KCB Group Plc – FY'2020
21st March, 2021

Valuation Summary

- We are of the view that KCB Group is an "**ACCUMULATE**" with a target price of Kshs 46.9, representing an upside of 15.8%, from the current price of Kshs 41.4 as of 19th March 2021, inclusive of a dividend yield of 2.4%,
- KCB Group is currently trading at a P/TBV of 1.0x and a P/E of 6.8x vs an industry average of 1.1x and 9.2x, respectively.

Key Highlights FY'2020

- KCB Group restructured loans amounting to 106.1 bn during the year, representing 19.6% of its loan book which stood at Kshs 595.3 bn in FY'2020. This is in line with the CBK's emergency measures announced on March 18th 2020 to provide relief to borrowers during the pandemic. Real estate, Tourism, restaurants and hotels and Personal loans contributed to the highest percentage of restructured loans in KCB's loan book, coming in at 27.6%, 16.7% and 16.6%, respectively, and,
- KCB Group disclosed it had entered into an agreement with Atlas Mara Limited (ATMA) to acquire 62.1% stake in Banque De Populaire du Rwanda (BPR) in Rwanda and 100.0% stake in African Banking Corporation Ltd Tanzania (ABC Tanzania). The Group also separately intends to make an offer to acquire the remaining shares from the respective shareholders. The proposed acquisition is subject to approval from the shareholders, the Central Bank of Kenya, the National Bank of Rwanda, the COMESA Competition Commission and the Capital Markets Authority. KCB also agreed to purchase 96.6% stake of ABC Tanzania held by ABC Holdings Limited (ABCH), the wholly owned subsidiary of Atlas Mara. Additionally, KCB separately intends to make an offer to acquire the remaining shares of 3.4% from the Tanzania Development Finance Company Limited.

Income Statement

- Core earnings per share declined by 22.1% to Kshs 6.1, from Kshs 7.8 in FY'2019, not in line with our projections of a 35.2% decline to Kshs 5.1. The performance was driven by a 209.5% increase in loan loss provisions to Kshs 27.5 bn from Kshs 8.9 bn in FY'2019, coupled with a 49.1% increase in total operating expenses to Kshs 70.7 bn, from Kshs 47.4 bn in FY'2019. The decline in the core earnings per share was lower than our projected decline of 35.2% as the lender had a slower 49.1% growth in Total Operating expenses, compared to our projection of a 54.6% increase,
- Total operating income increased by 14.3% to Kshs 96.4 bn, from Kshs 84.3 bn in FY'2019. This was driven by a 21.0% increase in Net Interest Income (NII) to Kshs 67.9 bn, from Kshs 56.1 bn in FY'2019, coupled with a 1.0% increase in Non-Funded Income (NFI) to Kshs 28.5 bn, from Kshs 28.2 bn in FY'2019,
- Interest income grew by 19.4% to Kshs 88.7 bn, from Kshs 74.4 bn in FY'2019, mainly driven by a 64.8% increase in interest income from government securities which increased to Kshs 23.2 bn, from Kshs 14.1 bn in FY'2019, coupled with a 9.8% increase in interest income from loans and advances, which increased to Kshs 64.8 bn from Kshs 59.0 bn in FY'2019. The increase was however weighed down by a 37.3% decline in income from deposits and placements with banking institutions to Kshs 0.8 bn, from Kshs 1.3 bn in FY'2019. The yield on interest-earning assets increased to 11.1% from 10.9% in FY'2019, attributable to the faster 19.4% growth in interest income, which outpaced the 16.9% growth in average interest earning assets,
- Interest expense increased by 14.2% to Kshs 20.8 bn, from Kshs 18.2 bn in FY'2019, following a 15.9% rise in Interest expense on customer deposits to Kshs 18.9 bn, from Kshs 16.3 bn in FY'2019. Interest expense on placements declined marginally by 0.1% to Kshs 1.954 bn from Kshs 1.953 bn in FY'2019. Cost of funds declined marginally by 0.1% points to 2.7% from 2.8% recorded in FY'2019, following a faster 22.3% increase in average interest bearing liabilities that outpaced the 14.2% increase in interest expense. Net Interest Margin (NIM) on the other hand, increased to 8.5%, from 8.2% in FY'2019 due to the faster 21.0% growth in NII that outpaced the 16.9% increase in average interest-earning assets,

- Non-Funded Income increased by 1.0% to Kshs 28.5 bn, from Kshs 28.2 bn in FY’2019, driven by a 19.8% increase in the group’s foreign exchange trading income to Kshs 5.4 bn, from Kshs 4.5 bn in FY’2019, coupled with a 38.1% increase in other income to Kshs 5.3 bn from Kshs 3.8 bn in FY’2019. The increase was however weighed down by an 18.2% decline in income from fees and commissions on loans and advances to Kshs 7.5 bn, from Kshs 9.2 bn in FY’2019, attributable to the waiver on bank fees seen during the year. Notably, total fees and commissions declined by 10.4% to Kshs 17.8 bn, from Kshs 19.9 bn recorded in FY’2019. The revenue mix shifted to 70:30 from 67:33 funded to non-funded income, owing to the faster 21.0% growth in NII compared to the 1.0% increase in NFI,
- Total operating expenses increased by 49.1% to Kshs 70.7 bn, from Kshs 47.4 bn in FY’2019, largely driven by a 209.5% increase in Loan Loss Provisions (LLP) to Kshs 27.5 bn, from Kshs 8.9 bn in FY’2019, on the back of the subdued operating environment seen during the year. Staff costs increased by 5.1% to Kshs 20.5 bn from Kshs 19.5 bn in FY’2019,
- Cost to Income Ratio (CIR) deteriorated to 73.3%, from 56.2% in FY’2019 owing to the 49.1% increase in total operating expenses to Kshs 70.7 bn from Kshs 47.4 bn in FY’2019, which outpaced the 14.3% increase in operating income to Kshs 96.4 bn from Kshs 84.3 bn in FY’2019. Without LLP, however, cost to income ratio improved to 44.8% from 45.7% in FY’2019, an indication of improving efficiency,
- Profit before tax declined by 30.3% to Kshs 25.7 bn, down from Kshs 36.9 bn in FY’2019 due to the 49.1% increase in total operating expenses to Kshs 70.7 bn, from Kshs 47.4 bn in FY’2019. Profit after tax declined by 22.1% to Kshs 19.6 bn in FY’2020, from Kshs 25.2 bn in FY’2019, with the effective tax rate declining to 23.8%, from 31.8% in FY’2019, and,
- The Board of Directors recommended a final Dividend Per Share (DPS) of Kshs 1.0, translating to a total dividend payout of Kshs 3.2 bn. At the current price of Kshs 41.4, this translates to a dividend yield of 2.4%.

Balance Sheet

- The balance sheet recorded an expansion as total assets grew by 9.9% to Kshs 987.8 bn, from Kshs 898.6 bn in FY’2019. The growth was supported by a 26.6% increase in government securities to Kshs 208.8 bn, from Kshs 164.9 bn in FY’2019, coupled with a 10.3% loan book expansion to Kshs 595.3 bn, from Kshs 539.7 bn in FY’2019. The increased allocation in government securities was mainly on the back of the lender’s cautious lending amid the elevated credit risk. Notably, the lender disclosed that they restructured 19.6% of the total loan book amounting to Kshs 106.1 bn. Of the restructured loans, the Real Estate Sector accounted for the highest percentage of restructured loans at 27.6% (Kshs 27.6 bn),
- Total liabilities rose by 10.0% to Kshs 845.4 bn, from Kshs 768.8 bn in FY’2019, driven by an 11.7% rise in customer deposits to Kshs 767.2 bn, from Kshs 686.6 bn in FY’2019, with customer deposits from NBK amounting to Kshs Kshs 99.2 bn in FY’2020. Deposits per branch increased by 6.5% to Kshs 2.1 bn from Kshs 2.0 bn in FY’2019, with the number of branches increasing to 359 as at the end of 2020, from 342 in FY’2019,
- The slower 10.3% growth in loans as compared to the 11.7% growth in deposits led to a decline in the loan to deposit ratio to 77.6% from 78.6% in FY’2019,
- Gross non-performing loans increased by 52.4% to Kshs 96.6 bn in FY’2020, from Kshs 63.4 bn in FY’2019. Consequently, the NPL ratio deteriorated to 14.8% in FY’2020, from 11.0% in FY’2019, attributable to the faster 52.4% growth in Non-Performing Loans, which outpaced the 10.3% growth in loans. The rise in non-performing loans was mainly attributable to the poor performance from the Corporate segment, MSME segment, mortgage segment and Check-Off loans recording NPL ratios of 18.6%, 13.9%, 8.7% and 2.6%, respectively,
- Loan Loss Provisions (LLP) increased by 209.5% y/y to Kshs 27.5 bn in FY’2020, from Kshs 8.9 bn in FY’2019. The NPL coverage on the other hand improved marginally to 59.8% in FY’2020 from 59.5% in FY’2019, as general Loan Loss Provisions increased by 59.9% to Kshs 45.9 bn from Kshs 28.7 bn in FY’2019, attributable to the deterioration of the NPL ratio to 14.8% from 11.0% in FY’2019,
- Shareholders’ funds increased by 9.8% to Kshs 142.4 bn in FY’2020, from Kshs 129.7 bn in FY’2019, supported by a 20.9% increase in retained earnings to Kshs 112.8 bn, from Kshs 93.3 bn in FY’2019,

- KCB Group remains sufficiently capitalized with a core capital to risk-weighted assets ratio of 18.2%, 7.7% points above the statutory requirement. In addition, the total capital to risk-weighted assets ratio came in at 21.6%, exceeding the statutory requirement by 7.1% points. Adjusting for IFRS 9, the core capital to risk-weighted assets stood at 18.4%, while total capital to risk-weighted assets came in at 21.8%, and,
- The bank currently has a Return on Average Assets (ROaA) of 2.1%, and a Return on Average Equity (ROaE) of 14.4%.

Key Take-Outs:

1. On account of the adverse effects of COVID-19 pandemic on the business environment in 2020, KCB took a proactive stance in its provisioning levels as Loan Loss Provisions (LLP) increased by 209.5% y/y to Kshs 27.5 bn in FY'2020, from Kshs 8.9 bn in FY'2019. On a q/q basis, the LLP increased by 37.5% to Kshs 27.5 bn from Kshs 20.0 bn,
2. The group's asset quality deteriorated, with the NPL ratio deteriorating to 14.8% in FY'2020, from 11.0% in FY'2019. The rise in the group's NPL ratio can be attributed to National Bank's high NPL ratio which came in at 37.2%. The rise in non-performing loans was also attributable to the poor performance from the corporate segment, MSME segment, mortgage segment and Check-Off loans recording NPL ratios of 18.6%, 13.9%, 8.7% and 2.6%, respectively. Asset quality however improved by 0.5% points q/q to 14.8%, from 15.3% recorded in Q3'2020 attributable to the gradual improvement in most sectors as restriction measures were eased during the last qurter of the year. NPL coverage, on the other hand, improved to 59.8% in FY'2020 from 59.5% in FY'2019, as general Loan Loss Provisions increased by 59.9% to Kshs 45.9 bn from Kshs 28.7 bn in FY'2019,
3. There was an improvement in efficiency levels as the cost to income ratio without LLP improved to 44.8% from 45.7% in FY'2019, an indication of improving efficiency, and,
4. The group has leveraged on digital innovation which was necessitated by the onset of COVID-19 in the country. During the financial year, 98.0% of transactions were performed outside the branch, with mobile banking, agency banking and ATM banking accounting for 77.0%, 18.0% and 3.0%, respectively. Key to note, the value of Mobile transactions increased by 75.6% in FY'2020 to Kshs 1.1 bn, from Kshs 0.6 bn in FY'2019.

Below is a summary of the bank's performance:

Balance Sheet Items	FY'2019	FY'2020	y/y change	FY'2020e	Expected y/y change	Variance in Actual Growth vs Expected
Net Loans and Advances	539.7	595.3	10.3%	597.1	10.6%	(0.3%)
Total Assets	**898.6**	**987.8**	**9.9%**	**1,013.5**	**12.8%**	**(2.9%)**
Customer Deposits	686.6	767.2	11.7%	811.3	18.2%	(6.5%)
Total Liabilities	768.8	845.4	10.0%	879.7	14.4%	(4.4%)
Shareholders' Funds	**129.7**	**142.4**	**9.8%**	**133.8**	**3.1%**	**6.7%**

Balance Sheet Ratios	FY'2019	FY'2020	% y/y change
Loan to Deposit Ratio	78.6%	77.6%	(1.0%)
Return on average equity	20.7%	14.4%	(6.3%)
Return on average assets	3.1%	2.1%	(1.0%)

Income Statement	FY'2019	FY'2020	y/y change	FY'2020e	Expected y/y change	Variance in Actual Growth vs Expected
Net Interest Income	56.1	67.9	21.0%	73.9	31.6%	(10.6%)
Net non-Interest Income	28.2	28.5	1.0%	22.7	(19.3%)	20.3%
Total Operating income	**84.3**	**96.4**	**14.3%**	**96.6**	**14.6%**	**(0.3%)**
Loan Loss provision	(8.9)	(27.5)	209.5%	(28.3)	218.5%	(9.0%)
Total Operating expenses	(47.4)	(70.7)	49.1%	(73.3)	54.6%	(5.5%)

Profit before tax	36.9	25.7	(30.3%)	23.3	(36.8%)	6.5%
Profit after tax	**25.2**	**19.6**	**(22.1%)**	**16.3**	**(35.2%)**	**13.1%**
Core EPS	**7.83**	**6.10**	**(22.1%)**	**5.08**	**(35.2%)**	**13.1%**

Income Statement Ratios	FY'2019	FY'2020	%point change
Yield from interest-earning assets	10.9%	11.1%	0.2%
Cost of funding	2.8%	2.7%	(0.1%)
Net Interest Spread	7.8%	7.8%	0.0%
Net Interest Margin	8.2%	8.5%	0.3%
Cost of Risk	10.5%	28.5%	18.0%
Net Interest Income as % of operating income	66.6%	70.5%	3.9%
Non-Funded Income as a % of operating income	33.4%	29.5%	(3.9%)
Cost to Income Ratio	56.2%	73.3%	17.1%

Capital Adequacy Ratios	FY'2019	FY'2020
Core Capital/Total Liabilities	18.1%	18.7%
Minimum Statutory ratio	8.0%	8.0%
Excess	**10.1%**	**10.7%**
Core Capital/Total Risk Weighted Assets	17.2%	18.2%
Minimum Statutory ratio	10.5%	10.5%
Excess	**6.7%**	**7.7%**
Total Capital/Total Risk Weighted Assets	19.0%	21.6%
Minimum Statutory ratio	14.5%	14.5%
Excess	**4.5%**	**7.1%**
Liquidity Ratio	37.1%	36.1%
Minimum Statutory ratio	20.0%	20.0%
Excess	**17.1%**	**16.1%**
Adjusted core capital/ total deposit liabilities	18.6%	18.9%
Adjusted core capital/ total risk weighted assets	17.6%	18.4%
Adjusted total capital/ total risk weighted assets	19.5%	21.8%