Co-operative Bank Kenya – FY’2018

21st March, 2019

Valuation Summary

- We are of the view that Co-operative Bank of Kenya is a “***buy***” with a target price of Kshs 19.9, representing an upside of 36.6%, from the current price of Kshs 15.3 as of 21st March 2019, inclusive of a dividend yield of 6.5%,
- Co-operative Bank of Kenya is currently trading at a P/TBV of 1.3x and a P/E of 7.1x vs an industry average of 1.5x and 7.0x, respectively.

Key Highlights FY’2018

- Co-operative Bank obtained financing of a USD 150.0 mn, 7-year senior loan from the IFC, which will mainly be used for onwards lending to SMEs. The loan from IFC was received in two tranches of USD 75.0 mn each, one in June 2018 and the other in February 2019;
- Co-operative Bank entered into a transaction to inject Kshs 200.0 mn share capital in the government's mortgage company, Kenya Mortgage Refinance Company, to support long term financing for affordable housing;

Income Statement

- Core earnings per share increased by 11.6% to Kshs 2.2 from Kshs 1.9 in FY’2017, in line with our projections. The performance was driven by a 5.0% increase in total operating income, which outpaced the 1.4% increase in total operating expenses,
- Total operating income increased by 5.0% to Kshs 43.7 bn from Kshs 41.6 bn in FY’2017. This was due to a 9.5% increase in Net Interest Income (NII) to Kshs 30.8 bn from Kshs 28.1 bn in FY’2017, which outweighed the 4.4% decline in Non-Funded Income (NFI) to Kshs 12.9 bn from Kshs 13.5 bn in FY’2017,
- Interest income increased by 6.6% to Kshs 43.0 bn, from Kshs 40.4 bn in FY’2017. This was driven by a 19.2% growth in interest income from government securities to Kshs 9.8 bn from Kshs 8.2 bn in FY’2017, a 3.1% increase in interest income from loans to Kshs 33.0 bn from Kshs 31.9 bn, and a 32.8% increase in interest income on placement assets to Kshs 0.3 bn, from Kshs 0.2 bn in FY’2017. Consequently, the yield on interest-earning assets rose albeit marginally to 12.7% from 12.65% in FY’2017,
- Interest expenses declined marginally by 0.2% to Kshs 12.2 bn from Kshs 12.3 bn in FY’2017, following a 40.8% decrease in the interest expense on placement liabilities to Kshs 0.1 bn from Kshs 0.2 bn in FY’2017. The decline in interest expense was however weighed down by the 1.6% increase in other interest expenses to Kshs 1.22 bn, from Kshs 1.20 bn in FY’2017, and the 0.4% increase in interest expense on customer deposits to Kshs 10.9 bn from Kshs 10.85 bn in FY’2017. Consequently, the cost of funds declined to 3.8% from 4.1% in FY’2017. Thus, the Net Interest Margin (NIM) improved to 9.5%, from 8.8% in FY’2017,
- Non-Funded Income (NFI) declined by 4.4% to Kshs 12.9 bn, from Kshs 13.5 bn in FY’2017. The decline was mainly caused by the 77.8% decline in fees and commissions on loans to Kshs 0.6 bn from Kshs 2.6 bn in FY’2017, which management attributed to the implementation of the Effective Interest Rate (EIR) model under IFRS 9, which requires banks to amortize the fees and commissions on loans, throughout the tenor of a loan. The decline in NFI was also caused by the 24.5% decline in other income, to Kshs 1.1 bn from Kshs 1.5 bn in FY’2017, which management attributed to reduced recoveries in 2018, compared to 2017. The decline in NFI was however mitigated by the 23.9% increase in other fees and commissions to Kshs 8.9 bn from Kshs 7.2 bn in FY’2017, attributable to increased transactional revenue from agency banking, and the digital channels, coupled with the 2.4% increase in forex trading income to Kshs 2.3 bn from Kshs 2.2 bn in FY’2017. The revenue mix shifted to 70:30 funded to non-funded income, from 68:22, owing to the decline in NFI coupled with the growth in NII,

- Total operating expenses rose by 1.4% to Kshs 25.7 bn from Kshs 25.3 bn in FY'2017, largely driven by a 13.4% increase in staff costs to Kshs 11.4 bn in FY'2018, from Kshs 10.1 bn in FY'2017, which management attributed to new specialized hires in data & big data analytics, machine learning and artificial intelligence from major IT firms such as IBM coupled with the 6.7% increase in other operating expenses to Kshs 12.4 bn in FY'2018, from Kshs 11.6 bn in FY'2017. The increase in total operating expenses was however mitigated by the 48.9% decline in Loan Loss Provisions (LLP) to Kshs 1.8 bn from Kshs 3.6 bn in FY'2017,
- The Cost to Income Ratio (CIR) improved to 58.8%, from 60.9% in FY'2017. However, without LLP, the cost to income ratio deteriorated to 54.6%, from 52.2% in FY'2017, highlighting the significant decline in the cost of risk to 4.2% from 8.7% in FY'2017,
- Profit before tax increased by 10.7% to Kshs 18.2 bn, up from Kshs 16.4 bn in FY'2017. Profit after tax grew by 11.6% to Kshs 12.7 bn in FY'2018, from Kshs 11.4 bn in FY'2017, with the difference in growth attributable to the decline in the effective tax rate to 29.9% from 31.3% in FY'2017,
- The bank recommends a first and final dividend of Kshs 1.0 per share, a 25.0% increase from the Kshs 0.8 paid in FY'2017, which translates to a dividend yield of 6.5%, and a payout ratio of 46.1%.

Balance Sheet

- The balance sheet recorded an expansion as total assets increased by 6.9% to Kshs 413.4 bn from Kshs 386.9 bn in FY'2017. This growth was largely driven by a 10.4% increase in government securities to Kshs 80.3 bn from Kshs 72.7 bn in FY'2017, coupled with a 53.0% increase in other assets to Kshs 25.5 bn from Kshs 16.7 bn in FY'2017,
- However, the loan book contracted by 3.3% to Kshs 245.4 bn from Kshs 253.9 bn in FY'2017, which management attributed to a repayment of approximately Kshs 8.0 bn by a single client in the real estate sector,
- Total liabilities rose by 8.1% to Kshs 342.2 bn from Kshs 316.6 bn in FY'2017, driven by a 6.5% increase in customer deposits to Kshs 306.1 bn from Kshs 287.4 bn in FY'2017, coupled with the 13.2% growth in borrowings to Kshs 24.0 bn from Kshs 21.2 bn in FY'2017, as management highlighted that the bank drew Kshs 7.5 bn from the IMF facility of Kshs 15.0 bn in June 2018. The growth was however weighed down by the 89.8% decline in placement liabilities to Kshs 0.4 bn from Kshs 4.4 bn in FY'2017. Deposits per branch increased by 6.5% to Kshs 2.0 bn from Kshs 1.9 bn in FY'2017, as the number of branches remained the same at 155,
- The faster growth in deposits as compared to the decline in loans led to a decline in the loan to deposit ratio to 80.2% from 88.3% in FY'2017,
- Gross Non-Performing Loans (NPLs) increased by 56.7% to Kshs 29.4 bn in FY'2018 from Kshs 18.8 bn in FY'2017. The NPL ratio thus deteriorated to 11.3% in FY'2018 from 7.2% in FY'2017. General Loan Loss Provisions increased by 63.0% to Kshs 9.9 bn from Kshs 6.1 bn in FY'2017. Thus, the NPL coverage improved to 48.1% in FY'2018 from 37.6% in FY'2017,
- Shareholders' funds increased marginally by 0.4% to Kshs 69.9 bn in FY'2018 from Kshs 48.4 bn in FY'2017, as the 41.0% increase in the statutory loan loss reserve to Kshs 1.0 bn, from Kshs 0.7 bn in FY'2017, was weighed down by the 2.4% decline in the retained earnings to Kshs 54.0 bn from Kshs 55.3 bn in FY'2017,
- Co-operative Bank remains sufficiently capitalized with a core capital to risk-weighted assets ratio of 16.0%, 5.5% above the statutory requirement. In addition, the total capital to risk-weighted assets ratio was 16.4%, exceeding the statutory requirement by 1.9%. Adjusting for IFRS 9, the core capital to risk weighted assets stood at 16.8%, while total capital to risk-weighted assets came in at 17.2%,
- The bank currently has a Return on Average Assets (ROaA) of 3.3%, and a Return on Average Equity (ROaE) of 18.3%.

Key Take-Outs:

1. The bank’s asset quality deteriorated significantly, with the NPL ratio deteriorating to 11.3% from 7.2% in FY’2017, as the gross NPLs rose by 56.7%. According to management, the deterioration was largely due to major clients in the manufacturing, trade and real estate sectors. According to management, the increase in NPLs was mitigated by a repayment of a Kshs 10.4 bn loan, which was almost non-performing, which highlights the relatively tougher operating environment of 2018,
2. The bank’s Non-Funded Income shrunk by 4.4% y/y, with the decline attributed to the significant 77.8% decline in fees and commissions on loans. This, as earlier highlighted was largely due to the implementation of the EIR model under IFRS 9, which requires the amortization of the fees over the tenor of the loan. However, the bank’s alternative channels aided in NFI generation via transactional revenue, as alternative channels contributed to more than 88.0% of all transactions. With the banks NFI contribution to total income currently at 29.5%, this has shifted to below the current industry average of 33.8%, highlighting the existence of a growth head room for the bank in this segment, and,
3. The bank’s efficiency reduced as the CIR deteriorated to 54.6%, from 52.2% in FY’2017, which was mainly driven by the steep 13.4% increase in staff costs, coupled with the 6.7% increase in other operating expenses, which management attributed to increased hires especially in data analytics, machine learning and artificial intelligence, coupled with the payment of specialized licenses for the digital software and technology. Management advised that the bank would begin to reap the benefits of the digital investments from June 2019.

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

i. **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,

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 MCo-op 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	FY'2017	FY'2018	y/y change	FY'2018e	Projected %y/y change	Variance in Growth Actual vs. Expected
Government Securities	72.68	80.27	10.4%	83.2	14.5%	(4.1%)
Net Loans and Advances	253.9	245.4	(3.3%)	251.7	(0.8%)	(2.5%)
Total Assets	**386.9**	**413.4**	**6.9%**	**409.0**	**5.7%**	**1.1%**
Customer Deposits	287.4	306.1	6.5%	303.5	5.6%	0.9%
Total Liabilities	**316.6**	**342.2**	**8.1%**	**340.1**	**7.4%**	**0.7%**
Shareholders Funds	**69.6**	**69.9**	**0.4%**	**68.1**	**(2.0%)**	**2.5%**

Balance Sheet Ratios	FY'2017	FY'2018	y/y change
Loan to Deposit Ratio	88.3%	80.2%	(8.2%)
Return on average equity	17.4%	18.3%	0.8%
Return on average assets	3.1%	3.3%	0.2%

Income Statement	FY'2017	FY'2018	y/y change	FY'2018e	Projected %y/y change	Variance in Growth Actual vs. Expected
Net Interest Income	28.1	30.8	9.5%	28.0	(0.5%)	10.1%
Non-Interest Income	13.5	12.9	(4.4%)	13.4	(0.9%)	(3.5%)
Total Operating income	**41.6**	**43.7**	**5.0%**	**41.3**	**(0.7%)**	**5.7%**
Loan Loss provision	(3.6)	(1.8)	(48.9%)	(1.8)	(50.9%)	2.0%
Total Operating expenses	(25.3)	(25.7)	1.4%	(23.4)	(7.7%)	9.1%
Profit before tax	16.4	18.2	10.7%	18.0	10.0%	0.7%
Profit after tax	**11.4**	**12.7**	**11.6%**	**12.6**	**10.7%**	**0.9%**
Earnings per share	**1.9**	**2.17**	**11.6%**	**2.15**	**10.7%**	**0.9%**

Income Statement Ratios	FY'2017	FY'2018
Yield from interest-earning assets	12.7%	12.7%
Cost of funding	4.1%	3.8%
Net Interest Spread	8.5%	8.9%
Net Interest Income as % of operating income	67.6%	70.5%
Non-Funded Income as a % of operating income	32.4%	29.5%
Cost to Income	60.9%	58.8%
Cost to Assets	6.5%	6.2%

Capital Adequacy Ratios	FY'2017	FY'2018
Core Capital/Total deposit Liabilities	20.00%	19.30%
Minimum Statutory ratio	10.50%	10.50%
Excess	**9.50%**	**8.80%**
Core Capital/Total Risk Weighted Assets	15.80%	16.00%
Minimum Statutory ratio	10.50%	10.50%
Excess	**5.30%**	**5.50%**
Total Capital/Total Risk Weighted Assets	22.00%	16.40%
Minimum Statutory ratio	14.50%	14.50%
Excess	**7.50%**	**1.90%**
Liquidity Ratio	33.80%	41.10%
Minimum Statutory ratio	20.00%	20.00%
Excess	**13.80%**	**21.10%**
Adjusted Core Capital/Total Risk Weighted Assets		16.80%
Adjusted Core Capital/Total Risk Weighted Assets		17.20%