Cytonn INVESTMENTS

Co-operative Bank – Q3’2019
15th November, 2019

Valuation Summary

- We are of the view that Co-operative Bank is a “HOLD” with a target price of Kshs 15.0, representing an upside of 6.4%, from the current price of Kshs 15.0 as of 15th November 2019, inclusive of a dividend yield of 6.4%,
- Co-operative Bank is currently trading at a P/TBV of 1.4x and a P/E of 7.9x vs an industry average of 1.2x and 6.0x, respectively,

Key Highlights Q3’2019

- The Bank was named Best Bank in Kenya; in EMEA Awards (African Banking Awards) 2019 and in the 2019 East African Financial Reporting (FiRe) Awards, the bank was named Overall Winner in the Environmental Sustainability Reporting category,
- The bank has been leveraging on the benefits of the “Soaring Eagle” Transformation Agenda which is reflected in the sustained growth in market share across all market segments and counties. This has deepened its Financial Inclusion model rooted in the over 15 million-member co-operative movement. For example, the MSME packages launched in 2018 has been taken up by over 56,800 customers where 4000 customers have already been trained on business management and planning,

Income Statement

- Core earnings per share increased by 5.5% to Kshs 1.6 in Q3’2019, from Kshs 1.5 in Q3’2018, which was not in line with our projections of a 7.3% increase. The performance was driven by a 9.1% increase in total operating income to Kshs 35.2 bn in Q3’2019 from Kshs 32.3 in Q3’2018 and an 11.3% increase in total operating expenses. The variance in core earnings per share growth against our expectations was largely due to the 11.3% rise in total operating expenses to Kshs 19.8 bn in Q3’2019, from Kshs 17.8 bn in Q3’2018, which was not in line with our expectation of an 8.0% increase to Kshs 19.2 bn,
- Total operating income increased by 9.1% to Kshs 35.2 bn in Q3’2019 from Kshs 32.3 bn in Q3’2018. This was due to a 33.3% increase in Non-Interest Income to Kshs 14.1 bn from Kshs 10.6 bn in Q3’2018. The growth was however mitigated by the 2.7% decline in Net Interest Income (NII) to Kshs 21.2 bn from Kshs 21.7 bn in Q3’2018,
- Interest income declined by 1.6% to Kshs 30.4 bn in Q3’2019, from Kshs 30.9 bn in Q3’2018. This was caused by a 33.7% decline in interest income from loans and advances to Kshs 21.8 bn, from Kshs 32.9 bn in Q3’2018, as well as the 16.2% decrease in interest income from government securities to Kshs 8.2bn from Kshs 9.8 bn in Q3’2018. The yield on interest-earning assets thus declined to 11.5%, from 11.9% in Q3’2018,
- Interest expense rose marginally by 0.9% to Kshs 9.2 bn in Q3’2019, from Kshs 9.1 bn in Q3’2018, largely due to a 34.2% rise in other interest expenses to Kshs 1.2 bn from Kshs 0.9 bn in Q3’2018. Interest expense on customer deposits, however, decreased by 2.5% to Kshs 8.0 bn from Kshs 8.2 bn in Q3 2018. Whereas, interest expense on bank placements recorded a decline of 25.6% to 35.5 mn from 47.7 mn in Q3’2018 The cost of funds declined to 3.6%, from 3.8% in Q3’2018, owing to a 9.2% increase in interest-bearing liabilities to Kshs 353.5 bn, from Kshs 323.6 bn in Q3’2018 despite the 0.9% decline in interest expense,
- Non interest Income rose by 33.3 % to Kshs 14.1 bn in Q3’2019, from Kshs 10.6 bn in Q3’2018. The increase was mainly driven by the 37.8% increase in fees and commissions on loans to Kshs 1.8 bn, from Kshs 1.3 bn in Q3’2018, as well as, a 48.3% increase in other fees to 9.8 bn from 6.6 bn in Q3’2018. The improvement in NFI was however weighed down by the 7.7% decline in forex trading income to Kshs 1.6 bn, from Kshs 1.8 bn in Q3’2018. As a consequence, the revenue mix shifted to 60:40, from 67:33 in Q3’2018 owing to the fast growth in NFI,

- Total operating expenses increased by 11.3% to Kshs 19.8 bn in Q3’2019, from Kshs 17.8 bn in Q3’2018, largely driven by the 66.8% rise in Loan Loss Provisions (LLP) to Kshs 2.1 bn from Kshs 1.3 bn in Q3’2018, coupled with the staff costs increase of 12.1% to Kshs 9.1 bn in Q3’2019 from Kshs 8.1 bn in Q3’2018
- The Cost to Income Ratio (CIR) deteriorated to 56.2%, from 55.1% in Q3’2018, following the faster rise in total operating expenses that outpaced total operating income. Without LLP, the cost to income ratio improved to 50.2% from 51.2% in Q3’2018,
- The bank registered a growth of 5.5% in profit after tax to Kshs 10.9 bn in Q3’2019 from Kshs 10.3 bn in Q3’2018 and a 5.5% growth in profit before tax to Kshs 15.5 bn from Kshs 14.6 bn in Q3’2018 with the similarity in growth attributable to the unchanged effective tax rate of 29.6% in both Q3’2019 and Q3’2018

Balance Sheet

- The balance sheet recorded an expansion as total assets grew by 9.1% to Kshs 440.8 bn in Q3’2019 from Kshs 404.2 bn in Q3’2018 owing to the increases in government securities by 13.6% to Kshs 94.6bn in Q3’2019 from Kshs 83.3 bn, coupled with increase in placements by 47.5% to Kshs 24.33 from Kshs 16.49 bn, increase in net loans and advances by 5.8% to Kshs 268.9 bn in Q3’2019 from Kshs 254.2 bn in Q3’2018,
- Total liabilities grew by 9.9% to Kshs 365.4 bn in Q3’2019 from Kshs 332.5 bn in Q3’2018 which was largely attributable to the 8.9% rise in customer deposits to Kshs 322.5 bn in Q3’2019 from Kshs 296.1 bn in Q3’2018,
- Borrowings rose by 14.4% to Kshs 29.7 bn from Kshs 26.0 bn in Q3’2018,
- The faster 8.9% growth in deposits which outpaced the 5.8% growth in net loans and advances, led to a decline in the loan to deposit ratio to 83.4%, from 85.9% in Q3’2018,
- Gross Non-Performing Loans (NPLs) increased by 1.3% to Kshs 30.1 bn in Q3’2019, from Kshs 29.7 bn in Q3’2018. The NPL ratio however improved to 10.5% in Q3’2019, from 11.2% in Q3’2018 owing to a faster growth in gross loans by 7.7% outpacing the 1.3% growth in gross non-performing loans
- General Loan Loss Provisions increased by 15.2% to Kshs 11.4 bn, from Kshs 9.9 bn in Q3’2018. The NPL coverage ratio thus improved to 55.5% in Q3’2019 from 36.8% in Q3’2018, due to the faster growth in General Loan Loss Provisions which outpaced the growth in Gross Non-Performing Loans (NPLs)
- Shareholders’ funds increased by 4.3% to Kshs 73.9 bn in Q3’2019 from Kshs 70.9 bn in Q3’2018, mainly driven by a 3.1% increase in the retained earnings to Kshs 64.4 bn, from Kshs 62.5 bn in Q3’2018,
- Co-operative Bank remains sufficiently capitalized with a core capital to risk-weighted assets ratio of 15.4%, 4.9% points above the statutory requirement of 10.5%. In addition, the total capital to risk-weighted assets ratio came in at 15.7%, exceeding the statutory requirement of 14.5% by 1.2% points.
- The bank currently has a Return on Average Assets (ROaA) of 3.2%, and a Return on Average Equity (ROaE) of 18.4%.

Key Take-Outs:

1. Non-Funded Income rose by 33.3 % to Kshs 14.1 bn in Q3’2019, from Kshs 10.6 bn in Q3’2018 exceeding the industry average growth of 21.3%. The increase was mainly driven by the 37.8% increase in fees and commissions on loans to Kshs 1.8 bn, from Kshs 1.3 bn in Q3’2018, as well as, a 48.3% increase in other fees to 9.8 bn from 6.6 bn. The improvement in NFI was however weighed down by the 7.7% decline in forex trading income to Kshs 1.6 bn, from Kshs 1.8 bn in Q3’2018. As a consequence, the revenue mix shifted to 60:40, from 67:33 in Q3’2018 owing to the fast growth in NFI which was attributable to increased activity in Bancassurance and advisory and training services
2. The bank’s asset quality improved , with the NPL ratio decreasing to 10.5% in Q3’2019, from 11.2% in Q3’2018 owing to a faster growth in gross loans by 7.7% outpacing the 1.3% growth in gross non-performing loans which is attributable to the implementation of credit management strategies

implemented since beginning of the year such as adherence to credit risk appetite and limits, credit risk early warning indicators, proper credit appraisal and approval mechanisms

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

I. **Refocus on the core operations-** Prior to Q3’2019 the bank preferred to diversify to increase NFI due to the declining interest income however, now that there is potential for increasing interest income, the bank should refocus on lending to private sector which will not only increase interest income but also, it will increase fees and commissions on loans
II. **Maximize on the interest rate cap repeal**: With the repeal of the interest rate cap the bank does not have to focus on cherry-picking loans to ensure proper credit management, instead, they can price loans according to the level of risk which will increase their loans to deposits ratio and interest income
III. **Improve cost efficiency through technology:** If the focus is placed more on online platforms and e-platforms the bank could be able to reduce costs especially staff costs which increased by 12.1%

Below is a summary of the bank’s performance:

Balance Sheet Items	Q3'2018	Q3'2019	y/y change	Q3'2019e	Projected %y/y change	Variance in Growth Actual vs. Expected
Government Securities	83.3	94.6	13.6%	96.5	16.0%	(2.4%)
Net Loans and Advances	254.2	268.9	5.8%	264.4	4.0%	1.7%
Total Assets	404.2	440.8	9.1%	441.6	9.3%	(0.2%)
Customer Deposits	296.1	322.5	8.9%	331.7	12.0%	(3.1%)
Total Liabilities	332.5	365.4	9.9%	365.6	10.0%	(0.1%)
Shareholders’ Funds	70.9	73.9	4.3%	75.9	7.1%	(2.8%)

Balance Sheet Ratios	Q3'2018	Q3'2019	y/y change
Loan to Deposit Ratio	85.9%	83.4%	(2.5%)
Return on average equity	17.6%	18.4%	0.7%
Return on average assets	3.1%	3.2%	0.1%

Income Statement	Q3'2018	Q3'2019	y/y change	Q3'2019e	Projected %y/y change	Variance in Growth Actual vs. Expected
Net Interest Income	21.7	21.2	(2.7%)	21.9	0.8%	(3.5%)
Non-Interest Income	10.6	14.1	33.3%	13.1	24.0%	9.3%
Total Operating income	**28.7**	**29.9**	4.1%	**22.1**	(23.2%)	**27.2%**
Loan Loss provision	(1.3)	(2.1)	66.8%	(1.7)	31.3%	35.5%
Total Operating expenses	(17.8)	(19.8)	11.3%	(19.2)	8.0%	3.3%
Profit before tax	14.6	15.5	5.5%	15.8	8.0%	(2.4%)
Profit after tax	10.3	10.9	5.5%	11.1	7.3%	(1.8%)
Earnings per share	1.5	1.58	5.5%	1.9	25.2%	(19.6%)

Income Statement Ratios	Q3'2018	Q3'2019
Yield from interest-earning assets	11.9%	11.5%
Cost of funding	3.8%	3.6%
Net Interest Spread	8.0%	7.8%
Net Interest Income as % of operating income	67%	60%
Non-Funded Income as a % of operating income	33%	40%
Cost to Income	55.1%	56.2%
Cost to Assets	4.1%	4.0%

Capital Adequacy Ratios	Q3'2018	Q3'2019
Core Capital/Total deposit Liabilities	20.6%	20.0%
Minimum Statutory ratio	8.0%	8.0%
Excess	**12.6%**	**12.0%**
Core Capital/Total Risk-Weighted Assets	16.5%	15.4%
Minimum Statutory ratio	10.5%	10.5%
Excess	**6.0%**	**4.9%**
Total Capital/Total Risk-Weighted Assets	16.6%	15.7%
Minimum Statutory ratio	14.5%	14.5%
Excess	**2.1%**	**1.2%**
Liquidity Ratio	41.7%	44.6%
Minimum Statutory ratio	20.0%	20.0%
Excess	**21.7%**	**24.6%**
Adjusted Core Capital/Total deposit liabilities	20.1%	21.6%
Adjusted Core Capital/Total Risk-Weighted Assets	15.6%	17.3%