Israel Discount Bank Ltd.
Conference Call
August 14, 2023

Operator Ladies and gentlemen, thank you for standing by.

Welcome to the Israel Discount Bank 2nd Quarter 2023 results Conference Call.

All participants are at present 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 *0.

As a reminder this conference is being recorded, August 14th 2023.

If you have not yet done so, please access the presentation on the Bank's web site: 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 in 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.

I would like to move first to Mr. Gad Barlev, head of investor relations, Mr. Barlev, would you like to begin?

Gad Barlev Thank you, Good afternoon and welcome to Discount bank's second quarter Conference Call.

Today, we have the opportunity to reflect on our accomplishments in the last quarter and provide you with an overview of our outstanding performance.

Participating in today's call are, Barak Nardi, CFO, and Yossi Baressi, Chief Accountant.

We will start with the review of the financial results by Mr. Barak Nardi,

and will then, open it up, for questions .

I will now, hand over to Barak

Barak Nardi Thank you all for joining us today. I am very proud to present our second quarter results.

Starting with slide 4, we will begin the review of the financial results. Our very strong second quarter results show the clear execution of our strategy that, combined with higher interest rates, helped us to generate net Income of almost 1.2 billion shekels and ROE of 18%. Our efficiency ratio is maintained below 50%, at 47.5%.

Given our strong results and our confidence in the robustness of our core business, we have decided to raise the dividend policy to up to 40% of net income. This reflects our long-term journey to increase value for our shareholders. At this point, the actual dividend payout remains at 30%.

Moving to slide 5, Before moving to discuss the financial highlights, I would like to briefly touch upon some key macroeconomic indicators of the Israeli economy. Despite the political unrest, the fundamentals of the Israeli economy are solid, and the expectation is for economic growth to slow down to 3% in the next 12 months. As a result of the high interest rate, the current expectation is for inflation, inflation to converge into BoI range of below of 3% with an estimation of 2.6% in the next 12 months. Labor market shows strength, and expected to remain relatively resilient, keeping unemployment levels at around 4%.

In slide 6 I would like to elaborate a bit on the financial highlights of the second quarter. Our 1.2-billion-shekel net income and 18% ROE was largely driven by revenue increase from core banking activity, supported with an additional 70 basis-points rising of the average interest rate during Q2. As a result, NII increased by 7% QoQ and by 41.5% vs. the parallel quarter in 22. Our cost income ratio was maintained at a low level of 47.5%, compared with 59.2% in Q2 22.

Given the macro conditions, we see lower demand for credit. Therefore, the total credit grew by only 1.6% this quarter. At the same time, as expected, we see increase in credit loss expenses. In the second quarter, we have recorded 312 million shekels of credit loss expense, which is about 49bps of the average credit balance.

Lastly, as mentioned before, we announced a change in our dividend policy, raising the payment to up to 40% of the net income. As mentioned the actual dividend payout remains at 30% this quarter.

On slide 7 you can see our credit growth. As mentioned before, our total credit grew by 1.6% in the second quarter, led by 3.8% growth in medium enterprises and by 2.6% growth in corporates. At the same time, we are seeing the slowdown of the economic activity and the cool down of the demands, with mortgages growing only by 1.5% this quarter, as the housing market slows down, and with consumer credit declining by 1.3% this quarter.

Looking ahead, we continue focusing on sustainable, profitable and responsible lending opportunities and a well-balanced loan book.

On slide 8 you can see a very good demonstration of the strength of our core business and the impact of higher interest rate. The average interest rate in the second quarter climbed to 4.58%, compared to about 3.89% in previous quarter and less than 50bps in the second quarter of the previous year. As a result, and in line with our anticipation, our NII grew in the second quarter by 41.5% YoY and by 7.1% QoQ. In addition, fee income grew by 2% YoY. Total adjusted revenue, grew by 3% compared with the previous quarter and by 41% YoY.

As you can see from the chart on the right-hand side – we continue growing in what we define as financing income from current operations – this is the income from our core banking activities - our "bread and butter". These numbers exclude the impact of a few items such as CPI, derivatir, derivative and fair value adjustments. The income from regular financing activities grew this quarter by around 48% vs. 2Q22, and NIM increased to 3.33%.

Moving to slide 9 to discuss expenses and cost income ratio. Our expenses were retained at the same level as the previous quarter with slight reduction in salary expenses.

Our strong revenues alongside with restraint expenses, led to a material improvement in cost income ratio, down to 47.5% compared with 59.2% a year ago. As you can see on the right-hand, on the right-hand chart, we are constantly improving our cost to income ratio, showing positive jaws of 12.5% CAGR between 2020 and 2023, generated by 19.5% revenues CAGR and by only by 7.0% expenses CAGR.

Switching to Slide 10 you can see the overall credit loss expense climbed to 49bps in the second quarter, in line, in line with current macro conditions. This quarter we are beginning to see an increase in specific provisions due to specific borrowers, but still not observing any material deterioration. We have kept the group-basis provision high, to reflect the potential risks that exist within the current interest rate environment.

On the right-hand side, you can see additional asset quality metrics. Non-performing loans rises with the NPL from total loans ratio at 0.89%, compared with 63bps in the previous quarter & 81bps in Q2 23. Allowance to loan loss provision went up to 1.39%, reflecting our conservative approach.

Moving now to slide 11, you can observe our, our ample liquidity and diversified deposit base. On the left you can see that 47% of our deposits are from our retail and private customers and only 12% are from institutional funds. On the righthand side we present the stability of our deposit base while customers are shifting from non-interest-bearing deposits to time-deposits as interest rate is climbing. Our liquidly ratios are well, well above the regulatory demand, presenting a solid LCR of 134.5%

Now, I would like to move on and quickly review our main subsidiaries on slide 12. Starting with Mercantile Bank that presents a record net income of 258 million shekels an ROE of 23.7%. Cost to income ratio is improved to 37%. Mercantile grew its loan book by 6.9% YoY with a well, a well-balanced growth across most segments.

Moving to talk on IDB Bank the bank has presented lower net income of $22m and ROE of 7.5% mainly due to higher salary expenses. The bank maintained total asset of $12.2 billion with asset quality remaining strong.

CAL is presenting strong results in the second quarter with a net income, with adjusted net income of 89 million shekels and ROE of 16.7%. Consumer credit grew by 12.4% YoY and transaction turnover is growing as well.

Nevertheless, in light of the strong results of Discount group, CAL attributes only 5.4% to the group's net profit. The future separation of Cal is expected to have a limited impact on Discount ongoing profitability.

Moving now to slide 13. We announce today that dividend policy is raised up to 40%. At this stage, actual dividend payout remains at 30%. As you can see in this slide, we are constantly growing our net income and dividend payout, creating value for our shareholders. At the same time, capital ratio remains solid as well.

On slide 14 we are delighted to present our new campus, a new home for Discount and Mercantile's head-office units, that gathers employees from 18 separate sites. This state-of-the-art facility is designed to change the way we work, to ease processes and improve collaboration through a direct in-person communication. As we announced last week, as part of the expected divesture from CAL, Discount will acquire CAL's share of the Campus.

On slide 15 I would like to briefly update you regarding greenlend, regarding greenland our new disruptive innovation initiative.

As we already discussed before, in addition to the drivers from the traditional banking, Discount is also continue to create value through disruptive innovation. Discount's unique positioning creates a competitive advantage as a player that is large enough to make an impact, and yet small enough to not fear cannibalization.

After introducing Paybox in 2021 we have announced earlier in 2023 the establishment of greenlend, a new fintech company to provide digital credit, in partnership with the English technology company ezbob. The new company will offer flexible, immediate and customized solutions in the field of consumer credit and credit for small businesses, in a simple and fast digital process for customers of all banks.

Less than 5 months after announcing greenlend, earlier this month we received BoI approval to control and hold greenlend in partnership with ezbob, and the company will start operating very soon. The launch of greenlend is another step in the implementation of the Discount Group's strategy to stimulate competition in the banking system through the promotion of disruptive innovation and the establishment of ventures that will operate as independent companies and compete with the entire banking system, including Discount Bank itself.

To summarize my overview, on slide 16, I would like to emphasize the key takeaways from this quarter results.

First - We delivered yet again very strong results, with net income of 1.19 billion shekels and ROE of 18%.

Second - We generated a substantial revenue increase from core banking activity, driven by the increase in interest rate and credit growth.

Third – Cost Income ratio maintained low at 47.5%.

Fourth – Once again, we present a responsible credit growth, in line with the current macro conditions, with asset quality remaining strong and reflecting the challenging macro conditions.

And lastly – Given our very strong performance and the confidence we have in on our ongoing profitability, we have raised the dividend policy to up to 40% as we continue our long-term journey to increase value for our shareholders.

Before finishing my overview, I would like to add one more thing on a personal note. After almost 4 years as Discount's CFO, I am moving to a new role, to be the Chairman of Cal and Mercantile, our 2 largest subsidiaries. It's been an enriching and fulfilling journey for me, and I would like to thank you all for being an important part of this journey.

With this I will finish and would like to open to Q&A.

Operator: 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 Tavy Rosner of Barclay’s. Please go ahead.

Tavy Rosner: Hi, thank you for taking my questions, and thank you for the presentation. I wanted to talk on capital equity. If my math is right, the 13.2% total capital is 70 basis points over the Bank of Israel requirements? Feel free to correct me if I'm wrong. But if that's the case, are you comfortable with – with that kind of buffer? And I'm especially asking in the context of the increased dividend payouts down the road.

Discount Speaker: *[pause]* You refer, Tavy, to the total? Or to the – to the tier 1?

Tavy Rosner: Yeah, the total.

Discount Speaker: Yeah. So – so it's – it's 70 basis points above the – the requirements. And we feel very comfortable, given the fact that we create such a substantial … on one … substantial ROE, which is a strong double digit on one hand. And on the other hand, we see the credit demand, and it's lower than it used to be. And currently the annual – the annual growth rate is, you know, around between 6 to 8%. We feel very comfortable with the gap we have between the – the ROE we are creating and the credit growth rate, and we feel very comfortable with the current buffer we have above the regulatory target. And you know, it's – it's been higher than it used to be. I think last quarter, it was a little bit between – below 13%, and now we are 13.15. So overall, feel – we feel very comfortable with the …[60 – 5] [65] *[timestamp 16:19]* basis points buffer we have.

Tavy Rosner: Okay, thank you. And then, I wanted to talk about the kind of level of interest some of clients have seemed to renegotiate their – their loans. So not necessarily problematic debt, but more sectors that starting to feel pressured. Is there a specific segment that just beyond the mortgage, is there anything segment that you're looking at, that we should be focusing on, in the foreseeable future?

Discount Speaker: First of all, we don't see, you know, a mass amount of customers looking to negotiate their terms. You know, I think it was more than six month ago, we offered a plan for the mortgage …, to be able to freeze the mortgage, or to restructure, redeploy it. And many little customers came with this request. So there are requests, but it's not very significant, and we deal it in case by case basis. Regarding the areas where we look, you know, more carefully around, of course it's mainly around real estate, it's around the high tech sector, mainly – maybe around non-banks credit providers. I think those are the main – the main areas.

Tavy Rosner: Okay, thanks a lot. And just the lastly, in the past we talked about the bank potentially divesting CAL, I think it has four years to do so. Can you elaborate on – obviously, the selling price will have an impact on what kind of contribution you get. But, can we have a sense of what kind of uplift you expect from a – it can be from a capital perspective, or from capital adequacies. What's the impact of CAL being divested?

Discount Speaker: So, first of all, it's not something that most probably will happen tomorrow. We have between three to four years to do it, we started counting only at the beginning of this year. So still, we still have time. As we show – show in slide number 12, we see that without CAL, there will be – there will be a slight negative impact on ROE, and a very positive impact on efficiency ratio. And of course, it's – it is expected to free some capital. We don't disclose the exact number, because it's also dependent on – on the – on the price, or the value, we are going to get for CAL. But of course, it will create some capital, and later on, we'll need to see what we will do with this – with this capital. Of course we are not disclosing at this stage what will be the amount of capital that is going to be freed by – by selling CAL.

Tavy Rosner: Okay, thank you very much, and good luck with your future endeavors within the group.

Discount Speaker: Thank you, Tavy.

Operator: *[pause]* The next question is from Irit Bar of Phoenix. Please go ahead.

Irit Bar: Hi. Thank you very much for the presentation, and congratulations for the results. I just have two questions. One about the NPLs, … non-performing loans increased … If I look at the numbers by segments, it's more linked to the real estate construction, and to a lesser extent to real estate other activities. Can you elaborate on that? What's – is it linked only to one big client falling, or a group of clients? And what do you expect to see in the coming months? The second – the second question will be after.

Discount Speaker: Maybe I'll start with the first question, the NPL.

Irit Bar: Yeah.

Discount Speaker: So, yeah. NPL went up to 89 basis points. Actually, maybe it's significantly higher than previous quarter, but if you compare it to second quarter of '22, it's more or less at the same level. And we really feel that we are, I know, in the benchmark. The reason it went up, it's due to a specific customer, it's not many customers, it's a specific customer. We are, of course, not disclosing a name or details. And it's – it's coming from the corporate sector. Beyond that, we cannot give specific details. But it's part of taking, you know, a conservative approach. We are taking conservative approach, and we feel that this was the right approach, that we feel very comfortable, first of all, with the ability of our portfolio and quality of our portfolio. Second, with our overall NPL level that is in the benchmark. And as I mentioned before, we also increase the allowance for loan loss provision to reflect this extra – to reflect this conservative approach we are using.

Irit Bar: Yeah, okay. Thank you. The second mention – question is linked to the …[result of??] credit data published lately by the BoI, we see construction in the credit growth globally in the system. So by 20 – 0.25%. Do you think that this is a turning point in credit growth, going forward?

Discount Speaker: You mean credit growth in the system for its entire credit? Or …

Irit Bar: … in the whole system, constructed by 0.25% in June.

Discount Speaker: *[pause]* You know, overall, you know, we will need to see until all banks in the next few days, all banks are publishing their financial statement, you know. Today, we – we show that we are growing by 1.5%, I think Poalim are growing at the same pace in this quarter. I don't see – I – assuming that the other banks will grow more or less the same, so, still, we are seeing growth. It's lower than we used to see, but we still see growth. And as we anticipated before, we do expect that the higher interest rate will generate a lower growth. Currently, you know, I don't see a decline in credit, but we do see a slower growth pace. And it's early – it's too early to call and to say what is going to be, you know, in Q3. But I can only refer to Q2 number, where we see a growth that is with a lower – a slower pace than we used to see in previous quarter. It's, you know, I can't predict what is going to be in, you know, Q3 and Q4.

Irit Bar: Is it mainly because of, well, low risk appetite from the side of the bank? Or – or also because of lower credit demand?

Discount Speaker: I say, it's comes mainly from lower demand, and mainly in the consumer credit.

Irit Bar: Mm-hmm.

Discount Speaker: Because we do see growth both in the corporate and in mid market.

Irit Bar: Mm-hmm.

Discount Speaker: It's mainly around lower demand, both in consumer credit and – and in mortgages, and in non-mortgages. Consumer credit.

Irit Bar: Mm-hmm. Mm-hmm. Okay. Thank you very much.

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]* The next question is from Micha Goldberg of Psagot. Please go ahead.

Micha Goldberg: Thank you. Firstly, congratulations on another strong quarter. A question. You mentioned the new payout policy, but you're still paying 30. When do you anticipate you'll be starting at 40%?

Discount Speaker: First of all, you know, we published 40%, so we have intention going there. Regarding the pace, you know, it depends on how we see the progress of the – of the credit demand in one hand, and the LLP on the other hand, profitability. So, you know, I cannot – I can't tell you whether it's going to be in next quarter or quarter after it. But we have the intention of – of getting there. But we – we don't disclose a specific quarter when it's going to be.

Micha Goldberg: Okay. Thank you. And when you look at your internal capital targets, what would be sufficient for you to say that you feel comfortable going to 40%? I mean, you're at 10.35 now. Where – where do you would feel comfortable at the number that say 40%?

Discount Speaker: No, we feel comfortable with the current numbers we have. As you can see, our current numbers, both when referring to tier 1 and total capital ratio, are higher than we used to – to have in previous quarter. In tier 1 it's … [13?? 30??] *[timestamp 25:39]* basis points above previous quarter, in total, total is 24 basis points above. So we feel very comfortable with the buffer we have. We always manage to have the right balance between adding the right buffer on one hand, and providing dividend on the other hand. So, so I don't think that the buffer is an issue. I'm not looking for a higher buffer.

Micha Goldberg: Assuming, as you pointed out during the presentation, that, you know, profitability will remain within similar kind of double digit number that you've been doing right now, and loan growth will remain approximately in the same limits right now, where … continue building of your … of tier 1 in the next couple of quarters?

Discount Speaker: *[pause]* You know, by the end of the day, that tier 1 is a result on one hand profitability, on the other hand – profitability and growth, on the other hand dividend payout. You know, we always take those consideration. I can tell you that the reason we put up to 40% is not just to put a number. It's to show our intention to go – to get there. You know, I can't be more specific whether it will be – take a quarter, or more. But it's – this is our overall direction, and we are planning to get there.

Micha Goldberg: Right. Okay, clear. Question. A potential S&P downgrade of Israel's credit rating, what would be the impact on your common equity tier 1?

Discount Speaker: *[pause]* According to what I heard, it's around 20 basis points.

Micha Goldberg: *[pause]* Okay. That's clear. Okay. Another question. I mean, your margins have been widening very nicely recently, and I'm just wondering, do you see the current levels as peak levels? Or do you think there is more expansion in the next couple of quarters?

Discount Speaker: Yeah. I think it could be a peak, because assuming that interest rates won't go up any more, and I think that the average interest rate in Q3 is going to be a little bit higher than in Q2, so we will see – we have some, you know, pressures on deposits and customers are looking for more. So I think we are – maybe we are not at the peak, but we are around the peak. And – and this is what we – I currently see. You know, if there will be future additional …, maybe it will continue growing. But at this point of time, it seems like we are near the peak.

Micha Goldberg: Okay, great. Now, I saw you guys are moving out to your new campus, and I'm just wondering, are there any additional potential real estate gains to be had in the coming quarters? Or, alternatively, any expenses that one should be thinking about, as a result of the move?

Discount Speaker: So, we already rec– already recognize some substantial gains. We have some still to go. One, the sale of Mercantile building, which we would expect to see later this year. And then, we haven't sold yet our – the current HQ here in Tel Aviv. So, it will be later on, I'm not sure if it will be in '23 or '24. But we are looking – we will see another – a gain. So this is on one hand. On the other hand, moving to the new real estate, of course, the depreciation, it's going to be higher than it currently is. So we are going to have some positive effects, and negative effects, both sides.

Micha Goldberg: Okay. Another question. I mean, … the vestiture of Visa, and I – I read in – somewhere in your report, of the – the government, or the

Minister of Finance is proposing to change Clause 10, which would allow local institutional investors to bid for the control of Visa, but have not yet been approved by the legislator. Right? Is that still in the process? And if so, can you tell us what the time frame on that potential would be.

Discount Speaker: Yeah. It's still – it's still in the process. We have heard the Ministry of Finance people saying they are supporting it, they are working on it. I hope it will be finalized later on in '23, already in '23. So it will be – enable us to sell CAL also to local institutional.

Micha Goldberg: Great. And then, my last question. I mean Mercantile has shown really remarkable profitability, and I know in the past, you guys considered all kind of thoughts about what to do with your stake. Is there any … on consolidating it, and the IPO is off? Or selling it? What – what are the options for your stake in Mercantile?

Discount Speaker: First of all, Mercantile is a great subsidiary, and showing great results, a phenomenal result. They show record ROE and profitability this quarter. The use potential, especially in the fast – highest growing sectors in the Israeli market, …profit …. And I think the fact that they are being operated as a standalone brand and a standalone company, creates a lot of advantages, and experience – expertise over there. So currently we don't have any reason to – to do – to treat it any differently that it's – it's being done today.

Micha Goldberg: Okay, thank you very much. And congratulations, and good luck on your new endeavors. Those …

Discount Speaker: Thank you. Thank you very much, Micha.

Operator: *[pause]* There are no further questions at this time. Thank you. This concludes the Israel Discount Bank Second Quarter 2023 Results

Conference Call. Thank you for your participation. You may go ahead and disconnect.

[End of conference call.]