

KCB Group Plc - 1H17 Earnings Update 'Surprise Dividend'

KCB Group posted a slight 0.5% y/y dip in 1H17 pretax profit to KES 14.8B. The earnings were supported by strong performance of the group's core retail and corporate business. Net interest income climbed 2.9% y/y (+23.8% q/q) to KES 23.2B. The lender declared a surprise interim dividend of KES 1.00 per share, a first in its recent history. Books closure has been slated for 4th September 2017.

Loan book growth momentum remains intact: Growth in the corporate and retail loan book, witnessed after the capping of interest rate late last year extended to 2Q17. Net loans and advances rose 16.7% y/y (+2.9% q/q) to KES 406.9B in 1H17, driven by improved performance in the lender's Kenyan asset portfolio. Net loans and advances in Kenya grew 19.0% y/y to KES 374B, as the capping of interest rates increased top-ups of existing loan facilities and boosted uptake of new credit.

Interest expense tumbles on stable deposit base: Net interest expense fell 20.8% y/y (-8.6% q/q) to KES 7.2B in 1H17, as customer deposits remained largely unchanged y/y at KES 482.8B, with 77% of the lender's funding coming from deposits in 1H17, down from 78.2% in 1H16. The group's deposit composition remained largely unchanged y/y. Non-interest bearing demand deposits accounted for 66.0% of the group's customer deposits. Savings and term deposits accounted for 27% of total customer deposits in 1H17, down from 29% in 1H16.

Non-interest income higher on increased commission income: Non-interest income for the half-year climbed 2.5% y/y (+6.5% q/q) to KES 11.5B, driven by a 14.5% y/y (+8.7% q/q) jump in fees and commission income. However, the gain was partially offset by a 30.1% y/y (-1.7% q/q) decline in other non-interest income to KES 1.6B. Non-interest income accounted for 33.2% of total operating income, largely unchanged y/y. Going forward we anticipate an increase in non-funded income as the group continues to diversify its income streams and reduces reliance on interest income. Furthermore, an increase in new credit facilities is expected to boost commission income while the introduction of new products (stock broking, Bancassurance) will drive growth in non-funded income.

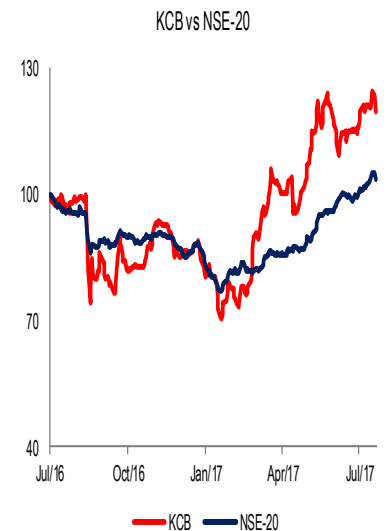
Digital channels continue to gain traction: The recently implemented cap on lending rates has fundamentally altered the industry landscape and forced lenders to innovate in a bid to reduce costs and preserve margins.

Bloomberg Ticker: KNCB.KN
Reuters Ticker: KCB.NR

Share Statistics

Current Price (KES)	39.50
Market Cap (USD M)	116.6
Issued Shares (M)	3,066.1
Year End	31-Dec
Foreign Ownership	29.4%
Free Float	74.0%
Avg Trading Vol. (USD k.)	799.9

Price Trend



Source: Bloomberg, ApexAfrica Research

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Competition in the digital banking space has continued to heat up as banks begin to fully appreciate the opportunities for growth and cost reduction that technology unlocks. Consequently, KCB has continued to beef up its presence in the digital segment. In 1H17, 86% of all transactions occurred outside the group's physical branches, up from 78% in 1H16. Mobile banking accounted for 57% of all transactions during the period, up from 50% in 1H16, while 14% of all 1H17 transactions occurred through the group's agency banking platform. The group's mobile banking platform processed transactions worth KES 116.0B in 1H17, up from KES 76.0B in 1H16. Going forward, we expect innovation and expansion in the group's digital platforms to play a key role in strategy development. Digital platforms are cheaper to maintain than brick and mortar branches and are an important stepping stone to higher margins. Furthermore, expansion into the digital frontier will help KCB increase its competitiveness among the region's increasingly tech-savvy population. The group's cost-to-income ratio dipped 30 bps y/y and 170 bps q/q to 50.8% in 1H17.

NPLs remain in line with expectations: Loan loss provision expense dipped 2.4% y/y (+10.1% q/q) to KES 2.0B as gross NPLs remained stable at KES 33.2B (+0.8% y/y). The group's NPL ratio remained stable at 7.8% (-130 bps y/y). A bulk of the group's NPLs comes from industries facing structural challenges; for instance, 15.6% of total NPLs came from borrowers operating in the building and construction sector. KCB's industry specific NPL ratios hover below industry averages, highlighting stringent lending controls. Nonetheless, we anticipate a spike in underperforming assets for the second half of the year, ahead of an expected slowdown in business activity, due to the general elections in Kenya.

Pre-tax profit dipped a marginal 0.5% y/y (+23.8% q/q) to KES 14.8B and net earnings stood at KES 10.3B (+25.9% q/q).

Looking ahead: KCB's results were largely within expectations, as the group continued to leverage on its ability to attract cheap deposits to grow its loan portfolio. However, the lender faces headwinds from the rate cap which is expected to squeeze margins, amidst volume growth. Looking ahead we anticipate NIM compression in the wake of the rate cap as yields on assets decline compared to historical averages. The group's yield on interest earning assets stood at 11.5% in 1H17, compared to 11.8% for FY16. Average lending rates in Kenya stood at 13.7% in December 2016, down heavily from 18.2% in January 2016, and are expected to come down further in 2017. Nonetheless, KCB Group is the largest bank in East Africa by asset base and its access to cheap, non-interest bearing deposits remains unhindered. Furthermore, the popularity of the group's alternative channels continues to drive traffic away from its traditional and more expensive brick and mortar branches, and we expect this to reduce the lender's cost to income ratio over the medium term; bolstering the bottom line. We expect loan book growth to be driven by increased use of mobile banking and growth in the group's corporate loan portfolio upon the passing of a peaceful election period. Nonetheless, some NIM compression seems inevitable in the medium term, as effects of the rate cap are felt across a complete financial year. Non-funded income is expected to hover around current levels as the group continues to divert excess liquidity into government securities.

Share Price Update: KCB's current share price of KES 39.50, sees the lender trade at 6.1 times FY16 earnings and 1.2 times FY16 book value, with an attractive trailing dividend yield of 7.6%. In our view, the surprise interim dividend and resilient earnings will help the group maintain its current valuation and may even provide a short-term boost to the share price.

Financials

	1Q16	2Q16	3Q16	4Q16	FY16	1Q17	2Q17	% chg y/y	% chg q/q	% chg y/y
Income Statement	KES '000	KES '000	KES '000	KES '000	KES '000	KES '000	KES '000	2Q17 v 2Q16	2Q17 vs 1Q17	1H17 v 1H16
Interest Income	16,040,308	15,568,517	16,982,293	14,214,957	62,806,075	14,113,676	16,249,818	4.4%	15.1%	-3.9%
Interest Expense	5,181,131	3,926,308	3,342,922	3,329,069	15,779,430	3,768,865	3,445,468	-12.2%	-8.6%	-20.8%
Net Interest Income	10,859,177	11,642,209	13,639,371	10,885,888	47,026,645	10,344,811	12,804,350	10.0%	23.8%	2.9%
Foreign Exchange Income	746,686	1,820,184	-167,967	3,094,793	5,493,696	1,285,092	1,359,604	-25.3%	5.8%	3.0%
Gross Fees and Commission	3,025,773	3,278,251	3,187,827	3,132,715	12,624,566	3,455,147	3,754,711	14.5%	8.7%	14.4%
Other Income	852,760	1,484,355	-835	1,995,464	4,331,744	823,553	809,609	-45.5%	-1.7%	-30.1%
Non Interest Income	4,625,219	6,582,790	3,019,025	8,222,972	22,450,006	5,563,792	5,923,924	-10.0%	6.5%	2.5%
Total Operating Income	15,484,396	18,224,999	16,658,396	19,108,860	69,476,651	15,908,603	18,728,274	2.8%	17.7%	2.8%
Total Operating Expenses	8,870,108	10,006,168	8,547,352	12,961,897	40,385,525	9,316,585	10,568,210	5.6%	13.4%	5.3%
Loan Loss Provision Expense	1,369,225	692,249	1,361,025	401,260	3,823,759	958,134	1,054,513	52.3%	10.1%	-2.4%
Operating Profit	6,614,288	8,218,831	8,111,044	6,146,963	29,091,126	6,592,018	8,160,064	-0.7%	23.8%	-0.5%
Profit Before Tax	6,614,289	8,218,830	8,111,044	6,146,963	29,091,126	6,592,018	8,160,064	-0.7%	23.8%	-0.5%
Current Tax	1,984,287	2,567,675	2,444,751	2,174,752	9,171,465	2,049,691	2,441,509	-4.9%	19.1%	-1.3%
Profit After Tax	4,630,002	5,651,155	5,666,293	3,774,997	19,722,447	4,542,327	5,718,555	1.2%	25.9%	-0.2%
EPS (KES)	6.12	0.82	-	-	6.46	5.93	0.76			
DPS (KES)	-	-	-	-	3.00	-	1.00			
Balance Sheet										
Total Shareholders' Equity	83,959,606	96,457,912	91,965,968	96,565,774	96,565,774	101,215,736	98,331,261	1.9%	-2.8%	1.9%
Deposits due to Banks & Financial Institutions	13,294,688	8,320,137	12,053,802	13,122,786	13,122,786	8,359,207	15,418,525	85.3%	84.4%	85.3%
Borrowed Funds	19,604,344	17,746,261.00	15,968,268.00	22,982,348	22,982,348	23,595,619	16,732,935	-5.7%	-29.1%	-5.7%
Customer Deposits	423,433,144	476,519,563	436,815,724	448,173,797	448,173,797	456,815,151	482,844,611	1.3%	5.7%	1.3%
Total Liabilities	472,841,168	468,986,010	478,134,918	498,673,868	498,673,868	504,539,050	532,276,778	13.5%	5.5%	13.5%
Total Equity and Liabilities	556,800,774	513,749,010	570,100,886	595,239,642	595,239,642	605,754,786	630,608,039	22.7%	4.1%	3.3%
Cash and CBK Balances	41,104,418	46,197,273	27,144,740	29,430,129	29,430,129	31,867,877	29,892,911	-35.3%	-6.2%	-35.3%
Balances due from Banks & Financial Institutions	36,080,572	84,948,133	45,604,979	43,507,143	43,507,143	38,858,626	43,271,021	-49.1%	11.4%	-49.1%
Government and Other Securities	105,571,087	101,496,979	100,813,963	102,470,849	102,470,849	105,973,949	115,794,724	14.1%	9.3%	14.1%
Net Loans and Advances	345,943,452	348,696,017	364,525,409	385,745,331	385,745,331	395,491,270	406,975,972	16.7%	2.9%	16.7%
Fixed Assets	8,383,551	10,663,990	9,143,585	9,372,955	9,372,955	9,453,613	9,493,791	-11.0%	0.4%	-11.0%
Total Assets	556,800,774	610,206,922	570,100,886	595,239,643	595,239,643	605,754,786	630,608,039	3.3%	4.1%	3.3%
Key Ratios										
Gross NPL (KES M)	30,436,873	32,978,280	31,096,578	31,812,856	31,812,856	32,151,386	33,248,978	0.8%	3.4%	0.8%
Interest In Suspense (KES M)	4,074,524	4,269,838	4,556,422	4,609,881	4,609,881	4,746,065	4,918,816	15.2%	3.6%	15.2%
Total NPL (KES M)	26,362,349	28,708,442	26,540,156	27,202,975	27,202,975	27,405,321	28,330,162	-1.3%	3.4%	-1.3%
Loan Loss Provision (KES M)	12,603,423	14,533,676	13,484,947	16,460,084	16,460,084	19,250,483	19,103,631	31.4%	-0.8%	31.4%
Net NPL	13,758,926	14,174,766	13,055,209	10,742,891	10,742,891	8,154,838	9,226,531	-34.9%	13.1%	-34.9%
NPL Ratio	8.5%	9.1%	8.2%	7.9%	7.9%	7.8%	7.8%			
Cost of Risk	1.6%	0.8%	1.5%	0.4%	1.0%	1.0%	1.0%			
Loan to Deposits	81.7%	73.2%	83.5%	86.1%	86.1%	86.6%	84.3%			
Yield on Interest Earning Assets	13.2%	11.6%	13.3%	10.7%	11.8%	10.4%	11.5%			
Cost of Funds	4.5%	3.1%	2.9%	2.7%	3.3%	3.1%	2.7%			
NIM	8.6%	8.5%	10.4%	7.9%	8.6%	7.4%	8.8%			
Non Funded/Total Income	29.9%	36.1%	18.1%	43.0%	32.3%	35.0%	31.6%			
Cost to Income Ratio	48.4%	51.1%	43.1%	65.7%	52.6%	52.5%	50.8%			
ROE	22.1%	23.4%	24.6%	15.6%	20.4%	18.0%	23.3%			
ROA	3.3%	3.7%	4.0%	2.5%	3.3%	3.0%	3.6%			
Core Capital/TRWA	16.4%	16.5%	16.6%	18.4%	18.4%	17.4%	17.4%			
Total Capital/TRWA	17.6%	17.7%	17.9%	19.7%	19.7%	18.7%	18.7%			
Liquidity Ratio	38.8%	41.8%	38.0%	37.5%	37.5%	38.7%	35.7%			
DPS (KES)					3.00					
P/E (x)					6.1					
P/B (x)					1.2					
Dividend Yield					7.6%					

Source: Company Filings, ApexAfrica Research

Appendix

Investment ratings

- ✦ **Buy:** A total return is anticipated in excess of the market's long-term historic annual rate (approximately 10%). Total return expectations should be higher for stocks that possess greater risk.
- ✦ **Hold:** Hold the shares with neither a materially positive total return nor a materially negative total return anticipated.
- ✦ **Sell:** Stock should be sold as materially negative total return is anticipated.

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