Kenya Commercial Bank Earnings Update – H1'2017

2nd August, 2017

Valuation Summary

- We are of the view that KCB Group stock is a "Buy" with a target price of Kshs 54.7, representing an upside of 42.7%, from the current price of Kshs 40.5, as at 4th August, inclusive of a dividend yield of 7.4%
- KCB Group is currently trading at a P/TBv of 1.3x and a P/E of 6.4x, vs an industry average of 1.5x and 7.3x, respectively

Key highlights during H1'2017

- The Global Credit Ratings (GCR) agency affirmed KCB Group's long and short-term national scale ratings of AA and A1+, respectively, with a stable outlook,
- Reports indicated that KCB Group had expressed interest to acquire the National Bank of Kenya (NBK) through a share swap, buying out 70.0% of the bank in the first phase, with a full acquisition to follow, and
- KCB Group announced it was offering a voluntary buyout program for employees considering early retirement. While the release of the annual report indicated the bank had laid off 223 staff in 2016, reports also indicate that the bank is keen on shutting down some branches in South Sudan. These measures are part of the group's transformation strategy to enhance operational efficiency following the capping of interest rates.

Income Statement

- Profit after tax (PAT) remained flat at Kshs 10.3 bn in H1'2017, whereas core earnings per share (EPS) registered a 3.6% decline, coming in at Kshs 6.7, from Kshs 6.9 in H1'2016. The decline in EPS was a result of the scrip dividend issue carried out last year. Adjusting for the scrip shares, the core earnings would have remained flat at Kshs 6.9 per share,
- The flat performance was attributed to a 5.3% growth in operating expenses to Kshs 19.9 bn from Kshs 18.9 bn registered in H1'2016, with operating income growing by 2.8% to Kshs 34.6 bn from Kshs 33.7 bn registered in H1'2016,
- Total operating income grew by 2.8% to Kshs 34.6 bn from Kshs 33.7 bn in H1'2016, supported by a 2.9% growth in in Net Interest Income (NII) and Non-Funded Income (NFI) growth of 2.5%,
- NII grew by 2.9% to Kshs 23.1 bn from Kshs 22.5 bn in H1'2016, following a 20.8% decline in interest expense to Kshs 7.2 bn from Kshs 9.1 bn in H1'2016, brought about by the effective management of the cost of funding, which outpaced interest income that declined by 3.9% to Kshs 30.4 bn from Kshs 31.6 bn in H1'2016. This resulted in the Net Interest Margin (NIM) improving to 8.7% from 8.1% in H1'2016,
- NFI increased by 2.5% to Kshs 11.5 bn from Kshs 11.2 bn in H1'2016 attributed to a 28.6% increase in fees and commissions on loans that came in at Kshs 3.1 bn, from Kshs 2.4 bn in H1'2016, despite a decline in other income, which decreased by 30.1% to Kshs 1.6 bn, from Kshs 2.3 bn in H1'2016. The current revenue mix remains relatively unchanged at 67:33 funded to non-funded income,
- Total operating expenses grew by 5.3% to Kshs 19.9 bn, from Kshs 18.9 bn in H1'2016, which was driven by a 12.5% growth in staff costs to Kshs 9.1 bn, from Kshs 8.1 bn in H1'2016, despite a notable decline in loan loss provision (LLP) by 2.4% to Kshs 2.0 bn, from Kshs 2.1 bn in H1'2016,
- Cost to income ratio worsened to 57.4% from 56.0% in H1'2016. Without LLP, cost to Income ratio stood at 51.6% from 49.9% in H1'2016,
- Profit before tax remained flat at Kshs 14.8 bn, while profit after tax remained flat at Kshs 10.3 bn in H1'2017

Balance Sheet

- The balance sheet recorded an expansion in H1'2017, with total assets increasing by 3.3% to Kshs 630.6 bn, from Kshs 610.2 bn in H1'2016, driven by a rise of 16.7% in the loan book,
- The Loan book grew by 16.7% to Kshs 407.0 bn, from Kshs 348.7 bn in H1'2017, in line with our expectations of a 15.7% growth, underpinned by strong performance in the retail and corporate segments,
- Total liabilities increased by 3.6% to Kshs 532.3 bn, from Kshs 513.7 bn in H1'2016, while shareholders' funds increased by 1.9% to Kshs 98.3 bn, from Kshs 96.5 bn in H1'2016,
- Customer deposits grew by 1.3% to Kshs 482.8 bn, from Kshs 476.5 bn in H1'2016. Consequently, the faster growth in loans compared to deposits resulted into the loan to deposit ratio increasing to 84.3% from 73.2% in H1'2016,

- Gross non-performing loans grew by 0.8% to Kshs 33.2 bn, from Kshs 33.0 bn in H1’2016, but the faster growth in loans saw the NPL ratio decline to 7.7%, from 9.0% in H1’2016,
- The yield on interest earning assets decreased to 11.2% from 11.9% in H1’2016, while the cost of funds came in at 2.7%, from 4.0% in H1’2016, which saw the net interest spread rise to 8.5%, from 7.8% in H1’2016,
- KCB Group is currently sufficiently capitalized with a core capital to risk weighted assets ratio of 17.4%, 6.9% above the statutory requirement, with total capital to total risk weighted assets exceeding statutory requirement by 4.2% to close the period at 18.7%,
- KCB Group currently has a return on assets of 3.2%, while return on equity stands at 20.2%, from 3.5% and 23.7% in H1’2016, respectively. The decline is attributable to a higher growth in expenses compared to growth in income, highlighting inefficiencies in business operations.

Key Take outs:

a) Following the resilient performance, the Board of Directors considered and approved the payment of an interim dividend of Kshs 1.0 per share, with book closure on 4th September 2017 and payment to be made on 31st October 2017. The payment will translate into an interim dividend yield of 2.5%, at the current price of Kshs 40.5, as at 4th August 2017. This dividend payout translated into an interim dividend payout ratio of 30.3%,
b) Regional expansion strategy continues to erode shareholders value as KCB Group continues to be affected by the ongoing political instability in South Sudan, coupled with the devaluation of the South Sudanese pound (SSP) and hyper-inflationary effects. The bank is now in the process of shutting down some branches in South Sudan, as it seeks to enhance operational efficiency and preserve shareholders value,
c) Following the operationalization of the Banking (Amendment) Act 2015, we expect NFI to be the key revenue driver for the bank as it seeks to diversify revenue streams and reduce over reliance on the NII in the era of compressed Net Interest Margin.

Going forward, we expect KCB Group growth to be driven by;

i. Review of the regional expansion strategy, with a key focus on consolidation of its regional business by optimizing performance in the existing markets while reducing the overall impact from South Sudan. The exit from non-profitable regional businesses would reduce the bank’s costs by 5.4% points, translating to a 6.1% rise in profit before tax amounting to Kshs 0.9 bn. KCB Group needs to focus on the much more profitable and stable Kenyan business,
ii. Revenue diversification with new business lines such as Bancassurance through KCB Insurance, as well as investment banking through KCB Capital and investment management. In our view, KCB Group is strong and can compete in fee income businesses. They should now focus more on fee-based business in order to grow non-funded income, which now accounts for 33.2% of the total operating income. Just pushing this to 40.0% would mean an additional 24.4% in revenues amounting to Kshs 8.5 bn, and,
iii. Continued implementation of cost reduction measures through adoption of digital platforms and other alternative channels of distribution for both loan disbursement and deposit mobilisation, with 86.0% of transactions now carried out outside the branches. This will help the bank achieve efficiency and keep the cost to income ratio at manageable levels. Bringing the cost to income ratio to 48.4%, comparable to the average of Coop Bank and Equity Holdings, would deliver an additional 15.9% in revenues amounting to Kshs 6.6 bn.

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

Figures in Kshs bn unless otherwise stated

Balance Sheet Items	H1'2016	H1'2017	y/y change	H1'2017e	Expected y/y change	Variance in Actual Growth vs Expected
Government Securities	100.7	115.8	15.0%	108.9	8.2%	6.8%
Net Loans and Advances	348.7	407.0	16.7%	403.5	15.7%	1.0%
Total Assets	**610.2**	**630.6**	**3.3%**	**626.6**	**2.7%**	**0.7%**

Customer Deposits	476.5	482.8	1.3%	467.8	(1.8%)	3.2%
Total Liabilities	513.7	532.3	3.6%	520.1	1.2%	2.4%
Shareholders’ Funds	**96.5**	**98.3**	**1.9%**	**106.5**	**10.4%**	**(8.4%)**

Balance Sheet Ratios	H1'2016	H1'2017	% y/y change
Loan to Deposit Ratio	73.2%	84.3%	11.1%
Return on average equity	23.7%	20.2%	(3.4%)
Return on average assets	3.5%	3.2%	(0.3%)

Income Statement	H1'2016	H1'2017	y/y change	H1'2017e	Expected y/y change	Variance in Actual Growth vs Expected
Net Interest Income	22.5	23.1	2.9%	21.2	(5.9%)	8.8%
Net non-Interest Income	11.2	11.5	2.5%	12.0	7.3%	(4.8%)
Total Operating income	**33.7**	**34.6**	**2.8%**	**33.2**	**(1.5%)**	**4.3%**
Loan Loss provision	2.1	2.0	(2.4%)	2.3	9.3%	(11.6%)
Total Operating expenses	18.9	19.9	5.3%	19.2	1.6%	3.7%
Profit before tax	14.8	14.8	(0.5%)	14.0	(5.6%)	5.0%
Profit after tax	**10.3**	**10.3**	**(0.2%)**	**9.8**	**(4.6%)**	**4.4%**
Core EPS	**6.9**	**6.7**	**(3.6%)**	**6.1**	**(11.7%)**	**8.1%**

Income Statement Ratios	H1'2016	H1'2017	y/y change
Yield from interest-earning assets	11.9%	11.2%	(0.7%)
Cost of funding	4.0%	2.7%	(1.3%)
Net Interest Spread	7.8%	8.5%	0.7%
Net Interest Margin	8.1%	8.7%	0.6%
Cost of Risk	6.4%	5.8%	(0.6%)
Net Interest Income as % of operating income	66.8%	66.8%	0.1%
Non-Funded Income as a % of operating income	33.2%	33.2%	(0.1%)
Cost to Income Ratio	56.0%	57.4%	1.4%

Capital Adequacy Ratios	H1'2016	H1'2017
Core Capital/Total Liabilities	17.8%	19.2%
Minimum Statutory ratio	8.0%	8.0%
Excess	**9.8%**	**11.2%**
Core Capital/Total Risk Weighted Assets	16.4%	17.4%
Minimum Statutory ratio	10.5%	10.5%
Excess	**5.9%**	**6.9%**
Total Capital/Total Risk Weighted Assets	17.7%	18.7%
Minimum Statutory ratio	14.5%	14.5%

Excess	**3.2%**	**4.2%**
Liquidity Ratio	39.1%	35.7%
Minimum Statutory ratio	20.0%	20.0%
Excess	**19.1%**	**15.7%**

Key Metrics	2012	2013	2014	2015	2016	Q1'2017	H1'2017
Funded Income; Non-Funded Income	66;34	66;34	62;28	63;37	68;32	65;35	67;33
NPL Ratio	6.8%	6.5%	6.2%	6.5%	7.8%	7.7%	7.7%
Total Capital to Risk Weighted Assets	23.4%	21.6%	17.3%	16.9%	19.7%	18.7%	18.7%
Loan Growth	6.5%	7.6%	24.6%	21.9%	11.5%	14.3%	16.7%
Deposit growth	11.1%	6.1%	23.4%	12.5%	5.6%	7.9%	1.3%
NIM	9.8%	10.0%	8.6%	7.9%	8.8%	8.6%	8.7%
Cost to Income Ratio	62.8%	59.8%	59.0%	57.6%	58.1%	58.6%	57.4%
ROE	24.7%	24.4%	24.2%	25.0%	22.2%	21.2%	20.2%
ROA	3.5%	3.8%	3.8%	3.7%	3.4%	3.4%	3.2%