Cytonn INVESTMENTS

Co-operative Bank – H1’2019
23rd August, 2019

Valuation Summary

- We are of the view that Co-operative Bank is a “***BUY***” with a target price of Kshs 17.1, representing an upside of 58.0%, from the current price of Kshs 11.5 as of 23rd August 2019, inclusive of a dividend yield of 8.7%,
- Co-operative Bank is currently trading at a P/TBV of 1.2x and a P/E of 6.0x vs an industry average of 1.3x and 6.6x, respectively.

Key Highlights H1’2019

- The bank was awarded the Best Bank in Sustainable Finance in Kenya 2019 during the Annual Energy Management Awards 2019; and,
- Co-operative Bank launched its financing scheme partnership with World Navi Co. Ltd for the importation of vehicles.

Income Statement

- Core earnings per share increased by 4.6% to Kshs 1.1, from Kshs 1.0 in H1’2018, which was not in line with our projections of a 1.7% decline. The performance was driven by a 5.5% increase in total operating income, which outpaced the 5.2% increase in total operating expenses. The variance in core earnings per share growth against our expectations was largely due to a faster 25.1% rise in Non-Funded Income to Kshs 8.8 bn, from Kshs 7.0 bn in H1’2018, which exceeded our expectation of an 8.1% increase to Kshs 7.6 bn,
- Interest income declined by 1.7% to Kshs 20.4 bn, from Kshs 20.8 bn in H1’2018. This was driven by a 9.1% decline in interest income from loans and advances to Kshs 14.7 bn, from Kshs 16.1 bn in H1’2018, which outweighed the 21.7% increase in interest income from government securities to Kshs 5.5 bn from Kshs 4.5 bn in H1’2018. The yield on interest-earning assets thus declined to 11.9%, from 12.2% in H1’2018,
- Interest expense rose by 3.5% to Kshs 6.2 bn, from Kshs 6.0 bn in H1’2018, largely due to a 38.8% rise in other interest expenses to Kshs 794.9 mn from Kshs 572.8 mn. Interest expense on customer deposits however remained flat at Kshs 5.4 bn, while interest expenses on placement liabilities declined by 26.2% to Kshs 21.0 mn, from Kshs 28.4 mn in H1’2018. The cost of funds declined to 3.7%, from 3.9% in H1’2018, owing to an 8.8% increase in interest bearing liabilities to Kshs 346.6 bn, from Kshs 318.6 bn in H1’2018, which grew faster than the 3.5% increase in interest expense. The Net Interest Margin (NIM) declined to 8.4%, from 8.6% in H1’2018, due to the decline in NII despite the rise in the average interest earning assets,
- Non-Funded Income rose by 25.1 % to Kshs 8.8 bn from Kshs 7.0 bn in H1’2018. The increase was mainly driven by the 38.1% increase in total fees and commissions to Kshs 7.1 bn, from Kshs 5.1 bn in H1’2018, which management attributed to increased usage of the firm’s alternative transaction channels. The improvement in NFI was however weighed down by the 22.1% decline in forex trading income to Kshs 1.0 bn, from Kshs 1.2 bn in H1’2018. As a consequence, the revenue mix shifted to 62:38, from 68:32 in H1’2018 owing to the fast growth in NFI coupled with the decline in NII,
- Total operating expenses increased by 5.2% to Kshs 12.6 bn, from Kshs 12.0 bn in H1’2018, largely driven by the 8.1% rise in Loan Loss Provisions (LLP) to Kshs 1.2 bn from Kshs 1.1 bn in H1’2018, coupled with the 3.1% increase in other operating expenses to Kshs 5.7 bn, from Kshs 5.5 bn in H1’2018, and the 6.8% increase in staff costs to Kshs 5.7 bn, from Kshs 5.3 bn in H1’2018,
- The Cost to Income Ratio (CIR) improved marginally to 54.8%, from 54.9% in H1’2018. Without LLP, the cost to income ratio also improved to 49.6% from 49.9% in H1’2018,
- Profit before tax increased by 4.6% to Kshs 10.4 bn, up from Kshs 10.0 bn in H1’2018. Profit after tax grew by 4.6% as well to Kshs 7.5 bn in H1’2019, from Kshs 7.1 bn in H1’2018.

Balance Sheet

- The balance sheet recorded an expansion as total assets increased by 7.8% to Kshs 429.6 bn, from Kshs 398.4 bn in H1’2018. Growth was supported by a 14.2% growth in government securities to Kshs 95.0 bn, from Kshs 83.1 bn, coupled with the 2.6% increase in the loan book to Kshs 257.6 bn from Kshs 251.1 bn in H1’2018,
- Total liabilities rose by 8.4% to Kshs 357.2 bn from Kshs 329.6 bn in H1’2018, driven by a 9.0% increase in customer deposits to Kshs 323.6 bn, from Kshs 297.0 bn in H1’2018. Deposits per branch increased by 8.3% to Kshs 2.1 bn from Kshs 1.9 bn in H1’2018, despite the number of branches increasing to 156 from 155 in H1’2018 as deposits grew at a faster rate,
- Borrowings rose by 16.5% to Kshs 21.5 bn from Kshs 18.4 bn in H1’2018,
- The fast 9.0% growth in deposits which outpaced the 2.6% growth in loans, led to a decline in the loan to deposit ratio to 79.6%, from 84.6% in H1’2018,
- Gross Non-Performing Loans (NPLs) increased by 8.3% to Kshs 30.6 bn in H1’2019, from Kshs 28.2 bn in H1’2018. The NPL ratio thus deteriorated to 11.2% in H1’2019, from 10.9% in H1’2018. Management attributed the deterioration in asset quality to players in the manufacturing sector, agriculture, real estate and trade sectors. General Loan Loss Provisions increased by 37.8% to Kshs 10.9 bn, from Kshs 7.9 bn in H1’2018. Thus, the NPL coverage improved to 51.4% in H1’2019 from 31.0% in H1’2018,
- Shareholders’ funds increased by 4.4% to Kshs 71.0 bn in H1’2019 from Kshs 68.0 bn in H1’2018, supported by a 4.8% increase in the retained earnings to Kshs 62.2 bn, from Kshs 59.4 bn in H1’2018,
- Co-operative Bank remains sufficiently capitalized with a core capital to risk-weighted assets ratio of 16.0%, 5.5% points above the statutory requirement of 10.5%. In addition, the total capital to risk-weighted assets ratio came in at 16.3%, exceeding the statutory requirement of 14.5% by 1.8% points. Adjusting for IFRS 9, the core capital to risk weighted assets stood at 16.4%, while total capital to risk-weighted assets came in at 16.7%, and,
- The bank currently has a Return on Average Assets (ROaA) of 3.2%, and a Return on Average Equity (ROaE) of 18.8%.

Key Take-Outs:

1. The bank’s asset quality deteriorated, with the NPL ratio deteriorating to 11.2%, from 10.9% in H1’2018. The main sectors that contributed to the NPLs were trade, personal consumer, manufacturing and real estate, which contributed 33.0%, 19.0%, 14.0% and 11.0% of the NPLs, respectively. We note that the bank has maintained its stringent credit standards, with management noting that they continue to cherry pick loans to issue, in a bid to tame the rising NPL,
2. The bank recorded a strong NFI growth y/y, supported by an improvement in the fee and commission income. Transactional income segment recorded an improvement aided by a 4.5% increase in the number of agency banking transactions to 23.0 mn from 22.0 mn in H1’2018, which lead to an 8.7% increase in revenue to 250.0 mn from 230.0 mn. The bank’s mobile banking platform recorded a 26.3% increase in the number of transactions to 24.0 mn from 19.0 mn, and as a consequence, commission income increased by 133.6% to Kshs 1.9 bn, from Kshs 782.0 mn in H1’2018. This led to an increment in the bank’s NFI contribution to total income to 38.0%.

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

I. **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,

II. **Enhanced Credit Management**: The bank continues to manage its loan portfolio through, cherry-picking of loan issuances, proactive debt management such as loan due reminders, enhancement of systems, processes and tooling to support credit management mainly loan origination process, and sustained collections. This could help the bank manage its asset quality, which has been pressured by the relatively tougher economic environment, and,

III. **Improved Operational Efficiency and cost management:** Focus on electronic channels such as the MCoop cash will continue to boost the firm's efficiency, by reducing the costs associated with brick and mortar operations model. Furthermore, with the banks e-credit channel being operational, the bank should be able to tap into that market and grow the credit portfolio.

Below is a summary of the bank's performance:

Balance Sheet Items	H1'2018	H1'2019	y/y change	H1'2019e	Projected %y/y change	Variance in Growth Actual vs. Expected
Government Securities	83.13	94.97	14.2%	84.8	2.0%	12.2%
Net Loans and Advances	251.1	257.6	2.6%	263.9	5.1%	(2.5%)
Total Assets	398.4	429.6	7.8%	437.4	9.8%	(1.9%)
Customer Deposits	297.0	323.6	9.0%	325.7	9.7%	(0.7%)
Total Liabilities	329.6	357.2	8.4%	359.8	9.1%	(0.8%)
Shareholders' Funds	68.0	71.0	4.4%	76.2	12.1%	(7.7%)

Balance Sheet Ratios	H1'2018	H1'2019	y/y change
Loan to Deposit Ratio	84.6%	79.6%	(5.0%)
Return on average equity	17.6%	18.8%	1.2%
Return on average assets	3.0%	3.2%	0.2%

Income Statement	H1'2018	H1'2019	y/y change	H1'2019e	Projected %y/y change	Variance in Growth Actual vs. Expected
Net Interest Income	14.8	14.3	(3.8%)	14.5	(2.0%)	(1.8%)
Non-Interest Income	7.0	8.8	25.1%	7.6	8.1%	17.0%
Total Operating income	**21.8**	**23.0**	5.5%	**22.1**	1.2%	**4.3%**
Loan Loss provision	(1.1)	(1.2)	8.1%	(0.9)	(18.5%)	26.5%
Total Operating expenses	(12.0)	(12.6)	5.2%	(12.1)	0.8%	4.4%
Profit before tax	10.0	10.4	4.6%	10.0	0.5%	4.1%
Profit after tax	7.1	7.5	4.6%	7.0	(1.7%)	6.3%
Earnings per share	1.0	1.1	4.6%	1.0	(1.7%)	6.3%

Income Statement Ratios	H1'2018	H1'2019
Yield from interest-earning assets	12.2%	11.9%
Cost of funding	3.9%	3.7%
Net Interest Spread	8.3%	8.2%
Net Interest Income as % of operating income	68%	62%
Non-Funded Income as a % of operating income	32%	38%
Cost to Income	54.9%	54.8%
Cost to Assets	3.0%	2.9%

Capital Adequacy Ratios	H1'2018	H1'2019
Core Capital/Total deposit Liabilities	20.0%	19.3%
Minimum Statutory ratio	8.0%	8.0%
Excess	**12.0%**	**11.3%**
Core Capital/Total Risk Weighted Assets	15.9%	16.0%

Minimum Statutory ratio	10.5%	10.5%
Excess	**5.4%**	**5.5%**
Total Capital/Total Risk Weighted Assets	16.0%	16.3%
Minimum Statutory ratio	14.5%	14.5%
Excess	**1.5%**	**1.8%**
Liquidity Ratio	37.7%	44.6%
Minimum Statutory ratio	20.0%	20.0%
Excess	**17.7%**	**24.6%**
Adjusted Core Capital/Total deposit liabilities	21.0%	19.8%
Adjusted Core Capital/Total Risk Weighted Assets	16.8%	16.4%