KCB Group Plc – H1’2022

26th August, 2022

Below is a summary of KCB Group’s H1’2022 performance:

Balance Sheet Items	H1’2021	H1’2022	y/y change
Net Loans and Advances	607.0	730.3	20.3%
Government Securities	213.0	277.8	30.4%
Total Assets	**1,022.2**	**1,210.1**	**18.4%**
Customer Deposits	786.0	908.6	15.6%
Deposits per Branch	2.2	1.8	(17.3%)
Total Liabilities	869.2	1,028.4	18.3%
Shareholders’ Funds	**152.9**	**179.1**	**17.1%**

Balance Sheet Ratios	H1’2021	H1’2022	% point change
Loan to Deposit Ratio	77.2%	80.4%	3.2%
Return on average equity	19.2%	23.2%	4.0%
Return on average assets	2.8%	3.5%	0.7%

Income Statement	H1’2021	H1’2022	y/y change
Net Interest Income	36.4	40.6	11.5%
Net non-Interest Income	14.8	19.2	29.9%
Total Operating income	**51.2**	**59.8**	**16.8%**
Loan Loss provision	(6.6)	(4.3)	(34.4%)
Total Operating expenses	(29.3)	(31.6)	8.0%
Profit before tax	21.9	28.2	28.6%
Profit after tax	**15.3**	**19.6**	**28.4%**
Core EPS	**4.8**	**6.1**	**28.4%**

Income Statement Ratios	H1’2021	H1’2022	% point change
Yield from interest-earning assets	11.2%	11.3%	0.1%
Cost of funding	2.6%	3.0%	0.4%
Net Interest Spread	8.6%	8.3%	(0.3%)
Net Interest Margin	8.7%	8.5%	(0.2%)
Cost of Risk	12.9%	7.2%	(5.7%)
Net Interest Income as % of operating income	71.1%	67.9%	(3.2%)
Non-Funded Income as a % of operating income	28.9%	32.1%	3.2%
Cost to Income Ratio	57.2%	52.9%	(4.3%)

Capital Adequacy Ratios	H1’2021	H1’2022	% points change
Core Capital/Total Liabilities	19.0%	17.3%	(1.7%)
Minimum Statutory ratio	8.0%	8.0%	-
Excess	**11.0%**	**9.3%**	**(1.7%)**
Core Capital/Total Risk Weighted Assets	18.6%	17.7%	(0.9%)
Minimum Statutory ratio	10.5%	10.5%	-
Excess	**8.1%**	**7.2%**	**(0.9%)**
Total Capital/Total Risk Weighted Assets	21.9%	21.6%	(0.3%)
Minimum Statutory ratio	14.5%	14.5%	-
Excess	**7.4%**	**7.1%**	**(0.3%)**
Liquidity Ratio	40.1%	39.0%	(1.1%)
Minimum Statutory ratio	20.0%	20.0%	-
Excess	**20.1%**	**19.0%**	**(1.1%)**

Key H1’2022 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. If successful, the deal will make KCB Group 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 28.4% to Kshs 6.1, from Kshs 4.8 in H1’2021, higher than our expectations of a 22.9% increase to Kshs 5.9, with the variance stemming from the 11.5% increase in total operating income, which was higher than our projection of a 6.6% increase. The performance was driven by the 16.8% growth in total operating income to Kshs 59.8 bn, from Kshs 51.2 bn in H1’2021, which outpaced the 8.0% growth in total operating expenses to Kshs 31.6 bn, from Kshs 29.3 bn in H1’2021,
- Total operating income increased by 16.8% to Kshs 59.8 bn, from Kshs 51.2 bn in H1’2021, driven by an 11.5% increase in Net Interest Income (NII) to Kshs 40.6 bn, from Kshs 36.4 bn in H1’2021, coupled with a 29.9% increase in Non-Funded Income (NFI) to Kshs 19.2 bn, from Kshs 14.8 bn in H1’2021,
- Interest income grew by 15.7% to Kshs 54.5 bn, from Kshs 47.1 bn in H1’2021, mainly driven by an 11.3% increase in interest income from loans and advances, to Kshs 38.4 bn, from Kshs 34.5 bn in H1’2021, coupled with a 31.5% increase in interest income from government securities to Kshs 15.9 bn, from Kshs 12.1 bn in H1’2021. The Yield on Interest-Earning Assets (YIEA) rose by 0.1% points to 11.3%, from 11.2% recorded in H1’2021, attributable to the faster 16.0% growth in trailling interest income which outpaced the 14.0% growth in 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 30.3% to Kshs 13.9 bn, from Kshs 10.7 bn in H1’2021, following a 26.0% increase in interest expense on customer deposits to Kshs 11.5 bn, from Kshs 9.2 bn in H1’2021, coupled with a 38.9% rise in Interest expense on deposits and placements to Kshs 2.1 bn, from Kshs 1.5 bn in H1’2021. Consequently, the Cost of funds (COF) increased by 0.4% points to 3.0%, from 2.6% recorded in H1’2021, following a faster 30.7% increase in Trailing interest expense, compared to the 11.8% 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 8.5%, from 8.7% in H1’2021 due to the slightly faster 11.8% increase in average interest-earning assets, compared to the 11.7%,growth in trailing Net Interest Income,
- Non-Funded Income (NFI) increased by 29.9% to Kshs 19.2 bn, from Kshs 14.8 bn in H1’2021, driven by an 81.5% increase in the group’s foreign exchange trading income in to Kshs 4.9 bn, from Kshs 2.7 bn in H1’2021, coupled with a 32.9% increase in income from fees and commissions on loans and advances to Kshs 5.3 bn, from Kshs 4.0 bn in H1’2021. Notably, total fees and commissions increased by 24.4% to Kshs 11.4 bn, from the Kshs 9.2 bn recorded in H1’2021. The revenue mix shifted to 68:32 from 71:29 funded to non-funded income, owing to the faster 29.9% growth in NFI compared to the 11.5% increase in NII,
- Total operating expenses increased by 8.0% to Kshs 31.6 bn, from Kshs 29.3 bn in H1’2021, largely driven by a 15.0% increase in staff costs to Kshs 14.1 bn, from Kshs 12.3 bn in H1’2021. The increase in expenses was mitigated by a 34.4% decline in Loan Loss Provisions (LLP), to Kshs 4.3 bn, from Kshs 6.6 bn in H1’2021,
- Cost to Income Ratio (CIR) improved to 52.9%, from 57.2% in H1’2021, owing to the 16.8% increase in total operating income, which outpaced the 8.0% increase in total operating expenses. Without LLP, Cost to Income ratio also improved to 44.5% from 48.0% in H1’2021, an indication of improving efficiency, and,

- Profit before tax increased by 28.6% to Kshs 28.2 bn, from Kshs 21.9 bn in H1’2021. with the effective tax rate increasing slightly to 30.3%, from 30.2% in H1’2021. Similarly, Profit after tax increased by 28.4% to Kshs 19.6 bn in H1’2022, from Kshs 15.3 bn in H1’2021.

Balance Sheet

- The balance sheet recorded an expansion as total assets grew by 18.4% to Kshs 1,210.1 bn, from Kshs 1,022.2 bn in H1’2021 , driven by a 20.3% growth in the loan book to Kshs 730.3 bn, from Kshs 607.0 bn in H1’2021, coupled with a 30.4% increase in government securities to Kshs 277.8 bn, from Kshs 213.0 bn in H1’2021,
- Total liabilities rose by 18.3% to Kshs 1,028.4 bn, from Kshs 869.2 bn in H1’2021, driven by a 15.6% growth in customer deposits to Kshs 908.6 bn, from Kshs 786.0 bn, with customer deposits from NBK amounting to Kshs 112.5 bn in H1’2022. Placements due to other banking instituitions also increased by 138.4% to Kshs 35.8 bn, from Kshs 15.0 bn in H1’2021. Deposits per branch decreased by 17.3% to Kshs 1.8 bn, from Kshs 2.2 bn in H1’2021, with the number of branches increasing to 495, from 354 in H1’2021. The increase in the number of branches is attributable to the acquisition of 137 branches in Rwanda following the acquisition of BPR Rwanda in 2021 in addition to opening of 1 branch each in the Kenya, Uganda and Tanzania segments,
- The faster 20.3% growth in loans as compared to the 15.6% growth in deposits led to an increase in the loan to deposits ratio to 80.4%, from 77.2% in H1’2021,
- Gross non-performing loans increased significantly by 81.2% to Kshs 173.4 bn, from Kshs 95.7 bn in H1’2021. Consequently, the group’s Asset Quality deteriorated, with the NPL ratio increasing to 21.4% in H1’2022, from 14.4% in H1’2021, attributable to the faster 81.2% growth in Non-Performing loans, which outpaced the 21.6% growth in gross loans. The increase in NPLs was mainly skewed by KCB-K’s NPLs which recorded an increase of 117.0% to Kshs 141.1 bn from Kshs 65.0 bn in H1’2021, following the reclassification of 9 large accounts as NLS,
- General Provisions (LLP) increased by 39.1% y/y to Kshs 65.1 bn in H1’2022, from Kshs 46.8 bn in H1’2021. The NPL coverage decreased to 45.8% in H1’2022, from 61.6% in H1’2021, attributable to the faster 81.2% growth in Gross non-performing loans, which outpaced the 39.1% 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,
- Shareholders’ funds increased by 17.1% to Kshs 179.1 bn in H1’2022, from Kshs 152.9 bn in H1’2021, supported by a 13.5% increase in retained earnings to Kshs 143.5 bn, from Kshs 126.5 bn in H1’2021,
- KCB Group remains sufficiently capitalized with a core capital to risk-weighted assets ratio of 17.7%, 7.2% 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 17.8%, while total capital to risk-weighted assets came in at 21.7%, and,
- The bank currently has a Return on Average Assets (ROaA) of 3.5%, and a Return on Average Equity (ROaE) of 23.2%.

Key Take-Outs:

1. **Deterioration of the Asset Quality** - The group’s asset quality deteriorated, with the NPL ratio increasing to 21.4% in H1’2022, from 14.4% in H1’2021, attributable to the 50.1% exposure to corporate loans, which have been impacted by delayed recovery from COVID-19, increased inflationary pressures and pending government bills, which have increased by 40.4% y/y. Additionally, increase in NPLs have been recorded from sectors such as building and construction, manufacturing, as well as the hospitality sectors. Key to note, the group’s asset quality was weighed down by the high NPL ratio from NBK which came in at 33.9%, despite having recorded an improvement y/y, from 37.3% in H1’2021. On the other hand, KCB-K was the only subsidiary that recorded an increase in the NPL ratio to 22.8%, from 11.9% in H1’2021, attributable to a reclassification of 9 large accounts to non-performing loans. On a q/q basis, KCB’s Asset quality also deteriorated by 4.5% points to 21.4%, from 16.9% recorded in Q1’2022,
2. **Reduced Provisioning** – Despite the 81.2% increase in Gross non-performing loans, the NPL coverage declined to 45.8% in H1’2022 from 61.6% in H1’2021, attributable to the faster growth in Gross non-performing loans, which outpaced the 39.1% 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. **Deterioration in efficiency levels** - The cost to income ratio without LLP deteriorated to 45.7% from 44.3% in H1’2021, an indication of reduced efficiency. Key to note, the cost to income ratio deteriorated by 1.2% points on a q/q basis to 45.7% from 44.5% recorded in Q1’2022, and,
4. **Reduced Lending** – H1’2022 was characterized by a faster 30.4% growth in government securities which outpaced the 20.3% growth in loans, mainly due to the bank’s cautious lending given 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. Additionally, KCB has announced plans to acquire 85.0% majority stake in Democratic Republic of Congo’s Trust Merchant Bank, pending regulatory approval. This is expected to boost KCB’s regional presence and participation, as well as accelerate its growth. The geographical expansion has continued to bear fruits, with the group’s subsidiaries with the expection of KCB-K, increasing their Profit Before Tax (PBT) contribution to 16.8%, up from 15.7% in H1’2021. 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.

Valuation Summary

- We are of the view that KCB Group is a “BUY” with a target price of Kshs 57.2, representing an upside of 47.0%, from the current price of Kshs 41.0 as of 26th August 2022, inclusive of a dividend yield of 7.0%,
- KCB Group is currently trading at a P/TBV of 0.7x and a P/E of 3.4x vs an industry average of 0.9x and 4.9x, respectively.