FFA Private Bank s.a.l.

Lebanese Banks			
Q2/14 Preview	Bank Audi (AUDI LB)	MARKETWEIGHT	USD 7.00
	Blom Bank (BLOM LB)	OVERWEIGHT	USD 10.00
July 17th, 2014	Byblos Bank (BYB LB)	MARKETWEIGHT	USD 1.60

As Lebanese banks still cope with difficult economic and political backdrops, we see no major catalysts in the short term that could drive banks' earnings and share prices significantly higher

■ **Resilient deposits growth so far in 2014 still funding banks' balance sheets and public budget shortfalls, yet at slower rates:** Banks have been weathering unfavorable political and economic conditions amidst a political standstill and a real GDP growth revised downwards to 1% for 2013e and 2014e (from 1.5% previously as per the IMF). Figures for the first five months of 2014 pointed to resilient, yet slower growth in key indicators (in the 2%-3.5% range for assets, deposits and loans totaling USD 169 billion, USD 139 billion and USD 49 billion respectively), providing continuous support to banks' liquidity which in turn finances the government's fiscal deficit. Non-resident deposits continue to hold a substantial share in total deposits at 20% at the end of May 2014 despite a 2% YTD drop to USD 28 billion explained by a 5% decrease in the month of January which was mostly recouped in the following months. We remind that assets remain mainly funded by deposits (82%), while asset allocation reflect two main avenues for liquidity including government securities and loans to the private sector. LDR at 35.2% reflects ample liquidity levels.

■ **We expect banks under coverage to sustain light balance sheet growth in Q2/14e, while remaining more energetic for Bank Audi driven by Turkey:** In Q1/14, Blom Bank and Byblos Bank saw their deposits and loans YTD growth at a respective 2% and 3% for Blom Bank, and at a respective 1% and 2% for Byblos Bank (with LDRs in the 28%-31% range), while Bank Audi saw more vigorous growth (+4% for both indicators) mainly driven by Turkish operations (reaching 23% of total assets at end-Q1/14 after 17 months of operations) with an LDR at 47%. We expect moderate growth in balance sheet in Q2/14e across our coverage universe while Bank Audi should keep an edge driven by Turkey yet at a more gradual rate (1%-2% range for Blom Bank and Byblos Bank in deposits and loans, 3%-4% range respectively for Bank Audi in deposits and loans).

■ **Lebanese banks still dealing with profitability constraints**, **expect no major catalysts in the short term** given**:** i) a low interest rate environment refraining asset yields along with limited capacity to further decrease the cost of funds, ii) soft fee generation and iii) softer balance sheet expansion. Alpha Banks reported USD 429 million in net profits in Q1/14 nudging down 3% YoY. Similarly net profits of banks under coverage remained lackluster: while Bank Audi and Blom Bank reported roughly flat YoY net profits in Q1/14, Byblos Bank saw a steeper decrease in earnings with a decline of 11% YoY largely due to further contraction in its interest margins. Our estimates for YoY net profit growth in Q2/14e stands at +2% and -2% for Blom Bank and Byblos Bank respectively while we expect Bank Audi to see a 11% decrease in its earnings YoY from stronger than average Q2/13. On a QoQ basis, Bank Audi net profits should move gradually higher benefiting from balance sheet growth and margins driven by Turkey. Despite a trend of alleviating provisions across our coverage universe, we note that the volatility in provisions and financial gains could remain a variable and continue to monitor Odea Bank's after losses incurred so far. Our expected EPS for the full year 2014e stands at USD 0.81, USD 1.60 and USD 0.19 for Bank Audi, Blom Bank and Byblos Bank respectively.

■ **Lack of visibility for investors is putting a strain on banks' share prices albeit seeing improvement on a YTD basis:** So far in 2014, we saw higher trading volume on the BSE at 22.4 million share in 5M-14 (up 29% YoY), while listed shares of banks under coverage saw low to mid-single digit growth performance (Bank Audi: +2.1% YTD, Blom Bank: +6.3% YTD, Byblos Bank: +3.2% YTD). Lebanon's 5 year CDS also saw improvement on a YTD basis to 354 bps down 76 bps from the same level last year. However we do not expect any sustainable multiple expansion given that share prices remain constrained by investors looking for further visibility in terms of a return to earnings growth, a pick-up in economic activity and abatement in political risks.

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 6.37	+2.1%	8.1x	0.99x	6.3%
Blom Bank	BLOM.LB	Overweight	USD 10.00	USD 8.77	+6.3%	5.5x	0.86x	5.7%
Byblos Bank	BYB.LB	Marketweight	USD 1.60	USD 1.60	+3.2%	8.4x	0.74x	8.3%

Source: Company reports, BSE, FFA Private Bank estimates Note:* listed shares as of market close of July 17, 2014 **Based on TTM EPS

■ **We continue to value the banks relative resilience in operations, generous 5%+ dividend yields and near 1x book valuation:** On a positive note, we continue to value dividend yields at 5%+ paid annually, favorable valuations at near 1x book multiple and relative resilience in operations versus other domestic sectors. We maintain our recommendation unchanged on the three banks (cf. table above) and remind that Blom Bank is Overweight in our coverage universe given higher than average efficiencies and ROE, stable growth in earnings despite difficult operating conditions, in addition to solid capitalization, sizeable liquidity buffers and conservative approach to growth.

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BANK AUDI

Company Description

Bank Audi is the largest bank in Lebanon in terms of assets with an asset base at USD 37.8 billion and TTM earnings at USD 305 million in Q1/14. The Bank had a total of 194 branches and 6,055 employees as of the end of March 2014 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 55%/45% and 76%/24% in Q1/14. In terms of assets Turkey is currently the biggest international market for Bank Audi. The current strategy is geared towards three key markets: Lebanon, Turkey and Egypt following the active balance sheet downsizing in Syria. We highlight the Bank's relatively sound asset quality (Gross NPL ratio at 2.9% as of Q1/14) amidst a difficult backdrop, the solid balance sheet growth and potential to pick up margins and profitability from current levels driven by Turkey.

Q1/14 Key Financial Highlights

Net profits at USD 86 million in Q1/14 (+98.1% QoQ, +0.3% YoY)

- Net interest income at USD 182 million, substantially up YoY and roughly unchanged QoQ.
- Solid fees and commissions income in Q1/14 at USD 52 million, 19% up YoY.
- Cost-efficiencies improve sequentially, yet still weaker YoY reflecting the expansion in Turkey.
- Gross NPL ratio up to 2.9% with a coverage ratio closer to the 100% level.
- Solid growth in key balance sheet indicators in the first quarter of 2014, mainly driven by Turkish operations.
- CAR III up to 12.5% following lowered RWA weighting on FC liquidity and portfolio securities at the BDL.

Latest Key Regional Highlights

- Bank Audi breakdown of assets and earnings between domestic and international operations stands at 55%/45% and 76%/24% respectively as at end March 2014 period.
- In 17 months of activity Odea Bank accumulated USD 8.8 billion in total assets representing 23% of group assets and is seeking gradual convergence towards breakeven in profits as branches gain maturity.
- The Bank operations in Syria were downsized to just 1% of consolidated assets and 4% of consolidated profits as of Q1/14, thus limiting the exposure of Bank Audi to Syria's heightened risk.
- The Bank has been recognizing net profits in Egypt in the last two years after the bulk of profits were allocated to provisions in 2011 in the outbreak of the political crisis. In Q1/14, the Group generated USD 14.5 million in earnings from Egypt accounting for 17% of consolidated profits.
- Given the unrest in Syria, the Bank's key growth markets are: Lebanon, Turkey and Egypt.
- Bank Audi has no presence in the Iraqi market.

FFA Model Assumptions

- We forecast net profits of USD 91 million in Q2/14e, up 6% QoQ however 11% lower YoY from an exceptionally strong quarter in Q2/13.
- Expect net interest income to continue growing (+1% QoQ, +15% YoY) from higher margins and solid earning assets momentum from Turkish expansion. Going forward, Odea Bank should continue to drive Bank Audi's margins gradually higher as Turkish banks typically boast higher margins and branches gain maturity.

- Fees and commissions are expected to reach USD 51 million (-3% QoQ, +15% YoY).
- Balance sheet is expected to remain driven by the branch rollout in Turkey. We expect QoQ growth at 3% and 4% in Q2/14e for deposits and loans respectively, with loans expected to remain more energetic driven by the Turkish expansion (LDR in Turkey: 110% vs. 35% for Lebanon as of March 2014).
- The LDR is expected to trend slightly higher reaching 48% by the end of Q2/14e.
- We forecast provisions of USD 19 million in Q2/14e in line with previous quarter.
- Our estimate for cost to income in Q2/14e at 55.0%, still high compared to pre-Turkey expansion levels.
- Looking at 2014e, net profits should total USD 328 million (+8% YoY) with EPS at USD 0.81, driven by strong net interest income growth and lower cost of risk. In terms of balance sheet growth, the increase in loans should trend towards more normal rates (15% in 2014e vs. 41% in 2013a).

Table 1: FFA Model Forecasts

USD million	FFA Q2/14e	Q1/14a	Q2/13a	QoQ %	YoY %	2013a	FFA 2014e
Net interest income	183.5	182.4	159.0	1%	15%	638.2	737.6
Operating income	294.1	285.7	300.2	3%	-2%	1069.4	1163.3
Net profits	91.3	85.7	102.8	6%	-11%	305.0	328.2
Diluted EPS	0.23	0.21	0.26			0.77	0.81
Assets	38,330	37,813	33,694	1%	14%	36,191	39,569
Deposits	33,225	32,320	29,162	3%	14%	31,095	34,297
Loans	15,928	15,293	12,710	4%	25%	14,713	16,948
BVPS to common	6.80	6.73	6.41			6.45	7.07
FFA Cost-to-income ratio	*55.0%*	*54.9%*	*47.1%*			*56.1%*	*58.0%*
Loans-to-deposits ratio	*47.9%*	*47.3%*	*43.6%*			*47.3%*	*50.0%*

Source: Company reports and FFA Private Bank estimates

Investment Opinion

We value Bank Audi's domestic leadership, asset quality and improving margins, however investors likely to remain on the sidelines waiting for more visibility in terms of generating returns from its growth strategy

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 gradually higher margins. We seek Turkish operations to pare back losses towards breakeven in the shorter term as branch network gains in maturity. We continue to rate Bank Audi shares at Marketweight although recognize upside potential for the shares in the medium to longer term once investors gain greater confidence on management's execution of its growth plan.

Target Price Revision and Recommendation

We reiterate our Marketweight rating on Bank Audi shares with a fair value at USD 7.00 per share

Based on our revised forecasts and discount rate assumptions to our Dividend Discount Model, our fair value estimate for Bank Audi is at USD 7.00 per share. Our DDM assumes a 14.5% cost of equity and a 3% 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.

BLOM BANK

Company Description

Blom Bank is the second largest Bank in Lebanon in terms of assets with an asset base at USD 26.7 billion and TTM earnings at USD 353 million in Q1/14. The Bank had a total of 191 branches and 4,511 employees as of the end of March 2014 with operations in its domestic market Lebanon as well 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 77%/23% in Q1/14. The Bank's current strategy is geared towards two key markets: Lebanon and Egypt as the Bank's operations in Syria have been downsized in terms of balance sheet. Egypt 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 historically surpassed its peers in terms of profitability levels and cost-efficiencies.

Q1/14 Key Financial Highlights

Net profits at USD 88 million roughly flat YoY and QoQ

- Net interest income at USD 137 million in Q1/14 (+1% QoQ, +5% YoY).
- Fees and commissions increased to USD 33 million in Q1/14 (+1% QoQ, +20% YoY), while financial gains saw greater volatility.
- Lower provisions in Q1/14, while NPLs improve to 4.4%. Cost-to-income ratio at 41% slightly higher than historical average.
- On the balance sheet side we note healthy growth in key indicators in Q1/14 in the 2%-3% range QoQ.
- Comfortable capital position with CAR III increasing to 17% following lowered RWA weighting on FC liquidity and portfolio securities at the BDL.

Latest Key Regional Highlights

- Blom Bank breakdown of assets and earnings between domestic and international operations stands at 78%/22% and 77%/23% respectively in Q1/14.
- The Bank operations in Syria have been downsized to just 1.7% of total assets and 0.8% of total profits as of Q1/14, thus limiting the exposure of Blom Bank to Syria's heightened risk.
- Given the unrest in Syria, the Bank's key growth markets are: Lebanon and Egypt.
- The Bank's presence in the Iraqi market is still at a very nascent stage; Blom Bank recently opened two branches (Baghdad and Erbil).

FFA Model Assumptions

- We expect net profits of USD 90 million in Q2/14e, edging up 3% QoQ and 2% YoY.
- We forecast operating income at USD 209 million in Q2/14e (+7% QoQ, -10% YoY).
- We expect net interest income to increase in Q2/14e (+4% QoQ, +7% YoY) as roughly flat margins are likely to be matched with moderate earnings assets growth. We expect slightly higher fees and commissions at USD 35 million for the quarter.
- We forecast provisions of USD 18 million. Our cost-to-income estimate stands at 38% in Q2/14e (within the Bank's usual 35%-38% range).

- Key balance sheet indicators are expected to grow at a low single digit in Q2/14e, edging up ~1% for assets, deposits and loans.
- The LDR should remain roughly unchanged at 28% reflecting ample liquidity and significant room to expand lending from current levels.
- For the year 2014e, net profits should total USD 352 million (+4% YoY) with EPS at USD 1.60. On the balance sheet side, growth of key indicators namely assets, deposits and loans should be in the 5%-7% range.

Table 2: FFA Model Forecasts

USD million	FFA Q2/14e	Q1/14a	Q2/13a	QoQ %	YoY %	2013a	FFA 2014e
Net interest income	141.6	136.8	132.8	4%	7%	528.3	561.9
Operating income	209.3	195.3	232.6	7%	-10%	800.2	826.9
Net profits	90.4	87.5	88.7	3%	2%	352.4	364.8
Diluted EPS	0.40	0.39	0.39			1.58	1.60
Assets	27,037	26,720	25,274	1%	7%	26,149	27,661
Deposits	23,245	23,010	22,056	1%	5%	22,572	23,727
Loans	6,602	6,511	5,989	1%	10%	6,345	6,786
BVPS to common	10.51	10.23	8.95			9.75	11.08
FFA Cost-to-income ratio	*38.0%*	*41.0%*	*35.2%*			*34.7%*	*38.0%*
Loans-to-deposits ratio	*28.4%*	*28.3%*	*27.2%*			*28.1%*	*28.6%*

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 see scope for dividends to grow over time on account of lower than average payouts

We recognize Blom Bank's solid positioning in its domestic market. We like the firm's conservative strategy translating into superior profitability and return ratios relative to its domestic peers despite sizeable liquidity buffers. In the short term, we look to the prudent management team to focus on limiting asset quality deterioration in light of difficult operations in key regional markets, while steadily growing earnings.

Recommendation

We reiterate our Overweight rating on Blom Bank shares with a fair value at USD 10.00 per share

Based on our revised forecasts and discount rate assumptions to our Dividend Discount Model, our fair value estimate has been maintained at USD 10.00 per share. Our DDM assumes a 15.5% cost of equity and a 3% 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.

BYBLOS BANK

Company Description

Byblos Bank is the third largest Bank in Lebanon in terms of assets with an asset base at USD 18.6 billion and TTM earnings at USD 151 million in Q1/14. The Bank had a total of 101 branches and 2,528 employees as of the end of March 2014 with operations in Lebanon as well across Europe, Africa and the MENA region. The Bank diversification across markets is lagging behind its peers with a breakdown of assets and earnings between domestic and international at 87%/13% and 82%/18% as of Q1/14. The Bank's balance sheet is mainly focused on Lebanon after operations in Syria have been downsized. 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.

Q1/14 Key Financial Highlights

Net profits down to USD 31 million in Q1/14 (-30% QoQ,-11% YoY)

- Net interest income at USD 56 million in Q1/14 (-10% QoQ, -12% YoY) on narrowing net interest margins.
- Non-interest income at USD 50 million in Q1/14 (+12% QoQ, -2% YoY).
- NPLs flat at 4.9% in Q1/14 and provisions up QoQ to USD 8 million.
- Cost-to-income up to 55% on weaker income.
- Deposits and loans edged up 1% and 2% respectively QoQ, with an LDR maintained at 30.7%.
- Comfortable capital position with CAR III increasing to 16.2% following lowered RWA weighting on FC liquidity and portfolio securities at the BDL.
- Profitability ratios at the low end of our coverage and dividend yield at an attractive ~8%.

Latest Key Regional Highlights

- Byblos Bank breakdown of assets and earnings between domestic and international operations stands at 87%/13% and 82%/18% respectively in Q1/14.
- The Bank operations in Syria have been downsized to just 2% of total assets as of Q1/14.
- Byblos Bank has operations in Iraq since 2007. Currently operations are conducted through three branches (Baghdad, Erbil and Basra). In Q1/14, the Bank' assets and net profits in Iraq totaled USD 262 million and USD 1.4 million representing around 1.4 %, and 4.6% of total assets and net profits respectively.

FFA Model Assumptions

- We expect net profits of USD 39 million in Q2/14e, up 29% QoQ and down 2% YoY.
- We forecast net interest income of USD 58 million in Q2/14e, ~5% higher QoQ and YoY.
- Fees and commissions income expected to remain stable at USD 24 million in Q2/14e.
- Key balance sheet indicators namely assets, deposits and loans are expected to witness moderate growth at a low single digit in Q1/14e (+2% QoQ), with an LDR maintained at 31%.
- We forecast provisions of USD 14 million in Q2/14e. Our cost-to-income estimate stands at 46% for Q2/14e and 47% for the full year 2014e (roughly flat from 2013a).

- Looking at the full year 2014e, net profits should reach USD 156 million (-1% YoY) with EPS at USD 0.19. Assets, deposits, and loans should reach USD 19.5 billion, USD 15.8 billion and USD 4.8 billion respectively by the end of the year following YTD growth rates in the 5%-7% range.

Table 3: FFA Model Forecasts

USD million	FFA Q2/14e	Q1/14a	Q2/13a	QoQ %	YoY %	2013a	FFA 2014e
Net interest income	58.4	55.8	56.2	5%	4%	232.2	237.3
Operating income	116.7	106.1	129.1	10%	-10%	448.1	463.0
Net profits	39.5	30.7	40.2	29%	-2%	156.2	154.0
Diluted EPS	0.05	0.04	0.05			0.19	0.19
Assets	18,902	18,581	17,567	2%	8%	18,485	19,461
Deposits	15,209	14,940	14,063	2%	8%	14,749	15,769
Loans	4,669	4,583	4,100	2%	14%	4,511	4,848
BVPS to common	2.20	2.18	1.98			2.13	2.24
FFA Cost-to-income ratio	*45.7%*	*55.3%*	*39.6%*			*46.9%*	*47.2%*
Loans-to-deposits ratio	*30.7%*	*30.7%*	*29.2%*			*30.6%*	*30.7%*

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 visibility and cost-efficiencies improve

We recognize Byblos Bank's position in its domestic retail market and solid fundamentals benefiting from 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 gains visibility on its outlook and redeploys capital to create additional shareholder value by way of expansion, acquisition, or return of capital.

Recommendation

We reiterate our Marketweight rating on Byblos Bank shares with a fair value of USD 1.60 per share

Based on our revised forecasts and discount rate assumptions to our Dividend Discount Model, our fair value estimate has been maintained at USD 1.60 per share. Our DDM assumes a 15.5% cost of equity and a 3% 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.

Lebanese Banking Sector Highlights

Recent Banking Sector Highlights

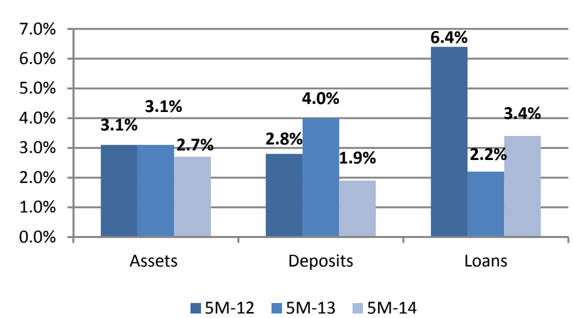
- **So far in 2014, balance sheet growth is maintaining resilience despite growing at a slower rate amidst difficult operating conditions**. Banks have been weathering the unfavorable political and economic conditions amidst a political standstill and a real GDP growth revised downwards to 1% for 2013e and 2014e (from 1.5% previously as per the IMF). Key balance sheet indicators grew in the 7%-10% range, while profits stalled with net earnings of Alpha Banks unchanged at USD 1.7 billion in 2013.

  Looking at 2014 so far, we note that Lebanese banks have seen a continuous growth in their key balance sheet indicators yet a slower rate compared to previous year: in the +2%-+3.5% range YTD (cf. figure 1), for assets, deposits and loans to reach USD 169 billion, USD 139 billion and USD 49 billion respectively at the end of May 2014. Continuous deposits inflows represent a sign of resilience for the sector and allow the financial system to continue to fund the budget shortfalls, while providing support to Central Bank FX reserves, which reached USD 33.3 billion in May 2014 up 5% since the beginning of the year.

- **Non-resident deposits continue to support banking system, funding 20% of total deposits**. Non-resident deposits nudged down 2% in 5M-14 to USD 28 billion explained by a 4.5% drop during the month of Jan-14 which was mostly recouped in following months. At the end of May 2014, non-resident deposits accounted for a substantial 20% of total deposits, in line with the average over the past year.

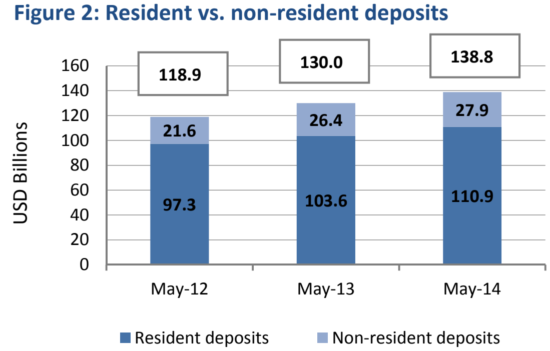
  We remind that assets remain mainly funded by deposits (82%), while asset allocation reflect two main avenues for liquidity including government securities and loans to the private sector. LDR at 35.2% reflects ample liquidity levels. Dollarization of deposits and loans stood at 65.7% and 76.1% respectively.

Figure 1: YTD growth in first five months of the year



Source: BDL

Figure 2: Resident vs. non-resident deposits



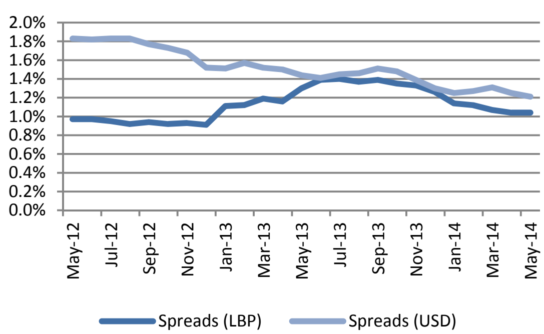
Source: BDL

- **Central Bank continues to stimulate the economy by subsidizing loans and offering facilities in reserves requirements**. With the aim of stimulating lending and encouraging economic growth, the Central Bank, has been offering interest rates subsidies on loans granted by banks to productive sectors (such as housing, agriculture, tourism and industry etc…) in order to reduce the cost of financing on SMEs and startups. A substantial portion of the ~USD 1.5 billion that BDL put at the disposal of the country's commercial banks at 1% interest rate in 2013 was aimed at supporting the real estate sector. The central bank announced at the end of last year that the plan would be extended to 2014 with a total of USD 800 million in preferential financing facilities available to commercial banks under the form of subsidized loans to help commercial banks finance housing and energy projects. Another measure to encourage commercial banks to enhance their medium and long term lending is the BDL's facilities on reserve requirements whenever banks extend loans, in LBP or in FC to productive sectors.

- **Latest statistics highlight that Lebanese banks are still operating in a challenging environment muting earnings growth**. The trend of roughly flat profits which was seen in 2013 across the Lebanese banking sector continues to drag into 2014. In the first quarter of 2014, the consolidated net profits of Alpha banks totaled USD 429 million nudging down 3% from the same quarter of last year suggesting that Lebanese banks' earnings are still lackluster on account of pressured margins, relatively high provisions against difficult backdrop, slower fee income and moderate balance sheet expansion.

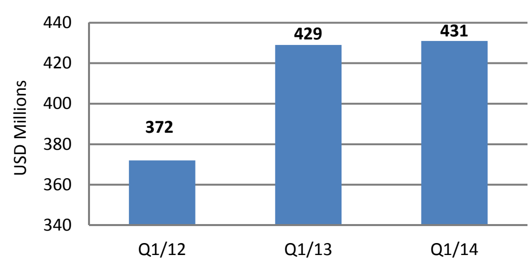
- **Both spreads in USD and LBP are on a downward trend in May 2014 compared to one year earlier**. Statistics from the ABL reveal that Lebanese banks are still operating in a low interest environment, limiting potential to improve earning asset yields within little room to further decrease the cost of funds. Spreads in USD decreased to 1.21% in May 2014 down from 1.44% one year earlier which has a substantial impact on Lebanese Bank's profitability given that the bulk of their liquidity is in USD. This decrease was driven by a 4 bps increase in the cost of funds in addition to a 19 bps decline in the weighted return on uses of funds from i) lower average rate on USD deposits at the BDL (down 43 bps to 2.10%) ii) lower weighted average yields on Eurobonds (down 38 bps to 6.58%), iii) lower 3-month Libor on USD deposits (down 4 bps to 0.23%). On the LBP side, we highlight that interest spreads were also lower in May 2014 from one year earlier (1.04% vs 1.30% in May 2013) principally due to a drop of 63 bps in the weighted average rate on CDs issued by the BDL to 8.21%.

Figure 3: Spreads in USD and LBP



Source: Association of Banks in Lebanon

Figure 4: Alpha banks' net profits in the first quarter



Source: Bank Data

- **After Standard and Poor's upgraded the sovereign rating of Lebanon to stable from negative, it has recently applied the same revision to the LT ratings of major Lebanese banks, while Moody's and Fitch maintain their negative outlook.** Last year Lebanon was assigned lower outlooks by the three main credit agencies which cited the increased political risk, weak economic conditions and deteriorating public finance and debt. Last year Fitch revised the outlook on Lebanon from stable to negative while maintaining its B long term rating unchanged, the agency recently affirmed Lebanon's sovereign ratings and negative outlook. Last year

Moody's also revised the outlook on Lebanon from stable to negative while maintaining its B1 long term rating. Standard and Poor's which downgraded the long term rating on Lebanon from B to B- , upgraded the outlook to stable this year citing the country's stable financial system, steady deposits inflows and recent cabinet formation. In this framework Standard and Poor's recently revised its outlook on the LT ratings of some major Lebanese banks to stable from negative given the banks high exposure to the sovereign.

Republic of Lebanon's 5 years CDS rates trades at 354 bps in July 2014 down 76 bps on the same point last year.

Regulatory Updates

- **Recent circular lowering the risk weighted assets (RWA) weighting on liquidity and portfolio securities in foreign currency at the Central Bank of Lebanon, drove Lebanese banks CAR III higher.** Earlier in 2014, the Central Bank of Lebanon issued a circular lowering the risk weighted assets (RWA) weighting from 100% to 50% on liquidity and portfolio securities in foreign currency at the Central Bank of Lebanon including CDs, deposits and reserves, which all else equal had an effect of increasing the banks' capital adequacy ratios given the RWAs component as a denominator in the CAR computation.

- **FATCA entered into effect as of July 1, 2014.** The Foreign Account Tax Compliance Act (FATCA) requires foreign financial institutions to identify and report the accounts of U.S citizens, US permanent residents, the accounts of foreign entities where US taxpayers hold a substantial ownership interest and/or other persons and entities specified by the Act. Banks and financial institutions that do not participate in FATCA as well as recalcitrant individuals will be subjected to 30% withholding on most types of US source income. As the Government of Lebanon has not signed an Inter-governmental Agreement with the US on the compliance with the FATCA, the Central Bank has recommended that banks and other financial institutions take all necessary measures to comply with the FATCA.

Recent M&A News

- **Some consolidation seen across the sector.** In recent months, the Lebanese banking landscape has seen some M&A transactions taking place among players looking to increase their market share and recognize synergies. The Near East Commercial Bank sal (NECB) and Banque de l'Industrie et du Travail sal announced their merger to form a new entity named BIT Bank sal. Media reported that the Lebanese operations of Ahli Bank has been seeking a buyer for quite some time, while Cedrus Invest Bank is expected to formally acquire the retail operations of Standard Chartered Bank operations in Lebanon. We note that the Governor of the Central Bank, Riad Salameh, has been encouraging consolidation among Lebanese banks in order to reduce the number of lenders in the country.

Comparable Valuation to MENA Peers

- **Lebanese banks continue to trade at a discount to MENA banks along with weaker profitability.** So far in 2014, we saw higher trading volume on the BSE at 22.4 million share in 5M-14 (up 29% YoY), while listed shares of banks under coverage saw low to mid-single digit growth performance (Bank Audi: +2.1% YTD, Blom Bank: +6.3% YTD, Byblos Bank: +3.2% YTD).

Based on today's listed share price, Lebanese banks are trading at 8.9x P/E, 0.9x P/B and dividend yield of 4.8% despite holding lower than average ROE of 10.9%. In comparison, banks in the MENA region trade at an average of 13.8x P/E, 1.7x P/B and offer a 3.1% dividend yield and a 14.4 % ROE (cf. table below).

Table 4: Comparable Valuation

Ticker	Name	Market Cap. In USD mn	Div. Yield (in %)	EPS Growth (in %)	ROE (in %)	PE ratio	PB ratio
AUDI LB Equity	BANK AUDI SAL	2,228	6.3	-19.8	11.1	8.1	1.0
BLOM LB Equity	BLOM BANK	1,886	5.7	4.1	15.0	5.5	0.9
BYB LB Equity	BYBLOS BANK	905	8.3	-8.1	9.2	8.4	0.7
BEMO LB Equity	BANQUE EUROPEENNE MOY ORIENT	133	0.5	21.6	7.5	17.6	1.3
BOB LB Equity	BANK OF BEIRUT	959	3.0	7.7	11.2	7.7	0.9
BLC LB EQUITY	BLC BANK SAL	305	n/a	-30.7	9.1	9.1	0.8
Average Lebanon		**1,069**	**4.8**	**-4.1**	**10.9**	**8.9**	**0.9**
Average UAE		**12,715**	**3.2**	**19.3**	**14.8**	**13.4**	**1.9**
Average Egypt		**2,735**	**6.3**	**33.9**	**28.0**	**9.1**	**2.4**
Average Kuwait		**10,630**	**1.9**	**-17.8**	**6.5**	**28.5**	**1.7**
Average Oman		**2,578**	**3.7**	**0.7**	**14.6**	**9.3**	**1.3**
Average Qatar		**12,493**	**4.1**	**4.6**	**15.0**	**15.6**	**2.3**
Average KSA		**13,629**	**2.8**	**6.2**	**12.6**	**14.9**	**1.7**
Average Turkey		**9,034**	**1.5**	**7.3**	**14.5**	**9.0**	**1.2**
TOTAL AVERAGE		**9,935**	**3.1**	**7.2**	**14.4**	**13.8**	**1.7**

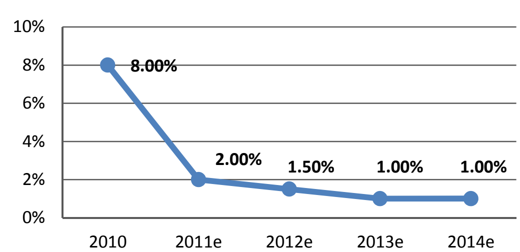
Source: Bloomberg priced as of market close on July 17th 2014 (July 16th close for banks in Turkey), FFA Private Bank for companies under coverage.

Macroeconomic Highlights

- **Economic activity still soft in light of rising uncertainties, in contrast to improvement in external position**

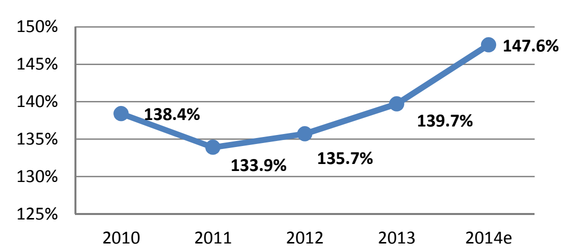
Economic developments continued to be soft in 2013 (following a trend initiated in 2011) with a real GDP growth recently revised downwards to 1% for 2013e and 2014e from 1.5% previously as per the IMF. Capital inflows into Lebanon edged up by 6% YoY to USD 16.2 billion in 2013, which did not offset the large trade deficit at USD 17.3 billion in 2013 which edged up 3% from 2012, thus translating into a balance of payments deficit at USD 1.1 billion in 2013 vs. a deficit of USD 1.5 billion in 2012. In first five months of 2014, balance of payments posted surplus of USD 776 million, as capital inflows slightly exceeded a trade deficit at USD 7 billion (+2% YoY).

Figure 5: Real GDP growth



Source: IMF World Economic Outlook Database April 2014

Figure 6: Gross debt to GDP ratio



Source: IMF World Economic Outlook Database April 2014

- **Drop in FDI inflows, yet resilience in remittances in 2013**

FDI inflows are estimated to have been among the most affected in the context of cautiousness related to regional uncertainties and a sluggish real estate market. Figures released by the UNCTAD show that FDI inflows to Lebanon totaled USD 2.8 billion in 2013, down 23% from USD 3.7 billion in 2012. In parallel, remittances from the Lebanese Diaspora, considered to be one of the largest in terms of proportion to the resident population, have proved to be resilient and are estimated by the World Bank to have reached USD 7.2 billion in 2013 (around 16% of nominal GDP), edging up from USD 6.9 billion 2012 and maintaining Lebanon's ranking among top recipients in developing countries. We expect these inflows to lend support to the Lebanese banking sector's liquidity levels.

- **Growing structural imbalances as fiscal deficit drives debt levels**

Lebanon's public finance continue to weaken in the context of slowing economic activity and prevailing political stalemate. Figures released by the Ministry of Finance show that the fiscal deficit totaled USD 4.2 billion in 2013 and widened by 8% from USD 3.9 billion in 2012 with a fiscal deficit as % of GDP reaching 9.3% in 2013 from 9.1% in 2012. As a result of the rising deficit, Lebanon's gross public debt reached USD 63.5 billion, up 10% from 2012 while the gross debt-to-GDP ratio estimate for 2013 stands at 140% higher than 136% in 2012, suggesting required efforts to improve the country's fiscal imbalances. Looking at the first five months of 2014, we note that gross public debt reached USD 65.1 billion at the end of May 2014 (+2.5% YTD, +9.9% YoY), likely funding fiscal shortfalls (data from Ministry of Finance unavailable since Feb-14).

- **The real economy impacted by regional developments is showing mixed signals**

Lebanon has been witnessing mixed performance in key economic sectors so far in 2014.

The coincident indicator, an index of economic activity in Lebanon comprising 8 weighted economic indicators, reached 285.1 points in April 2014 up from 271.8 in March 2014 and 272.0 in April 2013.

The real estate market is showing some positive signs so far in 2014 with number of transactions increasing 9% YoY in the first five months of 2014 and stronger growth in supply indicators including total area of newly issued construction permits which upped 11% YoY (5M-14).

As for the banking sector's balance sheet growth, we note a deceleration into May 2014 with key balance sheet indicators edging up around +2%-3.5% range YTD. The Governor of the Central Bank expects more moderate growth for the full year closer to 5% following an increase in the 7%-10% range in 2013. Non-resident deposits dropped by 2% YoY in the first five months of 2014 to USD 28 billion, although remain at 20% of total deposits. We note a loans to deposits ratio at 35% in May 2014, reflecting ample liquidity and we highlight that Lebanese banks are still operating in an environment limiting potential for earnings growth.

Looking at tourism, we note that incoming tourists are still on a downward trend as highlighted by a 9% YoY decrease in the number of tourists' arrivals in the first five months of 2014 to 443,071 with a 9% decline in tourist arrivals from Arab countries which accounted for 34% of total visitors in 5M-14. EY's Benchmark Survey of the Middle East hotel sector indicated that the average occupancy rate of hotels in Beirut was 46% in 5M-14 down from 58% in the same period last year. Revenues per available room were USD 73 in Beirut in 5M-14 down from USD 99 in 5M-13.