

## Bank of Palestine

### Recent Developments and Highlights

We reiterate our buy recommendation at a price objective of **USD 2.89**. Bank of Palestine was able to accelerate growth of credit facilities during one of the hardest times for the Palestinian economy, while the whole region is going through a never seen before turmoil. But the bank's minor increase in profits during the second quarter made us change our estimates regarding the estimated net income of the bank in 2012 from USD 40.36 million to USD 37 million.

### Further growth in H1 2012 in terms of credit facilities, while deposits and profitability remained almost stable

Net credit facilities grew to USD 839 million in the second quarter of 2012 compared to USD 745 million reported in the end of Q1 2012, a 12.6% increase in only one quarter. This growth was mostly due to several new loan programs the bank has launched during the period, including a unique Real Estate loan program that was not previously available in Palestine.

Net income amounted to USD 16.84 million, compared to USD 16.80 during the same period last year, a very modest increase compared to the substantial growth in credit facilities. The drop in profit margin witnessed this year was mostly due to an increase in employee compensation expense.

### Downside risks

The Palestinian economy remains one of our major concerns in our valuation, even though BOP was not severely affected by the economic conditions yet, the current fiscal position of the Palestinian Authority (PA), the high unemployment rates, the budget deficit and the deteriorating living conditions of the people in Palestine are all alarming signs.

### Key Financial Highlights

	2010	2011	Q1 2012	H1 2012	2012 E
# of Shares (million)	100	120	120	134	134
Stock Price (USD)	3.4	2.6	2.75	2.7	2.8
Interest Income (USD m)	50.58	65.48	17.96	35.76	73.34
Net income (USD m)	30.12	33.98	13.17	16.84	37
EPS (USD)	0.30	0.28	0.11	0.13	0.28
P/E	11.29	9.29	9.76	10.38	11.7
Sh. Equity (USD m)	163.31	194.40	209.50	206.55	211
BV per share (USD)	1.63	1.62	1.75	1.54	1.57
P/BV	2.08	1.60	1.57	1.60	2.24

Source: Bank of Palestine, Bloomberg, Awraq Investments

October 10, 2012

Recommendation: Buy

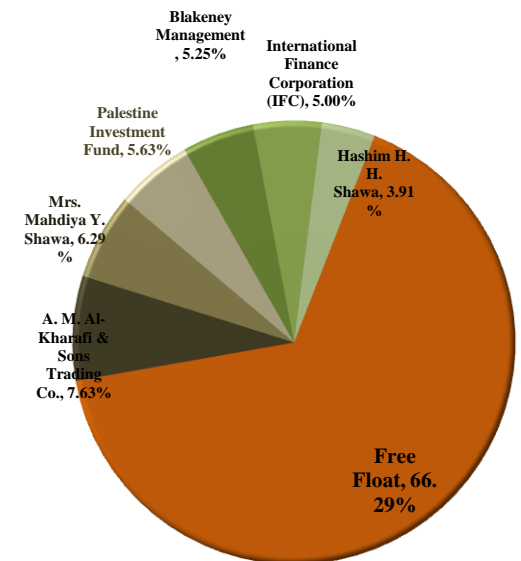
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Stock Data	
Price*	2.60
Fair Value	2.89
Market Cap (Mn)	348.400
52 Week High	3.22
52 Week Low	2.59
Bloomberg	BOP PS
Free Float	66.29%

\* Price as of 8 October 2012

Figure1: Ownership Structure



Source: BOP annual report

## **Economy Brief**

The Palestinian Authority's (PA) fiscal position remains challenging, where revenue collection is still under the budget target, and the deficit being above the budget. The government owes more than USD 1.1 billion in bank loans and about USD 400 million in unpaid revenues to private sector contractors.

According to the IMF, the PA did not increase its borrowings from domestic banking sector during the first quarter of the year. However, during the second quarter this position has changed, where during May and June government borrowing from the banks has increased by USD 300 million, which caused the Governor of the Palestinian Monetary Authority (PMA) to advice banks not to lend the government any further unless donors start funding the government among concerns that the PA will not be able to pay the banks back.

In addition, the salaries of the public sector were delayed by a week in June. This combined with the high exchange rate between the NIS and the USD has troubled public sector workers, where they get their salaries in NIS but have to pay their loans in USD.

The PA has announced during August that its VAT rate will increase by one percent to 15.5%, which was estimated to bring in an extra USD 20 – 30 million of tax revenues per annum. However, the anticipated increase in VAT accompanied with the increase in the cost of fuel – which has gone up from USD 1.5 to USD 2 per litter in the last two months alone – were met with protests and demonstrations demanding decreases in taxes, better life conditions and decreasing fuel prices. The intensity of the demonstrations has forced Salam Fayyad, the Palestinian prime minister – who has been a key target of demonstrators – to unveil prices and tax cuts, including dropping fuel prices to their August levels, and reducing the VAT to 15% which he stated was the minimum the PA could afford at the moment.

Since year 2009, Consumer Price Inflation has increased by 2% in Gaza and 13% in the West Bank. Inflation in Palestine is mainly dependant on increases in global food and fuel prices. Also, according to the terms of the Paris Protocol, the PA's VAT rate cannot be more than two percentage points lower than the VAT rate in Israel, while gasoline prices must be within 15% of gasoline prices in Israel, which could be one of the main causes that the PA has increased gasoline prices and VAT rates since they have increased recently in Israel.

On the brighter side, during June the Arab states has pledged to provide the PA with USD 100 million each month as a backup if clearance revenues are withheld by Israel. In addition to a transfer of USD 25 million from Iraq - which was the first Iraqi contribution to the PA during the last decade - and a transfer of USD 100 million from Saudi Arabia during June to ease the fiscal conditions of the PA.

Luckily, the economic conditions did not affect the performance of the Bank of Palestine and we do not believe it might affect it severely in the near future. However, its instability remains a major concern to any business operating in the country.

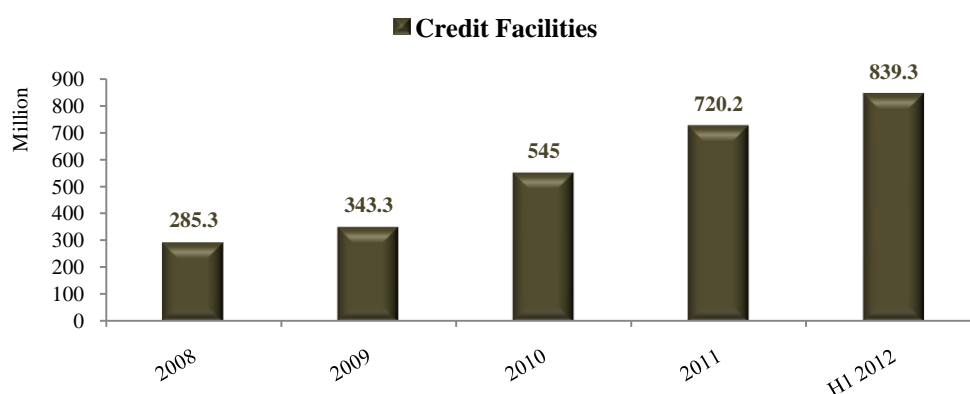
The real progress towards a more sustainable Palestinian economy is through the private sector, while the PA continues to raise domestic revenues and control its expenditures to lower its budget deficit, also a key step to the progress of the Palestinian economy is to remove the obstacles caused by the dissection of the Palestinian territories, where these obstacles constrain investment, raise costs and harm economic stability.

## **Bank of Palestine H1 Developments**

Bank of Palestine has witnessed an impressive quarter in terms of growth in credit facilities, where they grew from USD 744 million to USD 839 million in only three months, a growth of 12.8%, increasing the bank's market share to 22.02% compared to 20.54% at the beginning of the year. At the same time, the bank's provision of impairment of credit facilities dropped from USD 6.88 million in the beginning of the year to USD 6.38 million.

This impressive increase in credit facilities was due to several actions taken by the bank, since the beginning of the year the bank has funded several big projects in different sectors, in addition, the bank has launched a real estate loan program that was never available in Palestine before that grants loans up to USD 250 thousand and a payment period that could reach up to 25 years. Also the bank has opened several new branches and is currently establishing new ones that will be ready to operate by the end of this year.

**Figure 2: Bank of Palestine Credit Facilities**



Source: Annual reports of BOP

Although several programs were launched to increase deposits, growth in deposits remained sluggish during the second quarter; deposits grew only by 1.62% during the second quarter, compared to 3.12% in the first quarter mostly due to the competitiveness of the sector. The sluggish growth of deposits combined with the substantial increase in credit facilities has caused the loans-to-deposits ratio to increase from 56% to 62% during the second quarter. It should be noted that the bank has been witnessing a drop in deposits growth since 2011, where deposits grew only by 3.44% during that year.

The bank's capital adequacy ratio has increased from 13.57% in the beginning of the year to 14.07% by the end of H1 2012.

## **Profitability**

Interest income during H1 2012 has reached USD 35.76 million compared to USD 31.59 during the same period last year, an increase of 13.2%. Interest expense increased from USD 3.03 million to USD 3.98 million by the end of H1 2012, while Income from commissions increased by 9.7% to reach USD 9.69 million in H1 2012.

Although both interest and commission income increased substantially, net income has increased only by 0.22% to USD 16.835 during H1 2012 from USD 16.797 in the same period last year. This modest increase was due mostly to an increase in employees' expense

which increased from USD 11.99 in H1 2011 to reach USD 14.1 by the end of H1 2012, where the number of employees increased during that period from 1,015 to 1,097 employees, in addition to a provision to impairment of financial assets that amounted to USD 1.86 million.

### **Performance of other Palestinian Banks**

Credit facilities in Palestine grew from USD 3.495 billion in the beginning of the year to USD 3.794 billion by the end of H1 2012, an increase of 8.5%. The largest portion of this growth was witnessed in the second quarter of the year where facilities grew by 5.3% during that period. The majority of total credit facilities were granted by Jordanian bank branches operating in Palestine, where facilities granted by those banks amounted to USD 2 billion, a 3.5% increase than their level at the beginning of the year.

All listed Palestinian banks have witnessed a growth in their credit facilities during H1 2012 – except for PIBC which witnessed a drop of 1.79% - as the following table shows.

**Figure 3: Credit Facilities of Listed Palestinian Banks**

	2011	H1 2012	Growth
	USD (Mn)	USD(Mn)	%
<i>AIB</i>	133	149	11.48%
<i>AMB</i>	76	167	52.79%
<i>QUDS</i>	288	305	5.94%
<i>PIBC</i>	79	77	-1.79%
<i>PCB</i>	56	70	23.87%
<i>ISBK</i>	187	202	8.05%
<i>BOP</i>	720	839	16.56%

Source: Banks' Financials

It should be noted that although the size of BOP's loan portfolio is much larger than other listed Palestinian banks, making the bank incomparable to other listed banks in terms of growth, its portfolio grew by 16.56% since the beginning of the year, a substantial growth considering the loan portfolio size.

In terms of customers' deposits, the banks' performance has varied significantly, Al Rafah Microfinance Bank deposits grew by 19.18% during the period, due mostly to its current attractive rates. While the two largest Palestinian banks, BOP and QUDS, witnessed rates of 1.7% and -1.82% respectively.

**Figure 4: Customers' Deposits of Listed Palestinian Banks**

	2011	H1 2012	Growth
	USD(Mn)	USD(Mn)	%
<i>AIB</i>	74	85	14.24%
<i>AMB</i>	130	155	19.18%
<i>QUDS</i>	338	332	-1.82%
<i>PIBC</i>	136	131	-3.62%
<i>PCB</i>	115	122	6.24%
<i>ISBK</i>	93	89	-4.24%
<i>BOP</i>	1,337	1,360	1.72%

Source: Banks' Financials, rounded

Although credit facilities and deposits grew well during the period, the banks' profitability did not match such growth. All of the banks witnessed high growth in their interest income and commission's income – except for PIBC who witnessed a drop in interest income – but at the same time most of the banks witnessed a considerable drop in net income, BOP, ISBK and AMB being the exception.

The reasons behind the drop in profits varied across banks, QUDS bank witnessed a notable increase in employee compensation, while PCB witnessed losses in financial assets. As for ISBK major change in profitability, it was due to the bank taking several provisions in the same period during last year, while this year the bank did not add to those provisions.

**Figure 5: Income from operations of Listed Palestinian Banks**

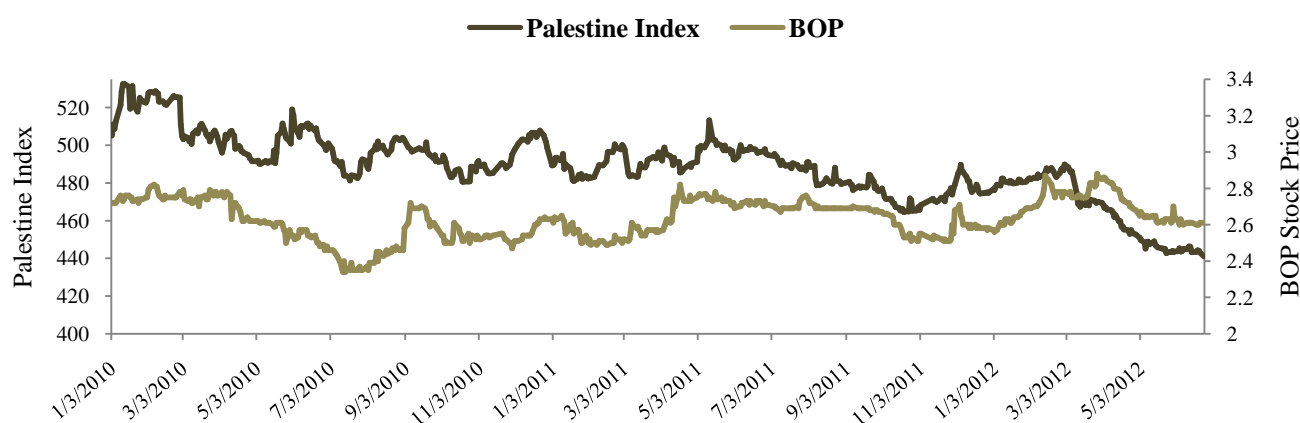
	Interest Income			Commissions Income			Net Income		
	H1 2011	H1 2012	Growth	H1 2011	H1 2012	Growth	H1 2011	H1 2012	Growth
	USD	USD	%	USD	USD	%	USD	USD	%
<i>AIB</i>	4,264,999	5,512,567	29.25%	506,828	637,513	25.78%	1,348,562	633,335	-53.04%
<i>AMB</i>	2,539,204	4,517,015	77.89%	583,758	1,126,969	93.05%	40,000	1,004,414	2411.04%
<i>QUDS</i>	9,027,070	10,098,398	11.87%	431,532	553,653	28.30%	2,356,461	1,632,587	-30.72%
<i>PIBC</i>	4,715,333	4,018,440	-14.78%	1,098,548	1,149,771	4.66%	580,391	573,015	-1.27%
<i>PCB</i>	3,055,344	3,367,386	10.21%	2,058,330	2,835,207	37.74%	238,134	(4,824)	-102.03%
<i>ISBK</i>	7,204,125	7,849,252	8.95%	1,078,572	1,224,964	13.57%	(641,956)	2,757,616	529.56%
<i>BOP</i>	31,592,177	35,764,226	13.21%	8,832,386	9,688,159	9.69%	16,797,705	16,835,128	0.22%

Source: Banks' Financials

### Stock Performance of Bank of Palestine

The year so far looks pretty dim for the Palestinian stock exchange, where the index has been dropping since the beginning of the year, especially since the beginning of the second quarter of the year where the drop began to escalate and eventually the index dropped 8% YTD. On the other hand, Bank of Palestine remained almost unaffected with the market drop, as its share price – using adjusted prices – maintained the same level they had at the beginning of the year, during the last three months the share remained trading around its USD 2.6 per share level.

**Figure 6: Palestine Stock Exchange Index & BOP Stock Price**



Source: Palestine Stock Exchange, using adjusted prices

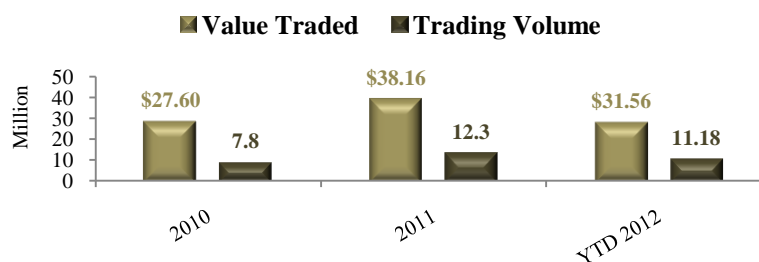
**Figure 7: Close Price & 52 weeks High & Low Prices**

	Close Price	52 Week High	52 Week Low
2010	3.4	3.78	3.15
2011	2.9	3.61	2.8
YTD 2012	2.6	3.22	2.59

Source: Palestine Stock Exchange  
 YTD 2012 as of 7 October, normal prices

In terms of trading value and volume, total volume traded YTD in the Palestine stock exchange has reached 104 million traded shares, a 26.7% drop from the same period last year, where traded volume amounted to 142 million. The drop in volume in addition to the general drop in the index has resulted in drop of 26.3% in value traded where it amounted to USD 196 million YTD. Even though the exchange has witnessed a drop in both volume and value, BOP's share trading volume has increased 55.1% to reach 11.9 million YTD, while trading value increased 34% to USD 33.6 million, showing that the bank's stock was not affected by the general conditions in the exchange and solidifying the stability of the stock.

**Figure 8: Value Traded & Trading Volume for BOP**



Source: Palestine Stock Exchange 2012 as of 7 October.

BOP remained the most traded bank in 2012 in terms of value and volume, the second most traded bank was the ISBK, were value traded amounted to USD 7.43 million in 2012 and volume reached 8.48 million shares.

**Figure 9: Value Traded for Palestinian Listed Banks**

	2011		YTD 2012	
	Value Traded	Trading Volume	Value Traded	Trading Volume
<i>BOP</i>	38,157,142	12,327,737	33,503,078	11,924,267
<i>AIB</i>	2,075,831	2,515,060	3,392,946	4,310,296
<i>AMB</i>	5,536,710	7,159,640	3,992,503	4,944,525
<i>ISBK</i>	6,750,276	7,822,799	7,425,573	8,475,416
<i>PIBC</i>	2,149,292	2,026,265	499,045	526,114
<i>QUDES</i>	3,857,226	3,520,768	505,480	531,841
<i>PCB</i>	2,081,120	2,695,278	240,568	300,932

Source: Palestine Stock Exchange  
 YTD 2012 as of 7 October.

## Valuation

In this valuation, we applied the Equity Cash Flow model, in addition to P/E peer valuation, giving the larger weight to the Equity Cash Flow model. The following is an overview of the banks included in the peer valuation. The selected banks include 4 banks in Jordan, one bank in Oman, UAE and Egypt. Although Bank of Palestine has the highest market capitalization compared to other listed banks in Palestine, it has the lowest between the considered peers.

**Figure 10: Peers considered for P/E valuation**

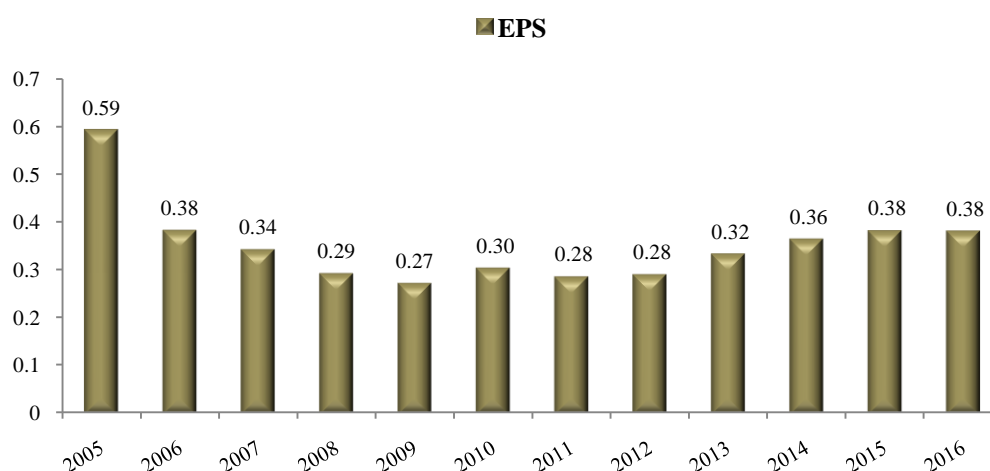
Name	Country	P/E
Bank Of Palestine	Palestine	11.35
Jordan Kuwait Bank	Jordan	8.05
Credit Agricole	Egypt	9.01
Bank of Jordan	Jordan	7.69
Cairo Amman Bank	Jordan	6.96
Bank Sohar	Oman	8.46
Commercial Bank	UAE	5.4
Jordan Ahli Bank	Jordan	7.57

Source: Bloomberg

Our discounted equity cash flow model yielded USD 3.04 per share. This is based on a 2% terminal growth rate, with 14.94% cost of equity, adjusted Beta of 0.72, market risk premium of 15% and risk free rate of 7.75%. We applied a weight of 90% to Equity Cash Flow model, and a weight of 10% to the P/E valuation. The P/E valuation yielded USD 2.37.

Bank of Palestine is the largest financial institution in Palestine and one of the major employers, yet we believe that the bank still has several growth areas that can be further explored, we expect that the additional branches to be opened, serving rural areas that are under served or not served at all, in addition to the possibility to branch out of the borders of Palestine will positively affect the future performance of the bank. We expect that credit facilities will grow 12% during 2012, 10% during 2013 and then growth will stabilize around 5% for the following years. EPS will maintain steady growth over the years as the following figure shows.

**Figure 11: Historical and Forecasted EPS**



Source : Bloomberg, Awraq investments



Our target price for Bank of Palestine is USD 3.04, 16% higher than the close price of USD 2.6 on October 8, 2012. Based on this valuation, our recommendation for Bank of Palestine is BUY. This valuation is based on the assumption that no major adverse events would happen throughout the forecast period. Should any negative developments arise, there could be a downside risk to our estimates.

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