# Co-op Bank of Kenya- FY'2020

**19th March, 2021**

**Valuation Summary**

- We are of the view that Co-operative Bank is an "**Accumulate**" with a target price of Kshs 15.6, representing an upside of 12.2%, from the current price of Kshs 13.9 as of 19th March 2021, inclusive of a dividend yield of 7.2%,
- Co-operative Bank is currently trading at a P/TBV of 1.0x and a P/E of 5.7x vs an industry average of 1.1x and 8.8x, respectively,

**Key Highlights FY'2020**

- During the year, Co-operative Bank Kenya completed the 90.0% acquisition of Jamii Bora Bank and rebranded it to Kingdom Bank Limited. The Central Bank of Kenya had approved the acquisition of a 90.0% stake of Jamii Bora's shareholding by the Co-operative Bank, which was completed on 21st August 2020 after the deal received all regulatory approval following approval by the National Treasury on 4th August 2020. In March 2020, the bank had opened talks of a 100.0% acquisition of Jamii Bora Bank (JBB) before varying their offer to a 90.0% stake for Kshs 1.0 bn effectively valuing Jamii Bora Bank at Kshs 1.1 bn, and,
- Loans restructured in support to the customers affected by COVID-19 according to their Q3'2020 investor briefing came in at Kshs 46.0 bn equivalent to about 14.9% of the bank's Loan Book.

**Income Statement**

- Core earnings per share declined by 24.4% to Kshs 1.6 in FY'2020, from Kshs 2.1 in FY'2019, which was not in-line with our projections of Kshs 1.8, where the earnings for the period came in at Kshs 10.8 bn, slightly lower than our expectations of Kshs 12.4 bn. The variance can be attributed to our expectation of higher earnings of Kshs 13.2 bn, compared to the Kshs 10.8 bn recorded. The performance was driven by a 41.7% increase in total operating expenses to Kshs 39.4 bn in FY'2020, from Kshs 27.8 bn in FY'2019 but was mitigated by the 11.1% increase in total operating income,
- Total operating income rose by 11.1% to Kshs 53.8 bn in FY'2020, from Kshs 48.5 bn in FY'2019. This was mainly due to a 16.1% increase in Net Interest Income (NII) to Kshs 36.4 bn, from Kshs 31.3 bn in FY'2019, coupled with the 1.9% increase in Non-Funded Income (NFI) to Kshs 17.5 bn, from Kshs 17.2 bn in FY'2019,
- Interest income rose by 11.9% to Kshs 48.8 bn in FY'2020, from Kshs 43.6 bn in FY'2019. The growth recorded was as a result of a 30.5% increase in interest income from government securities to Kshs 14.8 bn, from Kshs 11.4 bn in FY'2019, as well as a 5.4% rise in interest income from loans and advances to Kshs 33.5 bn, from Kshs 31.8 bn in FY'2019. The yield on interest-earning assets, however, declined to 11.4%, from 11.8% in FY'2019 due to the faster 18.1% growth in the average interest-earning assets that outpaced the 11.9% growth in interest income,
- Interest expense increased by 1.3% to Kshs 12.5 bn in FY'2020, from Kshs 12.3 bn in FY'2019, largely due to a 2.6% rise in interest expense from customer deposits to Kshs 10.9 bn, from Kshs 10.7 bn. This was however weighed down by a 13.2% decline in Other interest expenses to Kshs 1.4 bn, from Kshs 1.6 bn in FY'2019. Consequently, the cost of funds declined to 3.0%, from 3.5% in FY'2019, owing to the faster 18.2% rise in the average interest-bearing liabilities, compared to the 1.3% decline in interest expense,
- Non-Funded Income increased by 1.9%, mainly driven by a 58.8% increase in fees and commissions on loans to Kshs 5.1 bn, from Kshs 3.2 bn in FY'2019, coupled with a 32.1% rise in Foreign Exchange trading income to Kshs 2.8 bn, from Kshs 2.1 bn in FY'2019. The gains in NFI was however weighed

down by an 18.9% decline in Other fees to Kshs 7.8 bn, from Kshs 9.6 bn in FY'2019, mainly attributed to the waiver on fees seen during the year, as well as other income which decreased by 20.5% to Kshs 1.7 bn from Kshs 2.2 in FY'2019. As a consequence, the revenue mix shifted to 68:32, from 65:35 funded to non-funded income owing to the faster 16.1% growth in NII compared to the 1.9% growth in NFI,

- Total operating expenses rose by 41.7% to Kshs 39.4 bn in FY'2020, from Kshs 27.8 bn in FY'2019, largely driven by the 219.5% rise in Loan Loss Provisions (LLP) to Kshs 8.1 bn, from Kshs 2.5 bn in FY'2019, coupled with a 38.7% rise in other operating expenses to Kshs 17.9 bn in FY'2020, from Kshs 12.9 bn in FY'2019. The increased provisioning levels by the lender is mainly as a result of the elevated levels of risk currently in the market. Staff costs also increased by 8.5% to Kshs 13.4 bn, from the Kshs 12.4 bn recorded in 2019,
- The Cost to Income Ratio (CIR) deteriorated to 73.2%, from 57.4% in FY'2019, following the faster 41.7% rise in total operating expenses that outpaced the 11.1% rise in total operating income. Without LLP, the cost to income ratio also deteriorated to 58.1% from 52.1% in FY'2019, an indication of reduced efficiency levels,
- The bank registered a 24.4% decline in profit after tax to Kshs 10.8 bn in FY'2020 from Kshs 14.3 bn in FY'2019. Profit before tax and exceptional items declined by 31.0% to Kshs 14.3 bn from Kshs 20.7 bn in FY'2019, with the effective tax rate declining to 28.8% in FY'2020 from 31.6% seen in FY'2019, and,
- The Board of Directors recommended a final Dividend per Share (DPS) of Kshs 1.0, translating to a total dividend payout of Kshs 5.9 bn. At the current price of Kshs 13.9, this translates to a dividend yield of 7.2%.

**Balance Sheet**

- The balance sheet recorded an expansion as total assets grew by 17.5% to Kshs 537.0 bn in FY'2020 from Kshs 457.0 bn in FY'2019, mainly attributable to the 37.4% growth in government securities to Kshs 161.9 bn from Kshs 117.8 bn, coupled with a 7.5% growth in net loans and advances to Kshs 286.6 bn in FY'2020 from Kshs 266.7 bn in FY'2019. The increase in allocation to government securities shows the bank's cautious lending strategy considering the elevated credit risk being experienced in the market. Additionally, the bank restructured Kshs 46.0 bn (14.9% of the bank's loan book) and highlighted that 46.0% of their loan book consisted of personal consumer loans and that they had a total exposure of about 3.0% in the manufacturing, tourism, restaurant and hotel sectors combined, which are among the most affected sectors,
- Total liabilities grew by 18.3% to Kshs 444.9 bn, from Kshs 376.2 bn in FY'2019, which was largely attributable to a 74.2% rise in borrowings to Kshs 46.0 bn in FY'2020, from Kshs 26.4 bn, which is attributed to a Kshs 21.6 bn borrowing by Kingdom Bank to support its operations, coupled with the 13.8% rise in customer deposits to Kshs 378.6 bn, from Kshs 332.8 bn in FY'2019. Deposits per branch increased by 13.8% to Kshs 2.4 bn from Kshs 2.1 bn, as the number of branches remained unchanged at 159 branches,
- The slower 7.5% growth in net loans and advances compared to the 13.8% growth in deposits, led to a decline in the loan to deposit ratio to 75.7%, from 80.1% in FY'2019,
- Gross Non-Performing Loans (NPLs) increased by 87.0% to Kshs 59.1 bn in FY'2020, from Kshs 31.6 bn in FY'2019. The NPL ratio deteriorated to 18.7% in FY'2020, from 11.2% in FY'2019 owing to slower growth in gross loans by 11.8% compared to the 87.0% growth in gross non-performing loans. It is important to note that the NPL Ratio is 11.0% higher than the 5-year average of 7.7%,

- General Loan Loss Provisions increased by 99.6% to Kshs 22.5 bn, from Kshs 11.3 bn in FY'2019. The NPL coverage ratio deteriorated to 50.3% in FY'2020, from 51.8% in FY'2019, due to the faster 99.6% growth in General Loan Loss Provisions which was outpaced by the 87.0% growth in Gross Non-Performing Loans (NPLs). If the NPL Coverage remained at the 51.8% level recorded in 2019, we would have had an additional provisioning of Kshs 0.9 bn, which would have reduced the earnings per share from the reported Kshs 2.1 to Kshs 1.8,
- Shareholders' funds increased by 14.4% to Kshs 90.7 bn in FY'2020 from Kshs 79.3 bn in FY'2019, mainly driven by a 19.5% increase in the retained earnings to Kshs 74.6 bn, from Kshs 62.4 bn in FY'2019,
- Co-operative Bank remains sufficiently capitalized with a core capital to risk-weighted assets ratio of 15.4%, 4.9% points above the statutory requirement of 10.5%. Also, the total capital to risk-weighted assets ratio came in at 16.9%, exceeding the statutory requirement of 14.5% by 2.4% points. Adjusting for IFRS 9, the core capital to risk-weighted assets stood at 13.9%, while total capital to risk-weighted assets came in at 15.4%, and,
- The bank currently has a Return on Average Assets (ROaA) of 2.1%, and a Return on Average Equity (ROaE) of 12.5%.

**Key Take-Outs**:

1) Total operating expenses rose by 41.7% to Kshs 39.4 bn in FY'2020, from Kshs 27.8 bn in FY'2019, largely driven by the 219.5% rise in Loan Loss Provisions (LLP) to Kshs 8.1 bn from Kshs 2.5 bn in FY'2019, coupled with a 38.7% rise in other operating expenses to Kshs 17.9 bn in FY'2020, from Kshs 12.9 bn in FY'2019. The increase in provisioning levels was expected considering the current situation surrounding the spread of COVID-19. The movement restrictions put in place to curb the virus led to subdued activity in the business environment. As such, households and businesses haven't been able to keep up with their debt obligations and that has increased Non-performing loans,
2) The bank's asset quality deteriorated, with the NPL ratio coming in at 18.7% in FY'2020, from 11.2% in FY'2019 owing to slower growth in gross loans by 11.8% compared to the 87.0% growth in gross non-performing loans. Generally, banks have had to go back to the drawing board to come up with new strategies to manage the worsening asset quality in the wake of the ongoing global pandemic,
3) The acquisition of Kingdom Bank has resulted to an increased borrowing of about Kshs 21.6 bn in Co-operative Bank's books, meant to be directed towards support operations in the bank.

Going forward, the factors that would drive the bank's growth would be:

I. **Lending to SMEs:** Putting into consideration the current state of affairs in the banking sector, it is evident that the risk factor when lending to businesses has increased significantly. It is, however, key to note that loan restructurings and increasing their loan book exposure to MSMEs will help support the bank during this period of uncertainty, and,
II. **Focus on diversification:** The bank's continued focus on channel diversification will likely continue to help the bank in generating profitability, as they continue to record increased usage and traffic. The focus on branch transformation and innovation centered on alternative channels will continue to drive NFI growth as well as transform braches to handle advisory, wealth management and advisory services,

Below is a summary of the bank's performance:

# Co-op Bank of Kenya- FY'2020

19th March, 2021

| Balance Sheet Items | FY'2019 | FY'2020 | y/y change | FY'2020f | Projected %y/y change | Variance in Growth Actual vs. Expected |
|---|---|---|---|---|---|---|
| Government Securities | 117.80 | 161.89 | 37.4% | 144.37 | 22.6% | 14.9% |
| Net Loans and Advances | 266.7 | 286.6 | 7.5% | 281.1 | 5.4% | 2.1% |
| **Total Assets** | **457.0** | **536.9** | **17.5%** | **520.6** | **13.9%** | **3.6%** |
| Customer Deposits | 332.8 | 378.6 | 13.8% | 381.4 | 14.6% | (0.8%) |
| Total Liabilities | 376.2 | 444.9 | 18.3% | 433.2 | 15.2% | 3.1% |
| **Shareholders' Funds** | **79.3** | **90.7** | **14.4%** | **85.7** | **8.0%** | **6.3%** |

| Balance Sheet Ratios | FY'2019 | FY'2020 | y/y change |
|---|---|---|---|
| Loan to Deposit Ratio | 80.1% | 75.7% | (5.5%) |
| Return on average equity | 19.2% | 12.5% | (34.7%) |
| Return on average assets | 3.3% | 2.1% | (34.7%) |

| Income Statement | FY'2019 | FY'2020 | y/y change | FY'2020f | Projected %y/y change | Variance in Growth Actual vs. Expected |
|---|---|---|---|---|---|---|
| Net Interest Income | 31.3 | 36.3 | 16.1% | 33.0 | 5.3% | 10.9% |
| Non-Interest Income | 17.2 | 17.5 | 1.9% | 15.8 | (7.6%) | 9.5% |
| **Total Operating income** | **48.5** | **53.8** | 11.1% | **48.8** | 0.7% | **10.4%** |
| Loan Loss provision | (2.5) | (8.1) | 219.5% | (4.4) | 73.1% | 146.4% |
| Total Operating expenses | (27.8) | (39.4) | 41.7% | (30.0) | 7.8% | 33.9% |
| Profit before tax | 20.7 | 14.3 | (31.0%) | 18.9 | (8.8%) | (22.2%) |
| Profit after tax | 14.3 | 10.8 | (24.4%) | 13.2 | (7.7%) | (16.8%) |
| Earnings per share | 2.08 | 1.57 | (24.4%) | 1.92 | (7.7%) | (16.8%) |

| Income Statement Ratios | FY'2019 | FY'2020 | % point change |
|---|---|---|---|
| Yield from interest-earning assets | 11.8% | 11.4% | (0.5%) |
| Cost of funding | 3.5% | 3.0% | (0.5%) |
| Net Interest Spread | 8.4% | 8.4% | (0.0%) |
| Net Interest Income as % of operating income | 64.6% | 67.5% | 2.9% |
| Non-Funded Income as a % of operating income | 35.4% | 32.5% | (2.9%) |
| Cost to Income | 57.4% | 73.2% | 15.8% |
| CIR without provisions | 52.1% | 58.1% | 6.0% |
| Cost to Assets | 5.5% | 5.8% | 0.3% |
| Net Interest Margin | 8.5% | 8.5% | (0.0%) |

| Capital Adequacy Ratios | FY'2019 | FY'2020 |
|---|---|---|
| Core Capital/Total deposit Liabilities | 20.2% | 19.1% |
| Minimum Statutory ratio | 8.0% | 8.0% |
| **Excess** | **12.2%** | **11.1%** |
| Core Capital/Total Risk-Weighted Assets | 16.3% | 15.4% |
| Minimum Statutory ratio | 10.5% | 10.5% |
| **Excess** | **5.8%** | **4.9%** |
| Total Capital/Total Risk-Weighted Assets | 16.8% | 16.9% |
| Minimum Statutory ratio | 14.5% | 14.5% |
| **Excess** | **2.3%** | **2.4%** |
| Liquidity Ratio | 46.2% | 52.2% |

| | | |
|---|---|---|
| Minimum Statutory ratio | 20.0% | 20.0% |
| **Excess** | **26.2%** | **32.2%** |
| Adjusted Core Capital/Total deposit liabilities | 16.3% | 13.9% |
| Adjusted Core Capital/Total Risk-Weighted Assets | 16.8% | 15.4% |