

“Banks to Fuel the Market’s Next Phase”

Ahmed Tabaqchali, September 4^h, 2023

The market, as measured by the Rabee Securities RSISX USD Index, was up 16.3% for the month and up 65.5% for the year.

As argued here over the last few months, most recently in “[Market Rallies as it Begins to Discount the Budget’s Passage](#)”, that the 2023-5 budget following its passage in June would lead to sizeable liquidity injections into the economy. This in combination with the positive global [macro-economic](#) developments, will drive economic growth that would eventually feed into meaningful growth in corporate profits, which in turn would sustain the market’s current rally. The banking sector, in particular the top-quality banks, are likely to be key beneficiaries of this emerging economic growth that would come with an increased adoption of banking, and a move away from the dominance of cash as both a store of value and a means of economic exchange. The thrust of AFC Iraq Fund investment thesis for the banking sector, as discussed in “[Banks & the Iraq Investment Thesis](#)” in February 2022, is that increased adoption of banking would come with growth in bank lending resulting in an expansion in the money circulating in the economy and consequently to an increase in non-oil GDP. Over time, banks’ earnings should grow substantially, leading to meaningful increases in their valuations, and ultimately feed into much higher market multiples.

This thesis is getting a substantial boost from a potent combination of recent fundamental and technical developments, that promises to accelerate the adoption of banking, and bring about a transformation of the sector and its role in the economy. Such a transformation should lead to a sustainable strong earnings growth, particularly for the top-quality banks, which would provide the fuel for the stock market’s next phase. The recent fundamental developments have come about as a consequence of the currency’s [upheavals](#), following the Central Bank of Iraq’s (CBI) new procedural requirements for its provisioning of U.S. dollars (USD) for importers in mid-November 2022. In the ensuing months, the CBI introduced a raft of measures to further regulate cross-border transfers, accelerate the adoption of banking, and strengthen the banking system – all of which have led to meaningful increases in new banking customers, growth in deposits and loan books, that have disproportionately benefited the top-quality banks (*).

While more time is needed for these developments to shape these banks’ future earnings profiles as they adapt their strategies and infrastructures, nevertheless, a glimpse of an emerging strong earnings profile can be had from the just-released second quarter earnings for 2023. The tables below feature four of the top-quality banks, of which three are among the top constituents of the RSISX USD Index (**). The tables compare selected balance sheet and income statement metrics for the second quarter of 2023 versus the first quarter to highlight the near-term changes as the CBI’s measures came into effect; and versus the second quarter of the prior year to highlight the scale of these changes.

Selected Balance Sheet and Income Statement Metrics

Selected Balance Sheet Metrics for Q2/2023	Cash Balances		Loan Book		Deposits	
	vs. Q1/2023	vs. Q2/2022	vs. Q1/2023	vs. Q2/2022	vs. Q1/2023	vs. Q2/2022
Bank of Baghdad (BBOB)	26%	35%	-7%	-40%	7%	23%
Commercial Bank of Iraq (BCOI)	35%	56%	0%	-49%	-5%	28%
Mansour Bank (BMNS)	17%	44%	4%	48%	19%	58%
National Bank of Iraq (BNOI)	16%	206%	18%	28%	21%	113%

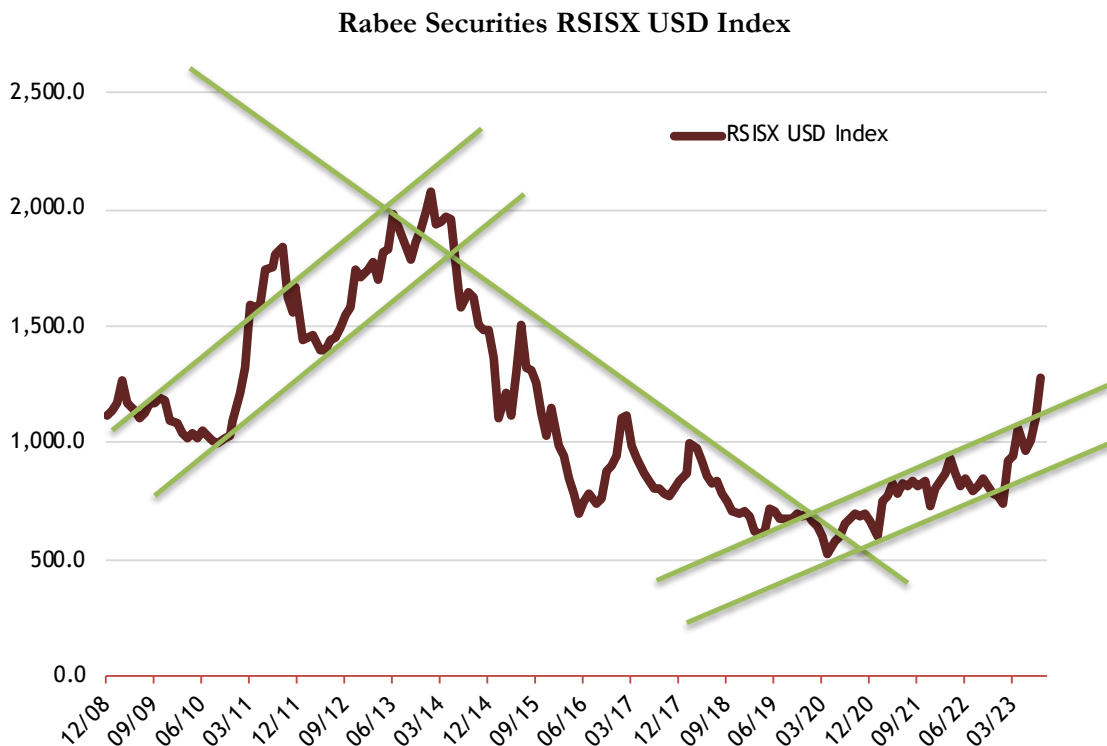
Selected Income Statement Metrics for Q2/2023	Net Commission Income		Net Interest Income		Net Pre-tax Income	
	vs. Q1/2023	vs. Q2/2022	vs. Q1/2023	vs. Q2/2022	vs. Q1/2023	vs. Q2/2022
Bank of Baghdad (BBOB)	66%	115%	-1%	34%	26%	205%
Commercial Bank of Iraq (BCOI)	21%	38%	-4%	4%	N/M	211%
Mansour Bank (BMNS)	170%	238%	5%	76%	89%	247%
National Bank of Iraq (BNOI)	125%	605%	31%	21%	88%	258%

(Source: [Rabee Securities](#), AFC Research, data are of un-audited quarterly reports. Note: Deposits include margin accounts that are associated with trade finance; Commission income is mainly derived from cross-border transfer fees; interest income includes interest income from investments that are primarily in Iraqi sovereign bonds)

Cementing this emerging leading market position for the top-quality banks was the latest of the CBI's [measures](#), in early August 2023, mandating all banks to increase their capital to no less than Iraqi dinar (IQD) 400 bn (USD 308 mn) by the end of 2024 – representing an increase of up 60% as most banks' capital base is IQD 250 bn. Additionally, foreign banks' branches are mandated to increase their working capital by no less than 60% of their operating capital by the end of 2023. Significantly, should any of the banks fail to comply with these mandates, then the CBI would initiate a merger, an acquisition, or a liquidation of such banks.

The technical development boosting the banking sector, would come about as banks increase their capital by up to 60% – in three stages as mandated by the CBI by the end of 2024 – through either a series of rights issues, stock dividends or a combination of the two. The peculiarities of the securities' regulation, and of the stock market action before and after a rights issue or stock dividend issuance could have major effects on the banking stocks' future prices. The first peculiarity is a stock's par value is always IQD 1.0, and as such rights issues are priced at par value irrespective of the stock's market price. While the second peculiarity is that stock prices don't always adjust fully for the effects of a rights issue or an issuance of a stock dividend – in other words, stock prices post-rights issues or ex-dividend don't decline proportionally to compensate for the rights issue or the stock-dividend's issuance. These peculiarities, when the market momentum is strong, can lead to a buying frenzy in a stock, that is expected to have a capital increase, ahead of the company's annual general meeting (AGM) that would drive the stock's price substantially above IQD 1.0 to provide holders the opportunity to own more of the stock at discounts to the market price. A sector-wide capital increase, under such a scenario, can lead to a substantial rally in the sector that could move the market.

The three-year period following the last time the CBI mandated sharp bank capital increases in late October 2010 illustrates the effects of the abovementioned peculiarities on the stock market. Then, the CBI mandated banks to increase their capital to IQD 100 bn by mid-2011, to IQD 150 bn by mid-2012, and then to IQD 250 bn by mid-2013. Subsequently, between October 2010 and the peak in January 2014 the Rabee Securities RSISX USD Index, increased by 102.7% in three phases – the first an increase of 80.2% between October 2010 and September 2011, followed by a correction of 24.0% by the end of May 2012, and finally by a further rally of 48.0% by the end of January 2014. The rally's peak was soon followed by the fall of Mosul to ISIS in June 2014 and the multi-year crises that led to a brutal bear-market that saw the market decline by 68.0% by the end of 2020 (chart below).



(Source: Rabee Securities, AFC Research, data as of August 31st 2023)

It's a major market fallacy, and folly in the extreme to expect that history would repeat in this case with the RSISX USD Index's future returns mirroring those of October 2010-January 2014. Moreover, Iraq's recent history of conflict, and extreme leverage to volatile oil prices, cautions against such excessive optimism. However, it's important to highlight that the earnings' profiles, the quality of earnings, and the opportunity of the top-quality banks are all substantially better than those that prevailed in the prior cycle. An improvement brought about by the increased adoption of banking since then, and the top-quality banks' strategies to address the structural weaknesses that were exposed in the 2014-17 crisis (see "[Banks & the Iraq Investment Thesis](#)" and ** below), as well the recent significant fundamental developments discussed above. Finally, the RSISX USD Index's even after its 65.5% increase year-to-date, is still 38.1% below its January 2014 peak (above chart).

Notes:

(*) Background to the currency's upheavals: As written here a few [months](#) ago, the CBI, as part of an ongoing process of encouraging the move towards the adoption of banking and away from the informality that dominates economic activity, implemented in mid-November 2022 new procedural requirements to those for its provisioning of USD for importers. These procedural requirements would bring the country's cross-border fund transfers in-line with global standards, which require a high level of transparency. However, they represented a seismic shift to the country's cash-dominated economy, in which large informal sectors drive the bulk of economic activity. As such, the introduction of the new procedural requirements had an immediate detrimental effect on the volumes of the CBI's daily USD-IQD transactions for cross-border fund transfers, which led to a supply-demand mismatch and consequently to a depreciation in the market price of the IQD versus the USD, and with those the currency's upheavals. Further reviews of these upheavals are: "[Currency Upheavals Disrupt Market Activity](#)" in January 2023; "[Market Begins to Discount Currency Upheavals](#)" in February 2023; "[Dinar Revalued Upwards, Market Shrugs](#)" in March 2023; "[Tag Ends of Currency Upheaval Sparks Market Rally](#)" in May 2023; and "[Market Takes a Breather, While the Currency Stabilises](#)" in June 2023.

(**) Prior market reports reviewed earnings profiles and business strategies of the National Bank of Iraq (BNOI) in "[The Opportunity in Retail Banking](#)" in April 2022, and of the Bank of Baghdad (BOB) in "[Banks and the Predictability of Earnings](#)" in November 2022.

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