FFA Private Bank s.a.l.

Flash Note
September 03, 2014

Bank Audi: Highlights on its Growth Strategy and Capital Increase

Sector: Banking
Country: Lebanon

MARKETWEIGHT

Target Price	**USD 7.00**
Closing Price	**USD 6.01**
Year to Date %	**-3.5%**
52 Week Range	**6.00 - 6.94**
Market Cap.	**USD 2,102.0 million**
Dividend Yield	**6.7%**
P/E (TTM)	**7.5x**
P/B to Common	**0.96x**

Note: share data represents Bank Audi listed shares (Bloomberg ticker: AUDI LB), priced as of September 2nd, 2014 market close
Source: Bloomberg, FFA Private Bank

Bank Audi's Growth Strategy

Bank Audi's growth strategy focuses on three pillars: Lebanon, Turkey and Egypt with value to shareholders likely to come from a return to growth

Bank Audi is the largest bank in Lebanon in terms of assets with an asset base at USD 39.3 billion and TTM earnings at USD 306 million in Q2/14. The Bank had a total of 204 branches and 6,161 employees as of June 2014 with operations spread in its domestic market, Lebanon as well as across Europe and MENAT. The Bank's diversification across markets translated into a breakdown of assets and earnings between domestic and international at a respective 55%/45% and 69%/31% in H1/14 with an objective to increase the contribution of its foreign operations to 50% of consolidated assets and 40% of consolidated earnings by 2015e.

The current growth strategy of the Group is geared towards three key markets: Lebanon, Turkey and Egypt following the active balance sheet downsizing in Syria. Management is also looking to consolidate its presence in Jordan, to increase efficiencies in its domestic market Lebanon and to focus on the development of its private banking activities. The medium term expansion plans under consideration for Bank Audi includes i) a branching out in Iraq, with 7 licenses acquired so far, and ii) an interest in UK, Latin America and Sub-Saharan Africa.

Conservative growth strategy in Lebanon, set to continue going forward with a CAGR in mid-single digits in the medium term

Bank Audi is the largest bank in Lebanon by assets where it has built a solid franchise of USD 21.4 billion in assets through a network of 80 branches. In recent years, Management has been adopting a conservative growth strategy in Lebanon. No substantial growth in balance sheet indicators was seen over recent years in Lebanon as Bank Audi has not engaged in fierce competition on deposits comforted by its leading position among Lebanese Banks in terms of consolidated assets.

Looking forward, the Bank targets a growth in assets at a CAGR in mid-single digits in Lebanon in the medium term, which we expect is achievable given the sector's growth of at least 8% per year over the past three years although H1/14 has slowed to 3.4% Ytd. Contribution from Lebanon to the Group's size is expected to witness further decrease in the medium term to reach 50% from 55% currently.

Focus on Egypt with an accelerated business plan and an objective to double the size of the assets in the medium term

Bank Audi Egypt is mainly engaged in commercial and retail activities through a network of 34 branches. At the end of June 2014, assets totaled USD 3.6 billion and earnings generated in H1/14 totaled USD 30 million (equivalent to 9.2% of consolidated assets and 15.7% of total earnings, highlighting the highest ROA levels compared to Bank Audi's other key markets including Lebanon, Europe and Turkey.)

We note that operations in Egypt have sounder asset quality given a gross NPL ratio at 2.7% as of June 14 vs. ~9%+ for the sector and relatively low LDR at ~50% (higher than the 42% average for the sector in March 2014 yet below MENA and Emerging markets), implying potential room to increase lending from current levels.

Looking at recent financial results, net profits coming from Egypt in 2013 were close to USD 50 million. In H1/14, net profits neared the USD 30 million level which we expect to double for the full year 2014e. The medium term target is to double the asset base in Egypt to reach ~USD 6-7 billion. Several growth initiatives include: enhancing housing loans, promoting Islamic banking, and opening new branches in 2014e-2015e. We estimate Egypt could continue to represent over 15% of consolidated earnings for Bank Audi.

Ambitious expansion plan in Turkey through its subsidiary Odea Bank with a target to account to over 25% of consolidated earnings in the medium term

After 20 months of activity, Odea Bank's assets, deposits and loans reached USD 9.6 billion, USD 7.9 billion and USD 6.7 billion respectively at the end of H1/14 accounting for 24% and 23% and 42% respectively of consolidated (largest international market for Bank Audi). Operations are conducted through a network of 45 branches (including kiosk branches) and a workforce of 1,279. Expansion was executed organically and Bank Audi was able to rapidly develop a presence despite some difficult market conditions which translated into lower spreads, higher provisions and lower profitability among well-established banks in Turkey.

Bank Audi is seeking to nearly double its business in Turkey at a mid-double-digit CAGR over the medium term, which we expect should drive over half of the growth in consolidated profits over coming years. Over the medium term, we estimate Turkey should contribute to over 30% in consolidated assets and 25% of consolidated earnings.

We note that Odea Bank's results in 2013 reflects a ~ USD 45 million loss reflecting the initial stage of expansion in Turkey, which in turn dragged down the consolidated profits to USD 305 million. First set of profits began in Q2/14 following quarterly losses since operations began, with USD 3.3 million profits coming out of Odea Bank. A break even in Turkey for the full year 2014e (with all else being equal) should drive the consolidated profits close to USD 350 million from USD 305 million in 2013. This also equates to an estimated 0.4%-0.5% operating ROA run rate at Q2/14 on a USD 9.6 billion balance sheet of Odea Bank plus the 1% ROA on Audi ex-Turkey operations on a USD 29.7 billion balance sheet.

Key catalysts for Odea's earnings growth include potential to increase margins, LDRs and efficiencies closer to sector's average
Improvement in Odea Bank's interest margins will remain a key catalyst for profitability going forward. So far in 2014 interest margins have witnessed quick improvement from 1.98% for the month of January 14 to 2.46% for the month of July 2014 and should continue benefiting from well-developed capital markets and a convergence closer to sector (~3.0-3.5%+ level) which will drive profitability. Another catalyst for growth and profitability in Odea Bank will be a gradual convergence of the LDR (at 85 % as of June 2014) towards Turkish banking system average (~115%), which should trigger earning assets expansion and translate into higher bottom line. Profitability will also be driven by the ease from the frontloading of expenses as branch network gains in maturity, driving Odea Bank's cost-to-income ratio closer to the 40-50% Turkish sector average down from 88% currently. Bearing in mind the average ROA of sector average at ~ 1.4%, we expect Odea's operating ROA will gradually improve from estimated 0.4%-0.5% run rate level at Q2/14.

Bank Audi's Capital Increase

- **Capital Increase Structure and Use of Proceeds Overview**

Bank Audi's capital increase highlights a 50 million common share issue at an issue price of USD 6/share with 3 offered warrants on Odea Bank as sweeteners
Bank Audi is issuing 50 common shares (which will add to the existing 350 million common shares). The new issue will total USD 300 million in amount given an issue price of USD 6 per share, slight discount to where the market is trading (listed shares). Out of the 50 million common shares available for subscription, 40 million will be exclusively for current shareholders with the remaining 10 million to new shareholders. Every existing shareholder will be entitled to a share in the capital increase at the pro-rata of his/her ownership in the existing capital. As a sweetener, the investors will also receive 3 warrants per common share on Odea Bank with an exercise price of USD 0.95 per share at maturity in 2019 considering a reverse stock split 10:1 of the shares of Odea Bank has occurred. There is also a commitment to list Odea Bank prior to the maturity of the warrants. Each warrant will entitle the holder, during the warrant exercise period, to purchase a share in the Bank's subsidiary, Odea Bank S.A. The subscription period is expected to begin on September 1, 2014 and to end on September 12, 2014.

The capital increase aims to increase conformance vis-à-vis regulatory requirements and fund the expansion plan in the coming 3 years
The first reason behind the capital increase is to fund the expansion plan from USD 39 billion in assets to our estimated USD 50+ billion over the medium term, although we expect the large share of funding to come from deposits, given the Bank's current funding profile.

The second reason behind the capital increase is to strengthen the regulatory capital of the Bank. Management wishes to strengthen its common equity in order to increase its comfort buffer vis-à-vis minimum regulatory requirements. We estimate that the core common equity tier one ratio will increase by ~130 bps to 8.9% up from 7.6% in June 2014 (vs. 7% requirement for 2014 and 8% requirement for 2015) at most as this assumes full capital deployed into 0% RWAs.

Table 1: Basel III Consolidated CAR

	Jun-14e	2014 Regulatory requirements	2015 Regulatory requirements
Core common tier one ratio	7.6%	7.0%	8.0%
Residual tier one ratio	2.2%	2.5%	
Tier one ratio	9.8%	9.5%	10.0%
Tier two ratio	2.4%	2.0%	
Total ratio	12.3%	11.5%	12.0%

Source: Company reports

It is worth noting that Odea Bank boasts comfortable capitalization levels with a Tier one ratio and a total CAR ratio at 12.8% and 13.6% respectively (as of June 2014) above domestic regulatory requirements of 6% and 12% respectively.

- **Analyzing the Impact of the New Capital Issuance**

Dilution effect of the capital issuance likely offset by the warrants appreciation should the growth plan materialize
We estimate the dilution effect by calculating a post-rights market cap and dividing it by the new number of total common shares. Considering the share price of Bank Audi listed prior to the announcement at USD 6.30/share, the pre-rights market cap stands at USD 2,205 million (350 million shares * USD 6.30/share).
We derived a post-rights market cap of USD 2,505 million, by adding USD 300 million to the pre-rights market cap. By dividing the post-rights market cap by the new number of shares (400 million), we get a share price of USD 6.26. The dilution effect to drop the Audi listed share price to USD 6.26 from USD 6.30 prior to the announcement. However, believe the loss of the 4c in dilution should more than come from the value of the warrant. (Explained hereunder)

Table 2: Dilution impact of the rights issue

Shares outstanding pre-issue	# 350 million
Listed share price before announcement	**USD 6.30**
Market cap pre issue	USD 2,205 million
Capital increase in amount	USD 300 million
Market cap post issue	USD 2,505 million
Shares outstanding post-issue	# 400 million
Adjusted listed share price	**USD 6.26**
Dilution impact	**4c**

Source: Company reports, BSE, FFA Private Bank estimates

Currently, we value Odea's Bank at USD 0.33 per share on an "as is" basis (~608 million USD shareholders' equity / fully exercised Odea share count * P/B of 0.9x). Taking into account, the Turkish growth story which comprises of nearly doubling the balance sheet over the medium term and then by 5% a year afterwards, improving interest margins (from 2.4% towards 3-3.5%+ Turkish average) and operating efficiencies closer to peers (cost to income from 88% towards 40-50% Turkish average), we value Odea Bank at an estimated USD 1.20 by means of our EPS and BVPS estimates and using comparable average P/E and P/B multiples. The book value would represent the cumulative profits from today until 2019e assuming no capital increases nor dividends.

So the loss of the 4c in dilution should be offset from the value of the warrants using an option pricing model with the USD 1.20 intrinsic value and USD 0.95 exercise price while making additional assumptions into interest rates, volatility, and time to maturity. The rationale being that existing investors are being compensated for the slight dilution by way of warrants which should gain in value should the business be worth over and above the exercise price at maturity.

Key Risks to our Intrinsic Valuation on Odea Bank: Upside risks to our warrant valuation include a higher than expected balance sheet and earnings growth in Turkey. Downside risks comes from deterioration in Turkish political and economic situation, execution risks due to early stage of operations which are rapidly growing, illiquidity of the warrants on Odea Bank prior to maturity.

Contacts:

Head of Research: Nadim Kabbara, CFA
n.kabbara@ffaprivatebank.com
+961 1 985 195
Analyst: Raya Freyha
r.freyha@ffaprivatebank.com
+961 1 985 195
Sales and Trading, FFA Private Bank (Beirut)
+961 1 985 225
Sales and Trading, FFA Dubai ltd (DIFC)
+ 971 4 3230300