Equity Research - Lebanese Banks - Q1/17 Preview

Expect recent sentiment improvement and marginally firmer macro to better help bank shares in 2017 although impact from budget ratification on bank results remains uncertain

Banking sector ends 2016 with solid growth in balance sheet aggregates and profitability, largely helped by BDL debt swap, with little change in macro fundamentals as outcome from recent political developments remains uncertain

Lebanese banking sector ended 2016 on stronger balance sheet with assets, deposits and loans at respective +10%, +7% and +6% YoY with the back half of the year contributing to most of the growth following the banks' participation in debt swap transactions with the BDL. Banking sector assets reached USD 204 billion in Q4/16, funded at ~80% by deposits at USD 162 billion while loans were at USD 51 billion, supported by BDL economic stimulus scheme totaling ~USD 6 billion since 2013 which targets productive sectors, housing, education and renewable energy projects. Alpha banks' profitability improved with net profits growing +11.9% in 2016 and return on average assets at 1.08% from 1.02%. BDL's debt swap operations took place between May and November 2016 with a total size estimated at ~USD 14 billion which reinforced BDL's foreign assets ending the year at around ~USD 40 billion up from ~USD 35 billion in April 2016 while providing the banking sector with ample liquidity in LBP as well as sizeable capital buffers ahead of IFRS 9 implementation and new BDL regulatory capital requirements. Balance of payment recorded a surplus of USD 1.2 billion in 2016 and USD 508.5 million by February 2017 after a deficit of USD 3.3 billion in 2015 largely helped by BDL's non-conventional operations. While 2017 started on a renewed sense of optimism, improvement in macro environment which is key to attracting FDIs and reactivating economic activity will depend on government efforts to hold parliamentary elections and ratify the state budget.

Balance sheet growth for banks under coverage underperforms the sector in 2016 while regulatory capital and profitability metrics strengthen

Bank Audi and Blom Bank saw a decline in assets on a consolidated basis at respective -2%/-2% QoQ largely weighed by f/x devaluations in Turkey and Egypt with deposit growth at respective +1%/-3%. Byblos Bank reported assets and deposits at respective +1%/flat underperforming banking sector at respective +3%/+3%. On a YoY basis, assets and deposits grew at +5%/-3% for Bank Audi, +2%/-1% for Blom Bank and +5%/+3% for Byblos Bank while loan growth QoQ/YoY was at -4%/-4% for Bank Audi, -5%/flat for Blom Bank and +1%/+5% for Byblos Bank. LDR for Blom Bank and Byblos Bank came in at ~29%, below the sector's average of ~31% while Bank Audi's LDR declined to ~48% although helped strong lending in Turkey and Egypt with LDRs at respective ~90% and ~65%. Banks under coverage reported higher CAR levels in Q4/16 ahead of new BDL regulatory requirements with Bank Audi at 15.3%, Blom Bank at 19.0% and Byblos Bank at 16.3% as participation in debt swap operations provided banks with additional capital buffers. Profitability estimated higher QoQ and YoY for Bank Audi and Blom Bank with ROA at respective 1.09% and 1.58% while Byblos Bank's ROA remained stable at 0.80%. QoQ/YoY growth in net profits came in at respective -4%/+21% for Bank Audi, +1%/+4% for Blom Bank and +31%/+6% for Byblos Bank.

Expect recovery in balance sheet growth for banks under coverage helped by marginal sentiment improvement domestically and favorable contribution from foreign operations while operating gains are capped by weaker NIM expansion

We expect marginal improvement in sentiment following recent political developments to favorably impact domestic balance sheet growth for banks under coverage going into 2017 through deposit accumulation and quality loan portfolio expansion which should also benefit from BDL stimulus package and higher LBP lending. On a regional level, we expect Bank Audi and Blom Bank balance sheet growth to be largely supported by foreign operations given stronger growth rates in Turkey and Egypt banking sectors and recovery in f/x conditions despite political/economic uncertainties. For Q1/17e, we forecast YoY growth in assets/deposits/loans at +10%/+7%/-3% for Bank Audi, +1%/flat/flat for Blom Bank and +5%/+3%/+7% for Byblos Bank. On the bottom line, we forecast limited expansion in NIMs as we highlight tighter spreads in LBP declining -11 bps between February 2016 and February 2017 while USD spreads are at +1 bps over the same period mainly on lower asset yields and lending rates in LBP, and higher LIBOR rates on USD interbank deposits and BDL CDs as a result of debt swap operations. We expect YoY profit growth for Bank Audi, Blom Bank and Byblos Bank at respective +12%, +10% and +3%, helped by lower provisions and stronger balance sheet growth. We highlight operational improvement and recent f/x stability in Turkey which should represent additional upside surprise for Bank Audi.

Shares of banks under coverage enter 2017 on a stronger footing driven by investor enthusiasm ahead of dividend season amid renewed sense of optimism although we remain cautious on impact of current political impasse and tax increases

We highlight favorable performance in bank shares going into 2017, trading in the +2%/+13% range pre-dividend payment (vs. -19% YTD for real estate) reflecting investor enthusiasm as Bank Audi and Blom Bank gross dividends were approved at respective LBP 753.75 (~USD 0.50) and LBP 1,500 (~USD 1.00), both increasing +25%. Byblos Bank gross dividends were proposed unchanged at LBP 200 (~USD 0.13) to be approved during next AGM. We believe banks offer an attractive entry point for investors particularly as Bank Audi and Blom Bank shares gave back gains after dividend payment in April 2017 as they provide double digit total returns given favorable dividend yields and trading multiples at discount to our target price and historical averages on a P/B basis. While we recognize marginal sentiment improvement from recent political progress and expect further favorable impact from parliamentary elections and budget ratification, we remain cautious on the outcome of current political impasse and implications of new taxes on banks operations which are likely to include higher corporate and interest income taxes.

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 6.40	-5.9%	5.9x	0.87x	7.8%
BLOM BANK	(BLOM LB)	OVERWEIGHT	↑ USD 12.50	USD 10.52	-0.8%	4.7x	0.84x	9.5%
BYBLOS BANK	(BYB LB)	MARKETWEIGHT	USD 1.55	USD 1.75	+2.9%	8.3x	0.72x	7.6%

Source: Company reports, BSE, FFA Private Bank estimates   Note: *April 21, 2017 market close, **Based on TTM EPS, *** Based on approved dividends for 2016 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 12.50 from USD 12.00 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.

Participation of banks under coverage in BDL's debt swap transactions

BDL's debt swap operations which likely exceeded ~USD 14 billion, were initiated as a response to the decline in its f/x reserves in a context of external account pressures and consisted of:
i) swapping local currency Treasury bonds (T-bills) held by the central bank with Eurobonds issued by the Ministry of Finance (MoF) 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 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); v) build provisions to cover for currency devaluations in foreign operations vi) 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.
As a result of banks participation in debt swap transactions, consolidated balance sheet of commercial banks shows a decline in foreign assets and loans to private sector as a percentage of total assets from ~38% in February 2016 to ~36% in February 2017 while deposits at BDL increased from ~38% to ~43%. We also highlight a higher LDR in LBP increasing from ~25% to ~28% over the same period while LDR in USD decreased from ~35% to 32% which reflects higher lending in LBP as encouraged by BDL. While we note a decline in LBP spreads YoY from excess liquidity, and roughly stable USD spreads, impact on banks was muted by reallocation of assets from interbank placements into higher yielding BDL CDs.
MoF issued USD 3 billion in Eurobonds in March 2017 distributed in three tranches (10, 15 and 20 years), part of which to replace bonds maturing in March. Subscription reached ~USD 18 billion with banks allowed to swap USD denominated CDs with newly issued Eurobonds.

Bank Audi

Exceptional gains for Bank Audi reached ~USD 1 billion allocated for impairment of goodwill and investments and write-off of intangible assets and one-off expenses (USD 231 million), additional collective provisions corresponding to 2% of risk-weighted loans (USD 306 million), write off of investments in Bank Audi Syria, Arabeya Online and National Bank of Sudan (USD 205 million) and exceptional tax expense resulting from debt swap transactions (USD 108 million). ~USD 203 million were not recognized in the income statement, of which USD 121 million were recognized in equity as other comprehensive income under non-distributable reserves, USD 52 million under other liabilities and Tier 2 capital and USD 30 million as current tax liabilities.
We highlight an increase of Bank Audi's assets domestic exposure at 58% in 2016 from 51% in 2015 driven by higher liquidity held in Lebanon which reached 60% when including BDL CDs compared to 46% in 2015. In addition to placements at BDL, excess liquidity is expected to also be channeled through Bank Audi's new lending program for SMEs in LBP. Bank Audi's exposure to Lebanese sovereign debt declined from 8% in 2015 to 4% in 2016 noting that exposure to Eurobonds was not material at year-end 2016 despite large participation in BDL debt swap, reflecting stronger investor appetite for Lebanese Eurobonds and Bank Audi's preference for USD CDs issued by BDL which have lower risk-weighing requirements. We also highlight a decline in gross NPLs resulting from increase in loans write-off and deconsolidation of Syria and Sudan subsidiaries with coverage of non-performing loans at 163% (including collective provisions). We highlight slight shift in balance sheet f/x allocation in favor of USD although not impacting asset-liability matching. At the liability maturity profile level, we highlight a shift from < 3 months maturities to 1-5 year maturities although not impacting asset-liability match given an extension at the assets levels with longer maturity CDs and cash at central banks. At the regulatory capital level, Bank Audi increased its CAR level by USD 574 million of which USD 524 million increase in Tier 1 capital (of which USD 228 million in CET1) and USD 50 million in Tier 2.

Blom Bank

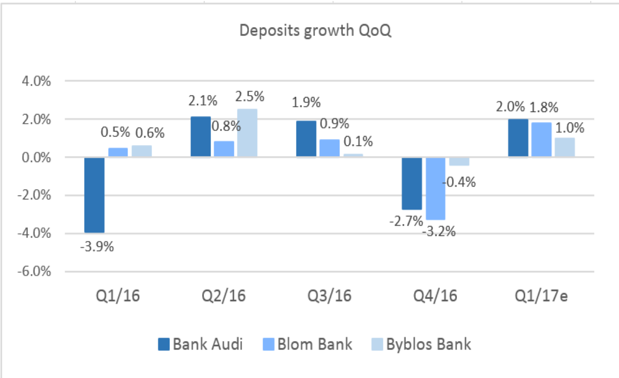
Exceptional gains for Blom Bank reached ~USD 436 million allocated for the write-off of two Syrian subsidiaries (~USD 85 million), additional collective provisions corresponding to 2% of risk-weighted loans (~USD 173 million) and exceptional tax expense resulting from debt swap transactions (USD 68 million). ~USD 110 million were not recognized in the income statement and recorded under deferred revenue within provisions for risks and charges.
Blom Bank's participation in BDL's debt swap transactions consisted in selling Lebanese Treasury Bills (nominal value: LBP 825 billion) and LBP denominated CDs (nominal value: 1,125 billion) in exchange of Eurobonds (nominal value: USD 200 million), USD denominated CDs (nominal value: USD 1 billion) and a placement in euro at the BDL for EUR 100,000. Blom Bank's domestic concentration of assets in Lebanon increased to 86% in 2016 from 83% in 2015 on higher balances with central banks up to 43% of total assets in 2016 from 35% in 2015 resulting in higher liquidity. We note no major impact of debt swap transactions on Blom Bank's f/x allocation. We highlight a shift in asset maturity from < 3 months to 1-5 years although maturity of liabilities remained unchanged resulting in a slight deterioration in asset-liability match for short-term maturities. The bank's exposure to government bonds decreased from 16% in 2015 to 13% in 2016 following participation in BDL debt swap while NPLs decreased likely from deconsolidation of subsidiaries in Syria with coverage of non-performing loans at 161% (including collective provisions). Blom Bank increased its CAR level by USD 305 million of which USD 195 million in Tier 1 capital and USD 100 million in Tier 2 capital.

Byblos Bank

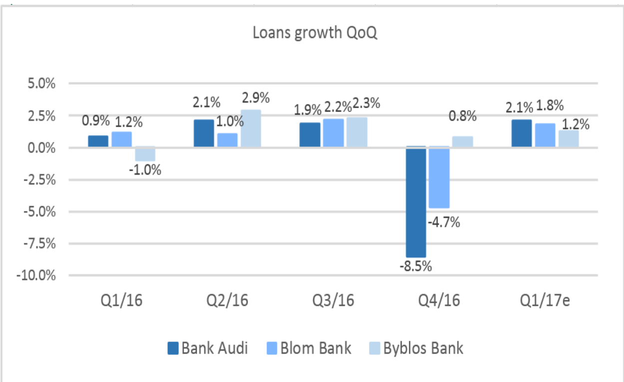
Exceptional gains for Byblos Bank reached ~USD 350 million for Byblos Bank allocated for the deconsolidation of Byblos Bank subsidiaries in Syria and Sudan (~USD 95 million), additional collective provisions corresponding to 2% of risk-weighted loans (~USD 68 million) and exceptional tax expense resulting from debt swap transactions. ~USD 84 million were not recognized in the income statement and recorded under deferred revenues within other liabilities. Domestic concentration of Byblos Bank assets roughly stable at ~86% of total assets with an increase in placements with central banks up from 23% in 2015 to 27% in 2016. Exposure to sovereign debt decreased from 21% in 2015 to 17% in 2016 following participation in BDL debt swap while exposure to BDL CDs remained unchanged. NPLs declined likely helped by deconsolidation of subsidiaries with coverage of non-performing loans at ~100% (including collective provisions). We highlight little impact from the participation in BDL debt swap on the bank's balance sheet f/x allocation and maturity profile. Byblos Bank increased its CAR level by USD 198 million with a USD 99 million increase in Tier 1 capital (of which USD 101 million increase in CET1 while additional Tier 1 decreased by USD 2 million) and USD 99 million increase in Tier 2.

Banks Under Coverage - Comparative Snapshots

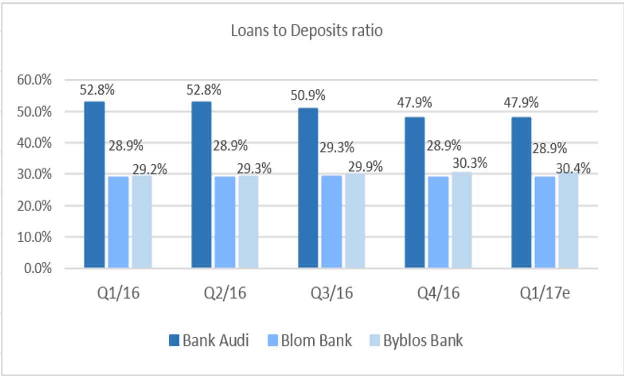
Expect deposit growth in Q1/17e in line with sector average for Byblos Bank while Bank Audi and Blom Bank benefit from stronger balance sheet growth in foreign operations on improving f/x conditions



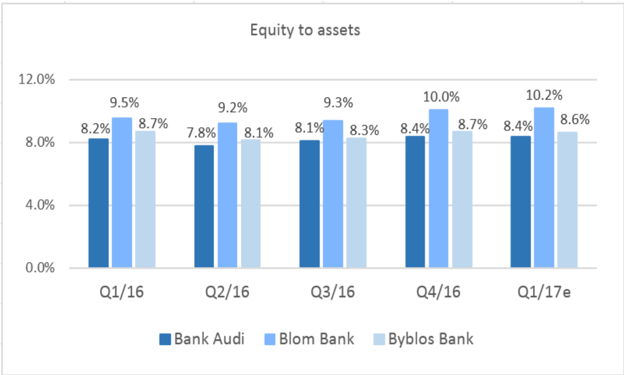
We forecast a recovery in loans growth following weaker Q4/16 as Bank Audi and Blom Bank benefit from stronger lending in foreign operations. Byblos Bank expected to outperform sector average although lower QoQ



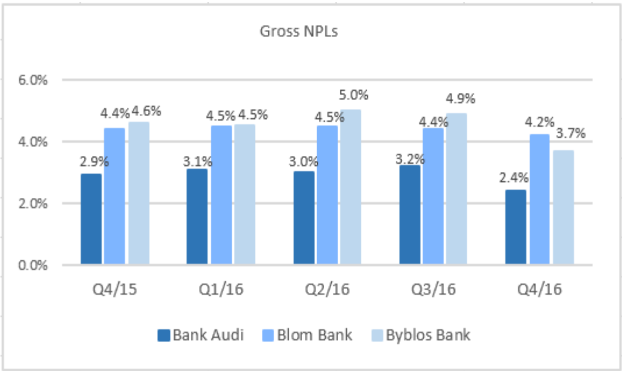
LDR forecasted stable for Bank Audi at ~48%, above sector level of 31% while Blom Bank and Byblos Bank expected below the sector at respective ~29% and ~30%



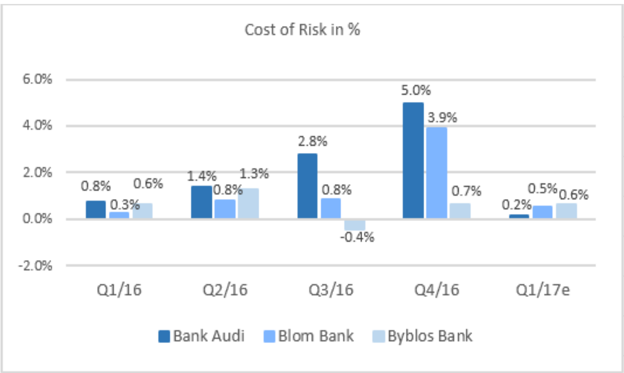
Expect banks under coverage to maintain stable capitalization ratios largely helped by BDL debt swap in Q4/16. Blom Bank still at the highest capitalization among banks under coverage with E/A at 10.2%



Lower NPL levels in Q4/16 for Bank Audi, Blom Bank and Byblos Bank partly helped by deconsolidation of foreign subsidiaries and loan write-offs. Bank Audi still at the lower end of our coverage at 2.4%

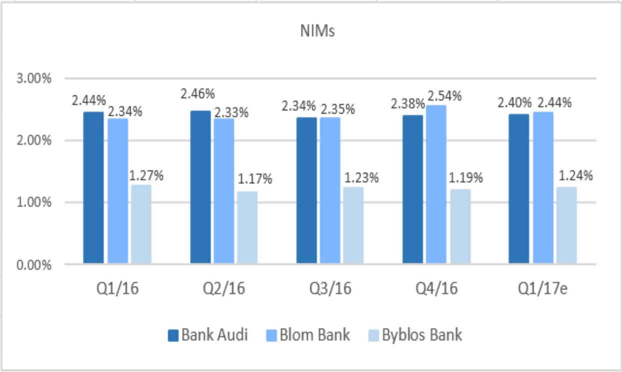


We forecast lower cost of risk in Q1/17e for banks under coverage following stronger provisioning levels in the back half of 2016 as required by BDL circular 446 with regards to gains from debt swap operations

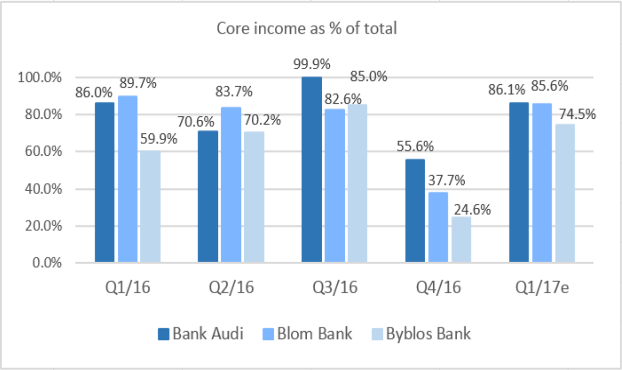


Source: Company reports and FFA Private Bank estimates

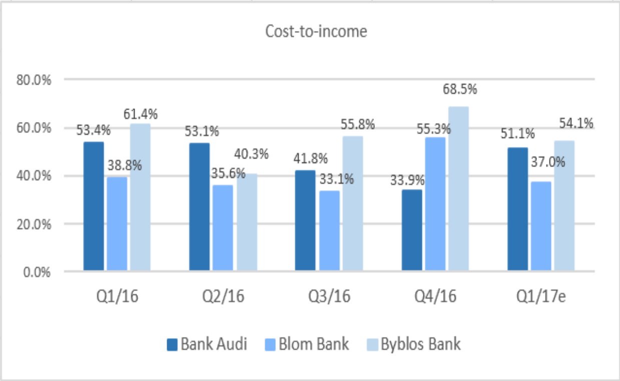
Expect NIMs to slightly improve QoQ for Bank Audi helped by margin expansion in Egypt and Turkey. Byblos Bank margins expected to recover from weaker Q4/16 level while Blom Bank NIMs forecasted lower following stronger Q4/16



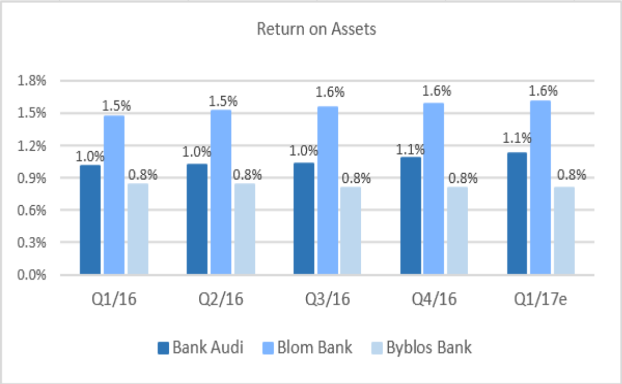
Core income is forecasted around 86% for Bank Audi and Blom Bank in Q1/17e while lower for Byblos Bank at 75% following material non-recurring gains in Q4/16



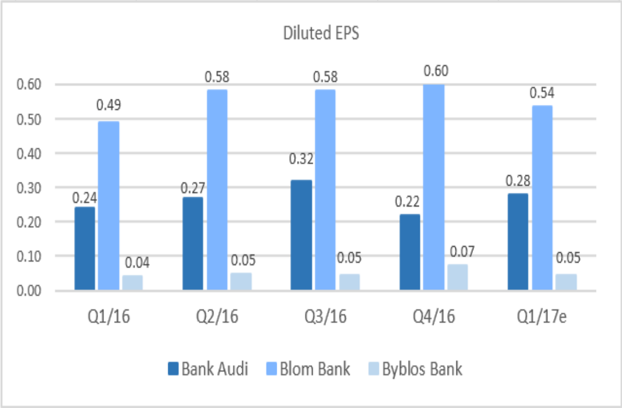
We forecast cost-to-income around pre-debt swap levels for banks under coverage with efficiency gains for Bank Audi and Byblos Bank while Blom Bank cost-to-income trends higher



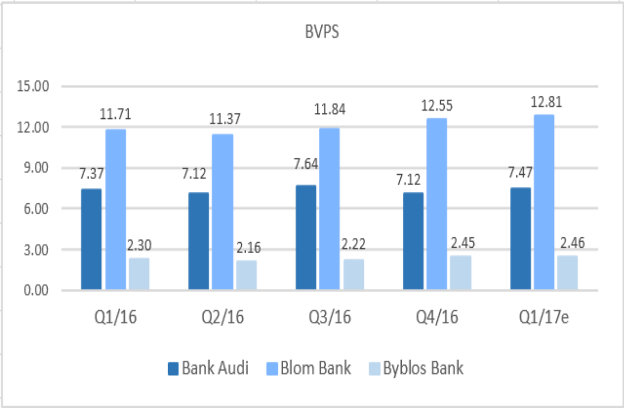
Profitability expected stable for Bank Audi, Blom Bank and Byblos Bank in Q1/17e with Blom Bank still at the higher end of our coverage at 1.6%



Expect Bank Audi to show EPS growth as contribution from foreign operations increases while Blom Bank and Byblos Bank EPS lower sequentially and higher YoY



Expect higher BVPS for Bank Audi, Blom Bank and Byblos Bank in Q1/17e



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 Q4/16 at USD 44.3 billion as well as Q4/16 earnings at USD 119.8 million. The Bank had a total of 201 branches and 7,017 employees as of Q4/16 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 59%/41% and 42%/58% in Q4/16. 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 2.4% in Q4/16) 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.

Q4/16 Key Financial Highlights

Net profits at USD 120 million in Q4/16 (-4% QoQ, +21% YoY)

- Net interest income registered at USD 259 million in Q4/16 (-1% QoQ, +3% YoY). We estimate net interest margins at 2.34% in Q4/16 higher than 2.34% in Q3/16 yet lower than Q4/15 level of 2.42%.
- Non-interest income declined in Q4/16 on lower fees and commissions income at USD 66 million (-90% QoQ, -6% YoY) in line with pre-debt swap levels although trading and investment came in significantly higher at USD 260 million resulting from Bank Audi's larger involvement in capital market activities in Lebanese securities in addition to f/x gains from Egypt operations. Revenue breakdown for Q3/16 reflects total contribution of core income (net interest income + fees & commissions income) to total operating income decreasing to 56% in Q4/16 from 99% in Q3/16 and 88% in Q4/15.
- Bank Audi saw lower cost-to-income in Q4/16 at 33.8% from 41.7% in Q3/16 and 56.6% in Q4/15.
- Bank Audi's consolidated gross NPLs were at 2.4% in Q4/16, from 3.2% in Q3/16 and 2.9% in Q4/15 and still lower than peers under coverage. Annualized cost of risk rose to an estimated 496 bps in Q4/16, from an estimated 276 bps in Q3/16 and 86 bps in Q4/15 on substantially higher provisioning levels at USD 214 million (+65% QoQ, +508% YoY).
- Assets and deposits declined -2% and -3% on a QoQ basis to respective USD 44 billion and USD 36 billion while loans grew by 2% to USD 17 billion. On a YoY basis, assets and deposits grew +5% and +1% respectively from Q4/15 while loans underperformed, decreasing -4%.
- Bank Audi saw net profits at USD 120 million in Q4/16 (-4% QoQ, +21% 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 Q4/16.
- 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 (50 branches including kiosks) and gains maturity. Odea Bank reported profits of USD 69 million in 2016, representing ~15% 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 2016, the Group had USD 3 billion in assets in Egypt and generated USD 160 million in earnings accounting for 7% of consolidated assets and 34% 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.
- In September 2016, Bank Audi deconsolidated and wrote-off its investments in Bank Audi Syria, National Bank of Sudan and Arabeya Online.
- In Q4/16, the Bank sold its 76.56% participation in National Bank of Sudan.
- In April 2017, Bank Audi announced an agreement with M1 Financial Technologies SAL to sell its electronic payment and card services business in a deal estimated at USD 185 million.

FFA Model Assumptions

- We forecast net profits at USD 123.6 million in Q1/17e (+3% QoQ, +12% YoY).
- We expect net interest income at USD 265.8 million in Q1/17e (+3% QoQ, +8% YoY) helped by stronger NIMs in Turkey and Egypt.
- Net fees and commissions expected to reach USD 67.6 million in Q1/17e (+2% QoQ, +3% YoY).
- We expect assets, deposits and loans at respective +2% QoQ /+10% YoY, +2% QoQ /+7% YoY, +2% QoQ /-3% YoY.
- LDR is expected at 47.9% in Q1/17e, unchanged from Q4/16 and lower than 52.8% in Q1/16.
- We forecast net provisions of USD 31.6 million in Q1/17e with an estimated annualized cost of risk of 72 bps for 2017e.
- Our estimate for cost-to-income in Q4/16e is at 51.1%.
- Looking at FY 2017e, net profits should reach USD 519.0 million (+10% YoY) with EPS at USD 1.20 (+13% YoY).

Table 2: FFA Model Forecasts

USD Million	FFA Q1/17e	Q4/16a	Q1/16a	QoQ %	YoY %	FFA 2017e
Net Interest Income	265.8	259.1	245.5	3%	8%	1,103.4
Fees & commissions income	67.6	66.2	65.6	2%	3%	268.7
Trading & investment income	53.7	259.8	50.7	-79%	6%	219.2
Operating Income	387.1	585.0	361.8	-34%	7%	1,591.2
Provisions	-31.6	-213.6	-34.0	-85%	-7%	-135.1
Operating expenses	-198.0	-198.1	-193.5	0%	2%	-795.0
Income tax	-33.9	-68.6	-24.3	-51%	40%	-142.2
Net Profits	123.6	119.8	110.2	3%	12%	519.0
Diluted EPS	0.28	0.22	0.24	28%	17%	1.18
Assets	44,983	44,267	41,022	2%	10%	46,830
Deposits	36,666	35,955	34,221	2%	7%	38,078
Loans	17,573	17,215	18,084	2%	-3%	18,434
BVPS to common	7.47	7.12	7.37	5%	1%	8.00
FFA Net interest margins	2.40%	2.38%	2.44%			2.40%
Core income to total operating income	86.1%	55.6%	86.0%			86.2%
FFA Cost-to income ratio	51.1%	33.9%	53.4%			50.0%
Immediate liquidity-to-deposits ratio	44.5%	43.8%	33.8%			43.8%
Loans-to-deposits ratio	47.9%	47.9%	52.8%			48.4%
Equity-to-asset ratio	8.4%	8.4%	8.2%			8.5%

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 Q4/16 at USD 29.5 billion as well as Q4/16 earnings at USD 119 million. The Bank had a total of 219 branches and 4,673 employees as of the end of Q4/16 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 81%/19% and 77%/23% respectively in Q4/16. 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.

Q4/16 Key Financial Highlights

Net profits at USD 119 million in Q4/16 (+1% QoQ, +4% YoY)

- Net interest income came in at USD 184 million in Q4/16 (+6% QoQ, +13% YoY) as higher NIMs (more favorable asset yields despite higher cost of funds) offset negative balance sheet growth. We estimate NIMs at 2.54% in Q4/16, above Blom Bank's targeted range of 2.00%-2.20%, vs. 2.35% in Q3/16 and 2.27% in Q4/15.
- Non-interest income came in significantly higher at USD 395 million in Q4/16 (+516% YoY) on materially stronger trading & investment income at USD 357 million, while fees & commissions were relatively stable at USD 38 million. Revenue breakdown for Q4/16 reflects a deterioration income mix quality with core income (net interest income + fees & commissions income) contribution to total operating income at ~38% slightly down from ~83% in Q3/16 and 88% in Q4/15.
- Blom Bank saw higher cost-to-income in Q4/16 at 55.3% from 33.1% in Q3/16 and 37.5% in Q4/15 still reflecting higher efficiencies vs. peers under coverage. Blom Bank's gross NPL at 4.2% slightly lower than +4.4% in Q3/16 and Q4/15 while cost of risk significantly increased to an estimated 391 bps in Q4/16 vs. 83 bps in Q3/16 and 57 bps in Q4/15 on stronger collective provisions with credit expenses at USD 70 million in Q4/16 vs. USD 16 million in Q3/16 and USD 10 million in Q4/15.
- Assets, deposits and loans declined by respective -2%, -3% and -5%. On a QoQ basis, assets grew +2% to USD 29.5 billion while deposits were down -1% to USD 25 billion and loans were down -0.5% to USD 7 billion.
- Blom Bank continues to boast the highest capitalization among peers under coverage. Capital adequacy ratio (as per Basel III) increased to 19.0% in Q4/16 from 18.1% in Q3/16 compared to BDL's 14.5% regulatory requirement. TTM ROA at ~1.6% in Q4/16 and TTM ROE at an estimated 16.3%.
- Blom Bank's net profits came in at USD 119 million in Q4/16 (+1% QoQ, +4% YoY).

Latest Key Regional/Operational Highlights

- Blom Bank breakdown of assets and earnings between domestic and international operations stands at 81%/19% and 77%/23% respectively in Q4/16.
- At the end of 2016, the Group had USD 1.5 billion in assets in Egypt and generated USD 54.2 million in net earnings accounting for around ~5% 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.
- Blom Bank wrote-off its investment in the two Syrian subsidiaries Bank of Syria and Overseas SA (BSO) and Syria International Insurance (AROPE Syria) as at December 31, 2016.

FFA Model Assumptions

- We expect net profits of USD 118.9 million in Q1/17e (flat QoQ, +10% YoY).
- We expect net interest income at USD 176.8 million in Q1/17e (-4% QoQ, +6% YoY).
- Net fees and commissions expected at USD 39.0 million in Q1/17e (+2% QoQ, +3% YoY).
- We expect provisions of USD 9.4 million equivalent to an estimated annualized cost of risk at 52 bps for 2017e.
- We estimate cost-to-income at 37.0% in Q1/17e, below Q4/16 level of 54.6% and Q1/16 level of 38.8%.
- We expect assets, deposits and loans QoQ growth at +1%, +2% and +2% while YoY growth is expected at +1%/flat/flat.
- We expect LDR at 28.9% in Q1/17e unchanged from Q4/16 and Q1/16.
- Looking at FY 2016e, net profits should reach USD 507.4 million (+10% YoY) with EPS expected at USD 2.30 (+2% YoY).

Table 3: FFA Model Forecasts

USD Million	FFA Q1/17e	Q4/16a	Q1/16a	QoQ %	YoY %	FFA 2017e
Net Interest Income	176.8	183.6	167.0	-4%	6%	751.1
Fees & commissions income	39.0	38.3	37.9	2%	3%	163.8
Trading & investment income	36.4	367.0	23.5	-90%	55%	151.0
Operating Income	252.2	588.9	228.3	-57%	10%	1,065.9
Provisions	-9.4	-70.0	-4.8	-87%	95%	-39.1
Operating expenses	-93.2	-321.5	-88.6	-71%	5%	-388.6
Income tax	-30.7	-77.3	-26.9	-60%	14%	-130.8
Net Profits	118.9	119.2	108.2	0%	10%	507.4
Diluted EPS	0.54	0.60	0.49	-11%	10%	2.30
Assets	29,733	29,552	29,302	1%	1%	31,883
Deposits	25,255	24,811	25,207	2%	0%	26,794
Loans	7,294	7,163	7,279	2%	0%	7,784
BVPS to common	12.81	12.55	11.71	2%	9%	13.73
FFA Net interest margins	2.43%	2.54%	2.34%			2.41%
Core income to total operating income	85.6%	37.7%	89.7%			85.8%
FFA Cost-to income ratio	37.0%	54.6%	38.8%			36.5%
Immediate liquidity-to-deposits ratio	56.9%	56.8%	49.5%			56.8%
Loans-to-deposits ratio	28.9%	28.9%	28.9%			29.1%
Equity-to-asset ratio	10.0%	10.0%	9.5%			10.2%

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 12.50 from USD 12.00 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 12.50 from USD 12.00 per share and reiterate our Overweight rating. Our DDM assumes a 14.0% discount rate and a 3.0% terminal growth rate. We corroborate our DDM valuation by means of the residual income method as well as historical and comparable P/E and P/B multiples.

Key Investment Risks

Key investment risks include credit, interest rate, sovereign, economic/political and foreign operations risks.

BYBLOS BANK

Company Description

Byblos Bank is the fourth largest bank in Lebanon in terms of assets with an asset base in Q4/16 at USD 20.8 billion with earnings at USD 51.3 million. The Bank had a total of 97 branches and 2,347 employees as of end of December 2016 (excluding Byblos Bank Syria and Byblos Bank Africa) 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 2016 excluding Byblos Bank Syria and Byblos Bank Africa). 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.

Q4/16 Key Financial Highlights

Net profits at USD 51 million in Q4/16 (+31% QoQ, +6% YoY)

- Net interest income was at USD 61 million in Q4/16 (-2% QoQ, -2% YoY). We estimate interest margins at 1.19% in Q4/16 lower than 1.23% in Q3/16 and 1.28% in Q4/15.
- Non-interest income substantially higher at USD 269 million in Q4/16 on higher trading and investment income at USD 249 million (+1678% QoQ, 789% YoY) while fees and commissions came in lower at USD 19.5 million (-1% QoQ, -3% YoY). Significant deterioration in Byblos Bank's income quality mix with revenue breakdown showing core income (net interest income + net fees & commissions income) contribution to total operating income declining to 25% in Q4/16 from 85% in Q3/16 and 74% in Q4/15.
- Cost of risk increased to an estimated 66 bps in Q4/16 from an estimated 41 bps in Q3/16 yet remained lower than 150 bps in Q4/15 with provisions at USD 9 million.
- Subdued growth of balance sheet in Q4/16 as assets grew by +1%, deposits remained unchanged while loans were up +1%. On a YoY basis, assets increased +5% to USD 21 billion, deposits increased +3% to USD 17 billion and loans +5% to USD 5 billion.
- Assets continue to be largely funded by deposits at ~82% while LDR remains below Lebanese banking sector average (~31%). Immediate liquidity to deposits ratio (including cash and balances with central banks and interbank placements) came in higher at 48% in Q4/16 vs. 44% in Q3/16 and Q4/15.
- Profitability ratios were unchanged with TTM ROA at an estimated 0.81% and TTM ROE at an estimated 9.4% in Q4/16, still at the lower end of our coverage universe.
- Byblos Bank saw net profits at USD 51 million in Q4/16 (+31% QoQ, +6% YoY).

Latest Key Regional/Operational Highlights

- Byblos Bank breakdown of assets between domestic and international operations stood at ~91%/9% for 2016.
- Byblos Bank completed its acquisition of Banque Pharaon & Chiha in Q4/16 for a total consideration of USD 98 million. At end of April 2016, Banque Pharaon & Chiha's assets and deposits stood at respective USD 308 million and USD 229 million.
- Byblos Bank deconsolidated its subsidiaries Byblos Bank Syria which was 59.87% owned by the Group and Byblos Bank Africa (Sudan) which was 56.86% owned by the Group.

FFA Model Assumptions

- We expect net profits of USD 34.8 million in Q1/17e (-32% QoQ, +3% YoY).
- We forecast net interest income of USD 64.1 million in Q1/17e (+4% QoQ, +2% YoY).
- Net fees and commissions expected at USD 20.7 million in Q1/17e (+6% QoQ, +3% YoY).
- We expect assets, deposits and loans to grow by a respective +1% QoQ /+5% YoY, +1% QoQ /+3% YoY, +1% QoQ /+7% YoY.
- At these growth levels, LDR should be at 30.4%, up from 30.3% in Q4/16 and 29.2% in Q1/16.
- We forecast provisions of USD 7.9 million in Q1/17e equivalent to an estimated annualized cost of risk at 59 bps for 2017e.
- Our cost-to-income estimate is at 54.1% for Q1/17e.
- Looking at FY 2017e, net profits should reach USD 145.4 million (-11% YoY) with EPS at USD 0.19 (-7% YoY).

Table 4: FFA Model Forecasts

USD Million	FFA Q1/17e	Q4/16a	Q1/16a	QoQ %	YoY %	FFA 2017e
Net Interest Income	64.1	61.4	62.7	4%	2%	260.6
Fees & commissions income	20.7	19.5	20.1	6%	3%	80.9
Trading & investment income	29.0	248.4	55.5	-88%	-48%	119.0
Operating Income	113.8	329.3	138.3	-65%	-18%	460.4
Provisions	-7.9	-8.5	-7.5	-8%	4%	-32.1
Operating expenses	-61.6	-225.5	-84.9	-73%	-27%	-243.2
Income tax	-9.5	-44.0	-12.1	-78%	-21%	-39.8
Net Profits	34.8	51.3	33.8	-32%	3%	145.4
Diluted EPS	0.05	0.07	0.04	-38%	10%	0.19
Assets	21,003	20,812	20,050	1%	5%	21,684
Deposits	17,272	17,102	16,733	1%	3%	17,872
Loans	5,244	5,179	4,884	1%	7%	5,452
BVPS to common	2.46	2.45	2.30	1%	7%	2.52
FFA Net interest margins	1.24%	1.19%	1.27%			1.22%
Core income to total operating income	74.5%	24.6%	59.9%			74.2%
FFA Cost-to income ratio	54.1%	68.5%	61.4%			52.8%
Immediate liquidity-to-deposits ratio	48.0%	48.1%	45.1%			47.6%
Loans-to-deposits ratio	30.4%	30.3%	29.2%			30.5%
Equity-to-asset ratio	8.6%	8.7%	8.7%			8.5%

Source: Company reports and FFA Private Bank estimates

Investment Opinion

While we like Byblos Bank's solid domestic retail franchise with strong risk management practices, we believe additional value could be generated for investors 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 of 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 14.0% 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.

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