Gulf Bank (GBK)

Recommendation	OUTPERFORM	Risk Rating	R-3
Share Price	KWd 268	Target Price	KWd 325
Implied Upside	+21.2%		

Restructuring Process Has Been a Success; Initiate With Outperform

Gulf Bank has been going through a restructuring process since the fallout of the 2008-2009 financial crisis coupled with a structured derivatives product that eroded the bank's equity. The bank has successfully turned around and is focused on regaining lost market share. GBK trades at a 27% discount to its historical P/B and a 2019e PEG of 0.7x. Moreover, the market is pricing in a sustainable RoE of 11.5% vs. 12.5% based on our estimates. The stock has performed well but has lagged its peers (CBK, NBK & KIB) over the last 12 months and we believe there is room for more upside. We initiate coverage with an Outperform rating and a PT of KWd (Fils) 325/sh.

Highlights

- **Strong earnings growth on the horizon:** We pencil in a bottom-line CAGR of 15.6% in 2017-2022e vs. +9.2% (2012-2017). This accelerating growth forecast in net income should be driven by net operating income, which we model to grow by 8.3% and small fall in credit provisions. *Having said this, there could be further upside to our estimates if GBK reduces provisions more than our model expectations*. Like all Kuwaiti banks, general/precautionary provisions (imposed by the Central Bank) are much greater than specific provisions (79% of total reserves are general and not specific). As such, hefty reversals or netting these built up reserves against impairments (when IFRS 9 is applied) can unlock value, boosting profitability (RoE > 12%).
- **Kuwait focused bank (90% of loans):** GBK initiated a balanced approach to its lending strategy. It focused on building its retail book, which almost doubled its contribution from 20% of total loans (2008) to 38% in 2017. Concurrently, it took a prudent approach to corporate lending. The retail portfolio expanded by a CAGR of 10.0% (2012-2017), while the corporate book remained flat during the same time frame. What is important to note is GBK reduced its exposure to the risky real estate sector; segment loans dropped by a CAGR of 10.1% (2012-2017); real estate makes up 13.7% of total loans ('17) vs. 28% in 2008. In line with its strategy, GBK operates the 2nd largest branch network among its conventional peers (58 branches).
- **NIMs to expand with further interest rate hikes given GBK's favorable deposits and loans mix.** We expect GBK to benefit from 2 expected interest rate hikes in 2019 for the following reasons: 1) Non-interest bearing deposits contribute 33% to total deposits, 2) Retail loans make up 38% of total loans (average duration of 2 years, positive for margin expansion), which command higher margins (in Kuwait existing retail loans are not instantly repriced with rate hikes; however, fresh loans are priced at higher rates) and 3) Corporate loans (62% of total loans) enjoy the advantage of being repriced instantly when interest rates go up. As such, GBK is at an advantage based on the above three points.
- **Clarity on IFRS 9 and lower CoR key to stronger profitability.** GBK, along with all other banks in Kuwait, has been booking excessive precautionary provisions since 2012 at the request of the Central Bank. With IFRS 9, given GBK's large general reserves (79% of total reserves), booking a one-time impairment charge against equity would not be detrimental. Going forward, we are of the view that GBK's general provisions would decrease, resulting in a significant drop in CoR. *Based on our industry checks, it seems that so far the Central Bank has not updated the banks on IFRS 9 implementation*.
- **Asset quality markedly improved; write-offs/reversals along with prudent risk control contributed positively.** GBK has cleaned up its books since 2009 when the NPL ratio reached a high of 30.33% to 1.80% in 2017. The jump in NPLs took place during the 2008 financial crisis when investment companies and real estate firms defaulted on their debts. The NPL ratio declined through write-offs and prudent risk control exercised by management. It is worth mentioning that GBK has been recovering a portion of the write-offs (further recoveries would be a positive surprise for earnings).
- **Strong capital position:** Based on our assumptions, we expect GBK to maintain a Tier-1 ratio of 14% and a dividend payout ratio of 50% without resorting to capital hikes. Moreover, with this trend we expect the bank to generate a RoE of 12% by 2020.

Catalysts

- 1) Clarity on implementation of IFRS 9 & 2) Possible MSCI EM & FTSE EM inclusion in 2019.

Recommendation, Valuation and Risks

- **Recommendation and valuation:** ***We assign a Price Target of KWd 325 and an Outperform rating.*** GBK is trading at a 2019e P/B and P/E of 1.2x and 11.4x, respectively. The stock is cheap trading at a PEG of 0.7x (below 1.0x) based on earnings of CAGR 15.6% (2017-2022e).
- **Risks:** 1) Geo-political factors, 2) Unexpected asset quality deterioration, 3) CoR does not improve & 4) Retail loans in the banking system significantly slows down.

Key Financial Data and Estimates

	FY2017	FY2018e	FY2019e	FY2020e
EPS (KWd) Reported	17.00	20.24	23.41	27.34
EPS Growth (%)	13.3	19.0	15.7	16.8
P/E (x)	16.2	13.2	11.4	9.8
BVPS (KWd)	207.5	218.7	232.1	247.5
P/B (x)	1.3	1.2	1.2	1.1
DPS (KWd)	9.00	10.00	12.00	14.00
Dividend Yield (%)	3.4	3.7	4.5	5.2

Source: Company data, QNBFS Research

Key Data

Current Market Price (KWd)	268
Dividend Yield (%)	3.7
Bloomberg Ticker	GBK KK
ADR/GDR Ticker	N/A
Reuters Ticker	GBKK.KW
ISIN	KW0EQ0100028
Sector	Banks & Financial Svcs.
52wk High/52wk Low (KWd)	283/233
3-m Average Volume ('000)	3,880.5
Mkt. Cap. ($ bn/KWD bn)	2.6/0.8
Shares Outstanding (mn)	2,898.1
1-Year Total Return (%)	+15.6
Fiscal Year End	December 31

Source: Bloomberg (as of December 17, 2018)

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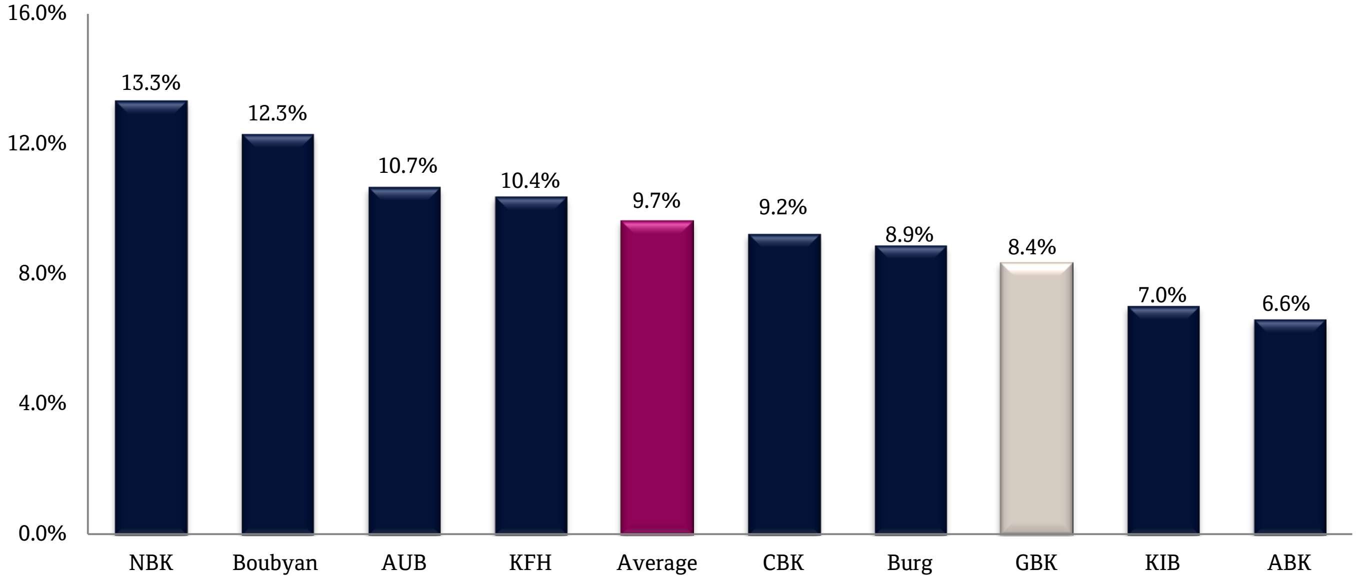
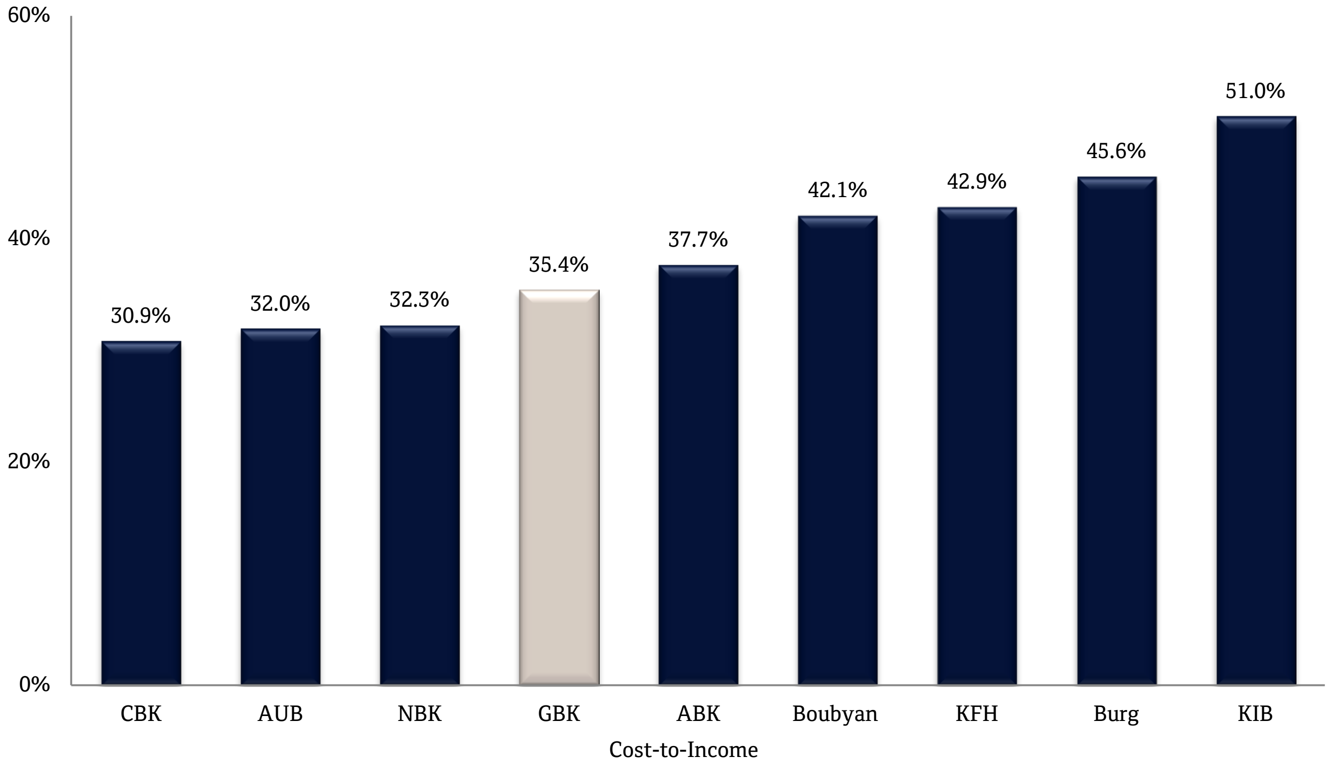
We Expect GBK to Generate RoE of 9.8% in 2018e and 12% by 2020e; Significant Improvement from 8.4% (2017)



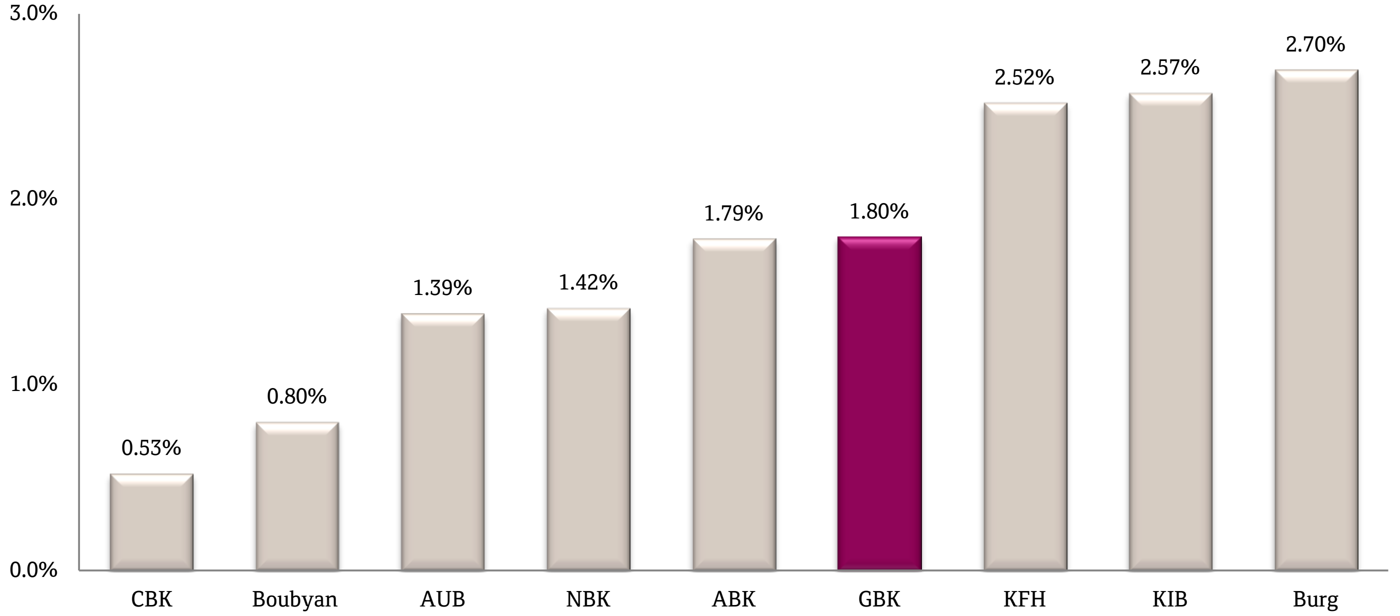
Source: Company data, QNBFS Research

Operating at an Optimal Level with Room for Modest Improvements



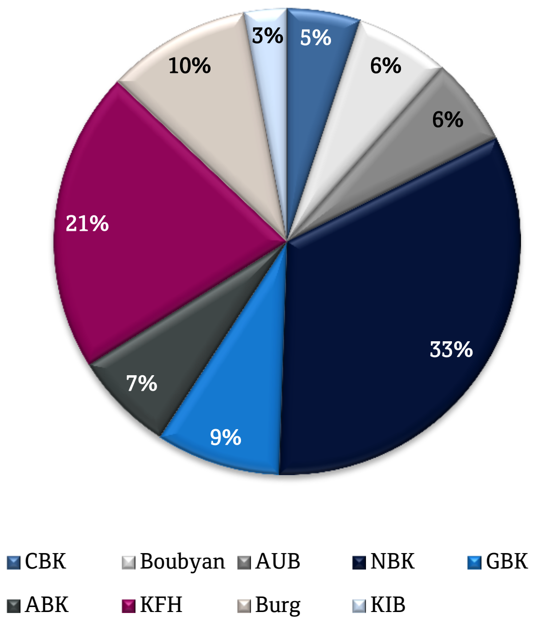
Source: Company data, QNBFS Research

NPL Ratio Drastically improved from 30% (2009) to 1.8% (2017) and Further to 1.5% in 9M2018



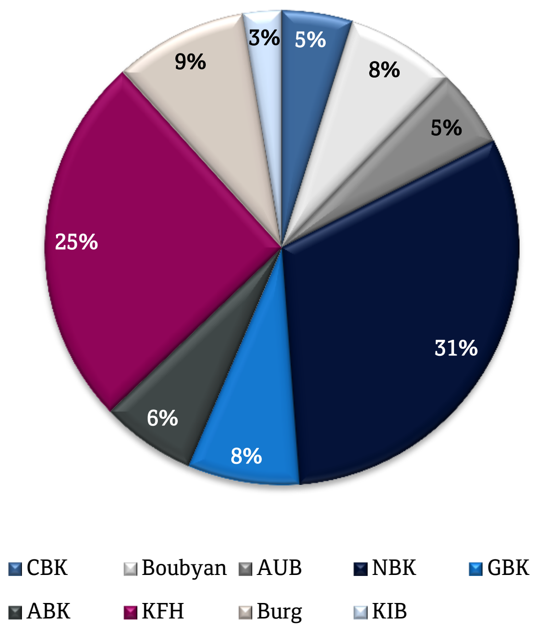
Source: Company data, QNBFS Research

4th Largest Market Share in Loans......................



Source: Company data, QNBFS Research

.... And Deposits



Valuation

We value GBK using 2 variations of the Residual Income Model (RI) – 1) Warranted Equity Valuation (WEV) and 2) RI based on a fundamental P/B:

a) We utilize a WEV technique derived from the Gordon Growth Model: P/B = (RoAE-g)/(Ke-g). This model uses sustainable return on average equity (RoAE) based on the mean forecast over the next seven years, cost of equity (Ke) and expected long-term growth in earnings (g) to arrive at a fair value for this stock. We consider this method best suited to arriving at an intrinsic valuation through the economic cycle.

b) We derive GBK's fair value by employing the RI valuation technique *(based on a fundamental P/B)*, which is calculated based on the sum of its beginning book value, present value of interim residuals (net income minus equity charge) and the present value of the terminal value (we apply a fundamental P/B multiple based on the Gordon Growth Model to the ending book value at the end of our forecast horizon). We derive the P/B from the Gordon Growth Model: P/B = (RoAE-g)/(Ke-g). This model uses sustainable return on equity (RoE) based on the median over our forecast period, cost of equity (Ke) and expected long-term growth in earnings (g) to arrive at fundamental/justified P/B. ***Based on this method we arrive at a fundamental P/B of 1.4x.***

The RI model is suitable for the following reasons: 1) when the company does not pay dividends or the pattern of dividend payments is unpredictable; 2) the company is expected to generate negative free cash flows for the foreseeable future and 3) as the traditional free cash flow to equity (FCFE) formula does not apply to banks. **A major advantage of RI in equity valuation is that a greater portion of the company's intrinsic value is recognized from the beginning BVPS as opposed to the terminal value (common in traditional FCFE methodology).**

We add Kuwait's 10 year swaps rate of 1.08% to the 10 year US government bond yield (3.01%) to arrive at a risk free rate of 4.1%. We factor in a beta of 1.0x. Finally, we add a local equity risk premium of 6.0% to arrive at a Ke of 10.63%.

Valuation Methodologies

Fundamental P/B (WEV)	
Sustainable RoE (%)	12.5
Estimated Cost of Equity (%)	10.30
Terminal Growth Rate (%)	5.0
Fundamental P/B	1.4x
Intrinsic Value (KWd)	328
Current Market Price (KWd)	268
Upside/(Downside) Potential (%)	+22.4

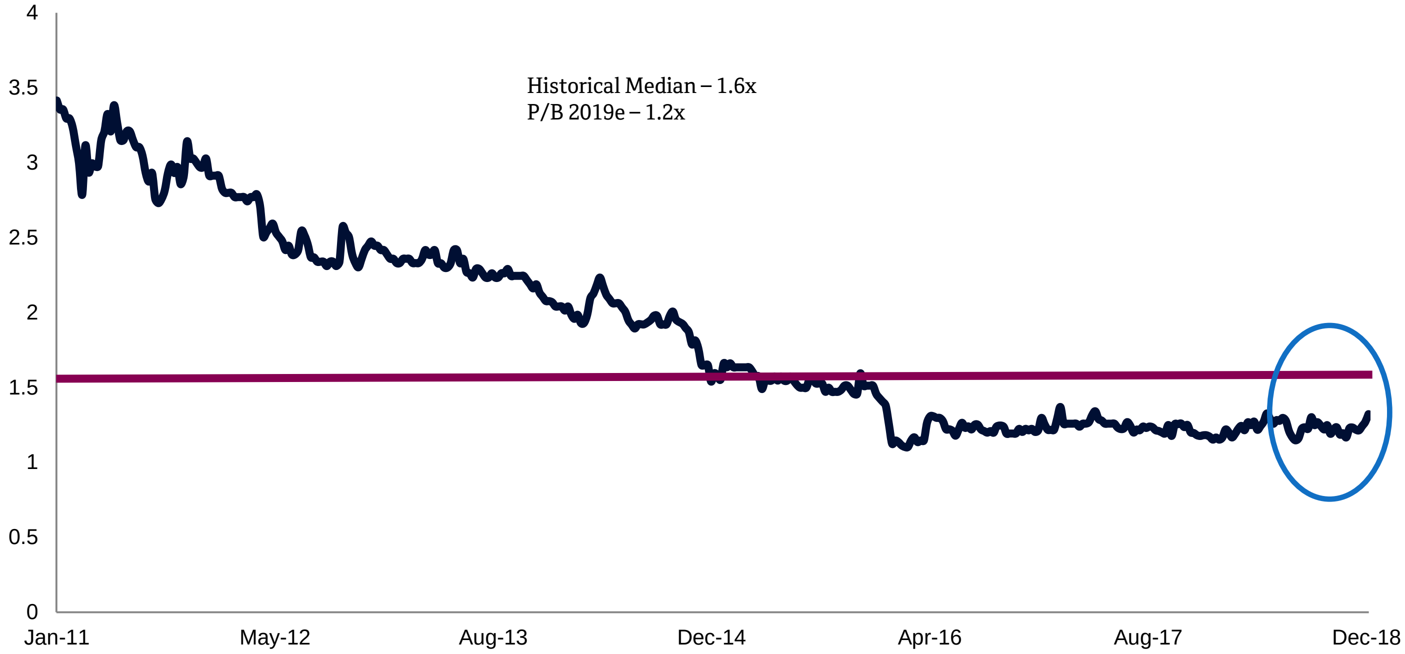
RI Based on Fundamental P/B	
Beginning BVPS (2019e) (KWd)	219
Present Value of Interim Residuals (KWd)	29
Present Value of Terminal Value (KWd)	74
Fundamental P/B	1.4x
Intrinsic Value (KWd)	322
Current Market Price (KWd)	268
Upside/(Downside) Potential (%)	+20.1

Source: QNBFS Research

Methodology	Equity Value (KWd)	Weight (%)	Weighted Fair Value (KWd)
Residual Income	322	50	161
WEV	328	50	164
Target Price			325
Closing Price			268
Upside/(Downside)			+21.2%

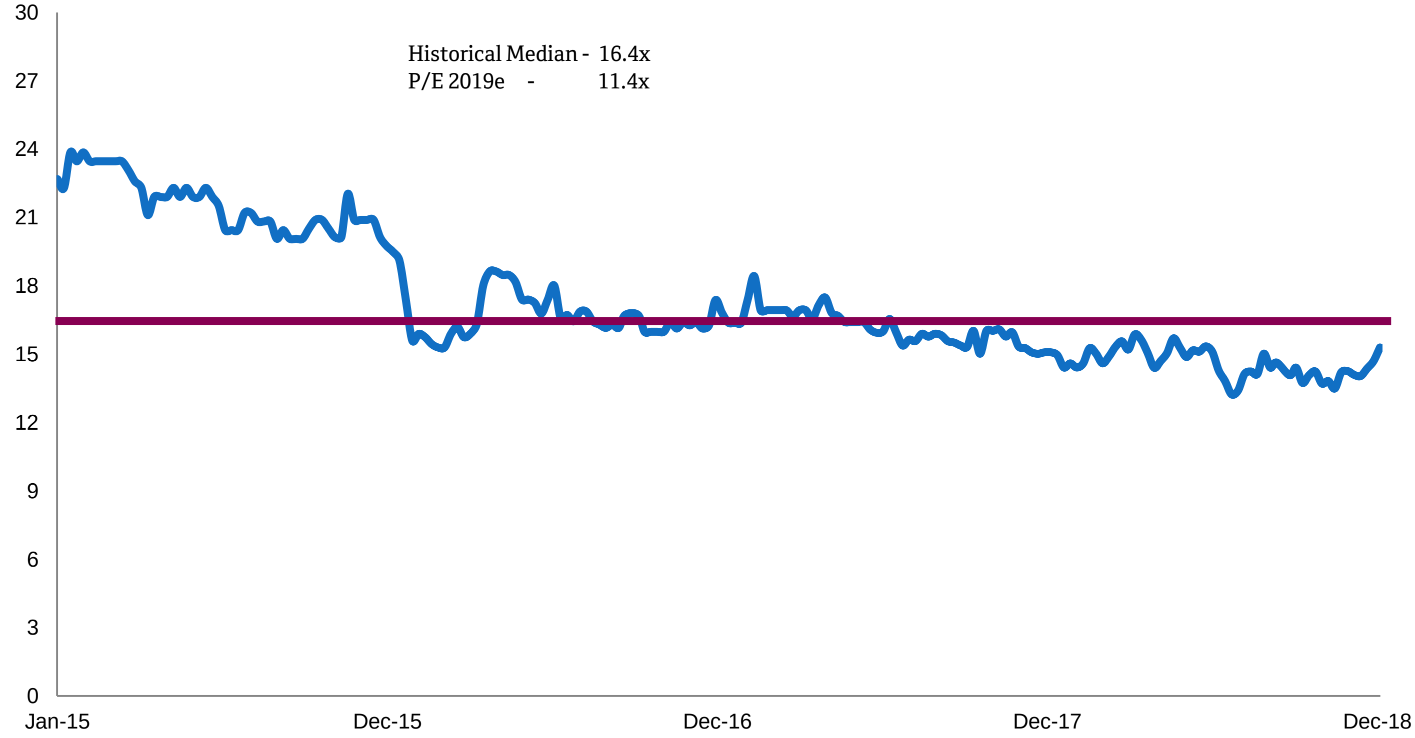
Source: QNBFS Research

Trading at a 27% Discount to its Historical P/B…



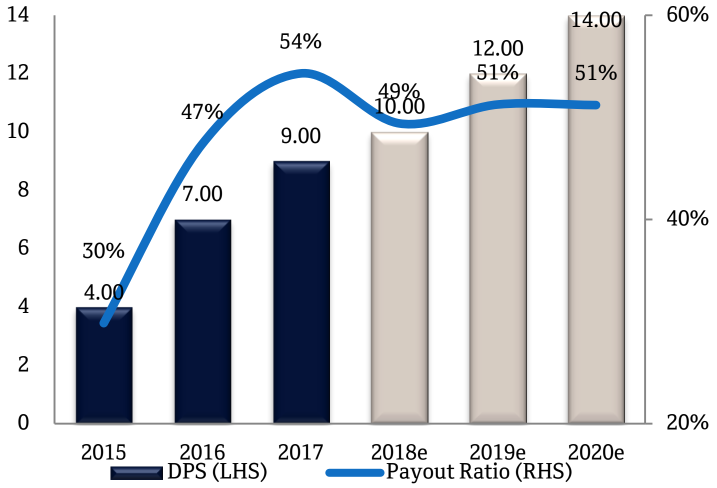
Source: Bloomberg, QNBFS Research

…And a 30% Discount to its Historical P/E

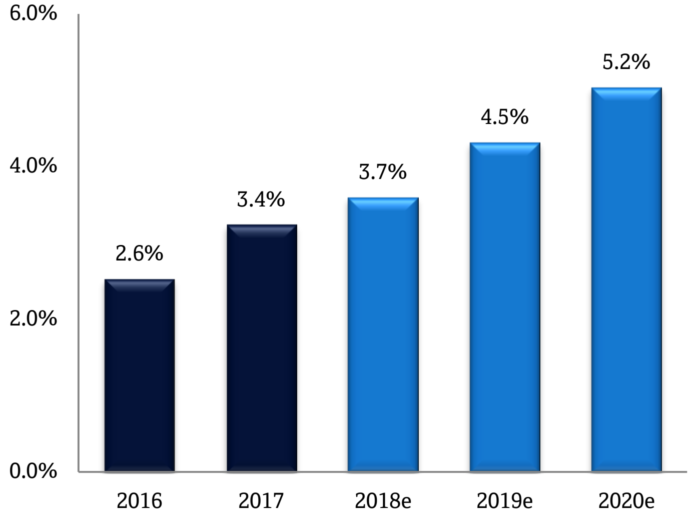


Source: Bloomberg, QNBFS Research

Started Paying Dividends (KWd) in 2015 After a 7 Year Hiatus



Healthy Yield



Source: Company data, QNBFS Research

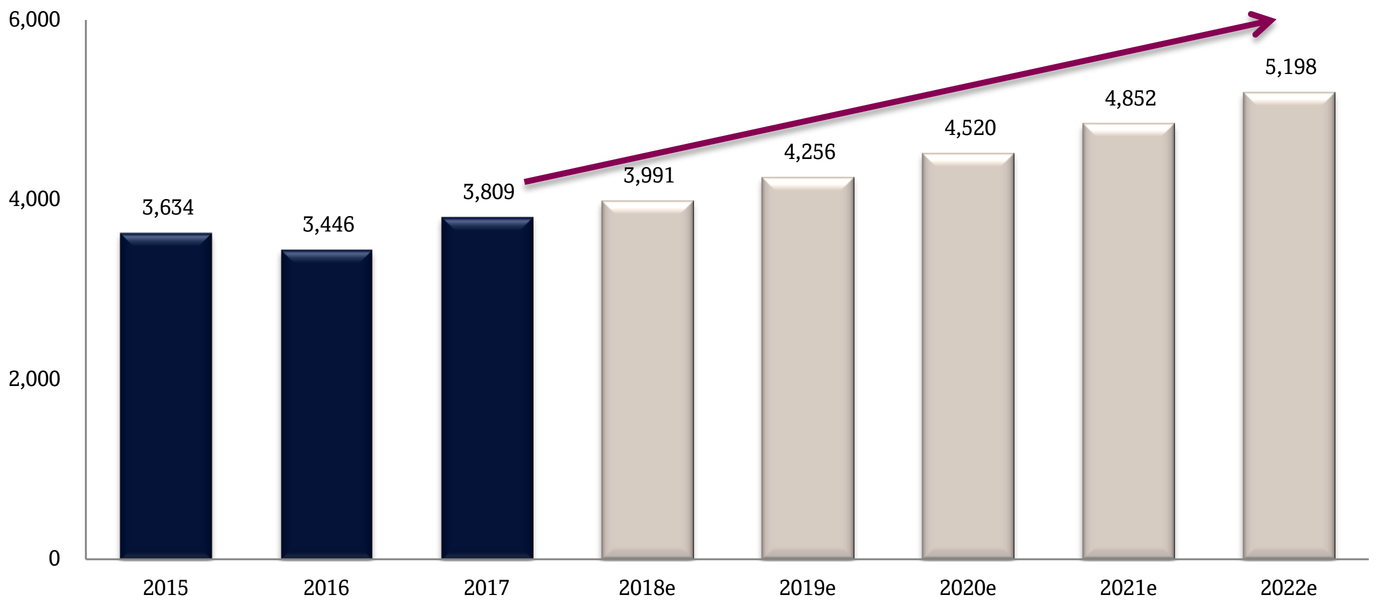
GBK started paying dividends in 2015 after a 7 year hiatus. GBK's treasury entered into a f/x derivative structured product on behalf of a client which generated losses for the bank. Hence the equity base was almost wiped out. Thus, the bank generated accumulated losses in 2008-2010. In 2009, the bank recapitalized with the help of Kuwait Investment Authority and Al Ghanim (founding shareholders). Due to this event, the bank did not pay dividends from 2008-2014 and instead bolstered its capital base. GBK started paying dividends in 2015. We are of the view that the bank would be able to maintain a 50% dividend payout ratio going forward.

Key Forecasts

Loan Portfolio

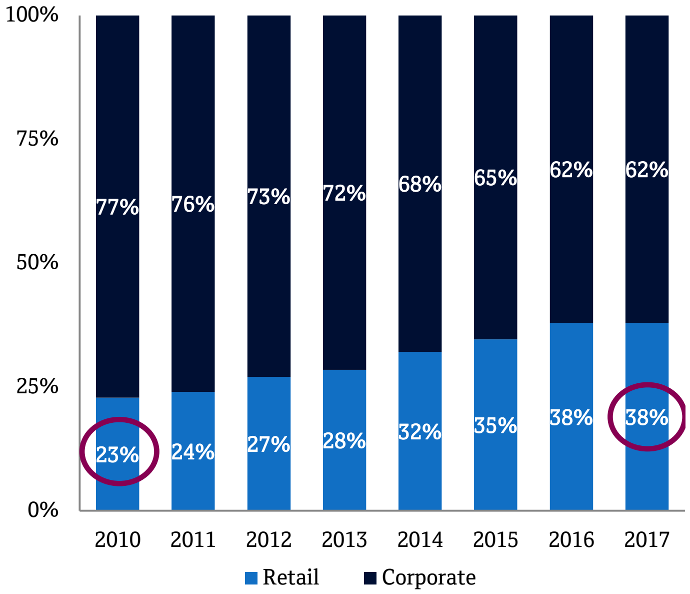
GBK is a Kuwait focused bank (~90% of loan book is based in Kuwait) and has a 9% market share in loans and 8% market share in deposits; we pencil in a loan book CAGR (2017-22e) of 6.4%. GBK initiated a balanced approach to its lending strategy. It focused on building its retail book, which almost doubled its contribution from 20% of total loans (2008) to 38%% in 2017. At the same time, it took a prudent approach to corporate lending. The retail portfolio expanded by a CAGR of 10.0% (2012-2017) while the corporate book remained flat during the same time frame. What is important to note here is that GBK reduced its exposure to the risky real estate sector, which led to segment loans falling by a CAGR of 10.1% (2012-2017). Hence, real estate represents 13.7% of total loans (2017) vs. 28% in 2008. Regarding real estate lending, the bank lends against cash flows vs. undeveloped projects in the past (GBK may still finance undeveloped projects depending on the developers' track record). In line with its strategy, the bank operates the 2nd largest network of branches in Kuwait among its conventional peers (58 branches vs. 60 domestic branches by NBK).

Loans (KWD mn) to Exhibit 6.4% CAGR vs. 2.8% (2012-17)



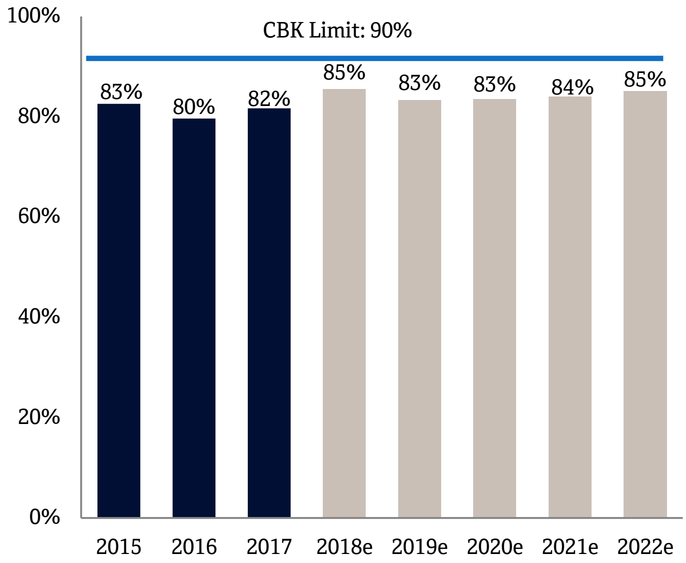
Source: Company data, QNBFS Research

Retail Book Increasing in Size

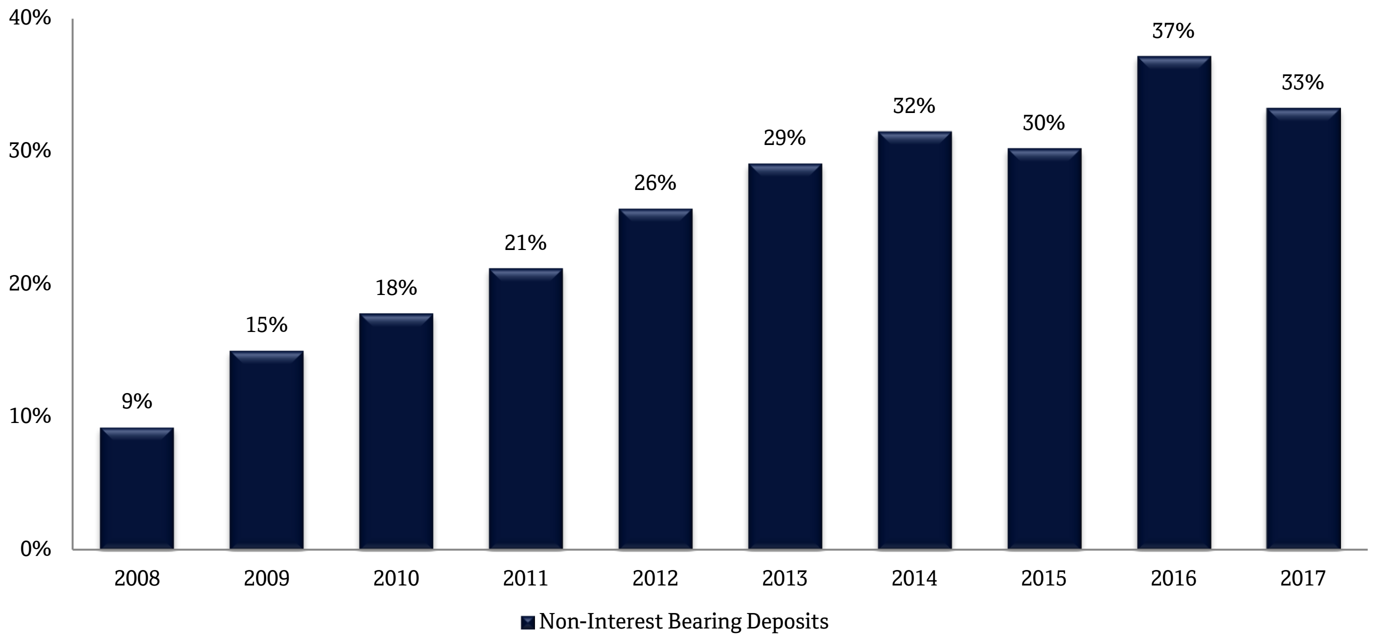


Source: Company data, QNBFS Research

LDR (incl. OFIs) Below CBK Limit; Room for Expansion



Non-Interest Bearing Deposits to Total Deposits is Pretty Significant; Supports Margin Expansion

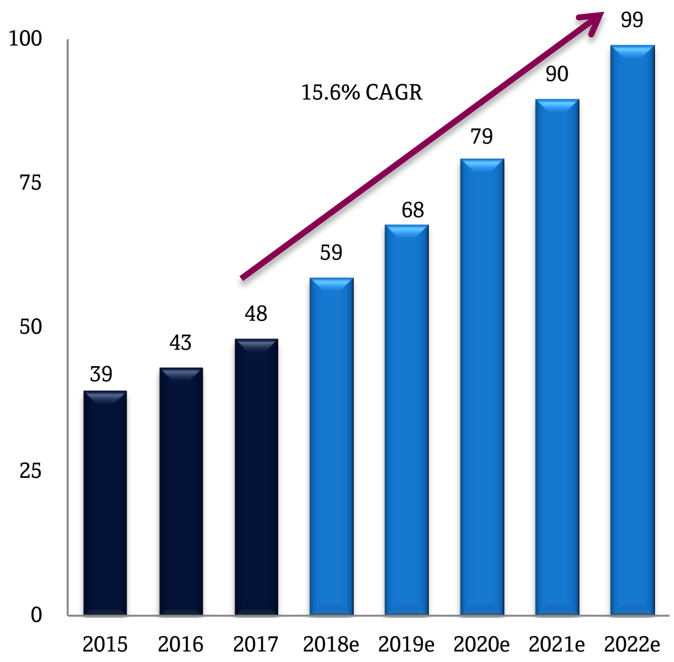


Source: Company data, QNBFS Research

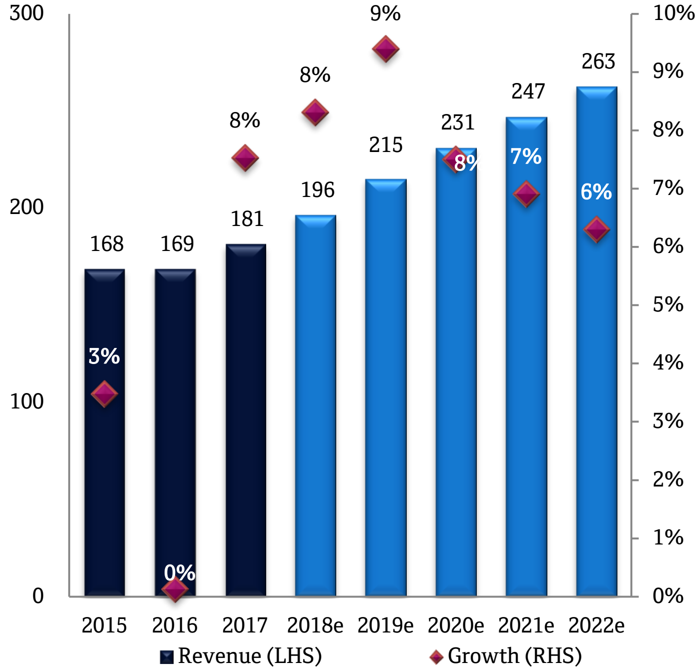
Operating Performance

We pencil in a bottom-line CAGR of 15.6% in 2017-2022e vs. +9.2% (2012-2017). The growth in net income is expected to be driven by net operating income, which we model to grow by 8.3% and a small decline in credit provisions. *Having said this, there could be further upside to our estimates if GBK reduces provisions more than our model expectations*. Like all Kuwaiti banks, general/precautionary provisions (imposed by the Central Bank) are much greater than specific provisions. As such, hefty reversals or netting these built up reserves against impairments (when IFRS 9 is applied) can unlock value, boosting profitability (RoE should materially increase). A recent settlement against a non-performing corporate loan resulted in an acquisition of a land property (in Fahaheel) and its subsequent sale to KIPCO's subsidiary. This led to an increase to total revenue of KWD 36.5mn. Moreover, ~KWD 19.7mn of interest is included GBK's total claim which is being disputed by the debtor and its guarantor (if GBK wins the court case, this amount would go directly to interest income). However, it is worth mentioning here that given the Central Bank's (CBK) conservative nature, CBK may require the bank to book more general provisions against KWD 36.5 recovery. In light of this, we have not included this amount in our 2018 earnings forecast.

Net Profit (KWD mn)

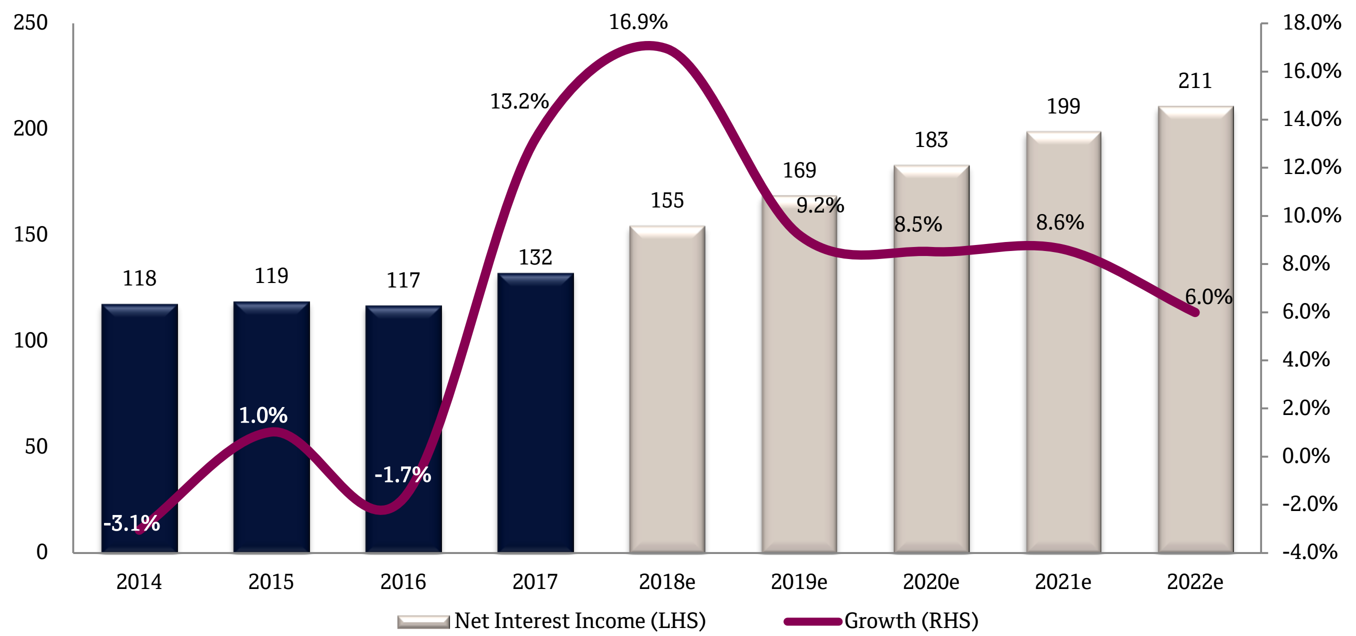


Total Revenue (KWD mn)



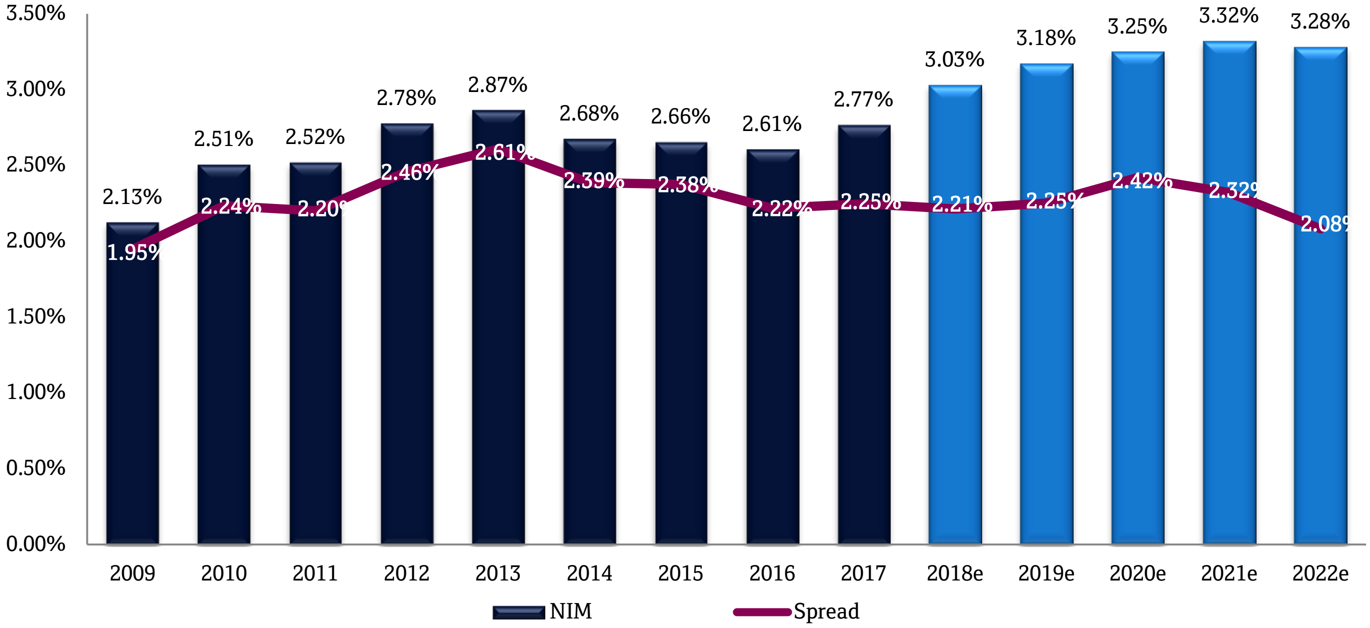
Source: Company data, QNBFS Research

Net Interest Income (KWD mn)



Source: Company data, QNBFS Research

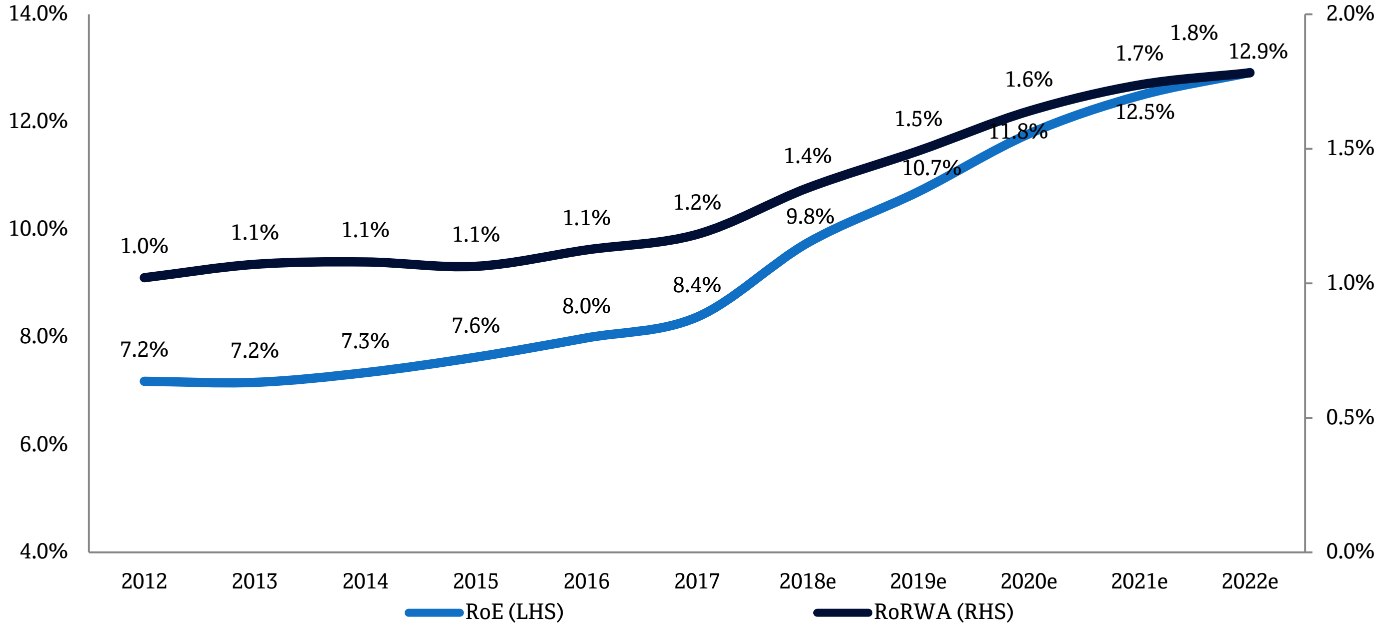
NIMs to Further Expand With Two Expected Rate Hikes



Source: Company data, QNBFS Research

NIMs to expand with further interest rate hikes given GBK's favorable deposits and loans mix. We expect GBK to benefit from 2 expected interest rate hikes in 2019 for the following reasons: 1) Non-interest bearing deposits contribute 33% to total deposits, 2) Retail loans make up 38% of total loans (average duration of 2 years, positive for margin expansion) which command higher margins (in Kuwait existing retail loans are not instantly repriced with interest hikes; however, fresh loans are priced at higher rates) and 3) Corporate loans (62% of total loans) enjoy the advantage of being repriced instantly when interest rates go up. As such, GBK is at an advantage based on the above three points.

RoE is Improving

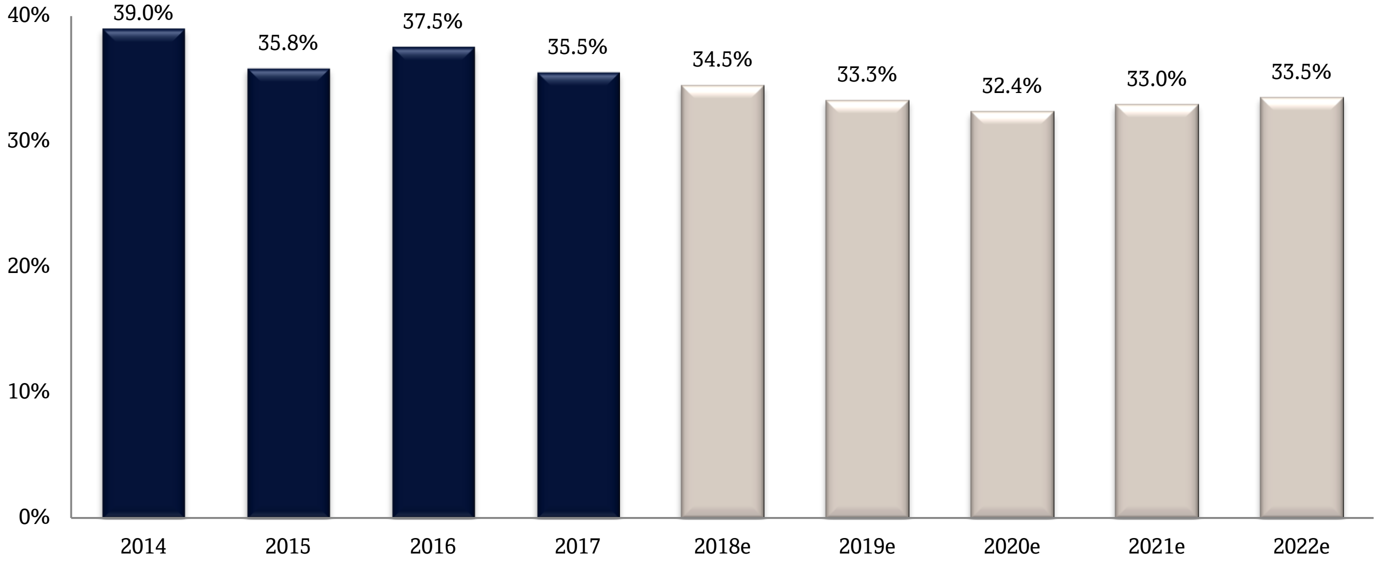


Source: Company data, QNBFS Research

Room for further upside dependent on CoR. RoE is steadily increasing based on our estimates. However, clarity from the Central Bank regarding IFRS 9 and precautionary provisions would determine the level of RoE. Hence, reversals or netting these built up reserves against impairments (when IFRS 9 is applied) can boost RoE significantly beyond our estimates.

Efficiency

GBK's Operating Efficiency is at an Acceptable Level

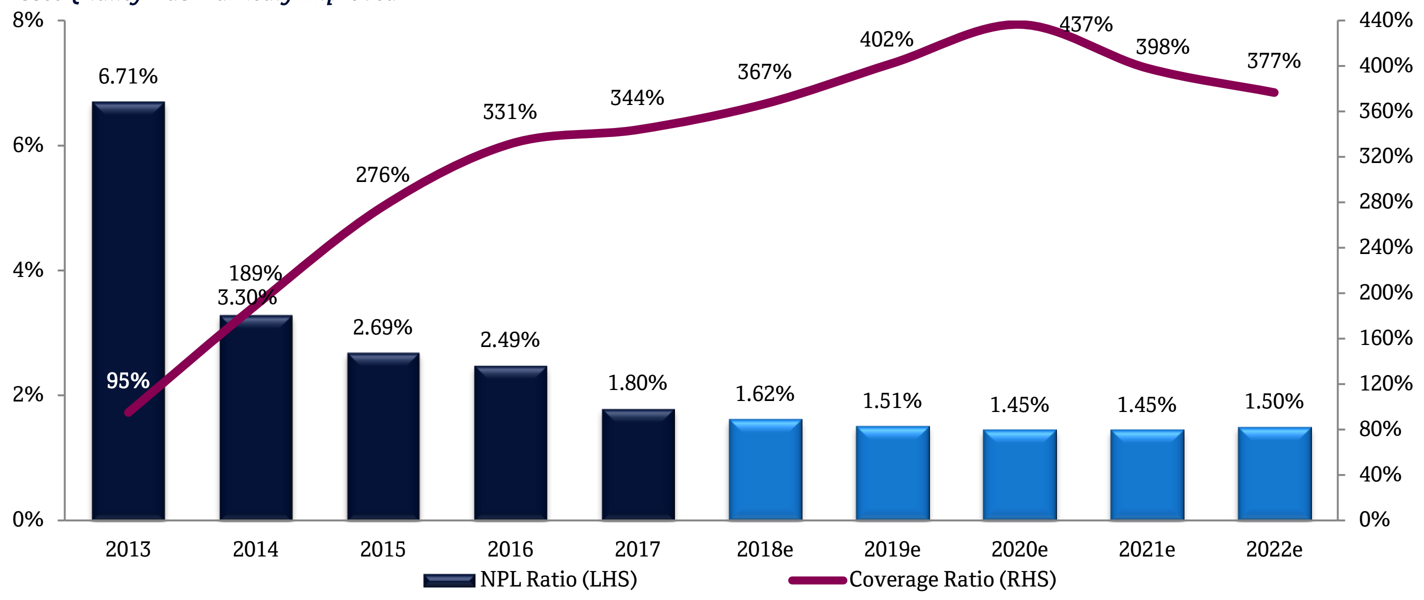


Source: Company data, QNBFS Research

C/I ratio to further improve; we estimate positive JAWS going forward. The bank's C/I ratio materially improved from 39% in 2014 to 35.5% in 2017. The C/I ratio is at an optimal level given GBK's large branch network and investments in technology. We expect the efficiency ratio to modestly improve and drop to the low 30%s in our forecast horizon. Moreover, based on our estimates GBK is modeled to generate positive JAWs of 3.1%, 3.7% and 2.9% in 2018, 2019 and 2020, respectively (vs. generally negative JAWs historically).

Asset Quality

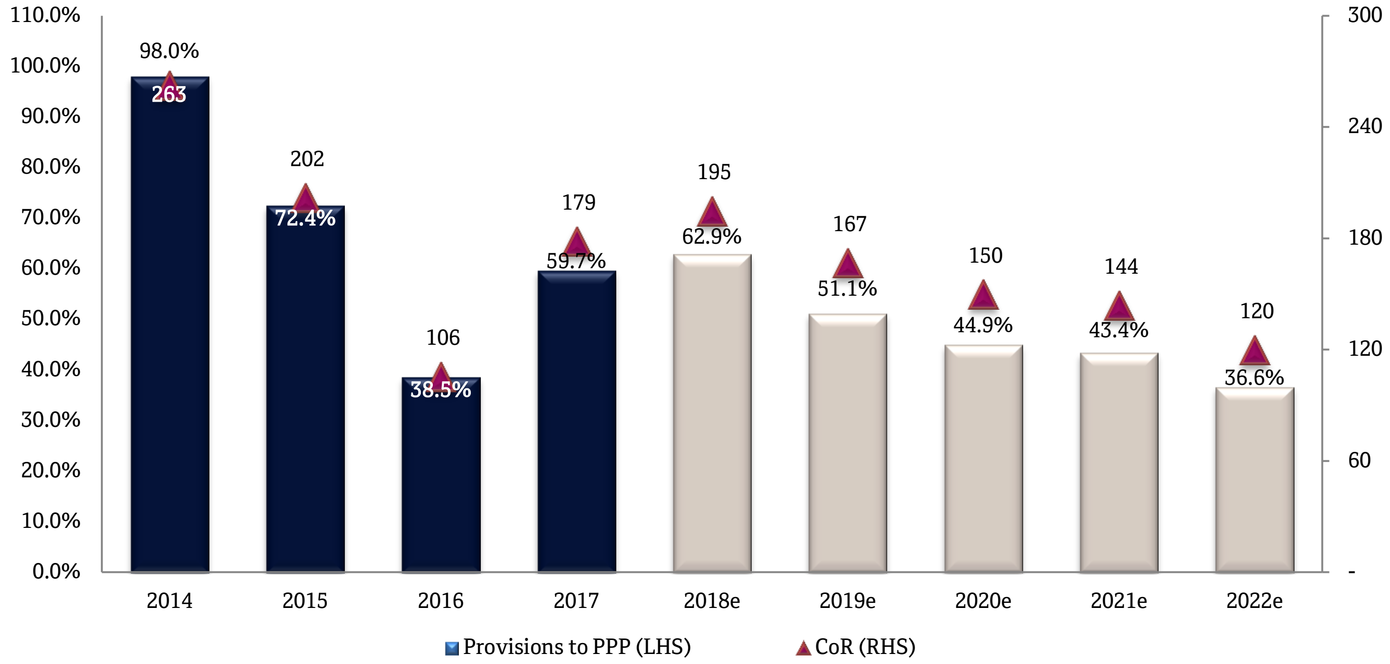
Asset Quality Has Markedly Improved



Source: Company data, QNBFS Research

We expect asset quality to further improve with declines in the NPL ratio. GBK has cleaned up its books since 2009 when the NPL ratio reached a high of 30.33% to 1.80% in 2017. The jump in NPLs took place during the 2008 financial crisis when investment companies and real estate firms defaulted on their debts. The NPL ratio declined through write-offs and prudent risk control exercised by management. It is worth mentioning that GBK has been recovering a portion of the write-offs (further recoveries would be a positive surprise for earnings).

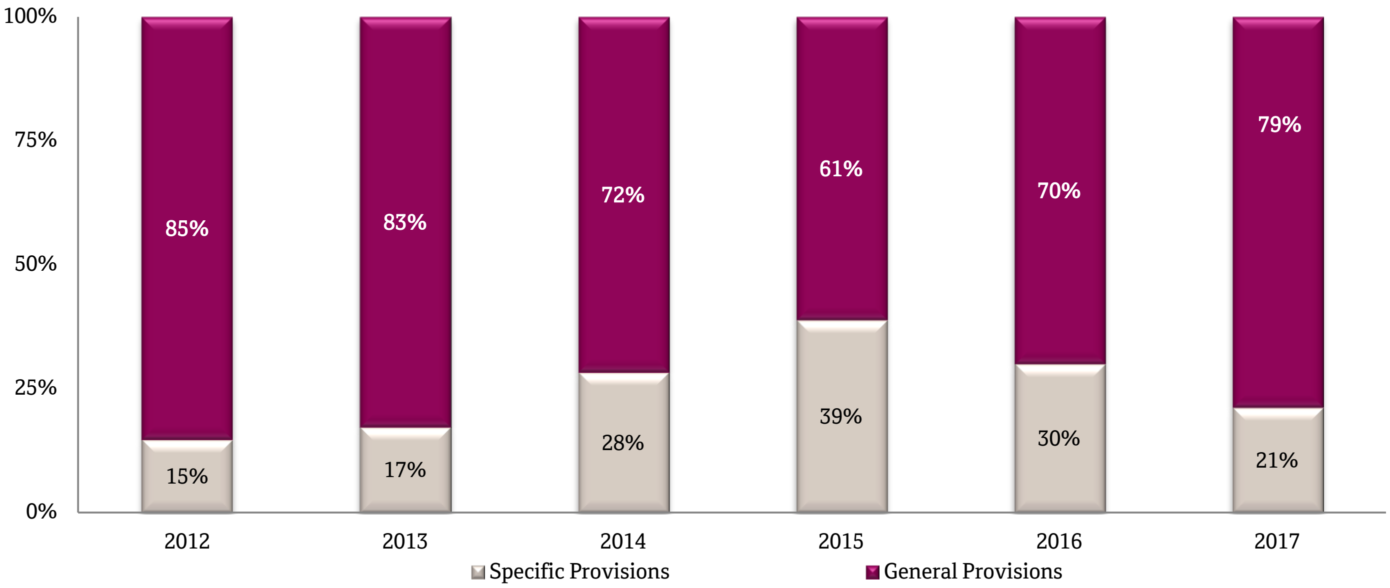
CoR Significantly Improved but Still Remains on the High Side



Source: Company data, QNBFS Research

Cost of risk needs to significantly improve like all banks in Kuwait. GBK's high cost of risk is mainly driven from the Central Bank of Kuwait (CBK) imposing excessive precautionary provisions on banks. CBK's precautionary & general provisions contributed 79% to total credit provisions in 2017, 70.0% in 2016, and 61.0% in 2015. A reversal of these provisions or applying them to ECLs as one time impairment charge would unlock great value and would materially enhance profitability metrics (RoE, RoA, Net Profit Margin etc.). GBK generated provisions of KWD 66.6mn (9M2018) vs. KWD 53.6mn (9M2017), an increase ahead of IFRS 9 implementation expected in 2019. It should be noted GBK has the highest level of general provisions to total provisions among its peers.

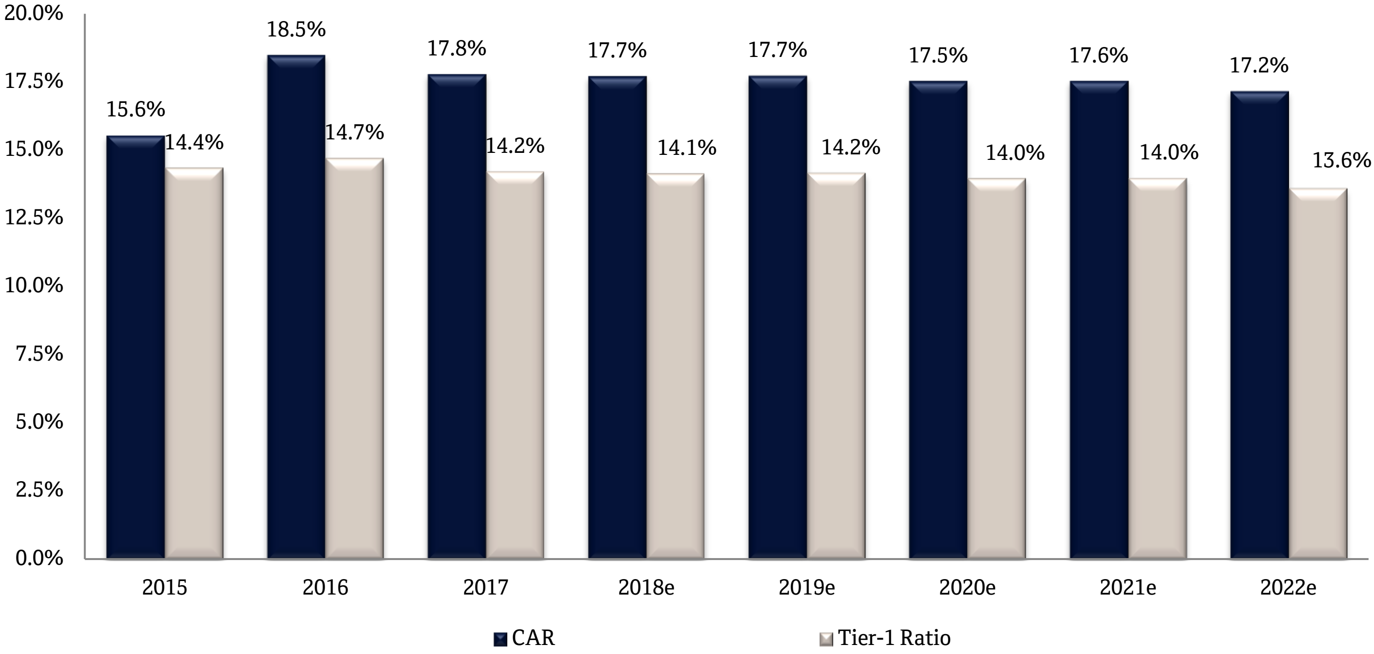
General Provisions/Precautionary to Total Provisions is Significant; Reversals Would Materially Improve Profitability Metrics



Source: Company data, QNBFS Research

Capitalization

Strong Capitalization Levels



Source: Company data, QNBFS Research

Capitalization remains robust. Based on our assumptions, we expect GBK to maintain a Tier-1 ratio of 14% and a dividend payout ratio of 50% without resorting to capital hikes. Moreover, with this trend we expect the bank to generate a RoE of 12% by 2020.

Company Description

Established in 1960, Gulf Bank is a Kuwait-focused bank and has a 9% market share in loans and a 8% market share in deposits. GBK is a universal bank offering services to corporates and retail customers, private banking and treasury services. The bank operates an extensive branch network of 58 branches (2nd largest branch network among its conventional peers).

Major Shareholders

Shareholders	Investor Type	Country	Share (%)
Kuwait Investment Authority (KIA)	Sovereign Wealth Fund	Kuwait	18.94
Bassam Yousef Ahmed Alghanim	Individual	Kuwait	14.98
Omar Kutayba Yousef Al-Ghanim & Group (Alghanim Trading Co.)	Private Co.	Kuwait	7.42
Alghanim Industries	Private Co.	Kuwait	6.71
Behbehani Investments and others	Private Co.	Kuwait	5.81
			53.86

Source: Company data

Detailed Financial Statements

Ratios	FY2017	FY2018e	FY2019e	FY2020e
Profitability (%)				
RoE	8.4	9.8	10.7	11.8
RoAA	0.9	1.0	1.1	1.2
RoRWA	1.2	1.4	1.5	1.6
NIM (% of IEAs)	2.77	3.03	3.18	3.25
NIM (% of RWAs)	3.26	3.57	3.72	3.79
NIM (% of AAs)	2.37	2.61	2.69	2.79
Spread	2.2	2.2	2.3	2.4
Efficiency (%)				
Cost-to-Income (Headline)	35.5	34.5	33.3	32.4
Cost-to-Income (Core)	36.3	34.6	33.6	32.7
Liquidity (%)				
LDR (incl. OFIs)	85.4	83.3	83.5	84.0
Loans/Assets	67.0	64.8	66.7	66.9
Cash & Interbank Loans-to-Total Assets	11.3	17.8	15.6	15.6
Deposits to Assets	61.4	60.2	61.2	60.9
Wholesale Funding to Loans	38.9	42.7	39.7	39.9
IEAs to IBLs	1.3x	1.2x	1.1x	1.1x
Asset Quality (%)				
NPL Ratio	1.80	1.62	1.51	1.45
NPLs to Shareholder's Equity	12.1	10.8	10.2	9.8
NPLs to Tier 1 Capital	12.1	11.0	10.4	10.0
Coverage Ratio	344.0	366.8	402.4	436.6
ALL/Average Loans	1.4	0.9	0.8	1.0
Cost of Risk	179	195	167	150
Capitalization (%)				
Tier 1 Ratio	14.2	14.1	14.2	14.0
CAR	17.8	17.7	17.7	17.5
Tier 1 Capital to Assets	10.6	10.2	10.3	10.3
Tier 1 Capital to Loans	15.8	15.7	15.5	15.5
Tier 1 Capital to Deposits	17.2	16.9	16.9	17.0
Leverage (x)	9.5	9.7	9.5	9.4
Growth (%)				
Net Interest Income	13.2	16.9	9.2	8.5
Non-Interest income	-5.2	-14.9	10.1	3.8
Total Revenue	7.5	8.3	9.4	7.5
Opex	1.7	5.2	5.7	4.6
Net Operating Income	11.0	10.0	11.4	9.0
Net Provisions & Impairments	10.5	0.9	7.4	1.3
Net Income	11.7	22.1	15.7	16.8
Loans	10.5	4.8	6.6	6.2
Deposits	2.8	6.2	5.3	5.5
Assets	4.0	8.3	3.7	5.9
RWAs	8.4	4.9	5.1	7.4

Source: Company data, QNBFS Research

Income Statement (In KWD mn)	FY2017	FY2018e	FY2019e	FY2020e
Net Interest Income	132	155	169	183
Fees & Commissions	31	31	32	34
FX Income	9	9	10	9
Other Income	9	2	4	5
Non-Interest Income	**49**	**42**	**46**	**48**
Total Revenue	**181**	**196**	**215**	**231**
Operating Expenses	(64)	(68)	(72)	(75)
Net Operating Income	**117**	**129**	**143**	**156**
Net Provisions & Investment Impairments	(67)	(67)	(72)	(73)
Net Profit Before Tax	**50**	**61**	**71**	**83**
Tax	(2)	(3)	(3)	(4)
Net Profit	**48**	**59**	**68**	**79**

Source: Company data, QNBFS Research

Balance Sheet (In KWD mn)	FY2017	FY2018e	FY2019e	FY2020e
Assets				
Cash & Balances with Central Bank	475	778	742	741
Interbank Loans	168	319	255	316
Net Investments	1,079	919	979	1,029
Net Loans	3,809	3,991	4,256	4,520
Other Assets	43	46	47	48
Net PP&E	30	31	32	34
OREO	79	71	71	71
Total Assets	**5,683**	**6,156**	**6,382**	**6,760**
Liabilities				
Interbank Deposits	412	519	395	440
Due From OFIs	969	1,086	1,194	1,266
Customer Deposits	3,490	3,706	3,903	4,117
Subordinated Tier-2 Notes	100	100	100	100
Other Liabilities	111	111	117	119
Total Liabilities	**5,082**	**5,522**	**5,709**	**6,042**
Shareholders' Equity	601	634	673	717
Total Liabilities & Shareholders' Equity	**5,683**	**6,156**	**6,382**	**6,760**

Source: Company data, QNBFS Research

Recommendations *Based on the range for the upside / downside offered by the 12 - month target price of a stock versus the current market price*	
OUTPERFORM	Greater than +20%
ACCUMULATE	Between +10% to +20%
MARKET PERFORM	Between -10% to +10%
REDUCE	Between -10% to -20%
UNDERPERFORM	Lower than -20%

Risk Ratings *Reflecting historic and expected price volatility versus the local market average and qualitative risk analysis of fundamentals*	
R-1	Significantly lower than average
R-2	Lower than average
R-3	Medium / In-line with the average
R-4	Above average
R-5	Significantly above average

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