

MENA Strategy

Egypt – implications of the turmoil

We expect the current social unrest to already have had negative implications for the Egyptian economy. A new government, irrespective of who the president is, will have to focus on getting the economy back on track. Expect stock market volatility until the economic outlook is clearer.

Chart 1 : EGX Index and Egypt 5-year CDS performance



Source: Bloomberg

Unprecedented events in Egypt

The reshuffle in the Egyptian government, with appointments of a new vice president, prime minister and cabinet, has increased the military's prominence in the Egyptian regime, with the appointments of ex-forces personnel to key positions. It suggests the military is in control for now and looking for an orderly handover of power. However, this was not what the public was looking for and it seems likely demonstrations will continue until the public's main wish (the resignation of President Mubarak and not just a cabinet reshuffle) has been fulfilled.

The events already have significant implications for the economy

We believe recent events have already had significant negative implications for economic growth forecasts for 2011, as we expect: 1) a negative impact on important sectors such as tourism; 2) deteriorating consumer confidence; 3) a drop in investment spending; and 4) a widening fiscal deficit as a result of an increase in wages and/or food subsidies to appease the population. However, if there is no u-turn in economic policy, we believe the long-term case for investing in Egypt remains intact.

We expect short-term volatility to continue until clarity on future economic direction

At first sight, the EGX30 Index is now looking attractive as one of the cheaper markets globally (Bloomberg consensus 8.3x 2011E P/E), but we believe this does not yet factor in lower economic forecasts, deteriorating consumer confidence, and above all a higher risk premium (Egypt's CDS has doubled to 430bp in recent weeks). Investors' risk aversion may only subside when Egypt's political and economic outlook becomes clearer and, despite the recent 22% drop in the EGX30 Index, we expect the market to remain under pressure.

Negative reactions in GCC stock markets appear largely unfounded

In the meantime, we still see good opportunities in the GCC (see our list of recommendations on page 8). Overall exposure to Egypt through stocks listed in the GCC is relatively small, but in this note we highlight stocks with varying degrees of exposure, both non-rated (eg, Savola, Barwa Real Estate and DSI) and stocks under our coverage (Dana Gas, NBAD, ADIB and Etisalat).

Important disclosures can be found in the Disclosures Appendix.

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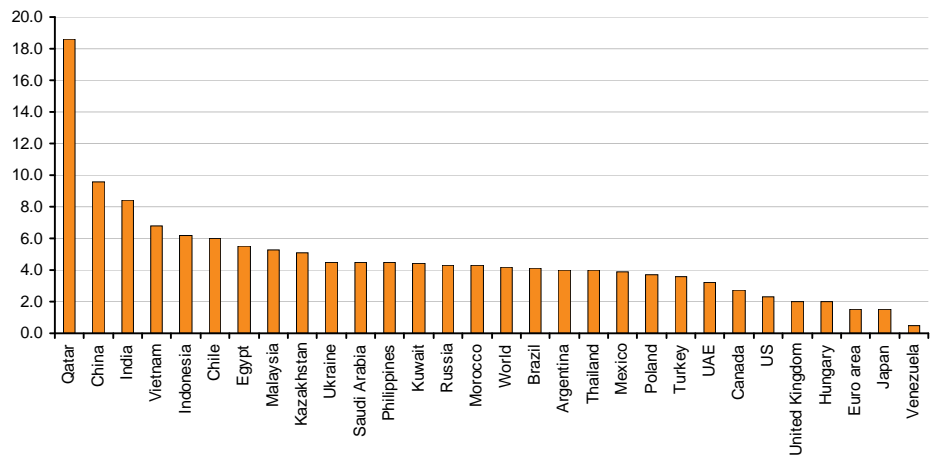
Impact on economic growth

We believe long-term fundamentals remain intact (as long as a new government continues to focus on economic growth), but expect current events to have a knock-on effect on the economy with falling tourism revenues, consumer confidence and foreign investment.

Macroeconomic background has been positive in a global context

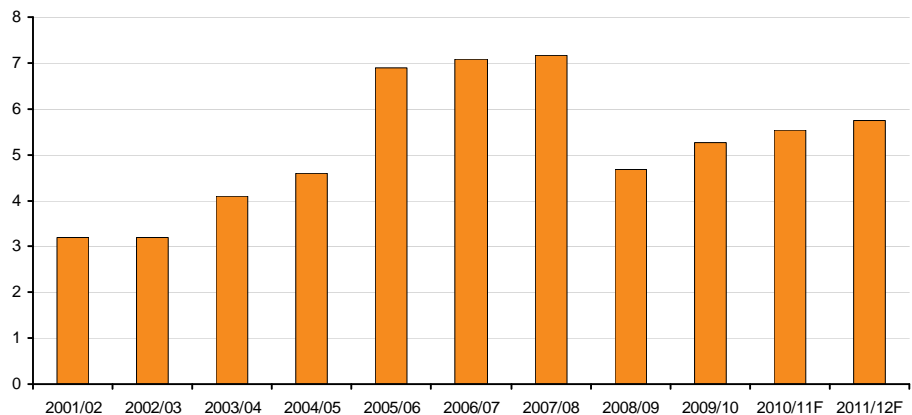
The Egyptian economy has performed relatively well during the past few years: Egypt's GDP has grown 6% on average over the past five years to June 2010 (Egypt's fiscal year runs to June), despite the global downturn. The IMF expects 5.5% growth in FY10/11F, higher than the forecast for global growth of 4.2%, and almost 6% in 2011/12F. Note that these forecast growth rates do not yet take the current events into account. Part of the recovery has been driven by consumer spending, part by a recovery in cyclical sectors such as construction and real estate. However, in 2010, the most important sources of foreign exchange in Egypt, tourism, Suez Canal revenues and foreign worker remittances, also showed signs of positive momentum. Amongst EMEA countries, Egypt offers one of the highest real GDP growth rates globally and, in the MENA region, only Qatar offers a higher rate, according to IMF forecasts.

Chart 2 : Real GDP growth 2011 for selected countries (% change yoy)



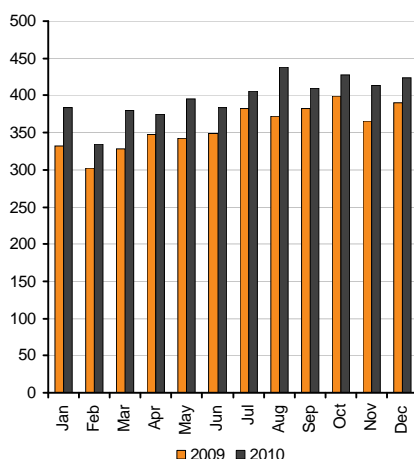
Source: IMF October 2010

Chart 3 : Egypt real GDP growth (% change yoy)



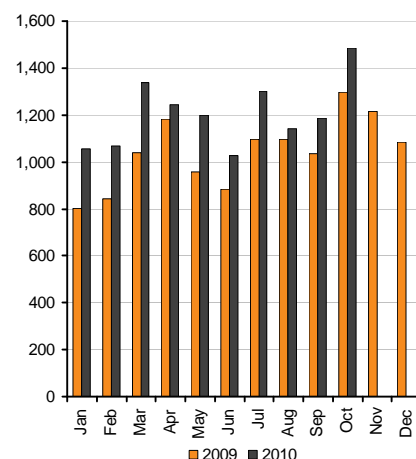
Source: IMF October 2010, Central Bank of Egypt

Chart 4 : Monthly Suez Canal revenues on an upward trend (US\$ m)



Source: Suez Canal Authority

Chart 5 : Monthly tourist arrivals – positive momentum in 2010 ('000)



Source: Ministry of Tourism

In addition to the strong recent performance of the Egyptian economy, long-term drivers for the economy are also positive, in particular the demographic profile of the domestic market: Egypt is the most populous country in the Arab world with a population of just under 80m. It also has a very young population, with c60% of the total population under the age of 30. The combination of a young population, a growing middle class and increasing urbanization (currently c43%) are key consumption and economic drivers for the country.

Unemployment, poverty, lack of low-cost housing and inflation at the root of the problem

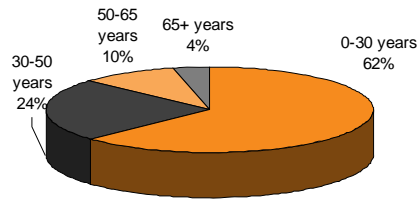
Fundamental economic problems

However, the economy has had another side to the coin. Besides political, there have been fundamental economic problems that have formed the base for the current unrest. Generally, Egypt's demographics can form the base of a positive investment case, but can also cause short-term problems, that could turn into even larger problems in the next few years if the government doesn't act proactively: unemployment and basic issues such as the cost of food and availability of low-cost housing have caused social unrest in the past.

Unemployment is high

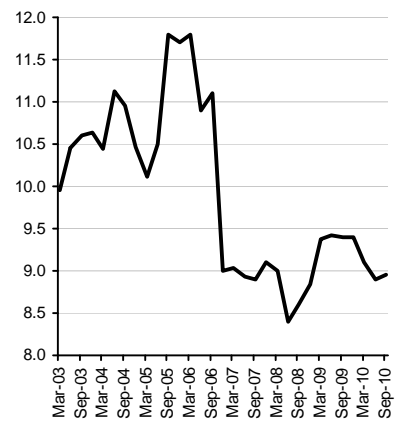
Current GDP growth is good in a global context, but the Central Bank of Egypt estimates that a higher rate of 7% is required to reduce unemployment. The unemployment rate fell during the time of high economic growth from c12% in 2006 to just over 8% in 2008, but increased again in 2009. More recently, the rate has been edging down again, but the latest reported figure of c9% in 3Q10 is still high and hides the much higher youth unemployment, which has been 30-40% over the past decade. The government has made progress in reforming the economy in recent years, to stimulate the economy and encourage the formation of SMEs to create jobs. It is vital that the government continues to do so: the IMF's growth expectations suggest that Egypt's population will increase by c1.5m per year, or the addition of c30m new citizens in the next 20 years, potentially increasing socio-economic tensions.

Chart 6 : Population is fast-growing, young...



(% of total population).
Source: CAPMAS

Chart 7 : ... and unemployed.



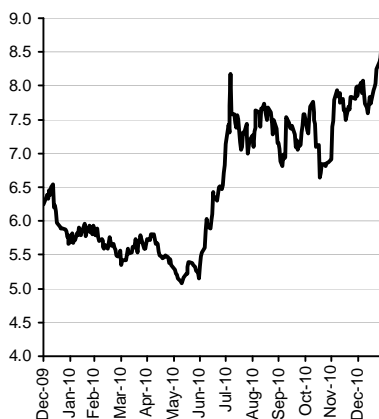
(headline inflation % change yoy).
Source: CAPMAS

High inflation and increases in prices for basic items have fuelled social unrest

Although headline inflation has come down from 11.7% in September 2010 to 10.3% in December, it is still high and the most recent core inflation of 9.6% is well outside the government's comfort zone of 6-8%. As a major importer of food (Egypt is the largest wheat importer globally in volume terms), food price inflation of c17% has been the main contributor to inflation. Food prices have continued an upward trend in 2011 and the recent fall in the Egyptian pound exacerbates the problem.

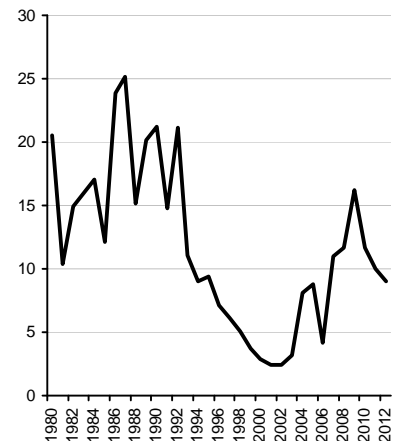
Inflation is a problem for a country with wide-spread poverty (around 40% of the population lives below the poverty line). One way the government has appeased the population in the past (most recently in May 2008) is through an increase in subsidies and/or increase in wages. A new government may increase subsidies again, but subsidies are already high and public finances relatively stretched (Egypt's fiscal deficit was c8.2% of GDP in FY09/10) and an increase could undermine expenditures in other areas. However, the government does have a cushion of foreign exchange reserves of US\$36bn as of December 2010.

Chart 8 : Egypt is the largest wheat importer globally – prices up almost 70% since last year...



(US\$/bushel).
Source: Bloomberg

Chart 9 : ... keeping inflation at a high level



(headline inflation % change yoy).
Source: Central Bank, IMF forecasts

We expect the current unrest to have a negative impact on the economy

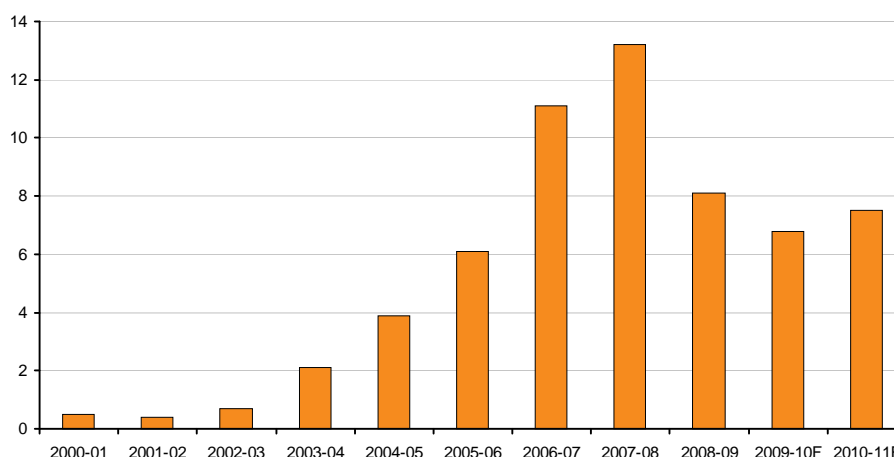
Expect growth expectations to be cut

Therefore, in a nutshell, whilst we believe long-term fundamentals will remain intact, as long as a new government continues to focus on economic growth, we expect the ongoing social unrest in the country to have a knock-on effect on the economy: it seems inevitable that tourism will be down this year, we expect a postponement in investment spending (public and private) and we expect general consumer confidence to drop from already low levels.

- In our view, tourist revenues are most at risk. Until October 2010, tourist arrivals increased by 18% over the same period in 2009. The Ministry of Tourism was forecasting an increase of 16% for 2011, but this will now likely not materialize, given most countries are recommending not to travel to Egypt at the moment and that the main tourist seasons are in Spring (March/April) and Autumn. Tourism's share in contribution to 2009/2010 GDP growth was significant at 9.3% and is one of the most important sources of foreign currency.
- We expect investment spending to drop: government and private domestic spending, as well as FDI. Recently, the government announced a target to attract FDI worth US\$10bn by pushing additional economic and regulatory reforms, and identifying four major infrastructure and industrial projects. FDI dropped sharply in FY08/09 and FY09/10, but more recently showed signs of recovery. We believe it is likely that the current uncertainty will stall this recovery and jeopardise these already ambitious plans to stimulate FDI for infrastructure projects.
- Domestic demand has been the most important contributor to growth in the past few years (more than 70% of the total growth of 5.3% in 2009/10), but we expect consumer confidence also to be negatively impacted by the current events.
- Suez Canal revenues were up 11% in 2010 cUS\$4.8bn. Whilst these revenues could be at risk, so far there is no indication that shipping through the Suez Canal will be negatively impacted. A potential closure of the Suez Canal, as a major shipping route between the East and the West, could have wider regional and global repercussions and possibly lead to higher oil prices. Market speculation that this could happen has already resulted in an uptick in the oil price in the past few days.

Closure of the Suez Canal could have global implications

Chart 10 : FDI could be jeopardised by current events (US\$ bn)



Source: Central Bank of Egypt, IMF forecasts

Implications for the stock markets

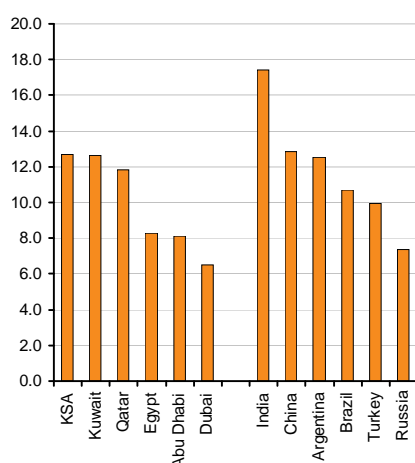
Egypt's market valuation looks more reasonable, but we think does not fully discount a higher risk premium yet given continued social uncertainty. We still see good investment opportunities in other MENA markets, despite some stock-specific Egypt exposure.

We expect the Egyptian market to remain volatile

The EGX30 Index was one of the better performing stock markets in the region in 2010 (+15%), but, as a result of the turmoil, the index has fallen sharply: the index first started falling after the ousting of Tunisia's president of 23 years, Zine El Abidine Ben Ali, but the fall accelerated when the actual unrest broke out last week. The index has dropped more than 22% from its 2011 peak early January to the close of 28 January – the market has been closed since then.

At the same time, market risk perception has increased substantially, with the 5-yr CDS moving from the low 200s in early January to 430bp as of 28 January 2011, propelling Egypt into the top 10 of riskiest countries globally (no 8). Clearly, this will have to be reflected in the valuation for the equities market as well.

Chart 11 : Current year PE ratios (x)



Source: Bloomberg

Chart 12 : Egypt: historical PE ratios (x)



Source: Bloomberg

Following the sell-off in the market, the EGX30 Index valuation is now at a 2011 P/E of 8.3x, according to Bloomberg consensus. However, despite this drop in the index and a valuation, which looks reasonable at first sight, we believe that it could go lower, as:

- Upside potential from a bottom-up perspective is 40% for the EGX30 index, based on consensus target prices for c90% of total market cap for the EGX30 (and EPS growth of on average 21%). However, the consensus has not been adjusted yet for the recent events and we believe is likely not yet discounting a higher equity risk premium, the effect of potentially lower economic growth, a weakening currency and potential reforms to certain sectors that may happen under a new government.
- This multiple is below the historical average, but the market has been lower (pre-2003 and in 2009) and we believe that the absolute level is not that relevant - the large increase in CDS after the close of the stock market, suggests that further falls cannot be ruled out.
- The only cheaper market in the region is the Dubai Financial Market (DFM), which currently trades on a 2011 P/E of c6x. This market is more heavily weighted towards the real estate sector, which has its own structural problems, but Dubai's CDS is at the same level as Egypt's, whereas the political situation is more stable in our opinion.

As long-term fundamentals remain valid at this point in time, we believe a buying opportunity will arise, but do not see a major recovery until the political situation stabilizes, or at least until it becomes clear how the economy can be put back on the right track.

GCC countries look stable, but stock markets have also been affected

Contagion risk mainly in other North African and Levant countries

Markets in the wider region have also reacted negatively, as a result of a reduction in risk appetite and on concerns of contagion – specific stocks with large exposure to Egypt have been the biggest victims. Are these capital outflows from the wider region justified?

Spreading of unrest could reduce investor risk appetite

The biggest risk to the region is further contagion: demonstrations have been reported in several countries in the region, albeit it not at the same scale as in Tunisia or Egypt, but markets have been worried of an escalation. In case unrest escalated in oil-exporting nations, this could have a major impact on oil prices and global recovery. However, the risk for contagion is higher in the North African and Levant countries rather than in the GCC, in our opinion.

Outside Egypt, the most investable markets in the region from an equity perspective are in the GCC, where we view the risk of political unrest as low, given dynamics for the economies are completely different from those countries in North Africa and the Levant. The GCC economies are oil-driven, have higher income per capita, populations are smaller than in Egypt, and standards of living are generally higher.

Exposure is stock specific

Therefore, we will mainly look at direct or indirect exposure to Egypt, in particular as there are a number of GCC companies that operate in the country. Most sectors (in particular banks, real estate, consumer and transport & logistics) in the GCC have exposure to Egypt, but the overall exposure is relatively limited. However, on a stock-specific basis, there is a varying degree of exposure. Amongst our coverage, we note the following exposures:

- Dana Gas (Buy, TP Dh0.90): Dana Gas Egypt is a 100% operator of two exploration concessions and nine development leases in the Nile Delta, a 50% joint operator of one exploration concession and one development lease in upper Egypt, and a 26.4% shareholder in the Gulf of Suez LPG recovery plant expected to come online mid-2011. Dana Gas Egypt currently produces gas and by-products at a rate of 48,000 barrels or equivalent per day and is responsible for c75% of Dana Gas total production. We forecast Dana gas will contribute 68.3% of 2011F revenue and 65.5% of 2012F revenue.
- Amongst our banks coverage universe of UAE and Qatari banks, the main exposures are NBAD (Buy, TP Dh13.2) and ADIB (Buy, TP Dh3.65). NBAD has about a third of its branches in Egypt and c6% of loans and 8% of deposits, mostly in large corporate and HNW.
- ADIB owns ADIB Egypt, which amounts to less than 10% of its revenues, but a significant portion of its upside potential in our valuation. ADIB Egypt is a rural bank which has been cleaning up its balance sheet of late.
- Etisalat (Buy, TP Dh13.60) holds a 100% stake in Etisalat Misr in Egypt and derived c8% of its revenues from Egypt in 2009.

Outside our coverage, we have screened the larger stocks in the GCC for exposure to Egypt. Sector-wise, companies in the following sectors been the most active in gaining presence in the country: banks, mainly from the UAE and Kuwait; Saudi consumer companies; real estate developers from Qatar and the UAE; and construction companies from the UAE. Amongst the other major sectors in the region (petrochemicals and telecoms), presence is limited, except for Etisalat mentioned above. Stocks with relevant exposure are:

- Air Arabia (UAE) started a hub in Alexandria in 2010 in a JV with Egypt's Travco Group; also has several routes from the UAE to Egypt.
- Barwa Real Estate (Qatar) has three fully-owned subsidiaries in Egypt, through which it derived c15% of its revenues in 2009.
- DSI (UAE) recently secured a major project in Egypt, accounting for c8% of its 3Q10 backlog.
- NBK (Kuwait) has 39 branches in Egypt and derived c8% of net profits there in 2009.
- Savola (Saudi Arabia) derived c12% of its revenues from Egypt in 2009 and has exposure to Egypt via its subsidiaries in edible oil, sugar and plastics.

Table 1 : Our current stock coverage in the GCC

Stock	Country	Sector	Rec	Current price	Target price	Up- /downside	Analyst
Oil & Gas							
Dana Gas	UAE	Oil & gas	Buy	0.64	0.90	41%	Daniel Abood
Financials							
ADCB	UAE	Financials	Hold	2.14	2.32	8%	Raj Madha
Abu Dhabi Islamic Bank	UAE	Financials	Buy	2.90	3.65	26%	Raj Madha
Dubai Islamic Bank	UAE	Financials	Sell	2.17	2.04	-6%	Raj Madha
Emirates NBD	UAE	Financials	Hold	2.88	3.41	18%	Raj Madha
First Gulf Bank	UAE	Financials	Buy	16.55	18.78	13%	Raj Madha
NBAD	UAE	Financials	Buy	11.45	13.20	15%	Raj Madha
Commercial Bank of Qatar	Qatar	Financials	Buy	83.50	109.40	31%	Raj Madha
Doha Bank	Qatar	Financials	Hold	59.30	63.20	7%	Raj Madha
Qatar Islamic Bank	Qatar	Financials	Hold	80.00	87.90	10%	Raj Madha
Qatar National Bank	Qatar	Financials	Hold	201.00	215.90	7%	Raj Madha
Telecoms							
Jordan Telecom	Jordan	Telecoms	Sell	5.55	4.34	-22%	Shrouk Diab
Wataniya	Kuwait	Telecoms	Buy	1.86	2.15	16%	Shrouk Diab
Omantel	Oman	Telecoms	Buy	1.25	1.33	6%	Shrouk Diab
Nawras	Oman	Telecoms	Hold	0.79	0.77	-2%	Shrouk Diab
Qatar Telecom	Qatar	Telecoms	Buy	172.50	216.72	26%	Shrouk Diab
Vodafone Qatar	Qatar	Telecoms	Hold	8.00	9.34	17%	Shrouk Diab
Zain Saudi	Saudi Arabia	Telecoms	Sell	7.85	7.75	-1%	Shrouk Diab
Mobily	Saudi Arabia	Telecoms	Buy	55.75	75.36	35%	Shrouk Diab
Du	UAE	Telecoms	Sell	3.02	2.15	-29%	Shrouk Diab
Etisalat	UAE	Telecoms	Buy	10.15	13.60	34%	Shrouk Diab

(Local fx, prices as of close of 30 Jan 2011).
Source: Rasmala, Bloomberg

Recommendation structure

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

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

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

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

Valuation and risks to target price

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

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