Co-operative Bank Earnings Update – Q3’2017

10th November, 2017

Valuation Summary

- We are of the view that Co-operative Bank is an “accumulate” stock with a target price of Kshs 17.5 representing an upside of 13.4%, from the current price of Kshs 16.3, as at 10th November, inclusive of a dividend yield of 5.7%
- Co-operative Bank is currently trading at a P/TBv of 1.4x and a P/E of 8.2x, vs an industry average of 1.4x and 8.1x, respectively.

Key highlights during Q3’2017

- Co-operative Bank embarked on the 2nd stage of its Soaring Eagle Transformation Agenda in August, focusing on 4 major themes namely, (i) Deposits growth, (ii) Loan book growth, (iii) Pro-active Retention (PAR), and (iv) grow product holding to 3.5 per customer
- The Chairman of the Board of Directors, Mr. Stanley Muchiri (EBS) and the Vice-Chairman, Mr. Julius Riungu retired from the Board of Directors after attaining the set retirement age, being replaced by Mr. John Murugu (OGW) and Mr. Macloud Malonza as Chairman and Vice Chairman, respectively.

Income Statement

- Core earnings per share (EPS) declined by 9.5% to Kshs 1.6 from the adjusted EPS of Kshs 1.8 in Q3'2016, attributed to a 4.3% decline in operating revenue, and a 0.7% increase in total operating expenses. The change in core EPS has been adjusted for the bonus share issue of one for every five ordinary shares held, which was approved by shareholders in May 2017. Without adjustment for the bonus share issue, EPS declined by 24.6% to Kshs 1.6 from Kshs 2.2 in Q3’2016,
- Total operating revenue declined by 4.3% to Kshs 30.9 bn from Kshs 32.3 bn in Q3’2016. The decline was attributed to a 7.3% drop in Net Interest Income to Kshs 20.8 bn from Kshs 22.4 bn in Q3’2016, despite a 2.7% increase in Non-Funded Income to Kshs 10.1 bn from Kshs 9.9 bn in Q3’2016,
- Interest Income declined by 7.7% to Kshs 29.9 bn from Kshs 32.3 bn in Q3’2016, despite a 14.2% growth in the loan book. Interest income on government securities declined by 8.2% y/y to Kshs 6.7 bn from Kshs 6.1 bn, while interest income on loans and advances recorded a 6.9% y/y decline to Kshs 23.6 bn from Kshs 25.3 bn. As a result, the yield on interest-earning assets declined to 12.3% from 14.9% in Q3’2016,
- Interest expense declined 8.5% to Kshs 9.1 bn from Kshs 9.9 bn in Q3’2016 following an 11.4% y/y decline in interest expense on customer deposits to Kshs 8.1 bn from Kshs 9.1 bn. The decline in interest expense is despite a 12.1% growth in deposits, the trend is attributed to reclassification of customer deposits to current and transaction accounts, which currently account for 59.5% of total deposits from 58.0% in Q3’2016, bringing down the cost of funds to 3.9% from 5.3% in Q3’2016,
- Net Interest Income declined by 7.3% to Kshs 20.8 bn from Kshs 22.4 bn, leading to a decline in the Net Interest Margin to 8.6% from 9.7% in Q3’2016,
- Non-Funded Income (NFI) recorded a growth of 2.7% to Kshs 10.1 bn from Kshs 9.9 bn in Q3’2016. The growth in NFI was driven by an increase in total fees and commissions that rose by 5.9% to Kshs 7.9 bn from Kshs 7.4 bn. The alternative banking channels including digital and agency banking supported this increase in fees and commissions. Forex income also registered a 9.9% increase to Kshs 1.5 bn from Kshs 1.4 bn in Q3’2015. The current revenue mix stands at 67:33 funded to non-funded income from 69:31 in Q3’2016,
- Total operating expenses grew slightly by 0.7% to Kshs 17.3 bn from Kshs 17.2 bn in Q3’2016, driven by an 8.3% y/y growth in staff costs to Kshs 7.2 bn from Kshs 6.7 bn. Loan Loss Provisions (LLP) rose 31.7% to Kshs 2.6 bn from Kshs 2.0 bn in Q3’2016, while other operating expenses recorded a 12.3% decline to Kshs 7.5 bn from Kshs 8.5 bn in Q3’2016. The growth in staff costs was attributed to an increase in staff number to the current 4,113 from 4,072 in Q3’2016 as the bank filled key strategic positions,
- Cost to income ratio deteriorated to 55.9% from 53.1% in Q3’2016, as a result of a 0.7% growth in operating expenses coupled with a 4.3% decline in operating revenue. Without LLP, cost to income ratio stood at 47.6% from 47.1% in the same period last year,
- Profit before tax declined by 9.8% to Kshs 13.7 bn from Kshs 15.2 bn in Q3’2016. Profit after tax also declined by 9.5% to Kshs 9.5 bn from Kshs 10.5 bn in Q3’2016. The effective tax rate remained relatively stable at 30.6% from 30.8% in Q3’2016.

Balance Sheet

- The balance sheet recorded an expansion in Q3'2017, with total assets increasing by 9.7% to Kshs 388.3 bn from Kshs 354.0 bn in Q3'2016. This growth was driven by a 14.2% y/y growth in the loan book to Kshs 259.4 bn from Kshs 227.1 bn in Q3'2016. Growth was supported by increased use of alternative channels to drive loan disbursement, with 86% of Co-operative Banks' total transactions year to date facilitated via alternative channels,
- The loan book was majorly composed of personal loans that accounted for 32% of total loans, an increase compared to 29.3% contribution in Q3'2016, while loans to corporates stood at 25.6%, a decline from its Q3'2016 contribution of 29.2%. Mortgage lending also experienced a growth, with the mortgage book now accounting for 17% of the total loan book, up from 15.7% in Q3'2016,
- Total liabilities increased by 8.8% to Kshs 321.1 bn from Kshs 295.2 bn in Q3'2016, driven by 12.1% growth in customer deposits to Kshs 289.0 bn from Kshs 257.8 bn in Q3'2016, driven by an increase in the collections from alternative channels especially agency banking, and the number of bank account holders, currently at 6.8 mn customers,
- The deposit mix remained relatively stable, with corporates and the retail segment contributing 48.5% and 19% of total deposits, respectively, similar to 48.5% and 20%, respectively in Q3'2016. In terms of deposits by type, there was an increase in transaction and current accounts, which currently account for 59.5% of total deposits from 58% in Q3'2016,
- Shareholders' funds increased by 13.8% to Kshs 67.3 bn from Kshs 59.2 bn in Q3'2016, due to a 16.9% y/y increase in retained earnings to Kshs 58.7 bn from Kshs 50.2 bn,
- The faster growth in loans as compared to deposits led to an increase in the loan to deposit ratio to 89.8% from 88.1% in Q3'2016, with Co-operative bank able to leverage on long-term funds from Development Partners to fund their loan book,
- Gross Non Performing Loans increased 69.5% to Kshs 16.9 bn from Kshs 10.0 bn in Q3'2016, thus increasing the NPL ratio to 6.4% from 4.7% in Q3'2016,
- The yield on interest earning assets declined to 12.3% from 14.9% in Q3'2016, with the cost of funds rising also declining to 3.9% from 5.3% in Q3'2016,
- Co-operative Bank is currently sufficiently capitalized with a core capital to risk weighted assets ratio at 15.9%, 5.4% above the statutory requirement, with total capital to total risk weighted assets exceeding statutory requirement by 8.1%,
- Co-operative Bank currently has a return on average assets of 3.1% and a return on average equity of 18.5%.

Key Take outs:

i. Co-operative Bank's performance was in line with our expectations, albeit registering a smaller increase in Non-Funded Income (NFI) than expected
ii. Despite the tough economic environment in South Sudan, Co-op bank subsidiary reported a profit of Kshs 39.2 mn in Q3'2017, leveraging on the unique partnership with Government of South Sudan which focuses more on government institutions and Non-Government Organisations
iii. We expect the bank to continue implementing its key transformation steps, including operational efficiencies, automation and use of alternative channels to support future growth. We are also of the view that in addition to cost efficiency brought about by the Soaring Eagle Transformation Strategy, Co-operative bank has untapped opportunity in the alternative revenue streams to drive NFI growth, just like its peers such as Equity Group.

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	Q3'2016	Q3'2017	y/y change	Q3'2017e	Expected y/y change	Variance in Actual Growth vs Expected
Government Securities	70.7	71.2	0.8%	68.6	(2.9%)	3.7%
Net Loans and Advances	227.1	259.4	14.2%	254.3	12.0%	2.2%
Total Assets	**354.0**	**388.3**	**9.7%**	**391.1**	**10.5%**	**(0.8%)**
Customer Deposits	257.8	289.0	12.1%	290.0	12.5%	(0.4%)
Total Liabilities	295.2	321.1	8.8%	323.7	9.6%	(0.9%)
Shareholders' Funds	**59.2**	**67.3**	**13.8%**	**67.6**	**14.2%**	**(0.4%)**

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Balance Sheet Ratios	Q3'2016	Q3'2017	%y/y change
Loan to Deposit Ratio	88.1%	89.8%	1.7%
Return on average equity	25.1%	18.5%	(6.6%)
Return on average assets	4.0%	3.1%	(0.8%)

Income Statement	Q3'2016	Q3'2017	%y/y change	Q3'2017e	Projected %y/y change	Variance in Growth Actual vs. Expected
Net Interest Income	22.4	20.8	(7.3%)	21.8	(2.7%)	(4.6%)
Non-Interest Income	9.9	10.1	2.7%	10.4	5.3%	(2.6%)
Total Operating income	**32.3**	**30.9**	**(4.3%)**	**32.2**	**(0.3%)**	**(4.0%)**
Loan Loss provision	(1.9)	(2.6)	31.7%	(2.2)	13.7%	18.1%
Total Operating expenses	**(17.2)**	**(17.3)**	**0.7%**	**(18.3)**	**7.0%**	**(6.3%)**
Profit before tax	15.2	13.7	(9.8%)	13.9	(8.5%)	(1.3%)
Profit after tax	**10.5**	**9.5**	**(9.5%)**	**9.8**	**(7.5%)**	**(2.1%)**
Core EPS	**1.8**	**1.6**	**(9.5%)**	**1.6**	**(7.5%)**	**(2.1%)**

Income Statement Ratios	Q3'2016	Q3'2017	%y/y change
Yield from interest-earning assets	14.9%	12.3%	(2.6%)
Cost of funding	5.3%	3.9%	(1.4%)
Net Interest Margin	9.7%	8.6%	(1.1%)
Net Interest Income as % of operating income	69.4%	67.2%	(2.2%)
Non-Funded Income as a % of operating income	30.6%	32.8%	2.2%
Cost to Income Ratio	47.1%	47.6%	0.5%
Cost to Assets	4.3%	3.8%	(0.5%)

Capital Adequacy Ratios	Q3'2016	Q3'2017
Core Capital/Total Liabilities	18.7%	19.8%
Minimum Statutory ratio	8.0%	8.0%
Excess	**10.7%**	**11.8%**
Core Capital/Total Risk Weighted Assets	15.7%	15.9%
Minimum Statutory ratio	10.5%	10.5%
Excess	**5.2%**	**5.4%**
Total Capital/Total Risk Weighted Assets	22.2%	22.6%
Minimum Statutory ratio	14.5%	14.5%
Excess	**7.7%**	**8.1%**
Liquidity Ratio	38.3%	35.0%
Minimum Statutory ratio	20.0%	20.0%
Excess	**18.3%**	**15.0%**