

7 July 2010



Banks

The long road to recovery

In the initial steps to recovery, one narrative is that of loan defaults, contract failures and property excesses; the other is of oil liquidity, infrastructure growth and progressive politics, with a chasm of uncertainty in between. We believe the UAE banks are priced for the former, while visibility for the latter is improving.

Banking sector – key forecasts

	Close		Rec	Last Yield	PER			PBR			ROE
	(Dh)	PT			2009	2010F	2011F	2009	2010F	2011F	
ADIB	2.45	2.67	Hold	6.8%	421.3	9.3	5.0	1.2	1.1	1.0	15%
ADCB	1.57	1.81	Buy	0.0%	nm	40.5	4.8	0.6	0.6	0.6	9%
DIB	1.94	1.97	Hold	7.3%	7.5	8.2	6.9	0.9	0.9	0.8	12%
ENBD	2.48	3.26	Buy	8.1%	4.3	12.7	3.9	0.7	0.6	0.6	13%
FGB	14.90	16.27	Hold	3.0%	7.0	7.1	5.2	1.3	1.1	1.0	17%
NBAD	11.15	12.86	Buy	0.8%	9.1	7.9	6.3	1.6	1.4	1.2	17%

Prices as of 01 July 2010. Source: Company reports, Zawya pricing data, Rasmala forecasts

Banking sector valuation in a difficult environment

We believe the market is pricing in three main categories of risks: existing balance sheet risk, the rescheduling/restructuring risks related to 'Dubai Inc' (about which we have ample public information), and the broader structural risks that are somewhat harder to quantify. Although growth looks elusive, we think returns for the sector are set to recover strongly once provisioning settles down. Consequently, with price to tangible book (PTB) valuations (which excludes intangibles) dropping as low as 0.60x and rising only as high as 1.38x in 2010F, we believe the central issue is clearly risk rather than growth.

Balance-sheet risk and short-term prospects driving relative valuations

We see key uncertainties related to the investment book, the property book and the coverage ratio. In addition, exposure to Dubai GREs is a factor, and all of these weigh particularly heavily on ENBD and ADCB. For broader structural risks, Dubai, with its overcooked, under-regulated property market, is the epicentre, which has no liquid funds of its own to ensure stability.

Signs of health: there's more to Dubai than property, and more to the UAE than Dubai

Many parts of the economy remain healthy, including Dubai's traditional strengths of tourism, trade, travel and logistics. Dubai's free zones are also a hub for knowledge economy industries such as financial advisory (if not financing), media and, perhaps, technology – industries that have been crowded out by the expanding property bubble. In addition, Abu Dhabi is planning infrastructure and energy sector investments amounting to Dh180bn.

Choosing the discount stocks

We recommend ENBD and ADCB on 2010F PTB of 0.64x and 0.60x, as the 'aspirant stocks' (First Gulf Bank, Abu Dhabi Islamic Bank and Dubai Islamic Bank) do not offer as good a value per unit risk, in our view. For those looking for GCC exposure with less Dubai risk, we recommend NBAD at the premium end of the inexpensive UAE scale (PTB 1.38x) as a relatively safe harbour in what should remain a turbulent economy. In addition, we see scope in our bull scenario for a reduction in our discount rates of up to 5%, which would provide a further 40-50% upside potential to our current target prices.

Important disclosures can be found in the Disclosures Appendix.

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Executive summary

We believe current valuations reflect continued dire expectations for Dubai, with elevated provisioning for an indefinite period and with a fundamentally broken business model. We do not agree with this outlook.

We believe UAE Banks are, on the whole, under valued

As might be expected, our positive view steers our recommendations toward value stocks such as Emirates NBD (ENBD) and Abu Dhabi Commercial Bank (ADCB). We believe the market is focusing too much on the aspirant stocks – First Gulf Bank (FGB), Abu Dhabi Islamic Bank (ADIB) and Dubai Islamic Bank (DIB) – as they offer less upside potential than the value stocks on positive news flow but just as much downside on negative events.

In our view, National Bank of Abu Dhabi (NBAD) offers investors a solid balance sheet and solid growth prospects as well as some regional diversification. Although within the UAE it trades at a premium, on a regional basis it is one of the least expensive opportunities outside the UAE. With investors worried about profitability and balance sheet risks, we do not believe growth is currently a significant driver of investment decisions.

Table 1 : Bank sector valuations

	Close (Dh)	PT	Rec	Last Yield	PER 2009	PER 2010F	PER 2011F	PBR 2009	PBR 2010F	PBR 2011F	ROE 2011F
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Prices as of 01 July 2010
Source: Company reports, Zawya pricing data, Rasmala forecasts

Dubai model challenged, not broken

Dubai's fundamental model has been to build infrastructure, attract industries and bring in an expatriate labour force to man those industries, all within a zero tax regime. Through fees, customs duties and ancillary businesses, Dubai would make the profits to fund the original infrastructure spend.

After five years of asset inflation, mission drift and speculation, the critical question now for the UAE banks is whether the Dubai business model is 'broken'. If it is not, which we consider to be most likely, then we expect to see a rebound in ROEs from the current 10.7% sector average back to a minimum of high teens by 2012-13.

The survival of the Dubai business model is the key driver for almost all the banks in the UAE and not just the Dubai-based banks for three reasons: 1) most of the Abu Dhabi-based banks have significant operations in Dubai; 2) many of the Abu Dhabi-based corporates have significant operations in Dubai; and 3) we believe many Abu Dhabi-based investors have investments in Dubai. No less importantly, the same could be said the other way around. In short, the economies are fully integrated.

There are two major current concerns in Dubai: the level of total fiscal and GRE debt, which the IMF estimates at Dh109bn (equivalent to 131% of Dubai's 2008 GDP), and the stock overhang in the property market. The policy challenge is to provide short-term solutions to the debt issue, and provide long-term solutions or rely on the market to provide long-term solutions to the property market, primarily through immigration. To be sustainable, this also needs to provide fiscal stability.

Restructuring Dubai GRE debt is making progress

The main plan for addressing indebtedness of Dubai government related entities (GREs) involves a restructuring of liabilities. To make this more palatable, the government has agreed to provide a US\$20bn subsidy of those liabilities through the newly created Dubai Financial Stabilisation Fund (DFSF) (seeded with US\$10bn of initial capital in November 2009). The plan was not just to bail out indebted entities, but to partially share the burden with the private sector, and to this end the

DFSF also appointed a chief restructuring officer, Aidan Birkett of Deloitte's, to renegotiate entitlements with liability holders. The most pressing issues for the DFSF have been Nakheel and Dubai World indebtedness. Other GREs and parts of Dubai Holding will also likely need assistance.

While the technicalities of who will end up sharing resultant impairments are still to be resolved, we do not foresee the banking sector as a whole having to absorb more than US\$5bn of write-downs. This compares to capital and reserves of US\$69bn, and total provisions for the sector of US\$13.2bn. The greater issue, however, is the indirect impact on the sector via the resolution of trade and other creditors, which we believe is or will be unremittingly positive.

Property sector overhang: coping not curing

We do not see many signs of optimism for the property development sector. There has been significant project cancellation and postponement. Nevertheless, industry analysts believe occupancy levels are low, and they still expect 55,000 residential units and 2.7m sq m of commercial property to be delivered before 2012 in Dubai alone, equivalent to 17% and 73% of existing stock. Although official figures suggest immigration rates to Dubai of some 7%, only modestly below peak levels, we are concerned that the basis for these estimates may be erroneous.

Times are tough for the property sector, but we do not believe that this should spell doom for the economy, or for the banks. We do think the drop in sales and profitability will mean a reduction in GDP contribution (construction, real estate and business services accounted for 25.0% of 2008 GDP), and a worsening of the financial situation of employees (employees accounted for 24.0% of the labour force in 2008) along the chain, but the collapse of the market was so sudden that most of the affected personnel may already be gone.

As for the corporates themselves, the primary problem is a lack of cash flow; with occupancy ratios falling in all areas of the market, pricing is likely to remain weak, new sales volumes will likely be limited and returns on rental property will likely be low. Largely pre-sold projects can be completed, easing the liquidity squeeze for everyone concerned. Where developers have sufficient equity, or access to other long-term funding, they can pay down liabilities and set aside projects on which significant progress hasn't been made. Following the announced reorganisations we now include all the GREs in this category.

The difficulty lies with those developers who do not have sufficiently pre-sold projects and do not have enough in-house liquidity to meet creditors' needs. The Strata Law (see page 13) may help bring in vulture investors, but only at the margin. So how serious a problem is this? We estimate this would amount to Dh20bn-40bn, excluding industrial and infrastructure projects and GRE loans, out of total Central Bank published construction loans of Dh124bn in 1Q10. This amount includes financing for developers and contractors, with the top-10 private developers accounting for perhaps Dh15bn. In a worst-case scenario, if 30% (or Dh10bn) of this went bad, we estimate that would raise the NPL ratio by 1 percentage point across the sector, not quite as much as the existing sector-wide general provision of Dh13bn.

Dubai economy: momentum mixed

We see little in the way of solid gains in economic momentum, albeit perhaps partially because many official statistics for FY09 have yet to be released (apart from monetary statistics). An isolated survey suggests business confidence is improving among CFOs. Air passengers have risen 13.9% yoy, while air freight volumes have increased 12.1% yoy trailing 12 months to 1Q10. Although these are welcome pieces of data, positive evidence on a rebounding economy from independently verified sources is fairly thin on the ground.

Dubai economy II: solid fundamentals

However, even though clear evidence for recovery in the short term has yet to be established, we believe the long-term fundamentals for a stable economy are in place. In particular, we believe Dubai can achieve and sustain fiscal breakeven without damaging its prime draw for corporates and individuals alike – the zero tax regime. While most of the property sector is still in intensive care, the rest of the economy is surviving. We believe that renewed focus on marketing the free zones, in particular, should begin to turn around the rate of migration. This is all the more true now that the cost of living has declined sharply in both absolute and relative terms (Mercer cost of living ranking of 55, down from 20 in 2009), and improvement continues in the 'ease of doing business' (ranking 33 from 47 in 2009).

In addition to concerns about the economy, the market's other major concern is whether Dubai

can really pay for the facilities and public services it consumes. If not, the model would prove unstable, and the end of its current tax-free status might prompt an exodus. However, we believe this is highly unlikely. While we don't have the scope (or the visibility) here to discuss the full fiscal situation in Dubai, we see six issues worth noting:

1. **'Dubai Inc'**: Although it has been getting a lot of negative coverage for poor business practice and high leverage, also included among the 'Dubai Inc' companies are a number of profitable entities – such as Emirates Airlines, Dubal and Jumeirah Group.
2. **Back to the core competencies**: With the decline of the construction sector, the engine of the economy is shifting back to the core competencies of re-export, trade and logistics, tourism and, to a lesser extent, finance.
3. **Free trade zones**: Free zones offer specialised tax-free zones for targeted industries, often with strong infrastructure support and an offshore operating environment. Although companies within these zones are guaranteed to be exempt from tax, the zones themselves can levy revenue through fees and leasing. Most free trade zones are owned either by TECOM, raising funds for Dubai Holding, or by the Government of Dubai.
4. **Federal budget**: Within any individual Emirate, some costs are born by the regional budget and some by the federal budget. This may well significantly lower non-discretionary spending, particularly for areas such as the military.
5. **Hydrocarbon support**: Dubai still produces perhaps 100,000 barrels of crude oil per day, which is a small contribution to GDP, but a useful component of the budget.
6. **No social security net for the majority of the population**: The population consists largely of expatriates, who are not entitled to social security, the vast majority of whom are part of the labour force.

While the absence of reliable data makes it practically impossible to provide quantifiable analysis, we see significant reasons to believe the problems in the property sector are resolvable. Some of this will be borne by Abu Dhabi, some by investors, some by industry participants and some by banks. In the longer term, many areas of the Dubai economy still look healthy. We expect the model of domestic investment and business-friendly policies will ultimately bring stability to the country.

Base-case summary

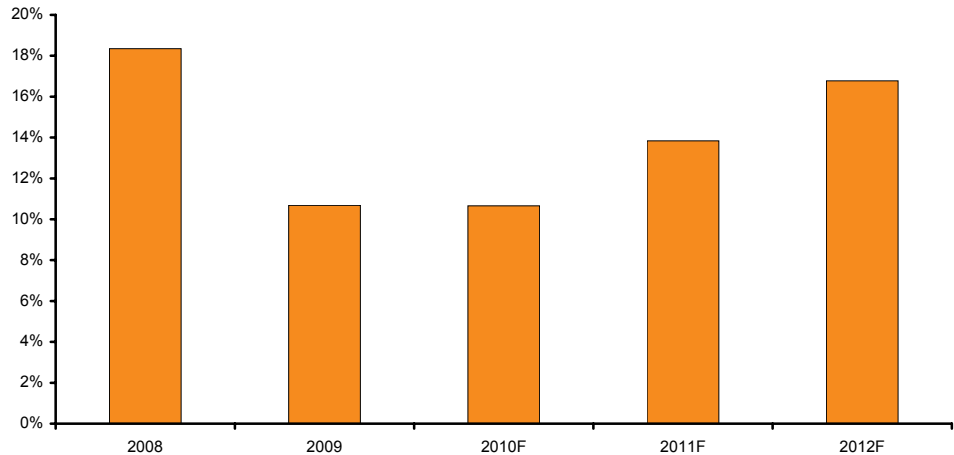
Our base-case scenario is one of Dubai being able to 'work through' the current debt issues. In many cases this will mean losses and write-downs for stakeholders, and particularly those in the property sector, and overflow into the financial sector. However, Dubai's liquidity is guaranteed by the federal government. Longer term, we believe asset disposals will stabilise the debt situation and the underlying surplus for GREs will stabilise Dubai's budget (Dh5.9bn deficit and 2% of 2008 GDP). Ultimately, this should enable Dubai to return to growth, albeit not on the scale we have seen before. In Abu Dhabi's case, public sector ownership of the economy and substantial resources should protect the economy.

Although our base case scenario is admittedly optimistic, we recognise that there are substantial uncertainties and informational deficiencies. Consequently, we note the significantly elevated risk, and take this into account with a substantially elevated discount rate of 14%.

What does this mean for the banks?

In the short term, we see broad market consensus for the banking sector in 2010: high (c5%) and rising (c6%) NPLs as a proportion of customer assets, heavy provisioning and impairments slicing 32% off operating profits, and very low credit growth amounting to just 4%, based on our estimates. However, over the next year or so, we also believe that there are a number of indicators that will turn positive and should grab the market's attention. While the property sector is likely to continue to be a dead weight both in Dubai and Abu Dhabi, a return to growth for other parts of the economy and for immigration is likely to mean investors will look beyond declining property occupancy levels. Adequate disclosure of course will be the key.

Chart 1 : ROAE, average across six banks



Source: Company reports, Rasmala forecasts

We believe Dubai will continue to see deleveraging of its economy and this will restrain credit growth to single digits, perhaps around 5%, until 2012. Abu Dhabi should fare better, particularly due to the lower likely penetration of retail loans, greater stability of the labour market and expanding infrastructure investments, although we do not expect credit growth to exceed 20%. One silver lining is that, although credit growth may be weak, loan growth and local banks' balance sheet growth may be better, driven by the increased on-shoring of financing and reduced local market participation of international banks (which maintain an asset market share of slightly above 20% levels). Nevertheless, credit growth is likely to remain low for the next couple of years, in the 10% range for Dubai banks and 15-20% for Abu Dhabi-based banks.

With regards to profitability, the basic framework is that the banks have a first world revenue base and a third world cost base, in a relatively unregulated uncompetitive environment. While provisioning has hammered profitability in the short term (1Q10 36% of operating profit), stabilisation of NPLs around the end of 2010 (4.8% universe average) should mean a recovery in ROE in 2011 (330bp yoy rise). At first this recovery will be limited, given the excess capital built up for prudential reasons. Nevertheless, we believe that returns around the 20% level will be achieved as leverage levels are regained, and can be maintained in the medium term.

In the long-term, as perceived loan book risks fade, we believe it is unlikely that strong growth will return as leverage levels in sectors of the economy are already relatively high, compared to the region. Consequently, the banks will be faced with excess capital and lower opportunities to raise leverage through growth, resulting in competition becoming more aggressive. We believe the banks are in part pre-empting this with an increased focus on non-interest income and cross-selling. Nevertheless, increased competition is likely to have a negative effect on profitability.

Investment thesis: restructurings to be a positive catalyst

We believe there has been an improvement in the underlying economy, but this has been overshadowed by the focus on the current restructurings. We expect the impact of current and future restructuring are going to be finite, and the dynamics of the sector will reassert themselves once any write-downs take effect. We also believe that the risk of systemic problems has declined significantly, and the prospect of a post-crisis Dubai economy is emerging. With this in mind, we believe that the market implied discount rate is too high and the sector offers value. In addition, if our core scenario continues to evolve, we expect discount rates to decline further, and value in the banks to become clearer.

Stock recommendations

Given our generally bullish view on the economy (that the existing leverage problems and property sector overhang will not cripple the economy), it should come as no surprise that we prefer the value plays, Emirates NBD and ADCB. With ENBD and ADCB trading at 33% and 37% discounts to sector averages, we believe the current valuation takes into account current balance sheet risk from the economy. However, at the other end of the scale, we believe that NBAD still offers solid value compared to GCC banks in general, with little to no risk and a sustainable ROE of 20%, in spite of trading at a 45% premium to the sector average 2010F PTB.

We are less keen on FGB and ADIB, which we estimate both now trade at premium valuations of

17% and 19%. In addition, we have little visibility on the property portfolios in both cases, and other areas of concern. We are least keen on DIB, which trades at a 2010F PTB discount of only 11%, in spite of having significant property exposure through different channels.

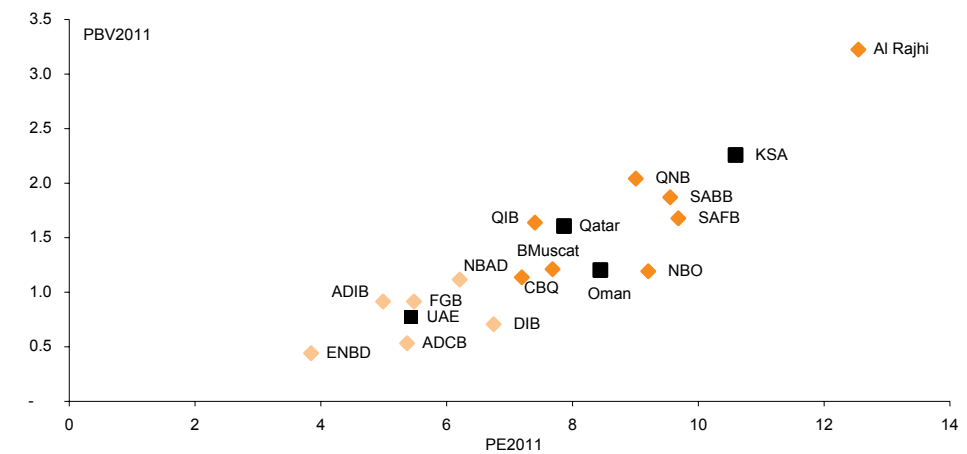
Cheap on a regional comparison

On a regional comparison, all of the UAE banks are extremely cheap, both on a PE basis and on a PTB basis, with discounts to Omani averages of 36% on both measures, to Qatari averages of 31% and 52% respectively and Kingdom of Saudi Arabia (KSA) averages of 49% and 66%. We believe that these numbers reflect an unjustified expectation of failure for the Dubai business model. In any other situation the UAE banks represent the best value in the region, in our view.

This can be seen most clearly with a comparison of NBAD with the non-UAE banks. Although NBAD has arguably lower medium-term growth prospects than some, it is priced more cheaply than all the banks in the region, in spite of having sustainable ROEs in excess of 20%.

We believe that stabilisation of the Dubai economic situation is likely to justify a decrease in the discount rate of around five percentage points. The upside this would create would amount to a further 40-50% increase in our target values.

Chart 2 : Regional valuations (2011F PE v PTB)



Source: Bloomberg, Rasmala Research

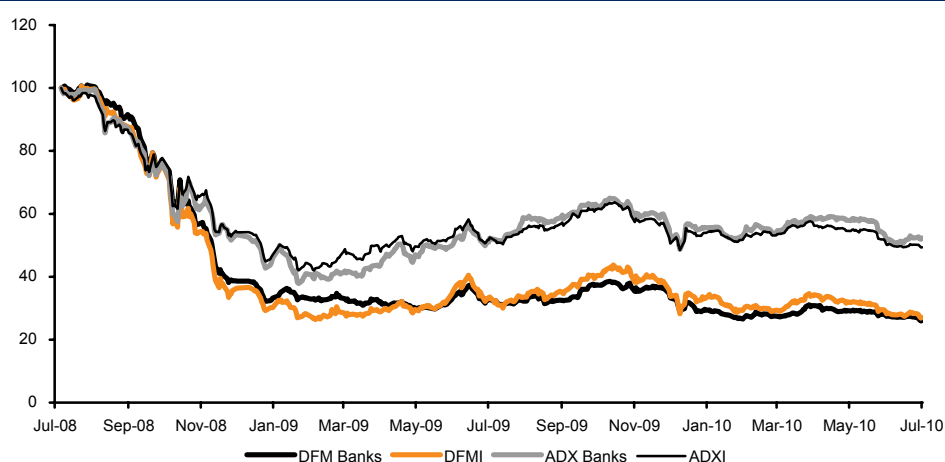
News flow stabilising but descent continues

The 2008 downturn identified a number of weaknesses in the Dubai economy, especially its dependence on asset inflation. Although markets bounced back in 4Q09, the announcement of GRE restructuring caused renewed concern.

Rough ride continues

There's no getting away from the fact that it's been a difficult time for bank valuations in the UAE. They started to crumble with the index at the start of the global crisis, and didn't touch bottom until May 2009. As CDS rates rebounded in the second half of the year, optimism increased that perhaps there was a way forward without structural change. That fallacy was laid to rest with the November announcement of Nakheel debt rescheduling, which ultimately culminated in the current Dubai World restructuring.

Chart 3 : Stock price indices



Source: Zawya Dow Jones

Although from a news flow perspective, sentiment should have touched bottom in 1Q10, increased global concerns have also been felt locally, with stocks and indices reaching new lows at the beginning of July. However, in comparison to the news and to declining stock prices, actual operating results of the banks have held up well, with only one bank (ADCB) reporting losses in either of 2008-09. Furthermore, market-related declines did their worst in 2008, provisioning fell sharply in 1Q10, and even the rate of increase of NPLs has slowed to just a 27 basis point increase yoy.

So if negative momentum is easing, why should stocks be touching new lows? Part of the reason is the global rise in risk aversion in the light of peripheral European developments. However, the imminent Dubai GRE restructuring and rescheduling, and growing pessimism about the longevity and impact of the Dubai property market difficulties are the main reasons. Although both of these are clearly negative events, we believe they are partially offset by ample liquidity, and therefore do not justify the scale of underperformance seen at the banks.

GRE restructuring in Dubai

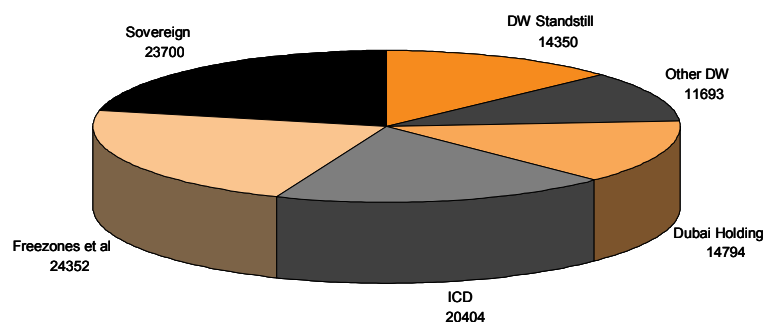
GRE was sparked by the near-default of Nakheel, resulting in a reassessment of implicit sovereign guarantees and a re-evaluation of GRE cash flows both by creditors and the companies themselves.

Impact from Dubai World and Nakheel

The IMF estimated that total debt for the Dubai government and GREs amounted to some US\$109bn, excluding bilateral loans, or 130% of GDP. During 2009, this was not a figure the market was concerned about because the belief was that there was an implied sovereign guarantee that backed the debt. Consequently, even with property and capital market assets declining sharply, the expectation was that this only amounted to a liquidity concern for the rest of the economy.

This situation came to a head on 25 November 2009, with the announcement of a restructuring at Dubai World and the announcement that Nakheel, Dubai's largest and most high profile developer might not meet its obligations with regard to a bond redemption falling due. This step into the void had the obvious consequences: the Dubai Financial Market dropped 27% over the next six trading days, while the Abu Dhabi Securities Exchange (ADX) declined 15%. Dubai has declined a further 4% since then, while the Dubai banks having dropped a further 10% to their 1 July 2010 close.

Chart 4 : Breakdown of GRE exposure (US\$bn)



Source: IMF 2009 Article IV consultation for UAE (Dealogic, Zawya, Bloomberg, Dubai authorities, IMF)

Dubai restructuring plans resolve Nakheel liabilities

The main thrust of the initial plan was to address the immediate issues for Nakheel, and set up a framework for resolving the issues related to Dubai World, as well as creating a new bankruptcy law and a chief restructuring officer, Aiden Birkett to manage the task of managing whatever debt workouts arose. To this end, the Dubai Financial Support Fund was funded with US\$10bn, with half of that being allocated to paying the Nakheel bonds due in December and April, and the other half allocated to trade creditors.

This may have brought Nakheel back from the brink, but it took a further promise of an US\$8bn cash injection and an equity conversion of US\$1.2bn of Government of Dubai held debt to put it on an even footing. Overall, this seems a surprisingly high sum, and may already have reflected the announced takeover of Limitless' operations.

Although Nakheel itself seems to have been saved, in the absence of a sovereign guarantee there are a number of other entities which need to be looked at. The largest of these is Dubai World, Nakheel's parent company, which owed, with its subsidiaries, a total of Dh26bn. However, Dubai Holding is another pool of uncertainty.

Dubai World restructuring: haircut likely

Dubai World announced a restructuring of US\$14.4bn debts not long after the initial standstill agreement. The current proposal on the table is for this amount to be restructured into a 5-year

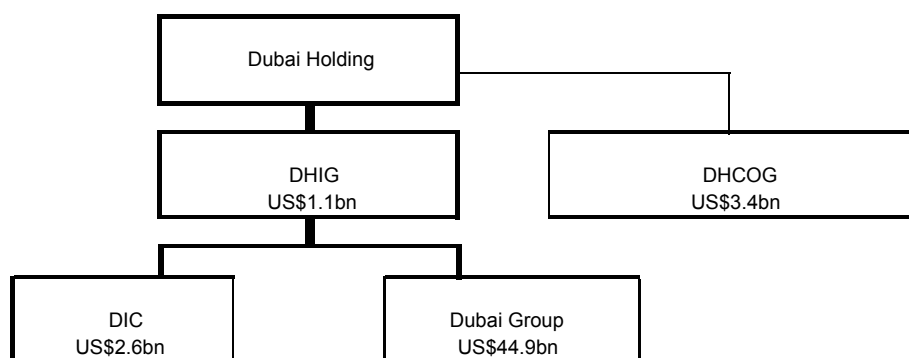
US\$4.4bn and an 8-year US\$10.0bn. The 5-year bond will receive a coupon of 1%, with no Government of Dubai shortfall guarantee. The 8-year bond will receive a 1% coupon, as well as a further payment in kind, and will have a Government of Dubai shortfall guarantee, albeit limited to US\$4.0bn. The deal is being sweetened by the government agreeing to convert its debt of US\$8.9bn into equity.

So far the company has already reached agreement with the Coordinating Committee of seven banks, including ENBD and ADCB, together holders of 60% of the debt. However, the remaining debt is split between 66 holders and for the moment DW is looking for unanimous agreement, both for publicity purposes, and likely also to head off later legal challenges.

Dubai Holding: Banks remain optimistic

The overall size of Dubai Holding's debt obligations amount to US\$12bn (Dh44bn), according to an unnamed source quoted by Bloomberg, roughly in line with the original estimate provided by the IMF. Of this, the property arm Dubai Holding Commercial Operations Group (DHCOG) discloses US\$3.4bn (Dh12.5bn) of debt, while the investment arm Dubai Holding Investment Group (DHIG) accounts for the remaining US\$8.6bn (Dh32bn), spread between the holding company and its subsidiaries.

Figure 1 : Debt obligations of Dubai Holding



Source: Bloomberg

Since DHCOG has a listed bond, we have visibility on this operation, which includes notably Jumeirah Group and TECOM, as well as Dubai Properties, Tameer and Sama Dubai. While the obligations are significant, at this stage there seems little need to default or reschedule this. The situation with the investment companies is more uncertain, however. These operations have been scaled back dramatically, with the wholesale replacement of the board of Dubai International Capital DIC to "implement a new governance structure" in January 2010.

DIC owns a number of international investments acquired in better times, including Alliance Medical (acquired for US\$1.25bn), and loss-making entities Travelodge and engineering company Doncaster's (US\$1.1bn), as well as troubled industrial groups Almatris (US\$1.2bn) and Mauser. While it has given no indication of disposing of these at current prices, it has disposed of much of its public equity holdings, including stakes in Merlin (of Madame Tussauds fame), EADS, HSBC, Sony and ICICI Bank in India.

So far, DIC has successfully asked its creditors (three British banks, ENBD, Mashreqbank and Noor Islamic) for a 3-month extension of a US\$1.25bn syndicated loan maturing in June 2010. With threats of asset seizures looming (for example of Alliance Medical), DIC has brought in Deloitte's and Lazard's to advise it on its options, while Dubai Group has additionally retained KPMG. The banks, however, remain optimistic that losses will not be significant.

Creditors likely to take a haircut

For now, we understand that assets within Dubai Holding are more than enough to meet liabilities, with banks rescheduling rather than restructuring loans. The trouble is that many of the assets are illiquid, and a fire sale in a weak market may not realise value. Consequently the main concerns are not within Dubai Holding, but within the Dubai World restructuring.

With the effective interest rate on DW restructured loans limited to a cash value of less than 2%, its clear that by any normal measure there has been a decline in NPV. If we were to use a 5%

discount rate, this would imply a 21% discount for the 5-year bond and a 23% discount for the 8-year bond. Nevertheless, although we believe a discount rate of 5-7% is appropriate, we believe the accounting will be politicised and assume a less conservative 15% haircut. As for timing, it is possible this amount will be reported in 2Q10 results, but we think the likelihood is that the write-down will take place in 3Q10, when the details have been more adequately worked out.

We believe ENBD has Dh10bn-15bn of total Dubai World exposure, of which perhaps two-thirds is being restructured. ADCB has disclosed Dh9bn of Dubai World exposure. However, they are guiding to a much smaller number undergoing restructuring. FGB also has more limited exposure, amounting to Dh869m.

Significant – but not critical – impact on earnings for ENBD and ADCB

We believe that about two-thirds of ENBDs holdings are being restructured, while the proportion for ADCB and FGB may be significantly less. With this in mind and a base case 15% haircut, we estimate an impairment of Dh1.2bn for ENBD, Dh450m for ADCB and Dh75m for FGB, amounting to 4%, 3% and 0.3% of book value. Although in principle this should be taken in 2Q10, we think the likelihood is that it will be delayed at least until 3Q10.

So why are losses so small?

It seems a little surprising that from an initial US\$109bn of troubled loans, the end result is that the worst affected bank has losses so small that they can be absorbed within a single quarter. In total, we assume that financial obligors are likely to absorb about US\$4bn of losses (US\$3bn on current restructurings and perhaps a further US\$1bn), and reduced revenues worth a further US\$2bn. If restructurings deteriorate in quality, or if the whole of free zone debt were to need restructuring, which we doubt, then total losses may treble this figure. Nevertheless the impact on the local banks is fairly modest.

The main reasons for the lack of impact are:

1. The international banks are shouldering 60% of the fiscal impact.
2. Sovereign and ICD debt is deemed to be credit-worthy, while no losses are expected on Dubai Holding debt, which together account for US\$59bn of these loans.
3. Nakheel at least has US\$20bn of existing equity to absorb write-downs, which compares to total asset size of US\$40bn. Dubai World may also have a substantial equity base.
4. The Dubai Financial Support Fund is centralising and/or subordinating its own claims with debt/equity swaps, so far amounting to US\$10.1bn.
5. We assume no further losses on its rolled over debt. This will depend on whether cash-flow will return to the property market and on whether Dubai as a whole is cash-generative in the longer term (please see page 25 for more detail).

Is the property market fixable?

The second interrelated problem for Dubai is the after-effects of the property market's collapse, which left developers facing cash flow problems. Although the market has become more stable, substantial new supply threatens the current situation.

Market problems encompass developers, contractors and investors

Current trends suggest that transaction volumes are rising and prices are on an increasing path. Nevertheless, the problems are manifest. Developers are having difficulty collecting money from buyers and are certainly selling fewer units in the primary market. As a result they have been unwilling or unable to pay contractors. In other cases, the cash flow obtainable from delivering projects and selling remaining units into a soft market does not cover the cost of completing them.

Meanwhile, contractors who haven't received payment for work already done are caught between a decision to abandon projects half way through or to extend yet more credit to developers in the hope of being paid. Customers for their part are also awkwardly placed with some of them already in negative equity, but others knowing that the developer is in negative equity and therefore unlikely to complete the project.

Meanwhile, the banks which provide financing for them all are looking at weak asset prices and seeing further supply entering the market for the next two years at least. For some projects this is a difficult situation for everyone concerned. Within the construction market, falling asset prices primarily affect the developers, but given the level of influence they hold, this has often resulted in pain elsewhere: buyers frequently receive products which fail to meet expectations, or have progress on delivery delayed extensively; contractors and consultants are often paid late, or in part, or sometimes not at all. And no matter who suffers, at the end of the day, the buck stops at the bank.

Initial regulatory developments were not positive

As the crisis unfolded, it became clear that the legal framework was not going to be helpful. In some cases, investor protection laws either were not being adequately enforced or were insufficient in scope, such as the Escrow law, which occasionally proved ineffective and exempted the major state-owned property companies. In other cases, the laws were reinterpreted in fundamentally different ways, such as the investor protection law, which dealt with cancellation of properties. The initial wording suggested that this was an investor protection law, but subsequent clarifications implied it was a law protecting developers from rebellious investors.

This shifting of the goal posts had the impact of undermining investor confidence in the sector. In addition, the indefinite postponement of the Strata Law and the decision by many developers to recoup losses elsewhere by raising service charges effectively set the low point for investors. The impact of this was to kill the off-plan market, as well as to raise the question of legal property rights and legal recourse for owners of finished property.

Recent moves to deregister properties more of a 'clean-up' operation

Property developers have taken various approaches to dealing with recalcitrant investors. Initially the developers were wholeheartedly in denial, expecting investors to pay on time, regardless of the likelihood or any evidence of any building actually taking place. Since then, there has been a period of 'working things out' – either cancelling projects, or providing progress or assurances to investors in an effort to bring them onside. However, more recently there has been a return to a more combative approach, that of deregistering ownership of properties.

This deregistration threat comes from developers taking advantage of Executive Council Resolution 6 of 2010 (released April 15). This empowers the property developers to request that the land department issues notices of deregistration, before deregistering and potentially auctioning the property, with up to 40% of the value of the property being retained by the developer, or 25% of the amount paid if construction has not yet reached 60%. Emaar, Deyaar, Omnyat and other developers have arranged for several hundred cancellation notices.

In the short term this will be negative for pricing, with investors attempting fire sales prior to cancellation, and in the medium term it will mean more stock becoming unclogged and delivered to market. While in both cases this is negative for pricing, it should add liquidity to a difficult area of the market, and will therefore be good for banks corporate customers.

Strata Law is a clear positive

The increases in service charges combined with the stalling of the Strata Law was clearly a low point for the property market. Shortly afterwards, the land department announced that it would be regulating service charges, and that brought some relief to the market, although clearly the damage, in terms of uncertainty, was done. What was required to resolve this issue was the long-awaited Strata Law, which provides the legal framework for fractional ownership of properties.

The consequence of the Strata Law is that buyers of communally-owned property (i.e. apartments) will have their rights and obligations more adequately spelled out. In addition, where there are joint responsibilities and rights, an owners association will be set up to adequately administer and enforce those rights. While the law came into force only at the end of May 2010, initial indications suggest the law has teeth, with developers (or at least Emaar) already publishing notices regarding the setting up of owners associations.

Owners associations have two key advantages. The first is that they change the relationship between property owners and the developers. Under the previous system, the service charge was somewhat arbitrarily set and widely abused. Going forward, the owners association will be able to determine their own service charges with reference to market conditions. Not only that, but they should be able to make the developer contribute to those parts of the building that it has retained for its own use.

One key advantage for the market is that this opens the door to a range of vulture and other investors who might otherwise be put off by a lack of legal framework. Although investors will still need to be convinced that Dubai can ultimately attract sufficient immigration to absorb overcapacity, this may be an important source of cash flow in the intermediate period.

Long-term health dependent on lower involuntary vacancy rates

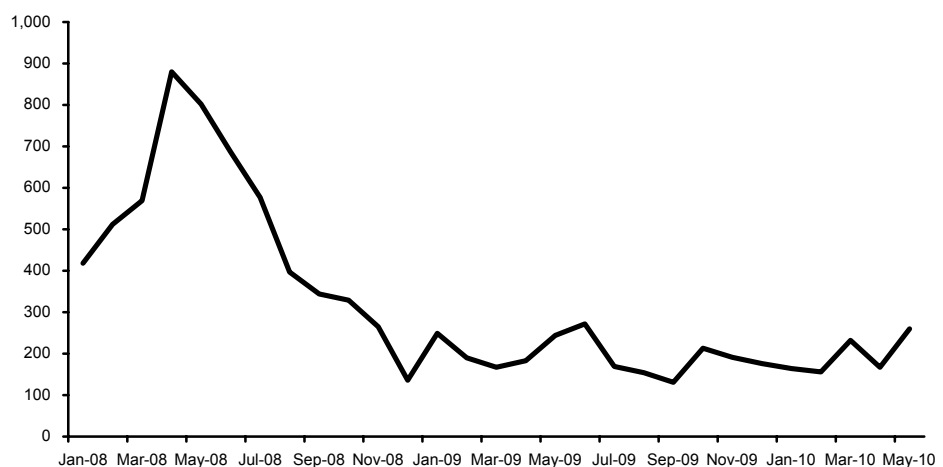
While the Strata Law may be effective in bringing new investors to the market, ultimately the price of property is driven by risk, affordability and occupancy rates. The Strata Law should help the market by reducing ownership costs, and improving ownership rights. It may even have a positive impact on vacant demand (use not as a primary residence). However, on its own, it is unlikely to solve the issue of high and rising involuntary vacancy rates.

Recent trends more positive

Transaction volumes see some life

While there has been some stabilisation of property prices (see later), transaction volumes have also been seeing hints of recovery. Buyers are more market aware than sellers, who tend to be focused on narrower issues. As a result, improving expectations will not immediately result in price increases, but should at least provide a pick-up in transaction volumes. The data in Chart 5 comes from the land department, and while the data suffers from a number of limitations especially as to timing, it is compatible with gently rising activity.

Chart 5 : Dubai property transaction (number per month)



Source: Dubai Land Department

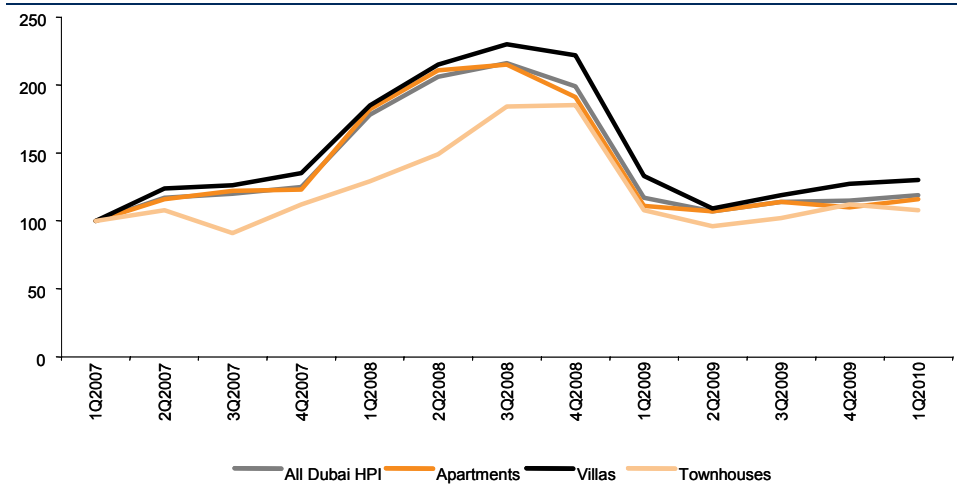
Although stabilising property prices would be good news for the property market directly, it also would lead to a more positive attitude from the banks when it comes to mortgage lending. Perceived price stabilisation is one of several factors that have contributed to lower loan rates and higher loan-to-value ratios, creating a mini-virtuous circle. However, a more stable labour market is likely to be as big a driver, while the successful conclusion of some property disclosures will have lowered the perceived legal risk. Going forward, we believe the increased prevalence of credit agency Emcredit will continue to have a positive outcome.

So have the banks eased up on mortgage lending? Yes, to some extent. For the best credit risks there has certainly been some easing, and headline rates have fallen to as low as 5.75%. In addition, more lenders are going on record discussing higher loan-to-value ratios and improved flexibility. Nevertheless, many of the existing biggest lenders – particularly housing financiers, Tamweel and Amlak - are willing to keep to the side lines (combined 1Q10 8% yoy decline in loan book), and there is certainly little sign of anyone aggressively pursuing market share.

Property prices are also finding a (temporary?) floor

After a near absence of property indices in Dubai just a couple of years ago, there is now a wealth of such data, with them all indicating a fairly similar pattern: that advertised prices peaked in 3Q08, and then declined 50% to its trough, which was still above the levels of 1Q07. Colliers estimates the trough for residential prices to have occurred in 2Q09, with three consecutive quarters of price increases since then.

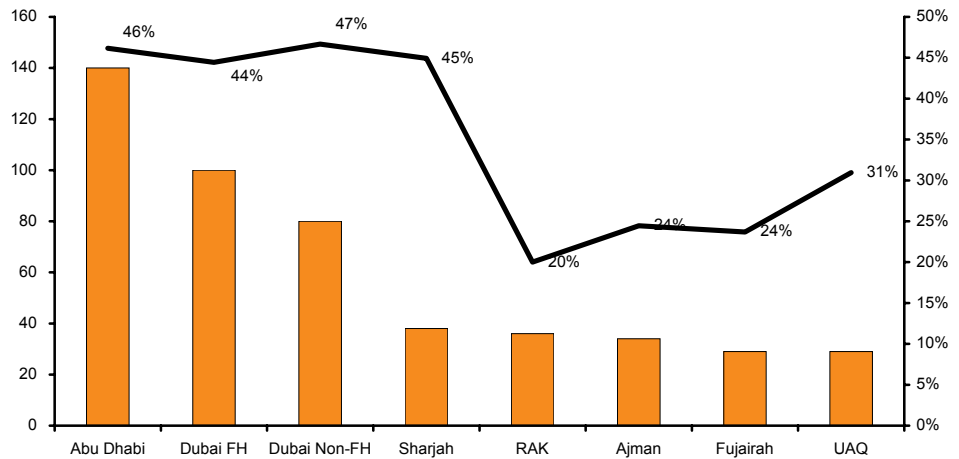
Chart 6 : House price indices by sub-type, Dubai



Source: Colliers International

Similar trends can be seen in the office and retail markets across the country, although there isn't the same availability of pricing data. Nevertheless, CBRE notes that Dubai office rental rates have declined by 58% yoy, while those in Abu Dhabi have slipped by 35% yoy to December 2009. CBRE also estimates that letting rate declines for residential properties have been broadly similar across the major Emirates, with the Northern Emirates less affected.

Chart 7 : Lease rates for 2-bedroom units, Dh '000 (LHS), % decline yoy (RHS)



Source: CB Richard Elli

While from one point of view this looks like an L-shaped property collapse, from another point of view it is more of an n-shaped property bubble, with prices reverting only to 2007 levels, but with occupancy rates likely to remain significantly low. Occupancy rates in Abu Dhabi are significantly higher, with Colliers estimating a current rate of 99%.

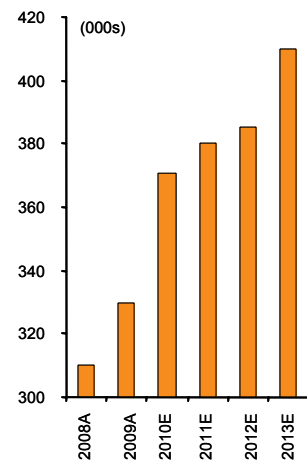
Increasing supply means higher vacancy rates

Colliers estimates that the occupancy rate on Dubai property is 80%. While many would expect that the current occupancy rate would be lower than that, the one thing we can be sure of is that occupancy rates will be lower in the future. Although established communities, with retail and leisure facilities, and good transport links have held on to their residents, other areas have seen falling occupancy rates, leading to a number of developments being cancelled or put on hold. In fact, BNC Network recently compiled a list of 91 such projects over US\$100m, without even considering the Dh350bn Jumeirah Gardens project.

While a lot of developments have been set aside, there are still substantial deliveries expected to come on line over the next three years. Forty thousand properties are expected to come on line in 2010, with a further 40,000 over the subsequent three years, according to Colliers. In the absence of fresh immigration this would suggest occupancy rates declining to 64% by 2013.

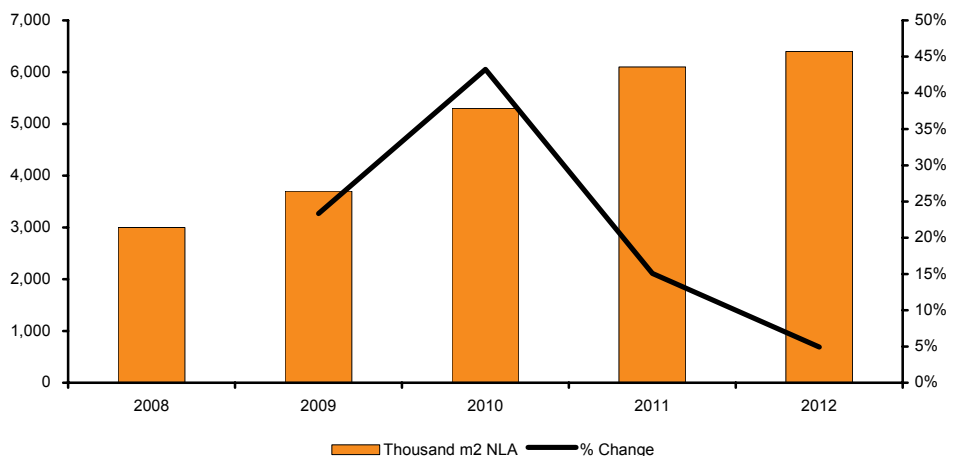
While the residential market may be of some concern, what is moving increasingly onto the radar is the office market. There occupancy rates are already low at 71%, with that in new developments at only 42%. While the new developments are gradually filling up, this is mostly at the expense of the established areas, and thanks to radical discounting of rents. In addition, going forward the supply looks even more extreme.

Chart 8 : Cumulative Number of Units, Dubai



Source: Colliers

Chart 9 : Office space Dubai, net leasable area



Source: Colliers

Both the hospitality sector and shopping malls are also likely to see increased capacity, but at least not on the same scale. Occupancy rates averaged 69% in 2009, generating RevPAR of just US\$162. Tourist numbers have been rising again though, and occupancy rates have followed suit.

Overall, it's clear that the residential property market is going to be plagued with a substantial quantity of vacant property for some time to come. This will keep prices under pressure, ensuring that there is no swift rebound. Nevertheless, with affordability improving significantly, and a more stable labour market, prices in premium areas may remain more stable than those in less desirable locations.

The office market is more of an unknown

Of even greater concern though is the office market, with its already low occupancy rates and 1.6m sq m, equivalent to 5,000 standard 320 sq m office spaces, to be delivered this year, mostly in Business Bay. While CB Richard Ellis recently rated Dubai the ninth most expensive office rental market in the world, it seems safe to say that it will have fallen a few places over the next 12 months.

So with falling asset prices, falling yields and falling occupancy levels, how much of a problem might the commercial property market be? Well the first thing to note is that we know significantly less about the commercial property market than we do about the residential market. From a banking sector perspective, the risks will be similar to those of the residential market: developers, sub-developers, contractors and consultants and owners. However, in this case, the owners are more likely to be corporates and high net worth individuals.

Although the commercial office market appears as a new risk, the reality is that most of the risk falls on the shoulders of the developers, contractors and consultants, and these are risks we already knew about from solvency discussions with developers.

Will the market tighten in the long term?

During the bull market, one of the main positive comments analysts made about the market was that supply was controlled by a small number of key developers and would be throttled back in the case of a market downturn. This proved to be a pretty poor safeguard, however, when the market collapse happened far faster and more deeply than most people had expected. The problem was that with all the delays, the market felt like a tight market, but the reality was that there was a lot of leveraged supply working its way down the pipeline. The result is that the feedback loop was and will be very much delayed.

But given that prices are only back to the levels of 2007, what is the incentive for developers to stop launching new projects? The main hurdle for new projects is the likely absence of buyer financing for the off-plan market. With developers previously able to take advance payments, they were able to use revenue from investments to subsidise building costs and still come out with adequate margins. The greater the delay in delivery, the greater was the benefit of the negative cash cycle. We do not believe that under the current environment it would be possible to maintain a negative cash cycle, and indeed it may be some time before off-plan sales are again a feature.

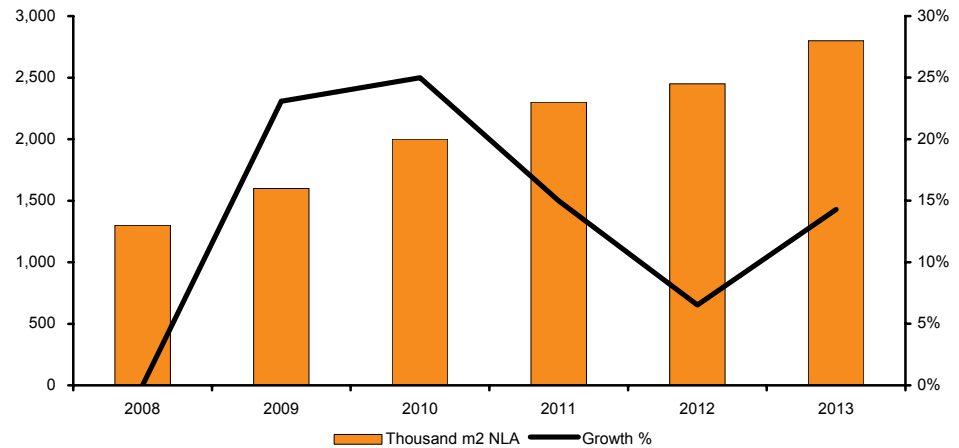
Without prepayments, and with stricter credit control from contractors and consultants, the economics of construction may be difficult to sustain. We estimate an apartment block costing Dh400 per square foot for the base build and Dh100 per square foot for the fit-out, will sell for no more than Dh700 per gross square foot at current prices even in a good area. Is that margin sufficient to pay for marketing, overheads, land, financing and risk? It certainly seems marginal.

Of course, there is still a pipeline of three years of deliveries to be absorbed. Beyond that, there are still going to be a wealth of potential projects in good areas where the infrastructure costs have already been sunk, making the economics of new build more compelling. Finally, there will be some developers still aiming for a sharp medium-term recovery in prices. While all these will keep downward pressure on prices, we think the market is likely to tighten from three years out.

Other property markets

With high occupancy rates in Abu Dhabi in particular, the market is not under such pressure. Office space in Abu Dhabi currently has a 99% occupancy rate, according to Colliers, while occupancy rates on residential properties are thought to be similar. Indeed, given the slow rate of housing development, Colliers believes the residential market will face excess demand, putting upward pressure on prices and encouraging intercity commuters from Dubai. As in Dubai though, the office market looks problematic.

Chart 10 : Office space Abu Dhabi, net leasable area



Source: Colliers

By comparison, with mall penetration half the level of Dubai, the room for modernisation of the retail proposition seems clear. The plans for the hotel industry in Abu Dhabi are for much more aggressive expansion, doubling the number of rooms available within 48 months. Whether or not this is successful will depend on Abu Dhabi's success in rebranding itself as a leisure tourist destination.

Cash-generation vs profitability

One of the trickiest tight ropes to walk is that of whether the property companies should be cash generative, by selling under-priced property into an already soggy market, or whether they should allow the market to tighten and thus improve pricing and profit margins. We would hope that a sensible compromise is reached to maximise long-term cash generation, while at the same time pursuing business and immigration-friendly policies to encourage occupancy increases. However, one of the biggest risks is that over-optimism on immigration will result in a continuation of too much product coming to the market.

Economic environment: off life-support

Dubai isn't all about property though, and the UAE isn't all about Dubai. The Dubai property market remains flat, but other sectors appear to be finding their feet.

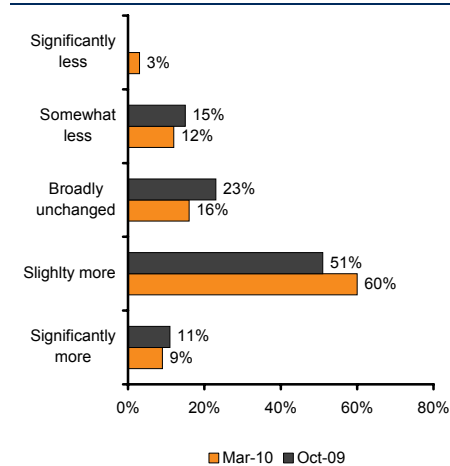
Two steps forward, one step back

It has been an unsteady beginning to a meandering path. Nevertheless, there are reasons to believe that forward-looking indicators are beginning to turn more positive, or at least less negative. The economy has been here before of course. That was immediately before the near-default of the Nakheel bond, which reignited concerns about the banking sector and put the economy back into six months of survival mode. Nevertheless, in spite of uncertainties relating to the state of Dubai Holding, this time the nascent stabilisation may be on a firmer footing.

Business confidence improving

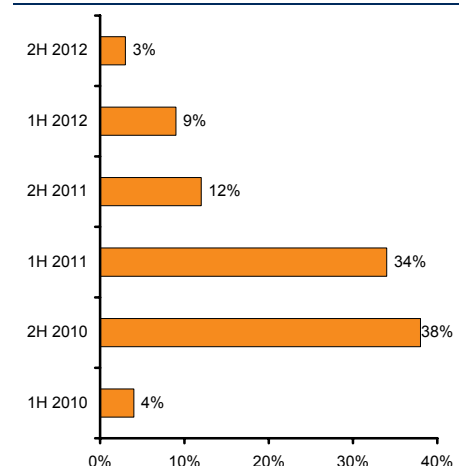
There isn't much in the way of forward-looking data in the region, such as business surveys or inventory analysis, and indeed there is quite a lot to be desired even when it comes to backward-looking data. Nevertheless, one interesting insight came from the Deloitte CFO survey, published in March 2010. While this is a regional survey, one-third of identified respondents were from the UAE, with Jordan and KSA combined accounting for another third. At least according to this survey, optimism has been rising over the previous six months, with most CFOs expecting demand increases either in 2H10 or 1H11.

Chart 11 : Compared with six months ago, how optimistic do you feel about your company's financial performance?



Source: Deloitte CFO survey

Chart 12 : When will growth in demand for your company's products and services accelerate?



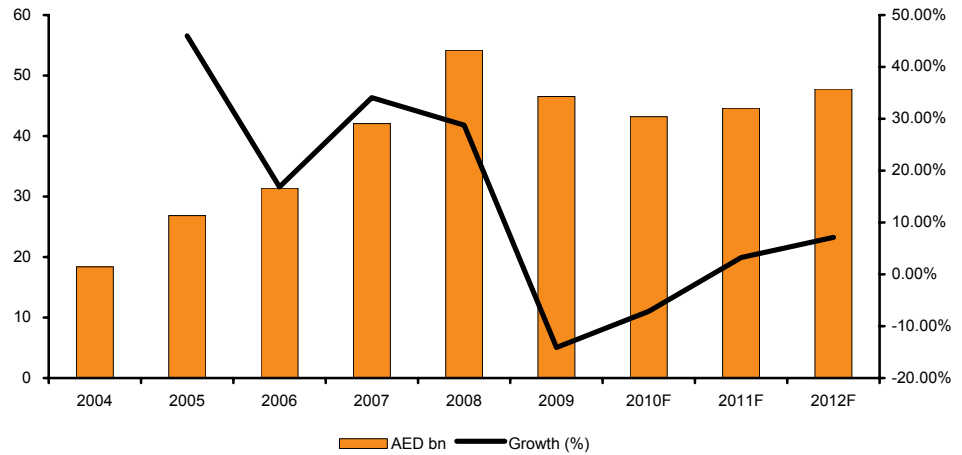
Source: Deloitte CFO survey

Although this survey is more broadly based (and is disproportionately weighted to the financial sector), business optimism appears to be rising. Is it rising fast? Not according to Chart 12, which indicates that no recovery in orders is expected any time in 1H10. Our conclusion would be that respondents are sensing a general improvement in sentiment, without that materialising yet into advance orders or plans – a conclusion that gels well with a number of pieces of anecdotal evidence. However, with NPLs continuing to rise and shops and businesses continuing to close, there needs to be hard evidence, at least for current stabilisation.

Tourism and retail spend stability coming soon?

The healthiest areas of the economy are sectors such as trade, tourism, and logistics, and these should be the key drivers of the economy, although the latest data is mixed. The most important of these for Dubai, however, is likely to be tourism (18-30% of 2008 GDP, depending on the definition). While luxury leisure tourism is the largest element, business tourism may have a disproportionate impact on the wider economy, as it is part of the wider MICE industry. The value of a tourist to the economy includes most simply his flight and accommodation, but also a substantial amount of consumer spending, particularly with Dubai marketing itself as a luxury shopping destination.

Chart 13 : Travel and tourism direct industry expenditure – modelled numbers



Source: World Travel & Tourism Council

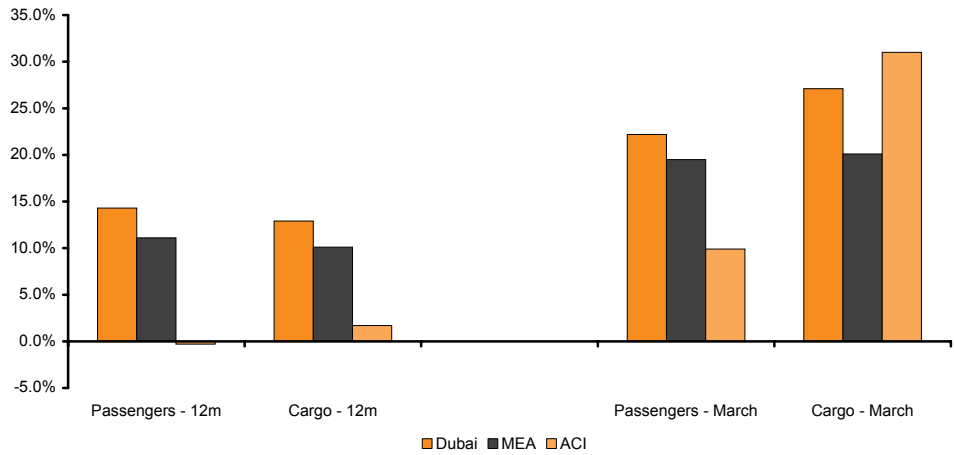
Indicators so far have been mixed. At least according to the World Travel and Tourism Council (WTTC), direct industry contribution to GDP took the major hit in 2009, with a 14% decline in nominal GDP contribution, and weakness continuing into 2010, with a further 7% decline. This was caused by a drop in visitor numbers starting from 2008, which saw a 7% decline, followed by further modest declines of 2-3% in 2009 and 2010. Similarly, STR Global, a research organisation for the hotel industry, estimates that RevPAR (revenue per available room) declined by about 3% yoy in 1Q10.

How does this compare with the feeling on the ground? Curiously, the issue on the ground is not so much the total number of people, but the average spend: while the main malls are still full, there aren't many people wandering around with shopping bags. The overall decline in spending, according to Mohidin bin Hendi, the owner of 45 restaurants and 110 retail outlets, has been of the order of 15-20%, although not quite as bad as the 25-30% he initially flagged. In addition, the newer malls are clearly taking share from the older malls. Bin Hendi Enterprises for example, recently closed its BinHendi Avenue in Deira City Centre Mall, citing luxury traffic moving to Dubai Mall.

Air traffic data more positive

Certainly, when it comes to passenger traffic through the UAE's largest airport, Dubai International, things are looking up. Chart 15 below highlights that total passenger traffic has risen by 13.9% yoy for the 12 months ending March 2010, according to the Airports Council International. Meanwhile, cargo volumes are up 12.1%, making it the fastest-growing airport (in the top 30) outside greater China. While world cargo traffic levels grew faster in March, that was really a reflection of depressed comparatives, while Dubai has grown throughout the period, and is accelerating.

Chart 14 : International air traffic, by number and tonnage, March 2010 data, growth yoy

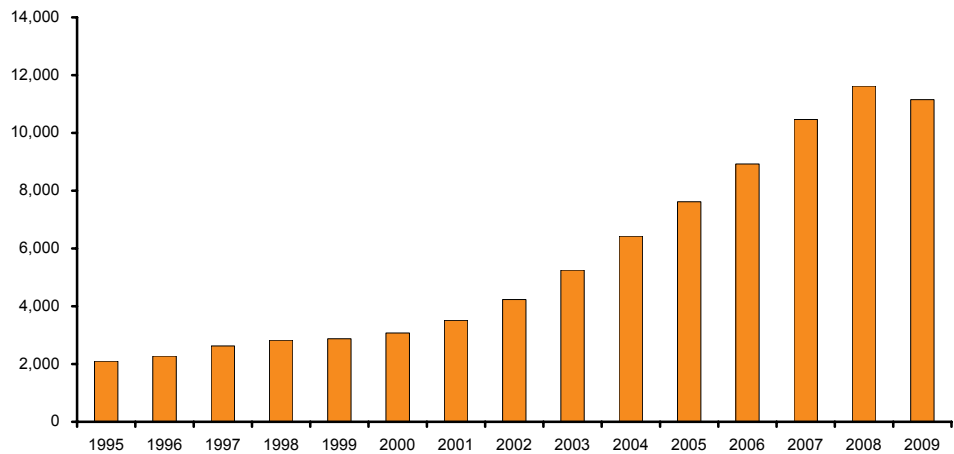


Source: Airports Council Internationals

Shipping and trade is still a mixed bag

Most cargo traffic comes by ship and this largely relates to the ports managed by DP World, which manages the flagship Jebel Ali Port, as well as Port Rashid in Dubai, Mina Zayed in Abu Dhabi and Fujairah port in Fujairah, as well as the under-construction Port Khalifa in Abu Dhabi. Global container volumes decreased 11.6% yoy in 2009, according to Drewry, a shipping analyst company, while UAE volumes were regarded as being relatively resilient, declining 6%. This year, there has been some recovery, with DP world reporting 1% yoy volume growth for 1Q10.

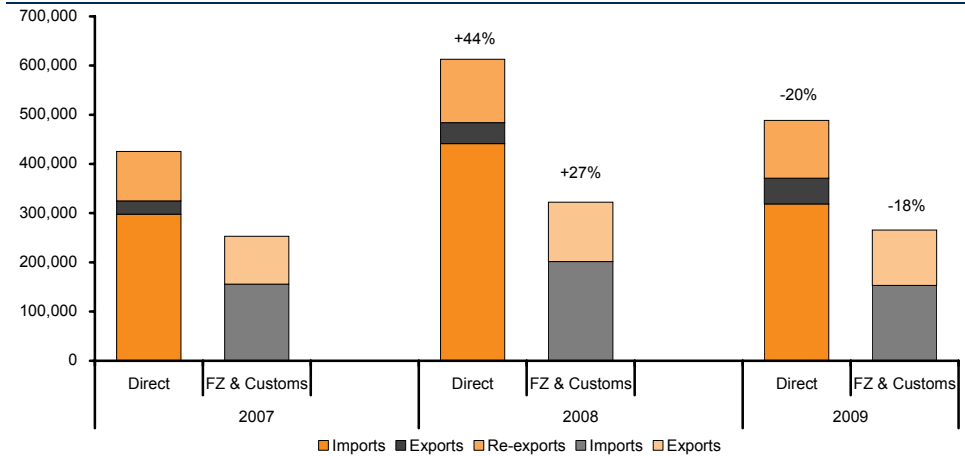
Chart 15 : TEUs handled by Jebel Ali Dubai (in thousands)



Source: DP World

The numbers in Chart 16 are broadly in agreement with that, with Jebel Ali traffic declining 6% in 2009. Only about 35% of this business is destination or origin Dubai, however; so although this is a significant contributor to the economy of Dubai, it is not really an indicator of the strength of the rest of the Dubai economy.

Chart 16 : Foreign trade by type – Emirate of Dubai (Dhm)

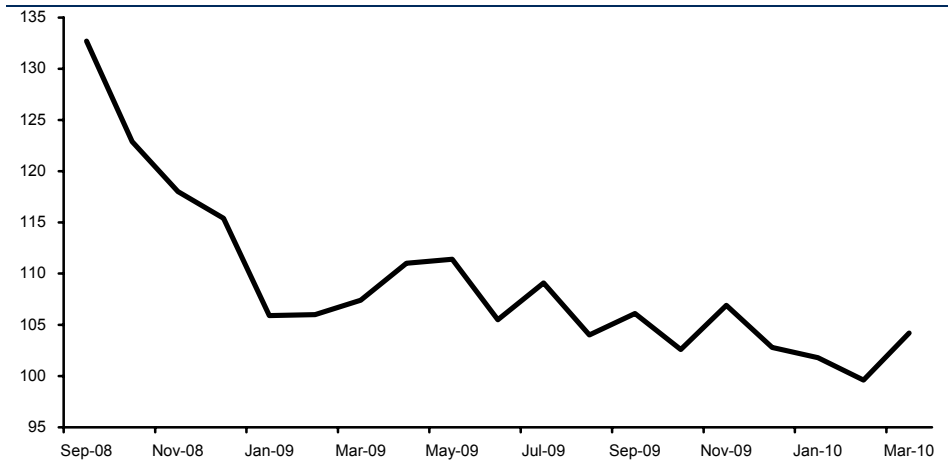


Source: DP World (via Dubai Statistics Centre)

While traffic by volume seemingly declined only 6% in 2009 (looking at the Jebel Ali data in Chart 16), traffic by value for the Emirate of Dubai declined by 18-20%. This in turn was driven by a 28% decline in direct imports and a 24% decline in Free-zone and Customs Warehouse imports. With some recovery in construction activity and some recovery in consumer spending, we would expect this figure to have recovered gradually through 2010.

Import volumes can also be approximated by looking at Letters of Credit (LCs), which are issued by banks as an enabling instrument for cross-border trade. There are broadly three ways of paying for imports: with cash, with LCs (effectively a counterparty guarantee by its local bank) and with credit. Given increased counterparty risk sensitivities, one might expect the use of unprotected credit to decrease. On the other hand, if exporters are particularly nervous, one might expect to see transactions being cash funded, rather than linked to credit, even guaranteed credit.

Chart 17 : Letters of credit (Dhbn)



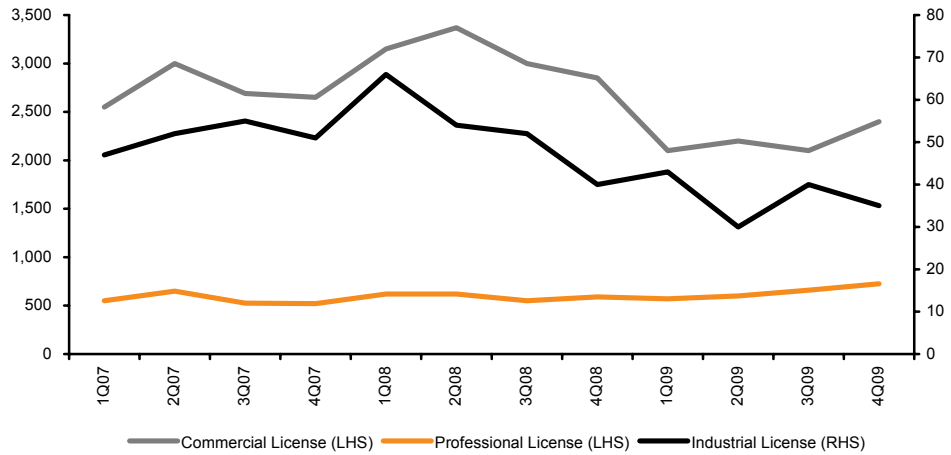
Source: Central Bank Monthly data

Whatever the reason, the bad news is that there has been a steep decline, and the decline continued throughout 2009 (20% yoy decline to 3Q2009). The good news, such as it is, is that business rebounded sharply in March 2010 data and was maintained in April.

Official sources of information are more positive

Forward-looking data is more promising, although less reliable. It also tends to be of an ad hoc nature, allowing local media to focus on the more reader-friendly items. While official data should give better insight, much of it is not subject to public scrutiny, and as such it is frequently difficult to establish whether it reflects genuine business trends. Official figures on immigration, for example, suggest that "Dubai continues to add more than 10,000 residents per month, with population crossing the 1.8 million-mark in the first quarter of 2010... up from 1,676,000 at the end of Q1 2009", while the 'active population in Dubai during the day at the end of 2009 averaged 2,638,778" (Dubai Statistics Centre).

Chart 18 : New trade licenses issued in Dubai



Source: Dubai Statistics Centre

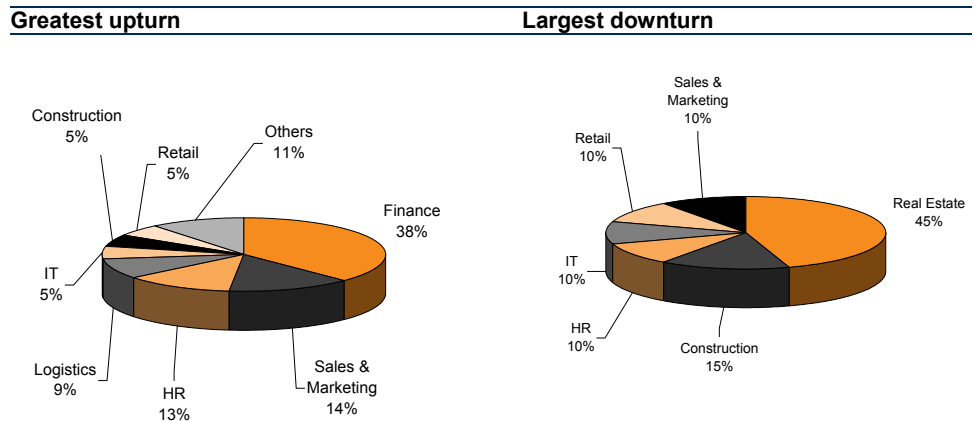
Other data more closely resembles experience, such as that on commercial licenses, which we reproduce in Chart 19. The number of commercial and professional licenses issued in 4Q09 showed some improvement after weakness earlier in the year. The improvement was modest, and may have been set back a further six months once the impact of the Dubai World news flowed through. Nevertheless, the general message is one of stabilisation, in spite of the 17% yoy decline in total New Trade Licenses.

Developments in the labour market

As the crisis developed in the second half of 2008, there was little in the way of redundancies, but these really gathered pace throughout 2009, initially in the construction and property sectors, but subsequently these broadened out across the economy. In addition to redundancies, it has been clear that there have been a number of corporate and outlet closures, corporate retrenchments and restructurings.

However, while isolated stories of bankruptcies and further downsizing continue, the bulk of this seems to have been achieved by 2H09. Consequently, the focus has now shifted to whether the labour market has merely stabilised, or whether the first signs of a labour market recovery are available. Certainly Pink Slip Dubai, a recruitment networking company does, with its survey of recruitment consultants, suggesting that financial recruitment is seeing the biggest pick-up. Nevertheless, there is little confirmation that any recovery has been particularly strong so far.

Chart 19 : Changes in recruitment activity, 2010 over 2009



Source: Pink Slip Dubai, Survey of Recruitment Consultants

Hard versus soft data

On the one hand the hard data is suggesting that the economy is declining, but at a slower pace, while on the other hand soft data projections and surveys suggest that stabilisation is under way. Both data sets have their limitations. The hard data is generally backward looking, and it is no surprise therefore that the economy was not looking strong in 4Q09. Soft data suffers from being prone to sampling error, has a general bias towards more positive stories and is partially sentiment driven.

We believe the economy was beginning to stabilise in 4Q09 before the announced restructurings interrupted this. Now, nine months later, we are almost back to the same point. We expect that some sort of recovery will take shape, but only if the structural issues can be resolved. The two largest of these are the problems in the Dubai property market, and the problems with Dubai debt.

Rebalancing Dubai

The main challenge for the Emirates is attaining sustainable growth: fiscal stability without relying on asset inflation.

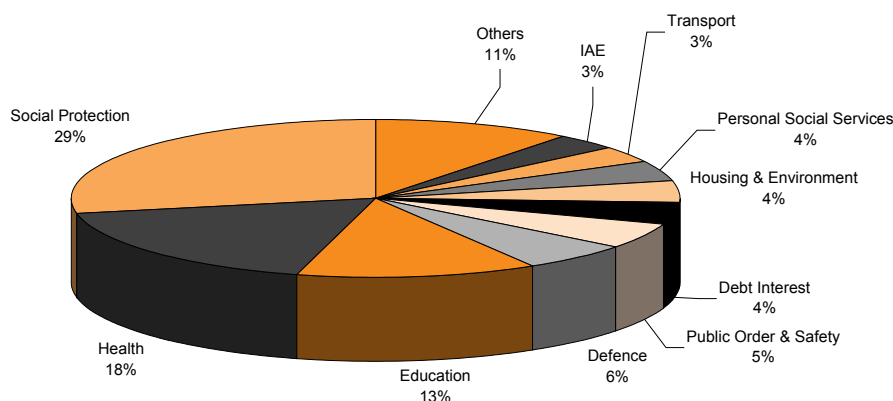
Indebtedness also poses a significant risk

The second major risk area – other than the property sector – is the scale of indebtedness of Dubai GREs and Dubai Holding. To some extent this is likely to be addressed with asset disposals, particularly of international holdings, and restructuring. In other cases, it is being deferred into the future, with rescheduling of privately owned debt over longer time horizons, and through borrowing from the Federally funded DFSF to pay down GRE debt, particularly that of Nakheel. Total debts of the Dubai Government amounted to just US\$19bn as of 30 September 2009, including more than half of this relating to the Dubai Financial Support Fund. However, by the end of restructuring this may be significantly higher.

The primary purpose of postponing repayments is to allow for an orderly asset disposal process. To this end we would expect to see Dubai World, and likely also Dubai Holding drip feeding assets into the market. Both have a significant portfolio of overseas assets that could be liquidated in an orderly manner. However, it remains doubtful whether disposals of its unwanted international portfolios will be sufficient to make a major dent in the overall debt pile. Consequently, Dubai GREs may also be forced to dispose of some of their more desirable local assets in addition.

However, although reducing debt levels with asset disposals is helpful, if Dubai Emirate were not able to achieve a fiscal balance, then continuing reductions of debt would be difficult. To this end, it is useful to compare Dubai's fiscal position and compare discretionary and non-discretionary expenditure with that of a developed country, and for this purpose we take the UK. With Dubai's current fiscal balance projected to be only 2% of GDP, it was really quite modest by international standards. Indeed, the total size of the budget was only 11-12% of GDP which compares to a figure of 35% for the UK.

Chart 20 : UK budgetary expenditure, 2008-09

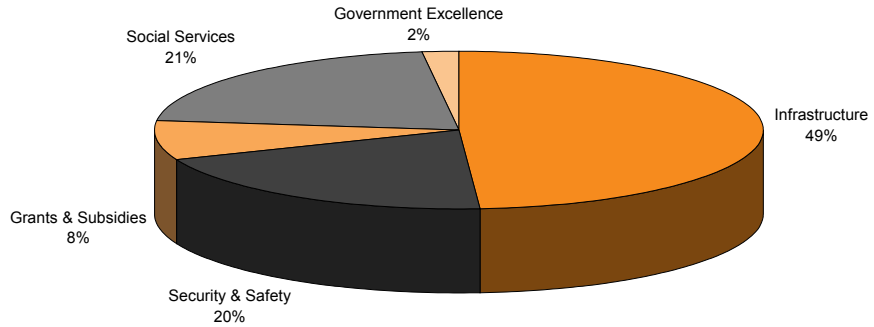


Source: HM Treasury

As can be seen from the pie chart, the three largest items are the three classes of social security. In the UAE, there is minimal social security for the expatriate population who instead have obligatory private insurance for health, and pay separately for private educational care. In addition, the state does not pay an unemployment benefit, with employees returning to their home countries if employment disappears. While there is some social security for citizens, the citizen population is itself quite small, particularly within the Emirate of Dubai, and the major benefits are mostly limited to interest-free loans, especially those for housing. In addition, the fourth-largest item, defence, is paid for out of the Federal budget.

Consequently, the major items within Dubai's budget are likely to be the police force, debt-servicing costs, road construction and citizen benefits. This can be seen in Chart 22 below, which suggests that the major components of the Dh35.4bn budget include infrastructure and social support. Total interest payments on a US\$100bn would of course be of the region of US\$5bn, a significant sum compared to the budget. However, the bulk of this will be paid for by the individual GREs.

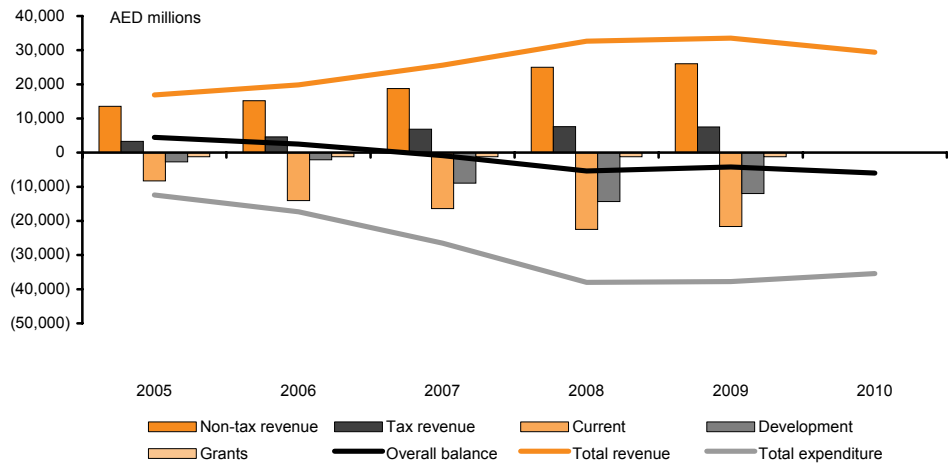
Chart 21 : Dubai budget 2010



Source: Department of Finance

Against this, there is the revenue-raising possibilities from three sources: 1) customs duties, licenses, lease agreements and other services related to the free zone fees; 2) revenue-generating commercial assets; and 3) revenue from oil supply estimated at up to 100,000 barrels per day. In the budget for 2010, these were estimated to raise Dh29.4bn, with, by implication, about a fifth of this coming from natural resources. Although this still leaves a Dh6bn budget deficit, equivalent to approximately 2% of GDP, this should be justified by excess infrastructure spend in the short term.

Chart 22 : Budgetary balance



Source: Department of Finance, Sourced from Prospectus

Looking again for growth

With the property sector taking a back seat, it's going to fall to other areas to drive growth, and that will depend on the attractiveness of Dubai for domestic investment. In this respect, we believe Dubai is a more attractive proposition than it has been recently.

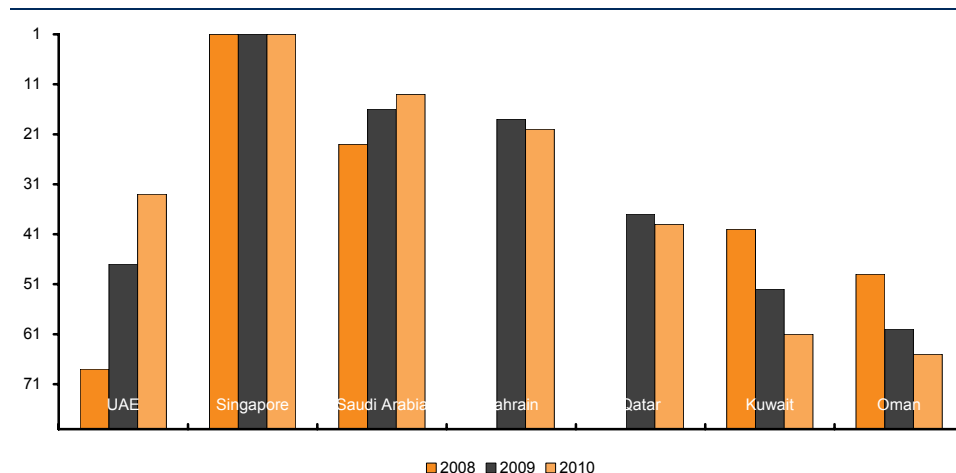
The Dubai offer to corporates

While it is possible to see some sectors of the economy returning to growth, primarily with an expansion of external demand, this will only have a limited impact on the domestic economy as a whole. For long-term sustained growth, and for an eventual resolution of property sector difficulties, Dubai will have to once again attract a growing population. For there to be a growing immigrant population, clearly there needs to be a growing labour market, and that involves attracting more corporates to do more business based out of Dubai.

The key attraction of Dubai is, of course, the zero-tax environment. In addition, though, free capital markets, low customs duties (particularly within the offshore environment), corporate-friendly and low-cost labour markets, access to skilled labour and a safe and pleasant living environment are all compelling features. The main weaknesses relate to contract enforcement, investor protection and, for those participating in the local market, adequate access to reliable, verifiable information.

As well as building an onshore business-friendly environment, the government has also set up a number of 'offshore' free zones across the city, designed to create a tailored business environment for specific areas of business, such as finance, shipping, aviation or media and technology. The free zones have their own sets of commercial laws in some cases, such as in the DIFC, and in all cases the free zones make explicit guarantees on tax-free status. These are mainly government owned, although TECOM, a part of Dubai Holding also manages a number of free zones. The free zones themselves earn revenues through trade licenses, fees and through property rental and sales. In return, the state guarantees a tax-free period, generally of 50 years.

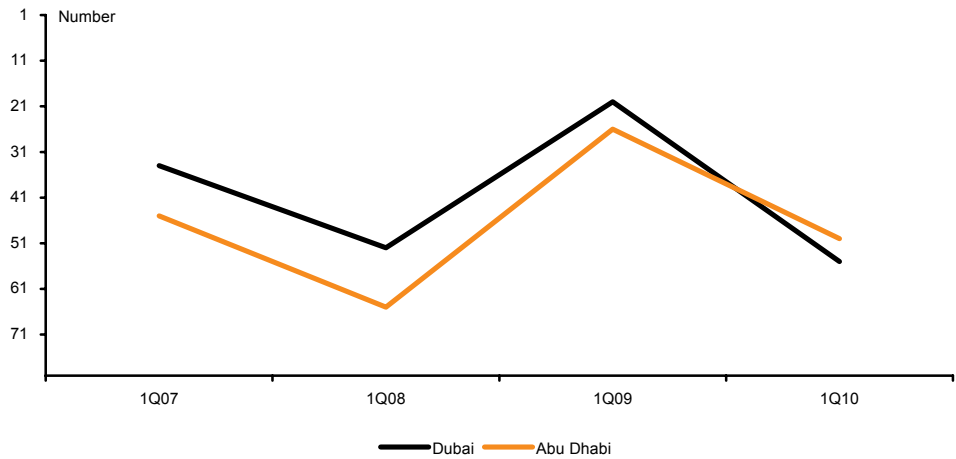
Chart 23 : IFC 'ease of doing business' rank



Source: World Bank

Overall, the UAE ranked 33rd on the World Bank's 'ease of doing business' survey, up from 47th the previous year. While this is respectable, the likely position of the free zones, with better investor protection, more streamlined processes and better contract enforcement procedures would almost certainly be higher. While during the boom, soaring costs were beginning to make the free zone concept less attractive, reduced rents have sharply improved the attractiveness of inward investment.

Chart 24 : Mercer cost of living ranking



Source: Mercer

One sign of clear improvement over a year ago has been on the cost of living, and therefore the level of comparative pay. While property inflation had previously driven Dubai up to a top-20 ranking, strong property and rental deflation has eased the cost of living back down to a position of 55. The lower cost of living is also likely to be a strong determinant of the attractiveness of the UAE proposition. In addition, with taxation on the rise elsewhere, this can only help the position of the UAE.

Conclusions for growth and risk

The World Bank suggests UAE real GDP growth of 1.3%, 3.1% and 4.8% for 2010, 2011 and 2015 respectively. While this suggests a strong positive, the reality is that this will be largely driven by the amount of oil being pumped, as well as by the steady expansion of the downstream petrochemical industry. As a result, the relationship between real GDP growth and real growth of the economy is a vicarious one. Compared to our expectations for the non-energy sector, we would assume that the IMF forecast paints a slightly too rosy picture, especially for the near term.

Chart 25 : GDP, constant prices, % change



Source: International Monetary Fund, World Economic Outlook Database, April 2010

For our part, we remain concerned about the impact of the property sector in Dubai, and particularly the office sector. While these difficulties have been exaggerated by the uncertainties of legal rights and enforcement (which we believe are now improving), the basic message is that there are high undesired vacancy rates with stock continuing to enter the market for the next three years.

In contrast, we believe that the questions as to the indebtedness will have a diminishing impact. The Dubai World restructuring has now been adequately reviewed by international banks, and while we don't have access to Dubai's long-term detailed plans, creditors that do seem confident about liabilities being funded.

In the long term, we believe Dubai is in a position to pay off its debts, mostly from income from its profitable investments, as well as income from the free trade zones, which we believe should resume growth and attract new business. Immigration is the key for most of the current issues, and that will depend on the strength of the labour market. However, how soon the business and investment community are willing to put their trust in this will depend on the determination of the authorities to provide clear, transparent and verifiable statistics.

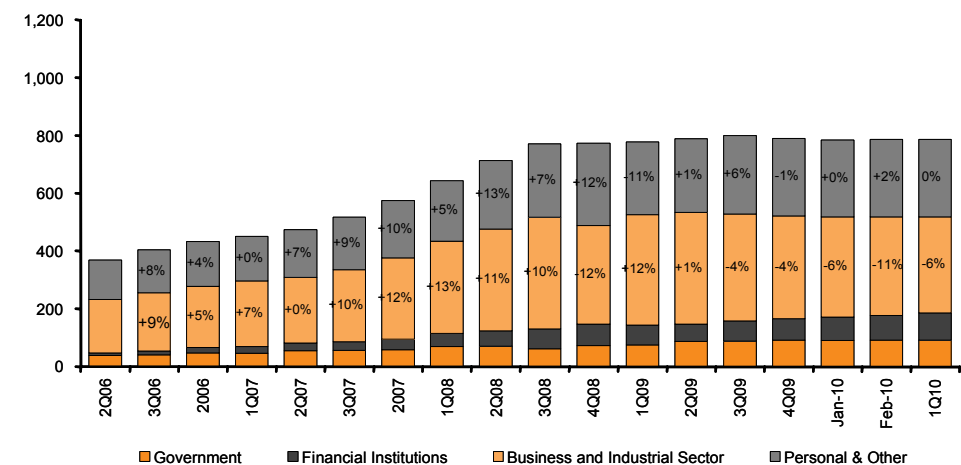
Banking system: still feeling the recession

Growth in the banking sector is nearly at a standstill following several years of rapid loan growth. We believe growth will recover but we do not expect to see it attain previous levels.

Sluggish loan growth and low profitability

It's clear that the UAE banking sector is going through a difficult time. Loan growth is down, provisions are up and profitability is bumping along the bottom. Furthermore, the economic backdrop is far from positive, with the solvency of the largest Dubai corporates uncertain (and the solvency even of Dubai seemingly in question) and with a property market not only moribund, but still expecting to see substantial deliveries over the next two years. It is difficult to see how these will be absorbed. On the other hand, given the seemingly much lower levels of gearing in Abu Dhabi and deep pools of liquidity, the situation is not as bad as it is in Dubai. However, given the overspill from problems in Dubai, and the weakness of its own property market, the situation can hardly be described as rosy.

Chart 26 : Bank lending, Dh bn, change qoq



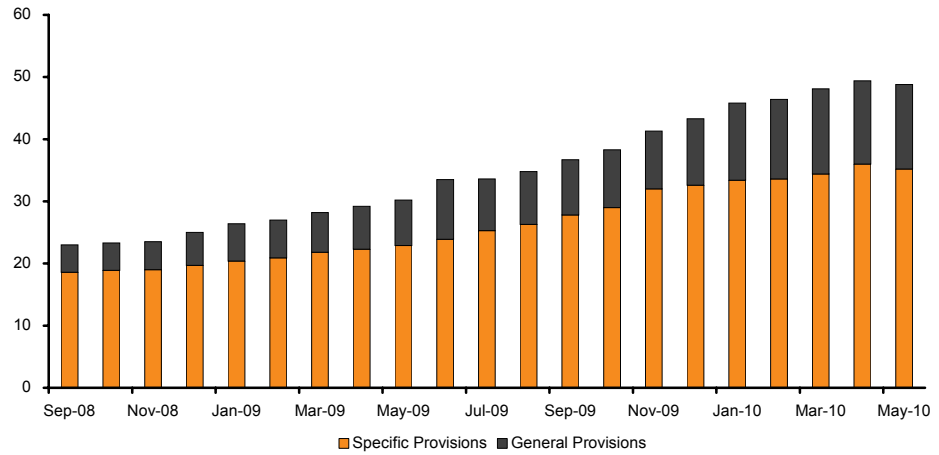
Source: Central Bank Statistics

For the moment, growth has stalled, with credit growth to residents of just 3% yoy for 1Q10, recovering from qoq decreases in the aftermath of restructuring. Banks have been preferring not to lend rather than making bad lending choices. Although the lack of credit growth could also be due to borrowers deciding to reduce investment and leverage-based consumption, we think the likelihood is that the primary driver is the banks focusing on the cost-of-risk, rather than growth.

Asset quality trends in the UAE banking sector

Unsurprisingly, with the property market as a backdrop, and debt problems in several major corporates, provisioning has been rising rapidly, with latest May 2010 data suggesting a 62% yoy rise to Dh49bn. However, slightly more positively, 1Q10 declines in provisioning at many of the banks indicated a level of confidence that NPLs were no longer accelerating. This is further corroborated by May 2010 mom data, which reflected a decline of 1.2%. Individual banks are also guiding to retail provisioning having reached a watershed, and that this is a leading indicator for the healthiness of corporate lending, as it suggests greater healthiness of the labour market.

Chart 27 : Specific and general provisions, Dh bn



Source : Central Bank UAE

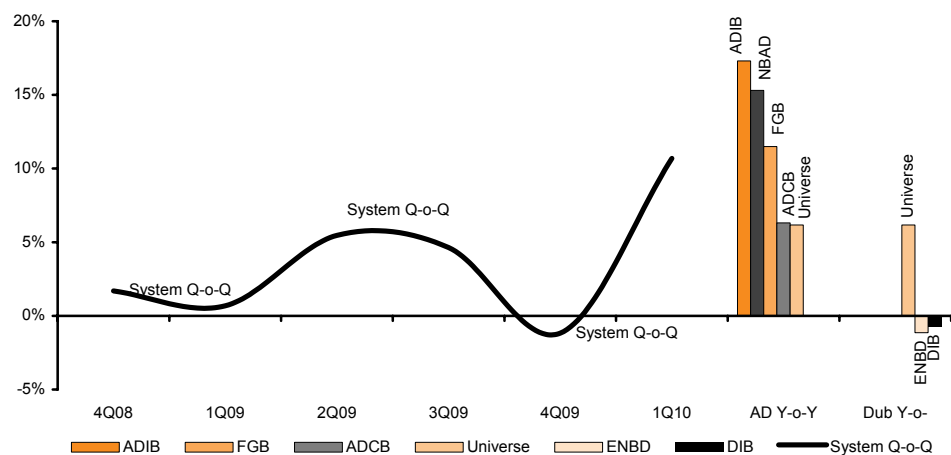
Although underlying provisioning may have passed its peak on a yoy basis, the Dubai World restructuring has yet to have an impact. We expect impairments to be taken by the most exposed banks in 3Q10. Nevertheless, we believe this spike is masking an underlying stabilisation.

No growth in Dubai

With the banks having shifted their sales teams over to debt collection, it is little surprise to see that loan growth rates remain weak (0.6% Ytd rise in sector loans). Loan growth did jump in March 2010, suggesting some growth momentum, but the reality is that growth stalled in April, suggesting the March figure may have been driven by a single large loan. The movement in bank deposits has been erratic, but cannot be clearly described as going in a positive direction.

Within the sector, the banks that we cover continue to take market share, accounting for 64% of loans and 62% of deposits. However, it is clearly the Abu Dhabi banks which have outperformed the Dubai equivalents when it comes to growth. ADIB has topped the market, reflecting its unique strategy (UAE national market penetration), while NBAD has also grown strongly on the back of close ties to the government and a relatively un-imperilled balance sheet. At the other end of the scale, the Dubai banks have been willing to surrender market share as they focus more on the quality of their loan books.

Chart 28 : Loan growth



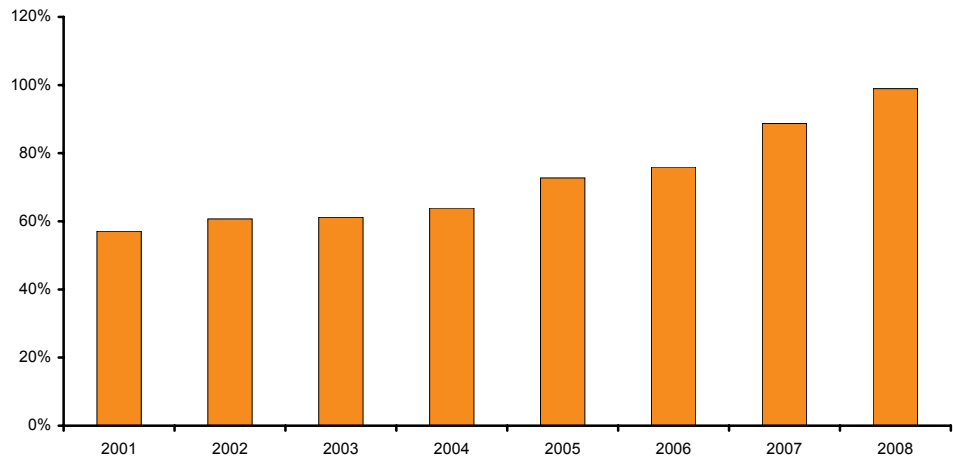
Source: Central Bank quarterly reports, Bank Quarterly reports

Going forward we expect very much more of the same. The Dubai-based banks may see their negative drift arrested and a shift back into positive growth, but we believe any growth for the Dubai banks will remain weak, and primarily driven by their Abu Dhabi branches. We estimate that they will recover to a growth rate of 10%.

Meanwhile the Abu Dhabi-based banks are likely to continue to see growth over the domestic average. ADCB and FGB are likely to remain the weakest of the four, given their broader

exposure to Dubai. We believe NBAD will benefit from growing government spending, while we expect ADIB to benefit from branch expansion and improvements in its customer service proposition as well as increased marketing expense plans.

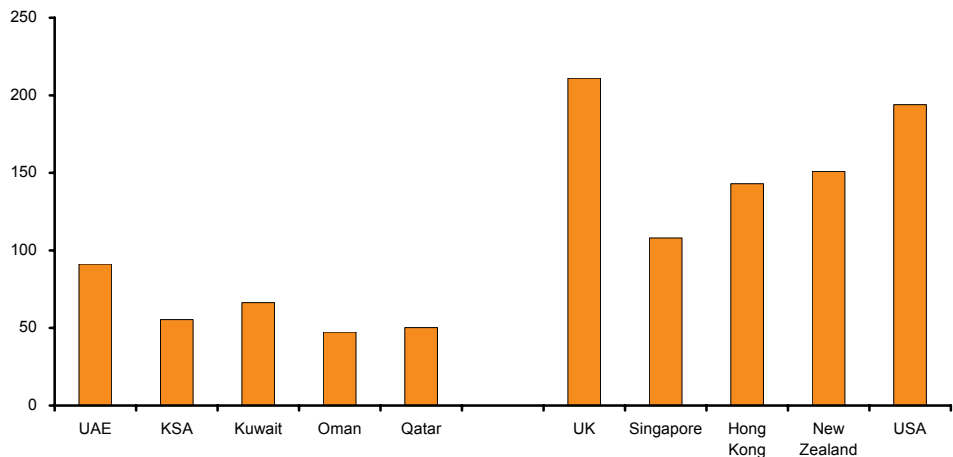
Chart 29 : Credit-to-GDP has risen precipitously



Source: CBUAE, UAE Ministry of Economy, Rasmala Research

Over the longer term, we do not believe that the banks will ever re-attain historical levels of growth, which saw credit-to-GDP rise from 60% to 100% in just five years, in spite of very strong nominal GDP growth. There are some areas of under-penetration still, including mortgages and SMEs. In addition the local population appears underserved, given the fact that they have stable job prospects and low default rates. In addition, we believe cross-border briefcase banking is a thing of the past, suggesting that banks loan growth rates may modestly exceed overall credit growth rates.

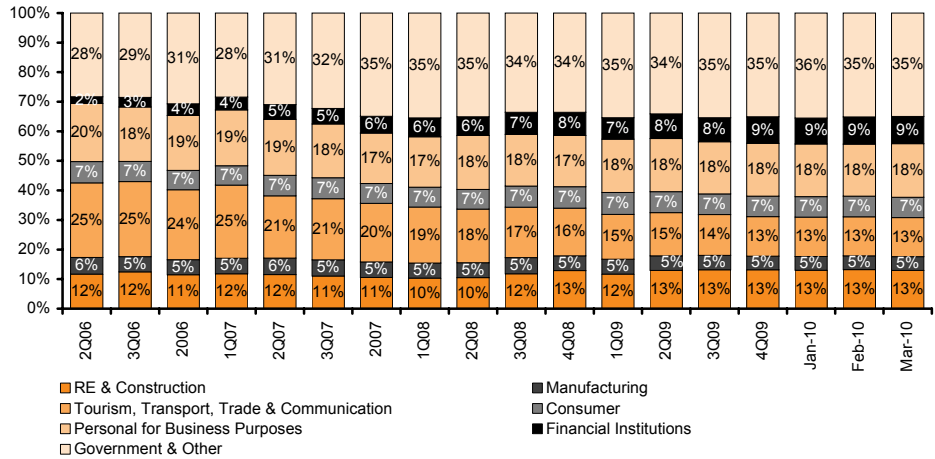
Chart 30 : Credit to the private sector (as % GDP) – cross-country basis



Source: World Bank, UAE central bank, Rasmala estimates

On a cross-country basis, we caution that the impact of having a large energy sector within GDP distorts these figures. We believe a better measure would be to exclude the energy sector from credit and from GDP, giving a result of 155%. On this basis, we believe the UAE is more fully penetrated than it seems, with a limited amount of product areas for above-trend growth. In particular, the most obvious area of underpenetration is on the retail mortgage side, where we believe there are structural reasons for lower penetration (consumer preferences among both the expatriate and local population), and where current momentum and pricing will prevent a rapid resurgence.

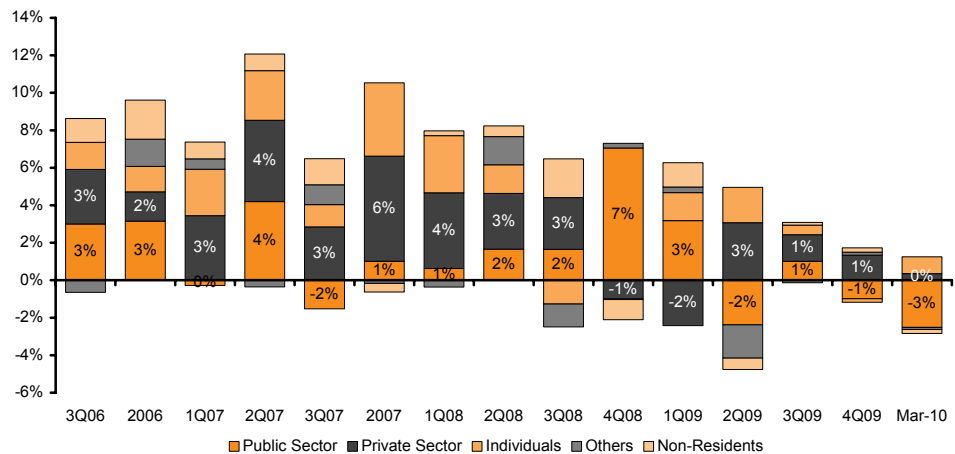
Chart 31 : Breakdown of lending by category



Source: Central Bank reports

In terms of specific numbers, we believe asset growth in Dubai is likely to be weak for the near future, and this year is unlikely to break into double digits. Abu Dhabi should be a little better, with infrastructure projects continuing to drive a little credit demand. We expect growth in 2010 to be weak (9% yoy rise) among the banks we cover. Recovery will continue in 2011F, but still at a modest rate of perhaps 10% for Dubai-based banks and an average of 15% for Abu-Dhabi-based banks.

Chart 32 : Bank deposits growth qoq, by factor contribution



Source: Central Bank

Deposit growth has also not been much to shout about, dropping into negative territory (May 2010 0.2% yoy decline). The main reason for that though has been the withdrawal of public sector credit over the past four quarters. We would expect deposit growth to pick up with loan growth. In the past, corporate or financial Euro Medium Term Note (EMTN) issuance allowed one or the other side of the market to grow disproportionately. However, over the next 12 months we expect EMTN issuance to be limited. The shift to rebalance the loan books is likely to mean that deposits are bid up, and those banks with already surplus deposits should find themselves well placed to defend themselves from returning spread pressure.

For now, though, growth is not the issue

Although growth is important, we believe the main drivers of stocks at the moment are only two things: balance sheet security and rebuilding returns. The main issues for balance sheet security, as we have discussed, are the fallout of the Dubai World scenario and the protracted downturn in the property market. Rebuilding returns on the other hand will be driven by a number of things, not least building up leverage again. We summarise this in the following section with a modified DuPont tree, using simple averages for the banks that we cover.

Rebuilding returns

Bank ROAEs are the primary driver of market valuations, and they are currently depressed by investment losses and provisioning. However, we believe a partial rebound is likely in 2011 due to easing provisioning, reduced writedowns and resumed revenue streams.

Returns on investments and property need to normalise

We believe that returns on equity bottomed in 2009 (10.7%), after at one time being well in excess of 20%. Although gearing levels were low going into the crisis, the prime impact on returns came from provisioning, resulting in a decline in ROAA (2009: 78bp yoy decline to 1.09%). The primary causes of the decline in ROAA have been lower revenues, from sources such as fee income, investment returns and property income, but especially excess loan provisioning.

With this in mind, we believe the following will need to occur to rebuild profitability. First, returns on underperforming asset classes needs to normalise, particularly on investment returns and on property. We model investment returns returning to a more normalised rate of 4-5% of underlying assets from 3Q10. If the banks could not achieve this, then they could use the assets to pay down interbank funding after all or yield high cost time-deposits.

More controversially, we assume that property returns should begin to normalise by the year 2012. We believe that banks will be slow to write down their property books, and that will be a drain on ROE as a result. Nevertheless, we expect some cash flow to re-emerge from 2012 onwards.

Visually there has also been a strong impact from tier 1 securities, which were provided as a boost to the balance sheets of all the banks in our sample except for DIB. These can be seen as the main negative influence on the 'XYZ margin', as we modelled them as an appropriation from profit. There will be a compensating improvement in 2009 margins of 23 basis points in 2009. We believe the issuance of the tier 1 deposits is a clear net positive, at least for the balance sheet, if not for the income statement.

Although both of these will affect non-core income, we also expect core non-interest income to show some improvement. Fees and commissions were also adversely affected, partially by declines in growth and partially by reduced demand for non-balance sheet services, such as asset management, FX, trade letters and so on. We expect that a return to growth and improvements in cross-selling should bring an improvement in the underlying contribution. Nevertheless, we believe most of the banks adjusted their fee schedules as the crisis was getting under way, and we see this as an area particularly prone to competitive erosion.

Chart 33 : Modified DuPont , investment universe of six banks, simple averages

STAGE ONE	STAGE TWO	STAGE THREE	STAGE FOUR	STAGE FIVE	ADDITIONAL COMMENTS
ROAE	Gearing	Total Capital Ratio			
FY08 FY09 FY10F FY11F	FY08 FY09 FY10F FY11F	FY08 FY09 FY10F FY11F			
18.3% 10.7% 10.7% 13.8%	10.59 11.09 11.13 11.00	12.3% 18.8% 18.8% 18.4%			
	ROAA	IEA / TA	Loans / IEAs		
	FY08 FY09 FY10F FY11F	FY08 FY09 FY10F FY11F	FY08 FY09 FY10F FY11F		
	1.87% 1.09% 1.09% 1.62%	84.5% 84.8% 85.1% 85.0%	83.2% 81.1% 79.8% 79.9%		
		Revenue / average IEAs	Interest Margins	Spreads	
		FY08 FY09 FY10F FY11F	FY08 FY09 FY10F FY11F	FY08 FY09 FY10F FY11F	
		4.47% 4.36% 4.43% 4.48%	3.15% 3.38% 3.27% 3.29%	3.27% 3.35% 3.28% 3.26%	
			Non Interest / average IEAs	Core Non-II to ave IEAs	
			FY08 FY09 FY10F FY11F	FY08 FY09 FY10F FY11F	
			1.33% 1.19% 1.16% 1.23%	1.36% 1.12% 1.05% 1.08%	
				Non-Core to ave IEAs	
				FY08 FY09 FY10F FY11F	
				-0.03% 0.07% 0.11% 0.15%	
		Net Profit Margin	Operating Margin	Cost-Income Ratio	
		FY08 FY09 FY10F FY11F	FY08 FY09 FY10F FY11F	FY08 FY09 FY10F FY11F	
		50.1% 25.4% 27.1% 41.2%	62.3% 66.3% 66.6% 67.2%	37.7% 33.7% 33.4% 32.8%	
			Provisioning Margin	Net Provisioning (as% Loans)	NPL ratio
			FY08 FY09 FY10F FY11F	FY08 FY09 FY10F FY11F	FY08 FY09 FY10F FY11F
			-13.8% -36.4% -35.4% -23.5%	0.95% 1.94% 1.81% 1.26%	2.45% 5.00% 5.27% 5.03%
			XYZ Margin		
			FY08 FY09 FY10F FY11F		
			1.6% -4.5% -4.0% -2.5%		

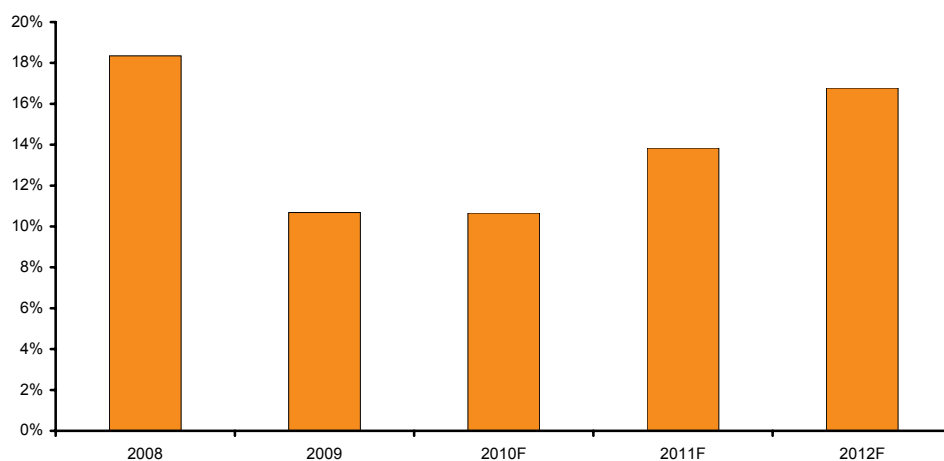
Source: Bank reports, Rasmala forecasts

As stated earlier, we believe the biggest improvement should be in provisions, with the negative provisioning margin shrinking from -36.4% in 2009, back to a level in the low teens by 2012. Historical provisioning has been as low as 30 basis points. Consequently, the jump to a 194 basis point provisioning level has hit returns hard. While the troubled property market will keep NPLs high and provisioning elevated in 2010-11, we expect provisioning will return to a normalised level beyond that.

The only negative for ROAAs and ROAEs will occur in costs, in our view. Normal growth costs have been rapidly scaled back. Although a reduction in the focus on collections should free up some costs in the medium term, our overall assumption would be that increased investment in growth would more than counterbalance this. Even so, cost-income ratios should decline modestly as revenues recover, with our estimates suggesting a drop from 33.7% in 2009 to 32.8% in 2011.

Equally importantly for ROAEs would be an increase in the level of gearing. We believe gearing ratios could reach 12x. Indeed, with the tier 1 debt capital available, the banks could take leverage to 15x by issuing tier 2 capital, although we don't think that's advisable or likely. In the longer run though, we believe that the minimum total capital ratio will be reduced from 12% back to 10%, which would make a leverage ratio over 12x more feasible.

Chart 34 : ROAE, average across six banks



Source: Company reports, Rasmala forecasts

Prospects for growth

We see little growth in the medium term, with lending in Dubai growing by 5% in 2010 and recovering to 10% in 2011, this will be particularly constrained by over-indebted companies and the gradual deleveraging of the personal and property sectors. In Abu Dhabi, we believe short-term growth will be stronger, with infrastructure spending and some SME lending being bright spots, and with less of a drag from personal and property lending. Given the overall level of indebtedness, however, we foresee no return to the exceptional levels of growth seen in the past, and a cap on lending growth at 15% beyond the immediate time horizon.

Given reduced competition from suitcase bankers, international banks and external financing, we believe the scope exists for loan growth among the six banks we cover to credit growth for the system as a whole, which may be significantly weaker. Given the circular flow of money, we estimate deposit growth will be broadly similar, although shifts in the funding base away from wholesale funding will create a positive differential for deposits, particularly for those banks like ENBD and ADCB that have significant wholesale and capital market funding. Banks with significant non-deposit funding are likely to aggressively pursue deposits, as well as deprioritising loan growth.

For those banks with low loan-to-deposit ratios, we would expect them to be well-positioned to take market share without compromising pricing. In short, the banking sector is shifting from competing on asset growth to competing on deposit growth, and those banks with high deposit contributions are clearly going to be better positioned. In addition, those banks less exposed to

overleveraged sectors such as property and construction should be able to grow faster, as should those with close links to the government and who are in a position to benefit from increased infrastructure spending, such as NBAD. Finally, Islamic lenders are also likely to benefit from a less leveraged consumer, who has traditionally not benefited from the full range of banking services.

Sustainable growth

The number one argument for financial services growing faster in emerging markets is the low penetration/growing middle class argument. Although within MENA, this argument does hold water in Egypt and Saudi Arabia (and eventually Iraq), it is difficult to sustain in the UAE. Instead, within the UAE the two main demographic trends are the estimated 2.5% population growth rate among bankable nationals (those over 20), and net immigration driven by the increasing size of the labour market. It is also possible that the UAE will open to non-productive immigration (retirees) at some point.

How fast can the labour market grow? Supply is not an issue (given the geographic proximity to Egypt and India), so the key question will be on demand, which will depend on the rate of growth of the non-oil economy (63% of GDP) generally. In turn the strength of the local economy can be split into that dependent on local demand, and that driven by international demand. The former is really just a multiplier, with the latter being the key driver. For this 'offshore' business the key driver will be the ease of doing business.

Are there risks? Economic planning is partially driven by the need to trickle down wealth (particularly resource wealth) into creating opportunities for citizens, and so far this has been a mixed bag. On the consumption side, Dubai has been a runaway success. Indeed, also on the capital side, the opportunities for entrepreneurs and investors have been impressive. However, private sector labour participation rates of UAE nationals have been low, and for the economic experiment to be deemed a success, this will have to change.

While the demographics are helpful, driven by large immigrant populations and a young local population, they are not the whole story. In addition, we believe there is still some scope for financial services to take a growing slice of the GDP pie. This will be driven by a number of factors, such as improved property rights, and improved credit assessments enabling larger credit limits for those individuals and corporates with better risk profiles, risk-responsive pricing and better products increasing demand, and an improved focus on selling non-balance sheet products.

Might Dubai compete internationally? It's a possibility. In the retail segment the focus will be on bringing a bigger slice of the pie onshore. In the corporate segment, property rights are likely to be the biggest feature. Banks, which currently have a reputation for changing contracts after they have been written, are not encouraging international inflows.

On the downside, segments of the economy will be deleveraging over the next few years, and in the world's property market, GSE and Dubai feature quite heavily here. We believe this deleveraging should be largely complete before the end of the explicit forecast period, but this will no doubt be a drag on growth.

Valuation methodology

We use a three-stage Gordon growth model as our basic valuation tool. The first stage is explicitly forecast for the period 2010 to 2013. Beyond 2013, we assume an efficient capital structure and then use structural ratios guided by 2013 exit variables. We use as key inputs to our model just two exit variables and three modelling variables:

- the initial level of RWA, equal to the 2013 RWA;
- the initial common equity capital, equal to the exit common equity capital;
- RWA growth rate;
- a target equity to RWA ratio; and
- an efficient ROE, based on removing excess capital and assuming a return contribution on that excess capital of 5%.

Beyond 2024, we use a standard GGM, with an ROE of 11% and growth rate of 6%. We use a single discount rate throughout the period, for comparability purposes. However, we believe this would be better structured as an elevated short-term discount rate, and a lower long-term discount rate, although the result is the same. The discount we use is based on a risk-free rate of 3.1% (US 10-year bond yield), a country-risk premium of 6% and a sector-risk premium of 5%, as well as a stock-risk premium in the range of 0-5%.

Uncertainties, forecast bias and discount rates

We aim to encapsulate with our discount rate not only the basic cost of capital and the level of uncertainty, but also investors' risk appetite and the greater downside risk. We base our risk free rate assumption on 10-year US Treasuries, currently trading at 3.1%.

Uncertainty and risk appetite

Risk appetite for the Middle East as a whole, and for the UAE in particular seems low at the moment, with foreign ownership levels and trading volumes both in the doldrums. While this is partially a result of global uncertainty, the lack of visibility in these markets is also a factor.

We believe the cost of risk will decline over the coming year, which reflects our unusual amount of uncertainty on the current environment. In particular, the overhang of property, the state of government finances, changes to the law, and reliable information about immigration levels, as well as where peak NPLs are headed. Many of these issues will have moved significantly towards a conclusion over the next 12 months, and it is difficult to imagine an endogenous shock which could compare, although exogenous geo-political developments would certainly be uncomfortable.

Forecast skew

We have outlined what we believe to be the most likely scenario, but if we are wrong, the likelihood is that the situation would be more negative than described. Exogenous shocks provide a low-likelihood, high-impact scenario, while the possibility for Dubai's debt problems rumbling on are also a strong possibility. The failure of rebooting immigration would also mean the property overhang would weigh heavily on the market.

In the long run, the lack of Emiratis in the labour market must also be considered a risk, given the low level of participation in the private sector, higher levels of unemployment and a growing labour force. Finally, potential changes to the legal environment and/or taxation could also add risk, although this is more evenly balanced.

Conclusion

We assume a basic discount rate for the sector of 14.1%, which is composed of a risk free rate of 3.1%, a country risk premium of 6.0% and a sector risk premium of 5.0%. In addition, we add a further stock premium of 0-5% for individual stocks. If all currently pending elements were to take a positive course, we could lower our discount rate by as much as 4%, which could raise our target values by approximately 40%.

Recommendations

Given our generally bullish view on the economy (in that we assume that it will recover eventually), it should come as no surprise that we prefer the value plays, Emirates NBD and ADCB. Although we are concerned about the impact of the Dubai economy on the balance sheet of both banks, we believe the current valuations take this into account, with ENBD and ADCB trading at a 33% and 37% discount to sector averages respectively. We also maintain a positive rating on NBAD, which trades at an 45% premium to the sector average 2010F PTB. We believe that it has minimal Dubai risk, and should be able to maintain a premium ROE of 19%.

Table 2 : Bank sector valuations

	Close		Rec	Last		PER			PBR			ROE
	(Dh)	PT		Yield	2009	2010F	2011F	2009	2010F	2011F		
ADIB	2.45	2.67	Hold	6.8%	421.3	9.3	5.0	1.2	1.1	1.0	15%	
ADCB	1.57	1.81	Buy	0.0%	nm	40.5	4.8	0.6	0.6	0.6	9%	
DIB	1.94	1.97	Hold	7.3%	7.5	8.2	6.9	0.9	0.9	0.8	12%	
ENBD	2.48	3.26	Buy	8.1%	4.3	12.7	3.9	0.7	0.6	0.6	13%	
FGB	14.90	16.27	Hold	3.0%	7.0	7.1	5.2	1.3	1.1	1.0	17%	
NBAD	11.15	12.86	Buy	0.8%	9.1	7.9	6.3	1.6	1.4	1.2	17%	

Prices as of 01 July 2010
Source: Company data, Rasmala forecasts

We are less keen on FGB and ADIB, which now trade at premium valuations of 17% and 19%, on our estimates. In addition, we have little visibility on the property portfolios in both cases, and other areas of concern. We are least keen on DIB, which trades at a discount of just 2010F PTB of 11%, despite having significant property exposure through different channels.

Recommendation structure

Absolute performance, short term (trading) recommendation: A Trading Buy recommendation implies upside of 5% or more and a Trading Sell indicates downside of 5% or more. The trading recommendation time horizon is 0-60 days. For Australian coverage, a Trading Buy recommendation implies upside of 5% or more from the suggested entry price range, and a Trading Sell recommendation implies downside of 5% or more from the suggested entry price range. The trading recommendation time horizon is 0-60 days.

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

Abu Dhabi Comm Bank (RIC: ADCB.AD, Rec: Buy, CP: Dh1.57, TP: Dh1.81): We believe the main risk to our GGM-derived target price is potential exposure to Istithmar or other leveraged PE entities, should they turn out to have greater problems than currently disclosed. In addition, we have concerns about generally higher provisioning, although we believe we have been appropriately cautious. Finally we have concerns about ADCB's weak communication policy, which continues to be below the market standard.

Abu Dhabi Islamic Bank (RIC: ADIB.AD, Rec: Hold, CP: Dh2.45, TP: Dh2.67): Downside risks to our valuation include a severe decline in Abu Dhabi real estate prices and management not being able to achieve its core business targets of 25% ROE, a cost-to-income ratio of 33% and annual growth of 20%.

Dubai Islamic Bank (RIC: DISB.AD, Rec: Hold, CP: Dh1.94, TP: Dh1.97): Upside risks to our GGM-derived valuation and target price include substantial improvement in performance of Dubai-based companies and a stabilisation of property prices in the Emirate. Downside risks, on the other hand, would be continuous deterioration in contribution from associates (primarily Deyaar) and subsidiaries.

Emirates NBD (RIC: ENDB.DU, Rec: Buy, CP: Dh2.48, TP: Dh3.26): From a risk perspective, we acknowledge that the balance sheet has weaknesses. Furthermore, the weakness of the Dubai economy remains a poor backdrop for the bank. Also, a highly negative scenario would likely involve one of three possible situations: a write-down of UP, a substantial restructuring of loans to government-related PE companies or a much higher NPL ratio and, by implication, higher provisioning.

First Gulf Bank (RIC: FGB.AD, Rec: Hold, CP: Dh14.90, TP: Dh16.27): 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.

Ntl Bank of Abu Dhabi (RIC: NDAB.AD, Rec: Buy, CP: Dh11.15, TP: Dh12.86): Upside risks to our valuation include a substantial increase in government spending on Abu Dhabi infrastructure.

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