

# iBank

## Executive Summary

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## 1. iBank Overview

This investment opportunity is being spearheaded by Shlomo Piotrkowsky, an experienced and accomplished bank executive in Israel. The analysis indicates a significant opportunity to capitalize on built-in market inefficiencies in the Israeli banking sector.

Mr. Piotrkowsky has an impressive track record.

- He turned a \$24m investment in the bank he ran as CEO into \$110m (the amount realized by the shareholders upon sale, not including dividends paid over the years);
- In addition, while at the bank, he created an independent credit card company and converted a \$45m investment into a stake worth ~\$155m; and
- He obtained \$100m from the shareholders of his bank for the purpose of establishing an Israeli cellular service provider (where he served as Chairman). He was instrumental in driving up the value of this venture so that they were able to realize in total \$850m upon sale of their stake.

Mr. Piotrkowsky intends to invest \$12.5m of his own money in this venture and become part of the control group that would own 51% of iBank.

Mr. Piotrkowsky's partner is Isaac Devash who has, for close to 20 years, been conducting investments and investment banking activities in New York, London, Tokyo and Tel Aviv.

Together they have compiled a comprehensive business plan detailing how they intend to establish and build iBank, an Internet bank that can exploit the structural inefficiencies in the Israeli banking and financial sectors. The plan was examined by the Bank of Israel (**BOI**) who has agreed to license this new bank (in itself a significant achievement, since no new bank license has been issued in Israel for the last 60 years). To withstand BOI scrutiny and gain BOI approval the plan (and the numbers presented below) is based on highly conservative assumptions.

Key investment parameters:

- Total capital raised: \$100 million
- Mr. Piotrkowsky intends to invest \$12.5m
- The Founders will be entitled to warrants to buy 20% at a strike price equal to total capital raised
- Set up period: 12-18 months
- Set up costs: \$20 million to be written off rather than capitalized
- Commence operations with \$80m of primary capital after expensing the set up costs
- Control stake: 50.1% of the \$100 million to be divided among several investors
- Non-control stake: 49.9% of the \$100 million to be raised from "passive" financial investors, each acquiring no more than 5% (a control investor may also purchase a non-control stake)

Key operational targets as presented (and approved) to the Bank of Israel for Year 2-5:

- Accumulated loss not to exceed \$32 million, including \$20 million of set up costs (second year of operation)

- Become profitable in Q3 of second year of operation
- Year 5 net profit: \$26 million after tax, growing yearly approx. 50%
- Year 5 personnel: 162 (FTE)
- Number of customers at year-end: Year 2 - 76,000; Year 5 - 200,000 (the business plan assumes that these customers will transfer only 33%-50% of their activities to iBank)
- Provisions for bad debt: 0.7% compared to less than 0.4% industry average

## 2. Inefficiencies in the Israeli Banking System

The Israeli banking industry is highly centralized with an oligopoly type structure, particularly in the retail banking segment (which cross subsidizes other sectors). According to BOI, there are no competitive threats in the industry in general and especially in the retail banking sector.

- The degree of concentration in Israel's banking industry is very high. The Bank of Israel (BOI) uses the Herfindhal Index to compare levels of concentration and reports that Israel has the third highest degree of concentration among industrialized countries (exceeded only by Finland and Switzerland and by orders of magnitude greater than the U.S or the U.K.). The top 5 Israeli banks have a 94% market share and the top 2 have 65%;
- Israeli banks are financial "supermarkets". The entire credit card industry and the distribution of capital markets products as well as mortgage banks and underwriting business fall under their control;
- There is no Israeli equivalent of a Charles Schwab or Fidelity. There are no low per-transaction brokerage costs - Israelis pay a fee that is a % of the transaction size;
- The cost per bank employee in Israel is about 3x that of the average for all workers. The average annual cost per bank employee in Israel is ~\$81k, vs. ~ \$62k in the U.S. The real discrepancy is even starker considering that the per capita income in the U.S. averages \$46k per annum compared to \$28k in Israel;
- The bank labor force is totally, unionized and the labor federation makes sure the union agreements covering compensation and benefits move more or less in lockstep between the various banks. Management's ability to increase labor efficiency is highly curtailed (firing bank employees for other than cause is just about impossible. Therefore, the Israeli banks are also overstaffed with about 47,000 employees);
- The cost structure of the Israeli banks totals ~\$7.3B and is very rigid:
  - Employee salaries & benefits: 47k employees x \$81k pa = \$3.8B; HR=~60% of total costs.
  - Overhead costs (including maintaining 1,286 branches) = \$2.6B
  - Provision for doubtful accounts: 0.5% on loans totaling ~\$155B = \$0.8B
- On the revenue side, fees generate ~\$3.1B and net interest income ~\$6.2B. Assuming a 30% tax rate results in net income of \$1.4B, a ~10% return on the \$14.8B book equity of Israeli banks.
- Retail banking accounts for ~80% of operating income; subsidizes other operations
- Households and small businesses account for ~50% of the \$3.1B in fees. This equates to ~\$775 per household pa. We don't have the corresponding number for the U.S., but in Canada and Australia the numbers are ~80% lower. These outrageous fees charged by Israeli banks have been the subject of much public debate and recent legislation may bring insignificant relief and the large discrepancy will remain even if the small anticipated reduction is realized.

- We suspect households and small businesses are not getting their fair share of interest income, thus helping the banks achieve a much larger than warranted net interest margin, but do not yet have the data to back this up.

### 3. The Lead Investor

Shlomo Piotrkowsky was Senior Deputy General Manager of Bank Leumi (one of Israel's two largest banks) until December 1990. In January 1991 he was appointed CEO of First International Bank of Israel (FIBI) which had been acquired by the Safra family in 1986 for \$24 million. He served as CEO of FIBI until 2001 and as its chairman from 2001 until 2003 when the Safra family sold FIBI and divested itself (against Piotrkowsky's advice) of all its other holdings in Israel, including Cellcom (see below). Piotrkowsky's tenure was marked by the following major accomplishments:

- Increased the bank's asset base, market share and profitability
- Diversified the bank's business
- Realized a significant profit by building FIBI to the point where it was sold for a valuation \$200 million (FIBI's valuation today is ~\$550 billion)

Piotrkowsky's business relationship with the three Safra brothers spanned 14 years (1990-2003) during which he achieved a position of trust that went far beyond his roles in Israel (e.g., Piotrkowsky headed all their International Worldwide Private Banking activities out of Brazil) and in the bank.

In 1994, Piotrkowsky initiated a \$300m joint venture between Safra and BellSouth and others to establish Cellcom, the second Israeli cellular service provider. During the 8 years following its founding, he served as Chairman of its Executive Committee and then as Its Chairman of the Board of Directors and played a key role in its success. Cellcom became the largest and most profitable Israeli cellular company, breaking the monopoly previously held by Pelephone (the first Israeli cellular operator owned at the time by Bezeq, the domestic incumbent telecom provider, and by Motorola) and competing successfully with Partner (the third operator). This \$300m investment (in the form of a shareholders' loan that was fully repaid by 1998) generated an enormous profit when the shareholders sold their stake at a \$2 billion valuation. Cellcom today has a market value of ~\$3.0B after having paid over the years dividends totaling ~\$1.95B (i.e. an initial investment of \$300m turned to be worth about \$5billion).

In 1998 Piotrkowsky founded Alfa Card, Israel's first independent credit card company (in Israel, almost all credit cards are issued by banks and are more akin to debit cards). The idea was to introduce competition to the credit card duopoly of the 2 largest banks (Leumi and Hapoalim). The company issued in a year or so ~100,000 credit cards to FIBI customers and ~ 130,000 credit cards to non FIBI customers, and was partially purchased by Leumi in 2000 for \$35 million and another portion of the company was sold for 20% stake in another credit card company which is currently owned by Discount Bank (~71%) and FIBI (~29%). The value of the 20% stake created by Piotrkowsky is worth about \$120m (plus the \$35m originally paid by Leumi).

As Lead Investor and a participant in the control group, Piotrkowsky will personally invest \$12.5m. Given these roles, Piotrkowsky, like any other control stake investor, will not be permitted by BOI to assume a management role in iBank. However, he will devote the bulk of his time to iBank in the 12-18 months set up phase and thereafter in his capacity as a board member and will be instrumental in selecting key management personnel, including the CEO, and in providing ongoing advice and monitoring.

#### 4. The iBank Plan - Overview

The plan requires capital of \$100m. In 2008 Piotrkowsky and his partner assembled an investor group anchored by U.S. billionaire William Morse Davidson, CEO and Chairman of Guardian Industries, one of the world's largest manufacturers of architectural and automotive glass. Delays ensued, first because of the financial meltdown that began in September 2008 and subsequently due to the death of Bill Davidson in March 2009, at which point the fund raising effort was aborted. It is now being re-started.

Retail banking in Israel is characterized by average profitability due to its high level of inefficiency and significantly lower risks. Piotrkowsky aims to replicate the success of ING Direct by offering full range of products and transparent retail banking products at very low cost: savings (deposits), loans (consumer credit, car loans, credit cards), payment accounts, and investment products, as well as marketing of mortgages underwritten by other banks and financial institutions. iBank will target customers who are already internet users (Israelis are already heavy internet users with a broadband penetration rate of over 75%, second in the world) and have medium-to-high socio-economic status in terms of salaries/financial assets. It will aim to reach a critical level of awareness and size within a short period of time and will offer:

- Far lower fees and transaction costs – at least 50% discounts
- Quick, easy and simple account opening process
- Easy access (24/7 call center, internet, video conferencing, mobile handset/smartphone alerts)
- ATM services
- Courier service for opening an account, receive a credit card
- Check deposit facility (possibly via Israel's postal bank).

Given their cost structure, Israeli banks are not well positioned to respond to competitive threats by lowering fees. It is interesting to note that 2 direct insurance companies in Israel were able to reach 20% of the relevant market with an average discount of less than 20% on car insurance.

#### 5. iBank Plan – Details

iBank will offer its customers a full retail-service relationship with dramatic price reductions and significant improvement in quality of service.

- Initial expenses and capital adequacy
  - a. \$15-20m will be allocated to the set up phase (~12-18 months) and will be written off (rather than capitalized). Of that amount, ~\$9.3m will be invested in IT:

	<b>Set Up phase</b>	<b>Year 1</b>
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
<b>Total investment</b>	<b>\$4,180</b>	<b>\$5,120</b>

- b. The ~\$80m remaining capital will be sufficient to comply with Basel II Accord requirements.
- Focus on retail (households and private banking)
  - a. iBank will operate 24x7 without branches
  - b. iBank will offer consumer credit (NIS, CPI linked, Forex) utilizing credit scoring & credit analysis to determine creditworthiness
- Capital market activities:
  - a. iBank will provide informational and transaction services, but not investment advice. It will enter into distribution agreements with asset & investment managers.
  - b. iBank will not operate a Forex dealing room; will deal via other banks' dealing rooms
  - c. iBank will offer consumers margin loans.
- Mortgages – only distribution; no underwriting
- Other banking services
  - a. ATM – integrated into the IL system
  - b. Money transfers
  - c. Online information services at no charge' no electronic mail commissions
  - d. Customized banking products for insurance company, retail chain, cellular operator clients
  - e. Distribution of insurance & pension products
- Low risk profile: iBank will NOT provide
  - a. Corporate/Commercial lending
  - b. Underwrite Mortgages
  - c. Operate Forex dealing room
  - d. Credit facilities (LOCs, guarantees, etc)
  - e. Credit card clearing services for merchants
  - f. Investment consulting
- Target customers:
  - a. Initially people who already use the Internet for banking (Israeli broadband penetration second only to Korea; Israelis already banking over Internet)
  - b. Wage earners, self-employed professionals, high tech industry employees
    - i. Medium-high socio-economic status, with salary/financial assets,
    - ii. Age 18-50+, Internet users
  - c. Students, armed services, pensioners: reduced fees
  - d. SMB: operational banking services at lower costs
  - e. Commercial and Corporate customers – None credit oriented services (deposits, securities, fund transfers, credit cards and current account management)
- Plan for rapid penetration in first 18 months:
 

Israeli consumers have demonstrated they are highly price sensitive: (i) two direct insurance companies were able to quickly capture a 20% market share of the local car insurance market with an average discount of less than 20%.; (ii) when price competition for international calls

was introduced the incumbent service provider dropped from 100% to less than 60% market share in 70 days and total minutes used grew by 87% in the first 3 years; (iii) when Cellcom entered the mobile market with a discount of 80% on the incumbent prices it became the largest operator within one year.

Factors that will work in iBank's favor in terms of rapid market penetration include:

- a. Direct image and product based advertising
- b. Direct approach to large employers
- c. Direct approach to government (employees, IDF, pensioners)
- d. Drastic reduction in banking services costs
- e. Drastic reduction in number and type of charges
- f. Flat fees on securities transactions
- g. Interest bearing checking account
- h. No custody fees
- i. No differentiation based on financial wealth (platinum, gold, silver, regular)
- j. No need to go to a branch to transact
- k. Customer can continue to maintain existing bank accounts
- l. Regulatory and consumer pressure
- m. The Israeli consumer doesn't like to be locked up and is well aware of the high banking fees & commissions it is being charged, and of the "...long, and perhaps even ridiculous, list of fees" (as noted by the BOI Governor).

## 6. Investor Mix Requirements & Holding Restrictions

The control group will invest 50.1% of the \$100 million. The balance will be provided by the non-control group. Control Investors are not obligated to invest new capital in the bank (i.e., beyond their initial commitment) in case of financial stress.

- BOI control group requirements and restrictions:
  - An individual or individuals may invest 100% of the control group (50.1%) amount
  - Several (2-6) investors can hold the control group
  - A holding company with less than 30% leverage may invest 100% of the control group amount provided its activities entail maintaining control positions in other corporations and holding tradable bonds
  - Institutional investors or investment funds may, in total, invest up to 40% of the control group amount
  - A single institutional investor or investment fund may invest up to 25% of the control group amount
  - Corporations may, in total, invest up to 25% of the control group amount
  - A single corporation may invest up to 15% of the control group amount
  - A single corporation in which a control stake of over 50% is held by a single shareholder may invest up to 25% of the control group amount
  - Control group members are expected to hold the investment for 5 years, unless iBank goes public earlier
  - Control group members can sell their investment only to a buyer approved by BOI (unless if they are selling to the market)

- Control group members are not allowed to control other entities that compete with iBank
  - In order to obtain BOI approval, control group candidates will need to provide financial information that includes a consolidated balance sheet
  - Integrity
  - Net worth of at least 2-3 times the amount invested
  - No leveraging or pledging of the investment (all equity)
  - BOI allows control group members to also hold non-control stakes
- BOI non-control group requirements and restrictions
- A single non control investor is limited to less than 5% stake in iBank
  - No BOI approval is required
  - These shares are freely tradable at any time

Example: assuming \$100m is being raised, the maximum amount an investment fund wishing to be part of the control group can invest is \$17.5m, comprised of 25% of the \$50m control stake (\$12.5m) plus \$5m of a non-control stake (5% of \$100m). If such maximum is invested, the remaining amount available for other investment funds wishing to be part of the control group is \$12.5m, comprised of 15% of the \$50m control stake (\$7.5m) plus \$5m of a non-control stake (5% of \$100m).

## 7. iBank Financial Model Highlights

NIS 3.67 = 1US\$ as of 2/2/2011

<u>Year of Activity</u>	<u>1</u>	<u>2</u>	<u>3</u>	<u>4</u>	<u>5</u>
Customers EOY	36,000	76,000	120,000	160,000	200,000
Total accounts in market	4,500,000	4,590,000	4,681,800	4,775,436	4,870,945
Customers accounts market share	0.8%	1.7%	2.6%	3.4%	4.1%
Internet Bank Deposits (**) (***)	360,000	1,264,200	2,479,400	3,944,500	5,616,000
Retail Market Deposits (***)	466,000,000	476,252,000	486,729,544	497,437,594	508,381,221
Deposit Market Share	0.08%	0.27%	0.51%	0.79%	1.10%
Internet Bank Loans (**) (***)	324,000	1,495,200	2,783,200	4,214,000	5,724,000
Total Market Loans (***)	158,000,000	161,002,000	164,061,038	167,178,198	170,354,583
Loans Market Share	0.21%	0.93%	1.70%	2.52%	3.36%
Internet Bank Credit Cards	7,200	22,400	41,160	61,600	82,800
Total Number of Credit Cards	4,369,680	4,457,074	4,546,215	4,637,139	4,729,882
Market Share	0.16%	0.50%	0.91%	1.33%	1.75%
** Based on average accounts per year			*** '000 NIS		

**Income Statement (NIS '000)**

	Set Up	Year 1	Year 2	Year 3	Year 4	Year 5
Net Interest Income		9,603	34,280	64,342	98,238	134,568
Interest on Capital		17,993	14,717	13,370	14,248	17,986
Provisions for Doubtful Debts		-3,024	-9,405	-17,483	-26,439	-35,874
Net Interest Income after Provisions		24,572	39,592	60,229	86,047	116,680
Operating Income		14,950	50,538	93,199	141,658	191,475
<b>Total Income</b>		<b>39,522</b>	<b>90,130</b>	<b>153,427</b>	<b>227,705</b>	<b>308,155</b>
Operating Cost	40,145	105,037	117,072	135,860	152,943	167,491
<b>Profit Before Tax</b>	<b>-40,145</b>	<b>-65,515</b>	<b>-26,942</b>	<b>17,567</b>	<b>74,763</b>	<b>140,664</b>
Taxes					0	-44,374
<b>Net Profit</b>	<b>-40,145</b>	<b>-65,515</b>	<b>-26,942</b>	<b>17,567</b>	<b>74,763</b>	<b>96,290</b>

**Pro-forma Balance Sheet (NIS '000)**

	Year 1	Year 2	Year 3	Year 4	Year 5
<b>Cash</b>	<b>340,320</b>	<b>151,158</b>	<b>221,805</b>	<b>467,848</b>	<b>867,718</b>
<b>Loans</b>	<b>324,000</b>	<b>1,495,200</b>	<b>2,783,200</b>	<b>4,214,000</b>	<b>5,724,000</b>
<b>Buildings and Equipment</b>	<b>35,020</b>	<b>32,240</b>	<b>28,860</b>	<b>24,880</b>	<b>20,300</b>
<b>Other Assets</b>	<b>0</b>	<b>0</b>	<b>0</b>	<b>0</b>	<b>0</b>
<b>Total Assets</b>	<b>699,340</b>	<b>1,678,598</b>	<b>3,033,865</b>	<b>4,706,728</b>	<b>6,612,018</b>
<b>Deposits</b>	<b>405,000</b>	<b>1,411,200</b>	<b>2,748,900</b>	<b>4,347,000</b>	<b>6,156,000</b>
<b>Commercial Papers</b>	<b>0</b>	<b>0</b>	<b>0</b>	<b>0</b>	<b>0</b>
<b>Capital</b>	<b>294,340</b>	<b>267,398</b>	<b>284,965</b>	<b>359,728</b>	<b>456,018</b>
<b>Total Liabilities</b>	<b>699,340</b>	<b>1,678,598</b>	<b>3,033,865</b>	<b>4,706,728</b>	<b>6,612,018</b>

**Capital Adequacy Analysis**

<b>Assumptions:</b>					
Minimum Capital Adequacy (MCA)		8%			
Operational Risk Factor (Added to MCA)		20%			
Adjusted Minimum Capital Adequacy		9.6%			
Potential for Secondary Capital Factor		50%			
Collateral Factor (% of Loans)		35%			
	Year 1	Year 2	Year 3	Year 4	Year 5
Loans	324,000	1,495,200	2,783,200	4,214,000	5,724,000
Risk Assets (Loans Adjusted for Collateral Factor)	210,600	971,880	1,809,080	2,739,100	3,720,600
Minimum Primary Capital Adequacy (MPCA)	16,848	77,750	144,726	219,128	297,648
MPCA, Adding Operational Risk Factor	20,218	93,300	173,672	262,954	357,178
End of Year Primary Capital	294,340	267,398	284,965	359,728	456,018
Excess Primary Capital Adequacy	274,123	174,098	111,293	96,774	98,841
Potential Secondary Capital (PSC)	147,170	133,699	142,483	179,864	228,009
Excess Capital Adequacy Assuming PSC	421,293	307,797	253,776	276,638	326,850
Risk Assets Ratio (Actual)	139.8%	27.5%	15.8%	13.1%	12.3%
Risk Assets Ratio (Including Secondary Capital)	209.6%	41.3%	23.6%	19.7%	18.4%

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