Bank Dhofar SAOG

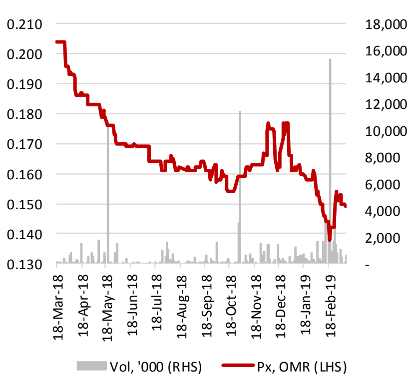
TP : OMR 0.160 / share
Upside/ (Downside): 6.7%

Recommendation	**HOLD**
Bloomberg Ticker	BKDB OM
Current Market Price (OMR)	0.150
52wk High / Low (OMR)	0.210/0.14
12m Average Vol. (000)	447.7
Mkt. Cap. (USD/OMR Mn)	1,092/420
Shares Outstanding (mn)	2,800.3
Free Float (%)	42%
3m Avg Daily Turnover	116.6
6m Avg Daily Turnover	95.9
PE 2019e (x)	8.6
PBv 2019e (x)	0.78
Dividend Yield (%)	6.0%

Price Performance:	
1 month (%)	4.17
3 month (%)	(7.98)
12 month (%)	(25.72)

Source: Bloomberg

Price-Volume Performance



Source: Bloomberg

- **Total credit and deposit market share of 12.6% each as of Dec'18**
- **Well capitalized with capital adequacy ratio (CAR) at 17.3%; Tier 1 Capital Ratio at 15.5%; well above minimum regulatory levels**
- **Net interest margin has improved to 2.61% in 2018 (2017: 2.51%, 2016: 2.93%)**
- **Proposed cash dividend per share of OMR 0.010 implies a yield of 6.7% at the current market price; proposed stock dividend of 7%**
- **Cost to income ratio at 50.5% above peer group average of 44.9%**

We revise our 12-month target price (TP) for Bank Dhofar (BKDB) to OMR 0.160 per share from our earlier TP of OMR 0.150 per share on revision in estimates and in spite of a rise in cost of equity, but maintain its rating at **HOLD**. Our fair value implies a P/e'19 of 9.2x and a P/b'19e of 0.83x. The bank has recently raised capital through an OMR 55mn rights issue and issued Tier 1 perpetual securities worth OMR 40mn, providing a significant boost to its capital adequacy (CAR for FY18: 17.3% vs. FY17: 15.4%).

Improving yield on interest-earning assets but rising cost of funding expected to weigh down net interest income

Bank Dhofar's yield on interest earning assets has been improving rapidly over the last couple of years, but at the same time, the rising cost of funding continues to weigh spreads down. Spreads and net interest margins have improved, albeit slowly. Net interest income for FY18 grew by 7%YoY in spite of a 3%YoY contraction in net loans.

Operating costs expected to stabilize in a couple of years once newer technologies are in place

Bank Dhofar's administrative costs rose 34%YoY in FY18, which coupled with an 8%YoY rise in staff costs and a 10%YoY rise in depreciation, resulted in a 15%YoY rise in operating expenses of the bank during FY18. As per the management of the bank, the bank is heavily investing in improving systems and procedures across the bank (including data protection & cyber-security) together with investment in human resource. The bank expects to witness a slower increase in operating expenses once the new technologies are in place. Cost-to-income of the bank rose to 50.5% in FY18 from 46.5% in FY17, in spite of a 6%YoY rise in operating income.

Asset quality to remain intact; Cost of risk to rise

The net expected credit losses (ECL) allowance charge was OMR 6.7mn in FY18 vs. net impairment charge of OMR 11.9mn in FY17 on adoption of IFRS9 since Jan 2018. Even though cost of risk declined to 19.4bps in FY18 from 36.3bps in FY17, we are expecting cost of risk to increase throughout the forecast period, on anticipation of pressure on asset quality given the macroeconomic situation remains subdued.

Outlook & Valuation

We expect the bank's top-line to grow on the back of improving net interest margin (NIM) as assets continue to be re-priced, with operating income growth at a CAGR of 5.8% over 2019-2023F. Operating expenses are expected to grow at a CAGR of about 5.4%. We expect expected credit loss (ECL) allowance charges to grow as loans grow, resulting in a modest growth expectation for net profit (CAGR: 6% over 2019-2023F).

Key Indicators

Year	FY-16	FY-17	FY-18	FY-19e	FY-20e	FY-21e
Total Net Loans (OMR mn)	2,989	3,249	3,159	3,301	3,450	3,622
Total Customer Deposits (OMR mn)	2,885	3,068	2,925	3,085	3,254	3,449
Operating Income (OMR mn)	127	127	134	141	148	156
Net Profit (OMR mn)	48	48	50	52	55	58
Diluted EPS (OMR)	0.025	0.021	0.018	0.017	0.017	0.017
Diluted BVPS (OMR)	0.220	0.209	0.194	0.192	0.190	0.188
P/E (x)	9.2	10.5	9.2	8.6	8.7	8.8
P/BVPS (x)	1.04	1.06	0.86	0.78	0.79	0.80
Dividend Yield (%)	5.9%	5.4%	6.0%	6.7%	6.7%	6.7%

Source: Company Financials, U Capital Research

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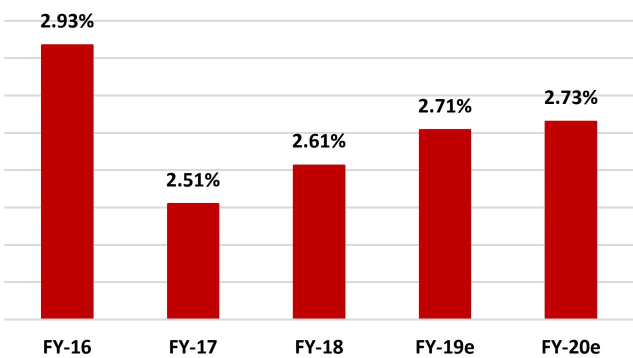
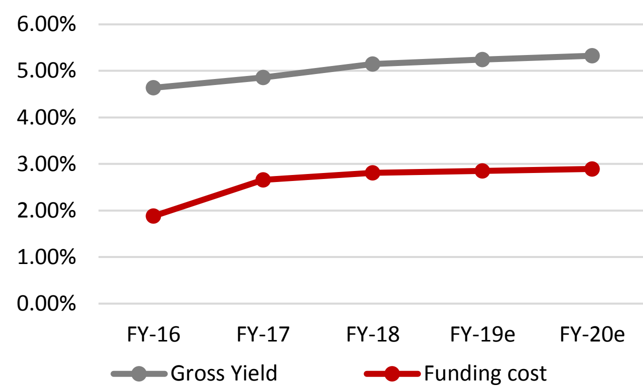
Net interest income rising on improving yields

The bank's total net interest income (including Islamic finance income) rose by 7%YoY on improvement in spreads characteristic of a rising interest rate environment. This increase materialized despite a 3%YoY decline in total net loans including Islamic financing. The bank is heavily reliant on term funding (52% of total deposits) as opposed to current & savings (CASA) deposits, which form only about 35% of total customer deposits (the lowest level amongst BKDB's local peer group), allowing limited access to low-cost funding. In spite of this, the bank was able to improve its spread on better pricing of new loans and re-negotiated pricing of existing loans. We expect the bank to be able to continue to improve its yields on earning assets, albeit slowly.

BKDB: Net Interest Margin



BKDB: Yield & Cost of Funding

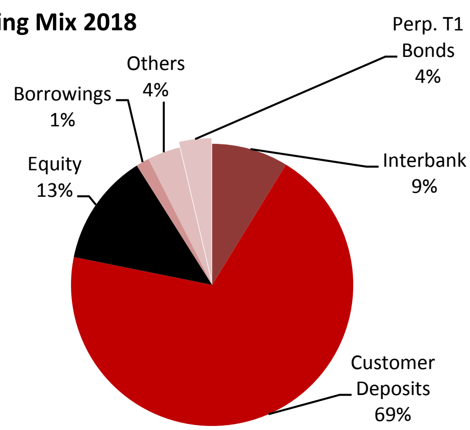


Source: Bank Financials, U Capital Research

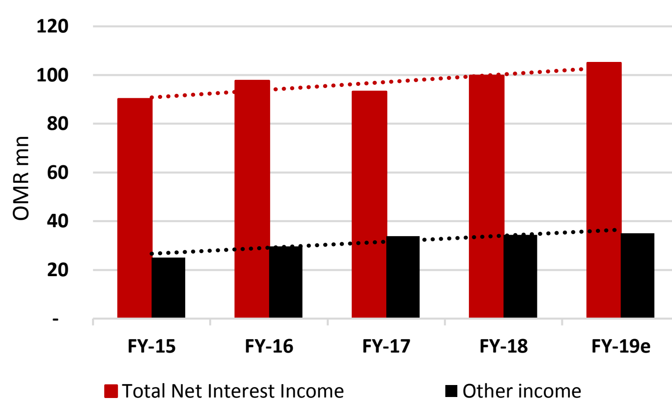
The bank's balance sheet is primarily funded through customer deposits (c69%). Furthermore, the bank has locked in relatively less expensive capital and some borrowing during the previous years. In 2015, the bank raised USD 300mn Perpetual Tier 1 Capital securities, with a fixed annual interest rate of 6.85% (to be reset at 5-year intervals). Another Perpetual Tier 1 Capital securities worth OMR 40mn were issued by the bank in Dec'18, at a fixed annual rate of 7.5%, again to be reset in 5-year intervals.

We believe that the bank's net interest income (including Islamic finance income) will grow at a CAGR of 6.0% over 2019-2023F, based on our assumption that assets will continue to be re-priced higher, and growth in cost of funding will remain at current levels, resulting in continuous improvement in spreads.

BKDB: Funding Mix 2018



BKDB: Operating Income Components



Source: Bank Financials, U Capital Research

Fee & Commission income under pressure; miscellaneous income rose in FY18

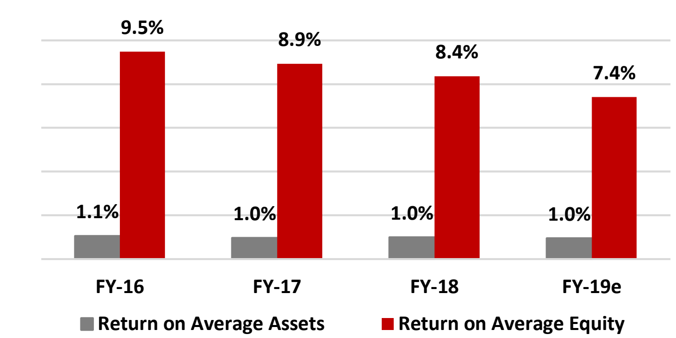
Other operating income, which constituted about 26% of total operating income of FY18, increased by 8%YoY, primarily on account of a rise in miscellaneous income. Net fee & commission, however, declined by 10%YoY and could be cause for concern. We believe that other operating income will stay under pressure due to competition from other local as well as regional players, and will rise only marginally over the forecast period.

Profitability metrics affected due to higher capital requirements

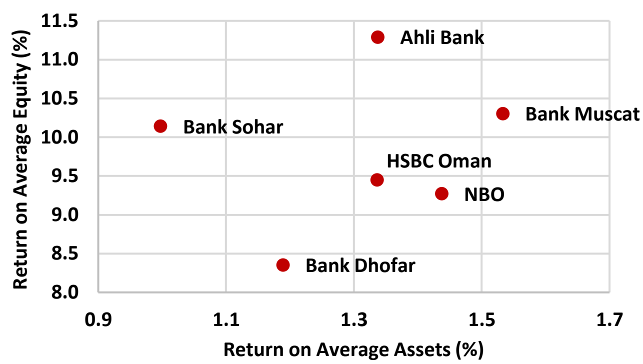
The bank's return on average equity (RoAE) has fallen to about 8.4% in FY18 from 8.9% in FY17 and 9.5% in FY16, primarily on account of higher capital requirements due to Basel III implementation and other regulatory requirements. This is true for most banks in Oman.

We believe that BKDB's profitability metrics will remain subdued, as profit growth is expected to remain at a CAGR of 6% over 2019-2023e on subdued loan growth. Furthermore, the additional interest expense for the new Perpetual Tier 1 capital securities is expected to further pressurize profitability in the short run, until proceeds can be mobilized into interest earning assets.

BKDB: Profitability Metrics



Profitability Metrics, 2018

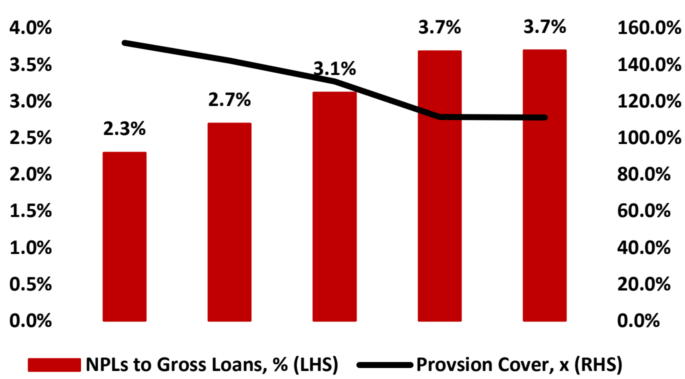


Source: Bank Financials, U Capital Research

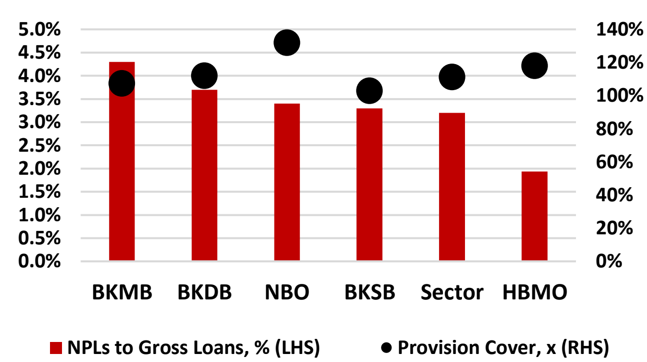
Cost of risk to increase with anticipated loan growth; Asset quality metrics have declined but are still sound

While loan asset quality metrics have weakened further, they remain sound with a moderately low level of non-performing loans (NPLs) as % of gross loans at 3.7%, which remains more than fully covered by provisions (FY:18 111%). We believe there might be further pressure on asset quality but the bank maintains sufficient capital to cover any unexpected losses.

BKDB: Asset Quality



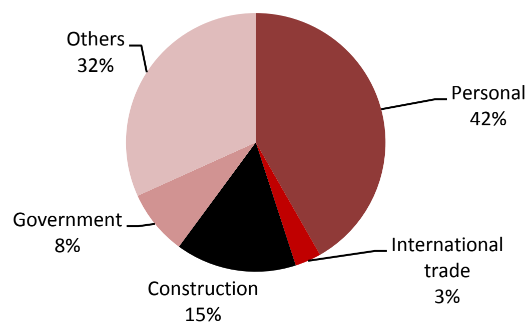
Peer-Group Comparison: Asset Quality



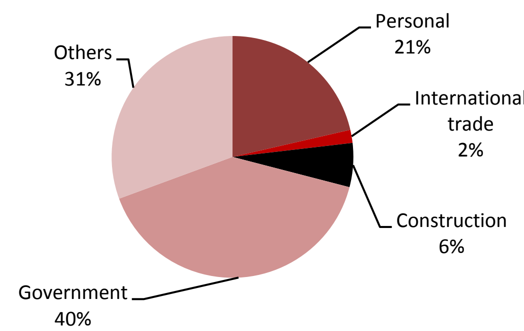
Source: Bank Financials, U Capital Research

The bank has about a 15% gross loan exposure to the real estate sector. We believe since the real estate market of Oman has been under pressure for a couple of years now, we might see some delinquencies from this sector's exposure. We have conservatively factored in a rise in cost of risk over the forecast period.

BKDB: Economic Concentration of Gross Loans



BKDB: Economic Concentration of Customer Deposits

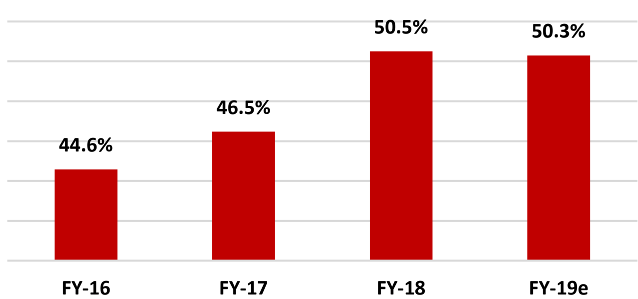


Source: Bank Financials, U Capital Research

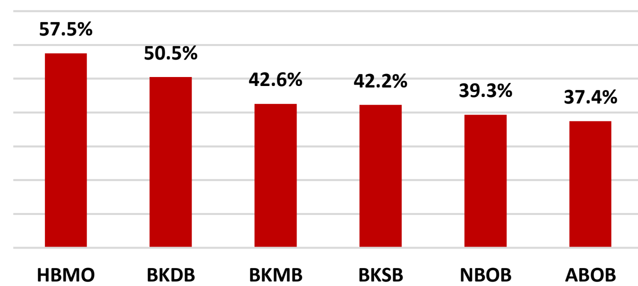
Cost to Income has been on the rise; Technological investments to bear fruition in the medium term

The bank's cost to income ratio has risen to 50.5% in FY18 from 46.5% in FY17, in spite of a growth in operating income. This is because of the bank's strategy to improve systems and invest in cyber security. The management expects the ratio to normalize in a couple of years' time once the planned investments are completed. We have factored in a marginal improvement in the ratio next two years before the ratio normalizes to its historic average.

BKDB: Cost to Income Ratio



Peer-Group Comparison: Cost to Income Ratio

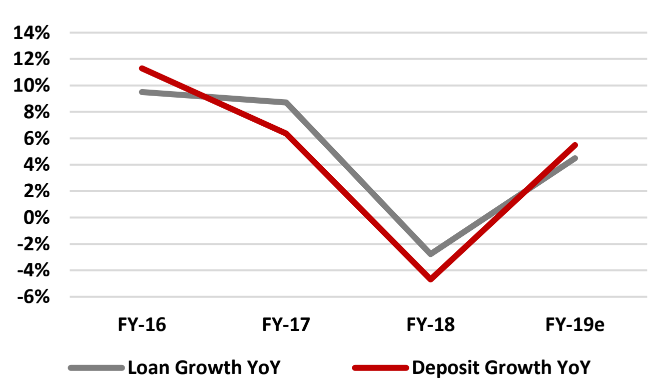


Source: Bank Financials, U Capital Research

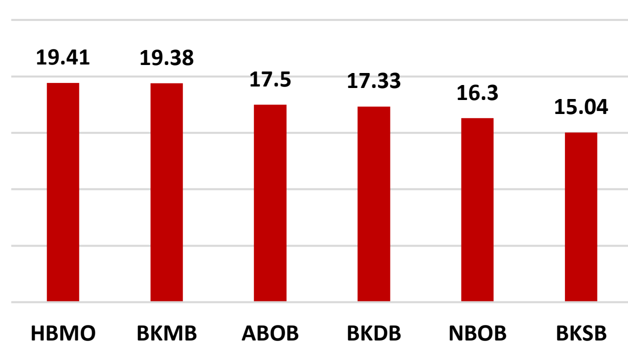
Deposit growth has lagged behind sector; Capital boost to provide impetus to loan growth

The bank's net loans have declined in FY18 by about 3%YoY. Customer deposits fell by 5%YoY, resulting in Loan-to-deposit ratio to reach 108% as at the end of FY18, from 106% a year ago. However, we believe that the bank will be able to post a positive credit and deposit growth in lieu of the capital raising activities during the last quarter of FY18 that boosted its capital adequacy levels.

BKDB: Loan & Deposit Growth



Capital Adequacy Ratio, FY'18



Source: Bank Financials, U Capital Research

Net Profit Estimates for FY19 and Q1'19

We believe that the bank will be able to post a net profit of OMR 52mn in FY19. However, the additional interest burden from the Tier 1 perpetual securities (OMR 40mn issued in Dec'18 at fixed interest rate of 7.5%p.a) will result in deterioration in return to common shareholders (ROaE). We believe that unless the bank grows its net loans at a faster rate than expected and yields improve at a faster rate than we anticipate, the bank will not be able to improve its ROaE in the near term. We are expecting the bank to post a net profit of OMR 13.6mn, slightly lower than OMR 13.7mn posted in Q4'18 (flat QoQ; -1%YoY).

Estimate Changes	Old FY19e	New FY19e	Difference %
Total Net Loans	3,531	3,301	-6.5%
Total Customer Deposits	3,367	3,085	-8.4%
Operating Income	139	141	1.3%
Operating Expenses	(67)	(71)	5.5%
Net Profit	53	52	-1.2%

Source: Company Financials, U Capital Research

All figures in OMR mn

Peer Group Comparison Snapshot

Name	Mkt Cap (OMR mn)	Last Px (OMR)	P/B'19e, (x)	P/E'19e, (x)	ROE'19e, (%)	Div Yield, %*
Bank Muscat	1,243.8	0.422	0.71	6.9	10.4%	5.9%
Bank Dhofar	420.0	0.150	0.78	8.6	8.7%	10.0%
NBO	310.6	0.191	0.75	7.8	9.8%	6.3%
Bank Sohar	224.0	0.113	0.71	7.6	9.1%	4.4%
Ahli Bank	209.5	0.140	0.70	6.5	11.0%	7.1%
HSBC Oman	238.0	0.119	0.66	8.6	7.8%	5.0%

Source: Bloomberg, U Capital Research

*Dividend yield is calculated on proposed cash dividends for FY18

Key Financials

(OMR mn)	FY-16	FY-17	FY-18	FY-19e	FY-20e	FY-21e
Income Statement						
Interest/Financing Income	154	180	196	204	217	230
Interest Expense/Payment to Depositors	(57)	(87)	(97)	(98)	(105)	(113)
Net Interest/Financing Income	**98**	**93**	**100**	**106**	**111**	**118**
Fee & Commission Income	15	17	16	16	17	17
Other Income	15	17	19	19	20	21
Other Operating income	**30**	**34**	**34**	**35**	**37**	**38**
Total Operating Income	**127**	**127**	**134**	**141**	**148**	**156**
Provisions expense	(16)	(12)	(7)	(8)	(8)	(9)
Operating Expenses	(57)	(59)	(68)	(71)	(74)	(78)
Profit Before Taxation	**54**	**56**	**60**	**62**	**66**	**69**
Taxation	(7)	(8)	(9)	(10)	(10)	(11)
Net Profit	**48**	**48**	**50**	**52**	**55**	**58**
Balance Sheet						
Cash Balances	266	327	302	354	403	455
Deposits with Banks & FIs	340	300	329	344	359	377
Gross Loans & Financings	3,107	3,387	3,294	3,442	3,597	3,777
Loan Loss Reserve	(119)	(138)	(135)	(141)	(148)	(155)
Net Loans & Financings	2,989	3,249	3,159	3,301	3,450	3,622
Net Fixed Assets	8	10	15	11	12	13
Other Assets	349	362	409	428	447	469
Total Assets	**3,952**	**4,247**	**4,213**	**4,437**	**4,670**	**4,936**
Deposits from Banks & FIs	351	388	369	390	411	436
Deposits from Customers	2,885	3,068	2,925	3,085	3,254	3,449
Other Borrowings	128	115	158	167	176	186
Other Liabilities	54	89	64	64	64	64
Paid-up Capital	190	226	232	239	321	343
Retained Earnings	72	55	59	69	77	86
Other Reserves	156	189	198	202	207	212
Perpetual Tier 1 Capital Securities	116	116	156	156	156	156
Shareholders' Equity	419	472	543	577	610	645
Total Equity & Liability	**3,952**	**4,247**	**4,213**	**4,437**	**4,670**	**4,936**
Cash Flow Statement						
Cash from operations	(130.9)	25.1	(52.1)	70.5	75.7	80.2
Cash from investing activities	2.9	4.5	9.1	(0.2)	4.9	5.0
Cash from financing	(40.2)	40.4	35.9	(18.3)	(22.0)	(22.8)
Net changes in cash	(173.9)	60.9	(25.3)	52.4	48.8	52.4
Cash at the end of period	265.9	326.8	301.5	353.9	402.7	455.1
Key Ratios						
Return on Average Assets	1.1%	1.0%	1.0%	1.0%	1.0%	1.0%
Return on Average Equity	9.5%	8.9%	8.4%	7.4%	7.5%	7.5%
Fee Income Yield	0.4%	0.4%	0.4%	0.4%	0.4%	0.4%
Recurring Income/Operating Income	88.2%	87.0%	86.0%	86.4%	86.5%	86.6%
Interest Earning/Financing Assets Yield	4.6%	4.9%	5.1%	5.3%	5.3%	5.4%
Cost of Funds	-1.9%	-2.7%	-2.8%	-2.9%	-2.9%	-2.9%
Net Spread	2.8%	2.2%	2.3%	2.4%	2.5%	2.5%
Cost to Income Ratio	44.6%	46.5%	50.5%	50.3%	50.1%	49.9%
Net Loans to Customer Deposits	103.6%	105.9%	108.0%	107.0%	106.0%	105.0%
Non Performing Loans	84	106	121	127	133	140
Loan Loss Reserve	(119)	(138)	(135)	(141)	(148)	(155)
NPLs to Gross Loans	2.7%	3.1%	3.7%	3.7%	3.7%	3.7%
NPL Coverage	142.1%	130.8%	111.4%	111.1%	110.8%	110.5%
Provisions/Total Income	93.3%	108.7%	100.7%	100.3%	99.7%	99.3%
Cost of Risk (bps)	53.6	36.3	19.4	20.0	20.5	21.0
Equity to Gross Loans	17.2%	17.3%	21.2%	21.3%	21.3%	21.2%
Equity to Total Assets	13.5%	13.8%	16.6%	16.5%	16.4%	16.2%
Cash Dividend Payout Ratio	53.8%	56.9%	55.7%	57.2%	58.1%	58.9%
Adjusted EPS (OMR)	0.025	0.021	0.018	0.017	0.017	0.017
Adjusted BVPS (OMR)	0.220	0.209	0.194	0.192	0.190	0.188
Market Price (OMR) *	0.230	0.222	0.166	0.150	0.150	0.150
Dividend Yield	5.9%	5.4%	6.0%	6.7%	6.7%	6.7%
P/E Ratio (x)	9.2	10.5	9.2	8.6	8.7	8.8
P/BV Ratio (x)	1.04	1.06	0.86	0.78	0.79	0.80

**Market price for 2019 and subsequent years as per latest closing price of 14/03/2019*

Source: Company Financials, U Capital Research

Recommendation

BUY	Greater than 20%
ACCUMULATE	Between +10% and +20%
HOLD	Between +10% and -10%
REDUCE	Between -10% and -20%
SELL	Lower than -20%

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