Co-operative Bank Earnings Update – H1’2017
17th August, 2017

Valuation Summary

- We are of the view that Co-operative Bank stock is an “Accumulate”, with a target price of Kshs 18.5 representing an upside of 19.0%, from the current price of Kshs 16.2, as at 18th August, inclusive of a dividend yield of 4.8%
- Co-operative Bank is currently trading at a P/TBv of 1.5x and a P/E of 7.1x, vs an industry average of 1.6x and 7.7x, respectively.

Key highlights during H1’2017

- Co-operative Bank Group got its first ever international ratings by the global credit ratings firm Moody’s, who assigned a B1 Global Rating and an Aa2 National Scale Rating to the bank, affirming the strong performance of the bank on all fronts,
- Co-operative Bank received regulatory approval from Central Bank of Kenya to enter into a Lessing business joint venture with Super Group Limited, an established global leader in leasing business based in South Africa,

Income Statement

- Core earnings per share declined by 25.4% to Kshs 1.1 from Kshs 1.5 in H1’2016, driven by a 3.7% decline in total operating revenue, coupled with a 3.5% growth in total operating expenses. Key to note is that this decrease was also due to an increase in the number of shares by 20%, following the conclusion of their 1 for 5 held bonus share issue,
- Total operating revenue declined by 3.7% to Kshs 20.5 bn from Kshs 21.3 bn in H1’2016. This was due to a 7.2% decline in Net Interest Income, despite a 3.7% growth in Non-Funded Income (NFI)
- Interest Income declined by 10.3% to Kshs 19.3 bn from Kshs 21.5 bn in H1’2016, despite a 16.7% decline in Interest expense to Kshs 5.8 bn from Kshs 7.0 bn in H1’2016. This led to a reduction in the Net Interest Margin to 8.8% from 8.9% in H1’2016
- Non-funded income (NFI) recorded a growth of 3.7% to Kshs 7.1 bn from Kshs 6.8 bn in H1’2016. The growth in NFI was driven by an increase in total fees and commissions that rose by 6.1% to Kshs 5.3 bn from Kshs 5.0 bn. The alternative banking channels including digital and agency banking supported this increase in fees and commissions. The current revenue mix stands at 65:35 funded to non-funded income from 68:38 in H1’2016
- Total operating expenses grew by 17.6% to Kshs 17.2 bn from Kshs 14.6 bn in H1’2016 following a 16.1% y/y growth in staff costs to Kshs 6.7 bn from Kshs 5.8 bn. Loan loss provisions (LLP) rose 28.0% to Kshs 2.0 bn from Kshs 1.5 bn in H1’2016, on account of an increase of 14.3% y/y in gross non-performing loans (NPL) to Kshs 10.0 bn from Kshs 8.7 bn. The NPL to total loans ratio thus increased to 4.4% from 4.1% in H1’2016
- Cost to income ratio improved to 53.1% from 54.8% in H1’2016. Without LLP, cost to income ratio stood at 47.1% from 49.0% in the same period last year
- Profit after tax increased by 22.3% to Kshs 10.5 bn from Kshs 8.6 bn in H1’2016.

Balance Sheet

- The balance sheet recorded an expansion in H1’2017, with total assets increasing by 6.4% to Kshs 354.0 bn from Kshs 332.9 bn in H1’2016. This growth was driven by a growth in the loan book by 6.9% y/y to Kshs 227.1 bn from Kshs 212.4 bn in H1’2016, in line with our expectations of a 6.5% increase. Growth was supported by increased use of alternative channels to drive loan disbursement, with 85% of Co-operative Banks’ total transactions year to date facilitated via alternative channels
- Total liabilities increased by 4.3% to Kshs 295.2 bn from Kshs 283.2 bn in H1’2016, slower than our projections of a 7.2% increase, while shareholders’ funds increased by 19.5% y/y to Kshs 59.2 bn from Kshs 49.5 bn
- Customer deposits increased by 1.7% to Kshs 257.8 bn from Kshs 253.5 bn in H1’2016, driven by an increase in the number of bank account holders, currently at 6.1 mn. The loan to deposit ratio thus rose to 88.1% from 83.8% in H1’2016, with Co-operative bank able to leverage on long-term funds from Development Partners to loan out despite the slow growth in deposits
- The yield on interest earning assets increased to 14.9% from 13.7% in H1’2016 with the cost of funds rising to 5.3% from 4.3% in H1’2016
- Co-operative Bank is currently sufficiently capitalized with a core capital to risk weighted assets ratio at 15.7%, 5.2% above the statutory requirement, with total capital to total risk weighted assets exceeding statutory requirement by 7.7%. Co-operative bank announced that they do not expect to raise capital from shareholders in 2017

- Co-operative Bank currently has a ROA of 4.0% and a ROE of 25.1%

Key Take outs:

i. Despite the tough economic environment in South Sudan, Co-op bank subsidiary reported a negligible loss of less than Kshs 1 mn in the first half of the year,

ii. Growth in its Non-Funded income, which currently accounts for 34.6% of its total operating income. Co-op Bank recently entered into a leasing business joint venture with Super Group Limited, which will enable the bank tap into major infrastructure projects, exploration and mining activities thus boosting its strategy to diversify its revenue streams. Ideally, Co-op Bank’s NFI contribution should be at least 40%, to be at par with the likes of Stanbic Bank at 45%

iii. Cost efficiency that was introduced by the Soaring Eagle Transformation strategy, which drove CIR from a high of 62.6% before the project to a target of 50.0% at the end of the strategy in 2018. The CIR of 55.3% needs to back to the Tier 1 average of 49.3%, and

iv. Deposit Growth: As of the top 3 deposit gatherers in the country, alongside KCB Group and Equity Bank, it is in their interest to actively lobby for the review of the interest rate cap legislation which is hurting not just industry players, but also the economy and the very consumers it was purportedly meant to help

Below is a summary of the key line items in the balance sheet and income statement

Figures in Kshs billions unless otherwise stated

Balance Sheet Items	H1’2016	H1'2017	y/y change	H1'2017e	Projected %y/y change	Variance in Growth Actual vs. Expected
Government Securities	64.9	70.7	67.3%	36.7	(48.1%)	115.4%
Net Loans and Advances	208.6	227.1	6.9%	226.1	(0.4%)	7.3%
Total Assets	**342.5**	**354.0**	**6.4%**	**376.0**	**6.2%**	**0.2%**
Customer Deposits	265.4	257.8	1.7%	289.4	12.3%	(10.6%)
Total Liabilities	292.7	295.2	4.3%	316.6	7.2%	(3.0%)
Shareholders’ Funds	**50.2**	**59.2**	**19.5%**	**59.9**	**1.3%**	**18.2%**

Balance Sheet Ratios	H1’2016	H1'2017	%y/y change
Loan to Deposit Ratio	83.8%	88.1%	4.3%
Return on average equity	24.5%	19.4%	(5.1%)
Return on average assets	3.7%	3.2%	(0.5%)

Income Statement	H1'2016	H1'2017	y/y change	H1'2017e	Projected %y/y change	Variance in Growth Actual vs. Expected
Net Interest Income	14.5	13.4	(7.2%)	14.3	(1.2%)	(6.0%)
Non-Interest Income	6.8	7.1	3.7%	7.2	4.8%	(1.1%)
Total Operating income	**21.3**	**20.5**	**(3.7%)**	**21.5**	**0.7%**	**(4.4%)**
Loan Loss provision	(1.3)	(1.5)	15.2%	(1.5)	12.3%	2.9%
Total Operating expenses	**(11.0)**	**(11.3)**	**3.5%**	**(11.8)**	**7.7%**	**(4.2%)**
Profit before tax	10.4	9.3	(11.3%)	9.8	(6.6%)	(4.6%)
Profit after tax	**7.4**	**6.6**	**(10.4%)**	**6.8**	**(8.0%)**	**(2.5%)**
Earnings per share	**1.52**	**1.13**	**(25.7%)**	**1.16**	**(23.5%)**	**(2.5%)**

Income Statement Ratios	H1’2016	H1'2017	%y/y change
Yield from interest-earning assets	14.2%	12.4%	(1.8%)
Cost of funding	5.5%	3.8%	(1.7%)
Net Interest Margin	8.9%	8.8%	(0.1%)
Cost of Risk	6.1%	7.4%	1.3%
Net Interest Income as % of operating income	68%	65%	(3.0%)
Non-Funded Income as a % of operating income	32%	35%	3.0%
Cost to Income Ratio	51.4%	55.3%	3.9%
Cost to Assets	2.7%	2.6%	(0.1%)

Capital Adequacy Ratios	H1’2016	H1'2017
Core Capital/Total Liabilities	16.4%	15.70%
Minimum Statutory ratio	8.00%	8.00%
Excess	**8.40%**	**7.70%**
Core Capital/Total Risk Weighted Assets	14.20%	15.70%
Minimum Statutory ratio	10.50%	10.50%
Excess	**3.70%**	**5.20%**
Total Capital/Total Risk Weighted Assets	20.50%	22.20%
Minimum Statutory ratio	14.50%	14.50%
Excess	**6.00%**	**7.70%**
Liquidity Ratio	32.90%	38.30%
Minimum Statutory ratio	20.00%	20.00%
Excess	**12.90%**	**18.30%**