

Bank Muscat (BKMB)

Investment Update
GBCM Research

Mixed Q1 2019 results, Positives on steady credit growth and expanding net interest margin, diminished by rising provisioning; Marginal upward revision in fair value.

Solid capital adequacy alleviates concerns on higher provision levels: The bank's credit quality has revealed marginal deterioration since beginning of Q2 2018. Bank Muscat has increased its provision coverage steadily from 110.3% in Q2 2018 to 116% in Q1 2019. Apart from rising NPAs provisioning, the bank's level 2 impairments for total loans have grown significantly by 19.3% YoY by the end of Q1 2019.

We have taken this trend into account in our projections and valuations. **Given the robust capital adequacy of the bank, we believe it's well positioned to manage (if the need arises) incremental unanticipated credit quality issues to an extent.** The bank commands robust capital adequacy (18.5% levels) among its peers in Oman.

Growth story intact amid steady credit off-take and strong operating performance:

Bank Muscat's operating profits increased by 14% YoY to RO 67.7 million in Q1 2019. It's net interest and financing income continued the YoY growth trend rising by 9.6% to RO 78.8 million. This growth came from a robust 7.9% YoY increase in total loans coupled with a YoY strengthening in net interest margin. **Driven by a robust operating performance, and despite higher provisioning, the net profit of the bank grew 2.2% YoY to reach RO 45.8 million in Q1 2019.**

Dominant Bank- Proxy to local Economy: Amidst mixed performance of the bank during Q1 2019 and the incorporation of earnings estimates for 2021E, we have revised the bank's fair value. **The stock price has outperformed as compared to benchmark index during 2019 mainly on the back of steady earnings trend, higher dividends and strong domination in Government Project lending.** We believe Bank Muscat acts as a proxy to Oman economy.

We expect the performance to remain stable amid strengthening oil prices, improving fiscal position, anticipated higher infrastructure and project spending. However, further economic slowdown may affect the bank's asset quality, thereby increasing provisioning requirements during the coming quarters.

At the current price, the bank trades at P/E (2019E) of 6.8X and P/BV (2019E) of 0.68X, we have an Accumulate rating on the stock with a fair value of RO 0.484. For 2019, we expect the bank's ROAE at 10.2% and dividend yield is at 8.1% levels (assuming 55% pay-out). The bank is among our Top 10 recommendations in Oman.

Key Financial Metrics

(In RO Millions) *	2016	2017	2018	2019E	2020E	2021E
Net Interest Income - Conv. and Islamic	274.1	281.3	304.3	326.8	348.9	370.1
Operating profit (EBITDA)	254.8	265.1	269.8	286.1	309.4	332.0
Adj. Net Profit	176.6	176.8	179.6	188.5	208.3	224.8
EPS (RO)	0.071	0.065	0.061	0.061	0.067	0.073
BVPS (RO)	0.620	0.623	0.610	0.608	0.642	0.678
DPS (RO)	0.025	0.030	0.035	0.033	0.037	0.040
ROAE	12.0%	10.9%	10.3%	10.2%	10.8%	11.0%
Equity / Assets	14.3%	15.1%	14.6%	14.5%	14.4%	14.4%
PE (x)	5.9	6.3	6.8	6.8	6.1	5.7
PBV (x)	0.67	0.66	0.68	0.68	0.64	0.61
Dividend Yield	6.0%	7.2%	8.5%	8.1%	8.9%	9.7%

Source: Company Reports, GBCM Research Estimates, *except per share data, ratios, and percentages



Rating	Accumulate
12M Fair value	RO 0.484
Price	RO 0.414

BKMB vs MSM30 Index (base: 100)



Stock Data

52-week H/L	RO 0.480 / 0.364
Market cap.	RO 1.28 billion
Shares outstanding	3.09 billion

Price performance

1-month	3.0%
3-months	0%
12-months	8.4%

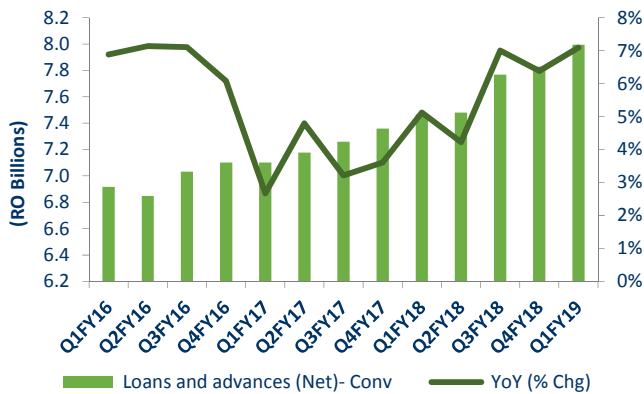
Robust growth in loan book driven by the corporate segment in Q1 2019

The loan book additions of the bank remained healthy during the quarter amid Project Finance demand. Bank Muscat's total (Islamic and conventional) net loans and financing increased 7.9% YoY and 2.5% QoQ to RO 9.16 billion in Q1 2019. The growth came primarily from corporate loans, which increased 12.8% YoY and 4% QoQ to RO 4.9 billion. In terms of segment performance, Islamic financing continued the robust growth trend rising by 14.2% YoY and 4.8% QoQ during the quarter.

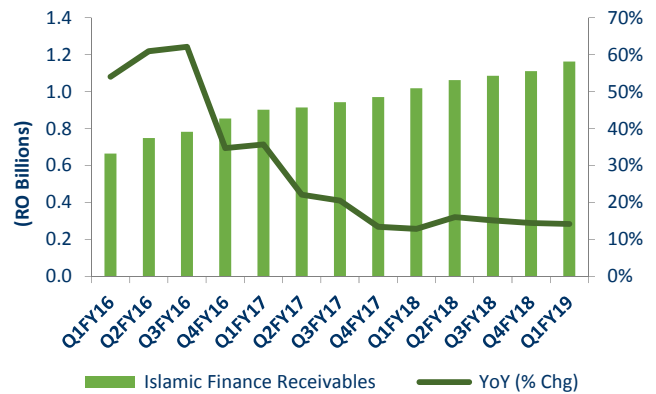
Retail lending expected to slowdown in the coming quarters.

Despite the bank's robust credit growth in Q1, based on our discussions with the management and the current macroeconomic environment in Oman, we continue to believe that the overall loan growth in 2019 will be lower than that of 2018. Retail lending demand to decline during 2019.

Net Conventional Loans



Net Islamic Financing



Source: Company Reports, GBCM Research

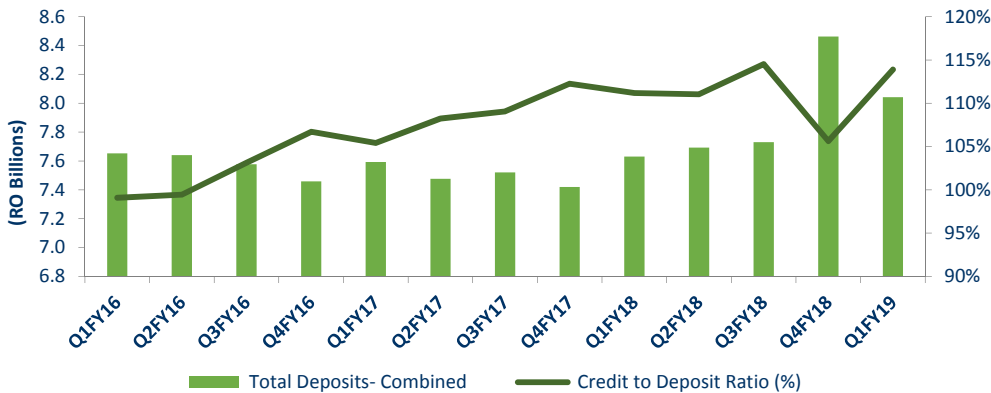
A higher credit-deposit ratio in Q1 2019 augurs well with our 2019 loan book projections

Due to the sharp decline in customer deposits (one-off deposits seen during Q4), the bank's credit to deposit ratio increased from 105.6% in Q4 2018 to 113.9% in Q1 2019. On a YoY basis, this ratio has also increased from 111.2% in Q1 2018. A higher credit to deposit ratio in Q1 2019 should limit significant credit growth in the remaining quarters of 2019.

Deposit growth to moderate in 2019

The bank's customer deposits increased by 5.4% YoY to reach RO 8.04 billion in Q1 2019. However, QoQ these deposits declined by 5% primarily due to shrinking time deposits. We expect a similar YoY level of deposit growth for the year.

Total (Conventional and Islamic) Customer Deposits

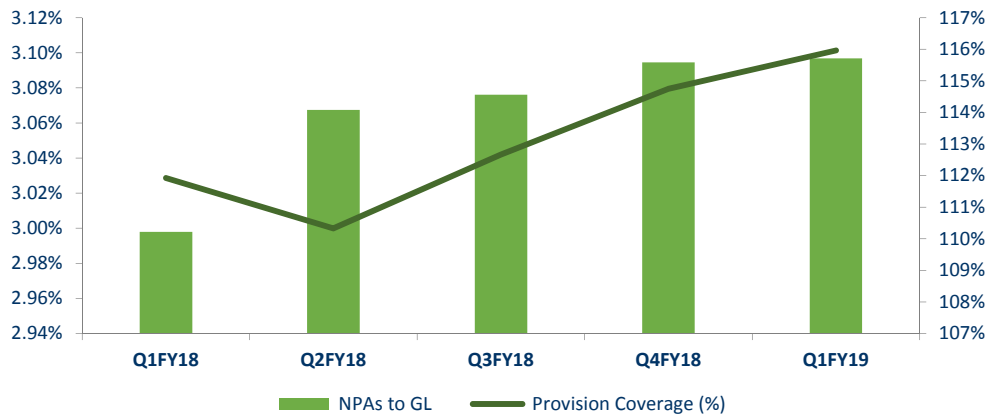


Source: Company Reports, GBCM Research

Marginal deterioration in asset quality expected to increase provisioning pressures in 2019

The bank's NPL ratio increased marginally to 3.10% in 1Q 2019 from 3% in Q1 2018 and 3.09% in Q4 2018. Meanwhile, Bank Muscat's provision coverage improved from 111.9% in 1Q 2018 and 114.8% in Q4 2018 to 116% in Q1 2019.

Asset Quality and Provision Coverage



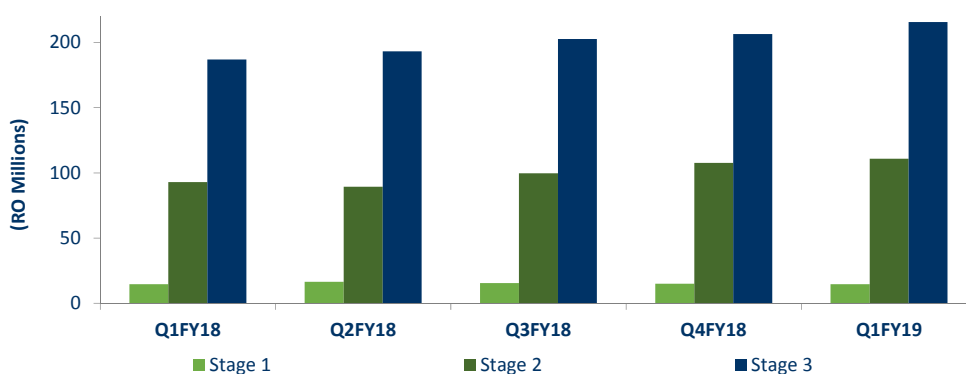
Source: Company Reports, GBCM Research

The loan loss provisioning of the bank has grown significantly YoY during Q1 2019. Net impairment losses on financial assets increased by 121.1% YoY to RO 13.46 million during the quarter.

Apart from the YoY increase of 11.8% in NPAs, the bank's level 2 Expect Credit Loss (ECL) for total loans have increased significantly by 20.2% in Q1 2019. This has translated into significant growth of ECL loan impairments for the category. The provisioning for level 2 loans has grown by 19.3% YoY in Q1 2019. On the positive side, the QoQ growth figure of 3% of these impairments is lower than those of 11.6% in Q3 2018 and 8% in Q4 2018.

Q1 2019 provisions increased due to outside Oman exposure

IFRS 9 Provisioning- ECL Impairments for Loans and advances



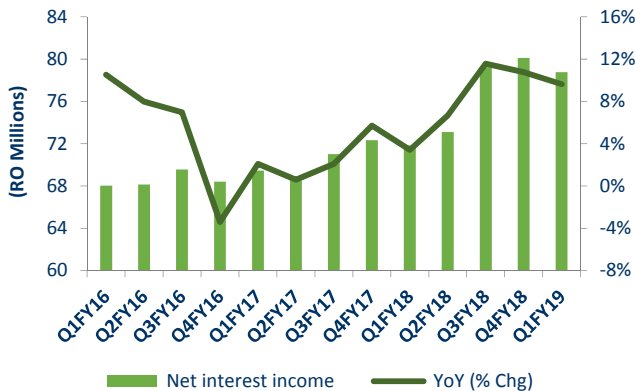
Source: Company Reports, GBCM Research

We expect the trend of the marginal deterioration of the bank's credit quality and build-up of provisions to continue throughout 2019. Additionally, we expect its provision coverage to be around Q1 2019 level reaching 120.8% by the end of the current year.

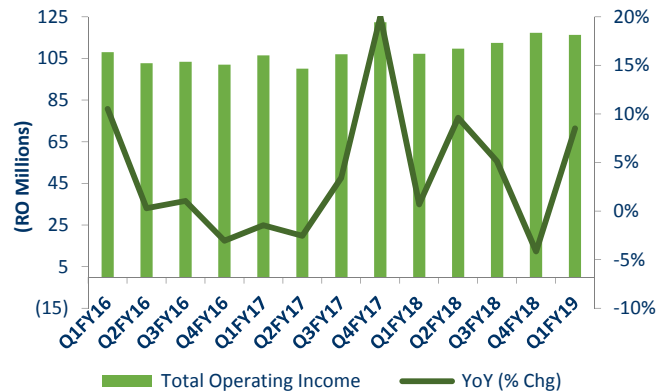
Robust operating performance in Q1 2019 keeps the biggest Omani bank's growth story intact

Overall, the Bank Muscat's revenue increased by 8.5% YoY to reach RO 116.3 million in Q1 2019. The bank's net interest income increased robustly YoY. However, the overall revenue growth was dampened by the fee-based component during the quarter.

Net Interest and Islamic Financing Income



Operating Income



Source: Company Reports, GBCM Research

Driven by conventional banking, the bank's net interest income continued the growth trend increasing 9.6% YoY to RO 78.76 million in Q1 2019. A robust credit growth, we mentioned earlier in this report, coupled with better net interest margin helped in the YoY growth of this crucial revenue stream.

During Q1 2019, the bank's net fee and commission income decreased 6.1% YoY to RO 22.8 million. Based on our discussions with the management, this revenue stream is expected to increase in the coming quarters of 2019. For the year, we expect YoY growth in fee and commission component to be at the 2018 level.

Driven by a strong operating performance, despite higher provisioning levels, the bank's profit growth turned green in Q1 2019. The net profit grew 2.2% YoY to reach RO 45.8 million. Earlier in Q3 2018 and Q4 2018, the profits had declined YoY by 2% and 3.6%, respectively.

Strong Operating performance driven by Credit growth and margin improvement

Valuation and key risks

At the current price, the bank trades at P/E (2019E) of 6.8X and P/BV (2019E) of 0.68X. We have revised our fair value of the bank marginally upwards to RO 0.484, considering its Q1 2019 results and the incorporation of 2021 estimates in our model. This fair value translates into a 17% upside to the current price (as of 28/05/2019), and we have an **Accumulate** rating on the stock.

We have valued the stock by the Residual Income (value: RO 0.510) and adjusted PBV (value: RO 0.459) methodologies. Our key assumptions employed include a risk-free rate of 6.5%, cost of equity of 11.5%, and a terminal growth rate of 2%.

The figure below highlights the sensitivity of the stock's value (based on our Residual Income valuation) to our fundamental assumptions of cost of equity and the terminal growth rate.

Sensitivity Analysis - BKMB's value (RO) through our Residual Income valuation

Cost of equity	Terminal growth						
	0.5%	1.0%	1.5%	2.0%	2.5%	3.0%	3.5%
10.0%	0.606	0.612	0.618	0.625	0.633	0.642	0.652
10.5%	0.570	0.574	0.578	0.582	0.587	0.593	0.600
11.0%	0.537	0.539	0.541	0.544	0.547	0.550	0.554
11.5%	0.507	0.508	0.509	0.510	0.511	0.513	0.514
12.0%	0.479	0.479	0.479	0.479	0.479	0.479	0.479
12.5%	0.454	0.453	0.452	0.451	0.450	0.449	0.447
13.0%	0.430	0.429	0.427	0.425	0.424	0.421	0.419

Fair value may get affected if the bank's risk profile changes.

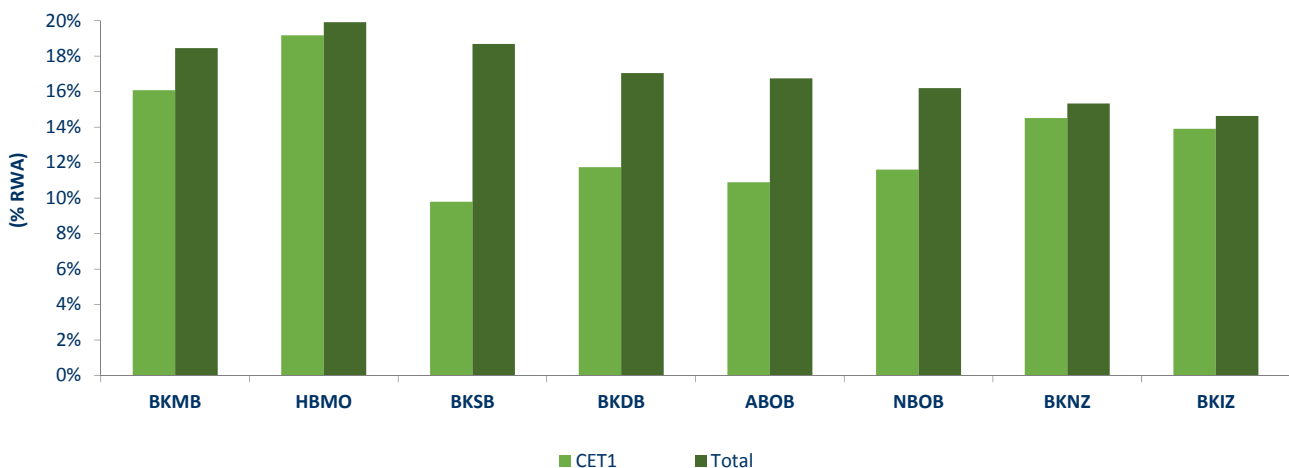
Source: GBCM Research Estimates

One of the key downside risks to our valuation is a slowdown in the domestic economy and more than anticipated deterioration in Bank Muscat's credit quality. **As we have mentioned earlier in this report, the bank's overall performance is tied significantly with the performance of the local economy.**

However, we believe the bank is well-positioned to manage unanticipated provisioning pressures, if any, to some extent. With ample dividend cover (2019E: 55% pay-out ratio), and healthy overall capital adequacy ratios (Q1 2019: 18.45%), we remain positive on the bank's short-to-medium term performance.

Among its peers in Oman, the bank commands robust capital ratios. **At the end of Q1 2019, the bank's Common Equity Tier 1 (CET1) ratio was 16.08% compared to 9.79% of BKSB, 10.89% of ABOB, ~11.6% of NBOB, 11.74% of BKDB, and 19.17% of HBMO.**

Capital Adequacy Ratios of Omani Banks (Q1 2019)



Source: Respective Company Reports, GBCM Research

Bank Muscat - Financial Highlights

(In RO millions)	2016	2017	2018	2019E	2020E	2021E
Income Statement Highlights						
Net Interest Income - Conv. and Islamic	274.1	281.3	304.3	326.8	348.9	370.1
YoY (% Chg.)	5.2%	2.6%	8.2%	7.4%	6.8%	6.1%
Other operating income	142.0	154.6	142.4	147.4	156.2	165.6
YoY (% Chg.)	-3.5%	8.9%	-7.9%	3.5%	6.0%	6.0%
Net operating income	416.2	436.0	446.7	474.1	505.1	535.7
YoY (% Chg.)	2.1%	4.8%	2.5%	6.1%	6.5%	6.1%
Operating Expenses (including dep.)	(174.1)	(184.1)	(190.3)	(201.6)	(209.7)	(218.2)
YoY (% Chg.)	1.8%	5.7%	3.4%	5.9%	4.0%	4.0%
Operating Profit (EBIT)	242.1	251.9	256.4	272.5	295.4	317.5
YoY (% Chg.)	2.3%	4.0%	1.8%	6.3%	8.4%	7.5%
Provisions for credit losses	(70.3)	(63.1)	(78.9)	(83.4)	(88.4)	(93.7)
YoY (% Chg.)	-2.4%	-10.2%	24.9%	5.8%	6.0%	6.0%
Recoveries from credit losses	36.2	41.2	36.7	33.8	39.4	41.9
YoY (% Chg.)	1.0%	13.6%	-10.9%	-7.9%	16.4%	6.3%
Profit before taxation	204.4	211.0	213.2	221.7	245.1	264.5
Taxation	(27.8)	(34.2)	(33.5)	(33.3)	(36.8)	(39.7)
Net Profit	176.6	176.8	179.6	188.5	208.3	224.8
Net Profit After Extraordinary	176.6	176.8	179.6	188.5	208.3	224.8
YoY (% Chg.)	0.6%	0.1%	1.6%	4.9%	10.6%	7.9%
Balance Sheet Highlights						
Assets						
Cash & Balances with CBO	1,041.6	934.7	1,306.8	1,504.1	1,621.2	1,731.7
Held to Maturity	563.6	608.0	518.7	528.7	538.7	548.7
Interbank Payments	526.6	592.0	476.0	504.6	572.7	662.3
Investments	446.3	419.2	750.8	742.7	755.5	768.4
Gross Loans - Combined	8,271.2	8,656.5	9,268.0	9,824.1	10,413.6	11,038.4
YoY (% Chg.)	8.4%	4.7%	7.1%	6.0%	6.0%	6.0%
Net Loans	7,957.3	8,328.7	8,938.9	9,452.7	9,997.8	10,575.9
Fixed Assets	74.2	72.1	69.5	71.6	73.7	75.9
Other Assets	162.3	194.4	227.2	216.1	229.1	242.8
Total Assets	10,820.1	11,149.2	12,288.0	13,020.6	13,788.8	14,605.8
Liabilities						
Total Interbank Liabilities	831.8	910.1	951.9	1,080.7	1,145.5	1,214.2
Total Customer deposits - Conv and Islamic	7,457.7	7,419.3	8,462.7	8,917.7	9,431.9	9,977.3
YoY (% Chg)	1.3%	-0.5%	14.1%	5.4%	5.8%	5.8%
Other Borrowings	448.0	461.5	429.6	429.6	429.6	429.6
Total Other liabilities	370.4	418.6	476.9	540.3	624.8	717.5
Total Tier two capital	165.5	121.4	39.3	39.3	39.3	39.3
Total Shareholders' Equity	1,546.7	1,688.3	1,797.7	1,883.0	1,987.7	2,097.9
YoY (% Chg)	10.7%	9.2%	6.5%	4.7%	5.6%	5.5%
Perpetual Tier 1 Capital		130.0	130.0	130.0	130.0	130.0
Total Liabilities	10,820.1	11,149.2	12,288.0	13,020.6	13,788.8	14,605.8
YoY (% Chg)	-13.7%	3.0%	10.2%	6.0%	5.9%	5.9%

Source: Company Reports, GBCM Research Estimates

Bank Muscat - Key Ratios and Trends

Ratio Analysis	2016	2017	2018	2019E	2020E	2021E
Per Share Analysis (RO)						
Earnings Per Share (Before Extraordinaires)	0.071	0.065	0.061	0.061	0.067	0.073
Earnings Per Share (Reported)	0.071	0.065	0.061	0.061	0.067	0.073
Dividend Per Share	0.025	0.030	0.035	0.033	0.037	0.040
Book Value Per Share	0.620	0.623	0.610	0.608	0.642	0.678
Valuation Ratios						
Price to Earnings Ratio	5.9	6.3	6.8	6.8	6.1	5.7
Price to Book Ratio	0.67	0.66	0.68	0.68	0.64	0.61
Dividend Yield	6.0%	7.2%	8.5%	8.1%	8.9%	9.7%
Profitability & Return Measures (%)						
Return on Equity	11.4%	10.5%	10.0%	10.0%	10.5%	10.7%
Return on Average Equity	12.0%	10.9%	10.3%	10.2%	10.8%	11.0%
Return on Assets	1.6%	1.6%	1.5%	1.4%	1.5%	1.5%
Return on Average Assets	1.5%	1.6%	1.5%	1.5%	1.6%	1.6%
Net Interest Income / Avg. Assets	2.3%	2.6%	2.6%	2.6%	2.6%	2.6%
Operating Profit / Avg. Assets	2.2%	2.4%	2.3%	2.3%	2.3%	2.3%
Cost to Income	41.8%	42.2%	42.6%	42.5%	41.5%	40.7%
Spreads (%)						
Yield on Interest bearing assets	3.90%	4.06%	4.26%	4.29%	4.31%	4.31%
Cost of Funds	1.16%	1.53%	1.76%	1.76%	1.78%	1.79%
Interest Spread	2.74%	2.53%	2.49%	2.53%	2.53%	2.52%
Net Interest Margins	2.44%	2.65%	2.72%	2.73%	2.74%	2.73%
Capital Adequacy (%)						
Equity / Assets	14.3%	15.1%	14.6%	14.5%	14.4%	14.4%
Equity / Gross Loans	18.7%	19.5%	19.4%	19.2%	19.1%	19.0%
Liquidity Measures (%)						
Liquid Assets / Total Assets	14.8%	13.8%	14.9%	15.6%	15.7%	15.6%
Bank Borrowings / Total Assets	7.7%	8.2%	7.7%	8.3%	8.3%	8.3%
Net Loans / Deposits	106.7%	112.3%	105.6%	106.0%	106.0%	106.0%
Customer Deposits / Total Liability	68.9%	66.5%	68.9%	68.5%	68.4%	68.3%
Credit Quality Indicators (%)						
Total Provisions / Gross Loans	3.8%	3.8%	3.6%	3.8%	4.0%	4.2%
Provision Coverage	130.6%	128.9%	114.8%	120.8%	126.7%	132.6%
NPA's / Gross Loans	2.9%	2.9%	3.1%	3.1%	3.2%	3.2%
NPA's / Total Assets	2.2%	2.3%	2.3%	2.4%	2.4%	2.4%
NPA's / Net Worth	15.5%	15.1%	16.0%	16.3%	16.5%	16.6%
Cost of Risk (Net Provisions to Avg. Net Loans)	0.45%	0.27%	0.49%	0.54%	0.50%	0.50%

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

Time Horizon

LT – Long Term rating with a 12 to 18-month horizon

ST – Short Term rating with a 3 to 6-month horizon

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