KCB Group Earnings Note– Q3'2020

13th November, 2020

Valuation Summary

- We are of the view that KCB Group is a "***buy***" with a target price of Kshs 45.8, representing an upside of 22.2%, from the current price of Kshs 37.5 as of 13th November 2020, inclusive of a dividend yield of 9.3%,
- KCB Group is currently trading at a P/TBV of 0.9x and a P/E of 7.1x vs an industry average of 1.1x and 6.9x, respectively.

Key Highlight Q3'2020

- KCB recently restructured loans amounting to Kshs 105.0 bn equivalent to 18.2% of its net loans, which stands at Kshs 577.5 bn in Q3'2020. 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,
- The International Finance Corporation (IFC) approved USD 150 mn loan to KCB Bank Kenya for onward lending to Micro, Small and Medium Enterprises (MSMEs). KCB is the third tier one lender in Kenya to be extended credit facilities that they will forwards to MSME's.

Income Statement

- Core earnings per share declined by 43.2% to Kshs 3.4, from Kshs 6.0 in Q3'2019, driven by a 60.1% growth in total operating expenses to Kshs 52.0 bn, from Kshs 32.5 bn in Q3'2019 which outweighed the 15.9% growth in total operating income to Kshs 69.1 bn, from Kshs 59.7 bn. The decline in core earnings per share was higher than our projected decline of 29.5% as the company had a much faster growth of 60.1% in the total operating expenses compared to our projection of 23.6% increase,
- Total operating income rose by 15.9% to Kshs 69.1 bn, from Kshs 59.7 bn in Q3'2019. This was driven by a 23.7% rise in Net Interest Income (NII) to Kshs 47.9 bn, from Kshs 38.7 bn in Q3'2019, coupled with a 1.5% rise in Non-Funded Income (NFI) to Kshs 21.3 bn, from Kshs 21.0 bn in Q3'2019,
- Interest income grew by 23.0% to Kshs 63.3 bn, from Kshs 51.4 bn in Q3'2019. This was driven by a 65.7% rise in interest income on government securities to Kshs 16.8 bn, from Kshs 10.2 bn in Q3'2019, coupled with a 12.9% rise in interest income on loans and advances to Kshs 45.8 bn, from Kshs 40.5 bn in Q3'2019. The yield on interest-earning assets however declined to 10.3% from 10.5% in Q3'2019 attributable to faster growth in the average interest-earning assets of 13.7%, which outpaced the 4.9% 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 20.8% to Kshs 15.4 bn, from Kshs 12.8 bn in Q3'2019, following a 23.6% rise in interest expense on customer deposits to Kshs 14.0 bn from Kshs 11.3 bn in Q3'2019. Interest expense on deposits and placement from banking institutions, declined by 1.1% to Kshs 1.4 bn, from Kshs 1.5 bn in Q3'2019. The cost of funds, on the other hand, declined to 2.6% from 2.9% in Q3'2019 owing to a faster 30.1% growth in average interest-bearing liabilities, which outpaced the 20.3% 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) remained unchanged at 7.8% from what was recorded in Q3'2019,
- Non-Funded Income (NFI) rose by 1.5% to Kshs 21.3 bn, from Kshs 21.0 bn in Q3'2019. The increase was mainly driven by a 20.8% rise in Other Fees and Commission income. The increase was however weighed down by a 14.2% decline in Fees and Commissions from loans and advances to Kshs 6.8 bn, from Kshs 7.9 bn in Q3'2019 coupled with a 4.2% decline in Foreign Exchange trading Income to Kshs 3.3 bn, from Kshs 3.5 bn in Q3'2019. Key to note, non-branch revenues declined by 12.8% to Kshs 7.5 bn from Kshs

8.6 bn recorded in Q3'2019 attributable to the waiver on mobile banking fees. As a result, the revenue mix shifted to 69:31 from 65:35 funded to non-funded income, due to the faster growth in NII compared to NFI,

- Total operating expenses grew by 60.1% to Kshs 52.0 bn, from Kshs 32.5 bn, largely driven by a 242.5% spike in Loan Loss Provisions (LLP) to Kshs 20.0 bn in Q3'2020, from Kshs 5.8 bn in Q3'2019, coupled with a 12.2% rise in Staff costs to Kshs 15.2 bn in Q3'2020, from Kshs 13.6 bn in Q3'2019. 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 75.2%, from 54.4% in Q3'2019 owing to the faster 60.1% rise in Total Operating Expenses to Kshs 52.0 bn from Kshs 32.5 bn in Q3'2019 which outpaced the 15.9% rise in Total Operating Income to Kshs 69.1 bn, from Kshs 59.7 bn in Q3'2019. Without LLP however, the cost to income ratio rose to 46.3% from 44.7% in Q3'2019, and,
- Profit before tax declined by 36.9% to Kshs 17.1 bn, down from Kshs 272 bn in Q3'2019 owing to the 2425% rise in Loan Loss Provisions (LLP) to Kshs 20.0 bn from Kshs 5.8 bn given the poor operating environment due to COVID-19. Profit after tax declined by 43.2% to Kshs 3.4 bn in Q3'2020, from Kshs 6.0 bn in Q3'2019 with the effective tax rate increasing to 36.5% from 29.5% in Q3'2019.

Balance Sheet

- The balance sheet recorded an expansion as total assets grew by 27.2% to Kshs 972.0 bn, from Kshs 764.3 bn in Q3'2019. This growth was driven by an 83.9% rise in investment in government and other securities to Kshs 236.2 bn, from Kshs 128.5 bn in Q3'2019. 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 an 18.7% growth to Kshs 577.5 bn, from Kshs 486.6 bn in Q3'2019,
- Total liabilities rose by 30.0% to Kshs 836.1 bn, from Kshs 643.1 bn in Q3'2019, driven by a 31.7% increase in customer deposits to Kshs 772.7 bn, from Kshs 586.7 bn in Q3'2019, with customer deposits from NBK amounting to Kshs 102.6 bn in Q3'2020. Key to note, NBK was amalgamated into the group in Q4'2019 and as such, the groups Q3'2019 results were exclusive of NBKs customer deposits. Deposits per branch declined by 5.6% to Kshs 2.2 bn from Kshs 2.3 bn in Q3'2019, with the number of branches having increased to 360 as at Q3'2020, from 258 in Q3'2019,
- The faster growth in deposits as compared to loans led to a decline in the loan to deposit ratio to 74.7%, from 82.9% in Q3'2019,
- Gross Non-Performing Loans (NPLs) rose by 127.8% to Kshs 97.0 bn in Q3'2020, from Kshs 42.6 bn in Q3'2019. Consequently, the NPL ratio deteriorated to 15.3%, from 8.3% in Q3'2019, 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 Corporate Segment, MSMEs segment, Mortgage segment and Check-off Loans recording NPL Ratios of 16.9%, 13.5%, 8.7% and 2.9%, respectively,
- General Loan Loss Provisions rose by 128.0% to Kshs 43.9 bn, from Kshs 19.2 bn in Q3'2019. The NPL coverage thus increased to 58.5%, from 56.5% in Q3'2019, due to the faster growth in General Loan Loss Provisions, which outpaced the growth in Gross Non-Performing Loans (NPLs),
- Shareholders' funds increased by 12.1% to Kshs 135.9 bn in Q3'2020, from Kshs 121.2 bn in Q3'2019, as retained earnings rose by 7.3% y/y to Kshs 108.5 bn, from Kshs 101.1 bn in Q3'2019,
- KCB Group is currently sufficiently capitalized with a core capital to risk-weighted assets ratio of 17.8%, 7.3% points above the statutory requirement. In addition, the total capital to risk-weighted assets ratio was 19.6%, exceeding the statutory requirement by 5.1% points. Adjusting for IFRS 9, the core capital to risk-weighted assets stood at 18.0% while total capital to risk-weighted assets came in at 19.8%, and,
- The bank currently has a Return on Average Assets (ROaA) of 1.9%, and a Return on Average Equity (ROaE) of 13.1%.

Key Take-Outs:

1. The group's Profit after Tax (PAT) declined by 43.2% to Kshs 10.9 bn, from Kshs 19.2 bn in Q3'2019, attributable to the 60.1% growth in Total Operating expenses to Kshs 52.0 bn, from Kshs 32.5 bn recorded in Q3'2019, that outweighed the 15.9% growth in total operating income to Kshs 69.1 bn, from Kshs 59.7 bn. The growth in the Total Operating expenses was mainly attributable to the 242.5% 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 15.3% from 8.3% in Q3'2019. The significant rise is attributable to KCB's acquisition of National Banks' non-performing loans portfolio of Kshs 29.3 bn. Additionally, given the effects emanating from the pandemic, the rise in non-performing loans was also driven by the poor performance from the Corporate Segment, MSMEs segment, Mortgage segment and Check-off Loans recording NPL Ratios of 16.9%, 13.5%, 8.7% and 2.9%, respectively,
3. Loan Loss Provisions increased by 242.5% to Kshs 20.0 bn, from Kshs 5.8 bn in Q3'2019. 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 77.0% on mobile, 17.0% on agency, Internet and POS and 4.0% 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	Q3'2019	Q3'2020	y/y change	Q3'2020e	Expected y/y change	Variance in Actual Growth vs Expected
Net Loans and Advances	486.4	577.5	18.7%	571.1	17.4%	1.3%
Total Assets	**764.3**	**972.0**	**27.2%**	**976.0**	**27.7%**	**(0.5%)**
Customer Deposits	586.7	772.7	31.7%	777.2	32.5%	(0.8%)
Total Liabilities	643.1	836.1	30.0%	842.8	31.1%	(1.1%)
Shareholders' Funds	**121.2**	**135.9**	**12.1%**	**133.2**	**9.9%**	**2.3%**

Balance Sheet Ratios	Q3'2019	Q3'2020	% y/y change
Loan to Deposit Ratio	82.9%	74.7%	(8.2%)
Return on average equity	22.2%	13.1%	(9.0%)
Return on average assets	3.5%	1.9%	(1.5%)

Income Statement	Q3'2019	Q3'2020	y/y change	Q3'2020e	Expected y/y change	Variance in Actual Growth vs Expected
Net Interest Income	38.7	47.9	23.7%	42.6	10.1%	13.6%
Net non-Interest Income	21.0	21.3	1.5%	16.9	(19.6%)	21.1%
Total Operating income	**59.7**	**69.1**	**15.9%**	**59.5**	**(0.3%)**	**16.2%**
Loan Loss provision	(5.8)	(20.0)	242.5%	(12.6)	115.0%	127.5%
Total Operating expenses	(32.5)	(52.0)	60.1%	(40.2)	23.6%	36.5%
Profit before tax	27.2	17.1	(36.9%)	19.3	(29.0%)	(8.0%)
Profit after tax	**19.2**	**10.9**	**(43.2%)**	**13.5**	**(29.5%)**	**(13.7%)**
Core EPS	**5.96**	**3.39**	**(43.2%)**	**4.21**	**(29.5%)**	**(13.7%)**

Income Statement Ratios	Q3'2019	Q3'2020	y/y change
Yield from interest-earning assets	10.5%	10.3%	(0.2%)
Cost of funding	2.9%	2.6%	(0.3%)
Net Interest Spread	7.6%	7.7%	0.1%
Net Interest Margin	7.8%	7.8%	0.0%
Cost of Risk	9.8%	28.9%	19.1%
Net Interest Income as % of operating income	64.8%	69.2%	4.4%
Non-Funded Income as a % of operating income	35.2%	30.8%	(4.4%)
Cost to Income Ratio	(54.4%)	(75.2%)	(20.8%)

Capital Adequacy Ratios	Q3'2019	Q3'2020
Core Capital/Total Liabilities	19.8%	17.3%
Minimum Statutory ratio	8.0%	8.0%
Excess	**11.8%**	**9.3%**
Core Capital/Total Risk Weighted Assets	18.1%	17.8%
Minimum Statutory ratio	10.5%	10.5%
Excess	**7.6%**	**7.3%**
Total Capital/Total Risk Weighted Assets	19.5%	19.6%
Minimum Statutory ratio	14.5%	14.5%
Excess	**5.0%**	**5.1%**
Liquidity Ratio	35.8%	38.1%
Minimum Statutory ratio	20.0%	20.0%
Excess	**15.8%**	**18.1%**
Adjusted core capital/ total deposit liabilities	20.5%	17.5%
Adjusted core capital/ total risk weighted assets	18.7%	18.0%
Adjusted total capital/ total risk weighted assets	20.1%	19.8%