Al Khalij Commercial Bank/Al Khaliji (KCBK)

Recommendation	**ACCUMULATE**	**Risk Rating**	**R-3**
Share Price	**QR16.67**	**Target Price**	**QR18.40**
Implied Upside	**10.4%**		

Young Bank with Potential to Grow

We are initiating coverage on Al Khalij Commercial Bank or Al Khaliji (KCBK) with a target price of QR18.40 and an Accumulate Rating. Al Khaliji is a young and small bank with potential to grow. In terms of loans (~2.8% market share), KCBK is the smallest of the five listed conventional banks (8th among the eight listed banks). Focused on Qatar, KCBK's management has set forth a 3-year strategy (2013-2015) that would improve the bank's market share and boost its ROAE to 15%, catching up to that of its peers.

Highlights

- **A play on Qatar's impending infrastructure/construction boom.** The NDS 2011-16 estimates that around $225bn of investment will be made during 2011-16 with significant capital being deployed in infrastructure and construction. Unsurprisingly, management has stated that its strategy is to focus on these segments. Given the bank's small size (1Q2013 total loan book: QR14.1bn), it will not take much to move the needle.
- **Liquid balance sheet coupled with a low LDR.** The bank has a very liquid balance sheet (liquid assets-to-total assets of 52%) and a low LDR (1Q2013: 81.3%), enabling management to redeploy funds into lucrative infrastructure/construction deals. Thus, we estimate loans to expand at a CAGR of 16.2% (2012-17e).
- **Loan growth should translate into robust profitability gains.** We estimate net interest income to grow at a CAGR of 20.8% over 2012-17e. Net profit is modeled to expand at a CAGR of 17.3% over the same period.

Catalysts

- **Visible progress in the realization of management's 2013-15 strategy.** We believe the following developments could be perceived positively by the market: 1) a consistent rise in market share; 2) an expansion of ROAE beyond 12% (2012 ROAE of 9.3% vs. cost of equity of 11.7%); 3) less reliance on treasury operations (investment portfolio worth QR16.0bn, makes up 46.5% of total assets) and 4) announcements/newsflow on infrastructure projects (QNB Group estimates an annual spend of approximately $30bn during the next three years,) which could also serve as catalyst for the broader banking sector.

Recommendation, Valuation and Risks

- **Recommendation and valuation: *We rate KCBK an Accumulate with a price target of QR18.40.*** Our target price implies an upside of 10.4%.
- **Risks:** 1) KCBK's market share gains do not materialize; 2) untested loan book and asset quality and 3) bank faces concentration risk and general risks rising from regional socio-political issues.

Key Financial Data and Estimates

	FY2010	FY2011	FY2012	FY2013e	FY2014e
EPS (QR)	1.19	1.35	1.42	1.54	1.81
EPS Growth (%)	155.1	14.1	5.2	8.5	17.3
P/E (x)	14.1	12.3	11.7	10.8	9.2
BVPS (QR)	14.6	15.0	15.8	15.9	16.7
P/B (x)	1.1	1.1	1.1	1.0	1.0
DPS (QR)	1.00	1.00	1.00	1.00	1.10
Dividend Yield (%)	6.0	6.0	6.0	6.0	6.6

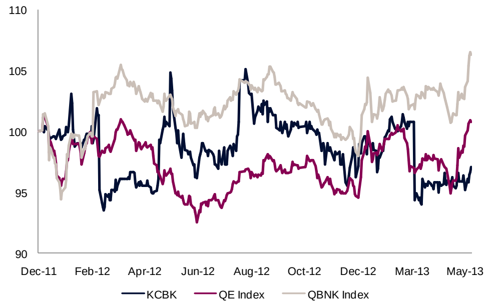
Source: Company data, QNBFS estimates; Note: All data based on current number of shares

Key Data:

Bloomberg Ticker	KCBK QD
ADR/GDR Ticker	N/A
Reuters Ticker	KCBK.QA
ISIN	QA000A0M6MD5
Sector	Banks & Financial Services
52wk High/52wk Low (QR)	18.29/15.70
3-m Average Volume	64,262
Mkt. Cap. ($ bn/QR bn)	1.6/6.0
Shares Outstanding (mn)	360.0
FO Limit* (%)	25.0%
Current FO* (%)	16.4%
1-Year Total Return (%)	8.38
Fiscal Year End	December 2013

Source: Bloomberg (as of May 9, 2013), *Qatar Exchange (as of May 9, 2013); Note: FO is foreign ownership

Relative Price Performance vs. Market Indices



Source: Bloomberg; Note: QE Index is Qatar Exchange Index and QBNK Index is QE All Share Banks & Financial Services Index

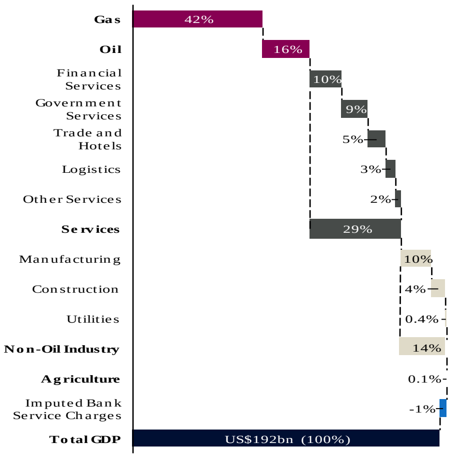
Shahan Keushgerian
+974 4476 6509
shahan.keushgerian@qnbfs.com.qa
Saugata Sarkar
+974 4476 6534
saugata.sarkar@qnbfs.com.qa

Executive Summary

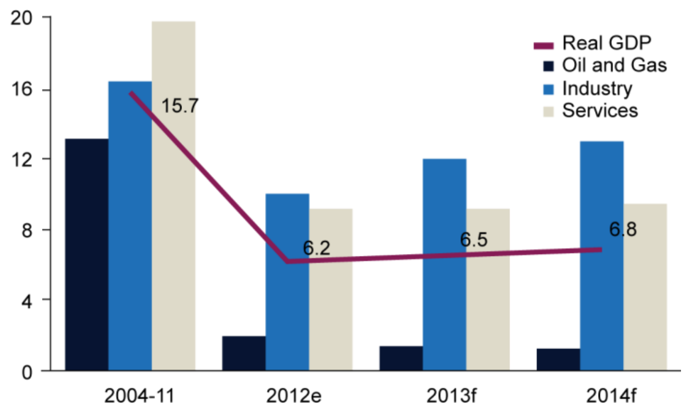
Qatar Focus

Qatar, the fastest growing economy in the world over the last 4 years (2008-12), is forecast to be the fastest growing economy in the GCC for 2013. Qatar's GDP grew at a CAGR of 12% from 2008-12, a significantly higher rate than the next fastest growing economy in the world. Moreover, QNB Group forecasts real GDP growth of 6.5% and 6.8% in 2013 and 2014, respectively.

Breakdown of GDP by Sector (2012)



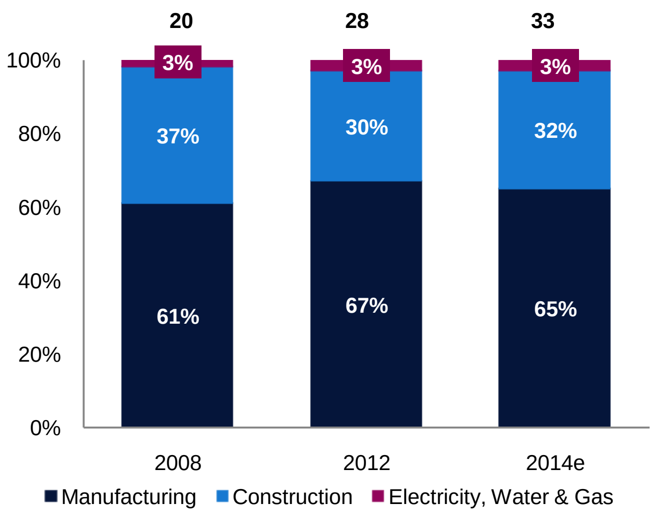
Real GDP Growth by Prevalent Sectors (2004-2014)



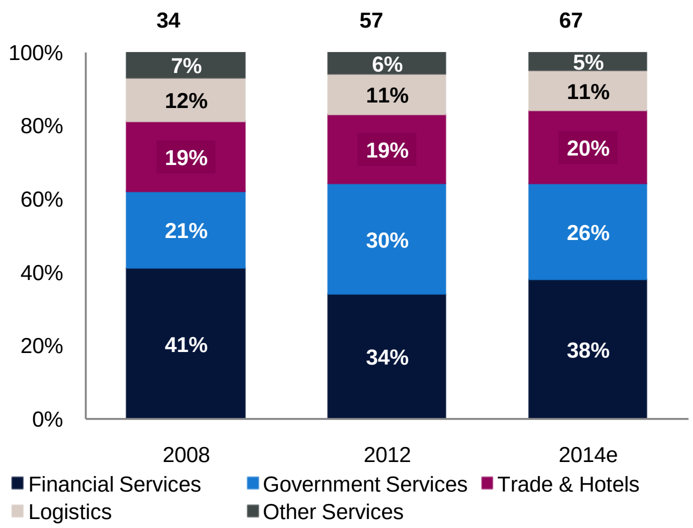
Source: Qatar Statistics Authority (QSA), IMF, QNB Group

Qatar's infrastructure expenditure to fuel growth in financial services. Qatar's long-term aspirations are imbedded in the Qatar National Vision 2030 and will be transpired through a series of medium-term plans, beginning with the National Development Strategy 2011-16 (NDS 2011-16). The NDS 2011-16 estimates that around $225bn investment will be made during 2011-16 (QNB Group estimates $183bn of this plan is still to be spent) with significant capital being deployed in infrastructure and construction. This is more or less in line with the estimated total budgets (~$248bn) of all projects currently underway in Qatar, including all those that have been initiated, plus those that are under study, being designed or in the tendering process, and also including medium-to-long-term spending plans. Hence, QNB Group forecasts the construction sector to significantly grow by 12% in 2013 and 15% in 2014 in real terms. In this respect, we envision the private sector to play a significant role in the implementation of the NDS strategy. As such, we are still of the view that the banking sector will be one of the primary beneficiaries and a major driver of Qatar's infrastructure and construction boom, as current and future projects need to be financed. Given Al Khaliji's focus on Qatar, we are confident that the bank would benefit from what Qatar has to offer.

Industrial Sector Nominal GDP (% Share, $bn)



Services Sector Nominal GDP (%Share, $bn)



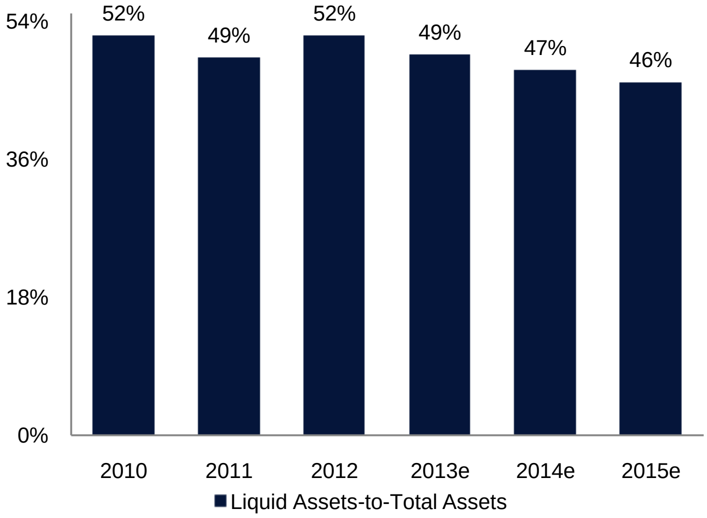
Source: Qatar Statistics Authority (QSA), QNB Group

Al Khaliji should also benefit from the boom in infrastructure/construction activities. KCBK has devised a three year (2013-15) strategy/plan to bolster its position in the corporate banking, public sector and infrastructure financing space. The bank has invested and upgraded its infrastructure, product range and enhanced its workforce by attracting new talent into its fold. Management's strategy is to build a reputation as a banker of choice for corporates, improve its market share and in turn lift its ROAE to 15% (2012: 9.3%). KCBK also wants to leverage its regional (UAE) and international (France) footprint to gain more business in the form of capturing trade flows (Qatar/Europe, UAE/Europe and Qatar/UAE).

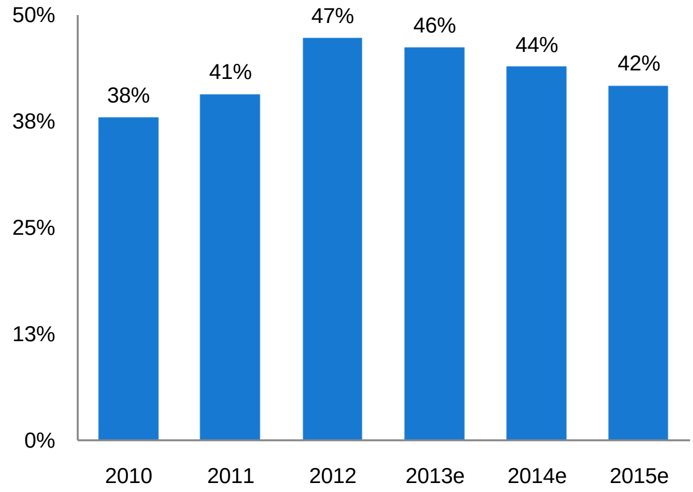
Liquid Balance Sheet Geared for Growth

With a liquid balance sheet coupled with a low loans-to-deposits ratio (LDR), Al Khaliji is well positioned for growth. KCBK is flushed with liquidity with the bank's liquid assets-to-total assets averaging 51% over the past three years. Moreover, the balance sheet value (1Q2013) of the bank's investment portfolio is QR16.0bn, representing 46.5% of total assets. As a result of the bank's liquid position, management is able to take advantage of lucrative deals by liquidating a portion of its investment holdings and redeploying them in higher yielding loans.

Excess Liquidity to Decline



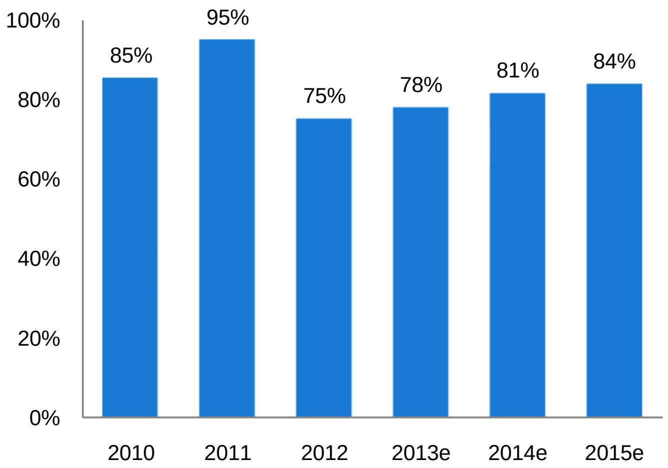
Investments Decelerate as Loans Pick Up



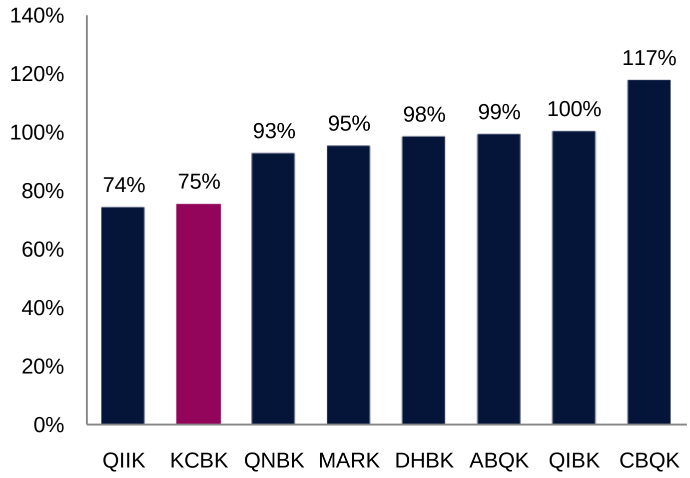
Source: Company data, QNBFS estimates

Al Khaliji's low LDR presents an exceptional opportunity for growth. KCBK enjoys one of the lowest LDRs among local banks. This liquid position gives management the ability and opportunity to increase its loan portfolio and optimize its LDR by edging closer to its peers.

LDR to Climb to Efficient Levels



Lowest LDR Among Peers (2012)



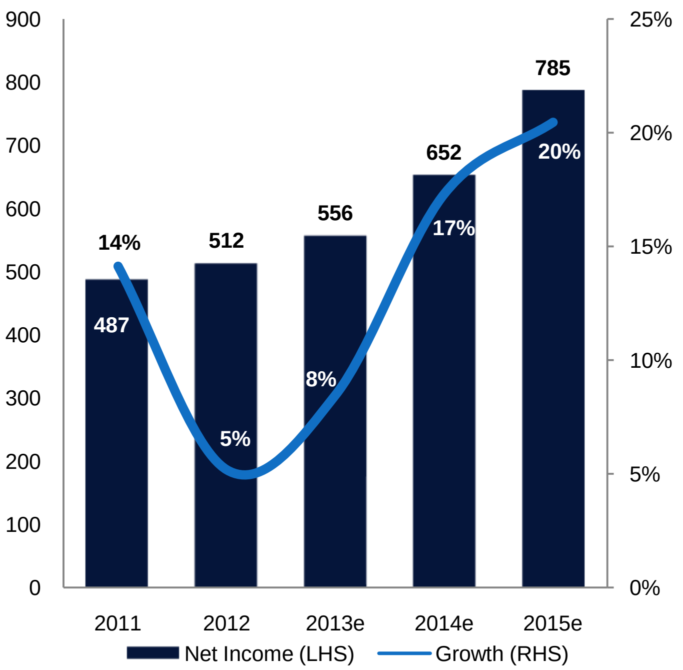
Source: Company data, QNBFS estimates

In order to take advantage of Qatar's expected loan growth; KCBK is focusing on expanding its balance sheet. During the first quarter of 2012 the bank's shareholders and its board approved a $750mn non-convertible bond issuance. However, the bank has not issued any paper as of yet. Most of its local peers took advantage of the favorable interest rate environment and issued paper during the fourth quarter of 2012 in anticipation of credit off-take resulting from the upcoming infrastructure boom and to help diversify their loan books by lending to sectors/firms that they had minimal exposure to. In this respect, QNB Group raised $1bn from a 5-year bond sale in November. This issue was priced at 145 basis points (bps) over the mid-swap rate; the bond offers a coupon of 2.125%. QNB Group issued another $1bn, 7-year bond in April 2013 with a coupon rate of 2.875%. Qatar Islamic Bank (QIBK), the biggest Shari'ah compliant bank (by assets) in Qatar, issued a $750mn, 5-year Sukuk in October 2012. This issue was priced at 175 bps over the mid-swap rate and the Sukuk offers a profit rate of 2.50%. Furthermore, Qatar International Islamic Bank (QIIK) issued a $700mn, 5-year Sukuk with a profit rate of 2.69%. Given the low interest rate environment and the demand for local credit, we are of the opinion that Al Khaliji may follow in the footsteps of its peers and issue paper during 2013.

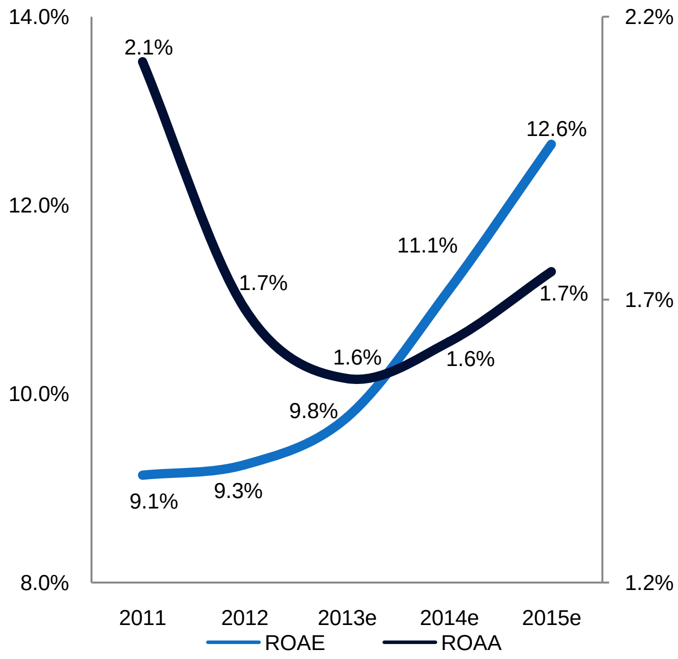
Solid Growth in Future Earnings

We estimate KCBK to register a CAGR of 17.3% in net profit for 2012-17e. We estimate net interest income to grow at a CAGR of 20.8% over 2012-17e. We envision Al Khaliji is going to grow its net operating income by deploying its funds in infrastructure projects (real estate segment) and the corporate segment. On the other hand, the bank is not expected to chase after mass retail but will focus on ultrahigh and high net-worth individuals. Management intimated that the bank has embarked on an aggressive strategy targeting business from the public sector and major local and regional corporates. Recently, Al Khaliji signed a deal with Al Fardan Properties to finance the real estate firm's forthcoming Kempinski Marsa Malaz Hotel Resort, worth ~QR1bn. This provides an indication that management is keen on following through on its strategy to achieve its objectives. Furthermore, management has obtained board approval to issue paper worth $750mn which would help the bank grow its balance sheet. We also expect that as KCBK increases its market share and books big ticket deals, it would allocate fewer funds to its investment portfolio, focusing instead on corporate and commercial banking. As such, if management's ambitious plans materialize, the bank's ROAE and ROAA can markedly improve and catch up with that of its local peers.

Net Income (QR mn) to Expand



ROAE and ROAA to Steadily Rise



Source: Company data, QNBFS estimates

1Q2013 Results

KCBK witnessed its 1Q2013 net profit rise 8.0% YoY buoyed by positive net interest income performance and a surge in fees. Al Khaliji posted a net profit of QR131.5mn in 1Q2013 vs. QR121.8mn in the same period last year, resulting in an increase of 8.0% YoY (-1.7% QoQ). Net profit was driven by net interest income coupled with fees and commissions and the absence of impairments on investments. Net interest income increased 13.4% YoY (+38.3% QoQ). The QoQ surge was due to a 21% gain in interest income while interest expense receded by 1.1%. Hence, the bank's NIM improved during the quarter between ~5bps to ~6bps to ~1.86%. Moreover, fees and commissions soared by 81.6% reaching QR47.3mn vs. QR26.0mn in 1Q2012. Al Khaliji's operating expenses increased by 12.1% YoY (-13.4% QoQ), causing the headline cost-to-income ratio to inch up to 42.1% vs. 40.3% in 1Q2012 (36.7% in 4Q2012). However, core cost-to-income ratio (excludes gains from investment securities) improved markedly, declining to 46.2% vs. 51.0% in 1Q2012. The bank's NPL ratio further improved declining to 0.39% vs. 0.45% (end-2012). The QoQ slip in net income was primarily due to a drop of 89.9% (-55.6% YoY) in gains from investments as KCBK did not book significant gains from investments relative to previous quarters. KCBK's trailing twelve months ROAE improved to 10% vs. 9.3% at the end of 2012. Net loans grew by 7.8% to QR14.1bn while deposits remained flattish YTD, lifting the LDR to 81.3% from 2012's 75.1%.

Catalysts

Visible Progress in the Realization of Management's 2013-15 Strategy

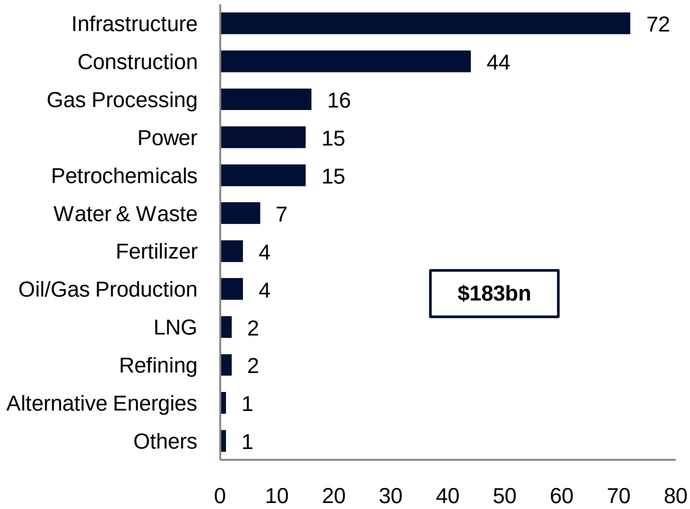
KCBK needs to boost its market share in loans. Al Khaliji currently claims a market share of ~2.8% in loans. We believe a consistent rise in market share could be a positive development. However, this may not come easily as banks are in heavy competition for business from the same pool.

ROAE needs to expand north of 12%. KCBK's 2012 ROAE of 9.3% is lower than its cost of equity (11.7%) and lower than that that of its local peers' average (~15%). Thus, we believe an ROAE expansion beyond 12% would be positively perceived by the market.

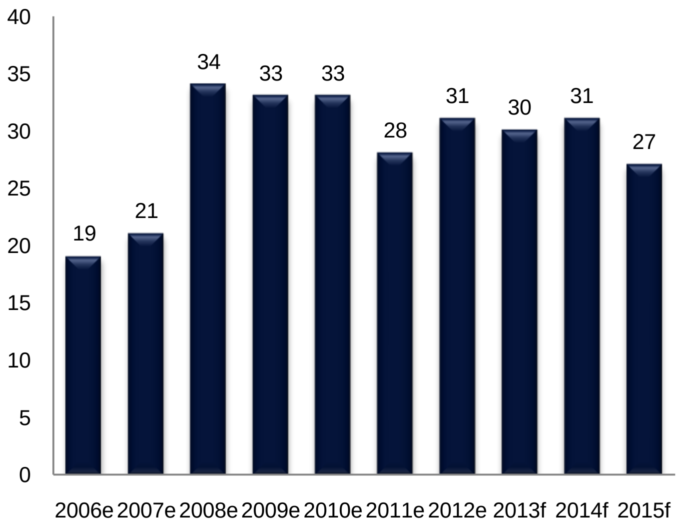
Less reliance on treasury operations. Al Khaliji carries on its balance sheet an investment portfolio worth QR16.0bn, representing 46.5% of total assets. On a positive note, 85% of the portfolio is liquid, enabling management to dispose of securities and redeploy the funds in higher yielding loans.

Announcements/newsflow on infrastructure projects. QNB Group estimates an annual spend of approximately $30bn during the next three years before a drop in spending in 2017 on projects that are currently underway or announced (owing to project completion). Thus, as the projects (worth ~248bn) are implemented and the private sector becomes more involved, we expect KCBK to expand its loan book by a CAGR of 16.2% (2012-17e). The increase in loans would lead to an 8.5% and 17.3% YoY net profit growth for 2013 & 2014, respectively. Furthermore, the growth rate in net income is expected to accelerate to 20.5% in 2015.

Planned Investments (NDS 2013-16) ($bn)



Projects Spend Approximately $30bn from 2008 to 2015 ($bn)



Source: GSDP, QSA, QNB Group, MEED Projects

Valuation

Our target price of QR18.40/share implies an upside of 10.4% from the current price. As such, we rate KCBK an Accumulate.

We value KCBK using a blended valuation methodology, which assigns a 50%:50% weighting to a) Warranted Equity Valuation (WEV) and b) Residual Income Model (RI).

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 5 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 also derive KCBK's fair value by employing the RI valuation technique, 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).

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) the traditional free cash flow to equity (FCFE) formula does not apply to banks. A major advantage of RI in equity valuation is 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). In Al Khaliji's case, 87% of the fair value is derived from the bank's beginning BVPS vs. 10% from the terminal value.

Both valuation methodologies rest on a common Cost of Equity (CoE) assumption of 11.7%.

We calculate a risk free rate of 3.7% by adding the 10-year US treasury bond yield (1.9%) to the inflation differential between Qatar (3.9%) and the US (2.0%). We factor in a beta of 1.0 vs. 0.46 (actual) to be conservative and to address relative illiquidity. Finally, we add a local equity risk premium of 8.0% to arrive at a CoE of 11.7%.

Valuation Matrix

WEV	
Sustainable RoAE (%)	12.7%
Book Value of 2013e (QR)	16.30
Estimated Cost of Equity (%)	11.7%
Terminal Growth Rate (%)	5.0%
Intrinsic Value (QR)	18.62
Current Market Price (QR)	16.67
Upside/(Downside) Potential (%)	11.7%
Equity Value (QR mn)	6,703

RI	
Beginning BVPS (2013) (QR)	15.75
Present Value of Interim Residuals (QR)	0.65
Present Value of Terminal Value (QR)	1.77
Terminal Growth Rate (%)	5.0%
Intrinsic Value (QR)	18.18
Current Market Price (QR)	16.67
Upside/(Downside) Potential (%)	9.1%
Equity Value (QR mn)	6,545

Methodology	Equity Value (QR mn)	Weight (%)	Fair Value (QR mn)
WEV	6,703	50	3,351
Residual Income	6,545	50	3,272
Blended Equity Value			6,624
Shares Outstanding (mn)			360.00
Target Price (QR)			18.40

Source: Bloomberg, *QNBFS estimates

Relative Valuation

Valuation appears to be undemanding. We believe the bank is trading at a discount relative to its Qatari peers primarily due to its short operating history and lack of a track record. We suspect Al Khaliji will trade inline with its peers, once the bank shows encouraging signs that it is gaining market share. As a result of market share expansion, KCBK's operating income and net profit will increase in volume and the bank will start to generate an ROAE of 15% (as per management's aspirations) vs. the current 9.3%. The bank trades on a P/E and P/B multiple of 10.8x and 1.13x on our 2013 estimates. On a P/B basis, Al Khaliji trades at a significant discount to the overall average of the Qatari banking sector. KCBK offers an attractive dividend yield (DY) of 6.0% for 2013, inline with the Qatari banking sector.

Peer Group Valuation

Name	Mkt. Cap (QR mn)	P/E LTM	P/E 2013	P/B	ROE 2013 (%)	Dividend Yield 2013 (%)
Al Khalij Commercial Bank*	**6,001**	**11.50**	**10.80**	**1.13**	**9.7**	**6.0**
Qatar National Bank	100,061	11.81	10.34	2.22	19.8	3.9
Commercial Bank of Qatar	16,752	8.18	8.18	1.21	14.9	8.0
Doha Bank*	11,885	7.83	8.65	1.12	14.4	8.2
Al Ahli Bank	7,370	14.15	15.55	2.32	N/A	5.2
Qatar Islamic Bank*	16,186	14.22	10.84	1.49	12.4	6.6
Masraf Al Rayan*	18,975	12.24	11.82	2.05	15.3	4.3
Qatar International Islamic Bank*	7,826	11.36	10.73	1.67	13.9	7.2
Peers' Average		**11.40**	**10.87**	**1.73**	**15.1**	**6.2**

Source: Bloomberg, *QNBFS estimates

Risks to Our Target Price

- **KCBK's market share remains flat.** Al Khaliji is still a relatively new entrant into the banking space and has to compete heavily with long running rivals. Given that the public sector has been the thrust of growth for the economy and in turn the banking sector, all banks are in stiff competition to gain new business from the public sector. As such, there is the possibility that KCBK may fall short of its aspired market share. However, given its shareholder base, a notable improvement may be achieved even in the short-term. It is well worth mentioning here that based on recent history QNBK and MARK have been the prime beneficiaries of public sector growth.
- **Up and coming bank with an untested loan book.** The bank does not have a long operating history or a track record. As such assessing the banks future and sustainable asset quality (NPL formation, NPL ratio and provisioning) with any degree of confidence remains a challenge.
- **KCBK faces concentration risk.** Since the majority of its operations and assets are within Qatar and to a small extent in the UAE, any downturn in the local economy, downward changes in oil and gas prices or deterioration in the regional socio-political status quo could pose a risk to the bank.

Qatar Banking Sector

In 1Q2013, as reported by the QCB, the banking sector loan book picked up a marginal 1.5% YTD vs. 2.2% during the same period last year. The uptick in loans has been solely driven by the private sector. Notwithstanding this marginal growth, total domestic public sector loans shed 5.2% YTD. The driver behind this decline was primarily the semi-government institutions segment, which contracted by 26.5% YTD. We continue to expect growth in public sector loans to pick up in the coming months and then grow thereafter as project mobilizations pick up. It should be noted that public sector loans experienced a sequential expansion of 26% in 2Q2012. On the other hand private sector loans exhibited positive performance relative to that of the public sector, gaining 4.9% YTD. Consumption (represents 32.0% of private sector loans) and services loans exhibited robust growth YTD; the former sub-segment expanded by 10.9% YTD, while the latter grew by 6.1% YTD. Moreover, credit extended to contractors and industry increased by 5.4% and 3.9% YTD, respectively. On the other hand, loans to real estate and general trade were flattish YTD. Hence, the private sector outperformed itself on a YTD basis by 4.9% in 1Q2013 vs. +2.0% YTD in 1Q2012. For the full year 2013, we forecast loans to increase by 15% to 20% but also expect NIMs to remain under pressure. We expect loan growth to pick up in the 2nd quarter and expand thereafter. Going forward in 2014, we expect better visibility on project executions to lead to strong loan book growth; we expect the loan book to increase by another 15% to 20%.

The private sector also outpaced the public sector in deposit growth during 1Q2013 (YTD). Although total deposits grew by 6.2% YTD, the companies/institutions and consumer segments expanded by 10.8% and 9.2% YTD, respectively. As such, private sector deposits grew by 10.0% YTD as opposed to a modest 3.8% growth experienced during the same period last year. On the other hand, public sector deposits lagged the private sector and climbed only 2.2% YTD. The semi-government institutions segment contracted by 17.8% YTD, while the government segment sequentially dropped by 17.7% YTD. However, the government institutions segment (which makes up 66% of public sector deposits) gained by 16.8% YTD. It should be noted that most of the growth in deposits during 2012 was realized in May and July.

1Q2013 earnings for listed Qatari banks have not been consistent. Overall, the listed banks posted a 4.0% YoY growth in 1Q2013 bottom-line. As is generally the case, QNBK contributed to the bulk of this bottom-line growth (QR134mn vs. QR160mn for the listed banks) followed by Masraf Al Rayan (MARK) and Commercial Bank of Qatar (CBQK). Growth in net profit for the overall banking sector was dented by QIBK's lackluster performance. As mentioned previously, growth drivers varied among the various banks; some banks exhibited growth through positive performance from net interest income and fees, while others witnessed growth from investment gains. Income from fees and commissions which had taken a beating in 2012, once again has shown life with all the banks experiencing growth with the exception of QIBK and QIIK. However, NIMs remained under pressure during the first quarter of 2013.

Net Income for Listed Qatari Banks

In QR mn	1Q2012	1Q2013	Change YoY
Al Ahli Bank	118	135	14.0%
Commercial Bank of Qatar	471	506	7.3%
Doha Bank	390	395	1.4%
Al Khalij Commercial Bank	122	131	8.0%
Masraf Al Rayan	353	400	13.2%
Qatar Islamic Bank	388	291	(24.9%)
Qatar International Islamic Bank	176	185	5.6%
QNB Group	2,004	2,138	6.7%
Total Banks	**4,023**	**4,182**	**4.0%**

Source: Company data

Company Description

KCBK is a conventional commercial bank offering commercial banking services and products to corporate and retail customers. Incorporated in 2007 and listed on the Qatar Exchange (QE) in August of that year, the bank offers commercial loans, trade and project finance, treasury services, consumer loans, current and savings accounts, time deposits, credit cards, e-cards, internet banking and phone banking services. As of April 2013, the bank had 7 branches (2 in Qatar, 4 in the UAE and 1 in Paris, France) and 29 ATMs (25 in Qatar and 4 in the UAE) in operation. Out of the listed banks on the QE, Al Khaliji has a market share of 2.8% and 3.6% in loans and deposits, respectively. Pursuant to its incorporation, Al Khaliji acquired 100% of BLC Bank France (S.A.) – the head office in Paris along with its branch network in the UAE from Qatar Holding. This acquisition opened windows of opportunity both regionally and internationally for the bank to capture trade flows between Qatar/Europe and UAE/Europe.

Solid shareholder base with clout. We believe KCBK enjoys strong support from the Qatari government as is evident from the 42.16% stake held collectively by sovereign institutions. Reinforcing its support and interest in Al Khaliji, Qatar Holding has appointed the Chairman of the bank. This should bode well with investors. The magnitude of this investment by the government prompts the idea that a larger plan may be in the making.

Major Shareholders

Shareholder	Investor Type	Country	Share (%)
Qatari Diar	Government	Qatar	17.24
Qatar Holding	Government	Qatar	10.00
Pension & Retirement General Authority	Government	Qatar	5.36
Qatar Health & Education Fund	Government	Qatar	5.00
Qatar Foundation	Government	Qatar	4.56
Total			**42.16**

Source: Company presentation

Management Team

Name	Designation
H.E. Sheikh Hamad Bin Faisal Bin Thani Al-Thani	Chairman
Abdulla Bin Nasser Al-Misnad	Vice Chairman
Robin McCall	Group Chief Executive Officer
Christiaan de Beer	Group Chief Financial Officer

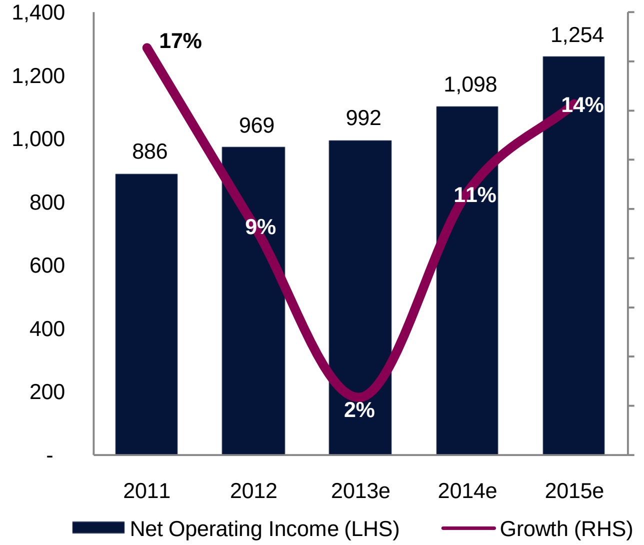
Source: Company data

Key Forecasts

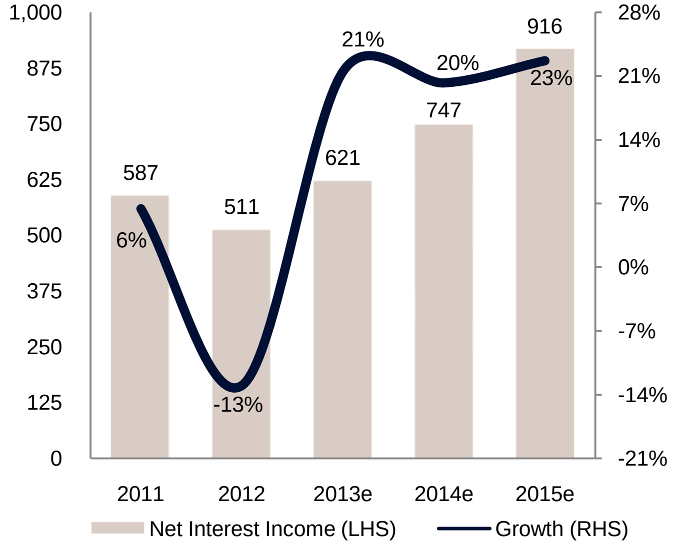
Revenue

We estimate net operating income to grow at a CAGR of 11.3% (2012-17e). We expect growth to come from net interest income, growing at a CAGR of 20.8% (2012-17e). The ensuing growth is based on our assumption of an expansion in the loan book by a CAGR of 16.2% (2012-17e). It is noteworthy here that based on our assumptions, net operating income is expected to grow by less from investment gains and more from net interest income, since we progressively decrease KCBK's dependence on income from its investment book. During the past few years, the source of the bank's growth was its investment gains. Investment gains surged by a CAGR of 105.1% during 2009-2012 due to a low base effect, and investment income contributed to 40.2% of net operating income in 2012 (18.5% in 2011). Having said this, we still factor in investment gains in our assumptions because currently KCBK is still driven by its treasury operations which contributes significantly to the bank's bottom-line. This scenario of generating growth through investment gains was a common theme among the majority of local banks with the exception of some. Competition within the banking industry was fierce as most banks saw the yields on their assets and NIMs take a dive while cost of funding remained rigid. Thus, KCBK's NIMs contracted by ~99 bps in 2012 reaching 1.8%, the lowest in the bank's operating history and lowest among its peers. However, in 1Q2013 Al Khaliji's NIMs recouped ~5 bps to ~6 bps. We do not estimate any further hikes in the NIM and hold it at 1.86% for 2013 as NIMs on a sector level are expected to remain under pressure in 2013.

Net Operating Income (QR mn)



Net Interest Income (QR mn)

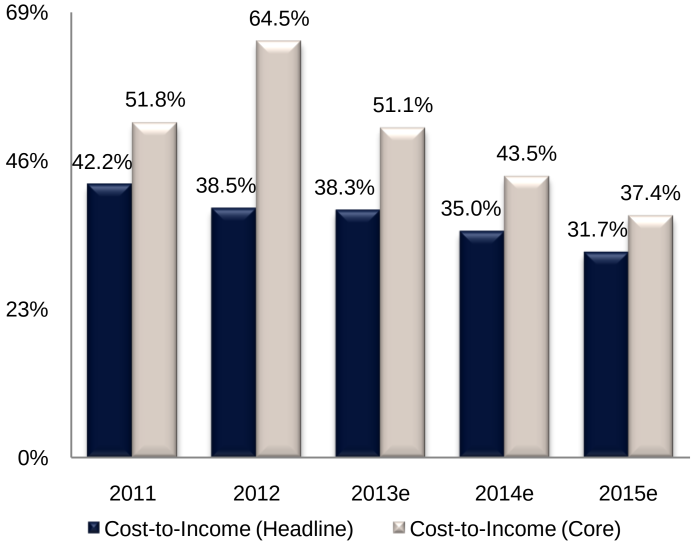


Source: Company data, QNBFS estimates

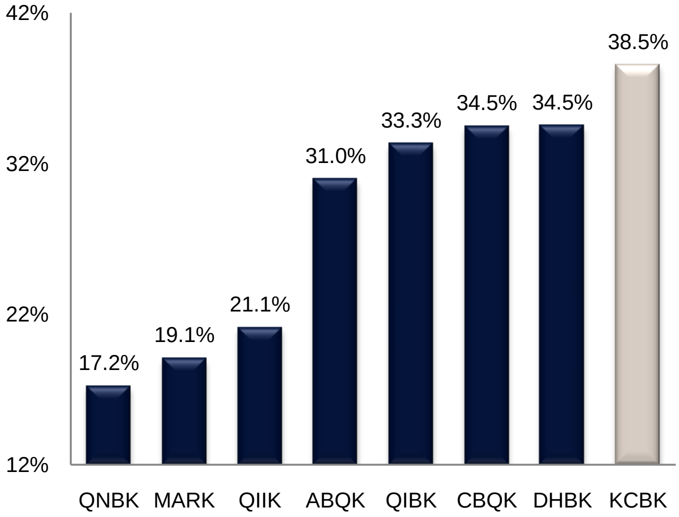
Efficiency

KCBK has room to further improve its efficiency in generating income. KCBK has continuously reduced its cost-to-income ratio from a high of 80.3% in 2008 to 38.5% in 2012. However, the bank's core cost-to-income ratio, measured as operating expenses to operating income less gains from investment securities (a more conservative approach to analyzing cost efficiency since operating income is defined as a bank's income arising from core banking activities) remains at an elevated level of 64.5% as of 2012. We estimate Al Khaliji's efficiency ratio to decline to an average of 31.7% between 2013 and 2017 as operating income increases in volume.

Improvement in Efficiency Over time



Local Peers' Efficiency Ratio (2012)

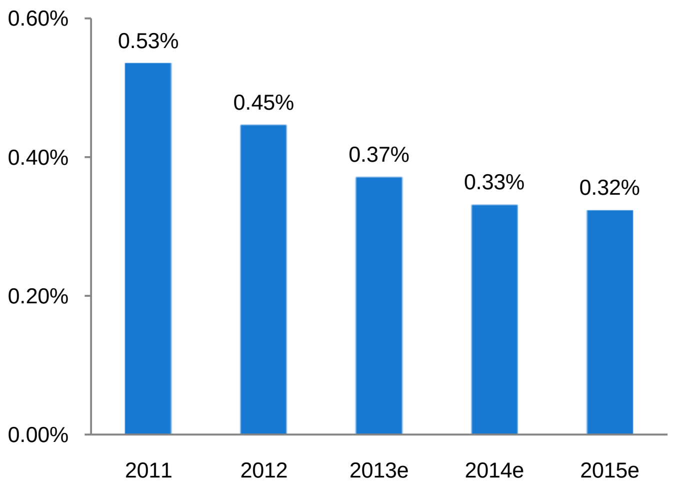


Source: Company data, QNBFS estimates

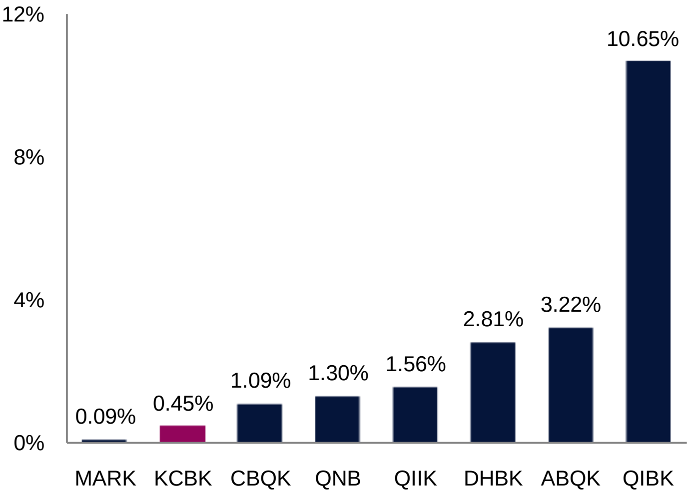
Asset Quality

At first glance, KCBK enjoys a healthy asset quality with a non-performing loans ratio (NPL) of 0.45%. KCBK's NPL ratio dropped from 2009's 3.5% to 0.45% in 2012. We believe the improvement in NPLs was due to a combination of management restructuring loans and taking a prudent approach to lending. We expect the NPL ratio to remain muted in the near to medium term as the bank's loan book has not seasoned. By 2012, management had restructured QR1.06bn in loans, representing 8.0% of the bank's total loan portfolio. Post restructuring, KCBK's NPL coverage ratio soared to 408% as we believe that management decided to maintain provisions on past impairments as a pre-emptive measure. However, maintaining such a ratio is unrealistic and unsustainable. Assuming that the current NPLs (QR59mn) are covered by 100%, then ~75% of the allowance for loan losses (ALL) is attributable to the restructured loans. Based on this estimate, we believe management has taken overall provisions of ~17% on restructured loans. Thus, we are of the view that management will optimize the bank's coverage ratio going forward by a combination of reversals and write-offs.

Healthy Asset Quality (NPL Ratio)



Peers' Asset Quality (2012)

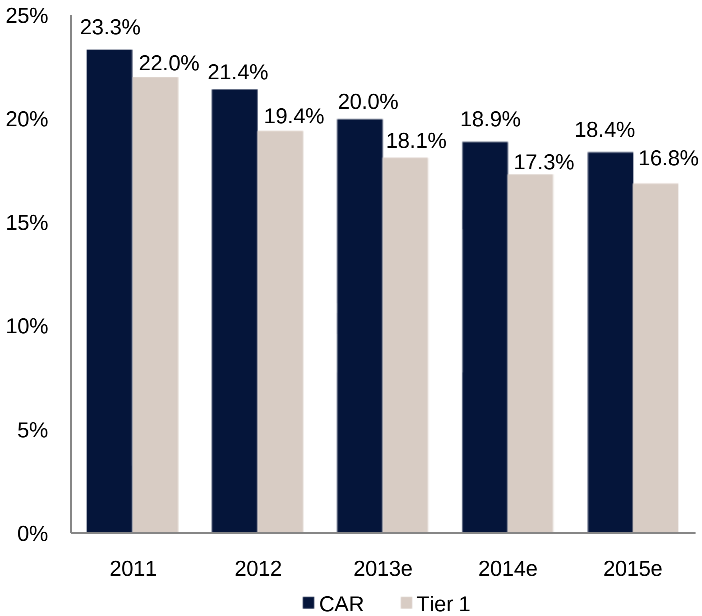


Source: Company data, QNBFS estimates

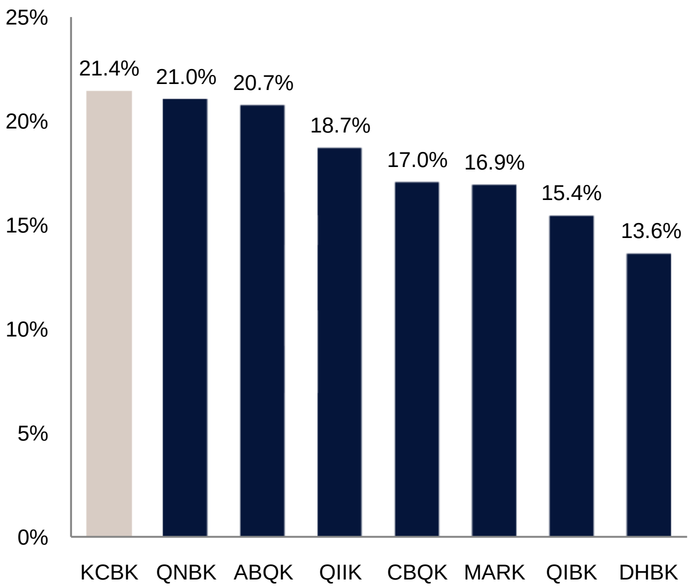
Capitalization

Al Khaliji is more than adequately capitalized. KCBK's Tier 1 ratio stood at an impressive 18.3% at the end of 1Q2013. It has a capital adequacy ratio of 19.9%, far greater than the QCB's minimum requirement of 10%. Hence, as far as safety is concerned, the bank is capable of weathering any storm in the foreseeable future. Having said this, we expect the bank's Tier 1 ratio to progressively decline as the bank's operations expand and risk weighted assets (RWA) gather pace.

Capital Adequacy Ratio (CAR) to Remain at Healthy Levels



Local Peers' CAR (2012)

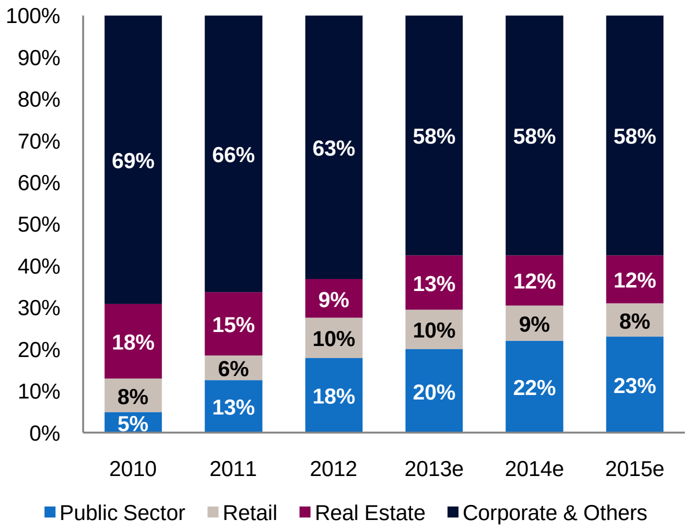


Source: Company data, QNBFS estimates

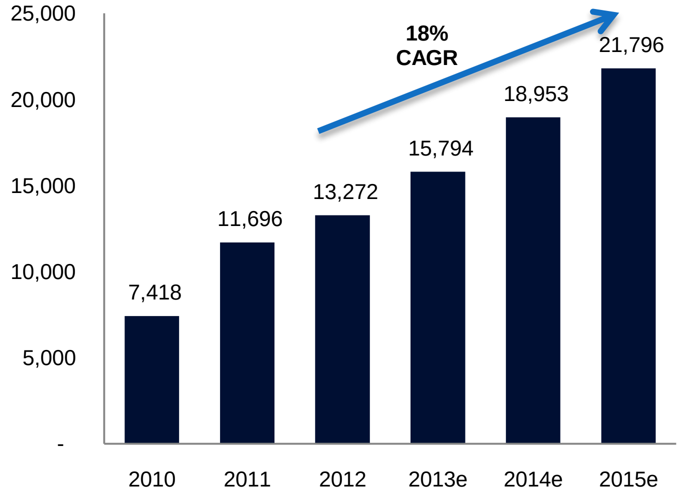
Loan Book

We estimate loans to grow by CAGR of 16.2% during 2012-17e. We expect the bulk of the growth to come from the public sector/infrastructure and corporate sector with additional support from the real estate sector. KCBK is focusing on booking big ticket deals from the public sector. Hence, we pencil in a CAGR of ~28% during 2012-15e. We believe this is attainable due to the bank's strong shareholder base. This growth is also partly due to a low base effect. Regarding the corporate sector, we estimate CAGR of ~14% during 2012-15e as the bank is positioning itself as a corporate bank as opposed to retail. On the corporate front, Al Khaliji along with a consortium of lenders recently contributed to the ~QR900mn financing of Gulf Drilling International (GDI). We estimate gross loans to expand by 19% and 20% in 2013 and 2014, respectively. In 1Q2013 net loans expanded by 7.8% YTD.

Loan Book Profile



Loans (QR mn)



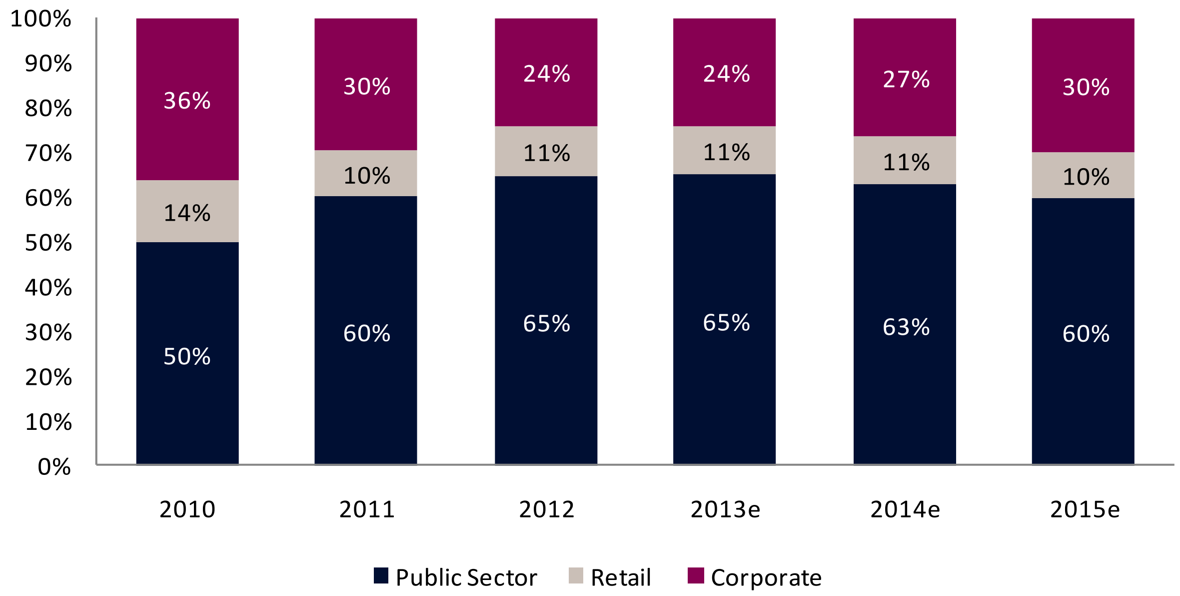
Source: Company data, QNBFS estimates

- **Real estate segment to aid growth.** Based on data for initiated projects, overall spending should be $30bn in 2013 and $31bn in 2014. Thus, QNB Group forecasts the construction sector to significantly grow by 12% in 2013 and 15% in 2014 in real terms. Inline with this expectation, Al Khaliji, recently signed a deal with Al Fardan Properties to finance the real estate firm's forthcoming Kempinski Marsa Malaz Hotel Resort, worth ~QR1bn. We estimate loan growth pertaining to KCBK's real estate book to expand at a CAGR of 26.6% (2012-2015e)
- **Consumer banking not in Al Khaliji's cards**. KCBK has a small branch network which prevents it from aggressively tapping the retail market. Moreover, management has indicated that it is not after the masses but is rather focusing on high net-worth individuals (HNI) and ultra high net-worth individuals (UHNWI). Moreover, QCB's recent directive on consumer banking does not make it enticing for bankers with limited exposure to retail to chase after business within this space. The directive states that the maximum amount of credit that could be extended to Qatari and non-Qatari citizens is QR1 million and QR400 thousand, respectively. Moreover, rates applied to consumer loans should not exceed the QCB rate + 1.5%, which only translates into a 6% yield. Prior to this directive, bankers were charging consumers north of 6%. Nevertheless, we estimate KCBK to allocate to retail around 8.7% (average) of its loan portfolio.

Deposit Book

KCBK is highly reliant on the public sector. Public sector deposits dominate Al Khaliji's deposit base, contributing by 64.6%. Retail contribution to KCBK's deposit base is insignificant and we expect it to remain that so for two reasons: 1) the bank has a very small branch network and 2) retail deposits are considered to be sticky deposits, as such KCBK would have to heavily compete in order to attract retail deposits which in turn would increase its cost of funding. Moreover, we envision the bank to gradually increase its deposits from corporates as it plans to aggressively compete for business within this space. On the other hand, Al Khaliji along with the more established banks face stiff competition in this area. As a consequence, we expect the bank to heavily rely on the public sector to raise deposits.

Deposits Profile

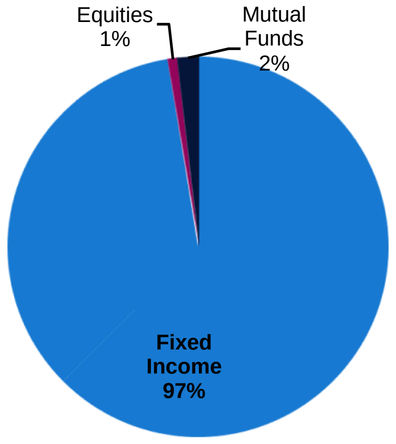


Source: Company data, QNBFS estimates

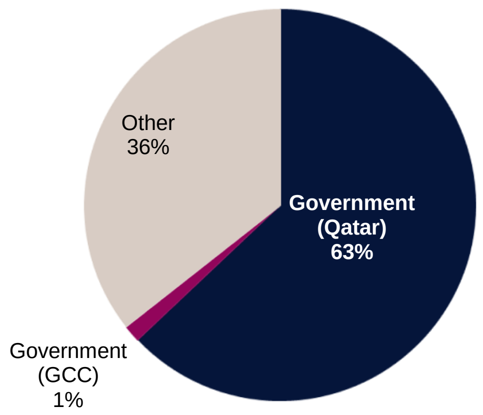
Investment Portfolio

KCBK boasts a substantial bond portfolio. Al Khaliji manages an investment portfolio worth QR16.0bn as of 1Q2013, representing a sizeable 46.5% of total assets and in excess of net loans (1.1x net loans). 97% of the portfolio consists of bonds and 63% of the bond portfolio is deployed in sovereign Qatari bonds. Consequently, the current profile of the bank can at best be described as a treasury operation. However, one must not forget that Al Khaliji is a young bank operating in a cutthroat environment and must deploy its funds in fixed income securities to generate returns until it is able to seek out far more lucrative avenues. Having said this, the bank's portfolio is a relatively safe investment.

Investment Portfolio (2012)



Bond Portfolio (2012)

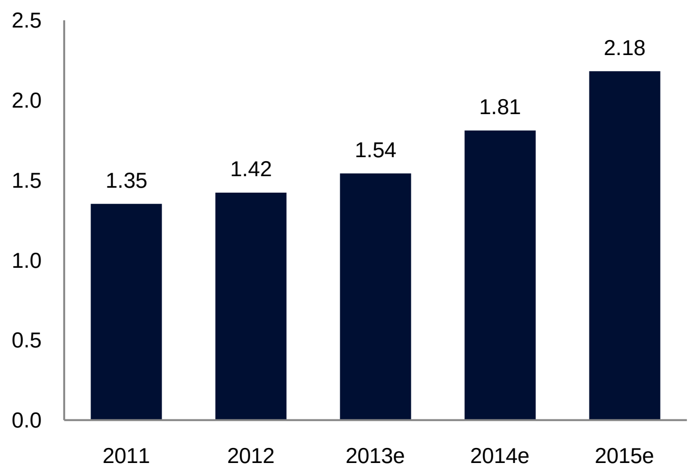


Source: Company data

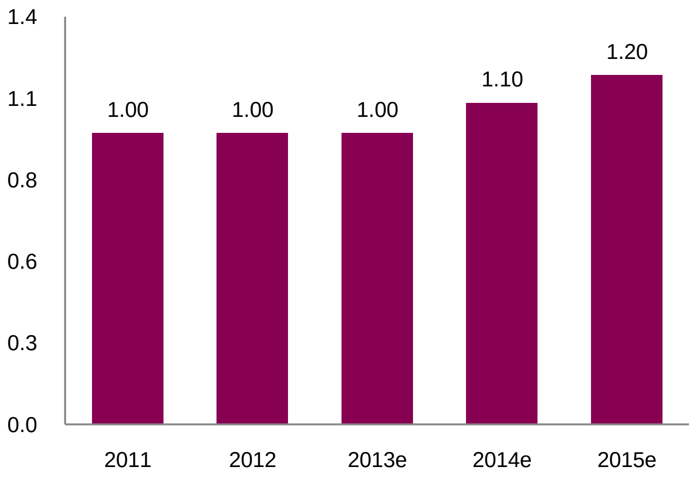
Earnings

KCBK is expected to conclude the year with an EPS of QR1.54, on the back of a rebound in net interest income coupled with investment gains. We believe the bank will maintain DPS of QR1.00 for 2013, as it will try to retain cash for future loan growth. We expect the dividend payout ratio on average to be 60.3% in the next few years vs. 70.3% in 2012. It should be noted that the bank's payout ratio has been on a downtrend. The payout ratio in 2010 was 84.4%, while in 2011 it dropped to 73.9%, further slipping to 70.3% in 2012.

EPS Estimates (QR)



DPS Estimates (QR)



Source: Company data, QNBFS estimates; Note: EPS & DPS based on current number of shares

Key Financial Data and Estimates

	2010	2011	2012	2013e	2014e
Profitability (%)					
RoAE	8.5	9.1	9.3	9.8	11.1
RoAA	2.4	2.1	1.7	1.6	1.6
RoRWA	2.4	2.5	2.3	2.2	2.3
Efficiency (%)					
Cost-to-Income (Headline)	51.9	42.2	38.5	38.3	35.0
Cost-to-Income (Core)	59.1	51.8	64.5	51.1	43.5
Liquidity (%)					
LDR	85.3	94.9	75.1	77.9	81.5
Loans/Assets	38.7	42.3	38.7	41.4	43.8
Liquid Assets-to-Total Assets	51.9	49.1	52.0	49.5	47.4
Asset Quality (%)					
NPL Ratio	1.35	0.53	0.45	0.37	0.33
NPLs-to-Shareholder's Equity	1.91	1.16	1.04	1.02	1.04
Cost of Risk	-0.9	0.4	0.5	0.3	0.2
Capitalization (%)					
Tier 1 Ratio	25.5	22.0	19.4	18.1	17.3
CAR	27.0	23.3	21.4	20.0	18.9
Growth (%)					
Net Interest Income	55.0	6.4	(13.0)	21.5	20.3
Net Operating Income	45.6	16.5	9.3	2.4	10.7
Net Income	155.1	14.1	5.2	8.5	17.3
Loans	(15.5)	58.6	13.2	19.3	20.3
Deposits	(8.0)	42.6	43.0	15.0	15.0

Source: Company data, QNBFS estimates; Note: All data based on current number of shares

Detailed Financial Statements

Income Statement

(In QR mn)	2010	2011	2012	2013e	2014e	2015e
Net Interest Income	552	587	511	621	747	916
Fees & Commissions	101	120	73	103	116	127
FX Income	12	7	(12)	13	14	14
Dividend Income	2	6	6	6	6	6
Gains from Investment Securities	93	164	390	249	216	191
Other Income	1	1	1	1	1	1
Non-Interest Income	**208**	**299**	**458**	**371**	**351**	**339**
Operating Income	**760**	**886**	**969**	**992**	**1,098**	**1,254**
Operating Expenses	(395)	(374)	(373)	(379)	(384)	(398)
Net Provisions	70	(51)	(67)	(39)	(41)	(46)
Net Profit Before Taxes & Non-Recurring Items	436	461	529	573	673	810
Non-Recurring Income/(Loss)	1	39	-	-	-	-
Net Profit Before Taxes	437	500	529	573	673	810
Tax	(11)	(13)	(17)	(18)	(21)	(25)
Net Profit	**427**	**487**	**512**	**556**	**652**	**785**

Source: Company data, QNBFS estimates Note: EPS based on current number of shares

Balance Sheet

(In QR mn)	2010	2011	2012	2013e	2014e	2015e
Assets						
Cash & Balances with Central Bank	1,387	860	1,779	1,396	1,376	1,542
Interbank Loans	2,322	3,118	2,241	2,487	2,991	3,445
Net Investments	7,083	11,029	15,865	17,281	18,649	19,573
Net Loans	7,257	11,511	13,032	15,544	18,696	21,529
Other Assets	237	303	416	513	617	710
Net PP&E	116	96	67	54	47	41
Goodwill & Intangible Assets	336	283	274	274	274	274
Total Assets	**18,737**	**27,200**	**33,672**	**37,549**	**42,651**	**47,114**
Liabilities						
Interbank Deposits	4,492	8,799	10,031	11,164	12,892	14,133
Customer Deposits	8,505	12,130	17,346	19,948	22,940	25,693
Term Loans	121	117	120	117	117	117
Other Liabilities	364	750	505	598	688	771
Total Liabilities	**13,482**	**21,797**	**28,001**	**31,827**	**36,637**	**40,713**
Shareholders' Equity						
Share Capital	3,600	3,600	3,600	3,600	3,600	3,600
Statutory Reserves	967	1,016	1,067	1,067	1,067	1,067
Risk Reserves	109	196	258	300	360	414
Fair Value Reserve	76	114	233	99	99	99
Foreign Currency Translation Reserve	9	4	14	4	4	4
Proposed Dividends	360	360	360	360	398	432
Retained Earnings	134	113	139	292	487	786
Total Shareholder's Equity	**5,255**	**5,402**	**5,671**	**5,722**	**6,014**	**6,401**
Total Liabilities & Shareholder's Equity	**18,737**	**27,200**	**33,672**	**37,549**	**42,651**	**47,114**

Source: Company data, QNBFS estimates

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

Contacts

Ahmed M. Shehada
Head of Trading
Tel: (+974) 4476 6535
ahmed.shehada@qnbfs.com.qa

Keith Whitney
Head of Sales
Tel: (+974) 4476 6533
keith.whitney@qnbfs.com.qa

Saugata Sarkar
Head of Research
Tel: (+974) 4476 6534
saugata.sarkar@qnbfs.com.qa

Sahbi Kasraoui
Manager - HNWI
Tel: (+974) 4476 6544
sahbi.alkasraoui@qnbfs.com.qa

QNB Financial Services SPC
Contact Center: (+974) 4476 6666
PO Box 24025
Doha, Qatar