Equity | United Arab Emirates | Banks

RASMALA

20 October 2010

Abu Dhabi Islamic Bank

Positive Confirmation

Buy

Target price
Dh3.65 (from Dh3.11)

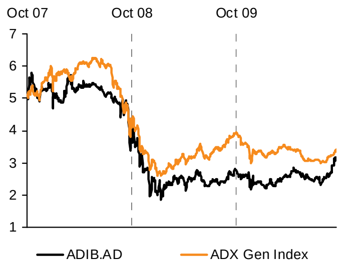
Price
Dh3.18

Short term (0-60 days)
n/a

Market view
No Weighting

Price performance

	(1M)	(3M)	(12M)
Price (Dh)	2.62	2.49	2.69
Absolute (%)	21.4	27.7	18.2
Rel market (%)	12.7	15.3	33.8
Rel sector (%)	17.3	15.0	28.2



Market capitalisation
Dh6.27bn (€1.24bn)

Average (12M) daily turnover
Dh2.16m (US$0.60m)

Sector: ADX Bank & Fin Index
RIC: ADIB.AD, ADIB UH
Priced Dh3.18 at close 19 Oct 2010.
Source: Bloomberg

After a stand-out set of results in the previous quarter, we believed ADIB had gone some way to establishing itself as a premium stock. Following strong 3Q10 numbers across the board, we now believe ADIB has taken a further step in the right direction.

Key forecasts

	FY08A	FY09A	FY10F	FY11F	FY12F
Reported PTP (Dhm)	851.1	75.00	1,174	1,600	2,118
Reported net profit (Dhm)	851.3	77.80	1,176	1,604	2,122
Reported EPS (Dh)	0.36	0.01	0.45	0.63	0.84
Normalised EPS (Dh)	0.36	0.01	0.45	0.63	0.84
Dividend per share (Dh)	0.18	0.00	0.24	0.26	0.43
Normalised PE (x)	8.84	546.9	7.15	5.08	3.77
Price/book value (x)	1.44	1.46	1.32	1.15	1.00
Dividend yield (%)	5.66	0.00	7.46	8.28	13.50
Return on avg equity (%)	16.60	1.50	21.70	26.10	30.10

Use of indicates that the line item has changed by at least 5%. year to Dec, fully diluted
Accounting standard: IFRS
Source: Company data, Rasmala forecasts

Another strong set of results

ADIB released 3Q10 results beating the already strong 2Q10 number, with headline and attributable income rising 31% yoy. At the heart of the results were higher spreads, better fees and commissions, and lower provisioning rooted in better asset quality. Costs were also higher, but, given the continuing investment in branches, ATMs and people, this does not come as too much of a surprise.

Reaffirming investment hypothesis

Our central idea is that ADIB is making a step change in product distribution and service standards to a loyal but underserved customer base. As a result we believe ADIB can continue to expand its rightful franchise, as well as to cross-sell into its existing franchise. Above-market growth, increased spreads, and proportionately higher fees and commissions are likely to be the result, at the cost of higher recurring expenses in absolute terms.

Upgrading EPS numbers

We were perhaps slow to upgrade EPS numbers after the 2Q10 results, and we make up for it now with increases of 27%, 18% and 7% for 2010-12 respectively. The main changes to recurring income have come from a 15bp positive adjustment to spreads as a result of higher a higher retail contribution, and an increased expectation of fee and commission penetration. In the short term, we have also cut our provisioning expectations, which has had the most impact on short-term EPS.

Good valuation, positive momentum

Following our earnings revisions, we do not believe that ADIB is particularly expensive on standard multiples, in spite of recent price increases. Although our revised target of Dh3.65 offers only 15% upside, we have yet to see the impact of a potential recovery in ADIB Egypt, we still maintain an elevated discount rate, and our medium-term return number is no better than average, in spite of rising evidence that the exit level of returns may be quite impressive. Our recommendation remains a Buy.

Analyst

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Results driving upgrades

ADIB produced another set of (what we believe will be) sector leading numbers, outperforming our 3Q10 forecast by 25% on sound quality. We upgrade our near-term and distant forecasts accordingly and maintain a positive recommendation.

Main positive variances net Islamic returns and provisioning

Net Islamic returns rose 3% qoq in 3Q10, to beat our forecast by 6%, proving that the strong 2Q10 number was not merely boosted by write-backs of interest in suspense. Provisioning was also better than expected, rising only 7% qoq and undershooting our forecast by 21%, albeit due to a one-off reversal of a counter-party provision. These two factors more than fully accounted for the 25% outperformance of headline and attributable income.

The main offsetting negative was a further 6% qoq increase in expenses, establishing that the 2Q10 number was not, after all, above trend. There was also a Dh22m impairment of investments, although this could be set against the revaluation gains that drove comprehensive income.

Table 1 : ADIB results summary, 2Q10 (versus prior periods and previous estimates)

Dh m	3Q09A	2Q10A	3Q10A	3Q10F	yoy	qoq	vs est
Balance Sheet							
Loans & Islamic Financing	39,253	45,201	47,159	47,126	20%	4%	0%
Financial instruments	1,196	1,342	1,223	1,437			
Total Assets	58,663	68,332	71,175	69,965	21%	4%	2%
Customer deposits & Islamic Funding	43,999	51,883	54,038	53,016	23%	4%	2%
Capital Market Liabilities	2,938	5,145	5,145	5,145	75%	0%	0%
Total Liabilities	50,751	60,630	63,111	62,013	24%	4%	2%
Net Liquid Assets	12,033	15,894	16,571	15,169			
Shareholders' Equity	7,911	7,701	8,064	7,952	2%	5%	1%
Income Statement							
Net Interest & Islamic Returns	529	648	669	630	26%	3%	6%
Core non-interest	73	89	118	95	60%	32%	24%
Non-core non-interest	18	7	0	23	-97%	-93%	-98%
Total Non-Interest Income	92	96	118	118	29%	23%	0%
Total Banking Income	621	744	787	747	27%	6%	5%
Total Operating Expenses	(248)	(311)	(330)	(315)	33%	6%	5%
Provisioning	(121)	(135)	(144)	(181)	18%	7%	-21%
Profit before tax	240	299	315	251	31%	5%	25%
Tax, Minorities & Appropriations	(0)	(60)	(0)	0	-85%	-100%	
Attributable Income	239	239	315	251	31%	32%	25%
Headline Net Income	239	302	315	251	31%	4%	25%
Comprehensive Income	247	217	363	251	47%	68%	45%

Source: Rasmala forecasts, Company reports

Solid balance sheet and spreads driving net Islamic returns

Loan growth of 4% qoq driven by retail lending for individuals

We had some worries after ADIB's tide had come in during 2Q10 that we would see it go out again in 3Q10, but this proved not to be the case. Loan growth of 4% qoq was fully in line with our forecasts. ADIB provided a new, and ultimately more helpful, breakdown of net loans this quarter, although the result in the short term is to modestly obscure the trends.

Nevertheless, some trends are clear: customer additions amounted to a very impressive 5.7% qoq, with ADIB stating that this was across the business areas, only just below the 6.3% average over the previous six quarters. Retail banking for individuals continued to be the engine of growth, although the Dh920m loan to Emirates Steel Industries (ESI) as part of an Dh4bn project financing, clearly also had an impact.

Deposit growth assisted by corporate time deposits

Deposit growth was strong also, rising 4% qoq, and beating our expectations by 2%. We expected ADIB to shed excess liquidity as competition picked up, but ADIB took the opportunity of adding reasonably-priced corporate term deposits when the opportunity presented itself during the quarter. Of some concern was the 9% drop in current account deposits, and the 2% decline in retail banking for individuals, although in both cases the figures are up ytd, and ADIB confirmed this was not a trend.

Strong retail driving spread stability

It was a positive surprise to us that spreads were more or less stable (on our measures), not giving back any of the leap in 2Q10. We believe this was driven by strong retail volumes, although the movement in 2Q10 must also have been stickier than we expected. Good loan and deposit growth, and wider spreads drove an 3% qoq rise in net Islamic returns to beat our forecast by 6%.

Fees and commissions (F&C) also a solid LT revenue contributor

F&C reached a respectable annualised figure of 0.98% of customer assets in 3Q10, not far below the sector average for the first time. Although this includes some overspill from 2Q10, the trend is still impressive. Particular highlights included the cards business, which benefitted partially from increased cross-sell, but also from the introduction of associated takaful products (Islamic insurance), such as payment protection and cash protection.

In the short term, we believe that the current level is sustainable. The running rate on account services will fall, we believe, but there was a notable absence of FX income, and trade related F&C commissions were also below trend in 3Q10, suggesting a degree of potential bounce back in these areas. Further out, we believe a continued rise in fees as a proportion of customer assets is likely, with ADIB mentioning transaction services in particular.

Provisioning and loan quality trends on target

Customer provisioning as expected, bar one-off impairment

Total provisioning for 3Q10 continued to undershoot our forecasts. However, this was due to the reversal of a provision for impairment of loans to financial institutions, and not related to customer items. Customer provisioning was as forecast. Nevertheless, with most of the new provision going into general provisions, we believe this was partially to reduce the impact of the new regulation on general provisions expected in 4Q10.

One area of debate has been the low coverage level, which on our numbers is currently 49% (up from 44% in 2Q10). This is effectively justified by the low write-off level, which cumulatively comes to Dh13m from 2005-2Q10, or less than 1% of current customer assets. Consequently a Dh29m impairment for 3Q10 alone is way above the historical trend. ADIB confirmed that this was from a single counterparty, and does not see it as part of a newly developing trend.

NPLs still rising, but past due loans are down

Although provisioning was a major contributor to outperformance, the real test on a quarterly basis is on loan quality trends. Impaired assets continued to rise, with impaired Murabaha adding 6% and Ijara increasing 13% qoq. Although these are broadly within forecast ranges, the decline in past due loans, we believe, may be a positive leading indicator for the future. We estimate that on our standardised measure of NPLs, the ratio has declined steadily from 9.87% at year-end 2009 to 8.98% as at 3Q10, and we expect further steady declines going forward.

Costs reflect investments

The one area where numbers were visually worse than expected was costs, where staff cost increases of 5% qoq and non-staff costs of 10% qoq meant total costs rose 33% yoy in 3Q10 and exceeded our forecast by 5%. We initially believed that the 10% qoq rise in 2Q10 was above trend, and so assumed more limited increases in 3Q10, but we have now had to raise our cost forecasts.

Cost increases are, however, understandable. Staffing levels have risen 7.7% ytd, while branches have increased 15% and ATMs increased 8% just in 3Q10. We believe costs will continue to rise, with revenues lagging until at least the end of 2011 when a degree of revenue catch-up will take the cost-income ratio back toward the sector average.

Sectoral analysis should be treated with caution

On a sectoral basis, the Private Banking operation and Burooj Properties are both trending below normal levels of profitability. Banking loans have been flat ytd, according to the new breakdown of the lending portfolio, while profitability has been decreasing according to the sectoral analysis. Although ADIB stresses that detailed sectoral analysis could be misleading, this reflects the pending strategic re-evaluation. Going forward we are not yet convinced that ADIB has the right customer base for an outward looking Private Banking platform.

Burooj Properties continues to make negative revenues, largely due to the absence of sales, but while reporting the cost of financing within revenues. Although ADIB stresses the fact that all property is booked at cost, we have some concerns that there was a Dh909m increase in advances against purchase of properties in 2008 at the peak of the market, and there must be some concern in this area. On the positive side though, a 5% return on property investment (before costs) would add approximately 13% to the current bottom line of the bank as a whole.

Summary forecast changes

In spite of generally good balance sheet numbers, we have applied not much in the way of revisions to our numbers, maintaining our current above market forecasts for growth. There were a couple of reasons to believe that the 3Q10 number was above trend, but with a bit more of a recovery in Abu Dhabi-based loan growth in 4Q10, we believe any slack can be resolved.

On the income statement side, we have been a little less miserly. We raise our spread expectation by 15 basis points, resulting in a Dh132m (11%) positive adjustment to our 2011 bottom line forecast. We also increase our expectations for fee and commission income, resulting in a further 4% increase in expectations. This will be, we believe, largely offset by higher cost increases, resulting in our forecast for 2011 operating profit rising by just 2%, although the improvement will be more pronounced in later years. With banks frequently tail end loading provisioning numbers, we continue to feel wary of being too optimistic. Nevertheless, our 145bp and 115bp forecast for provisioning in 2010-11 is looking unjustifiably pessimistic, and we revise these downwards.

Impact of forecast changes

We raise our EPS numbers by 27%, 18% and 8% for 2010-12 respectively. Consequently, in spite of the 24% absolute performance and 16% ADX-relative performance since 20 September, the stock remains good value on standard multiples, in our view.

For our three-stage DCF, we lower the discount rate by 30bp to reflect improved visibility, and by 61bp to reflect declines in the US 10-year yield. We believe we continue to have conservative inputs here, including particularly our stage two ROE of only 20% (against an exit return on core capital of 30%). Furthermore, if visibility continues to improve, we may well continue to lower the discount rate.

Following the various revisions, we raise our price target to Dh3.65 from Dh3.11, and maintain our recommendation of Buy.

Table 2 : Valuation parameters

Stage 1 (2010-2013)				**2010**	**2011**	**2012**	**2013**
Explicit Dividends	Forecast Dividends			561	623	1,011	1,363
	NPV Stage 1	**2,702**		2,702	2,495	2,181	1,363
Stage 2 (2014-23)			Model Numbers				
Modelled Dividends	Excess Capital	(144)		ROE1	Growth	Capital Req'd	RWA
	Modelled Dividends	3,571		20%	15%	8,822	98,026
	NPV Stage 2	**2,166**					
Stage 3 (2024+)			Model Numbers				
Terminal Value	2023	16,964		ROE1	Growth	Capital Req'd	
	NPV Stage 3	**2,324**		11%	6%	35,691	
Total NPV	Stage 1 (2010-2013)	2,702	**COE**				
	Stage 2 (2014-23)	2,166	US RFR				2.52%
	Stage 3 (2024+)	2,324	Country Risk Spread				6.00%
	NPV	7,193	Sector Risk Spread				4.50%
			Stock Spread				3.50%
	Shares	1,971	**Discount Rate**				16.52%
	Price Target	**3.65**					
	Price	**3.18**					
	Upside/(Downside)	**15%**					

Source: Rasmala forecasts

Figure 1 : Dupont

STAGE ONE | STAGE TWO | STAGE THREE | STAGE FOUR | STAGE FIVE | ADDITIONAL COMMENTS

ADIB
Sector Average

STAGE ONE

ROE

	'08	'09	'10	'11
ADIB	15.8%	0.2%	18.6%	24.1%
Sector Average	*18.3%*	*10.6%*	*11.9%*	*17.6%*

STAGE TWO

Gearing

	'08	'09	'10	'11
ADIB	9.83	12.47	12.76	12.79
Sector Average	*10.59*	*10.92*	*10.88*	*10.61*

ROAA

	'08	'09	'10	'11
ADIB	1.80%	0.02%	1.54%	1.89%
Sector Average	*1.87%*	*1.09%*	*1.20%*	*1.72%*

STAGE THREE

Tier 1 ratio

	'08	'09	'10	'11
ADIB	13.5%	13.5%	12.2%	11.5%
Sector Average	*11.4%*	*13.8%*	*13.6%*	*13.1%*

IEA / TA

	'08	'09	'10	'11
ADIB	84.1%	86.0%	85.8%	86.4%
Sector Average	*84.5%*	*84.8%*	*84.7%*	*85.1%*

Revenue / average IEAs

	'08	'09	'10	'11
ADIB	4.7%	4.5%	4.8%	5.0%
Sector Average	*4.4%*	*4.3%*	*4.4%*	*4.5%*

Net Profit Margin

	'08	'09	'10	'11
ADIB	40.8%	0.6%	35.1%	41.6%
Sector Average	*50.1%*	*25.4%*	*29.8%*	*43.2%*

STAGE FOUR

TCR

	'08	'09	'10	'11
ADIB	11.6%	17.0%	15.4%	14.5%
Sector Average	*11.7%*	*18.2%*	*18.5%*	*18.2%*

Loans / IEAs

	'08	'09	'10	'11
ADIB	79.3%	73.4%	78.1%	79.4%
Sector Average	*83.2%*	*81.1%*	*80.9%*	*81.6%*

Interest Margins

	'08	'09	'10	'11
ADIB	4.39%	4.32%	4.41%	4.42%
Sector Average	*3.15%*	*3.38%*	*3.31%*	*3.32%*

Non II / average IEAs

	'08	'09	'10	'11
ADIB	0.81%	0.65%	0.69%	0.80%
Sector Average	*1.32%*	*1.18%*	*1.12%*	*1.26%*

Op. Margin

	'08	'09	'10	'11
ADIB	57.4%	59.6%	57.9%	58.9%
Sector Average	*62.3%*	*66.3%*	*66.5%*	*67.0%*

Provn Margin

	'08	'09	'10	'11
ADIB	-11.3%	-47.1%	-18.3%	-14.4%
Sector Average	*-13.8%*	*-36.4%*	*-31.3%*	*-21.2%*

XYZ Margin

	'08	'09	'10	'11
ADIB	-5.3%	-11.9%	-4.5%	-3.0%
Sector Average	*1.6%*	*-4.5%*	*-5.4%*	*-2.5%*

STAGE FIVE

Spreads

	'08	'09	'10	'11
ADIB	4.41%	4.31%	4.41%	4.40%
Sector Average	*3.27%*	*3.35%*	*3.29%*	*3.29%*

Core to ave IEAs

	'08	'09	'10	'11
ADIB	0.36%	0.43%	0.59%	0.66%
Sector Average	*1.35%*	*1.11%*	*1.02%*	*1.11%*

Non-Core to ave IEAs

	'08	'09	'10	'11
ADIB	0.45%	0.22%	0.10%	0.14%
Sector Average	*-0.03%*	*0.07%*	*0.09%*	*0.16%*

Cost-Income Ratio

	'08	'09	'10	'11
ADIB	42.6%	40.4%	42.1%	41.1%
Sector Average	*37.7%*	*33.7%*	*33.5%*	*33.0%*

Net Provisioning

	'08	'09	'10	'11
ADIB	0.94%	3.34%	1.30%	1.00%
Sector Average	*0.98%*	*2.00%*	*1.60%*	*1.16%*

ADDITIONAL COMMENTS

NPL ratio

	'08	'09	'10	'11
ADIB	3.85%	9.87%	8.80%	8.36%
Sector Average	*2.51%*	*5.21%*	*5.73%*	*5.49%*

Source: Company reports, Rasmala forecasts

Income statement

Dhm	FY08A	FY09A	FY10F	FY11F	FY12F
Net interest income	1728	2109	2572	2981	3361
Non-interest income	357.3	357.3	424.7	575.6	717.4
Total income	**2086**	**2466**	**2997**	**3557**	**4078**
Operating costs	-887.8	-996.4	-1261	-1462	-1574
Goodwill (amort/impaired)	n/a	n/a	n/a	n/a	n/a
Other costs	0.00	0.00	0.00	0.00	0.00
Pre-prov operating profit	1198	1469	1736	2095	2504
Provisions charges	-346.9	-1391	-572.6	-510.7	-421.8
Post-prov op prof	851.1	78.2	1163	1584	2082
Associates (pre-tax)	0.00	-3.22	10.6	16.2	35.7
Other pre-tax items	0.00	0.00	0.00	0.00	0.00
Reported PTP	**851.1**	**75.0**	**1174**	**1600**	**2118**
Taxation	-1.03	-1.03	-1.00	-1.36	-1.80
Minority interests	0.21	-0.25	-0.16	-0.16	-0.16
Preference dividends	0.00	-60.0	-120.0	-120.0	-120.0
Other post-tax items	1.03	64.0	124.0	124.9	125.9
Reported net profit	**851.3**	**77.8**	**1176**	**1604**	**2122**
Tot normalised items	0.00	0.00	0.00	0.00	0.00
Normalised PTP	851.1	75.0	1174	1600	2118
Normalised net profit	851.3	77.8	1176	1604	2122

Source: Company data, Rasmala forecasts — year to Dec

Balance sheet

Dhm	FY08A	FY09A	FY10F	FY11F	FY12F
Net loans to customers	34179	40474	48806	57533	66205
Other int earn assets	8897	14658	13666	14959	16882
Goodwill	0.00	0.00	0.00	0.00	0.00
Oth non-int earn assets	3442	3194	3754	4470	5268
Total assets	**51210**	**64084**	**72799**	**83925**	**96132**
Total customer deposits	37486	48220	55395	64437	73488
Oth int-bearing liabs	6514	6424	6495	7230	8583
Non int-bearing liab	2000	2297	3200	3692	4512
Total liabilities	**46000**	**56940**	**65090**	**75360**	**86583**
Share capital	5207	5141	5706	6562	7546
Reserves	0.00	0.00	0.00	0.00	0.00
Total equity (excl min)	**5207**	**7141**	**7706**	**8562**	**9546**
Minority interests	2.60	2.86	3.01	3.01	3.01
Total liab & sh equity	**51210**	**64084**	**72799**	**83925**	**96132**
Risk weighted assets	39619	49516	59660	70328	80929
Est non-perf loans	n/a	n/a	n/a	n/a	n/a
Specific provisions	-589.3	-1751	-2265	-2730	-3097
General provisions	n/a	n/a	n/a	n/a	n/a

Source: Company data, Rasmala forecasts — year ended Dec

Capital

Dhm	FY08A	FY09A	FY10F	FY11F	FY12F
Risk weighted assets	39619	49516	59660	70328	80929
Reported net profit	851.3	77.8	1176	1604	2122
Opening risk assets	29142	39619	49516	59660	70328
Closing risk assets	39619	49516	59660	70328	80929
Change in risk assets	10477	9897	10144	10668	10601
Capital required	1048	989.7	1014	1067	1060
Free capital flow	-196.5	-851.9	282.0	657.0	1182
Ordinary dividend paid	-425.6	0.00	-561.2	-623.0	-1011
Share buy back/spec div	0.00	0.00	0.00	0.00	0.00
Equity / preference issue	0.00	0.00	0.00	0.00	0.00
Cash flow from financing	-425.6	0.00	-561.2	-623.0	-1011
Net capital flow	-622.1	-851.9	-279.2	34.0	170.1
Tier 1 capital	5581	7169	7662	8511	9487
Tier 1 capital ratio (%)	14.1	14.5	12.8	12.1	11.7

Source: Company data, Rasmala forecasts — year to Dec

Recommendation structure

Absolute performance, long term (fundamental) recommendation: The recommendation is based on implied upside/downside for the stock from the target price and only reflects capital appreciation. A Buy/Sell implies upside/downside of 10% or more and a Hold less than 10%.

Performance parameters and horizon: Given the volatility of share prices and our pre-disposition not to change recommendations frequently, these performance parameters should be interpreted flexibly. Performance in this context only reflects capital appreciation and the horizon is 12 months.

Market or sector view: This view is the responsibility of the strategy team and a relative call on the performance of the market/sector relative to the region. Overweight/Underweight implies upside/downside of 10% or more and Neutral implies less than 10% upside/downside.

Target price: The target price is the level the stock should currently trade at if the market were to accept the analyst's view of the stock and if the necessary catalysts were in place to effect this change in perception within the performance horizon. In this way, therefore, the target price abstracts from the need to take a view on the market or sector. If it is felt that the catalysts are not fully in place to effect a re-rating of the stock to its warranted value, the target price will differ from 'fair' value.

Valuation and risks to target price

Abu Dhabi Islamic Bank (RIC: ADIB.AD, Rec: Buy, CP: Dh3.18, TP: Dh3.65): Downside risks to our GGM-based valuation and target price include a severe decline in Abu Dhabi real estate prices and management not being able to achieve its core business targets of 25% ROE, a cost-to-income ratio of 33% and annual growth of 20%.

Disclaimer