

Valuation Summary

- We recommend an Accumulate for the Co-op Bank stock with a target price of Kshs 16.0 representing an upside of 18.9%, from the current price of Kshs 14.1, inclusive of a dividend yield of 5.4%
- Co-op Bank is currently trading at a P/B of 1.2x and a P/E of 5.5x, vs an industry average of 1.3x and 6.2x, respectively.

Key highlights during H1'2016

- Co-op Bank successfully completed its Branch Transformation Phase I, and embarked on Phase II focusing on sales optimization, part of the key agendas for the Transformation Program dubbed the Soaring Eagle Transformation Programme
- Co-op Bank has continued to leverage on its partnerships with DFIs and has since secured long-term debt of over US\$ 337.39 mn from the developmental partners.

Income Statement

- Core earnings per share grew by 18.7% to Kshs 1.5 from Kshs 1.3 in H1'2015, against our projection of Kshs 1.4. The growth in EPS was driven by a 20.1% growth in total operating revenue to Kshs 21.3 bn despite a 21.0% increase in total operating expenses Kshs 11.0 bn
- Total operating revenue grew by 20.1% to Kshs 21.3 bn from Kshs 17.7 bn in H1'2015 driven by net interest income growth of 22.8% to Kshs 14.5 bn from Kshs 11.8 bn in H1'2015, supported by a 28.7% growth in interest income, despite a faster interest expense growing by 42.8% to Kshs 21.5 bn from Kshs 16.7 bn in H1'2015. Net interest margin improved to 9.1% from 8.8% in H1'2015
- Non-interest income grew by 14.7% to Kshs. 6.8 bn, from Kshs 6.0 bn in H1'2015, supported by the bank's continued focus on alternative distribution channels. Other income increased by 288.1% to Kshs 845.4 mn as the subsidiary business registered improved performance. The current revenue mix stands at 67.9% Funded to 32.1% Non-Funded Income
- Total operating expenses grew by 21.0% to Kshs 11.0 bn from Kshs 9.1 bn on account of a 96.4% rise in loan loss provision (LLP) to Kshs 1.3 bn from Kshs 0.7 bn in H1'2015 attributed to delayed payments by clients in real estate sector. Excluding LLP, operating expenses grew by 15.0% to Kshs 9.7 bn from Kshs 8.4 bn in H1'2015. Cost to income ratio remained flat at 51.4% from 51.1% in H1'2015
- PAT growth came in at 18.7% to Kshs 7.4 bn from Kshs 6.2 bn in H1'2015.

Balance Sheet

- Total assets grew by 11.7% to Kshs 363.0 bn from Kshs 325.1 bn in HY'2015 supported by a 46.9% growth in allocation to government securities which stood at Kshs 81.1 bn from Kshs 55.2 bn to take advantage of yields on account of slow growth in loans
- Loan and advances grew by 8.0% to Kshs 221.3 bn from Kshs 204.8 bn in H1'2015 with the Bank slowing down its lending as it streamlines its non-performing book
- Customer deposits grew by 12.0% to Kshs 278.3 bn from Kshs 248.3 bn in H1'2015 on the back of increased focus on mobilization of deposits and also benefiting from flight to safety after closure of Chase Bank in Q2'2016, faster than our estimates of a 10.0% growth. Loans to deposit ratio came in at 79.5% from 82.5% in H1'2015, falling below the industry average of 82.5%
- Total liabilities increased by 9.9% to Kshs 305.4 bn from Kshs 277.8 bn in H1'2015 with borrowings decreasing by 20.8% to Kshs 14.8 bn from Kshs 18.7 bn in H1'2015
- Gross NPL ratio stood at 4.5% from 4.2% in H1'2015, with the bank attributing it to delayed payments by clients in real estate sector
- Yield from interest earning assets increased to 14.2% from 12.8% in H1'2015, while cost of funds increased to 5.5% from 3.8% in H1'2015 supported by the high lending rates and high cost of deposits, respectively. Net interest margin improved to 9.1% from 8.8% in H1'2015

- Co-op Bank is currently sufficiently capitalized with core capital to risk weighted assets ratio at 15.2%, 4.7% above the statutory requirement
- Co-op Bank currently operates at an RoA and RoE of 3.7% and 24.5%, up from 3.2% and 21.9% in H1'2015.

Key Take outs:

- a) Co-op Bank performance was above expectations, with strong top line growth, above our estimates
- b) Despite the tough economic environment in South Sudan, Co-op bank subsidiary reported Kshs 29.2 mn in H1'2016, leveraging on the unique partnership with Government of South Sudan which focuses more on government institutions and government employees
- c) However, cost containment remains a key challenge, with the cost to income ratio remaining above 50% barely 1 year after the bank hired McKinsey to restructure its operations. We expect the bank to continue implementing its key transformation steps, including automation and use of alternative channels to support future growth.

Below is a summary of the key line items in the balance sheet and income statement

Figures in Kshs billions unless otherwise stated

Balance Sheet Items	H1'2015	H1' 2016	y/y change	H1' 2016E	Projected %y/y change	Variance in Growth Actual vs. Expected
Government Securities	55.2	81.1	46.9%	35.8	(35.3%)	82.1%
Net Loans and Advances	204.8	221.3	8.0%	220.5	7.6%	0.4%
Total Assets	325.1	363.0	11.7%	364.4	12.1%	(0.4%)
Customer Deposits	248.3	278.3	12.0%	272.2	9.6%	2.4%
Total Liabilities	277.8	305.4	9.9%	306.5	10.3%	(0.4%)
Shareholders Funds	47.1	57.9	23.0%	58.5	24.3%	(1.2%)

Income Statement	H1'2015	H1' 2016	y/y change	H1' 2016E	Projected %y/y change	Variance in Growth Actual vs. Expected
Net Interest Income	11.8	14.5	22.8%	12.0	2.0%	20.9%
Non-Interest Income	6.0	6.8	14.7%	7.1	18.8%	(4.1%)
Total Operating income	17.7	21.3	20.1%	19.1	7.6%	12.5%
Loan Loss provision	(0.7)	(1.3)	96.4%	(0.7)	11.6%	84.8%
Total Operating expenses	(9.1)	(11.0)	21.0%	(9.6)	6.1%	14.9%
Profit before tax	8.8	10.4	19.3%	9.5	8.4%	10.9%
Profit after tax	6.2	7.4	18.7%	6.6	6.4%	12.3%
Earnings per share	1.3	1.5	18.8%	1.4	6.3%	12.5%

Ratios	H1'2015	H1'2016
Loan to Deposit ratio	82.5%	79.5%
Return on average equity	21.9%	24.5%
Return on average assets	3.2%	3.7%
Cost of funding	3.8%	5.5%
Yield from interest-earning assets	12.8%	14.2%
Net Interest Margin	8.8%	9.1%
Cost to Income Ratio	51.1%	51.4%