Valuation Summary

- We are of the view that Co-operative Bank is an “Accumulate” with a target price of Kshs 19.7, representing an upside of 19.6%, from the current price of Kshs 17.1 as of 15th August, inclusive of a dividend yield of 4.4%,
- Co-operative Bank Holdings is currently trading at P/TBV of 1.5x and a P/E of 9.3x vs an industry average of 1.7x and 9.2x, respectively.

Key Highlights H1’2018

- Co-operative Bank has set aside Kshs 200 mn for capital injection into the government’s Kenya Mortgage Refinance Company (KMRC) to support long term financing for affordable housing,
- The bank refined the “soaring eagle” transformation agenda, to focus on improving operational efficiencies via cost management and income growth by leveraging on innovative delivery systems,
- Co-operative Bank obtained financing of a USD 150 mn, 7-year senior loan from the IFC, which will mainly be used for onwards lending to SMEs. The loan from IFC will be received in two tranches of USD 75 mn each, one in June 2018 and the other in February 2019;

Income Statement

- Core earnings per share increased by 7.6% to Kshs 2.0 from Kshs 1.9 in H1’2017, in line with our expectation of a 6.1% increase to Kshs 2.0. Performance was driven by a 6.3% increase in total operating income, despite a 5.5% increase in total operating expenses,
- Total operating income increased by 6.3% to Kshs 21.8 bn in H1’2018 from Kshs 20.5 bn in H1’2017. This was due to a 10.4% increase in Net Interest Income (NII) to Kshs 14.8 bn from Kshs 13.4 bn in H1’2017, despite a 1.6% decline in Non-Funded Income (NFI) to Kshs 7.0 bn from Kshs 7.1 bn in H1’2017,
- Interest income increased by 7.9% to Kshs 20.8 bn from Kshs 19.3 bn in H1’2017. The interest income on loans and advances increased by 5.7% to Kshs 16.1 bn from Kshs 15.3 bn in H1’2017. Interest income on government securities increased by 17.5% to Kshs 4.5 bn from Kshs 3.9 bn in H1’2017. The yield on interest earning assets however declined to 12.2% in H1’2018 from 12.4% in H1’2017, due to the increase in interest earning assets mainly being government securities that have a lower yield than loans,
- Interest expense increased by 2.2% to Kshs 6.0 bn from Kshs 5.8 bn in H1’2017, following a 2.9% increase in the interest expense on customer deposits to Kshs 5.4 bn from Kshs 5.2 bn in H1’2017. Other interest expenses declined by 5.0% to Kshs 572.8 mn in H1’2018 from Kshs 602.7 mn in H1’2017. The cost of funds increased slightly to 3.9% from 3.8% in H1’2017. Consequently, the Net Interest Margin declined to 8.6% from 8.8% in H1’2017,
- Non-Funded Income decreased by 1.6% to Kshs 7.0 bn from Kshs 7.1 bn in H1’2017. The decline in NFI was caused by a 41.4% decrease in fees and commissions on loans to Kshs 0.8 bn from Kshs 1.4 bn in H1’2017. The decline in fees is attributable to a contracting loan book, and growth in loans extended to corporates, which the bank charged minimal fees and commissions. Other fees and commissions income rose 11.0% to Kshs 4.3 bn from Kshs 3.9 bn in H1’2017, while foreign exchange trading income declined by 1.7% to Kshs 0.8 bn from Kshs 0.6 bn in H1’2017. The current revenue mix stands at 68:32 funded to non-funded income as compared to 65:35 in H1’2017. The proportion of non-funded income to total revenue declined owing to the faster growth in NII, coupled with the decrease in NFI,
- Total operating expenses increased by 5.5% to Kshs 12.0 bn from Kshs 11.3 bn in H1’2017, largely driven by a 13.0% increase in staff costs to Kshs 5.3 bn in H1’2018 from Kshs 4.7 bn in H1’2017, coupled with an 8.4% increase in other operating expenses to Kshs 5.5 bn from Kshs 5.1 bn in H1’2017. Staff

costs rose faster than industry average, in part due to specialized hires made by the bank in the IT department to be used for big data analytics and credit pre-scoring purposes, with the bank indicating the hires were being paid at a premium to average market rates. The Loan Loss Provisions (LLP) declined by 27.6% to Kshs 1.1 bn from Kshs 1.5 bn in H1’2017,

- The cost to income ratio improved albeit marginally to 54.9% from 55.3% in H1’2017. Without LLP, the Cost to income ratio deteriorated to 49.9% from 47.9% in H1’2017,
- Profit before tax increased by 7.6% to Kshs 10.0 bn up from Kshs 9.3 bn in H1’2017. Profit after tax also increased by 7.6% to Kshs 7.1 bn in H1’2018 from Kshs 6.6 bn in H1’2017,

Balance Sheet

- The balance sheet recorded an expansion as total assets increased by 3.9% to Kshs 398.4 bn from Kshs 383.3 bn in H1’2017. This growth was largely driven by a 12.0% increase in government securities to Kshs 83.1 bn from Kshs 74.2 bn in H1’2017,
- The loan book contracted marginally by 0.6% to Kshs 251.1 bn from Kshs 252.6 bn in H1’2017. The proportion of the loans extended to SMEs and Personal banking increased during the period to 8.9% and 32.2%, up from 6.7% and 31.5%, respectively in H1’2017, while Corporate loans declined to 25.0% from 26.3% in H1’2017,
- Total liabilities rose by 3.3% to Kshs 329.6 bn from Kshs 319.0 bn in H1’2017, driven by a 3.9% increase in total deposits to Kshs 297.0 bn from Kshs 285.8 bn in H1’2017. Deposits per branch remained at Kshs 1.92 bn, similar to H1’2017 despite the number of branch outlets increasing by 2 branches to 155 during the quarter,
- The faster growth in deposits as compared to loans led to a decline in the loan to deposit ratio to 84.6% from 88.4% in H1’2017,
- Gross non-performing loans increased by 130.8% to Kshs 28.2 bn in H1’2018 from Kshs 12.2 bn in H1’2017. As a consequence, the NPL ratio deteriorated to 10.9% in H1’2018 from 4.7% in H1’2017. Loan loss provisions increased by 75.6% to Kshs 7.9 bn from Kshs 4.5 bn in H1’2017.The NPL coverage decreased to 31.0% in H1’2018 from 44.7% in H1’2017, due to the relatively faster increase in the gross non-performing loans. The increase in the non-performing loans was attributed to major clients in the trade and manufacturing sectors,
- Shareholders’ funds increased by 5.5% to Kshs 68.0 bn in H1’2018 from Kshs 64.5 bn in H1’2017,
- Co-operative Bank Holdings is currently sufficiently capitalized with a core capital to risk weighted assets ratio of 15.9%, 5.4% above the statutory requirement. In addition, the total capital to risk weighted assets ratio was 16.0%, exceeding the statutory requirement by 1.5%. Adjusting for IFRS 9, the core capital to risk weighted assets stood at 16.8%, while total capital to risk weighted assets came in at 16.9%, indicating that the bank’s total capital relative to its risk-weighted assets declined by 0.9% due to implementation of IFRS 9,
- Co-operative Bank currently has a return on average assets of 3.0% and a return on average equity of 18.0%.

Key Take-Outs:

1. The bank’s five-year strategy dubbed the “soaring eagle” strategy has aided the bank in navigating the tough operating environment occasioned by the interest rate cap regime, which depressed interest income. The strategy focuses on increasing operational efficiency and enhancing income growth. The banks objective of deepening financial inclusion is being achieved, by the increasing number of users who access the bank’s services via alternative channels such as MCoop Cash and agency banking. Both of these channels recorded an increase in the number of transactions done via the channels by 78% and 30%, respectively. This saw 87% of all transactions being done on alternative channels, with only

13% of the transactions being done via the branches. Branches have increasingly been used only for high-value transactions, as well as providing other services such as advisory services. The increased utilization of alternative channels helped increase the other fees and commission income.

2. The bank is also increasing its usage of sophisticated method of credit risk assessment, by using big-data technology and data analytics for credit pre-scoring and risk assessment. This consequently saw the bank make specialized hires, as well as increase the IT infrastructure. This is expected to aid the bank increase its operational efficiency as well as prudent credit risk assessment, and by extension, provisioning as required by the new IFRS 9 reporting standard.
3. The bank experienced a deterioration in asset quality, with gross non-performing loans (NPLs) rising by 130.8% to Kshs 28.2 bn in H1’2018 from Kshs 12.2 bn in H1’2017. This was largely due to major clients in the trade and manufacturing sectors. However, provisioning levels failed to rise in tandem, increasing by a 75.6%, leading to a decline in the NPL coverage to 31.0% in H1’2018 from 44.7% in H1’2017.

We expect the bank’s growth to be driven by:

a. Non-Funded Income growth initiatives – Co-operative Bank’s NFI is below the industry average, coming in at 32.1%, which is lower than the industry average of 36.0%. The bank needs to focus on increasing fee income and transactional income. To this effect, the bank is taking advantage of its alternative channels such as the mobile wallet platform, MCoop Cash mobile app, and agency banking to increase its transactional income, as more customers increase the usage of these platforms,
b. Increased adoption of alternative channels by customers will improve operational efficiency in addition to increasing the bank’s transactional income. The bank is planning to aggressively grow its number of agents to 20,000 agents from the current 10,000. Agency outlets will be transformed such that basic banking services such as account opening will be done by agents in a bid to migrate transactions from the bank’s branches. Such initiatives will see the bank’s cost-to-income ratio improve significantly from the current 54.9%.

Below is a summary of the bank’s performance:

Balance Sheet Items	H1' 2017	H1' 2018	y/y change	H1' 2018e	Projected %y/y change	Variance in Growth Actual vs. Expected
Government Securities	74.20	83.13	12.0%	83.2	12.1%	(0.1%)
Net Loans and Advances	252.6	251.1	(0.6%)	266.7	5.6%	(6.2%)
Total Assets	383.3	398.4	3.9%	409.7	6.9%	(2.9%)
Customer Deposits	285.8	297.0	3.9%	304.8	6.7%	(2.7%)
Total Liabilities	319.0	329.6	3.3%	337.4	5.8%	(2.4%)
Shareholders Funds	64.5	68.0	5.5%	71.5	11.0%	(5.5%)

Balance Sheet Ratios	H1' 2017	H1' 2018	y/y change
Loan to Deposit Ratio	88.4%	84.6%	(3.8%)
Return on average equity	17.9%	18.0%	0.1%
Return on average assets	2.9%	3.0%	0.1%

Co-operative Bank – H1’2018

16th August, 2018

Income Statement	H1'2017	H1'2018	y/y change	H1'2018e	Projected %y/y change	Variance in Growth Actual vs. Expected
Net Interest Income	13.4	14.8	10.4%	14.2	5.9%	4.5%
Non-Interest Income	7.1	7.0	(1.6%)	8.1	14.1%	(15.6%)
Total Operating income	20.5	21.8	6.3%	22.3	8.8%	(2.5%)
Loan Loss provision	(1.5)	(1.1)	(27.6%)	(1.7)	10.4%	(37.9%)
Total Operating expenses	(11.3)	(12.0)	5.5%	(12.4)	8.9%	(3.3%)
Profit before tax	9.3	10.0	7.6%	10.1	8.6%	(1.0%)
Profit after tax	**6.6**	**7.1**	**7.6%**	**7.0**	**6.1%**	**1.4%**
Earnings per share	**1.9**	**2.0**	**7.6%**	**2.0**	**6.1%**	**1.4%**

Income Statement Ratios	H1'2017	H1'2018
Yield from interest-earning assets	12.4%	12.2%
Cost of funding	3.8%	3.9%
Net Interest Spread	8.6%	8.3%
Net Interest Income as % of operating income	65.4%	67.9%
Non-Funded Income as a % of operating income	34.6%	32.1%
Cost to Income	55.3%	54.9%

Capital Adequacy Ratios	H1'17	H1'18
Core Capital/Total deposit Liabilities	19.5%	20.0%
Minimum Statutory ratio	10.5%	10.5%
Excess	**9.0%**	**9.5%**
Core Capital/Total Risk Weighted Assets	15.9%	15.9%
Minimum Statutory ratio	10.5%	10.5%
Excess	**5.4%**	**5.4%**
Total Capital/Total Risk Weighted Assets	22.8%	16.0%
Minimum Statutory ratio	14.5%	14.5%
Excess	**8.3%**	**1.5%**
Liquidity Ratio	35.3%	37.7%
Minimum Statutory ratio	20.0%	20.0%
Excess	**15.3%**	**17.7%**
Adjusted Core Capital/Total Deposit Liabilities		21.0%
Adjusted Core Capital/Total Risk Weighted Assets		16.8%