

# Omani Islamic Banking Sector

March 21, 2018

**Bank Nizwa**  
**Alizz Islamic Bank**

**BUY**  
**BUY**

We maintain our target price on **Bank Nizwa (BKNZ)** and reduce our target price on **Alizz Islamic Bank (BKIZ)** while maintaining **BUY** rating on both names, with fair values of **OMR 0.114 per share** and **OMR 0.092 per share**, respectively.

## Robust growth story continues for Islamic banking in Oman

Islamic banking in Oman is growing at a faster rate than conventional banking, with Islamic banking credit up by 25%YoY at the end of Dec'17, according to the Central Bank of Oman (CBO), pointing to a wider acceptability of products. Total credit of Islamic banks and the Islamic banking windows of conventional lenders in Dec'17 amounted to OMR3.03bn, compared to OMR2.43bn in FY'16, taking Islamic banking's market share of total credit within the country to 12.9% in 2017, from 11% in 2016. We believe that Islamic banking will continue to grow at a strong rate in the coming years; however, growth momentum is expected to slow down as the sector matures.

## Rising yields on assets expected to offset rising cost of funding

The cost of funding has increased, and this has squeezed banks' financing margins in 2016 and 2017. Although the pressure eased a bit after Oman's Government issued international bonds and unlocked payments to contractors, we think the cost of funding will remain inflated in 2018-2019. Any subsequent U.S. Federal Reserve (Fed)'s rate hikes, which effectively feed into Oman's economy through the USD-OMR peg, could result in Islamic deposits shifting to profit-sharing investment accounts from unremunerated current accounts. If this happens, it would raise the cost of funding even further. However, we have seen improvement in Finance Income yield (profit rate on Financing Assets) also and that has helped to partially offset the higher cost of funding. Net interest margins are expected to have bottomed out and will begin to pick up from hereon, albeit slowly.

## Cost of risk has declined; Expected to marginally rise from hereon

Cost of risk has been on a decline for both banks. However, we foresee slightly higher credit losses in the coming years, due to rising cost of funding. Exposure to subcontractors, SMEs, and retail customers (especially expatriates) will likely fuel the upward trend for credit losses.

## Deferred tax amortization to have an uncertain effect on earnings

Both Bank Nizwa & Alizz Islamic Bank have taxable losses available for offset against future taxable profits, which can be utilized prior to their expiry. The banks must utilize the deferred tax asset within five years of creation of that asset. For BKNZ, a total of OMR 2.68mn while for BKIZ, OMR 3.57mn of deferred tax asset is available for amortization as at the end of FY18. In our model-building process, we have assumed a 50% amortization p.a. of the asset sequentially until it is fully exhausted. Nonetheless, in the absence of guidance on asset amortization, our estimates might vary from the actual profit numbers.

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	Market Cap (OMR mn)	CMP (OMR)	Target Price (OMR)	Upside / Downside (%)	P/E'18e (x)	P/B'18e (x)
Bank Nizwa	127.5	0.085	0.114	34%	12.9	0.90
Alizz Islamic Bank	76	0.076	0.092	21%	47.0	0.95

Source: Bloomberg, U Capital Research

Note: P/E'19e of BKIZ is 24.9x

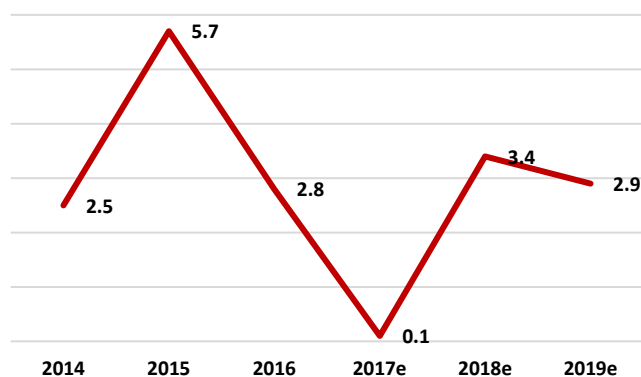
## Sector Dynamics & Outlook

We believe that the key growth drivers for Islamic Banking, like their conventional counterparts, are: (1) Economic sectors to be promoted under the Government-backed USD20bn Tanfeedh Program that is to be funded through Public-Private Partnership initiatives (2) Government spending on mega projects such as the Sohar Refinery and Duqm Airport; (3) Favorable demographics of Oman (~43% working age population -aged 25 to 54 years)<sup>1</sup> as a key driver for growth in the consumer lending segment and higher disposable incomes of the youth population.

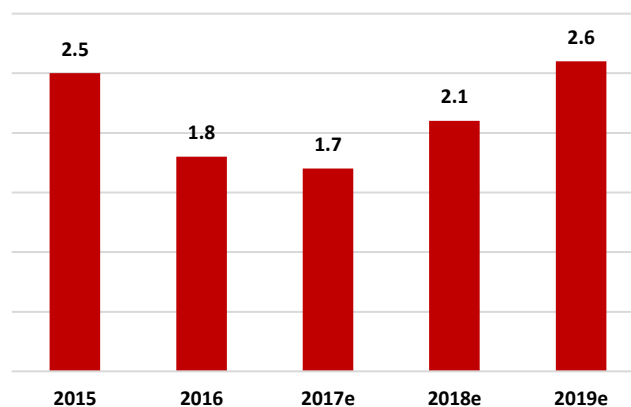
### *Oman's macroeconomic outlook is encouraging on the back of planned non-oil GDP growth triggers*

Oman's economic growth is set to recover modestly over the medium term, as forecasted by the IMF & World Bank. A boost in the hydrocarbon sector is expected in 2018, mainly on end of "OPEC plus" restrictions on oil supply coupled with the Khazzan gas project's increased production capacity. As the gradual recovery of oil prices improves confidence and encourages private sector investment, overall GDP growth is projected to rebound to 2.9% by 2019. As has been the case for many years now, the government is focused on economic diversification. Over the longer term, pro-business reforms such as the foreign ownership law and the FDI law, and the lifting of sanctions on Iran are expected to increase trade and investment opportunities.

**Oman Real GDP growth (%), at constant market prices**



**Gross Fixed Capital Investment Growth (%)**



Source: World Bank (Note: GDP growth at constant market prices)

We expect credit growth in Oman to soften to an average of 6% between 2019-2022F, with Islamic Banking consistently increasing its market share albeit slowly as compared to previous years. Overall, the banking system is well-positioned for sustained growth in the future and will benefit from the Sultanate's systematic shift towards a more diversified economy.

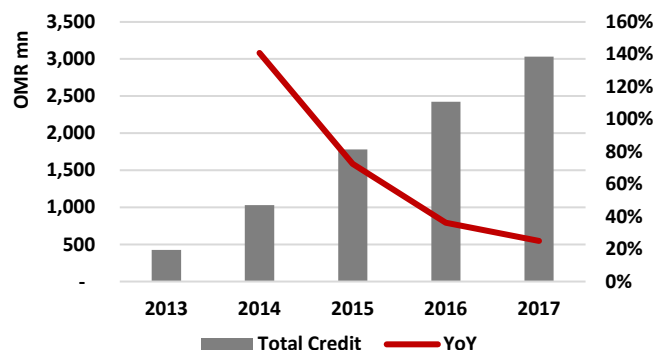
### *Robust growth story continues for Islamic banking in Oman*

Islamic banking in Oman is growing at a faster rate than conventional banking segment, with Islamic banking credit up by 25%YoY at the end of Dec'17, according to the Central Bank of Oman (CBO), on wider acceptability of Islamic Banking products. Total credit of Islamic banks and the Islamic banking windows of conventional lenders in Dec'17 amounted to OMR3.03bn, compared to OMR2.43bn in FY'16. This took Islamic banking's market share of total credit within the country to 12.9%, from 11% 2016.

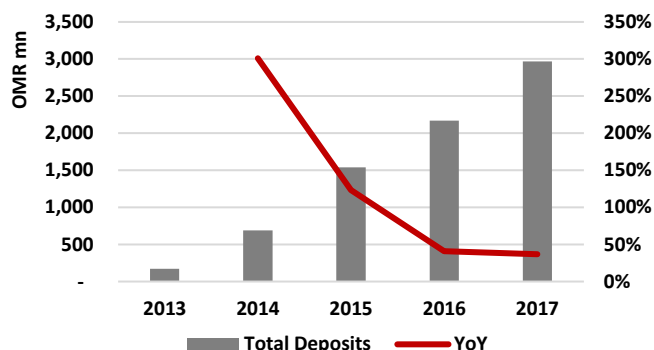
<sup>1</sup> CIA World Fact book, July 2016 est.

We believe that Islamic banking will continue to grow at a strong rate in the coming years, however, growth momentum is expected to inadvertently slow down as the sector matures.

**Omani Islamic Banking -Credit**



**Omani Islamic Banking -Deposits**

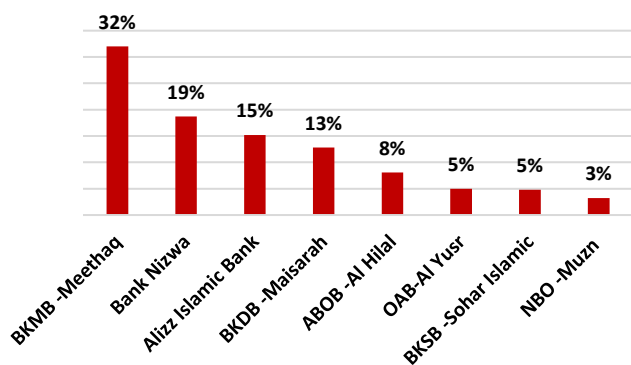


Source: CBO, U Capital Research

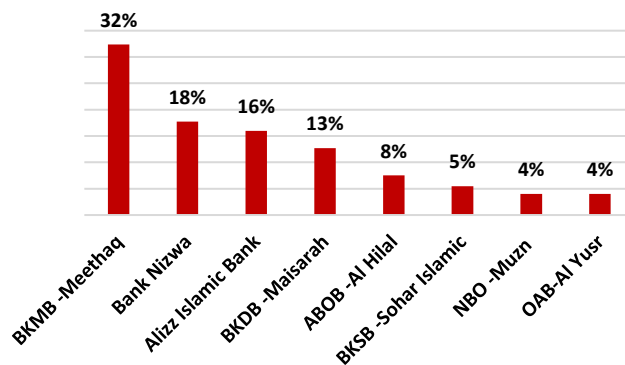
**Bank Nizwa & Alizz Islamic Bank continue to expand market share**

Within the Islamic banking space, Bank Muscat’s Islamic Banking arm, Meethaq, remains the market leader in terms of both credit as well as deposit share. However, Bank Nizwa and Alizz Islamic Bank have rapidly gained market share in both credit & deposit base, in spite of commencing operations later than other conventional banks’ Islamic windows.

**Islamic Financing Market Share**



**Islamic Deposits' Market Share**

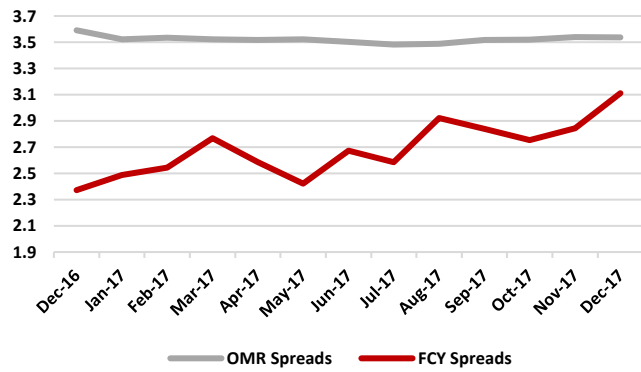


Source: Bank Financials, U Capital Research

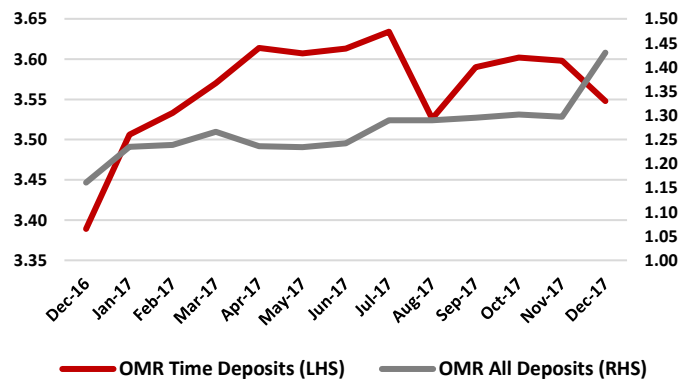
**Rising yields on assets expected to offset rising cost of funding**

The cost of funding has increased, and this has squeezed banks’ financing margins in 2016 and 2017. Although the pressure eased a bit after Oman’s Government issued international bonds and unlocked payments to contractors, we think the cost of funding will remain inflated in 2018-2019. Any subsequent U.S. Federal Reserve (Fed)’s rate hikes, which effectively feed into Oman’s economy through the USD-OMR peg, could result in Islamic deposits shifting to profit-sharing investment accounts from unremunerated current accounts. If this happens, it would raise the cost of funding even further. However, we have seen improvement in Finance Income yield (profit rate on Financing Assets) and that has helped to partially offset the higher cost of funding.

Weighted Average Interest Spread, %



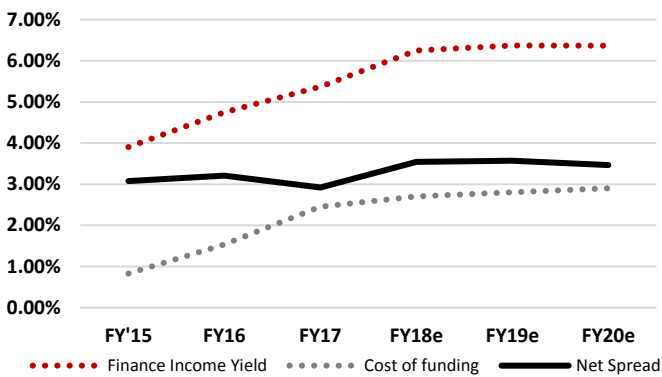
Private Sector Weighted Average Interest Rates, %



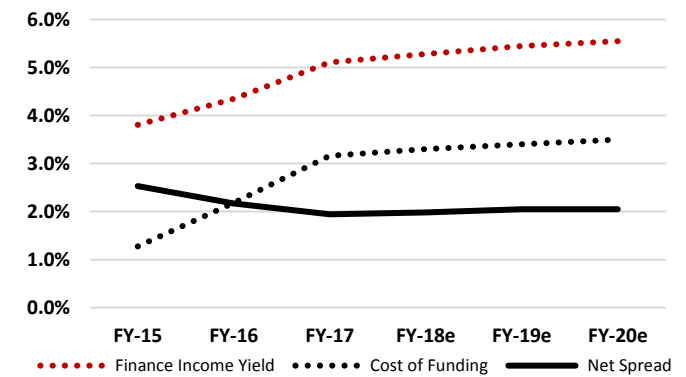
Source: CBO, U Capital Research

For both BKNZ & BKIZ, we foresee marginal recovery in net spreads over the forecast period which will contribute to revenue growth in addition to loan-book growth.

BKIZ: Net Spread



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Source: CBO, U Capital Research

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Cost of risk has been on a decline for both banks. . However, we foresee slightly higher credit losses in the coming years, due to rising cost of funding. Exposure to subcontractors, SMEs, and retail customers (especially expatriates) will likely fuel the upward trend for credit losses.

# Bank Nizwa

TP: OMR 0.114 / share

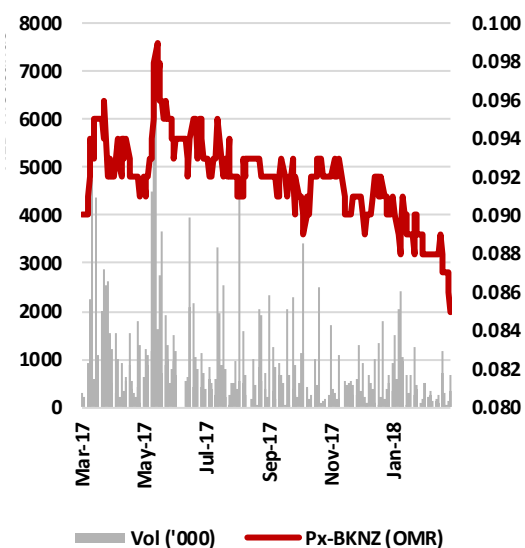
<b>Recommendation</b>	<b>Buy</b>
Bloomberg Ticker	BKNZ OMR
Current Market Price (OMR)	0.085
52wk High / Low (OMR)	0.100/0.080
12m Average Vol. (000)	872.1
Mkt. Cap. (USD/OMR mn)	331.1/127.5
Shares Outstanding (mn)	1,500
Free Float (%)	80%
3m Avg Daily Turnover (000)	44.3
6m Avg Daily Turnover (000)	49.4
PE 2018e (x)	12.9
PBv 2018e (x)	0.90
Dividend Yield '18e (%)	-

#### Price Performance:

1 month (%)	(3.41)
3 month (%)	(6.59)
12 month (%)	(5.56)

Source: Bloomberg

#### Price Volume Performance:



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We maintain our target price for Bank Nizwa at OMR 0.114 per share and maintain our **BUY** rating. We believe that the bank's exceptional performance and balance sheet growth is not reflected in its current price level. In spite of a higher cost of equity, we believe the bank is undervalued. Our target price implies a P/E'18e and a P/E'19e of 15.3x and 11.2x, respectively. It implies a P/B'18e and P/B'19e of 1.1x and 1.0x, respectively.

#### Stellar loan-book growth as Islamic Banking gains acceptance in Oman

The bank's total assets grew by 35%YoY to reach OMR 697mn as at the end of FY17, while total net loans increased by 41%YoY to reach OMR 560.6mn, showing significant growth despite a challenging operating environment. Bank Nizwa gained market share in FY17, reaching 18% as compared to 16% in FY16, of the total gross Islamic finance assets of the country. We expect the total assets of the bank to grow at CAGR of 12% over the next five years on account of increasing loan book (expected CAGR of 13% over 2018-2022e).

#### Operating income to grow at a CAGR of 14% over 2018-2022e

Operating income of the bank is expected to increase from OMR 22.4mn in FY17 to OMR 415mn in 2022, growing at a CAGR of 14%. Revenue growth will be primarily driven by improving Net Interest Margins (NIMs) (as interest rates rise as outlined **above**) as well as new loan origination fee as loan-book expands.

#### Operating costs and cost of risk to remain under control

As the bank has been bringing its cost-to-income ratio down historically, we believe the bank will continue to maintain tight control on costs in order to bring the ratio down further through income growth. We expect the bank's operating profit before provisions to increase at a CAGR of 32% over 2018-2022. Furthermore, we expect cost of risk to remain low as current asset quality is maintained over the forecast horizon.

#### TP offers an upside of 34%; CMP: OMR 0.085/share

Our target price offers an upside of 34% compared to the current market price of OMR 0.085/share. The bank is trading at an attractive PBv multiple of 0.90x for 2018 compared to the industry average of 1.18x. Furthermore, the bank is expected to benefit from sequentially reducing its deferred tax asset from its loss-making years, where it has 5 years to amortize the asset from the date of creation. This might result in higher or lower earnings than our forecast, based on 50% asset amortization per year.

#### Key Indicators

	FY'15	FY16	FY17	FY18e	FY19e	FY20e
Net Loans, OMR'000	268,986	397,807	560,545	652,287	770,372	880,776
Customer Deposits, OMR '000	189,387	352,268	526,150	606,500	685,903	796,274
Operating Income, OMR '000	11,913	17,379	22,392	30,097	35,351	39,952
Operating Profit, OMR '000	(3,464)	1,525	5,972	13,091	17,739	21,711
Net Profit*, OMR '000	(5,260)	110	3,787	9,894	13,557	15,560
EPS, OMR	-0.004	0.000	0.003	0.007	0.009	0.010
BVPS, OMR	0.084	0.085	0.087	0.094	0.104	0.116
P/E (x)	NM	NM	35.7	12.9	9.4	8.2
P/BVPS (x)	0.83	0.98	1.03	0.90	0.81	0.73

Source: Company Financials, U Capital Research

NM = Not meaningful

\*Includes Tax Amortization Benefit

### Stellar balance sheet growth

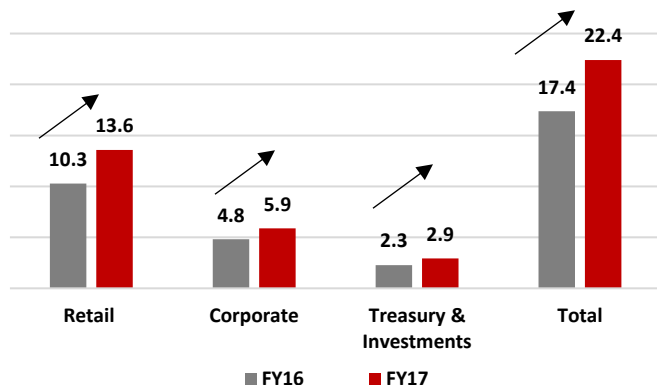
The bank's total assets grew by 35%YoY to reach OMR 697mn as at the end of FY17, while total net loans increased by 41%YoY to reach OMR 560.6mn, showing significant growth despite a challenging operating environment. Bank Nizwa gained market share in FY17, reaching 18% as compared to 16% in FY16, of the total gross Islamic finance assets of the country. We expect the total assets of the bank to grow at CAGR of 12% over the next five years on account of increasing loan book (expected CAGR of 13% over 2018-2022e). Customer deposits of the bank increased by 49%YoY to reach OMR 526.2mn, showing significant growth in the face of difficult macro-economic circumstances.

### Solid Operational Performance

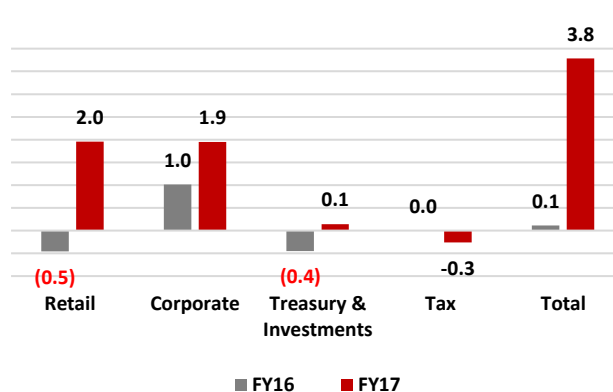
Bank Nizwa marked a significant milestone in 2017 by achieving net profit in every segment, and attain full-year profitability at the end of year. Its operating income for the year rose by 29%YoY, while its operating expenses increased only by 3.6%YoY, reflecting tight cost management. As a result, cost-to-income ratio has been consistently declining since inception, and has reached 73.3% in FY17, from 91% a year ago.

During the year, the bank's retail banking further consolidated its position as the leading Islamic Bank in Oman by increasing its customer base (in 2017) by over 18%, 31% increase in Retail deposits and 20% growth in assets through its network of 12 branches. The corporate segment also saw a 22% jump in revenues, and a whopping 75% jump in its assets. Similarly, treasury & investments division also saw a jump of 28% in revenues and a 17% jump in total assets of the segment.

BKNZ: Segmental Revenues (OMR mn)



BKNZ: Segmental PAT (OMR mn)



Source: Bank Financials, U Capital Research

We expect the operating income of the bank to grow at a CAGR of 11% over 2018-2022F, which together with controlled costs, is expected to boost net profit at a CAGR of 14% over 2018-2022F.

### Superior Asset Quality

The bank has been able to maintain its non-performing assets (NPAs) at a very low 0.22% (0.13% in FY16) of net Islamic finance assets as compared to the Omani Banking Sector at ~3% of total.

NPA coverage is more than ample as provisions are made as per CBO guidelines, since NPLs remain extremely low. Cost of risk also declined from 78bps in FY15 to 37 bps in FY16. We have been conservative in our estimates, and therefore we have increased cost of risk sequentially over the forecast horizon, given the current weak macroeconomic environment.

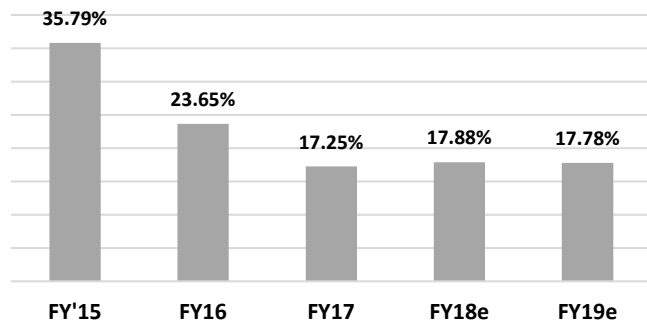
### Robust Capital Buffers albeit expected to decline

Bank Nizwa maintains capital adequacy ratio at 17.25%, which is above the regulatory minimum of 13.25% including capital buffers. However, the bank's capital adequacy levels have been declining as the bank takes on more risk, down from 26.5% as at the end of 2015 and 23.65% at the end of 2016 to 17.25%.

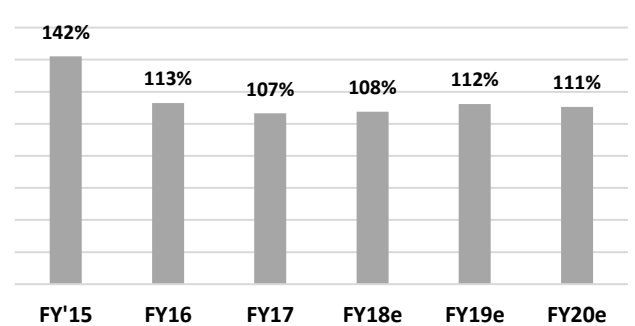
We expect this ratio to be maintained around the current level over the forecast period, as the bank shores up capital through increasing earnings and no dividend payouts for the first few years.

The bank has consistently brought its Net Loan-to-Deposit ratio down from highs of 142% in FY15 to 107% in FY17. We believe that this ratio will continue to remain above 100% over the forecast period as liquidity remains under pressure.

**BKNZ: Capital Adequacy Ratio (CAR)**



**BKNZ: Loan-to-Deposit Ratio**



Source: Company Financials, U Capital Research

## Financial Statements

(OMR '000)	2015	2016	2017	2018e	2019e	2020e
<b>Income Statement</b>						
Financing Income	10,063	17,982	27,956	39,183	46,710	54,042
Payment to Depositors	(1,313)	(4,480)	(11,285)	(16,609)	(20,891)	(25,965)
<b>Net Interest/Financing Income</b>	<b>8,751</b>	<b>13,502</b>	<b>16,671</b>	<b>22,574</b>	<b>25,819</b>	<b>28,077</b>
Fee & Commission Income	1,377	1,922	3,502	4,605	5,835	7,270
Investment Income	1,685	1,744	1,806	2,376	3,010	3,750
Other Income	100	211	412	542	687	855
<b>Total Non-Interest/Financing Income</b>	<b>3,162</b>	<b>3,877</b>	<b>5,721</b>	<b>7,523</b>	<b>9,532</b>	<b>11,876</b>
<b>Total Operating Income</b>	<b>11,913</b>	<b>17,379</b>	<b>22,392</b>	<b>30,097</b>	<b>35,351</b>	<b>39,952</b>
Provisions expense	(2,005)	(1,415)	(1,926)	(2,447)	(3,009)	(3,650)
Operating Expenses	(15,377)	(15,854)	(16,420)	(17,006)	(17,612)	(18,241)
<b>Profit Before Taxation</b>	<b>(5,468)</b>	<b>110</b>	<b>4,046</b>	<b>10,644</b>	<b>14,730</b>	<b>18,061</b>
Taxation	208	-	(260)	(750)	(1,173)	(2,501)
<b>Net Profit</b>	<b>(5,260)</b>	<b>110</b>	<b>3,787</b>	<b>9,894</b>	<b>13,557</b>	<b>15,560</b>
<b>Balance Sheet</b>						
Cash Balances	14,626	16,600	42,814	39,176	17,690	36,207
Deposits with Banks & FIs	3,315	4,920	3,464	4,192	3,828	4,010
Investment Securities	25,012	29,360	47,721	51,793	54,033	56,385
Sales receivables & other receivables -net	75,758	100,103	161,398	209,818	251,781	289,549
Ijara Muntahia Bittamleek -net	155,580	234,054	282,110	324,426	389,311	447,708
Wakala Bel Istithmar -net	37,648	62,851	91,311	109,573	120,530	132,583
Other Assets	71,803	130,960	159,130	163,707	177,082	193,615
<b>Total Assets</b>	<b>346,094</b>	<b>515,995</b>	<b>696,638</b>	<b>793,112</b>	<b>893,726</b>	<b>1,027,473</b>
Deposits from Banks & FIs	16,940	23,233	19,339	21,272	23,400	25,740
Deposits from Customers	115,043	193,294	298,074	370,419	447,961	524,873
Other Liabilities	13,093	13,433	20,400	23,708	27,877	31,797
Equity of unrestricted inv acctholders & owners' equity	74,344	158,974	228,076	236,081	237,942	271,402
Paid-up Capital	150,000	150,000	150,000	150,000	150,000	150,000
Retained Earnings / (Accumulated Losses)	(25,274)	(25,175)	(21,771)	(11,877)	1,680	17,240
Other Reserves	1,948	2,226	2,127	2,127	2,127	2,127
Shareholders' Equity	126,674	127,061	130,749	141,632	156,546	173,662
<b>Total Equity &amp; Liability</b>	<b>346,094</b>	<b>515,995</b>	<b>696,638</b>	<b>793,112</b>	<b>893,726</b>	<b>1,027,473</b>
<b>Cash Flow Statement</b>						
Cash from operations	4,622	5,475	44,079	259	(20,774)	19,335
Cash from investing activities	14,979	3,779	17,767	4,887	2,068	2,374
Cash from financing	(109)	278	(99)	989	1,356	1,556
Net changes in cash	(10,466)	1,974	26,214	(3,638)	(21,486)	18,516
<b>Cash at the end of period</b>	<b>14,626</b>	<b>16,600</b>	<b>42,814</b>	<b>39,176</b>	<b>17,690</b>	<b>36,207</b>
<b>Key Ratios</b>						
Return on Average Assets	-1.8%	0.0%	0.6%	1.3%	1.6%	1.6%
Return on Average Equity	-4.1%	0.1%	2.9%	7.3%	9.1%	9.4%
Recurring Income/Operating Income	85.0%	88.8%	90.1%	90.3%	89.5%	88.5%
Profit Yield	3.9%	4.7%	5.4%	6.2%	6.4%	6.4%
Profit Paid	0.8%	1.5%	2.5%	2.7%	2.8%	2.9%
Net Spread	3.1%	3.2%	2.9%	3.5%	3.6%	3.5%
Cost to Income Ratio	129.1%	91.2%	73.3%	56.5%	49.8%	45.7%
Net Loans to Customer Deposits	90.7%	86.3%	96.6%	96.7%	97.1%	97.4%
NPLs to Gross Loans	0.17%	0.13%	0.22%	0.23%	0.24%	0.25%
NPL Coverage	1964%	1388%	738%	753%	834%	966%
Cost of Risk (bps)	77.7	37.4	37.0	39.0	41.0	43.0
Equity to Gross Loans	44.4%	30.2%	22.1%	20.5%	19.2%	18.6%
Equity to Total Assets	36.6%	24.6%	18.8%	17.9%	17.5%	16.9%
Dividend Payout Ratio	-	-	-	-	-	-
Adjusted EPS (OMR)	(0.004)	0.000	0.003	0.007	0.009	0.010
Adjusted BVPS (OMR)	0.084	0.085	0.087	0.094	0.104	0.116
Market Price (OMR) *	0.070	0.083	0.090	0.085	0.085	0.085
P/E Ratio (x)	NM	NM	NM	12.9	9.4	8.2
P/BV Ratio (x)	0.83	0.98	1.03	0.90	0.81	0.73

Source: Company Financials, U Capital Research

\* Market price for 2018 and subsequent years as per latest closing price of 20-Mar-18

NM = not meaningful



# Alizz Islamic Bank

TP: OMR 0.092 / share

Recommendation	BUY
Bloomberg Ticker	BKIZ OM
Current Market Price (OMR)	0.076
52wk High / Low (OMR)	0.090/0.060
12m Average Vol. (000)	374.5
Mkt. Cap. (USD/OMR mn)	197.4/76
Shares Outstanding (mn)	1,000.0
Free Float (%)	60%
3m Avg Daily Turnover (000)	31.6
6m Avg Daily Turnover (000)	24.2
PE 2018e (x)	47.0
PBv 2018e (x)	0.95
Dividend Yield '18e (%)	-

#### Price Performance:

1 month (%)	4.11
3 month (%)	22.58
12 month (%)	7.04

Source: Bloomberg

#### Price Volume Performance:



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We reduce our target price of BKIZ to OMR 0.092 per share and maintain its rating at **BUY**. The bank posted a larger than expected loss in 2017 as compared to our estimates, on lower operating income, forcing us to revise our estimates for the future years in addition to upward revision in cost of equity. Furthermore, we had incorporated an OMR 30mn Tier 1 Capital increase in our earlier estimates that did not materialize so far. However, in spite of these changes, the stock's fair value offers a 21% upside to last closing price on expected loan-book growth and rising operating income.

#### First Quarterly Net Profit of OMR 154k reported in Q4'17

On quarterly basis, the bank posted its very first quarterly profit, of OMR 154k in Q4'17. Operating income for Q4'17 increased by 68%YoY and 16%QoQ to reach OMR 3.83mn. Operating expenses rose by 8%YoY and declined by 4%QoQ resulting in an operating profit of OMR 283k. Provisions declined by 76%YoY and 82%QoQ resulting in a net profit of OMR 154k. We believe that the bank will achieve a full-year operational profitability at the end of 2018. Operating income of the bank is expected to increase from OMR 12.4mn in 2017 to OMR 21.5mn in 2021, growing at a CAGR of 15%. Revenue growth will be primarily driven by improving Net Interest Margins (NIMs) on a growing loan-book.

#### Cost-to-Income Ratio is declining; cost of risk to remain under control

We expect the bank to reach optimal operating cost structure within the next couple of years. The bank has already posted a sequential decline in operating cost-to-income ratio since inception (FY16: 141%, FY17: 113%), as operating income has been on the rise. We expect this to result in operating profit before provisions to increase at a CAGR of 50% over 2019-2024. Furthermore, we expect cost of risk to remain low as current asset quality is maintained over the forecast horizon (FY17 Non-performing asset (NPA) at 0.24% of net loans).

#### TP offers 21% upside; CMP:

Our target price offers a 21% upside compared to the current market price. We believe that this TP is justified because of the bank's performance in FY17 and expected operational profitability in 2018. Additionally, the bank has been able to grow its loan-book and deposits while gaining market share in each segment.

#### Key Indicators

	FY'15	FY16	FY17	FY18e	FY19e	FY20e
Net Loans, OMR'000	199,442	312,796	460,206	566,507	649,306	745,034
Customer Deposits, OMR '000	161,382	291,029	474,470	575,083	689,857	816,939
Operating Income, OMR '000	5,995	8,971	12,384	15,288	17,592	19,260
Operating Profit, OMR '000	(4,649)	(3,680)	(1,624)	859	2,730	3,952
Net Profit*, OMR '000	(5,356)	(4,725)	(2,996)	1,617	3,058	3,202
EPS, OMR	-0.0054	-0.0047	-0.0030	0.0016	0.0031	0.0032
BVPS, OMR	0.086	0.081	0.078	0.080	0.083	0.087
P/E (x)	NM	NM	NM	47.0	24.9	23.7
P/BVPS (x)	0.81	1.02	0.84	0.95	0.92	0.88

Source: Company Financials, U Capital Research

NM = not meaningful

\*Includes Tax Amortization Benefit

### Operational profitability expected at the end of 2018

The bank's revenue from financing and investing activities increased by 69%YoY to OMR 21mn. Total operating income grew by 38%YoY to reach OMR 12.4mn. Net operating loss before provisions and tax reduced by 56% to OMR 1.62mn while the bank achieved operating profit of OMR 283K in the fourth quarter of the year. Net loss of the Bank reduced by 37%YoY to OMR 2.99mn and the bank posted net profit of OMR 154K in fourth quarter of 2017.

We expect the bank to reach optimal operating cost structure within the next couple of years. The bank has already posted a sequential decline in operating cost-to-income ratio since inception (FY16: 141%, FY17: 113%), as operating income has been on the rise. We expect this to result in operating profit before provisions to increase at a CAGR of 50% over 2019-2024.

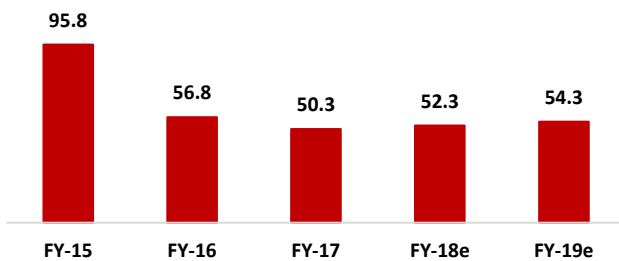
### Rapidly gaining credit & deposit market share

The bank witnessed solid growth in all the core business areas which resulted in an increase in financing receivables by 47%YoY to reach OMR 460.2mn. The bank was able to increase its market share to 15% of total Omani Islamic credit in FY17, as compared to 13% in FY16. Deposits increased by 63%YoY to reach OMR 474.5mn, taking the bank's market share to 16% from 13% in FY16.

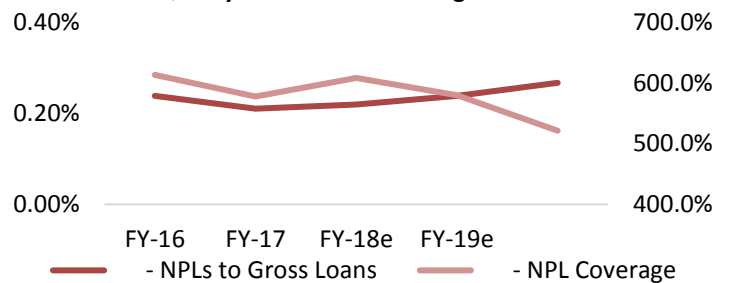
### Excellent Asset Quality

The bank has been able to maintain its non-performing assets (NPLs) at a very low % (0.24% in FY17) of total finance assets as compared to the Omani Banking Sector at ~3% of total. NPL coverage is fairly large as provisions are made as per CBO regulations. Cost of risk also declined from 96bps in FY15 to 50 bps in FY17. We have been conservative in our estimates, and therefore we have increased cost of risk sequentially over the forecast horizon, given the current weak macroeconomic environment.

BKIZ: Cost of Risk, bps



BKIZ: Credit Quality & Provision Coverage



Source: Company Financials, U Capital Research

### Deferred Tax Amortization to have an uncertain effect on Earnings

The Bank has assessed that following taxable losses available for offset against future taxable profits which can be utilized prior to their expiry:

Deadline	Tax Benefit (OMR)
Available until 31 December 2018 (declared)	3,568,508
Available until 31 December 2019 (declared)	7,543,788
Available until 31 December 2020 (declared)	6,678,921
Available until 31 December 2021 (declared)	5,558,375
Available until 31 December 2022 (estimated)	3,930,918

Source: Company Financials

For the purpose of determining the taxable result of the year, the accounting loss has been adjusted for tax purposes. None of the assessments of the bank have been agreed by the tax authorities. The Islamic finance regulations relating to tax treatment of various products are also currently awaited. Thus based on the current regulations governing taxation in Oman, deferred tax asset on taxable losses net of timing differences arising on property and equipment and intangibles has been recorded in these financial statements at the current applicable tax rate of 12%, until FY16. From Q1'17 onwards, a tax rate of 15% is applicable.

In our model-building process, we have assumed 50% deferred tax amortization over the next few years until 5 years of first taxable profit. Therefore, actual reported net profit / (loss) might be significantly different from our estimates.

### Adequate Capital Buffers

BKIZ's capital adequacy ratio (CAR) declined to 16.67% in FY17 from 24.5% in FY16 as RWAs grew with normal loan-book expansion. However, it is still higher than the required levels as per Basel committee, which is 8%, and Central Bank of Oman's requirement of 3.250% inclusive of capital conservation buffer of 1.250%. We expect this ratio to continue to marginally decline over the forecast period as the bank grows its net loans at a faster pace, increasing RWAs, in spite of shoring up capital through increasing earnings post-2010 and no dividend payouts. The bank has brought its Net Loan-to-Deposit ratio down from a high of 107% in FY16 to 97% in FY17. We are expecting the ratio to remain below 100% over the forecast period as the bank grows its loan-book opportunistically.

### Future Outlook

New shari'a compliant products and services are planned to be launched for wholesale banking and high networth individuals to meet the banking needs of this segment. The Bank will focus on core business growth and will remain open for inorganic growth opportunities.

## Financial Statements

(OMR '000)	2015	2016	2017	2018e	2019e	2020e
<b>Income Statement</b>						
Financing Income	6,088	12,529	21,159	28,379	34,047	39,455
Payment to Depositors	(1,171)	(4,998)	(12,266)	(17,924)	(22,794)	(28,180)
<b>Net Interest/Financing Income</b>	<b>4,917</b>	<b>7,531</b>	<b>8,893</b>	<b>10,455</b>	<b>11,253</b>	<b>11,276</b>
Fee & Commission Income	844	1,154	2,442	3,381	4,434	5,585
Investment Income	235	287	1,049	1,452	1,905	2,399
Other Income	-	-	-	-	-	-
<b>Total Non-Interest/Financing Income</b>	<b>1,078</b>	<b>1,440</b>	<b>3,491</b>	<b>4,833</b>	<b>6,339</b>	<b>7,984</b>
<b>Total Operating Income</b>	<b>5,995</b>	<b>8,971</b>	<b>12,384</b>	<b>15,288</b>	<b>17,592</b>	<b>19,260</b>
Provisions expense	(1,532)	(1,635)	(2,084)	(2,810)	(3,444)	(4,089)
Operating Expenses	(10,644)	(12,651)	(14,009)	(14,429)	(14,862)	(15,308)
<b>Profit Before Taxation</b>	<b>(6,181)</b>	<b>(5,315)</b>	<b>(3,709)</b>	<b>(1,952)</b>	<b>(714)</b>	<b>(137)</b>
Taxation	825	591	713	3,569	3,772	3,339
<b>Net Profit / (Loss)</b>	<b>(5,356)</b>	<b>(4,725)</b>	<b>(2,996)</b>	<b>1,617</b>	<b>3,058</b>	<b>3,202</b>
<b>Balance Sheet</b>						
Cash Balances	6,063	12,484	26,693	19,759	51,461	82,409
Deposits with Banks & FIs	31,255	32,648	22,522	24,775	27,252	29,977
Investment Securities	5,483	9,218	41,314	45,445	49,989	54,988
Murabaha	481	18,165	42,989	60,592	83,184	103,980
Ijara Muntahia Bittamleek -net	130,090	184,411	237,965	273,659	314,708	361,914
Wakala Bel Istithmar -net	25,312	55,289	100,306	140,428	154,470	169,918
Other Assets	79,356	124,721	197,474	251,344	271,385	300,594
<b>Total Assets</b>	<b>252,728</b>	<b>381,646</b>	<b>568,958</b>	<b>675,574</b>	<b>797,979</b>	<b>933,863</b>
Deposits from Banks & FIs	1,925	3,658	5,775	8,085	10,511	13,664
Deposits from Customers	140,515	226,492	361,166	464,055	553,862	661,331
Other Liabilities	3,485	5,716	10,424	12,768	14,609	16,735
Equity of unrestricted inv acctholders & owners' equity	20,868	64,537	113,304	111,028	135,995	155,608
Paid-up Capital	100,000	100,000	100,000	100,000	100,000	100,000
Retained Earnings / (Accumulated Losses)	(14,256)	(18,981)	(22,244)	(20,627)	(17,570)	(14,367)
Other Reserves	(98)	(64)	(24)	(24)	(24)	(24)
Shareholders' Equity	85,936	81,244	78,288	79,638	83,002	86,525
<b>Total Equity &amp; Liability</b>	<b>252,728</b>	<b>381,646</b>	<b>568,958</b>	<b>675,574</b>	<b>797,979</b>	<b>933,863</b>
<b>Cash Flow Statement</b>						
Cash from operations	(10,441)	9,724	45,865	(2,502)	35,976	35,663
Cash from investing activities	(2,025)	3,337	31,695	4,166	4,580	5,034
Cash from financing	(82)	33	40	(267)	306	320
<b>Net changes in cash</b>	<b>(8,498)</b>	<b>6,421</b>	<b>14,210</b>	<b>(6,935)</b>	<b>31,702</b>	<b>30,948</b>
<b>Cash at the end of period</b>	<b>6,063</b>	<b>12,484</b>	<b>26,693</b>	<b>19,759</b>	<b>51,461</b>	<b>82,409</b>
<b>Key Ratios</b>						
Return on Average Assets	-2.9%	-1.5%	-0.6%	0.3%	0.4%	0.4%
Return on Average Equity	-6.0%	-5.7%	-3.8%	2.0%	3.8%	3.8%
Recurring Income/Operating Income	96.1%	96.8%	91.5%	90.5%	89.2%	87.5%
Profit Yield	3.8%	4.3%	5.1%	5.3%	5.5%	5.6%
Profit Paid	1.3%	2.2%	3.2%	3.3%	3.4%	3.5%
Net Spread	2.5%	2.2%	1.9%	2.0%	2.1%	2.1%
Cost to Income Ratio	177.6%	141.0%	113.1%	94.4%	84.5%	79.5%
Net Loans to Customer Deposits	86.5%	90.5%	95.3%	95.8%	96.0%	96.1%
NPLs to Gross Loans	0.1%	0.2%	0.2%	0.2%	0.2%	0.3%
NPL Coverage	650.0%	613.5%	578.0%	608.7%	580.0%	521.4%
Cost of Risk (bps)	95.8	56.8	50.3	52.3	54.3	56.3
Equity to Gross Loans	32.6%	29.9%	16.3%	13.4%	12.2%	11.1%
Equity to Total Assets	34.0%	21.3%	13.8%	11.8%	10.4%	9.3%
Dividend Payout Ratio	-	-	-	-	-	-
Adjusted EPS (OMR)	(0.005)	(0.005)	(0.003)	0.002	0.003	0.003
Adjusted BVPS (OMR)	0.086	0.081	0.078	0.080	0.083	0.087
Market Price (OMR) *	0.070	0.083	0.066	0.076	0.076	0.076
Dividend Yield	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%
P/E Ratio (x)*	NM	NM	NM	47.0	24.9	23.7
P/BV Ratio (x)*	0.81	1.02	0.84	0.95	0.92	0.88

Source: Company Financials, U Capital Research

\*Market price for 2018 and subsequent years as per latest closing price of 20-Mar-18

NM = Not Meaningful

## Recommendation

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

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