ApexAfrica CAPITAL LTD
Part of AXYS Group

November 2018

Co-operative Bank of Kenya

“A Medley Range of Digital Era Banking”

Recommendation: BUY

We recommend a **BUY** on Cooperative Bank of Kenya guided by our **fair value estimate of KES 16.18** with **forward P/B and P/E** multiples of **1.3x and 7.8x** respectively. We project an **upside potential of 14.4%** based on the **current share price** of **KES 14.15**. However, we are 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 0.80** will be **maintained** for the **next two years** but **anticipate** that the **dividend** may be **raised** to **KES 1.00 in FY20**.

Growth Drivers

- Top banker for SACCOs with SACCOs’ popularity increasing by the day banking over 15M Kenyans
- Loan book growth to be fuelled by diversification
- Deposit growth to be supported by a large market share, diversification and a recovery in the economy

Risks

- Slow credit growth due to the impeding rate cap and tough macroeconomic conditions
- A changing macroeconomic and regulatory environment may cause unexpected pressures going forward
- Rising NPLs lowering quality of the asset book

Summary

Income Statement	FY15A KES M	FY16A KES M	FY17A KES M	FY18F KES M	FY19F KES M	FY20F KES M	y/y change %	3-yr CAGR %
Net Interest Income	19,783	24,582	24,003	25,579	26,142	27,903	6.6	5.1
Non Interest Income	16,607	17,689	17,592	18,519	19,594	20,931	5.3	6.0
Loan Loss Provision Expense	2,019	2,600	3,601	2,551	3,438	3,826	(29.2)	2.0
Profit After Tax	11,706	12,676	11,405	12,153	13,006	14,081	6.6	7.3
Customer Deposits	265,399	260,153	287,372	301,740	324,371	356,808	5.0	7.5
Net Loans and Advances	208,572	232,307	253,862	256,400	272,503	296,471	1.0	5.3
EPS (KES)	2.39	2.59	1.94	2.07	2.22	2.40	6.6	7.3
DPS (KES)	0.80	0.80	0.80	0.80	0.80	1.00	-	7.7
ROaE (%)	25.4	23.1	17.5	17.4	17.3	16.7		
ROaA (%)	3.7	3.7	3.1	3.1	3.2	3.2		
P/E (x)			7.3	7.8	7.3			
P/B (x)			1.2	1.3	1.2			.

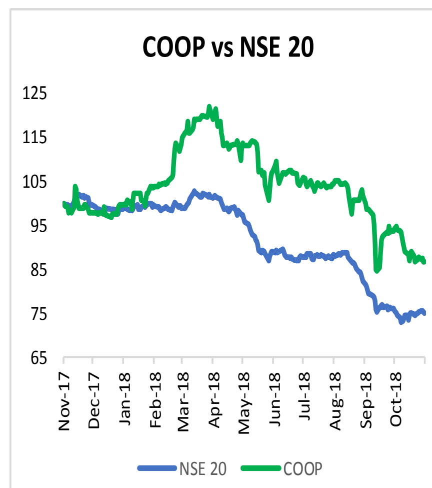
Source: ApexAfrica Estimates, Company filings

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

Share Statistics

Current Price (KES)	**14.15**
Fair Value (KES)	**16.18**
Upside (%)	**14.4**
Issued shares (M)	5867.2
Market cap (USD M)	992.1
Year end	Dec
Foreign ownership (%)	4.2
Free float (%)	32.2
Ave daily trading vol (USDk)	1100.5

Price Trend



Source: Bloomberg

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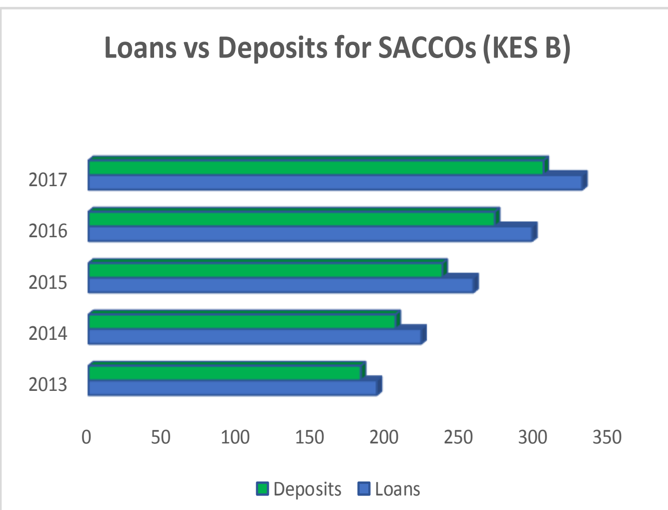
The Kingdom Bank– a bouquet of flowers

Co-operative Bank has over time been known as 'the SACCO banker'. As such given that SACCOs currently bank over 15M Kenyans, their contribution to the bank's business is expected to remain a key factor in its brand as a SACCO banker. However, this space has been invaded by other banking sector players who have, over time, lured Saccos with competitive rates on deposits and loans.

In line with banking trends in the county, Cooperative bank is set to continue leveraging on government, corporate, SME and mobile banking space; pegged on sustained economic recovery. We therefore view the bank's presence as a bouquet service provider touching on various components of modern banking.



Source: SASRA

Loan book growth to be fueled by diversification

FY18 began with anticipation of a repeal of the rate cap which didn't materialize as the legislators opted to remove the floor to spur lending; we see this as a futile effort. The situation has aggravated the current credit crunch as lenders remain stringent on lending given the low pricing on risk. We forecast a 3-year CAGR of 5.3% on the loan book to KES 296.5B premised on the prevailing rate cap.

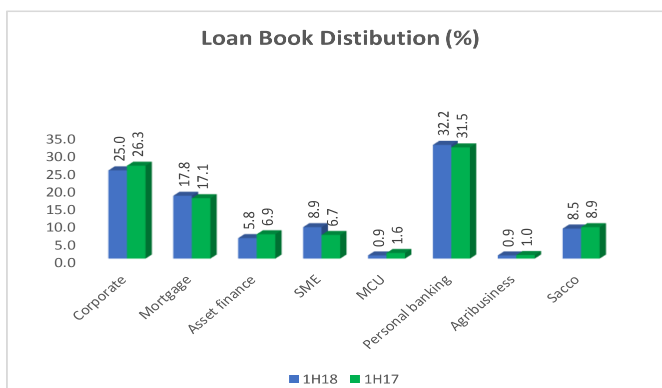
We expect growth to be fueled by diversification efforts such as leasing. The bank currently has a joint venture with South Africa's Super Group that has so far bagged a KES 2.2B government contract to supply trucks to the Kenya Police.

As the government and corporates hunt for different asset financing options, we project leasing to grow even further at the benefit of the lender's loan book.

Given the complexity in pricing loans, the lender is advancing more consumer loans to government schemes with check-off systems. This enables them to manage risk. This is expected to be a key growth driver of its book.

Given the current lull in the real estate sector due to a slump in uptake of housing units, we project a slag in lending to the sector. However, successful implementation of the government's Big 4 Agenda may see loans advanced to the sector surge. The Bank has approved a KES 200M share capital injection into the Kenya Mortgage Refinance Company which is anticipated to advance affordable mortgages to consumers.

The bank secured a KES 15.2B IFC loan to enable lending to MSME's and the recently launched unsecured loan product is expected to increase the lender's market share in the SME lending space. However, given the low pricing of risk as a result of the rate cap and the high exposure of SME businesses to default risk, we expect the uptake of new SME client accounts to remain constrained and anticipate that the lender will mostly lend to existing customers. Therefore, we do not foresee aggressive lending in this sector as long as the cap is in place.



Source: Co-operative Bank

With credit lines from banks drying up, borrowers turned to SACCOs and microfinance institutions for loans. As such, we anticipate SACCOs to remain a key driver in loan book growth.

We expect a cautious approach to mobile lending given the recently witnessed rise in default rate on mobile loans and multi borrowing is set to realize a slow down in mobile lending.

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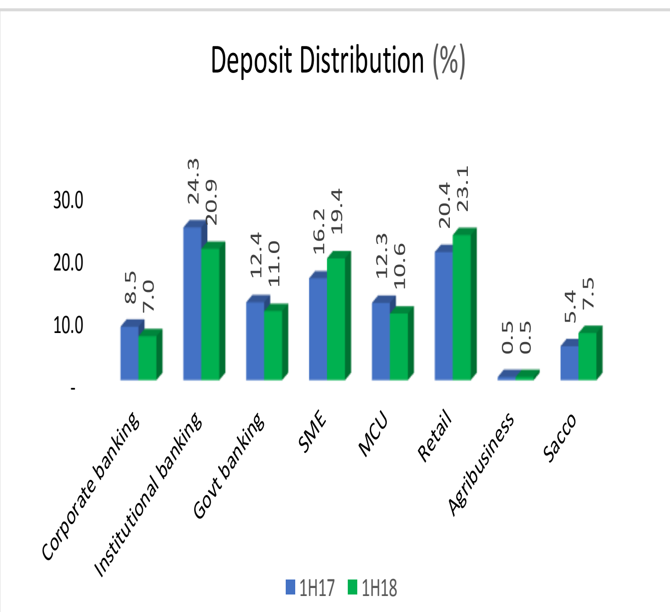
Macroeconomic environment to support deposit growth

We predict a 3 year CAGR of 7.5% on deposits to KES 356.8B on the back of rising retail and institutional deposits growth in tandem with economic recovery. We expect deposit growth to be fast tracked by the prevailing rise in foreign inflows following the prevailing tax amnesty that has seen a surge in diaspora remittances. Further, following abundant rainfall in 1H18, an efflux of agricultural exports is expected to boost deposit growth.

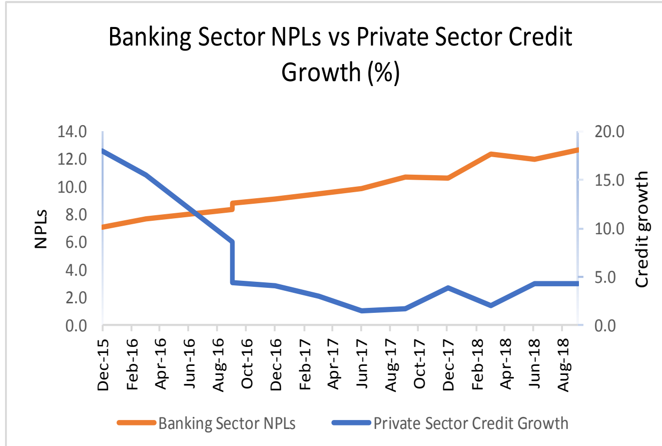
However the current cash crunch by treasury as the government effects tough austerity measures cutting back on spending may see liquidity tighten in the short term; a challenge to deposit growth. Also, given that most of the funds received from diaspora remittances are non– sticky (for investment purposes) and that the tax amnesty extension may not be retained in the next fiscal year, the positive impact on the tax amnesty is projected to be short-lived

The prevailing rate cap has been a bottleneck in SME growth. A repeal/positive amendment to the rate cap will enhance lending to the SMEs which will in turn raise deposits from the sector.

Removal on the floor on deposits came as a reprieve to deposit takers, however given a largely competitive environment, the removal of the floor may have little effect in the near term. We therefore expect cost of deposits to remain between 2.8% to 3.5%.



Source: Co-operative Bank



Source: CBK & Monthly Economic Indicators

Non-performing loans to remain a conundrum in the banking sector

Before the coming to pass of the rate cap, NPLs were on the rise, but they remained somewhat manageable as the aggressive lending kept NPL ratio manageable. Though we cannot attribute the recent rise in NPLs to the rate cap, the cap may have exacerbated the rally. With the cap in place, banks were unable to effectively price risks to their loans; contracting lending to the private sector. The resultant tight liquidity to the private sector contributed partly to the rising NPLs.

The situation has further been aggravated by a cash crunch in the Treasury. Delays in release of payments by the government to counties and government agencies worsened the already weak working capital by government suppliers and contractors. The scenario has been replicated by struggling corporates, especially supermarkets which have huge outstanding amounts owed to suppliers. A proposal by a section of legislators seeks to amend the Public Procurement and Asset Disposal Act, 2015 to ensure that government suppliers and contractors are paid within 30 days of delivery. The Ministry of Trade is also seeking to cap the maximum repayment period to supermarket suppliers to 30 days. Though the two enactments will be a huge reprieve to suppliers and contractors, the bureaucratic law making process will keep NPLs aloft.

With no respite of depressed conditions in the real estate sector due to lack of access to credit, demand for newly-built units is still on the decline. The trend is expected to continue as experts foresee a case of oversupply with falling demand portending the end of a 10-year real estate boom in the country.

We expect that NPL contribution by real estate will remain high until a solution to the rate cap is effected opening up credit access.

An influx of imports from Asia and some African countries, and high production costs in the country has rendered some locally manufactured goods uncompetitive. We therefore expect that coupled with low access to credit, NPLs due from manufacturing and the trade industry are expected to remain high. Manufacturing is a key pillar in the Government's Big 4 Agenda, but recent tax hikes and current high power costs are a deterrent to the sector. Before the government puts its house in order on manufacturing, the current depressed demand for locally manufactured goods will keep the NPLs elevated.

Regional Business: Eyeing Ethiopia

The recently signed peace agreement in war-torn South Sudan may put an end to turbulence in the oil rich nation that has seen a prolonged period of hyperinflation in the last 2 years. Business has been hit hard by translation effects of hyperinflation, shortage of foreign exchange and an unstable currency. The subsidiary's 9M18 PBT stood at KES 235.1M with an expectation of a break even in FY18 despite the prevailing challenges. In line with management, we do not foresee any expansion plans given the prevailing economic turbulence.

With Ethiopia coming out as the new gem for expansion by Kenyan financial services firms, we are optimistic that Ethiopia may be the new cash cow for international corporates once the robust market fully opens doors. Though Kenyan corporates have currently adopted a wait and watch approach, we are optimistic that the market could come out as very profitable for Cooperative Bank given its cooperative model. Saccos have been playing an active role both in rural and urban areas in Ethiopia with a compound growth rate of 28% per year (2015). Management is optimistic that their cooperative model would be easily adopted with an execution strategy expected to be rolled out in the 2020-2024 Strategic Plan.

Bank's strengths that will enhance agility going forward

Despite frequent macroeconomic shocks, with the prevailing rate cap and regular regulatory changes, the bank stands fleet footed with a solid balance sheet and an liquidity ratio of over 41.7% (3Q18). This gives the bank impetus to any opportunistic growth that may arise such as the mortgage refinancing under the Big 4 Agenda that is still under the first steps of initiation. In addition, considering its large and diverse market share, the bank is able to diversify operations despite a tough lending environment such as with the aforementioned check-off system.

We remain cautious of rollout of loans to SMEs in the short term to medium term in the rate cap regime given their high risk profile despite the KES 15B loan granted by the IFC to fund lending to SMEs in February 2018. Also we do not foresee any uptake of additional borrowing in the short-term given stringent lending and continued rise in LIBOR rates that has depressed interest margins.

We expect inflation to remain subdued in the short term though this may turnaround going forward given the anticipated rise in global oil prices. The recent report by IMF that the shilling is over-valued by 17.5%, the expiry of the IMF KES 150B standby credit facility, the ongoing rise in trade deficit following continuing rise in crude prices and the increase in debt repayment obligations are expected to see the shilling weaken against the dollar. The anticipated volatility may spur forex income, supporting non funded income.

We remain cautious of the rising NPLs given the current cash crunch that has seen treasury drag its feet in the in releasing funds and the resolve to cut on development expenditure. We expect the loan loss provisions to surge, reflecting the rising NPL's in FY19 after the lapse of the leeway given in IFRS 9 allowing banks a one-off opportunity to provide for potential loan book loss through the balance sheet as opposed to through P&L. This is also expected to dampen the bottom line in FY19 going forward.

Some investors have expressed concerns over the possibility of a change in leadership at the bank given the long tenure (since 2001) of the current CEO. To put these worries to rest, the CEO is anticipated to retain the realms of power given his exemplary performance in the transformation of the bank over the years and the board's apparent confidence in his ability to steer the bank in the murky waters ahead.

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Tier 1 Comparable

Based on FY17 Statistics	Coop	Equity	KCB	Stanchart	Barclays	DTB	Stanbic
Price(16/11/18)	14.10	39.25	39.00	190.00	11.55	158.00	91.00
EPS (KES)	1.94	5.01	6.43	20.13	1.28	23.07	10.98
DPS (KES)	0.80	2.00	3.00	17.00	1.00	2.60	5.25
NAV/Share	11.9	24.7	34.6	132.9	8.1	173.0	83.6
P/Ex	7.3	7.8	6.1	9.4	9.1	6.8	8.3
P/Bx	1.2	1.6	1.1	1.4	1.4	0.9	1.1
ROE(%)	16.4	20.3	18.6	15.1	15.7	14.3	13.1
Dividend yield (%)	5.7	5.1	7.7	8.9	8.7	1.6	5.8
Cost of funds(%)	4.3	2.9	3.0	3.3	2.5	5.2	3.1
Net Interest Margin(%)	7.8	7.6	8.1	7.9	8.8	5.8	4.6
Cost/Income Ratio(%)	52.2	53.5	50.9	47.9	55.5	42.3	55.2
NPL Ratio(%)	7.2	6.3	8.5	13.2	7.3	7.3	7.7
NPL Coverage Ratio(%)	32.5	36.2	54.3	38.6	44.2	55.5	31.3
NFI/Total Income(%)	32.4	42.3	32.2	32.1	28.0	21.1	43.2
Core Capital/TRWA(%)	15.8	19.7	15.4	15.6	15.9	17.3	15.4
Total Capital/TRWA(%)	22.0	20.4	16.6	18.5	18.0	19.0	16.9

Source: Company fillings, ApexAfrica Research

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3Q18 Earnings Recap

Income Statement	3Q17 KES M	1Q18 KES M	2Q18 KES M	3Q18 KES M	chg y/y %	chg q/q %
Interest Income	10,595	10,384	10,396	10,112	-4.6	-2.7
Interest Expense	3,244	2,974	2,992	3,183	-1.9	6.4
Net Interest Income	**7,351**	**7,410**	**7,404**	**6,929**	**-5.7**	**-6.4**
Foreign Exchange Income	297	753	470	528	78.0	12.4
Gross Fees and Commission	2,586	2,559	2,565	2,768	7.1	7.9
Other Income	152	204	361	285	87.0	-21.1
Non Interest Income	**3,035**	**3,516**	**3,479**	**3,581**	**18.0**	**2.9**
Total Operating Income	10,385	10,925	10,884	10,510	1.2	-3.4
Total Operating Expenses	4,871	5,335	5,546	5,652	16.0	1.9
Loan Loss Provision Expense	**1,053**	**763**	**330**	**179**	**-83.0**	**-45.7**
Operating Profit	5,514	5,590	5,338	4,859	-11.9	-9.0
PBT and exceptional items	4,462	4,827	5,007	4,679	4.9	-6.6
Share of profit of associate	7	71	70	-9	-238.5	-113.4
Profit Before Tax	**4,270**	**4,898**	**5,078**	**4,670**	**9.4**	**-8.0**
Current Tax	1,570	1,450	1,386	1,496	-4.7	8.0
Profit After Tax	**2,701**	**3,448**	**3,692**	**3,174**	**17.5**	**-14.0**
EPS (KES)	1.56	0.59	0.63	1.76	12.8	
Balance Sheet						
Total Shareholders' Equity	**67,338**	**67,947**	**68,018**	**70,836**	**5.2**	**4.1**
Deposits due to Banks & Fin Insti	1,226	4,047	3,194	1,520	24.0	-52.4
Customer Deposits	**288,964**	**295,884**	**296,965**	**296,084**	**2.5**	**-0.3**
Total Liabilities	321,138	329,104	329,639	332,452	3.5	0.9
Total Equity and Liabilities	388,476	397,793	398,427	404,153	4.0	1.4
Cash and CBK Balances	24,101	23,149	23,223	23,323	-3.2	0.4
Bal due from Banks & Fin Insti	12,035	16,024	13,453	16,492	37.0	22.6
Government and Other Securities	**71,189**	**78,077**	**83,129**	**85,812**	**20.5**	**3.2**
Net Loans and Advances	**259,390**	**252,825**	**251,110**	**254,207**	**-2.0**	**1.2**
Fixed Assets	7,637	7,138	6,960	6,886	-9.8	-1.1
Total Assets	388,299	397,793	398,427	404,153	4.1	1.4
Key Ratios						
Gross NPL (KES M)	**16,931**	**28,369**	**28,215**	**29,674**	**75.3**	**5.2**
Interest In Suspense (KES M)	897	767	861	998	11.2	15.9
Total NPL (KES M)	16,034	27,601	27,354	28,676	78.8	4.8
Loan Loss Provision (KES M)	5,560	7,911	7,888	9,918	78.4	25.7
Net NPL	10,474	19,690	19,466	18,758	79.1	-3.6
NPL Ratio	6.4%	10.9%	10.9%	11.2%		
Coverage Ratio	32.8%	27.9%	28.0%	33.4%		
Cost of Risk	1.6%	1.2%	0.9%	0.8%		
Loan to Deposits	89.8%	85.4%	84.6%	85.9%		
Yield on Interest Earning Assets	12.4%	12.0%	12.0%	13.0%		
Cost of Funds	4.0%	4.0%	4.0%	3.8%		
NIM	7.9%	8.0%	5.9%	8.6%		
Non Funded/Total Income	29.2%	32.2%	32.1%	32.7%		
Cost to Income Ratio	46.9%	48.8%	49.9%	51.2%		
ROE	19.9%	20.3%	21.0%	21.8%		
ROA	3.4%	3.5%	3.5%	3.1%		
Core Capital/TRWA	15.9%	16.3%	16.3%	16.5%		
Total Capital/TRWA	22.6%	16.4%	16.0%	16.6%		
Liquidity Ratio	35.0%	38.7%	37.7%	41.7%		
P/B (x)				**1.2**		
P/E (x)				**8.0**		

Source: Company Filings, ApexAfrica Research

Valuation

P/B Valuation	
Historical Average	1.3x
Tier 1 Banks Average	1.2x
Weighted Average	1.3x
NAV/Share (KES)	13.60
Per share value (KES)	**17.20**

P/E Valuation	
Historical Average	7.8x
Tier 1 Banks Average	7.0x
Weighted Average	7.6x
EPS (KES)	2.07
Per share value (KES)	**15.74**

DDM Valuation

	FY18E	FY19E	FY20E	Terminal
Dividend (KES M)	4,694	4,694	5,867	107,565
Period (years)	0.1	1.1	2.1	
Present Value (KES M)	4,594	3,960	4,267	
Cumulative PV (KES M)	91,055			
Shares in issue (M)	5,867			
Per share value (KES)	**15.60**			

Blended fair value (KES)	**16.18**
Current Price (KES)	**14.15**
Upside (%)	**14.4**

Source: Apex Africa Estimates, Company filings

Financials Summary

Income Statement	FY15A KES M	FY16A KES M	FY17A KES M	FY18F KES M	FY19F KES M	FY20F KES M	y/y change %	3-yr CAGR %
Interest Income	33,370	37,350	36,273	37,671	38,911	41,790	3.9	4.8
Interest Expense	13,587	12,768	12,269	12,092	12,769	13,887	-1.4	4.2
Net Interest Income	19,783	24,582	24,003	25,579	26,142	27,903	6.6	5.1
Non Interest Income	**16,607**	**17,689**	**17,592**	**18,519**	**19,594**	**20,931**	**5.3**	**6.0**
Total Operating Income	36,390	42,271	41,596	44,098	45,737	48,834	6.0	5.5
Total Operating Expenses	19,372	22,045	21,726	24,355	23,964	25,207	12.1	5.1
Loan Loss Provision Expense	**2,019**	**2,600**	**3,601**	**2,551**	**3,438**	**3,826**	**-29.2**	**2.0**
Operating Profit	17,017	20,226	19,870	19,743	21,772	23,627	-0.6	5.9
Profit Before Tax	**15,383**	**17,724**	**16,398**	**17,191**	**18,335**	**19,801**	**4.8**	**6.5**
Current Tax	3,678	5,047	4,994	5,038	5,329	5,720	0.9	4.6
Profit After Tax	**11,706**	**12,676**	**11,405**	**12,153**	**13,006**	**14,081**	**6.6**	**7.3**
EPS (KES)	2.39	2.59	1.94	2.07	2.22	2.40	6.6	7.3
DPS (KES)	**0.80**	**0.80**	**0.80**	**0.80**	**0.80**	**1.00**	**-**	**7.7**
Balance Sheet								
Total Shareholders' Equity	**49,303**	**60,620**	**69,813**	**76,570**	**84,487**	**93,473**	**9.7**	**10.2**
Customer Deposits	265,399	260,153	287,372	301,740	324,371	356,808	5.0	7.5
Total Liabilities	293,197	291,208	317,045	333,244	359,589	395,928	5.1	7.7
Total Equity and Liabilities	342,500	351,829	386,858	409,814	444,076	489,401	5.9	8.2
Government and Other Securities	**64,927**	**61,917**	**73,322**	**86,010**	**92,351**	**101,155**	**17.3**	**11.3**
Net Loans and Advances	**208,572**	**232,307**	**253,862**	**256,400**	**272,503**	**296,471**	**1.0**	**5.3**
Fixed Assets	8,021	8,309	7,494	7,868	8,262	8,675	5.0	5.0
Total Assets	342,500	351,829	386,858	409,814	444,249	489,829	5.9	8.2
Key Ratios								
Gross NPLs (KES M)	**8,189**	**11,274**	**18,761**	**29,850**	**28,296**	**28,449**	**59.1**	**14.9**
Cost of Risk (%)	1.0	1.1	1.4	1.0	1.3	1.3		
Loan to Deposits (%)	78.6	89.3	88.3	85.0	84.0	83.1		
Yield on Interest Earning Assets (%)	14.0	14.0	12.5	12.2	12.0	12.0		
NPL Ratio (%)	3.9	4.9	7.4	11.7	10.7	10.0		
Cost of deposits	4.2	3.7	3.2	3.5	3.4	3.4		
Net Interest Margin (%)	9.8	10.3	9.3	8.7	8.6	8.6		
Non Funded/Total Income (%)	33.2	32.1	32.7	33.0	33.5	33.4		
Cost to Income Ratio (%)	53.2	52.2	52.2	55.2	52.4	51.6		
ROaE (%)	25.4	23.1	17.5	17.4	17.3	16.7		
ROaA (%)	3.7	3.7	3.1	3.1	3.2	3.2		
P/E (x)			**7.3**	**7.8**	**7.3**			
P/B (x)			**1.2**	**1.3**	**1.2**			
Dividend Yield (%)			**5.6**	**4.9**	**4.9**			

Source: ApexAfrica Research Estimates

Appendix

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.

Disclaimer

ApexAfrica Capital Ltd
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