BANK MUSCAT

Slow but Steady

September 01, 2010

KEY DATA

Fair Value per Share (RO)	0.860
Closing Price (RO) *	0.843
52-week High / Low (RO)	0.900 / 0.590
YTD / 12-month Return	28% / 29%
Trailing P/B	1.5
Market Cap (RO Millions)	1,135
Shares Outstanding (Millions)	1,346.42
Free Float**	27%
Reuters / Bloomberg	BMAO.OM / BKMB OM

**As of September 01, 2010, **estimate Sources: Reuters, Muscat Securities Market, and NBK Capital*

KEY METRICS

	2009A	2010F	2011F	2012F
EPS (RO)	0.05	0.07	0.08	0.10
EPS Growth	-21%	19%	22%	20%
P/B	1.6	1.5	1.3	1.2
Dividend Yield	1.9%	2.6%	3.3%	4.0%
RoAA	1.2%	1.5%	1.7%	1.9%
RoAE	10.3%	11.8%	13.2%	14.3%
Op. Income *(RO millions)*	227	239	266	295
Op. Income Growth	-2.6%	5.0%	11.4%	10.9%
Net Profit *(RO millions)*	74	88	108	129
Net Profit Growth	-21.3%	19.4%	22.3%	20.0%
Net Interest Margin	3.1%	3.1%	3.1%	3.2%

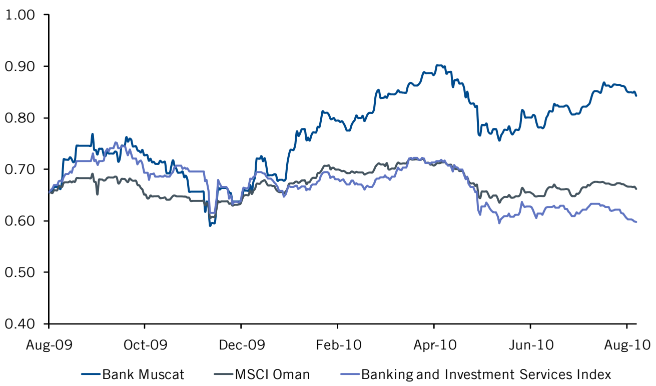
Sources: Bank Muscat's financial statements, Reuters, and NBK Capital

FORECASTS

RO Millions	3Q2009A	2Q2010A	3Q2010F	4Q2010F
Operating Income	58	56	59	61
Income before Provisions	33	28	33	35

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

REBASED PERFORMANCE



Sources: Reuters and NBK Capital

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HIGHLIGHTS

12-Month Fair Value: RO 0.860

Recommendation: Hold – Risk Level: 3**

Reason for Report: 1H2010 Update

- Our new estimate of Bank Muscat's fair value per share stands at RO 0.860, which is 2% above the share's closing price as of September 01, 2010. Hence, our recommendation on the stock is "Hold." This value is 7% below our prior fair value of RO 0.928 driven primarily by lower estimates for operating income and net profit over our forecast horizon.
- We believe lending growth will remain slow for Bank Muscat and the overall banking sector in 2H2010, as was the case in 1H2010. Accordingly, we forecast Bank Muscat's loans to grow by 1.5% in FY2010, followed by a compound annual growth rate (CAGR) of 8% in the five years ending in 2015. We expect deposits to grow almost in line with loans in 2H2010, resulting in FY2010 deposit growth of 13%, followed by a CAGR of 8% in the coming five years.
- We expect margins to remain under pressure in FY2010, and improve gradually in the following years. We believe Bank Muscat will end FY2010 with 1% growth in net interest income and 5% growth in operating income compared to FY2009. However, lower loan loss provisioning will support net profit, which we expect to grow by 19% in FY2010, followed by a CAGR of 15% in the five years ending in 2015.
- We expect a further weakening in asset quality and see the non-performing loans (NPLs)-to-gross loans ratio reaching 4.9% and 5.1%, by the end of 2010 and 2011, respectively. We believe provisioning peaked in FY2009, and thus expect net provisioning charges to decline and stand at 1% of average gross loans in FY2010, compared with 2.23% in FY2009. Bank Muscat's exposure to Dubai World, worth RO 19.25 million, matured in July 2010 and is a part of the restructuring plan. We believe Bank Muscat's asset quality will remain slightly vulnerable until the restructuring is finalized.
- Bank Muscat recorded a net profit of RO 22.6 million in 2Q2010, up 88% year-on-year (Y-o-Y), but down 8% quarter-on-quarter (Q-o-Q). Bank Muscat's 2Q2010 operating income suffered (down 2% Y-o-Y and 10% Q-o-Q) primarily due to losses incurred at the bank's subsidiary in Bahrain—BMI Bank. The Bahraini operation recorded a net loss of USD 23 million (BD 8.8 million) in 2Q2010, on the back of high provisioning charges in that quarter.

***Please refer to page 7 for recommendations and risk ratings.*

VALUATION

Our new estimate of Bank Muscat's fair value per share stands at RO 0.860, which is 2% above the share's closing price as of September 01, 2010. Hence, our recommendation on the stock is "Hold." This value is 7% below our prior fair value of RO 0.928 driven primarily by lower estimates for operating income and net profit over our forecast horizon.

Our estimate of Bank Muscat's fair value per share stands at RO 0.860

Figure 1 Weighted Average Fair Value per Share

Valuation Method	Value (RO)	Weight (%)
Discounted Equity Cash Flow (DECF)	1.000	40%
Dividend Discount Model (DDM)	0.640	40%
Peer-Based Valuation	1.030	20%
Weighted Average Fair Value	**0.860**	**100%**

Source: NBK Capital

Performance in 1H2010

Bank Muscat recorded a net profit of RO 47.1 million in 1H2010 compared with RO 60.4 million in 1H2009. However, the net profit in 1H2009 was inflated by a post-tax gain of RO 53.2 million from the sale of the HDFC Bank stake in that period. If that one-off gain were excluded, net profit in 1H2009 would have stood at RO 7.2 million, as the bank recorded losses from associates and took significant provisioning charges in that period.

Bank Muscat's net interest income (NII) stood at RO 88.1 million in 1H2010, 6% above 1H2009. However, when examining NII on a Q-o-Q basis, we see that NII declined by 7% and 1% in 1Q2010 and 2Q2010, respectively. The decline was driven by weak lending growth (-0.8% in 1Q2010 and +0.5% in 2Q2010) and a drop in net interest margins in the respective periods. Net interest margins were under pressure as a result of muted lending combined with rapid deposit growth, even though Bank Muscat's focus was on gathering low-cost deposits. Furthermore, an increase in liquidity (liquid assets-to-total assets grew from 28% in December 2009 to 31% in June 2010) added pressure on total asset yields, which declined more than the drop in the cost of funds in the period. Income from fees and commissions remained flat Y-o-Y, reaching RO 26.5 million in 1H2010, but improved (+13%) compared to 2H2009. Foreign exchange income, on the other hand, witnessed strong growth of 45% compared with 1H2009.

Overall, operating income was strong in 1Q2010 reaching RO 62.4 million, up 17% Y-o-Y and 5% Q-o-Q. However, in 2Q2010 Bank Muscat's operating income suffered slightly due to losses incurred at the bank's subsidiary in Bahrain—BMI Bank. The Bahraini operation reported a net loss of USD 23 million (BD 8.8 million) in 2Q2010, on the back of high provisioning charges, including both general and specific. Net loan loss provisioning charges stood at BD 9.1 million in 2Q2010, versus income before provisions (IBP) of BD 321 thousand, resulting in a net loss in that period. This directly impacted Bank Muscat's operating income, which dropped to RO 55.9 million in 2Q2010, down 2% Y-o-Y and 10% Q-o-Q.

Total costs increased by 17% in 1H2010, after having declined by 2.5% in FY2009. The bank's cost-to-income ratio (CIR) rose to 41.7% in 1H2010, slightly above the medium-term target of 38 to 40%, and higher than the 36% recorded in FY2009.

Lending was muted in 1H2010 as Bank Muscat's net loans declined slightly (-0.3%) to stand at RO 3.83 billion at the end of June 2010. Comparatively, total banking sector loans grew slightly quicker at 2% between December 2009 and May 2010. Bank Muscat's deposits, however, expanded by 13% in 1Q2010, followed by a 2.7% decline in 2Q2010, to stand at RO 3.38 billion at the end of June 2010. As was the case in 2009, Bank Muscat continued to build on low-cost deposits in 1H2010. This was reflected by the 21% increase in current and call deposits, which helped reduce the cost of funds in that period. The share of current and call deposits in total deposits increased from 31% as of December 2009 to 34% as of June 2010. Overall, the quicker growth in deposits compared to lending resulted in a drop in the bank's simple LDR to 113% as of June 2010, compared with 125% at the end of 2009. The bank also successfully completed the certificates of deposits (CDs) auctions as part of the RO 250 million issuance program. The issues were oversubscribed by nearly two-fold. At the end of June 2010, outstanding CDs stood at RO 177.5 million, compared with RO 139.2 million at the end of 2009.

In terms of asset quality, Bank Muscat's NPLs formation continued in 1H2010, although at a much slower rate than seen in FY2009. Total NPLs grew by 7% in 1H2010, to stand at RO 183.5 million as of June 2010. As lending was muted in this period, the NPLs-to-gross loans ratio increased from 4.3% as of December 2009 to 4.6% as of June 2010. Bank Muscat's exposure to Dubai World stood at RO 19.25 million and was originally due to mature in July 2010. The exposure is part of the Dubai World restructuring plan, which is expected to be finalized in 2H2010, and was not yet classified as an NPL at the end of June 2010. The slowdown of the NPLs formation was paired with a decline in net provisioning charges, which stood at RO 14 million in 1H2010, compared with RO 46.6 million in 1H2009. Therefore, the ratio of net provisioning charges-to-gross loans (risk cost) stood at 0.70% in 1H2010 (annualized), compared with 2.23% in FY2009. The NPL coverage ratio was maintained at 108% as of June 2010, compared with 107% as of December 2009.

Bank Muscat's capital adequacy ratio (CAR) declined for two consecutive quarters from 15.2% in December 2009 to 14.8% in March 2010, and further to 14.5% in June 2010. However, the CAR still stands comfortably above the 12% minimum required by the Central Bank of Oman (CBO), which was raised from 10% in March 2010, and is effective December 2010.

Bank Muscat's net profit in 1H2010 looks favorable when compared to the adjusted net profit (excluding the gain from the sale of the HDFC Bank stake) in 1H2009

Figure 2 Performance in 1H2010

RO Thousands	2009	% Change in 2009	Jun-2010	YTD Change %
Net Loans and Advances	3,838,211	3.0%	3,826,340	-0.3%
Customer Deposits	3,068,425	-3.3%	3,382,195	10.2%
Shareholders' Equity	711,104	-0.5%	735,695	3.5%
Total Assets	5,850,736	-2.9%	6,147,705	5.1%

RO Thousands	2009	% Change in 2009	1H2009	1H2010	Y-o-Y Change %
Net Interest Income	174,366	7.6%	83,369	88,086	5.7%
Net Fees and Commissions	49,811	-9.1%	26,376	26,452	0.3%
Share of Profit of Assoc.	(10,455)	221.9%	(4,690)	(3,590)	-23.5%
Operating Income*	227,390	-2.6%	110,236	118,336	7.3%
Total Costs	(82,125)	-2.5%	(42,363)	(49,370)	16.5%
Prov. for Credit Losses, net	(87,653)	629.1%	(46,606)	(14,020)	-69.9%
Prov. for Invest. and others	(2,515)	-83.4%	(2,205)	72	n/m
Impairment of Associates	(20,315)	47.7%	-	-	n/m
Net Profit	**73,763**	**-21.3%**	**60,438**	**47,063**	**-22.1%**
Net Profit Excl. Sale of HDFC	**20,563**	**-78.1%**	**7,238**	**47,063**	**550.2%**

**Excluding gain from the sale of HDFC Sources: Bank Muscat's financial statements and NBK Capital*

Outlook and Forecasts

We believe lending growth will remain slow for Bank Muscat and the overall sector in 2H2010. Accordingly, we forecast Bank Muscat's loans to grow by 1.5% in FY2010, as opposed to our prior forecast of 10%, which was based on our expectation of a pickup in credit demand in FY2010. However, this has not been the case so far in 2010 in Oman, and more so for Bank Muscat. As lending activity improves, we believe Bank Muscat will be able to record a CAGR of 8% for net loans in the five years ending in 2015. We expect deposits to grow almost in line with loans in 2H2010, resulting in FY2010 deposit growth of 13%, followed by a CAGR of 8% in the coming five years. We expect net interest margins to be under pressure in FY2010 as lending remains muted; however, we believe Bank Muscat will continue to build on low-cost current and call deposits in order to support the margins. As previously stated, the bank's simple LDR stood at 113% as of June 2010, an improvement compared to 125% reached at the end of December 2009. Although the LDR may still seem a little stretched, especially when compared with the sector's LDR of 102% (May 2010), we believe Bank Muscat is in a good position to take advantage of an improvement in the Omani economy. We believe the bank will have the ability to increase credit when the lending appetite returns as the funding base will also be supported by the RO 250 million CD program and other wholesale funding sources, including unsecured bonds, floating rate notes, convertible bonds, and subordinated debt. Overall, we expect total borrowings to account for 5% to 7% of the total assets over our forecast horizon.

Figure 3 Forecasts

We expect NII to grow only marginally in 2010, while lower loan loss provisioning will support net profit, which we forecast to grow by 19% in 2010

	2010 Forecasts (RO Thousands)			2010f versus 2009a	5-year CAGR *
	Old	New	Diff %		
Net Loans and Advances	4,220,531	3,895,762	-7.7%	1.5%	8.0%
Customer Deposits	3,440,317	3,456,507	0.5%	12.6%	8.4%
Net Interest Income	183,646	176,642	-3.8%	1.3%	9.2%
Net Fees and Commissions	54,377	50,752	-6.7%	1.9%	10.9%
Operating Income**	254,748	238,672	-6.3%	5.0%	10.2%
Total Costs	(95,389)	(94,709)	-0.7%	15.3%	10.9%
Provisions for Credit Losses	(44,714)	(41,309)	-7.6%	-52.9%	-12.4%
Net Profit	**99,007**	**88,055**	**-11.1%**	**19.4%**	**15.2%**

**CAGR: 2010–2015 **Excluding gain from the sale of HDFC Source: NBK Capital*

Bank Muscat witnessed a declining trend in net interest margins in 1Q2010 and 2Q2010 compared with the most recent quarters in 2009. Going forward, we expect margins to continue to be under pressure in 2H2010 as credit growth remains slow. Overall, we forecast margins to decline slightly in FY2010 compared with FY2009 levels, and gradually increase over our forecast horizon. We expect net interest income to grow marginally (+1%) in FY2010, followed by a CAGR of 9% in the five years ending in 2015.

We expect fees and commissions in 2H2010 to be similar to the levels seen in 1H2010, resulting in growth of 2% in FY2010. As lending and overall banking activity picks up in FY2011 and beyond, we expect income from fees and commissions to increase, posting a CAGR of 11% for the five years ending in 2015. We believe the growth will be primarily driven by core fees, which we believe will account for approximately 70% of the total fee and commission income.

A key component of operating income in 1H2010 was the share of earnings from associates. As previously mentioned, losses incurred by BMI Bank in Bahrain in 2Q2010, due to a surge in provisioning charges, reduced Bank Muscat's operating income in that period. While we do not expect any further major provisioning charges at BMI Bank, we expect the bank to end FY2010 with a net loss, which will impact Bank Muscat's operating income accordingly. Going forward, we expect BMI to contribute positively, although very marginally, to Bank Muscat's operating income. Overall, we expect Bank Muscat's operating income to grow by 5% in FY2010, followed by a CAGR of 10% in the five years ending in 2015.

We expect Bank Muscat's costs to increase by 15% in FY2010, taking the bank's CIR to nearly 40%, compared with 36% in FY2009. This is in line with the bank's medium-term target of maintaining a CIR ranging between 38% and 40%. Overall, we expect costs to record a CAGR of 11% in the five years ending in 2015.

We expect a further weakening in asset quality and see the NPLs-to-gross loans ratio reaching 4.9% and 5.1%, by the end of 2010 and 2011, respectively. With the Dubai World issue still pending, the bank's asset quality remains slightly vulnerable, although to a much smaller degree than some other banks in the region with more significant exposure. The bank expects the restructuring plan to be finalized in 2H2010. However, no decision has yet been made on which payment option will be selected from those offered by Dubai World. We believe provisioning peaked in FY2009, and therefore expect net provisioning charges to decline and stand at 1% of average gross loans in FY2010, compared with 2.23% in FY2009. We forecast Bank Muscat's NPL coverage ratio to reach 111% by the end of FY2010, and expect it to remain above 100% over our forecast horizon.

To conclude, we expect only a marginal increase in net interest income in FY2010, while lower loan loss provisioning will be the key driver of the 19% growth in net profit in that year. We expect margins to remain under pressure in FY2010 and improve gradually in the following years. Furthermore, good cost control and lower loan loss provisioning will support net profit, which we expect to grow by a CAGR of 15% in the five years ending in 2015.

FINANCIAL STATEMENTS

Balance Sheet (RO Thousands)	Historical		Forecast				
Fiscal Year Ends December	2008	2009	2010	2011	2012	2013	2014
ASSETS							
Cash and Balances with Central Banks	452,761	608,099	901,753	981,007	1,079,406	1,156,246	1,258,552
Due from Banks	1,077,557	1,015,691	946,288	1,001,782	1,072,267	1,141,303	1,214,154
Net Investments	469,321	209,219	218,045	238,668	266,045	298,147	335,872
Net Loans and Advances	3,727,700	3,838,211	3,895,762	4,171,778	4,536,577	4,899,040	5,288,674
Property and Equipment	21,948	26,276	30,795	34,449	38,651	43,483	49,040
Other Assets	278,949	153,240	179,941	198,412	218,730	241,181	265,484
Total Assets	**6,028,236**	**5,850,736**	**6,172,585**	**6,626,097**	**7,211,676**	**7,779,401**	**8,411,777**
LIABILITIES & EQUITY							
Due to Banks	1,412,576	1,395,747	1,220,712	1,252,228	1,415,392	1,506,520	1,639,108
Customer Deposits	3,173,032	3,068,425	3,456,507	3,733,978	4,086,400	4,431,583	4,795,834
Other Purchased Funds	341,628	397,903	436,528	472,872	420,225	417,550	412,812
Other Liabilities	386,250	277,345	281,976	312,086	342,566	374,493	404,580
Total Liabilities	**5,313,486**	**5,139,420**	**5,395,722**	**5,771,165**	**6,264,583**	**6,730,147**	**7,252,334**
Minority Interest	**-**	**212**	**176**	**176**	**176**	**176**	**176**
Total Shareholders' Equity	**714,750**	**711,104**	**776,687**	**854,756**	**946,917**	**1,049,078**	**1,159,267**
Total Liabilities and Equity	**6,028,236**	**5,850,736**	**6,172,585**	**6,626,097**	**7,211,676**	**7,779,401**	**8,411,777**

Income Statement (RO Thousands)	Historical		Forecast				
Fiscal Year Ends December	2008	2009	2010	2011	2012	2013	2014
Net Interest Income	162,107	174,366	176,642	189,675	209,720	230,580	251,895
Income from Fees and Commissions	54,827	49,811	50,752	57,103	62,829	70,498	77,245
Other Operating Income	16,619	3,213	11,277	19,173	22,298	23,925	26,220
Total Operating Income	**233,553**	**227,390**	**238,672**	**265,951**	**294,847**	**325,003**	**355,359**
Provisions for Credit Losses	(12,022)	(87,653)	(41,309)	(33,559)	(25,395)	(21,211)	(21,255)
Salaries and Employee-Related Expenses	(48,899)	(45,883)	(52,793)	(59,355)	(65,804)	(72,534)	(79,309)
General and Administrative Expenses	(29,472)	(29,500)	(33,943)	(38,162)	(42,308)	(46,635)	(50,991)
Depreciation	(5,737)	(6,622)	(7,973)	(9,242)	(10,629)	(12,223)	(14,056)
Other Provisions and Operating Expenses	(29,012)	(22,950)	72	-	-	-	-
Total Operating Expenses	**(125,142)**	**(192,608)**	**(135,946)**	**(140,319)**	**(144,136)**	**(152,604)**	**(165,612)**
Net Operating Profit	**108,411**	**34,782**	**102,726**	**125,632**	**150,711**	**172,399**	**189,747**
Other Income / (Expenses)	-	53,200	-	-	-	-	-
Income Taxes	(14,680)	(14,264)	(14,671)	(17,942)	(21,524)	(24,621)	(27,099)
Net Profit	**93,731**	**73,763**	**88,055**	**107,690**	**129,187**	**147,777**	**162,648**
EPS (RO)	**0.070**	**0.055**	**0.065**	**0.080**	**0.096**	**0.110**	**0.121**

Key Ratios	Historical		Forecast				
Fiscal Year Ends December	2008	2009	2010	2011	2012	2013	2014
Growth in Loans	38.7%	3.0%	1.5%	7.1%	8.7%	8.0%	8.0%
Growth in Deposits	36.6%	-3.3%	12.6%	8.0%	9.4%	8.4%	8.2%
Growth in Net Profit	11.2%	-21.3%	19.4%	22.3%	20.0%	14.4%	10.1%
Growth in Operating Income	30.9%	-2.6%	5.0%	11.4%	10.9%	10.2%	9.3%
Loans-to-Assets	61.8%	65.6%	63.1%	63.0%	62.9%	63.0%	62.9%
Loans-to-Deposits	117.5%	125.1%	112.7%	111.7%	111.0%	110.5%	110.3%
NPLs-to-Gross Loans	1.7%	4.3%	4.9%	5.1%	5.0%	4.9%	4.8%
NPL Coverage	154.5%	107.1%	111.1%	113.7%	117.0%	119.5%	121.7%
Capital Adequacy	13.0%	15.2%	16.1%	16.4%	15.4%	15.7%	16.0%
Growth in Costs	19.8%	-2.5%	15.3%	12.7%	11.2%	10.7%	9.9%
Non Interest Expense-to-Average Assets	2.4%	3.2%	2.3%	2.2%	2.1%	2.0%	2.0%
Cost-to-Income	36.1%	36.1%	39.7%	40.1%	40.3%	40.4%	40.6%
Non Interest Income-to-Operating Income	30.6%	23.3%	26.0%	28.7%	28.9%	29.1%	29.1%
Dividend Payout	23.0%	29.2%	33.6%	34.4%	35.3%	35.5%	37.1%
Net Interest Margin	3.4%	3.1%	3.1%	3.1%	3.2%	3.2%	3.3%
RoAE	14.0%	10.3%	11.8%	13.2%	14.3%	14.8%	14.7%
RoAA	1.8%	1.2%	1.5%	1.7%	1.9%	2.0%	2.0%

Sources: Bank's financial statements and NBK Capital

RISK AND RECOMMENDATION GUIDE

RECOMMENDATION	UPSIDE (DOWNSIDE) POTENTIAL
BUY	MORE THAN 20%
ACCUMULATE	BETWEEN 5% AND 20%
HOLD	BETWEEN -10% AND 5%
REDUCE	BETWEEN -25% AND -10%
SELL	LESS THAN -25%

RISK LEVEL				
LOW RISK				HIGH RISK
1	2	3	4	5

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