Valuation Summary

- We are of the view that Co-operative Bank is a “Buy” with a target price of Kshs 18.4, representing an upside of 46.5%, from the current price of Kshs 12.9 as of 22nd May 2020, inclusive of a dividend yield of 8.0%,
- Co-operative Bank is currently trading at a P/TBV of 1.0x and a P/E of 5.1x vs an industry average of 1.0x and 5.4x, respectively,

Key Highlights Q1’2020

- The Bank launched an import finance product for Micro, Small & Medium-sized Enterprises (MSMEs) in Kenya as it commits to remain innovative in offering relevant services in the dynamic business segment. The financing product for importers is designed to help them to have a seamless process during the clearing and transportation of imported cargo from the port of origin to the final destination.
- The Board of Directors of Co-operative Bank of Kenya Limited has approved the progression of discussions with Jamii Bora Bank Limited, which if successful, would lead to the Co-operative Bank of Kenya Limited acquiring 100% shareholding in Jamii Bora Bank Limited,

Income Statement

- Core earnings per share decreased marginally by 0.3% to Kshs 0.612 in Q1’2020, from Kshs 0.613 in Q1’2019, which was in line with our projections. The performance was driven by the 20.6% increase in total operating expenses, which grew faster than the 12.5% growth in total operating income in Q1’2020,
- Total operating income increased by 12.5% to Kshs 12.5 bn in Q1’2019, from Kshs 11.1 in Q1’2019. This was due to a 19.0% increase in Non-Interest Income to Kshs 5.0 bn from Kshs 4.2 bn in Q1’2019, coupled with an 8.5% growth in Net Interest Income (NII) to Kshs 7.5 bn from Kshs 6.9 bn in Q1’2019,
- Interest income rose by 4.5% to Kshs 10.5 bn in Q1’2020, from Kshs 10.1 bn in Q1’2019. The growth recorded was as a result of a 5.2% increase in interest income from loans and advances to Kshs 7.6 bn, from Kshs 7.2 bn in Q1’2019, as well as a 3.1% rise in interest income from government securities to Kshs 2.9 bn from Kshs 2.8 bn in Q1’2019. The yield on interest-earning assets, however, declined to 11.3%, from 11.9% in Q1’2019 due to the faster 9.0% growth in the average interest-earning assets that outpaced the 4.5% growth in interest income,
- Interest expense declined by 4.4% to Kshs 3.0 bn in Q1’2020, from Kshs 3.2 bn in Q1’2019, largely due to a 5.0% decline in interest expense from customer deposits to Kshs 2.6 bn from Kshs 2.8 bn in Q1’2019. Other interest expenses also declined by 1.8% to Kshs 382.7 mn from Kshs 389.7 mn in Q1’2019. Consequently, cost of funds declined to 3.4%, from 3.7% in Q1’2019, owing to the 4.4% decline in interest expense, which was outpaced by the 7.2% rise in average interest-bearing liabilities to Kshs 356.2 bn, from Kshs 323.1 bn in Q1’2019,
- Non-interest income rose by 19.0% to Kshs 5.0 bn in Q1’2020, from Kshs 4.2 bn in Q1’2019. The rise was mainly driven by a 31.0% increase in other fees and commissions from digital banking to 3.8 bn from 2.9 bn in Q1’2019, as well as a 14.0% rise in fees and commissions on loans to Kshs 0.6 bn, from Kshs 0.5 bn in Q1’2019 The growth in NFI was however weighed down by a 21.0% decline in forex trading income to Kshs 0.5 bn, from Kshs 0.6 bn in Q1’2019 as well as other income which declined by 29.1% to Kshs bn from Kshs in Q1’2019. As a consequence, the revenue mix shifted to 62:38, from 60:40 in Q1’2019 funded versus non-funded owing to the faster growth in NFI,
- Total operating expenses rose by 20.6% to Kshs 7.3 bn in Q1’2020, from Kshs 6.0 bn in Q1’2019, largely driven by the 79.5% rise in Loan Loss Provisions (LLP) to Kshs 0.9 bn from Kshs 0.5 bn in Q1’2019, coupled

with a 25.0% rise in staff costs to Kshs 3.5 bn in Q1’2020 from Kshs 2.8 bn in Q1’2019. Key to note, the increased loan provisioning levels trend has been recorded in all banks that have released their financials as Banks’ cover for downgraded facilities, with the expectation of an increase in defaults across sectors, brought about by the COVID-19 pandemic,

- The Cost to Income Ratio (CIR) deteriorated to 58.1%, from 54.2% in Q1’2019, following the faster rise in total operating expenses that outpaced total operating profit. Without LLP, the cost to income ratio also deteriorated to 50.9% from 49.7% in Q1’2019,
- The bank registered a marginal 0.3% decline in profit after tax to Kshs 3.59 bn in Q1’2020 from Kshs 3.60 bn in Q1’2019. Profit before tax and exceptional items, on the other hand, grew by 3.7% to Kshs 3.7 bn from Kshs 3.6 bn in Q1’2019, with the effective tax rate increasing marginally to 29.9% in Q1’2020 from 29.6% seen in Q1’2019.

Balance Sheet

- The balance sheet recorded an expansion as total assets grew by 10.5% to Kshs 470.4 bn in Q1’2020 from Kshs 425.7 bn in Q1’2019, mainly attributable to the 11.5% growth in government securities to Kshs 115.9 bn in Q1’2020 from Kshs 103.9 bn, coupled with a 9.8% growth in net loans and advances to Kshs 276.2 bn in Q1’2020 from Kshs 251.6 bn in Q1’2019. Deposits placements also rose by 27.0% to Kshs 19.3 bn from Kshs 15.2bn,
- Total liabilities grew by 10.1% to Kshs 386.9 bn in Q1’2020 from Kshs 351.5 bn in Q1’2019, which was largely attributable to a 15.5% increase in borrowings to Kshs 27.4 bn from Kshs 23.7 bn in Q1’2019 and a 6.9% rise in customer deposits to Kshs 339.6 bn in Q1’2020 from Kshs 317.8 bn in Q1’2019.
- The faster 9.8% growth in net loans and advances which outpaced the 6.9% growth in deposits, led to a marginal increase in the loan to deposit ratio to 81.3%, from 79.2% in Q1’2019. 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 7.1% to Kshs 31.8 bn in Q1’2020, from Kshs 29.7 bn in Q1’2020. The NPL ratio, however, improved to 10.8% in Q1’2020, from 11.1% in Q1’2019 owing to faster growth in gross loans by 9.9% outpacing the 7.1% growth in gross non-performing loans,
- General Loan Loss Provisions increased by 9.8% to Kshs 11.9 bn, from Kshs 10.9 bn in Q1’2019. The NPL coverage ratio thus increased to 54.8% in Q1’2020 from 52.2% in Q1’2019, due to the faster growth in General Loan Loss Provisions which outpaced the growth in Gross Non-Performing Loans (NPLs),
- Shareholders’ funds increased by 12.6% to Kshs 82.0 bn in Q1’2020 from Kshs 72.8 bn in Q1’2019, mainly driven by a 14.4% increase in the retained earnings to Kshs 66.9 bn, from Kshs 58.5 bn in Q1’2019,
- Co-operative Bank remains sufficiently capitalized with a core capital to risk-weighted assets ratio of 15.6%, 5.1% points above the statutory requirement of 10.5%. In addition, the total capital to risk-weighted assets ratio came in at 16.1%, exceeding the statutory requirement of 14.5% by 1.6% points. Adjusting for IFRS 9, the core capital to risk-weighted assets stood at 15.5%, while total capital to risk-weighted assets came in at 15.9%, and,
- The bank currently has a Return on Average Assets (ROaA) of 3.2%, and a Return on Average Equity (ROaE) of 18.5%.

Key Take-Outs:

I. Non-Funded Income rose by rose by 19.0% to Kshs 5.0 bn in Q1’2020, from Kshs 4.2 bn in Q1’2019 below the industry average growth of 21.6%. The increase was mainly driven by the 31.0% increase in other fees and commissions to 3.8 bn from 2.9 bn in Q1’2019. As a consequence, the revenue mix shifted to 60:40, from 62:38 in Q1'2019 owing to the fast growth in NFI despite the repeal of the interest rate cap. The growth in NFI is below the current industry average of 21.6%, and,

II. The bank's asset quality improved, with the NPL ratio reducing to 10.8% in Q1'2020, from 11.1% in Q1'2019 owing to faster growth in gross loans by 9.9% outpacing the 7.1% growth in gross non-performing loans, which is attributable to the implementation of credit management strategies implemented since the beginning of the year such as adherence to credit risk appetite and limits, credit risk early warning indicators, proper credit appraisal, and approval mechanisms. The main sectors that contributed to Non-Performing Loans are Trade, Personal Consumer and Manufacturing sectors contributing 32.0%, 18.0%, and 16.0%, respectively, to total NPL.

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

I. **Business Model Restructuring:** The bank's continued implementation of "Soaring Eagle" transformation initiatives is expected to drive growth and increase efficiency. The initiatives are set on the following eight key pillars; branch transformation, MSME transformation, sales force effectiveness, shared services and digitization, NPL management and credit processes, cost management, data analytics, and staff productivity. We expect the initiatives to culminate into improved revenue levels, 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	Q1' 2019	Q1 '2020	y/y change	Q1 '2020e	Projected %y/y change	Variance in Growth Actual vs. Expected
Government Securities	103.93	115.87	11.5%	94.8	(8.8%)	20.2%
Net Loans and Advances	251.6	276.2	9.8%	261.0	3.7%	6.0%
Total Assets	**425.7**	**470.4**	**10.5%**	**457.6**	**7.5%**	**3.0%**
Customer Deposits	317.8	339.6	6.9%	329.9	3.8%	3.1%
Total Liabilities	351.5	386.9	10.1%	373.2	6.2%	3.9%
Shareholder's Funds	**72.8**	**82.0**	**12.6%**	**82.9**	**13.8%**	**(1.2%)**

Balance Sheet Ratios	Q1' 2019	Q1 '2020	y/y change
Loan to Deposit Ratio	79.2%	81.3%	2.1%
Return on average equity	18.3%	18.5%	0.2%
Return on average assets	3.1%	3.2%	0.1%

Income Statement	Q1' 2019	Q1 '2020	y/y change	Q1 '2020e	Projected %y/y change	Variance in Growth Actual vs. Expected
Net Interest Income	6.9	7.5	8.5%	6.4	(8.1%)	16.7%
Non-Interest Income	4.2	5.0	19.0%	4.5	6.9%	12.1%
Total Operating income	**11.1**	**12.5**	**12.5%**	**10.8**	**(2.5%)**	**14.9%**
Loan Loss provision	(0.5)	(0.9)	79.5%	(0.5)	2.2%	77.2%
Total Operating expenses	(6.0)	(7.3)	20.6%	(6.1)	2.1%	18.5%
Profit before tax	**5.1**	**5.1**	**0.1%**	**4.7**	**(7.8%)**	**7.9%**
Profit after tax	**3.6**	**3.6**	**(0.3%)**	**3.5**	**(1.8%)**	**1.5%**

Income Statement Ratios	Q1' 2019	Q1 '2020	y/y change
Yield from interest-earning assets	11.9%	11.3%	(5.3%)
Cost of funding	3.7%	3.4%	(8.4%)
Net Interest Spread	1.9%	1.8%	(5.3%)
Net Interest Income as % of operating income	62.3%	60.1%	(3.5%)
Non-Funded Income as a % of operating income	37.7%	39.9%	5.8%
Cost to Income Ratio (CIR)	54.2%	58.09%	7.2%
CIR without provisions	49.7%	50.89%	2.4%
Cost to Assets	1.3%	1.4%	4.3%
Net Interest Margin	8.4%	8.2%	(3.4%)

Capital Adequacy Ratios	Q1' 2019	Q1 '2020
Core Capital/Total deposit Liabilities	20.2%	19.0%
Minimum Statutory ratio	8.0%	8.0%
Excess	12.2%	11.0%
Core Capital/Total Risk-Weighted Assets	15.6%	15.6%
Minimum Statutory ratio	10.5%	10.5%
Excess	5.1%	5.1%
Total Capital/Total Risk-Weighted Assets	16.1%	15.9%
Minimum Statutory ratio	14.5%	14.5%
Excess	1.6%	1.4%
Liquidity Ratio	49.0%	45.2%
Minimum Statutory ratio	20.0%	20.0%
Excess	29.0%	25.2%
Adjusted Core Capital/Total deposit liabilities	20.0%	19.7%
Adjusted Core Capital/Total Risk-Weighted Assets	15.5%	16.1%