Commercial Bank of Kuwait (CBK)

Recommendation	MARKET PERFORM	Risk Rating	R-4
Share Price	KWd 575	Target Price	KWd 516
Implied Upside/(Downside)	(10.3)		

Valuation Multiples Remain Rich; Initiate with Market Perform

Since 2010 and after the financial crisis hurt the bank, the Commercial Bank of Kuwait has been de-risking its loan book, especially its exposure to investment companies. The bank has witnessed negative- to-muted loan growth during this time-frame. CBK trades at a premium to its historical P/B and a 2019e PEG of 1.2x (indicating the stock is relatively expensive). Moreover, the market is pricing in a sustainable RoE of 13.6%, higher than our estimate of 12.8%. The stock has outperformed the entire banking sector over the last 12 months and we believe there is little room for further upside. ***We initiate coverage with a Market Perform rating and a PT of KWd (Fils) 516/sh.***

Highlights

- **Estimated earnings driven by a drop in provisions, recoveries and net interest income.** The growth in net income is expected to be driven by net interest income (7.0% 5-year CAGR) and a drop in net provisions and impairments and recoveries, which we model to decrease by 25.9% vs. -12.5% (past 5 years). *Having said this, there could be further upside to our estimates if CBK reduces provisions and books recoveries ahead of our model expectations*. Like all Kuwaiti banks, general/precautionary provisions (imposed by the Central Bank) are much greater than specific provisions (100% of total reserves are general and not specific). As such, hefty reversals or netting these built up reserves against impairments can unlock value, boosting profitability (RoE > 12%). Furthermore, CoR is elevated at 485bps while coverage ratio is greater than 1,000%.
- **Corporate focused bank, targeting quality loans vs. volume.** CBK is a mid-sized corporate focused bank and has a 5% market share in loans and deposits; we pencil in a loan book CAGR (2018-23e) of 5.0%. CBK has been de-risking its loan book since 2010 when the financial crisis took a toll on the bank. As such, there has been no growth. The bank focused on building its trade & commerce book, which almost doubled its contribution from 14% of total loans (2010) to 29% in 2018. The bank is focused on financing government-related projects which it deems safe. What is important to note here is that CBK reduced its exposure to the risky financial institutions, which led to segment loans falling by a CAGR of 18% (2010-2018). Hence, financial institutions represent 3% of total loans (2018) vs. 12% in 2010. Regarding real estate lending, segment declined by a modest 0.7% during the same time frame.
- **CBK has adopted a zero NPLs policy.** The way CBK's zero NPLs policy works is that once a customer defaults, the bank writes off the loan but still books provisions. Hence, there will be NPLs but it will not be visible as it would automatically be written off. CBK has cleaned up its books since 2010 when the NPL ratio reached a high of 16.5% to 0.53% in 2017 and 0% in 2018. The jump in NPLs took place during the 2008-10 financial crisis when investment companies and real estate firms defaulted on their debt. The NPL ratio declined through write-offs and de-risking the loan book. It is worth mentioning that CBK has been recovering a good portion of the write-offs (further recoveries would be a positive surprise for earnings).
- **Lowest cost-to-income ratio, positive JAWS would be a plus.** CBK's C/I ratio is at an optimal level given that opex on an absolute basis is small. We expect the efficiency ratio to remain stable during our forecast horizon. It should be noted that CBK has generally not been successful in generating positive JAWS due to weak growth in revenue vs. aggressive growth in opex.
- **Robust capital position:** CBK has been generating Tier-1 ratio of 17% over the past few years. Based on our assumptions, we expect CBK to maintain a Tier-1 ratio of 17%. Moreover, with this trend we expect the bank to generate a RoE of 11.8% and 12.9% by 2022 & 2023, respectively.

Catalysts

- 1) Further recoveries of write-offs & 2) Resumption in loan growth.

Recommendation, Valuation and Risks

- **Recommendation and valuation:** ***We assign a Price Target of KWd 516 and a Market Perform rating.*** CBK is trading at a 2019e P/B and P/E of 1.5x and 15.7x, respectively. The stock is trading at a PEG of 1.2x (which means the stock is expensive) based on earnings of CAGR 13.3% (2018-2023e).
- **Risks:** 1) Geo-political factors, 2) Unexpected asset quality deterioration & 3) CoR does not improve.

Key Financial Data and Estimates

	2018	2019e	2020e	2021e
EPS (KWd)	32.20	36.71	41.03	46.52
Growth	15.0	14.0	11.8	13.4
P/E (x)	17.9	15.7	14.0	12.4
BVPS (KWd)	368.2	386.8	407.8	434.3
P/B (x)	1.6	1.5	1.4	1.3
DPS (KWd)	20.00	20.00	20.00	20.00
Dividend Yield (%)	3.2	3.5	3.5	3.5

Source: Company data, QNB FS Research

Key Data

Current Market Price (KWd)	575
Dividend Yield (%)	3.5
Bloomberg Ticker	CBK KK
ADR/GDR Ticker	N/A
Reuters Ticker	CBKK.KW
ISIN	KW0EQ0100036
Sector	Banks & Financial Svcs.
52wk High/52wk Low (KWd)	636/345
3-m Average Volume ('000)	161.9
Mkt. Cap. ($ bn/KWD bn)	3.8/1.1
Shares Outstanding (mn)	1,979.88
Current FO* (%)	0.42
1-Year Total Return (%)	+55.7
Fiscal Year End	December 31

Source: Bloomberg (as of April 15, 2019) *Boursa Kuwait (as of April 10, 2019); Note: FO is foreign ownership

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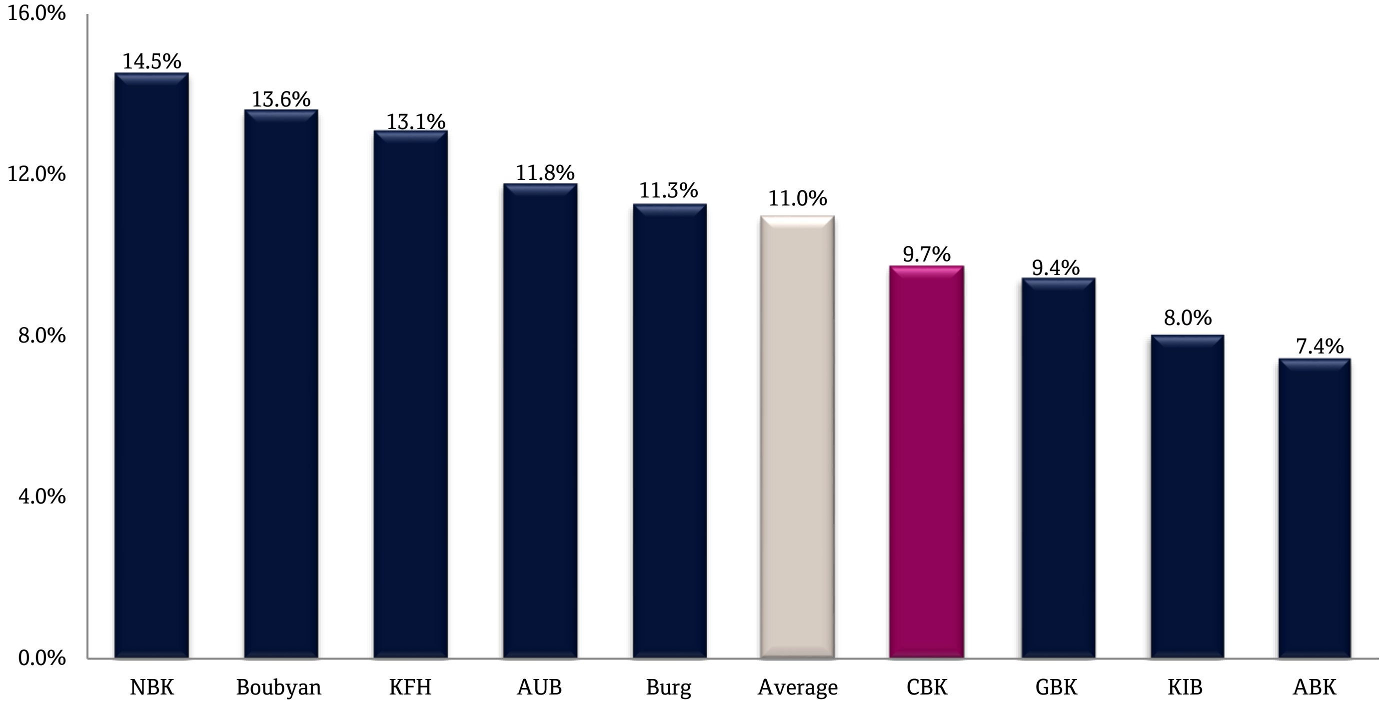
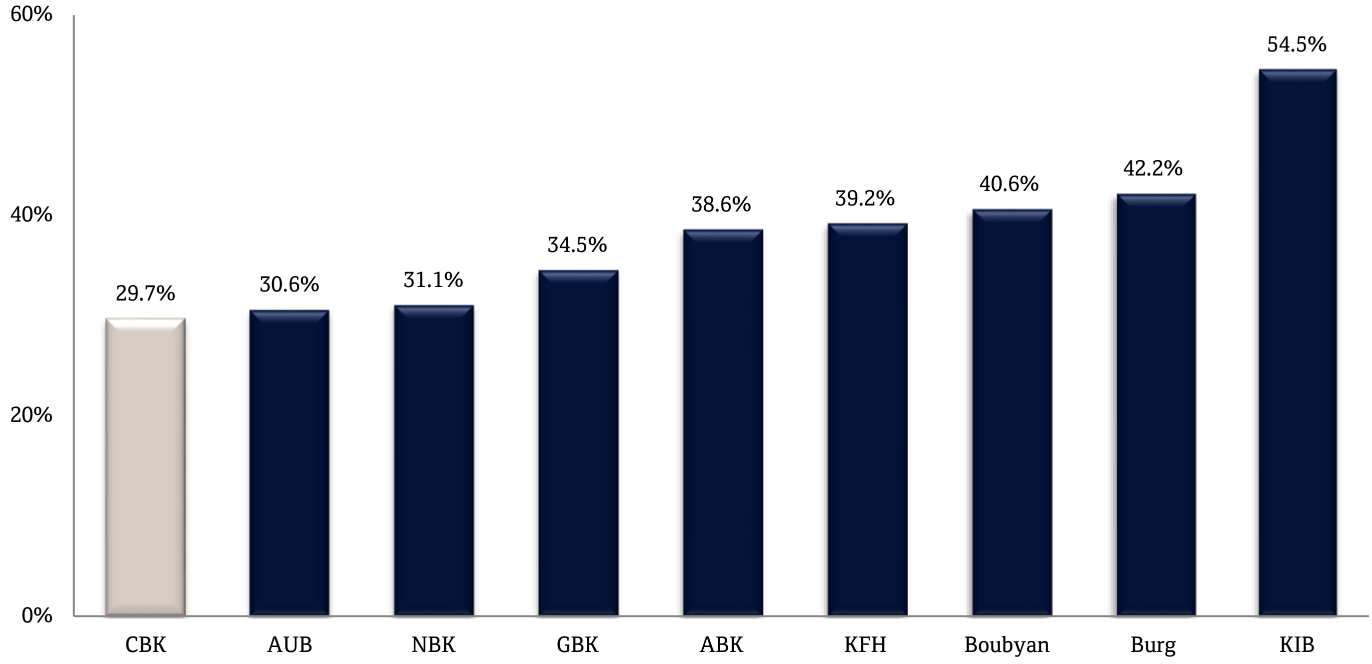
We Expect CBK to Generate RoE of 10.0% in 2019e and 12.9% by 2023e



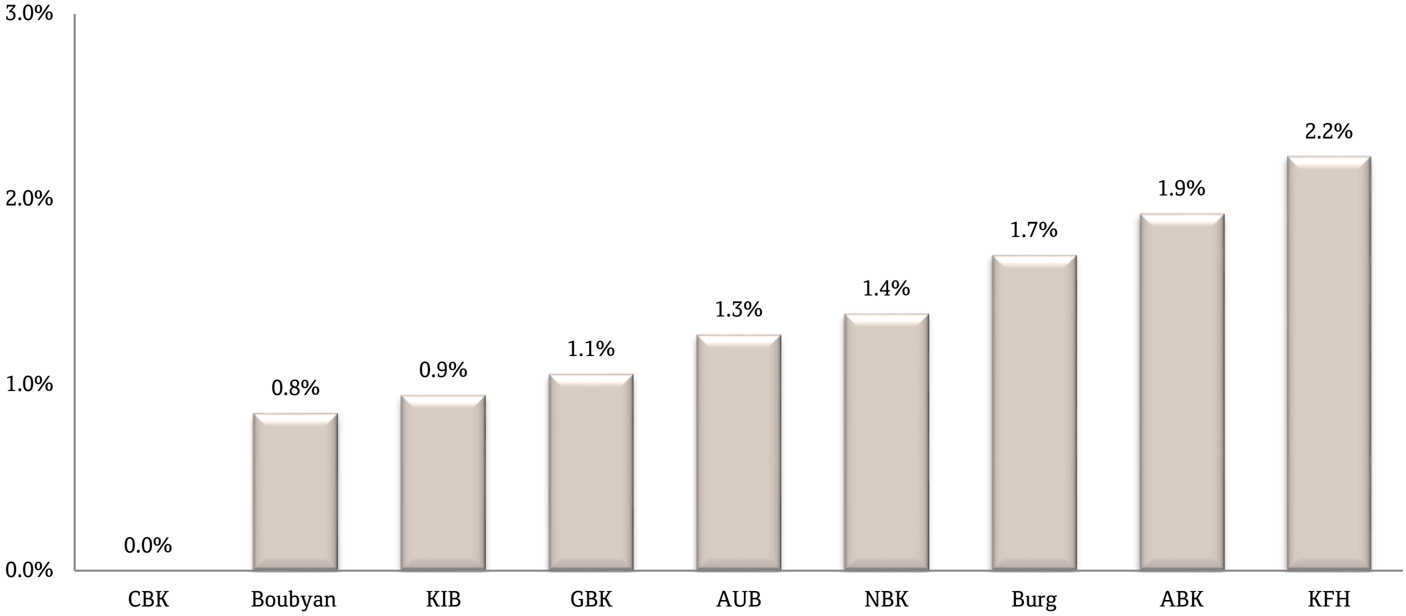
Source: Company data, QNB FS Research

Lowest Cost-to-Income Ratio Among Peers



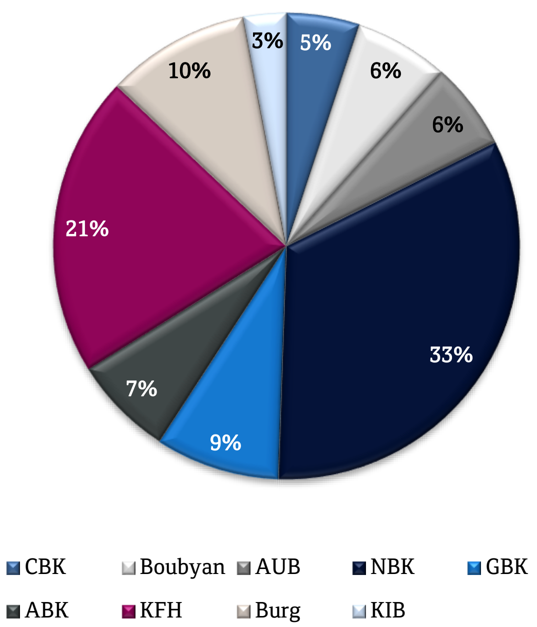
Source: Company data, QNB FS Research

CBK Has No NPLs

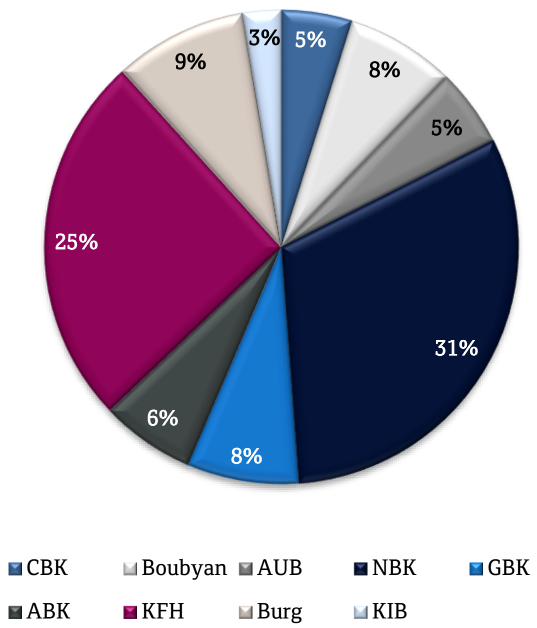


Source: Company data, QNB FS Research

5th Largest Market Share in Loans......................



.... And Deposits



Source: Company data, QNB FS Research

Valuation

We value CBK 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 = (RoE-g)/(Ke-g). This model uses sustainable return on average equity (RoE) 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 CBK'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 = (RoE-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 1.09% to the 10 year US government bond yield (2.67%) to arrive at a risk free rate of 3.8%. We factor in a beta of 1.0x. Finally, we add a local equity risk premium of 7.0% to arrive at a Ke of 10.76%.

Valuation Methodologies

Fundamental P/B (WEV)	
Sustainable RoE (%)	12.8
Estimated Cost of Equity (%)	10.76
Terminal Growth Rate (%)	5.0
Fundamental P/B	1.4x
Intrinsic Value (KWd)	524
Current Market Price (KWd)	575
Upside/(Downside) Potential (%)	(8.9)

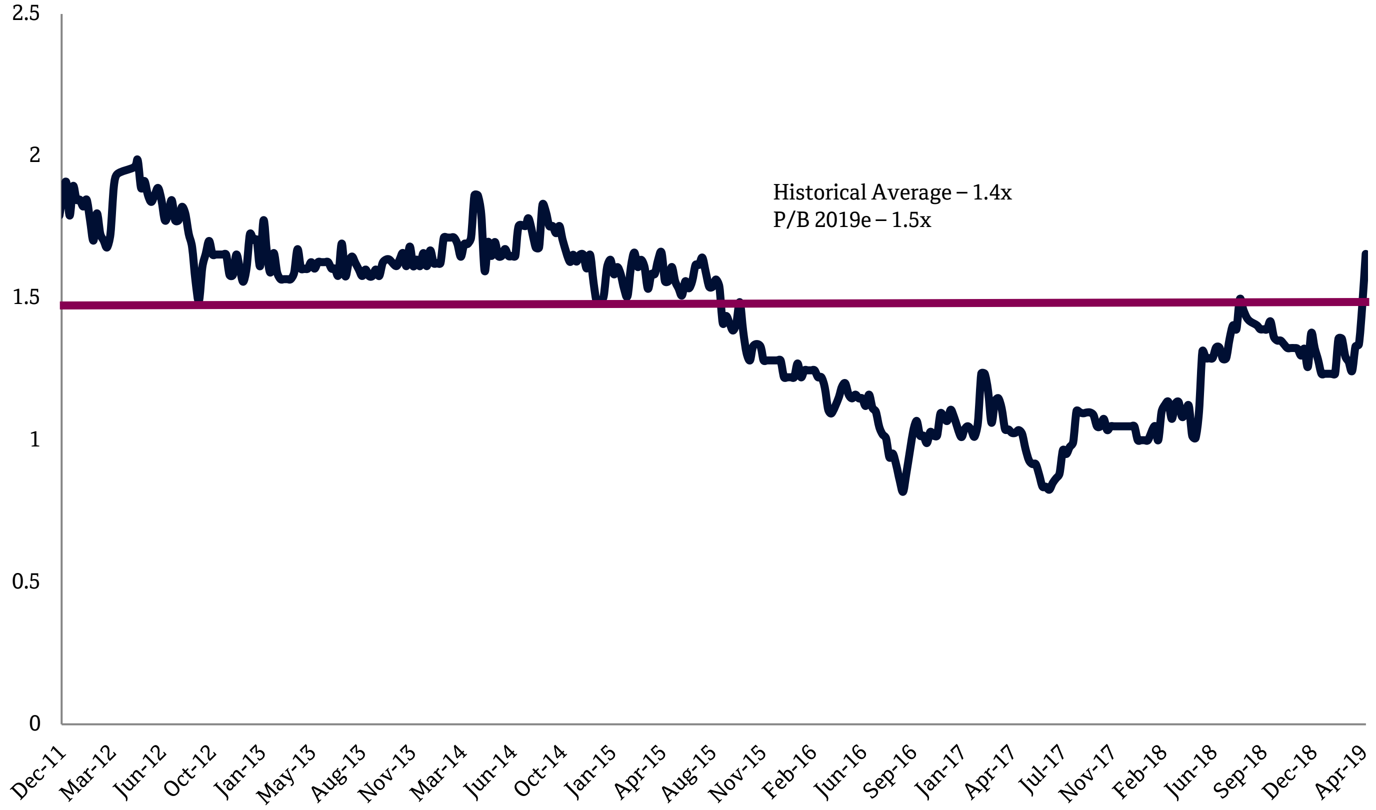
RI Based on Fundamental P/B	
Beginning BVPS (2019) (KWd)	368
Present Value of Interim Residuals (KWd)	39
Present Value of Terminal Value (KWd)	119
Fundamental P/B	1.4x
Intrinsic Value (KWd)	508
Current Market Price (KWd)	575
Upside/(Downside) Potential (%)	(11.6)

Source: QNB FS Research

Methodology	Equity Value (KWd)	Weight (%)	Weighted Fair Value (KWd)
Residual Income	508	50	254
WEV	575	50	262
Target Price			516
Closing Price			575
Upside/(Downside) Potential (%)			(10.3)

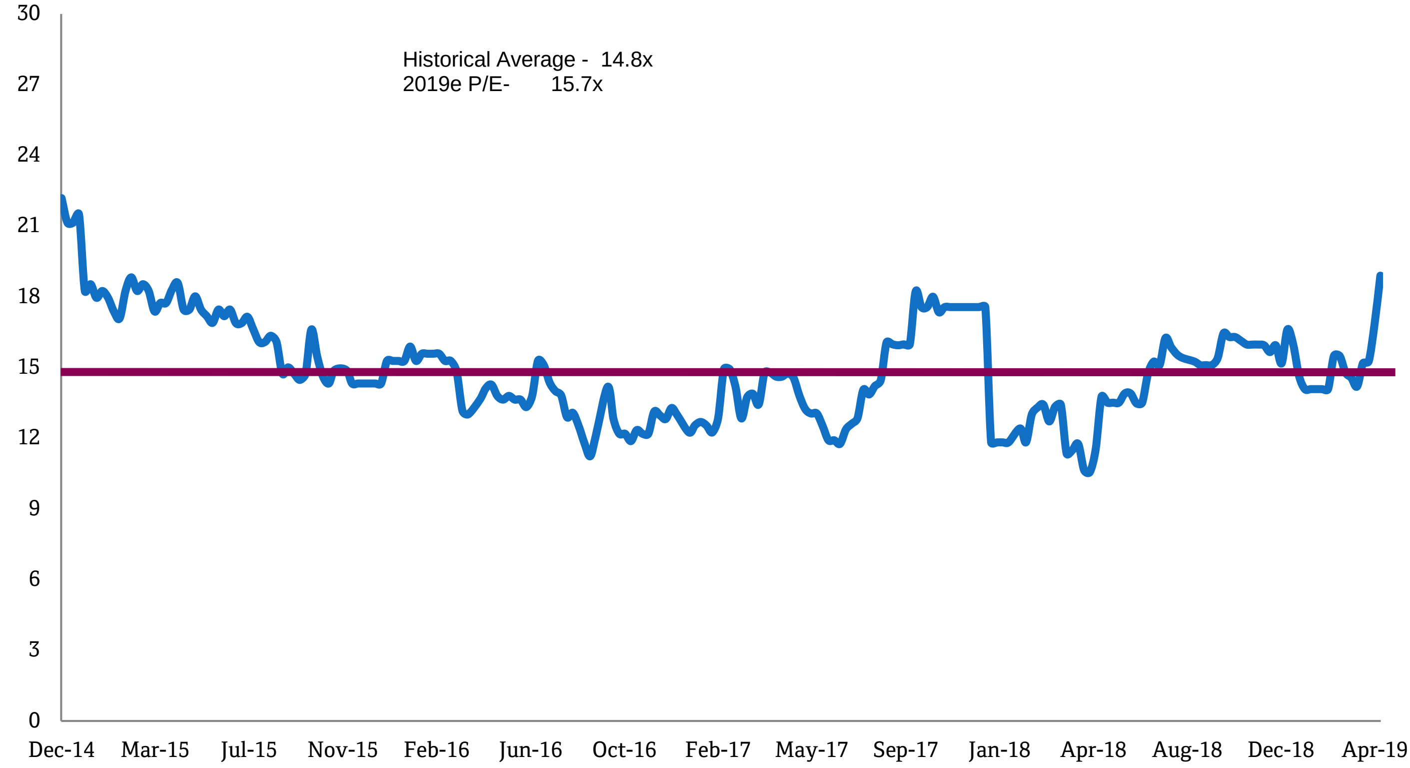
Source: QNB FS Research

Trading at a 5.4% Premium to its Historical P/B…



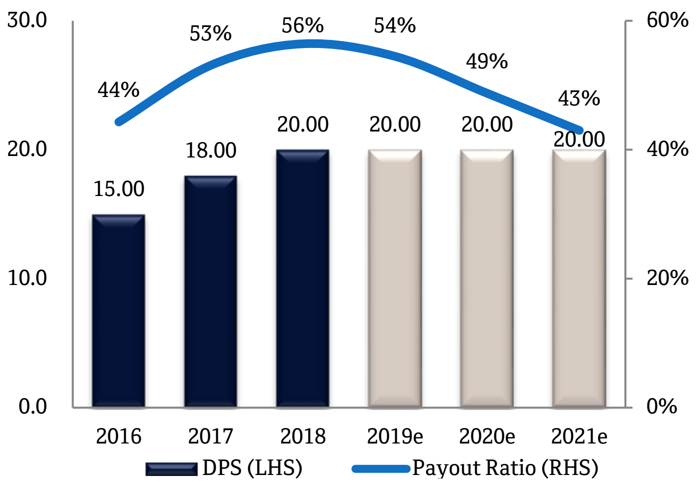
Source: Bloomberg, QNB FS Research

…And 6.1% to its Historical P/E

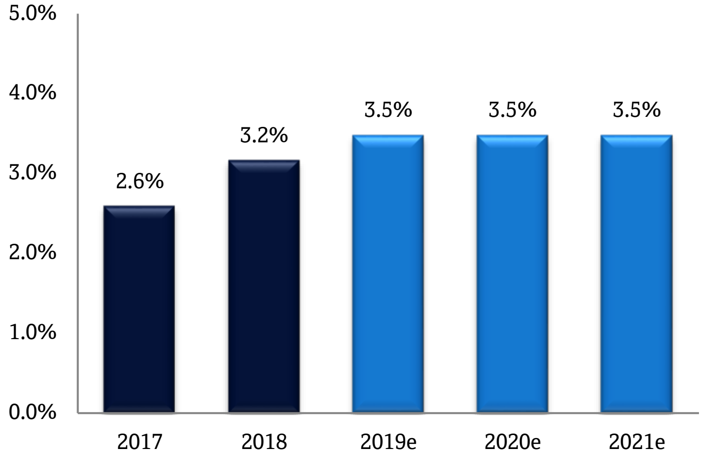


Source: Bloomberg, QNB FS Research

Adopted a Min. 20 fils Cash DPS (KWd)



Decent Yield



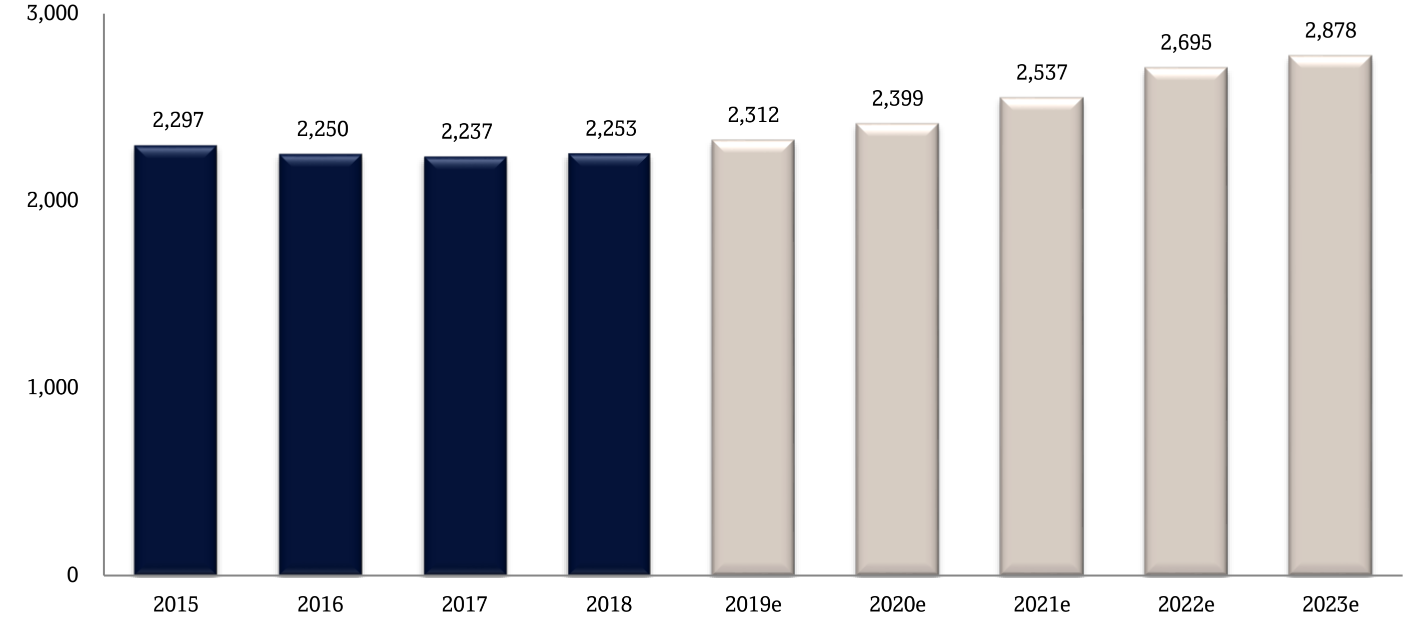
Source: Company data, QNB FS Research

Key Forecasts

Loan Portfolio

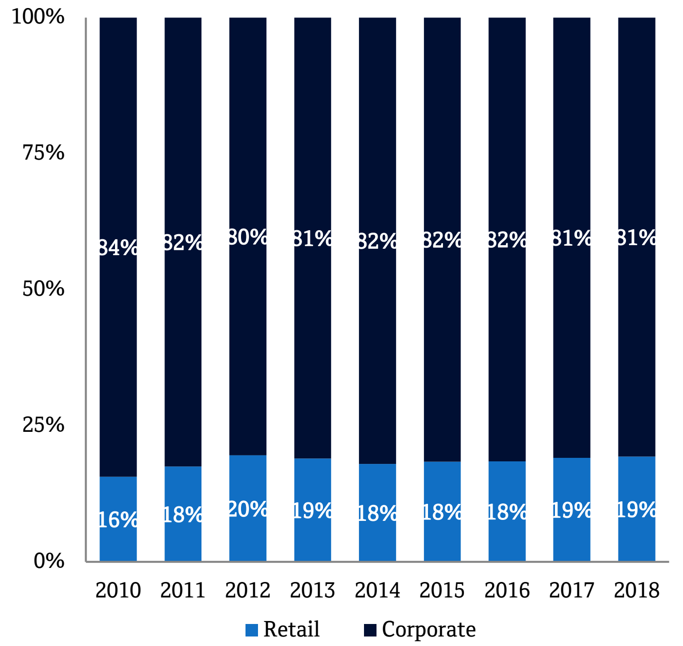
CBK is a mid-sized corporate focused bank and has a 5% market share in loans and deposits; we pencil in a loan book CAGR (2018-23e) of 5.0%. CBK has been de-risking its loan book since 2010 when the financial crisis took a toll on the bank. As such, growth was muted. The bank focused on building its trade & commerce book, which almost doubled its contribution from 14% of total loans (2010) to 29% in 2018. The bank is focused on financing government-related projects which it deems safe. What is important to note here is that CBK reduced its exposure to the risky financial institutions, which led to segment loans falling by a CAGR of 18% (2010-2018). Hence, financial institutions represent almost 3% of total loans (2018) vs. 12% in 2010. Regarding real estate lending, segment declined by a modest 0.7% during the same time frame.

Loans (KWD mn) to Exhibit 5.0% CAGR vs. -0.6% (2012-18)



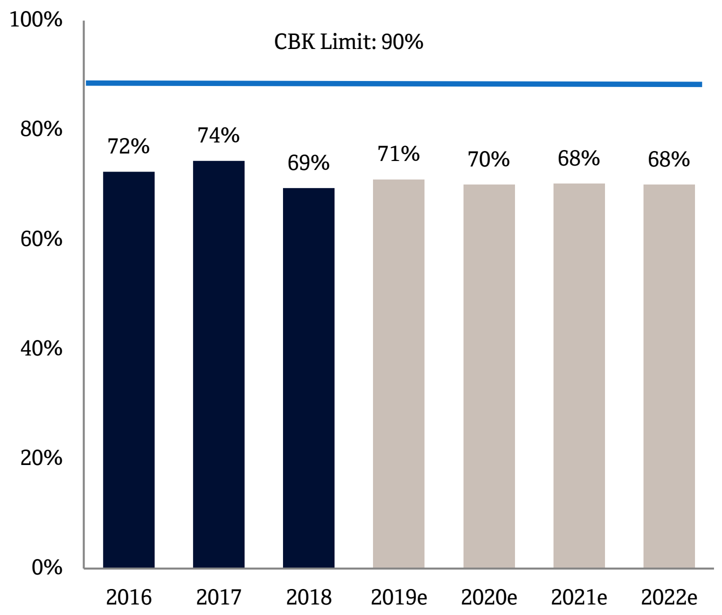
Source: Company data, QNB FS Research

Corporate Focused; Modest Increase in Retail



Source: Company data, QNB FS Research

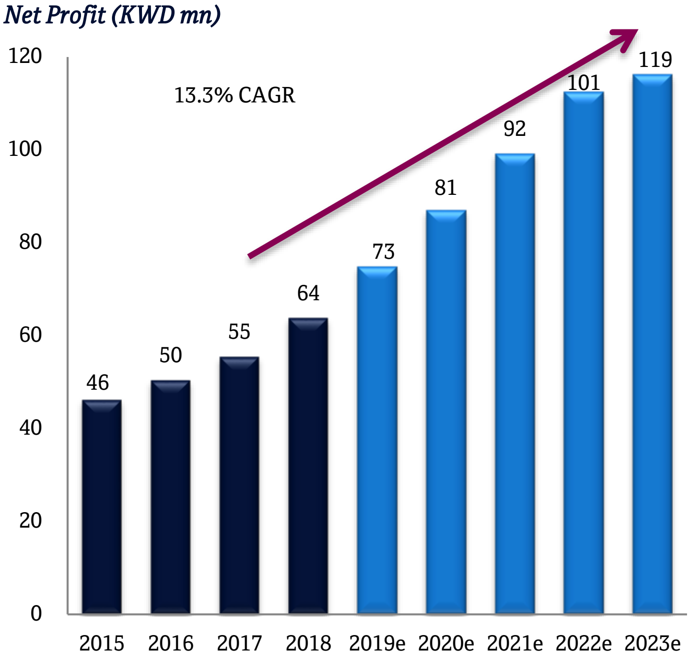
LDR (incl. OFIs) Below CBK Limit; Room for Expansion



Operating Performance

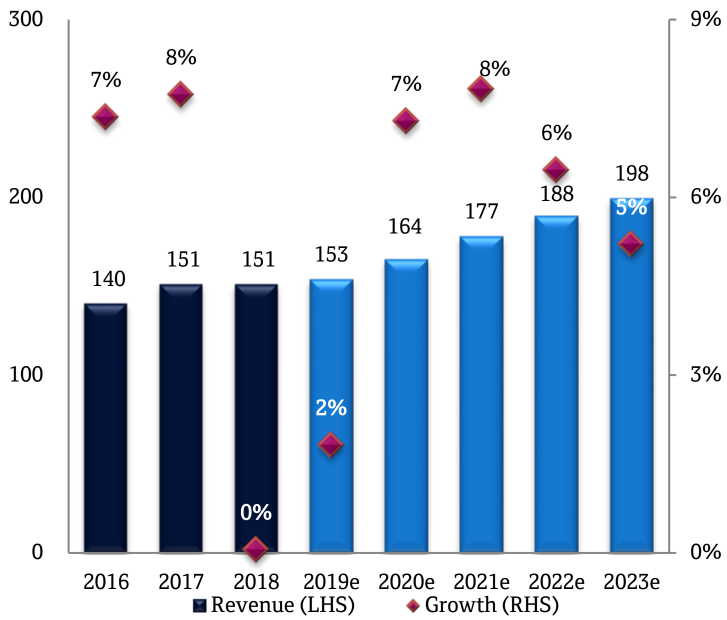
We pencil in a bottom-line CAGR of 13.3% in 2018-2023e vs. +22.1% (2013-2018). The growth in net income is expected to be driven by a net interest income (7.0% 5-year CAGR) and drop in net provisions and impairments and recoveries which we model to decrease by 25.9% vs. -12.5% (past 5 years). *Having said this, there could be further upside to our estimates if CBK reduces provisions and books recoveries ahead of 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 can unlock value, boosting profitability (RoE should materially increase).

Net Profit (KWD mn)

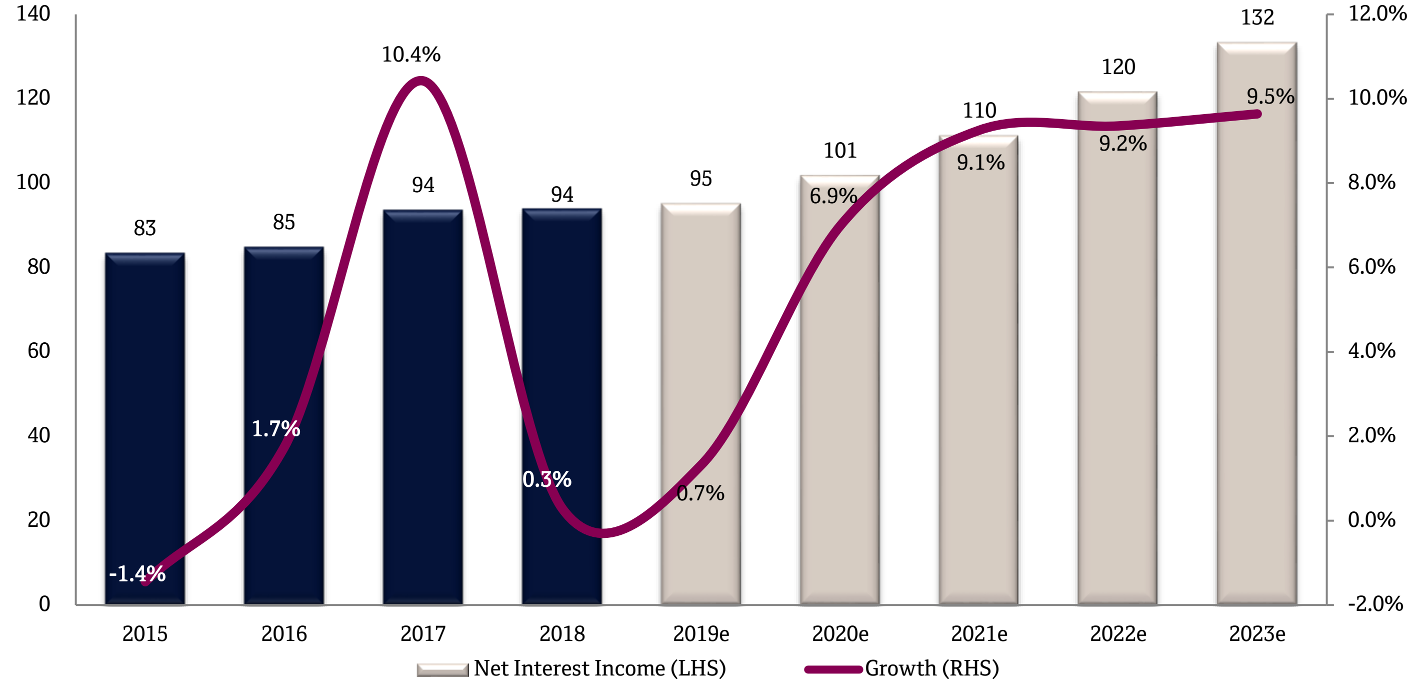


Source: Company data, QNB FS Research

Total Revenue (KWD mn)



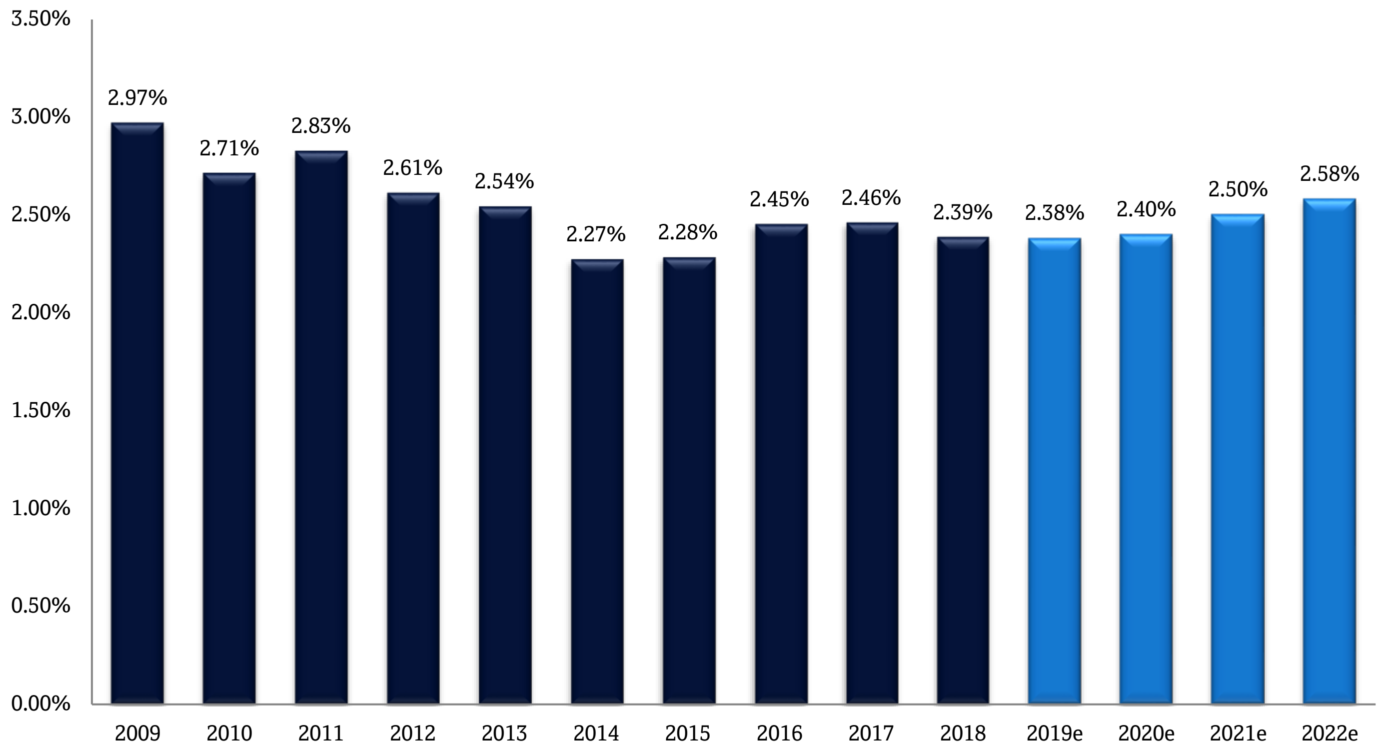
Net Interest Income (KWD mn)



Source: Company data, QNB FS Research

Growth in net interest income to pick up. We forecast NII to grow by a CAGR of 7.0% (2018-2023e) vs. 1.6% (2013-2018) as loans start to grow (de-risking process has come to an end).

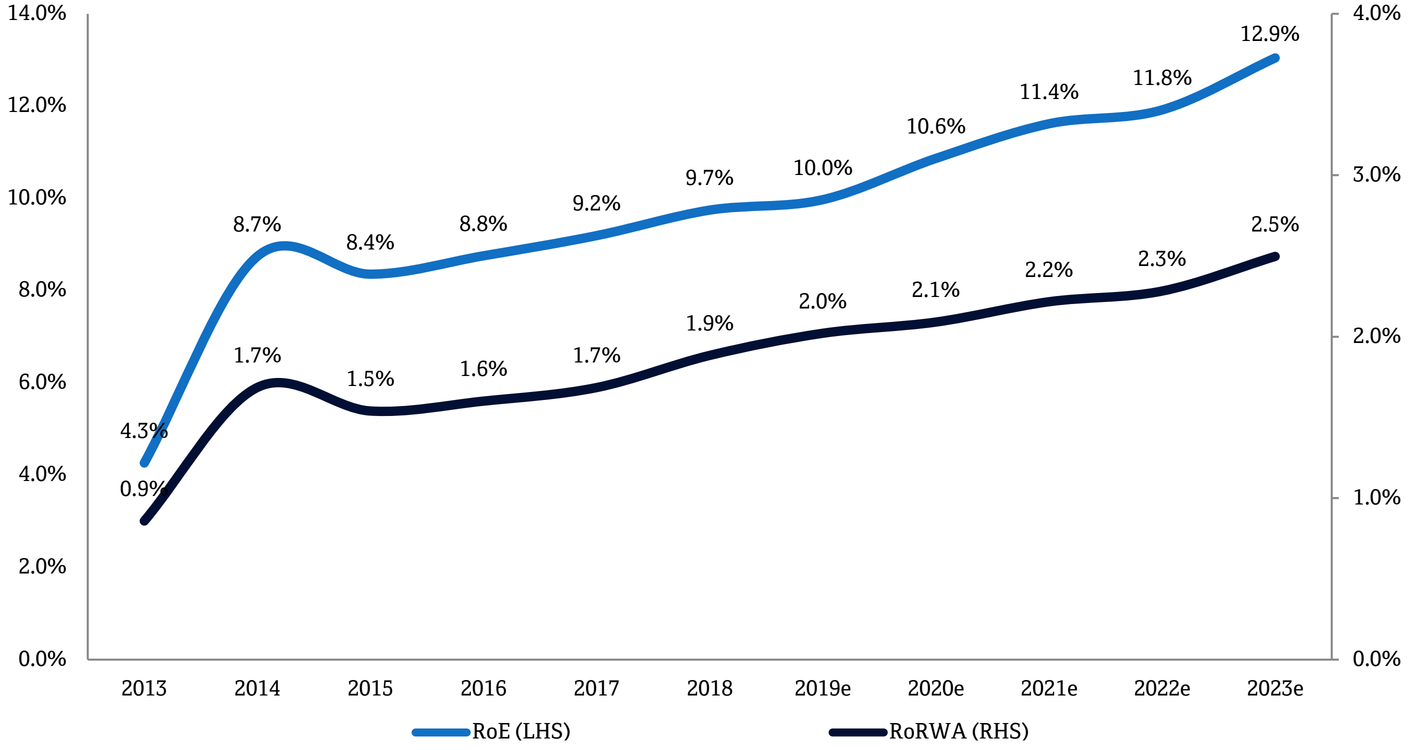
NIMs to Remain Stable



Source: Company data, QNB FS Research

We do not expect NIMs to grow aggressively. We expect only modest increases in the NIM due to the fact that CBK is geared towards low-margin corporate banking and government-backed projects.

RoE is Improving

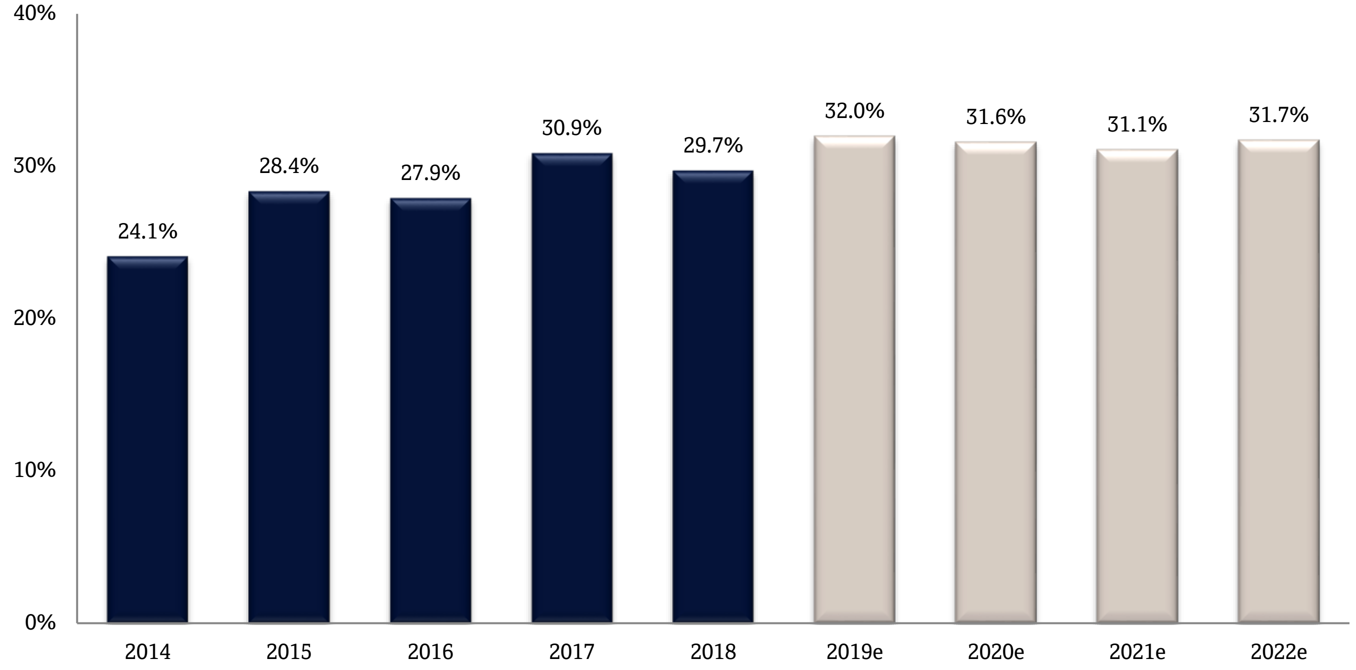


Source: Company data, QNB FS Research

RoE improvement dependent on CoR. RoE is steadily increasing based on our estimates. Reversals of reserves for loan losses and recoveries from net write-offs can boost RoE significantly beyond our estimates as CBK's ALLs are 100% general and not specific as of 2018 and net recoveries contributed on average 66% of the bottom-line (2013-2018).

Efficiency

CBK's Operating Efficiency is at an Optimal Level, Consistent Positive JAWS Would be a Positive

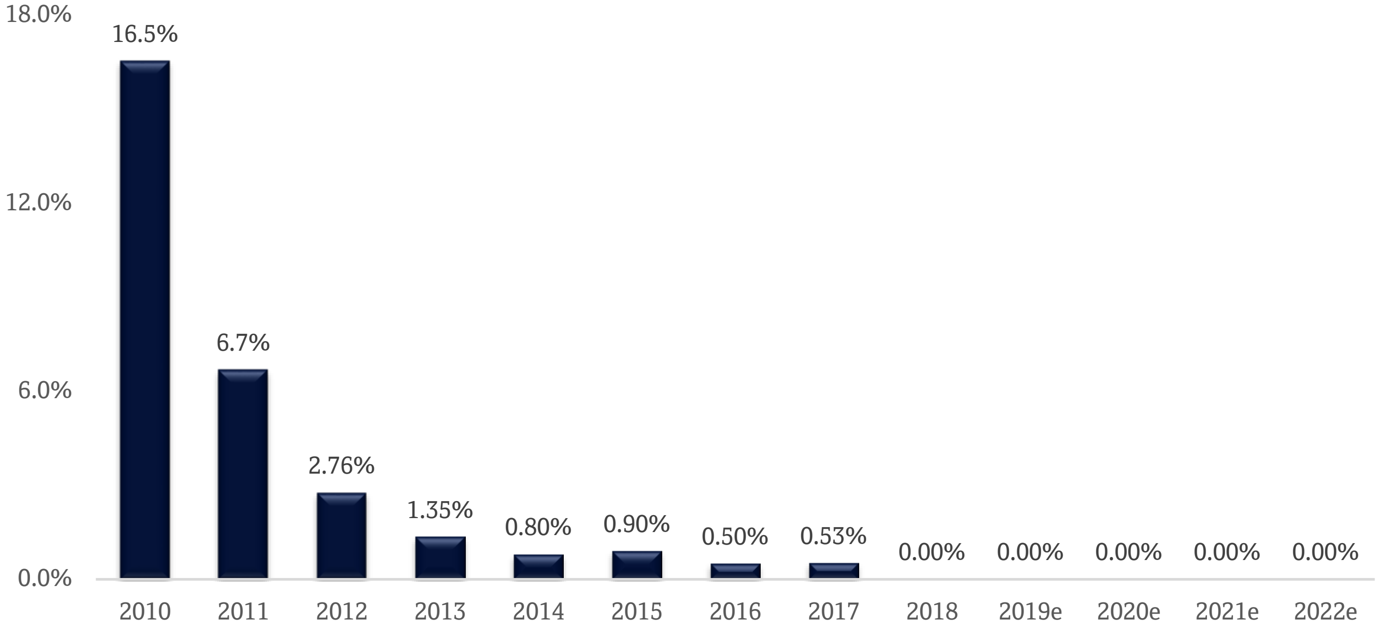


Source: Company data, QNB FS Research

Lowest C/I ratio among peers. CBK's C/I ratio is at an optimal level given that opex on an absolute basis is small. We expect the efficiency ratio to remain stable in our forecast horizon.

Asset Quality

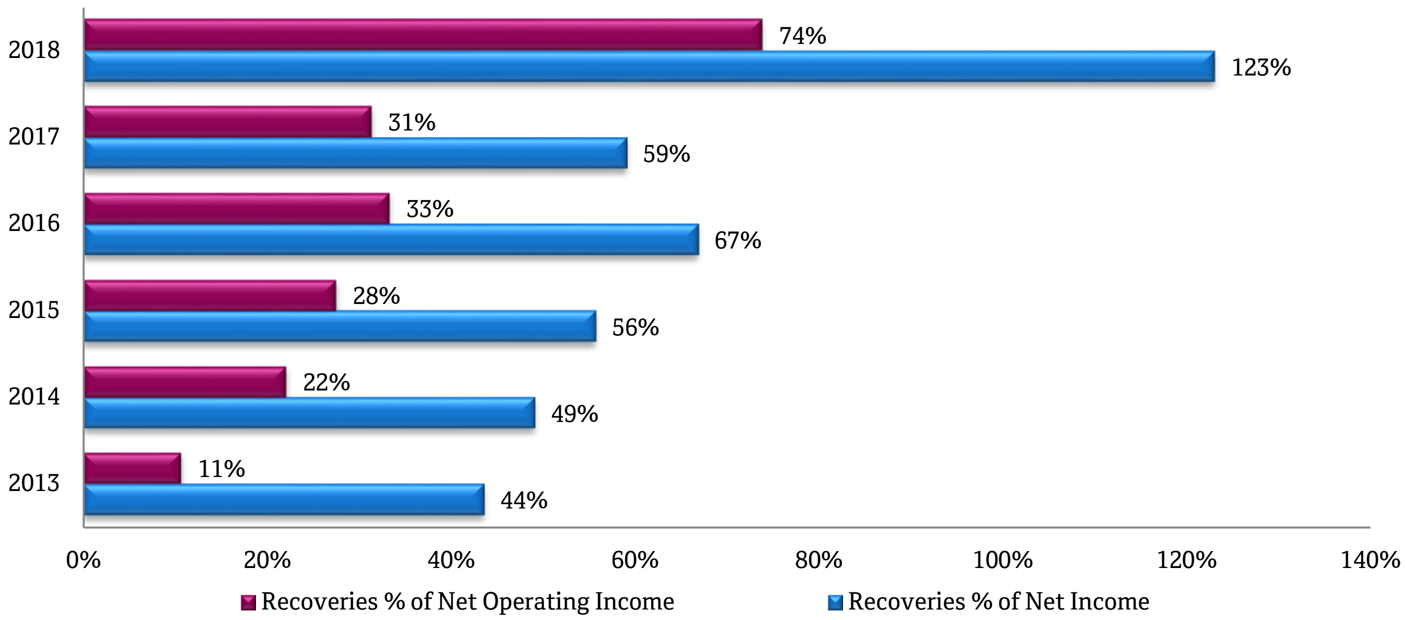
Zero NPLs.....



Source: Company data, QNB FS Research

CBK adopted a zero NPLs policy going forward. The way CBK's zero NPLs policy works is that once a customer defaults, the bank writes off the loan but still books provisions. Hence, there will be NPLs but it will not be visible as it would automatically be written off. CBK has cleaned up its books since 2010 when the NPL ratio reached a high of 16.5% to 0.53% in 2017 and 0% in 2018. The jump in NPLs took place during the 2008-10 financial crisis when investment companies and real estate firms defaulted on their debt. The NPL ratio declined through write-offs and de-risking the loan book. It is worth mentioning that CBK has been recovering a good portion of the write-offs (further recoveries would be a positive surprise for earnings).

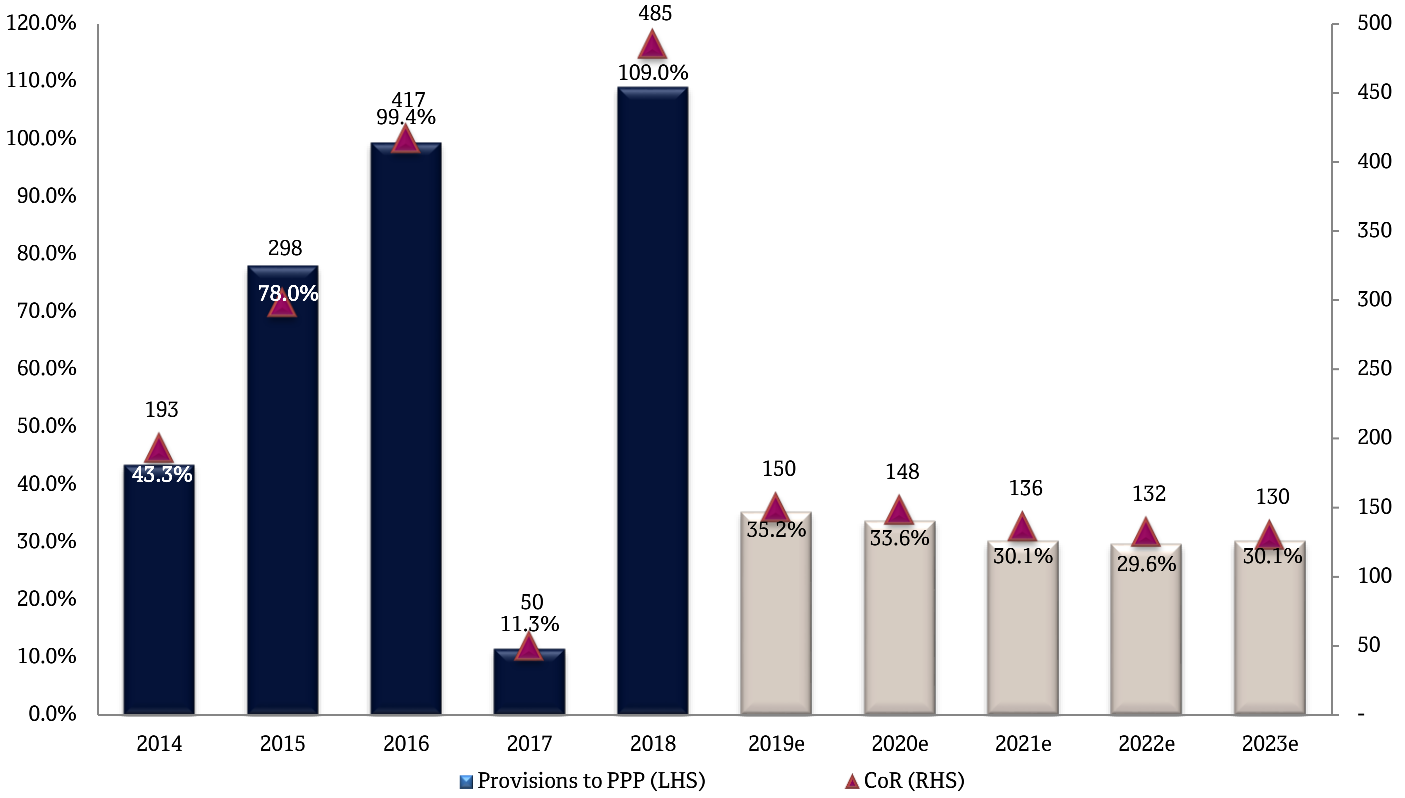
Recoveries Key to Bottom-Line Growth



Source: Company data, QNB FS Research

Recoveries of loans written-off materially influence bottom-line growth. Recoveries have practically contributed >50% to CBK's profitability. More recoveries are expected and would be a positive surprise for earnings. Since 2010, the bank has written off KWD 96.2mn loans on an average per year (4% of average loans 2010-2018) vs. average recoveries of KWD34.2mn (which means they have recovered ~35% of loans written off).

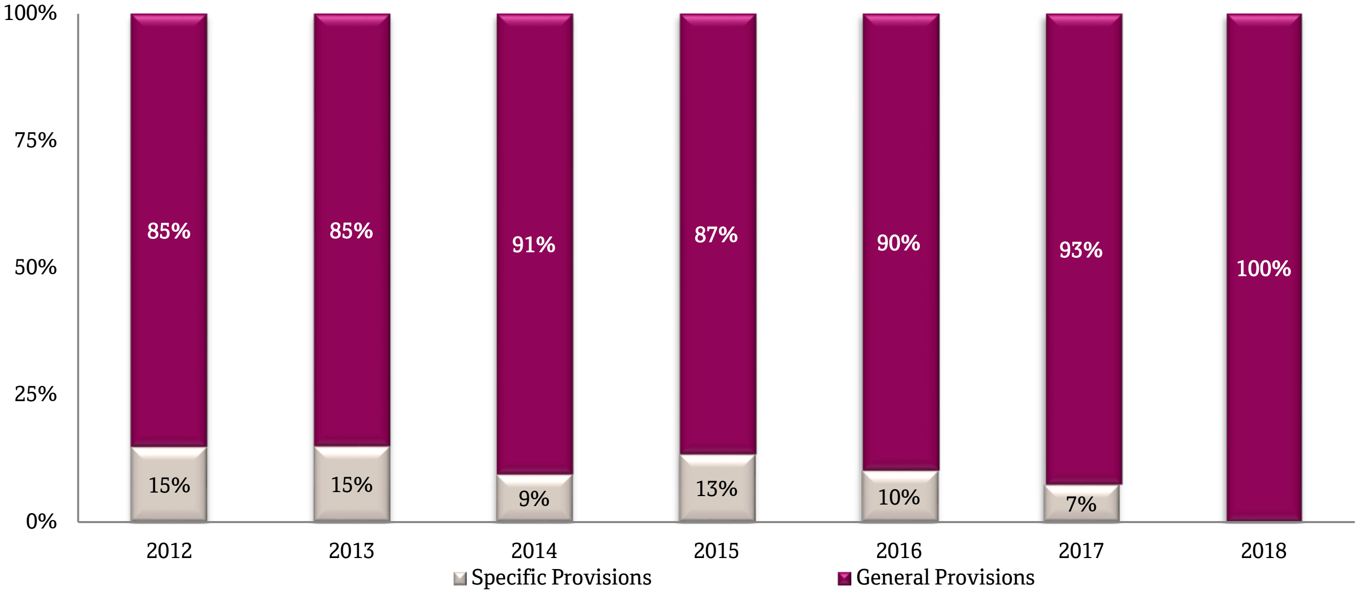
CoR Significantly Improved but Still Remains on the High Side



Source: Company data, QNB FS Research

Cost of risk needs to significantly improve like all banks in Kuwait. CBK'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 90.0% to total credit provisions in 2016, 93.0% in 2017, and 100.0% in 2018. A reversal of these provisions or applying them to ECLs as a one-time impairment charge would unlock great value and would materially enhance profitability metrics (RoE, RoA, Net Profit Margin etc.). It is worth mentioning that CBK has the highest level of general provisions-to-total provisions among its peers. As per IFRS 9, CBK's ECLs amount to KWD 29.05mn vs. general provisions of KWD 142.21mn, generating excess provisions of KWD 113.16mn

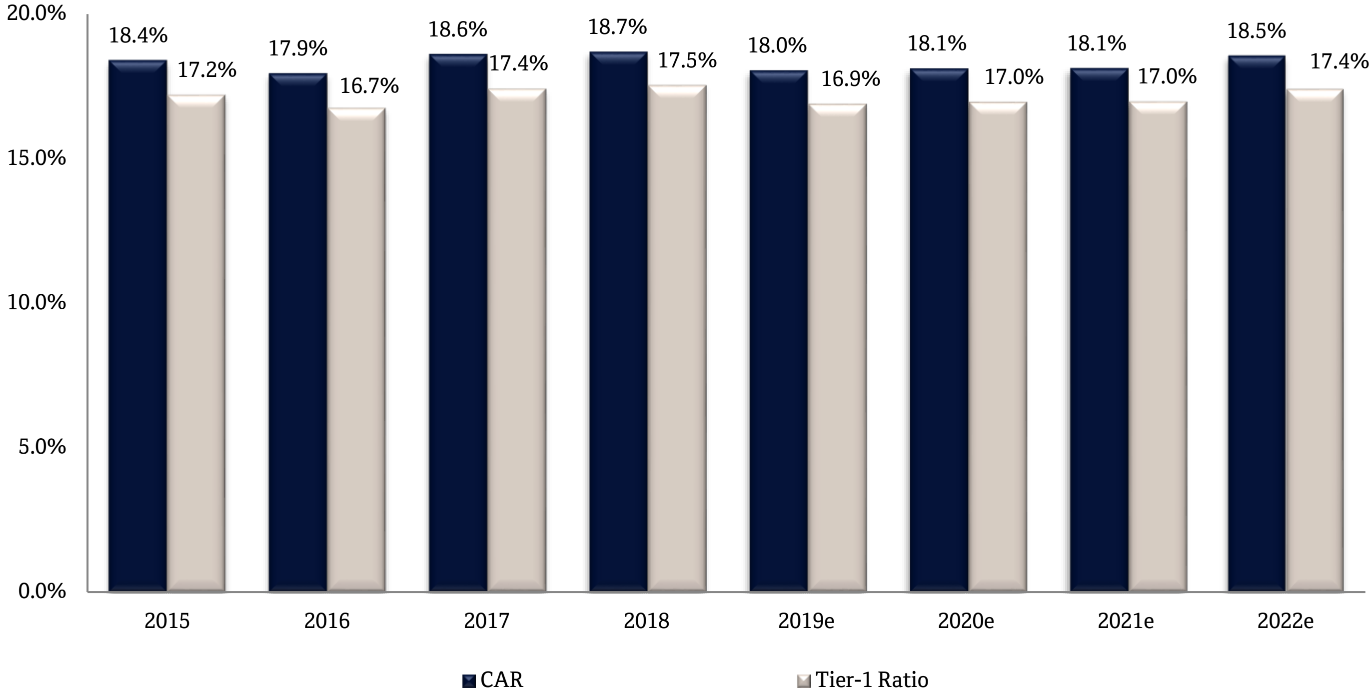
General Provisions/Precautionary to Total Provisions is Significant; Reversals Would Materially Improve Profitability Metrics



Source: Company data, QNB FS Research

Capitalization

Robust Capitalization Levels; CBK Capable of Maintaining High Capital Levels Through Optimization of RWA's



Source: Company data, QNB FS Research

Company Description

Established in 1960, CBK is a mid-sized Kuwait-focused bank and has a 5% market share in loans, along with a 5% market share in deposits. CBK is a universal bank offering services to corporates and retail customers, private banking and treasury services. The bank operates a branch network of 43 branches.

Major Shareholders

Shareholders	Investor Type	Country	Share (%)
Al Sharq Holding Co.	Private	Kuwait	23.22

Source: Boursa Kuwait

Detailed Financial Statements

Ratios	FY2018	FY2019e	FY2020e	FY2021e
Profitability (%)				
RoE (based on Beg. Book Value)	9.7	10.0	10.6	11.4
RoAA	1.4	1.6	1.6	1.8
RoRWA	1.9	2.0	2.1	2.2
NIM (% of IEAs)	2.39	2.38	2.40	2.50
NIM (% of RWAs)	2.77	2.63	2.60	2.65
NIM (% of AAs)	2.12	2.03	2.04	2.12
Spread	1.97	1.91	1.93	2.04
Efficiency (%)				
Cost-to-Income (Headline)	29.7	32.0	31.6	31.1
Cost-to-Income (Core)	30.7	33.1	32.6	32.1
Liquidity (%)				
LDR (incl. OFIs)	71.0	69.6	68.0	68.2
Loans/Assets	50.4	47.5	47.7	47.1
Cash & Interbank Loans-to-Total Assets	27.5	29.6	27.6	27.1
Deposits to Assets	51.3	49.2	50.2	49.3
Wholesale Funding to Loans	57.1	65.8	64.5	67.4
IEAs to IBLs	1.3x	1.3x	1.3x	1.2x
Asset Quality (%)				
NPL Ratio	0.00	0.00	0.00	0.00
NPLs to Shareholder's Equity	0.00	0.00	0.00	0.00
NPLs to Tier 1 Capital	0.00	0.00	0.00	0.00
Coverage Ratio	N/M	N/M	N/M	N/M
ALL/Average Loans	0.0	0.0	0.0	0.0
Cost of Risk	485	150	148	136
Capitalization (%)				
Tier 1 Ratio	17.5	16.9	17.0	17.0
CAR	18.7	18.0	18.1	18.1
Tier 1 Capital to Assets	13.4	13.1	13.5	13.6
Tier 1 Capital to Loans	26.6	27.5	28.3	28.8
Tier 1 Capital to Deposits	26.2	26.6	26.8	27.5
Leverage (x)	6.1	6.4	6.2	6.3
Growth (%)				
Net Interest Income	0.3	0.7	6.9	9.1
Non-Interest income	-0.3	2.7	7.8	5.7
Total Revenue	0.1	1.5	7.2	7.8
Opex	-3.7	9.2	6.0	6.1
Net Operating Income	1.7	-1.8	7.8	8.6
Net Provisions & Impairments	-14.8	-28.4	-3.0	-6.6
Net Income	15.0	14.0	11.8	13.4
Loans	0.7	2.6	3.8	5.8
Deposits	4.0	4.5	5.5	5.0
Assets	1.7	8.9	3.5	7.0
RWAs	2.4	10.1	6.2	7.7

Source: Company data, QNB FS Research

Income Statement (In KWD mn)	FY2018	FY2019e	FY2020e	FY2021e
Net Interest Income	94	95	101	110
Fees & Commissions	41	43	45	49
FX Income	7	6	8	7
Other Income	9	10	9	11
Non-Interest Income	**57**	**59**	**63**	**67**
Total Revenue	**151**	**153**	**164**	**177**
Operating Expenses	(45)	(49)	(52)	(55)
Net Operating Income	**106**	**104**	**112**	**122**
Net Provisions & Investment Impairments	(39)	(28)	(27)	(26)
Net Profit Before Tax	**67**	**76**	**85**	**97**
Tax	(3)	(3)	(4)	(4)
Net Profit Before Minority Interest	**64**	**73**	**81**	**92**
Minority Interest	(0)	(0)	(0)	(0)
Net Profit	**64**	**73**	**81**	**92**

Source: Company data, QNB FS Research

Balance Sheet (In KWD mn)	FY2018	FY2019e	FY2020e	FY2021e
Assets				
Cash & Balances with Central Bank	859	886	884	876
Interbank Loans	370	555	504	584
Net Investments	881	991	1,124	1,254
Net Loans	2,253	2,312	2,399	2,537
Other Assets	73	88	89	101
Net PP&E	29	28	29	31
Intangible Assets	4	4	4	4
Total Assets	**4,468**	**4,864**	**5,033**	**5,386**
Liabilities				
Interbank Deposits	347	540	490	584
Due From OFIs	881	925	999	1,069
Customer Deposits	2,292	2,395	2,527	2,653
Subordinated Tier-2 Notes	58	58	58	58
Other Liabilities	160	180	152	162
Total Liabilities	**3,738**	**4,097**	**4,225**	**4,525**
Shareholders' Equity	729	766	807	860
Total Liabilities & Shareholders' Equity	**4,468**	**4,864**	**5,033**	**5,386**

Source: Company data, QNB FS 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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