KCB Group Earnings Note– H1’2020

14th August, 2020

Valuation Summary

- We are of the view that KCB Group is a “***buy***” with a target price of Kshs 45.7, representing an upside of 49.6%, from the current price of Kshs 30.6 as of 14th August 2020, inclusive of a dividend yield of 11.5%,
- KCB Group is currently trading at a P/TBV of 0.8x and a P/E of 3.8x vs an industry average of 0.9x and 5.1x, respectively.

Key Highlight H1’2020

- KCB recently restructured loans amounting to Kshs 101.1 bn equivalent to 18.1% of its net loans, which stands at Kshs 559.9 bn in H1’2020. The loan restructuring involves placing moratoriums on both interest and principal payments for three months, in effect giving reprieve to its customers who found it difficult to repay their loans due to the impact caused by the pandemic, and,
- Moody’s Credit Rating Agency affirmed KCB Group B_2 rating and changed the groups long-term deposits rating to negative from stable,

Income Statement

- Core earnings per share declined by 40.4% to Kshs 2.4, from Kshs 4.0 in H1’2019, despite a 16.7% growth in total operating income to Kshs 45.0 bn, from Kshs 38.6 bn, as the total operating expenses grew by 56.0% to Kshs 32.2 bn, from Kshs 20.6 bn in H1’2019. The decline in the core earnings per share was lower than our projected decline of 44.8% as the company had a much faster growth of 16.7% in the total operating income compared to our projection of 3.9% decline,
- Total operating income rose by 16.7% to Kshs 45.0 bn, from Kshs 38.6 bn in H1’2019. This was driven by a 22.3% rise in Net Interest Income (NII) to Kshs 31.1 bn, from Kshs 25.4 bn in H1’2019, coupled with a 6.0% rise in Non-Funded Income (NFI) to Kshs 14.0 bn, from Kshs 13.2 bn in H1’2019,
- Interest income grew by 23.2% to Kshs 41.4 bn, from Kshs 33.6 bn in H1’2019. This was driven by a 63.6% rise in interest income on government securities to Kshs 10.8 bn, from Kshs 6.6 bn in H1’2019, which outpaced the 11.9% rise in interest income on loans and advances to Kshs 30.0 bn, from Kshs 26.8 bn in H1’2019. The yield on interest-earning assets declined to 10.1% from 11.0% in H1’2019 attributable to faster growth in the average interest-earning assets of 32.0%, which outpaced the 21.4% growth in trailing interest income. Trailing interest income refers to the performance of the interest income for the past 12 consecutive months,
- Interest expense rose by 25.7% to Kshs 10.3 bn, from Kshs 8.2 bn in H1’2019, following a 29.2% rise in interest expense on customer deposits to Kshs 9.3 bn from Kshs 7.2 bn in H1’2019. Interest expense on deposits and placement from banking institutions, rose by 3.1% to Kshs 0.99 bn, from Kshs 0.96 bn in H1’2019. The cost of funds, on the other hand, declined marginally to 2.6% from 3.0% in H1’2019 owing to a faster 31.2% growth in average interest-bearing liabilities, which outpaced the 25.7% rise in the trailing interest expense. Trailing interest expense refers to the performance of the interest expense for the past 12 consecutive months. The Net Interest Margin (NIM) declined to 7.6% from 8.1% in H1’2019, owing to the faster 32.0% growth in average interest-earning assets, which outpaced the 22.3% growth in Net Interest Income (NII),
- Non-Funded Income (NFI) rose by 6.0% to Kshs 14.0 bn, from Kshs 13.2 bn in H1’2019. The increase was mainly driven by a 14.3% rise in Foreign Exchange trading Income to Kshs 2.4 bn, from Kshs 2.1 bn in H1’2019, coupled with a 4.3% increase in Fees and Commissions from loans and advances to Kshs 4.9 bn, from Kshs 4.7bn in H1’2019. As a result, the revenue mix shifted to 69:31 from 66:34 funded to non-funded income, due to the faster growth in NII compared to NFI,

- Total operating expenses grew by 56.0% to Kshs 32.2 bn, from Kshs 20.6 bn, largely driven by a 263.8% spike in Loan Loss Provisions (LLP) to Kshs 11.0 bn in H1’2020, from Kshs 3.0 bn in H1’2019, coupled with a 12.3% rise in Staff costs to Kshs 10.1 bn in H1’2020, from Kshs 9.0 bn in H1’2019. The increased provisioning levels were witnessed as the Group covered for downgraded facilities, with the expectation of an increase in defaults across sectors, brought about by the COVID-19 pandemic,
- Cost to Income Ratio (CIR) deteriorated to 71.5%, from 53.5% in H1’2019 owing to the faster 56.0% rise in Total Operating Expenses to Kshs 32.2 bn from Kshs 20.6 bn in H1’2019 which outpaced the 16.7% rise in Total Operating Income to Kshs 45.0 bn, from Kshs 38.6 bn in H1’2019. Without LLP however, the cost to income ratio rose to 47.0% from 45.7% in H1’2019, and,
- Profit before tax declined by 28.5% to Kshs 12.8 bn, down from Kshs 17.9 bn in H1’2019 owing to the 263.8% rise in Loan Loss Provisions (LLP) to Kshs 11.0 bn from Kshs 3.0 bn given the poor operating environment due to COVID-19. Profit after tax declined by 40.4% to Kshs 7.6 bn in H1’2020, from Kshs 12.7 bn in H1’2019 with the effective tax rate increasing to 40.9% from 29.1% in H1’2019. The growth in the effective tax rate can be attributed to the 28.5% decline in the profit before tax and the 1.9% increase in total tax to Kshs 5.3 bn from Kshs 5.2 bn in H1’2019.

Balance Sheet

- The balance sheet recorded an expansion as total assets grew by 27.7% to Kshs 953.1 bn, from Kshs 746.5 bn in H1’2019. This growth was driven by a 54.5% rise in investment in government and other securities to Kshs 208.5 bn, from Kshs 135.0 bn in H1’2019. The rise in the investments in government securities is mainly due to the bank's cautious stance with regards to lending. The loan book also recorded a 17.0% growth to Kshs 559.9 bn, from Kshs 478.7 bn in H1’2019. The strong balance sheet growth is also partly attributable to KCB consolidating assets following the acquisition of NBK as first published in the Q1’2020 results,
- Total liabilities rose by 30.5% to Kshs 820.9 bn, from Kshs 629.0 bn in H1’2019, driven by a 34.6% increase in customer deposits to Kshs 758.2 bn, from Kshs 563.2 bn in H1’2019, with customer deposits from NBK amounting to Kshs 99.6 bn in H1’2020. Deposits per branch declined by 4.5% to Kshs 2.1 bn from Kshs 2.2 bn in H1’2019, with the number of branches having increased to 359 as at H1’2020, from 258 in H1’2019,
- The faster growth in deposits as compared to loans led to a decline in the loan to deposit ratio to 73.8%, from 85.0% in H1’2019,
- Gross Non-Performing Loans (NPLs) rose by 114.5% to Kshs 83.9 bn in H1’2020, from Kshs 39.1 bn in H1’2019. Consequently, the NPL ratio deteriorated to 13.8%, from 7.8% in H1’2019, due to the faster growth in Gross Non-Performing Loans (NPLs), which outpaced the growth in loans. The rise in non-performing loans was mainly attributable to the poor performance from the MSMEs segment, Corporate Segment, Mortgage segment and Check-off Loans recording NPL Ratios of 14.9%, 12.0%, 10.3% and 2.9%, respectively,
- General Loan Loss Provisions rose by 124.5% to Kshs 36.1 bn, from Kshs 16.1 bn in H1’2019. The NPL coverage thus increased to 56.9%, from 52.7% in H1’2019, due to the faster growth in General Loan Loss Provisions, which outpaced the growth in Gross Non-Performing Loans (NPLs),
- Shareholders’ funds increased by 12.4% to Kshs 132.1 bn in H1’2020, from Kshs 117.5 bn in H1’2019, as retained earnings rose by 11.0% y/y to Kshs 105.2 bn, from Kshs 94.8 bn in H1’2019,
- KCB Group is currently sufficiently capitalized with a core capital to risk-weighted assets ratio of 17.9%, 7.4% points above the statutory requirement. In addition, the total capital to risk-weighted assets ratio was 19.5%, exceeding the statutory requirement by 5.0% points. Adjusting for IFRS 9, the core capital to risk-weighted assets stood at 18.3% while total capital to risk-weighted assets came in at 19.8%, and,
- The bank currently has a Return on Average Assets (ROaA) of 2.4%, and a Return on Average Equity (ROaE) of 16.0%.

Key Take-Outs:

1. The group’s Profit after Tax (PAT) declined by 40.4% y/y to Kshs 7.6 bn from Kshs 12.7 bn in H1’2019 attributable to the 56.0% growth in Total Operating expenses to Kshs 32.2 bn from Kshs 20.6 bn. The growth in the Total Operating expenses was mainly attributable to the 263.8% growth in Loan Loss Provisions as the group provisioned for potential loan losses that may arise from the COVID-19 pandemic,
2. The group’s asset quality remains under threat as seen in the increase of the group's Non- Performing Loans (NPL) ratio to 13.8% from 7.8% in H1’2019. The significant rise is attributable to KCB’s acquisition of National Banks’ non-performing loans portfolio of Kshs 28.7 bn. Additionally, given the effects emanating from the pandemic, the rise in non-performing loans was also driven by the poor performance from the MSMEs segment, Corporate Segment Mortgage segment and Check-off Loans recording NPL Ratios of 14.9%, 12.0%, 10.3% and 2.9%, respectively,
3. Loan Loss Provisions increased by 263.8% to Kshs 11.0 bn from Kshs 3.0 bn. The increased provisioning levels were witnessed as the Group provided cover for downgraded facilities, with the expectation of an increase in defaults across sectors, brought about by the COVID-19 pandemic, and,
4. The group has been able to leverage on digital and innovation as seen in the robust growth in the number of transactions performed outside the branch comprising of 79.0% on mobile, 16.0% on agency, Internet and POS and 3.0% on ATMs. This growth can also be attributed to the push to digital transactions and the transaction fee waivers seen during the COVID-19 period.

Below is a summary of the bank’s performance:

Balance Sheet Items	H1'2019	H1'2020	y/y change	H1'2020e	Expected y/y change	Variance in Actual Growth vs Expected
Net Loans and Advances	478.7	559.9	17.0%	541.1	13.0%	3.9%
Total Assets	**746.5**	**953.1**	**27.7%**	**947.2**	**26.9%**	**0.8%**
Customer Deposits	563.2	758.2	34.6%	755.3	34.1%	0.5%
Total Liabilities	629.0	820.9	30.5%	829.0	31.8%	(1.3%)
Shareholders’ Funds	**117.5**	**132.1**	**12.4%**	**118.6**	**0.9%**	**11.5%**

Balance Sheet Ratios	H1'2019	H1'2020	% y/y change
Loan to Deposit Ratio	85.0%	73.8%	(11.2%)
Return on average equity	22.7%	16.0%	(6.7%)
Return on average assets	3.5%	2.4%	(1.1%)

Income Statement	H1'2019	H1'2020	y/y change	H1'2020e	Expected y/y change	Variance in Actual Growth vs Expected
Net Interest Income	25.4	31.1	22.3%	27.9	9.7%	12.6%
Net non-Interest Income	13.2	14.0	6.0%	9.2	(30.0%)	36.0%
Total Operating income	**38.6**	**45.0**	**16.7%**	**37.1**	**(3.9%)**	**20.6%**
Loan Loss provision	(3.0)	(11.0)	263.8%	(7.6)	152.3%	111.5%
Total Operating expenses	(20.6)	(32.2)	56.0%	(27.1)	31.1%	25.0%
Profit before tax	17.9	12.8	(28.5%)	10.0	(44.1%)	15.6%
Profit after tax	**12.7**	**7.6**	**(40.4%)**	**7.0**	**(44.8%)**	**4.4%**
Core EPS	**3.96**	**2.36**	**(40.4%)**	**2.18**	**(44.8%)**	**4.4%**

Income Statement Ratios	H1'2019	H1'2020	y/y change
Yield from interest-earning assets	11.0%	10.1%	(0.9%)

Cost of funding	3.0%	2.6%	(0.4%)
Net Interest Spread	7.9%	8.6%	0.6%
Net Interest Margin	8.1%	7.6%	(0.5%)
Cost of Risk	7.9%	24.5%	16.6%
Net Interest Income as % of operating income	65.9%	69.0%	3.1%
Non-Funded Income as a % of operating income	34.1%	31.0%	(3.1%)
Cost to Income Ratio (With LLP)	(53.5%)	(71.5%)	(18.0%)

Capital Adequacy Ratios	H1'2019	H1'2020
Core Capital/Total Liabilities	20.1%	17.5%
Minimum Statutory ratio	8.0%	8.0%
Excess	**12.1%**	**9.5%**
Core Capital/Total Risk Weighted Assets	18.0%	17.9%
Minimum Statutory ratio	10.5%	10.5%
Excess	**7.5%**	**7.4%**
Total Capital/Total Risk Weighted Assets	19.4%	19.5%
Minimum Statutory ratio	14.5%	14.5%
Excess	**4.9%**	**5.0%**
Liquidity Ratio	34.9%	40.0%
Minimum Statutory ratio	20.0%	20.0%
Excess	**14.9%**	**20.0%**
Adjusted core capital/ total deposit liabilities	20.8%	17.8%
Adjusted core capital/ total risk weighted assets	18.6%	18.3%
Adjusted total capital/ total risk weighted assets	20.1%	19.8%