Equity | M East & Africa

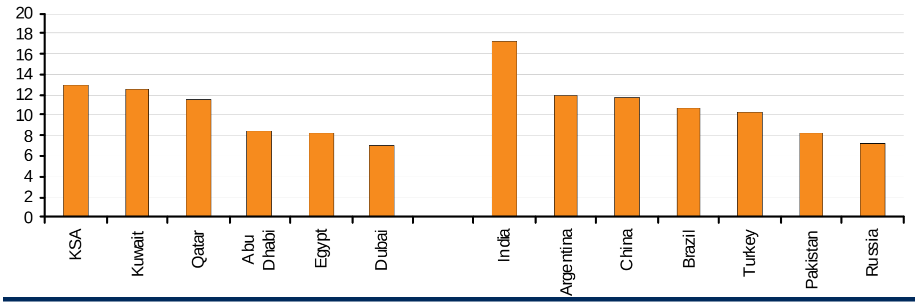
21 February 2011

# MENA Strategy

## Egypt – the challenge

**We expect the market to be volatile once open – it is by no means cheap and there are still many challenges ahead. We believe more clarity on Egypt's economic direction beyond 2011 could restore investor confidence in a longer-term positive outlook.**

**Current year P/E ratios (x)**




Source: Bloomberg

**Egypt still faces many political and economic challenges**

While unrest is spreading elsewhere in the region, Egypt has moved to the next stage: the army is in charge for now and has given a timeframe to draft constitutional amendments, to be submitted to a referendum, followed by parliamentary elections within six months. A new government will face the same socio-economic problems that contributed to the recent revolt and will have to balance appeasing the population without alienating foreign investors, stretching government finances and damaging growth prospects beyond 2011 too much. If it makes the right decisions, we believe Egypt could well end up with a structurally stronger economy, and an even more interesting place for FDI and capital market investors than before.

**Return to growth necessary to restore investor confidence**

Meanwhile, the recent events have already negatively affected GDP, FDI, inflation and the fiscal deficit, but we expect spending on capital goods (consumer and corporate) and tourism to have been hardest hit. We estimate each could reduce growth by 1-2ppt and, combined with disruption to businesses, bring GDP growth down from about 5.5% in 1H10/11 to low single digits. We expect some effects of the slowdown to be temporary, in particular tourism, but we believe the government needs to focus on jump-starting the economy as rapidly as possible.

**Stock market set to open once the banking system is back running at full capacity**

The regulator has announced measures to reduce market volatility, including reduced trading hours and trading limits for the wider EGX100. However, the EGX was also considering cancelling all transactions for the EGX100 on the last day it traded (27 January), which could dent already fragile foreign investor confidence.

**The market looks by no means cheap, we pick defensives and foreign exposure**

Given the changed economic environment, consensus earnings downgrades of 10-30% for 2011 are not unlikely, but this also implies the market will by no means be cheap: a 20% downgrade would take the Bloomberg consensus 2011 P/E up from 8.3x to 10.4x, in line with perceived less risky Turkey. However, we see a mixed performance stock- and sector-wise, and prefer more defensive stocks (telecoms, consumer staples) and those stocks less dependent on the domestic market over sectors subject to larger downgrades (consumer discretionary, real estate, tourism) or with a high perceived political risk (real estate, steel).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# The political and economic challenge

**There are still many challenges ahead before the country can return to economic growth. Much depends on what populist measures will be taken; the one certainty, in our view, is that unemployment is likely to be top of the agenda, whoever leads the government.**

### Look beyond 2011

The Supreme Military Council is in charge for now, has suspended the constitution and dissolved parliament. It has given a timeframe to draft constitutional amendments: they are to be submitted to a referendum within two months, followed by parliamentary elections within six months.

**Tourism and private consumption hit the hardest**

In our note, 'Egypt – implications of the turmoil', (1 February 2011), we flagged our expectation that the political turmoil would already have had significant implications for the Egyptian economy in 2011 with lower growth, less foreign direct investment, higher inflation and a widening fiscal deficit. The Institute of International Finance (IIF) has already revised its forecast of 6.1% GDP growth in FY11 (ending June 2011) to 1.5% and the fiscal deficit to widen from an 8.1% in FY10 to 9.5% in FY11, whereas the Economic Intelligence Unit (EIU) is expecting 4.1% real GDP growth, but a higher fiscal deficit of 12%. We expect expect spending on capital goods (consumer and corporate) and in particular tourism to be hardest hit, the latter being one of the main sources of foreign currency for Egypt – tourism revenues were cUS$11bn in 2009/10. The Ministry of Finance stated that 1.2m tourists had left the country in the past few weeks, equal to the monthly average in 2010. The impact of the slowdown on the different sectors comes in several forms:

- We expect the sharp slowdown in economic growth to impact stocks with a larger share of revenues coming from the domestic market, and particularly those more dependent on tourism, investments and discretionary consumer spending.
- The government's promise to increase public sector wages by 15% from 1 April will mainly impact listed companies where the state is the major shareholder, but demands from labour in the wider economy could put pressure on the private sector as well.
- A weakening currency impacts importers of materials, food ingredients, etc, but will also have a positive impact on exporters.

**Jump starting the economy**

The extent of the slowdown now depends on how quickly the Egyptian economy can be jump-started, possibly with help from other countries or transnational organisations – the International Monetary Fund (IMF) and the United Nations (UN) have stated they would respond to any financing needs Egypt may have. Some effects, in particular tourism, can rebound quickly, other depend on actions the government may take.

### Potential reforms could strengthen the economy in the longer term

**A balancing act**

One key issue facing the government in the short term, in our view, is what populist measures to adopt. This could determine the economic situation in 2011 and beyond and the government will have to balance appeasing the population without alienating foreign investors, stretching government finances and damaging growth prospects beyond 2011 too much. We expect the government to adopt a number of measures to show willingness to improve living standards across the board, which could include the following:

- Addressing alleged corruption: this could have the added advantage of Egypt becoming a more attractive place to do business, depending on how the Supreme Council, or a future democratically elected government deals with the issue.
- Increasing subsidies (food in particular but also promoting rural versus urban subsidies): this could be financed to an extent by further lowering natural gas and electricity subsidies to industry or through higher taxes on luxury goods, import tariffs on non-food products, etc.
- Increasing government spending, which could be necessary to make up a likely decline in corporate spending, probably with the help from other countries (US, EU, GCC, etc) or transnational organisations. This effort is likely to be focused on accelerated spending on Egypt's creaking infrastructure, in particular roads.
- Further increasing public sector wages to avoid spreading of strikes – which is the biggest risk to any jump-start of the economy, in our view. The risk is clearly still there, as evidenced by public worker strikes last week, demanding higher wages.

# Market set to remain volatile

### Earnings in a different economic background

**Investments, tourism revenues and consumer discretionary spending to be hit the most**

The stock market has been closed for the past three weeks and will only open when the banking system is fully up and running. Short term (2011), the market will likely focus on how the events of the last month have impacted earnings for the individual stocks, which we expect to imply a volatile market until there is more clarity over the longer-term direction of the economy. We believe that it is more important to look at the longer term, as the market on 2011 multiples is by no means cheap in a global perspective, and that only a more positive outlook for 2012 and beyond can convince long-term investors to return to the market.

### GDRs give little guidance and are not representative of the wider market anyway

The GDRs, which have continued trading, have been volatile and now the telecom stocks are trading at a premium (all others at a discount) to the local share as of the close of 18 February. Telecom Egypt has been trading at par, reaching a maximum premium of 10% over the past few weeks, but having dropped following the announcement it will increase wages by 15% (TE is 80% owned by the government). In any case, we believe the GDRs do not represent the wider market as, outside the few stocks in the table below, most are relatively illiquid.

**Table 1 : GDRs for Egyptian stocks**

| Stock | Ticker | Cairo (EGP) | London (US$) | GDR / ord | Exchange rate | Implied (EGP) | Premium/ discount |
|---|---|---|---|---|---|---|---|
| Orascom Telecom | OTLD LI | 3.62 | 3.34 | 5 | 5.878 | 3.94 | 8.5% |
| OCI | ORSD LI | 227.07 | 36.06 | 1 | 5.878 | 221.89 | -6.7% |
| EFG Hermes | EFGD LI | 26.42 | 8.00 | 2 | 5.878 | 24.83 | -11.0% |
| Telecom Egypt | TEEG LI | 16.03 | 14.41 | 5 | 5.878 | 15.52 | 5.7% |
| CIB | CBKD LI | 36.49 | 5.98 | 1 | 5.878 | 35.47 | -3.7% |

Prices as of close of 27 January 2011 for local stocks, 18 February 2011 for GDR
Source: Bloomberg

### The market looks by no means cheap

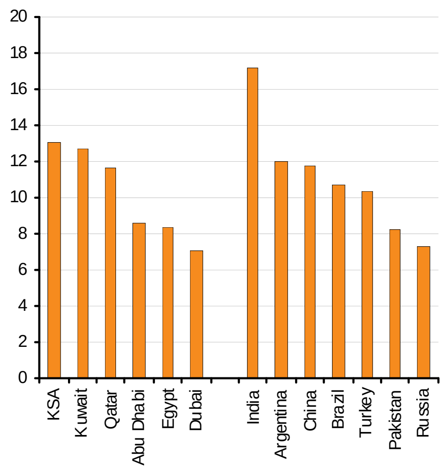
**A higher risk premium**

The 2011 market P/E was c8.3x on the close of 27 January (the last day of trading) according to Bloomberg, but consensus still suggests average EPS growth of 20%. We estimate that, depending on the level of downgrades, the 2011 P/E could go back to over 10x for a 20% downgrade and 11x for a 25% downgrade, which would bring it in line with perceived less risky countries such as Turkey (10x). The current five-year CDS of 354bp (close of 18 February), up from 237bp on 3 January, suggests an increase in the equity risk premium of 100-150bp.

**Expect a volatile market**

On top of potential further outflows from (foreign and domestic) investors, we believe that when the market opens it will be volatile until there is more clarity on what will happen to the economy in the longer term. We believe individual stock performance will be dependent on which companies have or have had in the past political ties to the Mubarak regime and for which companies the market expects most earnings downgrades.

**Chart 1 : Current year P/E ratios (x)**




Source: Bloomberg

**Chart 2 : Egypt: historical P/E ratios (x)**


Source: Bloomberg

**Mixed fortunes**

In the short term, we believe the economic environment in 2011 will favour companies in defensive sectors (telecoms, consumer staples) and companies that generate a higher proportion of revenues outside the country, rather than those dependent on discretionary spending (automotive, luxury goods, real estate, etc) and tourism.

**Telecoms still an attractive sector, in our view**

We believe the telecommunications sector in Egypt provides the safest haven in light of the current and ongoing unfolding events, owing to: 1) the population's increasing awareness of the powerfulness of the internet as a tool for communications (Facebook was the underlying application behind the rise of the Egyptian revolution); 2) none of the major shareholders of the existing Egyptian telecom companies have been implicated to have had ties with the former regime; 3) the inherent, defensive nature of the industry; and 4) the average dividend yield for both Telecom Egypt and Mobinil of about 7.5% on their respective last closing prices is attractive and would become more attractive if share prices were to fall further.

In the financials sector, economic dislocation brings costs for banks as corporate and labour market cash flow become harder to anticipate. In addition, we might see loan growth take a hit in the short term for the same reasons, although this is likely to be offset by higher pricing as a reflection of the greater uncertainty. Wage increases, as required by the unions, may well be good for retail lending, but would be less good for the quality of corporate loans.

**Boost to public sector spending?**

More generally, public sector spending by any government keen to calm social upheaval is also likely to provide a boost for both banks and companies active in the infrastructure space such as road building. Whatever happens to domestic spending, an international community eager to show its support is likely to be a driver of increased FDI in all but the worst circumstances, and that should be a driver of both corporate expansion, and perhaps improved labour markets, both directly feeding into lending volumes for the banks.

**Which companies have ties to the Mubarak regime?**

Besides economics, the market is likely to avoid stocks with obvious links to the Mubarak regime. While there are some links, we believe only a limited number of the constituents of the EGX30 index appear to have direct links with politics, but clearly the market will also try to establish if there are any indirect links.

**The Supreme Council is addressing the issue**

A balanced, orderly approach to this issue (rather than instigating a 'witch hunt') will benefit general sentiment in the country and restore some confidence for foreign investors, in our view. A travel ban has been imposed on several members of the previous cabinet, including the Interior, Tourism and Housing & Urban Development Ministers. The Supreme Council has also asked the US and the EU to freeze assets of some officials close to former President Hosni Mubarak, without identifying who they are. It has now also emerged that, according to press reports, Egypt has detained two former government ministers (former Tourism Minister Zuheir Garana and former Housing Minister Ahmed al Maghrabi), and businessman Ahmed Ezz to assist in an investigation into diverting public funds. Except for Palm Hills and TMG Holding, those with some form of link have issued statements:

- Ahmed Ezz owns 66% of ezzsteel, but the company has stated that any measures against Mr Ezz are personal and do not affect the company's operations. Mr Ezz was a prominent member of Gamal Mubarak's circle and an NDP parliamentarian before resigning from the party on 29 January. A travel ban has been imposed on Mr Ezz, but in a statement he refutes all allegations made in the press about corruption.
- EFG-Hermes declared on 14 February 2011 that Mr Gamal Mubarak did not have direct or indirect ownership in EFG Hermes, nor was he a shareholder in any of the firm's local or foreign investment funds. He has, however, owned 18% of one of the holding's subsidiaries, EFG Hermes Private Equity since 1997. Revenues of this business are less than 7% and AuM stands at US$919m, with the majority of the funds owned by GCC investors. The company also stated it is not managing any funds belonging to the Mubarak family.
- SODIC declared on 16 February that no SODIC shares had ever been held by any member of the Mubarak family and that there had never been a single controlling shareholder at any time in the company's history. The company's non-executive chairman since inception is Mr Magdi Rasekh (father-in-law of Alaa Mubarak, son of former president Hosni Mubarak) who currently owns a nominal 649 shares comprising 0.0017% of the outstanding shares.

We list all stocks with a market cap in excess of US$500m in Table 2, in which we highlight sectors as well as major shareholders (>50%). In that list, those stocks which generate a significant part of revenues from outside Egypt (exports and foreign operations) are: Orascom Construction Industries (international revenues 78% of revenues in 9M10), El Sewedy (70%), Sidi Kerir (40% of export polyethylene volumes), Oriental Weavers (37%) and Maridive (which can deploy its fleet globally).

**Table 2 : Egyptian-listed stocks with market cap >US$500m**

| Company | Mkt cap (US$m) | Sector | Shareholders > 50% | Comments |
|---|---|---|---|---|
| OCI | 7,993 | Construction, Fertilisers | Sawiris family 55% | International revenues 78% of total 9M 2010 |
| Telecom Egypt | 4,655 | Telecoms | Government 80% | Domestic |
| CIB | 3,664 | Financials | - | Mostly domestic |
| Orascom Telecom | 3,231 | Telecoms | Wind telecom (Sawiris family & others) 52.1% | c16% of profit from continuing operations outside Egypt 2010 |
| NSGB | 2,665 | Financials | Societe Generale Group 77.2% | Domestic |
| Mobinil | 2,266 | Telecoms | - | Domestic |
| TMG Holding | 2,237 | Real Estate | TMG Investment 50.27% | Domestic revenues, 50m sqm land bank (6.8m in Saudi Arabia) |
| Golden Pyramids Plaza Company | 2,118 | Real Estate | - | Domestic |
| EFG Hermes | 1,720 | Financials | - | Revenue split not available, has operations across region |
| Abu Qir Fertilizer Company | 1,693 | Fertilisers | - | Local Market represents c 87% of revenues for FY10 |
| ezzsteel | 1,472 | Steel | Ahmed Ezz 66% | Long product 45%, flat product 43% market share in 1H10 |
| El Sewedy | 1,335 | Electric Cables | El Sewedy family 64% | Egypt 30%, exports from Egypt 37% of revenues 9M 2010 |
| Sidi Kerir | 1,145 | Petrochemicals | Government and GREs c77% | Polyethylene volumes 60% domestic, 40% exports |
| Suez Cement | 1,058 | Cement | Italcementi Group 80.1% | Domestic |
| EK Holding | 1,058 | Private equity | - | Investments mostly in Egypt, but active across the region |
| Maridive | 940 | Oil services | - | Fleet can be deployed globally, revenues for the major part from outside Egypt |
| Eastern Company | 937 | Consumer Staples | Government 54% | Local market represents c98% of revenues as of FY10 |
| Palm Hills | 869 | Real Estate | El Mansour and El Maghraby Investment 55% | Domestic revenues, 48msqm land bank (6m in Saudi Arabia) |
| GB Auto | 857 | Consumer Discretionary | - | Majority of revenues from Egypt, automotive sector |
| Alexandria Mineral Oils | 718 | Oil & Gas | - | Domestic |
| Juhayna Food Industries | 676 | Consumer Staples | - | Local market represents c92% of revenues as of March 2010 |
| Credit Agricole Egypt | 642 | Financials | - | Domestic |
| Amer Group | 620 | Real Estate | - | Domestic |
| Citadel Capital | 804 | Private equity | - | Egypt 84% of total investments 2009 |
| Egyptian Iron & Steel Company | 576 | Steel | Government 90% | Domestic |
| Sinai Cement Company | 543 | Cement | - | Domestic |
| Alexandria Portland Cement Company | 540 | Cement | AlexandriaDevelopment Company 88% | Domestic |
| Misr Cement Company | 516 | Cement | - | Domestic |
| Oriental Weavers | 500 | Consumer Discretionary | Mohammed Farid Khamis and Family 57% | Local market represents c37% of revenues as of 1H10 |
| SODIC | 500 | Real Estate | - | Domestic revenues, 7.5m sqm land bank (1.4m in Syria) |

Source: Company data, Bloomberg, Zawya

## Egypt could come out stronger

**The economy can go several ways**

Looking beyond 2011, the Egyptian economy could go several ways, depending on actions by the Supreme Council or a new government. In many press articles, Egypt's future has been likened to democracies with strong militaries, most notably Turkey, a functioning democracy with a strong Islamist party and a thriving economy. However, the question remains whether the future holds improved prosperity (shared more equitably) or a country struggling for some time to come. One thing is clear though, if Egypt plays its cards right, there are plenty of opportunities to become a more economically powerful nation, underpinned by a vast and relatively low-cost labour force, a strategic geographical location, a liquid banking system and a large domestic consumer market.

**The economy needs to get back on track**

The previous government started economic reform only in 2004, when it was faced with sluggish GDP growth, a large fiscal deficit, high unemployment and low business confidence. The government implemented reforms (reductions in customs and tariffs; lowering the corporate tax rate to 20% from 40%; reducing red tape to start up new businesses, etc), which helped boost economic growth (real GDP growth averaged 6% over the past five years to June 2010). The new government faces very similar problems and needs to get the economy back on track.

**Tackling unemployment will be high on the agenda**

With elections yet to take place, at this point in time, it is difficult to assess what the future economic direction of the country will be, especially since a new government will face the same socio-economic problems that contributed to the recent revolt: it needs to tackle poverty and create jobs for a fast-growing population. In terms of policies, in our view, the one certainty is that the labour market is likely to be top of the agenda whoever leads the government. For unemployment to be properly addressed would require, in our view, a rapid return to economic growth to create more jobs in the private sector. Other agenda items are, we feel, more speculative but could include.

- Reforms in certain sectors: further reform of the real estate sector, for example, would likely gain strong approval from the population.
- If the IMF gets involved, IMF-led privatisations, with the most obvious candidate being the banks sector, which is still heavily dominated by state banks. However, this is likely to be lower on the agenda for the government, as in many cases privatisations involve job cuts.
- Increasing costs for industry, such that it can pay for food subsidies to the population. This could be done in the form of increases in natural gas and electricity prices, something that has already done in the past few years, or taxes. Sectors which are larger users of natural gas include cement and fertilisers.

**Real estate developers are an easy target**

The real estate developers are an easy political target, as many land transactions over the past 20 years have created wealth for a small part of the population and some of the listed developers have, or have had, ties to the former establishment. Some companies (TMG and Palm Hills) were already (2010) involved in lawsuits regarding previous land deals, some which have not been resolved yet. However, a reversal of land deals without proper scrutinising of the deals, could also provoke capital flight and spook foreign investors.

**But cheap land deals are common across and outside the region**

Cheap land deals (as little as US$1 per square metre in many cases) should not necessarily be seen as a form of corruption: it is not uncommon for governments to sell land at low prices to attract investment and many countries, especially in the Gulf (free land), but also in Europe, with the aim of attracting investment and creating jobs. Especially in regions where undeveloped land has little value (remote deserts), developers take a risk in making large initial investments and attracting investors. The problem arises in cases where the government made direct allocations without competitive tenders. However, the former housing minister had already introduced a tendering process during his tenure.

In the financials sector, the biggest issues are likely to remain the balance sheet and regulatory issues. For the balance sheet, the t-bill market has long been a source of free low-risk profitability, and this is vulnerable to a reassessment, particularly if inflation/currency weakness erodes the real return. In principle the role of the state banks, with their large NPL portfolios, may come under the spotlight, particularly if there is an IMF-led privatisation strategy. However, this is likely longer term, and it is far from clear whether recent events would accelerate or decelerate moves in this direction. In addition, it would require a strong technocratic government indeed to undertake the tough medicine of cleaning up the lending books, which entails upfront costs for deferred and less readily identifiable gain.

## 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

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