Bank Muscat

Oman's Heavyweight

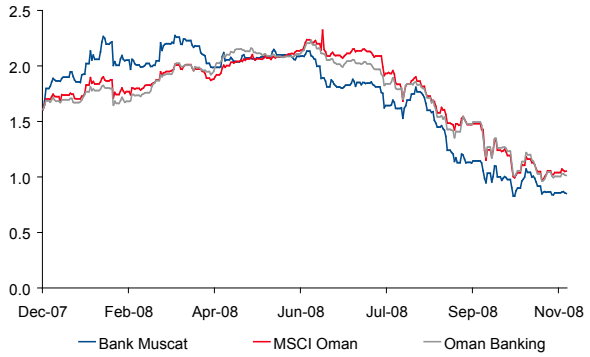
December 04, 2008

Key Data

Closing Price*	Avg. Value Traded per Day
RO 0.851	RO 2.3 million
52-Week High	**Market Cap**
RO 2.274	RO 0.9 billion
52-Week Low	**Shares Outstanding**
RO 0.827	1077.1 million
Reuters	**Bloomberg**
BMAO.OM	BKMB OM
Ownership Structure	
Closely Held: 60%	Public: 40% **

** As of December 03, 2008, ** estimate. Sources: Reuters, Muscat Securities Market, and NBK Capital*

Rebased Performance



Sources: Reuters and NBK Capital

Key Ratios

	2007 a	2008 f	2009 f	2010 f	2011 f
P/B (latest)	1.2	1.2	1.1	1.0	0.9
P/E (latest)	8.2	8.1	7.8	6.7	5.9
Net Profit Growth	39.4%	34.6%	3.9%	15.5%	13.3%
RoAE	17.8%	16.3%	14.7%	15.5%	16.0%
RoAA	2.3%	2.2%	1.9%	2.0%	2.1%
Net Interest Margin	4.0%	3.7%	3.4%	3.5%	3.7%
Dividend Payout	63.9%	42.8%	45.2%	44.1%	42.8%

1Q2008 IBP a	2Q2008 IBP a
RO 31.4 million	RO 35.1 million
3Q2008 IBP a	**4Q2008 IBP f**
RO 31.7 million	RO 27 million

IBP = Income before Provisions, a = actual, f = forecast.
Sources: Reuters and NBK Capital

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Highlights

12-Month Fair Value: RO 1.310

Recommendation: Buy – Risk Level*: 3**

Reason for Report: Initiation of Coverage

- Bank Muscat is the heavyweight of the Omani banking sector, accounting for 43%, 40%, and 36% of total sector assets, loans, and deposits, respectively. Bank Muscat is the market leader in both retail banking and corporate banking, and has consistently exhibited better efficiency and asset quality indicators than its peers.
- Bank Muscat's broad strategy is to maintain the bank's dominant position in Oman in addition to expanding abroad. Domestically, some of the sectors that the bank is focusing on include oil and gas, petrochemicals, contracting, and tourism.
- Bank Muscat's recent performance has been very robust, with loans and deposits expanding by 154% and 118%, respectively, between December 2005 and September 2008. Net profit grew by a CAGR of 33% in the four years ending in 2007 and rose by a further 44% in 9M2008. This robust performance compares favorably with the bank's peers, which Bank Muscat outperformed in 2007 and 9M2008 in terms of net profit growth.
- We forecast Bank Muscat's net loans and deposits to grow by a CAGR of 11% and 12%, respectively, in the five years ending in 2013. Total operating income and net profit are forecasted to grow by a CAGR of 12% and 10%, respectively, reaching RO 415 million and RO 186 million in 2013.
- Our estimate of Bank Muscat's 12-month fair value per share stands at RO 1.310, 54% above the share's closing price as of December 03—hence, our "Buy" recommendation.
- We have assigned Bank Muscat a risk rating of 3 (on a scale of 1 to 5). We believe the major risk faced by Bank Muscat relates to the current global and regional financial and economic situation, which brings with it investment losses, lower liquidity, higher risk aversion, worsening asset quality, and lower profitability for all regional banks, including Bank Muscat.

**** Please refer to the last page for recommendations and risk ratings.*

EXECUTIVE SUMMARY 3

VALUATION 4

Discounted Equity Cash Flow 4
Dividend Discount Model 6
Peer-based Valuation 6
Risks and Challenges 7

OMAN BANKING SECTOR HIGHLIGHTS 9

Sector Size versus Economy Size 9
Lending and Deposit Growth 10
Personal Lending 11
Profitability 12

BANK OVERVIEW 13

Bank Background 13
Strategy 13
International Operations 13

FINANCIAL OVERVIEW AND FORECASTS 15

Lending 15
Deposit Accumulation 17
Total Balance Sheet Growth and Uses of Funds 18
Profitability 20
Asset Quality 23

FINANCIAL STATEMENTS 25

EXECUTIVE SUMMARY

Bank Muscat is the heavyweight of the Omani banking sector, accounting for 43%, 40%, and 36% of total sector assets, loans, and deposits, respectively, having defended well its market share in the past few years. Bank Muscat is the market leader in retail banking and corporate banking, and has consistently exhibited better efficiency and asset quality indicators than its peers.

Bank Muscat's broad strategy is to maintain its dominant position in Oman in addition to expanding abroad. Domestically, some of the sectors that the bank is focusing on include oil and gas, petrochemicals, contracting, and tourism. Additional focus areas are SMEs, housing, insurance, and investment banking. A strategic goal is to increase fee-based earnings, especially in the face of declining net interest margins. Bank Muscat is also focusing on sales and customer service in the bank's branches. Abroad, the bank's strategy is to expand prudently in the GCC and beyond by opening branches and owning stakes in other banks and financial institutions.

Bank Muscat's recent performance has been very robust, with loans and deposits expanding by 154% and 118%, respectively, between December 2005 and September 2008. Net profit grew by a CAGR of 33% in the four years ending in 2007 and rose by a further 44% in 9M2008. Strong growth in net interest income, income from fees and commissions, and low net provisioning were the major drivers of profitability in the past three years. This robust performance compares favorably with the bank's peers, which Bank Muscat outperformed in 2007 and 9M2008 in terms of net profit growth.

Going forward, we expect lending growth and deposit accumulation to drop markedly from the levels seen in the past two years, as the price of oil has dropped significantly, leading to a deceleration in Oman's GDP growth and to a tighter liquidity situation.

We forecast Bank Muscat's net loans and deposits to grow by a CAGR of 11% and 12%, respectively, in the five years ending in 2013. Total operating income and net profit are forecasted to grow by a CAGR of 12% and 10%, respectively, reaching RO 415 million and RO 186 million in 2013.

Our estimate of Bank Muscat's 12-month fair value per share stands at RO 1.310, 54% above the share's closing price as of December 03—hence, our "Buy" recommendation. This value is a weighted average of three estimates reached using three valuation models: Discounted Equity Cash Flow, the Dividend Discount Model, and a peer-based multiples valuation model.

We have assigned Bank Muscat a risk rating of 3 (on a scale of 1 to 5). This follows our subjective criteria for risk, such as franchise strength, stock price volatility, and the overall operating environment. We believe the major risk and challenge facing Bank Muscat are:

- The current global and regional financial and economic condition: We believe this currently represents the most important risk facing any financial institution.
- The capital adequacy ratio (CAR) of Bank Muscat dropped from 15.1% in 2007 to 12.2% in September 2008: Although the CAR is still above the 10% regulatory minimum, there will be pressure on future growth, considering that Bank Muscat wishes to keep its CAR above 12%.

VALUATION

The purpose of this valuation exercise is to estimate Bank Muscat's fair value per share 12 months from now. Although the estimate is our best guess of the share's value one year from now, this does not mean we believe this value will necessarily prevail at that time. Ultimately, it is investor behavior that determines the price of any share. This behavior is a function of a wide array of factors, including sentiment, risk tolerance, objectives, and technical analysis, as well as analyst recommendations.

Our estimate of Bank Muscat's 12-month fair value per share stands at RO 1.310, 54% above the share's closing price as of December 03. This value is a weighted average of three estimates reached via three valuation models: Discounted Equity Cash Flow (DECF), the Dividend Discount Model (DDM), and a peer-based multiples valuation model, which is a variant of the Warranted Equity Valuation (WEV) model (Figure 1). DECF carries the highest weight because it is a more firm-specific, cash-flow-based valuation method that entails a comprehensive and detailed breakdown of the bank's future cash flows.

Our 12-month fair value for Bank Muscat is RO 1.310 per share

Figure 1 Weighted Average Fair Value per Share

Valuation Method	Value (RO)	Weight (%)
Discounted Equity Cash Flow (DECF)	1.440	60%
Dividend Discount Model (DDM)	1.060	30%
Peer-based Valuation	1.240	10%
Weighted Average Fair Value	**1.310**	**100%**

Source: NBK Capital

Discounted Equity Cash Flow

DECF is a function of the following variables, which we forecast over the next five years:

- Forecasts of Net Attributable Income (NAI) – This is an earnings measure, and therefore, primarily a function of total income, cost structure, and provisioning levels.
- Forecasts of Changes in Risk-weighted Assets – Globally accepted standards and local Omani banking regulations mandate that minimum levels of capital adequacy be maintained as growth occurs. Hence, a percentage of income must be reinvested, which is thus not available for distribution. While the current minimum ratio required by the Central Bank of Oman (CBO) is 10%, Bank Muscat's management has indicated that 12% is a level they would not like to fall below. Hence, 12% was used for Bank Muscat.
- Forecasts of Depreciation – These are primarily a function of the bank's gross fixed assets level.

In addition, estimates of the following two variables are required:

- The long-term expected growth rate in equity cash flows beyond the forecast horizon (that is, beyond the next five years) – This should be a sustainable growth rate that

extends in perpetuity and is necessary to estimate Bank Muscat's value at the end of the forecast horizon, widely known as the Terminal Value.

- The Cost of Equity for Bank Muscat – This is the investors' minimum required return for investing in Bank Muscat's shares, and hence, is used to discount future equity cash flows.

In the DECF valuation (Figure 2), full financial statements are forecasted until 2013. Equity cash flows (ECFs), defined as NAI plus depreciation minus 12% of the increase in risk-weighted assets, are then extracted from those financial statements. In addition, ECFs are assumed to grow at a perpetual rate of 4.5% in 2014 and beyond. ECFs beyond 2008 are then discounted to a point in time that is 12 months from now, yielding a total value to shareholders of RO 1.55 billion. Dividing this value by the current number of shares outstanding (1,077 million) yields a fair value of RO 1.440 per share.

The chosen cost of equity (11%) is mainly a function of interest rate levels, risks in the operating environment, a subjective assessment of the equity risk premium, and the volatility of Bank Muscat's share price returns compared to those of the stock market.

The DECF valuation resulted in a fair value of RO 1.440 per share

Figure 2 DECF Valuation

Figures in RO Thousands	Forecast				
Fiscal Year Ends December	2009	2010	2011	2012	2013
Net Attributable Income	117,853	136,072	154,171	169,274	185,590
Equity Cash Flows	43,365	57,117	70,945	90,222	119,932
Terminal Value					1,928,139
Total Value of Equity in 12 Months		1,553,927			
Number of Shares Outstanding ('000)		1,077,134			
Fair Value per Share (RO)		1.440			

Source: NBK Capital

One major drawback of discounted cash flow valuations is that they are highly sensitive to the inputs. This issue is more acute in the case of banks because they are more heavily leveraged than most other types of companies. To assess the impact of input changes on the valuation output, we performed a sensitivity analysis on two primary inputs of the DECF model: the cost of equity and the perpetual growth rate (Figure 3).

The estimate of fair value is highly sensitive to two primary inputs

Figure 3 DECF Valuation

		Perpetual Growth Rate				
		3.50%	4.00%	4.50%	5.00%	5.50%
Cost of Equity	10.0%	1.5	1.6	1.7	1.9	2.0
	10.5%	1.4	1.5	1.6	1.7	1.8
	11.0%	1.3	1.4	1.4	1.5	1.7
	11.5%	1.2	1.3	1.3	1.4	1.5
	12.0%	1.1	1.2	1.2	1.3	1.4

Source: NBK Capital

Dividend Discount Model

The DDM can be used when the dividend stream can be reasonably forecasted—a situation that generally applies to banks. DDM is a function of the following variables:

- Dividends that will be declared and paid during the forecast horizon,
- An assumption regarding the perpetual growth rate in dividends beyond the forecast horizon (similar to the case for the DECF model), and
- Bank Muscat's cost of equity.

We are forecasting a drop in Bank Muscat's dividend payout ratio in the next few years (to average around 44%), driven by falling capital adequacy. The DDM yields a total value for shareholders of RO 1.14 billion 12 months from now. Dividing by 1,077 million shares outstanding, we have arrived at a fair value of RO 1.060 per share (Figure 4).

The DDM resulted in a fair value of RO 1.060 per share

Figure 4 Dividend Discount Model

Figures in RO Thousands	Forecast				
Fiscal Year Ends December	**2009**	**2010**	**2011**	**2012**	**2013**
Dividend Payout	45.2%	44.1%	42.8%	42.9%	44.9%
Dividends	**53,318**	**59,953**	**65,948**	**72,543**	**83,267**
Terminal Value					**1,338,677**
Total Value of Equity in 12 Months		**1,140,613**			
Number of Shares Outstanding ('000)		**1,077,134**			
Fair Value per Share (RO)		**1.060**			

Source: NBK Capital

Peer-Based Valuation

We used a peer-based multiples valuation model that is a variant of the WEV valuation model. We employed this model by comparing the adjusted price-to-book (P/B) multiples of some similarly rated commercial banks operating in countries comparable to Oman in terms of gross domestic product (GDP) per capita.

In this peer-based valuation, we adjust the P/B ratio by correcting for two variables that significantly affect the P/B level, namely, expectations of future earnings growth and future return on equity levels. Specifically, the adjusted P/B is obtained by dividing the raw leading P/B by both the CAGR in earnings per share (EPS) for the coming three or four years and the average return on equity (ROE) for the same period (all based on consensus estimates). The rationale behind this adjustment is that different P/B multiples among banks do not necessarily reflect differences in "valuations," but rather can be a reflection of different growth expectations and potential. After adjusting the P/B ratios for the sample of Bank Muscat's peers, we eliminate the highest and lowest values and then we average. We then assume that Bank Muscat's adjusted P/B should be equal to that average. Afterward, we plug in our forecast of Bank Muscat's CAGR in EPS and average ROE for the coming four years to extract a raw leading P/B ratio. Finally, using our forecast of Bank Muscat's book value per share, we arrive at a value of RO 1.240 per share for Bank Muscat (Figure 5).

Bank Muscat appeared undervalued compared to its peers

Figure 5 Peer-based Valuation

Country	Bank	P/B* (2008 f)	ROE **	EPS Growth ***	WEV	FSR Moody's
Czech Republic	Komercni Banka	1.9	21.6%	3.3%	271.1	C
Hungary	OTP Bank	0.7	16.8%	7.4%	56.5	C+
Portugal	Banco Comercial Portugues	0.8	11.1%	26.4%	26.3	C+
Portugal	Banco Espirito Santo SA	0.6	12.7%	11.4%	42.1	C+
Saudi Arabia	Arab National Bank	1.6	22.2%	13.9%	52.0	C
Saudi Arabia	Banque Saudi Fransi	2.2	26.5%	14.7%	55.5	C+
Saudi Arabia	Riyad Bank	1.1	16.1%	12.4%	56.6	C
Saudi Arabia	Samba Financial Group	2.1	24.6%	8.1%	105.4	C+
Saudi Arabia	Saudi British Bank	2.8	30.5%	14.5%	63.9	C+
Saudi Arabia	Saudi Hollandi Bank	2.2	19.8%	17.0%	64.7	C-
South Korea	Daegu Bank	0.6	15.0%	8.0%	46.1	C-
South Korea	Industrial Bank of Korea	0.5	10.9%	2.0%	206.7	D+
South Korea	Jeonbuk Bank	0.7	8.7%	4.9%	159.8	D+
South Korea	Kookmin Bank	1.1	14.3%	4.2%	188.4	C
South Korea	Korea Exchange Bank	0.7	13.5%	7.3%	66.9	C-
South Korea	Pusan Bank	0.5	15.1%	8.0%	42.4	C-
South Korea	Shinhan Financial Group	0.8	14.1%	4.9%	114.5	C
Taiwan	Taiwan Cooperative Bank	0.7	10.9%	3.3%	186.6	D
Oman	National Bank of Oman	1.9	14.8%	10.5%	119.2	D+
Oman	Oman International Bank	1.1	16.7%	14.8%	44.0	D+
	Average				**92.8**	
Oman	**Bank Muscat**	**1.6**	**16.3%**	**10.5%**	**92.8**	**C**
	12-month Fair Value (RO)	**1.240**				

** Prices as of December 03, 2008. ** ROE is the average of the forecasted ROEs for the next three or four years, based on consensus estimates. *** EPS growth is the CAGR in the forecasted EPS for the next three or four years, based on consensus estimates. Sources: Reuters Knowledge, Moody's, and NBK Capital*

Risks and Challenges

- We believe the current global and regional financial and economic situation represents the most important risk facing any financial institution. The current environment brings with it possible investment losses, lower liquidity, higher risk aversion, worsening asset quality, and, most importantly, a lower price for oil, which would, no doubt, lead to lower economic growth and, hence, lower profitability for all regional banks, including Bank Muscat.

- Bank Muscat has a strategy of expansion abroad. While expansion beyond the Omani borders is expected to help diversify the earning stream in the long term, this strategy still has its own risks. There is implementation risk in expanding into countries whose banking sectors are less understood by Bank Muscat than the Omani banking sector. Furthermore, expansion into countries with significant macroeconomic problems (such as Pakistan, where Bank Muscat has a 35% stake in SaudiPak Commercial Bank) brings with it additional risks. Finally, there is the risk of overpaying when acquiring a stake in another financial institution, thereby penalizing Bank Muscat's shareholders.

- The capital adequacy ratio (CAR) of Bank Muscat dropped from 15.1% in 2007 to 12.2% in September 2008. Although the CAR is still above the 10% regulatory minimum, there will be pressure on future growth, considering that Bank Muscat wishes to keep its CAR above 12%.
- Risk of loss in market share. Bank Muscat has long dominated the Omani banking sector—the bank has enjoyed the lion's share of loans, deposits, and assets. Maintaining a high market share in the face of increased competition from banks with a much smaller base to grow will be a tough task for Bank Muscat to achieve.

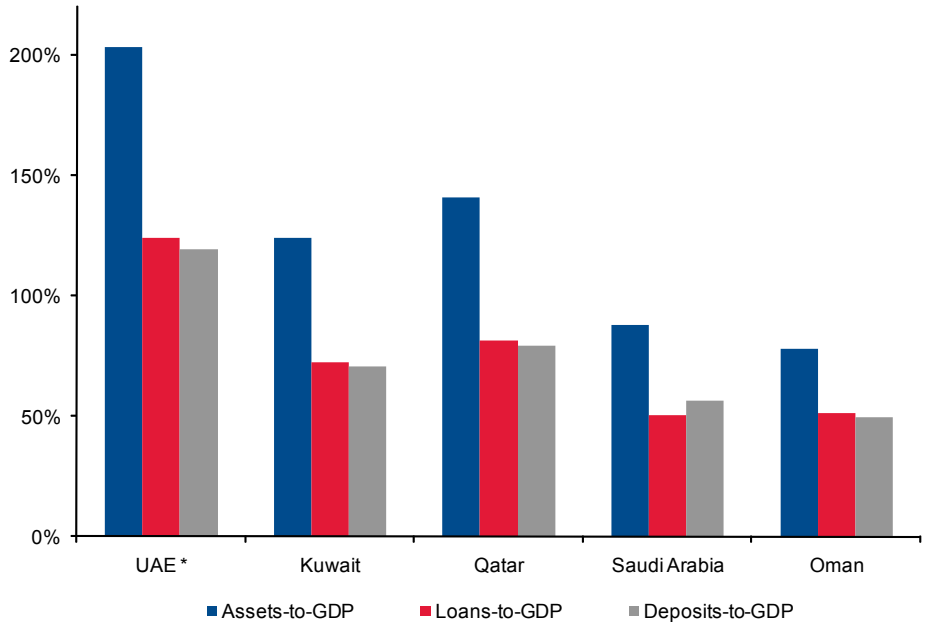
OMAN BANKING SECTOR HIGHLIGHTS

Sector Size versus Economy Size

The Omani banking sector is the smallest in the GCC in terms of total assets, which reached RO 12.9 billion (USD 33.5 billion) at the end of September 2008. Despite being relatively crowded, with 19 banks serving a population of around 2.6 million, the Omani banking sector has the lowest penetration rates in the GCC, as measured by the loans-to-GDP and deposits-to-GDP ratios. In addition, around half the population is young (under the age of 20), providing ample room for growth in retail banking. Oman does not have Islamic banking institutions, and traditional commercial banks do not offer Shari'a compliant products.

The Omani banking sector exhibits the lowest penetration rates in the GCC, which indicates ample room for growth

Figure 6 Banking Penetration Rates - August 2008



** As of June 2008. GDP figures for 2007. Sources: GCC central banks and NBK Capital*

The Omani sector is comprised of 19 commercial banks, nine of which are locally owned, while the remaining 10 are branches of foreign banks. The sector's potential for growth and the relatively welcoming attitude toward foreign participation have led to a great deal of foreign interest and presence. Not only are there more foreign banks than local ones, but several local banks are also partly owned by foreign partners. Some of the new players in the sector, in addition to Bank Sohar, which began operations in April 2007, are the Bank of Beirut and Qatar National Bank. Moreover, Alliance Housing Bank, previously a mortgage lender, has converted to a commercial bank.

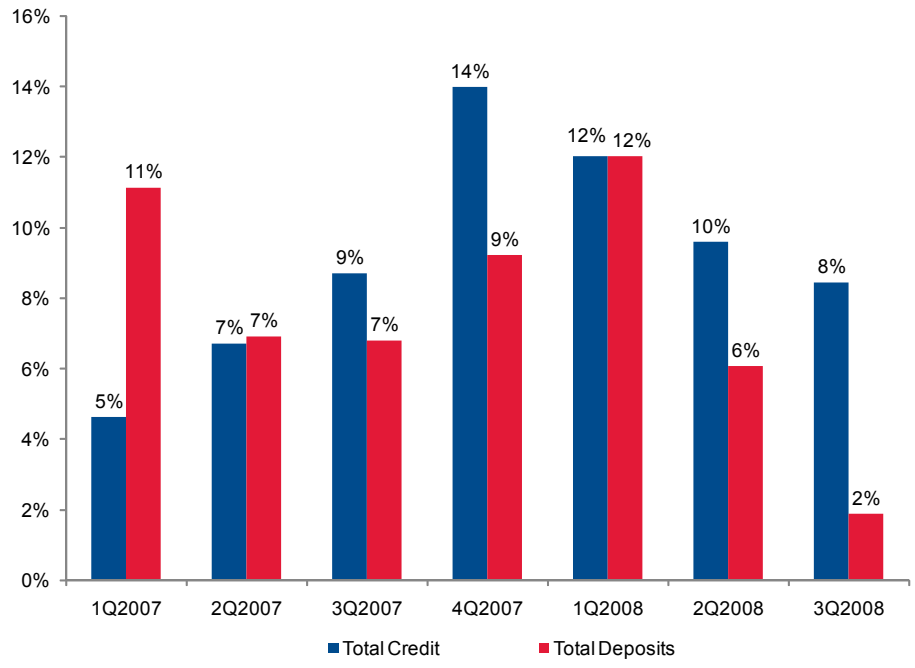
The Omani economy, like those of its GCC counterparts, has witnessed robust growth over the past few years, driven by the rising price of oil. The government has been focusing on diversifying the economy away from the oil sector. The share of petroleum activities in total real GDP has dropped from 28% in 2003 to 23% in 2006. In contrast to the other GCC

countries, there is a greater need for Oman to diversify its economy, as its oil reserves are lower and its oil production smaller than its GCC counterparts. Nevertheless, the country still largely depends on the hydrocarbon sector, and the high liquidity that resulted from surging oil prices before July 2008 has supported the growth of the banking sector. On average, in the past four years, total bank assets in Oman grew at a CAGR of 23%, higher than the country's four-year GDP CAGR of 17%. The International Monetary Fund (IMF) is forecasting nominal GDP to grow at a CAGR of 7% in the five years ending in 2013. The money supply, as measured by M2, reported a CAGR of 21% in the four years ending in 2007. Growth in M2 peaked in 4Q2007 at 12%, but the rate of growth has dropped markedly since that time, registering 9.7%, 4.6%, and 1.4% in 1Q2008, 2Q2008, and 3Q2008, respectively; this drop reflects the tighter liquidity situation characterizing the Omani banking sector.

Lending and Deposit Growth

Lending has been growing very rapidly, exceeding deposit growth in the past five quarters, although the rate of growth slowed down in 2008 after peaking in 4Q2007 (Figure 7). The quicker growth in lending led to an increase in the loans-to-deposits ratio to 110% as of September 2008, up from 94% in June 2007. We believe that lending growth will continue to drop in 2009 from the unsustainable levels witnessed in 2007 and 2008, especially with the steep fall in the price of oil and the resulting deceleration in economic activity that is expected to occur.

Figure 7 Growth in Lending and Deposits - Quarter-on-Quarter



Sources: CBO and NBK Capital

Lending to the mining and quarrying sector saw the fastest growth in 2006 and 2007 at 72% and 112%, respectively, but still constituted only 6% of total lending at the end of 2007. Personal lending accounted for 43% and 32% of the total increase in lending in 2007 and 1H2008, respectively, and continues to make up the biggest share (38.5% as of June 2008) of total credit.

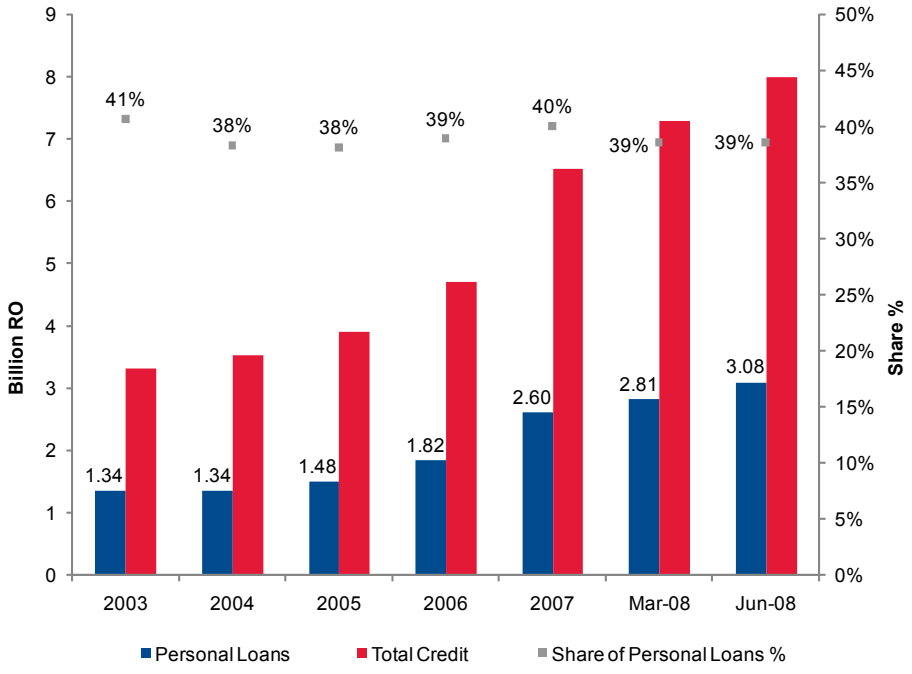
Personal Lending

The banks' ability to expand their personal loan portfolios has been limited by a CBO regulation that puts a cap on the share of personal loans in total loans. The initial regulation that capped the share of personal loans at 42.5% of total loans was modified in late 2006, to a 40% cap on the share of personal loans and a 5% cap on the share of mortgage loans. Earlier this year, in June, the cap on mortgage loans was raised to 10%. The mortgage business has significant potential to grow, owing to its current underpenetrated status. Personal lending is a lucrative business, enjoying high margins and generally low risk due to the salary assignment feature. Going forward, banks will have to grow their corporate books by a similar rate to that of their retail books if they do not wish to see a drop in the share of personal loans in total loans, and consequently, a drop in margins and profitability.

The CBO places a cap on the maximum interest rate that can be charged on personal loans. This cap has been reduced from 8.5% to 8.0%, effective June 2008, following an earlier cut from 9% to 8.5% in March 2008. As personal loans constitute a big chunk of total loans for all banks, decreasing the interest cap on personal loans will impact banks' interest margins.

Personal loans as a share of total loans have been stable at around 40% in the past few years

Figure 8 Personal Lending versus Total Credit



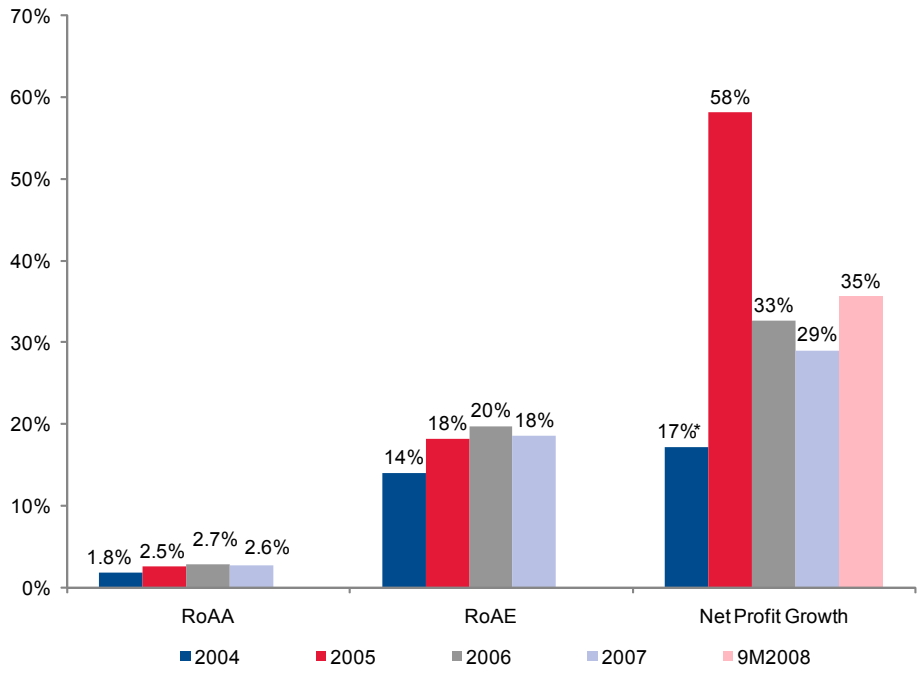
Sources: CBO and NBK Capital

Profitability

Net profit of a sample of the five largest Omani banks rose by a robust 39% CAGR in the three years ending in 2007. Rapid growth in lending is one driver for the increased profitability, with total net loans increasing by a CAGR of 30% in the last two years. Strong growth in income from fees and commissions, low net provisioning owing to significant non-performing loan recoveries, and a controlled cost expansion were also major drivers of the increase in net profits. Robust net profit growth was maintained in 9M2008, with the combined net profit of the sample increasing by 35%. Return on average equity (RoAE) for the sample as a whole has been in the 18%–20% range in the past three years, with the slight drop in 2007 being partly attributed to the fact that few banks undertook capital-increasing activities during that year. Similarly, strong balance sheet growth led to a slight decline in the return on average assets (RoAA) in 2007 to 2.6%, from 2.7% in the previous year.

Despite strong net profit growth, the RoAE for the sample fell in 2007, primarily due to the fact that few banks undertook capital increases

Figure 9 Returns and Net Profit Growth: Five Largest Omani Banks



**Note: National Bank of Oman was excluded from calculations because it incurred a loss in 2003. Sources: Banks' financial statements and NBK Capital*

BANK OVERVIEW

Bank Background

With total assets reaching RO 5.6 billion (USD 14.4 billion) at the end of September 2008, Bank Muscat is by far the largest bank in Oman, commanding a 43% share of the country's total banking assets. The two largest shareholders of Bank Muscat are the Omani Royal Court Affairs and the UAE-based Dubai Financial Group, holding 25% and 15% of the capital, respectively. Bank Muscat's operations can be broadly broken down into four major segments: corporate banking, retail banking, wholesale banking, and international banking, accounting for 29%, 49%, 21%, and 1%, respectively, of the bank's total operating income in 2007. The bank has 118 branches operating in Oman in addition to 300 ATMs. As of September 2008, Bank Muscat employed 2418 employees, with an Omanization rate of 92%. Bank Muscat is rated by the main international rating agencies, Standard and Poor's, Moody's, and Fitch, as BBB+, A2, and A-, respectively—the strongest ratings among banks in Oman.

Strategy

Bank Muscat's broad strategy is to maintain the bank's dominant position in Oman in addition to expanding abroad, both organically and inorganically. Domestically, some of the sectors that Bank Muscat is focusing on include oil and gas, petrochemicals, contracting, and tourism. Additional focus areas are SMEs, housing, insurance, and investment banking. A strategic goal is to increase fee-based earnings, especially in the face of declining net interest margins. Bank Muscat is also focusing on sales and customer service in its branches. Abroad, the bank's strategy is to expand prudently in the GCC and beyond. In the GCC, expansion will happen primarily via Bank Muscat itself, where the bank aims to have a presence in each GCC country. Bank Muscat's expansion in the MENA ex GCC, Central Asia, and East Africa regions will be done primarily via the bank's associate, BMI Bank (BMI), in which Bank Muscat owns a 49% stake. Additionally, Bank Muscat already owns 35% of SaudiPak Commercial Bank, a medium-sized bank in Pakistan, and 43% of Mangal Keshav Holdings, a small securities company in India. Ultimately, Bank Muscat may set up an entity in Asia, similar to BMI, which will take care of Bank Muscat's holdings in Asia and oversee the bank's expansion in that part of the world.

International Operations

Bank Muscat has a meaningful presence abroad through significant stakes in associates as well as branches, as previously mentioned. The most significant presence is through BMI, a small Bahraini bank, in which Bank Muscat owns a 49% stake. While BMI gives Bank Muscat exposure to the Bahraini market, we believe another important aspect of that relationship is BMI's regional expansionary plans, and hence, the indirect regional expansion of Bank Muscat. BMI already has a 21% stake in an Islamic bank in Kenya, a stake in an off-shore bank in Seychelles, and a commitment to hold a stake in a bank in Botswana. Furthermore, BMI has recently opened a branch in the Qatar Financial Centre. BMI is constantly looking at acquisition opportunities, especially in the MENA ex GCC, Central Asia, and East Africa regions, and Bank Muscat envisions BMI to be an "emerging markets bank based in the Gulf."

In 2008, Bank Muscat acquired a 35% stake in SaudiPak Commercial Bank (SPCB), a medium-sized Pakistani bank, along with the International Finance Corporation (IFC), Nomura International, and Sinthos Capital. While expanding to Pakistan might be lucrative in the long term, as the country has low commercial banking penetration rates and a large population (estimate of 158 million in 2007), significant risks are present in the short term. First, the SPCB has not been profitable in the past three years; in fact, the consortium investment is supposed to turn around the bank. Bank Muscat believes that SPCB could become profitable in a year's time. Second, Pakistan is facing significant macroeconomic problems, which will surely have a negative impact on the growth of the banking sector and its profitability. Nevertheless, the stake in SPCB represents a small share (less than 1%) of Bank Muscat's assets as of September 2008, such that any losses derived from that investment in the short term will not have a drastic impact on Bank Muscat's bottom line, although the impact on net profit will be felt.

Bank Muscat also holds a 43% stake in Mangal Keshav Holdings (MKH), a small, closely-held security house in India, which Bank Muscat will want to exit from through an IPO when the time is appropriate. The impact of any deterioration in MKH's profitability due to the current market conditions will have a very negligible effect on Bank Muscat's bottom line, as the stake in MKH represents a very small percentage of Bank Muscat's total assets.

Bank Muscat used to hold a 17% share in Centurion Bank of Punjab, an Indian bank. That bank merged with HDFC Bank, another Indian bank, in May 2008, and Bank Muscat's holding dropped to a mere 2.67% post-merger. This holding is not a strategic one anymore, and Bank Muscat would like to sell that stake when the time is appropriate.

In the GCC, Bank Muscat has a branch in Saudi Arabia, a representative office in the UAE, and has already received approval from the Central Bank of Kuwait to open a branch in Kuwait, which is expected to be launched in early 2009. Bank Muscat wishes to have a presence in all GCC countries, believing that a minor presence initially facilitates a greater expansion afterward.

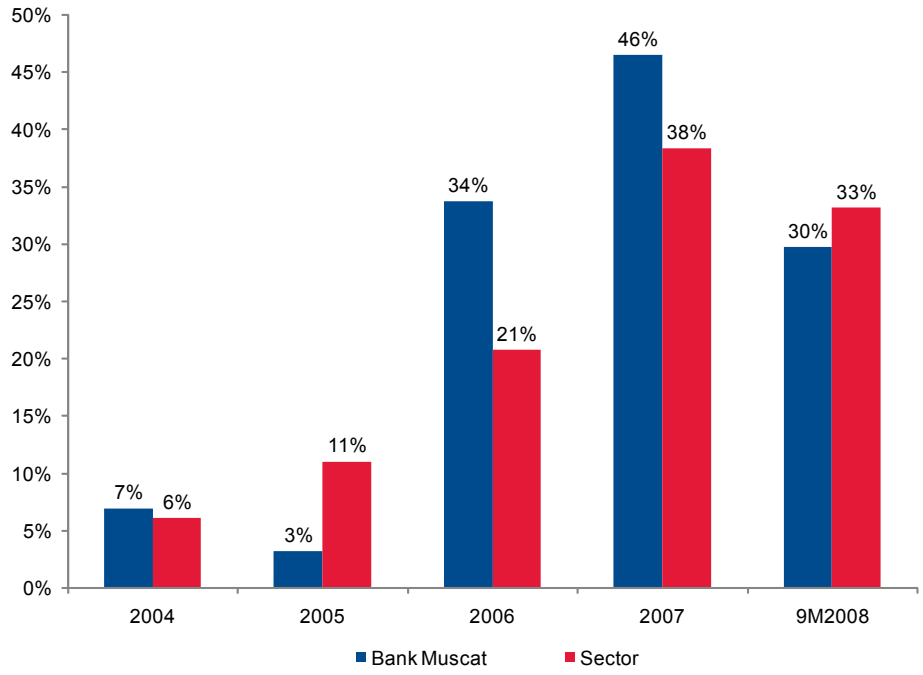
FINANCIAL OVERVIEW AND FORECASTS

LENDING

Bank Muscat's lending growth has been very rapid in the past three years, with net loans growing by 154% in the period between December 2005 and September 2008. Bank Muscat's lending growth was quicker than the sector's lending growth in 2006 and 2007, but was slightly below the sector's growth in 9M2008 (Figure 10).

Bank Muscat outperformed the sector in terms of lending growth in 2006 and 2007, but slightly underperformed it in 9M2008

Figure 10 Loan Growth: Bank Muscat versus Sector

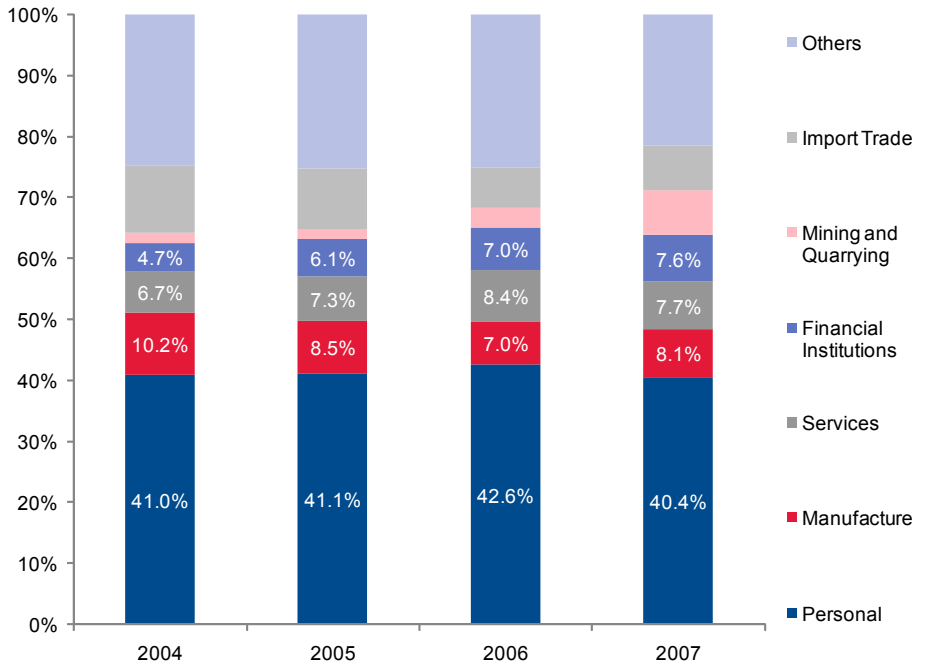


Sources: Bank Muscat's financial statements, CBO, and NBK Capital

Figure 11 shows the breakdown of Bank Muscat's lending portfolio during the past four years. Similar to other banks in Oman, personal loans have constituted around 40% of Bank Muscat's total loans. The mining and quarrying sector was the fastest growing in 2006 and 2007, at 180% and 219%, respectively, driving up its share of total loans from a negligible share in 2005 to around 7.5% in 2007. Despite constituting only 3.3% of total loans at the end of 2006, lending to that sector accounted for 17% of the total increase in loans in 2007. Quarterly financial statements do not provide a full breakdown of the loan book; nevertheless, personal loans constituted 39.7% of total loans at the end of September 2008, indicating that Bank Muscat's personal loans grew at a slightly slower rate than the bank's corporate loans in 9M2008.

Personal loans have represented around 40% of Bank Muscat's total loans in the past few years

Figure 11 Breakdown of Bank Muscat's Lending Book

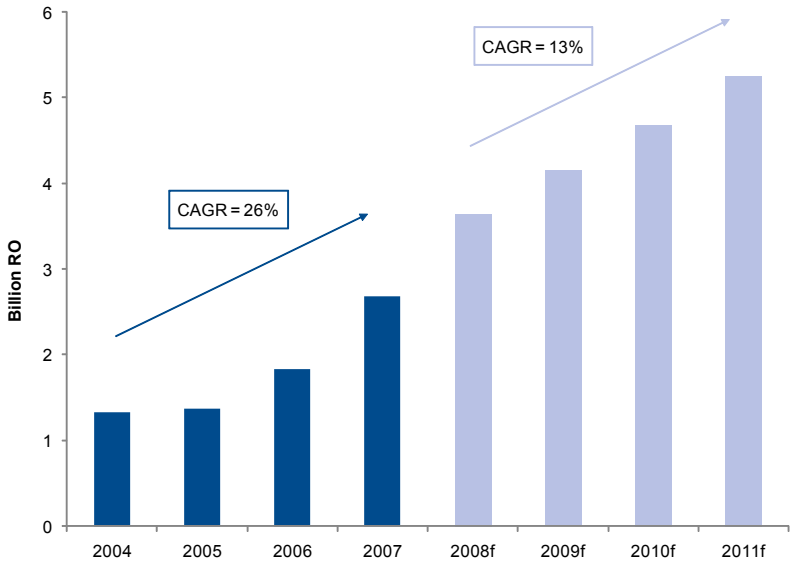


Sources: Bank Muscat's financial statements and NBK Capital

Commercial banking penetration rates (as measured by loans-to-GDP, for example) have been increasing in Oman. Nevertheless, with a low loans-to-GDP ratio of 42% in 2007, we believe there is still room for growth. We expect lending growth to slow down in Oman from the very high, unsustainable levels witnessed in 2007 and 2008, especially with the significant drop in the price of oil since July 2008. We believe both corporate lending and personal lending will witness a slowdown in the rate of growth as GDP growth rates drop, and banks exercise more prudence and conservatism in extending loans, partly due to their less liquid situation and partly due to fears of deteriorating asset quality. We believe banks will not want to see the share of high-margin personal and housing loans dropping from the current 40%. In fact, we expect banks to attempt to fully exploit the caps imposed on those lending categories (personal loans capped at 40% of total loans and housing loans at 10%) to try to defend margins and, hence, profitability. We believe Bank Muscat will witness a slight drop in its market share going forward, primarily because the bank has a much bigger base to grow in the first place. We forecast Bank Muscat's net loans to reach RO 3.65 billion by the end of 2008, and to grow by a CAGR of 13% in the coming three years (Figure 12).

We forecast Bank Muscat's net loans to grow by a CAGR of 13% in the three years ending in 2011

Figure 12 Bank Muscat's Net Loans



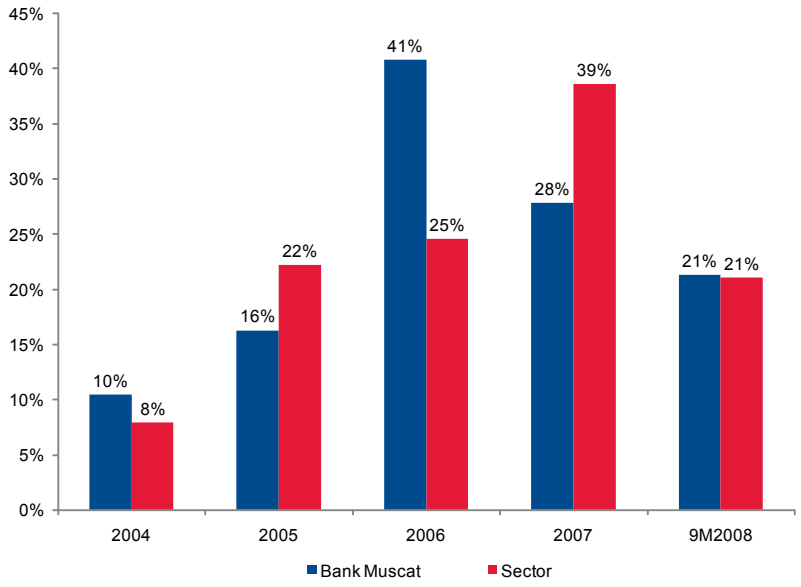
Sources: Bank Muscat's financial statements and NBK Capital

Deposit Accumulation

Bank Muscat's deposit growth has been rapid in the past three years, reaching 118% in the period between December 2005 and September 2008. The bank's deposits grew in line with the sector's in 9M2008, after falling behind the sector in this respect in 2007 (Figure 13).

Bank Muscat's deposits grew in line with the sector's in 9M2008 after falling behind it in 2007

Figure 13 Deposit Growth: Bank Muscat versus Sector

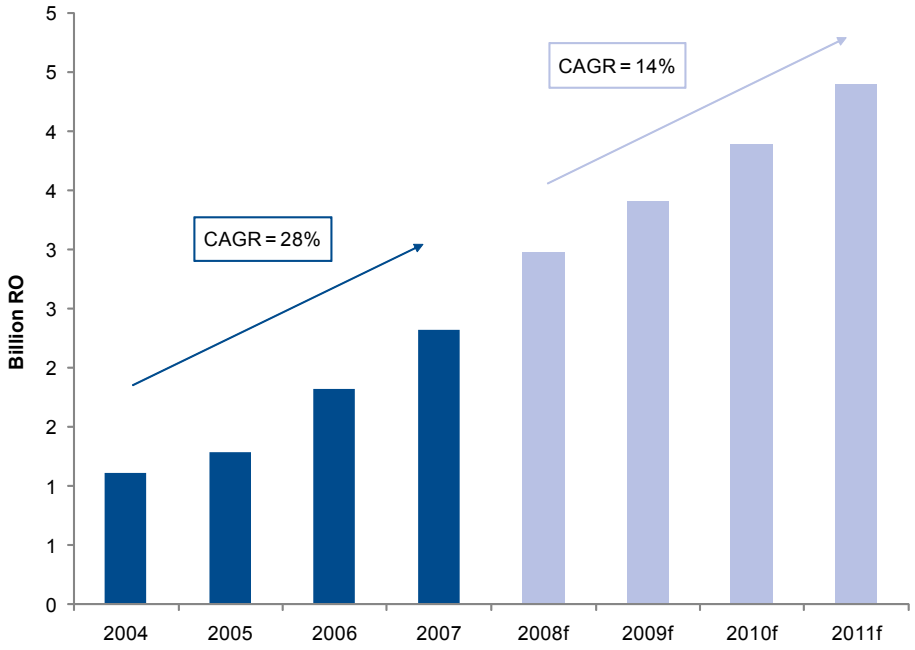


Sources: Bank Muscat's financial statements, CBO, and NBK Capital

Deposit growth fell behind lending growth in 2007 and 9M2008, thus driving up the simple loans-to-deposits ratio (LDR) from 101% in 2006 to a high 124% in September 2008. While the CBO does not have a cap on the simple LDR, it does impose a cap on the "lending ratio," which is defined as total gross loans divided by total deposits plus borrowings plus equity plus net interbank abroad. In June, the CBO dropped that ratio from 87.5% to 85%, and further to 82.5% effective the beginning of November, hoping to slow down the previous rapid growth in credit and the soaring inflation. Nevertheless, in late October, the CBO announced that it will delay the dropping of the "lending ratio" from 85% to 82.5% until after global liquidity conditions return to normal. We believe Bank Muscat's lending ratio has come close to the current 85% cap and, hence, expect the bank's deposit growth to slightly surpass its lending growth going forward. We forecast the simple LDR ratio to drop from the high of 124% it reached in September and to hover between 117% and 122% during our forecast horizon. Accordingly, we forecast deposits to reach RO 2.98 billion at the end of this year and to grow by a CAGR of 14% in the coming three years (Figure 14).

We forecast Bank Muscat's deposits to grow by a CAGR of 14% in the three years ending in 2011

Figure 14 Bank Muscat's Deposits



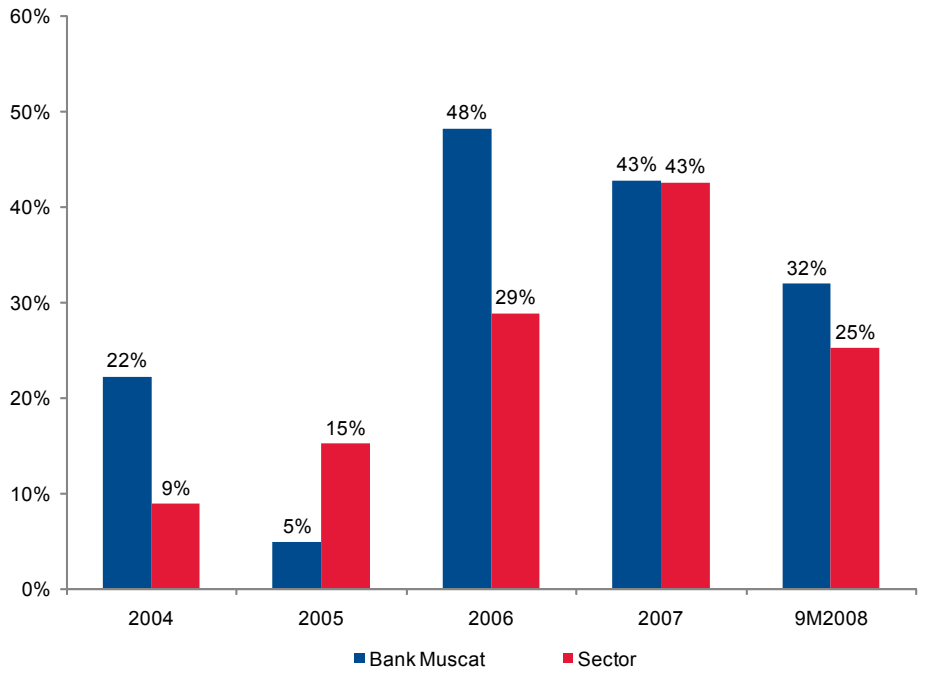
Sources: Bank Muscat's financial statements and NBK Capital

Total Balance Sheet Growth and Uses of Funds

Bank Muscat's balance sheet has grown rapidly, more quickly than both loans and deposits, in the past three years, expanding by 179% between December 2005 and September 2007. Total assets of Bank Muscat slightly outgrew the sector's in 9M2008 after growing in line with it in 2007 (Figure 15).

Bank Muscat outgrew the sector in terms of balance sheet growth in 9M2008 after growing in line with it in 2007

Figure 15 Asset Growth: Bank Muscat versus Sector

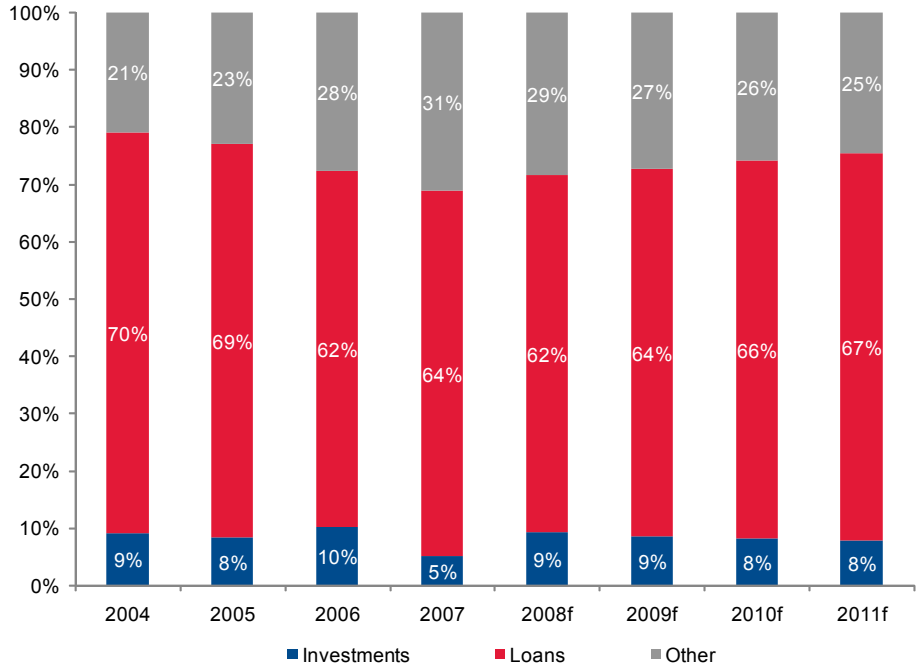


Sources: Bank Muscat's financial statements, CBO, and NBK Capital

Loans as a share of assets have been relatively stable in the past two years at around 62% to 64%, after being higher in the years before. Liquid assets, defined as cash and balances with central banks and placements with banks, have represented a bigger share (between 20% and 26%) of the balance sheet in the past two years, reflecting the high liquidity prevailing in the Omani banking sector during that time. The CBO had increased the issuing of Certificate of Deposits (CDs), especially at the end of 2007 and early 2008 whereby the value of CDs outstanding rose to RO 1.37 billion at the end of June 2008, up from RO 292 million in July 2007. However, CD issuance has dropped significantly in 3Q2008 and is expected to remain low in the current environment of tight liquidity. Going forward, we expect Bank Muscat's loans to represent a bigger share of the balance sheet, reaching 67% by 2011 and liquid assets to drop as a share of total assets but to remain at comfortable levels (Figure 16).

We expect an increase in the share of loans in total assets, growing from 64% in 2007 to 67% in 2011

Figure 16 Bank Muscat's Asset Breakdown



Sources: Bank Muscat's financial statements and NBK Capital

Profitability

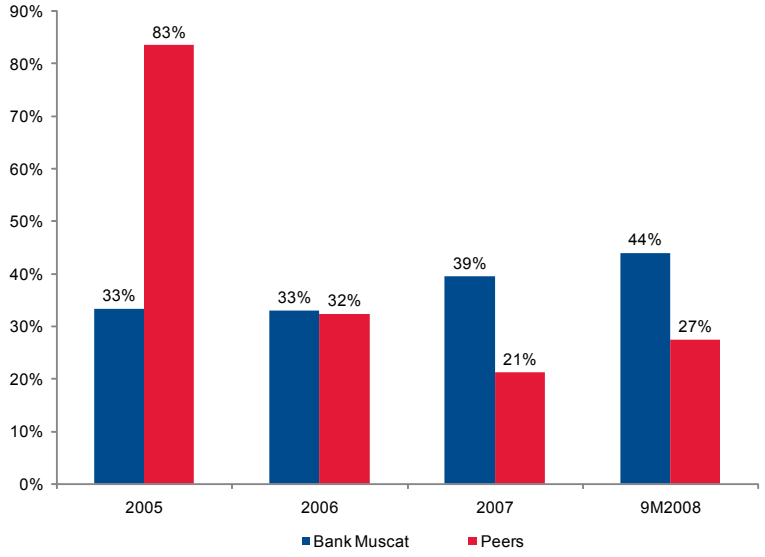
Bank Muscat's net profit has been growing very rapidly in the past few years, logging a 33% CAGR in the four years ending in 2007 and rising by a further 44% in 9M2008. While net profit growth in 2004 and 2005 was driven by a drop in net provisioning, little cost expansion, and one-off gains (in 2005), net profit growth in the past three years was driven by a robust increase in all earning components. Net interest income grew by 28% in 2006, 25% in 2007, and by a further 27% in 9M2008 on the back of a 154% growth in net loans between December 2005 and September 2008, as previously mentioned, and despite falling net interest margins during that period. The drop in net interest margins is primarily driven by higher funding costs, as interest rates were high during that period, and especially with the existence of an interest rate cap on personal loans, which, all else constant, leads to a permanent drop in margins when interest rates increase. Another reason behind the robust profitability was income from fees and commissions, which grew by 53% in 2006, 49% in 2007, and by a further 55% in 9M2008.

Another boost to Bank Muscat's profitability in the past three years has been low net provisioning due to significant recoveries of nonperforming loans (NPLs). In fact, sizable recoveries characterized the Omani banking sector in the past few years as the operating environment was favorable on the back of rapidly growing GDP. The previous high level of NPLs goes back to the early 2000s when several large corporate clients faced financial trouble.

Bank Muscat grew its net profit quicker than its peers did in 2007 and 9M2008 (Figure 17). The major reason for this outperformance was a much quicker growth in net interest income, which expanded by 25% in 2007 and 27% in 9M2008 for Bank Muscat compared with 6% and 15%, respectively, for its peers.

Bank Muscat's net profit growth has been robust in the past few years with the bank clearly outperforming its peers in the past two years

Figure 17 Net Profit Growth: Bank Muscat versus Peers

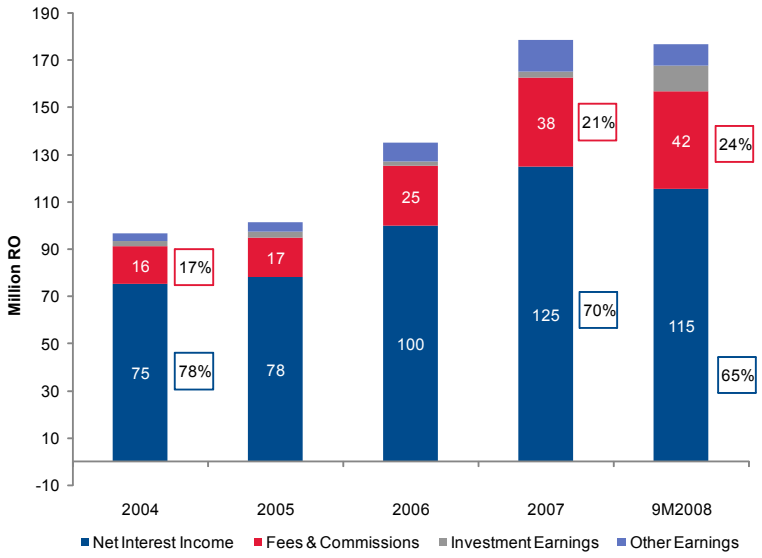


Sources: Banks' financial statements and NBK Capital

In Figure 18, we plot the components of Bank Muscat's operating income in the past four years.

The share of fees and commissions in total operating income has been increasing, while the share of net interest income has been decreasing in the past few years

Figure 18 Components of Bank Muscat's Operating Income



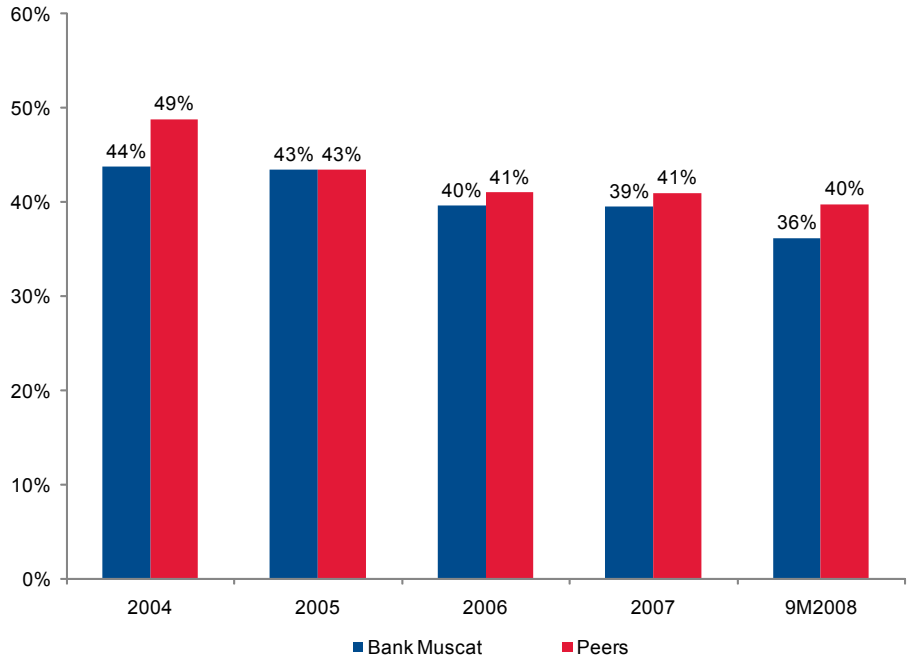
Sources: Bank Muscat's financial statements and NBK Capital

As we can see in the figure above, the share of income from fees and commissions in total operating income increased to 24% in 9M2008, up from 17% in 2004. Bank Muscat, as well as other Omani banks, had low shares of non-interest income in total operating income. In fact, all Omani banks have been trying to strengthen their non-interest earnings, especially through fees and commissions. The dropping net interest margin makes it even more imperative for banks to boost their fee income. Boosting fee income is a strategic goal for Bank Muscat, and the bank's management would like to reach a stage where fee income represents around 35% of operating income.

As for cost dynamics, Bank Muscat's total costs expanded rapidly in the past few years, reaching 22% in 2006, 32% in 2007, and 31% in 9M2008, after growing at much lower levels in the previous years. However, Bank Muscat has shown better operational efficiency, as measured by the cost-to-income ratio, than its peers in the past five years, as can be seen in Figure 19.

Bank Muscat exhibited a lower cost-to-income ratio than its peers in the past three years

Figure 19 Cost-to-Income Ratio: Bank Muscat versus Peers



Sources: Banks' financial statements and NBK Capital

The cost-to-income ratio for Bank Muscat, as well as for its peers, has been dropping in the past few years, as can be seen in the figure above. Omani banks tend to have higher cost-to-income ratios than their GCC peers, although not especially high according to international norms. A lower level of operating income, especially due to the lower level of non-interest income, is one factor behind that.

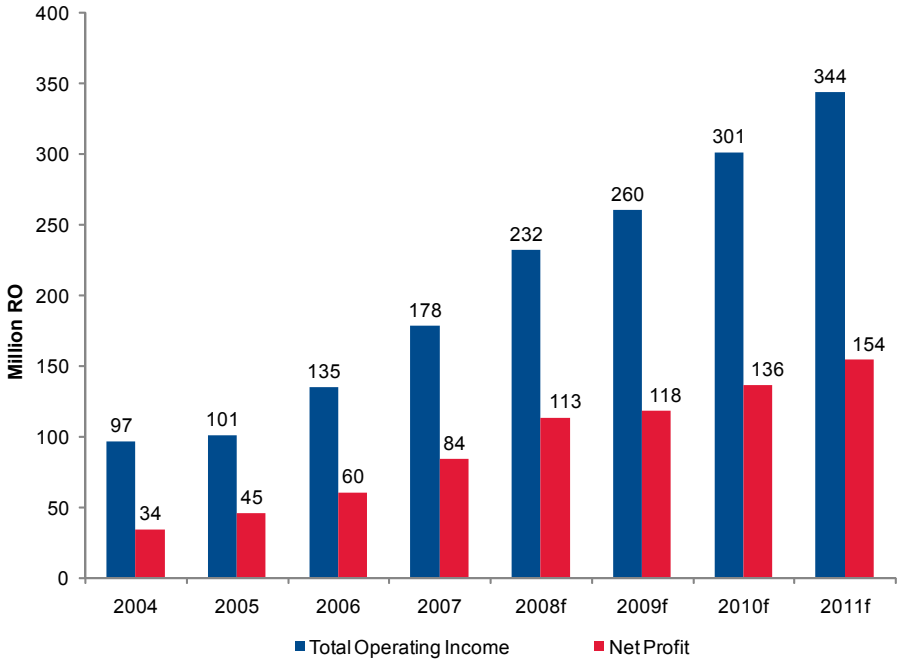
Going forward, we expect net interest income to remain the major income component, accounting for around 69% of total operating income in our forecast horizon. We expect growth in fees and commissions to drop from the unsustainable levels (around 50%) witnessed in the past few years to average around 13.5% CAGR between 2008 and 2013,

putting the fee-to-operating income ratio at close to 25% in our forecast horizon. As for cost dynamics, we expect cost expansion to drop from the high of 32% reached in 2007 to around 12% to 16% per annum, such that the cost-to-income ratio will be maintained at around 40% to 42%.

All in all, we forecast Bank Muscat's total operating income to grow by a CAGR of 14% in the three years ending in 2011, reaching RO 344 million, and net profit to grow by a CAGR of 11% in the same period to reach RO 154 million (Figure 20).

We forecast Bank Muscat's net profit and operating income to grow by a CAGR of 14% and 11%, respectively, in the three years ending in 2011

Figure 20 Bank Muscat's Total Operating Income and Net Profit



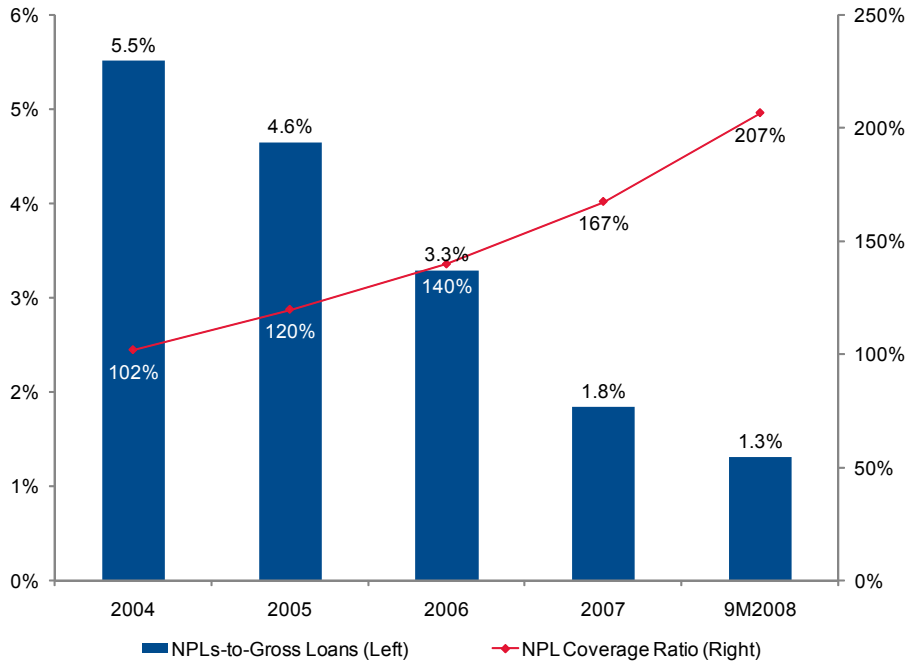
Sources: Bank Muscat's financial statements and NBK Capital

Asset Quality

Bank Muscat's asset quality indicators have considerably improved in the past few years, as can be seen in Figure 21. The NPLs-to-gross loans ratio decreased from 5.5% in 2004 to 1.3% in 9M2008. NPLs even dropped in absolute terms from RO 78 million in 2004 to RO 47 million in September 2008 on the back of significant write-offs and recoveries. The NPL coverage ratio has more than doubled during that period, increasing from 102% in 2004 to 207% as of September 2008. In fact, Bank Muscat has consistently exhibited better asset quality indicators compared with its peers in the past few years. Going forward, we expect decelerating GDP growth and tighter liquidity to lead to worsening asset quality of both the personal and corporate books. Hence, we are factoring in an increase in provisioning, a rise in NPLs-to-gross loans, and a drop in NPL coverage during our forecast horizon. Excess provisions that have been accumulated before will prove useful, serving as a cushion in the short term.

Asset quality indicators have considerably improved in the past few years

Figure 21 Bank Muscat's Asset Quality Indicators



Sources: Bank Muscat's financial statements and NBK Capital

Bank Muscat's CAR dropped to 12.22% as of September 2008, down from 15.14% at the end of 2007. While the regulatory minimum required by the CBO is 10%, Bank Muscat's management has indicated that they wish to keep the CAR higher than 12%. Hence, we believe the level reached in September will put pressure on balance sheet growth going forward. We expect a drop in dividend payout to counter the fall in capital adequacy, which we expect will remain higher than 12% during our forecast horizon.

FINANCIAL STATEMENTS

Balance Sheet (RO Thousands)			Forecast					
Fiscal Year Ends December	**2006**	**2007**	**2008**	**2009**	**2010**	**2011**	**2012**	**2013**
ASSETS								
Cash and balances with Central Banks	116,217	487,912	520,869	564,876	581,500	603,931	714,137	789,276
Due from Banks	524,741	587,802	914,082	957,144	1,004,786	1,056,334	1,104,324	1,143,409
Net Investments	299,053	212,980	545,608	557,631	574,051	608,824	647,714	776,836
Net Loans and Advances	1,834,678	2,686,863	3,651,424	4,150,963	4,685,493	5,253,947	5,777,548	6,188,180
Property and Equipment	11,438	19,090	23,106	24,809	26,734	28,909	31,366	34,143
Other Assets	168,731	223,078	217,072	226,722	230,890	235,672	240,548	244,947
Total Assets	**2,954,858**	**4,217,725**	**5,872,161**	**6,482,145**	**7,103,453**	**7,787,617**	**8,515,637**	**9,176,791**
LIABILITIES & EQUITY								
Due to Banks	363,207	663,236	1,444,249	1,483,573	1,507,179	1,531,684	1,579,183	1,577,905
Customer Deposits	1,817,107	2,322,089	2,978,275	3,408,894	3,885,318	4,400,791	4,880,697	5,271,549
Other Purchased Funds	229,923	289,223	351,628	395,378	417,295	449,606	525,786	662,761
Other Liabilities	224,536	315,607	333,533	360,443	377,050	394,706	415,816	437,374
Total Liabilities	**2,634,773**	**3,590,155**	**5,107,685**	**5,648,287**	**6,186,841**	**6,776,786**	**7,401,482**	**7,949,588**
Minority Interest	-	-	-	-	-	-	-	-
Total Shareholders' Equity	**320,085**	**627,570**	**764,476**	**833,858**	**916,612**	**1,010,830**	**1,114,155**	**1,227,203**
Total Liabilities and Equity	**2,954,858**	**4,217,725**	**5,872,161**	**6,482,145**	**7,103,453**	**7,787,617**	**8,515,637**	**9,176,791**

Income Statement (RO Thousands)			Forecast					
Fiscal Year Ends December	**2006**	**2007**	**2008**	**2009**	**2010**	**2011**	**2012**	**2013**
Net Interest Income	99,873	124,822	156,884	180,978	207,712	238,465	263,658	285,855
Income from Fees and Commissions	25,253	37,607	54,537	65,232	74,640	84,424	93,684	102,582
Other Operating Income	9,672	15,999	20,213	13,739	18,583	20,752	23,312	26,100
Total Operating Income	**134,798**	**178,428**	**231,634**	**259,948**	**300,936**	**343,642**	**380,653**	**414,538**
Provisions for Credit Losses	(11,126)	(10,502)	(12,374)	(20,815)	(24,477)	(27,432)	(27,774)	(25,323)
Salaries and Employee-Related Expenses	(32,404)	(40,829)	(51,036)	(59,202)	(68,674)	(79,662)	(90,815)	(100,805)
General and Administrative Expenses	(17,435)	(25,293)	(31,616)	(36,675)	(42,543)	(49,350)	(56,259)	(62,447)
Depreciation	(3,366)	(4,086)	(5,717)	(6,591)	(7,448)	(8,416)	(9,510)	(10,747)
Other Operating Expenses	(510)	(11)	583	-	-	-	-	-
Total Operating Expenses	**(64,841)**	**(80,721)**	**(100,161)**	**(123,283)**	**(143,142)**	**(164,860)**	**(184,358)**	**(199,321)**
Net Operating Profit	**69,957**	**97,707**	**131,473**	**136,665**	**157,793**	**178,782**	**196,295**	**215,216**
Other Income / (Expenses)	-	-	-	-	-	-	-	-
Income Taxes	(9,525)	(13,450)	(18,098)	(18,813)	(21,721)	(24,610)	(27,021)	(29,626)
Minority Interest	-	-	-	-	-	-	-	-
Net Profit	**60,432**	**84,257**	**113,375**	**117,853**	**136,072**	**154,171**	**169,274**	**185,590**

Key Ratios			Forecast					
Fiscal Year Ends December	**2006**	**2007**	**2008**	**2009**	**2010**	**2011**	**2012**	**2013**
Growth in Loans	33.7%	46.4%	35.9%	13.7%	12.9%	12.1%	10.0%	7.1%
Growth in Deposits	40.7%	27.8%	28.3%	14.5%	14.0%	13.3%	10.9%	8.0%
Growth in Net Profit	33.0%	39.4%	34.6%	3.9%	15.5%	13.3%	9.8%	9.6%
Growth in Operating Income	33.4%	32.4%	29.8%	12.2%	15.8%	14.2%	10.8%	8.9%
Loans-to-Assets	62.1%	63.7%	62.2%	64.0%	66.0%	67.5%	67.8%	67.4%
Loans-to-Deposits	101.0%	115.7%	122.6%	121.8%	120.6%	119.4%	118.4%	117.4%
NPLs-to-Gross Loans	3.3%	1.8%	1.4%	1.6%	1.8%	2.0%	2.2%	2.4%
NPL Coverage	139.7%	167.3%	186.3%	173.4%	164.2%	156.7%	150.3%	144.8%
Capital Adequacy	15.4%	15.1%	13.2%	12.9%	12.7%	12.6%	12.7%	12.9%
Growth in Costs	21.5%	32.0%	25.9%	16.0%	15.8%	15.8%	13.9%	11.1%
Non Interest Expense-to-Average Assets	2.6%	2.3%	2.0%	2.0%	2.1%	2.2%	2.3%	2.3%
Cost-to-Income	39.6%	39.4%	38.2%	39.4%	39.4%	40.0%	41.1%	42.0%
Non Interest Income-to-Operating Income	25.9%	30.0%	32.3%	30.4%	31.0%	30.6%	30.7%	31.0%
Dividend Payout	48.2%	63.9%	42.8%	45.2%	44.1%	42.8%	42.9%	44.9%
Net Interest Margin	4.4%	4.0%	3.7%	3.4%	3.5%	3.7%	3.7%	3.7%
RoAE	19.9%	17.8%	16.3%	14.7%	15.5%	16.0%	15.9%	15.9%
RoAA	2.4%	2.3%	2.2%	1.9%	2.0%	2.1%	2.1%	2.1%

Sources: Bank Muscat's financial statements and NBK Capital

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Risk and Recommendation Guide

Recommendation	Upside (Downside) Potential
Buy	more than 20%
Accumulate	between 10% and 20%
Hold	between -5% and 10%
Reduce	between -10% and -5%
Sell	less than -10%

Risk Level				
1	2	3	4	5
Low Risk				High Risk

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