Research Department

UAE Banks

Sector Note

20 July 2009

2Q09 Earnings Preview–Retreating Concerns

- **We estimate 2Q09 earnings of banks under our coverage universe to decline 20.9% from 2Q08.**
- **The sovereign guarantee of debt is expected to induce confidence in the UAE's financial sector, raising the inflow of deposits and preventing potential disputes. However, we maintain our bad loan charges of AED1,189 million in 2Q09 due to the uncertainty surrounding the exposure to troubled Saudi companies until official clarifications are out.**
- **We reiterate our recommendations on banks under our coverage universe.**

2Q09 estimates

We estimate 2Q09 earnings of banks in our coverage universe to decline by 20.9% on average from 2Q08. On a QoQ basis, net income estimates translate to a slight growth of 3.4%. Our forecasted estimates for bad loan charges are at AED1,189 million for the eight banks under coverage in 2Q09, compared to AED1,518.5 million in 1Q09 and AED883 million in 2Q08. However, as the trickledown effect of the low interest rate environment dominates the sector more visibly during 2Q09, and with CBD reporting 2Q09 earnings just 5% above our estimates, we expect UAE banking earnings to come in line with our estimates.

Government guaranteeing debt, yet Saudi exposure remains blurry

Last month, the UAE Federal National Council ratified a law allowing it to guarantee bank bonds and medium term notes given that they are issued prior to October 10th, 2011, implying that it will only guarantee new issuances. The guarantees are set to expire in five years from the date of issuance. Similarly, it will guarantee bank deposits for a period of three years ending in December 2012. The guarantee is applicable to national banks, branches of foreign banks and foreign deposits. We view this as a positive step by the sovereign authorities to assure investors and the public that the financial system is strongly backed by the government. It also generates confidence in the sector, leading to a healthy inflow of deposits. We believe this law would also help prevent disputes such as the one between Shuaa Capital and Dubai Banking Group over bond conversion. Nevertheless, trouble appeared when two Saudi conglomerates announced a liquidity squeeze, hurting creditors. We are now waiting for the Central Bank of the UAE (CBUAE) to disclose official exposure figures as well as when and how to book for potential defaults. With DIB and CBD announcing no exposures and therefore safe from write downs, we believe that the remaining big banks under our coverage will not suffer large losses. However, we will maintain our provision charged estimates to remain on the conservative side in case of potential surprises.

We reiterate our recommendations

We reiterate our recommendations for banks under our coverage until 2Q09 results are disclosed. We will also monitor factors which are set to threaten asset quality, such as the real estate market and retail lending exposure.

Key Performance Indicators

Fiscal Year	ENBD	NBAD	ADCB	DIB	FGB	ADIB	UNB	CBD
EPS	0.7	1.6	0.29	0.39	2.2	0.38	0.6	0.5
P/E (x)	4.5	6.36	5.99	5.95	6.7	7.51	5.9	6.7
P/B (x)	0.6	1.05	0.5	1.04	0.9	0.94	0.7	1.1
ROAE	14.4%	19.6%	8.5%	16.9%	15.5%	12.8%	13.2%	18.2%
ROAA	1.3%	2.0%	0.9%	1.6%	2.7%	1.4%	1.8%	2.5%
Dividend Yield	4.44%	4.72%	6.68%	4.20%	2.23%	3.33%	3.38%	3.74%

ENBD	**BUY**
Target Price (AED)	**6.16**
Market Price (AED)	3.17
Upside	94.3%
NBAD	**BUY**
Target Price (AED)	**11.84**
Market Price (AED)	10.2
Upside	16.1%
ADCB	**HOLD**
Target Price (AED)	**2.03**
Market Price (AED)	1.73
Upside	17.3%
DIB	**HOLD**
Target Price (AED)	**3.22**
Market Price (AED)	2.34
Upside	37.6%
FGB	**HOLD**
Target Price (AED)	**12.17**
Market Price (AED)	14.85
Downside	-18.0%
ADIB	**SELL**
Target Price (AED)	**2.76**
Market Price (AED)	2.83
Downside	-2.47%
UNB	**BUY**
Target Price (AED)	**4.22**
Market Price (AED)	3.45
Upside	22.3%
CBD	**HOLD**
Target Price (AED)	**3.61**
Market Price (AED)	3.49
Downside	3.4%

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How is 2009 Doing So Far?

Interest rates relaxation

In our 1Q09 preview we sensed a glimpse of recovery in HSBC and ENBD dropping interest rates as well as raising LTV ratios. We see more banks following the same trend over the course of 2Q09 due to the confirmed relaxation of EIBOR rates and the government's prolonged bail our plans spilling over during 2Q09. As a result, banks became more confident in growing their loans. There is still reason for caution, however, with CBD's loan book growing by a slight 2.0% QoQ.

We see banks embarking on expanding the retail segment by setting up SME units to stimulate lending as well as raising LTV ratios, helping the property market as prices are bottoming out. A few banks are expanding their Islamic banking operations due to its safe profile and lack of engagement with toxic assets. ADCB has set a specialized unit serving the SME segment, and ENBD affirmed its penetration of the same market. NBAD set up an Islamic banking unit and ADCB has incorporated an Islamic finance company as well. Mortgage rates have rebounded to previous levels ranging between 75%-90%, in addition to slightly relaxing rates from an average of 8.5% to about 7%. It is worth noting that HSBC, one of the most conservative banks, has dropped the interest rate on its E-saver account from 5.0% to 3.0%. Nevertheless, we cannot see this as a complete rebound as banks will not resort to the asset growth levels seen during FY08, since they are committed to adhere to the CBUAE directive of smoothing out their L/D ratios. This is demonstrated by CBD's LD dropping to 108% in 1H09 versus 112.2% in FY08.

Government guarantee of debt instruments raises confidence in the sector

The United Arab Emirates' Federal National Council ratified a law allowing it to guarantee bank bonds and medium term notes for five years without specifying the amount guaranteed. Bonds eligible for the guarantee must be issued before October 10th, 2011. The guarantees will expire in five years from the date of issue. This implies that it would only guarantee new issuances from local banks.

Similarly, the UAE government will guarantee bank deposits for a period of three years ending in December 2012. The guarantee is applicable to national banks, branches of foreign banks and foreign deposits. This will eventually result in large amounts of deposits entering the banking system once the law is implemented.

We expect these two laws to help stabilize the UAE's financial system and create confidence for investors.

Mixed signals of Saudi group and uncertain charging dates

Banks around the region have been affected by the troubles of two Saudi conglomerates, Saad Group and Ahmad Hamad Al Gosaibi & Brothers Co, who announced a liquidity squeeze preventing them from meeting their financial obligations. Banks are involved in several forms of debt, including syndicated loans and sukuk. So far, the exposure published by the media has not been verified by official figures. Nevertheless, the Saudi Arabian Monetary Authority (SAMA) froze both conglomerates' accounts as Saad Group defaulted on sukuk payment and the International Banking Corporation a Bahraini Bank, owned by Al Gosaibi, defaulted on loan payments. The CBUAE accordingly directed banks to cease lending to both parties. According to figures released by the media, there are 88 global banks caught up with the two entities, with loans just over USD7.4 billion. BNP Paribas and Citigroup have the highest syndicated loan exposure.

Table 1: Banks' Exposure to the Troubled Conglomerates

USD mill	Amount
BNP Paribas	522.5
Citigroup	515.0
National Bank of Oman*	17.0
Commercial Bank of Kuwait	119.0
Dhofar Bank	10.0
Bank Muscat*	171.0
Abu Dhabi Commercial Bank	500.0
Mashreq Bank	515.0

*officially disclosed by the banks

Source: Bloomberg, HC Brokerage

It is worth noting that in June 2009, the troubled entities announced that they are in talks with creditors to structure their debt obligations. Separately, however, signs have not been promising; for example, the law firm representing Al Gosaibi Group withdrew from its efforts and is no longer representing its claim against Ma'an Al Sanea because of "divergent opinions regarding the appropriate strategy." This implies that the restructuring may take longer than expected.

The governor of the central bank of the UAE stated that the UAE banks have significant exposure to the conglomerates. Banks were allowed to mortgage their securities against commercial paper. They can also take possessions of assets of the two Saudi Arabian business groups Maan Al Sanea and Al Gosaibi group if they are owed money by them. This is expected to mitigate the effect of complete write downs.

Within our coverage universe, NBAD, ENBD and UNB announced that their exposure is negligible compared to their loan books. DIB and CBD announced that they have no exposure to the troubled entities. However, we are concerned with ADCB's USD500 million exposure (which has not yet been confirmed by the bank), making up 1.6% of 1Q09 loans and bringing up our NPL forecast to 3.6% for the year.

However, we are uncertain as of when the banks would book NPL charges related to their exposure. According to the media, most of the groups' loans mature in 2010, with a few maturing during 2Q09. Hence, we may see few write downs. We are also awaiting the CBUAE's directives, as it is expected to review exposure reports and advise banks on how and when to provide for possible write downs. However, even with large banks having material exposure, we do not believe charges would affect earnings tremendously. Due to the uncertainty surrounding the issue, we will maintain our provisioning for the year for our universe.

We reiterate our concerns regarding NPLs arising from retail exposure, which most of our banks secure large stakes in, especially with personal loans which carry salaries as their only collaterals.

Tier I capital boosting banks capitalization further

Overall, CARs of banks in the UAE are well capitalized above the CBUAE's regulations of 10%. However, their Tier I capital needs to be boosted to 11% by June 2009, as per the CBUAE regulations. ENBD acted accordingly (since it stood at 9.7%) and issued debt securities worth AED4 billion to Investment Corporation of Dubai, helping it to meet the CBUAE's requirement. The notes carry a fixed interest rate of 6.45% during the first five years and a floating rate thereafter. After the issuance, ENBD's total capital adequacy ratio increased to more than 17% from 11.4% in FY08. We are not concerned with the positions of NBAD, ADIB and UNB as the Abu Dhabi Government provided them with the AED16 billion notes which are included under Tier I capital.

Table 2: Bank's 1Q09 CAR

%	Tier 1	CAR
ENBD	9.7%	11.1%
NBAD	na	18%
ADCB	14.0%	19.6%
DIB	11.7%	11.1%
FGB*	na	14.1%
UNB*	9.8%	11.6%
CBD	13.7%	14.3%
ADIB	na	10.79%

*FY08
Source: Bloomberg, HC Brokerage

What to Expect in 2Q09 Earnings Season

Commercial Bank of Dubai (CBD) was the first to announce its results among our eight banks, reporting a net income of AED268 million, down 10.4% from to AED299 million in 2Q08. We estimated a net income figure of AED255 million and the 2Q09 net interest income was higher than our expectations, helped by stronger margins. On the other hand, loan loss charges were more than we estimated.

We expect DIB to be the worst performing bank in 2Q09, with net income dropping by 49.8% YoY on the back of provisions resulting from bad loans and lower fee income. On the other hand, we expect the best performing bank to be FGB, with net income rising by only 5% as it has booked most of its provisions during 1Q09.

Table 3: 2Q09 Earning Estimates Snapshot (ENBD, NBAD, ADCB, DIB)

AED mil.	ENBD			NBAD			ADCB			DIB		
	2Q09E	2Q08A	Cons.	2Q09E	2Q08A	Cons.	2Q09E	2Q08A	Cons.	2Q09E	2Q08A	Cons.
NII	1,653.0	1,362.9	na	995.6	823.4	na	720.6	629.9	na	491.1	523.1	na
Fee inc.	477.3	536.6	na	344.8	321.7	na	208.7	247.3	na	188.9	269.6	na
Total inc.	2,288.5	2,480.6	na	1,483.4	1,454.6	na	1,014.2	1,043.7	na	788.9	1,019.6	na
NPL cha.	302.4	247.3	na	187.1	76.7	na	232.1	218.7	na	100.0	44.0	na
Net inc.	984.4	1,451.3	918.8	863.4	1,001.5	594.0	509.1	621.2	363.3	375.0	747.1	309.0

Source: HC Brokerage, Bloomberg

Table 4: 2Q09 Earning Estimates Snapshot (FGB, UNB, CDB, ADIB)

AED mil.	FGB			UNB			CBD*			ADIB		
	2Q09E	2Q08A	Cons.	2Q09E	2Q08A	Cons.	2Q09E	2Q08A	Cons.	2Q09E	2Q08A	Cons.
NII	913.4	623.5	na	383.6	366.5	na	300.5	265.9	na	425.8	423.6	na
Fee inc.	320.2	322.7	na	135.9	149.4	na	80.2	88.6	na	16.9	15.6	na
Total inc.	1,380.2	1,156.9	na	579.4	560.4	na	421.7	441.4	na	513.0	624.1	na
NPL cha.	221.0	157.2	na	19.1	(29.1)	na	21.8	6.8	na	105.6	161.7	na
Net inc.	848.9	808.4	753.6	417.0	424.1	256.8	255.2	298.8	na	198.9	275.5	193.5

*CBD reported 2Q09 figures
Source: HC Brokerage, Bloomberg

Rating Scale

Recommendation	Upside
Buy	> 25%
Hold	0%-25%
Sell	< 0%

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