Lebanese Banks	Bank Audi (AUDI LB)	MARKETWEIGHT	USD 7.00
Q3/14 Preview	Blom Bank (BLOM LB)	OVERWEIGHT	USD 10.00
October 13th, 2014	Byblos Bank (BYB LB)	MARKETWEIGHT	USD 1.60

While Lebanese Banks trade at discount to MENA peers constrained by difficult macro backdrop, lower profitability and structural BSE-related issues, we value their attractive dividends for income oriented investors

■ **Resilient deposits should continue funding private sector and fiscal shortfalls:** Banks have been navigating well through unfavorable conditions amidst a political standstill and a soft real GDP growth averaging 2% in the 2011-2014e period as per the IMF. Figures for 8M-14 pointed to moderate banking sector growth (in the 3%-5% range for assets, deposits and loans reaching USD 170.3 billion, USD 141.5 billion and USD 49.7 billion respectively). At this growth level, assets reached ~360% of 2014e GDP pointing to an oversized banking sector with excess liquidity being deployed towards the public rather than private sector. Non-resident deposits grabbed a 21% share in deposits at the end of Aug-14, along with resilient remittances (holding well above USD 7 billion as per the World Bank) which continue to fuel banks' already high liquidity which in turn finance public debt (~60% held by commercial banks) and provide support to the CB fx reserves while also financing the private sector to a lesser extent (helped by CB initiatives). Should fiscal shortfalls exceed materially or deposits slow considerably, this could put the arrangement at risk.

■ **Balance sheet growth of banks under coverage should sustain same pace as in Q2/14:** In Q2/14, Blom Bank and Byblos Bank saw their deposits and loans QoQ growth at a respective 2% and 4% for Blom Bank, and at a respective 2% and 1% for Byblos Bank (with LDRs in the 29%-30% range), while Bank Audi saw more vigorous growth (+5% for both indicators) mainly driven by Turkish operations (reaching 24% of total assets at the end of Q2/14) with an LDR at 47% distancing itself away from the 35% sector's average in Lebanon as the LDR of Odea Bank (~85%) moves gradually closer to sector's average in Turkey (~115%). We expect soft growth in balance sheet in Q3/14e across our universe while Bank Audi should keep an edge driven by Turkey yet at a more gradual rate (3%-5% range respectively for Bank Audi, 1%-2% range for Blom Bank and Byblos Bank in deposits and loans).

■ **Banks to continue dealing with profitability constraints, although BS growth and easing provisions could alleviate pressures:** Lebanese banks are still dealing with narrowing asset yields from maturing higher coupon gov't securities and low global benchmark policy rates, along with limited capacity to lower the cost of funds given market share concerns amidst slower deposit accumulation (interest spreads in USD and LBP down 14 bps and 43 bps respectively YoY in Aug-14 as per the ABL). On a positive note, we expect continued balance sheet growth and easing provisioning to help alleviate pressures. We note that Q2/14 held no major surprise for profits of banks under coverage at the exception of Bank Audi which saw notably higher profits from a stronger top line. Our estimates for YoY net profit growth in Q3/14e stands at +20%, +5% and +9% for Bank Audi, Blom Bank and Byblos Bank respectively. We continue to closely monitor Odea Bank's results given first set of profits in Q2/14 and its aggressive growth not without possible execution risks. Our expected EPS for the full year 2014e stands at USD 0.83, USD 1.61 and USD 0.20 for Bank Audi, Blom Bank and Byblos Bank. BSE listed banks average at ~11% ROE remains well below MENAT at ~14.5%.

■ **Lack of visibility for investors and underdeveloped equity market likely putting a strain on banks' share prices:** So far in 2014, we saw higher trading volume on the BSE at 75.8 million share in 9M-14 (up 144% YoY), while listed shares of banks under coverage saw slightly negative to mid-single digit growth (Bank Audi: -3.7% Ytd, Blom Bank: +6.1% Ytd, Byblos Bank: +5.2% Ytd). We do not expect any sustainable multiple expansion as 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. Furthermore, we also highlight the fact that the BSE remains underdeveloped and illiquid, hindering stock performance as indicated by relatively low stock market cap as % of GDP and stock market turnover ratio as well as few issuers dominating the market.

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 6.00	-3.7%	7.5x	0.96x	6.7%
Blom Bank	BLOM.LB	Overweight	USD 10.00	USD 8.75	+6.1%	5.5x	0.87x	5.7%
Byblos Bank	BYB.LB	Marketweight	USD 1.60	USD 1.63	+5.2%	8.6x	0.80x	8.1%

Source: Company reports, BSE, FFA Private Bank estimates Note:* listed shares as of market close of October 13, 2014 **Based on TTM EPS

■ **In the absence of any significant multiple expansion, we continue to value the banks relative resilience in operations as well as generous 5%+ dividend yields:** While multiple expansion remains hindered by unstable operating conditions and structural illiquidity on the BSE, we value dividend yields at 5%+ (defended given low payouts and stable profits) as well as relative resilience in operations vs. other domestic sectors. We keep our recommendations unchanged (see table above) and remind that Blom Bank is Overweight in our universe given higher than average margins, efficiencies and ROE, stable growth in earnings, in addition to solid capitalization, sizeable liquidity 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 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 the end of June 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 69%/31% in Q2/14. 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 2.5% as of Q2/14) amidst a difficult backdrop, the solid balance sheet growth and potential to pick up margins and profitability from current levels driven by Turkey. Bank Audi has recently closed a capital increase representing around 50 million additional common shares at an issue price of USD 6.00 per share and 3 warrants on Odea Bank. The capital increase aims to increase conformance vis-à-vis regulatory requirements and fund the expansion plan in the coming three years.

Q2/14 Key Financial Highlights

Net profits at USD 104 million in Q2/14 (+21.3% QoQ, +1.5% YoY) from stronger operating income

- Net interest income up to USD 192 million (+5% QoQ, +20% YoY), from higher balance sheet volumes and margins improvement.
- Surge in fees and commissions in Q2/14 to reach USD 63 million (+21% QoQ, +43% YoY).
- Cost-to-income at 58% in Q2/14, reflecting weaker efficiencies sequentially and YoY, partly on account of the expansion in Turkey.
- Improved asset quality with the gross NPL ratio down to 2.5% translating into lower cost of risk.
- CAR III at 12.3% in Q2/14, while profitability ratios were flat to slightly up.

Latest Key Regional Highlights

- Bank Audi breakdown of assets and earnings between domestic and international operations stands at 55%/45% and 69%/31% respectively as at end June 2014 period.
- In 20 months of activity Odea Bank accumulated USD 9.6 billion in total assets representing 24% of group assets and is seeking gradual convergence towards breakeven in profits as branches gain maturity. H1/14 losses reached nearly USD 5 million despite first set of net profits in Q2/14 at ~ USD 3 million.
- The Bank operations in Syria were downsized to just 1% of consolidated assets and 4% of consolidated profits as of H1/14, thus limiting the exposure of Bank Audi to Syria's heightened risks.
- In H1/14, the Group generated USD 29.8 million in earnings from Egypt accounting for 16% of consolidated profits and 9% of total assets. Management has adopted an accelerated business plan for Egypt with and an objective to double the size of the assets in the medium term.
- Given the unrest in Syria, the Bank's current key growth markets are: Lebanon, Turkey and Egypt.

FFA Model Assumptions

- We forecast net profits of USD 88 million in Q3/14e, up 20% YoY however below USD 104 million in Q2/14.
- Expect net interest income to continue growing (+4% QoQ, +18% YoY) from higher margins and solid earning assets momentum from Turkish expansion. Going forward, Odea Bank should help Bank Audi's margins as Turkish banks typically boast higher margins and as branches gain maturity. Odea Bank's margins have so far in 2014 been trending higher to reach 2.46% for the month of July 2014 (vs. 1.98% in Jan-14) and should converge closer to the sector (~3.0-3.5%+ level).
- Net fees and commissions to reach USD 58 million (-8% QoQ, +28% YoY).
- Balance sheet is expected to remain driven by the branch rollout in Turkey. We expect QoQ growth at 3% and 5% in Q3/14e for deposits and loans respectively, with loans expected to remain more energetic driven by the Turkish expansion (LDR in Turkey: 115% vs. 35% for Lebanon as of June 2014).
- The LDR is expected to trend slightly higher reaching 48% by the end of Q3/14e.
- We forecast provisions of USD 19 million in Q3/14e equivalent to an estimated cost of risk of 0.19%.
- Our estimate for cost to income in Q3/14e at ~60%, still high compared to pre-Turkey expansion levels.
- Looking at 2014e, net profits should total USD 349 million (+14% YoY) with EPS at USD 0.83, driven by stronger operating income and lower cost of risk.

Table 1: FFA Model Forecasts

USD million	FFA Q3/14e	Q2/14a	Q3/13a	QoQ %	YoY %	2013a	FFA 2014e
Net interest income	198.8	191.8	168.6	4%	18%	638.2	776.3
Operating income	318.3	338.9	256.1	-6%	24%	1069.4	1258.0
Net profits	87.7	104.0	73.1	-16%	20%	305.0	349.5
Diluted EPS	0.20	0.26	0.19	-21%	6%	0.80	0.83
Assets	40,493	39,262	34,470	3%	17%	36,191	41,535
Deposits	35,027	33,960	29,471	3%	19%	31,095	35,990
Loans	16,792	16,034	13,565	5%	24%	14,713	17,608
BVPS to common	6.34	6.28	6.31	1%	1%	6.17	6.40
FFA Cost-to-income ratio	*60.0%*	*57.7%*	*58.0%*			*56.1%*	*59.7%*
Loans-to-deposits ratio	*47.9%*	*47.2%*	*46.0%*			*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 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 14.0% 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 27.4 billion and TTM earnings at USD 356 million in Q2/14. The Bank had a total of 224 branches and 4,552 employees as of the end of June 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 76%/24% in Q2/14. 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.

Q2/14 Key Financial Highlights

Net profits up to USD 92 million in Q2/14 (+5% QoQ, +3% YoY)

- Net interest income at USD 136 million in Q2/14, flat QoQ, up 3% YoY.
- Fees and commissions increased to USD 35 million in Q2/14 (+6% QoQ, +3% YoY), representing 17% of total operating income.
- Provisions at USD 13 million in Q2/14, higher sequentially yet still significantly lower YoY. Cost-to-income ratio ratio at 38.5% reflecting high efficiencies.
- On the balance sheet side we note healthy growth in key indicators in Q2/14 in the 2%-4% range QoQ, 4%-7% range Ytd.
- Comfortable capital position with CAR III stable at 17% and profitability ratios at the high end of our coverage universe.

Latest Key Regional Highlights

- Blom Bank breakdown of assets and earnings between domestic and international operations stands at 78%/22% and 76%/24% respectively in Q2/14.
- The Bank operations in Syria have been downsized to just 1.6% of total assets and 2.5% of total profits as of Q2/14, thus limiting the exposure of Blom Bank to Syria's heightened risks.
- In H1/14, the Group generated USD 20.2 million in net earnings from Egypt accounting for 11% of consolidated profits and 7% of total assets.
- Given the unrest in Syria, the Bank's key growth markets are: Lebanon and Egypt.

FFA Model Assumptions

- We expect net profits of USD 91 million in Q3/14e, edging up 5% YoY and roughly flat from previous quarter.
- We forecast operating income at USD 206 million in Q3/14e (-2% QoQ, +17% YoY).
- We expect net interest income at USD 139 million in Q3/14e (+2% QoQ, +3% YoY) as roughly flat margins are likely to be matched with moderate earnings assets growth.
- We forecast slightly higher fees and commissions at USD 33 million for the quarter (-7% QoQ, +15% YoY).

- We expect provisions of USD 18 million equivalent to a 0.20% estimated cost of risk. Our cost-to-income estimate stands at 39% in Q3/14e (within the Bank's usual range).
- Key balance sheet indicators including assets, deposits and loans are expected to grow at a low single digit in Q3/14e, ranging between 1% and 2%.
- At these growth levels, the LDR should remain relatively unchanged edging up 2 bps QoQ to 29% which reflects ample liquidity and significant room to expand lending from current levels.
- For the year 2014e, net profits should total USD 364 million (+3% YoY) with EPS at USD 1.61.

Table 2: FFA Model Forecasts

USD million	FFA Q3/14e	Q2/14a	Q3/13a	QoQ %	YoY %	2013a	FFA 2014e
Net interest income	139.0	136.4	135.3	2%	3%	528.3	549.8
Operating income	206.3	210.4	175.7	-2%	17%	800.2	822.9
Net profits	91.2	91.7	86.9	-1%	5%	352.4	363.9
Diluted EPS	0.40	0.41	0.39	-2%	2%	1.58	1.61
Assets	27,792	27,371	25,694	2%	8%	26,149	28,203
Deposits	23,835	23,484	22,313	1%	7%	22,572	24,191
Loans	6,912	6,758	6,230	2%	11%	6,345	7,064
BVPS to common	10.38	10.10	9.35	3%	11%	9.75	10.67
FFA Cost-to-income ratio	*38.8%*	*38.6%*	*40.3%*			*36.3%*	*38.6%*
Loans-to-deposits ratio	*29.0%*	*28.8%*	*27.9%*			*28.1%*	*29.2%*

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 and dividends.

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 150 million in Q2/14. The Bank had a total of 102 branches and 2,515 employees as of the end of June 2014 with operations in Lebanon as well across Europe, Africa and the MENA region. The Bank's diversification across markets is lagging behind its peers with a breakdown of assets and earnings between domestic and international at 90%/10% and 84%/16% as of H1/14. 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.

Q2/14 Key Financial Highlights

Net profits at USD 39 million in Q2/14 (+26% QoQ,-6% YoY)

- Net interest income at USD 62 million in Q2/14 (+10% QoQ, +10% YoY).
- Non-interest income at USD 49 million in Q2/14, roughly flat QoQ, yet lower YoY.
- NPL ratio improved to 4.8% in Q2/14 while provisions edged up QoQ to USD 10 million (yet still lower YoY). Cost-to-income at 48%.
- Deposits and loans edged up 2% and 1% respectively QoQ, with an LDR at 30.2%.
- Profitability ratios at the low end of our coverage and dividend yield at an attractive 8.2%.

Latest Key Regional Highlights

- Byblos Bank breakdown of assets and earnings between domestic and international operations stands at 90%/10% and 84%/16% respectively in H1/14.
- The Bank operations in Syria have been downsized to just 1.5% of total assets as of June 2014.
- Byblos Bank has operations in Iraq since 2007. Currently operations are conducted through three branches (Baghdad, Erbil and Basra). In H1/14, the Bank' assets and net profits in Iraq totaled USD 243 million and USD 2.4 million representing around 1.3% and 3.7% of total assets and net profits respectively.

FFA Model Assumptions

- We expect net profits of USD 41 million in Q3/14e, up 5% QoQ and 9% YoY.
- We forecast net interest income of USD 63 million in Q3/14e, up 2% QoQ and 10% YoY, consistent with a trend initiated in past quarter as Management takes initiatives against compressed margins.
- Fees and commissions income expected at USD 26 million in Q2/14e (+5% YoY).
- Key balance sheet indicators namely assets, deposits and loans are expected to witness moderate growth at a low single digit in Q3/14e (+2% QoQ), with an LDR maintained at 30%.
- We forecast provisions of USD 14 million in Q3/14e equivalent to an estimated cost of risk at 0.30%. Our cost-to-income estimate stands at 46% for Q3/14e and 48% for the full year 2014e.
- Looking at 2014e, net profits should reach USD 155 million with EPS at USD 0.20, both roughly unchanged from last year.

Table 3: FFA Model Forecasts

USD million	FFA Q3/14e	Q2/14a	Q3/13a	QoQ %	YoY %	2013a	FFA 2014e
Net interest income	62.5	61.6	57.0	2%	10%	232.2	243.3
Operating income	119.6	110.2	103.4	9%	16%	448.1	456.7
Net profits	40.9	38.8	37.7	5%	9%	156.2	155.4
Diluted EPS	0.05	0.05	0.05	7%	3%	0.20	0.20
Assets	19,004	18,633	18,029	2%	5%	18,485	19,209
Deposits	15,533	15,274	14,407	2%	8%	14,749	15,790
Loans	4,702	4,617	4,260	2%	10%	4,511	4,787
BVPS to common	2.08	2.06	2.05	1%	1%	2.13	2.10
FFA Cost-to-income ratio	*46.2%*	*48.1%*	*51.8%*			*46.9%*	*47.8%*
Loans-to-deposits ratio	*30.2%*	*30.2%*	*29.6%*			*30.6%*	*30.2%*

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.

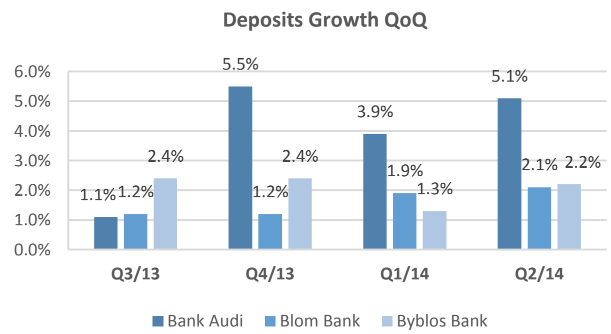
Recommendation

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

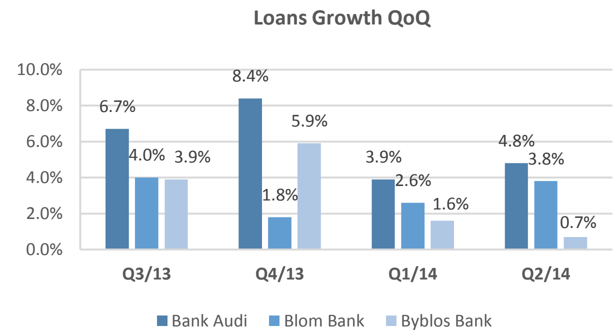
Based on our revised forecasts and discount rate assumptions to our Dividend Discount Model, our fair value estimate has been maintained at USD 1.60 per share. Our DDM assumes a 15.5% cost of equity and a 3% terminal growth rate. We corroborate our DDM valuation by means of the residual income method as well as historical and comparable P/E and P/B multiples.

Banks Under Coverage – Comparative Snapshots

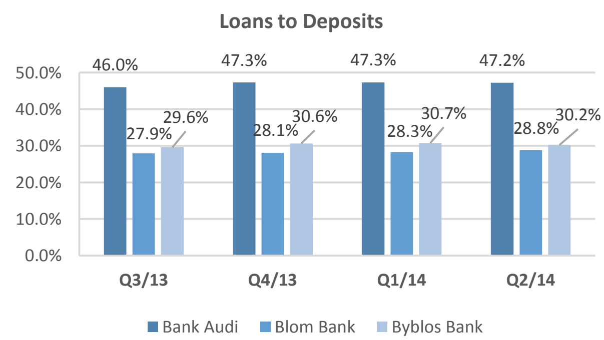
Bank Audi has been accumulating deposits at higher rate than peers on account of Turkish expansion



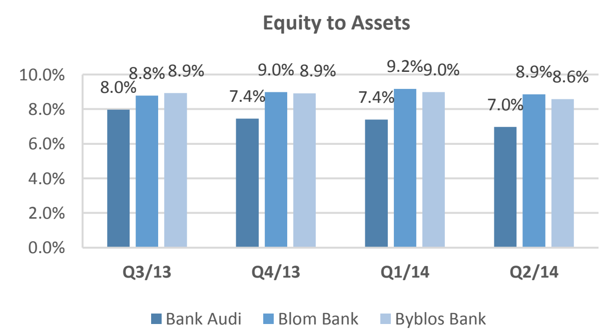
Blom Bank and Byblos Bank have sustained moderate loan growth, while Bank Audi's lending activity remains driven by Turkey



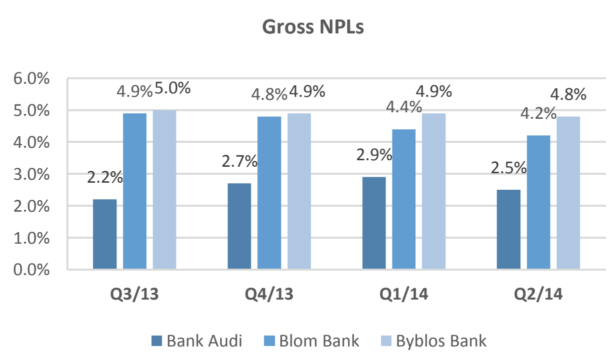
While Blom Bank and Byblos Bank's LDR remain below sector's average at 35%, Bank Audi LDR exceeds average at ~47%



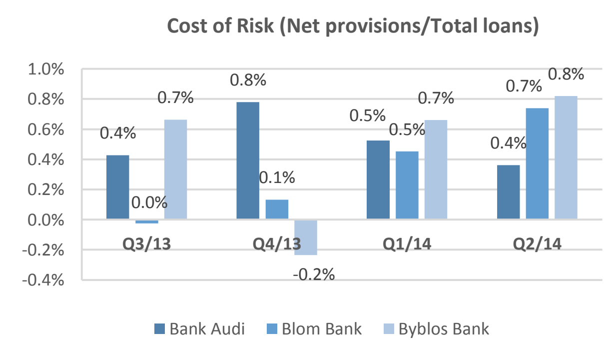
Recent USD 300 million capital increase to strengthen Bank Audi's weaker capital position compared to peers



We value Bank Audi's lower NPLs levels compared to peers which we continue to closely monitor given its higher growth and LDR

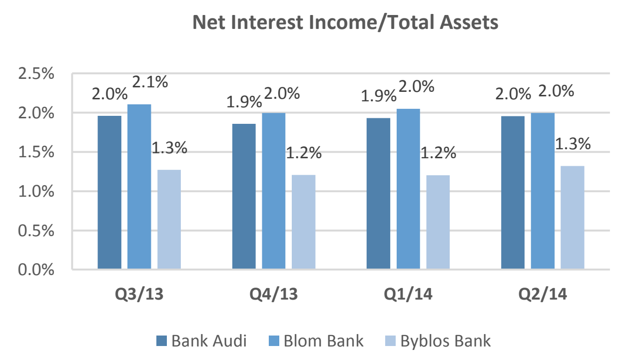


Provisioning pressures have eased in past quarters following 2012's provisioning peaks despite disparities between quarters and banks

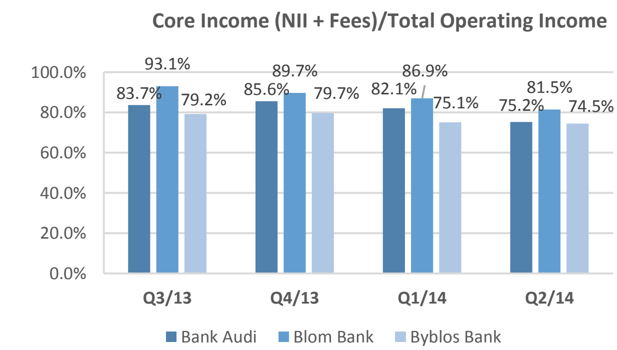


Source: Company reports and FFA Private Bank estimates

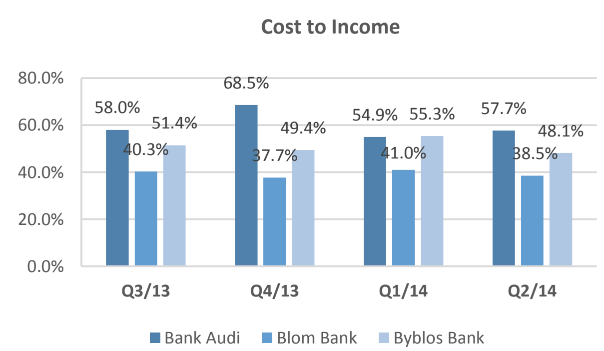
Stable margins for Blom Bank, while Bybos Bank's liquidity accumulation strategy has dampened margins and Audi's margins to improve as Odea converges towards Turkish average



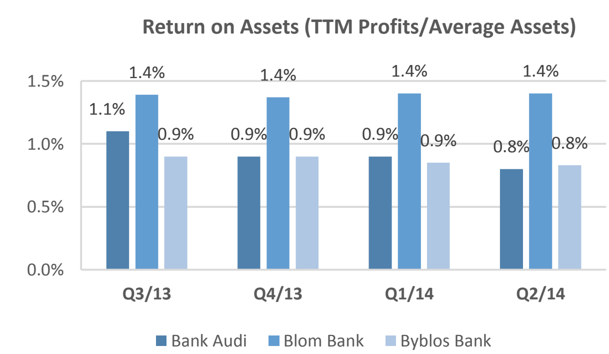
Blom Bank core income's contribution to total higher than peers although witnessing a decline over the past four quarters



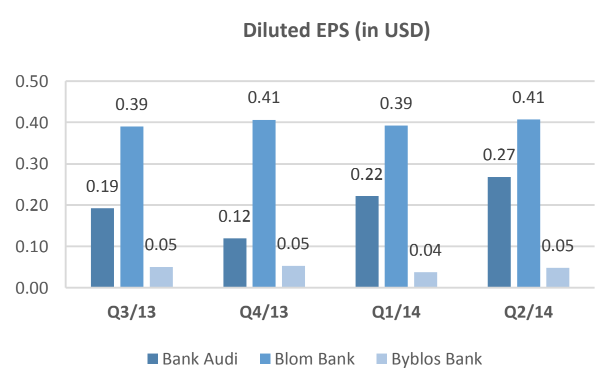
Blom Bank typically boasts higher efficiencies than peers, while Bank Audi cost-to-income surged reflecting Odea's initial stage of expansion



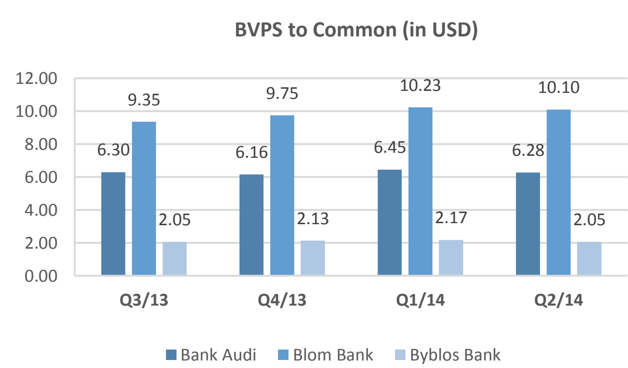
We value Blom Bank higher profitability compared to peers at a stable 1.4% over the past four quarters



EPS volatility has been higher for Bank Audi with a noticeable improvement in the last reported quarter



Book value per share to common reveals that only Blom Bank has witnessed substantial improvement over the past four quarters



Source: Company reports and FFA Private Bank estimates

Lebanese Banking Sector Highlights

Recent Banking Sector Highlights

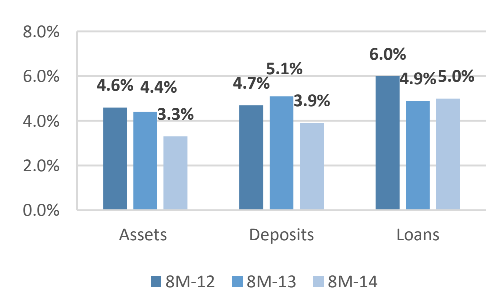
- **Lebanese banks still reporting descent balance sheet growth amidst difficult operating conditions**. Banks have been weathering the unfavorable political and economic conditions amidst a political standstill and a lackluster real GDP growth averaging 2% in the 2012e-2014e period as per the IMF latest estimates. In 2013, key balance sheet indicators grew in the 7%-10% range, while profits remained flat.

  Looking at 2014 , we note that Lebanese banks have, so far, seen a continuous growth in their key balance sheet indicators in the 3%-5% range Ytd (see figure 1), for assets, deposits and loans to reach USD 170.3 billion, USD 141.5 billion and USD 49.7 billion respectively at the end of August 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 35.1 billion in July 2014 up 11% since the beginning of the year. Looking at market shares by key balance sheet indicators at end-2013, we highlight that Bank Audi is the market leader in terms of assets, deposits and loans, Blom Bank comes second, while Byblos Bank holds the third position in assets and deposits and ranks 4th just after Fransabank in terms of loans.

- **Non-resident deposits funds 21% of total deposits and remains a key strength for the sector**. Non-resident deposits edged up 3% Ytd in 8M-14 to USD 29.3 billion as the 5% QoQ drop that was registered in Jan-14 was recouped in following months. At the end of August 2014, non-resident deposits accounted for a substantial 21% of total deposits (compared to 14% in 2007), pointing to a gradual higher contribution over past several years; although at a slower pace this year.

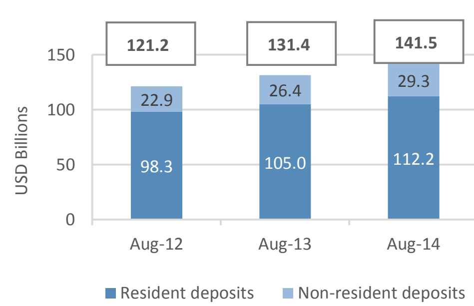
  Assets remain mainly funded by deposits at 83%, while asset allocation at the end of Jul-14 reflects two main avenues for liquidity including government securities and loans to the private sector. LDR at 35% reflects ample liquidity levels. Dollarization of deposits and loans stood at 66% and 76% respectively.

Figure 1: Ytd growth in first eight months of the year



Source: BDL

Figure 2: Resident vs. non-resident deposits



Source: BDL

- **We believe that the banking system has to grow by 6% per year to keep on funding fiscal shortfalls.** The majority of the asset base of Lebanese banks is exposed to government securities (T-bills, Eurobonds, and CDs at ~ 50%) and loans to the private sector (~30%). We note that ~60% of government gross debt (T-bills + Eurobonds) is held by Lebanese banks which ties both parties together ensuring a healthy market for government securities. We estimate the banking system needs to grow 6% in deposits equivalent to ~USD 8.5 billion in order for the share of liquidity that does not go into private lending can be directed towards absorbing the new government shortfalls. A slower growth rate in deposits on account of higher risk in Lebanon or higher fiscal deficit would put this arrangement in question.

- **Central Bank continues to stimulate the economy by subsidizing loans and offering facilities in reserve 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 Banque du Liban (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. 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.

- **Lebanese banks are still operating in a challenging environment putting pressure on earnings growth, although not yet at the detriment of dividends**. Sluggishness in earnings growth continues to prevail across the banking system. Net earnings of alpha banks and sector were roughly unchanged in 2013 at USD 1.7 billion and USD 1.8 billion respectively, with alpha banks' net profits accounting for nearly 95% of the sector total net profits. Looking at H1/14, alpha banks saw their net profits increasing 6% YoY to USD 910.5 million which should be interpreted with caution given that the alpha group (banks with deposits in excess of USD 2 billion) moved from a total of 13 banks in 2013 to 14 banks in 2014. More generally, it seems like Lebanese banks' earnings are still lackluster on account of pressured margins and moderate balance sheet expansion although helped by easing provisioning pressures following a peak seen in 2012 as books in Syria have been severely downsized.

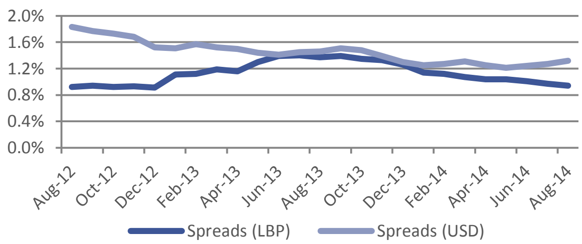
  Although banks' profits have been uninspiring over the past couple of years, we have not seen significant cut in dividends programs, which we expect to remain safe and attractive for investors with payouts at an average of ~50% of profits for banks under coverage in 2013 (at nearly 52% for Bank Audi, 32% for Blom Bank and 68% for Byblos Bank).

- **Both spreads in USD and LBP are on a downward trend in August 2014 compared to one year earlier**. Statistics from the ABL for the month of August 2014 reveal that Lebanese banks are still operating in a low interest environment, limiting potential to improve earning asset yields along with limited capacity to decrease the cost of funds given market share concerns amidst slower deposit accumulation.

  Spread in USD decreased to 1.32% in August 2014 down from 1.46% 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 15 bps increase in the cost of funds to 3.04% in the context of roughly unchanged weighted average on uses of funds at ~4.35%. Reminder, banks are still dealing with a negative carry on USD liquidity.

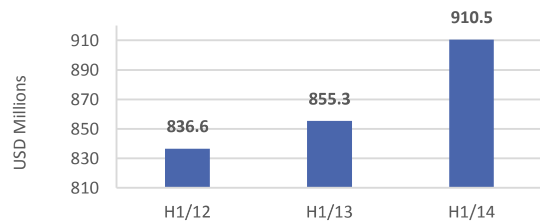
Spreads in LBP narrowed YoY in August 2014 (0.94% vs. 1.37% in Aug-13) from higher cost of funds (+8 bps to 5.51%) and lower return on uses of funds (-35 bps to 6.45%) which was dragged down by lower lending rates (-7 bps to 7.34%) and more essentially lower rates on CDs issued by the BDL (-67 bps to 8.12%) despite higher weighted yield on T-bills (+20 bps to 6.92%).

Figure 3: Spreads in USD and LBP



Source: Association of Banks in Lebanon

Figure 4: Alpha banks net profits in first half of the year



Source: Bank Data

- **Interest rates are not expected to increase in the short term, which should continue to weigh on earnings, although growing balance sheets and easing provisions to help profits**. The Governor of the BDL Riad Salame recently stated that he expects interest rates in Lebanon to remain stable in the absence of external market pressures given that banks hold a substantial portion of their liquidity between placements at Central Bank and interbank which are tied to global benchmark rates. Current global interest rates' policies remain accommodative although could see the beginning of a gradual increase in rates starting next year for Bank of England and Fed, while the ECB and Japan remain accommodative and keeping interest rates low for the foreseeable future.

  Furthermore, Lebanese banks used to hold in their balance sheet high yielding government bonds that matured which going forward could either put pressure on margins or on their capacity to fund provisions. On the cost of funds side, most banks are unlikely to drastically increase rates facing pressured interest margins and flat earnings while maintaining them sufficiently attractive to depositors to maintain market share and drive earning assets growth.

  Although expect tighter interest margins from maturing higher coupon government securities and still low global benchmark rates, sustained growth in earning assets funded by deposits and easing provision pressures should continue to ease downward pressures on banks' profits and ultimately support dividends.

News and Regulatory Updates

- **In August 2014, Central Bank issued amendment to basic circular 81, tightening conditions for retail loans.** The Central Bank of Lebanon recently issued an intermediate circular 369 on August 21, 2014 (which amends basic circular 81 dating February 21, 2001) and should enter into effect as of October 1, 2014. The amendments tightened regulations on retail lending. On one hand, the article imposes more restrictive limits on lending amount based on the value of purchase for housing loans and car loans, and other limitation on the cumulative monthly payments depending on borrower's monthly income. On another hand, the circular also introduced specific and general provisions requirements against these retail loans.

- **In its Article IV Consultation Report on Lebanon issued in July 2014, the IMF issued recommendations for Lebanese banks ranging from deposit growth and sovereign exposure to capital buffers and loan classification.** IMF considered that a growth rate of about 8% for deposits would be enough to finance the economy and the Central Bank's reserve requirements, it recommends banks to avoid a return to double digit deposit growth that would generate excess liquidity. The IMF recommends that the banking sector should reduce its reliance on government securities over time. It also tackled capitalization and NPLs considerations, recommending banks to strengthen their capital buffers given their large exposure to the sovereign and called on the BDL to improve loan classification and restructuring rules.

Comparable Valuation to MENA Peers

- **Lebanese banks trade at a discount to MENAT banks along with weaker profitability, yet offer higher dividend yields and refuge from global markets.** We saw higher trading volume on the BSE at 75.8 million share in 9M-14 (up 144% YoY), while listed shares of banks under coverage saw slightly negative to mid-single digit growth performance (Bank Audi: -3.7% Ytd, Blom Bank: +6.1% Ytd, Byblos Bank: +5.2% Ytd).

  Based on today's listed share price, Lebanese banks are trading at 8.9x P/E, 0.9x P/B and attractive dividend yield of ~5% despite holding lower than average ROE of 10.7%. In comparison, banks in the MENAT region trade at an average of 13.8x P/E, 1.7x P/B and offer a 3.3% dividend yield and a 14.4 % ROE (see table below).

  While stock price appreciation of Lebanese banks could only benefit to long term patient investors as banks can remain cheap at 1x book given weaker profitability and higher risk levels, they could rather benefit from ~5% returns from attractive dividend programs and negligible correlation levels to MENAT and global markets ranging between -0.05 to +0.05.

Table 4: Comparable Valuation

Ticker	Name	Market Cap. In USD mn	Ytd Growth (in %)	Div. Yield (in %)	EPS Growth (in %)	ROE (in %)	PE ratio	PB ratio
AUDI LB Equity	BANK AUDI SAL	2,338.5	-3.7	6.7	-8.3	11.3	7.5	1.0
BLOM LB Equity	BLOM BANK	1,881.3	6.1	5.7	2.4	15.5	5.5	0.9
BYB LB Equity	BYBLOS BANK	921.8	5.2	8.1	-11.4	9.5	8.6	0.8
BEMO LB Equity	BANQUE EUROPEENNE MOY ORIENT	127.3	-6.0	0.6	21.6	7.5	16.7	1.3
BOB LB Equity	BANK OF BEIRUT	928.1	-3.2	3.1	7.7	11.2	7.4	0.8
BLC LB EQUITY	BLC BANK SAL	259.6	-12.8	n/a	-30.7	9.1	7.8	0.7
Average Lebanon		**1,076.1**	**-2.4**	**4.8**	**-3.1**	**10.7**	**8.9**	**0.9**
Average UAE		**12,712.1**	**25.2**	**3.2**	**19.3**	**15.0**	**12.6**	**1.9**
Average Egypt		**3,358.5**	**45.5**	**5.0**	**33.9**	**26.1**	**11.2**	**2.8**
Average Kuwait		**10,720.6**	**13.0**	**1.8**	**-17.8**	**7.6**	**27.9**	**1.9**
Average Oman		**2,615.1**	**19.5**	**3.6**	**0.7**	**14.6**	**9.3**	**1.3**
Average Qatar		**13,458.2**	**34.3**	**4.0**	**4.6**	**14.9**	**15.7**	**2.3**
Average KSA		**15,012.6**	**30.4**	**2.4**	**6.2**	**12.6**	**16.7**	**1.9**
Average Turkey		**7,551.6**	**5.4**	**1.7**	**7.3**	**14.0**	**7.8**	**1.0**
TOTAL AVERAGE		**8,313.1**	**21.4**	**3.3**	**6.4**	**14.4**	**13.8**	**1.7**

Source: Bloomberg priced as of market close on October 13th 2014, FFA Private Bank for companies under coverage.

Lebanese banks valuation should remain capped by high political and security risks, keeping investors on the sideline and limiting multiple expansion. On a positive note dividend yields are still attractive compared to global and regional benchmark and are typically paid in the month of April/May each year for banks under coverage.

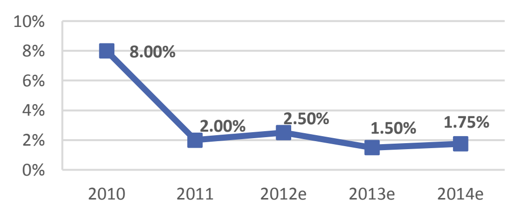
- **The BSE remains generally underdeveloped and illiquid, limiting stock performance upside**. According to the IMF's latest Global Financial Stability Report, the BSE market clearly lags behind other MENA markets. It points the fact that Lebanon's non-bank financial sector is underdeveloped (~15% of GDP) compared to the oversized banking sector with assets at about 360% of 2014e GDP. The stock market is dominated by one large real estate player, Solidere and several banks (Bank Audi, Blom Bank, Byblos Bank, Bank of Beirut, Banque Bemo, and BLC Bank) which together represented 96%+ of the stock market total market cap for 2013 including preferred shares and GDRs. Stock market cap as percent of GDP is low compared to regional and global benchmarks at just ~25%. Stock market turnover ratio also appears low on a regional and global scale at around 20% highlighting low liquidity levels. Studies have shown that a large banking sector can constrain capital markets' development in addition to the dominance of family businesses and weaker corporate governance, need for stronger regulatory, legal frameworks and stock market privatization, high sensitivity to political and security incidents, high yielding government papers competing with listed securities, delayed privatizations which could make way for IPOs.

Macroeconomic Highlights

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

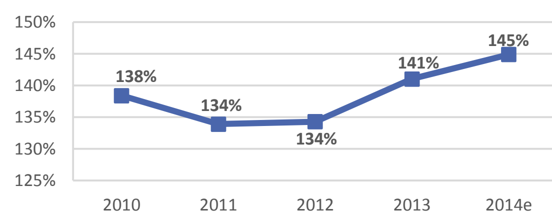
Economic developments continue to be soft with a GDP growth rate averaging 2% between 2011 and 2014 as per the IMF estimates (see figure 5) down from a 9% average in the previous four year period, suggesting sharp deceleration in economic activity. However, we note that in its recent October 2014 economic outlook database, the IMF revised its estimates for Lebanon's GDP slightly upwards for the 2012-2014 period to ~2% from 1.2% previously. Capital inflows into Lebanon increased 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 (+3% YoY), 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 the first eight months of 2014, balance of payments posted surplus of USD 433 million, as capital inflows slightly exceeded a trade deficit at USD 12 billion (-2% YoY).

Figure 5: Real GDP growth



Source: IMF World Economic Outlook Database October 2014

Figure 6: Gross debt to GDP ratio

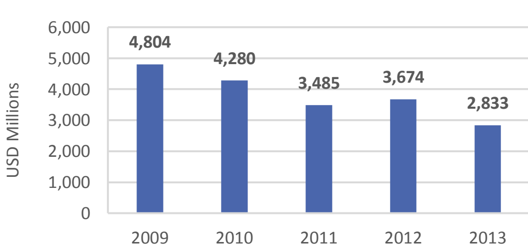


Source: IMF World Economic Outlook Database October 2014

- **Drop in FDI inflows, yet resilience in remittances to continue to lend support to the banking sector**

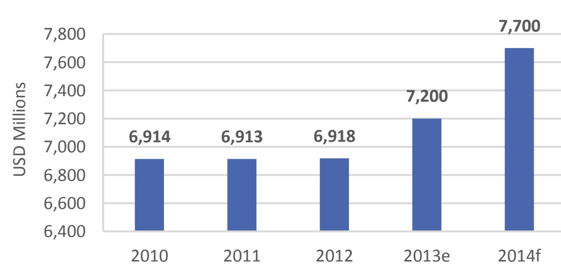
FDI inflows are estimated to have been among the most affected in the context of cautiousness related to regional uncertainties and a sluggish real estate market. Figures released by the UNCTAD show that FDI inflows to Lebanon totaled USD 2.8 billion in 2013, down 23% from USD 3.7 billion in 2012. In 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 larger and more stable than FDIs inflows 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 in 2012 and maintaining Lebanon's ranking among top recipients in developing countries. In its recently published Migration and Development Brief, the World Bank estimates stronger remittances inflows into Lebanon for 2014 at USD 7.7 billion (equivalent to 17% of 2013 GDP). We expect these inflows to continue to lend support to the Lebanese banking sector's liquidity levels.

Figure 7: FDI inflows



Source: UNCTAD

Figure 8: Remittances inflows



Source: World Bank, April 2014 update

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

Lebanon's public finances continue to weaken in the context of slowing economic activity and the prevailing political stalemate. Figures released by the Ministry of Finance show that the fiscal deficit totaled USD 4.2 billion in 2013 widening 8% from USD 3.9 billion in 2012 with a fiscal deficit as % of GDP reaching an approximate 9.4% 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 141% higher than 134% in 2012, suggesting required efforts to improve the country's fiscal imbalances. Gross public debt reached USD 65.9 billion at the end of August 2014 (+3.7% Ytd, +8.9% YoY), funding fiscal shortfalls. While government fiscal situation worsens, budget deficit as % of GDP is expected to increase to ~11% of GDP for 2014, driving gross debt to reach 145% of GDP in 2014 according to the IMF. Resilient capital inflows into the banking system should continue to finance the debt as oversized banking system continues to purchase government securities on account of high liquidity levels and slower economic environment.

- **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 of economic an index of economic activity in Lebanon comprising eight weighted economic indicators, reached 273.4 in June 2014 compared to 283.6 in May 2014 yet still higher than 265.5 in June 2013.

The real estate market, a traditional growth engine which has suffered in the past few years, is showing some positive signs so far in 2014 with number of transactions increasing 3% YoY in the first eight months of 2014 and positive growth in supply indicators including total area of issued construction permits which upped 9% YoY in 7M-14.

As for the banking sector, key balance sheet indicators saw an increase in the +3%-5% range Ytd reaching USD 170.3 billion, USD 141.5 billion and USD 49.7 billion for assets, deposits and loans respectively. Non-resident deposits grew by 3% Ytd in the first eight months of 2014 to USD 29.3 billion, funding 21% of total deposits.

Looking at tourism, we note that the sector remains lackluster although paring back the sharp decrease in activity seen in previous years. Incoming tourists stagnated so far in 2014 as highlighted by a 1% YoY increase in the number of tourists' arrivals in the first eight months of 2014 to 897,106 with a 5% increase in tourist arrivals from Arab countries which accounted for 32% of total visitors in 8M-14. Airport activity (including number of arrivals, departures and transit) was up 2% YoY in 8M-14. EY's Benchmark Survey of the Middle East hotel sector indicated that the average occupancy rate of hotels in Beirut was 49% in 8M-14 down from 54% in the same period last year. Revenues per available room were USD 81 in Beirut in 8M-14 down from USD 93 in 8M-13.

- **Profound structural issues facing the Lebanese economy will continue to threaten sustainable growth unless serious reforms are undertaken**

The overall assessment undoubtedly point to the fact that the Lebanese economy has been suffering from the adverse effect of the prolonged Syrian crisis as highlighted by i) a deceleration in GDP growth to 1-2% in the 2011-2014e period as per the IMF, significantly below pre-Syria crisis levels ii) lower FDIs inflows on account of a deterioration in the investment environment, iii) drastically declining tourism activity iv) slower real estate activity (with both tourism and real estate market considered among the key pillars of the Lebanese economy) v) large inflows of Syrian refugees now estimated to account for more than a quarter of the population with serious impact on levels of employment, poverty, and government social/medical programs. World Bank estimates fiscal strains from Syrian refugees at a cumulative USD 2.6 billion between 2012 and 2014 (equivalent to ~6% of 2013 GDP).

In addition to the growing pressures from regional tensions and domestic uncertainties, Lebanon has also to deal with fiscal imbalances which are inflating debt levels. The structural imbalances are a direct reflection of the surge in public expenditures related to the absence of comprehensive budgetary framework, poor tax collections and the absence of any fiscal adjustment efforts which is driving Lebanon's large debt burden higher and now ranking among the highest in the world. Serious fiscal measures to reduce the structural imbalances and to insure the long-term financial immunity of the country seems unavoidable. Among these measures are: enhancing the efficiency of non-profitable government entities specifically EDL, improving tax collections, promoting private sector participation in infrastructure investment and defining a fiscal framework.

On a positive note, the Lebanese economy has been showing some pockets of resilience including continuous growth in the banking system, resilient remittances inflows from Lebanese expatriates as well as monetary stability.

A return to healthier economic growth (convergence towards potential GDP) will remain dependent on the improvement in the domestic security situation and on regional political stability, although even with such improvement structural issues facing the Lebanese economy will continue to threaten sustainable growth unless serious reforms are undertaken. Within this backdrop, we do not expect to see a marked improvement in operating environment for banks beyond growth in the low to mid-single digits at the bottom line.