DYER & BLAIR INVESTMENT BANK EARNINGS UPDATE

Founder Member of the Nairobi Securities Exchange

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DYER & BLAIR INVESTMENT BANK

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COOPERATIVE BANK GROUP: 1H17 EARNINGS UPDATE

Dear All,

COOPERATIVE BANK GROUP (CO-OP) released its 1H17 results recording a 10.4% y-o-y drop in profit after tax (PAT) to KES 6.6 BN. Its EPS stands at KES 1.13. Its Trailing EPS stands at KES 2.25. Its annualized ROE and ROA ratios stand at 20.7% and 3.5% respectively.

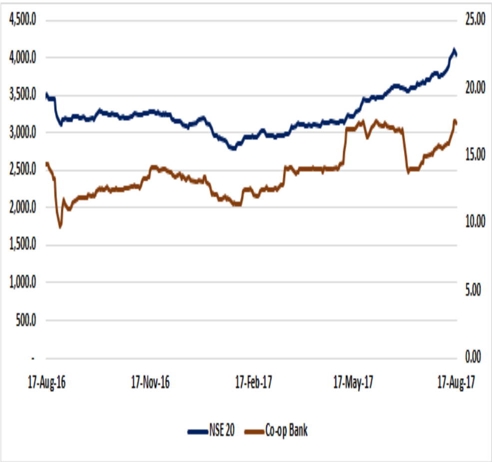
Below please find key highlights:

Net interest income declined 7.2% y-o-y to KES 13.4 BN (+0.7% q-o-q). This was driven by a 10.3% y-o-y decrease in interest income to KES 19.3 BN (+2.3% q-o-q) and aided by a 16.7% y-o-y decline in interest expense to KES 5.8 BN (+6.3% q-o-q) that led to an 83 bps y-o-y decline in the cost of funds to 3.7%. Annualized yield on interest earning assets declined 259 bps y-o-y to 11.4% which consequently saw a 176 bps y-o-y NIMs compression to 7.6%. Comparing 2Q17 and 2Q16, the group saw a 9.9% y-o-y decline in interest income to KES 9.7 BN, a 4.1% y-o-y decline in interest expense to KES 3.0 BN and consequently a 12.2% y-o-y decline in net-interest income to 6.7 BN.

Across interest income segments, interest income from loans and advances declined 9.0% y-o-y to KES 15.3 BN (-1.1% q-o-q) and contributed 79.3% of total interest income, up 110 bps y-o-y. Interest income from government securities declined 12.2% y-o-y to KES 3.9 BN (+20.0% q-o-q) and contributed 20.1% of total interest income down 40 bps y-o-y.

Across interest expense segments, interest expense from customer deposits declined 19.6% y-o-y to KES 5.2 BN (+ 8.7% q-o-q) on the back of deposit account reclassification and flight to quality-and contributed 89.3% of the total interest expense down 330 bps. Other interest expense rose 19.3% y-o-y to KES 0.6 BN. Interest expense from placements from banks was immaterial.

COOP GROUP: 52 WEEK PRICE PERFORMANCE



(Source: NSE, DBIB Research)

PRICE RETURN	ABSOLUTE RETURN	EXCESS RETURN
3 month (%)	2.6	-20.5
6 month (%)	44.8	7.6
12 month (%)	21.2	5.9

KEY METRICS	
Current Price (KES)	17.45
52 week Range (KES)	9.75-17.55
YTD Return (%)	32.2
Issued Shares (MN)	4889.3
Market Cap (USD BN)	825.6

Recommendation	HOLD
Trailing EPS (KES)	2.25
NAV (KES)	13.19
P/E (x)	7.8
P/B (x)	1.3
Div. Yld (%)	-

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Non-funded income rose 3.7% y-o-y to KES 7.1 BN. This was courtesy of a 28.3% y-o-y rise in forex income to KES 1.2 BN (+22.0% q-o-q) and a 6.1% y-o-y rise in fees and commissions to KES 5.3 BN. Other operating income however declined 34.7% y-o-y to KES 0.6 BN. The rise of non-funded income vis-à-vis funded income led to a 248 bps y-o-y decline in the funded income reliance ratio to 65.4%. Comparing 2Q17 and 2Q16, the group recorded a 45.0% y-o-y increase in forex income to KES 0.7 BN, a 6.2% y-o-y rise in fees and commissions to KES 2.7 BN and a 9.8% y-o-y decline in other operating income to KES 0.3 BN.

Operating expenses less loan loss provisions rose 1.9% y-o-y to KES 9.8 BN. This was mainly due to an 8.7% y-o-y rise in staff costs to KES 4.7 BN (+2.8% q-o-q) due to inflationary pressures. However other operating expenses declined 5.9% y-o-y to KES 3.2 BN (+3.5% q-o-q) courtesy of continued efficiency gains from the " Soaring Eagle" transformation strategy. The group's cost to income ratio rose 264 bps y-o-y to 47.9% (up 298 bps q-o-q). Management indicated that over 600 staff have been deployed as sales staff (60%) and service staff (40%) in a move that is expected to release at least 20.0% productivity in the sales staff. The group has also implemented the SAP Enterprise Resource Planning solution with the aim of optimizing on costs across all its branches. Notably, Co-op's Cost to Income ratio has dropped from 59.0% in FY14 to 47.9% in 1H17.

Total assets rose 5.6% y-o-y to KES 383.3 BN (+1.3% q-o-q) driven by a 14.2% y-o-y growth in loans and advances to KES 252.6 BN (+ 2.7% q-o-q). Investment securities however declined 8.8% y-o-y to KES 74.2 BN, contrary to the trend in the rest of the banking sector. On the other hand, customer deposits grew 2.7% y-o-y to KES 285.8 BN (+2.1% q-o-q) whereas borrowed funds rose 64.6% y-o-y to KES 24.3 BN (+0.3% q-o-q). Loans to deposits ratio gained 887 bps y-o-y to 88.4% whereas loans to deposits and borrowed funds ratio gained 592 bps y-o-y to 88.1%.

Across loan segments: Personal loans accounted for 31.5% of the loan book up 350 bps y-o-y, corporate loans accounted for 26.3% of the loans down 240 bps y-o-y, whereas Mortgages accounted for 17.1% of the loan book up 60 bps y-o-y. Key to note is that the personal lending book is mainly on a scheme basis with government employees including the Kenya Defense Forces, Teachers Service Commission and the Kenya Police. We believe that the typically low attrition rates in those entities and the on-going government focus on developing them will continue to facilitate loan book growth without necessarily impacting asset quality.

Across deposit segments: Current and transactional accounts accounted for 59.5% of deposits, savings accounted for 3.2% whereas call and fixed deposits accounted for 9.6% and 27.7% respectively. Management is forecasting a deposit growth of about 12.0% in FY17 citing tea bonus payout, government payments and allocations as potential key drivers of the ambitious target.

Gross non-performing loans (Gross NPLs) rose 19.2% y-o-y to KES 12.2 BN whereas interest in suspense declined 20.1% y-o-y to KES 0.9 BN. Consequently, total non-performing loans rose 24.5% y-o-y to 11.3 BN. The NPL ratio rose 19 bps y-o-y to 4.6%. The NPL coverage ratio declined 190 bps y-o-y to 39.9%. Management does not expect any further deterioration of their NPLs this year. Material recoveries are however not expected until sometime next year. Loan loss provisions expense on the income statement rose 15.2% y-o-y to KES 1.5 BN. Management mentioned that they have revamped their credit scoring models in order to minimize non-performance going forward. With respect to IFRS 9 implementation, management expects about 15.0% increase in provisions as at January 1st 2018 when the standard comes into force.

The group's core capital ratio (Core capital/TRWA) declined 50 bps y-o-y to 15.8% whereas Total capital/TRWA declined 130 bps y-o-y to 22.7%. Both ratios remain above the statutory minimum of 10.5% and 14.5% respectively. Liquidity ratio declined 290 bps y-o-y to 34.7% (above the statutory minimum of 20.0%).

Alternative Channels: 94.0% of total transactions were through the group's alternative channels. MCo-op Cash– the group's mobile solution recorded a loan book size of KES 7.6 BN up 55.4% from FY16. The group also made strides towards re-establishing itself as a " Digital Bank" following an external diagnostic process conducted by IFC. Management expects to complete key recommended projects in the next 6 months.

The group's South Sudan's subsidiary recorded a marginal loss of KES 0.006 MN in 1H17 due to the difficult operating environment characterized by hyperinflation**.** The group is currently operating 4 branches in Juba-the capital of South Sudan and 5 non-oil collection centers. Co-op bank South Sudan is a unique joint venture between the group (51.0%) and the government of South Sudan (49.0%).

Moody's Rating: Moody's Investors Service assigned a first-time B1/ Not Prime global local-currency deposit ratings fully aligned with the B1 (Stable) rating of the Kenyan government. On the Kenyan national scale, Moody's also assigned deposit ratings of Aa2.ke/KE-1 to Co-operative Bank.

New Leasing Business with Supergroup: Co-op has received Central Bank of Kenya's approval to enter into a 25%-75% Joint Venture with Super-group. Supergroup provides world class fleet solutions to their global client base focusing on the containment of costs and operational risks associated with fleet ownership. It is listed on the Johannesburg Securities Exchange with a market capitalization of circa KES 100.4 BN. Co-op's upside from the partnership is two-fold; it will share profits recorded by the venture on a 50-50 basis and secondly, it will be able to expand its loan group by lending to the venture. The latter is the reason why its stake is capped at 25.0% consistent with Central Bank of Kenya's prudential guidelines.

Going forward: Co-op is keen on leveraging its relationship with IFC to become the dominant bank in the micro, small and medium market enterprises (MSME) segment. In this arrangement, IFC is providing advisory services as well as some of the funds that will be lent to MSMEs. It is also working to immediately operationalize its Joint Venture with Supergroup in order to take advantage of the growing leasing business occasioned by major infrastructure projects, government vehicle leasing program, growth in the exploration and mining activities as well as in other heavy-equipment dependent sectors such as Building and Construction.

Management guidance: Management expects profit before tax to hold flat y-o-y in FY17 on the back of a 12.0% y-o-y growth in both loans and deposits. From a return standpoint, they expect a Return on Average Equity and a Return on Average Assets of 20.0% and 3.5% respectively. With respect to topline performance, they expect a cost of funds of 4.0% and a Net Interest Margin of 9.0%. Cost of risk, NPL and Cost to Income ratios are targeted at 1.3%, 4.5% and 50.0% respectively.

On a trailing basis, Coop Bank Group is trading at a P/E ratio of 7.8x, relative to an industry median of 7.65x, a P/B of 1.3x, relative to an industry median of 1.31x, an ROE of 20.7%, relative to an industry median of 17.00% and an ROA of 3.5%, relative to an industry median of 2.47%. We issue a **HOLD** recommendation.

PROFIT AND LOSS SUMMARY (KES MN)

Year End: December	1H17	1H16	y-y% ch	2Q17	1Q17	2Q16	y-y% ch	q-q% ch
Interest income	19,258	21,472	(10.3)	9,740	9,518	10,806	(9.9)	2.3
Interest expense	5,840	7,009	(16.7)	3,008	2,831	3,136	(4.1)	6.3
Net interest income	13,418	14,463	(7.2)	6,732	6,686	7,670	(12.2)	0.7
Other operating income	600	918	(34.7)	343	257	380	(9.8)	33.2
Fees and commission income	5,263	4,962	6.1	2,692	2,571	2,535	6.2	4.7
Net income from forex dealings	1,244	969	28.3	683	560	471	45.0	22.0
Total non-interest income	7,106	6,849	3.7	3,718	3,389	3,386	9.8	9.7
Total income	20,524	21,312	(3.7)	10,449	10,075	11,056	(5.5)	3.7
Less operating expenses	9,838	9,654	1.9	5,012	4,826	5,043	(0.6)	3.8
Operating profit	10,686	11,658	(8.3)	5,438	5,249	6,013	(9.6)	3.6
Bad debt charge	(1,509)	(1,310)	15.2	(759)	(750)	(685)	10.8	1.2
Exceptional items	92	97	(5.3)	81	12	178	(54.6)	599.0
Profit before income tax	9,269	10,446	(11.3)	4,759	4,510	5,506	(13.6)	5.5
Less tax	(2,632)	(3,036)	(13.3)	(1,350)	(1,282)	(1,531)	(11.8)	5.3
Profit after tax	6,637	7,410	(10.4)	3,410	3,228	3,975	(14.2)	5.6
Attributable Income	6,637	7,410	(10.4)	3,410	3,228	3,975	(14.2)	5.6
EPS (KES)	1.13	1.52	(25.7)	0.47	0.66	1	(42.5)	(28.8)

(Source: Company, DBIB Research)

BALANCE SHEET SUMMARY (KES MN)

Year End: December	1H17	1Q17	1H16	y/y % ch	q-q% ch
Total shareholder's equity	64,478	63,827	57,937	11.3	1.0
Minority interest	(197)	(216)	(374)	(47.5)	(8.8)
Total Equity	64,281	63,612	57,563	11.7	1.1
Deposits due to other banks	1,408	1,770	1,315	7.0	(20.5)
Customer deposits	285,753	279,847	278,252	2.7	2.1
Borrowed funds	24,341	24,277	14,789	64.6	0.3
Other liabilities	7,543	8,957	11,090	(32.0)	(15.8)
Total equity and liabilities	383,326	378,462	363,009	5.6	1.3
Central bank balances	21,795	30,721	30,571	(28.7)	(29.1)
Deposits due from banks	11,286	13,163	4,534	148.9	(14.3)
Investment securities	74,200	60,538	81,318	(8.8)	22.6
Held for dealing securities	0	3,831	0	0.0	0.0
Customer loans and advances	252,613	245,858	221,289	14.2	2.7
Other assets	13,961	14,805	16,226	(14.0)	(5.7)
Intangible assets	1,167	1,278	1,291	(9.6)	(8.7)
Fixed assets	8,305	8,268	7,779	6.8	0.4
Total assets	383,326	378,462	363,009	5.6	1.3

(Source: Company, DBIB Research)

INVESTMENT RETURN

	1H17*	1H16*	1Q17*	y-y bps ch	q-q bps ch
ROA (%)	3.5	4.1	3.4	(62)	5
ROIC (%)	3.5	4.2	3.5	(68)	3
ROE (%)	20.7	25.7	20.3	(509)	35

(Source: Company, DBIB Research)
**Annualized*

CAPITAL ADEQUACY, LIQUIDITY & ASSET QUALITY

	1H17	1H16	1Q17	y-y bps ch	q-q bps ch
Core capital/TRWA (%)	15.8	16.3	15.1	(50)	70
Min. Statutory Ratio (%)	10.5	10.5	10.5	-	-
Total capital/TRWA (%)	22.7	24.0	22.8	(130)	(10)
Min. Statutory Ratio (%)	14.5	14.5	14.5	-	-
Liquidity Ratio (%)	34.7	37.6	41.0	(290)	(630)
Min. Statutory Ratio (%)	20.0	20.0	20.0	-	-

NPL Ratio (%)**	4.6	4.4	4.4	19	25
NPL Coverage Ratio (%)**	39.9	41.8	34.3	(190)	565
Long Term Debt to Total Liabilities and Equity (%)	6.3	4.1	6.4	228	(6)
NTA/share (KES)	12.9	11.6	12.8	136	16
Book value/share (KES)	13.2	11.8	13.1	134	13

(Source: Company, DBIB Research)
***Total Loan Portfolio net of Interbank Lending*

OPERATING PERFORMANCE

	1H17	1H16	1Q17	y-y bps ch	q-q bps ch
Yield on interest earning assets (%)*	11.4	14.0	14.7	(259)	(330)
Cost of funds (%)*	3.7	4.6	5.4	(83)	(164)
Net Interest Margin (%)*	7.6	9.4	9.3	(176)	(166)
Loan-to-Deposits ratio (%)	88.4	79.5	81.7	887	674
Loan-to-Dep.& Borrowed Funds ratio (%)	81.1	75.2	74.4	592	670
Funded Income Generating Potential (%)	88.2	84.6	82.8	359	540
Funded Income Reliance (%)	65.4	67.9	66.2	(248)	(85)
Cost to income ratio (%)	47.9	45.3	45.0	264	298
Pre-tax margin (%)	45.2	49.0	48.2	(385)	(300)
PAT margin (%)	32.3	34.8	33.5	(243)	(115)

(Source: Company, DBIB Research)
** Annualized*

APPENDIX

COMPANY INVESTMENT RATINGS

Buy: Share price may generate more than 15.0% upside over the next 12 months

Overweight: Share price may generate between 5.0% and 15.0% upside over the next 12 months

Hold: Share price may fall within the range of <+5.0/ -10.0% over the next 12 months

Take Profit: Target price has been attained. Look to accumulate at lower levels. Company fundamentals however remain strong

Underweight: Share price may generate between 10.0% and 15.0% downside over the next 12 months

Sell: Share price may generate more than 15.0% downside over the next 12 months, significant business and/ or financial risks present, industry concerns

Not Rated: Counter is not within regular research coverage

SECTOR INVESTMENT RATINGS

Overweight： Industry performance better than that of the whole market

Equal weight： Industry performance about the same as that of the whole market

Underweight： Industry performance worse than that of the whole market

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