Global Research
Result Update
Equity - Kuwait
Banking Sector
13 March, 2011

Kuwait Finance House (KFH)

HOLD
Target Price
KWD1.15

Market Data

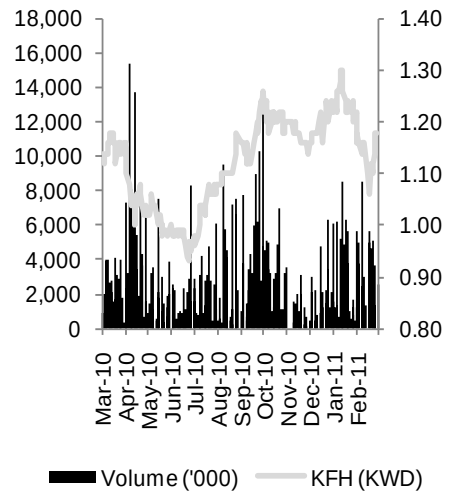
Bloomberg Code:	KFIN KK
Reuters Code:	KFIN.KW
CMP (13th March 2011):	1.18
O/S (mn)	2,489.9
Market Cap (KWD mn):	2,938.0
Market Cap (USD mn):	10,530.6
P/E 2011e (x):	28.2
P/BV 2011e (x):	2.5

Price Performance 1-Yr

High (KWD):	1.30
Low (KWD):	0.93
Average Volume ('000):	2,680.6

	1m	3m	12m
Absolute (%)	1.7	1.7	3.5
Relative (%)	5.3	7.1	15.8

Price Volume Performance



Source: Zawya

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- **Profitability dives in 4Q10; higher than anticiapted provisions**
- **Asset quality dives further**
- **Top-line portrays healthy performance, resilience**
- **Fair value remains unchanged, recommendation maintained**

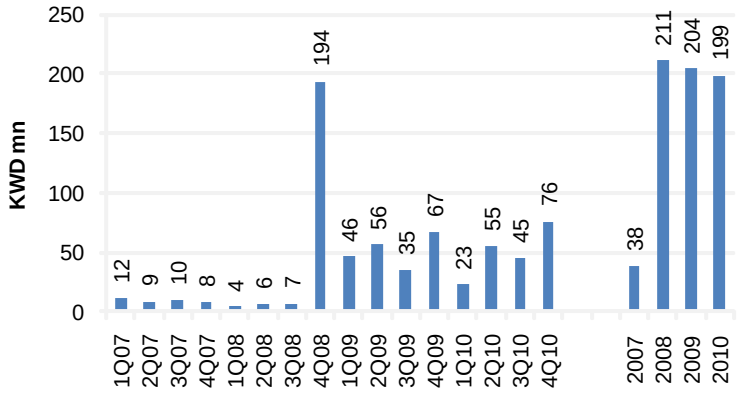
Profitability dives in 4Q10, misses expectations

Kuwait Finance House (KFH) reported a 4Q10 profit of KWD8.6mn, significantly below our expectations of KWD24.1mn for the ending quarter and lower by 30%YoY. The surprise came from higher than anticipated provisions during the quarter. Excluding the KWD64mn loss in 4Q08 (when the impact of the financial crisis was at its peak), 4Q10 posted the worse figures in at least the last 12 quarters. For the full year KFH posted a profit of KWD106, down 11%YoY, marking 2010 as the third consecutive year of profitability decline.

Continuation of heavy provisions drowns earnings

KFH continued to take heavy provisions throughout the year, with the biggest pinch coming in 4Q10, leading to the deviation in profits with respect to our expectations. Provisions during the year hovered around the KWD200mn level, no different from what we saw in the preceding 2 years; exhibiting that respite was still not in sight.

Total Provisions



Source: Company Accounts

Decomposing total provisions into respective components, we realize that those related to investments (and others) have actually reduced by 36%YoY in 2010. This reduction was however offset by a similar jump in provisions against receivables and leased assets. Provisions against loans could have been higher had KFH not ploughed into its existing general provisions, releasing over KWD31mn during the process.

Asset quality worsens further

KFH's NPLs ratio worsened by another 210bps during the year, driven by a 31%YoY jump in non-performing assets. NPLs ratio was reported at 12.4% in 2010 while the absolute amount of infected loans touched KWD911mn. We believe that this could be an outcome of exposure to investment and real estate companies; high exposure to retail also seems to be a probable reason.

The impact of the decline in loan loss provisions (general) along with a considerably rise in NPLs had a toll on the coverage ratio which slipped from 63.2% in 2009 to 59.4% in 2010. Noteworthy, NPL coverage through specific provisions increased from 31.4% in 2009 to 42.7% in 2010. We still believe that the coverage ratio is too low and KFH may need to take high provisions going forward to reach adequate levels, even if NPL formation remains tamed.

Net Commission Income rises!

KFH's top-line grew 6%YoY in 2010, edging 3% higher than our forecast. Net commission income growth was propelled by volumes alone while spreads remained under pressure and eroded by another 12bps during the year. KFH's financing assets (receivables and leases) and deposits outpaced the industry, growing by 7%YoY and 5%YoY respectively against 0.4%YoY and 1.3%YoY respectively for the industry. Top-line growth and the clear exhibition of muscle to collate deposits and disburse loans were therefore very positive indicators of KFH's resilience in a tough operating environment.

It is noteworthy that there was a marked shift in KFH's liability mix, with dependence on interbank borrowing increasing for the first time in the last few years. Interbank borrowing which averaged at 17% of the total interest bearing liabilities jumped to 22% in 2010; an outcome of a 51%YoY rise in deposits from banks and FIs. This could perhaps help explain why the decline in yields on earning assets was faster than the decline in cost of funds. It is also interesting to note that loan growth emanated purely from international operations while loans disbursement in the middle-east flat-lined. Tapping foreign economies for loans growth opportunities seems like a good strategy given that such prospects have been difficult to come by in Kuwait recently.

Non Commission Income down due to losses made by associates

KFH's non commission income declined by 8%YoY in 2010, led primarily by share of loss of associates, which doubled (KWD57mn) over the previous year. Albeit details are not available, this could be due to Aayan Leasing and other real estate companies partly owned by KFH. The bank nevertheless managed to offset this loss with one-offs coming in from cancellation of aircraft contract (KWD20mn, possibly from its subsidiary ALAFCO) and sale of exploration assets (KWD25mn, possibly from Aref Group). Interestingly enough KFH also made good profits of over KWD51mn through sale of its real estate investments, without which profits would have been terribly lower.

Operating profit remains unchanged over the year; reversal in minority interest brings the difference

KFH's operating profit remained stagnant over 2009, standing at KWD76.3mn. The decline in net earnings was therefore due to shrinkage in reversal of minority interest, which fell 27%YoY to KWD34mn in 2010. This reversal seen only in the past 2 years is of course not sustainable and will have a muting effect on profitability growth when operating income shows improvement and reversals in minority interest cease.

Down but not out…

KFH is expected to break free from its declining-profits stint and is forecast to show improvement in earnings in 2011. This is believed to be driven by single digit growth in net commission income similar to what was seen in 2010, contraction in losses from associates and resultantly higher investment income (and non-commission income) and narrowing down of investment and other provisions. The year 2012 is seen as a remarkable year for KFH, which is expected to be one of the primary beneficiaries of a let up in economy and a slide in loan related provisions, thereby leading to a spike in profitability growth. We nevertheless expect provisions to remain on the higher side throughout the forecast period, given our discomfort with the current level of NPL coverage and due to having limited clarity on the health of assets. We understand that the bank will strive to move towards at least 100% coverage in successive yearly steps, reaching the target by the end of our forecast period. We maintain our reservations regarding the extent and/or proposed timing of the implementation of the Kuwait Developmental Plan, the realization of which will prompt us to revise our forecasts for KFH in a very favourable manner.

Estimates Revision - 2011

KWD mn	Earlier Estimates	Revised Estimates	% Change
Loans	8,379.4	7,937.6	-5.3%
Deposits	8,005.1	8,100.0	1.2%
Net Commission Income	366.6	377.0	2.8%
Operating Income	653.9	613.5	-6.2%
Provisions	144.4	176.0	21.9%
Net Profit	131.0	112.4	-14.2%

Source: Company Accounts, Global Research

KFH reported a CAR of 14.2% in 2010, down from 15.2% in 2009, however the capital adequacy measure still stands at a comfortable level.

Valuation update – Maintain HOLD, fair value relatively unchanged

KFH recommended a dividend payout of 20fils per share along with an 8% bonus shares distribution. The bank's cash payout ratio therefore comes up to be 46.5%, similar to its historic 3-year average. A change in forward estimates and incorporation of increased risk premium (up by 1%) due to political tension in the region leads us to alter our fair value for KFH from KWD1.14/share to **KWD1.15/share**; an upward revision of 0.5%. The fair value is based on pre-bonus number of shares and will be adjusted once the stock turns ex-bonus. At the market price of KWD1.18/share as at March 13, 2011, the bank offers a downside of 2.9%. We maintain our recommendation on KFH at **HOLD**.

Financial Statements

(KWD mn)	2008	2009	2010	2011e	2012e	2013e	2014e
Income Statement							
Interest/Financing Income	561	528	518	551	604	684	797
Interest Expense/Payment to Depositors	(217)	(193)	(163)	(174)	(190)	(220)	(260)
Net Interest/Financing Income	**344**	**336**	**355**	**377**	**414**	**464**	**537**
Fee & Commission Income	70	63	65	70	84	94	117
Investment Income	210	112	92	99	106	122	140
Other Income	44	63	61	67	74	83	93
Total Non-Interest/Financing Income	**324**	**238**	**219**	**237**	**264**	**298**	**349**
Total Operating Income	**668**	**574**	**573**	**613**	**678**	**762**	**886**
Provisions expense	(211)	(204)	(199)	(176)	(138)	(137)	(147)
Operating Expenses	(277)	(293)	(298)	(315)	(345)	(393)	(452)
Profit Before Taxation	**180**	**77**	**76**	**123**	**195**	**232**	**287**
Taxation & Minority Interest	(23)	42	30	(10)	(33)	(42)	(52)
Net Profit Attributable to Parent	**157**	**119**	**106**	**112**	**162**	**191**	**236**
Balance Sheet							
Cash Balances	368	445	448	584	543	730	770
Deposits with Banks & FIs	1,312	1,258	1,597	1,407	1,354	1,163	1,221
Investment Securities	1,039	1,042	1,183	1,242	1,304	1,370	1,301
Gross Loans & Financings	6,288	6,781	7,360	7,938	8,781	9,938	11,444
Loan Loss Reserve	(327)	(402)	(541)	(673)	(790)	(906)	(1,032)
Net Loans & Financings	5,962	6,378	6,819	7,265	7,991	9,032	10,412
Investment in Associates	449	411	339	322	355	408	469
Investment Properties	337	633	783	937	1,239	1,666	2,083
Net Fixed Assets	591	602	751	921	1,105	1,273	1,464
Other Assets	486	522	629	661	727	800	879
Total Assets	**10,544**	**11,291**	**12,548**	**13,339**	**14,618**	**16,441**	**18,600**
Deposits from Banks & FIs	1,595	1,461	2,212	2,344	2,461	2,585	2,714
Deposits from Customers	6,612	7,262	7,649	8,100	8,943	10,322	11,957
Other Borrowings	-	-	-	-	-	-	-
Other Liabilities	821	1,085	1,167	1,289	1,536	1,763	2,035
Paid-up Capital	206	231	249	269	269	269	269
Retained Earnings/Reserves	956	928	960	1,018	1,064	1,122	1,201
Other Reserves	-	-	-	-	-	-	-
Shareholders' Equity	1,162	1,159	1,209	1,287	1,333	1,391	1,470
Minority Interest	355	324	312	318	345	380	423
Total Equity & Liability	**10,544**	**11,291**	**12,548**	**13,339**	**14,618**	**16,441**	**18,600**
Ratio Analysis							
Return on Average Assets	1.6%	1.1%	0.9%	0.9%	1.2%	1.2%	1.3%
Return on Average Equity	14.6%	10.9%	9.4%	9.5%	13.3%	15.3%	18.3%
Net Interest Income/Operating Income	51.6%	58.5%	61.9%	61.4%	61.1%	60.9%	60.6%
Recurring Income/Operating Income	62.1%	69.5%	73.2%	72.9%	73.5%	73.2%	73.8%
Interest Earning/Financing Assets Yield	8.5%	7.1%	6.4%	6.5%	6.7%	7.0%	7.3%
Cost of Funds	2.9%	2.3%	1.8%	1.7%	1.7%	1.8%	1.9%
Net Spread	5.5%	4.8%	4.7%	4.7%	5.0%	5.2%	5.4%
Cost to Income Ratio	41.4%	51.1%	52.1%	51.3%	50.9%	51.5%	51.0%
OPEX/Average Assets	2.9%	2.7%	2.5%	2.4%	2.5%	2.5%	2.6%
Net Loans to Customer Deposits	90.2%	87.8%	89.1%	89.7%	89.4%	87.5%	87.1%
Non Performing Loans	727	697	911	984	1,010	1,024	1,030
Loan Loss Reserve	327	402	541	673	790	906	1,032
NPLs to Gross Loans	11.6%	10.3%	12.4%	12.4%	11.5%	10.3%	9.0%
NPL Coverage	41.1%	63.2%	59.4%	68.3%	78.3%	88.5%	100.2%
Cost of Risk (bps)	285	157	190	172	141	124	117
Equity to Gross Loans	18.5%	17.1%	16.4%	16.2%	15.2%	14.0%	12.8%
Equity to Total Assets	11.0%	10.3%	9.6%	9.6%	9.1%	8.5%	7.9%
Dividend Payout Ratio	52.3%	47.9%	46.5%	62.8%	66.6%	67.7%	69.0%
Adjusted EPS (fils)	58.4	44.2	39.4	41.8	60.2	70.9	87.6
Adjusted BVPS (fils)	432.1	431.0	449.4	478.6	495.6	517.2	546.5
Market Price (fils) *	1,760.0	1,100.0	1,160.0	1,180.0	1,180.0	1,180.0	1,180.0
Dividend Yield	2.3%	2.2%	1.7%	2.2%	3.4%	4.1%	5.1%
P/E Ratio (x)	23.1	21.4	27.3	28.2	19.6	16.7	13.5
P/BV Ratio (x)	3.1	2.2	2.4	2.5	2.4	2.3	2.2

Source: Company Reports & Global Research

** Market price for 2011 and subsequent years as per closing prices on KSE on March 13, 2011*

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Disclosure Checklist

Company	Recommendation	Bloomberg Ticker	Reuters Ticker	Price	Disclosure
Kuwait Finance House	HOLD	KFIN KK	KFIN.KW	KWD 1.18	1,10

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