National Bank of Kuwait

2Q 2018

Earnings Conference Call

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Corporate participants:

Mr. Isam Al Sagar – Group CEO

Mr. Jim Murphy – Group CFO

Mr. Amir Hanna – Head of Investor Relations

Chairperson:

Elena Sanchez – EFG Hermes

Operator: Good day and welcome to the National Bank of Kuwait 2Q 2018 earnings call. Today's conference is being recorded. At this time I'd like to turn the conference over to Elena Sanchez of EFG Hermes. Please go ahead.

Elena Sanchez: Good afternoon and good morning everyone and welcome to the National Bank of Kuwait 2Q 18 results conference call and webcast. It is a pleasure to have with us in the call today Mr. Isam Al Sager, Group CEO of NBK, Mr. Jim Murphy, Group CFO of NBK and Mr. Amir Hanna, Head of Investor Relation of NBK. I would like to handover the call now to Mr. Amir Hanna.

Thank you

Amir Hanna: Thank you Elena for the introduction.

Good afternoon everyone. We are glad to have you on our call today.

Similar to our previous call I will start by reading a brief disclaimer while our full disclaimer will be displayed on the screens in front of you "Certain comments in this presentation may constitute forward-looking statements. These comments reflect the Bank's expectations and are subject to risks and uncertainties that may cause actual results to differ materially and may adversely affect the outcome and financial effects of the plans described herein. You are cautioned not to rely on such forward-looking statements. The Bank does not assume any obligation to update its view of such risks and uncertainties or to publicly announce the result of any revisions to the forward-looking statements made herein." This concludes our disclaimer for this event.

On the structure of the call, we will start the call by some opening remarks from our Group CEO, Mr. Isam Al Sager. This will be followed by a detailed presentation by Mr. Jim Murphy, our Group CFO, on the quarterly and half year figures. After concluding the management presentation, we will start addressing all your questions received through the webcast facility but feel free to type in your questions at any time during the call. As the case will always be, we will make every effort to answer all the questions received but if any were left unanswered due to time constraints or for any follow up questions that you might have, please feel free to reach us through our investor relations email address which you can find on NBK Group website.

You can also download the presentation as well as our full set of financial reports for the reporting period from NBK Investor Relations website.

Without further comments let me hand the call over to Mr. Isam Al Sager, our Group Chief Executive Officer for his opening remarks.

Isam Al Sagar: Thank you Amir.

Good afternoon everyone,

Thank you all for joining our second quarter 2018 results conference call and webcast.

During the first half of 2018, we saw a continuation of the robust business performance and profitability trends achieved in 2017. We started the year with a very strong first quarter and the positive trend continued in the second quarter as well. Our first half net attributable profits now reached KD185.9 million which is equivalent to USD613.8 million. This is 12.9% increase compared to the first half of 2017. This leads us to believe that 2018 will be another year of record profits for NBK.

I would also like to highlight our quarterly profits which reached KD92.3 million in the second quarter and growing by 16.3% year on year.

We are very proud of these exceptional results and the efforts behind them. More importantly, we are quite satisfied with how these results are achieved. And here I would like to specifically highlight that most of our profit growth comes from core banking revenues. This has allowed us to deliver consistently strong results. As you all know, NBK is one of the very few banks in the region with little volatility in its bottom line. We continue to report steady income growth quarter after quarter and year after year and this is our main strength.

Moving to our balance sheet, the main thing I would like to highlight here is the continuation of the strong performance of our business lines. On the assets side all our businesses performed well and continued to book new and high quality assets. Our diversification strategy is keeping us ahead of our peers as we benefit from the strong operating environment in Kuwait as well as in some of our other key markets, mainly Egypt and GCC. We have outpaced the growth trends in the domestic market over the past few quarters as was evident in our loan growth figures. Coming back to 2018, our year-to-date loan growth reached 5% and that is an indication of the growth in the business activity we are seeing in different segments as well as in our different locations.

In Kuwait, we continued to see good momentum in the economic indicators. The capital spending plan remains a key driver of economic activity and the stability of oil prices, after recovering earlier, continued to support the country’s fiscal position and the private sector sentiment.

Our operations in Kuwait remain very strong and we continue to benefit from this strong economic backdrop. This helps the overall sentiment and supports our outlook for good credit growth going forward.

Also our Islamic banking subsidiary, Boubyan Bank is helping us strengthen our market positon in Kuwait, being the only Kuwaiti bank with access to both conventional and Islamic banking markets. Boubyan continued to deliver strong growth and the outlook for its operations remains very positive, with improved contribution to group earnings.

Similarly, our international operations are very solid supporting our diversification targets. The profits from our international business remained strong contributing close to 30% of the Group’s bottom line.

As you might recall, I have mentioned in the previous quarter our focus on innovation and technology being important pillars to our strategy execution. To update you on that front, during the second quarter, NBK introduced SWIFT GPI service joining the GPI community which consists of more than 150 banks. We also signed with Ripple Labs to be the first bank in Kuwait to offer the latest technology for instant cross-border payments. These two initiatives will position NBK ahead of peers in transfer technology enabling us to better serve our customers through improved offerings along with more enhanced and complete customer experience.

With that I would like to conclude my comments and handover the call to Jim to cover our quarterly and half year results in more details and answer any questions.

Jim.

Jim Murphy: Good afternoon everyone, and welcome. I am very pleased to have this opportunity to take you through our June 2018 financial results.

We have announced profits of KD185.9m for the six month period to June 2018. That represents a 12.9% increase over the comparable period in 2017.

The profit for the second quarter of 2018 was KD92.3m. This compares with a profit of KD93.6 m in the opening quarter of this year. Note that this slight drop in quarterly earnings is due to higher provisioning in the second quarter.

I am pleased to point out however that the operating surplus in quarter two is significantly ahead of this years first quarter, ahead by KD9.3m.

The KD92.3m net profit for the current quarter compares with KD79.3m in the comparable quarter last year. This is a period on period increase of 16.3%.

The Groups operations during the reporting period took place in what I would describe as broadly supportive operating environments. Macro-economic conditions and business confidence have been trending upwards, and the continued rise in domestic and international interest rates has been conducive to earnings growth at the Group.

We saw solid performances across entirety of our Group operations. We saw solid performances across our various lines of business within Kuwait and across our various geographies, both in the MENA region and in our international operations further afield.

In addition to our geographic and lines of business diversification, NBK is of course uniquely positioned to actively compete in both conventional banking and Islamic Banking in Kuwait. We compete in Islamic Banking through our subsidiary Boubyan Bank.

We will see later on the extent and importance of our diversified operating portfolio when we look at the contributions to Group earnings from the various diversified operations.

Returning now to our results. The operating surplus (i.e. pre-provision pre-tax earnings) for the six month period to June 2018 was KD307.1m. That is a 12.4% increase on the comparable period in 2017. The period benefitted from a solid 10.9% increase in total income, whilst the growth in costs was contained at 7.5%.

Later on I will drill into the drivers behind the income growth and the cost growth.

Looking briefly at the quarterly results, we can see that the KD158.2m operating surplus for quarter June 2018 compares with KD148.9m in quarter one of this year. That is a 6.2% increase quarter on quarter.

The operating surplus in quarter June 2017 was KD139.3m. Quarter June 2018 is therefore 13.6% ahead of the comparable quarter last year. This serves to demonstrate the extent of growth and momentum that has been in evidence of late.

Operating income grew by 10.9% in the six month period to June 2018 as compared to the six month period to June 2017. Operating income for the period totaled KD442.2m, as compared to KD398.8m last year.

Just taking a quick look again at the quarterly results, we see that operating income for the second quarter of this year was KD228.7m as compared to KD213.4m in the opening quarter of this year, and with KD203.4m in the second quarter of last year.

The primary drivers behind the growth in operating income are (1) a very solid 10.4% growth in net interest income and (ii) an exceptionally strong performance in fee income. Fee income is 13.6% ahead of this time last year. I will go into some details on this shortly.

The operating income mix is profiled on the bottom right hand right side of this first slide. 76% of our total operating income is in respect of net interest income and 24% from non-interest income sources. The mix remains essentially as per last year.

I will now examine our net interest income performance for the period, and the growth drivers behind this performance.

Net interest income at KD336.8m in the six month period to June 2018 compares with KD305.2m in the period to June 2017. That is a period on period growth of 10.4%.

Looking briefly at the quarterly results, we see that the net interest income at KD173.2m for the June 2018 quarter compares with KD163.6m in the opening quarter of this year, and with KD157.7m in the second quarter of 2017.

Net interest income is of course a function of volumes and margins.

In terms of volumes - the period saw steady growth in average interest earning assets.

Average interest earning assets were KD25.4bn during the half year to June 2018. This is a growth of 3.2% on the six month period to December 2017, and a 6.8% growth on the six month period to June 2017. This growth in interest earning assets reflected strong growth in loans and in investments.

I will return to the matter of loan growth shortly.

Coupled with the solid growth in interest earning assets, we can see that the Group is enjoying the benefit of an increasing net interest margin.

If you look at the bottom left hand side of this slide you will see that the average net interest margin for the six month period to June 2018 was 2.68%. That compares with 2.59% in the comparable period in 2017.

You will note that the average NIM for the second quarter of this year is higher than the year to date average, at 2.71%. The quarter two NIM reflects the impact of the increase in the Central Bank of Kuwait's discount rate which took effect in March of this year. The discount rate was raised by 25bps to 3%.

By way of note I can advise that the Groups funding cost increased by 40 basis points in the half year to June 2018 as compared to the half year to June 2017. The funding cost in the current six month period was 1.57%, as compared with 1.17% this time last year.

The Groups yield in the half year to June 2018 was 4.08%, as compared to 3.64% in the six month period to June 2017. That is an increase of 44 basis points. So just to recap, an increase in yield of 44 basis points, and a 40 basis points increase in funding cost.

If you look at the bottom right hand side of this slide you will see the constituent drivers that moved the NIM by 9 bps, from 2.59% in June 2017 to 2.68% in June 2018. The NIM was impacted favorably by 33bps due to movements in respect of the loan book, whilst the higher cost of deposits impacted NIM to the extent of 26bps.

We will now look at how non-interest income performed during the period.

Non-interest income for the six months to June 2018 was KD105.4m. This compares to KD93.6m in the six month period to June 2017. A 12.6% increase.

The composition of the KD105.4m total non-interest income is KD76.5m in respect of fees and commissions, KD19.0m in respect of foreign exchange activities and KD9.9m from other non-interest income sources. KD8.1m of the KD9.9m other income is in respect of investment and trading income.

Fees and commissions income delivered an excellent 13.6% period on period growth. We are particularly pleased with the performance of this income line, demonstrating as it does buoyant levels of business activities across our operations. The sources of the increase in fees and commission income were many, and were well spread across our various business lines and geographies.

As is clearly evident, the vast bulk of our non-interest income comes from core banking activities. NBK typically derives minimal contribution from volatile investment or trading incomes, focusing as always on our core franchise businesses.

Total non-interest income in the second quarter of 2018 was KD55.5m. That compares with KD49.9m in the opening quarter of this year, an 11.4% increase. We had several notable business events in the current quarter giving rise to additional fee income.

By way of comparison with quarter June 2017, total non-interest income in the second quarter of this year is 21.3% ahead.

Turning now to how operating expenses performed. Total operating expenses in the six month period to June 2018 was KD135.1m. That compares with KD125.7m in the six month period to June 2017, a 7.5% increase.

In looking at costs performance it is pertinent to point out that the 7.5% increase is of course in respect of the fuller NBK group. We have two very strongly performing subsidiaries i.e. Boubyan Bank and NBK Egypt. These two key subsidiaries continue to deliver very impressive growth, and accordingly they experience a higher rate of cost increase than is in effect across the fuller Group.

Closer to home, staff costs were impacted by changes to the Labor law in Kuwait during the course of 2017, which served to increase our staff costs period on period.

Looking now at the quarterly results, total operating expenses in quarter June 2018 were KD70.6m, as compared to KD64.5m in the first quarter of this year. I would point out that we typically witness a degree of seasonality in our cost base.

Staff costs in a second quarter for instance are impacted by the timing of our annual salary review cycle.

I would also make the point that we continue to invest heavily in our IT infrastructures, in cyber security technologies and in business enabling technologies.

NBK has long prided itself in being at the forefront of developments in technology, and we continue to press ahead in the pursuit of this core imperative for the Group.

We are very pleased to see that the consequent cost to income ratio has fallen to 30.6%, from 33% in the preceding six month period. I think it is fair to say that by most benchmark standards this is a very impressive ratio for this key operating efficiency measure.

I would also mention in passing that even at this low level the Groups overall cost to income ratio belies the fact that our efficiency ratio in Kuwait is sub 30%.

Turning now to provisions and impairments. Total provisions and impairments in the six month period to June 2018 amounted to KD93.9m. This KD93.9m charge against income comprises KD86.5m in respect of provisions for credit facilities and KD7.4m in respect of impairment losses on investments in associates at one of our subsidiaries.

Provisions and impairments in quarter June 2018 were KD51.6m. That compares with KD42.3m in the opening quarter of this year, and with KD48.1m in the second quarter of 2017.

I'll just take this opportunity if I may to remind you that the State of Kuwait has not yet fully adopted the provisioning requirements of IFRS 9. IFRS 9 requirements pertaining to expected credit losses on lending facilities remain superseded by the provisioning requirements of the Central Bank of Kuwait in this regard. We therefore computed an ECL charge in respect of other financial assets only.

We await further developments on this matter.

I would now like to return to the matter of earnings diversification.

One of the primary strategic objectives at NBK has long been an imperative to diversify our operations and earnings, but to do so of course in a manner that is consistent with risk and other prevailing parameters.

This slide demonstrates the impact of our diversification agenda on the Groups financial performance.

NBKs International operations contributed KD55.5m to Group profits in the six month period to June 2018. This compares to KD47.8m in the six month period to June 2017. That represents a period on period increase of 16%.

You will see from the pie chart on the right hand side that earnings from our International operations now contribute a well-established 30% of total Group profits.

In addition to our geographic diversification and as mentioned earlier, NBK is unique among Kuwaiti Banks in being positioned to operate in both conventional banking and Islamic banking. The Groups Islamic banking subsidiary Boubyan bank continued to perform extremely well, and delivered profits of KD25.8m in the six month period to June 2018. This compares very favorably to KD21.8m in the six month period to June 2017, and represents a strong period on period 18.6% increase in bottom line profit.

Looking at the totality and culmination of our diversification strategy, it is comforting to observe that almost 40% of Group earnings in the six month period to June 2018 were derived from our International and Islamic banking operations combined.

The impact of diversification on our assets base is such that 51% of Group assets are at our conventional Domestic operations in Kuwait, 15% at Boubyan Bank and 34% at our International operations. This is in keeping with the distribution of Group assets last year.

On this slide we will look at some key volume metrics for the period.

Total assets increased to KD26.9bn at the end of June 2018. This represents a 3.5% increase over December 2017, and a 5.7% increase as compared to June 2017. This increase in assets is driven primarily by growth in our loan book.

Our loan book, at KD15.2bn, increased by approximately KD700m in the six month period to June 2018, and by approximately KD900m in the twelve month period from June last year. This represents a very strong 5% growth in our loan book in the six month period to June 2018.

It is very encouraging to note that strong underlying growth was had in all of the Groups key lending markets i.e. Domestic, International and Islamic.

Customer Deposits, at KD14.6bn, grew by 6.1% as compared to December 2017, and by 7.8% as compared to June 2017.

In addition to witnessing this very strong growth in Customer Deposits we were very pleased to see that a very significant part of this growth was in respect of core franchise deposits, with excellent growth in retail deposits.

The growth in retail deposits reflects a focus on the deposit gathering aspects of our business in recent times, including a focus on bringing new, innovative and relevant products to the market place.

I would also like to mention that in growing our deposit funding base we are able to capitalize on the strong NBK brand, leveraging the well established relationships that have been in place for many years across our various banking businesses and geographies.

Our funding mix has changed slightly, and favorably, over recent periods, with Customer Deposits now comprising 64% of the Groups funding mix. This has increased from 62% in June 2017 and December 2017.

Before moving on from this slide I would just like to remind that deposits from our financial institution customers are not included with customer deposits. This distinction is relevant if one were to try computing a loan to deposit ratio.

On this final slide we will look at the impact of our financial results on certain key performance metrics.

The Return on Average Equity for the six months to June 2018 was 12.3%. This compares to 10.8% for the full year 2017, and to 11.3% in the six months to June 2017.

The Return on Average Assets for the six months to June 2018 was 1.41%. This compares to 1.28% for the full year 2017, and to 1.34% in the six months to June 2017.

The Capital Adequacy Ratio at June 2018 was 17.2%. This compares to 17.8% at year-end December 2017. This decline is primarily due to the construct of the ratio at interim reporting periods. Interim profits are excluded from the computation at interim reporting periods.

In addition to this matter of timing, there was also a small negative impact on our capital base as a result of the partial transition to IFRS9 earlier this year.

Assets quality ratios remain solid, with the NPL ratio at 1.4% and the coverage ratio at 254%. Although somewhat tighter than the very strong ratios that were in existence in June 2017, the current ratios remain broadly in line with the December 2017, where the NPL ratio was 1.42% and the coverage ratio 287%.

That brings an end to my presentation.

Before I hand back to Amir, I am happy to summarize by saying that 2018 has thus far been a very solid and satisfactory operating period. Excellent growth has been had across all business units of the Group against a backdrop of broadly favorable trading and operating conditions.

We look forward with confidence to the remainder of 2018, with strong hopes of building on the results of the first six months of this year and hopeful of harnessing the strong momentum that is in the business.

Thank you again for your time.

And now back to Amir.

Amir Hanna: Thank you everyone for listening. We will pause for a minute or two while you type in your questions. If you have any questions put it in. We will leave the line with the operator.

Operator: Thank you. If you would like to ask a question, please type them over the webcast facility. We'll pause for just a moment to allow everyone an opportunity to enter their question.

Amir Hanna: So we are back on the line. We are just waiting for the questions to come in. We have a question that we will start with.

The first question is basically asking; could you provide some color on why did impairment charges go up significantly in Q2? Particularly specific provisioning. Are you expecting some big NPAs? Jim

Jim Murphy: Thank you Amir.

What we saw in effect was a continuation of the situation that we had in the earlier quarter of this year. We await the full implementation of the IFRS 9. In advance of the full adoption of the standard we have the opportunity to address facilities that we expect would fall under the impact of IFRS 9. So given that the facilities in question would be addressed in due course, we feel that the time is appropriate to continue with the review of the loan book as per Q1.

We don't expect any major change until the time we get greater clarity from the regulator.

Amir Hanna: The second question says corporate banking total assets grew year-on-year and by 0.6% year to date. Is growth coming mainly from consumer banking and Islamic banking? Your comments on this and is there project award activity happening at a good pace?

Jim Murphy: One has to bear in mind that corporate banking is impacted by timing. Quarter on quarter it is difficult to detect trends, but I can say that corporate lending continues to perform very solidly. We have had some sizeable settlements earlier as you may know. When you stand back and look at the totality of the corporate loan book out over time, in respect of domestic corporates and foreign corporates , I think what we will see is a progressive, true, and fairer picture of how corporate banking is performing.

Amir Hanna: The third question, what kind of growth do you expect to see in the Saudi market? And what could be its contribution to loan growth and profitability in FY 2018 and FY 2019?

Isam Al Sager: We are expanding our presence in Saudi Arabia. We have a license to open 2 more branches, one in Riyadh and one in the Eastern Province. And also, we are expanding by introducing our wealth management operations. I think this will give us good growth in the Saudi market overall.

Amir Hanna: Next question, has CBK shared any updates on loan provisioning related to IFRS9?

Jim Murphy: We have nothing concrete, obviously we are in very close contact with the Central Bank of Kuwait and we are running the standard in parallel with the existing provisioning regime. So as such, we will just continue to see what emerges in the coming quarters.

Amir Hanna: What is the CASA share of overall deposits? And what drove the increase in deposits in H1?

Jim Murphy: CASA constitutes approximately above 30% of our book. The increase in deposits was across the board, with increases in CASA and in time. We have been focusing as I mentioned earlier during the presentation on retail deposits. Retail deposits for a Bank are good deposits; franchise deposits. Through our extensive network and established relationships we have been actively gathering deposits of various tenor. For the past couple of quarters and certainly for the first six months of this year, we had seen very good returns in terms of the efforts that we have put into deposits gathering.

Amir Hanna: The next question is basically repeating the question on provisioning and NPLs. Could you provide some color on the cost of risk in H1? Why is it so high? Are you seeing lot of NPLs formation taking place? Are you doing write-offs? With the latter if happening; why?

Jim if you don't mind can you just pick up this briefly for someone who missed the answer in the first round.

Jim Murphy: What we are doing in advance of IFRS9 taking full traction is reviewing our book and taking the opportunity to provide what we feel is appropriate for facilities that will in due course fall under IFRS9.

Amir Hanna: A question on – can you provide a breakdown of the fee income? What were the main drivers of the strong Q2 performance? What kind of trends should we expect in H2 and in 2019?

Jim Murphy: Fee income was particularly strong in the quarter. A very welcome feature of fee income during the quarter was the strong growth in evidence across all our lines of business and across our geographies. We saw very solid growth in Kuwait. We saw solid growth overseas and we saw solid growth at our Islamic operations.

Within Kuwait, we saw good performances in the key lines of business; credit cards, trade finance, and our asset management business. NBK Capital, which of course is a very important part of NBK's armoury, performed strongly.

Jim Murphy: There is momentum within the business. Will we see a repeat of the Q2 performance? Probably not, because some large transactions came together in that particular quarter. But overall, when you stand back and look at how fee income is performing, we do expect growth to continue, albeit not perhaps, at the same rate witnessed in Q2.

Amir Hanna: Next question; 'How have the project award implementation activities been in Q2 and how do you see it evolving over the rest of the year?'

Isam Al Sager: Well, this also depends on the government, if they are going to award any of the projects – I mean the major projects – in the next quarter, or the next two quarters. Hopefully I think, as I mentioned earlier, there is more sentiment for more projects to be awarded in the next half of this year. Of course, as you know, NBK is a big player in this big project and a main driver in it and we benefit a lot if more projects are being awarded.

Amir Hanna: We're just waiting for more questions. We don't have any further questions at the moment, so we'll give it another couple of minutes and we'll conclude if nothing comes in.

Jim Murphy: Okay. We're getting more questions coming in pertaining to IFRS9. I think these questions may have come in late – just to repeat, we await the fuller implementation of IFRS9. The exact guidelines, and exactly how they will be applied, we await guidance from the Central Bank. And unfortunately, in respect of one or two questions we have here, I'd be disinclined to anticipate exactly what the Central Bank will require in this regard.

Amir Hanna: We have a question on NIM movement. 'What is the sensitivity of the balance sheet to interest rate increases? How should the 25 basis point rate rise boost NIM?'

Jim Murphy: Well, broadly the way to look at it is a 25 basis points increase in the discount rate would typically add in the region of 10 to 13 million to our net interest income. Based on that, you will be able to compute the impact on NIM.

Operator: Your line is open, yes.

Amir Hanna: Yes, I think with this, we would like to conclude our call. Sorry if there was any inconvenience. We are not seeing any more questions; all questions have been handled and I would like to conclude that call. Thank you again all for joining us and I will take that back to the Operator.

Operator: This concludes today's conference call. Thank you for your participation. You may now disconnect.