KCB Group Plc – Q3’2022

18th November, 2022

Below is a summary of KCB Group’s Q3’2022 performance:

Balance Sheet Items	Q3'2021	Q3'2022	y/y change
Net Loans and Advances	651.8	758.8	16.4%
Government Securities	252.4	269.9	6.9%
Total Assets	**1,122.5**	**1,276.3**	**13.7%**
Customer Deposits	859.1	922.3	7.4%
Total Liabilities	**958.1**	**1,086.1**	**13.4%**
Shareholders’ Funds	**163.0**	**187.8**	**15.2%**

Balance Sheet Ratios	Q3'2021	Q3'2022	% y/y change
Loan to Deposit Ratio	75.9%	80.1%	4.3%
Return on average equity	22.7%	22.6%	(0.1%)
Return on average assets	3.2%	3.3%	0.1%

Income Statement	Q3'2021	Q3'2022	y/y change
Net Interest Income	56.4	61.6	9.1%
Net non-Interest Income	23.5	30.6	30.2%
Total Operating income	**79.9**	**92.1**	**15.3%**
Loan Loss provision	(9.3)	(7.3)	(22.1%)
Total Operating expenses	(44.1)	(48.8)	10.8%
Profit before tax	35.8	43.3	20.9%
Profit after tax	**25.2**	**30.6**	**21.4%**
Core EPS	**7.8**	**9.5**	**21.4%**

Income Statement Ratios	Q3'2021	Q3'2022	y/y change
Yield from interest-earning assets	10.9%	10.9%	-
Cost of funding	2.6%	3.0%	0.4%
Net Interest Spread	8.3%	7.9%	(0.4%)
Net Interest Margin	8.4%	8.1%	(0.3%)
Cost of Risk	11.7%	7.9%	(3.8%)
Net Interest Income as % of operating income	70.6%	66.8%	(3.8%)
Non-Funded Income as a % of operating income	29.4%	33.2%	3.8%
Cost to Income Ratio	55.2%	53.0%	(2.2%)

Capital Adequacy Ratios	Q3'2021	Q3'2022	% points change
Core Capital/Total Liabilities	17.0%	15.6%	(1.4%)
Minimum Statutory ratio	8.0%	8.0%	
Excess	**9.0%**	**7.6%**	**(1.4%)**
Core Capital/Total Risk Weighted Assets	17.3%	14.5%	(2.8%)
Minimum Statutory ratio	10.5%	10.5%	
Excess	**6.8%**	**4.0%**	**(2.8%)**
Total Capital/Total Risk Weighted Assets	20.6%	18.1%	(2.5%)
Minimum Statutory ratio	14.5%	14.5%	
Excess	**6.1%**	**3.6%**	**(2.5%)**
Liquidity Ratio	41.3%	38.5%	(2.8%)
Minimum Statutory ratio	20.0%	20.0%	
Excess	**21.3%**	**18.5%**	**(2.8%)**

Key Q3'2022 highlights:

- KCB Group announced that it had entered into a definitive agreement with shareholders of Trust Merchant Bank (TMB) to acquire an 85.0% stake in the Democratic Republic of Congo (DRC)- based lender, with an option to acquire the remaining stake after two years. With the shareholder's approval in September, the deal is nearly complete pending approvals from COMESA Competition Commission and the Central Bank of DRC. This will mark the second Kenyan banking group to enter the DRC banking market after Equity Group Holdings. For this acquisition, KCB will pay a cash consideration based on the net asset value of TMB at completion of the proposed transaction using a Price to Book (P/B) multiple of 1.5x, subject to regulatory, shareholders and other approvals. For more information, please see our Cytonn Weekly #31 2022.

Income Statement

- Core earnings per share rose by 21.4% to Kshs 9.5, from Kshs 7.8 in Q3'2021, higher than our expectations of a 14.7% increase to Kshs 9.0, with the variance stemming from the 15.3% increase in total operating income, which was slightly higher than our projection of a 13.0% increase. The performance was driven by the 15.3% growth in total operating income to Kshs 92.1 bn, from Kshs 79.9 bn in Q3'2021, which outpaced the 10.8% growth in total operating expenses to Kshs 48.8 bn, from Kshs 44.1 bn in Q3'2021,
- Total operating income increased by 15.3% to Kshs 92.1 bn, from Kshs 79.9 bn in Q3'2021, driven by a 9.1% increase in Net Interest Income (NII) to Kshs 61.6 bn, from Kshs 56.4 bn in Q3'2021, coupled with a 30.2% increase in Non-Funded Income (NFI) to Kshs 30.6 bn, from Kshs 23.5 bn in Q3'2021,
- Interest income grew by 13.6% to Kshs 83.5 bn, from Kshs 73.5 bn in Q3'2021, mainly driven by a 10.2% increase in interest income from loans and advances, to Kshs 58.9 bn, from Kshs 53.4 bn in Q3'2021, coupled with a 28.2% increase in interest income from government securities to Kshs 24.3 bn, from Kshs 18.9 bn in Q3'2021. The Yield on Interest-Earning Assets (YIEA) remained relatively costant at 10.9%, similar to what was recorded in Q3'2021 attributable to a similar 13.3% growth in trailling interest income and Average Interest Earning Assets (AIEA). Trailing Interest Income refers to the performance of the interest income for the past 12 consecutive months,
- Interest expenses rose by 28.4% to Kshs 21.8 bn, from Kshs 17.1 bn in Q3'2021, following a 21.7% increase in interest expense on customer deposits to Kshs 17.8 bn, from Kshs 14.7 bn in Q3'2021, coupled with a 53.8% increase in Interest expense on deposits and placements to Kshs 3.7 bn, from Kshs 2.4 bn in Q3'2021. Consequently, the Cost of funds (COF) increased by 0.4% points to 3.0%, from 2.6% recorded in Q3'2021, following a faster 30.4% increase in Trailing interest expense, compared to the 12.0% increase in average interest bearing liabilities. Trailing interest expense refers to the performance of the interest expense for the past 12 consecutive months. Net Interest Margin (NIM) declined to 8.1%, from 8.4% in Q3'2021 due to the faster 13.3% increase in average interest-earning assets, compared to the 8.3%,growth in trailing Net Interest Income,
- Non-Funded Income (NFI) increased by 30.2% to Kshs 30.6 bn, from Kshs 23.5 bn in Q3'2021, driven by a significant 86.4% increase in the group's foreign exchange trading income in to Kshs 8.4 bn, from Kshs 4.5 bn in Q3'2021, highlighting the group's increased foreign exchange margins, coupled with an 18.7% increase in income from fees and commissions on loans and advances to Kshs 7.8 bn, from Kshs 6.6 bn in Q3'2021. Notably, total fees and commissions increased by 17.3% to Kshs 17.0 bn, from the Kshs 14.5 bn recorded in Q3'2021. The revenue mix shifted to 67:33 from 71:29 funded to non-funded income, owing to the faster 30.2% growth in NFI compared to the 9.1% increase in NII,
- Total operating expenses increased by 10.8% to Kshs 48.8 bn, from Kshs 44.1 bn in Q3'2021, largely driven by a 14.5% increase in staff costs to Kshs 21.3 bn, from Kshs 18.6 bn in Q3'2021. The increase in expenses was mitigated by a 22.1% decline in Loan Loss Provisions (LLP), to Kshs 7.3 bn, from Kshs 9.3 bn in Q3'2021,
- Cost to Income Ratio (CIR) improved to 53.0%, from 55.2% in Q3'2021, owing to the 15.3% increase in total operating income, which outpaced the 10.8% increase in total operating expenses. Without LLP, Cost to Income ratio deteriorated to 45.1% from 43.5% in Q3'2021, an indication of reduced efficiency, and,

- Profit before tax increased by 20.9% to Kshs 43.3 bn, from Kshs 35.8 bn in Q3'2021, with the effective tax rate declining slightly to 29.3%, from 29.6% in Q3'2021. Similarly, Profit after tax increased by 21.4% to Kshs 30.6 bn in Q3'2022, from Kshs 25.2 bn in Q3'2021.

Balance Sheet

- The balance sheet recorded an expansion as total assets grew by 13.7% to Kshs 1,276.3 bn, from Kshs 1,122.5 bn in Q3'2021, driven by a 16.4% growth in the loan book to Kshs 758.8 bn, from Kshs 651.8 bn in Q3'2021, coupled with a 6.9% increase in government securities to Kshs 269.9 bn, from Kshs 252.4 bn in Q3'2021,
- Total liabilities rose by 13.4% to Kshs 1,086.1 bn, from Kshs 958.1 bn in Q3'2021, driven by a 7.4% growth in customer deposits to Kshs 922.3 bn, from Kshs 859.1 bn, with customer deposits from NBK amounting to Kshs 108.4 bn in Q3'2022. Placements due to other banking instituitions also increased by 23.2% to Kshs 32.7 bn, from Kshs 26.6 bn in Q3'2021. Deposits per branch increased by 5.8% to Kshs 1.9 bn, from Kshs 1.7 bn in Q3'2021, with the number of branches increasing to 498, from 491 in Q3'2021,
- The faster 16.2% growth in loans as compared to the 7.4% growth in deposits led to an increase in the loan to deposits ratio to 80.1%, from 75.9% in Q3'2021,
- Gross non-performing loans increased significantly by 52.1% to Kshs 149.3 bn, from Kshs 98.1 bn in Q3'2021. Consequently, the group's Asset Quality deteriorated, with the NPL ratio increasing to 17.8% in Q3'2022, from 13.7% in Q3'2021, attributable to the faster 52.1% growth in Non-Performing loans, which outpaced the 17.3% growth in gross loans. The increase in NPLs was mainly skewed by KCB-K's NPLs which recorded an increase of 87.4% to Kshs 123.9 bn from Kshs 66.1 bn in Q3'2021, attributable to loan stocks from sectors such as building and construction, manufacturing, and Transport and communication. However, the NPLs ratio improved on quarterly basis by 3.6% to 17.8% from 21.4% in Q2'2022 as a result of fast tracking of recoveries and also improved loan repayments by building and construction, real estate and manufacturing sectors.
- General Provisions (LLP) increased by 30.6% y/y to Kshs 65.4 bn in Q3'2022, from Kshs 50.1 bn in Q3'2021. The NPL coverage decreased to 52.8% in Q3'2022, from 63.4% in Q3'2021, attributable to the faster 52.1% growth in Gross non-performing loans, which outpaced the 30.6% growth in general Loan Loss Provisions. In light of the prevailing credit risk and asset quality deterioration, we expect to see robust increase in provisioning going forward,
- Shareholders' funds increased by 15.2% to Kshs 187.8 bn in Q3'2022, from Kshs 163.0 bn in Q3'2021, supported by a 2.6% increase in retained earnings to Kshs 136.5 bn, from Kshs 132.9 bn in Q3'2021,
- KCB Group remains sufficiently capitalized with a core capital to risk-weighted assets ratio of 14.5%, 4.0% points above the statutory requirement of 10.5%. In addition, the total capital to risk-weighted assets ratio came in at 18.1%, exceeding the statutory requirement of 14.5% by 3.6% points. Adjusting for IFRS 9, the core capital to risk-weighted assets stood at 14.5%, while total capital to risk-weighted assets came in at 18.2%, and,
- The bank currently has a Return on Average Assets (ROaA) of 3.3%, and a Return on Average Equity (ROaE) of 22.6%.

Key Take-Outs:

1. **Deterioration of the Asset Quality** - The group's asset quality deteriorated, with the NPL ratio increasing to 17.8% in Q3'2022, from 13.7% in Q3'2021, attributable to the continued high exposure to corporate loans at 47.8% in Q3'2022, which have been impacted by delayed recovery from COVID-19, increased inflationary pressures and pending government bills. Additionally, increase in NPLs have been recorded from sectors such as building and construction, manufacturing, and Transport and communication. Additionally, the group's asset quality was further weighed down by the high NPL ratio from NBK which came in at 24.5%, despite having recorded an improvement y/y, from 35.1% in Q3'2021. On the other hand, KCB-K subsidiary recorded a significant increase in the NPL ratio to 19.8%, from 11.8% in Q3'2021, attributable to loan stocks by corporates due to delayed payments from government contracts . On a q/q basis, KCB's Asset quality improved by 3.6% points to 17.8%, from 21.4% recorded in Q2'2022,

2. **Reduced Provisioning** – The NPL coverage declined to 52.8% in Q3’2022 from 63.4% in Q3’2021, attributable to the faster 52.1% growth in Gross non-performing loans, which outpaced the 30.6% growth in general Loan Loss Provisions. With the slow recovery in some sectors locally and the high NPL ratios in some of the group’s subsidiaries, we expected the group to provision more to cater for the prevailing credit risk,
3. **Improved efficiency levels** – The group’s cost to income ratio without LLP improved to 53.0% from 55.2% in Q3’2021, an indication of improved efficiency, and,
4. **Improved Lending** – Q3’2022 was characterized by a faster 16.4% growth in loans which outpaced the 6.9% growth in government securities, and 7.4% increase in deposits, highlighting the the Group’s strategy to increase lending despite the deterioration in the Group’s asset quality.

Going forward, the factors that would drive the bank’s growth would be:

I. **Geographical Diversification** – The bank has been aggressively expanding in the region, as evidenced by the completion of the acquisition of Banque De Populaire du Rwanda (BPR) in Rwanda in 2021. In September, KCB shareholders approved the proposal to acquire 85.0% majority stake in Democratic Republic of Congo’s Trust Merchant Bank. This is expected to boost KCB’s regional presence and participation, as well as accelerate its growth. The bank is also planning on expanding into the Ethiopian market, further expanding its presence in the region and consequently drive growth in the near future.

II. **Digitization** - The Group has continued to enhance financial access through its digital platforms for customer convenience which will likely see it continue generating more profit. As of Q3’2022, 98.0% of the transactions were done through the alternative channels with 44.0% year-on-year increase in number of non-branch transactions. Value of mobile loans also increased by 20.7% to Kshs 138.8 bn in Q3’2022, from Kshs 115.0 bn in Q3’2021.

<u>Valuation Summary</u>

- We are of the view that KCB Group is a “BUY” with a target price of Kshs 57.8, representing an upside of 48.9%, from the current price of Kshs 38.8 as of 18th November 2022, inclusive of a dividend yield of 2.5%,
- KCB Group is currently trading at a P/TBV of 0.6x and a P/E of 3.2x vs an industry average of 0.9x and 4.8x, respectively.