KCB Group Limited – Q3’2017

10th November, 2017

Valuation Summary

- We are of the view that KCB Group Limited stock is a “buy”, with a target price of Kshs 57.1 representing an upside of 45.9%, from the current price of Kshs 40.5, as at 10th November, inclusive of a dividend yield of 4.9%,
- KCB Group is currently trading at a P/TBV of 1.3x and a P/E of 6.2x, vs an industry average of 1.4x and 8.1x, respectively.

Key highlights during Q3’2017

- 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 grew by 5.0% to Kshs 4.9 from Kshs 4.6 in Q3’2016, driven by a 4.6% increase in operating revenue, which was more than the 5.7% increase in operating expenses. Key to note is that KCB Group restated the Q3’2016 earnings without which the earning per share would have recorded a decline of 5.5%,
- Total operating revenue grew by 4.6% y/y to Kshs 53.2 bn from Kshs 50.8 bn, driven by an 18.4% growth in Non-Funded Income (NFI) to Kshs 17.5 bn from Kshs 14.8 bn in Q3'2016; which made up for the 1.0% decline in Net Interest Income (NII) to Kshs 35.7 bn from Kshs 36.0 bn,
- Interest Income declined by 3.6% to Kshs 46.8 bn from Kshs 48.5 bn in Q3’2016, despite the loan book recording a 15.1% growth, implying that the decline was an effect of the interest rate cap. The interest income on loans and advances alone declined by 4.4% y/y to Kshs 37.1 bn from Kshs 38.8 bn, while interest income on government securities grew by 1.9% y/y to Kshs 9.3 bn from Kshs 9.1 bn. As a result, the yield on interest-earning assets declined to 11.3% from 12.4% in Q3’2016,
- Interest expense decreased by 10.9% to Kshs 11.1 bn from Kshs 12.4 bn in Q3’2016, following a 13.2% decline in interest expense on customer deposits to Kshs 9.9 bn from Kshs 11.4 bn. This is despite a 13.6% increase in deposits. The increase in deposits yet interest expense decreasing is attributed to reclassification of customer deposits to current accounts, which currently account for 66% of total deposits up from 64% in Q3’2016, bringing down the cost of funds to 2.9% from 3.7% in Q3’2016,
- Net Interest Income declined by 1.0% to Kshs 35.7 bn from Kshs 36.0 bn with Net Interest Margin remaining relatively stable at 8.7% from 8.9% in Q3'2016,
- Non-Funded Income (NFI) recorded a growth of 18.4% to Kshs 17.5 bn from Kshs 14.8 bn in Q3'2016. The growth in NFI was driven by a 29.8% increase in total fees and commissions on loans to Kshs 4.8 bn from Kshs 3.7 bn in Q3’2016, a 22.4% increase in other fees and commissions to Kshs 6.4 bn from Kshs 5.2 bn, and a 14.4% increase in other income to Kshs 2.6 bn from Kshs 2.3 bn in Q3’2016. The current revenue mix stands at 67:33 funded to non-funded income from 71:29 in Q3’2016,
- The 29.8% increase in total fees and commissions on loans was driven by a 15.1% expansion in the value of total loans issued and an increase in fees charged on loans by banks,
- The 22.4% 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 86% from Kshs 80% in Q3’2016,
- Total operating expenses increased by 5.7% to Kshs 30.7 bn from Kshs 29.1 bn, driven by an 11.3% increase in Staff Costs to Kshs 13.8 bn from Kshs 12.4 bn in Q3'2016. This was despite a decline in Loan Loss Provision (LLP), which declined by 7.8% to Kshs 3.1 bn from Kshs 3.4 bn in Q3'2016. The growth in staff costs is attributed to the voluntary employee buyout programme that the group rolled out, whose costs would be recovered within 18 months,,

- The Cost to Income ratio slightly increased to 57.8% from 57.2% in Q3'2016 following a 5.7% increase in total operating expenses. Without LLP, the Cost to Income ratio worsened to 51.9% from 50.5% in Q3'2016,
- Profit before tax grew by 3.1% to Kshs 22.4 bn from Kshs 21.7 bn. Profit after tax grew by 5.0% to Kshs 15.1 bn from Kshs 14.4 bn in Q3’2016, following the booking of a deferred tax asset of Kshs 0.8 bn in Q3’2017.

Balance Sheet

- The total assets increased by 12.9% to Kshs 643.8 bn from Kshs 570.1 bn in Q3'2016. This growth was driven by a 15.1% growth in the loan book to Kshs 419.5 bn from Kshs 364.5 bn in Q3’2016. Investment in government and other securities increased by 2.8% to Kshs 103.6 bn from Kshs 100.8 bn in Q3'2016,
- The loan book was majorly composed of personal loans that accounted for 31.9% 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 29 bn, Kshs 16 bn and Kshs 9 bn, respectively, from Q3’2016,
- Total liabilities rose by 13.1% to Kshs 540.6 bn from Kshs 478.1 bn in Q3'2016, driven by a 13.6% increase in deposits to Kshs 496.3 bn from Kshs 436.8 bn in Q3'2016,
- The deposit mix remained relatively stable, with corporates and the retail segment contributing 49% and 45% of total deposits, respectively, similar to 49% and 46%, respectively in Q3’2016. In terms of deposits by type, there was an increase in current accounts, which currently account for 66% of total deposits from 64% in Q3’2016,
- Shareholders’ funds increased by 12.2% to Kshs 103.2 bn from Kshs 92.0 bn in Q3’2016, 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 loan book compared to deposits led to an increase in the loan to deposit ratio to 84.5% from 83.5% in Q3'2016,
- Gross non-performing loans increased by 11.7% to Kshs 34.7 bn from Kshs 31.1 bn. The NPL ratio however declined to 7.8% from 8.1% in Q3’2016, due to the faster growth of the loan book,
- The yield on interest earning assets declined to 11.3% from 12.4% in Q3’2016, while the cost of funds declined to 2.9% from 3.7% in Q3’2016,
- KCB Group is currently sufficiently capitalized with a core capital to risk weighted assets ratio at 17.4%, 6.9% above the statutory requirement, with total capital to total risk weighted assets exceeding statutory requirement by 4.2%.
- KCB Group currently has a return on average assets of 3.4% and a return on average equity of 21.0%.

Key Take Out:

- **Growth in Non-Funded income**, which currently accounts for 33.9% of total revenue, against 29.1% in Q3'2016. With the introduction of the interest rate caps, KCB Group has diversified its revenue sources leveraging on its Fintech strategy. This strategy aggressively focuses on non-branch channels such as Mbenki, KCB MPESA, Mobi and payments, which currently account for 86% of total transactions, an increase from 80% in Q3’2016. Fees and commissions from these avenues have contributed to the 18.4% growth of the Bank’s non-funded income. Going forward, and given the trends in net interest income revenue stream, the profitability of the bank is going to be mainly supported by the growth in non- funded income,

Going forward, KCB Group should continue leveraging on its Fintech strategy to boost its growth and increase its competitiveness in the current tough operating environment. By Q3'2017, 86% of the bank's transaction were handled through alternative channels such as mobile, internet, merchant, ATMs and agency banking with the remaining 14% being branch transactions. In our view, the Group should focus more on the fee-based business in order to reduce the dominance of interest income revenue line item, which currently is at 67.0% of the total operating income.

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	Q3'2016	Q3'2017	y/y change	Q3'2017e	Expected y/y change	Variance in Actual Growth vs Expected
Government Securities	100.8	103.6	2.8%	121.8	20.8%	(18.0%)
Net Loans and Advances	364.5	419.5	15.1%	414.7	13.8%	1.3%
Total Assets	**570.1**	**643.8**	**12.9%**	**645.9**	**13.3%**	**(0.4%)**
Customer Deposits	436.8	496.3	13.6%	492.5	12.7%	0.9%

Total Liabilities	478.1	540.6	13.1%	542.2	13.4%	(0.3%)
Shareholders’ Funds	**92.0**	**103.2**	**12.2%**	**103.7**	**12.7%**	**(0.5%)**

Balance Sheet Ratios	Q3'2016	Q3'2017	% y/y change
Loan to Deposit Ratio	83.5%	84.5%	1.1%
Return on average equity	23.3%	21.0%	(2.3%)
Return on average assets	3.4%	3.4%	(0.1%)

Income Statement	Q3'2016	Q3'2017	y/y change	Q3'2017e	Expected y/y change	Variance in Actual Growth vs Expected
Net Interest Income	36.0	35.7	(1.0%)	36.1	0.1%	(1.1%)
Net non-Interest Income	14.8	17.5	18.4%	16.1	8.8%	9.6%
Total Operating income	**50.8**	**53.2**	**4.6%**	**52.1**	**2.6%**	**2.0%**
Loan Loss provision	3.4	3.1	(7.8%)	3.9	14.6%	(22.3%)
Total Operating expenses	29.1	30.7	5.7%	29.9	2.7%	3.0%
Profit before tax	21.7	22.4	3.1%	22.3	2.5%	0.6%
Profit after tax	**14.4**	**15.1**	**5.0%**	**15.6**	**8.7%**	**(3.6%)**
Core EPS	**4.6**	**4.9**	**5.0%**	**5.0**	**8.7%**	**(3.6%)**

Income Statement Ratios	Q3'2016	Q3'2017	y/y change
Yield from interest-earning assets	12.4%	11.3%	(1.0%)
Cost of funding	3.7%	2.9%	(0.8%)
Net Interest Spread	8.6%	8.4%	(0.2%)
Net Interest Margin	8.9%	8.7%	(0.2%)
Cost of Risk	6.7%	5.9%	(0.8%)
Net Interest Income as % of operating income	70.9%	67.1%	(3.8%)
Non-Funded Income as a % of operating income	29.1%	32.9%	3.8%
Cost to Income Ratio	57.2%	57.8%	0.6%

Capital Adequacy Ratios	Q3'2016	Q3'2017
Core Capital/Total Liabilities	18.4%	19.2%
Minimum Statutory ratio	8.0%	8.0%
Excess	**10.4%**	**11.2%**
Core Capital/Total Risk Weighted Assets	16.6%	17.4%
Minimum Statutory ratio	10.5%	10.5%
Excess	**6.1%**	**6.9%**
Total Capital/Total Risk Weighted Assets	17.9%	18.7%
Minimum Statutory ratio	14.5%	14.5%
Excess	**3.4%**	**4.2%**
Liquidity Ratio	38.0%	37.7%
Minimum Statutory ratio	20.0%	20.0%
Excess	**18.0%**	**17.7%**