Valuation Summary

- We are of the view that KCB Group Holdings is an “***buy***” with a target price of Kshs 61.3, representing an upside of 62.8%, from the current price of Kshs 39.5 as of 15th November 2018, inclusive of a dividend yield of 7.6%,
- KCB Group Holdings is currently trading at P/TBV of 1.2x and a P/E of 6.7x vs an industry average of 1.4x and 6.7x, respectively.

Key Highlights Q3’2018

- In September, S&P Global Ratings, the rating agency affirmed KCB Bank Kenya’s ratings of B+/B in the long & short-term while assigning a stable outlook for the Bank, based on KCB’s resilient earnings amid regulatory changes & challenging economic conditions;

Income Statement

- Core earnings per share increased by 19.7% to Kshs 5.9 from Kshs 4.9 in Q3’2017, above our expectation of a 12.4% increase to Kshs 5.5. The performance was driven by a 2.0% increase in total operating income, coupled with the 6.8% decline in the total operating expenses. The variance in core earnings per share growth against our expectations was largely due to the 2.6% rise in Non Funded Income (NFI) to Kshs 17.9 bn from Kshs 17.5 bn which was not in line with our expectations of a 1.3% decline,
- Total operating income increased by 2.0% to Kshs 54.2 bn from Kshs 53.2 bn in Q3’2017. This was due to a 1.8% increase in Net Interest Income (NII) to Kshs 36.3 bn from Kshs 35.7 bn in Q3’2017, coupled with a 2.6% rise in Non-Funded Income (NFI) to Kshs 17.9 bn, from Kshs 17.5 bn in Q3’2017,
- Interest income increased by 5.1% to Kshs 49.2 bn, from Kshs 46.8 bn in Q3’2017. This was driven by a 4.9% growth in interest income from government securities to Kshs 9.7 bn from Kshs 9.3 bn in Q3’2017, and a 5.2% increase in interest income on loans and advances to Kshs 39.0 bn, from Kshs 37.1 bn in Q3’2017. The yield on interest-earning assets remained unchanged at 11.4%,
- Interest expense increased by 16.0% to Kshs 12.9 bn from Kshs 11.1 bn in Q3’2017, following a 13.9% increase in the interest expense on customer deposits to Kshs 11.3 bn, from Kshs 9.9 bn in Q3’2017. Interest expense on deposits and placements from banking institutions increased by 33.0% to Kshs 1.6 bn from Kshs 1.2 bn in Q3’2017. The cost of funds thus rose to 3.2%, from 2.9% in Q3’2017. As a consequence, the Net Interest Margin (NIM) declined to 8.5%, from 8.7% in Q3’2017,
- Non-Funded Income (NFI) increased by 2.6% to Kshs 17.9 bn, from Kshs 17.5 bn in Q3’2017. The increase was driven by a 2.4% increase in other fees and commission income to Kshs 6.6 bn from Kshs 6.4 bn in Q3’2017, and a 24.1% increase in other income to Kshs 3.3 bn, from Kshs 2.6 bn in Q3’2017 outweighing the 7.9% decline in fees and commissions on loans to Kshs 4.4 bn from Kshs 4.8 bn in Q3’2017. As a result, the revenue mix remained the same at 67:33 funded to non-funded income,
- Total operating expenses declined by 6.8% to Kshs 28.6 bn, from Kshs 30.7 bn, largely driven by a 42.6% decline in Loan Loss Provisions (LLP) to Kshs 1.8 bn in Q3’2018, from Kshs 3.1 bn in Q3’2017, coupled with a 7.4% decline in staff costs to Kshs 12.8 bn in Q3’2018, from Kshs 13.8 bn in Q3’2017,
- Consequently, the Cost to Income Ratio (CIR) improved to 52.8%, from 57.8% in Q3’2017. Without LLP, the cost to income ratio also improved to 49.5%, from 51.9% in Q3’2017,
- Profit before tax increased by 14.2% to Kshs 25.6 bn, up from Kshs 22.4 bn in Q3’2017. Profit after tax increased by 19.7% to Kshs 18.0 bn in Q3’2018, from Kshs 15.1 bn in Q3’2017 as the effective tax rate declined to 32.5% from 36.4% in Q3’2017.

Balance Sheet

- The balance sheet recorded an expansion as total assets increased by 6.3% to Kshs 684.2 bn from Kshs 643.8 bn in Q3’2017. This growth was largely driven by a 15.3% increase in government securities to Kshs 119.5 bn, from Kshs 103.7 bn in Q3’2017, coupled with a 3.8% increase in their loan book to Kshs 435.3 bn from Kshs 419.5 bn in Q3’2017 which was mainly attributed to an increase in the corporate loan book,
- Total liabilities rose by 7.0% to Kshs 578.7 bn from Kshs 540.6 bn in Q3’2017, driven by a 6.2% increase in customer deposits to Kshs 526.8 bn from Kshs 496.3 bn in Q3’2017. Deposits per branch increased by 8.6% to Kshs 2.1 bn from Kshs 1.9 bn in Q3’2017, with the number of branches having reduced to 257 from 263 in Q3’2017. Placement liabilities increased by 20.4% to Kshs 12.6 bn from Kshs 10.5 bn in Q3’2017. Borrowings increased by 43.7% to Kshs 20.7 bn from Kshs 14.4 bn in Q3’2017,
- The faster growth in deposits as compared to loans led to a decline in the loan to deposit ratio to 82.6% from 84.5% in Q3’2017,
- Gross Non-Performing Loans (NPLs) declined by 0.1% to Kshs 34.8 bn in Q3’2018 from Kshs 34.7 bn in Q3’2017. The NPL ratio thus improved to 7.6% in Q3’2018 from 7.8% in Q3’2017. General Loan Loss Provisions (LLPs) declined by 15.6% to Kshs 16.7 bn from Kshs 19.8 bn in Q3’2017. The NPL coverage declined to 60.4% in Q3’2018 from 67.9% in Q3’2017, as provisions declined at a faster rate than the NPLs,
- Shareholders’ funds increased by 2.2% to Kshs 105.5 bn in Q3’2018 from Kshs 103.2 bn in Q3’2017, as retained earnings grew by 25.6% y/y to Kshs 79.1 bn from Kshs 63.0 bn in Q3’2017,
- KCB group is currently sufficiently capitalized with a core capital to risk-weighted assets ratio of 16.3%, 5.8% above the statutory requirement. In addition, the total capital to risk-weighted assets ratio was 17.8%, exceeding the statutory requirement by 3.3%. Adjusting for IFRS 9, the core capital to risk-weighted assets stood at 17.6%, while total capital to risk-weighted assets came in at 19.0%, indicating that the bank’s total capital relative to its risk-weighted assets declined by 1.2% due to implementation of IFRS 9,
- The bank currently has a Return on Average Assets (ROaA) of 3.5% and a Return on Average Equity (ROaE) of 21.7%.

Key Take-Outs:

1. Increased innovation and digitization has seen 87.0% of all transactions of the bank being done on alternative channels, with mobile transactions taking up 42.0% of all transactions, while agency and internet banking contributing 33.0% of all transactions. A key aspect to note is that Agency banking recorded a 74.0% growth in volumes of transactions to Kshs 153.0 bn from Kshs 88.0 bn, while volumes from mobile banking recorded a 34.0% rise to Kshs 242.0 bn from Kshs 181.0 bn. This has aided the banks improved Non-Funded Income (NFI) performance which increased by 2.6% to Kshs 17.9 bn, from Kshs 17.5 bn in Q3’2017,
2. Interest expense grew by 16.0% to KES 12.9bn with the key driver for interest expense being the growth in customer deposits, which grew by 13.9% and a 33.0% and increase in interest expense on deposits and placements from banking institutions. This indicates that the banks deposit mobilisation came at a cost, which resulted in the cost of funds increasing to 3.2%, from 2.9% in Q3’2017. As a consequence, the Net Interest Margin (NIM) declined to 8.5%, from 8.7% in Q3’2017, and,
3. The bank’s asset quality improved, with the NPL ratio improving to 7.6% from 7.8% in Q3’2017. The improved NPL ratio was mainly attributed to an improvement in the corporate loan book’s NPL ratio to 9.6% in Q3’2018 from in 10.4% in Q3’2017. The SME and Micro loan book has also been improving coming in at 14.3% in Q3’2018, down from 15.2%, 16.3% and 16.4% recorded in H1’2018, Q1’2018 and FY’2017, respectively. With the ongoing economic recovery, the bank’s asset quality is likely to continue improving, across the other segments such as SMEs and the agricultural segments.

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, which led to lower staff cost demands. 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, and,
2. Continued economic recovery buoyed by positive macroeconomic environment, which has led to asset quality improvement, as well as reducing associated economic-wide credit risks, thereby paving the way for increased economic activity, creating demand for the bank’s loan products. This will likely also lead to increased lending activities by the bank, thereby leading to Net Interest Income expansion.

Below is a summary of the bank’s performance:

Balance Sheet Items	Q3'2017	Q3'2018	y/y change	Q3'2018e	Expected y/y change	Variance in Actual Growth vs Expected
Net Loans and Advances	419.5	435.3	3.8%	429.3	2.3%	1.4%
Total Assets	**643.8**	**684.2**	**6.3%**	**683.9**	**6.2%**	**0.0%**
Customer Deposits	496.3	526.8	6.2%	535.4	7.9%	(1.7%)
Total Liabilities	540.6	578.7	7.0%	579.3	7.2%	(0.1%)
Shareholders’ Funds	**103.2**	**105.5**	**2.2%**	**103.8**	**0.6%**	**1.6%**

Balance Sheet Ratios	Q3'2018	H1'2018	% y/y change
Loan to Deposit Ratio	84.5%	82.6%	(1.9%)
Return on average equity	21.0%	21.7%	0.7%
Return on average assets	3.4%	3.5%	0.2%

Income Statement	Q3'2017	Q3'2018	y/y change	Q3'2018e	Expected y/y change	Variance in Actual Growth vs Expected
Net Interest Income	35.7	36.3	1.8%	37.0	3.8%	(2.0%)
Net non-Interest Income	17.5	17.9	2.6%	17.3	(1.3%)	3.9%
Total Operating income	**53.2**	**54.2**	**2.0%**	**54.3**	**2.1%**	**(0.1%)**
Loan Loss provision	3.1	1.8	(42.6%)	2.1	(32.1%)	(10.5%)
Total Operating expenses	30.7	28.6	(6.8%)	30.1	(2.2%)	(4.7%)
Profit before tax	22.4	25.6	14.2%	24.2	8.0%	6.2%
Profit after tax	**15.1**	**18.0**	**19.7%**	**17.0**	**12.4%**	**7.2%**
Core EPS	**4.9**	**5.9**	**19.7%**	**5.5**	**12.4%**	**7.2%**

Income Statement Ratios	Q3'2017	Q3'2018	y/y change
Yield from interest-earning assets	11.4%	11.4%	(0.0%)
Cost of funding	2.9%	3.2%	0.2%
Net Interest Spread	8.5%	8.2%	(0.2%)
Net Interest Margin	8.7%	8.5%	(0.3%)
Cost of Risk	5.9%	3.3%	(2.6%)
Net Interest Income as % of operating income	67.1%	66.9%	(0.2%)
Non-Funded Income as a % of operating income	32.9%	33.1%	0.2%
Cost to Income Ratio	57.8%	52.8%	(5.0%)