Equity Research - Lebanese Banks - Q4/16 Preview

Believe improved political climate and recent BDL debt swap operations to have favorably impacted bank shares. Expect improvement to continue on marginally firmer macro and sentiment going into a yield appetizing dividend season

Debt swap between BDL and banks bolsters foreign assets and drives banking sector balance sheet after subdued deposits growth in H1/16

Lebanese banking sector registered stronger growth in Q3/16 with assets, deposits and loans at respective +6%, +4% and +4% YTD following particularly slower growth during the first half of the year. Banking sector assets reached USD 198 billion in Q3/16, funded at ~80% by deposits at USD 158 billion while loans were at USD 50 billion, supported by BDL economic stimulus scheme totaling ~USD 5 billion since 2013, recently extended by ~USD 1 billion until October 2017 targeting productive sectors, housing, education and renewable energy projects. Alpha banks saw an improvement in profitability with net profits at +9.7% YoY in 9M 16 and return on average assets at 1.17% from 1.00%. BDL's several debt swap operations likely exceeding USD 12 billion, which took place between May and November 2016, led to higher deposits growth, particularly from non-resident USD deposits. The scheme succeeded in reinforcing the BDL's foreign assets to around USD 40 billion by November 2016 from around USD 35 billion in April 2016. BDL's non-conventional response to the decline in its foreign reserves-which are necessary to maintain the stability of the Lebanese pound- came in a context of external account pressures from growing trade deficits and slower remittances while softer real estate market, weaker investor sentiment and absence of reforms also negatively impacted FDIs. Net foreign assets were also impacted by the USD 2 billion T-bills-Eurobonds swap between BDL and the MoF which netted BDL's foreign assets lower given additional Republic of Lebanon USD liability.

Bank Audi and Blom Bank reported strengthened capital positions and improved profitability in Q3/16 mainly from material one-off gains following debt swap operations and steady growth in profits while Byblos Bank growth underperformed

Bank Audi saw stronger QoQ growth in assets and deposits in Q3/16 at +8%/+6% on large participation in BDL swap transactions while Blom Bank and Byblos Bank registered growth at respective +2%/+1% and +1%/flat. On a YoY basis, assets and deposits grew at +7%/+3% for Bank Audi, +4%/+3% for Blom Bank and +6%/+6% for Byblos Bank. Loans growth QoQ/YoY was at +2%/+11% for Bank Audi, +2%/+7% for Blom Bank and +2%/+9% for Byblos Bank. LDR for Blom Bank and Byblos Bank came in at ~29%, below the sector's average of ~32% while Bank Audi's LDR stood at ~51% benefiting from strong lending in Turkey and Egypt with LDRs at respective ~92% and ~66%. Bank Audi and Blom Bank reported higher CAR levels in Q3/16 at respective 15.5% and 18.1% as gains from debt swap provided them with additional regulatory capital. Byblos Bank's CAR declined on less favorable risk weights following T-bills/Eurobonds swap as LBP enjoys preferential treatment. Profitability was estimated higher QoQ and YoY for Bank Audi and Blom Bank with ROA at respective 1.08% and 1.55% while Byblos Bank's ROA slightly declined to 0.81%. QoQ/YoY growth in net profits came in at respective +8%/+22% for Bank Audi, flat/+18% for Blom Bank and flat/-11% for Byblos Bank.

Expect banks under coverage to benefit domestically from political progress and improved sentiment while f/x volatility and uncertain outlook in foreign operations should weigh on consolidated results

We expect balance sheets of banks under coverage to benefit from marginal improvement in domestic environment in Q4/16e and going into 2017, which should favor deposit growth while LBP lending encouraged by BDL amid stable NPLs should support quality loan growth. Bank Audi and Blom Bank are expected to be impacted by material currency devaluation in their key foreign markets with losses in TRY and EGP against the USD at respective 17% and 104% in Q4/16. However, results in local currency are expected to remain somewhat stable in Egypt as positive effects of IMF loan start to materialize. The outlook for Turkey is still uncertain as political/security environment remains unfavorable for a recovery in capital inflows. For Q4/16e, we forecast YoY growth in assets/deposits/loans at +4%/+4%/+5% for Bank Audi, +2%/+1%/+4% for Blom Bank and +4%/+5%/+6% for Byblos Bank. On the bottom line, Lebanese banks should continue to benefit from NIMs improvement with higher spreads in LBP and USD at respective +22 bps and +15 bps between December 2015 and November 2016 mainly on higher asset yields in LBP (+18 bps), and higher rates on USD deposits at BDL (+110 bps) despite increase in cost of funds in USD (+27 bps). We expect banks to see yield improvements on their USD denominated assets following debt swap as liquidity shores up at BDL via CDs and as rise in Libor helps interbank, which should help their core income. Profit growth is also expected to benefit from lower cost of risk following strong provisions taken in Q3/16 and contained NPLs.

Non-recurring gains improve banks' capitalization ahead of tighter regulatory requirements while more favorable political climate and steady core income growth should reflect positively on shares prices going into dividend season

Despite the banking system's profitability and capitalization improving on non-recurring gains during the back half of 2016 and as shares have reacted favorably to improved political climate, we believe Lebanese banks offer an interesting entry point for investors given stable core income growth and favorable dividend yields. We highlight Blom Bank's capacity to increase dividends given its steady earnings growth and superior Common Equity Tier 1 ratios ahead of new BDL standards. We expect recent political progress which should translate into improved investment environment and stabilizing credit risk for Lebanon, to reflect positively on shares ahead of dividend programs typically paid annually in April.

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 6.54	-3.8%	6.2x	0.86x	6.1%
BLOM BANK	(BLOM LB)	OVERWEIGHT	↑ USD 12.00	USD 10.80	+1.9%	4.9x	0.91x	7.7%
BYBLOS BANK	(BYB LB)	MARKETWEIGHT	USD 1.55	USD 1.71	+0.6%	8.5x	0.77x	7.8%

Source: Company reports, BSE, FFA Private Bank estimates Note: *January 20, 2017 market close, **Based on TTM EPS, *** Based on approved dividends for 2015 results

We update our target price for Blom Bank while keeping it unchanged for Bank Audi and Byblos Bank and note that Blom Bank is the sole Overweight in our coverage universe: We update our target price for Blom Bank to USD 12.00 from USD 11.50 and maintain our target price unchanged for Bank Audi and Byblos Bank at USD 7.00 and USD 1.55. We note 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, sizable liquidity and conservative approach to growth. While Bank Audi is Marketweight, we see upside on account of efforts to improve profitability and diversify risk through geographical expansion.

BDL debt swap led to sizeable gains for Lebanese banks, subject to BDL Circular 446 by end of 2016

BDL's debt swap operations were initiated as a response to the decline in its foreign reserves in a context of external account pressures, particularly from slower remittances and deposits sourced from neighboring countries -mainly GCC- as their economies faced tougher conditions amid lower oil prices and fiscal consolidation while the softer real estate market and absence of economic and budgetary reforms also impacted FDIs. Foreign assets were also impacted by the USD 2 billion T-bills/Eurobonds swap which netted BDL's foreign assets lower given additional Republic of Lebanon USD liability. Trade deficit resulting from lower exports partly due to the closure of borders with Syria as well as subdued domestic economic activity weighing on the current account while weak capital flows led to a deficit in the balance of payments. The debt swap operation, which likely exceeded USD 12 billion, consisted of:

i) swapping local currency Treasury bonds (T-bills) held by the central bank with Eurobonds issued by the Ministry of Finance in the amount of USD 2 billion

ii) acquiring T-bills held by Lebanese banks on the condition of subscribing in USD denominated Eurobonds and CDs at an equivalent amount. T-bills and future coupons were discounted at 0%, subject to a 50% haircut on future coupons in favor of the central bank

In order to engage in this operation, Lebanese banks had to source USD liquidity from overseas operations and interbank or from selected clients offering them exceptional rates on term deposits.

BDL Circular 446, issued in December 2016 and applicable by 31/12/2016, requires banks to comply with a number of directives before recognizing any distributable profits from their participation in the debt swap:

i) book the excess liquidity made from debt swap transactions under deferred liabilities and include it in Tier 2 capital

ii) comply with BDL's collective provisions requirements

iii) comply with BDL's capital adequacy requirements

iv) constitute necessary reserves for IFRS 9 implementation (targeted by BDL at an average of 2% of risk weighted assets)

vi) build provisions to cover for currency devaluations in foreign operations

vii) cover impairment on goodwill

In case of remaining surplus, 70% of the amount would be recognized as non-distributable reserves under Common Equity Tier 1 and 30% would remain under deferred liabilities and included in Tier 2 capital.

BDL swap transactions resulted in a better capitalized banking system and an improved balance of payments position in Q3/16 while exposure to foreign-currency denominated debt increased

While the BDL's debt swap transactions succeeded in reinforcing the central bank's foreign assets to around USD 40 billion by November 2016, we highlight some of its immediate impacts on the banking sector and macro level:

i) banks benefited from non-recurrent income in LBP which they should use to strengthen their regulatory capital ahead of new BDL capital adequacy requirements raised to 14.5% by end of 2017 and 15.0% by end of 2018 from 14.0% in 2016 well above Basel III standards, and build provisions ahead of IFRS 9 implementation in January 2018 therefore by minimizing the new requirements' impact on the bottom line

ii) banks benefited from improved yields on their USD denominated assets raised from abroad now placed at BDL, although partly mitigated by rise in cost of deposits given likely shortage in f/x

iii) government's cost of borrowing was reduced as maturing T-bills were swapped against Eurobonds amounting to USD 2 billion although we highlight higher exposure to exchange rate risk for the Ministry of Finance. In addition, the gains released by banks from BDL's scheme were transferred from the public sector to the private sector given its zero-sum gain nature. BDL balance sheet weakened on higher exposure to USD denominated debt

iv) balance of payments registered a cumulative surplus of USD 332.0 million in November 2016 from a cumulative deficit of USD 1.8 billion in May 2016 on account of stronger deposit growth accelerating from 0.9% YTD at end of April 2016 to 5.0% YTD at end of November 2016

v) although ~70% of loans in the Lebanese banking sector are denominated in USD, reduced USD and excess LBP liquidity has not yet had an immediate impact on interest rates for private sector borrowers although we highlight potential impact on loan interest rates, which are variable in a large part, given increase in cost of deposits in USD. LBP surplus is expected to be absorbed as lending in local currency increases and as BDL offers banks improved terms to place their LBP liquidity in term-deposits until the Ministry of Finance issues LBP-denominated debt

vi) given banking sector's position as a primary subscriber to sovereign debt, its reduced USD liquidity raises concerns over future issuance of Eurobonds particularly as around USD 3 billion in foreign-currency denominated debt will be maturing in 2017

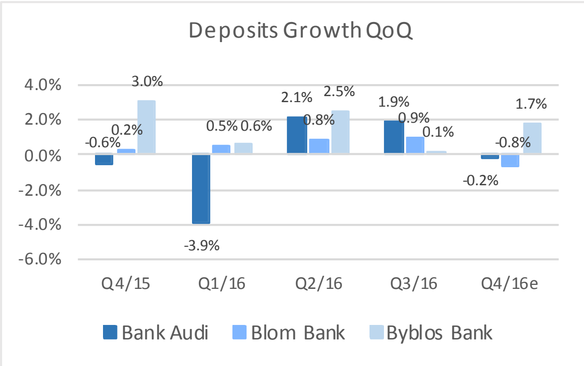
vii) we believe a rise in inflationary pressures from higher LBP supply and growth in CPI since September 2016 could lead to a distortion in USD/LBP fundamentals. Going forward, an inflationary environment may necessitate adverse effects on LBP and USD policy rates

Expect political progress and marginally firmer macro to drive steady growth in core income which should reflect positively on share prices for banks under coverage

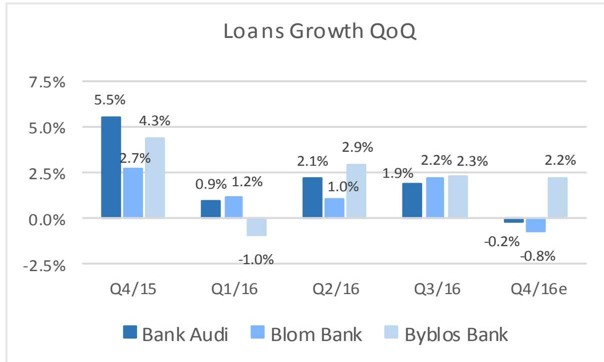
The election of a president and the formation of a new cabinet in Q4/16 following two years of political impasse were translated in a marginal improvement in sentiment as Byblos Bank/AUB consumer confidence ended Q4 higher with an average of 50.4 for the quarter after surging +79% in December and the Blom PMI composite index rose in November and December reversing the downward trend witnessed in the first ten months of the year -although it remains below 50, the level signaling an expansion. Moving forward, this marginal improvement should benefit the balance sheets of banks under coverage as a more stable environment would accommodate capital inflows although political progress is yet to translate into structural reforms that would support improved fundamentals for the Lebanese economy. Despite the banking system's profitability and capitalization levels improving on non-recurring gains during the back half of 2016 and as shares have reacted favorably to improved political climate, we believe Lebanese banks still offer an interesting entry point for investors particularly given stable core income growth and favorable dividend yields. We expect recent political developments to translate into an improved investment environment as Lebanon's credit risk stabilizes, which should reflect positively on shares ahead of dividend programs typically paid annually in April.

Banks Under Coverage - Comparative Snapshots

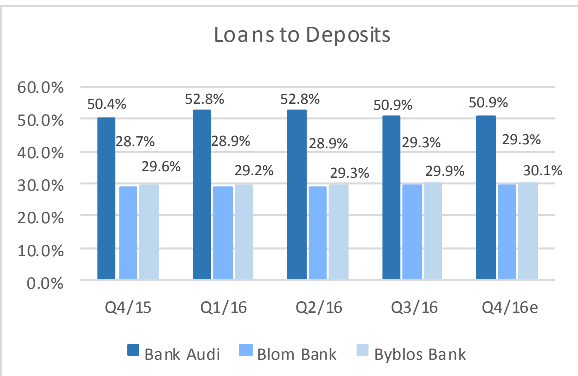
Expect declines in Bank Audi and Blom Bank's deposits as a result of material currency devaluation affecting their foreign operations on a consolidated basis. Byblos Bank to outperform following subdued growth in Q3/16



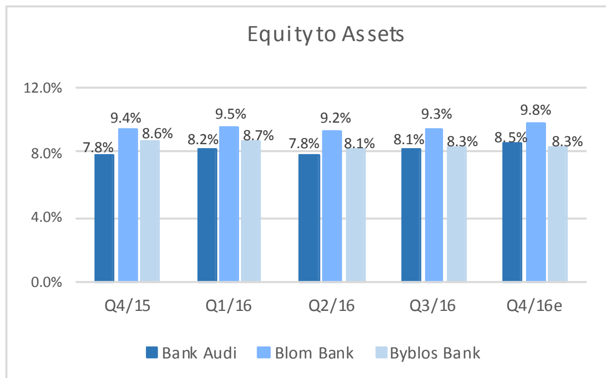
We forecast a decline in loans for Bank Audi and Blom Bank although benefiting from growth in local currencies. Byblos Bank loan growth expected to outperform on higher LDR and lending in LBP



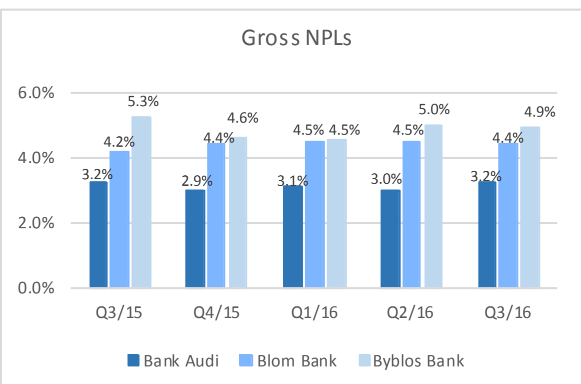
Bank Audi's LDR seen as stable at ~51% in Q4/16e, although below previous levels. Blom Bank and Byblos Bank's LDRs expected at respective ~29% and ~30% slightly below sector average at ~32%



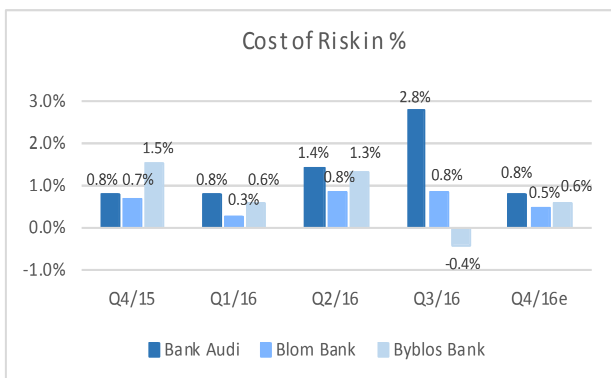
We expect Bank Audi and Blom Bank capitalization ratios to improve as a result of BDL debt swap with Blom Bank maintaining highest capitalization among banks under coverage. Byblos Bank's E/A ratio forecasted stable at 8.3%



Roughly stable NPL formation in Q3/16 for banks under coverage despite challenging macro environment domestically and in foreign operations. Bank Audi still at the lower end of our coverage at 3.2%

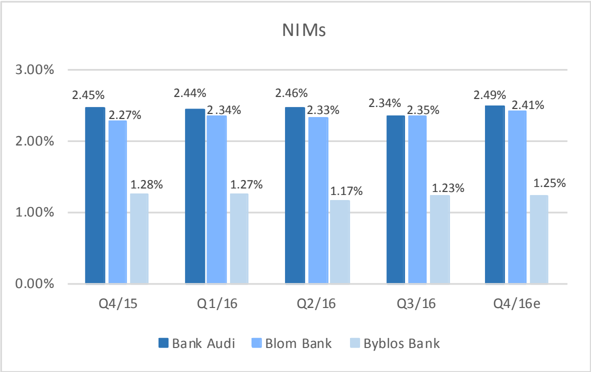


We expect cost of risk to stabilize around pre-debt swap levels for banks under coverage, amid stable NPL formation and lending growth

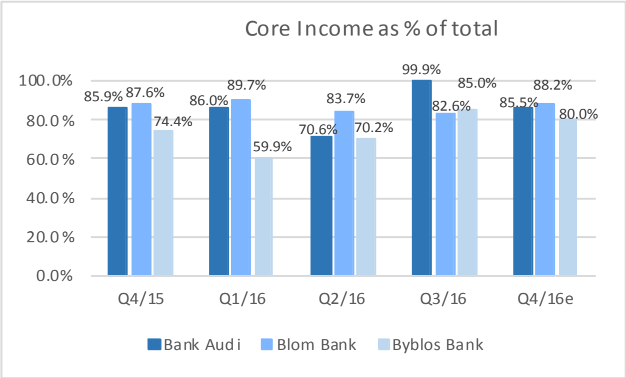


Source: Company reports and FFA Private Bank estimates

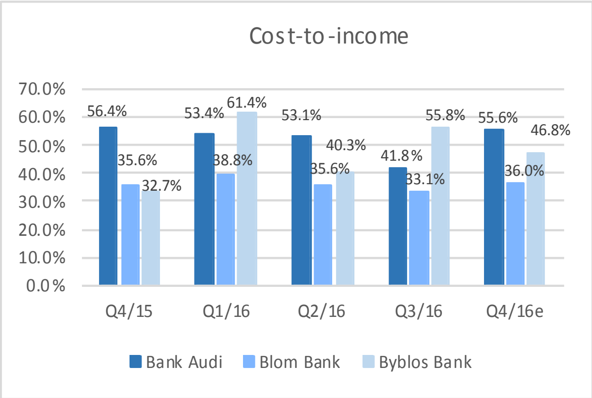
NIMs expected to increase for banks under coverage as spreads improve domestically despite tighter liquidity in USD. Bank Audi's NIMs expected to rebound after weaker Q3/16 although we forecast tighter margins for Turkey as political/security uncertainty persists



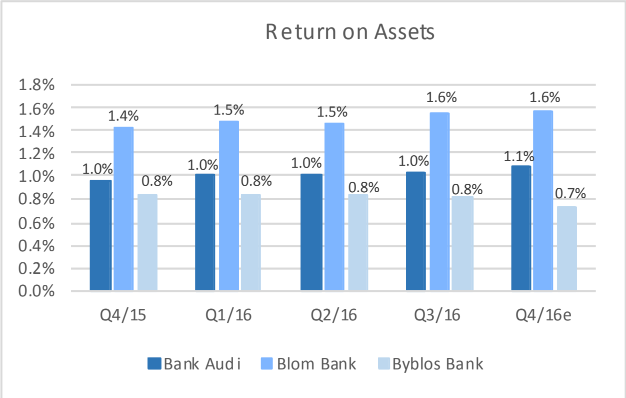
We estimate core income in the 80%-90% range for banks under coverage. Bank Audi's core income expected to adjust after exceptional fees and commission income in Q3/16 from large participation in BDL debt swap



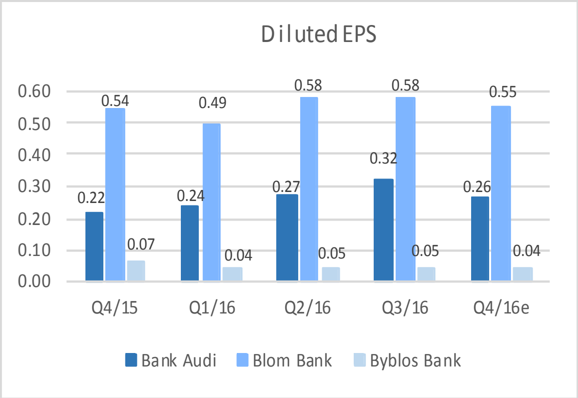
We forecast cost-to-income for Bank Audi to stabilize around pre-debt swap level. We expect QoQ efficiency gains for Byblos Bank while cost-to-income is slightly higher for Blom Bank



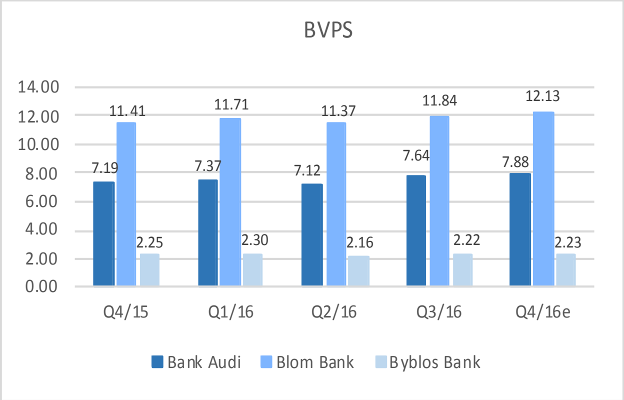
We forecast improved profitability in Q4/16e for Bank Audi at 1.1% on expected decline in assets while stable for Blom Bank and Byblos Bank. Blom Bank still at the higher end of our coverage at 1.6%



EPS expected lower for Bank Audi and Blom Bank following stronger Q3/16. Byblos Bank EPS forecasted slightly lower



BVPS expected higher for Bank Audi, Blom Bank and Byblos Bank in Q4/16e



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 Q3/16 at USD 45.3 billion as well as Q3/16 earnings at USD 124.7 million. The Bank had a total of 196 branches and 6,865 employees as of Q3/16 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 55%/45% and 56%/44% in Q3/16. 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 geographic key markets: Lebanon, Turkey and Egypt, as well as private banking. We highlight the Bank's relatively sound asset quality (gross NPL ratio at 3.2% in Q3/16) 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.

Q3/16 Key Financial Highlights

Net profits at USD 125 million in Q3/16 (+8% QoQ, +22% YoY)

- Net interest income registered at USD 261 million in Q3/16 (+3% QoQ, +2% YoY). We estimate net interest margins at 2.34% in Q3/16 vs. 2.45% in Q2/16 and 2.44% in Q3/15.
- Non-interest income surged in Q3/16 from significantly higher net fees & commissions at USD 690 million (+905% YoY) from large participation in BDL debt swap while trading & investment income declined to USD 1 million (-173% YoY). Revenue breakdown for Q3/16 reflects total contribution of core income (net interest income + fees & commissions income) to total operating income increasing from 71% in Q2/16 to ~99%.
- Bank Audi saw lower cost-to-income in Q3/16 at 41.8% from 53.1% in Q2/16 and 56.1% in Q3/15, helped by one-off gains made from BDL debt swap.
- Bank Audi's consolidated gross NPLs were at 3.2%, slightly higher than Q2/16 level of 3.0% yet unchanged from Q3/15 level and still lower than peers under coverage. Annualized cost of risk rose to an estimated 276 bps in Q3/16, from an estimated 139 bps in Q2/16 and 86 bps in Q3/15 on substantially higher provisioning levels at USD 130 million (+103% QoQ, +253% YoY).
- Significant balance sheet growth in Q3 boosted by BDL swap operation, as assets grew YoY by +8.0%, deposits by +6.0% and loans by +2.0% to respective USD 45 billion, USD 37 billion and USD 19 billion. On a YoY basis, assets and deposits grew +7.0% and +3.0% respectively from Q3/15. Loans outperformed at USD 19 billion, increasing +11.0%.
- Bank Audi saw net profits at USD 125 million in Q3/16 (+8% QoQ, +22% YoY).

Latest Key Regional/Operational Highlights

- Bank Audi's breakdown of assets and earnings between domestic and international operations stood at 55%/45% and 56%/44% in Q3/16.
- Odea Bank accumulated USD 11 billion in total assets representing 24% of the group assets and is seeking to benefit from operating leverage as branch network expands (56 branches including kiosks) and gains maturity. Odea Bank reported profits of USD 31 million in Q3/16, representing ~12% 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 Q3/16, the Group had USD 5 billion in assets in Egypt and generated USD 21 million in earnings accounting for 11% of consolidated assets and 19% of total profits.
- Bank Audi's current key geographic markets are: Lebanon, Turkey and Egypt, as well as private banking.
- Odea Bank completed a capital increase of 1.0 billion Turkish Lira in June 2016 in which the International Finance Corporation (IFC), the European Bank for Reconstruction and Development (EBRD) and other private investors participated. Bank Audi Group remains the major shareholder of Odea Bank following the capital increase with a stake of more than 75%.
- In Q4/16, Bank Audi issued 2.5 million Series "I" preferred shares, with an amount of USD 250 million.

FFA Model Assumptions

- We forecast net profits at USD 114.6 million in Q4/16e (-8% QoQ, +16% YoY).
- We expect net interest income at USD 270.1 million in Q4/16e (+3% QoQ, +4% YoY) although uncertainty in Turkey and Egypt, which typically boast higher margins, is expected to weigh on consolidated results and could lead to tighter margins.
- Net fees and commissions expected to reach USD 77.7 million in Q4/16e (-89% QoQ, +3% YoY) following exceptional gains in Q3/16 from large participation in BDL debt swap.
- We expect assets, deposits and loans at respective -2% QoQ /+4% YoY, flat QoQ /+4% YoY, flat QoQ /+5% YoY from material currency devaluation in Turkey and Egypt.
- LDR is expected at 50.9% in Q4/16e, unchanged from Q3/16 and slightly higher than Q4/15 level of 50.4%.
- We forecast net provisions of USD 35.7 million in Q4/16e with an estimated annualized cost of risk of 140 bps for 2016e.
- Our estimate for cost-to-income in Q4/16e is at 55.6%.
- Looking at FY 2016e, net profits should reach USD 465.0 million (+15% YoY) with EPS at USD 1.08 (+19% YoY).

Table 2: FFA Model Forecasts

USD Million	FFA Q4/16e	Q3/16a	Q4/15a	QoQ %	YoY %	FFA 2016e	FFA 2017e
Net Interest Income	270.1	261.1	259.8	3%	4%	1,029.8	1,106.1
Fees & commissions income	77.7	689.9	75.4	-89%	3%	897.2	276.3
Trading & investment income	59.0	1.0	76.1	5837%	-22%	243.1	265.8
Operating Income	406.8	951.9	411.3	-57%	-1%	2,170.1	1,648.2
Provisions	-35.7	-129.7	-34.5	-73%	3%	-263.4	-155.0
Operating expenses	-226.1	-382.2	-221.9	-41%	2%	-1,040.8	-842.5
Income tax	-30.5	-108.9	-32.5	-72%	-6%	-195.1	-136.7
Net Profits	114.6	124.7	99.0	-8%	16%	465.0	514.1
Diluted EPS	0.26	0.32	0.22	-19%	16%	1.08	1.15
Assets	44,147	45,275	42,272	-2%	4%	44,147	46,297
Deposits	36,871	36,963	35,609	0%	4%	36,871	38,673
Loans	18,768	18,814	17,943	0%	5%	18,768	19,762
BVPS to common	7.88	7.64	7.19	3%	9%	7.88	8.62
FFA Net interest margins	2.49%	2.34%	2.50%			2.37%	2.43%
Core income to total operating income	85.5%	99.9%	81.5%			88.8%	83.9%
FFA Cost-to income ratio	55.6%	41.8%	53.9%			48.0%	51.1%
Immediate liquidity-to-deposits ratio	39.0%	41.7%	35.5%			39.0%	39.1%
Loans-to-deposits ratio	50.9%	50.9%	50.4%			50.9%	51.1%
Equity-to-asset ratio	8.5%	8.1%	7.8%			8.5%	9.4%

Source: Company reports and FFA Private Bank estimates

Investment Opinion

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

Bank Audi is the largest Alpha bank in Lebanon in terms of balance sheet size with a demonstrated franchise and the confidence of its clients in Lebanon and abroad. 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 and trade finance driving higher quality core income despite some room for improvement on Tier 1 capital. We continue to rate Bank Audi shares at Marketweight although we 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 at USD 7.00

Based on our revised forecasts and discount rate assumptions to our Dividend Discount Model, we maintain our fair value estimate for Bank Audi 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 Q3/16 at USD 30.1 billion as well as Q3/16 earnings at USD 117.4 million. The Bank had a total of 262 branches and 5,029 employees as of the end of Q3/16 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 75%/25% respectively in Q3/16. The Bank's main geographic markets are Lebanon and MENA led by Egypt and Jordan. 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.

Q3/16 Key Financial Highlights

Net profits at USD 117 million in Q3/16 (-1% QoQ, +18% YoY)

- Net interest income came in at USD 172 million in Q3/16 (+3% QoQ, +11% 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 2.35% in Q3/16, above Blom Bank's targeted range of 2.00%-2.20%, vs. 2.33% in Q2/16 and 2.20% in Q3/15.
- Non-interest income came in at USD 80 million in Q3/16 (+60% YoY) on stronger trading & investment income at USD 44 million (+214% YoY), while fees & commissions were slightly lower at USD 36 million. Revenue breakdown for Q3/16 reflects a deterioration income mix quality with core income (net interest income + fees & commissions income) contribution to total operating income at ~83% slightly down from ~84% in Q2/16 and 93% in Q3/15.
- Blom Bank saw improved efficiencies in Q3/16 with cost-to-income at 34.7%, below Q2/16 level of 35.6% and 38.9% in Q3/15, still reflecting higher efficiencies vs. peers under coverage. Blom Bank's gross NPLs were at +4.4% in Q3/16, slightly lower than 4.5% in Q2/16 yet higher that 4.2% in Q3/15 while cost of risk increased to an estimated 83 bps in Q3/16 vs. 81 bps in Q2/16 yet lower than 148bps in Q3/15 on stronger collective provisions with credit expenses at USD 16 million in Q3/16 vs. USD 14.8 million in Q2/16 and USD -0.2 million in Q3/15.
- Despite YoY improvement, balance sheet growth was sequentially subdued, likely on challenging domestic operating conditions and f/x pressure. Assets grew to USD 30 billion (+2% QoQ, +4% YoY), deposits at USD 26 billion (+1% QoQ, +3% YoY) while loans outpaced at USD 7 billion (+2% QoQ, +7% YoY) despite concerns around the sector's lending environment.
- Blom Bank continues to boast the highest capitalization among peers under coverage. Capital adequacy ratio (as per Basel III) came in at 18.1%, from 18.0% in Q2/16 and well above BDL's requirement of 12.0% for 2015. TTM ROA estimated at 1.6% and TTM ROE estimated at 16.9%.
- Blom Bank's net profits came in at USD 117 million in Q3/16 (-1% QoQ, +18% YoY).

Latest Key Regional/Operational Highlights

- Blom Bank breakdown of assets and earnings between domestic and international operations stands at 78%/22% and 75%/25% respectively in Q3/16.
- At the end of Q3/16, the Group had USD 2.6 billion in assets in Egypt and generated USD 12.2 million in net earnings accounting for around ~9% of consolidated assets and ~12% of consolidated profits.
- The Bank's key pillar markets are: Lebanon and Egypt.
- Blom Bank signed an agreement to acquire HSBC Middle East Limited in November 2016 subject to BDL's approval expected during the first half of 2017. As of June 2016, HSBC Middle East Limited had three branches in Lebanon and around USD 953 million in assets. The acquisition will allow Blom Bank to expand its corporate and commercial business and retail activities which will help diversify its assets and revenues.

FFA Model Assumptions

- We expect net profits of USD 115.6 million in Q4/16e (-1% QoQ, +1% YoY).
- We expect net interest income at USD 174.2 million in Q4/16e (+1% QoQ, +8% YoY).
- Net fees and commissions expected at USD 38.3 million in Q4/16e (+7 QoQ, +3% YoY).
- We expect provisions of USD 9.7 million equivalent to an estimated annualized cost of risk at 60 bps for 2016e.
- We estimate cost-to-income at 36.0% in Q4/16e, above Q3/16 level of 34.7% and Q4/15 level of 35.6%.
- We expect assets, deposits and loans to decline QoQ -2%, -1% and -1% while YoY growth is expected at +2%, +1% and +4%.
- We expect LDR at 29.3% in Q4/16e unchanged from Q3/16 level yet higher than 28.7% in Q4/15.
- Looking at FY 2016e, net profits should reach USD 459.7 million (+14% YoY) with EPS expected at USD 2.20 (+18% YoY).

Table 3: FFA Model Forecasts

USD Million	FFA Q4/16e	Q3/16a	Q4/15a	QoQ %	YoY %	FFA 2016e	FFA 2017e
Net Interest Income	174.2	172.4	161.4	1%	8%	680.9	737.2
Fees & commissions income	38.3	35.8	37.2	7%	3%	150.4	157.9
Trading & investment income	28.5	43.9	28.1	-35%	1%	135.9	112.9
Operating Income	241.0	252.1	226.6	-4%	6%	967.2	1,008.1
Provisions	-9.7	-15.7	-13.0	-38%	-25%	-44.9	-46.7
Operating expenses	-86.7	-87.4	-80.8	-1%	7%	-346.2	-368.0
Income tax	-28.9	-31.7	-17.7	-9%	63%	-112.4	-118.7
Net Profits	115.6	117.4	114.9	-1%	1%	459.7	474.7
Diluted EPS	0.55	0.58	0.54	-5%	2%	2.20	2.27
Assets	29,585	30,131	29,099	-2%	2%	29,585	31,739
Deposits	25,447	25,644	25,091	-1%	1%	25,447	27,266
Loans	7,456	7,514	7,196	-1%	4%	7,456	8,038
BVPS to common	12.13	11.84	11.41	2%	6%	12.13	13.33
FFA Net interest margins	2.41%	2.35%	2.27%			2.36%	2.38%
Core income to total operating income	88.2%	82.6%	87.6%			85.9%	88.8%
FFA Cost-to income ratio	36.0%	34.7%	35.6%			35.8%	36.5%
Immediate liquidity-to-deposits ratio	48.4%	49.3%	49.1%			48.4%	48.4%
Loans-to-deposits ratio	29.3%	29.3%	28.7%			29.3%	29.5%
Equity-to-asset ratio	9.8%	9.3%	9.4%			9.8%	10.0%

Source: Company reports and FFA Private Bank estimates

Investment Opinion

We view Blom Bank's higher returns and solid liquidity and capitalization 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 and excess capital buffers

We recognize Blom Bank's solid positioning in its domestic market. We highlight the firm's conservative strategy focusing on preserving asset quality and higher capitalization ratios which translates in lower cost of risk and excess common equity Tier 1 capital respectively. We highlight Blom Bank's 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 steady earnings growth while dividends should continue to benefit from lower than average payouts and above average excess Tier 1 common equity capital.

Target Price Revision and Recommendation

We reiterate our Overweight rating on Blom Bank shares and revise our fair value to USD 12.00 from USD 11.50 per share

Based on our revised forecasts and discount rate assumptions to our Dividend Discount Model, we revise our fair value estimate for Blom Bank to USD 12.00 from USD 11.50 per share and reiterate our Overweight rating. Our DDM assumes a 13.9% 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 Q3/16 at USD 20.5 billion with earnings at USD 39.0 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 at the expense of weaker margins and profitability.

Q3/16 Key Financial Highlights

Net profits at USD 39 million in Q3/16 (flat QoQ, -11% YoY)

- Net interest income was at USD 63 million in Q3/16 (+6% QoQ, -5% YoY) mainly on higher interest margins despite a subdued growth in balance sheet. We estimate stronger interest margins at 1.23% in Q3/16 vs. 1.16% in Q2/16 yet significantly lower than 1.37% in Q3/15.
- Non-interest income was at USD 35 million in Q3/16 (-34% QoQ, -20% YoY) with fees & commissions income at USD 21 million (+3% QoQ, +2% YoY), on substantial decrease in trading & investment income to USD 15 million (-56% QoQ, -39% YoY). Significant improvement in Byblos Bank's income quality mix on lower operating income, with revenue breakdown showing core income (net interest income + net fees & commissions income) contribution to total operating income increasing to 85% in Q3/16 from 70% in Q2/16 and 78% in Q3/15.
- Cost of risk declined to an estimated 41 bps in Q3/16 from an estimated 129 bps in Q2/16 on reversal in provisions at USD 5.2 million in Q3/16 following provisions of USD 16.2 million in Q2/16.
- Subdued growth of balance sheet in Q3/16 as assets grew by +1%, deposits remained unchanged while loans outperformed, growing at +2%. On a YoY basis, assets and deposits increased ~+6% and loans were up +9% despite concerns around slowing economic activity which was expected to pressure balance sheet growth.
- 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 slightly higher at 44% in Q3/16 vs. 43% in Q2/16 and Q3/15.
- Profitability ratios were slightly lower with TTM ROA at an estimated 0.81% and TTM ROE at an estimated 9.6% in Q3/16, still at the lower end of our coverage universe.
- Byblos Bank saw net profits at USD 39 million in Q3/16 (flat QoQ, -11% YoY).

Latest Key Regional/Operational Highlights

- Byblos Bank breakdown of assets between domestic and international operations stood at ~91%/9% for 2015.
- Byblos Bank completed its acquisition of Banque Pharaon & Chiha in Q4/16. At end of 2015, Banque Pharaon & Chiha's assets and deposits stood at respective USD 318 million and USD 242 million.

FFA Model Assumptions

- We expect net profits of USD 38.2 million in Q4/16e (-2% QoQ, -21% YoY).
- We forecast net interest income of USD 63.5 million in Q4/16e (+2% QoQ, +2% YoY).
- Net fees and commissions expected at USD 20.1 million in Q4/16e (+2% QoQ, flat YoY).
- We expect assets, deposits and loans to grow by a respective +1% QoQ /+4% YoY, +2% QoQ /+5% YoY, +2% QoQ /+6% YoY.
- At these growth levels, LDR should be at 30.1%, up from 29.9% from Q3/16 and 29.6% in Q4/15.
- We forecast provisions of USD 7.9 million in Q4/16e equivalent to an estimated annualized cost of risk at 50 bps for 2016e following provision reversals in Q3/16.
- Our cost-to-income estimate is at 46.8% for Q4/16e.
- Looking at FY 2016e, net profits should reach USD 150.1 million (-7% YoY) with EPS at USD 0.18 (-13% YoY).

Table 4: FFA Model Forecasts

USD Million	FFA Q4/16e	Q3/16a	Q4/15a	QoQ %	YoY %	FFA 2016e	FFA 2017e
Net Interest Income	63.5	62.5	62.5	2%	2%	247.4	261.4
Fees & commissions income	20.1	19.7	20.1	2%	0%	79.1	81.5
Trading & investment income	20.9	14.6	28.4	43%	-27%	124.0	122.4
Operating Income	104.4	96.7	111.1	8%	-6%	450.5	465.3
Provisions	-7.9	5.2	-18.5	-250%	-57%	-26.4	-36.7
Operating expenses	-48.9	-54.0	-36.3	-9%	35%	-232.4	-235.0
Income tax	-9.5	-9.1	-7.7	5%	24%	-41.6	-41.6
Net Profits	38.2	39.0	48.6	-2%	-21%	150.1	152.0
Diluted EPS	0.04	0.05	0.07	-3%	-34%	0.18	0.18
Assets	20,678	20,572	19,869	1%	4%	20,678	21,633
Deposits	17,464	17,172	16,637	2%	5%	17,464	18,294
Loans	5,250	5,138	4,931	2%	6%	5,250	5,536
BVPS to common	2.23	2.22	2.25	1%	-1%	2.23	2.35
FFA Net interest margins	1.25%	1.23%	1.28%			1.21%	1.23%
Core income to total operating income	80.0%	85.0%	74.4%			72.5%	73.7%
FFA Cost-to income ratio	46.8%	55.8%	32.7%			51.6%	50.5%
Immediate liquidity-to-deposits ratio	42.9%	44.4%	43.7%			42.9%	42.6%
Loans-to-deposits ratio	30.1%	29.9%	29.6%			30.1%	30.3%
Equity-to-asset ratio	8.3%	8.3%	8.6%			8.3%	8.2%

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 by providing additional visibility on its growth plan via geographic diversification and new business segments

We recognize Byblos Bank's position in its domestic retail market as well as its capacity to show sizeable liquidity buffers 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. We favor further efforts towards both organic and inorganic growth targeting geographical expansion and new business segments with focus on new markets and private banking/asset management which would respectively improve interest margins and core income.

Target Price Revision and Recommendation

We reiterate our Marketweight rating on Byblos Bank shares and maintain our fair value at USD 1.55 per share

Based on our revised forecasts and discount rate assumptions to our Dividend Discount Model, we maintain our fair value estimate for Byblos Bank at USD 1.55 and reiterate our Marketweight rating. Our DDM assumes a 14.3% 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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