7 July 2010

Initiation of coverage

Buy

Target price
Dh1.81

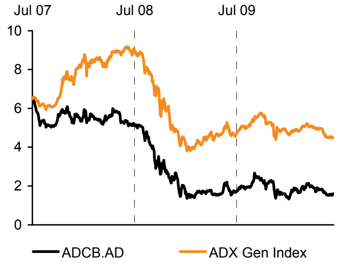
Price
Dh1.57

Short term (0-60 days)
n/a

Market view
No Weighting

Price performance

	(1M)	(3M)	(12M)
Price (Dh)	1.63	2.09	1.59
Absolute (%)	-3.7	-24.9	-1.3
Rel market (%)	-3.0	-15.1	2.8
Rel sector (%)	-5.3	-15.4	-1.8



Market capitalisation
Dh8.79bn (€1.92bn)

Average (12M) daily turnover
Dh5.13m (US$1.45m)

Sector: ADX Bank & Fin Index
RIC: ADCB.AD, ADCB UH
Priced Dh1.57 at close 1 Jul 2010.
Source: Bloomberg

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Abu Dhabi Comm Bank

Risks quantified

At a 40% discount to book value and with the full backing of the Abu Dhabi government, ADCB appears to be well positioned to absorb losses it has booked in the past and to push forward with a more disciplined investment approach. We initiate at Buy with a Dh1.81 target price.

Key forecasts

	FY08A	FY09A	FY10F	FY11F	FY12F
Reported PTP (Dhm)	1,530	-153	499.5	2,107	2,592
Reported net profit (Dhm)	1,237	-559	136.0	1,764	2,058
Reported EPS (Dh)	0.26	-0.06	0.04	0.32	0.41
Normalised EPS (Dh)	0.26	-0.06	0.04	0.32	0.41
Dividend per share (Dh)	0.10	0.00	0.13	0.11	0.09
Normalised PE (x)	5.94	n/m	40.50	4.84	3.83
Price/book value (x)	0.57	0.58	0.60	0.56	0.50
Dividend yield (%)	6.37	0.00	8.19	6.74	5.41
Return on avg equity (%)	9.43	-3.69	0.92	11.60	12.40

Accounting standard: IFRS
Source: Company data, Rasmala forecasts
year to Dec, fully diluted

ADCB's balance-sheet quality concerns persist but are easing

With the Malaysian stock market recovering, we now believe the mark-to-market risk related to ADCB's 25%-owned Malaysian associate RHB Capital has significantly abated. In addition, ADCB's investment book is now nearly fully written down and our concerns about its property book, on which it has taken a 9% write-down, are somewhat reduced.

Putting its 'accident-prone' reputation behind it

ADCB has had direct exposure to nearly every risky asset in the Persian Gulf region and beyond, including US subprime, Saad/Algosaibi and Dubai World, but has, in our view, taken appropriate steps to help mitigate the risk of a repeat scenario through changes in management and systems. We believe its recent policy suggests a new culture of disclosure and, we hope, prudence. We expect 2010 to be a watershed year for many of its legacy issues, including the Dh4bn investment book, the Dh2.2bn of Saudi exposure and Dh9bn of Dubai World exposure.

Main downside risk – uncovered NPLs

The key remaining problem is its uncovered NPLs: the total NPL ratio had risen to 5.2% by end-2009 and we expect further increases. Meanwhile, the coverage ratio was just 68% at the same date. This shortfall is now Dh2bn, which, even if it were justifiable, is significant compared to the rest of the sector.

Valuation and recommendation

ADCB is the cheapest stock in our universe of UAE banks, trading at a 2011F adjusted PE of 4.8x and a PB ratio of 0.6x. Although it is clearly one of the riskier stocks, we do not believe it merits a 37% discount to the UAE sector average. We base our valuation on an appropriately cautious discount rate of 18.7%,, with low expectations for medium-term ROEs (18%) and an elevated cost of risk for three years (174bp average). On this basis, we ascribe a target price of Dh1.81, based on a three-stage Gordon growth model, suggesting a 13% upside potential to the current share price. We assign a recommendation of Buy.

Risks quantified

At a 40% discount to book value and with the full backing of the Abu Dhabi government, ADCB appears to be well positioned to absorb losses it has booked in the past and to push forward with a more disciplined investment approach.

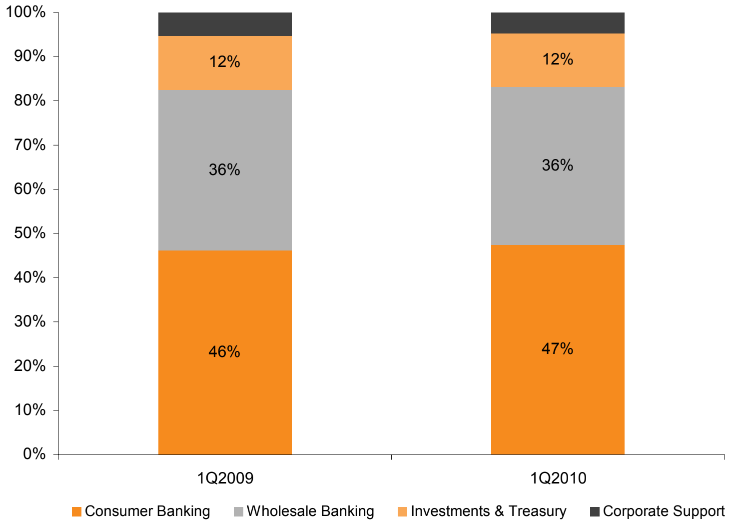
One of the largest UAE consumer banking franchises

Although ADCB is the third largest bank in the UAE in terms of assets (market share of 11.5% in 1Q10), it has only the seventh largest distribution network, with 48 branches, ahead of FGB. It chiefly operates in consumer and wholesale banking, which contributed 47% and 36% of its 1Q10 revenue. Key operations within consumer banking are personal accounts, loans, credit card services, bank assurance and Islamic banking products; wholesale banking is dominated by financing, cash management, trade and treasury and investment services. The third operational division is investments and treasury, which incurred many of the recent investment losses.

Internationally, ADCB maintains two branches in India, with no plans for further expansion. International loans accounted for 7.9% of the loan book as of 1Q10, with the bulk of these being cross-border loans in the GCC.

ADCB is 65% owned by the Government of Abu Dhabi via the Abu Dhabi Investment Council, With a free float of 35%, the stock has foreign and GCC ownership limits of 25%, but is very far from reaching these limits, with just 0.5% GCC ownership, 0.6% other Arab and 1.8% other foreign.

Chart 1 : Revenue split, by division



Source: Company reports

Strategic pursuit of inorganic growth and sticky deposits

Given ADCB's limited direct communications with the market, we have had to infer much of its strategy based on the company's recent activity. The most visible recent developments have been at the periphery of the business: the de-prioritisation and thus potential partial disposal of its mortgage associate Abu Dhabi Finance; the rearrangement of its JVs with Macquarie Bank; and a new Swiss private banking JV with Schroder's. Other developments have been more internal, such as building out the new SME operation, BusinessEdge.

We believe the less visible, internal challenges are likely to be the most critical. We assume one of the company's key strategic objective is the rebalancing of its funding base, which suffers from the highest loan deposit ratio in the sector at 130% and is significantly supplemented by capital market borrowing of Dh36bn, equivalent to 22% of total assets (see Chart 5). The bank plans to avoid refinancing a large portion of its debt at high rates and perhaps short-term repayment schedules, which would increase the already-mismatched asset-liability profile. Therefore, we believe finding sufficient 'sticky' deposits and, if necessary, spending to offer these at attractive enough terms could be an important part of company's strategy.

Macquarie JVs

The two JVs with Macquarie Bank – an infrastructure fund and a treasury fund – were designed to deliver corporate finance solutions to clients without ADCB having to spend time building a team from scratch. They were thus aimed at combining the skill base of Macquarie Bank with ADCB's customer book, with ADCB retaining rights to the client.

The JVs' profitability was initially impressive in 2007-08, with ADCB booking Dh244m of profits in 2008, its best year, equivalent to 16% of net income before minority deductions of Dh122m. However, the following year was clearly a difficult one, with profits declining 62%. Although ADCB indicated the business had simply fulfilled its objectives, it decided to put the treasury JV into run-off, while retaining and expanding the infrastructure JV.

Acquisition of RBS's UAE retail business – three branches and a credit card portfolio

We believe ADCB's key short-term objective is to complete its recently announced purchase and integration of RBS's retail business in the UAE. We have few details at the moment, apart from the fact that this business includes three branches and a strong credit card portfolio. The acquisition cost was just Dh54m, although a certain amount of equity will be added to the business. According to ADCB's press release on the purchase, Dh46m of intangibles will be generated. We have not yet adjusted our numbers for this, but believe the transaction will be completed sometime in the third or fourth quarter and that it will expand ADCB's total assets by less than 10%.

Securing the balance sheet

ADCB currently trades at a 40% discount to historical book value, which implies either that it will be unable to return to profitability or there are serious concerns about its book value, which we believe are only in part justified. This is perhaps not surprising given that nearly every major negative news event over the past two years has had some negative repercussions for ADCB (at least until Greece and BP). Although the market recovery has offset the bad news in some of these areas, we see four vulnerable areas of the balance sheet: associates, the investment book, property investments, and the loan book.

Associates – RHB Capital looks solid

ADCB has one major associate: the 25% stake it bought in RHB Capital of Malaysia in 2Q08. RHB Capital is "the fourth largest fully integrated financial service group in Malaysia", including a conventional and an Islamic bank, with some regional diversification, as well as an insurance company. ADCB paid a hefty 36% premium to market value at the time, valuing the acquired stake at Dh4.4bn, equivalent to 3.1x BV.

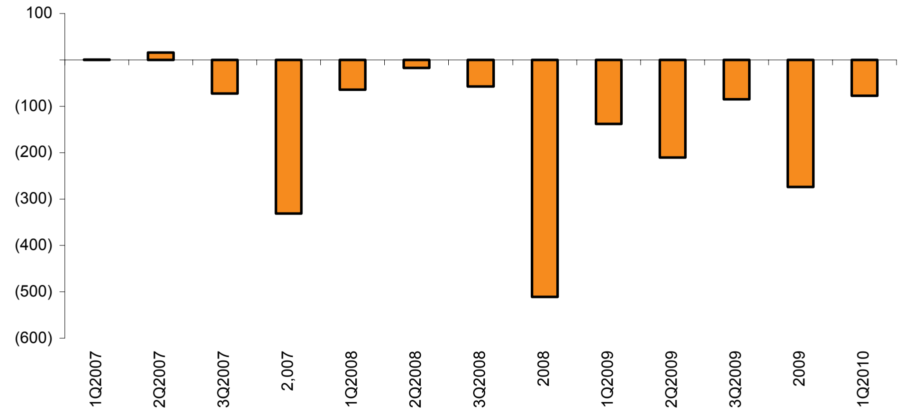
After RHB Capital shares peaked at RM5.35 in May 2008 (still short of the RM7.20 acquisition price), it collapsed to a low of RM3.06, before recovering to the current level of RM5.85. In principal, this would value the stake at approximately RM3bn, or Dh3.5bn, about Dh1.3bn short of the current book value.

ADCB could claim that the market has undervalued the relatively illiquid stock. RHB's profitability of 14.5% has been relatively steady through 2009, the year of the financial crisis. Net interest income accounts for 66% of revenue and is sufficient to cover combined costs and provisioning by 113% in 2009. Fee and foreign exchange income accounts for the bulk of other revenues. In short, the quality of earnings seems to be good. With RHB trading at 11x earnings and 1.4x 2009 book value, ADCB may be right in its assessment.

Investment book – no more to lose

The investment book has certainly been a source of much woe for ADCB. It first started recording losses in 2006, but the problems increased in 2007, when it started reporting large US subprime losses on ABSs, CDOs, SIVs and FRNs. In total, losses to date have reached Dh1.8bn, equivalent to 47% of its original investment value and 18% of book value.

Chart 2 : Three years of trading and investment losses (Dhm)



Source: ADCB reports (dividend income + gain on investments + impairments of investment securities & CDSs)

The good news is that we believe the losses have bottomed. The CDO and FRN books combined now total only Dh431m, down from a peak of Dh1.7bn in 1Q08, and the equity book amounts to only Dh240m (mostly unquoted), down from a peak of Dh531m in 2Q09. Most of the rest of the investment book is in listed bonds and government securities. Although there may be some remaining Dubai World and Nakheel exposure that will need to be written down (we have assumed that related writedowns are within the loan portfolio), the pain appears to have diminished. For its part, ADCB highlights only a further Dh300m as being “potentially toxic”, for which we have assumed a further Dh100m writedown.

Property investment – head office to take a haircut?

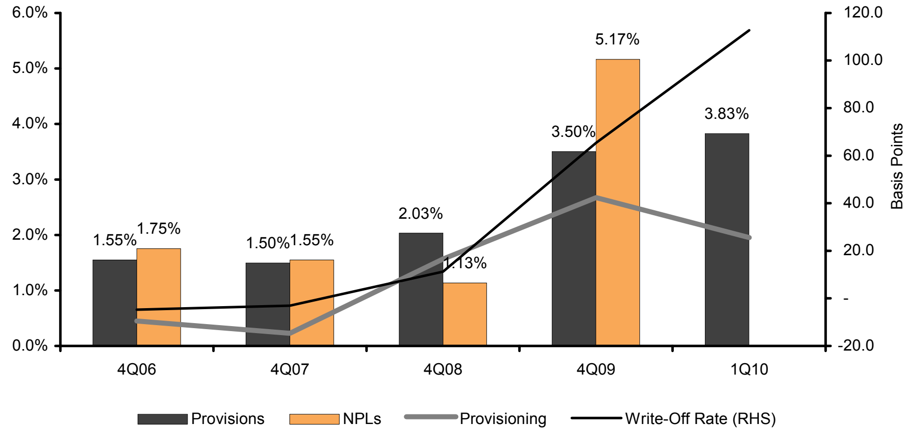
The property portfolio amounts to Dh549m and relates primarily to unused floors within the ADCB head office. The value was initially disclosed at Dh446m (including a Dh249m write-up), before being written up further to Dh632m, and then being written down again to Dh549m. Although the latest valuation is provided by independent agencies, we believe a further writedown would be justifiable. Property prices are back at 2007 levels, which in this case would mean Dh197m. However, with ADCB’s real estate at full occupancy and drawing rent, we question whether the company will apply an impairment charge. We assume a further Dh50m charge is booked in 2Q10. Declining market prices and potentially lower rental yields in the Abu Dhabi office market are likely to be the triggers.

Loan book – provisioning shortfall our primary concern

ADCB did not disclose an NPL number at the end of 1Q10, but as of 4Q09, the NPL ratio had jumped to 5.17%, with a coverage ratio of just 68%. Although ADCB may have been more forthcoming about NPLs than its competitors, this does not fully offset our concern about a provisioning shortfall.

In contrast to its Islamic bank peers at no more than 2bp, ADCB’s write-off rate has risen sharply to an annualised equivalent of 112bp (see Chart 3). Although this rate is exceptionally high by UAE standards, we assume it will remain at this level for several years to come. However, if it rises significantly, the current coverage ratio will likely prove inadequate. Overall, the coverage shortfall amounts to Dh2bn, equivalent to 13% of common equity. By comparison, we forecast Dh10bn of provisioning between 2Q10 and 4Q12. Consequently, we believe ADCB has been unduly punished for its high write-off rate.

Chart 3 : Provisioning and NPLs



Source: Company reports

Specific exposure

ADCB's primary exposure in 2009 was to Saad and Algosaibi, amounting to Dh2.2bn. Following central bank guidance that UAE banks should make provisions for 50% of all loans related to these two groups and 100% for those related to their financing arms, we believe total related provisioning now exceeds Dh1.5bn. Any uncovered portion would, of course, be included in the above shortfall, and should be relatively minor.

In 2010, the company's primary exposure announcement has been to Dubai World, at Dh9bn. As discussed in more detail in the main body of this report, we believe a 15% haircut on the portion of this exposure that is subject to restructuring is quite likely, although this is probably above market consensus. However, the main uncertainty is how much of the Dh9bn is subject to restructuring. For ENBD, we assumed it was about two-thirds of the total amount. However, for ADCB, management guidance is for a "much lower" number, which we assume is one-third of the total exposure, with the remainder being loaned to Dubai World's subsidiaries, Istithmar and/or Nakheel. We therefore forecast total restructuring impairments of Dh450m. So far, we believe that, following the recapitalisation of Nakheel, any writedowns will be minor. For Istithmar, we have limited hard facts, although the UAE banks have stated with confidence that losses will be minor.

Analysis of risks facing ADCB

A writedown on RHB Capital is possible but, from what we know, we do not believe it will be necessary. Further writedowns of the investment book are likely, but should be short term and relatively small. Property investments are still cash-generative and have already been written down. With our provisioning numbers, we believe we now appropriately account for the Saudi exposures, the Dubai World restructuring and the Nakheel exposure. Consequently, we believe ADCB's main risk is exposure to the troubled Istithmar vehicle, on which ADCB and the other banks are confident. We capture this risk in the discount rate below.

Forecasting some recovery

Despite balance sheet problems, ADCB's income statement displays more positive trends: steadily increasing net interest income; strong, stable fee and commission income; and efficient cost ratios.

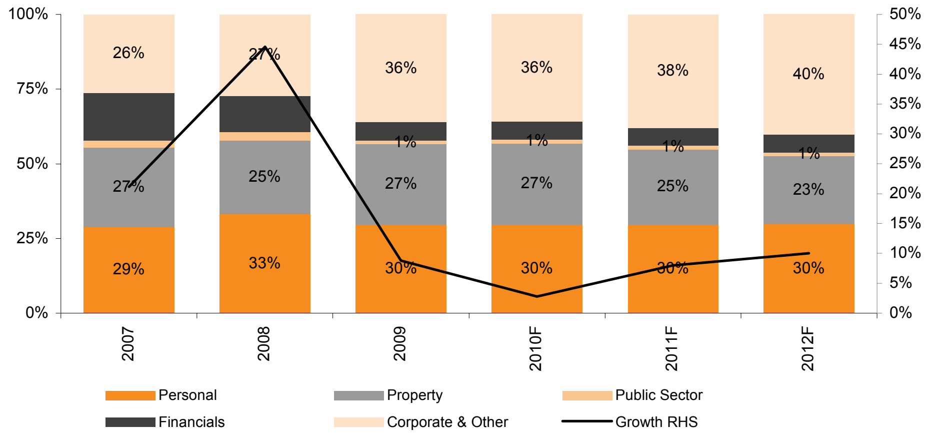
Although ADCB has a history of underperforming expectations with exceptional losses on its investment book, loan book or property book, we believe many of these losses have followed the general theme of 'yield-chasing', which does not focus sufficiently on the risk side of risk/reward. The various changes in management around the beginning of the crisis should provide a fresh start, once the legacy issues have been resolved. Going forward, therefore, we believe ADCB will come closer to matching market expectations.

Balance sheet short on deposits

Recent growth at ADCB has been driven predominantly by personal lending, with ADCB marketing aggressively in both Dubai and Abu Dhabi, and providing a strong value proposition to customers. During 2008, retail loans nearly doubled, rising 91% to 13% of the book, against 45% growth for the loan book as a whole. Personal loans not secured on salary rose even faster, jumping 92% over the same period to 7% of the loan book. Elsewhere, only growth in loans to the service and construction sectors increased, contributing Dh6.8bn and Dh9.6bn of the overall increase in gross customer loans of Dh34.2bn.

With the exception of construction loans, growth in these sectors came to a halt in 2009. Service sector loans jumped Dh11.5bn, but this was mostly due to a recategorisation of a single large loan (perhaps Dh6.5bn) from financial institutions to services. Consequently, although there was some growth in 2009, it was largely in two of the areas in which we have concerns.

Chart 4 : Loan book split, yoy growth %

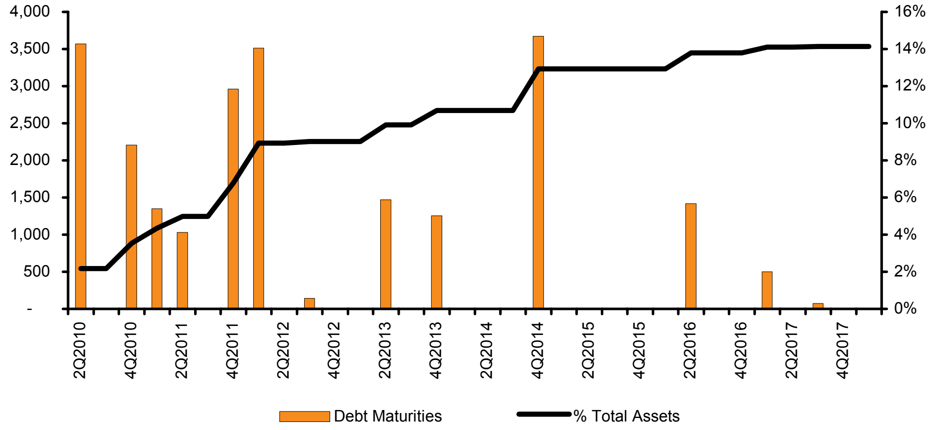


Source: Company reports, Rasmala forecasts

Although it remains uncertain when or whether the bank will be able to achieve broad-based growth, over coming quarters we believe that it should also be a beneficiary of increased government spending. However, we also expect to see a number of constraining factors, including an unwinding of its Dubai exposure, a reduction in the 11% of loans secured against investment books, and managing down its residential and commercial construction exposure.

Not only is ADCB likely to see limited growth due to constraints on the asset side of its balance sheet, but we believe the limited deposit base is also likely to be a constraint. During 1Q10, ADCB recorded an LRD of 130%, with the 91% loans-to-stable-resources ratio achievable only with significant capital market funding. With Dh2.2bn maturing in 4Q10 and a further Dh2.4bn in 1H11, there will be a significant amount of funding to replace within a short period of time.

Chart 5 : Debt profile (Dhm)



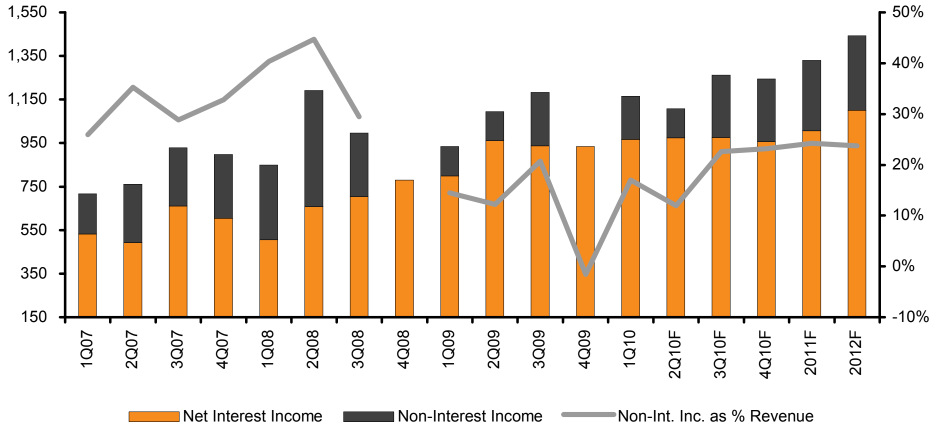
Source: Company reports, Bloomberg

Overall, therefore, we expect ADCB's loan growth rates to be closer to the 10% level typically seen in Dubai than to the 15% level seen in Abu Dhabi, with growth in the short term particularly constrained at 1% this year and recovering to 8% in 2011. To achieve even these loan growth rates, however, we estimate ADCB will need to grow deposits at 14.1% in 2011 and 15.4% in 2012. While on the basis of 1Q10 results this seems eminently possible, it likely means ADCB will continue to use high-cost funding, attracting price-sensitive deposits.

Revenue growth has been erratic, with ADCB's record quarter still being 2Q08, which included Dh178m revaluation gains on property. Interest income has progressed more steadily, but spreads have also been volatile, affected by a policy of active loan repricing during the middle of 2008, which contributed to a rise in measured spreads from 228bp in 1Q09 to 273bp (on a short-term basis) in 2Q09. This was partially reversed the following quarter, perhaps as NPLs took their toll.

Non-interest income has been volatile, but a more positive trend will depend on ending investment book losses. We believe core non-interest income is relatively low for a bank with a large retail franchise, but the far greater impact is the 59bp of non-core losses (measured in proportion to interest-earning assets). We estimate that ADCB will book further losses in 2Q10, but the downside will be limited beyond that. We also forecast modest positive returns on the portfolio from 2011 onwards, making a 1% positive contribution to revenue.

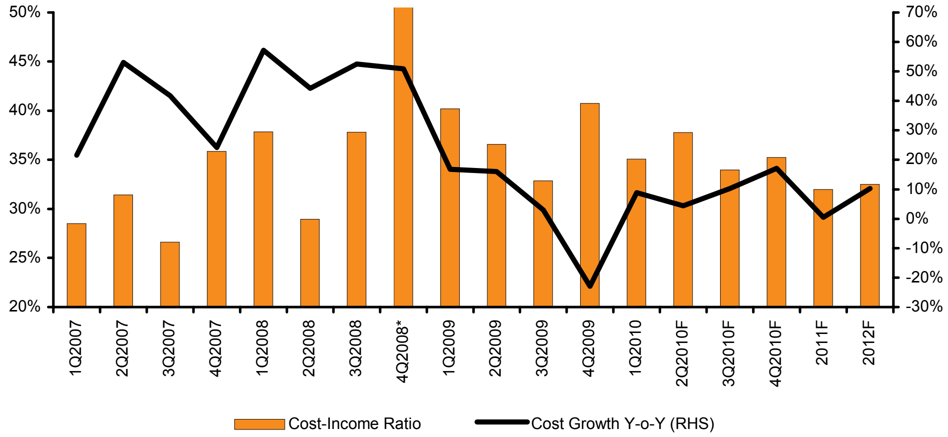
Chart 6 : Revenue split (Dhm)



Source: Company reports, Rasmala forecasts

With erratic revenues, we are not really surprised that ADCB's cost-to-income ratio has also been erratic. Nevertheless, historical yoy cost growth of up to 50% was certainly higher than asset or revenue growth. As a result, the expense ratio deteriorated from one of the best in the sector at 30.6% in 2007 to 41.9% in 2008, and only modestly lower than that in 2009 at 37.3%. Total costs were actually lower in 4Q09, although the bounce-back in 1Q10 suggests this may have been due to timing. The broader picture, though, is that we expect the cost-to-income ratio to improve significantly as revenues recover, but then to be little changed going forward.

Chart 7 : Cost-to-income ratio, cost growth, yoy

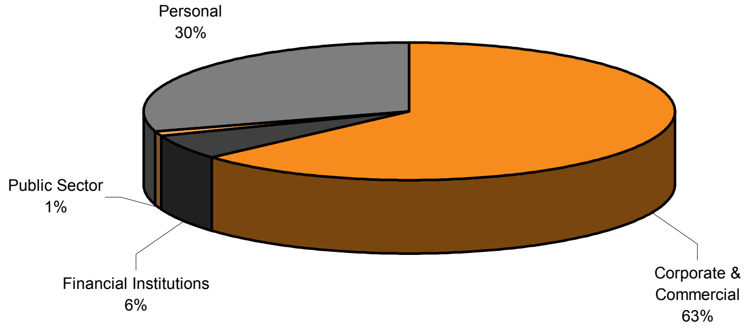


* Exceeds 50%
Source: Company data, Rasmala forecasts

Provisioning for ADCB was already high at 2.7% in 2009, and we estimate 2010 is at 2.5%. However, much of this reflects the special impairments in each year, the Saudi exposure in 2009 and Dubai World exposures in 2010. Underlying provisioning levels have been lower, at around 2.0% for both years. We continue to expect the NPL ratio to rise during 2010, but current Zawya Dow Jones sentiment suggests it will do so at a declining pace, topping out at perhaps 6.0%. A recovery from there is likely to be slow, with write-offs not generally exceeding 15% of brought-forward provisions, and few provisions being written back, given the continued weakness of the economy.

Overall, we believe provisioning for ADCB will continue to be above the sector average for two reasons: 1) the low coverage ratio; and 2) the high exposure to construction and personal loans, although provisioning for the personal loan book may now have nearly run its course. As a result, we forecast provisioning above the sector average for each of the next three years at 2.5%, 1.5% and 1.25%, respectively.

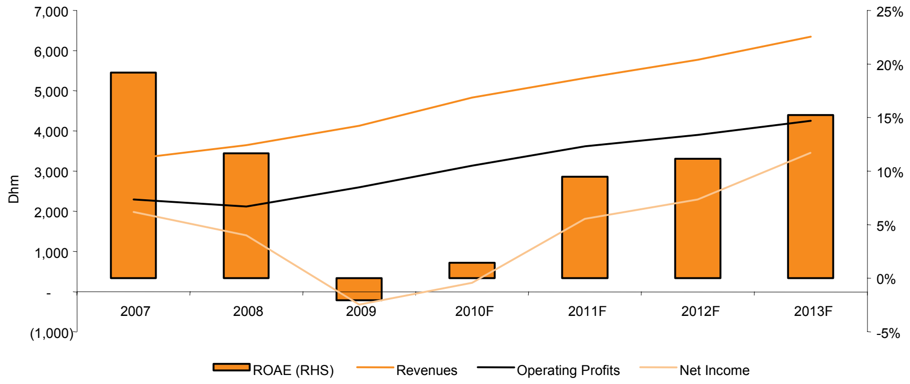
Chart 8 : ADCB's Dh122bn loan book, 1Q10



Source: ADCB Reports, Rasmala

Returns have been depressed since at least 2007 as a result of inadequate returns on the investment book. However, losses in these areas expanded dramatically in 2009, while FX revenues halved. Although spreads expanded, from 246bp to 272bp, this was insufficient to absorb the impact on revenue returns. Good cost control meant that operating profits progressed steadily. However, high provisioning charges drove net income into the red.

Chart 9 : Income statement, ROAE



Source: Company reports, Rasmala forecasts

Going forward, our two largest assumptions are that ADCB can achieve breakeven or a little better on its investment book, and that provisioning can be brought down from 267bp to 125bp in 2012 and 60bp beyond that. We forecast very little in the way of net interest income growth over the coming two years (CAGR of 7.4%).

Valuation and recommendation

ADCB currently trades at a 2011F adjusted PE of 4.8x and a PB ratio of 0.6x, making it the cheapest stock among the UAE banks we cover. We admit that 20% of book value is looking a little shaky, but we fully take this into account in our discount rate.

Given the higher level of risk, we assume a discount rate across our forecast period of 18.7%, which comprises 3.1% for the risk-free rate (based on the US 10-year bond), 11.0% for sector risk and 4.6% for stock risk. Furthermore, we exit our forecast period with a conservative 2013F ROAE of 15%, and assume that only 18% should be realisable in the medium term, even with re-leveraging.

Based on the Gordon growth model, we ascribe a target price of Dh1.81, suggesting 13% upside potential to the current share price of Dh1.57. At our target price, this also suggests a P/E of 5.60 and a P/B of 0.64 for 2011F – a 35% discount to the UAE sector average. We initiate with a Buy rating.

We believe we have taken a sufficiently cautious stance on the stock. Our near-term forecasts are for little more than breakeven in 2010, making us 77% below Zawya consensus net profit figures. However, our 2011 EPS forecasts are 47% higher than the market consensus, probably due to front-loading provisioning into 2010. Our 2012 EPS forecast remains 15% above market consensus. The mean recommendation on the stock is +0.29, assuming a Buy rating equates to +1 and a Sell rating equates to -1, making it the market's second-least favoured bank in our UAE coverage (after DIB). Our target price is 13% below Zawya consensus, presumably due to a higher discount rate.

Key catalysts for the stock are an absence of further exceptional losses, allowing underlying profitability. A topping-out of NPLs would also be a substantial driver, and possibly even more so for ADCB than for the rest of the sector.

Key risks

We believe the main risk to our price target 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.

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Table 1 : Gordon growth model valuation

Stage 1 (2010-2013): explicit dividends	Dhm	2010F	2011F	2012F	2013F
Forecast dividends		618	592	476	1,473
NPV stage 1	**2,335**	2,335	2,037	1,716	1,473
Stage 2 (2014-23): modelled dividends					
Excess capital	3,193	**Assumptions**			
Modelled dividends	6,293	ROE1	Growth	Capital Req'd	RWA
NPV stage 2	**5,671**	18%	12%	15,954	177,267
Stage 3 (2024+): terminal value					
2023	19,493	**Assumptions**			
NPV stage 3	**2,097**	ROE1	Growth	Capital Req'd	
		11%	6%	49,551	
Total NPV					
Stage 1 (2010-2013)	2,335				
Stage 2 (2014-23)	5,671				
Stage 3 (2024+)	2,097				
Total	10,102				
No of shares (m)	5,596				
Price target (Dh)	**1.81**				
Price (Dh)	**1.57**				
Upside/(Downside)	**13%**				

COE: US RFR 3.11%, country risk spread 6.00%, sector risk spread 5.00%, stock spread 4.60%, discount rate 18.71%
Source: Rasmala

Appendix

Rebuilding returns

Revenue weakness and provisioning hurting ROAEs

ADCB last achieved returns at the 20% level in 2007, and since then it has faced ongoing challenges. The two main problem areas have been revenues and provisioning. In turn, the main reason for the recent weakness in revenues has been the persistently high level of losses on the investment book. Much weaker trading and derivative income also took their toll.

Investment returns should normalise

Going forward, we expect investment returns to snap back to positive territory as soon as the current round of losses have been booked, albeit with a much reduced investment book. In addition, property writedowns should come to an end, with rental revenue still being booked to other operating income, albeit with little in the way of positive inflationary pressure.

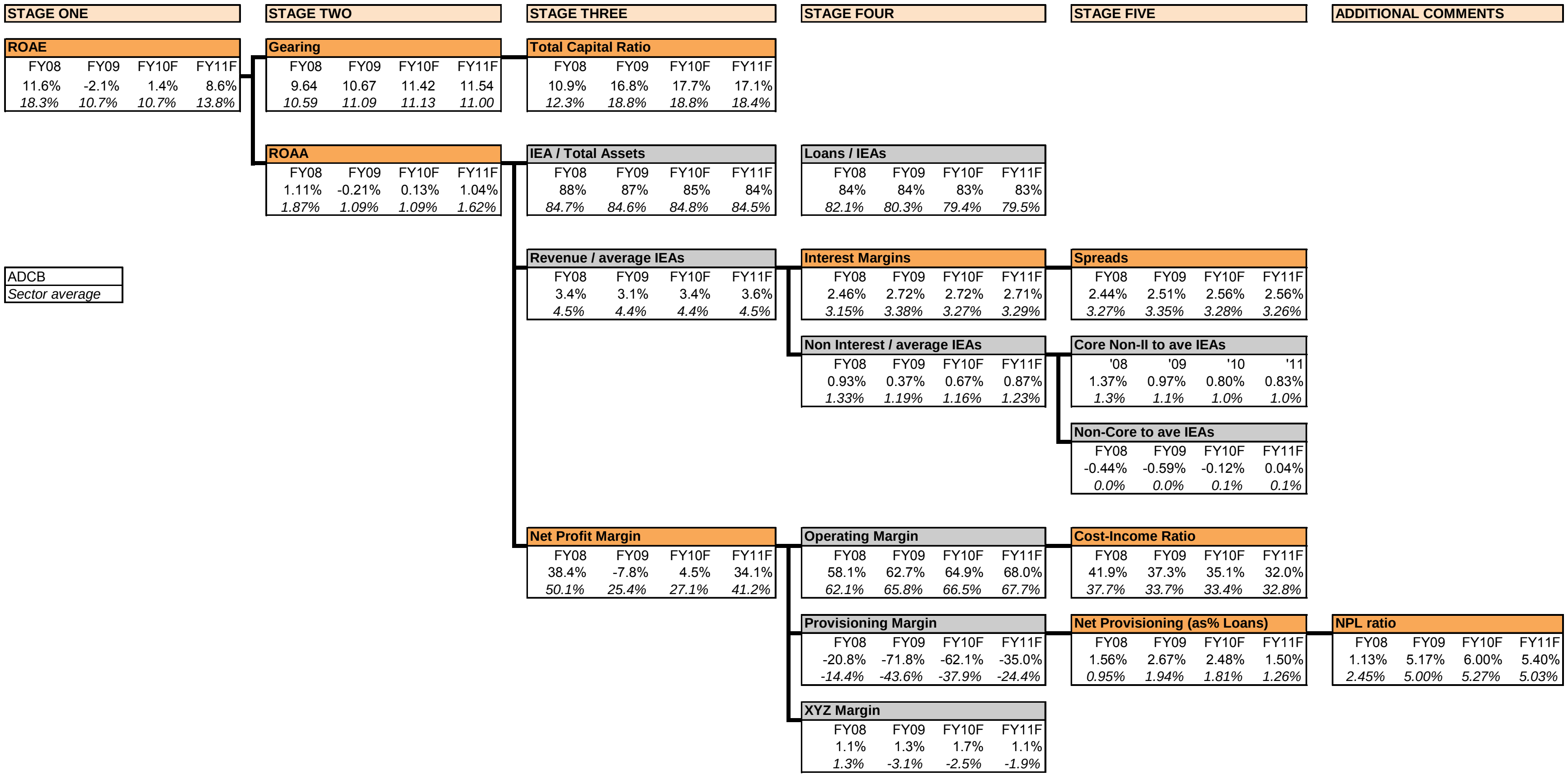
High funding costs

In terms of more structural elements, ADCB suffers from lower spreads, driven primarily by a high cost of funding. Time deposits, which amount to 75% of conventional deposits, are one structural reason. However, the large proportion of capital market funding will likely be another. As ADCB borrowed approximately Dh6bn of its capital market funding at a fixed rate, the current low interest rate environment is not helpful.

Choosing between high spreads and low costs

ADCB will need to rebuild its deposit book over the medium term, and eventually build stickier deposits than it is currently achieving, if it really aims to expand spreads. This, however, is often a costly exercise as it is depends on revenue from brand and retail customers. For the moment, the company is likely to make do with high-cost retail deposits, which are not the fair-weather friends that the capital markets have been.

Chart 10 : Modified Dupont



STAGE ONE

ROAE

FY08	FY09	FY10F	FY11F
11.6%	-2.1%	1.4%	8.6%
18.3%	*10.7%*	*10.7%*	*13.8%*

ADCB
Sector average

STAGE TWO

Gearing

FY08	FY09	FY10F	FY11F
9.64	10.67	11.42	11.54
10.59	*11.09*	*11.13*	*11.00*

ROAA

FY08	FY09	FY10F	FY11F
1.11%	-0.21%	0.13%	1.04%
1.87%	*1.09%*	*1.09%*	*1.62%*

STAGE THREE

Total Capital Ratio

FY08	FY09	FY10F	FY11F
10.9%	16.8%	17.7%	17.1%
12.3%	*18.8%*	*18.8%*	*18.4%*

IEA / Total Assets

FY08	FY09	FY10F	FY11F
88%	87%	85%	84%
84.7%	*84.6%*	*84.8%*	*84.5%*

Revenue / average IEAs

FY08	FY09	FY10F	FY11F
3.4%	3.1%	3.4%	3.6%
4.5%	*4.4%*	*4.4%*	*4.5%*

Net Profit Margin

FY08	FY09	FY10F	FY11F
38.4%	-7.8%	4.5%	34.1%
50.1%	*25.4%*	*27.1%*	*41.2%*

STAGE FOUR

Loans / IEAs

FY08	FY09	FY10F	FY11F
84%	84%	83%	83%
82.1%	*80.3%*	*79.4%*	*79.5%*

Interest Margins

FY08	FY09	FY10F	FY11F
2.46%	2.72%	2.72%	2.71%
3.15%	*3.38%*	*3.27%*	*3.29%*

Non Interest / average IEAs

FY08	FY09	FY10F	FY11F
0.93%	0.37%	0.67%	0.87%
1.33%	*1.19%*	*1.16%*	*1.23%*

Operating Margin

FY08	FY09	FY10F	FY11F
58.1%	62.7%	64.9%	68.0%
62.1%	*65.8%*	*66.5%*	*67.7%*

Provisioning Margin

FY08	FY09	FY10F	FY11F
-20.8%	-71.8%	-62.1%	-35.0%
-14.4%	*-43.6%*	*-37.9%*	*-24.4%*

XYZ Margin

FY08	FY09	FY10F	FY11F
1.1%	1.3%	1.7%	1.1%
1.3%	*-3.1%*	*-2.5%*	*-1.9%*

STAGE FIVE

Spreads

FY08	FY09	FY10F	FY11F
2.44%	2.51%	2.56%	2.56%
3.27%	*3.35%*	*3.28%*	*3.26%*

Core Non-II to ave IEAs

'08	'09	'10	'11
1.37%	0.97%	0.80%	0.83%
1.3%	*1.1%*	*1.0%*	*1.0%*

Non-Core to ave IEAs

FY08	FY09	FY10F	FY11F
-0.44%	-0.59%	-0.12%	0.04%
0.0%	*0.0%*	*0.1%*	*0.1%*

Cost-Income Ratio

FY08	FY09	FY10F	FY11F
41.9%	37.3%	35.1%	32.0%
37.7%	*33.7%*	*33.4%*	*32.8%*

Net Provisioning (as% Loans)

FY08	FY09	FY10F	FY11F
1.56%	2.67%	2.48%	1.50%
0.95%	*1.94%*	*1.81%*	*1.26%*

ADDITIONAL COMMENTS

NPL ratio

FY08	FY09	FY10F	FY11F
1.13%	5.17%	6.00%	5.40%
2.45%	*5.00%*	*5.27%*	*5.03%*

Source: Company data, Rasmala forecasts

Income statement

Dhm	FY08A	FY09A	FY10F	FY11F	FY12F
Net interest income	2649	3632	3873	4028	4401
Non-interest income	998.4	498.8	954.2	1291	1373
Total income	**3647**	**4131**	**4827**	**5318**	**5773**
Operating costs	-1530	-1539	-1694	-1702	-1876
Goodwill (amort/impaired)	n/a	n/a	n/a	n/a	n/a
Other costs	0.00	0.00	0.00	0.00	0.00
Pre-prov operating profit	2117	2592	3133	3617	3897
Provisions charges	-758.4	-2968	-3000	-1863	-1677
Post-prov op prof	1359	-376.4	133.3	1754	2220
Associates (pre-tax)	171.6	223.2	366.2	353.7	371.4
Other pre-tax items	0.00	0.00	0.00	0.00	0.00
Reported PTP	**1530**	**-153.2**	**499.5**	**2107**	**2592**
Taxation	-8.52	-3.23	-3.40	-14.3	-17.6
Minority interests	-121.9	-46.6	-36.5	-36.5	-36.5
Preference dividends	0.00	-120.0	-242.7	-242.7	-242.7
Other post-tax items	-163.4	-236.3	-81.0	-50.0	-237.0
Reported net profit	**1237**	**-559.4**	**136.0**	**1764**	**2058**
Tot normalised items	0.00	0.00	0.00	0.00	0.00
Normalised PTP	1530	-153.2	499.5	2107	2592
Normalised net profit	1237	-559.4	136.0	1764	2058

Source: Company data, Rasmala forecasts — year to Dec

Balance sheet

Dhm	FY08A	FY09A	FY10F	FY11F	FY12F
Net loans to customers	108813	116610	117986	126990	139797
Other int earn assets	20951	22722	25021	26931	29647
Goodwill	0.00	0.00	0.00	0.00	0.00
Oth non-int earn assets	13421	16188	19554	23598	24613
Total assets	**147728**	**160209**	**167350**	**182630**	**199628**
Total customer deposits	84361	86300	97928	111751	128613
Oth int-bearing liabs	37640	42389	35627	30999	28211
Non int-bearing liab	10293	12430	15069	16259	17220
Total liabilities	**132294**	**141119**	**148624**	**159008**	**174044**
Share capital	15327	15021	14652	15824	17406
Reserves	0.00	0.00	0.00	0.00	0.00
Total equity (excl min)	**15327**	**19021**	**18652**	**19824**	**21406**
Minority interests	107.6	69.1	73.3	3798	4178
Total liab & sh equity	**147728**	**160209**	**167350**	**182630**	**199628**
Risk weighted assets	130552	143476	135088	145397	160060
Est non-perf loans	n/a	n/a	n/a	n/a	n/a
Specific provisions	-2258	-4232	-6208	-7139	-7745
General provisions	n/a	n/a	n/a	n/a	n/a

Source: Company data, Rasmala forecasts — year ended Dec

Capital

Dhm	FY08A	FY09A	FY10F	FY11F	FY12F
Risk weighted assets	130552	143476	135088	145397	160060
Reported net profit	1237	-559.4	136.0	1764	2058
Opening risk assets	95685	130552	143476	135088	145397
Closing risk assets	130552	143476	135088	145397	160060
Change in risk assets	34867	12924	-8388	10309	14664
Capital required	3487	1422	-1007	1237	1760
Free capital flow	-2250	-1861	1385	769.5	541.1
Ordinary dividend paid	-481.0	0.00	-618.2	-591.7	-475.7
Share buy back/spec div	0.00	0.00	0.00	0.00	0.00
Equity / preference issue	4608	12.3	6.99	0.00	0.00
Cash flow from financing	4127	12.3	-611.2	-591.7	-475.7
Net capital flow	1877	-1849	774.0	177.8	65.4
Tier 1 capital	0.11	0.12	0.12	0.12	0.12
Tier 1 capital ratio (%)	0.00	0.00	0.00	0.00	0.00

Source: Company data, Rasmala forecasts — year to Dec

7 July 2010

Abu Dhabi Islamic Bank

Ambitious plans, but uncertain

Initiation of coverage

Hold

Target price
Dh2.67

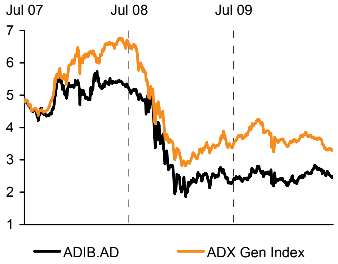
Price
Dh2.45

Short term (0-60 days)
n/a

Market view
No Weighting

Price performance

	(1M)	(3M)	(12M)
Price (Dh)	2.58	2.60	2.30
Absolute (%)	-5.0	-5.8	6.5
Rel market (%)	-4.4	6.5	11.0
Rel sector (%)	-6.7	6.2	5.9



Market capitalisation
Dh4.83bn (€1.06bn)

Average (12M) daily turnover
Dh2.45m (US$0.71m)

Sector: ADX Bank & Fin Index
RIC: ADIB.AD, ADIB UH
Priced Dh2.45 at close 1 Jul 2010.
Source: Bloomberg

ADIB is the only bank in our UAE universe with a strategy of strong expansion, and building out its branch network, product franchise and geographical reach. We believe ADIB is well-placed to expand its geographical and product reach. Still, we have concerns about its coverage ratio and property exposure.

Key forecasts

	FY08A	FY09A	FY10F	FY11F	FY12F
Reported PTP (Dhm)	851.1	75.00	741.5	1,273	1,992
Reported net profit (Dhm)	851.3	77.80	741.4	1,273	1,992
Reported EPS (Dh)	0.36	0.01	0.26	0.49	0.79
Normalised EPS (Dh)	0.36	0.01	0.26	0.49	0.79
Dividend per share (Dh)	0.18	0.17	0.12	0.20	0.50
Normalised PE (x)	6.81	421.3	9.34	5.03	3.10
Price/book value (x)	1.11	1.22	1.13	1.00	0.89
Dividend yield (%)	7.35	6.80	4.98	8.36	20.30
Return on avg equity (%)	16.60	1.56	15.00	23.30	32.40

Accounting standard: IFRS Source: Company data, Rasmala forecasts year to Dec, fully diluted

Core strategy of growth and profitability improvement

ADIB is the only bank in our UAE universe with a core strategy focusing on growth, branch expansion and product roll-out. The bank has set aggressive short-term targets to expand its branch network from 52 to 70 by the year-end, and medium-term targets for 20% growth, 33% cost efficiency and 25% profitability. If it can achieve these targets it should be able to move beyond its current target price, although we believe this may be a stretch.

Franchise driven by the UAE National Retail segment

ADIB's domestic franchise focuses mainly on the retail business for Nationals, many of whom are in secure public sector jobs. People in this segment can be characterised as being relatively affluent, with well-paid stable jobs, though many are likely under-provided with religiously compatible banking services. We believe that, by improving its service proposition, filling the product pipeline and expanding its physical and technological footprint, ADIB can pick the low hanging fruit. Egyptian operations provide further upside once the clean-up of National Development Bank yields tangible results.

NPLs are a significant concern and property is uncertain

The principle area for investor concern is ADIB's growing non-performing loan book, which jumped to a market breaking 8.59% in the latest 4Q09 data (versus a sector average of 5.00%). Despite this, ADIB seems comfortable with its coverage ratio and confident that its provisioning is adequate based on its very low level of write-offs. There has been nothing in the way of property write-downs. Although we don't dispute the companies' judgements on these issues, we believe there are limitations on visibility in this area.

Valuation and recommendation

ADIB trades at 1.0x PB and just 5.0x 2011F adjusted earnings. We believe this is good value for a stock that can achieve quality earnings, but we need more visibility before being comfortable lowering the discount rate. More stable loan book quality should be the primary catalyst, as would a thorough disclosure of property values. With an appropriately cautious discount rate of 17.9%, at the high end of our range, we get to a Dh2.67 TP and Hold rating.

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Important disclosures can be found in the Disclosures Appendix.
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Primary focus is the UAE National segment

ADIB is the only bank in our UAE universe with a strategy of strong expansion, building out its branch network, product franchise and geographical reach. But its coverage ratio and property exposure are concerns.

ADIB is a universal bank, based in Abu Dhabi, within the UAE, with a domestic network of 55 branches. Of these, ADIB's main presence is in Abu Dhabi Emirate with 35 branches. The rest are split across Dubai and the Northern Emirates. Although ADIB is a universal bank, its main business is retail and private banking, which can be seen both in the divisional segmentation and in the loan book.

Table 1 : ADIB by divisions (2009 y/e)

Retail	Wholesale	Private Banking	Capital Market	Real Estate	Other
- SME and private deposits,	- Corporate & Instit. clients	- HNW Banking	- Money market brokerage,	- Investment	- Head Office
- Murabahat, Ijara,		- Wealth Management	- Trading & treasury services	- Development	- Subsidiaries
- Credit cards			- ALM	- Brokerage	- Associates
- Cash Management			- Investment Banking	- Leasing	
- Trade Finance				- Management	
- Affluent Banking					
Revenue Contribution					
63%	19%	7%	8%	2%	1%
Net Profit Margin					
61%	46%	71%	86%	12%	neg.

Source: Company reports

With ADIB being an Islamic bank, it is well placed to target the more conservative UAE National segment, and in this it has been very successful, with UAE Nationals comprising 80% of its customer base. The key attractions of this segment are:

- A growing population: we estimate approximately a 2.5% CAGR in the over-20 population;
- The population is underserved, at least with competitive religiously-compliant products;
- Much of the population has secure, well remunerated and generally public-sector employment;
- Arguably the segment is less price discriminatory, and more relationship focused;
- Nevertheless, we believe it is becoming more sophisticated and more demanding in its use of financial services, enabling increased cross-sell opportunities.

With nearly 300,000 UAE National customers, ADIB now services approximately 30% of the UAE population, which is particularly high, given that nearly 40% of the population is thought to be under the age of 20, based on 2005 census data.

Beyond the domestic operation, ADIB also includes a loss-making 49%-owned Egyptian operation National Development Bank, which is mid-way through a comprehensive three-year overhaul. While the geographical size of this operation is substantial, with around 70 branches, the market capitalisation and balance sheet are only around 10% of those of ADIB. Over the long term, a new banking licence in Iraq provides potential, as does the slow-moving application for an Algerian licence.

Aggressive growth strategy

Increased footprint and channel expansion

ADIB is the only bank in our UAE universe aggressively pursuing a growth strategy, the most visible aspect of which is the branch build out, with 70 branches targeted by the end of 2010 (from 55 as at 1Q10 and 45 the year before). Given ADIB's strong position in Al Ain, and Abu Dhabi emirate generally, most of these branches are likely to be in Dubai and the Northern Emirates, where ADIB has a smaller footprint. As well as placing these in malls, like other banks, ADIB also plans to broaden its presence in residential areas, particularly those with large UAE National populations.

In addition to building out its physical presence, following on from the implementation of its new Phoenix core banking system, ADIB has been broadening its customer touch points. Indeed, ADIB now claims to have the best internet banking service in the UAE, as well as a useful m-banking solution.

New core banking solution, new products

Other retail banking innovations include the relaunch of dedicated women-only branches, expansion of the credit card offering and a premier banking service. However, the most important change has been the service quality improvement. This has been measured by standard metrics, such as waiting time on various channels and also with customer questionnaires, and in both cases ADIB has seen large improvements. Externally this is affirmed by Ethos consulting, an independent consultancy advising ADIB on related matters, which rated ADIB the most improved bank of 2009.

Private Banking is also being revamped, moving away from just a “red-carpet product”. In particular, wealth management will be launched in 3Q10, with products also being made available for the branch network. The new Private Banking operation will be offered to customers “later in the year”.

Within wholesale banking, ADIB is relaunching cash management, and building its Islamic investment banking operation, an area which has hitherto been dominated by DIB and HSBC Amanah within the UAE. Although this is not externally verifiable, ADIB claims to have made progress on several deals already.

Retail Islamic services – increasing competition

While providing religiously compliant services to the National population does seem to be an area of unmet need, it is not a well-kept secret. DIB plans to expand its operations into Abu Dhabi, and aims to shift its target customer from real estate related corporate lending to the retail segment. Hilal Bank and Noor Bank have also been set up to provide Islamic banking services. While ADIB may be the leading competitor in Abu Dhabi, it certainly is not the only competitor.

The increase in competition may well impact profitability, but in a growing market it is least likely to harm the bank that is competing the hardest. In this case, ADIB, with its aggressive targets, new management, new IT investments and new approach to product building seems to be the customer-driven bank in the space.

New targets

ADIB is one of the few banks to actually publish targets. It has also agreed to link remuneration to those targets, suggesting it is serious about achieving them. We believe these targets will be a challenge. The three targets that ADIB has set itself are:

- a core business ROE of 25%;
- a cost-income ratio of 33%; and,
- annual growth of 20%.

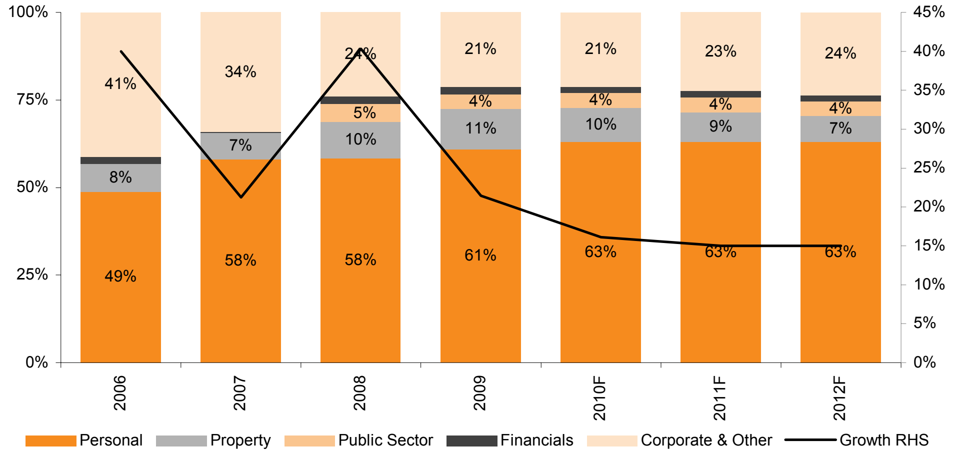
The current cost-income ratio is 42%, which seems a long way off the target. However, given depressed revenues and costs bloated by investment expenditure, it may not be as much of a stretch as it first seemed to be. Indeed, our assumption for the overall business is that a cost-income ratio of 37% is achievable by 2012, and that may imply a figure close to 33% for the core business, which excludes international operations, subsidiaries and associates.

The ROE target also looks challenging. We expect a 2010 ROE of 12.1%, once provisioning returns to a half respectable level of 1.7% of customer assets. Given negligible returns on property and associates, the core business will get something better than that, and with improvements in the cost-income ratio and potential improvements in leverage 25% seems a plausible, if challenging, target.

Leading the pack for growth

During the early part of the boom, ADIB had relatively low growth adding just 21% in loans in 2007, with management and shareholder changes and changes in strategic direction taking up most of the focus. Since 2008, however, it has been the fastest growing bank in our UAE universe, adding 38% even as the market was slowing, 18% in 2009 and 4% qoq in 1Q10. Not only that, but the quality of the loan book has improved, with retail becoming a gradually more important sector and public sector business fading away as a segment. We believe that ADIB will continue to be amongst the fastest growing banks, although systemic growth will be sharply lower than previously.

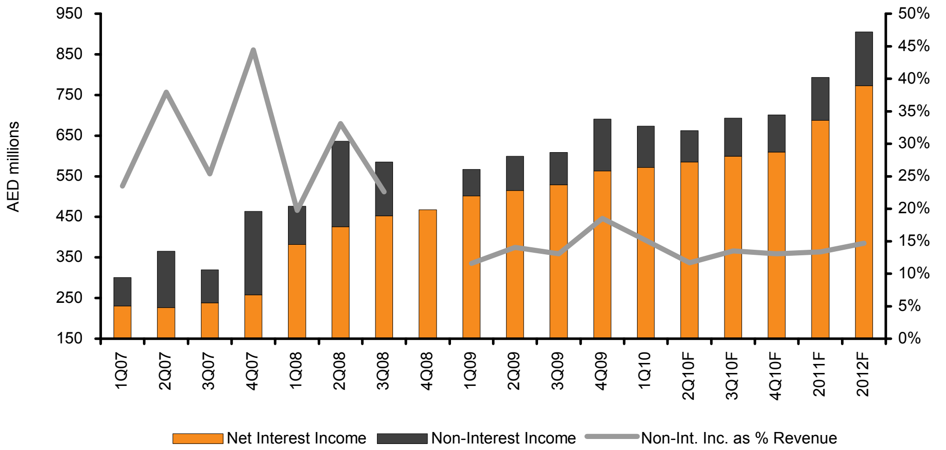
Chart 1 : Contributions to the loan book and growth



Source: Company Reports, Rasmala Forecasts

ADIB has always delivered relatively weak non-interest income at 91bp of interest earning assets (IEAs) in 2008 (sector average of 133bp). Part of this, we believe, is as a result of the way it discloses revenues, as is evidenced by the low contribution from accounts services fees. However, it is also partially driven by the lack of cross-sell and improvements in this area should bring a greater contribution. Core non-interest income is approximately half of the average even in the exit year. Consequently, even though we do not expect the contribution of fee income to match the sector as a whole, we believe that while the contribution of core non-interest income will rise.

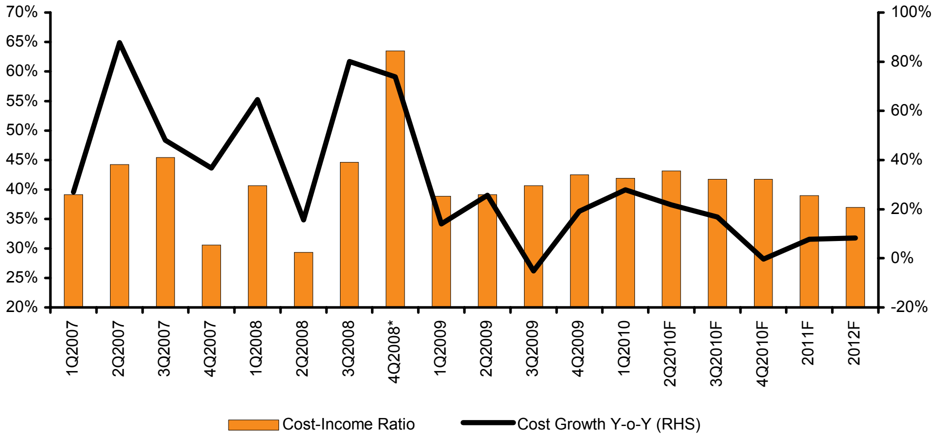
Chart 2 : Revenue split, (Dh m)



Source: Company Reports, Rasmala Forecasts

Although we expect an improvement in core non-interest income, we are not expecting an overall improvement in the contribution of non-interest, as can be seen in chart 2. This is partially due to the improved revenue growth overall, and also partially due to the continued weakness of the property market, and actual declining property income in 2011. This resulted in non-core, non-interest income declining from 50bp to an expected 14bp in 2010. We do anticipate some recovery in property earnings sometime around 2013, and we will see a bigger uptick as a result. Consequently, the quality of non-interest income has been rising during the forecast period, although the actual contribution has risen only marginally.

Chart 3 : Cost-income ratio

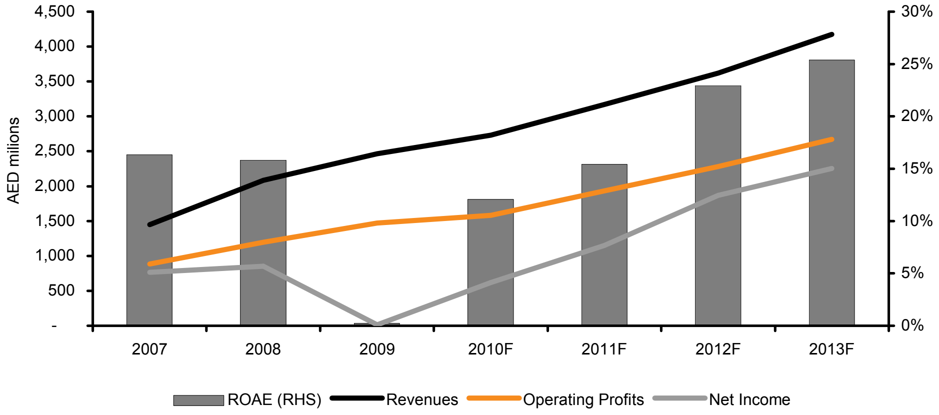


Source: Company Reports, Rasmala forecasts

Chart 3 illustrates the declining cost-income ratio over coming quarters. This, however, is in spite of costs rising at 8% a year, and reflects the strength of revenues discussed in previous paragraphs. Investment costs should also ease going forward, given that the main jump in investment costs is now in the past.

The overall income statement trends can be seen summarised in Chart 4. Returns have been low at ADIB mostly due to low levels of gearing. However, in 2009 that reversed, with gearing improving sharply from 9.8x to 13.5x the equity base, due to asset growth and equity shrinkage. However, net income collapsed (with ROAA declining to 2bp). The main reason for the drop in net income was clearly provisioning, which jumped from 74bp to 299bp, although ADIB also disclosed a Dh187m impairment of loans to financial institutions.

Chart 4 : Income statement, ROAEs



Source: Company Reports, Rasmala forecasts

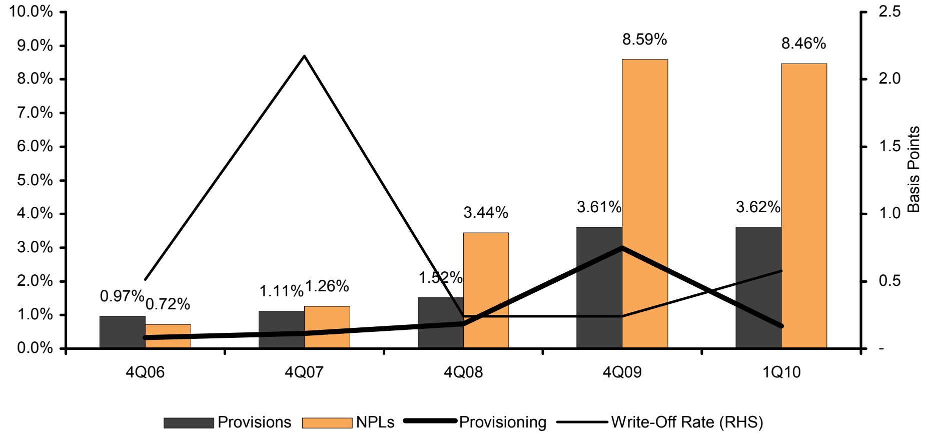
With impairments disappearing, we forecast a strong recovery in profitability. In addition, as secondary sources of revenue, such as property and investment income recover, we should see ROAEs rise further. Finally, with leverage improving , we believe we can get to an exit rate close to management's targets.

Balance sheet uncertainties

uncovered NPLs – management confidence

The main concern about the balance sheet is the quality of the loan portfolio. Provisions on a 90-day basis are now at 8.5% of gross loan book, nearly double the sector average. With a very low coverage ratio of only 43%, this implies the uncovered portion of NPLs is now equivalent to 48% of equity. One reason for management's comfort on the issue is the extremely low rate of write-offs. Over the last four years, this has only exceeded 1bp in a single year. While that gives us some comfort, until we see NPLs start performing again, we believe this is a significant risk, as well as a cost of lost income.

Chart 5 : Provisions vs NPLS and provisioning vs write-offs, as % customer assets



Source: Company reports

As can be seen from chart 1, the personal sector accounts for 62% of loan book, and the construction sector for a further 11%. We assume that these also account for the bulk of NPLs. As we know, ADIB accounts for a large proportion of government employees, and is disproportionately linked to UAE nationals. It may be that customer behaviour within this segment is radically different to the market at large. Perhaps the same can be said of the Abu Dhabi construction sector, which is often backed by deep pockets. Nevertheless, we believe the low coverage ratio, which is possibly as low as 35% if we exclude estimated Algosaibi/Saad provisioning of Dh700m, is a cause for concern.

Burooj Real Estate – slow-moving property for many years to come

The other cause for concern is the property exposure through subsidiary Burooj Real Estate, amounting to a further Dh2.4bn (equivalent to 47% of common shareholders equity). Up to half of this relates to properties contracted during 2Q and 3Q08, we believe, disclosed as "advances against purchases of properties".

Burooj Properties has been associated with a number of projects, including the flagship Dh18bn Sharjah Marina, as well as Burooj Views, Burooj Terraces and Burooj Pearl all on Abu Dhabi's Reem Island, and the recently delivered Al Gurm Gardens. However, less successful projects include Burooj Crystal (on Hold), and Burooj Jordan (on Hold). Most recently it has also acquired for sale 425 units of Palm Hills Developments, Village Garden Katameya in Egypt.

While management remains positive on the prospects for Burooj properties, actual news-flow remains mixed and it will likely take substantial commitments to develop their existing portfolio. Sharjah Marina is now only scheduled for delivery for 2015, after the plans have been substantially overhauled. Notwithstanding management's confidence the possibility of a write-down is difficult to rule out. Nevertheless, from a cash-flow perspective, we have assumed very little in the way of returns over the forecast period.

National Bank for Development Egypt – overall a positive, but some downside risk

ADIB bought a 49% in NBD in 2Q08, with the stake being booked on the balance sheet, after various rights issues, at Dh443m. Meanwhile, parent company EIIC took a further small stake, giving ADIB absolute control. NBD Egypt was a small non-Islamic and predominantly rural bank, with an NPL ratio around 50%, after many years of failing to address problems. ADIB set about restructuring the bank immediately, with the aim of making it Shariah compliant, profitable and much more urban.

So far, the conversion has gone relatively well, although NBD has only made a profit in a single quarter and has required a number of rights issues to support the capital base. Nevertheless, the local market has been unimpressed with the stock declining 65% over two years. That being said ADIB bought its initial stake at a discount to the market, and the current market capitalisation of EGP824m (Dh550m) is not materially below the original purchase price plus subsequent rights issues. Although ultimately we would need to see profitability before we can safely say the value has reached a floor, the absence of competition in the Shariah compliant space, and the substantial branch network justify the price, if not necessarily the sunk cost of management time.

More broadly on associates, it is clear these assets are not pulling their weight in terms of returns. The last time associate income was positive was in 2007, and then the return was 0.5%. To justify their current book values, returns should be expected to rise.

Treatment of risks and cost of capital

In terms of the treatment of these risks, we have more or less accepted management's point of view on them: that provisioning is adequate, and that property is valued at a level which reflects realisable value. NBD Egypt is a relatively small investment, and while scope exists for the whole of associates to be marked down, we do not believe this will actually happen.

Although we have taken company guidance on these matters, we have compensated this by having a significantly elevated discount rate. We believe there is both uncertainty and potential forecast bias and raise the discount rate 350bp points to compensate for this, which has the impact of lowering our estimated target value by 36%. Declining NPLs and/or asset disposals would therefore have a strongly positive impact on our target value.

Table 2 : Valuation

Stage 1 (2010-2013): explicit dividends		**2010**	**2011**	**2012**	**2013**
Forecast dividends		289	484	1,174	1,397
NPV stage 1	**2,396**	2,396	2,484	2,358	1,397
Stage 2 (2014-23): modelled dividends					
Excess capital	(681)	**Assumptions**			
Modelled dividends	2,778	ROE1	Growth	Capital Req'd	RWA
NPV stage 2	**1,279**	20%	15%	7,947	88,305
Stage 3 (2024+): terminal value					
2023	13,498	**Assumptions**			
NPV stage 3	**1,585**	ROE1	Growth	Capital Req'd	
		11%	6%	32,152	
Total NPV					
Stage 1 (2010-2013)	2,396				
Stage 2 (2014-23)	1,279				
Stage 3 (2024+)	1,585				
Total	**5,260**				
No of shares	1,971				
Price target	**2.67**				
Price	2.45				
Upside/(Downside)	9%				

COE: US RFR 3.11%, country risk spread 6.00%, sector risk spread 5.00%, stock spread 3.80%, discount rate 17.91%
Source: Rasmala

Valuation and recommendation

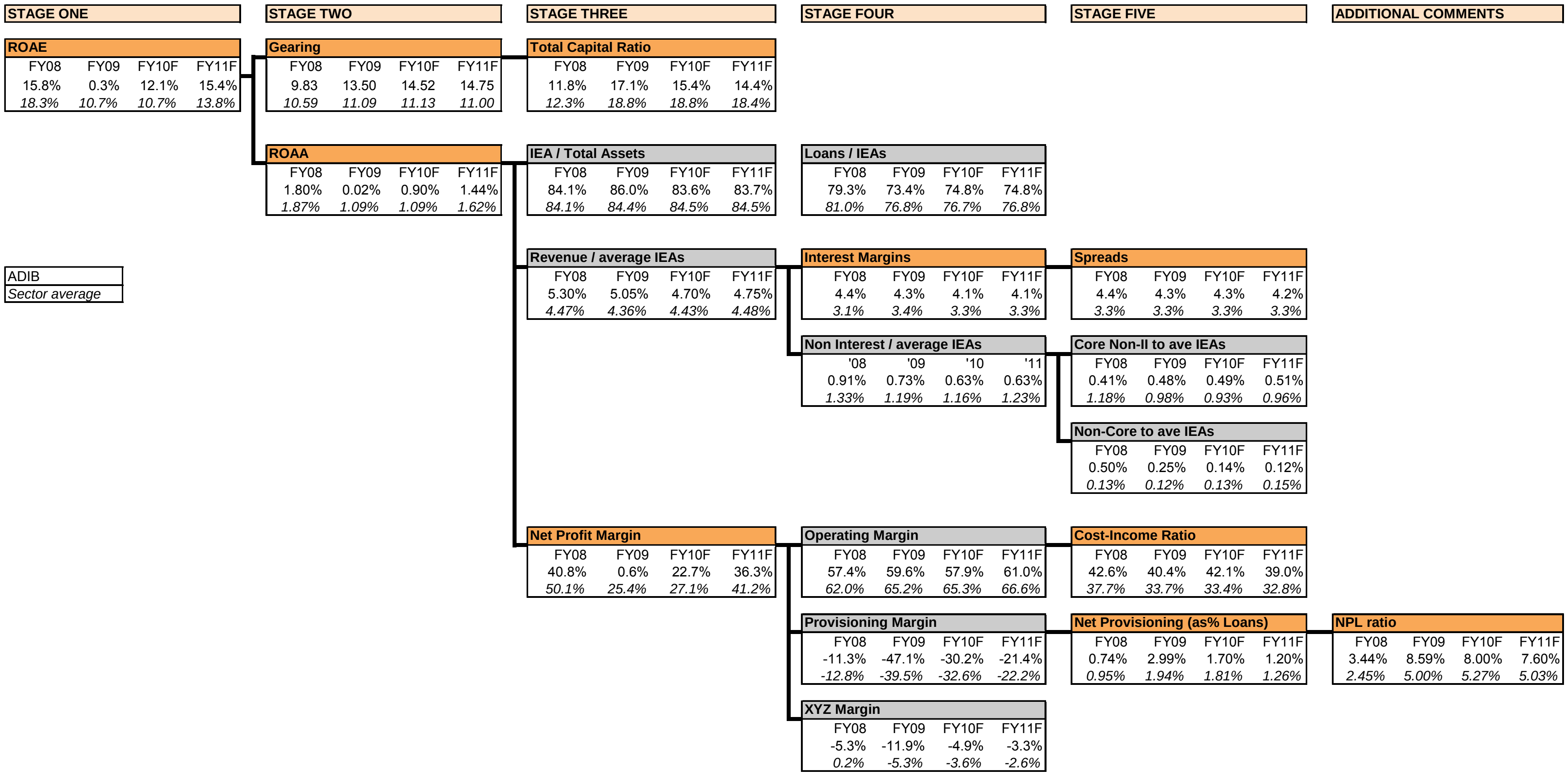
Our forecasts are based on ADIB coming close to achieving its targets, with a minimal amount of problems related to the uncertainties within its balance sheet. We believe it should be able to get double-digit growth rates, although we do not forecast the 20% level that the company targets. We do assume though that the company can attain a 25% return on equity by 2013, albeit partially due to higher leverage. While our 2010 net headline income forecast is 16% below Zawya consensus, most likely due to provisioning, we are 4% and 40% more optimistic in 2011-12. All five forecasts provided a Buy recommendation, with a price target of Dh3.1-6.4.

That being said, for our terminal value assumption we assume a more modest 20% level of return in the 2014-23 period, as capital intensity rises, and competition and uncertainty take their toll.

We believe that ADIB currently trades at a premium of 18% to the sector with a PB of 1.0x and a mid-ranging PE of 5.0x in both cases for 2011. Although we believe that these multiples are far too cheap for a stock of this quality, we believe that having to rely on the confidence of management to offset our concerns about the balance sheet is a risk, which we reflect in the elevated discount rate. With these risks in mind, we would recommend a Hold rating on the stock, with a price target of Dh2.67.

Catalysts for a positive re-rating would include the disposal of its property portfolio, although this is not in our forecasts. As for all the banks, stabilisation and reversal of NPLs would create a large opportunity for upward re-rating.

Chart 6 : Modified DuPont



STAGE ONE

ROAE

FY08	FY09	FY10F	FY11F
15.8%	0.3%	12.1%	15.4%
18.3%	*10.7%*	*10.7%*	*13.8%*

ADIB

Sector average

STAGE TWO

Gearing

FY08	FY09	FY10F	FY11F
9.83	13.50	14.52	14.75
10.59	*11.09*	*11.13*	*11.00*

ROAA

FY08	FY09	FY10F	FY11F
1.80%	0.02%	0.90%	1.44%
1.87%	*1.09%*	*1.09%*	*1.62%*

STAGE THREE

Total Capital Ratio

FY08	FY09	FY10F	FY11F
11.8%	17.1%	15.4%	14.4%
12.3%	*18.8%*	*18.8%*	*18.4%*

IEA / Total Assets

FY08	FY09	FY10F	FY11F
84.1%	86.0%	83.6%	83.7%
84.1%	*84.4%*	*84.5%*	*84.5%*

Revenue / average IEAs

FY08	FY09	FY10F	FY11F
5.30%	5.05%	4.70%	4.75%
4.47%	*4.36%*	*4.43%*	*4.48%*

Net Profit Margin

FY08	FY09	FY10F	FY11F
40.8%	0.6%	22.7%	36.3%
50.1%	*25.4%*	*27.1%*	*41.2%*

STAGE FOUR

Loans / IEAs

FY08	FY09	FY10F	FY11F
79.3%	73.4%	74.8%	74.8%
81.0%	*76.8%*	*76.7%*	*76.8%*

Interest Margins

FY08	FY09	FY10F	FY11F
4.4%	4.3%	4.1%	4.1%
3.1%	*3.4%*	*3.3%*	*3.3%*

Non Interest / average IEAs

'08	'09	'10	'11
0.91%	0.73%	0.63%	0.63%
1.33%	*1.19%*	*1.16%*	*1.23%*

Operating Margin

FY08	FY09	FY10F	FY11F
57.4%	59.6%	57.9%	61.0%
62.0%	*65.2%*	*65.3%*	*66.6%*

Provisioning Margin

FY08	FY09	FY10F	FY11F
-11.3%	-47.1%	-30.2%	-21.4%
-12.8%	*-39.5%*	*-32.6%*	*-22.2%*

XYZ Margin

FY08	FY09	FY10F	FY11F
-5.3%	-11.9%	-4.9%	-3.3%
0.2%	*-5.3%*	*-3.6%*	*-2.6%*

STAGE FIVE

Spreads

FY08	FY09	FY10F	FY11F
4.4%	4.3%	4.3%	4.2%
3.3%	*3.3%*	*3.3%*	*3.3%*

Core Non-II to ave IEAs

FY08	FY09	FY10F	FY11F
0.41%	0.48%	0.49%	0.51%
1.18%	*0.98%*	*0.93%*	*0.96%*

Non-Core to ave IEAs

FY08	FY09	FY10F	FY11F
0.50%	0.25%	0.14%	0.12%
0.13%	*0.12%*	*0.13%*	*0.15%*

Cost-Income Ratio

FY08	FY09	FY10F	FY11F
42.6%	40.4%	42.1%	39.0%
37.7%	*33.7%*	*33.4%*	*32.8%*

Net Provisioning (as% Loans)

FY08	FY09	FY10F	FY11F
0.74%	2.99%	1.70%	1.20%
0.95%	*1.94%*	*1.81%*	*1.26%*

ADDITIONAL COMMENTS

NPL ratio

FY08	FY09	FY10F	FY11F
3.44%	8.59%	8.00%	7.60%
2.45%	*5.00%*	*5.27%*	*5.03%*

Source: Company reports, Rasmala forecasts

Income statement

Dhm	FY08A	FY09A	FY10F	FY11F	FY12F
Net interest income	1728	2109	2365	2750	3089
Non-interest income	357.3	357.3	363.8	423.6	531.7
Total income	**2086**	**2466**	**2729**	**3173**	**3621**
Operating costs	-887.8	-996.4	-1149	-1238	-1340
Goodwill (amort/impaired)	n/a	n/a	n/a	n/a	n/a
Other costs	0.00	0.00	0.00	0.00	0.00
Pre-prov operating profit	1198	1469	1580	1936	2281
Provisions charges	-346.9	-1391	-848.5	-679.3	-325.4
Post-prov op prof	851.1	78.2	731.1	1256	1956
Associates (pre-tax)	0.00	-3.22	10.4	16.2	35.7
Other pre-tax items	0.00	0.00	0.00	0.00	0.00
Reported PTP	**851.1**	**75.0**	**741.5**	**1273**	**1992**
Taxation	-1.03	-1.03	-1.00	-1.72	-2.69
Minority interests	0.21	-0.25	-0.07	-0.07	-0.07
Preference dividends	0.00	-60.0	-120.0	-120.0	-120.0
Other post-tax items	1.03	64.0	121.0	121.7	122.7
Reported net profit	**851.3**	**77.8**	**741.4**	**1273**	**1992**
Tot normalised items	0.00	0.00	0.00	0.00	0.00
Normalised PTP	851.1	75.0	741.5	1273	1992
Normalised net profit	851.3	77.8	741.4	1273	1992

Source: Company data, Rasmala forecasts

year to Dec

Balance sheet

Dhm	FY08A	FY09A	FY10F	FY11F	FY12F
Net loans to customers	34179	40474	46533	53456	61879
Other int earn assets	8897	14658	15703	18039	20881
Goodwill	0.00	0.00	0.00	0.00	0.00
Oth non-int earn assets	3442	3194	4885	5639	6743
Total assets	**51210**	**64084**	**74444**	**85416**	**98833**
Total customer deposits	37486	50427	59728	69150	79898
Oth int-bearing liabs	6514	4217	4909	5220	6075
Non int-bearing liab	2000	2691	2678	3250	4370
Total liabilities	**46000**	**57335**	**67315**	**77621**	**90343**
Share capital	5207	4747	5126	5793	6488
Reserves	0.00	0.00	0.00	0.00	0.00
Total equity (excl min)	**5207**	**6747**	**7126**	**7793**	**8488**
Minority interests	2.60	2.86	2.93	2.93	2.93
Total liab & sh equity	**51210**	**64084**	**74444**	**85416**	**98833**
Risk weighted assets	39619	49516	57451	65998	76397
Est non-perf loans	n/a	n/a	n/a	n/a	n/a
Specific provisions	-589.3	-1751	-2488	-2918	-2952
General provisions	n/a	n/a	n/a	n/a	n/a

Source: Company data, Rasmala forecasts

year ended Dec

Capital

Dhm	FY08A	FY09A	FY10F	FY11F	FY12F
Risk weighted assets	39619	49516	57451	65998	76397
Reported net profit	851.3	77.8	741.4	1273	1992
Opening risk assets	29142	39619	49516	57451	65998
Closing risk assets	39619	49516	57451	65998	76397
Change in risk assets	10477	9897	7935	8547	10399
Capital required	1048	989.7	952.2	1026	1248
Free capital flow	-196.5	-851.9	-90.8	366.9	863.7
Ordinary dividend paid	-425.6	-394.1	-288.5	-484.4	-1174
Share buy back/spec div	0.00	0.00	0.00	0.00	0.00
Equity / preference issue	0.00	0.00	0.00	0.00	0.00
Cash flow from financing	-425.6	-394.1	-288.5	-484.4	-1174
Net capital flow	-622.1	-1246	-379.3	-117.5	-310.0
Tier 1 capital	0.14	0.14	0.13	0.12	0.12
Tier 1 capital ratio (%)	0.00	0.00	0.00	0.00	0.00

Source: Company data, Rasmala forecasts

year to Dec

Equity | United Arab Emirates | Banks

7 July 2010

Dubai Islamic Bank

New directions

Initiation of coverage

Hold

Target price
Dh1.97

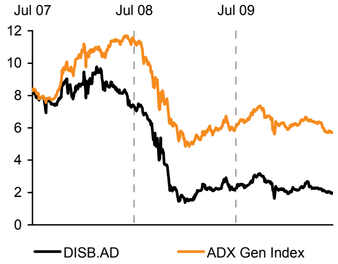
Price
Dh1.94

Short term (0-60 days)
n/a

Market view
No Weighting

Price performance

	(1M)	(3M)	(12M)
Price (Dh)	2.09	2.69	2.31
Absolute (%)	-7.2	-28.0	-15.8
Rel market (%)	-6.5	-18.7	-12.3



Market capitalisation
Dh7.37bn (€1.61bn)

Average (12M) daily turnover
Dh21.56m (US$5.92m)

RIC: DISB.AD, DIB UH
Priced Dh1.94 at close 1 Jul 2010.
Source: Bloomberg

As the UAE's largest and most liquid Islamic bank, we see DIB as a classic thematic play. We have concerns about its overall property exposure in both its loan book, through direct ownership and through its associates, and investments. But its highly liquid balance sheet appears to offer some upside.

Key forecasts

	FY08A	FY09A	FY10F	FY11F	FY12F
Reported PTP (Dhm)	1,723	1,130	1,018	1,221	1,613
Reported net profit (Dhm)	1,730	1,207	1,022	1,225	1,617
Reported EPS (Dh)	0.42	0.28	0.24	0.28	0.37
Normalised EPS (Dh)	0.42	0.26	0.24	0.28	0.37
Dividend per share (Dh)	0.23	0.14	0.14	0.17	0.19
Normalised PE (x)	4.63	7.52	8.24	6.87	5.20
Price/book value (x)	0.91	0.87	0.85	0.82	0.78
Dividend yield (%)	11.70	7.31	7.32	8.63	9.56
Return on avg equity (%)	20.00	13.60	11.90	13.90	17.50

Accounting standard: IFRS
Source: Company data, Rasmala forecasts

year to Dec, fully diluted

DIB finds itself with a lot of property exposure

DIB's leading product has been commercial mortgages, which in a strong economic environment would provide reliable cash flows for a long time to come. However, in a more difficult environment, DIB ends up with property sector risk and difficulties with maturity mismatch. Furthermore, although the loan portfolio has been protected by not being in freehold areas, this segment is likely to average down in quality over the coming periods.

Developing a retail franchise

Although DIB has always been growing its retail franchise (currently 16% of its loan book), the emphasis was on providing auto loans, and then mortgage loans. DIB's main strategic change has been to put the real-estate lending segment into run off (temporarily), and to build up its retail product range more aggressively particularly with asset gathering products. Initial signs have been promising, but we believe that DIB is a little late to the party, with Noor Bank and ADIB both targeting the same customers.

Balance sheet risks are not to be ignored

We note the following risks: 1) property developer Deyaar, which currently trades 69% below book value, is included in associates; 2) low NPL coverage of 43%; 3) the potential buy-out and integration of Tamweel which adds uncertainty and thereby risk; and 4) the Dubai risk is considerable, particularly that relating to the property market. As a consequence, we assume an elevated discount rate of 17.1% (compared to a UAE sector minimum of 14.1%).

Premium valuation looks unjustified

Although we like DIB's strategy of redirecting itself towards retail banking, we believe that its valuation is a little rich given existing uncertainties. The stock currently trades at forward 2010 PB and adjusted PE multiples of 0.85 and 8.24, respectively. We do not believe that DIB justifies its premium to the market, particularly as it has structurally lower returns, weak growth and at best similar risk. We set a target price of Dh1.97, and give the stock a Hold recommendation with only 1.5% upside to our target.

Analyst

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Important disclosures can be found in the Disclosures Appendix.
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New directions

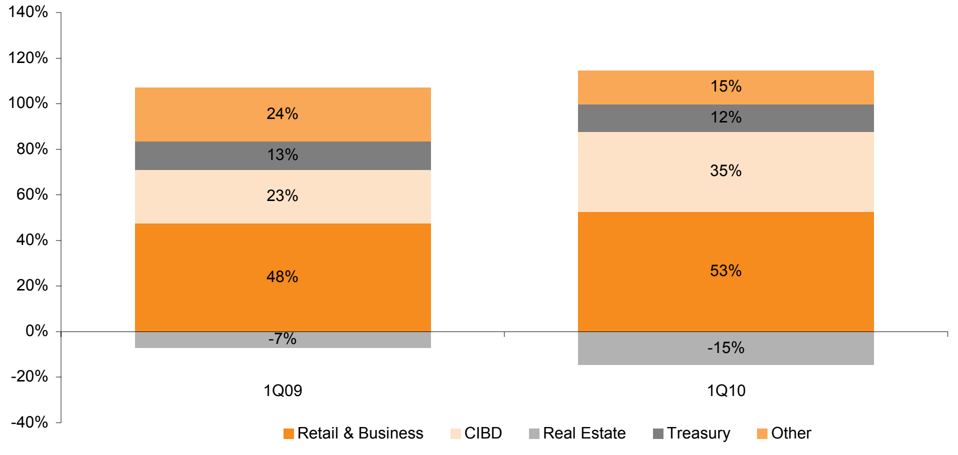
We see DIB as a classic thematic play. We have concerns about its overall property exposure in both its loan book, through direct ownership and through its associates and investments. Nevertheless, its highly liquid balance sheet appears to offer some upside.

DIB is the leading Islamic bank in the UAE

DIB is the largest and oldest Islamic Bank in the UAE, and one of the top four Islamic institutions globally. Domestically it has one of the larger branch networks with 62 outlets as of December 2009, serving a total of 900,000 customers, equivalent to nearly 20% of the UAE population. Following a 1Q10 reorganisation, DIB now operates through four main divisions: Retail & Business, Corporate & Investment Banking, Treasury and the loss-making Real Estate. Within the UAE, DIB has a 5% market share in loans and 6% in deposits.

Internationally, DIB has a 37-branch Pakistani subsidiary, as well as several associates in a number of countries including Bosnia and Sudan. International operations account for less than 10% of gross income, but nearly 30% of capital expenditure.

Chart 1 : Revenue split, 1Q2010



Source: Company reports

ICD hold a 30.49% stake in DIB, while founding shareholder, Saeed Lootah owns a further 7.19%. The stock is open to foreign and GCC ownership, up to a maximum of 15%. However, total foreign ownership amounts to just 9%, with interest predominantly coming from GCC Nationals and other Arabic citizens.

Strategy: reorienting towards retail

DIB has substantial exposure to the property sector through its loan book, direct ownership and associates, amounting to 33% of assets and 318% of equity. Hence, it should come as little surprise that DIB has become a little nervous over recent quarters. Not only is property lending a substantial credit risk in a falling property market, but, when banking sector liquidity becomes tight, the huge asset liability mismatch is difficult to mitigate.

As a result of these two difficulties, DIB's key strategic aim is to reposition itself away from the property market. On the negative side, this means putting the property loan book into run-off until it reaches a more proportionate level. With an average life on these products of around six years, this could mean several years with a drain on growth. On the positive side, DIB is focussing on a movement towards the retail segment. The retail segment for Islamic Banks is primarily driven by UAE citizens, who tend to be low risk and highly profitable. DIB has been aiming to provide more retail products, especially on the funding side. One example is DIB's personal unsecured lending product known as Salam Finance.

With a determination to build more of a retail franchise, DIB will need to refocus and build out its branch network. To this end, it is planning six to seven new branches. However, these branches are likely to be express branches (providing a presence with simple banking products) and are likely to be leased rather than bought (involving relatively little capex).

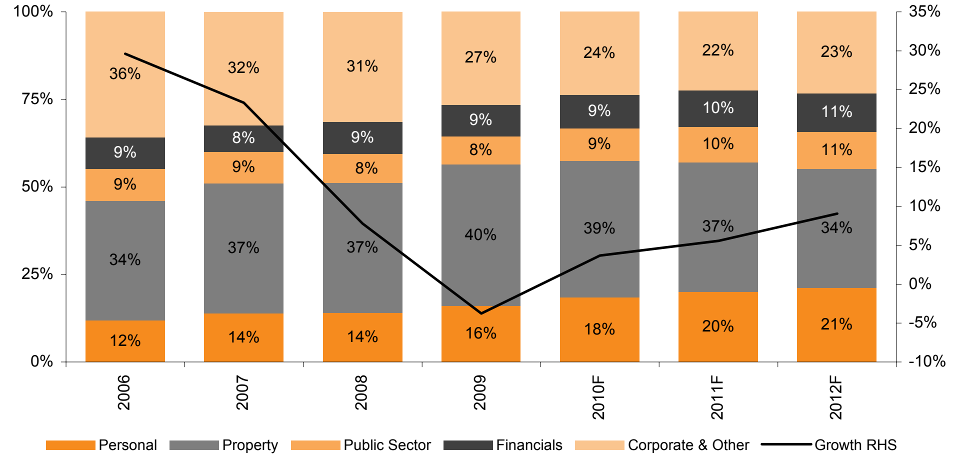
Although DIB is generally moving away from the commercial mortgage sector, DIB has said it is considering raising its stake in Tamweel, which would presumably make sense only as an acquisition, as a larger minority stake would take on more risk in a troubled entity, without gaining any further control. DIB already has a significant working relationship with Tamweel which processes the back office for its mortgage operations. Consequently, cost synergies would be fairly limited. However, the main benefit of any integration would be balance sheet synergies. Tamweel is short on funding and lacks leverage due to the absence of a banking license. DIB has excess funding which it is warehousing in liquid low-return assets.

Performance withstanding deleveraging

As an Islamic bank, the most natural kind of lending is asset backed lending, and that lends itself particularly well to commercial and residential mortgage lending. In addition, while conventional banks are limited to having maximum exposure to the property and construction sector equivalent to 20% of deposits, Islamic banks have no such limitations. Consequently, DIB has grown the real estate segment well beyond that limit.

From 2006 to 2008, the main engine of growth was the commercial mortgage product. This product initially related to properties in old Dubai, rather than the Freehold areas, where established tenants provided reliable cash flows. DIB also targeted the residential mortgage sector with this being a significant driver of personal loan growth. However, once the property market collapsed, and liquidity evaporated, the maturity mismatch was made clear and the risk concentration was unjustifiable.

Chart 2 : Loan book split and growth %



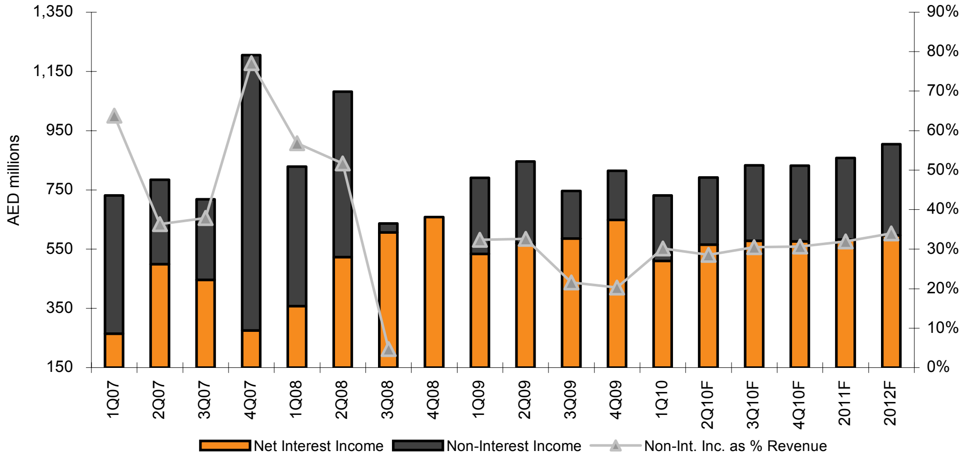
Source: Company reports

Since the crisis, therefore, DIB has put its commercial mortgage portfolio into run-off, aiming to build out instead its personal banking products, diversifying away its product base from the run-of-the-mill asset-backed auto and property loans. This had little impact in 2008, as DIB had built up a Dh31bn loan commitment book (equivalent to 59% of the loan book), much of which must have been related to property. During 2009, the real estate book continued to grow, but loan commitments were brought down to Dh11bn.

Other than real estate, the only other sector returning positive growth has been the personal financing sector. In 2008, it was estimated that 75% of this related to auto loans, but the increasing focus has been to develop innovative Shariah-compliant products to address the full range of customer needs, and to this end DIB recently launched a commodity-backed unsecured lending product known as Salam Finance.

After -4% gross loan growth in 2009, we expect DIB to return to positive territory in 2010 as retail banking expansion outweighs real estate contraction. Reductions in the corporate and commercial loan book may amount to as much as 5%, but at least with significant excess liquidity, DIB would not be constrained from growth in other sectors, and we expect around 10% growth in personal lending. We expect some success in building out a broader retail operation, though we caution that Noor bank is already in that space and ADIB's main area for branch expansion is likely to be Dubai.

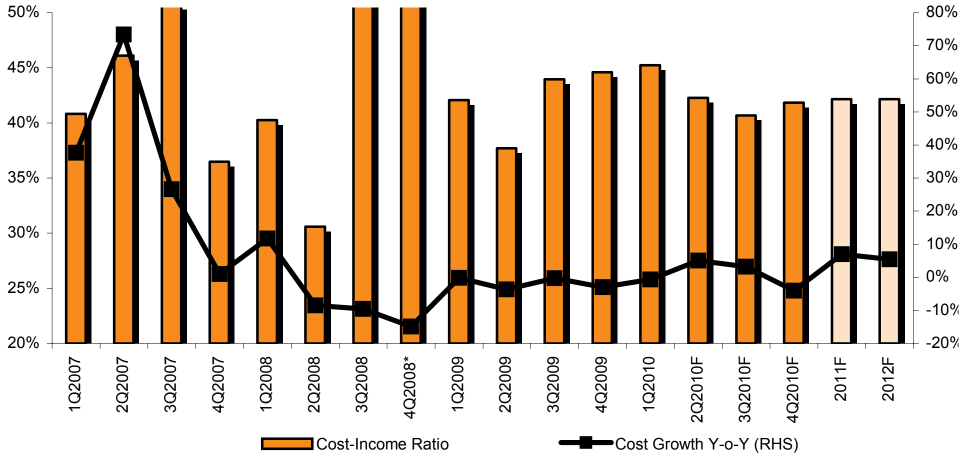
Chart 3 : Revenue split



Source: Company reports

Unsurprisingly, revenue growth has also been weak, with 1Q10 showing a yoy decrease of 8%. Although it is true that this is partly the result of an exceptionally poor quarter for spreads, and comparatives previously benefited from large amounts of other operating income, the trend of anaemic growth is clear. Going forward, we expect a short-term recovery in spreads, amounting to 32bp, but still leaving them 10bp below the average for 2009. Beyond that, we expect a recovery in investment returns and then finally a recovery in property returns, all assisting in a smooth recovery of revenues to 5.6% in 2011 and then 6.0% of interest earnings assets in 2012.

Chart 4 : Cost-income ratio, cost growth yoy%

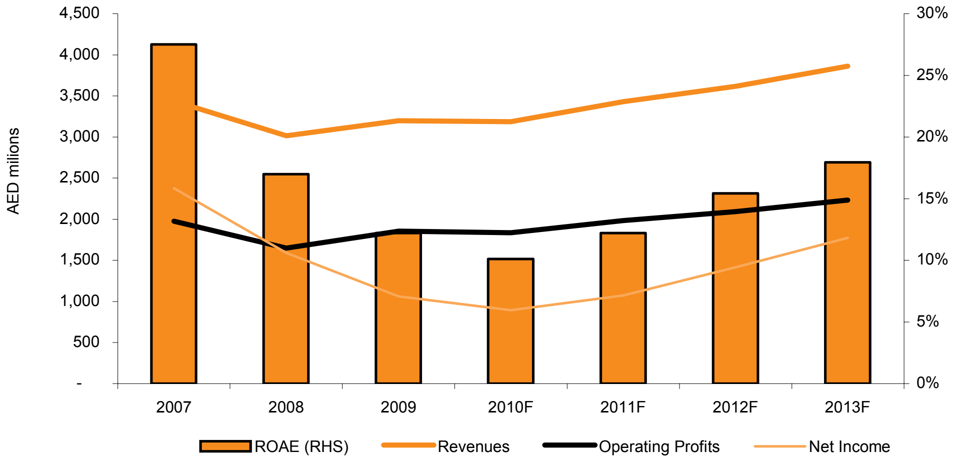


Source: Company reports

The cost-income ratio has generally been pretty high for DIB, averaging 45.8% over the last three years, which may be a reflection of its extensive physical presence, somewhat unusual for a predominantly corporate bank. This extensive branch network may cushion the cost of developing a broader retail franchise, as many of the costs may already have been implemented. For the moment, we do not believe there is much drive to push the cost-income ratio downwards, but over the long-term there certainly is the possibility of working the cost-base harder with mid-thirties seeming to be a reasonable target.

In common with the rest of the sector, we expect the NPL ratio to peak during 2010 at the 8.65% level, before declining slowly. However, DIB's exposure is very much to the commercial mortgage sector in the non-freehold areas of the city. As discussed earlier, this has been an area which has been largely untouched by the crisis so far, with high occupancy rates driving strong cash-flows to support these mortgages. In time, though, we expect these to equilibrate with office space across the Dubai emirate and come under pressure, undermining both the cash-flows and the underlying collateral values. As such, the recovery in provisioning may be more protracted for DIB.

Chart 5 : Income statement, ROAE



Source: Company reports, Rasmala forecasts

Balance sheet quality compromised by property exposure

Property problems

DIB has been plagued by property problems across its business. Within lending, the most high profile is the CCH loan. Within investments, the difficulties at 20%-owned property financier Tamweel have been well acknowledged. Within property development, 41%-owned associate Deyaar has been a source of concern. There have been a number of legal issues arising in all three situations. DIB also maintains a substantial property investment book, has a significant property mortgage book and has no less than 40% of its loan book linked to real estate loans.

Deyaar and Tamweel

Property developer Deyaar is listed, allowing significant visibility into its operations. The stock has been falling consistently over the last year, along with declining business volumes and operating profits falling into losses. Legal investigations of key staff members have also knocked investor confidence. This year, Deyaar is still promising delivery of five towers (in Business Bay), but a visual inspection suggests this is highly unlikely. Deyaar trades at a 65% discount to book value, implying a write-down of DIB’s stake amounting to Dh1.5bn, equivalent to 18% of DIB’s equity.

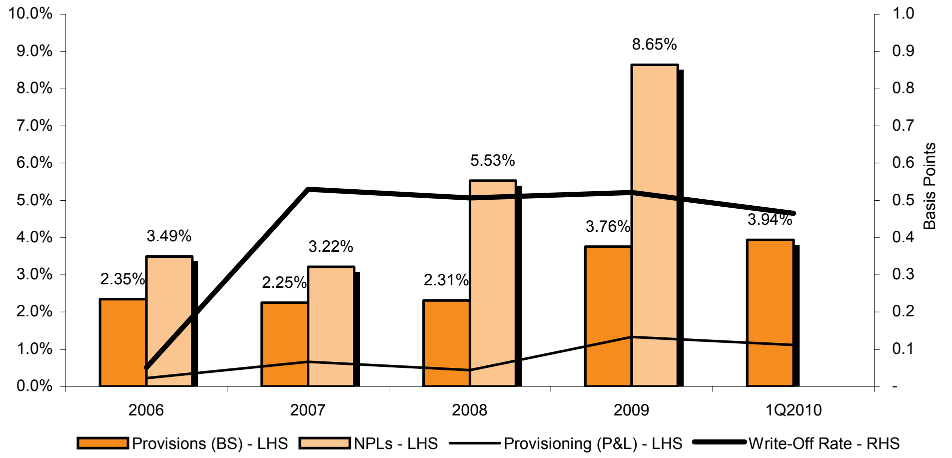
The situation with property financier Tamweel is rather more complex, although the book value of the holding is only about Dh519m. The chief uncertainty comes from the likely strategic solution for the company: possibilities include a merger with fellow property financier, Amlak, or reintegration into DIB. The stock was suspended in November 2008 as its liquidity position became untenable and as provisioning began to concern the market. We believe that either solution would crystallise the existing loss, but that otherwise the risks are evenly weighted. If this loss were to crystallised, it would amount to Dh322m, equivalent to 4% of DIB’s common equity.

If Tamweel were integrated, the impact on DIB would depend on the acquisition price. However, using DIB’s lower cost funding would immediately make the venture more profitable, while inevitably the integration of Dh10bn of mortgages into DIB’s book would raise the risk profile. Overall, an acquisition at Dh1 per share would be unlikely to change our view on DIB, although we suspect that the market might take that positively.

Quality of the loan book

Much like ADIB, DIB has one of the highest NPL ratios, at 8.65% on a 90 day basis (year end 2009), and one of the lowest coverage ratios at 43%. Uncovered loans amount to Dh2, 537m or 30% of equity. There are three reasons why DIB is broadly happy with that: 1) net write-offs have always been minor; 2) most debt is collateralised; and 3) about a third of this is regarded by DIB as “substandard of 91 days” rather than impaired.

Chart 6 : Provisioning schedule as % of customer assets



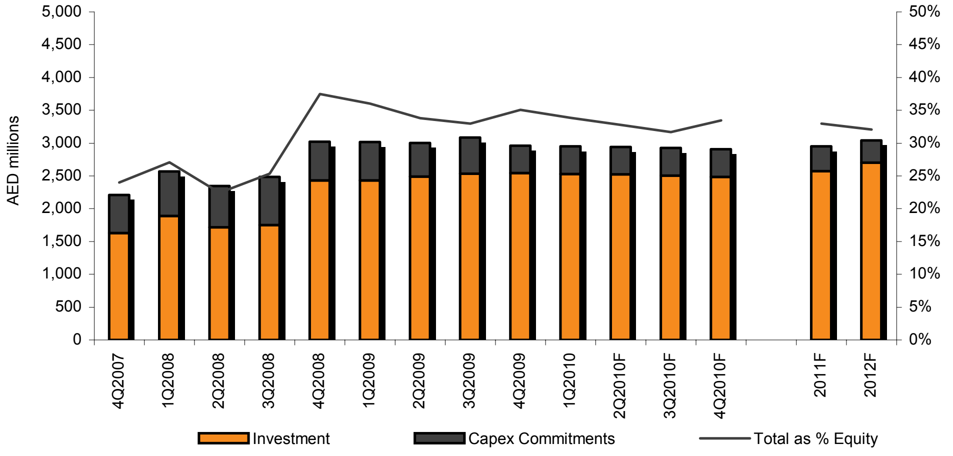
Source: Company reports

While all the above points are true, we remain concerned about the comparability of provisions versus the other banks. In addition, cash flows at the older office properties in Dubai are only just beginning to weaken. As a result, although these collaterals have held up well in the past, this may be less true going forward.

Property book

Although the property book is substantial in relation to its equity, much has been held since before the 2Q07 deconsolidation of Deyaar, and DIB itself is keen to emphasise that all of the property is held at cost or was marked to market long before the pre-crash boom. This different emphasis can also be seen in the current 3% rental yield on the overall portfolio, although we forecast this to dip to 2%. Overall, while of course there is risk, we believe the property portfolio is relatively secure from mark-to-market risk.

Chart 7 : Property book exposure



Source: Company reports, Rasmala forecasts

Overall risk is elevated

The two main sources of balance sheet risk are, in our view: 1) the Deyaar exposure, which is on the books for significantly more than current market value; and 2) the uncertainty related to the low coverage ratio on the NPL portfolio, potentially more of an issue with falling collateral and cash-flow in the non-freehold commercial property segment. In addition, we have concerns that DIB will be asked to buy out the Tamweel stake at a value that reflects broader political considerations. Finally, DIB suffers from more general Dubai risk (due to the turbulent economy).

Offsetting this is the fact that DIB is less leveraged than the average, with a lower loan-deposit ratio, and a less efficient balance sheet.

Overall, we believe that DIB has above-average risk, and we assign a 17.3% discount rate, reflecting a 3.1% risk free rate, a 10.2% sector risk premium and a 3.0% stock risk premium, with the latter also reflecting the general market preference for liquid Islamic Banks.

Valuation and recommendation

We exit the forecast time horizon with an 2013F ROE of 18%, and assume that it will be difficult for DIB to maintain anything much better than that over the medium term. Although there will be a pick-up in overall profitability, we do not expect to see the cost-income ratio move rapidly towards the average for the remaining banks and believe that DIB is a late entrant to the increasingly competitive market of Islamic retail.

We also expect growth to be limited in the medium term, with DIB's loan book constrained by its strategy of reorienting its business away from commercial real estate. In addition, DIB's heavy Dubai exposure is likely to constrain growth, in spite of likely efforts to expand in Abu Dhabi. Our forecasts are more cautious than the Zawya consensus in 2010, when we focus on provisioning, but actually we end up with more positive numbers in 2011-12, with relatives for headline net profit of 84%, 104% and 140% of the consensus forecasts. Analysts are overwhelmingly negative on DIB, with a -0.17% average rating score (+1 for a buy, -1 for a sell), and with no positive recommendations.

Overall, we assign a target price of Dh1.97, reflecting a 1% premium to current market value, and therefore give a Hold recommendation. Our target price is at the bottom end of the range, which has a mean of Dh2.62 and a median of Dh2.36. The principle catalyst for a more positive target price, however, would be if it appeared that DIB could realise greater value from its associates and subsidiaries. In addition, we have taken a relatively cautious view on the reorientation to retail, which the company itself is guiding quite positively on.

Key risks

Upside risks to our 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.

Table 1 : Gordon growth model valuation

Stage 1 (2010-2013): explicit dividends	**Dhm**	**2010**	**2011**	**2012**	**2013**
Forecast dividends		540	636	704	745
NPV stage 1	**2,060**	2,060	1,780	1,340	745
Stage 2 (2014-23): modelled dividends					
Excess capital	2,327	**Assumptions**			
Modelled dividends	4,441	ROE1	Growth	Capital Req'd	RWA
NPV stage 2	**4,214**	19%	10%	7,981	88,678
Stage 3 (2024+): terminal value					
2023	9,316	**Assumptions**			
NPV stage 3	**1,195**	ROE1	Growth	Capital Req'd	
		11%	6%	20,701	
Total NPV					
Stage 1 (2010-2013)	2,060				
Stage 2 (2014-23)	4,214				
Stage 3 (2024+)	1,195				
Total	**7,469**				
No of shares (m)	3,799				
Price target (Dh)	**1.97**				
Price (Dh)	**1.94**				
Upside/(Downside)	**1.5%**				

COE: US RFR 3.11%, country risk spread 6.00%, sector risk spread 5.00%, stock spread 3.00%, discount rate 17.11%
Source: Rasmala

Appendix

Rebuilding returns

Low leverage, low capital ratios, but no tier one support

In spite of the generally weak news coverage, ROEs at DIB have held up better than average, dropping to 12.2% in 2009. Leverage has been below average, although, rather contradictorily, the total capital ratio at 17.9% has also been lower than much of the sector. This is because most of the rest of the sector benefits from tier 1 debt funding boosting total capital ratios, and enabling higher levels of leverage.

Strong 2009 ROAA boosted by spreads

Nevertheless, strong revenues in 2009 (at 4.9% of average IEAs) and good profit margins (at 33.3%) have both meant that the return on assets has been strong.

The main driver for the strong return on assets has been the strong spreads, in common with many Islamic banks, which benefit from a low-cost funding base. However, in DIB's case this has been assisted by the high proportion of customer funding (90%), with most of the remainder coming from the obligatory tier 2 funding. Fees and commissions have also been strong, driving core non-interest income to 1.36% of average IEAs in 2009, with strong trade business being the principle driver of that.

Recovery to come from non-core revenues

The main weakness has been in non-core revenues, where weak 'income from other investments' and 'impairment losses' have affected investment income, and an absence of property disposal gains has restricted property earnings. Overall, we expect a recovery in non-core revenues as property returns come back, and as capital markets put in a more even performance. This should provide an overall revenue recovery.

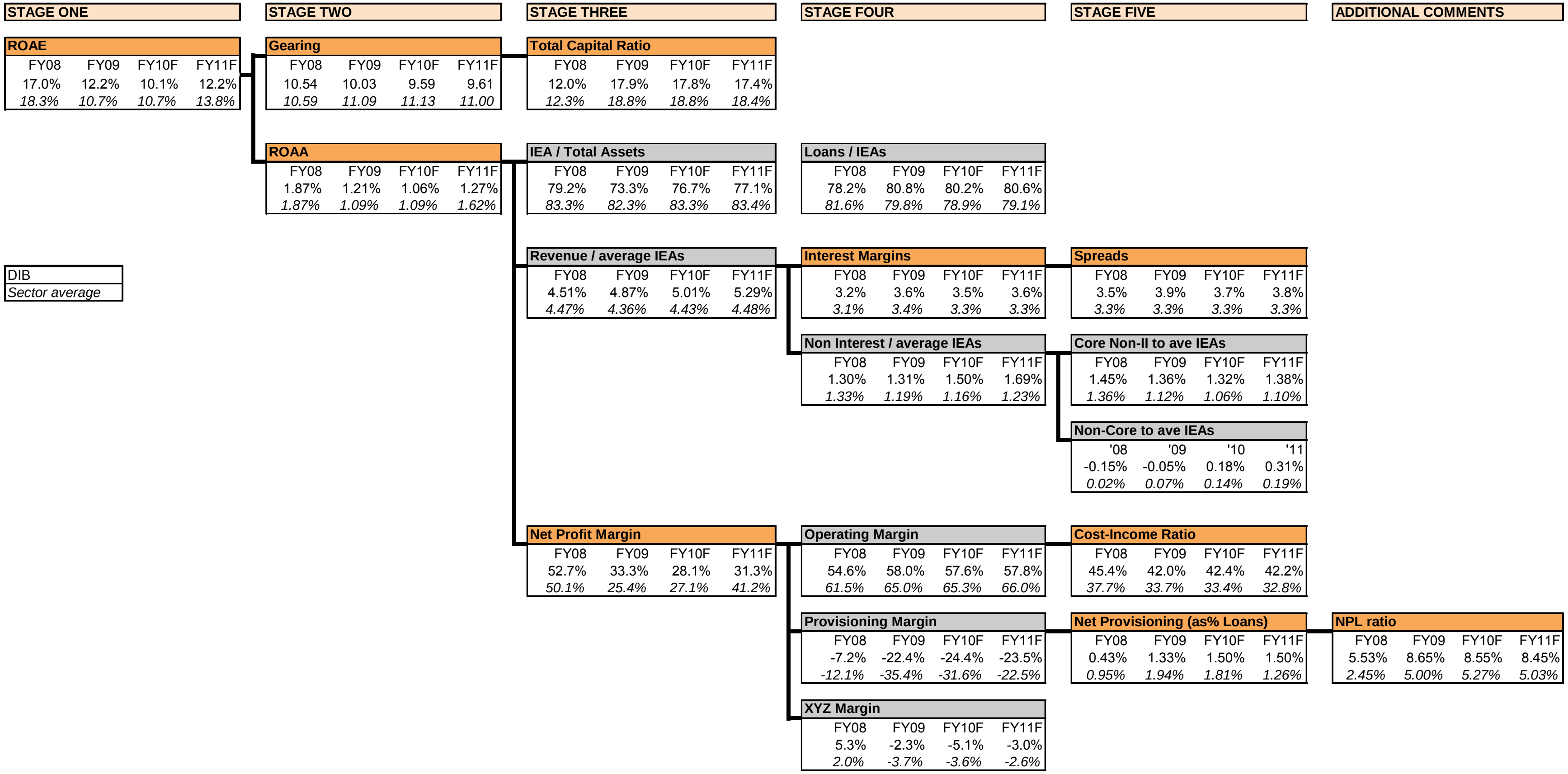
But uncovered loans may lead to higher provisioning for longer

In addition, the solid net profit margin in 2009 was not driven by a good cost-income ratio, but rather by a low provisioning number, which is at odds with the substantial leap in the NPL ratio.

However, the high cost-income ratio is a structural problem that will need to be addressed. Returns from associates are also weak, and are likely to remain so, given the uncertain situation at Deyaar. Finally, 'zakat' (Islamic community tax) of 4-12% of pre-zakat earnings will also weigh on returns.

With the headwinds of higher medium term provisioning, weak property income and income from associates and zakat, it is likely that it will be difficult for DIB to regain its higher ROEs even in the medium term. The absence of tier 1 debt could also limit the amount of leverage that DIB will be able to manage.

Chart 8 : Modified DuPont



STAGE ONE

ROAE

FY08	FY09	FY10F	FY11F
17.0%	12.2%	10.1%	12.2%
18.3%	*10.7%*	*10.7%*	*13.8%*

DIB

Sector average

STAGE TWO

Gearing

FY08	FY09	FY10F	FY11F
10.54	10.03	9.59	9.61
10.59	*11.09*	*11.13*	*11.00*

ROAA

FY08	FY09	FY10F	FY11F
1.87%	1.21%	1.06%	1.27%
1.87%	*1.09%*	*1.09%*	*1.62%*

STAGE THREE

Total Capital Ratio

FY08	FY09	FY10F	FY11F
12.0%	17.9%	17.8%	17.4%
12.3%	*18.8%*	*18.8%*	*18.4%*

IEA / Total Assets

FY08	FY09	FY10F	FY11F
79.2%	73.3%	76.7%	77.1%
83.3%	*82.3%*	*83.3%*	*83.4%*

Revenue / average IEAs

FY08	FY09	FY10F	FY11F
4.51%	4.87%	5.01%	5.29%
4.47%	*4.36%*	*4.43%*	*4.48%*

Net Profit Margin

FY08	FY09	FY10F	FY11F
52.7%	33.3%	28.1%	31.3%
50.1%	*25.4%*	*27.1%*	*41.2%*

STAGE FOUR

Loans / IEAs

FY08	FY09	FY10F	FY11F
78.2%	80.8%	80.2%	80.6%
81.6%	*79.8%*	*78.9%*	*79.1%*

Interest Margins

FY08	FY09	FY10F	FY11F
3.2%	3.6%	3.5%	3.6%
3.1%	*3.4%*	*3.3%*	*3.3%*

Non Interest / average IEAs

FY08	FY09	FY10F	FY11F
1.30%	1.31%	1.50%	1.69%
1.33%	*1.19%*	*1.16%*	*1.23%*

Operating Margin

FY08	FY09	FY10F	FY11F
54.6%	58.0%	57.6%	57.8%
61.5%	*65.0%*	*65.3%*	*66.0%*

Provisioning Margin

FY08	FY09	FY10F	FY11F
-7.2%	-22.4%	-24.4%	-23.5%
-12.1%	*-35.4%*	*-31.6%*	*-22.5%*

XYZ Margin

FY08	FY09	FY10F	FY11F
5.3%	-2.3%	-5.1%	-3.0%
2.0%	*-3.7%*	*-3.6%*	*-2.6%*

STAGE FIVE

Spreads

FY08	FY09	FY10F	FY11F
3.5%	3.9%	3.7%	3.8%
3.3%	*3.3%*	*3.3%*	*3.3%*

Core Non-II to ave IEAs

FY08	FY09	FY10F	FY11F
1.45%	1.36%	1.32%	1.38%
1.36%	*1.12%*	*1.06%*	*1.10%*

Non-Core to ave IEAs

'08	'09	'10	'11
-0.15%	-0.05%	0.18%	0.31%
0.02%	*0.07%*	*0.14%*	*0.19%*

Cost-Income Ratio

FY08	FY09	FY10F	FY11F
45.4%	42.0%	42.4%	42.2%
37.7%	*33.7%*	*33.4%*	*32.8%*

Net Provisioning (as% Loans)

FY08	FY09	FY10F	FY11F
0.43%	1.33%	1.50%	1.50%
0.95%	*1.94%*	*1.81%*	*1.26%*

ADDITIONAL COMMENTS

NPL ratio

FY08	FY09	FY10F	FY11F
5.53%	8.65%	8.55%	8.45%
2.45%	*5.00%*	*5.27%*	*5.03%*

Source: Company data, Rasmala forecasts

Income statement

Dhm	FY08A	FY09A	FY10F	FY11F	FY12F
Net interest income	2146	2339	2231	2332	2387
Non-interest income	869.2	858.1	956.2	1098	1229
Total income	**3015**	**3197**	**3187**	**3430**	**3616**
Operating costs	-1368	-1343	-1352	-1446	-1525
Goodwill (amort/impaired)	n/a	n/a	n/a	n/a	n/a
Other costs	-36.9	0.00	0.00	0.00	0.00
Pre-prov operating profit	1610	1854	1835	1984	2091
Provisions charges	-288.5	-741.0	-822.8	-806.8	-567.9
Post-prov op prof	1322	1113	1012	1177	1524
Associates (pre-tax)	401.0	17.3	5.61	43.9	89.6
Other pre-tax items	0.00	0.00	0.00	0.00	0.00
Reported PTP	**1723**	**1130**	**1018**	**1221**	**1613**
Taxation	-132.4	-146.3	-122.6	-147.1	-194.3
Minority interests	0.00	-4.79	-1.00	-1.20	-1.58
Preference dividends	0.00	0.00	0.00	0.00	0.00
Other post-tax items	139.9	228.2	127.9	152.7	200.3
Reported net profit	**1730**	**1207**	**1022**	**1225**	**1617**
Tot normalised items	0.00	83.9	0.00	0.00	0.00
Normalised PTP	1723	1130	1018	1221	1613
Normalised net profit	1730	1124	1022	1225	1617

Source: Company data, Rasmala forecasts year to Dec

Balance sheet

Dhm	FY08A	FY09A	FY10F	FY11F	FY12F
Net loans to customers	52659	49925	51063	53271	57857
Other int earn assets	14708	11848	12569	12814	12563
Goodwill	0.00	34.5	34.5	34.5	34.5
Oth non-int earn assets	8904	8343	9218	9056	9914
Total assets	**85031**	**84304**	**83031**	**85740**	**91750**
Total customer deposits	66427	64196	62807	64990	70007
Oth int-bearing liabs	6086	7617	7553	7602	7716
Non int-bearing liab	4453	4050	3975	4191	4533
Total liabilities	**76966**	**75862**	**74335**	**76783**	**82256**
Share capital	8065	8437	8690	8951	9488
Reserves	0.00	0.00	0.00	0.00	0.00
Total equity (excl min)	**8065**	**8437**	**8690**	**8951**	**9488**
Minority interests	0.12	4.91	5.06	5.21	5.52
Total liab & sh equity	**85031**	**84304**	**83031**	**85740**	**91750**
Risk weighted assets	68916	68778	70345	73387	79705
Est non-perf loans	n/a	n/a	n/a	n/a	n/a
Specific provisions	-1245	-1948	-2724	-3524	-4084
General provisions	n/a	n/a	n/a	n/a	n/a

Source: Company data, Rasmala forecasts year ended Dec

Capital

Dhm	FY08A	FY09A	FY10F	FY11F	FY12F
Risk weighted assets	68916	68778	70345	73387	79705
Reported net profit	1730	1207	1022	1225	1617
Opening risk assets	51808	68916	68778	70345	73387
Closing risk assets	68916	68778	70345	73387	79705
Change in risk assets	17108	-137.9	1567	3042	6318
Capital required	1711	-13.8	188.1	365.0	758.2
Free capital flow	19.5	1221	833.8	860.4	859.3
Ordinary dividend paid	-860.5	-538.6	-539.7	-636.0	-704.2
Share buy back/spec div	0.00	-67.6	0.00	0.00	0.00
Equity / preference issue	14.8	5.44	0.00	0.00	0.00
Cash flow from financing	-845.8	-600.8	-539.7	-636.0	-704.2
Net capital flow	-826.2	620.5	294.1	224.4	155.1
Tier 1 capital	0.13	0.13	0.13	0.12	0.12
Tier 1 capital ratio (%)	0.00	0.00	0.00	0.00	0.00

Source: Company data, Rasmala forecasts year to Dec

7 July 2010

Emirates NBD

Riding out Dubai risk

Initiation of coverage

Buy

Target price
Dh3.26

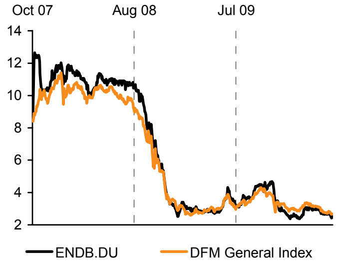
Price
Dh2.48

Short term (0-60 days)
n/a

Market view
No Weighting

Price performance

	(1M)	(3M)	(12M)
Price (Dh)	2.65	2.98	3.60
Absolute (%)	-6.4	-16.8	-31.1
Rel market (%)	-2.0	3.8	-14.8



Market capitalisation
Dh13.78bn (€3.01bn)

Average (12M) daily turnover
Dh2.58m (US$0.71m)

RIC: ENDB.DU, EMIRATES UH
Priced Dh2.48 at close 1 Jul 2010.
Source: Bloomberg

Emirates NBD (ENBD) is the sector's value play. As Dubai's bellwether stock, it suffers by association. We believe concerns are overstated and that ENBD will deliver double-digit ROEs even in the short term. It will be a rough ride, but that's why it offers value.

Key forecasts

	FY08A	FY09A	FY10F	FY11F	FY12F
Reported PTP (Dhm)	3,669	3,322	1,343	3,801	4,899
Reported net profit (Dhm)	3,681	3,346	1,085	3,543	4,641
Reported EPS (Dh)	0.66	0.57	0.20	0.64	0.83
Normalised EPS (Dh)	0.66	0.57	0.20	0.64	0.83
Dividend per share (Dh)	0.18	0.20	0.16	0.14	0.29
Normalised PE (x)	3.76	4.32	12.70	3.89	2.97
Price/book value (x)	0.56	0.51	0.50	0.45	0.41
Dividend yield (%)	7.33	8.07	6.52	5.70	11.60
Return on avg equity (%)	15.20	13.00	3.99	12.20	14.60

Accounting standard: IFRS Source: Company data, Rasmala forecasts year to Dec, fully diluted

NBD's ROEs should return to 17% in 2011

While we expect returns to be low in 2010, underlying profitability still looks strong, which is reflected in our 2011 ROE forecasts. ENBD has significant exposure to sectors likely to see deleveraging over the medium term, such as property and construction and indeed sovereign lending. This should limit growth to a four-year CAGR of 7%. However, easing provisioning after 2011 and higher returns on various asset classes could mean ROEs recover to 17%.

Making progress on the issues

ENBD may still be in the storm, but is to our mind steadily making progress. We expect to hear confirmation of the Dubai World restructuring, and believe it is easily able to weather any issues related to debts of the financial services arm of Dubai Holding. Although we are concerned about the Dh6.0bn of total balance sheet exposure to troubled property developer Union Properties, potential delivery of projects should offset this.

Solid coverage ratios

With the exception of the aforementioned issues, we have few concerns about the balance sheet. Provisions look sufficient to provide 89% coverage for non-performing loans. The NPL ratio itself, at 2.7% of the loan book, is the second-lowest in our sample. There is, however, a disconnect between the relatively benign NPL ratio and a tough Dubai economy, but we believe this is priced in.

Valuation burdened by NPL uncertainties

ENBD's 2010F price-to-tangible book (PTB) ratio of 0.64x is 33% below the sector average of 0.95x. Its 2011F ROAE of 13.8% is in line with the sector average. We have concerns, particularly about Union Properties, but also about potential write-downs of loans to the government-related entity (GRE) private equity companies, although we assess that a 10% haircut would have only a 7% impact on the target price. In the long run, we believe improving visibility will certainly justify a higher rating and lower discount rate. Our price target of Dh3.26 implies 31% upside to the current share price and a 2010F PTB of 0.84x. We have a Buy recommendation.

Important disclosures can be found in the Disclosures Appendix.
Distributed outside MENA by The Royal Bank of Scotland N.V. and its affiliates under a strategic alliance with Rasmala Investment Bank Ltd.

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Riding out Dubai risk

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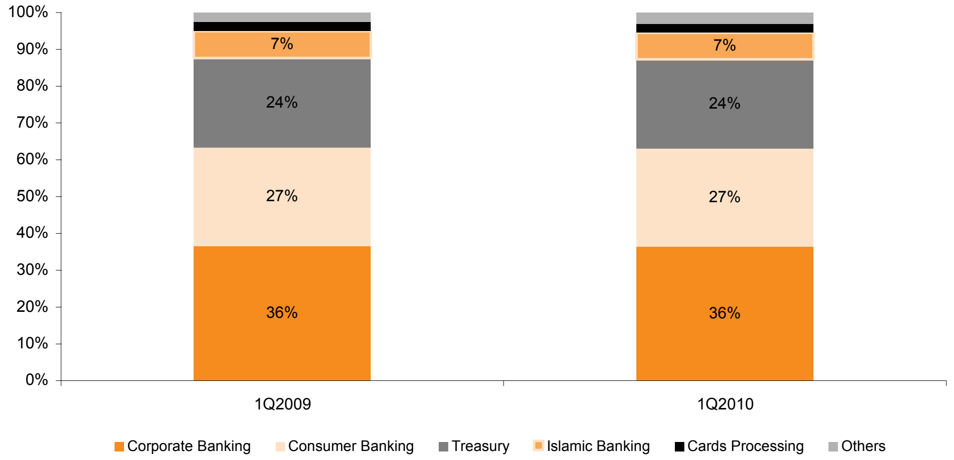
ENBD is the leading bank in Dubai

ENBD is the largest bank in the UAE by branches, deposits and loans, with 142 branches and 16 pay offices. ENBD was created with the 2007 integration of Emirates Bank and National Bank of Dubai, a merger that was substantially complete by year-end 2009. The most visible aspect of this has been the reduction from three branch networks to two: Emirates NBD and Emirates Islamic Bank. The bank itself is split into six divisions, as shown in the next chart. Within the UAE, ENBD has 21% market share in loans and 19% in deposits.

Internationally, ENBD has a single branch licence in Saudi Arabia, an additional branch in Doha and branches in London and the Channel Islands. It maintains rep offices in Iran, India and Singapore. No international segmentation is provided.

ENBD is 55.6% owned by the Investment Corporation of Dubai (ICD) and 5.3% by long-standing shareholder Jumaa Koraiban. The freefloat amounts to 39%, with a foreign and Gulf Cooperation Council (GCC) ownership limit of 5%, and the current level is 3.77%. GCC investors hold 1.79%, other Arabs an additional 0.11% and international investors an additional 1.87%.

Chart 1 : Revenue split by divisions



Source: Company reports

Balance sheet and other risks manageable

Aside from the Dh6bn of goodwill and intangibles (2% of total assets), which, in any case, we deduct from all ratios, ENBD has a relatively clean balance sheet. There is only a small shortfall on provisioning coverage, according to FY09 data (Dh700m, equivalent to 3% of common equity), and the size of the direct property portfolio is also not too material – equivalent to 6% of equity – suggesting write-downs (if any) may not be excessively traumatic. Indeed, the greatest uncertainty is within associates and relates to the 48%-owned troubled developer Union Properties.

Associates – Union Properties (UP) facing liquidity problems

UP is facing liquidity problems that are delaying delivery of many of its near-completion properties, as well as write-downs on its book. The result has been losses within the last three periods of 2009, and a decline in the share price to 38% of nominal value and 23% of book value. ENBD has already taken a related Dh316m impairment charge, and we assume it will book an additional Dh400m in 2010. We understand that UP is currently valued at Dh2.3bn on ENBD's books, suggesting Dh1.7bn downside to a mark-to-market price (6% of common equity).

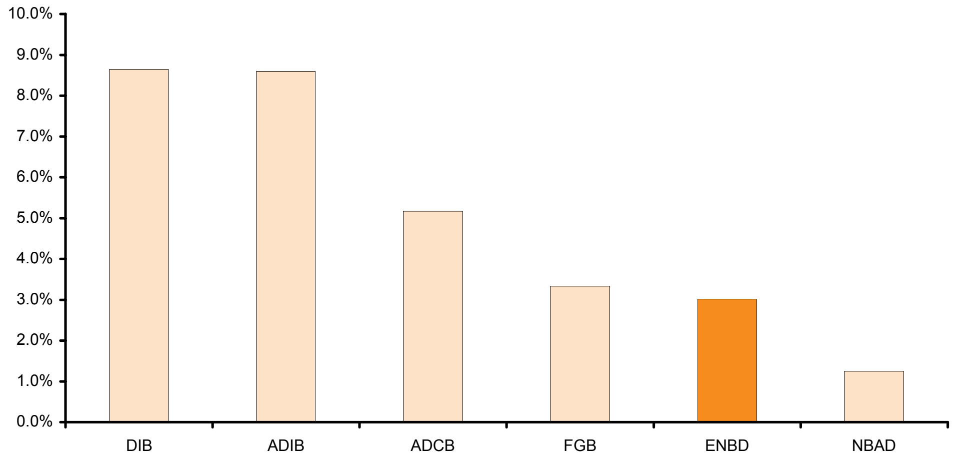
As well as the potential write-down of equity, there is the additional question of interparty transactions. ENBD reports loans to associates of Dh3.8bn, most of which relates to UP. Total bank loans for UP amount to Dh5.6bn, of which Dh2.75bn fell due in September 2009 prior to being extended to December 2010, giving UP a window in which to improve its liquidity, particularly with completion of the Ritz Carlton, Limestone House and the Index Tower. With no great improvement in UP's situation, we would be concerned about a possible impairment of these liabilities.

However, we do not subscribe to the view that there is no value in UP and a major haircut is imminent. That said, a bear-case scenario of a 100% write-down of receivables due over one year, amounting to Dh1.3bn, and a 30% write-down of the Dh13.2bn property book, would leave equity at near zero, but with its debt intact. In our forecasts, we assume a Dh400m impairment with a plausible downside limited to Dh1.9bn in the event of UP hitting a liquidity wall.

Loan book – adequate cover, NPL ratios suggest book performing well

With an 89% coverage ratio, provisioning seems adequate if not optimal, with the shortfall equivalent to Dh706m as of 4Q10, equivalent to just 3% of equity value. We also calculate a 90-day NPL ratio of 3.0%, but adjusted to exclude fully impaired investments, this ratio drops to 2.7%.

Chart 2 : NPL ratios, 90-day basis, 2009



Source: Company reports

The NPL ratio of 2.7% compares with an average for the UAE stocks we cover of 4.7% and an average provision across the market of 4.8%, according to central bank data. Given the situation in Dubai, this looks surprising to us. According to ENBD data, this is primarily the result of a very low level of corporate NPLs. NPLs in retail lending amount to 10.1%, and in Islamic lending to 3.7% – in both cases not far off expectations. In corporate lending NPLs amount to just 1.1%, based on 4Q09 data, and is probably a reflection of the substantial amount of sovereign exposure on its balance sheet, amounting to Dh51bn, or 31% of corporate lending.

It is clear why NBAD has a much better NPL ratio, given its strong affiliation with the Abu Dhabi government and its well-documented conservative lending practices. In some ways, ENBD's role within Dubai is similar to that of NBAD's in Abu Dhabi, acting as banker to the Emirate, as can be seen in the Dh50bn of sovereign lending, equivalent to 26% of total lending. In addition, we believe ENBD has a leading role financing Dubai's GREs. Nevertheless, with NPL numbers this impressive, our concern is that the differential may not be sustainable.

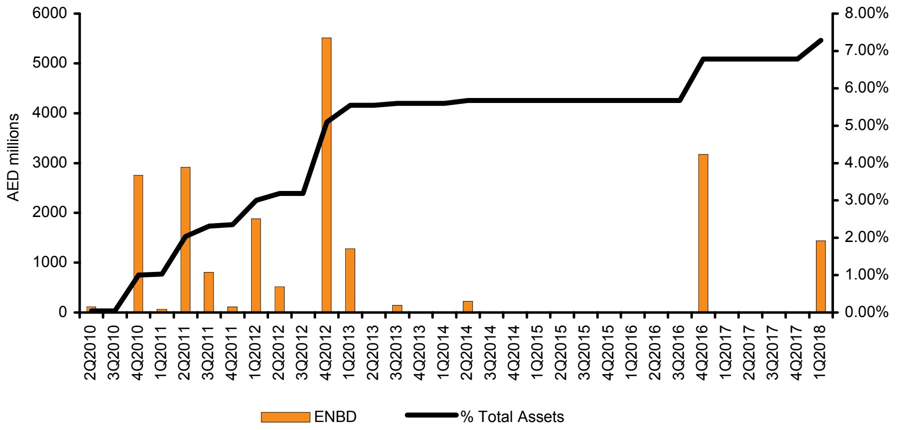
Management departures are a concern

Within a two-week period, Vice-Chairman Abdullah Saleh left the board and was recently hired head of private banking Robbert Jan Voogt, ex-NBD head of retail Suvo Sarkar and CFO Sanjay Uppal all left. Although we have no reason to believe these departures are connected, the simultaneous departures do suggest that the management team was not wholly content. Although in each case, 'seeking fresh challenges' may have been the official reason, we speculate that Suvo Sarkar's departure at least may have been linked to the legacy divide between Emirates Bank staff and National Bank of Dubai staff. In addition, we suspect Robbert Jab Voogt had expected to have far more resources put behind the private banking operation than was eventually the case.

Refinancing risk will be a drag on growth

ENBD has total capital market financing, excluding tier-1 debt, of Dh20.4bn, equivalent to 7% of total assets. Although this may not be a risk to the balance sheet, it certainly is a risk for growth. We believe it unlikely that ENBD can raise capital at an appropriate price unless perceived risk levels decline or economic visibility improves. Consequently, we estimate that if ENBD does not raise capital on the markets in the next three years, it will need to raise more than Dh5bn per year in deposits, just to maintain its funding base, knocking three percentage points off deposit growth each year. While this may be no calamity, it is certainly likely to be a restraint on overall balance sheet growth.

Chart 3 : Bond maturity profile, Dh m



Source: Company reports, Bloomberg

Overall balance sheet risk is above average for the sector

We remain concerned about the overall exposure to Union Properties, as does ENBD no doubt. For the moment, we assume a possible Dh200m write-down in 2Q10, followed by an additional Dh200m in 4Q10. Further write-downs are possible. We also note that the coverage ratio of 89% is adequate, if not optimal. The more salient issue is whether the current NPL ratio represents the real situation on the ground. Overall, we believe uncertainty is elevated for ENBD and therefore set a discount rate of 19.3%, at the top of the range.

Strategic targets all internal

ENBD's strategy for the past three years has been all about integration and synergies – a process largely completed by the end of 2009. Although in some areas ENBD is now in a position to move on from that, the key elements of strategy are predictably defensive. ENBD's three main stated objectives are:

- balance sheet optimization;
- optimising revenues; and
- risk management.

These three objectives are all about resolving weaknesses in the company's structure and resolving external threats, a strategy that looks particularly apposite in a time of crisis.

As discussed earlier, the emphasis from a financial point of view is to develop liability products as an intermediate stage to raising the contribution of customer funding. Optimising revenues should be about matching lending and pricing to risk, and maximising cross-sell to balance sheet customers. Risk management aims to ensure capital is allocated appropriately, and that risk is monitored and controlled. We believe these are important initiatives, although the impact on the financial statements is subtle.

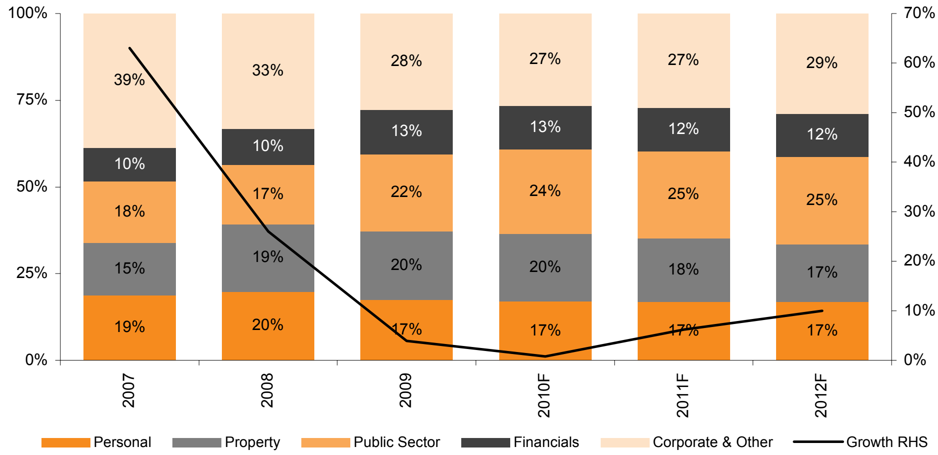
In terms of revenue-generating businesses, the main intention has been to expand ENBD's reach into SME operations, as well as to further develop the wealth management franchises. Wealth management activities include the Suhail premium banking operation and the Emirates NBD Private Banking operation, which succeeded TPO (The Private Office), a red carpet operation for the very top customers. The intention to create a national brand has not been smooth, however. The operation is still short of product despite paying up for manpower, perhaps contributing to the May 2010 departure of the head of the operation.

Internationally, ENBD has gone back and forth on expansion by acquisition, but at the moment its plans have become more modest. ENBD launched a greenfield operation in Saudi Arabia, so far extending to one branch, although a broader network is still intended. More recently, ENBD applied for a licence in Libya, but is one of six competitors for two licences.

Growth objectives yielding to stabilisation priority

After more than matching the 34% loan growth rate of the sector as a whole in 2007, ENBD's descent to earth has been sudden. Much of ENBD's above-market loan growth was achieved by increasing its exposure to the property sector loans, just before the great bust. While, for the moment, real estate loans continue to grow, courtesy of longer-term loan commitments, ultimately these will unwind to a level keeping with the smaller role for the industry going forward. Indeed, excluding loans to the sovereign, total lending for 1Q10 contracted 6% yoy.

Chart 4 : Loan split, loan growth



Source: Company reports, Rasmala forecasts

Deleveraging to slow balance sheet growth

Going forward, we believe deleveraging in Dubai, including sovereign lending, real -estate lending and construction lending, will prevent any significant recovery in loan growth for ENBD, given its strong representation in these sectors. Indeed, with loan commitments having being managed down to Dh7.9bn currently from Dh20.1bn in 1Q09, it is clear to us where ENBD's priorities lie. Asset gathering has been strong though, with deposits jumping 12% during 2009. As the loan deposit ratio comes further into balance, growth may return to the agenda.

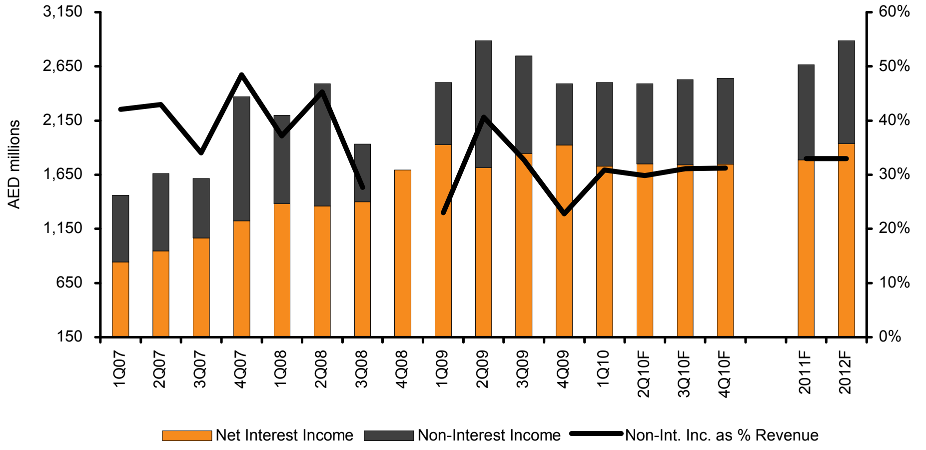
We estimate 0% loan growth in 2010, although even that represents a modest recovery from 1Q10 shrinkage. However, we expect this to rise to a CAGR of 9% over the next three years. We estimate stronger deposit growth, at an average CAGR of 10% throughout the period, although ENBD made a very strong start with 6% qoq growth in 1Q10.

Revenues going sideways

Although ENBD registered strong deposit growth of 12% during 2009, all of this has come from high-cost time deposits, resulting in an upward squeeze on funding costs of perhaps 10-15bp, compensated only by falling interbank rates. On the opposite side, we believe most of the new funding has merely gone into rebuilding liquid reserves, as a precaution against constrained funding in the future. While this should in principle still mean marginal positive spreads on new business and an increase in net interest income, asset yields declined 48bp in 1Q10 to 5.02%, resulting in weak net interest income. We expect these trends to continue through the year, with net interest revenue actually declining 6%.

Non-interest income has also been weak, in 1Q10 down 4% against an already weak 2009 average quarterly figure, with impairments on investment securities (of Dh55m) demolishing investment income (to Dh4m). Fees and commissions have also been falling (by 3% against the 2009 average), with lower fees from trade activity and less foreign exchange earnings. The likelihood is that investment income will recover in 3Q10 after weak markets in 1H10, although trade and foreign exchange may take more time. Beyond the immediate time horizon, we would expect more service-driven areas, such as Private Banking, to drive stronger core non-interest growth. However, we will wait to see the evidence before pricing that in.

Chart 5 : Revenue split, Dh m

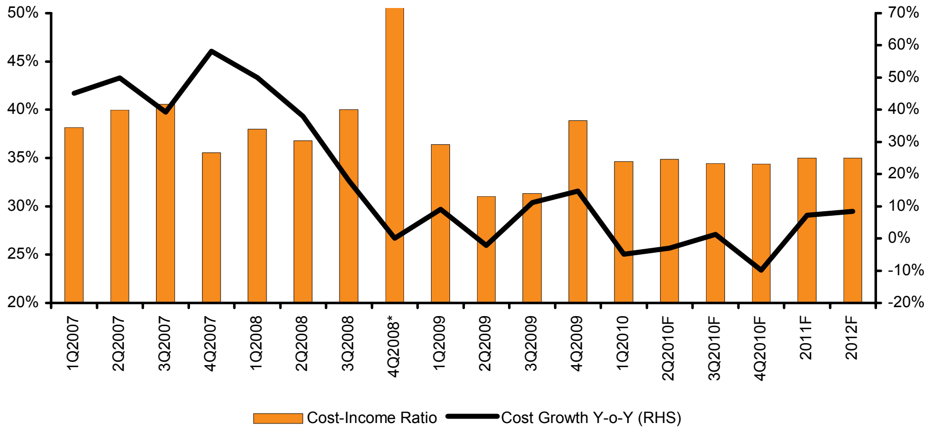


Source: Company reports, Rasmala forecasts

Cost-income ratio targets reassessed to mid-30s

ENBD once stated that it was not sustainable for costs to be maintained much below 40% over the medium term. While that may have been true when cost investments were relatively heavy, now that the banks are operating in a low-growth environment, ENBD has been able to reassess and manage down its cost base closer to its targeted mid-30s level. The decision to improve the proportion of high-cost nationals in the workforce is likely to be an upward driver of costs, but so far this seems to have been absorbed by revenue growth. Going forward, we believe the cost-income ratio will be broadly steady. However, as the bank moves away from the current crisis mode, this may bring a return of efforts to manage this down to the market best of around 30%.

Chart 6 : Cost-income ratio, cost growth (RHS)



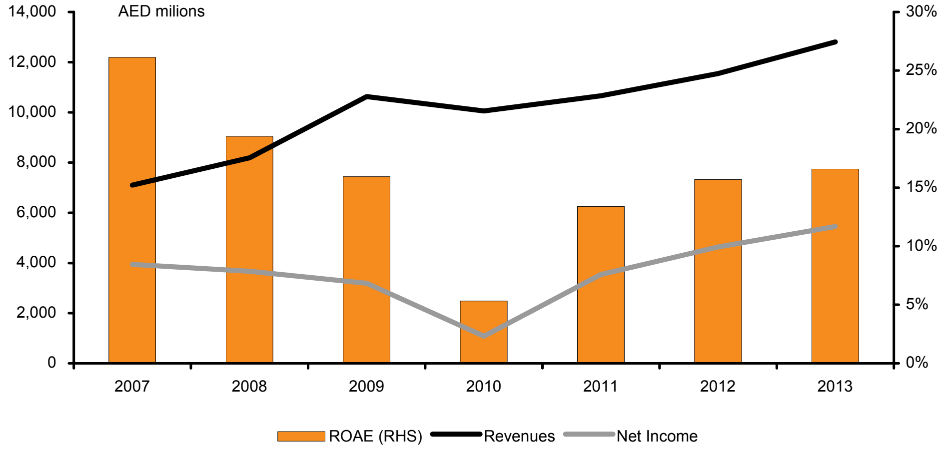
Source: Company reports, Rasmala forecasts

Slow provision recovery likely

Provisioning will, for the short term, be driven mostly by issues related to Dubai World. We assume Dh8bn of debt currently being restructured, and, with a 15% impairment rate, the impact would be Dh1.2bn. We believe this will be accounted for in 3Q10, although ENBD may take general provisions in 2Q10 to smooth the impact on earnings. Once Dubai World is out of the way, the next step will be to get comfort about the various government-related private equity firms.

We see, in the next chart, what this means for three of the key financial indicators. Revenues were boosted in 2009 by unusually high spreads, as well as surprisingly high non-interest income. In 2010, not only was this reversed, but Dubai World provisioning, high other provisioning and write-downs at associates severely damaged profitability and earnings. We believe that beyond 2011, earnings and revenues should return to normalised levels, although leverage remains low, constraining returns.

Chart 7 : ROAE, revenues and net income



Source: Company reports, Rasmala forecasts

Sensitivity to impairments

A very negative scenario would likely involve one of three possible situations: a write-down of UP, substantial restructuring of loans to government-related PE companies or a much higher NPL ratio, and, by implication, higher provisioning. We believe the limit of exposure to UP is Dh6.0bn, while exposure to the PE companies amounts to perhaps Dh2bn-4bn. If we take the top end of that range, a 10% haircut on both would shave 7% from our target price.

ENBD has a reported NPL ratio of 2.7% compared with the UAE average of 4.7%. We believe the bank has been slower than the rest in recognising NPLs, but, at a current price-to-tangible book (PTB) value of 0.56x FY10F, investors have already reflected any incremental NPLs. On our forecasts, every 100bp increase in write-downs or impairments would result in a decrease of Dh 2.1bn in value, equivalent to 7.5% of 1Q10 book value or 20% of TTM operating profits.

Valuation and recommendation

We acknowledge that, from a risk perspective, the balance sheet has weaknesses. Furthermore, the weakness of the Dubai economy remains a poor backdrop for the bank. However, we believe we have sufficiently captured this downside with appropriately cautious forecasts and a very elevated discount rate. Growth forecasts are weak in the medium term. Nevertheless, we expect a recovery in ROEs, even in a very bearish economic scenario, unless the provisioning number deteriorates suddenly and unexpectedly.

We exit the forecast period with a 2013 ROE of 17%. Although higher levels of capital efficiency could provide an ROE up to 21%, given the state of Dubai, we assume a more conservative 18% ROE in the medium term and only a 10% growth rate. Overall, our near-term forecasts are 67%, 17% and 10% lower than the market consensus provided by Zawya, although the likelihood is that this is driven by a more conservative estimate on Dubai World and Union Properties provisioning in 2010. Even on this basis though, we calculate a fair PE of 5.0x 2011F earnings and 0.74x 2011F PBT. On this basis, we recommend a Buy on the stock with 31% potential upside to our target price of Dh3.26.

We believe the key catalysts for achieving this are the conclusion of the various restructurings in the short term and the delivery of the three projects by Union Properties. As for the entire sector, a topping out of NPLs potentially in 4Q10 should be a factor. For ENBD to realise its full value, however, we believe there must be a higher level of transparency in Dubai.

Table 1 : Valuation

Stage 1 (2010-2013): explicit dividends		**2010**	**2011**	**2012**	**2013**
Forecast dividends		899	785	1,604	2,121
NPV stage 1	**3,972**	3,972	3,645	3,392	2,121
Stage 2 (2014-23): modelled dividends					
Excess capital	7,863	**Assumptions**			
Modelled dividends	11,391	ROE1	Growth	Capital Req'd	RWA
NPV stage 2	**11,539**	18%	10%	23,160	257,329
Stage 3 (2024+): terminal value					
2023	23,818	**Assumptions**			
NPV stage 3	**2,590**	ROE1	Growth	Capital Req'd	
		11%	6%	60,070	
Total NPV					
Stage 1 (2010-2013)	3,972				
Stage 2 (2014-23)	11,539				
Stage 3 (2024+)	2,590				
Total	**18,101**				
No of shares	5,557				
Price target	3.26				
Price	2.48				
Upside/(Downside)	31%				

COE: US RFR 3.11%, country risk spread 6.00%, sector risk spread 5.00%, stock spread 4.50%, discount rate 18.61%
Source: Rasmala

Appendix

Rebuilding returns

Historical ROE driven by gearing

ENBD actually has had one of the highest levels of ROE in the sector, at 15.9% for 2009, largely driven by much higher leverage (at 13.2x) and also a higher return on average assets (1.19%). Nevertheless, the total capital ratio is also above average thanks to a large supply of tier-2 financing, even before government support. The presence of this tier-2 funding means the total capital ratio understates the real level of leverage in comparison with the rest of the sector.

Dubai World provisioning should dent 2010 profitability

While higher leverage is one driver of higher returns, the above-average ROAA of 1.19% driven by a high net profit margin also has been a factor. Surprisingly, this was the result of a relatively low level of provisioning in 2009, despite Saudi exposures and problems in the Dubai market. As discussed, higher provisioning in 2010 will have a short-term impact on returns. Although we believe this may be partially offset by lower losses related to Union Properties, we still would expect the ROE to decline to just 5.9%.

Recovery beyond that will be gradual

Over the longer term, provisioning should return to a more normalised level of 1.3% in 2011, before gradual recovery helps it drop. Property and capital market revenues are less of a feature for ENBD, but nevertheless some recovery would be helpful to non-core revenues. Core revenues, which in 2009 included the discounted buy-back of its bond, should fall, but should be stable in the longer term. Improved cross-sell is clearly a focus, but one that has not yielded the expected results so far, particularly in private banking.

And still driven by high gearing

Overall, we expect ENBD to deliver a UAE sector average ROE of 13.4% in 2011, but with that being driven by the higher level of gearing that the added tier-2 capital provides.

Table 2 : Modified DuPont

STAGE ONE

ROAE

FY08	FY09	FY10F	FY11F
19.4%	15.9%	5.3%	13.4%
18.3%	*10.7%*	*10.7%*	*13.8%*

ENBD
Sector average

STAGE TWO

Gearing

FY08	FY09	FY10F	FY11F
14.77	13.17	13.19	12.45
10.59	*11.09*	*11.13*	*11.00*

ROAA

FY08	FY09	FY10F	FY11F
1.39%	1.19%	0.42%	1.23%
1.87%	*1.09%*	*1.09%*	*1.62%*

STAGE THREE

Total Capital Ratio

FY08	FY09	FY10F	FY11F
11.4%	20.8%	21.3%	21.5%
12.3%	*18.8%*	*18.8%*	*18.4%*

IEA / Total Assets

FY08	FY09	FY10F	FY11F
86.6%	88.4%	87.6%	86.7%
84.5%	*84.8%*	*85.1%*	*85.0%*

Revenue / average IEAs

FY08	FY09	FY10F	FY11F
3.60%	4.32%	4.07%	4.15%
4.47%	*4.36%*	*4.43%*	*4.48%*

Net Profit Margin

FY08	FY09	FY10F	FY11F
44.8%	30.0%	10.8%	33.2%
50.1%	*25.4%*	*27.1%*	*41.2%*

STAGE FOUR

Loans / IEAs

FY08	FY09	FY10F	FY11F
88.3%	88.9%	85.6%	85.6%
83.2%	*81.1%*	*79.8%*	*79.9%*

Interest Margins

FY08	FY09	FY10F	FY11F
2.6%	3.0%	2.8%	2.8%
3.1%	*3.4%*	*3.3%*	*3.3%*

Non Interest / average IEAs

FY08	FY09	FY10F	FY11F
1.04%	1.31%	1.25%	1.37%
1.33%	*1.19%*	*1.16%*	*1.23%*

Operating Margin

FY08	FY09	FY10F	FY11F
58.9%	65.8%	65.4%	65.0%
62.3%	*66.3%*	*66.6%*	*67.2%*

Provisioning Margin

FY08	FY09	FY10F	FY11F
-17.1%	-28.8%	-47.1%	-29.2%
-13.8%	*-36.4%*	*-35.4%*	*-23.5%*

XYZ Margin

FY08	FY09	FY10F	FY11F
3.0%	-7.0%	-7.5%	-2.6%
1.6%	*-4.5%*	*-4.0%*	*-2.5%*

STAGE FIVE

Spreads

FY08	FY09	FY10F	FY11F
2.7%	3.0%	2.8%	2.8%
3.3%	*3.3%*	*3.3%*	*3.3%*

Core Non-II to ave IEAs

FY08	FY09	FY10F	FY11F
1.46%	1.34%	1.22%	1.27%
1.36%	*1.12%*	*1.05%*	*1.08%*

Non-Core to ave IEAs

FY08	FY09	FY10F	FY11F
-0.43%	-0.04%	0.04%	0.10%
-0.03%	*0.07%*	*0.11%*	*0.15%*

Cost-Income Ratio

FY08	FY09	FY10F	FY11F
41.1%	34.2%	34.6%	35.0%
37.7%	*33.7%*	*33.4%*	*32.8%*

Net Provisioning (as% Loans)

FY08	FY09	FY10F	FY11F
0.83%	1.44%	2.15%	1.40%
0.95%	*1.94%*	*1.81%*	*1.26%*

ADDITIONAL COMMENTS

NPL ratio

FY08	FY09	FY10F	FY11F
2.24%	3.02%	3.50%	3.40%
2.45%	*5.00%*	*5.27%*	*5.03%*

Source: Company data, Rasmala forecasts

Income statement

Dhm	FY08A	FY09A	FY10F	FY11F	FY12F
Net interest income	5834	7412	6964	7146	7742
Non-interest income	2357	3217	3096	3513	3810
Total income	**8191**	**10629**	**10060**	**10659**	**11551**
Operating costs	-3368	-3635	-3479	-3731	-4043
Goodwill (amort/impaired)	n/a	n/a	n/a	n/a	n/a
Other costs	-95.9	-93.9	-93.9	-93.9	-93.9
Pre-prov operating profit	4727	6899	6486	6835	7414
Provisions charges	-1397	-3100	-4742	-3111	-2596
Post-prov op prof	3330	3800	1744	3724	4818
Associates (pre-tax)	338.6	-477.6	-401.6	77.0	80.9
Other pre-tax items	0.00	0.00	0.00	0.00	0.00
Reported PTP	**3669**	**3322**	**1343**	**3801**	**4899**
Taxation	0.00	0.00	0.00	0.00	0.00
Minority interests	-0.72	3.30	0.74	-1.00	-4.66
Preference dividends	0.00	-132.6	-258.0	-258.0	-258.0
Other post-tax items	12.7	153.2	-0.74	1.00	4.66
Reported net profit	**3681**	**3346**	**1085**	**3543**	**4641**
Tot normalised items	0.00	0.00	0.00	0.00	0.00
Normalised PTP	3669	3322	1343	3801	4899
Normalised net profit	3681	3346	1085	3543	4641

Source: Company data, Rasmala forecasts year to Dec

Balance sheet

Dhm	FY08A	FY09A	FY10F	FY11F	FY12F
Net loans to customers	208930	214614	213604	226022	249027
Other int earn assets	27764	26811	36012	38106	41984
Goodwill	6139	6045	5952	5858	5764
Oth non-int earn assets	19217	11169	12872	16526	15970
Total assets	**279553**	**279014**	**291000**	**310457**	**339066**
Total customer deposits	162315	181162	199460	216981	244047
Oth int-bearing liabs	81756	58950	51421	50060	46798
Non int-bearing liab	10731	8042	8459	8998	10770
Total liabilities	**254802**	**248155**	**259339**	**276039**	**301615**
Share capital	24655	26765	27568	30325	33357
Reserves	0.00	0.00	0.00	0.00	0.00
Total equity (excl min)	**24655**	**30765**	**31568**	**34325**	**37357**
Minority interests	96.8	94.1	93.3	93.3	93.3
Total liab & sh equity	**279553**	**279014**	**291000**	**310457**	**339066**
Risk weighted assets	217286	201180	200234	211874	233439
Est non-perf loans	n/a	n/a	n/a	n/a	n/a
Specific provisions	-3314	-5948	-8609	-9998	-10594
General provisions	n/a	n/a	n/a	n/a	n/a

Source: Company data, Rasmala forecasts year ended Dec

Capital

Dhm	FY08A	FY09A	FY10F	FY11F	FY12F
Risk weighted assets	217286	201180	200234	211874	233439
Reported net profit	3681	3346	1085	3543	4641
Opening risk assets	172658	217286	201180	200234	211874
Closing risk assets	217286	201180	200234	211874	233439
Change in risk assets	44628	-16105	-946.6	11640	21565
Capital required	4463	-1611	-113.6	1397	2588
Free capital flow	-782.3	5089	1456	2404	2311
Ordinary dividend paid	-1011	-1112	-899.2	-784.9	-1604
Share buy back/spec div	0.00	0.00	0.00	0.00	0.00
Equity / preference issue	0.00	0.00	0.00	0.00	0.00
Cash flow from financing	-1011	-1112	-899.2	-784.9	-1604
Net capital flow	-1793	3977	557.1	1619	707.3
Tier 1 capital	0.09	0.13	0.14	0.14	0.14
Tier 1 capital ratio (%)	0.00	0.00	0.00	0.00	0.00

Source: Company data, Rasmala forecasts year to Dec

7 July 2010

First Gulf Bank

A mix of risk and quality

Initiation of coverage

Hold

Target price
Dh16.27

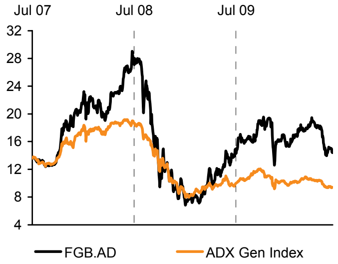
Price
Dh14.90

Short term (0-60 days)
n/a

Market view
No Weighting

Price performance

	(1M)	(3M)	(12M)
Price (Dh)	14.85	18.00	13.25
Absolute (%)	0.3	-17.2	12.5
Rel market (%)	1.0	-6.5	17.1
Rel sector (%)	-1.4	-6.7	11.8



Market capitalisation
Dh22.35bn (€4.88bn)

Average (12M) daily turnover
Dh8.33m (US$2.40m)

Sector: ADX Bank & Fin Index
RIC: FGB.AD, FGB UH
Priced Dh14.90 at close 1 Jul 2010.
Source: Bloomberg

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FGB is known, rightly so, for two things: stellar growth rates and property market exposure. We believe the growth rate is driven by good management, an efficient operation and strong client relationships. Nevertheless, the size of the property book is a concern in a turbulent market, and limits the premium payable. Hold.

Key forecasts

	FY08A	FY09A	FY10F	FY11F	FY12F
Reported PTP (Dhm)	2,937	3,331	3,410	4,561	5,917
Reported net profit (Dhm)	3,005	3,244	3,476	4,635	6,001
Reported EPS (Dh)	2.07	2.08	2.11	2.88	3.78
Normalised EPS (Dh)	2.07	2.14	2.11	2.88	3.78
Dividend per share (Dh)	0.32	0.45	0.49	0.79	1.00
Normalised PE (x)	7.19	6.97	7.06	5.18	3.94
Price/book value (x)	1.42	1.25	1.11	0.96	0.82
Dividend yield (%)	2.14	3.03	3.32	5.29	6.72
Return on avg equity (%)	23.40	19.80	18.30	21.40	23.70

Accounting standard: IFRS Source: Company data, Rasmala forecasts year to Dec, fully diluted

Premium bank, with growth not driven by risk

FGB has long been the high-quality play in the UAE, with loan growth rates that were double the sector average (2004-08: CAGR of 87%), and with an ROAA figure of 3.15% even in 2008, against a sector average of 1.87%. While many were concerned that FGB was simply a leveraged play on the property market, wrongly in our view, the downturn in Dubai's fortunes has instead shown the resilience of earnings, if not growth, with ROAAs remaining at 2.67% and 2.37% in 2009 and 1Q10 respectively.

Refocusing away from growth

In this more difficult environment, FGB was one of the first banks to re-orientate itself away from growth, reassigning regional managers to collections from sales and stepping up the frequency of credit review committees. International expansion is still on target, particularly in Libya, but the organic loan growth, which we estimate at 9%, is unlikely to be dramatic and acquisitions remain off the table.

Property exposure is a concern

Total property exposure for FGB amounts to Dh9.7bn or 62% of total equity, with Dh6.3bn being on-balance sheet exposure and the remainder commitments for future expenditure. Much of this property exposure is in Abu Dhabi, either in Reem Island or Khalifa City, but some is in Dubai. We believe the quality of the Dubai component varies and that the absence of a write-down anywhere on the book is an anomaly.

Valuation premium looks justified, but upside limited

In spite of the higher risk, we believe the stock deserves to trade at a premium. Using an elevated discount rate of 16.3%, we believe a fair P/B multiple is 1.2x 2010 book value. However, this value is widely recognised and FGB already trades at a 2010 P/B multiple of 1.1x, a 17% premium to the sector average. Consequently, we see limited upside unless and until we get greater clarity on the property portfolio. Our target price of Dh16.27 implies 9% potential upside and we have a Hold recommendation on the stock.

Important disclosures can be found in the Disclosures Appendix.
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A mix of risk and quality

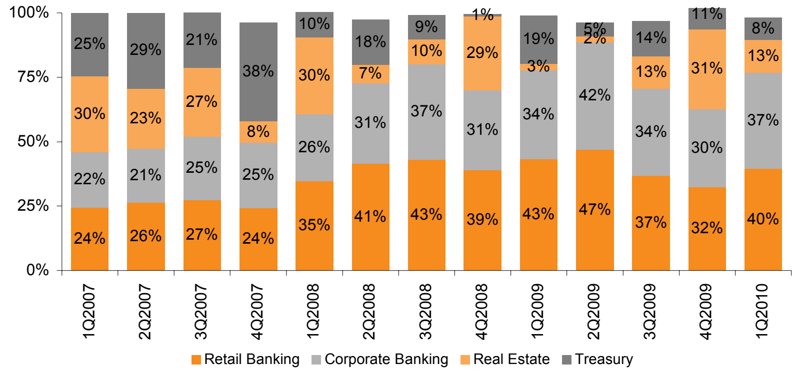
FGB is known for: stellar growth rates and property market exposure. We believe the growth rate is driven by good management, an efficient operation and strong client relationships. Nevertheless, the property book is a concern in a turbulent market. Hold.

The fastest bank in the UAE

First Gulf Bank (FGB), headquartered in Abu Dhabi, was established in 1979 and provides financial services in various businesses through a network of 19 branches across the emirates. FGB remains one of the best performing local banks as its operating income and net profit have had a 78% and 70% CAGR, respectively during 2002-09. As of March 2010, the bank's market share in loans and deposits amounted to 9.1% and 8.8% respectively, representing an increase of 72bp and 114bp over a year. The bank is characterised by a riskier asset exposure than the sector but with a better 2009 ROAA of 2.7% (sector average 1.1%).

FGB is 66.9% owned by the members of the Abu Dhabi Ruling Family, with a free float of 26.4%. The stock has a foreign and GCC ownership limit of 15%, and is quite close to that limit, with 5% GCC ownership, 1% other Arab and 8% other foreign.

Chart 1 : Revenue breakdown by division



Source: Company Reports

Reinventing the strategy

After four years of driving growth at a phenomenal CAGR of 87%, FGB shifted its focus in 2009 almost exclusively to debt collection. This situation was just beginning to ease by 4Q09, before the announced restructuring of Dubai World set things back a year. From an internal point of view this means that the bank is once again stepping up the frequency of creditors meetings, and has continued to reposition regional managers into a 'special accounts unit', where the focus is on debt collection rather than growth.

The second key priority for FGB is to retain its most valuable clients. Nearly every bank has identified Abu Dhabi as the target for expansion going forward, and especially the HNW Emirati segment. While FGB, as the incumbent, benefits from established client relationships in this segment, it will have to be innovative and proactive to defend this market share without compromising pricing.

FGB maintains a substantial property portfolio, amounting to Dh6.3bn, equivalent to 5% of total assets or 35% of common equity, which it holds mostly within its subsidiary, property developer Mismak. This has been a key concern of the market, which hoped that FGB would offload some of this exposure before the market closed down. While FGB did indeed sell down a range of towers during 3Q09 to 1Q10, it is believed that this has now run its course. Going forward, FGB's strategic intention is to develop these properties as and when the market will bear it. Many of these properties are on Reem Island, although a more limited selection is in Dubai, particularly Business Bay.

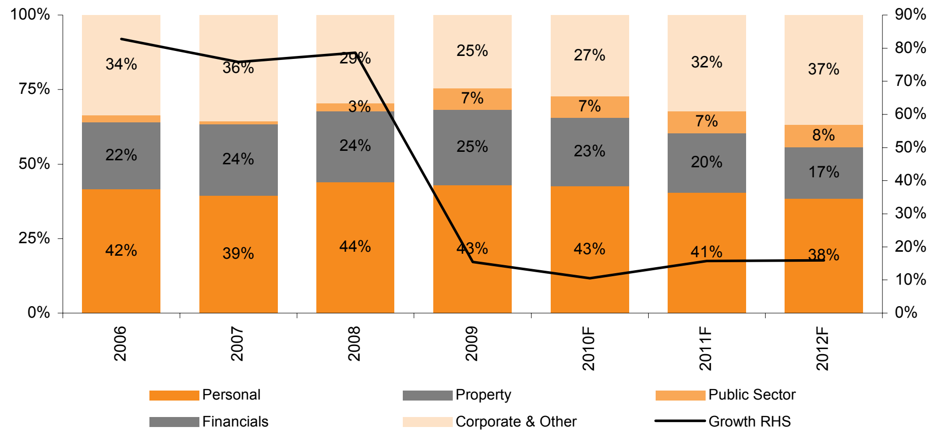
Internationally, FGB has been cautious about its intentions. It applied for an Algerian licence back in 2007, but this has so far proved a slow-moving target. However, it has now successfully launched corporate banking operations in Libya through a joint venture with the Economic & Social Development Fund of Libya. Elsewhere, FGB is expanding cautiously: it has set up a rep office in Singapore and is suggesting extensions in international markets such as the UK and China, but with no acquisitions.

Back to more earthly levels of growth

FGB grew initially by aggressively building out its corporate banking operation, but followed this up with expansion into retail banking and eventually building out a full product portfolio (with the possible exceptions of investment banking and not really focussing on developing a mass-market franchise). By 2006, growth was roughly symmetric, with personal banking contributing more to the loan book than any other segment. Exposure to the property sector (real estate and construction), however, was disproportionate, with FGB actively pursuing expansion in Dubai.

This credit expansion came to a dramatic halt in 2009, with growth rates declining from 79% to 15% in one year. Although initially it looked like a recovery might be possible early in 2010, following on from the restructuring of Dubai World, any such recovery has been postponed, with FGB guiding to a weakening market in 2010, rather than a strengthening one. Recent growth has been driven primarily by continued growth of retail loans and a strong contribution from disbursements related to a National Housing scheme.

Chart 2 : Loan book split and growth %

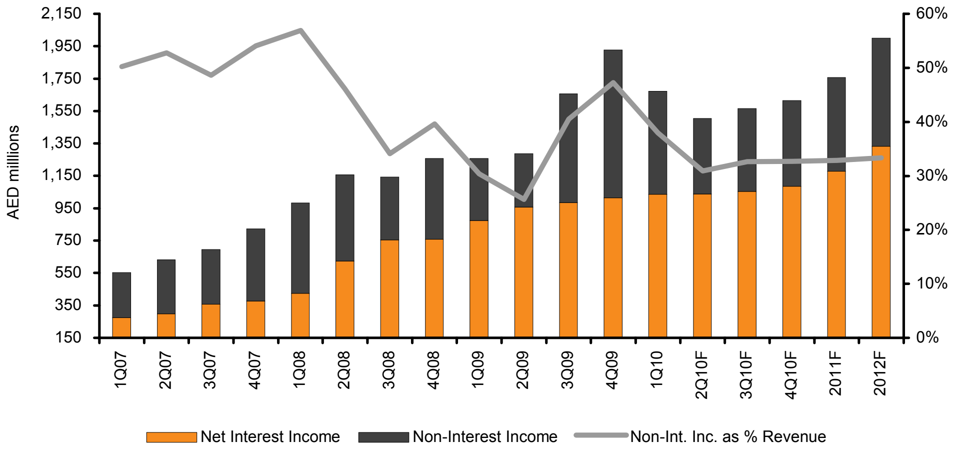


Source: Company reports, Rasmala forecasts

Going forward, we believe that loan growth at FGB will recover modestly, partially due to being in Abu Dhabi, partially driven by the quality of its relationships, and also helped by its proven ability to grow loans above the market rate. Nevertheless, its substantial exposure to the property market and partial exposure to Dubai is likely to hold it back. From a financing point of view, FGB was fortunate to raise US$500m of financing immediately before the problems at Nakheel entered their acute phase. Consequently, there is little in the way of wholesale funding needing to be rolled over in coming quarters with the next major instalment of Dh4.8bn due 4Q12.

In spite of little in the way of balance sheet growth over the coming quarters, we are more optimistic about revenue. Revenue peaked in 4Q09, although that was significantly driven by asset disposals, which continued into 1Q10. Consequently, FGB starts 2Q10 at a lower level but with a higher proportion of recurring income. Our base forecasts a stabilisation of capital markets from 3Q10 and a recovery in activity in areas such as FX and derivative income in 2011. Beyond rental income, we do not assume much in the way of a recovery in property income until 2013.

Chart 3 : Revenue split

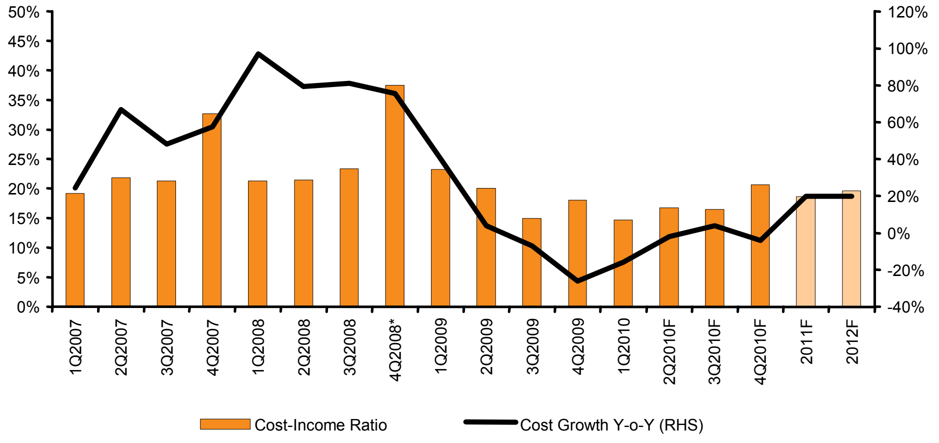


Source: Company reports, Rasmala forecasts

Cost inflation has also been muted. The cost-base peaked in 4Q08 (in which we include payments to directors), but subsequently declined sharply for a yoy decline in 4Q09 of 26% as FGB cut back on some of its costs related to future growth. Going forward, as FGB sees signs of rebounding market opportunities, it is likely to bring back a certain amount of costs, and this has been the primary driver of the higher cost inflation figures of 20% CAGR we forecast in 2011 and 2012.

We also expect that more competition in the segment may drive FGB, and other banks, to compete more aggressively on services. While other banks can offset this with tighter cost control, FGB's cost control is already so tight (cost income ratio of just 18.7% in 2009, against the sector average of 33.7%) it is difficult to see where additional savings could come from. Finally, FGB has managed so far, with a branch network substantially smaller than its loan book would imply, with loans per branch of Dh4.5bn compared with Dh2.4bn at ADCB for example. Any necessity to expand this branch network would bring further costs.

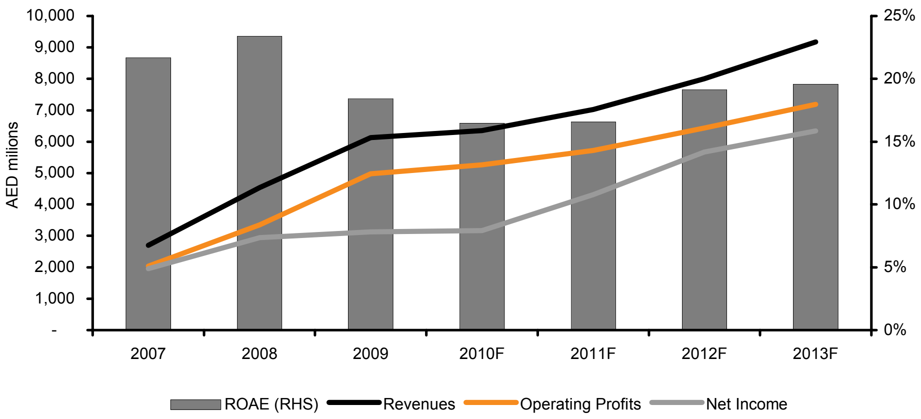
Chart 4 : Cost-income ratio, cost growth



Source: Company reports, Rasmala forecasts

While provisioning has been in line with the market, at 2.1% of gross loans in 2009 and an expected 2.0% in 2010, the NPL ratio has been fairly low at 3.3% so far. While NPL levels are increasing at a declining rate, FGB continues to warn of corporate loans whose quality deterioration can only be extended so far before they are rolled over into NPLs. Although this is likely to be a reference to the system as a whole, nevertheless, we are cautious about a recovery in quality. The latest central bank data suggests some turnaround but this tone is not yet reflected in comments coming from management.

Chart 5 : Income statement, ROAEs



Source: Company reports, Rasmala forecasts

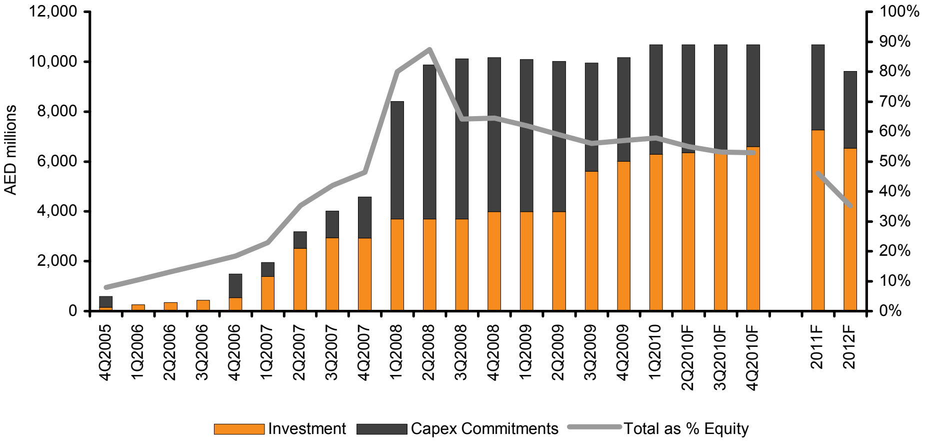
Balance sheet security and other concerns

Property exposure amounts to 62% of common equity

By far the greatest concern for FGB investors is the size of its property book, amounting to Dh6.3bn (and rising) of property investments and a commitment for a further Dh3.4bn (and falling) of capital expenditure, in total amounting to Dh9.7bn of exposure.

The distribution of the portfolio is mostly in Reem Island, Abu Dhabi, although FGB also has developments within several major Dubai projects, including particularly Business Bay, and at least one tower in Sharjah. Most of the build-up of the property portfolio was in 2007-1Q08, and in addition FGB has booked Dh1.1bn of revaluation gains over the last four years, suggesting that the property was revalued at close to peak of the market levels, although FGB states that revaluations were done on a conservative basis.

Chart 6 : Property investments and capex commitments



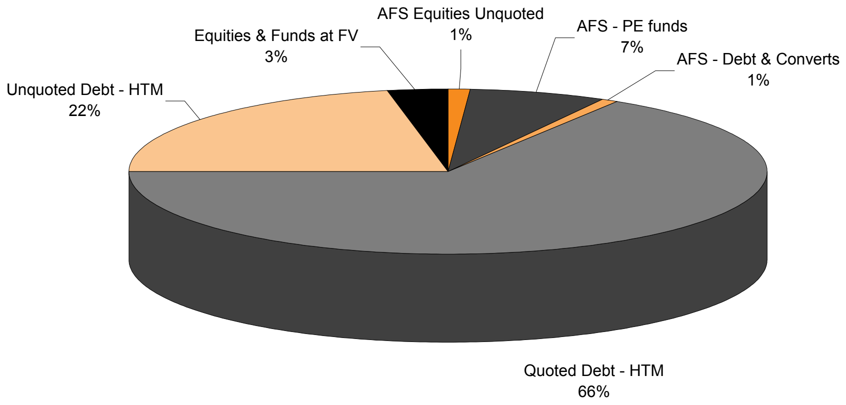
Source: Company reports, Rasmala forecasts

As for all UAE banks, FGB's property portfolio is subject to external verification on a twice yearly basis. Nevertheless, with several master-developments in Dubai being terminally bogged down, we believe it would have been prudent to write-down some of these assets, by perhaps as much as Dh1bn. On the positive side, the properties in Business Bay are progressing rapidly, suggesting there are at least no operational issues within the property portfolio. In addition, advances on property under development total just over Dh1bn, suggesting that, if these properties are, on average, 50% prepaid, probably somewhere around Dh2bn of property has been presold.

Investment portfolio

The large proportion of the investment portfolio consists of quoted debt, while the remainder is largely unquoted debt, with a small portion of listed equity. We believe the debt portion is secure, with FGB not having to take write-downs on this exposure even in turbulent markets. Consequently, the main uncertainties relate to the 7% of the portfolio invested in PE funds (mostly built up during 2007) as well as the 1% invested in unquoted equities. In total, this amounts to just 6% of common equity. Nevertheless, given the -53% return achieved by 3i, for example, in the year to 2009 (albeit followed by a 16% rebound), we might expect some diminution in value for the FGB stakes.

Chart 7 : Investment Portfolio, 1Q10



Source: Company reports

Write-downs in the pipeline? None scheduled…

While we think a Dh1bn write-down of property is plausible, and would improve confidence in the balance sheet, we are not sure management has any intention of actually doing this. The obvious time to expect write-downs would have been 3Q09-1Q10, when FGB was booking gains on disposal, and these could have been set against write-downs elsewhere in the book. Similarly, we do not expect that FGB will write down its private equity portfolio unless any value decreases are recognised as being irrecoverable.

Risks and discount rates

Maintaining a property book equivalent to 62% of equity during a property market crash clearly elevates the level of uncertainty for the bank, and this uncertainty is all on the downside. Although FGB had some success disposing of a small selection of towers, we believe that going forward these assets will be slow-moving, provide weak returns, and in some cases show little prospect of providing normal rates of return, even in the distant future. This, on its own, would justify a very significantly elevated discount rate.

In other areas of the business, we are more positive. FGB has proven able to drive more retail loans per branch than anyone else (at Dh4.5bn per branch), and get more revenues per loan than anyone else (at 7.2%), even in years where some of its assets were returning little or nothing. On top of which it has done so with one of the smallest cost bases. Consequently, from an operational point of view, we see one of the lowest levels of operational gearing, as evidenced by the net profit margin of 51% for 2009, against a sector average of 25.4%. Overall, therefore, we ascribe a median level of risk and set a discount rate of 16.3%, comprising a 3.1% US risk free rate, a 11.0% sector risk premium and a 2.5% stock spread.

Valuation and recommendation

Near term, our net income forecasts on a reported basis are 100%, 108% and 118% of market consensus, of 10 analysts, all but one of whom have Buy recommendations, with a target price between Dh18.1 and Dh23.3. We believe the difference is primarily related to the discount rate. Given this fact, the key to a re-rating, we believe would be to lower its risk profile, primarily by reducing its property exposure. A stabilisation of NPLs would, as for the rest of the sector, cause a rebound.

We exit our forecast period with an ROAE of 20%, but with significant excess capital. If we assume FGB sheds this excess capital, we believe they could obtain an ROAE of 29%. While we do not believe FGB can maintain this as an average over 2014-23, we do assume a 23% return, as well as a 15% growth rate throughout the same time period.

On this basis, we calculate a fair value of Dh16.27, which gives an implied FV P/B of 1.1 for 2011 and an adjusted PE of 5.7x. In total this suggests only 9% upside, however, and on this basis we assign a Hold rating.

Table 1 : Valuation

Stage 1 (2010-2013): explicit dividends		**2010**	**2011**	**2012**	**2013**
Forecast dividends		741	1,182	1,501	4,980
NPV stage 1	**6,031**	6,031	6,153	5,783	4,980
Stage 2 (2014-23): modelled dividends					
Excess capital	10,493	**Assumptions**			
Modelled dividends	9,651	ROE1	Growth	Capital Req'd	RWA
NPV stage 2	**12,802**	22%	15%	16,865	187,386
Stage 3 (2024+): terminal value					
2023	39,706	**Assumptions**			
NPV stage 3	**5,570**	ROE1	Growth	Capital Req'd	
		12%	6%	68,227	
Total NPV					
Stage 1 (2010-2013)	6,031				
Stage 2 (2014-23)	12,802				
Stage 3 (2024+)	5,570				
Total	24,403				
No of shares	1,500				
Price target	**16.27**				
Price	14.90				
Upside/(Downside)	**9%**				

COE: US RFR 3.11%, country risk spread 6.00%, sector risk spread 5.00%, stock spread 2.20%, discount rate 16.31%
Source: Rasmala

Appendix

Rebuilding returns

Exceptional property revenue continues into 2010

Although we are looking for an improvement in many areas of the income statement over the coming couple of years, the impact on returns on equity is likely to be limited. This is for a number of reasons, the least exciting of which is that ROAEs for FGB have actually held up pretty well, declining from 23.4% in 2008, to a low of ROAE 16.5% in 2010. Even in 2010, however, there is a contribution from exceptional property disposals of around Dh170mn, which is likely to account for 5% of 2010 net income, and this is unlikely to recur in 2011.

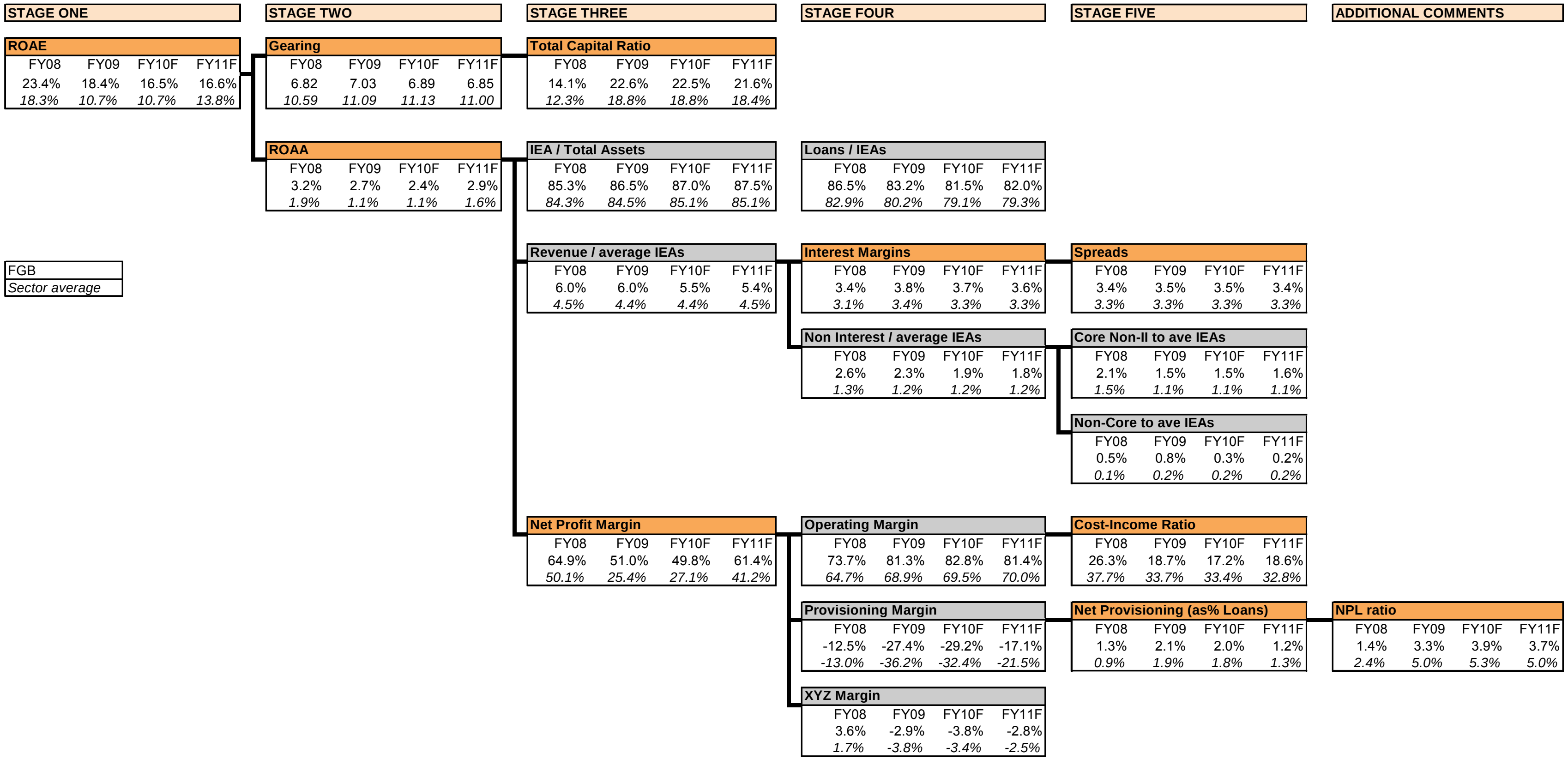
High spreads, high non-interest income

The second reason is the very strong operating margin, driven by strong revenues and low costs. Interest spreads at an average through the period of 3.45% remain higher than the market average of 3.29%, which is a surprising achievement given the proportion of high cost funding. Core non-interest income is also higher at 1.5% of interest earning assets, compared to a sector average of 1.0%, with large contributions from credit cards, foreign exchange income and derivative income, and that leaves little in the way of improvements.

Leverage to increase ROAEs

So with so many of the components of returns already being at elevated levels, how will returns be improved? The most obvious place is leverage, which is low at just 7.0x, compared to a sector average of 10.6x (2009 numbers) – a number which is also reflected in the elevated total capital ratio of 22.6% as at year end 2009. Gradually lower provisioning beyond 2011 should have a strong impact on rebuilding returns beyond 2011. Finally, we assume only a 2% return on the property portfolio, and that due to rental returns. Beyond 2013, perhaps, this will return to a healthier ratio.

Chart 8 : Modified Dupont



STAGE ONE

ROAE

FY08	FY09	FY10F	FY11F
23.4%	18.4%	16.5%	16.6%
18.3%	*10.7%*	*10.7%*	*13.8%*

FGB

Sector average

STAGE TWO

Gearing

FY08	FY09	FY10F	FY11F
6.82	7.03	6.89	6.85
10.59	*11.09*	*11.13*	*11.00*

ROAA

FY08	FY09	FY10F	FY11F
3.2%	2.7%	2.4%	2.9%
1.9%	*1.1%*	*1.1%*	*1.6%*

STAGE THREE

Total Capital Ratio

FY08	FY09	FY10F	FY11F
14.1%	22.6%	22.5%	21.6%
12.3%	*18.8%*	*18.8%*	*18.4%*

IEA / Total Assets

FY08	FY09	FY10F	FY11F
85.3%	86.5%	87.0%	87.5%
84.3%	*84.5%*	*85.1%*	*85.1%*

Revenue / average IEAs

FY08	FY09	FY10F	FY11F
6.0%	6.0%	5.5%	5.4%
4.5%	*4.4%*	*4.4%*	*4.5%*

Net Profit Margin

FY08	FY09	FY10F	FY11F
64.9%	51.0%	49.8%	61.4%
50.1%	*25.4%*	*27.1%*	*41.2%*

STAGE FOUR

Loans / IEAs

FY08	FY09	FY10F	FY11F
86.5%	83.2%	81.5%	82.0%
82.9%	*80.2%*	*79.1%*	*79.3%*

Interest Margins

FY08	FY09	FY10F	FY11F
3.4%	3.8%	3.7%	3.6%
3.1%	*3.4%*	*3.3%*	*3.3%*

Non Interest / average IEAs

FY08	FY09	FY10F	FY11F
2.6%	2.3%	1.9%	1.8%
1.3%	*1.2%*	*1.2%*	*1.2%*

Operating Margin

FY08	FY09	FY10F	FY11F
73.7%	81.3%	82.8%	81.4%
64.7%	*68.9%*	*69.5%*	*70.0%*

Provisioning Margin

FY08	FY09	FY10F	FY11F
-12.5%	-27.4%	-29.2%	-17.1%
-13.0%	*-36.2%*	*-32.4%*	*-21.5%*

XYZ Margin

FY08	FY09	FY10F	FY11F
3.6%	-2.9%	-3.8%	-2.8%
1.7%	*-3.8%*	*-3.4%*	*-2.5%*

STAGE FIVE

Spreads

FY08	FY09	FY10F	FY11F
3.4%	3.5%	3.5%	3.4%
3.3%	*3.3%*	*3.3%*	*3.3%*

Core Non-II to ave IEAs

FY08	FY09	FY10F	FY11F
2.1%	1.5%	1.5%	1.6%
1.5%	*1.1%*	*1.1%*	*1.1%*

Non-Core to ave IEAs

FY08	FY09	FY10F	FY11F
0.5%	0.8%	0.3%	0.2%
0.1%	*0.2%*	*0.2%*	*0.2%*

Cost-Income Ratio

FY08	FY09	FY10F	FY11F
26.3%	18.7%	17.2%	18.6%
37.7%	*33.7%*	*33.4%*	*32.8%*

Net Provisioning (as% Loans)

FY08	FY09	FY10F	FY11F
1.3%	2.1%	2.0%	1.2%
0.9%	*1.9%*	*1.8%*	*1.3%*

ADDITIONAL COMMENTS

NPL ratio

FY08	FY09	FY10F	FY11F
1.4%	3.3%	3.9%	3.7%
2.4%	*5.0%*	*5.3%*	*5.0%*

Source: Company data, Rasmala forecasts

Income statement

Dhm	FY08A	FY09A	FY10F	FY11F	FY12F
Net interest income	2560	3834	4218	4718	5330
Non-interest income	1982	2295	2139	2311	2669
Total income	**4542**	**6129**	**6357**	**7029**	**7999**
Operating costs	-1195	-1147	-1090	-1307	-1567
Goodwill (amort/impaired)	n/a	n/a	n/a	n/a	n/a
Other costs	0.00	0.00	0.00	0.00	0.00
Pre-prov operating profit	3347	4982	5267	5723	6432
Provisions charges	-566.3	-1680	-1858	-1205	-562.3
Post-prov op prof	2780	3301	3408	4518	5870
Associates (pre-tax)	156.9	29.0	1.82	43.2	47.6
Other pre-tax items	0.00	0.00	0.00	0.00	0.00
Reported PTP	**2937**	**3331**	**3410**	**4561**	**5917**
Taxation	0.00	0.00	0.00	0.00	0.00
Minority interests	8.05	-2.63	-3.26	-3.26	-3.26
Preference dividends	0.00	-120.0	-240.0	-240.0	-240.0
Other post-tax items	60.0	36.4	309.3	316.6	327.2
Reported net profit	**3005**	**3244**	**3476**	**4635**	**6001**
Tot normalised items	0.00	-83.6	0.00	0.00	0.00
Normalised PTP	2937	3331	3410	4561	5917
Normalised net profit	3005	3328	3476	4635	6001

Source: Company data, Rasmala forecasts year to Dec

Balance sheet

Dhm	FY08A	FY09A	FY10F	FY11F	FY12F
Net loans to customers	79363	90386	98536	113902	132782
Other int earn assets	12393	18199	22356	25080	28519
Goodwill	0.00	0.00	0.00	0.00	0.00
Oth non-int earn assets	6769	5340	6485	6870	7610
Total assets	**107522**	**125473**	**138904**	**158807**	**182085**
Total customer deposits	73963	86422	93609	108432	124613
Oth int-bearing liabs	13098	11761	15267	16130	17913
Non int-bearing liab	4319	5064	5493	6687	7827
Total liabilities	**91380**	**103247**	**114369**	**131248**	**150353**
Share capital	15768	17841	20160	23184	27357
Reserves	0.00	0.00	0.00	0.00	0.00
Total equity (excl min)	**15768**	**21841**	**24160**	**27184**	**31357**
Minority interests	374.4	384.9	374.8	374.8	374.8
Total liab & sh equity	**107522**	**125473**	**138904**	**158807**	**182085**
Risk weighted assets	110350	115685	126116	145783	169947
Est non-perf loans	n/a	n/a	n/a	n/a	n/a
Specific provisions	-1141	-2530	-4135	-4926	-4996
General provisions	n/a	n/a	n/a	n/a	n/a

Source: Company data, Rasmala forecasts year ended Dec

Capital

Dhm	FY08A	FY09A	FY10F	FY11F	FY12F
Risk weighted assets	110350	115685	126116	145783	169947
Reported net profit	3005	3244	3476	4635	6001
Opening risk assets	64149	110350	115685	126116	145783
Closing risk assets	110350	115685	126116	145783	169947
Change in risk assets	46201	5335	10432	19666	24165
Capital required	4620	533.5	1252	2360	2900
Free capital flow	-1615	2831	2464	2515	3341
Ordinary dividend paid	-477.4	-677.0	-740.9	-1182	-1501
Share buy back/spec div	0.00	0.00	0.00	0.00	0.00
Equity / preference issue	3555	-154.0	0.00	0.00	0.00
Cash flow from financing	3078	-831.0	-740.9	-1182	-1501
Net capital flow	1463	2000	1723	1333	1841
Tier 1 capital	0.15	0.19	0.19	0.19	0.19
Tier 1 capital ratio (%)	0.00	0.00	0.00	0.00	0.00

Source: Company data, Rasmala forecasts year to Dec

7 July 2010

Ntl Bank of Abu Dhabi

Ever dependable

Initiation of coverage

Buy

Target price
Dh12.86

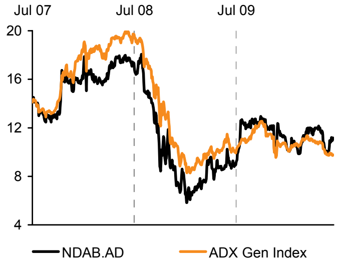
Price
Dh11.15

Short term (0-60 days)
n/a

Market view
No Weighting

Price performance

	(1M)	(3M)	(12M)
Price (Dh)	10.10	11.95	9.04
Absolute (%)	9.4	-7.5	22.2
Rel market (%)	10.2	4.5	27.3
Rel sector (%)	7.5	4.2	21.6



Market capitalisation
Dh26.43bn (€5.74bn)

Average (12M) daily turnover
Dh3.81m (US$1.03m)

Sector: ADX Bank & Fin Index
RIC: NDAB.AD, NBAD UH
Priced Dh11.15 at close 1 Jul 2010.
Source: Bloomberg

NBAD is the most reliable bank in the sector, in our view. It has little exposure to many of the problem areas afflicting the rest of the sector, a balance sheet which is closely linked to public sector projects, and few investments of its own. It does trade at a premium, but we believe this is justified.

Key forecasts

	FY08A	FY09A	FY10F	FY11F	FY12F
Reported PTP (Dhm)	2,913	3,088	3,692	4,557	5,494
Reported net profit (Dhm)	3,019	3,020	3,603	4,447	5,360
Reported EPS (Dh)	1.26	1.21	1.40	1.76	2.14
Normalised EPS (Dh)	1.19	1.21	1.40	1.76	2.14
Dividend per share (Dh)	0.25	0.09	0.24	0.38	0.72
Normalised PE (x)	9.40	9.21	7.94	6.35	5.21
Price/book value (x)	1.94	1.64	1.38	1.18	1.03
Dividend yield (%)	2.22	0.82	2.19	3.45	6.47
Return on avg equity (%)	23.40	20.10	20.30	21.20	22.10

Accounting standard: IFRS Source: Company data, Rasmala forecasts year to Dec, fully diluted

Balance sheet risk seems minimal

NBAD has a solid balance sheet. NPLs amount to just 1.3% of loans and are covered 164% by provisions. The investment book is just 10% of assets and predominantly comprises fixed-income government securities or bonds issued by government-backed financials. Liquid assets (ie, cash, central bank deposits and interbank assets) amount to 20% of assets. Finally, 100% of the capital market liabilities are covered with cash and only 20% are due within 12 months.

Remains the primary banker to the government

NBAD is 70.5% owned by the government of Abu Dhabi, via the Abu Dhabi Investment Council, and NBAD still acts as the government bank. We expect the key driver of UAE's economic growth to be government infrastructure and energy spending (Dh180bn over five years) and NBAD seems ideally placed to benefit from that. Government deposits account for 54% of the total and government and public sector loans are 39% of the loan book.

Growth drivers comprise local market penetration and new division expansion

Apart from its continuous focus on being the primary banker to the government, NBAD's strategy is to enhance its market share in retail, SME and corporate banking, and increasing the profitability of its real estate management, leasing and Islamic finance businesses. Looking ahead, we expect the bank to be the biggest gainer of the potentially large infrastructural spending in the Emirate and thus record double-digit loan and net profit growth over 2010-12.

Valuation and recommendation

NBAD is the second-most expensive bank in our UAE coverage universe, trading at a 2011F PE of 6.3x and a P/BV of 1.2x. Nevertheless, we believe this is justified by a manifestly lower level of risk and greater level of transparency. We assume a discount rate of 14.1% and an exit ROE of 20%, and thus ascribe a target price of Dh12.86, suggesting 15% upside to the current share price of Dh11.15.

Important disclosures can be found in the Disclosures Appendix.
Distributed outside MENA by The Royal Bank of Scotland N.V. and its affiliates under a strategic alliance with Rasmala Investment Bank Ltd.

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www.rasmala.com

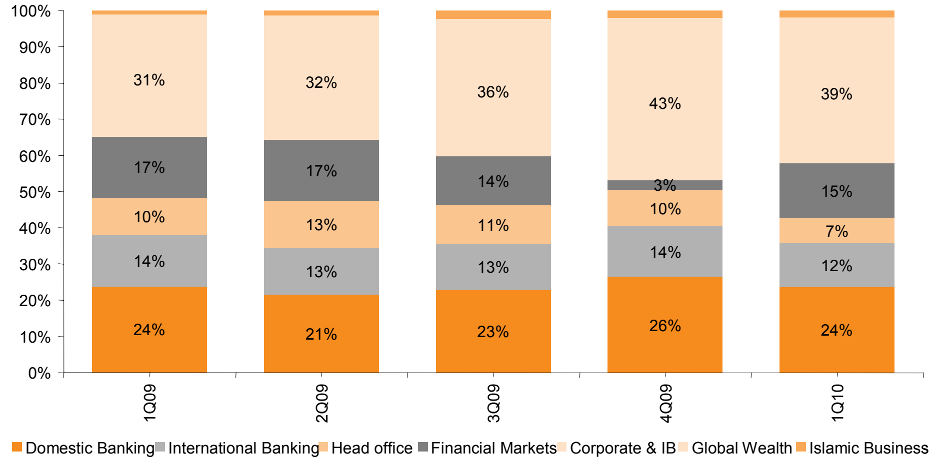
Regionally diversified operations

NBAD is the most reliable bank in the sector, in our view. It has little exposure to many problems afflicting the sector, a balance sheet closely linked to public sector projects and few investments of its own. It does trade at a premium, but we believe this is justified.

National Bank of Abu Dhabi (NBAD) was originally set up to serve as the primary banker to the Abu Dhabi and the federal government, and today it still maintains that role. NBAD is the second-largest bank in the UAE, both in terms of assets market share (13.1% in 1Q10) and physical presence through its 103 local branches. Besides serving the corporate and retail market, NBAD has ancillary businesses such as equity brokerage, leasing, property management, and private banking and fund management. Internationally, NBAD has two 'home' markets besides the UAE, namely Egypt and Oman. However, it also has a smaller presence across the MENA region and global financial centres. Total international operations accounted for 13% of operating profit during 2009.

The bank is 70.5% owned by the government of Abu Dhabi, via the Abu Dhabi Investment Council, with a free float of 29.5%. The stock has total foreign and GCC ownership limits of 25%, but is significantly below that limit, with 0.3% GCC ownership, 0.1% other Arab and 1.9% other foreign.

Chart 1 : Revenue split by division



Source: Company data

Strategy remains to serve the government, develop new avenues

Apart from its continuous focus on being the primary banker to the government (as of 2009, 54% of deposits and 39% of loans are to the government and public sector combined), NBAD's strategy is to enhance its domestic banking capability by increasing market share in retail banking, developing SME relations for corporate banking and focusing on UAE's HNW individuals for elite banking. The bank positions itself as the safest in the UAE, utilising this as a key marketing tool in asset gathering. NBAD aims to become one of the top three asset management firms in the MENA region, facilitated partly by private banking.

As a result of a slowdown in the real estate market, NBAD has reprioritised its property arm, Abu Dhabi National Property, towards a fee-driven business, particularly expanding its property management operations. Within lending, areas of particular strength include the small leasing segment and the equally small Islamic financing division, which grew 72% yoy in 1Q10, although it still accounts for just 3% of total assets and 2% of net profit.

Regional operations account for about 11% of NBAD's loan book. Overall, the bank's international network has 47 branches, which contributed 11% to its 1Q10 operating profit. NBAD's long-term intention, is for aggressive expansion. However, it believes the short-term outlook in that country is not conducive and, therefore, growth of physical assets will be limited to one or two branches.

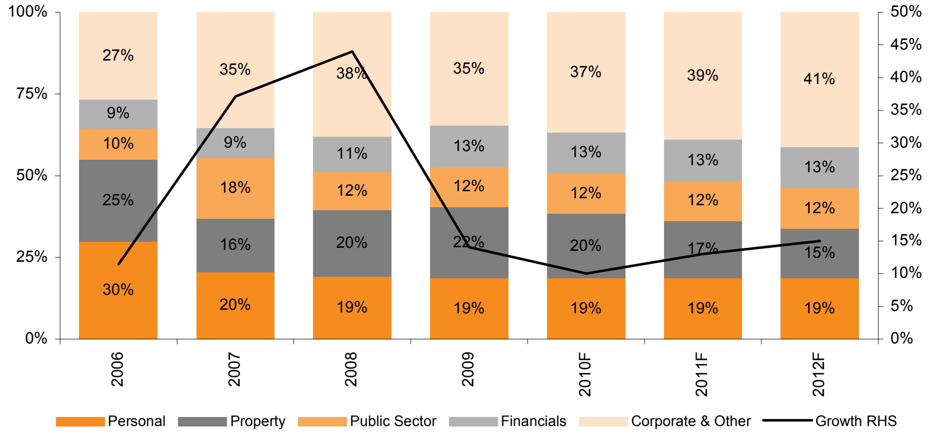
Broadly speaking, international operations follow a two-tier structure: an offshore banking model and a full service model. The offshore model focuses primarily on trade flows and includes branches in major financial centres. However, in the Arab countries, including recently launched Jordanian operations, NBAD will seek to establish large corporate balances, with blue-chip corporates and HNW individuals being the primary focus.

Double-digit growth with high asset quality

NBAD's conservative nature is well illustrated in Chart 2 below. A boom was well under way in 2006 and 2007, but NBAD was loathe to extend itself beyond its core market of large corporates with public-sector relations. As the bank grew more aggressive in 2007-08, its loan growth picked up sharply to 45% in 2008 from just 12% in 2006. However, while mortgage, SMEs and property development products were still between the concept and incubation stage, the boom came to a dramatic halt and NBAD had to decide what to do about these fledgling businesses. In general, what it sought to do was roll them over into fee-driven operations. The pick-up in activity in 2008 was driven by property, but this did not extend significantly beyond NBAD's comfort zone.

Similar to other banks, some of NBAD's current growth continues to come from the real estate sector, but unlike the others, this is apparently not driven by running down loan commitments. Loans to the energy sector also increased during 2009, and we believe these two themes were on the back of growth in both sectors, which was linked to increased government infrastructure spending. Overall, 1Q10 yoy loan book growth amounted to 15%, amongst the highest in the market. However, this included an expansion of lending to financial institutions and lending for personal consumption, both of which are counterintuitive and therefore raise uncertainty given that expansion in these areas is driven by rising leverage for private equity companies and individuals, respectively.

Chart 2 : Loan book split, loan growth

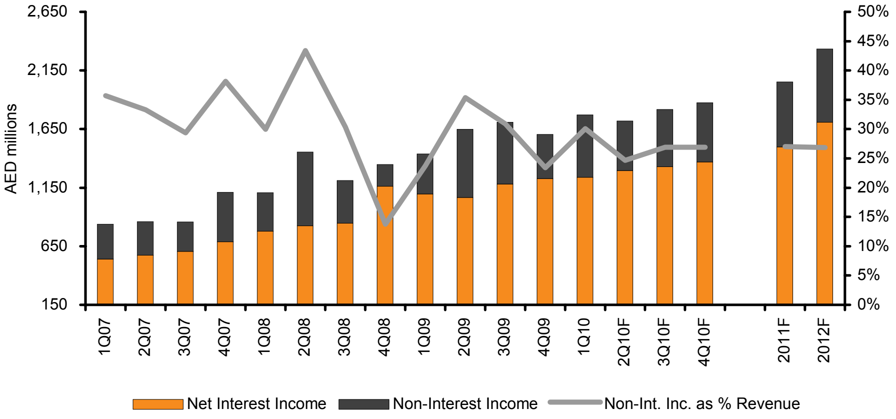


Source: Company data, Rasmala forecasts

Going forward, we believe NBAD is well-placed to capture what growth there is in the market. In Abu Dhabi, we expect the core of economic growth to be driven by public-sector infrastructure spending, and that is really NBAD's home market. In 1Q10 qoq growth dipped to 1%, but we expect a recovery later in the year. NBAD is predominantly deposit funded and we expect it to have sufficient liquidity. However, even if this was not the case, we note that NBAD was one of the few institutions that was able to raise funding even during the turbulent 1Q10.

In contrast to many of its competitors, NBAD has maintained revenues on more or less a steady upward projection, with 1Q10 yoy growth of 23% not being out of line with that since the crisis began and, broadly speaking, matching the progression of interest-earning assets. This doesn't reflect an underlying simplicity but a range of effects that all cancel each other out. Firstly, tier-1 funding contributed to margins holding up at a below-market average of 2.93% (from 2.87%) even though spreads were under pressure, dipping to 2.90% from 3.15%. Secondly, after a sharp descent into trading losses in 2008, a recovery in investment income compensated for the absence of growth in other non-interest income.

Chart 3 : Revenue, split by net-interest income and other

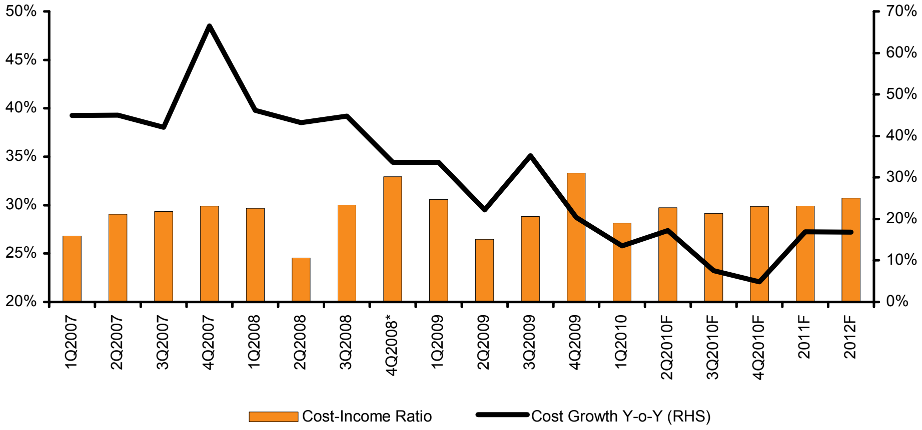


Source: Company data, Rasmala forecasts

Indeed, without exceptional losses of one kind or another, net profit in 2009 was solid and could be difficult to match in 2010 in terms of ROE, primarily due to a decline in revenue returns on average interest earning assets (IEAs). We also expect spreads to decline in 2010 at the high-quality end of the market in which NBAD operates, driving spreads to 2.80% from 2.90% after rising sharply in 2007 and 2008. In addition, with foreign exchange income being high and volatile in 2009, it is likely this will be a less benign influence in 2010.

In the longer term, it is clear that NBAD aims to focus more on niche areas. In principle that should lead to an increase in the contribution of non-interest income, which we believe will be 1.06% of IEAs in 2010F, marginally below the UAE sector average of 1.16%. However, given the size of NBAD’s franchise, this may be a challenge. The bank that has been most successful at this has been FGB, which generates significant credit card (28bp of IEAs) and derivative fees, but with most of the difference in returns coming from miscellaneous fees and commissions, probably related to offering additional account services.

Chart 4 : Cost-income ratio, cost growth



Source: Company data, Rasmala forecasts

One consequence of relatively little fresh investment is that cost growth has been small, and we expect, even shrinking over the coming quarters. With continued growth of revenues, this is likely to mean falling cost-to-income ratios. We expect costs to pick up in later periods, however, as NBAD continues to expand its product range. Declines in revenue returns may also be a factor. In the longer term, we expect cost-to-income ratios to rise slowly, as competition for premium Abu Dhabi clients intensifies.

Provisioning and NPLs remain low for NBAD. Until 2007, provisioning averaged just 23bp over customer assets over the previous three years. However, with the arrival of the crisis, provisioning jumped to 85bp in 2008 and 112bp in 2009, matching the creation of new NPLs. In spite of the severity of the crisis, we don't expect provisioning and NPL numbers to show much of an increase from here on.

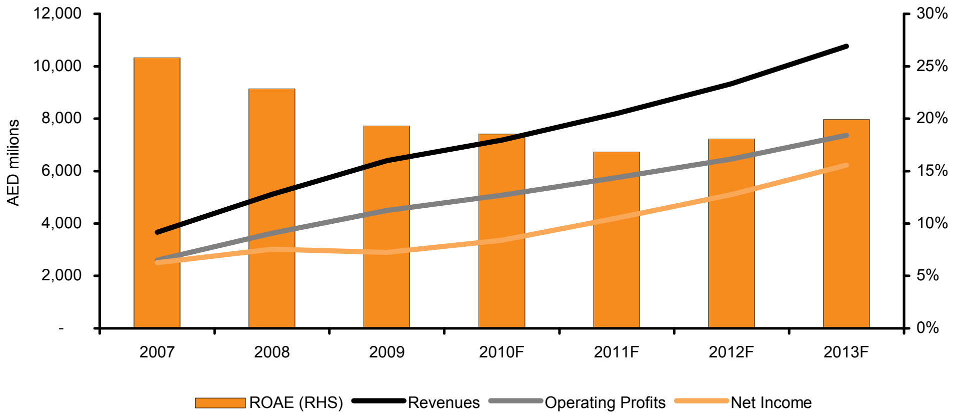
How does this compare to targets?

NBAD publishes regular updates on its main four financial targets, which we highlight below:

- ROE of 25% over the medium term (20% for 2010);
- Cost-to-income ratio of less than 35%;
- Earnings growth of 20% pa over the medium term; and,
- Dividend cover of at least 2.5x.

The company already meets two of these criteria: the cost-to-income ratio is, by our calculations, 29.7% as of 2009, while the dividend cover is 5.75x. We forecast a 23% earnings CAGR over 2010-13, but with declining rates of growth beyond that. In addition, we expect NBAD to get near its 2010 ROE target of 20%, but a 25% long-term ROE target is likely to prove more challenging. We forecast an exit ROE of just 20%, and do not expect a 25% ROE to be attainable without significantly higher levels of leverage.

Chart 5 : Income statement, ROEs



Source: Company Reports, Rasmala Forecasts

The summary of the income statement for NBAD, as seen in Chart 5, is fairly straight-forward. Growth in revenues and operating profits has been fairly steady since 2007, although the effect of lower growth rates can also be seen. Net income was clearly impacted in 2009 by higher provisioning, and also by the cost of tier-1 deposits. Meanwhile, lower levels of leverage meant that ROAEs declined throughout the period.

Going forward, broadly speaking, we see a reversal of these trends. Impairment charges are likely to ease beyond 2010 and leverage levels will start to increase again as visibility comes back to the market. As a result returns should start to climb again.

Few concerns about the balance sheet

NBAD has a healthy balance sheet, in our view**.** Loans account for 67% of assets, while financial assets account for a further 10%. However, NBAD is the only bank with particularly high coverage of 164%. Dubai World exposure amounted to just Dh865m as at the end of 2009, with that exposure mostly relating to Nakheel (the indebted Dubai World unit) and Limitless**.** So, it is not being included in the current restructuring. We estimate the total Dubai exposure at around 15% of the loan book, or Dh20bn as at end-2009. Consequently, the excess provision of Dh1bn is sufficient to absorb a write-down of 5% of all Dubai exposure (which we believe is unrealistically high) on top of existing provisions, without affecting earnings.

As for the investment portfolio, almost all the investments are in international bonds (86% AFS debt and 9% HTM debt), with most being either government (25%) or in state-supported financials (69%), as of 3Q09. While much of this has been placed in Europe, there is little reason to believe that it would be in the peripheral countries, as NBAD has no reputation for chasing yields.

Cash, central bank deposits and interbank deposits amount to Dh39bn, just short of 20% of the balance sheet. Although NBAD has sufficient liquidity, it is the only bank since the DW restructuring announcement to set a benchmark for MTN borrowing (US$750m was raised at an approximate effective rate of 5%), highlighting its capability to grow loans (at a CAGR of 15%) where the opportunity presents itself, without having to compete in the aggressive market for deposits.

Valuation and recommendation

NBAD is the second most expensive bank in our UAE coverage universe, trading at a 2011F PE of 6.3x and a P/BV of 1.2x. Nevertheless, we believe this is justified by a manifestly lower level of risk and greater level of transparency. Given the lower level of risk, we assume a discount rate across the period of 14.1%, which comprises 3.1% for the risk-free rate (based on the US 10-year bond), 11.0% for sector risk and 0% for stock risk. We exit our forecast period with an expected ROE of 20%, but assume that 23% should be realisable in the medium term with higher levels of leverage.

On this basis we ascribe a target price of Dh12.65, suggesting 15% upside to the current share price of Dh11.15. This also suggests a TP/E of 9.2 and a TP/B of 1.6 for 2010. We believe the primary catalyst will be improved visibility for the UAE as a whole. Continued growth at current levels will also help distinguish NBAD from the competition.

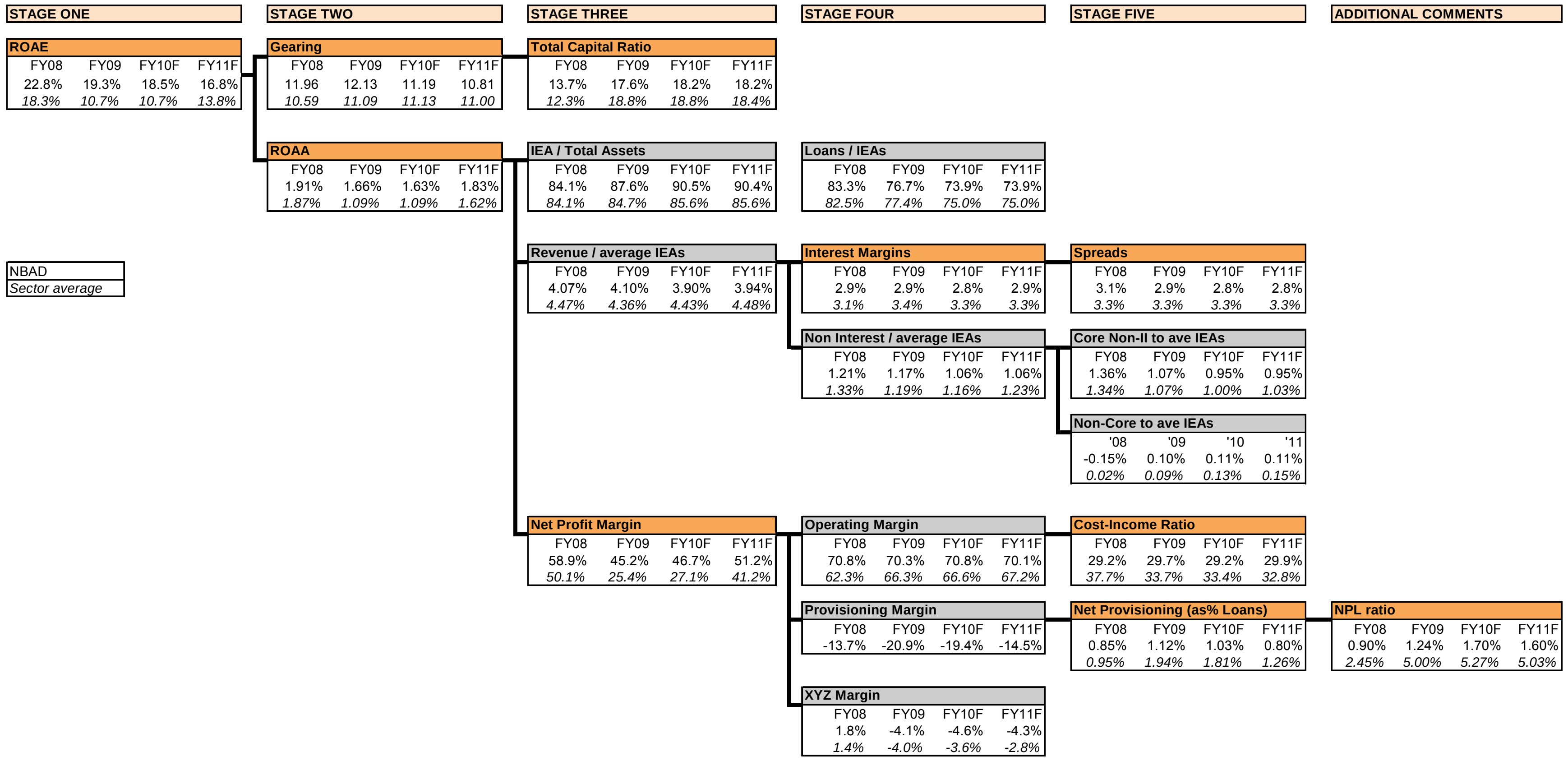
Our 2010-12 forecasts for headline net profit are broadly in line with Zawya consensus estimates of 107%, 107% and 90%. Zawya consensus is made up of eight analysts with an average recommendation of +.75 (based on +1 for a Buy, -1 for a Sell). Our target price is just below the median.

Table 1 : Valuation

Stage 1 (2010-2013): explicit dividends		**2010**	**2011**	**2012**	**2013**
Forecast dividends		584	919	1,726	3,633
NPV stage 1	**5,159**	5,159	5,221	4,909	3,633
Stage 2 (2014-23): modelled dividends					
Excess capital	8,988	**Assumptions**			
Modelled dividends	16,001	ROE1	Growth	Capital Req'd	RWA
NPV stage 2	**16,818**	24%	15%	19,586	217,618
Stage 3 (2024+): terminal value					
2023	48,850	**Assumptions**			
NPV stage 3	**8,783**	ROE1	Growth	Capital Req'd	
		11%	6%	79,235	
Total NPV					
Stage 1 (2010-2013)	5,159				
Stage 2 (2014-23)	16,818				
Stage 3 (2024+)	8,783				
Total	**30,761**				
No of shares	2,392				
Price target	**12.86**				
Price	11.15				
Upside/(Downside)	15%				

COE: US RFR 3.11%, country risk spread 6.00%, sector risk spread 5.00%, stock spread 0.00%, discount rate 14.11%
Source: Rasmala

Chart 6 : Modified DuPont



NBAD
Sector average

ROAE

FY08	FY09	FY10F	FY11F
22.8%	19.3%	18.5%	16.8%
18.3%	*10.7%*	*10.7%*	*13.8%*

Gearing

FY08	FY09	FY10F	FY11F
11.96	12.13	11.19	10.81
10.59	*11.09*	*11.13*	*11.00*

ROAA

FY08	FY09	FY10F	FY11F
1.91%	1.66%	1.63%	1.83%
1.87%	*1.09%*	*1.09%*	*1.62%*

Total Capital Ratio

FY08	FY09	FY10F	FY11F
13.7%	17.6%	18.2%	18.2%
12.3%	*18.8%*	*18.8%*	*18.4%*

IEA / Total Assets

FY08	FY09	FY10F	FY11F
84.1%	87.6%	90.5%	90.4%
84.1%	*84.7%*	*85.6%*	*85.6%*

Revenue / average IEAs

FY08	FY09	FY10F	FY11F
4.07%	4.10%	3.90%	3.94%
4.47%	*4.36%*	*4.43%*	*4.48%*

Net Profit Margin

FY08	FY09	FY10F	FY11F
58.9%	45.2%	46.7%	51.2%
50.1%	*25.4%*	*27.1%*	*41.2%*

Loans / IEAs

FY08	FY09	FY10F	FY11F
83.3%	76.7%	73.9%	73.9%
82.5%	*77.4%*	*75.0%*	*75.0%*

Interest Margins

FY08	FY09	FY10F	FY11F
2.9%	2.9%	2.8%	2.9%
3.1%	*3.4%*	*3.3%*	*3.3%*

Non Interest / average IEAs

FY08	FY09	FY10F	FY11F
1.21%	1.17%	1.06%	1.06%
1.33%	*1.19%*	*1.16%*	*1.23%*

Operating Margin

FY08	FY09	FY10F	FY11F
70.8%	70.3%	70.8%	70.1%
62.3%	*66.3%*	*66.6%*	*67.2%*

Provisioning Margin

FY08	FY09	FY10F	FY11F
-13.7%	-20.9%	-19.4%	-14.5%

XYZ Margin

FY08	FY09	FY10F	FY11F
1.8%	-4.1%	-4.6%	-4.3%
1.4%	*-4.0%*	*-3.6%*	*-2.8%*

Spreads

FY08	FY09	FY10F	FY11F
3.1%	2.9%	2.8%	2.8%
3.3%	*3.3%*	*3.3%*	*3.3%*

Core Non-II to ave IEAs

FY08	FY09	FY10F	FY11F
1.36%	1.07%	0.95%	0.95%
1.34%	*1.07%*	*1.00%*	*1.03%*

Non-Core to ave IEAs

'08	'09	'10	'11
-0.15%	0.10%	0.11%	0.11%
0.02%	*0.09%*	*0.13%*	*0.15%*

Cost-Income Ratio

FY08	FY09	FY10F	FY11F
29.2%	29.7%	29.2%	29.9%
37.7%	*33.7%*	*33.4%*	*32.8%*

Net Provisioning (as% Loans)

FY08	FY09	FY10F	FY11F
0.85%	1.12%	1.03%	0.80%
0.95%	*1.94%*	*1.81%*	*1.26%*

NPL ratio

FY08	FY09	FY10F	FY11F
0.90%	1.24%	1.70%	1.60%
2.45%	*5.00%*	*5.27%*	*5.03%*

Source: Company data, Rasmala forecasts

Income statement

Dhm	FY08A	FY09A	FY10F	FY11F	FY12F
Net interest income	3608	4571	5234	5989	6829
Non-interest income	1517	1828	1952	2217	2507
Total income	**5124**	**6399**	**7186**	**8206**	**9337**
Operating costs	-1494	-1903	-2100	-2456	-2869
Goodwill (amort/impaired)	n/a	n/a	n/a	n/a	n/a
Other costs	-10.9	-37.5	0.00	0.00	0.00
Pre-prov operating profit	3619	4459	5086	5750	6468
Provisions charges	-706.2	-1370	-1394	-1193	-974.4
Post-prov op prof	2913	3088	3692	4557	5494
Associates (pre-tax)	0.00	0.00	0.00	0.00	0.00
Other pre-tax items	0.00	0.00	0.00	0.00	0.00
Reported PTP	**2913**	**3088**	**3692**	**4557**	**5494**
Taxation	-72.1	-72.9	-93.9	-115.9	-139.8
Minority interests	0.00	0.00	0.00	0.00	0.00
Preference dividends	0.00	-120.0	-240.0	-240.0	-240.0
Other post-tax items	177.7	124.5	244.9	245.7	246.4
Reported net profit	**3019**	**3020**	**3603**	**4447**	**5360**
Tot normalised items	177.0	0.00	0.00	0.00	0.00
Normalised PTP	2913	3088	3692	4557	5494
Normalised net profit	2842	3020	3603	4447	5360

Source: Company data, Rasmala forecasts — year to Dec

Balance sheet

Dhm	FY08A	FY09A	FY10F	FY11F	FY12F
Net loans to customers	115432	132258	144514	163187	188047
Other int earn assets	23067	40127	50996	57585	66358
Goodwill	0.00	0.00	0.00	0.00	0.00
Oth non-int earn assets	6723	6403	5974	7111	9986
Total assets	**164654**	**196845**	**215935**	**244202**	**283195**
Total customer deposits	103481	121205	127172	146868	174883
Oth int-bearing liabs	42052	49611	59011	63057	68548
Non int-bearing liab	5358	5805	6446	7690	9788
Total liabilities	**150891**	**176621**	**192630**	**217614**	**253220**
Share capital	13764	16223	19306	22587	25976
Reserves	0.00	0.00	0.00	0.00	0.00
Total equity (excl min)	**13764**	**20223**	**23306**	**26587**	**29976**
Minority interests	0.00	0.00	0.00	0.00	0.00
Total liab & sh equity	**164654**	**196845**	**215935**	**244202**	**283195**
Risk weighted assets	126940	132668	144962	163692	188629
Est non-perf loans	n/a	n/a	n/a	n/a	n/a
Specific provisions	-1550	-2658	-3656	-4309	-4647
General provisions	n/a	n/a	n/a	n/a	n/a

Source: Company data, Rasmala forecasts — year ended Dec

Capital

Dhm	FY08A	FY09A	FY10F	FY11F	FY12F
Risk weighted assets	126940	132668	144962	163692	188629
Reported net profit	3019	3020	3603	4447	5360
Opening risk assets	84494	126940	132668	144962	163692
Closing risk assets	126940	132668	144962	163692	188629
Change in risk assets	42446	5728	12294	18731	24937
Capital required	4245	630.1	1475	2248	2992
Free capital flow	-1226	2510	2368	2439	2608
Ordinary dividend paid	-593.0	-217.4	-583.7	-919.1	-1726
Share buy back/spec div	0.00	0.00	0.00	0.00	0.00
Equity / preference issue	1408	5.98	0.00	0.00	0.00
Cash flow from financing	815.2	-211.4	-583.7	-919.1	-1726
Net capital flow	-410.7	2298	1784	1520	882.1
Tier 1 capital	0.12	0.16	0.17	0.17	0.17
Tier 1 capital ratio (%)	0.00	0.00	0.00	0.00	0.00

Source: Company data, Rasmala forecasts — year to Dec

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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