National Bank of Kuwait

3Q 2019 Earnings Conference Call

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Corporate participants:

Mr. Jim Murphy – Group CFO

Mr. Amir Hanna – Head of Investor Relations and Corporate Communications

Chairperson:

Elena Sanchez – EFG Hermes

Operator: Good day and welcome to the National Bank of Kuwait 3Q 2019 results conference call. Today's conference is being recorded. At this time, I'd like to turn the conference over to Elena Sanchez. Please go ahead Elena.

Elena Sanchez: Yes, thank you.

Good afternoon and good morning everyone. This is Elena Sanchez from EFG Hermes, welcome to the National Bank of Kuwait 3Q 2019 results conference call and webcast. It is a pleasure to have with us in the call today Mr. Jim Murphy, Group CFO of NBK and Mr. Amir Hanna, Head of Investor Relations and Corporate Communications of NBK. I would like to handover the call now to Mr. Amir Hanna.

Thank you.

Amir Hanna: Thank you Elena.

Good afternoon everyone. We are glad to have you with us today on our third quarter 2019 earnings webcast.

Before we start I would like to bring to your attention that 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. Also I would like to refer you to the full disclaimer in our presentation for today's call.

After concluding our presentation, we will start addressing all your questions but feel free to type them in at any time during the call. You can also send any follow-up questions to our Investor Relations email address. Finally and for your convenience, today's presentation is already available on our Investor Relations website.

Now let me hand over the call to Mr. Jim Murphy, our Group CFO, to run you through the third quarter and of the nine months results in details.

Jim …

Jim Murphy: Thank you Amir

Hello everyone, and welcome. I am very pleased to have this opportunity to take you through our results in respect of the nine months period ended September 2019.

We have announced profit of KD302.2m for the full nine months to September 2019. This is a 10.9% increase in bottom line profit over the comparable period last year.

The profit for quarter three of this year was KD93.1m. This compares with a quarter two profit of KD101.4m, a decrease of 8.2%. Profit for the current quarter was however 7.6% ahead of the corresponding quarter last year.

Before going into the details behind our results I would first however like to say a few words as to the overall operating environment so far this year.

Conditions have remained broadly favorable. That said, whilst good business opportunities were to be had, competition has been strong and keenness in pricing is a feature of the market. Overall however the general trend is encouraging and the current period demonstrates positive momentum.

Progress continued as regards implementation of the government's multi-year development plan. Although the pace of project awards has been below expectations so far this year, we remain of the view that this is a matter of time shifting to future period.

The implication for the banking sector remains therefore that the direct financing and the cascade or ripple through effect associated with the execution of the development plan will continue to offer solid business opportunities going forward.

Returning now to the operating performance and financial results for the period.

Solid growth in levels of business activity was had at our Kuwait and International operating units, across multiple lines of business.

We saw continued strong growth at our Islamic Banking subsidiary Boubyan Bank. Boubyan Bank delivered a 12.2% year on year increase in profits, to KD45.2m for the opening nine months of this year.

Our International businesses also continue to perform strongly. We will see later in this presentation the materiality and importance of our fuller diversification agenda when looking at the contributions to total Group earnings made by the various banking footprints enjoyed by the Group.

The Groups operating surplus (i.e. pre-provision pre-tax earnings) was KD451.0m, a 1.9% reduction on last year. Income growth during the period was 1.7%, whilst growth in costs was 9.8%.

The 10.9% growth in net profit was therefore driven essentially by a lowered cost of risk, with loan provisions totaling KD101.3m, as compared to KD136.9m last year.

As regards quarterly performance, the operating surplus for the third quarter of this year was KD144.9m. This was lower than Q219's operating surplus, primarily due to lower non-interest income and higher costs. The KD144.9m Q319 operating surplus compares to a higher KD152.6m operating surplus in Q318. These lower numbers were due to subdued period on period income growth, and higher costs.

As regards operating income, the operating income for the first nine months of this year was KD672.8m. This compares to KD661.8m in September 2018, a 1.7% increase.

The drivers behind the year on year growth in operating income were net-interest income, fee income, FX income and other non-interest income sources.

The operating income in respect of the September 19 quarter was KD220.9m. This is down on the KD226.3m reported in Q219, but 0.6% ahead of the comparable quarter last year.

I will go into the main drivers behind the movements in income, margins and costs in our later charts.

The operating income mix is profiled on the bottom right hand right side of this first slide. 77% of total operating income is in respect of net interest income, and 23% from non-interest income sources. This compares with a mix of 78% and 22% last year.

Moving on now to chart number 2.

Here we will look net interest income and at the growth drivers behind its performance.

Net interest income at KD517.0m in the nine months to September 2019 compares to KD515.0m in 2018. Whilst net interest income benefitted from strong growth in loan and investment volumes, the outcome however was adversely impacted by attrition in the net interest margin.

Net interest income for the September 19 quarter, at KD172.6m, was in line with the preceding quarter, but down on Q318.

Interest earning assets averaged KD26.7bn in the opening nine months of this year. This is a year on year increase of 4.6%. The growth in interest earning assets essentially reflected strong growth in the lending and investment portfolios, the details of which we will look at shortly.

We have however experienced a contraction in our net interest margin vis a vis last year. This was in part due to the timing effect on our book in respect of the increase in the local discount rate that occurred in Q1 of 2018. Our margins typically boost relatively quickly in a rising interest rate cycle due to the repricing characteristics of our book whilst awaiting the lagged impact on funding costs to take full effect.

If you look at the bottom left hand side of this chart you will see that the net interest margin during the nine months averaged 2.59%. This compares to an average margin of 2.70% in the September 18 nine months.

The Groups funding cost averaged 2.15% during the opening nine months of this year, as compared to 1.64% in the comparable period last year.

The Groups yield averaged 4.50% in the period. This compared to a yield of 4.17% last year.

On the bottom right hand side of this slide we can see the constituent drivers that moved the average NIM downwards by 11ps, from 2.70% in the September 18 nine months period to 2.59% this year. The NIM was impacted favorably by 33bps due to the combined movements attaching to loans and other assets, whilst the higher cost of deposits impacted the NIM to the extent of 44bps.

Moving on now to chart no 3.

I will now speak about the Groups non-interest income.

Total non-interest income in the nine months to September 2019 was KD155.8m. This is 6.1% ahead of the comparable period last year.

The composition of the KD155.8m total non-interest income is KD116.8m in respect of fees and commissions income, KD31.0m in respect of foreign exchange activities and a net KD7.9m from other non-interest income sources.

Fees and commissions income was 2.1% ahead of this time last year.

Total non-interest income for the September 19 quarter was KD48.3m. This was down on quarter Q219 primarily due to lower fee and commissions' income, noting that Q219 was a particularly strong quarter, and negative valuation movements impacting on the investment and trading income line.

Total non-interest income is however 16.7% ahead of quarter three last year.

I would like to mention here that the sources of fees and commission income remain well spread across our various business lines and geographies. Business lines including lending, credit card, trade finance, asset management and brokerage continued to produce strong fee income on the back of solid operating performances.

As always, the bulk of our non-interest income came from what we regard as core banking activities. The Groups non-interest income is sourced primarily from fees and commissions and from foreign exchange activities. Earnings in respect of trading and investment income remains very small, at just 1% of total income.

Turning now to operating expenses. Total operating expenses in the nine months to September 2019 was KD221.8m. This is 9.8% ahead of last year.

There are a number of factors at play explaining the increase in costs and I would like to take time to elaborate on some of the cost drivers.

One such reason is the selective additional investment into a number of our businesses and geographies. We commenced new wealth management operations in KSA at the end of last year, and we also embarked upon a modest enlargement of our commercial banking footprint in that country. In addition we continue to press ahead with expansion of our Islamic banking operations at Boubyan Bank and our operations at NBK Egypt.

During the current year we also incurred Brexit related costs on foot of converting our former branch in France into a full subsidiary of the Group as a means of safeguarding business continuity post-Brexit. Some of these costs were once-off, whilst others will endure given the now changed status of our presence in that country.

In addition to driving forward with the normal business of the bank, we of course remain committed to maintaining appropriate and additional investment into those areas of operation that drive long term and sustained value to the Group.

We continued our ongoing programme of investment in IT and into advancing the Groups digital banking agenda. The global banking model is facing significant challenges, not least from digital disruption from established industry players but also from the rapidly evolving FinTech sector. We must respond appropriately to these challenges, and such responses require elevated levels of investment.

In this regard the Group invests heavily in (1) selectively developing and deploying the latest business enabling technology solutions, (2) in refreshing its IT platforms and infrastructures and (3) in ensuring first class cyber security resilience and capabilities.

We are focused on directing investment equally towards technologies that serve to improve the banking services that customers experience and also to technologies that improve the long-term efficiency and effectiveness of bank office operations. In this regard we are investing heavily into robotic process automation, focused on improving efficiency and customer service levels, and leading in time to cost saving opportunities.

We recently reinforced the banks executive band-width by way of on-boarding a number of additional senior technology personnel. With this comes a commitment to ramping up the associated investment into additional manpower resources and related IT expenditures.

And whilst on the subject of IT, I can advise that we have commissioned the Groups new modular data centre in Kuwait City. The data centre is state-of- the-art, complete with a full tier 3 certification.

Staying on the subject of costs, a new accounting standard took effect on January 1st this year, IFRS 16. The standard impacts on the accounting treatment for leases. This new standard requires an entity to recognize leases on balance sheet at amounts that recognize or value the right of use to an asset for the term of each lease, together with the associated liability in respect of future lease payments.

The salient part of the standard as regards its impact on our income statement is the recognition of the depreciation and interest expense associated with the relevant stock of leases, in lieu of rental expenses being included in other administrative expenses. The substantive impact has been an increase in depreciation and reduction in other administrative expenses of approximately KD6.9m - essentially therefore a reclassification between expenses categories.

So, to conclude on the subject of costs, I can say that whilst our cost to income ratio, at 33.0% has trended slightly upwards of late in response to the various cost and investment programmes that add to the long term health and resilience of the Group, we remain satisfied with what is still a very low ratio by international industry standards.

Moving on to provisions and impairments.

Total provisions and impairments in the opening nine months of this year amounted to KD104.7m, which compares to a total charge of KD145.4m last year. Note that KD8.5m of last year's charge was in respect of impairment losses re investments in associates primarily held through our subsidiaries.

The relevant charge for the September 19 quarter was KD37.5m. This compares to a charge of KD35.7m in Q219 and to KD51.5m in Q318.

Credit provisions in the nine months to September 19 therefore amounted to 22.5% of the Groups operating surplus, significantly below last year's level. This is naturally a very welcome development.

I will take this opportunity if I may to remind you that the Central Bank of Kuwait had earlier determined that the provisioning regime applicable to banks in Kuwait is such that the provision for losses on credit facilities be determined as the higher of expected credit losses under IFRS9 as per Central Bank of Kuwait guidelines, and provisions as computed in accordance with CBK rules and instructions.

As the latter instance prevailed, we therefore computed an ECL charge in respect of non-credit financial assets only, the income statement impact of which was immaterial.

Moving on now to chart no 4.

I would like to return to the matter of earnings diversification at the Group.

NBK is unique amongst Kuwaiti banks in terms of its geographical spread of operations, and also because of its ability to conduct business in both conventional banking and Islamic banking. This diversification gives a significant degree of resilience to Group earnings and provides what we consider a strong competitive advantage to the Group.

As mentioned earlier we established a new CMA regulated Wealth Management company in KSA late last year and opened two additional commercial banking branches in that country. This is significant as it now gives NBK a presence and enhanced reach in three cities, Jeddah, Riyadh, and Al Khobar.

We have also recently reinforced our private banking capabilities by creating an overarching Group level Private Banking structure that is tasked to grow and coordinate our private banking businesses across our international network.

And as mentioned earlier, the Group has not escaped the headaches and costs associated with Brexit. In order to best protect our business presence in Europe, we converted our operation in France into a fully-fledged subsidiary of the Group, from its earlier status as a branch of our UK subsidiary NBK International plc.

Returning now to the chart - the purpose of this chart is to demonstrate the impact of our diversification agenda on the Groups financial results.

Looking firstly at diversification by geography.

The operating income at our international operations, at KD164.4m, grew by 5.8% as compared to the prior year. The profit contribution from our international operations however was 3.3% below last year’s corresponding number. A large part of this disconnect is due to the increased investments and associated costs into our international businesses as already mentioned.

You will see from the pie chart on the top right hand side that the contribution to Group operating income from our International operations was 24%, slightly up on the 23% of last year.

The contribution to Group profits however in respect of our international operations reduced to 28% from 32% last year, essentially due to the falling cost of risk at Kuwait.

NBK is currently present in 14 countries outside of Kuwait, including of course in Egypt. NBK Egypt increased its number of branches in the period, from 48 to 50.

The Groups Islamic banking subsidiary Boubyan Bank continues to perform strongly, and delivered profits of KD45.2m in the opening nine months of this year. This compares favorably to a KD40.3m profit last year, representing as it does a strong year on year increase of 12.2%.

And finally on this chart, we see that the profile of assets was such that 47% of Group assets were at our conventional Domestic operations in Kuwait, 36% at our International operations and 17% at Boubyan Bank.

Moving to chart number 5.

On this slide we will look at some of the movements in key volumes during the period.

Total assets reached KD28.9bn. This is a 6.6% increase on the comparable period last year. As mentioned previously, the increase was driven primarily by strong growth in lending and investments.

Group lending increased to KD16.4bn, an increase of KD1.0bn in the twelve month period to September 2019, representing as it does a very solid year on year growth of 6.2%.

A significant part of this twelve month loan growth occurred in calendar year 2019. The loan book grew by 5.5% since the end of 2018.

Customer Deposits, at KD15.8bn, are 12.2% ahead of September 18 and show a 9.7% growth in the nine months to September 2019 - and just for purposes of clarity please note that customer deposits as defined here do not include deposits taken by the Group from financial institutions. This is in keeping with the presentation of customer deposits in our published financial statements.

An important message here is that within the headline numbers we continue to see a favorable movement in the Groups overall funding mix. We experienced very strong growth in core franchise deposits, noting in particular excellent growth in deposits at the retail banking arms of the Group in Kuwait, both conventional and Islamic. We were thus able to retire deposits of a more wholesale nature.

The growth in retail deposits reflects a sustained focus on the deposit gathering aspects of our business in recent times, leveraging NBK's long standing ability to capitalize on the Groups strong brand, customer appeal and credit ratings.

The Groups overall funding mix is profiled on the bottom right hand of this chart. Customer deposits comprise 65% of the total mix, which is higher than earlier periods as shown on this chart.

Moving to our next chart.

Here we will look at the impact that our financial results had on certain key performance metrics.

The Return on Average Equity in the nine months to September 2019 was 12.6%. This compares to 11.9% last year, and to 12.0% for the fuller year 2018.

The Return on Average Assets was 1.45%, the comparable returns being 1.36% last year and 1.38% for the fuller year 2018.

The total Capital Adequacy Ratio at September was 15.8%. This compares to 17.2% at year-end December 2018, noting that current year earnings are not factored into the computation of interim period ratios. The September ratio also reflects the impact of revised CBK prescribed risk weightings attaching to certain claims on sovereigns and public sector enterprises.

The T1 capital ratio at September 19 was 13.9%, whilst the CET 1 ratio was 12.6%.

As regards asset quality ratios, the NPL ratio was 1.37%, with coverage at 227.4%. These ratios are very much in keeping with earlier periods, and accordingly remain comfortable.

Before concluding, allow me to make a few comments as to how we expect the remainder of 2019 to unfold.

Generally speaking, we expect the momentum and trends that we have seen so far this year to continue.

Specifically, as regards loan growth. Loan growth in the nine months to September 19 was 5.5%. We expect to see out this year with high-mid to high-single digit growth for the fuller twelve-month period.

The net interest margin averaged 2.59% in the nine months period. Going forward, cognizant of the expectations for lower international interest rates and the likely implications for local benchmark rates, we expect to see continued pressure on margins. This, allied to ongoing pricing competition, can be expected to result in some further margin attrition.

Turning now to the cost to income ratio, which averaged 33.0% in the nine months to September 2019. We expect this ratio to remain broadly in line with existing levels whilst noting some upwards pressure due to the ongoing costs associated with our digitization and selective expansion agendas.

The cost of risk has been falling from earlier periods, to 82bps in the opening nine months of this year. We are assuming for now the charge for the fuller year to remain in this general territory.

Therefore, aggregating all relevant factors and assuming the reasonableness of the above, we currently expect full year earnings to broadly follow the year-to-date trend.

That brings an end to my presentation.

So before handing back to Amir I will summarize by saying that all things considered we are satisfied with the results so far this year. Solid and sustained business growth continued throughout the Group, albeit in conditions characterized by changed interest rate conditions and aggressive competition leading to pressure on margins.

It is against this backdrop that low growth in income was recorded. The income statement importantly however also reflects the progressive and future looking cost investment agenda that I touched upon earlier. The Group continues with its strategy of investing in its people and in emerging technologies and selectively into reinforcing its geographic footprint in order to best protect the bank into the future.

The lowered provisioning levels are a continued positive, and as always it is reassuring to see the ongoing benefits of our diversified earnings base work to support the fuller Group performance.

Looking ahead, we are hopeful that momentum will continue, notwithstanding the various challenges and uncertainties.

Thank you very much for your time.

And now back to Amir.

Amir Hanna: Thank you Jim, and thank you everyone for listening to our presentation.

We will just pause for a minute a questions come in and then we will start answering the questions one by one.

We got few question to answer here.

The first question is asking about the weakness in non-interest income and how much of that is seasonally and also requesting some explanation of reasons behind the continued increase in operational cost?

We've covered most of it but Jim will add few more words on both topics.

Jim Murphy: As regards fee income, I think it has been a very good nine months. We appear to be a modest 2.1% up on last year. You have to bear in mind however that the businesses have been in very good shape of late. We had a very good performance last year and I think this year is also a very good performance, building on a strong last year.

Within our non-interest income, fees and commissions are the main driver. This is where we see our lines of business activity. The credit card business, the asset management business, the trade finance business, and I think we mentioned the brokerage business. All these businesses are doing well with good activity levels and good momentum.

I feel comfortable and consistent in saying that fee income has performed strongly. FX income performed very strongly at 6% ahead of last year. I believe there is a good story to tell there.

In terms of costs, I have gone through that. We are investing in the business, we have had a couple of expansion undertakings in certain overseas locations, increasing the footprint slightly. We are also investing heavily in IT. To be honest, I don't really think that this is a matter of cost as much as an investment matter. We really have to spend today to safeguard the best interests of the bank going forward.

I feel comfortable in saying that non-interest income is performing solidly, and that our cost line is well under control and is being wisely taken care of.

We have been asked to talk about guidance on NIMs.

Our NIMs are contracting and if you trend down through the quarters of this year, you will see that margins have been progressively tightening. We are estimating that were the Central Bank of Kuwait to follow the Fed in terms of any further pricing downwards within say the coming month or two, that would impact us by tightening NIMs, affecting net-interest income to the tune broadly of about KD 10 million annualized per any 25 bps cut in the discount rate.

So between competition on both sides of the balance sheet as regards pricing, and potential for lowering of relevant benchmark pricing rates, we may well see the attrition continue going forward.

Amir Hanna: A couple of questions on the recent changes in the risk weights from CBK and its impact on CAR?

Jim.

Jim Murphy: The Central Bank laid down new guidelines attaching to risk weights, risk weights attaching to certain sovereign exposures and public sector enterprises exposures. The risk weights are more onerous than previously. We had more favorable risk weightings attaching to these exposures up to now.

The change came into effect in September. That had an adverse impact therefore on the ratio, combining with the fact that interim earnings are not taken into the computation. These two factors together primarily account for the reduction in CAR ratio.

Amir Hanna: There is a question on guidance but that's fully covered in the slides so all the guidance details that are in the public domain are included in the presentation we shared and the presentation is available on our website

That's most of the questions for now, we will give it another minute to wait for more questions

We got a question on the macro picture and what themes we see in Kuwait in 2019 and onwards.

Basically we have the same outlook continuing with us. Capital spending should continue. As we mentioned in our opening remarks we have seen some slower award activity during the year. But that said the pipeline is still strong in terms of tendering.

We are expecting around USD 7 billion to be awarded this year but currently there are around KD3.5-4.0 billion in the tendering pipeline and those are key infrastructure projects. So despite the volatility in the award activity we do expect that longer term the awards will continue to be strong and that will lead to a general improvement in non-oil GDP activity in the remaining of 2019 and 2020.

So there has not been any change in the outlook and that should be driving some banking activity going forward.

One more question on funding about the contribution of the USD based funding in our balance sheet.

Jim Murphy: The point to make here is that about half of our balance sheet tends to be in non-KD, that is in foreign currency, a substantive part of that being dollars.

Tied into this there is a question on the impact of lower libor. We don't run open positions so earnings are not really that sensitive. Our earnings are not that sensitive to movements in libor per say.

What is of interest to us is how the Central Bank of Kuwait responds to movements in Fed rates. The pricing benchmark, i.e. the discount rate, is most important to us. That's really the variable that we need to look at in terms of impact on earnings going forward.

Amir Hanna: With that and considering time limitations we will conclude the call for today. If you have any follow up questions as I said earlier, please send it to our IR email address and we will respond to it in due course. Thank you very much for listening today

Operator: Ladies and gentlemen, this concludes today's call.

Thank you for your participation. You may now disconnect.