# Equity Research - Lebanese Banks - Q3/16 Preview

**Although the banking sector is likely to benefit from recent BDL debt swap transactions through higher balance sheet growth and profitability, our view remains tampered by weaker operating environment and significant exposure to riskier sovereign debt**

**Banking sector growth in assets, deposits and loans at respective +6%, +4% and +7% YoY in Q2/16 while banks operate in weaker macro environment with particular pressure on BDL f/x reserves:** Lebanese banks maintain growth momentum although constrained by unfavorable economic conditions and political standstill delaying structural reforms. Wider trade and fiscal deficits, lower GDP growth estimates and decline in capital inflows fueled macroeconomic concerns given growing public debt and weaker BDL f/x reserves, likely triggering BDL's latest ~USD 10 billion debt swap. The operation resulted in unabsorbed LBP liquidity and material gains for banks, part of which should support the banks' recapitalization ahead of IFRS 9 requirements starting in 2018, while boosting the Central Bank's weaker net f/x reserves. Banks are expected to have materially benefited from multiple transactions, particularly in a context of tightening funding conditions, mostly from the non-resident component given challenged regional economic conditions, and significant exposure to riskier sovereign debt weighing on their credit risk. Net profits of Alpha banks rose +8% YoY in Q2/16. Assets reached USD 207 billion in Q2/16 growing 1.5% YTD after registering subdued growth in Q1/16. Deposits were up 1.2% YTD mainly from growth in domestic deposits and continue to fund 82% of the banking sector's assets which largely exceed the economy's size with an estimated asset/GDP ratio at ~400%. Lending (claims on resident private sector in LBP and foreign currency) grew +3% YTD with total loans at USD 66 billion, supported by BDL's stimulus package targeting housing and productive sectors.

**Low single-digit balance sheet growth for banks under coverage expected in Q3/16e as competition for deposits and quality lending increases domestically:** Bank Audi and Byblos Bank saw above sector QoQ growth in assets and deposits in Q2/16 at +2%/+2% for Bank Audi and +2%/+2% for Byblos Bank, while Blom Bank underperformed at +1%/+1%. On a YoY basis, assets and deposit growth was at -1%/-3% for Bank Audi and +3%/+3% for Blom Bank while Byblos Bank outperformed with YoY growth at +7%/+7%. Loans growth QoQ/YoY at +2%/+8% for Bank Audi, +1%/+5% for Blom Bank and +3%/+7% for Byblos Bank. LDR for Blom Bank and Byblos Bank came in at ~29% and at ~53% for Bank Audi, well above the sector's average of ~32%, helped by Egypt and Turkey with LDRs at respective ~66% and ~91%. For Q3/16e, we expect unfavorable economic conditions to continue to weigh on balance sheet growth particularly as competition over deposits and high quality corporate loans tightens. We forecast QoQ growth in assets and loans respectively at +2%/+3% for Bank Audi, +1%/+2% for Blom Bank and +3%/+3% for Byblos Bank while deposits expected to grow +3% for Bank Audi, +2% for Blom Bank and +3% for Byblos Bank, helped by rebound in non-resident deposits resulting from recent BDL debt swap transactions.

**Bottom line of banks under coverage helped by non-interest income, improvement in NIMs and cost containment efforts although loan loss provisions forecasted higher:** Lebanese banks continue to witness improvement in NIMs on higher spreads in LBP and USD at respectively +28 bps and +18 bps on improved asset yields from more attractive liquidity avenues at +30 bps in LBP and +31 bps in USD, despite tighter funding costs (COF) (for July 2016, COF in USD +13 bps YoY and COF in LBP +2 bps). We expect banks under coverage to see higher total operating income YoY mainly driven by i) balance sheet/NIM improvement particularly stemming from foreign operations, ii) higher trading and investment income partly from financial gains made on Central Bank debt swap transactions, and iii) higher net fees and commissions income to a lesser extent. We forecast higher loan loss provisions YoY in Q3/16e with estimated annualized cost of risk at respective 172 bps, 79 bps and 132 bps for Bank Audi, Blom Bank and Byblos Bank from higher financial gains while NPL levels remain contained. Bottom line of banks under coverage continues to benefit from cost containment efforts while higher operating income also expected to keep cost-to-income ratios stable to lower. We estimate YoY growth in net profits in Q3/16e for Bank Audi at +14% (EPS at USD 0.26 and BVPS at USD 7.66), +18% for Blom Bank (EPS at USD 0.55 and BVPS at USD 11.71) and -15% for Byblos Bank (EPS at USD 0.04 and BVPS at USD 2.17). For 2016e, we expect net profits to reach USD 454.5 million for Bank Audi (EPS at USD 1.02 and BVPS at USD 7.81), USD 467.1 million for Blom Bank (EPS at USD 2.21 and BVPS at USD 12.07) and USD 144.7 million for Byblos Bank (EPS at USD 0.18 and BVPS at USD 2.18).

**Although banks are expected to benefit from BDL debt swap transactions through higher deposits and liquidity, we expect trading multiples to remain capped by challenging macro/political environment weighing on investor sentiment:** We expect the banks' exposure to riskier and more challenging domestic environment to continue discouraging investor enthusiasm which should limit multiple expansion despite Central Bank support in preserving banking sector stability. In this context, contribution from foreign operations should remain a key source of earnings and balance sheet growth while interest in domestic capital markets should increase with more favorable macro environment and increased capital market regulations, likely to be triggered by improved political institutions, much needed structural reforms and stability in neighboring countries.

**Table 1: FFA Private Bank - Lebanese Banks Coverage**

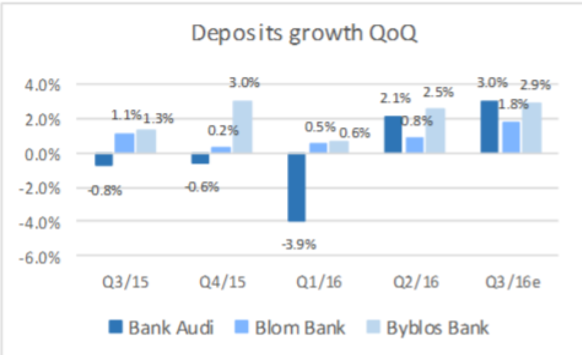
| Company | Symbol | Recommendation | Target Price | Share Price * | YTD Change | P/E ** | P/B to common | Dividend Yield *** |
|---|---|---|---|---|---|---|---|---|
| BANK AUDI | (AUDI LB) | MARKETWEIGHT | USD 7.00 | USD 6.20 | +2.5% | 6.5x | 0.87x | 6.5% |
| BLOM BANK | (BLOM LB) | OVERWEIGHT | USD 11.50 | USD 10.10 | +7.4% | 4.9x | 0.89x | 8.2% |
| BYBLOS BANK | (BYB LB) | MARKETWEIGHT | USD 1.55 | USD 1.64 | +1.9% | 7.8x | 0.76x | 8.1% |

Source: Company reports, BSE, FFA Private Bank estimates Note:* October 21, 2016 market close, **Based on TTM EPS, *** Based on approved dividends for 2015 results

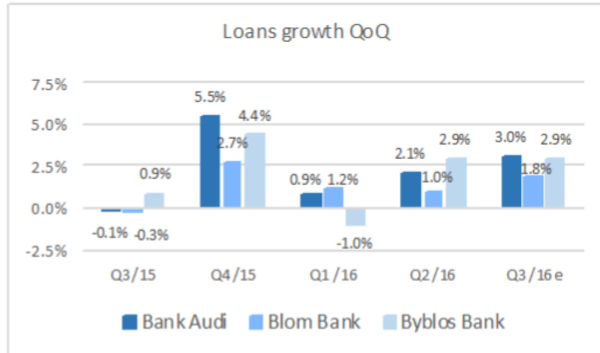
**We maintain our target prices unchanged for Bank Audi, Blom Bank and Byblos Bank and note that Blom Bank is the sole Overweight in our coverage universe:** We maintain our target prices for Bank Audi, Blom Bank and Byblos Bank unchanged at USD 7.00, USD 11.50 and USD 1.55 respectively. We note that Blom Bank is the sole Overweight in our coverage universe, given its higher quality core income, above average margins, efficiencies, stable growth in earnings, solid capitalization, sizable liquidity and conservative approach to growth. While Bank Audi is Marketweight, we see upside on account of efforts to improve profitability and diversify risk through geographical expansion.

# Banks Under Coverage - Comparative Snapshots

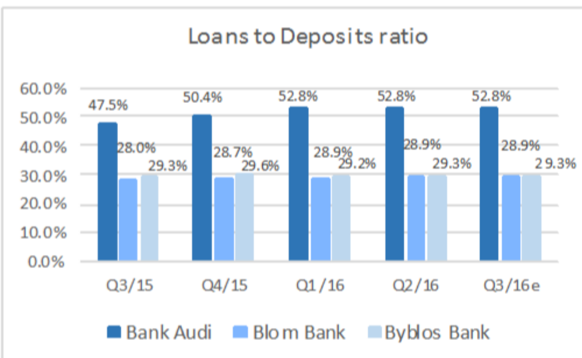
**We expect higher QoQ deposit growth for Bank Audi, Blom Bank and Byblos Bank helped by a rebound in non-resident deposits resulting from BDL's recent debt swap**



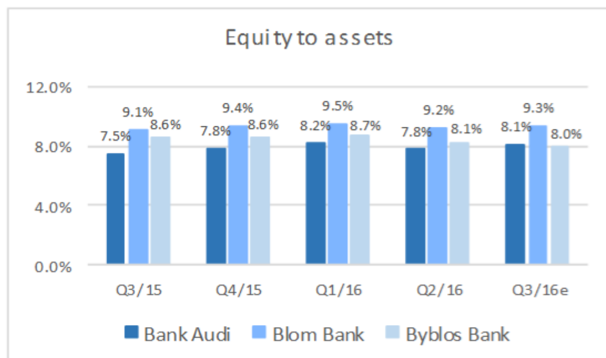

**We estimate stronger QoQ loan growth for Bank Audi and Blom Bank at respective 3.0% and 1.8% likely helped by higher lending growth in foreign operations while Byblos Bank loan growth forecasted at 2.9% QoQ**



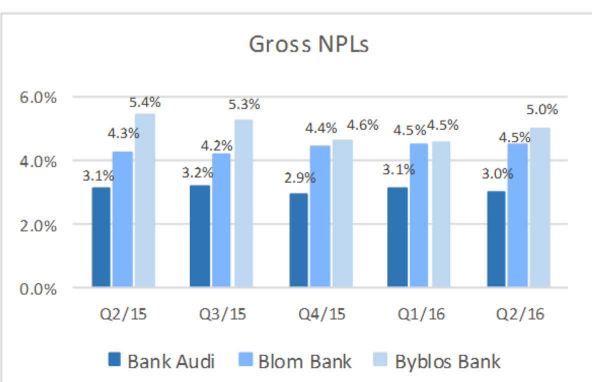

**Bank Audi's LDR forecasted at ~53%, still well above sector's average (~32%), while Blom Bank and Byblos Bank's LDRs expected stable at ~29% in Q3/16e**



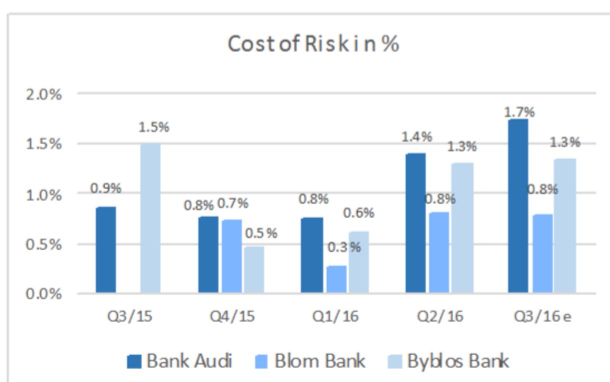

**Bank Audi and Byblos Bank capitalization ratio expected at respective 8.1% and 8.0% in Q3/16e while Blom Bank expected to maintain highest capitalization among banks under coverage with E/A ratio forecasted at 9.3%.**




**Stable NPL formation in Q2/16 for Bank Audi and Blom Bank, while Byblos Bank NPLs trended higher reaching ~5% amid increased attention to credit quality in the**

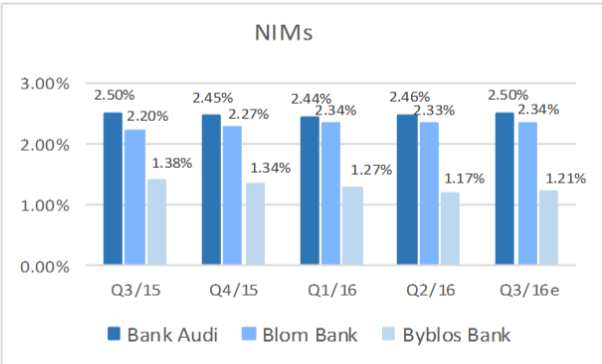



**Cost of risk expected higher QoQ for Bank Audi and stable for Blom Bank and Byblos Bank while NPLs remain contained as we forecast above average non-interest income near Q2/16 levels**

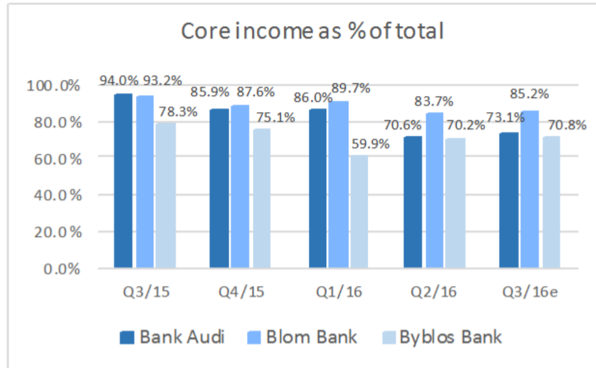



Source: Company reports and FFA Private Bank estimates

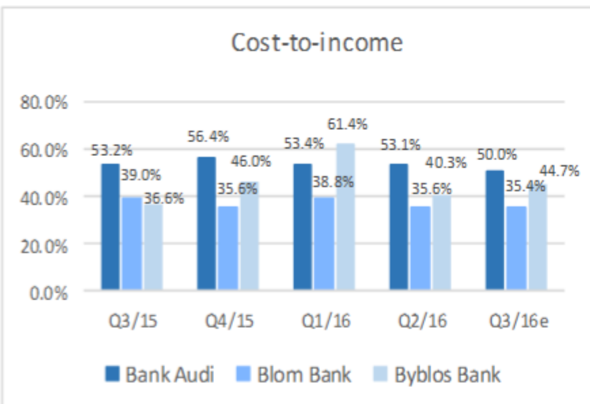
**We estimate higher NIMs QoQ for banks under coverage on account of higher spreads domestically in addition to favorable yields in foreign operations for Bank Audi and Blom Bank while Byblos Bank recovers from weak Q2/16**



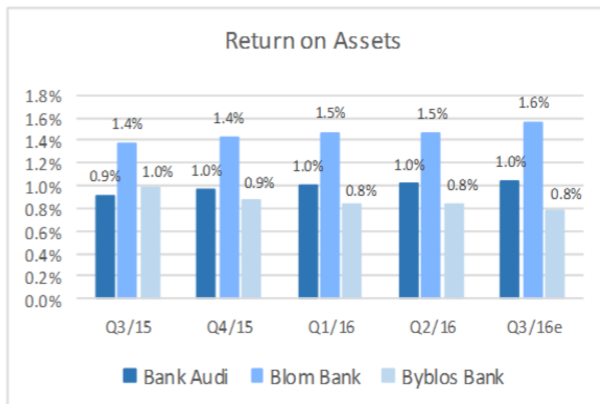

**We expect slight improvement in core income for banks under coverage in Q3/16e on the back of stronger financial gains related to BDL debt swap in Q2/16 and Q3/16e**



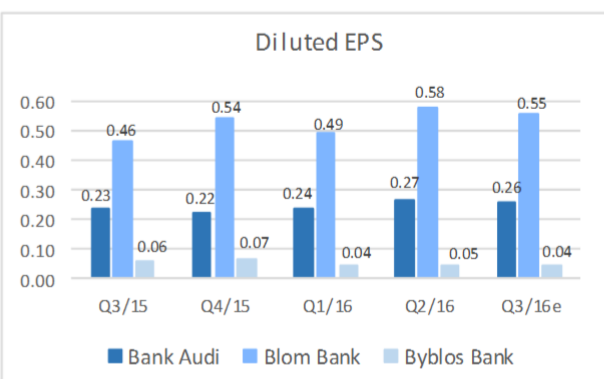

**We expect QoQ efficiency gains for Bank Audi from improved Odea profitability. Cost-to-income expected to increase Byblos Bank while roughly stable for Blom Bank**



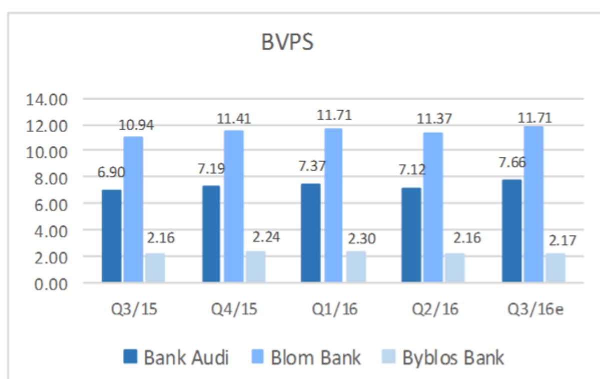

**Improved profitability forecasted for Blom Bank at 1.6% in Q3/16e while estimated stable at 1.0% for Bank Audi and 0.8% for Byblos Bank**




**We highlight lower QoQ EPS growth for banks under coverage in Q3/16e following strong performance in Q2/16**




**We forecast higher BVPS sequentially for Bank Audi, Blom Bank and Byblos Bank in Q3/16e**




Source: Company reports and FFA Private Bank estimates

# BANK AUDI

### Company Description

Bank Audi is the largest bank in Lebanon in terms of assets with an asset base in Q2/16 at USD 42.0 billion as well as earnings at USD 115.5 million. The Bank had a total of 226 branches and 7,209 employees as of Q2/16 with operations in its domestic market Lebanon as well as across Europe, MENA and Turkey. The Bank's diversification across markets translates into a breakdown of assets and earnings between domestic and international at a respective 52%/48% and 49%/51% in Q2/16. In terms of assets, Turkey is currently the biggest international market for Bank Audi with 25% of total assets. The current strategy is geared towards three key markets: Lebanon, Turkey and Egypt. We highlight the Bank's relatively sound asset quality (gross NPL ratio at 3.0% in Q2/16) amidst a difficult backdrop, balance sheet growth and consolidated margins to remain favorably impacted by higher margins driven largely by Turkey as they converge towards Turkish sector average.

### Q2/16 Key Financial Highlights

**Net profits at USD 115 million in Q2/16 ( +5% QoQ, +13% YoY)**

- Net interest income registered at USD 253 million in Q2/16 (+3% QoQ, +8% YoY) with YoY improvement on higher NIMs. We estimate net interest margins at 2.45% in Q2/16 vs. 2.43% in Q1/16 and 2.24% in Q2/15.
- Non-interest income increased significantly in Q2/16 from higher trading & investment income at USD 132 million (+273% YoY) while net fees & commissions came in lower at USD 64 million (-4% YoY). Revenue breakdown for Q2/16 reflects less favorable income mix quality QoQ with core income (net interest income + fees & commissions income) contribution to total operating income at 71% in Q2/16, deteriorating from 89% in Q2/15.
- Bank Audi saw a slight improvement in efficiency in Q2/16 as cost-to income came in at 53.1% (still above pre-Turkey expansion levels) from 53.4% in Q1/16 and 54.2% in Q2/15 helped by higher operating income in Q2/16.
- Bank Audi's consolidated gross NPLs were at 3.0%, slightly below Q1/16 and Q2/15 level of 3.1% and still lower than peers under coverage. Cost of risk rose to an estimated 139 bps in Q2/16, from an estimated 75 bps in Q1/16 and 67 bps in Q2/15 on higher provisioning levels at USD 64 million (+88% QoQ, +125% YoY).
- Despite FX pressures in key international markets and challenging domestic operating conditions, assets, deposits and loans grew +2% sequentially in Q2/16 to respective USD 42 billion, USD 35 billion and USD 18 billion. However on a YoY basis, assets and deposits declined –1% and –3% respectively from Q2/15. Loans outperformed at USD 18 billion, growing +8% YoY.

### Latest Key Regional Highlights

- Bank Audi's breakdown of assets and earnings between domestic and international operations stood at 52%/48% and 49%/51% in Q2/16.
- Odea Bank accumulated USD 11 billion in total assets representing 25% of the group assets and is seeking to benefit from operating leverage as branch network expands (56 branches including kiosks) and gains maturity. Odea Bank reported profits of USD 16 million in Q2/16, representing ~10% of consolidated net profits. We expect Odea Bank's profitability to continue to improve as margins, efficiencies and LDRs move higher and closer to peers, driving its share of consolidated net profits considerably higher.
- In Q2/16, the Group had USD 5 billion in assets in Egypt and generated USD 17 million in earnings accounting for 11% of consolidated assets and 20% of total profits.
- The Bank's current key pillar markets are: Lebanon, Turkey and Egypt.

### FFA Model Assumptions

- We forecast net profits at USD 116.9 million in Q3/16e (+1% QoQ, +14% YoY).
- We expect net interest income at USD 263.6 million in Q3/16e (+4% QoQ, +1% YoY) with Turkish operations continuing to help with higher earning assets and margins improvement as Turkish banks typically boast higher margins and as branches gain maturity.
- Net fees and commissions expected to reach USD 69.3 million in Q3/16e (+8% QoQ, -3% YoY).
- We expect assets, deposits and loans to grow by respectively +2% QoQ /+1% YoY, +3% QoQ /+1 YoY, +3% QoQ /+12% YoY.
- LDR is expected at 52.8% in Q3/16e, unchanged from Q2/16 and above Q2/15 level of 47.5%.
- We forecast net provisions of USD 81.8 million in Q3/16e with an estimated annualized cost of risk of 112 bps for 2016e.
- Our estimate for cost-to-income in Q3/16e is at 50.0%.
- Looking at 2016e, net profits should reach USD 454.5 million (+13% YoY) with EPS at USD 1.02 (+12% YoY), driven by stronger operating income and higher margins.

### Table 2: FFA Model Forecasts

| USD Million | FFA Q3/16e | Q2/16a | Q3/15a | QoQ% | YoY% | FFA 2016e |
|---|---|---|---|---|---|---|
| Net Interest Income | 263.6 | 253.2 | 260.3 | 4% | 1% | 1,033.1 |
| Fees & commissions income | 69.3 | 64.0 | 71.4 | 8% | -3% | 265.7 |
| Trading & investment income | 122.4 | 132.4 | 20.8 | -8% | 488% | 363.0 |
| **Operating Income** | 455.2 | 449.6 | 352.5 | 1% | 29% | 1,661.8 |
| Provisions | -81.8 | -64.0 | -36.6 | 28% | 123% | -216.7 |
| Operating expenses | -227.8 | -239.1 | -187.7 | -5% | 21% | -879.2 |
| Income tax | -29.2 | -31.4 | -26.2 | -7% | 11% | -112.9 |
| **Net Profits** | 116.9 | 115.5 | 102.1 | 1% | 14% | 454.5 |
| Diluted EPS | 0.26 | 0.27 | 0.23 | -3% | 11% | 1.02 |
| Assets | 42,965 | 41,938 | 42,358 | 2% | 1% | 43,811 |
| Deposits | 36,040 | 34,993 | 35,829 | 3% | 1% | 36,761 |
| Loans | 19,018 | 18,466 | 17,015 | 3% | 12% | 19,398 |
| BVPS to common | 7.66 | 7.12 | 6.90 | 8% | 11% | 7.81 |
| FFA Net interest margins | 2.50% | 2.46% | 2.50% | | | 2.41% |
| Core income to total operating income | 73.1% | 70.6% | 94.1% | | | 78.2% |
| FFA Cost-to income ratio | 50.0% | 53.1% | 53.2% | | | 52.9% |
| Immediate liquidity-to-deposits ratio | 36.2% | 34.9% | 36.4% | | | 36.1% |
| Loans-to-deposits ratio | 52.8% | 52.8% | 47.5% | | | 52.8% |
| Equity-to-asset ratio | 8.1% | 7.8% | 7.5% | | | 8.1% |

Source: Company reports and FFA Private Bank estimates

### Investment Opinion

**We value Bank Audi's domestic leadership, asset quality and margins, and expect investors to gain confidence in its growth plan as higher quality earnings accelerate and risk diversifies away from its domestic market**

Bank Audi is the largest Alpha bank in Lebanon in terms of balance sheet size with a demonstrated franchise and the confidence of its clients in Lebanon and abroad. We value its fundamentals mainly from the preservation of its asset quality and interest margins as well as an ambitious expansion strategy in Turkey that is materializing into assets diversifying away from Lebanon's risk and towards gradually higher margins and trade finance driving higher quality core income despite some room for improvement on Tier 1 capital. We continue to rate Bank Audi shares at Marketweight although see upside on account of: i) Turkey expansion with balance sheet expected to increase from one-quarter to one-third of total balance sheet by M-T ii) Egypt balance sheet expansion potentially reaching USD 10 billion by M-T iii) international expansion coupled with continued growth in domestic market should drive assets to target USD 55 billion by M-T, which on improved profitability should accelerate earnings and diversify risk.

### Target Price Revision and Recommendation

**We reiterate our Marketweight rating on Bank Audi shares and maintain our fair value unchanged at USD 7.00 per share**

Based on our revised forecasts and discount rate assumptions to our Dividend Discount Model, we maintain our fair value estimate for Bank Audi unchanged at USD 7.00 and reiterate our Marketweight rating. Our DDM assumes a 13.0% discount rate and a 3.0% terminal growth rate. We corroborate our DDM valuation by means of the residual income method as well as historical and comparable P/E and P/B multiples.

### Key Investment Risks

Key investment risks include credit, interest rate, sovereign, economic/political and foreign operations risks.

# BLOM BANK

### Company Description

Blom Bank is the second largest bank in Lebanon in terms of assets with an asset base in Q2/16 at USD 29.5 billion as well as earnings at USD 118.4 million. The Bank had a total of 259 branches and 4,963 employees as of the end of Q2/16 with operations in its domestic market Lebanon as well as across Europe and the MENA region. The Bank's diversification across markets translated into a breakdown of assets and earnings between domestic and international at 78%/22% and 72%/28% respectively in Q2/16. The Bank's main geographic markets are Lebanon and MENA led by Egypt and Jordan. The Bank has so far adopted a conservative approach to growth translating into ample liquidity buffers and solid capitalization. We also note that Blom Bank has surpassed its peers in terms of earnings stability, interest margins and cost-efficiencies.

### Q2/16 Key Financial Highlights

**Net profits at USD 118 million in Q2/16 (+9% QoQ, +19% YoY)**

- Net interest income came in at USD 167 million in Q2/16 ( flat QoQ, +12% YoY) helped YoY by higher NIMs (more favorable asset yields despite higher cost of funds) and balance sheet improvement YoY to a lesser extent, although muted sequentially. We estimate NIMs at 2.33% in Q2/16, above Blom Bank's targeted range of 2.00%-2.20%, vs. 2.34% in Q1/16 and 2.14% in Q2/15.
- Non-interest income came in at USD 78 million in Q2/16 (+42% YoY) on stronger trading & investment income at USD 40 million (+158% YoY), while fees & commissions income came in lower at USD 38 million (-3% YoY). Revenue breakdown for Q2/16 reflects a deterioration income mix quality with core income (net interest income + fees & commissions income) contribution to total operating income at ~84% up from ~90% in Q1/16 and ~92% in Q2/15.
- Blom Bank saw improved efficiencies in Q2/16 with cost-to-income at 35.6%, below Q1/16 level of 38.8% and 39.4% in Q2/15, still reflecting higher efficiencies vs. peers under coverage. Blom Bank's gross NPLs were stable QoQ around 4.5% and higher than 4.3% in Q2/15 while cost of risk increased to an estimated 81 bps in Q2/16, vs. an estimated 25 bps in Q1/16 and 5 bps in Q2/15, on materially higher provisioning levels at USD 15 million in Q2/16 vs. USD 1 million in Q2/15.
- Despite YoY improvement, balance sheet growth was sequentially subdued, likely on challenging domestic operating conditions and FX pressure. Assets grew to USD 29 billion (+1% QoQ, +3% YoY), deposits at USD 25 billion (+1% QoQ, +3% YoY) while loans outpaced at USD 7 billion (+1% QoQ, +5% YoY) despite concerns around the sector's lending environment.
- Blom Bank continues to boast the highest capitalization among peers under coverage. Capital adequacy ratio (as per Basel III) came in at 18.0%, unchanged from Q1/16 level, well above BDL's requirement of 12.0% for 2015. TTM ROA estimated at 1.5% and TTM ROE estimated at 16.8%.

### Latest Key Regional Highlights

- Blom Bank breakdown of assets and earnings between domestic and international operations stands at 78%/22% and 72%/28% respectively in Q2/16.
- At the end of Q2/16, the Group had around USD 2.5 billion in assets in Egypt and generated USD 14.1 million in net earnings accounting for around ~9% of consolidated assets and ~12% of consolidated profits.
- The Bank's key pillar markets are: Lebanon and Egypt.

### FFA Model Assumptions

- We expect net profits of USD 117.2 million in Q3/16e (-1% QoQ, +18% YoY).
- We expect net interest income at USD 171.0 million in Q3/16e (+2% QoQ, +10% YoY).
- Net fees and commissions expected at USD 38.5 million in Q3/16e (flat QoQ; +8% YoY).
- We expect provisions of USD 14.8 million equivalent to an estimated annualized cost of risk at 60 bps for 2016e.
- We estimate cost-to-income at 35.4% in Q3/16e, below Q2/16 level of 35.6% and Q3/15 level of 39.0%.
- We expect assets, deposits and loans to grow by respectively +1% QoQ /+3% YoY , +2% QoQ /+3% YoY , +2% QoQ /+7% YoY.
- At these growth levels, LDR should be at 28.9% in Q3/16e.
- For the year 2016e, net profits should reach USD 467.1 million (+15% YoY) with EPS expected at USD 2.21 (+19% YoY).

**Table 3: FFA Model Forecasts**

| USD Million | FFA Q3/16e | Q2/16a | Q3/15a | QoQ% | YoY% | FFA 2016e |
|---|---|---|---|---|---|---|
| Net Interest Income | 171.0 | 167.4 | 155.2 | 2% | 10% | 682.1 |
| Fees & commissions income | 38.5 | 38.4 | 35.6 | 0% | 8% | 154.5 |
| Trading & investment income | 36.2 | 40.1 | 14.0 | -10% | 159% | 132.4 |
| **Operating Income** | 245.7 | 245.8 | 204.8 | 0% | 20% | 969.0 |
| Provisions | -14.8 | -14.7 | 0.2 | 1% | -7789% | -45.7 |
| Operating expenses | -87.1 | -87.6 | -79.8 | -1% | 9% | -350.0 |
| Income tax | -26.6 | -24.9 | -25.8 | 7% | 3% | -106.4 |
| **Net Profits** | 117.2 | 118.4 | 99.4 | -1% | 18% | 467.1 |
| Diluted EPS | 0.55 | 0.58 | 0.46 | -5% | 20% | 2.21 |
| Assets | 29,934 | 29,502 | 28,931 | 1% | 3% | 30,407 |
| Deposits | 25,869 | 25,413 | 25,029 | 2% | 3% | 26,257 |
| Loans | 7,485 | 7,353 | 7,004 | 2% | 7% | 7,598 |
| BVPS to common | 11.71 | 11.37 | 10.94 | 3% | 7% | 12.07 |
| FFA Net interest margins | 2.34% | 2.33% | 2.20% | | | 2.30% |
| Core income to total operating income | 85.2% | 83.7% | 93.2% | | | 86.3% |
| FFA Cost-to income ratio | 35.4% | 35.6% | 39.0% | | | 36.1% |
| Immediate liquidity-to-deposits ratio | 48.4% | 48.6% | 48.5% | | | 48.6% |
| Loans-to-deposits ratio | 28.9% | 28.9% | 28.0% | | | 28.9% |
| Equity-to-asset ratio | 9.3% | 9.2% | 9.1% | | | 9.5% |

Source: Company reports and FFA Private Bank estimates

## Investment Opinion

**We view Blom Bank's higher returns and solid liquidity and capitalization levels as a reflection of a prudent management team and highlight the Bank's ability to propose higher dividends on account of lower than average payouts and excess capital buffers**

We recognize Blom Bank's solid positioning in its domestic market. We highlight the firm's conservative strategy focusing on preserving asset quality and higher capitalization ratios which translates in lower cost of risk and excess common equity Tier 1 capital respectively. We highlight Blom Bank's superior profitability and return ratios relative to its domestic peers from relatively higher margins and operating efficiencies, despite sizeable liquidity buffers. We also value Blom Bank's higher quality core income which translates into steady earnings growth while dividends should continue to benefit from lower than average payouts and above average excess Tier 1 common equity capital.

## Target Price Revision and Recommendation

**We reiterate our Overweight rating on Blom Bank shares and maintain our fair value unchanged at USD 11.50 per share**

Based on our revised forecasts and discount rate assumptions to our Dividend Discount Model, we maintain our fair value estimate for Blom Bank at USD 11.50 per share and reiterate our Overweight rating. Our DDM assumes a 14.0% discount rate and a 3.0% terminal growth rate. We corroborate our DDM valuation by means of the residual income method as well as historical and comparable P/E and P/B multiples.

## Key Investment Risks

Key investment risks include credit, interest rate, sovereign, economic/political and foreign operations risks.

# BYBLOS BANK

## Company Description

Byblos Bank is the third largest bank in Lebanon in terms of assets with an asset base in Q2/16 at USD 20.4 billion as well as earnings at USD 40.0 million. The Bank had a total of 105 branches and 2,548 employees as of end of December 2015 with operations in Lebanon as well as across Europe, Africa and the MENA region. The Bank's diversification across markets is lagging behind its peers with a breakdown of assets between domestic and international at ~91%/9% for 2015. The Bank's balance sheet is mainly focused on Lebanon. The Bank has so far adopted a conservative growth strategy translating into ample liquidity levels and solid capitalization at the expense of weaker margins and profitability.

## Q2/16 Key Financial Highlights

**Net profits at USD 40 million in Q2/16 (+18% QoQ, +9% YoY)**

- Net interest income was at USD 59 million in Q2/16 (-6% QoQ, -9% YoY) mainly on softer interest margins despite above average growth in balance sheet. We estimate weaker interest margins on a QoQ and YoY in Q2/16 at 1.16% vs. 1.26% in Q1/16 and 1.36% in Q2/15.
- Non-interest income was at USD 53 million in Q2/16 (-30% QoQ, -10% YoY) with fees & commissions income at USD 20 million (flat QoQ, flat YoY), on substantial decrease in trading & investment income to USD 33 million (-41% QoQ, -15% YoY). Despite an improvement in Byblos Bank's income quality mix, it remains at lower end of our coverage universe with revenue breakdown showing core income (net interest income + net fees & commissions income) contribution to total operating income increasing to 70% in Q2/16 from 60% in Q1/16 and 68% in Q2/15.
- Cost of risk rose significantly in Q2/16 to an estimated 129 bps from 62 bps in Q1/16 and 58 bps in Q2/15 on higher provisioning which increased to USD 16 million in Q2/16 up from USD 8 million in Q1/16 and USD 7 million in Q2/15.
- Assets and deposits grew at +2% in Q2/16 to USD 20 billion and USD 17 billion respectively while loans outperformed at +3% to USD 5 billion. On a YoY basis, assets and loans grew ~7% range despite concerns around slowing economic activity which was expected to pressure balance sheet growth.
- Assets continue to be largely funded by deposits at ~84% while LDR remains below Lebanese banking sector average (~32%). Immediate liquidity to deposits ratio (including cash and balances with Central Banks and interbank placements) came in lower sequentially at ~43% in Q2/16 vs. ~45% in Q1/16.
- Profitability ratios were slightly lower with TTM ROA at an estimated 0.83% in Q2/16 and TTM ROE at an estimated 10.0% in Q2/16, still at the lower end of our coverage universe.

## Latest Key Regional Highlights

- Byblos Bank breakdown of assets between domestic and international operations stands at ~91%/9% for 2015.

## FFA Model Assumptions

- We expect net profits of USD 36.8 million in Q3/16e (-6% QoQ, -15% YoY).
- We forecast net interest income of USD 62.5 million in Q3/16e (+6% QoQ, -5% YoY).
- Net fees and commissions expected at USD 19.9 million in Q3/16e (+4% QoQ, -2% YoY).
- We expect assets, deposits and loans to grow by a respective +3% QoQ /+8% YoY, +3% QoQ /+9% YoY, +3% QoQ /+9% YoY.
- At these growth levels, LDR should be at 29.3%, unchanged from Q2/16 and Q3/15 levels.
- We forecast provisions of USD 17.1 million in Q3/16e equivalent to an estimated annualized cost of risk at 93 bps for 2016e.
- Our cost-to-income estimate is at 44.7% for Q3/16e .
- Looking at 2016e, net profits should reach USD 144.7 million (-8% YoY) with EPS at USD 0.18 (-13% YoY).

**Table 4: FFA Model Forecasts**

| USD Million | FFA Q3/16e | Q2/16a | Q3/15a | QoQ% | YoY% | FFA 2016e |
|---|---|---|---|---|---|---|
| Net Interest Income | 62.5 | 58.8 | 65.9 | 6% | -5% | 248.6 |
| Fees & commissions income | 19.9 | 19.2 | 20.3 | 4% | -2% | 78.9 |
| Trading & investment income | 33.9 | 33.0 | 23.9 | 3% | 42% | 151.8 |
| **Operating Income** | 116.3 | 111.0 | 110.1 | 5% | 6% | 479.3 |
| Provisions | -17.1 | -16.2 | -16.8 | 5% | 1% | -48.7 |
| Operating expenses | -52.0 | -44.7 | -40.2 | 16% | 29% | -242.7 |
| Income tax | -10.4 | -10.9 | -9.5 | -5% | 9% | -43.2 |
| **Net Profits** | 36.8 | 39.2 | 43.6 | -6% | -15% | 144.7 |
| Diluted EPS | 0.04 | 0.05 | 0.06 | -8% | -24% | 0.18 |
| Assets | 20,965 | 20,434 | 19,347 | 3% | 8% | 21,208 |
| Deposits | 17,642 | 17,150 | 16,154 | 3% | 9% | 17,904 |
| Loans | 5,171 | 5,024 | 4,726 | 3% | 9% | 5,263 |
| BVPS to common | 2.17 | 2.16 | 2.16 | 0% | 0% | 2.18 |
| FFA Net interest margins | 1.21% | 1.17% | 1.38% | | | 1.19% |
| Core income to total operating income | 70.8% | 70.2% | 78.3% | | | 68.3% |
| FFA Cost-to income ratio | 44.7% | 40.3% | 36.5% | | | 50.6% |
| Immediate liquidity-to-deposits ratio | 43.0% | 43.3% | 42.7% | | | 42.6% |
| Loans-to-deposits ratio | 29.3% | 29.3% | 29.3% | | | 29.4% |
| Equity-to-asset ratio | 8.0% | 8.1% | 8.6% | | | 7.9% |

Source: Company reports and FFA Private Bank estimates

## Investment Opinion

**While we like Byblos Bank's solid domestic retail franchise with strong risk management practices, we believe additional value could be generated for investors by providing additional visibility on its growth plan via geographic diversification and new business segments**
We recognize Byblos Bank's position in its domestic retail market as well as its capacity to show sizeable liquidity buffers and superior asset/ liability management practices, a validation of management's risk practices although at the detriment to profitability ratios. We also recognize the firm's leadership at better managing its asset/liability mismatch with the issuance of costlier longer term liabilities. We believe Byblos Bank's shares could generate more value once the firm provides visibility on its business plan. We favor further efforts towards both organic and inorganic growth targeting geographical expansion and new business segments with focus on new markets and private banking/asset management which would respectively improve interest margins and core income.

## Target Price Revision and Recommendation

**We reiterate our Marketweight rating on Byblos Bank shares and maintain our fair value unchanged at USD 1.55 per share**
Based on our revised forecasts and discount rate assumptions to our Dividend Discount Model, we maintain our fair value estimate for Byblos Bank at USD 1.55 and reiterate our Marketweight rating. Our DDM assumes a 14.5% discount rate and a 3.0% terminal growth rate. We corroborate our DDM valuation by means of the residual income method as well as historical and comparable P/E and P/B multiples.

## Key Investment Risks

Key investment risks include credit, interest rate, sovereign, economic/political and foreign operations risks.

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