Conference Call transcript

15 November 2018

Q3 2018 RESULTS

Operator
Good day ladies and gentlemen and welcome to the Co-operative Bank of Kenya Ltd Q3 2018 financial results. All participants are currently in listen-only mode. There will be an opportunity to ask questions later during the conference. If you should need assistance during the call please signal an operator by pressing star and then zero. Please note that this call is being recorded. I would now like to turn the conference over to James Kaburu. Please go ahead, sir.

James Kaburu
Good morning, good afternoon, good evening ladies and gentlemen. Welcome to the Co-operative Bank of Kenya conference call to discuss the financial results for Q3 with the management. With me is Mr Patrick Nyaga, our Chief Finance Officer. I have Mr Robert Aloo, the bank Treasurer. I have Mr [unclear] Mwangi, Senior Manager Credit Management Division. I also have Anthony Muli, the bank Economist. I'm James Kaburu, Head of Investor Relations and Strategy. To start us off I will hand over to Anthony Muli to take us through the macroeconomic environment. Over to you, Muli.

Anthony Muli
Good day everyone. Thank you for joining us on this call. I will probably just take you through slides one to six. And what we have noticed is that economic activity has started to pick up especially looking at the official numbers for Q1 and Q2 from the Statistical Bureau. We have seen that GDP is now at 6.3% real GDP growth. That compares to about 4.7% in the similar period last year. I think to notice for us is that the pick-up has been broad based in the sense that agriculture has now picked up, which is good news for export flows. We have seen some god numbers for tea, coffee and horticultural flows which now translates to some strengthening in the Kenyan Shilling in the last few months.

We have also seen good flows from tourism and also some good numbers especially on the incoming tourists. The other thing that has also contributed to these good numbers is that the services industry has picked up, especially [unclear] and also on the government front. We haven't had any shocks especially around oil and food in terms of drought, and that has left our inflation numbers between 4.4% and 7% in the last nine months. Also interesting to note is that October closed at 5.5% which is within the CBK target range of 2.5% to 7.5%.

Looking at the Shilling it remained muted most of the nine months. However in the last one week we have seen a bit of volatility and depreciation. I think today might close around KSh 103 to the Dollar. Most of the volatility has been shed away by good export flows especially from agriculture and we have also seen a very muted import bill especially now that most of the industrial sector has not really picked up. And remittance flows have also been quite positive.

On the interest rate front on slide six we have seen a fairly stable money market in most of the three quarters up to September. Most of this has been attributed to huge liquidity within the banking sector. And closing the year we still see the same trend continuing especially up to December because most of the banking sector has not picked up on private sector credit lending. And what we have seen in that the official numbers are showing that up to August 2018 private sector credit has now picked up to around 4.3% year on year growth from a low of 0.6% in the similar period August 2017. At this juncture I will hand over to the CFO, Patrick Nyaga.

Patrick Nyaga
Thank you Anthony. Good day ladies and gentlemen. Thank you again for joining us on this call. I am going through the next couple of slides. I will focus on some and skip others, and then I will be more focussed on the financial analysis. Slide number seven in case you don't know Co-operative Bank's structure is there for you to go through. Slide number eight is just showing what kind of products the bank is dealing with. And I will also not take too much time there. Slide number nine is showing all our channels and the number of customers that we have on each channel. The numbers have been growing.

Slide number ten is showing the continued transformation journey that we undertook in 2014 with eight key pillars. And I can confirm that we have continued to implement most of this and are reaping benefits as we go along. Slide number 11 is just to show that the transformation focussed on customer experience or customer excellence has been good with a customer score of 95.2. We have also shown a pie chart there to give details on how our MCo-op Cash transaction does especially on transaction types, the biggest chunk being mobile money, followed by balance enquiry, airtime top-up, fund transfer, cash withdrawal quite minimal and loan-related transactions about 8%.

Slide number 12 we are showing the number of transactions on each of our channels. Just to note that other than two channels that are declining in transaction volumes all the other channels have grown very significantly. The two channels which are declining are branch banking – which is expected as we continue to migrate our customers to other alternative, more convenient channels – and ATM which is expected because they are better and more convenient channels for customers, mainly MCo-op Cash, internet banking and agency banking. Again as you can see in the graph growing very significantly.

On slide number 13 we have put there the number of customers that are accessing our MCo-op cash loan products, about 1.3 million customers. Cumulatively as at today we have lent about KSh 17.8 billion through the mobile. And in terms of migration of our customers currently now we are at about 11% in branch transactions and about 89% on alternative channels. So again continuing to grow our alternative channels that are cheaper and more convenient.

Slide number 14, remember our SME transformation. Well, we are trying to make sure we sell as much as we can to the micro and small/medium enterprises by defining the products and services, looking at the credit risk management, sales and customer management and frontline capacity building. That is done. We now are rolling out that into all our branches, and as you will see now our SME loan book has grown.

Slide number 16 is focusing on our digital bank transformation. A lot of implementation especially on omni-channel which is expected to have significant benefit for us in 2019. Business sources management with several modules, that [unclear] implementation. In terms of NPL management that is very key especially in the current macroeconomic environment. A bit of deterioration of the loan book compared to the same period last year, but again because of the transformation work we have done we have it would probably have been worse.

Cost management, our costs edged up slightly as at Q3 compared to last year mainly because as we digitise the bank we needed a number of skills so that we were able to implement the software. And that increased our cost of staff slightly. We have also been paying a bit of annual maintenance contract on the systems that we are implementing. So that has made our costs edge up a bit. But most of the benefit is starting to be realised in Q4 and into 2019. Data analytics is a journey completed now and a lot of benefit is being reaped from the perspective of ability to have self-serving tools for reporting. We are also looking at staff optimisation and staff productivity on slide number 20, also doing very well.

On slide number 21 we are showing a comparison between 2017 and 2018 in terms of our funding from development partners. We signed a $150 million this year. We have drawn $75 million which we continue to invest in various assets. Slide number 22 and 23 I will skip. Slide number 24 is just to confirm that now the Co-op Bank Fleet Africa Leasing Limited is now fully incorporated and already we have done one deal worth about KSh 1 billion so far. So that has already picked up and we will be seeing its contribution to the numbers into 2019.

South Sudan, slide number 25, last year we made a loss of KSh 39.15 million in Shillings terms. That business has contributed about KSh 235 million in Q3 profitability. So again the business is doing well. And with the ongoing peace agreements we expect the business to grow even faster.

Looking at the finances now, in terms of our balance sheet our total assets grew by 4.1% from about KSh 388 billion to KSh 404 billion. The loan book in growth terms grew if you compare this with last year Q3 but from a net stance we dropped about 2%. This is because we increased our NPLs from about KSh 15.2 billion to about KSh 28 billion. This was the same situation as at Q2. For those we were conversing with in Q2 that hasn't changed much in to Q3. Government securities have increased by 22.3% mainly because excess cash that is not being lent is being invested in government securities. Total deposits grew by 2.6%. Again borrowed funds dropped because we continued paying throughout the year but the $75 million was drawn in October. So probably by the time we close the year the borrowed funds will show a growth. Shareholders' funds out of the profitability that we had grew by 5.3% from KSh 67.3 billion to KSh 70.9 billion.

Slide number 28 is just showing the compounded annual growth of the balance sheet. Total assets have grown by about 8%, the loan book by 9%, 8% in terms of deposits and 11% for shareholders' funds. So generally there has been growth over the last five years of our balance sheet into those percentages. Looking at the loan distribution on slide number 29 there has not been any significant change in terms of the loan book composition. Personal banking continued being our biggest source of loans at about 33.4%, corporate about 24.6%, mortgage 17.3%, SME 9.2% and SACCO banking 8.1%. So basically there has not been any significant change in the distribution of the loan book.

Looking at the distribution per sector now from a [unclear] perspective personal and consumer banking we are looking at about KSh 98 billion. The next biggest loan is trade, about KSh 40.9 billion. Trade is mainly the SMEs and the normal traders for import/export. Energy and water about KSh 18.1 billion. Real estate about KSh 40.2 billion. And the others are there. So basically we have a well distributed book but personal and consumer, which is mainly check offs both from government, parastatals and private sector to some extent, is about KSh 98 billion.

Looking at our liability portfolio the KSh 6.8 billion growth in deposits mainly came from SME, retail and SACCO. The three grew their book, and also corporates to some extent, but not significantly. Institutional banking and government banking declined slightly because of some of the policies that are in place now. Looking at slide number 32 our balance sheet continues to be dominated by local currency at about 18% in terms of loan book and about 88% in terms of funding. No significant change happened. Looking at the portfolio trends on slide 33 I just mentioned that if you look at our NPL book from last year Q3 the NPL was about KSh 15.2 billion. Into Q2 this year and Q3 our NPL is about KSh 28 billion in Q2 and about KSh 29 billion in Q3.

Let's look at NPL by sector book. Here we are saying for example of the total book that is in agriculture 17% is in NPL, in manufacturing 46%, building and construction about 16%, trade 20%, financial services – SACCOs are included there – about 13%, real estate about 10%, tourism, restaurants and hotels about 13%. But again you need to look at this in relation to the size of the book because this is just a percentage of the book itself. But when you look at for example manufacturing although the percentage here is 46% the total manufacturing book is about KSh 8 billion so it is not the most significant of our book. In terms of sector NPL by total NPL trade leads the pack there with about 29%. Personal consumer about 20%. Manufacturing about 14%. Financial services about 12%. Real estate about 14%. So you can tell from that slide where the sources of our NPL are.

Loan loss provision Q3 2017 to Q3 2018 we significantly increased our provisions year on year compared to last year. we did KSh 4.4 billion through reserves out of IFRS 9 and we did another almost KSh 3.6 billion through the P&L, part of it last year, part of it this year. Capital adequacy, we are adequately capitalised other than for total capital which we have a small buffer of about 1.9%. But again this is using our profit at 50% as per the requirements of CBK. So once you use the full 100% at the year-end then the buffer would be much higher.

In terms of profitability our profit before tax was KSh 14.5 billion compared to KSh 13.6 billion, a 7% growth. Our net interest income grew by 4.7% from KSh 20.8 billion to KSh 21.7 billion. We grew interest income. Interest expenses remained flat. That is why we were able to grow our interest income. In terms of other operating income fees and commissions grew very slightly, and this is mainly because although we significantly grew other lines of income commission on loans and advances had a significant drop comparing this year and last year. So we were able to replace commission on loans and advances with other commissions to make sure that we have grown by about 0.6%. FX income grew by 13.6%. Other income grew by 24.1%. This is mainly recoveries on previously written off debt.

So our total operating income grew by 4.6% to KSh 32.3 billion. Loan loss provision based on the fact that we did KSh 4.4 billion through the reserve our provisions have gone down by about 50%. When you factor in the costs which I have mentioned in terms of employing quite a bit of skills at the moment to help our digital journey, which then we will reap the benefits in 2019, and also a few operating expenses supporting some of those expansions. Our profit before tax then is KSh 14.45 billion. If you include the share of profit from associates, which is mainly CIC, which grew by about 33.2%, therefore our profit before tax was KSh 14.6 billion compared to KSh 13.7 billion, a 7% growth.

Slide number 39 is self-explanatory. Slide number 40 is looking at how the returns on assets have been especially post interest rate cap. We have seen immediately after the interest rate cap it dropped our interest income by 7%, 4% in full year 2017. In Q1 2018 we grew that by 9%. But as the CBK continued to come down then the return on loans and advances and other assets went down slightly. Yield on earning assets we are now standing at about 8%. Net interest margins we are at about 8.5% and unlikely to go lower unless there is a significant drop of CBK because we now have no floor on the deposits, so we have reduced our risk effective October. So we expect some gains on interest costs, so we will probably maintain the NIM. In terms of slide number 41 as I have mentioned if you look at our M-wallet or the MCo-op Cash it grew by 51%. [Break in audio].

Operator
Ladies and gentlemen, please do remain online while we wait for the main venue to reconnect. Ladies and gentlemen, please do remain on line. Thank you, sir. You may continue.

Patrick Nyaga

Sorry for that. I think we got disconnected. I can continue. I was saying our various lines of commissions are doing very well. Jumbo Link, 7%. Inward EFT, 2%. Agency banking commissions, 25%. Internet banking, 9%. As you notice from the graph there the negotiation fees and appraisal fees which are loan related dropped significantly. However we were able to grow our total commission income by about 1%. Treasury continues to support the business commissions by about 27% compared to about 25% of commissions that we registered in Q3 2017.

If I go to slide number 43 just looking in terms of our asset categories we have seen a drop in the share of loans from 67% to 63%, and that has been replaced by government securities from 18% to 21%. In terms of funding categories no significant change from the various sources of funding. In terms of liquidity we are seeing quite a bit of liquidity in Q3 compared to the same period last year. And in terms of loans to deposit ratio we are sitting at about 78.6%, down from 82.2% full year last year.

In terms of slide number 45 we are looking at agency banking. And from the slide you can see that agency banking channel is mainly for depositing and very minimal withdrawals. So that helps us grow our business in terms of deposits. Company performance, we are looking at what various subsidiaries contributed. Co-op Consultancy and Insurance Agency did about KSh 376 million, a 6% growth. Co-op Trust Investments Ltd did KSh 38.2 million, about 27% growth. Kingdom Securities given the current macroeconomic environment and the market the way it is registered a loss of about KSh 14.6 million. Co-op Bank South Sudan a significant growth of about 500% to KSh 235 million. And then share of profit from CIC KSh 131 million compared to KSh 99 million last year. So in total KSh 14.6 billion compared to KSh 13.7 billion.

In terms of page 47 we are seeing the number of ratios there. I think we have mentioned them at some point in time as we presented the other areas. If I now go to the outlook we expect to close the year with a profit growth of about 10% given that Q4 last year was not very good, so we should be able to continue with the same momentum this year. Loans and advances, I know the schedule you have says 5% but we have revised that to 0%, and the reason being sometime in October we got one of our customers pay off a debt of about KSh 8 billion. So by the time we give loans [unclear] about KSh 23 billion so that will have a net of KSh 8 billion to close the gap I think the year will have been over. So we expect to grow into 2019. The other projections there are spot on.

Deposit growth, we have seen a bit of that into Q4 already. Cost to income ratio, we are still projecting about 50%. And the various other ratios are there including the return on average equity at 22%. We expect to close with a profit before tax growth of about 10% so that will slightly increase our return on average compared to where it is today. So basically that is where we are as Co-operative Bank. A relatively difficult year, but still being able to grow our PBT by about 7%. So thank you very much. I think we can take a number of questions and then we will answer them. Thank you.

Operator
Thank you sir. Ladies and gentlemen, if anyone would like to ask a question please press star and then one on your touchtone phone. If you however wish to withdraw your question please press star and then two to remove yourself from the question queue. If anyone would like to ask a question please press star and then one. Our first question is from Kevin Harding of Investec.

Kevin Harding
Hi everybody. Thank you for the presentation. I've got a couple of questions. Number one is on the transformation strategy. Since March 2017 we've seen negative jaws, so costs growing ahead of revenues, and you speak to this performance turning around in the fourth quarter and in 2019. And I just want to get a sense of where this earnings growth is coming from. Is it because you are going to

slow down the cost growth, or is this translating into actually a significant revenue growth? The 4% that you posted versus 2016 isn't as strong as I would have thought. Just a sense around that. Then just on loan growth, interest rate cap remains in play. Seemingly it is not going to come off any time soon and you're projecting loans and advances growth of 0% for 2018. You've had negative loan growth. So what happens next year? Where do you find that loan growth? And then on net interest margins the interest yield rate curve has been coming down. You have been seeing interbank lending rates coming down. So how are you positioning your portfolio given your investment in government securities to try and abate that declining yield curve? And then lastly on deposits I've seen growth year on year slowing down 2% and actually declined about 30 bps in the quarter. I just want to get a sense of what is driving this. Thank you.

Patrick Nyaga
Thank you, Kevin, for your four questions. Let me start them not necessarily the way you asked them. I will start probably with the question on NII. I think I can probably answer that with the growth on loans. What we've done post Q3 is we have looked at the various sectors that are growing in the economy and we have seen quite a number of areas where we can cherry pick good loans. We may not go back in 2019 to the growth of 20% but given some of the areas we have seen in terms of trade, the traditional personal lending, and probably even when you go to manufacturing looking at not the cement manufacturers and stuff like that but probably some of the other smaller manufacturers that are doing well in the country, and also given the four agendas the government is pursuing, we should be able to grow loans probably by 5% to 10%, not maybe to the 15% level.

And then that also aligns to some extent to whatever deposits we collect and we cannot lend them we will continue pushing that into government securities and also looking at maybe the right tenures and where the yield in these government securities is higher. Also to say that one of the things we have done on the loan growth is despite the fact that we may not grow the loans themselves significantly there are some loans that are more income-generating than others. For example in corporate you will probably not get appraisal fees and negotiation fees and such. But if you lend personal loans, SME business loans, you are able to get that. So over and above the interest you are then able to get additional revenue. So we are focussing more on those loans where you can get additional revenues.

In terms of the transformation journey, yes, we have seen our costs edge up. Specifically these are mainly costs relating to implementation of systems this year. A number of those systems required very specialist skills. So we have seen ourselves employ quite a number of people to pus that digitisation even as we contracted FinTechs to do that. Therefore that created a cost growth. But the way we look at it is that cost is now, but some of the things that we are doing with that digitisation, for example account opening, automating some processes, we definitely expect a value in them in terms of the customer service, the ability to sell using those platforms. And therefore that's why I'm saying into 2019 we expect a revenue uplift out of some of those areas. And also at the same time we will not be investing in these systems throughout, so there will also be a decelerated growth in costs. So both cost management element and also benefit coming from some of the investments we have done this year we expect to then create a growth in PBT.

So in terms of deposits, yes, we have only grown our deposits by about KSh 6.8 billion this year. But there is still headroom or there is still opportunity in that area. For example we have been doing a lot of collections accounts and then some of this money we put elsewhere. So we have a strategy to invest in a bit of executive banking so that we can then have people collecting. Especially private companies. If they collect these funds then rather than transfer them for purposes of using to other banks then they are able to get good service from us and use it there. We have revamped our cash management solutions because that is one very good source of both deposits and commissions. Agency banking, we have continued to really grow our agency banking platform and we expect that as we continue growing the agency platform then as you saw in our slides we are attracting deposits through the agency banking.

The other thing that we've seen in the market that will help us a bit in the cost of funding is the removal of the floor on savings deposits and such kind of accounts. And that will also give us some leverage. So in a nutshell we will continue growing deposits. Once we get the deposits we have already mapped some of the areas that we should grow our loans into. Whatever we can't grow in loans – and those loans that we are going to grow are specifically those ones that have other revenues – we are putting in the government securities. That is how we have mapped the four areas you asked about. Thank you.

Kevin Harding
Thank you.

Operator
Ladies and gentlemen, if anyone else would like to ask a question please press star and then one. We will pause a moment to see if we have any further questions. We do have a question from Ola Ogunsanya of Rencap.

Ola Ogunsanya
Hi. Good afternoon. Thank you for the presentation and taking my questions. My first question is really on your views on the overall interest rate environment especially going into next year. If you could also please just share your views on the currency as well, the way you see that going in the short term. And I guess it would be good to get… I know you have spoken about this quite a bit in the past on the NPL book, but if you could please just explain why the rate of resolution hasn't been as sharp as expected. Rather we are actually seeing a bit of pressure still on that book. Those are all my questions for now. Thank you.

Patrick Nyaga
Thank you very much. I think our economist will help us a bit on the interest rate projections.

Anthony Muli
Thanks, Ola, for your question. The issue of where we see the interest rate environment in 2019, our view is that looking at the short end – short end means government paper between three months to 364 – we don't see much change there. However what we also note is that with the rate cap we are still lending at CBR plus 4%. So we still don't see any change in that law in the next couple of months. So lending rate for us will still be around the CBR plus 4%. The other thing is that government has tried to take advantage of the higher liquidity in the market and so it has kept the bond yield quite low. So that is our view.

Robert Aloo
Ola, this is Robert from treasury. I will just add on to the point on where the currency might move in the next six to 12 months. I think the Kenyan economy definitely will be affected by externality. I think one key one is crude oil prices. If those spike then there is a risk of our Shilling depreciating slightly. Maybe the outlook I would say is we have seen a slight depreciation, so I think a high of KSh 105 in the medium term may be where we would look at it. Currently we are seeing it coming under pressure. But it is generally going to be affected by externalities, either portfolio flows or money going out into the US or other economies where yields are slightly better as our yields decline. And also if we are now having a high import bill, especially if crude misbehaves, that is not likely maybe in the short term but in the

longer term we could see crude actually going higher. So that would be my view on the currency. Thank you.

Patrick Nyaga
Ola, in terms of NPL a very good question. I know we have discussed this quite a bit. I think our view is that if you look at specifically costs from Q3 last year to Q3 this year, and also Q2 this year, we saw our NPL shoot from about 7% to about 11%. And this was also in line with IFRS 9 discussions and computations. And it was also a good opportunity to clean up the book. Now, we probably are seeing the worst of the growth in NPLs. That is our view. However, whatever is in NPL right now to get it back to the 7% is not going to be very fast. This is because of a few factors. For example, if you look at county governments and national government on average owe about KSh 200 billion. Even if for example Co-op doesn't have exposure to government suppliers directly, government suppliers are also being supplied by other people who we could be banking. Therefore there is a bit of a slowdown there. Unless a bit of that money is paid we will see a bit of a drag on some of those customers being unable to pay. We have also seen one or two private sector companies, especially the smaller individuals, having a struggle especially given that last year the year was quite bad as we went through the elections. But by the time some of those customers completely recover it could be a year and a half or two. So a bit of that is also holding on the NPL. We have seen a number of businesses collapse in Kenya like Nakumatt supermarkets. Uchumi is there but not doing very well. So some of those customers are affected. And therefore by the time they regain their business and start trading properly again they put a bit of pressure on the NPL. We have seen a bit of retrenchments in the private sector, in parastatals. So a number of those factors. And not to say the interest rate cap where lending to the real estate completely dried up at some point. We have just seen now the private sector credit is starting to pick up at about 4.3%. So one of the positive things is that as the private sector credit picks up some of these areas like the real estate we should be able to bounce back and customers should be able to buy properties for those who have developed properties and they are not being bought. So you can see a number of factors. But from where we sit we don't think the NPL book will increase significantly from there. It is only that we will continue managing what we have, both as an industry and as a bank, and push that down. Our projection is probably to move from about 11% to about 9% by the year end. And this is driven by the fact that a number of customers already passed the quarter showing good signs. Thank you.

Operator
Ladies and gentlemen, just one final reminder, if you would like to ask a q question please press star and then one. We will pause a moment to see if we have any further questions. It seems we have no further questions on the lines, sir. Would you like to make any closing comments?

Patrick Nyaga
I would want to take this opportunity to thank you for your participation in the conference call. We are still available for any answers through emails, through conference calls. So we can still continue discussing these numbers. But again thank you so very much and have a good evening. Thank you.

Operator
Thank you, sir. Ladies and gentlemen, that concludes this conference. Thank you for joining us. You may now disconnect your lines.

END OF TRANSCRIPT