Analyst:
Linda Kiraithe
+254 719 712 031
lkiraithe@apexafrica.com

COMPANY UPDATE

Co-operative Bank of Kenya

Sector: Banking

ApexAfrica CAPITAL LTD
Part of AXYS Group

NFI to Buoy the Bottomline in the Short to Medium Term

Recommendation: STRONG BUY

We recommend a **Strong Buy** on Co-operative Bank of Kenya guided by our **fair value estimate of KES 15.65** with **forward P/B and P/E** multiples of **1.0x** and **5.1x** respectively. We project an **upside potential of 30.4%** based on the **current share price** of **KES 12.00**. We however downgrade our previous fair value estimate of KES 16.18 premised on a dimming outlook on the bottom line given the resolve by legislature to maintain the rate cap. We are also cognizant that the current bear run has significantly depressed the counter's price driving up the potential upside. We expect the **current dividend of KES 1.00** to be **maintained** for the **next two years** but **anticipate** that the **dividend** may be **raised** to **KES 1.20 in FY21**.

Growth Drivers

- Positive loan book growth may reach higher single digits
- Deposit growth despite slow economic growth
- Rejuvenated growth in NFI supporting the top-line
- Anticipated dividend yield of 8.3%

Risks

- Rising NPLs lowering quality of the asset book
- Instability in the South Sudan market

Bloomberg Ticker :	**COOP KN**
Reuters Ticker:	**COOP.NR**

Share Statistics

Current Price (KES)	**12.00**
Fair Value	**15.65**
Upside (%)	**30.4**
Issued shares (M)	5,867.2
Market cap (USD M)	675.6
Year end	December
52 –Week High (KES)	16.80
52 –Week Low (KES)	10.50
YTD High (KES)	16.60
YTD Low (KES)	10.50

Summary

Income Statement	FY18A KES M	FY19E KES M	FY20E KES M	FY21E KES M	FY22E KES M	FY23E KES M	5-yr CAGR	y/y change
Net Interest Income	31,300	32,358	34,501	37,140	39,859	43,554	6.8%	3.4%
Non Interest Income	12,259	16,633	17,163	17,918	18,897	19,426	9.6%	35.7%
Loan Loss Provision Expense	1,722	2,966	3,434	3,667	3,969	4,286	20.0%	72.2%
Profit After Tax	12,732	13,795	14,685	15,820	16,301	18,512	7.8%	8.3%
Customer Deposits	306,117	332,137	360,369	391,000	410,550	437,236	7.4%	8.5%
Net Loans and Advances	245,410	257,681	270,565	293,563	317,048	342,412	6.9%	5.0%
Gross NPLs	29,402	30,922	31,656	35,228	38,046	37,665	5.1%	5.2%
EPS (KES)	2.17	2.35	2.50	2.70	2.78	3.16		
DPS (KES)	1.00	1.00	1.00	1.20	1.20	1.20		
ROaE (%)	18.2	19.5	18.6	17.9	16.5	17.1		
ROaA (%)	3.3	3.3	3.3	3.2	3.1	3.3		
P/E (x)	5.6	5.1						
P/B (x)	1.0	1.0						

Source: ApexAfrica Research Estimates

Loan book growth to be fueled by SME lending and E-credit

On the back of stable economic growth, we forecast a 6.9% 5-year CAGR in loan book growth to KES 342.4B. We anticipate that this will be fueled by personal lending to civil servants through the check off system and lending to cherry picked segments of the private sector on the back of an improving economic environment.

However, key focus to drive lending is pegged on E-Credit with the growing popularity of mobile loans in Kenya. On its M-coop Cash platform, the bank has lent out KES 34.6B in 1H19 with the main product being the 3-month flexi loan.

The leasing deal with Supergroup that has over KES 7B in pipeline is also expected to improve the asset book.

In partnership with IFC, the lender continues to expand lending to SMEs. To counter caveats relating to the sector, training on business operations has been intensified to these clients to contain their risky profiles.

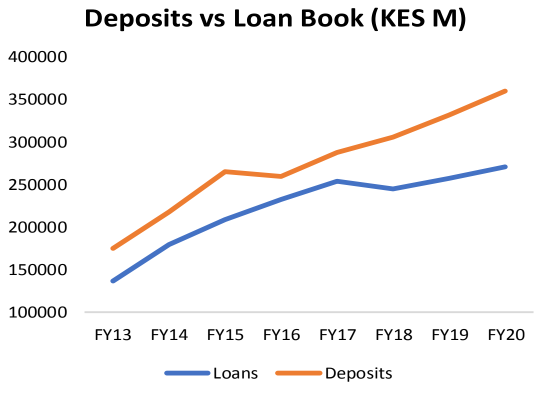
However, despite our positive outlook on growth we expect to see a slowdown in lending in 2021 going into 2022 with the onset of the electioneering period in Kenya that has historically slowed down the business environment. Before the onset of the past general election, the bank was able to maintain double digit growth in its loan book, though declining in the wake of the prevailing rate cap. Though on a path to recovery, we do not forecast loan book growth to hit double digits as the cap prevails and the aforementioned slow down in the next two years. Nevertheless, we are cognizant of the lenders diversification efforts with the onset of aggressive lending on E-Credit which not only boosts non funded income but is also expected to see improved efficiency levels.

Single-digit growth in deposits

The rebound in economic activity has been certain but remains slow given the crowding out of the private sector by government as well as contracted government capital spending. In an ideal scenario, we would expect that government activities through spending and tax policies would spur growth in the private sector. We therefore do not feel optimistic about double digit growth in deposits. We however expect the lender to achieve and perhaps, maintain high single digit growth in deposits. We forecast a 7.4% 5-year CAGR in deposits to KES 437.2B. We may see growth decline to lower single digits in FY22 leaning on historical tendencies of slowed economic activity during the election year.

SMEs and retail segments of the lender's business are expected to spur deposit growth. The growth is also expected to be driven by mobile banking.

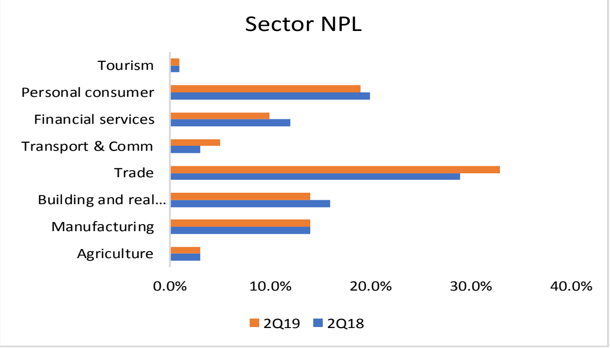
Cost of deposits is expected to remain modest due to mobilization of cheap deposits from SME and mobile banking.



Non funded income growth impressive

Non funded income is expected to remain a key driver of the top-line driven by increased mobile lending. We forecast a 5 –year CAGR of 9.6% in non-interest income to KES 19.4B on the back or rising income from fees and commissions due to increased mobile lending activities.

Operational efficiency and the Group's strategic focus on optimization of digitization are expected to remain the key drivers of non funded income growth.



Source: Co-op Bank filings

The NPL headache

The lender continues to face challenges in its asset book quality, with the current NPL ratio remaining worrisome (FY18 gross NPL ratio of 12.0%). Struggling corporates and slowed lending to manufacturing and trade sectors may see these sectors continue underperform further worsening NPLs.

The lender has been working to turnaround the trend through restructures especially on real estate loans. E-loans write off occurs after 3 months; maintaining quality of the book from e-sector. We expect NPLs to remain elevated falling on slow economic recovery as private sector credit growth remains below potential and government continues to slash capital spending. A repeal of the rate cap was thought to be a solution in revamping economic activity.

However, legislature has shown no intent of repealing the rate cap.

Government has been aggressive on domestic borrowing, crowding out private sector credit growth. On the back of these developments, we feel that the most effective solution to changing the NPL tale would be loan restructures and cherry-picking loans when lending to prevent new loans from going bad. As the loan book grows faster than NPLs the quality of the book will be enhanced over time.

Should we expect any acquisitions?

We remain optimistic that Ethiopia may be the new cash cow for international corporates once the robust market fully opens its doors. The group is looking to expand into Ethiopia and we expect that the cooperative model will be a useful tool in gaining ground. Management asserts that the group is not considering any other acquisitions in the East African region.

Though the business environment has improved in South Sudan, the market is yet to fully stabilize with inflation remaining high at 53.1% in August 2019. We therefore expect the bank to focus on maintaining profitability in the short term to medium term.

The lender remains fundamentally sound with current improvement in product delivery through mobile lending and branch expansion to underserved areas, expected to improve efficiency. However, in a market likely faced by continuous turmoil with expected surge in oil prices amid anticipation of recession in the offing the lender remains susceptible to these myriad uncertainties.

KEY FINANCIALS

1H19 Earnings review

Valuation Assumptions	
Cost of equity	18.4%
Long term growth rate	10.0%
No. of shares in issue (M)	5,867
Risk free rate (5-yr Bond)	11.7%
Market risk	18.4%
Beta	1.0

P/B Valuation	
Historical Average (x)	1.6
Tier 1 Banks Average (x)	1.2
Weighted ave	1.4
NAV/Share (KES)	11.80
Per share value (KES)	16.63

P/E Valuation	
Historical Average (x)	7.5
Tier 1 Banks Average (x)	7.0
Weighted ave	7.3
EPS (KES)	2.2
Per share value (KES)	15.77

DDM Valuation	FY19E	FY20E	FY21E	FY22E	FY23E	Terminal
Dividend (KES M)	5,867	5,867	7,041	7,041	7,041	129,078
Period	0.3	1.3	2.3	3.3	4.3	
Present Value (KES M)	5,607	4,736	4,800	4,054	3,424	62,770
Cumulative PV (KES M)	85,390					
Shares in issue (M)	5,867					
Per share value (KES M)	14.55					

Blended fair value (KES)	**15.65**
Current Price (KES)	**12.00**
Upside	30.4%

Source: ApexAfrica Estimates

Income Statement	1H18 KES M	1H19 KES M	chg y/y
Interest Income	20,780	20,425	-1.7%
Interest Expense	5,966	6,172	3.5%
Net Interest Income	14,814	14,254	-3.8%
Foreign Exchange Income	1,222	952	-22.1%
Gross Fees and Commission	5,124	7,074	38.1%
Other Income	565	638	12.8%
Non Interest Income	6,995	8,752	25.1%
Total Operating Income	21,809	23,005	5.5%
Total Operating Expenses	10,881	11,414	4.9%
Loan Loss Provision	1,093	1,181	8.1%
Operating Profit	10,928	11,591	6.1%
PBT & exceptional items	9,835	10,410	5.9%
Share of profit of associate	141	27	-81.1%
Profit Before Tax	9,976	10,437	4.6%
Current Tax	2,836	2,967	4.6%
Profit After Tax	7,140	7,469	4.6%
EPS (KES)	1.22	1.27	4.1%
Balance Sheet			
Total Shareholders' Equity	68,018	71,006	4.4%
Deposits due to Banks	3,194	1,494	-53.2%
Customer Deposits	296,965	323,600	9.0%
Total Liabilities	329,639	357,198	8.4%
Total Equity and Liabilities	398,427	429,591	7.8%
Cash and CBK Balances	23,223	34,548	48.8%
Bal due from Banks	13,453	16,754	24.5%
Government and Other Securiti	83,129	96,995	16.7%
Net Loans and Advances	251,110	257,564	2.6%
Fixed Assets	6,960	5,407	-22.3%
Total Assets	398,427	429,591	7.8%
Key Ratios			
Gross NPL (KES M)	28,215	30,556	8.3%
Interest In Suspense (KES M)	861	4,827	460.5%
Total NPL (KES M)	27,354	25,729	-5.9%
Loan Loss Provision (KES M)	7,888	10,869	37.8%
Net NPL	19,466	14,859	-23.7%
NPL Ratio	10.9%	11.4%	
Coverage Ratio	28.0%	28.0%	
Cost of Risk	0.9%	0.9%	
Loan to Deposits	84.6%	79.6%	
Yield on Interest Earning Assets	12.0%	11.0%	
Cost of Funds	4.0%	3.8%	
NIM	5.9%	5.5%	
Non Funded/Total Income	32.1%	38.0%	
Cost to Income Ratio	49.9%	49.6%	
ROE	10.5%	10.5%	
ROA	3.6%	3.5%	

Source: Company Filings, ApexAfrica Research

Financial Analysis

Income Statement	FY18A KES M	FY19E KES M	FY20E KES M	FY21E KES M	FY22E KES M	FY23E KES M	5-yr CAGR
Interest Income	43,541	45,125	48,288	52,125	55,817	60,449	6.8%
Interest Expense	12,240	12,766	13,787	14,985	15,958	16,895	6.7%
Net Interest Income	31,300	32,358	34,501	37,140	39,859	43,554	6.8%
Non Interest Income	12,259	16,633	17,163	17,918	18,897	19,426	9.6%
Total Operating Income	43,560	48,991	51,664	55,058	58,756	62,980	7.7%
Total Operating Expenses	23,852	26,631	27,565	29,166	31,720	32,877	6.6%
Loan Loss Provision Expense	1,722	2,966	3,434	3,667	3,969	4,286	20.0%
Operating Profit	19,708	22,229	23,968	25,761	26,905	29,972	8.7%
Profit Before Tax	18,157	19,434	20,706	22,265	23,107	25,857	7.3%
Current Tax	5,425	5,639	6,021	6,446	6,806	7,345	6.2%
Profit After Tax	12,732	13,795	14,685	15,820	16,301	18,512	7.8%
EPS (KES)	2.17	2.35	2.50	2.70	2.78	3.16	7.8%
DPS (KES)	1.00	1.00	1.00	1.20	1.20	1.20	3.7%
Balance Sheet							
Total Shareholders' Equity	70,755	79,081	88,429	98,615	108,060	119,742	11.1%
Customer Deposits	306,117	332,137	360,369	391,000	410,550	437,236	7.4%
Total Liabilities	342,915	362,867	399,123	435,688	458,177	489,684	7.4%
Total Equity and Liabilities	413,671	441,948	487,552	534,303	566,237	609,426	8.1%
Government and Other Securities	82,829	93,233	108,304	117,510	131,596	140,150	11.1%
Net Loans and Advances	245,410	257,681	270,565	293,563	317,048	342,412	6.9%
Fixed Assets	6,614	6,945	7,292	7,657	8,039	8,441	5.0%
Total Assets	413,671	441,947	487,552	533,835	564,397	605,292	7.9%
Key Ratios							
Gross NPLs (KES M)	29,402	30,922	31,656	35,228	38,046	37,665	5.1%
Cost of Risk (%)	1.0	1.2	1.3	1.3	1.3	1.3	
Loan to Deposits (%)	80.2	77.6	75.1	75.1	77.2	78.3	
Yield on Interest Earning Assets (%)	15.3	16.8	17.5	18.0	17.9	17.9	
NPL Ratio (%)	12.0	12.0	11.7	12.0	12.0	11.0	
Cost of deposits	3.5	3.5	3.5	3.5	3.5	3.5	
Net Interest Margin (%)	11.8	13.3	14.0	14.5	14.3	14.4	
Non Funded/Total Income (%)	22.0	27.0	26.3	25.6	25.3	24.4	
Cost to Income Ratio (%)	54.8	54.5	53.5	53.1	54.1	52.3	
ROaE (%)	18.2	19.5	18.6	17.9	16.5	17.1	
ROaA (%)	3.3	3.3	3.3	3.2	3.1	3.3	
P/E (x)	5.6	5.1					
P/B (x)	1.0	1.0					
Dividend Yield (%)							

Source: ApexAfrica Research Estimates

CONTACT US

Research

Harrison Gitau
Senior Research Analyst
hgitau@apexafrica.com

Linda Kiraithe
Research Analyst
lkiraithe@apexafrica.com

Trading

Samuel Wachira
Head of Trading
wachiras@apexafrica.com

Sheema Shah
Wealth Manager & Equities Trader
Sheema@apexafrica.com

Rajesh Goswami
Equities & Fixed Income Trader
rgoswami@apexafrica.com

Customer care

Esther Kamau
Head of Customer Care
ekamau@apexafrica.com

Ted Kamaliki
Customer Care
tkamaliki@apexafrica.com

The Riverfront, 1st Floor, Prof. David Wasawo Drive, Off Riverside Drive

(254) 20 222 6440

invest@apexafrica.com

www.apexafrica.com

part of **AXYS Group**

www.axys-group.com

Investment ratings

- **Strong Buy:** Issued on counters with strong fundamentals with a fair value above 20.0%. The counter is anticipated to register strong growth with and is currently undervalued.

- **Buy:** Issued on counters with strong fundamentals whose upside lies between 10.0% and 20.0%. The same may be issued for counters with challenged fundamentals whose upside is over 20.0%. Such a scenario is targeted for risk neutral investors.

- **Accumulate:** Issued on counters with an upside of between 5.0% - 10.0%. The counter may be facing contracting avenues for growth with a tepidly growing bottom-line.

- **Hold:** Issued on counters with an upside of between 0% and 5.0% with limited avenues for growth. Contracting bottom-line with an attractive dividend yield of about 5.0%.

- **Lighten:** The company is anticipated to record a moderate downside on its fair value, though it may have strong fundamentals.

- **Sell:** The counter currently has weak fundamentals coupled with significant potential downside.