Co-operative Bank – Q1’2019
22nd May, 2019

Valuation Summary

- We are of the view that Co-operative Bank is a “***BUY***” with a target price of Kshs 18.5, representing an upside of 69.6%, from the current price of Kshs 11.5 as of 22nd May 2019, inclusive of a dividend yield of 8.7%,
- Co-operative Bank is currently trading at a P/TBV of 1.0x and a P/E of 5.2x vs an industry average of 1.3x and 6.7x, respectively.

Key Highlights Q1’2019

- 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 4.4% to Kshs 0.61, from Kshs 0.59 in Q1’2018, in line with our projections. The performance was driven by a 1.7% increase in total operating income, coupled with a 1.2% decline in total operating expenses. The variance in core earnings per share growth against our expectations was largely due to a slower 7.0% rise in total operating expenses to Kshs 8.8 bn, from Kshs 8.2 bn in Q1’2018, which was not in line with our expectation of a 13.2% increase to Kshs 9.3 bn,
- Interest income declined by 2.9% to Kshs 10.1 bn, from Kshs 10.4 bn in Q1’2018. This was caused by a 14.1% decline in interest income from loans and advances to Kshs 7.2 bn, from Kshs 8.4 bn in Q1’2018, which outweighed the 39.6% increase in interest income from government securities to Kshs 2.8 bn from Kshs 2.0 bn in Q1’2018, and the 267.6% increase in interest income from placement assets to Kshs 0.1 bn from Kshs 0.03 bn in Q1’2018. The yield on interest-earning assets thus declined to 11.9%, from 12.3% in Q1’2018,
- Interest expense rose by 6.2% to Kshs 3.2 bn, from Kshs 3.0 bn in Q1’2018, largely due to the 4.1% increase in the interest expense on customer deposits to Kshs 2.8 bn, from Kshs 2.7 bn in Q1’2018, coupled with a 30.0% increase in other interest expenses to Kshs 0.4 bn, from Kshs 0.3 bn in Q1’2018. However, interest expenses on placement liabilities declined by 82.2% to Kshs 3.2 mn, from Kshs 17.8 mn in Q1’2018. The cost of funds declined to 3.7%, from 4.0% in Q1’2018, owing to a 7.1% increase in interest bearing liabilities to Kshs 343.7 bn, from Kshs 320.6 bn in Q1’2018, which grew faster than the 6.2% increase in interest expense. As a result, the Net Interest Margin (NIM) rose to 8.7%, from 8.6% in Q1’2018,
- Non-Funded Income rose by 19.1 % to Kshs 4.2 bn, from Kshs 3.5 bn in Q1’2018. The increase was mainly driven by the 33.6% increase in total fees and commissions to Kshs 3.4 bn, from Kshs 2.6 bn in Q1’2018, which management attributed to increased usage of the firm’s alternative transaction channels. The improvement in NFI was however weighed down by the 15.3% decline in forex trading income to Kshs 0.6 bn, from Kshs 0.8 bn in Q1’2018, and the 35.5% decline in other income to Kshs 0.1 bn, from Kshs 0.2 bn in Q1’2018. As a consequence, the revenue mix shifted to 62:38, from 68:32 in Q1’2018 owing to the fast growth in NFI coupled with the decline in NII,
- Total operating expenses declined by 1.2% to Kshs 6.0 bn, from Kshs 6.1 bn in Q1’2018, largely driven by the 34.3% decrease in Loan Loss Provisions (LLP) to Kshs 0.5 bn from Kshs 0.8 bn in Q1’2018, which outpaced the 1.5% increase in other operating expenses to Kshs 2.74 bn, from Kshs 2.70 bn in Q1’2018, and the 5.6% increase in staff costs to Kshs 2.8 bn, from Kshs 2.6 bn in Q1’2018,
- The Cost to Income Ratio (CIR) improved to 54.2%, from 55.8% in Q1’2018. Without LLP, the cost to income ratio deteriorated to 49.7% from 48.8% in Q1’2018, highlighting the decline cost of risk to 4.5% from 7.0% in Q1’2018, implying a lower provisioning amount relative to the total operating income,

- Profit before tax increased by 4.4% to Kshs 5.1 bn, up from Kshs 4.9 bn in Q1’2018. Profit after tax grew by 4.4% to Kshs 3.6 bn in Q1’2019, from Kshs 3.4 bn in Q1’2018.

Balance Sheet

- The balance sheet recorded an expansion as total assets increased by 7.0% to Kshs 425.7 bn, from Kshs 397.8 bn in Q1’2018. Growth was supported by a 33.1% growth in government securities to Kshs 103.9 bn, from Kshs 78.1 bn, coupled with the 10.1% increase in other assets to Kshs 18.8 bn from Kshs 17.1 bn in Q1’2018,
- The loan book shrunk by 0.5% to Kshs 251.6 bn, from 252.8 bn in Q1’2018, which management attributed to the repayment of a Kshs 10.0 bn loan by a single client,
- Total liabilities rose by 6.8% to Kshs 351.5 bn from Kshs 329.1 bn in Q1’2018, driven by a 7.4% increase in customer deposits to Kshs 317.8 bn, from Kshs 295.9 bn in Q1’2018. Deposits per branch increased by 7.4% to Kshs 2.1 bn from Kshs 1.9 bn in Q1’2018, as the number of branches remained unchanged,
- Borrowings rose by 14.9% to Kshs 23.7 bn from Kshs 20.7 bn in Q1’2018,
- The fast growth in deposits coupled with the decline in loans, led to a decline in the loan to deposit ratio to 79.2%, from 85.4% in Q1’2018,
- Gross Non-Performing Loans (NPLs) increased by 4.8% to Kshs 29.7 bn in Q1’2019, from Kshs 28.4 bn in Q1’2018. The NPL ratio thus deteriorated to 11.1% in Q1’2019, from 10.9% in Q1’2018. Management attributed the deterioration in asset quality to players in the manufacturing sector, agriculture and trade sectors. General Loan Loss Provisions increased by 37.6% to Kshs 10.9 bn, from Kshs 7.9 bn in Q1’2018. Thus, the NPL coverage improved to 52.2% in Q1’2019 from 30.6% in Q1’2018,
- Shareholders’ funds increased by 7.1% to Kshs 72.8 bn in Q1’2019 from Kshs 67.9 bn in Q1’2018, supported by a 4.7% increase in the retained earnings to Kshs 58.5 bn, from Kshs 55.9 bn, and the increase in the statutory loan loss reserve to Kshs 0.9 bn from a zero balance in Q1’2018,
- 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 15.9%, exceeding the statutory requirement of 14.5% by 1.4% points. Adjusting for IFRS 9, the core capital to risk weighted assets stood at 16.1%, while total capital to risk-weighted assets came in at 16.5%, and,
- The bank currently has a Return on Average Assets (ROaA) of 3.2%, and a Return on Average Equity (ROaE) of 18.3%.

Key Take-Outs:

1. The bank’s asset quality deteriorated, with the NPL ratio deteriorating to 11.1%, from 10.9% in Q1’2018. The main sectors that contributed to the NPLs were manufacturing, agriculture, trade, and building & construction, which contributed 46.0%, 20.0%, 23.0% and 19.0% 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 NPLs. This consequently affected the associated interest income. Furthermore, the bank shifted its focus to government security investments, which recoded a 33.1% growth y/y. The increase however failed to mitigate declines in funded income, largely due to the decline in yields on government securities, and,
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 5.6% increase in the number of agency banking transactions to 11.3 mn from 10.7mn in Q1’2018, which lead to an 8.7% increase in revenue to 125.0 mn from 115.0 mn. The bank’s mobile banking platform recorded a 25.0% increase in the number of transactions to 10.0 mn from 8.0 mn, and as a consequence, commission income increased by 98.9% to Kshs 744.0 mn, from Kshs 374.0 mn in Q1’2018.

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	Q1'2018	Q1'2019	y/y change	Q1'2019e	Projected %y/y change	Variance in Growth Actual vs. Expected
Government Securities	78.08	103.93	33.1%	81.2	4.0%	29.1%
Net Loans and Advances	252.8	251.6	(0.5%)	253.7	0.3%	(0.8%)
Total Assets	**397.8**	**425.7**	**7.0%**	**424.6**	**6.7%**	**0.3%**
Customer Deposits	295.9	317.8	7.4%	313.8	6.0%	1.4%
Total Liabilities	**329.1**	**351.5**	**6.8%**	**349.9**	**6.3%**	**0.5%**
Shareholder's Funds	**67.9**	**72.8**	**7.1%**	**73.3**	**7.9%**	**(0.8%)**

Balance Sheet Ratios	Q1'2018	Q1'2019	y/y change
Loan to Deposit Ratio	85.4%	79.2%	(6.3%)
Return on average equity	17.6%	18.3%	0.7%
Return on average assets	3.0%	3.2%	0.2%

Income Statement	Q1'2018	Q1'2019	y/y change	Q1'2019e	Projected %y/y change	Variance in Growth Actual vs. Expected
Net Interest Income	7.4	6.9	(6.5%)	7.3	(1.8%)	(4.7%)
Non-Interest Income	3.5	4.2	19.1%	4.0	14.8%	4.3%
Total Operating income	10.9	11.1	1.7%	11.3	3.5%	(1.8%)
Loan Loss provision	(0.8)	(0.5)	(34.3%)	(0.7)	(1.9%)	(32.4%)
Total Operating expenses	(6.1)	(6.0)	(1.2%)	(6.5)	7.1%	(8.4%)
Profit before tax	4.9	5.1	4.4%	4.9	1.0%	3.3%
Profit after tax	**3.4**	**3.6**	**4.4%**	**3.5**	**0.5%**	**3.9%**
Earnings per share	**0.6**	**0.61**	**4.4%**	**0.59**	**0.5%**	**3.9%**

Income Statement Ratios	Q1'2018	Q1'2019
Yield from interest-earning assets	12.3%	11.9%
Cost of funding	4.0%	3.7%

Net Interest Spread	8.3%	8.2%
Net Interest Income as % of operating income	67.8%	62.3%
Non-Funded Income as a % of operating income	32.2%	37.7%
Cost to Income	55.8%	54.2%
Cost to Assets	1.5%	1.4%

Capital Adequacy Ratios	Q1'2018	Q1'2019
Core Capital/Total deposit Liabilities	19.5%	19.0%
Minimum Statutory ratio	10.5%	10.5%
Excess	**9.0%**	**8.5%**
Core Capital/Total Risk Weighted Assets	16.3%	15.6%
Minimum Statutory ratio	10.5%	10.5%
Excess	**5.8%**	**5.1%**
Total Capital/Total Risk Weighted Assets	16.4%	15.9%
Minimum Statutory ratio	14.5%	14.5%
Excess	**1.9%**	**1.4%**
Liquidity Ratio	38.7%	45.2%
Minimum Statutory ratio	20.0%	20.0%
Excess	**18.7%**	**25.2%**
Adjusted Core Capital/Total Risk Weighted Assets		16.1%
Adjusted Core Capital/Total Risk Weighted Assets		16.5%