Market Review: “Banks Lead Market Recovery”

Ahmed Tabaqchali, August 9th, 2020

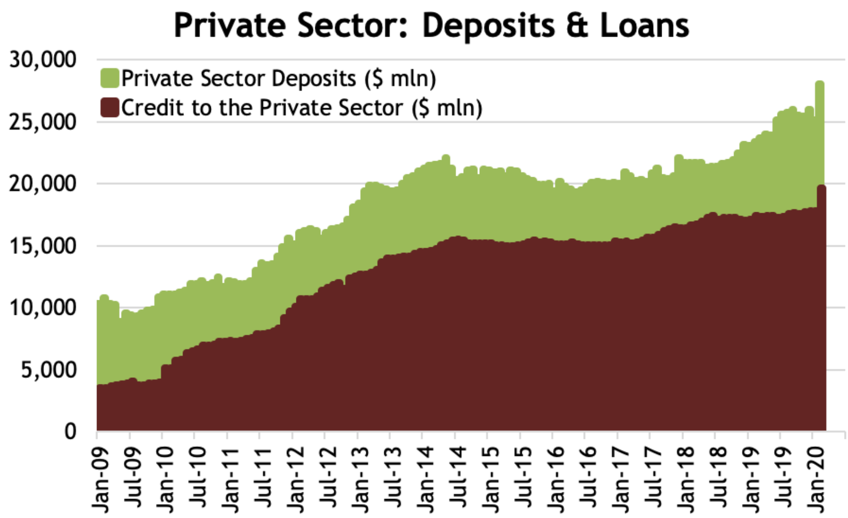
The extreme summer heat in July, much hotter this year than usual, and rising COVID-19 infections were supposed to keep a lid on the market’s activities. But the reverse happened as a revived banking sector led to increased trading activity and rising prices across the board. The market, as measured by the Rabee Securities RSISX USD Index (RSISUSD), was up 8.4% for the month, and up 25.8% from the multi-year lows in April, but the market is still down 6.4% for the year.

The revival of the banking sector was driven by the Bank of Baghdad (BBOB) and the National Bank of Iraq (BNOI) – among the top-quality banks in the country. Both reported strong first half 2020 results (H1/2020) which were discussed over Zoom conference calls – a first for these companies and for the Iraq Stock Exchange (ISX) (*links on the ISX organised calls for BBOB & BNOI in Arabic & English*). BBOB was up 28.6% for the month on the back of an increase of 12.9% in June, while BNOI was up 36.0% for the month, but was flat in June.

The unaudited results of the two banks highlight different aspects of the recovery in the banking sector, each reflecting the different dynamics of the two banks. For BBOB, the gradual recovery continues from the hangover following the heady expansion during the boom years up to 2014. Customer deposits for H1/2020 were up 4.1%, following recoveries of 2.4% and 5.2% in 2019 and 2018 respectively. Its loan book continues to decline, decreasing 4.5% in H1/2020, on the back of declines of 7.6% and 4.5% in 2019 and 2018 respectively. The results are consistent with the new management’s focus over the last few years on addressing the company specific issues and structural weaknesses that were exposed by the crisis of 2014-2017. Management’s success can be seen from H1/2020 pre-tax earnings which were 6.6% higher than the full year 2019 pre-tax earnings – which could indicate a doubling of full year pre-tax earnings should the second half of the year be a replay of the past.

For BNOI, growth continues to accelerate with customer deposits continuing to increase – up 66.2% in H1/2020, on the back of increases of 32.0% and 2.7% in 2019 and 2018 respectively. The loan book on the other hand was up 26.7% in H1/2020, following an increase of 119.9% in 2019 versus a contraction of 42.8% in 2018. Results were driven by management’s focus on growing the bank’s retail business where BNOI is emerging as a market leader. BNOI’s pre-tax earnings were 14.6% higher in H1/2020’s than those for the whole of 2019 which could lead to 130% growth for FY2020 if BNOI maintains the same momentum for the whole year. The success of BNOI’s retail strategy in attracting sticky consumer deposits, and subsequently growing its retail loan book, demonstrates the potential opportunity from banking adoption in Iraq’s cash dominated economy.

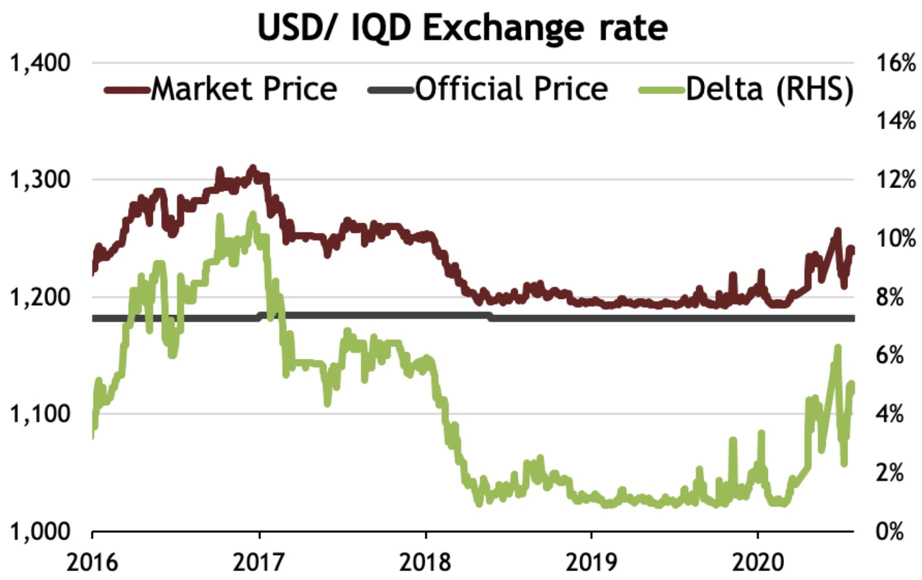
While the two banks benefited from strong execution by new management teams, both were helped by the recovery in private sector deposits and loans that began in 2018, as can be seen from the Central Bank of Iraq (CBI) data as of end of March (chart below).



(Source: Central Bank of Iraq, Asia Frontier Capital, data as March 31st)

The data does not reflect the effects of the lockdown that began mid-March on deposits and loans – both of which would likely have deteriorated, especially deposits as the private sector would have used them to finance operations. Nevertheless, the data are encouraging given that the economic slowdown for Iraq began with the start of nationwide demonstrations in October, then made worse by the events early in the year with the US assassination of Iran's top general in Baghdad and the subsequent Iranian rocket attacks on Iraqi military bases. The upshot is that any post-lockdown decline would take place from a higher base, which should alleviate the negative effect on banks.

Another tailwind for the banks in H1/2020, and probably for the rest of the year, is the increased spread between the official and market price of the exchange rate of the Iraqi Dinar (IQD) versus the USD, which benefits the banks' FX spreads and thus their earnings. Interestingly, this is the mirror image of what occurred in 2018 (chart below) that hurt their earnings and led to accelerated selloff's in the sector.



(Source: Central Bank of Iraq, Iraqi Foreign Exchange Houses, Asia Frontier Capital, data as of July 28th)

Typically, the market price of the USD trades at a premium to the official price, but spikes higher during periods of uncertainty or crises. The crisis of 2014-2017 led to a prolonged period of high premiums which was a boon to bank earnings during the difficult phase in which deposits declined and non-performing loans rose sharply. The end of conflict and a recovery of oil prices resulted in sustained premium declines which hurt banks' earnings disproportionally as the sectors' recovery was yet to take place. The momentous events at the start of the year, that raised the spectre of a US-Iran proxy war fought in the country, led to a spike in the premium, followed by a further spike to more elevated levels as the lockdown came into full effect. These elevated levels continued even though the full lockdown came to an end, as the government's newly imposed rolling curfews on Thursday-Saturday as part of its COVID-19 containment efforts meant that the five-day working week has been cut down by one day, to Sunday-Wednesday.

The banks were not the only ones performing much better than feared, as both Pepsi bottler, Baghdad Soft Drinks (IBSD), and mobile phone operator, AsiaCell (TASC), declared strong dividends. IBSD increased its dividend by 50% year-over-year to yield 5.6%, and the stock rallied 11.1% for the month. TASC on the other hand, maintained its high dividend of the last few years and declared a 14.3% dividend yield. This compares to yields of 12.2%, 12.0% and 14.3% for the last three years. TASC was up 14.4% for the month.

The market's recovery over the last three months notwithstanding, arguably the claim made here in May still stands: that the 'worst-case' prognosis for Iraq in the wake of the carnage brought about by COVID-19 was not as bad as originally feared, however the market still continues to price it in.