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Earnings Note

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Earnings Update

Results Review

KCB Group Q3'23 Earnings Note

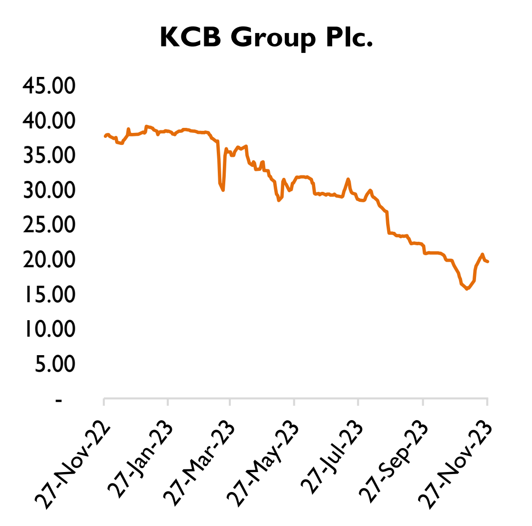
Recommendation:	Current Price:	Target Price:
HOLD	KES 19.70	KES 25.50

Company details

Bloomberg Ticker	KNCB:KN
NSE Code:	KCB
Issued Shares (Bn)	3.21
52-week high price:	KES 43.00
52-week low price:	KES 15.00

As at 27th November 2023

Graph 1: Price chart – Last 12 Months



Source: NSE, AIB-AXYS Research

Historical Price Performance

	1m	3m	6m	12m
Absolute	4.51%	-17.23%	-36.55%	-47.81%

Source: NSE, AIB-AXYS Research,

Analysts

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Summary

- **KCB posted a marginal 41bps y/y climb in after-tax profits (PAT) to KES 30.72Bn in the nine months to September 2023**. The trailing earnings per share (EPS) momentum however improved 998bps to KES 12.75 over the quarter. Profitability was compressed by a faster surge in operating costs (57.00% y/y), relative to the uptick in operating incomes (27.30% y/y). The trailing Returns on Equity (ROE) improved 110bps q/q to 20.15% while the trailing returns on assets (ROA) flatlined q/q at 2.40%.

- **Deposit growth soared by unprecedented margins on faster deposit mobilization across regional subsidiaries, even as the overall balance sheet crossed the KES 2.00Tn mark.** Group deposits soared 79.60% y/y to KES 1.65Tn, while net loans and advances grew by 38.1% y/y to clock KES 1.05Tn – driven by unwinding demographic dividends from Tanzania, Uganda and Trust Merchant Bank (DRC) businesses. Despite the increased scope to pump reinvestment returns, the Group's net interest margins narrowed 30bps to 6.62% – driven by a faster jump in the cost of funds (78bps) relative to the yield on interest earning assets (48bps y/y). The group also posted a 43.02% jump in fair value losses on their government holdings to KES 10.24Bn – implying a high duration-sensitive, government securities portfolio.

Key Highlights

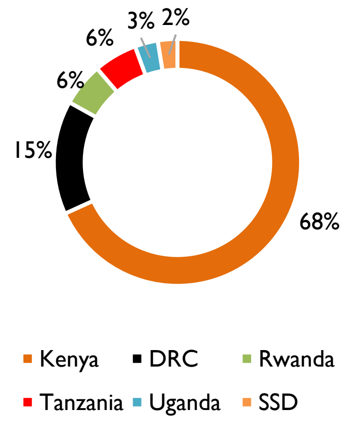
- **Deepening digital channels:** KCB Group registered notable gains from augmented self-serve capabilities – with up to 99% of all group transactions now taking place via digital channels – away from legacy channels (ATMs and Branches). The deepening digital uptake not only propelled growth in funded and non-funded incomes, but also scaled effectiveness in loan disbursement. Robust credit scoring models have proved pivotal to the scaling of financial services across its vast retail and corporate franchise. This seismic shift unlocks greater scope for funding income growth while allowing for cost rationalization.

- **Moderating Non-Performing Loan Ratio:** The ratio of non-performing loans (NPLs) to net loans and advances, eased 190bps to 16.00% - driven by marked improvement in the tourism and transport portfolio. Nevertheless, the group NPL ratio remains well-above the industry average of 15.00%. The stock of total non-performing loans (NPLs) increased 23.42% y/y to 167.60Bn due to downgrades in the period and exchange rate depreciation effects. Of all group subsidiaries, NBK recorded the highest NPL ratio of 24.4%, followed by KCB Bank Kenya at 18.8% while TMB stands third at 11.9%. The sectoral contribution to NPLs was highest at 24.9% in the manufacturing sector – which comprises 15.3% of gross loans. On the flipside, the bulky personal and household sector –accounting for 32.0% of gross loans, contributed 18.6% to total non-performing loans. In our view, we infer a skewed credit risk exposure to the recession-sensitive manufacturing sector.

- **Vigorous Subsidiary Growth:** We noted the tremendous growth in overall performance of both banking and non-banking subsidiaries – even as the Kenyan banking units curled under pressure. We observed strong double-digit revenue growth across banking subsidiaries led by Uganda, Tanzania and South Sudan which grew by 63%,56% and 41% y/y respectively. The Kenyan banking wing recorded a slump in profitability, while National Bank of Kenya posted a KES 3.05Bn loss on the back of an adverse legal award and increased provisions.

Unlocking New Frontiers – Windfall gains driven largely by fast organic growth across regional subsidiaries, coupled with consolidation effects from the Trust Merchant Bank acquisition, helped shore regional deposits to KES 1.66Tn - lifting group assets beyond KES 2.00Tn mark. Organic balance sheet expansion accounted for 43% of total growth in deposits, while 22% was attributed to the TMB consolidation. While the increase in deposits came with a 78bps rise in group cost of funds, the reinvestment returns on government securities were 130bps y/y lower while up merely 10bps on loans and advances – suggesting suboptimal deployment of marginal investable funds.

Graph 2: Contribution of Subsidiaries to Net Profit

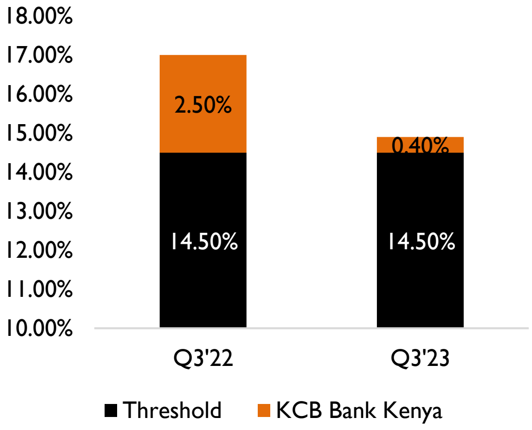


Source: Company Fillings, AIB-AXYS Research

Diversification – The benefits of regional diversification became more apparent, as the widening footprint helped scatter country-specific risks across the region. As of September 2023, over 26% of total group assets were invested outside Kenya – with TMB contributing 13.3% to total group assets. We expect stronger organic growth in Uganda and Tanzania banking subsidiaries. Diversification by delivery channels also scaled up the value of mobile lending portfolio while supporting growth in both funded and non-funded incomes. The total value of mobile loans disbursed grew 77% y/y to KES 245.2Bn driven by Fuliza (personal and business), and introduction of term loans on KCB Mobi Loan as well as KCB M-Pesa.

Thinning Capital Buffers – The group recorded notable thinning of capital buffers above industry thresholds – especially in the Kenya banking business. The total capital to risk-weighted assets ratio in KCB Kenya trimmed 210bps to 40bps above industry minimum This came largely on the back of increased write-downs and deployment to boost liquidity. Management hinted at a possible 100% retention of FY23 net earnings in a bid to restore capital buffers to 200bps.

Graph 3: Thinning Capital Buffers



Source: Company Fillings, AIB-AXYS Research

Stickier yet Dearer Deposits – The Group recorded a sizeable increase in the proportion of savings and term deposits, promising predictable liquidity, but at higher costs. The Group acceded to dearer term deposits over the period, even as industry-wide competition for deposits paced up. The proportion of demand deposits declined 600bps to 60%, while the proportion of savings deposits dialed up 700bps to 23%. Term deposits on the other hand rose 300bps to comprise 23% of the quantum deposit base. We think this raises the imperative to maximize reinvestment returns – to avoid a trimming in the funding/lending spread.

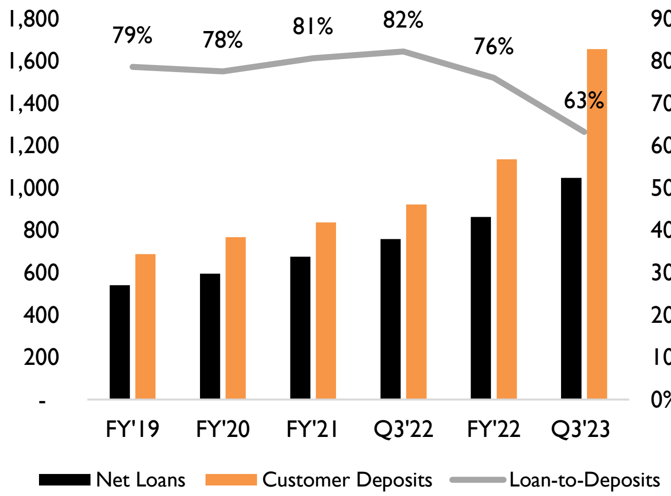
Building Back Better – Despite the varied headwinds faced by KCB, the ongoing cleanup of the myriad legacy issues – primarily aged delinquencies, promises to yield a "*phoenix out of the ashes*". The management remains resolute in building back a more resilient Group, agile to the dynamic needs of its footprint to feature prominently on the continental landscape in coming years. We commend the move to double down loan-loss provisions without incurring a loss in shareholder value. We think this is prudent in galvanizing downgraded facilities and offseting forward exchange rate risks.

Outlook - We anticipate the lender's growth will be propelled by the accelerated uptake of digital banking products, as well as unwinding demographic dividends from the growing regional footprint. We further anticipate that the focus on fast-tracking recovery efforts, and tighter risk underwriting standards on newly extended loans will restore asset quality to a better standing. We expect loan portfolio growth – and topline interest revenues - to be driven by further rate up pricing under the risk-based credit-pricing regime. Furthermore, we expect the growth in term and savings deposits to support a widening of net interest margins given the prevailing reinvestment returns. However, we remain concerned about asset quality deterioration and the diminishing capital buffers - especially in the Kenyan banking units.

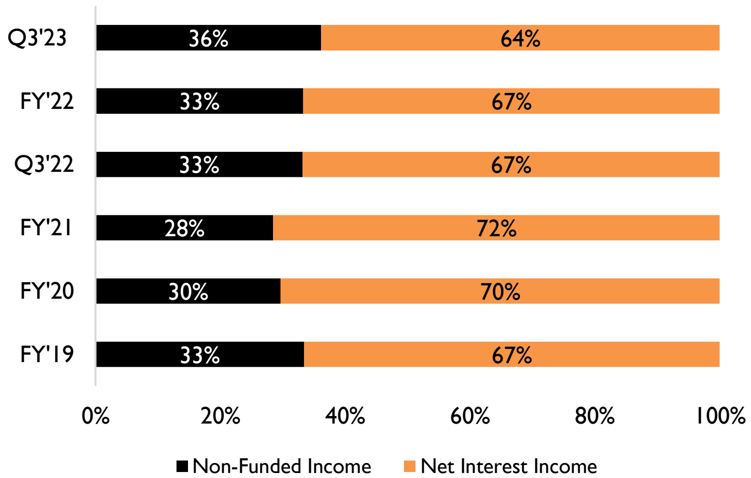
Valuation – The counter is currently trading at a P/E ratio of 1.55x and a P/B ratio of 0.29x. The counter closed yesterday's trading at KES 19.70 - representing a YTD loss of 48.30%. We maintain our 12-month **HOLD** recommendation on the counter with a target price of KES 25.50 representing an upside of 29.44% from yesterday's closing price.

KCB Group Q3'23 Earnings Charts

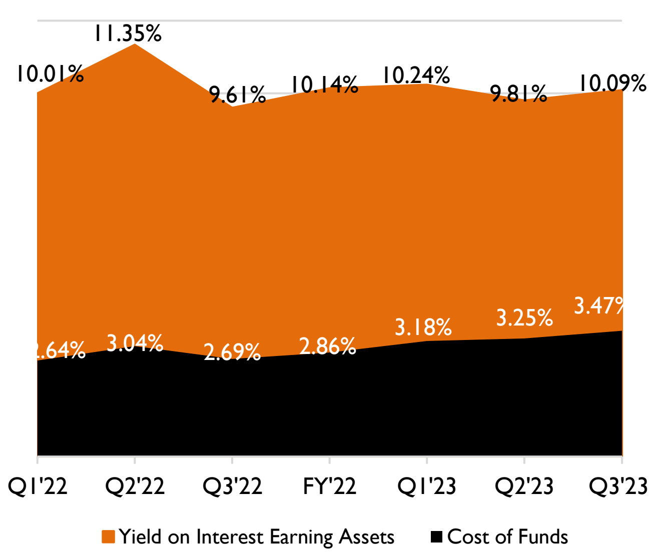
Graph 4: Faster growth in deposits, driving balance sheet growth



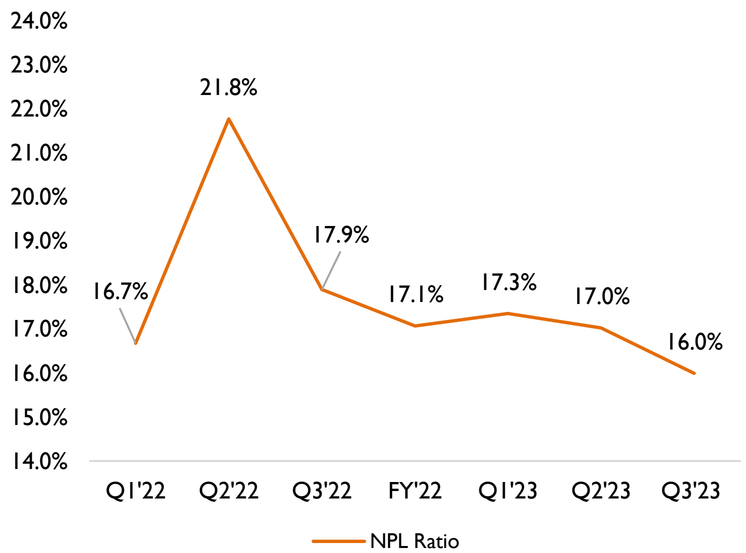
Graph 5: Revenue Mix Tilted in Favor of Non-Interest Income



Graph 6: Rising Cost of Funds Trims Net Interest Margins (JAWS)



Graph 7: Easing Non-Performing Loan Ratio



Source: Company Fillings, AIB-AXYS Research

Financial Statement Summary

1. Statement of Profit and Loss

Consolidated Results (KES Mn)	FY'19	FY'20	FY'21	Q3'22	FY'22	Q3'23	% y/y change
Net Interest Income	56,131.00	67,535.86	77,694.02	61,593.02	86,653.31	74,873.53	21.56%
Non-Interest Income	28,171.54	28,450.60	30,940.59	30,550.66	43,251.52	42,388.33	38.75%
Total Operating income	84,302.54	95,986.46	108,634.61	92,143.68	129,904.82	117,261.86	27.26%
Loan-Loss Provisions	(8,888.94)	(27,508.44)	(12,988.10)	(7,267.76)	(13,206.88)	(15,848.57)	118.07%
Total Operating expenses	(47,405.18)	(70,669.30)	(60,820.30)	(48,840.71)	(72,573.47)	(76,667.75)	56.98%
Profit before tax	**36,897.36**	**25,317.16**	**47,814.30**	**43,302.97**	**57,331.35**	**40,594.11**	-6.26%
Profit after tax	**25,165.17**	**19,201.92**	**34,173.02**	**30,593.85**	**40,837.74**	**30,721.31**	0.42%
Annualized EPS	7.83	5.98	10.63	12.69	12.71	12.75	0.42%

2. Statement of Financial Position

Balance Sheet (KES Mn)	FY'19	FY'20	FY'21	Q3'22	FY'22	Q3'23	% y/y change
Government Securities	128,459.45	208,764.86	270,835.05	269,887.44	278,020.34	371,273.54	37.57%
Loans and Advances	539,747.26	595,254.30	675,480.44	758,815.99	863,268.08	1,047,865.75	38.09%
Total Assets	**898,572.21**	**987,810.25**	**1,139,672.57**	**1,276,282.69**	**1,554,029.97**	**2,099,541.15**	64.50%
Customer Deposits	686,583.18	767,224.47	837,141.38	922,303.72	1,135,417.38	1,656,369.73	79.59%
Total Liabilities	768,831.11	845,385.97	966,164.96	1,086,064.19	1,347,753.71	1,873,448.13	72.50%
Shareholder's Funds	**129,741.11**	**142,424.28**	**171,713.20**	**187,771.58**	**200,200.42**	**218,818.74**	16.53%

3. Key Metrics

	Q1'22	Q2'22	Q3'22	FY'22	Q1'23	Q2'23	Q3'23
Growth Metrices (y/y)							
Loan book Growth	17.96%	20.33%	16.42%	27.80%	31.87%	32.10%	38.09%
Customer Deposits Growth	12.86%	15.59%	7.36%	35.63%	41.47%	61.93%	79.59%
PAT Growth	54.59%	28.40%	21.37%	19.50%	-1.05%	-18.27%	0.42%
Spreads Analysis							
Yield on Assets	10.01%	11.35%	9.61%	10.14%	10.24%	9.81%	10.09%
Cost of Funds	2.64%	3.04%	2.69%	2.86%	3.18%	3.25%	3.47%
Net Interest Margin	7.37%	8.30%	6.92%	7.28%	7.06%	6.56%	6.62%
ROaE	22.87%	23.20%	22.56%	21.96%	20.89%	19.08%	20.15%
ROaA	3.51%	3.45%	3.30%	3.03%	2.91%	2.42%	2.43%
Profit Margin	33.95%	32.85%	33.20%	31.44%	26.47%	21.98%	26.20%
Operating Effiency							
Cost of Income Less LLP	44.52%	45.66%	45.12%	45.70%	51.23%	55.32%	51.87%
Cost of Assets	1.11%	2.26%	3.26%	3.82%	1.16%	2.17%	2.90%
Loan to Deposit	83.28%	80.38%	82.27%	76.03%	77.62%	65.58%	63.26%
Asset Quality							
NPL	16.67%	21.78%	17.90%	17.07%	17.35%	17.03%	15.99%
NPL Coverage	52.65%	45.82%	52.83%	52.39%	57.26%	51.12%	62.09%
Cost of Risk	7.15%	7.22%	7.89%	10.17%	11.18%	13.95%	13.52%
Capital Adequency							
Core Capital/TRWA	19.20%	17.70%	14.50%	13.90%	13.60%	15.00%	14.50%
Total Capital /TRWA	22.80%	21.60%	18.10%	17.10%	17.00%	18.40%	17.80%
Liquidity	36.90%	39.00%	38.50%	40.90%	43.70%	52.10%	50.30%

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