

**Valuation Summary**

- We are of the view that KCB Group is a “**buy**” with a target price of Kshs 60.0, representing an upside of 62.8%, from the current price of Kshs 39.0 as of 24<sup>th</sup> May 2019, inclusive of a dividend yield of 9.0%,
- KCB Group is currently trading at a P/TBV of 1.0x and a P/E of 5.2x vs an industry average of 1.3x and 6.7x, respectively.

**Key Highlights Q1'2019**

- During the quarter, KCB Group announced its intention to acquire a 100% stake in the National Bank of Kenya (NBK). The offer will be by way of a share swap at a ratio of 10:1, 10 ordinary shares of NBK for 1 ordinary share of KCB.

**Income Statement**

- Earnings per share increased by 11.4% to Kshs 7.5 from Kshs 6.8 in Q1'2018, which was in line with our expectation. The performance was driven by a 10.6% increase in total operating income to Kshs 18.8 bn from Kshs 17.0 bn in Q1'2018,
- Total operating income increased by 10.6% to Kshs 18.8 bn from Kshs 17.0 bn in Q1'2018. This was due to an 11.2% increase in Net Interest Income (NII) to Kshs 12.7 bn from Kshs 11.4 bn in Q1'2018, coupled with the 9.2% increase in Non-Funded Income (NFI) to Kshs 6.0 bn, from Kshs 5.5 bn in Q1'2018,
- Interest income increased by 7.1% to Kshs 16.8 bn, from Kshs 15.7 bn in Q1'2018. This was driven by a 7.3% growth in interest income from government securities to Kshs 3.2 bn from Kshs 3.0 bn in Q1'2018, and a 6.4% increase in interest income on loans and advances to Kshs 13.4 bn, from Kshs 12.6 bn in Q1'2018. The yield on interest-earning assets however declined to 11.4% from 11.8% in Q1'2018 attributed to a decline in yields on government securities as well as a decline in lending rates due to the 100 bps CBR cuts last year,
- Interest expenses declined by 4.1% to Kshs 4.1 bn, from Kshs 4.2 bn in Q1'2018, following a 5.9% decline in the interest expense on customer deposits to Kshs 3.6 bn, from Kshs 3.8 bn in Q1'2018, which outpaced the 12.0% rise in interest expense on placement liabilities to Kshs 493.9 mn, from Kshs 440.9 mn in Q1'2018. The cost of funds however remained unchanged at 3.1%. The Net Interest Margin (NIM) declined to 8.5%, from 8.9% in Q1'2018,
- Non-Funded Income (NFI) increased by 9.2% to Kshs 6.0 bn, from Kshs 5.5 bn in Q1'2018. The increase was mainly driven by an 11.6% rise in total fees and commissions income to Kshs 4.0 bn, from Kshs 3.6 bn in Q1'2018. The growth was however weighed down by the 5.4% decline in forex trading income to Kshs 0.98, from Kshs 1.03 bn in Q1'2018. As a result, the revenue mix shifted to 68:32 from 67:33, due to the faster growth in NII compared to NFI,
- Total operating expenses increased by 8.2% to Kshs 10.3 bn, from Kshs 9.5 bn, largely driven by a 93.8% rise in Loan Loss Provisions (LLP) to Kshs 1.2 bn in Q1'2019, from Kshs 0.6 bn in Q1'2018, coupled with a 4.1% rise in staff costs to Kshs 4.6 bn in Q1'2019, from Kshs 4.5 bn in Q1'2018,
- Due to the faster growth of total operating income that outpaced the growth in operating expenses, Cost to Income Ratio (CIR) improved to 54.7%, from 55.9% in Q1'2018. Without LLP, the cost to income ratio also improved, to 48.5%, from 52.4% in Q1'2018, and,
- Profit before tax increased by 13.5% to Kshs 8.5 bn, up from Kshs 7.5 bn in Q1'2018. Profit after tax grew by 11.4% to Kshs 5.8 bn in Q1'2019, from Kshs 5.2 bn in Q1'2018 as the effective tax rate increased to 32.0% from 30.7% in Q1'2018.

**Balance Sheet**

- The balance sheet recorded an expansion as total assets increased by 12.1% to Kshs 725.7 bn, from Kshs 647.5 bn in Q1'2018. This growth was largely driven by a 19.0% increase in investment in government and other securities to Kshs 133.3 bn, from Kshs 112.1 bn in Q1'2018, coupled with a 10.9% increase in their loan book to Kshs 464.3 bn, from Kshs 418.6 bn in Q1'2018,
- Total liabilities rose by 10.7% to Kshs 606.2 bn, from Kshs 547.8 bn in Q1'2018, driven by an 11.2% increase in deposits to Kshs 552.2 bn, from Kshs 496.4 bn in Q1'2018. Deposits per branch increased by 13.4% to Kshs 2.1 bn from Kshs 1.9 bn in Q1'2018, with the number of branches having reduced to 258 from 263 in Q1'2018,
- The faster growth in deposits as compared to loans led to a decline in the loan to deposit ratio to 84.1% from 84.3% in Q1'2018,
- Gross Non-Performing Loans (NPLs) declined by 11.3% to Kshs 38.8 bn in Q1'2019 from Kshs 43.8 bn in Q1'2018. The NPL ratio thus improved to 8.0% from 9.9% in Q1'2018. General Loan Loss Provisions declined by 26.1% to Kshs 15.2 bn, from Kshs 14.4 bn in Q1'2018. The NPL coverage consequently declined to 51.0% in from 58.6% in Q1'2018,
- Shareholders' funds increased by 19.9% to Kshs 119.5 bn in Q1'2019, from Kshs 99.6 bn in Q1'2018, as retained earnings grew by 35.1% y/y to Kshs 91.0 bn, from Kshs 67.3 bn in Q1'2018,
- KCB Group is currently sufficiently capitalized with a core capital to risk-weighted assets ratio of 18.6%, 8.1% above the statutory requirement. In addition, the total capital to risk-weighted assets ratio was 20.0%, exceeding the statutory requirement by 5.5%. 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 20.8%, and,
- The bank currently has a Return on Average Assets (ROaA) of 3.6%, and a Return on Average Equity (ROaE) of 22.4%.

**Key Take-Outs:**

1. The bank's asset quality improved, with the NPL ratio improving to 8.0% from 9.9% in Q1'2018. The improved NPL ratio was mainly attributed to an improvement in the corporate loan book's NPL ratio to 10.5% in Q1'2019 from in 14.8% in Q1'2018, as well as the SME and Micro loan book, which improved to 15.6% in Q1'2019, down from 16.3% in Q1'2018, respectively, and,
2. There was an improvement in operational efficiency as evidenced by the improvement in the Cost to Income Ratio (CIR) to 54.7%, from 55.9% in Q1'2018 and to 48.5% from 52.4% in Q1'2018. This has mainly been driven by increased innovation and digitization has seen with 91% of total transactions performed outside the branch comprising of 56.0% on mobile, 27.0% on agency, internet and POS and 8.0% on the ATM which has facilitated the faster growth of transactional income outpacing the growth in operating expenses.

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. 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.

Below is a summary of the bank's performance:

Balance Sheet Items	Q1'2018	Q1'2019	y/y change	Q1'2019e	Expected y/y change	Variance in Actual Growth vs Expected
Net Loans and Advances	418.6	464.3	10.9%	463.4	10.7%	0.2%
<b>Total Assets</b>	<b>647.5</b>	<b>725.7</b>	<b>12.1%</b>	<b>723.1</b>	<b>11.7%</b>	<b>0.4%</b>
Customer Deposits	496.4	552.2	11.2%	550.9	11.0%	0.3%
Total Liabilities	547.8	606.2	10.7%	603.5	10.2%	0.5%
<b>Shareholders' Funds</b>	<b>99.6</b>	<b>119.5</b>	<b>19.9%</b>	<b>119.5</b>	<b>20.0%</b>	<b>(0.1%)</b>

Balance Sheet Ratios	Q1'2018	Q1'2019	% y/y change
Loan to Deposit Ratio	84.3%	84.1%	(0.3%)
Return on average equity	20.3%	22.4%	2.2%
Return on average assets	3.2%	3.6%	0.3%

Income Statement	Q1'2018	Q1'2019	y/y change	Q1'2019e	Expected y/y change	Variance in Actual Growth vs Expected
Net Interest Income	11.4	12.7	11.2%	12.1	5.5%	5.8%
Net non-Interest Income	5.5	6.0	9.2%	6.0	7.8%	1.4%
<b>Total Operating income</b>	<b>17.0</b>	<b>18.8</b>	<b>10.6%</b>	<b>18.0</b>	<b>6.2%</b>	<b>4.3%</b>
Loan Loss provision	0.6	1.2	93.8%	0.9	46.9%	46.8%
Total Operating expenses	9.5	10.3	8.2%	9.7	1.8%	6.4%
Profit before tax	7.5	8.5	13.5%	8.4	11.8%	1.8%
<b>Profit after tax</b>	<b>5.2</b>	<b>5.8</b>	<b>11.4%</b>	<b>5.9</b>	<b>13.0%</b>	<b>(1.6%)</b>
<b>Core EPS</b>	<b>1.7</b>	<b>1.88</b>	<b>11.4%</b>	<b>1.91</b>	<b>13.0%</b>	<b>(1.6%)</b>

Income Statement Ratios	Q1'2018	Q1'2019	y/y change
Yield from interest-earning assets	11.8%	11.4%	(0.4%)
Cost of funding	3.1%	3.1%	0.0%
Net Interest Spread	8.7%	8.3%	(0.4%)
Net Interest Margin	8.9%	8.5%	(0.5%)
Cost of Risk	3.5%	6.2%	2.7%
Net Interest Income as % of operating income	67%	68%	0.4%
Non-Funded Income as a % of operating income	33%	32%	(0.4%)
Cost to Income Ratio	55.9%	54.7%	(1.2%)