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Co-operative Bank: 1H2013 Results Note

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RECOMMENDATION: BUY

Current Market Price (12.08.13)	16.45
Trailing BVPS: FY2012	7.01
3-Year Average P/B	2.39
Forecasted BVPS: FY2013	8.54
Target Price	**20.39**
Upside Potential	**24.0%**

Share Statistics

Issued Shares (Mn)	4,191
Market Cap (Kshs Mn)	68,939
Market Cap (USD Mn)	788.87

Source: NSE

Summary

We revise our recommendation from HOLD to **BUY** based on our revised **price target of KES 20.39** (an upside potential of 24.0% from the prevailing market price as at August 12, 2013). This is based on the adjusted FY2012 results (audited results), 3-year historical average P/B and our revised FY2013 forecasts.

In our review, we note the bank's growing momentum in deposit mobilization. However, we are yet to see the same momentum on the lending side.

Key 1H2013 Results Highlights

- **Interest income dips on account of depressed yields:** The bank's interest income experienced a 9.7% drop from KES 13.0 billion (1H2012) to KES 11.7 billion (1H2013)
- **Sharp drop in interest expenses boosts net interest income:** The total interest expense dropped by a significant 48.1% to KES 2.9 billion (1H2013) compared with KES 5.6 billion (1H2012)
- **Significant deposit mobilization…:** The customer deposits grew by 6.5% to KES 172.8 billion in the 6 months to June 2013
- **Pressure on capital adequacy:** The core capital/total risk weighted assets dropped sharply from 20.3% (FY2012) to 15.1% (1H2013), only 4.6% above the minimum required ratio. In addition, the total capital/total risk weighted assets dropped from 23.8% (FY2012) to 18.1% (1H2013)

Year to 31 Dec	2010A	2011A	2012A	2013F
Net Income (Kshs '000)	4,580,698	5,332,779	7,723,857	9,208,468
EPS (Kshs)	1.31	1.53	1.84	2.20
BVPS (Kshs)	5.7	6.0	7.0	8.5
P/E x	12.96	11.13	9.22	7.74
P/B x	3.0	2.8	2.4	2.0
ROE	23.1%	25.6%	26.4%	25.9%
ROA	3.0%	3.2%	3.8%	3.7%
C/I Ratio	58.9%	62.4%	59.6%	58.1%

Source: Company reports, FIB estimates

Results Highlights

Income Statement (KES '000)	1H2012	1H2013	% Change
Interest income	12,998,170	11,743,502	-9.7%
Interest expense	5,553,481	2,881,309	-48.1%
Net Interest Income	**7,444,689**	**8,862,193**	19.0%
Non-interest income	4,037,686	4,498,174	11.4%
Total Income	**11,482,375**	**13,360,367**	16.4%
Operating expenses	6,087,966	7,105,309	16.7%
Loan loss provision	498,003	500,000	0.4%
PBT	**4,896,406**	**5,755,058**	17.5%
PAT	**4,020,729**	**4,714,074**	17.2%
EPS	***0.96***	***1.12***	
Cost/Income Ratio	***53.0%***	***53.2%***	

Source: Company Release

Balance Sheet (KES'000)	FY2012	1H2013	% Change
ASSETS			
Kenya government securities	33,360,776	34,393,057	3.1%
Loans & advances to customers	119,087,748	124,922,159	4.9%
Total Assets	**200,773,296**	**225,252,258**	12.2%
LIABILITIES			
Customer deposits	162,267,227	172,833,142	6.5%
Deposits from other banks	1,065,302	5,882,877	452.2%
Borrowings	4,572,005	5,269,985	15.3%
Total Liabilities	**170,832,551**	**191,529,453**	12.1%
Shareholders' Funds	**29,940,747**	**33,722,808**	12.6%
Loan /deposit Ratio	***77.3%***	***72.3%***	
Core capital/total risk weighted assets	***20.3%***	***15.1%***	
Total Capital/Total Risk-Weighted Assets	***23.8%***	***18.1%***	
Liquidity Ratio	***35.8%***	***39.3%***	

Source: Company Release

Lower yields depress interest income

- **Interest income dips on account of depressed yields:** The bank's interest income experienced a 9.7% drop from KES 13.0 billion (1H2012) to KES 11.7 billion (1H2013). This may be attributed to yield pressures during the review period.

Yield on loans declined by about 216 bps. Yield on government securities remained relatively flat at 5.5%. Yield on balances with other banking institutions was down by 7.1%.

Decline in interest expenses boosts net interest income

- **Sharp drop in interest expenses boosts net interest income:** The total interest expense dropped by a significant 48.1% to KES 2.9 billion (1H2013) compared with KES 5.6 billion (1H2012).

The cost of customer deposits averaged 1.5% in 1H2013, 163 bps lower than in a similar period in 2012. This was mainly attributed to the general decline in the cost of funds during the period, with the general interest rates depicting a downward trend. The Central Bank Rate (CBR) dropped by 100 bps from 9.5% in January 2013.

As a result, net interest income rose by 19.0% to KES 8.9 billion in 1H2013.

Growth in fees & commissions, forex income boosts non-funded income

- **11.4% rise in non-funded income:** The total non-funded income rose by 11.4% from KES 4.0 billion (1H2012) to KES 4.5 billion (1H2013). This was mainly attributed to a 65.3% growth in fees and commissions from loans (supported by a 4.9% loan book expansion), 5.8% growth in activity fees and commission and 8.3% increase in forex income.

Growth in other fees and commissions may have been boosted by growth in agents ('*Co-op Kwa Jirani*'). The banks agents grew to 5,800 compared with about 5,000 in FY2012.

Co-op marshals KES 10.6 billion in deposits (2Q2013)

- **Significant deposit mobilization…:** The customer deposits grew by 6.5% to KES 172.8 billion in the 6 months to June 2013. A quarter/quarter analysis reveals that all of this growth was realized in 2Q2013. The bank recorded 0.0% growth in 1Q2013.

Growth in 2Q2013 may have been boosted by growth in customer numbers from about 3.2 million customers (FY2012) to about 3.5 million customers by the end of June 2012.

Pressure on lending

- **…but slight pressure on lending:** Despite mobilizing KES 10.6 billion in 2Q2013, only 54.7% was loaned out. In addition to customer deposits, Co-op managed to mobilize KES 4.1 billion from other financial institutions.

This implies some pressure on the lending side, in our view.

Staff costs, rent, depreciation pushes OpEx up

- **OpEx up 16.7%:** The total operating expenses (OpEx) went up by 16.7% from KES 6.1 billion (1H2012) to KES 7.1 billion (1H2013). This was mainly driven by a 53.9% increase in depreciation charge, 7.2% rise in staff costs, 33.3% growth in rental charges and a 21.5% increase in other operating expenses.

The bank continues to roll out its branch network, and this may have escalated the operating costs. As disclosed, the bank opened an additional 11 branches by June 2013, bringing the total branches to 125 compared to 114 by the end of 2012.

With the devolved government system, Co-op plans to increase its presence in every county.

We expect C/I ratio to remain at the current levels

With the growing cost components, we expect the cost/income (C/I) ratio to remain at the current levels. C/I ratio stood at 53.2% (1H2013) compared with 53.0% in 1H2012.

Slight hit on asset quality

- **Slight deterioration of the loan book:** The gross non-performing loans (GNPLs) grew by 1.3% to KES 6.8 billion as at June 2013 compared to KES 6.7 billion in 1Q2013. Loan loss provision increased by 0.4% to KES 500 million.

Pressure on capital adequacy

- **Pressure on capital adequacy:** The core capital/total risk weighted assets dropped sharply from 20.3% (FY2012) to 15.1% (1H2013), only 4.6% above the minimum required ratio. In addition, the total capital/total risk weighted assets dropped from 23.8% (FY2012) to 18.1% (1H2013).

Needs for increased profitability

This, in our view, creates very minimal headroom for a significant growth in risky assets. The bank will need to boost growth in profitability in the absence of any new capital injection.

Outlook

Momentum in deposit mobilization encouraging

The bank seems to be gaining momentum in terms of deposit mobilization. Increased presence in the counties, through agencies and strategic branches may continue to bear fruit in the medium term.

Recently, the bank ventured into South Sudan through a partnership with the government. We are yet to see how this will contribute to the bank's profitability. Expansion into other East African countries is still not clear.

We revise our recommendation from HOLD to BUY

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