KCB Group Earnings Update – H1’2016

4th August, 2016

Valuation Summary

- We recommend a BUY for the KCB Group stock with a target price of Kshs 49.4 representing an upside of 60.5%, from the current price of Kshs 32.0, inclusive of a dividend yield of 6.2%
- KCB Group is currently trading at a P/B of 1.1x and a P/E of 4.7x, vs an industry average of 1.3x and 6.2x, respectively.

Key highlights during H1’2016

- KCB Group was appointed the receiver manager of Chase Bank (In Receivership) in April with a view of restoring Chase Bank back to operation. According to KCB Group, the bank will scale back 50% of its resources from Chase Bank (IR) by end of August and finally 100% by end of September 2016.
- KCB Group concluded scrip issue, recording a 54.0% subscription and raised Kshs 1.6 bn out of targeted Kshs 2.9 bn, reducing the total capital needs from Kshs 10.0 bn to Kshs 8.5 bn
- KCB Group continues to be affected by the ongoing political instability in South Sudan, coupled by the recent devaluation of the South Sudanese pound. The bank has closed 8 out of the 9 branches it has in Juba. The remaining 10 branches in other states remain open at select times. 90.0% of the Kenyan staff have been evacuated from South Sudan and are currently operating from the Nairobi head office

Income Statement

- Core earnings per share grew by 13.6% to Kshs 3.4 from Kshs 3.0 in H1'2015, driven by a 7.2% growth in total operating revenue which outpaced a 1.8% growth in total operating expenses
- Total operating revenue grew by 7.2% to Kshs 32.9 bn from Kshs 30.7 bn in H1’2015, slower than our estimate of 18.1% growth. Net interest income increased by 15.9% to Kshs 22.5 bn from Kshs 19.5 bn in H1’2015, supported by a 22.4% growth in interest income despite a 42.1% rise in interest expense
- Non-funded income (NFI) recorded a decline of 7.7% to Kshs 10.4 bn from Kshs 11.3 bn in H1’2015, below our expectation of a 9.6% increase. The decline in NFI was driven by a 9.5% decline in other fees and a 21.7% drop in forex income to Kshs 1.6 bn from Kshs 2.0 bn in H1’2015 attributable the continued impact of the South Sudan currency devaluation. NFI to total operating income declined to 31.6% from 36.7% in H1’2015
- Total operating expenses grew marginally by 1.8% to Kshs 17.8 bn from Kshs 17.5 bn on account of a 20.1% decline in loan loss provision (LLP) to Kshs 2.1 bn from Kshs 2.6 bn in H1’2015, resulting in a decrease in the cost to income ratio to 54.2% from 57.0% in H1’2015. Excluding LLP, operating expenses grew by 5.7% to Kshs 15.8 bn from Kshs 14.9 bn in H1’2015. KCB Group management noted that the decline in loan loss provision was occasioned by a higher provision in H1’2015 for South Sudan business, which was not the case in H1’2016
- H1’2016 PBT growth came in at 14.3% to Kshs 15.1 bn, higher than our expectations of an 8.1% growth to Kshs 14.3 bn, while PAT increased by 13.6% to Kshs 10.5 bn from Kshs 9.2 bn in H1’2015.

Balance Sheet

- The balance sheet recorded a contraction in H1’2016, with total assets decreasing by 1.2% to Kshs 559.9 bn from Kshs 566.6 bn in HY’2015 driven by a decline in value of placements and government securities which declined by 45.2% and 15.8% to Kshs 43.8 bn and Kshs 95.6 bn, respectively, attributable to the devaluation in South Sudan balance sheet. South Sudan currently accounts to 5% of the total assets compared to 15% in H1’2015. Total liabilities decreased by 4.0% to Kshs 467.0 bn from Kshs 488.5 bn in H1’2015 compared to our projections of a 1.1% growth, while shareholders’ funds increased by 16.5% to Kshs 90.9 bn
- Customer deposits declined by 2.2% to Kshs 433.4 bn from Kshs 443.0 bn in H1’2015 driven by the impact of devaluation of South Sudan business. Considering Kenyan business alone, deposit grew by 15.7% to Kshs 366.8 bn
- Loan growth came in at 8.4% to Kshs 347.4 bn from Kshs 320.6 bn in H1’2015 supported by improvement of trade in Kenya retail and corporate business coupled with increased use of alternative channels to drive loan disbursement. Loans to deposit ratio came in at 80.2% from 72.4% in H1’2015, slightly lower than the industry average of 82.5%
- Gross NPL ratio stood at 8.9% from 7.3% in H1’2015, with the bank attributing it to 3 accounts in construction sector and government related institutions. Yield from interest earning assets increasing to 12.4% from 11.3% in H1’2015, while cost of funds increased to 4.2% from 3.0% in H1’2015 highlighting the expensive nature of deposits. Net interest margin improved to 8.7% from 7.4% in H1’2015,

- KCB Group is currently sufficiently capitalized with a core capital to risk weighted assets ratio at 17.5%, 9.5% above the statutory requirement. KCB Group has announced that it will not be coming to the market in 2016 for a cash call through the rights issue as earlier indicated as KCB Group expects to receive up to USD 200 mn in tier II debt.

Key Take outs:

a) KCB Group registered stronger growth in Kenya, compared to regional business as was demonstrated with Kenyan business growing earnings by 19% vs a 14% growth for the overall group and 9% growth in total assets in Kenyan business unit compared to a 1% decline in overall group growth. KCB should therefore concentrate on its more profitable and high growth markets and cut down on slow growth and high risk markets like South Sudan; the regional expansion strategy is destroying shareholder value
b) KCB Group registered weak performance on NFI, as such losing its grip on revenue diversification with NFI to total income at 31.6% in H1'2016, down from 37.3% in FY'2015 and 36.7% in H1'2015. As much as the bank has benefited greatly from its expansive alternative, KCB Group needs to urgently improve its position on forex and we expect the bank to reduce reliance on high risk markets and focus more on the Kenyan business.

Moving forward KCB Group with thrive on;

i. the uptake of KCB Group products and services through 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,
ii. Revenue diversification with new business lines such as Bancassurance through KCB Insurance, Islamic banking as well as investment banking through KCB Capital
iii. Review of the regional expansion strategy with key focus on consolidation of its regional business by optimizing performance in the existing markets while reducing the overall impact from South Sudan. KCB Group will have to focus more on the much profitable and stable Kenyan business

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	H1'2015	H1'2016	y/y change	H1'2016e	Projected %y/y change	Variance in Growth Actual vs. Expected
Government Securities	96.9	113.5	95.5	(15.8%)	102.2	(9.9%)	(5.9%)
Net Loans and Advances	346.0	320.6	347.4	8.4%	362.9	13.2%	(4.8%)
Total Assets	**558.1**	**566.6**	**559.9**	**(1.2%)**	**583.4**	**3.0%**	**(4.1%)**
Customer Deposits	424.4	443.0	433.4	(2.2%)	443.8	0.2%	(2.3%)
Total Liabilities	476.8	488.5	469.0	(4.0%)	494.1	1.1%	(5.1%)
Shareholders' Funds	**81.3**	**78.1**	**91.0**	**16.5%**	**89.3**	**14.4%**	**2.1%**

Balance Sheet Ratios	FY'2015	H1'2015	H1'2016
Loan to Deposit Ratio	81.5%	72.4%	80.2%
Return on average equity	25.0%	25.1%	24.7%
Return on average assets	3.7%	1.8%	3.7%

Income Statement	FY'2015	H1'2015	H1'2016	y/y change	H1'2016e	Projected %y/y change	Variance in Growth Actual vs. Expected
Net Interest Income	39.2	19.4	22.5	15.9%	23.9	23.0%	(7.2%)
Net non-Interest Income	23.4	11.3	10.4	(7.7%)	12.3	9.6%	(17.3%)
Total Operating income	**62.6**	**30.7**	**32.9**	**7.2%**	**36.3**	**18.1%**	**(10.9%)**
Loan Loss provision	4.7	2.6	2.1	(20.1%)	4.6	77.7%	(97.8%)
Total Operating expenses	**36.1**	**17.5**	**17.8**	**1.8%**	**22.0**	**25.6%**	**(23.8%)**

Profit before tax	26.5	13.2	15.1	14.3%	14.3	8.1%	6.2%
Profit after tax	**19.6**	**9.2**	**10.5**	**13.6%**	**10.0**	**8.1%**	**5.5%**

Income Statement Ratios	FY'2015	H1'2015	H1'2016	y/y change
Yield from interest-earning assets	12.3%	11.3%	12.4%	1.2%
Cost of funding	3.9%	3.0%	4.2%	1.2%
Net Interest Spread	8.4%	8.3%	8.2%	(0.1%)
Net Interest Margin	7.9%	7.4%	8.7%	1.3%
Cost of Risk	1.4%	1.7%	1.2%	(0.5%)
Net Interest Income as % of operating income	62.7%	63.3%	68.4%	5.1%
Non-Funded Income as a % of operating income	37.3%	36.7%	31.6%	(5.1%)
Cost to Income Ratio	57.6%	57.0%	54.2%	(2.9%)
Cost to Assets	6.0%	3.0%	2.8%	(0.2%)