Bank Dhofar (BKDB)

Target Price (TP): OMR 0.116

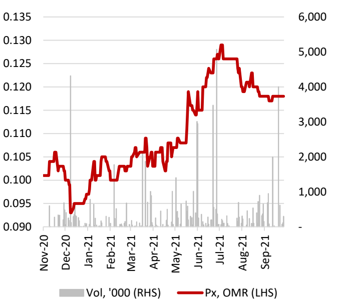
Upside / (Downside): (2%)

Recommendation	**HOLD**
Bloomberg Ticker	BKDB OM
Current Market Price (OMR)	0.118
52wk High / Low (OMR)	0.130/0.090
12m Average Vol. (000)	283.1
Mkt. Cap. (USD/OMR Mn)	919/354
Shares Outstanding (mn)	2,996.4
Free Float (%)	66%
3m Avg Daily Turnover (OMR'000)	45.4
6m Avg Daily Turnover (OMR'000)	44.3
P/E '21e (x)	12.6
P/B '21e (x)	0.65
Dividend Yield '21e(%)	4.2%

Price Performance:	
1 month (%)	-
3 month (%)	(6.35)
12 month (%)	12.38

Source: Bloomberg

Price-Volume Performance



Source: Bloomberg

28th September 2021

Ayisha Zia
a.zia@u-capital.net
Tel: +968 24 949 036

- **Oman's improving macroeconomic, with its GDP expected to grow at 2.5% in 2021 with a 3% average growth over the medium term (Source: IMF), warrants a positive banking sector credit growth outlook.**
- **Second-largest bank of Oman with an asset base of OMR 4.4bn (-2%QoQ; +4%YTD); a moderate retail franchise, with a market share of 14% of the total banking sector assets at end-Jun'21.**
- **BKDB's asset quality has weakened due to the overall macroeconomic situation in lieu of covid-19 pandemic.**
- **Adequate capital adequacy metrics; CAR: 17.4%, Tier 1 Ratio: 16.2% and CET1 Ratio at 12.4%, all above the regulatory minima**

We increase our **12-month Target Price (TP)** for Bank Dhofar (BKDB) to OMR 0.116 per share, on a lower cost of equity as compared to the one used before when we set the TP at OMR 0.100 per share. Bank Dhofar has so far posted a better-than-expected operating performance in during 1H21. However, we note that the bank has seen a rise in cost of risk during 1H21, while most of its local peers have seen contraction in the metric. We believe that this could point to an anticipation of a further asset quality deterioration in the 2H21, warranting a base-case estimate of cost of risk peaking at 80bps during FY21e, before tapering off over the forecast horizon as macroeconomic situation eases.

Our TP implies a P/E'21 of 12.3x and a P/B'21e of 0.64x, which is below the sector average as the bank has weak asset quality metrics and relatively mediocre capital adequacy. Years of capital raising activities have helped in building adequate capital buffers, but steadily increasing risk-weighted assets have continued to weigh down capital adequacy metrics as well as profitability of the bank.

A look at 1H21/2Q21 financial performance

BKDB's net interest income from conventional banking for 1H21 is down by about 9%YoY, on a much faster increase in interest cost at 5%YoY vs. interest income fall of 2%YoY. The bank's Islamic finance window posted a good performance for 1H21, with net Islamic finance income growing about 25%YoY. The bank's total net Interest & Islamic Finance income, however, dropped 5%YoY, on tepid performance from conventional banking.

BKDB's other operating income grew 51%YoY, supporting the total operating income that stood at OMR 130.5mn for 1H21, rising 3%YoY.

Other operating income was supported by a notable 51%YoY expansion in net fee and commission income. Further support was provided by miscellaneous income that also rose 50%YoY. Details on this income are not disclosed. Operating expenses dropped by about 8%YoY and supported operating profit growth of 21%YoY. Cost-to-income ratio stood at 53.4% for 1H21 vs. 50% seen in FY20.

The net Expected Credit Loss (ECL) provision charge rose by about 70%YoY, weighing on net profit, which grew by 8%YoY to OMR 17mn. The annualized cost of risk for 1H21 stood at 49bps (FY20: 75bps) as compared to 30bps recorded in 1H20, despite a 7% expansion in Interest Earning Assets (IEAs). It must be noted that the CBO has delayed re-classification of deferred loans until the 30th of September 2021. The impairment charge during 1H21 includes management overlays, which point to an anticipation of asset quality pain ahead.

The bank's net loans & Islamic financing assets rose 4.1%YoY and 1%QoQ during 2Q21. Its customer deposits have shown a commendable growth of 9.1%YoY but have dropped 1.7%QoQ. Net loan-to-deposit ratio has expanded to 109% from 106% recorded in 1Q21 but is down from 114% recorded a year ago.

Outlook & Valuation

We have factored into our model a reasonable loan growth for the bank at a CAGR of about 6% over the forecast period, supported by Islamic financing and given the positive outlook on GDP growth that the IMF is forecasting. Further, we expect the bank's top-line to grow at about 7%, weighed down by high interest cost at the start and then supported by rising interest rates from 2022e onwards. Operating expenses are expected to largely stay under control. We believe that the bank's cost of risk will be high for 2021e before easing over the rest of the forecast period.

Key Indicators

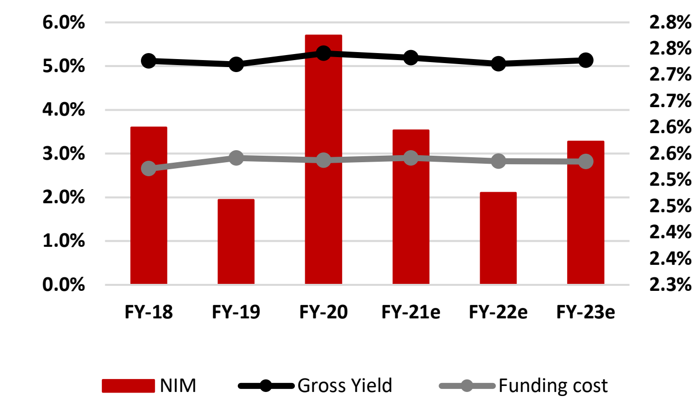
Year	FY-18	FY-19	FY-20	FY-21e	FY-22e	FY-23e
Total Net Loans (OMR mn)	3,249	3,063	3,265	3,430	3,681	3,918
Total Customer Deposits (OMR mn)	3,068	2,943	2,861	3,147	3,329	3,569
Operating Income (OMR mn)	134	130	130	130	133	146
Net Profit (OMR mn)	50	30	31	28	30	36
Diluted EPS (OMR)	0.018	0.010	0.010	0.009	0.010	0.012
Diluted BVPS (OMR)	0.194	0.177	0.180	0.183	0.184	0.188
P/E (x)	9.2	12.2	9.5	12.6	11.9	9.9
P/BV (x)	0.86	0.69	0.54	0.65	0.64	0.63
Dividend Yield (%)	6.0%	2.4%	4.1%	4.2%	4.2%	5.1%

Source: Company Financials, U Capital Research

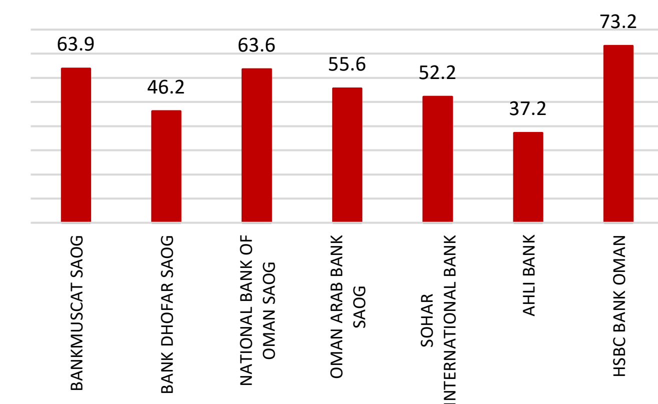
Net Interest income under pressure due to a weak NIM, despite a 1%YTD expansion in RWAs

BKDB's net interest income is under pressure due to weak NIMs (one of the lowest amongst the peer-group). This is despite the bank having increased its risk-weighted assets (RWAs) on a year-to-date (YTD) basis. We expect NIMs to remain under pressure until 2022e, beyond which rising interest rates are expected to somewhat support NIMs. However, it must be noted that interest rate on personal loans, which account for about 36% of the bank's loan book, continues to be capped at 6% as mandated by regulator, the Central Bank of Oman (CBO). Further, the bank heavily relies on costlier term deposits, with its CASA ratio being the second lowest at 46% within the local peer group. This is not ideal for the bank in a low interest rate environment as it negatively affects net interest margins.

BKDB: Yield & Cost of Funding



Oman Banks: CASA Ratio 1H21

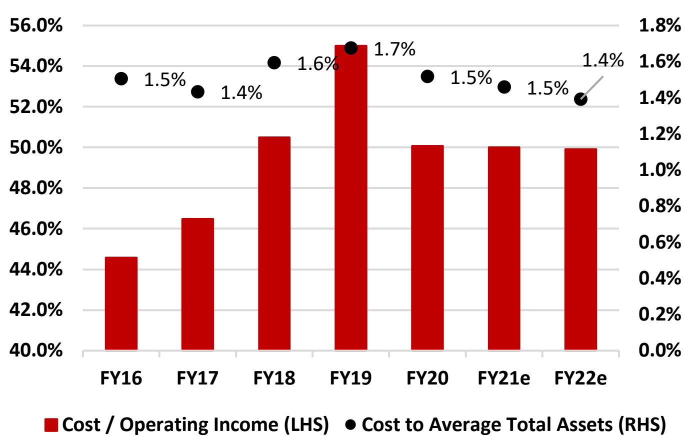


Source: Company Financials, U Capital Research

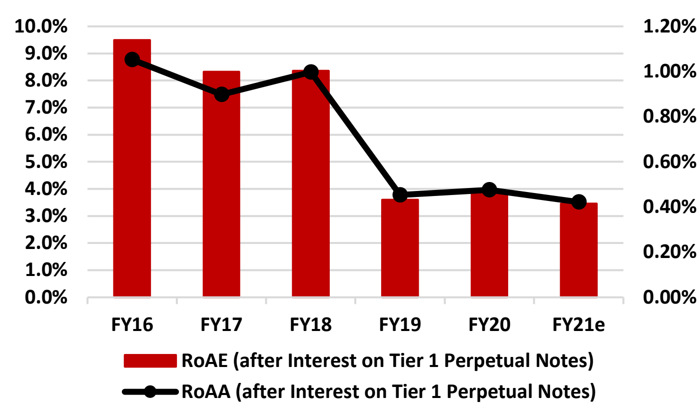
Cost efficiency likely to remain low, with improvement near the end of the forecast period

BKDB has been revamping its IT systems in line with bank strategy, leading to escalation of it cost-to-income ratio reaching record high of 55% in 2019 vs. 50% in 2018. We expect this ratio to remain at about 50% throughout most of the forecast period, as operating income normalizes but operating expenses remain under control.

BKDB: Efficiency metrics



BKDB: Profitability Metrics



Source: Company Financials, U Capital Research

Profitability under pressure due to stringent capital requirements

Bank Dhofar's profitability metrics have weakened with the stringent needs for capital adequacy as mandated by the regulator. This has resulted in the bank's return on average equity and return on average assets to remain on a somewhat downward trajectory over the last few years. Bank Dhofar's current capital adequacy ratio at 17.4% is reasonable as compared to peers and is well above the regulatory minimum mandated by the Central Bank of Oman.

This problem is further compounded by deployment of capital into low-yielding assets, which could potentially be due to intense competition within the banking sector of Oman.

Asset quality pressures to ease from 2022e onwards

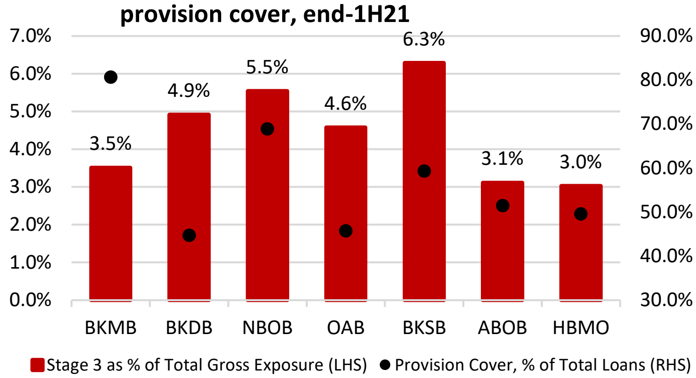
BKDB's gross non-performing loans (NPL) ratio improved in FY20, despite the covid-19 pandemic-related macroeconomic problems, with the ratio improving from 4.7% in FY19 to 4.53% in FY20. However, as at 1H21-end, the bank's NPL ratio has shot up to 4.92%. This is despite the extension of deadline to start re-classification of deferred loans to September 30th, 2021. The bank's Stage 3 loans ratio rose to 4.9% at end-1H21 from 4.5% at end-1Q21. Further, its Stage 3 provision cover is sub-50% and lowest within the local peer-group. We believe that the true extent of asset quality deterioration is currently obscured, given the large share of borrowers currently benefiting from the temporary Loan Deferral Programme as advised by the regulator (CBO) and regulatory forbearance on loan re-classification. Payment deferrals were introduced last year in the wake of the covid-19 pandemic and the Programme expiry deadline has been extended since then. The current deadline is just around the corner on September 30th, 2021.

BKDB had earlier reported a hefty **44%** of its gross loans to be **taking benefit of the deferral program at end-FY20**. This ratio is now **down to 23% at end-1H21**, which is still high, in our view, and exposes the bank to re-classification risk as the regulatory measures unwind. Furthermore, deferral uptake has been largely on the corporate side, with about 98% of deferrals from corporate customers.

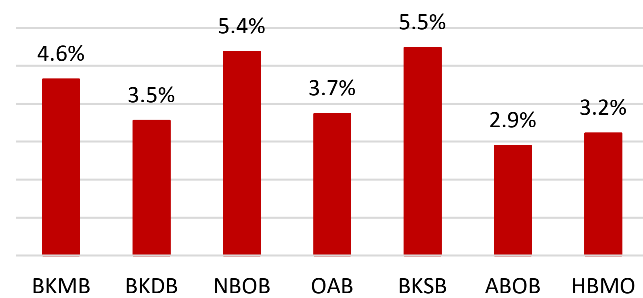
Compounding the situation is the increasing annualized cost of risk over the last 2 quarters, while its total provision as a % of total Loans & Islamic Financing at about 3.5% is at the lower end of the range amongst peers, which renders the bank vulnerable to potential credit migration in 2021e.

We conservatively expect BKDB's cost of risk to rise to 80bps in 2021e vs. about 50bps at end-1H21 and 75bps at end-FY20, before tapering off over the forecast period on the anticipated economic recovery.

Stage 3 Exposure of banks and corresponding provision cover, end-1H21



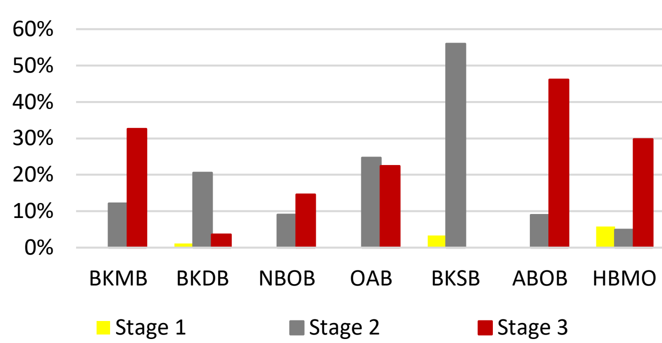
Oman Banks: Total Provision as % of Total Loans & Islamic Financing, end-1H21



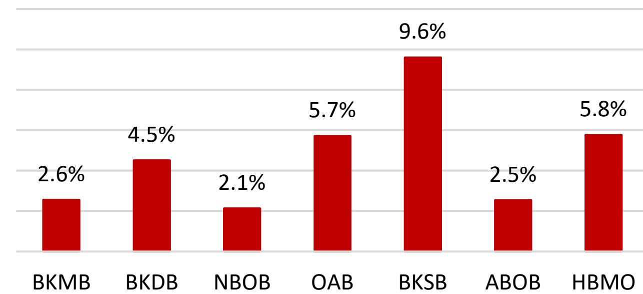
Source: Bank Financials, U Capital Research

To reiterate, we believe that the expiration of deferrals (currently expected at the end of September) poses a sizeable risk to asset quality metrics of the bank despite a reported fall in the deferred amounts.

Oman Banks: Stage-wise Restructured Loans as % of Total Loans & Islamic Financing, end-1H21



Oman Banks: Restructured Loans as % of Total Loans & Islamic Financing, end-1H21



Source: Bank Financials for 1H21, U Capital Research

Valuation Assumptions & Sensitivity Analysis

We have used a risk-free rate of 5% (April'21: 5.25% vs. May'20: 7.3%) US risk premium of 9% (previously: 7.9%), and a 2-yr weekly adjusted Beta of 1.09 (Source: Bloomberg). Our base case cost of risk assumption for the year 2021e is 80bps vs previous estimate of 66bps, while our assumption for average peer-group P/B multiple is 0.73x for 2021e. We have assigned a weightage of 80% to excess return methodology and 20% to P/B multiple-based approach.

Bank Dhofar

Beginning book value of Equity invested currently	**539,477**				
OMR'000	**FY-21**	**FY-22**	**FY-23**	**FY-24**	**FY-25**
Net Income	28,145	29,680	35,579	42,156	49,016
Less: Equity Cost	(80,925)	(81,942)	(82,741)	(84,422)	(86,640)
Excess Equity Return	**(52,780)**	**(52,262)**	**(47,161)**	**(42,266)**	**(37,624)**
Present value of Excess Equity Return	(50,891)	(43,828)	(34,399)	(26,813)	(20,759)
Sum of present value of Excess Return	**(176,691)**				
Terminal value projections					
Book value of equity at start of year 6	**594,203**				
Net income in Stable period	68,333				
Less equity cost	72,077				
Excess return	(3,743)				
Terminal Value	(52,001)				
PV of Terminal Value	**(28,692)**				
Total Equity value	**334,094**				
Total shares out	2,996,350				
Target price , OMR	**0.112**				
Peer-Group Valuation					
Peer Group P/B (x) '21e	**0.73**				
BVPS'21e	**0.183**				
Fair Value, OMR	**0.133**				
Weighted Average Fair Value (OMR)	**0.116**				
Current price , OMR	0.118				
Upside / (downside), %	**-1.7%**				

Source: U Capital Research

Our target price (TP) is sensitive to changes in cost of risk from our base case scenario for 2021e, with TP increasing/decreasing by about +3%/-3% with every +10bps/-10bps change in cost of risk.

Our TP is not sensitive to 100bps changes in cost of equity from our base case scenario for 2021e, with TP dropping/rising by only about 3-4% with every 50bps increase/decrease in cost of risk.

With each 0.5x increase/decrease in peer-group average forward P/B multiple, our TP increases/decreases by about +/-2%.

BKDB

Cost of Equity	Cost of Risk '21e, bps	60	70	80	90	100
	13.0%	0.131	0.128	0.125	0.122	0.119
	14.0%	0.126	0.123	0.120	0.118	0.115
	15.0%	0.121	0.119	**0.116**	0.113	0.110
	16.0%	0.117	0.114	0.111	0.109	0.106
	17.0%	0.113	0.110	0.107	0.105	0.102

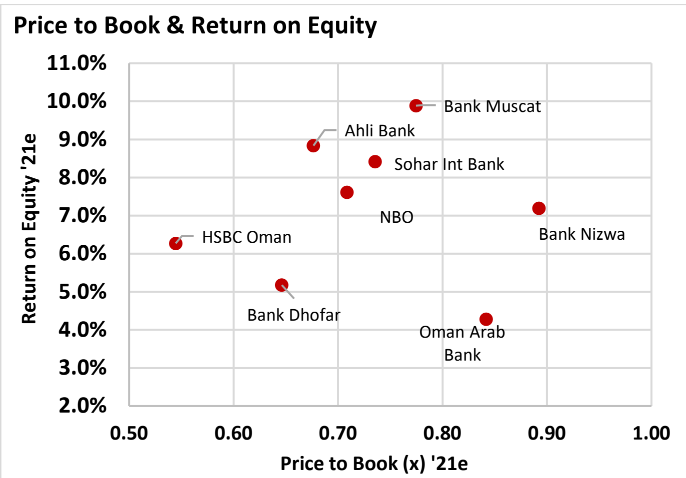
Cost of Equity	Peer-Group Average P/B'21 Multiple	**0.63**	**0.68**	**0.73**	**0.78**	**0.83**
	13.0%	0.121	0.123	0.125	0.127	0.129
	14.0%	0.117	0.118	0.120	0.122	0.124
	15.0%	0.113	0.114	**0.116**	0.118	0.120
	16.0%	0.108	0.110	0.111	0.113	0.115
	17.0%	0.104	0.106	0.107	0.109	0.111

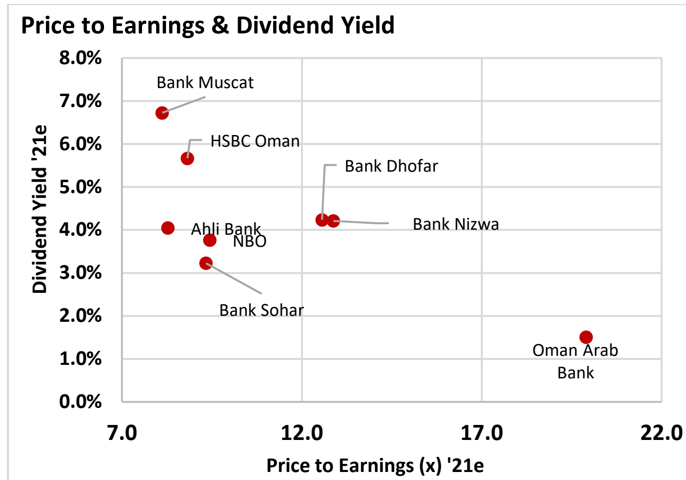
Key Risks

The key downside risks to our valuation are: (1) continuing uncertainty surrounding the duration of the coronavirus impact (2) a rise in cost of equity due to deterioration in macroeconomic indicators (3) higher-than-expected level of loan re-classification once regulatory measures unwind.

Upside risks include better realization of yields on loans & Islamic financing, better-than-expected economic recovery along with improvements in asset quality metrics.

Peer Group Valuation





Source: Bloomberg, U Capital Research

Name	Mkt Cap (OMR mn)	Last Px (OMR)	Px Change 1M, %	Px Change 3M, %	Px Change YTD, %	Current P/B	P/B'21e, (x)	P/E'21e, (x)	ROE'21e, (%)	Cash Div Yield'21e, %
Bank Muscat	1,594.2	0.446	1	6	25	0.83	0.77	8.1	9.9%	6.7%
Bank Dhofar	353.6	0.118	0	-6	22	0.66	0.65	12.6	5.2%	4.2%
Oman Arab Bank	308.8	0.185	0	-1	-3	0.86	0.84	19.9	4.3%	1.5%
NBO	302.4	0.186	-1	-6	16	0.70	0.71	9.4	7.6%	3.8%
Sohar Int Bank	227.5	0.093	1	-4	2	0.67	0.74	9.3	8.4%	3.2%
Ahli Bank	210.6	0.108	0	-4	-15	0.72	0.68	8.3	8.8%	4.0%
HSBC Oman	184.0	0.092	-1	-9	1	0.55	0.54	8.8	6.3%	5.7%
Bank Nizwa	212.5	0.095	-4	-1	-1	0.87	0.89	12.9	7.2%	4.2%
Average						**0.73**	**0.73**	**11.2**	**7.2%**	**4.2%**
Median						**0.71**	**0.72**	**9.4**	**7.4%**	**4.1%**

Source: Bloomberg, U Capital Research

Key Financials

(OMR mn)	FY18	FY19	FY20	FY21e	FY21e	FY22e
Income Statement						
Interest/Financing Income	196	194	205	205	211	229
Interest Expense/Payment to Depositors	(97)	(99)	(98)	(102)	(108)	(114)
Net Interest/Financing Income	**100**	**95**	**108**	**102**	**104**	**115**
Fee & Commission Income	16	14	14	18	19	20
Other Income	19	21	9	10	10	11
Total Non-Interest/Financing Income	**34**	**35**	**22**	**28**	**29**	**31**
Total Operating Income	**134**	**130**	**130**	**130**	**133**	**146**
Operating Expenses	(68)	(71)	(65)	(65)	(66)	(73)
Operating Profit	**66**	**58**	**65**	**65**	**67**	**73**
Provisions expense	(7)	(22)	(29)	(32)	(31)	(31)
Profit Before Taxation	**60**	**36**	**36**	**33**	**35**	**42**
Taxation & others	(9)	(6)	(5)	(5)	(5)	(6)
Net Profit	**50**	**30**	**31**	**28**	**30**	**36**
Interest on Tier 1 Perpetual Securities	(8)	(11)	(10)	(9)	(9)	(9)
Net Profit Attributable to shareholders	**42**	**19**	**20**	**19**	**20**	**26**
Balance Sheet						
Cash Balances	327	300	209	407	332	353
Deposits with Banks & FIs	300	471	122	127	136	144
Net Loans & Islamic financing	**3,249**	**3,063**	**3,265**	**3,430**	**3,681**	**3,918**
Investments	330	379	458	479	513	544
Net Fixed Assets	10	19	21	14	13	13
Other Assets	71	93	182	190	204	216
Total Assets	**4,286**	**4,326**	**4,257**	**4,647**	**4,878**	**5,188**
Deposits from Banks & FIs	388	490	452	529	559	599
Total Customer Deposits	**3,068**	**2,943**	**2,861**	**3,147**	**3,329**	**3,569**
Other Borrowings	89	64	35	35	35	35
Other Liabilities	115	142	213	234	248	266
Total liabilities	**3,660**	**3,640**	**3,561**	**3,945**	**4,170**	**4,469**
Paid-up Capital	226	300	300	300	300	300
Retained Earnings	55	10	34	39	42	51
Other Reserves	189	221	207	208	210	213
Shareholders' Equity	**471**	**531**	**540**	**547**	**552**	**564**
Tier 1 Perpetual Notes	156	156	156	156	156	156
Total Equity & Liabilities	**4,286**	**4,326**	**4,257**	**4,647**	**4,878**	**5,188**
Cash Flow Statement						
Cash from operations	(50)	109	30	223	(27)	67
Cash from investing activities	(20)	78	82	14	33	31
Cash from financing	5	(31)	(40)	(12)	(15)	(15)
Net changes in cash	(25)	(1)	(92)	198	(75)	21
Cash at the end of period	327	300	209	407	332	353
Key Ratios						
Return on Average Assets	1.2%	0.7%	0.7%	0.6%	0.6%	0.7%
Return on Average Equity	9.9%	5.6%	5.7%	5.2%	5.4%	6.4%
Net Interest & Islamic Finance Income / Operating Income	74.3%	73.0%	82.8%	78.7%	78.0%	78.6%
Other operating income / Operating Income	25.7%	27.0%	17.2%	21.3%	22.0%	21.4%
Net fee Income/Operating Income	11.6%	10.9%	10.5%	13.7%	14.2%	13.8%
Interest Earning/Financing Assets Yield	5.12%	5.04%	5.29%	5.19%	5.06%	5.13%
Cost of Funds	2.65%	2.90%	2.85%	2.90%	2.83%	2.82%
Net Spread	2.46%	2.14%	2.44%	2.29%	2.23%	2.32%
Cost to Income Ratio	50.5%	55.0%	50.1%	50.0%	49.9%	49.9%
Net Loans & Islamic Financing to Customer Deposits (Total LTD)	108.0%	104.1%	114.1%	109.0%	110.6%	109.8%
Non Performing Loans, OMR mn	121	150	154	180	193	206
NPLs to Gross Loans & Islamic financing	3.7%	4.7%	4.5%	5.0%	5.0%	5.0%
NPL Coverage, %	111.4%	79.1%	93.4%	89.3%	89.0%	88.6%
Cost of Risk, bps	17.3	58.1	74.7	80.0	75.0	70.0
Shareholders' Equity to Total Loans & Islamic Financing, x	0.16	0.17	0.16	0.15	0.14	0.14
Shareholders' Equity to Total Assets, x	0.15	0.15	0.15	0.14	0.13	0.13
Capital Adequacy Ratio, %	17.3%	17.9%	17.7%	17.5%	17.6%	16.8%
EPS, OMR	0.018	0.010	0.010	0.009	0.010	0.012
BVPS, OMR	0.194	0.177	0.180	0.183	0.184	0.188
Market Price, OMR*	0.166	0.123	0.097	0.118	0.118	0.118
Cash Dividend Payout Ratio, %	55.7%	29.7%	39.2%	53.2%	50.5%	50.5%
Cash Dividend Yield, %	6.0%	2.4%	4.1%	4.2%	4.2%	5.1%
P/E Ratio, x	9.2	12.2	9.5	12.6	11.9	9.9
P/BV Ratio , x	0.86	0.69	0.54	0.65	0.64	0.63

*Market price for current year and subsequent years as per the closing price on 28-Sep-2021

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%

Ubhar Capital SAOC (U Capital)

Website: www.u-capital.net
PO Box 1137
PC 111, Sultanate of Oman
Tel: +968 2494 9036
Fax: +968 2494 9099
Email: research@u-capital.net