Cooperative Bank Holdings – Q1’2018

25th May, 2018

Valuation Summary

- We are of the view that Cooperative Bank is an “Accumulate” with a target price of Kshs 20.5, representing an upside of 15.1%, from the current price of Kshs 18.0 as of 24th May, inclusive of a dividend yield of 4.4%,
- Cooperative 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 Q1’2018

- 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
- The Bank was feted with several awards during the Banker Africa-East Africa Award 2018 where the bank was crowned as (i) Best Retail Bank in Kenya, (ii) Best SME Bank in Kenya, and (iii) Best Investment Institution in Kenya
- Cooperative Bank obtained financing of USD 150 mn 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 6.8% to Kshs 2.4 from Kshs 2.2 in Q1’2017, in line with our expectation of a 5.9% increase to Kshs 2.3. Performance was driven by an 8.4% increase in total operating income, despite a 9.4% increase in the total operating expenses,
- Total operating income increased by 8.4% to Kshs 10.9 bn in Q1’2018 from Kshs 10.1 bn in Q1’2017. This was due to a 10.8% increase in Net Interest Income (NII) to Kshs 7.4 bn from Kshs 6.7 bn in Q1’2017, coupled with a 3.8% increase in Non-Funded Income (NFI) to Kshs 3.5 bn from Kshs 3.4 bn in Q1’2017,
- Interest income increased by 9.1% to Kshs 10.4 bn from Kshs 9.5 bn in Q1’2017 bn. The interest income on loans and advances increased by 8.8% to Kshs 8.4 bn from Kshs 7.7 bn in Q1’2017. Interest income on government securities increased by 13.4% to Kshs 2.0 bn in Q1’2018 from Kshs 1.8 bn in Q1’2017. The yield on interest earning assets however declined to 12.3% in Q1’2018 from 14.1% in Q1’2017, due to the relatively faster increase in the interest earning assets to Kshs 347.0 bn from Kshs 323.0 bn in Q1’2017,
- Interest expense increased by 5.0% to Kshs 3.0 bn from Kshs 2.8 bn in Q1’2017, following a 6.3% increase in the interest expense on customer deposits to Kshs 2.7 bn from Kshs 2.5 bn in Q1’2017. Other interest expenses declined by 6.2% to Kshs 0.3 bn in Q1’2018 from Kshs 0.3 bn in Q1’2017. The cost of funds remained unchanged at 4.0%. Net Interest Margin declined to 8.6% from 10.1% in Q1’2017,
- Non-Funded Income increased by 3.8% to Kshs 3.5 bn from Kshs 3.4 bn in Q1’2017. The growth in NFI was driven by a 13.7% increase in other fees and commissions to Kshs 2.2 bn from Kshs 1.9 bn in Q1’2017, and a 34.4% increase in foreign exchange trading income to Kshs 0.8 bn from Kshs 0.6 bn in Q1’2017. Fees and commissions on loans however declined by 40.3% to Kshs 0.4 bn from Kshs 0.7 bn in Q1’2017. This was due to a growth in loans extended to corporates, which the bank did not charge any fees and commissions. The current revenue mix stands at 68:32 funded to non-funded income as compared to 66:34 in Q1’2017. The proportion of non-funded income to total revenue declined slightly owing to the faster growth in NII as compared to NFI,
- Total operating expenses increased by 9.4% to Kshs 6.1 bn from Kshs 5.6 bn, largely driven by a 13.1% increase in staff costs to Kshs 2.6 bn in Q1’2018 from Kshs 2.3 bn in Q1’2017, coupled with a 9.4% increase in other operating expenses to Kshs 1.7 bn in Q1’2018 from Kshs 1.6 bn in Q1’2017. Staff costs

rose due to specialized hires made by the bank in the IT department to be used for big data analytics for credit pre-scoring purposes. The rise in staff costs could also be attributed to the bank’s restructuring by eliminating redundancies, which saw 84 employees leave the bank during the quarter. The Loan Loss Provisions (LLP) increased by 1.7% to Kshs 0.76 bn from Kshs 0.75 bn in Q1’2017, largely due to an increase in the non-performing loans by 152.5%, coupled with increased provisioning levels due to implementation of IFRS 9,

- The cost to income ratio deteriorated albeit marginally to 55.8% from 55.3% in Q1’2017. Without LLP, the Cost to income ratio also deteriorated to 48.8% from 47.9% in Q1’2017,
- Profit before tax increased by 8.6% to Kshs 4.9 bn, up from Kshs 4.5 bn in Q1’2017. Profit after tax increased 6.8% to Kshs 3.4 bn in Q1’2018 from Kshs 3.2 bn in Q1’2017,

Balance Sheet

- The balance sheet recorded an expansion as total assets increased by 5.1% to Kshs 397.8 bn from Kshs 378.5 bn in Q1’2017. This growth was largely driven by a 21.3% increase in government securities to Kshs 78.1 bn from Kshs 64.4 bn in Q1’2017.
- The loan book increased by 2.8% to Kshs 252.8 bn in Q1’2018 from Kshs 245.9 bn in Q1’2017,
- Total liabilities rose by 4.5% to Kshs 329.1 bn from Kshs 314.8 bn in Q1’2017, driven by a 5.7% increase in total deposits to Kshs 295.9 bn from Kshs 279.9 bn in Q1’2017. Deposits per branch increased by 2.3% to Kshs 1.93 bn from Kshs 1.89 bn in Q1’2017
- The faster growth in deposits as compared to loans led to a decline in the loan to deposit ratio to 85.4% from 87.9% in Q1’2017,
- Gross non-performing loans increased by 152.5% to Kshs 28.4 bn in Q1’2018 from Kshs 11.2 bn in Q1’2017. As a consequence, the NPL ratio deteriorated to 10.8% in Q1’2018 from 4.5% in Q1’2017. Loan loss provisions increased by 124.3% to Kshs 7.9 bn from Kshs 3.5 bn in Q1’2017.The NPL coverage decreased to 30.6% in Q1’2018 from 40% in Q1’2017, due to the relatively faster increase in the gross non-performing loans. The increase in the non-performing loans could be attributed to major clients in the real estate and manufacturing sector, whose activities were affected by the economic slump occasioned by a prolonged election period coupled with the drought witnessed in 2017,
- Shareholders’ funds increased by 6.5% to Kshs 68.0 bn in Q1’2018 from Kshs 63.8 bn in Q1’2017.
- Cooperative Bank Holdings is currently sufficiently capitalized with a core capital to risk weighted assets ratio of 16.3%, 5.8% above the statutory requirement. In addition, the total capital to risk weighted assets ratio was 16.4%, exceeding the statutory requirement by 1.9%. Adjusting for IFRS 9, the core capital to risk weighted assets stood at 17.2%, while total capital to risk weighted assets came in at 17.3%, indicating that the bank’s total capital relative to its risk-weighted assets declined by 0.9% due to implementation of IFRS 9,
- Cooperative Bank currently has a return on average assets of3.0% and a return on average equity of 17.6%.

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 56% and 32% 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 152.5%, to Kshs 28.4 bn from Kshs 11.2 bn in Q1’2017. This was largely due to major clients in the real estate, manufacturing and retail sectors. However, provisioning levels failed to rise in tandem, increasing by a mere 1.7%, leading to a decline in the NPL coverage to 30.6% in Q1’2018 from 40.0% in Q1’2017

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

a. Non-Funded Income growth initiatives – Co-operative Bank’s NFI is below the industry average, coming in at 32.0%, which is lower than the industry average of 33.6%. 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. For instance, MCoop cash has had the number of loan customers increase by 86.9% to 867,000 customers from 464,000 in Q1’2017. This brings the total number of customers subscribed to MCoop cash to 3.7 million customers. This consequently increased commission income from the app by 28.1% to Kshs 367.9 mn in Q1’2018 from Kshs 287.1 mn in Q1’2017.

b. Increased adoption of alternative channels by the 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. For instance, the bank had 87.0% of total transactions carried out using alternative sources, while 13.0% of transactions were handled at the branches in Q1’2018. Such initiatives will see the bank’s cost-to-income ratio improve significantly from the current 55.8%,

c. The bank has adopted increased measures to improve its asset quality. This include (i) Utilization of an E-collect system, which has seen collections increase by 83% y/y (ii) Launch of a collaborative curing between businesses and the remedial department, (iii) outsourcing of collection of lower ticket micro-credit loans. These initiatives will aid to improve the asset quality of the bank, and consequently reduce the loan loss provision expense.

Below is a summary of the bank’s performance:

Balance Sheet Items (bn)	Q1' 2017	Q1' 2018	y/y change	Q1' 2018e	Projected %y/y change	Variance in Growth Actual vs. Expected
Government Securities	64.37	78.1	21.3%	73.8	14.7%	6.6%
Net Loans and Advances	245.9	252.8	2.8%	271.9	10.6%	(7.7%)
Total Assets	**378.5**	**397.8**	**5.1%**	**412.9**	**9.1%**	**(4.0%)**
Customer Deposits	279.8	295.9	5.7%	296.0	5.8%	(0.0%)

Total Liabilities	314.8	329.1	4.5%	339.3	7.8%	(3.2%)
Shareholders' Funds	**63.8**	**67.9**	**6.5%**	**72.9**	**14.2%**	**(7.7%)**

Balance Sheet Ratios	Q1' 2017	Q1' 2018	y/y change
Loan to Deposit Ratio	87.9%	85.4%	(2.4%)
Return on average equity	19.3%	17.6%	(1.7%)
Return on average assets	3.2%	3.0%	(0.2%)

Income Statement	Q1'2017	Q1'2018	y/y change	Q1'2018e	Projected %y/y change	Variance in Growth Actual vs. Expected
Net Interest Income	6.7	7.4	10.8%	7.0	4.7%	6.1%
Non-Interest Income	3.4	3.5	3.8%	4.0	18.0%	(14.3%)
Total Operating income	**10.1**	**10.9**	8.4%	**11.0**	9.2%	**(0.7%)**
Loan Loss provision	(0.8)	(0.8)	1.7%	(0.7)	(6.7%)	8.4%
Total Operating expenses	(5.6)	(6.1)	9.4%	(6.1)	9.4%	(0.0%)
Profit before tax	4.5	4.9	8.6%	4.9	8.6%	(0.0%)
Profit after tax	**3.2**	**3.4**	**6.8%**	**3.4**	**5.9%**	**0.9%**
Earnings per share	**2.2**	**2.35**	**6.8%**	**2.33**	**5.9%**	**0.9%**

Income Statement Ratios	Q1'2017	Q1'2018
Yield from interest-earning assets	14.1%	12.3%
Cost of funding	4.0%	4.0%
Net Interest Spread	10.1%	8.4%
Net Interest Income as % of operating income	66.4%	67.8%
Non-Funded Income as a % of operating income	33.6%	32.2%
Cost to Income	55.3%	55.8%
Cost to Assets	1.3%	1.3%

Capital Adequacy Ratios	Q1'17	Q1'18
Core Capital/Total deposit Liabilities	19.80%	19.50%
Minimum Statutory ratio	10.50%	10.50%
Excess	**9.30%**	**9.00%**
Core Capital/Total Risk Weighted Assets	17.00%	16.30%
Minimum Statutory ratio	10.50%	10.50%
Excess	**6.50%**	**5.80%**
Total Capital/Total Risk Weighted Assets	24.80%	16.40%
Minimum Statutory ratio	14.50%	14.50%
Excess	**10.30%**	**1.90%**
Liquidity Ratio	38.20%	38.70%
Minimum Statutory ratio	20.00%	20.00%
Excess	**18.20%**	**18.70%**
Adjusted Core Capital/Total Risk Weighted Assets		17.20%
Adjusted Core Capital/Total Risk Weighted Assets		17.30%