KCB GROUP RECOMMENDATION

17th September 2021

KCB GROUP

This is a follow up to our KCB Group 1H2021 results analysis and an update to our valuation of KCB Group (read previous valuation [here](#))

To provide some context for the valuation changes and for the reader's convenience, we recap the bank's performance for the 1H2021(The more detailed analysis can be found [here](#)).

KCB Group's after tax profits increased by 101.9% y/y to KES 15.3 billion in 1H2021 from KES 7.6 billion in 1H2020. The higher profitability was buoyed by higher interest income, lower loan loss provisions and lower effective taxation.

Net interest income rose by 17.2% y/y to KES 36.4 billion. This was mainly due to higher growth in total interest income (13.9% y/y to KES 47.1 billion) relative to the growth in total interest expense (3.8% y/y to KES 10.7 billion)

Net interest margin (NIM) grew by 10 bps to 7.9% due to a faster rise in net interest income (+17.2% y/y to KES 36.4 billion) than in total interest earning assets (6.2% y/y to KES 872.6 billion). The growth in net interest margin reflected higher yields on loans and advances (+50 bps to 11.5%) and a lower cost of funds (2.6% from 2.7% in 1H2020).

Non-interest income grew by 5.9% y/y to KES 14.8 billion as other income grew by 35.3% y/y to KES 2.9 billion and other fees and commissions income rose by 16.2% y/y to KES 5.2 billion. Fees and commissions on loans and advances decreased by 18.9% y/y to KES 4.0 billion which management attributed to deliberate actions to reduce mobile lending(particularly on KCB MPESA and Vooma) in order to mitigate against higher NPLs.

Total operating expenses (excluding provisions) rose by 7.2% y/y to KES 22.7 billion due to higher staff costs (+21.4% y/y to KES 12.3 billion) which offset the decline (-12.7% y/y to KES 29.3 billion) in "other expenses". The cost-to-income ratio (excluding provisions) however dipped to 44.3% (1H2020: 47.0%) owing to the faster rise in operating income (+13.7% y/y to KES 51.2 billion).

Loan loss provisions eased by 40.3% y/y to KES 6.6 billion as the COVID-19 related impairments had been recognized in FY2020 and the facilities restructured. Cost of risk improved to 2.2% from 4.0% in 1H2020 driven by reduced impairment charge on corporate and digital lending facilities largely from KCB Kenya.

Gross non-performing loans edged up by 14.1% y/y to KES 95.7 billion. The NPL ratio (gross NPLs/gross loans) rose to 14.3% (1H2020: 13.1%). However, this was an improvement compared to the 1Q2021 NPL ratio of 14.8%.

The group's effective tax rate decline to 30.2% from 40.9% in the 1H2020.

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RECOMMENDATION

We retain our **NEUTRAL** recommendation on KCB group with a revised target price of KES 47.54(previous target price: KES 44.59) representing a downside potential of 2.1% from the current market price of KES 48.55 (17/09/2021). The counter is currently trading a trailing P/B multiple of 0.99x (using price of KES 48.55 and IH2021 book value).

What Changed in the new estimates?

Lower cost of risk: We have reduced the cost of risk over the five year forecast period from an average of 2.5% (2021: 3.0%) to an average of 2.0% (2021: 2.0%) on account of increased recoveries and improving macroeconomic environment(a big factor in the expected credit model).

Higher Net Interest Margin (NIM): We expect our NIM forecast to gradually rise to 9.3% in 2025(previous estimate: 9.0%). Our five year forecast average NIM is expected to increase to 9.0% from our previous forecast average of 8.8%. The increase in NIM is mainly due to lower cost of funds (from average of 2.6% to an average of 2.4%) as the bank continues to leverage on alternative channels to grow cheaper deposits.

We retain the yield uplift on loans at 58bps over the forecast period. Just like in the previous estimates, we have not factored yield uplift from implementation of a risk based pricing model which is yet to receive approval from the CBK.

In 2021, compared to our previous estimates, we also expect:

Slower organic deposit mobilization: Our previous estimates factored a higher deposit market share of 18.5% and thus a higher deposit growth rate of 11.0% y/y to KES 851.6 billion (management guidance: 12.0% y/y). However, deposit mobilization in the first two quarters has been slower than anticipated. Management attributed this to tighter liquidity conditions in the period. Although management remains optimistic that it may make up for the slower deposit mobilization in the second half of the year, we take a more cautious direction and factor a lower deposit market share of 17.6% and a lower customer deposit growth rate of 6.1% y/y (to KES 814.0 billion). We have also retained the lower deposit market share in the forecast period. This negatively impacts gross loan growth and non-interest income estimates (transactional income and fees and commissions on lending).

Summary of the changes to the Estimates*

	Current	Previous
Gross Loans CAGR (2021 – 2025)	8.9%	9.1%
Customer Deposit CAGR (2021 – 2025)	8.6%	8.8%
Cost of Funds	2.4%	2.6%
Cost of risk	2.0%	2.5%
NIM	9.0%	8.8%
Non-Interest Income CAGR (2021 – 2025)	10.3%	11.3%
Total Non-interest income to Total Operating Income Ratio	29.4%	29.9%

*Excludes impact of acquisitions made during the period

OUTLOOK

Overall, we remain positive on the bank's prospects. This is mainly due to the improving macroeconomic environment. We note that the government has stepped efforts to increase COVID-19 vaccination rates. This will lower the likelihood of the government imposing more stringent containment measures leading to minimal disruptions in business activities. With this, we expect relatively higher credit growth and improvement in loan book quality.

The higher inflationary environment remains a cause of concern.

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VALUATION

Valuation Inputs	
Cost of Equity	18.89%
Excess Return Growth Rate	5.00%
Justified Exit P/B Multiple (for Dividend Discount Model terminal value estimation)	0.97x

Weighted Target Price	Weight	Target Price (KES)	Weighted Target Price (KES)
Residual Income model	0.5	46.2	23.12
Dividend Discount Model(with justified exit P/B)	0.5	48.9	24.43
Target Price			47.54
Current Market Price			48.55
Upside/(Downside)			(2.1%)

BPR and BancABC are valued at cost and adjustment made for the cash transaction

FINANCIAL FORECASTS

INCOME STATEMENT

KES Millions	2016	2017	2018	2019	2020	2021F	2022F	2023F	2024F	2025F
Interest Income	62,772	63,673	66,280	74,350	88,745	95,532	102,827	112,742	123,985	136,407
Interest Expense	(15,779)	(15,287)	(17,450)	(18,220)	(20,808)	(21,079)	(21,741)	(23,076)	(24,591)	(26,215)
Net Interest Margin	46,993	48,386	48,830	56,130	67,938	74,452	81,086	89,666	99,395	110,192
Total Non-Interest Income	22,449	23,000	22,973	28,171	28,451	30,765	33,675	37,328	41,467	46,055
Total Operating Income	69,442	71,386	71,803	84,301	96,388	105,218	114,761	126,994	140,862	156,247
Loan Impairment Provisions	(3,823)	(5,914)	(2,944)	(8,889)	(27,508)	(13,508)	(14,438)	(15,700)	(17,110)	(18,656)
Operating Expenses	(33,104)	(34,996)	(34,698)	(38,679)	(43,161)	(46,181)	(50,350)	(55,587)	(61,485)	(68,001)
Pre-Tax Profit(Loss)	29,057	29,115	33,859	36,897	25,719	45,528	49,973	55,707	62,267	69,589
Tax Expense	(9,368)	(9,410)	(9,864)	(11,732)	(6,115)	(13,658)	(14,992)	(16,712)	(18,680)	(20,877)
Net Profit(Loss)	19,689	19,705	23,995	25,165	19,604	31,869	34,981	38,995	43,587	48,712

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STATEMENT OF FINANCIAL POSITION

KES Millions	2016	2017	2018	2019	2020	2021F	2022F	2023F	2024F	2025F
Loans and Advances(Net)	385,745	422,685	455,880	539,747	595,255	616,591	660,272	712,604	768,546	831,406
Government Securities	102,470	110,007	120,838	164,866	210,784	231,184	259,002	291,667	327,673	367,345
Total Assets	**595,240**	**646,668**	**714,313**	**898,572**	**987,810**	**1,059,732**	**1,149,879**	**1,250,579**	**1,359,016**	**1,479,372**
Equity										
Total Equity	96,566	105,965	113,661	129,741	142,423	171,079	195,000	218,040	243,826	272,642
Liabilities										
Customer Deposits	448,174	499,549	537,460	686,583	767,224	814,044	882,267	961,145	1,044,598	1,132,892
Total Equity & Liabilities	**595,240**	**646,668**	**714,313**	**898,572**	**987,810**	**1,059,732**	**1,149,879**	**1,250,579**	**1,359,016**	**1,479,372**

FINANCIAL INDICATORS

Indicators	2016	2017	2018	2019	2020	2021F	2022F	2023F	2024F	2025F
Net Interest Margin	9.7%	9.1%	8.4%	8.4%	8.7%	8.7%	8.9%	9.0%	9.1%	9.3%
Non-Interest Income to Total Operating Income	32.3%	32.2%	32.0%	33.4%	29.5%	29.2%	29.3%	29.4%	29.4%	29.5%
Cost to Income Ratio(Excl. Provisions)	47.7%	49.0%	48.3%	45.9%	44.8%	43.9%	43.9%	43.8%	43.6%	43.5%
Cost of Risk	1.0%	1.4%	0.6%	1.7%	4.4%	2.0%	2.0%	2.0%	2.0%	2.0%
Return on Average Equity	22.1%	19.5%	21.9%	20.7%	14.4%	20.3%	19.1%	18.9%	18.9%	18.9%
Return on Average Assets	3.3%	3.0%	3.4%	2.8%	2.0%	3.0%	3.0%	3.1%	3.2%	3.3%

Please note the following about the financial forecasts:

- The presentation of the financial forecasts below exclude the impact of BPR and BancABC acquisition.
- Our forecasts use the statutory reporting format. You might notice some differences with the numbers reported in annual report particularly for the interest income (mainly due to differences in interest income from loans) and non-interest income (due to differences in income fees and loans on loans and advances.

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Recommendation Guide:

LONG-TERM BUY: The company has strong fundamentals (strong financial performance, clear/reasonable strategy, competent management team etc.). However, there are certain investments or strategies that would require an investor to have a long-term view of the company to allow for capital appreciation. Also, the company may be facing head wings which we view as short term.

BUY: Strong fundamentals. Minimal risks to the catalysts/growth drivers

NEUTRAL: This is where the positives and negatives in a company almost balance out. You can accumulate for the long term.

SELL: Deteriorating fundamentals. Risks outweigh the catalyst/growth drivers.

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