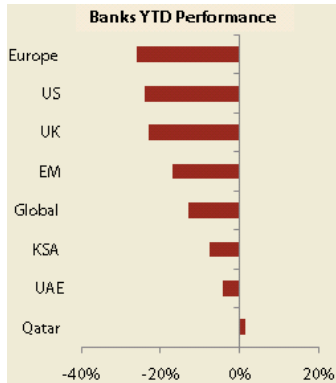




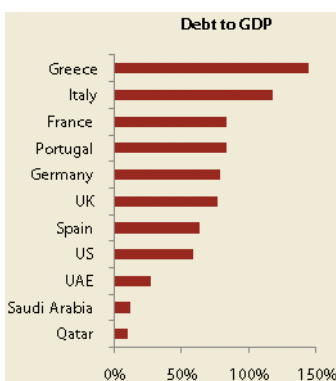
## MENA BANKS: LOW RISK HOLDING IN UNCERTAIN TIMES



Source: Bloomberg



Source: Audi Capital



Source: IMF

### SECTOR COVERAGE

**Wael Chalak, CFA**  
Senior Equity Analyst  
wael.chalak@asib.com

**Youssef Nizam, CFA**  
Head of Equity Research  
youssef.nizam@audicapital.com

Recently, global financials have materially suffered on the back of sovereign debt issues, stress testing and country specific factors. In the US we saw banking shares decline sharply, driven by economic slowdown, higher capital requirements, exposure to Europe and the Foreclosure Settlements emerging from the mortgage business. Europe also posted a material drop in share prices YTD, on the back of sovereign default fears, outsized weaknesses from Stress Testing and mortgage lawsuits from the US. Financials were also one of the worst performing sectors in the emerging markets on concerns that the sovereign debt woes will spread to EM and rising reserve requirements in countries such as China and Turkey.

We are of the opinion that today there is a fundamental difference between the global banks. We see European banks at the most risky end of the spectrum due to sovereign issues, funding and liquidity constraints and US mortgage lawsuits, while the MENA banks are among the safest in the world with minimal debt to GDP and very healthy core Tier 1 capital ratios. Valuations for European and US banks have turned attractive in a historical context, yet in our opinion, investors concerns in relation to book quality have not been addressed properly and we are likely to see new lows until a clear, concise view becomes visible. In this context, the banks in the MENA region are considerably a safer play, probably with lower long term upside potential, but with a substantially lower volatility on the downside, especially in the near term.

### CAPITAL ADEQUACY AND SOVEREIGN RISK ARE THE KEY FOCUS

With banking investors focusing on capital adequacy and sovereign exposure, we highlight the MENA banks as a sheltered investment, due to their robust fundamentals that differentiate them from most European and US banks, outlined by:

- ✎ Stronger capital ratios in times where capital adequacy is most crucial. We note that the majority of MENA banks capital should classify as Core Tier 1 capital.
- ✎ Absence of exposure to sovereign debt. The MENA region benefits from low debt to GDP, with the key economies delivering continuous fiscal surpluses, driven by strength in natural resources.
- ✎ Higher profitability measured by a superior return on assets and strong return on equity.
- ✎ Improving asset quality with falling provisions. This is the opposite of what could occur in Europe over the coming periods with potential triggering of sovereign defaults on the banks balance sheets.
- ✎ Exposure to potential inclusion of Qatar and UAE to MSCI, as banks are among the largest constituents of the stock exchanges in Abu Dhabi, Dubai and Qatar.
- ✎ Lower need to tap the wholesale markets owing to stronger liquidity, in times of rising risk premiums.
- ✎ Sticky access to cheap cost of funds due to the high proportion of demand deposits.
- ✎ Immaterial exposure to international operations, limiting the risk of default contagion.

All of the above positions the MENA banks at a major advantage in terms of potential loan growth, further earnings recovery and turnaround in share price performance.

### FAVORABLE RISK-ADJUSTED RETURN IN MENA

For investors looking to limit their risk exposure, we recommend entering the banks in the MENA region as a holding in a global portfolio. Given their different risk-return profile, we see the MENA banks complimenting European and US banks. At this stage European and US banks carry more short term risk but the valuations are at severe discount, while valuations for the MENA banks are richer but with high quality loan books and very limited downside.



## DOWNSIDE RISK IN THE US AND EUROPE REMAINS MATERIAL

The result of the sovereign crisis is a material rise in risk with investors reducing their exposure to the banking sector globally. At the same time valuations have become very attractive in the US and Europe for investors who are willing to bear some volatility. Today the US banks trade at an average PB11 of 0.62x, PE11 of 7.4x and PE 12 of 6.1x. In Europe the average banking PB11 is at 0.56x with PE11 at 6.3x and PE12 of 5.7x.

The average 2011 price to book ratio of MENA banks is materially higher than the averages in Europe and the US, however this is more than justified by the differentials in ROE and ROA ( See charts on page 3). In addition the quality of the book of US and European banks is currently very questionable, which adds an element of uncertainty to conducting a global PB comparison.

Downside risk remains on the front line in both the US and Europe. Sovereign debt fears are likely to persist for a while. European banks' exposure to struggling economies such as Italy, Greece, Ireland, Spain and Portugal is still causing concerns for the markets. In addition banks must hold a Core Tier 1 capital ratio of 5 percent under the EBA stress test. Participations and hybrid instruments (apart from exceptional government convertibles) have been eliminated from the definition of what constitutes core tier 1 capital, with several European banks holding substantial hybrids on their books. The stress test results from the EBA revealed that 8 European banks have failed to meet the solvency pass rate of 5%. The number of fails increases dramatically if the threshold is raised to more realistic levels, as can be seen below:

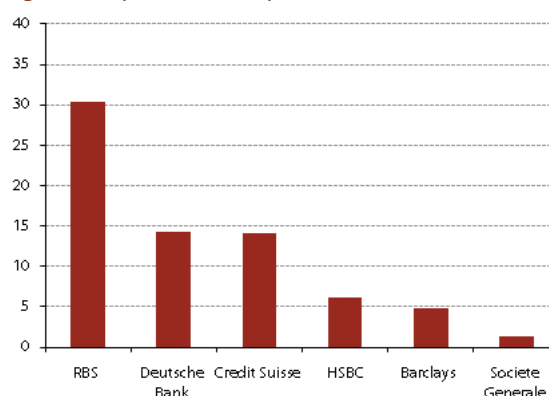
**Table 1:** EBA Stress Test Implication

Core Tier 1 Ratio	No of Failing Banks	Capital Shortfall (Eur Bn)
5%	8	2.5
6%	25	10.7
7%	42	43.1

Source: Audi Capital, EBA

European banks are confronting 3 other major issues on top of sovereign exposures. The first one relates to the lawsuits coming from the US in relation to mortgage backed securities. Royal Bank of Scotland, Credit Suisse and Deutsche Bank are among the most exposed while Barclays and Societe Generale disputed mortgages are potentially manageable

**Figure 1:** Exposure of European Banks to US MBS Lawsuits (USbn)



Source: FHFA, Audi Capital

The second burden that European banks have to deal with is the gradual adoption of Basel III requirements. While the requirements are globally intended, European banks seem to have



the largest upcoming difficulties, notably in the areas of liquidity, balance sheet funding and capital adequacy (including G-SIFI). It is estimated that European banks need approximately an additional 500bn Euros of liquid assets to comply with the new Liquidity Coverage Ratio (LCR) requirements. Among the most affected are Danske, Societe Generale, Credit Agricole, Deutsche Bank and Commerzbank. It is worth noting that the LCR requirements are under revision from the Basel III committee, with the potential of introducing a softer version, given the many challenges that European banks face in the near term.

Funding the European banks balance sheet is another source of concern. The material sovereign exposures have induced institutional investors to shy away from funding the European banks at bearable cost. This has been obvious recently with US money market funds withdrawing substantial portions from Europe, leaving many European banks reliant on the ECB to close the gap. We note that 20% of Greece's banking assets are funded from the ECB, followed by Ireland (15%) and Portugal (8%). Italian banks also witnessed a material increase in ECB funding.

The picture in the US is a little bit healthier. US banks exposure to Italy is less than 2% of their assets. But in a scenario of escalating sovereign default fears, selling will occur across the board. US employment data also came disappointing recently, with no jobs added in the month of August and weak home sales records. US investors are looking for structural economic reforms to regain confidence, namely in the areas of housing, employment and taxation. In addition US banks are also exposed to substantial outstanding claims in relation to mortgage securities.

### MENA BANKS AMONG THE MOST PROFITABLE GLOBALLY

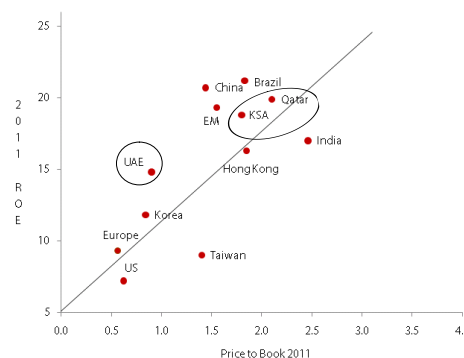
For the MENA region, the first half of 2011 was full of political uncertainty where a number of countries saw ongoing protests and government transformation. Yet among all this, the banking sector in the MENA region remained relatively resilient. In fact S&P Panarab banking index managed to outperform the S&P Panarab index.

The UAE, Qatar and Saudi Arabia remained intact from political disruptions. We see deep value in selected banks in each of these countries. Today the MENA banks may not appear cheap at a first glance; however a deeper look at the fundamentals reveals a different story.

*KSA, Qatar, UAE least impacted by political unrest*

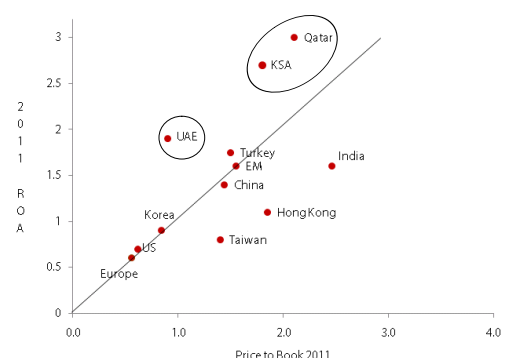
*Valuation in line with EM but only due to excess capital. If adjusted, MENA banks trade at a discount*

**Figure 2: Global PE - ROE Regression**



Source: Audi Capital

**Figure 3: Global PB - ROA Regression**



Source: Audi Capital

On a PB-ROE regression MENA banks do not offer a material discount to EM owing to high capital ratios. We see a different picture from a PB-ROA perspective as MENA banks are among the most profitable globally.



MENA banks become relatively in a league of their own when it comes to profitability. The region benefits from cheap access to funding , low banking penetration and firm macro fundamentals.

### **... AND POSITIONED FAVORABLY AGAINST THEIR GLOBAL PEERS**

Tighter capital standards are a must going forward, banks with lower capital ratios will have to increase capital. With the new definition of Tier 1 capital under Basel III , there will be no escape from raising equity. For MENA banks, almost all Tier 1 capital is comprised of equity , therefore we see a competitive advantage over time where we expect global banks (especially in the US and Europe) to increase capital at substantially higher rates than banks in countries such as Saudi Arabia, Qatar and UAE. As global banks raise their equity levels to comply with capital regulations, ROEs will fall gradually, all else equal. Therefore we expect MENA banks global superiority in ROA to translate into ROE advantage over time.

**We see limited downside at present, as inexpensive valuations, lack of sovereign issues, adequate capital base, low LDRs and high proportions of demand deposits have rendered the MENA banks far less vulnerable than other global peers to uncertainty in global credit markets.**



## SNAPSHOT OF THE MENA BANKS

The banking sector offers the largest exposure to the MENA region. Compared to other sectors, banking is the largest in the MENA region. Similar to their global peers, banks constitute substantial percentages of the MENA exchanges as can be seen below:

**Table 2:** Banks Share of Stock Exchanges

Banks Share of Stock Exchange	
Saudi Arabia	31%
Abu Dhabi	42%
Dubai	33%
Qatar	60%
Egypt	30%
Lebanon	68%
Jordan	44%
Oman	40%
Kuwait	40%

Source: Bloomberg

When it comes to the banking sector, we see Saudi Arabia, the UAE and Qatar as the key countries in the MENA region with Egypt potentially offering an alternative at a later stage.

We highlight below some key themes within the major MENA banking countries:

**Table 3:** MENA Banks Structural Indicators

	Saudi Arabia	Qatar	UAE
System Structure	12 banks, with the top 5 accounting for around 60% of banking assets.	14 banks, with top 5 banks accounting for about 75% of banking assets.	52 banks in total, with the top ten banks accounting for more than 80% of banking assets.
Credit Cycle	Medium recovery, loan growth picking up but remains low in a historical context	Middle of the cycle, with loan growth still elevated on tight LDRs, yet asset quality remains intact.	Early recovery stage with loan growth still sluggish, asset quality concerns receding but not vanished.
Provisioning	Cost of risk on the decline. Expect further earnings improvement from diminishing impairment charges.	NPL slightly rising but asset quality remains a minimal concern at an NPL average of 2.1%. Public sector lending and healthy corporate balance sheets still dominate the Qatari market.	Slowing NPL formation but asset quality concerns not completely gone. We estimate NPLs to peak in the UAE in 2011.
Liquidity	Average sector LDRs at 78% with many Saudi Banks adopting a conservative approach to date.	LDRs relatively high when considering future growth. Nevertheless the Qatari banks are positioned well to tap the wholesale markets.	LDRs improved recently due to deposit growth and slowdown in lending activity, We do not envisage any liquidity constraints over the short term.
NIM Outlook	Slightly positive (6bps QoQ), we expect slight pressure on corporate spreads over the short term, offset by higher retail penetration.	Neutral, We expect falling cost of funds and QCB bond yields to relatively offset yield competition.	Positive, UAE banks could benefit from recently falling interbank rates.

Source: Audi Capital

Within the MENA region, we are fundamentally positive on the banks in Saudi Arabia, Qatar and selective banks within the UAE. These countries have no exposure to the political unrest witnessed in places like Syria, Egypt and Yemen. Qatar and the UAE enjoy high per capita income and standards of living hence we do not foresee a rising need for change on the socio-economic front.

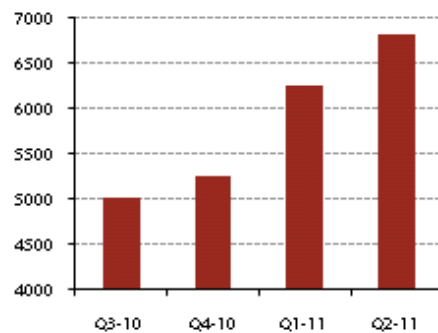


For Saudi Arabia, we believe the recently adopted government initiatives are leading the kingdom on the right path. The Saudi government is extremely aware that it needs to address social and economic needs, such as lowering unemployment and improving the standards of living. Recently there was a number of steps taken towards this end. The new changes announced by the Saudi government amount for USD 130bn of which USD 55bn will be spent in 2011. We also find the government's expansionary fiscal policy very supportive on this front. We take a cautious stance on Egyptian banks, as we believe asset quality issues are likely to become challenging over the short term, and we would rather wait for a better entry point.

### SAUDI BANKS : DECLINING PROVISIONS WITH PICK UP IN PRIVATE SECTOR LENDING ACTIVITY

The Saudi banking sector is characterized by declining provisions, credit growth recovery, robust capital management and improving net interest margins ready to drive earnings recovery. Going forward, we expect loan growth to rise from the bottom of the cycle. YTD loan growth picked up by 5%. While we see loan growth rising sharply from current levels, the recent pick up represents the strongest rate seen in over two years. We expect the retail sector to be the major driver for loan growth on the short term. We perceive continuous decline in provisions on the back of stable to falling NPL ratios. We favor banks with increased retail penetration, adequate liquid mix, high proportion of demand deposits and high NPL coverage ratios.

Figure 4: Saudi Banks Earnings (SAR mn)



Source: Saudi Banks Results

### QATAR BANKS: SUPERIOR LOAN GROWTH, ROBUST FUNDAMENTALS, INCREASED PRIVATE SECTOR LENDING

Expansion in the LNG business, coupled with booming construction supported by the 2022 world cup, provides Qatar with a competitive edge in the MENA region. The banking sector is heavily involved in the public lending business. The private sector is also recently witnessing a surge in lending with government spending flowing to the rest of the economy.

In addition, the recent government announcement to increase government and military employees by 60% and 120% respectively, will boost deposits in the domestic market and eases pressures on the Qatari bank to tap the wholesale markets for continuous lending growth.

We see some decoupling in the Qatari banking sector, on one hand there's the growth banks with substantial public sector penetration, on the other there are high dividend/value play banks.

### UAE BANKS : LARGELY IMPROVED ASSET QUALITY WHILE LOAN GROWTH REMAINS SLUGGISH

Going forward we see an upcoming improvement in loan growth in the UAE as NPLs peak. We believe the recent slowdown in lending activity is mainly owing to the UAE banks short term focus on asset quality and slow recovery in the real estate sector. UAE banks trade at a sharp discount to their MENA and EM peers, with unease still existing on asset quality. We consider the NPL cycle nearing its peak, while noticeable improvement in credit quality should start to materialise over the next six months.

## ROBUST CAPITALISATION PUTS MENA BANKS AT A CRUCIAL ADVANTAGE

We argue that MENA banks hold a crucial advantage to most financial institutions globally. Having beefed up their capital buffers over the last 3 years, we consider the MENA region as one of the most ready globally to absorb the changes coming from Basel III and domestic regulations.

### BASEL III SUMMARY

**Purpose:** to increase the quality and global consistency of regulatory capital and to standardize the required deductions and adjustments. The changes will be effective in 2012 over a transition period of 6 years.

**Key changes from Basel II and Impact on Banks:**

1. It focuses primarily on Core Tier 1 capital: mainly equity and retained earnings.
2. Stricter rules on hybrid instruments: very few hybrids will be classified as Tier 1, and the ones that do usually have less seniority to deposits.
3. A number of items are now 100% deductions from Tier 1 (under Basel II it used to be 50%). The main ones are minority Interests, unrealized losses on balance sheet assets, cash flow hedge reserves, deferred tax assets, defined benefit deficits, investment in unconsolidated subsidiaries such as insurance companies.
4. An increase in the risk weighting on counterparty risk and derivatives transactions.
5. Introduction of capital charges on potential mark to market losses.
6. Introduction of leverage ratio: The committee introduced conservative measurements which puts pressure for the need for further capital raisings and makes wholesale funding more expensive on a ROE basis.
7. Provisions moved to pro-cyclical view: This means that banks will have to move to a forward looking provisioning model instead of the incurred loss approach. For example in time of solid asset quality, banks still have to provide in line with the average provision it incurs on a long term average. The purpose of this is to make earnings less volatile for banks from year to year.
8. Liquidity metrics introduced: high quality liquid assets should support cash outflows for a period of 30 days. This implies that banks will have to hold more liquids, hence stimulating downward pressure on NIMS. The flip side is that this contributes to higher capital ratios. We note that the Basel committee imposes a liquidity coverage ratio of 100% on banks, with many banks currently below this threshold. European banks specifically could take a substantial earnings hit to comply with this requirement. We note however that regulators are currently reassessing this requirement to potential introduce a softer version.
9. Regulations on asset – liability management: this is addressed under the introduction of the net stable funding ratio.

*Focus is on Core Tier 1*

*Liquidity and leverage ratios have been introduced*

### THE SURCHARGE ON G-SIFI

On June 25, the Basel Committee announced an agreement under which a capital surcharge of 1.0–2.5% will be applied to the world's major banks. The surcharge is to be phased in from 2016 and become completely compulsory as at January 2019. Major Banks will be categorized into five groups based on how systemically important they are, with the surcharge applied on top of the 7% minimum common equity Tier 1 (CET1) ratio.

There will also be an additional 1ppt surcharge (which makes it a total 3.5%), for the most important banks in exceptional cases to guard against any increase in their systemic influence and risk to the market. Majority of the banks are able to meet the G-SIFI standards but obviously with a negative impact on dividend and ROE.

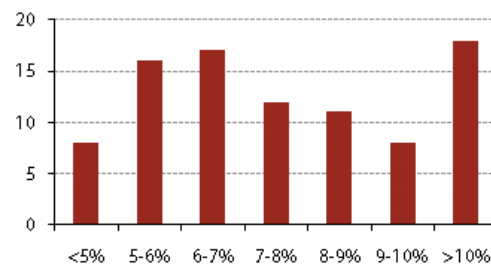
So going forward who does classify as a G-SIFI? Further clarity on this will come from the G20 meeting in November but what counts is the size of total assets, scale of exposure to other financial institutions, degree of global presence and sophistication of financial products.



## EBA STRESS TESTING

On July 15 the EBA revealed that 8 banks failed the Stress Test's key criteria of holding 5% Core Tier 1 capital. Though the result is generally positive, the results failed to assert confidence in the market with a substantial number of banks recording a Core Tier 1 below more realistic levels (i.e. 6-7%). The EBA defines Core Tier 1 as Tier 1 capital net of participations of parent companies/affiliates. Some Hybrids do qualify as Core Tier 1 such as government supported convertibles.

**Figure 5:** Core Tier 1 Distribution of European Banks



Number of failed European banks increases dramatically when Core Tier 1 requirement is raised to more realistic levels

Source: Audi Capital

## HOW ARE THE MENA BANKS POSITIONED FOR ALL THIS?

With the current capitalization levels, we see the MENA banks more than ready to comply with the upcoming changes on capital. We note that the majority of Tier 1 Capital for the MENA banks should qualify as Core Tier 1. We examine below the Tier 1 ratio of the major MENA banks and compare it to main EM and DM banking averages:

**Table 4:** Tier 1 Capital Comparison

	Tier 1
Al Rajhi Bank (KSA)	15.2%
Samba Financial Group (KSA)	17.8%
Riyad Bank (KSA)	16.0%
National Bank of Abu Dhabi (UAE)	16.2%
First Gulf Bank (UAE)	19.3%
Qatar National Bank (Qatar)	20.0%
Commercial Bank of Qatar (Qatar)	17.0%
Brazil	13.7%
Russia	12.6%
India	12.6%
China	9.8%
US	12.5%
UK	12.1%
Europe	12.0%
Emerging Markets	11.7%

Quality Capital of MENA banks among the highest globally

Source: Audi Capital, Bloomberg

Another major drag on banks coming from Basel III is the need to move to cycle forward looking provisioning instead of incurred loss approach. In this context, the MENA banks are very well positioned with an adequate NPL coverage ratio and conservative lending policies.

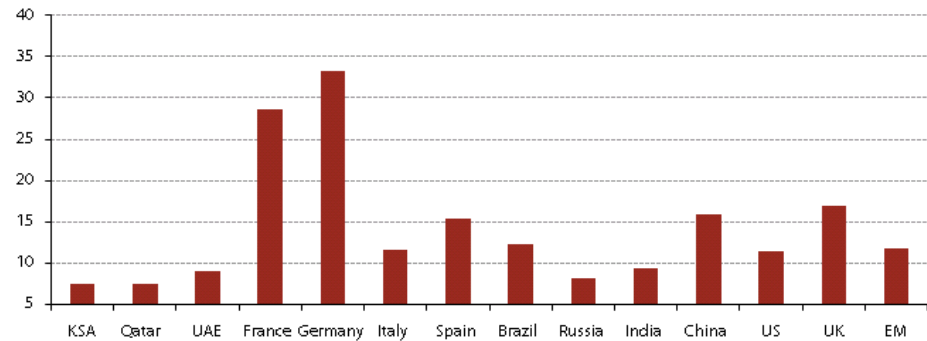
On the liquidity front, the MENA banks are also placed at a favourable advantage. The average loan to deposit ratio in the MENA region is amongst the lowest globally. In addition most banks in MENA hold a high proportion of liquid assets to total assets.



MENA banks among the least leveraged globally

The Basel III introduction of leverage ratio should also have a minimal effect on the MENA banks, we compare below, the leverage ratios of the key MENA banks vs global averages, measured by assets/equity.

**Figure 6:** Global Comparison of the Leverage Ratio



Source: Audi Capital, Bloomberg

Last but not least the G-SIFI regulations should have no direct impact on the MENA banks as most of them have limited international exposure and are relatively small to be considered Global Systematically Important Financial Institutions.

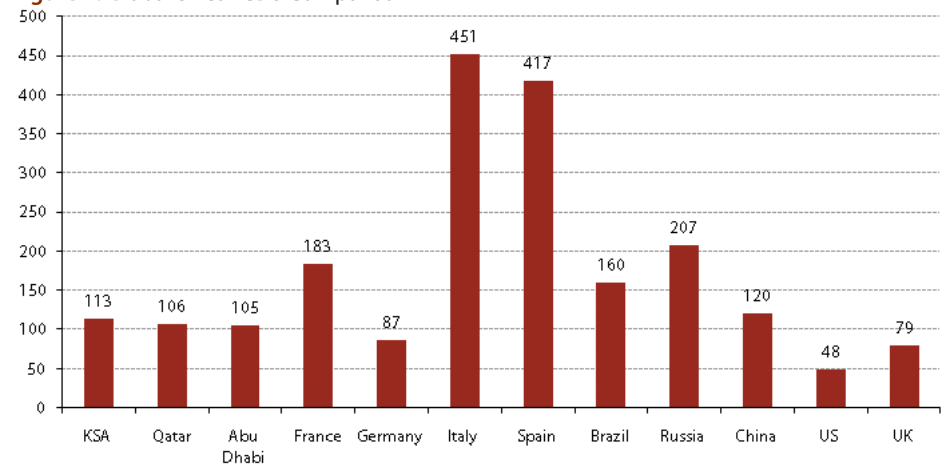
## SOVEREIGN EXPOSURE A MAJOR DISADVANTAGE FOR THE EUROPEAN BANKS

Concerns over Europe's debt problems are certainly escalating again. There is a growing worry that the European sovereign debt crisis has reached more serious levels alongside a rise in the yield on Italian government bonds. Italian CDS is now at an all time high, and its bonds maturing in the next three years exceed 500 billion Euros, nearly double the 256 billion Euros provided to Greece, Ireland and Portugal in their three-year aid programs. With rising wholesale funding costs and deposit spreads as well as climbing CDS, we anticipate further potential negative impact on the banks earnings in the Eurozone. Recently Moody's downgraded Portugal and put Italy on ongoing review. Further deterioration of sovereign debt means European banks will suffer on 2 fronts, first from sovereign bonds revaluations on the banks books, and second from higher risk premium on the investor end.

Year to date, we saw a strong correlation between the European banks relative performance to MSCI Europe with peripheral Europe average 5 Year CDS.

GCC (excluding Dubai) benefits from low CDS

**Figure 7:** Global 5 Year CDS Comparison

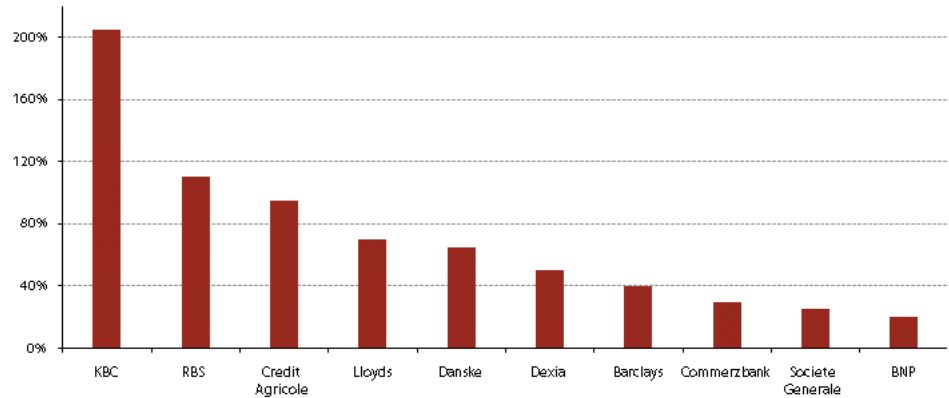


Source: Bloomberg



The picture is also not very encouraging when we look at some European banks' peripheral exposure to Core Tier 1 capital:

**Figure 8:** Periphery Exposure (% of Core Tier 1 Capital)

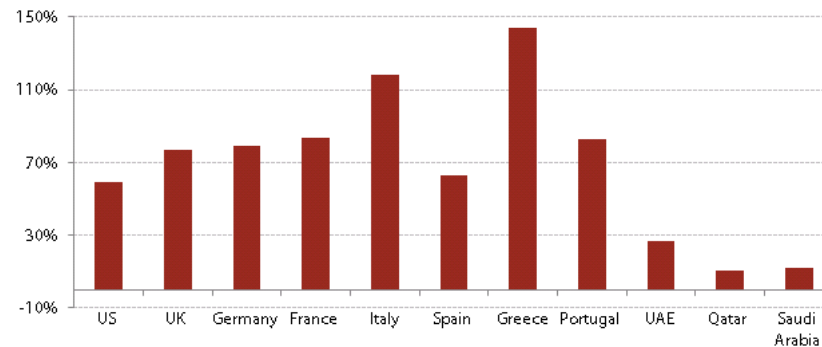


Source: Consensus Estimates

The other issue is that investors have reduced their willingness to fund the banks with escalating doubts on sovereign solvency. The result is that European banks have become more dependent on the ECB on the funding side.

We note that the MENA region also ranks highly in terms of debt to GDP. In addition, high oil prices have helped the GCC countries to increase fiscal spending without increasing the debt burden.

**Figure 9:** Debt to GDP



Source: IMF

Debt to GDP among the lowest for the GCC economies

## FALLING PROVISIONS IN MENA BUT LIKELY TO ESCALATE IN EUROPE

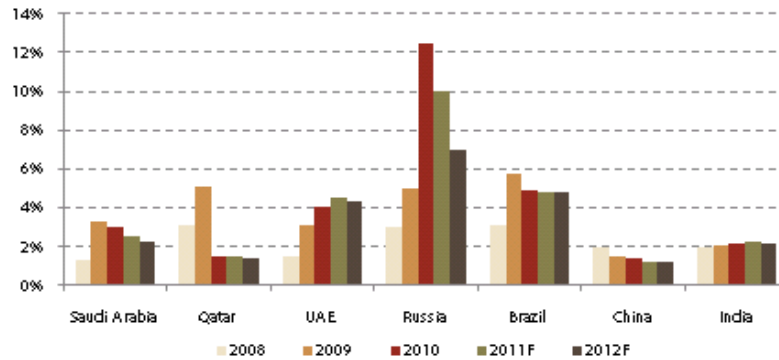
As a result of conservative lending, cost of risk in the MENA region has been falling. NPLs have peaked for banks in Saudi Arabia and are expected to peak by the end of 2011 for the UAE banks. In Qatar asset quality remains a minor concern with the public sector being the major borrower and a private sector supported by healthy corporate balance sheets.

In Europe we are likely to see rising provisions over the coming quarters to cover for doubtful sovereign exposure. The net effect of such scenario is a negative drag on European banks ROEs and a slowdown in lending.



For the MENA region, we expect corporate lending to pick up gradually as banks get more comfortable on risk appetite. We also expect the cost of risk for MENA banks to gradually diminish in an environment of declining NPLs and adequate provisioning coverage.

**Figure 10:** Historical and Forecast NPLs (MENA and BRIC)

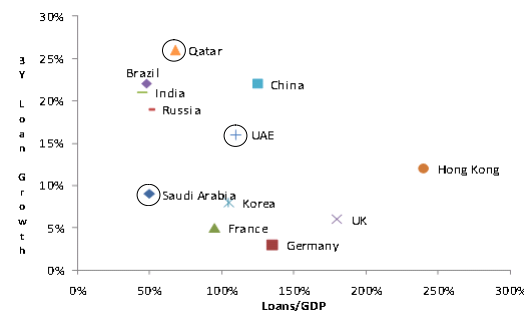


Source: Audi Capital

## MENA LOAN GROWTH SUPPORTED BY LOW BANKING PENETRATION AND FISCAL SPENDING

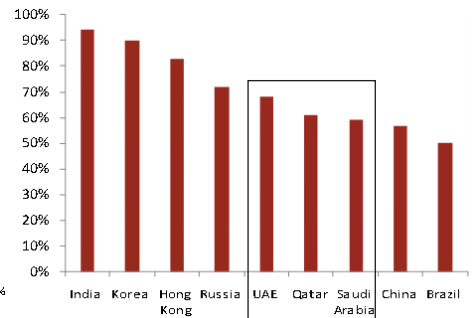
We believe that MENA banks are among the best positioned for lending growth going forward. In addition to asset quality outlook, we have considered demographics, banking penetration, leverage, and balance sheet liquidity. Saudi Arabia with its high fertility rate and currently young population will be among the highest countries in terms of bankable population growth. So far, lending in Saudi Arabia has been corporate focused but going forward retail lending has a substantial growth potential with limited competition. UAE should also be a major beneficiary from retail lending with 30% of its population less than 15 years old. Leverage and liquidity mostly support Saudi Arabia, Qatar, Russia and Brazil as witnessed in Loans/GDP Loans/ Deposit Ratios.

**Figure 11:** Global Banking Penetration



Source: Audi Capital

**Figure 12:** Loans to Total Assets



Source: Audi Capital

In Saudi Arabia, we saw signs of loan growth acceleration over the last 2 quarters on the back of earnings recovery and improved loan book quality. We believe loan growth will accelerate further in 2012 for Saudi Arabian banks. We also expect the UAE to follow KSA loan growth trend but with a certain time lag to allow for further asset quality improvement. Qatar's double digit growth remains intact backed by robust public and private sector activity.



## QATAR AND UAE BANKS TO BENEFIT FROM POTENTIAL MSCI EM INCLUSION

Last year, the MSCI committee refused to upgrade UAE and Qatar to emerging markets due to settlement dealing and foreign ownership restrictions. This year the settlement mechanism has been dealt with the implementation of delivery versus payment (DvP) system but no major changes were made to the foreign ownership issue. Reclassifying the MSCI Qatar Index and the MSCI UAE Index from Frontier Market to Emerging Market rank has been extended to December 2011. MSCI EM is by far the most widely adopted benchmark for accessing emerging markets and ranking EM fund managers. An upgrade to EM status lifts liquidity and attracts institutional investors to the region's markets. In this context the banks in UAE and Qatar are placed favorably, as many of them are amongst the largest constituents of the relevant exchanges.

**Table 5:** Abu Dhabi Index Top Holdings

	Sector	% of Index
Etisalat	Telecoms	29.3%
National Bank of Abu Dhabi	Banks	11.8%
Qtel	Telecoms	9.0%
First Gulf Bank	Banks	8.4%
Abu Dhabi Commercial Bank	Banks	6.0%

Source: Bloomberg

**Table 6:** Dubai Index Top Holdings

	Sector	% of Index
Emaar Properties	Real Estate	17.5%
Dubai Islamic Bank	Banks	12.9%
Emirates NBD	Banks	10.8%
Emirates Integrated Telecom	Telecoms	7.9%
Dubai Investments	Holdings	6.2%

Source: Bloomberg

**Table 7:** Qatar Index Top Holdings

	Sector	% of Index
Qatar National Bank	Banks	22.0%
Industries Qatar	Industrial	9.7%
Masraf al Rayan	Banks	8.6%
Qatar Islamic Bank	Banks	7.5%
Commercial Bank of Qatar	Banks	7.5%

Source: Bloomberg

## MONETARY TIGHTENING: DELAYED BUT NOT GONE

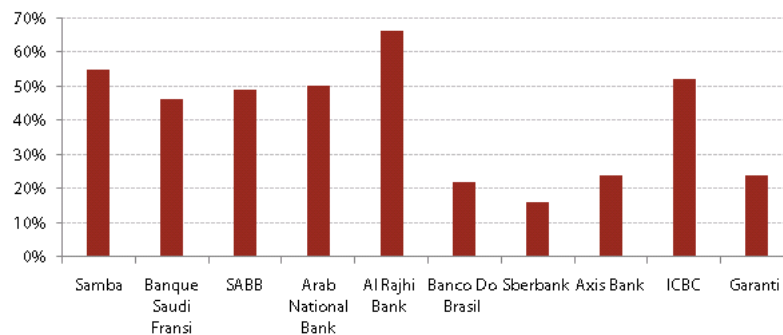
We expect Saudi banks to benefit the most once monetary tightening kicks in. Saudi banks have the highest proportion of demand deposits. We highlight Al Rajhi Bank as best positioned in this space owing to its low cost sticky deposit base.

Saudi Arabia, Qatar and the UAE are all pegged to the US dollar, from this perspective monetary tightening depends heavily on the US Federal Reserve policies. However with the Europe sovereign crisis still hovering and weak economic indicators stemming from the US, we now do not anticipate

*MENA banks benefit from rising interest rates*

tightening before the end of 2013. Most MENA banks follow a traditional banking model where deposits constitute the largest proportion of funding. Since 2009 the banks took advantage from the low interest rate environment and increased their share of demand deposits. Today demand deposits constitute a substantial portion of total deposits (especially for Saudi Banks). In Such environment, the cost of funds becomes less sensitive to interest rates hikes than the lending rate, allowing NIMs to widen and ROEs to rise. For Saudi Arabia we estimate every 25 bps to increase NIM by 11 bps with Al Rajhi Bank being the highest beneficiary in a rising interest rate environment.

**Figure 13:** Demand Deposits (% of Total Deposits)



Source: Audi Capital

## CONCLUSION

We are of the opinion that drastic differences currently exist between developed markets banks and banks in the MENA region. We believe that banks in Europe and the US potentially offer deep value but with a material downside risk. This is mainly due to risky sovereign exposure as well as upcoming headwinds emerging from funding constraints, liquidity shortfalls, capital scarcity and wholesale funding pressures.

On the contrary we see the MENA banks more suitable for investors looking for less volatility and limited downside. Despite the richer valuations, we think that the MENA banks solid fundamentals, especially in KSA and Qatar, will support them to be materially less impacted than developed banks in the current environment.

We believe the MENA banks offer a hedged investment in the global banking universe. Year to date, in our view, the MENA banks performance did not reflect their strong fundamentals, highlighted by:

- 📁 Robust capital adequacy ahead of Basel III and other global regulations with the majority of capital classifying as Core Tier 1 capital.
- 📁 Lack of sovereign debt exposure. Low debt to GDP and high commodity prices ensures that the MENA region will remain comfortable on this issue.
- 📁 Declining NPLs while asset quality in Europe is likely to deteriorate going forward
- 📁 Sustained higher profitability.

With recovering earnings and solid balance sheets, we believe that the MENA banks are positioned well for a turnaround in performance. Valuations are now at the low end of the cycle, the major catalysts in our opinion are:

- 📁 The rate at which provisions will fall.
- 📁 A sustainable improvement in net interest margins.
- 📁 Continued momentum in lending growth.

*Mena banks carry lower fundamental risk, hence lower downside*



## APPENDIX 1: GLOBAL BANKING VALUATIONS

**Table 8:** Global Banking Valuations

	PB 2011	PE 2011	PE 2012	ROA 2011	ROE 2011 (%)	10-12 EPS Growth	DY 2011 %
KSA	1.80	11.3	9.6	2.7	18.8	26%	3.1
Qatar	2.10	11.8	10.2	3.0	20.0	25%	4.5
UAE	0.90	7.1	5.8	1.8	14.9	67%	3.2
EM	1.55	8.8	8.1	1.6	19.3	14%	3.9
China	1.44	7.1	6.4	1.3	20.8	13%	5.2
Brazil	1.83	9.1	8.4	1.3	21.5	11%	3.5
Taiwan	1.32	15.3	14.7	1.8	9.3	14%	3.5
India	2.46	16.2	13.8	0.8	17.0	11%	1.5
South Africa	1.55	10.7	8.7	1.6	17.1	18%	4.5
Russia	1.36	6.8	6.5	1.5	21.2	19%	5.5
Mexico	1.90	12.1	9.7	2.6	18.0	25%	1.2
Malaysia	2.20	13.2	11.7	3.0	20.7	30%	4.5
Indonesia	3.20	15.7	12.9	1.4	23.0	15%	1.5
Turkey	1.30	8.3	7.3	2.4	16.2	15%	2.7
Korea	0.80	6.0	6.2	1.9	11.8	3%	2.8
UK	0.47	7.8	6.0	0.9	11.2	14%	1.7
US	0.62	7.4	6.1	0.6	7.2	15%	1.5
Europe	0.56	6.3	5.7	0.6	9.3	5%	4.7

Source: Audi Capital, Bloomberg

## APPENDIX 2: THE MACRO PICTURE

**Fundamental differences between the MENA countries:** There are some large differences within the MENA region in terms of GDP size and growth, per capita income and market size.

- ☞ Saudi Arabia is by far the largest; the country is fueled with oil reserves and positioned extremely well to grow.
- ☞ The UAE is the second largest with a GDP of USD 241bn. The country is driven by Abu Dhabi's oil reserves and Dubai's real estate and financial markets.
- ☞ Qatar is a crucial play in the MENA region, with the highest per capita income in the world and is forecast to grow at 20% and 8% for the years 2011 and 2012 respectively.

**Table 9:** MENA Macro Indicators

	GDP (USD bn)	GDP Per Capita USD 000's	2011 E GDP Growth	Debt/GDP (estimates)	Exch Mkt Cap (USD bn)
Saudi Arabia	435	15	7.5%	7	321
UAE	241	50	3.3%	25	103
Qatar	111	70	20.0%	7	120
Egypt	217	2	1.0%	80	66
Kuwait	117	54	5.3%	13	95
Lebanon	39	9	2.5%	151	10
Oman	57	16	4.4%	5	17

Source: Audi Capital, Bloomberg



## SAUDI ARABIA ECONOMY

When it comes to global oil markets, Saudi Arabia remains the most powerful country. The kingdom holds 22% of global oil reserves and 13% of oil production. The rise in oil prices from 2003 to 2008 has boosted the government reserves and budget spending plan. The country also ranks 4th in terms of natural gas reserves. Today Saudi Arabia has tremendous capacity for anti-cyclical fiscal policy in order to stimulate economic growth. In addition, KSA is one of the least leveraged countries in the world with debt to GDP at 10%.

Banque Saudi Fransi's Business Confidence Index achieved its 4th consecutive quarterly rise. Saudi businesses see Brent crude sustainable above \$100 supporting government spending and growth. As an outcome, most corporate are on a hiring spree with expectations of rising profits over the next year. The survey also revealed an increase in cash deployment and in equity investments. Despite a jump in projected expenditures this year, Saudi Arabia should manage to produce a respectable fiscal surplus owing to a rise in oil prices in the first quarter to \$94 a barrel for U.S. crude and \$105 for Brent. As of May 2011, net foreign assets grew 15.6% Y-o-Y to USD480.7 billion, resulting in a widening fiscal surplus. Oil production has also risen in the last three months as the world's top oil exporter strived to compensate for a shortfall in output by OPEC producer Libya, currently entangled in political instability. The IMF forecasts Saudi Arabia's economy to grow by 7.5% for 2011.

Saudi Arabia revealed a new employment initiative under which it intends to boost the ratio of nationals in the private sector from the current level of one Saudi in every 10. The government aims to succeed in creating 1.12 million new jobs for Saudi nationals by 2014.

**Table 10:** Saudi Arabia Economic Indicators

	2009	2010	2011E	2012E
Real GDP growth (%)	0	4	8	5
Inflation (%)	5	5	6	6
Tot.gov. revenue (US bn)	510	735	904	849
Domestic debt (% of GDP)	16	12	7	6
Oil export revenues (US bn)	163	215	252	237
Curr.account (% of GDP)	6	15	15	10
Unemployment (%)	11	11	10	9
daily oil production (mbpd)	8	8	9	9

Source: IMF, Bloomberg

## UAE ECONOMY

Historically, The UAE has relied on its oil reserves to achieve strong economic growth. Recently however, The UAE has succeeded in diversifying its economic sources with non oil GDP contributing to 65% of total GDP. The UAE was caught in the Global Financial Crisis as witnessed in the 2% economic contraction that occurred in 2009. In 2010 however the economy underwent a gradual recovery driven mainly by rising hydrocarbon production, government spending and signs of pick up in private sector activity. Fears about further deterioration in credit risk are now easing with non performing loans in the banking sector approaching stability.

The restructuring of Dubai World and Dubai Holdings has also increased confidence in the market, though risks have not completely faded. Inflation in 2010 remained contained, rising 2% from 2009 level. We expect spending in the oil, gas and petrochemicals sectors to exceed \$ 70bn over the coming



ten years. The government of Abu Dhabi also intends to diversify its economic sources further, by investing substantially in infrastructure, manufacturing, real estate and services as mentioned in the plan Abu Dhabi 2030. There is currently about \$960bn worth of projects in progress in the UAE, making it one of the largest construction markets in the MENA region. After the sharp fall in real estate prices over the last 2 years, supply –demand dynamics are starting to look favorable in both Dubai and Abu Dhabi. Recently we witnessed a turnaround in the lending appetite for Dubai; the emirate's recent capital raising came oversubscribed. Though to a largely lesser extent than Saudi Arabia, the UAE is still significantly reliant on hydrocarbons with oil activities accounting to about 30% of GDP most of which emerges from the emirate of Abu Dhabi. Abu Dhabi's wealth coupled with the strong ties between the public sector and the private sector.

**Table 11:** UAE Economic Indicators

	2009	2010	2011E	2012E
Real GDP growth (%)	-3	3	3	4
Inflation (%)	2	1	4	3
Domestic debt (% of GDP)	30	27	25	24
Curr.account (% of GDP)	3	8	10	11
Unemployment (%)	3	3	3	3
daily oil production (mbpd)	2	2	2	2

Source: IMF, Bloomberg

## QATAR ECONOMY

Qatar's economy stands in a league of its own, in 2010 the economy grew by 16.3%. Today Qatar continues to lead the region in terms of economic growth with the IMF forecasting the country's GDP to grow by 20% for 2011. Infrastructure spending and energy related projects remain Qatar's core strength. Public spending and LNG production increase are the main contributors to the economy, however the economy also witnessed growth in the areas of manufacturing and commerce. The Qatari economy operates in a different economic landscape than the rest of the Arab countries. During the period of political turmoil Qatar's 5 year CDS spread rose the least among its neighboring countries. GDP per capita is by far the highest in the region, socio-economic challenges are extremely low if not non-existent. Considering Qatar's continuous surpluses, the country's debt to GDP of 20% is assessed to be evidently favorable.

**Table 12:** Qatar Economic Indicators

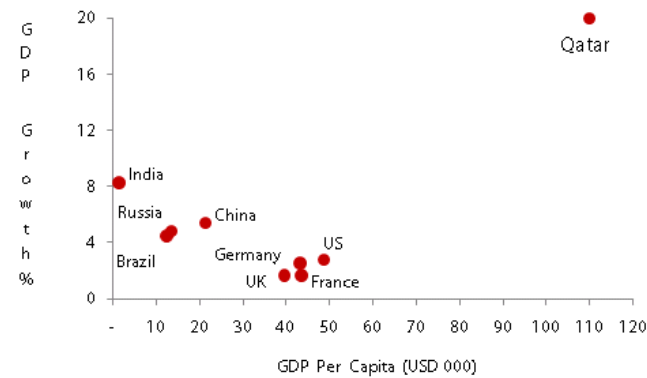
	2009	2010	2011E	2012E
Real GDP growth (%)	9	16	20	8
Inflation (%)	-5	-2	4	4
Domestic debt (% of GDP)	16	10	7	6
Curr.account (% of GDP)	10	19	36	34
Unemployment (%)	4	4	3	3

Source: IMF, Bloomberg



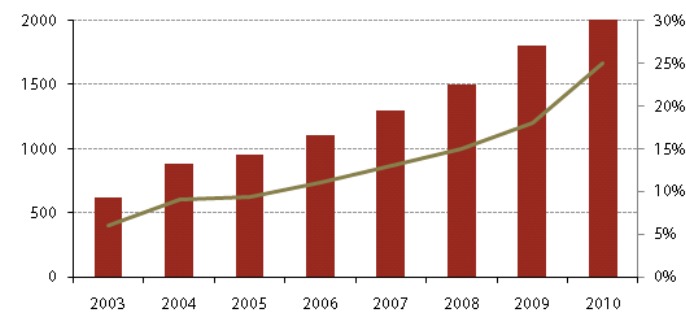
Monetary policy has also been extremely supportive with the Qatar Central Bank reducing interest rates by 50bps this year and removing fees on excess reserves in order to stimulate credit growth. Qatar's undergoing projects are estimated to exceed \$250bn with the majority coming from infrastructure, hydrocarbons and real estate. The budget for 2011-2012 reveals a surge in government expenditure exceeding 30%. The current account is forecast to reach a surplus of 36% of GDP while the fiscal surplus is expected to end at 13.5% of GDP for 2011.

**Figure 14: Qatar's Economy vs. Global**



Source: Audi Capital, Bloomberg

**Figure 15: Qatar LNG Production & World Market Share (bn of cubic feet)**



Source: Audi Capital, Bloomberg



## ADDRESS

### Audi Capital

Centria Building • Prince Mohammad bin Abdulaziz Road (Tahlia) • P.O. Box 250744 • Riyadh 11391 • Saudi Arabia  
Phone: +966 1 2199300 • Fax: +966 1 4627942 • Email: [contactus@audicapital.com](mailto:contactus@audicapital.com)

## DISCLAIMER

"All rights reserved. This research document is prepared for the use of clients of Audi Capital and Bank Audi SAL and may not be redistributed, retransmitted or disclosed, in whole or in part, or in any form or manner, without the express written consent of Audi Capital and Bank Audi SAL. Receipt and review of this research document constitute your agreement not to redistribute, retransmit, or disclose to others the contents, opinions, conclusion, or information contained in this document prior to public disclosure of such information by Audi Capital and Bank Audi SAL. The information herein was obtained from various public sources believed to be reliable but we do not guarantee its accuracy. Audi Capital and Bank Audi SAL make no representations or warranties whatsoever as to the data and information provided and Audi Capital and Bank Audi SAL do not represent that the information content of this document is complete or free from any error. This research document provides general information only. Neither the information nor any opinion expressed constitutes an offer or an invitation to make an offer, to buy or sell any securities or other investment products related to such securities or investments. It is not intended to provide personal investment advice and it does not take into account the specific investment objectives, financial situation and the particular needs of any specific person who may receive this document.

Investors should seek financial, legal or tax advice regarding the appropriateness of investing in any securities, other investment or investment strategies discussed or recommended in this document and should understand that statements regarding future prospects may not be realized. Investors should note that income from such securities or other investments, if any, may fluctuate, and that the price or value of such securities and investments may rise or fall. Accordingly, investors may receive back less than originally invested. Audi Capital and Bank Audi SAL or its officers or one or more of its affiliates (including research analysts) may have a financial interest in securities of the issuer(s) or related investments. Audi Capital and Bank Audi SAL shall not be liable for any loss or damages that may arise, directly or indirectly, from any use of the information contained in this research document. This research document is subject to change without prior notice."