

Banking

BUY: TP @ 0.143

Valuation Summary (TTM)

Price (OM)	0.118
PER (x)	7.4
P/Book (x)	0.7
P/Sales (x)	2.5
Dividend Yield (%)	4.8
Free Float (%)	39%
Shares O/S (mn)	2,000
YTD Return (%)	-7%
Beta	0.8

(mn)	OMR	USD
Market Cap	236	613
Total assets	2,334	6,062

Price performance (%)	1M	3M	12M
HBMO	-2%	-1%	-1%
MSM 30 Index	0%	-1%	-11%
Banking Index	-1%	-1%	-7%

Trading liquidity (,000)	1M	3M	6M
Avg daily turnover (RO ,000)	0.02	0.02	0.04
Avg Daily Volume (,000)	181	205	303

52 week	High	Low	CTL*
Price (RO)	0.128	0.100	18.0

* CTL is % change in CMP to 52wk low

Major shareholders

HSBC Middle East Holdings	51.0%
Dr. Omar Al Zawawi	5.1%
Zawawi Trading Company	4.7%
Others	39.3%

Other details

Exchange	MSM
Sector	Banking
Index weight (%)	4.7%

Key ratios	2015	2016	2017
EPS (RO)	0.006	0.008	0.010
BVPS (RO)	0.154	0.157	0.162
DPS (RO)	0.004	0.005	0.006
Payout ratio (%)	65	63	57



HSBC Bank Oman

HSBC Bank Oman has a strong business franchise supported by strong capital quality and access to cheapest source of funds, and a strong parent. Despite recent improvement in fundamentals, and an outlook for higher dividends, the stock is trading as the cheapest valuation ratios among its domestic peers. We initiate HSBC Bank Oman with a BUY rating and assign 12M Target Price of RO 0.143, offering return potential of 21% from current levels.

Though HBMO has only a limited market presence in Oman, its business franchise is supported by the strong parentage of HSBC Global. HSBC is one of the leading financial institution with global reach with presence across geographies. Apart from financial aid, the parent also brings strong expertise in banking. The bank has one of the highest capitalization in the industry and is supported by a strong equity base, with limited dependence on tier 2 capital. We expect the bank to continue to maintain superior capital quality vis-à-vis its peers in the medium term. Though the bank is constrained by systematic risks pertaining to funding, it has one of the best funding profile among its peers. More than 80% of its funding requirements were met by deposits and the bank had limited dependence on market funding. Added to this, given the bank's strong pedigree, we expect that the bank has sufficient room to raise funds at favorable cost as and when required. We also take into account the weak profitability and asset quality of the bank. However, we expect both to improve in the medium term. Our investment call on the stock is based on attractive valuation of 0.7x the bank's 2018 book value, and dividend yield of 7.3%

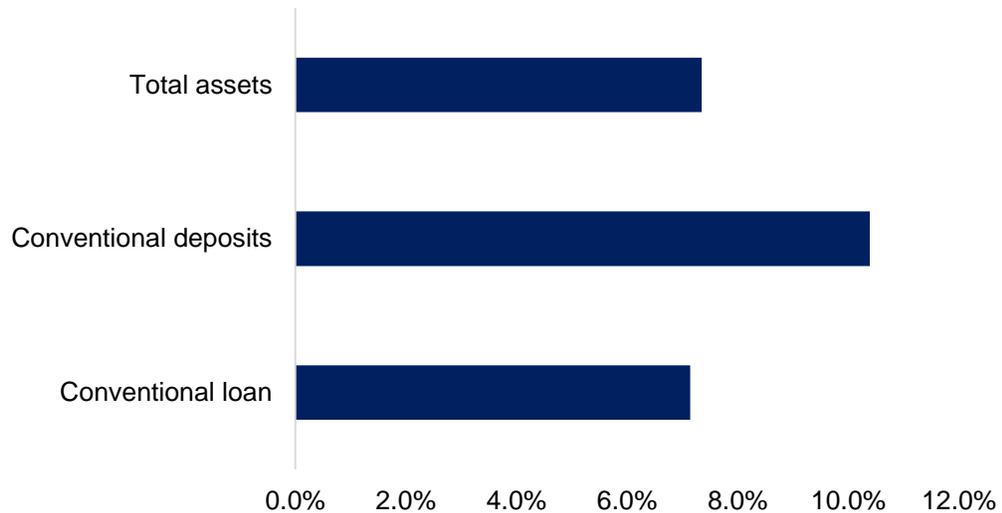
Asset quality weak, though improving: Post the merger of HSBC Oman and OIB, NPL of the bank increased from 1.2% in 2011 to 7.1% in 2012, after reassessment of the bank's loan portfolio. Since then, the NPL levels have fallen to 3.8% in 2017. Though the same is worse than industry average, we expect the same to improve in the medium term to average peer levels.

Profitability improvement to continue over the medium term: In 2017, 27% of the bank's operating assets were made up of investments, this is substantially higher than the industry average of 11%. The lower yield from these investments has been pressuring the bank's profitability resulting in ROA of 0.8% in 2017, lower than the peer company average of 1.2%. However, with the implementation of new interbank transaction guidelines introduced by the CBO, the bank has been trying to improve its asset composition, leading to 590% growth in its higher yielding interbank book. This has resulted in a positive impact on the profitability of the bank, with net income expected to grow by 50% in 2018 to 28.6 million. We estimate the bank to report the highest long term profitability CAGR of 13% during 2017-22E, among all the domestic banks in the Sultanate.

Strong capital quality: Tier 1 ratio of HBMO at 16% was higher than the industry average of 15.2%. High equity base aided the higher capitalization of the bank. Quality of capital was also strong, with the same being made substantially by equity. We expect the bank to continue to have strong capitalization, better than or equal to peer average in the medium term.

Strong business franchise aided by strong parent

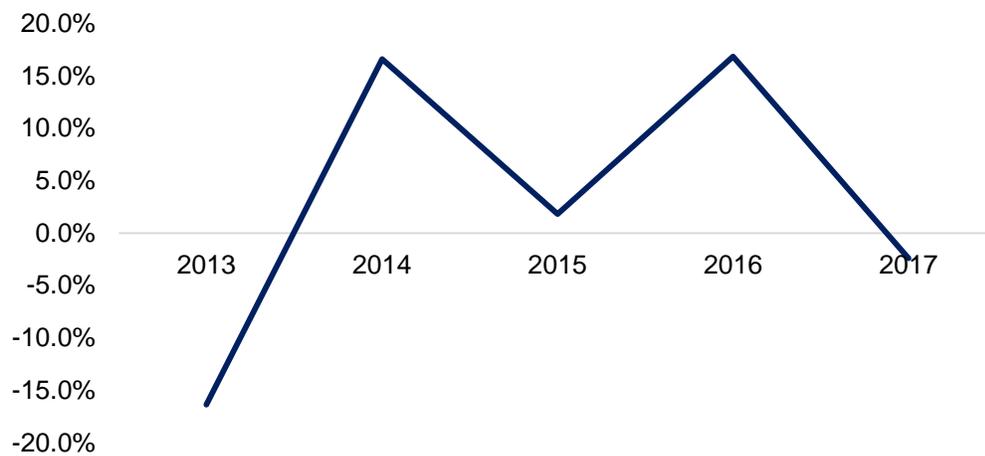
Figure - 1 Market share of HBMO



Source: Company filings, US Research

HBMO has a moderate market position in Oman, with a market share of 7% in terms of conventional loans and total assets and 10.4% in terms of conventional deposits. Despite its small market presence in the country, we feel that the bank has a strong business franchise aided by a strong parentage in the form of HSBC Holding PLC. It holds 51% stake in HBMO through HSBC Middle East Holding BV. HSBC is one of the leading financial corporations in the world catering to 38 million customers, 67 markets that account for more than 90% of the global GDP, with a total capital of USD182 billion. It is also the number one global transaction bank and international bank in Asia and is a top 3 dividend payer among companies listed in FTSE. Apart from the financial support the bank is likely to receive in case of need, the parent also provides substantial international experience, best practices and operating knowledge.

Figure - 2 Growth in conventional loan

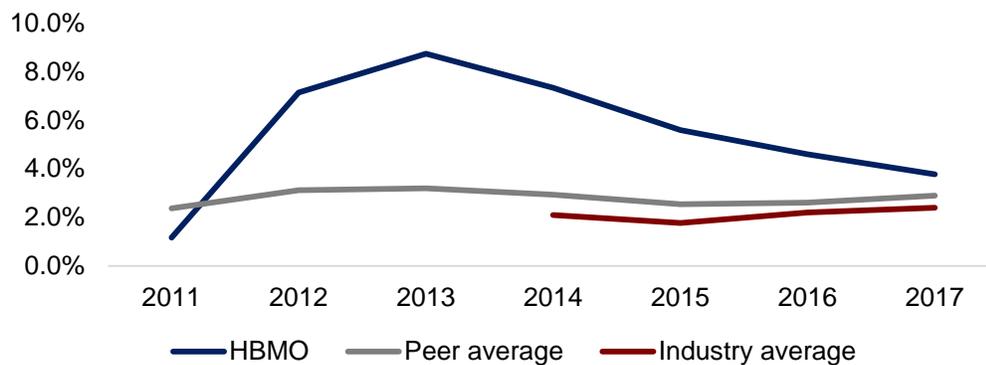


Source: Company filings, US Research

Gross loans and advance fell by 2.4% YoY and was mainly due to the repayment of a short term borrowing by a single large customer. Going forward, we expect the bank to improve its business model, by increasing its composition of loans to total assets. The same has increased from 50% in 2012, when HBMO merged its operations with OIB. We expect this trend to continue, which in turn is likely to aid in strong growth in the medium term.

Legacy issues with problem loans might defer asset quality improvement

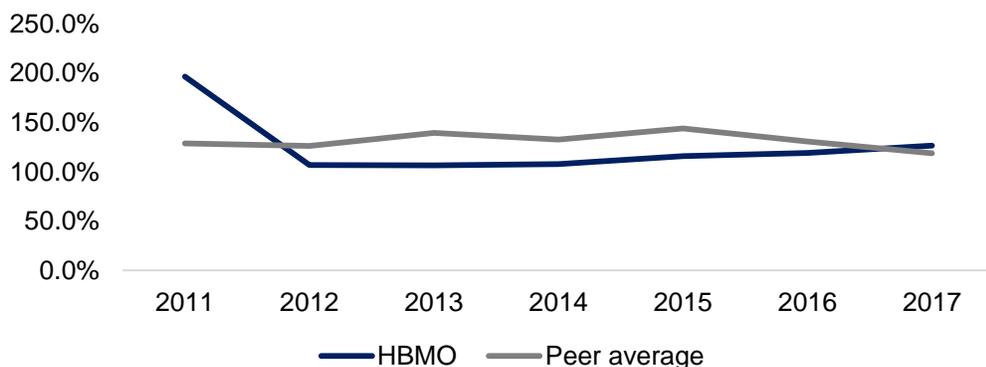
Figure - 3 NPL levels of HBMO



Source: Company filings, US Research

Asset quality of HBMO has fallen from 4.6% in 2016 to 3.8% in 2017, though the same was substantially higher than the industry average of 2.4% and peer average of 2.9%. The NPL levels increased from 1.2% in 2011 to 7.1% in 2012, after review of the loan portfolio by HSBC post-merger. Since then the NPL levels have been coming down consistently. We see this move as positive, since it gives a better picture on the asset quality of the bank. Going forward, we expect this trend to continue and the NPL levels are likely to fall to industry average levels over the medium term. NPL coverage at 126.6% was higher than the industry average of 118.9% for 2017 and we expect the bank to continue to maintain coverage higher than industry average. Added to this, we expect the NPL coverage to increase, as the bank's exposure to NPL comes down while provisions remain stable.

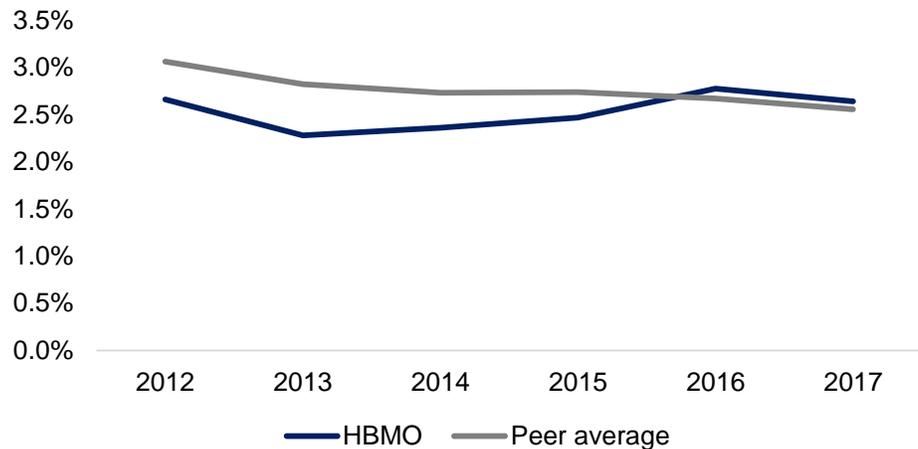
Figure - 4 NPL coverage of HBMO



Source: Company filings, US Research

Profitability consistently below industry average, though the same is expected to improve going forward

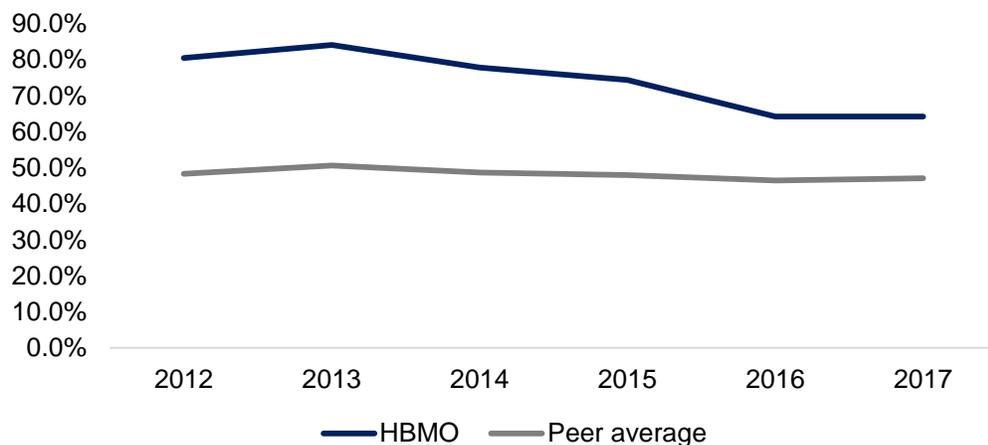
Figure - 5 NIM trend



Source: Company filings, US Research

HBMO's revenue stream in 2017 was concentrated with net fee income contributing to a moderate 15.5%. The proportion of other income on the other hand was high at 12% for the same period. However, we expect the proportion of other income to come down going forward, as we expect the bank to focus more on improving its assets composition. Net interest income of HBMO was flat at OR54.2 million, in line with 2016 levels, in line with the flat growth in gross loans. NIM of HBMO at 2.6% was in line with peer average for 2017. Though the asset yield of HBMO was relatively low, due to its high proportion of earnings assets coming from investments, it also had a relatively low cost of funds, given that it had one of the best funding structure in the industry. With c.85% of its funding coming from deposits, the bank has a relative advantage in terms of cost of funds, which in turn makes up for the lower yield. Going forward, we expect the NIM to improve from the current levels, as the proportion of loans and advances to total assets improves.

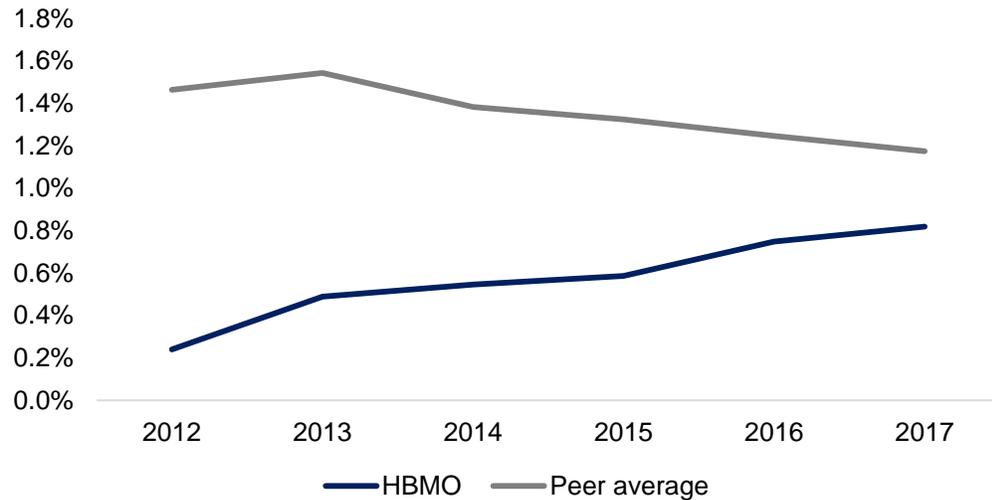
Figure - 6 Cost to income trend



Source: Company filings, US Research

Provisions for loan losses fell marginally by 2% YoY to RO 5.5 million, though the same was relatively high compared to its historical levels. Operating expenses on the other hand were flat, with cost to income ratio high at c.64%, yet substantially higher than industry average of 47% in 2017. Going forward, we expect this to come down, in line with improvement in total income.

Figure - 7 ROA trend

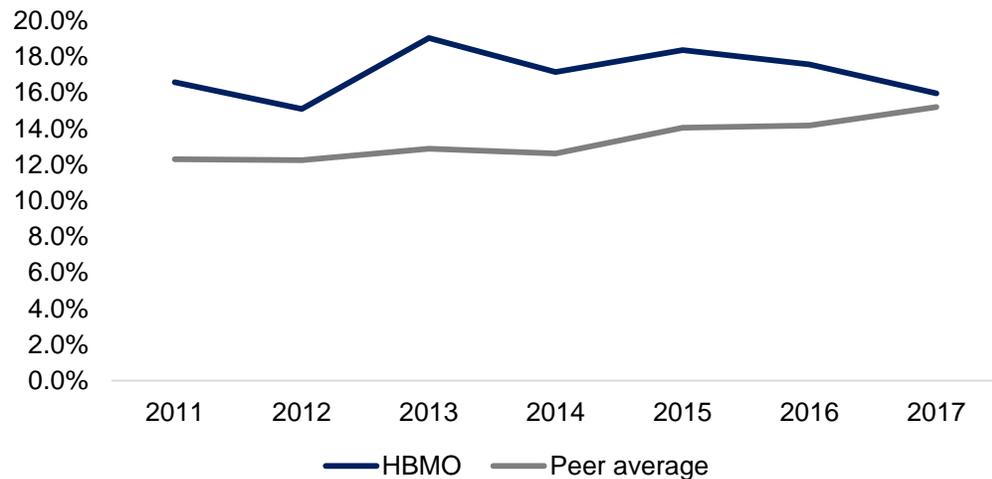


Source: Company filings, US Research

Overall ROA of the bank at 0.8% in 2017, was slightly lower than 2016 levels of 0.7% and peer average 1.2% in 2017. Going forward, we expect this too to improve, in line with the change in asset composition of the bank.

Strong capital quality, aided by its relatively lower risk balance sheet

Figure - 8 Tier 1 capital trend



Source: Company filings, US Research

Capital quality of HBMO was strong with a tier 1 ratio of 16.0% for 2017, flat in line with 2016 levels and better than the industry average of 15.2%. Capital quality of HBMO was very strong with more than 90% of its total capital being in the form of equity. Apart from this the bank's reliance on tier 2 capital was also low, with the same accounting for a mere 6% of tier 1 capital. This in turn offers the bank substantial flexibility to manage future growth. Apart from a strong equity base, capitalization of the bank was also aided by a relatively low RWA to total assets of 82.1% in 2017, compared to the industry average of 92%. However, we feel that this is likely to converge to industry average in the medium term, as the asset composition of the bank converges with the industry average.

Funding profile and liquidity best among its peers

In 2017, 84% of the bank's funding was from deposits, amongst the highest in the industry, while market funding contributing a mere 2%. We feel that the funding profile of the bank was amongst the best in the industry. Though deposits of the bank are likely to be concentrated in line with its peers, this we feel is part of the systematic risk of investing in Omani banks. With loans to deposits ratio of 75.8% was also the lowest in the industry, aiding liquidity. Apart from this the bank also had strong liquid assets accounting for 37.6% of tangible assets and 44.5% of short term funding. While we expect the proportion of liquid asset to come down, the same is likely to be more than sufficient to manage the banks liquidity risk. Added to this, we feel that the loans to deposits ratio is also likely to continue to be at favorable levels for the bank.

Quarterly performance – 9M18

Figure - 9 Key quarterly financials

9M18 financial statement	9M18	9M17	YoY change
Net interest income	45.0	39.8	13.2%
Other income	19.1	15.5	23.0%
Total income	64.1	55.3	15.9%
Impairments	3.0	-2.6	-215.9%
Net total income	67.1	52.7	27.4%
Operating cost	-37.0	-36.3	1.9%
Profit before tax	30.1	16.4	83.9%
Income tax	-5.1	-2.7	88.8%
Net income	25.0	13.7	83.0%
Key balance sheet items			
Net loans and advances	1,440	1,332	8.1%
Earning assets	2,211	2,224	-0.5%
Liquid assets	607	971	-37.5%
Customers deposits	1,942	2,003	-3.1%
Equity	334	318	5.0%
Total assets	2,348	2,416	-2.8%

Source: Company filings, US Research

Total income of HBMO increased by 15.9% YoY to RO 64.1 million and was aided by increase in income across revenue streams. Net interest income increased by 13.2% YoY and was aided by favourable changes in the asset mix leading to 25 bps improvement in net yield. Net non interest income in 9M18 was higher by 23.0% YoY in, which was contributed by investment income growth of 19.5%. Total impairments in 9M18 was a net writeback of RO 3.0 million, compared to RO 2.6 million of provisions. Operating expenses increased by 1.9% YoY in 9M18, but operating efficiency improved to 55.1% vis-à-vis 68.9% in 9M17. The improvement was aided mainly by higher total income. Overall ROA of HBMO witnessed remarkable improvement to 1.4% in 9M18, contributed by the improvement in asset composition and increased yield from investments.

Figure - 10 Key ratios

Ratios	1H18	2017
Capital Quality		
Tier 1	17.7%	16.0%
Asset Quality		
NPL to total loans	3.9%	3.8%
Provisions to NPL	128.3%	126.6%
Provisions to gross loans	5.0%	4.8%
Earnings quality		
Net yield	2.6%	2.6%
Cost to income ratio	55.1%	68.9%
ROA	1.4%	0.8%
Liquidity and Funding		
Market funds to tangible assets	1.6%	1.5%
Liquid assets to tangible assets	40.4%	37.6%

Source: Company filings, US Research

Asset quality was nearly flat in 9M18, as NPL to gross loans at 3.9% was almost in line with 3.8% in 2017. NPL coverage on the other hand improved marginally to 128.3%, compared to 126.6% in 2017.

We valued HSBC Bank Oman at RO 0.126 using Residual income valuation method

We have discounted the residual income of HBMO using a cost of equity 10.7%, derived from a risk-free rate 5.0%, beta of 0.9x and equity risk premium of 6.5%. We have assumed a terminal growth rate of 3.0%, beyond our forecast period. The value arrived based on this method is RO 0.126 per share, a 6.6% upside from the current market price.

Figure - 11 Residual valuation of HBMO

Residual Valuation	2018E	2019E	2020E	2021E	2022E
Equity O/b	323	338	352	369	386
Net income	29	29	33	34	35
Cost of equity	(35)	(36)	(38)	(40)	(41)
Residual income	(6)	(8)	(4)	(5)	(6)
Discounted residual income	(6)	(6)	(3)	(4)	(4)
Terminal value (RO mn)					(49)
Equity value (RO mn)					252
Value per share (RO)					0.126
CMP (RO)					0.118
% upside					6.6%
Implied P/BV (2018E)					0.8x

Source: Company filings, US Research

For our relative valuation we have used the five years P/BV multiple of HBMO, which is at 1.0x, implying a price of RO 0.169 per share or a c.43% upside from the current market price.

Our base case blended weighted average of residual income and relative valuation of HBMO resulted in a 12-month target price of OR 0.143 per share, which offers an upside potential of c.21% from the current market price. Given the upside, we rate the stock as **STRONG BUY**.

Figure - 12 Blended Fair value of HSBC Oman at RO 0.143/Share

Methodology	Value per share	Weight	Average
Residual valuation	0.126	60%	0.075
Relative valuation	0.169	40%	0.068
Blended fair value of HSBC Bank Oman			0.143
CMP			0.118
upside			21%

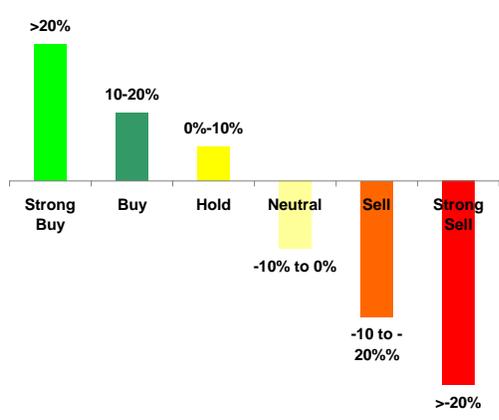
Source: Company filings, US Research

Income statement	2013	2014	2015	2016	2017	2018E	2019E	2020E	2021E	2022E
Net interest income	48	49	49	54	54	60	63	66	68	70
Fee income	12	13	13	12	12	12	13	14	15	16
Other Op. income	9	10	12	9	9	1	1	1	1	1
Total income	69	71	74	75	75	85	90	95	99	103
Total provisions/Impairments	2	(3)	(3)	(6)	(6)	(1)	(4)	(3)	(3)	(3)
Net total income	71	68	70	70	70	84	86	93	96	100
Total operating cost	(58)	(55)	(55)	(48)	(48)	(50)	(52)	(53)	(56)	(58)
Profit before tax	13	13	15	21	21	3428	34	39	40	41
Income tax expense	(2)	(1)	(2)	(4)	(2)	(5)	(5)	(6)	(6)	(6)
Net income	11	12	13	17	19	29	29	33	34	35

Balance sheet	2013	2014	2015	2016	2017	2018E	2019E	2020E	2021E	2022E
Cash and balances with CBO	118	180	278	285	224	224	224	224	224	224
Due from banks	194	156	10	80	40	280	280	280	280	280
Loans, advances and financing, net	980	1,161	1,201	1,418	1,395	1,533	1,682	1,814	1,877	1,943
Investments	823	666	633	413	615	563	474	511	536	565
Other assets	62	36	42	23	29	29	29	29	29	29
Intangible assets	12	10	8	6	3	1	0	0	0	0
Property and equipment	31	30	27	27	26	26	26	26	26	26
Deferred tax assets	0	3	1	2	2	2	2	2	2	2
Total Assets	2,221	2,243	2,200	2,254	2,334	2,417	2,477	2,645	2,733	2,828
Liabilities										
Due to banks	42	29	36	37	36	25	27	18	8	8
Customers' deposits	1,793	1,852	1,802	1,867	1,932	2,008	2,044	2,198	2,274	2,354
Other liabilities	81	48	50	30	38	44	49	54	54	47
Current tax liabilities	0	2	2	6	5	5	5	5	5	5
Deferred tax liabilities	0	1	0	0	0	0	0	0	0	0
Total Liabilities	1,915	1,933	1,891	1,940	2,011	2,082	2,125	2,274	2,341	2,414
Shareholders' Equity	306	310	309	314	323	335	352	371	392	414
Total Liabilities and Equity	2,221	2,243	2,200	2,254	2,334	2,417	2,477	2,645	2,733	2,828

Ratios	2013	2014	2015	2016	2017	2018E	2019E	2020E	2021E	2022E
Capital Quality										
Tier 1	19.0%	17.2%	18.4%	17.6%	16.0%	15.5%	15.3%	14.7%	15.0%	15.4%
Total capital ratio	20.2%	18.2%	19.4%	18.7%	16.9%	16.3%	16.2%	15.5%	15.8%	16.1%
Equity to total assets	13.8%	13.8%	14.0%	13.9%	13.9%	13.9%	14.2%	14.0%	14.3%	14.6%
RWA to total assets	65.4%	73.1%	71.8%	74.5%	82.1%	85.1%	88.1%	91.1%	91.1%	91.1%
Asset Quality										
NPL to total loans	8.8%	7.3%	5.6%	4.6%	3.8%	3.3%	2.8%	2.5%	2.5%	2.5%
Provisions to NPL	106.7 %	107.9 %	115.8 %	119.1 %	126.6 %	135.3 %	142.5 %	147.6 %	147.6 %	147.6 %
Provisions to gross loans	9.3%	7.9%	6.5%	5.5%	4.8%	4.4%	4.0%	3.7%	3.7%	3.7%
Earnings quality										
NIM - Conventional	2.3%	2.4%	2.5%	2.8%	2.6%	2.7%	2.8%	2.9%	2.9%	2.9%
Yields on Islamic Financing	16.8%	17.7%	17.0%	16.4%	15.5%	16.0%	15.7%	15.6%	15.4%	15.4%
Fee income to total income	-30.7x	24.5x	21.3x	13.2x	13.6x	72.5x	-45.6x	322.0x	38.7x	38.8x
Provision coverage	84.2%	77.9%	74.4%	64.3%	64.2%	63.3%	53.7%	49.5%	46.1%	43.4%
Cost to income ratio	0.5%	0.5%	0.6%	0.7%	0.8%	1.0%	1.4%	1.4%	1.5%	1.6%
ROA	3.6%	4.0%	4.2%	5.4%	5.9%	7.1%	9.7%	10.3%	10.5%	10.8%
ROE	2.3%	2.4%	2.5%	2.8%	2.6%	2.7%	2.8%	2.9%	2.9%	2.9%
Liquidity and Funding										
Deposits to total funding	83.8%	84.5%	83.9%	84.2%	84.3%	84.8%	84.3%	84.9%	85.0%	84.8%
Market funds to total funds	2.0%	1.3%	1.7%	1.7%	1.6%	1.1%	1.1%	0.7%	0.3%	0.3%
Market funds to tangible assets	1.9%	1.3%	1.7%	1.7%	1.5%	1.0%	1.1%	0.7%	0.3%	0.3%
Liquid assets to short term funds	61.1%	52.5%	49.9%	40.7%	44.5%	40.5%	35.5%	34.9%	34.9%	35.0%
Liquid assets to tangible assets	50.7%	44.3%	41.9%	34.5%	37.6%	34.1%	29.7%	29.2%	29.2%	29.2%
Valuation										
Dividend yield	0.5%	2.4%	4.3%	3.7%	4.0%	5.2%	7.5%	8.4%	9.0%	9.8%
P/E	34.6x	26.2x	19.7x	12.3x	13.0x	9.6x	6.7x	6.0x	5.6x	5.1x
P/BV	1.2x	1.0x	0.8x	0.7x	0.8x	0.7x	0.6x	0.6x	0.6x	0.6x

Rating Criteria and Definitions

Rating	Rating Definitions
	<p>Strong Buy This recommendation is used for stocks whose current market price offers a deep discount to our 12-Month target price and has an upside potential in excess of 20%</p> <p>Buy This recommendation is used for stocks whose current market price offers a discount to our 12-Month target price and has an upside potential between 10% to 20%</p> <p>Hold This recommendation is used for stocks whose current market price offers a discount to our 12-Month target price and has an upside potential between 0% to 10%</p> <p>Neutral This recommendation is used for stocks whose current market price offers a premium to our 12-Month target price and has a downside side potential between 0% to -10%</p> <p>Sell This recommendation is used for stocks whose current market price offers a premium to our 12-Month target price and has a downside side potential between -10% to -20%</p> <p>Strong Sell This recommendation is used for stocks whose current market price offers a premium to our 12-Month target price and has a downside side potential in excess of 20%</p> <p>Not rated This recommendation used for stocks which does not form part of Coverage Universe</p>

Disclaimer

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