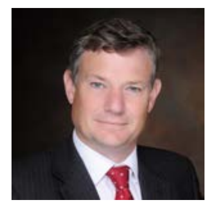
BANKING ON FURTHER KUWAITI CATALYSTS

OCTOBER 2018

Upon returning from our November 2017 research visit to Kuwait, we felt confident the economy was on improved footing after what had been an extended hangover from the 2008 financial crisis. However, what stopped us from getting more excited at the time was the fact many stocks had rallied hard on FTSE Russell's announcement to move Kuwait to its Emerging Markets Index. Despite some positive meetings and witnessing companies making decent fundamental improvements, valuations appeared rich and we felt comfortable maintaining our significant country-level underweight.



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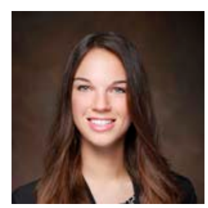

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Almost a year on, the first phase of Kuwait's move to FTSE's Emerging Markets Index is complete. The risk/reward is looking more attractive and the banking system continues to recover as margins expand on rate hikes, a pick-up in loan growth and continued improvement in asset quality. Financials analyst Iona Dent returned to Kuwait in September to get a sense of conditions on the ground and revisit our investment thesis across the banking and real estate sectors.

- The economy has stabilised and corporates are confident about the macro outlook. At the current oil price, Kuwait should achieve a fiscal surplus of about 13.5% this year, with a current account surplus of 12%.[1]
- Our confidence in the banking sector has improved considerably. Project spending and associated loan growth is feeding through, margin expansion is playing out on rising interest rates and there is evidence of loan loss provisions normalising over the medium term.
- Longer term, the trends to watch for include the establishment of mortgage laws and an increasing preference for Islamic banking services – both of which could be significant catalysts for select companies.
- As we become more excited about Kuwait's opportunities and find companies with improved corporate governance and growth opportunities, we have been gradually lifting our allocation and it now stands at nearly 20% of our portfolios. This takes our long-held and significant country underweight to just 2% below the index's allocation, as at the end of September 2018.

[1] IMF, 2018

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Our trip included meetings with seven of the ten banks in the Kuwaiti system. Each of the banks we met with spoke of having solid loan growth pipelines, largely associated with increased government spending on projects. Government budget execution has improved substantially and project approval is accelerating via a more streamlined political process.

Management teams were optimistic about the country’s outlook with Kuwait set to register a fiscal and current account surplus this year. GDP growth should accelerate in 2019 – with support from higher oil prices, increased oil production, project spending and delayed austerity measures. For example, the implementation of VAT and excise taxes is being pushed back to 2021.

We met with Kuwait’s largest bank, the National Bank of Kuwait (NBK), which is a core holding in our Frontier portfolio, due to its high quality and leading retail franchise. The bank looks well positioned to capitalise on the increased project spending, given its large balance sheet and the concentrated structure of the Kuwaiti banking system, of which NBK has a 30%[2] market share. Returns have been held back by excess provisioning, but we see this normalising over the next two years and return on equity (ROE) should climb from approximately 10% to 15%[3]. However, provisioning has not held back the share price and the stock has rallied since 2016.

The highlight meeting was with a subsidiary bank of NBK, Boubyan Bank, which has a niche in Islamic banking services. This is a sector growing faster than, and that could overtake, conventional banking. Demand for Islamic services has rocketed in recent years, a trend likely to accelerate. According to experts we met, 70% of Kuwaiti locals would prefer Islamic if given the choice between two otherwise similar accounts.

After being founded in 2004, the bank had a 2% share of the market in 2010, but now commands 8.5%[4] and is competing with the sector’s largest players. Being a relatively young bank bodes well for asset quality, as it does not have the same legacy issues as other banks. It also has a consumer loan book 100% payroll-backed – another indicator of its high quality. Other competitive advantages include

[2] Source: T. Rowe Price
[3] Source: T. Rowe Price
[4] Source: T. Rowe Price

Boubyan's early investment in digital and customer services, which has led to some tech-savvy systems. This has helped attract a young customer base, with an average age below 30 years old.

A discussion referenced in multiple meetings was mortgage law. There is currently no mortgage law in Kuwait, which means there are no mortgages. Instead there is a major onus on consumer and installment financing. The new mortgage law has been drafted by committees within the Central Bank and is set to be agreed by 2021, which would effectively allow customers to borrow about 3x what they can now for house purchases. This could be a significant catalyst, especially for banks with strong retail franchises and capital bases. We see both NBK and Boubyan as potential beneficiaries.

Aside from the banks, we took a site tour to a new mall operated by Mabanee, a new real estate holding in the strategy. The mall felt more like an 'experience' than just a place to go shopping – with two hotels, numerous restaurants and many visitors clearly there to mingle and dine, as well as shop. Since the mall's opening this summer, foot traffic has averaged 100k a day and multinational chain Sephora's outlet in this mall is its most profitable globally.

The pace of store openings is accelerating and today the mall is close to 90% occupancy, which is likely to tick to full capacity soon, ahead of an opening of a further phase of the mall. After a period of flattish earnings, we expect a gradual return to growth, as revenues from the new mall catch up with costs.

Returning from the trip, we are far more optimistic about Kuwait's fundamental outlook and about both the medium and longer-term outlook for the banking sector. Higher conviction has translated into new positions, with the added catalyst of higher investor interest given Kuwait's inclusion in FTSE's Emerging Index. MSCI's own index review cycle should have an additional impact, with Kuwait likely moving to the MSCI Emerging Markets Index in 2020.

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