

National Bank of Kuwait (NBK)

Recommendation	ACCUMULATE	Risk Rating	R-3
Share Price	KWD748	Target Price	KWD856
Implied Upside	+14.5%		

Dominant Franchise with Strong Fundamentals

NBK is the most profitable banking franchise in Kuwait vs. its peers in terms of its RoE and the only bank with RoE>CoE. Moreover, the name remains a leading cost-efficient bank in the GCC, along with strong asset quality. Most notably, NBK is the only bank in Kuwait that offers both conventional and Islamic banking via its Boubyan Bank acquisition. We initiate coverage with an Accumulate & a PT of KWD856.

Highlights

- **Strong earnings growth on the horizon.** We pencil in a bottom-line CAGR of 12.6% in 2017-2022e vs. 0.1% (2012-2017). This accelerating growth forecast in net income should be driven by net interest income, which we model to grow by 9.8% and flat provisions. *Having said this, there could be further upside to our estimates if NBK reduces provisions more than our model expectations.*
- **First of its kind.** Following the consolidation of Boubyan Bank (58.4% stake) in 2012, NBK is the only conventional bank in Kuwait that offers both conventional and Islamic banking services. This gives the bank a competitive advantage vs. its peers given the significance and growth of Islamic banking in Kuwait.
- **Kuwait's most profitable bank:** NBK's RoE has consistently declined from its most recent high of ~20% (2009) to ~13% in 2017, primarily due to high general provisions imposed by the central bank. We are of the view this trend will reverse in 2018 as the bank fully applies IFRS 9 and general provisions are discontinued. The bank generated a tangible RoE of 13.3% in 2017 (13.5% in 2016) vs. a CoE of 11.03%, generating economic profits vs. economic losses by its local peers. *We expect NBK's RoEs to increase; based on our model, we forecast RoEs of 14.5% (2018), 15.9% (2019) and 16.1% (2020).*
- **IFRS 9 is a positive for NBK, leading to lower CoR and stronger profitability.** NBK, along with all other banks in Kuwait, has been booking excessive general provisions since 2012 at the request of the central bank. With IFRS 9, rather than booking a one-time impairment charge against equity, banks have been using the buffers built to write off Stage 2 loans that are expected to be impaired. As such, going forward, NBK would not have to book general provisions, resulting in a significant drop in CoR. *We expect CoR to drop from 118bps in 2017 to 105 bps in 2018, 92bps (2019) and 82bps (2020). It should be noted that we are being conservative as CoR can decline well below our estimates.*
- **NBK's operating efficiency at optimal levels.** Cost-to-income ratio has hovered around 32/33% since 2012 as management has managed costs effectively. We expect the bank's C/I ratio to decline to the 31% levels as revenue growth strengthens. Hence, we expect NBK to continue generating positive JAWs (4.9% in 2017, 2.3% and 1% in 2018e and 2019e, respectively).
- **Asset quality improved although it was always healthy; continued write-offs along with prudent risk control contributed positively.** NBK's NPL ratio receded to 1.42% in 2017 from 2.75% in 2012, while the coverage ratio jumped to 288% vs. 157% (2012). *We pencil in NPL ratios around the 1.4% level going forward.*
- **Robust capitalization position.** NBK enjoys one of the highest Tier-1 and CAR levels in Kuwait, maintaining it at 15.8% and 17.8% levels for the past couple of years. *We expect this trend to persist while not being a significant drag on RoE.*

Catalysts

- 1) Revival of bid for the remaining 42% stake in Boubyan Bank and 2) Clarity on implementation of IFRS 9 on loan book.

Recommendation, Valuation and Risks

- **Recommendation and valuation:** *We assign a Price Target of KWD856 and an Accumulate rating.* NBK is trading at a 2018e P/B and P/E of 1.4x and 13.1x, respectively. The stock offers a healthy yield of 4.0%.
- **Risks:** 1) Geo-political factors, 2) unexpected asset quality deterioration & 3) CoR does not improve.

Key Financial Data and Estimates

	FY2017	FY2018e	FY2019e	FY2020e
EPS (KWD)	53.00	56.95	67.39	74.16
EPS Growth (%)	8.2	7.5	18.3	10.1
P/E (x)	14.1	13.1	11.1	10.1
BVPS (KWD)	487.6	516.4	553.8	598.0
P/B (x)	1.5	1.4	1.4	1.3
DPS (KWD)	30.00	30.00	30.00	30.00
Dividend Yield (%)	3.8	4.0	4.0	4.0

Source: Company data, QNBFS Research

Key Data

Current Market Price (KWD)	748
Dividend Yield (%)	4.0
Bloomberg Ticker	NBK KK
ADR/GDR Ticker	N/A
Reuters Ticker	NBKK.KW
ISIN	KW0EQ0100010
Sector	Banks & Financial Svcs.
52wk High/52wk Low (KWD)	762/631
3-m Average Volume ('000)	2,476.7
Mkt. Cap. (\$ bn/KWD bn)	15.4/4.6
Shares Outstanding (mn)	6,213.3
1-Year Total Return (%)	+22.3
Fiscal Year End	December 31

Source: Bloomberg (as of June 10, 2018)

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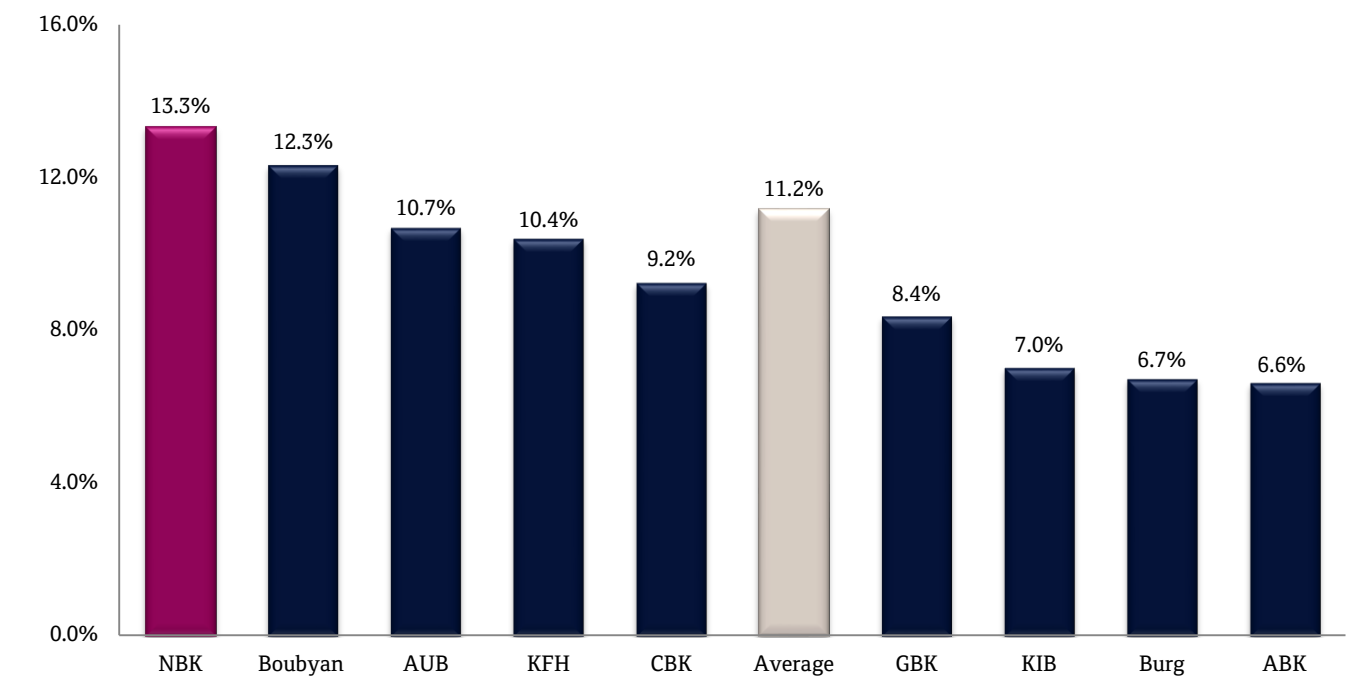
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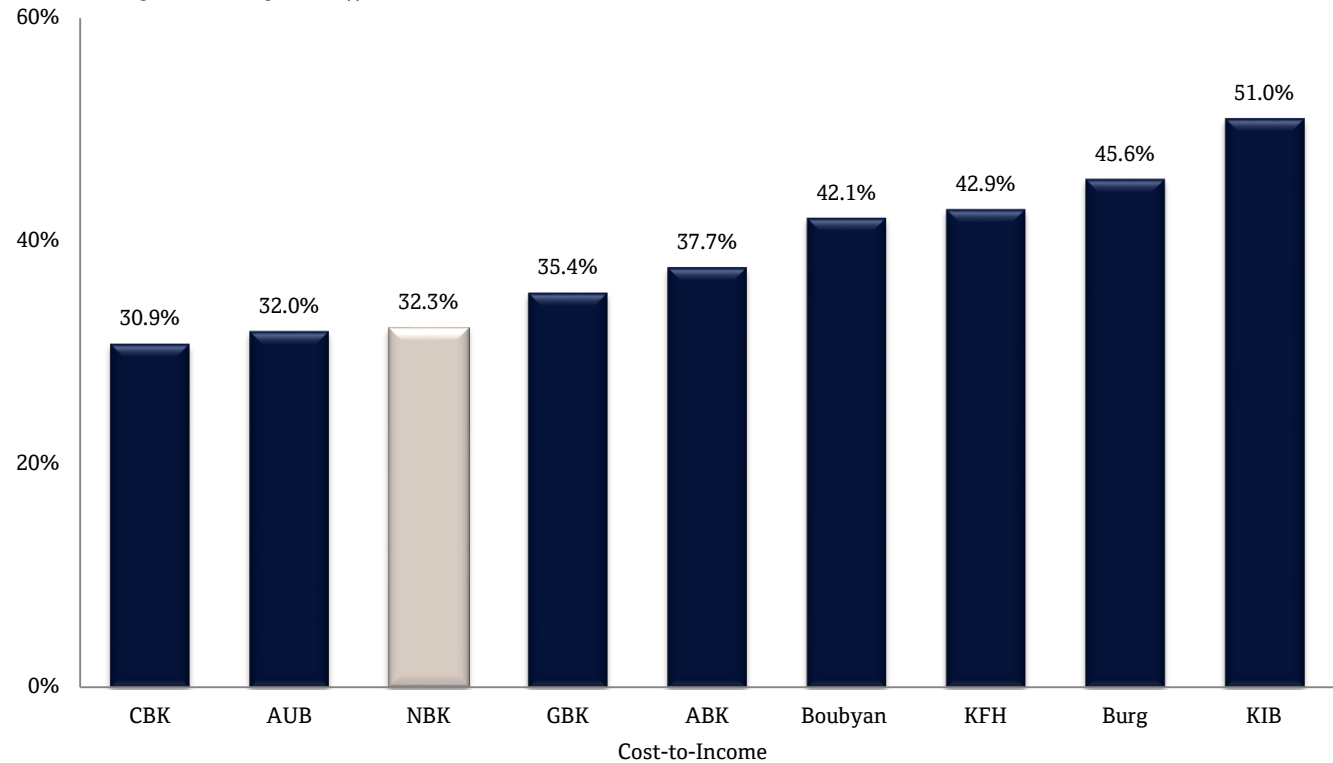
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NBK is the Most Profitable Bank in Kuwait with a RoE of 13.3%



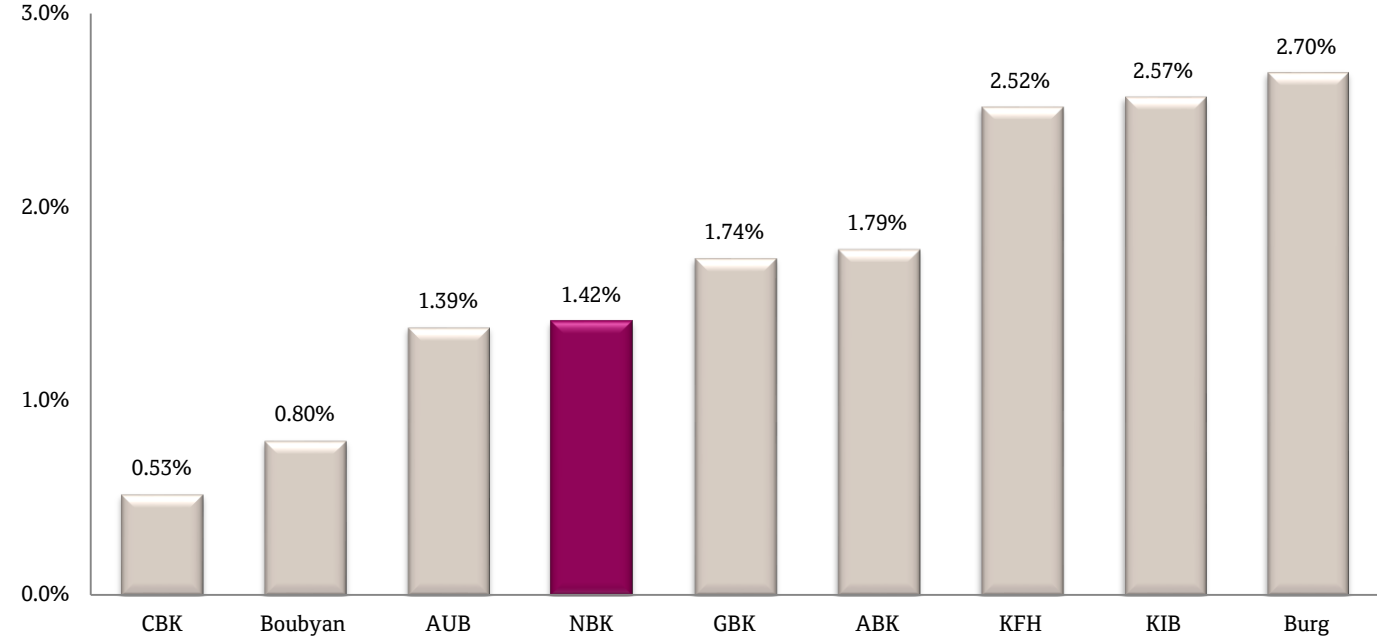
Source: Company data, QNBFS Research

NBK is Among the Leading Cost-Efficient Banks



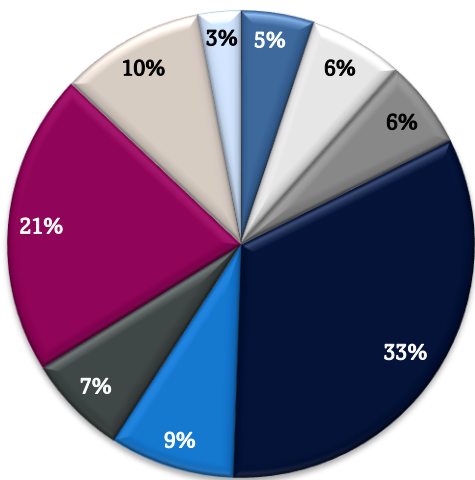
Source: Company data, QNBFS Research

NBK Enjoys Robust Asset Quality



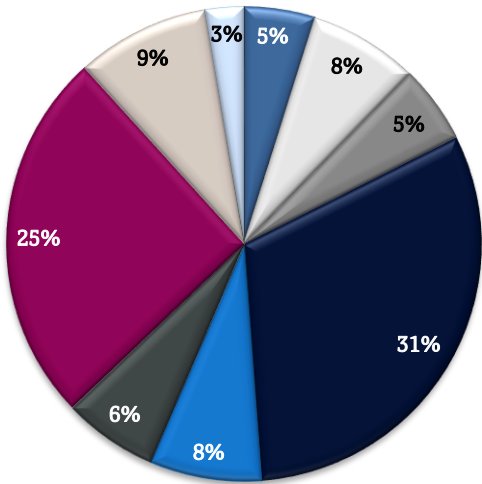
Source: Company data, QNBFS Research

Boasts Largest Market Share in Loans.....



CBK Boubyan AUB NBK GBK
ABK ABK KFH Burg KIB

..... And Deposits



CBK Boubyan AUB NBK GBK
ABK ABK KFH Burg KIB

Source: Company data, QNBFS Research

Valuation

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

- 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), expected long-term growth in earnings (g) and present value of interim dividends 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.
- We derive NBK'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 tangible return on beginning equity (RoE) based on the mean 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 1.9x.

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 CDS of 1.05% to the 10 year US Treasury (2.97%) to arrive at a risk free rate of 4.0% and factor in an adjusted beta of 1.0. Finally, we add an equity risk premium of 7.0% to arrive at a Ke of 11.03%.

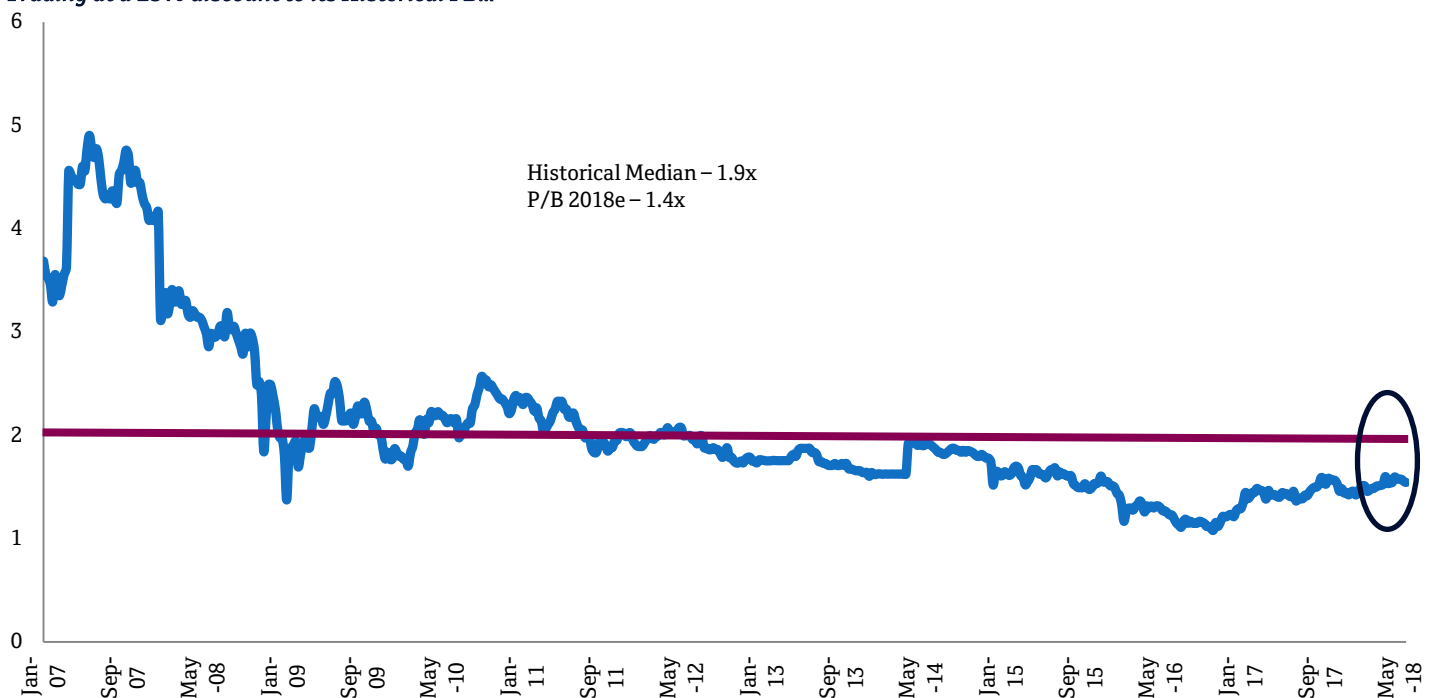
Valuation Methodologies

Fundamental P/B (WEV)	
Sustainable RoE (%)	16.2
Estimated Cost of Equity (%)	11.03
Terminal Growth Rate (%)	5.0
Fundamental P/B	1.9x
Less: Goodwill & Intangibles	94
Intrinsic Value (KWD)	862
Current Market Price (KWD)	748
Upside/(Downside) Potential (%)	+15.3

RI Based on Fundamental P/B	
Beginning BVPS (2018e) (KWD)	488
Present Value of Interim Residuals (KWD)	115
Present Value of Terminal Value (KWD)	341
Less: Goodwill & Intangibles	94
Fundamental P/B	1.9x
Intrinsic Value (KWD)	850
Current Market Price (KWD)	748
Upside/(Downside) Potential (%)	+13.6

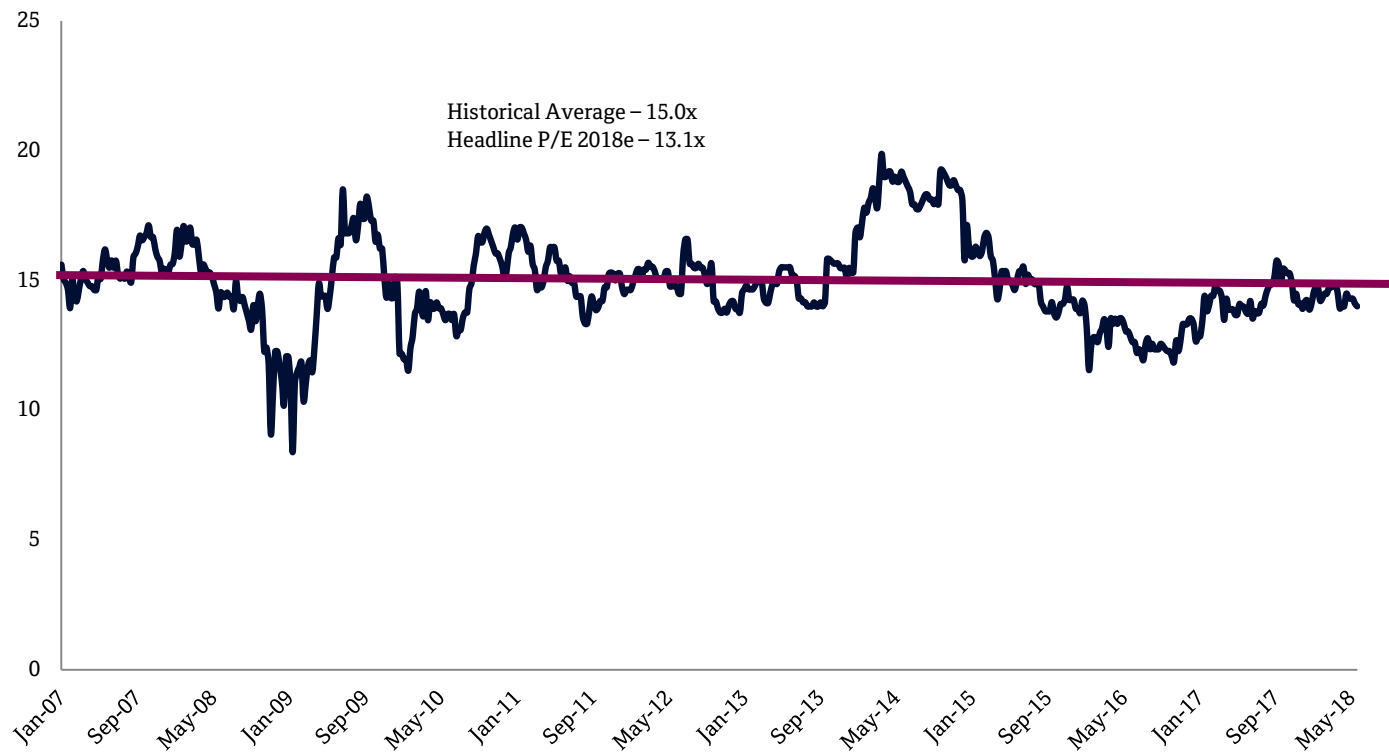
Source: QNBFS Research

Trading at a 23% discount to its Historical PB...



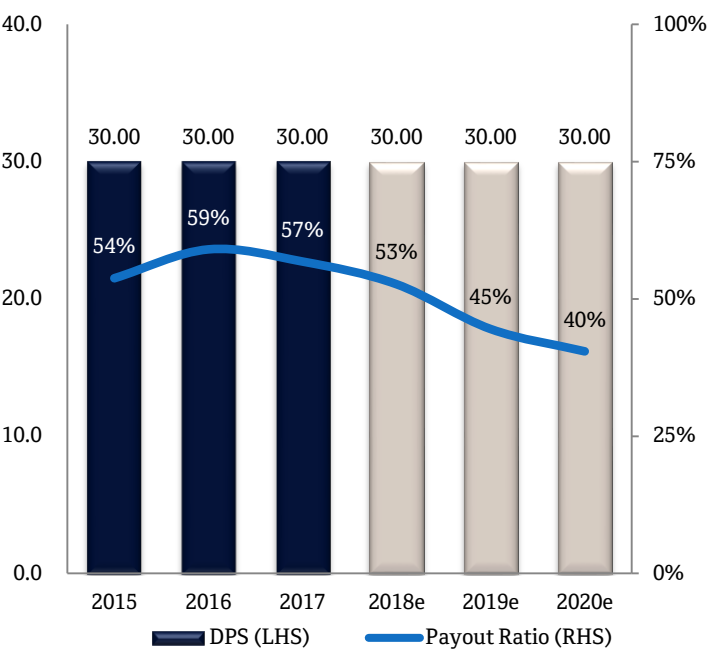
Source: Bloomberg, QNBFS Research

...And a 13% discount to its Historical P/E

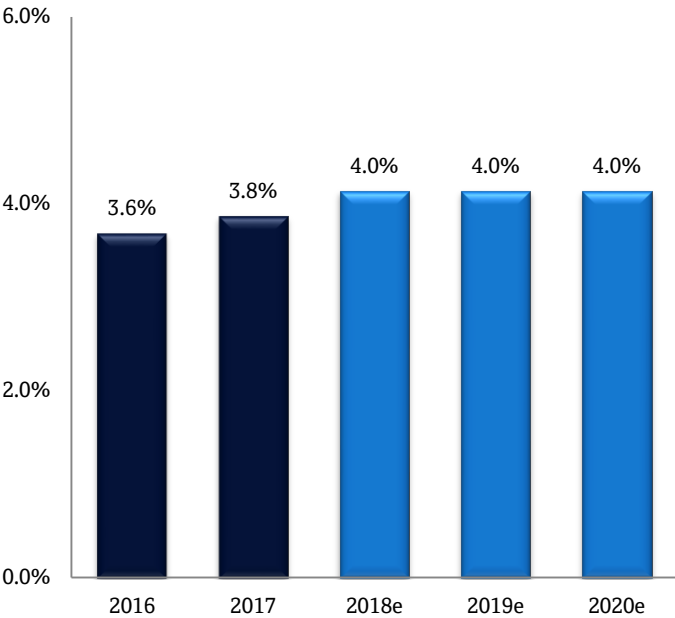


Source: Bloomberg, QNBFS Research

Consistent Dividends



Healthy Dividend Yield



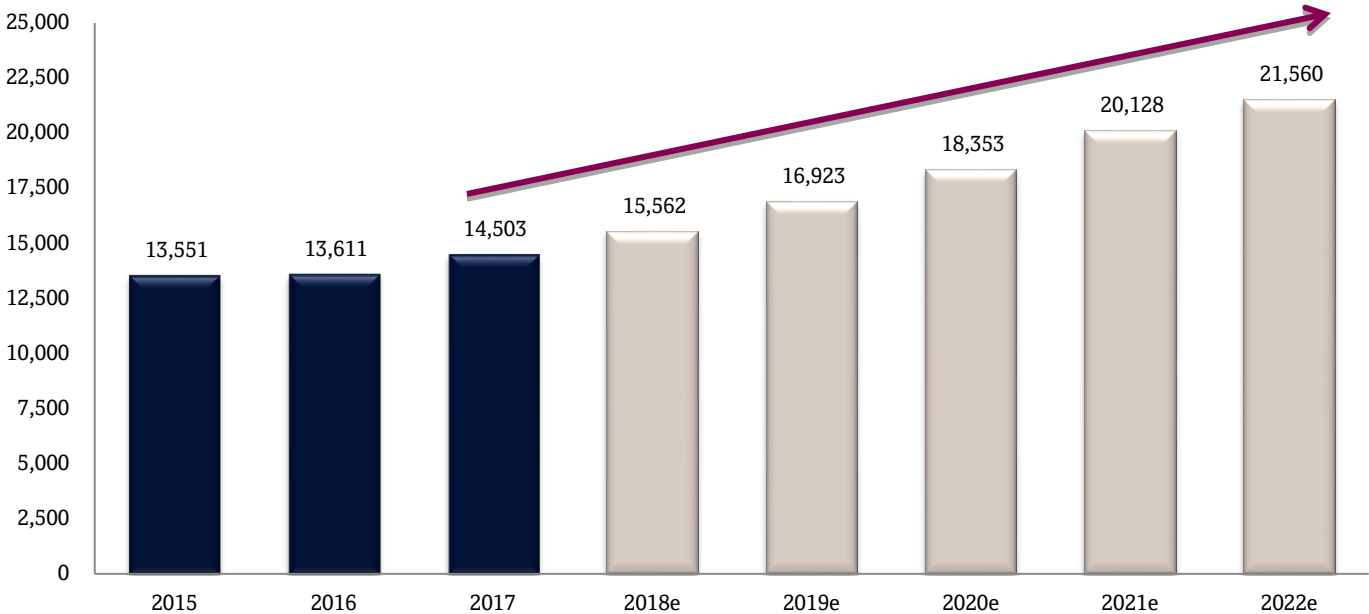
Source: Company data, QNBFS Research

Key Forecasts

Loan Portfolio

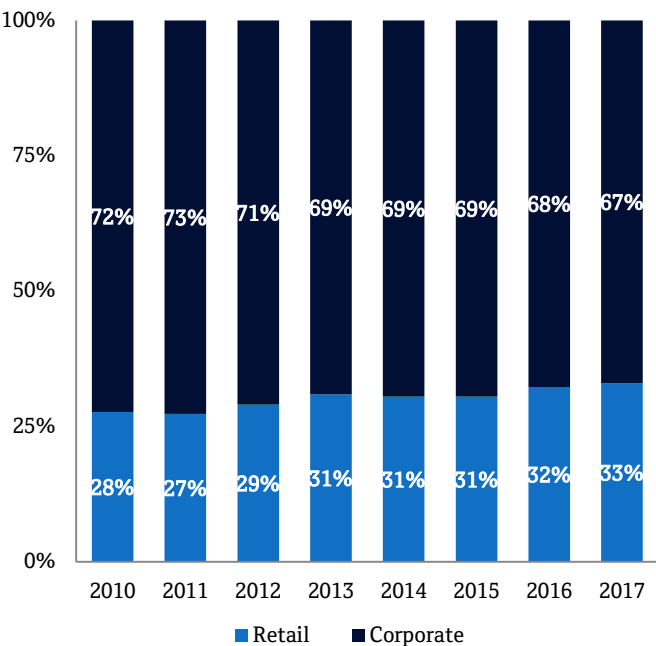
NBK is the dominant bank in Kuwait and has a 32% market share in loans and 31% market share in deposits; we pencil in a loan book CAGR (2017-22e) of 8.3%. NBK has generally focused on Kuwait's blue chip corporates, mass retail (north of 30% market share) and HNIs through its extensive private banking network. The company has recently ventured off into lending to Tier 2 and Tier 3 firm in order to further diversify its loan portfolio, resulting in margin expansion.

Loans (KWD mn) to Exhibit 8.3% CAGR vs. 8.0% (2012-17)

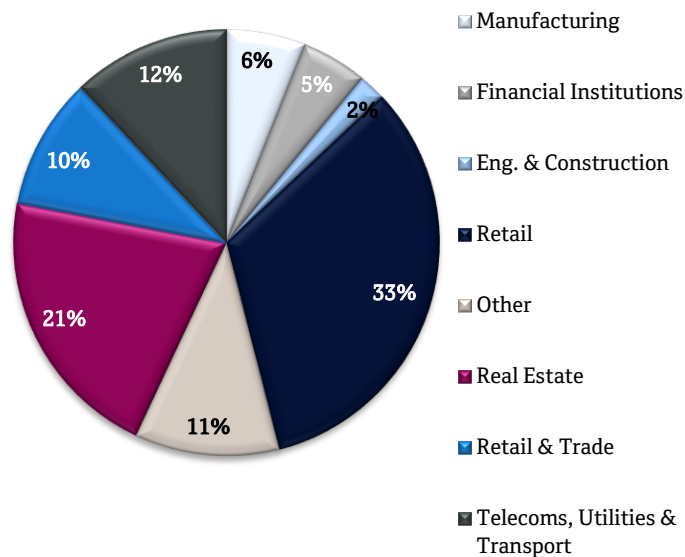


Source: Company data, QNBFS Research

Retail Book Increasing in Size



Well Diversified Loan Book

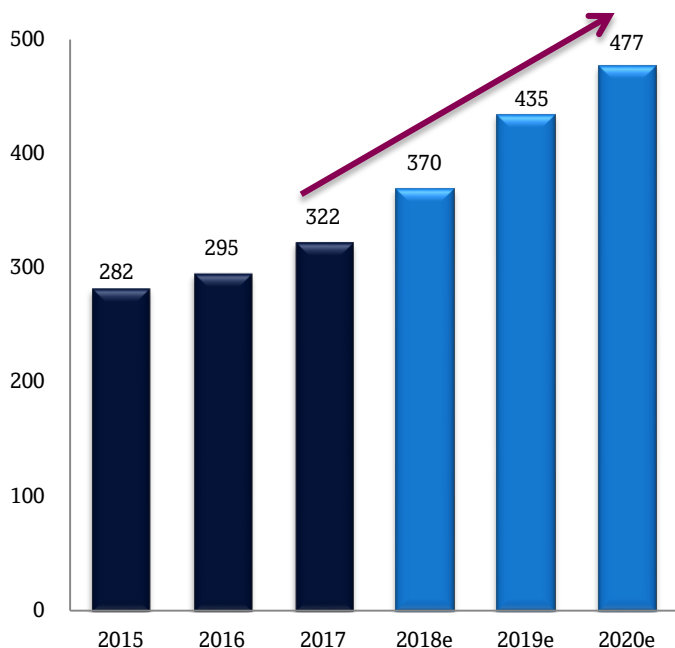


Source: Company data, QNBFS Research

Operating Performance

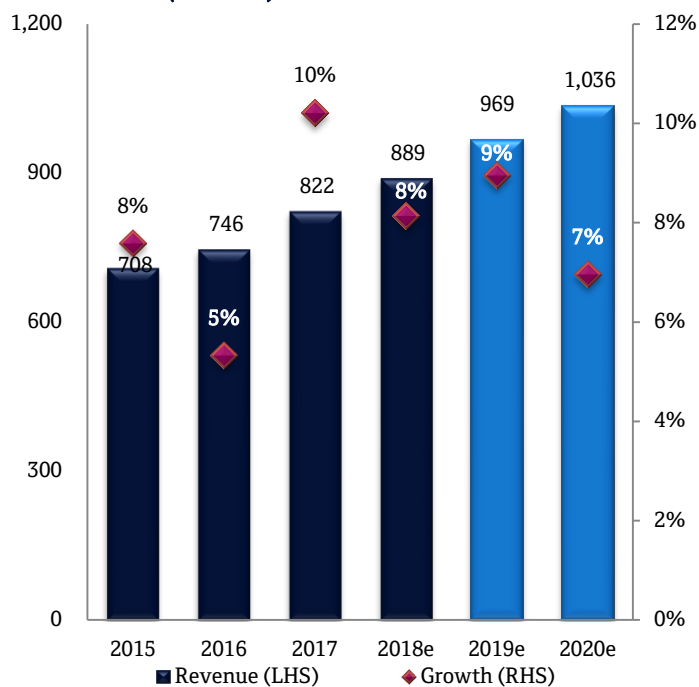
We pencil in a bottom-line CAGR of 12.6% in 2017-2022e vs. 0.1% (2012-2017). The growth in net income is expected to be driven by net interest income which we model in a growth of 9.8% and flat provisions. Having said this, there could be further upside to our estimates if NBK reduces provisions more than our model expectations.

Net Profit (KWD)

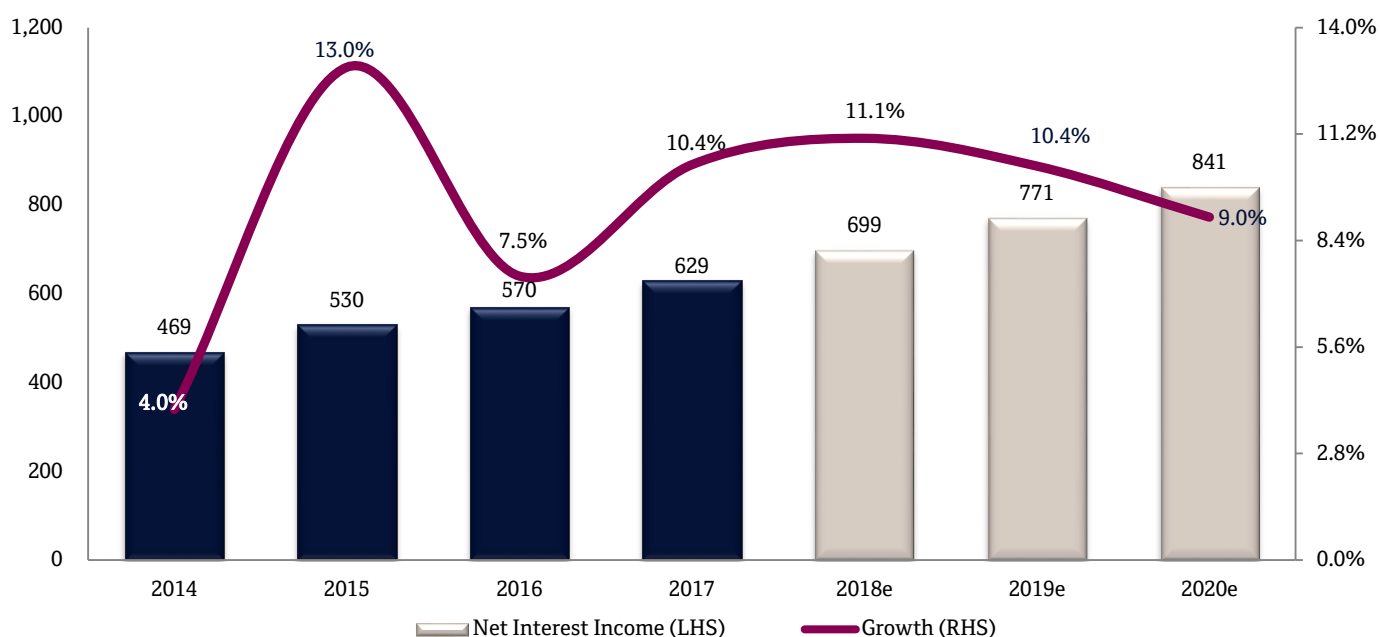


Source: Company data, QNBFS Research

Total Revenue (KWD mn)

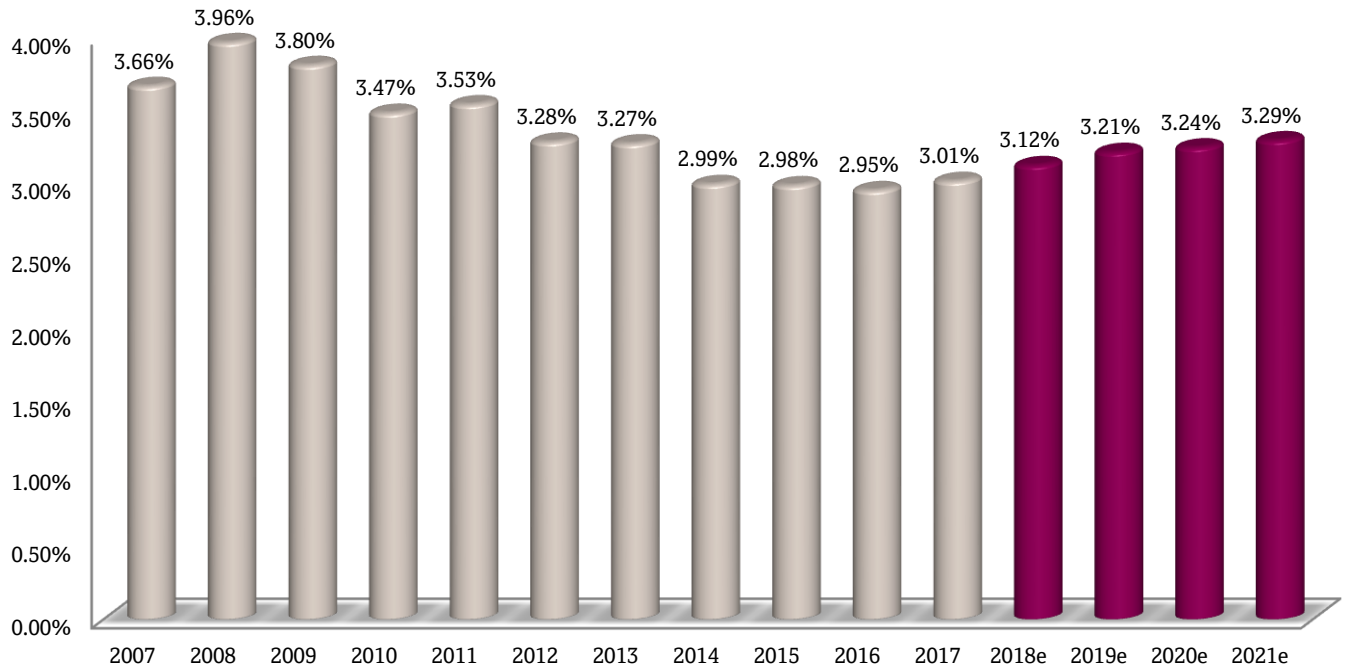


Net Interest Income (KWD mn)



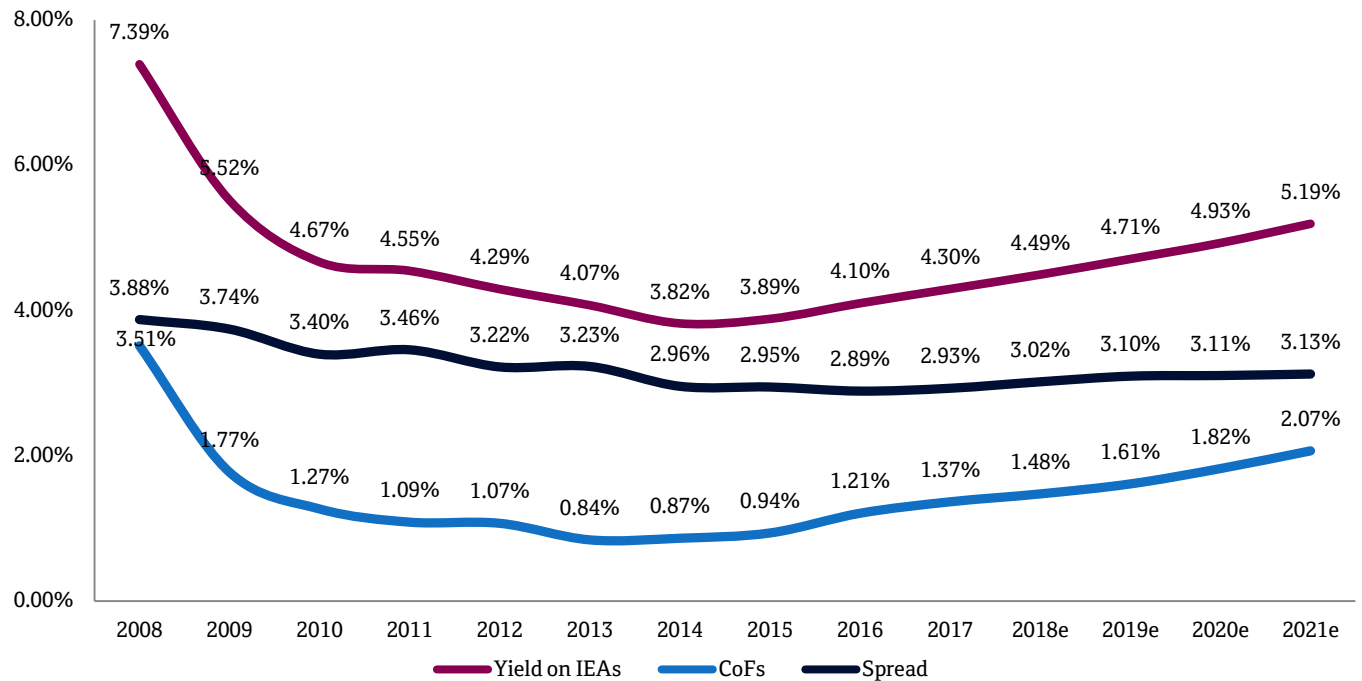
Source: Company data, QNBFS Research

NIMs To Further Expand With Expected Rate Hikes



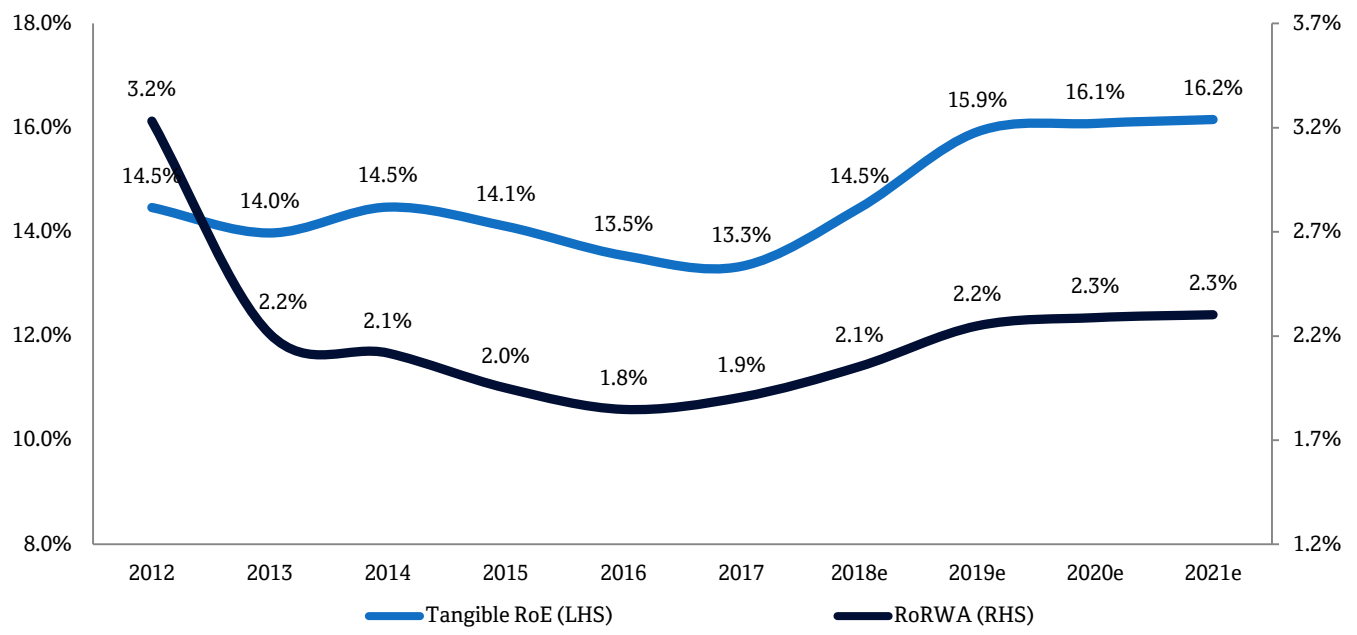
Source: Company data, QNBFS Research

Spreads To Strengthen In The Near Term & Stabilize Afterwards



Source: Company data, QNBFS Research

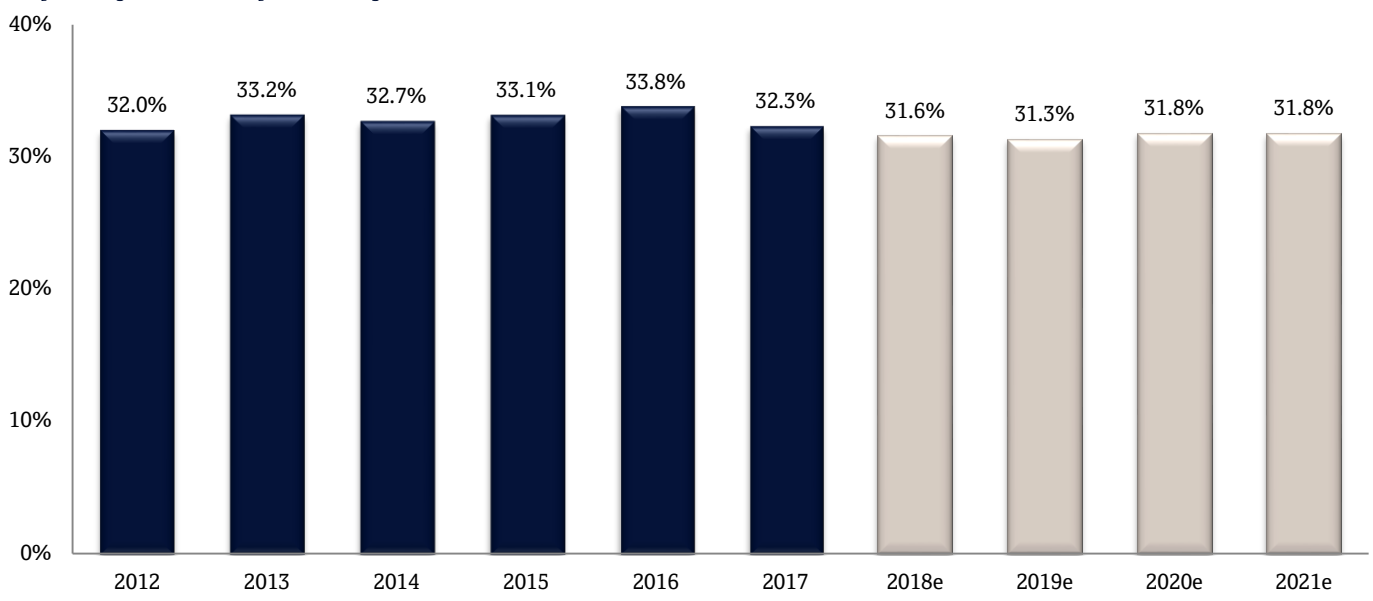
One of the Highest RoEs in Kuwait; We Expect RoE to Increase as Provisions Decline



Source: Company data, QNBFS Research

Efficiency

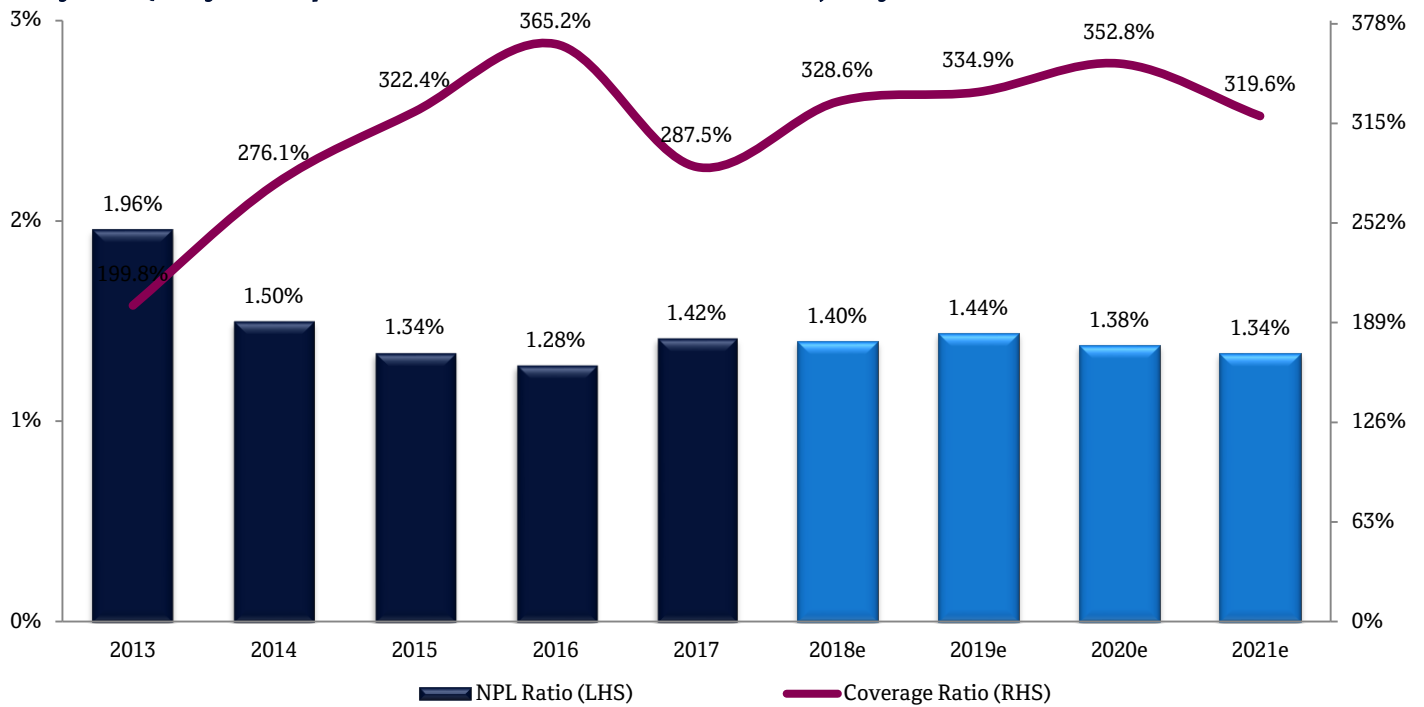
NBK Operating Within an Optimal Range



Source: Company data, QNBFS Research

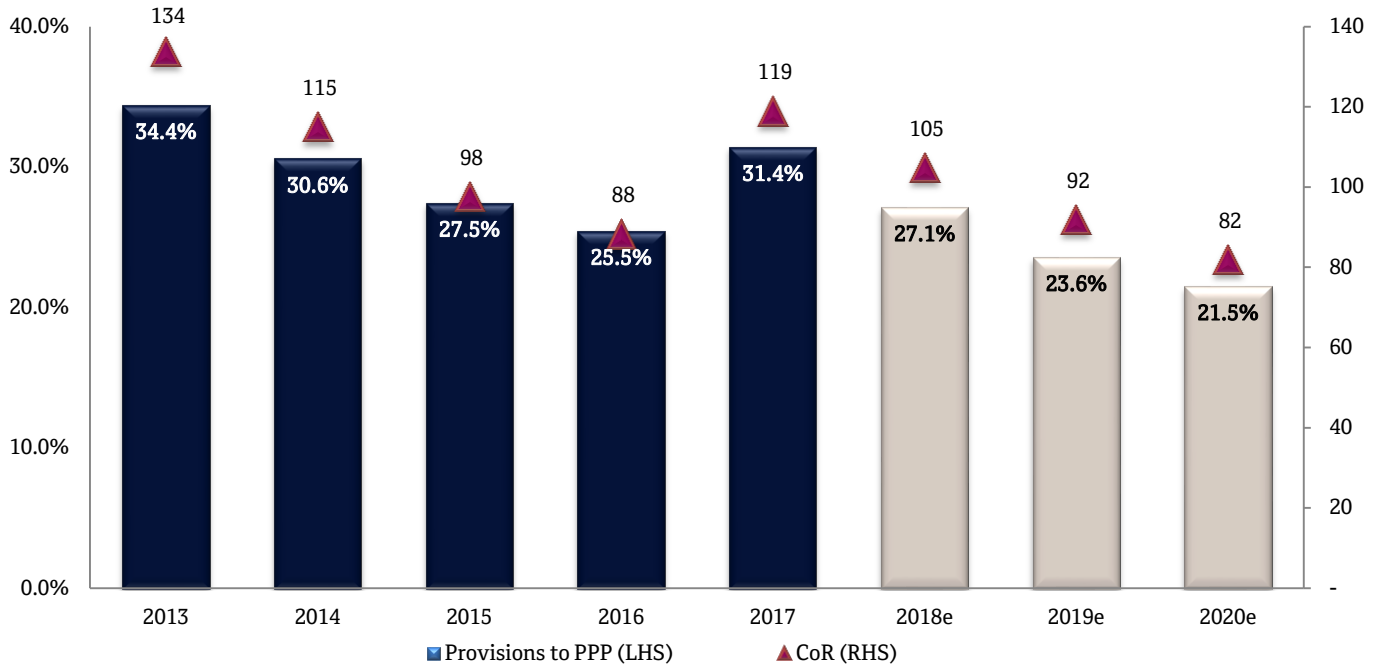
Asset Quality

Healthy Asset Quality & We Expect the NPL Ratio to Continue its Downward Trajectory



Source: Company data, QNBFS Research

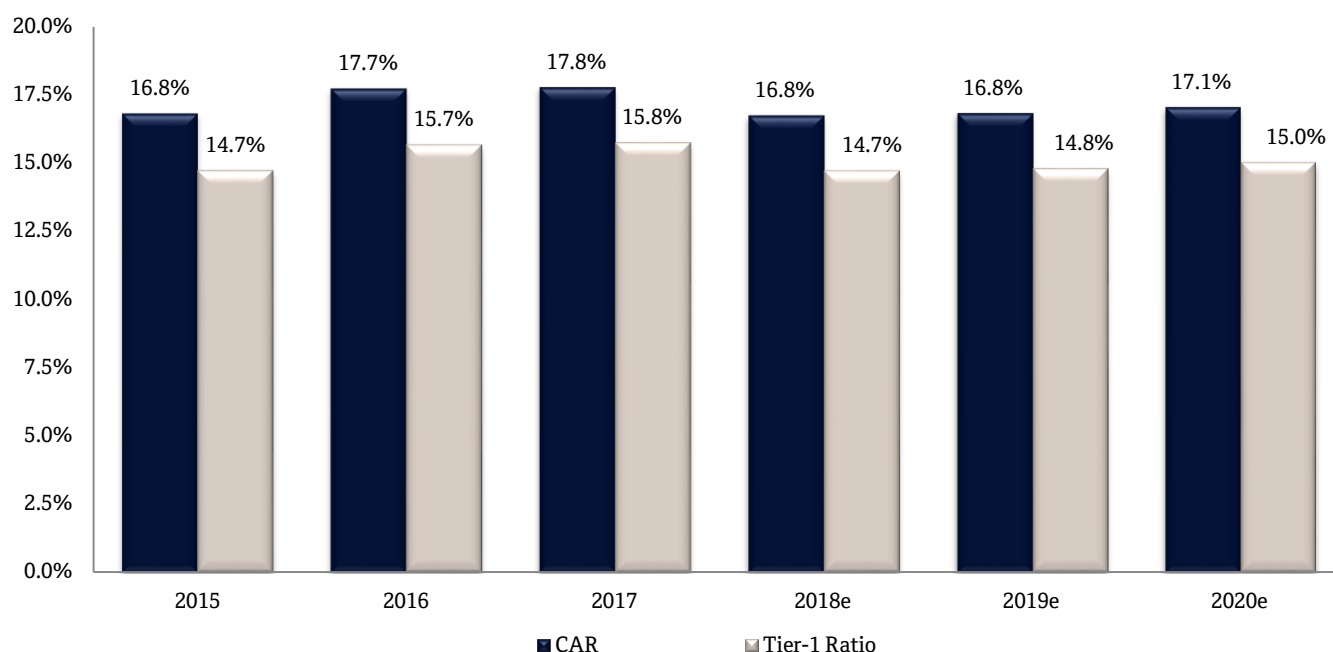
Cost of Risk Markedly Improved; We Foresee CoR below Historical Range From 2018 and Beyond



Source: Company data, QNBFS Research

Capitalization

Capitalization Levels Remain Good



Source: Company data, QNBFS Research

Company Description

National Bank of Kuwait is a first full service bank established in 1952 as the first local bank; NBK is the dominant bank in Kuwait and has a 32% market share in loans and 31% market share in deposits. NBK is a universal bank offering services to corporates and retail customers, private banking, investment banking, brokerage and asset management. The bank operates across a spectrum of 15 countries with a focus on the MENA region and has a network of ~145 branches (68 in Kuwait & 43 in Egypt) and ~600 ATMs.

Stable Shareholder base. The bank was established by leading Kuwaiti merchants and has maintained the same core shareholder base since inception.

Major Shareholders

Shareholders	Investor Type	Country	Share (%)
The Public Institution for Social Security	Government	Kuwait	5.5

Source: Company data

Subsidiaries/Associates

Company	Country	Share (%)
Boubyan Bank	Kuwait	58.4
NBK Egypt	Egypt	98.5
Watani Investment Company	Kuwait	99.9
NBK Banque Privée (Suisse) S.A.	Switzerland	100.0
National Bank of Kuwait (International) plc	United Kingdom	100.0
Turkish Bank A.S.	Turkey	34.3
Bank Syariah Muamalat Indonesia T.B.K.	Indonesia	30.5

Source: Company data

Detailed Financial Statements

Ratios	FY2017	FY2018e	FY2019e	FY2020e
Profitability (%)				
RoAE	10.4	11.3	12.6	12.9
RoAA	1.3	1.4	1.5	1.5
RoRWA	1.9	2.1	2.2	2.3
NIM (% of IEAs)	3.01	3.12	3.21	3.24
NIM (% of RWAs)	3.90	4.05	4.14	4.17
NIM (% of AAs)	2.50	2.60	2.68	2.73
Spread	2.9	3.0	3.1	3.1
Efficiency (%)				
Cost-to-Income (Headline)	32.3	31.6	31.3	31.8
Cost-to-Income (Core)	33.1	32.1	31.7	32.2
Liquidity (%)				
LDR	101.6	101.6	101.1	101.5
Loans/Assets	55.7	56.1	56.8	57.6
Cash & Interbank Loans-to-Total Assets	20.1	20.5	19.3	17.1
Deposits to Assets	54.8	55.2	56.2	56.8
Wholesale Funding to Loans	53.9	51.6	50.4	48.3
IEAs to IBLs	1.1x	1.1x	1.1x	1.1x
Asset Quality (%)				
NPL Ratio	1.42	1.40	1.44	1.38
NPLs to Shareholder's Equity	7.1	7.1	7.4	7.2
NPLs to Tier 1 Capital	9.1	9.6	9.8	9.2
Coverage Ratio	287.5	328.6	334.9	352.8
ALL/Average Loans	0.7	1.0	1.1	1.0
Cost of Risk	119	105	92	82
Capitalization (%)				
Tier 1 Ratio	15.8	14.7	14.8	15.0
CAR	17.8	16.8	16.8	17.1
Tier 1 Capital to Assets	10.0	9.5	9.6	9.9
Tier 1 Capital to Loans	18.0	16.9	16.9	17.1
Tier 1 Capital to Deposits	18.3	17.2	17.1	17.4
Leverage (x)	8.6	8.6	8.7	8.6
Growth (%)				
Net Interest Income	10.4	11.1	10.4	9.0
Non-Interest income	9.6	-1.5	3.8	-1.1
Total Revenue	10.2	8.1	9.0	7.0
Opex	5.3	5.8	8.1	8.5
Net Operating Income	12.7	9.2	9.4	6.3
Net Provisions & Impairments	9.2	14.7	17.7	9.7
Net Income	9.1	15.2	18.3	10.1
Loans	6.5	7.3	8.7	8.4
Deposits	9.6	7.3	9.3	8.0
Assets	7.4	6.5	7.5	6.9
RWAs	6.1	7.7	8.3	8.0

Source: Company data, QNBFS Research

Income Statement (In KWD mn)	FY2017	FY2018e	FY2019e	FY2020e
Net Interest Income	629	699	771	841
Fees & Commissions	139	140	147	148
FX Income	34	35	37	34
Other Income	21	16	13	13
Non-Interest Income	194	190	198	195
Total Revenue	823	889	969	1,036
Operating Expenses	(265)	(281)	(304)	(329)
Net Operating Income	557	608	665	707
Net Provisions & Investment Impairments	(188)	(185)	(167)	(162)
Net Profit Before Tax & Minority Interest	369	423	498	545
Tax	(27)	(31)	(36)	(40)
Net Profit Before Minority Interest	342	392	462	505
Minority Interest	(20)	(23)	(27)	(28)
Net Profit (Headline/Reported)	322	370	435	477
Interest on Tier-1 Note	(15)	(16)	(16)	(16)
Net Profit (Attributable)	307	354	419	461

Source: Company data, QNBFS Research

Balance Sheet (In KWD mn)	FY2017	FY2018e	FY2019e	FY2020e
Assets				
Cash & Balances with Central Bank	2,744	3,062	3,180	3,254
Interbank Loans	2,488	2,614	2,572	2,202
Net Investments	5,081	5,211	5,794	6,652
Net Loans	14,503	15,562	16,923	18,353
Investment in Associates	63	64	65	66
Other Assets	250	274	291	312
Net PP&E	324	350	385	424
Goodwill & Intangibles	582	579	576	573
Total Assets	26,035	27,717	29,786	31,835
Liabilities				
Interbank Deposits	7,469	7,683	8,180	8,511
Customer Deposits	14,270	15,312	16,736	18,075
Global MTNs & Subordinated Tier-2 Notes	346	346	346	346
Other Liabilities	388	612	502	578
Tier-1 Notes	211	211	211	211
Total Liabilities	22,684	24,164	25,975	27,721
Shareholders' Equity	3,029	3,209	3,441	3,715
Total Liabilities & Shareholders' Equity	26,035	27,717	29,786	31,835

Source: Company data, QNBFS Research

Recommendations	
<i>Based on the range for the upside / downside offered by the 12 - month target price of a stock versus the current market price</i>	
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	
<i>Reflecting historic and expected price volatility versus the local market average and qualitative risk analysis of fundamentals</i>	
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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