Israel Discount Bank Ltd.

Conference Call

August 11, 2022

Operator: Ladies and gentlemen, thank you for standing by. Welcome to the Israel Discount Bank Second Quarter 2022 Results Conference Call. All participants are in listen-only mode. Following Management's formal presentation, instructions will be given for the question-and-answer session. For Operator assistance during the conference, please press star-zero. With us on-line today are Mr. Barak Nardi, Mr. Yossi Beressi, and Ms. Lena Schwartz. As a reminder, this conference is being recorded August 11th, 2022. If you have not yet done so, please access the presentation on the bank's website, investors.discountbank.co.il. I would like to remind everyone that forward-looking statements for the respected company's business, financial condition, and results of its operations, are subject to risks and uncertainties that could cause actual results to differ materially from those contemplated. Such forward-looking statements include but are not limited to product demand, pricing, market acceptance, changing economic conditions, risks and product and technology development, and the effect of the company's accounting policies, as well as certain other risk factors, which are detailed from time to time in the company's filings with the various securities authorities. Ms. Schwartz, would you like to begin?

Lena Schwartz: Yes. Thank you. Good afternoon everyone, and I thank you for joining our second quarter results conference call. I'd like to turn over to Barak Nardi for the overview, and a …. highlights of the second quarter.

Barak Nardi: Thank you, Lena. Good afternoon, all, and I hope you are well. Starting with slide 4, we will begin the review of the financial results. Our strong second quarter results show the clearest year execution of our strategy that help us generate net income of 680 million shekels, and an ROE of 11.8.%. We have grown in credit by 16.4% year on year, leveraging the equity raise at the end of the first quarter. At the same time we continue to remain committed to improving the efficiency ratio which stood at 59.2% for the second quarter. Now I would like to elaborate a bit on the financial highlights of the second quarter and … as you can see on slide 5. The 680 million shekel net income was largely driven by increase in revenues from core banking activity. As we continue to execute our strategy of credit growth, we leverage our successful 1.4 billion shekel equity raise at the end of the first quarter into almost 15 billion shekel, or 6.7% credit growth over the second quarter – over the first – over the second quarter. We focused on our targeted segments where we believe we have the greatest potential to outgrow the market, and which can bring the highest contribution to the bank and our shareholders. As such, we grew by about 29% in mortgages, and by 22% in medium enterprises, year over year. We also took advantage of a unique market opportunity, which allowed us to grow in high quality corporate credit by 10.3% during this quarter. As a result, and supported by growth in net interest margin, our net interest income grew by 23% year on year, and we view it as a clear strength of the bank. At the same time, we remain focused on the quality of our lending. After several quarters of credit growth expenses …, we have recorded 131 million shekels of credit …, which is about 0/23% of the average credit balance, and it is related largely to credit growth and change in macro assumptions which was partly offset by the improvement in the quality of the loan book according to our models. Other credit metrics continue to enhance …. Lastly, this is another quarter where alongside the growth, we have announced on a 20% dividend distribution, totaled about 136 million shekels. On slide 6, I would like to briefly touch upon some key indicators of the Israeli economy and explain the mixed impact on the bank's results. The fundamentals of the Israeli economy are still strong, with unemployment rate of 3.4%, back to pre-COVID levels, and the expectation for its 2022 GDP growth are still impressive, about 5% according to Bank of Israel, despite the expected slowdown of the global economy. Inflation has increased, yet it remains structurally lower compared to many other developed economies. Bank of Israel has followed the Fed and started to increase interest rates during the second quarter. While the macro indicators of the Israeli economy are still robust, we look cautiously on the developments in the global economy, on the volatility in the market, and on the potential impact on the local economy. At the same time, we do see a positive impact of increasing interest rates on our results, the increase in NII. However, the full impact of the rate increase is not yet reflected in our numbers, and I will elaborate more on this later. And finally, we are confident in our ability to carefully navigate in these conditions, and all in all, we expect to benefit from the net positive impact of rising rates on our bottom line for increasing revenues, and this is despite the potential negative impact on the borrower as reflected in increasing credit losses. On slide 7, you can see our strong credit growth, as mentioned, leveraged by the equity raise, we grew by almost 15 billion shekel, or 6.7% in second quarter, and by almost 17% year on year. We focused on our targeted segments, first of all mortgages, which grew by 7.1% during the quarter, and by almost 29% year on year, and are now comprising almost 26% of our loan book, compared to about 22% when we set our strategy. Credit to medium enterprises grew by about 4% during the quarter, and by 22% year on year. During the second quarter, we took the opportunity of market conditions, and leveraged our capital rates to grow by 10% in corporate credit, after we held back in growth in Q1. We believe that this was unique opportunity to grow responsible – responsibly in this segment, by taking profitable high quality loans, which is aligned with our risk appetite. Looking ahead, we see many additional opportunities for growth, and will examine each of them to make sure that our lending is sustainable, profitable, and responsible. On slide 8 you can see a very good demonstration of the trends of our core business. NII grew by 23% as of last year, to above 2 billion shekels, and the fee income grew by about 8%. This was partly offset by a decline in non-interest financing income as a result of our interest … position, much of which will likely reverse and generate income in the course of the year. Total income grew by 13.2% in the second quarter compared to same quarter in 2021. As you can see from the chart on the right hand side, we continue growing in what we define as income from regular financing activities. Each of the incomes from our core banking activities, our bread and butter, these numbers exclude the impact of CPI derivative per value adjustment, et cetera. The income from regular financing activities grew this quarter by almost 24% versus last year, and NIM increased 2.63%. I would like to stress that we recorded this substantial increase in net interest income in the second quarter, while the base rate has only started to increase. It means that we have not yet seen the full impact of the rate hike, and we expect to continue benefit from it in the upcoming quarters. Moving to slide 9, the expenses remain overall flat this quarter, and they grew slightly compared to last year, largely due to expenses related to increased activity at Cal. Cal’s payments to partners have increased because of much higher issuing and credit activity. Our increasing income, and the disciplined cost management, led to improving cost income ratio, to 57.2% for the first half of 2022, continuing an improving trend over the past year. On slide 10, you can see some of our key credit metrics. This quarter, after five consecutive quarters of credit loss …, credit losses were 0.23% from the average credit, all of it generated by general group provisioning. The main drivers for the LLP this quarter are the substantial credit growth we have, and the change in macro assumptions, in particularly, the increasing interest rates. This was partly offset by the improvement of the quality of the loan book, according to our models, implemented through CISL, which is why the individual provision remains negative. We remain focused on the good quality of our lending, and maintain solid NPL and NPL coverage ratio. Moving on to the performance of our key subsidiaries, starting with slide 11. Mercantile produced a set of very strong results with net income of 144 million shekel, and an ROE of 15.5%. This was mainly generated by robust loan growth, particularly in mortgages that were up 7.6% in the quarter. Mercantile cost to income ratio improved to below 50% this quarter, supported by top line growth from core banking activity and strict cost management. In New York, as seen on slide 12, we saw higher net interest margins, which led to 26.7% increase in net interest income. Coupled with still negative credit loss expenses, the ROE stood at 10.8%. Cal, shown on slide 13, enjoyed a very positive momentum in 2022, following the post-COVID economic recovery and increase in product consumption and in particularly, material increase to overseas travel. Overall activity volume in credit cards and consumer lending has grown materially, leading Cal to produce 81 million shekels net income in the second quarter, with ROE of 14.6%. Moving on to slides 14 and 15, we continue our path toward achieving our targets at our three-pillar strategic plan and our determined execution enable us to do so. At the same time, rising interest rates and expectations, which are almost 0.7% higher now compared to the time of the announcement of our financial targets, allow us to accelerate the pace towards achieving those targets. To summarize, I would like to emphasize the key takeaway from this quarter results, as you can see on slide 16. First, we deliver strong second quarter results, which reflect continuous execution of our strategic initiative, while at this stage we only partially benefited from the rising interest rates. Second, we leverage the equity raise to generate 14.6 billion shekels credit growth, focusing on our targeted sector, mortgages and medium enterprises. We also took advantage this quarter of the market opportunity and grow substantially in corporate lendings. Third, we remain focused on increasing revenues from core banking activity, and on tight cost control, leading us to improve cost income ratio. And lastly, interest rate increases allows us to accelerate the pace towards reaching our target of 3.5 billion shekels in net income, 12.5% ROE, and below 55% cost income ratio. With this, I will finish the overview, and would like to open to your questions.

Operator: *[pause]* We'll begin the question-and-answer session. Ladies and gentlemen, at this time, we will begin the question-and-answer session. If you have a question, please press star-one. If you wish to cancel your request, please press star-two. If you are using speaker equipment, kindly lift the handset before pressing the numbers. Your questions will be polled in the order they are received. Please stand by we poll for your questions. *[pause]* The first question is from Tavy Rosner of Barclay's. Please go ahead.

Chris Reimer: Hi, this is Chris Reimer on for Tavy. Thank you for taking my questions. The loan growth, I – you already mentioned earlier the strong loan growth and loan loss provisions having been rather low. Looking ahead, given the macro headwinds and raising rates, how should we think about loan growth and LLPs through the cycle?

Barak Nardi: So, first of all regarding loan growth, we still see a demand for loan and growth in Israel. As I mentioned before, I don't think that the 6.7% we grew this quarter is representative, because we had some strategic opportunities this quarter that I don't believe will be – we'll see in the next quarter. But still, I do expect to continue to see overall growth, credit growth, in the Israeli market. Regarding the LLP, and as I mentioned, our entire LLP is coming from group provisioning, and a big portion of it is due to the macro economic situation, especially the rising interest rate, so we put some provision to reflect this additional risk. So, you know, it's too early to call what it's going to be in the next quarters, but currently we believe that our current LLP and current provision are reflecting accurately the current situation as we see it.

Chris Reimer: Mm-hmm. Okay. And just touching on costs. Cost inefficiencies have been a key priority for you guys. Are you comfortable with where you are, where the expenses are today? Or should we expect further cost cutting measures in the near future?

Barak Nardi: Well, first of all, as you mentioned, it's key priority for us, and we are very happy and proud with the results … with the declining cost income ratio this half, and also the fact that the revenue is growing much faster than expenses. We still believe we have additional potential to continue reducing our costs, and it's a clear up side for us. One other comment I would like to add, that when you analyze our expenses growth, you need to take into consideration that part of our portfolio is Cal, the credit card company. They have a different PNL structure, and their expenses, where their business is growing, there is also impact on their expenses because part of the revenue is being paid to their partners, and it's going to the Other Expenses line. So if you put –

Chris Reimer: Ah.

Barak Nardi: And this is a good news. This is a good reason for the expense to grow. If you put Cal aside, so the Discount Group results is even better when you – when it's – you look at the expense growth. So it's – another thing you need to take into consideration.

Chris Reimer: Mm-hmm. Okay. Thanks for the color. That's it for me.

Operator: *[pause]* The next question is from Micha Goldberg of Psagot. Micha, please go ahead.

Micha Goldberg: Hi, good afternoon. First of all, congratulations on a very strong quarter and a great first half. A couple of questions, about – you mentioned net interest margins expanding. And I'm just wondering, if you exclude the impact of the CPI and the hike in interest rate, are the underlying core margins expanding, or are they dropping?

Barak Nardi: So, I think, even if you put aside the positive impact of CPI, we still see a positive result, and it's coming from two areas. First of all, the increased interest rate. And second, a change of mix, and bring in to the – our portfolio some very profitable deals. So actually the increasing NIM is coming from three elements, the CPI, the interest rate that is being growing, and the mix and the more profitable deals we brought into the table.

Micha Goldberg: But even if you exclude the CPI and the Bank of Israel interest rate hike impact, you are saying you're still in expansion in the margins?

Barak Nardi: Yeah. I see, I think, a very substantial impact in CPI and the interest rate. But even if you exclude them the results are good. I don't think – so, we are not giving a specific disclosure what is the impact when you put it aside, but overall we feel very comfortable with the – with the margins, even when you put aside those two external factors.

Micha Goldberg: Okay. Because – I mean, you provide those numbers in your reports, and when you exclude those, it actually looks like the margins are slightly on the way down. But, maybe my numbers are wrong. Okay. Another question. I understand – I understand Visa ICC are subsidiaries that are supposed to implement CISL in – January – from January 1st, 2023. Is that correct?

Barak Nardi: Yes.

[speaking together]

Micha Goldberg: Does it have any impact on your calculations, or …

Barak Nardi: So, I heard your question regarding Cal, and they will start implementing CISL in '23. What was the other question, Micha?

Micha Goldberg: I was just – I was wondering if the – if the change, the implementation of CISL on Visa ICC will have an impact on Discount Bank's equity ratios.

Barak Nardi: It's not – it's insignificant.

Micha Goldberg: Okay. Thank you very much. Now, I understand that as of July 1st, there are two new regulations that also have impact on your capital ratio, the FACTR on the derivative? And the Bank of Israel requirement of … assets for highly leveraged real estate lending? Could you tell me what the impact of those two will be on your capital ratios?

Barak Nardi: I – you are not sound very well, so I'm not – I didn't understand the question.

[speaking together]

Yossi Beressi: Micha, the – you are asking about the impact of the – FACTR? And the new rule on loans to the real estate?

Micha Goldberg: Yes.

Yossi Beressi: So, the first one is more – less than 0.1%, it's about, I think, five basis points. 0.05 … And the new guideline on real estate loans will affect our capital – capital adequacy ratio by around – the maximum is 0.1%. This will be implemented along the next four quarters.

Micha Goldberg: Okay. So, just 0.025 per quarter, right?

Barak Nardi: Maximum, yeah.

Speaker: Oh?

Barak Nardi: 2.5 po– basis points. *[pause]* Per quarter.

Yossi Beressi: Per quarter, yes.

Micha Goldberg: Okay, great. Thank you very much. So, when you take them and look at your current capital buffer, is that enough to let you grow at even much lower rate than you're currently growing your … loan book? Or is – is – I mean, is there anything else that needs to be done?

Barak Nardi: No, we feel very confident with this. We think that our growth – together with profits we are going to generate in future quarters, we believe we have sufficient room for sufficient growth, the credit growth, in the areas we are targeting. And as I mentioned before, we don't think that the 6.7% quarterly growth is representative. But when we are looking at representative numbers, we feel very comfortable with the level of equity we have right now.

Operator: *[pause]* The next question is from Michael Klahr of Excellence. Please go ahead.

Michael Klahr: Hi, good afternoon, and well done on a good quarter. I wanted to ask, firstly, on margins, and what you're seeing in individual segments, or categories. So, for example, mortgages. Are you seeing higher spreads, lower spreads? Or unchanged? And the same question also with middle market and with – and with corporate. I just wanted to understand a bit more what the – awaits from interest rates on the margin side, in terms of –

Barak Nardi: So, overall, and as I mentioned before, when it comes to the corporate segment, we did see some very interesting opportunities in the second quarter, which enable us to take some deals in a higher spread than it used to be in previous quarters. Overall – overall, we do see – in some sectors, the spreads are getting higher. For example, also in mid size businesses, in housing a little bit. So it's not dramatic changes. But the overall – the trends that we see in the second quarter versus previous quarters is a positive one.

Michael Klahr: Well, would that – is that also true in morge– where are your – where are spreads in mortgages, versus, let's say, six months ago? Are they higher, lower, the same, would you say?

Barak Nardi: In mortgages?

Michael Klahr: Yeah, mortgages…

Barak Nardi: In mortgages, they are a bit higher.

Michael Klahr: They're a bit higher. Okay. All right. And, also, I just wanted to ask also on capital. So, you know, I under– I got your answer to the last – to the question from the last caller. But, just, you know, by my calculations, your, you know, even if you grow on a – on a lower, you know, at a lower rate through the second half, you know, your capital is going to decline. Or your CT1 will decline. So, just wanted to understand where, you know, what the important levels are for you, in terms of the 20% dividend payout. And, you know, is there a – perhaps, a transfer you would need to – to raise more capital, you know, six months from now, if growth rates don't moderate as much as you expect them to.

Barak Nardi: So, first of all, you know, it depends – when you make the …, it depends what you assume our profit will be. So, if – when you take into consideration our growth plan, and the planned or the estimated profit, we feel very comfortable with the level of equity we have. We think we will be able support our growth plan. You need to take also into consideration that we reduce the level of – *[consults with someone]* – volatility we had, because we shifted some of our loans to L2 maturity. So even if we are going to have some, you know, macro economic surprises, in … years, the impact of it on our CT ratio is – is going to be much lower than it used to be. So, we feel sufficient. We feel also sufficient with the level of 20% dividends. And we are planning, you know, it's – the outlook is to continue paying this dividend, going forward.

Michael Klahr: Okay. All right, that's – so, if anything, you know, if we take all those different factors, if anything's going to give way here, it's on the growth side rather than, you know, rather than anything else, rather than the dividend, or the – you know, or additional equity raising.

Barak Nardi: Yeah, but the growth rate, you know, as I mentioned, the 6.7% we have growing … in the last quarter is not representative. It's not going to be – to be that – the rate going forward. But using, or growing reasonable rate that used to grow also in the past, we believe that we really can support it. And with existing equity level, combining with the profit we are going to gain on the dividends, we feel very comfortable with the – with the configuration.

Michael Klahr: Okay. All right. Thank you.

Barak Nardi: Thanks.

Operator: *[pause]* If there are any additional questions, please press star-one. If you wish to cancel your request, please press star-two. Please stand by while we poll for more questions. *[pause]* There is another question by Micha Goldberg from Psagot. Please go ahead.

Micha Goldberg: Hi. I hope you can hear me better now?

Yossi Beressi: Yeah.

Barak Nardi: Yes.

Micha Goldberg: Okay. I apologize for that. So I – just one question I had that I think I missed. If I remember correctly, your original … about leaving Visa ICC in the ownership of Israel Discount Bank, it's supposed to expire, or be … by the end of this year. I'm just wondering if you have any indication where that's going to go, and what will you do, if you're required to sell that off?

Barak Nardi: *[pause]* To sell – you're referring to Cal?

Micha Goldberg: Yes. Visa Cal.

Barak Nardi: Ah, okay. So, currently, the current – the point where the government can make a decision to split Cal from Discount Bank is until the end of January 2023. If they are not – if they won't decide, so Cal is staying with Discount. We believe, first of all, we have the good reason why Discount should keep Cal. First of all, we think, when you combine this with the current political situation, and the fact that probably there is not going to be a new government until early 2023, there is a very good chance that the decision – there is not going to be made any decision that, you know, to take Cal out of Discount. So we feel comfortable with the current situation. And you know, if we will have to sell Cal, first of all, we will get – we'll have time to do it. Both Poalim and Leumi got between three to four years to do this kind of transaction. Cal is a great company, a great asset, and we will get, you know, full value for it. But we feel very comfortable currently that we'll be able to keep Cal and enjoy from their – from their good performance.

Micha Goldberg: Thank you very much. And, again, congratulations on a small quarter.

Barak Nardi: Thank you. Thank you, Micha.

Operator: *[pause]* There are no further questions at this time. Thank you. This concludes the Israel Discount Bank Second Quarter 2022 Results Conference Call. Thank you for your participation. You may go ahead and disconnect.

[End of conference call]