Equity | United Arab Emirates

31 October 2011

# Banks

## Neutral

## 3Q11 – flattered by falling rates

**The most distinctive element of the 3Q11 results has been the enormous benefit seen at three banks under our coverage from falling rates. However, loan growth remains weak and provisioning high, limiting any sector-wide re-rating.**

**Key recommendations & forecasts**

| | Reuters | Year end | Recom | Price | Target price | EPS 1fcst | PE 1fcst |
|---|---|---|---|---|---|---|---|
| NBAD | NBAD.AD | Dec 2011 | Hold | Dh10.25 | Dh11.11 | 1.23 | 8.30 |
| ADCB | ADCB.AD | Dec 2011 | Hold | Dh2.89 | Dh3.18 | 0.21 | 14.00 |
| First Gulf Bank | FGB.AD | Dec 2011 | Buy | Dh15.00 | Dh19.14 | 2.18 | 6.90 |
| ADIB | ADIB.AD | Dec 2011 | Buy | Dh3.21 | Dh3.83 | 0.45 | 7.10 |
| Emirates NBD | ENBD.DU | Dec 2011 | Hold | Dh3.50 | Dh4.55 | 0.37 | 9.50 |
| DIB | DISB.DU | Dec 2011 | Hold | Dh1.96 | Dh2.28 | 0.22 | 8.80 |

Source: Company data, Rasmala forecasts

**Sector performance**

| | (1M) | (3M) | (12M) |
|---|---|---|---|
| Absolute | -43.6 | -66.4 | -75.3 |
| Absolute (%) | -4.5 | -6.7 | -7.6 |
| Rel market (%) | -3.2 | 1.3 | -4.8 |

ADX Bank & Fin Index: 3947.11
DFM Financials: 917.37
Source: Bloomberg

### Headline numbers strongly ahead, but results in line on a recurring basis

Of the six banks that we cover, ADCB, NBAD and DIB were significantly ahead of our expectations, FGB was in line, ADIB slightly behind, and Emirates NBD (ENBD) substantially behind. We believe the main features were volatility in the net interest income, and in the case of ENBD, higher provisioning. Balance sheet volumes showed little signs of acceleration.

### Net interest income driven primarily by falling EIBOR rates

Although the net interest income was strong, rising 28% qoq at ADCB, 13% qoq at ENBD and 11% qoq at FGB, we believe this was mainly due to a sharp decline in interbank rates in 2Q11 that affected liabilities yields in 3Q11, but impacted asset yields mostly in 4Q11. In addition, we believe that deferred interest income was booked from interest in suspense, further boosting the results of ADCB in particular. On a recurring basis, the lack of volume growth is likely to mean relatively low net interest income improvements.

### Some Abu Dhabi volume growth, but limited

Three banks benefitted from 3Q11 volume growth on a qoq basis: NBAD +1.9%, FGB +3.4% and ADCB +5.8%. NBAD has shown decent growth this year, and this represents a slowdown from 2Q11. For FGB, this represents an acceleration, which management regards as broadly based. ADCB benefited substantially from financing its own RHB stake disposal. Elsewhere, growth was hard to come by, with ENBD sneaking into positive territory thanks to the loan demand from the government of Dubai.

### Overall, 2011 upgrades and 2012 downgrades

We believe the strength of net interest income and the lack of negative surprises are adding pressure for upgrades to 2011F EPS numbers, with the exception of ENBD, which has guided more conservatively on the need to retain general provisions. However, lack of balance sheet growth and higher guidance on 2012 provisioning is likely to pressure longer-term numbers.

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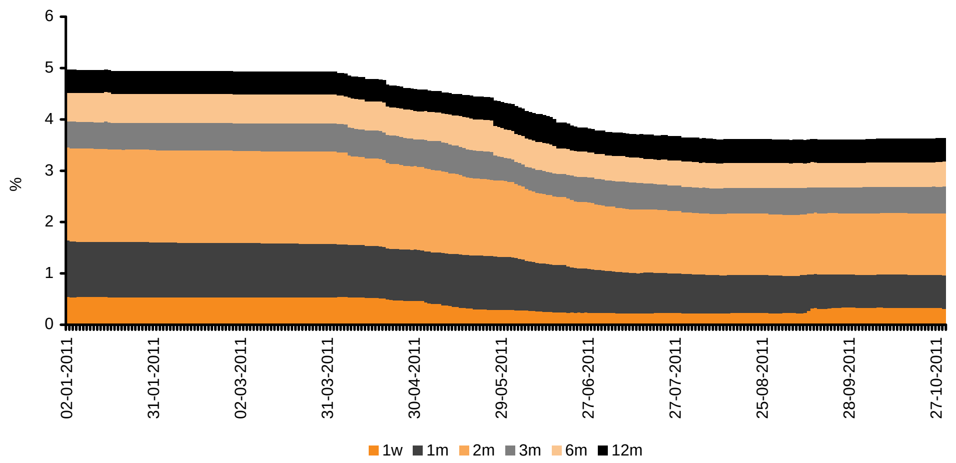
# Falling EIBOR rates driving interest revenue

**EIBOR rates declined substantially in 2Q11, having a positive impact on shorter-term liability rates, with asset rates coming down more slowly.**

The most salient aspect of 3Q11 results has been the substantial outperformance of net interest income. In the main, we believe there are four things going on here:

(i) Firstly and most importantly, the decline in EIBOR – the most significant decline in EIBOR occurred between April – June 2011, which with a three-month lag meant that most of this was priced into 3Q11 liability rates. Since much of the asset yield is longer maturity, it will be priced in more gradually, mostly in 4Q11.

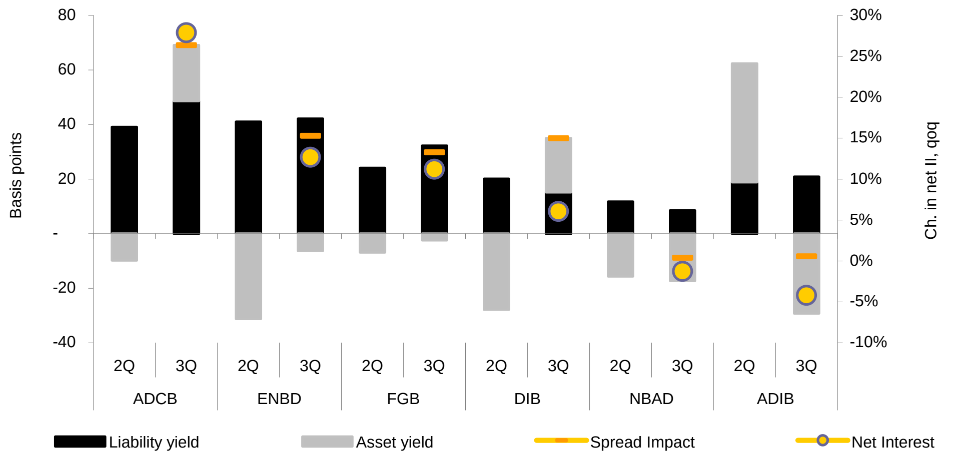
**Chart 1 : EIBOR declines during 2011**




Source: Company data, Central bank data

However, not every bank experienced a big rise in net interest income. Broadly speaking, ADCB saw the biggest estimated spread increase, while FGB, ENBD and DIB occupied the middle ground. ADIB and NBAD saw their spreads shrink. Clearly, there must have been some other factor/factors besides the impact of EIBOR.

**Chart 2 : Impact of asset / liability yield changes on spreads and net interest income**




Source: Company data, Rasmala estimates

(ii) Interest in suspense – in most cases, asset yields declined, but ADCB and DIB saw a sharp positive movement. In ADCB's case, we believe this was due to accruing interest in suspense over previous quarters, and booked in 3Q11 when the underlying loan began performing again. Although only ADCB specifically refers to a write-back of interest in suspense, there may have been some impact on other stocks.

(iii) Balance sheet mix – For banks maintaining a more liquid balance sheet, we expect limited or potentially no benefit at all. DIB and ADIB certainly fell in that category with a large net positive interbank position. A significant reason for DIB's improved spreads was the decline in interbank balances and the loss of high-cost deposits.

(iv) Competition and regulation – Both NBAD and ADIB suffered on the asset yield side of the equation. In NBAD's case, the bank attributed this to competition from international banks for the public sector business. For ADIB, the greater issue may be regulations on retail lending.

## Outlook

Going forward, we expect most issues relating to EIBOR pricing to run their course within one to two quarters, and the same can be said for interest in suspense. As a result, banks that failed to benefit should see the performance differential fall. Competition and regulation are, of course, less likely to normalise, in our view, and that might mean the negative asset yield impacts would be more lasting than the positives. Indeed, liability yields have been increasing since 3 October 2011, albeit only to the tune of 3.75bp.

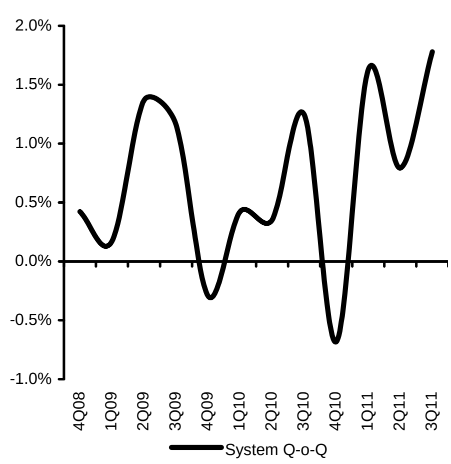
As a result, although there was a substantial variance in performance caused by margin movements this quarter, we expect this to phase out over coming quarters. Only NBAD has mentioned increasing asset competition, but the decline in liquidity seen as a result of government deposit draw-downs may mean some increase in liability rates.

# Balance sheet growth still anaemic

**System growth has remained stuck in the mid-single digit annual level for some time. Public sector growth is positive, but there are a few other areas where green shoots are apparent.**

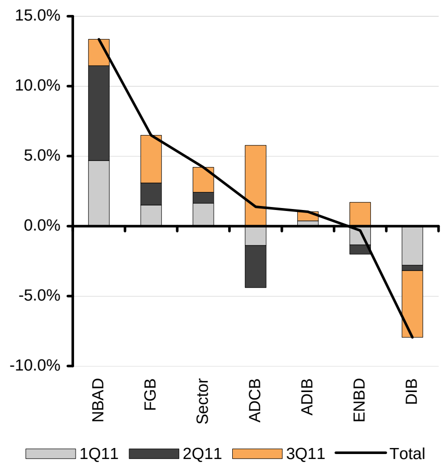
We did expect higher growth rates earlier in the year, but these have largely failed to materialise. There has been some acceleration from the 0-1% qoq level to the 1-1.5% level, but this still adds up to mid-single digit growth for 2011. The large banks we cover have also generally been losing market share this year, with the exception of NBAD, and to a lesser extent FGB, as smaller banks like Qatari-associates UAB and CBI have added to their cost base and priced more aggressively.

**Chart 3 : System credit growth**




Source: Central bank

**Chart 4 : YTD loan growth**




Source: Central bank, statistics, Bank reports

It is clear that the public sector business in Abu Dhabi has been a driver for lending growth, but we suspect GRE deleveraging in Dubai has actually been a deterrent. Private sector lending as a whole shrunk 8% from December 2008 to June 2011, making the near flat performance for 1H11 seem relatively positive. However, pockets of growth were mostly in extractive industries in 1Q11, and largely in wholesale trade in 2Q11. Credit to non-residents has also been a driver through 1H11.

Given this scenario, it should be no surprise that NBAD has been the tearaway performer. FGB has also benefited from market share gains across the credit industry. ADCB's headline growth levels were respectable, but only due to the self-financing of its RHB stake disposal, and the general trend continues to be deleveraging across its book, but particularly in the retail lending space.

At the other end of the scale, ADIB has disappointed, continuing to claim double the market level of growth, but actually seeing little improvement. ADIB is most exposed to retail banking regulations so the strong customer acquisition we have seen, and glowing reviews of its customer service have not transposed into actual volume growth. Dubai banks have both suffered from continuing Dubai deleveraging, although ENBD benefitted more from strong public sector growth in 3Q11, and pointed more optimistically to firmer forward-looking indicators.

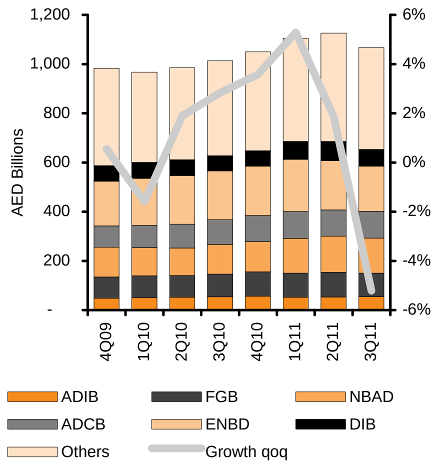
## Prospects for growth – a few green shoots

There hasn't been much signs of acceleration in growth either. ENBD mentioned 1-2% growth over the next 12 months as deleveraging continues. Meanwhile, Abu Dhabi banks are guiding for around mid-single digit levels. Broadly, the trend seems to be more of the same, although deleveraging in Dubai should slow once the restructuring of Dubai Inc nears completion in 1Q12F, and there may be some prospects for limited private sector growth in Abu Dhabi. Overall, we expect the prospects for growth to remain limited.

## Deposit growth has also been weak

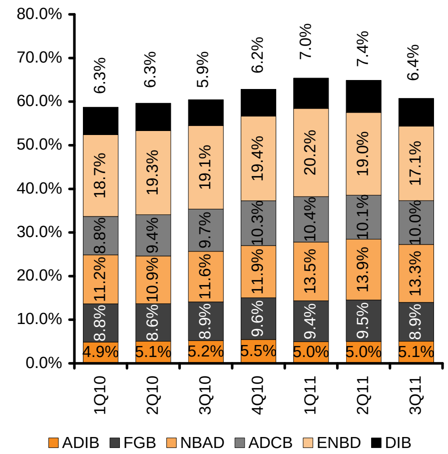
It has also been an interesting quarter for deposit growth, with that for the system as a whole dropping 5.2% qoq, against a fairly innocuous trend. This time, we believe there are two main drivers. First, the decline in EIBOR is removing the incentive for corporate time depositors to play the arbitrage trade. Second, we have seen a substantial draw-down from many of the banks of their public sector deposits.

**Chart 5 : Deposit growth**




Source: Company reports, Central bank statistics

**Chart 6 : Deposit market shares**




Source: Company reports, Central bank statistics

This has certainly been the case at DIB and ENBD, which have disclosed as much, but it also appears to have been the case for NBAD and FGB. ADCB perhaps benefited less from the carry trade, and has also been improving the quality of its deposit base over recent quarters. ADIB, with its strong retail focus has gained market share.

### Little concern so far

Although this takes the loan-deposit ratio above 100% for the first time since September 2010, we don't believe this is a major concern yet. The market has been going through a period of excess liquidity, perhaps partly as a matter of policy, but as interbank rates have normalised this has left the system.

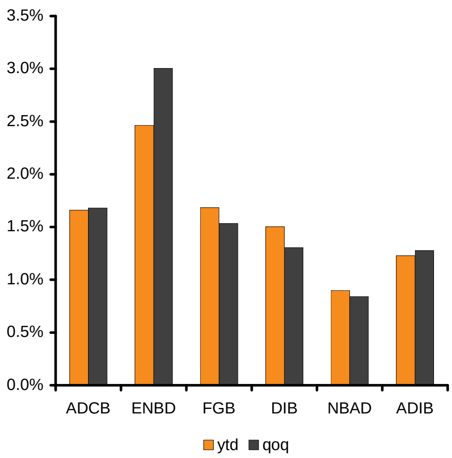
Although the loss of excess liquidity is not something the banks are particularly going to miss, the more limited room for manoeuvre will mean they are likely to be more competitive about their deposit bases, potentially having a tightening impact on liability spreads. We do, however, expect more symmetric loan-deposit growth going forward.

# Provisioning – mixed, but cautious outlook

**Banks were a mixed bag in terms of provisioning this quarter, but the more interesting trend may have been the consensus on further issues ahead.**

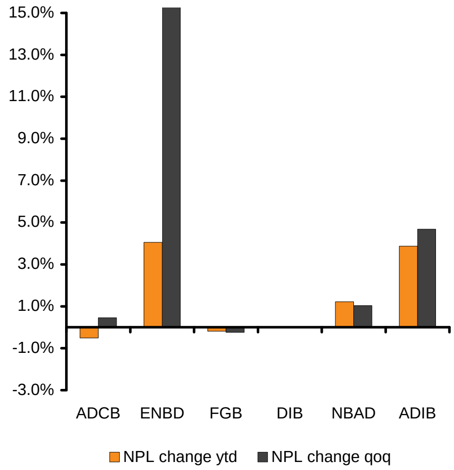
Generally speaking, banks have trended better on provisioning, with the quarterly run rate below the annualised run rate, which was already generally better than feared. The main exception to this trend was ENBD, which was more sensitive to Dubai Holding exposure than expected and surprised the market, by taking the impairment a quarter early, and at a provisioning rate close to 20% rather than 10%.

**Chart 7 : Provisioning, annualised**




Source: Company reports

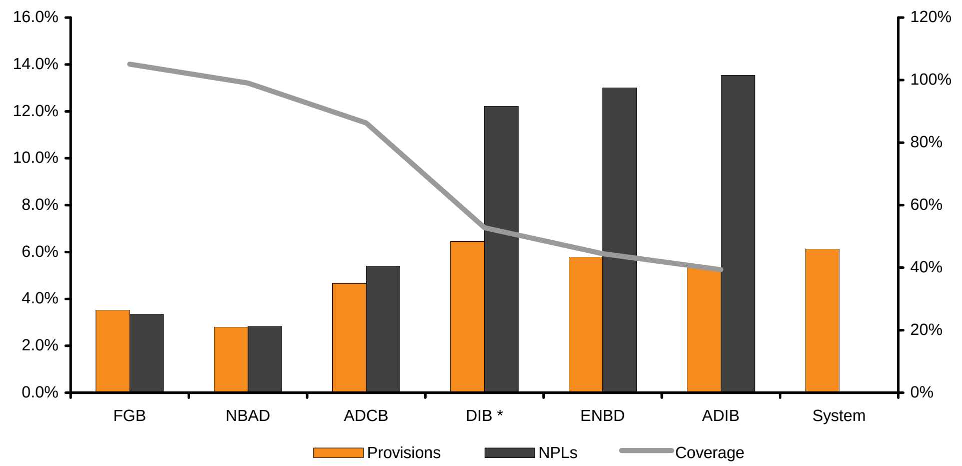
**Chart 8 : Net NPL creation, annualised**




* DIB does not report quarterly NPL data
Source: Company reports,

The increase in provisioning at ADCB and ADIB reflected an acceleration in new NPL creation. In ADCB's case, the increase was a mixture of specific provisions against the corporate book, and a further topping up of general provisions. For ADIB, the issue is in an adjustment we make, rather than the reported numbers themselves, which actually declined. Nevertheless, the increase in adjusted numbers reflects a 73% jump in Ijara financing past due.

**Chart 9 : NPL/impaired loan ratio, provisions and coverage**




* DIB does not report quarterly NPL data, so based on 4Q10 NPL data
Source: Company data

For Abu Dhabi banks, provisioning is more or less in line with NPLs, although the same cannot be said for Islamic banks and ENBD, albeit for different reasons. In ENBD's case, it reports an impaired assets ratio, and impaired assets typically have a coverage ratio of 10-20% compared with NPLs of up to 100%, biasing the number downwards. ADCB, in particular, would see its NPL ratio double and coverage ratio half if impaired assets were also included.

For DIB and ADIB, the reason is different. The presumption is that Islamic banks have high NPL ratios. Most of the NPLs will not be eventually written off, but will be converted back into performing, and the low write-off proportion at both banks adds weight to this argument. One reason is the higher proportion of collateralised lending, but a simpler explanation is different customer behaviour.

## Outlook statements cautious

Although there wasn't anything too concerning in 3Q11 numbers, we did see a pattern for more cautious guidance than we had expected going forward, more or less across the board. We had been expecting the rescheduling of Dubai debt to mark the high point of NPLs, with a relatively low level of NPL formation beyond that, and so a sharp drop in provisions. According to the companies themselves, this may be over optimistic.

**Table 1 : Asset quality outlook comments**

| **FGB** | **"In general. we see the NPL formation on a gradual declining trend", but guidance for over 100 bp recurring provisions** |
|---|---|
| NBAD | "NPLs expected to rise in the fourth quarter to 3 / 3¼% of performing loans, tending to stabilise thereafter" |
| ADCB | Cost of risk likely to remain over 100bps |
| DIB | |
| ENBD | Impaired assets ratio likely to rise 1% in each of 2012-13 |
| ADIB | "The UAE may face another down cycle in the credit environment triggered by the prevailing negative global sentiment and its impact on the entire region," |

Source: Company presentations, Management discussion, Press Articles ("The National")

This more cautious approach from banks can be seen in the continued increases in general provisions, and continued references to a difficult economy, and uncertainty on the corporate banking side. We had, for example, expected ENBD to utilise some of its general provision when it impaired Dubai Holding, but in the event, management decided to retain general provisions for subsequent quarters.

# Conclusion on 3Q11 results

**Overall, the numbers look good, and in line even setting aside the benefit from margin increases. However, we see little positive development of the balance sheet, with less improvement on asset quality than we expected.**

We expect the tendency will be to improve 2011 numbers for the sector, factoring in strong net interest income, and slightly better-than-expected provisioning, with the exception of ENBD, where sharply higher provisioning costs will weigh on results.

Going into 2012, we are less positive, with likely negative revisions to growth forecasts, and a higher level of recurring provisions, particularly at FGB and ADCB. We also believe we will not see the benefit of falling EIBOR rates again, and the likelihood is that the next significant move will be upwards, although we do not expect that to happen in 2012.

## Recommendation structure

Absolute performance, long term (fundamental) recommendation: The recommendation is based on implied upside/downside for the stock from the target price and only reflects capital appreciation. A Buy/Sell implies upside/downside of 10% or more and a Hold less than 10%.

Performance parameters and horizon: Given the volatility of share prices and our pre-disposition not to change recommendations frequently, these performance parameters should be interpreted flexibly. Performance in this context only reflects capital appreciation and the horizon is 12 months.

Market or sector view: This view is the responsibility of the strategy team and a relative call on the performance of the market/sector relative to the region. Overweight/Underweight implies upside/downside of 10% or more and Neutral implies less than 10% upside/downside.

Target price: The target price is the level the stock should currently trade at if the market were to accept the analyst's view of the stock and if the necessary catalysts were in place to effect this change in perception within the performance horizon. In this way, therefore, the target price abstracts from the need to take a view on the market or sector. If it is felt that the catalysts are not fully in place to effect a re-rating of the stock to its warranted value, the target price will differ from 'fair' value.

## Valuation and risks to target price

For a discussion of the valuation methodologies used to derive our price targets and the risks that could impede their achievement, please refer to our latest published research on those stocks at http://research.rbsm.com

## Disclaimer