ApexAfrica CAPITAL LTD
Part of AXYS Group

May 2018

KCB Group Plc

"Brawl of the Lions"

Recommendation: Strong BUY

We recommend a **Strong BUY** on KCB Group Plc (KCB Bank) guided by our **fair value estimate of KES 57.00** with forward P/B and P/E multiples of 1.5x and 8.3x. We foresee an **upside potential of 23.2%** based on the current share price of KES 46.25. We expect the current dividend of KES 3.00 to be maintained for the next year.

KCB Bank has remained resilient in the tough business environment with its earnings stable and its fundamentals strong. We anticipate a rebound in loan book growth and non-funded income mirroring expected robust growth in the economy with the onset of rains, an end of the election period and repeal/removal of the lending rate cap.

Growth Drivers

- Increased investment in digital banking platform and growing presence in the fintech space
- Largest market share by number of customers and strong corporate client base
- Planned repeal/removal of the rate cap to drive up loan book growth

Risks

- Implementation of IFRS 9 increasing provisions
- Competition from non-bank players in mobile lending
- Slow credit growth due to the impeding rate cap and tough macroeconomic conditions

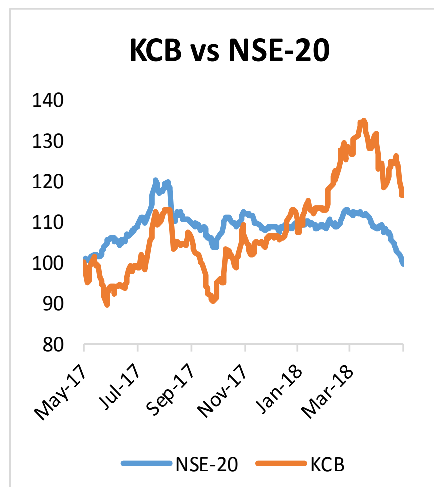
Summary	FY15A	FY16A	FY17A	FY18E	FY19E	FY20E
Total interest income (KES M)	56,443	62,806	63,673	68,619	75,367	83,086
% growth		11.3	1.4	7.8	9.8	10.2
Total interest expenses (KES M)	17,148	15,779	15,288	16,433	17,383	18,312
% growth		-8.0	-3.1	7.5	5.8	5.3
Non-funded income (KES M)	19,732	22,450	23,001	24,355	25,587	26,891
% growth		13.8	2.5	5.9	5.1	5.1
EPS (KES)	6.40	6.43	6.43	6.83	7.46	8.31
DPS (KES)	2.00	3.00	3.00	3.00	3.00	3.00
ROaE (%)	25.0	22.2	19.5	18.6	18.1	18.2
ROaA (%)	3.7	3.4	3.2	3.1	3.0	3.0

Source: ApexAfrica Research & Company filings

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

Share Statistics	
Fair Value (KES)	**57.00**
Current Price (KES)	46.25
Upside	23.2%
Dividend Yield	6.3%
1-yr Forward P/B	1.5x
1-yr Forward P/E	8.3x
Market cap (USD M)	1,431
Year end	Dec
Foreign ownership (%)	29.4
Free float (%)	74.9
Av daily trading vol (USD k)	840.6

Price Trend



Source: Bloomberg

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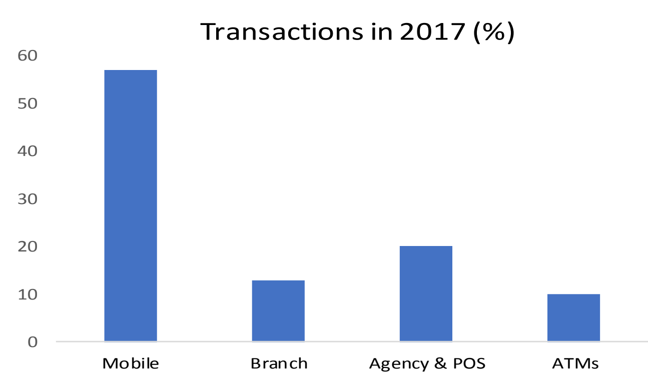
Digital distruption; The banking enigma

With increased inclination of customers to digital banking, the lender has been on the forefront in the transformation of banking services from conventional banking to digitalized transactions. About 87% of transactions are conducted outside the branch. The bank is making considerable investment in fintech having spent KES 1.5B in a new Huawei mobile banking platform with greater transactions capability to help drive an ambitious plan that will see at least 80% of all new transactions conducted on its digital platform in future. This will be launched in 2H18 and is expected to attract about 6.5M customers borrowing via mobile phones by the end of the year. Having lent out KES 30B on mobile phones in the last year, we project these numbers to improve going forward akin to the launch of the mobile banking platform and enhanced marketing of mobile lending services by the lender. We expect this to give the lender a competitive edge on operational costs given market projections estimate of an average of 25.0% reduction on costs by shifting services to digital platforms giving impetus to the overall bottom-line growth.



Source: ApexAfrica Research & Company filings

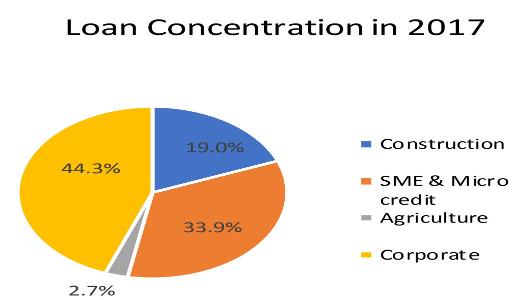
An end to Physical branches? No, not yet

KCB plans to close about 5-6 branches in Kenya in the next year as transactions are digitized precipitating redundancy in physical branches. Overall, branches are expected to remain as service points for conducting high value transactions which will also translate to reduced operational expenses.

Loan book growth to level off

Given that loan pricing is based on risk premium, the lender has been stringent in lending to sectors deemed as too risky. We therefore expect the current lending pace to persist until a repeal/removal of the rate cap is effected. We project loan book growth of 10.0% y/y in FY18 to KES 464.9B premised on the prevailing rate cap and slow private sector credit growth. We however remain optimistic of a rise in loan growth to 12.0% y/y to 572.8B in FY20 on the back of increased mobile lending and a repeal/removal of the rate cap.

Increased liquidity precipitated by slow lending has resulted in banks tilting their lending to the government. We project a 3-year CAGR of 7.0% in government securities to KES 134.7B as the lender adjusts its books to lend more aggressively conditional on a repeal of the rate cap.



Source: ApexAfrica Research & Company filings

Deposit growth despite tough business environment

Slow private sector credit growth, and a tough business environment has put a strain on disposable income slowing down deposit growth in the banking industry. We remain optimistic that the tide is bound to turn resulting in a strong economic environment supported mainly by the resurgence in private sector credit growth. As such, we forecast a 3-year CAGR of 11.0% in customer deposits to KES 683.2B by FY20. The deposit growth will be complemented by the group's strategy of bringing in new corporate deposits and activation of some stagnant client accounts.

To tame interest expenses, KCB plans to reduce its expensive deposits and increase its non-interest bearing deposits (64.0% of total deposits).

Non performing loans, a reflection of a robust business environment

We expect to see an improvement in the NPL ratio to 7.0% in FY18 from 8.5% in FY17 supported by a rebound in the macro-economic environment. The Group may carry out debt restructuring for some of its corporate clients accounting for a huge chunk of its NPLs (about 75.0% of the loan book). We remain cautious that the SME sector will continue contributing significantly to NPLs. The lender has fully implemented IFRS 9 and in line with management guidance, we project that the cost of risk is set to go up 25bps y/y to 1.7% in FY18 reflected on an increase in loan loss provision to KES 8.1B.

Regional Expansion and Sustainability of South Sudan

The lender has been increasing its exposure in its regional subsidiaries with the exception of South Sudan in line with a stable business environment outside Kenya. There are however no plans of further expansion in the near future. Operations in Ethiopia will continue through a representative office. Subsidiaries excluding Tanzania remain profitable and the lender is optimistic that the numbers will be even better going forward. A 97.0% drop in FY17 earnings in Tanzania was caused by a sudden surge in impairment on loans and advances to KES 578M due to a newly introduced regulation on apportioning of impairment losses; commercial banks should set aside 1.0% of fresh loans until four settlements have been made.

On South Sudan, the lender is still effecting its restructuring plans with 10 branches operational from an initial number of 21. Business has been hit hard by translation effects of hyperinflation, shortage of foreign exchange and an unstable currency.

Key Issues for the lender

Prevailing rate cap

Given that interest rates are used as pricing for underlying risk, KCB has practised stringent lending with the rate cap effect being felt in the banking sector. The original intent of the cap was to avail cheap credit but the aftermath was complete alienation of small and medium enterprises (SMEs) access to credit given their high risk profile. Pressure has been building up from the IMF given that the KES 150B 6-month standby loan extension was pegged on the repeal of the rate cap. The President has also supported plans to have the cap repealed but members of parliament are opposed to the move citing collusion by banks to overprice loans. We opine that, the executive arm of the Government will strong-arm, if necessary, the legislature to repeal/review the cap given that the Head of State wields significant political power. It is expected that a repeal/removal of the rate cap will take place after June with the motion for a repeal/removal tabled in Parliament by the Treasury CS alongside the budget. This is expected to boost lending which may accelerate the Group's top-line growth.

However, according to Kenya Bankers Association, slow adjustment to credit growth is expected as the market corrects and as lenders take time to adjust to credit terms that existed before the September 2016 ceilings on loan charges were enforced.

In our opinion, a repeal of the rate cap is inevitable given the adverse effect it has had on the economy, with private sector credit growth dropping to lows of 1.8% as at January 2018.

IFRS 9

The standard calls for earlier recognition of credit impairment under an expected loss model as opposed to an incurred loss model that was in use before (IAS 39). Provisions on loans and advances are expected to increase. The standard also requires greater provisions for business sectors with greater sensitivity to economic cycles. A revamp in the macroeconomic environment is expected to reduce provisions, given the IFRS 9 guideline. The standard has also led to additional capital buffers by the lender to cater for higher provisioning. We expect the bank to tighten its credit appraisal processes resulting in improved asset quality.

Competition from non-bank players

KCB is cognisant of existing non-bank mobile money lenders that have gained a significant market share in the fintech space. To gain a competitive edge, the lender is planning on enhancing lending on the KCB M-pesa platform through aggressive marketing. Considering the exorbitant lending rates on these platforms, consumers may find bank rates more friendly as banks are regulated and have a price ceiling. However, the platforms have more friendlier prerequisites which may see them onboard more clients.

We deduce that the Group's strong brand, its large market share and the popularity of M-Pesa will hand it a competitive edge to sustain/grow its mobile banking market share.

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Tier 1 Comparable

Based on FY17 Statistics	KCB	Equity	Coop	Stanchart	Barclays	DTB	Stanbic
Price (KES) as at 25/05/18	46.25	48.25	17.55	210.00	11.75	192.00	92.50
EPS (KES)	6.43	5.01	1.94	20.13	1.28	23.07	10.98
DPS (KES)	3.00	2.00	0.90	17.00	1.00	2.60	5.25
NAV/Share	34.6	24.7	11.9	132.9	8.1	173.0	83.6
P/Ex	7.3	9.8	9.4	10.4	9.2	8.5	8.4
P/Bx	1.4	2.0	1.5	1.6	1.4	1.1	1.1
ROE(%)	18.6	20.3	16.4	15.1	15.7	14.3	13.1
Dividend yield (%)	6.4	4.1	4.9	8.1	8.5	1.3	5.7
Cost of funds(%)	3.0	2.9	4.3	3.3	2.5	5.2	3.1
Net Interest Margin(%)	8.1	7.6	7.8	7.9	8.8	5.8	4.6
Cost/Income Ratio(%)	50.9	53.5	52.2	47.9	55.5	42.3	55.2
NPL Ratio(%)	8.5	6.3	7.2	13.2	7.3	7.3	7.7
NPL Coverage Ratio(%)	54.3	36.2	32.5	38.6	44.2	55.5	31.3
NFI/Total Income(%)	32.2	42.3	32.4	32.1	28.0	21.1	43.2
Core Capital/TRWA(%)	15.4	19.7	15.8	15.6	15.9	17.3	15.4
Total Capital/TRWA(%)	16.6	20.4	22.0	18.5	18.0	19.0	16.9

Valuation

We have used a P/B multiple methodology to arrive at a fair value of KES 57.00.

P/B Valuation	
Historical Average	1.6x
Tier 1 Banks Average	1.5x
Weighted Average	1.5x
NAV/Share (KES)	36.82
Per share value (KES)	**57.05**
Fair Value/Share (KES)	**57.00**
Current Price (KES)	46.25
Upside (%)	**23.2**

1Q18 earnings recap

KCB Group posted a 14.1% y/y (+12.0% q/q) rise in net profits to KES 5.2B riding on a revamp in the business environment in 2018 due to recovery in the political environment, improved inflation, and a stable shilling. The lender's net interest income was up 10.5% y/y (-10.1% q/q) to KES 11.4B while non funded income marginally declined 0.4% y/y (+0.4% q/q) to KES 5.5B.

Net loans and advances growth slow on account of the rate cap. In line with expectations, the lender remained stringent in lending with loan book growth standing at 5.8% y/y (-1.0% q/q) to KES 418.6B. Investment in government securities rose 5.8% y/y (+1.9% q/q) to KES 112.1B as the bank diversified its revenue streams. This resulted in an 11.0% y/y (-7.3% q/q) increase in interest income to KES 15.7B. We expect the lender to further practice stringent lending as the rate cap prevails and with enhanced liquidity project that the lender will keep on lending to the government.

NPLs stood at 9.8% of total loan book against an industry average of 12.0% while the NPL coverage ratio was 46.9%. An improvement in the economy coupled with a repeal/ review of the rate is anticipated to normalize business operations, driving down NPLs.

Deposits grow despite tough macroeconomic environment

Customer deposits grew 8.7% y/y to KES 496.4B despite slow private sector credit growth (1.8% in January 2018) that strained disposable income. Borrowed funds rose 51.2% q/q to KES 22.5B on account of the first tranche of KES 8.0B of the KES 10.0B loan from African Development Bank (AfDB). Consequently, interest expense rose 12.6% y/y to KES 4.2B. We do not foresee the lender taking up more borrowings in the year.

Digitization of transactions to drive up non-funded income, drive down operational costs

Innovation and digitization of transactions saw 87% of transactions conducted outside the branch. Mobile money transactions contributed 57.0% (+1700 bps y/y) with branch transactions at 13.0% (-800bps y/y). Mobile loan disbursement grew 64.0% y/y to KES 9.2B. Cost to income ratio remained flat at 52.4% (+10bps y/y). Digitization of transactions is expected to drive up non-funded income and reduce operational costs. Going forward, branches are expected to operate as service points for high value transactions.

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Income Statement	FY15A KES M	FY16A KES M	FY17A KES M	FY18E KES M	FY19E KES M	FY20E KES M	y/y change %	3-yr CAGR %
Interest Income	56,443	62,806	63,673	68,619	75,367	83,086	7.8	9.3
Interest Expense	17,148	15,779	15,288	16,433	17,383	18,312	7.5	6.2
Net Interest Income	**39,295**	**47,027**	**48,385**	**52,186**	**57,984**	**64,773**	**7.9**	**10.2**
Non Interest Income	**19,732**	**22,450**	**23,001**	**24,355**	**25,587**	**26,891**	**5.9**	**5.3**
Total Operating Income	59,027	69,476	71,386	76,541	83,572	91,665	7.2	8.7
Total Operating Expenses	(30,310)	(33,104)	(36,357)	(38,472)	(41,856)	(45,257)	5.8	7.6
Loan Loss Provision Expense	**(2,179)**	**(3,823)**	**(5,914)**	**(8,132)**	**(9,027)**	**(10,020)**	**37.5**	**19.2**
Operating Profit	28,717	36,372	35,029	38,068	41,716	46,407	8.7	9.8
Profit Before Tax	**26,538**	**32,549**	**29,114**	**29,936**	**32,689**	**36,388**	**2.8**	**7.7**
Current Tax	(6,915)	(9,368)	(9,409)	(8,981)	(9,807)	(10,916)	(4.6)	5.1
Profit After Tax	**19,623**	**19,723**	**19,705**	**20,955**	**22,883**	**25,472**	**6.3**	**8.9**
EPS (KES)	6.40	6.43	6.43	6.83	7.46	8.31	6.3	8.9
DPS (KES)	**2.00**	**3.00**	**3.00**	**3.00**	**3.00**	**3.00**	**-**	**-**
Balance Sheet								
Total Shareholders' Equity	**81,253**	**96,566**	**105,966**	**119,813**	**132,519**	**147,817**	**13.1**	**11.7**
Customer Deposits	**424,391**	**448,174**	**499,549**	**554,500**	**615,495**	**683,199**	**11.0**	**11.0**
Total Liabilities	476,841	498,674	540,703	601,264	661,604	733,994	11.2	10.7
Total Equity and Liabilities	**558,094**	**595,240**	**646,668**	**721,077**	**794,123**	**881,811**	**11.5**	**10.9**
Cash and CBK Balances	68,219	56,920	50,714	60,450	68,301	79,024	19.2	15.9
Government and Other Securities	96,949	102,470	110,007	117,682	125,934	134,693	7.0	7.0
Net Loans and Advances	**345,969**	**385,745**	**422,685**	**464,948**	**516,092**	**572,862**	**10.0**	**10.7**
Fixed Assets	9,028	9,373	10,454	10,966	11,706	12,520	4.9	6.2
Total Assets	**558,094**	**595,240**	**646,668**	**721,077**	**794,123**	**881,811**	**11.5**	**10.9**
Key Ratios								
Cost of Risk (%)	0.6	1.0	1.4	1.7	1.7	1.7		
Loan to Deposits (%)	81.5	86.1	84.6	83.9	83.9	83.9		
Yield on Interest Earning Assets (%)	13.2	13.0	12.0	11.8	11.9	11.9		
Cost of Funds (%)	4.1	3.5	3.1	3.1	2.9	2.8		
Net Interest Margin (%)	9.1	9.5	8.9	8.8	8.9	9.1		
Non Funded/Total Income (%)	33.4	32.3	32.2	31.8	30.6	29.3		
Cost to Income Ratio (%)	51.3	47.6	50.9	50.3	50.1	49.4		
ROaE (%)	25.0	22.2	19.5	18.6	18.1	18.2		
ROaA (%)	3.7	3.4	3.2	3.1	3.0	3.0		
P/E (x)				**8.3**				
P/B (x)				**1.5**				
Dividend Yield (%)				**6.3**				

Source: ApexAfrica Research Estimates

Appendix

Investment ratings

✦ **Strong Buy:** Issued on counters with strong fundamentals with a fair value above 20.0%. The counter is anticipated to register strong growth with and is currently undervalued.

✦ **Buy:** Issued on counters with strong fundamentals whose upside lies between 10.0% and 20.0%. The same may be issued for counters with challenged fundamentals whose upside is over 20.0%. Such a scenario is targeted for risk neutral investors.

✦ **Accumulate:** Issued on counters with an upside of between 5.0% - 10.0%. The counter may be facing contracting avenues for growth with a tepidly growing bottom-line.

✦ **Hold:** Issued on counters with an upside of between 0% and 5.0% with limited avenues for growth. Contracting bottom-line with an attractive dividend yield of about 5.0%.

✦ **Lighten:** The company is anticipated to record a moderate downside on its fair value, though it may have strong fundamentals.

✦ **Sell:** The counter currently has weak fundamentals coupled with significant potential downside.

Disclaimer

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