Gulf Bank of Kuwait

Earnings Conference Call Edited Script – Year End 2020

15 February 2021

Corporate Participants:

Mr. Tony Daher – CEO

Mr. Kevin Smith – CFO

Ms. Dalal AlDousari – Head of Investor Relations

Host:

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 year-end 2020 earnings 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 on the key highlights of year-end 2020 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 year-end 2020 earnings conference call. We will start the call today with the key highlights and updates on the operating environment of Gulf Bank during the year 2020 presented by the Chief Executive Officer, Mr. Tony Daher followed by a detailed presentation of our financial results by the Chief Financial Officer, Mr. Kevin Smith. All amounts in the presentation are shown in millions of Kuwaiti 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 Kuwaiti 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 corporate 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 11** of the presentation, with respect to forward looking statements and confidential information. Please feel free to reach out to our investor relations team if you have any questions.

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

Tony: Thanks, Dalal. Before we cover the detailed financials, I would like to make a few brief points about 2020.

2020 was truly an unprecedented year as our everyday lives were upended by the global pandemic. As a result, the operating environment for most of 2020 was met with historically low interest rates, low economic activity, and lots of uncertainty. However, our financial performance and our ability to serve our customers through these tough times highlighted the strength and resilience of the Bank.

With that backdrop, I would like to summarize our 2020 results with six key messages shown on **page 2**.

First, we remained profitable, reporting a net profit of 28.8 million in 2020, compared to a net profit of 63.6 million in 2019.

Second, our earnings per share was 10 fils and the Board of Directors is recommending a 5 fils cash dividend. If approved at the AGM in March 2021, this will be the sixth year in a row where we have paid out cash dividends and the fourth year in a row where we have paid out at least 50% of our earnings to shareholders.

Third, our portfolio quality remained strong, as our non-performing loan ratio at year end 2020 stood at 1.1%, no change from the prior year-end ratio. In addition, we provided 100% for our consumer loans more than 90 days past due and wrote off those loans from an accounting perspective, so that segment ended with a zero NPL ratio to start off the new year.

Fourth, we ended 2020 with 112 million in provisions in excess of the IFRS9 requirements. This is the third straight year since the accounting standard was implemented that we've ended the year in excess of 100 million in excess provisions. These excess provisions represent nearly 40% of our total provisions.

Fifth, to support stress and position ourselves for future growth, we increased our capital buffers by more than 100 basis points compared with the levels at the end of 2019. Even when measured against the pre-COVID regulatory minimums, our Tier 1 ratio has a buffer of 285 basis points (14.85% vs. 12%) and our capital adequacy ratio (CAR) has a buffer of 425 basis points (18.25% vs. 14%).

And sixth, the Bank maintained its ‘A’ ratings from the four major credit rating agencies and here is where we stand today:

- Moody’s Investors Service maintained the Long-Term Deposits Rating of “A3” with a “Stable” outlook.
- Fitch Ratings affirmed the Bank Long-term Issuer Default Rating of “A+” with a “Negative” outlook.
- S&P Global Ratings affirmed the Bank Issuer Credit Rating at “A-” with a “Negative” outlook
- Capital Intelligence affirmed Gulf Bank’s Long-term Foreign Currency Rating of “A+” with a “Stable” outlook.

So, even though 2020 was an extremely challenging year, we have put ourselves in a position of strength going into 2021 and that will allow us to continue tackling the headwinds while supporting the growth needs of our customers.

With that, I’ll turn it over to our CFO, Kevin Smith, who will cover the financials of 2020 in more depth.

Kevin: Thanks Tony.

Page 3 shows the year over year changes in operating margin. Before I go through this slide, please keep in mind that we have excluded the non-recurring income and expenses that were publicly disclosed in 2019 and 2020, so we can see the true underlying operating margin. These are shown in the footnotes in the lower left. The biggest one is the 19.7 million of interest income from the Fahaheel land settlement that was recorded in the fourth quarter of 2019. In addition, we also had a one-time expense of 2.8 million in 2019 and one-time expense credits of 4.6 million in 2020.

Starting with the blue bar on the left, we generated 113 million of operating margin in 2019. The blue bar on the far right shows that we generated 90 million of operating margin in 2020, a drop of 23 million or 20%.

In terms of the composition of that decline, in the first red bar, you can see our interest income dropped by KD 47 million, mainly from the re-pricing of corporate loans and other assets due to the lower interest rate environment which began with the CBK decision in March of 2020 to reduce its discount rate by 125 basis points. This immediately re-priced roughly 2/3 of the gross customer loans on our balance sheet.

The second red bar shows that fee and foreign exchange income dropped by KD 8 million primarily due to lower loan volume that we saw and lower economic activity.

Other income, the third red bar, was down by 2 million.

Without any mitigation, these three items would have cut our operating profit approximately in half over the course of one year.

However, the favorable liquidity environment and relaxed regulatory ratios helped us lower our interest expense by 27 million. In addition, we reduced our operating expenses by 7 million.

So, a combination of lower interest expense and lower operating expenses offset 60% of the revenue shock and helped us turn a 50% reduction in operating margin into a 20% reduction in operating margin.

Page 4 shows the income statement line items for the last four quarters and the full year 2020 compared with the prior full year in 2019.

On the previous slide, I discussed Operating Margin and that is shown on line 8. If you include the non-recurring items, our reported operating margin was down 35 million or 27% and this is shown in the second to last column on the right.

Since there were essentially no major variances in credit costs, provisions, and impairments, the 35 million lower operating margin fell to the bottom line, causing our net profit, line 13, to also decline by 35 million compared to 2019.

On the previous page, I described the year-over year variances in operating margin, so I want to focus the discussion on the quarterly trends that we saw for each of the line items.

Starting from interest income, line 1, you can see the impact coming from the lower interest rate environment, but the rate of decline slowed in the fourth quarter.

Interest expense, line 2, fell by nearly half, from 29 million in the first quarter to 15 million in the fourth quarter.

With this favorable cost of funds trend, you can see that net interest income, line 3, actually increased in the fourth quarter and has been relatively stable over the last three quarters.

Fee and foreign exchange income, shown in line 4, is up 44% in the fourth quarter compared to the second quarter when economic activity in Kuwait was at its lowest point in the year, moving from 6.3 in second quarter to 9.1 in fourth quarter.

You can see on line 7 that we were able to reduce operating expenses significantly in the second and third quarter. The fourth quarter pace has picked up in line with economic activity in Kuwait.

And credit costs, line 9, fell by a third, from 21 million in the second quarter to 14 million in the fourth quarter.

Page 5 shows the balance sheet and how the individual line items have moved from the 31st of December 2019 to the 31st of December 2020. This page also shows the mix of assets 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 1-14.

Over the course of the last 12 months, our total assets shrank by 133 million or 2% to 6.1 billion compared to 6.245 billion in the year before. This was largely driven by a 122 million or 3% decline in gross customer loans, shown on line 6. Even though we continued to see strong growth in retail loans, which grew by 6% or nearly 100 million, this was more than offset by lower loan demand we saw from our corporate customers.

In terms of the broad asset categories, you can see that the mix is essentially unchanged from a year ago. The broad asset categories include liquid assets, line 5, net loans, line 9, investment securities, line 10, and other assets, line 13.

On line items 15, 16, and 17, you can see that nearly all our funding comes from Due to Banks, Deposits from Financial Institutions, and Customer Deposits. As a result of growing our customer deposits and attracting more short-term bank funding, we were able to reduce the deposit mix coming from financial institutions which is on line 16.

Our debt-to-equity ratio remained around 9 to 1, similar to prior year.

Our non-performing loan ratio, shown on line 25, declined from 1.5% at the end of September 2020 to 1.1% at the end of December 2020 and our coverage ratio, line 26, improved from 462% at the end of September 2020 to 568% at the end of December 2020.

Before I move to the next page, I would like to draw your attention to the total loan provisions as of the 31st of December 2020 which were 269 million as shown on line 8.

On Page 6, you can see that the same number of 269 million on the top right under 'provisions on cash facilities' as of 31 December 2020. On top of that, we have 15 million in provisions on non-cash facilities which are included in 'other liabilities' on our balance sheet. So, the total provisions we have on our balance sheet are 284 million as of end of year.

When you compare our total provisions of 284 million with our IFRS 9 requirements of 172 million, we ended 2020 with 112 million of excess provisions, an increase of 6 million compared with the year-ago level of 106 million. So, a very healthy balance sheet going into 2021.

Page 7 shows that our 2020 year-end regulatory capital ratios as Tony mentioned earlier remain well above our current minimums and our pre-COVID 19 minimums, the old minimums

On the top left, our Tier 1 ratio reached 14.85%, 535 basis points above our current regulatory minimum of 9.5% and 285 basis points above our pre-COVID-19 regulatory minimum of 12%.

On the bottom left, our Capital Adequacy Ratio of 18.25% was 675 basis points above our current regulatory minimum of 11.5% and 425 basis points above our pre-COVID 19 regulatory minimum of 14%.

Our risk weighted assets, shown on the top right, fell by nearly 5% mainly due to the reduction in our gross customer loans contributed favorably to both capital ratios.

On the bottom right, our leverage ratio ended the year 2020 at 9.9%, higher than the end of December 2019, and well above the 3% minimum.

Page 8 shows our key liquidity ratios. On the left side, you can see slight declines in our average daily Liquidity Coverage Ratio and Net Stable Funding Ratios, but both are still well above their respective minimums of 80%.

It is worth noting that both of those ratios regulatory minimums were reduced from 100% to 80% by the Central Bank of Kuwait in April 2020.

Page 9 shows the Bank maintained our 'A' ratings from the four major credit rating agencies as Tony mentioned earlier.

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

Dalal: Thank you Kevin. We are now 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)

Ok, we will go through the questions.

Dalal (Q1): There was a small improvement in NIM and on cost of funds in Q4 vs. Q3– do you find this sustainable into 2021, and what is your outlook for margins in 2021?

Kevin (A1): Unfortunately, there are many factors and it's just too difficult right now to predict how they will all play out on our 2021 net interest margins. Assuming the CBK discount rate stays where it is, which we think it will be for at least this year, we will continue to see downward pressure as existing retail loans written at higher rates are replaced with new loans at much lower rates and new loans are priced 125 basis points lower that they were just 9 months ago. As was mentioned in the question, cost of funds went down in Q4 vs. Q3 and went down a bit more in January 2021, but there's a limit to that as we're already below 1% and there are already signs of rising liquidity pressures in the market. If we can continue growing retail loans faster than corporate loans, which we were exceptional in the past three plus years, we will get a favorable mix impact, so that could also help. The best we can hope for is to mitigate these external pressures with things within our control like the mix between retail and corporate growth and optimizing fee income a low point being mid-2020 and operating expenses associated with this growth.

Dalal (Q2): **What is the amount received in grant from the government towards staff expenses, your view on operating expenses in 2020 and your expectations for 2021?**

Kevin (A2): We were very happy with how we managed expenses in 2020. We received 4.6 million in staff cost subsidies and these were booked in the staff cost line item. Even if you exclude non-recurring expenses in 2019 and these subsidies in 2020, our underlying operating expenses fell from 75 million in 2019 to 69 million in 2020, a decline of nearly 10%. Nearly 90% of that reduction came from staff costs. At least in the short term while interest rates remain low and with so much uncertainty out there, we will continue to tightly manage our expenses since it's an important initiative. To the extent we need to invest in certain cost categories to grow our two business segments, we will attempt to offset these investments with productivity gains to limit the growth in annual operating expenses.

Dalal (Q3): **Could you throw some color on the significant improvement in consumer impaired loans (declined to 1.8 million from 19.4 million in 2019). And, even in past due not impaired, consumer's increase is reasonable (+14%), but corporate has increased 2.4 times. Is this related to Covid-19 related delays from your corporate book?**

And another related questions, has the corporate deferral ended completely by end of December 2020 and there is movement in staging now or are you still offering deferral on a case-by-case basis to corporate loans into 2021 as well?

Kevin (A3): There are a lot there, let me take it one at a time. As Tony mentioned, we decided to fully provide for all consumer impaired loans at the end of 2020 and completely write them off from an accounting perspective, that is why we saw a significant improvement in the NPL ratio regardless of the delinquency bucket. Whereas the provision rules require a 20% provision for accounts 91-180 days past due and 50% for accounts 181 -365 days past due, so we wrote them all off. So, if we receive cash on any of these accounts, that will be booked as recoveries in 2021. As you hinted, we were encouraged that the past due but not impaired bucket for Consumer was up only modestly, 14%, from 74 million to 85 million even though the installment deferral ended at the end of September 2020. On the corporate side, yes, the 'past due but not impaired category increased from approximately 9.5 million at the end of 2019 to 23 million at the end of 2020. However, the majority of that increase has already shifted to the 'neither past due nor impaired category' early in 2021, so that is not a concern for us right now which is good news.

To answer the last question, the corporate deferral program ended at the end of September 2020 without any subsequent deferral program offered to our clients since then, the 'past due but not impaired' disclosures I just mentioned give you an early read on the portfolio quality of our Consumer and Corporate business segments as of the end of December 2020.

Dalal (Q4): **How has the payment behavior been in corporate and retail books after the deferral ended? NPL formation has been business as usual in 2020. Can we expect the same trend in 2021 or is it too early for you to comment as Covid-19 related NPL formation has not fed into the books yet?**

Kevin (A4): As mentioned in the previous question, given the fact that the corporate and consumer deferrals ended at the end of September and any delinquency is still in the 'less than 90 day' bucket, it's too early to predict and give guidance on how delinquency, provisioning, and credit costs will evolve in 2021, however we are watching it very closely.

Dalal (Q5): **We have seen in the media different numbers quoted for the number of expats that have left Kuwait during 2020. Has this put some pressure on the quality of the retail book, or do you see this as a concern for 2021?**

Kevin (A5): As I mentioned before, we’ve seen an uptick in the less than 90 day delinquency bucket, from 74 million at the end of 2019 to 85 million at the end of 2020. It’s still early, but it's fair to say that there are a lot of resources being focused on monitoring early warning signs like accounts with no salary received, but not delinquent which is getting a lot of our attention. In addition, we are monitoring collections and delinquency on a daily basis as well as ensuring more than adequate collection resources inside and outside of Kuwait. And, we’re putting equal weight collecting across all delinquency buckets, regardless of whether they are early stage or late-stage delinquency, and having our utmost attention and staying on top of it

Dalal (Q6): Retail has been the main driver of credit growth for Gulf Bank over the past few years. What do you expect to be the drivers of credit growth in 2021?

Kevin (A6): On the retail side, even though it's become extremely competitive and we've tightened our underwriting standards to expatriates, we maintained our market share in 2020 growing in line with industry at 6%. The good news is that these low interest rates are driving strong growth and we feel well positioned to continue grabbing our fair share of industry growth. On the corporate side, the uncertainty around macro and pandemic conditions make it difficult to predict how our clients will be impacted this year and their demands for new loans. For example, until we get a new debt law and see through the latest restrictions that went into effect on the 7th of February, we expect growth to be muted.

Dalal: Thanks Kevin. We will take another pause to receive more questions.

(Pause)

Dalal (Q7): Any update on recoveries from NPL formation in Q1’19?

Kevin (A7): It is fair to say, we are still involved in settlement discussions, but it’s too early to predict the timing of recoveries? The good news is that these accounts have been fully provided and written-off in 2019, so any settlements would go straight to recoveries, but that conservative financial provisioning in those accounts will not influence our negotiating position or legal strategy to secure what we’re entitled to under the law.

Dalal (Q8): Can you explain why did the Corporate loan balances drop in 2020?

Kevin (A8): In terms of our existing clients, there were limited drawdowns against approved credit lines, not much borrowing appetite, and, in fact, some paid down their debt obligations. And the uncertain environment limited our appetite to underwrite new clients who were facing a period of uncertainty in terms of their business model and cash flow and from underwriting prospective we needed to be careful.

Dalal (Q9): **Our next question is about CASA mix.**

Kevin (A9): We saw an opportunity to grow CASA at a low expense, were our CASA ratio for year end 2020 was around 37% in comparison to 33% in year end 2019.

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.