11 MAY 2023

Initiation of Coverage

Dubai Islamic Bank

A global Islamic banking icon

Last close, AED	5.50
Fair value, AED	7.05
Upside	28%
Stock rating	Over-Weight

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Islamic finance on a roll

Islamic finance has been gaining traction globally for the better part of fifty years and growing faster than conventional banking for at least a decade. Some of this expansion comes from growing Islamic populations around the world. The other part comes from outright cannibalization of traditional banking, as Islamic banks compete more fiercely for market share.

The UAE has always been at the forefront of Islamic finance. The first ever, formal, Islamic commercial bank was established in 1975 in the UAE. Incidentally, this was Dubai Islamic Bank (DIB), the very topic of this report.

A global Islamic champion

DIB is the largest Islamic bank by assets in the UAE, and among the top three globally. It operates in seven countries through a combination of branches, subsidiaries, and representative offices. Management is likely to consider opportunistic external growth, and we believe that DIB has the firepower to expand inorganically, both locally and internationally. Many smaller UAE Islamic franchises would qualify as relevant targets.

The principal shareholder of DIB is the Government of Dubai, which indirectly owns 28% of outstanding shares through the Investment Corporation of Dubai (ICD), the local sovereign wealth fund. This government backing is good news in our opinion, as it makes DIB a quasi-sovereign institution with an unlikely probability of default. In addition, DIB has been rated a Domestically Systemically Important Bank (D-SIB).

A bright financial outlook

DIB historically outpaced its peers in financial performance, as the bank consistently delivered superior returns compared to the UAE banking industry. Although the bank's financing portfolio was challenged by early settlements, the bank is committed to focusing on sustainable growth, particularly in the longer term, whilst ensuring the quality of the loan book.

DIB is one of the strongest dividend players among the large cap liquid banking stocks. The bank paid a dividend of 30 fills per share in 2022 translating into a dividend yield of 5.5%. With a winning combination of high ROE and high dividend yield, DIB finds itself in the most desirable quadrant of the ROE-Yield matrix, ahead of many larger UAE lenders.

An attractive entry-point

We ran a four-way valuation of DIB to arrive at a blended fair value of **AED 7.05 per share**. This implies an **upside of +28%** to the last closing price. We conclude that the stock is undervalued and offers an attractive entry point at the current price. We initiate our coverage with an **OVER-WEIGHT** recommendation.

The stock is down 3.5% year to date, broadly in line with the UAE Banking sector. The solid earnings performance has not fully translated into the valuation of the stock, in our opinion. The shy valuation and hesitant market performance are in contrast with the underlying strong fundamentals and compelling dividend yield. We continue to view DIB as one of the most compelling UAE Banking stocks and believe it's a must-own for any UAE driven portfolio.

Stock Rating

Current Rating	Over-Weight
Fair Value	7.05
Former Rating	NA
Previous Fair Value	NA
Target Upside	28%
Listing location	Dubai
Sector	Banking
Local Exchange	DIB
Bloomberg	DIB UH
Reuters	DISB.DU

Source: Al Ramz Capital, Bloomberg

Stock Statistics

Last Close, AED	5.50
Market Cap (AED m)	39,824
Avg. Daily Vol 3m (m)	5.0
Shares Out. (m)	7,241
Free Float	72%
YTD Change	-3.5%
52w High (AED)	6.35
52w Low (AED)	5.10

Source: Al Ramz Capital, Bloomberg

Stock Price

Source: Al Ramz Capital, Bloomberg

Key ratios

Indicator	2023E
P/E	6.6
P/B	1.21
Dividend Yield	5.8%
ROTE	18.3%
ROA	2.1%

Source: Al Ramz Capital, Bloomberg

Note: P/B is calculated using tangible equity

Islamic finance on a roll

Islamic finance has been gaining traction globally for the better part of fifty years, growing faster than conventional banking for at least a decade. Some of this expansion comes from customers new to banking altogether, as growing Islamic populations around the world become wealthier and demand financial services.

The other part comes from outright cannibalization of traditional banking, as Islamic banks compete more fiercely for market share, and their products become more appealing, including to a wider global population.

The new Islamic finance haven

Islamic finance is based on the main Shariah principle where banks are prohibited from collecting interest from their clients. Instead, they earn money using an equity participation system and share the profits and losses. Certain other activities, such as gambling or consuming pork or alcohol, are also prohibited by Islamic principles and Islamic institutions will generally not invest in businesses which behave contrary to such principles.

The Mit-Ghamr Savings Bank was established in Egypt in 1963 and is commonly referred to as the first Islamic institution. Its creation marks the inception of modern Islamic finance.

There are 1,679 Islamic financing institutions in the world today, with over 47 countries complying with Islamic finance regulations. Islamic finance assets amounted to USD 4.0tn in 2021. Although this seems like a large number, it only represents circa 2.2% of total banking assets. This suggests that Islamic finance may yet have a bright future ahead, even with all the growth already achieved to date.

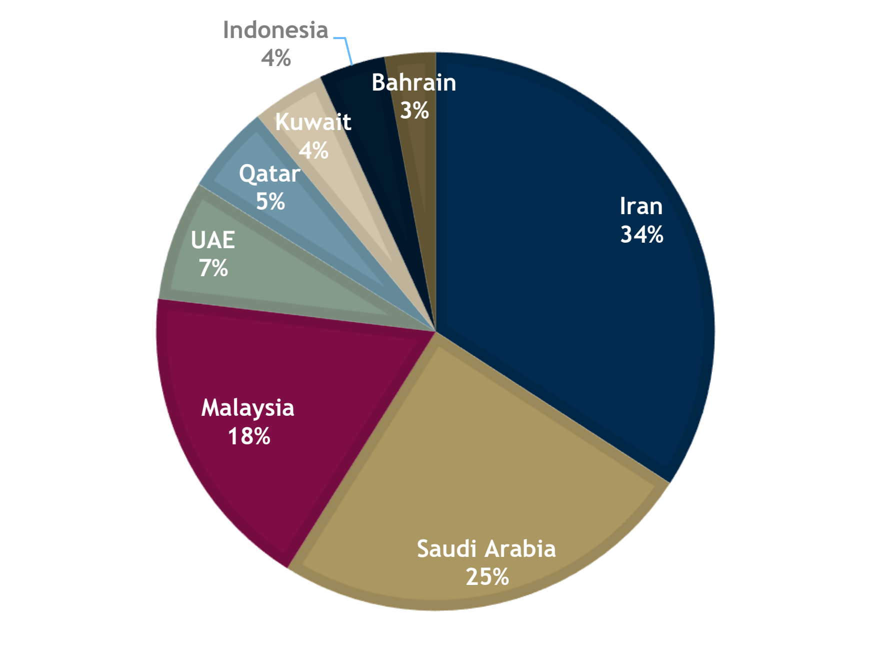
Table 1: Differences between Islamic and conventional banking

Islamic	Conventional
Follows the Sharia law and is consistent with the teachings of the Quran.	Follows widely accepted economic and financial theories that aim at maximizing profits.
Earns revenue through equity participation – profit sharing. When a client suffers a loss, the bank makes no profit.	Earns revenue through interest collection on loans and investments, foreign exchange operations, returns on assets, commission, etc. Legally, banks should receive their share of the money lent or equitable compensation, even if their customer makes a loss.
Collecting interest from borrowers (a.k.a. Riba) is prohibited.	There are no restrictions on interest. Banks receive interest on loans as well as investments.
Investing/trading in assets that involve speculation and high risk is against Islamic rules.	Few restrictions on trading. investors are free to speculate, and some invest in high-risk assets to generate higher returns.

Source: Al Ramz Investment Research

Iran, followed by Saudi Arabia, constitutes the largest proportion of Islamic banking assets. We also see a notable contribution from Asia, as impacted by the large Muslim populations of Indonesia and Malaysia.

Chart 1: Islamic banking assets by country, 2021



Source: Al Ramz Investment Research, Refinitiv

Shariah supervisory boards at the helm

Each Islamic finance institution has a sharia supervisory board (SSB) which is composed of at least three jurists. SSBs decide what is allowed or forbidden based on the Quran (the holy book in Islam) and the Sunnah (A guide on how to live life). Board decisions are taken by majority vote and are binding on the institution being supervised.

There are two supervisory bodies for Islamic finance at an international level: the Bahrain-based Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) and the Malaysian Islamic Financial Services Board (IFSB).

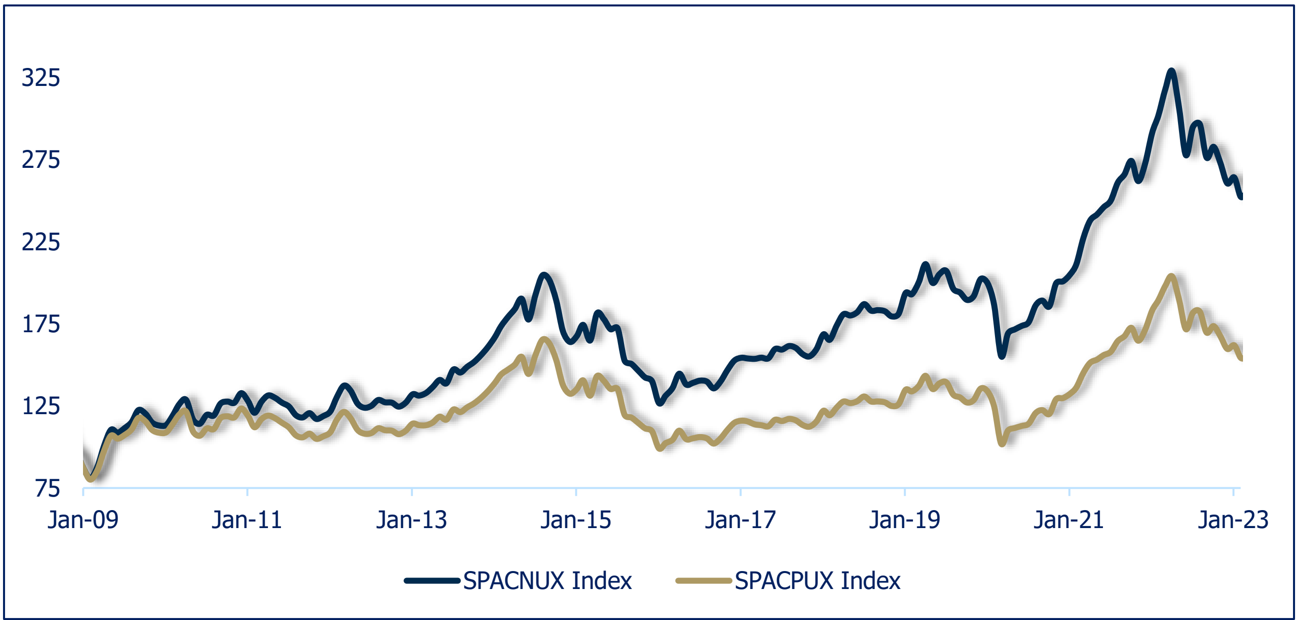
The AAOIFI sets basic standards for the industry while the IFSB issues recommendations based on risk assessment. These bodies collaborate with institutions such as the IMF or the World Bank to promote Shariah compliance globally.

Some evidence of out-performance for Shariah investing

Shariah stocks are meant to represent a more socially and religiously responsible form of investment. Shariah companies are expected to be less financially risky, due to a more conservative use of financial leverage and debt.

The relationship between stock market performance and ethical investing is a wider discussion than the purpose of this note, and the debate remains open about any potential and systematic outperformance of ethical versus traditional investing. However, a common benchmark to track the performance of Shariah compliant stocks is the S&P Pan Arab Large-Mid Cap Index also known as the SPACNUX index. The index is up +190% since 2009 while the SPACPUX which contains most GCC stocks including non-Shariah compliant companies, is only up by +80%. This suggests that Shariah compliant stocks could perform better over the longer term.

Chart 2: GCC Shariah compliant versus traditional stock performance



Source: Al Ramz Investment Research, Bloomberg

There are multiple terms specific to the Islamic finance industry and for every part and distinction of Islamic contracts. It is beyond the scope of this research to define them all. However, we list below the most relevant ones.

Table 2: Glossary of most widely used Islamic finance terms

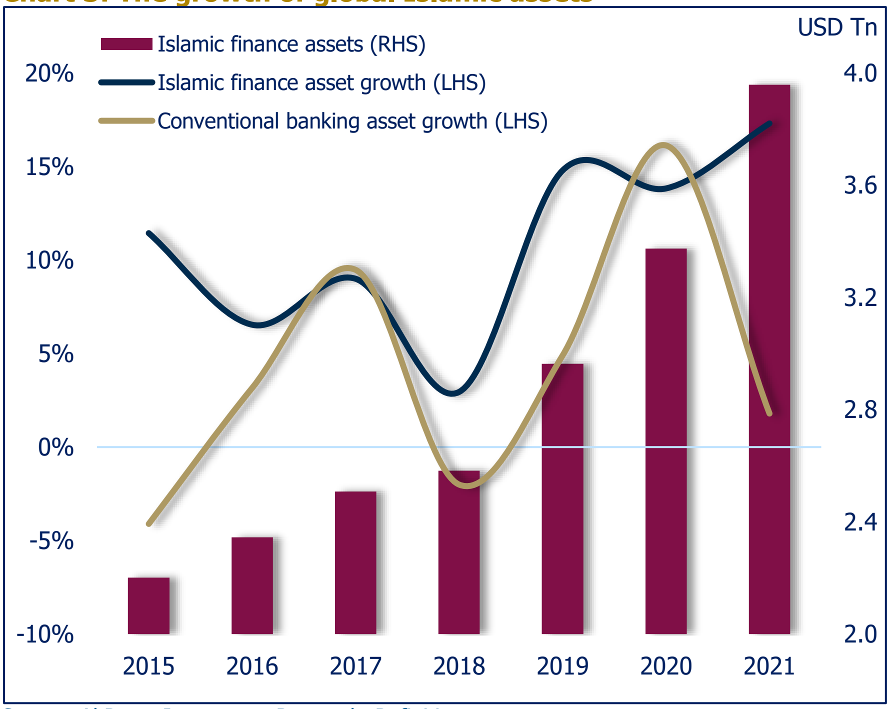
Term	Definition
MUDARABAH	Mudarabah refers to a profit and loss sharing partnership. This is an agreement where the financier, or rab-ul mal, provides the capital to the other partner, the mudarib.
MUDARIB	The investment management responsible for the management and investment of the funds.
MURABAHA	A financial institution agrees to purchase merchandise for a client and the client promises to buy it from the institution at an agreed mark-up.
MUSHARAKA	Musharakah refers to a joint venture. All parties involved contribute capital as well as share all profit and loss on a pro-rata basis.
QARDH	Qardh is a fungible item, like a loan, which is transferred from one party (the lender) to another (the borrower), with the understanding that the latter will return it to the former at some future date.
RIBA	Riba means to increase or to exceed and is commonly used in reference to unequal exchanges or charges and fees for borrowing.
SHARIA	Islamic law originating in Islamic scripture, as defined in practices and explanations by the Prophet Mohammed.
SUKUK	A sukuk is an Islamic financial certificate like a bond, which complies with Islamic religious law commonly known as Sharia
TAKAFUL	Islamic insurance, an alternative to conventional commercial insurance based on the concept of mutual support. It provides mutual protection of assets and property; the takaful company oversees a pool of funds contributed by all policy holders but does not necessarily bear risk itself.
WADIAH	Wadiah in Islamic banking refers to a deposit. It involves entrusting one's belongings to another for a specified number of days without paying any fee.
ZAKAH / ZAKAT	Zakat on wealth is a form of almsgiving. It is a mandatory charitable contribution, often considered to be a tax.

Source: Al Ramz Investment Research, Refinitiv

Faster growth than traditional banking

The Islamic finance industry expanded rapidly over the past decade. Its assets grew at an average of 10.4% between 2014 and 2021, against only 3.9% for conventional banking. There are three main reasons to explain this out-performance in our view: The growth of the oil economy, the expansion of Muslim populations across the world, and a generally supportive regulation.

Chart 3: The growth of global Islamic assets



Source: Al Ramz Investment Research, Refinitiv

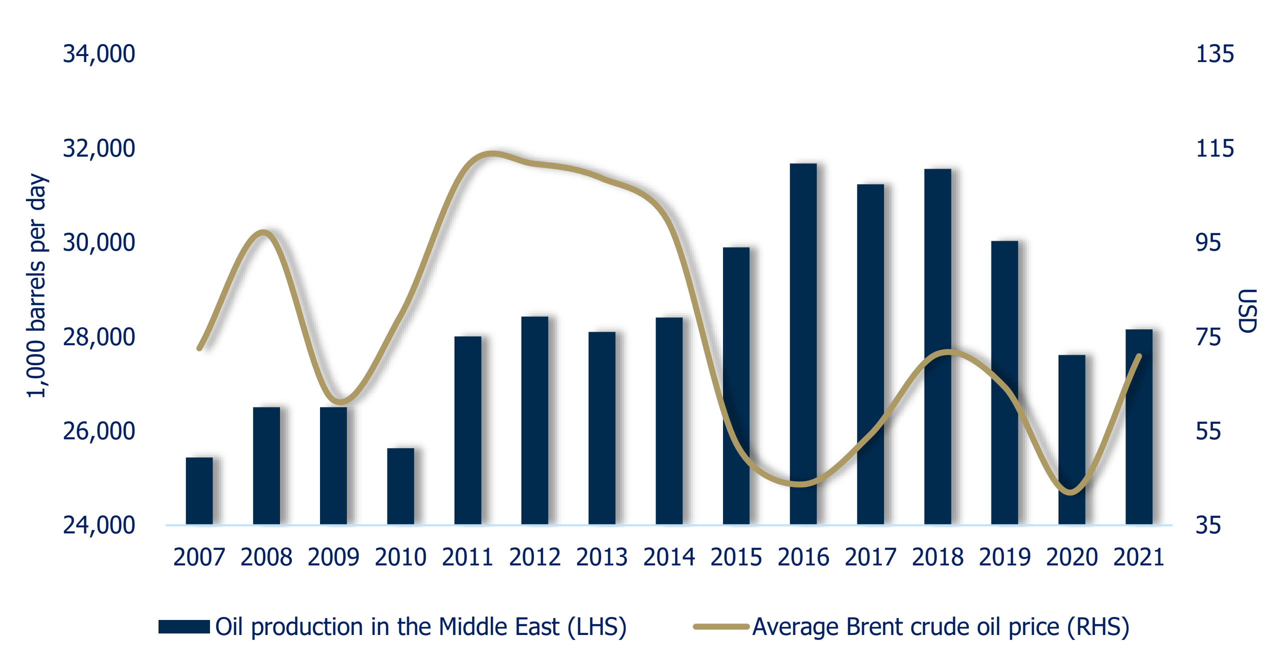
More demand for Islamic banking as oil-rich Islamic nations prosper

The Middle East mainly consists of oil-producing, Muslim countries including Saudi Arabia, Iraq, the United Arab Emirates, Iran, or Kuwait – to name just the largest producers. Middle Eastern oil producers combined represent 31% of total world oil production.

Regional oil production has been on a consistently rising trend, increasing by +13.2% since January 2005. This is notwithstanding some fluctuations in the price of the commodity or the competition from the non-fossil economy. Also, the average oil price has almost doubled during the same period.

Consequently, most Islamic, Middle Eastern economies have done well, which has pushed their consumption and demand for Islamic banking and Islamic financial products.

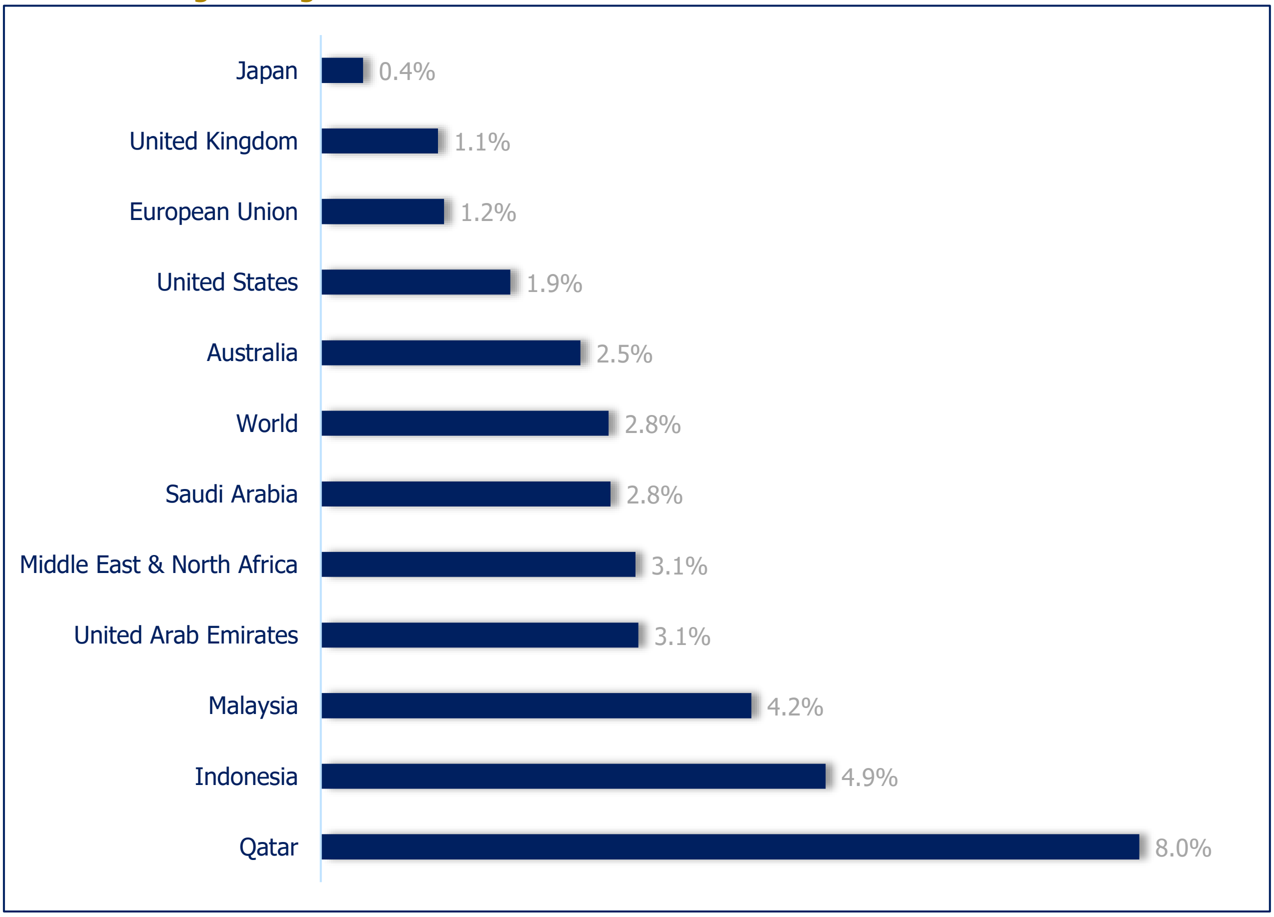
Chart 4: Oil production vs. oil prices



Source: Al Ramz Investment Research, Statistica, Bloomberg

Middle Eastern oil producing countries grew faster than non-oil producing countries, as shown in the chart below. Islamic banking being an integral part of the financial landscape in Shariah-abiding countries, it inevitably grew faster than conventional banking.

Chart 5: Average GDP growth from 2005 to 2021



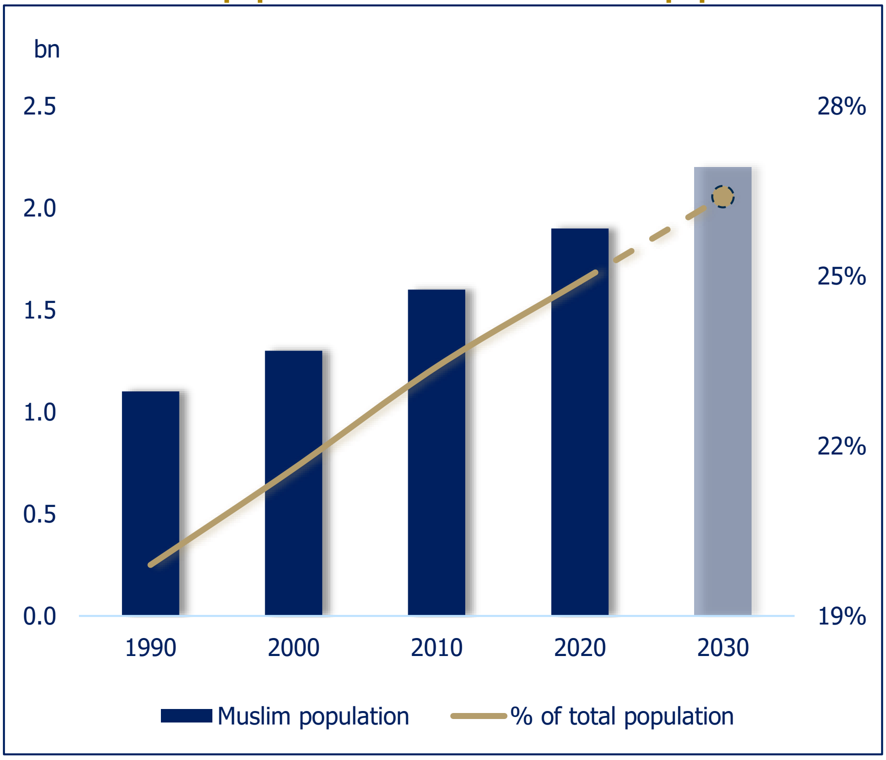
Source: Al Ramz Investment Research, World Bank

Islamic population growth adds to the effervescence

Muslim populations have expanded rapidly, growing from 23% of total world population in 2010 to 25% currently. This increase in proportion, adjusted for world population growth, represents a near 25% jump in size and makes for a total worldwide Muslim population of nearly 2bn individuals today.

We believe this may be another major contributing factor to the growth of Islamic banking assets. Furthermore, the PEW Research think-tank estimates that Muslims should represent 29% of the world population by 2050, which should further contribute to the growth of Islamic banking.

Chart 6: Muslim population as a % of total world population



Source: Al Ramz Investment Research, Wikipedia, PEW Research

Regulators promote Islamic finance

Muslim countries have increasingly been inclined to push Shariah compliant banking and investments in their respective jurisdictions. Governments have also been actively regulating the space, most often in the interest of Sharia finance.

In Saudi Arabia, the Vision 2030 development program introduced in 2016 by the government included commitments to bring the share of Islamic banking to 22.5%.

In Pakistan, the Federal Shariat Court declared in April 2022 that, since Riba is prohibited as per Islamic law, all conventional banking transactions should become Shariah-compliant within five years.

These are all examples of local government intervention favorable to Islamic banking. We believe that Islamic finance should generally continue to benefit from such initiatives in the foreseeable future.

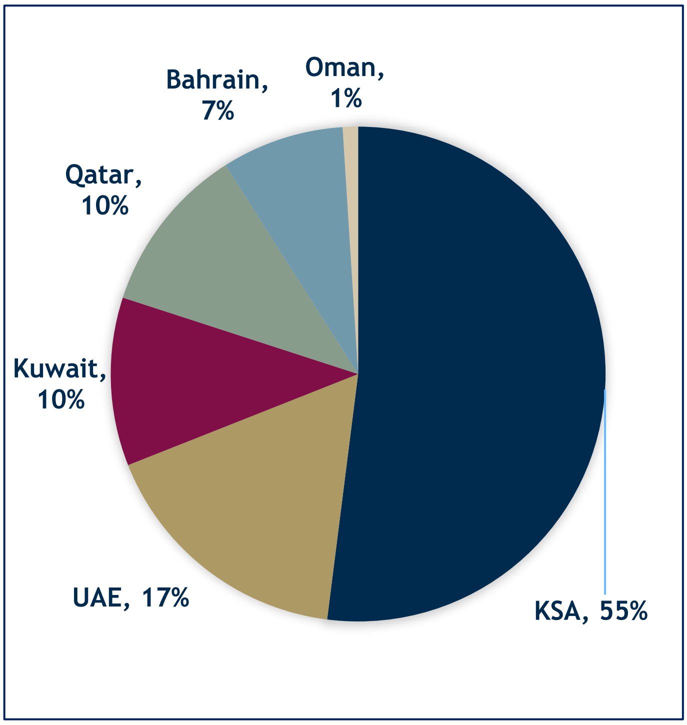
Further potential for Islamic finance in the UAE

The UAE has always been at the forefront of Islamic finance. Mit-Ghamr Savings Bank was the first attempt at Islamic banking in the world and was mostly a local, Egyptian savings bank. One of the first, truly commercial, Islamic banks to be globally established originated in the UAE in 1975. This was Dubai Islamic Bank (DIB), the very topic of this report.

There are currently six fully-fledged local Islamic banks and two foreign Islamic banks licensed to operate in the UAE. In addition, fifteen conventional banks have also established Islamic banking windows to increase their diversity and market reach.

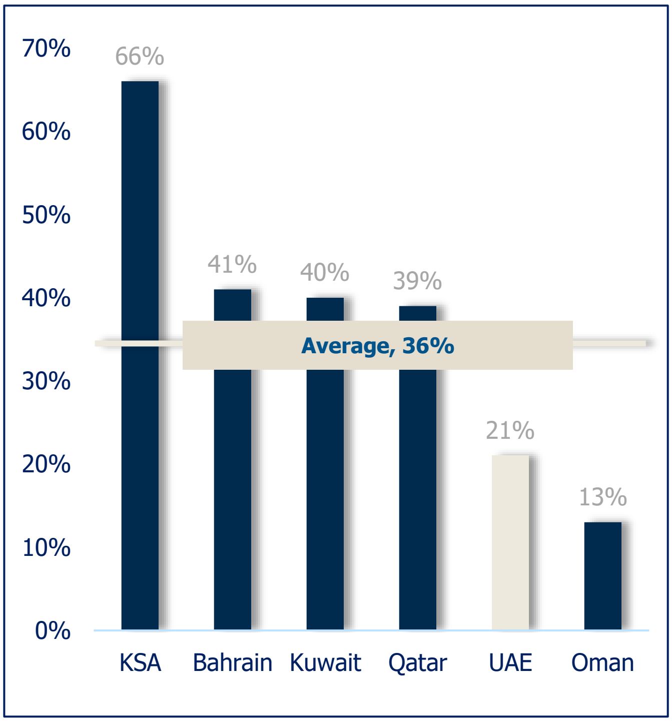
Islamic assets amounted to AED 394bn in the UAE in 2022. They represent 17% of total Islamic GCC assets and stand second after Saudi Arabia. However, Islamic banking penetration in the UAE is only 21%, which is relatively weaker than the regional average of 36%.

Chart 7: GCC Islamic banking assets, 2021



Source: Al Ramz Investment Research, Refinitiv

Chart 8: GCC % Islamic assets vs total assets



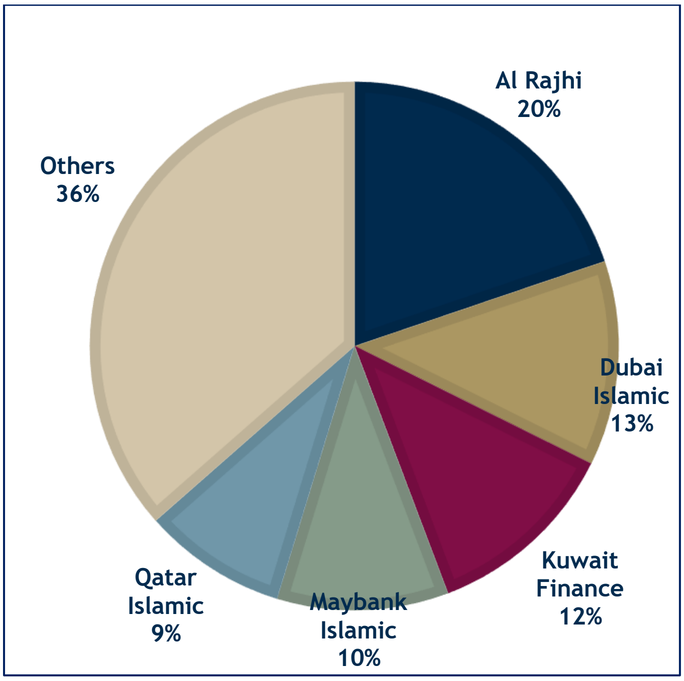
Source: Al Ramz Investment Research, Moody's

We believe that UAE penetration of Islamic assets should grow over time, at least to align with the industry average of 36%. This would represent an increase of c. 70% in UAE Islamic assets to AED 672bn, assuming conventional banking assets remain stagnant. Islamic networks including DIB stand to benefit from this expected evolution.

DIB: A global Islamic champion

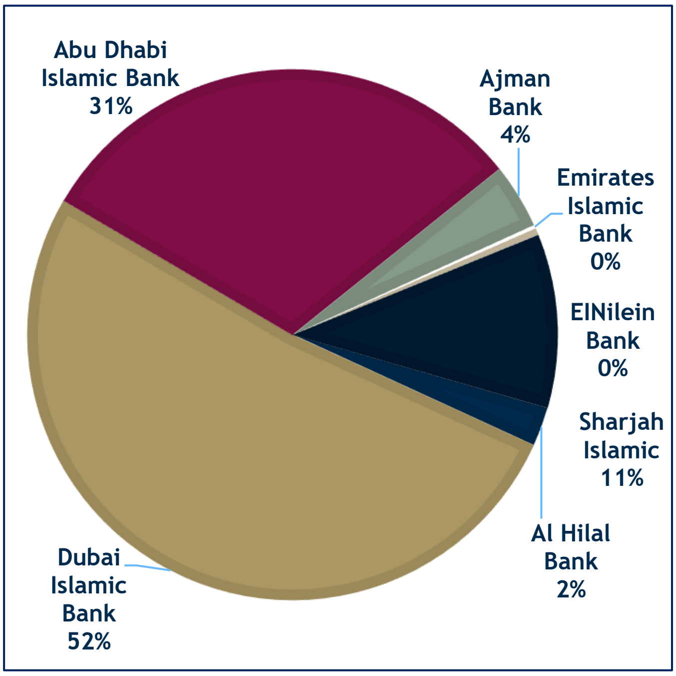
Dubai Islamic Bank (DIB) is the largest Islamic bank in the UAE by assets, and among the top 3 globally. The lender completed the acquisition of Noor Bank in late 2020 which solidified its position as a leading network in the global Islamic finance industry.

Chart 9: Global market share of Islamic assets



Source: Al Ramz Investment Research, Company financials

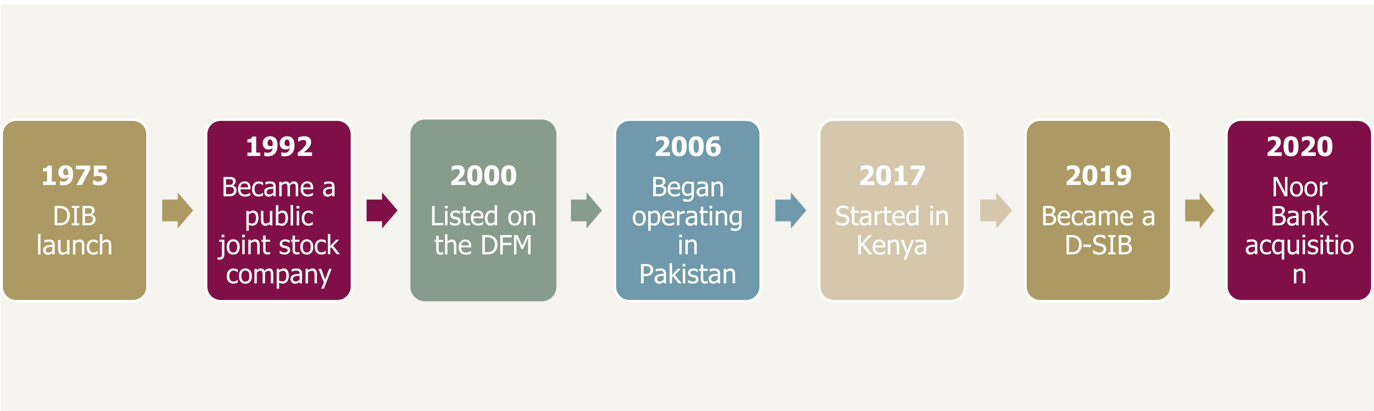
Chart 10: UAE market share of Islamic assets



Source: Al Ramz Investment Research, Company financials

DIB spearheaded the evolution of the global Islamic finance industry. It is also the world's first full-service Islamic bank with around 500 branches in its vast global network across the Middle East, Asia, and Africa. DIB was designated as a D-SIB (Domestic Systemically Important Bank) in 2018 by the UAE authorities/Central Bank.

Figure 1: Corporate timeline of Dubai Islamic Bank



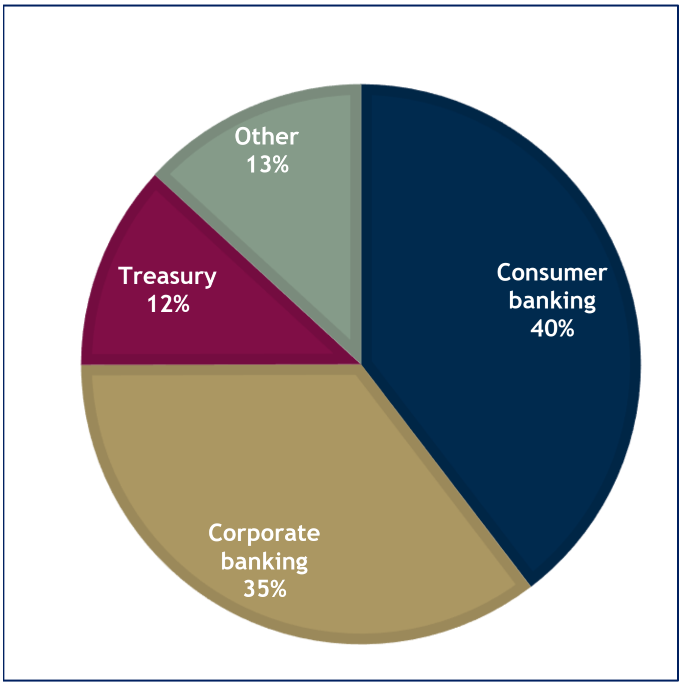
Source: Al Ramz Investment Research, Company financials

Mostly driven by corporate clients

The client base of DIB is spread across the UAE, but mostly skewed towards corporate borrowers. Higher corporate exposure is beneficial for growth due to much larger average loan sizes relative to retail.

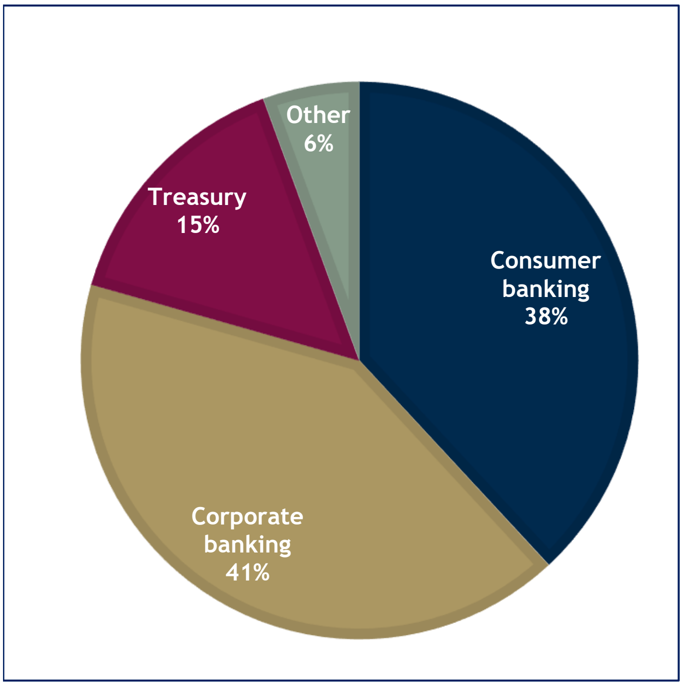
While most of DIB's profits, assets, and liabilities are corporate driven, we note that a large part of the revenue comes from the retail segment. This is common across all banks as retail customers are charged a higher interest on loans and a lower interest is paid on deposits compared to corporates.

Chart 11: Revenue mix



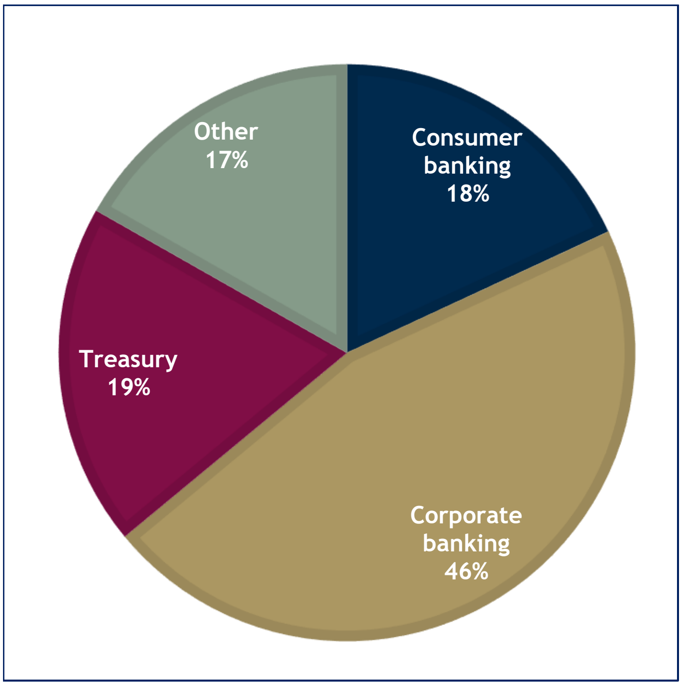
Source: Al Ramz Investment Research, Company data

Chart 12: Operating income mix



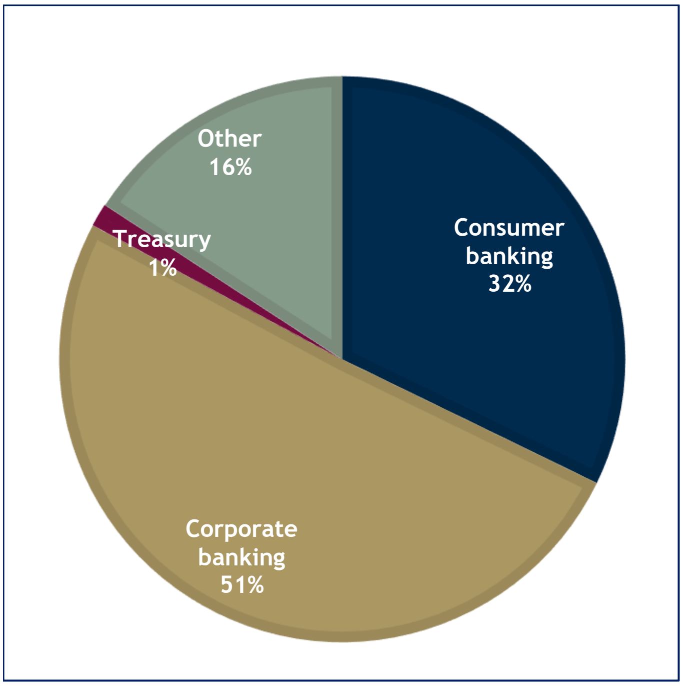
Source: Al Ramz Investment Research, Company data

Chart 13: Asset mix



Source: Al Ramz Investment Research, Company data

Chart 14: Liability mix



Source: Al Ramz Investment Research, Company data

The race for size

DIB has a strong international presence. It operates in 7 countries through a combination of branches, subsidiaries, and representative offices.

We believe that DIB has the firepower to expand inorganically, both locally and internationally. Many smaller UAE Islamic franchises would qualify as relevant targets for DIB. We understand from management that it would likely consider opportunistic inorganic growth, if it adds value to shareholders.

On the 3rd of May, the Bank announced that the board approved the potential entry of the bank into Turkey. This will be a part acquisition of 25% of a new digital banking group in Turkey. This acquisition is subject to necessary approvals from relevant regulatory authorities. This deal was widely expected as the management commented on a potential expansion into Turkey during our meeting. However, we expected this deal to happen in the second half of 2023. Further details about the deal haven't been disclosed by the bank/management and other sources like Bloomberg.

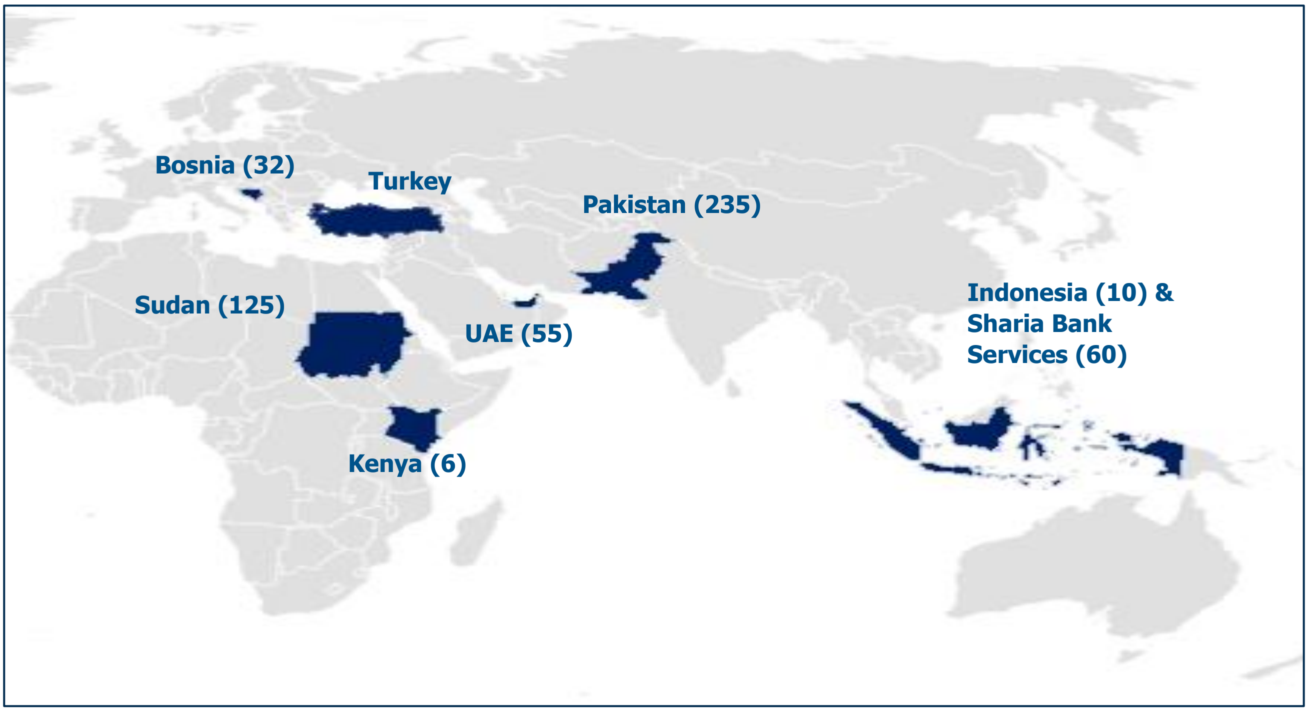
The acquisition should have a marginal impact on the financials as costs may increase due to the acquisition. However, the acquisition should overall be value accretive as banks in Turkey trade at a large discount.

Table 3: Subsidiaries and associates

Name	Country	Ownership
Dubai Islamic Bank Pakistan Ltd.	Pakistan	100.0%
PT. Bank Panin Dubai Syariah Tbk	Indonesia	25.1%
DIB Bank Kenya Ltd.	Kenya	100.0%
Bank of Khartoum	Sudan	29.5%
Bosnia Bank International	Bosnia	27.3%

Source: Al Ramz Investment Research, Company financials

Figure 2: Existing international presence and branch numbers



Source: Al Ramz Investment Research, Company financials

DIB Pakistan unaffected by PKR depreciation

DIB Pakistan is the largest international subsidiary accounting for c. 50% of DIB's total international presence. It began operations in 2006 and is currently present in 70-80 cities in Pakistan via 300 branches. It is the only profit-making international subsidiary of DIB. Overall, DIB Pakistan has been performing well and we expect this out-performance to continue.

DIB Pakistan had a stellar year in 2022 when it recorded a profit of PKR 3.9bn, up 27% from 2021. This increase was mainly due to higher NII growth (63%), driven by the 625bps rate hike by the Central Bank of Pakistan on the back of soaring inflation.

This fundamental performance was clouded by the forex impact of a deeply depreciating PKR. The forex sensitivity is such that every 5% depreciation in the Pakistani currency has an impact of AED 4.2m on consolidated group profits.

However, DIB Pakistan currently contributes less than 1% to the group bottom-line. All-in-all, the negative forex impact will have a marginal impact on the group profit.

Tapping into underpenetrated markets by acquiring Noor Bank

Noor bank was established in 2008 and was the 11th largest UAE bank by assets at the time. It was a full-service Shariah-compliant lender, offering a range of products and services in corporate banking, personal banking, wealth management, Takaful (Islamic insurance), treasury, and trading. It was present across the country, in multiple locations like Abu Dhabi, Dubai, Sharjah and Al Ain.

DIB acquired 100% of Noor Bank in 2020 with a three-pronged strategic rationale:

- DIB wanted to cement its position as one of the largest Islamic lenders.
- Noor bank had a strong wealth management client base, an area of expertise DIB lacked but wanted to tap into.
- Noor Bank had a large SME portfolio which was compelling for DIB to complement its existing corporate franchise.

This acquisition was an overall success as it drove DIB's assets and liabilities to the next level. The acquisition boosted assets by AED 48bn while the loan book expanded by AED 31bn. Deposits too recorded a notable jump of AED 35bn.

The acquisition impacted the NPL ratio uplifting it by about 50bps. These NPLs are collateralized, and the management doesn't view this as a major threat to the asset quality.

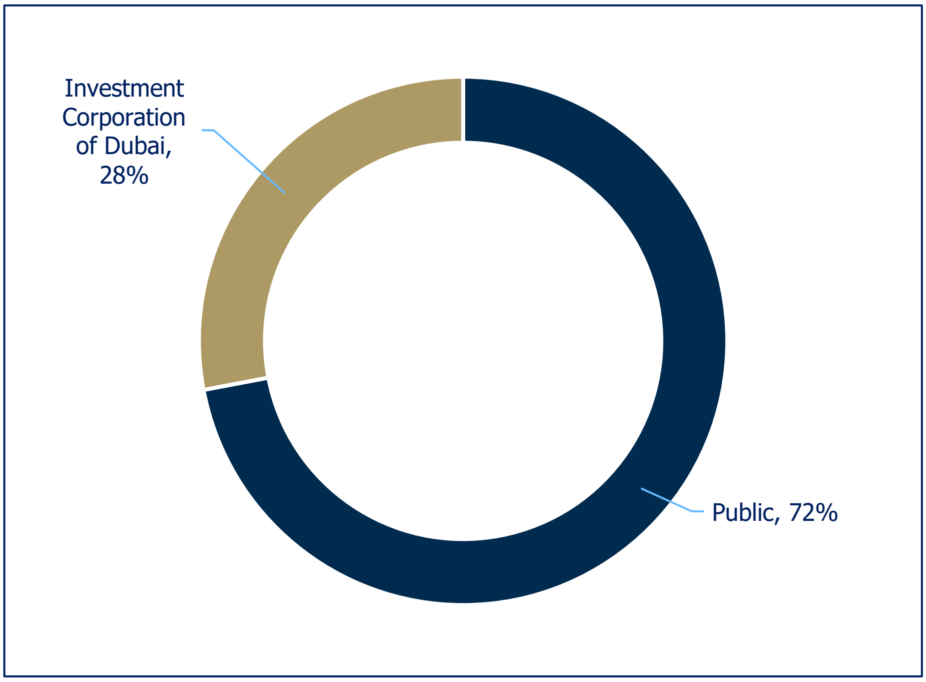
Support from the Government of Dubai

The principal shareholder of DIB is the Government of Dubai, which indirectly owns 28% of outstanding shares through the Investment Corporation of Dubai (ICD). ICD is a sovereign wealth fund which is majority-owned by the Dubai government.

We believe that a major shareholding by the government is beneficial due to two specific reasons. DIB should be positively impacted by the high sovereign credit-rating of Dubai, as rating agencies might treat DIB as a quasi-sovereign entity with an unlikely probability of default.

DIB is rated A3 by Moody's which translates into a five-notch uplift from its Baseline Credit Assessment (BCA) of ba1. The rating is based on the high expected probability of support by the government in case of need.

Chart 15: Shareholder structure



Source: Al Ramz Investment Research, Company financials

Multiple strengths to show for

Figure 3: SWOT analysis

Strengths	•A large domestic and global islamic banking franchise •One of the most cost-efficient banks in the UAE •Comfortable capital position to fund dividend game
Weaknesses	•Comparatively high NPLs •High concentration of loans in Real Estate
Opportunities	•Unmet Islamic banking potential in the UAE places DIB at an advantage to grow its presence further
Threats	•Changes in banking regulation Format •A potential economic slowdown impacting sector growth

Source: Al Ramz Investment Research, Company financials

A bright financial outlook

DIB has delivered superior return and cost efficiency metrics to date. In this section, we analyze its operational performance against UAE peers.

A strong lending track record

DIB showed clear outperformance in growth versus the Islamic banking industry. Its loan book grew at an average annual rate of 9.7% between 2018 and 2021, nearly four times faster than industry growth of 2.3%.

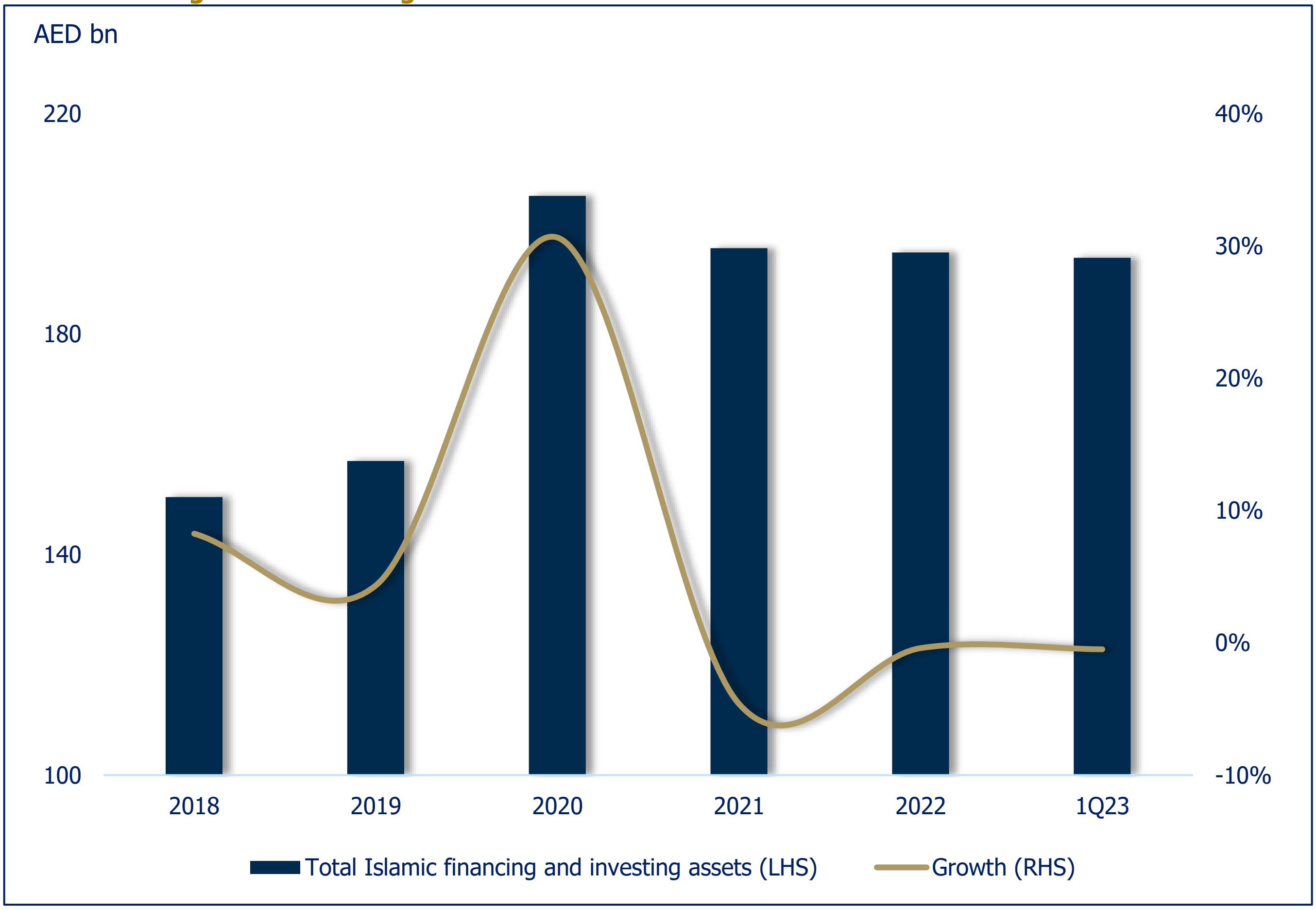
2022 strikes a pause

New loans were encouraging in 2022 and amounted to AED 31bn from the corporate segment and another AED 18bn from retail financing. As a result, loan growth from new loan creation came in at a hefty +25%. However, this was more than compensated for by repayments of AED 49bn of existing loans. As a result, the overall loan book contracted marginally by 0.3%.

A similar trend was demonstrated in the first quarter of 2023, with the loan book declining by 1% year to date due to repayments and early settlements.

We did not get specific guidance from management as to when such repayments could ease. Our own expectation is that repayments should continue at least through the first half of 2023, as rates remain relatively elevated. Taking a conservative approach, we expect loan growth to expand by +4.1% this year, slightly below management guidance of 5%.

Chart 16: DIB gross loans and growth

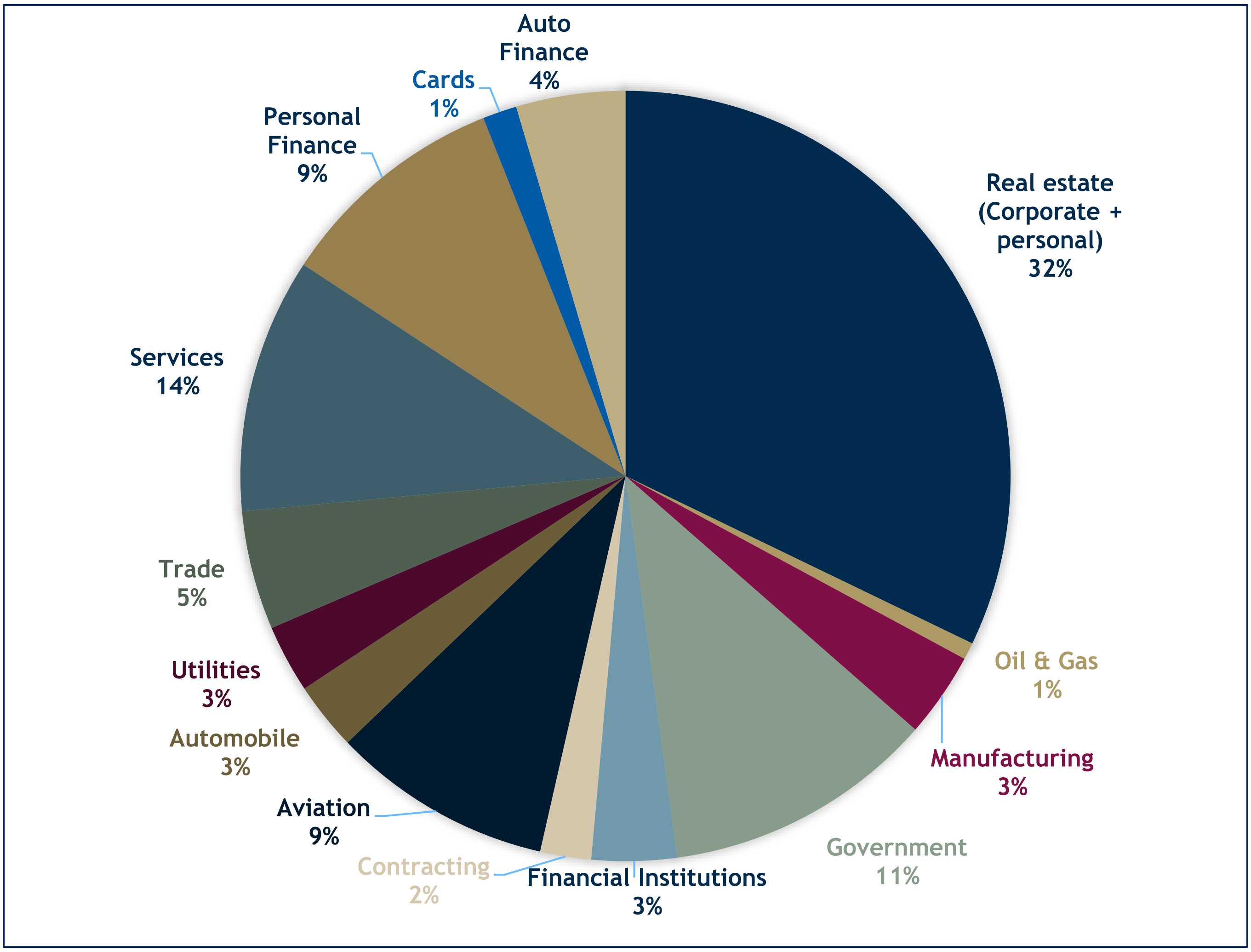


Source: Al Ramz Investment Research, Company financials

The weight of real estate

DIB has had exemplary lending performance historically. However, the concentration of its loan book remains a concern. Notably, it has significant exposure to the volatile real estate sector, with a total of 32% of loans if we include both corporate (20%) and personal mortgages (12%).

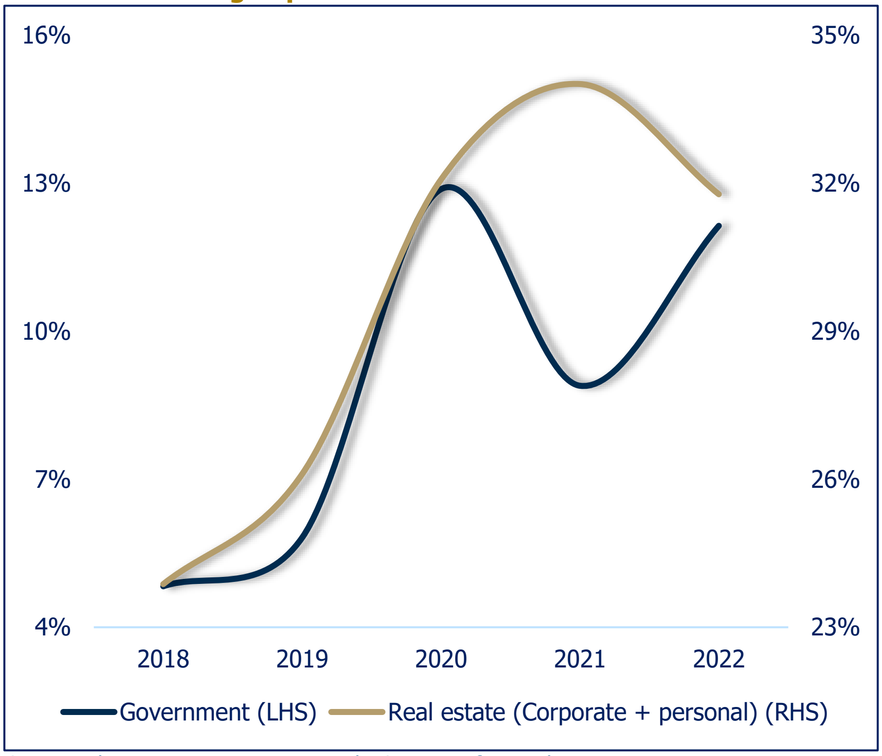
Chart 17: Loan book mix, 1Q23



Source: Al Ramz Investment Research, Company financials

The Central Bank of the UAE imposed a regulatory limit of 30% in 2021 to any real estate exposure by the banks, based on credit risk-weighted assets. DIB has been reducing the proportion of its loans to the real-estate sector accordingly, to comply with the new regulation. This de-risking was done by gearing the book towards more loans to government and limiting real estate financing.

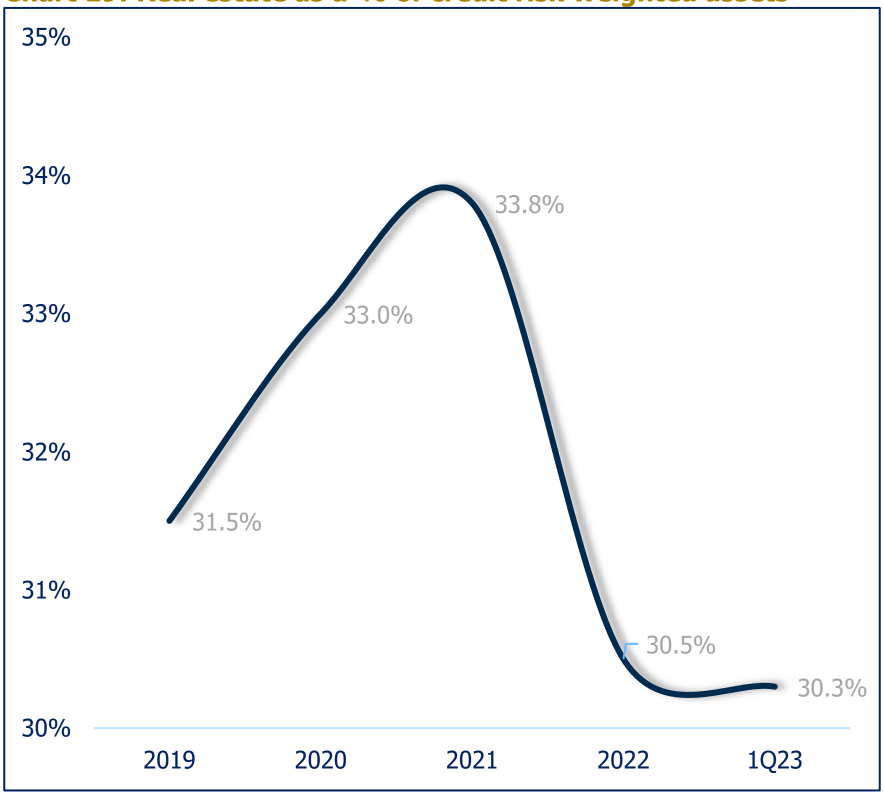
Chart 18: Lending exposure



Source: Al Ramz Investment Research, Company financials

Aggregate real estate exposure is now back to 30.3% of total credit risk weighted assets, in line with the regulatory threshold. Despite meeting the regulatory requirement, management intends to conservatively continue to gear its book towards safer government loans, to further improve loan book quality.

Chart 19: Real estate as a % of credit risk weighted assets

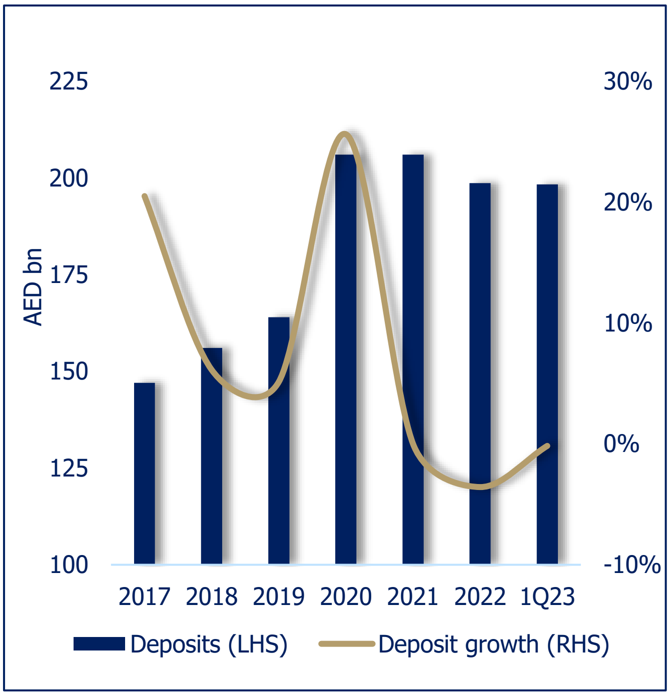


Source: Al Ramz Investment Research, Company data

Funding and liquidity intact

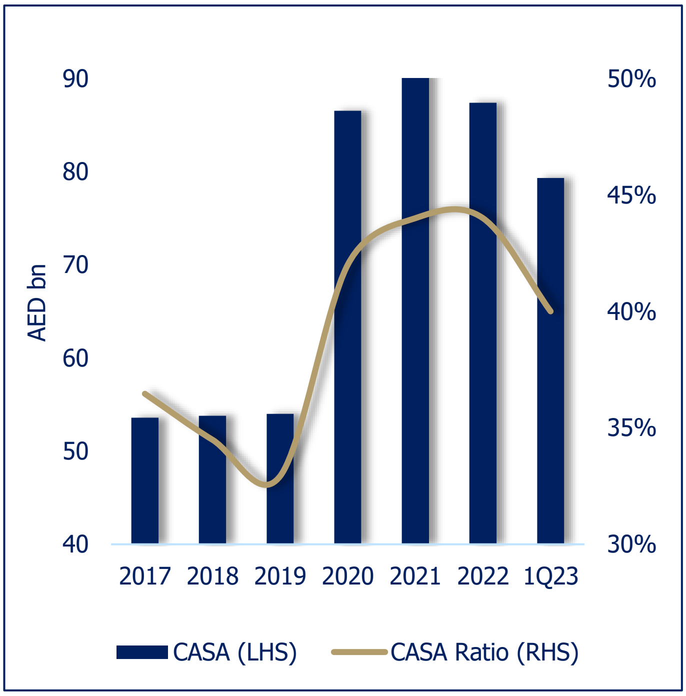
Average growth of deposits (+11.0%) and CASA (+12.3%) was robust from 2016 to 2021. However, 2022 was a challenging year from a funding perspective as deposits shrunk by 3.6% while the CASA ratio remained flat. Deposit growth was flat in the first quarter of 2023 while the CASA ratio declined from 44% in 2022 to 40%.

Chart 20: Deposits trend



Source: Al Ramz Investment Research, Company financials

Chart 21: CASA trend



Source: Al Ramz Investment Research, Company financials

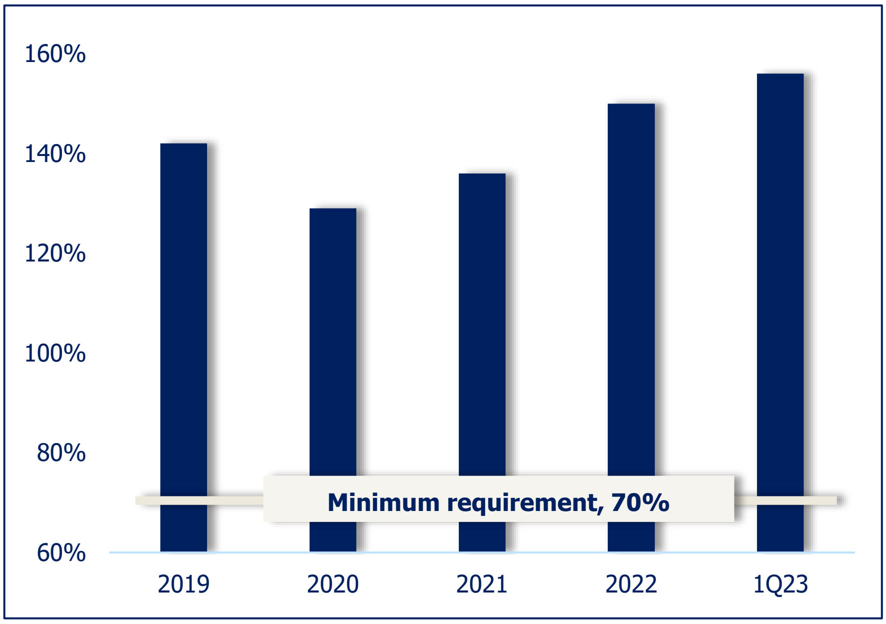
Deposits fell as the bank shed costly funds, and companies optimized balance sheets by repaying costly loans from the liquidity placed in deposit accounts.

The drop in CASA, however, is a common phenomenon in a rising interest rate environment as most customers typically shift from CASA to term deposits. While we expect interest rates to keep increasing at least through the first half of 2023, we look for CASA to remain at current levels, with no further growth.

DIB enhanced its funding base by issuing a USD 750m sustainable sukuk in 4Q 2022. This should add some support to the funding profile and relief to the net interest margin (which we discuss below).

Liquidity remains robust with the liquidity coverage ratio well above the minimum regulatory requirement of 70%. The net stable funding ratio is also stable at 108%. All in all, we are not concerned about the drop in deposits due to the strong and robust liquidity and funding profile.

Chart 22: Liquidity coverage ratio



Source: Al Ramz Investment Research, Company financials

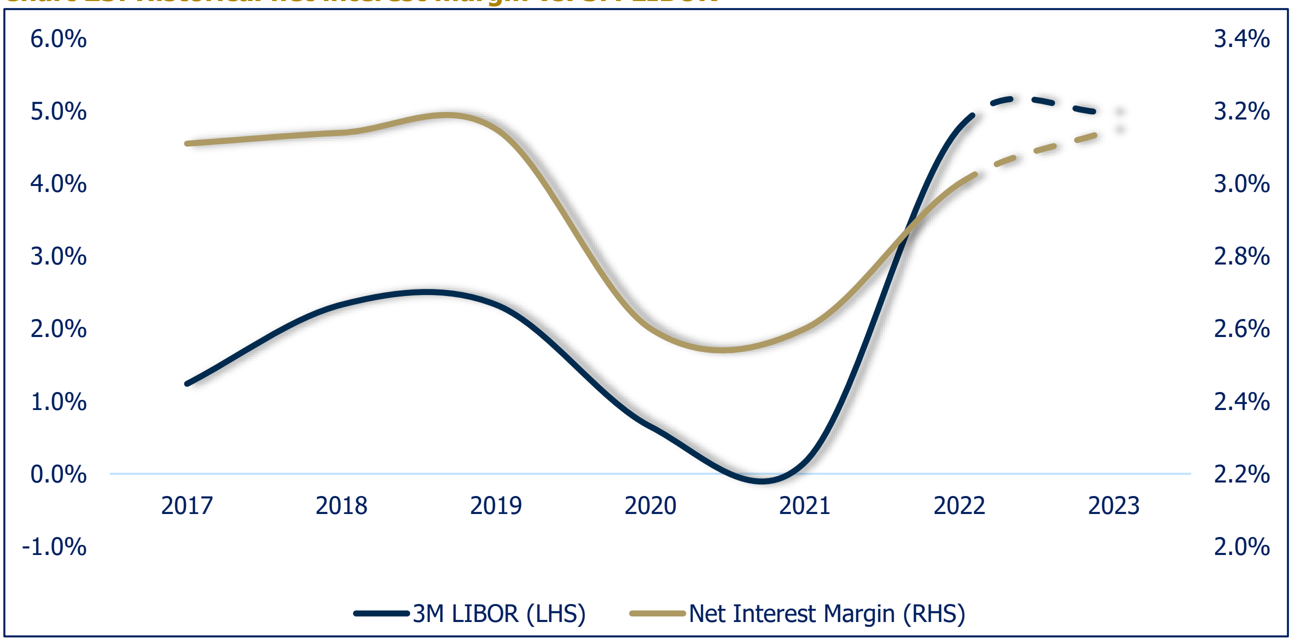
Stabilizing rates could limit margin expansion

NIMs historically higher than the industry

The net interest margin has historically been above the industry average for two main reasons, in our opinion. Firstly, the loan book structure of DIB causes loans to reprice faster than deposits, while the opposite is generally true in the industry. This was a strategic choice by the management to hedge against rising interest rates.

Secondly, 70% to 80% of the loan book consists of mortgage-type, variable loans which adjust to changing benchmark rates. This is as opposed to fixed-rate loans which are generally applicable to vehicle financing, and do not adjust to the interest rate cycle. With mostly variable-rate loans in the book, the margins of DIB have benefitted from the current rate cycle.

Chart 23: Historical net interest margin vs. 3M LIBOR



Source: Al Ramz Investment Research, Company data

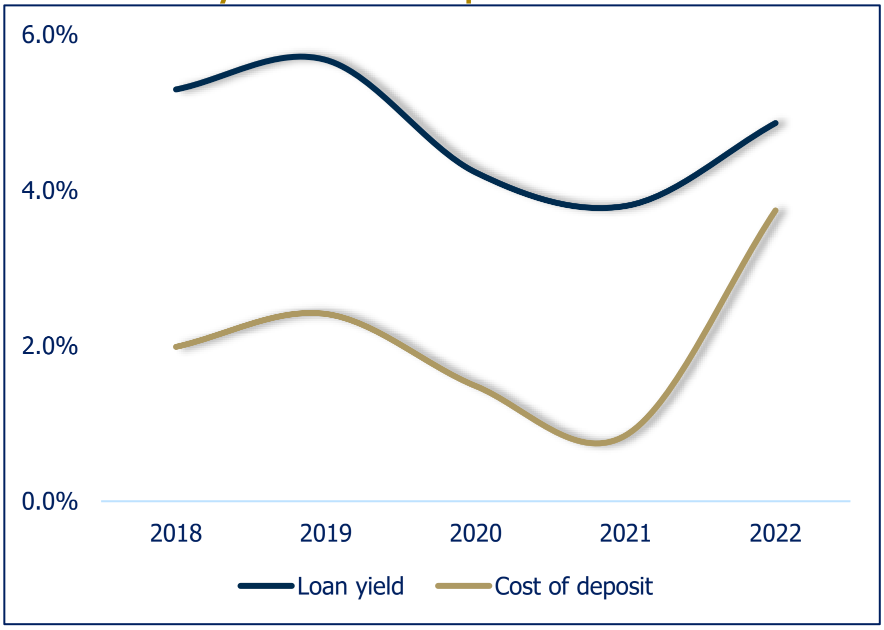
Slowdown in 2022

Margin expansion slowed in 2022. We note that the spread between the asset yield and cost of deposits narrowed to 112bps in 2022 from 295bps in 2021. We see two possible reasons for the narrowing spread.

Firstly, the shift from higher yielding real estate lending to low yield government-related credit may have slimmed the spread. Although the recent conservative stance of management has resulted in a compression of the yields, we find that this policy should be rewarding in the long term for the lender, as it trades higher margins for better quality and a more sustainable book.

Secondly, the less costly CASA deposits fell to 44%. Meanwhile, with an effort to support credit growth and reduce the currently elevated loan-to-deposit ratio, DIB mobilized more deposits in the fourth quarter. This also pushed the cost of funds higher.

Chart 24: Asset yield vs. cost of deposits



Source: Al Ramz Investment Research, Company financials

Off to a good start in 2023

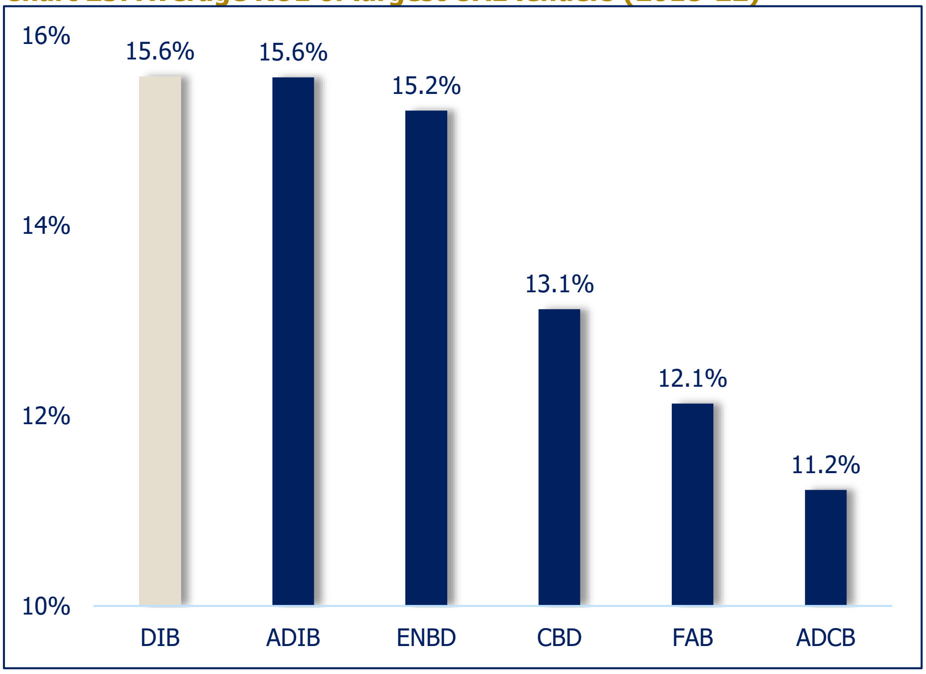
The current NIM of 3.2% comes ahead of the initial 3.0% management guidance. Higher NIMs are due to the variable nature of the loan book.

NIMs should most likely remain at the current level throughout the first half of 2023. However, as rates stabilize in 2H23, NIM expansion could subside. Consequently, we expect NIMs at 3.15% in 2023E, 15bps higher than last year but 5bps lower than the 1st quarter of 2023E. This is marginally higher than the current management guidance of 3.0%, which we believe could be revised upwards.

Superior returns

Over the past 5 years, DIB maintained exceptional return metrics. It delivered a superior average Return on Equity (ROE) of 15.6% over 2018-22, outperforming its local competitors. Outperforming loan growth, solid margin expansion, well-managed costs, and sound capitalization ratios are the core reasons behind these superior returns.

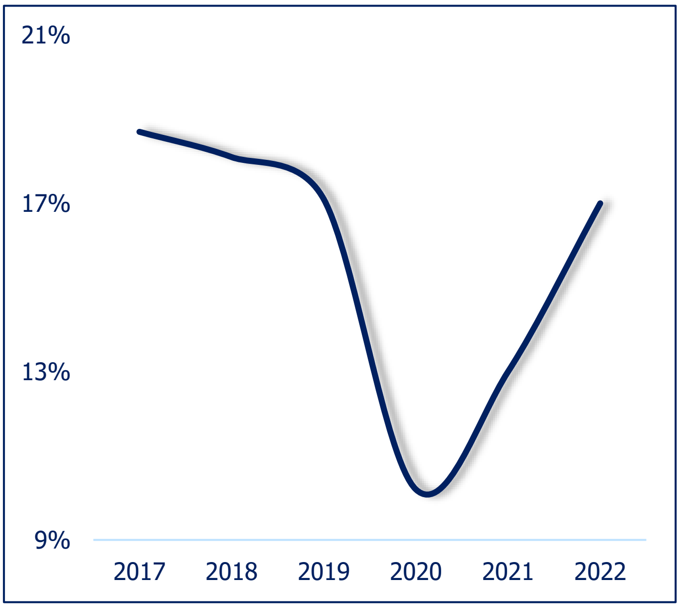
Chart 25: Average ROE of largest UAE lenders (2018-22)



Source: Al Ramz Investment Research, Bloomberg

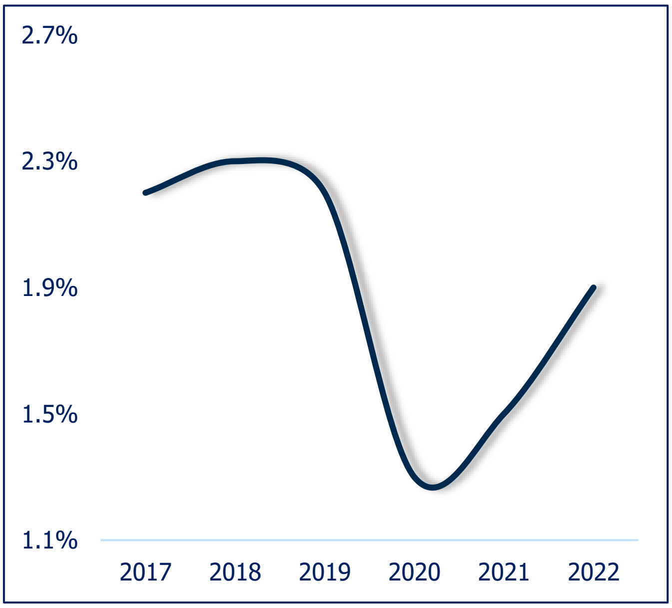
2020 was a bad year for all economies that were hit by the pandemic. Most UAE banks had single digit ROTEs. DIB on the other hand continued to show superior returns to the industry with a double-digit ROTE. In 2022, ROTE stood at 17.0%.

Chart 26: ROTE



Source: Al Ramz Investment Research, Bloomberg

Chart 27: ROA

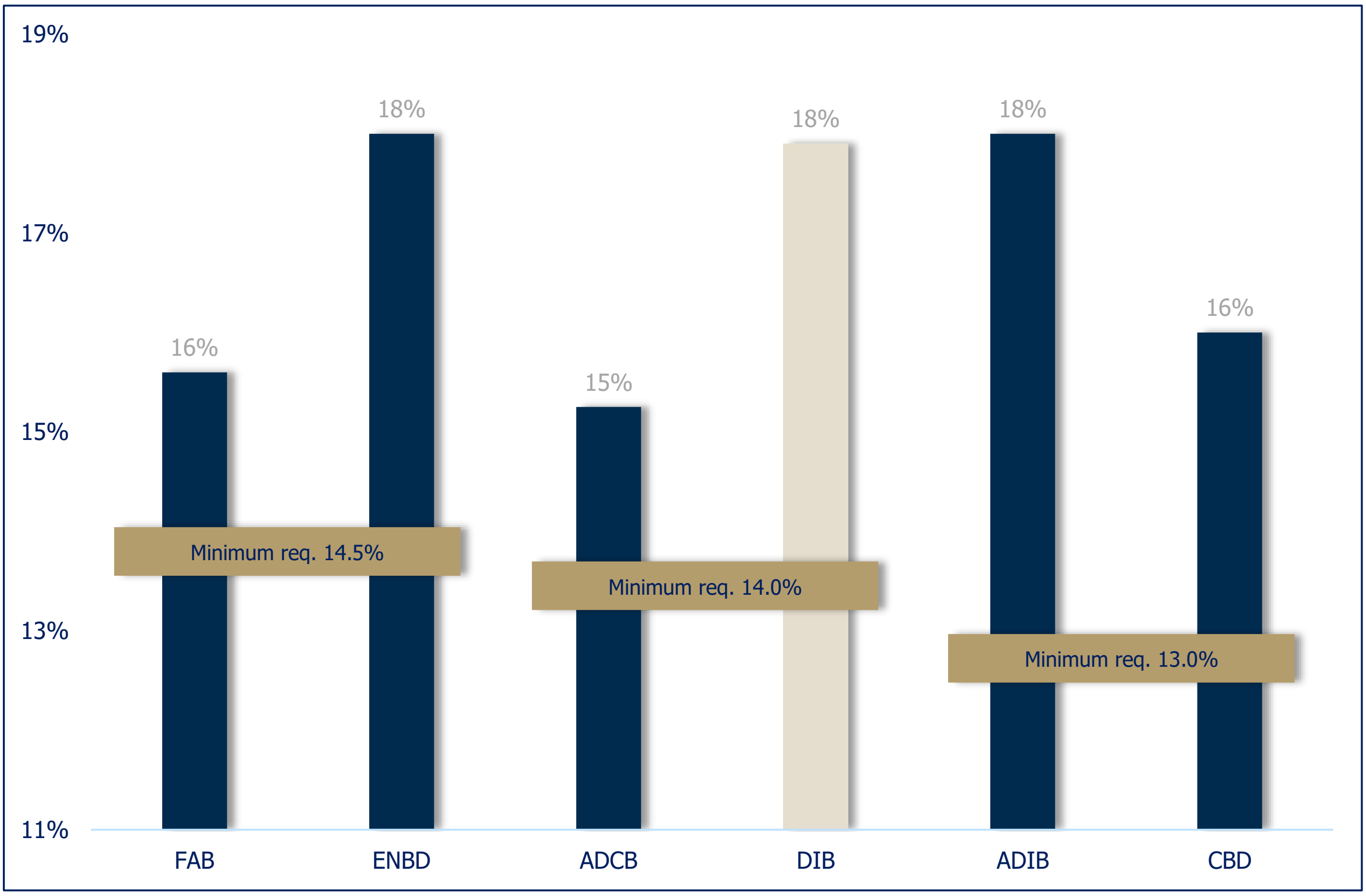


Source: Al Ramz Investment Research, Bloomberg

Strong earnings and higher capital for better dividend growth

The capital adequacy ratio (CAR) of 17.9% as at 1Q23 is well above the central bank minimum requirement of 13.5%. This indicates an additional capital buffer of approx. AED 12bn. DIB successfully issued USD 1bn of AT1 Sukuk in November 2020 and another USD 500m in 2021 which contributed to the strong growth in CAR.

Chart 28: Comparative CET1 ratio and minimum requirement, 2022

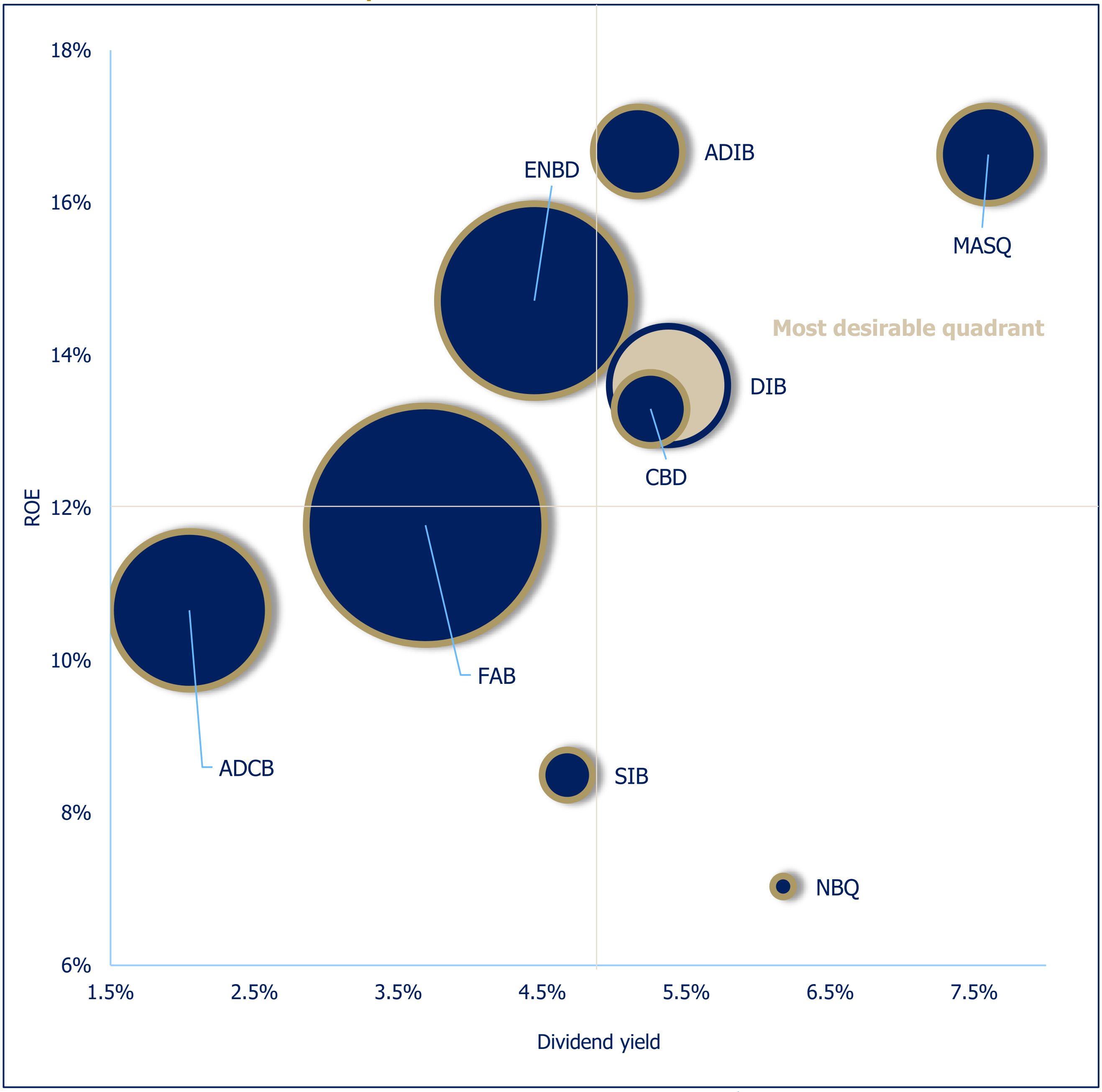


Source: Al Ramz Investment Research, Company financials

High capital buffers enabled stable payout ratios and impressive dividends. DIB is one of the strongest dividend payers among the large cap liquid banking stocks. The bank paid a dividend of 30 fills per share in 2022 translating into a dividend yield of 5.6%. While we assume the same payout ratio in 2023E, we forecast a dividend of 33 fills per share in 2023E.

With a winning combination of high ROE and high dividend yield, DIB finds itself in the most desirable quadrant of the ROE-Yield matrix, ahead of many larger UAE lenders.

Chart 29: Dividend vs. ROE comparison



Source: Al Ramz Investment Research, Company financials, Refinitiv, Note – Prices as at 10th May 2023

Uncompromised cost efficiency

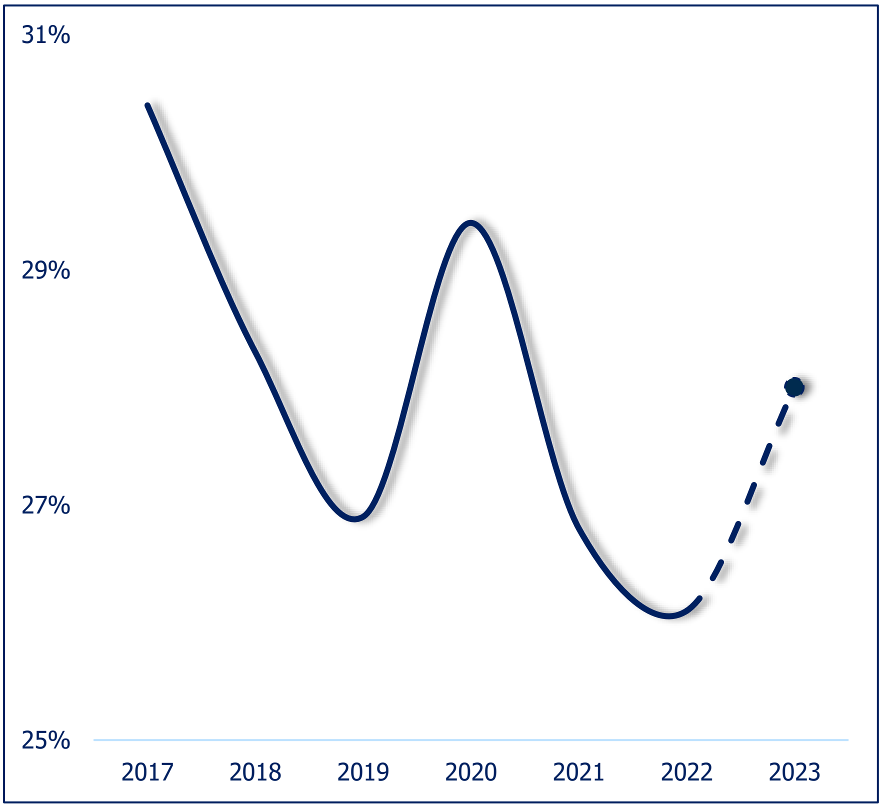
DIB is the most cost-efficient bank in the UAE alongside CBD. This helps maintain superior return metrics in an already high inflationary environment. Asset quality metrics are also on an improving trend.

A cost leader

The cost-to-income ratio of DIB came down significantly faster than the industry average, from a high of 30% in 2017 to an all-time low of 26.9% in 1Q23. This positions DIB as the most cost-efficient bank in the UAE, alongside CBD.

This improvement in cost efficiency is attributable primarily to three factors – a large decline in operating expenses, a sharp upward momentum in operating income, and an expanding digital banking footprint.

Chart 30: Cost to income of DIB

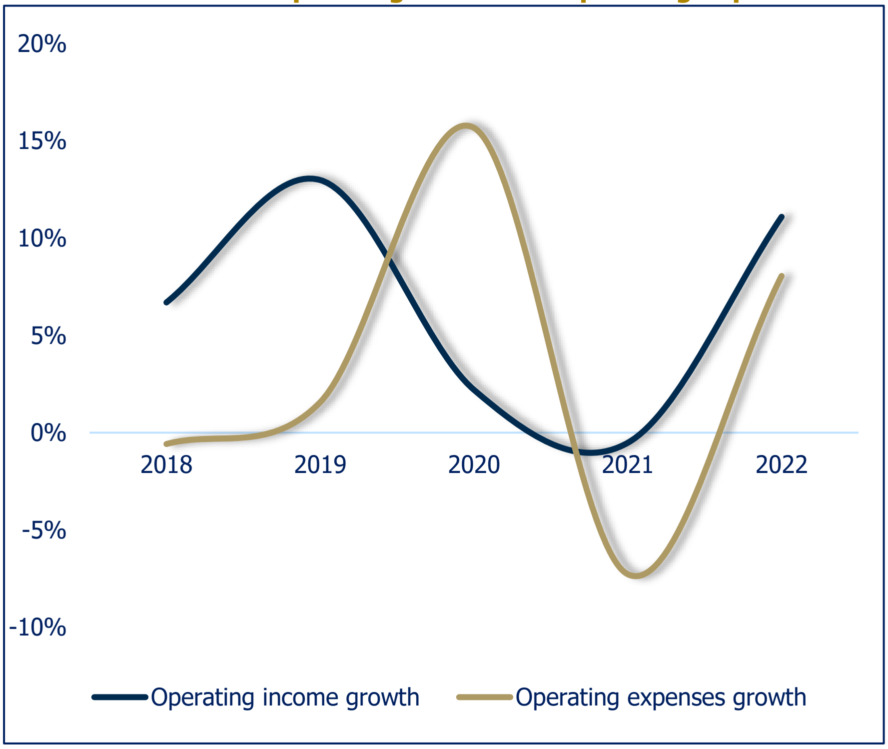


Source: Al Ramz Investment Research, Company financials

Operating income growth held strong and contributed to maintaining healthy cost efficiency. However, expenses have caught up now amid inflationary pressures - a common concern across the industry.

In the likely event that expenses should continue to increase at the current pace and in line with persistent inflation, we expect a negative impact on cost efficiency for DIB. We conservatively assume that the cost-to-income ratio should go back to 28% in 2023E, while remaining altogether below industry average.

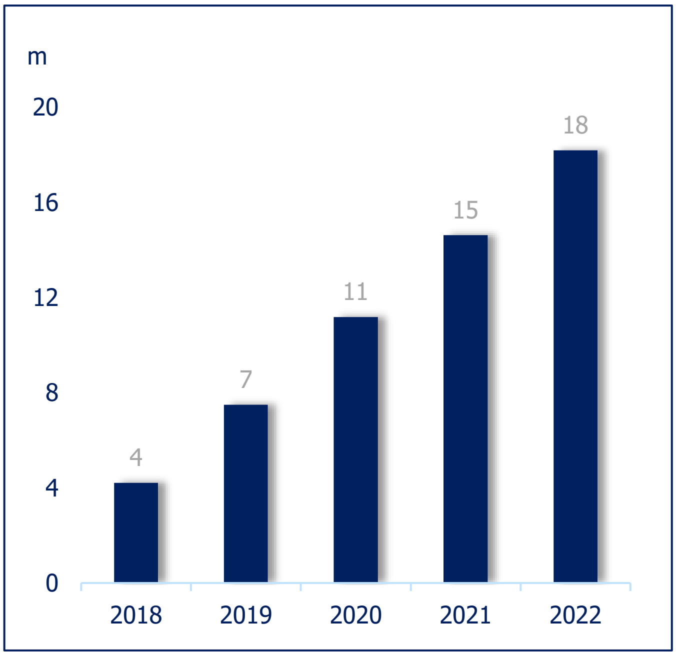
Chart 31: Growth of operating income vs. operating expense



Source: Al Ramz Investment Research, Company financials

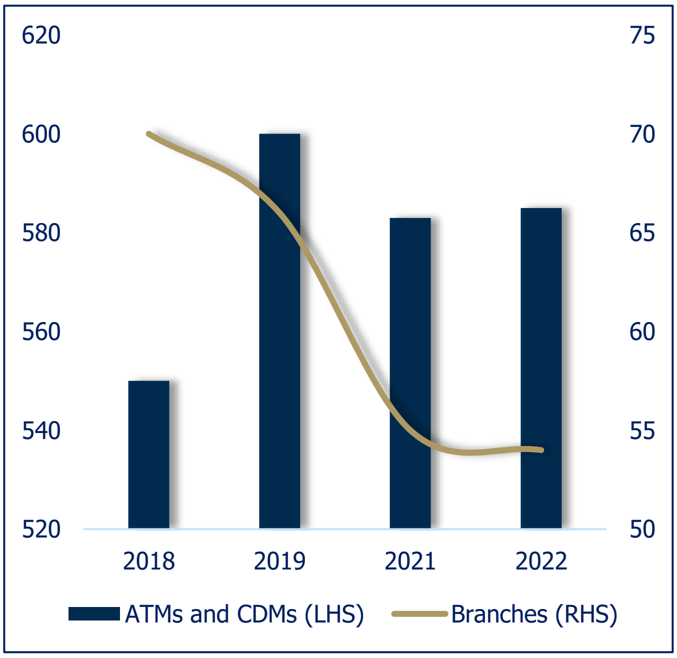
The digitalization process has been vigorous at DIB, with digital banking users more than doubling since 2018. As a result, ATM machines increased while the number of physical branches declined, to cater to a more "mobile" world. Management confirms that they will continue to invest in digitalization and FinTech, which should feed into the bottom line in the medium term as costs are reduced and operational leverage increases.

Chart 32: No. of digital users



Source: Al Ramz Investment Research, Company financials

Chart 33: No. of CDMs and ATMs vs. branches



Source: Al Ramz Investment Research, Company financials

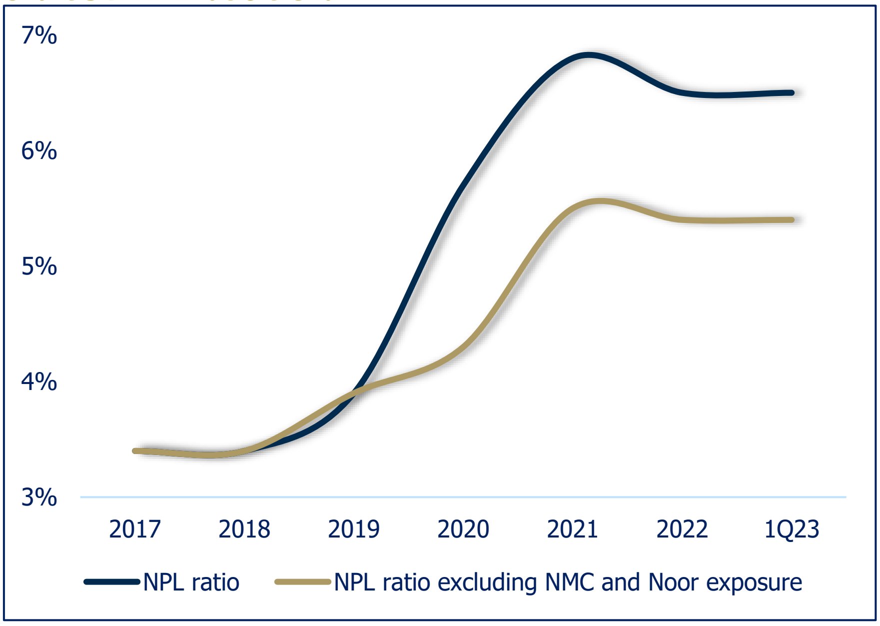
Strong asset quality excluding NMC exposure

Asset quality deteriorated since 2018 mainly due to higher real estate exposure. Furthermore, the acquisition of Noor bank and the NMC deal lifted DIB's overall NPL further by c. 130bps.

In 2020, NMC Health reported it had found evidence of suspected fraud in its finances. Its total debt ballooned to USD 6.6bn, more than three times the USD 2.1bn in debt it had previously declared in its official accounts. With NMC no longer a going concern, this reduced the recoverability of borrowings.

DIB was exposed to NMC via a USD 425m loan, (AED 1.6bn) with an additional USD 116m via its subsidiary Noor Bank PJSC, which was extended prior to its acquisition by DIB. The aggregate exposure constituted approximately 0.6% of the total assets at the time the scandal occurred (2020).

Chart 34: NPL ratio trend

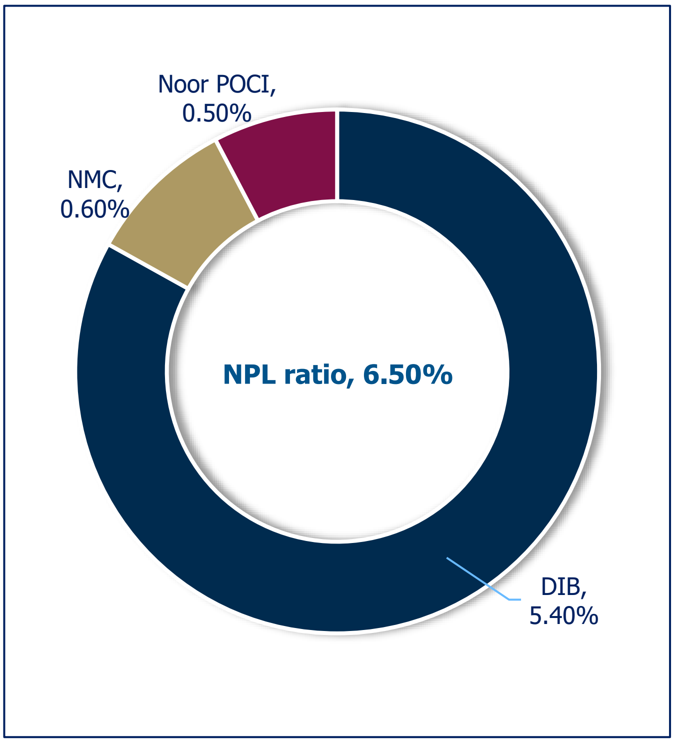


Source: Al Ramz Investment Research, Company financials

So far, the bank has managed to recover 18% of these loans from NMC. We expect the remainder to be recovered over the next 2-3 years bringing the total exposure to zero by 2025. This should have a significant positive impact of 60bps on the NPL ratio in 2025.

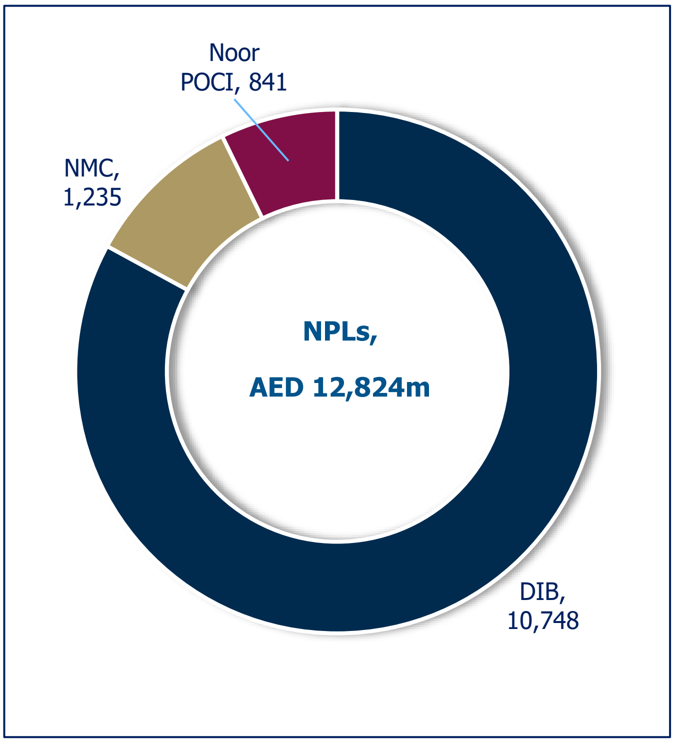
All in all, we expect the NPL ratio to improve to 6.25% in 2023E, in line with management guidance. Once NMC loans are fully recovered by 2025, the NPL ratio should drop to approx. 5.5%.

Chart 35: Nonperforming finance ratio mix



Source: Al Ramz Investment Research, Company financials

Chart 36: Nonperforming finance mix

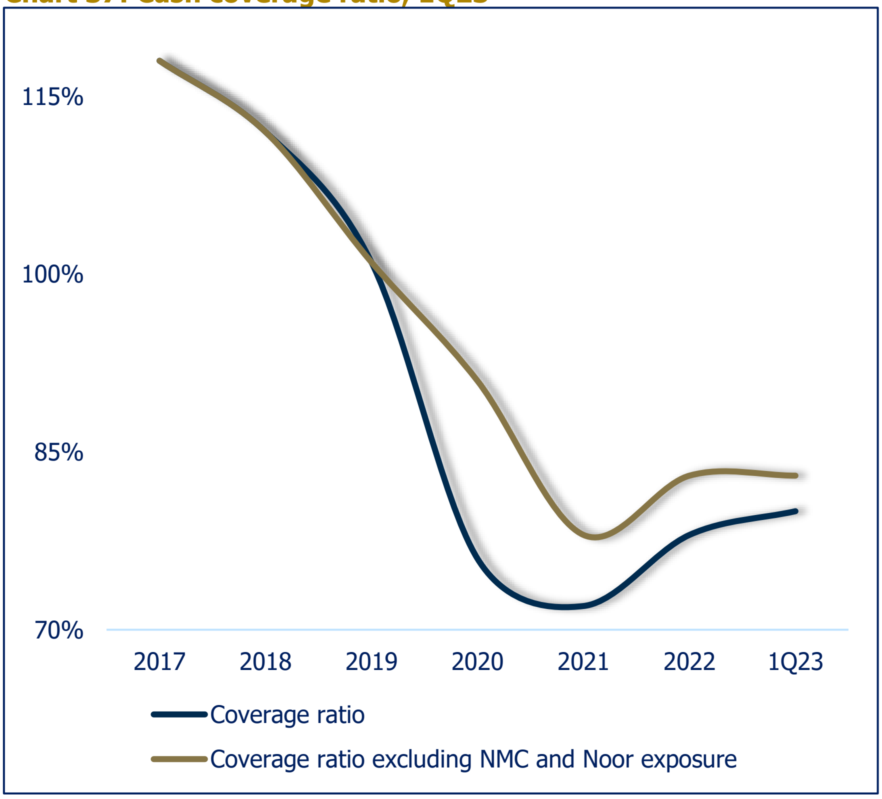


Source: Al Ramz Investment Research, Company financials

Coverage ratio uplift

The cash coverage ratio was impacted too, as it dropped from 101% in 2019 to a low of 72% in 2021. However, we note an improvement of 800bps in the coverage ratio since the beginning of 2022.

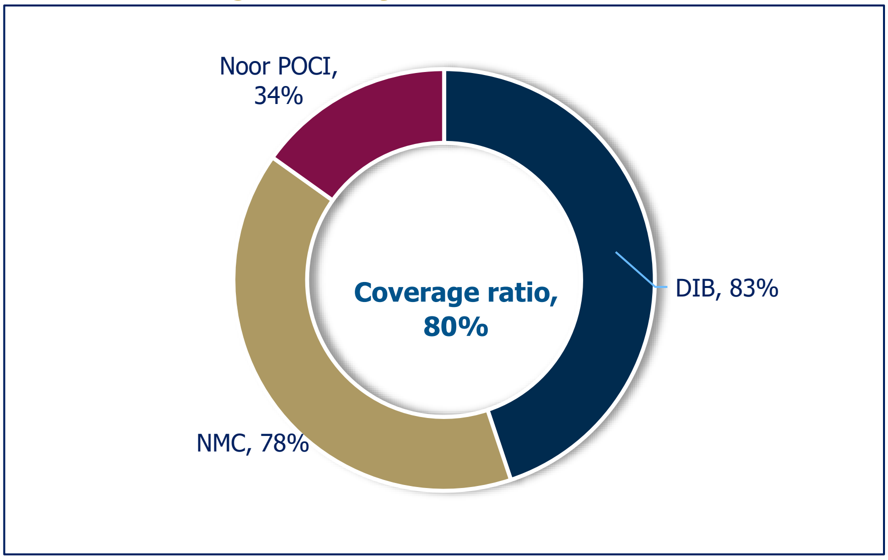
Chart 37: Cash coverage ratio, 1Q23



Source: Al Ramz Investment Research, Company financials

NMC's coverage improved significantly from 52% in 2020 to 78% in 1Q23. While we expect the management to gradually reduce its exposure in NMC loans over the next 2-3 years, it is likely that the coverage ratio may not see a material impact. This is because a loan loss provision of 78% is already made on these loans.

Chart 38: Coverage ratio, 1Q23



Source: Al Ramz Investment Research, Company financials

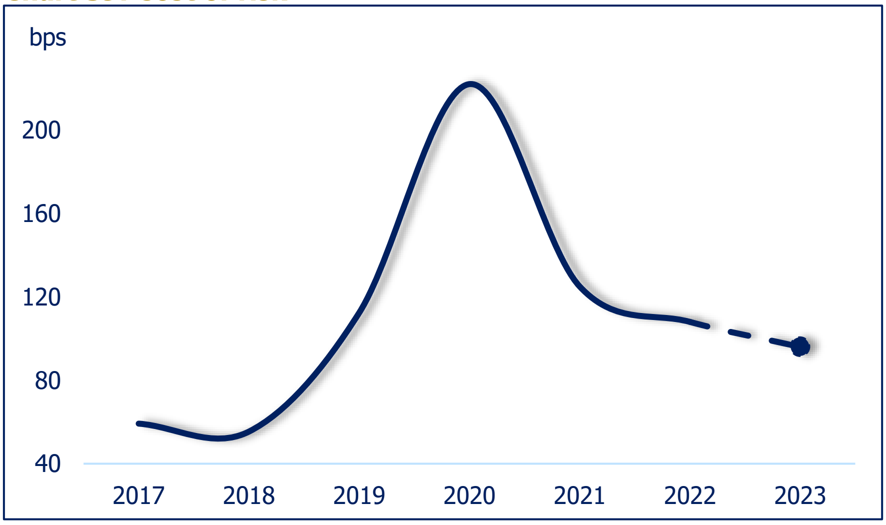
Cost of risk likely to stabilize from here

The cost of risk (CoR) rose from a low point of 51bps in 2018 to a peak of 137bps in 2020, after which it reversed. It currently hovers around 80bps, below its historic average of 86bps.

Impairments increased to AED 496m in the first quarter of 2023, up +19% YoY but down 24% sequentially. This translates into an annualized CoR of 80bps. We expect this ratio to remain at 80bps over the next 2-3 years as the bank has made adequate provisions historically.

We expect the exposure to NMC loans to eventually reach 0% over the next 2-3 years through recoveries. Should NMC make a recovery payment, the overall impairment cost will decline by the recovered amount in the form of an impairment reversal. This could lower the cost of risk to about 75-65bps.

Chart 39: Cost of risk



Source: Al Ramz Investment Research, Company financials

An attractive entry-point

As we look at the valuation from four different angles, we arrive at a blended fair value of **AED 7.05 per share**. This implies an **upside of 28%** to the last closing price. We conclude that the stock is currently undervalued and offers an attractive entry point at current levels. We initiate our coverage with **OVER-WEIGHT**. We detail our valuations and conclusion below.

We use four methodologies to value DIB: Dividend discount model (DDM), residual income model (RIM), and relative valuation to the sector and to its own trading history.

We decide to underweight the relative valuation, as we feel that the deep historical discount of DIB to its listed peers is unjustified, and that the valuation against its own trading history is a more meaningful indicator of potential future value for the stock. We summarize our findings below.

Table 4: Blended valuation summary

Valuation method	Weight	Fair value
Dividend discount model	30%	5.38
Residual income model	30%	9.25
Relative valuation	10%	5.68
Historical valuation	30%	6.98
Blended fair value		**7.05**
Last closing price		5.50
Upside		**28%**

Source: Al Ramz Investment Research

Growth and return assumptions

We detail below the assumptions used in our valuation models:

- Risk-free rate (Rf): We approximate the risk-free rate using the current 10-year yield of UAE government bonds as provided by our Fixed Income desk.
- Beta (B): Our beta is based on the regression of daily price changes against the local index (DFM) over the past one year. Daily prices are sourced from Refinitiv.
- Equity risk premium (ERP): Based on the long-term historical average return for the UAE equity market return and risk-free rate, we calculate an ERP of 5.50%.
- Cost of equity (r): We derive our cost of equity using the capital asset pricing model (CAPM): Rf + (B x ERP).
- Terminal growth (g): We assume that ENBD's earnings should grow to perpetuity in line with the long-term real GDP of the UAE. Our terminal growth rate is based on historical average of UAE real GDP growth from 1980 to 2021.
- Sustainable ROE: Our sustainable ROE is derived from our financial model and forecasts.

Table 5: Valuation assumptions

Valuation parameter	Assumed rate
Risk-free rate	4.00%
Market risk premium	5.50%
Beta	1.05
Cost of equity	**9.78%**
Terminal growth rate (g)	3.00%
Tangible sustainable average ROTE	16.5%

Source: Al Ramz Investment Research, Bloomberg

Dividend discount model: AED 5.38 per share

We value DIB at AED 5.38 based on a two-stage Gordon growth valuation model, which is made up of future dividend distributions for the forecasting period and a terminal dividend payment.

Table 6: Dividend discount valuation summary

AED m		2023E	2024E	2025E	2026E	2027E	Terminal Value
Net profits		6,027	6,242	6,392	6,502	6,668	
Dividend payout ratio (E)	x	38.4%	40.6%	41.9%	44.5%	43.4%	
Dividends (E)	=	2,317	2,534	2,679	2,896	2,896	44,034
Discount factor	x	0.94	0.86	0.78	0.71	0.65	0.65
Present value (PV) of dividends	=	2,182	2,174	2,093	2,061	1,878	28,549
Total equity value		38,937					
# of shares outstanding (m)	/	7,241					
Fair value per share (AED)	**=**	**5.38**					

Source: Al Ramz Investment Research

Table 7: Sensitivity analysis for DDM valuation

		Cost of equity						
		8.5%	9.0%	9.5%	9.8%	10.5%	11.0%	11.50%
Growth rate	2.0%	5.78	5.37	5.01	4.83	4.43	4.19	3.97
	2.5%	6.16	5.69	5.29	5.08	4.63	4.36	4.13
	3.0%	6.61	6.06	5.60	**5.38**	4.86	4.57	4.30
	3.3%	6.92	6.32	5.82	5.57	5.02	4.70	4.42
	4.0%	7.81	7.04	6.41	6.10	5.43	5.05	4.72
	4.5%	8.63	7.68	6.93	6.57	5.79	5.35	4.98
	5.0%	9.69	8.50	7.57	7.13	6.21	5.70	5.27

Source: Al Ramz Investment Research

Residual income: AED 9.25 per share

We value DIB at AED 9.25 per share based on residual income valuation, which assumes that the value of the company is the present value of the excess returns (net profit – equity charge). Equity charge is the cost of equity multiplied by shareholder equity.

Table 8: Residual income valuation summary

AED m		2023	2024	2025	2026	2027	Terminal value
Beginning value of Tangible book value		33,040	32,870	35,607	38,820	42,006	
Net profit		6,027	6,242	6,392	6,502	6,668	
Equity charge (Beg. BV x Cost of equity)	-	3,230	3,213	3,481	3,795	4,106	
Excess equity return	=	2,797	3,029	2,911	2,707	2,562	38,947
PV factor	x	0.94	0.86	0.78	0.71	0.65	0.65
PV of excess return	=	2,634	2,598	2,275	1,927	1,661	25,250
Sum of PV of excess return		36,344					
Beginning equity invested	+	30,602					
Total Value	=	66,946					
No of shares	/	7,241					
Fair value	**=**	**9.25**					

Source: Al Ramz Investment Research

Table 9: Sensitivity analysis for residual income valuation

		Cost of equity						
		8.5%	9.0%	9.5%	9.8%	10.5%	11.0%	11.50%
Growth rate	2.0%	10.65	9.83	9.12	8.76	7.95	7.46	7.02
	2.5%	11.06	10.15	9.37	8.98	8.11	7.58	7.12
	3.0%	11.54	10.53	9.66	**9.25**	8.29	7.73	7.23
	3.3%	11.88	10.78	9.86	9.41	8.41	7.82	7.30
	4.0%	12.83	11.50	10.41	9.88	8.73	8.07	7.50
	4.5%	13.71	12.14	10.89	10.29	9.01	8.28	7.66
	5.0%	14.84	12.95	11.48	10.79	9.34	8.53	7.85

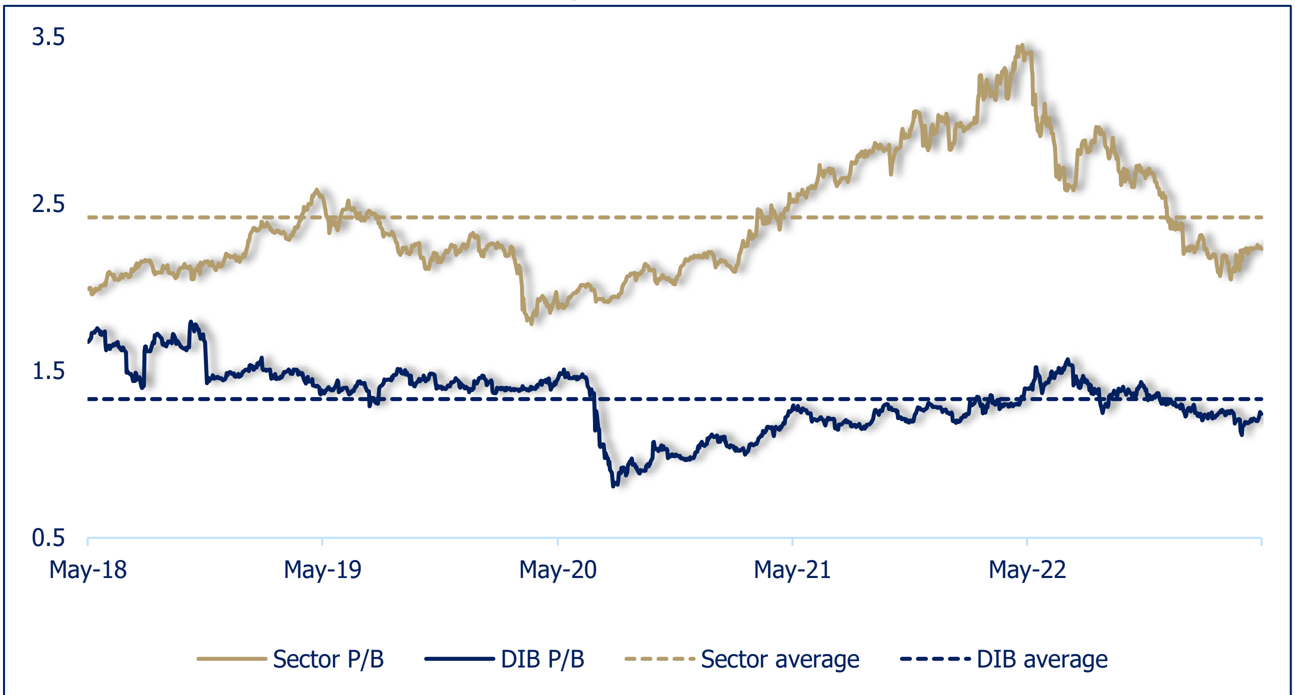
Source: Al Ramz Investment Research

Sector relative valuation: AED 5.68 per share

For valuation purposes, we find that the GCC Islamic Banking sector is the most comparable sector to DIB from the perspectives of size, business activity, franchise positioning, source of revenues, and geographic location.

To achieve a credible valuation comparison, we look at the long-term, historical P/B valuation of both Dubai Islamic and the sector. We find that the sector traded at an average P/B multiple of 2.4x since May 2018, while DIB traded at a ratio of 1.3x over the same period. This suggests a structural discount of about 45% compared to the sector. The following chart illustrates this conclusion.

Chart 40: Valuation of GCC Islamic banking sector and DIB



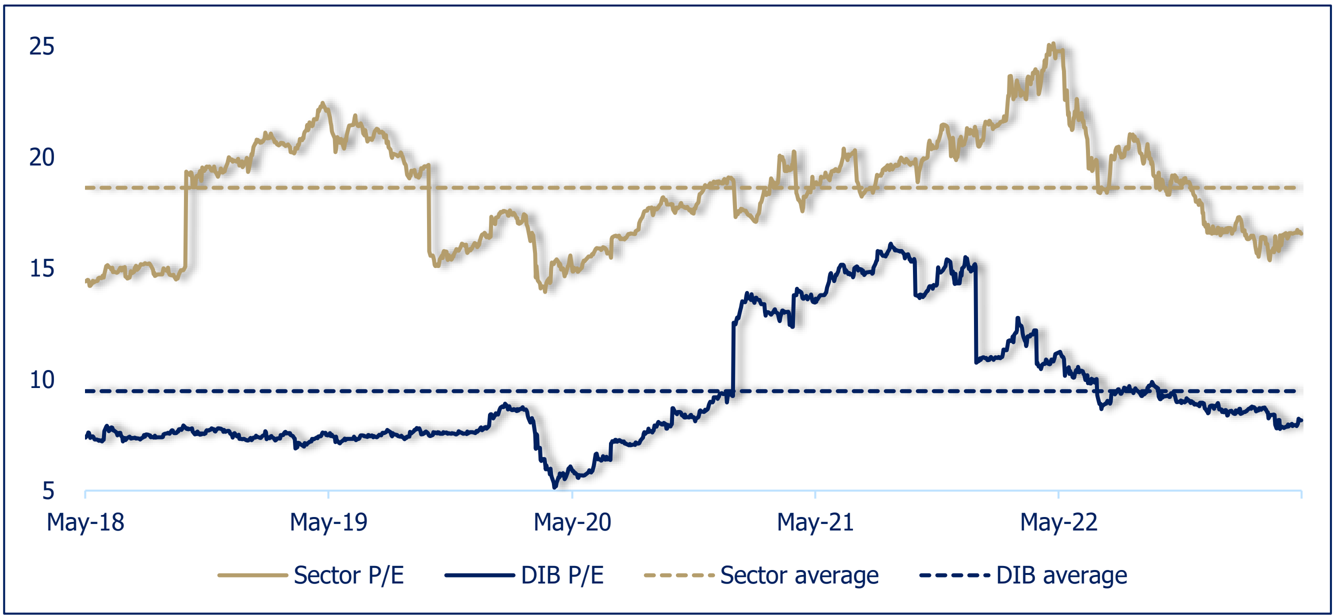
Source: Al Ramz Investment Research, Bloomberg

Applying the historical discount of 45% to the current trailing valuation of the GCC Islamic bank yields a target tangible P/B ratio of 1.23 for DIB and a fair value of AED 5.54 on that basis.

Similarly, we find that sector traded at an average P/E multiple of 18.1x since May 2018, while DIB traded at a ratio of 9.0x over the same period. This suggests a structural discount of about 51% to the sector. The following chart illustrates this conclusion.

Applying this discount of 51% to the current trailing valuation of the GCC Islamic bank yields a target P/E ratio of 7.95x for DIB and a fair value of AED 5.82 on that basis. As a result, taking both methods into account, the blended price of the two methods results in a fair value of AE 5.68.

Chart 41: P/E valuation of GCC Islamic banking sector and DIB



Source: Al Ramz Investment Research, Bloomberg

Applying this discount of 51% to the current trailing valuation of the GCC Islamic bank yields a target P/E ratio of 7.95x for DIB and a fair value of AED 5.82 on that basis. As a result, taking both methods into account, the blended price of the two methods results in a fair value of AE 5.68.

On a final comment regarding relative valuation, we observe that the UAE Islamic lender has very similar ROE and ROA metrics to the weighted average of the peers (see table 14). In this context, the c. 50% historical valuation discount we observed earlier is difficult to justify.

On the other hand, it would be difficult to assume that DIB should trade in line with peer average if it has never done so. Guessing a value somewhere in between to anchor the valuation is not a convincing methodology. To err on the side of caution, we decided to use the average peer valuation as a benchmark, but to assign to it a reduced weight of 10% in the blended valuation, as per table 7 above.

Table 14: Comparative valuation and return ratios of GCC Islamic banks

Banks	Market cap, USD m	P/B	P/E	D/Y	ROTE	ROA
Al Rajhi Bank	80,205	3.6	17.9	1.7%	20.5%	2.2%
Kuwait Finance House	34,573	2.2	21.7	1.7%	12.7%	1.9%
Alinma Bank	16,612	2.3	17.2	3.2%	13.7%	1.9%
Qatar Islamic Bank	12,169	2.0	11.5	3.3%	18.0%	2.1%
Emirates Islamic Bank	11,076	4.1	27.1	NA	16.1%	2.0%
Abu Dhabi Islamic Bank	10,761	2.4	10.8	4.5%	23.1%	2.4%
Masraf Al Rayan	7,264	1.1	22.5	3.5%	4.9%	0.7%
Qatar International Islamic Bank	4,284	2.3	15.8	3.9%	15.3%	1.7%
Sharjah Islamic Bank	1,745	1.1	9.0	4.8%	12.3%	1.2%
Ajman Bank PJSC	1,030	1.5	21.3	NA	6.9%	1.0%
Average		**2.2**	**12.0**	**2.5%**	**16.5%**	**1.9%**
Dubai Islamic Bank	**10,845**	**1.2**	**7.7**	**5.5%**	**16.8%**	**1.8%**

Source: Al Ramz Investment Research, Bloomberg, Note 1– all financials are as at 1Q23, prices as at 10th May 2023

Historical Valuation: AED 6.98 per share

Our last valuation method looks at the value of DIB today compared to where the stock traded historically. Our assumption is that a stock should revert to its average trading valuation after it has diverged from it. This is in the absence of structural shifts in the underlying business.

Apart from the Noor bank acquisition, there have been little structural shifts in the business of DIB over the years. The historical, 10-year, P/B multiple of the bank stands at 1.63x. This compares to its current P/B value of 1.24. We therefore conclude that DIB trades at a discount of 23.6% to its historical book value multiple. Based on its average historical multiple, the lender should be worth AED 7.20 per share today.

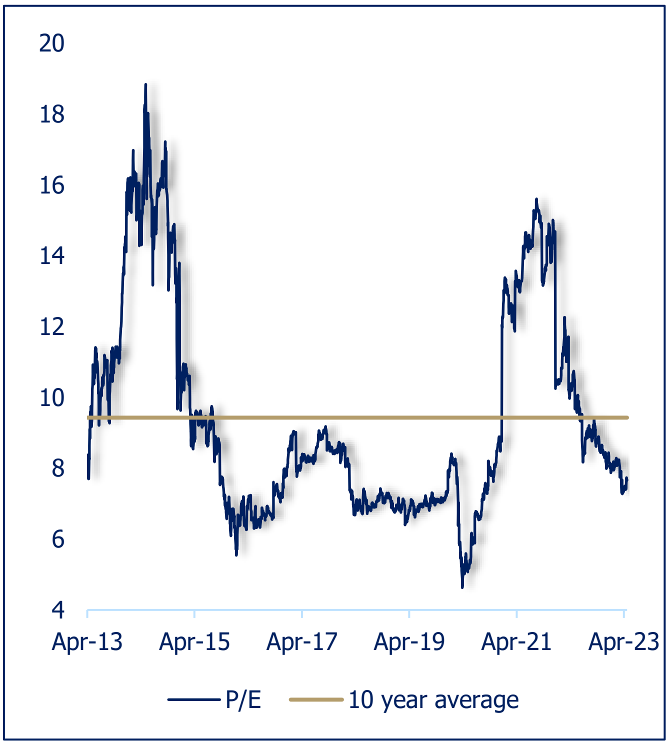
When we look at earnings multiples, we find that the company trades at a significant discount of 18.9% to its average historical P/E ratio of 9.43. On this metric, DIB deserves to trade today at a fairer value of AED 6.76 per share.

On the blended and equally weighted basis of P/B and P/E, we find that DIB deserves to trade today at AED 6.98 per share based on a reversion to its mean historical valuation.

Chart 42: Price to book ratio

Source: Al Ramz Investment Research, Bloomberg

Chart 43: Price to earnings ratio

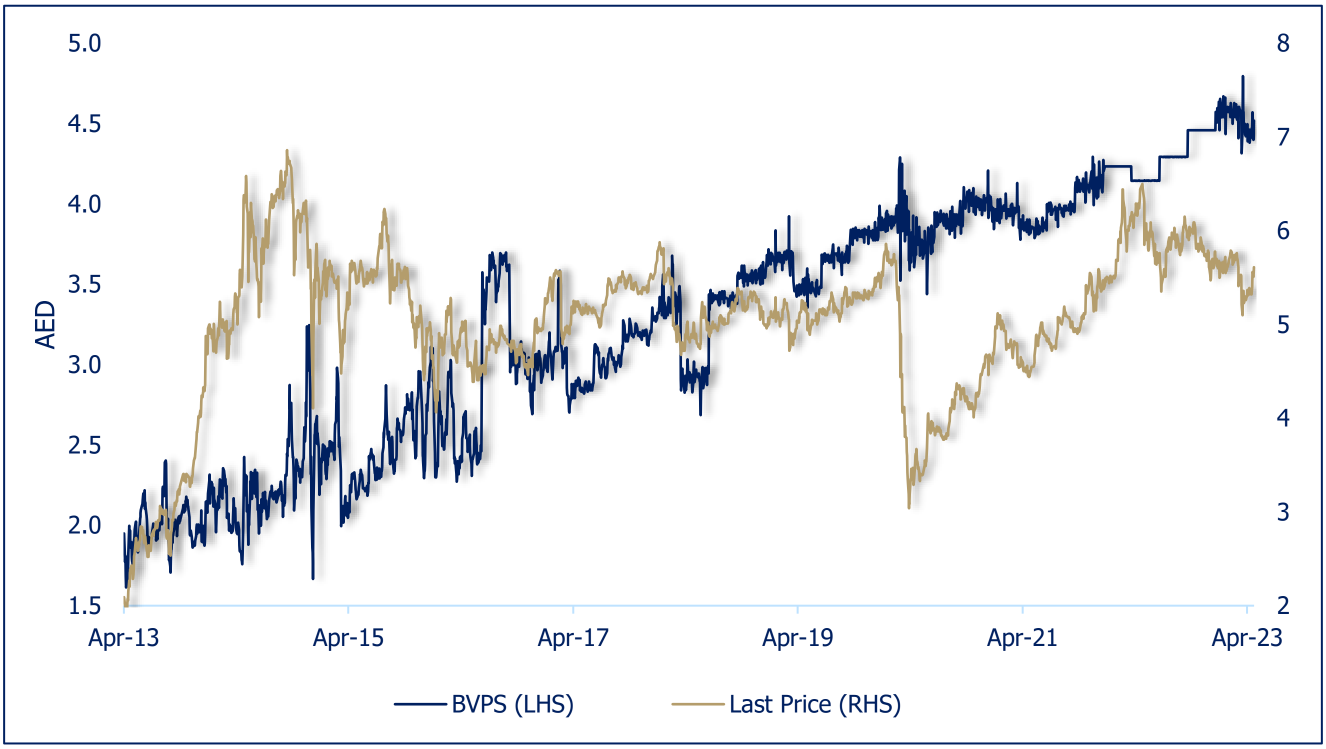


Source: Al Ramz Investment Research, Bloomberg

We also observe that DIB valuation multiples have contracted steadily since their peak in 2015. Looking closer, we find that the underlying trend is one where the fundamental metrics (book value, earnings) have expanded all along, while the stock price has remained stable.

Total equity has almost doubled since April 2015 (+82%), while the share price is up some +2.6% in the same time span. Historical price performance has therefore not reflected the fundamental growth of the bank. We believe a re-rating is overdue.

Chart 44: Stock price relative to book value



Source: Al Ramz Investment Research, Boomberg

A favorable risk-reward

Finally, we look at peak-to-trough valuations to assess the reward-to-risk multiple (R/R) of an investment in DIB. Our assumption is that long-term valuations of an asset tend to reflect solid boundaries where the stock can potentially trade again, but which are difficult to breach.

In other words, if an asset has traded within specific min/max valuation boundaries for a decade, only very significant structural shifts should allow it to trade outside of such boundaries.

For instance, over the past ten years, DIB traded at a P/B multiple of 0.8x at the lowest and 3.1x at the highest. It is likely that the stock will recover those values sometime, but unlikely that it will break them without a structural shift in the fundamentals.

If we accept that an asset should mostly be bound by its long-term extreme valuations, we can deduct the distance of travel from the current valuation to these extremes. A greater distance to peak means greater reward than risk. The higher the reward compared to the risk, the more attractive the asset.

Table 15: Reward to risk (R/R)

	P/B	P/E
Minimum	0.8x	4.6x
Maximum	3.1x	18.4x
Distance to minimum	-55%	-67%
Distance to maximum	+150%	+140%
Maximum to minimum	2.7x	2.1x
Average reward-risk ratio	**2.4x**	

Source: Al Ramz Investment Research, Bloomberg

In the case of DIB and as per the table above, we find that the average R/R multiple of 2.4 times is skewed towards the reward. In other words, there are 2.4 times more reward than risk in investing in DIB, which makes such an investment very compelling.

We conclude that DIB is a must-own asset for any UAE investment portfolio.

Key risks to our investment theme

We believe the operating environment for the banking sector in the UAE remains promising. This is in view of a combination of healthy macro drivers, including solid macroeconomic growth in the UAE, elevated oil prices, and strong balance sheets in the banking sector overall.

However, we note that this encouraging environment could swing in the opposite direction, impacted by global interest rates and the inflation situation. We identify four risks to DIB growth scenario.

Table 18: Key risks to our investment thesis

Key Risk	Description
Macro outlook reversal	○ Indications of a recession have started to show up in global markets: an inverted yield curve, rising interest rates owing to high inflation, and continuing supply chain disruptions. ○ If a recession were to materialize, the key focus in the context of our thesis would be to assess the contamination potential to the UAE which could be detrimental to the growth picture of the UAE banking sector.
NIM squeeze from Fed pivot	○ The UAE's banking industry has benefited from the current rising interest rate environment. ○ The benign interest rate scenario could change if the increase in rates were to trigger a recession.
Shock to oil prices	○ The UAE economy is heavily dependent on oil prices and a reversal in the price would materially impact the growth of the UAE and future earnings of the country's banking sector, including DIB.

Source: Al Ramz Investment Research

Summary financials

Summary income statement. AED m	2020	2021	2022	2023E	2024E	2025E
Interest income	10,370	9,013	11,739	15,429	17,815	18,935
Interest expense	(3,672)	(2,373)	(3,634)	(6,636)	(8,335)	(9,104)
Net interest income	6,699	6,639	8,105	8,793	9,480	9,831
Non-interest income	2,772	2,782	2,363	2,511	2,856	2,976
Total income	9,471	9,422	10,467	11,304	12,336	12,807
Operating expense	(2,728)	(2,529)	(2,733)	(2,987)	(3,336)	(3,581)
Provision expense	(4,552)	(2,448)	(2,103)	(2,074)	(2,036)	(2,094)
Profit before tax	3,206	4,444	5,631	6,244	6,964	7,132
Taxes and others	(46)	(38)	(79)	(131)	(627)	(642)
Net profit attributable to equity holders	3,294	4,391	5,474	6,027	6,242	6,392

Source: Al Ramz Investment Research, Company data Note: Net profit attributable to equity holders is before tier 1 payments

Summary balance sheet, AED m	2020	2021	2022	2023E	2024E	2025E
Cash and balances with central banks	29,206	28,080	26,489	26,230	29,378	30,846
Customer loans	196,689	186,691	186,043	188,885	194,839	203,132
Investment in Sukuk	35,355	41,794	52,228	56,801	57,369	58,516
Total assets	289,556	279,082	288,239	294,915	306,564	320,094
Customer deposits	205,925	205,845	198,637	201,769	209,840	220,332
Total shareholder equity	40,543	38,866	41,304	41,134	43,872	47,084

Source: Al Ramz Investment Research, Company data

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A stock is rated "over-weight" when Al Ramz Investment Research believes that its fair value lies 15% above the current market price and the stock is likely to reach such fair value within the next 12 months.

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A stock is rated "equal-weight" when Al Ramz Investment Research believes that its fair value lies between -15% and +15% of the current market price and the stock is likely to remain within this range during the next 12 months.

UNDER-WEIGHT

A stock is rated "under-weight" when Al Ramz Investment Research believes that its fair value lies 15% below its current market price and the stock is likely to reach such fair value within the next 12 months.

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