Israel Discount Bank Ltd.

Conference Call

November 23, 2022

Operator: Ladies and gentlemen, thank you for standing by. Welcome to the Israel Discount Bank Third Quarter 2022 Results Conference Call. All participants are at present in a 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 November 23rd, 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 would 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 event – 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. Mr. Nardi, would you like to begin?

Barak Nardi: Thank you. Good afternoon, everyone, and I hope you are well. Starting with slide 4, we will begin the review of the financial results. Our exceptional third quarter results show the clear execution of our strategy that combined with higher interest rates helped us to generate net income of 893 million shekels, and ROE of 15.%. Our efficiency ratio improved materially, and stood at 55.2% for the third quarter, bringing us very close to our long term strategic target of 55%. Now I would like to elaborate a bit on the financial highlights of the third quarter and first nine months of the year, as you can see on slide 5. Our 893 million shekel net income in the third quarter did not include any special one-off items, and was largely driven by increase in revenues from core banking activity, supported with rising interest rates. Net NII in the third quarter increased by 37.6% from parallel quarter in 2021, and reached almost 2.3 billion shekel. This material growth in revenues drove an improvement in our cost income ratio that improved to 55.2%. Credit growth slowed down a bit in the third quarter, aligned with lower demand we are observing. Nevertheless, we remain 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. At the same time, we remain focused on the quality of our lendings. In the third quarter, we have recorded 101 million shekel of credit loss expense, which is about 18 basis points of the average credit balance, and it’s related largely to increase in Group basis provisions, which reflect worsening macro assumptions, partially offset by the improvement of the quality of the loan book, according to our models. Other credit metrics continue to remain solid. Lastly, this is another quarter where we have announced on a 20% dividend distribution, totaled about 179 million shekels. On slide 6, I would like to briefly touch upon some key macroeconomics indicators of the Israeli economy, and explain the potential impact on the bank’s results. The fundamentals of the Israeli economy are still strong, and the expectation is for economic growth to continue in 2023, but at a much lower pace, as the rising interest rate is cooling down the economic activity and the demand. Labor market is still strong, and expected to remain relatively resilient, although we have seen slight increase in unemployment in recent data. Inflation is rising, nevertheless, it remains structurally lower compared to many other developed economies. Now, I would like to discuss the impact of the macro developments on the bank. We start to observe early signs of slowdown in economic activity and cooldown of the demands. As such, the credit growth slowed down in Q3, and we expect similar trend to continue in the next quarter. At the same time, the impact of increasing interest rates on the profitability is material and positive, as we have seen in – at the substantial increase in net interest income in the third quarter, in line with our previous expectations. Another impact of interest rate increase is on the …[bohel?? 4:57]. So far, we have not observed a deterioration in individual …[bohel] capabilities to service a debt. Yes, we continue to increase the credit of provisions to reflect worsening macro assumptions. Finally, we are looking at a development in the economy, and expect the operating conditions to remain volatile. Nevertheless, we are confident in our performance, and expect the net outcome of the mixed impact of the macro economic environment and particularly of the increasing interest rates, to be positive to the bank. On slide 7, you can see our credit growth. As mentioned in the first quarter, credit growth slowed down, and we grew by about 2%, which was evident across all segments. Nevertheless, compared with the third quarter of 2021, we grew by 16%, focusing on our targeted segments. Mortgages, which grew by 26% year on year, and are now comprising about 26% of our loan book, compared to about 22% two years ago, and credit to medium enterprises that grew by about 18% year on year. Looking ahead, we continue focusing on sustainable, profitable, and responsible lending opportunities. On slide 8 you can see a very good demonstration of the trends of our core business, and the impact of higher interest rates on the performance. The average interest rate in third quarter was 1.5% compared to almost half percent only in previous quarter, and close to zero in Q3 2021. As a result, and in line with our anticipation, NII grew by 37.6% versus last year, to about 2.3 billion shekel. In addition, fee income grew by about 8%. Total income grew by 23.8% in third 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 financing income from current operation. This is the income from our core banking activities, our bread and butter, these numbers exclude the impact of few items, such CPI derivative and fair value adjustments. The income from regular financing activities grew this quarter by 42% versus last year, and NIM increased to 2.74%. Going forward, we expect that the impact of additional increase in interest rate will remain positive, although its marginal impact will moderate. Moving to slide 9, the expenses grew this quarter, mostly because of growth in other expenses, largely due to revenue related expenses linked to increased activity at Cal. Nevertheless, due to the exceptional increase in revenues, which materially outpaced the growth in expenses, as you can see on the right hand chart, and evidenced by positive draws of 12.8%, cost income ratio continually improving, reaching 56.5% for the first nine months of 2022, and 55.2% for third quarter, bringing us close to our strategic target of below 55%. On slide

10, you can see the evolution of credit loss expenses. This quarter, we are still not observing a material deterioration in specific …[boreals?? 8:32] conditions, as evidenced by very low specific basic provisions. We continue to increase group basic provisions to reflect worsening macro assumptions, and particularly, the increasing interest rates. Overall credit loss expense …[?? 8:49]% from credit in third quarter, and commodities credit loss expense in nine months was 0.1%. On the next slide, you can see additional asset quality metrics. Allowance for loan loss provisions from total credit increased slightly to … 1.31%. Non-performing loss from total loans were 0.67%, slight improvement from previous quarter, largely due to include specification of problematic borrowers. NPL coverage is also very strong, as the loan loss provision covers non-performing loss, by almost twice. These indicators reflect the solid quality of our loan book, and our conservative underwriting. Touching briefly on funding and liquidity on slide 12. Our deposit base is granular and diversified, with about 64% in …[little??] base. …[Owdoes??] and small enterprises. Deposit base continue to grow, total deposits grew by 3.3% from the previous quarter, and by almost 20% from third quarter of 2021. We continue to maintain solid liquidity ratios for above – far above the regulatory limit. Moving on the performance of out subsidiaries, starting with slide 13. Mercantile produced very strong results this quarter, with net income of 185 million shekels, an ROE of 19.3%. This was mainly due to increase in net interest income and …. Loan growth slowed down at Mercantile as well, but overall credit grew by 17.54% year on year, with year on year growth of 30% in mortgages. Mercantile cost to income ratio continued to improve, and was below 50% this quarter. In New York, as seen on slide 14, we saw higher net interest margins, which led to 43.8% increase in net interest income. After five consecutive quarters of credit loss provision release, credit losses were positive this quarter, at 0.23%, reflecting the shifting economic environment. Cal, shown on slide 15, continues to enjoy a very positive momentum in 2022, following 24.1% increase in consumer credit, and 16% increase in credit card …[conduction?? 11:10] turnover. Cal recorded net income of 109 million shekels in Q3, with ROE of 20.9%, which included also profit from sales of Visa, Inc. shares of about 30 million shekel. To summarize, I would like to emphasize the key takeaways from this quarter results. First, we delivered record Q3 results, with ROE of …[15% ?? 11:34], and cost income ratio of 55.2%, as we remain focused on continuous execution of our strategic initiative. Second, we benefited from increase in interest rate, which became evident during the quarter, and led to increase of 37.6% in net interest income, to 2.3 billion shekels in Q3. Third, the credit growth in Q3 slowed down, aligned to market conditions. We remain focused on our targeted segments and grew by 26% year on year in mortgages, and 18% year on year in medium enterprises. And lastly, loan book continues to display resilience with solid asset quality metrics, that reflect worsening macro indicators increasing group basis provisioning.. With this, I will finish the overview, and would like to open to Q&A. Thanks.

Operator: *[pause]* Thank you. 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 Chris Reimer of Barclay's. Please go ahead.

Chris Reimer: Hi, thank you for taking my questions. First off, I wanted to touch on the macroeconomics slowdown. Also, what you mentioned in your opening statement, that you are seeing a cooldown in demand. If you could just give some color on – on what segment you might be seeing impacted more than others.

Barak Nardi: So, thanks. First of all the slowdown is across the board. I think one of the – of the things that the Bank of Israel increase their interest rate in order to cool down inflation, of bringing down inflation. They're expecting, or they are pushing, to see slowdown in economic activity, so this is not a surprise. So, the slowdown is across the board. I think the most dominant segment that we start seeing it, is one, is around consumer credit. It's that first that we see substantial slowdown. And second, the second area, is mortgages. Where the higher interest rates cool down the market a little bit, and the growth rate in this quarter is lower than what we have seen in the past. So I do believe that Q3 growth that we're currently experiencing is a more accurate reflection of what is expected to be …

Chris Reimer: Uh-huh. Okay. And, assuming that the level of activity does slow down more, what segment of the portfolio do you see most at risk of facing higher provisions?

Barak Nardi: So, overall, as I said before, at this point, we still don't see specific, like, any – any specific signs yet. So the level of write-offs is very low. So currently, we don't see that this negative side. But we do expect that with higher interest rate, higher level of LLP will come. So first of all, I think we will experience it across the board, and we start – as I mentioned before, we already start the – putting group provisioning exactly for this scenario. If I try to be more specific, I think the two areas that we might see higher LLP, it might be around – set around real estate. Where in recent years the leverage over there was quite high, and I think with higher interest rate we might find some negative, maybe, activity over there. And second is around consumer credit. With higher interest rates, aligned with … or the … [15:58] mortgages and maybe other consumer credit, we be– I do believe that they will do everything they can to pay the mortgage, but in other consumer credit, we might see some – some more defaults than we used to see in the past.

Chris Reimer: Got it. Thank you, that's very helpful. That's it for me.

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 we poll for more questions. *[pause]* The next question is from Micha Goldberg of Psagot. Micha, please go ahead.

Micha Goldberg: Hi, good afternoon. First of all, congratulations on an excellent quarter. Just a short one, on the numbers. Is there anything unique, one-time, in this quarter that one should try to exclude in order to get to some kind of representative return equity?

Barak Nardi: No, as I mentioned before, in this quarter, we don't have any, like, one-time, that we shouldn't expect to see in future quarters. So it's a very solid and clear quarter. Of course, as I mentioned before, you know, I – we – not true that we can expect that the low, very low LLP in this quarter, you know, will continue to next quarter. But we don't have any special, like, one-time that you should exclude.

Micha Goldberg: Okay, thank you. My second question, then, is, I mean, it looks like the last, I don't know, several quarters, if not the last couple of years, your profitability has been significantly above your long term strategic guidelines of 12.5% by 2025. And I'm just wondering, will you be reconsidering that return equity target? And if so, will you be publishing something in that direction later on?

Barak Nardi: So, I think, as you mentioned, and you are right, we actually reached this quarter the long term target we have put for 2025. We need to take into consider– that's both in terms of ROE and cost income ratio. We need to take into consideration that when we have put the target, it was only a year ago, but it was in totally different economic environment, with totally different interest rate expectation. We are working, you know, internally, on our future year targets. And after we'll have it, we need to see whether we communicate updated targets or not. It's too early to call. And I think there, also, in this period, there is some uncertainty around, you know, around interest rates level, the implication. So I think it will be wise to wait a little bit before setting long term goals and communicating them.

Micha Goldberg: Okay. One more question. I mean, you mentioned there could be a potential deterioration in asset quality in the future, although you're at this point in time not seeing that. I'm just wondering, on your provision policy, would it have been more prudent to provide more this quarter on that behalf? To put more aside in the case of a future deterioration?

Barak Nardi: No. Based on our models, also this quarter and the previous quarter, we put, based on macro indicators and the rising interest rate, we put – we put aside for – currently we feel very comfortable with our current level of provisioning, and we think it will serve us in future, you know, future developments. So I don't think there is a need to put – there was a need to put more aside at this stage.

Micha Goldberg: I understand. And my last question is, you mentioned that credit demand is slowing down, and you expect that might continue to slow down even more. If the current, you know, profitability is somewhat sustainable even with a slightly higher cost of risk, then my question is, why do you need to, sort of, factor some growth rate and, I don't know, let's say, a 12% return equity, why do you need to keep so much capital on? In other words, would you consider paying out more dividend?

Barak Nardi: Well, first of all, I think always we like to look at it from – like to look at the equity the scale we thought it, and to have the right balance between supporting growth and paying out dividends. We have a policy of up to 30%. And I do think that if the trend of very high ROE of double digits, and fulfillment of the current expectation of low growth rate, you know, it might make sense in the future to continue to, you know, to look at the dividend payout and to see what is the right timing to continue the increase trend, toward the 30% policy we have.

Micha Goldberg: Okay. Thank you very much. Congrats …

Barak Nardi: Thank you.

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

[End of conference call]