Oman Arab Bank SAOG

TP: OMR 0.225 / share

Upside/ (Downside): 12.4%

Recommendation	Accumulate
Bloomberg Ticker	OAB OM
Current Market Price (OMR)	0.200
52wk High / Low (OMR)	0.220/0.190
Mkt. Cap. (USD/OMR mn)	868/334
Shares Outstanding (mn)	1,669.4
Free Float (%)	100%
P/E'20e (x)	14.6
P/B'20e (x)	0.9
Cash Dividend Yield '20e (%)	4.0%

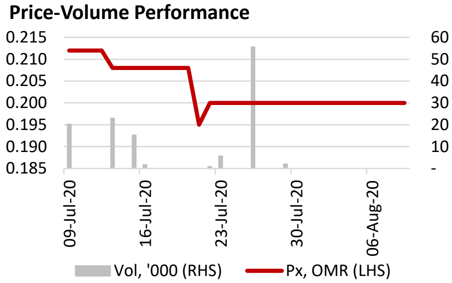
Price Performance:

1 month (%)	na
3 month (%)	na
12 month (%)	na

Source: Bloomberg

Note: Stock listed on Muscat Securities Market on the 6th of July 2020

Price-Volume Performance



Source: Bloomberg

9th August, 2020

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- **Fourth-largest lender within the Omani banking space in terms of net loans outstanding with a market share of 10.5% as at the end of 1H20**
- **Second-lowest Loan-to-Deposit Ratio at 100% within the sector, providing ample room to grow**
- **Well capitalized with CAR at 15.16%; Tier 1 capital ratio at 14.28%; above regulatory minima**
- **Recent merger with Alizz Islamic Bank and controlling stake acquisition by Arab Bank Plc in the merged entity expected to provide cost synergies**

We initiate coverage on Oman Arab Bank (OAB) with a 12-month target price (TP) of OMR 0.225 per share, offering limited upside to the current market price, and implying a P/E'20 of 16.5x and P/B'20e of 1.0x. We assign it an **Accumulate** rating. Our weighted average TP is derived using Excess Returns model (80% weight) and peer-group P/B'20e Multiple-based valuation (20% weight). For excess returns, we value the bank using a combination of the book value and a present value of excess returns over the forecast period, i.e. the amount by which 2020-24e profits are expected to exceed the required cost of equity. We use a discount rate of 10.9% and a perpetual growth rate of 3%. The key upside risks to our valuation are (1) lower-than-expected provisioning costs and (2) better efficiency metrics.

Valuation & Outlook

With its recently completed merger with Alizz Islamic Bank, Oman Arab Bank is now the fourth largest bank in Oman in terms of assets. The bank has outperformed sector loan growth previously, with 2013-19 loan growth CAGR of 10.9% vs. sector's 8.8%. It has brought down its retail exposure from 41% in 2018 to 37% in 2019. Post-merger, its loan mix is expected to improve further.

The bank's credit quality concerns remain high, given the current macroeconomic backdrop and its relatively high exposure to construction (13%), mining & quarrying (9%), manufacturing (7%), and services industries (7%). Its annualized cost of risk has shot up to about 72bps in 1H20, and we have assumed a base case of 70bps for full FY20 with sequential reduction over the rest of the forecast period. Furthermore, its non-performing loans to gross loans (at 3.8% in 1H20) is better than sector average (at 4.2% in FY19) but provision cover is relatively low at 0.88x in 1H20 (vs. sector average of 0.92x) in FY19. However, with prudent step-up of provisions given the current macroeconomic situation, we expect this ratio to improve.

The bank had improved its CASA mix to 54% in 2019 vs. 53% in 2018, which together with its strong corporate orientation (63% in FY19) supported its above average NIM as compared to other listed banks of Oman. However, with the recent merger, the bank's CASA mix has fallen to 52% and its corporate exposure has fallen to 61% in 1H20 leading to some pressure visible on NIM front. The current weak non-oil GDP growth is expected to weigh on its profitability improvements expected to materialize post-merger as cost optimization kicks in. We have assumed rapid cost optimization on majority stake acquisition of Arab Bank Plc, which itself operates at a cost-to-income ratio of 40% as of FY19 (Average ratio: 40.9% over 2015-19).

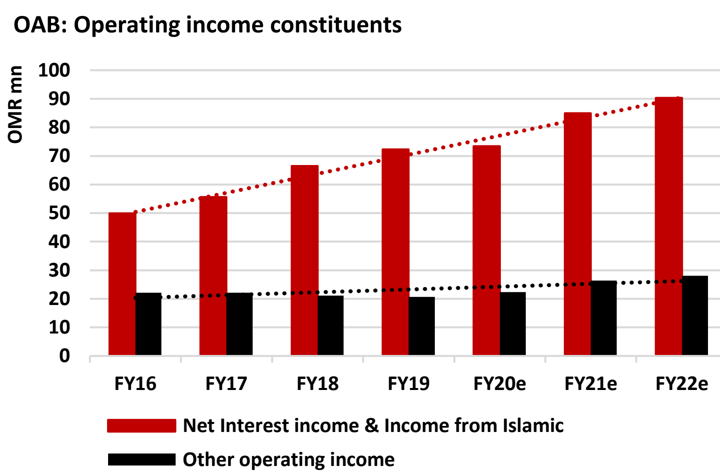
Key Indicators

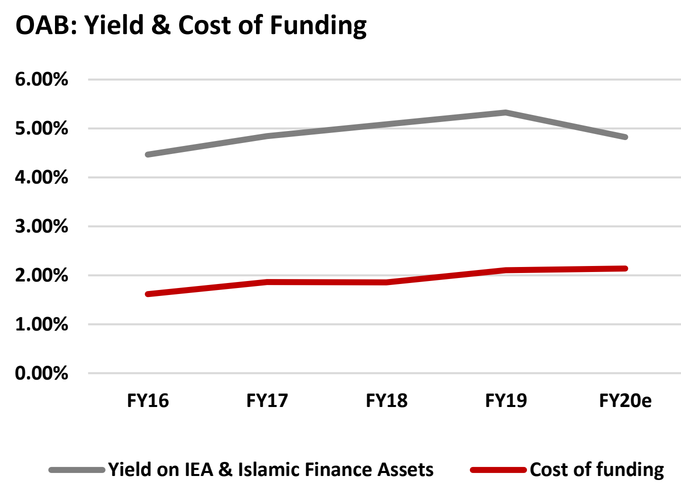
Year	FY17	FY18	FY19	FY20e	FY21e	FY22e
Total Net Loans (OMR mn)	1,654.0	1,832.8	2,006.3	2,639.0	2,778.6	2,937.2
Total Customer Deposits (OMR mn)	1,746.9	1,870.6	1,998.4	2,628.6	2,764.9	2,919.8
Operating Income (OMR mn)	77.7	87.6	93.0	95.8	111.3	118.5
Net Profit (OMR mn)	26.5	30.1	32.6	22.8	29.1	33.1
Diluted EPS (OMR)	0.020	0.022	0.024	0.014	0.017	0.020
Diluted BVPS (OMR)	0.205	0.211	0.220	0.220	0.231	0.240
P/E (x)	NA	NA	NA	14.65	11.49	10.08
P/BVPS (x)	NA	NA	NA	0.91	0.87	0.83
Dividend Yield (%)	NA	NA	NA	4.0%	5.3%	6.0%

Source: Company Financials, U Capital Research

Reliance on costlier term funding to weigh on net interest margin (NIM)

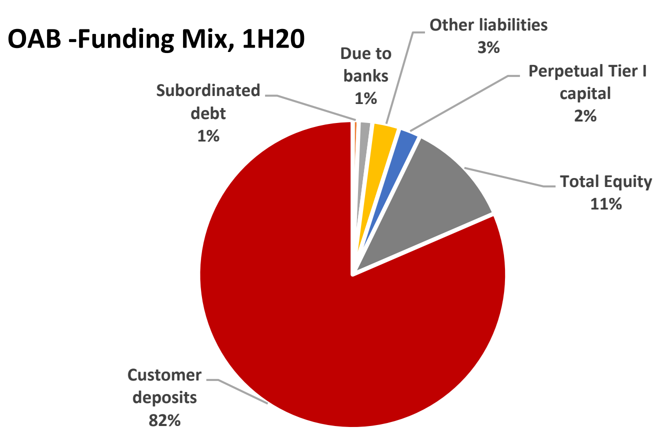
The bank's interest income has been rising on net loan growth as well as improvement in net interest margin over the last few years as interest rates rose. However, due to the current macroeconomic outlook and falling interest rates, we have seen downward pressure on the bank's NIM in 1H20 post-merger with NIM having dropped from a superior 3.38% in FY19 to 2.98% in 1H20, as per our calculations. Therefore, we have conservatively assumed NIM to stay under pressure over the forecast years, improving only towards the end of the forecast.

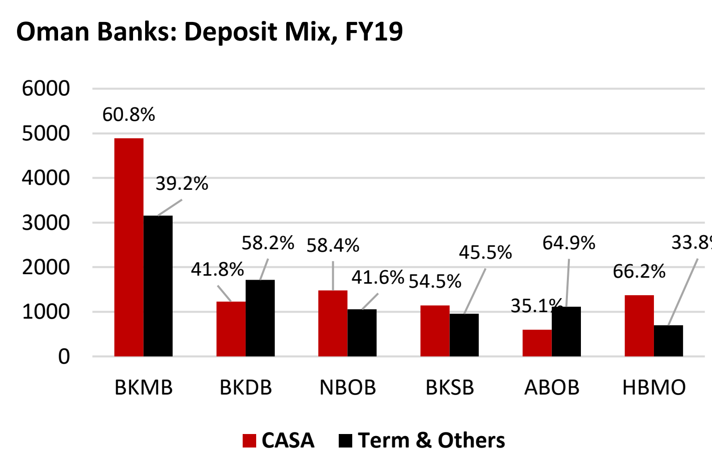




Source: Bank Financials, U Capital Research

OAB has a fair amount of liquidity though reliance on customer deposits to fund its balance sheet (c82% of total assets). However, its CASA mix at 52% as at the end of 1H20 may not be entirely favorable in times of falling interest rates. Some of its peers sport a better deposit mix profile with total sector, excluding OAB, at 55% CASA mix as at the end of FY19. Furthermore, cost of funding has risen for the bank in 1H20 by 22bps YoY vs. average interest rate improvement of 20bps YoY in 1H20. Central Bank of Oman's (CBO) mandate to offer loan payment deferrals to those borrowers who are adversely affected by the covid-19 pandemic is also going to negatively affect net interest income for FY20e.





Source: Bank Financials, U Capital Research

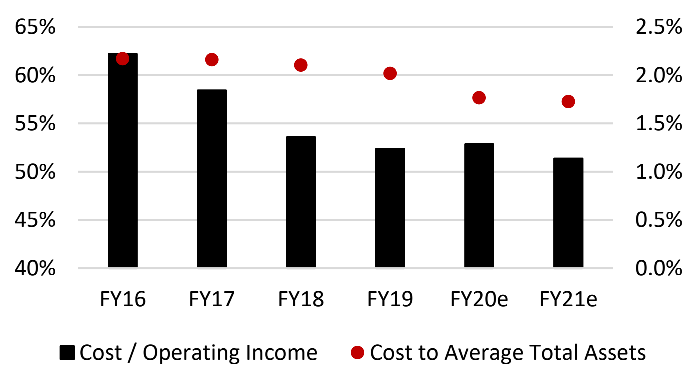
Other operating income to remain under pressure

Tepid loan growth prospects as well as measures introduced by the Central Bank of Oman (CBO) to support borrowers like freeze on new fees and possible reduction in fees charged by banks will weigh on other operating income growth. We are foreseeing a somewhat flat other operating income for OAB in FY20e. However, we expect this income constituent to pick up from 2021 onwards, albeit slowly, as loan growth picks up on recovery in GDP growth. The World Bank forecasts Oman's real GDP to decline by 3.5%YoY in 2020, followed by an expansionary year with real GDP output expected to pick up to 2.7% in 2021. The IMF also expects an average growth of 1.23% over the period 2021-2024 which we believe will translate into a credit growth of about ~6% over 2020-2024e.

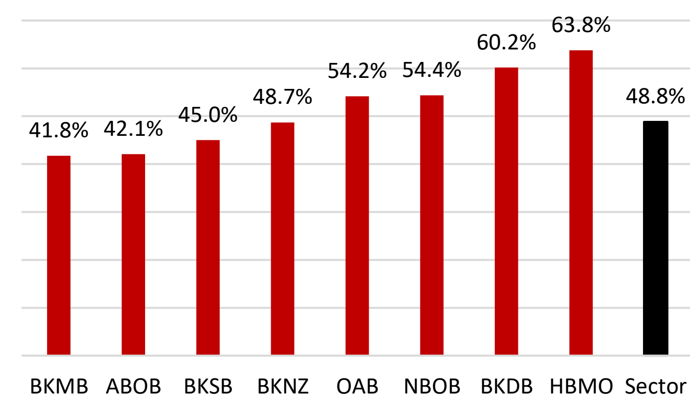
Efficiency expected to improve

The bank's operating expenses have increased by 4%YoY in 1H20. Despite operating income increase of 1%YoY, the bank's cost-to-income ratio has increased to 54.2% in 1H20 from 52.3% in FY19. This occurred due to merger with Alizz Islamic Bank (BKIZ), as BKIZ's cost-to-income ratio was very high (+80%). The bank's operational efficiency is one of the weakest amongst its peer-group and is above the sector at about 49%. However, we foresee cost optimization on merger with BKIZ and Arab Bank's majority shareholding to result in reduction in the ratio over the forecast period, based on our assumption of operating income growth.

OAB: Efficiency metrics



Oman banks: Cost-to-income Ratio Comparison 1H20



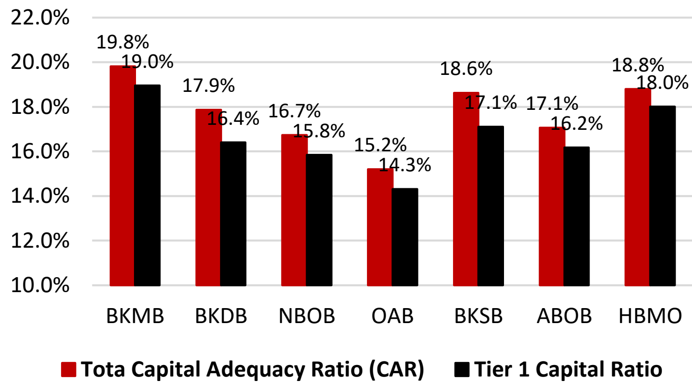
Source: Bank Financials, U Capital Research

Capital buffers strong; one of the lowest Loan-to-deposit Ratios

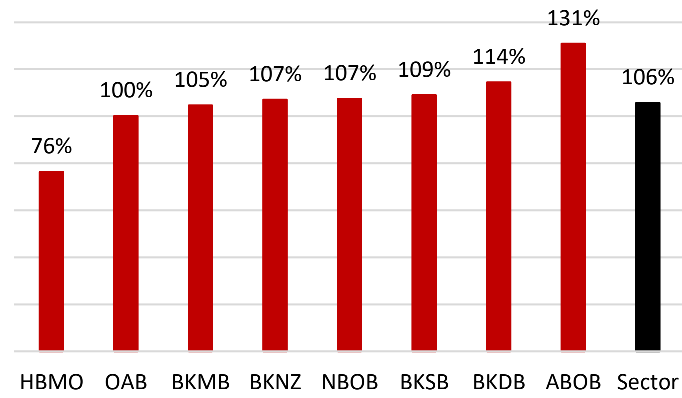
OAB boasts a robust Tier 1 capital adequacy ratio at 14.28% and a total capital adequacy ratio of 15.16% as at the end of 1H20. Acquisition of BKIZ and growth in risk-weighted assets (RWAs) has resulted in slight reduction in capital buffers from stand-alone OAB's 14.31% (Tier1 CAR) and 15.2% (CAR) in FY19. The ratios remain well above minima prescribed by the CBO.

Its core equity Tier 1 (CET1) ratio at 11.74% is also above CBO's recently reduced minimum of 8.25% (from 9.5% earlier due to a CCB cut of 125bps to 1.25% under pandemic constraints).

Oman Banks: Capital Adequacy, 2019



Oman banks: Loan-to-Deposit Ratio 1H20

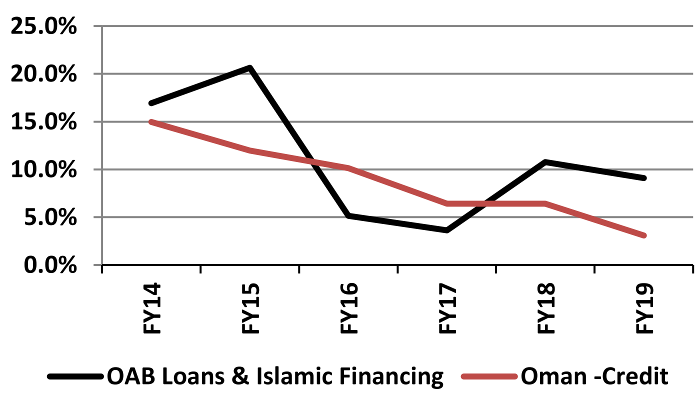


Source: Bank Financials, U Capital Research

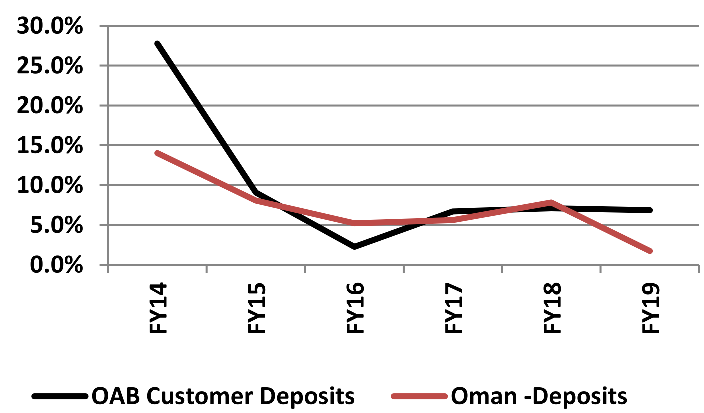
OAB has historically been a conservative lender, operating with a Loan-to-deposit (LTD) ratio of below 100% which compares well with its local peers. LTD has been on the rise, albeit slowly, and touched 100.4% in FY19. In 1H20, net LTD stood at 100.2%. This has resulted in preservation of profitability metrics while some peers' ROaA and ROaE have contracted more due to capital raising activities to balance out relatively more aggressive lending approaches.

We believe that the bank will continue its conservative approach and keep LTD ratio lower than sector-average in order to preserve its capital buffers and defend its profitability ratios against possible declines that could result from deterioration in asset quality or pressure on operating income due to competition with other banks.

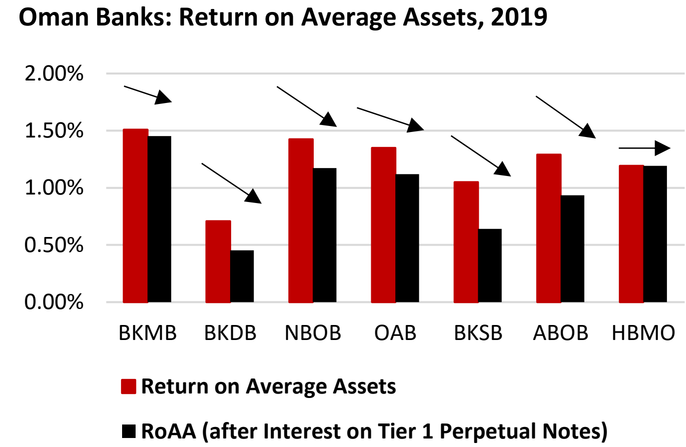
Oman Credit vs OAB (YoY Growth)

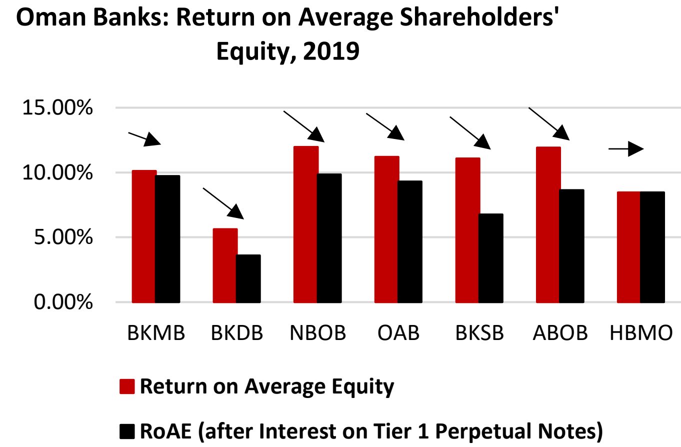


Oman Deposits vs OAB (YoY Growth)



Source: Bank Financials, U Capital Research

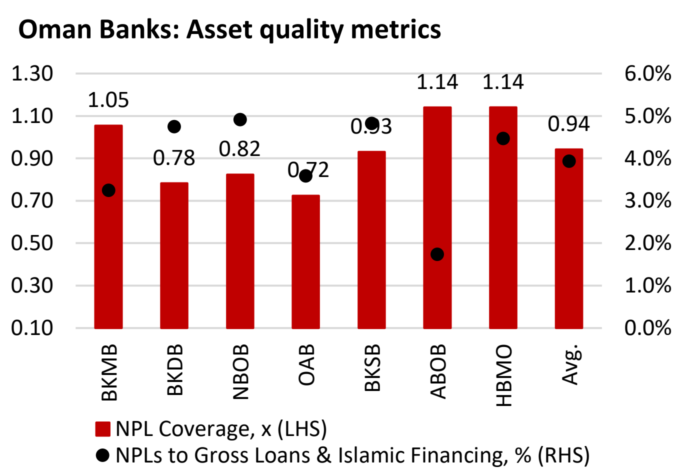


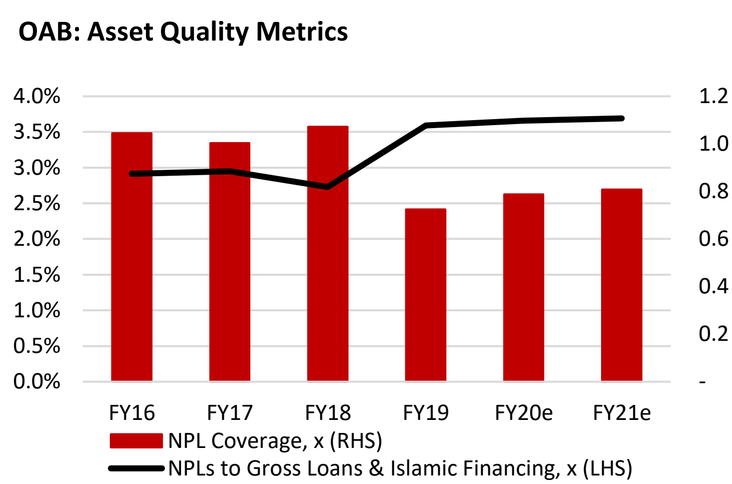


Source: Bank Financials, U Capital Research

Macroeconomic situation to weigh on asset quality metrics

OAB's asset quality improved from FY17 to FY18, but deteriorated again in FY19, while still remaining better than some peers. In FY19, the bank's provision cover was below peer-group average, but its non-performing loans (NPL) as a % of gross loans was amongst the lowest at 3.6%. In 1H20, its NPL ratio stood at 3.7% and its provision cover stood at 0.88x.





Source: Bank Financials, U Capital Research Note: for HBMO, Gross Loans only.

We believe that while the bank will continue to build provisions over the remainder of 2020, it will likely be able to contain any unexpected rise in NPL ratio. Furthermore, any provision write-backs, probability of which is low given the current macroeconomic situation, in our view, will likely result in profit improvement for the year.

The bank's cost of risk has shot up to an annualized 72.4bps in 1H20 while in FY19 it stood at 26.9bps. We have assumed a base case cost of risk of 75bps. For target price sensitivity on cost of risk assumption, please see the section on Sensitivity Analysi.

Valuation

Our weighted-average 12M target price (TP) is derived using Excess Returns model (80% weight) and peer-group P/B'20e Multiple-based valuation (20% weight). For excess returns, we value the bank using a combination of the book value and a present value of excess returns over the forecast period, i.e. the amount by which 2020-24e profits are expected to exceed the required cost of equity. We use a discount rate of 10.9% and a perpetual growth rate of 3% for the terminal value based on a retention ratio of 40%. We assign a HOLD rating to our stock on limited upside to the current market price. The key upside risks to our rating are (1) lower-than-expected provisioning costs and (2) better efficiency metrics. Deterioration in the macroeconomic situation resulting in slower loan growth and slower efficiency improvements pose downside risks to our valuation.

Beginning book value of Equity invested currently	**358,148**				
OMR'000	**FY-20**	**FY-21**	**FY-22**	**FY-23**	**FY-24**
Net Income	23,193	29,534	33,621	38,380	44,044
Less: Equity Cost	32,174	39,964	42,159	44,360	46,806
Excess Equity Return	**(8,981)**	**(10,430)**	**(8,538)**	**(5,980)**	**(2,762)**
Present value of Excess Equity Return	(8,613)	(9,023)	(6,663)	(4,209)	(1,754)
Sum of present value of Excess Return	(30,263)				
<u>Terminal value projections</u>					
Book value of equity at start of year 6	**457,549**				
Net income in Stable period	56,736				
Less equity cost	49,685				
Excess return	7,051				
Terminal Value	125,454				
PV of Terminal Value	**79,661**				
Total Equity value , OMR'000	**407,546**				
Total shares out, '000	1,669,410				
Target price, OMR	**0.244**				
Peer-Group Valuation					
Peer Group P/B (x) '20e	**0.67**				
BVPS'20e	**0.220**				
Fair Value, OMR	**0.148**				
Weighted Average Fair Value (OMR)	**0.225**				
Current price , OMR	0.200				
Upside / (downside), %	**12.4%**				

Source: Bank Financials, U Capital Research

Sensitivity Analysis

Our target price (TP) is sensitive to cost of risk assumption indicating that with every 20bps +/- change in cost if risk, TP changes by about -/+5%. Our TP is more sensitive to reduction in cost of equity, with every 100bps change in the assumed cost of equity leading to a 21% increase in TP. It is relatively less sensitive to increases in cost of equity, with every 100bps increase, the TP reduces by about 14%.

Our TP is not sensitive to changes in peer-group P/B'20e multiple as the weightage assigned to this method is low at 20%.

OAB

Cost of Equity	Cost of Risk, bps 30	50	70	90	110
8.9%	0.380	0.362	0.345	0.328	0.310
9.9%	0.299	0.286	0.273	0.259	0.246
10.9%	0.246	0.235	**0.225**	0.214	0.203
11.9%	0.209	0.199	0.191	0.182	0.174
12.9%	0.181	0.173	0.166	0.159	0.151

Cost of Equity	Peer-Group Average P/B'20 Multiple 0.57	0.62	0.67	0.72	0.77
8.9%	0.340	0.343	0.345	0.347	0.349
9.9%	0.268	0.271	0.273	0.275	0.277
10.9%	0.220	0.223	**0.225**	0.227	0.229
11.9%	0.187	0.189	0.191	0.193	0.196
12.9%	0.161	0.163	0.166	0.168	0.170

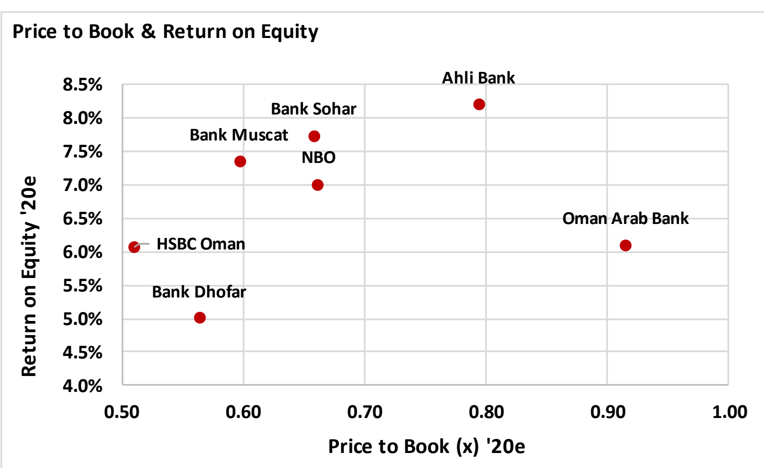
Source: Bank Financials, U Capital Research

Peer-Group Analysis

Name	Last Px (OMR)	Target Price (OMR)	Upside / (Downside) (%)	Current P/B	P/B'20e, (x)	P/E'20e, (x)	ROE'20e, (%)	Cash Div Yield, %*
Bank Muscat	0.350	**0.370**	6%	0.63	0.60	8.18	7.4%	8.6%
Bank Dhofar	0.101	**0.097**	-4%	0.58	0.56	11.29	5.0%	3.0%
NBO	0.169	**0.172**	2%	0.67	0.66	9.16	7.0%	5.9%
Oman Arab Bank	0.200	**0.225**	1%	0.93	0.91	14.40	7.0%	4.0%
Bank Sohar	0.093	**0.080**	-14%	0.69	0.66	8.59	7.8%	6.5%
Ahli Bank	0.130	**0.126**	-3%	0.85	0.79	9.75	8.2%	7.7%
HSBC Oman	0.092	**0.101**	10%	0.56	0.51	8.50	6.1%	7.0%
Average				**0.70**	**0.67**	**9.98**	**6.9%**	**6.1%**

Source: Bloomberg, U Capital Research

For our valuation report on other Oman banks, please ***click here****.*



Source: Bloomberg, U Capital Research

About Oman Arab Bank

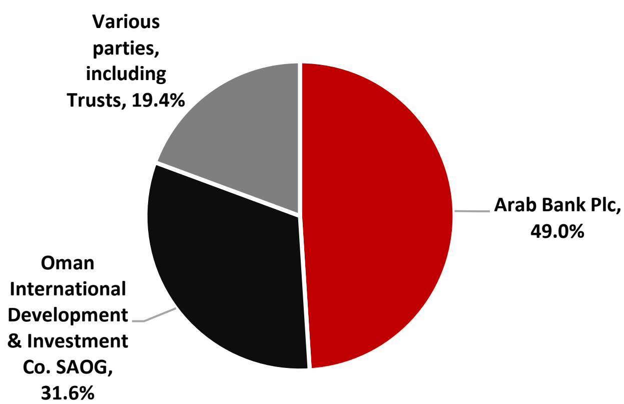
Oman Arab Bank SAOG was incorporated in the Sultanate of Oman on 1st October 1984 as a closed joint stock SAOC company. It is principally engaged in commercial and investment banking activities through a network of branches in the Sultanate of Oman. For the period from 1984 to 29 June 2020, the Bank was a subsidiary of Oman International Development and Investment Company SAOG. The bank employed 1,220 staff as at the end of 1H20.

Acquisition of Alizz Islamic Bank SAOG

On 30th June 2020, the Bank acquired 99.98% of the shares and voting interests in Alizz Islamic Bank SAOG. As a result, the Bank obtained full control over Alizz Islamic Bank SAOG, which made it a wholly owned subsidiary. Alizz Islamic Bank was previously listed on the Muscat Securities Market (MSM) and upon acquisition by Oman Arab Bank, the shares of Alizz Islamic Bank were delisted. Subsequently these shares were exchanged for the shares in Oman Arab Bank. The exchange of shares was based on the agreed ratio of 81:19. On 6th July 2020, Oman Arab Bank SAOG became a listed Bank. Consequently, the ordinary equity shares of Oman Arab Bank SAOG were listed on the Muscat Securities Market (MSM).

Shareholding Structure

OAB- Shareholding Structure



Source: Bank Financials, U Capital Research

In June 2020, Arab Bank Plc acquired 11.76% of Oman Arab Bank's stake from Oman International Development & Investment Co. OMINVEST) at 1.3x net book value of OAB as at 31st March 2020. This resulted in OMINVEST's loss of control over OAB and therefore OMINVEST will reclassify its investment in OAB from a subsidiary to an associate. Meanwhile, Arab Bank Plc maintained its shareholding in OAB at 49% despite merger of OAB with Alizz Islamic Bank.

Key Financials

(OMR mn)	FY17	FY18	FY19	FY20e	FY21e	FY22e
Income Statement						
Interest/Financing Income	88.1	100.6	113.9	124.2	143.3	151.5
Interest Expense/Payment to Depositors	(32.5)	(34.1)	(41.6)	(50.7)	(58.3)	(61.1)
Net Interest/Financing Income	**55.6**	**66.5**	**72.3**	**73.5**	**84.9**	**90.4**
Fee & Commission Income	14.4	14.7	14.1	15.3	18.0	19.2
Other Income	7.7	6.4	6.5	7.1	8.3	8.9
Total Non-Interest/Financing Income	**22.1**	**21.1**	**20.7**	**22.3**	**26.3**	**28.1**
Total Operating Income	**77.7**	**87.6**	**93.0**	**95.8**	**111.3**	**118.5**
Operating Expenses	(45.4)	(47.0)	(48.7)	(50.6)	(57.1)	(59.1)
Operating Profit	**32.3**	**40.7**	**44.3**	**45.2**	**54.1**	**59.4**
Provisions expense	(0.9)	(4.9)	(5.5)	(18.0)	(19.5)	(20.0)
Profit Before Taxation	**31.5**	**35.8**	**38.8**	**27.1**	**34.6**	**39.4**
Taxation & others	(4.9)	(5.7)	(6.2)	(4.3)	(5.5)	(6.3)
Net Profit Attributable to Parent	**26.5**	**30.1**	**32.6**	**22.8**	**29.1**	**33.1**
Interest of Tier 1 Perpetual Securities	-	(2.5)	(5.5)	(5.5)	(5.5)	(5.5)
Net Profit Attributable to shareholders	**26.5**	**27.6**	**27.0**	**17.3**	**23.5**	**27.6**
Balance Sheet						
Cash Balances	162	195	180	193	175	173
Deposits with Banks & FIs	109	91	51	71	75	79
Net Loans & Islamic financing	**1,737**	**1,955**	**2,146**	**2,797**	**2,959**	**3,142**
Investments	138	131	165	218	229	242
Net Fixed Assets	29	30	40	45	46	47
Other Assets	(37)	(74)	(84)	(86)	(104)	(124)
Total Assets	**2,139**	**2,329**	**2,497**	**3,238**	**3,380**	**3,560**
Deposits from Banks & FIs	4	15	31	46	49	51
Total Customer Deposits	**1,747**	**1,871**	**1,998**	**2,629**	**2,765**	**2,920**
Other Borrowings	20	20	20	20	-	-
Other Liabilities	63	66	78	103	108	115
Total liabilities	1,833	1,972	2,128	2,798	2,922	3,086
Paid-up Capital	135	135	135	167	167	167
Retained Earnings	68	69	64	58	91	103
Other Reserves	73	81	97	143	128	132
Shareholders' Equity	276	284	296	368	386	401
Minority Interest &/orTier 1 Perpetual Notes	30	73	73	73	73	73
Total Equity & Liabilities	**2,139**	**2,329**	**2,497**	**3,238**	**3,380**	**3,560**
Cash Flow Statement						
Cash from operations	(36)	12	15	(30)	14	17
Cash from investing activities	1	1	9	5	1	1
Cash from financing	(54)	21	(21)	49	(31)	(18)
Net changes in cash	(91)	33	(15)	13	(17)	(2)
Cash at the end of period	162	195	180	193	175	173
Key Ratios						
Return on Average Assets	1.3%	1.3%	1.3%	0.8%	0.9%	1.0%
Return on Average Equity	10.0%	10.8%	11.2%	6.9%	7.7%	8.4%
Net Interest Income & Islamic Finance Income/ Operating Income	71.5%	75.9%	77.8%	76.7%	76.3%	76.3%
Other Operating Income/Operating Income	28.5%	24.1%	22.2%	23.3%	23.7%	23.7%
Net fee income/Operating Income	18.5%	16.8%	15.2%	15.9%	16.2%	16.2%
Interest Earning/Finance Asset Yield	4.8%	5.1%	5.3%	4.8%	4.8%	4.8%
Cost of Funds	1.9%	1.9%	2.1%	2.1%	2.1%	2.1%
Net Spread	3.0%	3.2%	3.2%	2.7%	2.6%	2.7%
Net Interest Margin (NIM), %	3.1%	3.4%	3.4%	2.9%	2.8%	2.8%
Cost to Income Ratio	58.4%	53.6%	52.3%	52.8%	51.3%	49.8%
Net Loans to Customer Deposits	94.7%	98.0%	100.4%	100.4%	100.5%	100.6%
Net Loans & Islamic Financing to Customer Deposits (Total LTD)	95%	98%	100%	100%	100%	101%
Non Performing Loans, OMR mn	50	52	74	99	105	112
NPLs to Gross Loans & Islamic Financing, %	2.9%	2.7%	3.6%	3.7%	3.7%	3.7%
NPL Coverage, %	100.4%	107.2%	72.4%	78.4%	70.5%	77.2%
Cost of Risk (bps)	4.9	25.7	26.9	70.0	65.0	63.0
Shareholders' Equity to Total Assets, x	0.13	0.12	0.12	0.11	0.11	0.11
Capital Adequacy Ratio, %	15.7%	16.5%	15.2%	15.3%	15.1%	14.7%
EPS (OMR)	0.020	0.022	0.024	0.014	0.017	0.020
BVPS (OMR)	0.205	0.211	0.220	0.220	0.231	0.240
Market Price (OMR) *	NA	NA	NA	0.200	0.200	0.200
Cash Dividend Payout Ratio, %	49.1%	49.1%	45.5%	58.6%	60.3%	60.5%
Cash Dividend Yield, %	-	-	-	4.0%	5.3%	6.0%
P/E Ratio (x)	-	-	-	14.6	11.5	10.1
P/BV Ratio (x)	-	-	-	0.91	0.87	0.83

*Market price for current year and subsequent years as per the closing price on 09-Aug-2020

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%

Disclosure: Oman Arab Bank is considered a related party of Ubhar Capital SAOC due to common shareholders.

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