Valuation Summary

- We are of the view that Cooperative Bank of Kenya limited is a "Hold" with a target price of Ksh 19.3, representing an upside of 6.7%, from the current price of Kshs 18.8 as of 15th March, inclusive of a dividend yield of 4.2%,
- Cooperative Bank is currently trading at P/TBV of 1.7x and a P/E of 9.5x vs an industry average of 1.6x and 9.2x, respectively.

Key highlights FY'2017

- The IMF extended a USD 150 million 7-year line of credit to Cooperative bank to support the bank's lending activities to small firms. The loan is supposed to be utilized to expand the bank's lending operations to the underserved Micro, small and Medium enterprises
- Moody's downgraded the credit ratings of three Kenyan banks, following the weakening profile of the Kenyan government. The banks KCB, Equity Bank and Cooperative were downgraded to B2 (stable outlook), from B1 (rating under review outlook).
- 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 declined by 10.0% to Kshs 1.9 per share from Kshs 2.2, much higher than our expectations of a 1.1% decline. The performance is due to a 1.6% decline in the total operating income coupled with a 2.8% increase in operating expenses,
- Total operating revenue declined by 1.6% to Kshs 41.6 bn from Kshs 42.3 bn, driven by a 4.7% decline in Net Interest Income (NII), despite a 5.6% increase in Non-Funded Income (NFI). NII declined by 4.7% to Kshs 28.1 bn from Kshs 29.5 bn in FY'2016, while NFI rose 5.6% to Kshs 13.5 bn from Kshs 12.8 bn in FY'2016,
- Interest Income declined by 4.5% to Kshs 40.4 bn from Kshs 42.4 bn in FY'2016. The interest income on loans and advances alone declined by 4.5% y/y to Kshs 31.9 bn from Kshs 33.4 bn, while interest income on government securities declined by 3.3% y/y to Kshs 8.2 bn from Kshs 8.5 bn. As a result, the yield on interest-earning assets declined to 11.9% from 13.9% in FY'2016,
- Interest expense decreased by 3.9% to Kshs 12.3 bn from Kshs 12.8 bn in FY'2016, following a 7.0% decline in interest expense on customer deposits to Kshs 10.8 bn from Kshs 11.7 bn, thus bringing down the cost of funds to 4.1% from 4.5% in FY'2016. The Net Interest Income declined by 4.7% to Kshs 28.1 bn from Kshs 29.5 bn leading to a decline in the Net Interest Margin to 9.2% from 9.9% in FY'2016,
- Non-Funded Income (NFI) recorded a growth of 5.6% to Kshs 13.5 bn from Kshs 12.8 bn in FY'2016. The growth in NFI was driven by an 11.5% increase in fees and commissions to Kshs 2.6 bn from Kshs 2.3 bn in FY'2016, and a 23.5% y/y increase in forex income to Kshs 2.2 bn from Kshs 1.8 bn. The current revenue mix stands at 68:32 funded to non-funded income from 70:30 in FY'2016, with the proportion of NFI increasing following the decline in Net Interest Income coupled with the increase in NFI,

- The 3.2% decline in income from other fees and commissions could be attributed to a decline in the transactions through traditional channels such as OTC and ATMs and an increase in transactions done via alternative (relatively cheaper) channels such as MCOOP cash and internet banking. Number of transactions done through the alternative channels increased from 83% in FY 2016 to 87% in FY’ 2017.
- Total operating expenses increased by 2.8% to Kshs 25.3 bn from Kshs 24.6 bn, driven by a 38.5% increase in Loan Loss Provisions to Kshs 3.6 bn from Kshs 2.6 bn in FY'2016, coupled with a 7.5% increase in staff costs to Kshs 10.1 bn from Kshs 9.4 bn in FY'2016. Other operating expenses declined by 13.6% to Kshs 7.4 bn from Kshs 8.6 bn in FY'2016,
- The Cost to Income ratio deteriorated to 61% from 58% in FY'2016. Without LLP, the Cost to Income ratio remained unchanged at 52%,
- Profit before tax declined by 7.3% to Kshs 16.4 bn from Kshs 17.7 bn while profit after tax declined by 10% to Kshs 11.4 bn from Kshs 12.7 bn in FY’2016,
- The bank recommends a first and final dividend of Kshs 0.8 per share, unchanged from 2016, translating to a dividend yield of 4.2%,

Balance Sheet

- The total assets increased by 9.9% to Kshs 386.9 bn from 351.9 bn in FY’2016. This growth was largely driven by a 7.1% increase in the loan book to Kshs 253.9 bn from Kshs 236.9 bn. Also, investment in government securities increased by 19.7% to stand at Ksh 69.2 bn from 57.8 bn in FY’ 2016.
- The loan book was majorly composed of personal loans that accounted for 35.3% of total loans followed by corporate lending, which was 24.2% of total loans.
- Total liabilities rose by 8.9% to Kshs 316.6 bn from Kshs 290.7 bn in FY’ 2016, driven by a 9.2% increase in total deposits from Kshs 263.6 bn in FY’2016 to Kshs 287.7 bn in FY’ 2017. Deposits per branch closed the year at Kshs 1.9 bn up by 8.6% from Kshs 1.75 bn in FY’2016,
- The deposit mix was relatively stable with retail and Institutional segments contributing 22.8% and 24.2% respectively compared to 20.2% and 24.2% respectively. In account types, current accounts accounted for 33.4% of total accounts, followed by transactional accounts at 26.2%. This relatively larger proportion of relatively ‘cheaper’ account types contributed in part to the decrease in the cost of funds
- The faster growth in deposits compared to the loan book led to a decline in the loan to deposit ratio to 88.2% from 89.9% in FY'2016,
- Gross non-performing loans increased by 66.4% to Kshs 18.8 bn from Kshs 11.3 bn, owing to increase in NPLs in the Trade sector and the Real Estate sector. The NPL ratio thus deteriorated to 7.0% from 4.3% in FY’2016, due to the faster growth NPLs compared to the loan book growth,
- Shareholders’ funds increased by 13.5% to Kshs 61.3 bn from Kshs 69.6 bn in FY’2016, due to a 14.8% increase in retained earnings to Kshs 55.3 bn from Kshs 48.2 bn,
- Co-operative Bank is currently sufficiently capitalized with a core capital to risk weighted assets ratio at 15.8%, 5.3% above the statutory requirement, with total capital to total risk weighted assets at 22.0%, exceeding statutory requirement by 7.5%.

Key Take out:

a) The relatively challenging macroeconomic environment coupled with the effects of the interest rate cap compressed the bank’s interest income. Loans mainly those issued to traders and real estate developers contributed a huge proportion of the rise in non-performing loans. The bank's main drivers for efficiency are the increased adoption of alternative channels by the customers with transactions done via alternative channels such as internet banking and mobile banking via MCoop cash currently standing at 87% of total transactions

The bank recorded a 14% increase in the number of registered customers on Mcoop cash, and an 11% increase in the customers on agency banking.

Going forward, we expect Co-operative Bank's growth to be propelled by;

(i) Channel diversification to more efficient and customer convenient channels such as mobile and digital channels that allow for more transactional fee-based income, thus increasing its Non-Funded Income,
(ii) Improvements in asset quality, with the increase in NPLs causing Co-operative Bank's Gross Non-Performing Loans ratio to deteriorate to 7.0%, which is however still below peer average of 8.2%.

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	FY'2016	FY'2017	y/y change	FY'2017e	Expected y/y change	Variance in Actual Growth vs Expected
Government Securities	61.9	72.7	17.4%	71.1	14.8%	2.5%
Net Loans and Advances	236.9	253.9	7.1%	258.6	9.1%	(2.0%)
Total Assets	351.9	386.9	9.9%	**391.7**	11.3%	(1.4%)
Customer Deposits	260.2	287.4	10.5%	293.9	13.0%	(2.5%)
Total Liabilities	290.7	316.6	8.9%	326.2	12.2%	(3.3%)
Shareholders' Funds	61.3	69.6	13.5%	**65.7**	7.2%	6.3%

Income Statement	FY'2016	FY'2017	y/y change	FY'2017e	Expected y/y change	Variance in Actual Growth vs Expected
Net Interest Income	29.5	28.1	(4.7%)	28.1	(4.7%)	(0.0%)
Net non-Interest Income	12.8	13.5	5.6%	13.9	8.5%	(2.8%)
Total Operating income	42.3	41.6	(1.6%)	42.0	(0.7%)	(0.9%)
Loan Loss provision	(2.6)	(3.6)	38.5%	(3.1)	18.2%	20.4%
Total Operating expenses	(24.6)	(25.3)	2.8%	(24.1)	(2.0%)	4.8%
Profit before tax	17.7	16.4	(7.5%)	17.9	1.1%	(8.6%)
Profit after tax	**12.7**	**11.4**	**(10.0%)**	**12.5**	**(1.1%)**	**(8.9%)**

Income Statement Ratios	FY'2016	FY'2017	y/y change
Yield from interest-earning assets	14.2%	12.7%	(1.5%)
Cost of funding	4.5%	4.1%	(0.4%)
Net Interest Spread	9.7%	8.5%	(1.2%)
Net Interest Income as % of operating income	69.8%	67.6%	(2.2%)

Non-Funded Income as a % of operating income	30.2%	32.4%	2.2%
Cost to Income Ratio	52.1%	52.2%	0.1%
Cost to Assets Ratio	6.3%	5.6%	(0.6%)

Capital Adequacy Ratios	**FY'2016**	**FY'2017**
Core Capital/Total Liabilities	19.7%	20.0%
Minimum Statutory ratio	8.0%	8.0%
Excess	**11.7%**	**12.0%**
Core Capital/Total Risk Weighted Assets	16.1%	15.8%
Minimum Statutory ratio	10.5%	10.5%
Excess	**5.6%**	**5.3%**
Total Capital/Total Risk Weighted Assets	22.7%	22.0%
Minimum Statutory ratio	14.5%	14.5%
Excess	**8.2%**	**7.5%**
Liquidity Ratio	33.7%	33.8%
Minimum Statutory ratio	20.0%	20.0%
Excess	**13.7%**	**13.8%**