Co-op Bank of Kenya- Q3'2020

20th November, 2020

Valuation Summary

- We are of the view that Co-operative Bank is a "***buy***" with a target price of Kshs 11.65, representing an upside of 36.2%, from the current price of Kshs 11.7 as of 20th November 2020, inclusive of a dividend yield of 8.6%,
- Co-operative Bank is currently trading at a P/TBV of 0.9x and a P/E of 4.8x vs an industry average of 0.9x and 6.4x, respectively,

Key Highlights Q3'2020

- On 25th August 2020, Co-operative Bank Kenya completed the 90.0% acquisition of Jamii Bora Bank and rebranded it to Kingdom Bank Limited. The Central Bank of Kenya approved the acquisition of a 90.0% stake of Jamii Bora's shareholding by the Co-operative Bank, which was to be completed on 21st August 2020 after the deal received all regulatory approval following approval by the National Treasury on 4th August 2020. In March 2020, the Co-operative bank opened talks of a 100.0% acquisition of Jamii Bora Bank (JBB) before varying their offer to a 90.0% stake for Kshs 1.0 bn effectively valuing Jamii Bora Bank at Kshs 1.1 bn,

Income Statement

- Core earnings per share declined by 10.2% to Kshs 1.4 in Q3'2020, from Kshs 1.6 in Q3'2019, which was in-line with our projections of Kshs 1.4, where the earnings for the period came in at Kshs 9.8 bn, slightly lower than our expectations of Kshs 9.9 bn. The performance was driven by an 18.3% increase in total operating expenses to Kshs 23.5 bn in Q3'2020 from Kshs 19.8 in Q3'2019 but was mitigated by the 5.6% increase in total operating income,
- Total operating income rose by 5.6% to Kshs 37.2 bn in Q3'2020, from Kshs 35.2 bn in Q3'2019. This was mainly due to an 11.7% increase in Net Interest Income (NII) to Kshs 23.6 bn from Kshs 21.2 bn in Q3'2019, which was weighed down by the 3.5% decline in Non-Funded Income (NFI) to Kshs 13.6 bn from Kshs 14.1 bn in Q3'2019,
- Interest income rose by 7.1% to Kshs 32.6 bn in Q3'2020, from Kshs 30.4 bn in Q3'2019. The growth recorded was as a result of a 19.9% increase in interest income from government securities to Kshs 9.8 bn, from Kshs 8.2 bn in Q3'2019, as well as a 2.1% rise in interest income from loans and advances to Kshs 22.3 bn from Kshs 21.8 bn in Q3'2019. The yield on interest-earning assets, however, declined to 10.9%, from 11.5% in Q3'2019 due to the faster 17.0% growth in the average interest-earning assets that outpaced the 7.7% growth in interest income,
- Interest expense declined by 3.5% to Kshs 8.9 bn in Q3'2020, from Kshs 9.2 bn in Q3'2019, largely due to a 3.0% decline in interest expense from customer deposits to Kshs 7.8 bn from Kshs 8.0 bn. Other interest expenses also declined by 5.3% to Kshs 1.1 bn from Kshs 1.2 bn in Q3'2019. Consequently, the cost of funds declined to 3.2%, from 3.6% in Q3'2019, owing to a 15.5% rise in interest-bearing liabilities, despite the 2.5% decline in interest expense,
- Non-Funded Income fell by 3.5% to Kshs 13.6 bn in Q3'2020, from Kshs 14.1 bn in Q3'2019. The decline was mainly driven by a 31.7% drop in fees and commissions on loans to Kshs 1.2 bn, from Kshs 1.8 bn in Q3'2019, as well as a 54.2% decline in other income to 0.4 bn from 0.9 bn in Q3'2019. The decline in NFI was however mitigated by a 13.9% increase in forex trading income to Kshs 1.8 bn, from Kshs 1.6 bn in Q3'2019 as well as other fees and commissions which increased by 3.5% to Kshs 10.1 bn from Kshs 9.8 in Q3'2019. As a consequence, the revenue mix shifted to 63:37, from 60:40 in Q3'2019 owing to the growth in NII whereas NFI recorded a decline,

- Total operating expenses rose by 18.3% to Kshs 23.5 bn in Q3'2020, from Kshs 19.8 bn in Q3'2019, largely driven by the 89.4% rise in Loan Loss Provisions (LLP) to Kshs 4.0 bn from Kshs 1.2 bn in Q3'2019, coupled with a 6.3% rise in staff costs to Kshs 9.7 bn in Q3'2020 from Kshs 9.1 bn in Q3'2019,
- The Cost to Income Ratio (CIR) deteriorated to 63.0%, from 56.2% in Q3'2019, following the faster rise in total operating expenses that outpaced total operating income. Without LLP, the cost to income ratio also deteriorated to 52.2% from 50.2% in Q3'2019, and indication of reduced efficiency levels,
- The bank registered a 10.2% decline in profit after tax to Kshs 9.8 bn in Q3'2020 from Kshs 10.9 bn in Q3'2019. Profit before tax and exceptional items declined by 10.5% to Kshs 13.8 bn from Kshs 15.5 bn in Q3'2019, with the effective tax rate declining to 24.8% in Q3'2020 from 29.6% seen in Q3'2019.

Balance Sheet

- The balance sheet recorded an expansion as total assets grew by 15.9% to Kshs 510.9 bn in Q3'2020 from Kshs 440.8 bn in Q3'2019, mainly attributable to the 50.5% growth in government securities to Kshs 142.3 bn from Kshs 94.6 bn, coupled with a 5.7% growth in net loans and advances to Kshs 284.2 bn in Q3'2020 from Kshs 268.9 bn in Q3'2019. Placements also rose by 11.9% to Kshs 27.2 bn in Q3'2020, from Kshs 24.3 bn,
- Total liabilities grew by 16.9% to Kshs 427.3 bn in Q3'2020 from Kshs 365.4 bn in Q3'2019 which was largely attributable to a 401.0% rise in placements to Kshs 6.9 bn in Q3'2020, from Kshs 1.4 bn, coupled with the 16.4% rise in customer deposits to Kshs 375.5 bn in Q3'2020 from Kshs 322.6 bn in Q3'2019. Borrowings declined by 12.0% to Kshs 26.2 bn from Kshs 29.7 bn in Q3'2019,
- The slower 5.7% growth in net loans and advances compared to the 16.4% growth in deposits, led to a decline in the loan to deposit ratio to 75.7%, from 83.4% in Q3'2019. Deposits per branch increased to Kshs 2.4 bn from Kshs 2.0 bn, as the number of branches remained unchanged at 159 branches,
- Gross Non-Performing Loans (NPLs) increased by 33.6% to Kshs 40.2 bn in Q3'2020, from Kshs 30.1 bn in Q3'2020. The NPL ratio deteriorated to 13.2% in Q3'2020, from 10.5% in Q3'2019 owing to slower growth in gross loans by 6.6% compared to the 33.6% growth in gross non-performing loans,
- General Loan Loss Provisions increased by 23.7% to Kshs 14.1 bn, from Kshs 11.4 bn in Q3'2019. The NPL coverage ratio however deteriorated to 50.1% in Q3'2020 from 55.5% in Q3'2019, due to the slower growth in General Loan Loss Provisions which was outpaced by the growth in Gross Non-Performing Loans (NPLs),
- NPL Coverage ratio dropped from 55.5% to 50.1%, which could suggest an under-provisioning. Had NPL Coverage remained at the 55.5% level recorded in Q3'2019, we would have had an additional provisioning of Kshs 2.2 bn, which would have reduced Earnings per Share from the reported Kshs 1.4 to Kshs 1.1,
- Shareholders' funds increased by 10.9% to Kshs 82.0 bn in Q3'2020 from Kshs 74.0 bn in Q3'2019, mainly driven by a 13.0% increase in the retained earnings to Kshs 72.8 bn, from Kshs 64.4 bn in Q3'2019,
- Co-operative Bank remains sufficiently capitalized with a core capital to risk-weighted assets ratio of 16.3%, 5.8% points above the statutory requirement of 10.5%. Also, the total capital to risk-weighted assets ratio came in at 16.8%, exceeding the statutory requirement of 14.5% by 2.3% points. Adjusting for IFRS 9, the core capital to risk-weighted assets stood at 15.5%, while total capital to risk-weighted assets came in at 15.9%, and,
- The bank currently has a Return on Average Assets (ROaA) of 2.7%, and a Return on Average Equity (ROaE) of 16.4%.

Key Take-Outs:

1) Total operating expenses grew by 18.3% mainly due to the increase in loan loss provisions by 89.4%, coupled with the 6.3% increase in staff costs. Consequently, the cost to income ratio deteriorated to 63.0% from 56.2% seen in Q3'2019. 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 and loss of jobs came about as a result of the same. Consequently, households and businesses haven't been able to keep up with their debt obligations and that has increased Non-performing loans, and,
2) The bank's asset quality deteriorated, with the NPL ratio coming in at 13.2% in Q3'2020, from 10.5% in Q3'2019, owing to slower growth in gross loans by 6.6% compared to the 33.6% growth in gross non-performing loans. 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.

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 through 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,

Below is a summary of the bank's performance:

Co-operative Bank Q3'2020 Key Highlights						
Balance Sheet						
Balance Sheet Items	**Q3'2019**	**Q3'2020**	**y/y change**	**Q3'2020f**	**Projected %y/y change**	**Variance in Growth Actual vs. Expected**
Government Securities	94.56	142.28	50.5%	132.41	40.0%	10.4%
Net Loans and Advances	268.9	284.2	5.7%	296.1	10.1%	(4.4%)
Total Assets	440.8	510.9	15.9%	513.0	16.4%	(0.5%)
Customer Deposits	322.5	375.5	16.4%	383.4	18.9%	(2.5%)
Total Liabilities	365.4	427.3	16.9%	430.6	17.8%	(0.9%)
Shareholders' Funds	73.9	82.0	10.9%	80.9	9.4%	1.6%

Balance Sheet Ratios	Q3'2019	Q3'2020	y/y change
Loan to Deposit Ratio	83.4%	75.7%	(7.7%)
Return on average equity	18.4%	16.4%	-2.0%
Return on average assets	3.1%	2.7%	-0.4%

Income Statement						
Income Statement Items	**Q3'2019**	**Q3'2020**	**y/y change**	**Q3'2020f**	**Projected %y/y change**	**Variance in Growth Actual vs. Expected**
Net Interest Income	21.2	23.6	11.7%	21.9	3.7%	8.0%
Non-Interest Income	14.1	13.6	(3.5%)	13.2	(6.5%)	3.0%

Total Operating income	**35.2**	**37.2**	**5.6%**	**35.1**	**(0.4%)**	**6.0%**
Loan Loss provision	(2.1)	(4.0)	89.4%	(1.9)	(9.5%)	98.9%
Total Operating expenses	(19.8)	(23.5)	18.3%	(21.0)	5.9%	12.4%
Profit before tax	15.5	13.8	(10.5%)	14.2	(8.4%)	(2.1%)
Profit after tax	10.9	9.8	(10.2%)	9.9	(8.9%)	(1.2%)
Earnings per share	**1.6**	**1.4**	**(10.2%)**	**1.4**	**(8.9%)**	**(1.2%)**

Income Statement Ratios	Q3'2019	Q3'2020	Y/Y Change
Yield from interest-earning assets	11.5%	10.9%	(5.0%)
Cost of funding	2.6%	2.2%	(18.0%)
Net Interest Spread	8.8%	8.7%	(1.2%)
Net Interest Income as % of operating income	60.0%	63.5%	5.8%
Non-Funded Income as a % of operating income	40.0%	36.5%	(8.7%)
Cost to Income	56.2%	63.0%	12.0%
CIR without provisions	50.2%	52.2%	3.9%
Cost to Assets	4.0%	3.8%	(5.3%)
Net Interest Margin	8.1%	8.0%	(2.1%)
Equity to Assets Ratio	17.1%	16.7%	(0.4%)

Capital Adequacy Ratios		
Capital Adequacy Ratios	**Q3'2019**	**Q3'2020**
Core Capital/Total deposit Liabilities	20.0%	19.0%
Minimum Statutory ratio	8.0%	8.0%
Excess	**12.0%**	**11.0%**
Core Capital/Total Risk-Weighted Assets	15.4%	16.3%
Minimum Statutory ratio	10.5%	10.5%
Excess	**4.9%**	**5.8%**
Total Capital/Total Risk-Weighted Assets	15.7%	16.8%
Minimum Statutory ratio	14.5%	14.5%
Excess	**1.2%**	**2.3%**
Liquidity Ratio	45.0%	45.2%
Minimum Statutory ratio	20.0%	20.0%
Excess	**25.0%**	**25.2%**
Adjusted Core Capital/Total Risk-Weighted Assets	15.6%	15.5%
Adjusted Total Capital/Total Risk-Weighted Assets	15.8%	15.9%