DYER & BLAIR INVESTMENT BANK EARNINGS UPDATE

Founder Member of the Nairobi Securities Exchange

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DYER & BLAIR INVESTMENT BANK

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KCB GROUP: FY18 EARNINGS UPDATE

Dear All,

KCB Group released its FY18 results recording a 21.8% y-o-y growth in profit after tax (PAT) to KES 24.0 BN. EPS for the period stood at KES 7.83. ROA and ROE multiples rose 31 bps and 252 bps y-o-y to 3.4% and 21.1% respectively. The Directors recommend a final dividend of KES 2:50 bringing the total dividend to KES 3:50.

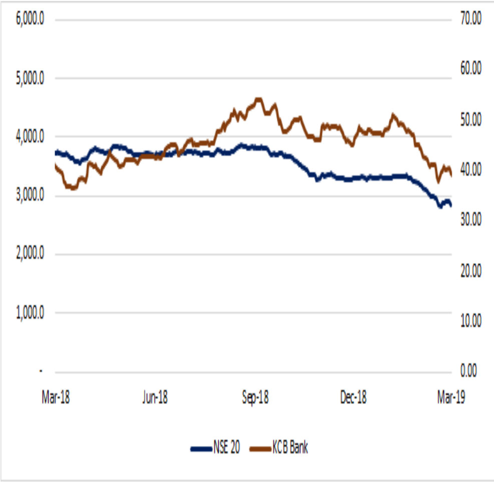
Below please find key highlights:

Net interest income rose 0.9% y-o-y to KES 48.8 BN (+3.0% q-o-q) on the back of a 4.1% y-o-y rise in interest income to KES 66.3 BN (up 0.9% q-o-q) and a 14.1% y-o-y rise in interest expense to KES 17.5 BN. Yield on interest earning assets declined 45 bps y-o-y to 11.5% whereas cost of funds rose 14 bps y-o-y to 3.1%. Consequently, net interest margin declined 59 bps y-o-y to 8.4%.

Interest income from loans and advances rose 3.7% y-o-y to KES 52.7 BN. As a result, yield on average loans declined 57 bps y-o-y to 12.0%. Interest income from government securities rose 5.0% y-o-y to KES 13.0 BN placing the yield on average government securities at 11.3%, down 35 bps. Interest expense on customer deposits grew 13.6% y-o-y to KES 15.5 BN. As a result, cost of average customer deposits rose 10 bps y-o-y to 3.0%. Management attributes the increase to liquidity issues between April and September 2018 and expects that to improve in FY19 on account of a better liquidity forecast.

Non-funded income declined 0.1% to KES 22.9 BN following a 3.1% y-o-y decline in fees and commission income to KES 14.2 BN, comprising a 33.0% y-o-y increase in fees from loans and advances to KES 7.4 BN and a 25.3% y-o-y decrease in other fees and commissions to KES 6.8 BN. Forex income also declined 6.2% y-o-y to KES 4.4 BN. Management attributed the decline in non funded income to a trifecta of the adoption of the effective interest rate method under IFRS 9, Kenya Shilling's relative stability and South Sudan's hyperinflation driven devaluation.

KCB GROUP: 52 WEEK PRICE PERFORMANCE



(Source: NSE, DBIB Research)

PRICE RETURN	ABSOLUTE RETURN	EXCESS RETURN
3 month (%)	7.5	3.2
6 month (%)	0.7	6.8
12 month (%)	(11.7)	10.4

KEY METRICS	
Current Price (KES)	43.05
52 week Range (KES)	35.75-54.00
YTD Return (%)	15.0
Issued Shares (MN)	3066.1
Market Cap (USD MN)	1,319.3

Recommendation	BUY
Target Price	57.83
Trailing EPS (KES)	7.83
NAV (KES)	37.07
P/E (x)	5.5
P/B (x)	1.2
Div Yld (%)	8.1

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Altogether, funded income reliance ratio rose 23 bps y-o-y to 68.0%. Going forward, management expects non funded income to grow significantly on the back of the recently launched (4Q18) digital platform (new KCB Mpesa platform) that has since 4Q18 seen the value of mobile loans disbursed rise from about KES 3.0 BN per month to about KES 10.0 BN per month.

Operating expenses (less loan loss provisions) declined 3.7% y-o-y to KES 35.0 BN. This followed an 11.2% y-o-y decline in staff costs to KES 17.0 BN. Other operating expenses rose 4.9% y-o-y to KES 13.2 BN. Cost to income ratio declined 219 bps y-o-y to 48.7%.

LOAN BOOK COMPOSITION

Sector	Composition
Mining	0.0%
Energy & Water	3.0%
Agric.	3.0%
Tourism	3.0%
Financials	6.0%
Transport	5.0%
Construction	8.0%
Trade	8.0%
Manufacturing	11.0%
Real estate	17.0%
Personal	36.0%

Source: Company

Gross loans and advances rose 8.7% y-o-y to KES 477.0 BN comprising KES 19.0 of additional retail loans, KES 17.0 BN of additional corporate loans and KES 2.0 BN of additional mortgage loans. Net loans and advances rose 7.9% y-o-y to KES 455.9 BN (up 4.7% q-o-q). All international subsidiaries with the exception of Uganda also saw an increase in loans and advances as shown below.

KES MN	FY17	FY18	Y/Y % CH
South Sudan	379	735	93.9
Burundi	1,403	2,397	70.8
Uganda	6,777	6,274	-7.4
Rwanda	11,899	12,776	7.4
Tanzania	14,283	16,465	15.3

Source: Company

Customer deposits on the other hand rose 7.6% y-o-y to KES 537.5 BN (up 2.0% q-o-q) whereas borrowed funds rose 50.7% y-o-y to KES 22.4 BN. The contribution of corporate deposits declined 200 bps y-o-y to 49% whereas that of retail deposits rose 200 bps y-o-y to 48%. The loan to deposit ratio rose 21 bps y-o-y to 84.8% while the loans to deposits and borrowed funds ratio declined 74 bps y-o-y to 81.4%.

KCB Bank Kenya's core capital ratio (core capital: total risk-weighted assets) rose 150 bps y-o-y to 16.4% (+140 bps q-o-q). The total capital to risk weighted assets ratio rose 170 bps y-o-y to 17.8% (+130 bps q-o-q). IFRS 9-provisions adjusted core and total capital ratios stood at 17.2% and 18.6% respectively. Liquidity ratio rose 90 bps y-o-y to 29.4%.

Management highlighted that the group recorded a write off of about KES 9.0 BN and recoveries of about KES 5.0 BN.

Gross NPLs declined 12.8% y-o-y to KES 32.7 BN. Total NPL (gross NPL less interest in suspense) declined 11.7% y-o-y to KES 28.6 BN. The NPL ratio declined 146 bps y-o-y to 6.7% (down 146 bps q-o-q). The NPL coverage ratio (loan loss provision/ total NPL) declined 1,254 bps y-o-y to 50.3%. The Central Bank coverage ratio remained fairly flat at 72.4% whereas IFRS coverage ratio rose 2600 bps y-o-y to 68.6%.

Notably, loan loss provision expense declined 50.2% y-o-y to KES 2.9 BN placing cost of risk at 0.7% and hence was a key driver of bottom line growth as pre-provisions operating profit only rose 5.1% y-o-y to KES 36.8 BN. Going forward management expects cost of risk to revert back to the typical 1.2% to 1.4%.

FY19 outlook: Management detailed their FY19 outlook as follows:

Item	Guidance
Loan growth	9%
Customer deposits growth	9%
Non funded income growth	20-25%
Cost to income	47%
Cost of funds	3.0%
Cost of risk	1.2%
Yield on assets	11.3%
NIMs	8.3%
NPL	7.0%

Source: Company

In our view: KCB's future performance is a bit of a mish-mash. While we acknowledge the positive results, we do not find them sustainable as they are primarily driven by cost efficiencies which in our view are not repeatable. Still, we believe that KCB is best prepared to continue performing well under the current macro environment. We agree with management's guidance on non funded income backed by growing fees and commissions from the revitalized KCB Mpesa platform and Safaricom's Fuliza partnership. We also find it likely that without a substantial amendment of the caps on interest rates, KCB's payout policy will keep growing to about 50.0% over our 3 year forecast period. With a customer deposit mix that is almost 50-50 between retail and corporate accounts, KCB will see a material shift in the cost of funds if the short end of the yield curve shifts significantly. We think that the short end will shift upwards if the caps are fully removed heightening a crowding out effect between banks and the government and hence pushing up the cost of funds. On the flip side, a full repeal or a substantial amendment that delinks lending caps from the monetary policy rate (CBR) could finally lead to policy cuts by the Central Bank given that the underlying factors namely inflation, current deficit and currency are all likely to remain positive in FY19. Such policy cuts would exert a downward pressure on the short end of the curve leaving market liquidity as the key determinant of treasury yields and cost of funds which is why we find a view on liquidity important.

FY19 LIQUIDITY TRIGGERS

1. Tax amnesty on repatriated funds
2. Corporate Bond Maturities (8 with 6 from entities in the financial services sector)
3. Exacerbated apathy towards equities by local fund managers
4. Momentum in the government's Big 4 agenda especially under the Housing plank

On a trailing basis, KCB is trading at a P/E multiple of 5.5x below the sector median of 6.6x and a P/B multiple of 1.2x above the sector median of 1.0x. Its ROA and ROE multiples stand at 3.4 and 21.1% against sector medians of 2.2% and 15.8% respectively. We thus maintain our **BUY** recommendation.

PROFIT AND LOSS SUMMARY (KES MN)

Year End: December	FY18	FY17	y-y% ch	4Q18	3Q18	4Q17	y-y % ch	q-q % ch
Interest income	66,281	63,673	4.1	17,110	16,951	16,909	1.2	0.9
Interest expense	17,450	15,288	14.1	4,585	4,791	4,197	9.2	(4.3)
Net interest income	48,831	48,385	0.9	12,526	12,159	12,712	(1.5)	3.0
Other operating income	4,361	3,641	19.8	1,109	1,371	1,020	8.7	(19.2)
Fees and commission income	14,239	14,694	(3.1)	3,234	4,230	3,463	(6.6)	(23.5)
Net income from forex dealings	4,374	4,665	(6.2)	690	861	1,034	(33.3)	(19.9)
Total non-interest income	22,974	23,001	(0.1)	5,032	6,462	5,517	(8.8)	(22.1)
Total income	71,804	71,386	0.6	17,557	18,621	18,229	(3.7)	(5.7)
Less operating expenses	35,001	36,357	(3.7)	8,162	9,137	8,755	(6.8)	(10.7)
Operating profit	36,803	35,029	5.1	9,396	9,484	9,474	(0.8)	(0.9)
Bad debt charge	(2,944)	(5,914)	(50.2)	(1,145)	(972)	(2,777)	(58.8)	17.8
Exceptional items	-	-	-	-	-	-	-	-
Profit before tax	33,859	29,114	16.3	8,251	8,513	6,697	23.2	(3.1)
Less tax	(9,864)	(9,409)	4.8	(2,300)	(2,580)	(2,068)	11.2	(10.8)
Profit after tax	23,995	19,705	21.8	5,951	5,933	4,629	28.6	0.3
Attributable Income	23,995	19,705	21.8	5,951	5,933	4,629	28.6	0.3
EPS (KES)	7.83	6.43	21.8	-0.02	3.90	-0.13	-	-
DPS (KES)	3.50	3.00	16.7	-	-	-	-	-

(Source: Company, DBIB Research)

BALANCE SHEET SUMMARY (KES MN)

Year End: December	FY18	3Q18	FY17	y-y % ch	q-q % ch
Total shareholder's equity	113,661	105,462	105,966	7.3	7.8
Minority interest	-	-	-	-	0.0
Total Equity	113,661	105,462	105,966	7.3	7.8
Deposits due to other banks	20,105	12,641	11,039	82.1	59.0
Customer deposits	537,460	526,844	499,549	7.6	2.0
Borrowed funds	22,447	20,725	14,895	50.7	8.3
Other liabilities	20,640	18,493	15,220	35.6	11.6
Total equity and liabilities	714,313	684,165	646,669	10.5	4.4
Central bank balances	50,101	39,712	29,091	72.2	26.2
Deposits due from banks	32,017	39,507	43,335	(26.1)	(19.0)
Investment securities	120,070	119,529	110,007	9.1	0.5
Held for dealing securities	-	-	-	-	-
Customer loans and advances	455,880	435,281	422,685	7.9	4.7
Other assets	42,234	36,746	27,726	52.3	14.9
Intangible assets	3,003	2,958	3,371	(10.9)	1.5
Fixed assets	11,008	10,431	10,454	5.3	5.5
Total assets	714,313	684,165	646,669	10.5	4.4

(Source: Company, DBIB Research)

INVESTMENT RETURN

	FY18	FY17	9M18	y-y bps ch	q-q bps ch
ROA (%)	3.4	3.0	3.5	31	(16)
ROIC (%)	3.6	3.2	3.7	39	(12)
ROE (%)	21.1	18.6	22.8	252	(170)

(*Source: Company, DBIB Research)*

**Annualized*

CAPITAL ADEQUACY, LIQUIDITY & ASSET QUALITY

	FY18	FY17	9M18	y-y bps ch	q-q bps ch
Core capital/TRWA (%)	16.4	14.9	15.0	150	140
Min. Statutory Ratio (%)	10.5	10.5	10.5	-	-
Total capital/TRWA (%)	17.8	16.1	16.5	170	130
Min. Statutory Ratio (%)	14.5	14.5	14.5	-	-
Liquidity Ratio (%)	29.4	28.5	30.4	90	(100)
Min. Statutory Ratio (%)	20.0	20.0	20.0	-	-

NPL Ratio (%)	6.7	8.1	7.4	(146)	(71)
NPL Coverage Ratio (%)	50.3	62.9	54.9	(1254)	(453)
Long Term Debt to Total Liabilities and Equity (%)	3.1	2.3	3.0	84	11
NTA/share (KES)	33.5	31.2	31.0	233	249
Book value/share (KES)	37.1	34.6	34.4	251	267
Payout ratio (%)	44.7	46.7	0.0	(196)	4470
Adj. payout ratio (%)	44.7	46.7	0.0	(196)	4472

(*Source: Company, DBIB Research)*

***Total Loan Portfolio net of Interbank Lending*

OPERATING PERFORMANCE

	FY18	FY17	9M18	y-y bps ch	q-q bps ch
Yield on interest earning assets (%)*	11.5	12.0	11.8	(45)	(31)
Cost of funds (%)*	3.0	2.9	3.0	12	(2)
Net Interest Margin (%)*	8.5	9.1	8.8	(56)	(28)
Loan-to-Deposits ratio (%)	84.8	84.6	82.6	21	220
Loan-to-Dep.& Borrowed Funds ratio (%)	81.4	82.2	79.5	(74)	193
Funded Income Generating Potential (%)	80.6	82.4	81.1	(174)	(46)
Funded Income Reliance (%)	68.0	67.8	66.9	23	108
Cost to income ratio (%)	48.7	50.9	49.5	(219)	(73)
Pre-tax margin (%)	47.2	40.8	47.2	637	(5)
PAT margin (%)	33.4	27.6	33.3	581	15

(Source: Company, DBIB Research)

**Annualized*

APPENDIX

COMPANY INVESTMENT RATINGS

Buy: Share price may generate more than 15.0% upside over the next 12 months

Overweight: Share price may generate between 5.0% and 15.0% upside over the next 12 months

Hold: Share price may fall within the range of <+5.0/ -10.0% over the next 12 months

Take Profit: Target price has been attained. Look to accumulate at lower levels. Company fundamentals however remain strong

Underweight: Share price may generate between 10.0% and 15.0% downside over the next 12 months

Sell: Share price may generate more than 15.0% downside over the next 12 months, significant business and/ or financial risks present, industry concerns

Not Rated: Counter is not within regular research coverage

SECTOR INVESTMENT RATINGS

Overweight： Industry performance better than that of the whole market

Equal weight： Industry performance about the same as that of the whole market

Underweight： Industry performance worse than that of the whole market

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