Internet Banking in Israel

An Investment Opportunity

iBank

2011
Confidential

The Entrepreneurs

Shlomo Piotrkowsky

-33 years long banking career
-CEO and then Chairman of The First International Bank of Israel 1991-2003
-Founder of Alfa Card and developer of the "Closed End Banking System"
-Deputy General Manager of Leumi; gained experience in all major departments, 1971-1990
-Co-Founder and Chairman of the Board of Directors and Chairman of the Finance Committee of Cellcom, Israel's largest cellular company 1994-2004 (return of 25X on investment)
-MBA from INSEAD

Isaac Devash

-20 years of investment banking and investment career
-Actively involved in structural reforms in the Israeli capital markets- representing international investors bidding for banks and asset management companies
-Founder of private equity funds and manager the $157M Renaissance Fund, 1994-2000
-Co-Founder of Biondvax, a start up company, developing multi-annual/multi-strain Flu Vaccine
-[redacted] specialist at CSFB in New York, London and Tokyo
-MBA from Harvard Business School; BA from Wharton

Internet Bank opportunity

- Israeli consumers and regulators are struggling to find ways to introduce competition to Israel's highly concentrated banking sector

- Already banking on-line, the Israeli consumers, being price sensitive and quick to switch, are ready for a stand alone Internet Bank; one of cost savings, service and transparency

Characteristics of the Israeli banking environment

- Highly centralized industry with an oligopoly type structure, mainly in the retail banking segment, which is cross subsidizing other sectors (2 banks control 60% of the retail market…);
- Israeli banks are major “supermarkets” controlling the entire credit card industry and the distribution of capital markets products (no “Charles Schwab”, “Fidelity”. No fixed fee brokerage costs. i.e. Israelis pay a fee that is a % of the transaction size…);
- According to the Bank of Israel, there are no “competitive threats” in the industry generally and in the retail banking segment in particular
- All Israel banks operate in an identical rigid “production function”-- minimizing potential for competition;
- High Financial and Operating margins, supported by low “consumer bargaining power”;

Rigid cost structure, HR a significant part

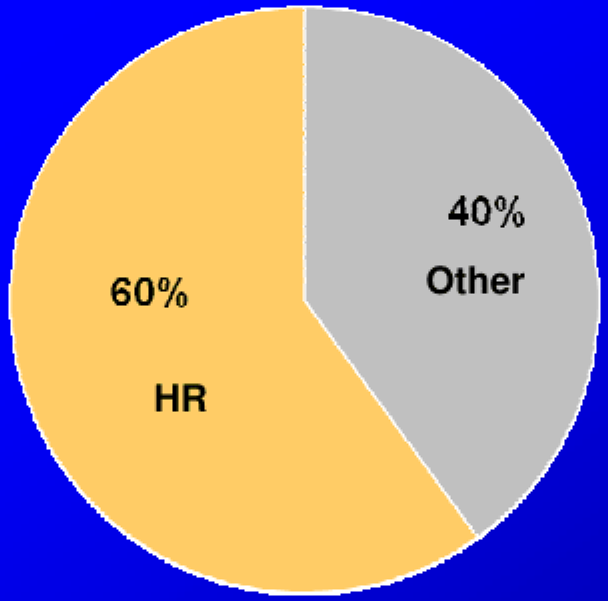
•1,286 branches,
•47,260 heavily unionized employees,
•NIS 14.4B annual salary cost,
300% of average national salary!!!

Lack of Flexibility in HR Management

"This is an outrageous scandal - on top of the cutbacks, the bank management is planning to replace older employees with high salaries with new employees … this is disgraceful"

Chairman, Employee Union Of Discount Bank

HR – The Most Significant Cost Component of the Israeli Banks
(5 largest banks)



Source: Bank of Israel

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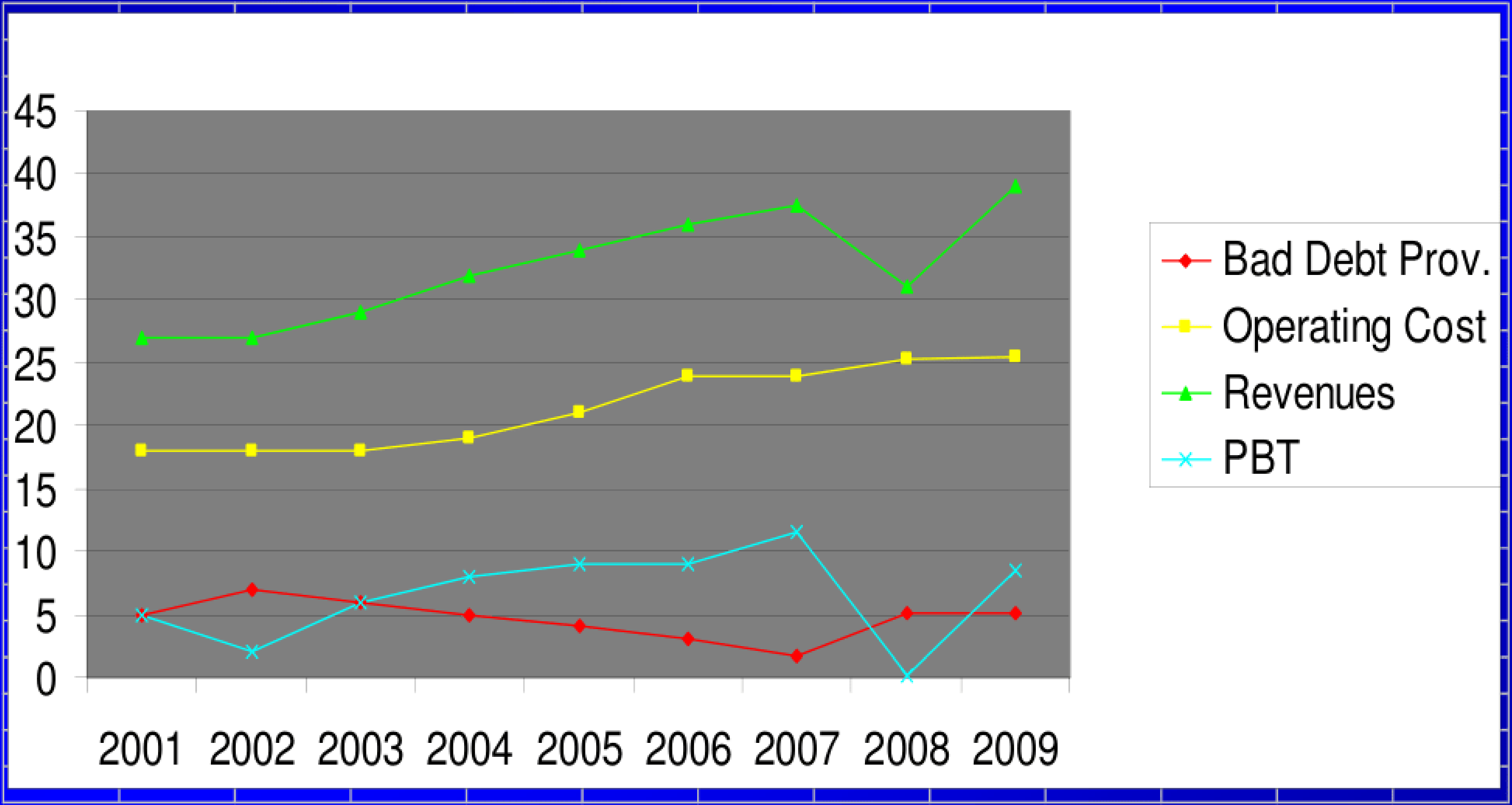
Positive correlation of Operating Cost with increasing revenues and NO correlation with increasing Bed debt Provisions



Israel Retail Banking –the lucrative segment (NIS)

- **Retail Banking represents 66% of Total Deposits (788B) and only 27% of Total Loans (669B)**
- **It represents 27% of Net Interest income (23B) but 81% of the Operational Income (15B)**
- **Represents 62% of Operational Costs (24B)**
- **Represents 50% of total banking system profit in 2007 (60% in 2004)**

Source: BOI

Total retail banking revenues: approx. NIS 18 B

Very profitable & low risk segment

Bad debt provisions less than 1/6 of total provisions*

Heavy cross subsidy

*based on Leumi and Hapoalim data
Including mortgages

Israel's Banking Industry at a snapshot

- Key facts*
  - Accounts: 4.5M
  - Total Assets (2008/2009)- NIS1,062B / NIS 1,088B
  - Total Loans (2008/2009)– NIS 732B / NIS 722B
  - Total Deposits (2008/2009)– NIS 820B / NIS 837B
  - Total Capital (2008/2009)– NIS 60B / NIS 68B
  - Total Income (2008/2009)– NIS 31B** / NIS 39B out of which (2008/2009)- NIS18B** / NIS 23B net interest income and (2008/2009)- NIS 13B / NIS16B Operating Income (fees & commissions)
  - Operating Expenses (2008/2009)– NIS 25B / NIS 25B , out of which labor NIS 14.7B / NIS 14.4B

- Profit
  - Profit before Tax (2008/2009)– NIS 0.2B / NIS 8.5B
  - Average Return on Equity (2008/2009)–1% / 8.7%
  - Return on Assets (2008/2009)- 0.03/0.69

- Total income by segments:
  - Retail (2008/2009)– 39.9% / 36.1%
  - Private Banking (2008/2009)– 12.7% / 12.0%
  - Small Businesses (2008/2009)– 13.9% / 12.8%
  - Medium Business (2008/2009)– 12.7% / 12.3%
  - Large Business (2008/2009)– 20.8% / 27.0%

*Dec, 2008/9
**Net of NIS 5.8B re-evaluation of Bonds

Internet banking emerging in the mid '90s

- Initial "hype" around internet banking in the ".com" era (1998-2001), only the focused ones survived, some were acquired by traditional banks.
- Low Internet penetration rate at that time forced the early players to spend heavy marketing $ on educating consumers for the new user habit of internet banking
- Since then successful Internet banks were established world wide
- Some examples:
  - ING world wide
  - Tesco Direct
  - EGG UK
  - NTT DoCoMo
  - Virgin is planning to launch an internet bank

Products that make it in the world of direct banking

British And Canadian Direct Ventures: Profits And Product Offering

Nature of Stakeholder	New entrants	Launched	Profit/(Loss) 2003 (mn)*	Current Account	Savings Accounts	Loans	Credit Cards	Mortgages	Mutual Funds	Life Insurance	Health Insurance	P&C Insurance	Pensions	Brokerage
Bank/Retailer	Tesco PF	1997	GBP173											
Bank	First Direct (UK)	1989	GBP49.9											
Insurer	Sc. Wid. Bank	1995	GBP16.5											
Bank	The *One* Account	1997	GBP23											
Bank/Retailer	Sainsbury's Bank	1997	GBP22											
Insurer	Standard Life Bank	1998	GBP4.6											
Bank	Direct Line Rescue	1998	GBP31											
Bank Insurer	ING Direct Canada	1997	Yes											
Former CU	Cahoot	2000	(GBP15)											
Bank	Goldfish	1996	(GBP30)											
Insurer	Egg	1998	(GBP34)											
Bank	Intelligent Finance	2000	(GBP53)											
Bank	PCF	1998	(CAD236)											
Bank Insuer	ING Direct UK	2003	No											
Credit Union	Citizens Bank of C.	1997	No											

Source: Celent direct banking case studies

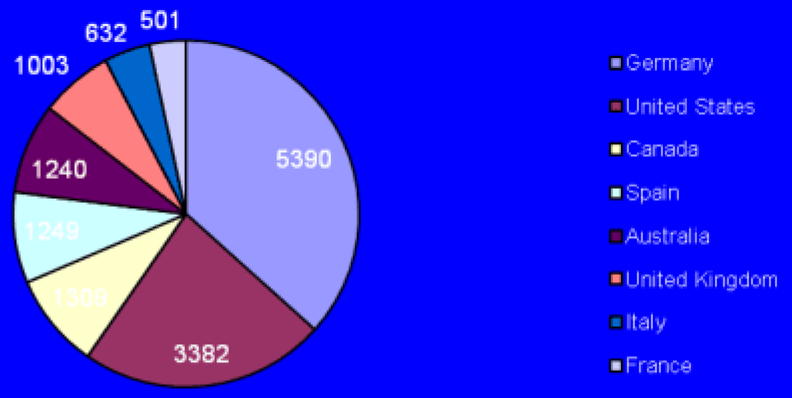
The optimal portfolio: concentrate on significant services with clear value added

Main success factors for Internet Banks
(Celent 43 case studies research)

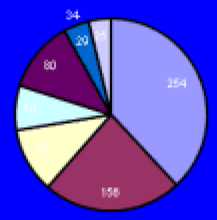
- **Costs.** The direct channels have to leverage their lower operating costs in order to offer better pricing and rates to the customer
- **Processes.** Selling direct is all about implementing better processes than rival multi-channel banks'.
- **Product.** The flagship product has to appeal to a large market, fill a gap, and be innovative, easy to understand, and easy to buy.
- **Speed.** it is important to reach a critical level of awareness and size in a short period of time, i.e., 12 to 18 months.
- **Marketing.** Marketing strategy is critical to the success of a direct venture
- **Channel conflicts.** Channel conflicts can be managed, but they have been a frequent cause of failure.
- **Convenience.** Convenience can never be the core proposition of a direct bank.
- **Technology.** Technology may be a critical competitive differentiator.
- **Commitment by stakeholders.** A give-it-a-try approach does not work. Either an institution and its shareholders commit to the plan, or they do not.

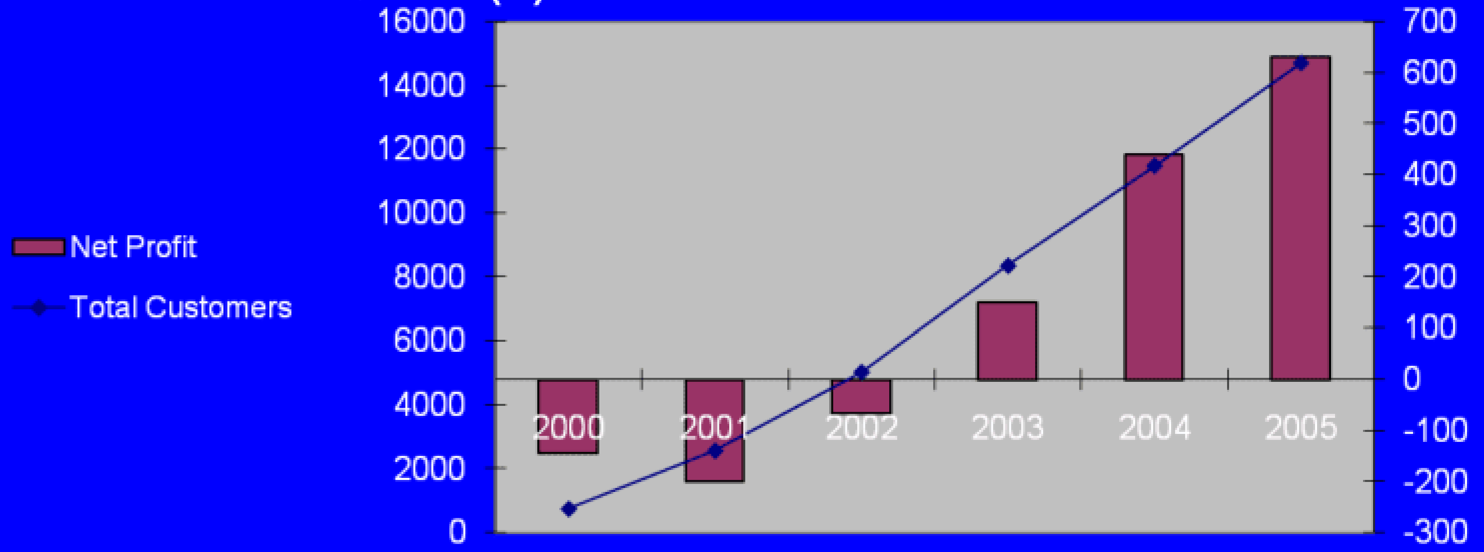
ING Direct case study- a world wide success story-the first years

2005 Customers (K)



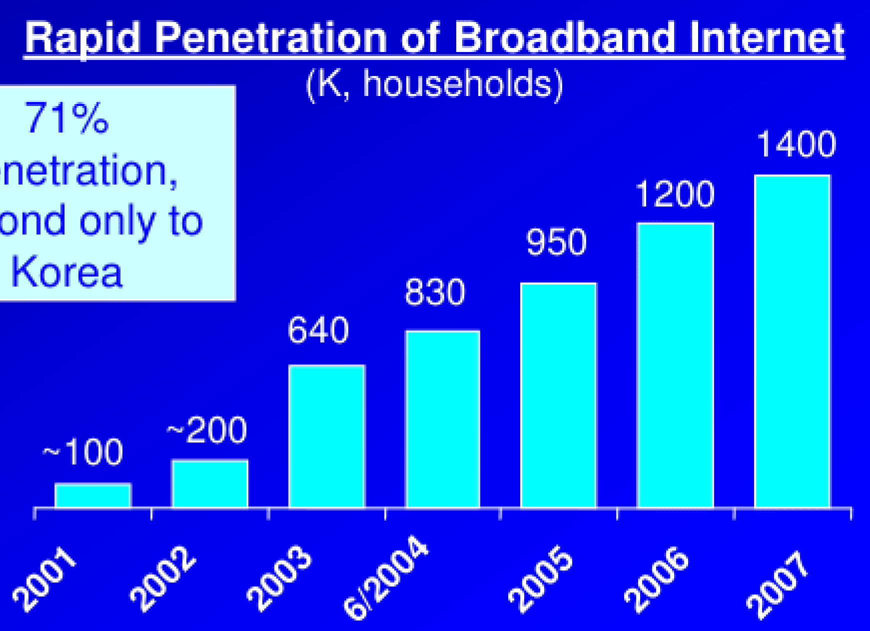
2005 Profit (eM)

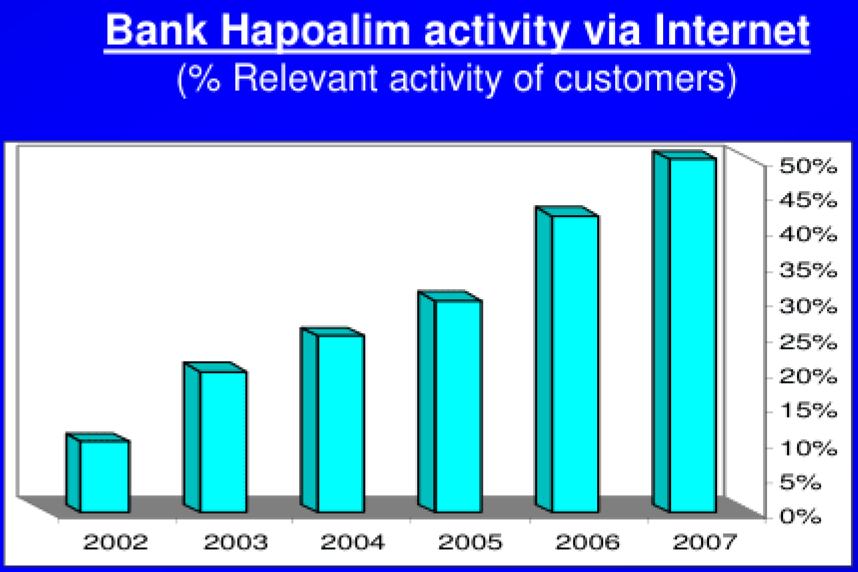




Israelis are already banking over the internet

71% penetration, second only to Korea





	Monthly visitors	Daily visitors	Monthly visits per visitor
Hapoalim	649K	110K	6.9
Leumi	355K	59K	6.3
Discount	49K	6K	4.0

ComScore internet panel, Jan 07

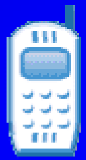
The Israeli Consumers have proven to be "price sensitive"

Insurance

- 2 direct insurance companies have reached 20% of the relevant market, with an average discount of less than 20% on car insurance

International Phone Calls

- As competition introduced in July 97, Bezeq dropped to less than 60% of the market <u>in 70 days!</u>
- Total usage (minutes) market grew by <u>87% in the first 3 years</u>



Mobile

- In 1995 Cellcom entered the mobile market with a discount of 80% on the incumbent prices! Within the year it became the largest operator
- The mobile market grew from $0.5B to $1.2B in 2 years (with 37% penetration) and reached $4.8B by 2008 (120% penetration rate!)

<u>Banking services</u>

- The Israeli banking industry is an oligopoly run by 2 major players; there are no real alternatives, "they are all the same", and without transparency and new offering it's hard to compare service + cost

The Israeli public is looking for a new banking offering

- **Dramatic change in the regulators' approach due to public pressure:**
  - The Knesset established a Special Investigational Committee focusing on the lack of competition in the retail banking market
  - Bank of Israel is acting towards reducing concentration in the industry: encouraging new entrants, Internet bank, Postal Bank, etc.
  - Anti Trust Commissioner is supporting internet bank, lowering barriers to entry, improving transparency of commissions and re-organizing the Postal Bank
- **The Israeli consumer doesn't like to be locked up**
  - "The total rating of the banking system is 5.4 compared to 6.6 for the cellular operators", (The Knesset Research Department Survey)
- **The banking fees & commissions are getting into public focus**
  - "The customers are raising a white flag … 2/3 of them admit that the basic charging method is not clear to them" (VP marketing, Bank Hapoalim)
  - "Another factor that does not add to the degree of competition is the long, <u>and perhaps even ridiculous, list of fees</u>. I fail to understand why in Israel the banking system operates thus, while in other countries banks make their money essentially from the spread between their lending and their borrowing interest rates." (Professor Stanley Fischer Governor BOI, Nov 06)

The time is right for Internet Banking in Israel

Super-competitive

Consumer friendly, Simple and Transparent

Using multiple points of contacts

(Phones, Mobile devices, Internet PCs, TV etc.)

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iBank will offer full RETAIL service relationship

- Deposits (Short and long term)
- Loans
  - Consumer credit
  - Car loans
  - Mortgages
  - Credit Cards
- Current accounts
- Capital markets trading (Brokerage)

Set of simple financial products competitively priced and easily understood

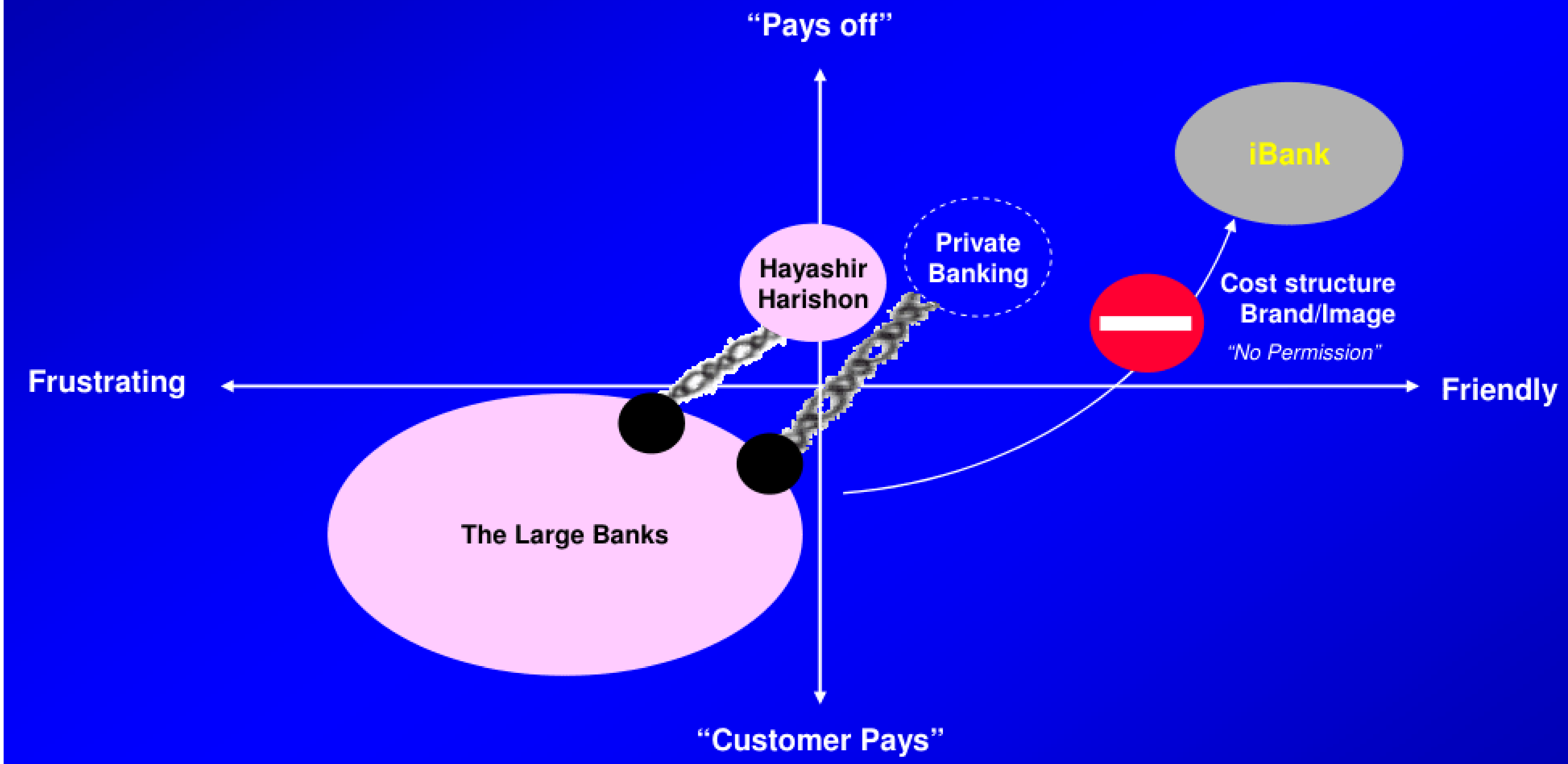
iBank is designed to operate in a low risk environment

- iBank will focus on retail and private banking services
- iBank will offer its corporate and commercial clients operational services and investment operations
- iBank will not be exposed to corporate/commercial lending
- iBank will not underwrite mortgages (will distribute for a fee)
- iBank will not operate a Forex dealing room (will interface with others)
- iBank will not advise on securities (decision support expert systems)
- iBanks's Nostro investment-policy--conservative & prudent
- iBank will utilize advanced risk management and control systems
- iBanks' operational platform -- strategic collaborations

IBank: marketing strategy

- **Dramatic price reduction**
  - Financial Margins & Commissions – reduction of at least 50%
  - Cancellation of numerous Fees & Commissions
- **Significant improvement in the quality of service**
  - Providing access to advanced expert systems free of charge
  - Full transparency as a leading motto
- **Empowering the retail customer**
  - Providing data for managing customers accounts in all banks
  - Minimizing switching costs

iBank - Competitive Concept of the Business Opportunity



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iBank: A variety of Interfaces with the customer

- Internet
- 24/7 call center
- Video conference technology (PC to Call Center)
- Services available on all ATMs
- Mobile handset alerts and activities
- Courier delivers to your door (opening an account, receive credit card etc.)
- Postal Bank services (e.g. depositing checks)

Lean cost structure supports heavy marketing oriented presence

iBank: Advertising and customer acquisition channels

- ❑ Internet
- ❑ Television
- ❑ Radio
- ❑ Newspapers
- ❑ Public Relations channels
- ❑ Strategic partnerships (Retail, Cellular, Insurance, Unions, etc.)

Aggressive acquisition budget with multiple channels strategy

The Traditional Banks have a Limited Ability to Respond

(Possible responses)

	Competitive Pricing	Establishing Operating Barriers	"Propaganda"
Definition	• Equal the VB offering to relevant customers	Cause delays, damages in inter-banking operative interfaces	Emphasize the credibility issue (small, new…)
Feasibility	• Can not discriminate price in the mass market • Internet channel is now 40% of banking- can't lower prices "only" on internet • Lowering costs to a significant number of customers will hurt significantly the banks profitability (return on capital)	• Difficult to create true operative barriers facing a well established operation on an existing platform (…Bank) • Regulators and public awareness.	• Can create an impact
	The bank has a limited ability to respond (cost structure)	Difficulty in creating barriers	An answer needed to a media attack

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Who is iBank's Target customer?

1. No. Barriers	2. Looking for an Alternative ("financially frustrated")	3. Profitability Potential

1. No. Barriers

- Free to decide (liabilities)
- Sophisticated and open minded
  - preference for Internet and direct banking channel users

2. Looking for an Alternative ("financially frustrated")

- Pays high fees (activity volumes)
- Feels that he is not maximizing control of his financial assets
- Considers his time as valuable

3. Profitability Potential

- Salaried (average and above)
- Students
- "Asset rich"
- Israelis abroad

Medium-high socio-economic status, with salary/financial assets, Age 18-50+, Internet users

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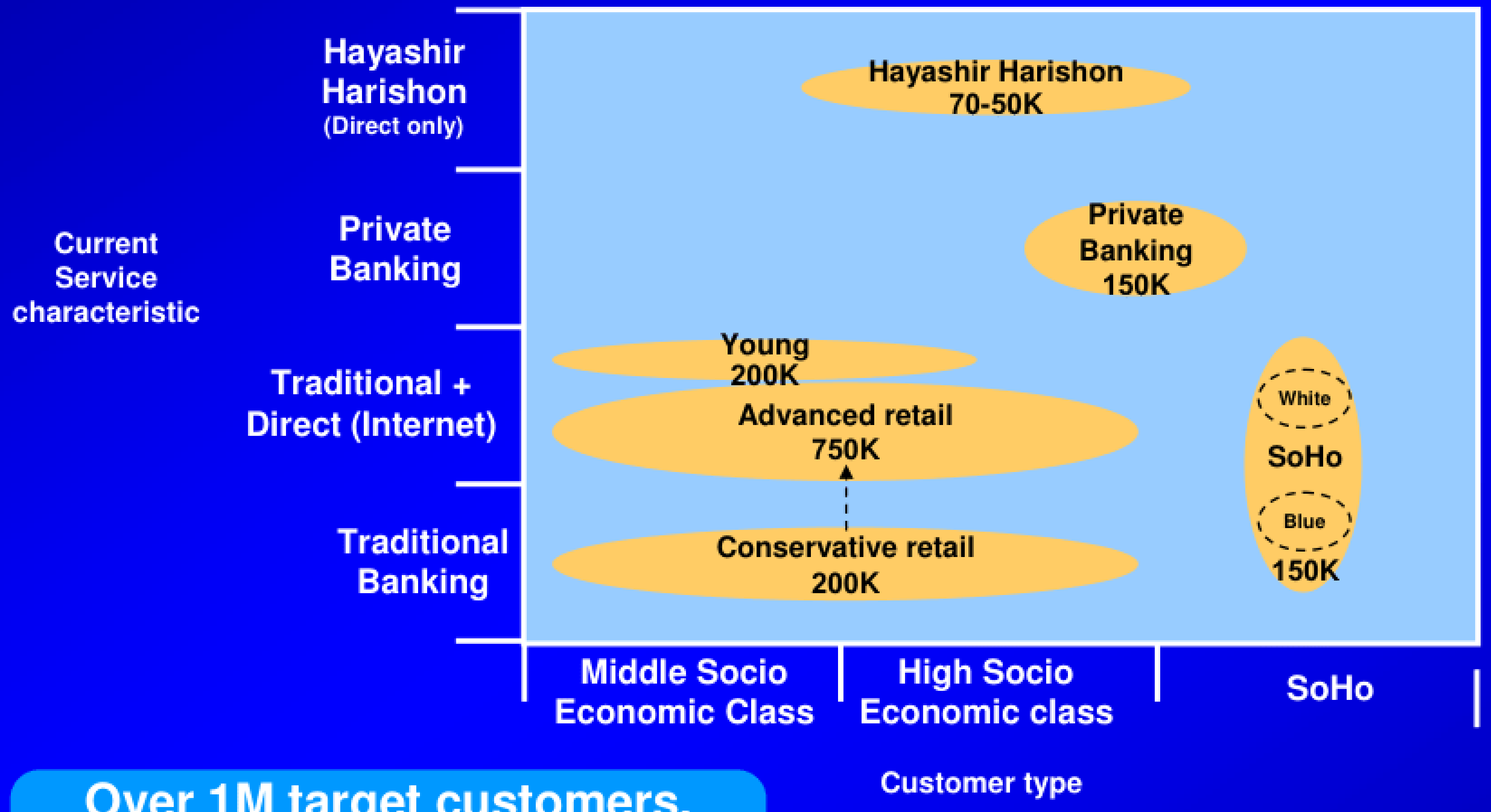
iBank: Variety of target segments



Over 1M target customers, representing 1.5M possible accounts

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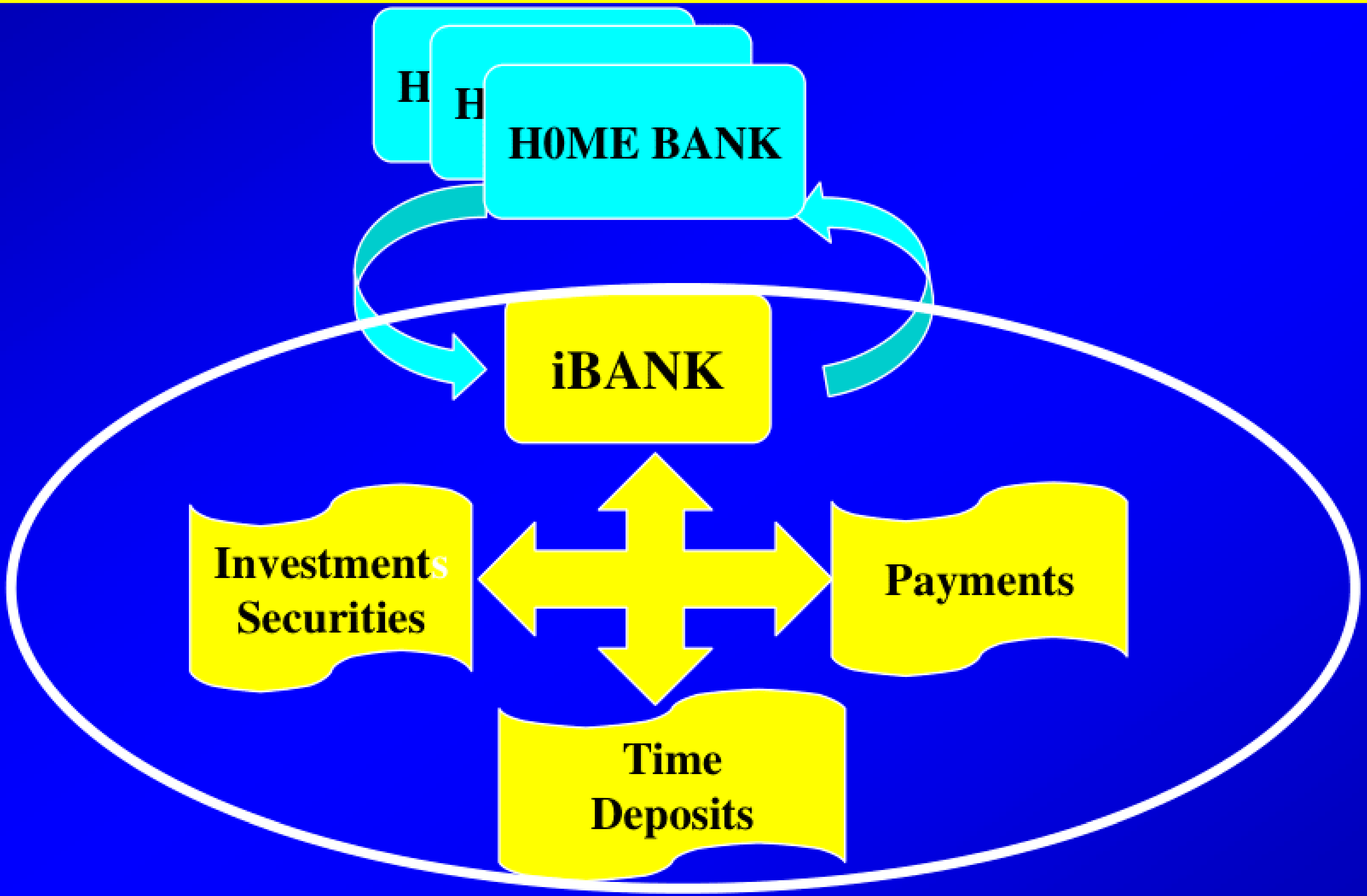
iBank: The Closed End Banking System



The Closed End Banking System covers the majority of the day to day retail banking activities

iBank: *Required investment in IT ('000 $)*

	Set Up phase	Year 1
Software Development	2,390	1,150
Software Products	830	2,130
Hardware	260	940
Other	80	270
Legal Cost	320	180
Other and unexpected	300	450
Total investment	**$4,180**	**$5,120**

iBank has received replies to its RFP from:

- **I-Flex (Oracle)**
- **SAP**
- **Accenture**
- **InfoSys**
- **IBM**
- **Temanos**

iBank: financial model – highlights

- Investment:
  - Set up period: 12-18 months
  - Set up costs: $20 million – $10 million by the Controlling Shareholders
  - Capital required: $100 million, including set up costs ($80 million upon launch)
  - Maximum accumulated loss: $32 million (E.O.Y 2) including $20 M Set up costs
  - Move towards Profitability as of Q3 of second year of operation
- Operations:
  - Net profit on year 5: $23 million after tax, growing yearly approx. 50%
  - Fifth year personnel: 162 (FTE)
  - Average Number of customers: 18,000 on year 1, growing to 180,000 on year 5
  - Provisions for bad debt: 0.7% compared to less than 0.4% industry average

iBank: Capital Structure

- Primary Capital – Shareholders Equity + General Reserves for bad debts
- Secondary Capital
- Third Tier Capital
- Hybrid Capital

- Total Eligible Capital - 215% of Primary Capital

iBank will commence operations with $80 million Primary Capital

The evolution of iBank

- Shlomo's extensive business experience in Banking and Cellular
- The Closed End Banking System
- Cellular banking
- Amdocs
- iBank gets a "road map" from the BOI in early 2007
- Submitting a comprehensive business plan in June 2007 and obtaining B.O.I approval to move to the next stage in December 2007
- Assembling the Control Group in 2008
- "Meltdown" of the global financial system in September 2008
- Passing away of anchor investor in March 2009
- Fund raising "re-start"
- Currently, there are two Control Group investors, each taking 25% of the Control Group (i.e. $12.5 million) + several others under discussions
- The remaining $50 million will be raised from passive/financial investors, after finalizing a term sheet among the Control Group

iBank: Role and commitment of the entrepreneurs

- Shlomo intends to be a pro-rata part of the Control Group
- Upon signing term sheet, Entrepreneurs will get an option to buy 20% of iBank for 10 years at the actual cost of the investment (i.e. 20% of the upside)
- The Control Group will have full and direct control on all decision-making process during the set up phase and thereafter through the Board of Directors of iBank

iBank: Regulator's demands from Control Investors

- Integrity
- Net worth of 2-3 times of their investment amount
- No leveraging or pledging of the investment (all equity)
- PE or VC Funds can not be more than 40% of the Control Stake ($20M)
- Investors are committed to 5 years, unless if iBank will go public earlier
- Divestment is allowed only to approved Investors (or by an IPO)
- Investors are not allowed to control other Israeli competing companies
- Investors are not subject to additional financial commitment beyond their investment

iBank: timetable, capital and licensing procedure

- The BOI has already approved: iBank's business plan; its capital ($100 million); its capital adequacy (15%) and the size of its "Control Group" (50.1%)

- Key phases of iBank's launch are:
  - Finalizing list of 3-4 core investors
  - Signing term sheet and advancing $500,000 from each investor,
  - Commitments for $50 million by the passive/financial investors,
  - Finalizing with the BOI last steps of phase 2 business plan (IT, Management Team, Control System, Procedures etc.),
  - Commencing iBank's set up phase,
  - Approval by the BOI of the Control Shareholders
  - Executing a "soft launch",
  - Injection to the required capital ($80 million) ,
  - "Going live"

Time to "Going live" Is estimated at 12-18 months from finalizing Term Sheet

iBank: summary of the opportunity

- The Israeli retail banking industry offers a unique window of opportunity in 2011 -2012 for the emergence of a stand alone Internet Bank
- An Internet based bank could be a formidable alternative to the current industry structure, offering attractive low prices and friendly approach
- The entrepreneurs intend to set up the internet bank within 12-18 months with an investment of approximately $ 20 million (total capital requirement of $100 million)
- The bank is projected to break even in the second half of second year and is projected to generate 30% IRR assuming Israel is the only market

Worldwide strategy: Going International in third year of operation

Thank You