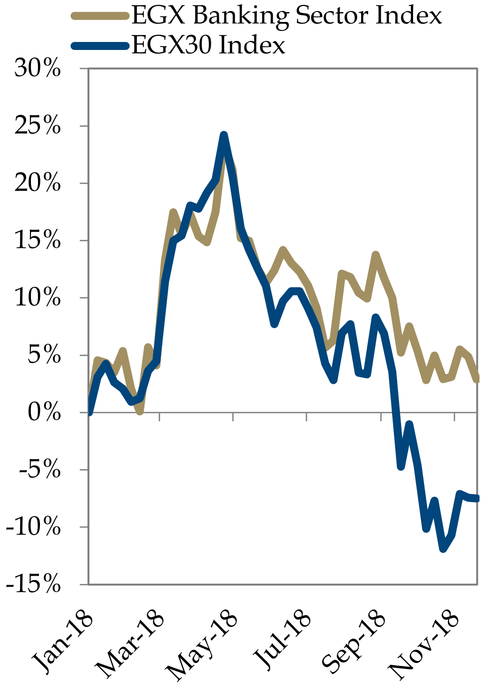
SHUAA

Egypt Banking Sector

Saturday, 24 November 2018
Egypt / Banking / Commentary

Relative performance — Banks vs. EGX 30



Source: EGX

Impact of New Tax Amendments on Banks

- **What Happened?** In its weekly meeting held last Wednesday, the **Egyptian Cabinet** approved a new tax treatment regarding interest income generated from Treasuries. This came through a proposed amendment within the context of Law No. 91 of the year 2005 concerning the separation of income generated from Treasuries from other banking income. In brief, the proposed new tax method will require accounting for income from Treasuries as part of taxable income, which would result in banks having to reallocate costs to match revenues. The process of reallocation will cause banks' other operating costs to shrink (theoretically), further amplifying banks' income from operations (other than Treasuries) and resulting in a higher effective tax rate for banks.

- **Reactions:** The initial reaction on the news by Egyptian banks came after a meeting for the **Federation of Egyptian Banks (FEB)** on Wednesday which did not challenge the tax amendment as a concept but demanded applying a different method when calculating the theoretical expenses related to income from Treasuries. Also, FEB's meeting minutes contained an example comparing between the government's method and the FEB's proposed method. We have extended those two examples to quantify the impact on banks' effective tax rate and profitability. Please see the example at the final page this note.

- **The Numbers:** Going along with the examples provided in FEB's meeting minutes of a typical bank, we ran an exercise to compare the current vs. the expected scenarios post the amendments.

  1. **Current Scenario:** Going along with the example provided in FEB's meeting minutes of a typical bank, we assumed a total banking income of EGP33bn, of which EGP14.5bn is income from Treasuries and EGP18.5bn making up the remainder from other sources. In this case, the bank would have to pay first and foremost EGP2.9bn in the form of a 20% withholding tax on income from Treasuries. Assuming the bank's total expenses are EGP21bn, income from operations (EBT) would be EGP12bn, implying taxes due of EGP2.7bn at a tax rate of 22.5%, which is lower than what the bank had already paid before (i.e. EGP2.9bn). Noting that income from Treasuries is tax deductible, the implied effective tax rate would then be 24.14% (EGP2.9bn compared to an EBT of EGP12bn).

  2. **Expected Scenario:** The new tax treatment would consider the bank's income tax as the sum of taxes paid on both income from Treasuries and other (non-Treasury) banking income. While taxes on income from Treasuries will remain the same (EGP2.9bn), the bank would be required to reallocate its total expenses (EGP21bn) to proportionally match both Treasuries and other banking income. To do so, the new system would apply the bank's current expense ratio (total expenses as a percentage of total revenues), resulting in lower expenses allocated to other banking income and hence a higher taxable income leading to a higher effective tax rate (36.76%).

Analysts

Amr Hussein Elalfy, MBA, CFA
Head of Research
aalfy@shuaasecurities.com
+202 2673 5991

Mohamed Saad
Equity Analyst
mfattah@shuaasecurities.com
+202 2673 5992

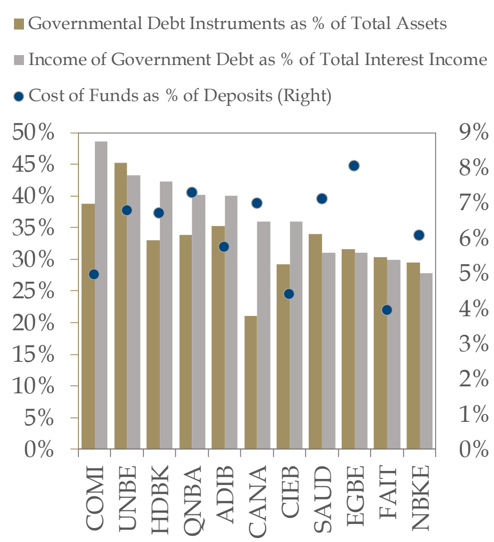
3. **FEB's proposal:** Alternatively, FEB is proposing a different method to reallocate expenses to income from Treasuries, suggesting two components: (1) calculating Treasuries' funding cost as per the bank's funding cost and (2) allocating G&A costs (excluding depreciation) to Treasuries based on their contribution to revenues. In our example, assuming a cost of funds of c.5% and a cost-to-income ratio (excluding depreciation) of 25%, total expenses allocated to income from Treasuries would be a bit lower than the Cabinet's approved calculation. Hence, the effect on the effective tax rate would be less harmful, albeit still higher (34.64%) than the current scenario.

- **Implications:** In sum, we believe applying the Cabinet's approved amendments will have different implications for banks, namely:

1. **All else the same, banks' profitability would be hurt** (earnings could be 17% lower in our hypothetical example above).
2. **Banks would either demand higher yields** in upcoming Treasury auctions *or* **reduce their exposure to Treasuries** altogether which would also lead to higher Treasury yields. Rising yields would help banks somewhat restore their earnings. According to our estimates, it would take an average of 335bps rise in Treasury yields for banks to offset the resulting tax hike.
3. **If yields do not rise enough, banks would then have to reallocate their excess liquidity** (from lower exposure to Treasuries) to higher-yielding inter-bank assets and loans. Alternatively, **banks may resort to reduce funding costs**, in order to mitigate higher effective tax rates. As a result, deposits growth (especially in private-sector banks) might slow down.
4. **On the other hand, foreign investors would probably be the most beneficiaries** of this tax amendments as they would then enjoy higher yields.

- **What will it mean for listed banks?** While the effect of such an amendment will be all over the sector, banks will be affected differently differ depending on (1) asset allocation, (2) cost of funding, and (3) how much of their interest income is dominated by income from Treasuries. That said, we gathered data for the 11 listed banks, focusing on the above mentioned three factors. As the chart on the left shows, banks with high exposure to Treasuries on both their balance sheet and income statement are more exposed to the amendment. On the other hand, banks with less exposure will be a bit safer as less expenses will be allocated to income from Treasuries and hence their effective tax rate and taxable income would not as high. All else the same, banks with lower funding costs should be able to compensate for the higher effective tax rate. Accordingly, banks like **COMI**, **HDBK**, and **QNBA** would be at risk as Treasuries contribute significantly to their income according to 9M 2018 financials. On the other hand, **NBKE** has the least exposure of income from Treasuries as a percentage of interest income, while **FAIT** (which comes second) enjoys low funding costs.

Banks' Exposure to Treasuries



Source: Company reports

Impact of new tax amendments on a typical bank

Key Assumptions			
Treasuries	90,816	18.97%	Assumed Yield
Purchase price	(76,334)		
Implied interest	14,482		
Income tax	(2,896)	20.00%	Tax rate
Interest income (net of tax)	11,586	15.18%	

Current	Total	Treasuries	Others
Revenues	33,000	14,482	18,518
Expenses	(21,000)	-	(21,000)
Income from operation	**12,000**	**14,482**	**(2,482)**
Tax rate	22.50%	20.00%	22.50%
Income tax	(2,896)	(2,896)	-
Effective income tax rate	24.14%		
Expenses/Revenues	64%	0%	113%
Operating margin	36%	100%	-13%
Income from operations, net of tax	**9,104**		

New Amendments Approved by the Cabinet	Total	Treasuries	Others
Revenues	33,000	14,482	18,518
Expenses	(21,000)	(9,216)	(11,784)
Income from operation	**12,000**	**5,266**	**6,734**
Tax rate	22.50%	55.00%	22.50%
Income tax	(4,412)	(2,896)	(1,515)
Change vs. current	(1,515)		
Variance vs. current	52%		
Effective income tax rate	36.76%		
Change vs. current	1263 bps		
Expenses/Revenues	64%	64%	64%
Operating margin	36%	36%	36%
Income from operations, net of tax	**7,588**		
	-17%		

Proposal by Federation of Egyptian Banks (FEB)

Treasuries	90,816
Assumed Treasuries as a % of deposits & other sources	35.00%
Assumed deposits & other sources	259,474
Assumed interest rate on deposits & other sources	4.91%
Assumed cost of deposits & other sources	(12,750)
(1) Assumed cost of Treasuries (cost of financing)	**(4,463)**
Assumed cost-to-income ratio (excl. depreciation)	25.00%
G&A expenses (excl. depreciation)	(8,250)
(2) Assumed cost of Treasuries (G&A)	**(3,621)**
Total assumed cost of Treasuries (1 + 2)	**(8,083)**

	Total	Treasuries	Others
Revenues	33,000	14,482	18,518
Expenses	(21,000)	(8,083)	(12,917)
Income from operation	**12,000**	**6,399**	**5,601**
Tax rate	22.50%	45.26%	22.50%
Income tax	(4,157)	(2,896)	(1,260)
Change vs. current	(1,260)		
Variance vs. current	44%		
Effective income tax rate	34.64%		
Change vs. current	1050 bps		
Expenses/Revenues	64%	56%	70%
Operating margin	36%		
Income from operations, net of tax	**7,843**		
	-14%		

Key Assumptions			
Treasuries	90,816	22.32%	Assumed Yield
Purchase price	(74,242)	**3.35%**	**Change in yield**
Implied interest	16,574		
Income tax	(3,315)	20.00%	Tax rate
Interest income (net of tax)	13,259	17.86%	

Future	Total	Treasuries	Others
Revenues	35,091	16,574	18,518
Expenses	(21,000)	(9,918)	(11,082)
Income from operation	**14,091**	**6,655**	**7,436**
Tax rate	22.50%	20.00%	22.50%
Income tax	(4,988)	(3,315)	(1,673)
Change vs. current	(2,091)		
Variance vs. current	72%		
Effective income tax rate	35.40%		
Change vs. current	1126 bps		
Expenses/Revenues	60%	60%	60%
Operating margin	40%	40%	40%
Income from operations, net of tax	**9,104**		
	0%		

Source: SHUAA Securities Egypt

Contact Details

+(202) 16331
143, Bank Zone, 5th Settlement,
New Cairo, First Abu Dhabi Bank Building (6th Floor)
Cairo, Egypt

Disclaimer

This document has been issued by SHUAA Securities Egypt for informational purposes only. This document is not and should not be construed as an offer or the solicitation of an offer to purchase or subscribe or sell any investment or subscribe to any investment management or advisory service. SHUAA Securities Egypt has based this document on information obtained from sources it believes to be reliable. It makes no guarantee, representation or warranty as to its accuracy or completeness and accepts no responsibility or liability in respect thereof or for any reliance placed by any person on such information. Accordingly, no representation or warranty, express or implied, is or will be made and no responsibility or liability is or will be accepted by SHUAA Securities Egypt or by any of its respective officers, employees, agents or affiliates in relation to the accuracy, completeness or fairness of the information or opinions contained herein or any other written or oral information made available to any interested party or its advisers and any such liability is expressly disclaimed. All opinions expressed herein are subject to change without notice. This document may not be reproduced or circulated without the prior written consent of SHUAA Securities Egypt. SHUAA Securities Egypt is regulated by the Financial Regulatory Authority under license number 91.

Issuer of Report

SHUAA Securities Egypt
Website: www.shuaasecurities.com

Copyright