Bank Muscat - 2018 Results Conference Call Update

(Closing: RO 0.416, Rating- Accumulate, 12 Month Fair Value: RO 0.482)

Management of Bank Muscat had 2018 results conference call to discuss on the 2018 performance and on the outlook for 2019. Key highlights discussed during the conference call are elaborated as follows.

Discussion on Oman Economy

Oman fiscal deficit has lowered during 2018 amid increase in oil prices and the measures taken towards revenue enhancement and decline in expenses. On the other hand, the decline in oil prices during Q4 2018 to impact fiscal position.

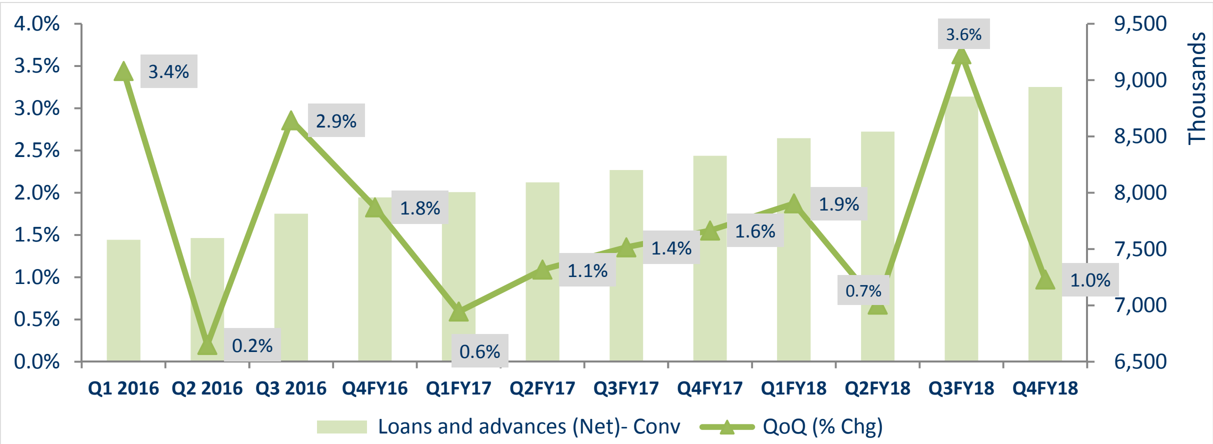
2019 Oman has budgeted based on the oil price of USD 58/ barrel. With current oil prices stabilizing above USD 60/ barrel, overall fiscal position to remain comfortable. The Government is estimated to maintain the current levels of investment spending and this would support overall steady economic growth rates in 2019.

2018 Performance

Credit and deposit growth remained in tandem…

End 2018, Conventional loan book of the bank is at RO 7.828 billion, reporting an increase of 6.4% YoY and 0.8% QoQ. The bank has continued its stable loan book addition trend during the quarter. Islamic book grew by 14.5% YoY and 2.3% QoQ. **Overall loan book (Conventional and Islamic) grew by 7.3% YoY and 1% QoQ amid increase in project lending.** As per the management, the bank has diversified loan book across various sectors. Of the total loans, Personal and housing loans form about 40% of total. The exposure to sensitive sectors like real estate and construction sector remain relatively lower and forms about 4% and 3.2% respectively.

Chart 1: Credit Growth Trend- QoQ (% Chg.)



Source: Company Reports, GBCM Research

Customer deposits growth remained strong during Q4 2018. Conventional customer deposits grew by 16.2% YoY and 10.7% QoQ; While the Islamic deposits remained flat YoY and increased 0.6% QoQ. The combined customer deposits grew by 14.1% YoY and 9.5% QoQ. This is above our estimates. Excluding the one-off increase in deposits, the growth remained at about 7% levels similar to the credit growth. The bank reported substantial increase in customer deposits during Q4 2018, due to an increase in short term deposits which are transit in nature. As per the management, these deposits have already exited from the bank.

Bank Muscat continued to maintain stable funding profile along with diversified funding base. As per the bank, the retail deposits form about 37% of total deposits, while the Government and other Private sector deposits would form about 30% each.

Chart 2: Customer Deposits Growth Trend- QoQ (% Chg.)

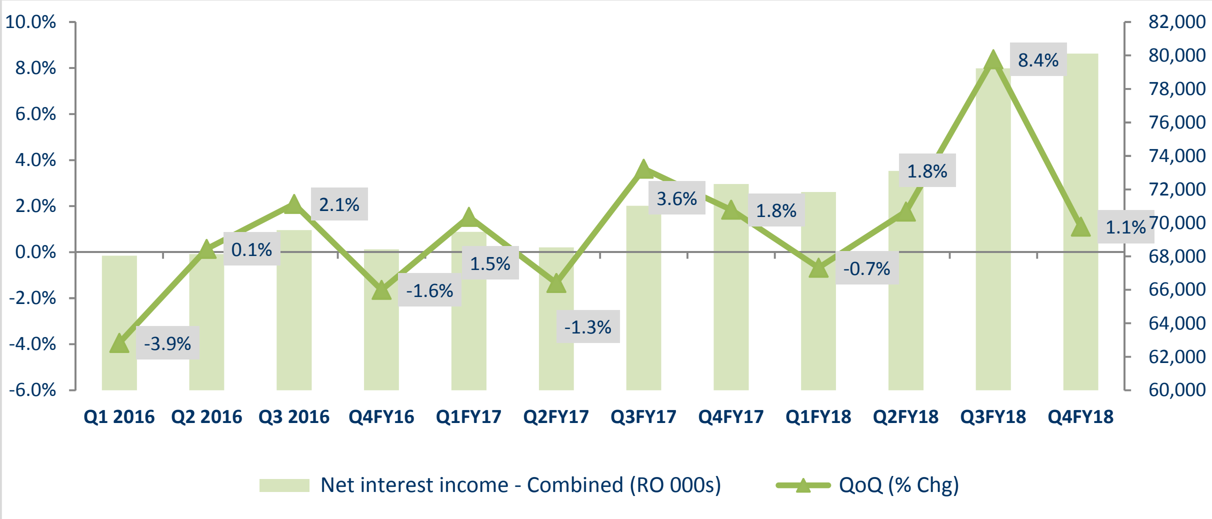
Source: Company Reports, GBCM Research

Net Interest margins remained stable…

The net interest income of the bank for 2018 has increased by 8.2% YoY to RO 304.29 million on the back of improvement in yield. The contribution from net interest income as percentage of total increased to 68% levels in 2018. Overall fees and commission income contribution increased to 22% of total revenue. The contribution from other income declined to 10% of overall revenues. While for Q4 2018, the net interest income (combined) has increased by 10.8% YoY and 1.1% QoQ amid steady growth in loan book and estimated increase in asset yield. **The bank has reported increase in asset yield, benefiting from US Fed rate increase and repricing efforts.** The bank also maintains significant low-cost deposit base which would continue to benefit which in turn has led to stable Net Interest Margins (NIMs) in 2018.

Non-interest income of the bank for 2018 revealed decline of 7.9% YoY amid higher base in 2017. Excluding the one-off items, the non-interest income growth revealed flattish trend. During Q4 2018, the other operating income declined 25.7% YoY (due to one-off gains) and increased 11.9% QoQ to RO 37.2 million.

Chart 3: Net Interest Income Growth Trend- QoQ (% Chg.)



Source: Company Reports, GBCM Research

Expenses under control…

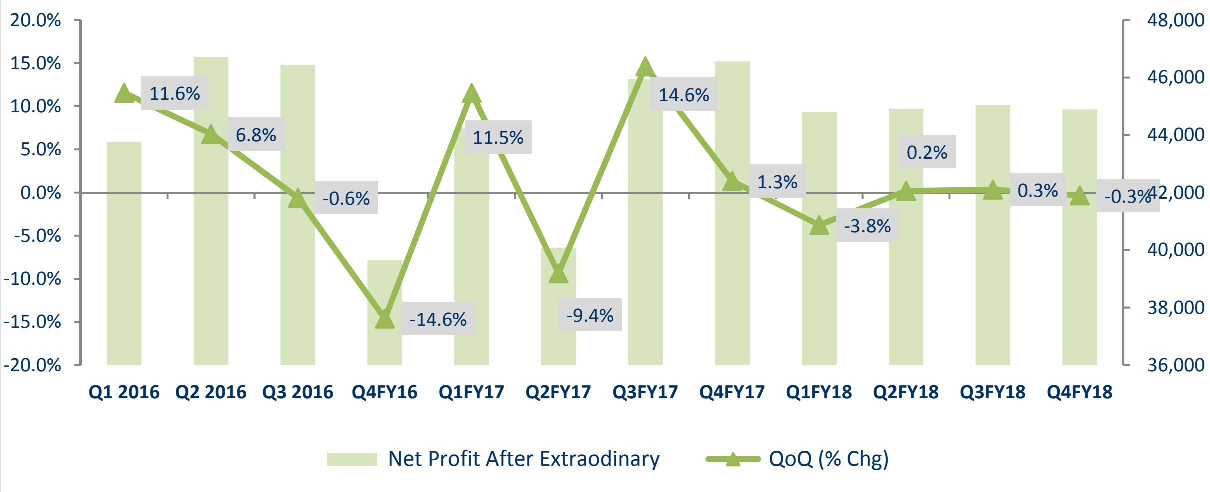
Operating expenses for 2018 increased 3.4% YoY to RO 190.3 million. Management has stated that the higher expenses is mainly attributed to increase in manpower related costs. For Q4 2018, total expenses have declined 2% YoY and increased 0.8% QoQ to RO 48.625 million. **Cost to income ratio of the bank stood at 42.6% levels, which is more in line with the range over the last five years.** 2018 Operating profit of the bank is at RO 256.4 million, an increase of 1.8% YoY. Q4 2018 operating profit of the bank is at RO 68.7 million, declining 5.6% YoY and increasing 6.9% QoQ, this is in line with our estimates.

Cost of risk increased during Q4 amid IFRS 9 related provisions…

As at end of 2018, overall Non-Performing loans to gross loans is at 3.09% levels, marginally increased as compared to 2.94% levels in 2017. The bank continued to adopt conservative provisioning policy and has also implemented provisioning related to IFRS9 during 2018. As per our estimates, the cost of risk (net) increased to 0.53% levels in 2018 as compared to 0.27% levels in 2017. The increase in provisioning during Q4 is primarily related to increase in collective provisioning levels due to the implementation of IFRS 9. During Q4, the cost of risk increased to about 0.94% levels.

2018 net profit of the bank has increased by 1.6% YoY to RO 179.6 million. Net profit of the bank for Q4 2018 stood at RO 44.9 million, reporting a decline of 3.6% YoY and -0.4% QoQ. This is more in line with our estimates of RO 44.5 million. The profit growth of the bank has been in a narrow band over the last four quarters, this clearly points out to stability in the numbers.

Chart 4: Net Profit Growth Trend- QoQ (% Chg.)



Source: Company Reports, GBCM Research

The bank has announced 2018 dividends of 30% in cash and 5% in stock, subject to CBO and shareholders' approval during the AGM (Mar 2018). The bank has maintained its dividend policy like the previous year.

Outlook for 2019

Credit Growth- Oman Banking Sector lending growth to remain about 4-6% levels in 2019 marginally lower than the growth rates seen in 2018. This is due to conclusion of select larger project financing in the previous year. **Management of Bank Muscat estimates their credit growth to be towards the upper end of the sector growth rates (around 6%) during the current fiscal year.** The growth is expected to be from diversified sectors which includes Power, Oil & Gas Downstream, logistics and tourism related projects.

Liquidity- Overall liquidity levels in the banking system remain stable and comfortable during 2019. USD liquidity would be towards catering to the growth in projects lending opportunities. Though no specific program is envisaged by the bank at this moment, they can access dollar funds quickly if the need arises through various streams. In terms of OMR liquidity, the growth in customer deposits base remain stable.

Spreads- Despite increase in cost of funding, the bank has maintained the overall spread levels due to increase in asset yield. Management anticipates stable spreads in 2019.

Asset Quality- Overall asset quality is estimated to remain stable during 2019. Management sees no major shift in cost of risk during the current fiscal year.

Capital Adequacy requirements- In terms of Basel III implementation, the total CAR requirements of Omani Banks as at end of 2019 would be about 14.5% levels. End 2018, Bank Muscat has total CAR of about 19.4% levels and the Tier 1 Capital ratio is at 18.1% levels, the highest levels within the sector.

Return on Equity- The total return on average equity (RoAE) of the bank has declined to about 10.8% levels (2018) from about 13.89% in 2014. The decline in RoAE over the years is on the back of increase in capital requirements due to Basel III implementation and other regulatory requirements. Management has guided for optimization of capital over the medium term. **While estimated RoAE of the bank in 2019 is about 11-12% levels.**

Sector Consolidation- In terms of local and regional banks sector consolidation, the management stated that Bank Muscat has been active in consolidation historically. **The Bank would look for right consolidation opportunities to participate and don't have any deal pipeline on this context currently.**

Valuations and Outlook- Demanding valuations, lack of triggers for re-rating…

Despite stable profitability trend over four years, the stock continued to trade at considerable discount (35% discount to book value) on macroeconomic challenges, subdued investor sentiments and the selling pressure seen from the foreign investors (since Q4 2014). As of now, the foreign ownership in Bank Muscat has reduced to meager to 5.28% levels as compared to the levels of c. 23.6% levels (as at end 2014), this clearly points out to the selling pressure seen in this stock over last four years.

On the valuations front, the bank trades at PBV (2018) of 0.68X and PBV (2019E) of 0.64X, remaining the cheapest bank in Oman and revealing discount to weighted average PBV of 0.74X for the local banking sector. Based on the dividends announced, the cash div. yield (2018E) works out to be c. 7.2% levels. **We have an Accumulate rating on the stock with the fair value of RO 0.482.**

Table 1: Bank Muscat- Key Ratios (Yearly Trend since 2012)

Growth Indicators	FY12	FY13	FY14	FY15	FY16	FY17	FY18
Gross Loan Growth	16.3%	9.7%	10.5%	8.0%	8.6%	4.7%	7.3%
Asset Growth	9.5%	7.2%	14.6%	28.9%	-13.7%	3.0%	10.2%
Customer Deposits Growth	12.1%	5.9%	16.4%	11.1%	1.3%	-0.5%	14.1%
Total Operating Income Growth	10.0%	5.1%	12.6%	6.4%	2.1%	4.8%	2.5%
Net Income Growth	18.4%	9.3%	7.3%	7.5%	0.6%	0.1%	1.6%
Profitability Indicators							
Return on Average Assets	1.84%	1.86%	1.79%	1.58%	1.51%	1.61%	1.53%
Return on Average Equity	14.33%	13.32%	12.93%	12.95%	12.00%	10.93%	10.31%
Interest Expenses/ Total Income	21.65%	23.22%	25.49%	22.24%	25.38%	27.90%	32.08%
NIM (%)	3.41%	3.23%	3.00%	2.69%	2.71%	2.90%	2.96%
Yield and Spread							
Yield on Interest Bearing Assets	4.43%	4.24%	3.93%	3.31%	3.45%	3.96%	4.19%
Cost of Funds	1.45%	1.49%	1.37%	1.05%	1.22%	1.61%	1.86%
Interest Spread	2.98%	2.75%	2.56%	2.26%	2.23%	2.35%	2.33%
Efficiency Indicators							
Non-Int expenses/ Assets	1.70%	1.69%	1.62%	1.36%	1.61%	1.65%	1.55%
Cost to Income Ratio (%)	41.59%	42.24%	41.21%	41.95%	41.83%	42.22%	42.61%
Liquidity Indicators							
Customer Deposits/ Shareholders Equity	4.96	4.58	4.80	4.82	4.33	3.83	4.17
Credit to Deposit Ratio (%)	105.2%	108.8%	103.1%	99.5%	106.7%	112.3%	105.6%
Equity to Assets Ratio (%) - CAR	13.6%	14.3%	13.5%	11.1%	14.3%	15.1%	14.6%
Credit Quality Indicators							
NPAs to GL	2.99%	2.65%	2.84%	2.75%	2.91%	2.94%	3.09%
Recoveries to GL	0.58%	0.51%	0.37%	0.47%	0.44%	0.48%	0.43%
Provision Coverage (%)	121.37%	129.20%	129.38%	142.10%	130.62%	128.95%	114.75%
Cost of Risk (%)	0.47%	0.31%	0.59%	0.51%	0.45%	0.27%	0.53%

Source: Company Reports, GBCM Research Estimates

Table 2: Oman Banking Sector- Comparable Valuations

Oman Banking Sector-Valuations	Closing (4-Feb-2019)	Rating	Market Cap (In RO 000s)	PE (2017)	PE (2018)	PBV (2017)	PBV (2018)	Div. Yield (2017)	Div. Yield (2018E)	RoAE (2017)	RoAE (2018E)
Bank Muscat	0.416	Accumulate	1,226,123	6.7	6.8	0.70	0.67	7.2%	7.2%	10.9%	10.3%
Bank Dhofar	0.154	Neutral	431,251	7.3	8.6	0.74	0.79	7.8%	6.5%	10.7%	9.9%
National Bank of Oman	0.185	Buy	300,800	6.5	5.9	0.66	0.71	8.1%	8.6%	10.3%	11.9%
Ahli Bank	0.145	Accumulate	216,962	7.7	7.5	0.81	0.85	6.9%	6.9%	10.7%	11.3%
HSBC Oman	0.125	Accumulate	250,039	13.1	8.0	0.77	0.73	4.6%	7.4%	6.0%	9.5%
Bank Sohar	0.111	Accumulate	220,074	7.8	7.5	0.67	0.75	4.5%	5.4%	9.0%	10.0%
Bank Nizwa	0.089	Neutral	133,500	35.3	17.8	1.02	0.97	0.0%	0.0%	2.9%	5.6%
Alizz Islamic	0.087	Neutral	87,000	-29.0	43.3	1.11	1.12	0.0%	0.0%	-3.8%	2.6%
Sector Average-Weighted			**2,865,749**	**7.7**	**8.8**	**0.74**	**0.74**	**6.4%**	**6.6%**	**9.4%**	**9.9%**

Source: Company Reports, GBCM Research Estimates

Stock Rating Methodology:

Buy - Upside more than 20%
Accumulate - Upside between 10% and 20%
Neutral - Upside or downside less than 10%
Reduce - Downside between 10% and 20%
Sell- Downside more than 20%
Not Rated - Stocks not in regular research coverage

LT- Long Term
ST- Short Term

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