**Valuation Summary**

- We are of the view that KCB Group PLC is a "buy" with a target price of Kshs 60.9, representing an upside of 32.4%, from the current price of Kshs 49.0 as of 16th August, inclusive of a dividend yield of 6.1%,
- KCB Group PLC is currently trading at P/TBV of 1.6x and a P/E of 6.2x vs an industry average of 1.7x and 9.2x, respectively.

**Key Highlights H1'2018**

- KCB Group was named the Best Retail Bank in the East African region at the Banker Africa, East Africa Awards 2018,
- KCB Group received the first tranche of Kshs 8.0 bn (USD 80.0 mn) of the USD 100.0 mn line of credit advanced by the African Development Bank (AfDB) following a deal signed by the two institutions in 2017. The funds are meant for onward lending to businesses in agricultural and energy sectors, as well as providing much-needed liquidity provision to enterprises in infrastructure and manufacturing,
- KCB Group was rated B+ with stable outlook by the global rating agency Fitch Ratings.

**Income Statement**

- Core earnings per share increased by 18.0% to Kshs 7.9 from Kshs 6.7 in H1'2017, exceeding our expectation of a 9.4% increase to Kshs 7.3. Performance was driven by a 2.9% increase in total operating income, coupled with a 6.8% decline in total operating expenses. The variance in core earnings per share growth against our expectations was largely due to a 58.9% decline in Loan Loss Provisions (LLP). We had expected a 9.5% decline in LLP to Kshs 1.8 bn from Kshs 2.0 bn in H1'2017, but came in at 0.8 bn,
- Total operating income increased by 2.9% to Kshs 35.6 bn in H1'2018 from Kshs 34.6 bn in H1'2017. This was due to a 4.3% increase in Net Interest Income (NII) to Kshs 24.1 bn from Kshs 23.1 bn in H1'2017, despite Non-Funded Income (NFI) remaining flat at Kshs 11.5 bn,
- Interest income increased by 6.1% to Kshs 32.2 bn from Kshs 30.4 bn in H1'2017, driven by a 7.1% increase in interest income on loans and advances to Kshs 25.6 bn from Kshs 23.9 bn, and a 3.6% increase in interest on government securities to Kshs 6.3 bn from Kshs 6.1 bn in H1'2017. As a result, the yield on interest-earning assets increased slightly to 11.4% from 11.2% in H1'2017,
- Interest expense increased by 11.9% to Kshs 8.1 bn from Kshs 7.2 bn in H1'2017, following a 12.0% increase in the interest expense on customer deposits to Kshs 7.3 bn from Kshs 6.5 bn in H1'2017.Interest expense on deposits and placements from banking institutions increased by 11.4% to Kshs 0.8 bn from Kshs 0.7 bn in H1'2017. Consequently, the cost of funds increased to 3.0% from 2.7% in H1'2017, while the Net Interest Margin declined to 8.6% from 8.7% in H1'2017,
- Non-Funded Income remained flat at Kshs 11.5 bn. This was due to a 1.2% decline in fees and commissions on loans to Kshs 3.08 bn from Kshs 3.11 bn in H1'2017, and a 9.7% decline in other fees and commissions to Kshs 3.7 bn from Kshs 4.1 bn in H1'2017, which offset a 7.0% rise in forex income to Kshs 2.8 bn from Kshs 2.6 bn in H1'2017, and a 15.0% rise in other income to Kshs 1.9 bn from Kshs 1.6 bn in H1'2017. The current revenue mix stands at 68:32 funded to non-funded income as compared to 67:33 in H1'2017. The proportion of funded income to total revenue increased slightly owing to the growth in NII while NFI remained flat,
- Total operating expenses declined by 6.8% to Kshs 18.5 bn from Kshs 19.9 bn in H1'2017, largely driven by a 58.9% decline in loan loss provisions to Kshs 0.8 bn in H1'2018 from Kshs 2.0 bn in H1'2017, coupled with a 5.0% decline in staff costs to Kshs 8.6 bn from Kshs 9.1 bn in H1'2017. Depreciation

charge on property and equipment however increased by 10.1% to Kshs 0.9 bn from Kshs 0.8 bn in H1'2017,

- The cost to income ratio improved to 52.0% from 57.0% in H1'2017. Without LLP, the cost to income ratio also improved to 49.7% from 51.6% in H1'2017,
- Profit before tax increased by 15.9% to Kshs 17.1 bn, up from Kshs 14.8 bn in H1'2017. Profit after tax increased by 18.0% to Kshs 12.1 bn from Kshs 10.3 bn in H1'2017,
- KCB declared an interim dividend of Kshs 1.0 per share, payable on 30th November 2018 to shareholder's registered at the close of business on 3rd September 2018. We expect a final dividend per share of Kshs 2.0, taking the total dividend for 2018 to Kshs 3.0 per share, translating to a dividend yield of 6.1%.

**Balance Sheet**

- The balance sheet recorded an expansion as total assets increased by 5.9% to Kshs 667.7 bn from Kshs 630.6 bn in H1'2017. This growth was driven by a 35.8% growth in other assets to Kshs 22.0 bn from Kshs 16.2 bn in H1'2017, and a loan book growth of 3.6% to Kshs 421.5 bn from Kshs 407.0 bn in H1'2017.
- Government securities declined by 2.8% to Kshs 112.5 bn from Kshs 115.8 bn in H1'2017,
- Total liabilities rose by 6.8% to Kshs 568.7 bn from Kshs 532.3 bn in H1'2017, driven by an 8.7% increase in customer deposits to Kshs 524.9 bn from Kshs 482.8 bn in H1'2017. . Deposits per branch increased by 11.1% to Kshs 2.0 bn from Kshs 1.8 bn in H1'2017. The bank highlighted the closure of 3 branches in H1'2018. The faster growth in deposits compared to loans led to a decline in the loan to deposit ratio to 80.3% from 84.3% in H1'2017,,
- Gross non-performing loans increased by 13.2% to Kshs 37.6 bn in H1'2018 from Kshs 33.2 bn in H1'2017. As a consequence, the NPL ratio deteriorated to 8.4% in H1'2018 from 7.7% in H1'2017.General Loan Loss Provisions increased by 1.4% to Kshs 19.4 bn from Kshs 19.1 bn in H1'2017.Thus, the NPL coverage declined marginally to 75.0 % in H1'2018 from 75.4% in H1'2017, due to the relatively faster growth in gross non-performing loans compared to growth in loan loss provisions,
- Total Shareholders' funds increased by 6.8% to Kshs 99.0 bn in H1'2018 from Kshs 98.3 bn in H1'2017.
- KCB Group is currently sufficiently capitalized with a core capital to risk weighted assets ratio of 15.7%, 5.2% above the statutory requirement. In addition, the total capital to risk weighted assets ratio was 17.2%, exceeding the statutory requirement by 2.7%. Adjusting for IFRS 9, the core capital to risk weighted assets stood at 16.6%, while total capital to risk weighted assets came in at 18.3%, indicating that the bank's total capital relative to its risky assets declined by 1.1%, due to implementation of IFRS 9,
- KCB Bank currently has a return on average assets of 3.5% and a return on average equity of 21.9%.

**Key Take-Outs:**

1. The bank experienced a deterioration in asset quality, with gross non-performing loans (NPLs) rising by 13.2%, to Kshs 37.6 bn from Kshs 33.2 bn in H1'2017. This was largely contributed by corporate, SME and Micro segments. This warranted increased provisioning by 1.4% to Kshs 19.4 bn from Kshs 19.1bn in H1'2017, although the provisioning did not rise in tandem with the Non-Performing Loans, and,
2. The bank's Non-Funded Income remained flat at Kshs 11.5 bn, with the strong performance largely buttressed by declining operating expenses with Loan Loss Provisions declining by 58.9% y/y. With slow revenue expansion, the bank may not be able to attain a sustainable growth, and needs to accompany expense reduction with revenue expansion to attain profit sustainability.

Going forward, we expect the bank's growth to be further driven by:

a. **Alternative Distribution Channels** – By leveraging on alternative distribution channels for the bank's products and services, such as agency banking, internet and mobile banking platforms, would address the stagnating growth in non-funded sources of income for the bank thereby creating efficiencies and improving overall profitability for the bank,
b. **Non-Funded Income Growth Initiatives** - This includes increasing other fees and commission income by leveraging on mobile and internet banking to increase the transaction income. Additionally, the brand is underutilized in fee income businesses such as investment banking, brokerage, asset and investment management, and advisory – this remains the biggest source of potential growth for KCB Group. KCB's NFI ratio currently stands at 32.0%, a decline from 33% in H1'2017. Just moving to an NFI ratio of 40% would mean Kshs 4.5 bn of additional revenue. KCB should diversify its sources of revenue in order to sustain profitability in the interest rate cap environment.

Below is a summary of the bank's performance:

| Balance Sheet Items | H1'2017 | H1'2018 | y/y change | H1'2018e | Expected y/y change | Variance in Actual Growth vs Expected |
|---|---|---|---|---|---|---|
| Government Securities | 115.8 | 112.5 | (2.8%) | 101.06 | 0.4% | (3.2%) |
| Net Loans and Advances | 407.0 | 421.5 | 3.6% | 444.2 | 9.1% | (5.6%) |
| **Total Assets** | **630.6** | **667.7** | **5.9%** | **681.4** | **8.1%** | **(2.2%)** |
| Customer Deposits | 482.8 | 524.9 | 8.7% | 521.2 | 7.9% | 0.8% |
| Total Liabilities | 534.1 | 568.7 | 6.5% | 575.7 | 7.8% | (1.3%) |
| **Shareholders' Funds** | **98.3** | **99.0** | **0.7%** | **105.7** | **7.5%** | **(6.8%)** |

| Balance Sheet Ratios | H1'2017 | H1'2018 | % y/y change |
|---|---|---|---|
| Loan to Deposit Ratio | 84.3% | 80.3% | (4.0%) |
| Return on average equity | 20.2% | 21.9% | 1.6% |
| Return on average assets | 3.2% | 3.5% | 0.3% |

| Income Statement | H1'2017 | H1'2018 | y/y change | H2'2018e | Expected y/y change | Variance in Actual Growth vs Expected |
|---|---|---|---|---|---|---|
| Net Interest Income | 23.1 | 24.1 | 4.3% | 24.7 | 6.8% | (2.5%) |
| Net non-Interest Income | 11.5 | 11.5 | (0.1%) | 12.1 | 5.3% | (5.4%) |
| **Total Operating income** | **34.6** | **35.6** | **2.9%** | **36.8** | **6.4%** | **(3.5%)** |
| Loan Loss provision | 2.0 | 0.8 | (58.9%) | 1.8 | (9.5%) | (49.3%) |
| Total Operating expenses | 19.9 | 18.5 | (6.8%) | 20.8 | 4.6% | (11.4%) |
| Profit before tax | 14.8 | 17.1 | 15.9% | 16.0 | 8.7% | 7.1% |
| **Profit after tax** | **10.3** | **12.1** | **18.0%** | **11.2** | **9.4%** | **8.6%** |

| Income Statement Ratios | H1'2017 | H1'2018 | y/y change |
|---|---|---|---|
| Yield from interest-earning assets | 11.2% | 11.4% | 0.2% |
| Cost of funding | 2.7% | 3.0% | 0.3% |
| Net Interest Spread | 8.5% | 8.4% | (0.1%) |
| Net Interest Margin | 8.7% | 8.6% | (0.1%) |
| Cost of Risk | 1.0% | 0.4% | (0.6%) |
| Net Interest Income as % of operating income | 67% | 68% | 0.9% |
| Non-Funded Income as a % of operating income | 33% | 32% | (0.9%) |

| | | | |
|---|---|---|---|
| Cost to Income Ratio | 57.4% | 52.0% | (5.4%) |

| Capital Adequacy Ratios | H1'2017 | H1'2018 |
|---|---|---|
| Core Capital/Total Liabilities | 19.2% | 16.9% |
| Minimum Statutory ratio | 8.0% | 8.0% |
| **Excess** | **11.2%** | **8.9%** |
| | | |
| Core Capital/Total Risk Weighted Assets | 17.4% | 15.7% |
| Minimum Statutory ratio | 10.5% | 10.5% |
| **Excess** | **6.9%** | **5.2%** |
| | | |
| Total Capital/Total Risk Weighted Assets | 18.7% | 17.2% |
| Minimum Statutory ratio | 14.5% | 14.5% |
| **Excess** | **4.2%** | **2.7%** |
| | | |
| Liquidity Ratio | 35.7% | 35.3% |
| Minimum Statutory ratio | 20.0% | 20.0% |
| **Excess** | **15.7%** | **15.3%** |
| Adjusted core capital/ total deposit liabilities | | 17.9% |
| Adjusted core capital/ total risk weighted assets | | 16.6% |
| Adjusted total capital/ total risk weighted assets | | 18.1% |