Conference Call transcript

25 March 2019

2018 RESULTS

Operator
Good day ladies and gentlemen and welcome to the Co-operative Bank of Kenya's 2018 final results discussion. All participants are currently in listen-only mode. There will be an opportunity to ask questions at the end of today's presentation. If you should need assistance during the conference please signal an operator by pressing star and then zero. Please note that this conference is being recorded. I would now like to hand the conference over to Anthony Muli. Please go ahead, sir.

Anthony Muli
Good day ladies and gentlemen. Welcome to this conference call for the Co-operative Bank of Kenya. I'm sure you have had time to go through our financial results for the year ended 2018 which were released last week on Thursday. So what we are going to do is I will go through the highlights of the operating environment in terms of the macroeconomic environment. Then I will hand over to Mr Patrick Nyaga who will give you the highlights of the financial statement, and then after that we will kick off with the questions and the answer. So before we go into that I would like to introduce my colleagues. First is Mr Patrick Nyaga, our CFO. Second at the table is James Kaburu, our Chief Manager Investor Relations and Strategy. We are also privileged to have our group Treasurer, who is Robert Aloo, and [unclear] who is the Head of our Credit Analysis Unit. Welcome to this conference call.

So just to kick you off, what we have noted is that 2018 was a good year in terms of the weather pattern. I think we also had a stable political environment. The other thing is that we saw the private sector credit slow down a bit. Otherwise tourism was up. And what we are looking at in 2019 is that we predict fairly similar growth in terms of overall GDP. However what we have seen in the last one week or so is the onset of the long rains has delayed, and so we are hoping that that won't impact on the food security situation and also in terms of our export earnings.

Looking at the interest rate environment we have noticed that it is now almost a year since the MPC started the rate cuts. And so far we haven't seen much uptake in terms of private sector credit from that, and so even as they meet this week on Wednesday we still don't see much reason for them to continue the cuts in CBR. Furthermore, we are looking at inflation looking up especially from the food situation given what we've seen on the weather pattern as from May. So obviously that forms the guess [?] for CBR being maintained at the current level. The other thing is that we've seen a marginal inward shift of the government securities yield curve. Obviously the government has been very keen to manage the cost of debt, so they have tried to press down their domestic borrowing cost.

The other thing is that the interbank rate has remained fairly stable other than the uptick we saw in mid-December last year. And obviously this was a result of payments of [unclear], probably companies maintaining good liquidity at the year end and also early closure around Christmas period. Otherwise currently the interbank is quite stable at around 2.2% with a high of 4.0%. Inflation I think our only worry is on the onset of the long rains which is also likely to [unclear] in terms of export earnings. We have seen a fairly good year in 2018. Tea exports were up about 6.5%, horticulture about 18% up, and also coffee. So that kept the currency quite stable and also it was in a period where the import bill remains fairly muted.

In terms of the private sector credit growth we've seen low numbers still, sort of within the low single-digit. What we have seen is that December closed at about 2.4% private sector credit growth. And what we are looking at is clearly the same trend might continue into the better half of this year. In South Sudan we've seen a peace accord now being respected, and that has given us some benefits. Oil production now is up about 20% daily. Inflation is now quite manageable at around 40%. Remember that this was above 300% at some point. So this is fairly good news in the sense that the country is able now to distribute food and other resources fairly well. However as we move into 2019 I think our only hope is that this peace accord will last. And the other thing is that budget allocation by the government will be to the priority sectors. I will stop there for now and Mr Patrick Nyaga will give you the highlights of the financial performance. Thank you.

Patrick Nyaga
Thank you very much, Anthony. Good day ladies and gentlemen. I will continue with where Anthony has left. We have given you quite a huge booklet with slides containing various information. I will start on slide number 11 where I'm looking at our strategic focus mainly driven by the five pillars. And in terms of shareholder value we want to continue optimising our returns to the shareholders, ensure that we have a sustainable business and grow market share. In terms of customers we want to continue being very customer-centric and ensuring customers are happy with our services and products, and also continuing making sure that we digitise most of the customers' journeys for efficiency and also for customer convenience.

We want to continue being the employer of choice, improve staff productivity significantly, and through staff development by training and various other aspects of staff development. In terms of our enterprise we want to increase operational efficiencies and manage our risk proactively. As you all know we have been having quite a bit of a year in 2018 in terms of AML and CTS counter-terrorism financing. And we want to continue optimising our digital strategy. We want to continue being a responsible citizen and therefore sustain economic, social and environmental impact.

I will skip a couple of slides so that I go to the more specific information. I will go to slide number 13 where we are look at our presence, currently now in Kenya and South Sudan, with our balance sheet size being about KSh 413 billion, 155 branches, over 4 million mobile cash customers, about 12,000 agents, 588 ATMs, 82,000 customers in Co-op Internet. We are supporting 464 SACCO front offices which are almost like branches. And currently we have about 14,596 diaspora banking customers. And all the numbers within the various channels continue to grow.

I will go to slide number 15 and just mention that as a bank we have continued driving our transformation agenda with the eight key pillars in different stages of implementation, some concluded and some still being pushed for market share growth and increased profitability. Key highlight is micro and small and medium enterprises where we have now given about 7,800 loans through the mobile. That is mainly on the business side. We have availed about KSh 15.2 billion for SME lending. We continue to drive our digital banking strategy and journey by implementing the omni-channel and also BPMS systems.

I will go to slide number 18. Anthony has highlighted a bit about South Sudan. I must say that with what is happening currently in South Sudan the business is really picking up. And if you look at that slide we are saying that we have four branches in Juba, five collection centres, own 31% of CAC Africa which is the South Sudan business of CAC, and we continue growing all parameters of our balance sheet and P&L. If you look at the last point there, in 2018 we reduced our loss in South Sudan from KSh 605 million in 2017 to only KSh 31 million.

And we are projecting in 2019 it will contribute significantly to the P&L. Now, the KSh 30.8 million is impacting the numbers with inflationary adjustments. Otherwise the business had made quite a bit of profit in FX income.

If I go to slide number 20 I am looking at the various channels. We have continued to grow our channels significantly. Looking at the channels that have grown, mainly agency banking, mobile cash and internet banking. And as we would expect branch banking has continued to reduce given that we continue driving our transaction volumes through the channels which is cheaper and more convenient. So 92% of our transactions are now on alternative channels. We have continued to give loans through the mobile. We now have about 1.4 million loans disbursed through the mobile platform, over KSh 20 billion disbursed so far. And we are looking at e-credit being a very key focus area in 2019.

On slide 21 is just a graphical representation of what I have said. And the various areas of growth mainly being the mobile platform at 69% growth, agency banking, 27% growth, internet banking, 19%, and the merchant banking about 138% growth. I will skip to slide number 22 just to show in terms of the mobile platform the various growths that we have seen in transaction numbers, in revenue and also in deposits through the mobile platform. So everything as you can see there is growing.

If we go to slide number 23 we look at agency banking. The number of agents has grown to over 12,000. Total revenue is over KSh 470 million. Total number of transactions has grown from 34 million to 44 million comparing 2017 to 2018. And deposits through agents are about KSh 309 million. I think the demonstration there is the fact that agency banking is a collection platform mainly. It is helping us grow collections quite a bit. ATMs, we have seen a bit of a decline in revenues there and also the number of transactions. What we continue to do is to increase the number of services that one can get from ATMs, being able to withdraw and better manage through our ATMs. And we expect that to increase the number of transactions.

Going to the next slide and looking at our financial position, our balance sheet grew to KSh 413 billion. Total deposits grew to KSh 306.7 billion. Our loan book declined from KSh 253.9 billion to KSh 249.4 billion. Towards the end of the year, November/December, we were paid off about KSh 10.5 billion, one significant portion of KSh 8 billion from one customer, the other KSh 2.5 billion from two or three customers. So we received cash which then we have reinvested in other areas of the business including government securities and we continued to give loans.

From a percentage perspective on the next slide the total assets grew by 7%, the loan book declined by 3%, government securities grew by 16% obviously as we look for more opportunities to grow our revenues. Total deposits grew by 6.5%, borrowed funds by 32.5% because we drew $75 million from IFC. I will move on to the next slide, slide number 28, just showing you the classification of our loan book. And in a nutshell not much significant change between the composition of our loan book in 2017 and in 2018. It was probably just mortgage that declined a bit. SME increased a bit as we can see the percentages.

I will go to slide number 30. Slide number 30 is showing the sources of funding our book in terms of liability portfolio. Again no significant change between 2017 and 2018. A bit of a decline in institutional banking, but nothing significant, and a bit of increase in retail banking. 36% of our deposits are in fixed and call. 64% of our deposits are now in savings, current accounts and transactional accounts where we don't pay much interest. And that has helped to reduce our cost of funding. We continue driving a balance in loan book foreign currency and local currency. It is very well balanced.

If I go to slide number 32 a bit of emphasis there. So we are looking at the quality of our loan book. If you remember in the last quarter in 2018, Q3, we mentioned that we had downgraded quite a bit of our book. So in terms of bad and doubtful debt that increased by 54% from KSh 18.7 billion to KSh 28.9 billion. But using IFRS we increased our provisions by 58% from KSh 10.2 billion to KSh 16.1 billion. So the figure above is just a breakdown of what is in normal, in watch, in substandard, in doubtful and in loss.

I will go to slide number 34, again just showing how our NPL book is by sector. And this is a percentage of what is in NPL out of that sector. So looking at manufacturing at 47%, meaning that there are one or two customers there out of the total book in manufacturing that are not doing very well. Other than that the number item is on trade. We are noticing there is for example in trade that declined significantly from 39% of the book to 23%. So some of the things we were saying earlier around customers that are turning around in trade, that has actually happened and we are seeing that decline quite a bit. The same with personal consumer which has dropped from 25% to 6%. If you look at sector NPL by the total NPL the biggest chunk of our NPL is in trade, but as we have said it is actually improving comparing 2017 to 2018. The next biggest chunk is on personal and consumer, which has also improved from 25% to 19%.

If you look at slide number 36 we are looking at coverage ratios. Our coverage ratios have improved quite significantly. Our cost of risk dropped from 1.5% to 0.7%. Obviously this is because IFRS allowed us to do quite a bit of provisioning through the reserves. Coverage IFRS increased by 10% from 38% to 48% and coverage by CBK increased by 2% from 54% to 56%. In terms of capital ratios despite the IFRS impact on the reserves and also our increased dividend we still have good buffers on both core capital to total risk-weighted assets, total risk capital to total risk-weighted assets and core capital to total deposits and liabilities. So we are able to continue growing our balance sheet given the buffer.

In terms of funding and asset mix no significant change in assets, only a bit of replacement between loans and advances and government securities where loans and advances as a percentage of the total assets declined to 63% from 66%, whereas government securities increased from 18% to 21%. In terms of funding categories it is relatively the same as it was in 2017. In terms of slide number 39 we are looking at the liquidity ratios, average 2018 was 41%. We were fairly liquid. We have now our loans to deposit ratio and loans to deposit ratio plus borrowed funds giving us a huge potential to grow because it was 74% and yet we can go up to about 85% to 90%.

In terms of the subsidiaries we are noting that we have seen in 2018 improved contribution from the subsidiaries. In 2017 subsidiaries lost us money, or rather they did not contribute to the group profitability because the bank had made KSh 16.3 billion, but in 2018 we saw our subsidiaries contribute at least 3% of PBT for the group mainly because South Sudan only returned a small loss after translation using IAS 29. So in a nutshell we think going forward in 2019 we will see much more contribution now coming from subsidiaries.

In terms of the P&L, profit and loss for the group, we made a profit before tax of KSh 18.2 billion compared to KSh 16.4 billion, and that is an 11% growth. Key areas of growth being on interest income, 9.5% growth, and therefore bringing our total operating income to a 5% growth from KSh 41.6 billion to KSh 43.6 billion. Our operating expenses and staff costs increased mainly because of two things. In terms of staff costs 2018 was a very significant implementation year for digital banking, so we needed to look for a few [unclear] out there and hire them so that they can drive our digital strategy, even as much as we collaborated with fintechs. And in terms of other operating expenses we had quite a bit of costs with software packages. So that is really what contributed to a bit of growth in our costs. We are on top of that in terms of getting the benefit of that investment into 2019.

In terms of return on equity and return on average assets we grew that. ROA grew by 3.2%. ROE grew to 18% from 17.4%. And comparing 2017 to 2018 we were able to grow our loan interest by 3% compared to a decline that we had recorded in 2017. Net interest margin from earning assets grew from 8.5% to 8.8%. Cost to income ratio increased by about 2%. I have explained it is mainly because of an increase in staff costs and also in other operating expenses. Treasury income continues to contribute to the bottom line of the bank. In 2018 there was a growth of 16% compared to a decline of 0.3% in 2017. Shareholders returns. We have continued to grow our returns to shareholders. The board has declared our Shilling dividends subject to approval by CMA and the AGM. And currently our pay-out ratio is now at 46% which has been on a growth trend all the way from 2014 at 31%.

So in terms of the outlook for 2019 I think Anthony has alluded that we expect almost a similar year compared to 2018, and therefore the projections are relatively the same, other than the fact that we will grow our loans and advances much better than we did. We do not anticipate any pay-offs by any customer, so we are projecting about a 29% growth. Deposits, last year we grew at 6.5%. We project about 13.9%. We will definitely have to reduce our cost to income ratio to about 50% from the 54.6%. And generally in terms of NIMs we expect them to remain relatively the same, whereas we expect the cost of risk to increase slightly now that there IFRS 9 in 2019. Any change in IFRS 9 provisions would be on the P&L. And at the same time as we continue growing our loans and advances we will have to make some provisions.

So I think that is what we have for you today. A good year for us looking at all the parameters, not looking at the fact that the year wasn't as good as we had expected. But still we were able to do a profit before tax of 11%. And we predict that 2019 is going to be relatively the same or even better, looking at some of the strategies that we have put in place. Thank you very much, and we can now have some questions. Thank you.

Operator
Thank you very much, gentlemen. Ladies and gentlemen, at this time if you would like to ask a question you are welcome to press star then one on your touchtone phone and that will place you in the question queue. If you however decide to withdraw the question you are welcome to press star then two on your touchtone phone to remove yourself from the question queue. Just a reminder, should you wish to ask a question you are welcome to press star and then one. The first question comes from Kevin Harding of Investec.

Kevin Harding
Hi gentlemen. Thanks so much for taking my questions, and congratulations on the results. Two questions from my side. If you could just explain what happened in the fourth quarter with fees and commissions on advances declining, and consequently a KSh 1.5 billion in interest income. Seemingly it looks like the auditors forced an IFRS 9 adjustment from an effective interest rate perspective. So could you just give us some colour there? And then just considering this Q4 adjustment how should we think about fees and commission on advances going forward from a growth perspective? And then if you could just touch on your loans and advances growth projection of about 11% for FY19. Where do you see that growth coming from? For FY2018 you had initially guided to about the same level, but subsequently cut those expectations as we went through the various quarterly reporting periods. So if you could just highlight where that growth is going to come from in 2019. Those are my questions. Thank you.

Patrick Nyaga
Thank you Kevin. Let me start with your first question. What happened to fees and commissions? Yes, I think some of this is impact of IFRS 9 adoption for 2018. There is a requirement by IFRS 9 to use expected interest rates. And therefore any revenues in terms of fees and commissions that are charged and received, as long as it

relates to a loan that is not maturing in that year then you are supposed to defer that income to the period of the loan. So out of the KSh 1.9 billion or so that we had earned in 2018 using the EIR [?] model then we were only able to earn about KSh 575 million. So the balance of about KSh 1.3 billion was deferred into the future. So what will be happening is we will be earning that as we go. So a bit of that portion would be already earned in 2019 and in the coming years.

In terms of interest income, again IFRS 9 does not recognise suspending of interest on stage three. And therefore again out of the discussions and the fact that you have to comply with IFRS 9, including a guidance that was given by the Institute of Certified Public Accountants of Kenya, there was an impact of about KSh 1.2 billion into the interest income. So basically that is why you are seeing that increase a bit on the interest income, but also a significant drop on the commission income. So they are almost offsetting each other.

In terms of loans and advances, yes, we are looking at the same traditional areas of growth. However, we have to look at cherry picking what is good. We still have perfects that are good to fund. But maybe for a bit more detail I will ask [unclear] to give us a bit of flavour in terms of where exactly we will be growing this loan book. Thank you.

Head of Credit Analysis
Thanks Kevin. Thank you so much. The year 2018 was a bit difficult for credit, especially in the beginning and even after Q3. But what we saw as the economy started to emerge out of the previous election period we saw some of the early sectors showing signs of growth. And starting from there you can see we had what I would call a technical growth. Because were we not paid the KSh 10.5 billion you would have seen some small technical growth. However, going to 2019 we are primarily looking at growing MSMEs. That is micro and small and medium enterprises. We have set aside a robust amount here, about KSh 15 billion. And we are working with the IOC specifically to bring these customers to speed in terms of managing their businesses. And therefore we expect growth there.

We have gone big on e-credit. I think last time when we talked we briefed that the bank had already finished piloting its e-credit offering and we had already started doing KSh 1 billion. Going into this year what we have seen is that this is going to give us tremendous opportunity, without going into figures. We also have the leasing [?] business fully set up and we expect from that arrangement to grow about seven [unclear]. So we are confident about growing this year.

Kevin Harding
Okay. Thank you so much. Thank you.

Operator
Ladies and gentlemen, just a reminder, should you wish to ask a question you are welcome to press star and then one. The next question comes from Toyosi Oni of Renaissance Capital.

Toyosi Oni
Hi and thank you for hosting the conference call. So my question is on your asset quality. Can we get an update on the resolution process on this, especially in the manufacturing and the trade segments?

Patrick Nyaga
Thank you. Yes, in terms of our asset quality as I have said we increased our… Comparing 2017 to 2018 our NPL book increased from about KSh 18 billion, which is about 7%, to about 11%. Now, if you look at manufacturing,

manufacturing is a very small sector of the total book, about 3% of the total book. If you go to the manufacturing itself and then look at the NPLs that's why I was saying it is about 47%. That is mainly because one of the customers there who was big in borrowing had a bit of issues and is downgrading. So in a nutshell it is not really a big problem for us given that manufacturing is only 3% of our total book. It is only when you look at that sector itself it is quite a bit of book.

In terms of trade it is about 15% of our book. Trade is 15% of our book. And again this is mainly all the small and medium enterprises. In a year where you have turbulence especially created by the elections that is the sector that suffers quite a bit. However, as you can see there has been significant improvement comparing 2017 to 2018 where the NPL was about 39% of the total book but now it is only 32% and improving. I think Kamangi [?] can also say one or two things around that.

Head of Credit Analysis
Thanks. I think once again just to say that specifically on trade, because I think the manufacturing is one step forward, we updated in quarter two that we are seeing signs of recovery. And what we did at that time is we accommodated our customers who were already making repayments. And what we were doing is really waiting for a six months period of consistent payments, which has been happening. And as that happens we upgrade. But notwithstanding there was one customer who went into problems. And again we decided in the last quarter to downgrade him. We do very many short-term facilities, so you may see the book not growing very much, but what you do in one year a quarter of it will be repaid within the term or even 30%. So clearly it's a book that may not grow so much and therefore the NPL may mature. But then the good thing for us is when there are signs of recovery it is the first one to recover. It can begin even now. Thank you.

Toyosi Oni
Thank you very much. I just had a follow-up question if that's okay. So I just wanted to ask your opinion on the new floor on the rate caps. It was ruled as unconstitutional. What impact do you think this would have? How long do you expect any changes to occur from this? And just your general opinion on that news.

Patrick Nyaga
Thank you, Toyosi. Well, as it was said by the judge, he just said that it was unconstitutional, but he gave 12 months for the parliament to think about it. So for now we can't really comment much as to what will happen. So we just probably wait and see.

Toyosi Oni
Thank you very much.

Operator
Ladies and gentlemen, just a reminder, should you wish to ask a question you are welcome to press star and then one. Gentlemen, we don't seem to have any further questions in the queue. Do you have any closing comments?

Patrick Nyaga
Okay. Thank you very much everyone for listening to us. It has been a pleasure to even answer your questions. We are always available. You have our email. In case of any further clarification you can always contact us. Thank you very much and have a good day. Thank you.

Operator

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

END OF TRANSCRIPT