

# Sohar International Bank SAOG

TP : OMR 0.121 / share

UpSide: 5.2%

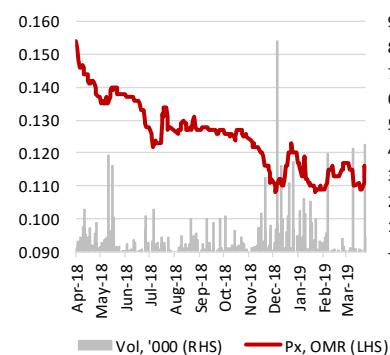
Recommendation	HOLD
Bloomberg Ticker	BKSB OM
Current Market Price (OMR)	0.115
52wk High / Low (OMR)	0.150/0.110
12m Average Vol. (000)	489.4
Mkt. Cap. (USD/OMR Mn)	593/228
Shares Outstanding (mn)	1,982.6
Free Float (%)	85%
3m Avg Daily Turnover (OMR'000)	61.7
6m Avg Daily Turnover (OMR'000)	67.8
PE 2019e (x)	6.5
PBV 2019e (x)	0.76
Dividend Yield '19e (%)	6.3%

## Price Performance:

1 month (%)	-
3 month (%)	(4.17)
12 month (%)	(22.82)

Source: Bloomberg

## Price-Volume Performance



Source: Bloomberg

- **Loan-to-Deposit Ratio declined from 127.8% in 2017 to 123.8% in 2018**
- **Completed OMR 100mn Tier 1 capital issuance in March 2019 to help boost capital adequacy (Capital Adequacy Ratio was 13.2% end-2018 vs. regulatory minimum of 13.5% effective from 1<sup>st</sup> Jan, 2019)**
- **Net interest margin has improved to 2.05% in 2018 (2017: 1.92%, 2016: 2.04%)**

We reduce our 12-month target price (TP) for Sohar International Bank (BKS), previously Bank Sohar, to OMR 0.121 per share from our earlier TP of OMR 0.150 per share due to: (1) a steep rise in risk-free rate of Oman (Current: 6.5%, our previous report: 5.1%), and (2) a higher Beta value sourced from Bloomberg. We revise its rating downward from Accumulate to HOLD.

Our fair value implies a P/e'19 of 6.7x and a P/b'19e of 0.79x. The bank's Tier 1 capital has been boosted through an OMR 100mn Perpetual Bond Issuance since regulatory minimum effective from 1<sup>st</sup> January 2019 is 13.5% (including capital conservation buffer). This issuance has been recently completed through private placement. The bank has an improving earnings profile but macroeconomic indicators warrant depressed valuations. Asset quality metrics of the bank, even though sound, have been deteriorating over the last few years, with the ratio of non-performing loans to gross loans having increased from 2.32% in 2017 to 3.29% in 2018, due to the deterioration of asset quality from a few major corporate customers.

## Q1'19 Financial Performance

The bank's Q1'19 net profit at OMR 10.2mn (+14%YoY; +37% QoQ) beat our estimate by 24% on much lower than expected impairment charge (down 57%QoQ). Operating income is in line with our estimate, however operating expenses rose 24%YoY and 16%QoQ, clocking in 23% above estimate, leading to an operating profit miss of 12%. Cost-to-Income for the bank rose to 46% in Q1'19 from 41% in Q4'18 and 43% in Q1'18. Lower impairment charges have surprised positively, and therefore we have adjusted our estimates for cost of risk accordingly. Gross loans, net loans and customer deposits for Q1'19 are all in line with our estimates.

## Outlook & Valuation

We expect the bank's top-line to grow on the back of improving net interest margin (NIM) as assets continue to be re-priced, with operating income growth expected at a CAGR of 9% over 2019-2023F. Operating expenses are expected to grow at a CAGR of about 8%. We expect expected credit loss (ECL) allowance charges to grow as loans grow, resulting in a growth expectation for net profit (CAGR: 10% over 2019-2023F).

## Key Indicators

Year	FY16	FY17	FY18	FY19e	FY20e	FY21e
Total Net Loans (OMR mn)	1,913	2,099	2,252	2,453	2,649	2,861
Total Customer Deposits (OMR mn)	1,532	1,643	1,818	1,981	2,148	2,329
Operating Income (OMR mn)	67	76	94	98	107	117
Net Profit (OMR mn)	19	25	29	35	40	43
EPS (OMR)	0.012	0.014	0.015	0.018	0.020	0.022
BVPS (OMR)	0.171	0.165	0.144	0.151	0.158	0.166
P/E (x)	13.4	10.8	7.5	6.5	5.7	5.3
P/BVPS (x)	0.94	0.92	0.77	0.76	0.73	0.69
Dividend Yield (%)	9.4%	3.3%	5.4%	6.3%	7.1%	7.6%

Source: Company Financials, U Capital Research

\* Market price for 2019 and subsequent years as per latest closing price of 17/04/2019

Date: 17<sup>th</sup> April 2019

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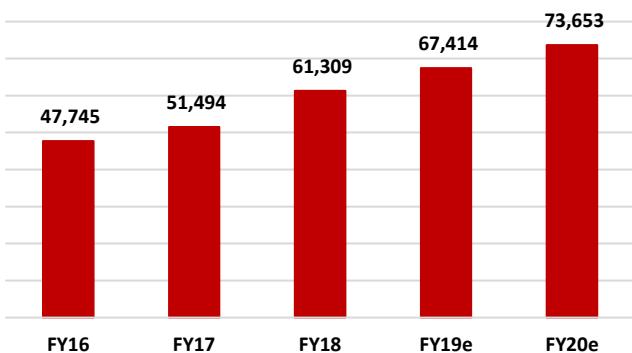
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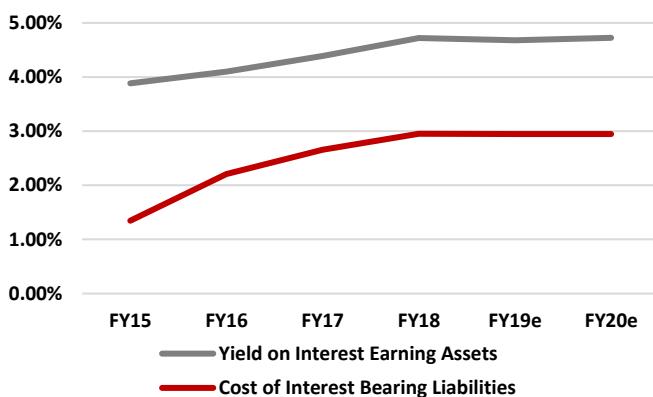
## Rapidly improving net interest income on rising yields

The bank's interest income has been consistently rising on net loan growth as well as improvement in spreads characteristic of a rising interest rate environment. However, BKS's deposit mix is more skewed towards higher cost long term deposits. This has resulted in a smaller improvement in the bank's net interest margin as compared to many other banks within the sector. Current & Savings (CASA) deposits form about 43% of total customer deposits, offering a more limited access to low-cost funding base as compared to the bank's peers.

BKS: Net Interest & Islamic Income (OMR mn)



BKMB: Yield & Cost of Funding

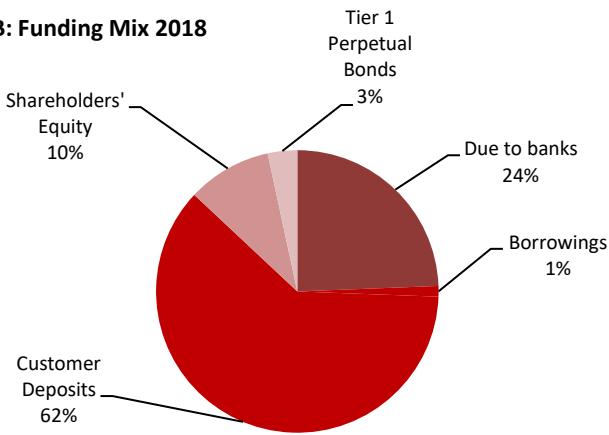


Source: Bank Financials, U Capital Research

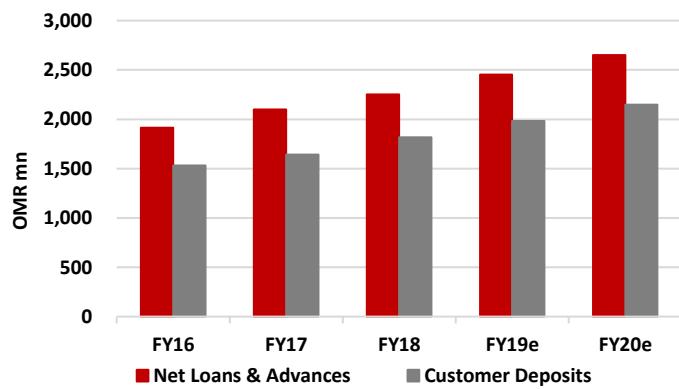
The bank's balance sheet is primarily funded through customer deposits (c62%). Furthermore, the bank has locked in relatively less expensive capital and some borrowing during the previous years. In 2017, the bank raised OMR 100mn through Perpetual Tier 1 bonds with a fixed annual rate of 7.75%, and another Perpetual Tier 1 Capital notes worth OMR 100mn, at a fixed annual rate of 7.5% in March this year.

We believe that the bank's net interest income (including Islamic finance income) will grow at a CAGR of 8.0% over 2019-2023F, based on our assumption that assets will continue to be re-priced higher along with a loan book growth that outpaces sector growth, and cost of funding to remain at current levels, resulting in some improvement in spreads.

BKS: Funding Mix 2018



BKS: Net Loans & Deposits

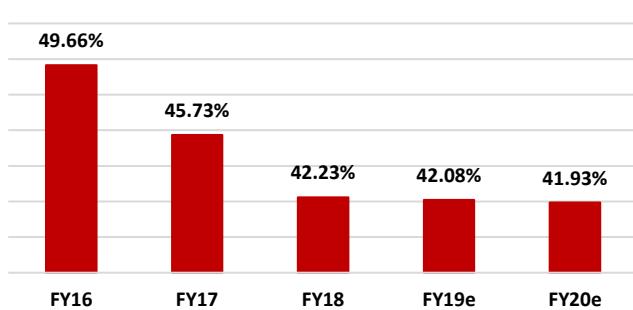


Source: Bank Financials, U Capital Research

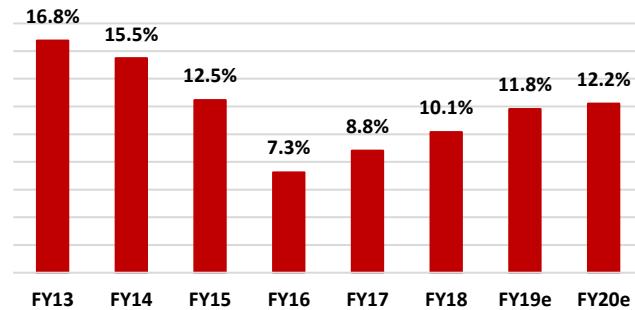
## Profitability metrics affected due to higher capital requirements

The bank's return on average equity (RoAE), using earnings less interest on Tier 1 perpetual securities, has improved to 10.1% in FY18, from 8.8% in FY17 and 7.3% in FY16. However, it is still below the average ROEs seen before FY15, primarily on account of higher capital requirements due to Basel III implementation and other regulatory requirements. We believe that the bank's profitability metrics will improve as profit growth is expected to remain at a CAGR of 10% over 2019-2023e. The bank is set for now, in terms of capital adequacy requirement fulfillment.

**BKSB: Cost-to-Income Ratio**



**BKSB: Return on Average Equity**

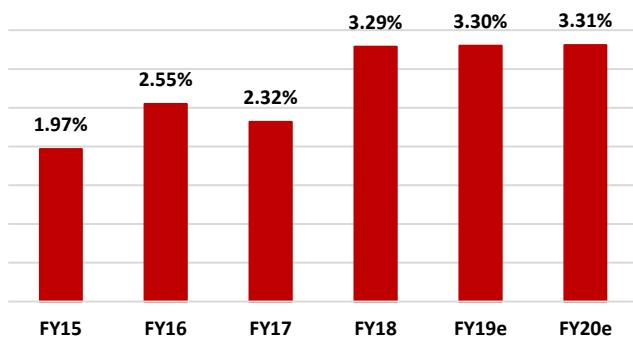


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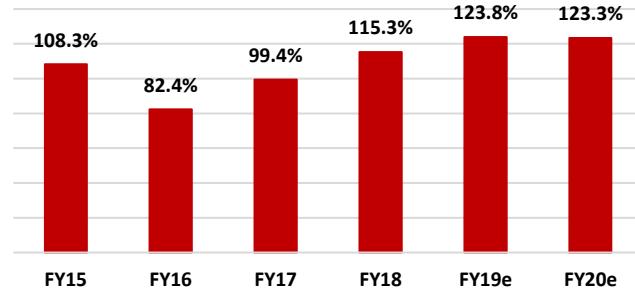
## Asset quality metrics declined but still sound

While loan asset quality metrics have weakened further, they remain sound with a moderately low level of non-performing loans (NPLs) as % of gross loans at 3.29%, which remains more than fully covered by provisions (FY:18 115%). We believe there might be further pressure on asset quality but the bank maintains sufficient capital to absorb any unexpected losses. We have assumed cost of risk to remain somewhat stable over the forecast period.

**BKSB: Non-performing loans as % of gross loans**



**BKSB: Provision cover (x)**



Source: Bank Financials, U Capital Research

## Loan book growth expected to outpace sector growth

For the Omani banking sector, we are expecting credit growth to average at 6% over the forecast period. However, for Sohar International, we expect loan book growth to outpace sector growth (averaging 8%) on anticipation of higher risk appetite of the bank as well as the recent capital raising activity, which has helped boost capital adequacy ratios of the bank.

## Revised Estimates on FY18 & Q1'9 performance cues

We have revised our income statement estimates for FY19 onwards based on the actual performance of FY18 and Q1'19.

	Old FY19e	New FY19e	Change New / Old
Net Interest & Islamic Income	64	67	5.3%
Other Operating Income	30	31	2.4%
<b>Operating Income</b>	<b>94</b>	<b>98</b>	<b>4.4%</b>
Operating expenses	43	41	-4.0%
<b>Operating Profit</b>	<b>51</b>	<b>57</b>	<b>11.4%</b>
ECL allowance expense	16	15	-3.3%
<b>PBT</b>	<b>35</b>	<b>41</b>	<b>18.2%</b>
Taxes	5	6	21.7%
<b>PAT</b>	<b>30</b>	<b>35</b>	<b>17.6%</b>
Interest on Tier 1 Perpetual Securities*	8	13	72.6%
<b>Profit attributable to common shareholders</b>	<b>22</b>	<b>22</b>	<b>-1.5%</b>
Adjusted EPS, OMR	0.011	0.011	-1.5%

All figures in OMR mn unless stated otherwise; all figures except EPS are rounded off to the nearest million

\*For interest on new OMR 100mn Tier 1 perpetual securities, new FY19 estimates are based on outstanding period of the securities from March 2019.

## Sensitivity Analysis

Cost of Equity	Stable Period Retention Ratio				
	53.0%	54.0%	55.0%	56.0%	57.0%
12.7%	0.146	0.146	0.146	0.146	0.146
13.2%	0.133	0.133	0.133	0.133	0.133
13.7%	0.121	0.121	<b>0.121</b>	0.121	0.121
14.2%	0.111	0.111	0.111	0.111	0.111
14.7%	0.102	0.102	0.102	0.102	0.102

**Key Financials**

(OMR mn)	2016	2017	2018	2019e	2020e	2020e
<b>Income Statement</b>						
Interest Income	91	109	130	142	155	168
Interest Expense	(46)	(62)	(74)	(80)	(88)	(95)
<b>Net Interest &amp; Islamic Financing Income</b>	<b>48</b>	<b>51</b>	<b>61</b>	<b>67</b>	<b>74</b>	<b>81</b>
Fee & Commission Income	17	18	16	17	19	20
Other Income	2	6	17	13	15	16
<b>Total Non-Interest/Financing Income</b>	<b>19</b>	<b>25</b>	<b>33</b>	<b>31</b>	<b>33</b>	<b>36</b>
<b>Total Operating Income</b>	<b>67</b>	<b>76</b>	<b>94</b>	<b>98</b>	<b>107</b>	<b>117</b>
Provision	(11)	(12)	(20)	(15)	(15)	(17)
Operating Expenses	(33)	(35)	(40)	(41)	(45)	(49)
<b>Profit Before Taxation</b>	<b>22</b>	<b>30</b>	<b>34</b>	<b>41</b>	<b>47</b>	<b>50</b>
Taxation	(3)	(5)	(5)	(6)	(7)	(7)
<b>Net Profit</b>	<b>19</b>	<b>25</b>	<b>29</b>	<b>35</b>	<b>40</b>	<b>43</b>
Interest on Tier 1 Perpetual Bonds	-	8	8	13	15	15
<b>Net Profit attributable to Common Shareholders</b>	<b>19</b>	<b>17</b>	<b>22</b>	<b>22</b>	<b>25</b>	<b>28</b>
<b>Balance Sheet</b>						
Cash Balances	120	182	72	241	243	247
Deposits with Banks & FIs	99	104	121	124	134	144
Gross Loans & Financings	1,954	2,148	2,341	2,550	2,754	2,975
Loan Loss Reserve	(41)	(49)	(89)	(97)	(105)	(114)
Net Loans & Financings	1,913	2,099	2,252	2,453	2,649	2,861
Investment Properties	3	3	3	3	3	3
Net Fixed Assets	16	17	20	20	20	20
Other Assets	370	438	578	630	680	735
<b>Total Assets</b>	<b>2,520</b>	<b>2,843</b>	<b>3,046</b>	<b>3,471</b>	<b>3,729</b>	<b>4,010</b>
Deposits from Banks & FIs	594	737	723	867	940	1,019
Deposits from Customers	1,532	1,643	1,818	1,981	2,148	2,329
Other Borrowings	91	38	35	31	27	24
Other Liabilities	29	31	85	92	100	108
Paid-up Capital	160	178	198	198	198	198
Retained Earnings	27	73	39	49	59	71
Other Reserves	86	42	48	52	56	60
Shareholders' Equity	274	294	285	299	313	329
Tier 1 Perpetual Bonds	-	100	100	200	200	200
<b>Total Equity &amp; Liability</b>	<b>2,520</b>	<b>2,843</b>	<b>3,046</b>	<b>3,471</b>	<b>3,729</b>	<b>4,010</b>
<b>Cash Flow Statement</b>						
Cash from operations	39	85	52	142	78	85
Cash from investing activities	76	64	122	48	46	50
Cash from financing	35	41	(40)	74	(29)	(30)
Net changes in cash	(3)	63	(110)	169	2	5
Cash at the end of period	120	182	72	241.01	243	247
<b>Key Ratios</b>						
Return on Average Assets	0.8%	0.9%	1.0%	1.1%	1.1%	1.1%
Return on Average Equity	7.3%	8.8%	10.1%	12.1%	13.0%	13.4%
Recurring Income/Operating Income	96.9%	91.6%	81.6%	86.3%	86.4%	86.5%
Interest Earning/Financing Assets Yield	4.1%	4.4%	4.7%	4.7%	4.7%	4.7%
Cost of Funds	2.2%	2.7%	3.0%	2.9%	2.9%	2.9%
Net Spread	1.9%	1.7%	1.8%	1.7%	1.8%	1.8%
Cost to Income Ratio	49.7%	45.7%	42.2%	42.1%	41.9%	41.8%
Net Loans to Customer Deposits	125%	128%	124%	124%	123%	123%
NPLs to Gross Loans	2.5%	2.3%	3.3%	3.3%	3.3%	3.3%
NPL Coverage	82.4%	99.4%	115.3%	123.8%	123.3%	122.8%
Provisions/Total Income	62%	65%	94%	99%	98%	98%
Cost of Risk (bps)	51.9	46.9	72.9	51.0	47.1	49.1
Equity to Gross Loans	0.1	0.1	0.1	0.1	0.1	0.1
Equity to Total Assets	11%	10%	9%	9%	8%	8%
Dividend Payout Ratio	126%	36%	41%	41%	41%	41%
Adjusted EPS (OMR)	0.012	0.014	0.015	0.018	0.020	0.022
Adjusted BVPS (OMR)	0.171	0.165	0.144	0.151	0.158	0.166
Market Price (OMR) *	0.160	0.152	0.111	0.115	0.115	0.115
Dividend Yield	9.4%	3.3%	5.4%	6.3%	7.1%	7.6%
P/E Ratio (x)	13.43	10.84	7.49	6.46	5.73	5.30
P/BV Ratio (x)	0.94	0.92	0.77	0.76	0.73	0.69

\* Market price for 2019 and subsequent years as per latest closing price of 17/04/2019

Source: Company Financials, U Capital Research

## Recommendation

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