Gulf Bank of Kuwait

Earnings Conference Call Edited Script – Q2 2019

11 July 2019

Corporate Participants:

Mr. Antoine Daher – CEO

Mr. Kevin Smith – CFO

Ms. Dalal AlDousari – Head of Investor Relations

Chairperson:

Ms. Elena Sanchez- EFG Hermes

Elena: Good afternoon and good morning everyone. This is Elena Sanchez and on behalf of EFG Hermes I would like to welcome you all to the Gulf Bank second quarter 2019 results conference call. It is a great pleasure to have with us on the call Mr. Antoine 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 on the key highlights of the results of the second quarter 2019 and then we will open the call for the Q&A session. I will now turn the call over to Dalal.

Dalal: Thank you, Elena. Good Afternoon and Welcome to Gulf Bank's second quarter 2019 financial results conference call. This is Dalal AlDousari from Gulf Bank's investor relations team. We will start the call today with Mr. Tony Daher, Chief Executive Officer, who will cover our key highlights from the second quarter. Afterwards, Mr. Kevin Smith, Chief Financial Officer, will cover our second quarter financial results. 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, www.e-gulfbank.com, 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 from the second quarter of 2019.

On **page 3**, you can see the progression and growth rate in our Net Profit since 2013. To summarize, 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 KD 12.2 million in the second quarter of 2019 compared with KD 11.8 million in the first quarter of 2019.

In terms of growth, we had a very strong second quarter as customer loans and advances grew by 8% on an annualized basis. In addition, we are extremely proud of our Consumer Business achieving its 12th straight quarter of loan growth and that has helped us reach an all-time high on gross customer loans. Our loans to individuals now represent 35% of our total loan portfolio, up from 26% five years ago.

On **page 4**, Gulf Bank continues to be well recognized in terms of its credit worthiness and financial strength internationally as it is rated "A" by all four leading credit rating agencies.

Moody's rating on the Bank is "A3" with a "Positive" Outlook
Fitch's rating is "A+" with a "Stable" outlook.
S&P's rating is "A-" with a "Stable" Outlook
Capital Intelligence's rating is "A+" with a "Stable" outlook.

Before we move to the next part of our presentation, I would like to take this opportunity to extend our congratulations and appreciation to the Capital Markets Authority, Boursa Kuwait and the Kuwait Clearing Company for their tremendous efforts that has led to the possible upgrade of Boursa Kuwait to an emerging market under the MSCI index. We believe this reclassification would lead to sustainable inflows of foreign investment funds, diversify the shareholder base, and improve liquidity. It is worth mentioning that Gulf Bank is one of the Kuwaiti companies on the initial watchlist of the May 2020 reclassified MSCI Kuwait Index. In addition, Gulf Bank has been part of the FTSE-Russel Kuwait secondary emerging market index since March 2019.

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 June 2018 to the 30th of June 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 KD 170 million or 3% to over KD 6 billion. Nearly two thirds of that growth came from customer loans, shown on line 6, which grew by KD 77 million, up 2% and investment securities, shown on line 9, which grew by KD 34 million, up 28%.

In terms of asset composition, no significant changes from a year ago. As of 30th of June 2019, 27% of our assets were held in the form of liquid assets, 66% as loans to customers, 3% as investment securities, and 2% as other assets.

If you look on lines 19 and 20, to the far right, of the KD 170 million in asset growth over the period, KD 144 million of that growth was funded with liabilities while KD 25 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 29 million increase in Other Liabilities from June 2018 to June 2019, KD 19.7 million relates to a 100% provision against KD 19.7 million of interest income that was collected when the Bank acquired and sold the Fahaheel land for KD 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 slightly from 2.8% at the end of March 2019 to 2.7% at the end of June 2019. On line 25, the coverage ratio on non-performing loans at the end of June was 288%, an increase compared with 267% reported at the end of March 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 I'll discuss later.

Page 6 shows our income statement performance in the first half of 2019 compared with the first half of 2018 along with some other key metrics.

To give you context, to the left of the two thick red lines in the center of the page, we are showing our full year results in 2018, % of average assets, and the income statement line item variances compared with 2017. All amounts are shown in KD millions and have been rounded to simplify the chart.

On line item 12, between the two thick red lines, under the column labelled 'H1-18', you can see that our Net Profit in the first half of 2018 was KD 26.8 million.

On that same line item 12, if you look under the column labeled `H1-19`, we reported a net profit of KD 24 million in the first half of 2019.

The decline in net profit was mainly driven by the following 3 factors:

(1) First, on line 5, Operating Income slipped by KD 1.5 million. 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. In addition, liquidity conditions tightened early this year as one of the large Public Sovereign Entities allocated more of its funds out of Kuwait. The good news is that the quarter to quarter increase in our interest expense has slowed down in the first two quarters of this year, up an average of KD 1.3 million in each of those two quarters. This compares favorably with the last three quarters of 2018 where the average quarterly increase was KD 1.6 million.

(2) Second, on line 6, expenses in the first half of 2019 were KD 7.9 million higher than the first half of 2018.

KD 6 million or nearly ¾ of that increase occurred in the first quarter of 2019 as that quarter included a one-time provision of KD 2.8 million.

In the second quarter of 2019, operating expenses stabilized at a level of 18.3 million, KD 3.2 million or 15% lower than the first quarter of 2019.

(3) Third, these two line items were mostly offset by lower impairments, shown on line item 10, which were KD 6.2 million lower in the first half of 2019 compared with the first half of 2018.

Page 7 compares our income statement performance in the most recent second quarter of 2019 versus the first quarter of 2019.

On line 12, between the two thick red lines, under the column labelled ‘Q1-19’, you can see that our Net Profit in the first quarter of 2019 was KD 11.8 million.

On that same line 12, if you look to the right of the second red thick line, we reported a Net Profit of KD 12.2 million in the second quarter of 2019 which was KD 0.4 million higher than the first quarter of 2019.

Comparing the two most recent quarters, you can see there were three adverse variances:

(1) First, on line 2, Interest expense was up KD 1.3 million. As I mentioned, interest expense increases are slowing down in 2019 compared with the last three quarters of 2018.

On line 7, even with that funding cost pressure, our Operating Margin improved by KD 4.3 million or 17% mainly as a result of expenses declining by 15% to a level of KD 18.3 million, and non-interest income increasing by KD 1.8 million or 18%.

(2) Second, on line 8, credit costs, defined as specific provisions plus write-offs less recoveries, were up KD 2.6 million in the second quarter compared to the first quarter.

Based on all the leading indicators in our loan portfolio, we are confident that this second quarter level isn’t indicative of any adverse long-term credit cost trend. It is more a case of applying conservative accounting rules than reflecting expected economic outcomes.

(3) Third, on lines 9 and 10, other provisions and impairments were KD 1.3 million higher in the second quarter mainly because, as Tony mentioned, we had strong loan growth in the second quarter and accounting principles require us to take a 1% general provision on that growth.

Turning to **page 8**, our regulatory capital ratios remained strong as our Tier 1 ratio of 13.1 % was roughly 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%. On the bottom right, our leverage ratio ended at 8.8%, higher than the end of June 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 increased from 325% in the second quarter of 2018 to 326% in the second 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 increased from 107% at the end of June 2018 to 112% at the end of June 2019. So, both liquidity ratios have more than adequate buffers above the regulatory minimums.

In summary, it has been a challenging first half with some headwinds. However, we saw very strong loan growth in the second quarter of 2019, giving us good momentum in both business segments going into the second half. In addition, the quality of our loan portfolio remains strong.

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. Our first and second quarter credit cost and NPL ratio were impacted by downgrading a corporate borrower who was servicing their debt, but early warning signals triggered an opportunity for us to utilize our senior lending position and strong legal documentation to gain access to assets with significant value held by the borrower.

However, since these assets aren't collateralized yet, accounting rules require us to conservatively write down the loan to zero over time and then record any asset proceeds from a settlement as a recovery.

In other words, specific provisions for such non-performing loans are recorded up front, recoveries are recorded only when cash is received, but economics are seen through the cycle.

So, this situation puts some short-term pressure on credit cost, Non-Performing Loans, and net profit until we settle this loan.

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 two quarters of the year, but at a slower pace than the last three quarters of 2018. In June, we saw a leveling-off of funding cost as the probability of a rate cut by the Fed started to increase. The market is now expecting nearly a 100% probability that the US Fed will decrease interest rates by 25 basis points this month and a 75% chance they will cut 25 basis points in July and another 25 basis points cut in December. So, the impact will depend on whether the Central Bank of Kuwait will follow with a decrease or not. In 2018, the Fed increased four times and the Central Bank of Kuwait increased only once. If the Central Bank doesn't follow on the way down, we would expect funding cost to fall and NIMs to improve over time. If the Central Bank follows, our Corporate loans are tied to that rate, so interest income will fall with lower funding cost lagging behind.

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): As I mentioned earlier, our second quarter expenses declined by 15% to KD 18.3 million and, our cost to income ratio also fell to 38% as shown on Page 7. Both a shift in our loan portfolio mix towards Consumer Banking, which comes with higher yields, and increasing our market penetration in both Business Segments, will be favorable towards net interest margins and our cost-to-income ratio. And, of course, the other impact depends on actions taken by the US Federal Reserve and the Central Bank of Kuwait.

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.