

## Valuation Summary

- We recommend a sell on Co-operative stock with a target price of Kshs. 18.0 representing a downside of 10.3%, with a dividend yield of 3.8% from the current price of Kshs 21.0
- Co-operative bank is trading at a P/B of 2.1x and a P/E of 8.8x

## Key highlights during the year 2015:

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- In 2014, Co-operative bank embarked on an ambitious Business Transformation Agenda called the Soaring Eagle, in order to sustain and put the bank on a new trajectory for growth. Key milestones of the project include;
  - Increased product sales performance by 40% resulting into customers with only one bank account reducing to 70% from 75%
  - Reduction in operating expenses by 4%, despite growth in asset base of the bank by 22%
  - Increased alternative channels transactions to 75% up from 68% in 2014. The number of cash loans disbursed through MCo-op cash increased by 544.4% to 183,000 with the value rising by 639% to Kshs 1.6 bn, resulting in an average loan transaction of Kshs 9,100
  - Customer queue time has reduced drastically by up to 74% in the transformed branches, which now stand at 80 branches, the remaining 60 branches to be transformed by July 2016
- Co-operative Bank of Kenya has partnered with digital money transfer provider SimbaPay to offer international money transfer services, with SimbaPay being able to offer the transactions for free as it gains from the forex trades
- Co-operative Bank of Kenya received USD 105 mn (Kshs 10.7 bn), in a 7-year long term financing from the International Finance Corporation, which will be used towards advancing loans to small and medium enterprises, construction and mortgage segments
- In terms of regional operations, Co-operative Bank currently operates 4 branches in Juba, up from 3 in the half year, and 4 non-oil collection centers. The subsidiaries made a profit before tax of Kshs 849.7 mn in 2015, despite translation losses from the devaluation of the South Sudan Pound of Kshs 1.9 bn. Its latest branch took just 2 weeks to breakeven

## Earnings Update:

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### Income Statement:

- **FY'2015 EPS growth came in higher than our estimate;** 36.7% y/y compared to our projection of 32.3% growth. Adjusted PAT growth, after stripping off the one off cost from early retirement of staff of Kshs 1.3 bn, the

EPS growth came in at 25.1% y/y from Kshs 1.85 in FY'2014 to Kshs 2.31 in FY'2015.

- Operating revenue increased 13.4% y/y to Kshs 36.4 bn from Kshs 32.1 bn in 2014, outpacing operating expenses growth which rose by 6.4% y/y to Kshs 21.4 bn from Kshs 20.1 bn in 2014, leading to a decline in the cost to income ratio to 53.2% from 59.0% in 2014. Growth in operating income was driven by a 9.1% y/y increase in net interest income to Kshs 23.2 bn from Kshs 21.3 bn in FY'2014, and non-funded income that rose 22.0% to Kshs 13.2 bn from Kshs 10.8 bn in FY'2014. The higher growth in non-funded income was due to a 125.3% increase in forex income to Kshs 3.2 bn, resulting into a revenue mix to stand at 63.8%:36.2% funded to non-funded income, respectively.
- Net interest income rose 9.1% y/y to Kshs 23.2 bn. This was below our forecasted growth of 12.3% y/y. Non funded income rose by 22% to Kshs 13.2 bn vs our projection of a 9.7% y/y increase.
- Interest income recorded a growth of 25.3% y/y to Kshs 36.8 bn from Kshs 29.4 bn, while interest expense accelerated by 68.2% y/y to Kshs 13.6 bn from Kshs 8.1 bn in FY'2014. The high increase in interest expense was as a result of the high interest rate environment that prevailed towards the end of 2015, and given that the bank's funding is predominantly institutions with fixed deposit accounts at 33% of their portfolio, the bank suffered higher interest payments on these deposits
- Total operating expenses rose by 6.4% y/y to Kshs 21.4 bn. We had anticipated a 3.1% increase to Kshs 20.7 bn on account of a decline in staff costs. Staff costs rose 5.8% y/y to Kshs 8.9 bn from Kshs 8.4 bn in FY'2014, owing to the bank changing the way it expensed staff bonuses to the year in which they were earned, as opposed to the subsequent year. This led to the bank expensing both 2014 and 2015-year staff bonuses in the current year. Loan loss provisions rose 71.8% y/y to Kshs 2.0 bn from Kshs 1.2 bn in FY'2014, lower than our projection of an 83.4% increase to Kshs 2.2 bn

### **Balance Sheet:**

- **FY'2015 Balance Sheet growth remained robust:** Co-operative Bank reported 21.9% y/y increase in customer deposits to Kshs 265.4 bn. This was higher than our projection for a 17.6% growth. Bucking the trend of banks that have reported so far, deposit growth outpaced loan growth, with loans rising 16.2% y/y to Kshs 208.6 bn from Kshs 179.5 bn in FY'2014. This resulted in a decline in the Loan to Deposit ratio to 78.6% from 82.4%.
- Non-performing loans rose a marginal 2.6% to Kshs 8.2 bn, from Kshs 8.0 bn. Following the faster increase in loans at 16.2%, this led to a reduction in NPL to total loans ratio to 3.9% from 4.4% in FY'2014
- The yield from the bank's interest earning assets stood at 14.0%, while the cost of funds came in at 5.2%, resulting in a net interest margin of 8.8%
- The bank's ROaA was at 3.7% while the ROaE came in at 25.0%

- The management recommends a dividend per share of Kshs 0.8, a payout of 33.4% compared to 30.5% in 2014 resulting into a dividend yield of 3.8%
- The bank remains well capitalized, with total capital to risk weighted assets ratio at 22.4% in 2015 from 22.9% in 2014, 7.9% above the statutory requirement of 14.5%

### Represented below is an analysis of the Balance Sheet and Income Statement (FY'2015)

**Figure 1: Balance Sheet Analysis**

*Figures in Kshs billions unless otherwise stated*

| Balance Sheet Items    | FY 2014 | FY'2015 | y/y change | FY'2015e | Projected %y/y change | Variance in Growth Actual vs. Expected |
|------------------------|---------|---------|------------|----------|-----------------------|--|
| Government Securities  | 45.8    | 64.9    | 41.7%      | 43.5     | (5.0%)                | 46.7%                                  |
| Net Loans and Advances | 179.5   | 208.6   | 16.2%      | 212.5    | 18.4%                 | (2.2%)                                 |
| Total Assets           | 285.4   | 342.5   | 20.0%      | 349.7    | 22.5%                 | (2.5%)                                 |
| Customer Deposits      | 217.7   | 265.4   | 21.9%      | 256.1    | 17.6%                 | 4.3%                                   |
| Total Liabilities      | 242.0   | 292.7   | 21.0%      | 300.9    | 24.4%                 | (3.4%)                                 |
| Shareholders' Funds    | 43.3    | 50.2    | 15.9%      | 48.6     | 12.0%                 | 3.8%                                   |

| Balance Sheet Ratios     | FY 2014 | FY'2015 |
|--------------------------|---------|---------|
| Loan to Deposit Ratio    | 82.4%   | 78.6%   |
| Return on average equity | 19.9%   | 25.0%   |
| Return on average assets | 3.1%    | 3.7%    |

**Figure 2: Income Statement Analysis**

*Figures in Kshs billions unless otherwise stated*

| Income Statement         | FY 2014 | FY'2015 | y/y change | FY'2015e | Projected %y/y change | Variance in Growth Actual vs. Expected |
|--------------------------|---------|---------|------------|----------|-----------------------|--|
| Net Interest Income      | 21.3    | 23.2    | 9.1%       | 23.9     | 12.3%                 | (3.3%)                                 |
| Non-Interest Income      | 10.8    | 13.2    | 22.0%      | 11.9     | 9.7%                  | 12.3%                                  |
| Total Operating income   | 32.1    | 36.4    | 13.4%      | 35.8     | 11.4%                 | 2.0%                                   |
| Loan Loss provision      | (1.2)   | (2.0)   | 71.8%      | (2.2)    | 83.4%                 | (11.6%)                                |
| Total Operating expenses | (20.1)  | (21.4)  | 6.4%       | (20.7)   | 3.1%                  | 3.3%                                   |
| Profit before tax        | 10.9    | 15.4    | 40.9%      | 15.1     | 38.8%                 | 2.2%                                   |
| Profit after tax         | 8.0     | 11.7    | 46.0%      | 10.6     | 32.3%                 | 13.7%                                  |
| Earnings per share       | 1.7     | 2.3     | 36.7%      | 2.2      | 32.3%                 | 4.4%                                   |

| Income Statement Ratios                      | FY 2014 | FY'2015 |
|--|---------|---------|
| Yield from interest-earning assets           | 13.8%   | 14.0%   |
| Cost of funding                              | 3.8%    | 5.2%    |
| Net Interest Spread                          | 10.1%   | 8.8%    |
| Net Interest Income as % of operating income | 66.3%   | 63.8%   |
| Non-Funded Income as a % of operating income | 33.7%   | 36.2%   |
| Cost to Income                               | 59.0%   | 53.2%   |
| Cost to Assets                               | 7.0%    | 6.2%    |

| Capital Adequacy Ratios                 | FY'2014     | FY'2015     |
|---|-------------|-------------|
| Core Capital liabilities ratio          | 18.1%       | 17.5%       |
| Minimum Statutory requirement           | 10.5%       | 10.5%       |
| <b>Excess/Deficit</b>                   | <b>7.6%</b> | <b>7.0%</b> |
| Core Capital risk weighted assets ratio | 15.5%       | 15.7%       |
| Minimum Statutory requirement           | 10.5%       | 10.5%       |
| <b>Excess/Deficit</b>                   | <b>5.0%</b> | <b>5.2%</b> |
| Total Capital risk weighted ratio       | 22.9%       | 22.4%       |
| Minimum Statutory requirement           | 14.5%       | 14.5%       |
| <b>Excess/Deficit</b>                   | <b>8.4%</b> | <b>7.9%</b> |