FFA Private Bank October 28, 2016

Flash Note - Bank Audi Q3/16 Results

Sector: Banking
Country: Lebanon

MARKETWEIGHT

Target Price	USD 7.00
Closing Price	USD 6.24
52 Week Range	USD 5.85-6.30
Year to Date %	+3.14%
Market Cap.	USD 2,494.4 million
Dividend Yield	6.4%
P/E (TTM)	6.0x
P/B to Common	0.82x

Note: the share data represents Bank Audi listed shares (Bloomberg ticker: AUDI LB). Bank Audi GDR shares at USD 6.65 (Bloomberg ticker: BQAD LI) and USD 6.44 (Bloomberg ticker: AUSR LB)
Source: Bloomberg, FFA Private Bank
Market close on October 28, 2016

Net profits at USD 124.7 million in Q3/16 (+8% QoQ, +22% YoY) above FFA estimate of USD 116.6 million as recurrent profits drive double-digit growth

Bank Audi posted net profits at USD 124.7 million (+8% QoQ, +22% YoY) exceeding FFA estimates of USD 116.6 million with diluted EPS at USD 0.32 (+19% QoQ, +36% YoY) also above our USD 0.26 estimate. Total operating income came in at USD 951.9 million largely exceeding FFA est. USD 455.2 million on exceptional fees and commission income at USD 689.9 million vs. FFA est. USD 69.3 million resulting from BDL debt swap transactions, while trading and investment income came in well below our estimates at USD 1.0 million vs. FFA est. USD 122.4 million on deconsolidation of operations in Syria and Sudan and net interest income at USD 261.1 million vs. FFA est. USD 263.6 million. Profits from continuing operations were significantly higher at USD 315.8 million. Very strong operating income was partially offset by higher opex at USD 397.5 million vs. FFA est. USD 227.8 million although cost-to-income decreased to 41.8%. Provisions also weighed on bottom line registering at USD 129.7 million vs. our estimate of USD 81.8 million, equivalent to an annualized cost of risk at ~276 bps which includes a substantial amount of collective provisions although NPL ratio was contained at ~3.2%, still lower than peers under coverage. Income tax reached USD 108.9 million vs. FFA est. of USD 29.2 million representing a tax rate of 25.6% vs. FFA est. 20.0%. Assets and deposits, helped by favorable results in foreign entities and recent BDL debt swap transactions, exceeded our forecasts at respective USD 45.3 billion and USD 37.0 billion while loans came in slightly below FFA est. at USD 18.8 billion.

Bank Audi Q3/16 results

USD million except per share data	Q3/16a	FFA Q3/16e	Q2/16a	Q3/15a	QoQ%	YoY%
Net interest income	261.1	263.6	253.2	254.9	*3.1%*	*2.4%*
Fees & commissions income	*689.9*	*69.3*	*64.0*	*68.6*	*977.5%*	*905.3%*
Trading & investment income	*1.0*	*122.4*	*132.4*	*-1.4*	*-99.2%*	*-172.5%*
Operating income	**951.9**	**455.2**	**449.6**	**322.2**	*111.7%*	*195.5%*
Provisions	-129.7	-81.8	-64.0	-36.7	102.5%	252.9%
Operating expenses	-397.5	-227.8	-238.6	-180.8	66.6%	119.8%
Income tax	-108.9	-29.2	-31.4	-26.2	246.5%	315.2%
Net profits	**124.7**	**116.6**	**115.5**	**102.1**	8.0%	22.1%
Diluted EPS to common	0.32	0.26	0.27	0.23	19.4%	36.3%
Assets	45,275	42,965	41,938	42,358	*8.0%*	*6.9%*
Deposits	36,963	36,040	34,993	35,829	*5.6%*	*3.2%*
Loans	18,814	19,018	18,466	17,015	*1.9%*	*10.6%*
BVPS to common	7.64	7.66	7.12	6.90	7.4%	10.8%
FFA Net interest margins	2.33%	2.50%	2.45%	2.44%		
Core income to total operating income	99.9%	73.1%	70.6%	94.0%		
FFA Cost-to-income ratio	41.8%	50.0%	53.1%	56.1%		
Immediate liquidity-to-deposit ratio	41.7%	36.2%	34.9%	36.4%		
Loan-to-deposit ratio	50.9%	52.8%	52.8%	47.5%		
Equity-to-asset ratio	8.1%	8.1%	7.8%	7.5%		

Source: Company reports and FFA Private Bank estimates

Net interest income at USD 261.1 million in Q3/16 weighed by lower NIMs likely from less favorable USD vs. LBP asset composition despite increased lending at higher margins in foreign entities

Net interest income came in at USD 261.1 million in Q3/16 (+3% QoQ, +2% YoY) while QoQ and YoY weakness in net interest margins likely driven by lower asset yields following BDL debt swap transaction despite favorable loan growth in Turkey and Egypt. Net interest margins decreased to 2.33% in Q3/16 from 2.45% in Q2/16 and 2.44% in Q3/15, partly on lower asset yields as return on USD denominated CDs held by banks as a result of BDL debt swap transactions is lower than return previously earned on Lebanese Treasury bills. We expect consolidated NIMs to be also impacted domestically by unabsorbed excess liquidity in LBP resulting from BDL debt swap transactions although should benefit from higher margins in Turkey and Egypt as operations expand and represent a larger share of group results. Pressure on NIMs expected to ease as excess liquidity in LBP gets mopped up by future MoF/BDL debt issues.

Latest banking sector's statistics from the ABL for the month of August 2016 show an improvement in LBP and USD spreads given higher asset yields, despite increasing cost of funds in USD likely as a result of BDL debt swap transactions

Spreads in USD and LBP were higher in August 2016 compared to one year earlier. Latest statistics from the ABL for the month of August 2016 reveal that Lebanese banks are still operating in a low interest environment while cost of funds increased in USD likely resulting from recent BDL debt swap transactions.

Spreads in USD increased to 1.54% in August 2016 from 1.28% in August 2015 which had a positive impact on banks' profitability given that the bulk of their liquidity is in USD. This difference was driven by an increase in weighted return on uses of funds (+43 bps to 4.88%), partially offset by higher cost of funds (+16 bps to 3.33%). Weighted return on uses of funds increased on higher rate on USD deposits at BDL (+74 bps to 3.40%), higher LIBOR 3-month on USD deposits (+49 bps to 0.81%) and higher lending rate (+22 bps to 7.24%) despite lower interest rate on Eurobonds (-7 bps to 6.61%).

Spreads in LBP increased to 1.01% in August 2016 from 0.86% in August 2015 on higher weighted return on uses of funds (+15 bps to 6.57%) and slightly lower cost of funds (-1 bps to 5.56%). Weighted return on uses of funds were increased on higher lending rate (+134 bps to 8.31%), higher yields on T-bills (+5 bps to 7.01%) and higher rate on CDs issued by the BDL (+1 bps to 8.17%).

Exceptional fees and commission income drives non-interest income in Q3/16 while trading and investment income lower from deconsolidation of operations in Syria and Sudan

Non-interest income reached USD 690.9 million in Q3/16 as fees and commission income increased to USD 689.9 million (+977% QoQ, +905% YoY) as a result of BDL's debt swap transactions. Trading and investment income declined to USD 1.0 million despite strong market activity largely in fixed income securities in Q3/16 mainly offset by write-offs of Bank Audi's operations in Syria and Sudan. Revenue breakdown for Q3/16 was considerably impacted by gains from BDL debt swap transactions with core income (net interest income + fees & commissions income) contribution to total operating income at 99% up from 71% in Q2/16 and 94% in Q3/15. However, given gradual improvement in recurrent results we believe Bank Audi's core income should continue to benefit in the medium term from i) improved interest margins as branch network roll out gains maturity in Odea Bank, and increased fees and commissions from lending growth in Turkey and Egypt, and ii) business line diversification including increased focus on private banking and asset management operations.

Stronger opex and provisions in Q3/16 at respective USD 397.5 million and USD 129.7 million as Bank Audi further reinforces fundamentals

Operating expenses rose to USD 397.5 million (+67% QoQ, +120% YoY) mostly from higher personnel expenses (which included extra compensation given difficult domestic economic conditions) and as excess gains were allocated towards goodwill impairment related to foreign operations and other non-recurring expenses aiming at reinforcing Bank Audi's fundamentals. Cost-to-income ratio at 41.8% in Q3/16 well below Q2/16 level of 53.1% and Q3/15 level of 56.1% helped by significantly above average revenue. NPL ratio remained stable at ~3.2% still lower than peers under coverage while cost of risk increased to an estimated 276 bps in Q3/16, from an 139 bps in Q2/16 and 86 bps in Q3/15 on account of stronger provisions, also from exceptional gains, at USD 129.7 million from USD 64.0 million in Q2/16 and USD 36.7 million in Q3/15. Coverage ratios improved to 76.5% on specific provisions, reaching 100% when accounting for real guarantees/collateral while collective provisions reached USD 539 million reflecting prudent management given political and macro risks in key pillars of operation, of which USD 302 million were taken ahead of IFRS9.

Net profits came in at USD 124.7 million in Q3/16 (+8% QoQ, +22% YoY) with solid growth in recurring operations in addition to gains from BDL debt swap transactions to a lesser extent

Net profits came in at USD 124.7 million in Q3/16 (+8% QoQ, +22% YoY) and diluted EPS at USD 0.32 (+19% QoQ, +36% YoY) with growth mainly stemming from favorable results and improved efficiencies in foreign entities despite challenging conditions in Egypt and Turkey. Odea Bank and Bank Audi Egypt contributed to 64% of net profit growth for the first nine months of 2016 despite below sector LDR in Turkey at ~85% capping additional upside. Bottom line was also helped by gains from BDL debt swap transactions to a lesser extent. Although operating income was boosted by stronger non-interest income, net profits were weighed by higher opex, provisions and income tax at USD 108.9 million (+246% QoQ, +315% YoY) with tax rate at 25.6% up from 21.4% in Q2/16 and 25.1% in Q3/15. Deconsolidation of operations in Syria and Sudan weighed on profit after tax with profits from continuing operations significantly higher at USD 315.8 million while also impacting minority interest despite increased effect from Odea Bank capital increase.

Strong balance sheet growth in Q3/16 supported by above average QoQ deposits accumulation from BDL debt swap transactions

Bank Audi registered significant balance sheet growth in Q3/16 as assets were up +8% to USD 45.2 billion, deposits were up +6% to USD 37 billion while loans underperformed growing by +2% to USD 18.8 billion. Balance sheet grew from inflows into the Lebanese banking sector resulting from BDL debt swap transactions in addition to foreign operations as Bank Audi finalized Odea Bank's capital increase. Balance sheet also saw an improvement on a YoY basis as assets, deposits and loans grew by respective +7%, +3% and +11%. Bank Audi's deposit-to-asset ratio slightly lower at ~82% in Q3/16 from ~83% in Q2/16 and ~85% in Q3/15 with LDR also lower at 50.9% in Q3/16 from 52.8% in Q2/16 yet higher than 47.5% in Q3/15 and well above the Lebanese banking sector average (~32.0% in August 2016). We highlight an increase in other liabilities (+68% QoQ, +58% YoY) which include exceptional gains related to the debt swap transactions booked as provisions awaiting BDL approval for release.

Improvement in profitability and significant increase in CAR III ratio at 15.5% from 13.9% in Q2/16

Bank Audi's capital adequacy ratio (Basel III) improved to 15.5% in Q3/16 from 13.9% in Q2/16, and above BDL's requirement of 12.0% particularly as provisions booked ahead of IFRS 9 are included in Tier 2 capital while Common Equity Tier 1 ratio at 9.9%. We highlight that Odea Bank's capital increase should support Bank Audi's business plan expansion in Turkey targeting one-third of the consolidated balance sheet in the medium term while also providing additional buffers for regulatory capital. Profitability ratios flat to higher with TTM ROA at an estimated ~1.0% in Q3/16, unchanged from Q2/16 and slightly higher than Q3/15 level of ~0.9% while TTM ROE came in at an estimated ~13.1% in Q3/16 down from ~13.5% in Q2/16 yet higher than ~12.0% in Q3/15. TTM EPS improved to USD 1.05 in Q3/16 from USD 0.96 in Q2/16 and USD 0.83 in Q3/15. Equity-to-asset higher at 8.1% vs. 7.8% in Q2/16 and 7.5% in Q3/15 while estimated book value per share (to common) came in at USD 7.64 in Q3/16 higher than USD 7.12 in Q2/16 and USD 6.90 in Q3/15.

Continued growth in balance sheet and improving profitability from core operations validate execution of management's business plan which should reflect positively on share price

We believe continued growth in balance sheet and improving profitability from core operations validate Bank Audi's growth plan resulting in increased revenues, profits and book value over the medium term while operating conditions likely remain challenging. We believe increased visibility provides potential upside on valuation multiples while increased dividend payout could complement capital appreciation with income generation. We suggest investors should look at sector rotating into banks given seasonal strength going into dividend programs typically paid annually in April particularly as banks have significantly underperformed real estate (~0%-5% for covered banks vs. ~35%+ for real estate) since discussions around a possible presidential election began late September.

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