Gulf Bank of Kuwait (K.S.C.P.)

Earnings Conference Call Edited Script – Q3 2019

29 October 2019

Corporate Participants:

Mr. Tony Daher – CEO

Mr. Kevin Smith – CFO

Ms. Dalal AlDousari – Head of Investor Relations

Chairperson:

Ms. Janany Vamadeva – Arqaam Capital

Janany: Good afternoon and good morning everyone. This is Janany Vamadeva on behalf of Arqaam Capital I would like to welcome you all to the Gulf Bank 2019 third quarter and year-to-date results conference call. It is a great pleasure to have with us on the call Mr. Tony Daher, CEO of Gulf Bank, Mr. Kevin Smith, CFO of Gulf Bank and Ms. Dalal AlDousari, Head of Investor Relations at Gulf Bank. The call will begin with a presentation from management and then we will open the call for the Q&A session. I will now turn the call over to Dalal.

Dalal: Thank you, Janany. Good Afternoon and Welcome to Gulf Bank's 2019 third quarter and year-to-date financial results conference call. We will start the call today with Mr. Tony Daher, Chief Executive Officer, who will cover our key highlights. Afterwards, Mr. Kevin Smith, Chief Financial Officer, will cover our financial results. All amounts in the presentation are shown in millions of Kuwait Dinars and have been rounded to simplify the charts. During our presentation, we will try not to repeat the currency when discussing specific amounts unless that amount is in a currency other than Kuwait Dinars. After the presentation, we will open the floor for Q and A received through the webcast facility. Feel free to type in your questions at any time during the call. The presentation will be available at our website and will be disclosed to Boursa Kuwait.

Please note that we can only comment on inquiries and information that are disclosed publicly. I would like to draw your attention to the disclosure on **page 2** of the presentation, with respect to forward looking statements and confidential information.

With that, I would like to handover the call to Mr. Tony Daher, Gulf Bank’s CEO. Tony?

Tony: Thanks, Dalal. I'm pleased to be with all of you today and would like to share some of the key highlights through the first nine months of 2019.

On **page 3**, you can see the progression and growth rate in our Net Profit since 2013. During this period, we've generated double-digit growth in our Net Profit over the last five years and that growth rate has accelerated from 10% for the three-year period from 2013 until 2016 to 12% in 2017 and 18% last year.

On the far right, you can see that we reported a Net Profit of 13.2 million in the third quarter of 2019, an increase of KD 1 million or 8% compared the second quarter of 2019. This was mainly driven by a 17% reduction in credit costs and a stable operating expense base.

Compared to the year-ago level, Gross Customer Loans and Advances grew by 6%, reaching another all-time high for the Bank. In addition, our Consumer Banking segment continues to deliver strong momentum, achieving a 13th straight quarter of loan growth and is on track to grow its loan book by nearly 2 times the industry growth rate for a second straight year in a row.

On **page 4**, Gulf Bank continues to be globally recognized in terms of its credit worthiness and financial strength by maintaining "A" ratings from all four leading credit rating agencies.

Moody's long-term deposits rating on the Bank is "A3" with a "Positive" outlook.
Fitch's long-term issuer default rating is "A+" with a "Stable" outlook.
S&P's issuer credit rating is "A-" with a "Stable" outlook.
Capital Intelligence's long-term foreign currency rating is "A+" with a "Stable" outlook.

Now I'll turn it over to our CFO, Kevin Smith, who will cover the financials in more depth.

Kevin: Thanks Tony. **Page 5** shows the balance sheet progression from the 30th of September 2018 to the 30th of September 2019. This page also shows the mix of assets and liabilities and how that has changed over the last 12 months.

First, I would like to focus on Assets which are shown on the top half of the slide, line items 1-13.

Over the course of the last 12 months, our total assets grew by 206 million to nearly 6.2 billion. More than 80% of that growth came from net customer loans, shown on line 6, which grew by 171 million to nearly 4 billion.

In terms of asset composition, no significant changes from a year ago. As of 30th of September 2019, 28% of our assets were held in the form of liquid assets, 67% as loans to customers and banks, 3% as investment securities, and 2% as other assets.

If you look on lines 19 and 20, to the far right, of the 206 million in asset growth over the period, 182 million or nearly 90% of that growth was funded with liabilities and the remaining 24 million was funded with equity.

On line items 14, 15, and 16, you can see that nearly all our funding comes from Due to Banks, Deposits from Financial Institutions, and Customer Deposits.

On line 18, of the KD 38 million increase in Other Liabilities from September 2018 to September 2019, 19.7 million relates to a 100% provision against an equivalent amount of interest income that was collected when the Bank acquired and sold the Fahaheel land for 90 million in the fourth quarter of 2018. This provision will be released to interest income pending a final court judgement in our favor.

Our non-performing loan ratio, as shown on line 24, declined from 2.7% at the end of June 2019 to 2.6% at the end of September 2019. On line 25, the coverage ratio on non-performing loans at the end of September 2019 was 314%, up from 288% at the end of June 2019.

Average assets and average equity are shown on line items 22 and 23 as this allows us to calculate our return on assets and return on equity which are shown on the next two pages.

Page 6 shows our income statement performance through the first nine months of 2019 compared with the year earlier period along with some other key metrics.

To give you context, on the left, we are showing our full year results in 2018, % of average assets, and the income statement line item variances compared with 2017.

On line item 13, under the column labelled ‘9M-18’, which stands for the first nine months of 2018, you can see that our Net Profit through the first nine months of 2018 was 42.7 million.

On that same line item 13, if you look under the column labelled `9M-19`, we reported a net profit of 37.1 million through the first nine months of 2019.

The change in net profit was driven largely by three factors as shown on the far right under the column ‘9M-19 vs. 9M-18’:

(1) First, on line 6, Operating Income slipped by 3.9 million or 3%. This was mainly due to funding cost pressures as a result of four US fed increases in 2018 and only one increase by the Central Bank of Kuwait in March 2018. The good news is that the quarter over quarter increases in interest expense over the last three quarters have averaged 1.2 million per quarter, down 26% from the last three quarters of 2018 when the average quarterly increase was 1.7 million. In addition, compared with other Banks in Kuwait, we had one of the lowest increases in H1’19 vs. H1’18 cost of funds.

(2) Second, on line 7, expenses over the first nine months of 2019 were 10.1 million higher than the year earlier period. Excluding the one-time expense provision of 2.8 million booked in the first quarter, expenses were up 7.3 million or 15%.

These higher expenses were driven by one, establishing a new central hub for our customers and employees at Crystal Tower, two, investing and enhancing our IT infrastructure, customer applications, and information security, three, an increase in incentive payments made to sales and support staff who are delivering strong performance for our Bank, and four, an increase in statutory benefit costs for our employees. Salary expenses have been contained, with mid-single digit growth, which is consistent with wage inflation in Kuwait as employment levels have been kept relatively flat.

(3) Third, more than half of those two adverse variances were offset by lower impairments of 7.4 million; specifically, 0.2 million in the first nine months of this year compared with 7.6 million in the year earlier period.

Page 7 compares the trend in our income statement performance over the three most recent quarters.

On line 13, under the column labelled ‘Q1-19’ you can see that our Net Profit in the first quarter of 2019 was 11.8 million.

On that same line 13, under the column ‘Q2-19’, we reported a Net Profit of 12.2 million in the second quarter of 2019, up 4% vs. the first quarter. In Q3-19, our net profit growth accelerated by another 1 million or an increase of 8% compared with the second quarter of 2019.

This acceleration of net profit growth in the 3rd quarter vs the 2nd quarter, shown in the last two columns under the heading ‘Q3-19 vs. Q2-19’, was mainly driven by a 2.9 million or 17% reduction in credit costs, from 16.5 million in the second quarter to 13.6 million in the third quarter as shown on line 9. On line 4, you can see our fees and F/X income have increased from 8.9 million in first quarter to 9.6 million in the second quarter to 10 million in the third quarter. These two favorable variances were partially offset by lower net interest income of 0.8 million, shown on line item 3, and second quarter, non-recurring gains from selling repossessed collateral, shown on line item 5. Operating expenses, shown on line 7, have remained stable over the last two quarters at an average of 18.4 million.

Turning to **page 8**, our regulatory capital ratios remain strong as our Tier 1 ratio of 13.1% was about 110 basis points above the regulatory minimum of 12% and our Capital Adequacy Ratio (CAR) of 16.5% was roughly 250 basis points above the regulatory minimum of 14%. Please keep in mind that these ratios don’t include the net profit of 37.1 million recorded in the first nine months of 2019. If this is included as capital, the ratios and buffers would increase by another 80 basis points to roughly 13.9% and 17.3%, respectively. On the bottom right, our leverage ratio was 8.6% at the end of September 2019, up from 8.2% at the end of September 2018 and well above the 3% minimum.

Page 9 shows our key liquidity ratios. On the left side, you can see that our average daily Liquidity Coverage Ratio was 304% during the third quarter of 2019 and is well above the minimum of 100% that came into effect on the 1st of January of this year. On the right side of the page, our NSFR ratio of 113% is also above the 100% minimum. So, both liquidity ratios have more than adequate buffers above the regulatory minimums.

In summary, it has been a challenging first nine months in 2019. However, as Tony mentioned, we set another all-time high in gross loans and continue to successfully execute an outperform strategy in our Consumer Banking segment, gaining coveted market share in this space. In addition, the quality of our underlying loan portfolio remains strong, with the latest quarter showing a downward trend in credit cost and that allowed us to more than offset margin pressures and report a stronger third quarter compared with the second quarter.

Now, I would like to turn it back over to Dalal for the Q&A session.

Dalal: Thank you Kevin. Now we are ready for Q and A. if you wish to ask a question, please submit your question into the designated questions text area. We will pause for few minutes to receive most of your questions.

(Pause)

Dalal (Q1): We are seeing a number of questions on NPL and credit costs? Kevin, would you like to comment please?

Kevin (A1): Sure. As a result of downgrading a corporate borrower in the first quarter of this year, this has caused short-term pressure on this year's credit costs, net profit, coverage ratio, and non-performing loan ratio. However, by the end of this year, we will fully provide for this borrower, write the loan off from an accounting perspective, and get the Bank's non-performing loan and coverage ratios much closer to end of 2018 levels rather than the end of September 2019 levels.

So, on this account, specific provisions have been front-end loaded in 2019 and recoveries will be back-end loaded when cash or asset swap settlements have been executed in 2020 and beyond.

Dalal (Q2): Thanks Kevin. There are some questions regarding cost of funds pressure and outlook on interest rates. Kevin, can you take this one?

Kevin (A2): As I discussed, interest expense continued to rise in the first three quarters of this year, but at a slower pace than the last three quarters of 2018. The good news is that the Central Bank of Kuwait didn't reduce rates after the US Federal Reserve cut rates by 25 basis points in July and another 25 basis points in September, so we didn't need to immediately reduce rates that we charge our corporate clients. However, if the US Federal Reserve cuts rates another 25 basis points this week and the Central Bank of Kuwait follows, this will put immediate pressure on our margins as yields are immediately impacted with a lagging benefit expected from lower funding costs.

Dalal (Q3): **Thanks Kevin. We are also receiving questions related to our expenses and cost to income ratio. Kevin, can you take this one as well?**

Kevin (A3): If you exclude the one-time expense provision of 2.8 million recorded in the first quarter of this year, we've been successful in managing expenses in a very tight range over the last four quarters with 18.4 million of expenses incurred in Q4'18, 18.8 million in Q1'19, 18.3 million in Q2'19, and 18.5 million in Q3'19. We view expense management as a crucial element to help mitigate funding cost pressures from 4 Fed increases and only 1 CBK increase last year and further yield pressure if the Central Bank of Kuwait follows the US Federal Reserve by cutting rates in the future.

Kevin (Q4): **So we are receiving some questions on the impact of 25 bps rate cut by the Central Bank of Kuwait, so let me address this one.**

Kevin (A4): Assuming this Central Bank discount rate action is met with a corresponding reduction in our screen rates offered to our customers, we would expect a negative impact of 3 million on our net interest income in the first full year after a 25 basis point reduction in the Central Bank discount rate. Obviously, this impact would be lower in the second year as we would get the full year impact of lower funding cost as time deposits are re-priced at lower screen rates.

Kevin (Q5): **There is another question related to our CET1 ratio as well as what is the minimum is for us.**

Kevin (A5): In fact, our CET1 ratio, if you turn back to page 8, is the same as our Tier 1 capital ratio because we have not issued any Additional Tier 1 capital above our CET 1 capital; so, 13.1% is our CET1 ratio and the minimum requirement including D-SIB for the Bank is 10.5%. So again it's 13.1% our CET1 ratio vs a minimum of 10.5%.

Dalal: Thank you Kevin. I believe we have covered the majority of the topics and questions that were raised today during the call. The remaining questions are either already covered during the presentation or are forward looking. And with that, we would like to conclude our call for today.

If you have any further questions, you may visit our investor relations page at our website. You can also reach us at our dedicated investor relations email.

Thank you all very much for your participation.