KCB Group Earnings Note– Q3'2019

14th November, 2019

Valuation Summary

- We are of the view that KCB Group is a "***buy***" with a target price of Kshs 61.4, representing an upside of 29.8%, from the current price of Kshs 50.0 as of 14th November 2019, inclusive of a dividend yield of 7.0%,
- KCB Group is currently trading at a P/TBV of 1.4x and a P/E of 6.4x vs an industry average of 1.5x and 7.9x, respectively.

Key Highlights Q3'2019

- During the quarter KCB completed the take-over of National Bank of Kenya Limited by way of a share swap at a ratio of 10:1, 10 ordinary shares of NBK for 1 ordinary share of KCB. This saw KCB Group Plc list an additional 142,979,717shares at the Nairobi Securities Exchange (NSE).

Income Statement

- Core earnings per share increased by 6.2% to Kshs 6.3 from Kshs 5.9 in Q3'2018, driven by a 10.0% growth in total operating income to Kshs 59.7 bn from Kshs 54.2 bn in Q3'2018. The growth in core earnings per share was not in line with our expectations of an 8.6% growth, with the variance being attributable to the 13.4% increase in total expenses which exceeded our expectations of a 6.2% growth. The performance was,
- Total operating income increased by 10.0% to Kshs 59.7 bn from Kshs 54.2 bn in Q3'2018. This was due to a 16.9% increase in Non-Funded Income (NFI) to Kshs 21.0 bn, from Kshs 17.9 bn in Q3'2018, coupled with a 6.5% increase in Net Interest Income (NII) to Kshs 38.7 bn from Kshs 36.3 bn in Q3'2018,
- Interest income increased by 4.6% to Kshs 51.4 bn, from Kshs 49.2 bn in Q3'2018. This was driven by a 4.7% increase in interest income from government securities to Kshs 10.2 bn, from Kshs 9.7 bn in Q3'2018 coupled with a 3.7% increase in interest income on loans and advances to Kshs 40.5 bn from Kshs 39.0 bn in Q3'2018. The yield on interest-earning assets however declined to 11.0% from 11.4% in Q3'2018 attributed to a decline in yields on government securities as well as a decline in lending rates, which saw interest income growing by only 4.6% despite interest earning assets growing by 7.9%,
- Interest expenses declined by 0.8% to Kshs 12.8 bn, from Kshs 12.9 bn in Q3'2018, following an 8.1% decline in interest expense on deposits and placement from banking institutions to Kshs 1.5 bn from Kshs 1.6 bn in Q3'2018. The rise however was mitigated by a 0.3% rise in interest expense on customer deposits to Kshs 11.31 bn from Kshs 11.28 bn in Q3'2018. The cost of funds thus declined to 2.9% from 3.2% in Q3'2018. The Net Interest Margin (NIM) declined to 8.2%, from 8.5% in Q3'2018, due to the faster growth of Interest earning assets that outpaced the growth in Net Interest Income (NII),
- Non-Funded Income (NFI) increased by 16.9% to Kshs 21.0 bn, from Kshs 17.9 bn in Q3'2018. The increase was mainly driven by a 78.9% rise in fees and commissions on loans to Kshs 7.9 bn, from Kshs 4.4 bn in Q3'2018. The growth was however weighed down by the 5.5% and 5.8% declines in other fees and forex trading income to Kshs 6.2 bn and Kshs 3.5 bn from KShs 6.6 bn and Kshs 3.7 bn, respectively. As a result, the revenue mix shifted to 65:35 from 67:33, due to the faster growth in NFI compared to NII,
- Total operating expenses increased by 13.4% to Kshs 32.5 bn, from Kshs 28.6 bn, largely driven by a 224.2% rise in Loan Loss Provisions (LLP) to Kshs 5.8 bn in Q3'2019, from Kshs 1.8 bn in Q3'2018, coupled with a 6.2% rise in staff costs to Kshs 13.6 bn in Q3'2019, from Kshs 12.8 bn in Q3'2018,
- Due to the faster growth of total operating expenses that outpaced the growth in operating income, Cost to Income Ratio (CIR) deteriorated to 54.4%, from 52.8% in Q3'2018. Without LLP however, the cost to income ratio improved, to 44.7%, from 49.5% in Q3'2018, and,

- Profit before tax increased by 6.1% to Kshs 19.2 bn, up from Kshs 18.0 bn in Q3'2018. Profit after tax grew by 6.2% to Kshs 19.2 bn in Q3'2019, from Kshs 18.0 bn in Q3'2018 with the effective tax rate remaining unchanged at 29.5%.

Balance Sheet

- The balance sheet recorded an expansion as total assets increased by 11.7% to Kshs 764.3 bn, from Kshs 684.2 bn in Q3'2018. This growth was largely driven by an 11.7% increase in the loan book to Kshs 486.4 bn from Kshs 435.3 bn in Q3'2018. Investment in government and other securities also recorded a 7.5% growth to Kshs 128.5 bn, from Kshs 119.6 bn in Q3'2018,
- Total liabilities rose by 11.1% to Kshs 643.1 bn, from Kshs 578.7 bn in Q3'2018, driven by an 11.4% increase in deposits to Kshs 586.7 bn, from Kshs 526.8 bn in Q3'2018. Deposits per branch increased by 10.9% to Kshs 2.3 bn from Kshs 2.0 bn in Q3'2018, with the number of branches having increased to 258 from 257 in Q3'2018,
- The faster growth in loans as compared to deposits led to a rise in the loan to deposit ratio to 82.9% from 82.6% in Q3'2018,
- Gross Non-Performing Loans (NPLs) rose by 22.4% to Kshs 42.6 bn in Q3'2019 from Kshs 34.8 bn in Q3'2019. The NPL ratio thus deteriorated to 8.3% from 7.6% in Q3'2018 due to the faster growth in Gross Non-Performing Loans (NPLs) which outpaced the growth in loans. General Loan Loss Provisions increased by 15.0% to Kshs 19.2 bn, from Kshs 16.7 bn in Q3'2018. The NPL coverage however declined to 56.5% from 60.4% in Q3'2018 due to the faster growth in Gross Non-Performing Loans (NPLs) which outpaced the growth in General Loan Loss Provisions,
- Shareholders' funds increased by 15.0% to Kshs 121.2 bn in Q3'2019, from Kshs 105.5 bn in Q3'2018, as retained earnings grew by 27.8% y/y to Kshs 101.1 bn, from Kshs 79.1 bn in Q3'2018,
- KCB Group is currently sufficiently capitalized with a core capital to risk-weighted assets ratio of 18.1%, 7.6% above the statutory requirement. In addition, the total capital to risk-weighted assets ratio was 19.5%, exceeding the statutory requirement by 5.0%. Adjusting for IFRS 9, the core capital to risk weighted assets stood at 18.7%, while total capital to risk-weighted assets came in at 20.1%, and,
- The bank currently has a Return on Average Assets (ROaA) of 3.6%, and a Return on Average Equity (ROaE) of 22.2%.

Key Take-Outs:

1. The bank's asset quality deteriorated, with the NPL ratio increasing to 8.3% from 7.6% in Q3'2018 due to the faster growth in Gross Non-Performing Loans (NPLs) which outpaced the growth in loans. The deterioration of the NPL ratio was mainly attributed to a deterioration in the corporate loan book's NPL ratio to 10.4% in Q3'2019 from in 9.6% in Q3'2018, the mortgage loan book to 9.4% from 7.5% in Q3'2018 as well as the SME and Micro loan book, which deteriorated to 14.7% in Q3'2019, from 14.3% in Q3'2018, respectively, and,

2. There was an improvement in operational efficiency as evidenced by the decline in the Cost to Income Ratio (CIR) without LLP to 44.7% in Q3'2019, from 49.5% in Q3'2018. This has mainly been driven by increased innovation and digitization has seen with 95.0% of total transactions performed outside the branch comprising of 75.0% on mobile, 15.0% on agency, internet and POS and 5.0% on the ATM, while only 5.0% was performed by Branch tellers. This has facilitated the faster growth of transactional income while maintaining a slower pace in the growth of operating expenses. This has also seen a 141.0% growth in non-branch revenue to over Kshs 8.6 bn

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	Q3'2018	Q3'2019	y/y change	Q3'2019e	Expected y/y change	Variance in Actual Growth vs Expected
Net Loans and Advances	435.3	486.4	11.7%	484.2	11.2%	0.5%
Total Assets	**684.2**	**764.3**	**11.7%**	**761.8**	**11.4%**	**0.4%**
Customer Deposits	526.8	586.7	11.4%	568.9	8.0%	3.4%
Total Liabilities	578.7	643.1	11.1%	637.5	10.2%	1.0%
Shareholders' Funds	**105.5**	**121.2**	**15.0%**	**124.4**	**17.9%**	**(3.0%)**

Balance Sheet Ratios	Q3'2018	Q3'2019	% y/y change
Loan to Deposit Ratio	82.6%	82.9%	0.3%
Return on average equity	21.7%	22.2%	0.4%
Return on average assets	3.5%	3.6%	0.0%

Income Statement	Q3'2018	Q3'2019	y/y change	Q3'2019e	Expected y/y change	Variance in Actual Growth vs Expected
Net Interest Income	36.3	38.7	6.5%	37.9	4.4%	2.1%
Net non-Interest Income	17.9	21.0	16.9%	20.5	14.1%	2.8%
Total Operating income	**54.2**	**59.7**	**10.0%**	**58.4**	**7.6%**	**2.3%**
Loan Loss provision	1.8	5.8	224.7%	3.7	104.4%	120.3%
Total Operating expenses	28.6	32.5	13.4%	30.4	6.2%	7.3%
Profit before tax	25.6	27.2	6.1%	28.0	9.3%	(3.2%)
Profit after tax	**18.0**	**19.2**	**6.2%**	**19.6**	**8.6%**	**(2.4%)**
Core EPS	**5.9**	**6.3**	**6.2%**	**6.39**	**8.6%**	**(2.4%)**

Income Statement Ratios	Q3'2018	Q3'2019	y/y change
Yield from interest-earning assets	11.4%	11.0%	(0.4%)
Cost of funding	3.2%	2.9%	(0.2%)
Net Interest Spread	8.2%	8.0%	(0.2%)
Net Interest Margin	8.5%	8.2%	(0.3%)
Cost of Risk	3.3%	9.8%	6.5%
Net Interest Income as % of operating income	66.9%	64.8%	(2.1%)
Non-Funded Income as a % of operating income	33.1%	35.2%	2.1%
Cost to Income Ratio	52.8%	54.4%	1.7%

Capital Adequacy Ratios	Q3'2018	Q3'2019
Core Capital/Total Liabilities	18.1%	19.8%
Minimum Statutory ratio	8.0%	8.0%
Excess	**10.1%**	**11.8%**

Core Capital/Total Risk Weighted Assets	16.3%	18.1%
Minimum Statutory ratio	10.5%	10.5%
Excess	**5.8%**	**7.6%**
Total Capital/Total Risk Weighted Assets	17.8%	19.5%
Minimum Statutory ratio	14.5%	14.5%
Excess	**3.3%**	**5.0%**
Liquidity Ratio	33.7%	35.8%
Minimum Statutory ratio	20.0%	20.0%
Excess	**13.7%**	**15.8%**
Adjusted core capital/ total deposit liabilities	19.5%	20.5%
Adjusted core capital/ total risk weighted assets	17.6%	18.7%
Adjusted total capital/ total risk weighted assets	19.0%	20.1%