Valuation Summary

- We are of the view that KCB Group is a "***buy***" with a target price of Kshs 61.3, representing an upside of 47.3%, from the current price of Kshs 44.0 as of 6th March 2019, inclusive of a dividend yield of 8.0%,
- KCB Group is currently trading at a P/TBV of 1.3x and a P/E of 5.9x vs an industry average of 1.5x and 7.1x, respectively.

Key Highlights FY'2018

- In September, S&P Global Ratings 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;
- The Bank was named the Best Retail bank in East Africa in the Banker Africa East Africa awards as well as the Best Bank in Sustainable Finance in the sustainable finance catalyst awards.

Income Statement

- Core earnings per share increased by 21.8% to Kshs 7.8, from Kshs 6.4 in FY'2017, above our expectation of a 19.4% increase to Kshs 7.7. The performance was driven by a 0.6% increase in total operating income, coupled with a 10.2% decline in total operating expenses. The variance in core earnings per share growth against our expectations was largely due to the 10.2% decline in total operating expenses to Kshs 37.9 bn, from Kshs 42.3 bn in FY'2017 largely driven by the 50.2% decline in Loan Loss Provisions (LLP) to Kshs 2.9 bn from Kshs 5.9 bn, which exceeded our expectation of a 4.2% decline,
- Total operating income increased marginally by 0.6% to Kshs 71.8 bn from Kshs 71.4 bn in FY'2017. This was due to a 0.9% increase in Net Interest Income (NII) to Kshs 48.8 bn, from Kshs 48.4 bn in FY'2017, while Non-Funded Income (NFI) declined marginally by 0.1% to Kshs 22.97 bn, from Kshs 23.0 bn in FY'2017,
- Interest income rose by 4.1% to Kshs 66.3 bn, from Kshs 63.7 bn in FY'2017. This was driven by a 5.0% growth in interest income from government securities to Kshs 13.0 bn, from Kshs 12.4 bn in FY'2017, and a 3.7% increase in interest income on loans and advances to Kshs 52.7 bn, from Kshs 50.8 bn in FY'2017. The yield on interest-earning assets however declined to 11.2%, from 11.5% in FY'2017, attributed to a decline in yields on government securities as well as a decline in lending rates due to the two Central Bank Rate (CBR) cuts in 2018. Furthermore, interest earning assets grew at a faster rate as compared to interest income, rising by 5.5% to Kshs 608.0 bn from Kshs 576.0 bn in FY'2017,
- Interest expense increased by 14.1% to Kshs 17.5 bn from Kshs 15.3 bn in FY'2017, following a 13.6% increase in the interest expense on customer deposits to Kshs 15.5 bn from Kshs 13.6 bn in FY'2017. Interest expense on deposits and placements from banking institutions increased by 18.7% to Kshs 2.0 bn, from Kshs 1.7 bn in FY'2017. The cost of funds thus rose to 3.2% from 3.0% in FY'2017, as the bank sought to support deposit growth amidst tight liquidity in the money market. As a consequence, the Net Interest Margin (NIM) declined to 8.2%, from 8.5% in FY'2017,
- Non-Funded Income (NFI) declined marginally by 0.1% to Kshs 22.97 bn, from Kshs 23.0 bn in FY'2017. The decline was mainly driven by a 25.3% reduction in other fees and commissions to Kshs 6.8 bn, from Kshs 9.1 bn in FY'2017, largely due to a slowdown in NFI growth from the bank's regional subsidiaries, coupled with the implementation of the Effective Interest Rate (EIR) under IFRS 9, which saw the bank amortize fees charged on loans over future period of a loan's tenor. As a result, the revenue mix remained unchanged at 68:32 funded to non-funded income,
- Total operating expenses declined by 10.2% to Kshs 37.9 bn, from Kshs 42.3 bn, largely driven by a 50.2% decline in Loan Loss Provisions (LLP) to Kshs 2.9 bn in FY'2018, from Kshs 5.9 bn in FY'2017, coupled with an 11.2% decline in staff costs to Kshs 17.0 bn in FY'2018, from Kshs 19.1 bn in FY'2017. The decline in staff

costs was due to the reduction in the number of staff to 6,220 staff in FY’2018 from 6,483 staff in FY’2017, following the staff rationalization programme, that cost the bank Kshs 2.0 bn, and resulted in the layoff of 709 staff,

- Consequently, the Cost to Income Ratio (CIR) improved to 52.8%, from 59.2% in FY’2017. Without LLP, the cost to income ratio also improved to 48.7%, from 50.9% in FY’2017,
- Profit before tax increased by 16.3% to Kshs 33.9 bn, up from Kshs 29.1 bn in FY’2017. Profit after tax grew by 21.8% to Kshs 24.0 bn in FY’2018, from Kshs 19.7 bn in FY’2017, as the effective tax rate declined to 33.3% from 34.8% in FY’2017,
- The bank recommends a final dividend of Kshs 2.5 per share, having already paid an interim dividend of Kshs 1.0 per share, translating to a total dividend payout of Kshs 3.5 per share, a 16.7% rise from the Kshs 3.0 paid in FY’2017, and translates to a dividend yield of 8.0%.

Balance Sheet

- The balance sheet recorded an expansion as total assets increased by 10.5% to Kshs 714.3 bn from Kshs 646.7 bn in FY’2017. This growth was largely driven by a 9.1% increase in government securities to Kshs 120.1 bn, from Kshs 110.0 bn in FY’2017, coupled with a 7.9% increase in their loan book to Kshs 455.9 bn from Kshs 422.7 bn in FY’2017, which management attributed to a growth in the corporate loan book,
- Total liabilities rose by 11.1% to Kshs 600.7 bn from Kshs 540.7 bn in FY’2017, driven by an 82.1% increase in Placement Liabilities to Kshs 20.1 bn from Kshs 11.0 bn in FY’2017, coupled with a 50.7% increase in Borrowings to Kshs 22.5 bn from Kshs 14.9 bn in FY’2017. The increase in borrowings is attributed to the receipt of the first tranche of the USD 80.0 mn of the USD 100 mn line of credit advanced by the African Development Bank (AfDB) following a deal signed by the two institutions in 2017,
- Customer deposits increased by 7.6% to Kshs 537.5 bn from Kshs 499.6 bn in FY’2017. Deposits per branch increased by 10.0% to Kshs 2.1 bn from Kshs 1.9 bn in FY’2017, owing to a reduction in the number of branches to 258 from 263 in FY’2017,
- The faster growth in loans as compared to deposits led to a marginal rise in the loan to deposit ratio to 84.8% from 84.6% in FY’2017,
- Gross Non-Performing Loans (NPLs) declined by 12.8% to Kshs 32.7 bn in FY’2018 from Kshs 37.5 bn in FY’2017. As a consequence, the NPL ratio improved to 6.9% in FY’2018 from 8.4% in FY’2017. The NPL coverage declined to 56.6% in FY’2018 from 67.9% in FY’2017, as provisions declined at a faster rate than the NPLs,
- Shareholders’ funds increased by 7.3% to Kshs 113.7 bn in FY’2018 from Kshs 106.0 bn in FY’2017, as retained earnings grew by 23.5% y/y to Kshs 85.2 bn from Kshs 69.0 bn in FY’2017,
- KCB Group is currently sufficiently capitalized with a core capital to risk-weighted assets ratio of 18.1%, 7.6% above the statutory requirement of 10.5%. In addition, the total capital to risk-weighted assets ratio was 19.5%, exceeding the statutory requirement of 14.5% by 5.0%. Adjusting for IFRS 9, the core capital to risk weighted assets stood at 21.3%, while total capital to risk-weighted assets came in at 18.8%,
- The bank currently has a Return on Average Assets (ROaA) of 3.6%, and a Return on Average Equity (ROaE) of 21.9%.

Key Take-Outs:

1. The bank’s asset quality improved, with the NPL ratio improving to 6.9% from 8.4% in FY’2017. The improved NPL ratio was mainly attributed to an improvement in the corporate loan book’s NPL ratio to 8.5% in FY’2018 from in 11.0% in ’2017, as well as the SME and Micro loan book, which improved to 13.0% in FY’2018, down from 16.4% in FY’2017. 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,

2. There was subdued Non-Funded Income growth. The decline in NFI's was largely due to a slowdown in NFI growth from the bank's regional subsidiaries, coupled with the implementation of the Effective Interest Rate (EIR) under IFRS 9, which saw the bank amortize fees charged on loans over future period of a loan's tenor. KCB Group's NFI contribution to revenue stands at 32.0%, which is 3.0% lower than its peer average of 35.0%. Going forward however, the Bank expects improved growth in NFI's since the effects of the rebasing of fees due to the Effective Interest Rate (EIR) application under IFRS 9 is one-off, and,
3. Increased innovation and digitization has seen 88.0% of all transactions of the bank being done on alternative channels, with mobile transactions taking up 45.0% of all transactions, while agency and internet banking contributing 32.0% of all transactions. Increased usage of these channels should aid the bank in expanding its NFI revenue.

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	FY'2017	FY'2018	y/y change	FY'2018e	Expected y/y change	Variance in Actual Growth vs Expected
Net Loans and Advances	422.7	455.9	7.9%	448.3	6.1%	1.8%
Total Assets	**646.7**	**714.3**	**10.5%**	**703.9**	**8.9%**	**1.6%**
Customer Deposits	499.5	537.5	7.6%	537.4	7.6%	0.0%
Total Liabilities	540.7	600.7	11.1%	586.0	8.4%	2.7%
Shareholders' Funds	**106.0**	**113.7**	**7.3%**	**117.9**	**11.3%**	**(4.0%)**

Balance Sheet Ratios	FY'2017	FY'2018	% y/y change
Loan to Deposit Ratio	84.6%	84.8%	0.2%
Return on average equity	19.5%	21.9%	2.4%
Return on average assets	3.2%	3.6%	0.5%

Income Statement	FY'2017	FY'2018	y/y change	FY'2018e	Expected y/y change	Variance in Actual Growth vs Expected
Net Interest Income	48.4	48.8	0.9%	50.4	4.2%	(3.3%)
Net non-Interest Income	23.0	23.0	(0.1%)	23.7	2.9%	(3.1%)
Total Operating income	**71.4**	**71.8**	**0.6%**	**74.1**	**3.8%**	**(3.2%)**
Loan Loss provision	5.9	2.9	(50.2%)	2.8	(52.1%)	1.9%
Total Operating expenses	42.3	37.9	(10.2%)	40.5	(4.2%)	(6.0%)
Profit before tax	29.1	33.9	16.3%	33.6	15.5%	0.8%
Profit after tax	**19.7**	**24.0**	**21.8%**	**23.5**	**19.4%**	**2.3%**
Core EPS	**6.4**	**7.8**	**21.8%**	**7.7**	**19.4%**	**2.3%**

Income Statement Ratios	FY'2017	FY'2018	y/y change
Yield from interest-earning assets	11.5%	11.2%	(0.3%)
Cost of funding	3.0%	3.2%	0.1%
Net Interest Spread	8.5%	8.0%	(0.4%)
Net Interest Margin	8.7%	8.2%	(0.5%)
Cost of Risk	8.3%	4.1%	(4.2%)
Net Interest Income as % of operating income	67.8%	68.0%	0.2%
Non-Funded Income as a % of operating income	32.2%	32.0%	(0.2%)
Cost to Income Ratio	59.2%	52.8%	(6.4%)

Capital Adequacy Ratios	FY'2017	FY'2018
Core Capital/Total Liabilities	17.1%	20.5%
Minimum Statutory ratio	8.0%	8.0%
Excess	**9.1%**	**12.5%**
Core Capital/Total Risk Weighted Assets	15.4%	18.1%
Minimum Statutory ratio	10.5%	10.5%
Excess	**4.9%**	**7.6%**
Total Capital/Total Risk Weighted Assets	16.6%	19.5%
Minimum Statutory ratio	14.5%	14.5%
Excess	**2.1%**	**5.0%**
Liquidity Ratio	29.0%	33.3%
Minimum Statutory ratio	20.0%	20.0%
Excess	**9.0%**	**13.3%**
Adjusted core capital/ total deposit liabilities		21.3%
Adjusted core capital/ total risk weighted assets		18.8%
Adjusted total capital/ total risk weighted assets		20.3%