KCB Group Earnings Update – Q3’2016

13th November, 2016

Valuation Summary

- We recommend a BUY for the KCB Group stock with a target price of Kshs 42.5 representing an upside of 63.5%, from the current price of Kshs 28.7, as at 11th November, inclusive of a dividend yield of 7.5%
- KCB Group is currently trading at a P/B of 1.0x and a P/E of 4.1x, vs an industry average of 0.9x and 5.2x, respectively.

Key highlights during Q3’2016

- S&P revised KCB Group’s rating to stable from negative after Kenya’s credit score review, reflecting the bank’s tight link to the national economy
- KCB Group will take over administering loans, car loans and mortgages on behalf of CIC Insurance Group in a deal worth Kshs 1 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. This has led to their deposits down 79.6% y/y to Kshs 19.3 bn from Kshs 94.6 bn in Q3’2015

Income Statement

- Core earnings per share grew by 16.1% to Kshs 5.2 from Kshs 4.4 in Q3'2015, driven by a 10.2% growth in total operating revenue, which outpaced a 4.3% growth in total operating expenses
- Total operating revenue grew by 10.2% to Kshs 50.4 bn from Kshs 45.7 bn in Q3’2015, slower than our estimate of 18.0% growth. This was supported by 27.4% growth in Net Interest Income despite a 17.9% decline in Non-Funded Income
- Interest Income grew by 22.5% to Kshs 48.6 bn from Kshs 39.7 bn in Q3’2015, faster than the 10.1% growth in Interest expense to Kshs 12.5 bn from Kshs 11.3 bn in Q3’2015. This led to an improvement in the Net Interest Margin to 9.2% from 7.1% in Q3’2015
- Non-funded income (NFI) distracted revenue growth, recording a decline of 17.9% to Kshs 14.2 bn from Kshs 17.3 bn in Q3’2015, below our expectation of a 1.7% increase. The decline in NFI was driven by an 18.0% decline in forex income to Kshs 2.4 bn from Kshs 2.9 bn in Q3’2015, and an 8.1% decline in fees earned to Kshs 9.5 bn from Kshs 10.3 bn in Q3’2015. The current revenue mix stands at 72:28 funded to non-funded income from 62:38 in Q3’2015. We believe KCB Group has a huge untapped opportunity to grow fee income through related businesses such as investment banking and asset management, which remain, surprisingly, untapped for such a strong brand
- Total operating expenses grew marginally by 4.3% to Kshs 27.4 bn from Kshs 26.3 bn in Q3’2015 following a 13.0% y/y growth in staff costs to Kshs 12.6 bn from Kshs 11.1 bn. Loan loss provisions (LLP) declined 11.2% to Kshs 3.4 bn from Kshs 3.9 bn in Q3’2015, on account of recoveries made during the quarter from 2 major clients non-performing loans
- Cost to income ratio improved to 54.4% from 57.6% in Q3’2015. Without LLP, cost to income ratio stood at 47.7% from 49.1% in the same period last year
- Profit after tax increased by 16.1% to Kshs 15.9 bn from Kshs 13.7 bn in Q3’2015.

Balance Sheet

- The balance sheet recorded a contraction in Q3’2016, with total assets decreasing by 6.1% to Kshs 570.1 bn from Kshs 607.3 bn in Q3’2015, driven by a decline in value of placements by 53.0% to Kshs 45.6 bn from Kshs 97.1 bn. In addition, the devaluation of the South Sudanese Pound led to a contraction in translated value of the bank’s foreign operations by Kshs 1.6 bn
- Loan book recorded a 4.9% growth to Kshs 364.5 bn from Kshs 347.6 bn in Q3'2015, in line with our expected 5.2% increase. Growth was supported by increased use of alternative channels to drive loan disbursement, with 91% of KCB’s total loan transactions year to date are facilitated on mobile platform.
- Total liabilities decreased by 9.0% to Kshs 478.1 bn from Kshs 525.4 bn in Q3’2015 compared to our projections of a 5.4% decline, while shareholders’ funds increased by 12.4% to Kshs 92.0 bn
- Customer deposits declined by 7.3% to Kshs 436.8 bn from Kshs 471.1 bn in Q3’2015 driven by the impact of devaluation of South Sudan business. Considering Kenyan business alone, deposits grew by 14.0% to Kshs 372.6 bn
- Loans to deposit ratio came in at 83.5% from 73.8% in Q3’2015

- Gross non-performing loans grew by 26.7% to Kshs 31.1 bn from Kshs 24.5 bn in Q3’2015 which led to an increase in NPL ratio to 8.5% from 7.1% in Q3’2015
- The yield on interest earning assets increased to 12.4% from 11.2% in Q3’2015 with the cost of funds rising to 3.7% from 3.3%
- KCB Group is currently sufficiently capitalized with a core capital to risk weighted assets ratio at 16.6%, 6.1% above the statutory requirement, with total capital to total risk weighted assets exceeding statutory requirement by 3.4%. KCB Group announced that they expect to receive up to Kshs 7.5 bn in debt in Q4’2016 from a Development Finance Institution partner to shore up their Tier II Capital

Key Take outs:

a) KCB Group registered stronger growth in Kenya, compared to regional business as was demonstrated with Kenyan business growing earnings by 27.6% vs a 16.1% growth for the overall group, and 8% growth in total assets in Kenyan business unit compared to a 6% decline in overall group growth. KCB Group 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 causing a distraction to growth
b) KCB Group registered weak performance on NFI, as such losing its grip on revenue diversification with NFI to total income at 28% in Q3’2016, down from 38% in Q3’2015. As much as the bank has benefited greatly from its expansive alternative channels, 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 M-pesa 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	Q3'2015	FY'2015	Q3'2016	y/y change	Q3'2016e	Projected %y/y change	Variance in Growth Actual vs. Expected
Government Securities	100.1	96.9	100.8	0.8%	103.0	3.0%	(2.2%)
Net Loans and Advances	347.6	346.0	364.5	4.9%	365.9	5.2%	(0.4%)
Total Assets	**607.3**	**558.1**	**570.1**	**(6.1%)**	**592.6**	**(2.4%)**	**(3.7%)**
Customer Deposits	471.1	424.4	436.8	(7.3%)	455.1	(3.4%)	(3.9%)
Total Liabilities	525.4	476.8	478.1	(9.0%)	496.8	(5.4%)	(3.6%)
Shareholders’ Funds	**81.8**	**81.3**	**92.0**	**12.4%**	**95.8**	**17.1%**	**(4.7%)**

Balance Sheet Ratios	Q3'2015	Q3'2016	%y/y change
Loan to Deposit Ratio	73.8%	83.5%	9.6%
Return on average equity	23.7%	25.1%	1.4%
Return on average assets	2.6%	3.7%	1.1%

Income Statement	Q3'2015	FY'2015	Q3'2016	%y/y change	Q3'2016e	Projected %y/y change	Variance in Growth Actual vs. Expected
Net Interest Income	28.4	39.2	36.1	27.4%	34.0	19.8%	7.6%
Net non-Interest Income	17.3	23.4	14.2	(17.9%)	17.6	1.7%	(19.7%)
Total Operating income	**45.7**	**62.6**	**50.4**	**10.2%**	**51.6**	**13.0%**	**(2.7%)**
Loan Loss provision	3.9	4.7	3.4	(11.2%)	4.3	11.1%	(22.3%)
Total Operating expenses	**26.3**	**36.1**	**27.4**	**4.3%**	**29.7**	**12.8%**	**(8.5%)**
Profit before tax	19.4	26.5	22.9	18.3%	21.9	13.1%	5.2%
Profit after tax	**13.7**	**19.6**	**15.9**	**16.1%**	**15.4**	**11.8%**	**4.3%**

Income Statement Ratios	Q3'2015	Q3'2016	%y/y change
Yield from interest-earning assets	11.2%	12.4%	1.2%
Cost of funding	3.3%	3.7%	0.5%
Net Interest Spread	7.9%	8.6%	0.7%
Net Interest Margin	7.1%	9.2%	2.1%
Cost of Risk	1.6%	1.3%	(0.3%)
Net Interest Income as % of operating income	62.1%	71.8%	9.7%
Non-Funded Income as a % of operating income	37.9%	28.2%	(9.7%)
Cost to Income Ratio	57.6%	54.4%	(3.1%)
Cost to Assets	4.2%	4.1%	(0.2%)

Capital Adequacy Ratios	Q3'2015	Q3'2016
Core Capital/Total Liabilities	14.60%	18.40%
Minimum Statutory ratio	8.00%	8.00%
Excess	**6.60%**	**10.40%**
Core Capital/Total Risk Weighted Assets	14.50%	16.60%
Minimum Statutory ratio	10.50%	10.50%
Excess	**4.00%**	**6.10%**
Total Capital/Total Risk Weighted Assets	15.70%	17.90%
Minimum Statutory ratio	14.50%	14.50%
Excess	**1.20%**	**3.40%**
Liquidity Ratio	26.90%	38.00%
Minimum Statutory ratio	20.00%	20.00%
Excess	**6.90%**	**18.00%**