Equity Research - Lebanese Banks - Q2/16 Preview

Expect cautious investor sentiment to limit bank shares given increasing macro vulnerabilities and heavier sovereign risks. Banking sector still showing signs of resilience amid difficult environment translating into tighter funding conditions and asset quality concerns

Lebanese banking sector sees some growth momentum in the first quarter of 2016 with assets, deposits, loans respectively growing YoY by +6%, +5%, +6%, although slowing domestic and regional economic activity is expected to pressure balance sheet and profitability in 2016: Lebanese banks are still operating in an unfavorable economic/political environment with real GDP growth estimated at near standstill according to IMF while the deteriorating fiscal position, rising government indebtedness, and pressure on f/x reserves drive BDL to intervene: i) real economy via continued stimulus programs, ii) increased participation in government debt auctions, and iii) latest debt swap scheme that addresses the BDL's softer f/x reserves, rising government interest costs, and looming tighter regulations on treatment of financial assets. Weaker economic activity is expected to slow credit expansion and negatively impact banks' asset quality, while high credit exposure to Lebanese sovereign debt adds to vulnerabilities from growing public debt and tighter funding conditions via weaker, and possibly costlier deposits. Net profits of Alpha banks rose +6% YoY during the first quarter of 2016 despite subdued QoQ growth in assets and a slight decline in customer deposits likely weighed by weaker remittances and deposits of foreign subsidiaries where Lebanon sources its remittances- mainly GCC and Europe. Assets reached USD 203 billion at the end of Q1/16, almost at their end of 2015 level, still mostly funded by the sector's deposits (81% in March 2016) and largely exceeding the economy's size given an estimated assets/GDP ratio at ~400%. Loans (claims on resident private sector in LBP and foreign currencies) grew +1% compared to end of December.

Muted growth in balance sheet for banks under coverage with slight improvement expected into Q2/16e as more favorable conditions in foreign operations contrast with softer domestic capital inflows: Blom Bank and Byblos Bank saw sluggish QoQ growth in assets and deposits in Q1/16 at +1%/0% for Blom Bank and +1%/+1% for Byblos Bank, while Bank Audi underperformed at -3/-4% partly on EGP devaluation. On a YoY basis, assets and deposits growth was at -1%/-2% for Bank Audi and +4%/+5% for Blom Bank, both challenged by weakened local currencies in foreign operations, while Byblos Bank outperformed with YoY growth at +6%/+7%. Loans growth QoQ/YoY at +1%/+10% for Bank Audi, +1%/+5% for Blom Bank and -1%/+4% 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%, driven by faster lending growth in Egypt and significantly higher LDRs in Turkey. For Q2/16e, we expect a continued slowdown in deposits weighed by its non-resident component from unfavorable domestic/regional economic conditions that are likely to impact capital inflows, also constraining their ability to cautiously grow loan portfolio as corporate lending becomes more competitive. We expect QoQ growth in assets, deposits and loans respectively at +1%/+1%/+1% for Bank Audi, +1%/+1%/+1% for Blom Bank and +1%/+1%/+1% for Byblos Bank and YoY growth at -2%/-4%/+7% for Bank Audi, +4%/+3%/+5% for Blom Bank and +6%/+6%/+5% for Byblos Bank.

Profitability of banks under coverage mainly driven by balance sheet and improvement in NIMs YoY while we expect flat provisioning levels and contained cost-to-income: Lebanese banks continue to witness improvement in NIMs on higher spreads in LBP and USD at respectively +39 bps and +13 bps on improved asset yields from more attractive liquidity avenues and greater maturities at +40 bps in LBP and +26 bps in USD, despite tighter funding costs (COF) (for May 2016, COF in USD +13 bps YoY and COF in LBP +1 bps). We expect banks under coverage to see higher total operating income YoY mainly driven by i) higher net interest income in Q2/16e at +6% YoY for Bank Audi, +10% YoY for Blom Bank while flat for Byblos Bank on balance sheet/NIM improvement and ii) higher net fees and commissions income to a lesser extent, at +7% YoY for Bank Audi, +4% YoY for Blom Bank and +3% YoY for Byblos Bank. Non-interest income growth is capped by lower gains on financial assets for Blom Bank and Byblos Bank despite expected growth in fees and commissions income for banks under coverage. Banks under coverage are expected to have higher loan loss provisioning YoY in Q2/16e with annualized cost of risk at respectively 76 bps, 40 bps and 80 bps for Bank Audi, Blom Bank and Byblos Bank. Cost-to-income is expected to improve slightly YoY in Q2/16e for banks under coverage at respectively 53%, 39% and 60%. We estimate YoY growth in net profits in Q2/16e for Bank Audi at +8% (EPS at USD 0.25 and BVPS at USD 7.48), +4% for Blom Bank (EPS at USD 0.47 and BVPS at USD 12.00) and -17% for Byblos Bank (EPS at USD 0.04 and BVPS at USD 2.30). For 2016e, we expect net profits to reach USD 437 million for Bank Audi (EPS at USD 0.98 and BVPS at USD 8.63), USD 428 million for Blom Bank (EPS at USD 1.95 and BVPS at USD 12.60) and USD 151 million for Byblos Bank (EPS at USD 0.19 and BVPS at USD 2.36).

We expect no expansion in trading multiples despite resiliency of banking sector, given unfavorable risk sentiment and slower earnings growth: With BVPS growth expected in the 0%-3% range QoQ and YTD performance for shares of banks under coverage ranging between 1% and 5% for the second quarter of 2016, we believe the domestic environment remains unfavorable for multiple expansion as difficult operating conditions, rising credit risks and declining non-resident deposits add to cautious market sentiment. While banks have so far remained resilient to the challenging domestic and regional setting, we expect better macro environment, security/political stability, acceleration in capital inflows along with development of domestic capital markets to be the main catalyst to a material rerating in bank shares in the longer term.

Table 1: FFA Private Bank - Lebanese Banks Coverage

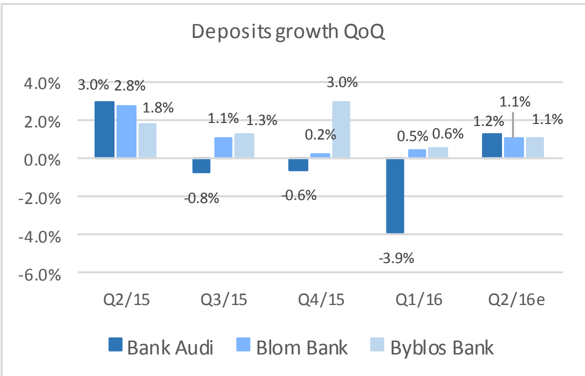
Company	Symbol	Recommendation	Target Price	Share Price *	YTD Change	P/E **	P/B to common	Dividend Yield ***
BANK AUDI	(AUDI LB)	MARKETWEIGHT	USD 7.00	USD 6.20	+2.5%	6.7x	0.84x	6.5%
BLOM BANK	(BLOM LB)	OVERWEIGHT	USD 11.50	USD 10.04	+6.8%	5.2x	0.86x	8.3%
BYBLOS BANK	(BYB LB)	MARKETWEIGHT	↓ USD 1.55	USD 1.66	+3.1%	8.3x	0.72x	8.0%

Source: Company reports, BSE, FFA Private Bank estimates Note:* July 19, 2016 market close, **Based on TTM EPS, *** Based on approved dividends for 2015

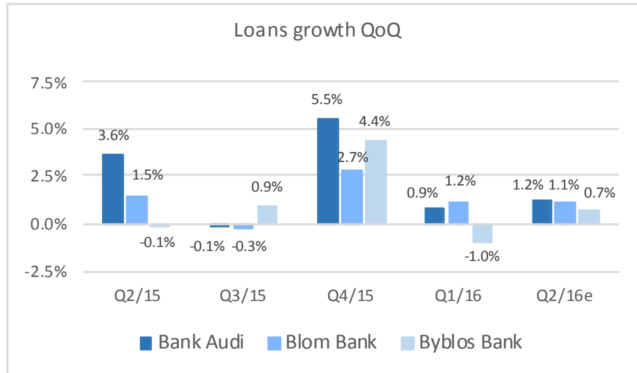
We update our target price on Byblos Bank, while keeping it unchanged for Bank Audi and Blom Bank and note that Blom Bank is the sole Overweight in our coverage universe: We maintain our target prices for Bank Audi and Blom Bank unchanged at USD 7.00 and USD 11.50 respectively, while we update Byblos Bank's target price to USD 1.55 from USD 1.60 and remind 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, sizeable liquidity and conservative approach to growth.

Banks Under Coverage - Comparative Snapshots

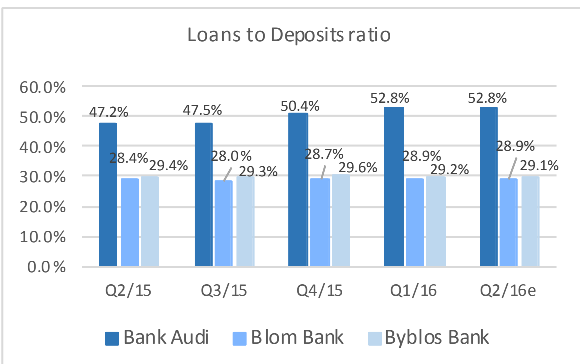
We expect Bank Audi, Blom Bank and Byblos Bank deposit growth to improve sequentially at respective +1.2%, +1.1% and 1.1% in Q2/16e



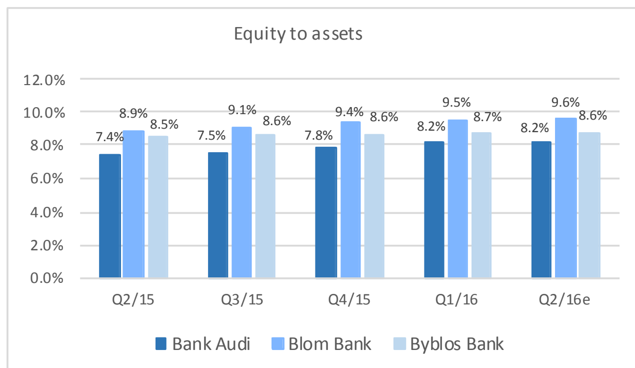
We estimate QoQ loan growth for Bank Audi and Blom Bank around +1% while Byblos Bank is expected to have loans growing at +0.7% sequentially in Q2/16e



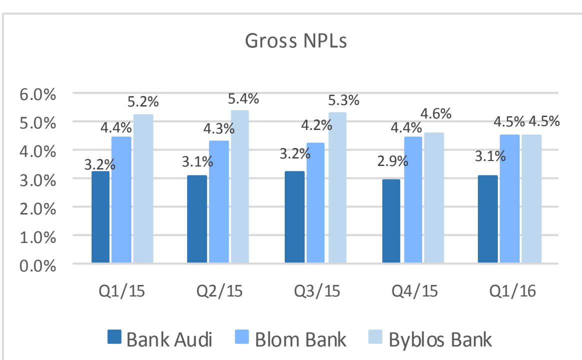
Bank Audi's LDR (~53%) expected to remain well above sector's average (~32%) helped by stronger lending in foreign operations while Blom Bank and Byblos Bank's LDRs expected to stay at ~29% in Q2/16e



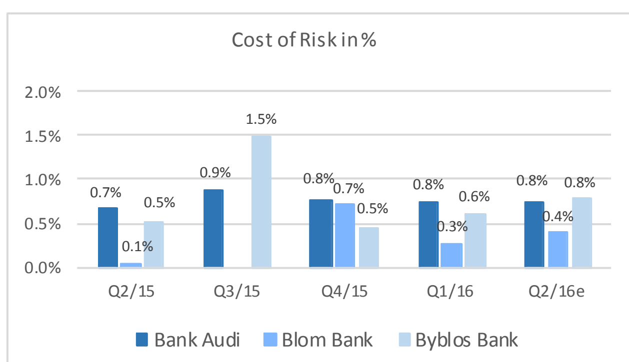
Blom Bank expected to maintain highest capitalization among banks under coverage with E/A ratio forecasted at 9.6% in Q2/16e, while Bank Audi and Byblos Bank expected at respective 8.2% and 8.6%



Slightly higher NPL formation in Q1/16 for Bank Audi and Blom Bank from weaker loan growth and more restrictive BDL classification requirements, while NPLs declined for Byblos Bank

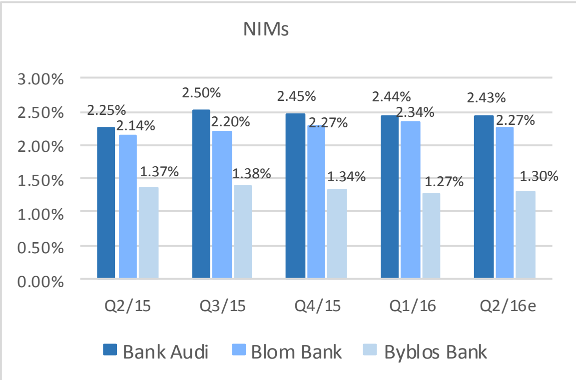


Bank Audi's cost of risk forecasted unchanged QoQ while Byblos Bank's cost of risk expected to increase in Q2/16e. Blom Bank continues to benefit from lower cost of risk, although volatile

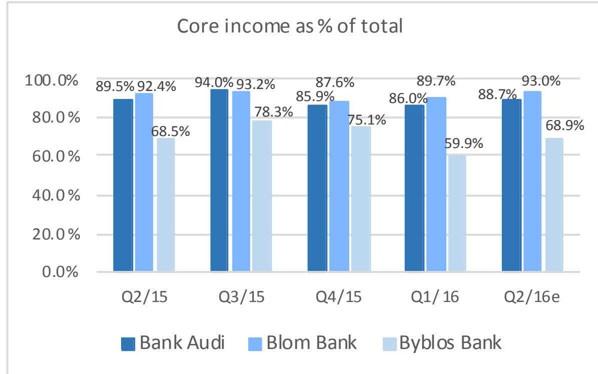


Source: Company reports and FFA Private Bank estimates

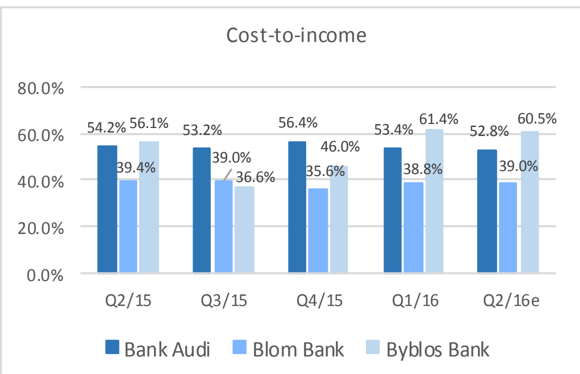
We note lower NIMs QoQ for Bank Audi and Blom Bank respectively on subdued balance sheet growth and strong Q1/16 while Byblos Bank NIMs estimated higher sequentially



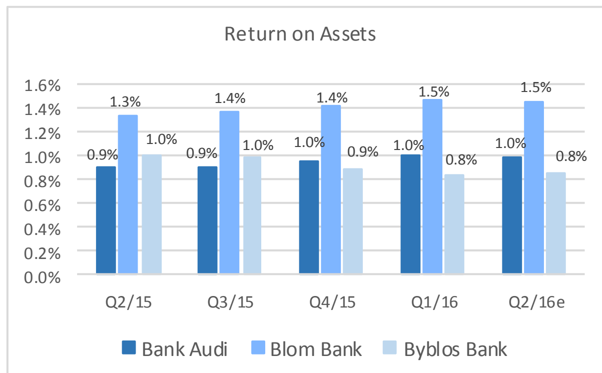
We expect improvement in income quality QoQ for banks under coverage in Q2/16e on the back of lower trading and investment income



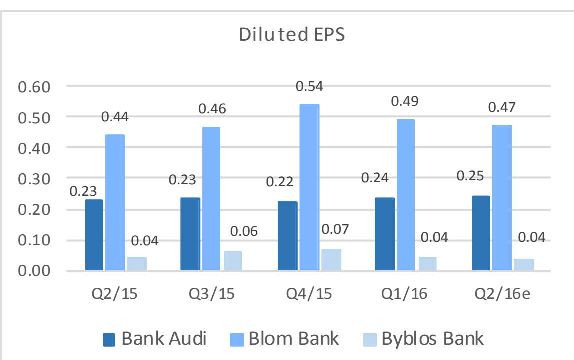
We highlight slight QoQ efficiency gains for Bank Audi and Byblos Bank, while cost-to-income expected to remain unchanged for Blom Bank



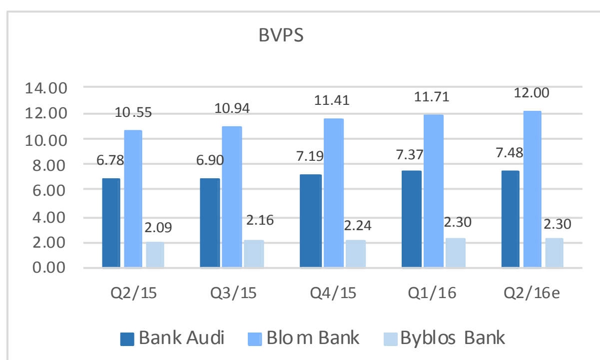
Higher profitability forecasted for Blom Bank compared to peers at 1.5% ROA, while Bank Audi and Byblos Bank ROAs are expected at 1.0% and 0.8% respectively



We highlight Blom Bank's higher expected EPS among banks under coverage, although lower QoQ. Slight EPS growth forecasted for Bank Audi while flat for Byblos Bank



Bank Audi and Blom Bank expected to witness higher BVPS in Q2/16e while Byblos Bank's BVPS forecasted at its Q1/16 level



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 Q1/16 at USD 41.0 billion as well as earnings at USD 110.2 million. The Bank had a total of 220 branches and 6,989 employees as of Q1/16 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 53%/47% and 46%/54% in Q1/16. 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 3.1% in Q1/16) 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.

Q1/16 Key Financial Highlights

Net profits at USD 110 million in Q1/16 (+11% QoQ, +10% YoY)

- Net interest income registered at USD 245 million in Q1/16 (-4% QoQ, +10% YoY) with YoY improvement on higher NIMs. We estimate net interest margins at 2.44% in Q1/16 vs. 2.45% in Q4/15 and 2.18% in Q1/15.
- Despite net fees & commissions displaying YoY growth for Q1/16 at USD 66 million (+11% YoY), non-interest income came in at USD 117 million (flat YoY) weighed by softer trading & investment income at USD 51 million (-12% YoY). Revenue breakdown for Q1/16 reflects unchanged income mix quality QoQ with core income (net interest income + fees & commissions income) contribution to total operating income at 86% in Q1/16, yet improving YoY from 83% in Q1/15.
- Bank Audi saw improved efficiencies in Q1/16 as cost-to income came in at 53.4% (still above pre-Turkey expansion levels) from 56.4% in Q4/15 yet deteriorating YoY from 52.4% in Q1/15, on higher opex, surpassing higher operating income.
- Bank Audi's consolidated gross NPLs were at 3.1%, above Q4/15 level of 2.9% yet below 3.2% in Q1/15 and still lower than peers under coverage. Cost of risk lower at an estimated 75 bps in Q1/16, from an estimated 77 bps in Q4/15 and 80 bps in Q1/15 on provisioning levels at USD 34 million (-2% QoQ, +3% YoY).
- With FX pressures in key international markets and challenging domestic operating conditions, Bank Audi saw subdued balance sheet growth in Q1/16 with assets and deposits at USD 41 billion (-3% QoQ, -1% YoY) and USD 34 billion (-4% QoQ, -2% YoY) respectively. Loans outperformed at USD 18 billion, +1% QoQ/+10% YoY.

Latest Key Regional Highlights

- Bank Audi's breakdown of assets and earnings between domestic and international operations stands at 53%/47% and 46%/54% in Q1/16.
- Odea Bank accumulated USD 10 billion in total assets representing 25% of the group assets and is seeking to benefit from operating leverage as branch network expands (55 branches including kiosks) and gains maturity. Odea Bank reported profits of USD 7 million in Q1/16, representing ~6% 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 Q1/16, the Group had USD 4 billion in assets in Egypt and generated USD 28 million in earnings accounting for 11% of consolidated assets and 25% of total profits.
- The Bank's current key pillar markets are: Lebanon, Turkey and Egypt.

FFA Model Assumptions

- We forecast net profits at USD 111 million in Q2/16e (flat QoQ, +8% YoY).
- We expect net interest income at USD 247 million in Q2/16e (+1% QoQ, +6% 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 71 million in Q2/16e (+9% QoQ, +7% YoY).
- We expect assets, deposits and loans to grow by respectively +1% QoQ /-2% YoY, +1% QoQ /-4% YoY, +1% QoQ /+7% YoY.
- LDR is expected at 52.8% in Q2/16e, unchanged from Q1/16 and above Q2/15 level of 47.2%.
- We forecast net provisions of USD 35 million in Q2/16e with an estimated annualized cost of risk of 74 bps for 2016e.
- Our estimate for cost-to-income in Q2/16e is at 52.8%.
- Looking at 2016e, net profits should reach USD 437 million (+8% YoY) with EPS at USD 0.98 (+8% YoY), driven by stronger operating income and improving efficiencies.

Table 2: FFA Model Forecasts

USD Million	FFA Q2/16e	Q1/16a	Q2/15a	QoQ%	YoY%	FFA 2016e
Net Interest Income	247	245	234	1%	6%	1,008
Fees & commissions income	71	66	67	9%	7%	291
Trading & investment income	41	51	35	-20%	15%	173
Operating Income	**359**	**362**	**336**	**-1%**	**7%**	**1,472**
Provisions	(35)	(34)	(28)	2%	22%	(140)
Operating expenses	(189)	(193)	(183)	-2%	3%	(799)
Income tax	(24)	(24)	(23)	0%	4%	(96)
Net Profits	**111**	**110**	**102**	**0%**	**8%**	**437**
Diluted EPS	0.25	0.24	0.23	5%	10%	0.98
Assets	41,413	41,022	42,310	1%	-2%	42,835
Deposits	34,647	34,221	36,106	1%	-4%	35,519
Loans	18,310	18,084	17,035	1%	7%	18,770
BVPS to common	7.48	7.37	6.78	2%	10%	8.63
FFA Net interest margins	2.43%	2.44%	2.25%			2.40%
Core income to total operating income	88.7%	86.0%	89.5%			88.3%
FFA Cost-to income ratio	52.8%	53.4%	54.2%			54.3%
Immediate liquidity-to-deposits ratio	32.6%	33.8%	35.7%			33.5%
Loans-to-deposits ratio	52.8%	52.8%	47.2%			52.8%
Equity-to-asset ratio	8.2%	8.2%	7.4%			9.1%

Source: Company reports and FFA Private Bank estimates

Investment Opinion

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

Bank Audi is the largest bank in Lebanon with a demonstrated franchise and the confidence of its clients in Lebanon and abroad. In light of difficult operating conditions, 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, comfortable cost of risk and improved CAR levels. 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 Q1/16 at USD 29.3 billion as well as earnings at USD 108.2 million. The Bank had a total of 258 branches and 4,876 employees as of the end of Q1/16 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 66%/34% respectively in Q1/16. The Bank's current strategy is geared towards two key markets: Lebanon and Egypt which is currently the biggest international market for Blom Bank. 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.

Q1/16 Key Financial Highlights

Net profits at USD 108 million in Q1/16 (-6% QoQ, +19% YoY)

- Net interest income came in at USD 167 million in Q1/16 (+3% QoQ, +15% 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 2.34% in Q1/16, above Blom Bank's targeted range of 2.00%-2.20%, vs. 2.27% in Q4/15 and 2.12% in Q1/15.
- Despite higher fees & commissions at USD 38 million (+2% QoQ, +11% YoY), Blom Bank saw non-interest income deteriorating in Q1/16 to USD 61 million (-6% QoQ) weighed sequentially by lower trading & investment income at USD 23 million (-16% QoQ). The YoY improvement in non-interest income was driven by higher fees & commission income (+11% YoY) as well as higher trading & investment income (+10% YoY). Revenue breakdown for Q1/16 reflects a higher income mix quality with core income (net interest income + fees & commissions income) contribution to total operating income at ~90% up from ~88% in Q4/15 and ~89% in Q1/15.
- Blom Bank saw improved efficiencies in Q1/16 with cost-to-income at 38.8%, above Q4/15 level of 35.6% yet below Q1/15 level of 41.1%, still reflecting higher efficiencies vs. peers under coverage. Blom Bank's gross NPLs were slightly above previous levels at 4.5% vs. 4.4% in Q4/15 and Q1/15, while cost of risk came in lower at an estimated 25 bps in Q1/16, vs. an estimated 72 bps in Q4/15 and 34 bps in Q1/15, on softer provisioning levels.
- Despite YoY improvement, balance sheet growth was sequentially subdued, likely on seasonal weakness, challenging domestic operating conditions and FX pressure. Assets grew to USD 29 billion (+1% QoQ, +4% YoY), deposits at USD 25 billion (flat QoQ, +5% YoY) while loans outpaced at USD 7 billion (+1% QoQ, +5% YoY).
- 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 Q4/15 level, well above BDL's requirement of 12.0% for 2015. TTM ROA estimated at 1.5% and TTM ROE estimated at 15.7%.

Latest Key Regional Highlights

- Blom Bank breakdown of assets and earnings between domestic and international operations stands at 78%/22% and 66%/34% respectively in Q1/16.
- At the end of Q1/16, the Group had around USD 2.4 billion in assets in Egypt and generated USD 13.5 million in net earnings accounting for around ~8% 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 103 million in Q2/16e (-5% QoQ, +4% YoY).
- We expect net interest income at USD 164 million in Q2/16e (-2% QoQ, +10% YoY).
- Net fees and commissions expected at USD 41 million in Q2/16e (+9% QoQ; +4% YoY).
- We expect provisions of USD 7 million equivalent to an estimated annualized cost of risk at 36 bps for 2016e.
- We estimate cost-to-income at 39.0% in Q2/16e, above Q1/16 level of 38.8% yet below Q2/15 level of 39.4%.
- We expect assets, deposits and loans to grow by respectively +1% QoQ /+4% YoY , +1% QoQ /+3% YoY , +1% QoQ /+5% YoY.
- At these growth levels, LDR should be at 28.9% in Q2/16e, which reflects ample liquidity and significant room to expand lending from current levels.
- For the year 2016e, net profits should reach USD 428 million (+6% YoY) with EPS expected at USD 1.95 (+5% YoY).

Table 3: FFA Model Forecasts

USD Million	FFA Q2/16e	Q1/16a	Q2/15a	QoQ%	YoY%	FFA 2016e
Net Interest Income	164	167	149	-2%	10%	665
Fees & commissions income	41	38	40	9%	4%	155
Trading & investment income	15	23	16	-34%	-1%	82
Operating Income	**220**	**228**	**205**	**-3%**	**8%**	**902**
Provisions	(7)	(5)	(1)	52%	726%	(27)
Operating expenses	(86)	(89)	(81)	-3%	6%	(336)
Income tax	(24)	(27)	(24)	-10%	1%	(102)
Net Profits	**103**	**108**	**99**	**-5%**	**4%**	**428**
Diluted EPS	0.47	0.49	0.44	-4%	7%	1.95
Assets	29,661	29,302	28,617	1%	4%	30,381
Deposits	25,488	25,207	24,754	1%	3%	26,065
Loans	7,361	7,279	7,021	1%	5%	7,531
BVPS to common	12.00	11.71	10.55	3%	14%	12.60
FFA Net interest margins	2.27%	2.34%	2.14%			2.24%
Core income to total operating income	93.0%	89.7%	92.4%			90.9%
FFA Cost-to income ratio	39.0%	38.8%	39.4%			37.2%
Immediate liquidity-to-deposits ratio	49.7%	49.5%	49.2%			50.1%
Loans-to-deposits ratio	28.9%	28.9%	28.4%			28.9%
Equity-to-asset ratio	9.6%	9.5%	8.9%			9.9%

Source: Company reports and FFA Private Bank estimates

Investment Opinion

We view Blom Bank's higher returns and solid liquidity 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
We recognize Blom Bank's solid positioning in its domestic market. We highlight the firm's conservative strategy translating into 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 a steady earnings growth while dividends should continue to benefit from lower than average payouts.

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 Q1/16 at USD 20 billion as well as earnings at USD 34 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.

Q1/16 Key Financial Highlights

Net profits at USD 34 million in Q1/16 (-29% QoQ, +3% YoY)

- Net interest income was at USD 63 million in Q1/16 (-5% QoQ, flat YoY) likely on subdued balance sheet growth and softer NIMs. We estimate weaker interest margins on a QoQ and YoY in Q1/16 at 1.26% vs. 1.33% in Q4/15 and Q1/15.
- Non-interest income was at USD 75 million in Q1/16 (+56% QoQ, +55% YoY) with fees & commissions income at USD 20 million (flat QoQ, -3% YoY), on substantial increase in trading & investment income to USD 55 million (+95% QoQ, +98% YoY). Byblos Bank's income quality mix 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 decreasing to 60% in Q1/16 from 75% in Q4/15 and Q1/15.
- Cost of risk rose in Q1/16 to an estimated 62 bps from 46 bps in Q4/15 and 57 bps in Q1/15 on slightly higher provisioning at USD 8 million in Q1/16 up from USD 6 million in Q4/15 and USD 7 million in Q1/15.
- Assets and deposits sequential growth at +1% in Q1/16 to USD 20 billion and USD 17 billion respectively while loans underperformed at -1% to USD 5 billion. On a YoY basis, assets and loans grew in the +6%/+7% range while loans grew +4%, still lower than previous years' levels on subdued domestic banking sector given Byblos Bank's large domestic exposure.
- Assets continue to be largely funded by deposits at ~83% 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 higher sequentially at ~45% in Q1/16 vs. ~44% in Q4/15.
- Profitability ratios were unchanged with TTM ROA at an estimated 0.83% in Q1/16 and Q4/15 and TTM ROE at an estimated 9.4% in Q1/16 and in Q4/15, 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 31 million in Q2/16e (-8% QoQ, -17% YoY).
- We forecast net interest income of USD 65 million in Q2/16e (+4% QoQ, flat YoY).
- Net fees and commissions expected at USD 20 million in Q2/16e (+1% QoQ, +3% YoY).
- We expect assets, deposits and loans to grow by a respective 1% QoQ /+6% YoY , 1% QoQ /+6% YoY , +1% QoQ /+5% YoY.
- At these growth levels, LDR should be at 29.1%, slightly below Q1/16 level of 29.2% and Q2/15 level of 29.4%.
- We forecast provisions of USD 10 million in Q2/16e equivalent to an estimated annualized cost of risk at 74 bps for 2016e.
- Our cost-to-income estimate is at 60.5% for Q2/16e .
- Looking at 2016e, net profits should reach USD 151 million (-6% YoY) with EPS at USD 0.19 (-10% YoY).

Table 4: FFA Model Forecasts

USD Million	FFA Q2/16e	Q1/16a	Q2/15a	QoQ%	YoY%	FFA 2016e
Net Interest Income	65	63	65	4%	0%	260
Fees & commissions income	20	20	20	1%	3%	82
Trading & investment income	39	55	39	-30%	-1%	148
Operating Income	**124**	**138**	**124**	**-10%**	**1%**	**490**
Provisions	(10)	(8)	(6)	30%	60%	(37)
Operating expenses	(75)	(85)	(69)	-12%	8%	(259)
Income tax	(8)	(12)	(11)	-32%	-24%	(43)
Net Profits	**31**	**34**	**37**	**-8%**	**-17%**	**151**
Diluted EPS	0.04	0.04	0.04	-10%	-17%	0.19
Assets	20,245	20,050	19,171	1%	6%	20,772
Deposits	16,911	16,733	15,948	1%	6%	17,420
Loans	4,917	4,884	4,684	1%	5%	5,031
BVPS to common	2.30	2.30	2.09	0%	10%	2.36
FFA Net interest margins	1.30%	1.27%	1.37%			1.27%
Core income to total operating income	68.9%	59.9%	68.5%			69.8%
FFA Cost-to income ratio	60.5%	61.4%	56.1%			52.8%
Immediate liquidity-to-deposits ratio	45.1%	45.1%	44.7%			44.9%
Loans-to-deposits ratio	29.1%	29.2%	29.4%			28.9%
Equity-to-asset ratio	8.6%	8.7%	8.5%			8.5%

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 as business plan visibility and cost-efficiencies improve

We recognize Byblos Bank's position in its domestic retail market as well as its capacity to show sizeable liquidity buffers, strong capitalization 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 as it relates to its business line and geographic diversification and possible redeployment of excess capital back to shareholders.

Target Price Revision and Recommendation

We reiterate our Marketweight rating on Byblos Bank shares and revise our fair value to USD 1.55 from USD 1.60 per share

Based on our revised forecasts and discount rate assumptions to our Dividend Discount Model, we revise our fair value estimate for Byblos Bank to USD 1.55 from USD 1.60 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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