Co-operative Bank of Kenya Ltd – Q3’2021

19th November, 2021

Below is a summary of Co-operative Bank of Kenya Ltd Q3’2021 performance:

Balance Sheet Items (Kshs bn)	Q3'2020	Q3'2021	y/y change
Government Securities	142.3	193.3	35.9%
Net Loans and Advances	284.2	306.3	7.8%
Total Assets	**510.9**	**592.9**	**16.0%**
Customer Deposits	375.5	420.4	12.0%
Total Liabilities	427.3	497.5	16.4%
Shareholders’ Funds	**82.0**	**95.0**	**15.9%**

Balance Sheet Ratios	Q3'2020	Q3'2021	% points y/y change
Loan to Deposit Ratio	75.7%	72.9%	(2.8%)
Return on average equity	16.5%	14.2%	(2.3%)
Return on average assets	2.8%	2.3%	(0.5%)

Income Statement (Kshs bn)	Q3'2020	Q3'2021	y/y change
Net Interest Income	23.6	28.7	21.3%
Non-Interest Income	13.6	15.7	15.6%
Total Operating income	**37.2**	**44.4**	**19.2%**
Loan Loss provision	(4.0)	(6.0)	50.3%
Total Operating expenses	(23.5)	(28.0)	19.2%
Profit before tax	13.8	16.5	19.2%
Profit after tax	**9.9**	**11.6**	**18.0%**
Earnings per share (Kshs)	**1.4**	**1.7**	**18.0%**

Income Statement Ratios	Q3'2020	Q3'2021	% points y/y change
Yield from interest-earning assets	10.9%	11.5%	0.6%
Cost of funding	2.2%	2.4%	0.2%
Net Interest Spread	8.7%	9.1%	0.4%
Net Interest Income as % of operating income	63.5%	64.6%	1.1%
Non-Funded Income as a % of operating income	36.5%	35.4%	(1.1%)
Cost to Income	63.0%	63.0%	(0.0%)
CIR without provisions	52.2%	49.4%	(2.8%)
Cost to Assets	3.8%	3.7%	(0.1%)
Net Interest Margin	8.0%	8.5%	0.5%

Capital Adequacy Ratios	Q3'2020	Q3'2021
Core Capital/Total deposit Liabilities	19.0%	18.0%
Minimum Statutory ratio	8.0%	8.0%
Excess	**11.0%**	**10.0%**
Core Capital/Total Risk Weighted Assets	16.3%	15.0%
Minimum Statutory ratio	10.5%	10.5%
Excess	**5.8%**	**4.5%**
Total Capital/Total Risk Weighted Assets	16.8%	16.5%
Minimum Statutory ratio	14.5%	14.5%
Excess	**2.3%**	**2.0%**
Liquidity Ratio	50.2%	56.5%
Minimum Statutory ratio	20.0%	20.0%

Excess	**30.2%**	**36.5%**
Adjusted Core Capital/Total Risk Weighted Assets	15.5%	12.5%
Adjusted Total Capital/Total Risk Weighted Assets	15.9%	14.0%

Income Statement

- Core earnings per share increased by 18.0% to Kshs 1.7 in Q3’2021, from Kshs 1.4 in Q3’2020, not in line with our projections of a 12.4% increase to Kshs 1.6. The performance was driven by a 19.2% increase in total operating income to Kshs 44.4 bn in Q3’2021, from Kshs 37.2 bn in Q3’2020, despite a similar increase of 19.2% in the total operating expenses to Kshs 28.0 bn in Q3’2021, from Kshs 23.5 bn in Q3’2020. The variance in our projections can be attributed to our expectation of a 10.5% decline in Non-Interest Income to Kshs 12.2 bn, compared to the actual growth of 15.6%,
- Total operating income rose by 19.2% to Kshs 44.4 bn in Q3’2021, from Kshs 37.2 bn in Q3’2020 mainly due to an 21.3% increase in Net Interest Income (NII) to Kshs 28.7 bn, from Kshs 23.6 bn in Q3’2020, coupled with the growth of 15.6% in Non-Funded Income (NFI) to Kshs 15.7 bn, from Kshs 13.6 bn in Q3’2020,
- Interest income rose by 21.6% to Kshs 39.6 bn in Q3’2021, from Kshs 32.6 bn in Q3’2020 driven by a 40.3% increase in interest income from government securities to Kshs 13.8 bn, from Kshs 9.8 bn in Q3’2020, coupled with a 14.0% rise in interest income from loans and advances to Kshs 25.4 bn, from Kshs 22.3 bn in Q3’2020. This growth was however weighed down by a 24.1% decline in interest income from deposits with other financial institutions to Kshs 0.3 bn in Q3’2021, from Kshs 0.4 bn in Q3’2020. Consequently, the Yield on Interest-Earning Assets increased to 11.5%, from 10.9% in Q3’2020 due to the faster 22.0% growth in trailing interest income, which outpaced the 15.5% 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 22.4% to Kshs 10.9 bn in Q3’2021, from Kshs 8.9 bn in Q3’2020, largely due to a 26.7% rise in interest expense from customer deposits to Kshs 9.8 bn, from Kshs 7.8 bn in Q3’2020. This was however mitigated by a 7.6% decline in other interest expenses to Kshs 1.0 bn in Q3’2021, from Kshs 1.1 bn in Q3’2020. As such, cost of funds increased to 3.3%, from 3.2% in Q3’2020, owing to the faster 20.6% increase in trailing interest expense, compared to the 15.0% rise in the average interest-bearing liabilities. Net Interest Margin (NIM) increased to 8.5%, from 8.0% in Q3’2020, attributable to the 22.5% growth of trailing Net Interest Income (NII), which outpaced the 15.5% growth in average interest-earning assets,
- Non-Funded Income increased by 15.6% to Kshs 15.7 bn in Q3’2021, from Kshs 13.6 bn in Q3’2020, mainly driven by a 349.8% rise in fees and commissions from loans and advances to Kshs 5.5 bn, from Kshs 1.2 bn in Q3’2020, coupled with a 3.9% increase in foreign exchange trading income to Kshs 1.9 bn in Q3’2021, from Kshs 1.8 bn in Q3’2020. The increased was in Non-Funded Income was, however, weighed down by a 31.9% decrease in other fees and commissions to Kshs 6.9 bn, from Kshs 10.1 bn in Q3’2020. Total fees and commissions increased by 9.4% overall to Kshs 12.4 bn in Q3’2021, from Kshs 11.3 bn in Q3’2020. As a result, the revenue mix shifted to 65:35, from 63:37 funded to non-funded income owing to the faster 21.3% growth in net interest income compared to the 15.6% increase in non-funded income,
- Total operating expenses rose by 19.2% to Kshs 28.0 bn in Q3’2021, from Kshs 23.5 bn in Q3’2020, largely driven by the 50.3% rise in Loan Loss Provisions (LLP) to Kshs 6.0 bn, from Kshs 4.0 bn in Q3’2020. The increased provisioning level is mainly attributable to the lender increasing its coverage for the high Non-Performing Loans from Kingdom Bank, which stood at Kshs 6.4 bn as of Q3’2021. On the other hand, Staff costs increased by 3.6% to Kshs 10.0 bn, from Kshs 9.7 bn in Q3’2020,
- The Cost to Income Ratio (CIR) remained unchanged at 63.0%, as was recorded in Q3’2020. Without LLP, the Cost to Income ratio improved to 49.4% from 52.2% in Q3’2020, an indication of improving efficiency levels, and,

- The bank registered an 18.0% increase in profit after tax to Kshs 11.6 bn in Q3’2021, from Kshs 9.9 bn in Q3’2020. Profit before tax and exceptional items rose by 19.2% to Kshs 16.5 bn, from Kshs 13.8 bn in Q3’2020, with the effective tax rate increasing to 29.5% in Q3’2021, from 24.8% seen in Q3’2020.

Balance Sheet

- The balance sheet recorded an expansion as total assets grew by 16.0% to Kshs 592.9 bn in Q3’2021, from Kshs 510.9 bn in Q3’2020, mainly attributable to the 35.9% growth in government securities to Kshs 193.3 bn, from Kshs 142.3 bn, coupled with a 7.8% growth in net loans and advances to Kshs 306.3 bn in Q3’2021, from Kshs 284.2 n in Q3’2020. 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 14.6% in Q3’2021 from 13.2% in Q3’2020,
- Total liabilities grew by 16.4% to Kshs 497.5 bn, from Kshs 427.3 bn in Q3’2020, which was largely attributable to a 12.0% rise in customer deposits to Kshs 420.4 bn in Q3’2021, from Kshs 375.5 bn in Q3’2020. Deposits per branch increased by 0.6% to Kshs 2.38 bn, from Kshs 2.36 bn in Q3’2020, as the number of branches increased by 18 branches to 177 from 159 branches in Q3’2020, as a result of the acquisition of Kingdom Bank which contributed 17 branches to the total branch count,
- The faster 12.0% growth in deposits compared to the 7.8% growth in net loans and advances, led to an decline in the loan to deposit ratio to 72.9%, from 75.7% in Q3’2020,
- Gross Non-Performing Loans (NPLs) increased by 23.2% to Kshs 49.5 bn in Q3’2021, from Kshs 40.2 bn in Q3’2020. The NPL ratio rose to 14.6% in Q3’2021, from 13.2% in Q3’2020, owing to the faster 23.2% growth in gross non-performing loans compared to the 11.3% growth in gross loans. The increase in the NPL ratio can also be attributed to Non-performing loans of Kshs 6.4 bn and an NPL ratio of 73.9% from Kingdom Bank where Cooperative Bank owns 90.0% stake,
- General Loan Loss Provisions increased by 81.1% to Kshs 25.6 bn, from Kshs 14.1 bn in Q3’2020. The NPL coverage ratio consequently improved to 65.5% in Q3’2021, from 50.1% in Q3’2020, due to the faster 81.1% growth in General Loan Loss Provisions which outpaced the 23.2% growth in Gross Non-Performing Loans (NPLs),
- Shareholders’ funds increased by 15.9% to Kshs 95.0 bn in Q3’2021, from Kshs 82.0 bn in Q3’2020, mainly driven by a 17.1% increase in the retained earnings to Kshs 85.2 bn, from Kshs 72.8 bn in Q3’2020,
- Co-operative Bank remains sufficiently capitalized with a core capital to risk-weighted assets ratio of 15.0%, 4.5% points above the statutory requirement of 10.5%. Also, the total capital to risk-weighted assets ratio came in at 16.5%, exceeding the statutory requirement of 14.5% by 2.0% points. Adjusting for IFRS 9, the core capital to risk-weighted assets stood at 12.5%, while total capital to risk-weighted assets came in at 14.0%, and,
- The bank currently has a Return on Average Assets (ROaA) of 2.3%, and a Return on Average Equity (ROaE) of 14.2%.

Key Take-Outs:

1. Total operating expenses rose by 19.2% to Kshs 28.0 bn in Q3’2021, from Kshs 23.5 bn in Q3’2020, largely driven by the 50.3% rise in Loan Loss Provisions (LLP) to Kshs 6.0 bn, from Kshs 4.0 bn in Q3’2020. The increased provisioning level is mainly attributable to the lender increasing its coverage for the high Non-Performing Loans from Kingdom Bank, which stood at Kshs 6.4 bn as of Q3’2021. The NPL ratio for Kingdom Bank increased to 73.9% in Q3’2021, from 66.1% in Q3’2020. The recent lifting of the COVID-related restrictions and the gradual improvement in the business environment is likely to see the Loan Loss Provisions by the bank decrease as credit risk falls in the medium term,
2. The bank’s asset quality deteriorated, with the NPL ratio deteriorating to 14.6% in Q3’2021, from 13.2% in Q3’2020 owing to the faster 23.2% growth in gross non-performing loans compared to the 11.3%

growth in gross loans, and partly stems from Non-performing loans of Kshs 6.4 bn and an NPL ratio of 73.9% from Kingdom Bank, which was acquired by Co-operative Bank in 2020. It is important to note that Co-op’s NPL Ratio has improved in the last three quarters where the ratio was at 18.7% in Q4’2020, 15.8% in Q3’2021 and 15.2% in H1’2021,

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 the performance of the bank in the medium term, and,
4. Notably, the bank has improved the operational efficiency on digital platforms where about 93.0% of the bank’s transactions have been done on alternative channels as opposed to the bank’s physical locations, as of June 2021. Additionally, the waiver in mobile banking transactions came to an end at the end of 2020 partly contributed to the 9.4% increase in total fees and commissions to Kshs 12.4 bn in Q3’2021, from Kshs 11.3 bn in Q3’2020.

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

I. 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 14.1, representing an upside of 14.6%, from the current price of Kshs 12.3 as of 19th November 2021, and,
- Co-operative Bank is currently trading at a P/TBV of 0.8x and a P/E of 5.7x vs an industry average of 1.1x and 5.8x, respectively.