

1 November 2010

Buy

Target price
Dh18.78 (from Dh17.43)

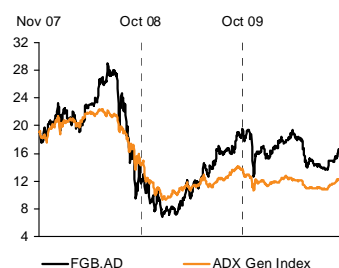
Price
Dh16.75

Short term (0-60 days)
n/a

Market view
No Weighting

Price performance

	(1M)	(3M)	(12M)
Price (Dh)	14.95	14.45	17.75
Absolute (%)	12.0	15.9	-5.6
Rel market (%)	5.8	4.8	3.7
Rel sector (%)	7.7	3.8	0.1



Market capitalisation
Dh25.13bn (€4.92bn)

Average (12M) daily turnover
Dh9.80m (US\$2.89m)

Sector: ADX Bank & Fin Index
RIC: FGB.AD, FGB.UH
Priced Dh16.75 at close 1 Nov 2010.
Source: Bloomberg

Analyst

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First Gulf Bank

Still delivering

Quarterly results suggested that FGB is continuing to deliver interest income and building fee and commission income. Market-related revenues were weak, but in our view should partially bounce back. Loan quality improvement was impressive, although FGB remains cautious in this area.

Key forecasts

	FY08A	FY09A	FY10F	FY11F	FY12F
Reported PTP (Dhm)	2,937	3,331	3,348	4,738 ▲	6,232 ▲
Reported net profit (Dhm)	3,005	3,244	3,414	4,814 ▲	6,321 ▲
Reported EPS (Dh)	2.07	2.08	2.07	3.00 ▲	3.99 ▲
Normalised EPS (Dh)	2.07	2.14	2.07	3.00 ▲	3.99 ▲
Dividend per share (Dh)	0.32	0.45	0.20 ▼	0.94 ▲	1.21 ▲
Normalised PE (x)	8.09	7.83	8.09	5.59	4.20
Price/book value (x)	1.59	1.41	1.25	1.08	0.92
Dividend yield (%)	1.90	2.69	1.18	5.63	7.22
Return on avg equity (%)	23.40	19.80	18.00	22.20 ▲	25.00 ▲

Use of ▲ ▼ indicates that the line item has changed by at least 5%.
Accounting standard: IFRS
Source: Company data, Rasmala forecasts

year to Dec, fully diluted

3Q10 results beat expectations on the bottom line

Although bottom-line earnings were down 9% yoy, this was due to the absence of property sales in the current quarter. On a qoq basis, headline net income was 8% ahead and while that was not repeated on either the attributable or comprehensive income basis, it was entirely due to the timing of the biannual coupon on the tier 1 bond. 3Q10 results were strong, beating our headline net income expectations by 7% and our attributable income forecast by 8%.

Revenues match our forecasts with better quality

We believe the key areas of outperformance vs expectations were net interest income, where FGB benefited from better-than-forecast spread stability, driving revenues up 3% qoq, and fee income, where retail banking fees advanced 31% qoq. Volatile income, such as trading, derivative dealing and property-related income all disappointed, but we believe some recovery (particularly of derivative revenues) is likely.

Upgrading our earnings forecasts

We upgrade our revenue forecasts to reflect the better spread expectations and higher F&C penetration. We expect derivative income to recover in the short term, but trim our medium-term expectations for other sources of volatile income. Costs were also higher, although on the back of higher activity levels, and this tempers our medium-term forecasts. Loan quality also surprised positively, with loans 90-180 days past due in particular falling sharply.

Still commanding a valuation premium

FGB currently stands at a premium to the sector under our coverage, which we believe is justified. We expect the stock will continue to attract high levels of returns in the medium term, as well as growth in line with the market or better. We do not believe a 2011F target PTB of 1.22x is excessive. Consequently, we raise our target price from Dh17.43 to Dh18.78 and maintain our Buy recommendation, with 12% upside potential. A reduction in the discount rate of 1pp from its current level of 15.2%, perhaps due to lower systemic risk, would further raise the upside potential to 23%, all else being equal.

Important disclosures can be found in the Disclosures Appendix.

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Solid results

There was little to complain about with 3Q10 results. Revenues were ahead in core areas, although the volatile earnings stream was notably weak. Costs indicated rising investment, while provision and NPLs seemed to be under control.

Bottom line beat expectations

Bottom-line earnings were impressive, declining yoy due to the absence of one-off property gains, but rising 8% qoq and beating our expectations by 7%. On an attributable income basis, net income was down 7% qoq, but this was largely due to the half-yearly charge related to tier 1 debt securities (excluded from headline net income). Comprehensive income benefited from some revaluation gains too.

Table 1 : FGB results summary, 3Q10 (vs prior periods and previous estimates)

Dhm	3Q09A	2Q10A	3Q10A	3Q10F	yoy	qoq	vs est
Balance sheet							
Loans & Islamic Financing	90,013	94,205	95,577	96,406	6%	1%	-1%
Financial instruments	13,688	17,607	16,392	17,353	20%	-7%	-6%
Total assets	124,321	131,528	137,454	133,491	11%	5%	3%
Customer deposits & Islamic Funding	89,365	88,428	92,251	89,658	3%	4%	3%
Capital market liabilities	3,030	11,191	11,191	11,191	269%	0%	0%
Total liabilities	102,197	107,941	113,401	109,286	11%	5%	4%
Net liquid assets	5,594	5,047	9,913	4,794			
Shareholders' equity	22,125	23,587	24,053	24,205	9%	2%	-1%
NPL ratio	3.19%	4.44%	4.42%	4.80%			
Income statement							
Net Interest & Islamic Returns	985	1,043	1,072	1,028	9%	3%	4%
Core non-interest	465	362	439	444	-6%	21%	-1%
Non-core non-interest	206	53	26	72	-88%	-51%	-64%
Total Non-Interest Income	672	415	464	516	-31%	12%	-10%
Total banking income	1,657	1,458	1,537	1,544	-7%	5%	0%
Total operating expenses	(248)	(268)	(290)	(268)	17%	8%	8%
Provisioning	(490)	(411)	(406)	(490)	-17%	-1%	-17%
Profit before tax	930	788	849	795	-9%	8%	7%
Tax, Minorities & Appropriations	(120)	(1)	(121)	(121)			
Attributable income	810	787	729	674	-10%	-7%	8%
Headline net income	930	787	849	794	-9%	8%	7%
Comprehensive income	849	831	772	674	-9%	-7%	14%

Source: Company reports, Rasmala forecasts

Growth on target

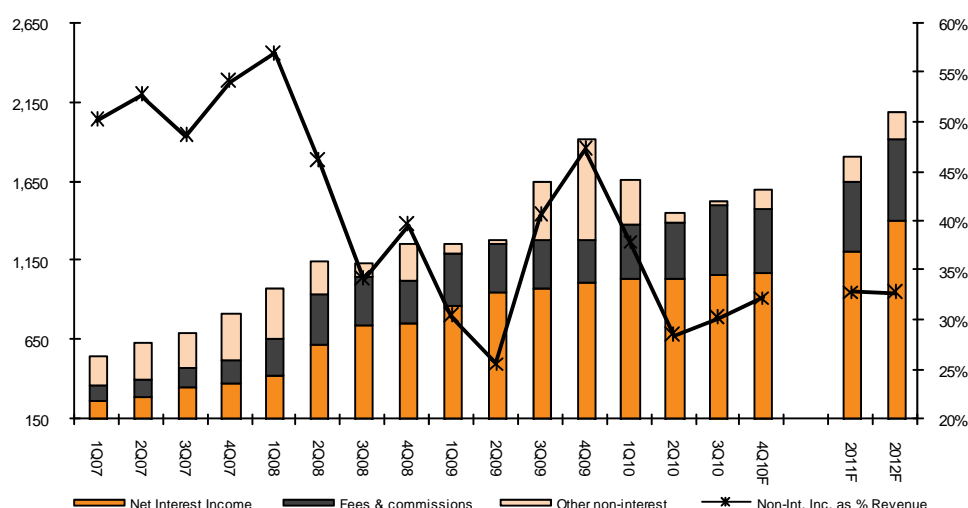
FGB's growth accelerated modestly on the asset side, with loan growth rising from 1.0% to 1.5%, which was mildly weaker than sector leaders NBAD and ADIB and 1% below our forecast. Nevertheless, we don't read terribly much into this at this stage, with many banks, FGB included, still focusing on NPLs rather than growth. ADIB is the exception given its strategy for expansion, while NBAD benefits from strong government links.

Deposit growth of 4.3% qoq was the strongest in the sector (of the banks we cover), although this was to some extent a bounce-back from a weak 2Q10, when FGB preferred to surrender high-cost deposits. Stronger deposit growth brought the LDR down to 104%, in line with the sector average of 102%, but leading to a build-up of short-term liquidity. We believe this higher level of liquidity will be maintained for now, with FGB taking advantage of longer-term interbank funding as cross-border liquidity returns.

Revenue stream on target, but better quality

The two main areas of revenue strength were net interest income and fees and commissions, although the latter benefited, we believe, from erratic corporate finance business. The primary driver for net interest income was higher spreads, against our general expectation of falling spreads as the banking market normalises. Beyond the capital market fee income, the main driver for fees & commissions was retail fee income, which jumped 31% on higher activity levels – something we would regard as broadly sustainable.

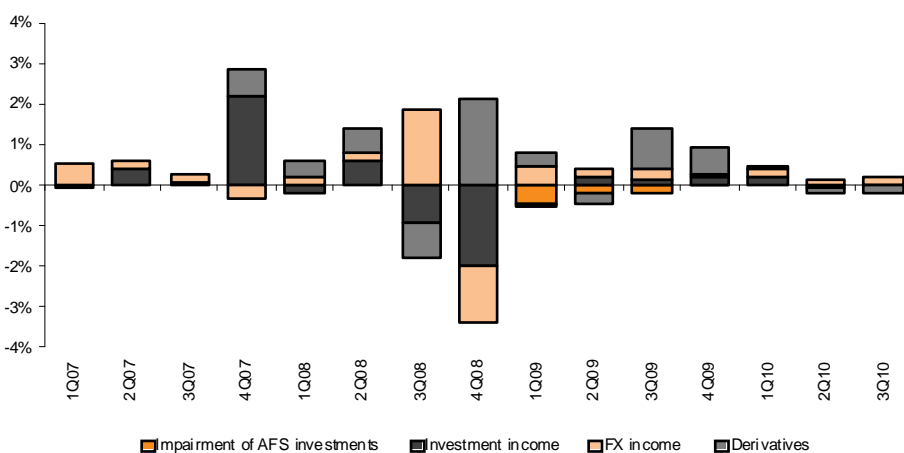
Chart 1 : Revenue breakdown, quarterly



Source: Company reports, Rasmala forecasts

More volatile income streams were a disappointment, with derivative income registering a second quarter of losses, in marked contrast to ADCB. FGB maintains a large book of derivatives held for trading, currently amounting to Dh33bn. Nevertheless, FGB maintains that the bulk of revenue from this segment is customer-related business. As such, as trading losses revert to neutrality, the customer business should drive a significant rebound in revenues.

Chart 2 : Volatile revenue streams as % of investment book

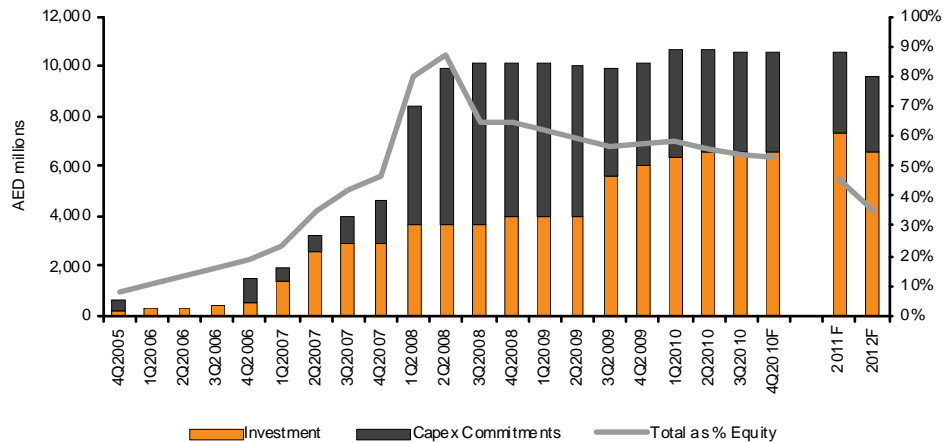


Source: Company reports

Rebuilding investment returns will be more time-consuming. The investment portfolio has become significantly more conservative since 2008, with greater allocations to bonds (89% vs 80% in 2008), and within that, greater allocation to sovereign guaranteed bonds (86% from 71% in 2008). Within the non-bond segment, the largest proportion of the portfolio (78%, from 62% in 2008) is in unquoted equities and private equity, for which returns are going to be lumpy, and likely deferred.

Property income also saw declines yoy due to the absence of property disposals, and qoq due to a reorganisation of the rental book and related declines in rental revenue. We believe these declines are here to stay, and forecast nothing in the way of property disposals until 2013. Indeed, we are not completely unconcerned about a potential downward revaluation of property in year-end results. However, with the property book (including commitments) now accounting for 50% of the common equity base, a moderate writedown would clearly impact but not severely dent the valuation story.

Chart 3 : Property investment, funded and unfunded, as % equity



Source: Company reports, Rasmala forecasts

With stable revenue streams outperforming and more volatile streams underperforming, we believe the prospects for improvement over coming quarters are well underpinned.

Loan quality story also supportive

Provisioning was low, but this has been an unreliable indicator of changes in loan quality across the sector. Consequently, it was good to see that FGB's 180-day NPL ratio remained stable from last quarter at 250bp, while on a 90-day basis we believe (from management comments at the results) that the ratio has fallen significantly from 4.5% in 2Q10 to around 4.1% in 3Q10, leaving our previous forecast NPL ratio of 5.0% high and dry. We adjust this to 4.2%, and trim our provisioning number accordingly.

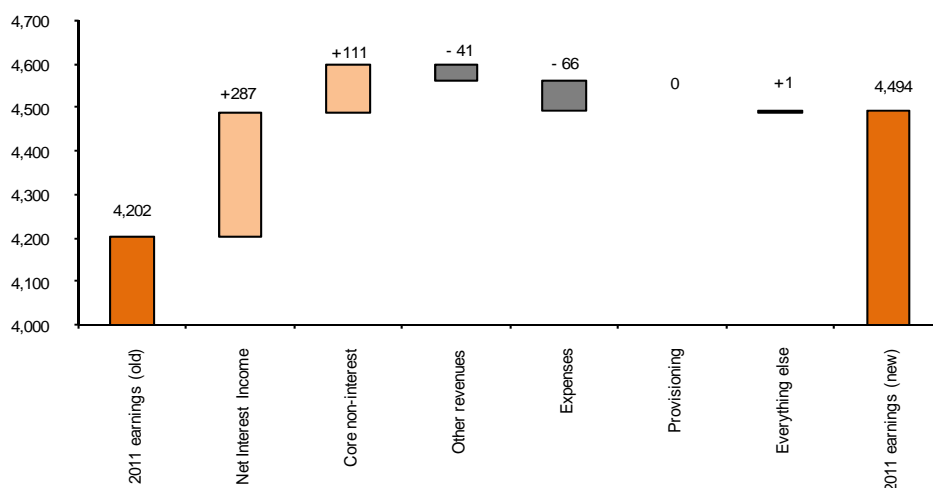
Cost increases were justifiable

Typically, FGB has a habit of matching costs with revenues, and we believe that in the absence of any real mishap on the revenue front, FGB sought to bring forward accruals from 4Q10 results. The last three years have seen dramatic 4Q seasonality (an average of 39% over the previous quarter), and we believe that FGB does not intend this to recur to the same extent.

Earnings adjustments mostly in fees & commissions

We raise our earnings forecasts for 2010-13 by about 5% pa. The chief areas of adjustment have been net interest income and fees and commissions, a component of core not interest income. A slower recovery in trading profits and reduced property income has impacted our expectations for other revenues, and higher activity levels are likely to mean higher costs. For now, we do not reduce our forecasts for provisioning, although our expectations for provisioning recovery now look to be on more solid ground. Overall, we increase our earnings forecast 7% for 2011.

Chart 4 : Breakdown of forecast changes for 2011F

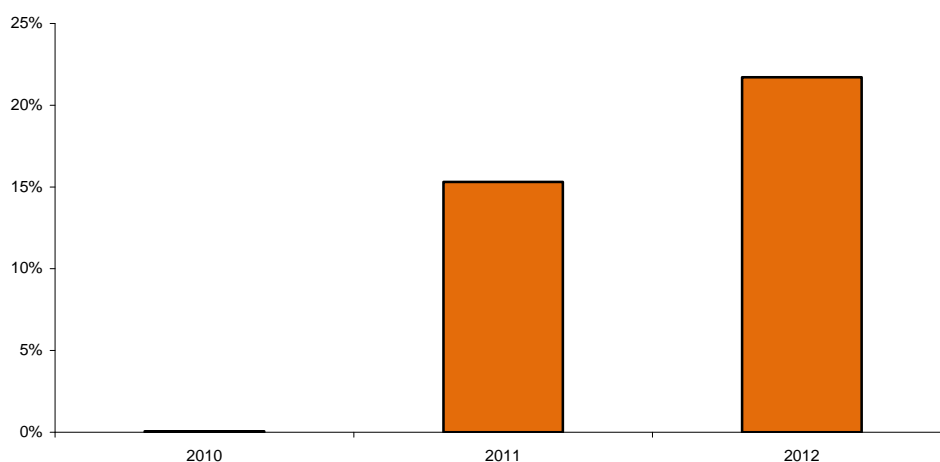


Source: Rasmala forecasts

Relative to consensus

We believe our forecasts are now substantially above the consensus. In particular, we are 15% and 22% above Zawya 2011-12 headline consensus earnings forecasts. We believe the difference may be driven primarily by provisioning expectations.

Chart 5 : Rasmala forecasts vs Zawya consensus



Source: Rasmala forecasts, Zawya consensus forecasts

Discount rate and recommendation

We lower the discount rate to reflect the decline in the US ten-year bond yield, which has a 7% positive impact on our target price. We maintain an elevated discount rate (stock-specific risk of 2.2%) to reflect the possibility of asset revaluations following 4Q10 results, although we believe the uncertainty related to Dubai exposure and the impact of its formerly high-growth strategy is beginning to dissipate. On this basis, we calculate 12% upside potential for the stock, in spite of recent outperformance, and continue to recommend a Buy with a new target price of Dh18.78. However, we also note that a further 1pp decrease in the discount rate would add a further 12pp upside to our fair value, all else being equal.

Table 2 : Gordon growth model valuation

Stage 1 (2010-2013): Explicit dividends		2010	2011	2012	2013
Forecast Dividends		296	1,414	1,815	5,415
NPV Stage 1	6,430	6,430	7,068	6,515	5,415
Stage 2 (2014-23): Modelled dividends		Assumptions			
Excess Capital	9,285	ROE1	Growth	Capital Req'd	RWA
Modelled Dividends	12,441	23%	15%	18,072	200,804
NPV Stage 2	14,203				
Stage 3 (2024+): Terminal value		Assumptions			
2023	47,579	ROE1	Growth	Capital Req'd	
NPV Stage 3	7,543	12%	6%	73,113	
Total NPV					
Stage 1 (2010-2013)	6,430	COE			
Stage 2 (2014-23)	14,203	US RFR			2.52%
Stage 3 (2024+)	7,543	Country Risk Spread		6.00%	
NPV	28,177	Sector Risk Spread		4.50%	
		Stock Spread			2.20%
Shares	1,500	Discount Rate			15.22%
Price target (Dh)	18.78				
Price (Dh)	16.75				
Upside/(downside)	12%				

Source: Company data, Rasmala forecasts

Income statement

Dhm	FY08A	FY09A	FY10F	FY11F	FY12F
Net interest income	2560	3834	4236	4866	5642
Non-interest income	1982	2295	2030	2381	2750
Total income	4542	6129	6266	7248	8392
Operating costs	-1195	-1147	-1168	-1348	-1645
Goodwill (amort/impaird)	n/a	n/a	n/a	n/a	n/a
Other costs	0.00	0.00	0.00	0.00	0.00
<u>Pre-prov operating profit</u>	3347	4982	5098	5899	6747
Provisions charges	-566.3	-1680	-1765	-1205	-562.3
<u>Post-prov op prof</u>	2780	3301	3333	4694	6185
Associates (pre-tax)	156.9	29.0	15.4	43.2	47.6
Other pre-tax items	0.00	0.00	0.00	0.00	0.00
Reported PTP	2937	3331	3348	4738	6232
Taxation	0.00	0.00	0.00	0.00	0.00
Minority interests	8.05	-2.63	-3.95	-3.95	-3.95
Preference dividends	0.00	-120.0	-240.0	-240.0	-240.0
Other post-tax items	60.0	36.4	309.3	320.2	332.8
Reported net profit	3005	3244	3414	4814	6321
Tot normalised items	0.00	-83.6	0.00	0.00	0.00
Normalised PTP	2937	3331	3348	4738	6232
Normalised net profit	3005	3328	3414	4814	6321

Source: Company data, Rasmala forecasts

year to Dec

Balance sheet

Dhm	FY08A	FY09A	FY10F	FY11F	FY12F
Net loans to customers	79363	90386	98629	113985	132857
Other int earn assets	12393	18199	23639	27973	33215
Goodwill	0.00	0.00	0.00	0.00	0.00
Oth non-int earn assets	6769	5340	3751	3150	3362
Total assets	107522	125473	138044	158069	182611
Total customer deposits	73963	86422	91725	106006	123557
Oth int-bearing liabs	13098	11761	16820	17696	19222
Non int-bearing liab	4319	5064	4952	6795	8088
Total liabilities	91380	103247	113497	130498	150867
Share capital	15768	17841	20160	23184	27357
Reserves	0.00	0.00	0.00	0.00	0.00
Total equity (excl min)	15768	21841	24160	27184	31357
Minority interests	374.4	384.9	386.7	386.7	386.7
Total liab & sh equity	107522	125473	138044	158069	182611
Risk weighted assets	110350	115685	126235	145890	170044
Est non-perf loans	n/a	n/a	n/a	n/a	n/a
Specific provisions	-1141	-2530	-4042	-4843	-4921
General provisions	n/a	n/a	n/a	n/a	n/a

Source: Company data, Rasmala forecasts

year ended Dec

Capital

Dhm	FY08A	FY09A	FY10F	FY11F	FY12F
Risk weighted assets	110350	115685	126235	145890	170044
Reported net profit	3005	3244	3414	4814	6321
Opening risk assets	64149	110350	115685	126235	145890
Closing risk assets	110350	115685	126235	145890	170044
Change in risk assets	46201	5335	10551	19654	24154
Capital required	4620	533.5	1055	1965	2415
Free capital flow	-1615	2831	2599	3089	4146
Ordinary dividend paid	-477.4	-677.0	-295.8	-1414	-1815
Share buy back/spec div	0.00	0.00	0.00	0.00	0.00
Equity / preference issue	3555	-154.0	-469.8	0.00	0.00
Cash flow from financing	3078	-831.0	-765.6	-1414	-1815
Net capital flow	1463	2000	1833	1675	2331
Tier 1 capital	16142	22226	24547	27571	31744
Tier 1 capital ratio (%)	14.6	19.2	19.4	18.9	18.7

Source: Company data, Rasmala forecasts

year to Dec

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

First Gulf Bank (RIC: FGB.AD, Rec: Buy, CP: Dh16.75, TP: Dh18.78): The primary downside risk to our GGM-derived valuation and target price is the property book (equivalent to 62% of equity). Further, we believe that going forward these property-related assets will be slow-moving, provide weak returns and, in some cases, show little prospect of providing normal rates of return.

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