Co-op Bank of Kenya- H1'2020

14th August, 2020

Valuation Summary

- We are of the view that Co-operative Bank is a "HOLD" with a target price of Kshs 14.3, representing an upside of 32.0%, from the current price of Kshs 10.9 as of 14th August 2020, inclusive of a dividend yield of 11.3%,
- Co-operative Bank is currently trading at a P/TBV of 0.8x and a P/E of 4.9x vs an industry average of 1.2x and 6.3x, respectively,

Key Highlights H1'2020

- The Central bank announced that Cooperative bank will officially acquire 90% stake in Jamii Bora bank on August 21st 2020 in a gazette notice, meaning that the bank had received all the required approvals including the treasury which gave the go ahead on 4th August. The move will help the two entities by diversifying their business models. The bank will acquire 224.2 mn ordinary shares in Jamii Bora Bank in exchange for Kshs 1.0 bn capital injection,

Income Statement

- Core earnings per share (EPS) declined by 3.6% to Kshs 1.05 in H1'2020, from Kshs 1.09 in H1'2019, which was much better than our projections of Kshs 0.8. The decline in the EPS was driven by a 15.7% increase in total operating expenses to Kshs 14.6 bn in H1'2020 from Kshs 12.6 in H1'2019, outweighing the 5.3% increase in total operating income,

- Total operating income increased by 5.3% to Kshs 24.2 bn in H1'2020, from Kshs 23.0 bn in H1'2019. This was mainly due to an 11.6% increase in Net Interest Income (NII) to Kshs 15.9 bn from Kshs 14.3 bn in H1'2019, which was weighed down by the 5.1% decline in Non-Funded Income (NFI) to Kshs 8.3 bn from Kshs 8.8 bn in H1'2019,

- Interest income rose by 6.8% to Kshs 21.8 bn in H1'2020, from Kshs 20.4 bn in H1'2019. The growth recorded was as a result of a 12.1% increase in interest income from government securities to Kshs 6.2 bn, from Kshs 5.5 bn in H1'2019, as well as a 2.4% rise in interest income from loans and advances to Kshs 15.0 bn from Kshs 14.7 bn in H1'2019. The yield on interest-earning assets, however, declined to 11.5%, from 11.9% in H1'2019 due to the faster 11.6% growth in the average interest-earning assets that outpaced the 6.8% growth in interest income,

- Interest expense declined by 4.4% to Kshs 5.9 bn in H1'2020, from Kshs 6.2 bn in H1'2019, largely due to a 4.7% decline in interest expense from customer deposits to Kshs 5.1 bn from Kshs 5.4 bn in H1'2019. Other interest expenses also declined by 2.1% to Kshs 778.1 mn from Kshs 794.9 mn in H1'2019. Consequently, the cost of funds declined to 3.2%, from 3.7% in H1'2019, owing to a 19.9% rise in interest-bearing liabilities which outpaced the 4.4% decline in interest expenses,

- Non-Funded Income fell by 5.1% to Kshs 8.3 bn in H1'2020, from Kshs 8.8 bn in H1'2019. The decline was mainly driven by a 42.5% drop in fees and commissions on loans to Kshs 0.6 bn, from Kshs 1.1 bn in H1'2019, as well as a 67.5% decline in other income to 0.2 bn from 0.7 bn in H1'2019. The decline in NFI was however mitigated by a 37.2% increase in forex trading income to Kshs 1.3 bn, from Kshs 1.0 bn in H1'2019 as well as other fees and commissions which increased by 2.4% to Kshs 6.2 bn from Kshs 6.0 in H1'2019. As a consequence, the revenue mix shifted to 66:34, from 62:38 in H1'2019 owing to the faster growth in NII,

- Total operating expenses rose by 15.7% to Kshs 14.6 bn in H1’2020, from Kshs 12.6 bn in H1’2019, largely driven by the 57.9% rise in Loan Loss Provisions (LLP) to Kshs 1.9 bn from Kshs 1.2 bn in H1’2019, coupled with a 15.5% rise in staff costs to Kshs 6.6 bn in H1’2020 from Kshs 5.7 bn in H1’2019,
- The Cost to Income Ratio (CIR) deteriorated to 60.1%, from 54.8% in H1’2019, following the faster rise in total operating expenses that outpaced total operating income. Without LLP, the cost to income ratio also deteriorated to 52.4% from 49.6% in H1’2019, and indication of reduced efficiency levels,
- The bank registered a 3.6% decline in profit after tax to Kshs 7.2 bn in H1’2020 from Kshs 7.5 bn in H1’2019. Profit before tax and exceptional items declined by 8.0% to Kshs 9.6 bn from Kshs 10.4 bn in H1’2019, with the effective tax rate declining to 25.0% in H1’2020 from 28.4% seen in H1’2019.

Balance Sheet

- The balance sheet recorded an expansion as total assets grew by 19.6% to Kshs 513.9 bn in H1’2020 from Kshs 429.6 bn in H1’2019, mainly attributable to the 28.8% growth in government securities to Kshs 122.4 bn from Kshs 95.0 bn, coupled with a 5.7% growth in net loans and advances to Kshs 272.2 bn in H1’2020 from Kshs 257.6 bn in H1’2019. Placements also rose by 5.8% to Kshs 17.7 bn in H1’2020, from Kshs 16.8 bn,
- Total liabilities grew by 21.0% to Kshs 432.2 bn in H1’2020 from Kshs 357.2 bn in H1’2019 which was largely attributable to a 247.1% rise in placements from banking institutions to Kshs 5.2 bn in H1’2020, from Kshs 1.5 bn, coupled with the 18.9% rise in customer deposits to Kshs 384.6 bn in H1’2020 from Kshs 323.6 bn in H1’2019. Borrowings also recorded a 19.4% increase to Kshs 25.6 bn from Kshs 21.5 bn in H1’2019,
- The slower 5.7% growth in net loans and advances compared to the 18.9% growth in deposits, led to a decline in the loan to deposit ratio to 70.8%, from 79.6% in H1’2019. Deposits per branch remained unchanged at Kshs 2.1 bn as the number of branches remained unchanged at 159 branches,
- Gross Non-Performing Loans (NPLs) increased by 12.3% to Kshs 34.3 bn in H1’2020, from Kshs 30.6 bn in H1’2020. The NPL ratio deteriorated to 11.8% in H1’2020, from 11.2% in H1’2019 owing to slower growth in gross loans by 6.4% compared to the 12.3% growth in gross non-performing loans,
- General Loan Loss Provisions increased by 20.2% to Kshs 13.1 bn, from Kshs 10.9 bn in H1’2019. The NPL coverage ratio thus improved to 54.6% in H1’2020 from 51.4% in H1’2019, due to the faster growth in General Loan Loss Provisions which outpaced the growth in Gross Non-Performing Loans (NPLs),
- Shareholders’ funds increased by 12.8% to Kshs 80.1 bn in H1’2020 from Kshs 71.0 bn in H1’2019, mainly driven by a 13.0% increase in the retained earnings to Kshs 62.2 bn, from Kshs 70.3 bn in H1’2019,
- Co-operative Bank remains sufficiently capitalized with a core capital to risk-weighted assets ratio of 16.3%, 5.8% points above the statutory requirement of 10.5%. Also, the total capital to risk-weighted assets ratio came in at 16.8%, exceeding the statutory requirement of 14.5% by 2.3% points. Adjusting for IFRS 9, the core capital to risk-weighted assets stood at 15.9%, while total capital to risk-weighted assets came in at 16.4%, and,
- The bank currently has a Return on Average Assets (ROaA) of 3.0%, and a Return on Average Equity (ROaE) of 18.6%.

Key Take-Outs:

1. Total operating expenses grew by 15.7% mainly due to the increase in loan loss provisions by 57.9%, coupled with the 15.5% increase in staff costs. Consequently, the cost to income ratio deteriorated to 60.1% from 54.8% seen in H1’2019. 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 and loss of jobs came about as a result of the same. Consequently, households and businesses haven’t been able to keep up with their debt obligations and that has resulted in an increase in Non-performing loans, and,
2. The bank’s asset quality deteriorated, with the NPL ratio coming in at 11.8% in H1’2020, from 11.2% in H1’2019, H1’2019 owing to slower growth in gross loans by 6.4% compared to the 12.3% 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.

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 through 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 centred 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:

Balance Sheet Items	H1'2019	H1'2020	y/y change	H1'2020f	Projected %y/y change	Variance in Growth Actual vs. Expected
Government Securities	94.97	122.37	28.8%	122.0	28.5%	0.4%
Net Loans and Advances	257.6	272.2	5.7%	267.7	3.9%	1.7%
Total Assets	429.6	513.9	19.6%	474.9	10.6%	9.1%
Customer Deposits	323.6	384.6	18.9%	346.4	7.1%	11.8%
Total Liabilities	357.2	432.2	21.0%	393.6	10.2%	10.8%
Shareholders’ Funds	71.0	80.1	12.8%	79.8	12.4%	0.5%

Balance Sheet Ratios	H1'2019	H1'2020	y/y change
Loan to Deposit Ratio	79.6%	70.8%	(8.8%)
Return on average equity	18.8%	18.6%	(0.2%)
Return on average assets	3.2%	3.0%	(0.2%)

Income Statement	H1'2019	H1'2020	y/y change	H1'2020f	Projected %y/y change	Variance in Growth Actual vs. Expected

Net Interest Income	14.3	15.9	11.6%	13.1	(8.2%)	19.8%
Non-Interest Income	8.8	8.3	(5.1%)	9.2	5.1%	(10.2%)
Total Operating income	**23.0**	**24.2**	5.3%	**22.3**	(3.1%)	**8.4%**
Loan Loss provision	(1.2)	(1.9)	57.9%	(2.1)	77.9%	(20.0%)
Total Operating expenses	(12.6)	(14.6)	15.7%	(13.7)	8.5%	7.1%
Profit before tax	10.4	9.6	(8.0%)	8.6	(17.1%)	9.1%
Profit after tax	7.5	7.2	(3.6%)	6.1	(18.9%)	15.3%
Earnings per share	**1.09**	**1.05**	**(3.6%)**	**0.9**	**(18.9%)**	**15.3%**

Income Statement Ratios	H1'2019	H1'2020	y/y Change
Yield from interest-earning assets	5.5%	2.7%	(51.1%)
Cost of funding	1.8%	2.0%	11.2%
Net Interest Spread	3.7%	0.7%	(81.0%)
Net Interest Income as % of operating income	62.0%	65.7%	6.0%
Non-Funded Income as a % of operating income	38.0%	34.3%	(9.8%)
Cost to Income	54.8%	60.1%	9.9%
CIR without provisions	49.6%	52.4%	5.7%
Cost to Assets	2.7%	2.5%	(7.0%)
Net Interest Margin	8.4%	8.4%	0.1%

Capital Adequacy Ratios	H1'2019	H1'2020
Core Capital/Total deposit Liabilities	19.3%	18.2%
Minimum Statutory ratio	8.0%	8.0%
Excess	**11.3%**	**10.2%**
Core Capital/Total Risk Weighted Assets	16.0%	16.3%
Minimum Statutory ratio	10.5%	10.5%
Excess	**5.5%**	**5.8%**
Total Capital/Total Risk Weighted Assets	16.3%	16.8%
Minimum Statutory ratio	14.5%	14.5%
Excess	**1.8%**	**2.3%**
Liquidity Ratio	44.6%	54.1%
Minimum Statutory ratio	20.0%	20.0%
Excess	**24.6%**	**34.1%**
Adjusted Core Capital/Total deposit liabilities	16.4%	15.9%
Adjusted Total Capital/Total Risk Weighted Assets	16.7%	16.4%