Gulf Bank of Kuwait

Earnings Conference Call Edited Script – Year End 2019

11 February 2020

Corporate Participants:

Mr. Antoine Daher – CEO

Mr. Kevin Smith – CFO

Ms. Dalal AlDousari – Head of Investor Relations

Chairperson:

Elena Sanchez- EFG Hermes

Elena: Good afternoon and good morning everyone, and welcome to the Gulf Bank year-end 2019 results conference call. It is a great pleasure to have with us in the call Mr Antoine Daher, CEO of Gulf Bank, Mr Kevin Smith, CFO of Gulf Bank and Ms Dalal Al Dousari, Head of Investor Relations at Gulf Bank. The call will begin with a presentation from management on the key highlights from our 2019 results and then we will open the call for the Q&A session

Dalal: Thank you, Elena. Good Afternoon and Welcome to Gulf Bank's year-end 2019 financial results conference call. We will start the call today with a presentation of the key highlights of the Gulf Bank performance during the year 2019 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 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 corporate 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. Please feel free to reach out to our investor relations team at investor.relations@gulfbank.com.kw if you have any inquiries.

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

Tony: Thanks, Dalal. I'm very pleased to be with all of you today and would like to summarize our 2019 results by sharing five key messages:

First, turning to **page 3,** we reported a net profit of 63.6 million in 2019, 12% higher than our 2018 net profit of 56.7 million.

Second, on **page 4**, you can see that our earnings per share also grew by 12% and the Board of Directors is recommending a cash dividend of 11 fils per share, subject to approval at the Annual

General Meeting to be held in March 2020. This represents a 50% payout ratio to our shareholders and a 10% increase vs. a payout of 10 fils per share in 2018.

Third, **Page 5** shows the progression of our total Customer Loans over the last three years. You can see from the blue line, we've grown our customer loans by 750 million or 20% since 2016.

We ended 2019 with total loans to customers exceeding 4.5 billion for the first time ever, up 6.2% compared with the end of 2018. The growth was well balanced as our Consumer business segment and Corporate business segment each contributed roughly half of the total growth. Corporate loans were particularly strong in the fourth quarter and we were able to catch up to the industry growth rate without compromising credit quality or losing market share. As a result, Corporate loan growth accelerated from 1.4% in 2018 to 4.6% in 2019. In our Consumer segment, loans grew 9.1% and has outpaced industry growth by nearly 2 times for the second year in a row

Fourth, on **page 6**, the non-performing loan ratio over the last two years has stabilized near industry norms and stood at 1.1% at the end of 2019.

Fifth, on **page 7**, we maintained our 'A 'ratings and outlook from the four major credit rating agencies and here is where we stand:

- Moody's Investors Service maintained its Long-Term Deposits Rating of "A3" with a "Positive" outlook.
- Fitch Ratings affirmed its Long-term Issuer Default Rating of "A+" with a "Stable" outlook.
- S&P Global Ratings affirmed its Issuer Credit Rating at "A-" with a "Stable" outlook.
- Capital Intelligence affirmed its Long-term Foreign Currency Rating of "A+" with a "Stable" outlook.

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

Kevin: Thanks Tony.

Page 8 shows how our balance sheet has moved from the 31st of December 2018 to the 31st of December 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 1-14.

Over the course of the last 12 months, our total assets grew by 229 million or 4% to over 6.2 billion. This was largely driven by growth in net loans, shown on line 9, which were up 344 million or 8% offset partially by a reduction in our liquid assets of 129 million, shown on line 5. This reduction in liquid assets was mainly driven by 164 million in maturing Kuwait Government Bonds and 43 million of maturing Central Bank of Kuwait Bills, shown on lines 2 and 3, and a 28 million reduction in financial institution deposits, shown on line 4, offset partially by holding 106 million more cash and cash equivalents, shown on line 1.

So, our net loan mix, shown on line 9, increased as a percentage of total assets from 68% to 71% while our liquid asset mix, shown on line 5, correspondingly decreased as a percentage of total assets from 27% to 24%.

The mix of investment securities and other assets, lines 10 and 13, remained relatively unchanged from a year ago, at 5% of total assets.

If you look on lines 20 and 21, to the far right, of the 229 million in asset growth over the period, 193 million or 84% of that growth was funded with liabilities and the remaining 36 million or 16% was funded with equity.

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.

Average assets and average equity are shown on line items 23 and 24 as these balance sheet metrics allow us to calculate our return on assets and return on equity which I'll discuss when we cover the income statement.

Our non-performing loan ratio, shown on line 25, declined from 2.6% at the end of September 2019 to 1.1% at the end of December 2019 and our coverage ratio improved from 314% at the end of September 2019 to 602% at the end of December 2019. As we mentioned during the third quarter earnings call, we have now fully provided for the loans which were downgraded in the first quarter and, even though there is collateral, personal guarantees, and company assets backing these loans, they have either been fully written off or written down to their collateral value. So, for these accounts, specific provisions have been front-end loaded in 2019 and future recoveries will be booked when cash or proceeds from collateral sales have been received or when asset swap settlements have been executed.

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 2019 of 282 million as shown on line 8.

Now, turning to **Page 9**, this is where we stand on IFRS 9 requirements and excess provisions as of the end of 2019. In the table on the right, under the column marked '2019', when you take the total loan provisions of 282 million as shown on the previous page and add provisions on non-cash facilities of 14 million, which are included in other liabilities, we had 296 million in total provisions on our balance sheet compared with 190 million in expected credit losses (or ECL) under the IFRS 9 accounting standard.

This means the amount of total provisions in excess of the IFRS 9 requirements, or what we call 'excess provisions', exceeded 100 million for the second straight year. On the left, you can see that these excess provisions represent an extremely healthy 36% of the total provisions on our balance sheet, unchanged from a year ago, and one of the highest ratios in the industry.

Page 10 shows our income statement performance from 2017 to 2019 along with some other key metrics, so you can see how our performance has changed over the last three years.

On line 11, you can see that our Net Profit in 2019 was 63.6 million, 12% higher than our net profit as reported in 2018. This helped us achieve important milestones in terms of our return metrics. Our return on assets, line 12 improved from 97 basis points in 2018 to 105 basis points in 2019 and our return on equity, line 13, improved from 9.4% to 10%. We are extremely pleased in getting these two metrics above 1% and 10%, respectively.

The change in 2019 vs. 2018 net profit was driven by three main factors as shown on the far right under the column '19 vs. 18':

(1) First, on line 6, Operating Income increased by 13 million or 7% driven primarily by higher Interest Income of 33 million, shown on line 1, offset partially by higher Interest Expense of 21 million, shown on line 2.

The higher interest income of 33 million was mainly due to growing our net loans by 8%, increasing our yields as a result of the full year effect of the CBK interest rate hike in March 2018, a positive mix impact as we shift from lower yielding corporate loans to higher yielding consumer loans, and recognizing

19.7 million of interest income from a previously impaired loan after winning an appeals court judgement in the fourth quarter of 2019.

The higher interest expense of 21 million was mainly due to funding cost pressures due to four US Federal Reserve interest rate increases of 25 basis points each in 2018 (and correspondingly higher screen rates offered to our depositors), but only one discount rate increase by the Central Bank of Kuwait in March 2018. The good news is that these funding cost pressures have started flattening out as the US Federal Reserve reversed course in 2019 by cutting their benchmark rate by 25 basis points three times in July, September, and October and the Central Bank of Kuwait cutting their benchmark by 25 basis points in October. As a result, our Interest Expense increased by only 0.2 million in the fourth quarter of 2019 vs. the third quarter of 2019 whereas the average quarterly increases over the previous six quarters were 1.4 million.

(2) Second, on line 7, operating expenses were 11 million higher than 2018. Excluding a one-time expense provision of 2.8 million booked in the first quarter, recurring expenses were up 8 million or 12% compared with 2018.

These higher expenses were driven by four major factors:

First, establishing a new central hub for our customers and employees at Crystal Tower.

Second, investing and enhancing our IT infrastructure, customer applications, and information security.

Third, increasing incentive payments made to sales and support staff who continue to deliver strong performance for us in terms of loan and revenue growth.

Fourth, hiring more front line and branch staff necessary to drive, support, and retain the 20% loan growth we have seen in our Consumer and Corporate business segments over the last three years

(3) The third factor driving our 12% net profit growth in 2019 can be seen on line 9 where our total provisions and impairments were lower in 2019 by 5 million.

Turning to **page 11**, our regulatory capital ratios remain strong as our Tier 1 ratio of 13.8% was about 180 basis points above the regulatory minimum of 12% and our Capital Adequacy Ratio (CAR) of 17.1% was roughly 310 basis points above the regulatory minimum of 14%.

On the bottom right, our leverage ratio was 9.3% at the end of December

2019, up slightly from 9.2% at the end of December 2018 and well above the 3% minimum.

Page 12 shows our key liquidity ratios. On the left side, you can see that our average daily Liquidity Coverage Ratio was 313% in 2019, well above the minimum of 100%. On the right side of the page, our NSFR ratio of 111% also exceeds the 100% minimum. So, both liquidity ratios have more than adequate buffers above the regulatory minimums.

In summary, 2019 was a challenging year in terms of the funding and operating expenses necessary to support the growth of the business segments. However, we overcame severe pricing pressure in the Corporate business segment over the first 9 months in 2019 by posting significant fourth quarter growth and catching up with the overall industry growth rate. In addition, we continued to execute our aggressive growth strategy in the Consumer Banking segment, gaining coveted market share and growing loans at nearly two times the industry rate for a second year in a row.

Finally, in 2018, we demonstrated an ability to recover previously written off principal on a historically impaired loan, that amount being 36.5 million. In 2019, we went a step further by demonstrating an ability to recover non-accrued interest on that same loan, that amount being 19.7 million. These two important steps have given us renewed confidence that our loans to corporate customers in Kuwait were structured properly, enforced legally, and provisioned conservatively.

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)

Questions

Dalal (Q1): We have a question on the drivers of loan growth in 2019. Kevin, can you comment?

Kevin (A1): Our Consumer Banking segment continued its strong momentum by growing 133 million, up 9% from the prior year and we've grown our loans in this segment for 14 straight quarters. As far as Corporate loans, despite intense competition, we were able to execute on a strong deal pipeline in the fourth quarter and our loans grew by 128 million for the year, up 4.6%. The growth was within our risk appetite, didn't compromise our hurdle rates, allowed us to match the industry growth rate for the year, and we didn't lose market share.

Dalal (Q2): We received a few questions regarding net interest income and margins, NIMs outlook, also interest expense and funding cost.

Kevin, can you cover these questions?

Kevin (A2):

First, let me start with interest income and yields. Excluding the 19.7 million interest income one-off, margins fell from the third quarter to the fourth quarter of 2019 and that was mainly due to the October discount rate cut by the Central Bank of Kuwait. Going forward, we expect the full year effect from the strong fourth quarter Corporate loan growth to more than offset the negative yield impact from the 25 basis point cut by the Central Bank in October 2019.

Second, regarding interest expense and funding cost. As I mentioned earlier, funding cost increases have been flattening out. And, in the last few days, screen rates have been reduced again and are now in line with the Federal Reserve cuts last year. And, that will also help. However, there is strong and growing demand amongst banks for deposits and we expect that will prevent funding cost from declining significantly from the current levels, at least over the short term.

Dalal (Q3): A question on the strong pickup in 4Q19 fee income and implications on 2020.

Kevin (A3): It's helpful to split fee income between net fees and foreign exchange fees on the income statement. Even though our fourth quarter 2019 net fees were up compared with the third quarter, our full year net fees in 2019 and 2018 were nearly the same at 30 million. On the other hand, we did see strong double-digit growth of 10% in foreign exchange income, from 9 million in 2018 to KD 10 million in 2019, and that growth was well balanced between our Consumer and Corporate business segments.

Dalal (Q4): we have several questions on operating expense growth and 2020 expectations.

Kevin (A4): Excluding the 2.8 million one-off in the first quarter of 2019, our total operating expenses in 2019 were 75 million, up 12% vs. 2018. As I mentioned earlier, we've made investments in a new central hub, IT infrastructure, and our businesses to support loan and deposit growth. As a result of a full year effect of these investments and inflation, we are trying to hold 2020 operating expenses to no more than mid-single digit growth above 2019 levels.

Dalal (Q5): Update on the drop in the NPL ratio and the downgraded corporate borrower of 2019?

Kevin (A5): At the end of 2019, we fully provided for this corporate borrower that was downgraded in the first quarter of 2019 and it has been fully written-off from an accounting perspective. This is the major driver behind the non-performing loan ratio dropping from 2.6% at the end of September 2019 to 1.1% at the end of December 2019. As a result, going forward, any cash and/or asset swap settlement associated with this borrower will be recorded as recoveries.

Dalal (Q6): a couple of questions on cost of risk and target for 2020? Kevin, can you answer these questions?

Kevin (A6): If you look on page 10, our cost of risk was 2.14% in 2017, .03% in 2018, and 1.38% in 2019. So, the three-year average cost of risk per year from 2017 through 2019 was 1.18%.

Given the fact that we have learned a great deal from what can go wrong and how to get access to our collateral through the legal and settlement process in Kuwait, we would expect to achieve a long-term cost of risk below that three year average.

In terms of 2020, given the conservative provisioning of several borrowers in 2019, the likely recoveries on these loans, a strong underlying loan portfolio, and ending the year with such a low non-performing loan ratio of 1.1%, we expect 2020 to be on the lighter side of that three year average.

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.