Co-operative Bank of Kenya– Q3’2018

16th November, 2018

Valuation Summary

- We are of the view that Co-operative Bank is an “***buy***” with a target price of Kshs 19.9, representing an upside of 45.8 %, from the current price of Kshs 14.4 as of 16th November 2018, inclusive of a dividend yield of 5.6%,
- Co-operative Bank is currently trading at P/TBV of 1.2x and a P/E of 6.9x vs an industry average of 1.4x and 6.8x, respectively.

Key Highlights Q3’2018

- Co-operative Bank of Kenya partnered with Xpress Money, one of the leading international money transfer service providers, by providing money transfer services. The partnership will see Kenyans send and receive cash to and from abroad through any Co-operative bank branch anywhere in the country;
- Co-operative Bank entered into a transaction to inject Kshs 200 mn share capital in the government's mortgage company, Kenya Mortgage Refinance Company, to support long term financing for affordable housing.
- Co-operative Bank launched a packaged financial solution for Micro, Small & Medium-sized Enterprises (MSMEs). The financial solution is segmented in bronze, silver and gold for micro, small and medium businesses respectively. Over the past one year, in partnership with the International Finance Corporation (IFC), the Bank has expended a lot of resources, customer engagements and research work to understand the dynamics of this critical business segment.

Income Statement

- Total operating income increased by 4.6% to Kshs 32.3 bn from Kshs 30.9 bn over the same period in Q3’2017. This was due to a 4.7% increase in Net Interest Income (NII) to Kshs 21.7 bn from Kshs 20.8 bn in Q3’2017, coupled with 4.3% growth in Non-Funded Income (NFI) to Kshs 10.6 bn, from Kshs 10.1 bn in Q3’2017,
- Interest income increased by 3.5% to Kshs 30.9 bn from Kshs 29.9 bn in Q3’2017. This was driven by a 13.1% growth in interest income from government securities to Kshs 6.9 bn from Kshs 6.1 bn in Q3’2017, and a marginal 0.8% increase in interest income on loans and advances to Kshs 23.8 bn, from Kshs 23.5 bn in Q3’2017. Interest income on deposits and placements with banking institutions rose by 13.3% to Kshs 0.17 bn from Kshs 0.15 bn in Q3’2017. However, the yield on interest-earning assets declined to 11.9% in Q3’2018 from 12.3% in Q3’2017, given the faster growth of 16.9% in government securities that have relatively lower yields than loans,
- Interest expense remained flat at Kshs 9.1 bn in Q3’2018. Interest on customer deposits increased by 2.5% to Kshs 8.2 mn from Kshs 8.0 mn, while other interest charges decreased by 3.4% to Kshs 0.88 bn from Kshs 0.91 bn in Q3’2017. The cost of funds decreased to 3.8% from 3.9% in Q3’2017. Consequently, net interest margin decreased to 8.3% from 8.6% in Q3’2017,
- Non-Funded Income (NFI) increased by 4.3% to Kshs 10.6 bn, from Kshs 10.1 bn in Q3’2017. The increase in NFI was realized across all NFI segments apart from fees and commissions on loans which declined by 29.7 % to Kshs 1.3 bn from Kshs 1.9 bn in Q3’2017, with management indicating that the appraisal fees declined by 51.0%, while negotiation fees declined by 16.0%. The values were however undisclosed. Other fees and commission income increased by 9.9% to Kshs 6.6 bn, from Kshs 6.0 bn in Q3’2017. Forex trading income increased by 13.6% to Kshs 1.8 bn, from Kshs 1.5 bn in Q3’2017. Other income increased by 24.1% to Kshs 0.9 bn, from Kshs 0.8 bn in Q3’2017, with management citing recoveries from loans and revenue from the custody business as the key drivers for the growth in the other income segment. As a result, the current revenue mix remained at 67:33 funded to non-funded income,
- Total operating expenses increased by 3.1% to Kshs 17.8 bn, from Kshs 17.3 bn, largely driven by a 12.5% increase in other operating expenses to Kshs 8.4 bn in Q3’2018, from Kshs 7.5 bn in Q3’2017,

as the bank improved its Information Technology (IT) infrastructure, as it pushes for further automation of its processes, together with improving its data analytics function. Staff costs increased by 12.3% to Kshs 8.1 bn from Kshs 7.2 bn in Q3’2017, attributed to recruitment by the bank for the IT department, with management indicating the expertize was hired at a premium. Loan Loss Provisions (LLP) however declined by 50.3% to Kshs 1.3 bn in Q3’2018, from Kshs 2.6 bn in Q3’2017,

- The Cost to Income Ratio (CIR) improved to 55.1%, from 55.9% in Q3’2017. Without LLP, the cost to income ratio deteriorated to 51.2%, from 47.6% in Q3’2017,
- Profit before tax increased by 6.6% to Kshs 14.6 bn, up from Kshs 13.7 bn in Q3’2017. Profit after tax increased by 8.2% to Kshs 10.3 bn in Q3’2018, from Kshs 9.5 bn in Q3’2017.

Balance Sheet

- The balance sheet recorded an expansion as total assets increased by 4.1% to Kshs 404.2 bn from Kshs 388.3 bn in Q3’2017. This growth was largely driven by a 16.9% increase in government securities to Kshs 83.3 bn, from Kshs 71.2 bn in Q3’2017. This was despite the 2.0% decrease in their loan book to Kshs 254.2 bn from Kshs 259.4 bn in Q3’2017,
- Total liabilities rose by 3.5% to Kshs 332.5 bn from Kshs 321.1 bn in Q3’2017, driven by a 2.5% increase in customer deposits to Kshs 296.1 bn from Kshs 289.0.8 bn in Q3’2017. In terms of distribution, transaction accounts, current accounts and fixed deposits accounted for the highest proportion at 29.5%, 28.9% and 22.6% respectively. Deposits per branch decreased by 1.5% to Kshs 1.91 bn from Kshs 1.94 bn in Q3’2017, with six branches opened to bring the total to 155 from 149 in Q3’2017. Placement liabilities increased by 24.0% to Kshs 1.5 bn from Kshs 1.2 bn in Q3’2017. Borrowings decreased by 7.2% to Kshs 26.0 bn from Kshs 28.0 bn in Q3’2017,
- The growth in deposits as compared to decline in loans led to a slight decline in the loan to deposit ratio to 85.9% from 89.8% in Q3’2017,
- Gross Non-Performing Loans (NPLs) increased by 75.3% to Kshs 29.7 bn in Q3’2018 from Kshs 16.9 bn in Q3’2017. Consequently, the NPL ratio increased to 11.2% in Q3’2018 from 6.4% in Q3’2017. The Loan Loss Provisions (LLPs) due to IFRS 9 increased by 78.4% to Kshs 9.9 bn from Kshs 5.6 bn in Q3'2017, however, the specific LLPs for the quarter decreased by 50.3% to Kshs 1.3 bn from Kshs 2.6 bn in Q3’2017. According to management, the decrease in specific provisions for the quarter, was due to the bank’s one-off provisioning of Kshs 4.6 bn charged on the bank’s retained earnings, which was incurred as a result of the initial implementation of IFRS 9, hence requiring lesser provisioning levels for the quarter. With the growth in NPLs partially matched with a similar increase in provisioning, the NPL coverage decreased to 36.8% in Q3’2018 from 38.1% in Q3’2017. The increase in the non-performing loans was attributed to challenges experienced in the manufacturing, trade, real estate, and consumer loans sectors,
- Shareholders’ funds increased by 5.3 % to Kshs 70.9 bn in Q3’2018 from Kshs 67.3 bn in Q3’2017, as retained earnings grew by 6.5% y/y to Kshs 62.5 bn from Kshs 58.7 bn in Q3’2017,
- Co-operative bank remains sufficiently capitalized with a core capital to risk-weighted assets ratio of 16.5%, 6.0% above the statutory requirement. In addition, the total capital to risk-weighted assets ratio was 16.6%, exceeding the statutory requirement by 2.1%. Adjusting for IFRS 9, the core capital to risk-weighted assets stood at 17.3%, while total capital to risk-weighted assets came in at 17.4%, indicating that the bank’s total capital relative to its risk-weighted assets declined by 0.8% due to implementation of IFRS 9. This is because the banks are allowed to add back amounts used in provisioning to capital for capital computation purposes, as they implement IFRS 9,
- The bank currently has a Return on Average Assets (ROaA) of 3.1% and a Return on Average Equity (ROaE) of 17.6%.

Key Take-Outs:

1. Asset quality remains a concern as Gross Non-Performing Loans (NPLs) increased by 75.3% to Kshs 29.7 bn in Q3'2018 from Kshs 16.9 bn in Q3'2017. Management highlighted that they experienced challenges in the manufacturing, trade, consumer loans and real estate sectors. Management attributed difficulty in these sectors to delayed payments by both the national and county governments, delayed payments for distributors by private institutions and low uptake in real estate. Management further stated, we should expect write-offs in the consumer loan book, of close to Kshs 1.0 bn,

2. Total operating expenses increased by 3.1%, largely driven by a 12.5% increase in other operating expenses to Kshs 8.4 bn in Q3'2018, from Kshs 7.5 bn in Q3'2017. Staff costs increased by 12.3% to Kshs 8.1 bn from Kshs 7.2 bn in Q3'2017, attributed to recruitment by the bank for the IT and development department as it pushes for further automation of its services. This was in line with our projection being that efficiency gains being generated by the bank from the digitization and automation of businesses under the Soaring Eagle initiative are yet to be fully realized. We however expect the Cost to Income ratio to improve to levels of less than 50.0% as the automation process begins to reap benefits, and,

3. Alternative channels were key drivers for Non-Funded Income (NFI), which increased by 4.3% to Kshs 10.6 bn, from Kshs 10.1 bn in Q3'2017. Merchant Banking, Mco-op Cash, and Agency Banking all increased in terms of transaction volume by 59.0%, 57.0 %, and 30.0 % respectively. Branch Banking and ATM transactions decreased 13.0% and 11.0% respectively. Management highlighted that this was in line with their efficiency strategy of reducing activity in branches and eventual closure of some. They however noted that reduced ATM activity was a concern as this was not entailed in the strategy.

Going forward, We expect the bank's growth to be driven by continued implementation its ***Soaring Eagle*** transformation project. Key strategies in this transformation that we expect to play a major part are the following;

1. **Branch Transformation and deepening financial inclusion**: Increased 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,

2. **Enhanced Credit Management**: The bank continues to manage its loan portfolio through, Proactive debt management including loan due reminders, Enhancement of systems, processes and tooling to support Credit management mainly loan origination process, and Sustained collections and follow up. this could improve the bank's asset quality, and,
3. **Improved Operational Efficiency and cost management**: Focus on electronic channels such as the MCo-op cash will continue to boost the firm's efficiency, by reducing the costs associated with brick and mortar operations model.

Below is a summary of the bank's performance:

Balance Sheet Items	Q3'2017	Q3'2018 Reported	Actual y/y Change	Q3'2018e	y/y Change Expected	Variance
Net loans and Advances	259.4	252.2	(2.8%)	257.5	(0.7%)	2.0%
Total Assets	**388.3**	**404.2**	**4.1%**	**409.4**	**5.4%**	**1.3%**
Customer Deposits	289.0	296.1	2.5%	304.4	5.3%	2.9%
Total Liabilities	**321.1**	**332.5**	**3.5%**	**337.4**	**5.1%**	**1.5%**

Balance sheet Ratios	Q3'2017	Q3'2018	% y/y change
Loan to Deposit Ratio	89.8%	85.9%	(3.9%)
Return on Average Equity	18.5%	17.6%	(0.9%)
Return on Average Assets	3.1%	3.1%	0.0%

Income Statement	Q3'2017	Q3'2018 Reported	Actual y/y Change	Q3'2018e	y/y Change Expected	Variance
Interest Income	29.9	30.9	3.5%	30.8	3.1%	(0.4%)
Net Interest Income	20.8	21.7	4.7%	22.5	8.1%	3.4%
Non-Interest Income	10.1	10.6	4.3%	11.3	11.7%	7.4%
Total Operating income	**30.9**	**32.3**	**4.6%**	**33.8**	**9.3%**	**4.7%**
Loan Loss provision	(2.6)	(1.3)	(50.3%)	(2.6)	(0.2%)	50.1%
Profit before tax	13.7	14.5	5.7%	14.8	7.6%	2.0%
Profit after tax	**9.5**	**10.3**	**8.2%**	**10.3**	**8.5%**	**0.4%**
Earnings per share	**1.6**	**1.8**	**8.3%**	**1.8**	**8.5%**	**0.2%**

Income Statement Ratios	Q3'2017	Q3'2018	y/y change
Yield from Interest Earning assets	12.3%	11.9%	(0.4%)
Cost of Funding	3.9%	3.8%	(0.1%)
Net Interest Spread	8.3%	8.0%	(0.3%)
Net Interest Margin	8.6%	8.3%	(0.3%)
Cost of Risk	8.3%	3.9%	(4.4%)
Net Interest Income as % of Operating Income	67.2%	67.3%	0.1%
Non-Funded Income as % of Operating income	32.8%	32.7%	(0.1%)
Cost to Income Ratio	55.9%	55.1%	(0.8%)

Capital Adequacy Ratios	Q3'2017	Q3'2018
Core Capital/Total Liabilities	17.3%	20.6%
Minimum Statutory ratio	8.0%	8.0%
Excess	**9.3%**	**12.6%**
Core Capital/Total Risk Weighted Assets	15.9%	16.5%
Minimum Statutory ratio	10.5%	10.5%
Excess	**5.4%**	**6.0%**
Total Capital/ Total Risk Weighted Assets	22.6%	16.6%
Minimum Statutory ratio	14.5%	14.5%
Excess	**8.1%**	**2.1%**
Liquidity Ratio	35.0%	41.7%
Minimum Statutory ratio	20.0%	20.0%
Excess	**35.0%**	**21.7%**
Adjusted core capital/Total deposit liabilities		21.6%
Adjusted core capital/Total risk-weighted assets		17.3%
Adjusted total capital/Total risk-weighted assets		17.4%