KCB Group Earnings Note– Q1'2020
22nd May, 2020

Valuation Summary

- We are of the view that KCB Group is a "***buy***" with a target price of Kshs 56.4, representing an upside of 55.5%, from the current price of Kshs 36.3 as of 22nd May 2020, inclusive of a dividend yield of 9.6%,
- KCB Group is currently trading at a P/TBV of 0.9x and a P/E of 4.6x vs an industry average of 1.0x and 5.4x, respectively.

Key Highlight Q1'2020

- KCB recently restructured loans amounting to Kshs 80.0 bn equivalent to 14.9% of its net loans, which stood at Kshs 535.4 bn in FY'2019. The loan restructuring involves placing moratoriums on both interest and principal payments for three months, in effect giving reprieve to its customers who found it difficult to repay their loans due to the impact caused by the pandemic.

Income Statement

- Core earnings per share rose by 8.4% to Kshs 1.95, from Kshs 1.80 in Q1'2019, driven by a 22.4% growth in total operating income to Kshs 23.0 bn, from Kshs 18.8 bn in Q1'2019. Total operating expenses grew by 36.7% to Kshs 14.0 bn, from Kshs 10.3 bn in Q1'2019. The growth in core earnings per share was not in line with our expectations of a 0.3% decrease, with the variance being attributable to the 22.4% increase in total operating income to Kshs 23.0 bn, from Kshs 18.8 bn in Q1'2020, which exceeded our expectations of a 0.7% increase,
- Total operating income rose by 22.4% to Kshs 23.0 bn, from Kshs 18.8 bn in Q1'2019. This was driven by a 30.5% rise in Non-Funded Income (NFI) to Kshs 7.9 bn, from Kshs 6.0 bn in Q1'2019, coupled with an 18.5% rise in Net Interest Income (NII) to Kshs 15.1 bn, from Kshs 12.7 bn in Q1'2019,
- Interest income grew by 20.4% to Kshs 20.2 bn, from Kshs 16.8 bn in Q1'2019. This was driven by 65.6% rise in interest income from government securities to Kshs 5.3 bn from Kshs 3.2 bn in Q1'2019, coupled with a 9.7% rise in interest income on loans and advances to Kshs 14.7 bn, from Kshs 13.4 bn in Q1'2019. The yield on interest-earning assets, however, declined to 10.8% from 11.2% in Q1'2019 attributable to a decline in lending rates, which saw trailing interest income grow by 15.4%, which was outpaced by the 19.8% growth recorded in the average interest-earning assets,
- Interest expense rose by 26.6% to Kshs 5.2 bn, from Kshs 4.1 bn in Q1'2019, following a 31.0% rise in interest expense on customer deposits to Kshs 4.7 bn from Kshs 3.6 bn in Q1'2019. Interest expense on deposits and placement from banking institutions, however, remained unchanged at Kshs 0.5 bn Q1'2020. The cost of funds, on the other hand, declined to 2.8% from 3.1% in Q1'2019 owing to a slower 11.7% growth in trailing interest expense, which grew slower than the 22.2% rise in the average interest-bearing liabilities. The Net Interest Margin (NIM) declined to 8.1% from 8.3% in Q1'2019, owing to the faster 19.8% growth in average interest-earning assets, which outpaced the 18.5% growth in Net Interest Income (NII),
- Non-Funded Income (NFI) rose by 30.5% to Kshs 7.9 bn, from Kshs 6.0 bn in Q1'2019. The increase was mainly driven by a 23.8% rise in fees and commissions on loans to Kshs 2.7 bn, from Kshs 2.2 bn in Q1'2019. As a result, the revenue mix shifted to 65:34 from 67:32 funded to non-funded income, due to the faster growth in NFI compared to NII,
- Total operating expenses grew by 36.7% to Kshs 14.0 bn, from Kshs 10.3 bn, largely driven by 25.5% rise in staff costs to Kshs 5.8 bn in Q1'2020, from Kshs 4.6 bn in Q1'2019, coupled with a 149.1% rise in Loan Loss Provisions (LLP) to Kshs 2.9 bn in Q1'2020, from Kshs 1.2 bn in Q1'2019. The increased provisioning levels were witnessed as the Group provided cover for downgraded facilities, with the expectation of an increase in defaults across sectors, brought about by the COVID-19 pandemic,

- Cost to Income Ratio (CIR) deteriorated to 61.1%, from 54.7% in Q1’2019 owing to the faster 36.7% rise in Total Operating Expenses to Kshs 14.0 bn from Kshs 10.3 bn in Q1’2019 which outpaced the 22.4% rise in Total Operating Income to Kshs 23.0 bn, from Kshs 18.8 bn in Q1’2019. Without LLP however, the cost to income ratio remained unchanged at 48.5% in Q1’2020, and,
- Profit before tax increased by 5.0% to Kshs 8.9 bn, up from Kshs 8.5 bn in Q1’2019. Profit after tax grew by 8.4% to Kshs 6.3 bn in Q1’2020, from Kshs 5.8 bn in Q1’2019 with the effective tax rate declining to 29.9% from 32.0% in Q1’2019,

Balance Sheet

- The balance sheet recorded an expansion as total assets grew by 30.5% to Kshs 947.1 bn, from Kshs 725.7 bn in Q1’2019. This growth was largely driven by a 52.0% increase in investment in government and other securities to Kshs 202.6 bn, from Kshs 133.3 bn in Q1’2019. The loan book also recorded a 19.3% growth to Kshs 553.9 bn, from Kshs 464.3 bn in Q1’2019. The strong balance sheet growth is also partly attributable to KCB consolidating assets following the acquisition of NBK,
- Total liabilities rose by 33.9% to Kshs 811.5 bn, from Kshs 606.2 bn in Q1’2019, driven by a 34.1% increase in customer deposits to Kshs 740.4 bn, from Kshs 552.2 bn in Q1’2019, with customer deposits from NBK amounting to Kshs 92.0 bn in Q1’2020. Deposits per branch rose by 4.8% to Kshs 2.2 bn from Kshs 2.1 bn in Q1’2019, with the number of branches having increased to 344 as at Q1’2020, from 258 in Q1’2019,
- The faster growth in deposits as compared to loans led to a decline in the loan to deposit ratio to 74.8%, from 84.1% in Q1’2019,
- Gross Non-Performing Loans (NPLs) rose by 70.5% to Kshs 66.2 bn in Q1’2020, from Kshs 38.8 bn in Q1’2019, attributable to the poor performance from the MSMEs segment of 16.4%, Mortgage segment of 8.3%, corporate segment of 8.2%, and Check-off loans of 2.4%. The NPL ratio thus deteriorated to 11.1%, from 8.0% in Q1’2019, due to the faster growth in Gross Non-Performing Loans (NPLs), which outpaced the growth in loans.
- General Loan Loss Provisions rose by 103.8% to Kshs 30.9 bn, from Kshs 15.2 bn in Q1’2019. The NPL coverage thus increased to 61.3%, from 51.0% in Q1’2019, due to the faster growth in General Loan Loss Provisions, which outpaced the growth in Gross Non-Performing Loans (NPLs),
- Shareholders’ funds increased by 13.5% to Kshs 135.5 bn in Q1’2020, from Kshs 119.5 bn in Q1’2019, as retained earnings grew by 8.6% y/y to Kshs 98.8 bn, from Kshs 91.0 bn in Q1’2019,
- KCB Group is currently sufficiently capitalized with a core capital to risk-weighted assets ratio of 17.1%, 6.6% points above the statutory requirement. In addition, the total capital to risk-weighted assets ratio was 19.0%, exceeding the statutory requirement by 4.5% points. Adjusting for IFRS 9, the core capital to risk-weighted assets stood at 17.1% while total capital to risk-weighted assets came in at 19.0%, and,
- The bank currently has a Return on Average Assets (ROaA) of 3.1%, and a Return on Average Equity (ROaE) of 20.1%.

Key Take-Outs:

1. The group’s Profit after Tax (PAT) grew by 8.4% y/y to Kshs 6.3 bn from Kshs 5.8 bn in Q1’2019 attributable to the robust growth of Net Non-Interest Income (NII) of 22.4% to Kshs 23.0 bn from Kshs 18.8 bn. The growth in the Non-Interest Income was mainly attributable to the group’s ability to leverage on digital channels and the 65.0% growth in non-branch revenue to Kshs 2.8 bn. In Q1’2020, 97.0% of transactions were carried out outside the branch (73.0% on mobile, 20.0% on agency, Internet and POS and 4.0% on ATMs),
2. Following the acquisition of National Bank of Kenya, the group’s asset quality remains under threat as seen in the increase of the groups Non- Performing Loans (NPL) ratio to 11.0% from 8.0% in Q1’2019. The significant rise is attributable to KCB’s acquisition of National Banks’ non-performing loans portfolio of Kshs 25.1 bn, and,

3. Loan Loss Provisions increased by 149.1% to Kshs 2.9 bn from Kshs 1.2 bn. The increased provisioning levels were witnessed as the Group provided cover for downgraded facilities, with the expectation of an increase in defaults across sectors, brought about by the COVID-19 pandemic.

Below is a summary of the bank’s performance:

Balance Sheet Items	Q1'2019	Q1'2020	y/y change	Q1'2020e	Expected y/y change	Variance in Actual Growth vs Expected
Net Loans and Advances	464.3	553.9	19.3%	533.8	15.0%	4.3%
Total Assets	**725.7**	**947.1**	**30.5%**	**887.6**	**22.3%**	**8.2%**
Customer Deposits	552.2	740.4	34.1%	680.0	23.1%	10.9%
Total Liabilities	606.2	811.5	33.9%	752.1	24.1%	9.8%
Shareholders’ Funds	**119.5**	**135.5**	**13.5%**	**135.5**	**13.4%**	**0.0%**

Balance Sheet Ratios	Q1'2019	Q1'2020	% y/y change
Loan to Deposit Ratio	84.1%	74.8%	(9.3%)
Return on average equity	22.4%	20.1%	(2.3%)
Return on average assets	3.6%	3.1%	(0.5%)

Income Statement	Q1'2019	Q1'2020	y/y change	Q1'2020e	Expected y/y change	Variance in Actual Growth vs Expected
Net Interest Income	12.7	15.1	18.5%	14.8	16.7%	1.8%
Net non-Interest Income	6.0	7.9	30.5%	4.1	(32.9%)	63.5%
Total Operating income	**18.8**	**23.0**	**22.4%**	**18.9**	**0.7%**	**21.7%**
Loan Loss provision	1.2	2.9	149.1%	1.3	8.5%	140.7%
Total Operating expenses	10.3	14.0	36.7%	10.7	3.9%	32.9%
Profit before tax	8.5	8.9	5.0%	8.2	(3.2%)	8.2%
Profit after tax	**5.8**	**6.3**	**8.4%**	**5.8**	**(0.3%)**	**8.6%**
Core EPS	**1.80**	**1.95**	**8.4%**	**1.79**	**(0.3%)**	**8.6%**

Income Statement Ratios	Q1'2019	Q1'2020	y/y change
Yield from interest-earning assets	11.2%	10.8%	(0.4%)
Cost of funding	3.1%	2.8%	(0.3%)
Net Interest Spread	8.1%	8.0%	(0.1%)
Net Interest Margin	8.3%	8.1%	(0.2%)
Cost of Risk	6.2%	12.6%	6.4%
Net Interest Income as % of operating income	67.7%	65.6%	(2.2%)
Non-Funded Income as a % of operating income	32.3%	34.4%	2.2%
Cost to Income Ratio	54.7%	61.1%	6.4%

Capital Adequacy Ratios	Q1'2019	Q1'2020
Core Capital/Total Liabilities	20.4%	17.1%
Minimum Statutory ratio	8.0%	8.0%
Excess	**12.4%**	**9.1%**
Core Capital/Total Risk Weighted Assets	18.1%	17.1%

Minimum Statutory ratio	10.5%	10.5%
Excess	**7.6%**	**6.6%**
Total Capital/Total Risk Weighted Assets	19.5%	19.0%
Minimum Statutory ratio	14.5%	14.5%
Excess	**5.0%**	**4.5%**
Liquidity Ratio	35.6%	40.1%
Minimum Statutory ratio	20.0%	20.0%
Excess	**15.6%**	**20.1%**
Adjusted core capital/ total deposit liabilities	21.3%	17.5%
Adjusted core capital/ total risk weighted assets	18.9%	17.5%
Adjusted total capital/ total risk weighted assets	20.3%	19.4%