Burgan Bank Group (BURG)

Recommendation	ACCUMULATE	Risk Rating	R-4
Share Price	KWd 285	Target Price	KWd 335
Implied Upside	+19.2%		

Cheapest Bank in Kuwait; Initiating with an Accumulate

Burgan Bank is the cheapest bank in Kuwait trading at a 10% discount to its book value (29% discount to its historical P/B) and a 2019e PEG of 0.6x. Moreover, the market is pricing in a sustainable RoE of 10% vs. 12% based on our estimates. The stock has significantly underperformed its peers over the last 12 months and we believe downside risk is low. We initiate coverage with an Accumulate rating and a PT of KWd (Fils) 335/sh.

Highlights

- **Strong earnings growth on the horizon.** We pencil in a bottom-line (attributable) CAGR of 14.5% in 2017-2022e vs. flat earnings (2012-2017). This accelerating growth forecast in net income should be driven by net operating income, which we model to grow by 9.3% and flat credit provisions. *Having said this, there could be further upside to our estimates if BURG 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 markedly increase).
- **Geographically diversified bank.** Due to limited growth in Kuwait, BURG has ventured into Turkey (material subsidiary), Algeria (material subsidiary), Iraq (insignificant) and Tunisia (insignificant). Turkey contributes ~23% (total loans) and ~20% (to total revenue), while Algeria contributes 10% and 14% to total loans and revenue, respectively. These subsidiaries generate strong margins for the bank as Kuwait operations yield tight margins.
- **Clarity on IFRS 9 and lower CoR key to stronger profitability.** BURG, 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, 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. Going forward, we are of the view that BURG would not have to book general provisions, resulting in a significant drop in CoR. It should be noted that so far the central bank has not updated the banks on IFRS 9 implementation.
- **Efficiency ratio requires improvement.** The bank is operating at an optimal level in Kuwait with a C/I ratio of 30.0% (past 3 years) given that it is corporate focused which is not cost-intensive. On the other hand, international operations have been inefficient (Turkey being the main contributor). Having said this, the efficiency ratio from international operations has improved from 64.5% in 2016 to 55.8% in 2017 (47.4% in 9M2018). We do not expect the efficiency ratio to drop below the ~40% level in our forecast horizon as the bank needs to grow revenue significantly vs. opex.
- **Asset quality markedly improved; write-offs/reversals along with prudent risk control contributed positively.** BURG's NPL ratio receded to 2.73% in 2017 from an all-time high of 11.5% in 2011, while the coverage ratio jumped to 144% vs. 35% (2012). *We pencil in steady improvements in the NPL ratio.*
- **Strong capitalization position following KWD60mn rights issue.** BURG's rights issue is expected to bolster CET1 ratio to 12.1% (vs. 10.8% in 9M2018) and Total Tier-1 ratio to 14.8% (vs. 13.5% in 9M2018) and CAR to 17.5% (vs. 16.5% in 9M2018) in 2018.

Catalysts

- 1) Clarity on implementation of IFRS 9 on loan book, 2) Possible FTSE EM inclusion in 2019 & 3) Stabilization of Turkish Lira.

Recommendation, Valuation and Risks

- **Recommendation and valuation:** ***We assign a Price Target of KWd 335 and an Accumulate rating.*** BURG is trading at a 2019e P/TB and P/E of 0.9x and 9.4x, respectively. The stock is cheap trading at a PEG of 0.6x (below 1.0x) based on earnings of CAGR 14.5% (2017-2022e).
- **Risks:** 1) Geo-political factors, 2) Unexpected asset quality deterioration, 3) CoR does not improve & 4) Volatility in Turkish lira.

Key Financial Data and Estimates

	FY2017	FY2018e	FY2019e	FY2020e
EPS (KWd) Reported	25.40	28.46	30.34	35.08
EPS Growth (%)	-5.9	12.0	6.6	15.6
P/E (x)	13.1	10.0	9.4	8.1
Tangible BVPS (KWd)	255.0	281.7	328.9	356.6
P/TB (x)	1.1	1.0	0.9	0.8
DPS (Fils)	7.00	7.00	9.00	15.00
Dividend Yield (%)	2.1	2.5	3.2	5.3

Source: Company data, QNBFS Research

Key Data

Current Market Price (KWd)	285
Dividend Yield (%)	2.5
Bloomberg Ticker	BURG KK
ADR/GDR Ticker	N/A
Reuters Ticker	BURG.KW
ISIN	KW0EQ0100077
Sector	Banks & Financial Svcs.
52wk High/52wk Low (KWd)	309/241
3-m Average Volume ('000)	2,426.2
Mkt. Cap. ($ bn/KWD bn)	2.3/0.7
Shares Outstanding (mn)	2,493.0
1-Year Total Return (%)	(0.7)
Fiscal Year End	December 31

Source: Bloomberg (as of December 2, 2018)

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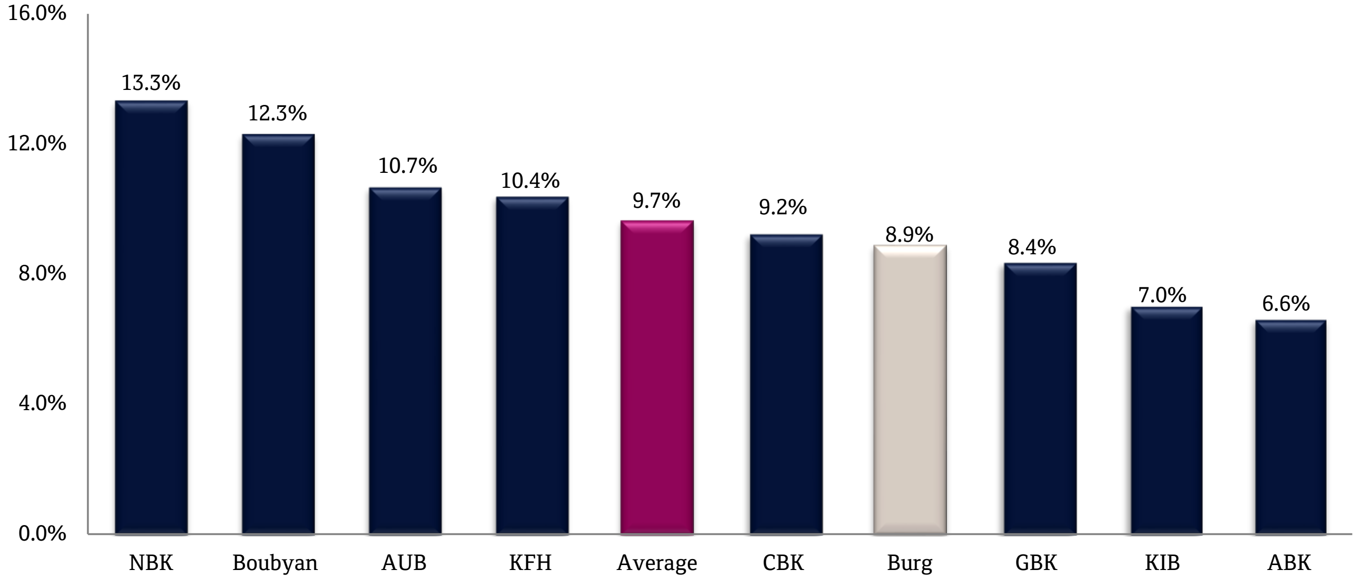
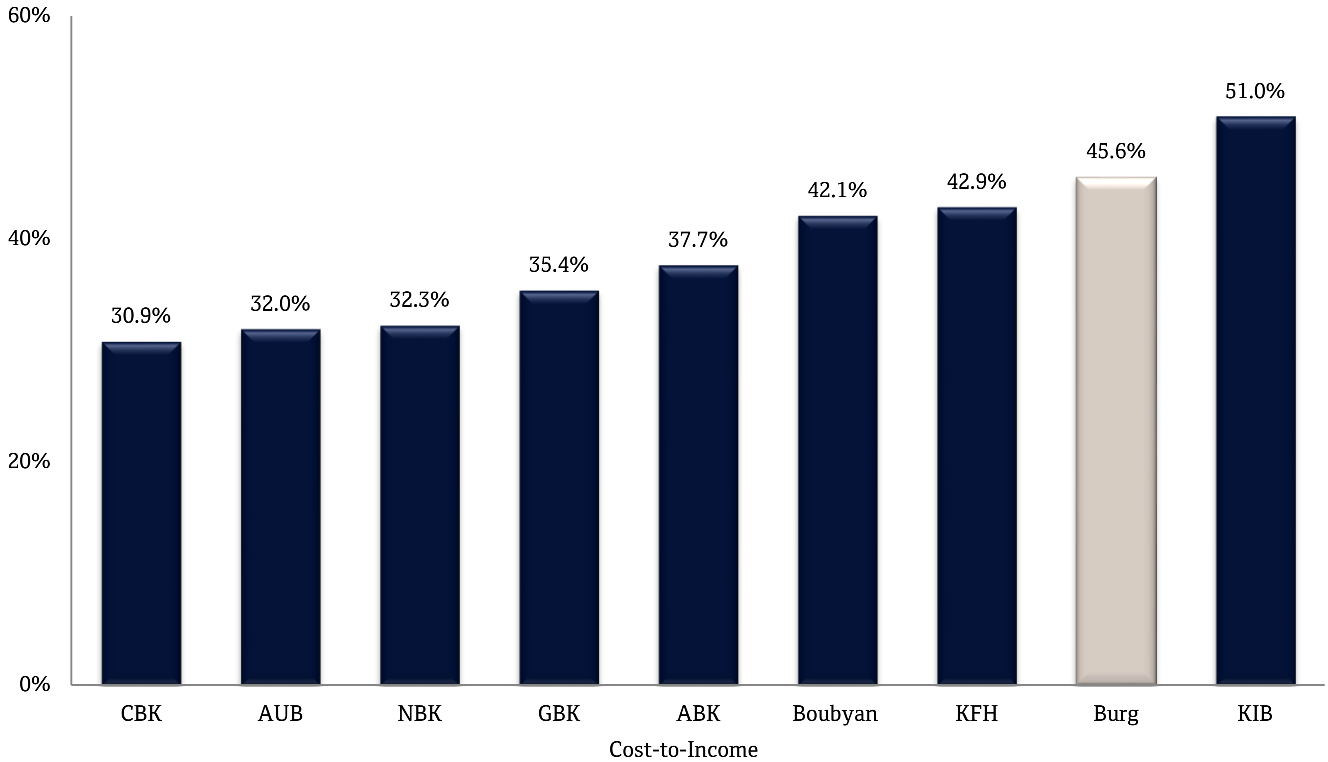
We Expect BURG to Generate RoE of 11.2% in 2018e; Significant Improvement from 8.9% (2017)



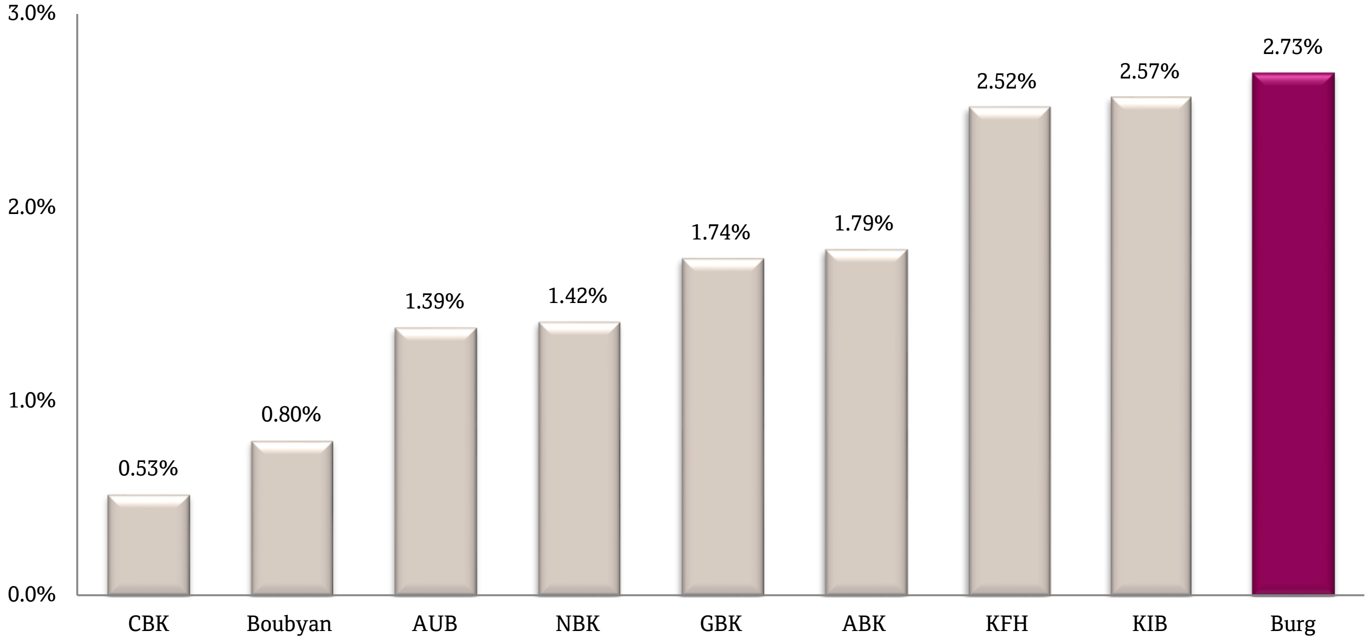
Source: Company data, QNBFS Research

International Operations In-Efficient; Kuwait Efficient at C/I of 30%



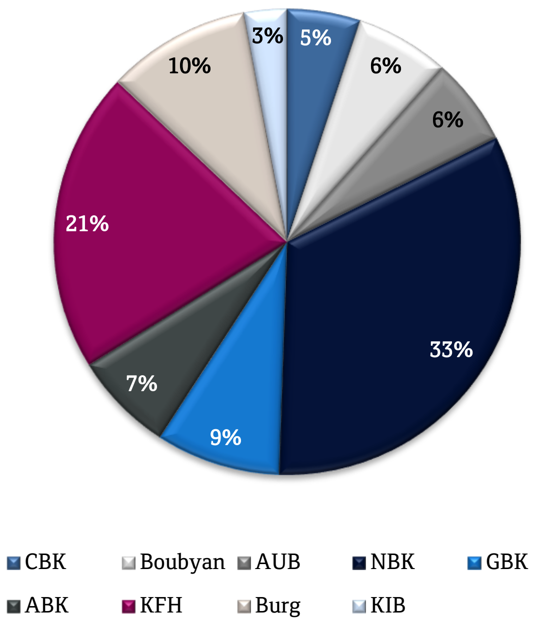
Source: Company data, QNBFS Research

NPL Ratio Highest Among Peers but has Drastically improved from 11.5% (2011)

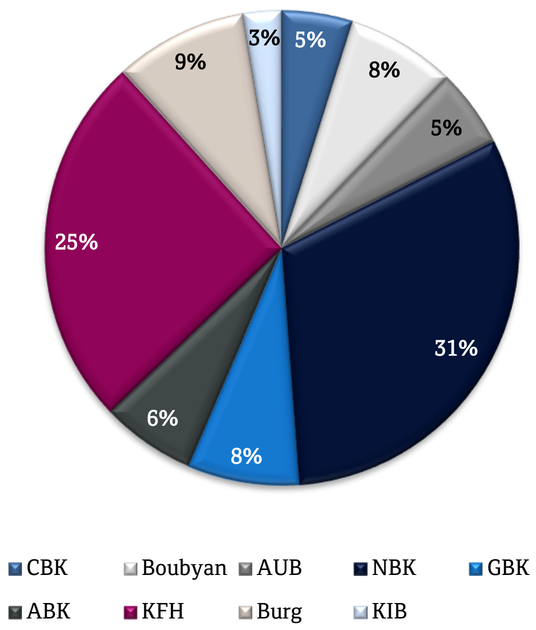


Source: Company data, QNBFS Research

3rd Largest Market Share in Loans......................



.... And Deposits



Source: Company data, QNBFS Research

Valuation

We value BURG 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 BURG'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 1.2x.***

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 6.5% to arrive at a Ke of 10.60%.

Valuation Methodologies

Fundamental P/B (WEV)	
Sustainable RoE (%)	11.6
Estimated Cost of Equity (%)	10.60
Terminal Growth Rate (%)	5.0
Fundamental P/B	1.2x
Intrinsic Value (KWd)	347
Current Market Price (KWd)	285
Upside/(Downside) Potential (%)	+21.8

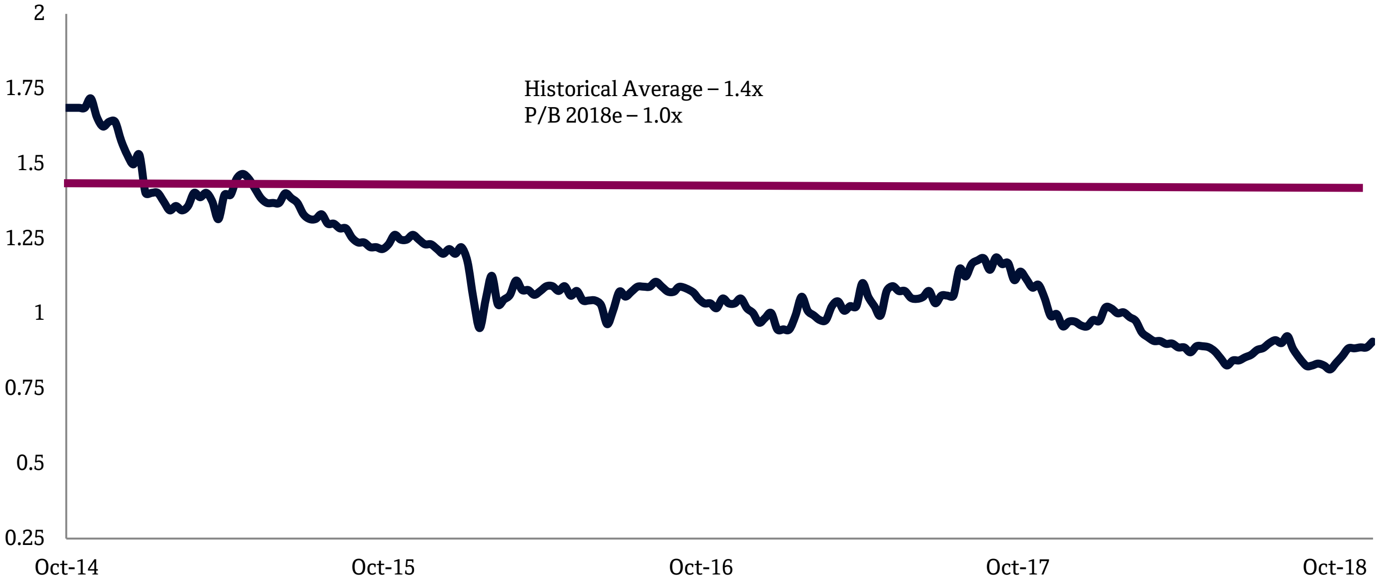
RI Based on Fundamental P/B	
Beginning BVPS (2018e) (KWd)	270
Present Value of Interim Residuals (KWd)	7
Present Value of Terminal Value (KWd)	46
Fundamental P/B	1.2x
Intrinsic Value (KWd)	323
Current Market Price (KWd)	285
Upside/(Downside) Potential (%)	+13.3

Source: QNBFS Research

Methodology	Equity Value (KWd)	Weight (%)	Weighted Fair Value (KWd)
Residual Income	323	50	161
WEV	347	50	174
Target Price			335
Closing Price			281
Upside/(Downside)			+19.2

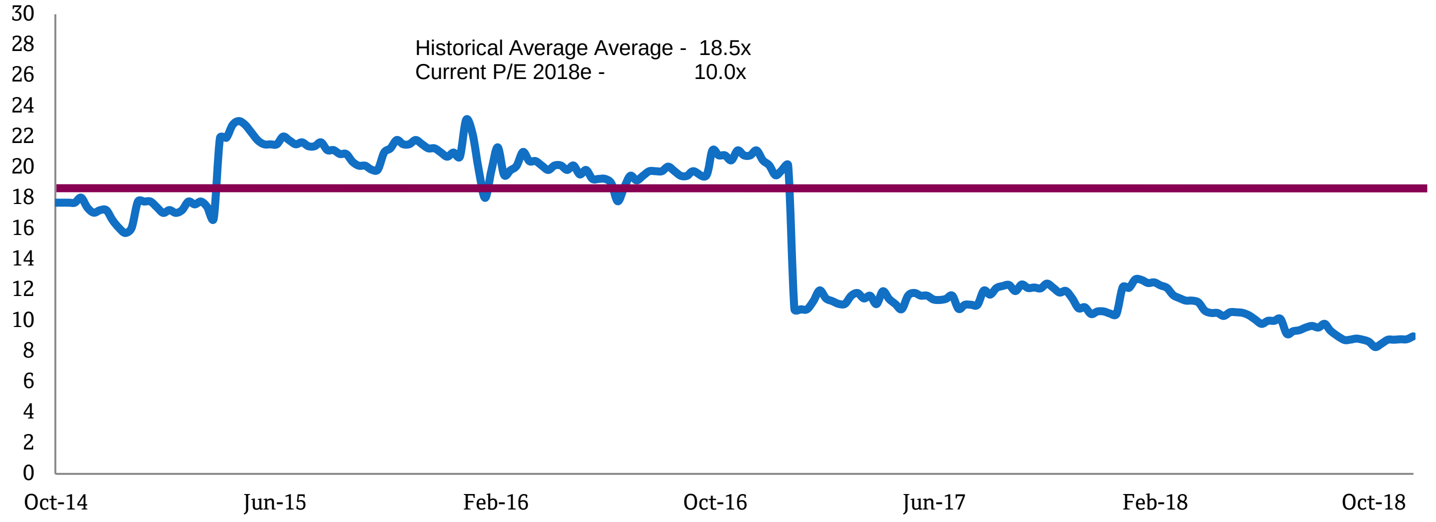
Source: QNBFS Research

Trading at a 29% Discount to its Historical P/B…



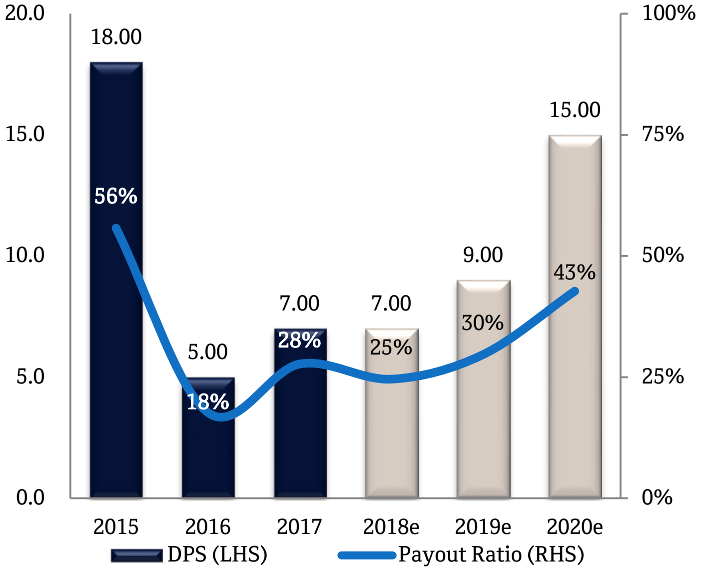
Source: Bloomberg, QNBFS Research

…And a 46% Discount to its Historical P/E



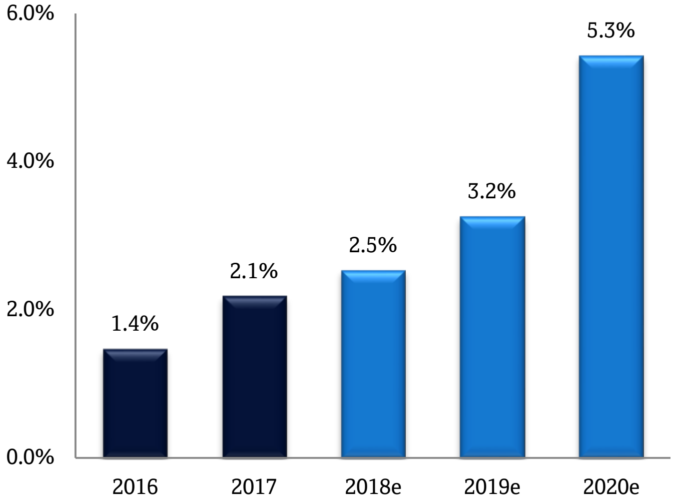
Source: Bloomberg, QNBFS Research

Consistently Pays Dividends (KWd), However Erratic



Source: Company data, QNBFS Research

Do Not Expect Generous Dividends After Recent Rights Issue

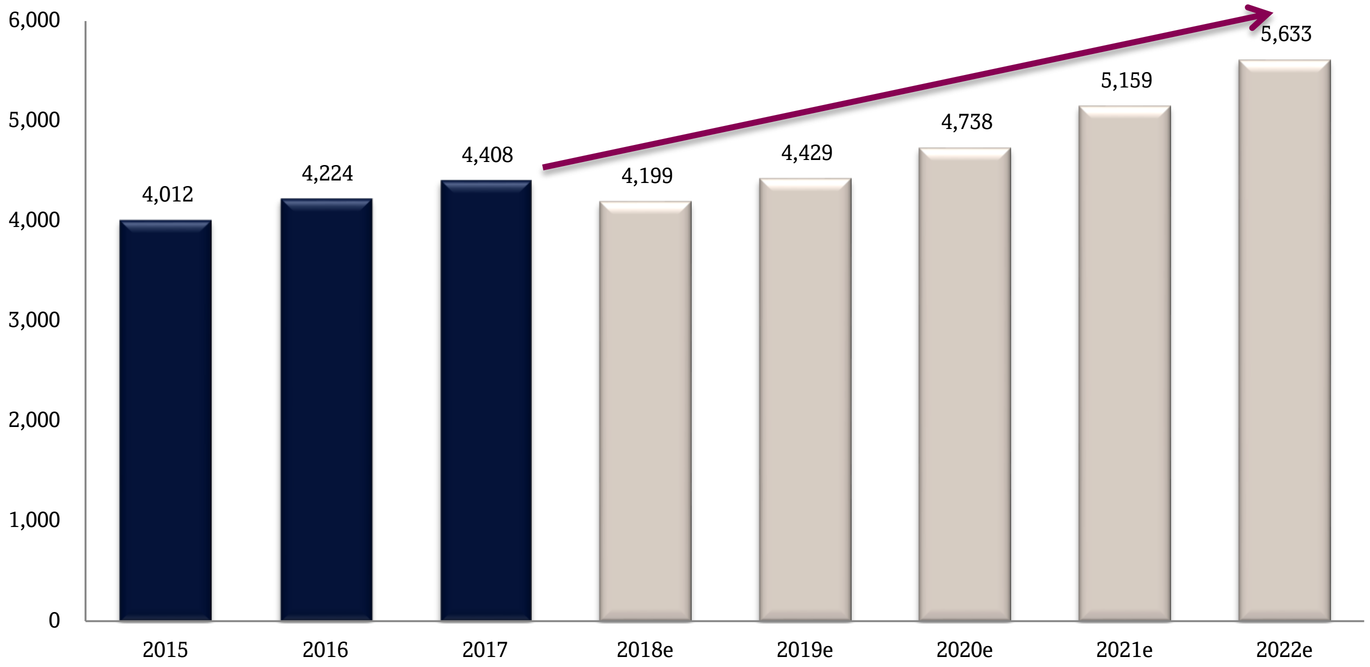


Key Forecasts

Loan Portfolio

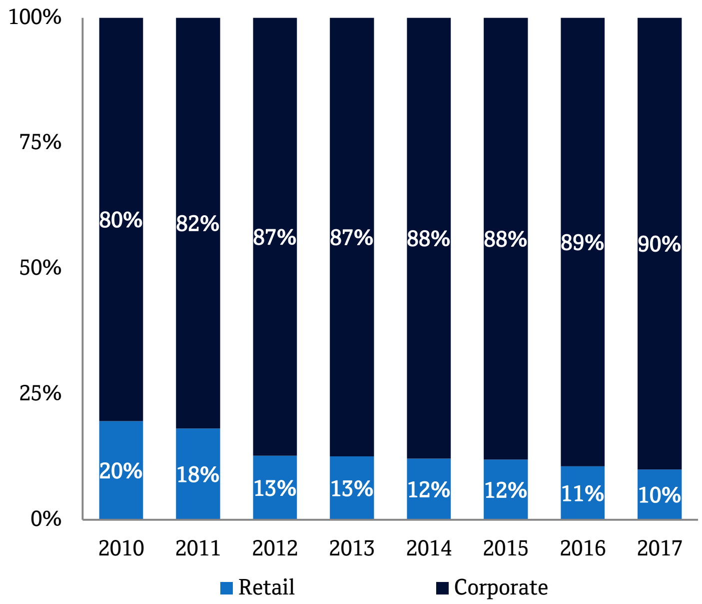
BURG is a diversified bank in Kuwait and has a 10% market share in loans and 9% market share in deposits; we pencil in a loan book CAGR (2017-22e) of 5.0%. BURG is generally focused on corporates and has insignificant exposure to mass retail which contributes 10% to the loan book through a small domestic banking network of 29 branches (not retail focused as previously mentioned). Turkey and Algeria contribute 23% and 10% to BURG's loan portfolio, respectively. The Turkish subsidiary mainly caters to mid-corporates and some retail while Algeria is focused on trade finance.

Loans (KWD mn) to Exhibit 5.0% CAGR vs. 5.5% (2012-17)

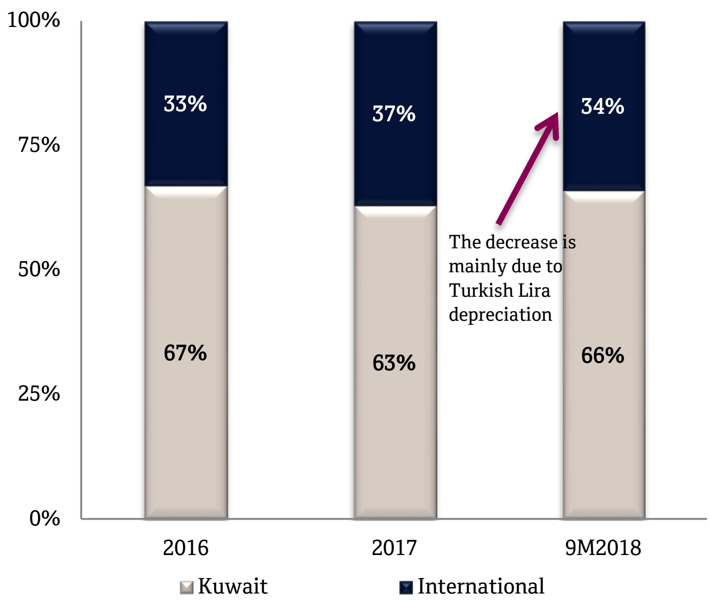


Source: Company data, QNBFS Research

Retail Book Decreasing in Size; Corporate Oriented



With Decent Contribution from International Operations

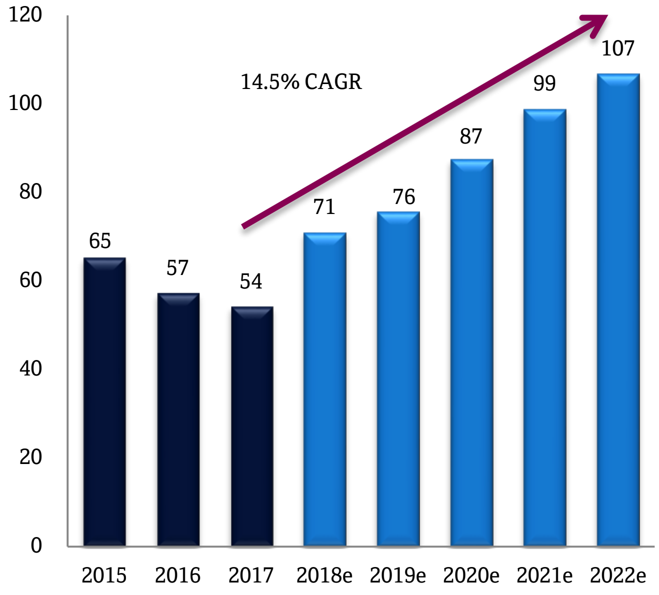


Source: Company data, QNBFS Research

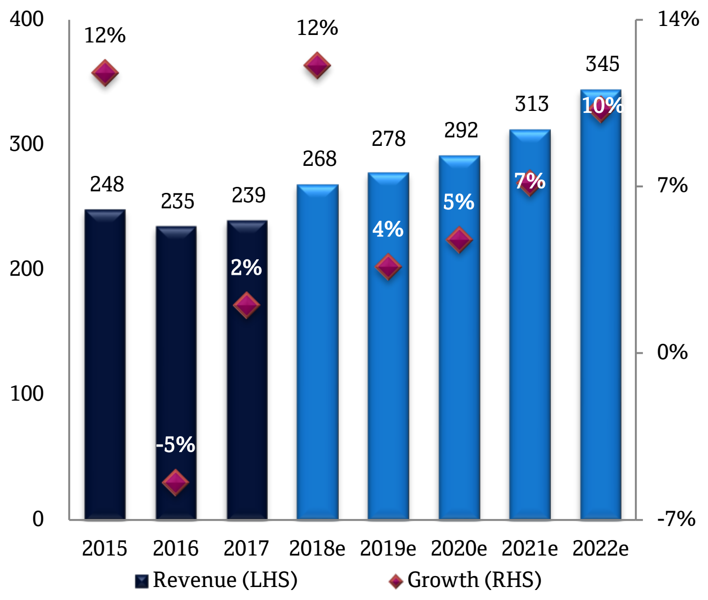
Operating Performance

We pencil in a bottom-line CAGR of 14.5% in 2017-2022e vs. flat performance (2012-2017). The growth in net income is expected to be driven by net operating income which we model in a growth of 9.3% and flat credit provisions. *Having said this, there could be further upside to our estimates if BURG 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 markedly increase).

Net Profit (KWD mn)

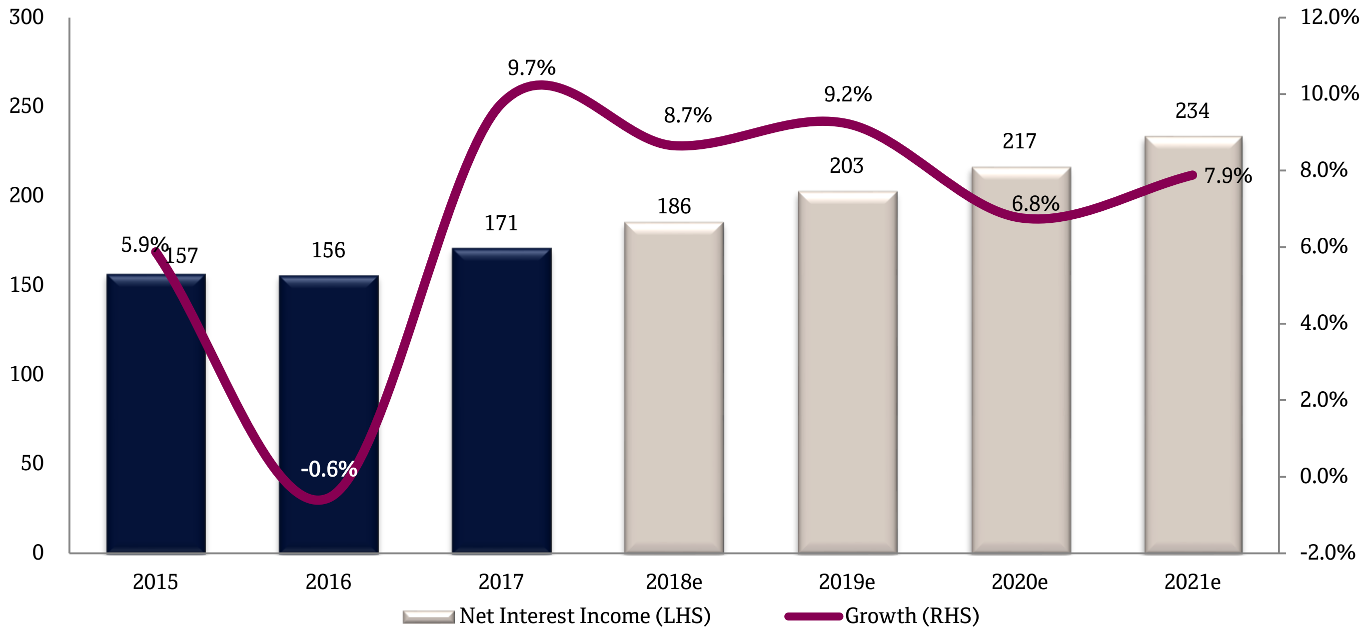


Total Revenue (KWD mn)



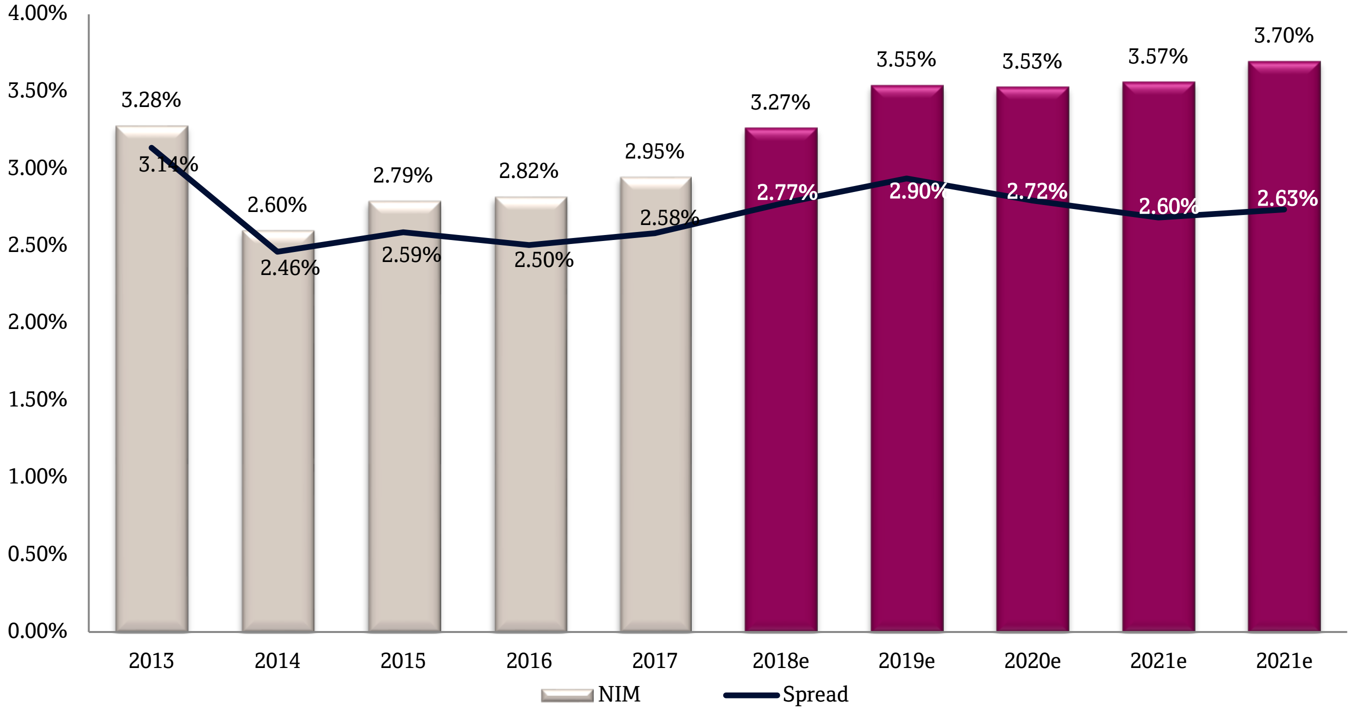
Source: Company data, QNBFS Research

Net Interest Income (KWD mn)



Source: Company data, QNBFS Research

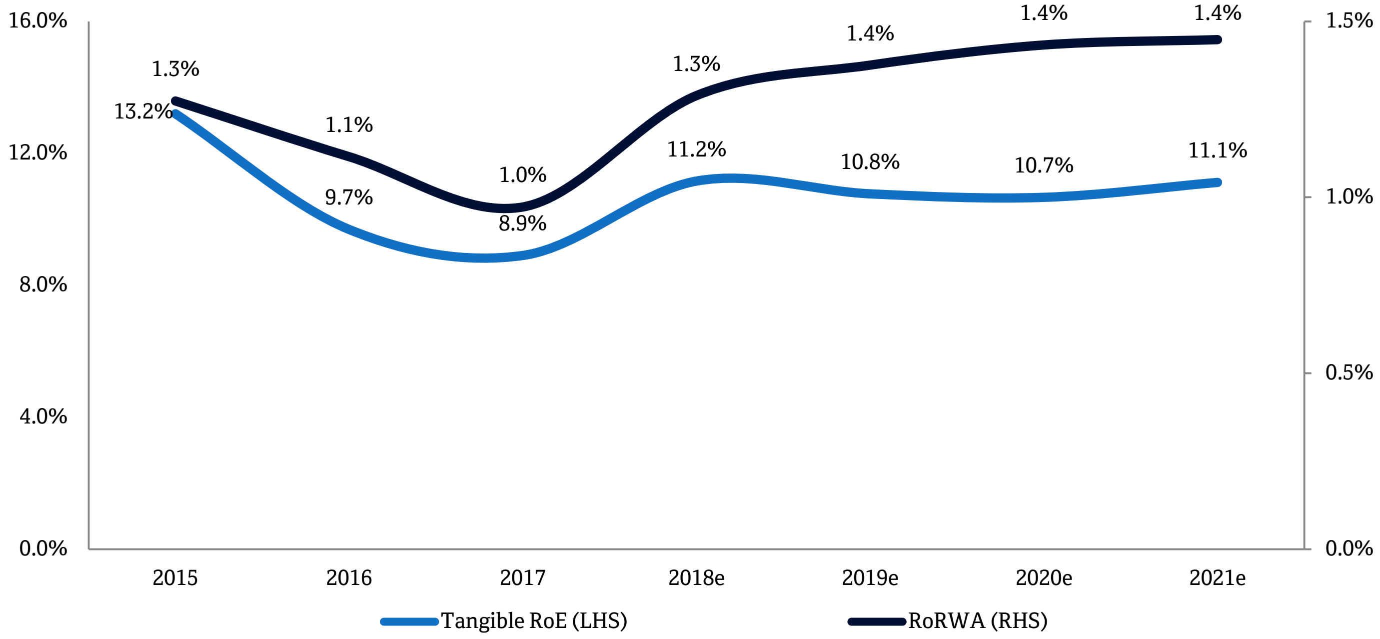
NIMs to Further Expand With Expected Rate Hikes; International Operations Support NIM due to Higher Margin Environment



Source: Company data, QNBFS Research

NIMs to expand with further interest hikes and contributions from international operations. BURG's Kuwait operations is corporate banking based, as such margins are not as large vs. retail banks. The bank has maintained a NIM of 2% from Kuwait operations, while margins are much wider in Turkey and Algeria given the operating environment in those countries. On a side note, Kuwait has an advantage that allows it to instantly reprice corporate loans when interest rates go up. As such, BURG is a corporate oriented bank can reprice loans in a rising interest rate environment allowing it to increase its margins.

RoE is Steadily Improving

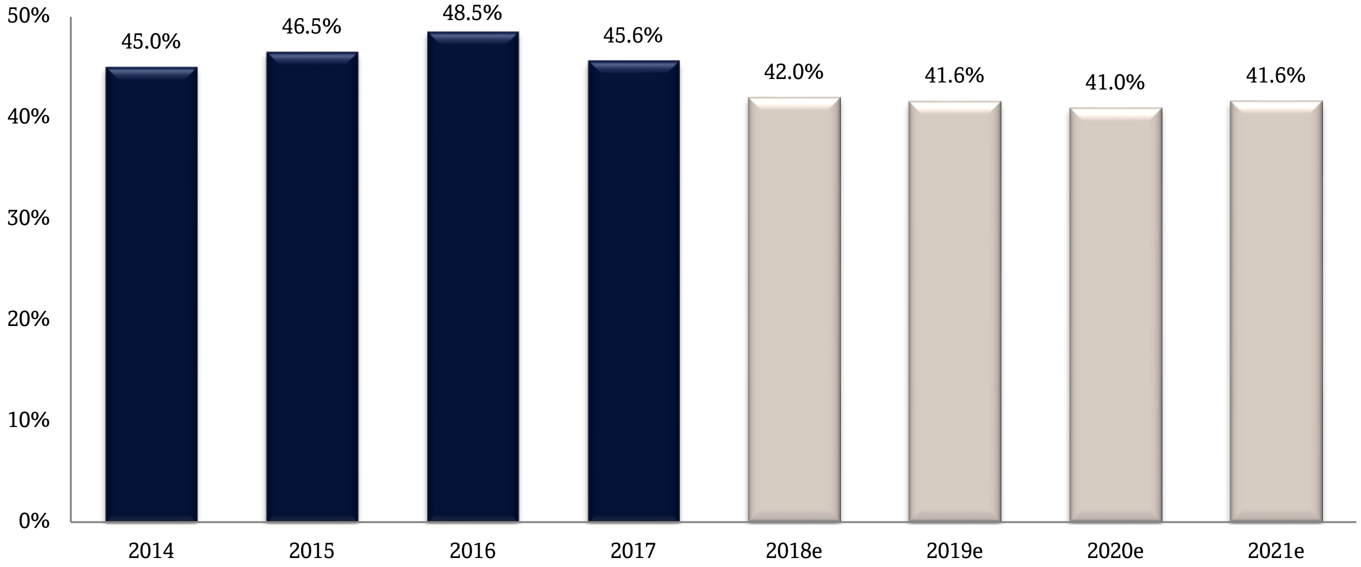


Source: Company data, QNBFS Research

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.

Efficiency

Burgan Operating Inefficiently at Elevated C/I

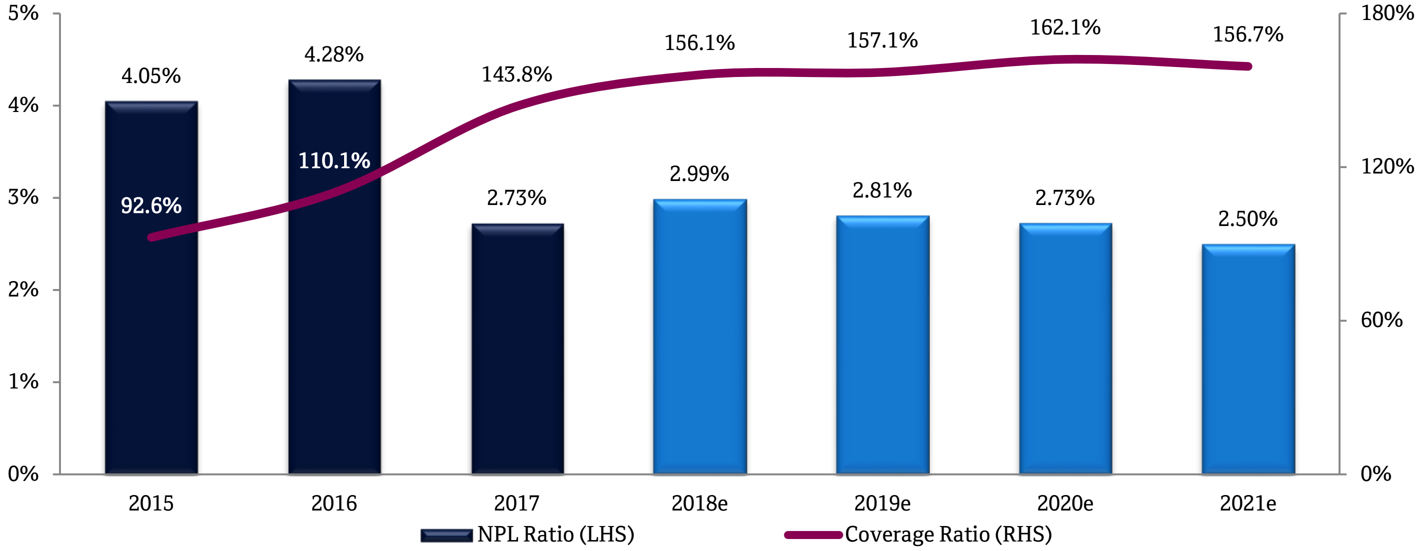


Source: Company data, QNBFS Research

International operations are a drag on efficiency but has been improving. The bank is operating at an optimal level in Kuwait with a C/I ratio of 30.0% (past 3 years) given that it is corporate focused which is not cost-intensive. On the other hand, international operations have been inefficient (Turkey being the main contributor). Having said this, the efficiency ratio from international operations has improved from 64.5% in 2016 to 55.8% in 2017 (47.4% in 9M2018). It is worth mentioning here that small banks in Turkey generally have high C/I ratios. We do not expect the efficiency ratio to drop below the ~40% level in our forecast horizon as the bank needs to grow revenue significantly vs. opex.

Asset Quality

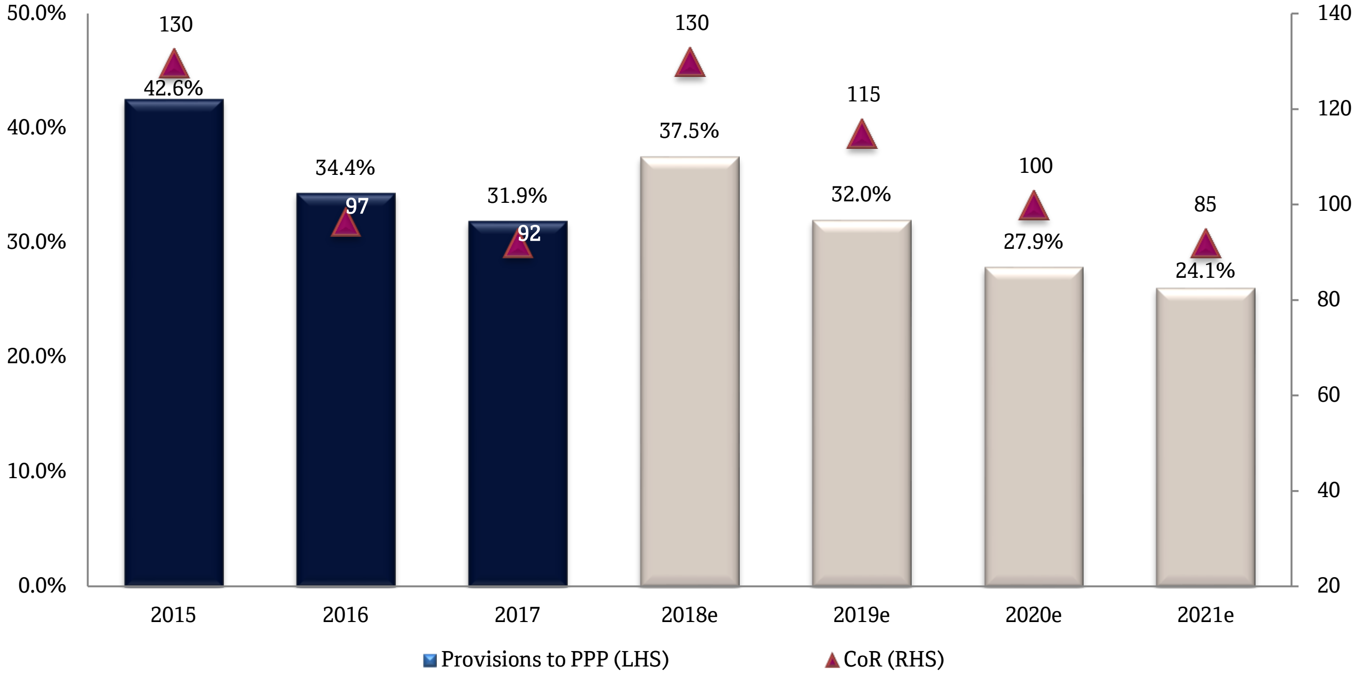
Asset Quality Has Materially Improved



Source: Company data, QNBFS Research

Asset quality unlikely an issue going forward. BURG has cleaned up its books since 2011 when the NPL ratio reached a high of 11.52% to 2.73% in 2017, although we expect a small increase to 2.99% in 2018e. Moreover, as of 9M2018 the coverage ratio stood at 170%.

CoR Significantly Improved but Still Remains on the High Side

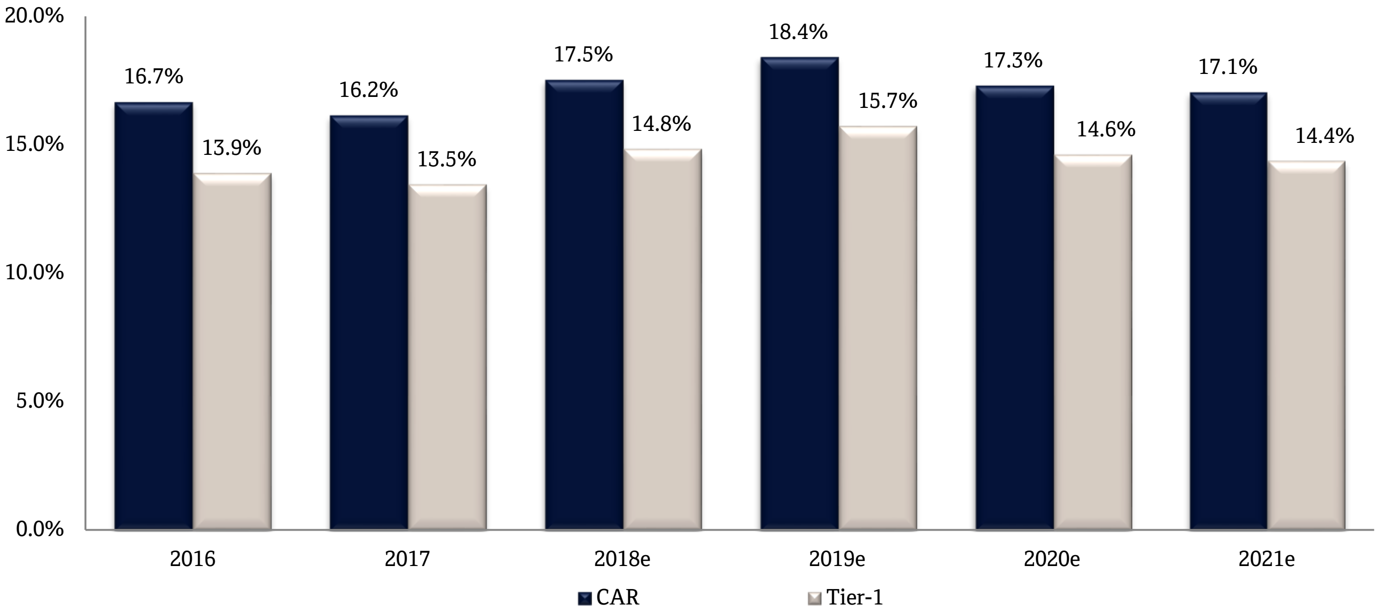


Source: Company data, QNBFS Research

Cost of risk needs to significantly improve. Burgan's high cost of risk is mainly driven from the central bank of Kuwait (CBK) imposing excessive precautionary provisions on banks. CBK's precautionary provisions contributed 52.9% to total credit provisions in 2017, 57.8% in 2016, and 41.6% in 2015. Excluding these excess provisions, Burgan's 2017 domestic CoR would have contributed only 13bps to total CoR vs. 31bps from international operations in 2017. A reversal of these provisions would be earnings accretive and would materially enhance profitability metrics (RoE, RoA, Net Profit Margin etc.) and thus value.

Capitalization

Capitalization Levels to Improve with KWD60mn Capital Increase



Source: Company data, QNBFS Research

KWD60mn rights issue to bolster CET1 ratio. BURG's rights issue is expected to bolster CET1 ratio to 12.1% (vs. 10.8% in 9M2018) and Total Tier-1 ratio to 14.8% (vs. 13.5% in 9M2018) in 2018.

Company Description

Established in 1977 Burgan Bank is a diversified full service bank with a footprint across North Africa, Turkey and Iraq; BURG is a corporate oriented bank in Kuwait and has a 10% market share in loans and 9% market share in deposits. BURG is a universal bank offering services to corporates and retail customers, private banking, investment banking and brokerage. The bank operates across a spectrum of 7 countries and has a network of 167 branches (29 branches in Kuwait).

Stable Shareholder base. Strong shareholder base as KIPCO is affiliated with the royal family.

Major Shareholders

Shareholders	Investor Type	Country	Share (%)
KIPCO	Private	Kuwait	63.04
The Public Institution for Social Security	Government	Kuwait	8.43
			73.47

Source: Company data

Subsidiaries

Company	Country	Share (%)
Algeria Gulf Bank	Algeria	86.01
Bank of Baghdad	Iraq	51.79
Tunis International Bank	Tunisia	86.70
Burgan Bank A.S.	Turkey	99.26
Burgan Bank Financial Services	Dubai	100.00

Source: Company data

Detailed Financial Statements

Ratios	FY2017	FY2018e	FY2019e	FY2020e
Profitability (%)				
RoE (Tangible)	8.9	11.2	10.8	10.7
RoAA	0.9	1.1	1.2	1.3
RoRWA	1.0	1.3	1.4	1.4
NIM (% of IEAs)	2.95	3.27	3.55	3.53
NIM (% of RWAs)	3.07	3.38	3.69	3.55
NIM (% of AAs)	2.33	2.57	2.82	2.86
Spread	2.6	2.8	2.9	2.7
Efficiency (%)				
Cost-to-Income (Headline)	45.6	42.0	41.6	41.0
Cost-to-Income (Core)	48.3	44.5	43.3	43.0
Liquidity (%)				
LDR	85.9	87.1	86.3	85.4
Loans/Assets	59.4	59.5	60.5	60.5
Cash & Interbank Loans-to-Total Assets	21.2	21.2	21.9	21.8
Deposits to Assets	56.0	55.5	56.7	57.2
Wholesale Funding to Loans	49.5	46.0	44.9	42.3
IEAs to IBLs	1.2x	1.2x	1.2x	1.2x
Asset Quality (%)				
NPL Ratio	2.73	2.99	2.81	2.73
NPLs to Shareholder's Equity	18.6	17.9	15.3	14.8
NPLs to Tier 1 Capital	20.1	20.6	17.3	16.8
Coverage Ratio	143.8	156.1	157.1	162.1
ALL/Average Loans	4.0	4.6	4.5	4.6
Cost of Risk	92	130	115	100
Capitalization (%)				
Tier 1 Ratio	13.5	14.8	15.7	14.6
CAR	16.2	17.5	18.4	17.3
Tier 1 Capital to Assets	10.4	11.1	12.3	12.1
Tier 1 Capital to Loans	17.5	18.7	20.3	20.1
Tier 1 Capital to Deposits	18.5	20.1	21.6	21.2
Leverage (x)	11.0	9.6	8.6	8.6
Growth (%)				
Net Interest Income	9.7	8.7	9.2	6.8
Non-Interest income	-13.2	20.7	-8.9	-0.6
Total Revenue	2.0	12.1	3.6	4.8
Opex	-4.0	3.2	2.7	3.1
Net Operating Income	7.7	19.6	4.3	6.0
Net Provisions & Impairments	12.5	14.2	-3.5	-8.1
Net Income (Reported/Headline)	-4.3	25.6	5.7	13.6
Net Income (Attributable)	-5.3	30.9	6.6	15.6
Loans	4.3	-4.7	5.5	7.0
Deposits	11.2	-5.8	6.0	8.0
Assets	2.0	-4.8	3.7	7.1
RWAs	5.2	-7.4	7.8	13.9

Source: Company data, QNBFS Research

Income Statement (In KWD mn)	FY2017	FY2018e	FY2019e	FY2020e
Net Interest Income	171	186	203	217
Fees & Commissions	37	33	36	35
FX Income	10	18	16	17
Other Income	22	31	24	23
Non-Interest Income	**69**	**83**	**75**	**75**
Total Revenue	**239**	**268**	**278**	**291**
Operating Expenses	(109)	(113)	(116)	(120)
Net Operating Income	**130**	**156**	**162**	**172**
Net Provisions & Investment Impairments	(50)	(57)	(55)	(51)
Net Profit Before Tax & Minority Interest	**80**	**98**	**107**	**121**
Tax	(11)	(14)	(15)	(17)
Net Profit Before Minority Interest	**69**	**84**	**92**	**104**
Minority Interest	(4)	(3)	(5)	(6)
Net Profit (Headline/Reported)	**65**	**82**	**87**	**98**
Interest on Tier-1 Note	(11)	(11)	(11)	(11)
Net Profit (Attributable)	**54**	**71**	**76**	**87**

Source: Company data, QNBFS Research

Balance Sheet (In KWD mn)	FY2017	FY2018e	FY2019e	FY2020e
Assets				
Cash & Balances with Central Bank	937	901	926	1,000
Interbank Loans	632	596	673	711
Net Investments	1,097	950	1,045	1,114
Net Loans	4,408	4,199	4,429	4,738
Investment in Associates	15	16	17	18
Other Assets	188	252	76	95
Net PP&E	102	110	121	133
Goodwill & Intangibles	37	33	29	25
Total Assets	**7,415**	**7,056**	**7,315**	**7,833**
Liabilities				
Interbank Deposits	884	668	643	552
Customer Deposits	5,130	4,822	5,130	5,550
Subordinated Notes	322	358	365	383
Other Liabilities	212	274	125	224
Tier-1 Notes	144	144	144	144
Total Liabilities	**6,692**	**6,267**	**6,407**	**6,854**
Shareholders’ Equity	672	735	849	914
Total Liabilities & Shareholders’ Equity	**7,415**	**7,056**	**7,315**	**7,833**

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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