Cytonn INVESTMENTS

Co-op Bank of Kenya - Q1’2021

21st May, 2021

Below is a summary of Co-operative Bank’s Q1’2021 performance:

Balance Sheet Items	Q1’2020	Q1’2021	y/y change
Government Securities	115.87	166.15	43.4%
Net Loans and Advances	276.2	298.2	8.0%
Total Assets	470.4	552.9	17.5%
Customer Deposits	339.6	393.8	16.0%
Total Liabilities	386.9	458.3	18.5%
Shareholders’ Funds	82.0	93.7	14.3%

Balance Sheet Ratios	Q1’2020	Q1’2021	% point Change
Loan to Deposit Ratio	81.3%	75.7%	(5.6%)
Return on average equity	18.7%	12.3%	(6.4%)
Return on average assets	3.2%	2.0%	(1.2%)

Income Statement	Q1’2020	Q1’2021	y/y Change
Net Interest Income	7.5	9.8	30.7%
Non-Interest Income	5.0	4.5	(9.2%)
Total Operating income	**12.5**	**14.4**	**14.8%**
Loan Loss provision	(0.9)	(2.3)	153.5%
Total Operating expenses	(7.3)	(9.3)	27.4%
Profit before tax	**5.1**	**5.0**	**(2.6%)**
Profit after tax	**3.6**	**3.5**	**(3.7%)**
Earnings per share	**0.52**	**0.50**	**(3.7%)**

Income Statement Ratios	Q1’2020	Q1’2021	% point Change
Yield from interest-earning assets	11.3%	11.6%	0.3%
Cost of funding	0.8%	0.8%	0.0%
Net Interest Spread	10.4%	10.7%	0.3%
Net Interest Income as % of operating income	60.1%	68.5%	8.3%
Non-Funded Income as a % of operating income	39.9%	31.5%	(8.3%)
Cost to Income	58.1%	64.5%	6.4%
CIR without provisions	50.9%	48.6%	(2.3%)
Cost to Assets	1.4%	1.3%	(0.1%)
Net Interest Margin	8.2%	8.6%	0.5%

Capital Adequacy Ratios	Q1’2020	Q1’2021
Core Capital/Total deposit Liabilities	20.2%	18.4%
Minimum Statutory ratio	8.0%	8.0%
Excess	**12.2%**	**10.4%**
Core Capital/Total Risk-Weighted Assets	15.6%	15.2%
Minimum Statutory ratio	10.5%	10.5%
Excess	**5.1%**	**4.7%**
Total Capital/Total Risk-Weighted Assets	16.1%	16.9%
Minimum Statutory ratio	14.5%	14.5%
Excess	**1.6%**	**2.4%**

Liquidity Ratio	49.0%	54.8%
Minimum Statutory ratio	20.0%	20.0%
Excess	**29.0%**	**34.8%**
Adjusted Core Capital/Total deposit liabilities	15.5%	13.3%
Adjusted Core Capital/Total Risk-Weighted Assets	15.9%	15.1%

Key Highlights Q1’2021

- In January 2021, the bank was able to secure a seven-year, USD 75.0 mn (Kshs 8.3 bn) long-term facility from the International Finance Corporation (IFC) for onward lending to micro, small and medium enterprises (MSMEs) which will be aimed at supporting businesses to better cope with the disruptions brought about by the pandemic, additionally,
- Loans restructured in support to the customers affected by COVID-19 according to their Q1’2021 earnings press release came in at Kshs 49.0 bn, equivalent to about 14.3% of the bank’s Loan Book.

Income Statement

- Core earnings per share declined by 3.7% to Kshs 0.50 in Q1’2021, from Kshs 0.52 in Q1’2020, which was not in-line with our projections of a 9.3% decline Kshs 0.47, where the earnings for the period came in at Kshs 3.5 bn, slightly lower than the Kshs 3.6 bn seen in Q1’2020. The variance can be attributed to our expectation of a faster growth in total operating expenses of 32.6%, compared to the actual growth of 27.4%. The performance was driven by a 27.4% increase in total operating expenses to Kshs 9.3 bn in Q1’2021, from Kshs 7.3 bn in Q1’2020 but was mitigated by a 14.8% increase in total operating income,
- Total operating income rose by 14.8% to Kshs 14.4 bn in Q1’2021, from Kshs 12.5 bn in Q1’2020 mainly due to a 30.7% increase in Net Interest Income (NII) to Kshs 9.8 bn, from Kshs 7.5 bn in Q1’2020. The growth in total operating income was weighed down by a 9.2% decline in Non-Funded Income (NFI) to Kshs 4.5 bn, from Kshs 5.0 bn in Q1’2020,
- Interest income rose by 27.6% to Kshs 13.4 bn in Q1’2021, from Kshs 10.5 bn in Q1’2020. The growth recorded was as a result of a 44.1% increase in interest income from government securities to Kshs 4.1 bn, from Kshs 2.9 bn in Q1’2020, coupled with a 22.5% rise in interest income from loans and advances to Kshs 9.2 bn, from Kshs 7.6 bn in Q1’2020. This growth was however weighed down by a 64.6% decline in interest income from the deposit with other financial institutions to Kshs 41.5 mn in Q1’2021, from Kshs 0.1 bn in Q1’2020. Consequently, the yield on interest-earning assets increased to 11.6%, from 11.3% in Q1’2020 due to the faster 17.4% growth in trailing interest income, which outpaced the 14.5% growth in the average interest-earning assets,
- Interest expense increased by 19.8% to Kshs 3.6 bn in Q1’2021, from Kshs 3.0 bn in Q1’2020, largely due to a 20.9% rise in interest expense from customer deposits to Kshs 3.2 bn, from Kshs 2.6 bn. This was however mitigated by a 2.7% decline in other interest expenses to Kshs 0.37 bn in Q1’2021, from Kshs 0.38 bn in Q1’2020. As such, cost of funds declined to 3.2%, from 3.4% in Q1’2020, owing to the faster 20.9% rise in the average interest-bearing liabilities, compared to the 7.3% increase in trailing interest expense. Net Interest Margin (NIM) increased to 8.6%, from 8.2% in Q1’2020,
- Non-Funded Income decreased by 9.2%, mainly driven by a 37.2% decrease in other fees and commissions to Kshs 2.4 bn, from Kshs 3.8 bn in Q1’2020. This was mitigated by a 115.6% rise in fees and commissions from loans and advances to Kshs 1.3 bn, from Kshs 0.6 bn in Q1’2020, coupled with a 41.5% increase in foreign exchange trading income to Kshs 0.7 bn in Q1’2021, from Kshs 0.5 bn in Q1’2020. Total fees and commissions decreased by 15.7% overall to Kshs 3.7 bn in Q1’2021, from Kshs

4.4 bn in Q1'2020. As a result, the revenue mix shifted to 68:32, from 60:40 funded to non-funded income owing to the faster 30.7% growth in NII compared to the 9.2% decline in NFI,

- Total operating expenses rose by 27.4% to Kshs 9.3 bn in Q1'2021, from Kshs 7.3 bn in Q1'2020, largely driven by the 153.5% rise in Loan Loss Provisions (LLP) to Kshs 2.3 bn, from Kshs 0.9 bn in Q1'2020. The increased provisioning levels by the lender is mainly as a result of the elevated levels of risk currently in the market. Notably Staff costs decreased by 7.8% to Kshs 3.2 bn, from the Kshs 3.5 bn recorded in Q1'2020,
- The Cost to Income Ratio (CIR) deteriorated to 64.5%, from 58.1% in Q1'2020, following the faster 27.4% rise in total operating expenses that outpaced the 14.8% rise in total operating income. Without LLP, the cost to income ratio improved to 48.6% from 50.9% in Q1'2020, an indication of improving efficiency levels, and,
- The bank registered a 3.7% decline in profit after tax to Kshs 3.5 bn in Q1'2021, from Kshs 3.6 bn in Q1'2020. Profit before tax and exceptional items declined by 2.6% to Kshs 5.0 bn, from Kshs 5.1 bn in Q1'2020, with the effective tax rate increasing to 30.7% in Q1'2021, from 29.9% seen in Q1'2020.

Balance Sheet

- The balance sheet recorded an expansion as total assets grew by 17.5% to Kshs 552.9 bn in Q1'2021, from Kshs 470.4 bn in Q1'2020, mainly attributable to the 43.4% growth in government securities to Kshs 166.2 bn, from Kshs 115.9 bn, coupled with a 8.0% growth in net loans and advances to Kshs 298.2 bn in Q1'2021, from Kshs 276.2 bn in Q1'2020. The increase in allocation to government securities shows the bank's cautious lending strategy considering the elevated credit risk being experienced in the market,
- Total liabilities grew by 18.5% to Kshs 458.3 bn, from Kshs 386.9 bn in Q1'2020, which was largely attributable to a 16.0% rise in customer deposits to Kshs 393.8 bn in Q1'2021, from Kshs 339.6 bn in Q1'2020, coupled with a 71.1% increase in borrowings to Kshs 46.9 bn, from Kshs 27.4 bn in Q1'2020. The increased borrowing levels can be attributed to a Kshs 21.6 bn borrowing by Kingdom Bank to support its operations. Deposits per branch increased by 4.2% to Kshs 2.2 bn, from Kshs 2.1 bn in Q1'2020, as the number of branches increased by 11.3% to 177 branches from 159 in Q1'2020,
- The slower 8.0% growth in net loans and advances compared to the 16.0% growth in deposits, led to a decline in the loan to deposit ratio to 75.7%, from 81.3% in Q1'2020,
- Gross Non-Performing Loans (NPLs) increased by 63.3% to Kshs 52.0 bn in Q1'2021, from Kshs 31.8 bn in Q1'2020. The NPL ratio rose to 15.8% in Q1'2021, from 10.8% in Q1'2020 owing to slower growth in gross loans by 4.8% compared to the 63.3% growth in gross non-performing loans. This can be attributed to Non-performing loans of Kshs 7.3 bn from the recently acquired Kingdom Bank where Cooperative Bank owns 90.0% stake. It is important to note that Co-operative Bank's NPL Ratio is lower than the sector's NPL ratio of 14.7%,
- General Loan Loss Provisions increased by 97.6% to Kshs 23.6 bn, from Kshs 11.9 bn in Q1'2020. The NPL coverage ratio improved to 58.4% in Q1'2021, from 54.8% in Q1'2020, due to the faster 97.6% growth in General Loan Loss Provisions which was outpaced by the 63.3% growth in Gross Non-Performing Loans (NPLs)
- Shareholders' funds increased by 14.3% to Kshs 93.7 bn in Q1'2021, from Kshs 82.0 bn in Q1'2020, mainly driven by a 16.4% increase in the retained earnings to Kshs 77.9 bn, from Kshs 66.9 bn in Q1'2020,
- Co-operative Bank remains sufficiently capitalized with a core capital to risk-weighted assets ratio of 15.2%, 4.7% points above the statutory requirement of 10.5%. Also, the total capital to risk-weighted

assets ratio came in at 16.9%, exceeding the statutory requirement of 14.5% by 2.4% points. Adjusting for IFRS 9, the core capital to risk-weighted assets stood at 13.3%, while total capital to risk-weighted assets came in at 15.1%, and,

- The bank currently has a Return on Average Assets (ROaA) of 2.0%, and a Return on Average Equity (ROaE) of 12.3%.

Key Take-Outs:

1) Total operating expenses rose by 27.4% to Kshs 9.3 bn in Q1'2021, from Kshs 7.3 bn in Q1'2020, largely driven by the 153.5% rise in Loan Loss Provisions (LLP) to Kshs 2.3 bn, from Kshs 0.9 bn in Q1'2020. 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 15.8% in Q1'2021, from 10.8% in Q1'2020 owing to slower growth in gross loans by 4.8% compared to the 63.3% growth in gross non-performing loans, and partly stems from NPLs of Kshs 7.3 bn from Kingdom Bank which was recently acquired by Co-operative Bank. It is important to note that the NPL Ratio is below the sector's average of 14.7% and has improved on a quarter-on-quarter basis where the ratio was at 18.7% in Q4'2020. Generally, banks have had to go back to the drawing board to come up with new strategies to manage the worsening 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 21.6 bn in Co-operative Bank's books, 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.

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

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 "**Accumulate**" with a target price of Kshs 14.0, representing an upside of 13.8%, from the current price of Kshs 12.3 as of 21st May 2021, and,
- Co-operative Bank is currently trading at a P/TBV of 0.8x and a P/E of 6.8x vs an industry average of 0.8x and 6.9x, respectively.