KCB Group Earnings Note– H1’2019

15th August, 2019

Valuation Summary

- We are of the view that KCB Group is a “***buy***” with a target price of Kshs 60.0, representing an upside of 60.4%, from the current price of Kshs 39.9 as of 15th August 2019, inclusive of a dividend yield of 8.8%,
- KCB Group is currently trading at a P/TBV of 1.1x and a P/E of 5.5x vs an industry average of 1.3x and 6.6x, respectively.

Key Highlights H1’2019

- During H1’2019, KCB Group announced its intention to acquire a 100% stake in the National Bank of Kenya (NBK). The offer will be by way of a share swap at a ratio of 10:1, 10 ordinary shares of NBK for 1 ordinary share of KCB. KCB served NBK the detailed Offer on 19th June 2019, following shareholder approval with the offer period to swap shares open until 30th August 2019.

- During H1’2019 KCB continued to work on the transfer of assets and liabilities of Imperial Bank which is expected to be concluded by 30th August 2019. After the initial review KCB had identified Kshs 10.0 bn loans that the lender intended to take over out of Imperial Bank’s nearly Kshs 25.0 bn loan book, but after due diligence the amount has come down to less than half according to KCB Group CEO and MD Joshua Oigara

Income Statement

- Core earnings per share increased by 5.0% to Kshs 4.1 from Kshs 4.0 in H1’2018, which was in line with our expectation. The performance was driven by a 8.3% increase in total operating income to Kshs 38.6 bn from Kshs 35.6 bn in H1’2018,
- Total operating income increased by 8.3% to Kshs 38.6 bn from Kshs 35.6 bn in H1’2018. This was driven by a 14.7% increase in Non-Funded Income (NFI) to Kshs 13.2 bn, from Kshs 11.5 bn in H1’2018, coupled with a 5.2% increase in Net Interest Income (NII) to Kshs 25.4 bn from Kshs 24.1 bn in H1’2018,
- Interest income increased by 4.3% to Kshs 33.6 bn, from Kshs 32.2 bn in H1’2018. This was driven by a 4.5% growth in interest income on loans and advances to Kshs 26.8 bn from Kshs 25.6 bn in H1’2018, and a 3.5% increase in interest income from government securities to Kshs 6.6 bn, from Kshs 6.3 bn in H1’2018. The yield on interest-earning assets however declined to 11.1% from 11.4% in H1’2018, attributed to a decline in yields on government securities as well as a decline in lending rates due to the 100 bps CBR cuts last year to 9.0%, which saw interest income growing by only 4.3% despite interest earning assets growing by 8.1%,
- Interest expenses rose by 1.6% to Kshs 8.2 bn from Kshs 8.1 bn in H1’2018, following a 26.8% rise in interest expense on deposits and placement from banking institutions to Kshs 960.9 mn from Kshs 757.8 mn in H1’2018. The rise however was mitigated by a 1.0% decline in interest expense on customer deposits to Kshs 7.2 bn from Kshs 7.3 bn. The cost of funds however remained unchanged at 3.0%. The Net Interest Margin (NIM) declined to 8.2%, from 8.6% in H1’2018,
- Non-Funded Income (NFI) increased by 14.7% to Kshs 13.2 bn from Kshs 11.5 bn in H1’2018. The increase was mainly driven by a 51.5% rise in total fees and commissions’ income to Kshs 4.7 bn, from Kshs 3.1 bn in H1’2018, which rose as the bank registered an acceleration in loan disbursement. The growth was however weighed down by the 27.0% decline in forex trading income to Kshs 2.1 bn, from Kshs 2.8 bn in H1’2018. As a result, the revenue mix shifted to 66:34 from 68:32 funded to non-funded income, due to the faster growth in NFI compared to NII,
- Total operating expenses increased by 11.4% to Kshs 20.6 bn, from Kshs 18.5 bn, largely driven by a 266.2% rise in Loan Loss Provisions (LLP) to Kshs 3.0 bn in H1’2019, from Kshs 827.7 mn in H1’2018, coupled with a 4.6% rise in staff costs to Kshs 9.0 bn in H1’2019, from Kshs 8.6 bn in H1’2018,

- Due to the faster growth of total operating expenses that outpaced the growth in operating income, Cost to Income Ratio (CIR) deteriorated to 53.5%, from 52.0% in H1'2018. Without LLP however, the cost to income ratio improved to 45.7%, from 49.7% in H1'2018, and,
- Profit before tax increased by 4.9% to Kshs 17.9 bn, up from Kshs 17.1 bn in H1'2018. Profit after tax grew by 5.0% to Kshs 12.7 bn in H1'2019, from Kshs 12.1 bn in H1'2018 with the effective tax rate increasing to 33.2% from 32.3% in H1'2018.
- Following the results, the Board of Directors approved a payment of an interim dividend of KShs: 1.0 per share. Shareholders will be paid the dividend in November 2019. Assuming a final dividend payout of Kshs 3.5 the dividend yield translates to 8.8%

Balance Sheet

- The balance sheet recorded an expansion as total assets increased by 11.8% to Kshs 746.5 bn, from Kshs 667.7 bn in H1'2018. This growth was largely driven by a 20.3% increase in investment in government and other securities to Kshs 132.9 bn, from Kshs 110.5 bn in H1'2018, coupled with a 13.6% increase in their loan book to Kshs 478.7 bn, from Kshs 421.5 bn in H1'2018,
- Total liabilities rose by 10.6% to Kshs 629.0 bn, from Kshs 568.7 bn in H1'2018, driven by a 7.3% increase in deposits to Kshs 563.2 bn, from Kshs 524.9 bn in H1'2018. Deposits per branch increased by 9.4% to Kshs 2.2 bn from Kshs 2.0 bn in H1'2018, with the number of branches having reduced to 258 from 263 in H1'2018,
- The faster growth in loans as compared to deposits led to a rise in the loan to deposit ratio to 85.0% from 80.3% in H1'2018,
- Gross Non-Performing Loans (NPLs) rose by 3.9% to Kshs 39.1 bn in H1'2019 from Kshs 37.6 bn in H1'2018. The NPL ratio however, improved to 7.8% from 8.4% in H1'2018 due to the faster growth in loans which outpaced the growth in the Gross Non-Performing Loans (NPLs). General Loan Loss Provisions declined by 17.0% to Kshs 16.1 bn, from Kshs 19.4 bn in H1'2018. The NPL coverage consequently declined to 52.7% from 63.6% in H1'2018,
- Shareholders' funds increased by 18.7% to Kshs 117.5 bn in H1'2019, from Kshs 99.0 bn in H1'2018, as retained earnings grew by 35.7% y/y to Kshs 94.8 bn, from Kshs 69.9 bn in H1'2018,
- KCB Group is currently sufficiently capitalized with a core capital to risk-weighted assets ratio of 18.0%, 7.5% above the statutory requirement. In addition, the total capital to risk-weighted assets ratio was 19.4%, exceeding the statutory requirement by 4.9%. Adjusting for IFRS 9, the core capital to risk weighted assets stood at 18.6%, while total capital to risk-weighted assets came in at 20.1%, and,
- The bank currently has a Return on Average Assets (ROaA) of 3.5%, and a Return on Average Equity (ROaE) of 22.7%.

Key Take-Outs:

1. The bank's asset quality improved, with the NPL ratio improving to 7.8% from 8.4% in H1'2018. The improved NPL ratio was mainly attributed to an improvement in the corporate loan book's NPL ratio to 9.5% in H1'2019 from in 11.6% in H1'2018, as well as the SME and Micro loan book, which improved to 14.1% in H1'2019, down from 15.2% in H1'2018, respectively, and,

2. There was an improvement in operational efficiency as evidenced by the decline in the Cost to Income Ratio (CIR) without LLP to 45.7% in H1'2019, from 49.7% in H1'2018. This has mainly been driven by increased innovation and digitization as seen with 96.0% of total transactions performed outside the branch comprising of 78.0% on mobile, 14.0% on agency, internet and POS and 4.0% on the ATM, which has facilitated the faster growth of transactional income outpacing the growth in operating expenses. This has also seen a 131.0% growth in non-branch revenue to over Kshs 5.2 bn,

3. Non-Funded Income (NFI) increased by 14.7% to Kshs 13.2 bn from Kshs 11.5 bn in H1’2018. As a result, the revenue mix shifted to 66:34 from 68:32 funded to non-funded income, due to the faster growth in NFI compared to NII. The average NFI growth for the listed Banks that have released their H1’2019 results currently stands at 16.8%.

We expect the bank’s growth to be driven by:

1. Increased ***Channeled diversification,*** which is likely to help the bank to continue improving its operational efficiency. The benefits of this are already being felt, as the bank aligned its staff head count to its operational needs. Continued emphasis on these alternative channels of transactions, as the bank rides on the digital revolution wave, will likely lead to further cost to income ratio improvements by cost rationalization and NFI expansion.

Below is a summary of the bank’s performance:

Balance Sheet Items	H1'2018	H1'2019	y/y change	H1'2019e	Expected y/y change	Variance in Actual Growth vs Expected
Net Loans and Advances	421.5	478.7	13.6%	470.6	11.6%	1.9%
Total Assets	**667.7**	**746.5**	**11.8%**	**745.0**	**11.6%**	**0.2%**
Customer Deposits	524.9	563.2	7.3%	563.2	7.3%	(0.0%)
Total Liabilities	568.7	629.0	10.6%	618.7	8.8%	1.8%
Shareholders’ Funds	**99.0**	**117.5**	**18.7%**	**126.3**	**27.6%**	**(8.8%)**

Balance Sheet Ratios	H1'2018	H1'2019	% y/y change
Loan to Deposit Ratio	80.3%	85.0%	4.7%
Return on average equity	21.9%	22.7%	0.9%
Return on average assets	3.5%	3.5%	0.0%

Income Statement	H1'2018	H1'2019	y/y change	H1'2019e	Expected y/y change	Variance in Actual Growth vs Expected
Net Interest Income	24.1	25.4	5.2%	26.1	8.3%	(3.1%)
Net non-Interest Income	11.5	13.2	14.7%	12.6	9.4%	5.4%
Total Operating income	**35.6**	**38.6**	**8.3%**	**38.7**	**8.6%**	**(0.3%)**
Loan Loss provision	0.8	3.0	266.2%	1.8	115.6%	150.7%
Total Operating expenses	18.5	20.6	11.4%	20.7	11.7%	(0.3%)
Profit before tax	17.1	17.9	4.9%	18.0	5.2%	(0.3%)
Profit after tax	**12.1**	**12.7**	**5.0%**	**12.6**	**4.0%**	**1.1%**
Core EPS	**4.0**	**4.15**	**5.0%**	**4.11**	**4.0%**	**1.1%**

Income Statement Ratios	H1'2018	H1'2019	y/y change
Yield from interest-earning assets	11.4%	11.1%	(0.3%)
Cost of funding	3.0%	3.0%	0.0%
Net Interest Spread	8.4%	8.1%	(0.3%)
Net Interest Margin	8.6%	8.2%	(0.3%)
Cost of Risk	2.3%	7.9%	5.5%
Net Interest Income as % of operating income	67.8%	65.9%	(1.9%)
Non-Funded Income as a % of operating income	32.2%	34.1%	1.9%
Cost to Income Ratio	52.0%	53.5%	1.5%

Capital Adequacy Ratios	H1'2018	H1'2019
Core Capital/Total Liabilities	16.9%	20.1%
Minimum Statutory ratio	8.0%	8.0%
Excess	**8.9%**	**12.1%**
Core Capital/Total Risk Weighted Assets	15.7%	18.0%
Minimum Statutory ratio	10.5%	10.5%
Excess	**5.2%**	**7.5%**
Total Capital/Total Risk Weighted Assets	17.2%	19.4%
Minimum Statutory ratio	14.5%	14.5%
Excess	**2.7%**	**4.9%**
Liquidity Ratio	35.3%	34.9%
Minimum Statutory ratio	20.0%	20.0%
Excess	**15.3%**	**14.9%**
Adjusted core capital/ total deposit liabilities	17.0%	20.8%
Adjusted core capital/ total risk weighted assets	16.6%	18.6%
Adjusted total capital/ total risk weighted assets	18.1%	20.1%