Co-operative Bank of Kenya Ltd – H1'2021

20th August, 2021

Below is a summary of Co-operative Bank of Kenya Ltd H1'2021 performance:

Balance Sheet Items (Kshs bn)	H1'2020	H1'2021	y/y change
Government Securities	122.4	182.0	48.7%
Net Loans and Advances	272.2	301.2	10.7%
Total Assets	**513.9**	**573.0**	**11.5%**
Customer Deposits	384.6	407.7	6.0%
Total Liabilities	432.2	480.4	11.1%
Shareholders' Funds	**80.1**	**92.6**	**15.6%**

Balance Sheet Ratios	H1'2020	H1'2021	% points y/y change
Loan to Deposit Ratio	70.8%	73.9%	3.1%
Return on average equity	18.2%	12.7%	(5.5%)
Return on average assets	3.0%	2.0%	(1.0%)

Income Statement (Kshs bn)	H1'2020	H1'2021	y/y change
Net Interest Income	15.9	18.8	18.3%
Non-Interest Income	8.3	10.3	24.3%
Total Operating income	**24.2**	**29.2**	20.4%
Loan Loss provision	(1.9)	(4.2)	123.0%
Total Operating expenses	(14.6)	(18.7)	28.3%
Profit before tax	9.6	10.5	9.6%
Profit after tax	**7.2**	**7.4**	**2.3%**
Earnings per share (Kshs)	**1.0**	**1.1**	**2.3%**

Income Statement Ratios	H1'2020	H1'2021	% points y/y change
Yield from interest-earning assets	11.5%	11.7%	0.2%
Cost of funding	3.1%	3.2%	0.1%
Net Interest Spread	10.0%	10.1%	0.1%
Net Interest Income as % of operating income	65.7%	64.6%	(1.1%)
Non-Funded Income as a % of operating income	34.3%	35.4%	1.1%
Cost to Income	60.1%	64.1%	4.0%
CIR without provisions	52.4%	49.9%	(2.5%)
Cost to Assets	2.5%	2.5%	0.0%
Net Interest Margin	8.2%	8.6%	0.4%

Capital Adequacy Ratios	H1'2020	H1'2021
Core Capital/Total deposit Liabilities	18.2%	18.2%
Minimum Statutory ratio	8.0%	8.0%
Excess	**10.2%**	**10.2%**
Core Capital/Total Risk Weighted Assets	16.3%	15.3%
Minimum Statutory ratio	10.5%	10.5%
Excess	**5.8%**	**4.8%**
Total Capital/Total Risk Weighted Assets	16.8%	17.0%
Minimum Statutory ratio	14.5%	14.5%
Excess	**2.3%**	**2.5%**
Liquidity Ratio	54.1%	55.7%
Minimum Statutory ratio	20.0%	20.0%
Excess	**34.1%**	**35.7%**

Adjusted Core Capital/Total Risk Weighted Assets	15.9%	13.1%
Adjusted Total Capital/Total Risk Weighted Assets	16.4%	14.8%

Income Statement

- Core earnings per share increased by 2.3% to Kshs 1.1 in H1'2021, from Kshs 1.0 in H1'2020, which was not in line with our projections of a 14.9% increase to Kshs 1.2. The variance can be attributed to our expectation of a faster growth in Net Interest Income of 34.1%, compared to the actual growth of 18.3%. The performance was driven by a 20.4% increase in total operating income to Kshs 29.2 bn in H1'2021 from Kshs 24.2 bn in H1'2020, despite a faster increase of 28.3% increase in total operating expenses to Kshs 18.7 bn in H1'2021, from Kshs 14.6 bn in H1'2020,
- Total operating income rose by 20.4% to Kshs 29.2 bn in H1'2021, from Kshs 24.2 bn in H1'2020 mainly due to an 18.3% increase in Net Interest Income (NII) to Kshs 18.8 bn, from Kshs 15.9 bn in H1'2020, coupled with the growth of 24.3% in Non-Funded Income (NFI) to Kshs 10.3 bn, from Kshs 8.3 bn in H1'2020,
- Interest income rose by 19.0% to Kshs 26.0 bn in H1'2021, from Kshs 21.8 bn in H1'2020. The growth recorded was as a result of a 42.3% increase in interest income from government securities to Kshs 8.8 bn, from Kshs 6.2 bn in H1'2020, coupled with a 12.7% rise in interest income from loans and advances to Kshs 16.9 bn, from Kshs 15.0 bn in H1'2020. This growth was however weighed down by a 69.3% decline in interest income from deposits with other financial institutions to Kshs 0.2 bn in H1'2021, from Kshs 0.6 bn in H1'2020. Consequently, the yield on interest-earning assets increased to 11.7%, from 11.5% in H1'2020 due to the faster 17.7% growth in trailing interest income, which outpaced the 16.2% growth in the average interest-earning assets. Trailing Interest Income refers to the performance of the interest income for the past 12 consecutive months,
- Interest expense increased by 20.9% to Kshs 7.1 bn in H1'2021, from Kshs 5.9 bn in H1'2020, largely due to a 25.3% rise in interest expense from customer deposits to Kshs 6.4 bn, from Kshs 5.1 bn in H1'2020. This was however mitigated by a 9.1% decline in other interest expenses to Kshs 0.7 bn in H1'2021, from Kshs 0.8 bn in H1'2020. As such, cost of funds declined to 3.1%, from 3.2% in H1'2020, owing to the faster 14.4% rise in the average interest-bearing liabilities, compared to the 13.8% increase in trailing interest expense. Net Interest Margin (NIM) increased to 8.6%, from 8.2% in H1'2020, attributable to the 19.1% growth of trailing Net Interest Income (NII), which outpaced the 16.2% growth in average interest-earning assets,
- Non-Funded Income increased by 24.3% to Kshs 10.3 bn in H1'2021 from Kshs 8.3 bn in H1'2020, mainly driven by a 340.9% rise in fees and commissions from loans and advances to Kshs 2.7 bn, from Kshs 0.6 bn in H1'2020 coupled with a 336.9% increase in Other income to Kshs 1.0 bn, from Kshs 0.2 bn in H1'2021 and a 1.4% increase in foreign exchange trading income to Kshs 1.32 bn in H1'2021, from Kshs 1.31 bn in H1'2020. There was a 14.4% decrease in other fees and commissions to Kshs 5.3 bn, from Kshs 6.2 bn in H1'2020 while the Total fees and commissions increased by 17.8% overall to Kshs 8.0 bn in H1'2021, from Kshs 6.8 bn in H1'2020. As a result, the revenue mix shifted to 65:35, from 66:34 funded to non-funded income owing to the faster 24.3% growth in non-funded income compared to the 18.3% increase in net interest income,
- Total operating expenses rose by 28.3% to Kshs 18.7 bn in H1'2021, from Kshs 14.6 bn in H1'2020, largely driven by the 123.0% rise in Loan Loss Provisions (LLP) to Kshs 4.2 bn, from Kshs 1.9 bn in H1'2020. The increased provisioning levels by the lender is mainly as a result of the elevated levels of credit risk currently in the market. Notably, Staff costs however declined by 1.3% to Kshs 6.5 bn from Kshs 6.6 bn in H1'2020,
- The Cost to Income Ratio (CIR) deteriorated to 64.1%, from 60.1% in H1'2020, following the faster 28.3% rise in total operating expenses that outpaced the 20.4% rise in total operating income. Without LLP, the cost to income ratio improved to 49.9% from 52.4% in H1'2020, an indication of improving efficiency levels, and,

- The bank registered a 2.3% increase in profit after tax to Kshs 7.4 bn in H1’2021, from Kshs 7.2 bn in H1’2020. Profit before tax and exceptional items rose by 8.4% to Kshs 10.5 bn, from Kshs 9.7 bn in H1’2020, with the effective tax rate increasing to 30.0% in H1’2021, from 25.0% seen in H1’2020.

Balance Sheet

- The balance sheet recorded an expansion as total assets grew by 11.5% to Kshs 573.0 bn in H1’2021, from Kshs 513.9 bn in H1’2020, mainly attributable to the 48.7% growth in government securities to Kshs 182.0 bn, from Kshs 122.4 bn, coupled with a 10.7% growth in net loans and advances to Kshs 301.2 bn in H1’2021, from Kshs 272.2 bn in H1’2020. The increase in allocation to government securities shows the bank’s cautious lending strategy considering the deteriorating asset quality, as evidenced by the bank’s NPL ratio rising to 15.2% in H1’2021 from 11.8% in H1’2020,
- Total liabilities grew by 11.1% to Kshs 480.4 bn, from Kshs 432.2 bn in H1’2020, which was largely attributable to a 6.0% rise in customer deposits to Kshs 407.7 bn in H1’2021, from Kshs 384.6 bn in H1’2020, coupled with a 73.3% increase in borrowings to Kshs 44.4 bn, from Kshs 25.6 bn in H1’2020. The increased borrowing levels can be attributed to a Kshs 21.0 bn borrowing by Kingdom Bank majorly from the Central Bank of Kenya (CBK) to support its operations. Deposits per branch decreased by 4.8% to Kshs 2.3 bn, from Kshs 2.4 bn in H1’2020, as the number of branches increased by 18 branches to 177 from 159 branches in H1’2020,
- The faster 10.7% growth in net loans and advances compared to the 6.0% growth in deposits, led to an increase in the loan to deposit ratio to 73.9%, from 70.8% in H1’2020,
- Gross Non-Performing Loans (NPLs) increased by 48.2% to Kshs 50.8 bn in H1’2021, from Kshs 34.3 bn in H1’2020. The NPL ratio rose to 15.2% in H1’2021 from 11.8% in H1’2020, owing to the slower 14.6% growth in gross loans compared to the 48.2% growth in gross non-performing loans. The increase in the NPL ratio can also be attributed to Non-performing loans of Kshs 6.7 bn and an NPL ratio of 61.2% from the recently acquired Kingdom Bank where Cooperative Bank owns 90.0% stake,
- General Loan Loss Provisions increased by 95.0% to Kshs 25.5 bn, from Kshs 13.1 bn in H1’2020. The NPL coverage ratio consequently improved to 63.5% in H1’2021, from 54.6% in H1’2020, due to the faster 95.0% growth in General Loan Loss Provisions which was outpaced by the 48.2% growth in Gross Non-Performing Loans (NPLs),
- Shareholders’ funds increased by 15.6% to Kshs 92.6 bn in H1’2021, from Kshs 80.1 bn in H1’2020, mainly driven by a 16.2% increase in the retained earnings to Kshs 81.7 bn, from Kshs 70.3 bn in H1’2020,
- Co-operative Bank remains sufficiently capitalized with a core capital to risk-weighted assets ratio of 15.3%, 4.8% points above the statutory requirement of 10.5%. Also, the total capital to risk-weighted assets ratio came in at 17.0%, exceeding the statutory requirement of 14.5% by 2.5% points. Adjusting for IFRS 9, the core capital to risk-weighted assets stood at 13.1%, while total capital to risk-weighted assets came in at 14.8%, and,
- The bank currently has a Return on Average Assets (ROaA) of 2.0%, and a Return on Average Equity (ROaE) of 12.7%.

Key Take-Outs:

1. Total operating expenses rose by 28.3% to Kshs 18.7 bn in H1’2021, from Kshs 14.6 bn in H1’2020, largely driven by the 123.0% rise in Loan Loss Provisions (LLP) to Kshs 4.2 bn, from Kshs 1.9 bn in H1’2020. The increase in provisioning levels was expected considering the current situation surrounding the spread of COVID-19. The movement restrictions put in place to curb the virus led to subdued activity in the business environment. As such, households and businesses haven’t been able to keep up with their debt obligations and that has increased Non-performing loans. Some of the major sectors affected include the hospitality sector, manufacturing, tourism, education and real estate sectors,

2. The bank’s asset quality deteriorated, with the NPL ratio deteriorating to 15.2% in H1’2021, from 11.8% in H1’2020 owing to slower growth in gross loans by 14.6% compared to the 48.2% growth in gross non-performing loans, and partly stems from Non-performing loans of Kshs 6.7 bn and an NPL ratio of 61.2% from the recently acquired Kingdom Bank. It is important to note that the NPL Ratio has improved in the last two quarters where the ratio was at 18.7% in Q4’2020 and 15.8% in H1’2021. Generally, banks have had to go back to the drawing board to come up with new strategies to manage the deteriorating asset quality in the wake of the ongoing global pandemic,
3. The acquisition of Kingdom Bank has resulted to an increased borrowing of about Kshs 21.0 bn in Cooperative Bank’s books, from the Central Bank of Kenya (CBK), meant to be directed towards support operations in the bank. This has resulted to an increase in expenses and ultimately weighed down on the performance of the bank in the medium term, and,
4. Notably, the bank has improved the operational efficiency on digital platforms where about 92.0% of the bank’s transactions have been done on alternative channels as opposed to the bank’s physical locations. Additionally, the waiver in mobile banking transactions came to an end at the end of 2020 and will likely boost the bank’s fees and commissions.

Going forward, we expect the bank’s growth to be driven by:

I. Lending to SMEs: Putting into consideration the current state of affairs in the banking sector, it is evident that the risk factor when lending to businesses has increased significantly. It is, however, key to note that loan restructurings and increasing their loan book exposure to MSMEs will help support the bank during this period of uncertainty, and,

II. 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.

Valuation Summary

- We are of the view that Co-operative Bank is a “Hold” with a target price of Kshs 14.5, representing an upside of 6.1%, from the current price of Kshs 13.7 as of 20th August 2021, and,
- Co-operative Bank is currently trading at a P/TBV of 0.9x and a P/E of 7.3x vs an industry average of 1.2x and 8.3x, respectively.