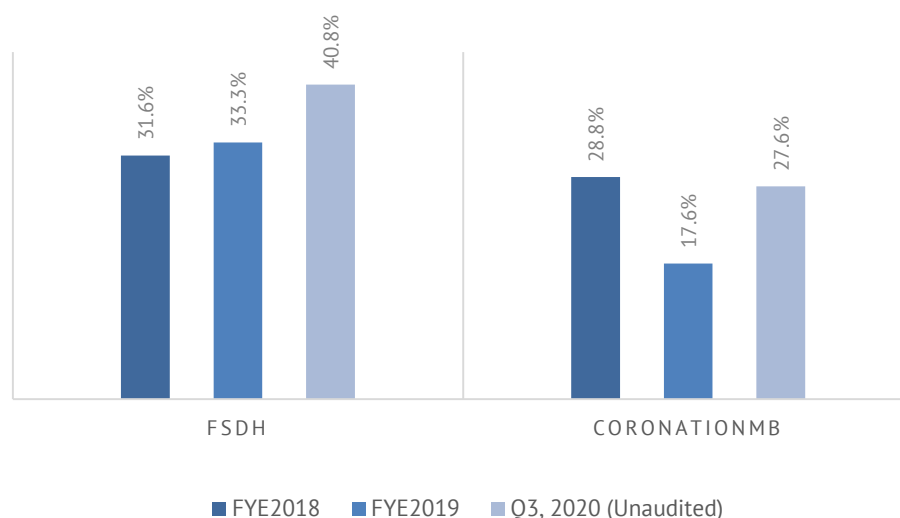
Nonetheless, we consider the Sponsor’s asset quality to be acceptable and we expect this narrative to remain in the short term. FSDH intends to close the 2020 financial year with an estimated 10% growth of the loan book in Q4, 2020, which we consider plausible. The Bank continues to maintain a loans-to-deposits ratio (LDR)

above the 65% regulatory minimum, recording 74.5% as at 30 September 2020. Going into 2021, the proposed bond issuance, if successful, will be used to ramp up the loan portfolio, targeting the fast-moving consumer goods (FMCG), healthcare and agro-allied value chain obligors.

Profitability subdued by a weak macroeconomic climate and lower asset yields

In the first three quarters ended 30 September 2020, the Sponsor's profitability was pressured by lower asset yields, higher impairment charges and technology-driven costs. Thus, net earnings declined by 18.1% year-on-year to ₦6.1 billion. Specifically, interest income fell by 23% due to the lower interest rate environment and a smaller loan portfolio. The 486.3% spike in cash reserves also moderated the Bank's ability to lend and increased the volume of non-earning assets. Nonetheless, the Sponsor's net interest spread (NIS) strengthened by 940 basis points to 40.8%, the highest in the history of the Bank. This feat was achieved on the back of a drop in funding costs (a 33.6% decline in interest expense) elicited by CBN's expansionary monetary policy stance and unorthodox liquidity management policies.

Figure 4: Net Interest Spread (Peer Comparison)



The weak macroeconomic environment and additional provisions made during the year translated to an uptick in impairment charges to ₦1.5 billion, compared to a write-back of ₦30.2 million recorded in Q3, 2019. Thus, FSDH's cost-of-risk rose to 3.9% and was the highest since the 2016/17 recession period. The Bank's cost of risk was also higher than CoronationMB's 0.1% for the same period. We anticipate an increase in impairment charges in the short term given the fragile macroeconomic environment.

FSDH Merchant Bank Limited's non-interest income grew by a marginal 5.7% to ₦3.6 billion in Q3, 2020 compared to the corresponding period in 2019. A considerable portion of the growth in non-interest income originated from the decline in yields on government securities which created opportunities to grow trading income by 61.8% year-on-year. Thus, non-interest income accounted for a higher 59.6% of net earnings

compared to 46.2% in Q3, 2019. We note positively the Bank's securities trading expertise garnered over its years as a discount house, which continues to support its bottom line as a merchant bank. We expect the Sponsor's ancillary income to uphold earnings in the short term given the adverse impact of the macroeconomic and regulatory environment on the banking industry's fund-based income.

Higher Cost to Income Ratio caused by high-cost profile and lower earnings

Despite inflationary pressures in 2020, the Sponsor's operating expenses (OPEX) grew by a marginal 3.3% compared to the corresponding period in 2019. We recognise cost savings from efficiencies occasioned by the pandemic as reflected in lower administration expenses. However, the Sponsor's operating expenses as a percentage of total assets and contingents at 1.8% in Q3, 2020 was twice that of CoronationMB (0.9%) in the same period. This is as a result of the Bank's Information and Technology (IT) related costs emanating from its digitisation drive, which includes a change in its core banking application. Coupled with lower net earnings, FSDH's cost-to-income ratio (CIR) rose to 59.4% in Q3, 2020, from 47.1% in Q3, 2019 and compared less favourably with its peer, CoronationMB: 53.1% in the same period. We expect the Bank's operating expenses to remain elevated on account of its continued digitisation drive and inflationary pressures.

Overall, FSDH's pre-tax profits amounted to ₦2.5 billion in the nine months ended 30 September 2020 (Q3, 2019: ₦3.9 billion) and resulted in an annualised pre-tax return on average assets (ROA) of 1.8% (Q3, 2019: 3.6%) and an annualised pre-tax return on average equity (ROE) of 12.0% (Q3, 2019: 18.6%). CoronationMB recorded a higher ROE of 14.2% in the same period. In our opinion, the Sponsor's profitability is satisfactory; notwithstanding, we believe that FSDH Merchant Bank Limited has adequate capacity to meet its obligations to bondholders in the short term.

Sufficient Capitalisation Ratios

As at 30 September 2020, the Sponsor's core (tier 1) capital stood at ₦28.1 billion, 5.1% higher than FYE2019's position. Growth was predominantly driven by the retention of earnings recorded during the period. However, FSDH's capital adequacy ratio (CAR) computed by Basel II standards, declined by 900 basis points to 21% on account of a reduction in the quality of collateral covers on its loans. Notwithstanding, the Bank's CAR remained higher than the regulatory minimum of 10% for merchant banks.

We consider the Sponsor's capitalisation ratios to be sufficient for its risk profile. In the short term, we expect the Bank's capitalisation ratios to be further strengthened by the issuance of Tranche A of the proposed bond which will qualify as tier II capital following necessary regulatory approvals. We estimate between 500 and 900 basis points increase in the Sponsor's CAR after the successful issuance of the proposed subordinated bond.

Good liability generation capacity; strong liquidity profile

Given regulatory constraints in generating deposit liabilities as a merchant bank, FSDH deploys other avenues to grow relatively cheaper funding for its lending activities. Within the FSDH Holding Company is an asset management subsidiary which is the retail hub for generating low-cost funds from high net worth individuals. In addition, FSDH has built relationships with large corporates where it generates deposits and acts as a collection bank. Worthy of note was FSDH's appointment as a collection bank for the Lagos State Government

in 2020 after securing the mandate for custom duties collection in October 2019. Supporting these initiatives is the adoption of digital platforms as the Bank launched its internet banking platform in 2019. FSDH's activities are also partly funded by Commercial Papers (CPs) which provide short term funding at prevailing market rates.

As at 30 September 2020, FSDH's customer deposits (excluding interbank takings) stood at ₦87.8 billion, up by 56% over FYE2019's position. The Bank's customer deposits were largely local currency (LCY) denominated which accounted for 80.9% (FYE 2019: 80%) of total deposits as at 30 September 2020. A further assessment of the deposits mix showed a stronger dominance of tenured deposits that represented 81.5% (FYE2019: 66.4%) of total deposits while 18.5% (FYE2019: 33.6%) was in low-cost current accounts. In Q3, 2020, significant levels of growths were observed across all deposit types which we view positively. However, the Sponsor's customer deposits remain largely skewed to tenured funds (predominantly from Pension Fund Administrators) which are rate sensitive and unstable. Notwithstanding, the Sponsor's weighted average cost of funds (WACF) moderated considerably to 3.8% in Q3, 2020 (FYE2019: 8.6%), and was lower than CornationMB's WACF of 5.4% in the same period.

FSDH maintains a strong liquidity profile despite the aggressive CRR debits by the CBN. As at 30 September 2020, liquid assets as a percentage of total LCY deposits stood at 84.2%, well above the regulatory liquidity ratio of 20% prescribed by the CBN for merchant banks. We consider FSDH's refinancing capacity to be good, as evidenced by the successful issuances of commercial papers in February and October 2020 where the Bank raised and refinanced up to ₦23 billion respectively.

OWNERSHIP, MANAGEMENT & STAFF

FSDH Merchant Bank is a wholly-owned subsidiary of FSDH Holding Company Limited, a non-operating entity that provides various financial services in Nigeria. As at 30 September 2020, the following shareholders held more than 5% of the holding company's equity stake: 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 is governed by a nine member Board of Directors comprising three Executive Directors, five Non-Executive Directors and an Independent Non-Executive Director. Mr Olufemi Agbaje is the Chairman of the Bank's Board of Directors while Mrs Hamda Ambah is the Managing Director and Chief Executive Officer. She is supported by a management team that includes two Executive Directors – Ms Olufunsho Olusanya and Mr Taiwo Oti.

In March 2020, Mr Vincent Omoike resigned from the Board of Directors and Mr Kelechi Okoro was appointed in his stead, effective 18 March 2020. Mr Kelechi Okoro is 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. He also worked with the Infrastructure and Natural Resources Group of the International Finance

Corporation (IFC) and at ARM Investment managers. He holds a B.Sc. in human psychology from the University of Ibadan. He also has an MBA Degree from the Lagos Business School.

As at 30 September 2020, the Sponsor's staff strength stood at 119 persons, lower than 126 persons as at FYE2019 and comprised 9% senior management staff, 20% middle management staff and 71% non-management staff. Staff productivity, measured as net earnings per staff (annualised) declined by 16.2% to ₦67.9 million due to lower earnings during the period. Net earnings per staff was sufficient to cover staff costs per employee 3.8 times (FY 2019 4.5 times) which we consider satisfactory though this was lower than the coverage recorded by Coronation MB (6.2 times) and the banking Industry average coverage of 4.6 times.

We consider FSDH's management team to be experienced and staff productivity to be satisfactory.

MARKET SHARE

The merchant banking segment ('the segment') of the Nigerian banking industry, remains a negligible contributor to the banking industry's resources. While considerable growth has been recorded over the years, merchant banks accounts for less than 2% of the banking industry's total assets and contingents. We believe that the relatively small size of the segment is caused by its wholesale banking focus and regulatory restrictions on permissible customer deposits volumes which can not be less than ₦50 million per tranche, thus preventing access to retail funds.

Although FSDH controlled a negligible 0.39% of the banking industry's total assets and contingents and 0.42%² of the industry's profits as at 30 September 2020, the Sponsor held an estimated 19% of the segment's total assets and contingents, making it the second-largest merchant bank in Nigeria. As at the same date, FSDH's market share of the segment's net loans and advances was estimated at 19% while the Bank controlled 17% of the segment's pre-tax profits.

We consider FSDH's market position in the merchant banking segment to be good. We expect an improvement in the near term with successful bond issuance and as the Bank leverages its affiliates in the holding company to grow its business.

OUTLOOK

In the short term, FSDH Merchant Bank Limited's performance will be shaped by the lingering COVID-19 pandemic, the regulatory environment and its proposed bond issuance that is expected to help the Bank exploit emerging opportunities. FSDH's loan portfolio is expected to shrink in 2020 *vis-a-vis* 2019; however, an estimated 53% rise in net loans is projected for 2021. In line with the Sponsor's projections, pre-tax profit is expected to also pick up in 2021, with an estimated growth rate of 11% on the back of a larger earning asset base (following a successful bond issue) and the Bank's fixed income trading activities. While we consider the

² Annualised

Sponsor's projections to be plausible, coming from a relatively small base, the containment of the coronavirus spread remains a determining factor. A successful bond issuance is expected to further strengthen the Bank's capitalisation ratios, which remain well above regulatory thresholds. This will also provide some buffer to absorb macroeconomic shocks that may adversely impact the Bank's concentrated loan book.

Table 2: Sponsor's projections for FY2020 and FY2021

	2019 (Actual)	2020 (Estimate)	2021 (Projected)
<i>Growth in Net Loans and Advances</i>	12%	-13%	53%
<i>Growth in Deposit Liabilities (Excluding Inter-Bank Takings)</i>	21%	-7%	60%
<i>Growth in Profit Before Tax</i>	-0.1%	-45%	11%
<i>Cost-to-Income Ratio</i>	49%	63%	65%
<i>Pre-tax Return on Average Equity</i>	19%	10%	10%

Based on the aforementioned, Agosto & Co. hereby attaches a "**stable**" outlook to the rating of FSDH Funding SPV Plc's Series 1 five-year subordinated bond (*Tranche A*) and Series 1 five-year senior unsecured bond (*Tranche B*) of up to ₦20 billion. We will continue to monitor the Sponsor's performance in the short term to reassess the impact of the pandemic on our outlook.

For more comprehensive information, kindly refer to the 2020 credit rating report of FSDH Merchant Bank Limited.

2020 Series I up to ₦20 billion combined 5-year Fixed rate subordinated unsecured bond (Tranche A) and 5-year Fixed rate senior unsecured bond (Tranche B).

FINANCIAL SUMMARY

FSDH MERCHANT BANK LIMITED

STATEMENT OF FINANCIAL POSITION AS AT	Unaudited					
	30-Sept-2020		31-Dec-2019		31-Dec-2018	
	₦'000		₦'000		₦'000	
ASSETS						
1 Cash & equivalents	5,723,947	2.9%	3,907,089	2.3%	1,324,953	0.9%
2 Government securities	56,347,991	28.6%	61,983,584	35.9%	38,782,026	27.5%
3 Money market placements	11,694,647	5.9%	9,817,413	5.7%	17,057,637	12.1%
4 Quoted investments						
5 Placements with discount houses						
6 LIQUID ASSETS	<u>73,766,585</u>	<u>37.4%</u>	<u>75,708,086</u>	<u>43.8%</u>	<u>57,164,616</u>	<u>40.6%</u>
7 BALANCES WITH NIGERIAN BANKS	216,641	0.1%	263,277	0.2%	657,634	0.5%
8 BALANCES WITH BANKS OUTSIDE NIGERIA	14,442,171	7.3%	4,779,983	2.8%	5,008,095	3.6%
9 Direct loans and advances - Gross	38,405,956	19.5%	46,753,615	27.1%	41,835,627	29.7%
10 Less: Cumulative loan loss provision	<u>(2,366,574)</u>	<u>-1.2%</u>	<u>(1,257,275)</u>	<u>-0.7%</u>	<u>(1,298,769)</u>	<u>-0.9%</u>
11 Direct loans & advances - net	36,039,382	18.3%	45,496,340	26.3%	40,536,858	28.8%
12 Advances under finance leases - net						
13 TOTAL LOANS & LEASES - NET	<u>36,039,382</u>	<u>18.3%</u>	<u>45,496,340</u>	<u>26.3%</u>	<u>40,536,858</u>	<u>28.8%</u>
14 INTEREST RECEIVABLE						
15 OTHER ASSETS	1,293,137	0.7%	776,778	0.4%	852,999	0.6%
16 DEFERRED LOSSES	2,888,150	1.5%	2,888,150	1.7%	3,223,982	2.3%
17 RESTRICTED FUNDS	42,280,245	21.5%	7,210,940	4.2%	4,196,302	3.0%
18 UNCONSOLIDATED SUBSIDIARIES & ASSOCIATES					961,377	0.7%
19 OTHER LONG-TERM INVESTMENTS	10,018,733	5.1%	17,688,428	10.2%	6,219,410	4.4%
20 FIXED ASSETS & INTANGIBLES	<u>896,350</u>	<u>0.5%</u>	<u>1,182,087</u>	<u>0.7%</u>	<u>816,632</u>	<u>0.6%</u>
21 TOTAL ASSETS	<u>181,841,394</u>	<u>92.3%</u>	<u>155,994,069</u>	<u>90.3%</u>	<u>119,637,905</u>	<u>85.0%</u>
22 TOTAL CONTINGENT ASSETS	15,236,611	7.7%	16,800,880	9.7%	21,177,188	15.0%
23 TOTAL ASSETS & CONTINGENTS	<u>197,078,005</u>	<u>100%</u>	<u>172,794,949</u>	<u>100%</u>	<u>140,815,093</u>	<u>100%</u>
CAPITAL & LIABILITIES						
24 TIER 1 CAPITAL (CORE CAPITAL)	28,122,533	14.3%	26,769,962	15.5%	29,335,557	20.8%
25 TIER 2 CAPITAL						
26 Medium to long-term borrowings	36,149,835	18.3%	32,823,321	19.0%	33,250,660	23.6%
27 Demand deposits	16,479,702	8.4%	9,670,569	5.6%	9,269,590	6.6%
28 Savings deposits						
29 Time deposits	71,339,702	36.2%	46,669,867	27.0%	37,449,771	26.6%
30 Inter-bank takings	21,411,500	10.9%	27,684,828	16.0%	4,744,992	3.4%
31 TOTAL DEPOSIT LIABILITIES - LCY	<u>109,230,904</u>	<u>55.4%</u>	<u>84,025,264</u>	<u>48.6%</u>	<u>51,464,353</u>	<u>36.5%</u>
32 Customers' foreign currency balances						
33 TOTAL DEPOSIT LIABILITIES	109,230,904	55.4%	84,025,264	48.6%	51,464,353	36.5%
34 INTEREST PAYABLE						
35 OTHER LIABILITIES	<u>8,338,122</u>	<u>4.2%</u>	<u>12,375,522</u>	<u>7.2%</u>	<u>5,587,335</u>	<u>4.0%</u>
36 TOTAL CAPITAL & LIABILITIES	<u>181,841,394</u>	<u>92.3%</u>	<u>155,994,069</u>	<u>90.3%</u>	<u>119,637,905</u>	<u>85.0%</u>
37 TOTAL CONTINGENT LIABILITIES	15,236,611	7.7%	16,800,880	9.7%	21,177,188	15.0%
38 TOTAL CAPITAL, LIABILITIES & CONTINGENTS	<u>197,078,005</u>	<u>100%</u>	<u>172,794,949</u>	<u>100%</u>	<u>140,815,093</u>	<u>100%</u>
BREAKDOWN OF CONTINGENTS						
39 Acceptances & direct credit substitutes	10,726,925	5.4%	11,060,498	6.4%	21,044,590	14.9%
40 Guarantees, bonds etc..	4,509,686	2.3%	5,740,382	3.3%	132,598	0.1%
41 Short-term self liquidating contingencies						

2020 Series I up to ₦20 billion combined 5-year Fixed rate subordinated unsecured bond (Tranche A) and 5-year Fixed rate senior unsecured bond (Tranche B).

FSDH MERCHANT BANK LIMITED

STATEMENT OF COMPREHENSIVE INCOME	Unaudited					
	30-Sept-2020 N'000		31-Dec-2019 N'000		31-Dec-2018 N'000	
42 Interest income	9,702,021	72.9%	16,495,503	79.2%	15,086,916	81.4%
43 Interest expense	(5,742,679)	-43.1%	(11,009,079)	-52.9%	(10,320,248)	-55.7%
44 Loan loss expense	(1,507,709)	-11.3%	400,568	1.9%	1,396,641	7.5%
45 NET REVENUE FROM FUNDS	2,451,633	18.4%	5,886,992	28.3%	6,163,309	33.3%
46 ALL OTHER INCOME	3,612,239	27.1%	4,326,839	20.8%	3,438,674	18.6%
47 NET EARNINGS	6,063,872	45.5%	10,213,831	49.1%	9,601,983	51.8%
48 Staff costs	(1,591,763)	-12.0%	(2,296,859)	-11.0%	(2,193,606)	-11.8%
49 Depreciation expense	(359,115)	-2.7%	(457,990)	-2.2%	(350,696)	-1.9%
50 Other operating expenses	(1,652,779)	-12.4%	(2,276,153)	-10.9%	(1,871,236)	-10.1%
51 TOTAL OPERATING EXPENSES	(3,603,657)	-27.1%	(5,031,002)	-24.2%	(4,415,538)	-23.8%
52 PROFIT (LOSS) BEFORE TAXATION	2,460,215	18.5%	5,182,829	24.9%	5,186,445	28.0%
53 TAX (EXPENSE) BENEFIT	(400,500)	-3.0%	(1,572,426)	-7.6%	(775,053)	-4.2%
54 PROFIT (LOSS) AFTER TAXATION	2,059,715	15.5%	3,610,403	17.3%	4,411,392	23.8%
55 NON-RECURRING INCOME (EXPENSE) - NET						
56 PROPOSED DIVIDEND			(4,614,343)	-22.2%	(2,207,887)	-11.9%
57 GROSS EARNINGS	13,314,260	100%	20,822,342	100%	18,525,590	100%
58 AUDITORS	Unaudited		PWC		PWC	
59 OPINION			CLEAN		CLEAN	

KEY RATIOS	30-Sept-2020 Annualised	31-Dec-2019	31-Dec-2018
EARNINGS			
60 Net interest margin	40.8%	33.3%	31.6%
61 Loan loss expense/Interest income	15.5%		
62 Return on average assets (Pre - tax)	1.8%	3.3%	3.5%
63 Return on average equity (Pre - tax)	12.0%	18.5%	17.8%
64 Operating Expenses/Net earnings	59.4%	49.3%	46.0%
65 Gross earnings/Total assets & contingents	7.2%	13.3%	12.6%
EARNINGS MIX			
66 Net revenue from funds	40.4%	57.6%	64.2%
67 All other income	59.6%	42.4%	35.8%
LIQUIDITY			
68 Total loans & leases - net/Total lcy deposits	17.2%	44.7%	37.3%
69 Liquid assets/Total lcy deposits	84.2%	134.8%	123.8%
70 Demand deposits/Total lcy deposits	15.1%	11.5%	18.0%
71 Savings deposits/Total lcy deposits			
72 Time deposits/Total lcy deposits	65.3%	55.5%	72.8%
73 Inter-bank borrowings/Total lcy deposits	19.6%	32.9%	9.2%
74 Interest expense - banks/Interest expense	12.5%	11.1%	12.1%
75 NET FOREIGN CURRENCY ASSETS (LIABILITIES)	14,442,171	4,779,983	5,008,095

2020 Series I up to ₦20 billion combined 5-year Fixed rate subordinated unsecured bond (Tranche A) and 5-year Fixed rate senior unsecured bond (Tranche B).

FSDH MERCHANT BANK LIMITED

KEY RATIOS CONT'D	30-Sept-2020 <i>Annualised</i>	31-Dec-2019	31-Dec-2018
ASSET QUALITY			
76 Performing loans (N'000)	36,182,354	44,512,784	39,601,393
77 Non-performing loans (N'000)	2,223,602	2,240,831	2,234,234
78 Non-performing loans/Total loans - Gross	5.8%	4.8%	5.3%
79 Loan loss provision/Total loans - Gross	6.2%	2.7%	3.1%
80 Loan loss provision/Non-performing loans	106.4%	56.1%	58.1%
81 Risk-weighted assets/Total assets & contingents	26.7%	35.0%	46.0%
CAPITAL ADEQUACY			
82 Adjusted capital/risk weighted assets	47.3%	38.8%	38.5%
83 Tier 1 capital/Adjusted capital	100%	100%	104%
84 Total loans - net/Adjusted capital	1.45	1.94	1.63
85 Capital unimpaired by losses (N'000)	25,234,383	23,881,812	26,111,575
CAPITAL ADEQUACY STRESS TEST			
86 Total shareholders' funds (N'000)	24,909,293	23,456,183	24,937,610
87 Cumulative loan loss provision (actual reserves)	2,366,574	1,257,275	1,298,769
88 Equity before all provision (line 86 + line 87)	27,275,867	24,713,458	26,236,379
89 Required reserves*	7,374,125	8,229,524	8,648,136
90 Equity after required reserves (line 88 - line 89)	20,977,459	17,559,651	18,663,960
86 Equity after required reserves/risk weighted assets	39.9%	29.0%	28.8%
STAFF INFORMATION			
87 Net earnings per staff (N'000)	48,126	81,062	71,657
88 Staff cost per employee (N'000)	16,844	18,229	16,370
89 Staff costs/Operating expenses	44.2%	45.7%	49.7%
90 Average number of employees	126	126	134
91 Average staff per branch	42	42	45
OTHER KEY INFORMATION			
92 Legal lending limit(N'000)	12,617,192	11,940,906	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			
96 Lcy deposits (excluding interbank takings)	2020 0.40%	2019 0.29%	2018 0.29%
97 Total assets & contingents	0.39%	0.39%	0.37%
98 Total loans & leases - net	0.21%	0.29%	0.32%
99 Net earnings	0.23%	0.38%	0.42%
100 Profit before tax	0.32%	0.56%	0.67%
101 Cash dividend	Nil	2.42%	0.79%

RATING DEFINITIONS

Aaa	Bonds rated 'Aaa' are judged to offer highest safety of timely payment of interest and principal. Though the circumstances providing this degree of safety are likely to change, such changes as can be envisaged are most unlikely to affect adversely the fundamentally strong position of such issues.
Aa	Bonds rated 'Aa' are judged to offer high safety of timely payment of interest and principal. They differ in safety from 'Aaa' issues only marginally.
A	Bonds rated 'A' are judged to offer adequate safety of timely payment of interest and principal; however, changes in circumstances can adversely affect such issues more than those in the higher rated categories.
Bbb	Bonds rated 'Bbb' are judged to offer sufficient safety of timely payment of interest and principal for the present; however, changing circumstances are more likely to lead to a weakened capacity to pay interest and repay principal than for bonds in higher rated categories.
Bb	Bonds rated 'Bb' are judged to carry inadequate safety of timely payment of interest and principal; while they are less susceptible to default than other speculative grade bonds in the immediate future, the uncertainties that the issuer faces could lead to inadequate capacity to make timely interest and principal payments.
B	Bonds rated 'B' are judged to have greater susceptibility to default; while currently interest and principal payments are met, adverse business or economic conditions would lead to lack of ability or willingness to pay interest or principal.
C	Bonds rated 'C' are judged to have factors present that make them vulnerable to default; timely payment of interest and principal is possible only if favourable circumstances continue.
D	Bonds rated 'D' are in default and in arrears of interest and principal payments or are expected to default on maturity. Such bonds are extremely speculative and returns from these bonds may be realised only on reorganisation or liquidation.

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

© Agosto&Co.
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