KCB Group Limited – FY'2017

8th March, 2018

Valuation Summary

- We are of the view that KCB Group Limited stock is a "Buy", with a target price of Kshs 59.7 representing an upside of 27.8%, from the current price of Kshs 48.3, as at 8th March, inclusive of a dividend yield of 4.1%,
- KCB Group is currently trading at a P/TBV of 1.5x and a P/E of 7.3x, vs an industry average of 1.6x and 9.1x, respectively.

Key highlights during FY'2017

- Global Credit Ratings (GCR) affirmed KCB Bank's long-term and short-term national scale ratings of AA and A1+, respectively, with a stable outlook for the fourth straight year. The rating is the highest for a Kenyan bank accorded by GCR, and it reflects KCB Bank's established domestic market position, risk appropriate capitalization, sound liquidity position, resilient earnings performance and support from its shareholders,
- KCB Group was feted as the Best Bank in Kenya and the Best Bank in Africa in Corporate and Social Responsibility during the 2017 Euromoney Awards for Excellence held in London. This is the third time the Bank has won the globally acclaimed Euromoney Award,
- African Development Bank (AfDB) extended a USD 100 mn line of credit to KCB Bank Kenya to support the bank's lending operations in Kenya especially to corporate, Small and Medium Enterprises (SMEs) and projects critical to the development of the economy.

Income Statement

- Core earnings per share remained flat at 6.4, similar to FY'2016, lower than our expectations for a 1.1% increase. Performance was driven by a 2.7% increase in operating income, despite a 4.7% increase in operating expenses,
- Total operating revenue grew by 2.7% y/y to Kshs 71.4 bn from Kshs 69.5 bn, driven by slight increases in both Net Interest Income (NII) and Non Funded Income (NFI). NII rose by 2.9% to Kshs 48.4 bn from Kshs 47.0 bn in FY'2016, while NFI rose 2.5% to Kshs 23.0 bn from Kshs 22.5 bn in FY'2016.
- Interest Income rose by 1.4% to Kshs 63.7 bn from Kshs 62.8 bn in FY'2016. The interest income on loans and advances alone declined by 0.8% y/y to Kshs 50.8 bn from Kshs 51.2 bn, while interest income on government securities grew by 13.8% y/y to Kshs 12.4 bn from Kshs 10.9 bn. As a result, the yield on interest-earning assets declined to 11.5% from 12.2% in FY'2016,
- Interest expense decreased by 3.1% to Kshs 15.3 bn from Kshs 15.8 bn in FY'2016, following a 6.0% decline in interest expense on customer deposits to Kshs 13.6 bn from Kshs 14.5 bn, thus bringing down the cost of funds to 3.0% from 3.3% in FY'2016. The Net Interest Income increased 2.9% to Kshs 48.4 bn from Kshs 47.0 bn. The Net Interest Margin however declined to 8.7% from 9.2% in FY'2016, owing to a faster growth in interest earning assets,
- Non-Funded Income (NFI) recorded a growth of 2.5% to Kshs 23.0 bn from Kshs 22.5 bn in FY'2016. The growth in NFI was driven by a 50.0% increase in other fees and commissions to Kshs 9.1 bn from Kshs 6.1 bn in FY'2016, despite a 14.7% decline in fees and commissions on loans to Kshs 5.6 bn from Kshs 6.6 bn in FY'2016. The current revenue mix stands at 68:32 funded to non-funded income, same as in FY'2016, owing to a similar increase in both the NII and NFI,
- The 50.0% increase in other fees and commissions was driven by a growth in commissions from alternative banking channels including digital platforms and agency banking. The volume of transactions made through these alternative channels increased to 87% from 77% in FY'2016,
- Total operating expenses increased by 4.7% to Kshs 42.3 bn from Kshs 40.4 bn, driven by a 54.7% increase in Loan Loss Provisions to Kshs 5.9 bn from Kshs 3.8 bn in FY'2016, coupled with an 8.1% increase in staff costs to Kshs 19.1 bn from Kshs 17.7 bn in FY'2016. The decline in costs came from the 15.2% decline in other operating expenses to Kshs 12.6 bn from Kshs 14.9 bn in FY'2016. The growth in staff costs is attributed to the staff rationalization programme that saw 316 staff released from service(249 from KCB Bank Kenya and 67 in KCB Subsidiaries), that cost Kshs 2.0 bn to rollout, whose costs are expected to be recovered within 18 months,
- The Cost to Income ratio deteriorated to 59.2% from 58.1% in FY'2016. Without LLP, the Cost to Income ratio improved to 50.9% from 52.6% in FY'2016.
- Profit before tax remained flat at Kshs 29.1 bn. Profit after tax was also flat at Kshs 19.7 bn.

Balance Sheet

- The total assets increased by 8.6% to Kshs 646.7 bn from Kshs 595.2 bn in FY'2016. This growth was driven by a 9.6% growth in the loan book to Kshs 422.7 bn from Kshs 385.7 bn in FY'2016. Investment in government and other securities increased by 7.4% to Kshs 110.0 bn from Kshs 102.5 bn in FY'2016,
- The loan book was majorly composed of personal loans that accounted for 35.1% of total loans, while loans to the real estate sector stood at 17.1%. Lending to the retail segment, corporates and mortgages experienced growth, with their loan books growing by Kshs 19 bn, Kshs 9 bn and Kshs 9 bn, respectively, from FY'2016,
- Total liabilities rose by 8.4% to Kshs 540.7 bn from Kshs 498.7 bn in FY'2016, driven by an 11.5% increase in deposits to Kshs 499.5 bn from Kshs 448.2 bn in FY'2016. Deposits per branch increased 10.2% to Kshs 1.9 bn from Kshs 1.7 bn in FY'2016,
- The deposit mix remained relatively stable, with corporates and the retail segment contributing 51% and 46% of total deposits, respectively, compared to 50% and 47%, respectively in FY'2016. In terms of deposits by type, current accounts remained stable at 65%, while there was a decrease in higher interest bearing term accounts that currently account for 24% from 26% in FY'2016,
- Shareholders' funds increased by 12.2% to Kshs 103.2 bn from Kshs 92.0 bn in FY'2016, due to a 14.4% y/y increase in retained earnings to Kshs 63.0 bn from Kshs 55.0 bn,
- The faster growth in deposits compared to the loan book led to a decline in the loan to deposit ratio to 84.6% from 86.1% in FY'2016,
- Gross non-performing loans increased by 17.9% to Kshs 37.5 bn from Kshs 31.8 bn. The NPL ratio thus deteriorated to 8.4% from 7.8% in FY'2016, due to the faster growth NPLs in the loan book,
- KCB Group is currently sufficiently capitalized with a core capital to risk weighted assets ratio at 15.4%, 4.9% above the statutory requirement, with total capital to total risk weighted assets exceeding statutory requirement by 2.1%.
- KCB Group currently has a return on average assets of 3.2% and a return on average equity of 19.5%.
- The bank recommends a final dividend of Kshs 2.0 per share, having already paid an interim dividend of Kshs 1.0 per share, translating to a total dividend payout of Kshs 3.0 per share, unchanged from 2016

Key Take out:

a) Sustained increase in costs, owing mainly to credit impairment charges that grew by 54.7% y/y, and the restructuring costs from the staff rationalization programme that cost Kshs 2 bn. However, drive for efficiency is taking off, with 87% of the bank's transactions in 2017 being handled through alternative channels such as mobile, internet, merchant, ATMs and agency banking with the remaining 13% being branch transactions.

Despite the flat growth in earnings, going forward, we expect KCB Group's growth can be propelled by;

(i) Channel diversification to more efficient and customer convenient channels such as mobile and digital channels that allow for more transactional fee based income, thus increasing its Non Funded Income. KCB's Funded to Non Funded Income ratio of 68:32 is still below peer average of 66:34 in terms of NFI contribution to total revenue,

(ii) Improvements in asset quality, with the increase in NPLs causing KCB's Gross Non-Performing Loans ratio to deteriorate to 8.4%, which is above peer average of 8.2%.

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'2016	FY'2017	y/y change	FY'2017e	Expected y/y change	Variance in Actual Growth vs Expected
Government Securities	102.5	110.0	7.4%	122.4	19.4%	(12.1%)
Net Loans and Advances	385.7	422.7	9.6%	430.0	11.5%	(1.9%)
Total Assets	**595.2**	**646.7**	**8.6%**	**673.4**	**13.1%**	**(4.5%)**
Customer Deposits	448.2	499.5	11.5%	506.2	13.0%	(1.5%)
Total Liabilities	498.7	540.7	8.4%	574.7	15.2%	(6.8%)
Shareholders' Funds	**96.6**	**106.0**	**9.7%**	**98.7**	**2.2%**	**7.6%**

Balance Sheet Ratios	FY'2016	FY'2017	% y/y change
Loan to Deposit Ratio	86.1%	84.6%	(1.5%)
Return on average equity	22.2%	19.5%	(2.7%)
Return on average assets	3.4%	3.2%	(0.2%)

Income Statement	FY'2016	FY'2017	y/y change	FY'2017e	Expected y/y change	Variance in Actual Growth vs Expected
Net Interest Income	47.0	48.4	2.9%	48.4	2.9%	(0.1%)
Net non-Interest Income	22.5	23.0	2.5%	25.6	13.9%	(11.4%)
Total Operating income	**69.5**	**71.4**	**2.8%**	**74.0**	**6.5%**	**(3.7%)**
Loan Loss provision	3.8	5.9	54.7%	4.5	17.3%	37.3%
Total Operating expenses	40.4	42.3	4.7%	45.8	13.4%	(8.7%)
Profit before tax	29.1	29.1	0.1%	28.2	(3.1%)	3.2%
Profit after tax	**19.7**	**19.7**	**(0.1%)**	**19.9**	**1.1%**	**(1.1%)**
Core EPS	**6.4**	**6.4**	**(0.1%)**	**6.5**	**1.1%**	**(1.1%)**

Income Statement Ratios	FY'2016	FY'2017	y/y change
Yield from interest-earning assets	12.2%	11.5%	(0.7%)
Cost of funding	3.3%	3.0%	(0.3%)
Net Interest Spread	8.9%	8.5%	(0.4%)
Net Interest Margin	9.2%	8.7%	(0.4%)
Cost of Risk	5.5%	8.3%	2.8%
Net Interest Income as % of operating income	67.7%	67.8%	0.1%
Non-Funded Income as a % of operating income	32.3%	32.2%	(0.1%)
Cost to Income Ratio	58.1%	59.2%	1.1%

Capital Adequacy Ratios	FY'2016	FY'2017
Core Capital/Total Liabilities	21.1%	17.1%
Minimum Statutory ratio	8.0%	8.0%
Excess	**13.1%**	**9.1%**
Core Capital/Total Risk Weighted Assets	18.4%	15.4%
Minimum Statutory ratio	10.5%	10.5%
Excess	**7.9%**	**4.9%**
Total Capital/Total Risk Weighted Assets	19.7%	16.6%
Minimum Statutory ratio	14.5%	14.5%
Excess	**5.2%**	**2.1%**
Liquidity Ratio	37.5%	29.0%
Minimum Statutory ratio	20.0%	20.0%
Excess	**17.5%**	**9.0%**