Cytonn INVESTMENTS

KCB Group Plc – Q1’2022

27th May, 2022

Below is a summary of KCB Group’s Q1’2022 performance:

Balance Sheet Items	Q1'2021	Q1'2022	y/y change
Net Loans and Advances	597.1	704.4	18.0%
Government Securities	212.1	274.4	29.4%
Total Assets	**977.5**	**1,166.9**	**19.4%**
Customer Deposits	749.4	845.8	12.9%
Total Liabilities	**830.0**	**983.2**	**18.5%**
Shareholders’ Funds	**147.5**	**181.8**	**23.3%**

Balance Sheet Ratios	Q1'2021	Q1'2022	% point change
Loan to Deposit Ratio	79.7%	83.3%	3.6%
Return on average equity	13.9%	22.9%	9.0%
Return on average assets	2.0%	3.5%	1.5%

Income Statement	Q1'2021	Q1'2022	y/y change
Net Interest Income	16.7	19.7	18.0%
Net non-Interest Income	6.3	9.3	47.2%
Total Operating income	**23.0**	**29.0**	**26.0%**
Loan Loss provision	(2.9)	(2.1)	(27.5%)
Total Operating expenses	(13.9)	(15.0)	7.7%
Profit before tax	9.1	14.0	53.9%
Profit after tax	**6.4**	**9.9**	**54.6%**
Core EPS	**2.0**	**3.1**	**54.6%**

Income Statement Ratios	Q1'2021	Q1'2022	% point change
Yield from interest-earning assets	10.9%	11.4%	0.5%
Cost of funding	2.6%	3.0%	0.4%
Net Interest Spread	8.3%	8.4%	0.1%
Net Interest Margin	8.4%	8.6%	0.2%
Cost of Risk	12.4%	7.1%	(5.3%)
Net Interest Income as % of operating income	72.6%	68.0%	(4.6%)
Non-Funded Income as a % of operating income	27.4%	32.0%	4.6%
Cost to Income Ratio	60.4%	51.7%	(8.7%)

Capital Adequacy Ratios	Q1'2021	Q1'2022	% points change
Core Capital/Total Liabilities	19.2%	19.7%	0.5%
Minimum Statutory ratio	8.0%	8.0%	-
Excess	**11.2%**	**11.7%**	**0.5%**
Core Capital/Total Risk Weighted Assets	18.2%	19.2%	1.0%
Minimum Statutory ratio	10.5%	10.5%	-
Excess	**7.7%**	**8.7%**	**1.0%**
Total Capital/Total Risk Weighted Assets	21.8%	22.8%	1.0%
Minimum Statutory ratio	14.5%	14.5%	-
Excess	**7.3%**	**8.3%**	**1.0%**
Liquidity Ratio	37.3%	36.9%	(0.4%)
Minimum Statutory ratio	20.0%	20.0%	-
Excess	**17.3%**	**16.9%**	**(0.4%)**

Income Statement

- Core earnings per share rose by 54.6% to Kshs 3.1, from Kshs 2.0 in Q1’2021, higher than our expectations of a 20.1% increase to Kshs 2.4, with the variance stemming from the 26.0% increase in total operating income, which was higher than our projection of a 13.9% increase. The performance was driven by the 26.0% growth in total operating income to Kshs 29.0 bn, from Kshs 23.0 bn in Q1’2021, coupled with a 27.5% decline in Loan Loss Provisions to Kshs 2.1 bn, from Kshs 2.9 bn in Q1’2021. The decline in Loan Loss Provisions is attributable to the declining credit risk in the market on the back of increased business activities in 2022 driven by the gradual economic recovery,
- Total operating income increased by 26.0% to Kshs 29.0 bn, from Kshs 23.0 bn in Q1’2021, driven by an 18.0% increase in Net Interest Income (NII) to Kshs 19.7 bn, from Kshs 16.7 bn in Q1’2021, coupled with a 47.2% increase in Non-Funded Income (NFI) to Kshs 9.3 bn, from Kshs 6.3 bn in Q1’2021
- Interest income grew by 21.2% to Kshs 26.6 bn, from Kshs 22.0 bn in Q1’2021, mainly driven by an 18.9% increase in interest income from loans and advances, which increased to Kshs 18.8 bn, from Kshs 15.8 bn in Q1’2021, coupled with a 28.6% increase in interest income from government securities which increased to Kshs 7.7 bn, from Kshs 6.0 bn in Q1’2021. The Yield on Interest-Earning Assets (YIEA) rose by 0.5% points to 11.4%, from 10.9% recorded in Q1’2021, attributable to the faster 18.0% growth in traiIling interest income which outpaced the 12.9% 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 expense rose by 31.4% to Kshs 6.9 bn, from Kshs 5.2 bn in Q1’2021, following a 26.4% increase in interest expense on customer deposits to Kshs 5.7 bn, from Kshs 4.5 bn in Q1’2021, coupled with a 48.0% rise in Interest expense on deposits and placements to Kshs 1.0 bn, from Kshs 0.7 bn in Q1’2021. Consequently, Cost of funds (COF) increased by 0.4% points to 3.0%, from 2.6% recorded in Q1’2021, following a faster 24.9% increase in Trailing interest expense, which outpaced the 3.9% 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) increased to 8.6%, from 8.4% in Q1’2021 due to the faster 15.9% increase in trailing Net Interest Income, which outpaced the 12.9%,growth in average interest-earning assets,
- Non-Funded Income (NFI) increased by 47.2% to Kshs 9.3 bn, from Kshs 6.3 bn in Q1’2021, driven by a 73.2% increase in income from fees and commissions on loans and advances to Kshs 2.6 bn, from Kshs 1.5 bn in Q1’2021, coupled with a 46.2% increase in the group’s foreign exchange trading income to Kshs 1.7 bn, from Kshs 1.2 bn in Q1’2021. Notably, total fees and commissions increased by 49.1% to Kshs 5.9 bn, from the Kshs 4.0 bn recorded in Q1’2021. The revenue mix shifted to 68:32 from 73:27 funded to non-funded income, owing to the faster 47.2% growth in NFI compared to the 18.0% increase in NII,
- Total operating expenses increased by 7.7% to Kshs 15.0 bn, from Kshs 13.9 bn in Q1’2021, largely driven by an 11.0% increase in staff costs to Kshs 6.7 bn, from Kshs 6.1 bn in Q1’2021. Loan Loss Provisions (LLP), on the other hand, recorded a 27.5% decline to Kshs 2.1 bn, from Kshs 2.9 bn in Q1’2021. The reduced provisioning level was due to declining credit risk on the back of increased business activities in 2022,
- Cost to Income Ratio (CIR) improved to 51.7%, from 60.4% in Q1’2021, owing to the 26.0% increase in total operating income to Kshs 29.0 bn, from Kshs 23.0 bn in Q1’2021, which outpaced the 7.7% increase in total operating expenses to Kshs 15.0 bn, from Kshs 13.9 bn in Q1’2021. Without LLP, Cost to Income ratio also improved to 44.5% from 48.0% in Q1’2021, an indication of improving efficiency, and,
- Profit before tax increased by 53.9% to Kshs 14.0 bn, from Kshs 9.1 bn in Q1’2021 due to the 26.0% increase in total operating income, which outpaced the 7.7% increase in total operating expenses. Profit after tax increased by 54.6% to Kshs 9.9 bn in Q1’2022, from Kshs 6.4 bn in Q1’2021, with the effective tax rate increasing to 29.8%, from 30.1% in Q1’2021.

Balance Sheet

- The balance sheet recorded an expansion as total assets grew by 19.4% to Kshs 1.2 tn, from Kshs 1.0 tn in Q1’2021. The growth was supported by an 18.0% loan book expansion to Kshs 704.4 bn, from Kshs 597.1 bn in

Q1’2021, coupled with a 29.4% increase in government securities to Kshs 274.4 bn, from Kshs 212.1 bn in Q1’2021,

- Total liabilities rose by 18.5% to Kshs 983.2 bn, from Kshs 830.0 bn in Q1’2021, driven by a 162.7% increase in placements due to other banking instituitions to Kshs 45.3 bn, from Kshs 17.2 bn in Q1’2021. Customer deposits increased as well by 12.9% to Kshs 845.8 bn, from Kshs 749.4 bn, with customer deposits from NBK amounting to Kshs 98.7 bn in Q1’2022. Deposits per branch decreased by 19.2% to Kshs 1.7 bn, from Kshs 2.1 bn in Q1’2021, with the number of branches increasing to 496, from 355 in Q1’2021. 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 1 branch in South Sudan and 3 others in Kenya in Q1’2022,
- The faster 18.0% growth in loans as compared to the 12.9% growth in deposits led to an increase in the loan to deposit ratio to 83.3%, from 79.7% in Q1’2021,
- Gross non-performing loans increased by 33.6% to Kshs 130.9 bn, from Kshs 98.0 bn in Q1’2021. The group’s Asset Quality therefore deteriorated, with the NPL ratio increasing to 16.9% in Q1’2022, from 14.9% in Q1’2021, attributable to the faster 33.6% growth in Non-Performing loans, which outpaced the 18.0% growth in loans,
- General Provisions (LLP) increased by 17.7% y/y to Kshs 55.4 bn in Q1’2022, from Kshs 47.1 bn in Q1’2021. The NPL coverage decreased to 52.7% in Q1’2022, from 61.6% in Q1’2021, attributable to the faster 33.6% growth in Gross non-performing loans, which outpaced the 17.7% growth in general Loan Loss Provisions,
- Shareholders’ funds increased by 23.3% to Kshs 181.8 bn in Q1’2022, from Kshs 147.5 bn in Q1’2021, supported by an 11.0% increase in retained earnings to Kshs 146.1 bn, from Kshs 131.6 bn in Q1’2021,
- KCB Group remains sufficiently capitalized with a core capital to risk-weighted assets ratio of 19.2%, 8.7% points above the statutory requirement. In addition, the total capital to risk-weighted assets ratio came in at 22.8%, exceeding the statutory requirement by 8.3% points. Adjusting for IFRS 9, the core capital to risk-weighted assets stood at 19.3%, while total capital to risk-weighted assets came in at 22.9%, and,
- The bank currently has a Return on Average Assets (ROaA) of 3.5%, and a Return on Average Equity (ROaE) of 22.9%.

Key Take-Outs:

1. The group’s asset quality deteriorated, with the NPL ratio increasing to 16.9% in Q1’2022, from 14.9% in Q1’2021, driven by the manufacturing, building and construction, as well as the hospitality sectors with corporate loans contributing a total of 29.3% to the NPLs. Additionally, the group’s asset quality was weighed down by the high NPL ratio of NBK which came in at 33.8%. Key to note, NBK’s asset quality recorded an improvement y/y, with the NPL ratio declining to 33.8% from 35.7% in Q1’2021. On a q/q basis, KCB’s Asset quality deteriorated by 0.3% points to 16.9%, from 16.6% recorded in FY’2021. The NPL coverage, on the other hand, decreased to 52.7% in Q1’2022 from 61.6% in Q1’2021, attributable to the faster 33.6% growth in Gross non-performing loans, which outpaced the 17.7% 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,
2. There was an improvement in efficiency levels as the cost to income ratio without LLP improved to 44.5% from 48.0% in Q1’2021, an indication of improving efficiency. Key to note, the cost to income ratio deteriorated by 0.5% points on a q/q basis to 44.5% from 44.0% recorded in FY’2021, and,
3. The deterioration in asset quality led the group to shy away from lending in Q1’2022, as evidenced by the faster 29.4% growth in government securities to Kshs 274.4 bn, from Kshs 212.1 bn in Q1’2021, which outpaced the 18.0% loan book expansion to Kshs 704.4 bn, from Kshs 597.1 bn in Q1’2021,

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. Although KCB cancelled its plans to acquire African Banking Corporation Tanzania Limited (BancABC), the lender disclosed that it will explore other expansion opportunities in order to enhance its regional participation and accelerate growth. The bank is also planning on expanding into the Ethiopian market, further expanding its presence in the region. This is also expected to 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 49.4, representing an upside of 37.8%, from the current price of Kshs 38.0 as of 27th May 2022, inclusive of a dividend yield of 7.9%,
- KCB Group is currently trading at a P/TBV of 0.6x and a P/E of 3.2x vs an industry average of 0.8x and 4.4x, respectively.