

Valuation Summary

- We recommend a BUY for the KCB Group stock with a target price of Kshs 53.70 representing an upside of 40.0%, from the current price of Kshs 39.75, as at Thursday, 26th May 2016, inclusive of a dividend yield of 4.9%
- KCB Group is currently trading at a P/B of 1.4x and a P/E of 7.7x, versus an industry average of 1.6x and 7.4x, respectively

Key highlights during the quarter

- KCB Group was appointed the receiver manager of Chase Bank that was put under receivership in April. with a view of acquiring a majority stake in the lender
- KCB Group plans to inject more capital through tier 2 debt and rights issue which was approved by shareholders. The bank has already issued a scrip dividend to buffer up capital
- KCB Group continues to gradually grow its Ethiopia business, currently operating as a representative office

Income Statement

- Core earnings per share grew by 6.1% growth in core EPS to earnings per share of Kshs 6.1 from Kshs 5.8 in Q1'2015, driven by an 11.5% growth in operating revenue in Q1'2016 which outpaced by a 15.9% growth in operating expenses in Q1'2016
- Operating revenue grew by only 11.5% to Kshs 15.5 bn from Kshs 13.9 bn in Q1'2015 despite a 23.7% increase in net interest income, which was supported by the relatively high interest environment but was offset by a 12.9% decline in non-funded income to Kshs 4.0 bn from Kshs 4.6 bn in Q1'2015
- Non-funded income recorded a decline of 12.9% to Kshs 4.0 bn from Kshs 4.6 bn in Q1'2015, much lower than our projection of an 8.4 % increase. This was brought on by: i) a 14.5% drop in forex income to Kshs 746.7 mn from Kshs 873.6 mn in Q1 2015 attributable partly to the South Sudan business on the back of currency devaluation, and ii) a 51.9% drop in other income to Kshs 258.9 mn from 538.1 mn in Q1 2015. Non-interest income to operating income declined to 26% from 33.3% in Q1'2015
- Operating expenses grew 15.9% to Kshs 8.9 bn from Kshs 7.7 bn on account of: (i) a 149.1% increase in loan loss provision to Kshs 1.4 bn from Kshs 0.5 bn, and ii) increase in staff costs by 7.3% to Kshs 4.1 bn from Kshs 3.8 bn. The faster growth of operating expenses to operating revenue resulted in an increase in the cost to income ratio to 57.3% from 55.1% in Q1'2015. Excluding LLPs, operating expenses grew by 5.6% to Kshs 7.5 bn from Kshs 7.1 bn in Q1'2015
- Q1'2016 PAT growth came in lower than our expectations; 6.1% growth to Kshs 4.6 bn from Kshs 4.4 bn compared to our projection of a 17% growth.

Balance Sheet

- The balance sheet recorded a relatively good growth with total liabilities increasing by 9.7% to Kshs 472.8 bn from Kshs 430.9 bn in Q1'2015 compared to our projections of a 15.6% growth while shareholders' funds increased by 5.7% to Kshs 84.0 bn
- Customer deposits grew by 6.6% to Kshs 423.4 bn from Kshs 397.1 bn in Q1'2015 while loan growth came in at 16.5% to Kshs 345.9 bn from Kshs 297.0 bn in Q1'2015 supported by the retail and corporate business coupled with increased use of KCB Mpesa. Digital platforms currently account for 70% of the Group businesses transactions. Loans to deposit ratio increased to 81.7% from 74.8% in Q1'2015, slightly lower than the industry average of 82.5%
- Non-performing loans grew by 39.1% to Kshs 30.4 bn from Kshs 21.9 bn in Q1'2015
- The yield on interest earning assets decreased to 11.0% from 12.0% in Q1'2016 while the cost of funds decreased to 3.1% from 3.2% leading to a decrease in the net interest margin to 7.9% from 8.8%
- KCB Group Holdings is currently sufficiently capitalized with a core capital to risk weighted assets ratio at 17.9%, 8.0% above the statutory requirement

Moving forward KCB Group with thrive on;

- the uptake of alternative channels such as mobile banking and agency banking with its own KCB Mpesa and KCB Mtaani which appeal to many as they are convenient and easy to use promoting deposit mobilisation and loan disbursements,
- product diversification with new business lines such as Bancassurance through KCB Insurance, Islamic banking as well as investment banking through KCB Capital

- iii. Regional expansion into countries such as Ethiopia as well as stability in Burundi and South Sudan will define the group positive future earnings

Below is a summary of the key line items in the balance sheet and income statement

Figures in Kshs billions unless otherwise stated

Balance Sheet Items	FY'2015	Q1'2015	Q1'2016	y/y change	Q1'2016e	Projected %y/y change	Variance in Growth Actual vs. Expected
Government Securities	96.95	98.15	104.82	6.8%	111.46	13.6%	-6.8%
Net Loans and Advances	345.97	297.03	345.94	16.5%	356.39	20.0%	-3.5%
Total Assets	558.09	510.26	556.80	9.1%	584.42	14.5%	-5.4%
Customer Deposits	424.39	397.10	423.43	6.6%	445.61	12.2%	-5.6%
Total Liabilities	476.84	430.86	472.84	9.7%	498.06	15.6%	-5.9%
Shareholders' Funds	81.25	79.41	83.96	5.7%	86.36	8.8%	-3.0%

Balance Sheet Ratios	FY'2015	Q1'2015	Q1'2016
Loan to Deposit Ratio	81.52%	74.80%	81.70%
Return on average equity	25.02%	23.68%	24.35%
Return on average assets	3.74%	0.95%	0.87%

Income Statement	FY'2015	Q1'2015	Q1'2016	y/y change	Q1'2016e	Projected %y/y change	Variance of Actual vs. Expected
Net Interest Income	39.24	9.26	11.45	23.7%	11.40	23.1%	0.6%
Net non-Interest Income	23.38	4.63	4.03	(12.9%)	5.48	18.4%	-31.3%
Total Operating income	62.62	13.89	15.48	11.5%	16.88	21.5%	-10.1%
Loan Loss provision	4.71	0.55	1.37	149.1%	1.05	91.7%	57.4%
Total Operating expenses	36.08	7.65	8.87	15.9%	9.59	25.2%	-9.4%
Profit before tax	26.54	6.23	6.61	6.1%	7.29	17.0%	-10.9%
Profit after tax	19.62	4.36	4.63	6.1%	5.11	17.0%	-10.9%

Income Statement Ratios	FY'2015	Q1'2015	Q1'2016	y/y change
Yield from interest-earning assets	12.3%	12.0%	12.9%	0.93%
Cost of funding	3.9%	3.2%	4.4%	1.24%
Net Interest Spread	8.4%	8.8%	8.5%	(0.30%)
Net Interest Income as % of operating income	62.7%	66.7%	74.0%	7.30%
Non-Funded Income as a % of operating income	37.3%	33.3%	26.0%	(7.30%)
Cost to Income Ratio	57.6%	55.1%	57.3%	2.17%
CIR without provisions		51.2%	48.4%	(2.72%)

Capital Adequacy Ratios	Q1'2015	Q1'2016
Core Capital/Total Liabilities	16.50%	17.90%
Minimum Statutory ratio	8.00%	8.00%
Excess	8.50%	9.90%
Core Capital/Total Risk Weighted Assets	16.00%	16.40%
Minimum Statutory ratio	10.50%	10.50%
Excess	5.50%	5.90%
Total Capital/Total Risk Weighted Assets	17.20%	17.60%
Minimum Statutory ratio	14.50%	14.50%
Excess	2.70%	3.10%
Liquidity Ratio	31.20%	38.80%
Minimum Statutory ratio	20.00%	20.00%
Excess	11.20%	18.80%