

10 November 2015

Co-operative Bank of Kenya

Efficiencies drive 9M15 earnings

- Action/Event:** Yesterday Co-Op held an investor call discussing the good 9M15 result (earnings + 37%/y). Costs savings offset weak NIMs and higher credit losses to deliver good earnings growth and an improved ROE of 25% (9M14: 21%). Such an ROE performance is comparable with Equity Group (9M15: 25%) however Co-Op (1.6x fwd PB) continues to trade at a significant discount to Equity Group (fwd PB: 2.0x). This suggests that the market is pricing in 2x the growth for Equity as it is for Co-Op. While growth paths may differ, we feel that such pricing divergence is unwarranted and recommend investors BUY Co-Op.
- Opex +1%/y despite strong asset (+23% y/y) and revenue (+21% y/y) growth.** The 'Soaring Eagle' transformation project is delivering the promised efficiencies with staff costs falling 13% y/y driven by an 11% reduction in head count. While the cost-to-income ratio of 49% (9M14: 58%) represents a significant improvement, management has guided to a 53% FY15 cost-to-income. We suspect 4Q15 will see expenditure brought forward from FY16 into FY15, absorbed by the significant improvement in FY15 profitability, and thereby supportive of FY16 earnings. Management meanwhile suggests planned 4Q15 opex relates to reconfiguring a further 20 branches (40 of the 143 branches reconfigured so far, resulting in a 40% increase in branch staff productivity), and a higher than budgeted salary increment for unionised staff.
- Provisioning boosted by +103%/y growth in credit impairments, resulting in a 1.0% cost of risk.** Despite NPLs declining to 4.0% (9M14: 4.5%), credit losses increased as management raised the IFRS coverage of NPLs significantly to 49% (9M14: 34%) and CBK coverage to 77% (9M14: 55%) while still expecting a 1.0% cost of risk for FY15. This brings Co-Op's provisioning in line with other large banks. In addition management is targeting 60% and 80% coverage under IFRS and CBK respectively by FY17.
- Loans+21%/y with trend growth expected to continue.** Management expects recent interest rate volatility to normalise with the one year Treasury rate seen at 14-15%. Under such a normalised interest rate environment management expects FY16 loan growth to range between 20-25% y/y. Similarly, management expects deposits to growth c25%/y, however all this being subject to a stable macro environment with higher rates reducing demand and affordability of credit.
- Funding costs pressure NIMs down to 8.9%.** Management expects NIMs to recover to 9.0% for FY15 as the loan book reprices and interest rates stabilise.
- No rights issue for FY16.** Existing capital sources sufficient for planned growth.
- Maintain BUY recommendation, forecasts and TP unchanged.** On this result Co-Op trades on a historic PE of 8.0x (TTM), a PB of 1.7x and a DY of 2.9% (TTM).

Key Forecasts	Dec 12A	Dec 13A	Dec 14A	Dec 15E	Dec 16E	Dec 17E
Adjusted headline earnings (group)	7,325	8,868	9,337	10,970	13,573	15,995
IFRS diluted HEPS (KSh)	1.75	2.12	1.91	2.24	2.78	3.27
IFRS diluted HEPS growth (%)	17.2	21.1	(9.7)	17.5	23.7	17.8
Price/adjusted HEPS (x)	6.2	7.2	10.5	7.6	6.2	5.2
Tangible book value per share	7.14	8.86	8.79	10.54	12.76	15.35
Price/tangible book value (x)	1.5	1.7	2.3	1.6	1.3	1.1
Adjusted return on tangible equity	28.6	26.6	23.4	23.3	23.9	23.3
DPS (c)	50	50	50	56	69	82
Dividend yield (%)	4.6	3.3	2.5	3.3	4.0	4.8

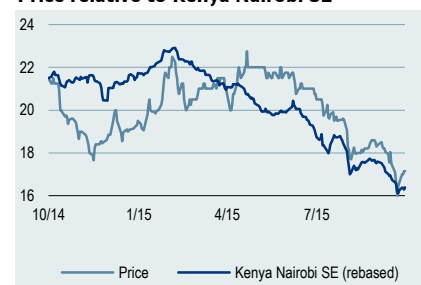
Source: Company financials, SBG Securities estimates

 Recommendation: **BUY** Maintained
 Target Price: **KSh 24.00**

 *Stock ratings are relative to the relevant country benchmark.¹ Target price is for 12 months

Share data	
RIC	COOP.NR
Sub industry	ICB Banks
Price (09 Nov 2015)	KSh 17.20
Market cap. (KSh m)	84,060
Enterprise value (KSh m)	
Market cap. (USD m)	822
Enterprise value (USD m)	n/a
Avg. daily trade value (USD m)	0.21
Free float (%)	100

Price relative to Kenya Nairobi SE



Historical performance relative to Kenya Nairobi SE (%)			
Performance over	1M	3M	12M
Absolute (%)	-1.1	-13.1	-13.6
Relative (%)	2.0	-1.3	9.7

Source: Kenya Nairobi SE, SBG Securities Research

The price relative chart measures performance against the Kenya Nairobi SE which closed at 3893 on 09 Nov 2015

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Results review

Equity Research | CEEMEA/Kenya | Banks

Statement of Comprehensive Income (US\$ m)	Dec 12A	%chg	Dec 13A	%chg	Dec 14A	%chg	Dec 15E	%chg	Dec 16E	%chg	Dec 17E	%chg
Net interest income (US\$ m)	185	32%	216	17%	235	9%	232	-1%	287	24%	336	17%
Non-interest revenue (US\$ m)	91	20%	107	18%	119	11%	121	2%	145	20%	177	22%
Total revenue	276	28%	323	17%	354	10%	353	0%	431	22%	513	19%
Operating expenses	(153)	14%	(192)	26%	(209)	9%	(176)	-16%	(213)	21%	(254)	19%
Indirect taxation		N/A		N/A		N/A		N/A		N/A		N/A
Pre-provision profits	123	52%	131	7%	145	11%	177	22%	218	23%	259	19%
Credit impairments	(12)	50%	(9)	-25%	(13)	44%	(23)	77%	(28)	22%	(35)	25%
Operating profit	111	52%	122	10%	132	8%	154	17%	190	23%	224	18%
Income (loss) from associates and JVs	0	N/A	0	N/A	0	N/A	0	N/A	0	N/A	0	N/A
Non-recurring items	4	100%	4	0%	(12)	>100%	0	-100%	0	N/A	0	N/A
Profit before tax	116	55%	126	9%	121	-4%	154	27%	190	23%	224	18%
Taxation	(26)	>100%	(20)	-23%	(32)	60%	(46)	44%	(57)	24%	(67)	18%
Profit after tax	90	43%	106	18%	89	-16%	107	20%	133	24%	157	18%
Attributable to minorities	0	N/A	(1)	N/A	(3)	>100%	0	-100%	0	N/A	0	N/A
Attributable to preference shareholders		N/A		N/A		N/A		N/A		N/A		N/A
Profit attrib. to ordinary shareholders	90	43%	104	16%	86	-17%	108	26%	133	23%	157	18%
Normalised headline earnings banking	85	39%	103	21%	103	0%	107	4%	133	24%	156	17%
Normalised headline earnings insurance	0	N/A	0	N/A	0	N/A	0	N/A	0	N/A	0	N/A
Normalised headline earnings	85	39%	103	21%	103	0%	107	4%	133	24%	156	17%
Key items from Statement of Financial Position (US\$ m)	Dec 12A	%chg	Dec 13A	%chg	Dec 14A	%chg	Dec 15E	%chg	Dec 16E	%chg	Dec 17E	%chg
Common equity	346	37%	426	23%	474	11%	503	6%	609	21%	732	20%
Customer deposits	1,885	13%	2,033	8%	2,404	18%	2,596	8%	3,082	19%	3,544	15%
Government securities	322	61%	293	-9%	233	-21%	260	12%	308	19%	354	15%
Goodwill and intangible assets	0	N/A	0	N/A	0	N/A	0	N/A	0	N/A	0	N/A
Gross advances	1,438	7%	1,641	14%	2,031	24%	2,195	8%	2,590	18%	2,978	15%
Total assets	2,332	18%	2,679	15%	3,152	18%	3,450	10%	4,049	17%	4,640	15%
Per share data	Dec 12A	%chg	Dec 13A	%chg	Dec 14A	%chg	Dec 15E	%chg	Dec 16E	%chg	Dec 17E	%chg
Normalised fully diluted HEPS (US\$)	0.02	0%	0.02	0%	0.02	0%	0.02	0%	0.03	50%	0.03	0%
IFRS diluted HEPS (US\$)	0.02	0%	0.02	0%	0.02	0%	0.02	0%	0.03	50%	0.03	0%
DPS - ordinary (US\$)	0.01	N/A	0.01	0%	0.01	0%	0.01	0%	0.01	0%	0.01	0%
Dividend payout ratio (x)	0.3	0%	0.2	-33%	0.3	50%	0.2	-33%	0.3	50%	0.3	0%
Tangible book value per share (US\$)	0.08	14%	0.10	25%	0.10	0%	0.10	0%	0.12	20%	0.15	25%
Diluted number of shares (period end) (m)	4,191	20%	4,191	0%	4,887	17%	4,887	0%	4,887	0%	4,887	0%
Diluted number of shares (time weighted) (m)	4,191	20%	4,191	0%	4,887	17%	4,887	0%	4,887	0%	4,887	0%
Key valuation Metrics	Dec 12A		Dec 13A		Dec 14A		Dec 15E		Dec 16E		Dec 17E	
Tangible book value per share	7.14		8.86		8.79		10.54		12.76		15.35	
Price/tangible book value (x)	1.5		1.7		2.3		1.6		1.3		1.1	
Price/adjusted HEPS (x)	6.2		7.2		10.5		7.6		6.2		5.2	
Dividend yield (%)	4.6		3.3		2.5		3.3		4.0		4.8	
Price / pre-provision profits (x)	4.3		5.6		7.4		5.8		4.7		4.0	
Ratio's disclosed by company	Dec 12A		Dec 13A		Dec 14A		Dec 15E		Dec 16E		Dec 17E	
Group ROE (%)	31.0		17.4		20.0		30.0					
Net interest margin (%)	0.0		10.8		10.1		10.1					
Credit impairment charge ratio (%)	0.0		0.0		0.0		1.0					
Cost-to-income ratio (%)							53.0					
Key ratio analysis	Dec 12A		Dec 13A		Dec 14A		Dec 15E		Dec 16E		Dec 17E	
Profitability ratios (%)												
Bank ROA (%)	4.0		4.1		3.6		3.4		3.5		3.6	
Bank gearing (%)	7.2		6.5		6.5		6.8		6.7		6.5	
Bank ROTe (%)	28.6		26.6		23.4		23.3		23.9		23.3	
Key income statement ratios												
Net Interest Margin (SBGS) (%)	10.6		10.7		10.0		9.0		9.2		9.2	
Bad debts charge (%)	0.9		0.6		0.7		1.2		1.2		1.3	
Cost-to-income ratio (%)	55.4		59.5		59.0		49.9		49.5		49.5	
NIR to operating expenses (%)	59.3		55.8		57.1		68.6		67.8		69.6	
Tax rate (%)	22.7		16.2		26.6		30.0		30.0		30.0	
Key balance sheet ratios												
Gross NPL ratio (%)	5.0		4.3		4.3		5.0		5.0		5.0	
Specific provisions as percent of NPL (%)	53.3		48.7		30.5		40.0		40.0		40.0	
Portfolio provisions to performing loans (%)	1.2		1.1		1.1		1.1		1.1		1.1	
Core tier 1 ratio (%)	20.3		15.7		14.6		14.8		15.6		17.2	
Tier 1 capital adequacy ratio (%)	20.3		15.8		14.6		14.8		15.6		17.3	
Total capital adequacy ratio (%)	23.9		21.2		21.7		20.7		20.7		21.9	

Source: SBG Securities Estimates, Company Financials

9M15 Results

Figure 1: Co-Op Bank: 9M15 results

Income Statement (Ksh m)	9M14	9M15	y/y		Annualised	SBGSe	Beat / (miss)	vs SBGSe	Balance Sheet & Key ratios		y/y		YTD	SBGSe	Difference
			9M15 / 9M14	9M15					9M15 / 9M14	Q3:15 / Q4:14	FY15E	vs FY SBGSe			
Interest Income	20 855	25 953	24%	34 604	34 259	1%	Customer loans (Ksh m)	175 970	212 360	21%	18%	218 973	(3%)		
Interest Expense	(5 818)	(8 574)	47%	(11 432)	(10 515)	9%	Customer deposits (Ksh m)	200 439	253 532	26%	16%	265 422	(4%)		
Net Interest Income	15 037	17 378	16%	23 171	23 744	(2%)	Total assets (Ksh m)	270 677	332 885	23%	17%	352 783	(6%)		
Non Interest Income	8 448	9 250	9%	12 333	12 352	(0%)	Total equity (Ksh m)	42 045	49 740	18%	15%	51 520	(3%)		
Total Operating Income	23 485	26 628	13%	35 505	36 096	(2%)	Net interest margin	9.6%	8.9%			9.0%			
Staff costs	(6 198)	(5 747)	(7%)	(7 662)	(8 438)	(9%)	NIR / Op Income	36%	35%			34%			
Total Opex	(13 679)	(13 060)	(5%)	(17 413)	(18 004)	(3%)	Cost to Income	58%	49%			50%			
PPOP	9 806	13 569	38%	18 091	18 093	(0%)	Effective tax rate	31%	29%			30%			
Loan loss provisions	(748)	(1 520)	103%	(2 026)	(2 391)	(15%)	Cost of Risk	0.6%	1.0%			1.2%			
PBT & Exceptional items	9 058	12 049	33%	16 065	15 702	2%	NPL / Gross Loans	4.5%	4.0%			5.0%			
Exceptional items	75	115	(35%)	154	-	0%	Loan to deposit	88%	84%			83%			
PBT	9 132	12 164	33%	16 219	15 702	3%	Leverage	6.4	6.7			6.8			
Tax	(2 819)	(3 543)	26%	(4 724)	(4 711)	0%	ROaA	3.4%	3.7%			3%			
PAT	6 313	8 621	37%	11 495	10 991	5%	ROaE	21%	25%			23%			

Source: Company filings, SBGS estimates

Note: SBG estimates presented above were estimates in place prior to the release of the 9M15 results

Companies Mentioned (Price as of 09 Nov 2015)

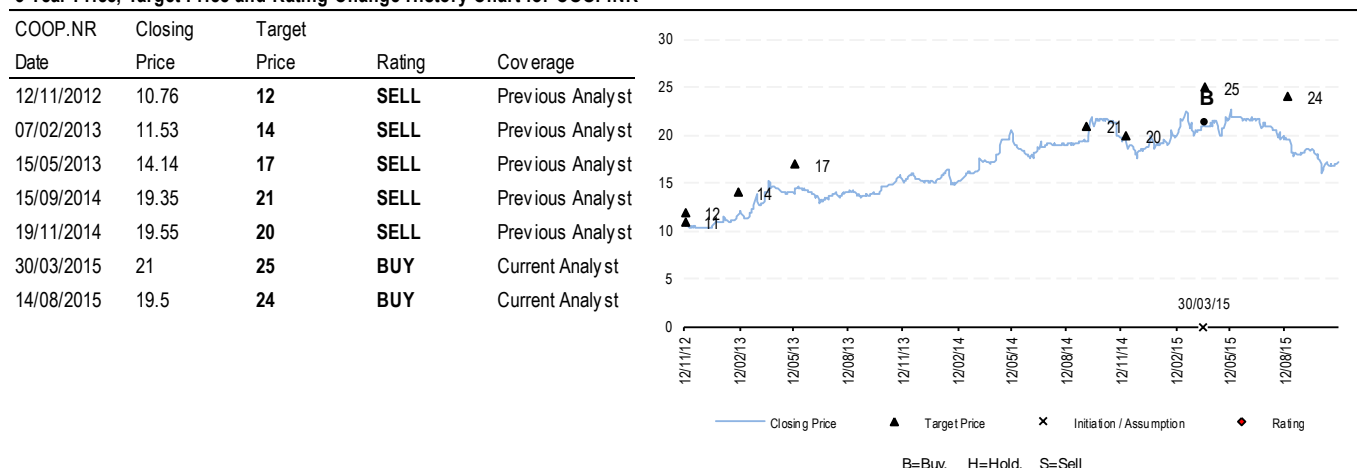
Co-operative Bank of Kenya (COOP.NR, KSh17.20, BUY, TP KSh24.00)

Equity Group Holdings Ltd (EQTY.NR, KSh42.00, HOLD, TP KSh47.00)

Disclosure Appendix
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See the Companies Mentioned section for full company names.

3-Year Price, Target Price and Rating Change History Chart for COOP.NR


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Recommendations with investment Banking Relationships (%)	78	80	83	100

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Price Target: (12 months) for (COOP.NR)

Methods: We value Co-operative Bank based on an exit price-to-book (P/B) multiple using the average ROE over the next two years. Given our average ROE of 24% over the next two year, cost of equity of 17% and a terminal growth rate of 10.0%, we arrive at an exit multiple of 1.9X. We apply this to our terminal NAV and discount it back along with dividends to today to arrive at our current fair value. We then roll this forward at the cost of equity less the dividend yield to arrive at our 12-month price target (rounded to the nearest shilling).

Risks: Cost efficiencies expected from the Soaring Eagle transformation project don't materialise. The tight liquidity environment as a result of the Central Bank of Kenya's intervention to manage the slide the Kenya shilling continues to place upward pressure on funding costs. Rising inflation (second round effects of KES weakness), puts pressure on households' debt servicing ability. Inflation: 7.0% for Jun 15 vs 6.3% in Mar 15. Increasing competition continues to erode NIMs by placing downward pressure on loan yields and bids up the cost of deposits. The increased push into SME lending could result in elevated credit losses should the credit mitigation process fail in this relatively new market segment.

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Co-operative Bank of Kenya	D
Equity Group Holdings Ltd	D

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** Disclosures are correct as of 10 November 2015.*

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