

Valuation Summary

- We recommend an Accumulate for the Co-operative Bank stock with a target price of Kshs 15.2 representing an upside of 15.5%, from the current price of Kshs 13.9, as at 17th November, inclusive of a dividend yield of 5.7%
- Co-operative Bank is currently trading at a P/B of 1.2x and a P/E of 5.4x, vs an industry average of 1.0x and 5.2x, respectively.

Key highlights during Q3'2016

- Co-operative Bank embarked on the 2nd Phase of 'The Soaring Eagle Transformation Agenda' in August, focusing on 4 major Pillars namely, (i) Deposits growth, (ii) Loan book growth, (iii) Pro-active Retention (PAR), and (iv) grow product holding to 3.5 per customer.

Income Statement

- Core earnings per share grew by 22.3% to Kshs 2.2 from Kshs 1.8 in Q3'2015, driven by a 21.2% growth in total operating revenue, which outpaced a 17.6% growth in total operating expenses
- Total operating revenue grew by 21.2% to Kshs 32.3 bn from Kshs 26.6 bn in Q3'2015, faster than our estimate of 9.0% growth. This was supported by 28.9% growth in Net Interest Income and a 6.8% increase in Non Funded Income
- Interest Income grew by 22.5% to Kshs 32.3 bn from Kshs 26.0 bn in Q3'2015, faster than the 15.8% growth in Interest expense to Kshs 9.9 bn from Kshs 8.6 bn in Q3'2015. This led to an improvement in the Net Interest Margin to 9.7% from 9.4% in Q3'2015
- Non-Funded Income (NFI) recorded a growth of 6.8% to Kshs 9.9 bn from Kshs 9.3 bn in Q3'2015, below our expectation of a 12.9% increase. The growth in NFI was driven by an increase in other fees and commissions that rose by 14.3% to Kshs 6.1 bn from Kshs 5.3 bn. However, forex income was a drag on NFI, declining 19.2% to Kshs 1.4 bn from Kshs 1.7 bn in Q3'2015. The current revenue mix stands at 69:31 Funded to Non-Funded Income from 65:35 in Q3'2015
- Total operating expenses grew by 17.6% to Kshs 17.2 bn from Kshs 14.6 bn in Q3'2015 following a 16.1% y/y growth in staff costs to Kshs 6.7 bn from Kshs 5.8 bn. Loan loss provisions (LLP) rose 28.0% to Kshs 2.0 bn from Kshs 1.5 bn in Q3'2015, on account of an increase of 14.3% y/y in gross non-performing loans (NPL) to Kshs 10.0 bn from Kshs 8.7 bn. The NPL to total loans ratio thus increased to 4.4% from 4.1% in Q3'2015
- Cost to income ratio improved to 53.1% from 54.8% in Q3'2015. Without LLP, cost to income ratio stood at 47.1% from 49.0% in the same period last year
- Profit after tax increased by 22.3% to Kshs 10.5 bn from Kshs 8.6 bn in Q3'2015.

Balance Sheet

- The balance sheet recorded an expansion in Q3'2016, with total assets increasing by 6.4% to Kshs 354.0 bn from Kshs 332.9 bn in Q3'2015. This growth was driven by a growth in the loan book by 6.9% y/y to Kshs 227.1 bn from Kshs 212.4 bn in Q3'2015, in line with our expectations of a 6.5% growth. This was supported by increased use of alternative channels to drive loan disbursement, with 85% of Co-operative Banks' total transactions year to date facilitated via alternative channels
- Total liabilities increased by 4.3% to Kshs 295.2 bn from Kshs 283.2 bn in Q3'2015, slower than our projections of a 7.2% increase, while shareholders' funds increased by 19.5% y/y to Kshs 59.2 bn from Kshs 49.5 bn
- Customer deposits increased by 1.7% to Kshs 257.8 bn from Kshs 253.5 bn in Q3'2015, driven by an increase in the number of bank account holders, currently at 6.1 mn. The loan to deposit ratio thus rose to 88.1% from 83.8% in Q3'2015, with Co-operative bank able to leverage on long-term funds from Development Partners to loan out despite the slow growth in deposits
- The yield on interest earning assets increased to 14.9% from 13.7% in Q3'2015 with the cost of funds rising to 5.3% from 4.3% in Q3'2015
- Co-operative Bank is currently sufficiently capitalized with a core capital to risk weighted assets ratio at 15.7%, 5.2% above the statutory requirement, with total capital to total risk weighted assets exceeding statutory requirement by 7.7%. Co-operative bank announced that they do not expect to raise capital from shareholders in 2017
- Co-operative Bank currently has a ROaA of 4.0% and a ROaE of 25.1%

Key Take outs:

- Co-operative Bank's performance was above expectations, with strong top line growth, above our estimates, and cost containment initiatives
- Despite the tough economic environment in South Sudan, Co-op bank subsidiary reported a profit of Kshs 45.1 mn in Q3'2016, leveraging on the unique partnership with Government of South Sudan which focuses more on government institutions and Non-Government Organisations
- The bank has witnessed an increase in loan applications and volume post enactment of the Banking Act Amendment Bill 2015 that capped interest rates on loans and set a floor on deposit pricing. This drove an increase in the bank's loan book by close to Kshs 7 bn
- We expect the bank to continue implementing its key transformation steps, including operational efficiencies, 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	Q3'2015	FY'2015	Q3'2016	y/y change	Q3'2016e	Projected %y/y change	Variance in Growth Actual vs. Expected
Government Securities	42.2	64.9	70.7	67.3%	36.7	(48.1%)	115.4%
Net Loans and Advances	212.4	208.6	227.1	6.9%	226.1	(0.4%)	7.3%
Total Assets	332.9	342.5	354.0	6.4%	376.0	6.2%	0.2%
Customer Deposits	253.5	265.4	257.8	1.7%	289.4	12.3%	(10.6%)
Total Liabilities	283.1	292.7	295.2	4.3%	316.6	7.2%	(3.0%)
Shareholders' Funds	49.5	50.2	59.2	19.5%	59.9	1.3%	18.2%

Balance Sheet Ratios	Q3'2015	Q3'2016	%y/y change
Loan to Deposit Ratio	83.8%	88.1%	4.3%
Return on average equity	22.6%	25.1%	2.5%
Return on average assets	3.4%	4.0%	0.5%

Income Statement	Q3'2015	FY'2015	Q3'2016	%y/y change	Q3'2016e	Projected %y/y change	Variance in Growth Actual vs. Expected
Net Interest Income	17.4	23.2	22.4	28.9%	18.6	6.9%	22.1%
Net non-Interest Income	9.2	13.2	9.9	6.8%	10.4	12.9%	(6.1%)
Total Operating income	26.6	36.4	32.3	21.2%	29.0	9.0%	12.3%
Loan Loss provision	1.5	2.0	1.9	28.0%	1.8	15.4%	12.6%
Total Operating expenses	14.6	21.4	17.2	17.6%	15.6	6.9%	10.7%
Profit before tax	12.2	15.4	15.2	25.2%	13.4	10.4%	14.7%
Profit after tax	8.6	11.7	10.5	22.3%	9.4	9.1%	13.2%

Income Statement Ratios	Q3'2015	Q3'2016	%y/y change
Yield from interest-earning assets	13.7%	14.9%	1.2%
Cost of funding	4.3%	5.3%	1.0%
Net Interest Spread	9.4%	9.6%	0.2%
Net Interest Margin	65.3%	69.4%	4.1%
Cost of Risk	34.7%	30.6%	(4.1%)
Net Interest Income as % of operating income	49.0%	47.1%	(1.9%)
Non-Funded Income as a % of operating income	4.4%	4.8%	0.5%
Cost to Income Ratio	13.7%	14.9%	1.2%
Cost to Assets	4.3%	5.3%	1.0%

Capital Adequacy Ratios	Q3'2015	Q3'2016
Core Capital/Total Liabilities	16.4%	18.70%
Minimum Statutory ratio	8.00%	8.00%
Excess	8.40%	10.70%
Core Capital/Total Risk Weighted Assets	14.20%	15.70%
Minimum Statutory ratio	10.50%	10.50%
Excess	3.70%	5.20%
Total Capital/Total Risk Weighted Assets	20.50%	22.20%
Minimum Statutory ratio	14.50%	14.50%
Excess	6.00%	7.70%
Liquidity Ratio	32.90%	38.30%
Minimum Statutory ratio	20.00%	20.00%
Excess	12.90%	18.30%