KCB Group Plc – Q1’2018 Performance

17th May, 2018

Valuation Summary

- We are of the view that KCB Group Plc is a “Buy” with a target price of Kshs 63.7 per share, representing an upside of 26.1%, from the current price of Kshs 50.5 as of 17th May, inclusive of a dividend yield of 4.0%,
- KCB Group is currently trading at P/TBV of 1.5x and a P/E of 4.3x vs an industry average of 1.7x and 9.2x, respectively.

Key Highlights Q1’2018

- In April 2018, KCB Group received the first tranche of Kshs 8.0 bn (USD 80.0 mn) of the USD 100.0 mn line of credit advanced by the African Development Bank (AfDB) following a deal signed by the two institutions in 2017. The funds are meant for onward lending to businesses in agricultural and energy sectors, as well as providing much-needed liquidity provision to enterprises in infrastructure and manufacturing.

Income Statement

- Core earnings per share increasing by 14.0% to Kshs 6.8 from Kshs 5.9 in Q1’2017, compared to our expectation of a 2.2% increase to Kshs 6.0. The performance was driven by a 6.7% increase in total operating income, which outpaced the 1.8% increase in total operating expenses, to Kshs 9.5 bn in Q1’2018 from Kshs 9.3 bn in Q1’2017. The variance in core earnings per share growth against our expectations was largely due to a 37.0% decline in KCB’s provisioning levels despite the compliance with IFRS 9 that adopts a forward-looking approach to credit risk assessment. We expected provisioning levels of Kshs 1.0 bn, that came in at Kshs 0.6 bn,
- Total operating income increased by 6.7% to Kshs 17.0 bn from Kshs 15.9 bn in Q1’2017, driven by an increase in Net Interest Income (NII) that rose by 10.0% to Kshs 11.4 bn from Kshs 10.3 bn in Q1’2017. Non-Funded Income (NFI) declined marginally by 0.4% to Kshs 5.5 bn, from Kshs 5.6 bn in Q1’2017,
- Interest income increased by 11.0% to Kshs 15.7 bn from Kshs 14.1 bn in Q1’2017. The interest income on loans and advances increased by 10.9% y/y to Kshs 12.6 bn from 11.3 bn, while interest income on government securities increased by 17.2% y/y to Kshs 3.0 bn from Kshs 2.6 bn. As a result, the yield on interest-earning assets increased slightly to 12.0% from 11.9% in Q1’2017,
- Interest expense increased 13.0% to Kshs 4.2 bn from Kshs 3.8 bn in Q1’2017, following an 18.9% increase in the interest expense on customer deposits to Kshs 3.8 bn in Q1’2018 from Kshs 3.1 bn in Q1’2017, thus consequently increasing the cost of funds to 3.1% from 3.0% in Q1’2017. The Net Interest Margin remained stable at 8.2%, as the rate of change in yield interest income and cost of interest expense was the same,
- Non-Funded Income (NFI) declined marginally by 0.4% to Kshs 5.5 bn from Kshs 5.6 bn in Q1’2017 due to a decline in total fees and commissions, which declined by 2.3% to Kshs 1.4 bn from Kshs 1.43 bn in Q1’2017, and forex trading income declined 19.7% to Kshs 1.0 bn from Kshs 1.3 bn in Q1’2017. However, other income rose 7.6% to Kshs 0.9 bn from Kshs 0.8 bn,
- The current revenue mix stands at about 67:33 funded to non-funded income, from 65:35 recorded in Q1’2017. The decline in the proportion of NFI to total income is due to a faster growth in NII coupled with a 0.4% decline in NFI,
- Total operating expenses increased by 1.8% to Kshs 9.5 bn from Kshs 9.3 bn in Q1’2017, largely driven by an increase in other operating expenses, which rose by 13.9% to Kshs 3.3 bn from Kshs 2.9 bn in Q1’2017. Rental charges rose 8.0% to Kshs 337.5 mn from Kshs 312.5 mn. Staff costs rose 0.2% to Kshs 4.5 bn in Q1’2018 from Kshs 4.4 bn in Q1’2017. However, loan loss provisions (LLP) decreased by 37.0% to Kshs 0.6 bn from Kshs 1.0 bn in Q1’2017,
- The cost to income ratio improved to 55.9% from 58.6% in Q1’2017. Without LLP, the Cost to income ratio also improved, albeit marginally to 52.4% in Q1’2018 from 52.5% in Q1’2017,

- Profit before tax increased by 14.0% and to stand at Kshs 7.5 bn, up from Kshs 6.6 bn in Q1’2017. Profit after tax also increased 14.0% to Kshs 5.2 bn from Kshs 4.5 bn in Q1’2017,

Balance Sheet

- The balance sheet recorded an expansion in Q1’2018. Total assets increased by 7.0% to Kshs 647.5 bn from Kshs 605.8 bn in Q1’2017. The loan book increased by 6.0% to stand at Kshs 418.6 bn from Kshs 395.5 bn in Q1’2017. Government securities increased by 5.8% to Kshs 112.1 bn from Kshs 106.0 bn in Q1’2017 while fixed assets increased by 5.1% to Kshs 11.0 bn from Kshs 9.5 bn,
- Total liabilities rose by 8.6% to Kshs 547.8 bn from Kshs 504.5 bn in Q1’2017, driven by an 8.7% increase in customer deposits to Kshs 496.4 bn from Kshs 456.8 bn in Q1’2017. Deposits per branch closed the quarter at Kshs 1.9 bn up by 11.8% from Kshs 1.7 bn in Q1’2017,
- The faster growth in deposits compared to loans led to a decline in the loan to deposit ratio to 84.3% in Q1’2018 from 86.6% in Q1’2017,
- Shareholders’ funds declined by 4.4% from Kshs 101.2 bn in Q1’2017 to Kshs 99.6 bn in Q1’2018, mainly due to the 92.7% decline in the statutory loan loss reserve to Kshs 0.9 bn from Kshs 11.7 bn in Q1’2017,
- Gross non-performing loans (NPLs) increased by 36.2% to Kshs 43.8 bn from Kshs 32.2 bn in Q1’2017. The NPL ratio as a consequence deteriorated to 9.9% in Q1’2018 from 7.7% in Q1’2017, as NPLs increased at a faster rate than the loan book,
- KCB Group Plc is currently sufficiently capitalized with a core capital to risk weighted assets ratio of 15.1%, 4.6% above the statutory requirement of 10.5%. The total capital to risk weighted assets ratio is 15.3%, exceeding the statutory requirement of 14.5% by just 0.8% an indication that the bank may seek to raise additional Tier II capital this year. Adjusting for IFRS 9, the core capital to risk weighted assets stood at 15.9%, while total capital to risk weighted assets came in at 16.9%, indicating that the bank’s total capital relative to its risk-weighted assets declined by 0.8% owing to IFRS 9 implementation,
- KCB Group currently has a return on average assets of 3.2% and a return on average equity of 20.3%.

Key Take-Outs:

a) KCB’s ratio of total capital to total risk weighted assets dropped by 3.4% to stand at 15.3% in Q1’2018 from 18.7% in Q1’2017, as provisions for default started to eat into its capital in line with the stricter accounting rules as a result of the adoption of the IFRS 9, which came into effect from January 2018. The narrow margin of 0.8% is an indication of deteriorating capital adequacy ratios in the wake of implementation of the new regulations.

b) Despite the 36.2% increase in NPLs and the requirement to comply with the forward-looking IFRS 9 accounting standard, KCB Group recorded a 37.3% decline in Loan Loss Provisions to Kshs 0.6 bn from Kshs 1.0 bn in Q1’2017. We find this trend worrying and highlights a possible increase in risk for the bank.

Going forward, we expect the bank’s growth to be propelled by;

I. Non-Funded Income Growth Initiatives - This includes increasing other fees and commission income by leveraging on mobile and internet banking to increase the transaction income. Additionally, the brand is underutilized in fee income businesses such as investment banking, brokerage, asset and investment management, and advisory and it does not seem like the current management has the ability to diversify the revenue streams. KCB’s NFI ratio currently stands at

33.0%, slightly lower than the industry average of 33.6%. KCB should diversify its sources of revenue in order to compete favorably in the interest rate cap environment,

II. Alternative Distribution Channels – By leveraging on alternative distribution channels for the bank's products and services, such as agency banking, internet and mobile banking platforms, would address the stagnating growth in non-funded sources of income for the bank thereby creating efficiencies and improving overall profitability for the bank, and,

III. Furthermore, the bank hopes to reduce the non-performing loans by aiding in reinstating of collapsed businesses, which will enable them to service their loans, and thus improve the bank's asset quality.

Balance Sheet Items	Q1'2017	Q1'2018	y/y change	Q1'2018e	Expected y/y change	Variance in Actual Growth vs Expected
Government Securities	106.0	94.6	(10.7%)	115.1	8.6%	(19.4%)
Net Loans and Advances	395.5	418.6	5.8%	431.0	9.0%	(3.1%)
Total Assets	**605.8**	**647.5**	**6.9%**	**661.3**	**9.2%**	**(2.3%)**
Customer Deposits	456.8	496.4	8.7%	509.5	11.5%	(2.9%)
Total Liabilities	504.5	547.8	8.6%	550.7	9.1%	(0.6%)
Shareholders' Funds	**101.2**	**99.6**	**(1.6%)**	**110.6**	**9.3%**	**(10.9%)**

Balance Sheet Ratios	Q1'2017	Q1'2018	% y/y change
Loan to Deposit Ratio	86.6%	84.3%	(2.2%)
Return on average equity	21.2%	20.3%	(0.9%)
Return on average assets	3.4%	3.2%	(0.1%)

Income Statement Ratios	Q1'2017	Q1'2018	y/y change
Yield from interest-earning assets	11.9%	12.0%	0.1%
Cost of funding	3.0%	3.1%	0.1%
Net Interest Spread	8.8%	8.9%	0.0%
Net Interest Margin	7.9%	8.2%	0.3%
Cost of Risk	1.0%	0.6%	(0.4%)
Net Interest Income as % of operating income	65.0%	67.2%	2.2%
Non-Funded Income as a % of operating income	35.0%	32.8%	(2.2%)
Cost to Income Ratio	58.6%	56.0%	(2.5%)

Capital Adequacy Ratios	Q1'2017	Q1'2018
Core Capital/Total Liabilities	19.8%	17.1%
Minimum Statutory ratio	8.0%	8.0%
Excess	**11.8%**	**9.1%**
Core Capital/Total Risk Weighted Assets	17.4%	15.1%

Minimum Statutory ratio	10.5%	10.5%
Excess	**6.9%**	**4.6%**
Total Capital/Total Risk Weighted Assets	18.7%	15.3%
Minimum Statutory ratio	14.5%	14.5%
Excess	**4.2%**	**0.8%**
Liquidity Ratio	38.7%	33.9%
Minimum Statutory ratio	20.0%	20.0%
Excess	**18.7%**	**13.9%**