KAMCO RESEARCH

Kuwait Finance House
Equity Research
April 2009

KAMCO

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KAMCO Recommendation Scale:

- ***Strong Buy***
- ***Buy***
- ***Hold***
- ***Sell***

Our Recommendation Indicates:

Strong Buy: the stock is undervalued by more than 15% of our Estimated Fair Value.
Buy: the stock is undervalued within the range of 5-15% below our Estimated Fair Value.
Hold: the stock is fairly valued in the market and has a potential to appreciate up to 5%.
Sell: the stock is currently overvalued relative to our Estimated Fair Value.

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KAMCO Research

Kuwait Finance House
Equity Research

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April 2009

Kuwait Banking Sector

Equity Research

Recommendation: Hold

Reuters Code: KFIN.KW

Current Price: KD 1.200

Fair Value: KD 1.220

Key Financial Facts *(KD million)*	**Dec 07**	**Dec 08**
Total Assets	8,797.9	10,544.1
Net Loans	4.918.8	5,961.6
Customer Deposits	5,361.2	6,611.6
Shareholders' Equity	1,210.0	1,240.3
Operating Income	588.6	668.1
Net Profit	275.3	157.0

Key Ratios *(%)*	**Dec 07**	**Dec 08**
Return on Average Assets	**3.64**	**1.62**
Return on Average Equity	**26.51**	**12.34**
Net Interest Margin	4.0	4.9
Cost/ Income Ratio	36.62	41.44
NPL Coverage Ratio	50.1	25.7
Net Loans/ Total Deposits	75.1	72.6

Share Data 7-April-09			
Current Price *(KD)*	1.200	**Fair Value / Share *(KD)***	**1.220**
Shares Outstanding *(mil.)*	2,305.4	Market Cap. *(KD million)*	2,767
52-Week High *(KD)*	3.100	52-Week Low *(KD)*	0.860
YTD-09 Turnover (%)	20.1	P/E Multiple (X)	17.63

Financial Highlights

- **KFH's net profit for FY-2008 witnessed a sharp drop of 43% to KD 156.96 million on the back of high provisions and impairment of investments which surged to KD 211 million. The bulk of impairments were taken in Q4-08 with a total amount of KD 193.7 million.**
- **The Bank was able to grow its net financing income by 53.5% to KD 344.5 million fuelled by the 21% growth in the loan portfolio to KD 5.96 billion.**
- **Following the 23.3% growth in its customer deposits to KD 6.61 billion, KFH became the biggest bank in Kuwait by customer deposit**
- **We forecast KFH's net loan portfolio to grow by a CAGR of 14.8% in the coming five years (2009-2013), while operating income and net profit are forecasted to grow by a CAGR of 10.0% and 20.6% to reach KD 858.9 million and KD 354.1 million in 2013.**

Valuation Snapshot

Our DCF model indicated a value of KD 1.232 per share, while the peer based multiples valuation model indicated values of KD 1.054 and KD 1.285 per share for the P/E and P/B multiples respectively.

We used a weighted average of the above valuation models, giving an 80% weight to the DCF method and 10% to each of the P/E and P/B methods to arrive at an estimated fair value of KFH at KD 1.220. KFH is now trading at a 1.60% discount to our estimated fair value, indicating a ***Hold*** following KAMCO's recommendation scale.

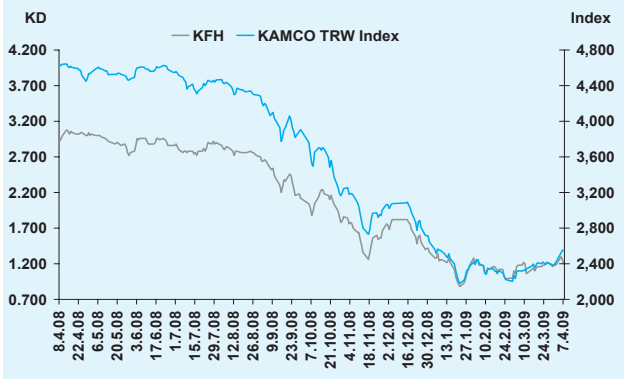


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Report Highlights

- Influenced by the global financial crisis and its consequences on the local banking system, KFH posted in 2008 the first drop in its net profit to KD 156.96 million. The drop came on the back of the high provision for impairment of receivables and the impairment of investments which together amounted to KD 211 million for the year. Following the plunge in the Bank's net profit in 2008, core profitability ratios deteriorated and fell below the peer group average. Return on Average Assets (ROAA) and Return on Average Equity (ROAE) dropped to 1.62% and 12.34% in 2008, down from 3.6% and 26.5% in 2007 respectively.

- Despite posting solid results during the first two quarters of the year, the plunge in FY-08 net profit was a direct outcome of the slump in Kuwait Stock Exchange and the global credit turmoil which led to sharp drop in investment income during Q3-08 and Q4-08. The Bank staged a muted performance during Q3-08 with a slight net profit quarter-over-quarter growth of 4.93% to KD 63.23 million. However, Q4-08 was the worst quarter for the Bank as it recorded a loss of KD 63.6 million driven by the provision for impairment of loans and the impairment of investments and leased assets which together amounted to KD 211 million for the year.

- During 2008, the Bank was able to grow its net financing income from KD 224.4 million in 2007 to KD 344.5 million, reflecting a year-over-year growth of 53.5% and following a growth of 48.4% last year. This growth in net financing income was mainly fuelled by the growth in the Bank's loan portfolio which increased by 21.2% over the same year to record KD 5.96 billion at the end of 2008. Also KFH's financing income in 2008 grew by 20.2% to reach KD 561.3 million, up from KD 466.9 million in 2007.

- While net financing income (net interest income) expanded by 53.5%, KFH was not able to sustain the double digit growth in its non-financing (non-interest) income which grew at a CAGR of 59% over the period 2003-2007 supported by investment income and fees and commission income which together constituted an average of 90% and 56% of the Bank's non-financing income and total operating income over the same period. Non-financing income dropped by 11.17% to record KD 323.6 million in 2008, down from a peak of KD 364.3 million in 2007.

- Investment income played a major role in dragging down the Bank's non-financing income and hence profitability growth for the year, as it is considered a vital income contributor constituting a five-year average of 70.5% of KFH non-interest income and 42.3% of total operating income. Investment income fell 22% to KD 210 million mainly due to the financial crisis and the huge losses incurred by the local and regional stock markets over the last 4 months of 2008.

- The drop in non-financing income was further intensified with the slowdown in fees and commission income which grew by 25% to reach KD 70.14 million, as compared to an average growth of 58% over the period 2004-2007.

- During 2008, KFH grew its assets by 19.85% to KD 10.54 billion, albeit at a slower pace when compared to a growth of 39.34% in the previous year. The Bank still holds the second largest asset base after National Bank of Kuwait. The Bank expanded its loan portfolio by 21.2% in 2008, lower than the growth of 43.6% in 2007 to record KD 5.96 billion, making it the second largest bank in Kuwait after National Bank of Kuwait and accounting for 25% of market share.

- Receivables, representing the major component of the Bank's loan portfolio, grew by 19.9% during 2008 to reach KD 4.8 billion and accounted for 80% of the total loan portfolio as of Dec-08. KFH's receivables quality indicators significantly worsened during the year, mainly due to the deterioration in the local equity market, liquidity issues in the credit market and excessive debt at Kuwaiti companies which led directly to an increase in bad debt and an even more brutal credit crunch for local banks. The absolute value of non-performing finance facilities increased drastically in 2008 to reach KD 642.2 million, up from KD 156 million.

- The Bank has maintained a high coverage ratio of its non-performing finance facilities over the period 2004-2006 when the coverage ratio averaged around 88%. However, this ratio has started to worsen in 2007 when it dropped to 50.1% and continued its downward trend in 2008 to reach 25.7%.

- We forecast KFH net loan portfolio to grow by a CAGR of 14.8% in the coming 5 years ending in 2013. Total operating income and net profit are forecasted to grow by a CAGR of 10.0% and 20.6%, to record KD 858.9 million and KD 354.1 million in 2013 respectively.

- Our Discounted Cash Flow valuation Model indicated a fair value per share of **KD 1.232**, while the weighted average value of the stock resulted from the two valuation methodologies: DCF and Relative Valuation Multiples was ***KD 1.220.***

Note: Kuwait Finance House is an Islamic financial institution that does not deal with usury (interest) and that abides by the Islamic law (Shari'a) in all of its practices. However, we will use throughout this report terms related to conventional (non-Islamic) banking such as "interest" and "loans" solely for the sake of comparing KFH performance to other conventional banks in the market.

Key Developments

Kuwait Finance House (KFH) received six awards for the services and products they presented in 2007. The bank received three awards in the IFN Awards Poll 2007; Best Overall Islamic Bank, Most Innovative Islamic Bank and Best Islamic Bank in Kuwait. Also in an effort to recognize KFH's willingness to create new products and enter new fields and markets, the bank received the Best Deal Award for the year which was a result of one of its investment projects in India, Trade Finance Deal of the Year for PT Krakatau Steel's International Murabaha Syndication, and Musharakah Deal of the Year for the KL Central Sukuk.

KFH received six awards for their 2007 performance.

KFH signed a USD 275 million speculation contract with Chinese based-Nan Hai Limited to invest in Peninsula project, the biggest real estate development project in Shekou and Shenzhen in China. The bank's participation in the Peninsula project is through KFH's Asian fund 2, which was recently established, and that the speculation contract that was signed is valid for 3 years. The project overlooks the sea and is divided into 5 constructional phases, with a cost that exceeds USD 3 billions, and expected to achieve no less than 15% in returns for KFH and investors when it is marketed.

Global expansion remains a key focus for KFH

The bank recently received an approval from the Capital Market Authority in Saudi Arabia to start its investment business in the Kingdom through its fully owned unit, Saudi Kuwait Finance House. KFH stresses on aggressive expansionary strategy through finding other investment opportunities in the GCC area such as the UAE, Oman, and Qatar to make it one of the most important corporations in the region. After KFH succeeded in the global markets such as Turkey, Malaysia, Bahrain, the bank is planning to enter other markets this year such as Jordan and Singapore.

KFH obtained the approval from the Capital Market Authority in KSA to launch its investment business in the Kingdom

KFH has gained right of organizing and managing the first Shariah compliant deal in Singapore for the benefit of "TPLIS" India Singapore Pte Ltd to finance building regular USD 120 million paraffin factory. The Development Enterprise Holding Company (DEH), which is owned by KFH and is located on Jurung Island in Singapore. The production is expected to reach 100 thousand metric ton annually of paraffin, which is extracted from kerosene.

KFH Malaysia, a subsidiary of KFH, increased its share capital to $500 million subsequent to the injection of $300 million from Kuwait Finance House, the parent company, and hence providing a strong liquidity and capital position which enables the bank to look at and seriously evaluate various investment opportunities in Malaysia and within the region, as stated by KFH Malaysia Managing Director.

KFH injected $300 million into it's subsidiary in Malaysia

Kuwait Finance House (Malaysia) recently launched the first Berhad Branch in Kuching and the seventh in KFHMB's branch network nationwide. The Kuching outlet will offer a full range of Islamic banking products and services.

KFH launched the seventh branch in KFHMB's branch network nationwide

The "Best Islamic Bank in the Middle East" and "Best Islamic Real Estate Provider" awards were granted by Euromoney to Kuwait Finance House. These two awards came after the KFH topped the list of The Banker biggest 500 banking brands for 2009, where KFH took first among the Arab region. This is in addition to winning the "Best Islamic Bank Award" for the third consecutive year in a poll organized by Islamic Finance News.

KFH recognized by Euromoney as the "Best Islamic Bank in the Middle East" and "Best Islamic Real Estate Provider"

KFH announced its participation in the biggest real estate development project in Malaysia; know as Iskandar City in Medini. The project is expected to achieve a total development value exceeding USD 6 billion during the coming 10 to 15 years. The success of the project will cement KFH's presence in Malaysia and South East Asia, which will highlight its image as one of the largest and most important real estate developers. This project will carry fruitful chances to achieve rewarding long-term profits for its clients and shareholders, which reflects the paramount role that KFH is playing as a contributor in developing the area's infrastructure to execute it in Asia.

KFH to participate in USD 6 billion real estate development project in Malaysia

Profitability

In the midst of the hard financial circumstances driven by the consequences of the global economic and financial meltdown that has been hitting the market since August-08, KFH posted its first bottom line drop of 43% to report a net profit of KD 156.96 million for the year 2008. Earnings per share for the year reached KD 0.076 compared to KD 0.138 registered for last year, reflecting a 45% decline. The board of directors has also met and proposed a cash dividend of 40% and a stock dividend of 12%, lower than that of last year's 65% and 20% respectively.

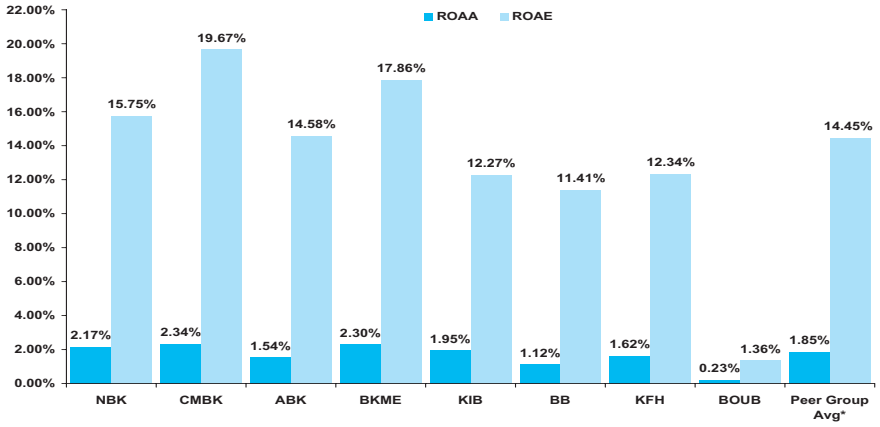
Announced profits by KFH for the FY 08 recorded a drop of 43%, to stand at KD 156.96 million

Despite posting solid results during the first two quarters of the year, KFH full year net profit plunge was a direct outcome of the Kuwait Stock Exchange crash and the global credit turmoil which led to reported drops in investment income during Q3-08 and Q4-08, of 33.10% and 16.84% respectively. The bank staged a muted performance during Q3-08 with a slight net profit quarter-over-quarter growth of 4.93% to KD 63.23 million. The bank however, lost stance during Q4-08 and recorded a loss of KD 63.6 million weighed by the provision for impairment of receivables financing to customers and the impairment of investments and leased assets which together amounted to KD 211 million for the year.

Investment losses in Q3-08 and Q4-08 resulted from the financial distress was a main driver for the plunge in net profit...

... this is in addition to the provision for impairment which amounted to KD 211 million in 2008

Chart 1. FY-08 ROAA & ROAE (KFH versus Peers)



** Peer group excludes Gulf Bank*

Source: Local Banks' Financial Statements & KAMCO Research

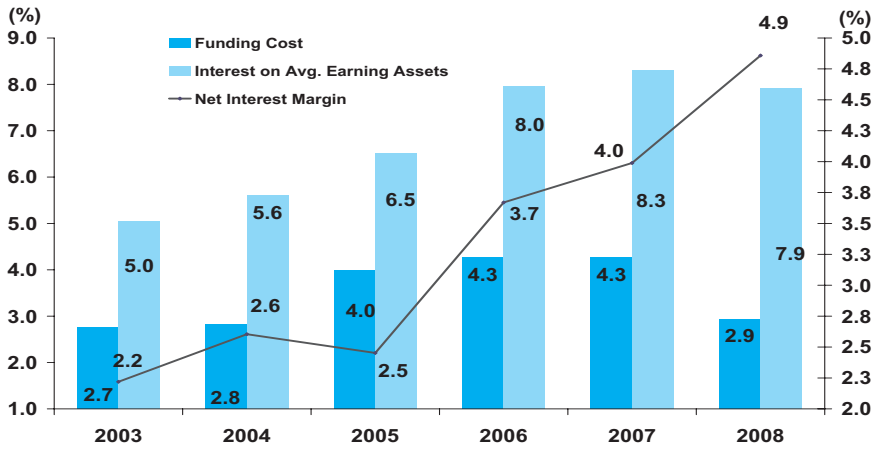
Weak net profits led to a deterioration in core profitability ratios

Following the plunge in the Bank's net profit in 2008, core profitability ratios deteriorated and fell below the peer group average. Return on Average Assets (ROAA) and Return on Average Equity (ROAE) dropped to 1.62% and 12.34% in 2008, down from 3.6% and 26.5% in 2007 respectively.

Fuelled by the growth in KFH's loan portfolio, net financing income rose by 53.5% to record KD 344.5 million in 2008 compared to KD 224.4 million in 2007

During 2008, the Bank was able to grow its net financing income from KD 224.4 million in 2007 to KD 344.5 million, reflecting a year-over-year growth of 53.5% and following a growth of 48.4% last year. This growth in net financing income was mainly driven by the Bank's loan portfolio which grew by 21.2% over the same year to record KD 5.96 billion at the end of 2008. Also KFH's financing income in 2008 grew by 20.2% to reach KD 561.3 million, up from KD 466.9 million in 2007.

Chart 2. KFH's Major Profitability Margins (2004-2008)



Source: KFH Financial Statements & KAMCO Research

KFH was able to further improve its net interest margin (NIM) in 2008 to a peak of 4.9% after recording 4% and 3.7% in 2007 and 2006 respectively. However, interest on average earning assets eased down to 7.9% from a peak of 8.3% in 2007. The bank's funding cost, which reflects financing expense (distribution to depositors) to average customer deposits and deposits from financial institutions, fell significantly from 4.26% in 2007 to 2.94% in 2008. This decline can be explained by the several rate cuts by the Central Bank of Kuwait that came within its continuous efforts to strengthen the banking sector and to face the challenges of the global financial crisis.

NIM to reach a higher point in 2008...

...while funding cost significantly fell to 2.94%.

The attractive return offered by KFH on its investment deposits, which is much higher than that offered by local commercial banks on fixed deposits with comparable maturities, is considered as the key element in attracting new customers and strengthening its customer base. In 2008, however, rate of return across different investment accounts witnessed a sharp drop amid the decline in interest rates. The highest return per annum which is generated from "Mustamera" investment deposits fell from 8.63% in 2007 to 4.3% in 2008 while that earned on "Al-Sedra" and "Tawfeer" investment accounts followed the same trend and dropped from 6.71% and 5.76% in 2007 to 3.34% and 2.87% respectively.

However, due to the economy's struggle with money supply and CBK's boosting efforts through executing several interest rate cuts, KFH deposits witnessed a relatively moderate growth this year causing the bank's average return on customer deposits, calculated as the distribution to depositors (interest expense) divided by the average customer deposits, to average 3.62% for 2008, down from 5.34% in 2007. This drop was in line with CBK's 12-month KD deposits with local banks interest rate decline from 4.79% to 2.75% over the same period.

Due to tight money supply, KFH return on deposits saw a downfall.

Average return on customer deposits fell to 3.62% in 2008 relative to 5.34% in 2007

Table 1. Average Returns On KD Fixed Deposits Compared to KFH Investment Deposits

(%)	2004	2005	2006	2007	2008
Kuwaiti Market :					
12 Month Fixed Deposits	2.29	4.63	5.51	4.79	**2.75**
6 Month Fixed Deposits	2.13	4.46	5.44	4.71	**2.64**
3 Month Fixed Deposits	1.89	4.29	5.40	4.54	**2.43**
Kuwait Finance House :					
Investment Deposits for an Unlimited Period (Mustamera)	4.80	6.81	8.46	8.63	**4.30**
Investment Deposits for an Unlimited Period (Al Sedra)	3.73	5.29	6.58	6.71	**3.34**
Investment Savings Accounts (Tawfeer)	3.20	4.54	5.64	5.76	**2.87**

Source: KFH Financial Statements, Central Bank of Kuwait Reports, & KAMCO Research

While net financing income (net interest income) expanded by 53.5%, KFH was not able to sustain the double digit growth in its non-interest income which grew at a CAGR of 59% over the period 2003-2007 fuelled by the investment income and fees and commission income which together constituted an average of 90% and 56% of the Bank's non-interest income and total operating income over the same period. Non-interest income dropped by 11.17% to record KD 323.6 million in 2008, down from a peak of KD 364.3 million in 2007.

Non-interest income saw a decline of 11.17% in FY 08, to reach KD 323.6 million compared to KD 364.4 million in 07

Investment income played a major role in dragging down the Bank's non-interest income and hence profitability growth for the year as it is considered a vital income contributor constituting a five-year average of 70.5% of KFH non-interest income and 42.3% of total operating income. Investment income fell 22% to KD 210 million mainly due to the financial crisis and the huge losses incurred by the local and regional stock markets over the last 4 months of 2008. Driven by the global financial crisis, credit turmoil, sharp drop in oil prices, lack of investor confidence and the credit difficulties faced by highly leveraged local investment companies, the Kuwait Stock Exchange suffered severe losses during 2008, as the KSE Weighted Index drastically fell by 50% from its peak of 814.2 points on 9 March-08.

Representing the main income generating stream in the past years, investment income dropped by 22% in 2008 to KD 210 million.

Like many other banks, KFH began to liquidate its investments as it did with 1st KFH Fund for Asian Real Estate which has a capital of USD 101 million; achieving a net profit USD 39.6 million with a 34.6% return on investment rate, and 15% internal return. The fund has distributed quarterly cash profit with 9% per annum rate to investors since the inception of the fund in 2006.

The Bank initiated the liquidation of its investments....

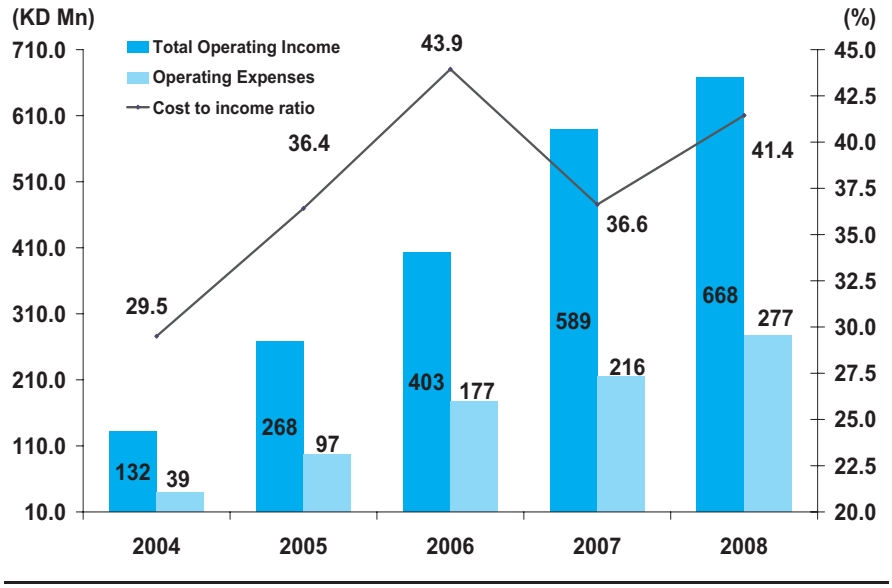
Furthermore, KFH disposed several equity interests in certain associates including, 17% of Sukouk Real Estate Development and 30% of Kuwait Energy Holding Co. resulting into a total gain on sale of KD 629 thousand. In the same year, the bank acquired 20% in Nafias Holding Co. and participated in rights issue in UAE-based National Bank of Sharjah.

...along with the disposal of it's equity stakes in associates

The drop in non-financing income was further intensified with the slowdown in fees and commission income and other operating income. While fees and commission income grew by 25% to reach KD 70.14 million, as compared to an average growth of 58% over the period 2004-2007, net gain from dealing in foreign exchange dropped by 8% to reach KD 13.5 million in 2008 mainly driven by the high fluctuations that dominated the international foreign exchange markets along with the depreciation of Kuwaiti Dinar against the U.S. Dollar where the Bank has a significant portion of its assets denominated in foreign currencies especially USD.

High fluctuations in international Forex markets resulted in a drop of 8% in the banks Forex operations

Chart 3. KFH Revenue & Cost Structure (2004-2008)



Source: KFH Financial Statements & KAMCO Research

Increase in the bank's operating expenses of 28.44%

KFH total operating expenses for 2008 grew by 28.44% as compared to 2007 to record KD 276.87 million. During the past two years, the bank has controlled the growth in operating cost through cutting down depreciation expenses which derived from subsidiaries to show a mere growth of 2.18% following last year's 17.23% decline to end 2008 at KD 28.55 million. The bank's high cost mainly from Murabaha and Ijarah transactions recorded KD 81.19 million for the year, up from KD 65.7 million in 2007.

KFH operating efficiency underperformed that of peers as the cost-to-income ratio climbed to 41.4% in 2008

On the other hand, general and administrative expenses rose by 37.08% to record KD 167.13 million compared to last year's growth of 9.70%. KFH operating efficiency ratio, remained to be on the lower side as compared to its peers showing a cost-to-income ratio of 41.4% for FY 08 higher than 36.62% for FY 07. Meanwhile, KFH's operating cost to average asset ratio remained stagnant from last year at 2.9%. Based on the bank's 9-month performance, KFH held the highest cost-to-income ratio of 38.99%, amongst the other listed banks' average ratio of 30.54%.

Balance Sheet Analysis

Asset Structure & Quality

During 2008, KFH grew its assets by 19.85% to KD 10.54 billion, albeit at a slower pace when compared to an annual growth of 39.34% in the previous year. The bank still holds the second largest asset base after National Bank of Kuwait. Net loans and advances, which include the bank's receivables (Local Murabaha & Wakala and Istisna'a) and leased assets, constitute the biggest component of total assets and accounted for around 56.5% of total assets as of December-08. The loan portfolio grew by 21.2%, lower than last year's remarkable growth of 43.6% to record KD 5.96 billion. As of September-08, KFH is the second largest bank in Kuwait after National Bank of Kuwait in terms of its loan portfolio and accounted for around 27.3% of market share.

Total assets growth slowdown from last year's to 19.85% to record KD 10.54 billion

Loan portfolio grew by 21.2% in 2008 compared to 43.6%% in last year

Table 2. KFH Assets Decomposition (2006-2008)

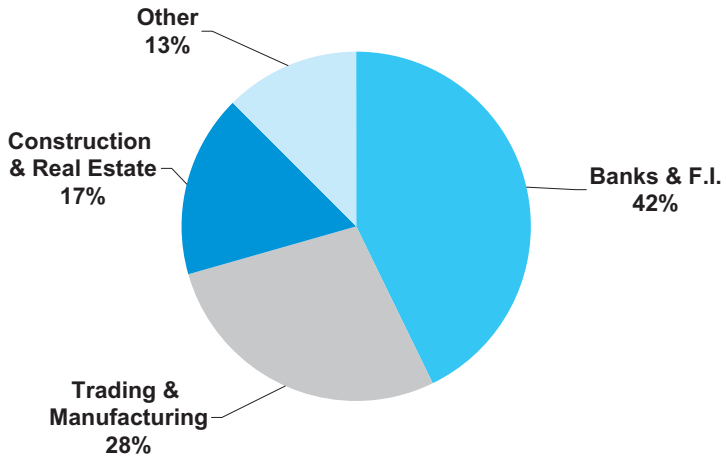
('000 KD)	2006	% of Assets	2007	% of Assets	2008	% of Assets
Cash & balances with bank	231,996	3.67%	553,565	6.29%	**368,062**	3.49%
S.T Int'l Murabaha	1,050,599	16.64%	1,067,291	12.13%	**1,312,153**	12.44%
Receivables	2,778,166	44.00%	3,988,131	45.33%	**4,779,788**	45.33%
Leased Assets	647,939	10.26%	930,657	10.58%	**1,181,825**	11.21%
Total Investments	1,075,759	17.04%	1,611,090	18.31%	**1,825,262**	17.31%
Fixed & Other Assets	529,332	8.38%	647,182	7.36%	**1,077,052**	10.21%
Total Assets	**6,313,791**	**100.00%**	**8,797,916**	**100.00%**	**10,544,142**	**100.00%**

Source: KFH Financial Statements & KAMCO Research

Receivables, representing the major component of the bank's loan portfolio, grew by 19.9% during 2008 to reach KD 4.8 billion and accounted for 80% of the total loan portfolio as of Dec-08. Receivables are mainly allocated among three major sectors; Banks and financial institutions, Trading & manufacturing and construction and real estate. Receivables extended to banks and financial institutions dropped by 2.6% to KD 2.18 billion and accounted for around 43% of gross receivables, while receivables initiated to the trading & manufacturing and to the construction and real estate sector grew by 33% and 41% during 2008 to KD 1.41 billion and KD 853.6 million respectively. The latter two sectors comprised together around 44.6% of gross receivables up from 40% for 2007. Leased assets, which constitute the remaining 20% of the loan portfolio, grew by 27% to KD 1.18 billion.

Being the main component of the bank's loan portfolio, receivables grew by 19.9% to stand at KD 4.8 billion as of December 2008

Chart 4. KFH Gross Receivables Distribution across Sectors as of Dec-08



Source: KFH Financial Statements & KAMCO Research

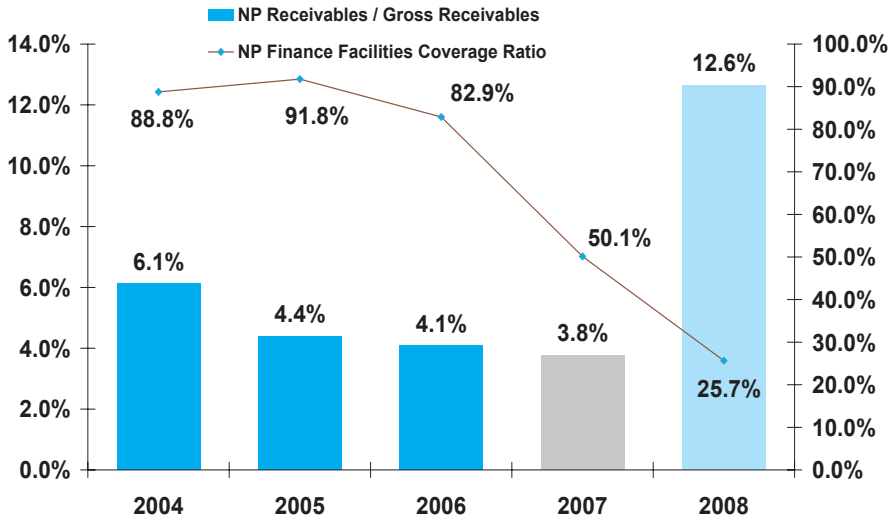
Receivables quality indicators have worsened during 2008 as the non-performing finance facilities increased significantly by KD 486 million to reach a peak of KD 642.2 million

KFH's receivables quality indicators significantly worsened during the year, mainly due to the deterioration in the local equity market, liquidity issues in the credit market and excessive debt at Kuwaiti companies which led directly to an increase in bad debt and an even more brutal credit crunch for local banks. The absolute value of non-performing finance facilities increased drastically in 2008 to reach KD 642.2 million, up from KD 156 million at the end of 2007. Consequently, non-performing finance facilities to gross receivables ratio increased to 12.64% in 2008, up from 3.8% in the previous year. Following this increase in non-performing receivables, provision for impairment of receivables from customers for finance facilities increased by KD 153.4 million to KD 299.1 million. Moreover, provisions for impairment of local Murabaha and Wakala accounted for the bulk of aggregate provisions with a total value of KD 261.3 million which can be explained by the Bank's high exposure to the local credit market with the total value of local Murabaha & Wakala amounting to KD 3.57 billion as of the end of 2008 and accounting for around 70% of gross finance receivables.

The Bank's coverage ratio of its Non-performing finance facilities has worsened to reach 25.7% down from an average of 88% over the period 2004-2006

The Bank has maintained a high coverage ratio of its non-performing finance facilities (Provision for Impairment/Non-performing finance facilities) over the period 2004-2006 when the coverage ratio averaged around 88%. However, this ratio has started to worsen in 2007 when it dropped to 50.1% and continued its downward trend in 2008 to reach 25.7% mainly driven by the increase in non-performing finance facilities resulted from the financial turbulence.

Chart 5. Quality Indicators of KFH's Receivables Finance Facilities (2004-2008)



Source: KFH Financial Statements & KAMCO Research

Investment portfolio saw a growth of 13.29% worth KD 1.83 billion

The Bank's investment portfolio is diversified along various investment classes including quoted and unquoted equity investments, managed portfolios and mutual funds, investment in associates and investment properties. The Bank holds an investment portfolio worth KD 1.83 billion as of December 2008, showing a yearly growth of 13.29% against last year's significant growth of 49.8%. During the fourth quarter of 2008, the Bank disposed around KD 90 million of its available for sale investments and realized an investment loss on disposal of KD 48.4 million driven by the slump in the local equity market and the deterioration in asset prices over the same quarter.

Provisions for impairment of investments increased to KD 48.4 million up from KD 7 million in 2007

High exposure to the Islamic investment and leasing companies will act as a drawback on the Bank's profitability in the 2009

KFH has a high exposure to Islamic leasing and investment companies and real estate projects developers and managers through its portfolio of investment in associates that have been affected by the financial crisis and the credit crunch. Investment in associates recorded around KD 449.5 million as at the end of 2008 and accounted for around 25% of the Bank's investment portfolio.

The major associates of the Bank include an equity stake of 20% in each of Gulf Investment House and National Bank of Sharjah, 30% equity stake in Munsha'at Real Estate Projects Co., 49% ownership in the share capital of Sokouk Real Estate Development and 16% equity stake in A'ayan Leasing & Investment Co. Until the date of the report, most of the Bank's associates have not yet released their full year 2008 financial statements and they are expected to record significant losses that will in turn impact the Bank's profitability and investment portfolio over the first half of 2009.

Most banks saw dramatic fall in their investment portfolios during the last

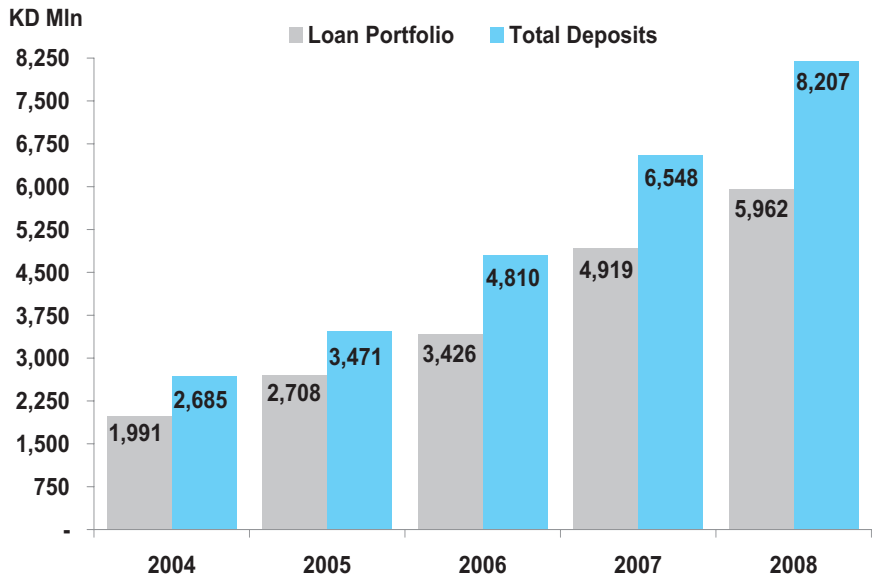
two quarters of 2008 due to the plunge in the local and regional financial markets; KFH was not an exception as it took during the year a total provision for impairment of investments of KD 48.4 million and also witnessed a sharp drop in its investment income to KD 210 million from KD 266.4 million reported in 2007.

Funding & Capital Base

KFH maintains its position as the second largest bank by total deposits after NBK

KFH remained to be the second largest bank in terms of total deposit size after National Bank of Kuwait (NBK), exceeding the KD 8 billion as of the end of December-08, while showing a yearly growth of 25.4% compared to last year's annual growth of 36%. During 2008 the Bank further expanded its customer deposit base to KD 6.61 billion and hence became the largest bank in Kuwait in terms of customer deposits. The growth in total deposits was mainly driven by the KD 1.25 billion increase in customer deposits which recorded KD 6.61 billion at the end of the year along with the 34.5% growth in deposits from banks and financial institutions to KD 1.6 billion. The annual growth of 23.3% in customer deposits during 2008 underperformed the growth in 2007 of 44% when the bank was successful in attracting around KD 1.63 billion. This slowdown in customer deposits is mainly attributed to the fierce competition in the local market and the drop in depositors' share of profit from a peak of 8.63% in 2007 to 4.3% in 2008 which came as a result of the continuous easing of interest rates in Kuwait and the countries where the Bank operates.

Chart 6. KFH Loan Portfolio versus Total Deposits (2004-2008)



Source: KFH Financial Statements & KAMCO Research

Shareholders' equity grew at a CAGR of 43.7% over the period 2003-2007, mainly due to the healthy profits and the strengthening of the Bank's capital base through rights issue. In 2008, however, shareholders' equity dropped by 4.2% to reach KD 1.24 billion dragged down by the sharp losses on investments available for sale which in turn eroded around KD 75 million out of the fair value reserve account along with the weak results reported for full year 2008. The Bank's capital adequacy ratio stood at 22% as of December-08, marginally lower than that recorded as at December-07 of 23%, while it was higher than the minimum total capital adequacy ratio required by the Central Bank of Kuwait of 12%. Risk weighted assets deployed in calculating the ratio increased by 22.7% to KD 6.96 billion, while total capital grew at a lower rate of 14.7% to KD 1.51 billion.

As of year end 2008, KFH equity dropped by 4.2% impacted by the losses on AFS investments

Projections

Since the bankruptcy of Lehman Brothers in September 2008, global financial markets have fallen into a tremendous state of turmoil. This, together with the deterioration in the global economy and the unsteady banking system, is fueling an adverse feedback loop that has engulfed the real economy. In order to stabilize the banking system and restore its normal function, governments in the U.S., Europe, EM and elsewhere are spending public funds to provide debt guarantees and capital injections for financial institutions. As a result, volatility in stock markets has eased recently, compared to the drastic volatility and decline in the last 3 months of 2008. Even so, there is still no clear sign of an end to the turmoil. The outlook for the global financial crisis remains rather gloomy, and the GCC economies remain threatened with slower economic growth driven by low oil prices, sharp losses in equity markets and the slump in the real estate sector.

A gloomy outlook shadowing over the global financial market, threatening the GCC economies

However, the situation in Kuwait changed suddenly with the plunge in share prices as the Kuwait Stock Exchange has bled over USD 123 billion in value in the last six-month period. Further adverse effects are possible if securities losses and unrealized losses at banks, investment companies and general businesses hurt their profits and core capital. A deterioration in economic activity and further decline in stock prices would lead directly to an increase in bad debt and even more brutal credit crunch for the Kuwaiti banks.

Based on the Bank's recent financial performance and the unprecedented economic developments and tough market conditions, we have updated our valuation of the Bank's stock to reflect the latest developments resulted

Positive future outlook despite the economic slowdown witnessed lately in the market

from the global financial turmoil and its consequences on the Banking sector. Hence, we have projected the Bank's bottom line over a forecast horizon of five years (2009-2013). Going forward, our future outlook for KFH continues to be positive, however, unfavorable macroeconomic conditions, uncertainties in equity markets and tight credit conditions will put pressure on the Bank's profitability over the next five years especially in 2009 and 2010 that will be challenging years for all the financial institutions to maintain the double digit growth witnessed over the last 4-year period.

Critical local economic situation is expected to result in a slowdown in credit facilities for the coming 3 years

Despite the proposed financial stimulus plan, we believe that credit facilities in Kuwait are expected to slowdown during the coming 3 years on the back of unfavorable local economic conditions, weakness in the stock market, falling oil prices, and the regulatory authorities close monitoring to credit in addition to the change in Bank's lending policies as they became more cautious in extending loans to customers. Hence, we expect KFH's loan portfolio to grow at a CAGR of 14.8 % over the projected horizon.

KFH assets are expected to grow at a CAGR of 19.1 % over the forecast horizon

The Islamic banking assets have been growing between 20% and 25% in the past few years, however we expect the industry to witness a moderate growth in the coming five years given the drop in demand for Islamic products in the market. Accordingly, we expect KFH's growth in assets to mirror a similar trend. We forecast KFH's total assets to grow by a CAGR of close to 19.1% over the forecast horizon.

Going forward, we expect net financing income to remain the major income contributor accounting for around 57% of net operating income over the forecast horizon. The Bank was able to maintain high margin over the last three years with net inertest margin improving from 3.7% in 2003 to 4.9% in 2008. Nevertheless, we expect spreads and margins to drop over the coming next two years driven by tight credit market conditions and the slowdown in economic activity, and then pick up in the later years.

Given the alarming declines seen in investment income and the bank's investment portfolio we expect KFH to witness a major slowdown in its investment income and hence reducing its contribution to total operating income over the forecast horizon.

High loan loss provisions and impairment losses on investments are also expected to be seen in the coming two years putting pressure on the bank's bottom line, as the slowdown in economic activity and uncertainties in capital markets will be prevailing over the coming two years and will have their impact on the bank's profitability. Consequently, we forecast net profit to grow at a CAGR of 20.6% in the coming five years from KD 167.3 million in 2009 to KD 354.1 million in 2013.

It's essential to note that, with the appearance of new players in the local Islamic Finance market, like Boubyan Bank and BKME which are in the process of converting their activities to comply with Islamic Sharia'a, an increased competition would emerge leading to a decrease in market share of existing banks hence a lower growth in this banking niche.

Table 3. KFH Key Projected Revenue & Income Figures

('000 KD)	2009f	2010f	2011f	2012f	2013f
Net Interest Income (Net Financing Income)	**336,048**	**351,643**	**382,797**	**431,370**	**502,248**
Investment Income	126,220	139,086	153,677	174,245	185,212
Fees & Commissions	77,154	84,869	93,356	102,692	112,961
Other Operating Income	47,222	51,233	54,884	56,687	58,469
Non-Interest Income	**250,596**	**275,189**	**301,917**	**333,624**	**356,642**
Total Net Operating Income	**586,644**	**626,831**	**684,714**	**764,994**	**858,890**
Total Operating Expenses	(298,354)	(321,732)	(351,225)	(384,850)	(423,536)
Net Profit	**167,297**	**219,844**	**252,785**	**299,053**	**354,063**

Source: KAMCO Research

Valuation

We updated the valuation of KFH's fair value per share on the basis of two valuation methodologies. The Discount Cash flow method using the estimated intrinsic value of KFH stock from the viewpoint of strategic/long-term investors, and the relative or comparable valuation methods using P/E and P/B ratios for the banking sector in Kuwait.

Discounted Cash Flow Valuation Model (DCF)

The DCF model calculates the free cash flow available to equity holders (FCFE) by adjusting the forecasted net income figures for non-cash expenses and expected capital expenditures.

After calculating KFH free cash flow to equity, a perpetual growth rate was estimated to arrive at the bank's terminal value. Finally, the FCFE figures in addition to the terminal value were discounted at the calculated cost of equity, which were then summed together to arrive at the DCF value of KFH equity. The DCF method resulted in a fair value per share of KD 1.232.

We value KFH at KD 1.232 per share based on the DCF model...

Table 4. DCF Valuation Assumptions

Perpetual Growth Rate					**5.00%**
KFH Beta*					1.45
Risk Free Rate^					6.625%
Equity Risk Premium#					6.5%
Cost of Equity##					**16.08%**
('000 KD)	**2009f**	**2010f**	**2011f**	**2012f**	**2013f**
Net Profit	**167,297**	**219,844**	**252,785**	**299,053**	**354,063**
Add: Depreciation	29,261	29,992	30,742	31,357	31,984
Add: Provision	93,663	49,399	39,493	32,371	23,646
CAPEX	**(8,799)**	**(9,548)**	**(9,681)**	**(8,309)**	**(9,918)**
FCFE	**281,422**	**289,688**	**313,338**	**354,472**	**399,775**
Terminal Value					**3,789,059**
PV of FCFE**	**242,442**	**214,995**	**200,337**	**195,244**	**189,697**
Total PV of FCFE	**1,042,714**				
PV of Terminal Value	**1,797,943**				
Total Equity Value	**2,840,657**				
Shares Outstanding ('000)	**2,305,419**				
Fair Share Value (KD)	**1.232**				

* *Based on trailing 3-year daily returns ^ Average yield on long-term treasury bonds*
\# *Aswath Damodaran interpretation of Kuwait's Equity Risk Premium*
\#\# *Calculated using the Capita Asset Pricing Model*
** *Discounted as of the end of December 2008*
Source: KAMCO Research

Table 5. presents a sensitivity analysis on KFH DCF value per share based on changes in the underlying cost of equity and the assumed terminal growth rate.

Table 5. Sensitivity Analysis of KFH DCF Value Per Share

Perpetual Growth Rate	Cost of Equity						
	13.50%	**14.00%**	**14.50%**	**15.50%**	**16.08%**	**16.50%**	**17.00%**
2.00%	1.299	1.242	1.190	1.096	1.048	1.016	0.980
2.50%	1.341	1.279	1.223	1.124	1.073	1.039	1.001
3.00%	1.386	1.320	1.260	1.154	1.100	1.064	1.024
3.50%	1.436	1.364	1.300	1.186	1.129	1.091	1.049
4.00%	1.491	1.413	1.343	1.222	1.161	1.120	1.075
4.50%	1.552	1.467	1.391	1.260	1.195	1.151	1.103
5.00%	1.620	1.527	1.444	1.302	1.232	1.185	1.134
5.50%	1.697	1.594	1.503	1.349	1.273	1.223	1.168
6.00%	1.784	1.670	1.569	1.400	1.317	1.263	1.204
6.50%	1.883	1.755	1.644	1.457	1.367	1.308	1.244
7.00%	1.998	1.853	1.728	1.521	1.422	1.358	1.288
7.50%	2.132	1.966	1.824	1.592	1.483	1.413	1.337
8.00%	2.291	2.098	1.935	1.674	1.552	1.474	1.391

Source: KAMCO Research

Relative Valuation

Following the Relative Valuation approach, we used the average Price to Earnings and Price to Book Value for the local Banking sector based on the latest market cap, full year earnings of 2008, and equity figures as of 31 December 2008. Noting that the peer group average excludes Gulf Bank which has been suspended from trading since 23 October-08. Hence, the selected banks' P/E and P/B multiples were calculated to be 14.52x and 2.17x respectively.

Based on KFH expected earnings per share and book value per share for 2009 of KD 0.073 and KD 0.593 respectively and capitalizing these per share figures to the local banking industry's average P/E and P/B multiples of 14.52x and 2.17x, resulted in KFH's value per share at KD 1.054 and KD 1.285 respectively.

...and KD 1.054 and KD 1.285 per share based on the P/E and P/B methods.

Valuation Conclusion

We used a weighted average of the above valuation models, assigning a 80% weight to the DCF - FCFE method, and 10% each to the P/E and P/B methods to arrive at an estimated fair value of ***KD 1.220 per*** share. KFH is

We estimate the weighted fair value of KFH at 1.220 per share and recommend a Hold.

currently trading at 1.60% discount to our fair value estimate indicating a **Hold** following KAMCO's recommendation scale.

Table 6. KFH Weighted Average Value per Share

Method	Weight (%)	Value per Share (KD)
Discounted Cash Flow	80	1.232
Peer Group P/E	10	1.054
Peer Group P/B	10	1.285
KFH Weighted Avg. Value per Share		**1.220**

Source: KAMCO Research

Trading & Share Data

	2004	2005	2006	2007	2008	YTD-09
Market Capitalization ('000 KD)	1,281,506	2,603,649	2,671,032	4,940,182	2,799,437	2,766,503
Closing Share Price (KD)	1.640	2.380	2.180	2.880	1.360	1.200
High (KD)	1.780	2.600	2.640	3.080	3.940	1.380
Low (KD)	1.200	1.340	1.800	1.880	1.260	0.860
Volume ('000 Shares)	169,585	267,136	188,110	499,344	768,551	400,628
Value (KD thousand)	256,216	500,664	403,091	1,276,983	1,816,664	463,458
Number of Deals	9,628	17,001	14,892	33,398	42,689	22,004
EPS (KD)	0.087	0.107	0.102	0.138	0.076	0.076
Book Value Per Share (KD)	0.418	0.549	0.574	0.705	0.604	0.604
Dividend Per Share (KD)	0.050	0.055	0.057	0.065	0.040	NA
Price to Earnings Multiple (X)	18.92	22.19	21.28	20.92	17.83	17.63
Price to Book Value Multiple (X)	3.93	4.33	3.80	4.08	2.25	2.23
Dividend Yield (%)	3.05%	2.31%	2.61%	2.26%	2.94%	2.98%
Pay-out Ratio (%)	57.70%	51.28%	55.65%	47.21%	52.43%	NA

NA: Not Applicable
**: YTD figures are as of 7-April -09*
Source: KAMCO Research

Ratio Analysis

	2003	2004	2005	2006	2007	2008
Growth						
Net Interest Income	(1.0%)	31.7%	19.6%	103.9%	48.4%	53.5%
Non Interest Income	33.1%	24.3%	175.7%	30.0%	44.9%	(11.2%)
Total Operating Income	15.1%	27.6%	102.5%	50.5%	46.2%	13.5%
Net Profit	6.5%	27.9%	59.5%	36.5%	69.9%	(43.0%)
Interest Earning Assets	12.2%	12.2%	40.2%	33.4%	38.9%	16.9%
Total Assets	19.1%	13.7%	35.4%	34.9%	39.3%	19.8%
Shareholders' Equity	13.7%	17.5%	88.4%	15.5%	67.0%	(4.2%)
Asset Structure Ratios						
Average Interest Earning Assets / Total Assets	69.8%	68.8%	64.6%	65.2%	63.9%	67.2%
Total Deposits/ Total Assets	77.7%	77.6%	74.1%	76.2%	74.4%	77.8%
Customer Deposits/ Total Assets	75.6%	74.1%	68.1%	59.1%	60.9%	62.7%
Net Loans/ Total Assets	69.5%	68.6%	72.0%	70.9%	68.0%	69.0%
Investment Assets / Total Assets	22.2%	23.1%	19.9%	17.0%	18.3%	17.3%
Shareholders' Equity / Total Assets	10.0%	10.3%	14.4%	12.3%	14.8%	11.8%
Equity to Net Loans	14.4%	15.1%	20.0%	17.4%	21.7%	17.1%
Asset Quality Ratios						
Loan-Loss Reserves/ Gross Loans	4.9%	4.9%	4.5%	3.8%	2.7%	4.3%
Non-Performing loans /Gross loans	4.4%	3.9%	2.8%	2.6%	2.5%	8.4%
LLP/ Non-Performing loans (X)	NA	0.89	0.92	0.83	0.50	0.26
Liquidity Ratios						
Net Loans / Customer Deposits	91.9%	92.5%	105.7%	120.0%	111.7%	110.0%
Net Loans / Total Deposits	89.5%	88.3%	97.1%	93.1%	91.4%	88.6%
Customer Deposits/ Total Deposits	97.3%	95.5%	91.9%	77.5%	81.9%	80.6%
Liquid Assets/ Customer Deposits	21.7%	20.6%	25.8%	34.4%	30.2%	25.4%
Liquid Assets/ Total Deposits	21.1%	19.6%	23.7%	26.7%	24.8%	20.5%
Liquid Assets Ratio	16.4%	15.2%	17.6%	20.3%	18.4%	15.9%
Profitability Ratios						
Return on Assets (ROA)	1.9%	2.2%	2.5%	2.6%	3.1%	1.5%
Return on Equity (ROE)	19.1%	20.8%	17.6%	20.8%	21.2%	12.6%
Return on Average Assets (ROAA)	2.1%	2.3%	2.9%	2.9%	3.6%	1.6%
Return on Average Equity (ROAE)	20.3%	22.5%	23.0%	22.3%	26.5%	12.3%
Margin Analysis						
Interest Income/ Avg. Earning Assets	5.0%	5.6%	6.5%	8.0%	8.3%	7.9%
Funding Cost	2.7%	2.8%	4.0%	4.3%	4.3%	2.9%
Interest Differential	2.3%	2.8%	2.5%	3.7%	4.0%	5.0%
Net Interest Margin	2.2%	2.6%	2.5%	3.7%	4.0%	4.9%
Distribution to Depositors/ Avg. Cust. Deposits	2.8%	2.9%	4.3%	5.1%	5.3%	3.6%
Contribution Analysis						
Net Interest Income / Operating Income	45.5%	46.9%	27.7%	37.5%	38.1%	51.6%
Non Interest Income / Operating Income	54.5%	53.1%	72.3%	62.5%	61.9%	48.4%
Cost To Income Ratio	35.5%	29.5%	36.4%	43.9%	36.6%	41.4%

Source: KFH Financial Statements & KAMCO Research

Financial Statements

Balance Sheet	2003	2004	2005	2006	2007	2008
('000 KD)						
Assets						
Cash With Banks & Other F.I	129,208	146,161	158,293	231,996	553,565	368,062
Short-Term Int'l Murabaha	369,369	380,646	663,848	1,050,599	1,067,291	1,312,153
Net Receivables	1,457,494	1,484,971	2,104,346	2,778,166	3,988,131	4,779,788
Leased Assets	287,990	505,550	603,333	647,939	930,657	1,181,825
Investments	433,410	565,038	698,013	793,889	1,237,377	1,488,098
Trading Properties	139,615	127,835	93,009	90,463	126,413	57,590
Investment Properties	102,447	105,921	140,892	191,407	247,300	279,574
Property & equipment	58,556	72,208	151,282	401,005	407,488	591,339
Other assets	63,021	69,736	68,102	128,327	239,694	485,713
Total Assets	**3,041,110**	**3,458,066**	**4,681,118**	**6,313,791**	**8,797,916**	**10,544,142**
Liabilities						
Due To Banks & F.I.	63,676	121,821	281,617	1,080,004	1,186,391	1,595,452
Customers' Deposits	2,300,161	2,563,185	3,189,344	3,729,930	5,361,155	6,611,556
Other Liabilities	169,864	204,807	220,795	289,325	380,853	394,033
Total Liabilities	**2,533,701**	**2,889,813**	**3,691,756**	**5,099,259**	**6,928,399**	**8,601,041**
Deferred Revenue	**182,410**	**189,002**	**235,239**	**299,263**	**374,608**	**344,426**
Fair Value Reserve	**19,776**	**31,680**	**62,092**	**66,654**	**86,843**	**11,394**
FX Translation Reserve	**-**	**-**	**11,401**	**8,683**	**1,972**	**(7,548)**
Minority Interest	**20,637**	**21,633**	**80,420**	**137,443**	**196,094**	**354,545**
Shareholders' Equity						
Share Capital	**71,689**	**78,141**	**109,397**	**122,525**	**171,535**	**205,842**
Share Premium	7,826	12,618	188,465	188,788	464,735	464,766
Treasury Shares	(867)	(1,016)	(1,278)	(304)	1,006	(6,645)
Proposed Cash Dividends	35,844	39,070	60,168	69,839	111,498	82,124
Proposed Issue of Bonus Shares	4,301	7,814	13,128	18,379	34,307	24,701
Retained Earnings	-	-	-	-	-	-
Reserves	165,793	189,311	230,330	299,025	422,682	465,259
Total Equity	**304,362**	**357,618**	**673,703**	**777,826**	**1,298,815**	**1,244,130**
Liabilities, Equity, & Others	**3,041,110**	**3,458,066**	**4,681,118**	**6,313,791**	**8,797,916**	**10,544,142**

Source: KFH Financial Statements & KAMCO Research

Income Statement	2006	2007	2008	2009f	2010f	2011f	2012f	2013f
('000 KD)								
Net Interest Income (financing income)	**151,161**	**224,365**	**344,471**	**336,048**	**351,643**	**382,797**	**431,370**	**502,248**
Investment Income	183,249	266,397	209,897	126,220	139,086	153,677	174,245	185,212
Fees & Commissions	44,008	56,125	70,140	77,154	84,869	93,356	102,692	112,961
Net Gains / (Losses) from Dealing in FX	3,332	14,696	13,547	14,224	14,936	15,682	16,310	16,880
Other Operating Income	20,875	27,037	29,998	32,998	36,298	39,201	40,377	41,589
Total Net Operating Income	**402,625**	**588,620**	**668,053**	**586,644**	**626,831**	**684,714**	**764,994**	**858,890**
General and Administrative Expenses	111,132	121,917	167,127	183,840	202,224	226,491	254,802	287,926
Depreciation	33,754	27,939	28,547	29,261	29,992	30,742	31,357	31,984
Murabaha & Ijara costs	32,041	65,712	81,194	85,254	89,516	93,992	98,692	103,626
Operating Expenses	**176,927**	**215,568**	**276,868**	**298,354**	**321,732**	**351,225**	**384,850**	**423,536**
Provision for Impairment	27,180	38,179	210,940	93,663	49,399	39,493	32,371	23,646
Net Operating Income after Provisions	**198,518**	**334,873**	**180,245**	**194,627**	**255,700**	**293,997**	**347,773**	**411,707**
KFAS	1,673	2,847	1,626	1,576	2,071	2,381	2,817	3,335
Board remuneration	150	200	160	160	160	170	170	170
National Labour Support Tax	3,465	6,257	2,573	4,379	5,753	6,615	7,825	9,263
Zakat	-	174	1,234	1,752	2,301	2,646	3,130	3,705
Minority interest	31,226	50,129	17,692	19,463	25,570	29,400	34,777	41,171
Net Profit	**162,004**	**275,266**	**156,960**	**167,297**	**219,844**	**252,785**	**299,053**	**354,063**

f: KAMCO Forecast

Source: KFH Financial Statements & KAMCO Research

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