

Lebanese Banks

Q4/14 Preview

January 16th, 2015

Bank Audi (AUDI LB)	MARKETWEIGHT	USD 7.00
Blom Bank (BLOM LB)	OVERWEIGHT	↑ USD 10.50
Byblos Bank (BYB LB)	MARKETWEIGHT	USD 1.60

While Lebanese Banks' share prices should remain challenged from unfavorable operating conditions translating into weaker earnings growth, we value attractive dividends for income oriented investors in light of upcoming distribution

■ **At the sector level deposits growth decelerated in 11M/14 just below 5% Ytd, while loans grew 6.6% Ytd helped by CB initiatives:** Banks have been weathering unfavorable conditions amidst a political standstill and soft real GDP growth averaging 2% between 2011 and 2014e as per IMF. Banking sector decelerated in 11M/14, looking to reach 5% Ytd in 2014: assets and deposits growth came close to 5% Ytd totaling USD 172.2 billion and USD 142.7 billion respectively, while loans growth was more energetic at 6.6% totaling USD 50.5 billion equivalent to a 35% LDR. We note that the stimulus plan of the Central Bank aiming at subsidizing some types of loans to the private sector helped lending activity in the last two years and was recently extended to 2015 for an amount of USD 1 billion. Deposits continue to fund 83% of the sector's assets which in turn largely exceed the size of the economy as highlighted by an estimated assets to GDP ratio at 360%+. Non-resident deposits grabbed a stable 21% share in deposits at the end of Nov-14, which along with resilient remittances so far continue to fuel the sector's ample liquidity. Going forward, weaker inflows into Lebanon on account of higher risks, lower oil prices and slowing global economy give rise to concern that deposits accumulation could see further slowdown.

■ **Balance sheet of banks under coverage should sustain a low single digit growth in Q4/14e:** In Q3/14, Blom Bank and Byblos Bank saw moderate deposits and loans growth in the 1%-3% range QoQ with LDRs maintained in the 29%-30% range. Bank Audi's balance sheet saw weakness as growth muted at Odea Bank (now representing 24% of the Group's assets) on account of Turkish Lira devaluation. Bank Audi's LDR was at 47% at the end of Q3/14 above the 35% sector average as the LDR of Odea Bank (~85%) has moved closer to the 100%+ sector's average in Turkey. In recent quarters, Bank Audi's LDR stabilized as growth from Turkish operations started to normalize. We expect soft growth in assets, deposits and loans in Q4/14e across our universe in the 0%-2% range. For 2014e, we expect banks under coverage to end the year mostly ahead of the sector in terms of assets, deposits and loans growth: 10%, 10% and 10% respectively for Bank Audi, 7%, 7% and 12% respectively for Blom Bank, 4%, 8% and 7% respectively for Byblos Bank.

■ **Expect banks under coverage to report flat to positive earnings growth for 2014, while having to deal with profitability constraints:** 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 deposits growth (interest spreads in USD and LBP down 12 bps and 48 bps respectively YoY in Nov-14 as per the ABL). Lebanese banks' profits have been uninspiring since 2011. Recent statistics show that Alpha banks' net profits increased by a soft 4% YoY in 9M/14 to USD 1.4 billion. Positive balance sheet growth along with easing provisioning and cost control measures should help alleviate pressures. We note that Q3/14 held no major surprise for profits of banks under coverage as results came in line. Our estimates for YoY net profit growth in Q4/14e stands at +4% and +3% for Blom Bank and Byblos Bank respectively, while Bank Audi should almost double its net profits from an exceptionally weak Q4/13 quarter. We continue to closely monitor Odea Bank's results given first set of profits in Q2/14 which further accelerated in Q3/14 and its ambitious growth not without possible market and execution risks. Our expected EPS for 2014e stands at USD 0.91, USD 1.61 and USD 0.20 for Bank Audi, Blom Bank and Byblos Bank respectively vs. USD 0.80, USD 1.58 and USD 0.20 respectively in 2013.

■ **While banks' share prices should remain challenged, we highlight Lebanese bank's attractive dividend yields for income oriented investors ahead of upcoming distribution season:** Listed shares' prices of banks under coverage saw slightly negative to mid-single digit growth in 2014 (Bank Audi: -3.7%, Blom Bank: +6.7%, Byblos Bank: +3.2%). Going forward, share prices appreciation should remain limited to book value expansion and do not expect any significant multiple expansion due to lack of visibility from difficult operating conditions, heightened country risk and underdeveloped/illiquid equity market. On a positive note, we highlight attractive dividend yields at 5%+ across our universe as investors typically position themselves ahead of the dividend season which starts in April. At current market prices and based on most recent dividend distribution, we note that Byblos Bank offers the highest div. yield at the expense of higher payout versus peers, while Blom Bank has significant scope to grow dividends over time given lower than average payout. Bank Audi: DPS \$ 0.40, 6.6% yield, payout 50%; Blom Bank: DPS \$0.50, 5.6% yield, payout 32%; Byblos Bank: DPS \$0.13, 8.2% yield, payout 65%.

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 6.04	+0.7%	7.3x	0.96x	6.6%
Blom Bank	BLOM.LB	Overweight	↑ USD 10.50	USD 8.81	+0.1%	5.5x	0.84x	5.6%
Byblos Bank	BYB.LB	Marketweight	USD 1.60	USD 1.62	+1.2%	8.6x	0.77x	8.2%

Source: Company reports, BSE, FFA Private Bank estimates Note: * listed shares as of January 16, 2015 market close **Based on TTM EPS

■ **We maintain our recommendation unchanged on the three banks and remind that Blom Bank is the sole Overweight in our bank coverage universe:** We keep our recommendations unchanged and remind that Blom Bank is Overweight (target price increased to USD 10.50 from USD 10.00 previously) in our universe given higher than average margins, efficiencies and ROE, stable growth in earnings, solid capitalization, sizeable liquidity and conservative approach to growth. In addition, we value Blom Bank's above average BVPS expansion compared to peers helping its share price as multiples remain constrained. We also remind that Blom Bank offers an appealing earnings and dividend yields and has lower than average payouts implying significant scope to grow dividends over time.

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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 39.9 billion and TTM earnings at USD 323 million in Q3/14. The Bank had a total of 204 branches and 6,237 employees as of the end of September 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 62%/38% in 9M/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 2.8% as of Q3/14) amidst a difficult backdrop, the solid balance sheet growth and potential to pick up margins and profitability from current levels driven largely by Turkey.

Q3/14 Key Financial Highlights

Net profits at USD 90 million in Q3/14 (-13% QoQ, +23% YoY)

- Net interest income up to USD 212 million in Q3/14 (+10% QoQ, +26% YoY). While YoY increase was driven by higher balance sheet volumes and margin improvement, QoQ growth was only on account of higher margins as balance sheet growth was rather muted.
- Further increase in fees and commissions in Q3/14 to reach USD 66 million (+4% QoQ, +44% YoY), helps drive core income.
- Consolidated cost-to-income down to 55% in Q3/14, while Odea Bank's net profits accelerates as branch network gains in maturity.
- Gross NPL ratio rose to 2.8% in Q3/14, and higher cost of risk (est. 0.9%) mostly from general provisions allocated at Odea Bank.
- Growth in key balance sheet indicators muted in Q3/14, as Turkish Lira's devaluation offsets Odea's Bank growth.
- CAR III increased to 13.5% in Q3/14 from 12.3% in Q2/14 as a result of the capital increase which closed in September, while profitability ratios were roughly unchanged.

Latest Key Regional Highlights

- Bank Audi's breakdown of assets and earnings between domestic and international operations stands at 55%/45% and 62%/38% respectively as of 9M/14.
- In almost two years of activity, Odea Bank accumulated USD 9.6 billion in total assets representing 24% of group assets and is seeking to benefit from operating leverage as branch network expands and gains maturity. Odea Bank started reporting its first set of profits in Q2/14 at USD 3.3 million, which further accelerated to USD 11.2 million in Q3/14 (accounting for 12% of consolidated net profits in Q3/14) as margins, efficiencies and LDRs moved higher and closer to peers.
- Operations in Syria were downsized to just 1% of consolidated assets and 5% of consolidated profits as of 9M/14, limiting the exposure of Bank Audi to Syria's heightened risks.
- In 9M/14, the Group had USD 3.8 billion in assets in Egypt and generated USD 42.7 million in earnings accounting for 10% of consolidated assets and 15% of total profits. Management has adopted an accelerated business plan for Egypt with an objective to double assets in the medium term.
- The Bank's current key pillar markets are: Lebanon, Turkey and Egypt.

FFA Model Assumptions

- We forecast net profits of USD 91 million in Q4/14e, up 108% YoY and slightly above USD 90 million in Q3/14.
- Expect net interest income at USD 214 million in Q4/14e, up +1% QoQ, +27% YoY from higher margins and solid earnings 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.
- Net fees and commissions to reach USD 67 million (+2% QoQ, +25% YoY).
- Balance sheet is expected to witness moderate growth. We expect QoQ growth at 1% in Q4/14e for deposits and loans.
- The LDR is expected to remain roughly unchanged at 47% by the end of Q4/14e.
- We forecast provisions of USD 24 million in Q4/14e equivalent to an estimated annualized cost of risk of 0.60%.
- Our estimate for cost to income in Q4/14e at 59%, still high compared to pre-Turkey expansion levels.
- Looking at 2014e, net profits should total USD 371 million (+22% YoY) with EPS at USD 0.91, driven by stronger operating income and lower cost of risk. For 2015e, we expect net profits of USD 410 million and EPS at USD 0.91.

Table 1: FFA Model Forecasts

USD million	FFA Q4/14e	Q3/14a	Q4/13a	QoQ %	YoY %	FFA 2014e	FFA 2015e
Net interest income	213.8	211.8	167.9	1%	27%	799.8	876.9
Operating income	333.7	330.8	258.7	1%	29%	1289.1	1421.1
Net profits	90.8	90.1	43.6	1%	108%	370.6	410.1
Diluted EPS	0.20	0.22	0.12	-11%	65%	0.91	0.91
Assets	39,735	39,889	36,191	0%	10%	39,735	42,334
Deposits	34,294	33,918	31,095	1%	10%	34,294	36,520
Loans	16,146	15,926	14,713	1%	10%	16,146	17,731
BVPS to common	6.42	6.32	6.17	2%	4%	6.42	6.93
FFA Cost-to-income ratio	59.0%	54.6%	68.5%			56.7%	56.1%
Loans-to-deposits ratio	47.1%	47.0%	47.3%			50.0%	52.9%

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 towards 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% 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 27.5 billion and TTM earnings at USD 359 million in Q3/14. The Bank had a total of 244 branches and 4,609 employees as of the end of September 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 77%/23% and 76%/24% in 9M/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. 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 surpassed its peers in terms of earnings stability, interest margins and cost-efficiencies.

Q3/14 Key Financial Highlights

Net profits at USD 90 million in Q3/14 (-2% QoQ, +4% YoY)

- Net interest income upped to USD 145 million in Q3/14 (+6% QoQ, +7% YoY), helped by likely higher margins and healthy lending activity.
- Fees and commissions at USD 34 million in Q3/14 consistent with past two quarters levels, while financial gains at USD 25 million display higher volatility.
- Not taking into consideration discrepancies between quarters, 9M/14 point to alleviating provisioning pressures helping profits although mitigated by higher cost-to-income ratio.
- On the balance sheet side we note healthy lending activity as loans grew 3% QoQ and 10% Ytd.
- Comfortable capital position with CAR III edging up to 17.5% 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 77%/23% and 76%/24% respectively in 9M/14.
- The Bank operations in Syria have been downsized to just 1.5% of total assets and 3.4% of total profits as of 9M/14, thus limiting the exposure of Blom Bank to Syria's heightened risks.
- In 9M/14, the Group had around USD 1.9 billion in assets in Egypt and generated USD 28.2 million in net earnings accounting for 7% of consolidated assets and 10% of consolidated profits.
- The Bank's key pillar markets are: Lebanon and Egypt.

FFA Model Assumptions

- We expect net profits of USD 93 million in Q4/14e, up 3% QoQ and 4% YoY.
- We forecast operating income at USD 208 million in Q4/14e (+2% QoQ, +13% YoY).
- We expect net interest income at USD 139 million in Q4/14e (-4% QoQ, +7% YoY) as slightly higher margins YoY are matched with moderate earnings assets growth.
- We forecast slightly higher fees and commissions at USD 36 million for the quarter (+8% QoQ, +12% YoY).
- We expect provisions of USD 12 million equivalent to an estimated annualized cost of risk at 0.68%. Our cost-to-income estimate stands at 39.7% in Q4/14e (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 Q4/14e, ranging between 1% and 2% with loans growth exceeding that of deposits.
- At these growth levels, the LDR should remain relatively unchanged edging up 20 bps QoQ to 29.6% which reflects ample liquidity and significant room to expand lending from current levels.

- For the year 2014e, net profits should total USD 362 million (+3% YoY) with EPS expected at USD 1.61. For 2015e, we expect net profits of USD 375 million and EPS at USD 1.64.

Table 2: FFA Model Forecasts

USD million	FFA Q4/14e	Q3/14a	Q4/13a	QoQ %	YoY %	FFA 2014e	FFA 2015e
Net interest income	139.4	145.1	130.5	-4%	7%	557.8	589.6
Operating income	208.5	203.9	184.9	2%	13%	818.1	857.8
Net profits	93.1	90.1	89.7	3%	4%	362.4	374.8
Diluted EPS	0.42	0.39	0.41	7%	2%	1.61	1.64
Assets	27,937	27,500	26,149	2%	7%	27,937	29,614
Deposits	24,056	23,706	22,572	1%	7%	24,056	25,379
Loans	7,121	6,965	6,345	2%	12%	7,121	7,614
BVPS to common	10.73	10.44	9.75	3%	10%	10.73	11.88
FFA Cost-to-income ratio	38.8%	40.4%	37.0%			39.7%	39.9%
Loans-to-deposits ratio	29.6%	29.4%	28.1%			29.6%	30.0%

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 from relatively higher margins and operating efficiencies, despite sizeable liquidity buffers. In the short term, we look to the prudent management team to focus on asset quality in light of difficult operations in key regional markets. We value the Bank's ability to steadily grow earnings while dividends should continue to benefit from lower than average payouts.

Recommendation

We reiterate our Overweight rating on Blom Bank shares with a fair value at USD 10.50 per share up from USD 10.00 previously

Based on our revised forecasts and discount rate assumptions to our Dividend Discount Model, our fair value estimate has been increased to USD 10.50 per share, from USD 10.00 previously. Our DDM assumes a 14.5% cost of equity and a 3% terminal growth rate. We corroborate our DDM valuation by means of the residual income method as well as historical and comparable P/E and P/B multiples.

BYBLOS BANK

Company Description

Byblos Bank is the third largest Bank in Lebanon in terms of assets with an asset base at USD 19.0 billion and TTM earnings at USD 155 million in Q3/14. The Bank had a total of 101 branches and 2,518 employees as of the end of September 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 85%/15% as of 9M/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.

Q3/14 Key Financial Highlights

Net profits at USD 43 million in Q3/14 (+11% QoQ, +14% YoY)

- Net interest income at USD 62 million in Q3/14 (+1% QoQ, +9% YoY), on moderate balance sheet expansion and still shy margin improvement.
- Non-interest income at USD 56 million in Q3/14 (+15% QoQ, +21% YoY). Fees and commissions holding relatively steady, while trading and investment income momentum points to greater volatility.
- Further improvement in NPLs to 4.5% in Q3/14 drives cost of risk lower, which along with lower cost to income helped profits.
- Assets, deposits and loans grew favorably in the 2%-3% range QoQ in Q3/14. Comfortable Liquidity and capitalization metrics with an LDR at ~30% and a CAR III at 16.5%.
- Profitability ratios edged up sequentially although at the low end of our coverage and attractive dividend yield.

Latest Key Regional Highlights

- Byblos Bank breakdown of assets and earnings between domestic and international operations stands at 90%/10% and 85%/15% respectively in 9M/14.
- The Bank operations in Syria have been downsized to just 1.3% of total assets as of September 2014.

FFA Model Assumptions

- We expect net profits of USD 44 million in Q4/14e, up 1% QoQ and 3% YoY.
- We forecast net interest income of USD 63 million in Q4/14e, up 1% QoQ and 13% YoY.
- Fees and commissions income expected at USD 24 million in Q4/14e (+2% QoQ, -5% YoY).
- Key balance sheet indicators namely assets, deposits and loans are expected to witness moderate growth at a low single digit in Q4/14e (+2% QoQ), with an LDR maintained at 30%.
- We forecast provisions of USD 9 million in Q4/14e equivalent to an estimated annualized cost of risk at 0.73%. Our cost-to-income estimate stands at 46% for Q4/14e and 49% for the full year 2014e.
- Looking at 2014e, net profits should reach USD 156 million with EPS at USD 0.20, both roughly unchanged from last year. For 2015e, we expect net profits of USD 168 million and EPS at USD 0.21.

Table 3: FFA Model Forecasts

USD million	FFA Q4/14e	Q3/14a	Q4/13a	QoQ %	YoY %	FFA 2014e	FFA 2015e
Net interest income	63.1	62.4	55.7	1%	13%	242.9	262.4
Operating income	119.3	118.2	101.3	1%	18%	453.9	481.2
Net profits	43.7	43.3	42.6	1%	3%	156.5	168.3
Diluted EPS	0.06	0.05	0.05	4%	7%	0.20	0.21
Assets	19,273	18,972	18,485	2%	4%	19,273	20,476
Deposits	15,864	15,588	14,749	2%	8%	15,864	16,895
Loans	4,810	4,735	4,511	2%	7%	4,810	5,189
BVPS to common	2.13	2.10	2.13	1%	0%	2.13	2.27
FFA Cost-to-income ratio	46.4%	47.5%	49.6%			49.2%	48.5%
Loans-to-deposits ratio	30.3%	30.4%	30.6%			30.3%	30.7%

Source: Company reports and FFA Private Bank estimates

Investment Opinion

While we like Byblos Bank's solid domestic retail franchise with strong risk management practices, we believe additional value could be generated for investors as visibility and cost-efficiencies improve

We recognize Byblos Bank's position in its domestic retail market and solid fundamentals benefiting from sizeable liquidity buffers, strong capitalization and superior asset/liability management practices, a validation of management's risk practices although at the detriment to profitability ratios. We also recognize the firm's leadership at better managing its asset liability mismatch with the issuance of costlier longer term liabilities. We believe Byblos Bank's shares could generate more value once the firm gains visibility on its outlook and redeploys capital to create additional shareholder value by way of expansion, acquisition, or return of capital.

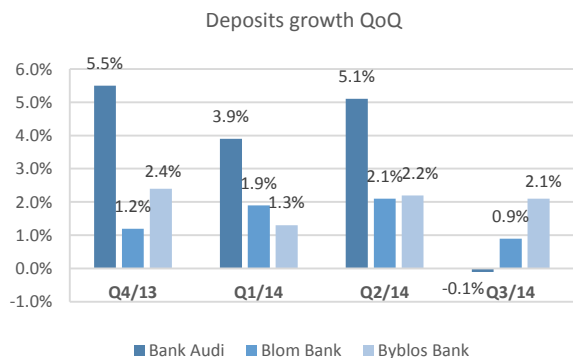
Recommendation

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

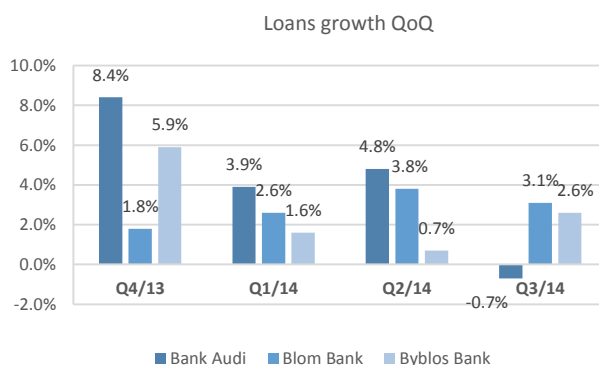
Based on our revised forecasts and discount rate assumptions to our Dividend Discount Model, our fair value estimate has been maintained at USD 1.60 per share. Our DDM assumes a 15% cost of equity and a 3% terminal growth rate. We corroborate our DDM valuation by means of the residual income method as well as historical and comparable P/E and P/B multiples.

Banks Under Coverage – Comparative Snapshots

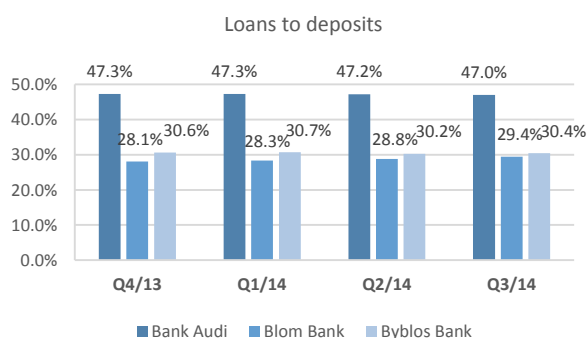
Bank Audi has been growing deposits at higher rate than peers on account of Turkish expansion, yet offset by TL devaluation in Q3/14



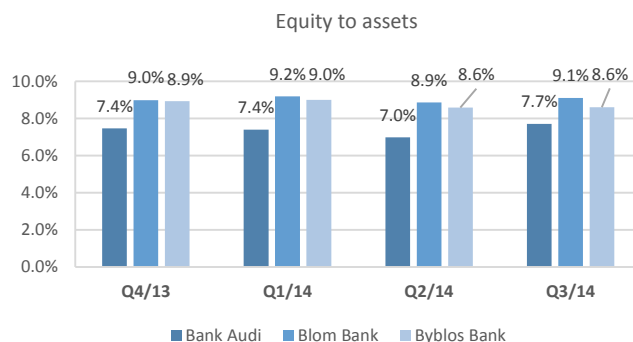
Loans growth muted for Bank Audi in Q3/14, while Blom Bank and Byblos Bank have sustained moderate increases



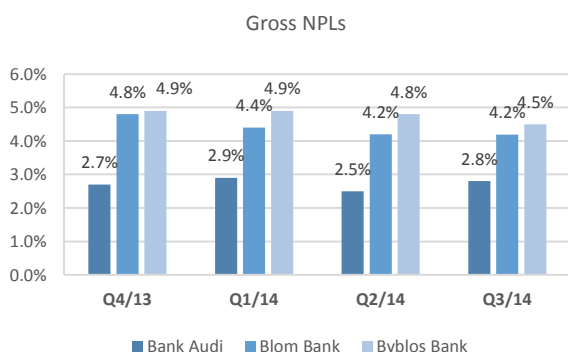
While Blom Bank and Byblos Bank's LDR remain below sector's average at 35%, Bank Audi LDR exceeds average at ~47%



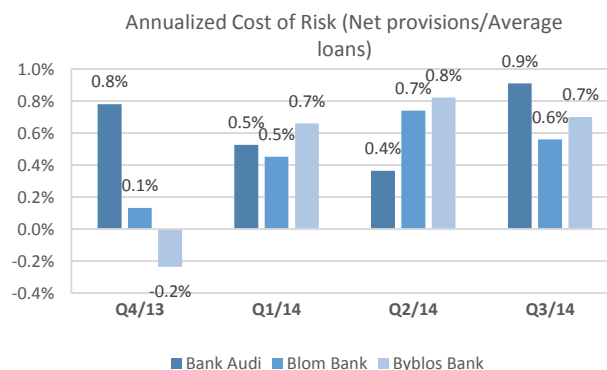
Recent USD 300 million capital increase strengthened Bank Audi's capital position closer to peers



We value Bank Audi's lower NPLs compared to peers which we continue to closely monitor given its rapid expansion in Turkey

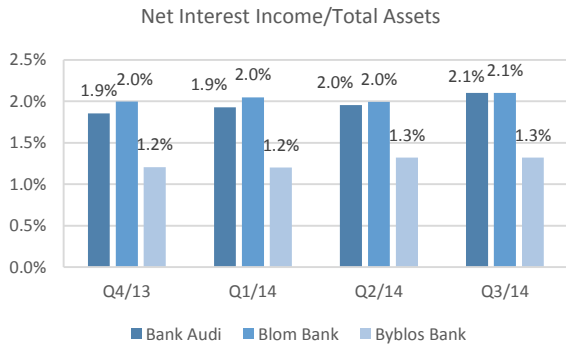


Cost of risk stabilizes lower over the past quarters in contrast to higher levels in 2012 and 2013

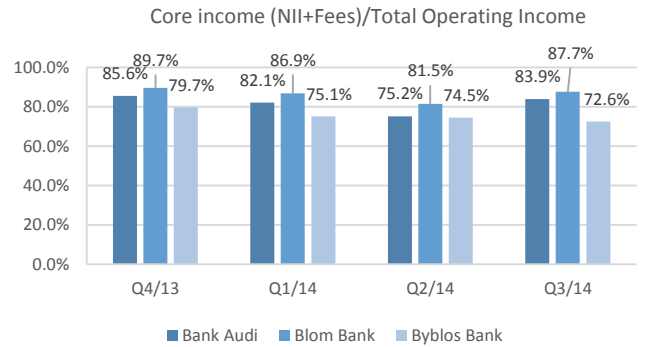


Source: Company reports and FFA Private Bank estimates

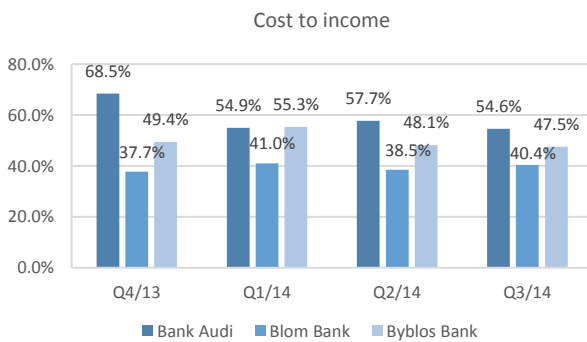
Relatively stable margins for Blom Bank, while Byblos Bank's liquidity accumulation strategy has dampened margins and Bank Audi's margins set to improve as Odea Bank converges towards Turkish average



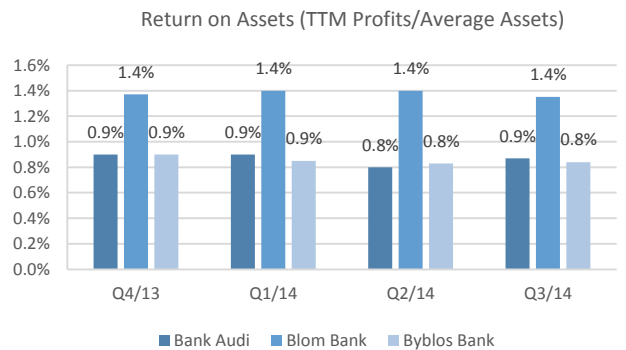
Blom Bank core income's contribution to total operating income higher than peers helps earnings stability



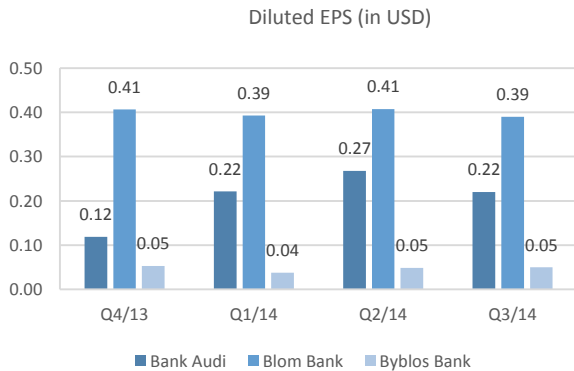
Blom Bank typically boasts higher efficiencies than peers, while Bank Audi's cost-to-income surged due to Odea's initial stage of



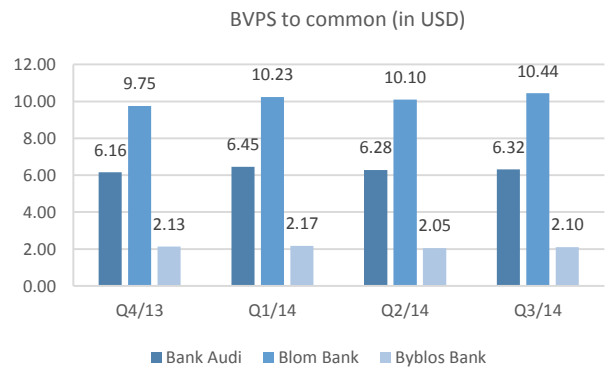
We value Blom Bank higher profitability compared to peers at a stable 1.4% ROA over the past four quarters



EPS volatility has been higher for Bank Audi, while Blom Bank has demonstrated stable earnings



Higher book value per share for Blom Bank has helped its share price as valuation levels remained steady



Source: Company reports and FFA Private Bank estimates

Lebanese Banking Sector Highlights

Recent Banking Sector Highlights

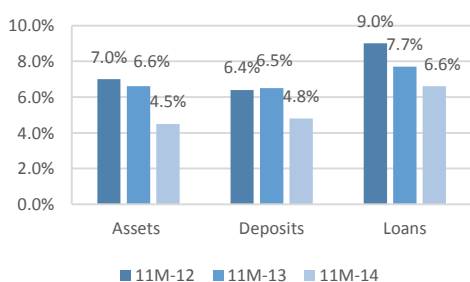
- Lebanese banks have seen more modest growth amidst difficult operating conditions.** Banks have been weathering the unfavorable political and economic conditions amidst a political standstill and lackluster real GDP growth averaging 2% in the 2012e-2014e period as per IMF latest estimates. In 2013,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

Looking at 2014, we note that Lebanese banks have seen a more modest growth in key banking aggregates at 4.5%, 4.8% and 6.6% in 11M/14, for assets, deposits and loans respectively to reach USD 172.2 billion, USD 142.7 billion and USD 50.5 billion at the end of November 2014. Loans growth kept an edge over deposits partly explained by the stimulus package of the BDL. Deposits inflows are needed to fund the budget shortfalls, while providing support to Central Bank FX reserves, which reached USD 33.1 billion in October 2014 up 4% since the beginning of the year (although down ~5% from a USD 35 billion record high in July 2014). Deposits continue to fund 83% of the sector’s assets which in turn largely exceed the size of the economy as highlighted by an estimated assets to GDP ratio at 360%+.

- Non-resident deposits funds a substantial 21% of total deposits.** Non-resident deposits edged up 4% Ytd in 11M-14 to USD 29.7 billion as the 5% QoQ drop that was registered in Jan-14 was recouped in following months. At the end of November 2014, non-resident deposits accounted for a substantial 21% of total deposits and has remained stable despite difficult domestic political and economic conditions which have prevailed in recent years.

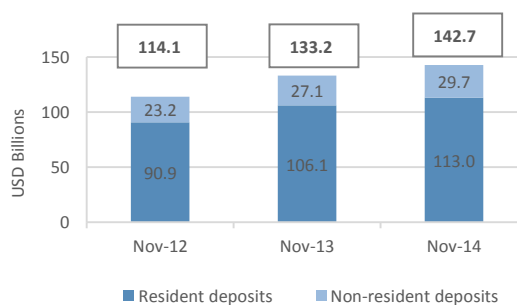
Assets remain mainly funded by deposits at 83%, while asset allocation at the end of Nov-14 reflects two main avenues for liquidity including government securities and loans to the private sector. LDR at 35% reflects ample liquidity levels. Dollarization of deposits and loans stood at 66% and 76% respectively.

Figure 1: Ytd growth in first eleven 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 ~5% 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 maintain current growth rates at ~5%/year in deposits 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 into question.

- Central Bank continues to support lending activity by subsidizing some type of loans at a time of market activity slowdown.** Central Bank’s policies are being supportive towards some sectors of the Lebanese economy, with the aim of stimulating lending and economic growth. The BDL has been offering interest rates subsidies on loans granted by banks to some consumer and productive sectors by extending loans to commercial banks at a 1% interest rate, which in turn allow banks to provide loans at reduced interest rates. The first stimulus package amounted to USD 1.5 billion was put at the disposal of commercial banks in 2013. The plan was extended to 2014 with a total of USD 800 million. The Central Bank recently announced an economic stimulus package of USD 1 billion for 2015 of which 60% allowed to be allocated to housing loans.
- 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 (banks with customer deposits above USD 2 billion), 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 9M/14, Alpha banks (banks with deposits in excess of USD 2 billion) saw their net profits increasing 4% YoY to USD 1.4 billion. Lebanese banks’ earnings are still lackluster on account of pressured margins and moderate balance sheet expansion although helped by cost control measures and easing provisioning pressures.

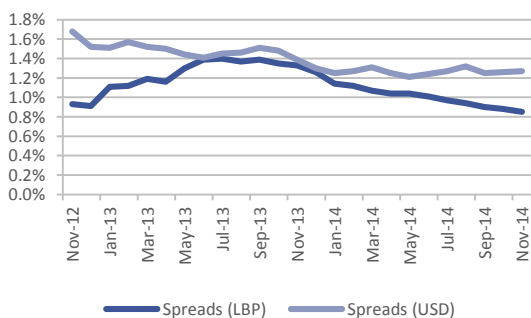
Although banks’ profits have been uninspiring over the past couple of years, we have not seen a reduction in dividends programs, which we expect to remain attractive for investors as highlighted by a 5%+ dividend yield for banks under coverage (Bank Audi 6.6%, Blom Bank 5.6%, Byblos Bank 8.2%) and an average payout ratio at 50% for banks under coverage (50% for Bank Audi, 32% for Blom Bank and 65% for Byblos Bank).

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

Spreads in USD decreased to 1.27% in November 2014 from 1.39% in November 2013 which has a substantial impact on 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 3.09% in the context of roughly unchanged weighted average on uses of funds at 4.36% edging up from 4.33%. Reminder, banks are still dealing with a negative carry on USD liquidity.

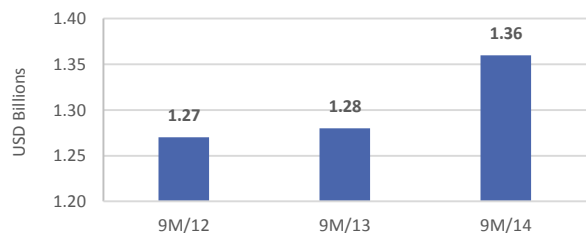
Spreads in LBP narrowed to 0.85% in November 2014 from 1.33% in November 2013 from higher cost of funds (+12 bps to 5.55%) and lower return on uses of funds (-36 bps to 6.40%) which was dragged down by lower lending rates (-21 bps to 7.11%) and more essentially lower rates on CDs issued by the BDL (-50 bps to 8.12%) despite slightly higher weighted yields on T-bills (+4 bps to 6.93%).

Figure 3: Spreads in LBP and USD



Source: Association of Banks in Lebanon

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



Source: Bank Data

- **Although not likely imminent, the start of the US rate hikes should provide favorable support to banks' variable rate assets denominated in foreign currency.** Current global interest rates' policies remain accommodative although could see the beginning of a gradual increase in rates starting as early as this year for Bank of England and Fed, while the ECB and Japan remain accommodative and keeping interest rates low for the foreseeable future. We expect Lebanese banks to benefit from assets that are priced on a variable basis once US rate normalization process begins given the dollarized economy.

News and Regulatory Updates

- **In November 2014, Central Bank issued an amendment to basic circular 81, tightening regulations for loans in terms of lending amount and provisions required.** The Central Bank of Lebanon recently issued an intermediate circular 376 on November 1, 2014 (which amends basic circular 81 dating February 21, 2001). The circular sets requirements for collective provisions taken against performing commercial loans. The circular has also tightened regulations on retail lending as it imposes more restrictive limits on lending amount based on the value of purchase for housing loans and car loans, and other limitations on cumulative monthly payments depending on borrower's monthly income. The circular sets provisions requirements against retail loans in the event of a non-payment period exceeding a month.
- **In December 2014, Central Bank issued an amendment to basic circular 81, amending collective provisions requirements on banks' loan portfolios.** The Central Bank of Lebanon issued Intermediate Circular 383 on December 24, 2014 (which amends basic circular 81 dated February 21, 2001). It stipulates that banks should build collective provisions against their performing commercial loans portfolio based on the results of a mandatory impairment test. The circular indicates that banks should build collective provisions against their performing retail loans.
- **In December 2014, Moody's downgraded Lebanon credit rating to B2 from B1, keeping negative outlook.** Towards the end of 2014, Lebanon's rating was downgraded by Moody's to B2 from B1, citing the rise in main government debt metrics and adverse spillovers effects from Syrian crisis on government finances, economic growth and political stability. Moody's maintained its negative outlook on Lebanon. We remind that Fitch has a B rating on Lebanon with a negative outlook, while Standard and Poor's has a B- rating on Lebanon with a stable outlook. Consequently, Moody's also downgraded the long term deposit ratings of Bank Audi, Blom Bank and Byblos Bank to B2 from B1 given their large holdings of government debt. It estimated Bank Audi's sovereign exposure at 2.5 times its tier one capital, that of Blom Bank at 2.6 times, and that of Byblos Bank at 4.4 times as of September 2014.

Republic of Lebanon's 5 year CDS trades near its one year low at 337 bps down ~40 bps from the same time last year with a one year high of 434 bps on January 7, 2015 and a one year low of 330 bps on June 9, 2014.

- **Some consolidation seen across the sector.** In recent months, the Lebanese banking landscape has seen some M&A transactions taking place among players looking to increase their market share and recognize synergies. The Lebanese operations of Jordan-based Al-Ahli Bank were formally acquired by Fransabank. First National Bank completed the acquisition of a 95.5% share in the financial advisory firm Corporate Finance House (CFH). In November/December 2014, Cedrus Invest Bank fully acquired Standard Chartered to form a new and separate entity named Cedrus Bank. We note that the Governor of the Central Bank, Riad Salameh, has been encouraging consolidation among Lebanese banks in order to reduce the number of lenders in the country, although preventing mergers and acquisitions among Alpha banks.

Comparable Valuation to MENAT 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 96.8 million share in 2014 (up 88% YoY), while listed shares of banks under coverage saw slightly negative to positive mid-single digit growth performance in 2014 (Bank Audi: -3.7%, Blom Bank: +6.7%, Byblos Bank: +3.2% Ytd).

Lebanese banks are currently trading at 9.0x P/E, 0.9x P/B and attractive dividend yields averaging 5% despite holding lower than average ROE at 10.6%. In comparison, banks in the MENAT region trade at an average of 12.0x P/E, 1.6x P/B and offer a 3.5% dividend yield and a 13.9% ROE (see table below).

While stock price appreciation of Lebanese banks could benefit longer term investors as banks can remain cheap at 1x book given weaker profitability and higher risk levels, they could rather enjoy ~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	2,414.5	0.7	6.6	-2.8	11.1	7.3	1.0
BLOM LB Equity	BLOM BANK	1,894.2	0.1	5.6	3.0	15.1	5.5	0.8
BYB LB Equity	BYBLOS BANK	916.1	1.2	8.2	-6.6	9.6	8.6	0.8
BEMO LB Equity	BEMO BANK	131.0	2.3	0.6	21.6	7.5	17.3	1.3
BOB LB Equity	BANK OF BEIRUT	928.6	0.0	3.1	7.7	11.2	7.4	0.8
BLC LB EQUITY	BLC BANK	259.6	0.0	n/a	-30.7	9.1	7.8	0.7
Average Lebanon		1090.7	0.7	4.8	-1.3	10.6	9.0	0.9
Average UAE		11,327.9	-3.1	3.6	19.3	15.4	10.6	1.6
Average Egypt		3,714.9	5.8	5.1	33.9	24.5	11.7	2.8
Average Kuwait		9,643.0	1.1	2.0	-17.8	8.5	20.3	1.6
Average Oman		2,167.3	2.5	4.2	12.4	13.6	7.9	1.0
Average Qatar		12,960.9	-0.4	4.2	3.9	15.0	13.9	2.0
Average KSA		12,809.6	2.8	2.8	18.7	12.8	13.6	1.6
Average Turkey		8,795.2	3.4	1.5	7.1	11.2	8.7	1.1
MENAT AVERAGE		7,813.7	1.6	3.5	9.5	13.9	12.0	1.6

Source: Bloomberg priced as of on January 15, 2015 market close (January 16, 2015 for Lebanon), FFA Private Bank for companies under coverage.

Lebanese banks valuation should remain capped by difficult operating conditions and high political and security risks, keeping investors on the sidelines and limiting multiple expansion. Therefore share price appreciation from current levels should rather originate from growth in banks' book values.

Banks Under Coverage Dividend Distribution

- We highlight Lebanese banks' upcoming dividend season and attractive distribution for income oriented investors.** Although Lebanese banks' profits have been uninspiring over the past couple of years, we have not seen a reduction in dividends programs and dividend yields are still attractive compared to global and regional benchmarks. We remind the following dividend distribution (before 5% tax) for banks under coverage in 2014 based on 2013 financial exercise: Bank Audi USD 0.40 per common share, Blom Bank 0.50 per common share, Byblos Bank USD 0.13 per common share. At current market prices, dividend yields for banks under coverage is at 5%+ (Bank Audi 6.6%, Blom Bank 5.6%, Byblos Bank 8.2%). While Byblos Bank

offers the most appealing dividend yield among banks in our coverage universe, it has a more stretched dividend payout (65%) pointing to limited room to increase dividends from current levels. Bank Audi's dividend payout stands lower at 50%. We believe Blom Bank has the highest potential to increase dividends from current levels given a payout ratio at 32%, having seen six increases in DPS over the past decade. In addition, we highlight that Blom Bank trades at more attractive levels than its peers on an implied P/B basis given its above average ROE levels on historical and forecasted levels.

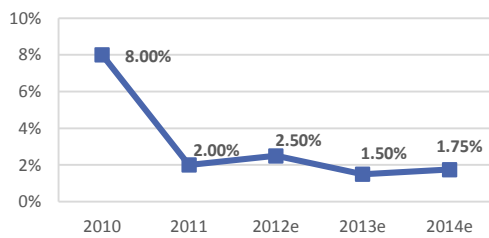
We note that dividends are typically paid starting the month of April each year for banks under coverage and investors typically position themselves ahead of the start of the dividend distribution season.

Macroeconomic Highlights

Economic activity still soft in light of rising uncertainties with real GDP growth estimated at ~2% in 2014e

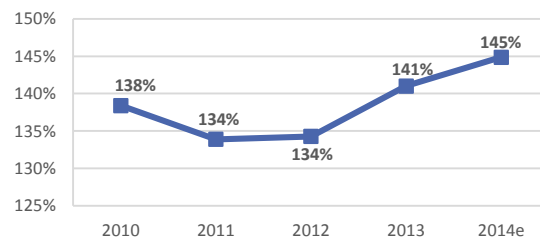
Economic developments continue to be soft with a GDP growth rate averaging ~2% between 2011 and 2014 as per IMF estimates down from a 9% average in the previous four-year period, suggesting sharp deceleration in economic activity. However, we note that in its recent October 2014 economic outlook database, the IMF revised its estimates for Lebanon’s GDP slightly upwards for the 2012-2014e period to ~2% from 1.2% previously. Similarly, balance of payments posted a deficit of USD 1.2 billion in 11M/14, as capital inflows were not enough to offset the large structural trade deficit.

Figure 5: Real GDP growth



Source: IMF World Economic Outlook Database October 2014

Figure 6: Gross debt to GDP ratio

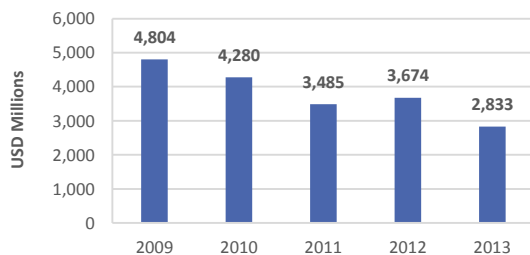


Source: IMF World Economic Outlook Database October 2014

Drop in FDI inflows, yet resilience in remittances to continue to lend support to the economy

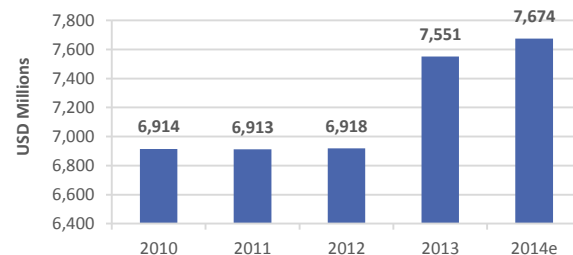
FDI inflows are estimated to have been among the most affected in the context of cautiousness related to regional uncertainties and a sluggish real estate market. Figures released by the UNCTAD show that FDI inflows to Lebanon totaled USD 2.8 billion in 2013 (~6% of 2013 nominal GDP), down 23% from USD 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 FDI inflows and are estimated by the World Bank to have reached USD 7.6 billion in 2013, up from USD 6.9 billion in 2012 and maintaining Lebanon’s ranking among top recipients in developing countries. The World Bank estimates still strong remittances inflows into Lebanon for 2014 at USD 7.7 billion (~16% of 2014 estimated nominal GDP). We expect these inflows to continue to lend support to the Lebanese economy, despite rising concerns from lower oil prices and slowing global growth.

Figure 7: FDI inflows



Source: UNCTAD

Figure 8: Remittances inflows



Source: World Bank, October 2014 update

Debt levels still growing to fund fiscal shortfalls

Lebanon's debt levels continue to gradually rise, funding fiscal shortfalls. Lebanon's gross public debt reached USD 66.6 billion at the end of November 2014 (+5% Ytd, +5% YoY). Gross debt should reach 145% of GDP in 2014e up from 141% in 2013 as per IMF on account of structural imbalances and weak economic growth. On a positive note, public finance figures for the first eight months of 2014 show that the fiscal deficit narrowed to USD 1.7 billion as compared to USD 2.6 billion in 8M/13 as a result of a 13% growth in public revenues versus a 2% decrease in public expenditures. Recent drop in oil prices should lend support to government's fiscal situation as it will slash Lebanon's energy import bill and government transfers to state-owned EDL. However, a projected increase in spending in 2015 mainly due to the expected adjustment in the salary scale for the public sector could re-swell the deficit.

The real economy, as portrayed by the performance of key sectors, 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 comprising eight weighted economic indicators, reached 272.6 in October 2014 higher than 264.3 in September 2014 and 270.5 in October 2013.

The real estate market, a traditional growth engine, has seen the number of transactions increasing 4% YoY in the first ten months of 2014, however picking up from a very low base in 2013 following several years of decline. On the supply side, total area of issued construction permits increased 7% YoY in 11M/14.

Banking sector's major aggregates saw a moderate increase in the +4.5%-6.6% range Ytd in 11M/14, reaching USD 172.2 billion, USD 142.7 billion and USD 50.5 billion for assets, deposits and loans respectively. Non-resident deposits grew by 4% Ytd in 11M/14 to USD 29.7 billion, funding 21% of total deposits.

Tourism remains lackluster although paring back the sharp decrease in activity seen in previous years. Number of incoming tourists increased 5% YoY in 10M/14.

Structural issues will continue to threaten sustainable growth unless serious reforms are undertaken

The overall assessment highlights that Lebanon is suffering from adverse effects of the prolonged Syrian crisis as highlighted by i) slowdown in GDP growth to 1%-2% in the 2011-2014e period as per IMF, significantly below pre-Syria crisis levels ii) lower FDIs inflows on account of a deterioration in the investment environment, iii) declining tourism activity iv) slower real estate activity 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 and poverty. World Bank estimates fiscal strains from Syrian refugees at USD 2.6 billion between 2012 and 2014e (~6% of 2013e GDP).

In addition to growing pressures from regional tensions and domestic uncertainties, Lebanon has also to deal with fiscal imbalances which are inflating debt levels. Fiscal measures to reduce the structural imbalances and to insure the long-term financial immunity of the country seems unavoidable.

On a positive note, the economy has been showing some pockets of resilience including continuous growth in the banking system although at a slower rate, resilient remittances inflows from Lebanese expatriates so far as well as monetary stability. A return to healthier economic growth (convergence towards potential GDP) will remain dependent on the improvement in the domestic political security situation, although even with such improvement structural issues facing the Lebanese economy will continue to threaten sustainable growth unless serious reforms are undertaken.