Masraf Al Rayan (MARK)

Recommendation	MARKET PERFORM	Risk Rating	R-3
Share Price	QR35.80	Current Target Price	QR34.00
Implied Upside	(5.03%)	Old Target Price	QR40.00

Tweaking Estimates and Lowering Price Target

Masraf Al Rayan (MARK) is the second largest Shari'ah compliant bank among listed banks. Incorporated in 2006, MARK is focused on the public sector, which dominates its loan portfolio. Public sector loans grew by a CAGR (2009-2015) of 28.2% and represents 50% (December 2015) of MARK's loan portfolio. On the other hand, retail loans make up an immaterial 8.3% of the loan book. Notably, MARK has the best asset quality with an NPL ratio of 0.09%, one of the highest RoAEs of ~17% and robust capitalization at 18.5%.

Highlights

- **Liquidity and subdued macro-economic outlook may prove to be a challenge for MARK; we tweak some of our assumptions for 2016 and 2017; expect positive performance in 2018.** Our bottom-line estimate for 2016 remains unchanged and we slightly lower 2017 net profit by 3.5% vs. our previous estimate. However, we revise other accounts. We revise our 2016 net interest income downward by 4.3% due to weak loan growth and margin compression. This is partly due to MARK's liquidity position; MARK is highly reliant on public sector deposits (54% and 45% of deposit book in 2014 & 2015, respectively); MARK saw its total deposits drop by 11.1% in 2015 (public sector deposits declined by 25.5%), resulting in an elevated LDR of 112% vs. 93% in 2014. We are of the view that MARK would have to be competitive in raising deposits, which would drive up its cost of funds in 2016 and 2017. Thus, we estimate NIMs of 2.59% and 2.53% in 2016 and 2017, respectively. As a result of QCB's 100% LDR rule, we pencil in loan book growth of 5.0% in 2016 and 7.5% in 2017. We note in light of the current situation, QCB may not require banks to adhere to the new ceiling by end-2017, in our view. On the other hand, we revised our non-interest income upward in 2016 and 2017 due to better than expected fees & commissions (which we now expect to increase by 8.0% and 10% in 2016 and 2017, respectively) and FX income (+25.0% in 2016 and +23% in 2017). Furthermore, we expect opex to be contained, increasing it by 7.3% (+7.6% in 2017) as the bank braces for a weak year. We do not expect a deterioration in asset quality and estimate negligible provisions. Net-net, our 2016 and 2017 bottom-line estimates grows by only 1.6% (QR2.05bn) and 1.3% (2.08bn), respectively. However, if we remove the effect of QR93.1mn (non-recurring/non-core income) from 2016's financials, then our estimated 2017 net income grows by 6.0%. *Our changes in estimates are based on our cautious outlook on 2016 and 2017.* Going into 2018, we estimate net income to grow by 10.7%. We expect positive performance across the board in 2018.

- **Based on our revised estimates, we decrease our price target to QR34.00 from QR40.00 and we rate MARK a Market Perform.** Our revision reflects a subdued fundamental outlook in 2016. We have also made some changes to our valuation assumptions. We revised our cost of equity to 11.5% vs. 10.9% previously and maintained our terminal growth rate at 5.0%. Moreover, we maintain the average RoAE at 18.5%. *Based on our revised estimates, the WEV and RI methods yield a price target of QR35.00 and QR34.00, respectively. As such, the blended price target is QR34.00.*

Catalysts

- **Beyond a stabilization/recovery in oil prices, the following developments could be perceived positively by the market:** 1) Growth in public sector loans after a weak 2015 and 2) Improvement in NIMs and spreads.

Recommendation, Valuation and Risks

- **Recommendation and valuation:** *We revise our Price Target to QR34.00.* MARK is trading at a 2016e P/B and P/E of 2.1x and 13.1x, respectively. The stock offers an attractive yield of 4.9% in 2015 and 2016.

- **Risks:** 1) Depressed oil prices remains the biggest risk for MARK and the banking sector, 2) Increase in credit costs, 3) MARK loses market share in the government segment and 4) LDR requirement from the QCB could create short-term issues.

Key Financial Data and Estimates

	FY2015	FY2016e	FY2017e	FY2018e
Attributable EPS (QR)	2.70	2.74	2.77	3.07
EPS Growth (%)	3.6	1.6	1.3	10.7
P/E (x)	13.3	13.1	12.9	11.7
BVPS (QR)	16.1	17.0	18.1	19.4
P/B (x)	2.2	2.1	2.0	1.8
DPS (QR)	1.75	1.75	1.75	2.00
Dividend Yield (%)	4.9	4.9	4.9	5.6

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

Key Data

Current Market Price (QR)	35.80
Dividend Yield (%)	4.9
Bloomberg Ticker	MARK QD
ADR/GDR Ticker	N/A
Reuters Ticker	MARK.QA
ISIN	QA000A0M8VM3
Sector*	Banks & Financial Svcs.
52wk High/52wk Low (QR)	49.90/28.60
3-m Average Volume ('000)	767.3
Mkt. Cap. ($ bn/QR bn)	7.4/26.9
Shares Outstanding (mn)	750.0
FO Limit* (%)	49.0
Current FO* (%)	9.3
1-Year Total Return (%)	(16.5)
Fiscal Year End	December 31

Source: Bloomberg (as of March 07, 2016), *Qatar Exchange (as of March 03, 2016); Note: FO is foreign ownership

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Revising Estimates

Liquidity and subdued macro-economic outlook may prove to be a challenge for MARK; we tweak some of our assumptions for 2016 and 2017; expect positive performance in 2018. Our bottom-line estimate for 2016 remains unchanged and we slightly lower 2017 net profit by 3.5% vs. our previous estimate. However, we revise other accounts. We revise our 2016 net interest income downward by 4.3% due to weak loan growth and margin compression. This is partly due to MARK's liquidity position; MARK is highly reliant on public sector deposits (54% and 45% of deposit book in 2014 & 2015, respectively); MARK saw its total deposits drop by 11.1% in 2015 (public sector deposits declined by 25.5%), resulting in an elevated LDR of 112% vs. 93% in 2014. We are of the view that MARK would have to be competitive in raising deposits, which would drive up its cost of funds in 2016 and 2017. Thus, we estimate NIMs of 2.59% and 2.53% in 2016 and 2017, respectively. As a result of QCB's 100% LDR rule, we pencil in loan book growth of 5.0% in 2016 and 7.5% in 2017. We note in light of the current situation, QCB may not require banks to adhere to the new ceiling by end-2017, in our view. On the other hand, we revised our non-interest income upward in 2016 and 2017 due to better than expected fees & commissions (which we now expect to increase by 8.0% and 10% in 2016 and 2017, respectively) and FX income (+25.0% in 2016 and +23% in 2017). Furthermore, we expect opex to be contained, increasing it by 7.3% (+7.6% in 2017) as the bank braces for a weak year. We do not expect a deterioration in asset quality and estimate negligible provisions. Net-net, our 2016 and 2017 bottom-line estimates grows by only 1.6% (QR2.05bn) and 1.3% (2.08bn), respectively. However, if we remove the effect of QR93.1mn (non-recurring/non-core income) from 2016's financials, then our estimated 2017 net income grows by 6.0%. *Our changes in estimates are based on our cautious outlook on 2016 and 2017.* Going into 2018, we estimate net income to grow by 10.7%. We expect positive performance across the board in 2018.

Major Estimate Changes

	2016e			2017e			2018e		
	Old	New	Change (%)	Old	New	Change (%)	Old	New	Change (%)
Net Interest Income	2,175	2,082	-4.3	2,357	2,213	-6.1	2,680	2,440	-9.0
Non Interest Income	419	516	23.3	484	587	21.3	536	666	24.3
Net Operating Income	2,049	2,006	-2.1	2,252	2,162	-4.0	2,573	2,409	-6.4
Net Income	2,056	2,054	-0.1	2,157	2,081	-3.5	2,463	2,304	-6.5

Source: QNBFS estimates

Valuation

Based on our revised estimates, we decrease our price target to QR34.00 from QR40.00 and assign a Market Perform rating. Our revision reflects a subdued fundamental outlook in 2016. We have also made some changes to our valuation assumptions. We revised our cost of equity to 11.5% vs. 10.9% previously and kept our terminal growth rate unchanged at 5.0%. Moreover, we maintain the average RoAE at 18.5%. *Based on our revised estimates, the WEV and RI methods yield a price target of QR35.00 and QR34.00, respectively. As such, the blended price target is QR34.00.*

We value MARK 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 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 also derive MARK'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.

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 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 MARK's case, 63% of the fair value is derived from the bank's beginning BVPS and interim residuals vs. 38% from the terminal value. Both valuation methodologies are based on a common Cost of Equity (CoE) assumption of 11.5%.

We calculate a risk free rate of 4.5% and factor in an adjusted beta of 1.0 as we believe banks are a direct proxy for the economy. Finally, we add a local equity risk premium of 7.02% (6.5% previously) to arrive at a CoE of 11.5%.

Valuation Matrix

WEV	
Sustainable RoAE (%)	18.5%
Book Value of 2016e (QR)	17.05
Estimated Cost of Equity (%)	11.5%
Terminal Growth Rate (%)	5.0%
Intrinsic Value (QR)	35.00
Current Market Price (QR)	35.80
Upside/(Downside) Potential (%)	(2.2%)
Equity Value (QR mn)	26,250

RI	
Beginning BVPS (2016) (QR)	16.06
Present Value of Interim Residuals (QR)	5.22
Present Value of Terminal Value (QR)	12.89
Terminal Growth Rate (%)	5.0%
Intrinsic Value (QR)	34.00
Current Market Price (QR)	35.80
Upside/(Downside) Potential (%)	(5.9%)
Equity Value (QR mn)	25,255

Source: Bloomberg, QNBFS estimates

Price Target Calculation

Methodology	Equity Value (QR mn)	Weight (%)	Fair Value (QR mn)
WEV	26,250	50	13,125
Residual Income	25,255	50	12,627
Blended Equity Value			25,752
Shares Outstanding (mn)			750.00
Target Price (QR)			34.00
Upside/(Downside)			**(5.0%)**

Source: Bloomberg, QNBFS estimates

We present below a scenario analysis of possible price targets based on a Base, Bull and Bear scenario.

Scenario Analysis	Bear	Base	Bull
Sustainable RoAE	16.5%	18.5%	19.0%
G	4.0%	5.0%	5.0%
Ke	12.5%	11.5%	10.5%
P/B	1.47	2.07	2.54
Blended Fair Value Based on WEV & RI	25.00	34.00	42.00

Source: QNBFS estimates

Detailed Financial Statements

Ratios	FY2015	FY2016e	FY2017e	FY2018e
Profitability (%)				
RoAE (Attributable)	17.3	16.5	15.8	16.4
RoAA (Attributable)	2.5	2.4	2.2	2.3
RoRWA (Attributable)	3.6	3.4	3.2	3.1
NIM (% of IEAs)	2.65	2.59	2.54	2.53
NIM (% of RWAs)	3.62	3.48	3.40	3.24
NIM (% of AAs)	2.48	2.40	2.37	2.40
Spread	2.4	2.4	2.3	2.3
Efficiency (%)				
Cost-to-Income (Headline)	22.9	22.8	22.8	22.4
Cost-to-Income (Core)	23.3	23.9	23.9	23.5
Liquidity (%)				
LDR	111.9	105.0	102.6	99.0
Loans/Assets	75.0	72.4	73.1	73.5
Cash & Interbank Loans-to-Total Assets	6.2	8.5	6.5	6.3
Deposits to Assets	67.0	69.0	71.3	74.2
Wholesale Funding to Loans	21.4	20.0	16.7	13.1
IEAs to IBLs	125.5	118.7	121.5	119.5
Asset Quality (%)				
NPL Ratio	0.09	0.09	0.10	0.09
NPLs to Shareholder's Equity	0.50	0.50	0.56	0.52
NPLs to Tier 1 Capital	0.56	0.58	0.65	0.61
Coverage Ratio	89.5	83.6	77.8	105.3
ALL/Average Loans	0.1	0.1	0.1	0.1
Cost of Risk	0.00	0.00	0.01	0.03
Capitalization (%)				
Tier 1 Ratio	18.5	17.6	17.2	15.1
CAR	18.5	17.6	17.2	15.1
Tier 1 Capital to Assets	12.9	12.1	12.2	11.6
Tier 1 Capital to Loans	17.1	16.8	16.6	15.8
Tier 1 Capital to Deposits	19.2	17.6	17.1	15.7
Leverage (x)	6.9	7.1	7.1	7.4
Growth (%)				
Net Interest Income	3.5	2.9	6.3	10.3
Non-Interest Income	5.6	32.4	13.7	13.5
OPEX	15.3	7.3	7.6	9.3
Net Operating Income	0.8	7.7	7.8	11.4
Net Income (Attributable)	3.6	1.6	1.3	10.7
Loans	7.5	5.0	7.5	12.0
Deposits	-11.1	12.0	10.0	16.0
Assets	3.7	8.8	6.5	11.4
RWAs	5.9	8.2	9.3	21.1

Source: Company data, QNBFS estimates

Income Statement (In QR mn)	FY2015	FY2016e	FY2017e	FY2018e
Net Interest Income	2,024	2,082	2,213	2,440
Fees & Commissions	238	257	283	326
FX Income	108	135	166	192
Other Income	44	124	138	148
Non-Interest Income	390	516	587	666
Total Income	2,414	2,598	2,800	3,106
Operating Expenses	(552)	(593)	(638)	(697)
Net Operating Income	1,862	2,006	2,162	2,409
Net Provisions	(47)	(10)	(8)	(24)
Net Profit Before Taxes & Non-Recurring Items	1,815	1,996	2,154	2,385
Non-Recurring Income	186	93	0	0
Net Profit After Non-Recurring Income	2,001	2,089	2,154	2,385
Tax	25	(2)	(3)	(3)
Net Profit Before Minority Interest	2,026	2,087	2,152	2,382
Minority Interest	47	20	(18)	(19)
Net Profit (Headline/Reported)	2,073	2,107	2,134	2,363
Social & Sports Contribution Fund	(52)	(53)	(53)	(59)
Net Profit (Attributable)	2,022	2,054	2,081	2,304

Source: Company data, QNBFS estimates

Balance Sheet (In QR mn)	FY2015	FY2016e	FY2017e	FY2018e
Assets				
Cash & Balances with Central Bank	2,737	3,738	3,426	3,975
Interbank Loans	2,376	3,924	2,812	2,755
Net Investments	14,625	16,108	18,500	20,324
Net Loans	62,261	65,402	70,305	78,727
Investment In Associates	469	501	536	574
Other Assets	410	445	422	567
Net PP&E	147	178	177	177
Investment in Real Estate	-	-	-	-
Total Assets	83,026	90,295	96,179	107,099
Liabilities				
Interbank Deposits	13,345	13,048	11,730	10,346
Customer Deposits	55,623	62,298	68,528	79,492
Other Liabilities	1,700	1,869	2,056	2,385
Total Liabilities	70,668	77,215	82,314	92,223
Total Shareholders' Equity	12,044	12,785	13,554	14,545
Total Liabilities & Shareholders' Equity	83,026	90,295	96,179	107,099

Source: Company data, QNBFS estimates

Recommendations			Risk Ratings	
Based on the range for the upside / downside offered by the 12 - month target price of a stock versus the current market price			Reflecting historic and expected price volatility versus the local market average and qualitative risk analysis of fundamentals	
OUTPERFORM	Greater than +20%		R-1	Significantly lower than average
ACCUMULATE	Between +10% to +20%		R-2	Lower than average
MARKET PERFORM	Between -10% to +10%		R-3	Medium / In-line with the average
REDUCE	Between -10% to -20%		R-4	Above average
UNDERPERFORM	Lower than -20%		R-5	Significantly above average

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